SUBCHAPTER A—INCOME TAX

PART 1—INCOME TAXES

Sec.

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Sections 1.23–1—1.23–6 also issued under 26 U.S.C. 23;
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Section 1.25–4T also issued under 26 U.S.C. 25.
Section 1.25–5T also issued under 26 U.S.C. 25.
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Section 1.42–4 is also issued under 26 U.S.C. 42(n);
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Section 1.48–9 also issued under 26 U.S.C. 38(b) (as in effect before the amendments made by subtitle F of the Tax Reform Act of 1984);
Sections 1.50A—1.50B also issued under 85 Stat. 553 (26 U.S.C. 40(b));
Section 1.52–1 also issued under 26 U.S.C. 52(b);
Section 1.56–1 also issued under 26 U.S.C. 56(f)(2)(H);
Section 1.56(g)–1 also issued under section 7611(g)(3) of the Omnibus Budget Reconciliation Act of 1989 (Pub. L. 101–239, 103 Stat. 2373); and
Section 1.58–9 is also issued under 26 U.S.C. 58(h).

SOURCE: T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, unless otherwise noted.

§ 1.0–1 Internal Revenue Code of 1954 and regulations.

(a) *Enactment of law.* The Internal Revenue Code of 1954 which became law upon enactment of Public Law 591, 83d Congress, approved August 16, 1954, provides in part as follows:

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That

(a) *Citation.* (1) The provisions of this Act set forth under the heading ‘‘Internal Revenue Title’’ may be cited as the ‘‘Internal Revenue Code of 1954’’

(2) The Internal Revenue Code enacted on February 10, 1939, as amended, may be cited as the ‘‘Internal Revenue Code of 1939’’.

(b) *Publication.* This Act shall be published as volume 68A of the United States Statutes at Large, with a comprehensive table of contents and an appendix; but without an index or marginal references. The date of enactment, bill number, public law number, and chapter number, shall be printed as a headnote.

(c) *Cross reference.* For saving provisions, effective date provisions, and other related provisions, see chapter 80 (sec. 7801 and following) of the Internal Revenue Code of 1954.

(d) *Enactment of Internal Revenue Title into law.* The Internal Revenue Title referred to in subsection (a)(1) is as follows:

* * * * *

In general, the provisions of the Internal Revenue Code of 1954 are applicable with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954. Certain provisions of that Code are deemed to be included in the Internal Revenue Code of 1939. See section 7851.

(b) *Scope of regulations.* The regulations in this part deal with (1) the income taxes imposed under subtitle A of the Internal Revenue Code of 1954, and (2) certain administrative provisions contained in subtitle F of such Code relating to such taxes. In general, the applicability of such regulations is commensurate with the applicability of the respective provisions of the Internal Revenue Code of 1954 except that with respect to the provisions of the Internal Revenue Code of 1954 which are deemed to be included in the Internal Revenue Code of 1939, the regulations relating to such provisions are applicable to certain fiscal years and short taxable years which are subject to the Internal Revenue Code of 1939. Those provisions of the regulations which are applicable to taxable years subject to the Internal Revenue Code of 1939 and the specific taxable years to which such provisions are so applicable are identified in each instance. The regulations in 26 CFR (1939) part 39 (Regulations 118) are continued in effect until superseded by the regulations in this part. See Treasury Decision 6091, approved August 16, 1954 (19 FR 5167, C.B. 1954–2, 47).

NORMAL TAXES AND SURTAXES

DETERMINATION OF TAX LIABILITY

TAX ON INDIVIDUALS

§ 1.1–1 Income tax on individuals.

(a) *General rule.* (1) Section 1 of the Code imposes an income tax on the income of every individual who is a citizen or resident of the United States and, to the extent provided by section 871(b) or 877(b), on the income of a nonresident alien individual. For optional tax in the case of taxpayers with adjusted gross income of less than $10,000 (less than $5,000 for taxable years beginning before January 1, 1970) see section 3. The tax imposed is upon taxable income (determined by subtracting the allowable deductions from gross income). The tax is determined in accordance with the table contained in section 1. See subparagraph (2) of this paragraph for reference guides to the appropriate table for taxable years beginning on or after January 1, 1964, and before January 1, 1965, taxable years beginning after December 31, 1964, and before January 1, 1971, and taxable years beginning after December 31, 1970. In certain cases credits are allowed against the amount of the tax. See part IV (section 31 and following), subchapter A, chapter 1 of the Code. In general, the tax is payable upon the basis of returns rendered by persons liable therefor (subchapter A (sections 6001 and following), chapter 61 of the Code) or at the source of the income by withholding. For the computation of tax in the case of a joint return of a husband and wife, or a return of a surviving spouse, for taxable years beginning before January 1, 1971, see section 2. The computation of tax in such a case for taxable years beginning after December 31, 1970, is determined in accordance with the table contained in section 1(a) as amended by the Tax Reform Act of 1969. For other rates of tax on individuals, see section 5(a). For the imposition of an additional tax for the calendar years 1968, 1969, and 1970, see section 51(a).

(2)(i) For taxable years beginning on or after January 1, 1964, the tax imposed upon a single individual, a head of a household, a married individual filing a separate return, and estates and trusts is the tax imposed by section 1 determined in accordance with the appropriate table contained in the following subsection of section 1:

	Taxable years beginning in 1964	Taxable years beginning after 1964 but before 1971	Taxable years beginning after Dec. 31, 1970 (references in this column are to the Code as amended by the Tax Reform Act of 1969)
Single individual	Sec. 1(a)(1)	Sec. 1(a)(2)	Sec. 1(c).
Head of a household	Sec. 1(b)(1)	Sec. 1(b)(2)	Sec. 1(b).
Married individual filing a separate return.	Sec. 1(a)(1)	Sec. 1(a)(2)	Sec. 1(d).
Estates and trusts	Sec. 1(a)(1)	Sec. 1(a)(2)	Sec. 1(d).

(ii) For taxable years beginning after December 31, 1970, the tax imposed by section 1(d), as amended by the Tax Reform Act of 1969, shall apply to the income effectively connected with the conduct of a trade or business in the United States by a married alien individual who is a nonresident of the United States for all or part of the taxable year or by a foreign estate or trust. For such years the tax imposed by section 1(c), as amended by such Act, shall apply to the income effectively connected with the conduct of a trade or business in the United States by an unmarried alien individual (other than a surviving spouse) who is a nonresident of the United States for all or part of the taxable year. See paragraph (b)(2) of §1.871–8.

(3) The income tax imposed by section 1 upon any amount of taxable income is computed by adding to the income tax for the bracket in which that amount falls in the appropriate table in section 1 the income tax upon the excess of that amount over the bottom of the bracket at the rate indicated in such table.

(4) The provisions of section 1 of the Code, as amended by the Tax Reform Act of 1969, and of this paragraph may be illustrated by the following examples:

Example 1. A, an unmarried individual, had taxable income for the calendar year 1964 of $15,750. Accordingly, the tax upon such taxable income would be $4,507.50, computed as follows from the table in section 1(a)(1):

Tax on $14,000 (from table)	$3,790.00
Tax on $1,750 (at 41 percent as determined from the table)	717.50
Total tax on $15,750	4,507.50

Example 2. Assume the same facts as in example (1), except the figures are for the calendar year 1965. The tax upon such taxable income would be $4,232.50, computed as follows from the table in section 1(a)(2):

Tax on $14,000 (from table)	$3,550.00
Tax on $1,750 (at 39 percent as determined from the table)	682.50
Total tax on $15,750	4,232.50

Example 3. Assume the same facts as in example (1), except the figures are for the calendar year 1971. The tax upon such taxable income would be $3,752.50, computed as follows from the table in section 1(c), as amended:

Tax on $14,000 (from table)	$3,210.00
Tax on $1,750 (at 31 percent as determined from the table)	542.50
Total tax on $15,750	3,752.50

(b) *Citizens or residents of the United States liable to tax.* In general, all citizens of the United States, wherever resident, and all resident alien individuals are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States. Pursuant to section 876, a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year is, except as provided in section 933 with respect to Puerto Rican source income, subject to taxation in the same manner as a resident alien individual. As to tax on nonresident alien individuals, see sections 871 and 877.

(c) *Who is a citizen.* Every person born or naturalized in the United States and subject to its jurisdiction is a citizen. For other rules governing the acquisition of citizenship, see chapters 1 and 2 of title III of the Immigration and Nationality Act (8 U.S.C. 1401–1459). For rules governing loss of citizenship, see sections 349 to 357, inclusive, of such Act (8 U.S.C. 1481–1489), Schneider v. Rusk, (1964) 377 U.S. 163, and Rev. Rul. 70–506, C.B. 1970–2, 1. For rules pertaining to persons who are nationals but not citizens at birth, e.g., a person born in American Samoa, see section 308 of such Act (8 U.S.C. 1408). For special rules applicable to certain expatriates who have lost citizenship with a principal purpose of avoiding certain taxes, see section 877. A foreigner who has filed his declaration of intention of becoming a citizen but who has not yet been admitted to citizenship by a final order of a naturalization court is an alien.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7332, 39 FR 44216, Dec. 23, 1974]

§ 1.1–2 Limitation on tax.

(a) *Taxable years ending before January 1, 1971.* For taxable years ending before January 1, 1971, the tax imposed by section 1 (whether by subsection (a) or subsection (b) thereof) shall not exceed 87 percent of the taxable income for the taxable year. For purposes of determining this limitation the tax under section 1 (a) or (b) and the tax at the 87-percent rate shall each be computed before the allowance of any credits against the tax. Where the alternative tax on capital gains is imposed under section 1201(b), the 87-percent limitation shall apply only to the partial tax computed on the taxable income reduced by 50 percent of the excess of net long-term capital gains over net short-term capital losses. Where, for purposes of computations under the income averaging provisions, section 1201(b) is treated as imposing the alternative tax on capital gains computed under section 1304(e)(2), the 87-percent limitation shall apply only to the tax equal to the tax imposed by section 1, reduced by the amount of the tax imposed by section 1 which is attributable to capital gain net income for the computation year.

(b) *Taxable years beginning after December 31, 1970.* If, for any taxable year beginning after December 31, 1970, an individual has earned taxable income which exceeds his taxable income as defined by section 1348, the tax imposed by section 1, as amended by the Tax Reform Act of 1969, shall not exceed the sum computed under the provisions of section 1348. For imposition of minimum tax for tax preferences see sections 56 through 58.

[T.D. 7117, 36 FR 9397, May 25, 1971]

§ 1.1–3 Change in rates applicable to taxable year.

For computation of the tax for a taxable year during which a change in the tax rates occurs, see section 21 and the regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960. Redesignated by T.D. 7117, 36 FR 9397, May 25, 1971]

§ 1.1(i)–1T Questions and answers relating to the tax on unearned income certain minor children (Temporary).

IN GENERAL

Q–1. To whom does section 1(i) apply?

A–1. Section 1(i) applies to any child who is under 14 years of age at the close of the taxable year, who has at least one living parent at the close of the taxable year, and who recognizes over $1,000 of unearned income during the taxable year.

Q–2. What is the effective date of section 1(i)?

A–2. Section 1(i) applies to taxable years of the child beginning after December 31, 1986.

COMPUTATION OF TAX

Q–3. What is the amount of tax imposed by section 1 on a child to whom section 1(i) applies?

A–3. In the case of a child to whom section 1(i) applies, the amount of tax imposed by section 1 equals the greater of (A) the tax imposed by section 1 without regard to section 1(i) or (B) the sum of the tax that would be imposed by section 1 if the child's taxable income was reduced by the child's net unearned income, plus the child's share of the allocable parental tax.

Q–4. What is the allocable parental tax?

A–4. The allocable parental tax is the excess of (A) the tax that would be imposed by section 1 on the sum of the parent's taxable income plus the net unearned income of all children of such parent to whom section 1(i) applies, over (B) the tax imposed by section 1 on the parent's taxable income. Thus, the allocable parental tax is not computed with reference to unearned income of a child over 14 or a child under 14 with less than $1,000 of unearned income. *See* A–10 through A–13 for rules regarding the determination of the parent(s) whose taxable income is taken into account under section 1(i). *See* A–14 for rules regarding the determination of children of the parent whose net unearned income is taken into account under section 1(i).

Q–5. What is the child's share of the allocable parental tax?

A–5. The child's share of the allocable parental tax is an amount that bears the same ratio to the total allocable parental tax as the child's net unearned income bears to the total net unearned income of all children of such parent to whom section 1(i) applies. See A–14.

Example 1. During 1988, D, and a 12 year old, receives $5,000 of unearned income and no earned income. D has no itemized deductions and is not eligible for a personal exemption. D's parents have two other children, E, a 15 year old, and F, a 10 year old. E has $10,000 of unearned income and F has $100 of unearned income. D's parents file a joint return for 1988 and report taxable income of $70,000. Neither D's nor his parent's taxable income is attributable to net capital gain. D's tax liability for 1988, determined without regard to section 1(i), is $675 on $4,500 of taxable income ($5,000 less $500 allowable standard deduction). In applying section 1(i), D's tax would be equal to the sum of (A) the tax that would be imposed on D's taxable income if it were reduced by any net unearned income, plus (B) D's share of the allocable parental tax. Only D's unearned income is taken into account in determining the allocable parental tax because E is over 14 and F has less than $1,000 of unearned income. *See* A–4. D's net unearned income is $4,000 ($4,500 taxable unearned income less $500). The tax imposed on D's taxable income as reduced by D's net unearned income is $75 ($500×15%). The allocable parental tax is $1,225, the excess of $16,957.50 (the tax on $74,000, the parent's taxable income plus D's net unearned income) over $15,732.50 (the tax on $70,000, the parent's taxable income). *See* A–4. Thus, D's tax under section 1(i)(1)(B) is $1,300 ($1,225+$75). Since this amount is greater than the amount of D's tax liability as determined without regard to section 1(i), the amount of tax imposed on D for 1988 is $1,300. *See A–3.*

Example 2. H and W have 3 children, A, B, and C, who are all under 14 years of age. For the taxable year 1988, H and W file a joint return and report taxable income of $129,750. The tax imposed by section 1 on H and W is $35,355. A has $5,000 of net unearned income and B and C each have $2,500 of net unearned income during 1988. The allocable parental tax imposed on A, B, and C's combined net unearned income of $10,000 is $3,300. This tax is the excess of $38,655, which is the tax imposed by section 1 on $139,750 ($129,750+10,000), over $35,355 (the tax imposed by section 1 on H and W's taxable income of $129,750). *See* A–4. Each child's share of the allocable parental tax is an amount that bears the same ratio to the total allocable parental tax as the child's net unearned income bears to the total net unearned income of A, B, and C. Thus, A's share of the allocable parental tax is $1,650 (5,000÷10,000×3,300) and B and C's share of the tax is $825 (2,500÷10,000×3,300) each. *See* A–5.

DEFINITION OF NET UNEARNED INCOME

Q–6. What is net unearned income?

A–6. Net unearned income is the excess of the portion of adjusted gross income for the taxable year that is not ''earned income'' as defined in section 911(d)(2) (income that is not attributable to wages, salaries, or other amounts received as compensation for personal services), over the sum of the standard deduction amount provided for under section 63 (c)(5)(A) ($500 for 1987 and 1988; adjusted for inflation thereafter), plus the greater of (A) $500 (adjusted for inflation after 1988) or (B) the amount of allowable itemized deductions that are directly connected with the production of unearned income. A child's net unearned income for any taxable year shall not exceed the child's taxable income for such year.

Example 3. A is a child who is under 14 years of age at the end of the taxable year 1987. Both of A's parents are alive at this time. During 1987, A receives $3,000 of interest from a bank savings account and earns $1,000 from a paper route and performing odd jobs. A has no itemized deductions for 1987. A's standard deduction is $1,000, which is an amount equal to A's earned income for 1987. Of this amount, $500 is applied against A's unearned income and the remaining $500 is applied against A's earned income. Thus, A's $500 of taxable earned income ($1,000 less the remaining $500 of the standard deduction) is taxed without regard to section 1 (i); A has $2,500 of taxable unearned income ($3,000 gross unearned income less $500 of the standard deduction) of which $500 is taxed without regard to section 1(i). The remaining $2,000 of taxable unearned income is A's net unearned income and is taxed under section 1(i).

Example 4. B is a child who is subject to tax under section 1(i). B has $400 of earned income and $2,000 of unearned income. B has itemized deductions of $800 (net of the 2 percent of adjusted gross income (AGI) floor on miscellaneous itemized deductions under section 67) of which $200 are directly connected with the production of unearned income. The amount of itemized deductions that B may apply against unearned income is equal to the greater of $500 or the deductions directly connected with the production of unearned income. *See* A–6. Thus, $500 of B's itemized deductions are applied against the $2,000 of unearned income and the remaining $300 of deductions are applied against earned income. As a result, B has taxable earned income of $100 and taxable unearned income of $1,500. Of these amounts, all of the earned income and $500 of the unearned income are taxed without regard to section 1(i). The remaining $1,000 of unearned income is net unearned income and is taxed under section 1(i).

UNEARNED INCOME SUBJECT TO TAX UNDER SECTION 1(I)

Q–7. Will a child be subject to tax under section 1(i) on net unearned income (as defined in section 1(i) (4) and A–6 of this section) that is attributable to property transferred to the child prior to 1987?

A–7. Yes. The tax imposed by section 1(i) on a child's net unearned income applies to any net unearned income of the child for taxable years beginning after December 31, 1986, regardless of when the underlying assets were transferred to the child.

Q–8. Will a child be subject to tax under section 1(i) on net unearned income that is attributable to gifts from persons other than the child's parents or attributable to assets resulting from the child's earned income?

A–8. Yes. The tax imposed by section 1(i) applies to all net unearned income of the child, regardless of the source of the assets that produced such income. Thus, the rules of section 1(i) apply to income attributable to gifts not only from the parents but also from any other source, such as the child's grandparents. Section 1(i) also applies to unearned income derived with respect to assets resulting from earned income of the child, such as interest earned on bank deposits.

Example 5. A is a child who is under 14 years of age at the end of the taxable year beginning on January 1, 1987. Both of A's parents are alive at the end of the taxable year. During 1987, A receives $2,000 in interest from his bank account and $1,500 from a paper route. Some of the interest earned by A from the bank account is attributable to A's paper route earnings that were deposited in the account. The balance of the account is attributable to cash gifts from A's parents and grandparents and interest earned prior to 1987. Some cash gifts were received by A prior to 1987. A has no itemized deductions and is eligible to be claimed as a dependent on his parent's return. Therefore, for the taxable year 1987, A's standard deduction is $1,500, the amount of A's earned income. Of this standard deduction amount, $500 is allocated against unearned income and $1,000 is allocated against earned income. A's taxable unearned income is $1,500 of which $500 is taxed without regard to section 1(i). The remaining taxable unearned income of $1,000 is net unearned income and is taxed under section 1(i). The fact that some of A's unearned income is attributable to interest on principal created by earned income and gifts from persons other than A's parents or that some of the unearned income is attributable to property transferred to A prior to 1987, will not affect the tax treatment of this income under section 1(i). *See* A–8.

Q–9. For purposes of section 1(i), does income which is not earned income (as defined in section 911(d)(2)) include social security benefits or pension benefits that are paid to the child?

A–9. Yes. For purposes of section 1(i), earned income (as defined in section 911(d)(2)) does not include any social security or pension benefits paid to the child. Thus, such amounts are included in unearned income to the extent they are includible in the child's gross income.

DETERMINATION OF THE PARENT'S TAXABLE INCOME

Q–10. If a child's parents file a joint return, what is the taxable income that must be taken into account by the child in determining tax liability under section 1(i)?

A–10. In the case of parents who file a joint return, the parental taxable income to be taken into account in determining the tax liability of a child is the total taxable income shown on the joint return.

Q–11. If a child's parents are married and file separate tax returns, which parent's taxable income must be taken into account by the child in determining tax liability under section 1(i)?

A–11. For purposes of determining the tax liability of a child under section 1(i), where such child's parents are married and file separate tax returns, the parent whose taxable income is the greater of the two for the taxable year shall be taken into account.

Q–12. If the parents of a child are divorced, legally separated, or treated as not married under section 7703(b), which parent's taxable income is taken into account in computing the child's tax liability?

A–12. If the child's parents are divorced, legally separated, or treated as not married under section 7703(b), the taxable income of the custodial parent (within the meaning of section 152(e)) of the child is taken into account under section 1(i) in determining the child's tax liability.

Q–13. If a parent whose taxable income must be taken into account in determining a child's tax liability under section 1(i) files a joint return with a spouse who is not a parent of the child, what taxable income must the child take into account?

A–13. The amount of a parent's taxable income that a child must take into account for purposes of section 1(i) where the parent files a joint return with a spouse who is not a parent of the child is the total taxable income shown on such joint return.

CHILDREN OF THE PARENT

Q–14. In determining a child's share of the allocable parental tax, is the net unearned income of legally adopted children, children related to such child by half-blood, or children from a prior marriage of the spouse of such child's parent taken into account in addition to the natural children of such child's parent?

A–14. Yes. In determining a child's share of the allocable parental tax, the net unearned income of all children subject to tax under section 1(i) and who use the same parent's taxable income as such child to determine their tax liability under section 1(i) must be taken into account. Such children are taken into account regardless of whether they are adopted by the parent, related to such child by half-blood, or are children from a prior marriage of the spouse of such child's parent.

RULES REGARDING INCOME FROM A TRUST OR SIMILAR INSTRUMENT

Q–15. Will the unearned income of a child who is subject to section 1(i) that is attributable to gifts given to the child under the Uniform Gift to Minors Act (UGMA) be subject to tax under section 1(i)?

A–15. Yes. A gift under the UGMA vests legal title to the property in the child although an adult custodian is given certain rights to deal with the property until the child attains majority. Any unearned income attributable to such a gift is the child's unearned income and is subject to tax under section 1(i), whether distributed to the child or not.

Q–16. Will a child who is a beneficiary of a trust be required to take into account the income of a trust in determining the child's tax liability under section 1(i)?

A–16. The income of a trust must be taken into account for purposes of determining the tax liability of a beneficiary who is subject to section 1(i) only to the extent it is included in the child's gross income for the taxable year under sections 652(a) or 662(a). Thus, income from a trust for the fiscal taxable year of a trust ending during 1987, that is included in the gross income of a child who is subject to section 1(i) and who has a calendar taxable year, will be subject to tax under section 1(i) for the child's 1987 taxable year.

SUBSEQUENT ADJUSTMENTS

Q–17. What effect will a subsequent adjustment to a parent's taxable income have on the child's tax liability if such parent's taxable income was used to determine the child's tax liability under section 1(i) for the same taxable year?

A–17. If the parent's taxable income is adjusted and if, for the same taxable year as the adjustment, the child paid tax determined under section 1(i) with reference to that parent's taxable income, then the child's tax liability under section 1(i) must be recomputed using the parent's taxable income as adjusted.

Q–18. In the case where more than one child who is subject to section 1(i) uses the same parent's taxable income to determine their allocable parental tax, what effect will a subsequent adjustment to the net unearned income of one child have on the other child's share of the allocable parental tax?

A–18. If, for the same taxable year, more than one child uses the same parent's taxable income to determine their share of the allocable parental tax and a subsequent adjustment is made to one or more of such children's net unearned income, each child's share of the allocable parental tax must be recomputed using the combined net unearned income of all such children as adjusted.

Q–19. If a recomputation of a child's tax under section 1(i), as a result of an adjustment to the taxable income of the child's parents or another child's net unearned income, results in additional tax being imposed by section 1(i) on the child, is the child subject to interest and penalties on such additional tax?

A–19. Any additional tax resulting from an adjustment to the taxable income of the child's parents or the net unearned income of another child shall be treated as an underpayment of tax and interest shall be imposed on such underpayment as provided in section 6601. However, the child shall not be liable for any penalties on the underpayment resulting from additional tax being imposed under section 1(i) due to such an adjustment.

Example 6. D and M are the parents of C, a child under the age of 14. D and M file a joint return for 1988 and report taxable income of $69,900. C has unearned income of $3,000 and no itemized deductions for 1988. C properly reports a total tax liability of $635 for 1988. This amount is the sum of the allocable parental tax of $560 on C's net unearned income of $2,000 (the excess of $3,000 over the sum of $500 standard deduction and the first $500 of taxable unearned income) plus $75 (the tax imposed on C's first $500 of taxable unearned income). *See* A–3. One year later, D and M's 1988 tax return is adjusted on audit by adding an additional $1,000 of taxable income. No adjustment is made to the amount reported as C's net unearned income for 1988. However, the adjustment to D and M's taxable income causes C's tax liability under section 1(i) for 1988 to be increased by $50 as a result of the phase-out of the 15 percent rate bracket. *See* A–20. In addition to this further tax liability, C will be liable for interest on the $50. However, C will not have to pay any penalty on the delinquent amount.

MISCELLANEOUS RULES

Q–20. Does the phase-out of the parent's 15 percent rate bracket and personal exemptions under section 1(g), if applicable, have any effect on the calculation of the allocable parental tax imposed on a child's net unearned income under section 1(i)?

A–20. Yes. Any phase-out of the parent's 15 percent rate bracket or personal exemptions under section 1(g) is given full effect in determining the tax that would be imposed on the sum of the parent's taxable income and the total net unearned income of all children of the parent. Thus, any additional tax on a child's net unearned income resulting from the phase-out of the 15 percent rate bracket and the personal exemptions is reflected in the tax liability of the child.

Q–21. For purposes of calculating a parent's tax liability or the allocable parental *tax imposed on a child, are other phase-outs, limitations, or floors on deductions or credits, such as the phase-out of the $25,000 passive loss allowance for rental real estate activities under section 469(i)(3) or the 2 percent of AGI floor on miscellaneous itemized deductions under section 67, affected by the addition of a child's net unearned income to the parent's taxable income?*

A–21. No. A child's net unearned income is not taken into account in computing any deduction or credit for purposes of determining the parent's tax liability or the child's allocable parental tax. Thus, for example, although the amounts allowable to the parent as a charitable contribution deduction, medical expense deduction, section 212 deduction, or a miscellaneous itemized deduction are affected by the amount of the parent's adjusted gross income, the amount of these deductions that is allowed does not change as a result of the application of section 1(i) because the amount of the parent's adjusted gross income does not include the child's net unearned income. Similarly, the amount of itemized deductions that is allowed to a child does not change as a result of section 1(i) because section 1(i) only affects the amount of tax liability and not the child's adjusted gross income.

Q–22. If a child is unable to obtain information concerning the tax return of the child's parents directly from such parents, how may the child obtain information from the parent's tax return which is necessary to determine the child's tax liability under section 1(i)?

A–22. Under section 6103(e)(1)(A)(iv), a return of a parent shall, upon written request, be open to inspection or disclosure to a child of that individual (or the child's legal representative) to the extent necessary to comply with section 1(i). Thus, a child may request the Internal Revenue Service to disclose sufficient tax information about the parent to the child so that the child can properly file his or her return.

[T.D. 8158, 52 FR 33579, Sept. 4, 1987; 52 FR 36133, Sept. 25, 1987]

§1.2–1 Tax in case of joint return of husband and wife or the return of a surviving spouse.

(a) *Taxable year ending before January 1, 1971.* (1) For taxable years ending before January 1, 1971, in the case of a joint return of husband and wife, or the return of a surviving spouse as defined in section 2(b), the tax imposed by section 1 shall be twice the tax that would be imposed if the taxable income were reduced by one-half. For rules relating to the filing of joint returns of husband and wife, see section 6013 and the regulations thereunder.

(2) The method of computing, under section 2(a), the tax of husband and wife in the case of a joint return, or the tax of a surviving spouse, is as follows:

(i) First, the taxable income is reduced by one-half. Second, the tax is determined as provided by section 1 by using the taxable income so reduced. Third, the tax so determined, which is the tax that would be determined if the taxable income were reduced by one-half, is then multiplied by two to produce the tax imposed in the case of the joint return or the return of a surviving spouse, subject, however, to the allowance of any credits against the tax under the provisions of sections 31 through 38 and the regulations thereunder.

(ii) The limitation under section 1(c) of the tax to an amount not in excess of a specified percent of the taxable income for the taxable year is to be applied before the third step above, that is, the limitation to be applied upon the tax is determined as the applicable specified percent of one-half of the taxable income for the taxable year (such one-half of the taxable income being the actual aggregate taxable income of the spouses, or the total taxable income of the surviving spouse, as the case may be, reduced by one-half). For the percent applicable in determining the limitation of the tax under section 1(c), see §1.1–2(a). After such limitation is applied, then the tax so limited is multiplied by two as provided in section 2(a) (the third step above).

(iii) The following computation illustrates the method of application of section 2(a) in the determination of the tax of a husband and wife filing a joint return for the calendar year 1965. If the combined gross income is $8,200, and the only deductions are the two exemptions of the taxpayers under section 151(b) and the standard deduction under section 141, the tax on the joint return for 1965, without regard to any credits against the tax, is $1,034.20 determined as follows:

1. Gross income	$8,200.00	
2. Less:		
Standard deduction, section 141	$820	....
Deduction for personal exemption, section 151	1,200	2,020.00
3. Taxable income	6,180.00	
4. Taxable income reduced by one-half	3,090.00	
5. Tax computed by the tax table provided under section 1(a)(2) ($310 plus 19 percent of excess over $2,000)	517.10	
6. Twice the tax in item 5	1,034.20	

(b) *Taxable years beginning after December 31, 1970.* (1) For taxable years beginning after December 31, 1970, in the case of a joint return of husband and wife, or the return of a surviving spouse as defined in section 2(a) of the Code as amended by the Tax Reform Act of 1969, the tax shall be determined in accordance with the table contained in section 1(a) of the Code as so amended. For rules relating to the filing of joint returns of husband and wife see section 6013 as amended and the regulations thereunder.

(2) The following computation illustrates the method of computing the tax of a husband and wife filing a joint return for calendar year 1971. If the combined gross income is $8,200, and the only deductions are the two exemptions of the taxpayers under section 151(b), as amended, and the standard deduction under section 141, as amended, the tax on the joint return for 1971, without regard to any credits against the tax, is $968.46, determined as follows:

1. Gross income	$8,200.00	
2. Less:		
Standard deduction, section 141	$1,066.00	
Deduction for personal exemption, section 151	1,300.00	2,366.00
3. Taxable income	5,834.00	
4. Tax computed by the tax table provided under section 1(a) ($620 plus 19 percent of excess over $4,000)	968.46	

(3) The limitation under section 1348 with respect to the maximum rate of tax on earned income shall apply to a married individual only if such individual and his spouse file a joint return for the taxable year.

(c) *Death of a spouse.* If a joint return of a husband and wife is filed under the provisions of section 6013 and if the husband and wife have different taxable years solely because of the death of either spouse, the taxable year of the deceased spouse covered by the joint return shall, for the purpose of the computation of the tax in respect of such joint return, be deemed to have ended on the date of the closing of the surviving spouse's taxable year.

(d) *Computation of optional tax.* For computation of optional tax in the case of a joint return or the return of a surviving spouse, see section 3 and the regulations thereunder.

(e) *Change in rates.* For treatment of taxable years during which a change in the tax rates occurs see section 21 and the regulations thereunder.

[T.D. 7117, 36 FR 9398, May 25, 1971]

§ 1.2–2 Definitions and special rules.

(a) *Surviving spouse.* (1) If a taxpayer is eligible to file a joint return under the Internal Revenue Code of 1954 without regard to section 6013(a) (3) thereof for the taxable year in which his spouse dies, his return for each of the next 2 taxable years following the year of the death of the spouse shall be treated as a joint return for all purposes if all three of the following requirements are satisfied:

(i) He has not remarried before the close of the taxable year the return for which is sought to be treated as a joint return, and

(ii) He maintains as his home a household which constitutes for the taxable year the principal place of abode as a member of such household of a person who is (whether by blood or adoption) a son, stepson, daughter, or stepdaughter of the taxpayer, and

(iii) He is entitled for the taxable year to a deduction under section 151 (relating to deductions for dependents) with respect to such son, stepson, daughter, or stepdaughter.

(2) See paragraphs (c)(1) and (d) of this section for rules for the determination of when the taxpayer maintains as his home a household which constitutes for the taxable year the principal place of abode, as a member of such household, of another person.

(3) If the taxpayer does not qualify as a surviving spouse he may nevertheless qualify as a head of a household if he meets the requirements of §1.2–2(b).

(4) The following example illustrates the provisions relating to a surviving spouse:

Example: Assume that the taxpayer meets the requirements of this paragraph for the years 1967 through 1971, and that the taxpayer, whose wife died during 1966 while married to him, remarried in 1968. In 1969, the taxpayer's second wife died while married to him, and he remained single thereafter. For 1967 the taxpayer will qualify as a surviving spouse, provided that neither the taxpayer nor the first wife was a nonresident alien at any time during 1966 and that she (immediately prior to her death) did not have a taxable year different from that of the taxpayer. For 1968 the taxpayer does not qualify as a surviving spouse because he remarried before the close of the taxable year. The taxpayer will qualify as a surviving spouse for 1970 and 1971, provided that neither the taxpayer nor the second wife was a nonresident alien at any time during 1969 and that she (immediately prior to her death) did not have a taxable year different from that of the taxpayer. On the other hand, if the taxpayer, in 1969, was divorced or legally separated from his second wife, the taxpayer will not qualify as a surviving spouse for 1970 or 1971, since he could not have filed a joint return for 1969 (the year in which his second wife died).

(b) *Head of household.* (1) A taxpayer shall be considered the head of a household if, and only if, he is not married at the close of his taxable year, is not a surviving spouse (as defined in paragraph (a) of this section, and (i) maintains as his home a household which constitutes for such taxable year the principal place of abode, as a member of such household, of at least one of the individuals described in subparagraph (3), or (ii) maintains (whether or not as his home) a household which constitutes for such taxable year the principal place of abode of one of the individuals described in subparagraph (4).

(2) Under no circumstances shall the same person be used to qualify more than one taxpayer as the head of a household for the same taxable year.

(3) Any of the following persons may qualify the taxpayer as a head of a household:

(i) A son, stepson, daughter, or stepdaughter of the taxpayer, or a descendant of a son or daughter of the taxpayer. For the purpose of determining whether any of the stated relationships exist, a legally adopted child of a person is considered a child of such person by blood. If any such person is not married at the close of the taxable year of the taxpayer, the taxpayer may qualify as the head of a household by reason of such person even though the taxpayer may not claim a deduction for such person under section 151, for example, because the taxpayer does not furnish more than half of the support of such person. However, if any such person is married at the close of the taxable year of the taxpayer, the taxpayer may qualify as the head of a household by reason of such person only if the taxpayer is entitled to a deduction for such person under section 151 and the regulations thereunder. In applying the preceding sentence there shall be disregarded any such person for whom a deduction is allowed under section 151 only by reason of section 152(c) (relating to persons covered by a multiple support agreement).

(ii) Any other person who is a dependent of the taxpayer, if the taxpayer is entitled to a deduction for the taxable year for such person under section 151 and paragraphs (3) through (8) of section 152(a) and the regulations thereunder. Under section 151 the taxpayer may be entitled to a deduction for any of the following persons:

(a) His brother, sister, stepbrother, or stepsister;

(b) His father or mother, or an ancestor of either;

(c) His stepfather or stepmother;

(d) A son or a daughter of his brother or sister;

(e) A brother or sister of his father or mother; or

(f) His son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law;

if such person has a gross income of less than the amount determined pursuant to § 1.151–2 applicable to the calendar year in which the taxable year of the taxpayer begins, if the taxpayer supplies more than one-half of the support of such person for such calendar year and if such person does not make a joint return with his spouse for the taxable year beginning in such calendar year. The taxpayer may not be considered to be a head of a household by reason of any person for whom a deduction is allowed under section 151 only by reason of sections 152 (a)(9), 152 (a)(10), or 152(c) (relating to persons not related to the taxpayer, persons receiving institutional care, and persons covered by multiple support agreements).

(4) The father or mother of the taxpayer may qualify the taxpayer as a head of a household, but only if the taxpayer is entitled to a deduction for the taxable year for such father or mother under section 151 (determined without regard to section 152(c)). For example, an unmarried taxpayer who maintains a home for his widowed mother may not qualify as the head of a household by reason of his maintenance of a home for his mother if his mother has gross income equal to or in excess of the amount determined pursuant to § 1.151–2 applicable to the calendar year in which the taxable year of the taxpayer begins, or if he does not furnish more than one-half of the support of his mother for such calendar year. For this purpose, a person who legally adopted the taxpayer is considered the father or mother of the taxpayer.

(5) For the purpose of this paragraph, the status of the taxpayer shall be determined as of the close of the taxpayer's taxable year. A taxpayer shall be considered as not married if at the close of his taxable year he is legally separated from his spouse under a decree of divorce or separate maintenance, or if at any time during the taxable year the spouse to whom the taxpayer is married at the close of his taxable year was a nonresident alien. A taxpayer shall be considered married at the close of his taxable year if his spouse (other than a spouse who is a nonresident alien) dies during such year.

(6) If the taxpayer is a nonresident alien during any part of the taxable year he may not qualify as a head of a household even though he may comply with the other provisions of this paragraph. See the regulations prescribed under section 871 for a definition of nonresident alien.

(c) *Household.* (1) In order for a taxpayer to be considered as maintaining a household by reason of any individual described in paragraph (a)(1) or (b)(3) of this section, the household must actually constitute the home of the taxpayer for his taxable year. A physical change in the location of such home will not prevent a taxpayer from qualifying as a head of a household. Such home must also constitute the principal place of abode of at least one of the persons specified in such paragraph (a)(1) or (b)(3) of this section. It is not sufficient that the taxpayer maintain the household without being its occupant. The taxpayer and such other person must occupy the household for the entire taxable year of the taxpayer. However, the fact that such other person is born or dies within the taxable year will not prevent the taxpayer from qualifying as a head of household if the household constitutes the principal place of abode of such other person for the remaining or preceding part of such taxable year. The taxpayer and such other person will be considered as occupying the household for such entire taxable year notwithstanding temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which a child or stepchild is absent for less than 6 months in the taxable year of the taxpayer, shall be considered temporary absence due to special circumstances. Such absence will not prevent the taxpayer from being considered as maintaining a household if (i) it is reasonable to assume that the taxpayer or such other person will return to the household, and (ii) the taxpayer continues to maintain such household or a substantially equivalent household in anticipation of such return.

(2) In order for a taxpayer to be considered as maintaining a household by

reason of any individual described in paragraph (b)(4) of this section, the household must actually constitute the principal place of abode of the taxpayer's dependent father or mother, or both of them. It is not, however, necessary for the purposes of such subparagraph for the taxpayer also to reside in such place of abode. A physical change in the location of such home will not prevent a taxpayer from qualifying as a head of a household. The father or mother of the taxpayer, however, must occupy the household for the entire taxable year of the taxpayer. They will be considered as occupying the household for such entire year notwithstanding temporary absences from the household due to special circumstances. For example, a nonpermanent failure to occupy the household by reason of illness or vacation shall be considered temporary absence due to special circumstances. Such absence will not prevent the taxpayer from qualifying as the head of a household if (i) it is reasonable to assume that such person will return to the household, and (ii) the taxpayer continues to maintain such household or a substantially equivalent household in anticipation of such return. However, the fact that the father or mother of the taxpayer dies within the year will not prevent the taxpayer from qualifying as a head of a household if the household constitutes the principal place of abode of the father or mother for the preceding part of such taxable year.

(d) *Cost of maintaining a household.* A taxpayer shall be considered as maintaining a household only if he pays more than one-half the cost thereof for his taxable year. The cost of maintaining a household shall be the expenses incurred for the mutual benefit of the occupants thereof by reason of its operation as the principal place of abode of such occupants for such taxable year. The cost of maintaining a household shall not include expenses otherwise incurred. The expenses of maintaining a household include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises. Such expenses do not include the cost of clothing, education, medical treatment, vacations, life insurance, and transportation. In addition, the cost of maintaining a household shall not include any amount which represents the value of services rendered in the household by the taxpayer or by a person qualifying the taxpayer as a head of a household or as a surviving spouse.

(e) *Certain married individuals living apart.* For taxable years beginning after December 31, 1969, an individual who is considered as not married under section 143(b) shall be considered as not married for purposes of determining whether he or she qualifies as a single individual, a married individual, a head of household or a surviving spouse under sections 1 and 2 of the Code.

[T.D. 7117, 36 FR 9398, May 25, 1971]

§1.3–1 Application of optional tax.

(a) *General rules.* (1) For taxable years ending before January 1, 1970, an individual whose adjusted gross income is less than $5,000 (or a husband and wife filing a joint return whose combined adjusted gross income is less than $5,000) may elect to pay the tax imposed by section 3 in place of the tax imposed by section 1 (a) or (b). For taxable years beginning after December 31, 1969 and before January 1, 1971 an individual whose adjusted gross income is less than $10,000 (or a husband and wife filing a joint return whose combined adjusted gross income is less than $10,000) may elect to pay the tax imposed by section 3 as amended by the Tax Reform Act of 1969 in place of the tax imposed by section 1 (a) or (b). For taxable years beginning after December 31, 1970 an individual whose adjusted gross income is less than $10,000 (or a husband and wife filing a joint return whose combined adjusted gross income is less than $10,000) may elect to pay the tax imposed by section 3 as amended in place of the tax imposed by section 1 as amended. See §1.4–2 for the manner of making such election. A taxpayer may make such election regardless of the sources from which his income is derived and regardless of whether his income is computed by the cash method or the accrual method. See section 62 and the regulations thereunder for the determination of adjusted gross income. For the purpose of determining whether a taxpayer may elect to pay the tax under section 3, the amount of the adjusted gross income is controlling, without reference to the number of exemptions to which the taxpayer may be entitled. See section 4 and the regulations thereunder for additional rules applicable to section 3.

(2) The following examples illustrate the rule that section 3 applies only if the adjusted gross income is less than $10,000 ($5,000 for taxable years ending before January 1, 1970).

Example 1. A is employed at a salary of $9,200 for the calendar year 1970. In the course of such employment, he incurred travel expenses of $1,500 for which he was reimbursed during the year. Such items constitute his sole income for 1970. In such case the gross income is $10,700 but the amount of $1,500 is deducted from gross income in the determination of adjusted gross income and thus A's adjusted gross income for 1970 is $9,200. Hence, the adjusted gross income being less than $10,000, he may elect to pay his tax for 1970 under section 3. Similarly, in the case of an individual engaged in trade or business (excluding from the term ''engaged in trade or business'' the performance of personal services as an employee), there may be deducted from gross income in ascertaining adjusted gross income those expenses directly relating to the carrying on of such trade or business.

Example 2. If B has, as his only income for 1970, a salary of $11,600 and his spouse has no gross income, then B's adjusted gross income is $11,600 (not $11,600 reduced by exemptions of $1,250) and he is not for such year, entitled to pay his tax under section 3. If, however, B has for 1970 a salary of $13,000 and incident to his employment he incurs expenses in the amount of $3,400 for travel, meals, and lodging while away from home, for which he is not reimbursed, the adjusted gross income is $13,000 minus $3,400 or $9,600. In such case his adjusted gross income being less than $10,000, B may elect to pay the tax under section 3. However, if B's wife has adjusted gross income of $400, the total adjusted gross income is $10,000. In such case, if B and his wife file a joint return, they may not elect to pay the optional tax since the combined adjusted gross income is not less than $10,000. B may nevertheless elect to pay the optional tax, but if he makes this election he must file a separate return and, since his wife has gross income, he may not claim an exemption for her in computing the optional tax.

(b) *Surviving spouse.* The return of a surviving spouse is treated as a joint return for purposes of section 3. See section 2, and the regulations thereunder, with respect to the qualifications of a taxpayer as a surviving spouse. Accordingly, if the taxpayer qualifies as a surviving spouse and elects to pay the optional tax, he shall use the column in the tax table, appropriate to his number of exemptions, provided for cases in which a joint return is filed.

(c) *Use of tax table.* (1) To determine the amount of the tax, the individual ascertains the amount of his adjusted gross income, refers to the appropriate table set forth in section 3 or the regulations thereunder, ascertains the income bracket into which such income falls, and, using the number of exemptions applicable to his case, finds the tax in the vertical column having at the top thereof a number corresponding to the number of exemptions to which the taxpayer is entitled.

(2) Section 3(b) (relating to taxable years beginning after Dec. 31, 1964 and ending before Jan. 1, 1970) contains 5 tables for use in computing the tax. Table I is to be used by a single person who is not a head of household. Table II is to be used by a head of household. Table III is to be used by married persons filing joint returns and by a surviving spouse. Table IV is to be used by married persons filing separate returns using the 10 percent standard deduction. Table V is to be used by married persons filing separate returns using the minimum standard deduction. For an explanation of the standard deduction see section 141 and the regulations thereunder.

(3) 30 tables are provided for use in computing the tax under the Tax Reform Act of 1969. Tables I through XV apply for taxable years beginning after December 31, 1969 and ending before January 1, 1971. Tables XVI through XXX apply for taxable years beginning after December 31, 1970. The standard deduction for Tables I through XV, applicable to taxable years beginning in 1970, is 10 percent. The standard deduction for Tables XVI through XXX, applicable to taxable years beginning in 1971, is 13 percent. For an explanation of the standard deduction and the low income allowance see section 141 as amended by the Tax Reform Act of 1969.

(4) In the case of married persons filing separate returns who qualify to use the optional tax imposed by section 3, such persons shall use the tax imposed by the table for the applicable year in accordance with the rules prescribed by sections 4(c) and 141 and the regulations thereunder governing the use and application of the standard deduction and the low income allowance.

(5) The tax shown in the tax tables set forth in section 3 or the regulations thereunder reflects full income splitting in the case of a joint return (including the return of a surviving spouse) and lesser income splitting in the case of a head of household. Therefore, it is possible for the tax shown in the tables relating to joint returns, or relating to a return of a head of a household, to be lower than that shown in the table for separate returns even though the amounts of adjusted gross income and the number of exemptions are the same.

[T.D. 7117, 36 FR 9420, May 25, 1971]

§1.4–1 Number of exemptions.

(a) For the purpose of determining the optional tax imposed under section 3, the taxpayer shall use the number of exemptions allowable to him as deductions under section 151. See sections 151, 152, and 153, and the regulations thereunder. In general, one exemption is allowed for the taxpayer; one exemption for his spouse if a joint return is made, or if a separate return is made by the taxpayer and his spouse has no gross income for the calendar year in which the taxable year of the taxpayer begins and is not the dependent of another taxpayer for such calendar year; and one exemption for each dependent whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than the applicable amount determined pursuant to §1.151–2. No exemption is allowed for any dependent who has made a joint return with his spouse for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins. The taxpayer may, in certain cases, be allowed an exemption for a dependent child of the taxpayer notwithstanding the fact that such child has gross income equal to or in excess of the amount determined pursuant to §1.151–2 applicable to the calendar year in which the taxable year of the taxpayer begins. The requirements for the allowance of such an exemption are set forth in paragraph (c) of §1.152–1. See paragraphs (c) and (d) of §1.151–1 with respect to additional exemptions for a taxpayer or spouse who has attained the age 65 years and for a blind taxpayer or blind spouse

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

Example 1. A, a married man whose duties as an employee require traveling away from his home, has as his sole gross income a salary of $5,600 for the calendar year 1954. His traveling expenses, including cost of meals and lodging, amount in such year to $750, and hence, his adjusted gross income is $4,850. His wife, B, has as her sole income interest in the amount of $85, and thus the aggregate adjusted gross income of A and B is $4,935. A has two dependent children neither of whom has any income. A and B file a joint return for 1954 on Form 1040. In such case four exemptions are allowable. The adjusted gross income falls within the tax bracket $4,900–4,950. By referring to such tax bracket in the tax table in section 3 and to the column headed ''4'' therein, the tax is found to be $407.

Example 2. C, a married man, has as his sole income in 1954 wages of $4,600, and has two dependent children neither of whom has any income. His wife, D, has adjusted gross income of $400. C files a separate return for 1954 and is entitled to claim three exemptions. C's income falls within the tax bracket $4,600–4,650 and hence, with three exemptions his tax is $480. No exemption is allowed with respect to since D has gross income and a joint return was not filed.

Example 3. D, a married man with no dependents, attains the age of 65 on September 1, 1954. The aggregate adjusted gross income of D and his wife for 1954 is $4,840. D and his wife file a joint return for 1954 and are entitled to three exemptions, one for each taxpayer and one additional exemption for D because of his age. Since the adjusted gross income of D and his wife falls within the tax bracket $4,800–4,850, the tax on a joint return is $509.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7114, 36 FR 9018, May 18, 1971]

§1.4–2 Elections.

(a) *Making of election.* The election to pay the optional tax imposed under section 3 shall be made by (1) filing a return on Form 1040A, or (2) filing a return on Form 1040 and electing in such return, in accordance with the provisions of section 144 and the regulations thereunder, to take the standard deduction provided by section 141.

(b) *Election under section 3 and election of standard deduction.* Section 144 (a) and the regulations thereunder provide rules for treating an election to pay the tax under section 3 as an election to take the standard deduction, and for treating an election to take the standard deduction as an election to pay the tax under section 3. For example, if the taxpayer's return shows $5,000 or more of adjusted gross income and he elects to take the standard deduction, he will be deemed to have elected to pay the tax under section 3 if it is subsequently determined that his correct adjusted gross income is less than $5,000.

(c) [Reserved]

(d) *Change of election.* For rules relating to a change of election to pay, or not to pay, the optional tax imposed under section 3, see section 144 (b) and the regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6581, 26 FR 11677, Dec. 6, 1961; T.D. 7269, 38 FR 9295, April 13, 1973]

§ 1.4–3 Husband and wife filing separate returns.

(a) *In general.* If the separate adjusted gross income of a husband is less than $5,000 and the separate adjusted gross income of his wife is less than $5,000, and if each is required to file a return, the husband and the wife must each elect to pay the optional tax imposed under section 3 or neither may so elect. If the separate adjusted gross income of each spouse is $5,000 or more, then neither spouse can elect to pay the optional tax imposed under section 3. If the adjusted gross income of one spouse is $5,000 or more and that of the other spouse is less than $5,000, the election to pay the optional tax imposed under section 3 may be exercised by the spouse having adjusted gross income of less than $5,000 only if the spouse having adjusted gross income of $5,000 or more, in computing taxable income, uses the standard deduction provided by section 141. If the spouse having adjusted gross income of $5,000 or more does not use the standard deduction, then the spouse having adjusted gross income of less than $5,000 may not elect to pay the optional tax and must compute taxable income without regard to the standard deduction. Accordingly, if the spouse having adjusted gross income of $5,000 or more itemizes the deductions allowed by sections 161 and 211 in computing taxable income, the spouse having adjusted gross income of less than $5,000 must also compute taxable income by itemizing the deductions allowed by sections 161 and 211, and must pay the tax imposed by section 1. For rules relative to the election to take the standard deduction by husband and wife, see part IV (section 141 and following), subchapter B, chapter 1 of the Code, and the regulations thereunder.

(b) *Taxable years beginning after December 31, 1963, and before January 1, 1970.* (1) In the case of a husband and wife filing a separate return for a taxable year beginning after December 31, 1963, and before January 1, 1970, the optional tax imposed by section 3 shall be—

(i) For taxable years beginning in 1964, the lesser of the tax shown in Table IV (relating to the 10-percent standard deduction for married persons filing separate returns) or Table V (relating to the minimum standard deduction for married persons filing separate returns) of section 3(a), and

(ii) For a taxable year beginning after December 31, 1964, and before January 1, 1970, the lesser of the tax shown in Table IV (relating to the 10-percent standard deduction for married persons filing separate returns) or Table V (relating to minimum standard deduction for married persons filing separate returns) of section 3(b).

(2) If the tax of one spouse is determined with regard to the 10-percent standard deduction provided for in Table IV of section 3(a) or 3(b) or if such spouse in computing taxable income uses the 10-percent standard deduction provided for in section 141(b), then the minimum standard deduction provided for in Table V of section 3(a) or 3(b) shall not apply in the case of the other spouse, if such spouse elects to pay the optional tax imposed under section (3). Thus, if a husband and wife compute their tax with reference to the

standard deduction, one cannot elect to use the 10-percent standard deduction and the other elect to use the minimum standard deduction. However, an individual described in section 141(d)(2) may elect pursuant to such section and the regulations thereunder to pay the tax shown in Table V of section 3(a) or 3(b) in lieu of the tax shown in Table IV of section 3(a) or 3(b). See section 141(d) and the regulations thereunder for rules relating to the standard deduction in the case of married individuals filing separate returns.

(c) *Taxable years beginning after December 31, 1969.* (1) In the case of a husband and wife filing a separate return for a taxable year beginning after December 31, 1969, the optional tax imposed by section 3 shall be the lesser of the tax shown in—

(i) The table prescribed under section 3 applicable to such taxable year in the case of married persons filing separate returns which applies the percentage standard deduction, or

(ii) The table prescribed under section 3 applicable to such taxable year in the case of married persons filing separate returns which applies the low income allowance.

(2) If the tax of one spouse is determined by the table described in subparagraph (1)(i) of this paragraph or if such spouse in computing taxable income uses the percentage standard deduction provided for in section 141(b), then the table described in subparagraph (1)(ii) of this paragraph shall not apply in the case of the other spouse, if such other spouse elects to pay the optional tax imposed under section 3. Thus, if a husband and wife compute the tax with reference to the standard deduction, one cannot elect to use the percentage standard deduction and the other elect to use the low income allowance. A married individual described in section 141(d)(2) may elect pursuant to such section and the regulations thereunder to pay the tax shown in the table described by subparagraph (1)(ii) of this paragraph in lieu of the tax shown in the table described by subparagraph (1)(i) of this paragraph. See section 141(d) and the regulations thereunder for rules relating to the standard deduction in the case of married individuals filing separate returns.

(d) *Determination of marital status.* For the purpose of applying the restrictions upon the right of a married person to elect to pay the tax under section 3, (1) the determination of marital status is made as of the close of the taxpayer's taxable year or, if his spouse died during such year, as of the date of death; (2) a person legally separated from his spouse under a decree of divorce or separate maintenance on the last day of his taxable year (or the date of death of his spouse, whichever is applicable) is not considered as married; and (3) with respect to taxable years beginning after December 31, 1969, a person, although considered as married within the meaning of section 143(a), is considered as not married if he lives apart from his spouse and satisfies the requirements set forth in section 143(b). See section 143 and the regulations thereunder.

[T.D. 6792, 30 FR 529, Jan. 15, 1965, as amended by T.D. 7123, 36 FR 11084, June 9, 1971]

§1.4–4 Short taxable year caused by death.

An individual making a return for a period of less than 12 months on account of a change in his accounting period may not elect to pay the optional tax under section 3. However, the fact that the taxable year is less than 12 months does not prevent the determination of the tax for the taxable year under section 3 if the short taxable year results from the death of the taxpayer.

TAX ON CORPORATIONS

§1.11–1 Tax on corporations.

(a) Every corporation, foreign or domestic, is liable to the tax imposed under section 11 except (1) corporations specifically excepted under such section from such tax; (2) corporations expressly exempt from all taxation under subtitle A of the Code (see section 501); and (3) corporations subject to tax under section 511(a). For taxable years beginning after December 31, 1966, foreign corporations engaged in trade or business in the United States shall be taxable under section 11 only on their taxable income which is effectively connected with the conduct of a trade or business in the United States (see section 882(a)(1)). For definition of the terms ''corporations,'' ''domestic,'' and ''foreign,'' see section 7701(a) (3), (4), and (5), respectively. It is immaterial that a domestic corporation, and for taxable years beginning after December 31, 1966, a foreign corporation engaged in trade or business in the United States, which is subject to the tax imposed by section 11 may derive no income from sources within the United States. The tax imposed by section 11 is payable upon the basis of the returns rendered by the corporations liable thereto, except that in some cases a tax is to be paid at the source of the income. See subchapter A (sections 6001 and following), chapter 61 of the Code, and section 1442.

(b) The tax imposed by section 11 consists of a normal tax and a surtax. The normal tax and the surtax are both computed upon the taxable income of the corporation for the taxable year, that is, upon the gross income of the corporation minus the deductions allowed by chapter 1 of the Code. However, the deduction provided in section 242 for partially tax-exempt interest is not allowed in computing the taxable income subject to the surtax.

(c) The normal tax is at the rate of 22 percent and is applied to the taxable income for the taxable year. However, in the case of a taxable year ending after December 31, 1974, and before January 1, 1976, the normal tax is at the rate of 20 percent of so much of the taxable income as does not exceed $25,000 and at the rate of 22 percent of so much of the taxable income as does exceed $25,000 and is applied to the taxable income for the taxable year.

(d) The surtax is at the rate of 26 percent and is upon the taxable income (computed without regard to the deduction, if any, provided in section 242 for partially tax-exempt interest) in excess of $25,000. However, in the case of a taxable year ending after December 31, 1974, and before January 1, 1976, the surtax is upon the taxable income (computed as provided in the preceding sentence) in excess of $50,000. In certain circumstances the exemption from surtax may be disallowed in whole or in part. See sections 269, 1551, 1561, and 1564 and the regulations thereunder. For purposes of sections 244, 247, 804, 907, 922 and §§ 1.51–1 and 1.815–4, when the phrase ''the sum of the normal tax rate and the surtax rate for the taxable year'' is used in any such section, the normal tax rate for all taxable years beginning after December 31, 1963, and ending before January 1, 1976, shall be considered to be 22 percent.

(e) The computation of the tax on corporations imposed under section 11 may be illustrated by the following example:

Example. The X Corporation, a domestic corporation, has gross income of $86,000 for the calendar year 1964. The gross income includes interest of $5,000 on United States obligations for which a deduction under section 242 is allowable in determining taxable income subject to the normal tax. It has other deductions of $11,000. The tax of the X Corporation under section 11 for the calendar year is $28,400 ($15,400 normal tax and $13,000 surtax) computed as follows:

Computation of Normal Tax

Gross income	$86,000	
Deductions:		
Partially tax-exempt interest	$5,000	
Other	11,000	16,000
Taxable income	70,000	
Normal tax (22 percent of $70,000)	15,400	

Computation of Surtax

Taxable income	70,000
Add: Amount of partially tax-exempt interest deducted in computing taxable income	5,000
Taxable income subject to surtax	75,000
Less: Exemption from surtax	25,000
Excess of taxable income subject to surtax over exemption	50,000
Surtax (26 percent of $50,000)	13,000

(f) For special rules applicable to foreign corporations engaged in trade or business within the United States, see section 882 and the regulations thereunder. For additional tax on personal holding companies, see part II (section 541 and following), subchapter G, chapter 1 of the Code, and the regulations thereunder. For additional tax on corporations improperly accumulating surplus, see part I (section 531 and following), subchapter G, chapter 1 of the Code, and the regulations thereunder. For treatment of China Trade Act corporations, see sections 941 and 942 and the regulations thereunder. For treatment of Western Hemisphere trade corporations, see sections 921 and 922 and the regulations thereunder. For treatment of capital gains and losses, see subchapter P (section 1201 and following), chapter 1 of the Code. For computation of the tax for a taxable year during which a change in the tax rates occurs, see section 21 and the regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7293, 38 FR 32792, Nov. 28, 1973; T.D. 74–13, 41 FR 12639, Mar. 26, 1976]

CHANGES IN RATES DURING A TAXABLE YEAR

§1.21–1 Changes in rate during a taxable year.

(a) Section 21 applies to all taxpayers, including individuals and corporations. It provides a general rule applicable in any case where (1) any rate of tax imposed by chapter 1 of the Code upon the taxpayer is increased or decreased, or any such tax is repealed, and (2) the taxable year includes the effective date of the change, except where that date is the first day of the taxable year. For example, the normal tax on corporations under section 11(b) was decreased from 30 percent to 22 percent in the case of a taxable year beginning after December 31, 1963. Accordingly, the tax for a taxable year of a corporation beginning on January 1, 1964, would be computed under section 11(b) at the new rate without regard to section 21. However, for any taxable year beginning before January 1, 1964, and ending on or after that date, the tax would be computed under section 21. For additional circumstances under which section 21 is not applicable, see paragraph (k) of this section.

(b) In any case in which section 21 is applicable, a tentative tax shall be computed by applying to the taxable income for the entire taxable year the rate for the period within the taxable year before the effective date of change, and another tentative tax shall be computed by applying to the taxable income for the entire taxable year the rate for the period within the taxable year on or after such effective date. The tax imposed on the taxpayer is the sum of—

(1) An amount which bears the same ratio to the tentative tax computed at the rate applicable to the period within the taxable year before the effective date of the change that the number of days in such period bears to the number of days in the taxable year, and

(2) An amount which bears the same ratio to the tentative tax computed at the rate applicable to the period within the taxable year on and after the effective date of the change that the number of days in such period bears to the number of days in the taxable year.

(c) If the rate of tax is changed for taxable years ‘‘beginning after’’ or ‘‘ending after’’ a certain date, the following day is considered the effective date of the change for purposes of section 21. If the rate is changed for taxable years ‘‘beginning on or after’’ a certain date, that date is considered the effective date of the change for purposes of section 21. This rule may be illustrated by the following examples:

Example 1. Assume that the law provides that a change in a certain rate of tax shall be effective only with respect to taxable years beginning after December 31, 1969. The effective date of change for purposes of section 21 is January 1, 1970, and section 21 must be applied to any taxable year which begins before and ends on or after January 1, 1970.

Example 2. Assume that the law provides that a change in a certain rate of tax shall be applicable only with respect to taxable years ending after December 31, 1970. For purposes of section 21, the effective date of change is January 1, 1971, and section 21 must be applied to any taxable year which begins before and ends on or after January 1, 1971.

Example 3. Assume that the law provides that a change in a certain rate of tax shall be effective only with respect to taxable years beginning on or after January 1, 1971. The effective date of change for purposes of section 21 is January 1, 1971, and section 21 must be applied to any taxable year which begins before and ends on or after January 1, 1971.

(d) If a tax is repealed, the repeal will be treated as a change of rate for purposes of section 21, and the rate for the period after the repeal (for purposes of computing the tentative tax with respect to that period) will be considered zero. For example, the Tax Reform Act of 1969 repealed section 1562, which imposed a 6 percent additional tax on controlled corporations electing multiple surtax exemptions, effective for taxable years beginning after December 31,

1974. For such controlled corporations having taxable years beginning in 1974 and ending in 1975, the rate for the period ending before January 1, 1975, would be 6 percent; the rate for the period beginning after December 31, 1974, would be zero. However, subject to the rules stated in this section, section 21 does not apply to the imposition of a new tax. For example, if a new tax is imposed for taxable years beginning on or after July 1, 1972, a computation under section 21 would not be required with respect to such new tax in the case of taxable years beginning before July 1, 1972, and ending on or after that date. If the effective date of the imposition of a new tax and the effective date of a change in rate of such tax fall in the same taxable year, section 21 is not applicable in computing the taxpayer's liability for such tax for such year unless the new tax is expressly imposed upon the taxpayer for a portion of his taxable year prior to the change in rate.

(e) If a husband and wife have different taxable years because of the death of either spouse, and if a joint return is filed with respect to the taxable year of each, then, for purposes of section 21, the joint return shall be treated as if the taxable years of both spouses ended on the date of the closing of the surviving spouse's taxable year. See section 6013 (c), relating to treatment of joint return after death of either spouse. Accordingly, if a change in the rate of tax is effective during the taxable year of the surviving spouse, the tentative taxes with respect to the joint return shall be computed on the basis of the number of days during which each rate of tax was in effect for the taxable year of the surviving spouse.

(f) Section 21 applies whether or not the taxpayer has a taxable year of less than 12 months. Moreover, section 21 applies whether or not the taxable income for a taxable year of less than 12 months is required to be placed on an annual basis under section 443. If the taxable income is required to be computed under section 443(b) then the tentative taxes under section 21 are computed as provided in paragraph (1) or (2) of section 443(b) and are reduced as provided in those paragraphs. The tentative taxes so computed and reduced are then apportioned as provided in section 21(a)(2) to determine the tax for such taxable year as computed under section 21.

(g) If a taxpayer has made the election under section 441(f) (relating to computation of taxable income on the basis of an annual accounting period varying from 52 to 53 weeks), the rules provided in section 441(f)(2) shall be applicable for purposes of determining whether section 21 applies to the taxable year of the taxpayer. Where a taxpayer has made the election under section 441(f) and where section 21 applies to the taxable year of the taxpayer the computation under section 21(a)(2) shall be made upon the basis of the actual number of days in the taxable year and in each period thereof.

(h)(1) Section 21 is applicable only if the rate of tax imposed by chapter 1 changes. Sections in which rates of tax are specified or incorporated by reference include the following: 1, 2, 3, 11, 511, 531, 541, 821, 831, 871, 881, 1201, and 1348 (for taxable years beginning after December 31, 1970). Except as provided in subparagraph (3) of this paragraph, section 21 is not applicable with respect to changes in the law relating to deductions from gross income, exclusions from or inclusions in gross income, or other items taken into account in determining the amount or character of income subject to tax. Moreover, section 21 is not applicable with respect to changes in the law relating to credits against the tax or with respect to changes in the law relating to limitations on the amount of tax. Section 21 is applicable, however, to all those computations specified in the section providing the rate of tax which are implicit in determining the rate. For example, if one of the tax brackets in the tax tables under section 3 were to be changed, section 21 would be applicable to that change. Thus, if the bracket relating to ''at least $4,200 but not less than $4,250'' for heads of households should be changed to increase or decrease the last sum specified, with corresponding changes being made in subsequent brackets, section 21 would be applicable. The enactment of sections 1561 and 1562 is considered a change in section 11(d) which constitutes a change in rate for the period ending after December 31, 1963. The amendment of section 1561 and the repeal of section 1562 by the Tax Reform Act of 1969 is considered a change in section 11(d) which constitutes a change in rate for the period ending after December 31, 1974. The repeal of the 2 percent additional tax imposed under section 1503 on corporations filing consolidated returns constitutes a change in rate for the period ending after December 31, 1963. The addition to the Code of section 1348 (relating to 50 percent maximum rate on earned income) is a change in rate to which section 21(a) is applicable. The amendment of section 11(d) by the Tax Reduction Act of 1975 which increases to $50,000 the surtax exemption for a taxable year ending during 1975 constitutes a change in rate for such portion of the taxable year (if less than the entire taxable year) as follows December 31, 1974. Similarly, the return of the surtax exemption to $25,000 for a taxable year ending during 1976 constitutes a change in rate for such portion of the taxable year (if less than the entire taxable year) as follows December 31, 1975.

(2) Ordinarily, both the old and the new rates are applied to the same amount of taxable income. However, where the rate of tax is itself taken into account in determining taxable income (for example, the special deduction for Western Hemisphere trade corporations under section 922), the taxable income used in determining the tentative tax employing the rate before the effective date of change shall be determined by reference to that rate of tax, and the taxable income for the purpose of determining the tentative tax employing the rate for the period on and after the effective date of the change shall be determined by reference to the new tax rate.

(3) Section 21 is applicable with respect to changes in the law relating to the standard deduction for individuals provided in part IV of subchapter B and to the deduction for personal exemptions for individuals provided in part V of subchapter B.

(i) If the rate of tax changes more than once during the taxable year, section 21 is applicable to each change in rate. For example, if the rate of normal tax changed for taxable years beginning on or after March 1, 1954, and changed again for taxable years beginning on or after June 1, 1954, section 21 requires computation of 3 tentative taxes for any taxable year which began before March 1, 1954, and ended on or after June 1, 1954: One tentative tax at the rate in effect before the March 1 change; another tentative tax at the rate in effect from March 1 to May 31; and a third tentative tax at the rate in effect from June 1 to the end of the taxable year. The proportion of each such tentative tax taken into account in determining the tax imposed on the taxpayer is computed by reference to the portion of the taxable year before March 1, 1954, by reference to the portion of the taxable year from March 1, 1954, through May 31, 1954, and by reference to the portion of the taxable year from June 1, 1954, to the end of the taxable year, respectively.

(j)(1) If a change in the rate of one tax imposed by chapter 1 of the Code does not affect the amount of other taxes imposed by chapter 1 of the Code the other taxes may be determined without regard to section 21 and section 21 will be applied only to the tax for which a change in rate is made. However, if the change of rate of one tax does affect the amount of other taxes imposed under chapter 1 of the Code, then the computation of the taxes under chapter 1 of the Code so affected shall be made by applying section 21. For example, if section 1201 applies to an individual taxpayer for a taxable year containing the effective date of a change in a rate of tax provided in section 1, then under section 21 the taxpayer must compute a tentative tax for each period for which a different rate of tax is effective under section 1. The tentative tax for each such period as computed under section 1201 will reflect the rate of tax provided by section 1 for such period.

(2) In certain cases chapter 1 of the Code provides that the particular tax to be imposed upon the taxpayer shall be one of several taxes, the basis of selection being the tax that is greater or lesser. See, for example, sections 821 and 1201. If in any such case the rate of any one of these taxes changes, then

the tentative taxes computed as provided by section 21 for each period shall be computed employing the tax selected in accordance with the general rule of selection for such a case, at the rate of tax in effect for such period. Thus, if a change in the rate of the alternative tax under section 1201 is such that the alternative tax under section 1201 is applicable if the old rate is used and is not applicable if the new rate is used, one tentative tax will consist of the alternative tax under section 1201 and the other tentative tax will consist of the tax imposed by the other applicable sections of chapter 1 of the Code. The two tentative taxes so computed are then prorated in accordance with section 21(a)(2) and the sum of the proportionate amounts is the tax imposed for the taxable year under chapter 1 of the Code. See the examples in paragraph (n) of this section.

(k) Section 21 does not apply in the following situations:

(1) The provisions of section 21 do not apply to the imposition of the tax surcharge by section 51. The proration rules of section 51(a) apply in the case of a taxable year ending on or after the effective date of the surcharge and beginning before July 1, 1970.

(2) The provisions of section 21 do not apply to the imposition of the minimum tax for tax preferences by section 56. The proration rules of section 301(c) of the Tax Reform Act of 1969 (83 Stat. 586) apply in the case of a taxable year beginning in 1969 and ending in 1970.

(l) In computing the number of days each rate of tax is in effect during the taxable year for purposes of section 21(a)(2), the effective date of the change in rate shall be counted in the period for which the new rate is in effect.

(m) Any credits against tax, and any limitation in any credit against tax, shall be based upon the tax computed under section 21. For credits against tax, see part IV (section 31 and following), subchapter A, chapter 1 of the Code.

(n) The application of section 21 may be illustrated by the following examples: (See also the examples in § 1.1561–2A(a)(3).)

Example 1. A, a married taxpayer filing a joint return, reports his income on the basis of a fiscal year ending June 30. For his fiscal year ending June 30, 1970, A reports taxable income (exclusive of capital gains and losses) of $50,000 and net long-term capital gain (section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)) of $75,000. The rate of tax on capital gains under section 1201(b) relating to the alternative tax has been increased from 25 percent to a maximum rate of 29½ percent with respect to gain in excess of $50,000 and the effective date of the change in rate is January 1, 1970. The income tax for the taxable year ended June 30, 1970, would be computed under section 21 as follows:

TENTATIVE TAX

Taxable income exclusive of capital gains and losses ..	$50,000
Long-term capital gain	75,000
	125,000
Deduct 50% of long-term capital gain ...	37,500
Taxable income	87,500
Tax under section 1 (1969 and 1970 rates)	37,690

ALTERNATIVE TAX UNDER SECTION 1201(b) (1969 RATES)

Taxable income ($50,000+50% of $75,000)	$87,500
Less 50% of long-term capital gain ...	37,500
Taxable income exclusive of capital gains	50,000
Partial tax (tax on $50,000)	17,060
Plus 25% of $75,000	18,750
Alternative tax under section 1201(b) at 1969 rates	35,810

ALTERNATIVE TAX UNDER SECTION 1201(b) (1970 RATES)

STEP I

Taxable income ($50,000 + 50% of $75,000)	$87,500	
Deduct 50% of net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)	37,500	
	50,000	
Tax on $50,000 (taxable income exclusive of capital gains)	....	$17,060

	STEP II	
(a) Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)	75,000	
(b) Subsection (d) gain	50,000	
25% of $50,000 (lesser of (a) or (b))		12,500
	STEP III	
(c) 29½% of $25,000 (excess of (a) over (b))	7,375	
(d) Ordinary income	$50,000	
50% of net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)	37,500	
	87,500	
Tax on $87,500	$37,690	
Ordinary income	$50,000	
50% of subsection (d) gain	25,000	
	75,000	
Tax on $75,000	30,470	
Difference	7,220	
Lesser of (c) or (d)	$7,220	
Alternative tax (total of 3 steps) at rates effective on and after January 1, 1970	36,780	

Since the alternative tax is less than the tax imposed under section 1 for both the period in 1969 and the period in 1970, the alternative tax applies for both periods. Thus, since the effective date of the change in the rate of tax on capital gains is January 1, 1970, the old rate of alternative tax is effective for 184 days of the taxable year and the new rate of alternative tax is effective for 181 days of the taxable year. The alternative taxes are apportioned as follows:

1969—184/365 of $35,810	$18,052.16
1970—181/365 of $36,780	18,238.85
	36,291.01
Tax surcharge (See §1.51–1(d)(1)(i))	2,729.28
Total tax for the taxable year	39,020.29

Example 2. B, a single individual not a head of a household, has a taxable year ending March 31. For the taxable year ending March 31, 1971, B has adjusted gross income of $18,500. His computation of the tax imposed is as follows:

1970 TENTATIVE TAX		
Adjusted gross income	$18,500.00	
Less:		
Standard deduction	$1,000.00	
Personal exemption	625.00	1,625.00
Taxable income under 1970 deduction provisions	16,875.00	
Tax on $16,875 (1970 rates):		
Tax on first $16,000	4,330.00	
42 percent of $875	367.50	
Tentative tax at rates and deduction provisions effective on or after January 1, 1970	4,697.50	
1971 TENTATIVE TAX		
Adjusted gross income	$18,500.00	
Less:		
Standard deduction	$1,500	
Personal exemption	650	2,150.00
Taxable income under 1971 deduction provisions	16,350.00	
Tax on $16,350 (1971 rates):		
Tax on first $16,000	3,830	
34 percent of $350	119	
Tentative tax at rates and deduction provisions effective on or after Januray 1, 1971	3,949.00	
The 1970 and 1971 tentative taxes are apportioned as follows:		
1970—275/365 of $4,697.50	3,539.21	
1971—90/365 of $3,949.00	973.73	
	4,512.94	
Tax surcharge (see §1.51–1(d)(1)(i))	56.26	
Total tax for the taxable year	4,569.20	

Example 3. H and W, husband and wife, have a foster child, C, who qualifies as a dependent under section 152(b)(2) for the period beginning after December 31, 1969. H and W file a joint return on the basis of a taxable year ending August 31. For the taxable year ending August 31, 1970, H and W have adjusted gross income of $12,500. Their computation of the tax imposed is as follows:

1969 TENTATIVE TAX		
Adjusted gross income	$12,500.00	
Less:		
Standard deduction	$1,000.00	
Personal exemption (2)	1,200.00	2,200.00
Taxable income under 1969 deduction provisions	10,300.00	
Taxable income reduced by one-half		5,150.00
Tax on $5,150 (1969 rates):		
Tax on first $4,000	$690.00	
22 percent of $1,150	253.00	943.00
Twice the tax on $5,150	$1,886.00	

Tentative tax at rates and deduction provisions effective on or after January 1, 1969	1,886.00	
1970 TENTATIVE TAX		
Adjusted gross income	$12,500.00	
Less:		
Standard deduction	$1,000.00	
Personal exemption (3)	1,875.00	2,875.00
Taxable income under 1970 deduction provisions	$9,625.00	
Tax on $9,625 (1970 rates):		
Tax on first $8,000	$1,380.00	
22 percent of $1,625	357.50	
Tentative tax at rates and deduction provisions effective on or after January 1, 1970	1,737.50	
The 1969 and 1970 tentative taxes are apportioned as follows:		
1969—122/365 of $1,886	$630.39	
1970—243/365 of $1,737.50	1,156.75	
	1,787.14	
Tax surcharge (see §1.51–1(d)(1)(i))	104.05	
Total tax for the taxable year	1,891.19	

Example 4. B, a single individual with one exemption, reports his income on the basis of a fiscal year ending June 30. For fiscal year ending June 30, 1971, B reports adjusted gross income of $250,000, consisting of earned net income of $240,000 and investment income of $10,000. In addition, on April 24, 1971, stock was transferred to B pursuant to his exercise of a qualified stock option, and the fair market value of such stock at that time exceeded the option price by $175,000. This $175,000 constitutes an item of tax preference described in section 57(a)(6). B claims itemized deductions in the amount of $34,000. By reason of section 1348, the maximum rate of tax on earned taxable income for a taxable year beginning after 1970 but before 1972 is 60 percent. The income tax for the taxable year ending June 30, 1971, would be computed under section 21 as follows:

1970 TENTATIVE TAX		
Adjusted gross income	$250,000.00	
Less:		
Itemized deductions	$34,000.00	
Personal exemption	625.00	34,625.00
Taxable income under 1970 deduction provisions	215,375.00	
Tax on $215,375 (1970 rates)		
Tax on first $100,000	$55,490.00	
70 percent of $115,375	80,762.50	
Tentative tax at rates and deduction provisions effective on or after January 1, 1970	136,252.50	
Minimum tax:		
Total tax preference items	175,000.00	
Less:		
Exemption	$30,000.00	
Income tax	136,252.50	166,252.50
Subject to 10 percent tax	8,747.50	
10 percent tax	874.75	
Total tentative tax ($136,252.50 + $874.75)	137,127.25	
1971 TENTATIVE TAX		
Adjusted gross income	$250,000.00	
Less:		
Itemized deductions	$34,000.00	
Personal exemption	650.00	34,650.00
Taxable income under 1971 deduction provisions	215,350.00	
(a) Tax on highest amount of taxable income on which rate does not exceed 60 percent ($50,000) (1971 rates)	20,190.00	
(b) Earned taxable income: ($215,350× $240,000/ $250,000)	$206,736.00	
Less: Tax preference offset: ($175,000 − $30,000)	145,000.00	
	61,736.00	
(c) 60% of the amount by which $61,736 exceeds $50,000	7,041.60	
(d) Tax on $215,350 (1971 rates)		
Tax on first $100,000	53,090.00	
70% of $115,350	80,745.00	
Total	133,835.00	
(e) Tax on $61,736 (1971 rates)		
Tax on first $60,000	26,390.00	
64% of $1,736	1,111.04	
Total	27,501.04	
(f) Excess of $133,835 over $27,501.04	106,333.96	
Tentative tax (total of Steps (a), (c), and (f)) at rates and deduction provisions effective on or after January 1, 1971	133,565.56	
Minimum tax:		
Total tax preference items	175,000.00	
Less:		
Exemption	$30,000.00	
Income tax	133,565.56	163,565.56
Subject to 10 percent tax	$11,434.44	

10 percent tax	1,143.44
Total tentative tax ($133,565.56 + $1,143.44)	134,709.00
The 1970 and 1971 tentative taxes are apportioned as follows:	
1970—184/365 of $137,127.25	69,127.16
1971—181/365 of $134,709	66,800.90
Total tax for the taxable year	135,928.06

Example 5. The surtax exemption of corporation M (one of 4 subsidiary corporations of W corporation), which files its income tax returns on the basis of a fiscal year ending March 31, 1964, is less than $25,000, by reason of section 1561 of the Code applicable to taxable years ending after December 31, 1963, and beginning before January 1, 1975. The taxable income of corporation M is $100,000, and the amount of the surtax exemption determined under the new rule for the 1964 taxable year is $5,000 ($25,000÷5). M's income tax liability for the taxable year ending March 31, 1964, is computed as follows:

1963 TENTATIVE TAX

Taxable income	$100,000
Normal tax on $100,000 (1963 rates) 30 percent of $100,000	$30,000
Surtax on $75,000 (1963 rates and $25,000 surtax exemption) 22 percent of $75,000	16,500
Total tentative tax at rates and surtax exemption effective before January 1, 1964	46,500

1964 TENTATIVE TAX

Taxable income	$100,000
Normal tax on $100,000 (1964 rates) 22 percent of $100,000	$22,000
Surtax on $95,000 (1964 rates and a $5,000 surtax exemption) 28 percent of $95,000	26,600
Total tentative tax at rates and surtax exemption effective after January 1, 1964	48,600
The 1963 and 1964 tentative taxes are apportioned as follows:	
1963—275/366 of $46,500	34,938.52
1964—91/366 of $48,600	12,083.61
Total tax for the taxable year	47,022.13

M has the same amount of taxable income in 1965. Its income tax liability for the fiscal year ending March 31, 1965, is computed as follows:

1964 TENTATIVE TAX

Taxable income	$100,000
Normal tax on $100,000 (1964 rates) 22 percent of $100,000	$22,000
Surtax on $95,000 (1964 rates and a $5,000 surtax exemption) 28 percent of $95,000	26,600
Total tentative tax at the 1964 rates	48,600

1965 TENTATIVE TAX

Taxable income	$100,000
Normal tax on $100,000 (1965 rates) 22 percent of $100,000	$22,000
Surtax on $95,000 (1965 rates and a $5,000 surtax exemption) 26 percent of $95,000	24,700
Total tentative tax at the 1965 rates	46,700
The 1964 and 1965 tentative taxes are apportioned as follows:	
1964—275/365 of $48,600	$36,616.44
1965—90/365 of $46,700	11,515.07
Total tax for the taxable year	48,131.51

Example 6. Assume the same facts as in example (5), except that M elected the additional tax under section 1562 for its fiscal year ending March 31, 1964. M's tax liability is completed as follows:

1963 TENTATIVE TAX

Taxable income	$100,000
Normal tax on $100,000 (1963 rates) 30 percent of $100,000	$30,000
Surtax on $75,000 (1963 rates and $25,000 surtax exemption) 22 percent of $75,000	16,500
Total tentative tax at rates and surtax exemption effective before January 1, 1964	46,500

1964 TENTATIVE TAX

Taxable income	$100,000
Normal tax on $100,000 (1964 rates) 22 percent of $100,000	$22,000

Surtax on $75,000 (1964 rates and $25,000 surtax exemption) 28 percent of $75,000	21,000
Additional tax on $25,000 6 percent of $25,000	1,500
Total tentative tax at rates and surtax exemption effective on and after January 1, 1964	44,500
The 1963 and 1964 tentative taxes are apportioned as follows:	
1963—275/366 of $46,500	$34,938.52
1964—91/366 of $44,500	11,064.21
Total tax for the taxable year	46,002.73

Example 7. Corporation N files its income tax returns on the basis of a fiscal year ending June 30. For its taxable year ending in 1976, the taxable income of N is $100,000. N's income tax liability is determined for the period July 1, 1975, through December 31, 1975, by taking into account two rates of normal tax under section 11(b)(2) (A) and (B) and the increase to $50,000 in the surtax exemption under section 11(d). For the period January 1, 1976, through June 30, 1976, N's income tax liability is determined by taking into account the single normal tax rate under section 11(b)(1) and the $25,000 surtax exemption under section 11(d). N's tax liability for the taxable year ending June 30, 1976, is computed as follows:

1975 Tentative Tax	
Taxable income	$100,000
Normal tax on $100,000 (1975 rates) 20 percent of $25,000	$5,000
22 percent of $75,000	16,500
Surtax on $50,000 (1975 rates and $50,000 surtax exemption) 26 percent of $50,000	13,000
Total tentative tax at rates and surtax exemption effective on and after January 1, 1975	34,500

1976 Tentative Tax	
Taxable income	$100,000
Normal tax on $100,000 (1976 rates) 22 percent of $100,000	$22,000
Surtax on $75,000 (1976 rates and $25,000 surtax exemption) 26 percent of $75,000	19,500
Total tentative tax at rates and surtax exemption effective on and after January 1, 1976	41,500
The 1975 and 1976 tentative taxes are apportioned as follows:	
1975—184/366 of $34,500	$17,344
1976—182/366 of $41,500	20,637
Total tax for the taxable year	37,981

(Secs. 1561(a) (83 Stat. 599; 26 U.S.C. 1561(a)) of the Internal Revenue Code)

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7164, 37 FR 4190, Feb. 29, 1972; T.D. 74–13, 41 FR 12639, Mar. 26, 1976; T.D. 7528, 42 FR 64694, Dec. 28, 1977; T.D. 7728, 45 FR 72651, Nov. 3, 1980]

§1.23–1 Residential energy credit.

(a) *General rule.* Section 23 or former section 44C provides a residential energy credit against the tax imposed by chapter 1 of the Internal Revenue Code. The credit is an amount equal to the individual's qualified energy conservation expenditures (set out in paragraph (b)) plus the individual's qualified renewable energy source expenditures (set out in paragraph (c)) for the taxable year. However, the credit is subject to the limitations described in paragraph (d) and the special rules contained in §1.23–3. The credit is nonrefundable (that is, the credit may not exceed an individual's tax liability for the taxable year). However, any unused credit may be carried over to succeeding years to the extent permitted under paragraph (e). Renters as well as owners of a dwelling unit may qualify for the credit. See §1.23–3(h) for the rules relating to the allocation of the credit in the case of joint occupants of a dwelling unit.

(b) *Qualified energy conservation expenditures.* In the case of any dwelling unit, the qualified energy conservation expenditures are 15 percent of the energy conservation expenditures made by the taxpayer with respect to the dwelling unit during the taxable year, but not in excess of $2,000 of such expenditures. See §1.23–2(a) for the definition of energy conservation expenditures.

(c) *Qualified renewable energy source expenditures.* In the case of taxable years beginning after December 31, 1979, the qualified renewable energy source expenditures are 40 percent of the renewable energy source expenditures made by the taxpayer during the taxable year (and before January 1, 1986) with respect to the dwelling units that do not exceed $10,000. In the case of taxable years beginning before January 1, 1980, the qualified renewable energy source expenditures are the renewable energy source expenditures made by the taxpayer with respect to the dwelling unit during the taxable year, but not in excess of—

(1) 30 percent of the expenditures up to $2,000, plus

(2) 20 percent of the expenditures over $2,000, but not more than $10,000.

See §1.23–2(b) for the definition of renewable energy source expenditures.

(d) *Limitations*—(1) *Minimum dollar amount.* No residential energy credit shall be allowed with respect to any return (whether joint or separate) for any taxable year if the amount of the credit otherwise allowable (determined without regard to the tax liability limitation imposed by paragraph (d)(3) of this section) is less than $10.

(2) *Prior expenditures taken into account*—(i) *In general.* For purposes of determining the credit for expenditures made during a taxable year, the taxpayer must reduce the maximum amount of allowable expenditures with respect to the dwelling until in computing qualified energy conservation expenditures (under paragraph (b)) or qualified renewable energy conservation expenditures (under paragraph (c)) by prior expenditures which were made by the taxpayer or by joint occupants (see §1.23–3(h)) with respect to the same dwelling unit, and which were taken into account in computing the credit for prior taxable years. In the case of expenditures made during taxable years beginning before January 1, 1980, the reduction of the maximum amount under paragraph (c) must first be made with respect to the first $2,000 of expenditures (to which a 30 percent rate applies) and then with respect to the next $8,000 of expenditures (to which a 20 percent rate applies). This reduction must be made if all or any part of the credit was allowed in or was carried over from a prior taxable year.

(ii) *Change of principal residence.* A taxpayer is eligible for the maximum credit for qualifying expenditures made with respect to a new principal residence notwithstanding the allowance of a credit for qualifying expenditures made with respect to the taxpayer's previous principal residence. Furthermore, except in certain cases involving joint occupancy (see §1.23–3(h)), a taxpayer is eligible for the maximum credit notwithstanding the allowance of a credit to a prior owner of the taxpayer's new principal residence.

(iii) *Example.* The rules with respect to the reduction for prior expenditures are illustrated by the following example:

Example. In 1978, A has $1,000 of energy conservation expenditures and $5,000 of renewable energy source expenditures in connection with A's principal residence. A's residential energy credit for 1978 is $1,350, made up of $150 of qualified energy conservation expenditures (15 percent of $1,000) plus $1,200 of qualified renewable energy source expenditures (30 percent of the first $2,000 plus 20 percent of the next $3,000). In 1979 A has an additional $2,000 of energy conservation expenditures and $3,000 of renewable energy source expenditures in connection with the same principal residence. A's residential energy credit for 1979 is $750, made up of $150 of qualified energy conservation expenditures (15 percent of the new maximum $1,000, which was reduced from $2,000 by $1,000 of energy conservation expenditures taken into account in 1978) plus $600 of qualified renewable energy source expenditures (20 percent of $3,000, which reflects the reduction of the maximum allowable expenditures by the $5,000 of renewable energy source expenditures taken into account in 1978). The maximum residential energy credit allowable to A with respect to the same principal residence in subsequent years in which the credit is allowable is $400 (20 percent of the new maximum of $2,000 for renewable energy source expenditures and none for energy conservation expenditures).

(3) *Effects of grants and subsidized energy financing*—(i) *In general.* Qualified expenditures financed with Federal, State, or local grants shall be taken into account for purposes of computing the residential energy credit only if the amount of such grants is taxable as gross income to the taxpayer under section 61 (relating to the definition of gross income) and the regulations

thereunder. In the case of taxable years beginning after December 31, 1980, qualified expenditures made from subsidized energy financing (as defined in § 1.23–2(i)) shall not be taken into account (except as provided in the following sentence) for purposes of computing the residential energy credit. In addition, the taxpayer must reduce the maximum amount allowable expenditures (reduced as provided in paragraph (d)(2) of this section) with respect to the dwelling unit in computing qualified energy conservation expenditures (under paragraph (b) of this section) or qualified renewable energy source expenditures (under paragraph (c) of this section), whichever is appropriate, by an amount equal to the sum of—

(A) The amount of expenditures from subsidized energy financing (as defined in § 1.23–2(i)) that were made by the taxpayer during the taxable year or any prior taxable year beginning after December 31, 1980, with respect to the same dwelling unit, and

(B) The amount of any funds received by the taxpayer during the taxable year or any prior taxable year beginning after December 31, 1980, as a Federal, State, or local government grant made in taxable years beginning after December 31, 1980, that were used to make qualified expenditures with respect to the same dwelling unit and that were not included in the gross income of the taxpayer.

(ii) *Example.* The provisions of this paragraph (d)(3) may be illustrated by the following example:

Example. A had in 1979 made a renewable energy source expenditure of $2,000 in connection with A's residence for which he took the then allowed credit of $600. In 1981 A made additional renewable energy source expenditures of $9,000 with respect to which he received a loan of $5,000 from the Federal Solar-Energy and Energy Conservation Bank. Assume that the loan is subsidized energy financing. A computes the credit as follows: The initial maximum allowable dollar limit is $10,000 which is reduced by the sum of the prior year expenditures of $2,000 and the subsidized energy financing loan of $5,000 leaving a dollar limit of $3,000 ($10,000 − ($2,000+$5,000)). The $5,000 portion of the $9,000 funded by the subsidized energy financing loan is not allowed as a renewable energy source expenditure. The remaining expenditures in 1981 are $4,000 ($9,000 − $5,000). However, this amount exceeds the allowed maximum dollar limit of $3,000. Therefore, A's creditable expenses for 1981 are only $3,000 on which the credit is $1,200 (40 percent of $3,000).

(4) *Tax liability limitation*—(i) *For taxable years beginning after December 31, 1983.* For taxable years beginning after December 31, 1983, the credit allowed by this section shall not exceed the amount of tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year, reduced by the sum of credits allowable under—

(A) Section 21 (relating to expenses for household and dependent care services necessary for gainful employment),

(B) Section 22 (relating to credit for the elderly and the permanently and totally disabled), and

(C) Section 24 (relating to contributions to candidates for public office).

See section 26 (b) and (c) for certain taxes that are not treated as imposed by chapter 1.

(ii) *For taxable years beginning before January 1, 1984.* For taxable years beginning before January 1, 1984, the credit allowed by this section shall not exceed the amount of the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year, reduced by the sum of the credits allowable under—

(A) Section 32 (relating to tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds),

(B) Section 33 (relating to the taxes of foreign countries and possessions of the United States),

(C) Section 37 (relating to retirement income),

(D) Section 38 (relating to investment in certain depreciable property),

(E) Section 40 (relating to expenses of work incentive programs),

(F) Section 41 (relating to contributions to candidates for public office),

(G) Section 42 (relating to the general tax credit),

(H) Section 44 (relating to purchase of new personal residence),

(I) Section 44A (relating to expenses for household and dependent care services), and

(J) Section 44B (relating to employment of certain new employees).

(e) *Carryforward of unused credit.* If the credit allowable by this section exceeds the tax liability limitation imposed by section 23(b)(5) (or former section 44C(b)(5)) and paragraph (d)(4) of this section, the excess credit shall be carried forward to the succeeding taxable year and added to the credit allowable under this section for the succeeding taxable year. A carryforward that is not used in the succeeding year because it exceeds the tax liability limitation shall be carried forward to later taxable years until used, except that no excess credit may be carried forward to any taxable year beginning after December 31, 1987.

[T.D. 7717, 45 FR 57715, Aug. 29, 1980. Redesignated and amended by T.D. 8146, 52 FR 26669, July 16, 1987]

§1.23–2 Definitions.

For purposes of section 23 or former section 44C and regulations thereunder—

(a) *Energy conservation expenditures*—(1) *In general.* The term ''energy conservation expenditure'' means an expenditure made on or after April 20, 1977, and before January 1, 1986, by a taxpayer for insulation or any other energy-conserving component, or for labor costs allocable to the original installation of such insulation or other component, if all of the following conditions are satisfied:

(i) The insulation (as defined in paragraph (c)) or other energy-conserving component (as defined in paragraph (d)) is installed in or on a dwelling unit that is used as the taxpayer's principal residence when the installation is completed. See §1.23–3(e) for the definition of principal residence.

(ii) The dwelling unit is located in the United States (as defined in section 7701(a)(9)).

(iii) The construction of the dwelling unit was substantially completed before April 20, 1977. See §1.23–3(f) for the definition of the terms ''construction'' and ''substantially completed''. In the case of expenditures made with respect to the enlargement of a dwelling unit, the construction of the enlargement must have been substantially completed before April 20, 1977.

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

Example 1. In 1978, A spent $500 for the purchase and installation of new storm windows to replace old storm windows, $100 to reinstall old storm windows, and $150 to transfer a A's house insulation which had been installed in A's garage. Only the $500 spent for new storm windows qualifies as an energy conservation expenditure. The $100 spent to reinstall storm windows and the $150 spent to transfer insulation to A's house do not qualify since the only installation costs that qualify are those for the original installation of energy conservation property the original use of which commences with the taxpayer.

Example 2. In June 1977, B purchased for B's principal residence a new house that was substantially completed before April 20, 1977. Pursuant to B's request the builder installed storm windows on May 1, 1977, the cost of this option being included in the purchase price of the house. The portion of the purchase price of the residence allocable to the storm windows constitutes an energy conservation expenditure. However, no other part of the purchase price may be allocated to energy conservation property (insulation and other energy conserving components) installed before April 20, 1977. To qualify as an energy conservation expenditure, an expenditure must be made (*i.e.*, installation of the energy conservation property must be completed) on or after April 20, 1977.

(b) *Renewable energy source expenditures.* The term ''renewable energy source expenditures'' means an expenditure made on or after April 20, 1977, and before January 1, 1986, by a taxpayer for renewable energy source property (as defined in paragraph (e)), or for labor costs properly allocable to the on-site preparation, assembly, or original installation such property, if both of the following conditions are satisfied:

(1) The renewable energy source property is installed in connection with a dwelling unit that is used as the taxpayer's principal residence when the installation is completed. See §1.23–3(e).

(2) The dwelling unit is located in the United States (as defined in section 7701(a)(9)).

Additionally, the term ''renewable energy source expenditures'' includes expenditures made after December 31, 1979, and before January 1, 1986, for an onsite well drilled for any geothermal deposit (as defined in paragraph (h)), or for labor costs properly allocable to onsite preparation, assembly, or original installation of such well, but only if the requirements of paragraphs (b) (1) and (2) of this section are met and the taxpayer has not elected under section 263(c) to deduct any portion of such expenditures or allocable labor costs.

Eligibility as a renewable energy source expenditure does not depend on the date of construction of the dwelling unit. Thus, such an expenditure may be made in connection with either a new or an existing dwelling unit. Renewable energy source expenditures need only be made in connection with a dwelling, rather than in or on a dwelling unit. For example, a solar collector that otherwise constitutes renewable energy source property is not ineligible merely because it is installed separately from the dwelling unit. The term ''renewable energy source expenditure'' does not include any expenditure allocable to a swimming pool even when used as an energy storage medium or to any other energy storage medium whose primary function is other than the storage of energy. It also does not include the cost of maintenance of an installed system or the cost of leasing renewable energy source property.

(c) *Insulation.* The term ''insulation'' means any item that satisfies all of the following conditions:

(1) The item is specifically and primarily designed to reduce, when installed in or on a dwelling or on a water heater, the heat loss or gain of such dwelling or water heater. To qualify as insulation the item must be installed between a conditioned area and a nonconditioned area (except when installed on a water heater, water pipe, or heating/cooling duct). Thus for example, awnings do not qualify as insulation. For purposes of this section the term ''conditioned area'' means an area that has been heated or cooled by conventional or renewable energy source means. Insulation includes materials made of fiberglass, rock wool, cellulose, urea based foam, urethane, vermiculite, perlite, polystyrene, and extruded polystyrene foam.

(2) The original use of the item begins with the taxpayer.

(3) The item can reasonably be expected to remain in operation at least 3 years.

(4) The item meets the applicable performance and quality standards prescribed in § 1.23–4 (if any) that are in effect at the time the taxpayer acquires the item. The term ''insulation'' shall not include items whose primary purpose is not insulation (e.g., whose function is primarily structural, decorative, or safety-related). For example, carpeting, drapes (including linings), shades, wood paneling, fireplace screens (including those made of glass), new or replacement walls (except for qualifying insulation therein) and exterior siding do not qualify although they may have been designed in part to have an insulating effect.

(d) *Other energy-conserving components.* The term ''other energy-conserving component'' means any item (other than insulation) that satisfies all of the following conditions:

(1) The original use of the item begins with the taxpayer.

(2) The item can reasonably be expected to remain in operation for at least 3 years.

(3) The item meets the applicable performance and quality standards prescribed in § 1.23–4 (if any) that are in effect at the time of the taxpayer's acquisition of the item.

(4) The item is one of the following items:

(i) *A furnace replacement burner.* The term ''furnace replacement burner'' means a device (for oil and gas-fired furnaces or boilers) that is designed to achieve a reduction in the amount of fuel consumed as a result of increased combustion efficiency. The burner must replace an existing burner. It does not qualify if it is acquired as a component of, or for use in, a new furnace or boiler.

(ii) *A device for modifying flue openings.* The term ''device for modifying flue openings'' means an automatically operated damper that—

(A) Is designed for installation in the flue, between the barometric damper or draft hood and the chimney, of a furnace; and

(B) Conserves energy by substantially reducing the flow of conditioned air through the chimney when the furnace is not in operation. Conditioned air is air that has been heated or cooled by conventional or renewable energy source means.

(iii) *A furnace ignition system.* The term ‘‘furnace ignition system’’ means an electrical or mechanical device, designed for installation in a gas-fired furnace or boiler that automatically ignites the gas burner. In order to qualify, the device must replace a gas pilot light. Furthermore, it does not qualify if it is acquired as a component of, or for use in, a new furnace or boiler.

(iv) *A storm or thermal window or door.* The terms ‘‘storm or thermal window’’ and ‘‘storm or thermal door’’ mean the following:

(A)(*1*) A window placed outside or inside an ordinary or prime window, creating an insulating air space.

(*2*) A window with enhanced resistance to heat flow through the glazed area by multi-glazing.

(*3*) A window that consists of glass or other glazing materials that have exceptional heat-absorbing or heat-reflecting properties. For purposes of this subdivision (iv), the term ‘‘glazing material’’ does not include films and coatings applied on the surface of a window.

(B)(*1*) A second door, installed outside or inside a prime exterior door, creating an insulating air space.

(*2*) A door with enhanced resistance to heat flow through the glazed area by multi-glazing.

(*3*) A prime exterior door that has an R-value (a measurement of the ability of insulation to resist the flow of heat) of at least 2 throughout.

For purposes of this subdivision, ‘‘multi-glazing’’ is an arrangement in which two or more sheets of glazing material are affixed in a window or door frame to create one or more insulating air spaces. Multi-glazing can be achieved by installing a preassembled, sealed insulating glass unit or by affixing one or more additional sheets of glazing onto an existing window (or sash) or door. For purposes of this subdivision, a storm or thermal window or door does not include any film applied on or over the surface of a window or door.

(v) *Automatic energy-saving setback thermostat.* The term ‘‘automatic energy-saving setback thermostat’’ means a device that is designed to reduce energy consumption by regulating the demand on the heating or cooling system in which it is installed, and uses—

(A) A temperature control device for interior spaces incorporating more than one temperature control level, and

(B) A clock or other automatic mechanism for switching from one control level to another.

(vi) *Caulking and weatherstripping.* The term ‘‘caulking’’ means pliable materials used to fill small gaps at fixed joints on buildings to reduce the passage of air and moisture. Caulking includes, but is not limited to, materials commonly known as ‘‘sealants’’, ‘‘putty’’, and ‘‘glazing compounds’’. The term ‘‘weatherstripping’’ means narrow strips of material placed over or in movable joints of windows and doors to reduce the passage of air and moisture.

(vii) *Energy usage display meter.* The term ‘‘energy usage display meter’’ means a device the sole purpose of which is to display the cost (in money) of energy usage in the dwelling. It may show cost information for electricity usage, gas usage, oil usage, or any combination thereof. The device may measure energy usage of the whole dwelling, or individual appliances or systems on an instantaneous or cumulative basis.

(viii) *Components specified by the Secretary.* The Secretary (or his delegate) may, in his discretion, after consultation with the Secretary of Energy and the Secretary of Housing and Urban Development (or their delegates), and any other appropriate Federal officers, specify by regulation other energy-conserving components for addition to the list of qualified items. See § 1.23–6 for the procedures and criteria to be used in determining whether an item will be considered for addition to the list of qualified items by the Secretary.

The term ‘‘other energy-conserving component’’ is limited to items in a category specifically listed in section 44(c)(4)(A) (i) through (vii) or added by the Secretary.

(e) *Renewable energy source property*—(1) *In general.* The term ''renewable energy source property'' includes any solar energy property, wind energy property, geothermal energy property, or property referred to in subparagraph (2), which meets the following conditions:

(i) The original use of the property begins with the taxpayer.

(ii) The property can reasonably be expected to remain in operation for at least 5 years.

(iii) The property meets the applicable performance and quality standards prescribed in § 1.23–4 (if any) that are in effect at the time of the taxpayer's acquisition of the property.

Renewable energy source property does not include heating or cooling systems, nor systems to provide hot water or electricity, which serve to supplement renewable energy source equipment in heating, cooling, or providing hot water or electricity to a dwelling unit, and which employ a form of energy (such as oil or gas) other than solar, wind, or geothermal energy (or other forms of renewable energy provided in paragraph (e)(2) of this section. Thus, heat pumps or oil or gas furnaces, used in connection with renewable energy source property, are not eligible for the credit. In order to be eligible for the credit for renewable energy source property, the property (as well as labor costs properly allocable to onsite preparation, assembly or installation of equipment) must be clearly identifiable. See § 1.23–3(l) for recordkeeping rules.

(2) *Renewable energy source specified by the Secretary.* In addition to solar, wind, and geothermal energy property, renewable energy source property includes property that transmits or uses another renewable energy source that the Secretary (or his delegate) specifies by regulations, after consultation with the Secretary of Energy and the Secretary of Housing and Urban Development (or their delegates), and any other appropriate Federal officers, to be of a kind that is appropriate for the purpose of heating or cooling the dwelling or providing hot water or (in the case of expenditures made after December 31, 1979) electricity for use within the dwelling. For purposes of this section, references to the transmission or use of energy include its collection and storage. See § 1.23–6 for the procedures and criteria to be used in determining when another energy source will be considered for addition to the list of qualified renewable energy sources.

(f) *Solar energy property*—(1) *In general.* The term ''solar energy property'' means equipment and materials of a solar energy system as defined in this paragraph (and parts solely related to the functioning of such equipment) which, when installed in connection with a dwelling, transmits or uses solar energy to heat or cool the dwelling or to provide hot water or (in the case of expenditures made after December 31, 1979) electricity for use within the dwelling. For this purpose, solar energy is energy derived directly from sunlight (solar radiation). Property which uses, as an energy source, fuel or energy which is indirectly derived from sunlight (solar radiation), such as fossil fuel or wood or heat in underground water, is not considered solar energy property. Materials and components of ''passive solar systems'' as well as ''active solar systems'', or a combination of both types of systems may qualify as solar energy property.

(2) *Active solar system.* An active solar system is based on the use of mechanically forced energy transfer, such as the use of fans or pumps to circulate solar generated energy, or thermal energy transfer, such as systems utilizing thermal siphon principles. Generally, this is accomplished through the use of equipment such as collectors (to absorb sunlight and create hot liquids or air), storage tanks (to store hot liquids), rockbeds (to store hot air), thermostats (to activate pumps or fans which circulate the hot liquids or air), and heat exchangers (to utilize hot liquids or air to heat air or water).

(3) *Passive solar system.* A passive solar system is based on the use of conductive, convective, or radiant energy transfer. In order to qualify as a passive solar system, a solar system used for heating purposes must contain all of the following: a solar collection area, an absorber, a storage mass, a heat distribution method, and heat regulation devices. The term ''solar collection area'' means an expanse of

transparent or translucent material, such as glass which is positioned in such a manner that the rays of the sun directly strike an absorber. The term ‘‘absorber’’ means a surface, such as a floor, that is exposed to the rays of the sun admitted through the solar collection area, which converts solar radiation into heat, and then transfers the heat to a storage mass. The term ‘‘storage mass’’ means material, such as masonry, that receives and holds heat from the absorber and later releases the heat to the interior of the dwelling. The storage mass must be of sufficient volume, depth, and thermal energy capacity to store and deliver adequate amounts of solar heat for the relative size of the dwelling. In addition, the storage mass must be located so that it is capable of distributing the stored heat directly to the habitable areas of the dwelling through a heat distribution method. The term ‘‘heat distribution method’’ means the release of radiant heating from the storage mass within the habitable areas of the dwelling, or convective heating from the storage mass through airflow paths provided by openings or by ducts in the storage mass, to habitable areas of the dwelling. The term ‘‘heat regulations devices’’ means shading or venting mechanisms (such as awnings or insulated drapes) to control the amount of solar heat admitted through the solar collection areas and nighttime insulation or its equivalent to control the amount of heat permitted to escape from the interior of the dwelling.

(4) *Components with dual function.* To the extent that a passive or active solar system utilizes portions of the structure of a residence, only the materials and components whose sole purpose is to transmit or use solar radiation (and labor costs associated with installing such materials and components) are included within the term ‘‘solar energy property’’. Accordingly, materials and components that serve a dual purpose, *e.g.,* they have a significant structural function or are structural components of the dwelling (and labor costs associated with installing such materials and components) are not included within the term ‘‘solar energy property’’. For example, roof ponds that form part of a roof (including additional structural components to support the roof), windows (including clerestories and skylights), and greenhouses do not qualify as solar energy property. However, with respect to expenditures made after December 31, 1979, a solar collector panel installed as a roof or portion thereof (including additional structural components to support the roof attributable to the collector) does not fail to qualify as solar energy property solely because it constitutes a structural component of the dwelling on which it is installed. For this purpose, the term ‘‘solar collector panel’’ does not include a skylight or other type of window. In the case of a trombe wall (a south facing wall composed of a mass wall and exterior glazing), the mass wall (and labor costs associated with installing the mass wall) will not qualify. However, the exterior (non-window) glazing will qualify. Any shading, venting and heat distribution mechanisms or storage systems that do not have a dual function will also qualify.

(g) *Wind energy property.* The term ‘‘wind energy property’’ means equipment (and parts solely related to the functioning of such equipment) which, when installed in connection with a dwelling, transmits or uses wind energy to produce energy in a useful form for personal residential purposes. Examples of equipment using wind energy to produce energy in a useful form are windmills, wind-driven generators, power conditioning and storage devices that use wind to generate electricity or mechanical forms of energy. Devices that use wind merely to ventilate do not qualify as wind energy property.

(h) *Geothermal energy property.* The term ‘‘geothermal energy property’’ means equipment (and parts solely related to the functioning of such equipment) necessary to transmit or use energy from a geothermal deposit to heat or cool a dwelling or provide hot water for use within the dwelling. With respect to expenditures made after December 31, 1979, the term ‘‘geothermal energy property’’ also means equipment (and parts solely related to the functioning of such equipment) necessary to transmit or use energy from a geothermal deposit to produce electricity for use within the dwelling.

Equipment such as a pipe that serves both a geothermal function (by transmitting hot geothermal water within a dwelling) and a non-geothermal function (by transmitting hot water from a water heater within a dwelling) does not qualify as geothermal property. A geothermal deposit is a geothermal reservoir consisting of natural heat which is from an underground source and is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure), having a temperature exceeding 50 degrees Celsius as measured at the wellhead or, in the case of a natural hot spring (where no well is drilled), at the intake to the distribution system.

(i) *Subsidized energy financing*—(1) *In general.* The term ''subsidized energy financing'' means financing (*e.g.*, a loan) made directly or indirectly (such as in association with, or through the facilities of, a bank or other lender) during a taxable year beginning after December 31, 1980, under a Federal, State, or local program, a principal purpose of which is to provide subsidized financing for projects designed to conserve or produce energy. For purposes of this paragraph (i), financing is made when funds that constitute subsidized energy financing are disbursed. Subsidized energy financing includes financing under a Federal, State, or local program having two or more principal purposes (provided that at least one of the principal purposes is to provide subsidized financing for projects designed to conserve or produce energy), but only to the extent that the financing—

(i) Is to be used for energy production or conservation purposes, or

(ii) Is provided out of funds designated specifically for energy production or conservation.

Loan proceeds meet the use test of paragraph (i)(l)(i) of this section only to the extent that the loan application, the loan instrument, or any other loan-related documents indicate that the funds are intended for such use. However, loan proceeds designated for the purchase either of property that contains ''insulation'' or any ''other energy-conserving component'' or of ''renewable energy source property'' as defined in paragraphs (c), (d), and (e), respectively, of this section meet the test of paragraph (i)(l)(i) of this section. Financing is subsidized if the interest rate or other terms of the financing (including any special tax treatment) provided to the taxpayer in connection with the program or used to raise funds for the program are more favorable than the terms generally available commercially. In addition, financing is subsidized if the principal obligation of the financing provided to the taxpayer is reduced by funds provided under the program. The source from which the funds for the program are derived is not a factor to be taken into account in determining whether the financing is subsidized. If a public utility disburses funds for the financing of energy conservation or renewable energy source property under a program that obtains the funds through sales to the utility's ratepayers, the program is not considered to be a Federal, State or local program even though the utility is a governmental agency, and, thus, the funds are not subsidized energy financing. Subsidized energy financing does not include a grant includible in gross income under section 61, non-taxable grants, a credit against State or local taxes made directly to the taxpayer claiming the credit provided for in section 23, or a loan guarantee made directly to the taxpayer claiming the credit provided for in section 23.

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

Example 1. State A has a farm and home loan program. The program is used to provide low interest mortgage loans. In 1984 State A's legislature enacted statutory amendments to its farm and home loan program in an effort to encourage energy conservation-type measures. Low interest loans for such improvements were made available to qualified purchasers and owners under the farm and home loan program. The energy conservation measures subsidized by the program include energy conserving components and renewable energy source devices. State A's tax exempt bonds are the source of funds for loans under the program. Although the 1984 legislation authorizing loans for energy conserving components and renewable energy source improvements did not diminish the original purpose of the farm and home loan program, the 1984 legislation added another principal purpose to the program. Therefore, State A's program which has two principal purposes, one of which is the conservation or production of energy, is considered as providing subsidized energy financing for purposes of section 23 (c)(10) of the Code, to the extent that financing is provided by State A out of funds designated specifically for energy production or conservation. State A's program will also be considered as providing subsidized energy financing to the extent that the loan proceeds are to be used for energy production or conservation purposes. Loan proceeds meet the use test of the preceding sentence only to the extent that loan application, the loan instruments, or any other loan-related documents indicate that the funds are intended for such use.

Example 2. The United States Department of Energy disburses funds to State B that the Department received from settlements from alleged petroleum pricing and allocation violations. State B establishes a program under which B will use the funds to make loans at below market interest rates directly to qualified applicants for the purchase of renewable energy source property. B's loans are subsidized energy financing.

Example 3. State C establishes a program under which C will make loans at below market interest rates directly to qualified applicants for the purchases of renewable energy source property. The program is funded with money that State C was able to borrow after it obtained a loan guarantee from a Federal agency. C's loans provided under the program are subsidized energy financing.

Example 4. Company D is an electric utility that is a Federal agency. D purchases its electricity from another federal agency, transmits the electricity over its own distribution system, and sells the electricity to numerous local public utilities that in turn sell the electricity to their customers. D wishes to start a program under which D will make loans at below market interest rates directly to customers of the local utilities for the purchase of renewable energy source property from D. The local public utility will act as the collection agent for repayment of the loans. The loans will be repayable over a period of time not in excess of 15 years. Under law, D must cover its full costs through its own revenues derived from the sale of power and other services. While D may borrow by sale of bonds to the United States Treasury, D must borrow at rates comparable to the rates prevailing in the market for similar bonds. Thus, the subsidized loans made under D's program will be financed by the profits from the sale of electricity to consumers and not by the federal government. D's program, which is substantially the same as that carried out by private (investor-owned) utilities, is not considered to be a Federal, State or local governmental program. Therefore, D's loans are not subsidized energy financing.

Example 5. The Solar Energy and Energy Conservation Bank (Bank) disburses funds to State E. E disburses a portion of the funds to Financial Institution F. Both the Bank and State E make these disbursements under a program the principal purpose of which is to provide subsidized financing for projects designed to conserve or produce energy. F uses the funds to reduce a portion of the principal obligation on loans it issues to finance energy conservation or solar energy expenditures. Taxpayer G borrows $3,000 from F in order to purchase a solar water heating system. F uses $500 of the funds it received from the Bank to reduce the principal obligation of the loan to G to $2,500. The amount of subsidized energy financing to G is $3,000.

Example 6. State H allows a tax credit to Financial Institution J under a program the principal purpose of which is to provide loans at below market interest rates directly to qualified applicants for the purchase of renewable energy source property. J receives a credit each year in the amount of the excess of the interest that would have been paid at private market rates over the actual interest paid on such loans. The State H tax credit arrangement is an interest subsidy. Thus, any low-interest loans made pursuant to this credit arrangement are subsidized energy financing.

[T.D. 7717, 45 FR 57716, Aug. 29, 1980. Redesignated and amended by T.D. 8146, 52 FR 26670, July 16, 1987]

§1.23–3 Special rules.

(a) *When expenditures are treated as made*—(1) *Timeliness of an expenditure for the energy credit.* In general, for the purpose of determining whether an expenditure qualifies as being timely for the residential energy credit under section 23 or former section 44C (*i.e.*, is made after April 19, 1977, and before January 1, 1986), the expenditure is treated as made when original installation of the item is completed. Thus, solely for that purpose, the time of payment or accrual is irrelevant.

(2) *Special rule for renewable energy source expenditures in the case of construction or reconstruction of a dwelling.* In the case of renewable energy source expenditures in connection with the construction or reconstruction of a dwelling that becomes the taxpayer's new principal residence, the expenditures are to be treated as made (for the purpose of determining the timeliness of an expenditure for the residential

energy credit) when the taxpayer commences use of the dwelling as his or her principal residence following its construction or reconstruction. The term ''reconstruction'' means the replacement of most of a dwelling's major structural components such as floors, walls, and ceiling. When a taxpayer reoccupies a reconstructed dwelling that was the taxpayer's principal residence prior to reconstruction, a renewable energy source expenditure is considered made when the original installation of the renewable energy source property is completed.

(3) *Taxable year in which credit is allowable.* For the purpose of determining the taxable year in which the credit for an expenditure is allowable (once it has qualified as timely under subparagraph (1) or (2)), an expenditure is treated as made on the later of (i) the date on which it qualifies as timely; or (ii) the date on which it is paid or incurred by the taxpayer.

(b) *Expenditures in 1977.* No credit under section 23 or former section 44C shall be allowed for any taxable year beginning before 1978. However, the amount of any credit under section 23 or former section 44C for the taxpayer's first taxable year beginning after December 31, 1977, shall take into account qualified energy conservation expenditures and qualified renewable energy source expenditures made during the period beginning April 20, 1977, and ending on the last day of such first taxable year.

(c) *Cross reference.* For rules relating to expenditures financed with Federal, State, or local government grants or subsidized financing see paragraph (d)(3) of § 1.23–1 and paragraph (i) of § 1.23–2.

(d) *Expenditures qualifying both as energy conservation expenditures and renewable source expenditures.* In the case of an expenditure which meets both the definition of an energy conservation expenditure (as defined in § 1.23–2(a)) and a renewable energy source expenditure (as defined in § 1.23–2(b)), the taxpayer may claim either a credit under § 1.23–1(b) (relating to qualified energy conservation expenditures) or § 1.23–1(c) (relating to qualified renewable energy source expenditures) but may not claim both credits with respect to the same expenditure.

(e) *Principal residence.* For purposes of section 23 or former section 44C the determination of whether a dwelling unit is the taxpayer's principal residence shall be made under principles similar to those applicable to section 1034 and the regulations thereunder (relating to sale or exchange of a principal residence) except that ownership of the dwelling unit is not required. In making this determination, the period for which a dwelling is treated as a taxpayer's principal residence includes the 30-day period ending on the first day on which the dwelling unit would (but for this sentence) be treated as being used as the taxpayer's principal residence under principles similar to those applicable to section 1034. Thus, installation that are completed within that 30-day period may be eligible for the credit although, in the absence of the 30-day rule, the date of habitation of the dwelling unit by the taxpayer would mark the beginning of the taxpayer's use of the unit as a principal residence.

(f) *Construction substantially completed.* Construction of a dwelling unit is substantially completed when construction has progressed to the point where the unit could be put to use as a personal residence, even though comparatively minor items remain to be finished or performed in order to conform to the plans or specifications of the completed building. For this purpose, construction includes reconstruction as defined in paragraph (a)(2). This rule may be illustrated by the following example:

Example. On January 1, 1979, A purchases a dwelling that is to become A's principal residence. The dwelling unit was originally constructed in 1950. A spends $50,000 to reconstruct the dwelling by replacing most of the dwelling's major structural components such as floors, walls, and ceilings. Included in the cost is $3,000 attributable to energy-conserving components. Reconstruction is substantially completed on April 1, 1979, and A moves into the reconstructed residence on May 1, 1979. Since construction includes reconstruction, A's reconstructed residence is not considered substantially completed before April 20, 1977. Thus, amounts spent with respect to A's reconstructed residence for energy-conserving components do not qualify as energy conservation expenditures.

(g) *Residential use of property.* To be eligible for the residential energy credit, expenditures must be made for personal residential purposes. If at least 80 percent of the use of a component or item of property is for personal residential purposes, the entire amount of the energy conservation expenditure or the renewable energy source expenditure is taken into account in computing the credit under this section. If less than 80 percent of the use of a component or item of property is for personal residential purposes, the amount of an expenditure taken into account is the amount that bears the same ratio to the amount of the expenditure as the amount of personal residential use of the component or item bears to its total use. For purposes of this paragraph, use of a component or an item of property with respect to a swimming pool is not a use for a personal residential purpose. The rules with respect to residential use of property are illustrated by the following examples:

Example 1. In 1978 A makes an expenditure of $3,000 for the installation of storm windows of which 50 percent is on the portion of A's dwelling used as the principal family residence and 50 percent is on the portion of the dwelling used as an office. A has made no other energy conservation expenditures for the residence. The allowable energy conservation expenditure is $1,500 (50 percent of $3,000), the portion attributable to residential use. Therefore, the residential energy credit is $225 (the qualified conservation expenditure of 15 percent of $1.500).

Example 2. During 1979, B makes $10,000 of renewable energy source expenditures on solar energy property for B's principal residence. Approximately 60 percent of the use of the solar energy property will be for heating B's swimming pool; the other 40 percent will be for heating the dwelling unit. B had not previously made renewable energy source expenditures with respect to the residence. Since use for a swimming pool is not considered a residential use, less than 80 percent of the use of B's solar energy property is considered used for personal residential purposes. Therefore, only $4,000 (40 percent of $10,000), the proportionate part of B's expenditures representing personal residential use, is treated as a renewable energy source expenditure. B is allowed a $1,000 residential energy credit (30 percent of $2,000 plus 20 percent of $2,000) for 1979.

(h) *Joint occupancy*—(1) *In general.* If two or more individuals jointly occupied and used a dwelling unit as their principal residence during any portion of a calendar year—

(i) The amount of the credit allowable under section 23 or former section 44C by reason of energy conservation expenditures or by reason of renewable energy source expenditures shall be determined by treating all of the joint occupants as one taxpayer whose taxable year is such calendar year; and

(ii) The credit under section 23 or former section 44C allowable to each joint occupant for the taxable year with which or in which such calendar year ends shall be an amount which bears the same ratio to the amount determined under paragraph (h)(1)(i) of this section as the amount of energy conservation expenditures or renewable energy source expenditures made by that occupant bears to the total amount of each type of such expenditures made by all joint occupants during such calendar year.

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

Example. A, a calendar year taxpayer, and B, a June 1 fiscal year taxpayer, make energy conservation exenditures of $2,000 (A making expenditures of $500 and B making expenditures of $1,500) on their principal and jointly occupied residence in 1978. A and B have not previously make energy conservation expenditures with respect to this residence. Of the $300 credit (15 percent of $2,000), $75 will be allocated to A ($500/$2,000×$300) and $225 to B ($1,500/$2,000×300). A will claim the allocable share of the credit on A's 1978 tax return and B will claim the allocable share of the credit on B's tax return for the fiscal year ending May 31, 1979.

(2) *Minimum credit.* The fact that one joint occupant may be unable to claim all or part of the credit under section 23 of former section 44C because of insufficient tax liability or because that occupant's allowable credit does not exceed the $10 minimum credit (as set forth in paragraph (d)(1) of §1.23–1) shall have no effect upon the computation of the amount of the allowable credits for the other joint occupants.

(3) *Prior expenditures.* Because joint occupants are treated as one taxpayer for purposes of determining the residential energy credit, the maximum

amount of energy conservation expenditures or renewable energy source expenditures must be reduced by the total amount of such expenditures made in connection with the dwelling unit during prior calendar years in which any one of the residents of the unit during the current calendar year was a resident (whether made by the current resident or by an individual previously occupying the dwelling with the current resident). However, the preceding sentence shall not apply to prior expenditures no part of which was taken into account in computing the credits under section 23 of former section 44C for such years. Prior years' expenditures are not to be allocated among joint occupants to take into account the specific expenditures of each of the occupants in prior years.

(4) The rules of this paragraph may be illustrated by the following examples:

Example 1. Assume A and B have together made prior years' energy conservation expenditures of $1,600 (A having made $1,200 of expenditures and B having made $400) on their principal and jointly occupied residence. In the current year, each makes energy conservation expenditures of $300 with respect to the same residence. The maximum qualified expenditure with respect to the residence is reduced by the $1,600 of prior expenditures made by A and B. Therefore, only $400 of the $600 current expenditures are eligible as energy conservation expenditures. The resulting residential energy credit is $60 (15 percent of $400) of which $30 apiece will be allocated to A and B ($300/$600 × $60). The fact that A had previously computed the credit in prior years with respect to $1,200 of the total $1,600 of expenditures is irrelevant to the apportionment of the credit in the current year.

Example 2. In 1978, spouses C and D make $10,000 of renewable energy source expenditures with respect to their principal residence, half of which is paid by each spouse. No prior renewable energy source expenditures have been taken into account with respect to that residence by either C or D. C and D file separate returns for the calendar year. Under the joint occupancy rule, the maximum allowable renewable energy source credit with respect to C and D's principal residence is $2,200 (30 percent of the first $2,000, and 20 percent of the next $8,000 of expenditures). Half of this amount or $1,100, will be allowed to each spouse. If either spouse makes renewable energy source expenditures with respect to the same principal residence in future years, none of those expenditures would be qualified renewable energy source expenditures for which a credit can be claimed. That is, not more than $2,200 may be taken in the aggregate by C and D as a renewable energy source credit with respect to their principal residence.

Example 3. In 1978, E and F make energy conservation expenditures of $1,500 on their principal and jointly occupied residence. In 1979, E moves away and G becomes the other joint occupant of the residence. F and G make energy conservation expenditures of $1,000 in 1979. In 1980 F moves away and H moves in with G. G and H make energy conservation expenditures of $500. The maximum qualified expenditure made by F and G with respect to the residence is reduced by the $1,500 of prior expenditures made in 1978 by E and F. The maximum qualified expenditures made by G and H with respect to the residence is reduced only by the expenditures in prior years in connection with the residence during which either G or H was a joint occupant. Accordingly, the maximum qualified expenditures made by G and H with respect to the residence is reduced only by the $1,000 of prior expenditures made in 1979 by F and G.

(i) *Condominiums and cooperative housing corporations.* An individual who is a tenant stockholder in a cooperative housing corporation (as defined in section 216) or who is a member of a condominium management association with respect to a condominium which he or she owns shall be treated as having made a proportionate share of the energy conservation expenditures or renewable energy source expenditures of such corporation or association. The cooperative stockholder's allocable share of the expenditures is to be the same as his or her proportionate share of the cooperative's total outstanding stock (including any stock held by the corporation). However, in the case where only certain cooperative stockholders are assessed for the expenditures made by the cooperative housing corporation, only those cooperative stockholders that are assessed shall be treated as having made a share of the expenditures of such corporation. In such case, the cooperative stockholder's share of the expenditures is the amount that the stockholder is assessed. The allocable share of a condominium management association member's energy conservation of renewable energy source expenditures is the amount that the member is assessed (or would be assessed in the case where expenditures are from general funds) by the association as a result of such expenditures. The residential energy credit for a qualified expenditure is allowable for the year in which the association or corporation has completed original installation of the item (or has paid or incurred the expenditure, if later). For purposes of this paragraph, the term ‘‘condominium management association’’ means an organization meeting the requirements of section 528(c)(1) of the Code (other than subparagraph (E) of that section), with respect to a condominium project substantially all the units of which are used as residences.

(j) *Joint ownership of energy conservation property or renewable energy source property*—(1) *In general.* Energy conservation property renewable energy source property include property which is jointly owned by the taxpayer and another person (or persons) and installed in connection with two or more dwelling units. For example, the fact that a windmill, solar collector, or geothermal well and distribution system is owned by two or more individuals does not preclude its qualification as renewable energy source property. The amount of the credit allowable under section 23 shall be computed separately with respect to the amount of the expenditures made by each individual, subject to the limitations of $2,000 imposed by section 23(b)(1) and $10,000 imposed by section 23(b)(2), per dwelling units of jointly owned property. For example, in 1982, A, B, and C purchased as joint owners renewable energy source property that serviced two houses. One of the houses is jointly owned and occupied by A and B and the other is owned and occupied by C alone. The renewable energy source property cost $30,000 of which A paid $9,000, B paid $6,000, and C paid $15,000. A and B must share the $4,000 credit (40% of $10,000 maximum) with respect to the expenditures for the jointly owned house. Therefore, A is allowed a $2,400 credit ($4,000 times $9,000 divided by $9,000 plus $6,000) and B is allowed a $1,600 credit ($4,000 times $6,000 divided by $9,000 plus $6,000) with respect to the expenditures attributable to the jointly owned house. C is entitled to a credit of $4,000 with respect to the expenditures attributable to the other house.

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

Example. A, B, and C each has a separate principal residence. They agree to finance jointly the construction of a solar collector, each providing one-third of the costs and taking one-third of the output of the collector. Each will separately pay for the costs of connecting the solar collector with his or her principal residence. Provided the solar collector and connection equipment otherwise qualify as renewable energy source property, A, B, and C will each be considered to have made renewable energy source expenditures equal to one-third of the cost of the collector plus his or her separate connection costs. Such expenditures will be subject to the limitations and other rules separately applicable to A, B, and C with respect to each principal residence, such as those with respect to the $10 minimum (§1.23–1(d)(1)), prior expenditures (§1.23–1(d)(2)), residential use (paragraph (g) of this section), and joint occupancy (paragraph (h) of this section).

(k) *Basic adjustments.* If a credit is allowed under section 23 or former section 44C for any expenditure with respect to any property, the increase in the basis of that property which would (but for this paragraph) result from such expenditure shall be reduced by the amount of the credit allowed.

(l) *Recordkeeping*—(1) *In general.* No residential energy credit is allowable unless the taxpayer maintains the records described in paragraph (l)(2) of this section. The records shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(2) *Records.* The taxpayer must maintain records that clearly identify the energy-conserving components and renewable energy source property with respect to which a residential energy credit is claimed, and substantiate their cost to the taxpayer, any labor costs properly allocable to them paid for by the taxpayer, and the method used for allocating such labor costs.

[T.D. 7717, 45 FR 57719, Aug. 29, 1980. Redesignated and amended by T.D. 8146, 52 FR 26672, July 16, 1987]

§ 1.23–4 Performance and quality standards. [Reserved]

[T.D. 7717, 45 FR 57721, Aug. 29, 1980. Redesignated by T.D. 8146, 52 FR 26672, July 16, 1987]

§ 1.23–5 Certification procedures.

(a) *Certification that an item meets the definition of an energy-conserving component or renewable energy source property.* Upon the request of a manufacturer of an item pursuant to paragraph (b) of this section which is supported by proof that the item is entitled to be certified, the Assistant Commissioner (Technical) shall certify (or shall notify the manufacturer that the request is denied) that:

(1) The item meets the definition of insulation (see § 1.23–2(c)(1)).

(2) The item meets the definition of an other energy-conserving component specified in section 23(c)(4) or former section 44C(c)(4) see (§ 1.23–2(d)(4)).

(3) The item meets the definition of solar energy property (see § 1.23–2(f)), wind energy property (see § 1.23–2(g)), or geothermal energy property (see § 1.23–2(h)).

(4) The item meets the definition of a category of energy-conserving component that has been added to the list of approved items pursuant to paragraph (d)(4)(viii) of § 1.23–2.

(5) The item meets the definition of renewable energy source property that transmits or uses a renewable energy source that has been added to the list of approved renewable energy sources pursuant to paragraph (e)(2) of § 1.23–2.

(b) *Procedure*—(1) *In general.* A manufacturer of an item desiring to apply under paragraph (a) shall submit the application to the Commissioner of Internal Revenue, Attention: Associate Chief Counsel (Technical), CC:C:E, 1111 Constitution Avenue NW., Washington, DC 20224. Upon being advised by the National Office, orally or in writing, that an adverse decision is contemplated a manufacturer may request a conference. The conference must be held within 21 calendar days from the date of that advice. Procedures for requesting an extension of the 21-day period and notifying the manufacturer of the Service's decision on that request are the same as those applicable to conferences on ruling requests by taxpayers (see section 9.05 of Rev. Proc. 80–20).

(2) *Contents of application.* The application shall include a description of the item (including appropriate design drawings and specifications) and an explanation of the purpose and function of the item. There shall accompany the application a declaration in the following form: ''Under penalties of perjury, I declare that I have examined this application, including accompanying documents and, to the best of my knowledge and belief, the facts presented in support of the application are true, correct, and complete.'' The statement must be signed by the person or persons making the application.

(c) *Effect of certification under paragraph (a).* Certifications granted under paragraph (a)(1), (2), or (3) will be applied retroactively to April 20, 1977. However, certifications granted under paragraph (a) (4) or (5) will be applied retroactively only to the date the applicable energy-conserving component or renewable energy source was added by Treasury decision to the list of qualifying components or sources. Certification of an item under this section means that the applicable definitional requirement of § 1.23–2 is considered satisfied in the case of any person claiming a residential energy credit with respect to such item. However, it does not relieve manufacturers of the need to establish that their items conform to performance and quality standards (if any) provided under § 1.23–4 and that their items can reasonably be expected to remain in operation at least 3 years, in the case of insulation and other energy-conserving components, or at least 5 years, in the case of renewable energy source property.

[T.D. 7717, 45 FR 57721, Aug. 29, 1980. Redesignated and amended by T.D. 8146, 52 FR 26672, July 16, 1987]

§ 1.23–6 Procedure and criteria for additions to the approved list of energy-conserving components or renewable energy sources.

(a) *Procedures for additions to the list of energy-conserving components or renewable energy sources*—(1) *In general.* A manufacturer of an item (or a group of manufacturers) desiring to apply for addition to the approved list of energy-conserving components or renewable energy sources pursuant to paragraph (d)(4)(viii) or (e)(2) of §1.23–2 shall submit an application to the Internal Revenue Service, Attention: Associate Chief Counsel (Technical), CC:C:E, 1111 Constitution Avenue, NW., Washington, DC 20224. The term ''manufacturer'' includes a person who assembles an item or a system from components manufactured by other persons. The application shall provide the information required under paragraph (b) of this section. An application may request that more than one item be added to the approved list. It will be the responsibility of the Office of the Associate Chief Counsel (Technical) upon receipt of the application to determine whether all the information required under paragraph (b) of this section has been furnished with the application. If an application lacks essential information, the applicant will be advised of the additional information required. If the information (or a reasonable explanation of the reason why the information cannot be made available) is not forthcoming within 30 days of the date of that advice, the application will be closed and the applicant will be so informed. Any resubmission of information beyond the 30-day period will be treated as a new application. If the Office of the Associate Chief Counsel (Technical) already is considering an application with respect to the same or a similar item, it may consolidate applications. The Office of the Associate Chief Counsel will make a report and recommendation to the ad hoc advisory board as to whether each item that is the subject to an application should be added in accordance with the manufacturer's request to the approved list of energy-conserving components or renewable energy sources in light of the applicable criteria provided in paragraph (c) and the standards for Secretarial determination provided in paragraph (d) of this section. In making this recommendation, the Office of the Associate Chief Counsel shall consult with the Secretary of Energy and the Secretary of Housing and Urban Development (or their delegates) and any other appropriate Federal officers to obtain their views concerning the item in question. In addition, the Office of the Associate Chief Counsel may request from the manufacturer clarification of information submitted with the application. The Office of the Associate Chief Counsel shall report its recommendation and forward the application to the ad hoc advisory board for further consideration.

(2) *Ad hoc advisory board.* The Commissioner of Internal Revenue and the Assistant Secretary (Tax Policy) shall establish an ad hoc advisory board to consider applications and recommendations forwarded by the Office of the Associate Chief Counsel (Technical). If a finding in favor of addition of any item is made, the board shall report its recommendation and forward the application to the Commissioner for further consideration. If the item is approved by the Commissioner, the application will be forwarded to the Secretary (or his delegate) for further consideration. The application will be closed with respect to an item if the board, the Commissioner, or the Secretary (or his delegate) determines that, under the applicable criteria or the standards for Secretarial determination, the item should not be added to the list of energy-conserving components or renewable energy sources.

(3) *Action on application.* (i) A final decision to grant or deny any application filed under paragraph (a)(1) shall be made within 1 year after the application and all information required to be filed with such request under paragraph (b) have been received by the Office of the Associate Chief Counsel (Technical). The applicant manufacturer shall be notified in writing of the final decision. In the event of a favorable determination, a regulation will be issued in accordance with the procedures contained in §601.601 to include the item as an energy-conserving component or as a renewable energy source. A final decision to grant approval of an application is made when a Treasury decision adding the item (that is subject of the application) as an energy-conserving component or as a renewable energy source is published in the FEDERAL REGISTER.

(ii) The applicant manufacturer shall be entitled to a conference and be so notified anytime an adverse action is contemplated by the Office of the Associate Chief Counsel, the ad hoc advisory board, the Commissioner of Internal Revenue, or the Secretary (or his delegate) and no conference was previously conducted. Upon being advised in writing that an adverse recommendation or decision as to any item that is the subject of an application is contemplated, a manufacturer may request a conference. The conference must be held within 21 calendar days from the mailing of that advice. Procedures for requesting an extension of the 21-day period and notifying the manufacturer of the recommendation or decision with respect to that request are the same as those applicable to conferences on ruling requests by taxpayers. The applicant is entitled to only one conference. There is no right to another conference when a favorable recommendation or decision is reversed at a higher level.

(iii) A report of any application which has been denied during the preceding month and the reasons for the denial shall be published each month.

(b) *Contents of application*. The application by the manufacturer shall include the following information:

(1) A description of the item and the generic class to which it belongs, including any features relating to safe installation and use of the item. This description shall include appropriate design drawings and technical specifications (or representative drawings and specifications when application by a group of manufacturers).

(2) An explanation of the purpose, function, and each recommended use of the item.

(3) An estimate (and explanation of the estimation methods employed and the assumptions made) of the total number of units that would be sold for each recommended use during the first 4 years following the addition of the item to the approved list and of the total number that would be sold for each recommended use during that period in the absence of addition. If the item is sold in more than one size, the estimate shall indicate the projected sales for each size. This estimate shall reflect total industry sales of the item. Past industry sales information for each recommended use for the previous two years shall also be provided.

(4) Whether sufficient capacity is available to increase production to meet any increase in demand for the item, or for associated fuels and materials, caused by such addition. This determination shall be based on industry-wide data and not just the manufacturing capability of the applicant. If the applicant has the exclusive right to manufacture the item, this information shall also be provided in the application.

(5) An estimate (including estimation methods and assumptions) of the energy in Btu's of oil and natural gas used directly or indirectly per unit by the applicant in the manufacture of the item and other items necessary for its use, the type of energy source (*e.g.*, oil, natural gas, coal, electricity), and the extent of its use in the manufacturing process of the item. The applicant must also provide a list of the major components of the item and their composition and weight.

(6) Test data and experience data (where experience data is available) to substantiate for each recommended use the energy savings in Btu's that are claimed will be achieved by one unit during a period of one year. The data shall be obtained by controlled tests in which, if possible, the addition of the item is the only variable. If the item may be sold in various configurations, data shall be provided with respect to energy savings from each configuration with significantly different energy use characteristics. Test methods are to conform to recognized industry or government standards. This determination shall take into account the seasonal use of the item. If the energy savings of the item varies with climatic conditions, data shall be provided with respect to each climate zone. The applicant may use the Department of Energy's climatic zones for heating and cooling (see § 450.35 of 10 CFR part 450 (1980)).

(7) The impact of increased demand on the price of the item and the energy source used by the item.

(8) The energy source which will be replaced or conserved by the item, and, in the case of a request for addition to the approved list of renewable energy

sources, data establishing that the energy source is inexhaustible.

(9) Data to show the total estimated savings of energy in Btu's attributable to reduced consumption of oil or natural gas whether directly or indirectly from use of the item, including assumptions underlying this estimate. If the consumption of both oil and natural gas will be reduced, data to show the energy savings in Btu's attributable to each shall be provided. The estimate is to be based on energy savings in Btu's per unit determined under paragraph (b)(6) of this section for the first four years of the useful life of the item and is to take into account only the additional units of the item estimated to be placed in service as a result of the addition using data obtained under paragraph (b)(3) of this section. If the item will result in reduction of oil or natural gas consumption by replacing an item which uses such an energy source, the application shall indicate the item replaced and the extent to which this reduction will occur.

(10) Geographical information if required under paragraph (b)(6) of this section to show the climatic zones of the country where the item is expected to be used, including an estimate of the total number of additional units to be placed in service during the first 4 years following the addition of the item in the area as a result of the addition of the item to the list of qualifying items.

(11) The retail cost of the item (or items if the item is sold in more than one size) including all installation costs necessary for safe and effective use.

(12) Whether the item is designed for residential use.

(13) The estimated useful life of the item and associated equipment necessary for its use.

(14) The type and amount of waste and emissions in weight per unit of energy saved resulting from use of the item.

(15) If the item might reasonably be suspected of presenting any health or safety hazard, test data to show that the item does not present such hazard. With respect to applications for addition to the approved list of renewable energy sources, the term ‘‘item’’ as used in this paragraph refers to the property which uses the energy source and not the energy source itself. The application should clearly indicate whether the request is for addition to the approved list of energy-conserving components or renewable energy sources, identify the provisions for which data is being submitted, and present the data in the order requested. The tests required under this paragraph may be conducted by independent laboratories but the underlying data must be submitted along with the test results. There shall accompany the request a declaration in the following form: ‘‘Under penalties of perjury, I declare that I have examined this application, including accompanying documents, and, to the best of my knowledge and belief, the facts presented in support of the application are true, correct and complete.’’ The statement must be signed by the person or persons making the application. The declaration shall not be made by the taxpayer's representative.

(c) *Criteria for additions*—(1) *Additions to the approved list of energy-conserving components.* For an item to be considered for addition to the approved list of energy-conserving components, the manufacturer must show that the item increases the energy efficiency of a dwelling. For an item to be considered as increasing the energy efficiency of a dwelling, all of the following criteria must be met:

(i) The use of the item must improve the energy efficiency of the dwelling structure, structural components of the dwelling, hot water heating, or heating or cooling systems.

(ii) The use of the item must result, directly or indirectly, in a significant reduction in the consumption of oil or natural gas.

(iii) The increase in energy efficiency must be established by test data and in accordance with accepted testing standards.

(iv) The item must not present a safety, fire, environmental, or health hazard when properly installed.

(2) *Additions to the approved list of renewable energy sources.* For an energy source to be considered for addition to the approved list of renewable energy

sources, the manufacturer must show that the following criteria are met:

(i) As in the case of solar, wind, and geothermal energy, the energy source must be an inexhaustible energy supply. Accordingly, wood and agricultural products and by-products are not considered renewable energy sources. Similarly, no exhaustible or depletable energy source (such as sources that are depletable under 611) will be considered.

(ii) The energy source must be capable of being used for heating or cooling a residential dwelling or providing hot water or electricity for use in such a dwelling.

(iii) A practical working device, machine, or mechanism, etc., must exist and be commercially available to use such renewable energy source.

(iv) The use of the renewable energy source must not present a significant safety, fire, environmental, or health hazard.

(d) *Standards for Secretarial determination*—(1) *In general.* The Secretary will not make any addition to the approved list of energy-conserving components or renewable energy sources unless the Secretary determines that—

(i) There will be a reduction in the total consumption of oil or natural gas as a result of the addition, and that reduction is sufficient to justify any resulting decrease in Federal revenues.

(ii) The addition will not result in an increased use of any item which is known to be, or reasonably suspected to be, environmentally hazardous or a threat to public health or safety, and

(iii) Available Federal subsidies do not make the addition unnecessary or inappropriate (in the light of the most advantageous allocation of economic resources).

(2) *Factors taken into account.* In making any determination under paragraph (d)(1)(i) of this section, the Secretary will—

(i) Make an estimate of the amount by which the addition will reduce oil and natural gas consumption, and

(ii) Determine whether the addition compares favorably, on the basis of the reduction in oil and natural gas consumption per dollar of cost to the Federal Government (including revenue loss), with other Federal programs in existence or being proposed.

(3) *Factors taken into account in making estimates.* In making any estimate under subparagraph (2)(i), the Secretary will take into account (among other factors)—

(i) The extent to which the use of any item will be increased as a result of the addition,

(ii) Whether sufficient capacity is available to increase production to meet any increase in demand for the item or associated fuels and materials caused by the addition,

(iii) The amount of oil and natural gas used directly or indirectly in the manufacture of the item and other items necessary for its use,

(iv) The estimated useful life of the item, and

(v) The extent additional use of the item leads, directly or indirectly, to the reduced use of oil or natural gas. Indirect uses of oil or natural gas include use of electricity derived from oil or natural gas.

(e) *Effective date of addition to approved lists.* In the case of additions to the approved list of energy-conserving components or renewable energy sources, the credit allowable by § 1.23–1 shall apply with respect to expenditures which are made on or after the date a Treasury decision amending the regulations pursuant to the application is published in the FEDERAL REGISTER. However, the Secretary may prescribe by regulations that expenditures for additions made on or after the date referred to in the preceding sentence and before the close of the taxable year in which such date occurs shall be taken into account in the following taxable year. Additions to the list will be subject to the performance and quality standards (if any) provided under § 1.23–4 which are in effect at the time of the addition. Furthermore, any addition made to the approved list will be subject to reevaluation by the Secretary for the purpose of determining whether the item still meets the requisite criteria and standards for addition to the list. If it is determined by the Secretary that an item no longer meets the requisite criteria, the Secretary will amend the regulations to delete the item from the approved list. Removal of an item from the list will be prospective from the date a Treasury decision amending the regulations is published in the FEDERAL REGISTER.

(Secs. 44C and 7805 of the Internal Revenue Code of 1954 (92 Stat. 3175, 26 U.S.C. 44C; 68A Stat. 917, 26 U.S.C. 7805). The amendments to the Statement of Procedural Rules are issued under the authority contained in 5 U.S.C. 301 and 552)

[T.D. 7861, 47 FR 56331, Dec. 16, 1982. Redesignated and amended by T.D. 8146, 52 FR 26673, July 16, 1987]

§1.25–1T Credit for interest paid on certain home mortgages (Temporary).

(a) *In general.* Section 25 permits States and political subdivisions to elect to issue mortgage credit certificates in lieu of qualified mortgage bonds. An individual who holds a qualified mortgage credit certificate (as defined in §1.25–3T) is entitled to a credit against his Federal income taxes. The amount of the credit depends upon (1) the amount of mortgage interest paid or accrued during the year and (2) the applicable certificate credit rate. See §1.25–2T. The amount of the deduction under section 163 for interest paid or accrued during any taxable year is reduced by the amount of the credit allowable under section 25 for such year. See §1.163–6T. The holder of a qualified mortgage credit certificate may be entitled to additional withholding allowances. See section 3402 (m) and the regulations thereunder.

(b) *Definitions.* For purposes of §§1.25–2T through 1.25–8T and this section, the following definitions apply:

(1) *Mortgage.* The term ''mortgage'' includes deeds of trust, conditional sales contracts, pledges, agreements to hold title in escrow, and any other form of owner financing.

(2) *State.* (i) The term ''State'' includes a possession of the United States and the District of Columbia.

(ii) Mortgage credit certificates issued by or on behalf of any State or political subdivision (''governmental unit'') by constituted authorities empowered to issue such certificates are the certificates of such governmental unit.

(3) *Qualified home improvement loan.* The term ''qualified home improvement loan'' has the meaning given that term under section 103A (1)(6) and the regulations thereunder.

(4) *Qualified rehabilitation loan.* The term ''qualified rehabilitation loan'' has the meaning given that term under section 103A (1)(7)(A) and the regulations thereunder.

(5) *Single-family and owner-occupied residences.* The terms ''single-family'' and ''owner-occupied'' have the meaning given those terms under section 103A (1)(9) and the regulations thereunder.

(6) *Constitutional home rule city.* The term ''constitutional home rule city'' means, with respect to any calendar year, any political subdivision of a State which, under a State constitution which was adopted in 1970 and effective on July 1, 1971, had home rule powers on the 1st day of the calendar year.

(7) *Targeted area residence.* The term ''targeted area residence'' has the meaning given that term under section 103A (k) and the regulations thereunder.

(8) *Acquisition cost.* The term ''acquisition cost'' has the meaning given that term under section 103A (1)(5) and the regulations thereunder.

(9) *Average area purchase price.* The term ''average area purchase price'' has the meaning given that term under subparagraphs (2), (3), and (4) of section 103A (f) and the regulations thereunder. For purposes of this paragraph (b)(9), all determinations of average area purchase price shall be made with respect to residences as that term is defined in section 103A and the regulations thereunder.

(10) *Total proceeds.* The ''total proceeds'' of an issue is the sum of the products determined by multiplying—

(i) The certified indebtedness amount of each mortgage credit certificate issued pursuant to such issue, by

(ii) The certificate credit rate specified in such certificate.

Each qualified mortgage credit certificate program shall be treated as a separate issue of mortgage credit certificates.

(11) *Residence.* The term ‘‘residence’’ includes stock held by a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b) (1) and (2)). It does not include property such as an appliance, a piece of furniture, a radio, *etc.*, which, under applicable local law, is not a fixture. The term also includes any manufactured home which has a minimum of 400 square feet of living space and a minimum width in excess of 102 inches and which is of a kind customarily used at a fixed location. The preceding sentence shall not apply for purposes of determining the average area purchase price for single-family residences, nor shall it apply for purposes of determining the State ceiling amount. The term ‘‘residence’’ does not, however, include recreational vehicles, campers, and other similar vehicles.

(12) *Related person.* The term ‘‘related person’’ has the meaning given that term under section 103(b)(6)(C)(i) and § 1.103–10(e)(1).

(13) *Date of issue.* A mortgage credit certificate is considered issued on the date on which a closing agreement is signed with respect to the certified indebtedness amount.

(c) *Affidavits.* For purposes of §§ 1.25–1T through 1.25–8T, an affidavit filed in connection with the requirements of §§ 1.25–1T through 1.25–8T shall be made under penalties of perjury. Applicants for mortgage credit certificates who are required by a lender or the issuer to sign affidavits must be informed that any fraudulent statement will result in (1) the revocation of the individual's mortgage credit certificate, and (2) a $10,000 penalty under section 6709. Other persons required by a lender or an issuer to provide affidavits must receive similar notice. A person may not rely on an affidavit where that person knows or has reason to know that the information contained in the affidavit is false.

[T.D. 8023, 50 FR 19346, May 8, 1985]

§ 1.25–2T Amount of credit (Temporary).

(a) *In general.* Except as otherwise provided, the amount of the credit allowable for any taxable year to an individual who holds a qualified mortgage credit certificate is equal to the product of the certificate credit rate (as defined in paragraph (b)) and the amount of the interest paid or accrued by the taxpayer during the taxable year on the certified indebtedness amount (as defined in paragraph (c)).

(b) *Certificate credit rate*—(1) *In general.* For purposes of §§ 1.25–1T through 1.25–8T, the term ‘‘certificate credit rate’’ means the rate specified by the issuer on the mortgage credit certificate. The certificate credit rate shall not be less than 10 percent nor more than 50 percent.

(2) *Limitation in certain States.* (i) In the case of a State which—

(A) Has a State ceiling for the calendar year in which an election is made that exceeds 20 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family owner-occupied residences located within the jurisdiction of such State, or

(B) Issued qualified mortgage bonds in an aggregate amount less than $150 million for calendar year 1983.

the certificate credit rate for any mortgage credit certificate issued under such program shall not exceed 20 percent unless the issuing authority submits a plan to the Commissioner to ensure that the weighted average of the certificate credit rates in such mortgage credit certificate program does not exceed 20 percent and the Commissioner approves such plan. For purposes of determining the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family owner-occupied residences located within the jurisdiction of such State, an issuer may rely upon the amount published by the Treasury Department for such calendar years. An issuer may rely on a different amount from that safe-harbor limitation where the issuer has made a more accurate and comprehensive determination of that amount. The weighted average of the certificate credit rates in a mortgage credit certificate program is determined by dividing the sum of the products obtained by multiplying the certificate credit rate of each certificate by the certified indebtedness amount with respect to that certificate by the sum of the certified indebtedness amounts of the certificates issued. See section 103A(g) and the regulations thereunder for the definition of the term ''State ceiling''.

(ii) The following example illustrates the application of this paragraph (b)(2):

Example. City Z issues four qualified mortgage credit certificates pursuant to its qualified mortgage credit certificate program. H receives a certificate with a certificate credit rate of 30 percent and a certified indebtedness amount of $50,000. I receives a certificate with a certificate credit rate of 25 percent and a certified indebtedness amount of $100,000. J and K each receive certificates with certificate credit rates of 10 percent; their certified indebtedness amounts are $50,000 and $100,000, respectively. The weighted average of the certificate credit rates is determined by dividing the sum of the products obtained by multiplying the certificate credit rate of each certificate by the certified indebtedness amount with respect to that certificate ((.3×$50,000) + (.25×$100,000) + (.1×$50,000) + (.1×$100,000)) by the sum of the certified indebtedness amounts of the certificates issued ($50,000+$100,000+$50,000+$100,000). Thus, the weighted average of the certificate credit rates is 18.33 percent ($55,000/$300,000).

(c) *Certified indebtedness amount*—(1) *In general.* The term ''certified indebtedness amount'' means the amount of indebtedness which is—

(i) Incurred by the taxpayer—

(A) To acquire his principal residence, §1.25–2T(c)(1)(i),

(B) As a qualified home improvement loan, or

(C) As a qualified rehabilitation loan, and

(ii) Specified in the mortgage credit certificate.

(2) *Example.* The following example illustrates the application of this paragraph:

Example. On March 1, 1986, State X, pursuant to its qualified mortgage credit certificate program, provides a mortgage credit certificate to B. State X specifies that the maximum amount of the mortgage loan for which B may claim a credit is $65,000. On March 15, B purchases for $67,000 a single-family dwelling for use as his principal residence. B obtains from Bank M a mortgage loan for $60,000. State X, or Bank M acting on behalf of State X, indicates on B's mortgage credit certificate that the certified indebtedness amount of B's loan is $60,000. B may claim a credit under section 25 (e) based on this amount.

(d) *Limitation on credit*—(1) *Limitation where certificate credit rate exceeds 20 percent.* (i) If the certificate credit rate of any mortgage credit certificate exceeds 20 percent, the amount of the credit allowed to the taxpayer by section 25(a)(1) for any year shall not exceed $2,000. Any amount denied under this paragraph (d)(1) may not be carried forward under section 25(e)(1) and paragraph (d)(2) of this section.

(ii) If two or more persons hold interests in any residence, the limitation of paragraph (d)(1)(i) shall be allocated among such persons in proporation to their respective interests in the residence.

(2) *Carryforward of unused credit.* (i) If the credit allowable under section 25 (a) and §1.25–2T for any taxable year exceeds the applicable tax limit for that year, the excess (the ''unused credit'') will be a carryover to each of the 3 succeeding taxable years and, subject to the limitations of paragraph (d)(2)(ii), will be added to the credit allowable by section 25 (a) and §1.25–2T for that succeeding year.

(ii) The amount of the unused credit for any taxable year (the ''unused credit year'') which may be taken into account under this paragraph (d)(2) for any subsequent taxable year may not exceed the amount by which the applicable tax limit for that subsequent taxable year exceeds the sum of (A) the amount of the credit allowable under section 25 (a) and §1.25–1T for the current taxable year, and (B) the sum of the unused credits which, by reason of this paragraph (d)(2), are carried to that subsequent taxable year and are attributable to taxable years before the unused credit year. Thus, if by reason of this paragraph (d)(2), unused credits from 2 prior taxable years are carried forward to a subsequent taxable year, the unused credit from the earlier of those 2 prior years must be taken into account before the unused credit from the later of those 2 years is taken into account.

(iii) For purposes of this paragraph (d)(2) the term ''applicable tax limit'' means the limitation imposed by section 26 (a) for the taxable year reduced by the sum of the credits allowable for that year under section 21, relating to expenses for household and dependent care services necessary for gainful employment, section 22, relating to the credit for the elderly and the permanently disabled, section 23, relating to the residential energy credit, and section 24, relating to contributions to candidates for public office. The limitation imposed by section 26 (a) for any taxable year is equal to the taxpayer's tax liability (as defined in section 26 (b)) for that year.

(iv) The following examples illustrate the application of this paragraph (d)(2):

Example 1. (i) B, a calendar year taxpayer, holds a qualified mortgage credit certificate. For 1986 B's applicable tax limit (*i.e.,* tax liability) is $1,100. The amount of the credit under section 25 (a) and § 1.25–2T for 1986 is $1,700. For 1986 B is not entitled to any of the credits described in sections 21 through 24. Under § 1.25–2T (d)(2), B's unused credit for 1986 is $600, and B is entitled to carry forward that amount to the 3 succeeding years.

(ii) For 1987 B's applicable tax limit is $1,500, the amount of the credit under section 25 (a) and § 1.25–2T is $1,700, and the unused credit is $200. For 1988 B's applicable tax limit is $2,000, the amount of the credit under section 25 (a) and § 1.25–2T is $1,300, and there is no unused credit. For 1987 and 1988 B is not entitled to any of the credits described in sections 21 through 24. No portion of the unused credit for 1986 my be used in 1987. For 1988 B is entitled to claim a credit of $2,000 under section 25 (a) and § 1.25–2T, consisting of a $1,300 credit for 1988, the $600 unused credit for 1986, and $100 of the $200 unused credit for 1987. In addition, B may carry forward the remaining unused credit for 1987 ($100) to 1989 and 1990.

Example 2. The facts are the same as in Example (1) except that for 1988 B is entitled to a credit of $400 under section 23. B's applicable tax limit for 1988 is $1,600 ($2,000 less $400). For 1988 B is entitled to claim a credit of $1,600 under section 25 (a) and § 1.25–2T, consisting of a $1,300 credit for 1988 and $300 of the unused credit for 1986. In addition, B may carry forward the remaining unused credits of $300 for 1986 to 1989 and of $200 for 1987 to 1989 and 1990.

[T.D. 8023, 50 FR 19346, May 8, 1985]

§ 1.25–3 Qualified mortgage credit certificate.

(a) through (g)(1)(ii) [Reserved] For further guidance, see § 1.25–3T(a) through (g)(1)(ii).

(g)(1)(iii) *Reissued certificate exception.* See paragraph (p) of this section for rules regarding the exception in the case of refinancing existing mortgages.

(g)(2) through (o) [Reserved] For further guidance, see § 1.25–3T(g)(2) through (o).

(p) *Reissued certificates for certain refinancings*—(1) *In general.* If the issuer of a qualified mortgage credit certificate reissues a certificate in place of an existing mortgage credit certificate to the holder of that existing certificate, the reissued certificate is treated as satisfying the requirements of this section. The period for which the reissued certificate is in effect begins with the date of the refinancing (that is, the date on which interest begins accruing on the refinancing loan).

(2) *Meaning of existing certificate.* For purposes of this paragraph (p), a mortgage credit certificate is an existing certificate only if it satisfies the requirements of this section. An existing certificate may be the original certificate, a certificate issued to a transferee under § 1.25–3T(h)(2)(ii), or a certificate previously reissued under this paragraph (p).

(3) *Limitations on reissued certificate.* An issuer may reissue a mortgage credit certificate only if all of the following requirements are satisfied:

(i) The reissued certificate is issued to the holder of an existing certificate with respect to the same property to which the existing certificate relates.

(ii) The reissued certificate entirely replaces the existing certificate (that is, the holder cannot retain the existing certificate with respect to any portion of the outstanding balance of the certified mortgage indebtedness specified on the existing certificate).

(iii) The certified mortgage indebtedness specified on the reissued certificate does not exceed the remaining outstanding balance of the certified mortgage indebtedness specified on the existing certificate.

(iv) The reissued certificate does not increase the certificate credit rate specified in the existing certificate.

(v) The reissued certificate does not result in an increase in the tax credit that would otherwise have been allowable to the holder under the existing certificate for any taxable year. The holder of a reissued certificate determines the amount of tax credit that would otherwise have been allowable by multiplying the interest that was scheduled to have been paid on the refinanced loan by the certificate rate of the existing certificate. In the case of a series of refinancings, the tax credit that would otherwise have been allowable is determined from the amount of interest that was scheduled to have been paid on the original loan and the certificate rate of the original certificate.

(A) In the case of a refinanced loan that is a fixed interest rate loan, the interest that was scheduled to be paid on the refinanced loan is determined using the scheduled interest method described in paragraph (p)(3)(v)(C) of this section.

(B) In the case of a refinanced loan that is not a fixed interest rate loan, the interest that was scheduled to be paid on the refinanced loan is determined using either the scheduled interest method described in paragraph (p)(3)(v)(C) of this section or the hypothetical interest method described in paragraph (p)(3)(v)(D) of this section.

(C) The scheduled interest method determines the amount of interest for each taxable year that was scheduled to have been paid in the taxable year based on the terms of the refinanced loan including any changes in the interest rate that would have been required by the terms of the refinanced loan and any payments of principal that would have been required by the terms of the refinanced loan (other than repayments required as a result of any refinancing of the loan).

(D) The hypothetical interest method (which is available only for refinanced loans that are not fixed interest rate loans) determines the amount of interest treated as having been scheduled to be paid for a taxable year by constructing an amortization schedule for a hypothetical self-amortizing loan with level payments. The hypothetical loan must have a principal amount equal to the remaining outstanding balance of the certified mortgage indebtedness specified on the existing certificate, a maturity equal to that of the refinanced loan, and interest equal to the annual percentage rate (APR) of the refinancing loan that is required to be calculated for the Federal Truth in Lending Act.

(E) A holder must consistently apply the scheduled interest method or the hypothetical interest method for all taxable years beginning with the first taxable year the tax credit is claimed by the holder based upon the reissued certificate.

(4) *Examples.* The following examples illustrate the application of paragraph (p)(3)(v) of this section:

Example 1. A holder of an existing certificate that meets the requirements of this section seeks to refinance the mortgage on the property to which the existing certificate relates. The final payment on the holder's existing mortgage is due on December 31, 2000; the final payment on the new mortgage would not be due until January 31, 2004. The holder requests that the issuer provide to the holder a reissued mortgage credit certificate in place of the existing certificate. The requested certificate would have the same certificate credit rate as the existing certificate. For each calendar year through the year 2000, the credit that would be allowable to the holder with respect to the new mortgage under the requested certificate would not exceed the credit allowable for that year under the existing certificate. The requested certificate, however, would allow the holder credits for the years 2001 through 2004, years for which, due to the earlier scheduled retirement of the existing mortgage, no credit would be allowable under the existing certificate. Under paragraph (p)(3)(v) of this section, the issuer may not reissue the certificate as requested because, under the existing certificate, no credit would be allowable for the years 2001 through 2004. The issuer may, however, provide a reissued certificate that limits the amount of the credit allowable in each year to the amount allowable under the existing certificate. Because the existing certificate would allow no credit after December 31, 2000, the reissued certificate could expire on December 31, 2000.

Example 2. (a) The facts are the same as *Example 1* except that the existing mortgage loan has a variable rate of interest and the refinancing loan will have a fixed rate of interest. To determine whether the limit under paragraph (p)(3)(v) of this section is met for any taxable year, the holder must calculate the amount of credit that otherwise would have been allowable absent the refinancing. This requires a determination of the amount of interest that would have been payable on the refinanced loan for the taxable year. The holder may determine this amount by—

(1) Applying the terms of the refinanced loan, including the variable interest rate or

rates, for the taxable year as though the refinanced loan continued to exist; or

(2) Obtaining the amount of interest, and calculating the amount of credit that would have been available, from the schedule of equal payments that fully amortize a hypothetical loan with the principal amount equal to the remaining outstanding balance of the certified mortgage indebtedness specified on the existing certificate, the interest equal to the annual percentage rate (APR) of the refinancing loan, and the maturity equal to that of the refinanced loan.

(b) The holder must apply the same method for each taxable year the tax credit is claimed based upon the reissued mortgage credit certificate.

(5) *Coordination with Section 143(m)(3).* A refinancing loan underlying a reissued mortgage credit certificate that replaces a mortgage credit certificate issued on or before December 31, 1990, is not a federally subsidized indebtedness for the purposes of section 143(m)(3) of the Internal Revenue Code.

[T.D. 8692, 61 FR 66214, Dec. 17, 1996]

§ 1.25–3T Qualified mortgage credit certificate (Temporary).

(a) *Definition of qualified mortgage credit certificate.* For purposes of §§ 1.25–1T through 1.25–8T, the term ''qualified mortgage credit certificate'' means a certificate that meets all of the requirements of this section.

(b) *Qualified mortgage credit certificate program.* A certificate meets the requirements of this paragraph if it is issued under a qualified mortgage credit certificate program (as defined in § 1.25–4T).

(c) *Required form and information.* A certificate meets the requirements of this paragraph if it is in the form specified in § 1.25–6T and if all the information required by the form is specified on the form.

(d) *Residence requirement*—(1) *In general.* A certificate meets the requirements of this paragraph only if it is provided in connection with the acquisition, qualified rehabilitation, or qualified home improvement of a residence, that is—

(i) A single-family residence (as defined in § 1.25–1T(b)(5)) which, at the time the financing on the residence is executed or assumed, can reasonably be expected by the issuer to become (or, in the case of a qualified home improvement loan, to continue to be) the principal residence (as defined in section 1034 and the regulations thereunder) of the holder of the certificate within a reasonable time after the financing is executed or assumed, and

(ii) Located within the jurisdiction of the governmental unit issuing the certificate.

See section 103a(d) and the regulations thereunder for further definitions and requirements.

(2) *Certification procedure.* The requirements of this paragraph will be met if the issuer or its agent obtains from the holder of the certificate an affidavit stating his intent to use (or, in the case of a qualified home improvement loan, that he is currently using and intends to continue to use) the residence as his principal residence within a reasonable time (*e.g.,* 60 days) after the mortgage credit certificate is issued and stating that the holder will notify the issuer of the mortgage credit certificate if the residence ceases to be his principal residence. The affidavit must also state facts that are sufficient for the issuer or his agent to determine whether the residence is located within the jurisdiction of the issuer that issued the mortgage credit certificate.

(e) *3-year requirement*—(1) *In general.* A certificate meets the requirements of this paragraph only if the holder of the certificate had no present ownership interest in a principal residence at any time during the 3-year period prior to the date on which the mortgage on the residence in connection with which the certificate is provided is executed. For purposes of the preceding sentence, the holder's interest in the residence with respect to which the certificate is being provided shall not be taken into account. See section 103A(e) and the regulations thereunder for further definitions and requirements.

(2) *Exceptions.* Paragraph (e)(1) shall not apply with respect to—

(i) Any certificate provided with respect to a targeted area residence (as defined in § 1.25–1T(b)(7)),

(ii) Any qualified home improvement loan (as defined in § 1.25–1T(b)(3)), and

(iii) Any qualified rehabilitation loan (as defined in § 1.25–1T(b)(4)).

(3) *Certification procedure.* The requirements of paragraph (e)(1) will be met if the issuer or its agent obtains from the holder of the certificate an affidavit stating that he had no present ownership interest in a principal residence at any time during the 3-year period prior to the date of which the certificate is issued and the issuer or its agent obtains from the applicant copies of the applicant's Federal tax returns for the preceding 3 years and examines each statement to determine whether the applicant has claimed a deduction for taxes on property which was the applicant's principal residence pursuant to section 164(a)(1) or a deduction pursuant to section 163 for interest paid on a mortgage secured by property which was the applicant's principal residence. Where the mortgage is executed during the period between January 1 and February 15 and the applicant has not yet filed has Federal income tax return with the Internal Revenue Service, the issuer may, with respect to such year, rely on an affidavit of the applicant that the applicant is not entitled to claim deductions for taxes or interest on indebtedness with respect to property constituting his principal residence for the preceding calendar year. In the alternative, when applicable, the holder may provide an affidavit stating that one of the exceptions provided in paragraph (e)(2) applies.

(4) *Special rule.* An issuer may submit a plan to the Commissioner for distributing certificates, in an amount not to exceed 10 percent of the proceeds of the issue, to individuals who do not meet the requirements of this paragraph. Such plan must describe a procedure for ensuring that no more than 10 percent of the proceeds of a such issue will be used to provide certificates to such individuals. If the Commissioner approves the issuer's plan, certificates issued in accordance with the terms of the plan to holders who do not meet the 3-year requirement do not fail to satisfy the requirements of this paragraph.

(f) *Purchase price requirement*—(1) *In general.* A certificate meets the requirements of this paragraph only if the acquisition cost (as defined in §1.25–1T(b)(8)) of the residence, other than a targeted area residence, in connection with which the certificate is provided does not exceed 110 percent of the average area purchase price (as defined in §1.25–1T(b)(9)) applicable to that residence. In the case of a targeted area residence (as defined in §1.251T(b)(7)) the acquisition cost may not exceed 120 percent of the average area purchase price applicable to such residence. See section 1093A(f) and the regulations thereunder for further definitions and requirements.

(2) *Certification procedure.* The requirements of paragraph (f)(1) will be met if the issuer or its agent obtains affidavits executed by the seller and the buyer that state these requirements have been met. Such affidavits must include an itemized list of—

(i) Any payments made by the buyer (or a related person) or for the benefit of the buyer,

(ii) If the residence is incomplete, an estimate of the reasonable cost of completing the residence, and

(iii) If the residence is purchased subject to a ground rent, the capitalized value of the ground rent.

The issuer or his agent must examine such affidavits and determine whether, on the basis of information contained therein, the purchase price requirement is met.

(g) *New mortgage requirement*—(1) *In general.* (i) A certificate meets the requirements of this paragraph only if the certificate is not issued in connection with the acquisition or replacement of an existing mortgage. Except in the case of a qualified home improvement loan, the certificate must be issued to an individual who did not have a mortgage (whether or not paid off) on the residence with respect to which the certificate is issued at any time prior to the execution of the mortgage.

(ii) *Exceptions.* For purposes of this paragraph, a certificate used in connection with the replacement of—

(A) Construction period loans,

(B) Bridge loans or similar temporary initial financing, and

(C) In the case of a qualified rehabilitation loan, an existing mortgage,

shall not be treated as being used to acquire or replace an existing mortgage. Generally, temporary initial financing is any financing which has a term of 24 months or less. See section 103A(j)(1) and the regulations thereunder for examples illustrating the application of these requirements.

(2) *Certification procedure.* The requirements of paragraph (g)(1) will be met if the issuer or its agent obtains from the holder of the certificate an affidavit stating that the mortage being acquired in connection with the certificate will not be used to acquire or replace an existing mortgage (other than one that falls within the exceptions described in paragraph (g)(1)(ii)).

(h) *Transfer of mortgage credit certificates*—(1) *In general.* A certificate meets the requirements of this paragraph only if it is (i) not transferable or (ii) transferable only with the approval of the issuer.

(2) *Transfer procedure.* A certificate that is transferred with the approval of the issuer is a qualified mortgage credit certificate in the hands of the transferee only if each of the following requirements is met:

(i) The transferee assumed liability for the remaining balance of the certified indebtedness amount in connection with the acquisition of the residence from the transferor,

(ii) The issuer issues a new certificate to the transferee, and

(iii) The new certificate meets each of the requirements of paragraphs (d), (e), (f), and (i) of this section based on the facts as they exist at the time of the transfer as if the mortgage credit certificate were being issued for the first time. For example, the purchase price requirement is to be determined by reference to the average area purchase price at the time of the assumption and not when the mortgage credit certificate was originally issued.

(3) *Statement on certificate.* The requirements of paragraph (h)(1) will be met if the mortgage credit certificate states that the certificate may not be transferred or states that the certificate may not be transferred unless the issuer issues a new certificate in place of the original certificate.

(i) *Prohibited mortgages*—(1) *In general.* A certificate meets the requirements of this paragraph only if it is issued in connection with the acquisition of a residence none of the financing of which is provided from the proceeds of—

(i) A qualified mortgage bond (as defined under section 103A(c)(1) and the regulations thereunder), or

(ii) A qualified veterans' mortgage bond (as defined under section 103A(c)(3) and the regulations thereunder).

Thus, for example, if a mortgagor has a mortgage on his principal residence that was obtained from the proceeds of a qualified mortgage bond, a mortgage credit certificate issued to such mortgagor in connection with a qualified home improvement loan with respect to such residence is not a qualified mortgage credit certificate. If, however, the financing provided from the proceeds of the qualified mortgage bond had been paid off in full, the certificate would be a qualified mortgage credit certificate (assuming all the requirements of this paragraph are met).

(2) *Certification procedure.* The requirements of paragraph (i)(1) will be met if the issuer or its agent obtains from the holder of the certificate an affidavit stating that no portion of the financing of the residence in connection with which the certificate is issued is provided from the proceeds of a qualified mortgage bond or a qualified veterans' mortgage bond.

(j) *Particular lenders*—(1) *In general.* Except as otherwise provided in paragraph (j)(2), a certificate meets the requirements of this paragraph only if the certificate is not limited to indebtedness incurred from particular lenders. A certificate is limited to indebtedness from particular lenders if the issuer, directly or indirectly, prohibits the holder of a certificate from obtaining financing from one or more lenders or requires the holder of a certificate to obtain financing from one or more lenders. For purposes of this paragraph, a lender is any person, including an issuer of mortgage credit certificates, that provides financing for the acquisition, qualified rehabilitation, or qualified home improvement of a residence.

(2) *Exception.* A mortgage credit certificate that is limited to indebtedness incurred from particular lenders will not cease to meet the requirements of

this paragraph if the Commissioner approves the basis for such limitation. The Commissioner may approve the basis for such limitation if the issuer establishes to the satisfaction of the Commissioner that it will result in a significant economic benefit to the holders of mortgage credit certificates (*e.g.*, substantially lower financing costs) compared to the result without such limitation.

(3) *Taxable bonds.* The requirements of this paragraph do not prevent an issuer of mortgage credit certificates from issuing mortgage subsidy bonds (other than obligations described in section 103 (a)) the proceeds of which are to be used to provide mortgages to holders of mortgage credit certificates provided that the holders of such certificates are not required to obtain financing from the proceeds of the bond issue. See §1.25–4T (h) with respect to permissible fees.

(4) *Lists of participating lenders.* The requirements of this paragraph do not prohibit an issuer from maintaining a list of lenders that have stated that they will make loans to qualified holders of mortgage credit certificates, provided that (i) the issuer solicits such statements in a public notice similar to the notice described in §1.25–7T, (ii) lenders are provided a reasonable period of time in which to express their interest in being included in such a list, and (iii) holders of mortgage credit certificates are not required to obtain financing from the lenders on the list. If an issuer maintains such a list, it must update the list at least annually.

(5) *Certification procedure.* The requirements of this paragraph will be met if (i) the issuer or its agent obtains from the holder of the certificate an affidavit stating that the certificate was not limited to indebtedness incurred from particular lenders or (ii) the issuer obtains a ruling from the Commissioner under paragraph (j)(2).

(6) *Examples.* The following examples illustrate the application of this paragraph:

Example 1. Under its mortgage credit certificate program, County Z distributes all the certificates to be issued to a group of 60 participating lenders. Residents of County Z may obtain mortgage credit certificates only from the participating lenders and only in connection with the acquisition of mortgage financing from that lender or one of the other participating lenders. Certificates issued under this program do not meet the requirements of this paragraph since the certificates are limited to indebtedness incurred from particular lenders. The certificates, therefore, are not qualified mortgage credit certificates.

Example 2. In connection with its mortgage credit certificate program, County Y arranges with Bank P for a line of credit to be used to provide mortgage financing to holders of mortgage credit certificates. County Y, pursuant to paragraph (j)(4), maintains a list of lenders participating in the mortgage credit certificate program. County Y distributes the certificates directly to applicants. Holders of the certificates are not required to obtain mortgage financing through the line of credit or through a lender on the list of participating lenders. Certificates issued pursuant to County Y's program satisfy the requirements of this paragraph.

(k) *Developer certification*—(1) *In general.* A mortgage credit certificate that is allocated by the issuer to any particular development meets the requirements of this paragraph only if the developer provides a certification to the purchaser of the residence and the issuer stating that the purchase price of that residence is not higher than the price would be if the issuer had not allocated mortgage credit certificates to the development. The certification must be made by the developer if a natural person or, if not, by a duly authorized official of the developer.

(2) *Certification procedure.* The requirements of this paragraph will be met if the issuer or its agent obtains from the holder of the certificate an affidavit stating that he has received from the developer the certification described in this paragraph.

(l) *Expiration*—(1) *In general.* A certificate meets the requirements of this paragraph if the certified indebtedness amount is incurred prior to the close of the second calender year following the calendar year for which the issuer elected not to issue qualified mortgage bonds under §1.25–4T with respect to that issue of mortgage credit certificates. Thus, for example, if on October 1, 1984, an issuing authority elects under §1.25–4T not to issue qualified mortgage bonds, a mortgage credit certificate provided under that program does not meet the requirements of this paragraph unless the indebtedness is incurred on or before December 31, 1986.

(2) *Issuer-imposed expiration dates.* An issuer of mortgage credit certificates may provide that a certificate shall expire if the holder of the certificate does not incure certified indebtedness by a date that is prior to the expiration date provided in paragraph (l)(1). A certificate that expires prior to the date provided in paragraph (l)(1) may be reissued provided that the requirements of this paragraph are met.

(m) *Revocation.* A certificate meets the requirements of this paragraph only if it has not been revoked. Thus, the credit provided by section 25 and § 1.25–1T does not apply to interest paid or accrued following the revocation of a certificate. A certificate is treated as revoked when the residence to which the certificate relates ceases to be the holder's principal residence. An issuer may revoke a mortgage credit certificate if the certificate does not meet all the requirements of § 1.25–3T (d), (e), (f), (g), (h), (i), (j), (k), and (n). The certificate is revoked by the issure's notifying the holder of the certificate and the Internal Revenue Service that the certificate is revoked. The notice to the Internal Revenue Service shall be made as part of the report requred by § 1.25–8T (b)(2).

(n) *Interest paid to related person*—(1) *In general.* A certificate does not meet the requirements of this paragraph if interest on the certified indebtedness amount is paid to a person who is a related person to the holder of the certificate.

(2) *Certification procedure.* The requirements of this paragraph will be met if the issuer or its agent obtains from the holder of the certificate an affidavit stating that a related person does not have, and is not expected to have, an interest as a creditor in the certified indebtedness amount.

(o) *Fraud.* Notwithstanding any other provision of this section, a mortgage credit certificate does not meet the requirements of this section and, therefore, the certificate is not a qualified mortgage credit certificate for any calendar year, if the holder of the certificate provides a certification or any other information to the lender providing the mortgage or to the issuer of the certificate containing a material misstatement and such misstatement is due to fraud. In determining whether any misstatement is due to fraud, the rules generally applicable to underpayments of tax due to fraud (including rules relating to the statute of limitations) shall apply. See § 1.6709–1T with respect to the penalty for filing negligent or fraudulent statements.

[T.D. 8023, 50 FR 19348, May 8, 1985, as amended at T.D. 8502, 58 FR 67689, Dec. 22, 1993; T.D. 8692, 61 FR 66215, Dec. 17, 1996]

§ 1.25–4T Qualified mortgage credit certificate program (Temporary).

(a) *In general*—(1) *Definition of qualified mortgage credit certificate program.* For purposes of §§ 1.25–1T through 1.25–8T, the term ''qualified mortgage credit certificate program'' means a program to issue qualified mortgage credit certificates which meets all of the requirements of paragraphs (b) through (i) of this section.

(2) *Requirements are a minimum.* Except as otherwise provided in this section, the requirements of this section are minimum requirements. Issuers may establish more stringent criteria for participation in a qualified mortgage credit certificate program. Thus, for example, an issuer may target 30 percent of the proceeds of an issue of mortgage credit certificates to targeted areas. Further, issuers may establish additional eligibility criteria for participation in a qualified mortgage credit certificate program. Thus, for example, issuers may impose an income limitation designed to ensure that only those individuals who could not otherwise purchase a residence will benefit from the credit.

(3) Except as otherwise provided in this section and § 1.25–3T, issuers may use mortgage credit certificates in connection with other Federal, State, and local programs provided that such use complies with the requirements of § 1.25–3T(j). Thus, for example, a mortgage credit certificate may be issued in connection with the qualified rehabilitation of a residence part of the cost of which will be paid from the proceeds of a State grant.

(b) *Establishment of program.* A program meets the requirements of this paragraph only if it is established by a State or political subdivision thereof for any calendar year for which it has the authority to issue qualified mortgage bonds.

(c) *Election not to issue qualified mortgage bonds*—(1) *In general.* A program meets the requirements of this paragraph only if the issuer elects, in the time and manner specified in this paragraph, not to issue an amount of qualified mortgage bonds that it may otherwise issue during the calendar year under section 103A and the regulations thereunder.

(2) *Manner of making election.* On or before the earlier of the date of distribution of mortgage credit certificates under a program or December 31, 1987, the issuer must file an election not to issue an amount of qualified mortgage bonds. The election (and the certification (or affidavit) described in paragraph (d)) shall be filed with the Internal Revenue Service Center, Philadelphia, Pennsylvania 19255. The election should be titled ''Mortgage Credit Certificate Election'' and must include—

(i) The name, address, and TIN of the issuer,

(ii) The issuer's applicable limit, as defined in section 103A (g) and the regulations thereunder,

(iii) The aggregate amount of qualified mortgage bonds issued by the issuing authority during the calendar year,

(iv) The amount of the issuer's applicable limit that it has surrendered to other issuers during the calendar year,

(v) The date and amount of any previous elections under this paragraph for the calendar year, and

(vi) The amount of qualfied mortgage bonds that the issuer elects not to issue.

(3) *Revocation of election.* Any election made under this paragraph may be revoked, in whole or in part, at any time during the calendar year in which the election was made. The revocation, however, may not be made with respect to any part of the nonissued bond amount that has been used to issue mortgage credit certificates pursuant to the election. The revocation shall be filed with the Internal Revenue Service Center, Philadelphia, Pennsylvania 19255. The revocation should be titled ''Revocation of Mortgage Credit Certificate Election'' and must include—

(i) The name, address, and TIN of the issuer,

(ii) The nonissued bond amount as originally elected, and

(iii) The portion of the nonissued bond amount with respect to which the election is being revoked.

(4) *Special rule.* If at the time that an issuer makes an election under this paragraph it does not know its applicable limit, the issuer may elect not to use all of its remaining authority to issue qualified mortgage bonds; this form of election will be treated as meeting the requirements of paragraph (c)(2) if, prior to the later of the end of the calendar year and December 31, 1985, the issuer amends its election so as to indicate the exact amount of qualified mortgage bond authority that it elected not to issue.

(5) *Limitation on nonissued bond amount.* The amount of qualified mortgage bonds which an issuer elects not to issue may not exceed the issuer's applicable limit (as determined under section 103A (g) and the regulations thereunder). For example, a governmental unit that, pursuant to section 103A (g)(3), may issue $10 million of qualified mortgage bonds that elects to trade in $11 million in qualified mortgage bond authority has not met the requirements of this paragraph, and mortgage credit certificates issued pursuant to such election are not qualified mortgage credit certificates.

(d) *State certification requirement*—(1) *In general.* A program meets the requirements of this paragraph only if the State official designated by law (or, where there is no State official, the Governor) certifies, based on facts and circumstances as of the date on which the certification is requested, following a request for such certification, that the issue meets the requirements of section 103A(g) (relating to volume limitation) and the regulations thereunder. A copy of the State certification must be attached to the issuer's election not to issue qualified mortgage bonds, except that, in the case of elections made during calendar year 1984, the certification may be filed with the Service prior to July 8, 1985 provided that mortgage credit certificates may not be distributed until the certification is filed. In the case of any constitutional home rule city, the certification shall be made by the chief executive officer of the city.

(2) *Certification procedure.* The official making the certification described in this paragraph (d) need not perform an independent investigation to determine whether the issuer has met the requirements of section 103A(g). In determining the aggregate amount of qualified mortgage bonds previously issued by that issuer during the calendar year the official may rely on copies of prior elections under paragraph (c) of this section made by the issuer for that year, together with an affidavit executed by an official of the issuer who is responsible for issuing bonds stating that the issuer has not, to date, issued any other issues of qualified mortgage bonds during the calendar year and stating the amount, if any, of the issuer's applicable limit that it has surrendered to other issuers during the calendar year; for any calendar year prior to 1985, the official may rely on an affidavit executed by a duly authorized official of the issuer who states the aggregate amount of qualified mortgage bonds issued by the issuer during the year. In determining the aggregate amount of qualified mortgage bonds that the issuer has previously elected not to issue during that calendar year, the official may rely on copies of any elections not to issue qualified mortgage bonds filed by the issuer for that calendar year, together with an affidavit executed by an official of the issuer responsible for issuing mortgage credit certificates stating that the issuer has not, to date, made any other elections not to issue qualified mortgage bonds. If, based on such information, the certifying official determines that the issuer has not, as of the date on which the certification is provided, exceeded its applicable limit for the year, the official may certify that the issue meets the requirements of section 103A(g). The fact that the certification described in this paragraph (d) is provided does not ensure that the issuer has met the requirements of section 103A(g) and the regulations thereunder, nor does it preclude the application of the penalty for overissuance of mortgage credit certificates if such over-issuance actually occurs. See § 1.25–5T.

(3) *Special rule.* If within 30 days after the issuer files a proper request for the certification described in this paragraph (d) the issuer has not received from the State official designated by law (or, if there is no State official, the Governor) certification that the issue meets the requirements of section 103A(g) or, in the alternative, a statement that the issue does not meet such requirements, the issuer may submit, in lieu of the certification required by this paragraph (d), an affidavit executed by an officer of the issuer responsible for issuing mortgage credit certificates stating that—

(i) The issue meets the requirements of section 103A(g) and the regulations thereunder,

(ii) At least 30 days before the execution of the affidavit the issuer filed a proper request for the certification described in this paragraph (d), and

(iii) The State official designated by law (or, if there is no State official, the Governor) has not provided the certification described in this paragraph (d) or a statement that the issue does not meet such requirements.

For purposes of this paragraph, a request for certification is proper if the request includes the reports and affidavits described in paragraph (d)(2).

(e) *Information reporting requirement*—(1) *Reports.* With respect to mortgage credit certificates issued after September 30, 1985, a program meets the requirements of this paragraph only if the issuer submits a report containing the information concerning the holders of certificates issued during the preceding reporting period required by this paragraph. The report must be filed for each reporting period in which certificates (other than transferred certificates) are issued under the program. The issuer is not responsible for false information provided by a holder if the issuer did not know or have reason to know that the information was false. The report must be filed on the form prescribed by the Internal Revenue Service. If no form is prescribed, or if the form prescribed is not readily available, the issuer may use its own form provided that such form is in the format set forth in this paragraph and contains the information required by this paragraph. The report must be titled ‘‘Mortgage Credit Certificate Information Report’’ and must include the name, address, and TIN of the issuer, the reporting period for which the information is provided, and the following tables containing information concerning the holders of certificates issued during the reporting period for which the report is filed:

(i) A table titled ‘‘Number of Mortgage Credit Certificates by Income and Acquisition Cost’’ showing the number of mortgage credit certificates issued (other than those issued in connection with qualified home improvement and rehabilitation loans) according to the annualized gross income of the holders (categorized in the following intervals of income:

$0–$9,999;
$10,000–$19,999;
$20,000–$29,999;
$30,000–$39,999;
$40,000–$49,999;
$50,000–$74,999; and
$75,000 or more)

and according to the acquisition cost of the residences acquired in connection with the mortgage credit certificates (categorized in the following intervals of acquisition cost:

$0–$19,999;
$20,000–$39,999;
$40,000–$59,999;
$60,000–$79,999;
$80,000–$99,999;
$100,000–$119,999;
$120,000–$149,999;
$150,000–$199,999; and
$200,000 or more).

For each interval of income and acquisition cost the table must also be categorized according to—

(A) The aggregate amount of fees charged to holders to cover any administrative costs incurred by the issuer in issuing mortgage credit certificates, and

(B) The number of holders that—

(*1*) Did not have a present ownership interest in a principal residence at any time during the 3-year period ending on the date the mortgage credit certificate is executed (*i.e.*, satisfied the 3-year requirement) and purchased residences in targeted areas,

(*2*) Satisfied the 3-year requirement and purchased residences not located in targeted areas,

(*3*) Did have a present ownership interest in a principal residence at any time during the 3-year period ending on the date the mortgage credit certificate is executed (*i.e.*, did not satisfy the 3-year requirement) and purchased residences in targeted areas, and

(*4*) Did not satisfy the 3-year requirement and purchased residences not located in targeted areas.

(ii) A table titled ‘‘Volume of Mortgage Credit Certificates by Income and Acquisition Cost’’ containing data on—

(A) The total of the certified indebtedness amounts of the certificates issued (other than those issued in connection with qualified home improvement and rehabilitation loans);

(B) The sum of the products of the certified indebtedness amount and the certificate credit rate for each certificate (other than those issued in connection with qualified home improvement and rehabilitation loans) according to annualized gross income (categorized in the same intervals of income as the preceding table) and according to the acquisition cost of the residences acquired in connection with mortgage credit certificates (categorized in the same intervals of acquisition cost as the preceding table); and

(C) For each interval of income and acquisition cost, the information described in paragraph (e)(1)(ii) (A) and (B) categorized according to the holders that—

(*1*) Satisfied the 3-year requirement and purchased residences in targeted areas,

(*2*) Satisfied the 3-year requirement and purchased residences not located in targeted areas,

(*3*) Did not satisfy the 3-year requirement and purchased residences in targeted areas, and

(*4*) Did not satisfy the 3-year requirement and purchased residences not located in targeted areas.

(iii) A table titled ‘‘Mortgage Credit Certificates for Qualified Home Improvement and Rehabilitation Loans’’ showing the number of mortgage credit certificates issued in connection with qualified home improvement loans and qualified rehabilitation loans, the total of the certified indebtedness amount with respect to such certificates, and the sum of the products of the certified indebtedness amount and the certificate credit rate for each certificate; the information contained in the table must also be categorized according to whether the residences with respect to which the certificates were provided are located in targeted areas.

(2) *Format.* If no form is prescribed by the Internal Revenue Service, or if the prescribed form is not readily available, the issuer must submit the report in the format specified in this paragraph (e)(2). The specified format of the report is the following:

MORTGAGE CREDIT CERTIFICATE INFORMATION REPORT

Name of issuer:
Address of issuer:
TIN of issuer:
Reporting period:

NUMBER OF MORTGAGE CREDIT CERTIFICATES BY INCOME AND ACQUISITION COST

3-year requirement: Annualized gross monthly income of borrowers	Satisfied		Not satisfied		Totals fees
	Nontargeted area	Targeted area	Nontargeted area	Targeted area	
$0 to $9,999.					
$10,000 to $19,999.					
$20,000 to $29,999.					
$30,000 to $39,999.					
$40,000 to $49,999.					
$50,000 to $74,999.					
$75,000 or more.					
Total.					
Acquisition Cost					
0 to $19,999.					
$20,000 to $39,999.					
$40,000 to $59,999.					
$60,000 to $79,999.					
$80,000 to $99,999.					
$100,000 to $119,999.					
$120,000 to $149,999.					
$150,000 to $199,999.					
$200,000 or more.					
Total.					

VOLUME OF MORTGAGE CREDIT CERTIFICATES BY INCOME AND ACOUISITION COST

Annualized gross monthly income of holders	Holders satisfying the 3-year requirement				3-year requirement not satisfied				Totals	
	Nontargeted area		Targeted area		Nontargeted area		Targeted area			
	Total of the certified indebtedness amounts	Sum of products of certified indebtedness amounts and credit rates	Total of the certified indebtedness amounts	Sum of products of certified indebtedness amounts and credit rates	Total of the certified indebtedness amounts	Sum of products of certified indebtedness amounts and credit rates	Total of the certified indebtedness amounts	Sum of products of certified indebtedness amounts and credit rates	Total of the certified indebtedness amounts	Total sum of products of certified indebtedness amounts and credit rates
$0 to $9,999.										
$10,000 to $19,999.										
$20,000 to $29,999.										
$30,000 to $39,999.										
$40,000 to $49,999.										
$50,000 to $74,999.										
$75,000 to more.										
Total.										
Acquisition Cost										
$0 to $19,999.										
$20,000 to $39,999.										
$40,000 to $59,999.										
$60,000 to $79,999.										
$80,000 to $99,999.										
$100,000 to $119,999.										
$120,000 to $149,999.										
$150,000 to $199,999.										
$200,000 or more.										
Total.										

MORTGAGE CREDIT CERTIFICATES FOR QUALIFIED HOME IMPROVEMENT AND REHABILITATION LOANS

	Nontargeted area	Targeted area	Totals
Home Improvement Loans			
Number of mortgage credit certificates.			
Total of the certified indebtedness amounts.			
Product of certified indebtedness amounts and credit rates.			
Rehabilitation Loans			
Number of mortgage credit certificates.			
Total of the certified indebtedness amounts.			
Product of certified indebtedness amounts and credit rates.			

(3) *Definitions and special rules.* (i) For purposes of this paragraph the term ''annualized gross income'' means the borrower's gross monthly income multiplied by 12. Gross monthly income is the sum of monthly gross pay, any additional income from investments, pensions, Veterans Administration (VA) compensation, part-time employment, bonuses, dividends, interest, current overtime pay, net rental income, etc., and other income (such as alimony and child support, if the borrower chooses to disclose such income). Information with respect to gross monthly income may be obtained from available loan documents, *e.g.*, the sum of lines 23D and 23E on the Application for VA or FmHA Home Loan Guaranty or for HUD/FHA Insured Mortgage (VA Form 26–1802a, HUD 92900, Jan. 1982), or the total line from the Gross Monthly Income section of FHLMC Residential Loan Application form (FHLMC 65 Rev. 8/78).

(ii) For purposes of this paragraph, the term ''reporting period'' means each one year period beginning July 1 and ending June 30, except that issuers need not provide data with respect to the period prior to October 1, 1985.

(iii) For purposes of this paragraph, verification of information concerning a holder's gross monthly income by utilizing other available information concerning the holder's income (*e.g.*, Federal income tax returns) is not required. In determining whether the holder of a mortgage credit certificate acquiring a residence in a targeted area satisfies the 3-year requirement, the issuer may rely on a statement signed by the holder.

(4) *Time for filing.* The report required by this paragraph shall be filed not later than the 15th day of the second calendar month after the close of the reporting period. The Commissioner may grant an extension of time for the filing of a report required by this paragraph if there is reasonable cause for the failure to file such report in a timely fashion. The report may be filed at any time before such date but must be complete based on facts and reasonable expectations as of the date the report is filed. The report need not be amended to reflect information learned subsequent to the date of filing, or to reflect changed circumstances with respect to any holder.

(5) *Place for filing.* The report required by this paragraph is to be filed at the Internal Revenue Service Center, Philadelphia, Pennsylvania 19255.

(f) *Policy statement.* A program established pursuant to an election under paragraph (c) made after 1984 meets the requirements of this paragraph only if the applicable elected representative of the governmental unit—

(1) Which is the issuer, or

(2) On whose behalf the certificates were issued,

has published (after a public hearing following reasonable public notice) a policy statement described in § 1.103A–2(1) by the last day of the year preceding the year in which the election under paragraph (c) is made, and a copy of such report has been submitted to the Commissioner on or before such last day. See § 1.103A–2(1) for further definitions and requirements.

(g) *Targeted areas requirement*—(1) *In general.* A program meets the requirements of this paragraph only if—

(i) The portion of the total proceeds of the issue specified in paragraph (g)(2) is made available to provide mortgage credit certificates in connection with owner financing of targeted area residents for at least 1 year after the date on which mortgage credit certificates are first made available with respect to targeted area residences, and

(ii) The issuer attempts with reasonable diligence to place such proceeds with qualified persons.

Mortgage credit certificates are considered first made available with respect to targeted area residences on the date on which the issuer first begins to accept applications for mortgage credit certificates provided under that issue.

(2) *Specified portion.* (i) The specified portion of the total proceeds of an issue is the lesser of—

(A) 20 percent of the total proceeds, or

(B) 8 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family, owner-occupied residences in targeted areas within the jurisdiction of the issuing authority.

For purposes of computing the required portion of the total proceeds specified in paragraph (g)(2)(i)(B) where such provision is applicable, an issuer may rely upon the safe-harbor formula provided in the regulations under section 103A(h).

(ii) See §1.25–1T(b)(10)(ii) for the definition of ‘‘total proceeds’’.

(h) *Fees*—(1) *In general.* A program meets the requirements of this paragraph only if each applicant is required to pay, directly or indirectly, no fee other than those fees permitted under this paragraph.

(2) *Permissible fees.* Applicants may be required to pay the following fees provided that they are reasonable:

(i) Points, origination fees, servicing fees, and other fees in amounts that are customarily charged with respect to mortgages not provided in connection with mortgage credit certificates,

(ii) Application fees, survey fees, credit report fees, insurance fees, or similar settlement or financing costs to the extent such amounts do not exceed the amounts charged in the area in cases where mortgages are not provided in connection with mortgage credit certificates. For example, amounts charged for FHA, VA, or similar private mortgage insurance on an individual’s mortgage are permissible so long as such amounts do not exceed the amounts charged in the area with respect to a similar mortgage that is not provided in connection with a mortgage credit certificate, and

(iii) Other fees that, taking into account all the facts and circumstances, are reasonably necessary to cover any administrative costs incurred by the issuer or its agent in issuing mortgage credit certificates.

(i) *Qualified mortgage credit certificate.* A program meets the requirements of this paragraph only if each mortgage credit certificate issued under the program meets each of the requirements of paragraphs (c) through (o) of §1.25–3T.

(j) *Good faith compliance efforts*—(1) *Eligibility requirements.* (i) A program under which each of the mortgage credit certificates issued does not meet each of the requirements of paragraphs (c) through (o) of §1.25–3T shall be treated as meeting the requirements of paragraph (i) of this section if each of the requirements of this paragraph (j)(1) is satisfied. A mortgage credit certificate program meets the requirements of this paragraph (j)(1) only if each of the following provisions is met:

(A) The issuer in good faith attempted to issue mortgage credit certificates only to individuals meeting each of the requirements of paragraphs (c) through (o) of §1.25–3T. Good faith requires that agreements with lenders and agents and other relevant instruments contain restrictions that permit the approval of mortgage credit certificates only in accordance with the requirements of paragraphs (c) through (o) of §1.25–3T. In addition, the issuer must establish reasonable procedures to ensure compliance with those requirements. Reasonable procedures include reasonable investigations by the issuer to determine whether individuals satisfy the requirements of paragraphs (c) through (o) of §1.25–3T.

(B) 95 percent or more of the total proceeds of the issue were devoted to individuals with respect to whom, at the time that the certificate was issued, all the requirements of paragraphs (c) through (o) of §1.25–3T were met. If a holder of a mortgage credit certificate fails to meet more than one of these requirements, the amount of the certificate (*i.e.,* the certificate credit rate multiplied by the certified indebtedness amount) issued to that individual will be taken into account only once in determining whether the 95-percent requirement is met. However, all of the defects in that individual’s certificate must be corrected pursuant to paragraph (j)(1)(i)(C).

(C) Any failure to meet the requirements of paragraphs (c) through (o) of §1.25–3T is corrected within a reasonable period after that failure is discovered. For example, if an individual fails to meet one or more of such requirements those failures can be corrected by revoking that individual’s certificate.

(ii) *Examples.* The following examples illustrate the application of this paragraph (j)(1):

Example 1. County X only distributes mortgage credit certificates to individuals who have contracted to purchase a principal residence. County X requires that applicants for mortgage credit certificates present the following information:

(i) An affidavit stating that the applicant intends to use the residence in connection with which the mortgage credit certificate is issued as his principal residence within a reasonable time after the certificate is issued by County X, that the applicant will notify the County if the residence ceases to be his principal residence, and facts that are sufficient for County X to determine whether the residence is located within the jurisdiction of County X,

(ii) An affidavit stating that the applicant had no present ownership interest in a principal residence at any time during the 3-year period prior to the date on which the certificate is issued,

(iii) Copies of the applicant’s Federal tax returns for the preceding 3 years,

(iv) Affidavits from the seller of the residence with respect to which the certificate is issued and the applicant stating the purchase price of the residence, including an itemized list of (A) payments made by or for the benefit of the applicant, (B) if the residence is incomplete, an estimate of the reasonable cost of completing the residence, and (C) if the residence is subject to a ground rent, the capitalized value of the ground rent,

(v) An affidavit executed by the applicant stating that the mortgage being acquired in connection with the certificate will not be used to acquire or replace an existing mortgage,

(vi) An affidavit executed by the applicant stating that no portion of the financing for the residence in connection with which the certificate is issued is provided from the proceeds of a qualified mortgage bond or qualified veterans' mortgage bond and that no portion of the mortgage for the residence is provided by a person related to the applicant (as defined in § 1.25–3T(n)),

(vii) An affidavit executed by the applicant stating that the certificate was not limited to indebtedness incurred from particular lenders, and

(viii) In the case of a mortgate credit certificate allocated for use in connection with a particular development, and affidavit executed by the applicant stating that the applicant received from the developer a certification stating that the price of the residence with respect to which the certificate was issued is no higher than it would be without the use of a mortgage credit certificate.

County X examines the information submitted by the applicant to determine whether the requirements of paragraphs (c), (d), (e), (f), (g), (i), (j), (k), and (n) of § 1.25–3T are met. County X determines that the certificate has not expired. The mortgage credit certificates issued by County X are in the form prescribed by § 1.25–6T and County X provides all the required information and statements. After determining that the applicant meets all these requirements County X issues a mortgage credit certificate to the applicant. This procedure for issuing mortgage credit certificates is sufficient evidence of the good faith of County X to meet the requirements of § 1.25–4T(j)(1)(i)(A).

Example 2. County W distributes preliminary mortgage credit certificates to individuals who have not entered into contracts to purchase a principal residence. County W issues preliminary certificates in the form prescribed by § 1.25–6T to those applicants that have submitted statements that they (i) intend to purchase a single-family residence located within the jurisdiction of County W which they will occupy as a principal residence, (ii) have had no present ownership interest in a principal residence within the preceding 3-year period, and (iii) will not use the certificate in connection with the acquisition or replacement of an existing mortgage. The certificates contain a maximum purchase price, the certificate credit rate, and a statement that the certificate will expire if the applicant does not enter into a closing agreement with respect to a loan within 6 months from the date of preliminary issuance. Holders of these certificates may apply for a mortgage loan from any lender. When the holder of the certificate applies for a loan the lender requires that he submit the following:

(i) An affidavit stating that the applicant intends to use the residence in connection with which the mortgage credit certificate is issued as his principal residence within a reasonable time after the certificate is issued by County W, that the applicant will notify the County if the residence ceases to be his principal residence, and facts that are sufficient for County W to determine whether the residence is located within the jurisdication of County W,

(ii) An affidavit stating that the applicant had no present ownership interest in a principal residence at any time during the 3-year period prior to the date on which the certificate is issued,

(iii) Copies of the applicant's Federal tax returns for the preceding 3 years,

(iv) Affidavits from the seller of the residence with respect to which the certificate is issued and the applicant stating the purchase price of the residence, including an itemized list of (A) payments made by or for the benefit of the applicant, (B) if the residence is incomplete, an estimate of the reasonable cost of completing the residence, and (C) if the residence is subject to a ground rent, the capitalized value of the ground rent,

(v) An affidavit executed by the applicant stating that the mortgage being acquired in connection with the certificate will not be used to acquire or replace an existing mortgage,

(vi) An affidavit executed by the applicant stating that no portion of the financing for the residence in connection with which the certificate is issued in provided from the proceeds of a qualified mortgage bond or qualified veterans' mortgage bond and that no portion of the mortgage for the residence is provided by a person related to the applicant (as defined in § 1.25–3T(n)),

(vii) An affidavit executed by the applicant stating that the certificate was not limited to indebtedness incurred from particular lenders, and

(viii) In the case of a mortgage credit certificate allocated for use in connection with a particular development, an affidavit executed by the applicant stating that the applicant received from the developer a certification stating that the price of the residence with respect to which the certificate was issued is no higher than it would be without the use of a mortgage credit certificate.

The lender then submits those affidavits, together with its statement as to the amount of the indebtedness incurred, to County W. After determining that the requirements of paragraphs (c), (d), (e), (f), (g), (i), (j), (k) and (n) of § 1.25–3T are met and determining that the certificate has not expired, County W completes the mortgage credit certificate. This procedure for issuing mortgage credit certificates is sufficient evidence of the good faith of County W to meet the requirements of §1.25–4T(j)(1)(i)(A).

(2) *Program requirements.* (i) A mortgage credit certificate program which fails to meet one or more of the requirements of paragraphs (b) through (h) of this section shall be treated as meeting such requirements if the requirements of this paragraph (j)(2) are satisfied. A mortgage credit certificate program meets the requirements of this paragraph (j)(2) only if each of the following provisions is met:

(A) The issuer in good faith attempted to meet all of the requirements of paragraphs (b) through (h) of this section. This good faith requirement will be met if all reasonable steps are taken by the issuer to ensure that the program complies with these requirements.

(B) Any failure to meet such requirements is due to inadvertent error, *e.g.*, mathematical error, after taking reasonable steps to comply with such requirements.

(ii) The following example illustrate the application of this paragraph (j)(2):

Example. City X issues an issue of mortgage credit certificates. However, despite taking all reasonable steps to determine accurately the size of the applicable limit, as provided in section 103A (g)(3) and the regulations thereunder, the limit is exceeded because the amount of the mortgages, originated in the area during the past 3 years is incorrectly computed as a result of mathematical error. Such facts are sufficient evidence of the good faith of the issuer to meet the requirements of paragraph (j)(2).

[T.D. 8023, 50 FR 19350, May 8, 1985, as amended by T.D. 8048, 50 FR 35538, Sept. 3, 1985]

§1.25–5T Limitation on aggregate amount of mortgage credit certificates (Temporary).

(a) *In general.* If the aggregate amount of qualified mortgage credit certificates (as defined in paragraph (b)) issued by an issuer under a qualified mortgage credit certificate program exceeds 20 percent of the nonissued bond amount (as defined in paragraph (c)), the provisions of paragraph (d) shall apply.

(b) *Aggregate amount of mortgage credit certificates*—(1) *In general.* The aggregate amount of qualified mortgage credit certificates issued under a qualified mortgage credit certificate program is the sum of the products determined by multiplying—

(i) The certified indebtedness amount of each qualified mortgage credit certificate issued under that program, by

(ii) The certificate credit rate with respect to such certificate.

(2) *Examples.* The following examples illustrate the application of this paragraph (b):

Example 1. For 1986 City Q has a nonissued bond amount of $100 million. After making a proper election, Q issues 2,000 qualified mortgage credit certificates each with a certificate credit rate of 20 percent and a certified indebtedness amount of $50,000. The aggregate amount of qualified mortgage credit certificates is $20 million (2,000 x (.2 x $50,000)). Since this amount does not exceed 20 percent of the nonissued bond amount (.2 x $100 million = $20 million), Q has complied with the limitation on the aggregate amount of mortgage credit certificates, provided that it does not issue any additional certificates.

Example 2. The facts are the same as in example (1) except that instead of issuing all its certificates at the 20 percent rate, Q issues (i) qualified mortgage credit certificates with a certificate credit rate of 10 percent and an aggregate principal amount of $25 million, (ii) qualified mortgage credit certificates with a certificate credit rate of 40 percent and an aggregate principal amount of $25 million, and (iii) qualified mortgage credit certificates with a certificate credit rate of 30 percent and an aggregate principal amount of $25 million. The aggregate amount of qualified mortgage credit certificates is $20 million ((10 percent of $25 million) plus (40 percent of $25 million) plus (30 percent of $25 million)). Q has complied with the limitation on the aggregate amount of qualified mortgage credit certificates, provided that it does not issue any additional certificates pursuant to the same program.

(c) *Nonissued bond amount.* The term ‘‘nonissued bond amount’’ means, with respect to any qualified mortgage credit certificate program, the amount of qualified mortgage bonds (as defined in section 103A(c)(1) and the regulations thereunder) which the issuer is otherwise authorized to issue and elects not to issue under section 25(c)(2) and §1.25–4T(b). The amount of qualified mortgage bonds which an issuing authority is authorized to issue is determined under section 103A(g) and the regulations thereunder; such determination shall take into account any prior elections by the issuer not to issue qualified mortgage bonds, the amount of any reduction in the State ceiling under paragraph (d) of this section, and the aggregate amount of qualified mortgage bonds issued by the issuer prior to its election not to issue qualified mortgage bonds.

(d) *Noncompliance with limitation on aggregate amount of mortgage credit certificates*—(1) *In general.* If the provisions of this paragraph apply, the State ceiling under section 103A(g)(4) and the regulations thereunder for the calendar year following the calendar year in which the Commissioner determines the correction amount for the State in which the issuer which exceeded the limitation on the aggregate amount of mortgage credit certificates is located shall be reduced by 1.25 times the correction amount with respect to such failure.

(2) *Correction amount.* (i) The term ''correction amount'' means an amount equal to the excess credit amount divided by .20.

(ii) The term ''excess credit amount'' means the excess of—

(A) The credit amount for any mortgage credit certificate program, over

(B) The amount which would have been the credit amount for such program had such program met the requirements of section 25(d)(2) and paragraph (a) of this section.

(iii) The term ''credit amount'' means the sum of the products determined by multiplying—

(A) The certified indebtedness amount of each qualified mortgage credit certificate issued under the program, by

(B) The certificate credit rate with respect to such certificate.

(3) *Example.* The following example illustrates the application of this paragraph:

Example. For 1987 City R has a nonissued bond amount of $100 million. City R issues all of its mortgage credit certificates with a certificate credit rate of 20 percent. City R issues certificates with an aggregate certified indebtedness amount of $120 million. The aggregate amount of mortgage credit certificates issued by City R is $24 million, which exceeds 20 percent of the nonissued bond amount. The State ceiling for the calendar year following the calendar year in which the Commissioner determines the correction amount is reduced by $25 million (the correction amount multiplied by 1.25). The correction amount is determined as follows: The credit amount is $24 million (.2×$120 million); the amount which would have been the credit amount for the program had it met the requirements of section 25(d)(2) is $20 million (.2×$100 million); the excess credit amount is $4 million ($24 million—$20 million); therefore, the correction amount is $20 million ($4 million/.2).

(4) *Cross-references.* See section 103A(g)(4) and the regulations thereunder with respect to the reduction of the applicable State ceiling.

[T.D. 8023, 50 FR 19353, May 8, 1985]

§ 1.25–6T Form of qualified mortgage credit certificate (Temporary).

(a) *In general.* Qualified mortgage credit certificates are to be issued on the form prescribed by the Internal Revenue Service. If no form is prescribed by the Internal Revenue Service, or if the form prescribed by the Internal Revenue Service is not readily available, the issuer may use its own form provided that such form contains the information required by this section. Each mortgage credit certificate must be issued in a form such that there are at least three copies of the form. One copy of the certificate shall be retained by the issuer; one copy shall be retained by the lender; and one copy shall be forwarded to the State official who issued the certification required by § 1.25–4T(d), unless that State official has stated in writing that he does not want to receive such copies.

(b) *Required information.* Each qualified mortgage credit certificate must include the following information:

(1) The name, address, and TIN of the issuer,

(2) The date of the issuer's election not to issue qualified mortgage bonds pursuant to which the certificate is being issued,

(3) The number assigned to the certificate,

(4) The name, address, and TIN of the holder of the certificate,

(5) The certificate credit rate,

(6) The certified indebtness amount,

(7) The acquisition cost of the residence being acquired in connection with the certificate,

(8) The average area purchase price applicable to the residence,

(9) Whether the certificate meets the requirements of §1.25–3T(d), relating to residence requirement,

(10) Whether the certificate meets the requirements of §1.25–3T(e), relating to 3-year requirement,

(11) Whether the certificate meets the requirements of §1.25–3T(g), relating to new mortgage requirement,

(12) Whether the certificate meets the requirements of §1.25–3T(i), relating to prohibited mortgages,

(13) Whether the certificate meets the requirements of §1.25–3T(j), relating to particular lenders,

(14) Whether the certificate meets the requirements of §1.25–3T(k), relating to allocations to particular developments,

(15) Whether the certificate meets the requirements of §1.25–3T(n), relating to interest paid to related persons,

(16) Whether the residence in connection with which the certificate is issued is a targeted area residence,

(17) The date on which a closing agreement is signed with respect to the certified indebtness amount,

(18) The expiration date of the certificate,

(19) A statement that the certificate is not transferable or a statement that the certificate may be transferred only if the issuer issues a new certificate, and

(20) A statement, signed under penalties of perjury by an authorized official of the issuer or its agent, that such person has made the determinations specified in paragraph (b) (9) through (16).

[T.D. 8023, 50 FR 19354, May 8, 1985]

§1.25–7T Public notice (Temporary).

(a) *In general.* At least 90 days prior to the issuance of any mortgage credit certificate under a qualified mortgage credit certificate program, the issuer shall provide reasonable public notice of—

(1) The eligibility requirements for such certificate,

(2) The methods by which such certificates are to be issued, and

(3) The other information required by this section.

(b) *Reasonable public notice*—(1) *In general.* Reasonable public notice means published notice which is reasonably designed to inform individuals who would be eligible to receive mortgage credit certificates of the proposed issuance. Reasonable public notice may be provided through newspapers of general circulation.

(2) *Contents of notice.* The public notice required by paragraph (a) must include a brief description of the principal residence requirement, 3-year requirement, purchase price requirement, and new mortgage requirement. The notice must also provide a brief description of the methods by which the certificates are to be issued and the address and telephone number for obtaining further information.

[T.D. 8023, 50 FR 19354, May 8, 1985]

§1.25–8T Reporting requirements (Temporary).

(a) *Lender*—(1) *In general.* Each person who makes a loan that is a certified indebtedness amount with respect to any mortgage credit certificate must file the report described in paragraph (a)(2) and must retain on its books and records the information described in paragraph (a)(3). The report described in paragraph (a)(2) is an annual report and must be filed on or before January 31 of the year following the calendar year to which the report relates. See section 6709(c) and the regulations thereunder for the applicable penalties with respect to failure to file reports.

(2) *Information required.* The report shall be submitted on Form 8329 and shall contain the information required therein. A separate Form 8329 shall be filed for each issue of mortgage credit certificates with respect to which the lender made mortgage loans during the preceding calendar year. Thus, for example, if during 1986 Bank M makes three mortgage loans which are certified indebtedness amounts with respect to State Z's January 15, 1986, issue of mortgage credit certificates, and two mortgage loans which are certified indebtedness amounts with respect to State Z's April 15, 1986, issue of mortgage credit certificates, and fifty mortgage loans which are certified indebtedness amounts with respect to County X's December 31, 1985, issue of mortgage credit certificates, Bank M

must file three separate reports for calendar year 1986. The lender must submit the Form 8329 with the information required therein, including—

(i) The name, address, and TIN of the issuer of the mortgage credit certificates,

(ii) The date on which the election not to issue qualified mortgage bonds with respect to that mortgage credit certificate was made,

(iii) The name, address, and TIN of the lender, and

(iv) The sum of the products determined by multiplying—

(A) The certified indebtedness amount of each mortgage credit certificate issued under such program, by

(B) The certificate credit rate with respect to such certificate.

(3) *Recordkeeping requirements.* Each person who makes a loan that is a certified indebtedness amount with respect to any mortgage credit certificate must retain the information specified in this paragraph (a)(3) on its books and records for 6 years following the year in which the loan was made. With respect to each loan the lender must retain the following information:

(i) The name, address, and TIN of each holder of a qualified mortgage credit certificate with respect to which a loan is made,

(ii) The name, address, and TIN of the issuer of such certificate, and

(iii) The date the loan for the certified indebtedness amount is closed, the certified indebtedness amount, and the certificate credit rate of such certificate.

(b) *Issuers*—(1) *In general.* Each issuer of mortgage credit certificates shall file the report described in paragraph (b)(2) of this section.

(2) *Quarterly reports.* (i) Each issuer which elects to issue mortgage credit certificates shall file reports on Form 8330. These reports shall be filed on a quarterly basis, beginning with the quarter in which the election is made, and are due on the following dates: April 30 (for the quarter ending March 31), July 31 (for the quarter ending June 30), October 31 (for the quarter ending September 30), and January 31 (for the quarter ending December 31). For elections made prior to May 8, 1985, the first report need not be filed until July 31, 1985. An issuer shall file a separate report for each issue of mortgage credit certificates. In the quarter in which the last qualified mortgage credit certificate that may be issued under a program is issued, the issuer must state that fact on the report to be filed for that quarter; the issuer is not required to file any subsequent reports with respect to that program. See section 6709(c) for the penalties with respect to failure to file a report.

(ii) The report shall be submitted on Form 8330 and shall contain the information required therein, including—

(A) The name, address, and TIN of the issuer of the mortgage credit certificates,

(B) The date of the issuer's election not to issue qualified mortgage bonds with respect to the mortgage credit certificate program and the nonissued bond amount of the program,

(C) The sum of the products determined by multiplying—

(*1*) The certified indebtedness amount of each qualified mortgage credit certificate issued under that program during the calendar quarter, by

(*2*) The certificate credit rate with respect to such certificate, and

(D) A listing of the name, address, and TIN of each holder of a qualified mortgage credit certificate which has been revoked during the calendar quarter.

(c) *Extensions of time for filing reports.* The Commissioner may grant an extension of time for the filing of a report required by this section if there is reasonable cause for the failure to file such report in a timely fashion.

(d) *Place for filing.* The reports required by this section are to be filed at the Internal Revenue Service Center, Philadelphia, Pennsylvania 19225.

(e) *Cross reference.* See section 6709 and the regulations thereunder with respect to the penalty for failure to file a report required by this section.

[T.D. 8023, 50 FR 19354, May 8, 1985]

§1.28–0 Credit for clinical testing expenses for certain drugs for rare diseases or conditions; table of contents.

In order to facilitate use of §1.28–1, this section lists the paragraphs, subparagraphs, and subdivisions contained in §1.28–1.

(a) General rule.
(b) Qualified clinical testing expenses.
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(i) In general.
(ii) Clinical testing in which taxpayer retains no rights.
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(A) In general.
(B) Drug by drug determination.
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(4) Special rule governing the application of section 41(b) beyond its expiration date.
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(1) In general.
(2) Definition of ‘‘human clinical testing’’.
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(d) Definition and special rules.
(1) Definition of ‘‘rare disease or condition’’.
(i) In general.
(ii) Cost of developing and making available the designated drug.
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(iii) Recovery from sales.
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[T.D. 8232, 53 FR 38710, Oct. 3, 1988; 53 FR 40879, Oct. 19, 1988]

§1.28–1 Credit for clinical testing expenses for certain drugs for rare diseases or conditions.

(a) *General rule.* Section 28 provides a credit against the tax imposed by chapter 1 of the Internal Revenue Code. The amount of the credit is equal to 50 percent of the qualified clinical testing expenses (as defined in paragraph (b) of this section) for the taxable year. The credit applies to qualified clinical testing expenses paid or incurred by the taxpayer after December 31, 1982, and before January 1, 1991. The credit may not exceed the taxpayer’s tax liability for the taxable year (as determined under paragraph (d)(2) of this section).

(b) *Qualified clinical testing expenses*—(1) *In general.* Except as otherwise provided in paragraph (b)(3) of this section, the term ‘‘qualified clinical testing expenses’’ means the amounts which are paid or incurred during the taxable year which would constitute ‘‘qualified research expenses’’ within the meaning of section 41(b) (relating to the credit for increasing research activities) as modified by section 28(b)(1)(B) and paragraph (b)(2) of this section. For example, amounts paid or incurred for the acquisition of depreciable property used in the conduct of clinical testing (as defined in paragraph (c) of this section) are not qualified clinical testing expenses.

(2) *Modification of section 41(b).* For purposes of paragraph (b)(1) of this section, section 41(b) is modified by substituting ‘‘clinical testing’’ for ‘‘qualified research’’ each place it appears in paragraph (2) of section 41(b) (relating to in-house research expenses) and paragraph (3) of section 41(b) (relating to contract research expenses). In addition, ‘‘100 percent’’ is substituted for ‘‘65 percent’’ in paragraph (3)(A) of section 41(b).

(3) *Exclusion for amounts funded by another person*—(i) *In general.* The term ‘‘qualified clinical testing expenses’’ shall not include any amount which would otherwise constitute qualified clinical testing expenses, to the extent such amount is funded by a grant, contract, or otherwise by another person (or any governmental entity). The determination of the extent to which an amount is funded shall be made in light of all the facts and circumstances. For a special rule regarding funding between commonly controlled businesses, see paragraph (d)(5)(iv) of § 1.28–1.

(ii) *Clinical testing in which taxpayer retains no rights.* If a taxpayer conducting clinical testing with respect to the designated drug for another person retains no substantial rights in the clinical testing under the agreement providing for the clinical testing the taxpayer’s clinical testing expenses are treated as fully funded for purposes of section 28(b)(1)(C). Thus, for example, if the taxpayer incurs clinical testing expenses under an agreement that confers on another person the exclusive right to exploit the results of the clinical testing, those expenses do not constitute qualified clinical testing expenses because they are fully funded under this paragraph (b)(3)(ii). Incidental benefits to the taxpayer from the conduct of the clinical testing (for example, increased experience in the field of human clinical testing) do not constitute substantial rights in the clinical testing.

(iii) *Clinical testing in which taxpayer retains substantial rights*—(A) *In general.* If a taxpayer conducting clinical testing with respect to the designated drug for another person retains substantial rights in the clinical testing under the agreement providing for the clinical testing, the clinical testing expenses are funded to the extent of the payments (and fair market value of any property at the time of transfer) to which the taxpayer becomes entitled by conducting the clinical testing. The taxpayer shall reduce the amount paid or incurred by the taxpayer for the clinical testing expenses that would, but for section 28(b)(1)(C) constitute qualified clinical testing expenses of the taxpayer by the amount of the funding determined under the preceding sentence. Rights retained in the clinical testing are not treated as property for purposes of this paragraph (b)(3)(iii)(A). If the property that is transferred to the taxpayer is to be consumed in the clinical testing (for example, supplies), the taxpayer should exclude the value of that property from both the payments received and the expenses paid or incurred for the clinical testing.

(B) *Drug by drug determination.* The provisions of this paragraph (b)(3) shall be applied separately to each designated drug tested by the taxpayer.

(iv) *Funding for qualified clinical testing expenses determinable only in subsequent taxable years.* If, at the time the taxpayer files its return for a taxable year, it is impossible to determine to what extent some or all of the qualified clinical testing expenses may be funded, the taxpayer shall treat the clinical testing expenses as fully funded for purposes of that return. When the amount of funding for qualified clinical testing expenses is finally determined, the taxpayer should amend the return and any interim returns to reflect the amount of funding for qualified clinical testing expenses.

(4) *Special rule governing the application of section 41(b) beyond its expiration date.* For purposes of section 28 and this section, section 41(b), as amended,

and the regulations thereunder shall be deemed to remain in effect after December 31, 1988.

(c) *Clinical testing*—(1) *In general.* The term ‘‘clinical testing’’ means any human clinical testing which—

(i) Is carried out under an exemption under section 505(i) of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 355(i)) and the regulations relating thereto (21 CFR part 312) for the purpose of testing a drug for a rare disease or condition as defined in paragraph (d)(1) of this section,

(ii) Occurs after the date the drug is designated as a drug for a rare disease or condition under section 526 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 360bb),

(iii) Occurs before the date on which an application for the designated drug is approved under section 505(b) of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 355(b)) or, if the drug is a biological product (other than a radioactive biological product intended for human use), before the date on which a license for such drug is issued under section 351 of the Public Health Services Act (42 U.S.C. 262), and

(iv) Is conducted by or on behalf of the taxpayer to whom the designation under section 526 of the Federal Food, Drug, and Cosmetic Act applies.

Human clinical testing shall be taken into account under this paragraph (c)(1) only to the extent that the testing relates to the use of a drug for the rare disease or condition for which the drug was designated under section 526 of the Federal Food, Drug, and Cosmetic Act. For purposes of paragraph (c)(1)(i) of this section the testing under section 505(i) exemption procedures (21 CFR part 312) of a biological product (other than a radioactive biological product intended for human use) pursuant to 21 CFR § 601.21 is deemed to be carried out under an exemption under section 505(i) of the Federal Food, Drug, and Cosmetic Act.

(2) *Definition of ‘‘human clinical testing.’’* Testing is considered to be human clinical testing only to the extent that it uses human subjects to determine the effect of the designated drug on humans and is necessary for the designated drug either to be approved under section 505(b) of the Federal Food, Drug, and Cosmetic Act and the regulations thereunder (21 CFR part 314), or if the designated drug is a biological product (other than a radioactive biological product intended for human use), to be licensed under section 351 of the Public Health Services Act and the regulations thereunder (21 CFR part 601). For purposes of this paragraph (c)(2), a human subject is an individual who is a participant in research, either as a recipient of the drug or as a control. A subject may be either a healthy individual or a patient.

(3) *Definition of ‘‘carried out under’’ section 505(i).* Human clinical testing is not carried out under section 505(i) of the Federal Food, Drug, and Cosmetic Act and the regulations thereunder (21 CFR part 312) unless the primary purpose of the human clinical testing is to ascertain the data necessary to qualify the designated drug for sale in the United States, and not to ascertain data unrelated or only incidentally related to that needed to qualify the designated drug. Whether or not this primary purpose test is met shall be determined in light of all of the facts and circumstances.

(d) *Definition and special rules*—(1) *Definition of ‘‘rare disease or condition’’*—(i) *In general.* The term ‘‘rare disease or condition’’ means any disease or condition which—

(A) Afflicts 200,000 or fewer persons in the United States, or

(B) Afflicts more than 200,000 persons in the United States but for which there is no reasonable expectation that the cost of developing and making available in the United States (as defined in section 7701(a)(9)) a drug for such disease or condition will be recovered from sales in the United States (as so defined) of such drug.

Determinations under paragraph (d)(1)(i)(B) of this section with respect to any drug shall be made on the basis of the facts and circumstances as of the date such drug is designated under section 526 of the Federal Food, Drug, and Cosmetic Act. Examples of diseases or conditions which in 1987 afflicted 200,000 or fewer persons in the United States are Duchenne dystrophy, one of the muscular dystrophies; Huntington’s disease, a hereditary chorea; myoclonus; Tourette’s syndrome; and amyotrophic lateral sclerosis (ALS or Lou Gehrig's disease).

(ii) *Cost of developing and making available the designated drug*—(A) *In general.* Except as otherwise provided in this paragraph (d)(1)(ii), the taxpayer's computation of the cost of developing and making available in the United States the designated drug shall include only the costs that the taxpayer (or any person whose right to make sales of the drug is directly or indirectly derived from the taxpayer, e.g., a licensee or transferee) has incurred or reasonably expects to incur in developing and making available in the United States the designated drug for the disease or condition for which it is designated. For example, if, prior to designation under section 526, the taxpayer incurred costs of $125,000 to test the drug for the rare disease or condition for which it is subsequently designated and incurred $500,000 to test the same drug for other diseases, and if, on the date of designation, the taxpayer expects to incur costs of $1.2 million to test the drug for the rare disease or condition for which it is designated, the taxpayer shall include in its cost computation both the $125,000 incurred prior to designation and the $1.2 million expected to be incurred after designation to test the drug for the rare disease or condition for which it is designated. The taxpayer shall not include the $500,000 incurred to test the drug for other diseases.

(B) *Exclusion of costs funded by another person.* In computing the cost of developing and making available in the United States the designated drug, the taxpayer shall not include any cost incurred or expected to be incurred by the taxpayer to the extent that the cost is funded or is reasonably expected to be funded (determined under the principles of paragraph (b)(3)) by a grant, contract, or otherwise by another person (or any governmental entity).

(C) *Computation of cost.* The cost computation shall use only reasonable costs incurred after the first indication of an orphan application for the designated drug. Such costs shall include the costs of obtaining data needed, and of meetings to be held, in connection with a request for FDA assistance under section 525 of the Federal, Food, Drug, and Cosmetic Act (21 U.S.C. 360aa) or a request for orphan designation under section 526 of that Act; costs of determining patentability of the drug; costs of screening, animal and clinical studies; costs associated with preparation of a Notice of Claimed Investigational Exemption for a New Drug (IND) and a New Drug Application (NDA); costs of possible distribution of drug under a ''treatment'' protocol; costs of development of a dosage form; manufacturing costs; distribution costs; promotion costs; costs to maintain required records and reports; and costs of the taxpayer in acquiring the right to market a drug from the owner of that right prior to designation. The taxpayer shall also include general overhead, depreciation costs and premiums for insurance against liability losses to the extent that the taxpayer can demonstrate that these costs are properly allocable to the designated drug under the established standards of financial accounting and reporting of research and development costs.

(D) *Allocation of common costs. Costs for developing and making available the designated drug for both the disease or condition for which it is designated and one or more other diseases or conditions.* In the case where the costs incurred or expected to be incurred in developing and making available the designated drug for the disease or condition for which it is designated are also incurred or expected to be incurred in developing and making available in the United States the same drug for one or more other diseases or conditions (whether or not they are also designated or expected to be designated), the costs shall be allocated between the cost of developing and making available the designated drug for the disease or condition for which the drug is designated and the cost of developing and making available the designated drug for the other diseases or conditions. The amount of the common costs to be allocated to the cost of developing and making available the designated drug for the disease or condition for which it is designated is determined by multiplying the common costs by a fraction the numerator of which is the sum of the expected amount of sales in the United States of the designated drug for the disease or condition for which the drug is designated and the denominator of which is the total expected amount of sales in the United States of the designated drug. For example, if prior to designation, the taxpayer incurs (among other costs) costs of $100,000 in testing the designated drug for its toxic effect on animals (without reference to any disease or condition), and if the taxpayer expects to recover $500,000 from sales in the United States of the designated drug for disease X, the disease for which the drug is designated, and further expects to recover another $1.5 million from the sales in the United States of the designated drug for disease Y, the taxpayer must allocate a proportionate amount of the common costs of $100,000 to the cost of developing and making available the designated drug for both disease X and disease Y. Since the ratio of the expected amount of sales in the United States of the designated drug for disease X to the total of both the expected amount of sales in the United States of the designated drug for disease X and the expected amount of sales in the United States of the designated drug for disease Y is $500,000/$2,000,000, 25% of the common costs of $100,000 (*i.e.*, $25,000) is allocated to the cost of developing and making available the designated drug for disease X.

(iii) *Recovery from sales.* In determining whether the taxpayer's cost described in paragraph (d)(1)(ii) of this section will be recovered from sales in the United States of the designated drug for the disease or condition for which the drug is designated, the taxpayer shall include anticipated sales by the taxpayer or any person whose right to make such sales is directly or indirectly derived from the taxpayer (such as a licensee or transferee). The anticipated sales shall be based upon the size of the anticipated patient population for which the designated drug would be useful, including the following factors: the degree of effectiveness and safety of the designated drug, if known: the projected fraction of the anticipated patient population expected to be given the designated drug and to continue to take it; other available agents and other types of therapy; the likelihood that superior agents will become available within a few years; and the number of years during which the designated drug would be exclusively available, *e.g.*, under a patent.

(iv) *Recordkeeping requirements.* The taxpayer shall keep records sufficient to substantiate the cost and sales estimates made pursuant to this paragraph (d)(1). The records required by this paragraph (d)(1)(iv) shall be retained so long as the contents thereof may become material in the administration of section 28.

(2) *Tax liability limitation*—(i) *Taxable years beginning after December 31, 1986.* The credit allowed by section 28 shall not exceed the excess (if any) of—

(A) The taxpayer's regular tax liability for the taxable year (as defined in section 26(b)), reduced by the sum of the credits allowable under—

(*1*) Section 21 (relating to expenses for household and dependent care services necessary for gainful employment),

(*2*) Section 22 (relating to the elderly and permanently and totally disabled),

(*3*) Section 23 (relating to residential energy),

(*4*) Section 25 (relating to interest on certain home mortgages), and

(*5*) Section 27 (relating to taxes on foreign countries and possessions of the United States), over

(B) The tentative minimum tax for the taxable year (as determined under section 55(b)(1)).

(ii) *Taxable years beginning before January 1, 1987, and after December 31, 1983.* The credit allowed by section 28 shall not exceed the taxpayer's tax liability for the taxable year (as defined in section 26 (b) prior to its amendment by the Tax Reform Act of 1986 (Pub. L. 99–514)), reduced by the sum of the credits allowable under—

(A) Section 21 (relating to expenses for household dependent care services necessary for gainful employment),

(B) Section 22 (relating to the elderly and permanently and totally disabled),

(C) Section 23 (relating to residential energy),

(D) Section 24 (relating to contributions to candidates for public office),

(E) Section 25 (relating to interest on certain home mortgages), and

(F) Section 27 (relating to the taxes on foreign countries and possessions of the United States).

(iii) *Taxable years beginning before January 1, 1984.* The credit allowed by section 28 shall not exceed the amount of the tax imposed by chapter 1 of the Internal Revenue Code for the taxable year, reduced by the sum of the credits allowable under the following sections as designated prior to the enactment of the Tax Reform Act of 1984 (Pub. Law 98–369):

(A) Section 32 (relating to tax withheld at source on nonresident aliens and foreign corporations and on taxfree convenant bonds),

(B) Sections 33 (relating to taxes of foreign countries and possessions of the United States),

(C) Section 37 (relating to the retirement income),

(D) Section 38 (relating to investment in certain depreciable property),

(E) Section 40 (relating to expenses of work incentive programs).

(F) Section 41 (relating to contributions to candidates for public office).

(G) Section 44 (relating to purchase of new principal residence).

(H) Section 44A (relating to expenses for household and dependent care services necessary for gainful employment).

(I) Section 44B (relating to employment of certain new employees).

(J) Section 44C (relating to residential energy).

(K) Section 44D (relating to producing fuel from a nonconventional source).

(L) Section 44E (relating to alcohol used as fuel).

(M) Section 44F (relating to increasing research activities), and

(N) Section 44G (relating to employee stock ownership).

The term ''tax imposed by chapter 1'' as used in this paragraph (d)(2)(iii) does not include any tax treated as not imposed by chapter 1 of the Internal Revenue Code under the last sentence of section 53(a).

(3) *Special limitations on foreign testing*—(i) *Clinical testing conducted outside of the United States—In general.* Except as otherwise provided in this paragraph (d)(3), expenses paid or incurred with respect to clinical testing conducted outside the United States (as defined in section 7701(a)(9)) are not eligible for credit under this section. Thus, for example, wages paid an employee clinical investigator for clinical testing conducted in medical facilities in the United States and Mexico generally must be apportioned between the clinical testing conducted within the United States and the clinical testing conducted outside the United States, and only the wages apportioned to the clinical testing conducted within the United States are qualified clinical testing expenses.

(ii) *Insufficient testing population in the United States*—(A) *In general.* If clinical testing is conducted outside of the United States because there is an insufficient testing population in the United States, and if the clinical testing is conducted by a United States person (as defined in section 7701(a)(30)) or is conducted by any other person unrelated to the taxpayer to whom the designation under section 526 of the Federal Food, Drug, and Cosmetic Act applies, then the expenses paid or incurred for clinical testing conducted outside of the United States are eligible for the credit provided by section 28.

(B) ''*Insufficient testing population.*'' The testing population in the United States is insufficient if there are not within the United States the number of available and appropriate human subjects needed to produce reliable data from the clinical investigation.

(C) ''*Unrelated to the taxpayer.*'' For the purpose of determining whether a person is unrelated to the taxpayer to whom the designation under section 526 of the Federal Food, Drug, and Cosmetic Act and the regulations thereunder applies, the rules of section 613A(d)(3) shall apply except that the number ''5'' in section 613A(d)(3) (A), (B), and (C) shall be deleted and the number ''10'' inserted in lieu thereof.

(4) *Special limitations for certain corporations*—(i) *Corporations to which section 936 applies.* Expenses paid or incurred for clinical testing conducted either inside or outside the United States by a corporation to which section 936 (relating to Puerto Rico and

possessions tax credit) applies are not eligible for the credit under section 28.

(ii) *Corporations to which section 934(b) applies.* For taxable years beginning before January 1, 1987, expenses paid or incurred for clinical testing conducted either inside or outside the United States by a corporation to which section 934(b) (relating to the limitation on reduction in income tax liability incurred to the Virgin Islands), as in effect prior to its amendment by the Tax Reform Act of 1986, applies are not eligible for the credit under section 28. For taxable years beginning after December 31, 1986, see section 1277(c)(1) of the Tax Reform Act of 1986 (100 Stat. 2600) which makes the rule set forth in the preceding sentence inapplicable with respect to corporations created or organized in the Virgin Islands only if (and so long as) an implementing agreement described in that section is in effect between the United States and the Virgin Islands.

(5) *Aggregation of expenditures*—(i) *Controlled group of corporations; organizations under common control*—(A) *In general.* In determining the amount of the credit allowable with respect to an organization that at the end of its taxable year is a member of a controlled group of corporations or a member of a group of organizations under common control, all members of the group are treated as a single taxpayer and the credit (if any) allowable to the member is determined on the basis of its proportionate share of the qualified clinical testing expenses of the aggregated group.

(B) *Definition of controlled group of corporations.* For purposes of this section, the term ‘‘controlled group of corporations’’ shall have the meaning given to the term by section 41(f)(5).

(C) *Definition of organization.* For purposes of this section, an organization is a sole proprietorship, a partnership, a trust, an estate, or a corporation, that is carrying on a trade or business (within the meaning of section 162). For purposes of this section, any corporation that is a member of a commonly controlled group shall be deemed to be carrying on a trade or business if any other member of that group is carrying on any trade or business.

(D) *Determination of common control.* Whether organizations are under common control shall be determined under the principles set forth in paragraphs (b) through (g) of 26 CFR 1.52–1.

(ii) *Tax accounting periods used*—(A) *In general.* The credit allowable to a member of a controlled group of corporations or a group of organizations under common control is that member's share of the aggregate credit computed as of the end of such member's taxable year.

(B) *Special rule where the timing of clinical testing is manipulated.* If the timing of clinical testing by members using different tax accounting periods is manipulated to generate a credit in excess of the amount that would be allowable if all members of the group used the same tax accounting period, the district director may require all members of the group to calculate the credit in the current taxable year and all future years by using the ‘‘conformed years’’ method. Each member computing a credit under the ‘‘conformed years’’ method shall compute the credit as if all members of the group had the same taxable year as the computing member.

(iii) *Membership during taxable year in more than one group.* An organization may be a member of only one group for a taxable year. If, without application of this paragraph (d)(5)(iii), an organization would be a member of more than one group at the end of its taxable year, the organization shall be treated as a member of the group in which it was included for its preceding taxable year. If the organization was not included for its preceding taxable year in any group in which it could be included as of the end of its taxable year, the organization shall designate in its timely filed return the group in which it is being included. If the return for a taxable year is due before May 1, 1985, the organization may designate its group membership through an amended return for that year filed on or before April 30, 1985. If the organization does not so designate, then the district director with audit jurisdiction of the return will determine the group in which the business is to be included.

(iv) *Intra-group transactions*— (A) *In general.* Because all members of a group under common control are treated as a single taxpayer for purposes of determining the credit, transactions between members of the group are generally disregarded.

(B) *In-house research expenses.* If one member of a group conducts clinical testing on behalf of another member, the member conducting the clinical testing shall include in its qualified clinical testing expenses any in-house research expenses for that work and shall not treat any amount received or accrued from the other member as funding the clinical testing. Conversely, the member for whom the clinical testing is conducted shall not treat any part of any amount paid or incurred as a contract research expense. For purposes of determining whether the in-house research for that work is clinical testing, the member performing the clinical testing shall be treated as carrying on any trade or business carried on by the member on whose behalf the clinical testing is performed.

(C) *Contract research expenses.* If a member of a group pays or incurs contract research expenses to a person outside the group in carrying on the member's trade or business, that member shall include those expenses as qualified clinical testing expenses. However, if the expenses are not paid or incurred in carrying on any trade or business of that member, those expenses may be taken into account as contract research expenses by another member of the group provided that the other member—

(*1*) Reimburses the member paying or incurring the expenses, and

(*2*) Carries on a trade or business to which the clinical testing relates.

(D) *Lease payments.* Amounts paid or incurred to another member of the group for the lease of personal property owned by a person outside the group shall be taken into account as in-house research expenses for purposes of section 28 only to the extent of the lesser of—

(*1*) The amount paid or incurred to the other member, or

(*2*) The amount of the lease expense paid to a person outside the group.

The amount paid or incurred to another member of the group for the lease of personal property owned by a member of the group is not taken into account for purposes of section 28.

(E) *Payment for supplies.* Amounts paid or incurred to another member of the group for supplies shall be taken into account as in-house research expenses for purposes of section 28 only to the extent of the lesser of—

(*1*) The amount paid or incurred to the other member, or

(*2*) The amount of the other member's basis in the supplies.

(6) *Allocations*—(i) *Pass-through in the case of an S corporation.* In the case of an S corporation (as defined in section 1361), the amount of the credit for qualified clinical testing expenses computed for the corporation for any taxable year shall be allocated among the persons who are shareholders of the corporation during the taxable year according to the provisions of section 1366 and section 1377.

(ii) *Pass-through in the case of an estate or a trust.* In the case of an estate or a trust, the amount of the credit for qualified clinical testing expenses computed for the estate or trust for any taxable year shall be apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each.

(iii) *Pass-through in the case of a partnership*—(A) *In general.* In the case of a partnership, the credit for qualified clinical testing expenses computed for the partnership for any taxable year shall be apportioned among the persons who are partners during the taxable year in accordance with section 704 and the regulations thereunder.

(B) *Certain partnership non-business expenditures.* A partner's share of an in-house research expense or contract research expense paid or incurred by a partnership other than in carrying on a trade or business of the partnership constitutes a qualified clinical testing expense of the partner if—

(*1*) The partner is entitled to make independent use of the result of the clinical testing, and

(*2*) The clinical testing expense paid or incurred in carrying on the clinical testing would have been paid or incurred by the partner in carrying on a trade or business of the partner if the partner had carried on the clinical testing that was in fact carried on by the partnership.

(C) *Apportionment.* Qualified clinical testing expenses to which paragraph (d)(6)(iii)(B) of this section applies shall be apportioned among the persons who are partners during the taxable year in accordance with section 704 and the regulations thereunder. For purposes of section 28, these expenses shall be treated as paid or incurred directly by the partners rather than by the partnership. Thus, the partnership shall disregard these expenses in computing the credit to be apportioned under paragraph (d)(6)(iii)(A) of this section, and each partner shall aggregate the portion of these expenses allocated to the partner with other qualified clinical testing expenses of the partner in making the computations under section 28.

(iv) *Year in which taken into account.* An amount apportioned to a person under paragraph (d)(6) of this section shall be taken into account by the person in the taxable year of such person in which or with which the taxable year of the corporation, estate, trust, or partnership (as the case may be) ends.

(v) *Credit allowed subject to limitation.* Any person to whom any amount has been apportioned under paragraph (d)(6)(i), (ii), or (iii) of this section is allowed, subject to the limitation provided in section 28(d)(2), a credit for that amount.

(7) *Manner of making an election.* To make an election to have section 28 apply for its taxable year, the taxpayer shall file Form 6765 (Credit for Increasing Research Activities (or for claiming the orphan drugs credit)) containing all the information required by that form.

[T.D. 8232, 53 FR 38711, Oct. 3, 1988; 53 FR 40879, Oct. 19, 1988; 53 FR 41013, Oct. 19, 1988]

CREDITS AGAINST TAX

CREDITS ALLOWABLE

§1.30–1 Definition of qualified electric vehicle and recapture of credit for qualified electric vehicle.

(a) *Definition of qualified electric vehicle.* A qualified electric vehicle is a motor vehicle that meets the requirements of section 30(c). Accordingly, a qualified electric vehicle does not include any motor vehicle that has ever been used (for either personal or business use) as a non-electric vehicle.

(b) *Recapture of credit for qualified electric vehicle*—(1) *In general*—(i) *Addition to tax.* If a recapture event occurs with respect to a taxpayer's qualified electric vehicle, the taxpayer must add the recapture amount to the amount of tax due in the taxable year in which the recapture event occurs. The recapture amount is not treated as income tax imposed on the taxpayer by chapter 1 of the Internal Revenue Code for purposes of computing the alternative minimum tax or determining the amount of any other allowable credits for the taxable year in which the recapture event occurs.

(ii) *Reduction of carryover.* If a recapture event occurs with respect to a taxpayer's qualified electric vehicle, and if a portion of the section 30 credit for the cost of that vehicle was disallowed under section 30(b)(3)(B) and consequently added to the taxpayer's minimum tax credit pursuant to section 53(d)(1)(B)(iii), the taxpayer must reduce its minimum tax credit carryover by an amount equal to the portion of any minimum tax credit carryover attributable to the disallowed section 30 credit, multiplied by the recapture percentage for the taxable year of recapture. Similarly, the taxpayer must reduce any other credit carryover amounts (such as under section 469) by the portion of the carryover attributable to section 30, multiplied by the recapture percentage.

(2) *Recapture event*—(i) *In general.* A recapture event occurs if, within 3 full years from the date a qualified electric vehicle is placed in service, the vehicle ceases to be a qualified electric vehicle. A vehicle ceases to be a qualified electric vehicle if—

(A) The vehicle is modified so that it is no longer primarily powered by electricity;

(B) The vehicle is used in a manner described in section 50(b); or

(C) The taxpayer receiving the credit under section 30 sells or disposes of the vehicle and knows or has reason to know that the vehicle will be used in a manner described in paragraph (b)(2)(i)(A) or (B) of this section.

(ii) *Exception for disposition.* Except as provided in paragraph (b)(2)(i)(C) of this section, a sale or other disposition (including a disposition by reason of an accident or other casualty) of a qualified electric vehicle is not a recapture event.

(3) *Recapture amount.* The recapture amount is equal to the recapture percentage times the decrease in the credits allowed under section 30 for all prior taxable years that would have resulted solely from reducing to zero the cost taken into account under section 30 with respect to such vehicle, including any credits allowed attributable to section 30 (such as under sections 53 and 469).

(4) *Recapture date.* The recapture date is the actual date of the recapture event unless a recapture event described in paragraph (b)(2)(i)(B) of this section occurs, in which case the recapture date is the first day of the recapture year.

(5) *Recapture percentage.* For purposes of this section, the recapture percentage is—

(i) 100, if the recapture date is within the first full year after the date the vehicle is placed in service;

(ii) 66⅔, if the recapture date is within the second full year after the date the vehicle is placed in service; or

(iii) 33⅓, if the recapture date is within the third full year after the date the vehicle is placed in service.

(6) *Basis adjustment.* As of the first day of the taxable year in which the recapture event occurs, the basis of the qualified electric vehicle is increased by the recapture amount and the carryover reductions taken into account under paragraphs (b)(1)(i) and (ii) of this section, respectively. For a vehicle that is of a character that is subject to an allowance for depreciation, this increase in basis is recoverable over the remaining recovery period for the vehicle beginning as of the first day of the taxable year of recapture.

(7) *Application of section 1245 for sales and other dispositions.* For purposes of section 1245, the amount of the credit allowable under section 30(a) with respect to any qualified electric vehicle that is (or has been) of a character subject to an allowance for depreciation is treated as a deduction allowed for depreciation under section 167. Therefore, upon a sale or other disposition of a depreciable qualified electric vehicle, section 1245 will apply to any gain recognized to the extent the basis of the depreciable vehicle was reduced under section 30(d)(1) net of any basis increase described in paragraph (b)(6) of this section.

(8) *Examples.* The following examples illustrate the provisions of this section:

Example 1. A, a calendar-year taxpayer, purchases and places in service for personal use on January 1, 1995, a qualified electric vehicle costing $25,000. On A's 1995 federal income tax return, A claims a credit of $2,500. On January 2, 1996, A sells the vehicle to an unrelated third party who subsequently converts the vehicle into a non-electric vehicle on October 15, 1996. There is no recapture upon the sale of the vehicle by A provided A did not know or have reason to know that the purchaser intended to convert the vehicle to non-electric use.

Example 2. B, a calendar-year taxpayer, purchases and places in service for personal use on October 11, 1994, a qualified electric vehicle costing $20,000. On B's 1994 federal income tax return, B claims a credit of $2,000, which reduces B's tax by $2,000. The basis of the vehicle is reduced to $18,000 ($20,000 − $2,000). On March 8, 1996, B sells the vehicle to a tax-exempt entity. Because B knowingly sold the vehicle to a tax-exempt entity described in section 50(b) in the second full year from the date the vehicle was placed in service, B must recapture $1,333 ($2,000×66⅔ percent). This recapture amount increases B's tax by $1,333 on B's 1996 federal income tax return and is added to the basis of the vehicle as of January 1, 1996, the beginning of the taxable year in which the recapture event occurred.

Example 3. X, a calendar-year taxpayer, purchases and places in service for business use on January 1, 1994, a qualified electric vehicle costing $30,000. On X's 1994 federal income tax return, X claims a credit of $3,000, which reduces X's tax by $3,000. The basis of the vehicle is reduced to $27,000 ($30,000 − $3,000) prior to any adjustments for depreciation. On March 8, 1995, X converts the qualified electric vehicle into a gasoline-propelled vehicle. Because X modified the vehicle so that it is no longer primarily powered by electricity in the second full year from the date the vehicle was placed in service, X must recapture $2,000 ($3,000 × 66⅔ percent). This recapture amount increases X's tax by $2,000 on X's 1995 federal income tax return. The recapture amount of $2,000 is added to the basis of the vehicle as of January 1, 1995, the beginning of the taxable year of recapture, and to the extent the property remains depreciable, the adjusted basis is recoverable over the remaining recovery period.

Example 4. The facts are the same as in *Example 3.* In 1996, X sells the vehicle for $31,000, recognizing a gain from this sale. Under paragraph (b)(7) of this section, section 1245 will apply to any gain recognized on the sale of a depreciable vehicle to the extent the basis of the vehicle was reduced by the section 30 credit net of any basis increase from recapture of the section 30 credit. Accordingly, the gain from the sale of the vehicle is subject to section 1245 to the extent of the depreciation allowance for the vehicle plus the credit allowed under section 30 ($3,000), less the previous recapture amount ($2,000). Any remaining amount of gain may be subject to other applicable provisions of the Internal Revenue Code.

(c) *Effective date.* This section is effective on October 14, 1994. If the recapture date is before the effective date of this section, a taxpayer may use any reasonable method to recapture the benefit of any credit allowable under section 30(a) consistent with section 30 and its legislative history. For this purpose, the recapture date is defined in paragraph (b)(4) of this section.

[60 FR 39649, Aug. 3, 1995]

§1.31–1 Credit for tax withheld on wages.

(a) The tax deducted and withheld at the source upon wages under chapter 24 of the Internal Revenue Code of 1954 (or in the case of amounts withheld in 1954, under subchapter D, chapter 9 of the Internal Revenue Code of 1939) is allowable as a credit against the tax imposed by Subtitle A of the Internal Revenue Code of 1954, upon the recipient of the income. If the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer. For the purpose of the credit, the recipient of the income is the person subject to tax imposed under Subtitle A upon the wages from which the tax was withheld. For instance, if a husband and wife domiciled in a State recognized as a community property State for Federal tax purposes make separate returns, each reporting for income tax purposes one- half of the wages received by the husband, each spouse is entitled to one-half of the credit allowable for the tax withheld at source with respect to such wages.

(b) The tax withheld during any calendar year shall be allowed as a credit against the tax imposed by Subtitle A for the taxable year of the recipient of the income which begins in that calendar year. If such recipient has more than one taxable year beginning in that calendar year, the credit shall be allowed against the tax for the last taxable year so beginning.

§1.31–2 Credit for “special refunds” of employee social security tax.

(a) *In general.* (1) In the case of an employee receiving wages from more than one employer during the calendar year, amounts may be deducted and withheld as employee social security tax with respect to more than $3,600 of wages received during the calendar year 1954, and with respect to more than $4,200 of wages received during a calendar year after 1954. For example, employee social security tax may be deducted and withheld on $5,000 of wages received by an employee during a particular calendar year if the employee is paid wages in such year in the amount of $3,000 by one employer and in the amount of $2,000 by another employer. Section 6413(c) (as amended by section 202 of the Social Security Amendments of 1954 (68 Stat. 1089)), permits, under certain conditions, a so-called ‘‘special refund’’ of the amount of employee social security tax deducted and withheld with respect to wages paid to an employee in a calendar year after 1954 in excess of $4,200 ($3,600 for the calendar year 1954) by reason of the employee receiving wages from more than one employer during the calendar year. For provisions relating to the imposition of the employee tax and the limitation on wages, see with respect to the calendar year 1954, sections 1400 and 1426(a)(1) of the Internal Revenue Code of 1939 and, with respect to calendar years after 1954, sections 3101 and 3121(a)(1) of the Internal Revenue Code of 1954, as amended by sections 208(b) and 204(a), respectively, of the Social Security Amendments of 1954 (68 Stat. 1094, 1091).

(2) An employee who is entitled to a special refund of employee tax with respect to wages received during a calendar year and who is also required to file an income tax return for such calendar year (or for his last taxable year beginning in such calendar year) may obtain the benefits of such special refund only by claiming credit for such special refund in the same manner as if such special refund were an amount deducted and withheld as income tax at the source. For provisions for claiming special refunds for 1955 and subsequent years in the case of employees not required to file income tax returns, see section 6413(c) and the regulations thereunder. For provisions relating to such refunds for 1954, see 26 CFR (1939) 408.802 (regulations 128).

(3) The amount of the special refund allowed as a credit shall be considered as an amount deducted and withheld as income tax at the source under chapter 24 of the Internal Revenue Code of 1954 (or, in the case of a special refund for 1954, subchapter D, chapter 9 of the Internal Revenue Code of 1939). If the amount of such special refund when added to amounts deducted and withheld as income tax exceeds the taxes imposed by subtitle A of the Internal Revenue Code of 1954, the amount of the excess constitutes an overpayment of income tax under Subtitle A, and interest on such overpayment is allowed to the extent provided under section 6611 upon an overpayment of income tax resulting from a credit for income tax withheld at source. See section 6401(b).

(b) *Federal and State employees and employees of certain foreign corporations.* The provisions of this section shall apply to the amount of a special refund allowable to an employee of a Federal agency or a wholly owned instrumentality of the United States, to the amount of a special refund allowable to an employee of any State or political subdivision thereof (or any instrumentality of any one or more of the foregoing), and to the amount of a special refund allowable to employees of certain foreign corporations. See, with respect to such special refunds for 1954, section 1401(d)(4) of the Internal Revenue Code of 1939, and with respect to such special refunds for 1955 and subsequent years, section 6413(c)(2) of the Internal Revenue Code of 1954, as amended by section 202 of the Social Security amendments of 1954.

§ 1.32–2 Earned income credit for taxable years beginning after December 31, 1978.

(a) *Allowance of credit.* For taxable years beginning after December 31, 1978, subject to the limitations of paragraph (b) of this section, an eligible individual (as defined in paragraph (c)(1) of this section) is allowed as a credit against the tax imposed by subtitle A of the Code for the taxable year, an amount equal to 10 percent of the first $5,000 of earned income (as defined in paragraph (c)(2) of this section) for the taxable year. For earlier taxable years beginning before January 1, 1979, see § 1.43–1.

(b) *Limitations*—(1) *Amount of credit.* The amount of the credit allowed by section 43 and paragraph (a) of this section for the taxable year must not exceed the excess, if any, of $500 over 12.5 percent of that amount of the adjusted gross income (or, if greater, the earned income) of the taxpayer for the taxable year which exceeds $6,000. For the meaning of the term ‘‘earned income,’’ see paragraph (c)(2) of this section. Adjusted gross income is determined under section 62 and the regulations thereunder. If an individual has adjusted gross income or earned income of $10,000 or more, the individual is not entitled to the credit.

(2) *Married individuals.* No credit is allowed by section 43 and paragraph (a) of this section in the case of an eligible individual who is married (within the meaning of section 143 and the regulations thereunder) unless the individual and spouse file a single return jointly (a joint return) for the taxable year (see section 6013 and the regulations thereunder relating to joint returns of income tax by husband and wife). The requirements of the preceding sentence do not apply to an eligible individual who is not considered as married under section 143(b) and the regulations thereunder (relating to certain married individuals living apart).

(3) *Length of taxable year.* No credit is allowed by section 43 and paragraph (a) of this section in the case of a taxable

year covering a period of less than 12 months. However, the rule of the preceding sentence does not apply to a taxable year closed by reason of the death of the eligible individual.

(c) *Definitions*—(1) *Eligible individual.* For purposes of this section, an eligible individual is an individual who meets the following requirements of this paragraph (c)(1).

(i) For the taxable year the individual must meet any one of the following three requirements set forth, respectively, in (A), (B), and (C) of this subdivision (i).

(A) The individual must be married (within the meaning of section 143 and the regulations thereunder) and be entitled to a deduction under section 151 for a child (within the meaning of section 151(e)(3) and the regulations thereunder). The child must have the same principal place of abode (as defined in §1.2–2(c)) as the individual and that principal place of abode must be in the United States for the entire taxable year.

(B) The individual must qualify as a surviving spouse (as determined under section 2(a) and the regulations thereunder). Thus, the spouse of the individual must have died within the period of the 2 taxable years immediately preceding the individual's taxable year. Also, the individual must have furnished over half the cost of maintaining as the individual's home a household in the United States for the entire taxable year which is the principal place of abode of a child of the individual who qualifies as a dependent for whom the individual is entitled to a deduction under section 151.

(C) The individual must qualify as a head of household (as determined under section 2(b) and the regulations thereunder but without regard to section 2(b)(1)(A)(ii) and (B) and the regulations, thereunder). Thus, the individual cannot be married as of the close of the taxable year and also cannot qualify as a surviving spouse under section 2(a). Also, the individual must have furnished over half the cost of maintaining as the individual's home a household in the United States for the entire taxable year which is the principal place of abode of a child or descendant of the individual who is unmarried or who qualifies as a dependent for whom the individual is entitled to a deduction under section 151.

(ii) For the entire taxable year, the individual must not be entitled to exclude any amount from gross income under section 911 (relating to earned income by individuals in certain camps outside the United States) or section 931 and the regulations thereunder (relating to income from sources within the possessions of the United States).

(iii) The rules of this paragraph (c)(1) are illustrated by the following examples:

Example 1. A, who is married and a member of the United States Armed Forces, maintains his household outside the United States for part of the taxable year. A is not an eligible individual. However, if A maintains his household inside the United States for the entire taxable year and is only temporarily absent therefrom by reason of military service and if the household is his principal place of abode and the principal place of abode of his child who receives over half of his support from the taxpayer for the calendar year in which the taxable year of the taxpayer begins and who either has less than $1,000 of gross income for the calendar year in which the individual's taxable year begins or who has not attained the age of 19 at the close of the calendar year in which the individual's taxable year begins or is a student, then the individual is an eligible individual if he meets the requirements of subdivision (ii) of this paragraph.

Example 2. B's wife died in 1975 and B has not remarried. For his entire taxable year beginning January 1, 1979, B maintains his household inside the United States. The household is, for the entire taxable year, B's principal place of abode and the principal place of abode of B's unmarried grandchild whose natural parents are deceased. Thus B qualifies as a head of household (as determined under section 2(b) without regard to subparagraphs (A)(ii) and (B) of section 2(b)(1)). In these circumstances, regardless of whether B provides sufficient support to claim the grandchild as a dependent, B is an eligible individual if he meets the requirements of subdivision (ii) of this paragraph.

Example 3. C is married and maintains his household inside the United States for the entire taxable year. The household is his principal place of abode and, for the entire year, is also the principal place of abode of a 12 year old child whose natural parents are deceased and who is placed with C by a State agency to provide the child with foster care. C receives compensation from the State agency to cover all of the cost of maintaining the child in his home. The child is in C's care and is cared for as C's own child. In these circumstances, the child is C's foster child, but C is not able to claim the child as a dependent since C did not provide half the child's support for the year. C is not eligible for the earned income credit.

Example 4. Assume the same facts as in example *(3)* except that C receives no compensation from the State agency, and C provides over half the child's support and is able to claim the child as a dependent. C is an eligible individual if he meets the requirements of subdivision (ii) of this paragraph.

Example 5. D's husband died in 1974 and D has not remarried. For the entire taxable year beginning January 1, 1979, D maintains her household inside the United States. The household is D's principal place of abode and, for the entire taxable year, is also the principal place of abode of D's unmarried son. D cares for her son in all respects except that her parents provide over half of the son's support. D qualifies as a head of household (as determined under section 2(b) without regard to subparagraph (A)(ii) and (B) of section 2(b)(1)). D is an eligible individual if D meets the requirements of subdivision (ii) of this paragraph.

Example 6. Assume the same facts as in example *5* except that D is married. Since D cannot qualify as a head of household, and D's son cannot be claimed as D's dependent, D is not an eligible individual.

(2) *Earned income.* For purposes of this section, earned income means—

(i) Wages, salaries, tips, other employee compensation, and

(iii) Net earnings from self-employment (within the meaning of section 1402(a) and the regulations thereunder). Earned income includes compensation excluded from gross income, such as disability income excluded under section 105(d), the rental value of a parsonage excluded under section 107, and the value of meals and lodging furnished for the convenience of the employer excluded under section 119. Earned income is computed without regard to any community property laws which may otherwise be applicable. Earned income is reduced by any net loss in earnings from self-employment. Earned income does not include amounts received as a pension, an annuity, unemployment compensation, or workmen's compensation, or an amount to which section 871(a) and the regulations thereunder apply (relating to income of nonresident alien individuals not connected with United States business).

(d) *Examples.* The application of this section is illustrated by the following examples. For purposes of these examples, assume that the eligible individual does not receive a pension, an annuity, or an amount to which section 871(a), 911, or 931 applies.

Example 1 . A and B (married individuals) maintain a household inside the United States which is their principal place of abode and the principal place of abode of their two children who are 12 and 14 years old. A and B are calendar year taxpayers and, for 1979, they file a joint return. A and B have a total earned income of $7,600 (computed without regard to any community property laws) and have adjusted gross income of less than $7,600. The earned income credit of $300 is determined as follows:

Basic credit (10 percent of $5,000 under paragraph (a) of this section)			$500
Initial limitation amount		$500	
Less: Reduction under paragraph (b)(1) of this section:			
Earned income for taxable year	$7,600		
Less	$6,000		
Excess over $6,000	1,600		
12½ percent of excess ($1,600)		$200	
Maximum credit (if less than basic credit)			$300

Example 2 . Assume the same facts as in example 1 except that A and B have earned income of $4,000 and adjusted gross income of $7,000. The earned income credit of $375 is determined as follows:

Basic credit (10 percent of $4,000 under paragraph (a) of this section)			$400
Initial limitation amount		$500	
Less: Reduction under paragraph (b)(1) of this section:			
Adjusted gross income for taxable year	$7,000		
Less	6,000		
Excess over $6,000	1,000		
12½ percent of excess ($1,000)		125	
Maximum credit (if less than basic credit)			375

(e) *Coordination of credit with advance payments*—(1) *Recapture of excess advance payments.* If any advance payment of earned income credit under section 3507 is made to an individual by an employer during any calendar year, then the total amount of these advance payments to the individual in that calendar year is treated as an additional amount of tax imposed (by chapter 1 of the Code) upon the individual on the tax return for the individual's last taxable year beginning in that calendar year.

(2) *Reconciliation of payments advanced and credit allowed.* Any additional amount of tax under paragraph (e)(1) of this section is not treated as a tax imposed by chapter 1 of the Code for purposes of determining the amount of any credit (other than the earned income credit) allowable under subpart A, part IV, subchapter A, chapter 1 of the Code.

[T.D. 7683, 45 FR 16175, Mar. 13, 1980. Redesignated by T.D. 8448, 57 FR 54923, Nov. 23, 1992]

§1.32–3T Eligibility requirements (Temporary).

(a) *In general.* A taxpayer who has been denied the earned income credit (EIC), in whole or in part, as a result of the deficiency procedures under subchapter B of chapter 63 (deficiency procedures) is ineligible to file a return claiming the EIC subsequent to the denial until the taxpayer demonstrates eligibility for the EIC in accordance with paragraph (c) of this section. If a taxpayer demonstrates eligibility for a taxable year in accordance with paragraph (c) of this section, the taxpayer need not comply with those requirements for any subsequent taxable year unless the Service again denies the EIC as a result of the deficiency procedures.

(b) *Denial of the EIC as a result of the deficiency procedures.* For purposes of this section, denial of the EIC as a result of the deficiency procedures occurs when a tax on account of the EIC is assessed as a deficiency (other than as a mathematical or clerical error under section 6213(b)(1)).

(c) *Demonstration of eligibility.* In the case of a taxpayer to whom paragraph (a) of this section applies, and except as otherwise provided by the Commissioner, no claim for the EIC filed subsequent to the denial is allowed unless the taxpayer properly completes Form 8862, *Information To Claim Earned Income Credit After Disallowance,* demonstrating eligibility for the EIC, and otherwise is eligible for the EIC. If any item of information on Form 8862 is incorrect or inconsistent with any item on the return, the taxpayer will be treated as not demonstrating eligibility for the EIC. The taxpayer must attach Form 8862 to the taxpayer's first income tax return on which the taxpayer claims the EIC after the EIC has been denied as a result of the deficiency procedures.

(d) *Failure to demonstrate eligibility.* If a taxpayer to whom paragraph (a) of this section applies fails to satisfy the requirements of paragraph (c) of this section with respect to a particular taxable year, the IRS can deny the EIC as a mathematical or clerical error under section 6213(g)(2)(J) [(K)].

(e) *Special rule where one spouse denied EIC.* The eligibility requirements set forth in this section apply to taxpayers filing a joint return where one spouse was denied the EIC for a taxable year prior to marriage and has not established eligibility as either an unmarried or married taxpayer for a subsequent taxable year.

(f) *Effective date.* This section applies to returns claiming the EIC for taxable years beginning after December 31, 1997, where the EIC was denied for a taxable year beginning after December 31, 1996.

[T.D. 8773, 63 FR 34596, June 25, 1998]

§1.34–1 Credit against tax and exclusion from gross income in case of dividends received by individuals.

(a) *In general.* (1) Section 34 provides a credit against the income tax of an individual for certain dividends received after July 31, 1954, and on or before December 31, 1964. The credit, subject to the limitations provided in section 34(b), is equal to 4 percent of the dividends received before January 1, 1964, and 2 percent of the dividends received during the calendar year 1964. The credit is allowable with respect to dividends received in any taxable year ending after July 31, 1954, but applies only to dividends received on or before December 31, 1964. The credit applies only to dividends which are received from domestic corporations and which are included in the gross income of the taxpayer. Section 116 provides for the exclusion from gross income of the first $100 ($50 for dividends received in taxable years beginning before January 1, 1964) of certain dividends received by an individual. See § 1.116–1. In determining which dividends are entitled to the credit against income tax provided by section 34, the exclusion from gross income provided in section 116 is applied to the first dividends received in the taxable year. Since the exclusion applies to dividends received at any time during a taxable year ending after July 31, 1954, dividends received before August 1, 1954, may be taken into account in determining the exclusion from gross income under section 116 but do not constitute dividends for which a credit is allowed.

(2) The application of section 34 (without regard to the limitations provided in section 34(b)) may be illustrated by the following example:

Example. A, an individual who makes his return on the basis of the calendar year, receives in the year 1954 the following dividends: $100 on March 1, $100 on June 1, $100 on September 1, and $100 on December 1. $50 of the dividends received by A on March 1, 1954, is excluded from gross income under section 116. The balance of the dividends received in 1954, amounting to $350, is includible in the gross income of A. Subject to the limitation in section 34(b) a credit of $8 is allowed under section 34 (4 percent of $200, the amount of the dividends received after July 31, 1954, that is, $100 received on September 1, 1954, and $100 received on December 1, 1954).

(b) *Tax credit.* The credit is used to reduce the tax imposed by Subtitle A of the Code, including the alternative tax under section 1201 in the case of capital gains and the self-employment tax under chapter 2 of the Code; however, it may not be used by the taxpayer as a credit against penalties, additions to the tax, or interest on delinquent taxes.

(c) *Joint return of husband and wife.* (1) In the case of a joint return the credit is determined on the basis of the dividends received by both the husband and wife after taking into account the exclusion allowed by section 116. See § 1.116–1. The credit is allowable in the case of a joint return on account of the dividends received by each spouse without regard to whether the spouse would be liable for the tax imposed by Subtitle A if the joint return had not been filed. However, the limitations on amount of credit in section 34(b) are determined by reference to the tax and the credit under section 33 required to be shown on the joint return and to the combined taxable income of husband and wife. For this purpose, it makes no difference whether the tax, the credit, or the taxable income is attributable to one or the other spouse. If both the husband and wife are entitled to the credit, their combined credit shall not exceed the amount so computed.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. H and W, husband and wife, make a joint return for the calendar year 1954. The only dividend received by either of them during the year is a dividend received by H on September 1 in the amount of $400. Subject to the limitations of section 34(b), the credit amounts to $14 (4 percent of $350, the dividends included in gross income after allowance of the exclusion of $50 under section 116).

Example 2. The facts are the same as in example (1) except that W also received a dividend on September 1 of $30. Since this dividend (being less than the maximum amount allowable as an exclusion under section 116(a)) is excluded from W's gross income, it does not affect the computation of the tax credit and the tax credit is the same as in example (1).

Example 3. H and W, husband and wife, make a joint return for the calendar year 1954. H and W each received a $400 dividend on September 1, 1954, and these were the only dividends received by them in 1954. Since H and W may each exclude $50 of the dividends received by them, $700 of dividend income is included in gross income. Subject to the limitations in section 34(b), the credit against the tax of H and W amounts to $28 (4 percent of $700).

(d) *Individuals receiving dividends.* Where two or more persons hold stock as tenants in common, as joint tenants, or as tenants by the entirety, the dividends received with respect to such stock shall be considered as being received by each tenant to the extent that he is entitled under local law to a share of such dividends. Where dividends constitute community property under local law each spouse shall be considered as receiving one-half of such dividends.

(e) *Time dividends are received.* In cases where it is necessary to determine the time of receipt of dividends, the rules established to determine in which taxable year dividends must be included in gross income apply, including the rules relating to constructive receipt. See section 451 and regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6777, 29 FR 17806, Dec. 16, 1964]

§ 1.34–2 Limitations on amount of credit.

(a) Under section 34(b) the credit may not exceed the lesser of either—

(1) The amount of the tax imposed by chapter 1 of the Code for the taxable year reduced by the foreign tax credit allowable under section 33, or

(2) Whichever of the following is applicable:

(i) In the case of a taxable year ending before January 1, 1955, or beginning after December 31, 1963, 2 percent of the taxable income for such taxable year;

(ii) In the case of a taxable year ending after December 31, 1954, and beginning before January 1, 1964, 4 percent of the taxable income for such taxable year. In the case of a taxpayer who computes his tax under section 3 or who uses the standard deduction provided by section 141, the taxable income for the taxable year is the adjusted gross income for the taxable year reduced by the standard deduction prescribed in section 141 and the deductions for personal exemptions provided in section 151. Where the alternative tax on capital gains is imposed under section 1201(b), the taxable income for such taxable year is the taxable income as defined in section 63, which includes 50 percent of the excess of net long-term capital gain over net short-term capital loss.

(b) The application of the limitations in paragraph (a) of this section may be illustrated by the following example:

Example. Assume the following facts in the case of an individual whose taxable year is the calendar year:

1954

Computation of tax liability without regard to the dividend received credit:

(1) Gross income	$7,500
(2) Deductions	2,900
(3) Taxable income	4,600
(4) Income tax liability	996
(5) Foreign tax credit	16
(6) Income tax liability minus foreign tax credit	980

Computation of limitation under section 34(b)(1):

(7) Dividends for which credit is allowable	$2,500
(8) Dividends received credit under section 34(a); (2,500×0.04)	100
(9) Dividends received credit, as limited by section 34(b)(1); (item (6) or item (8) whichever is lesser)	100

Computation of limitation under section 34(b)(2):

(10) Taxable income	$4,600
(11) Dividends received credit under section 34(b)(2); (4,600×0.02)	92

Dividends received credit allowable:

Item (6), item (9), or item (11), whichever is lesser	$92

1955

Computation of tax liability without regard to the dividend received credit:

(12) Gross income	$7,500
(13) Deductions	2,900
(14) Taxable income	4,600
(15) Income tax liability	996
(16) Foreign tax credit	816
(17) Income tax liability minus foreign tax credit	180

Computation of limitation under section 34(b)(1):

(18) Dividends for which credit is allowable	$2,500
(19) Dividends received credit under section 34(a); (2,500×0.04)	100
(20) Dividends received credit as limited by section 34(b)(1); (item (17) or item (19) whichever is lesser)	100

Computation of limitation under section 34(b)(2):

(21) Taxable income	$4,600
(22) Dividends received credit under section 34(b)(2); (4,600×0.04)	184

Dividends received credit allowable:

Item (17), item (19), or item (22), whichever is lesser	$100

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6777, 29 FR 17807, Dec. 16, 1964]

§ 1.34–3 Dividends to which the credit and exclusion apply.

(a) *General rule.* The credit under section 34 and the exclusion under section 116 apply only to distributions of property defined as dividends by section 316. Thus, the credit and the exclusion are not allowed with respect to patronage dividends paid by either exempt or taxable farm cooperatives. Nor are they allowed for distributions to nonstockholding policyholders by an insurance company having shares of stock or for any distribution by a mutual insurance company. See paragraph (b) of this section for an additional restriction with respect to stock life insurance companies. The credit and the exclusion are, however, allowed with respect to dividends paid on capital stock by nonexempt cooperatives and with respect to dividends paid on capital stock by building and loan associations. However, see paragraph (b) of this section with respect to so-called dividends paid by building and loan associations ineligible for the credit and the exclusion. The credit and the exclusion are allowed with respect to distributions from any organization taxed as a corporation if the distribution falls within the definition of a dividend in section 316.

(b) *Dividends from certain corporations.* (1) Section 34 (c) and (d) contains further restrictions on the type of distributions which are treated as dividends for purposes of the credit and exclusion. Thus, no credit or exclusion is applicable with respect to dividends received from a corporation organized under the China Trade Act, 1922; from stock life insurance companies before January 1, 1959, in taxable years ending before such date; from corporations which during their taxable year of the distribution or their preceding taxable year were corporations to which section 931 applies (relating to income from sources within possessions of the United States); from corporations which during the taxable year of the distribution or the preceding taxable year are corporations exempt from tax either under section 501, relating to charitable, etc., organizations, or under section 521, relating to farmers' cooperative associations.

(2) So-called dividends paid by mutual savings banks, cooperative banks, and building and loan associations which are allowed as a deduction under section 591 are ineligible for the credit and exclusion.

(3) For special rules as to the limitation on the amount of dividends for which a credit and exclusion are allowable in the case of dividends paid by a regulated investment company, see section 854 and the regulations thereunder.

(4) See section 857(c) and paragraph (d) of § 1.857–4 for special rules which deny a credit under section 34 and exclusion under section 116 in the case of dividends received from a real estate investment trust with respect to a taxable year for which such trust is taxable under part II, subchapter M, chapter 1 of the Code.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4092, Apr. 28, 1962; T.D. 6625, 27 FR 12541, Dec. 19, 1962]

§ 1.34–4 Taxpayers not entitled to credit and exclusion.

(a) The credit or exclusion is not available to nonresident aliens with respect to whom a tax is imposed for the taxable year under section 871(a). If the taxpayer elects under section 6014 to have the Government compute his tax, the credit is not taken into account in such computation although the taxpayer is allowed the exclusion under section 116.

(b) For treatment of dividends received by estates or trusts, and the allocation of such dividends between an estate or trust and the beneficiary thereof, see sections 642, 652, and 662 and the regulations thereunder. 3

(c) For treatment of dividends received by a partnership see section 702 and the regulations thereunder.

(d) For treatment of dividends received by a common trust fund, see section 584 and the regulations thereunder.

§ 1.34–5 Effective date; taxable years ending after July 31, 1954, subject to the Internal Revenue Code of 1939.

Pursuant to section 7851(a)(1)(C), the regulations prescribed in §§ 1.34–1 to 1.34–4, inclusive, shall also apply to taxable years beginning before January 1, 1954, and ending after July 31, 1954, and to taxable years beginning after December 31, 1953, and ending after July 31, 1954, but before August 17, 1954, though such years are subject to the Internal Revenue Code of 1939.

§1.34–6 Dividends received after December 31, 1964.

In the case of dividends received after December 31, 1964, section 34 and the regulations issued thereunder do not apply.

[T.D. 6777, 29 FR 17807, Dec. 16, 1964]

§1.35–1 Partially tax-exempt interest received by individuals.

(a) The credit against tax under section 35 shall be allowed only to individuals and if the requirements of both paragraphs (1) and (2) of section 35(a) are met. Where the alternative tax on capital gains is imposed under section 1201(b), the taxable income for such taxable year is the taxable income as defined in section 63, which includes 50 percent of the excess of net long-term capital gain over net short-term capital loss.

(b) For the treatment of partially tax-exempt interest in the case of amounts not allocable to any beneficiary of an estate or trust, see section 642(a)(1), and for treatment of amounts allocable to a beneficiary, see sections 652 and 662. For treatment of partially tax-exempt interest received by a partnership, see section 702(a)(7). For treatment of such interest received by a common trust fund, see section 584(c)(2).

(c) The application of section 35 may be illustrated by the following example:

Example. In his taxable year, 1955, A received $4,500 of partially tax-exempt interest. A's taxable income is $4,000 upon which the tax prior to any credits against tax is $840. His foreign tax credit under section 33 is $610, and his dividends received credit under section 34 is $120. A's credit under section 35 for partially tax-exempt interest is $110, determined as follows:

Section 35(a)		
Partially tax-exempt interest		$4,500
Credit computed under section 35(a); 3 percent of $4,500		135
Section 35(b)(1)		
Tax imposed by chapter 1		840
Less:		
Credit allowed under section 33	$610	
Credit allowed under section 34	120	
		$730
Limitation on credit under section 35(b)(1)		110
Section 35(b)(2)		
Taxable income		4,000
Limitation on credit under section 35(b)(2); 3 percent of $4,000		120

Since of the three figures ($135, $110, and $120), the lesser is $110, A's credit under section 35 is limited to $110.

§1.35–2 Taxpayers not entitled to credit.

For taxable years beginning after December 31, 1957, no credit shall be allowed under section 35 to a nonresident alien individual with respect to whom a tax is imposed for such taxable year under section 871(a).

§1.37–1 General rules for the credit for the elderly.

(a) *In general.* In the case of an individual, section 37 provides a credit against the tax imposed by chapter 1 of the Internal Revenue Code of 1954. This section and §§1.37–2 and 1.37–3 provide guidance in the computation of the credit for the elderly provided under section 37 for taxable years beginning after 1975. For rules relating to the computation of the retirement income credit provided under section 37 for taxable years beginning before 1976, see 26 CFR 1.37–1 through 1.37–5 (Rev. as of April 1, 1980). Note that section 403 of the Tax Reduction and Simplification Act of 1977 provides that a taxpayer may elect to compute the credit under section 37 for the taxpayer's first taxable year beginning in 1976 in accordance with the rules applicable to taxable years beginning before 1976.

(b) *Limitation on the amount of the credit.* The credit allowed by section 37 for a taxable year shall not exceed the tax imposed by chapter 1 of the Code for the taxable year (reduced, in the case of a taxable year beginning before 1979, by the general tax credit allowed by section 42).

(c) *Married couples must file joint returns.* If the taxpayer is married at the close of the taxable year, the credit provided by section 37 shall be allowed only if the taxpayer and the taxpayer's spouse file a joint return for the taxable year. The preceding sentence shall not apply in the case of a husband and wife who are not members of the same household at any time during the taxable year. For the determination of marital status, see §§143 and 1.143–1.

(d) *Nonresident aliens ineligible.* No credit is allowed under section 37 to any individual for any taxable year during which that individual is at any time a nonresident alien unless the individual is treated, by reason of an election under section 6013 (g) or (h), as a resident of the United States for that taxable year.

[T.D. 7743, 45 FR 84049, Dec. 22, 1980]

§ 1.37–2 Credit for individuals age 65 or over.

(a) *In general.* This section illustrates the computation of the credit for the elderly in the case of an individual who has attained the age of 65 before the close of the taxable year. This section shall not apply to an individual for any taxable year for which the individual makes the election described in section 37(e)(2) and paragraph (b) of § 1.37–3.

(b) *Computation of credit.* The credit for the elderly for an individual to whom this section applies equals 15 percent of the individual's ''section 37 amount'' for the taxable year. An individual's ''section 37 amount'' for a taxable year is the initial amount determined under section 37(b)(2), reduced as provided in section 37(b)(3) and (c)(1).

(c) *Examples.* The computation of the credit for the elderly for individuals to whom this section applies may be illustrated by the following examples:

Example 1. A, a single individual who is 67 years old, has adjusted gross income of $8,000 for the calendar year 1977. A also receives social security payments of $1,450 during 1977. A does not itemize deductions. A's credit for the elderly is $120, computed as follows:

Initial amount under section 37(b)(2)		$2,500
Reductions required by section 37 (b)(3) and (c)(1):		
Social security payments	$1,450	
One-half the excess of adjusted gross income over $7,500	250	1,700
Section 37 amount		800
15 pct. of $800		$120

A's tax from the tax tables, which reflect the allowance of the general tax credit, is $662. Accordingly, the limitation of section 37(c)(2) and paragraph (b) of § 1.37–1 does not reduce A's credit for the elderly.

Example 2. H and W, who have both attained the age of 65, file a joint return for calendar year 1977. For that year H and W have adjusted gross income of $8,120; H also receives a railroad retirement pension of $1,550, and W receives social security payments of $1,200. H and W do not itemize deductions. The credit for the elderly allowed to H and W for 1977 is $139, computed as follows:

Initial amount under section 37(b)(2)		$3,750
Reductions required by section 37 (b)(3):		
Railroad retirement pension	$1,550	
Social Security payments	1,200	2,750
Section 37 amount		1,000
15 pct. of $1,000		150
Limitation based upon amount of tax (derived from table reflecting allowance of general tax credit)		$139

Since the adjusted gross income of H and W is not greater than $10,000, no reduction of the initial amount is required under section 37 (c)(1).

[T.D. 7743, 45 FR 84050, Dec. 22, 1980]

§ 1.37–3 Credit for individuals under age 65 who have public retirement system income.

(a) *In general.* This section provides rules for the computation of the credit for the elderly under section 37(e) in the case of an individual who has not attained the age of 65 before the close of the taxable year and whose gross income for the taxable year includes retirement income within the meaning of paragraph (d)(1)(ii) of this section (*i.e.*, under a public retirement system). If such an individual is married within the meaning of section 143 at the close of the taxable year and the spouse of the individual has attained the age of 65 before the close of the taxable year, this section shall apply to the individual for the taxable year only if both spouses make the election described in paragraph (b) of this section. If both spouses make the election described in paragraph (b) of this section for the taxable year, the credit of each spouse shall be determined under the rules of this section. See paragraph (f)(2) of this section for a limitation on the effects of community property laws in making determinations and computations under section 37(e) and this section.

(b) *Election by certain married taxpayers.* If a married individual under age 65 at the close of the taxable year has retirement income and the spouse of that individual has attained the age of 65 before the close of the taxable year, both spouses may elect to compute the credit provided by section 37 under the rules of section 37(e) and this section. The spouses shall signify the election on the return (or amended return) for the taxable year in the manner prescribed in the instructions accompanying the return. The election may be made at any time before the expiration of the period of limitation for filing claim for credit or return for the taxable year. The election may be revoked without the consent of the Commissioner at any time before the expiration of that period by filing an amended return.

(c) *Computation of credit.* The credit of an individual under section 37(e) and this section equals 15 percent of the individual's credit base for the taxable year. The credit base of an individual for a taxable year is the lesser of—

(1) The retirement income of the individual for the taxable year, or

(2) The amount determined under section 37(e)(5), as modified by section 37(e) (6) and (7).

(d) *Retirement income*—(1) *General rule*—(i) *For individuals 65 or over.* Section 37(e)(4)(A) enumerates the kinds of income which may be treated as the retirement income of an individual who has attained the age of 65 before the close of the taxable year. They include income from pensions and annuities, interest, rents, dividends, certain bonds received under a qualified bond purchase plan, and certain individual retirement accounts or annuities.

(ii) *For individuals under 65.* In the case of an individual who has not attained the age of 65 before the close of the taxable year, retirement income consists only of income from pensions and annuities (including disability annuity payments) under a public retirement system which arises from services performed by that individual or by a present or former spouse of that individual. The term ''public retirement system'' means a pension, annuity, or retirement, or similar fund or system established by the United States, a State, a possession of the United States, any political subdivision of any of the foregoing, or the District of Columbia.

(2) *Rents.* For purposes of section 37(e)(4)(A)(iii), income from rents shall be the gross amount received, not reduced by depreciation or other expenses, except that beneficiaries of a trust or estate shall treat as retirement income only their proportionate shares, of the taxable rents of the trust or estate. In the case of an amount received for board and lodging, only the portion of the amount received for lodging is income from rents.

(3) *Disability annuity payments received by individual under age 65.* Disability annuity payments received under a public retirement system by an individual under age 65 at the close of the taxable year shall not be treated as retirement income unless the payments are for periods after the date on which the individual reached minimum retirement age, that is, the age at which the individual would be eligible to receive a pension or annuity without regard to disability, and any of the following conditions is satisfied—

(i) The individual is precluded from seeking the benefits of section 105(d) (relating to certain disability payments) for that taxable year by reason of an irrevocable election;

(ii) The individual was not permanently and totally disabled at the time of retirement (and was not permanently and totally disabled either on January 1, 1976, or on January 1, 1977, if the individual retired before the later date on disability or under circumstances which entitled the individual to retire on disability); or

(iii) The payments are for periods after the individual reached mandatory retirement age.

For purposes of this paragraph, disability annuity payments include payments to an individual who retired on partial or temporary disability.

(4) *Compensation of personal services rendered during taxable year.* Retirement income does not include any amount representing compensation for personal services rendered during the taxable year. For this purpose, amounts received as a pension shall not be treated as representing compensation for personal services rendered during the taxable year if the period of service during the taxable year is not substantial when compared with the total years of service. For example, an individual on the calendar year basis retires on November 30 after 5 years of service and receives a pension during the remainder of his taxable

year. The pension is not treated as representing compensation for personal services rendered during such taxable year merely because it is paid by reason of the services of the individual for a period of 5 years which includes a portion of the taxable year.

(5) *Amounts not includible in gross income.* Retirement income does not include any amount not includible in the gross income of the individual for the taxable year. For example, if a portion of an annuity is excluded from gross income under section 72, relating to annuities, that portion of the annuity is not retirement income; similarly, the portion of dividend income excluded from gross income under section 116, relating to the partial exclusion of dividends received by individuals is not retirement income.

(e) *Earned income*—(1) *In general.* The term ‘‘earned income’’ in section 37(e)(5)(B) generally has the same meaning as in section 911(b), except that earned income does not include any amount received as a pension or annuity. See section 911(b) and the regulations thereunder. Section 911(b) provides, in general, that earned income includes wages, salaries, professional fees, and other amounts received as compensation for personal services rendered.

(2) *Earned income from self-employment.* For purposes of section 37(e)(5)(B), the earned income of a taxpayer from self-employment in a trade or business shall not exceed—

(i) The taxpayer’s share of the net profits from the trade or business if capital is not a material income-producing factor in that trade or business; or

(ii) Thirty percent of the taxpayer’s share of the net profits from the trade or business if capital is a material income-producing factor in that trade or business.

For other rules relating to the determination of earned income from self-employment in a trade or business, see section 911(b) and the regulations thereunder.

(3) *Disability annuity payments received by individuals under age 65.* Disability annuity payments received under a public retirement system by an individual under age 65 at the close of the taxable year shall be treated as earned income for purposes of section 37(e)(5)(B) unless the payments are treated as retirement income under paragraph (d)(3) of this section.

(f) *Computation of credit under section 37(e) in the case of joint returns*—(1) *In general.* In the case of a joint return of husband and wife, the credit base of each spouse under section 37(e) is computed separately. The spouses then combine their credit bases and compute a single credit. The limitation in section 37(c)(2) and paragraph (b) of § 1.37–1 on the amount of the credit is determined by reference to the joint tax liability of the spouses. Thus, regardless of whether a spouse would be liable for the tax imposed by chapter 1 of the Code if the joint return had not been filed, the credit base of that spouse is taken into account in computing the credit.

(2) *Community property laws.* For taxable years beginning after 1977, married individuals filing joint returns shall disregard community property laws in making any determination or computation required under section 37(e) or this section. Each item of income is attributed in full to the spouse whose income it would have been in the absence of community property laws. Thus, if a 67-year old individual files a joint return with a 62-year old spouse for 1979 and the only income of the couple is from a public pension of the older spouse, that public pension is attributed in full to the older spouse for purposes of section 37(e) even though the applicable community property law may treat one-half of the pension as the income of the 62-year old spouse. Since the younger spouse consequently has no retirement income within the meaning of paragraph (d) of this section, the couple may not make the election described in paragraph (b) of this section.

(g) *Examples.* The computation of the credit for the elderly under section 37(e) and this section is illustrated by the following examples:

Example 1. B, who is 62 years old and single, receives a fully taxable pension of $2,400 from a public retirement system during 1977. B performed the services giving rise to the pension. During that year, B also earns $2,650 from a part-time job. B receives no tax-exempt pension or annuity in 1977. Subject to the limitation of section 37(c)(2) and paragraph (b) of § 1.37–1, B's credit for the elderly for 1977 under section 37(e) is $195, computed as follows:

Maximum retirement income level under section 37(e)(5)		$2,500
Earned income offset under section 37(e)(5)(B)(ii):		
Earned income in excess of $1,700	$950	
One-half of earned income in excess of $1,200, but not in excess of $1,700	250	1,200
Amount determined under section 37(e)(5)		1,300
Retirement income		2,400
Credit for the elderly (15 pct. of $1,300)		195

Example 2. During 1978 H, who is 67 years old, has earnings of $1,300 and retirement income (rents, interest, etc.) of $6,000. H also receives social security payments totalling $1,400. During 1978 W, who is 63 years old, earns $1,600 and receives a fully taxable pension of $1,400 from a public retirement system that constitutes retirement income. W performed the services giving rise to the pension. H and W file a joint return for 1978 and elect to compute the credit for the elderly under section 37(e). Under the applicable law these items of income are community income, and both spouses share equally in each item. Because H and W are filing a joint return, they disregard community property laws in computing their credit under section 37(e). The couple allocates $1,600 of the $3,750 referred to in section 37(e)(6) to W and $2,150 to H. Subject to the limitation of section 37(c)(2) and paragraph (b) of § 1.37–1, their credit for the elderly is $315, computed as follows:

Credit base of H:		
Amount allocated to H under section 37(e)(6)		$2,150
Reductions required by section 37(e)(5):		
Social Security payments	$1,400	
One-half of excess of earnings over $1,200	50	1,450
Amount determined under section 37(e)(5)		700
Retirement income		6,000
Credit base of H		700
Credit base of W:		
Amount allocated to W under section 37(e)(6)		$1,600
Reduction required by section 37(e)(5)(B):		
One-half of excess of earnings over $1,200		$200
Amount determined under section 37(e)(5)		1,400
Retirement income		1,400
Credit base of W		1,400
Computation of credit:		
Credit base of H		700
Credit base of W		1,400
Combined credit base		2,100
Credit for the elderly (15 pct. of $2,100)		315

Example 3. (a) Assume the same facts as in example (2) of this paragraph, except that H and W live apart at all times during 1978 and file separate returns. Under these circumstances, H and W must give effect to the applicable community property law in determining their credits under section 37(e). Thus, each spouse must take into account one-half of each item of income.

(b) Subject to the limitation of section 37(c)(2) and paragraph (b) of § 1.37–1, H's credit for the elderly is $157.50, computed as follows:

Maximum retirement income level under section 37(e)(7)		$1,875
Reductions required by section 37(e)(5):		
Social security payments	$700	
One-half of excess of earnings over $1,200 (taking into account one-half of combined earnings of $2,900)	125	825
Amount determined under section 37(e)(5)		1,050
Retirement income		3,700
Credit of H (15 pct. of $1,050)		157.50

(c) Subject to the limitation of section 37(c)(2) and paragraph (b) of § 1.37–1, W's credit for the elderly is computed as follows:

Maximum retirement income level under section 37(e)(7)	$1,875	
Reductions required by section 37(e)(5):		
Social security payments	$700	
One-half of excess of earnings over $1,200	125	825
Amount determined under section 37(e)(5)	1,050	
Retirement income (limited to W's share of public pension)	700	
Credit of W (15 pct. of $700)	105	

[T.D. 7743, 45 FR 84050, Dec. 22, 1980]

§ 1.38–1 Investment in certain depreciable property.

Regulations under sections 46 through 50 are prescribed under the authority granted the Secretary by section 38(b) to prescribe regulations as may be necessary to carry out the purposes of section 38 and subpart B, part IV, subchapter A, chapter 1 of the Code.

[44 FR 20417, Apr. 5, 1979]

§ 1.40–1 Questions and answers relating to the meaning of the term “qualified mixture” in section 40(b)(1).

Q–1. What is a ‘‘qualified mixture’’ within the meaning of section 40(b)(1)?

A–1. A ‘‘qualified mixture’’ is a mixture of alcohol and gasoline or of alcohol and special fuel which (1) is sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture.

Q–2. Must alcohol be present in a product in order for that product to be considered a mixture of alcohol and either gasoline or a special fuel?

A–2. No. A product is considered to be a mixture of alcohol and gasoline or of alcohol and a special fuel if the product is derived from alcohol and either gasoline or a special fuel even if the alcohol is chemically transformed in producing the product so that the alcohol is no longer present as a separate chemical in the final product, provided that there is no significant loss in the energy content of the alcohol. Thus, a product may be considered to be ‘‘mixture of alcohol and gasoline or of alcohol and a special fuel’’ within the meaning of section 40(b)(1)(B) if such product is produced in a chemical reaction between alcohol and either gasoline or a special fuel. Similarly a product may be considered to be a ‘‘mixture of alcohol and gasoline or of alcohol and a special fuel’’ if such product is produced by blending a chemical compound derived from alcohol with either gasoline or a special fuel.

Thus, for example, a blend of gasoline and ethyl tertiary butyl ether (ETBE), a compound derived from ethanol (a qualified alcohol), in a chemical reaction in which there is no significant loss in the energy content of the ethanol, is considered for purposes of section 40(b)(1)(B) to be a mixture of gasoline and the ethanol used to produce the ETBE, even though the ethanol is chemically transformed in the production of ETBE and is not present in the final product.

[T.D. 8291, 55 FR 8948, Mar. 9, 1990]

TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1986

SOURCE: Sections 1.41–0—1.41–9 appear by T.D. 8251, 54 FR 21204, May 17, 1989, unless otherwise noted.

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§1.41–1 Introduction to regulations under section 41.

Sections 1.41–2 through 1.41–9 deal only with certain provisions of section 41. The following table identifies the provisions of section 41 that are dealt with, and lists each with the section of the regulations in which it is covered:

Section of the regulations	Section of the Code
1.41–2	41(b)(1) 41(b)(2)(A)(ii) 41(b)(2)(A)(iii) 41(b)(2)(B) 41(b)(3)
1.41–3	41(c)(2) 41(f)(4)
1.41–5	41(d)
1.41–7	41(e)
1.41–8	41(f)(1)

Section of the regulations	Section of the Code
1.41–9	41(f)(2) 41(f)(3) 41(g)

Sections 1.41–4 and 1.41–6 deal with the definition of qualified research and basic research for taxable years beginning after December 31, 1985. Section 1.41–3 also deals with the special rule in section 221(d)(2) of the Economic Recovery Tax Act of 1981 relating to taxable years overlapping the effective dates of section 41. Section 41 was formerly designated sections 30 and 44F. The regulations refer to these sections as section 41 for conformity purposes. Of course, whether section 41, 30 or 44F applies to a particular expenditure depends upon when the expenditure was paid or incurred.

§ 1.41–2 Qualified Research Expenses.

(a) *Trade or business requirement*—(1) *In general.* An in-house research expense of the taxpayer or a contract research expense of the taxpayer is a qualified research expense only if the expense is paid or incurred by the taxpayer in carrying on a trade or business of the taxpayer. The phrase ‘‘in carrying on a trade or business’’ has the same meaning for purposes of section 41(b)(1) as it has for purposes of section 162; thus, expenses paid or incurred in connection with a trade or business within the meaning of section 174(a) (relating to the deduction for research and experimental expenses) are not necessarily paid or incurred in carrying on a trade or business for purposes of section 41. A research expense must relate to a particular trade or business being carried on by the taxpayer at the time the expense is paid or incurred in order to be a qualified research expense. For purposes of section 41, a contract research expense of the taxpayer is not a qualified research expense if the product or result of the research is intended to be transferred to another in return for license or royalty payments and the taxpayer does not use the product of the research in the taxpayer's trade or business.

(2) *New business.* Expenses paid or incurred prior to commencing a new business (as distinguished from expanding an existing business) may be paid or incurred in connection with a trade or business but are not paid or incurred in carrying on a trade or business. Thus, research expenses paid or incurred by a taxpayer in developing a product the sale of which would constitute a new trade or business for the taxpayer are not paid or incurred in carrying on a trade or business.

(3) *Research performed for others*—(i) *Taxpayer not entitled to results.* If the taxpayer performs research on behalf of another person and retains no substantial rights in the research, that research shall not be taken into account by the taxpayer for purposes of section 41. See § 1.41–5(d)(2).

(ii) *Taxpayer entitled to results.* If the taxpayer in carrying on a trade or business performs research on behalf of other persons but retains substantial rights in the research, the taxpayer shall take otherwise qualified expenses for that research into account for purposes of section 41 to the extent provided in § 1.41–5(d)(3).

(4) *Partnerships*—(i) *In general.* An in-house research expense or a contract research expense paid or incurred by a partnership is a qualified research expense of the partnership if the expense is paid or incurred by the partnership in carrying on a trade or business of the partnership, determined at the partnership level without regard to the trade or business of any partner.

(ii) *Special rule for certain partnerships and joint ventures.* (A) If a partnership or a joint venture (taxable as a partnership) is not carrying on the trade or business to which the research relates, then the general rule in paragraph (a)(4)(i) of this section would not allow any of such expenditures to qualify as qualified research expenses.

(B) Notwithstanding paragraph (a)(4)(ii)(A) of this section, if all the partners or venturers are entitled to make independent use of the results of the research, this paragraph (a)(4)(ii) may allow a portion of such expenditures to be treated as qualified research expenditures by certain partners or venturers.

(C) First, in order to determine the amount of credit that may be claimed by certain partners or venturers, the amount of qualified research expenditures of the partnership or joint venture is determined (assuming for this purpose that the partnership or joint venture is carrying on the trade or business to which the research relates).

(D) Second, this amount is reduced by the proportionate share of such expenses allocable to those partners or venturers who would not be able to claim such expenses as qualified research expenditures if they had paid or incurred such expenses directly. For this purpose such partners' or venturers' proportionate share of such expenses shall be determined on the basis of such partners' or venturers' share of partnership items of income or gain (excluding gain allocated under section 704(c)) which results in the largest proportionate share. Where a partner's or venturer's share of partnership items of income or gain (excluding gain allocated under section 704(c)) may vary during the period such partner or venturer is a partner or venturer in such partnership or joint venture, such share shall be the highest share such partner or venturer may receive.

(E) Third, the remaining amount of qualified research expenses is allocated among those partners or venturers who would have been entitled to claim a credit for such expenses if they had paid or incurred the research expenses in their own trade or business, in the relative proportions that such partners or venturers share deductions for expenses under section 174 for the taxable year that such expenses are paid or incurred.

(F) For purposes of section 41, research expenditures to which this paragraph (a)(4)(ii) applies shall be treated as paid or incurred directly by such partners or venturers. See §1.41–9(a)(3)(ii) for special rules regarding these expenses.

(iii) The following examples illustrate the application of the principles contained in paragraph (a)(4)(ii) of this section.

Example 1. A joint venture (taxable as a partnership) is formed by corporations A, B, and C to develop and market a supercomputer. A and B are in the business of developing computers, and each has a 30 percent distributive share of each item of income, gain, loss, deduction, credit and basis of the joint venture. C, which is an investment banking firm, has a 40 percent distributive share of each item of income, gain, loss, deduction, credit and basis of the joint venture. The joint venture agreement provides that A's, B's and C's distributive shares will not vary during the life of the joint venture, liquidation proceeds are to be distributed in accordance with the partners' capital account balances, and any partner with a deficit in its capital account following the distribution of liquidation proceeds is required to restore the amount of such deficit to the joint venture. Assume in Year 1 that the joint venture incurs $100x of ‘‘qualified research expenses.'' Assume further that the joint venture cannot claim the research credit for such expenses because it is not carrying on the trade or business to which the research relates. In addition A, B, and C are all entitled to make independent use of the results of the research. First, the amount of qualified research expenses of the joint venture is $100x. Second, this amount is reduced by the proportionate share of such expenses allocable to C, the venturer which would not have been able to claim such expenses as qualified research expenditures if it had paid or incurred them directly, C's proportionate share of such expenses is $40x (40% of $100x). The reduced amount is $60x. Third, the remaining $60x of qualified research expenses is allocated between A and B in the relative proportions that A and B share deductions for expenses under section 174. A is entitled to treat $30x ((30%/(30%+30%)) $60x) as a qualified research expense. B is also entitled to treat $30x ((30%/(30%+30%)) $60x) as a qualified research expense.

Example 2. Assume the same facts as in example (1) except that the joint venture agreement provides that during the first 2 years of the joint venture, A and B are each allocated 10 percent of each item of income, gain, loss, deduction, credit and basis, and C is allocated 80 percent of each item of income, gain, loss, deduction, credit and basis. Thereafter the allocations are the same as in example (1). Assume for purposes of this example that such allocations have substantial economic effect for purposes of section 704 (b). C's highest share of such items during the life of the joint venture is 80 percent. Therefore C's proportionate share of the joint venture's qualified research expenses is $80x (80% of $100x). The reduced amount of qualified research expenses is $20x ($100x − $80x). A is entitled to treat $10x ((10%/(10%+10%)) $20x) as a qualified research expense in Year 1. B is also entitled to treat $10x ((10%/(10%+10%)) $20x) as a qualified research expense in Year 1.

(b) *Supplies and personal property used in the conduct of qualified research*—(1) *In general.* Supplies and personal property (except to the extent provided in paragraph (b)(4) of this section) are used in the conduct of qualified research if they are used in the performance of qualified services (as defined in section 41(b)(2)(B), but without regard to the last sentence thereof) by an employee of the taxpayer (or by a person acting in a capacity similar to that of an employee of the taxpayer; see example (6) of § 1.41–2(e)(5)). Expenditures for supplies or for the use of personal property that are indirect research expenditures or general and administrative expenses do not qualify as inhouse research expenses.

(2) *Certain utility charges*—(i) *In general.* In general, amounts paid or incurred for utilities such as water, electricity, and natural gas used in the building in which qualified research is performed are treated as expenditures for general and administrative expenses.

(ii) *Extraordinary expenditures.* To the extent the taxpayer can establish that the special character of the qualified research required additional extraordinary expenditures for utilities, the additional expenditures shall be treated as amounts paid or incurred for supplies used in the conduct of qualified research. For example, amounts paid for electricity used for general laboratory lighting are treated as general and administrative expenses, but amounts paid for electricity used in operating high energy equipment for qualified research (such as laser or nuclear research) may be treated as expenditures for supplies used in the conduct of qualified research to the extent the taxpayer can establish that the special character of the research required an extraordinary additional expenditure for electricity.

(3) *Right to use personal property.* The determination of whether an amount is paid to or incurred for another person for the right to use personal property in the conduct of qualified research shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8) (as that section read before it was repealed by the Tax Reform Act of 1986). See § 5c.168(f)(8)–1(b).

(4) *Use of personal property in taxable years beginning after December 31, 1985.* For taxable years beginning after December 31, 1985, amounts paid or incurred for the use of personal property are not qualified research expenses, except for any amount paid or incurred to another person for the right to use (time-sharing) computers in the conduct of qualified research. The computer must be owned and operated by someone other than the taxpayer, located off the taxpayer's premises, and the taxpayer must not be the primary user of the computer.

(c) *Qualified services*—(1) *Engaging in qualified research.* The term ‘‘engaging in qualified research’’ as used in section 41(b)(2)(B) means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments).

(2) *Direct supervision.* The term ‘‘direct supervision’’ as used in section 41(b)(2)(B) means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). ‘‘Direct supervision’’ does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist.

(3) *Direct support.* The term ‘‘direct support’’ as used in section 41(b)(2)(B) means services in the direct support of either—

(i) Persons engaging in actual conduct of qualified research, or

(ii) Persons who are directly supervising persons engaging in the actual conduct of qualified research. For example, direct support of research includes the services of a secretary for typing reports describing laboratory results derived from qualified research, of a laboratory worker for cleaning equipment used in qualified research, of a clerk for compiling research data, and of a machinist for machining a part of an experimental model used in qualified research. Direct support of research activities does not include general administrative services, or other services only indirectly of benefit to research activities. For example, services of payroll personnel in preparing salary checks of laboratory scientists, of an accountant for accounting for research expenses, of a janitor for general cleaning of a research laboratory, or of officers engaged in supervising financial or personnel matters do not qualify as direct support of research. This is true whether general administrative personnel are part of the research department or in a separate department. Direct support does not include supervision. Supervisory services constitute ''qualified services'' only to the extent provided in paragraph (c)(2) of this section.

(d) *Wages paid for qualified services*—(1) *In general.* Wages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an inhouse research expense. In the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of inhouse research expense shall be determined by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year.

(2) *''Substantially all.''* Notwithstanding paragraph (d)(1) of this section, if substantially all of the services performed by an employee for the taxpayer during the taxable year consist of services meeting the requirements of section 41(b)(2)(B) (i) or (ii), then the term ''qualified services'' means all of the services performed by the employee for the taxpayer during the taxable year. Services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute substantially all of the services performed by the employee during a taxable year only if the wages allocated (on the basis used for purposes of paragraph (d)(1) of this section) to services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute at least 80 percent of the wages paid to or incurred by the taxpayer for the employee during the taxable year.

(e) *Contract research expenses*—(1) *In general.* A contract research expense is 65 percent of any expense paid or incurred in carrying on a trade or business to any person other than an employee of the taxpayer for the performance on behalf of the taxpayer of—

(i) Qualified research as defined in §1.41–5, or

(ii) Services which, if performed by employees of the taxpayer, would constitute qualified services within the meaning of section 41(b)(2)(B).

Where the contract calls for services other than services described in this paragraph (e)(1), only 65 percent of the portion of the amount paid or incurred that is attributable to the services described in this paragraph (e)(1) is a contract research expense.

(2) *Performance of qualified research.* An expense is paid or incurred for the performance of qualified research only to the extent that it is paid or incurred pursuant to an agreement that—

(i) Is entered into prior to the performance of the qualified research,

(ii) Provides that research be performed on behalf of the taxpayer, and

(iii) Requires the taxpayer to bear the expense even if the research is not successful.

If an expense is paid or incurred pursuant to an agreement under which payment is contingent on the success of the research, then the expense is considered paid for the product or result rather than the performance of the research, and the payment is not a contract research expense. The previous sentence applies only to that portion of a payment which is contingent on the success of the research.

(3) *''On behalf of.''* Qualified research is performed on behalf of the taxpayer if the taxpayer has a right to the research results. Qualified research can be performed on behalf of the taxpayer notwithstanding the fact that the taxpayer does not have exclusive rights to the results.

(4) *Prepaid amounts.* Notwithstanding paragraph (e)(1) of this section, if any contract research expense paid or incurred during any taxable year is attributable to qualified research to be

conducted after the close of such taxable year, the expense so attributable shall be treated for purposes of section 41(b)(1)(B) as paid or incurred during the period during which the qualified research is conducted.

(5) *Examples.* The following examples illustrate provisions contained in paragraphs (e) (1) through (4) of this section.

Example 1. A, a cash-method taxpayer using the calendar year as the taxable year, enters into a contract with B Corporation under which B is to perform qualified research on behalf of A. The contract requires A to pay B $300x, regardless of the success of the research. In 1982, B performs all of the research, and A makes full payment of $300x under the contract. Accordingly, during the taxable year 1982, $195x (65 percent of the payment of $300x) constitutes a contract research expense of A.

Example 2. The facts are the same as in example (1), except that B performs 50 percent of the research in 1983. Of the $195x of contract research expense paid in 1982, paragraph (e)(4) of this section provides that $97.5x (50 percent of $195x) is a contract research expense for 1982 and the remaining $97.5x is contract research expense for 1983.

Example 3. The facts are the same as in example (1), except that instead of calling for a flat payment of $300x, the contract requires A to reimburse B for all expenses plus pay B $l00x. B incurs expenses attributable to the research as follows:

Labor	$90x
Supplies	20x
Depreciation on equipment	50x
Overhead	40x
Total	200x

Under this agreement A pays B $300x during 1982. Accordingly, during taxable year 1982, $195x (65 percent of $300x) of the payment constitutes a contract research expense of A.

Example 4. The facts are the same as in example (3), except that A agrees to reimburse B for all expenses and agrees to pay B an additional amount of $100x, but the additional $100x is payable only if the research is successful. The research is successful and A pays B $300x during 1982. Paragraph (e)(2) of this section provides that the contingent portion of the payment is not an expense incurred for the performance of qualified research. Thus, for taxable year 1982, $130x (65 percent of the payment of $200x) constitutes a contract research expense of A.

Example 5. C conducts in-house qualified research in carrying on a trade or business. In addition, C pays D Corporation, a provider of computer services, $100x to develop software to be used in analyzing the results C derives from its research. Because the software services, if performed by an employee of C, would constitute qualified services, $65x of the $100x constitutes a contract research expense of C.

Example 6. C conducts in-house qualified research in carrying on C's trade or business. In addition, C contracts with E Corporation, a provider of temporary secretarial services, for the services of a secretary for a week. The secretary spends the entire week typing reports describing laboratory results derived from C's qualified research. C pays E $400 for the secretarial service, none of which constitutes wages within the meaning of section 41(b)(2)(D). These services, if performed by employees of C, would constitute qualified services within the meaning of section 41(b)(2)(B). Thus, pursuant to paragraph (e)(1) of this section, $260 (65 percent of $400) constitutes a contract research expense of C.

Example 7. C conducts in-house qualified research in carrying on C's trade or business. In addition, C pays F, an outside accountant, $100x to keep C's books and records pertaining to the research project. The activity carried on by the accountant does not constitute qualified research as defined in section 41(d). The services performed by the accountant, if performed by an employee of C, would not constitute qualified services (as defined in section 41(b)(2)(B)). Thus, under paragraph (e)(1) of this section, no portion of the $100x constitutes a contract research expense.

§ 1.41–3 Base period research expense.

(a) *Number of years in base period.* The term ''base period'' generally means the 3 taxable years immediately preceding the year for which a credit is being determined (''determination year''). However, if the first taxable year of the taxpayer ending after June 30, 1981, ends in 1981 or 1982, then with respect to that taxable year the term ''base period'' means the immediately preceding taxable year. If the second taxable year of the taxpayer ending after June 30, 1981, ends in 1982 or 1983, then with respect to that taxable year the term ''base period'' means the 2 immediately preceding taxable years.

(b) *New taxpayers.* If, with respect to any determination year, the taxpayer has not been in existence for the number of preceding taxable years that are included under paragraph (a) of this section in the base period for that year, then for purposes of paragraph (c)(1) of this section (relating to the determination of average qualified research expenses during the base period), the taxpayer shall be treated as—

(1) Having been in existence for that number of additional 12-month taxable years that is necessary to complete the base period specified in paragraph (a) of this section, and

(2) Having had qualified research expenses of zero in each of those additional years.

(c) *Definition of base period research expenses.* For any determination year, the term ‘‘base period research expenses’’ means the greater of—

(1) The average qualified research expenses for taxable years during the base period, or

(2) Fifty percent of the qualified research expenses for the determination year.

(d) *Special rules for short taxable years*—(1) *Short determination year.* If the determination year for which a research credit is being taken is a short taxable year, the amount taken into account under paragraph (c)(1) of this section shall be modified by multiplying that amount by the number of months in the short taxable year and dividing the result by 12.

(2) *Short base period year.* For purposes of paragraph (c)(1) of this section, if a year in the base period is a short taxable year, the qualified research expenses paid or incurred in the short taxable year are deemed to be equal to the qualified research expenses actually paid or incurred in that year multiplied by 12 and divided by the number of months in that year.

(3) *Years overlapping the effective dates of section 41 (section 44F)*—(i) *Determination years.* If a determination year includes months before July 1981, the determination year is deemed to be a short taxable year including only the months after June 1981. Accordingly, paragraph (d)(1) of this section is applied for purposes of determining the base period expenses for such year. See section 221(d)(2) of the Economic Recovery Tax Act of 1981.

(ii) *Base period years.* No adjustment is required in the case of a base period year merely because it overlaps June 30, 1981.

(4) *Number of months in a short taxable year.* The number of months in a short taxable year is equal to the number of whole calendar months contained in the year plus fractions for any partially included months. The fraction for a partially included month is equal to the number of days in the month that are included in the short taxable year divided by the total number of days in that month. Thus, if a short taxable year begins on January 1, 1982, and ends on June 9, 1982, it consists of 5 and 9/30 months.

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

Example 1. X Corp., an accrual-method taxpayer using the calendar year as its taxable year, is organized and begins carrying on a trade or business during 1979 and subsequently incurs qualified research expenses as follows:

1979	$10x
1980	150x
1/1/81–6/30/81	90x
7/1/81–12/31/81	110x
1982	250x
1983	450x

(i) *Determination year 1981.* For determination year 1981, the base period consists of the immediately preceding taxable year, calendar year 1980. Because the determination year includes months before July 1981, paragraph (d)(3)(i) of this section requires that the determination year be treated as a short taxable year. Thus, for purposes of paragraph (c)(1) of this section, as modified by paragraph (d)(1) of this section, the average qualified research expenses for taxable years during the base period are $75x ($150x, the average qualified research expenses for the base period, multiplied by 6, the number of months in the determination year after June 30, 1981, and divided by 12). Because this amount is greater than the amount determined under paragraph (c)(2) of this section (50 percent of the determination year’s qualified research expense of $110x, or $55x), the amount of base period research expenses is $75x. The credit for determination year 1981 is equal to 25 percent of the excess of $110x (the qualified research expenditures incurred during the determination year including only expenditures accrued on or after July 1, 1981, through the end of the determination year) over $75x (the base period research expenses).

(ii) *Determination year 1982.* For determination year 1982, the base period consists of the 2 immediately preceding taxable years, 1980 and 1981. The amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is $175x (($150x+$90x+$110x)/2). This amount is greater than the amount determined under paragraph (c)(2) of this section, (50 percent of $250x, or $125x). Accordingly, the amount of base period research expenses is $175x. The credit for determination year 1982 is equal to 25 percent of the excess of $250x (the qualified research expenses incurred during the determination year) over $175x (the base period research expenses).

(iii) *Determination year 1983.* For determination year 1983, the base period consists of the 3 immediately preceding taxable years 1980, 1981 and 1982. The amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is $200x (($150x+$200x+$250x)/3). The amount determined under paragraph (c)(2) of this section is $225x (50 percent of the $450x of qualified research expenses in 1983). Accordingly, the amount of base period research expenses is $225x. The credit for determination year 1983 is equal to 25 percent of the excess of $450x (the qualified research expenses incurred during the determination year) over $225x (the base period research expenses).

Examp1e 2. Y, an accrual-basis corporation using the calendar year as its taxable year comes into existence and begins carrying on a trade or business on July 1, 1983. Y incurs qualified research expenses as follows:

7/1/83—12/31/83	$80x
1984	200x
1985	200x

(i) *Determination year 1983.* For determination year 1983, the base period consists of the 3 immediately preceding taxable years: 1980, 1981 and 1982. Although Y was not in existence during 1980, 1981 and 1982, Y is treated under paragraph (b) of this section as having been in existence during those years with qualified research expenses of zero. Thus, the amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is $0x (($0x+$0x+$0x)/3). The amount determined under paragraph (c)(2) of this section is $40x (50 percent of $80x). Accordingly, the amount of base period research expenses is $40x. The credit for determination year 1983 is equal to 25 percent of the excess of $80x (the qualified research expenses incurred during the determination year) over $40x (the base period research expenses).

(ii) *Determination year 1984.* For determination year 1984, the base period consists of the 3 immediately preceding taxable years: 1981, 1982, and 1983. Under paragraph (b) of this section, Y is treated as having been in existence during years 1981 and 1982 with qualified research expenses of zero. Because July 1 through December 31, 1983 is a short taxable year, paragraph (d)(2) of this section requires that the qualified research expenses for that year be adjusted to $160x for purposes of determining the average qualified research expenses during the base period. The $160x results from the actual qualified research expenses for that year ($80x) multiplied by 12 and divided by 6 (the number of months in the short taxable year). Accordingly, the amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is $53⅓x (($0x+$0x+$160x)/3). The amount determined under paragraph (c)(2) of this section is $100x (50 percent of $200x). The amount of base period research expenses is $100x. The credit for determination year 1984 is equal to 25 percent of the excess of $200x (the qualified research expenses incurred during the determination year) over $100x (the base period research expenses).

(iii) *Determination year 1985.* For determination year 1985, the base period consists of the 3 immediately preceding taxable years: 1982, 1983, and 1984. Pursuant to paragraph (b) of this section, Y is treated as having been in existence during 1982 with qualified research expenses of zero. Because July 1 through December 31, 1982, is a short taxable year, paragraph (d)(2) of this section requires that the qualified research expense for that year be adjusted to $160x for purposes of determining the average qualified research expenses for taxable years during the base period. This $160x is the actual qualified research expense for that year ($80x) multiplied by 12 and divided by 6 (the number of months in the short taxable year). Accordingly, the amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is $120x (($0x+$160x+$200x)/3). The amount determined under paragraph (c)(2) of this section is $100x (50 percent of $200x). The amount of base period research expenses is $120x. The credit for determination year 1985 is equal to 25 percent of the excess of $200x (the qualified research expenses incurred during the determination year) over $120x (the base period research expenses).

§ 1.41–4 Qualified research for taxable years beginning after December 31, 1985. [Reserved]

§ 1.41–5 Qualified research for taxable years beginning before January 1, 1986.

(a) *General rule.* Except as otherwise provided in section 30(d) (as that section read before amendment by the Tax Reform Act of 1986) and in this section, the term ‘‘qualified research’’ means research, expenditures for which would be research and experimental expenditures within the meaning of section

174. Expenditures that are ineligible for the section 174 deduction elections are not expenditures for qualified research. For example, expenditures for the acquisition of land or depreciable property used in research, and mineral exploration costs described in section 174(d), are not expenditures for qualified research.

(b) *Activities outside the United States*—(1) *In-house research.* In-house research conducted outside the United States (as defined in section 7701(a)(9)) cannot constitute qualified research. Thus, wages paid to an employee scientist for services performed in a laboratory in the United States and in a test station in Antarctica must be apportioned between the services performed within the United States and the services performed outside the United States, and only the wages apportioned to the services conducted within the United States are qualified research expenses unless the 80 percent rule of §1.41–2(d)(2) applies.

(2) *Contract research.* If contract research is performed partly within the United States and partly without, only 65 percent of the portion of the contract amount that is attributable to the research performed within the United States can qualify as contract research expense (even if 80 percent or more of the contract amount was for research performed in the United States).

(c) *Social sciences or humanities.* Qualified research does not include research in the social sciences or humanities. For purposes of section 30(d)(2) (as that section read before amendment by the Tax Reform Act of 1986) and of this section, the phrase ‘‘research in the social sciences or humanities’’ encompasses all areas of research other than research in a field of laboratory science (such as physics or biochemistry), engineering or technology. Examples of research in the social sciences or humanities include the development of a new life insurance contract, a new economic model or theory, a new accounting procedure or a new cookbook.

(d) *Research funded by any grant, contract, or otherwise*—(1) *In general.* Research does not constitute qualified research to the extent it is funded by any grant, contract, or otherwise by another person (including any governmental entity). All agreements (not only research contracts) entered into between the taxpayer performing the research and other persons shall be considered in determining the extent to which the research is funded. Amounts payable under any agreement that are contingent on the success of the research and thus considered to be paid for the product or result of the research (see §1.41–2(e)(2)) are not treated as funding. For special rules regarding funding between commonly controlled businesses, see §1.41–8(e).

(2) *Research in which taxpayer retains no rights.* If a taxpayer performing research for another person retains no substantial rights in research under the agreement providing for the research, the research is treated as fully funded for purposes of section 41(d)(4)(H), and no expenses paid or incurred by the taxpayer in performing the research are qualified research expenses. For example, if the taxpayer performs research under an agreement that confers on another person the exclusive right to exploit the results of the research, the taxpayer is not performing qualified research because the research is treated as fully funded under this paragraph (d)(2). Incidental benefits to the taxpayer from performance of the research (for example, increased experience in a field of research) do not constitute substantial rights in the research. If a taxpayer performing research for another person retains no substantial rights in the research and if the payments to the researcher are contingent upon the success of the research, neither the performer nor the person paying for the research is entitled to treat any portion of the expenditures as qualified research expenditures.

(3) *Research in which the taxpayer retains substantial rights*—(i) *In general.* If a taxpayer performing research for another person retains substantial rights in the research under the agreement providing for the research, the research is funded to the extent of the payments (and fair market value of any property) to which the taxpayer becomes entitled by performing the research. A taxpayer does not retain substantial rights in the research if the taxpayer must pay

for the right to use the results of the research. Except as otherwise provided in paragraph (d)(3)(ii) of this section, the taxpayer shall reduce the amount paid or incurred by the taxpayer for the research that would, but for section 41(d)(4)(H), constitute qualified research expenses of the taxpayer by the amount of funding determined under the preceding sentence.

(ii) *Pro rata allocation.* If the taxpayer can establish to the satisfaction of the district director—

(A) The total amount of research expenses,

(B) That the total amount of research expenses exceed the funding, and

(C) That the otherwise qualified research expenses (that is, the expenses which would be qualified research expenses if there were no funding) exceed 65 percent of the funding, then the taxpayer may allocate the funding pro rata to nonqualified and otherwise qualified research expenses, rather than allocating it 100 percent to otherwise qualified research expenses (as provided in paragraph (d)(3)(i) of this section). In no event, however, shall less than 65 percent of the funding be applied against the otherwise qualified research expenses.

(iii) *Project-by-project determination.* The provisions of this paragraph (d)(3) shall be applied separately to each research project undertaken by the taxpayer.

(4) *Independent research and development under the Federal Acquisition Regulations System and similar provisions.* The Federal Acquisition Regulations System and similar rules and regulations relating to contracts (fixed price, cost plus, etc.) with government entities provide for allocation of certain ‘‘independent research and development costs’’ and ‘‘bid and proposal costs’’ of a contractor to contracts entered into with that contractor. In general, any ‘‘independent research and development costs’’ and ‘‘bid and proposal costs’’ paid to a taxpayer by reason of such a contract shall not be treated as funding the underlying research activities except to the extent the ‘‘independent research and development costs’’ and ‘‘bid and proposal costs’’ are properly severable from the contract. See § 1.451–3(e); see also section 804(d)(2) of the Tax Reform Act of 1986.

(5) *Funding determinable only in subsequent taxable year.* If at the time the taxpayer files its return for a taxable year, it is impossible to determine to what extent particular research performed by the taxpayer during that year may be funded, then the taxpayer shall treat the research as completely funded for purposes of completing that return. When the amount of funding is finally determined, the taxpayer should amend the return and any interim returns to reflect the proper amount of funding.

(6) *Examples.* The following examples illustrate the application of the principles contained in this paragraph.

Example 1. A enters into a contract with B Corporation, a cash-method taxpayer using the calendar year as its taxable year, under which B is to perform research that would, but for section 41(d)(3)(H), be qualified research of B. The agreement calls for A to pay B $120x, regardless of the outcome of the research. In 1982, A makes full payment of $120x under the contract, B performs all the research, and B pays all the expenses connected with the research, as follows:

In-house research expenses	$100x
Outside research:	
(Amount B paid to third parties for research, 65 percent of which ($26x) is treated as a contract research expense of B)	40x
Overhead and other expenses	10x
Total	150x

If B has no rights to the research, B is fully funded. Alternatively, assume that B retains the right to use the results of the research in carrying on B’s business. Of B’s otherwise qualified research expenses of $126x + $26x), $120x is treated as funded by A. Thus $6x ($126x − $120x) is treated as a qualified research expense of B. However, if B establishes the facts required under paragraph (d)(3) of this section, B can allocate the funding pro rata to nonqualified and otherwise qualified research expenses. Thus $100.8x ($120x ($126x/$150x)) would be allocated to otherwise qualified research expenses. B’s qualified research expenses would be $25.2x ($126x − $100.8x). For purposes of the following examples (2), (3) and (4) assume that B retains substantial rights to use the results of the research in carrying on B’s business.

Example 2. The facts are the same as in example (1) (assuming that B retains the right to use the results of the research in carrying on B’s business) except that, although A makes full payment of $120x during 1982, B does not perform the research or pay the associated expenses until 1983. The computations are unchanged. However, B's qualified research expenses determined in example (1) are qualified research expenses during 1983.

Example 3. The facts are the same as in example (1) (assuming that B retains the right to use the results of the research in carrying on B's business) except that, although B performs the research and pays the associated expenses during 1982, A does not pay the $120x until 1983. The computations are unchanged and the amount determined in example (1) is a qualified research expense of B during 1982.

Example 4. The facts are the same as in example (1) (assuming that B retains the right to use the results of the research in carrying on B's business) except that, instead of agreeing to pay B $120x, A agrees to pay $100x regardless of the outcome and an additional $20x only if B's research produces a useful product. B's research produces a useful product and A pays B $120x during 1982. The $20x payment that is conditional on the success of the research is not treated as funding. Assuming that B establishes to the satisfaction of the district director the actual research expenses, B can allocate the funding to nonqualified and otherwise qualified research expenses. Thus $84x ($100x ($126x/$150x)) would be allocated to otherwise qualified research expenses. B's qualified research expenses would be $42x ($126x − $84x).

Example 5. C enters into a contract with D, a cash-method taxpayer using the calendar year as its taxable year, under which D is to perform research in which both C and D will have substantial rights. C agrees to reimburse D for 80 percent of D's expenses for the research. D performs part of the research in 1982 and the rest in 1983. At the time that D files its return for 1982, D is unable to determine the extent to which the research is funded under the provisions of this paragraph. Under these circumstances, D may not treat any of the expenses paid by D for this research during 1982 as qualified research expenses on its 1982 return. When the project is complete and D can determine the extent of funding, D should file an amended return for 1982 to take into account any qualified research expense for 1982.

§1.41–6 Basic research for taxable years beginning after December 31, 1985. [Reserved]

§1.41–7 Basic research for taxable years beginning before January 1, 1986.

(a) *In general.* The amount expended for basic research within the meaning of section 30(e) (before amended by the Tax Reform Act of 1986) equals the sum of money plus the taxpayer's basis in tangible property (other than land) transferred for use in the performance of basic research.

(b) *Trade or business requirement.* Any amount treated as a contract research expense under section 30(e) (before amendment by the Tax Reform Act of 1986) shall be deemed to have been paid or incurred in carrying on a trade or business, if the corporation that paid or incurred the expenses is actually engaged in carrying on some trade or business.

(c) *Prepaid amounts*—(1) *In general.* If any basic research expense paid or incurred during any taxable year is attributable to research to be conducted after the close of such taxable year, the expense so attributable shall be treated for purposes of section 30(b)(1)(B) (before amendment by the Tax Reform Act of 1986) as paid or incurred during the period in which the basic research is conducted.

(2) *Transfers of property.* In the case of transfers of property to be used in the performance of basic research, the research in which that property is to be used shall be considered to be conducted ratably over a period beginning on the day the property is first so used and continuing for the number of years provided with respect to property of that class under section 168(c)(2) (before amendment by the Tax Reform Act of 1986). For example, if an item of property which is 3-year property under section 168(c) is transferred to a university for basic research on January 12, 1983, and is first so used by the university on March 1, 1983, then the research in which that property is used is considered to be conducted ratably from March 1, 1983, through February 28, 1986.

(d) *Written research agreement*—(1) *In general.* A written research agreement must be entered into prior to the performance of the basic research.

(2) *Agreement between a corporation and a qualified organization after June 30, 1983*—(i) *In general.* A written research agreement between a corporation and a qualified organization (including a qualified fund) entered into after June 30, 1983, shall provide that

the organization shall inform the corporation within 60 days after the close of each taxable year of the corporation what amount of funds provided by the corporation pursuant to the agreement was expended on basic research during the taxable year of the corporation. In determining amounts expended on basic research, the qualified organization shall take into account the exclusions specified in section 30(e)(3) (before amendment by the Tax Reform Act of 1986) and in paragraph (e) of this section.

(ii) *Transfers of property.* In the case of transfers of property to be used in basic research, the agreement shall provide that substantially all use of the property is to be for basic research, as defined in section 30(e)(3) (before amendment by the Tax Reform Act of 1986).

(3) *Agreement between a qualified fund and a qualified educational organization after June 30, 1983.* A written research agreement between a qualified fund and a qualified educational organization (see section 30(e)(4)(B)(iii) (before amendment by the Tax Reform Act of 1986)) entered into after June 30, 1983, shall provide that the qualified educational organization shall furnish sufficient information to the qualified fund to enable the qualified fund to comply with the written research agreements it has entered into with grantor corporations, including the requirement set forth in paragraph (d)(2) of this section.

(e) *Exclusions*—(1) *Research conducted outside the United States.* If a taxpayer pays or incurs an amount for basic research to be performed partly within the United States and partly without, only 65 percent of the portion of the amount attributable to research performed within the United States can be treated as a contract research expense (even if 80 percent or more of the contract amount was for basic research performed in the United States).

(2) *Research in the social sciences or humanities.* Basic research does not include research in the social sciences or humanities, within the meaning of §1.41–5(c).

(f) *Procedure for making an election to be treated as a qualified fund.* In order to make an election to be treated as a qualified fund within the meaning of section 30(e)(4)(B)(iii) (before amendment by the Tax Reform Act of 1986) or as an organization described in section 41(e)(6)(D), the organization shall file with the Internal Revenue Service center with which it files its annual return a statement that—

(1) Sets out the name, address, and taxpayer identification number of the electing organization (the ''taxpayer'') and of the organization that established and maintains the electing organization (the ''controlling organization''),

(2) Identifies the election as an election under section 41(e)(6)(D) of the Code,

(3) Affirms that the controlling organization and the taxpayer are section 501(c)(3) organizations,

(4) Provides that the taxpayer elects to be treated as a private foundation for all Code purposes other than section 4940,

(5) Affirms that the taxpayer satisfies the requirement of section 41(e)(6)(D)(iii), and

(6) Specifies the date on which the election is to become effective.

If an election to be treated as a qualified fund is filed before February 1, 1982, the election may be made effective as of any date after June 30, 1981, and before January 1, 1986. If an election is filed on or after February 1, 1982, the election may be made effective as of any date on or after the date on which the election is filed.

§ 1.41–8 Aggregation of expenditures.

(a) *Controlled group of corporations; trades or businesses under common control*—(1) *In general.* In determining the amount of research credit allowed with respect to a trade or business that at the end of its taxable year is a member of a controlled group of corporations or a member of a group of trades or businesses under common control, all members of the group are treated as a single taxpayer and the credit (if any) allowed to the member is determined on the basis of its proportionate share (if any) of the increase in qualified research expenses of the aggregated group.

(2) *Definition of trade or business.* For purposes of this section, a trade or

business is a sole proprietorship, a partnership, a trust, an estate, or a corporation that is carrying on a trade or business (within the meaning of section 162). For purposes of this section, any corporation that is a member of a commonly controlled group shall be deemed to be carrying on a trade or business if any other member of that group is carrying on any trade or business.

(3) *Determination of common control.* For rules for determining whether trades or businesses are under common control, see paragraphs (b) through (g) of §1.52–1 except that the words ‘‘singly or’’ in §1.52–1(d)(1)(i) shall be treated as deleted.

(4) *Examples.* The following examples illustrate provisions of this paragraph.

Example 1. (i) *Facts.* A controlled group of four corporations (all of which are calendar-year taxpayers) had qualified research expenses (‘‘research expenses’’) during the base period and taxable year as follows:

Corporation	Base period (average)	Taxable year	Change
A	$60	$40	($20)
B	10	15	5
C	30	70	40
D	15	25	10

(ii) *Total credit.* Because the research expenses of the four corporations are treated as if made by one taxpayer, the total amount of incremental expenses eligible for the credit is $35 ($55 increase attributable to B, C, and D less $20 decrease attributable to A). The total amount of credit allowable to members of the group is 20% of the incremental amount or $7.00.

(iii) *Allocation of credit.* No amount of credit is allocated to A since A’s research expenses did not increase in the taxable year. The $7.00 credit is allocated to B, C, and D, the members of the group that increased their research expenses. This allocation is made on the basis of the ratio of each corporation’s increase in its research expenses to the sum of increases in those expenses. Inasmuch as the total increase made by those members of the group whose research expenses rose (B, C, and D) was $55, B’s share of the $7.00 credit is 5/55; C’s share is 40/55; and D’s share is 10/55.

Example 2. The facts are the same as in example (1) except that A had zero research expenses in the taxable year. Thus, the controlled group had a decrease rather than an increase in aggregate research expenses. Accordingly, no amount of credit is allowable to any member of the group even though B, C, and D actually increased their research expenses in comparison with their own base period expenses.

(b) *Minimum base period research expenses.* For purposes of this section, the rule in section 41(c)(3) (pertaining to minimum base period research expenses) shall be applied only to the aggregate amount of base period research expenses. See the treatment of corporation C in example (1) of paragraph (a)(4) of this section.

(c) *Tax accounting periods used*—(1) *In general.* The credit allowable to a member of a controlled group of corporations or of a group of trades or businesses under common control is that member’s share of the aggregate credit computed as of the end of such member’s taxable year. In computing the aggregate credit in the case of a group whose members have different taxable years, a member shall generally treat the taxable year of another member that ends with or within the determination year of the computing member as the determination year of that other member. The base period research expenses taken into account with respect to a determination year of another member shall be the base period research expenses determined for that year under §1.41–3, except that §1.41–3(c)(2) shall be applied only at the aggregate level.

(2) *Special rule where timing of research is manipulated.* If the timing of research by members using different tax accounting periods is manipulated to generate a credit in excess of the amount that would be allowable if all members of the group used the same tax accounting period, the district director may require each member of the group to calculate the credit in the current taxable year and all future years as if all members of the group had the same taxable year and base period as the computing member.

(d) *Membership during taxable year in more than one group.* A trade or business may be a member of only one group for a taxable year. If, without application of this paragraph, a business would be a member of more than one group at the end of its taxable year, the business shall be treated as a member of the group in which it was included for its preceding taxable year.

If the business was not included for its preceding taxable year in any group in which it could be included as of the end of its taxable year, the business shall designate in its timely filed (including extensions) return the group in which it is being included. If the return for a taxable year is due before July 1, 1983, the business may designate its group membership through an amended return for that year filed on or before June 30, 1983. If the business does not so designate, then the district director with audit jurisdiction of the return will determine the group in which the business is to be included.

(e) *Intra-group transactions*—(1) *In general.* Because all members of a group under common control are treated as a single taxpayer for purposes of determining the research credit, transfers between members of the group are generally disregarded.

(2) *In-house research expenses.* If one member of a group performs qualified research on behalf of another member, the member performing the research shall include in its qualified research expenses any in-house research expenses for that work and shall not treat any amount received or accrued as funding the research. Conversely, the member for whom the research is performed shall not treat any part of any amount paid or incurred as a contract research expense. For purposes of determining whether the in-house research for that work is qualified research, the member performing the research shall be treated as carrying on any trade or business carried on by the member on whose behalf the research is performed.

(3) *Contract research expenses.* If a member of a group pays or incurs contract research expenses to a person outside the group in carrying on the member's trade or business, that member shall include those expenses as qualified research expenses. However, if the expenses are not paid or incurred in carrying on any trade or business of that member, those expenses may be taken into account as contract research expenses by another member of the group provided that the other member—

(i) Reimburses the member paying or incurring the expenses, and

(ii) Carries on a trade or business to which the research relates.

(4) *Lease Payments.* The amount paid or incurred to another member of the group for the lease of personal property owned by a member of the group is not taken into account for purposes of section 41. Amounts paid or incurred to another member of the group for the lease of personal property owned by a person outside the group shall be taken into account as in-house research expenses for purposes of section 41 only to the extent of the lesser of—

(i) The amount paid or incurred to the other member, or

(ii) The amount of the lease expenses paid to the person outside the group.

(5) *Payment for supplies.* Amounts paid or incurred to another member of the group for supplies shall be taken into account as in-house research expenses for purposes of section 41 only to the extent of the lesser of—

(i) The amount paid or incurred to the other member, or

(ii) The amount of the other member's basis in the supplies.

§ 1.41–9 Special rules.

(a) *Allocations*—(1) *Corporation making an election under subchapter S*—(i) *Pass-through, for taxable years beginning after December 31, 1982, in the case of an S corporation.* In the case of an S corporation (as defined in section 1361) the amount of research credit computed for the corporation shall be allocated to the shareholders according to the provisions of section 1366 and section 1377.

(ii) *Pass-through, for taxable years beginning before January 1, 1983, in the case of a subchapter S corporation.* In the case of an electing small business corporation (as defined in section 1371 as that section read before the amendments made by the subchapter S Revision Act of 1982), the amount of the research credit computed for the corporation for any taxable year shall be apportioned pro rata among the persons who are shareholders of the corporation on the last day of the corporation's taxable year.

(2) *Pass-through in the case of an estate or trust.* In the case of an estate or trust, the amount of the research credit computed for the estate or trust for any taxable year shall be apportioned

among the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each.

(3) *Pass-through in the case of a partnership*—(i) *In general.* In the case of a partnership, the research credit computed for the partnership for any taxable year shall be apportioned among the persons who are partners during the taxable year in accordance with section 704 and the regulations thereunder. See, for example, §1.704–1(b)(4)(ii). Because the research credit is an expenditure-based credit, the credit is to be allocated among the partners in the same proportion as section 174 expenditures are allocated for the year.

(ii) *Certain expenditures by joint ventures.* Research expenses to which §1.41–2(a)(4)(ii) applies shall be apportioned among the persons who are partners during the taxable year in accordance with the provisions of that section. For purposes of section 41, these expenses shall be treated as paid or incurred directly by the partners rather than by the partnership. Thus, the partnership shall disregard these expenses in computing the credit to be apportioned under paragraph (a)(3)(i) of this section, and in making the computations under section 41 each partner shall aggregate its distributive share of these expenses with other research expenses of the partner. The limitation on the amount of the credit set out in section 41(g) and in paragraph (c) of this section shall not apply because the credit is computed by the partner, not the partnership.

(4) *Year in which taken into account.* An amount apportioned to a person under this paragraph shall be taken into account by the person in the taxable year of such person which or within which the taxable year of the corporation, estate, trust, or partnership (as the case may be) ends.

(5) *Credit allowed subject to limitation.* The credit allowable to any person to whom any amount has been apportioned under paragraph (a)(1), (2) or (3)(i) of this section is subject to section 41(g) and sections 38 and 39 of the Code, if applicable.

(b) *Adjustments for certain acquisitions and dispositions—Meaning of terms.* For the meaning of ''acquisition,'' ''separate unit,'' and ''major portion,'' see paragraph (b) of §1.52–2. An ''acquisition'' includes an incorporation or a liquidation.

(c) *Special rule for pass-through of credit.* The special rule contained in section 41(g) for the pass-through of the credit in the case of an individual who owns an interest in an unincorporated trade or business, is a partner in a partnership, is a beneficiary of an estate or trust, or is a shareholder in an S corporation shall be applied in accordance with the principles set forth in §1.53–3.

(d) *Carryback and carryover of unused credits.* The taxpayer to whom the credit is passed through under paragraph (c) of this section shall not be prevented from applying the unused portion in a carryback or carryover year merely because the entity that earned the credit changes its form of conducting business.

TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1987

§1.41–0A Credit or deduction for political and newsletter fund contributions—scope and note.

Section 41 allows a limited credit against the income tax for political and newsletter fund contributions. Section 218 allows a limited deduction for contributions. The Revenue Act of 1978, however, increases the maximum annual credit under section 41 and repeals section 218. These changes are effective for political and newsletter fund contributions payment of which is made in taxable years of the contributor beginning after December 31, 1978. Sections 1.41–1A through 1.41–8A apply to both sections 41 and 218.

[T.D. 7603, 44 FR 18222, Mar. 27, 1979. Redesignated and amended by T.D. 8251, 54 FR 21204, May 17, 1989]

§1.41–1A Same—definitions of certain items.

(a) *Campaign committee.* A ''campaign committee'' is any group described in section 41(c)(1)(B). Thus, to be a campaign committee a group must be organized and operated exclusively to further the nomination or election of one or more candidates. That means it may not, except as otherwise provided in

§1.41–3A(a), spend any money for any other purpose. Therefore, a group that engages in any general political, educational, or legislative activities is not a campaign committee. Such a group may, however, organize a separate campaign committee exclusively to further the nomination or election of one or more candidates.

(b) *Candidate.* A ''candidate'' is an individual described in section 41 (c)(2). A candidate remains a candidate until enough money has been raised to pay the debts incurred in a previous campaign for elective public office. For example, A, a candidate for Senator from State X in 1977, is elected to that office in 1978. A sustains a campaign debt with respect to A's Senatorial campaign. A remains a candidate solely for the purpose of soliciting contributions to extinguish the campaign debt.

(c) *Elective public office.* An ''elective public office'' is any governmental position for which one must be directly chosen by the casting of votes by the general public or the Electoral College. It does not, however, include any office or position in any national, state, or local political party or similar organization, or membership in the Electoral College.

(d) *Furthering a candidacy.* Expenditures further a candidacy within the meaning of section 41(c)(1) (A) and (B) if they are directly related to, and are intended to support, a candidate's campaign for elective public office. Examples include payments for—

(1) Researching and polling campaign issues;

(2) Trips in connection with campaigning by the candidate or persons acting on his or her behalf;

(3) Raising funds; and

(4) Campaign-related debts left over from a previous political campaign.

(e) *Meets the qualifications.* An individual ''meets the qualifications prescribed by law'' to hold an elective public office if the individual can be reasonably expected to meet those qualifications on or before the date the office is to be filled.

(f) *Newsletter fund contribution.* The term ''newsletter fund contribution'' means a contribution of money or gift of money directly to a fund described in section 527(g) (relating to the treatment of newsletter funds as political organizations).

(g) *Political contribution.* A ''political contribution'' is a contribution of money or gift of money directly to a person described in section 41(c)(1). A political contribution is not limited to that portion of the contribution or gift that is eligible as a credit under section 41(b) or deduction under section 218(b).

(h) *Publicly announces.* An individual ''publicly announces'' that he or she is a candidate by making a positive statement available for media distribution that he or she is seeking nomination or election to a specific elective public office. An example is a news release or other statement by an individual intended for distribution via television, radio, newspapers, or magazines within the geographic area associated with the elective public office being sought which states that he or she seeks nomination or election to the office. Incumbency in an office does not constitute a public announcement that one is seeking reelection to that office. Furthermore, if because of death or any other reason an individual does not make a public announcement, the individual is not a candidate even though the individual was about to make a public announcement.

[T.D. 7603, 44 FR 18222, Mar. 27, 1979. Redesignated and amended by T.D. 8251, 54 FR 21204, May 17, 1989]

§1.41–2A Same—limitations and special rules.

(a) *When payment must be made.* A taxpayer may elect the credit under section 41 or the deduction under section 218 only if a political or newsletter fund contribution is actually paid within the taxable year for which the taxpayer claims the credit or deduction. The method of accounting the taxpayer uses and the date the contribution is pledged are irrelevant. Where a partnership makes a political or newsletter fund contribution, each partner is considered as having paid his or her distributive share of the political or newsletter fund contribution.

(b) *Campaign committee supporting more than one individual.* A section 41 credit or section 218 deduction may be available for a contribution of money to a campaign committee that supports, or intends to support, more than one candidate if at least one individual it supports is a candidate for the calendar year in which the contribution is made. However, if a taxpayer indicates at the time the contribution is made that it is for a specific individual, and that individual is not a candidate for the calendar year in which the contribution is made, no credit or deduction is available.

(c) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. B, an individual, makes a contribution of money in 1977 to the Good Government Committee, which is a campaign committee. The Good Government Committee supports C and D in 1977. C is a candidate for 1977. D is not a candidate for 1977. B may elect the credit under section 41 or deduction under section 218 for the contribution in 1977.

Example 2. Assume the same facts as in example (1), except that B earmarks the contribution solely to further the candidacy of D. B may not elect the credit under section 41 or deduction under section 218 for the 1977 contribution.

FT.D. 7603, 44 FR 18223, Mar. 27, 1979. Redesignated by T.D. 8251, 54 FR 21204, May 17, 1989]

§1.41–3A Same—unspent contributions.

(a) *General rule.* Except as provided in paragraph (b) of this section, all unspent political contributions must be used within a reasonable period of time to make a deposit or contribution described in section 527 (d).

(b) *Special rules*—(1) *Candidates.* An individual who was a candidate may retain unspent political contributions in reasonable anticipation of using them solely to support his or her future candidacy for any Federal, State, or local elective public office.

(2) *Campaign committee.* A campaign committee may retain unspent political contributions in reasonable anticipation of using them to support the future candidacy of any individual for any Federal, State, or local elective public office.

[T.D. 7603, 44 FR 18223, Mar. 27, 1979. Redesignated by T.D. 8251, 54 FR 21204, May 17, 1989]

§1.41–4A Same—procedure for electing a credit or deduction.

(a) *Scope note.* This section prescribes procedures for making the election under sections 41 and 218 to take either a credit or deduction for political and newsletter contributions.

(b) *How to elect.* A taxpayer elects the credit or deduction by making the appropriate entries on his or her income tax return for the taxable year in which the contribution is made.

(c) *Changing or revoking one's election.* The election may be changed or revoked. Thus, a taxpayer may change an election from credit to deduction or vice versa. In addition, if a taxpayer elects a credit or deduction for a particular taxable year to which, it later turns out, he or she is not entitled, the taxpayer must pay any additional tax that is due as a result. A taxpayer may change or revoke the election by use of an amended return.

[T.D. 7603, 44 FR 18223, Mar. 27, 1979. Redesignated by T.D. 8251, 54 FR 21204, May 17, 1989]

§1.41–5A Same—verifications.

This section prescribes rules under sections 41(b)(3) and 218(b)(2) to tell a taxpayer how to verify political and newsletter fund contributions for which a credit or deduction is claimed. A taxpayer must have a written receipt to substantiate any claim that a contribution was made. A cancelled check, the payee of which is a person or fund described in section 41(c) (1) or (5), ordinarily meets this requirement. However, in appropriate cases, the Internal Revenue Service may require a taxpayer to furnish additional proof that the payee was a person or fund described in section 41(c) (1) or (5), or that the purpose of the payment was to make a political or newsletter fund contribution.

[T.D. 7603, 44 FR 18223, Mar. 27, 1979. Redesignated by T.D. 8251, 54 FR 21204, May 17, 1989]

§1.41–6A Same—taxation of certain organizations.

See section 527 and the regulations thereunder for the tax treatment of a person or fund described in section

41(c) (1) or (5) that is treated as a section 527(e)(1) political organization.

[T.D. 7603, 44 FR 18223, Mar. 27, 1979. Redesignated by T.D. 8251, 54 FR 21204, May 17, 1989]

§ 1.41–7A Same—transitional rule for past contributions.

A credit or deduction for a political contribution the payment of which was made before January 1, 1980 will be allowed if it meets the requirements for a credit or deduction under the notice of proposed rulemaking published on September 19, 1972 (37 FR 19140).

[T.D. 7603, 44 FR 18223, Mar. 27, 1979. Redesignated by T.D. 8251, 54 FR 21204, May 17, 1989]

§ 1.41–8A Same—effective dates.

(a) *Political contributions.* Except as otherwise provided, these regulations apply to political contributions made in taxable years of the contributor beginning after December 31, 1971.

(b) *Newsletter fund contributions.* These regulations apply to newsletter fund contributions made in taxable years of the contributor beginning after December 31, 1974.

[T.D. 7603, 44 FR 18223, Mar. 27, 1979. Redesignated by T.D. 8251, 54 FR 21204, May 17, 1989]

§ 1.42–0 Table of contents.

This section lists the paragraphs contained in §§ 1.42–1 and 1.42–2.

§ 1.42–1 [Reserved]

§ 1.42–2 Waiver of requirement that an existing building eligible for the low-income housing credit was last placed in service more than 10 years prior to acquisition by the taxpayer.

(a) Low-income housing credit for existing building
(b) Waiver of 10-year holding period requirement
(c) Waiver requirements
(1) Federally-assisted building
(2) Federal mortgage funds at risk
(3) Statement by the Department of Housing and Urban Development or the Farmers' Home Administration
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(d) Application for waiver
(1) Time and manner
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[T.D. 8302, 55 FR 21189, May 23, 1990]

§ 1.42–1 [Reserved]

§ 1.42–1T Limitation on low-income housing credit allowed with respect to qualified low-income buildings receiving housing credit allocations from a State or local housing credit agency (temporary).

(a) *In general*—(1) *Determination of amount of low-income housing credit.* Section 42 provides that, for purposes of section 38, a low-income housing credit is determined for a building in an amount equal to the applicable percentage of the qualified basis of the qualified low-income building. In general, the credit may be claimed annually for a 10–year credit period, beginning with the taxable year in which the building is placed in service or, at the election of the taxpayer, the succeeding taxable year. If, after the first year of the credit period, the qualified basis of a building is increased in excess of the qualified basis upon which the credit was initially determined, the allowable credit with respect to such additional qualified basis is determined using a credit percentage equal to two-thirds of the applicable percentage for the initial qualified basis. The credit for additions to qualified basis is generally allowable for the remaining years in the 15-year compliance period which begins with the first taxable year of the credit period for the building. In general, the low-income housing credit is available with respect to buildings placed in service after December 31, 1986, in taxable years ending after that date. *See* section 42 for the definitions of ''qualified low-income building'', ''applicable percentage'', ''qualified basis'', ''credit period'', ''compliance period'', and for other rules relating to determination of the amount of the low-income housing credit.

(2) *Limitation on low-income housing credit allowed.* Generally, the low-income housing credit determined under section 42 is allowed and may be claimed for any taxable year if, and to the extent that, the owner of a qualified low-income building receives a housing credit allocation from a State

or local housing credit agency. The aggregate amount of housing credit allocations that may be made in any calendar year by all housing credit agencies within a State is limited by a State housing credit ceiling, or volume cap, described in paragraph (b) of this section. The authority to make housing credit allocations within the State housing credit ceiling may be apportioned among the State and local housing credit agencies, under the rules prescribed in paragraph (c) of this section. Upon apportionment of the State housing credit volume cap, each State or local housing credit agency receives an aggregate housing credit dollar amount that may be used to make housing credit allocations among qualified low-income buildings located within an agency's geographic jurisdiction. The rules governing the making of housing credit allocations by any state or local housing credit agency are provided in paragraph (d) of this section. Housing credit allocations are required to be taken into account by owners of qualified low-income buildings under the rules prescribed in paragraph (e) of this section. Exceptions to the requirement that a qualified low-income building receive a housing credit allocation from a State or local housing credit agency are provided in paragraph (f) of this section. Rules regarding termination of the authority of State and local housing credit agencies to make housing credit allocations after December 31, 1989, are specified in paragraph (g) of this section. Rules concerning information reporting by State and local housing credit agencies and owners of qualified low-income buildings are provided in paragraph (h) of this section. Special statutory transitional rules are incorporated into this section of the regulations as described in paragraph (i) of this section.

(b) *The State housing credit ceiling.* The aggregate amount of housing credit allocations that may be made in any calendar year by all State and local housing credit agencies within a State may not exceed the State's housing credit ceiling for such calendar year. The State housing credit ceiling for each State for any calendar year is equal to $1.25 multiplied by the State's population. A State's population for any calendar year is determined by reference to the most recent census estimate (whether final or provisional) of the resident population of the State released by the Bureau of the Census before the beginning of the calendar year for which the State's housing credit ceiling is set. Unless otherwise prescribed by applicable revenue procedure, determinations of population are based on the most recent estimates of population contained in the Bureau of the Census publication, ''Current Population Reports, Series P–25: Population Estimates and Projections, Estimates of the Population of States''. For purposes of this section, the District of Columbia and United States possessions are treated as States.

(c) *Apportionment of State housing credit ceiling among State and local housing credit agencies*—(1) *In general.* A State's housing credit ceiling for any calendar year is apportioned among the State and local housing credit agencies within such State under the rules prescribed in this paragraph. A ''State housing credit agency'' is any State agency specifically authorized by gubernatorial act or State statute to make housing credit allocations on behalf of the State and to carry out the provisions of section 42(h). A ''local housing credit agency'' is any agency of a political subdivision of the State that is specifically authorized by a State enabling act to make housing credit allocations on behalf of the State or political subdivision and to carry out the provisions of section 42(h). A ''State enabling act'' is any gubernatorial act, State statute, or State housing credit agency regulation (if authorized by gubernatorial act or State statute). A State enabling act enacted on or before October 22, 1986, the date of enactment of the Tax Reform Act of 1986, shall be given effect for purposes of this paragraph if such State enabling act expressly carries out the provisions of section 42(h).

(2) *Primary apportionment.* Except as otherwise provided in paragraphs (c) (3) and (4) of this section, a State's housing credit ceiling is apportioned in its entirety to the State housing credit agency. Such an apportionment is the ''primary apportionment'' of a State's housing credit ceiling. There shall be

no primary apportionment of the State housing credit ceiling and no grants of housing credit allocations in such State until a State housing credit agency is authorized by gubernatorial act or State statute. If a State has more than one State housing credit agency, such agencies shall be treated as a single agency for purposes of the primary apportionment. In such a case, the State housing credit ceiling may be divided among the multiple State housing credit agencies pursuant to gubernatorial act or State statute.

(3) *States with 1 or more constitutional home rule cities*—(i) *In general.* Notwithstanding paragraph (c)(2) of this section, in any State with 1 or more constitutional home rule cities, a portion of the State housing credit ceiling is apportioned to each constitutional home rule city. In such a State, except as provided in paragraph (c)(4) of this section, the remainder of the State housing credit ceiling is apportioned to the State housing credit agency under paragraph (c)(2) of this section. *See* paragraph (c)(3)(iii) of this section. The term ''constitutional home rule city'' means, with respect to any calendar year, any political subdivision of a State that, under a State constitution that was adopted in 1970 and effective on July 1, 1971, had home rule powers on the first day of the calendar year.

(ii) *Amount of apportionment to a constitutional home rule city.* The amount of the State housing credit ceiling apportioned to a constitutional home rule city for any calendar year is an amount that bears the same ratio to the State housing credit ceiling for that year as the population of the constitutional home rule city bears to the population of the entire State. The population of any constitutional home rule city for any calendar year is determined by reference to the most recent census estimate (whether final or provisional) of the resident population of the constitutional home rule city released by the Bureau of the Census before the beginning of the calendar year for which the State housing credit ceiling is apportioned. However, determinations of the population of a constitutional home rule city may not be based on Bureau of the Census estimates that do not contain estimates for all of the constitutional home rule cities within the State. If no Bureau of the Census estimate is available for all such constitutional home rule cities, the most recent decennial census of population shall be relied on. Unless otherwise prescribed by applicable revenue procedure, determinations of population for constitutional home rule cities are based on estimates of population contained in the Bureau of the Census publication, ''Current Population Reports, Series P–26: Local Population Estimates''.

(iii) *Effect of apportionments to constitutional home rule cities on apportionments to other housing credit agencies.* The aggregate amounts of the State housing credit ceiling apportioned to constitutional home rule cities under this paragraph (c)(3) reduce the State housing credit ceiling available for apportionment under paragraph (c) (2) or (4) of this section. Unless otherwise provided in a State constitutional amendment or by law changing the home rule provisions adopted in a manner provided by the State constitution, the power of the governor or State legislature to apportion the State housing credit ceiling among local housing credit agencies under paragraph (c)(4) of this section shall not be construed as allowing any reduction of the portion of the State housing credit ceiling apportioned to a constitutional home rule city under this paragraph (c)(3). However, any constitutional home rule city may agree to a reduction in its apportionment of the State housing credit ceiling under this paragraph (c)(3), in which case the amount of the State housing credit ceiling not apportioned to the constitutional home rule city shall be available for apportionment under paragraph (c) (2) or (4) of this section.

(iv) *Treatment of governmental authority within constitutional home rule city.* For purposes of determining which agency within a constitutional home rule city receives the apportionment of the State housing credit ceiling under this paragraph (c)(3), the rules of this paragraph (c) shall be applied by treating the constitutional home rule city as a ''State'', the chief executive officer of a constitutional home rule city as a ''governor'', and a city council as a ‘‘State legislature’’. A constitutional home rule city is also treated as a ‘‘State’’ for purposes of the set-aside requirement for housing credit allocations to projects involving a qualified nonprofit organization. *See* paragraph (c)(5) of this section for rules governing set-aside requirements. In this connection, a constitutional home rule city may agree with the State housing credit agency to exchange an apportionment set aside for projects involving a qualified nonprofit organization for an apportionment that is not so restricted. In such a case, the authorizing gubernatorial act, State statute, or State housing credit agency regulation (if authorized by gubernatorial act or State statute) must ensure that the set-aside apportionment transferred to the State housing credit agency be used for the purposes described in paragraph (c)(5) of this section.

(4) *Apportionment to local housing credit agencies*—(i) *In general.* In lieu of the primary apportionment under paragraph (c)(2) of this section, all or a portion of the State housing credit ceiling may be apportioned among housing credit agencies of governmental subdivisions. Apportionments of the State housing credit ceiling to local housing credit agencies must be made pursuant to a State enabling act as defined in paragraph (c)(1) of this section. Apportionments of the State housing credit ceiling may be made to housing credit agencies of constitutional home rule cities under this paragraph (c)(4), in addition to apportionments made under paragraph (c)(3) of this section. Apportionments of the State housing credit ceiling under this paragraph (c)(4) need not be based on the population of political subdivisions and may, but are not required to, give balanced consideration to the low-income housing needs of the entire State.

(ii) *Change in apportionments during a calendar year.* The apportionment of the State housing credit ceiling among State and local housing credit agencies under this paragraph (c)(4) may be changed after the beginning of a calendar year, pursuant to a State enabling act. No change in apportionments shall retroactively reduce the housing credit allocations made by any agency during such year. Any change in the apportionment of the State housing credit ceiling under this paragraph (c)(4) that occurs during a calendar year is effective only to the extent housing credit agencies have not previously made housing credit allocations during such year from their original apportionments of the State housing credit ceiling for such year. To the extent apportionments of the State housing credit ceiling to local housing credit agencies made pursuant to this paragraph (c)(4) for any calendar year are not used by such local agencies before a certain date (*e.g.,* November 1) to make housing credit allocations in such year, the amount of unused apportionments may revert back to the State housing credit agency for reapportionment. Such reversion must be specifically authorized by the State enabling act.

(iii) *Exchanges of apportionments.* Any State or local housing credit agency that receives an apportionment of the State housing credit ceiling for any calendar year under this paragraph (c)(4) may exchange part or all of such apportionment with another State or local housing credit agency to the extent no housing credit allocations have been made in such year from the exchanged portions. Such exchanges must be made with another housing credit agency in the same State and must be consistent with the State enabling act. If an apportionment set aside for projects involving a qualified nonprofit organization is transferred or exchanged, the transferee housing credit agency shall be required to use the set-aside apportionment for the purposes described in paragraph (c)(5) of this section.

(iv) *Written records of apportionments.* All apportionments, exchanges of apportionments, and reapportionments of the State housing credit ceiling which are authorized by this paragraph (c)(4) must be evidenced in the written records maintained by each State and local housing credit agency.

(5) *Set-aside apportionments for projects involving a qualified nonprofit organization*—(i) *In general.* Ten percent of the State housing credit ceiling for a calendar year must be set aside exclusively for projects involving a qualified nonprofit organization (as defined in

paragraph (c)(5)(ii) of this section). Thus, at least 10 percent of apportionments of the State housing credit ceiling under paragraphs (c) (2) and (3) of this section must be used only to make housing credit allocations to buildings that are part of projects involving a qualified nonprofit organization. In the case of apportionments of the State housing credit ceiling under paragraph (c)(4) of this section, the State enabling act must ensure that the apportionment of at least 10 percent of the State housing credit ceiling be used exclusively to make housing credit allocations to buildings that are part of projects involving a qualified nonprofit organization. The State enabling act shall prescribe which housing credit agencies in the State receive apportionments that must be set aside for making housing credit allocations to buildings that are part of projects involving a qualified nonprofit organization. These set-aside apportionments may be distributed disproportionately among the State or local housing credit agencies receiving apportionments under paragraph (c)(4) of this section. The 10-percent set-aside requirement of this paragraph (c)(4) is a minimum requirement, and the State enabling act may set aside more than 10 percent of the State housing credit ceiling for apportionment to housing credit agencies for exclusive use in making housing credit allocations to buildings that are part of projects involving a qualified nonprofit organization.

(ii) *Projects involving a qualified nonprofit organization.* The term ''projects involving a qualified nonprofit organization'' means projects with respect to which a qualified nonprofit organization is to materially participate (within the meaning of section 469(h)) in the development and continuing operation of the project throughout the 15-year compliance period. The term ''qualified nonprofit organization'' means any organization that is described in section 501(c) (3) or (4), is exempt from tax under section 501(a), and includes as one of its exempt purposes the fostering of low-income housing.

(6) *Expiration of unused apportionments.* Apportionments of the State housing credit ceiling under this paragraph (c) for any calendar year may be used by housing credit agencies to make housing credit allocations only in such calendar year. Any part of an apportionment of the State housing credit ceiling for any calendar year that is not used for housing credit allocations in such year expires as of the end of such year and does not carry over to any other year. However, any part of an apportionment for 1989 that is not used to make a housing credit allocation in 1989 may be carried over to 1990 and used to make a housing credit allocation to a qualified low-income building described in section 42(n)(2)(B). *See* paragraph (g)(2) of this section.

(d) *Housing credit allocations made by State and local housing credit agencies*—(1) *In general.* This paragraph governs State and local housing credit agencies in making housing credit allocations to qualified low-income buildings. The amount of the apportionment of the State housing credit ceiling for any calendar year received by any State or local housing credit agency under paragraph (c) of this section constitutes the agency's aggregate housing credit dollar amount for such year. The aggregate amount of housing credit allocations made in any calendar year by a State or local housing credit agency may not exceed such agency's aggregate housing credit dollar amount for such year. A State or local housing credit agency may make housing credit allocations only to qualified low-income buildings located within the agency's geographic jurisdiction.

(2) *Amount of a housing credit allocation.* In making a housing credit allocation, a State or local housing credit agency must specify a credit percentage, not to exceed the building's applicable percentage determined under section 42(b), and a qualified basis amount. The amount of the housing credit allocation for any building is the product of the specified credit percentage and the specified qualified basis amount. In specifying the credit percentage and qualified basis amount, the State or local housing credit agency shall not take account of the first-year conventions described in section 42(f) (2)(A) and (3)(B). A State or local housing credit agency may adopt rules or regulations governing conditions for

specification of less than the maximum credit percentage and qualified basis amount allowable under section 42 (b) and (c), respectively. For example, an agency may specify a credit percentage and a qualified basis amount of less than the maximum credit percentage and qualified basis amount allowable under section 42 (b) and (c), respectively, when the financing and rental assistance from all sources for the project of which the building is a part is sufficient to provide the continuing operation of the building without the maximum credit amount allowable under section 42.

(3) *Counting housing credit allocations against an agency's aggregate housing credit dollar amount.* The aggregate amount of housing credit allocations made in any calendar year by a State or local housing credit agency may not exceed such agency's aggregate housing credit dollar amount (*i.e.*, the agency's apportionment of the State housing credit ceiling for such year). This limitation on the aggregate dollar amount of housing credit allocations shall be computed separately for set-aside apportionments received pursuant to paragraph (c)(5) of this section. Housing credit allocations count against an agency's aggregate housing credit dollar amount without regard to the amount of credit allowable to or claimed by an owner of a building in the taxable year in which the allocation is made or in any subsequent year. Thus, housing credit allocations (which are computed without regard to the first-year conventions as provided in paragraph (d)(2) of this section) count in full against an agency's aggregate housing credit dollar amount, even though the first-year conventions described in section 42(f) (2)(A) and (3)(B) may reduce the amount of credit claimed by a taxpayer in the first year in which a credit is allowable. *See also* paragraph (e)(2) of this section. Housing credit allocations count against an agency's aggregate housing credit dollar amount only in the calendar year in which made and not in subsequent taxable years in the credit period or compliance period during which a taxpayer may claim a credit based on the original housing credit allocation. Since the aggregate amount of housing credit allocations made in any calendar year by a State or local housing credit agency may not exceed such agency's aggregate housing credit dollar amount, an agency shall at all times during a calendar year maintain a record of its cumulative allocations made during such year and its remaining unused aggregate housing credit dollar amount.

(4) *Rules for when applications for housing credit allocations exceed an agency's aggregate housing credit dollar amount.* A State or local housing credit agency may adopt rules or regulations governing the awarding of housing credit allocations when an agency expects that applicants during a calendar year will seek aggregate allocations in excess of the agency's aggregate housing credit dollar amount. The State enabling act may provide uniform standards for the awarding of housing credit allocations when there is actual or anticipated excess demand from applicants in any calendar year.

(5) *Reduced or additional housing credit allocations*—(i) *In general.* A State or local housing credit agency may not reduce or rescind a housing credit allocation made to a qualified low-income building in the manner prescribed in paragraph (d)(8) of this section. Thus, a housing credit agency may not reduce or rescind a housing credit allocation made to a qualified low-income building which is acquired by a new owner who is entitled to a carryover of the allowable credit for such building under section 42(d)(7). A housing credit agency may make additional housing credit allocations to a building in any year in the building's compliance period, whether or not there are additions to qualified basis for which an increased credit is allowable under section 42(f)(3). Each additional housing credit allocation made to a building is treated as a separate allocation and is subject to the rules and requirements of this section. However, in the case of an additional housing credit allocation made with respect to additions to qualified basis for which an increased credit is allowable under section 42(f)(3), the amount of the allocation that counts against the agency's aggregate housing credit dollar amount shall be computed as if the specified credit

percentage were unreduced in the manner prescribed in section 42(f)(3)(A) and the specified qualified basis amount were unreduced by the first-year convention prescribed in section 42(f)(3)(B).

(ii) *Examples.* The rules of paragraph (d)(5)(i) of this section may be illustrated by the following examples:

Example 1. For 1987, the County L Housing Credit Agency has an aggregate housing credit dollar amount of $2 million. D, an individual, places in service on July 1, 1987, a new qualified low-income building. As of the close of each month in 1987 in which the building is in service, the building consists of 100 residential rental units, of which 20 units are both rent-restricted and occupied by individuals whose income is 50 percent or less of area median gross income. The total floor space of the residential rental units is 120,000 square feet, and the total floor space of the low-income units is 20,000 square feet. Tne building is not Federally subsidized within the meaning of section 42(i)(2). As of the end of 1987, the building has eligible basis under section 42(d) of $1 million. Thus, the qualified basis of the building determined without regard to the first-year convention provided in section 42(f) is $166,666.67 (*i.e.,* $1 million eligible basis times ⅙, the floor space fraction which is required to be used instead of the larger unit fraction). However, the amount of the low-income housing credit determined for 1987 under section 42 reflects the first-year convention provided in section 42(f)(2). Since the building has the same floor space and unit fractions as of the close of each of the six months in 1987 during which it is in service, upon applying the first-year convention in section 42(f)(2), the qualified basis of the building in 1987 is $83,333.33 (*i.e.,* $1 million eligible basis times 1⁄12, the fraction determined under section 42(f)(2)(A)). Under paragraph (d)(2) of this section, the County L Housing Credit Agency may make a housing credit allocation by specifying a credit percentage, not to exceed 9 percent, and a qualified basis amount, which may be greater or less than the qualified basis of the building in 1987 as determined under section 42(c), without regard to the first-year convention provided in section 42(f)(2). If the County L Housing Credit Agency specifies a credit percentage of 8 percent and a qualified basis amount of $100,000, the amount of the housing credit allocation is $8,000. Under paragraph (d)(3) of this section, the County L Housing Credit Agency's aggregate housing credit dollar amount for 1987 is reduced by $8,000, notwithstanding that D is entitled to claim less than $8,000 of the credit in 1987 under the rules in paragraph (e) of this section. Under paragraph (e)(2) of this section, in 1987 D is entitled to claim only $4,000 of the credit, determined by applying the first-year convention of 6⁄12 to the specified qualified basis amount contained in the housing credit allocation (*i.e.,* .08 x $100,000 x (6⁄12)).

Example 2. The facts are the same as in *Example 1* except that on July 1, 1988, the number of occupied low-income units increases to 50 units and the floor space of the occupied low-income units increases to 48,000 square feet. These occupancy fractions remain unchanged as of the close of each month remaining in 1988. Under section 42(c), the qualified basis of the building in 1988, without regard to the first-year convention in section 42(f)(3)(B), is $400,000 (*i.e.,* $1 million eligible basis times .4, the floor space fraction which is required to be used instead of the larger unit fraction). D's 1987 housing credit allocation from the County L Housing Credit Agency remains effective in 1988 and entitles D to a credit of $8,000 (*i.e.,* .08, the specified credit percentage, times $100,000, the specified qualified basis amount). With respect to the additional $300,000 of qualified basis which the 1987 housing credit allocation does not cover, D must apply to the County L Housing Credit Agency for an additional housing credit allocation. Assume that the County L Housing Credit Agency has a sufficient aggregate housing credit dollar amount for 1988 to make a housing credit allocation to D in 1988 by specifying a credit percentage of 9 percent and a qualified basis amount of $300,000. The amount of the housing credit allocation that counts against the County L Housing Credit Agency's aggregate housing credit dollar amount is $27,000 (*i.e.,* the amount counted (.09 times $300,000) is unreduced in the manner prescribed in section 42(f)(3) (A) and (B)). Since D's qualified basis in 1987 was $166,666.67, D is entitled to claim a credit in 1988 with respect to such basis of $14,000 (*i.e.,* .08 x $100,000, the 1987 credit alllocation, +.09 x $66,666.67, the 1988 credit allocation). In addition, D is entitled to claim a credit in 1988 and subsequent years in the 15-year compliance period with respect to the additional $233,333.33 of qualified basis covered by the 1988 housing credit allocation. However, the allowable credit for 1988 with respect to this amount of additional qualified basis is subject to reductions prescribed in section 42(f)(3) (A) and (B). Thus, D is entitled in 1988 to a credit at a 6-percent rate applied to $116,666.67 of additional qualified basis, which is reduced to reflect the first-year convention. D's total allowable low-income housing credit in 1988 is $21,000 (*i.e.,* $14,000 with respect to original qualified basis + $7,000 with respect to 1988 additions to qualified basis). If the County L Housing Credit Agency had specified an 8-percent credit percentage in 1988 with respect to the qualified basis not covered by the 1987 housing credit allocation to D, D's allowable credit with respect to the $233,333.33 of additions to qualified basis would not exceed, in 1988 and subsequent years, an amount determined by applying a specified credit percentage of 5.33 percent (*i.e.*, two-thirds of 8 percent). In 1988, D's specified qualified basis amount would be adjusted for the first-year convention.

(6) *No carryover of unused aggregate housing credit dollar amount.* Any portion of a State or local housing credit agency's aggregate housing credit dollar amount for any calendar year that is not used to make a housing credit allocation in such year may not be carried over to any other year, except as provided in paragraph (g) of this section. An agency may not permit owners of qualified low-income buildings to transfer housing credit allocations to other buildings. However, an agency may provide a procedure whereby owners may return to the agency, prior to the end of the calendar year in which housing credit allocations are made, unusable portions of such allocations. In such a case, an owner's housing credit allocation is deemed reduced by the amount of the allocation returned to the agency, and the agency may reallocate such amount to other qualified low-income buildings prior to the end of the year.

(7) *Effect of housing credit allocations in excess of an agency's aggregate housing credit dollar amount.* In the event that a State or local housing credit agency makes housing credit allocations in excess of its aggregate housing credit dollar amount for any calendar year, the allocations shall be deemed reduced (to the extent of such excess) for buildings in the reverse order in which such allocations were made during such year.

(8) *Time and manner for making housing credit allocations*—(i) *Time.* Housing credit allocations are effective for the calendar year in which made in the manner prescribed in paragraph (d)(8)(ii) of this section. A State or local housing credit agency may not make a housing credit allocation to a qualified low-income building prior to the calendar year in which such building is placed in service. An agency may adopt its own procedures for receiving applications for housing credit allocations from owners of qualified low-income buildings. An agency may provide a procedure for making, in advance of a building's being placed in service, a binding commitment (*e.g.*, by contract, inducement, resolution, or other means) to make a housing credit allocation in the calendar year in which a qualified low-income building is placed in service or in a subsequent calendar year. Any advance commitment shall not constitute a housing credit allocation for purposes of this section.

(ii) *Manner.* Housing credit allocations are deemed made when part I of IRS Form 8609, Low-Income Housing Credit Allocation Certification, is completed and signed by an authorized official of the housing credit agency and mailed to the owner of the qualified low-income building. A copy of all completed (as to part I) Form 8609 allocations along with a single completed Form 8610, Annual Low-Income Housing Credit Agencies Report, must also be mailed to the Internal Revenue Service not later than the 28th day of the second calendar month after the close of the calendar year in which the housing credit was allocated to the qualified low-income building. Housing credit allocations to a qualified low-income building must be made on Form 8609 and must include—

(A) The address of the building;

(B) The name, address, and taxpayer identification number of the housing credit agency making the housing credit allocation;

(C) The name, address, and taxpayer identification number of the owner of the qualified low-income building;

(D) The date of the allocation of housing credit;

(E) The housing credit dollar amount allocated to the building on such date;

(F) The specified maximum applicable credit percentage allocated to the building on such date;

(G) The specified maximum qualified basis amount;

(H) The percentage of the aggregate basis financed by tax-exempt bonds taken into account for purposes of the volume cap under section 146;

(I) A certification under penalties of perjury by an authorized State or local housing credit agency official that the allocation is made in compliance with the requirements of section 42(h); and

(J) Any additional information that may be required by Form 8609 or by an applicable revenue procedure.

See paragraph (h) of this section for additional rules concerning filing of forms.

(iii) *Certification.* The certifying official for the State or local housing credit agency need not perform an independent investigation of the qualified low-income building in order to certify on part I of Form 8609 that the housing credit allocation meets the requirements of section 42(h). For example, the certifying official may rely on information contained in an application for a low-income housing credit allocation submitted by the building owner which sets forth facts necessary to determine that the building is eligible for the low-income housing credit under section 42.

(iv) *Fee.* A State or local housing credit agency may charge building owners applying for housing credit allocations a reasonable fee to cover the agency's administrative expenses for processing applications.

(v) *No continuing agency responsibility.* The State or local housing credit agency need not monitor or investigate the continued compliance of a qualified low-income building with the requirements of section 42 throughout the applicable compliance period.

(e) *Housing credit allocation taken into account by owner of a qualified low-income building*—(1) *Time and manner for taking housing credit allocation into account.* An owner of a qualified low-income building may not claim a low-income housing credit determined under section 42 in any year in excess of an effective housing credit allocation received from a State or local housing credit agency. A housing credit allocation made to a qualified low-income building is effective with respect to any owner of the building beginning with the owner's taxable year in which the housing credit allocation is received. A housing credit allocation is deemed received in a taxable year, except as modified in the succeeding sentence, if that allocation is made (in the manner described in paragraph (d)(8) of this section) not later than the earlier of (i) the 60th day after the close of the taxable year, or (ii) the close of the calendar year in which such taxable year ends. A housing credit allocation is deemed received in a taxable year ending in 1987, if such allocation is made (in the manner described in paragraph (d)(8) of this section) on or before December 31, 1987. A housing credit allocation is not effective for any taxable year if received in a calendar year which ends prior to when the qualified low-income building is placed in service. A housing credit allocation made to a qualified low-income building remains effective for all taxable years in the compliance period. A taxpayer is required to complete the Form 8609 on which a housing credit agency made the applicable housing credit allocation and submit a copy of such Form 8609 with its Federal income tax return for each year in the compliance period. Failure to comply with the requirement of the preceding sentence with respect to any taxable year after the first taxable year in the credit period shall be treated as a mathematical or clerical error for purposes of the provisions of section 6213 (b)(1) and (g)(2).

(2) *First-year convention limitation on housing credit allocation taken into account.* For purposes of the limitation that the allowable low-income housing credit may not exceed the effective housing credit allocation received from a State or local housing credit agency, as provided in paragraph (e)(1) of this section, the amount of the effective housing credit allocation shall be adjusted by applying the first-year convention provided in section 42(f)(2)(A) and (3)(B) and the percentage credit reduction provided in section 42(f)(3)(A). Under paragraphs (d) (2) and (5) of this section, the State or local housing credit agency must specify the credit percentage and qualified basis amount, the product of which is the amount of the housing credit allocation, without taking account of the first-year convention described in section 42(f)(2)(A) and (3)(B) or the percentage credit reduction prescribed in section 42(f)(3)(A). However, for purposes of the limitation on the amount of the allowable low-income housing credit, as provided in paragraph (e)(1) of this section, in a taxable year in which the first-year convention applies to the

amount of credit determined under section 42(a), the specified qualified basis amount shall be adjusted by the first-year convention fraction which is equal to the number of full months (during the first taxable year) in which the building was in service divided by 12. In addition, for purposes of the limitation on the amount of the allowable low-income housing credit, as provided in paragraph (e)(1) of this section, in a taxable year in which the reduction in credit percentage applies to additions to qualified basis, as prescribed in section 42(f)(3), the specified credit percentage shall be reduced by one-third. *See* examples in paragraphs (d)(5)(ii) and (e)(3)(ii) of this section.

(3) *Use of excess housing credit allocation for increases in qualified basis*—(i) *In general.* If the housing credit allocation made to a qualified low-income building exceeds the amount of credit allowable with respect to such building in any taxable year (without regard to the first-year conventions under section 42(f)), such excess is not transferable to another qualified low-income building. However, if in a subsequent year there are increases in the qualified basis for which an increased credit is allowable under section 42(f)(3) at a reduced credit percentage, the original housing credit allocation (including the specified credit percentage and qualified basis amount) would be effective with respect to such increased credit.

(ii) *Example.* The provisions of this paragraph (e)(3) may be illustrated by the following example:

Example. In 1987, a newly-constructed qualified low-income building receives a housing credit allocation of $90,000 based on a specified credit percentage of 9 percent and a specified qualified basis amount of $1,000,000. The building is placed in service in 1987, but the qualified basis in such year is only $800,000, resulting in an allowable credit in 1987 (determined without regard to the first-year conventions) of $72,000. In 1988, the qualified basis is increased to $1,100,000, resulting in an additional credit allowable under section 42(f)(3) (without regard to the first-year conventions) of $18,000 (*i.e.*, $300,000 × .06, or ⅔ of .09). The unused portion of the 1987 housing credit allocation ($18,000) is effective in 1988 and in each subsequent year in the compliance period only with respect to the specified qualified basis for the 1987 housing credit allocation ($1,000,000). Thus, the owner is allowed to claim a credit in 1988 and in each subsequent year (without regard to the first-year conventions), based on the effective housing credit allocation from 1987, of $84,000 (*i.e.*, $72,000 + ($200,000 × .06)). The owner of the qualified low-income building must obtain a new housing credit allocation in 1988 with respect to the additional $100,000 of qualified basis in order to claim a credit on such basis in 1988 and in each subsequent year. If the applicable first-year convention under section 42(f)(3)(B) entitled the owner in 1988 to only ½ of the otherwise applicable credit for the additions to qualified basis, under paragraph (e)(2) of this section the owner is allowed to claim a credit in 1988, based on the effective housing credit allocation from 1987, of $78,000 (*i.e.*, $72,000 + ($200,000 × .06 × .5)).

(4) *Separate housing credit allocations for new buildings and increases in qualified basis.* Separate housing credit allocations must be received for each building with respect to which a housing credit may be claimed. Rehabilitation expenditures with respect to a qualified low-income building are treated as a separate new building under section 42(e) and must receive a separate housing credit allocation. Increases in qualified basis in a qualified low-income building are not generally treated as a new building for purposes of section 42. To the extent that a prior housing credit allocation received with respect to a qualified low-income building does not allow an increased credit with respect to an increase in the qualified basis of such building, an additional housing credit allocation must be received in order to claim a credit with respect to that portion of increase in qualified basis. *See* paragraph (e)(3) of this section. The amount of credit allowable with respect to an increase in qualified basis is subject to the credit percentage limitation of section 42(f)(3)(A) and the first-year convention of section 42(f)(3)(B). *See* paragraph (d)(5) of this section for a rule requiring that the State or local housing credit agency count a housing credit allocation made with respect to an increase in qualified basis as if the specified credit percentage were unreduced in the manner prescribed in section 42(f)(3) and the specified basis amount were unreduced by the first-year convention prescribed in section 42(f)(3)(B).

(5) *Acquisition of building for which a prior housing credit allocation has been made.* If a carryover credit would be allowable to an acquirer of a qualified low-income building under section 42(d)(7), such acquirer need not obtain a new housing credit allocation with respect to such building. Under section 42(d)(7), the acquirer would be entitled to claim only such credits as would have been allowable to the prior owner of the building.

(6) *Multiple housing credit allocations.* A qualified low-income building may receive multiple housing credit allocations from different housing credit agencies having overlapping jurisdictions. A qualified low-income building that receives a housing credit allocation set aside exclusively for projects involving a qualified nonprofit organization may also receive a housing credit allocation from a housing credit agency's aggregate housing credit dollar amount that is not so set aside.

(f) *Exception to housing credit allocation requirement*—(1) *Tax-exempt bond financing*—(i) *In general.* No housing credit allocation is required in order to claim a credit under section 42 with respect to that portion of the eligible basis (as defined in section 42(d)) of a qualified low-income building that is financed with the proceeds of an obligation described in section 103(a) (''tax-exempt bond'') which is taken into account for purposes of the volume cap under section 146. In addition, no housing credit allocation is required in order to claim a credit under section 42 with respect to the entire qualified basis (as defined in section 42(c)) of a qualified low-income building if 70 percent or more of the aggregate basis of the building and the land on which the building is located is financed with the proceeds of tax-exempt bonds which are taken into account for purposes of the volume cap under section 146. For purposes of this paragraph, ''land on which the building is located'' includes only land that is functionally related and subordinate to the qualified low-income building. *See* § 1.103–8(b)(4)(iii) for the meaning of the term ''functionally related and subordinate''. For purposes of this paragraph, the basis of the land shall be determined using principles that are consistent with the rules contained in section 42(d).

(ii) *Determining use of bond proceeds.* For purposes of determining the portion of proceeds of an issue of tax-exempt bonds used to finance (A) the eligible basis of a qualified low-income building, and (B) the aggregate basis of the building and the land on which the building is located, the proceeds of the issue must be allocated in the bond indenture or a related document (as defined in § 1.103–13(b)(8)) in a manner consistent with the method used to allocate the net proceeds of the issue for purposes of determining whether 95 percent or more of the net proceeds of the issue are to be used for the exempt purpose of the issue. If the issuer is not consistent in making this allocation throughout the bond indenture and related documents, or if neither the bond indenture nor a related document provides an allocation, the proceeds of the issue will be allocated on a pro rata basis to all of the property financed by the issue, based on the relative cost of the property.

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

Example. In 1987, County K assigns $500,000 of its volume cap for private activity bonds under section 146 to a $500,000 issue of exempt facility bonds to provide a qualified residential rental project to be owned by A, an individual. The aggregate basis of the building and the land on which the building is located is $700,000. Under the terms of the bond indenture, the net proceeds of the issue are to be used to finance $490,000 of the eligible basis of the building. More than 70 percent of the aggregate basis of the qualified low-income building and the land on which the building is located is financed with the proceeds of tax-exempt bonds to which a portion of the volume cap under section 146 was allocated. Accordingly, A may claim a credit under section 42 without regard to whether any housing credit dollar amount was allocated to that building. If, instead, the aggregate basis of the building and land were $800,000, A would be able to claim the credit under section 42 without receiving a housing credit allocation for the building only to the extent that the credit was attributable to eligible basis of the building financed with tax-exempt bonds.

(g) *Termination of authority to make housing credit allocation*—(1) *In general.* No State or local housing credit agency shall receive an apportionment of a State housing credit ceiling for calendar years after 1989. Consequently, no housing credit allocations may be made after 1989, except as provided in paragraph (g)(2) of this section. Housing credit allocations made prior to January 1, 1990, remain effective after such date.

(2) *Carryover of unused 1989 apportionment.* Any State or local housing credit agency that has an unused portion of its apportionment of the State housing credit ceiling for 1989 from which housing credit allocations have not been made in 1989 may carry over such unused portion into 1990. Such carryover portion of the 1989 apportionment shall be treated as the agency's apportionment for 1990. From this 1990 apportionment, the State or local housing credit agency may make housing credit allocations only to a qualified low-income building meeting the following requirements:

(i) The building must be constructed, reconstructed, or rehabilitated by the taxpayer seeking the allocation;

(ii) More than 10 percent of the reasonably anticipated cost of such construction, reconstruction, or rehabilitation must have been incurred as of January 1, 1989; and

(iii) The building must be placed in service before January 1, 1991.

(3) *Expiration of exception for tax-exempt bond financed projects.* The exception to the requirement that a housing credit allocation be received with respect to any portion of the eligible basis of a qualified low-income building, as provided in paragraph (f) of this section, shall not apply to any building placed in service after 1989, unless such building is described in paragraphs (g)(2) (i), (ii), and (iii) of this section.

(h) *Filing of forms and special rules*—(1) *Completed form.* For purposes of this section, a form shall be treated as completed if the State or local housing credit agency or the building owner has made a good faith effort to complete the form in accordance with the form and the instructions for the form.

(2) *Manner of filing.* A completed Form 8586, Low-Income Housing Credit, shall be filed with the owner's Federal income tax return for each taxable year the owner of a qualified low-income building is claiming the low-income housing credit during the 10-year credit period. A completed Form 8609 (or copy thereof) shall be filed with the owner's Federal income tax return for each of the 15 taxable years in the compliance period. If a housing credit allocation is not required to be received by an owner under paragraph (f) of this section, the owner shall obtain a blank copy of Form 8609 and fill in the address of the building and the name and address of the owner in part I. Part II of Form 8609 shall be completed by the owner of the qualified low-income building only for the first year the low-income housing credit is claimed by the building owner. Part III of Form 8609 (Statement of Qualification) shall be completed by the owner of the qualified low-income building for each year of the 15-year compliance period.

(3) *Revised or renumbered forms.* If any form is revised or renumbered, any reference in this section to the form shall be treated as a reference to the revised or renumbered form.

(i) *Transitional rules.* The transitional rules contained in section 252(f)(1) of the Tax Reform Act of 1986 are incorporated into this section of the regulations for purposes of determining whether a qualified low-income building is entitled to receive a housing credit allocation or is excepted from the requirement that a housing credit allocation be received. Housing credit allocations made to qualified low-income buildings described in section 252(f)(1) shall not count against the State or local housing credit agency's aggregate housing credit dollar amount. The transitional rules contained in section 252(f)(2) of the Tax Reform Act of 1986 are incorporated into this section of the regulations for purposes of determining amounts available to certain State or local housing credit agencies for the making of housing credit allocations to certain qualified low-income housing projects. Amounts available to housing credit agencies under section 252(f)(2) shall be treated as special apportionments unavailable for housing credit allocations to qualified low-income buildings not described in section 252(f)(2). Housing credit allocations made from the special apportionments shall not count against the State or local credit agency's aggregate housing credit dollar amount. The set-aside requirements shall not apply to these special apportionments. The transitional rules contained in section 252(f)(3) of the Tax Reform Act 1986 are incorporated in this section of the regulations for purposes of determining the amount of housing credit allocations received by certain qualified low-income buildings. Housing credit allocations deemed received under section 252(f)(3) shall not count against the State or local housing credit agency's aggregate housing credit dollar amount.

[T.D. 8144, 52 FR 23433, June 22, 1987; 52 FR 24583, July 1, 1987]

§ 1.42–2 Waiver of requirement that an existing building eligible for the low-income housing credit was last placed in service more than 10 years prior to acquisition by the taxpayer.

(a) *Low-income housing credit for existing building.* Section 42 provides that, for purposes of section 38, new and existing qualified low-income buildings are eligible for a low-income housing credit. The eligibility rules for new and existing buildings differ. Under section 42(d)(2), an existing building may be eligible for the low-income housing credit based upon the acquisition cost and amounts chargeable to capital account (to the extent properly included in eligible basis) if—

(1) The taxpayer acquires the building by purchase (as defined in section 179(d)(2), as applicable under section 42(d)(2)(D)(iii)(I)),

(2) There is a period of at least 10 years between the date of the building's acquisition by the taxpayer and the later of—(i) The date the building was last placed in service, or

(ii) The date of the most recent nonqualified substantial improvement of the building, and

(3) The building was not previously placed in service by the taxpayer, or by a person who was a related person (as defined in section 42(d)(2)(D)(iii)(II)) with respect to the taxpayer as of the time the building was last previously placed in service.

(b) *Waiver of 10-year holding period requirement.* Section 42(d)(6) provides that a taxpayer may apply for a waiver of the 10-year holding period requirement specified in paragraph (a)(2) of this section. The Internal Revenue Service will grant a waiver only if—

(1) The existing building satisfies all of the requirements in paragraph (c) of this section, and

(2) The taxpayer makes an application in conformity with the requirements in paragraph (d) of this section.

(c) *Waiver requirements*—(1) *Federally-assisted building.* To satisfy the requirement of this paragraph, a building must be a Federally-assisted building. The term ''Federally assisted building'' means any building which is substantially assisted, financed, or operated under section 8 of the United States Housing Act of 1937, section 221(d)(3) or 236 of the National Housing Act, or section 515 of the Housing Act of 1949, as such acts were in effect on October 22, 1986.

(2) *Federal mortgage funds at risk.* To satisfy the requirement of this paragraph, Federal mortgage funds must be at risk with respect to a mortgage that is secured by the building or a project of which the building is a part. For purposes of this paragraph, Federal mortgage funds are at risk if, in the event of a default by the mortgagor on the mortgage secured by the building or the project of which the building is a part—

(i) The mortgage could be assigned to the Department of Housing and Urban Development or the Farmers' Home Administration, or

(ii) There could arise a claim against a Federal mortgage insurance fund (or such Department or Administration).

(3) *Statement by the Department of Housing and Urban Development or the Farmers' Home Administration.* (i) To satisfy the requirement of this paragraph, a letter or other written statement must be made or received and approved by the national office of the Department of Housing and Urban Development or the Farmers' Home Administration (''the Federal agency''). This letter or statement shall include the following:

(A) A statement that, as of the earlier of the time of the taxpayer's acquisition of the building or the taxpayer's application for a waiver, the building is a Federally-assisted building within the meaning of paragraph (c)(1) of this section and identifies the source of Federal assistance;

(B) A statement that a waiver of the 10-year holding period requirement is necessary to avert Federal mortgage funds being at risk within the meaning of paragraph (c)(2) of this section; and

(C) A statement that the Federal agency has taken a Federal agency action as described in paragraph (c)(3)(ii) of this section.

(ii) The following specified Federal agency actions shall be the only means of satisfying the requirement of this paragraph:

(A) The Federal agency intends to accept an assignment of a mortgage secured by the building or the project of which the building is a part, and such assignment requires payments by the agency or a mortgage insurance fund maintained by the agency to the prior mortgagee;

(B) The Federal agency or a mortgage insurance fund maintained by the agency intends to accept, as a consequence of foreclosure proceedings or otherwise, conveyance of the building or the project of which the building is a part;

(C) The Federal agency or a mortgage insurance fund maintained by the agency intends, as a consequence of default, to take possession of, hold title to, or otherwise assume ownership of the building or the project of which the building is a part; or

(D) The Federal agency has designated the building or the project of which the building is a part as a troubled building or project. A designation of a troubled building or project must satisfy the following requirements:

(*1*) Designation of troubled status must be based on a review by the Federal agency of the financial condition of the building or project and on a determination by the Federal agency of a history of financial distress or mortgage defaults;

(*2*) Designation of troubled status must be made or received and approved by the national office of the Federal agency; and

(*3*) Federal agency regulations or procedures must provide that, in the event of transfer of the ownership of a designated troubled building or project, the building or project may be subject to continued review by the Federal agency. Each Federal agency may prescribe its own standards and procedures for designating a troubled building or project so long as such standards are consistent with the requirements of this paragraph (c)(3)(ii)(D).

(4) *No prior credit allowed.* The requirement of this paragraph is satisfied only if no prior owner was allowed a low-income housing credit under section 42 for the building.

(d) *Application for waiver*—(1) *Time and manner.* In order to receive a waiver of the 10-year holding period requirement specified in paragraph (a)(2) of this section, a taxpayer must file an application (including the applicable user fee) that complies with the requirements of this paragraph (d) and Rev. Proc. 90–1, 1990–1 I.R.B. 8 (or any subsequent applicable revenue procedure). The application must be filed by a taxpayer who has acquired the building by purchase or who has a binding contract to purchase the building. Such binding contract may be conditioned upon the granting of a waiver under this section. The application may be filed at any time after a binding contract has been entered into, but no later than 12 months after the taxpayer's acquisition of the building. An application for a waiver of the 10-year holding period requirement must not contain a request for a ruling on any other issue arising under section 42 or other sections of the Internal Revenue Code. An application for a waiver of the 10-year holding period requirement must be mailed or delivered to the address listed in section 3.01 of Rev. Proc. 90–1 (or any subsequent applicable revenue procedure).

(2) *Information required.* An application for a waiver of the 10-year holding period requirement must contain the following information:

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

(ii) The name (if any) and address of the acquired building and the project (if any) of which it is a part;

(iii) The date of acquisition or the date of the binding contract for acquisition of the building by the taxpayer and the expected date of acquisition, the amount of consideration paid or to be paid for the acquisition (including the value of any liabilities assumed by the taxpayer), and the taxpayer's certification that such acquisition is by purchase (as defined in section 179(d)(2), as applicable under section 42 (d)(2)(D)(iii)(I));

(iv) The identity of the person from whom the building is acquired, and whether such person is a Federal agency, a mortgagee holding title to the building, or the mortgagor or prior owner;

(v) The date the building was last placed in service and the date of the most recent (if any) nonqualified substantial improvement of the building (as defined in section 42 (d)(2)(D)(i));

(vi) The taxpayer's certification that the building was not previously placed in service by the taxpayer, or by a person who was a related person (as defined in section 42(d)(2)(D)(iii)(II)) with respect to the taxpayer as of the time the building was last placed in service;

(vii) The amount and disposition (*e.g.*, discharge, assignment, assumption, or refinance) of the outstanding mortgage at the time of acquisition and the identities of the mortgagee and mortgagor;

(viii) The taxpayer's certification that no prior owner was allowed a low-income housing credit under section 42 for the building (made to the best of the taxpayer's knowledge, with no documentation from other persons needed to be submitted); and

(ix) The statement from the Federal agency required by paragraph (c)(3)(i) of this section.

(3) *Other rules.* (i) In the event that an acquired building will be owned by more than one taxpayer, a single application for waiver may be filed by one taxpayer on behalf of the co-owners if the application contains the names, addresses and taxpayer identification numbers of the other owners. A general partner or a designated limited partner may file an application for waiver on behalf of a partnership.

(ii) In the event that multiple Federally-assisted buildings in a project are being acquired by the taxpayer, a single application for waiver with respect to such buildings may be filed if the application contains the required information set out for the address of each Federally-assisted building involved.

(iii) In the event that specific Federally-assisted buildings are being acquired by the taxpayer in a project consisting of multiple buildings that may or may not be Federally-assisted, a single application for waiver with respect to the Federally-assisted buildings being acquired may be filed if the application contains the required information set out for the address of each Federally-assisted building being acquired.

(4) *Effective date of waiver.* A waiver will be effective when granted in writing by the Internal Revenue Service after submission of a completed application for waiver filed under this paragraph (d).

(5) *Attachment to return.* A waiver letter granted by the Internal Revenue Service shall be filed with the taxpayer's Federal income tax return for the first taxable year the low-income housing credit is claimed by the taxpayer.

(e) *Effective date of regulations.* The provisions of § 1.42–2 are effective for buildings placed in service by the taxpayer after December 31, 1986.

[T.D. 8302, 55 FR 21189, May 23, 1990; 55 FR 25973, June 26, 1990]

§ 1.42–3 Treatment of buildings financed with proceeds from a loan under an Affordable Housing Program established pursuant to section 721 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

(a) *Treatment under sections 42(i) and 42(b).* A below market loan funded in whole or in part with funds from an Affordable Housing Program established under section 721 of FIRREA is not, solely by reason of the Affordable Housing Program funds, a below market Federal loan as defined in section 42(i)(2)(D). Thus, any building with respect to which the proceeds of the loan are used during the tax year is not, solely by reason of the Affordable Housing Program funds, treated as a federally subsidized building for that tax year and subsequent tax years for purposes of determining the applicable percentage for the building under section 42(b).

(b) *Effective date.* The rules set forth in paragraph (a) of this section are effective for loans made after August 8, 1989.

[56 FR 48734, Sept. 26, 1991]

§1.42–4 Application of not-for-profit rules of section 183 to low-income housing credit activities.

(a) *Inapplicability to section 42.* In the case of a qualified low-income building with respect to which the low-income housing credit under section 42 is allowable, section 183 does not apply to disallow losses, deductions, or credits attributable to the ownership and operation of the building.

(b) *Limitation.* Notwithstanding paragraph (a) of this section, losses, deductions, or credits attributable to the ownership and operation of a qualified low-income building with respect to which the low-income housing credit under section 42 is allowable may be limited or disallowed under other provisions of the Code or principles of tax law. See, *e.g.*, sections 38(c), 163(d), 465, 469; *Knetsch* v. *United States*, 364 U.S. 361 (1960), 1961–1 C.B. 34 (''sham'' or ''economic substance'' analysis); and *Frank Lyon Co.* v. *Commissioner,* 435 U.S. 561 (1978), 1978–1 C.B. 46 (''ownership'' analysis).

(c) *Effective date.* The rules set forth in paragraphs (a) and (b) of this section are effective with respect to buildings placed in service after December 31, 1986.

[T.D. 8420, 57 FR 24729, June 11, 1992]

§1.42–5 Monitoring compliance with low-income housing credit requirements.

(a) *Compliance monitoring requirement*—(1) *In general.* Under section 42(m)(1)(B)(iii), an allocation plan is not qualified unless it contains a procedure that the State or local housing credit agency (''Agency'') (or an agent of, or other private contractor hired by, the Agency) will follow in monitoring for noncompliance with the provisions of section 42 and in notifying the Internal Revenue Service of any noncompliance of which the Agency becomes aware. These regulations only address compliance monitoring procedures required of Agencies. The regulations do not address forms and other records that may be required by the Service on examination or audit. For example, if a building is sold or otherwise transferred by the owner, the transferee should obtain from the transferor information related to the first year of the credit period so that the transferee can substantiate credits claimed.

(2) *Requirements for a monitoring procedure*—(i) *In general.* A procedure for monitoring for noncompliance under section 42(m)(1)(B)(iii) must include—

(A) The recordkeeping and record retention provisions of paragraph (b) of this section;

(B) The certification and review provisions of paragraph (c) of this section;

(C) The inspection provision of paragraph (d) of this section; and

(D) The notification-of-noncompliance provisions of paragraph (e) of this section.

(ii) *Order and form.* A monitoring procedure will meet the requirements of section 42 (m)(1)(B)(iii) if it contains the substance of these provisions. The particular order and form of the provisions in the allocation plan is not material. A monitoring procedure may contain additional provisions or requirements.

(b) *Recordkeeping and record retention provisions*—(1) *Recordkeeping provision.* Under the recordkeeping provision, the owner of a low-income housing project must be required to keep records for each qualified low-income building in the project that show for each year in the compliance period—

(i) The total number of residential rental units in the building (including the number of bedrooms and the size in square feet of each residential rental unit);

(ii) The percentage of residential rental units in the building that are low-income units;

(iii) The rent charged on each residential rental unit in the building (including any utility allowances);

(iv) The number of occupants in each low-income unit, but only if rent is determined by the number of occupants in each unit under section 42(g)(2) (as in effect before the amendments made by the Revenue Reconciliation Act of 1989);

(v) The low-income unit vacancies in the building and information that shows when, and to whom, the next available units were rented;

(vi) The annual income certification of each low-income tenant per unit. For an exception to this requirement, see section 42(g)(8)(B) (which provides a special rule for a 100 percent low-income building);

(vii) Documentation to support each low-income tenant's income certification (for example, a copy of the tenant's federal income tax return, Forms W–2, or verifications of income from third parties such as employers or state agencies paying unemployment compensation). For an exception to this requirement, see section 42(g)(8)(B) (which provides a special rule for a 100 percent low-income building). Tenant income is calculated in a manner consistent with the determination of annual income under section 8 of the United States Housing Act of 1937 (''Section 8''), not in accordance with the determination of gross income for federal income tax liability. In the case of a tenant receiving housing assistance payments under Section 8, the documentation requirement of this paragraph (b)(1)(vii) is satisfied if the public housing authority provides a statement to the building owner declaring that the tenant's income does not exceed the applicable income limit under section 42 (g);

(viii) The eligible basis and qualified basis of the building at the end of the first year of the credit period; and

(ix) The character and use of the nonresidential portion of the building included in the building's eligible basis under section 42 (d) (*e.g.*, tenant facilities that are available on a comparable basis to all tenants and for which no separate fee is charged for use of the facilities, or facilities reasonably required by the project).

(2) *Record retention provision*. Under the record retention provision, the owner of a low-income housing project must be required to retain the records described in paragraph (b)(1) of this section for at least 6 years after the due date (with extensions) for filing the federal income tax return for that year. The records for the first year of the credit period, however, must be retained for at least 6 years beyond the due date (with extensions) for filing the federal income tax return for the last year of the compliance period of the building.

(c) *Certification and review provisions*—(1) *Certification*. Under the certification provision, the owner of a low-income housing project must be required to certify at least annually to the Agency that, for the preceding 12-month period—

(i) The project met the requirements of:

(A) The 20–50 test under section 42 (g)(1)(A), the 40–60 test under section 42 (g)(1)(B), or the 25–60 test under sections 42 (g)(4) and 142 (d)(6) for New York City, whichever minimum set-aside test was applicable to the project; and

(B) If applicable to the project, the 15–40 test under sections 42(g)(4) and 142 (d)(4)(B) for ''deep rent skewed'' projects;

(ii) There was no change in the applicable fraction (as defined in section 42(c)(1)(B)) of any building in the project, or that there was a change, and a description of the change;

(iii) The owner has received an annual income certification from each low-income tenant, and documentation to support that certification; or, in the case of a tenant receiving Section 8 housing assistance payments, the statement from a public housing authority described in paragraph (b)(1)(vii) of this section. For an exception to this requirement, see section 42(g)(8)(B) (which provides a special rule for a 100 percent low-income building);

(iv) Each low-income unit in the project was rent-restricted under section 42(g)(2);

(v) All units in the project were for use by the general public and used on a nontransient basis (except for transitional housing for the homeless provided under section 42 (i)(3)(B)(iii));

(vi) Each building in the project was suitable for occupancy, taking into account local health, safety, and building codes;

(vii) There was no change in the eligible basis (as defined in section 42(d)) of any building in the project, or if there was a change, the nature of the change (*e.g.*, a common area has become commercial space, or a fee is now charged for a tenant facility formerly provided without charge);

(viii) All tenant facilities included in the eligible basis under section 42(d) of any building in the project, such as swimming pools, other recreational facilities, and parking areas, were provided on a comparable basis without charge to all tenants in the building;

(ix) If a low-income unit in the project became vacant during the year, that reasonable attempts were or are being made to rent that unit or the next available unit of comparable or smaller size to tenants having a qualifying income before any units in the project were or will be rented to tenants not having a qualifying income;

(x) If the income of tenants of a low-income unit in the project increased above the limit allowed in section 42(g)(2)(D)(ii), the next available unit of comparable or smaller size in the project was or will be rented to tenants having a qualifying income; and

(xi) An extended low-income housing commitment as described in section 42(h)(6) was in effect (for buildings subject to section 7108(c)(1) of the Revenue Reconciliation Act of 1989).

(2) *Review.* The review provision must—

(i) Require that the Agency review the certifications submitted under paragraph (c)(1) of this section for compliance with the requirements of section 42;

(ii) Contain at least one of the following requirements:

(A) The owners of at least 50 percent of all low-income housing projects in the Agency's jurisdiction must submit to the Agency for compliance review a copy of the annual income certification, the documentation the owner has received to support that certification, and the rent record for each low-income tenant in at least 20 percent of the low-income units in their projects;

(B) The Agency must inspect at least 20 percent of low-income housing projects each year and must inspect the low-income certification, the documentation the owner has received to support that certification, and the rent record for each low-income tenant in at least 20 percent of the low-income units in those projects; or

(C) The owners of all low-income housing projects must submit to the Agency each year information on tenant income and rent for each low-income unit, in the form and manner designated by the Agency, and the owners of at least 20 percent of the projects must submit to the Agency for compliance review a copy of the annual income certification, the documentation the owner has received to support that certification, and the rent record for each low-income tenant in at least 20 percent of the low-income units in their projects; and

(iii) Require that the Agency determine which tenants' records are to be inspected or submitted by the owners for review. If a monitoring procedure includes the review provision described in paragraph (c)(2)(ii)(B) of this section, the records to be inspected must be chosen in a manner that will not give owners of low-income housing projects advance notice that their records for a particular year will or will not be inspected. However, an Agency may give an owner reasonable notice that an inspection will occur so that the owner may assemble records (for example, 30 days notice of inspection). See paragraph (d) of this section for the inspection provision that is required to be included in all monitoring procedures.

(3) *Frequency and form of certification.* A monitoring procedure must require that the certifications and reviews of paragraph (c)(1) and (2) of this section be made at least annually covering each year of the 15-year compliance period under section 42(i)(1). The certifications must be made under penalty of perjury. A monitoring procedure may require certifications and reviews more frequently than on a 12-month basis, provided that all months within each 12-month period are subject to certification.

(4) *Exception for certain buildings*—(i) *In general.* The review requirements under paragraph (c)(2)(ii) (A), (B), and (C) of this section may provide that owners are not required to submit, and the Agency is not required to review, the tenant income certifications, supporting documentation, and rent

records for buildings financed by the Farmers Home Administration (FmHA) under the section 515 program, or buildings of which 50 percent or more of the aggregate basis (taking into account the building and the land) is financed with the proceeds of obligations the interest on which is exempt from tax under section 103 (tax-exempt bonds). In order for a monitoring procedure to except these buildings, the Agency must meet the requirements of paragraph (c)(4)(ii) of this section.

(ii) *Agreement and review.* The Agency must enter into an agreement with the FmHA or tax-exempt bond issuer. Under the agreement, the FmHA or tax-exempt bond issuer must agree to provide information concerning the income and rent of the tenants in the building to the Agency. The Agency may assume the accuracy of the information provided by FmHA or the tax-exempt bond issuer without verification. The Agency must review the information and determine that the income limitation and rent restriction of section 42 (g)(1) and (2) are met. However, if the information provided by the FmHA or tax-exempt bond issuer is not sufficient for the Agency to make this determination, the Agency must request the necessary additional income or rent information from the owner of the buildings. For example, because FmHA determines tenant eligibility based on its definition of ‘‘adjusted annual income,’’ rather than ‘‘annual income’’ as defined under Section 8, the Agency may have to calculate the tenant's income for section 42 purposes and may need to request additional income information from the owner.

(iii) *Example.* The exception permitted under paragraph (c)(4)(i) and (ii) of this section is illustrated by the following example.

Example. An Agency chooses the review requirement of paragraph (c)(2)(ii)(A) of this section and some of the buildings selected for review are buildings financed by the FmHA. The Agency has entered into an agreement described in paragraph (c)(4)(ii) of this section with the FmHA with respect to those buildings. In reviewing the FmHA-financed buildings, the Agency obtains the tenant income and rent information from the FmHA for 20 percent of the low-income units in each of those buildings. The Agency calculates the tenant income and rent to determine whether the tenants meet the income and rent limitation of section 42 (g)(1) and (2). In order to make this determination, the Agency may need to request additional income or rent information from the owners of the FmHA buildings if the information provided by the FmHA is not sufficient.

(d) *Inspection provision.* Under the inspection provision, the Agency must have the right to perform an on-site inspection of any low-income housing project at least through the end of the compliance period of the buildings in the project. The inspection provision of this paragraph (d) is separate from any review of low-income certifications, supporting documents, and rent records under paragraph (c)(2)(ii) of this section.

(e) *Notification-of-noncompliance provision*—(1) *In general.* Under the notification-of-noncompliance provisions, the Agency must be required to give the notice described in paragraph (e)(2) of this section to the owner of a low-income housing project and the notice described in paragraph (e)(3) of this section to the Service.

(2) *Notice to owner.* The Agency must be required to provide prompt written notice to the owner of a low-income housing project if the Agency does not receive the certification described in paragraph (c)(1) of this section, or does not receive or is not permitted to inspect the tenant income certifications, supporting documentation, and rent records described in paragraph (c)(2)(ii)(A), (B), or (C) of this section (whichever is applicable), or discovers by inspection, review, or in some other manner, that the project is not in compliance with the provisions of section 42.

(3) *Notice to Internal Revenue Service*—(i) *In general.* The Agency must be required to file Form 8823, ‘‘Low-Income Housing Credit Agencies Report of Noncompliance,’’ with the Service no later than 45 days after the end of the correction period (as described in paragraph (e)(4) of this section, including extensions permitted under that paragraph) and no earlier than the end of the correction period, whether or not the noncompliance or failure to certify is corrected. The Agency must explain

on Form 8823 the nature of the noncompliance or failure to certify and indicate whether the owner has corrected the noncompliance or failure to certify. Any change in either the applicable fraction or eligible basis under paragraph (c)(1)(ii) and (vii) of this section, respectively, that results in a decrease in the qualified basis of the project under section 42 (c)(1)(A) is noncompliance that must be reported to the Service under this paragraph (e)(3). If an Agency reports on Form 8823 that a building is entirely out of compliance and will not be in compliance at any time in the future, the Agency need not file Form 8823 in subsequent years to report that building's noncompliance.

(ii) *Agency retention of records.* An Agency must retain records of noncompliance or failure to certify for 6 years beyond the Agency's filing of the respective Form 8823. In all other cases, the Agency must retain the certifications and records described in paragraph (c) of this section for 3 years from the end of the calendar year the Agency receives the certifications and records.

(4) *Correction period.* The correction period shall be that period specified in the monitoring procedure during which an owner must supply any missing certifications and bring the project into compliance with the provisions of section 42. The correction period is not to exceed 90 days from the date of the notice to the owner described in paragraph (e)(2) of this section. An Agency may extend the correction period for up to 6 months, but only if the Agency determines there is good cause for granting the extension.

(f) *Delegation of Authority*—(1) *Agencies permitted to delegate compliance monitoring functions*—(i) *In general.* An Agency may retain an agent or other private contractor (''Authorized Delegate'') to perform compliance monitoring. The Authorized Delegate must be unrelated to the owner of any building that the Authorized Delegate monitors. The Authorized Delegate may be delegated all of the functions of the Agency, except for the responsibility of notifying the Service under paragraph (e)(3) of this section. For example, the Authorized Delegate may be delegated the responsibility of reviewing tenant certifications and documentation under paragraph (c) (1) and (2) of this section, the right to inspect buildings and records as described in paragraph (d) of this section, and the responsibility of notifying building owners of lack of certification or noncompliance under paragraph (e)(2) of this section. The Authorized Delegate must notify the Agency of any noncompliance or failure to certify.

(ii) *Limitations.* An Agency that delegates compliance monitoring to an Authorized Delegate under paragraph (f)(1)(i) of this section must use reasonable diligence to ensure that the Authorized Delegate properly performs the delegated monitoring functions. Delegation by an Agency of compliance monitoring functions to an Authorized Delegate does not relieve the Agency of its obligation to notify the Service of any noncompliance of which the Agency becomes aware.

(2) *Agencies permitted to delegate compliance monitoring functions to another Agency.* An Agency may delegate all or some of its compliance monitoring responsibilities for a building to another Agency within the State. This delegation may include the responsibility of notifying the Service under paragraph (e)(3) of this section.

(g) *Liability.* Compliance with the requirements of section 42 is the responsibility of the owner of the building for which the credit is allowable. The Agency's obligation to monitor for compliance with the requirements of section 42 does not make the Agency liable for an owner's noncompliance.

(h) *Effective date.* Allocation plans must comply with these regulations by June 30, 1993. The requirement of section 42 (m)(1)(B)(iii) that allocation plans contain a procedure for monitoring for noncompliance becomes effective on January 1, 1992, and applies to buildings for which a low-income housing credit is, or has been, allowable at any time. Thus, allocation plans must comply with section 42(m)(1)(B)(iii) prior to June 30, 1993, the effective date of these regulations. An allocation plan that complies with these regulations, with the notice of proposed rulemaking published in the FEDERAL REGISTER on December 27, 1991, or with a reasonable interpretation of section 42(m)(1)(B)(iii) will satisfy the requirements of section 42(m)(1)(B)(iii) for periods before June 30, 1993. Section 42(m)(1)(B)(iii) and these regulations do not require monitoring for whether a building or project is in compliance with the requirements of section 42 prior to January 1, 1992. However, if an Agency becomes aware of noncompliance that occurred prior to January 1, 1992, the Agency is required to notify the Service of that noncompliance.

[T.D.8430, 57 FR 40121, Sept. 2, 1992; 57 FR 57280, Dec. 3, 1992; 58 FR 7748, Feb. 9, 1993; T.D. 8563, 59 FR 50163, Oct. 3, 1994]

§ 1.42–6 Buildings qualifying for carryover allocations.

(a) *Carryover allocations.* A carryover allocation is an allocation that meets the requirements of section 42(h)(1) (E) or (F). If the requirements of section 42(h)(1) (E) or (F) that are required to be satisfied by the close of the calendar year are not satisfied, the allocation is treated as if it had not been made. For example, if the taxpayer's basis in the project as of the close of the calendar year of allocation is not more than 10 percent of the taxpayer's reasonably expected basis in the project as of the close of the second calendar year following the year of allocation, the carryover allocation is not valid and is treated as if it had not been made.

(b) *Carryover-allocation basis*—(1) *In general.* Subject to the limitations of paragraph (b)(2) of this section, a taxpayer's basis in a project for purposes of section 42(h)(1) (E)(ii) or (F) (carryover-allocation basis) is the taxpayer's adjusted basis in land or depreciable property that is reasonably expected to be part of the project, whether or not these amounts are includible in eligible basis under section 42(d). Thus, for example, if the project is to include property that is not residential rental property, such as commercial space, the basis attributable to the commercial space, although not includible in eligible basis, is includible in carryover-allocation basis. The adjusted basis of land and depreciable property is determined under sections 1012 and 1016, and generally includes the direct and indirect costs of acquiring, constructing, and rehabilitating the property. Costs otherwise includible in carryover-allocation basis are not excluded by reason of having been incurred prior to the calendar year in which the carryover allocation is made.

(2) *Limitations*—For purposes of determining carryover-allocation basis under paragraph (b)(1) of this section, the following limitations apply.

(i) *Taxpayer must have basis in land or depreciable property related to the project.* A taxpayer has carryover-allocation basis to the extent that it has basis in land or depreciable property and the land or depreciable property is reasonably expected to be part of the project for which the carryover allocation is made. This basis includes all items that are properly capitalizable with respect to the land or depreciable property. For example, a nonrefundable downpayment for, or an amount paid to acquire an option to purchase, land or depreciable property may be included in carryover-allocation basis if properly capitalizable into the basis of land or depreciable property that is reasonably expected to be part of a project.

(ii) *High cost areas.* Any increase in eligible basis that may result under section 42(d)(5)(C) from a building's location in a qualified census tract or difficult development area is not taken into account in determining carryover-allocation basis or reasonably expected basis.

(iii) *Amounts not treated as paid or incurred.* An amount is not includible in carryover-allocation basis unless it is treated as paid or incurred under the method of accounting used by the taxpayer. For example, a cash method taxpayer cannot include construction costs in carryover-allocation basis unless the costs have been paid, and an accrual method taxpayer cannot include construction costs in carryover-allocation basis unless they have been properly accrued. See paragraph (b)(2)(iv) of this section for a special rule for fees.

(iv) *Fees.* A fee is includible in carryover-allocation basis only to the extent the requirements of paragraph (b)(2)(iii) of this section are met and—

(A) The fee is reasonable;

(B) The taxpayer is legally obligated to pay the fee;

(C) The fee is capitalizable as part of the taxpayer's basis in land or depreciable property that is reasonably expected to be part of the project;

(D) The fee is not paid (or to be paid) by the taxpayer to itself; and

(E) If the fee is paid (or to be paid) by the taxpayer to a related person, and the taxpayer uses the cash method of accounting, the taxpayer could properly accrue the fee under the accrual method of accounting (considering, for example, the rules of section 461(h)). A person is a related person if the person bears a relationship to the taxpayer specified in sections 267(b) or 707(b)(1), or if the person and the taxpayer are engaged in trades or businesses under common control (within the meaning of subsections (a) and (b) of section 52).

(3) *Reasonably expected basis.* Rules similar to the rules of paragraphs (a) and (b) of this section apply in determining the taxpayer's reasonably expected basis in a project (land and depreciable basis) as of the close of the second calendar year following the calendar year of the allocation.

(4) *Examples.* The following examples illustrate the rules of paragraphs (a) and (b) of this section.

Example 1. (i) *Facts.* C, an accrual-method taxpayer, receives a carryover allocation from Agency, the state housing credit agency, in September of 1993. As of that date, C has not begun construction of the low-income housing building C plans to build. However, C has owned the land on which C plans to build the building since 1985. C's basis in the land is $100,000. C reasonably expects that by the end of 1995, C's basis in the project of which the building is to be a part will be $2,000,000. C also expects that because the project is located in a qualified census tract, C will be able to increase its basis in the project to $2,600,000. Before the close of 1993, C incurs $150,000 of costs for architects' fees and site preparation. C properly accrues these costs under its method of accounting and capitalizes the costs.

(ii) *Determination of carryover-allocation basis.* C's $100,000 basis in the land is includible in carryover-allocation basis even though C has owned the land since 1985. The $150,000 of costs C has incurred for architects' fees and site preparation are also includible in carryover-allocation basis. The expected increase in basis due to the project's location in a qualified census tract is not taken into account in determining C's carryover-allocation basis. Accordingly, C's carryover-allocation basis in the project of which the building is a part is $250,000.

(iii) *Determination of whether building is qualified.* C's reasonably expected basis in the project at the close of the second calendar year following the calendar year of allocation is $2,000,000. The expected increase in eligible basis due to the project's location in a qualified census tract is not taken into account in determining this amount. Because C's carryover-allocation basis is more than 10 percent of C's reasonably expected basis in the project of which the building is a part, the building for which C received the carryover allocation is a qualified building for purposes of section 42(h)(1)(E)(ii) and paragraph (a) of this section.

Example 2 . (i) *Facts.* D, an accrual-method taxpayer, receives a carryover allocation from Agency, the state housing credit agency, on September 11, 1993. As of that date, D has not begun construction of the low-income housing building D plans to build and D does not have basis in the land on which D plans to build the building. In 1993, D incurs some costs related to the planned building, including architects' fees. However, at the close of 1993, these costs do not exceed 10 percent of D's reasonably expected basis in the project.

(ii) *Determination of whether building is qualified.* Because D's carryover-allocation basis is not more than 10 percent of D's reasonably expected basis in the project of which the building is a part, the building for which D received a carryover allocation is not a qualified building for purposes of section 42(h)(1)(E)(ii) and paragraph (a) of this section. The carryover allocation to D is not valid, and is treated as if it had not been made.

(c) *Verification of basis by Agency*—(1) *Verification requirement.* An Agency that makes a carryover allocation to a taxpayer must verify that, as of the close of the calendar year of allocation, the taxpayer has incurred more than 10 percent of the reasonably expected basis in the project (land and depreciable basis).

(2) *Manner of verification.* An Agency may verify that a taxpayer has incurred more than 10 percent of its reasonably expected basis in a project by obtaining a certification from the taxpayer, in writing and under penalty of perjury, that the taxpayer has incurred by the close of the calendar year of the allocation more than 10 percent of the reasonably expected basis in the

project. The certification must be accompanied by supporting documentation that the Agency must review. Supporting documentation may include, for example, copies of checks or other records of payments. Alternatively, an Agency may verify that the taxpayer has incurred adequate basis by requiring that the taxpayer obtain from an attorney or certified public accountant a written certification to the Agency, that the attorney or accountant has examined all eligible costs incurred with respect to the project and that, based upon this examination, it is the attorney's or accountant's belief that the taxpayer has incurred more than 10 percent of its reasonably expected basis in the project by the close of the calendar year of the allocation.

(3) *Time of verification.* An Agency may require that the basis certification be submitted to or received by the Agency prior to the close of the calendar year of allocation or within a reasonable time after the close of the calendar year of allocation. The Agency will need to verify basis in order to accurately complete the Form 8610, Annual Low-Income Housing Credit Agencies Report, for the calendar year. If certification is not timely made, or supporting documentation is lacking, inadequate, or does not actually support the certification, the Agency should notify the taxpayer and try to get adequate documentation. If the Agency cannot verify before the Form 8610 is filed that the taxpayer has satisfied the basis requirement for a carryover allocation, the allocation is treated as if it had not been made and the carryover allocation document should not be filed with the Form 8610.

(d) *Requirements for making carryover allocations*—(1) *In general.* Generally, an allocation is made when an Agency issues the Form 8609, Low-Income Housing Credit Allocation Certification, for a building. See § 1.42–1T(d)(8)(ii). An Agency does not issue the Form 8609 for a building until the building is placed in service. However, in cases where allocations of credit are made pursuant to section 42(h)(1)(E) (relating to carryover allocations for buildings) or section 42(h)(1)(F) (relating to carryover allocations for multiple-building projects), Form 8609 is not used as the allocating document because the buildings are not yet in service. When an allocation is made pursuant to section 42(h)(1) (E) or (F), the allocating document is the document meeting the requirements of paragraph (d)(2) of this section. In addition, when an allocation is made pursuant to section 42(h)(1)(F), the requirements of paragraph (d)(3) of this section must be met for the allocation to be valid. An allocation pursuant to section 42(h)(1) (E) or (F) reduces the state housing credit ceiling for the year in which the allocation is made, whether or not the Form 8609 is also issued in that year.

(2) *Requirements for allocation.* An allocation pursuant to section 42(h)(1) (E) or (F) is made when an allocation document containing the following information is completed, signed, and dated by an authorized official of the Agency—

(i) The address of each building in the project, or if none exists, a specific description of the location of each building;

(ii) The name, address, and taxpayer identification number of the taxpayer receiving the allocation;

(iii) The name and address of the Agency;

(iv) The taxpayer identification number of the Agency;

(v) The date of the allocation;

(vi) The housing credit dollar amount allocated to the building or project, as applicable;

(vii) The taxpayer's reasonably expected basis in the project (land and depreciable basis) as of the close of the second calendar year following the calendar year in which the allocation is made;

(viii) The taxpayer's basis in the project (land and depreciable basis) as of the close of the calendar year in which the allocation is made and the percentage that basis bears to the reasonably expected basis in the project (land and depreciable basis) as of the close of the second following calendar year;

(ix) The date that each building in the project is expected to be placed in service; and

(x) The Building Identification Number (B.I.N.) to be assigned to each building in the project. The B.I.N. must reflect the year an allocation is first made to the building, regardless of the year that the building is placed in service. This B.I.N. must be used for all allocations of credit for the building. For example, rehabilitation expenditures treated as a separate new building under section 42(e) should not have a separate B.I.N. if the building to which the rehabilitation expenditures are made has a B.I.N. In this case, the B.I.N. used for the rehabilitation expenditures shall be the B.I.N. previously assigned to the building, although the rehabilitation expenditures must have a separate Form 8609 for the allocation. Similarly, a newly constructed building that receives an allocation of credit in different calendar years must have a separate Form 8609 for each allocation. The B.I.N. assigned to the building for the first allocation must be used for the subsequent allocation.

(3) *Special rules for project-based allocations*—(i) *In general.* An allocation pursuant to section 42(h)(1)(F) (a project-based allocation) must meet the requirements of this section as well as the requirements of section 42(h)(1)(F), including the minimum basis requirement of section 42(h)(1)(E)(ii).

(ii) *Requirement of section 42(h)(1)(F)(i)(III).* An allocation satisfies the requirement of section 42(h)(1)(F)(i)(III) if the Form 8609 that is issued for each building that is placed in service in the project states the portion of the project-based allocation that is applied to that building.

(4) *Recordkeeping requirements*—(i) *Taxpayer.* When an allocation is made pursuant to section 42(h)(1) (E) or (F), the taxpayer must retain a copy of the allocation document and file an additional copy with the Form 8609 that is issued to the taxpayer for a building after the building is placed in service. The taxpayer need only file a copy of the allocation document with the Form 8609 for the building for the first year the credit is claimed. However, the Form 8609 must be filed for the first taxable year in which the credit is claimed and for each taxable year thereafter throughout the compliance period, whether or not a credit is claimed for the taxable year.

(ii) *Agency.* The Agency must retain a copy of the allocation document and file the original with the Agency's Form 8610 that accounts for the year the allocation is made. The Agency must also retain a copy of the Form 8609 that is issued to the taxpayer and file the original with the Agency's Form 8610 that reflects the year the form is issued.

(5) *Separate procedure for election of appropriate percentage month.* If a taxpayer receives an allocation under section 42(h)(1) (E) or (F) and wishes to elect under section 42(b)(2)(A)(ii) to use the appropriate percentage for a month other than the month in which a building is placed in service, the requirements specified in §1.42–8 must be met for the election to be effective.

(e) *Special rules.* The following rules apply for purposes of this section.

(1) *Treatment of partnerships and other flow-through entities.* With respect to taxpayers that own projects through partnerships or other flow-through entities (e.g., S corporations, estates, or trusts), carryover-allocation basis is determined at the entity level using the rules provided by this section. In addition, the entity is responsible for providing to the Agency the certification and documentation required under the basis verification requirement in paragraph (c) of this section.

(2) *Transferees.* If land or depreciable property that is expected to be part of a project is transferred after a carryover allocation has been made for a building that is reasonably expected to be part of the project, but before the close of the calendar year of the allocation, the transferee's carryover-allocation basis is determined under the principles of this section and section 42(d)(7). See also Rev. Rul. 91–38, 1991–2 C.B. 3 (see §601.601(d)(2)(ii)(*b*) of this chapter). In addition, the transferee is treated as the taxpayer for purposes of the basis verification requirement of this section, and therefore, is responsible for providing to the Agency the required certifications and documentation.

[T.D. 8520, 59 FR 10069, Mar. 3, 1994]

§ 1.42–7 Substantially bond-financed buildings. [Reserved]

§ 1.42–8 Election of appropriate percentage month.

(a) *Election under section 42(b)(2)(A)(ii)(I) to use the appropriate percentage for the month of a binding agreement*—(1) *In general.* For purposes of section 42(b)(2)(A)(ii)(I), an agreement between a taxpayer and an Agency as to the housing credit dollar amount to be allocated to a building is considered binding if it—

(i) Is in writing;

(ii) Is binding under state law on the Agency, the taxpayer, and all successors in interest;

(iii) Specifies the type(s) of building(s) to which the housing credit dollar amount applies (i.e., a newly constructed or existing building, or substantial rehabilitation treated as a separate new building under section 42(e));

(iv) Specifies the housing credit dollar amount to be allocated to the building(s); and

(v) Is dated and signed by the taxpayer and the Agency during the month in which the requirements of paragraphs (a)(1) (i) through (iv) of this section are met.

(2) *Effect on state housing credit ceiling.* Generally, a binding agreement described in paragraph (a)(1) of this section is an agreement by the Agency to allocate credit to the taxpayer at a future date. The binding agreement may include a reservation of credit or a binding commitment (under section 42(h)(1)(C)) to allocate credit in a future taxable year. A reservation or a binding commitment to allocate credit in a future year has no effect on the state housing credit ceiling until the year the Agency actually makes an allocation. However, if the binding agreement is also a carryover allocation under section 42(h)(1) (E) or (F), the state housing credit ceiling is reduced by the amount allocated by the Agency to the taxpayer in the year the carryover allocation is made. For a binding agreement to be a valid carryover allocation, the requirements of paragraph (a)(1) of this section and § 1.42–6 must be met.

(3) *Time and manner of making election.* An election under section 42(b)(2)(A)(ii)(I) may be made either as part of the binding agreement under paragraph (a)(1) of this section to allocate a specific housing credit dollar amount or in a separate document that references the binding agreement. In either case, the election must—

(i) Be in writing;

(ii) Reference section 42(b)(2)(A)(ii)(I);

(iii) Be signed by the taxpayer;

(iv) If it is in a separate document, reference the binding agreement that meets the requirements of paragraph (a)(1) of this section; and

(v) Be notarized by the 5th day following the end of the month in which the binding agreement was made.

(4) *Multiple agreements*—(i) *Rescinded agreements.* A taxpayer may not make an election under section 42(b)(2)(A)(ii)(I) for a building if an election has previously been made for the building for a different month. For example, assume a taxpayer entered into a binding agreement for allocation of a specific housing credit dollar amount to a building and made the election under section 42(b)(2)(A)(ii)(I) to apply the appropriate percentage for the month of the binding agreement. If the binding agreement subsequently is rescinded under state law, and the taxpayer enters into a new binding agreement for allocation of a specific housing credit dollar amount to the building, the taxpayer must apply to the building the appropriate percentage for the elected month of the rescinded binding agreement. However, if no prior election was made with respect to the rescinded binding agreement, the taxpayer may elect the appropriate percentage for the month of the new binding agreement.

(ii) *Increases in credit.* The election under section 42(b)(2)(A)(ii)(I), once made, applies to any increase in the credit amount allocated for a building, whether the increase occurs in the same or in a subsequent year. However, in the case of a binding agreement (or carryover allocation that is treated as a binding agreement) to allocate a credit amount under section 42(e)(1) for substantial rehabilitation treated as a separate new building, a taxpayer may make the election under section 42(b)(2)(A)(ii)(I) notwithstanding that a prior election under section 42(b)(2)(A)(ii)(I) is in effect for a prior allocation of credit for a substantial rehabilitation that was previously placed in service under section 42(e).

(5) *Amount allocated.* The housing credit dollar amount eventually allocated to a building may be more or less than the amount specified in the binding agreement. Depending on the Agency's determination pursuant to section 42(m)(2) as to the financial feasibility of the building (or project), the Agency may allocate a greater housing credit dollar amount to the building (provided that the Agency has additional housing credit dollar amounts available to allocate for the calendar year of the allocation) or the Agency may allocate a lesser housing credit dollar amount. Under section 42(h)(7)(D), in allocating a housing credit dollar amount, the Agency must specify the applicable percentage and maximum qualified basis of the building. The applicable percentage may be less, but not greater than, the appropriate percentage for the month the building is placed in service, or the month elected by the taxpayer under section 42(b)(2)(A)(ii)(I). Whether the appropriate percentage is the appropriate percentage for the 70-percent present value credit or the 30-percent present value credit is determined under section 42(i)(2) when the building is placed in service.

(6) *Procedures*—(i) *Taxpayer.* The taxpayer must give the original notarized election statement to the Agency before the close of the 5th calendar day following the end of the month in which the binding agreement is made. The taxpayer must retain a copy of the binding agreement and the election statement and must file an additional copy of each with the taxpayer's Form 8609, Low-Income Housing Credit Allocation Certification, for the first taxable year in which credit is claimed for the building.

(ii) *Agency.* The Agency must file with the Internal Revenue Service the original of the binding agreement and the election statement with the Agency's Form 8610, Annual Low-Income Housing Credit Agencies Report, that accounts for the year the allocation is actually made. The Agency must also retain a copy of the binding agreement and the election statement.

(7) *Examples.* The following examples illustrate the provisions of this section. In each example, X is the taxpayer, Agency is the state housing credit agency, and the carryover allocations meet the requirements of §1.42–6 and are otherwise valid.

Example 1. (i) In August 1993, X and Agency enter into an agreement that Agency will allocate $100,000 of housing credit dollar amount for the low-income housing building X is constructing. The agreement is binding and meets all the requirements of paragraph (a)(1) of this section. The agreement is a reservation of credit, not an allocation, and therefore, has no effect on the state housing credit ceiling. On or before September 5, 1993, X signs and has notarized a written election statement that meets the requirements of paragraph (a)(3) of this section. The applicable percentage for the building is the appropriate percentage for the month of August 1993.

(ii) Agency makes a carryover allocation of $100,000 of housing credit dollar amount for the building on October 2, 1993. The carryover allocation reduces Agency's state housing credit ceiling for 1993. Due to unexpectedly high construction costs, when X places the building in service in July 1994, the product of the building's qualified basis and the applicable percentage for the building (the appropriate percentage for the month of August 1993) is $150,000, rather than $100,000. Notwithstanding that only $100,000 of credit was allocated for the building in 1993, Agency may allocate an additional $50,000 of housing credit dollar amount for the building from its state housing credit ceiling for 1994. The appropriate percentage for the month of August 1993 is the applicable percentage for the building for the entire $150,000 of credit allocated for the building, even though separate allocations were made in 1993 and 1994. Because allocations were made for the building in two separate calendar years, Agency must issue two Forms 8609 to X. One Form 8609 must reflect the $100,000 allocation made in 1993, and the other Form 8609 must reflect the $50,000 allocation made in 1994.

(iii) X gives the original notarized statement to Agency on or before September 5, 1993, and retains a copy of the binding agreement, election statement, and carryover allocation document. X files a copy of the binding agreement, election statement, and carryover allocation document with X's Form 8609 for the first taxable year in which X claims credit for the building.

(iv) Agency files the original of the binding agreement, election statement, and 1993 carryover allocation document with its 1993

Form 8610. Agency retains a copy of the binding agreement, election statement, and carryover allocation document. After the building is placed in service in 1994, Agency issues to X a copy of the Form 8609 reflecting the 1993 carryover allocation of $100,000 and files the original of that form with its 1994 Form 8610. Agency also files the original of the 1994 Form 8609 reflecting the $50,000 allocation with its 1994 Form 8610 and issues to X a copy of the 1994 Form 8609. Agency retains copies of the Forms 8609 that are issued to X.

Example 2. (i) In September 1993, X and Agency enter into an agreement that Agency will allocate $70,000 of housing credit dollar amount for rehabilitation expenditures that X is incurring and that X will treat as a new low-income housing building under section 42(e)(1). The agreement is binding and meets all the requirements of paragraph (a)(1) of this section. The agreement is a reservation of credit, not an allocation, and therefore, has no effect on Agency's state housing credit ceiling. On or before October 5, 1993, X signs and has notarized a written election statement that meets the requirements of paragraph (a)(3) of this section. The applicable percentage for the building is the appropriate percentage for the month of September 1993. Agency makes a carryover allocation of $70,000 of housing credit dollar amount for the building on November 15, 1993. The carryover allocation reduces by $70,000 Agency's state housing credit ceiling for 1993.

(ii) In October 1994, X and Agency enter into another binding agreement meeting the requirements of paragraph (a)(1) of this section. Under the agreement, Agency will allocate $50,000 of housing credit dollar amount for additional rehabilitation expenditures by X that qualify as a second separate new building under section 42(e)(1). On or before November 5, 1994, X signs and has notarized a written election statement meeting the requirements of paragraph (a)(3) of this section. On December 1, 1994, X receives a carryover allocation under section 42(h)(1)(E) for $50,000. The carryover allocation reduces by $50,000 Agency's state housing credit ceiling for 1994. The applicable percentage for the rehabilitation expenditures treated as the second separate new building is the appropriate percentage for the month of October 1994, not September 1993. The appropriate percentage for the month of September 1993 still applies to the allocation of $70,000 for the rehabilitation expenditures treated as the first separate new building. Because allocations were made for the building in two separate calendar years, Agency must issue two Forms 8609 to X. One Form 8609 must reflect the $70,000 allocation made in 1993, and the other Form 8609 must reflect the $50,000 allocation made in 1994.

(iii) X gives the first original notarized statement to Agency on or before October 5, 1993, and retains a copy of the first binding agreement, election statement, and carryover allocation document issued in 1993. X gives the second original notarized statement to Agency on or before November 5, 1994, and retains a copy of the second binding agreement, election statement, and carryover allocation document issued in 1994. X files a copy of the binding agreements, election statements, and carryover allocation documents with X's Forms 8609 for the first taxable year in which X claims credit for the buildings.

(iv) Agency retains a copy of the binding agreements, election statements, and carryover allocation documents. Agency files the original of the first binding agreement, election statement, and 1993 carryover allocation document with its 1993 Form 8610. Agency files the original of the second binding agreement, election statement, and 1994 carryover allocation document with its 1994 Form 8610. After X notifies Agency of the date each building is placed in service, the Agency will issue copies of the respective Forms 8609 to X, and file the originals of those forms with the Agency's Form 8610 that reflects the year each form is issued. The Agency also retains copies of the Forms 8609.

(b) *Election under section 42(b)(2)(A)(ii)(II) to use the appropriate percentage for the month tax-exempt bonds are issued*—(1) *Time and manner of making election.* In the case of any building to which section 42(h)(4)(B) applies, an election under section 42(b)(2)(A)(ii)(II) to use the appropriate percentage for the month tax-exempt bonds are issued must—

(i) Be in writing;

(ii) Reference section 42(b)(2)(A)(ii)(II);

(iii) Specify the percentage of the aggregate basis of the building and the land on which the building is located that is financed with the proceeds of obligations described in section 42(h)(4)(A) (tax-exempt bonds);

(iv) State the month in which the tax-exempt bonds are issued;

(v) State that the month in which the tax-exempt bonds are issued is the month elected for the appropriate percentage to be used for the building;

(vi) Be signed by the taxpayer; and

(vii) Be notarized by the 5th day following the end of the month in which the bonds are issued.

(2) *Bonds issued in more than one month.* If a building described in section 42(h)(4)(B) (substantially bond-financed building) is financed with tax-exempt bonds issued in more than one month, the taxpayer may elect the appropriate percentage for any month in which the bonds are issued. Once the election is made, the appropriate percentage elected applies for the building even if all bonds are not issued in that month. The requirements of this paragraph (b), including the time limitation contained in paragraph (b)(1)(vii) of this section, must also be met.

(3) *Limitations on appropriate percentage.* Under section 42(m)(2)(D), the credit allowable for a substantially bond- financed building is limited to the amount necessary to assure the project's feasibility. Accordingly, in making the determination under section 42(m)(2), an Agency may use an applicable percentage that is less, but not greater than, the appropriate percentage for the month the building is placed in service, or the month elected by the taxpayer under section 42(b)(2)(A)(ii)(II).

(4) *Procedures*—(i) *Taxpayer.* The taxpayer must provide the original notarized election statement to the Agency before the close of the 5th calendar day following the end of the month in which the bonds are issued. If an authority other than the Agency issues the tax-exempt bonds, the taxpayer must also give the Agency a signed statement from the issuing authority that certifies the information described in paragraphs (b)(1)(iii) and (iv) of this section. The taxpayer must file a copy of the election statement with the taxpayer's Form 8609 for the first taxable year in which credit is claimed for the building. The taxpayer must also retain a copy of the election statement.

(ii) *Agency.* The Agency must file with the Internal Revenue Service the original of the election statement and the corresponding Form 8609 for the building with the Agency's Form 8610 that reflects the year the Form 8609 is issued. The Agency must also retain a copy of the election statement and the Form 8609.

[T.D. 8520, 59 FR 10071, Mar. 3, 1994]

§1.42–9 For use by the general public.

(a) *General rule.* If a residential rental unit in a building is not for use by the general public, the unit is not eligible for a section 42 credit. A residential rental unit is for use by the general public if the unit is rented in a manner consistent with housing policy governing non-discrimination, as evidenced by rules or regulations of the Department of Housing and Urban Development (HUD) (24 CFR subtitle A and chapters I through XX). See HUD Handbook 4350.3 (or its successor). A copy of HUD Handbook 4350.3 may be requested by writing to: HUD, Directives Distribution Section, room B–100, 451 7th Street, SW., Washington, DC 20410.

(b) *Limitations.* Notwithstanding paragraph (a) of this section, if a residential rental unit is provided only for a member of a social organization or provided by an employer for its employees, the unit is not for use by the general public and is not eligible for credit under section 42. In addition, any residential rental unit that is part of a hospital, nursing home, sanitarium, lifecare facility, trailer park, or intermediate care facility for the mentally and physically handicapped is not for use by the general public and is not eligible for credit under section 42.

(c) *Treatment of units not for use by the general public.* The costs attributable to a residential rental unit that is not for use by the general public are not excludable from eligible basis by reason of the unit's ineligibility for the credit under this section. However, in calculating the applicable fraction, the unit is treated as a residential rental unit that is not a low-income unit.

[T.D. 8520, 59 FR 10073, Mar. 3, 1994]

§1.42–10 Utility allowances.

(a) *Inclusion of utility allowances in gross rent.* If the cost of any utilities (other than telephone) for a residential rental unit are paid directly by the tenant(s), the gross rent for that unit includes the applicable utility allowance determined under this section. This section only applies for purposes of determining gross rent under section 42(g)(2)(B)(ii) as to rent-restricted units.

(b) *Applicable utility allowances*—(1) *FmHA-assisted buildings.* If a building receives assistance from the Farmers Home Administration (FmHA-assisted building), the applicable utility allowance for all rent-restricted units in the building is the utility allowance determined under the method prescribed by the Farmers Home Administration (FmHA) for the building. For example, if a building receives assistance under FmHA's section 515 program (whether or not the building or its tenants also receive other state or federal assistance), the applicable utility allowance for all rent-restricted units in the building is determined using Exhibit A–6 of 7 CFR part 1944, subpart E (or a successor method of determining utility allowances).

(2) *Buildings with FmHA assisted tenants.* If any tenant in a building receives FmHA rental assistance payments (FmHA tenant assistance), the applicable utility allowance for all rent-restricted units in the building (including any units occupied by tenants receiving HUD rental assistance payments) is the applicable FmHA utility allowance.

(3) *HUD-regulated buildings.* If neither a building nor any tenant in the building receives FmHA housing assistance, and the rents and utility allowances of the building are reviewed by HUD on an annual basis (HUD-regulated building), the applicable utility allowance for all rent-restricted units in the building is the applicable HUD utility allowance.

(4) *Other buildings.* If a building is neither an FmHA-assisted nor a HUD-regulated building, and no tenant in the building receives FmHA tenant assistance, the applicable utility allowance for rent-restricted units in the building is determined under the following methods.

(i) *Tenants receiving HUD rental assistance.* The applicable utility allowance for any rent-restricted units occupied by tenants receiving HUD rental assistance payments (HUD tenant assistance) is the applicable Public Housing Authority (PHA) utility allowance established for the Section 8 Existing Housing Program.

(ii) *Other tenants*—(A) *General rule.* If none of the rules of paragraphs (b)(1), (2), (3), and (4)(i) of this section apply to any rent-restricted units in a building, the appropriate utility allowance for the units is the applicable PHA utility allowance. However, if a local utility company estimate is obtained for any unit in the building in accordance with paragraph (b)(4)(ii)(B) of this section, that estimate becomes the appropriate utility allowance for all rent-restricted units of similar size and construction in the building. This local utility company estimate procedure is not available for and does not apply to units to which the rules of paragraphs (b) (1), (2), (3), or (4)(i) of this section apply.

(B) *Utility company estimate.* Any interested party (including a low-income tenant, a building owner, or an Agency) may obtain a local utility company estimate for a unit. The estimate is obtained when the interested party receives, in writing, information from a local utility company providing the estimated cost of that utility for a unit of similar size and construction for the geographic area in which the building containing the unit is located. The local utility company estimate may be obtained by an interested party at any time during the building's extended use period (see section 42(h)(6)(D)) or, if the building does not have an extended use period, during the building's compliance period (see section 42(i)(1)). Unless the parties agree otherwise, costs incurred in obtaining the estimate are borne by the initiating party. The interested party that obtains the local utility company estimate (the initiating party) must retain the original of the utility company estimate and must furnish a copy of the local utility company estimate to the owner of the building (where the initiating party is not the owner), and the Agency that allocated credit to the building (where the initiating party is not the Agency). The owner of the building must make available copies of the utility company estimate to the tenants in the building.

(c) *Changes in applicable utility allowance.* If at any time during the building's extended use period (or, if the building does not have an extended use period, the building's compliance period), the applicable utility allowance for a unit changes, the new utility allowance must be used to compute gross rents of rent-restricted units due 90 days after the change. For example, if rent must be lowered because a local utility company estimate is obtained that shows a higher utility cost than the otherwise applicable PHA utility allowance, the lower rent must be in effect for rent due more than 90 days after the date of the local utility company estimate.

[T.D. 8520, 59 FR 10073, Mar. 3, 1994]

§1.42–11 Provision of services.

(a) *General rule.* The furnishing to tenants of services other than housing (whether or not the services are significant) does not prevent the units occupied by the tenants from qualifying as residential rental property eligible for credit under section 42. However, any charges to low-income tenants for services that are not optional generally must be included in gross rent for purposes of section 42(g).

(b) *Services that are optional*—(1) *General rule.* A service is optional if payment for the service is not required as a condition of occupancy. For example, for a qualified low-income building with a common dining facility, the cost of meals is not included in gross rent for purposes of section 42(g)(2)(A) if payment for the meals in the facility is not required as a condition of occupancy and a practical alternative exists for tenants to obtain meals other than from the dining facility.

(2) *Continual or frequent services.* If continual or frequent nursing, medical, or psychiatric services are provided, it is presumed that the services are not optional and the building is ineligible for the credit, as is the case with a hospital, nursing home, sanitarium, lifecare facility, or intermediate care facility for the mentally and physically handicapped. See also §1.42–9(b).

(3) *Required services*—(i) *General rule.* The cost of services that are required as a condition of occupancy must be included in gross rent even if federal or state law requires that the services be offered to tenants by building owners.

(ii) *Exceptions*—(A) *Supportive services.* Section 42(g)(2)(B)(iii) provides an exception for certain fees paid for supportive services. For purposes of section 42(g)(2)(B)(iii), a supportive service is any service provided under a planned program of services designed to enable residents of a residential rental property to remain independent and avoid placement in a hospital, nursing home, or intermediate care facility for the mentally or physically handicapped. For a building described in section 42(i)(3)(B)(iii) (relating to transitional housing for the homeless), a supportive service includes any service provided to assist tenants in locating and retaining permanent housing.

(B) *Specific project exception.* Gross rent does not include the cost of mandatory meals in any federally-assisted project for the elderly and handicapped (in existence on or before January 9, 1989) that is authorized by 24 CFR 278 to provide a mandatory meals program.

[T.D. 8520, 59 FR 10074, Mar. 3, 1994]

§1.42–12 Effective dates and transitional rules.

(a) *Effective date.* The rules set forth in §§1.42–6 and 1.42–8 through 1.42–12 are effective May 2, 1994. However, binding agreements, election statements, and carryover allocation documents entered into before May 2, 1994, that follow the guidance set forth in Notice 89–1, 1989–1 C.B. 620 (see §601.601(d)(2)(ii)(*b*) of this chapter) need not be changed to conform to the rules set forth in §§1.42–6 and 1.42–8 through 1.42–12.

(b) *Prior periods.* Notice 89–1, 1989–1 C.B. 620 and Notice 89–6, 1989–1 C.B. 625 (see §601.601(d)(2)(ii)(*b*) of this chapter) may be applied for periods prior to May 2, 1994.

[T.D. 8520, 59 FR 10074, Mar. 3, 1994; 59 FR 15501, Apr. 1, 1994]

§1.42–13 Rules necessary and appropriate; housing credit agencies' correction of administrative errors and omissions.

(a) *Publication of guidance.* Under section 42(n), the Secretary has authority to prescribe regulations as may be necessary or appropriate to carry out the purposes of section 42. The Secretary may also provide guidance through various publications in the Internal Revenue Bulletin. (See §601.601(d)(2)(ii)(*b*) of this chapter.)

(b) *Correcting administrative errors and omissions*—(1) *In general.* An Agency may correct an administrative error or omission with respect to allocations and recordkeeping, as described in paragraph (b)(2) of this section, within a reasonable period after the Agency discovers the administrative error or omission. Whether a correction is made within a reasonable period depends on the facts and circumstances of each situation. Except as provided in paragraph (b)(3)(iii) of this section, an Agency need not obtain the prior approval of the Secretary to correct an administrative error or omission, if the correction is made in accordance with paragraph (b)(3)(i) of this section. The administrative errors and omissions to which this paragraph (b) applies are strictly limited to those described in paragraph (b)(2) of this section, and, thus, do not include, for example, any misinterpretation of the applicable rules and regulations under section 42. Accordingly, an Agency's allocation of a particular calendar year's low-income housing credit dollar amount made after the close of that calendar year, or the use of an incorrect population amount in calculating a State's housing credit ceiling for a calendar year are not administrative errors that can be corrected under this paragraph (b).

(2) *Administrative errors and omissions described.* An administrative error or omission is a mistake that results in a document that inaccurately reflects the intent of the Agency at the time the document is originally completed or, if the mistake affects a taxpayer, a document that inaccurately reflects the intent of the Agency and the affected taxpayer at the time the document is originally completed. Administrative errors and omissions described in this paragraph (b)(2) include the following—

(i) A mathematical error;

(ii) An entry on a document that is inconsistent with another entry on the same or another document regarding the same property, or taxpayer;

(iii) A failure in tracking the housing credit dollar amount an Agency has allocated (or that remains to be allocated) in the current calendar year (e.g., a failure to include in its State housing credit ceiling a previously allocated credit dollar amount that has been returned by a taxpayer);

(iv) An omission of information that is required on a document; and

(v) Any other type of error or omission identified by guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter) as an administrative error or omission covered by this paragraph (b).

(3) *Procedures for correcting administrative errors or omissions*—(i) *In general.* An Agency's correction of an administrative error or omission, as described in paragraph (b)(2) of this section, must amend the document so that the corrected document reflects the original intent of the Agency, or the Agency and the affected taxpayer, and complies with applicable rules and regulations under section 42.

(ii) *Specific procedures.* If a document corrects a document containing an administrative error or omission that has not yet been filed with the Internal Revenue Service, the Agency, or the Agency and the affected taxpayer, should complete and file the corrected document as the original. When a document containing an administrative error or omission has already been filed with the Service, the Agency, or the Agency and the affected taxpayer, should refile a copy of the document containing the administrative error or omission, and prominently and clearly note the correction thereon or on an attached new document. The Agency should indicate at the top of the document(s) that the correction is being made under § 1.42–13 of the Income Tax Regulations.

(iii) *Secretary's prior approval required.* An Agency must obtain the Secretary's prior approval to correct an administrative error or omission, as described in paragraph (b)(2) of this section, if the correction is not made before the close of the calendar year of the error or omission and the correction—

(A) Is a numerical change to the housing credit dollar amount allocated for the building or project;

(B) Affects the determination of any component of the State's housing credit ceiling under section 42(h)(3)(C); or

(C) Affects the State's unused housing credit carryover that is assigned to the Secretary under section 42(h)(3)(D).

(iv) *Requesting the Secretary's approval.* To obtain the Secretary's approval under paragraph (b)(3)(iii) of this section, an Agency must submit a request for the Secretary's approval within a reasonable period after discovering the administrative error or omission, and must agree to any conditions that may be required by the Secretary under paragraph (b)(3)(v) of this section. When requesting the Secretary's approval, the Agency, or the Agency and the affected taxpayer, must file an application that complies with the requirements of this paragraph (b)(3)(iv). For further information on the application procedure see Rev. Proc. 93–1, 1993–1 I.R.B. 10 (or any subsequent applicable revenue procedure). (See §601.601(d)(2)(ii)(*b*) of this chapter.) The application requesting the Secretary's approval must contain the following information—

(A) The name, address, and identification number of each affected taxpayer;

(B) The Building Identification Number (B.I.N.) and address of each building or project affected by the administrative error or omission;

(C) A statement explaining the administrative error or omission and the intent of the Agency, or of the Agency and the affected taxpayer, when the document was originally completed;

(D) Copies of any supporting documentation;

(E) A statement explaining the effect, if any, that a correction of the administrative error or omission would have on the housing credit dollar amount allocated for any building or project; and

(F) A statement explaining the effect, if any, that a correction of the administrative error or omission would have on the determination of the components of the State's housing credit ceiling under section 42(h)(3)(C) or on the State's unused housing credit carryover that is assigned to the Secretary under section 42(h)(3)(D).

(v) *Agreement to conditions.* To obtain the Secretary's approval under paragraph (b)(3)(iii) of this section, an Agency, or the Agency and the affected taxpayer, must agree to the conditions the Secretary considers appropriate.

(c) *Examples.* The following examples illustrate the scope of this section:

Example 1. Individual B applied to Agency X for a reservation of a low-income housing credit dollar amount for a building that is part of a low-income housing project. When applying for the low-income housing credit dollar amount, B informed Agency X that B intended to form Partnership Y to finance the project. After receiving the reservation letter and prior to receiving an allocation, B formed Partnership Y and sold partnership interests to a number of limited partners. B contributed the low-income housing project to Partnership Y in exchange for a partnership interest. B and Partnership Y informed Agency X of the ownership change. When actually allocating the housing credit dollar amount, Agency X sent Partnership Y a document listing B, rather than Partnership Y, as the building's owner. Partnership Y promptly notified Agency X of the error. After reviewing related documents, Agency X determined that it had incorrectly listed B as the building's owner on the allocation document. Since the parties originally intended that Partnership Y would receive the allocation as the owner of the building, Agency X may correct the error without obtaining the Secretary's approval, and insert Partnership Y as the building's owner on the allocation document.

Example 2. Agency Y allocated a lower low-income housing credit dollar amount for a low-income housing building than Agency Y originally intended. After the close of the calendar year of the allocation, B, the building's owner, discovered the error and promptly notified Agency Y. Agency Y reviewed relevant documents and agreed that an error had occurred. Agency Y and B must apply, as provided in paragraph (b)(3)(iv) of this section, for the Secretary's approval before Agency Y may correct the error.

(d) *Effective date.* This section is effective February 24, 1994. However, an Agency may elect to apply these regulations to administrative errors or omissions that occurred before the publication of these regulations. Any reasonable method used by a State or local housing credit agency to correct an administrative error or omission prior to February 24, 1994, will be considered proper, provided that the method is consistent with the rules of section 42.

[T.D. 8521, 59 FR 8861, Feb. 24, 1994]

§ 1.42–14 Allocation rules for post-1989 State housing credit ceiling amounts.

(a) *In general.* The State housing credit ceiling for a State for any calendar year after 1989 is comprised of four components. The four components are—

(1) $1.25 multiplied by the State population (the population component);

(2) The unused State housing credit ceiling, if any, of the State for the preceding calendar year (the unused carryforward component);

(3) The amount of State housing credit ceiling returned in the calendar year (the returned credit component); plus

(4) The amount, if any, allocated to the State by the Secretary under section 42(h)(3)(D) from a national pool of unused credit (the national pool component).

(b) *The population component.* The population component of the State housing credit ceiling of a State for any calendar year is determined pursuant to section 146(j). Thus, a State's population for any calendar year is determined by reference to the most recent census estimate, whether final or provisional, of the resident population of the State released by the Bureau of the Census before the beginning of the calendar year for which the State's housing credit ceiling is set. Unless otherwise prescribed by applicable revenue procedure, determinations of population are based on the most recent estimates of population contained in the Bureau of the Census publication, *Current Population Report, Series P–25; Population Estimates and Projections, Estimates of the Population of States.* For convenience, the Internal Revenue Service publishes the population estimates annually in the Internal Revenue Bulletin. (See § 601.601(d)(2)(ii)(*b*)).

(c) *The unused carryforward component.* The unused carryforward component of the State housing credit ceiling of a State for any calendar year is the excess, if any, of the sum of the population and returned credit components, over the aggregate housing credit dollar amount allocated for the year. Any credit amounts attributable to the national pool component of the State housing credit ceiling that remain unallocated at the close of a calendar year are not carried forward to the succeeding calendar year; instead, the credit expires and cannot be reallocated by any Agency.

(d) *The returned credit component*—(1) *In general.* The returned credit component of the State housing credit ceiling of a State for any calendar year equals the housing credit dollar amount returned during the calendar year that was validly allocated within the State in a prior calendar year to any project that does not become a qualified low-income housing project within the period required by section 42, or as required by the terms of the allocation. The returned credit component also includes credit allocated in a prior calendar year that is returned as a result of the cancellation of an allocation by mutual consent or by an Agency's determination that the amount allocated is not necessary for the financial feasibility of the project. For purposes of this section, credit is allocated within a State if it is allocated from the State's housing credit ceiling by an Agency of the State or of a constitutional home rule city in the State.

(2) *Limitations and special rules.* The following limitations and special rules apply for purposes of this paragraph (d).

(i) *General limitations.* Notwithstanding any other provision of this paragraph (d), returned credit does not include any credit that was—

(A) Allocated prior to calendar year 1990;

(B) Allowable under section 42(h)(4) (relating to the portion of credit attributable to eligible basis financed by certain tax-exempt bonds under section 103); or

(C) Allocated during the same calendar year that it is received back by the Agency.

(ii) *Credit period limitation.* Notwithstanding any other provision of this paragraph (d), an allocation of credit may not be returned any later than 180 days following the close of the first taxable year of the credit period for the building that received the allocation. After this date, credit that might otherwise be returned expires, and cannot be returned to or reallocated by any Agency.

(iii) *Three-month rule for returned credit.* An Agency may, in its discretion, treat any portion of credit that is returned from a project after September 30 of a calendar year and that is not reallocated by the close of the calendar year as returned on January 1 of the succeeding calendar year. In this case, the returned credit becomes part of the returned credit component of the State housing credit ceiling for the succeeding calendar year. Any portion of credit that is returned from a project after September 30 of a calendar year that is reallocated by the close of the calendar year is treated as part of the returned credit component of the State housing credit ceiling for the calendar year that the credit was returned.

(iv) *Returns of credit.* Subject to the limitations of paragraphs (d)(2) (i) and (ii) of this section, credit is returned to the Agency in the following instances in the manner described in paragraph (d)(3) of this section.

(A) *Building not qualified within required time period.* If a building is not a qualified building within the time period required by section 42, it loses its credit allocation and the credit is returned. For example, a building is not qualified within the required time period if it is not placed in service within the period required by section 42 or if the project of which the building is a part fails to meet the minimum set-aside requirements of section 42(g)(1) by the close of the first year of the credit period.

(B) *Noncompliance with terms of the allocation.* If a building does not comply with the terms of its allocation, it loses the credit allocation and the credit is returned. The terms of an allocation are the written conditions agreed to by the Agency and the allocation recipient in the allocation document.

(C) *Mutual consent.* If the Agency and the allocation recipient cancel an allocation of an amount of credit by mutual consent, that amount of credit is returned.

(D) *Amount not necessary for financial feasibility.* If an Agency determines under section 42(m)(2) that an amount of credit allocated to a project is not necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period, that amount of credit is returned.

(3) *Manner of returning credit—(* i) *Taxpayer notification.* After an Agency determines that a building or project no longer qualifies under paragraph (d)(2)(iv)(A), (B), or (D) of this section for all or part of the allocation it received, the Agency must provide written notification to the allocation recipient, or its successor in interest, that all or part of the allocation is no longer valid. The notification must also state the amount of the allocation that is no longer valid. The date of the notification is the date the credit is returned to the Agency. If an allocation is cancelled by mutual consent under paragraph (d)(2)(iv)(C) of this section, there must be a written agreement signed by the Agency, and the allocation recipient, or its successor in interest, indicating the amount of the allocation that is returned to the Agency. The effective date of the agreement is the date the credit is returned to the Agency.

(ii) *Internal Revenue Service notification.* If a credit is returned within 180 days following the close of the first taxable year of a building's credit period as provided in paragraph (d)(2)(ii) of this section, and a Form 8609, *Low-Income Housing Credit Allocation Certification,* has been issued for the building, the Agency must notify the Internal Revenue Service that the credit has been returned. If only part of the credit has been returned, this notification requirement is satisfied when the Agency attaches to an amended Form 8610, *Annual Low- Income Housing Credit Agencies Report,* the original of an amended Form 8609 reflecting the correct amount of credit attributed to the building together with an explanation for the filing of the amended Forms. The Agency must send a copy of the amended Form 8609 to the taxpayer that owns the building. If the building is not issued an amended Form 8609 because all of the credit allocated to the building is returned, notification to the Internal Revenue Service is satisfied by following the requirements prescribed in §1.42–5(e)(3) for filing a Form

8823, *Low-Income Housing Credit Agencies Report of Noncompliance.*

(e) *The national pool component.* The national pool component of the State housing credit ceiling of a State for any calendar year is the portion of the National Pool allocated to the State by the Secretary for the calendar year. The national pool component for any calendar year is zero unless a State is a *qualified State.* (See paragraph (i) of this section for rules regarding the National Pool and the description of a qualified State.) Credit from the national pool component of a State housing credit ceiling must be allocated prior to the close of the calendar year or the credit expires and cannot be reallocated by any Agency. A national pool component credit that is allocated during a calendar year and returned after the close of the calendar year may qualify as part of the returned credit component of the State housing credit ceiling for the calendar year that the credit is returned.

(f) *When the State housing credit ceiling is determined.* For purposes of accounting for the State housing credit ceiling on Form 8610 and for purposes of determining the set-aside apportionment for projects involving qualified nonprofit organizations described in section 42(h)(5) and § 1.42–1T(c)(5), the State housing credit ceiling for any calendar year is determined at the close of the calendar year.

(g) *Stacking order.* Under section 42(h)(3)(C), credit is treated as allocated from the various components of the State housing credit ceiling in the following order. The first credit allocated for any calendar year is treated as credit from the sum of the population and returned credit components of the State housing credit ceiling. Once all of the credit in these components has been allocated, the next credit allocated is treated as credit from the unused carryforward component of the State housing credit ceiling. Finally, after all of the credit from the population component, returned credit component, and unused carryforward component has been allocated, any further credit allocated is treated as credit from the national pool component.

(h) *Nonprofit set-aside*—(1) *Determination of set-aside.* Under section 42(h)(5) and § 1.42–1T(c)(5), at least 10 percent of a State housing credit ceiling in any calendar year must be set aside exclusively for projects involving qualified nonprofit organizations (the nonprofit set-aside). However, credit allocated from the nonprofit set-aside in a calendar year and returned in a subsequent calendar year does not retain its nonprofit set-aside character. The credit becomes part of the returned credit component of the State housing credit ceiling for the calendar year that the credit is returned and must be included in determining the nonprofit set-aside of the State housing credit ceiling for that calendar year. Similarly, credit amounts that are not allocated from the nonprofit set-aside in a calendar year and are returned in a subsequent calendar year become part of the returned credit component of the State housing credit ceiling for that year and are also included in determining the set-aside for that year.

(2) *Allocation rules.* An Agency may allocate credit from any component of the State housing credit ceiling as part of the nonprofit set-aside and need not reserve 10 percent of each component for the nonprofit set-aside. Thus, an Agency may satisfy the nonprofit set-aside requirement of section 42(h)(5) and § 1.42–1T(c)(5) in any calendar year by setting aside for allocation an amount equal to at least 10 percent of the total State housing credit ceiling for the calendar year.

(i) *National Pool*—(1) *In general.* The unused housing credit carryover of a State for any calendar year is assigned to the Secretary for inclusion in a national pool of unused housing credit carryovers (National Pool) that is reallocated among qualified States the succeeding calendar year. The assignment to the Secretary is made on Form 8610.

(2) *Unused housing credit carryover.* The unused housing credit carryover of a State for any calendar year is the excess, if any, of the unused carryforward component of the State housing credit ceiling for the calendar year over the excess, if any, of—

(i) The total housing credit dollar amount allocated for the year; over

(ii) The sum of the population and returned credit components of the State housing credit ceiling for the year.

(3) *Qualified State*—(i) *In general.* The term *qualified State* means, with respect to any calendar year, any State that has allocated its entire State housing credit ceiling for the preceding calendar year and for which a request is made by the State, not later than May 1 of the calendar year, to receive an allocation of credit from the National Pool for that calendar year. Except as provided in paragraph (i)(3)(ii) of this section, a State is not a qualified State in a calendar year if there remains any unallocated credit in its State housing credit ceiling at the close of the preceding calendar year that was apportioned to any Agency within the State for the calendar year.

(ii) *Exceptions*—(A) *De minimis amount.* If the amount remaining unallocated at the close of a calendar year is only a de minimis amount of credit, the State is a qualified State eligible to participate in the National Pool. For that purpose, a credit amount is de minimis if it does not exceed 1 percent of the aggregate State housing credit ceiling of the State for the calendar year.

(B) *Other circumstances.* Pursuant to the authority under section 42(n), the Internal Revenue Service may determine that a State is a qualified State eligible to participate in the National Pool even though the State's unallocated credit is in excess of the 1 percent safe harbor set forth in paragraph (A) of this section. The Internal Revenue Service will make this determination based on all the facts and circumstances, weighing heavily the interests of the States who would otherwise qualify for the National Pool. The Internal Revenue Service will generally grant relief under this paragraph only where a State's unallocated credit is not substantial.

(iii) *Time and manner for making request.* For further guidance as to the time and manner for making a request of housing credit dollar amounts from the National Pool by a qualified State, see Rev. Proc. 92–31, 1992–1 C.B. 775. (See 601.601(d)(2)(ii)(*b*)).

(4) *Formula for determining the National Pool.* The amount allocated to a qualified State in any calendar year is an amount that bears the same ratio to the aggregate unused housing credit carryovers of all States for the preceding calendar year as that State's population for the calendar year bears to the population of all qualified States for the calendar year.

(j) *Coordination between Agencies.* The Agency responsible for filing Form 8610 on behalf of all Agencies within a State and making any request on behalf of the State for credit from the National Pool (the Filing Agency) must coordinate with each Agency within the State to ensure that the various requirements of this section are complied with. For example, the Filing Agency of a State must ensure that all Agencies within the State that were apportioned a credit amount for the calendar year have allocated all of their respective credit amounts for the calendar year before the Filing Agency can make a request on behalf of the State for a distribution of credit from the National Pool.

(k) *Examples.* (1) The operation of the rules of this section may be illustrated by the following examples. Unless otherwise stated in an example, Agency A is the sole Agency authorized to make allocations of housing credit dollar amounts in State M, all of Agency A's allocations are valid, and for calendar year 1994 Agency A has available for allocation a State housing credit ceiling consisting of the following housing credit dollar amounts:

A. Population component	$100
B. Unused carryforward component	50
C. Returned credit component	10
D. National pool component	0
Total	160

(2) In addition, the $10 of returned credit component was returned before October 1, 1994.

Example 1—(i) *Additional facts.* By the close of 1994, Agency A had allocated $80 of the State M housing credit ceiling. Of the $80 allocated, $16 was allocated to projects involving qualified nonprofit organizations.

(ii) *Application of stacking rules.* The first credit allocated is treated as allocated from the population and returned credit components of the State housing credit ceiling, to the extent of those components. In this case, the $80 of credit allocated is less than the sum of the population and returned credit components. The excess of the sum of the population and returned credit components over the total amount allocated for the calendar year ($110 − 80=$30) becomes the unused carryforward component of State M's 1995 State housing credit ceiling. Because Agency A did not allocate credit in excess of the sum of the population and returned credit components, no credit is treated as allocated from State M's $50 unused carryforward component in 1994. Because none of this component may be carried forward, all $50 is assigned to the Secretary for inclusion in the National Pool. Under paragraph (i)(3) of this section, State M does not qualify for credit from the National Pool for the 1995 calendar year.

(iii) *Nonprofit set-aside.* Agency A allocated exactly the amount of credit to projects involving qualified nonprofit organizations as necessary to meet the nonprofit set-aside requirement ($16, 10% of the $160 ceiling).

Example 2—(i) *Additional facts.* By the close of 1994, Agency A had allocated $130 of the State M housing credit ceiling. Of the $130 allocated, $20 was allocated to projects involving qualified nonprofit organizations.

(ii) *Application of stacking rules.* The first $110 of credit allocated is treated as allocated from the population and returned credit components. In this case, because all of the population and returned credit components are allocated, no amount is included in State M's 1995 State housing credit ceiling as an unused carryforward component. The next $20 of credit allocated is treated as allocated from the $50 unused carryforward component. The $30 remaining in the unused carryforward component is assigned to the Secretary for inclusion in the National Pool for the 1995 calendar year. Under paragraph (i)(3) of this section, State M does not qualify for credit from the National Pool for the 1995 calendar year.

(iii) *Nonprofit set-aside.* Agency A allocated $4 more credit to projects involving qualified nonprofit organizations than necessary to meet the nonprofit set-aside requirement. This does not reduce the application of the 10% nonprofit set-aside requirement to the State M housing credit ceiling for the succeeding year.

Example 3—(i) *Additional fact.* None of the applications for credit that Agency A received for 1994 are for projects involving qualified nonprofit organizations.

(ii) *Nonprofit set-aside.* Because at least 10% of the State housing credit ceiling must be set aside for projects involving a qualified nonprofit organization, Agency A can allocate only $144 of the $160 State housing credit ceiling for calendar year 1994 ($160 − 16=$144). If Agency A allocates $144 of credit, the credit is treated as allocated $110 from the population and returned credit components and $34 from the unused carryforward component. The $16 of unallocated credit that is set aside for projects involving qualified nonprofit organizations is treated as the balance of the unused carryforward component, and is assigned to the Secretary for inclusion in the National Pool. Under paragraph (i)(3) of this section, State M does not qualify for credit from the National Pool for the 1995 calendar year.

Example 4—(i) *Additional facts.* The $10 of returned credit component was returned prior to October 1, 1994. However, a $40 credit that had been allocated in calendar year 1993 to a project involving a qualified nonprofit organization was returned to the Agency by a mutual consent agreement dated November 15, 1994. By the close of 1994, Agency A had allocated $160 of the State M housing credit ceiling, including $16 of credit to projects involving qualified nonprofit organizations.

(ii) *Effect of three-month rule.* Under the three-month rule of paragraph (d)(2)(iii) of this section, Agency A may treat all or part of the $40 of previously allocated credit as returned on January 1, 1995. If Agency A treats all of the $40 amount as having been returned in calendar year 1995, the State M housing credit ceiling for 1994 is $160. This entire amount, including the $16 nonprofit set-aside, has been allocated in 1994. Under paragraph (i)(3) of this section, State M qualifies for the National Pool for the 1995 calendar year.

(iii) *If three-month rule not used.* If Agency A treats all of the $40 of previously allocated credit as returned in calendar year 1994, the State housing credit ceiling for the 1994 calendar year will be $200 of which $50 will be attributable to the returned credit component ($10+$40=$50). Because credit amounts allocated in a prior calendar year that are returned in a subsequent calendar year do not retain their nonprofit character, the nonprofit set-aside for calendar year 1994 is $20 (10% of $200). The $160 that Agency A allocated during 1994 is first treated as allocated from the population and returned credit components, which total $150. The next $10 of credit allocated is treated as allocated from the unused carryforward component. The $40 of unallocated credit from the unused carryforward component includes the $4 of unallocated nonprofit set-aside. The entire $40 of credit from the carryforward component is assigned to the Secretary for inclusion in the National Pool for the 1995 calendar year. State M does not qualify for credit from the National Pool for the 1995 calendar year.

Example 5—(i) (A) *Additional facts.* For calendar year 1994, Agency A has a State housing credit ceiling that consists of the following housing credit dollar amounts:

A. Population component	$100
B. Unused carryforward component ..	0

C. Returned credit component	20
D. National pool component	10
Total	130
Minimum nonprofit set-aside	13
Ceiling amount not set-aside	117

In addition, the $20 of returned credit component was returned before October 1, 1994. By the close of 1994, Agency A had allocated $100 of the State housing credit ceiling.

(ii) *Application of stacking rules.* The $20 excess of the sum of the population component and the returned credit component over the total amount allocated for the calendar year ($120 − 100=$20) becomes the unused carryforward component of the State housing credit ceiling for the 1995 calendar year. The $10 of unallocated credit from the national pool component expires and cannot be reallocated. This amount is neither carried over to 1995 by State M nor assigned to the Secretary for inclusion in the National Pool. Under paragraph (i)(3) of this section, State M does not qualify for credit from the National Pool for the 1995 calendar year.

(l) *Effective date.* The rules set forth in §1.42–14 are effective January 1, 1994.

[T.D. 8563, 59 FR 50163, Oct. 3, 1994; 60 FR 3345, Jan. 17, 1995]

§1.42–15 Available unit rule.

(a) *Definitions.* The following definitions apply to this section:

Applicable income limitation means the limitation applicable under section 42(g)(1) or, for deep rent skewed projects described in section 142(d)(4)(B), 40 percent of area median gross income.

Available unit rule means the rule in section 42(g)(2)(D)(ii).

Comparable unit means a residential unit in a low-income building that is comparably sized or smaller than an over-income unit or, for deep rent skewed projects described in section 142(d)(4)(B), any low-income unit. For purposes of determining whether a residential unit is comparably sized, a comparable unit must be measured by the same method used to determine qualified basis for the credit year in which the comparable unit became available.

Current resident means a person who is living in the low-income building.

Low-income unit is defined by section 42(i)(3)(A).

Nonqualified resident means a new occupant or occupants whose aggregate income exceeds the applicable income limitation.

Over-income unit means a low-income unit in which the aggregate income of the occupants of the unit increases above 140 percent of the applicable income limitation under section 42(g)(1), or above 170 percent of the applicable income limitation for deep rent skewed projects described in section 142(d)(4)(B).

Qualified resident means an occupant either whose aggregate income (combined with the income of all other occupants of the unit) does not exceed the applicable income limitation and who is otherwise a low-income resident under section 42, or who is a current resident.

(b) *General section 42(g)(2)(D)(i) rule.* Except as provided in paragraph (c) of this section, notwithstanding an increase in the income of the occupants of a low-income unit above the applicable income limitation, if the income of the occupants initially met the applicable income limitation, and the unit continues to be rent-restricted—

(1) The unit continues to be treated as a low-income unit; and

(2) The unit continues to be included in the numerator and the denominator of the ratio used to determine whether a project satisfies the applicable minimum set-aside requirement of section 42(g)(1).

(c) *Exception.* A unit ceases to be treated as a low-income unit if it becomes an over-income unit and a nonqualified resident occupies any comparable unit that is available or that subsequently becomes available in the same low-income building. In other words, the owner of a low-income building must rent to qualified residents all comparable units that are available or that subsequently become available in the same building to continue treating the over-income unit as a low-income unit. Once the percentage of low-income units in a building (excluding the over-income units) equals the percentage of low-income units on which the credit is based, failure to maintain the over-income units as low-income units has no immediate significance. The failure to maintain the over-income units as low-income units, however, may affect the decision of whether or not to rent a particular available unit at market rate at a later time. A unit is not available for purposes of the available unit rule when the unit is no longer available for rent due to contractual arrangements that are binding under local law (for example, a unit is not available if it is subject to a preliminary reservation that is binding on the owner under local law prior to the date a lease is signed or the unit is occupied).

(d) *Effect of current resident moving within building.* When a current resident moves to a different unit within the building, the newly occupied unit adopts the status of the vacated unit. Thus, if a current resident, whose income exceeds the applicable income limitation, moves from an over-income unit to a vacant unit in the same building, the newly occupied unit is treated as an over-income unit. The vacated unit assumes the status the newly occupied unit had immediately before it was occupied by the current resident.

(e) *Available unit rule applies separately to each building in a project.* In a project containing more than one low-income building, the available unit rule applies separately to each building.

(f) *Result of noncompliance with available unit rule.* If any comparable unit that is available or that subsequently becomes available is rented to a nonqualified resident, all over-income units for which the available unit was a comparable unit within the same building lose their status as low-income units; thus, comparably sized or larger over-income units would lose their status as low-income units.

(g) *Relationship to tax-exempt bond provisions.* Financing arrangements that purport to be exempt-facility bonds under section 142 must meet the requirements of sections 103 and 141 through 150 for interest on the obligations to be excluded from gross income under section 103(a). This section is not intended as an interpretation under section 142.

(h) *Examples.* The following examples illustrate this section:

Example 1. This example illustrates noncompliance with the available unit rule in a low-income building containing three over-income units. On January 1, 1998, a qualified low-income housing project, consisting of one building containing ten identically sized residential units, received a housing credit dollar amount allocation from a state housing credit agency for five low-income units. By the close of 1998, the first year of the credit period, the project satisfied the minimum set-aside requirement of section 42(g)(1)(B). Units 1, 2, 3, 4, and 5 were occupied by individuals whose incomes did not exceed the income limitation applicable under section 42(g)(1) and were otherwise low-income residents under section 42. Units 6, 7, 8, and 9 were occupied by market-rate tenants. Unit 10 was vacant. To avoid recapture of credit, the project owner must maintain five of the units as low-income units. On November 1, 1999, the certificates of annual income state that annual incomes of the individuals in Units 1, 2, and 3 increased above 140 percent of the income limitation applicable under section 42(g)(1), causing those units to become over-income units. On November 30, 1999, Units 8 and 9 became vacant. On December 1, 1999, the project owner rented Units 8 and 9 to qualified residents who were not current residents at rates meeting the rent restriction requirements of section 42(g)(2). On December 31, 1999, the project owner rented Unit 10 to a market-rate tenant. Because Unit 10, an available comparable unit, was leased to a market-rate tenant, Units 1, 2, and 3 ceased to be treated as low-income units. On that date, Units 4, 5, 8, and 9 were the only remaining low-income units. Because the project owner did not maintain five of the residential units as low-income units, the qualified basis in the building is reduced, and credit must be recaptured. If the project owner had rented Unit 10 to a qualified resident who was not a current resident, eight of the units would be low-income units. At that time, Units 1, 2, and 3, the over-income units, could be rented to market-rate tenants because the building would still contain five low-income units.

Example 2. This example illustrates the provisions of paragraph (d) of this section. A low-income project consists of one six-floor building. The residential units in the building are identically sized. The building contains two over-income units on the sixth floor and two vacant units on the first floor. The project owner, desiring to maintain the over-income units as low-income units, wants to rent the available units to qualified residents. J, a resident of one of the over-income units, wishes to occupy a unit on the first floor. J's income has recently increased above the applicable income limitation. The project owner permits J to move into one of the units on the first floor. Despite J's income exceeding the applicable income limitation, J is a qualified resident under the available unit rule because J is a current resident of the building. The unit newly occupied by J becomes an over-income unit under the available unit rule. The unit vacated by J assumes the status the newly occupied unit had immediately before J occupied the unit. The over-income units in the building continue to be treated as low-income units.

(i) *Effective date.* This section applies to leases entered into or renewed on and after September 26, 1997.

[T.D. 8732, 62 FR 50505, Sept. 26, 1997]

§1.42–16 Eligible basis reduced by federal grants.

(a) *In general.* If, during any taxable year of the compliance period (described in section 42(i)(1)), a grant is made with respect to any building or the operation thereof and any portion of the grant is funded with federal funds (whether or not includible in gross income), the eligible basis of the building for the taxable year and all succeeding taxable years is reduced by the portion of the grant that is so funded.

(b) *Grants do not include certain rental assistance payments.* A federal rental assistance payment made to a building owner on behalf or in respect of a tenant is not a grant made with respect to a building or its operation if the payment is made pursuant to—

(1) Section 8 of the United States Housing Act of 1937 (42 U.S.C. 1437f)

(2) A qualifying program of rental assistance administered under section 9 of the United States Housing Act of 1937 (42 U.S.C. 1437g); or

(3) A program or method of rental assistance as the Secretary may designate by publication in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(c) *Qualifying rental assistance program.* For purposes of paragraph (b)(2) of this section, payments are made pursuant to a qualifying rental assistance program administered under section 9 of the United States Housing Act of 1937 to the extent that the payments—

(1) Are made to a building owner pursuant to a contract with a public housing authority with respect to units the owner has agreed to maintain as public housing units (PH-units) in the building;

(2) Are made with respect to units occupied by public housing tenants, provided that, for this purpose, units may be considered occupied during periods of short term vacancy (not to exceed 60 days); and

(3) Do not exceed the difference between the rents received from a building's PH-unit tenants and a pro rata portion of the building's actual operating costs that are reasonably allocable to the PH-units (based on square footage, number of bedrooms, or similar objective criteria), and provided that, for this purpose, operating costs do not include any development costs of a building (including developer's fees) or the principal or interest of any debt incurred with respect to any part of the building.

(d) *Effective date.* This section is effective September 26, 1997.

[T.D. 8731, 62 FR 50503, Sept. 26, 1997]

§1.42A–1 General tax credit for taxable years ending after December 31, 1975, and before January 1, 1979.

(a)(1) *Allowance of credit for taxable years ending after December 31, 1975, and beginning before January 1, 1977.* Subject to the special rules of paragraphs (b)(1), (c) and (d) and the limitation of paragraph (e)(1) of this section, an individual is allowed as a credit against the tax imposed by chapter 1 for the taxable year in the case of taxable years ending after December 31, 1975, and beginning before January 1, 1977, an amount equal to the greater of—

(i) 2 percent of so much of the individual's taxable income as does not exceed $9,000, or

(ii) $35 multiplied by the total number of deductions for personal exemptions to which the individual is entitled for the taxable year under section 151 (b) and (e) and the regulations thereunder (relating to allowance of deductions for personal exemptions with respect to the individual, the individual's spouse, and dependents).

For purposes of applying subdivision (ii) of this paragraph (a)(1), the total number of deductions for personal exemptions shall not include any additional exemptions to which the individual or his spouse may be entitled based upon age of 65 or more or blindness under section 151 (c) or (d) and the regulations thereunder.y

(2) *Allowance of credit for taxable years beginning after December 31, 1976, and ending before January 1, 1979.* Subject to the special rules of paragraphs (b)(2), (c) and (d) and the limitation of paragraph (e)(2) of this section, an individual is allowed as a credit against the tax imposed by section 1, or against the tax imposed in lieu of the tax imposed by section 1, for the taxable year in the case of taxable years beginning after December 31, 1976, and ending before January 1, 1979, an amount equal to the greater of—

(i) 2 percent of so much of the individual's taxable income for the taxable year, reduced by the zero bracket amount determined under section 63 (d), as does not exceed $9,000, or

(ii) $35 multiplied by the total number of deductions for personal exemptions to which the individual is entitled for the taxable year under section 151 and the regulations thereunder (relating to allowance of deductions for personal exemptions).

(b) *Married individuals filing separate returns*—(1) *For taxable years ending after December 31, 1975, and beginning before January 1, 1977.* In the case of taxable years ending after December 31, 1975, and beginning before January 1, 1977, a married individual who files a separate return for the taxable year is allowed as a credit for the taxable year an amount equal to either—

(i) 2 percent of so much of the individual's taxable income as does not exceed $4,500, or

(ii) $35 multiplied by the total number of deductions for personal exemptions to which the individual is entitled for the taxable year under section 151 (b) and (e) and the regulations thereunder, but only if both the individual and the individual's spouse elect to have the credit determined in the manner described in this subdivision (ii) for their corresponding taxable years. The elections shall be made by both married individuals separately calculating and claiming the credit in the manner and amount described in this subdivision (ii) on their separate returns for their corresponding taxable years. The rules of section 142 (a) and the regulations thereunder (relating to individuals not eligible for the standard deduction) in effect for taxable years beginning before January 1, 1977, apply to determine whether the taxable years of the individual and the individual's spouse correspond to each other. For purposes of applying this subdivision (ii), the total number of deductions for personal exemptions shall not include any additional exemptions to which the individual may be entitled based upon age of 65 or more or blindness under section 151 (c) or (d) and the regulations thereunder.

(2) *For taxable years beginning after December 31, 1976, and ending before January 1, 1979.* In the case of taxable years beginning after December 31, 1976, and ending before January 1, 1979, a married individual who files a separate return for the taxable year shall determine the amount of the credit for the taxable year under section 42(a)(2) and § 1.42A–1(a)(2)(ii).

(3) *Determination of marital status.* For purposes of this paragraph, the determination of marital status shall be made as provided by section 143 and the regulations thereunder (relating to the determination of marital status).

(c) *Return for short period on change of annual accounting period.* In computing the credit provided by section 42 and this section for a period of less than 12 months (hereinafter referred to as a ‘‘short period''), where income is to be annualized under section 443(b)(1) in order to determine the tax—

(1) The credit allowed by paragraphs (a) (1)(i) and (2)(i) of this section shall be computed based upon the amount of the taxable income annualized under the rules of section 443(b)(1) and § 1.443–1(b)(1), or

(2)(i) The credit allowed by paragraph (a)(1)(ii) of this section shall be computed based upon the total number of deductions for personal exemptions to which the individual is entitled for the short period under section 151 (b) and (e) and the regulations thereunder (relating to allowance of deductions for personal exemptions with respect to the individual, the individual's spouse, and dependents), and

(ii) The credit allowed by paragraph (a)(2)(ii) of this section shall be computed based upon the total number of deductions for personal exemptions to which the individual is entitled for the short period under section 151 and the regulations thereunder (relating to allowance of deductions for personal exemptions).

As so computed, the credit allowed by section 42 and this section shall be allowed against the tax computed on the basis of the annualized taxable income. See §1.443–1(b)(1)(vi).

(d) *Certain persons not eligible*—(1) *Estates and trusts.* The credit provided by section 42 and this section shall not be allowed in the case of any estate or trust. Thus, the credit shall not be allowed to an estate of an individual in bankruptcy or to an estate of a deceased individual. However, in the case of a deceased individual, the credit shall be allowed on the decedent's final return filed by his executor or other representative. Also, the credit provided by section 42 and this section shall be allowed in the case of a return filed by an estate of an infant, incompetent, or an individual under a disability.

(2) *Nonresident alien individuals.* The credit provided by section 42 and this section shall not be allowed in the case of any nonresident alien individual. As used in this subparagraph, the term ''nonresident alien individual'' has the meaning provided by §1.871–2. See, however, section 6013(g) for election to treat nonresident alien individual as resident of the United States. The credit shall be allowed to an alien individual who is a resident of the United States for part of the taxable year. See §1.871–2(b) for rules relating to the determination of residence of an alien individual. For purposes of paragraphs (a) (1)(i) and (2)(i) of this section, the credit allowed shall be computed by taking into account only that portion of the individual's taxable income which is attributable to the period of his residence in the United States. For purposes of paragraph (a)(1)(ii) of this section, the credit allowed shall be computed by taking into account only the total number of deductions for personal exemptions to which the individual is entitled under section 151 (b) and (e) for the period of his residence in the United States. For purposes of paragraph (a)(2)(ii) of this section, the credit allowed shall be computed by taking into account only the total number of deductions for personal exemptions to which the individual is entitled under section 151 for the period of his residence in the United States. See §1.871–13 for rules relating to changes of residence status during a taxable year.

(e) *Limitation*—(1) *For taxable years ending after December 31, 1975, and beginning before January 1, 1977.* For taxable years ending after December 31, 1975, and beginning before January 1, 1977, the credit allowed by section 42 and this section shall not exceed the amount of tax imposed by chapter 1 for the taxable year. In the case of an alien individual who is a resident of the United States for a part of the taxable year, the credit allowed by section 42 and this section shall not exceed the amount of tax imposed by chapter 1 for that portion of the taxable year during which the alien individual was a resident of the United States. See §1.871–13.

(2) *For taxable years beginning after December 31, 1976, and ending before January 1, 1979.* For taxable years beginning after December 31, 1976, and ending before January 1, 1979, the credit allowed by section 42 and this section shall not exceed the amount of tax imposed by section 1, or the amount of tax imposed in lieu of the tax imposed by section 1, for the taxable year. In the case of an alien individual who is a resident of the United States for a part of the taxable year, the credit allowed by section 42 and this section shall not exceed the amount of tax imposed by section 1, or the amount of tax imposed in lieu of the tax imposed by section 1, for that portion of the taxable year during which the alien individual was a resident of the United States. See §1.871–13.

(f) *Application with other credits.* In determining the credits allowed under—

(1) Section 33 (relating to foreign tax credit),

(2) Section 37 (relating to credit for the elderly),

(3) Section 38 (relating to investment in certain depreciable property),

(4) Section 40 (relating to expenses of work incentive programs), and

(5) Section 41 (relating to contributions to candidates for public office),

the tax imposed for the taxable year shall first be reduced (before any other reduction) by the credit allowed by section 42 and this section for the taxable year.

(g) *Income tax tables to reflect credit.* The tables prescribed under section 3 shall reflect the credit allowed by section 42 and this section.

(h) *Effective dates.* The credit allowed by section 42 and this section applies only for taxable years ending after December 31, 1975, and before January 1, 1979.

[T.D. 7547, 43 FR 19653, May 8, 1978]

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[T.D. 8448, 57 FR 54923, Nov. 23, 1992]

§1.43–1 The enhanced oil recovery credit—general rules.

(a) *Claiming the credit*—(1) *In general.* The enhanced oil recovery credit (the ‘‘credit’’) is a component of the section 38 general business credit. A taxpayer that owns an operating mineral interest (as defined in §1.614–2(b)) in a property may claim the credit for qualified enhanced oil recovery costs (as described in §1.43–4) paid or incurred by the taxpayer in connection with a qualified enhanced oil recovery project (as described in §1.43–2) undertaken with respect to the property. A taxpayer that does not own an operating mineral interest in a property may not claim the credit. To the extent a credit included in the current year business credit under section 38(b) is unused under section 38, the credit is carried back or forward under the section 39 business credit carryback and carryforward rules.

(2) *Examples.* The following examples illustrate the principles of this paragraph (a).

Example 1. Credit for operating mineral interest owner. In 1992, A, the owner of an operating mineral interest in a property, begins a qualified enhanced oil recovery project using cyclic steam. B, who owns no interest in the property, purchases and places in service a steam generator. B sells A steam, which A uses as a tertiary injectant described in section 193. Because A owns an operating mineral interest in the property with respect to which the project is undertaken, A may claim a credit for the cost of the steam. Although B owns the steam generator used to produce steam for the project, B may not claim a credit for B’s costs because B does not own an operating mineral interest in the property.

Example 2. Credit for operating mineral interest owner. C and D are partners in CD, a partnership that owns an operating mineral interest in a property. In 1992, CD begins a qualified enhanced oil recovery project using cyclic steam. D purchases a steam generator and sells steam to CD. Because CD owns an operating mineral interest in the property with respect to which the project is undertaken, CD may claim a credit for the cost of the steam. Although D owns the steam generator used to produce steam for the project, D may not claim a credit for the costs of the steam generator because D paid these costs in a capacity other than that of an operating mineral interest owner.

(b) *Amount of the credit.* A taxpayer’s credit is an amount equal to 15 percent of the taxpayer’s qualified enhanced oil recovery costs for the taxable year, reduced by the phase-out amount, if any, determined under paragraph (c) of this section.

(c) *Phase-out of the credit as crude oil prices increase*—(1) *In general.* The amount of the credit (determined without regard to this paragraph (c)) for any taxable year is reduced by an amount which bears the same ratio to the amount of the credit (determined without regard to this paragraph (c)) as—

(i) The amount by which the reference price determined under section 29(d)(2)(C) for the calendar year immediately preceding the calendar year in which the taxable year begins exceeds $28 (as adjusted under paragraph (c)(2) of this section); bears to

(ii) $6.

(2) *Inflation adjustment*—(i) *In general.* For any taxable year beginning in a calendar year after 1991, an amount equal to $28 multiplied by the inflation adjustment factor is substituted for the $28 amount under paragraph (c)(1)(i) of this section.

(ii) *Inflation adjustment factor.* For purposes of this paragraph (c), the inflation adjustment factor for any calendar year is a fraction, the numerator of which is the GNP implicit price deflator for the preceding calendar year and the denominator of which is the GNP implicit price deflator for 1990. The ‘‘GNP implicit price deflator’’ is the first revision of the implicit price deflator for the gross national product as computed and published by the Secretary of Commerce. As early as practicable, the inflation adjustment factor for each calendar year will be published by the Internal Revenue Service in the Internal Revenue Bulletin.

(3) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. Reference price exceeds $28. In 1992, E, the owner of an operating mineral interest in a property, incurs $100 of qualified enhanced oil recovery costs. The reference price for 1991 determined under section 29(d)(2)(C) is $30 and the inflation adjustment factor for 1992 is 1. E’s credit for 1992 determined without regard to the phase-out for crude oil price increases is $15 ($100 × 15%). In determining E’s credit, the credit is reduced by $5 ($15 × ($30 − ($28 × 1))/6). Accordingly, E's credit for 1992 is $10 ($15 − $5).

Example 2. Inflation adjustment. In 1993, F, the owner of an operating mineral interest in a property, incurs $100 of qualified enhanced oil recovery costs. The 1992 reference price is $34, and the 1993 inflation adjustment factor is 1.10. F's credit for 1993 determined without regard to the phase-out for crude oil price increases is $15 ($100 × 15%). In determining F's credit, $30.80 (1.10 × $28) is substituted for $28, and the credit is reduced by $8 ($15 × ($34 − $30.80)/6). Accordingly, F's credit for 1993 is $7 ($15 − $8).

(d) *Reduction of associated deductions*—(1) *In general.* Any deduction allowable under chapter 1 for an expenditure taken into account in computing the amount of the credit determined under paragraph (b) of this section is reduced by the amount of the credit attributable to the expenditure.

(2) *Certain deductions by an integrated oil company.* For purposes of determining the intangible drilling and development costs that an integrated oil company must capitalize under section 291(b), the amount allowable as a deduction under section 263(c) is the deduction allowable after paragraph (d)(1) of this section is applied. See § 1.43–4(b)(2) (extent to which integrated oil company intangible drilling and development costs are qualified enhanced oil recovery costs).

(e) *Basis adjustment.* For purposes of subtitle A, the increase in the basis of property which would (but for this paragraph (e)) result from an expenditure with respect to the property is reduced by the amount of the credit determined under paragraph (b) of this section attributable to the expenditure.

(f) *Passthrough entity basis adjustment*—(1) *Partners' interests in a partnership.* To the extent a partnership expenditure is not deductible under paragraph (d)(1) of this section or does not increase the basis of property under paragraph (e) of this section, the expenditure is treated as an expenditure described in section 705(a)(2)(B) (concerning decreases to basis of partnership interests). Thus, the adjusted bases of the partners' interests in the partnership are decreased (but not below zero).

(2) *Shareholders' stock in an S corporation.* To the extent an S corporation expenditure is not deductible under paragraph (d)(1) of this section or does not increase the basis of property under paragraph (e) of this section, the expenditure is treated as an expenditure described in section 1367(a)(2)(D) (concerning decreases to basis of S corporation stock). Thus, the bases of the shareholders' S corporation stock are decreased (but not below zero).

(g) *Examples.* The following examples illustrate the principles of paragraphs (d) through (f) of this section.

Example 1. Deductions reduced for credit amount. In 1992, G, the owner of an operating mineral interest in a property, incurs $100 of intangible drilling and development costs in connection with a qualified enhanced oil recovery project undertaken with respect to the property. G elects under section 263(c) to deduct these intangible drilling and development costs. The amount of the credit determined under paragraph (b) of this section attributable to the $100 of intangible drilling and development costs is $15 ($100 × 15%). Therefore, G's otherwise allowable deduction of $100 for the intangible drilling and development costs is reduced by $15. Accordingly, in 1992, G may deduct under section 263(c) only $85 ($100 − $15) for these costs.

Example 2. Integrated oil company deduction reduced. The facts are the same as in *Example 1,* except that G is an integrated oil company. As in *Example 1,* the amount of the credit determined under paragraph (b) of this section attributable to the $100 of intangible drilling and development costs is $15, and G's allowable deduction under section 263(c) is $85. Because G is an integrated oil company, G must capitalize 25.50 ($85 × 30%) under section 291(b). Therefore, in 1992, G may deduct under section 263(c) only $59.50 ($85 − $25.50) for these intangible drilling and development costs.

Example 3. Basis of property reduced. In 1992, H, the owner of an operating mineral interest in a property, pays $100 to purchase tangible property that is an integral part of a qualified enhanced oil recovery project undertaken with respect to the property. The amount of the credit determined under paragraph (b) of this section attributable to the $100 is $15 ($100 × 15%). Therefore, for purposes of subtitle A, H's basis in the tangible property is $85 ($100 − $15).

Example 4. Basis of interest in passthrough entity reduced. In 1992, I is a $50% partner in IJ, a partnership that owns an operating mineral interest in a property. IJ pays $200 to purchase tangible property that is an integral part of a qualified enhanced oil recovery project undertaken with respect to the property. The amount of the credit determined under paragraph (b) of this section attributable to the $200 is $30 ($200 × 15%). Therefore, for purposes of subtitle A, IJ's basis in the tangible property is $170 ($200 − $30). Under paragraph (f) of this section, the amount of the purchase price that does not increase the basis of the property ($30) is treated as an expenditure described in section 705(a)(2)(B). Therefore, I's basis in the partnership interest is reduced by $15 (I's allocable share of the section 705(a)(2)(B) expenditure ($30 × 50%)).

[T.D. 8448, 57 FR 54923, Nov. 23, 1992; 58 FR 7987, Feb. 11, 1993]

§1.43–2 Qualified enhanced oil recovery project.

(a) *Qualified enhanced oil recovery project.* A ''qualified enhanced oil recovery project'' is any project that meets all of the following requirements—

(1) The project involves the application (in accordance with sound engineering principles) of one or more qualified tertiary recovery methods (as described in paragraph (e) of this section) that is reasonably expected to result in more than an insignificant increase in the amount of crude oil that ultimately will be recovered;

(2) The project is located within the United States (within the meaning of section 638(1));

(3) The first injection of liquids, gases, or other matter for the project (as described in paragraph (c) of this section) occurs after December 31, 1990; and

(4) The project is certified under §1.43–3.

(b) *More than insignificant increase.* For purposes of paragraph (a)(1) of this section, all the facts and circumstances determine whether the application of a tertiary recovery method can reasonably be expected to result in more than an insignificant increase in the amount of crude oil that ultimately will be recovered. Certain information submitted as part of a project certification is relevant to this determination. See §1.43–3(a)(3)(i)(D). In no event is the application of a recovery method that merely accelerates the recovery of crude oil considered an application of one or more qualified tertiary recovery methods that can reasonably be expected to result in more than an insignificant increase in the amount of crude oil that ultimately will be recovered.

(c) *First injection of liquids, gases, or other matter*—(1) *In general.* The ''first injection of liquids, gases, or other matter'' generally occurs on the date a tertiary injectant is first injected into the reservoir. The ''first injection of liquids, gases, or other matter'' does not include—

(i) The injection into the reservoir of any liquids, gases, or other matter for the purpose of pretreating or preflushing the reservoir to enhance the efficiency of the tertiary recovery method; or

(ii) Test or experimental injections.

(2) *Example.* The following example illustrates the principles of this paragraph (c).

Example. Injections to pretreat the reservoir. In 1989, A, the owner of an operating mineral interest in a property, began injecting water into the reservoir for the purpose of elevating reservoir pressure to obtain miscibility pressure to prepare for the injection of miscible gas in connection with an enhanced oil recovery project. In 1992, A obtains miscibility pressure in the reservoir and begins injecting miscible gas into the reservoir. The injection of miscible gas, rather than the injection of water, is the first injection of liquids, gases, or other matter into the reservoir for purposes of determining whether the first injection of liquids, gases, or other matter occurs after December 31, 1990.

(d) *Significant expansion exception*—(1) *In general.* If a project for which the first injection of liquids, gases, or other matter (within the meaning of paragraph (c)(1) of this section) occurred before January 1, 1991, is significantly expanded after December 31, 1990, the expansion is treated as a separate project for which the first injection of liquids, gases, or other matter occurs after December 31, 1990.

(2) *Substantially unaffected reservoir volume.* A project is considered significantly expanded if the injection of liquids, gases, or other matter after December 31, 1990, is reasonably expected to result in more than an insignificant increase in the amount of crude oil that ultimately will be recovered from reservoir volume that was substantially unaffected by the injection of

liquids, gases, or other matter before January 1, 1991.

(3) *Terminated projects.* Except as otherwise provided in this paragraph (d)(3), a project is considered significantly expanded if each qualified tertiary recovery method implemented in the project prior to January 1, 1991, terminated more than 36 months before implementing an enhanced oil recovery project that commences after December 31, 1990. Notwithstanding the provisions of the preceding sentence, if a project implemented prior to January 1, 1991, is terminated for less than 36 months before implementing an enhanced oil recovery project that commences after December 31, 1990, a taxpayer may request permission to treat the project that commences after December 31, 1990, as a significant expansion. Permission will not be granted if the Internal Revenue Service determines that a project was terminated to make an otherwise nonqualifying project eligible for the credit. For purposes of section 43, a qualified tertiary recovery method terminates at the point in time when the method no longer results in more than an insignificant increase in the amount of crude oil that ultimately will be recovered. All the facts and circumstances determine whether a tertiary recovery method has terminated. Among the factors considered is the project plan, the unit plan of development, or other similar plan. A tertiary recovery method is not necessarily terminated merely because the injection of the tertiary injectant has ceased. For purposes of this paragraph (d)(1), a project is implemented when costs that will be taken into account in determining the credit with respect to the project are paid or incurred.

(4) *Change in tertiary recovery method.* If the application of a tertiary recovery method or methods with respect to an enhanced oil recovery project for which the first injection of liquids, gases, or other matter occurred before January 1, 1991, has not been terminated for more than 36 months, a taxpayer may request a private letter ruling from the Internal Revenue Service whether the application of a different tertiary recovery method or methods after December 31, 1990, that does not affect reservoir volume substantially unaffected by the previous tertiary recovery method or methods, is treated as a significant expansion. All the facts and circumstances determine whether a change in tertiary recovery method is treated as a significant expansion. Among the factors considered are whether the change in tertiary recovery method is in accordance with sound engineering principles and whether the change in method will result in more than an insignificant increase in the amount of crude oil that would be recovered using the previous method. A more intensive application of a tertiary recovery method after December 31, 1990, is not treated as a significant expansion.

(5) *Examples.* The following examples illustrate the principles of this paragraph (d).

Example 1. Substantially unaffected reservoir volume. In January 1988, B, the owner of an operating mineral interest in a property, began injecting steam into the reservoir in connection with a cyclic steam enhanced oil recovery project. The project affected only a portion of the reservoir volume. In 1992, B begins cyclic steam injections with respect to reservoir volume that was substantially unaffected by the previous cyclic steam project. Because the injection of steam into the reservoir in 1992 affects reservoir volume that was substantially unaffected by the previous cyclic steam injection, the cyclic steam injection in 1992 is treated as a separate project for which the first injection of liquids, gases, or other matter occurs after December 31, 1990.

Example 2. Tertiary recovery method terminated more than 36 months. In 1982, C, the owner of an operating mineral interest in a property, implemented a tertiary recovery project using cyclic steam injection as a method for the recovery of crude oil. The project was certified as a tertiary recovery project for purposes of the windfall profit tax. In May 1988, the application of the cyclic steam tertiary recovery method terminated. In July 1992, C begins drilling injection wells as part of a project to apply the steam drive tertiary recovery method with respect to the same project area affected by the cyclic steam method. C begins steam injections in September 1992. Because C commences an enhanced oil recovery project more than 36 months after the previous tertiary recovery method was terminated, the project is treated as a separate project for which the first injection of liquids, gases, or other matter occurs after December 31, 1990.

Example 3. Change in tertiary recovery method affecting substantially unaffected reservoir volume. In 1984, D, the owner of an operating mineral interest in a property, implemented a tertiary recovery project using cyclic steam as a method for the recovery of crude oil. The project was certified as a tertiary recovery project for purposes of the windfall profit tax. D continued the cyclic steam injection until 1992, when the tertiary recovery method was changed from cyclic steam injection to steam drive. The steam drive affects reservoir volume that was substantially unaffected by the cyclic steam injection. Because the steam drive affects reservoir volume that was substantially unaffected by the cyclic steam injection, the steam drive is treated as a separate project for which the first injection of liquids, gases, or other matter occurs after December 31, 1990.

Example 4. Change in tertiary recovery method not affecting substantially unaffected reservoir volume. In 1988, E, the owner of an operating mineral interest in a property, undertook an immiscible nitrogen enhanced oil recovery project that resulted in more than an insignificant increase in the ultimate recovery of crude oil from the property. E continued the immiscible nitrogen project until 1992, when the project was converted from immiscible nitrogen displacement to miscible nitrogen displacement by increasing the injection of nitrogen to increase reservoir pressure. The miscible nitrogen displacement affects the same reservoir volume that was affected by the immiscible nitrogen displacement. Because the miscible nitrogen displacement does not affect reservoir volume that was substantially unaffected by the immiscible nitrogen displacement nor was the immiscible nitrogen displacement project terminated for more than 36 months before the miscible nitrogen displacement project was implemented, E must obtain a ruling whether the change from immiscible nitrogen displacement to miscible nitrogen displacement is treated as a separate project for which the first injection of liquids, gases, or other matter occurs after December 31, 1990. If E does not receive a ruling, the miscible nitrogen displacement project is not a qualified project.

Example 5. More intensive application of a tertiary recovery method. In 1989, F, the owner of an operating mineral interest in a property, undertook an immiscible carbon dioxide displacement enhanced oil recovery project. F began injecting carbon dioxide into the reservoir under immiscible conditions. The injection of carbon dioxide under immiscible conditions resulted in more than an insignificant increase in the ultimate recovery of crude oil from the property. F continues to inject the same amount of carbon dioxide into the reservoir until 1992, when new engineering studies indicate that an increase in the amount of carbon dioxide injected is reasonably expected to result in a more than insignificant increase in the amount of crude oil that would be recovered from the property as a result of the previous injection of carbon dioxide. The increase in the amount of carbon dioxide injected affects the same reservoir volume that was affected by the previous injection of carbon dioxide. Because the additional carbon dioxide injected in 1992 does not affect reservoir volume that was substantially unaffected by the previous injection of carbon dioxide and the previous immiscible carbon dioxide displacement method was not terminated for more than 36 months before additional carbon dioxide was injected, the increase in the amount of carbon dioxide injected into the reservoir is not a significant expansion. Therefore, it is not a separate project for which the first injection of liquids, gases, or other matter occurs after December 31, 1990.

(e) *Qualified tertiary recovery methods*—(1) *In general.* For purposes of paragraph (a)(1) of this section, a ‘‘qualified tertiary recovery method’’ is any one or any combination of the tertiary recovery methods described in paragraph (e)(2) of this section. To account for advances in enhanced oil recovery technology, the Internal Revenue Service may by revenue ruling prescribe that a method not described in paragraph (e)(2) of this section is a ‘‘qualified tertiary recovery method.’’ In addition, a taxpayer may request a private letter ruling that a method not described in paragraph (e)(2) of this section or in a revenue ruling is a qualified tertiary recovery method. Generally, the methods identified in revenue rulings or private letter rulings will be limited to those methods that involve the displacement of oil from the reservoir rock by means of modifying the properties of the fluids in the reservoir or providing the energy and drive mechanism to force the oil to flow to a production well. The recovery methods described in paragraph (e)(3) of this section are not ‘‘qualified tertiary recovery methods.’’

(2) *Tertiary recovery methods that qualify*—(i) *Thermal recovery methods*—(A) *Steam drive injection.* The continuous injection of steam into one set of wells (injection wells) or other injection source to effect oil displacement toward and production from a second set of wells (production wells);

(B) *Cyclic steam injection*—The alternating injection of steam and production of oil with condensed steam from the same well or wells; and

(C) *In situ combustion.* The combustion of oil or fuel in the reservoir sustained by injection of air, oxygen-enriched air, oxygen, or supplemental fuel supplied from the surface to displace unburned oil toward producing wells. This process may include the concurrent, alternating, or subsequent injection of water.

(ii) *Gas Flood recovery methods*—(A) *Miscible fluid displacement.* The injection of gas (*e.g.,* natural gas, enriched natural gas, a liquified petroleum slug driven by natural gas, carbon dioxide, nitrogen, or flue gas) or alcohol into the reservoir at pressure levels such that the gas or alcohol and reservoir oil are miscible;

(B) *Carbon dioxide augmented waterflooding.* The injection of carbonated water, or water and carbon dioxide, to increase waterflood efficiency;

(C) *Immiscible carbon dioxide displacement.* The injection of carbon dioxide into an oil reservoir to effect oil displacement under conditions in which miscibility with reservoir oil is not obtained. This process may include the concurrent, alternating, or subsequent injection of water; and

(D) *Immiscible nonhydrocarbon gas displacement.* The injection of nonhydrocarbon gas (*e.g.,* nitrogen) into an oil reservoir, under conditions in which miscibility with reservoir oil is not obtained, to obtain a chemical or physical reaction (other than pressure) between the oil and the injected gas or between the oil and other reservoir fluids. This process may include the concurrent, alternating, or subsequent injection of water.

(iii) *Chemical flood recovery methods*—(A) *Microemulsion flooding.* The injection of a surfactant system *(e.g.,* a surfactant, hydrocarbon, cosurfactant, electrolyte, and water) to enhance the displacement of oil toward producing wells; and

(B) *Caustic flooding*—The injection of water that has been made chemically basic by the addition of alkali metal hydroxides, silicates, or other chemicals.

(iv) *Mobility control recovery method—Polymer augmented waterflooding.* The injection of polymeric additives with water to improve the areal and vertical sweep efficiency of the reservoir by increasing the viscosity and decreasing the mobility of the water injected. Polymer augmented waterflooding does not include the injection of polymers for the purpose of modifying the injection profile of the wellbore or the relative permeability of various layers of the reservoir, rather than modifying the water-oil mobility ratio.

(3) *Recovery methods that do not qualify.* The term ‘‘qualified tertiary recovery method’’ does not include—

(i) Waterflooding—The injection of water into an oil reservoir to displace oil from the reservoir rock and into the bore of the producing well;

(ii) Cyclic gas injection—The increase or maintenance of pressure by injection of hydrocarbon gas into the reservoir from which it was originally produced;

(iii) Horizontal drilling—The drilling of horizontal, rather than vertical, wells to penetrate hydrocarbon bearing formations;

(iv) Gravity drainage—The production of oil by gravity flow from drainholes that are drilled from a shaft or tunnel dug within or below the oil bearing zones; and

(v) Other methods—Any recovery method not specifically designated as a qualified tertiary recovery method in either paragraph (e)(2) of this section or in a revenue ruling or private letter ruling described in paragraph (e)(1) of this section.

(4) *Examples.* The following examples illustrate the principles of this paragraph (e).

Example 1. Polymer augmented waterflooding. In 1992 G, the owner of an operating mineral interest in a property, begins a waterflood project with respect to the property. To reduce the relative permeability in certain areas of the reservoir and minimize water coning, G injects polymers to plug thief zones and improve the areal and vertical sweep efficiency of the reservoir. The injection of polymers into the reservoir does not modify the water-oil mobility ratio. Accordingly, the injection of polymers into the reservoir in connection with the waterflood project does not constitute polymer augmented waterflooding and the project is not a qualified enhanced oil recovery project.

Example 2. Polymer augmented waterflooding. In 1993 H, the owner of an operating mineral interest in a property, begins a caustic flooding project with respect to the property. Engineering studies indicate that the relative permeability of various layers of the reservoir may result in the loss of the injectant to thief zones, thereby reducing the areal and vertical sweep efficiency of the reservoir. As part of the caustic flooding project, H injects polymers to plug the thief zones and improve the areal and vertical sweep efficiency of the reservoir. Because the polymers are injected into the reservoir to improve the effectiveness of the caustic flooding project, the project is a qualified enhanced oil recovery project.

[T.D. 8448, 57 FR 54925, Nov. 23, 1992; 58 FR 6678, Feb. 1, 1993]

§1.43–3 Certification

(a) *Petroleum engineer's certification of a project*—(1) *In general.* A petroleum engineer must certify, under penalties of perjury, that an enhanced oil recovery project meets the requirements of section 43(c)(2)(A). A petroleum engineer's certification must be submitted for each project. The petroleum engineer certifying a project must be duly registered or certified in any State.

(2) *Timing of certification.* The operator of an enhanced oil recovery project or any other operating mineral interest owner designated by the operator (‘‘designated owner'') must submit a petroleum engineer's certification to the Internal Revenue Service Center, Austin, Texas, or such other place as may be designated by revenue procedure or other published guidance, not later than the last date prescribed by law (including extensions) for filing the operator's or designated owner's federal income tax return for the first taxable year for which the enhanced oil recovery credit (the ‘‘credit'') is allowable. The operator may designate any other operating mineral interest owner (the ‘‘designated owner'') to file the petroleum engineer's certification.

(3) *Content of certification*—(i) *In general.* A petroleum engineer's certification must contain the following information—

(A) The name and taxpayer identification number of the operator or the designated owner submitting the certification;

(B) A statement identifying the project, including its geographic location;

(C) A statement that the project involves a tertiary recovery method (as defined in section 43(c)(2)(A)(i)) and a description of the process used, including—

(*1*) A description of the implementation and operation of the project sufficient to establish that it is implemented and operated in accordance with sound engineering practices;

(*2*) If the project involves the application of a tertiary recovery method approved in a private letter ruling described in paragraph (e)(1) of §1.43–2, a copy of the private letter ruling, and

(*3*) The date on which the first injection of liquids, gases, or other matter occurred or is expected to occur.

(D) A statement that the application of a qualified tertiary recovery method or methods is expected to result in more than an insignificant increase in the amount of crude oil that ultimately will be recovered, including—

(*1*) Data on crude oil reserve estimates covering the project area with and without the enhanced oil recovery process,

(*2*) Production history prior to implementation of the project and estimates of production after implementation of the project, and

(*3*) An adequate delineation of the reservoir, or portion of the reservoir, from which the ultimate recovery of crude oil is expected to be increased as a result of the implementation and operation of the project; and

(E) A statement that the petroleum engineer believes that the project is a qualified enhanced oil recovery project within the meaning of section 43(c)(2)(A).

(ii) *Additional information for significantly expanded projects.* The petroleum engineer's certification for a project that is significantly expanded must in addition contain—

(A) If the expansion affects reservoir volume that was substantially unaffected by a previously implemented project, an adequate delineation of the reservoir volume affected by the previously implemented project;

(B) If the expansion involves the implementation of an enhanced oil recovery project more than 36 months after the termination of a qualified tertiary recovery method that was applied before January 1, 1991, the date on which the previous tertiary recovery method terminated and an explanation of the data or assumptions relied upon to determine the termination date;

(C) If the expansion involves the implementation of an enhanced oil recovery project less than 36 months after the termination of a qualified tertiary recovery method that was applied before January 1, 1991, a copy of a private letter ruling from the Internal Revenue Service that the project implemented after December 31, 1990 is treated as a significant expansion; or

(D) If the expansion involves the application after December 31, 1990, of a tertiary recovery method or methods that do not affect reservoir volume that was substantially unaffected by the application of a different tertiary recovery method or methods before January 1, 1991, a copy of a private letter ruling from the Internal Revenue Service that the change in tertiary recovery method is treated as a significant expansion.

(b) *Operator's continued certification of a project*—(1) *In general.* For each taxable year following the taxable year for which the petroleum engineer's certification is submitted, the operator or designated owner must certify, under penalties of perjury, that an enhanced oil recovery project continues to be implemented substantially in accordance with the petroleum engineer's certification submitted for the project. An operator's certification must be submitted for each project.

(2) *Timing of certification.* The operator or designated owner of an enhanced oil recovery project must submit an operator's certification to the Internal Revenue Service Center, Austin, Texas, or such other place as may be designated by revenue procedure or other published guidance, not later than the last date prescribed by law (including extensions) for filing the operator's or designated owner's federal income tax return for any taxable year after the taxable year for which the petroleum engineer's certification is filed.

(3) *Content of certification.* An operator's certification must contain the following information—

(i) The name and taxpayer identification number of the operator or the designated owner submitting the certification;

(ii) A statement identifying the project including its geographic location and the date on which the petroleum engineer's certification was filed;

(iii) A statement that the project continues to be implemented substantially in accordance with the petroleum engineer's certification (as described in paragraph (a) of this section) submitted for the project; and

(iv) A description of any significant change or anticipated change in the information submitted under paragraph (a)(3) of this section, including a change in the date on which the first injection of liquids, gases, or other matter occurred or is expected to occur.

(c) *Notice of project termination*—(1) *In general.* If the application of a tertiary recovery method is terminated, the operator or designated owner must submit a notice of project termination to the Internal Revenue Service.

(2) *Timing of notice.* The operator or designated owner of an enhanced oil recovery project must submit the notice of project termination to the Internal Revenue Service Center, Austin, Texas, or such other place as may be designated by revenue procedure or other published guidance, not later than the last date prescribed by law (including extensions) for filing the operator's or designated owner's federal income tax return for the taxable year in which the project terminates.

(3) *Content of notice.* A notice of project termination must contain the following information—

(i) The name and taxpayer identification number of the operator or the designated owner submitting the notice;

(ii) A statement identifying the project including its geographic location and the date on which the petroleum engineer's certification was filed; and

(iii) The date on which the application of the tertiary recovery method was terminated.

(d) *Failure to submit certification.* If a petroleum engineer's certification (as described in paragraph (a) of this section) or an operator's certification (as described in paragraph (b) of this section) is not submitted in the time or manner prescribed by this section, the credit will be allowed only after the appropriate certifications are submitted.

[T.D. 8384, 56 FR 67177, Dec. 30, 1991; 57 FR 6074, Feb. 20, 1992; 57 FR 6353, Feb. 24, 1992. Redesignated and amended by T.D. 8448, 57 FR 54927, Nov. 23, 1992]

§1.43–4 Qualified enhanced oil recovery costs.

(a) *Qualifying costs*—(1) *In general.* Except as provided in paragraph (e) of this section, amounts paid or incurred in any taxable year beginning after December 31, 1990, that are qualified tertiary injectant expenses (as described in paragraph (b)(1) of this section), intangible drilling and development costs (as described in paragraph (b)(2) of this section), and tangible property costs (as described in paragraph (b)(3) of this section) are ''qualified enhanced oil recovery costs'' if the amounts are paid or incurred with respect to an asset which is used for the primary purpose (as described in paragraph (c) of this section) of implementing an enhanced oil recovery project. Any amount paid or incurred in any taxable year beginning before January 1, 1991, in connection with an enhanced oil recovery project is not a qualified enhanced oil recovery cost.

(2) *Costs paid or incurred for an asset which is used to implement more than one qualified enhanced oil recovery project or for other activities.* Any cost paid or incurred during the taxable year for an asset which is used to implement more than one qualified enhanced oil recovery project is allocated among the projects in determining the qualified enhanced oil recovery costs for each qualified project for the taxable year. Similarly, any cost paid or incurred during the taxable year for an asset which is used to implement a qualified enhanced oil recovery project and which is also used for other activities (for example, an enhanced oil recovery project that is not a qualified enhanced oil recovery project) is allocated among the qualified enhanced oil recovery project and the other activities to determine the qualified enhanced oil recovery costs for the taxable year. See §1.613–5(a). Any cost paid or incurred for an asset which is used to implement a qualified enhanced oil recovery project and which is also used for other activities is not required to be allocated under this paragraph (a)(2) if the use of the property for nonqualifying activities is *de minimis* (*e.g.,* not greater than 10%). Costs are allocated under this paragraph (a)(2) only if the asset with respect to which the costs are paid or incurred is used for the primary purpose of implementing an enhanced oil recovery project. *See* paragraph (c) of this section. Any reasonable allocation method may be used. A method that allocates costs based on the anticipated use in a project or activity is a reasonable method.

(b) *Costs defined*—(1) *Qualified tertiary injectant expenses.* For purposes of this section, ''qualified tertiary injectant expenses'' means any costs that are paid or incurred in connection with a qualified enhanced oil recovery project and that are deductible under section 193 for the taxable year. *See* section 193 and §1.193–1. Qualified tertiary injectant expenses are taken into account in determining the credit with respect to the taxable year in which the tertiary injectant expenses are deductible under section 193.

(2) *Intangible drilling and development costs.* For purposes of this section, ''intangible drilling and development costs'' means any intangible drilling and development costs that are paid or incurred in connection with a qualified enhanced oil recovery project and for which the taxpayer may make an election under section 263(c) for the taxable year. Intangible drilling and development costs are taken into account in determining the credit with respect to the taxable year in which the taxpayer may deduct the intangible drilling and development costs under section 263(c). For purposes of this paragraph (b)(2), the amount of the intangible drilling and development costs for which an integrated oil company may make an

election under section 263(c) is determined without regard to section 291(b).

(3) *Tangible property costs*—(i) *In general.* For purposes of this section, ''tangible property costs'' means an amount paid or incurred during a taxable year for tangible property that is an integral part of a qualified enhanced oil recovery project and that is depreciable or amortizable under chapter 1. An amount paid or incurred for tangible property is taken into account in determining the credit with respect to the taxable year in which the cost is paid or incurred.

(ii) *Integral part.* For purposes of this paragraph (b), tangible property is an integral part of a qualified enhanced oil recovery project if the property is used directly in the project and is essential to the completeness of the project. All the facts and circumstances determine whether tangible property is used directly in a qualified enhanced oil recovery project and is essential to the completeness of the project. Generally, property used to acquire or produce the tertiary injectant or property used to transport the tertiary injectant to a project site is property that is an integral part of the project.

(4) *Examples.* The following examples illustrate the principles of this paragraph (b). Assume for each of these examples that the qualified enhanced oil recovery costs are paid or incurred with respect to an asset which is used for the primary purpose of implementing an enhanced oil recovery project.

Example 1. Qualified costs—in general. (i) In 1992, X, a corporation, acquires an operating mineral interest in a property and undertakes a cyclic steam enhanced oil recovery project with respect to the property. X pays a fee to acquire a permit to drill and hires a contractor to drill six wells. As part of the project implementation, X constructs a building to serve as an office on the property and purchases equipment, including downhole equipment (*e.g.,* casing, tubing, packers, and sucker rods), pumping units, a steam generator, and equipment to remove gas and water from the oil after it is produced. X constructs roads to transport the equipment to the wellsites and incurs costs for clearing and draining the ground in preparation for the drilling of the wells. X purchases cars and trucks to provide transportation for monitoring the wellsites. In addition, X contracts with Y for the delivery of water to produce steam to be injected in connection with the cyclic steam project, and purchases storage tanks to store the water.

(ii) The leasehold acquisition costs are not qualified enhanced oil recovery costs. However, the costs of the permit to drill are intangible drilling and development costs that are qualified costs. The costs associated with hiring the contractor to drill, constructing roads, and clearing and draining the ground are intangible drilling and development costs that are qualified enhanced oil recovery costs. The downhole equipment, the pumping units, the steam generator, and the equipment to remove the gas and water from the oil after it is produced are used directly in the project and are essential to the completeness of the project. Therefore, this equipment is an integral part of the project and the costs of the equipment are qualified enhanced oil recovery costs. Although the building that X constructs as an office and the cars and trucks X purchases to provide transportation for monitoring the wellsites are used directly in the project, they are not essential to the completeness of the project. Therefore, the building and the cars and trucks are not an integral part of the project and their costs are not qualified enhanced oil recovery costs. The cost of the water X purchases from Y is a tertiary injectant expense that is a qualified enhanced oil recovery cost. The storage tanks X acquires to store the water are required to provide a proximate source of water for the production of steam. Therefore, the water storage tank are an integral part of the project and the costs of the water storage tanks are qualified enhanced oil recovery costs.

Example 2. Diluent storage tanks. In 1992, A, the owner of an operating mineral interest, undertakes a qualified enhanced oil recovery project with respect to the property. A acquires diluent to be used in connection with the project. A stores the diluent in a storage tank that A acquires for that purpose. The storage tank provides a proximate source of diluent to be used in the tertiary recovery method. Therefore, the storage tank is used directly in the project and is essential to the completeness of the project. Accordingly, the storage tanks is an integral part of the project and the cost of the storage tank is a qualified enhanced oil recovery cost.

Example 3. Oil storage tanks. In 1992, Z, a corporation and the owner of an operating mineral interest in a property, undertakes a qualified enhanced oil recovery project with respect to the property. Z acquires storage tanks that Z will use solely to store the crude oil that is produced from the enhanced oil recovery project. The storage tanks are not used directly in the project and are not essential to the completeness of the project.

Therefore, the storage tanks are not an integral part of the enhanced oil recovery project and the costs of the storage tanks are not qualified enhanced oil recovery costs.

Example 4. Oil refinery. B, the owner of an operating mineral interest in a property, undertakes a qualified enhanced oil recovery project with respect to the property. Located on B's property is an oil refinery where B will refine the crude oil produced from the project. The refinery is not used directly in the project and is not essential to the completeness of the project. Therefore, the refinery is not an integral part of the enhanced oil recovery project.

Example 5. Gas processing plant. C, the owner of an operating mineral interest in a property, undertakes a qualified enhanced oil recovery project with respect to the property. A gas processing plant where C will process gas produced in the project is located on C's property. The gas processing plant is not used directly in the project and is not essential to the completeness of the project. Therefore, the gas processing plant is not an integral part of the enhanced oil recovery project.

Example 6. Gas processing equipment. The facts are the same as in *Example 5* except that C uses a portion of the gas processing plant to separate and recycle the tertiary injectant. The gas processing equipment used to separate and recycle the tertiary injectant is used directly in the project and is essential to the completeness of the project. Therefore, the gas processing equipment used to separate and recycle the tertiary injectant is an integral part of the enhanced oil recovery project and the costs of this equipment are qualified enhanced oil recovery costs.

Example 7. Steam generator costs allocated. In 1988, D, the owner of an operating mineral interest in a property, undertook a steam drive project with respect to the property. In 1992, D decides to undertake a steam drive project with respect to reservoir volume that was substantially unaffected by the 1988 project. The 1992 project is a significant expansion that is a qualified enhanced oil recovery project. D purchases a new steam generator with sufficient capacity to provide steam for both the 1988 project and the 1992 project. The steam generator is used directly in the 1992 project and is essential to the completeness of the 1992 project. Accordingly, the steam generator is an integral part of the 1992 project. Because the steam generator is also used to provide steam for the 1988 project, D must allocate the cost of the steam generator to the 1988 project and the 1992 project. Only the portion of the cost of the steam generator that is allocable to the 1992 project is a qualified enhanced oil recovery cost.

Example 8. Carbon dioxide pipeline. In 1992, E, the owner of an operating mineral interest in a property, undertakes an immiscible carbon dioxide displacement project with respect to the property. E constructs a pipeline to convey carbon dioxide to the project site. E contracts with F, a producer of carbon dioxide, to purchase carbon dioxide to be injected into injection wells in E's enhanced oil recovery project. The cost of the carbon dioxide is a tertiary injectant expense that is a qualified enhanced oil recovery cost. The pipeline is used by E to transport the tertiary injectant, that is, the carbon dioxide to the project site. Therefore, the pipeline is an integral part of the project. Accordingly, the cost of the pipeline is a qualified enhanced oil recovery cost.

Example 9. Water source wells. In 1992, G the owner of an operating mineral interest in a property, undertakes a polymer augmented waterflood project with respect to the property. G drills water wells to provide water for injection in connection with the project. The costs of drilling the water wells are intangible drilling and development costs that are paid or incurred in connection with the project. Therefore, the costs of drilling the water wells are qualified enhanced oil recovery costs.

Example 10. Leased equipment. In 1992, H, the owner of an operating mineral interest in a property undertakes a steam drive project with respect to the property. H contracts with I, a driller, to drill injection wells in connection with the project. H also leases a steam generator to provide steam for injection in connection with the project. The drilling costs are intangible drilling and development costs that are paid in connection with the project and are qualified enhanced oil recovery costs. The steam generator is used to produce the tertiary injectant. The steam generator is used directly in the project and is essential to the completeness of the project; therefore, it is an integral part of the project. The costs of leasing the steam generator are tangible property costs that are qualified enhanced oil recovery costs.

(c) *Primary purpose*—(1) *In general.* For purposes of this section, a cost is a qualified enhanced oil recovery cost only if the cost is paid or incurred with respect to an asset which is used for the primary purpose of implementing one or more enhanced oil recovery projects, at least one of which is a qualified enhanced oil recovery project. All the facts and circumstances determine whether an asset is used for the primary purpose of implementing an enhanced oil recovery project. For purposes of this paragraph (c), an enhanced oil recovery project is a project that satisfies the requirements of paragraphs (a) (1) and (2) of section 1.43–2.

(2) *Tertiary injectant costs.* Tertiary injectant costs generally satisfy the primary purpose test of this paragraph (c).

(3) *Intangible drilling and development costs.* Intangible drilling and development costs paid or incurred with respect to a well that is used in connection with the recovery of oil by primary or secondary methods are not qualified enhanced oil recovery costs. Except as provided in this paragraph (c)(3), a well used for primary or secondary recovery is not used for the primary purpose of implementing an enhanced oil recovery project. A well drilled for the primary purpose of implementing an enhanced oil recovery project is not considered to be used for primary or secondary recovery, notwithstanding that some primary or secondary production may result when the well is drilled, provided that such primary or secondary production is consistent with the unit plan of development or other similar plan. All the facts and circumstances determine whether primary or secondary recovery is consistent with the unit plan of development or other similar plan.

(4) *Tangible property costs.* Tangible property costs must be paid or incurred with respect to property which is used for the primary purpose of implementing an enhanced oil recovery project.

If tangible property is used partly in a qualified enhanced oil recovery project and partly in another activity, the property must be primarily used to implement the qualified enhanced oil recovery project.

(5) *Offshore drilling platforms.* Amounts paid or incurred in connection with the acquisition, construction, transportation, erection, or installation of an offshore drilling platform (regardless of whether the amounts are intangible drilling and development costs) that is used in connection with the recovery of oil by primary or secondary methods are not qualified enhanced oil recovery costs. An offshore drilling platform used for primary or secondary recovery is not used for the primary purpose of implementing an enhanced oil recovery project.

(6) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. Intangible drilling and development costs. In 1992, J incurs intangible drilling and development costs in drilling a well. J intends to use the well as an injection well in connection with an enhanced oil recovery project in 1994, but in the meantime will use the well in connection with a secondary recovery project. J may not take the intangible drilling and development costs into account in determining the credit because the primary purpose of a well used for secondary recovery is not to implement a qualified enhanced oil recovery project.

Example 2. Offshore drilling platform. K, the owner of an operating mineral interest in an offshore oil field located within the United States, constructs an offshore drilling platform that is designed to accommodate the primary, secondary, and tertiary development of the field. Subsequent to primary and secondary development of the field, K commences an enhanced oil recovery project that involves the application of a qualified tertiary recovery method. As part of the enhanced oil recovery project, K drills injection wells from the offshore drilling platform K used in the primary and secondary development of the field and installs an additional separator on the platform.

Because the offshore drilling platform was used in the primary and secondary development of the field and was not used for the primary purpose of implementing tertiary development of the field, costs incurred by K in connection with the acquisition, construction, transportation, erection, or installation of the offshore drilling platform are not qualified enhanced oil recovery costs. However, the costs K incurs for the additional separator are qualified enhanced oil recovery costs because the separator is used for the primary purpose of implementing tertiary development of the field. In addition, the intangible drilling and development costs K incurs in connection with drilling the injection wells are qualified enhanced oil recovery costs with respect to which K may claim the enhanced oil recovery credit.

(d) *Costs paid or incurred prior to first injection*—(1) *In general.* Qualified enhanced oil recovery costs may be paid or incurred prior to the date of the first injection of liquids, gases, or other matter (within the meaning of § 1.43–2(c)). If the first injection of liquids, gases, or other matter occurs on or before the date the taxpayer files the taxpayer’s federal income tax return for the taxable year with respect to which the costs are allowable, the costs may be taken into account on that return. If the first injection of liquids, gases, or other matter is expected to occur after the date the taxpayer files that return, costs may be taken into account on that return if the Internal Revenue Service issues a private letter ruling to the taxpayer that so permits.

(2) *First injection after filing of return for taxable year costs are allowable.* Except as provided in paragraph (d)(3) of this section, if the first injection of liquids, gases, or other matter occurs or is expected to occur after the date the taxpayer files the taxpayer's federal income tax return for the taxable year with respect to which the costs are allowable, the costs may be taken into account on an amended return (or in the case of a Coordinated Examination Program taxpayer, on a written statement treated as a qualified return) after the earlier of—

(i) The date the first injection of liquids, gases, or other matter occurs; or

(ii) The date the Internal Revenue Service issues a private letter ruling that provides that the taxpayer may take costs into account prior to the first injection of liquids, gases, or other matter.

(3) *First injection more than 36 months after close of taxable year costs are paid or incurred.* If the first injection of liquids, gases, or other matter occurs more than 36 months after the close of the taxable year in which costs are paid or incurred, the taxpayer may take the costs into account in determining the credit only if the Internal Revenue Service issues a private letter ruling to the taxpayer that so provides.

(4) *Injections in volumes less than the volumes specified in the project plan.* For purposes of this paragraph (d), injections in volumes significantly less than the volumes specified in the project plan, the unit plan of development, or another similar plan do not constitute the first injection of liquids, gases, or other matter.

(5) *Examples.* The following examples illustrate the provisions of paragraph (d) of this section.

Example 1. First injection before return filed. In 1992, L, a calendar year taxpayer, undertakes a qualified enhanced oil recovery project on a property in which L owns an operating mineral interest. L incurs $1,000 of intangible drilling and development costs, which L may elect to deduct under section 263(c) for 1992. The first injection of liquids, gases, or other matter (within the meaning of §1.43–2(c)) occurs in March 1993. L files a 1992 federal income tax return in April 1993. Because the first injection occurs before the filing of L's 1992 federal income tax return, L may take the $1,000 of intangible drilling and development costs into account in determining the credit for 1992 on that return.

Example 2. First injection after return filed. In 1993, M, a calendar year taxpayer, undertakes a qualified enhanced oil recovery project on a property in which M owns an operating mineral interest. M incurs $2,000 of intangible drilling and development costs, which M elects to deduct under section 263(c) for 1993. The first injection of liquids, gases, or other matter is expected to occur in 1995. M files a 1993 federal income tax return in April 1994. Because the first injection of liquids, gases, or other matter occurs after the date on which M's 1993 federal income tax return is filed in April 1994, M may take the $2,000 of intangible drilling and development costs into account on an amended return for 1993 after the earlier of the date the first injection of liquids, gases, or other matter occurs, or the date the Internal Revenue Service issues a private letter ruling that provides that M may take the $2,000 into account prior to first injection.

Example 3. First injection more than 36 months after taxable year. N, a calendar year taxpayer, owns an operating mineral interest in a property on which N undertakes an immiscible carbon dioxide displacement project. In 1994, N incurs $5,000 in connection with the construction of a pipeline to transport carbon dioxide to the project site. The first injection of liquids, gases, or other matter is expected to occur after the pipeline is completed in 1998. Because the first injection of liquids, gases, or other matter occurs more than 36 months after the close of the taxable year in which the $5,000 is incurred, N may take the $5,000 into account in determining the credit only if N receives a private letter ruling from the Internal Revenue Service that provides that N may take the $5,000 into account prior to first injection.

(e) *Other rules*—(1) *Anti-abuse rule.* Costs paid or incurred with respect to an asset that is acquired, used, or transferred in a manner designed to duplicate or otherwise unreasonably increase the amount of the credit are not qualified enhanced oil recovery costs, regardless of whether the costs would otherwise be creditable for a single taxpayer or more than one taxpayer.

(2) *Costs paid or incurred to acquire a project.* A purchaser of an existing qualified enhanced oil recovery project may claim the credit for any section 43 costs in excess of the acquisition cost. However, costs paid or incurred to acquire an existing qualified enhanced oil recovery project (or an interest in an existing qualified enhanced oil recovery project) are not eligible for the credit.

(3) *Examples.* The following examples illustrate the principles of paragraph (e) of this section.

Example 1. Duplicating or unreasonably increasing the credit. O owns an operating mineral interest in a property with respect to which a qualified enhanced oil recovery project is implemented. O acquires pumping units, rods, casing, and separators for use in connection with the project from an unrelated equipment dealer in an arm's length transaction. The equipment is used for the primary purpose of implementing the project. Some of the equipment acquired by O is used equipment. The costs paid by O for the used equipment are qualified enhanced oil recovery costs. O does not need to determine whether the equipment has been previously used in an enhanced oil recovery project.

Example 2. Duplicating or unreasonably increasing the credit. P and Q are co-owners of an oil property with respect to which a qualified enhanced oil recovery project is implemented. In 1992, P and Q jointly purchase a nitrogen plant to supply the tertiary injectant used in the project. P and Q claim the credit for their respective costs for the plant. In 1994, X, a corporation unrelated to P or Q, purchases the nitrogen plant and enters into an agreement to sell nitrogen to P and Q. Because this transaction duplicates or otherwise unreasonably increases the credit, the credit is not allowable for the amounts incurred by P and Q for the nitrogen purchased from X.

Example 3. Duplicating or unreasonably increasing the credit. The facts are the same as in *Example 2.* In addition, in 1995, P and Q reacquire the nitrogen plant from X. This constitutes the acquisition of property in a manner designed to duplicate or otherwise unreasonably increase the amount of the credit. Therefore, the credit is not allowable for amounts incurred by P and Q for the nitrogen plant purchased from X.

Example 4. Duplicating or unreasonably increasing the credit. R owns an operating mineral interest in a property with respect to which a qualified enhanced oil recovery project is implemented. R acquires a pump that is installed at the site of the project. After the pump has been placed in service for 6 months, R transfers the pump to a secondary recovery project and acquires a replacement pump for the tertiary project. The original pump is suited to the needs of the secondary recovery project and could have been installed there initially. The pumps have been acquired in a manner designed to duplicate or otherwise unreasonably increase the amount of the credit. Depending on the facts, the cost of one pump or the other may be a qualified enhanced oil recovery cost; however, R may not claim the credit with respect to the cost of both pumps.

Example 5. Acquiring a project. In 1993, S purchases all of T's interest in a qualified enhanced oil recovery project, including all of T's interest in tangible property that is an integral part of the project and all of T's operating mineral interest. In 1994, S incurs costs for additional tangible property that is an integral part of the project and which is used for the primary purpose of implementing the project. S also incurs costs for tertiary injectants that are injected in connection with the project. In determining the credit for 1994, S may take into account costs S incurred for tangible property and tertiary injectants. However, S may not take into account any amount that S paid for T's interest in the project in determining S's credit for any taxable year.

[T.D. 8448, 57 FR 54927, Nov. 23, 1992; 58 FR 7987, Feb. 11, 1993]

§ 1.43–5 At-risk limitation. [Reserved]

§ 1.43–6 Election out of section 43.

(a) *Election to have the credit not apply*—(1) *In general.* A taxpayer may elect to have section 43 not apply for any taxable year. The taxpayer may revoke an election to have section 43 not apply for any taxable year. An election to have section 43 not apply (or a revocation of an election to have section 43 not apply) for any taxable year is effective only for the taxable year to which the election relates.

(2) *Time for making the election.* A taxpayer may make an election under paragraph (a) of this section to have section 43 not apply (or revoke an election to have section 43 not apply) for any taxable year at any time before the expiration of the 3-year period beginning on the last date prescribed by law (determined without regard to extensions) for filing the return for the taxable year. The time for making the election (or revoking the election) is prescribed by section 43(e)(2) and may not be extended under § 1.9100–1.

(3) *Manner of making the election.* An election (or revocation) under paragraph (a)(1) of this section is made by attaching a statement to the taxpayer's federal income tax return or an amended return (or, in the case of a Coordinated Examination Program taxpayer, on a written statement treated as a qualified amended return) for the taxable year for which the election (or revocation) applies. The taxpayer must indicate whether the taxpayer is electing to not have section 43 apply or is revoking such an election and designate the project or projects to which the election (or revocation) applies. For any taxable year, the last election (or revocation) made by a taxpayer within the period prescribed in paragraph (a)(2) of this section determines whether section 43 applies for that taxable year.

(b) *Election by partnerships and S corporations.* For partnerships and S corporations, an election to have section 43 not apply (or a revocation of an election to have section 43 not apply) for any taxable year is made, in accordance with the requirements of paragraph (a) of this section, by the partnership or S corporation with respect to the qualified enhanced oil recovery costs paid or incurred by the partnership or S corporation for the taxable year to which the election relates.

[T.D. 8448, 57 FR 54930, Nov. 23, 1992]

§1.43–7 Effective date of regulations.

The provisions of §§1.43–1, 1.43–2 and 1.43–4 through 1.43–7 are effective with respect to costs paid or incurred after December 31, 1991, in connection with a qualified enhanced oil recovery project. The provisions of §1.43–3 are effective for taxable years beginning after December 31, 1990. For costs paid or incurred after December 31, 1990, and before January 1, 1992, in connection with a qualified enhanced oil recovery project, taxpayers must take reasonable return positions taking into consideration the statute and its legislative history.

[T.D. 8448, 57 FR 54931, Nov. 23, 1992]

§1.44–1 Allowance of credit for purchase of new principal residence after March 12, 1975, and before January 1, 1977.

(a) *General rule.* Section 44 provides a credit against the tax imposed by chapter 1 of the Internal Revenue Code of 1954 in the case of an individual who purchases a new principal residence (as defined in paragraph (a) of §1.44–5) which is property to which section 44 applies (as provided in §1.44–2). Subject to the limitations set forth in paragraph (b) of this section, the credit is in an amount equal to 5 percent of the purchase price (as defined in paragraph (b) of §1.44–5).

(b) *Limitations*—(1) *Maximum credit.* The credit allowed under section 44 and this section may not exceed $2,000.

(2) *Limitation to one residence.* Such credit shall be allowed with respect to only one residence of the taxpayer; the combined purchase prices of more than one new principal residence cannot be aggregated to increase the credit allowed.

(3) *Married individuals.* In the case of a husband and wife who file a joint return under section 6013, the maximum credit allowed on the joint return is $2,000. In the case of married individuals filing separate returns the maximum credit allowable to each spouse is $1,000. Where a husband and wife do not make equal contributions with respect to the purchase price of the new principal residence, allocation of the credit is to be made in proportion to their respective ownership interests in such residence. For this purpose, tenants by the entirety or joint tenants with right of survivorship are treated as equal owners.

(4) *Certain other taxpayers.* Where a new principal residence is purchased by two or more taxpayers (other than a husband and wife), the amount of the credit allowed will be allocated among the taxpayers in proportion to their respective ownership interests in such residence, with the limitation that the sum of the credits allowed to all such taxpayers shall not exceed $2,000. For this purpose, joint tenants with right of survivorship are treated as equal

owners. For an example of the operation of this provision see *Example (2)* of § 1.44–5(b)(2)(ii).

(5) *Application with other credits.* The credit allowed by this section shall not exceed the amount of the tax imposed by chapter 1 of the Code for the taxable year, reduced by the sum of the credits allowable under—

(i) Section 33 (relating to taxes of foreign countries and possessions of the United States),

(ii) Section 37 (relating to retirement income),

(iii) Section 38 (relating to investment in certain depreciable property),

(iv) Section 40 (relating to expenses of work incentive program),

(v) Section 41 (relating to contributions to candidates for public office), and

(vi) Section 42 (relating to personal exemptions).

[T.D. 7391, 40 FR 55851, Dec. 2, 1975]

§ 1.44–2 Property to which credit for purchase of new principal residence applies.

The provisions of section 44 and the regulations thereunder apply to a new principal residence which satisfies the following conditions:

(a) *Construction.* The construction of the residence must have begun before March 26, 1975. For this purpose construction is considered to have commenced in the following circumstances:

(1)(i) Except as provided in subparagraph (2) of this paragraph, construction is considered to commence when actual physical work of a significant amount has occurred on the building site of the residence. A significant amount of construction requires more than drilling to determine soil conditions, preparation of an architect's sketches, securing of a building permit, or grading of the land. Land preparation and improvements such as the clearing and grading (excavation or filling), construction of roads and sidewalks, and installation of sewers and utilities are not considered commencement of construction of the residence even though they might involve a significant expenditure. However, driving pilings for the foundation, digging of the footings, excavation of the building foundation, pouring of floor slabs, or construction of compacted earthen pads when specifically prepared and designed for a particular residential structure and not merely as a part of the overall land preparation, constitute a significant amount of construction of the residence. In the case of a housing or condominium development construction of recreational facilities no matter how extensive does not by itself constitute commencement of construction of any residential unit. However, where residential units are part of a building structure, as in the case of certain condominium and cooperative housing units, then digging of the footings or excavation of the building foundation constitutes commencement of construction for all units in that building.

(ii) The rules in subdivision (i) of this subparagraph are illustrated by the following examples:

Example 1. A location chosen for a housing development has extremely hilly terrain. In order to make the location suitable for development, the builder moves large amounts of earth and places it elsewhere on the location. In addition, the earth material which has been moved must be compacted according to government specifications in order to provide a stable base. Such activities constitute land preparation and, therefore, do not constitute the commencement of construction.

Example 2. A location chosen for a housing development has swampy and marshy terrain. In order to make the location suitable for development the builder utilizes large quantities of fill. This activity constitutes land preparation and does not constitute commencement of construction.

Example 3. Assume the same facts as in either *Example 1* or *Example 2* except that the builder also constructs an earthen pad of compacted fill specifically prepared for a particular residential structure and not merely as a part of the overall land preparation. Construction of the compacted earthen pad is considered in the same light as excavation of the building foundation and accordingly constitutes commencement of construction.

(2) Construction of a factory-made home (as defined in paragraph (e) of § 1.44–5) is considered to have commenced when construction of important parts of the factory-made home

has commenced. For this purpose, commencement of construction of important parts means the cutting and shaping or welding of structural components for a specific identifiable factory-made home, whether the work was done by the manufacturer of the home or by a subcontractor thereof.

(b) *Acquisition and occupancy.* The residence must be acquired and occupied by the taxpayer after March 12, 1975, and before January 1, 1977. For this purpose a taxpayer ‘‘acquires’’ a residence when legal title to it is conveyed to him at settlement, or he has possession of it pursuant to a binding purchase contract under which he makes periodic payments until he becomes entitled under the contract to demand conveyance of title. A taxpayer ‘‘occupies’’ a residence when he or his spouse physically occupies it. Thus, for example, moving of furniture or other household effects into the residence or physical occupancy by a dependent child of the taxpayer is not ‘‘occupancy’’ for purposes of this paragraph. The credit may be claimed when both the acquisition and occupancy tests have been satisfied. Thus, where a taxpayer meets the acquisition and occupancy tests set forth above after March 12, 1975, and before January 1, 1976, the credit is allowable for 1975. Where a taxpayer occupied a residence prior to March 13, 1975, without having acquired it (as where his occupancy was pursuant to a leasing arrangement pending settlement under a binding contract to purchase or pursuant to a leasing arrangement where a written option to purchase was contained in the original lease agreement) he will nonetheless satisfy the acquisition and occupancy tests set forth above if he acquires the residence and continues to occupy it after March 12, 1975, and before January 1, 1977.

(c) *Binding contract.* Except in the case of self-construction, the new principal residence must be acquired by the taxpayer (within the meaning of paragraph (b) of this section) under a binding contract entered into by the taxpayer before January 1, 1976. An otherwise binding contract for the purchase of a residence which is conditioned upon the purchaser’s obtaining a loan for the purchase of the residence (including conditions as to the amount or interest rate of such loan) is considered binding notwithstanding that condition.

(d) *Self-constructed residence.* A self-constructed residence (as defined in paragraph (d) of §1.44–5) must be occupied by the taxpayer before January 1, 1977. Where self-construction of a principal residence was begun before March 13, 1975, only that portion of the basis of the property allocable to construction after March 12, 1975, and before January 1, 1977, shall be taken into consideration in determining the amount of the credit allowable. For this purpose, the portion of the basis attributable to the pre-March 13 period includes the total cost of land acquired (as defined in paragraph (b) of this section) prior to March 13, 1975, on which the new principal residence is constructed and the cost of expenditures with respect to construction work performed prior to March 13, 1975. The costs incurred in stockpiling materials for later stages of construction, however, are not allocated to the pre-March 13 period. Thus, for example, if prior to March 13, 1975, a taxpayer who qualifies for the credit has constructed a portion of a residence at a cost of $10,000 (including the cost of the land purchased prior to March 13, 1975) and the total cost of the residence is $40,000 and the taxpayer’s basis after the application of section 1034(e) (relating to the reduction of basis of new principal residence where gain is not recognized upon the sale of the old residence) is $36,000, the amount subject to the credit will be $27,000:

$$(\$30{,}000 \div \$40{,}000) \times \$36{,}000.$$

[T.D. 7391, 40 FR 55852, Dec. 2, 1975; 40 FR 58138, Dec. 15, 1975]

§1.44–3 Certificate by seller.

(a) *Requirement of certification by seller.* Taxpayers claiming the credit should attach Form 5405, Credit for Purchase or Construction of New Principal Residence, to their tax returns on which the credit is claimed. Except in the case of self-construction (as defined in §1.44–5(d)), taxpayers must attach a certification by the seller that construction of the residence began before March 26, 1975, and that the purchase price is the lowest price at which the residence was offered for sale after February 28, 1975. For purposes of section 44(e)(4) and this section, the term ''price'' generally does not include costs of acquisition other than the amount of the consideration from the purchaser to the seller. However, for rules relating to adjustments in price due to changes in financing terms and closing costs see paragraph (d)(2) of this section.

(b) *Form of certification.* The following form of the certification statement is suggested:

> I certify that the construction of the residence at (specify address) was begun before March 26, 1975, and that this residence has not been offered for sale after February 28, 1975 in a listing, a written private offer, or an offer by means of advertisement at a lower purchase price than (state price), the price at which I sold the residence to (state name, present address, and social security number of purchaser) by contract dated (give date).
>
> (Date, seller's signature and taxpayer identification number.)

However, any written certification filed by the taxpayer will be accepted provided that such certification is signed by the seller and states that construction of the residence began before March 26, 1975, and that the purchase price of the residence is the lowest price at which the residence was offered for sale after February 28, 1975. With regard to factory-made homes the seller, in the absence of his own knowledge as to the commencement of construction, may attach to his own certification a certification from the manufacturer that construction began before March 26, 1975, and may certify based on the manufacturer's certification. It is suggested that both certifications include the serial number, if any, of the residence.

(c) *Offer to sell.* (1) For purposes of section 44(e)(4) and this section, an offer to sell is limited to an offer to sell a specified residence at a specified purchase price.

(2) An ''offer'' includes any written offer, whether made to a particular purchaser or to the public, and any offer by means of advertising. Advertising includes an offer to sell published by billboards, flyers, brochures, price lists (unless the lists are exclusively for the internal use of the seller and are not made available to the public), mailings, newspapers, periodicals, radio, or television. The listing of a property with a real estate agency, the filing of a prospectus and the registration of construction plans and price lists with the appropriate authorities (in the case of condominiums or cooperative housing developments) are to be considered offers made to the public.

(3) An offer to sell a specified residence includes:

(i) Both an offer to sell an existing residence and an offer to build and sell a residence of substantially the same design or model as that purchased by the taxpayer on the same lot as that on which the taxpayer's new principal residence was constructed. It does not include an offer to sell the same model residence on a different lot. Where a residence of a particular design or model is offered at a specific base price, additions of property to the residence, no matter how extensive, will not result in the residence being treated as a different residence for the purpose of determining the lowest offer (as defined in paragraph (f) of §1.44–5).

(ii) In the case of a condominium or cooperative housing development where units are offered for sale on the basis of models (*e.g.*, all Model C two-bedroom apartments sell at a specified base price), an offer to sell a specified residence includes an offer to sell a specific type of unit (with appropriate adjustments to be made for the location of such unit and as provided in paragraph (d) of this section).

(iii) In the case of a factory-made home, an offer to sell a specified residence includes an offer to sell the same model home as that purchased by the taxpayer, provided that the offer is made after the seller has the right to sell the home purchased by the taxpayer (*i.e.*, has that specific home in his inventory). However, it does not include an offer to sell such home with land which is not included in the taxpayer's purchase nor an offer to sell such home without land which is included in the taxpayer's purchase. Appropriate adjustments to a prior offer shall be made as provided in paragraph

(d) of this section, including adjustments for any delivery and installation charges as provided in paragraph (d)(3).

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

Example 1. In March 1975 A advertised colonial-style homes on section I of subdivision C at a base price of $40,000. At the time none of the homes had been completed but construction of all homes on section I was commenced before March 26, 1975. After one-half of the homes were sold, A offers to sell the remaining homes in May 1975 at a base price of $45,000. Under the facts above the base price of $45,000 is not the lowest offer since the seller had offered to sell the same model home on the same lot at a lower purchase price after February 28, 1975.

Example 2. In June 1975 A offers houses, otherwise qualifying, on section II for the first time for a base price of $50,000. They are colonial homes and substantially the same as the homes he previously offered on section I. Under the facts stated above the base price of $50,000 is the lowest offer since the same model home on the same lot was not previously offered for sale.

Example 3. In March 1975 B, a condominium developer, offers to sell any two-bedroom unit in a particular high rise condominium for $45,000 with an added $5,000 for units with a lakefront view and an additional $2,000 for units on higher floors. With regard to all two-bedroom units in the condominium an offer to sell a specified residence at a specified purchase price has been made. This is true even though at the time of the offer construction had not reached the floor on which the particular unit will be located.

(4) A specified purchase price means a stated definite price for a particular residence or a specific base price for a residence of a particular model or design. An offer to sell for an indefinite price (*e.g.*, an advertisement that all houses sell in the $40,000's) is not considered an offer to sell at a specified purchase price.

(5) An offer to sell includes an offer to sell subject to special conditions imposed by the seller. Thus, if the lowest price at which a house was advertised was ''at $40,000 for March only'', the $40,000 price would be the lowest offer. However, certain conditions may necessitate adjustments in determining the lowest offer. See paragraph (d) of this section.

(6) An offer to sell two or more residences together as for example, in a bulk sale shall be disregarded, even though each residence is assigned a specific purchase price for the purpose of such a sale. With regard to factory-made homes an offer to sell does not include an offer made by the manufacturer to a dealer in such homes.

(7)(i) Where new residences are purchased at a foreclosure sale (including a conveyance by the owner in lieu of foreclosure) and prior to the foreclosure sale such residences had been offered for sale by the foreclosure seller at specified prices, the foreclosure purchaser is bound by such prices in determining the lowest offer. He is not bound by the prices paid to the foreclosure seller since such prices do not constitute voluntary offers.

(ii) For this purpose, if the foreclosure seller and foreclosure purchaser are not related parties (as defined in subdivision (iii) of this subparagraph), and if the foreclosure purchaser does not have knowledge of the date of commencement of construction and the lowest offer made by such seller with respect to each of the foreclosed residences, the foreclosure purchaser must request and try to obtain from the foreclosure seller a certificate specifying such facts. Upon a subsequent sale of a particular residence by the foreclosure purchaser, he must certify whether the price is the lowest offer for that particular residence based on the certification of the foreclosure seller, a copy of which must be attached to the certification of the foreclosure purchaser. If the foreclosure seller refuses to so certify, the foreclosure purchaser must make a reasonable effort to determine the date construction commenced and the lowest offer made by the foreclosure seller. For this purpose, reasonable effort includes the effort to locate and examine advertising and listings published or used by the foreclosure seller. If the foreclosure seller and foreclosure purchaser are related parties (as defined in subdivision (iii) of this subparagraph), the foreclosure purchaser will be considered as having knowledge of the date of the commencement of construction and the lowest offer made by such seller with respect to each of the foreclosed residences, and, upon a subsequent sale of a particular residence by the foreclosure purchaser, he must comply with the certification requirements prescribed by paragraphs (a) and (b) of this section.

(iii) For purposes of this subparagraph related parties shall include the relationships described in subparagraph (2) of § 1.44–5(c), and the constructive ownership rules of section 318 shall apply, but family members for this purpose shall include spouses, ancestors, and lineal descendants.

(d) *Adjustments in determining lowest price.* (1)(i) In determining whether a residence was sold at the lowest offer appropriate adjustment shall be made for differences in the property offered and in the terms of the sale. Where the sale to the taxpayer includes property which was not the subject of the prior offer or excludes property which was included in the prior offer, the amount of the prior offer shall be adjusted to reflect the fair market value of such property, provided that, in the case of property included in the sale which was not a part of the residence at the time of execution of the contract of purchase, the taxpayer had the option to require inclusion or exclusion of such property. The fair market value of any excluded property is to be determined at the time of the prior offer, while all additions are to be valued at their fair market value on the date of execution of the contract of sale. If a seller increases his present offer to include financing or other costs of the seller in connection with his ownership of the residence, the present offer does not qualify as being the lowest offer.

(ii) The rules in subdivision (i) of this subparagraph are illustrated by the following examples:

Example 1. A offered to sell a new home without a garage for $35,000. Having found no buyers A added a garage and sold the home for $40,000. At the time the contract of sale was executed the fair market value of the garage was $5,000. The offer to sell for $40,000 qualifies since it equals the seller's lowest offer plus the fair market value of the garage.

Example 2. B, unable to sell colonial-style homes presently under construction and previously offered for sale for $40,000, makes extensive changes in decor and identifies the homes as his new Williamsburg model. The Williamsburg models are not different residences for purposes of this section. To the extent that the additions have not yet been added at the time of execution of a contract of sale, in order to qualify for the credit the taxpayer must have the option as to whether to include these additions, and if these additions are included B must charge no more than the fair market value of the additions on that date of execution of the contract of sale.

(2) Appropriate adjustment to a prior offer to sell shall be made for differences in financing terms and closing costs which increase the seller's actual net proceeds and the purchaser's actual costs. A seller may pass on to the purchaser without affecting the purchase price only those additional amounts he is required to expend in connection with such differences. The seller may not by changing the financing terms or closing costs indirectly increase the purchase price. For these purposes closing costs include all charges paid at settlement for obtaining the mortgage loan and transferring real estate title. Thus, for example, where a seller previously offered a residence for sale for $40,000 and agreed to pay financing ‘‘points’’ required by the mortgagee, and now offers the same residence also for $40,000 but requires the purchaser to pay the points, the present offer does not constitute the lowest offer. On the other hand, a prior offer to sell based upon a large down payment by the prospective purchaser may be adjusted to reflect the additional costs to the seller of accepting a small down payment from the taxpayer. For purposes of determining the seller's net proceeds, proceeds received by all related parties within the meaning of section 318 must be taken into account. For purposes of determining the lowest offer, where an offer provided for a rebate (*e.g.*, of cash or of a contribution toward mortgage payments) or included, without additional charge or at less than fair market value, property not normally included in the sale of a residence (*e.g.*, an automobile), such offer must be reduced by the amount of such rebate or by the amount by which the fair market value of such property at the time of the offer exceeds the amount paid for it by the purchaser. Thus, where a residence was advertised for sale at $40,000, but the seller agreed to pay $200 a month on the purchaser's mortgage

for 10 months, such residence is considered to have been offered for sale at $38,000.

(3) In the case of a factory-made home, where delivery and installation costs are included in the specified base price of such home an appropriate adjustment is to be made in such specified base price for differences in the fair market value of the delivery and installation in determining the lowest offer.

(e) *Civil and criminal penalties.* If a person certifies that the price for which the residence was sold does not exceed the lowest offer and if it is found that the price for which the residence was sold exceeded the lowest offer, then such person is liable (under section 208(b) of the Tax Reduction Act of 1975) to the purchaser for damages in an amount equal to three times the excess of the certified price over the lowest offer plus reasonable attorney's fees. No income tax deduction shall be allowed for two-thirds of any amount paid or incurred pursuant to a judgment entered against any person in a suit based on such liability. However, attorney's fees, court costs, and other such amounts paid or incurred with respect to such suit which meet the requirements of section 162 are deductible under that section. In addition, an individual who falsely certifies may be subject to criminal penalties. For example, section 1001 of Title 18 of the United States Code provides as follows:

§1001 Statements or entries generally.

Whoever, in any matter within the jurisdiction of any department or agency of the United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined not more than $10,000 or imprisoned not more than five years, or both.

The treble damages and criminal sanctions provided under this paragraph apply only with regard to false certification as to the lowest offer, not to false certification as to commencement of construction. However, with regard to false certification as to commencement of construction there may exist contractual or tort remedies under State law.

(f) *Denial of credit.* In the absence of the taxpayer's participation in, or knowledge of, a false certification by the seller, the credit is not denied to a taxpayer who otherwise qualifies for the credit solely because the seller has falsely certified that the new principal residence was sold at the lowest offer. However, if certification as to the commencement of construction is false, no credit is allowed since such residence does not qualify as a new principal residence construction of which began before March 26, 1975.

[T.D. 7391, 40 FR 55852, Dec. 2, 1975]

§1.44–4 Recapture for certain dispositions.

(a) *In general.* (1) Under section 44(d) except as provided in paragraphs (b) and (c) of this section, if the taxpayer disposes of property, with respect to the purchase of which a credit was allowed under section 44(a), at any time within 36 months after the date on which he acquired it (or, in the case of construction by the taxpayer, the date on which he first occupied it as his principal residence), then the tax imposed under chapter 1 of the Code for the taxable year in which the replacement period (as provided under subparagraph (2) of this paragraph) terminates is increased by an amount equal to the amount allowed as a credit for the purchase of such property.

(2) The replacement period is the period provided for purchase of a new principal residence under section 1034 of the Code without recognition of gain on the sale of the old residence. In the case of residences sold or exchanged after December 31, 1974, it is generally 18 months in the case of acquisition by purchase and 2 years in the case of construction by the taxpayer provided, however, that such construction has commenced within the 18-month period. Thus, a calendar-year taxpayer who disposes of his old principal residence in December 1975 and does not qualify under paragraph (b) or (c) of this section will include the amount previously allowed as additional tax on his 1977 tax return.

(3) Except as provided in paragraphs (b) and (c) of this section, section 44(d)

applies to all dispositions of property, including sales (including foreclosure sales), exchanges (including tax-free exchanges such as those under sections 351, 721, and 1031), and gifts.

(4) In the case of a husband and wife who were allowed a credit under section 44(a) claimed on a joint return, for the purpose of section 44(d) and this section the credit shall be allocated between the spouses in accordance with the provisions of paragraph (b)(3) of § 1.44–1.

(b) *Acquisition of a new residence.* (1) Section 44(d)(1) and paragraph (a) of this section shall not apply to a disposition of property with respect to the purchase of which a credit was allowed under section 44(a) in the case of a taxpayer who purchases or constructs a new principal residence (within the meaning of § 1.44–5(a)) within the applicable replacement period provided in section 1034. In determining whether a new principal residence qualifies for purposes of this section the rules relating to construction, acquisition, and occupancy under § 1.44–2 do not apply. Where a disposition has occurred and the taxpayer's purchase (or construction) costs of a new principal residence are less than the adjusted sales price (as defined in section 1034(b)) of the old residence, the tax imposed by chapter 1 of the Code for the taxable year following the taxable year during which disposition occurs is increased by an amount which bears the same ratio to the amount allowed as a credit for the purchase of the old residence as (i) the adjusted sales price of the old residence (within the meaning of section 1034), reduced (but not below zero) by the taxpayer's cost of purchasing (or constructing) the new residence (within the meaning of such section) bears to (ii) the adjusted sales price of the old residence.

(2) The rules of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. On July 15, 1975, A purchases a new principal residence for a total purchase price of $40,000. The property meets the tests of § 1.44–2, and A is allowed a credit of $2,000 on his 1975 tax return. On January 15, 1977 (within 36 months after acquisition) A sells his residence for an adjusted sales price of $50,000 and on March 15, 1977, purchases a new principal residence at a cost of $40,000. Since the new principal residence was purchased within the 18-month replacement period (provided in section 1034), the amount recaptured is limited to $400, determined by multiplying the amount of the credit allowed ($2,000) by a fraction, the numerator of which is $10,000 (determined by reducing the adjusted sales price of the old residence ($50,000) by A's cost of purchasing the new principal residence ($40,000)) and the denominator of which is $50,000 (the adjusted sales price). Therefore, A's tax liability for 1978, the year following the taxable year in which the disposition occurred, is increased by $400.

(c) *Certain involuntary dispositions.* Section 44(d)(1) and paragraph (a) of this section shall not apply to the following:

(1) A disposition of a residence made on account of the death of any individual having a legal or equitable interest therein occurring during the 36-month period described in paragraph (a) of this section,

(2) A disposition of the residence if it is substantially or completely destroyed by a casualty described in section 165(c)(3),

(3) A disposition of the residence if it is compulsorily and involuntarily converted within the meaning of section 1033(a), or

(4) A disposition of the residence pursuant to a settlement in a divorce or legal separation proceeding where the other spouse retains the residence as principal residence (as defined in § 1.44–5(a)).

[T.D. 7391, 40 FR 55854, Dec. 2, 1975; 40 FR 58138, Dec. 15, 1975]

§ 1.44–5 Definitions.

For purposes of section 44 and the regulations thereunder—

(a) *New principal residence.* The term ''new principal residence'' means a principal residence, the original use of which commences with the taxpayer. The term ''principal residence'' has the same meaning as under section 1034 of the Code. For this purpose, the term ''residence'' includes, without being limited to, a single family structure, a residential unit in a condominium or cooperative housing project, a townhouse, and a factory-made home. In the case of a tenant-stockholder in a cooperative housing corporation references to property used by the taxpayer as his principal residence and references to the residence of a taxpayer shall include stock held by the tenant-stockholder in a cooperative housing project provided, however, that the taxpayer used as his principal residence the house or apartment which he was entitled as such stockholder to occupy. ‘‘Original use’’ of the new principal residence by the taxpayer means that such residence has never been used as a residence prior to its use as such by the taxpayer. For this purpose, a residence will qualify if the first occupancy was by the taxpayer pursuant to a lease arrangement pending settlement under a binding contract to purchase or pursuant to a lease arrangement where a written option to purchase the then existing residence was contained in the original lease agreement.

A renovated building does not qualify as new, regardless of the extent of the renovation nor does a condominium conversion qualify.

(b) *Purchase price*—(1) *General rule.* For purposes of section 44(a) and §1.44–1, the term ‘‘purchase price’’ means the adjusted basis of the new principal residence on the date of acquisition and includes all amounts attributable to the acquisition or construction, but only to the extent that such amounts constitute capital expenditures and are not allowable as deductions in computing taxable income. Such capital expenditures include but are not limited to the cost of acquisition or construction, title insurance, attorney’s fees, transfer taxes, and other costs of transfer. For these purposes the adjusted basis of a factory-made home includes the cost of moving the home and setting it up as the taxpayer’s principal residence only where such cost is included in the base price of the residence; it also includes the purchase price of the land on which the home is located, but only if such land was purchased by the taxpayer after March 12, 1975 and only if the taxpayer acquired the land prior to or in conjunction with the acquisition of such factory-made home. However, the adjusted basis does not include any expenditures involved in connection with the leasing of land on which the factory-made home is located. In the case of factory-made homes the adjusted basis includes furniture only where it is included in the base price of the unit.

(2) *Sale of old principal residence.* (i) The adjusted basis is reduced by any gain from the sale or involuntary conversion of an old principal residence, which is not recognized due to the application of section 1033 or section 1034. However, no reduction will be made for any gain excluded from tax by reason of the special treatment provided under the tax laws in the case of a sale by a taxpayer who has attained age 65 (section 121 of the code).

(ii) The rules in subdivision (i) of this subparagraph are illustrated by the following examples:

Example 1. A sells an old principal residence for $30,000 which has an adjusted basis of $20,000. A reinvests the proceeds by purchasing a new principal residence for $40,000 (including settlement costs which are capital in nature), and this purchase satisfies the statutory criteria under section 1034 for nonrecognition of gain. The credit under section 44 applies with respect to $30,000 ($40,000 costs minus $10,000 unrecognized gain) of the cost of the new principal residence.

Example 2. B and C, two sisters, purchase a new principal residence as joint tenants with the right of survivorship for a total purchase price of $40,000. B has previously sold her old principal residence for $25,000 and a $10,000 gain on the sale has qualified for nonrecognition under section 1034. B contributes $25,000 and C contributes $15,000. The adjusted basis of the new principal residence is $30,000 representing the total purchase price of $40,000 less $10,000 representing unrecognized gain under section 1034. The total credit allowable, therefore, is $1,500. Since joint tenants are treated as equal owners and since allocation of the credit is made in proportion to the taxpayer’s respective ownership interests in such residence B and C each will receive a credit of $750.

Example 3. Taxpayer D is 65 years old and sells his old principal residence for $20,000 excluding all gain under section 121. He then purchases a new principal residence for $30,000. D’s adjusted basis in his new principal residence is $30,000, and he is allowed a credit of $1,500.

(3) *Tie-in sales.* In the case of a purchase of a new principal residence which is tied in to the transfer of other property by the seller to the purchaser, whether purportedly by sale or gift, the adjusted basis of the residence is reduced by the amount of the excess of the fair market value of such other

property received over the amount, if any, purportedly paid for it by the purchaser of the residence. For example, if a taxpayer receives a new car with a fair market value of $2,500 upon the purchase of a condominium apartment for a total purchase price of $40,000 (including settlement costs which are capital in nature) his adjusted basis in the residence for computation of the credit is $37,500.

(4) *Basis of new principal residence.* The taxpayer's basis in his new principal residence is not in any way affected by the allowance of the credit.

(c) *Purchase*—(1) *General rule.* Except as provided in subparagraph (2) of this paragraph, the term ''purchase'' means any acquisition of property.

(2) *Exceptions.* (i) An acquisition does not qualify as a purchase for the purpose of this paragraph if the property is acquired from a person whose relationship to the person acquiring it would result in the disallowance of losses under section 267 or 707(b). Such persons include—

(A) The purchaser's spouse, ancestors and lineal descendants,

(B) Related corporations as provided under section 267(b)(2),

(C) Related trusts as provided under section 267(b), (4), (5), (6), and (7),

(D) Related charitable organizations as provided under section 267(b)(9), and

(E) Related partnerships as provided under section 707(b)(1).

For purposes of this subdivision the constructive ownership rules of section 267(c) shall apply except that paragraph (4) of section 267(c) shall be treated as providing that the family of an individual shall include only his spouse, ancestors, and lineal descendants.

(ii) An acquisition does not qualify as a purchase for the purpose of this paragraph if the basis of the property in the hands of the person acquiring such property is determined—

(A) In whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired (*e.g.*, a gift under section 1015), or

(B) Under section 1014(a) (relating to property acquired from a decedent).

(d) *Self-construction.* The term ''self-construction'' means the construction of a residence (other than a factory-made home) to the taxpayer's specifications on land already owned or leased by the taxpayer at the time of commencement of construction. Thus, where a taxpayer purchases land and either builds a residence himself or hires an architect and a contractor to build a residence on that land, the taxpayer has ''self-constructed'' the residence.

(e) *Factory-made home.* The term ''factory-made homes'' includes mobile homes, houseboats and prefabricated and modular homes.

(f) *Lowest offer.* The term ''lowest offer'' means the lowest price at which the residence was offered for sale after February 28, 1975.

[T.D. 7391, 40 FR 55855, Dec. 2, 1975]

§ 1.44A–1 Expenses for household and dependent care services necessary for gainful employment.

(a) *In general.* (1) This section applies only for expenses incurred in taxable years beginning after December 31, 1975. For deductibility of expenses incurred in taxable years beginning before January 1, 1972, see § 1.214–1. For deductibility of expenses incurred in taxable years beginning after December 31, 1971, and before January 1, 1976, see §§ 1.214A–1 through 1.214A–5.

(2) Section 44A allows a credit against the tax imposed by chapter 1 of the Code to an individual who maintains a household (within the meaning of paragraph (d) of this section) which includes as a member one or more qualifying individuals (as defined in paragraph (b) of this section). The amount of the credit is equal to the applicable percentage of the employment-related expenses (as defined in paragraph (c) of this section) paid by the individual during the taxable year (but subject to the limits prescribed in § 1.44A–2(a)). However, the credit cannot exceed the tax imposed by chapter 1, reduced by the sum of the allowable credits enumerated in section 44A(b). The term ''applicable percentage'' means 30 percent reduced by 1 percentage point for each $2,000 (or fraction thereof) by which the taxpayer's adjusted gross income for the taxable year exceeds $10,000, but in no event

shall the percent be less than 20 percent. Thus, for example, if a taxpayer's adjusted gross income is over $10,000, but less than $12,000.01, the applicable percentage is 29 percent. (For expenses incurred in taxable years beginning before January 1, 1982, the applicable percentage is a flat 20 percent).

(3) Generally, the credit for employment-related expenses is allowable, regardless of the taxpayer's method of accounting, only for expenses which are actually paid during the taxable year and which are incurred during the taxable year or were incurred during a prior taxable year beginning after December 31, 1975. If the expenses are incurred but not paid during the taxable year, no credit may be taken for that year on account of those expenses. Thus, if an expense is incurred in the last month of a taxable year but not paid until the following taxable year, a credit for the expense is not allowed for the earlier taxable year but is allowed for the following taxable year. However, if an expense is incurred in a taxable year beginning before January 1, 1976, and paid in a later taxable year, no credit is allowed with respect to the expense under section 44A. Section 214 and the regulations thereunder are applicable in determining whether a deduction for the expense is allowed in the year of payment.

(4) Since an expense cannot be an employment-related expense until the services for which the expense was incurred are performed (see paragraph (c) of this section), prepaid expenses may be claimed only in the taxable year in which the services are performed.

(5) The requirements of section 44A, this section and §§1.44A–2 through 1.44A–4 are applied to expenses as of the time they are incurred regardless of when they are paid.

(6) For special rules relating to employment-related expenses which also qualify as medical expenses deductible under section 213, see §1.44A–4(b).

(7) For substantiation of the credit, see paragraph (e) of this section.

(b) *Qualifying individual*—(1) *In general.* A person is considered to be a qualifying individual if he or she is—

(i) The taxpayer's dependent who is under the age of 15 and is an individual for whom the taxpayer is entitled to a deduction for a personal exemption under section 151(e);

(ii) The taxpayer's dependent (not described in subdivision (i)) who is physically or mentally incapable of self-care; or

(iii) The taxpayer's spouse who is physically or mentally incapable of self-care.

The term "dependent," as used in this paragraph (b)(1), includes any individual who is a dependent within the meaning of section 152. However, see paragraph (b)(2) of this section for special rules for determining which parent may treat a child as a qualifying individual where the parents are divorced, legally separated, or separated under a written separation agreement.

(2) *Special dependency test in case of divorced or separated parents.* A child (as defined in section 151(e)(3)) who—

(i) Is under age 15 or is physically or mentally incapable of self-care,

(ii) Receives over half of his or her support during the calendar year from his or her parents who are divorced or legally separated under a decree of divorce or separate maintenance or who are separated under a written separation agreement, and

(iii) Is in the custody of one or both of his or her parents for more than one-half of the calendar year,

is treated for any taxable year beginning in the calendar year as a qualifying individual (described in subdivision (i) or (ii), as the case may be, of paragraph (b)(1) of this section) of that parent who has custody for a longer period during the calendar year than the other parent. Accordingly, a child may be treated as a qualifying individual of a parent even though the parent is not entitled to a dependency exemption for the child. The child cannot be treated as a qualifying individual with respect to more than one parent.

(3) *Qualification on a daily basis.* The status of a person as a qualifying individual is determined on a daily basis. Thus, if a dependent or spouse of a taxpayer ceases to be a qualifying individual on September 16, the dependent or spouse is treated as a qualifying individual through September 15 only.

(4) *Physical or mental incapacity.* An individual is considered to be physically or mentally incapable of self-

care if as a result of a physical or mental defect the individual is incapable of caring for his or her hygienical or nutritional needs, or requires full-time attention of another person for his or her own safety or the safety of others. The fact that an individual, by reason of a physical or mental defect, is unable to engage in any substantial gainful activity, or is unable to perform the normal household functions of a homemaker or to care for minor children, does not of itself establish that the individual is physically or mentally incapable of self-care. An individual who is physically handicapped or is mentally defective, and for such reason requires constant attention of another person, is considered to be physically or mentally incapable of self-care.

(c) *Employment-related expenses*—(1) *Gainful employment*—(i) *In general.* Expenses are considered to be employment-related expenses only if they are incurred to enable the taxpayer to be gainfully employed and are paid for household services or for the care of one or more qualifying individuals. The expenses must be incurred while the taxpayer is gainfully employed or is in active search of gainful employment. The employment may consist of service either within or without the home of the taxpayer and may include self-employment. An expense is not considered to be employment-related merely because it is incurred while the taxpayer is gainfully employed. The purpose of the expense must be to enable the taxpayer to be gainfully employed. Volunteer work for a nominal salary does not constitute gainful employment. Whether the purpose of an expense is to enable the taxpayer to be gainfully employed depends upon the facts and circumstances of the particular case. Any tax required to be paid by the taxpayer under section 3111 (relating to the Federal Insurance Contributions Act) and 3301 (relating to the Federal Unemployment Tax Act), or under similar State payroll taxes, in respect of any wages which otherwise constitute employment-related expenses is considered to be an employment-related expense.

(ii) *Determination of period of employment on a daily basis.* An allocation of expenses is required on a daily basis when the expenses cover any period during part of which the taxpayer is gainfully employed or is in active search of gainful employment and during the other part of which there is no employment or active search for gainful employment. Thus, for example, if a taxpayer incurs during each month of the taxable year $60 of expenses which would be employment-related if he or she were gainfully employed all year, and the taxpayer is gainfully employed, or in active search of gainful employment, for only 2 months and 10 days during such year, the amount of employment-related expenses is limited to $140.

(2) *Household services.* Expenses are considered to be paid for household services if they are paid for the performance in and about the taxpayer's home of ordinary and usual services necessary to the maintenance of the household. However, expenses are not considered as paid for household services unless the expenses are attributable in part to the care of the qualifying individual. Thus, amounts paid for the services of a domestic maid or cook are considered to be expenses paid for household services if a part of those services is provided to the qualifying individual. Amounts paid for the services of an individual who is employed as a chauffeur, bartender, or gardener, however, are not considered to be expenses paid for household services.

(3) *Care of qualifing individual*—(i) *In general.* The primary purpose of expenses for the care of a qualifying individual must be to assure that individual's well-being and protection. Not all benefits bestowed upon a qualifying individual are considered as provided for the individual's care. Accordingly, amounts paid to provide food, clothing, or education are not expenses paid for the care of a qualifying individual. However, where the manner of providing care is such that the expense which is incurred includes expenses for other benefits which are incident to and inseparably a part of the care, the full amount of the expense is considered to be incurred for care. Thus, for example, the full amount paid to a nursery school in which a qualifying child is enrolled is considered as being for the care of the child, even though

the school also furnishes lunch and educational services. Educational expenses incurred for a child in the first or higher grade level are not expenses incurred for the care of a qualifying individual. Expenses incurred for transportation of a qualifying individual described in paragraph (b)(1)(i) of this section between the taxpayer's household and a place outside the taxpayer's household where services for the care of the qualifying individual are provided are not incurred for the care of a qualifying individual.

(ii) *Manner of providing care.* The manner of providing the care need not be the least expensive alternative available to the taxpayer. For example, the taxpayer's mother may reside at the taxpayer's home and be available to provide adequate care at no cost for the taxpayer's wife who is physically or mentally incapable of caring for herself. Nevertheless, the expenses incurred in providing a nurse for the wife may be an expense for the care of the wife. See paragraph (c)(1)(i) of this section with respect to the requirement that the expense must be for the purpose of permitting the taxpayer to be gainfully employed.

(4) *Services outside the taxpayer's household.* The credit is allowed under section 44A with respect to employment-related expenses incurred for services performed outside the taxpayer's household only if those expenses are incurred for the care of—

(i) One or more qualifying individuals who are described in paragraph (b)(1)(i) of this section; or

(ii) One or more qualifying individuals (as to expenses incurred for taxable years beginning after December 31, 1981) who are described in paragraph (b)(1) (ii) or (iii) of this section and who regularly spend at least 8 hours each day in the taxpayer's household.

(5) *Dependent care centers.* The credit is allowed under section 44A with respect to employment-related expenses incurred in taxable years beginning after December 31, 1981, for services provided outside the taxpayer's household by a dependent care center only if—

(i) The center complies with all applicable laws and regulations of a State or unit of local government (*e.g.,* State or local requirements for licensing, if applicable, and building and fire Code regulations); and

(ii) The requirement provided in paragraph (c)(4)(i) or (ii) of this section is met.

The term ''dependent care center'' means any facility that provides full-time or part-time care for more than six individuals (other than residents of the facility) on a regular basis during the taxpayer's taxable year, and receives a fee, payment, or grant for providing services for any such individuals (regardless of whether such facility is operated for profit). For purposes of the preceding sentence, a facility will be presumed to provide full-time or part-time care for six or less individuals on a regular basis during the taxpayer's taxable year if the facility has six or less individuals (including the qualifying individual) enrolled for full-time or part-time care on the day the qualifying individual is enrolled in the facility (or on the first day of the taxable year the qualifying individual attends the facility in the case where the individual was enrolled in the facility in the preceding taxable year) unless the Internal Revenue Service demonstrates that the facility provides full-time or part-time care for more than six individuals on a regular basis during the taxpayer's taxable year.

(6) *Allocation of expenses.* Where a portion of an expense is for household services or for the care of a qualifying individual and a portion of such expense is for other purposes, a reasonable allocation must be made and only the portion of the expense paid which is attributable to such household services or care is considered to be an employment-related expense. No allocation is required to be made, however, if the portion of expense for the other purpose is minimal or insignificant. An allocation must be made, for example, if a servant performs household duties, cares for the qualifying children of the taxpayer, and also performs social services for the taxpayer (for which a deduction is not allowable) or clerical services in the office of the taxpayer outside the home (for which a deduction may be allowable under section 162). Employment-related expenses include household service expenses which

are provided in conjunction with the care of a qualifying individual. Thus, if an expense is in part attributable to the care of a qualifying individual and in part to household services, no allocation is required.

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

Example 1. The taxpayer lives with her mother who is physically incapable of caring for herself. In order to be gainfully employed the taxpayer hires a practical nurse whose sole duty consists of providing for the care of the mother in the home while the taxpayer is at work. All amounts spent for the services of the nurse are employment-related expenses.

Example 2. The taxpayer has a dependent child 10 years of age who has been attending public school. The taxpayer, who has been working part time, is offered a position involving full-time employment which she can accept only if the child is placed in a boarding school. The taxpayer accepts the position and the child is sent to a boarding school. The expenses paid to the school must be allocated between that part of the expenses which represents care for the child and that part which represents tuition for education. The part of the expense representing care of the child is incurred for the purpose of permitting the taxpayer to be gainfully employed.

Example 3. The taxpayer, in order to be gainfully employed, employs a full-time housekeeper who cares for the taxpayer's two children, aged 9 and 15 years, respectively, performs regular household services of cleaning and cooking, and chauffeurs the taxpayer to and from his place of employment. The chauffeuring service never requires more than 30 minutes out of the total period of employment each day. No allocation is required for purposes of determining the portion of the expense attributable to the chauffeuring (not a household service expense) since it is *de minimis.* Further, no allocation is required for the purpose of determining the portion of the expense attributable to the care of the 15-year-old child (not a qualifying individual) since the household expense is in part attributable to the care of the 9-year-old child, who is a qualifying individual. Accordingly, the entire expense of employing the housekeeper is an employment-related expense. However, the total amount of employment-related expenses taken into account would be limited to the amount allowable for one qualifying individual.

(d) *Maintenance of a household*—(1) *In general.* An individual is considered to have maintained a household for the taxable year (or lesser period) only if the individual (and his or her spouse if the individual is married) have furnished over one-half of the cost incurred for such taxable year (or lesser period) in maintaining the household. The household must actually constitute for the taxable year the principal place of abode of the taxpayer and the qualifying individual or individuals described in paragraph (b) of this section. It is not sufficient that the taxpayer maintain the household without being its occupant. A physical change in the location of the home does not, however, prevent the home from constituting the principal place of abode of the taxpayer and a qualifying individual. The fact that an individual is born or dies during the taxable year does not prevent a home from constituting his or her principal place of abode for such year. An individual is not considered to have terminated a household as his or her principal place of abode merely by reason of temporary absences therefrom by reason of illness, education, business, vacation, military service, or a custody agreement.

(2) *Two or more families.* Solely for purposes of section 44A and this section, if two or more families occupy living quarters in common, each of the families is treated as constituting a separate household, and the taxpayer who provides more than one-half of the costs of maintaining such a separate household is treated as maintaining that household. Thus, for example, if two unrelated taxpayers each with children occupy living quarters in common and each taxpayer pays more than one-half of the household costs incurred by each respective family, each taxpayer will be treated as maintaining a separate household.

(3) *Costs of maintaining a household.* The costs of maintaining a household are the expenses incurred for the mutual benefit of the occupants thereof by reason of its operation as the principal place of abode of the occupants. The expenses of maintaining a household include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food

consumed on the premises. These expenses do not include the cost of clothing, education, medical treatment, vacations, life insurance, or transportation or payments on mortgage principal or for the purchase, permanent improvement, betterment, or replacement of property. Further, the costs of maintaining a household do not include the value of services performed in the household by a qualifying individual described in paragraph (b) of this section. An expense incurred by a taxpayer which is paid or reimbursed by another is not considered as a cost of maintaining a household.

(4) *Monthly proration of annual costs.* In determining the cost incurred for a period of less than a taxable year in maintaining a household, the cost incurred during the entire taxable year must be prorated on the basis of the number of calendar months within such lesser period. For this purpose a period of less than a calendar month will be treated as a calendar month. Thus, for example, if the cost of maintaining a household for a taxable year is $6,600, and the period in respect of which a determination is being made under section 44A is from June 20 to December 31, the taxpayer must furnish more than $1,925 ([$6,600×7⁄12]×50 percent) in maintaining the household from June 1 to December 31.

(e) *Substantiation.* A taxpayer claiming a credit under paragraph (a) of this section for employment-related expenses must substantiate by adequate records or other sufficient evidence any credit taken under this section. For example, if requested, the taxpayer must furnish information as to the nature and period of the physical or mental incapacity of any dependent or spouse in respect of whom a credit is claimed, including necessary information from the attending physician as to the nature of the physical or mental incapacity.

(Secs. 44A(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1565, 26 U.S.C. 44A(g); 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7643, 44 FR 50332, Aug. 28, 1979, as amended by T.D. 7951, 49 FR 18091, Apr. 27, 1984]

§1.44A–2 Limitations on amount creditable.

(a) *Annual dollar limit on amount creditable.* The amount of the employment-related expenses incurred during any taxable year which may be taken into account under §1.44A–1 (a) cannot exceed—

(1) $2,400 ($2,000 in the case of expenses incurred in taxable years beginning before January 1, 1982) if there is one qualifying individual with respect to the taxpayer at any time during the taxable year, or

(2) $4,800 ($4,000 in the case of expenses incurred in taxable years beginning before January 1, 1982) if there are two or more qualifying individuals with respect to the taxpayer at any one time during the taxable year.

For example, a calendar year taxpayer whose only qualifying individual reaches age 15 on April 1, 1982, is subject for 1982 to the entire annual dollar limit of $2,400, without proration of the $2,400 limit. However, only expenses incurred prior to the child's 15th birthday may be employment-related expenses.

(b) *Earned income limitation*—(1) *In general.* The amount of employment-related expenses incurred during any taxable year which may be taken into account under §1.44A–1(a) cannot exceed—

(i) For an individual not married at the close of the year, the individual's earned income for the year, or

(ii) For an individual married at the close of the year, the lesser of the individual's earned income or the earned income of his or her spouse for the year.

For purposes of this paragraph (b)(1), the earned income of only the spouse to whom the taxpayer is married at the close of the year is taken into account (and not the earned income of another spouse who died or was divorced from the taxpayer during the year). Further, the spouse's earned income for the entire year is taken into account, even though the taxpayer and his or her spouse were married for only a part of the year. For purposes of this paragraph (b), certain married individuals legally separated or living apart are treated as not married (see § 1.44A–3 (b) and (c), respectively).

(2) *Earned income.* For purposes of this section, earned income means—

(i) Wages, salaries, tips, other employee compensation, and

(ii) Net earnings from self-employment (within the meaning of section 1402(a) and the regulations thereunder).

For taxable years beginning before January 1, 1979, earned income includes only amounts described in subdivision (i) or (ii) of this paragraph (b)(2) which are includible in the eligible individual's gross income for the taxable year of the individual in which the credit is claimed. For all taxable years, however, earned income is computed without regard to any community property laws which may otherwise be applicable. Earned income is reduced by any net loss in earnings from self-employment. Earned income does not include amounts received as a pension or an annuity or an amount to which section 871(a) and the regulations thereunder apply (relating to income of nonresident alien individuals not connected with United States business).

(3) *Special rule for spouse who is a student or incapable of self-care.* (i) For purposes of this section, a spouse is deemed, for each month during which the spouse is a full-time student or is a qualifying individual described in § 1.44A–1(b)(1)(iii), to be gainfully employed and to have earned income of not less than—

(A) $200 ($166 for taxable years beginning before January 1, 1982) if there is one qualifying individual with respect to the taxpayer at any one time during the taxable year, or

(B) $400 ($333 for taxable years beginning before January 1, 1982), if there are two or more qualifying individuals with respect to the taxpayer at any one time during the taxable year.

However, in the case of any husband and wife, this subparagraph shall apply with respect to only one spouse for any one month.

(ii) A ''full-time student'' is an individual who is enrolled at and attends and educational institution during each of 5 calendar months of the taxable year of the taxpayer for the number of course hours which is considered to be a full-time course of study. The enrollment for 5 calendar months need not be consecutive. School attendance exclusively at night does not constitute a full-time course of study. However, a full-time course of study may include some attendance at night.

(iii) For the definition of ''educational institution'', see § 1.151–3(c).

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. During the 1982 taxable year, A, a married taxpayer, incurs and pays employment-related expenses of $4,000 for the care of a qualifying individual. A's earned income for the taxable year is $20,000 and his wife's earned income is $1,500. Under these circumstances, the amount of employment-related expenses for the year which may be taken into account under § 1.44A–1(a) is $1,500, determined as follows:

Employment-related expenses incurred during taxable year ($4,000, but limited to $2,400 by paragraph (a)(1) of this section), ... $2,400

Application of paragraph (b)(1)(ii) of this section (employment-related expenses, may not exceed wife's earned income of $1,500 . . . . . $1,500

Employment-related expenses taken into account $1,500

Example 2. Assume the same facts as in *Example 1* except that A's wife is a full-time student for nine months of the taxable year and earns no income for the year. Under these circumstances, the amount of employment-related expenses for the year which may be taken into account under § 1.44A–1(a) is $1,800, determined as follows:

Employment-related expenses incurred during taxable year ($4,000, but limited to $2,400 by paragraph (a)(1) of this section $2,400

Application of paragraph (b)(3) of this section [employment-related expenses may not exceed wife's earned income of $1,800 (200×9) . . $1,800

Employment-related expenses taken into account $1,800

(Secs. 44A(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1565, 26 U.S.C. 44A(g); 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7643, 44 FR 50334, Aug. 28, 1979, as amended by T.D. 7951, 49 FR 18092, Apr. 27, 1984]

§ 1.44A–3 Special rules applicable to married individuals.

(a) *Joint return requirement.* This section applies only if the taxpayer is married at the close of a taxable year in which employment-related expenses are paid. In such a case the credit provided by section 44A with respect to employment-related expenses is allowed only if for the taxable year the taxpayer and his or her spouse file a joint return. If either spouse dies during the taxable year and a joint return may be made for the year under section 6013(a)(2) for the survivor and the deceased spouse, the credit is allowed for the year only if a joint return is made. If, however, the surviving spouse remarries before the end of the taxable year in which his or her first spouse dies, a credit is allowed on the separate return which is made for the decedent spouse. For purposes of this section, certain married individuals legally separated or living apart are treated as not married, as provided in paragraphs (b) and (c), respectively, of this section.

(b) *Marital status.* For purposes of section 44A, an individual legally separated from his or her spouse under a decree of divorce or of separate maintenance is not considered as married.

(c) *Certain married individuals living apart.* For purposes of section 44A, an individual who is married within the meaning of section 143(a) is treated as not married for the entire taxable year, if the individual—

(1) Files a separate return for the year,

(2) Maintains as his or her home a household which constitutes for more than one-half of the taxable year the principal place of abode of a qualifying individual, and

(3) Furnishes over one-half of the cost of maintaining the household for the year,

and if the individual's spouse is not a member of the household at any time during the last 6 months of the year. Thus for example, an individual who is married during the taxable year, but is treated as not married by reason of this paragraph, may determine the earned income limitation upon the amount of employment-related expenses without taking into account the earned income of his or her spouse under §1.44A–2(b).

[T.D. 7643, 44 FR 50335, Aug. 28, 1979]

§1.44A–4 Other special rules relating to employment-related expenses.

(a) *Payments to related individuals*—(1) *Taxable years beginning after December 31, 1978.* For taxable years beginning after December 31, 1978, a credit is not allowed under section 44A with respect to the amount of any employment-related expenses paid by the taxpayer to an individual—

(i) With respect to whom for the taxable year a deduction under section 151(e) (relating to deduction for personal exemptions for dependents) is allowable either to the taxpayer or his or her spouse, or

(ii) Who is a child of the taxpayer (within the meaning of section 151(e)(3)) who is under age 19 at the close of the taxable year.

For purposes of this paragraph (a)(1), the term ‘‘taxable year’’means the taxable year of the taxpayer in which the service is performed. (1943)

(2) *Taxable years beginning before January 1, 1979.* For taxable years beginning before January 1, 1979, except as otherwise provided in paragraph (a)(3) of this section, a credit is not allowed under section 44A with respect to the amount of any employment-related expenses paid by the taxpayer to an individual who bears to the taxpayer any relationship described in section 152(a) (1) through (8). These relationships are those of a son or daughter or descendant thereof; a stepson or stepdaughter; a brother, a sister, stepbrother, or stepsister; a father or mother or an ancestor, of either; a stepfather or stepmother; a nephew or niece; an uncle or aunt; or a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law. In addition, no credit is allowed with respect to the amount of any employment-related expenses paid by the taxpayer to an individual who qualifies as a dependent of the taxpayer for the taxable year within the meaning of section 152(a)(9), which relates to an individual (other than the taxpayer's spouse) whose principal place of abode for the taxable year is the home of the taxpayer and who is a member of the taxpayer's household.

(3) *Exception for payments to certain related individuals.* For taxable years beginning before January 1, 1979, a credit

is allowed for the amount of any employment-related expenses paid by the taxpayer to an individual provided that neither the taxpayer nor his or her spouse is entitled to a deduction under section 151(e) (relating to deduction for personal exemptions for dependents) with respect to such individual for the taxable year in which the service is performed; and the service with respect to which the amount is paid constitutes employment within the meaning of section 3121(b). The following services performed for a taxpayer by a relative who is an employee of the taxpayer may qualify as employment within the meaning of section 3121(b):

(i) Services performed by the taxpayer's child age 21 or over.

(ii) Domestic services in the taxpayer's home performed by the taxpayer's parent if—

(A) The taxpayer has living in his or her home a child (as defined in section 151(e)(3)) who is under age 18 or who has a physical or mental condition requiring the personal care of an adult during at least 4 continuous weeks in the calendar quarter, and

(B) The taxpayer is a widow or widower or is divorced, or has a spouse living in the home who, because of a physical or mental condition, is incapable of caring for his or her child during at least 4 continuous weeks in the calendar quarter in which services are rendered.

(iii) Services of all relatives other than a child, spouse, or parent of the taxpayer.

For taxable years beginning before January 1, 1979, a credit is not allowed under section 44A with respect to employment-related expenses paid by the taxpayer to a relative for services which do not constitute employment under section 3121(b). Services performed by a relative do not constitute employment if they relate to the relative's trade or business the income from which is includible in computing the relative's net earnings for purposes of the self-employment tax under section 1401.

(4) *Payments to entities or partnerships.* If the services are performed by an entity or partnership, paragraph (a) (1) and (2) of this section is normally not applicable. If, however, the entity or partnership is established or maintained primarily to avoid the application of paragraph (a) (1) or (2) in order to permit the taxpayer to obtain the credit with respect to employment-related expenses, for purposes of this paragraph (a), the payments of employment-related expenses shall be treated as made directly to each owner of the entity or partner in proportion to his or her share of the entity or partnership. A factor to consider for purposes of determining whether an entity or partnership is so established or maintained is whether the entity or partnership is set up solely to care for the taxpayer's qualifying individual and to provide household services to the taxpayer.

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

Example 1. For A's taxable year ending December 31, 1978, A, a divorced taxpayer, pays $5,000 of employment-related expenses to his mother for the care of his child age 5. A's mother cares for the child in her home. The services performed by A's mother do not constitute employment under section 3121(b). Accordingly, A is not allowed a credit with respect to the amounts paid to the mother for the care of his child.

Example 2. Assume the same facts as in *Example 1* except that A's taxable year under consideration begins after December 31, 1978. A is not entitled to a deduction under section 151(e) for his mother. Accordingly, A is allowed a credit with respect to the amounts paid to the mother for the care of his child even though the services performed by A's mother do not constitute employment under section 3121(b).

Example 3. For B's taxable year ending December 31, 1978, B, a divorced taxpayer, pays $6,000 of employment-related expenses to his sister (who is not a dependent of the taxpayer) for the care of his child. The services performed by B's sister in the care of his child constitute a trade or business the income from which is includible in computing net earnings for purposes of the self-employment tax under section 1401. Accordingly, B is not allowed a credit with respect to the amounts paid to the sister for the care of his child.

Example 4. Assume the same facts as in *Example 3* except that B's taxable year under consideration begins after December 31, 1978. B is allowed a credit with respect to the amounts paid to the sister for the care of his child, even though the services performed by

B's sister do not constitute employment under section 3121(b).

(b) *Expenses qualifying as medical expenses.* An expense which may constitute an amount otherwise deductible under section 213, relating to medical, etc., expenses, may also constitute an expense with respect to which a credit is allowable under section 44A. In such a case, that part of the amount with respect to which a credit is allowed under section 44A will not be considered as an expense for purposes of determining the amount deductible under section 213. On the other hand, where an amount is treated as a medical expense under section 213 for purposes of determining the amount deductible under that section, it may not be treated as an employment-related expense for purposes of section 44A. The application of this paragraph may be illustrated by the following examples:

Example 1. In 1982, a calendar year taxpayer incurs and pays $5,000 of employment-related expenses during the taxable year for the care of his child when the child is physically incapable of self-care. These expenses are incurred for services performed in the taxpayer's household and are of a nature which qualify as medical expenses under section 213. The taxpayer's adjusted gross income for the taxable year is $100,000. Of the total expenses, the taxpayer may take $2,400 into account under section 44A; the balance of the expenses, or $2,600, may be treated as medical expenses to which section 213 applies. However, this amount does not exceed 3 percent of the taxpayer's adjusted gross income for the taxable year and is thus not allowable as a deduction under section 213.

Example 2. Assume the same facts as in *Example 1.* It is not proper for the taxpayer first to determine his deductible medical expenses of $2,000 ($5,000—[$100,000×3 percent]) under section 213 and then claim the $3,000 balance as employment-related expenses for purposes of section 44A. This is because the $3,000 balance has been treated as a medical expense in computing the amount deductible under section 213.

Example 3. In 1982, a calendar year taxpayer incurs and pays $12,000 of employment-related expenses during the taxable year for the care of his child. These expenses are incurred for services performed in the taxpayer's household, and they also qualify as medical expenses under section 213. The taxpayer's adjusted gross income for the taxable year is $18,000. The taxpayer takes $2,400 of such expenses into account under section 44A. The balance, or $9,600, he treats as medical expenses for purposes of section 213. The allowable deduction under section 213 for the expenses is limited to the excess of the balance of $9,600 over $540 (3 percent of the taxpayer's adjusted gross income of $18,000), or $9,060.

(Secs. 44A(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1565, 26 U.S.C. 44A(g); 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7643, 44 FR 50335, Aug. 28, 1979, as amended by T.D. 7951, 49 FR 18092, Apr. 27, 1984]

§1.44B–1 Credit for employment of certain new employees.

(a) *In general*—(1) *Targeted jobs credit.* Under section 44B a taxpayer may elect to claim a credit for wages (as defined in section 51(c) paid or incurred to members of a targeted group (as defined in section 51(d)). Generally, to qualify for the credit, the wages must be paid or incurred to members of a targeted group first hired after September 26, 1978. However, wages paid of incurred to a vocational rehabilitation referral (as defined in section 51(d)(2)) hired before September 27, 1978, may qualify for the credit if a credit under section 44B (as in effect prior to enactment of the Revenue Act of 1978) was claimed for the individual by the taxpayer for a taxable year beginning before January 1, 1979. The amount of the credit shall be determined under section 51. Section 280C(b) (relating to the requirement that the deduction for wages be reduced by the amount of the credit) and the regulations thereunder will not apply to taxpayers who do not elect to claim the credit.

(2) *New jobs credit.* Under section 44B (as in effect prior to enactment of the Revenue Act of 1978) a taxpayer may elect to claim as a credit the amount determined under sections 51, 52, and 53 (as in effect prior to enactment of the Revenue Act of 1978). Section 280C(b) (relating to the requirement that the deduction for wages be reduced by the amount of the credit) and the regulations thereunder will not apply to taxpayers who do not elect to claim the credit.

(b) *Time and manner of making election.* The election to claim the targeted jobs credit and the new jobs credit is made by claiming the credit on an original return, or on an amended return, at any time before the expiration of the 3-year period beginning on the last date prescribed by law for filing the return for the taxable year (determined without regard to extensions). The election may be revoked within the above-described 3-year period by filing an amended return on which the credit is not claimed.

(c) *Election by partnership, electing small business corporation, and members of a controlled group.* In the case of a partnership, the election shall be made by the partnership. In the case of an electing small business corporation (as defined in section 1371(a)), the election shall be made by the corporation. In the case of a controlled group of corporations (within the meaning of section 52(a) and the regulations issued thereunder) not filing a consolidlated return under section 1501, the election shall be made by each member of the group. In the case of an affiliated group filing a consolidated return under section 1501, the election shall be made by the group.

(Secs. 44B, 381, and 7805 of the Internal Revenue Code of 1954 (92 Stat. 2834, 26 U.S.C. 44B; 91 Stat. 148, 26 U.S.C. 381(c)(26); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7921, 48 FR 52904, Nov. 23, 1983]

RULES FOR COMPUTING CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY

§ 1.46–1 Determination of amount.

(a) *Effective dates*—(1) *In general.* This section is effective for taxable years beginning after December 31, 1975. However, transitional rules under paragraph (g) of this section are effective for certain earlier taxable years.

(2) *Acts covered.* This section reflects changes made by the following Acts of Congress:

Act and Section

Tax Reduction Act of 1975, section 301.
Tax Reform Act of 1976, sections 802, 1701, 1703.
Revenue Act of 1978, sections 311, 312, 315.
Energy Tax Act of 1978, section 301.
Economic Recovery Tax Act of 1981, section 212.
Technical Corrections Act of 1982, section 102(f).
Tax Reform Act of 1986, section 251.

(3) *Prior regulations.* For taxable years beginning before January 1, 1976, see 26 CFR 1.46–1 (Rev. as of April 1, 1979). Those regulatons do not reflect changes made by Pub. L. 89–384, Pub. L. 89–389, and Pub. L. 91–172.

(b) *General rule.* The amount of investment credit (credit) allowed by section 38 for the taxable year is the portion of credit available under section 46(a)(1) that does not exceed the limitation based on tax under section 46(a)(3).

(c) *Credit available.* The credit available for the taxable year is the sum of—

(1) Unused credit carried over from prior taxable years under section 46(b) (carryovers).

(2) Amount of credit determined under section 46(a)(2) for the taxable year (credit earned), and

(3) Unused credit carried back from succeeding taxable years under section 46(b) (carrybacks).

(d) *Credit earned.* The credit earned for the taxable year is the sum of the following percentages of qualified investment (as determined under section 46 (c) and (d))—

(1) The regular percentage (as determined under section 46),

(2) For energy property, the energy percentage (as determined under section 46), and

(3) For the portion of the basis of a qualified rehabilitated building (as defined in § 1.48–12(b)) that is attributable to qualified rehabilitation expenditures (as defined in § 1.48–12(c)), the rehabilitation percentage (as determined under section 46(b)(4)).

(e) *Designation of credits.* The credit available for the taxable year is designated as follows:

(1) The credit attributable to the regular percentage is the ‘‘regular credit’’.

(2) The credit attributable to the ESOP percentage is the ‘‘ESOP credit’’.

(3) The credit attributable to the energy percentage for energy property other than solar or wind is the ‘‘nonrefundable energy credit’’.

(4) The credit attributable to the energy percentage for solar or wind energy property is the ‘‘refundable energy credit’’.

(5) The credit attributable to the rehabilitation percentage for qualified rehabilitation expenditures is the rehabilitation investment credit.

(f) *Special rules for certain energy property.* Energy property is defined in section 48(l). Under section 46(a)(2)(D), energy property that is section 38 property solely by reason of section 48(l)(1) qualifies only for the energy credit. Other energy property qualifies for both the regular credit (and, if applicable, the ESOP credit) and the energy credit. For limitation on the energy percentage for property financed by industrial development bonds, see section 48(l)(11).

(g) *Transitional rule for regular and ESOP credit*—(1) *In general.* Although section 46(a)(2) was amended by section 301(a)(1) of the Energy Tax Act of 1977 to eliminate the transitional rules under section 46(a)(2)(D), those rules still apply in certain instances. Section 46(a)(2)(D) was added by section 301(a) of the Tax Reduction Act of 1975 and amended by section 802(a) of the Tax Reform Act of 1976.

(2) *Regular credit.* Under section 46(a)(2)(D), the regular credit is 10 percent and applies for the following property:

(i) Property to which section 46 (d) does not apply, the construction, reconstruction, or erection of which is completed by the taxpayer after January 21, 1975, but only to the extent of basis attributable to construction, reconstruction, or erection after that date.

(ii) Property to which section 46(d) does not apply, acquired by the taxpayer after January 21, 1975.

(iii) Qualified progress expenditures (as defined in section 46(d)) made after January 21, 1975.

(3) *ESOP credit.* See section 48(m) for transitional rules limiting the period for which the ESOP percentage under section 46(a)(2)(E) applies. For prior statutes, see section 46(a)(2) (B) and (D), as added by section 301 of the Tax Reduction Act of 1975 and amended by section 802 of the Tax Reform Act of 1976.

(4) *Cross reference.* (i) The principles of §1.48–2 (b) and (c) apply in determining the portion of basis attributable to construction, reconstruction, or erection after January 21, 1975, and in determining the time when property is acquired.

(ii) Section 311 of the Revenue Act of 1978 made the 10 percent regular credit permanent.

(5) *Seven percent credit.* To the extent that, under paragraph (g)(1) of this section, the 10 percent does not apply, the regular credit, in general, is 7 percent. For a special limitation on qualified investment for public utility property (other than energy property), see section 46(c)(3)(A).

(6) *Qualified progress expenditures.* For progress expenditure property that is constructed, reconstructed, or erected by the taxpayer within the meaning of §1.48–2(b), the ten-percent credit applies in the year the property is placed in service to the portion of the qualified investment that remains after reduction for qualified progress expenditures under section 46(c)(4), but only to the extent that the remaining qualified investment is attributable to construction, reconstruction, or erection after January 21, 1975. For progress expenditure property that is acquired by the taxpayer (within the meaning of §1.48–2(b)) after January 21, 1975, and placed in service after that date, the ten-percent credit applies in the year the property is placed in service to the entire portion of qualified investment that remains after reduction for qualified progress expenditures.

(h) *Tax liability limitation*—(1) *In general.* Section 46(a)(3) provides a tax liability limitation on the amount of credit allowed by section 38 (other than the refundable energy credit) for any taxable year. See section 46(a)(10)(C)(i). Tax liability is defined in paragraph (j) of this section. The excess of available credit over the applicable tax liability limitation for the year is an unused credit which may be carried forward or carried back under section 46(b).

(2) *Regular and ESOP tax liability limitation.* In general, the tax liability limitation for the regular and ESOP credits is the portion of tax liability that does not exceed $25,000 plus a percentage of the excess, as determined under section 46(a)(3)(B).

(3) *Nonrefundable energy credit tax liability limitation.* (i) For nonrefundable energy credit carrybacks to a taxable year ending before October 1, 1978, the tax liability limitation is the portion of tax liability that does not exceed

$25,000 plus a percentage of the excess, as determined under section 46(a)(3)(B).

(ii) For a taxable year ending after September 30, 1978, the tax liability limitation for available nonrefundable energy credit is 100 percent of the year's tax liability.

(4) *Alternative limitations.* Alternative limitations apply for certain utilities, railroads, and airlines in determining the regular tax liability limitation and, for nonrefundable energy credit carrybacks to taxable years ending before October 1, 1978, the nonrefundable energy credit tax liability limitation. These alternative limitations do not apply in determining the energy tax liability limitation for a taxable year ending after October 1, 1978. The provisions listed below set forth the alternative limitations:

Code section	Type	Years applicable
46(a)(6)[1]	Utilities	Taxable years ending in 1975–1978
46(a)(7)[2]	Utilities	Taxable year ending in 1979
46(a)(8)	Railroads and Airlines	Taxable year ending in 1979 or 1980
46(a)(8)[3]	Railroads	Taxable years ending in 1977 or 1978
46(a)(9)[3]	Airlines	Taxable years ending in 1977 or 1978

[1] Section 46(a)(6) was added by section 301(b)(2) of the Tax Reduction Act of 1975 and redesignated as section 46(a)(7) by section 302(a)(1) of the Tax Reform Act of 1976.

[2] Section 46(a)(7) was amended by section 312(b)(1) of the Revenue Act of 1978.

[3] These provisions were repealed by section 312(b)(2) of the Revenue Act of 1978.

(i) [Reserved]

(j) *Tax liability*—(1) *In general.* ''Tax liability'' for purposes of the regular and ESOP credit and carrybacks of nonrefundable energy credit to a taxable year ending before October 1, 1978, means the liability for tax as defined in section 46(a)(4). For ordering of regular, ESOP, and nonrefundable energy credits, see paragraph (m) of this section. In addition to taxes excluded under section 46(a)(4), tax liability does not include tax resulting from recapture of credit under section 47 and the alternative minimum tax imposed by section 55. See sections 47(c) and 55(c)(1).

(2) *Certain nonrefundable energy credit.* For a taxable year ending after September 30, 1978, ''tax liability'' for purposes of the nonrefundable energy credit is liability for tax, as defined in section 46(a)(4) and paragraph (j)(1) of this section, reduced by the regular and ESOP credit allowed for the taxable year. Thus, carrybacks of regular or ESOP credit to a taxable year may displace nonrefundable energy carryovers or credit earned taken into account in that year. However, carrybacks of regular, ESOP, or nonrefundable energy credit do not affect refundable energy credit which is treated as an overpayment of tax under section 6401(b). See paragraph (k) of this section.

(k) *Special rule for refundable energy credit.* The amount of the refundable energy credit is determined under the rules of section 46 (other than section 46(a)(3)). However, to permit the refund, the refundable energy credit for purposes of the Internal Revenue Code (other than section 38, part IVB, and chapter 63 of the Code) is treated as allowed by section 39 and not by section 38. The refundable credit is not applied against tax liability for purposes of determining the tax liability limitation for other investment credits. Rather, it is treated as an overpayment of tax under section 6401(b).

(l) *FIFO rule.* If the credit available for a taxable year is not allowed in full because of the tax liability limitation, special rules determine the order in which credits are applied. Under the first-in-first-out rule of section 46(a)(1) (FIFO), carryovers are applied against the tax liability limitation first. To the extent the tax liability limitation exceeds carryovers, credit earned, and carrybacks are then applied.

(m) *Special ordering rule*—(1) *In general.* Under section 46(a)(10)(A), the FIFO rule applies separately—

(i) First, with respect to regular and ESOP credits, and

(ii) Second, with respect to nonrefundable energy credit.

(2) *Regular and ESOP credit.* Under § 1.46–8(c)(9)(ii), regular and ESOP credits available are applied in the following order:

(i) Regular carryovers;

(ii) ESOP carryovers;

(iii) Regular credit earned;

(iv) ESOP credit earned;

(v) Regular carrybacks; and

(vi) ESOP carrybacks.

(3) *Example.* For an example of the order of application of regular and ESOP credits, see §1.46–8(c)(9)(iii).

(n) *Examples.* The following examples illustrate paragraphs (a) through (m) of this section.

Example 1. (a) Corporation M's regular credit available for its taxable year ending December 31, 1979 is as follows:

Regular carryovers	$5,000
Regular credit earned	10,000
Regular carrybacks	15,000
Credit available	30,000

(b) M's ''tax liability'' for 1979 is $30,000. M's tax liability limitation for 1979 for the regular credit is $28,000, consisting of $25,000 plus 60 percent of the $5,000 of ''tax liability'' in excess of $25,000.

(c) The regular carryovers and credit earned are allowed in full. However, only $13,000 of the regular carryback is allowed for 1979. The remaining $2,000 must be carried to the next year to which it may be carried under section 46(b).

Example 2. (a) For its taxable year ending December 31, 1980, corporation N has $30,000 regular credit earned and $9,000 nonrefundable energy credit earned. N has no carryovers to 1980 and no ''tax liability'' for pre-1980 years.

(b) N's ''tax liability'' for 1980 for the regular credit is $35,000. N's tax liability limitation for 1980 for the regular credit is $32,000, consisting of $25,000 plus 70 percent of the $10,000 of ''tax liability'' in excess of $25,000.

(c) The entire regular credit is allowed in 1980.

(d) N's ''tax liability'' for 1980 for the nonrefundable energy credit is $5,000, consisting of $35,000 less $30,000 regular credit allowed for 1980. N's tax liability limitation for 1980 for the nonrefundable energy credit is 100 percent of $5,000.

(e) $5,000 of the nonrefundable energy credit is allowed for 1980. The remaining $4,000 energy credit is an unused nonrefundable energy credit which must be carried to the next year to which it may be carried under section 46(b).

Example 3. (a) Assume the same facts as in *Example 2* except that in its taxable year ending December 31, 1981, N earns a regular credit of which it may carry back $2,000 to 1980.

(b) The $30,000 regular credit earned and $2,000 of the regular carryback is allowed for 1980. N's ''tax liability'' for 1980 for the nonrefundable energy credit is reduced to $3,000, consisting of $35,000 less $32,000 regular credit allowed for 1980. The nonrefundable energy credit allowed for 1980 is reduced to $3,000. The remaining $6,000 is an unused nonrefundable energy credit which must be carried to the next year to which it may be carried under section 46(b).

Example 4. (a) For its taxable year ending December 31, 1980, corporation P's regular credit earned is $20,000. P also has a $9,000 refundable energy credit for 1980. There are no carryovers or carrybacks to 1980.

(b) P's ''tax liability'' for 1980 for the regular credit is $25,000 which is also the tax liability limitation for the regular credit.

(c) The entire $20,000 regular credit is allowed for 1980. The entire $9,000 refundable energy credit is treated as an overpayment of tax under section 6401(b), even though ''tax liability'' remains.

Example 5. Assume the same facts as in *Example 4,* except that in the following year P earns a regular credit, $5,000 of which it may carry back to 1980. The $5,000 carryback is allowed in full in 1980.

Example 6. (i) Corporation X, a calendar year taxpayer, constructs a ship on which it begins construction on January 1, 1973, and which, when placed in service on December 31, 1980, has a basis of $450,000. Of that amount, $100,000 is attributable to construction before January 22, 1975. X makes an election under section 46(d) (qualified progress expenditures) for taxable years after 1975.

(ii) For 1976, 1977, 1978, and 1979, qualified progress expenditures total $200,000. The ten-percent credit applies to those expenditures.

(iii) For 1980, qualified investment for the ship is $450,000. Under section 46(c)(4), X must reduce this amount by $200,000, the amount of qualified progress expenditures taken into account. The ten-percent credit applies to the portion of the remaining qualified investment attributable to construction after January 21, 1975 ($150,000). The seven-percent credit applies to the portion of qualified investment attributable to construction before January 22, 1975 ($100,000).

Example 7. (i) Corporation Y agrees to build a ship for Corporation X, which uses the calendar year. In 1973, Y begins construction of the ship which X acquires and places in service on December 31, 1980. X makes an election under section 46(d) for taxable years after 1974. The contract price is $400,000.

(ii) For 1975, 1976, 1977, 1978, and 1979, qualified progress expenditures total $250,000. The ten-percent credit applies to those expenditures.

(iii) For 1980, qualified investment for the ship is $400,000, which is the contract price. X must reduce qualified investment by $250,000, the amount of qualified progress expenditures. The ten-percent credit applies to the $150,000 of qualified investment that remains after reduction for qualified progress expenditures.

(o) *Married individuals.* If a separate return is filed by a husband or wife, the tax liability limitation is computed by substituting a $12,500 amount for the $25,000 amount that applies under section 46(a)(3). However, this reduction of the $25,000 amount to $12,500 applies only if the taxpayer's spouse is entitled to a credit under section 38 for the taxable year of such spouse which ends with, or within, the taxpayer's taxable year. The taxpayer's spouse is entitled to a credit under section 38 either because of investment made in qualified property for such taxable year of the spouse (whether directly made by such spouse or whether apportioned to such spouse, for example, from an electing small business corporation, as defined in section 1371(b)), or because of an investment credit carryback or carryover to such taxable year. The determination of whether an individual is married shall be made under the principles of section 143 and the regulations thereunder.

(p) *Apportionment of $25,000 amount among component members of a controlled group*—(1) *In general.* In determining the tax liability limitation under section 46(a)(3) for corporations that are component members of a controlled group on December 31, only one $25,000 amount is available to those component members for their taxable years that include that December 31. See subparagraph (2) of this paragraph for apportionment of such amount among such component members. See subparagraph (3) of this paragraph for definition of ''component member''.

(2) *Manner of apportionment.* (i) In the case of corporations which are component members of a controlled group on a particular December 31, the $25,000 amount may be apportioned among such members for their taxable years that include such December 31 in any manner the component members may select, provided that each such member less than 100 percent of whose stock is owned, in the aggregate, by the other component members of the group on such December 31 consents to an apportionment plan. The consent of a component member to an apportionment plan with respect to a particular December 31 shall be made by means of a statement, signed by a person duly authorized to act on behalf of the consenting member, stating that such member consents to the apportionment plan with respect to such December 31. The statement shall set forth the name, address, employer identification number, and taxable year of each component member of the group on such December 31, the amount apportioned to each such member under the plan, and the location of the Service Center where the statement is to be filed. The consent of more than one component member may be incorporated in a single statement. The statement shall be timely filed with the Service Center where the component member having the taxable year first ending on or after such December 31 files its return for such taxable year and shall be irrevocable after such filing. If two or more component members have the same such taxable year, a statement of consent may be filed by any one of such members. However, if the due date (including any extensions of time) of the return of such member is on or before December 15, 1971, the required statement shall be considered as timely filed if filed on or before March 15, 1972. Each component member of the group on such December 31 shall keep as a part of its records a copy of the statement containing all the required consents.

(ii) An apportionment plan adopted by a controlled group with respect to a particular December 31 shall be valid only for the taxable year of each member of the group which includes such December 31. Thus, a controlled group must file a separate consent to an apportionment plan with respect to each taxable year which includes a December 31 as to which an apportionment plan is desired.

(iii) If the apportionment plan is not timely filed, the $25,000 amount specified in section 46(a)(3) shall be reduced for each component member of the controlled group, for its taxable year which includes a December 31, to an amount equal to $25,000 divided by the number of component members of such group on such December 31.

(iv) If a component member of the controlled group makes its income tax return on the basis of a 52–53-week taxable year, the principles of section

441(f)(2)(A)(ii) and paragraph (b)(1) of §1.441–2 apply in determining the last day of such taxable year.

(3) *Definitions of controlled group of corporations and component member of controlled group.* For the purpose of this paragraph, the terms ‘‘controlled group of corporations’’ and ‘‘component member’’ of a controlled group of corporations shall have the same meaning assigned to those terms in section 1563 (a) and (b). For purposes of applying §1.1563–1(b)(2)(ii)(*c*), an electing small business corporation shall be treated as an excluded member whether or not it is subject to the tax imposed by section 1378.

(4) *Members of a controlled group filing a consolidated return.* If some component members of a controlled group join in filing a consolidated return pursuant to §1.1502–3(a)(3), and other component members do not join, then, unless a consent is timely filed apportioning the $25,000 amount among the group filing the consolidated return and the other component members of the controlled group, each component member of the controlled group (including each component member which joins in filing the consolidated return) shall be treated as a separate corporation for purposes of equally apportioning the $25,000 amount under subparagraph (2)(iii) of this paragraph. In that case, the tax liability limitation for the group filing the consolidated return is computed by substituting for the $25,000 amount under section 46(a)(3) the total amount apportioned to each component member that joins in filing the consolidated return. If the affiliated group filing the consolidated return and the other component members of the controlled group adopt an apportionment plan, the affiliated group shall be treated as a single member for the purpose of applying subparagraph (2)(i) of this paragraph. Thus, for example, only one consent executed by the common parent to the apportionment plan is required for the group filing the consolidated return. If any component member of the controlled group which joins in the filing of the consolidated return is an organization to which section 593 applies or a cooperative organization described in section 1381(a), see paragraph (a)(3)(ii) of §1.1502–3.

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

Example 1. At all times during 1976 Smith, an individual, owns all the stock of corporations X, Y, and Z. Corporation X files an income tax return on a calendar year basis. Corporation Y files an income tax return on the basis of a fiscal year ending June 30. Corporation Z files an income tax return on the basis of a fiscal year ending September 30. On December 31, 1976, X, Y, and Z are component members of the same controlled group. X, Y, and Z all consent to an apportionment plan in which the $25,000 amount is apportioned entirely to Y for its taxable year ending June 30, 1977 (Y's taxable year which includes December 31, 1976). Such consent is timely filed. For purposes of computing the credit under section 38, Y's tax liability limitation for its taxable year ending June 30, 1977, is so much of Y's tax liability as does not exceed $25,000, plus 50 percent of Y's tax liability in excess of $25,000. X's and Z's limitations for their taxable years ending December 31, 1976, and September 30, 1977, respectively, are equal to 50 percent of X's tax liability for 50 percent of Z's tax liability. On the other hand, if an apportionment plan is not timely filed, X's limitation would be so much of X's tax liability as does not exceed $8,333.33, plus 50 percent of X's liability in excess of $8,333.33, and Y's and Z's limitations would be computed similarly.

Example 2. At all times during 1976, Jones, an individual, owns all the outstanding stock of corporations P, Q, and R. Corporations Q and R both file returns for taxable years ending December 31, 1976. P files a consolidated return as a common parent for its fiscal year ending June 30, 1977, with its two wholly-owned subsidiaries N and O. On December 31, 1976, N, O, P. Q, and R are component members of the same controlled group. No consent to an apportionment plan is filed. Therefore, each member is apportioned $5,000 of the $25,000 amount ($25,000 divided equally among the five members). The tax liability limitation for the group filing the consolidated return (P, N, and O) for the year ending June 30, 1977 (the consolidated taxable year within which December 31, 1976, falls) is computed by using $15,000 instead of the $25,000 amount. The $15,000 is arrived at by adding together the $5,000 amounts apportioned to P, N, and O.

(q) *Rehabilitation percentage*—(1) *General rule*—(i) *In general.* Due to amendments made by the Tax Reform Act of 1986, different rules apply depending on when the property attributable to the qualified rehabilitated expenditures (as defined in § 1.48–12(c)) is placed in service. Paragraph (q)(1)(ii) of this section contains the general rule relating to property placed in service after December 31, 1986. Paragraph (q)(1)(iii) of this section contains rules relating to property placed in service before January 1, 1987. Paragraph (q)(1)(iv) of this section contains rules relating to property placed in service after December 31, 1986, that qualifies for a transition rule.

(ii) *Property placed in service after December 31, 1986.* Except as otherwise provided in paragraph (q)(1)(iv) of this section, in the case of section 38 property described in section 48(a)(1)(E) placed in service after December 31, 1986, the term ''rehabilitation percentage'' means—

(A) 10 percent in the case of qualified rehabilitation expenditures with respect to a qualified rehabilitated building other than a certified historic structure, and

(B) 20 percent in the case of qualified rehabilitation expenditures with respect to a certified historic structure.

(iii) *Property placed in service before January 1, 1987.* For qualified rehabilitation expenditures (as defined in § 1.48–12(c)) with respect to property placed in service before January 1, 1987, section 46(b)(4)(A) as in effect prior to the enactment of the Tax Reform Act of 1986 provided for a three-tier rehabilitation percentage. The applicable rehabilitation percentage for such expenditures depends on whether the qualified rehabilitated building is a ''30-year building,'' a ''40-year building,'' or a certified historic structure (as defined in section 48(g)(3) and § 1.48–12(d)(1)). The rehabilitation percentage for such qualified rehabilitation expenditures incurred with respect to a qualified rehabilitated building is 15 percent to the extent that the building is a 30-year building (*i.e.,* at least 30 years, but less than 40 years, has elapsed between the date the physical work on the rehabilitation began and the date the building was first placed in service), 20 percent to the extent that the building is a 40-year building (*i.e.*, at least 40 years has so elapsed), and 25 percent for certified historic structures, regardless of age. See paragraph (q)(2)(ii) of this section for rules concerning buildings to which additions have been added.

(iv) *Property placed in service after December 31, 1986, that qualifies under the transition rules.* In the case of section 38 property described in section 48(a)(1)(E) placed in service after December 31, 1986, and to which the amendments made by section 251 of the Tax Reform Act of 1986 do not apply because the transition rules in section 251(d) of that Act and § 1.48–12(a)(2)(iv)(B) or (C) apply, the rehabilitation percentage for a ''30-year building'' (within the meaning of paragraph (q)(1)(iii) of this section) shall be 10 percent, the rehabilitation percentage for a ''40-year building'' (within the meaning of paragraph (q)(1)(iii) of this section) shall be 13 percent, and the rehabilitation percentage for a certified historic structure shall be 25 percent.

(2) *Special rules*—(i) *Moved buildings.* With respect to paragraph (q)(1)(ii) of this section, § 1.48–12(b)(5) provides that a building (other than a certified historic structure) is not a qualified rehabilitated building unless it has been at the location where it is being rehabilitated since January 1, 1936. In addition, for purposes of paragraph (q)(1) (iii) and (iv) of this section, a building is not a ''30-year building'' unless it has been at the location where it is being rehabilitated for the thirty-year period immediately preceding the beginning of the rehabilitation process, and is not a ''40-year building'' unless it has been at the location where it is being rehabilitated for the forty-year period immediately preceding the beginning of the rehabilitation process.

(ii) *Building to which additions have been added*—(A) *Property placed in service after December 31, 1986.* For purposes of paragraph (q)(1)(ii) of this section, if part of a building meets the definition of a qualified rehabilitated building, and part of the building does not meet the definition of a qualified rehabilitated building because such part is an addition that was placed in service after December 31, 1935, the qualified rehabilitation expenditures made to the building must be allocated to the pre-1936 portion of the building and the post-1935 portion of the building using the principles in § 1.48–12(c)(10)(ii). Qualified rehabilitation expenditures attributable to the post-1935 addition shall not qualify for the 10 percent rehabilitation percentage.

(B) *Property placed in service before January 1, 1987, and property qualifying for a transitional rule.* For purposes of paragraphs (q)(1) (iii) and (iv) of this section, if part of a building meets the definition of a ''40-year building'' and part of the building is an addition that was placed in service less than forty years before physical work on the rehabilitation began but more than thirty years before such date, then the qualified rehabilitation expenditures made to the building shall be allocated between the forty year old portion of the building and the thirty year old portion of the building, and a 20 percent rehabilitation percentage shall be applied to the forty year old portion of the building and a 15 percent rehabilitation percentage shall be applied to the thirty year old portion. This allocation shall be made using the principles in §1.48–12(c)(10)(ii). If an allocation cannot be made between the expenditures to the forty year old portion of the building and the thirty year old portion of the building, then the building will be considered to be a 30-year building. Furthermore, for purposes of this paragraph (q), a building (other than a certified historic structure) is not a qualified rehabilitated building to the extent of that portion of the building that is less than 30 years old. If rehabilitation expenditures are incurred with respect to an addition to a qualified rehabilitated building, but the addition is not considered to be part of the qualified rehabilitated building because the addition does not meet the age requirement in section 48(g)(1)(B) (as in effect prior to its amendment by the Tax Reform Act of 1986) and §1.48–12(b)(4)(i)(B), then no rehabilitation percentage will be applied to the expenditures attributable to the rehabilitation of the addition. Thus, for purposes of paragraphs (q)(1) (iii) and (iv) of this section, it may be necessary to allocate rehabilitation expenditures incurred with respect to a building between the original portion of the building and the addition.

(iii) *Mixed-use buildings.* If qualified rehabilitation expenditures are incurred for property that is excluded from section 38 property described in section 48(a)(1)(E) (because, for example, they are made with respect to a portion of the building used for lodging within the meaning of section 48(a)(3) and §1.48–1(h)), an allocation of the expenditures must be made between the expenditures that result in an addition to basis that is section 38 property and the expenditures that result in an addition to basis that is excluded from the definition of section 38 property since the rehabilitation percentage is applicable only to section 38 property. These allocations should be made using the principles contained in §1.48–12(c)(10)(ii).

(3) *Regular and energy percentages not to apply.* The regular percentage and the energy percentage shall not apply to that portion of the basis of any building that is attributable to qualified rehabilitation expenditures (as defined in §1.48–12(c)).

(4) *Effective date.* The rehabilitation percentage is applicable only to qualified rehabilitation expenditures (as defined in §1.48–12(c)). For rules relating to applicability of the regular percentage to qualified rehabilitation expenditures (as defined in §1.48–11(c)), see §1.48–11.

[T.D. 6731, 29 FR 6064, May 8, 1964]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.46–1, see the List of CFR Sections Affected in the Finding Aids section of this volume.

§1.46–2 Carryback and carryover of unused credit.

(a) *Effective date.* This section is effective for taxable years beginning after December 31, 1975. For taxable years beginning before January 1, 1976, see 26 CFR 1.46–2 (Rev. as of April 1, 1979).

(b) *In general.* Under section 46(b)(1), unused credit may be carried back and carried over. Carrybacks and carryovers of unused credit are taken into account in determining the amount of credit available and the credit allowed for the taxable years to which they may be carried. In general, the application of the rules of this section to regular and ESOP credits are separate from their application to nonrefundable energy credits. For example, the limitations on carrybacks and carryovers of unused nonrefundable energy credit under section 46(b) (2) and (3), respectively, differ in amount from the limitations on the regular and ESOP credits because the tax liability limitations for those credits differ. See § 1.46–1(h). For a further example, see the special ordering rule in § 1.46–1(m). Section 46(b) does not apply to the refundable energy credit.

(c) *Unused credit.* If carryovers and credit earned (as defined in § 1.46–1(c)(1)) exceed the applicable tax liability limitation, the excess attributable to credit earned is an unused credit. The taxable year in which an unused credit arises is referred to as the ‘‘unused credit year’’.

(d) *Taxable years to which unused credit may be carried.* An unused credit is a carryback to each of the 3 taxable years preceding the unused credit year and a carryover to each of the 7 taxable years succeeding the unused credit year. An unused credit must be carried first to the earliest of those 10 taxable years. An unused credit then must be carried to each of the other 9 taxable years (in order of time) to the extent that the unused credit was not absorbed during a prior taxable year because of the limitations under section 46(b) (2) and (3).

(e) *Special rule for pre-1971 years*—(1) *In general.* For unused credit years ending before January 1, 1971, unused credit is allowed a 10-year carryover rather than the 7-year carryover. The principles of paragraph (d) of this section apply to this 10-year carryover.

(2) *Cross reference.* For limitations on the taxable years to which unused credit from pre-1971 credit years may be carried, see paragraph (g) of this section.

(f) *Limitations on carrybacks.* Under the FIFO rule to section 46(a)(1), carryovers and credit earned are applied against the tax liability limitation before carrybacks. Thus, carrybacks to a taxable year may not exceed the amount by which the applicable tax liability limitation for that year exceeds the sum of carryovers to and credit earned for that year. Carrybacks from an unused credit year are applied against tax liability before carrybacks from a later unused credit year. To the extent an unused credit cannot be carried back to a particular preceding taxable year, the unused credit must be carried to the next succeeding taxable year to which it may be carried.

(g) *Limitations on carryovers*—(1) *General rule.* Carryovers to a taxable year may not exceed the applicable tax liability limitation for that year. Carryovers from an unused credit year are applied before carryovers from a later unused credit year.

(2) *Exception.* A 10-year carryover from a pre-1971 unused credit year may, under certain circumstances, be postponed to prevent a later-earned 7-year carryover from expiring. This exception does not extend the 10-year carryover period for pre-1971 unused credit. See section 46(b)(1)(D).

(h) *Examples.* The following examples illustrate paragraphs (a) through (g) of this section.

Example 1. (a) Corporation M is organized on January 1, 1977 and files its income tax return on a calendar year basis. Assume the facts set forth in columns (1) and (2) of the following table. The determination of the regular credit allowed for each of the taxable years indicated is set forth in the remaining portions of the table.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Credit available	Tax liability	Percent	Tax liability limitation (remaining from col. (6) on preceding line)	Credit allowed (lower of (1) or (4))	Remaining tax liability limitation ((4)–(5))	Unused credit ((1)–(5)) or (amount absorbed)
1977:							
A. Credit earned	$20,000	$45,000	50	$35,000	$20,000	$15,000	0
B. Carryback from 1978	*15,000			[15,000]	15,000		
1978:							
A. Credit earned	80,000	55,000	50	40,000	40,000	0	$20,000
Carryback to 1977							(*15,000)
Carryover to 1979							(*5,000)
1979:							
A. Carryover from 1978	*5,000	50,000	60	40,000	6,000	35,000	

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Credit available	Tax liability	Percent	Tax liability limitation (remaining from col. (6) on preceding line)	Credit allowed (lower of (1) or (4))	Remaining tax liability limitation ((4)–(5))	Unused credit ((1)–(5)) or (amount absorbed)
B. Credit earned	50,000	....	....	[35,000]	35,000	0	15,000
Carryover to 1980	....	....	....	....	....	....	(*15,000)
1980:							
A. Carryover from 1979	*15,000	55,000	70	46,000	15,000	31,000	....
B. Credit earned	25,000	....	....	[31,000]	25,000	6,000	0

*For line ‘‘A’’ each year: Lesser of (1) tax liability or (2) $25,000 + (percentage in col. (3) × [col. (2) − $25,000]). See, §1.46–1(h). For other lines: Amount in col. (6) on preceding line.

Example 2. (a) Assume the same facts as in *Example 1* except for 1979 M earns a $35,000 nonrefundable energy credit. The following table shows the determinations for each year.

	(1)	(2)		(3)	(4)	(5)	(6)	(7)
	Credit available	Tax liability		Percent	Tax liability limitation* (remaining from col. (6) on preceding line)	Credit allowed (lower of (1) or (4))	Remaining tax liability limitation ((4)–(5))	Unused credit ((1)–(5)) or (amount absorbed)
		(a) Regular	(b) Energy ((2)(a)–(5)(R))					
1977:								
Regular:								
A. Credit earned	$20,000	$45,000	....	50	$35,000	$20,000R	$15,000	0
B. Carryback from 1978	*15,000	....	....	....	[15,000]	15,000R	0	....
1978:								
Regular:								
A. Credit earned	60,000	55,000	....	50	40,000	40,000R	0	$20,000
Carryback to 1977	....	....	....	....	....	....	....	(*15,000)
Carryover to 1979	....	....	....	....	....	....	....	(*5,000)
Energy:								
A. Carryback from 1979	*15,000	....	$15,000	100	15,000	15,000E	0	....
1979:								
Regular:								
A. Carryover from 1978	*5,000	50,000	....	60	40,000	5,000R	35,000	....
B. Credit earned	50,000	....	....	....	[35,000]	35,000R	0	15,000
Carryover to 1980	....	....	....	....	....	....	....	(*15,000)
Energy:								
A. Credit earned	35,000	....	10,000	100	10,000	10,000E	0	25,000
Carryback to 1978	....	....	....	....	....	....	....	(*15,000)
Carryover to 1980	....	....	....	....	....	....	....	(*10,000)
1980:								
Regular:								
A. Carryover from 1979	*15,000	55,000	....	70	46,000	15,000R	31,000	....
B. Credit earned	25,000	....	....	....	[31,000]	25,000R	6,000	0
Energy:								
A. Carryover from 1979	*10,000	....	15,000	100	15,000	10,000E	5,000	....

*See footnote to the chart in *Example 1.*

(b) Although, in general, a nonrefundable energy credit may be carried back to taxable years ending before October 1, 1978, in this example the unused nonrefundable energy credit from 1979 may not be absorbed in 1977. The 1977 tax liability limitation for the nonrefundable energy credit is the same as it is for the regular credit, reduced by regular credit previously allowed for 1977. See §§1.46–1(h)(3) and 1.46–1(m).

Example 3. (a) Assume the same facts as in *Example 2* except M has regular credit of $37,000 for 1981 and M’s tax liability for 1981 is $32,500. The determinations for 1980 and 1981 are set forth in the following table.

	(1)	(2)		(3)	(4)	(5)	(6)	(7)
	Credit available	Tax liability		Percent	Tax liability limitation* (remaining from col. (6) on preceding line)	Credit allowed (lower of (1) or (4))	Remaining tax liability limitation ((4)–(5))	Unused credit ((1)–(5)) or (amount absorbed)
		(a) Regular	(b) Energy ((2)–(5)(R))					
1979 (restated):								
Energy:								
To be carried over								$10,000
Carryover to 1980								(*9,000)
Carryover to 1981								(*1,000)
1980 (restated):								
Regular:								
A. Carryover from 1979	$15,000	$55,000		70	$46,000	$15,000R	$31,000	
B. Credit earned	*25,000				[31,000]	25,000R	6,000	0
C. Carryback from 1981	*6,000				[6,000]	6,000R	0	
Energy:								
A. Carryover from 1979	*9,000		$9,000	100	9,000	9,000E		
1981: Regular:								
A. Credit earned	37,000	32,500		80	31,000	31,000R	0	6,000
Carryback to 1980								(*6,000)
Energy:								
A. Carryover from 1979	*1,000		1,500	100	1,500	1,000E	500	0

*See footnote to chart under *Example 1.*

(b) Allowance of the regular carryback in 1980 from 1981 requires that the computations for 1980 be restated. The energy tax liability limitation for 1980 is reduced from $15,000 (as determined in *Example 2*) to $9,000. Thus, $1,000 of the $10,000 energy credit allowed for 1980 is displaced by the regular carryback. That amount may not be carried back because there is no remaining energy tax liability limitation for the prior 3 years (see table in *Example 2*). It may be carried over to 1981 and allowed in full in that year.

(i) [Reserved]

(j) *Electing small business corporation.* A shareholder of an electing small business corporation (as defined in section 1371(b)) may not take into account unused credit of the corporation attributable to unused credit years for which the corporation was not an electing small business corporation. However, a taxable year for which the corporation is an electing small business corporation is counted as a taxable year for determining the taxable years to which that unused credit may be carried.

(k) *Periods of less than 12 months.* A fractional part of a year that is considered a taxable year under sections 441(b) and 7701(a)(23) is treated as a preceding or succeeding taxable year for determining under section 46(b) the taxable years to which an unused credit may be carried.

(l) *Corporate acquisitions.* For carryover of unused credits in the case of certain corporate acquisitions, see section 381(c)(23).

(Secs. 7805 (68A Stat. 917, 26 U.S.C. 7805) and 38(b) (76 Stat. 962, 26 U.S.C. 38))

[T.D. 7751, 46 FR 1679, Jan. 7, 1981]

§ 1.46–3 Qualified investment.

(a) *In general.* (1) With respect to any taxable year, the qualified investment of the taxpayer is the aggregate (expressed in dollars) of (i) the applicable percentage of the basis of each new section 38 property placed in service by the taxpayer during such taxable year, plus (ii) the applicable percentage of the cost of each used section 38 property placed in service by the taxpayer during such taxable year. With respect to any section 38 property, qualified investment means the applicable percentage of the basis (or cost) of such property. Section 38 property placed in service by the taxpayer during the taxable year includes the taxpayer's share of the basis (or cost) of section 38 property placed in service by a partnership in the taxable year of such partnership ending with or within the taxpayer's taxable year. In the case of a shareholder of an electing small business corporation (as defined in section 1371(b)), or a beneficiary of an estate or trust, see §§1.48–5 and 1.48–6, respectively, for apportionment of the basis (or cost) of section 38 property placed in service by such corporation, estate, or trust. For the definitions of new section 38 property and used section 38 property, see §§1.48–2 and 1.48–3, respectively. *See* §1.46–5 for special rules for progress expenditure property.

(2) The basis (or cost) of section 38 property placed in service during a taxable year shall not be taken into account in determining qualified investment for such year if such property is disposed of or otherwise ceases to be section 38 property during such year, except where §1.47–3 applies. Thus, if individual A places in service during a taxable year section 38 property and later in the same year sells such property, the basis (or cost) of such property shall not be taken into account in determining A's qualified investment. On the other hand, if A places in service section 38 property during a taxable year and dies later in the same year, the basis (or cost) of such property would be taken into account in computing qualified investment. Similarly, if section 38 property is destroyed by fire in the same year in which it is placed in service and paragraph (h) of this section applies to reduce the basis (or cost) of replacement property, the basis (or cost) of the destroyed property would be taken into account in computing qualified investment. In order to determine whether section 38 property is disposed of or otherwise ceases to be section 38 property see §1.47–2.

(3) Qualified investment is reduced in the case of property which is ''public utility property'' (see paragraph (h) of this section), and in the case of property of organizations to which section 593 applies, regulated investment companies or real estate investment trusts subject to taxation under subchapter M, chapter 1 of the Code, and cooperative organizations described in section 1381(a) (see §1.46–4).

(b) *Applicable percentage.* The applicable percentage to be applied to the basis (or cost) of property is 33⅓ percent if the estimated useful life of the property is 3 years or more but less than 5 years; 66⅔ percent if the estimated useful life is 5 years or more but less than 7 years; or 100 percent if the estimated useful life is 7 years or more. In the case of property which is not described in section 50, the preceding sentence shall be applied by substituting ''4 years'' for ''3 years'', ''6 years'' for ''5 years'', and ''8 years'' for ''7 years''. The provisions of this paragraph may be illustrated by the following example:

Example. Corporation Y acquires and places in service during 1972 the following new and used section 38 properties:

Property	Estimated useful life (years)	Basis (or cost)
A (new)	4	$60,000
B (new)	10	90,000
C (new)	6	150,000
D (used)	3	30,000

Corporation Y's qualified investment for 1972 is $220,000 determined in the following manner:

Property	Basis (or cost)	Applicable percentage	Qualified investment
A	$60,000	33⅓	$20,000
B	90,000	100	90,000
C	150,000	66⅔	100,000
D	30,000	33⅓	10,000
Total			220,000

(c) *Basis or cost.* (1) The basis of any new section 38 property shall be determined in accordance with the general rules for determining the basis of property. Thus, the basis of property would generally be its cost (see section 1012), unreduced by the adjustment to basis provided by section 48(g)(1) with respect to property placed in service before January 1, 1964, and any other adjustment to basis, such as that for depreciation, and would include all items properly included by the taxpayer in the depreciable basis of the property, such as installation and freight costs. However, for purposes of determining qualified investment, the basis of new section 38 property constructed, reconstructed, or erected by the taxpayer shall not include any depreciation sustained with respect to any other property used in the construction, reconstruction, or erection of such new section 38 property. (See paragraph (b)(4) of § 1.48–1.) If new section 38 property is acquired in exchange for cash and other property in a transaction described in section 1031 in which no gain or loss is recognized, the basis of the newly acquired property for purposes of determining qualified investment would be equal to the adjusted basis of the other property plus the cash paid. See § 1.48–4 for the basis of property to a lessee where the lessor has elected to treat such lessee as a purchaser.

(2) The cost of any used section 38 property shall be determined in accordance with paragraph (b) of § 1.48–3. However, the aggregate cost of used section 38 property which may be taken into account in any taxable year in computing qualified investment cannot exceed $50,000 (see paragraph (c) of § 1.48–3).

(3) For reduction in the basis (or cost) of certain property which replaces other property which was destroyed or damaged by fire, storm, shipwreck, or other casualty, or which was stolen, see paragraph (h) of this section.

(d) *Placed in service.* (1) For purposes of the credit allowed by section 38, property shall be considered placed in service in the earlier of the following taxable years:

(i) The taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins; or

(ii) The taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity.

Thus, if property meets the conditions of subdivision (ii) of this subparagraph in a taxable year, it shall be considered placed in service in such year notwithstanding that the period for depreciation with respect to such property begins in a succeeding taxable year because, for example, under the taxpayer's depreciation practice such property is accounted for in a multiple asset account and depreciation is computed under an ''averaging convention'' (see § 1.167(a)–10), or depreciation with respect to such property is computed under the completed contract method, the unit of production method, or the retirement method.

(2) In the case of property acquired by a taxpayer for use in his trade or business (or in the production of income), the following are examples of cases where property shall be considered in a condition or state of readiness and availability for a specifically assigned function:

(i) Parts are acquired and set aside during the taxable year for use as replacements for a particular machine (or machines) in order to avoid operational time loss.

(ii) Operational farm equipment is acquired during the taxable year and it is not practicable to use such equipment for its specifically assigned function in the taxpayer's business of farming until the following year.

(iii) Equipment is acquired for a specifically assigned function and is operational but is undergoing testing to eliminate any defects.

(iv) Reforestation expenditures (as defined in § 1.194–3(c)) are incurred during the taxable year in connection with qualified timber property (as defined in § 1.194–3(a)).

However, fruit-bearing trees and vines shall not be considered in a condition or state of readiness and availability for a specifically assigned function until they have reached an income-producing stage. Moreover, materials and parts acquired to be used in the construction of an item of equipment shall not be considered in a condition or state of readiness and availability for a specifically assigned function.

(3) Notwithstanding subparagraph (1) of this paragraph, property with respect to which an election is made under § 1.48–4 to treat the lessee as having purchased such property shall be considered placed in service by the lessor in the taxable year in which possession is transferred to such lessee.

(4)(i) The credit allowed by section 38 with respect to any property shall be allowed only for the first taxable year in which such property is placed in service by the taxpayer. The determination of whether property is section 38 property in the hands of the taxpayer shall be made with respect to such first taxable year. Thus, if a taxpayer places property in service in a taxable year and such property does not qualify as section 38 property (or only a portion of such property qualifies as section 38 property) in such year, no credit (or a credit only as to the portion which qualifies in such year) shall be allowed to the taxpayer with respect to such property notwithstanding that such property (or a greater portion of such property) qualifies as section 38 property in a subsequent taxable year. For example, if a taxpayer places property in service in 1963 and uses the property entirely for personal purposes in such year, but in 1964 begins using the property in a trade or business, no credit is allowable to the taxpayer under section 38 with respect to such property. See §1.48–1 for the definition of section 38 property.

(ii) Notwithstanding subdivision (i) of this subparagraph, if, for the first taxable year in which property is placed in service by the taxpayer, the property qualifies as section 38 property but the basis of the property does not reflect its full cost for the reason that the total amount to be paid or incurred by the taxpayer for the property is indeterminate, a credit shall be allowed to the taxpayer for such first taxable year with respect to so much of the cost as is reflected in the basis of the property as of the close of such year, and an additional credit shall be allowed to the taxpayer for any subsequent taxable year with respect to the additional cost paid or incurred during such year and reflected in the basis of the property as of the close of such year. The estimated useful life used in computing each additional credit with respect to the property shall be the same as the estimated useful life used in computing the credit for the first taxable year in which the property was placed in service by the taxpayer. Assume, for example, that in 1964 X Corporation, a utility company which makes its return on the basis of a calendar year, enters into an agreement with Y Corporation, a builder, to construct certain utility facilities for a housing development built by Y. Assume further that part of the funds for the construction of the utility facilities is advanced by Y under a contract providing that X will repay the advances over a 10-year period in accordance with an agreed formula, after which no further amounts will be repayable by X even though the full amount advanced by Y has not been repaid. Assuming that the utility facilities are placed in service in 1964 and qualify as section 38 property, X is allowed a credit for 1964 with respect to its basis in the utility facilities at the close of 1964. For each succeeding taxable year X is allowed an additional credit with respect to the increase in the basis of the utility facilities resulting from the repayments to Y during such year.

(e) *Estimated useful life*—(1)(i) *In general.* With respect to assets placed in service by the taxpayer during any taxable year, for the purpose of computing qualified investment the estimated useful lives assigned to all assets which fall within a particular guideline class (within the meaning of Revenue Procedure 62–21) may be determined, at the taxpayer's option, under either subparagraph (2) or (3) of this paragraph. Thus, the taxpayer may assign estimated useful lives to all the assets falling in one guideline class in accordance with subparagraph (2) of this paragraph, and may assign estimated useful lives to all the assets falling within another guideline class in accordance with subparagraph (3) of this paragraph. See subparagraphs (4) and (5) of this paragraph for determination of estimated useful lives of assets not subject to subparagraph (2) or (3) of this paragraph.

(ii) Except as provided in subparagraph (7), this paragraph shall not apply to property described in section 50.

(2) *Class life system.* The taxpayer may assign to each asset falling within a guideline class, which is placed in service during the taxable year, the class life of the taxpayer for the guideline class for such year as determined under section 4, part II of Revenue Procedure 62–21. The preceding sentence may be applied to the assets falling within a guideline class irrespective of whether

the taxpayer uses single asset accounts or multiple asset accounts in computing depreciation with respect to such assets and irrespective of whether the taxpayer chooses to have his depreciation allowance with respect to such assets examined under the rules provided in Revenue Procedure 62–21.

(3) *Individual useful life system.* (i) The taxpayer may assign an individual estimated useful life to each asset falling within a guideline class which is placed in service during the taxable year. With respect to the assets falling within the guideline class which are placed in single asset accounts for purposes of computing depreciation, the estimated useful life used for each asset for that purpose shall be used in determining qualified investment. With respect to the assets falling within the guideline class which are placed in multiple asset accounts (including a guideline class account described in Revenue Procedure 62–21) for which a group, classified, or composite rate is used in computing depreciation (or in single asset accounts for which an average life rate is used), the determination of estimated useful life for each asset in the account shall be made individually on the best estimate obtainable on the basis of all the facts and circumstances. The individual estimated useful lives used for all the assets placed in a multiple asset account, when viewed together, must be consistent with the group, classified, or composite life used for the account for purposes of computing depreciation.

(ii) In determining the individual estimated useful lives of assets similar in kind contained in a multiple asset account (or in single asset accounts for which an average life rate is used), the taxpayer may *(a)* assign to each of such assets the average useful life of such assets used for purposes of computing depreciation, or *(b)* assign separate lives to such assets based on the estimated range of years taken into consideration in establishing the average useful life. Thus, for example, if a taxpayer places nine similar trucks with an average estimated useful life of 7 years, based on an estimated range of 6 to 8 years (two trucks with a useful life of 6 years, five trucks with a useful life of 7 years, and two trucks with a useful life of 8 years), in a multiple asset account for which a group rate is used in computing depreciation, he may either assign a useful life of 6 years to two of the trucks, 7 years to five of the trucks, and 8 years to two of the trucks, or he may assign the average useful life of the trucks (7 years) to each of the nine trucks. Likewise, if a taxpayer places 100 similar telephone poles with an average useful life of 28 years, based on an estimated range of 3 to 40 years (two with a useful life of less than 4 years, three with a useful life of 4 to 6 years, four with a useful life of 6 to 8 years, and 91 with a useful life of more than 8 years), in a multiple asset account for which a group rate is used in computing depreciation, he may either assign useful lives corresponding to the estimated range of years of the poles (i.e., a useful life of less than 4 years to two of the poles, etc.), or he may assign the average useful life of the poles (28 years) to each of the poles.

(iii) [Reserved]

(iv) For purposes of subdivision (ii) of this subparagraph, assets (other than ‘‘mass assets’’) shall not be considered as ‘‘similar in kind’’ in respect of other assets unless all such assets are substantially of the same value, nor shall used section 38 property be considered as ‘‘similar in kind’’ to new section 38 property.

(4) *Useful life of property subject to amortization*—(i) *In general.* In the case of property with respect to which amortization in lieu of depreciation is allowable, the term over which amortization deductions are taken shall be considered as the estimated useful life of such property.

(ii) *Qualified timber property.* In the case of qualified timber property (within the meaning of section 194(c)(1)), the normal growing period of such property shall be considered its estimated useful life.

(5) *Useful life of property subject to certain methods of depreciation.* If a taxpayer is using a method of depreciation, such as the unit of production or retirement method, which does not measure the useful life of the property in terms of years, he must estimate such useful life in years in order to compute his qualified investment.

(6) *Record requirements.* The taxpayer shall maintain sufficient records to determine whether section 47 (relating to certain dispositions, etc., of section 38 property) applies with respect to any asset.

(7) *Section 50 property.* (i) The provisions of this subparagraph and subparagraphs (4) and (6) of this paragraph shall apply to property which is described in section 50.

(ii) The estimated useful life of property for purposes of computing qualified investment shall be the useful life used or to be used by the taxpayer in computing the allowance for depreciation with respect to such property under section 167 for the taxable year in which the property is placed in service. Thus, if property is placed in service by a taxpayer in a taxable year but the period for depreciation with respect to such property does not begin until a succeeding taxable year (see paragraph (d)(1) of this section), the estimated useful life for purposes of computing qualified investment must be the estimated useful life that the taxpayer uses in computing the allowance for depreciation. See subdivision (iv) of this subparagraph for rules for determining the estimated useful life of property with respect to which the allowance for depreciation under section 167 is computed under the unit of production method, the income-forecast method, or any other method which does not measure the useful life of the property in terms of years.

(iii)*(a)* The estimated useful life of any section 38 property to which an election under section 167(m) applies shall be the asset depreciation period selected for such property under §1.167(a)–11(b)(4), whether or not such property constitutes mass assets (as defined in §1.47–1(e)(4)).

(b) The estimated useful life of any section 38 property to which an election under section 167(m) does not apply and which is placed in a multiple asset account for which a group, classified, or composite rate is used in computing depreciation (or in single asset accounts for which an average life rate is used) shall be determined individually for each asset on the best estimate obtainable on the basis of all the facts and circumstances. The individual estimated useful life for each asset placed in a multiple asset account (including a mass asset account) must be the same as the useful life of such asset used in determining the group, classified, or composite life for the account for purposes of computing depreciation. The individual estimated useful lives of assets similar in kind may be determined in accordance with subdivisions (ii) and (iv) of subparagraph (3) of this paragraph. In the case of mass assets, subdivision (iii) of subparagraph (3) of this paragraph shall apply.

(f) *Partnerships*—(1) *In general.* In the case of a partnership, each partner shall take into account separately, for his taxable year with or within which the partnership taxable year ends, his share of the basis of partnership new section 38 property and his share of the cost of partnership used section 38 property placed in service by the partnership during such partnership taxable year. Each partner shall be treated as the taxpayer with respect to his share of the basis of partnership new section 38 property and his share of the cost of partnership used section 38 property. The estimated useful life to each partner of such property shall be deemed to be the estimated useful life of the property in the hands of the partnership. Partnership section 38 property shall not, by reason of each partner taking his share of the basis or cost into account, lose its character as either new section 38 property or used section 38 property, as the case may be. For computation of each partner's qualified investment for the energy credit for a qualified intercity bus, see §1.48–9(q)(9)(iv).

(2) *Determination of partner's share.* (i) Each partner's share of the basis (or cost) of any section 38 property shall be determined in accordance with the ratio in which the partners divide the general profits of the partnership (that is, the taxable income of the partnership as described in section 702(a)(9)) regardless of whether the partnership has a profit or a loss for its taxable year during which the section 38 property is placed in service. However, if the ratio in which the partners divide the general profits of the partnership changes during the taxable year of the

partnership, the ratio effective for the date on which the property is placed in service shall apply.

(ii) Notwithstanding subdivision (i) of this subparagraph, if all related items of income, gain, loss, and deduction with respect to any item of partnership section 38 property are specially allocated in the same manner and if such special allocation is recognized under section 704 (a) and (b) and paragraph (b) of § 1.704–1, then each partner's share of the basis of such item of new section 38 property or the cost of such item of used section 38 property shall be determined by reference to such special allocation effective for the date on which the property is placed in service.

(iii) Notwithstanding subdivisions (i) and (ii) of this subparagraph, if with respect to a partnership's taxable year the conditions set forth in *(a)* through *(c)* of this subdivision are satisfied with respect to a partner, then such partner shall not take into account the basis (or cost) of any section 38 property placed in service by the partnership during such taxable year. The conditions referred to in the preceding sentence are:

(a) Such partner's interest in the general profits of the partnership during the taxable year is 5 percent or less;

(b) Under the partnership agreement, such partner will retire from the partnership during the taxable year or within 7 years after the end of such year; and

(c) The partnership agreement provides that the basis (or cost) of section 38 property placed in service by the partnership during the taxable year shall not be taken into account by a partner described in *(a)* and *(b)* of this subdivision.

Any basis (or cost) of section 38 property which is not taken into account by a partner because of the provisions of this subdivision shall be taken into account by the other partners in accordance with subdivision (i) of this subparagraph.

(3) *Examples.* This paragraph may be illustrated by the following examples:

Example 1. Partnership ABCD acquires and places in service on January 1, 1962, an item of new section 38 property, and acquires and places in service on September 1, 1962, another item of new section 38 property. The ABCD partnership and each of its partners reports income on the basis of the calendar year. Partners A, B, C, and D share partnership profits equally. Each partner's share of the basis of each new partnership section 38 property is 25 percent.

Example 2. Assume the same facts as in *Example 1* and the following additional facts: A dies on June 30, 1962, and B purchases A's interest as of such date. Each partner's share of the profits from January 1 to June 30 is 25 percent. From July 1 to December 31, B's share of the profits is 50 percent, and C and D's share of the profits is 25 percent each. For A's last taxable year (January 1 to June 30, 1962), A shall take into account 25 percent of the basis of the section 38 property placed in service on January 1. B shall take into account 25 percent of the basis of the section 38 property placed in service on January 1 and 50 percent of the basis of the section 38 property placed in service on September 1, C and D shall each take into account 25 percent of the basis of each new section 38 property placed in service by the partnership in 1962.

Example 3. Partnership MR is engaged in the business of renting soda fountain equipment and icemakers to restaurants. The partnership makes no elections under § 1.48–4 to treat its lessees as having purchased such property. Under the terms of the partnership agreement, the income, gain or loss on disposition, depreciation, and other deductions attributable to the icemakers are specially allocated 70 percent to partner M and 30 percent to partner R. In all other respects M and R share profits and losses equally. If the special allocation with respect to the icemakers is recognized under section 704 (a) and (b) and paragraph (b) of § 1.704–1, the basis (or cost) of the icemakers which qualify as partnership section 38 property shall be taken into account 70 percent by M and 30 percent by R. The basis (or cost) of partnership section 38 property not subject to the special allocation shall be taken into account equally by M and R.

Example 4. Assume the same facts as in *Example 3* and the following additional facts: During November 1962, the partnership, which reports its income on the basis of a fiscal year ending May 31, acquires and places in service two items which qualify as new section 38 property, an icemaker and a soda fountain. The icemaker has an estimated useful life of 8 years to the partnership and a basis of $1,000. The soda fountain has an estimated useful life of 6 years to the partnership and a basis of $600. Partner M also owns and operates a business as a sole proprietorship and reports income on the calendar year basis. During 1963, M acquires and places in service in his sole proprietorship a machine which qualifies as new section 38 property. This machine has an estimated useful life of 4 years and a basis of $300. M owns no interest in any other partnerships, electing small business corporations, estates, or trusts. M's total qualified investment for 1963 is $1,000, computed as follows:

Property	Estimated useful life	Basis	M's share of basis	Applicable percentage	Qualified investment
Partnership MR					
Icemaker	8	$1,000	$700	100	$700
Soda fountain	6	600	300	66⅔	200
Sole proprietorship					
Machine	4	300	....	33⅓	100
Total					1,000

(g) *Public utility property*—(1) *In general*—(i) *Scope of paragraph*. This paragraph only applies to property described in section 50. For rules relating to public utility property not described in section 50, see 26 CFR part 1, § 1.46–3(g) (as revised April 1, 1977). This paragraph does not reflect amendments to section 46(c) made after enactment of the Revenue Act of 1971.

(ii) *Amount of qualified investment*. A taxpayer's qualified investment in section 38 property that is public utility property is 4/7 of the amount otherwise determined under this section.

(2) *Meaning and uses of certain terms*. For purposes of this paragraph—

(i) *Public utility property*. ''Public utility property'' is property used by a taxpayer predominantly in a trade or business that is a public utility activity and property that is nonregulated communication property.

(ii) *Public utility activity*. A ''public utility activity'' is any activity in which the goods or services described in section 46(c)(3)(B) (i), (ii), or (iii) are furnished or sold at regulated rates. If property is used by a taxpayer both in a public utility activity and in another activity, the characterization of such property is based on the predominant use of such property during the taxable year in which it is placed in service.

(iii) *Regulated rates*. A taxpayer's rates are ''regulated'' if they are established or approved on a rate-of-return basis. Rates regulated on a rate-of-return basis are an authorization to collect revenues that cover the taxpayer's cost of providing goods or services, including a fair return on the taxpayer's investment in providing such goods or services, where the taxpayer's costs and investment are determined by use of a uniform system of accounts prescribed by the regulatory body. A taxpayer's rates are not ''regulated'' if they are established or approved on the basis of maintaining competition within an industry, insuring adequate service to customers of an industry, or charging ''reasonable'' rates within an industry since the taxpayer is not authorized to collect revenues based on the taxpayer's cost of providing goods or services. Rates are considered to have been ''established or approved'' if a schedule of rates is filed with a regulatory body that has the power to approve such rates, even though the regulatory body takes no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer.

(iv) *Nonregulated communication property*. ''Nonregulated communication property'' is property that is clearly the same type of property (and is used by the taxpayer predominantly for the same type of communication purposes) as communication property, but it is used by the taxpayer predominantly in a trade or business that is not a public utility activity. For purposes of this paragraph (g)(2)(iv), of this section, communication property is property ordinarily used for communication purposes by persons who provide regulated telephone or microwave communication services described in section 46(c)(3)(B)(iii). The determination of whether property is clearly of this same type and is used predominantly for these same communication purposes as communication property is made on the basis of the facts and circumstances of each particular case, including the current state of technology in the communications industry and the range and type of services permitted or required to be provided by the regulated telephone and microwave communication industry. As of 1978, wires or cables used predominantly to distribute to subscribers the signals of one or more television broadcast stations or cablecast stations (such as in a CATV system) are not used for the same type of communication purposes as communication property. Communication property includes microwave transmission equipment, private communication equipment (other than land mobile radio equipment for which the operator must obtain a license from the Federal Communications Commission), private switchboard (PBX) equipment, communications terminal equipment connected to telephone networks, data transmission equipment, and communications satellites. Communication property does not include (as of 1978) computer terminals or facsimile reproduction equipment that is connected to telephone lines to transmit data. It also does not include office furniture stands for communication property, tools, repair vehicles, and similar property, even if such property is exclusively used in providing regulated telephone or microwave communication services.

(3) *Leased property.* Public utility property includes property which is leased to others by a taxpayer where the leasing of such property is part of the lessor's public utility activity. Thus, such leased property is public utility property even though the lessee uses such property in an activity which is not a public utility activity, and whether or not the lessor of such property makes a valid election under § 1.48–4 to treat the lessee as having purchased such property for purposes of the credit allowed by section 38. Property leased by a lessor, where the leasing is not part of a public utility activity, to a lessee who uses such property predominantly in a public utility activity is public utility property for purposes of computing the lessor's or lessee's qualified investment with respect to such property.

(4) *Property used in both the production or transmission of gas and the local distribution of gas.* (i) With respect to properties of a taxpayer engaged in both the production or transmission of gas and the local distribution of gas, section 38 property shall be considered as used predominantly in the trade or business of the furnishing or sale of gas through a local distribution system if expenditures for such property are chargeable to any of the following accounts under either the uniform system of accounts prescribed for natural gas companies (class A and class B) by the Federal Power Commission, effective January 1, 1961, or the uniform system of accounts for class A and B gas utilities adopted in 1958 by the National Association of Railroad and Utility Commissioners (or would be chargeable to any of the following accounts if the taxpayer used either of such systems):

(a) Accounts 360 through 363, inclusive (Local Storage Plant), or

(b) Accounts 374 through 387, inclusive (Distribution Plant).

(ii) If expenditures for section 38 property are chargeable (or would be chargeable) to any of the following accounts under either of the systems named in subdivision (i) of this subparagraph, the determination of whether or not such property is used predominantly in the trade or business of the furnishing or sale of gas through a local distribution system shall be made under all the facts and circumstances relating to the actual use of such property in the year such property is placed in service:

(a) Accounts 304 through 320, inclusive (Manufactured Gas Production Plant), or

(b) Accounts 389 through 399, inclusive (General Plant).

For example, if an office machine is used 55 percent of the time for billing customers of the taxpayer's local distribution system in the year in which it is placed in service, such office machine shall be considered as used predominantly in the trade or business of the furnishing or sale of gas through a local distribution system.

(5) *Certain submarine cable property.* In the case of any interest in a submarine cable circuit which is property described in section 50 used to furnish telegraph service between the United States and a point outside the United

States of a taxpayer engaged in furnishing international telegraph service (if the rates for such furnishing have been established or approved by a governmental unit, agency, instrumentality, commission, or similar body described in subparagraph (2) of this paragraph), the qualified investment shall not exceed the qualified investment attributable to so much of the interest of the taxpayer in the circuit as does not exceed 50 percent of all interests in the circuit.

(h) *Certain replacement property*. (1)(i) If section 38 property is placed in service by the taxpayer to replace property (whether or not section 38 property) similar or related in service or use, which was destroyed or damaged before August 16, 1971, by fire, storm, shipwreck, or other casualty, or was stolen before such date, then for purposes of paragraph (a) of this section the basis (or cost) of the replacement section 38 property otherwise determined under paragraph (c) of this section shall be reduced by an amount equal to the lesser of—

(a) The amount of money, or the fair market value of other property, received as compensation, by insurance or otherwise, for the property which was destroyed, damaged, or stolen, or

(b) The adjusted basis of such destroyed, damaged, or stolen property (immediately before such destruction, damage, or theft).

(ii) For purposes of subdivision (i) of this subparagraph—

(a) Section 38 property placed in service after the due date (including extensions of time thereof) for filing the taxpayer's income tax return for the taxable year in which the other property was destroyed, damaged, or stolen shall not be considered as replacement section 38 property, and

(b) If the property which is destroyed, damaged, or stolen, is leased property, no other leased property shall be considered as replacement property with respect to the property destroyed, damaged, or stolen, in any case in which the lessor makes or made an election under section 48(d) (relating to election with respect to certain leased property) with respect to either the property destroyed, damaged, or stolen, the other leased property, or both.

(2) Subparagraph (1) of this paragraph shall not apply to replacement property if the reduction, under such subparagraph (1), in the basis (or cost) of such replacement property is less than the excess of—

(i) The qualified investment with respect to the destroyed, damaged, or stolen property, over

(ii) The recomputed qualified investment with respect to such property (determined under the principles of paragraph (a) of §1.47–1).

(3) This paragraph may be illustrated by the following examples:

Example 1. (i) A acquired and placed in service on January 1, 1962, machine No. 1, which qualified as section 38 property, with a basis of $30,000 and an estimated useful life of 6 years. The amount of qualified investment with respect to such machine was $20,000. On January 2, 1963, machine No. 1 is completely destroyed by fire. On January 1, 1963, the adjusted basis of such machine in A's hands is $24,500. On November 1, 1963, A receives $23,000 in insurance proceeds as compensation for the destroyed machine, and on December 15, 1963, A acquires and places in service machine No. 2, which qualifies as section 38 property, with a basis of $41,000 and an estimated useful life of 6 years to replace machine No. 1.

(ii) Under subparagraph (1) of this paragraph, the $41,000 basis of machine No. 2 is reduced, for purposes of paragraph (a) of this section, by $23,000 (that is, the $23,000 insurance proceeds since such amount is less than the $24,500 adjusted basis of machine No. 1 immediately before it was destroyed) to $18,000 since such reduction (that is, $23,000) is greater than the $20,000 reduction in qualified investment which would be made if paragraph (a) of §1.47–1 were to apply to machine No. 1 ($20,000 qualified investment less zero recomputed qualified investment).

Example 2. (i) The facts are the same as in *Example 1* except that on November 1, 1963, A receives only $19,000 in insurance proceeds as compensation for the destroyed machine.

(ii) The $41,000 basis of machine No. 2 is not reduced, for purposes of paragraph (a) of this section, under this paragraph since the $19,000 reduction which would have been made under this paragraph had it applied (that is, the $19,000 insurance proceeds since such amount is less than the $24,500 adjusted basis of machine No. 1 immediately before it was destroyed) is less than the $20,000 reduction in qualified investment which is made since paragraph (a) of §1.47–1 applies to machine No. 1 ($20,000 qualified investment less zero recomputed qualified investment).

(Secs. 194 (94 Stat. 1989; 26 U.S.C. 194) and 7805 (68A Stat. 917, 26 U.S.C. 7805) of the Internal Revenue Code of 1954; secs. 38(b) (76 Stat. 963, 26 U.S.C. 38(b)), 48(l)(16) (94 Stat. 264, 26 U.S.C. 48(l)(16)), and 7805 (68A Stat. 917, 26 U.S.C. 7805)

[T.D. 6731, 29 FR 6068, May 8, 1964, as amended by T.D. 6931, 32 FR 14026, Oct. 10, 1967; T.D. 7203, 37 FR 17125, Aug. 25, 1972; T.D. 7602, 44 FR 17667, Mar. 23, 1979; T.D. 7927, 48 FR 55849, Dec. 16, 1983; T.D. 7982, 49 FR 39541, Oct. 9, 1984; T.D. 8183, 53 FR 6618, Mar. 2, 1988; T.D. 8474, 58 FR 25557, Apr. 27, 1993]

§ 1.46–4 Limitations with respect to certain persons.

(a) *Mutual savings institutions.* In the case of an organization to which section 593 applies (that is, a mutual savings bank, a cooperative bank, or a domestic building and loan association)—

(1) The qualified investment with respect to each section 38 property shall be 50 percent of the amount otherwise determined under § 1.46–3, and

(2) The $25,000 amount specified in section 46(a)(2), relating to limitation based on amount of tax, shall be reduced by 50 percent of such amount.

For example, if a domestic building and loan association places in service on January 1, 1963, new section 38 property with a basis of $30,000 and an estimated useful life of 6 years, its qualified investment for 1963 with respect to such property computed under § 1.46–3 is $20,000 (66⅔ percent of $30,000). However, under this paragraph such amount is reduced to $10,000 (50 percent of $20,000). If an organization to which section 593 applies is a member of an affiliated group (as defined in section 46(a)(5)), the $25,000 amount specified in section 46(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of § 1.46–1 before such amount is further reduced under this paragraph.

(b) *Regulated investment companies and real estate investment trusts.* (1) In the case of a regulated investment company or a real estate investment trust subject to taxation under subchapter M, chapter 1 of the Code—

(i) The qualified investment with respect to each section 38 property otherwise determined under § 1.46–3, and

(ii) The $25,000 amount specified in section 46(a)(2), relating to limitation based on amount of tax, shall be reduced to such person's ratable share of each such amount. If a regulated investment company or a real estate investment trust is a member of an affiliated group (as defined in section 46(a)(5)), the $25,000 amount specified in section 46(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of § 1.46–1 before such amount is further reduced under this paragraph.

(2) A person's ratable share of the amount described in subparagraph (1)(i) and the amount described in subparagraph (1)(ii) of this paragraph shall be the ratio which—

(i) Taxable income for the taxable year, bears to

(ii) Taxable income for the taxable year plus the amount of the deduction for dividends paid taken into account under section 852(b)(2)(D) in computing investment company taxable income, or under section 857(b)(2)(B) (section 857(b)(2)(C), as then in effect, for taxable years ending before October 5, 1976) in computing real estate investment trust taxable income, as the case may be.

For purposes of the preceding sentence, taxable income means, in the case of a regulated investment company its investment company taxable income (within the meaning of section 852(b)(2)), and in the case of a real estate investment trust its real estate investment trust taxable income (within the meaning of section 857(b)(2)). In the case of a taxable year ending after October 4, 1976, real estate investment trust taxable income, for purposes of section 46(e) and this paragraph, is determined by excluding any net capital gain, and by computing the deduction for dividends paid without regard to capital gains dividends (as defined in section 857(b)(3)(C)). The amount of the deduction for dividends paid includes the amount of deficiency dividends (other than capital gains deficiency dividends) taken into account in computing investment company taxable income or real estate investment trust taxable income for the taxable year. See section 860(f) for the definition of deficiency dividends. For purposes of this paragraph only, in computing taxable income for a taxable year beginning before January 1, 1964, a regulated investment company or a real estate investment trust may compute depreciation deductions with respect to section 38 property placed in service before January 1, 1964, without regard to the reduction in basis of such property required under §1.48–7.

(3) This paragraph may be illustrated by the following example:

Example. (i) Corporation X, a regulated investment company subject to taxation under section 852 of the Code which makes its return on the basis of the calendar year, places in service on January 1, 1964, section 38 property with a basis of $30,000 and an estimated useful life of 6 years. Corporation X's investment company taxable income under section 852(b)(2) is $10,000 after taking into account a deduction for dividends paid of $90,000.

(ii) Under this paragraph, corporation X's qualified investment for the taxable year 1964 with respect to such property is $2,000, computed as follows: *(a)* $20,000 (qualified investment under §1.46–3), multiplied by *(b)* $10,000 (taxable income), divided by *(c)* $100,000 (taxable income plus the deduction for dividends paid). For 1964, the $25,000 amount specified in section 46(a)(2) is reduced to $2,500.

(c) *Cooperatives.* (1) In the case of a cooperative organization described in section 1381(a)—

(i) The qualified investment with respect to each section 38 property otherwise determined under §1.46–3, and

(ii) The $25,000 amount specified in section 46(a)(2), relating to limitation based on amount of tax,

shall be reduced to such cooperative's ratable share of each such amount. If a cooperative organization described in section 1381(a) is a member of an affiliated group (as defined in section 46(a)(5)), the $25,000 amount specified in section 46(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of §1.46–1 before such amount is further reduced under this paragraph.

(2) A cooperative's ratable share of the amount described in subparagraph (1)(i) and the amount described in subparagraph (1)(ii) of this paragraph shall be the ratio which—

(i) Taxable income for the taxable year, bears to

(ii) Taxable income for the taxable year plus the sum of *(a)* the amount of the deductions allowed under section 1382(b), *(b)* the amount of the deductions allowed under section 1382(c), and *(c)* amounts similar to the amounts described in *(a)* and *(b)* of this subdivision the tax treatment of which is determined without regard to subchapter T, chapter 1 of the Code and the regulations thereunder.

Amounts similar to deductions allowed under section 1382 (b) or (c) are, for example, in the case of a taxable year of a cooperative organization beginning before January 1, 1963, the amount of patronage dividends which are excluded or deducted and any nonpatronage distributions which are deducted under section 522(b)(1). In the case of a taxable year of a cooperative organization beginning after December 31, 1962, such amounts are the amount of patronage dividends and nonpatronage distributions which are excluded or deducted without regard to section 1382 (b) or (c) because they are paid with respect to patronage occurring before 1963. For purposes of this paragraph only, in computing taxable income for a taxable year beginning before January 1, 1964, a cooperative may compute depreciation deductions with respect to section 38 property placed in service before January 1, 1964, without regard to the reduction in basis of such property required under §1.48–7.

(3) This paragraph may be illustrated by the following example:

Example. (i) Cooperative X, an organization described in section 1381(a) which makes its return on the basis of the calendar year, places in service on January 1, 1964, section 38 property with a basis of $30,000 and an estimated useful life of 6 years. Cooperative X's taxable income is $10,000 after taking into account deductions of $20,000 allowed under section 1382(b), deductions of $60,000 allowed under section 1382(c), and deductions of $10,000 allowed under section 522(b)(1)(B).

(ii) Under this paragraph, cooperative X's qualified investment for the taxable year 1964 with respect to such property is $2,000, computed as follows: *(a)* $20,000 (qualified investment under §1.46–3), multiplied by *(b)* $10,000 (taxable income), divided by *(c)* $100,000 (taxable income plus the sum of the deductions allowed under sections 1382(b), 1382(c), and 522(b)(1)(B)). For 1964, the $25,000 amount specified in section 46(a)(2) is reduced to $2,500.

(d) *Noncorporate lessors.* (1) In the case of a lease entered into after September

22, 1971, a credit is allowed under section 38 to a noncorporate lessor of property with respect to the leased property only if—

(i) Such property has been manufactured or produced by the lessor in the ordinary course of his business, or

(ii) The term of the lease (taking into account any options to renew) is less than 50 percent of the estimated useful life of the property (determined under § 1.46–3(e)), and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.

In the case of property of which a partnership is the lessor, the credit otherwise allowable under section 38 with respect to such property to any partner which is a corporation shall be allowed notwithstanding the first sentence of this subparagraph. For purposes of this subparagraph, an electing small business corporation (as defined in section 1371) shall be treated as a person which is not a corporation. This paragraph shall not apply to property used by the taxpayer in his trade or business (other than the leasing of property) for a period of at least 24 months preceding the day on which any lease of such property is entered into.

(2) For purposes of subparagraph (1)(ii) of this paragraph, if at the time the lessor files his income tax return for the taxable year in which the property is placed in service, the lessor is unable to show that the more-than-15-percent test has been satisfied, then no credit may be claimed by the lessor on such return with respect to such property unless (i) taking into account the lessor's obligations under the lease it is reasonable to believe that the more-than-15-percent test will be satisfied, and (ii) the lessor files a statement with his return from which it may be determined that he expects to satisfy the more-than-15-percent test. If the more-than-15-percent test is not satisfied with respect to the property, the taxpayer must file an amended return for the year in which the property is placed in service.

(3)(i) The more-than-15-percent test described in subparagraph (1)(ii) of this paragraph is based on the relationship of the expenses of the lessor relating to or attributable to the property to the gross income from rents of the taxpayer produced by the property. The test is applied with respect to such expenses and gross income as are properly attributable to the period consisting of the first 12 months after the date on which the property is transferred to the lessee. When more than one property is subject to a single lease and, pursuant to subparagraph (4) of this paragraph, the arrangement is considered to be a separate lease of each property, the test is applied separately to each such lease by making an apportionment of the payments received and expenses incurred with respect to each such property, considering all relevant factors. Such apportionment is made in accordance with any reasonable method selected and consistently applied by the taxpayer. For example, under subparagraph (4) of this paragraph, where a taxpayer leases an airplane which he owns to an airline along with a baggage truck, he is treated as having made two separate leases, one covering the airplane and one covering the baggage truck. Thus, the test will be applied by apportioning the related income and expenses between the two leases. Similarly, where a taxpayer leases a factory building erected by him containing section 38 property (machinery and equipment), the test will be applied to the taxpayer as though he had leased (to the lessee) the building and the section 38 property separately. Thus, the rental income and expenses are apportioned between the building and the section 38 property.

(ii) Only those deductions allowable solely by reason of section 162 are taken into account in applying the more-than-15-percent test. Hence, depreciation allowable by reason of section 167 (including amortization allowable in lieu of depreciation); interest allowable by reason of section 163; taxes allowable by reason of section 164; and depletion allowable by reason of section 611 are examples of deductions which are not taken into account in applying the test. Moreover, rents and reimbursed amounts paid or payable by the lessor are not taken into account notwithstanding that a deduction in respect of such rents or reimbursed amounts is allowable solely by reason of section 162. For purposes of this paragraph, a reimbursed amount is any expense for which the lessee or some other party is obligated to reimburse the lessor. Section 162 expenses paid or payable by any person other than the lessor are not taken into account unless the lessor is obligated to reimburse the person paying the expense. Further, if the lessee is obligated to pay to the lessor a charge for services which is separately stated or determinable, the expenses incurred by the lessor with respect to those services are not taken into account.

(iii) For purposes of the more-than-15-percent test, the gross income from rents of the lessor produced by the property is the total amount which is payable to the lessor by reason of the lease agreement other than reimbursements of section 162 expenses and charges for services which are separately stated or determinable. The fact that such amount depends, in whole or in part, on the sales or profits of the lessee or the performance of significant services by the lessor shall not affect the characterization of such amounts as gross income from rents for purposes of this paragraph. Gross income from rents also includes any taxes imposed on the lessor by local law but which are paid directly by the lessee on behalf of the lessor.

(4) For purposes of determining under this paragraph whether property is subject to a lease, the provisions of §1.57–3(d)(1) (relating to definition of a lease) shall apply. If a noncorporate lessor enters into two or more successive leases with respect to the same or substantially similar items of section 38 property, the terms of such leases shall be aggregated and such leases shall be considered one lease for the purpose of determining whether the term of such leases is less than 50 percent of the estimated useful life of the property subject to such leases. Thus, for example, if an individual owns an airplane with an estimated useful life of 7 years and enters into three successive 3-year leases of such airplane, such leases will be considered to be one lease for a term of nine years for the purpose of determining whether the term of the lease is less than 3½ years (50 percent of the 7-year estimated useful life).

(5) The requirements of this paragraph shall not apply with respect to any property which is treated as section 38 property by reason of section 48(a)(1)(E).

(Sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)); and sec. 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6731, 29 FR 6071, May 8, 1964, as amended by T.D. 6958, 33 FR 9170, June 21, 1968; T.D. 7203, 37 FR 17126, Aug. 25, 1972; T.D. 7767, 46 FR 11262, Feb. 6, 1981; T.D. 7936, 49 FR 2105, Jan. 18, 1984; T.D. 8031, 50 FR 26697, June 28, 1985]

§1.46–5 Qualified progress expenditures.

(a) *Effective date.* This section applies to taxable years ending after December 31, 1974. This section reflects amendments to the Internal Revenue Code made only by the Tax Reduction Act of 1975, the Tax Reform Act of 1976, and the Revenue Act of 1978.

(b) *General rule.* Under section 46(d), a taxpayer may elect to take the investment credit for qualified progress expenditures (as defined in paragraph (g) of this section). In general, qualified progress expenditures are amounts paid (paid or incurred in the case of self-constructed property) for construction of progress expenditure property. The taxpayer must reasonably estimate that the property will take at least 2 years to construct and that the useful life of the property will be 7 years or more. Qualified progress expenditures may not be taken into account if made before the later of January 22, 1975, or the first taxable year to which an election under section 46(d) applies. In general, qualified progress expenditures are not allowed for the year property is placed in service, nor for the first year or any subsequent year recapture is required under section 47(a)(3). There is a percentage limitation on qualified progress expenditures for taxable years beginning before January 1, 1980. For a special rule relating to transfers of progress expenditure property, see paragraph (r) of this section.

(c) *Reduction of qualified investment.* Under section 46(c)(4), a taxpayer must reduce qualified investment for the year property is placed in service by qualified progress expenditures taken into account by that person or a predecessor. A ''predecessor'' of a taxpayer is a person whose election under section 46(d) carries over to the taxpayer under paragraph (o)(3) of this section.

(d) *Progress expenditure property.* Progress expenditure property is property constructed by or for the taxpayer, with a normal construction period of 2 years or more. The taxpayer must reasonably believe that the property will be new section 38 property with a useful life of 7 years or more when placed in service. Whether property is progress expenditure property is determined on the basis of facts know at the close of the taxable year of the taxpayer in which construction begins (or, if later, at the close of the first taxable year to which an election under section 46(d) applies). For purposes of this paragraph (d), property is constructed by or for the taxpayer only if it is built or manufactured from materials and component parts. Accordingly, progress expenditure property does not include property such as orchards, vineyards, livestock, or motion picture films or videotapes.

(e) *Normal construction period*—(1) *In general.* (i) The normal construction period is the period the taxpayer reasonably expects will be required to construct the property. The period begins on the date physical work on construction of the property commences and ends on the date the property is available to be placed in service. The normal construction period does not include, however, construction before January 22, 1975, nor construction before the first day of the first taxable year for which an election under section 46(d) is in effect. Physical work on construction of property does not include preliminary activities such as planning, designing, preparing blueprints, exploring, or securing financing.

(ii) The determination of the time when physical work on construction commences is based on the facts and circumstances of each case. Physical work on construction of property may include the physical work done by a subcontractor on a component specifically designated as part of the property. Also, the commencement of physical work on construction may occur at a site different from the main site of construction of the property. For example, if a shipyard orders a turbine before it begins work on building a ship, the normal construction period of the ship is measured from the time the subcontractor commences physical work on construction of the turbine (if it is normal for such work to precede the work of the main contractor).

(iii) Generally, physical work on construction does not include physical activity that is not necessary to complete construction of the property, nor does it include physical work on construction of a building or other property that will not be new section 38 property when placed in service. Physical work on construction also does not include research and development activities in a laboratory or experimental setting.

(iv) The normal construction period of property ends on the date it is expected the property will be available to be placed in service. Property is considered available to be placed in service when construction is completed and the property is available for delivery to the site of its assigned function. It is not necessary that property be in a state of readiness for a specifically assigned function. Nor is it necessary that it actually be delivered to the site of its assigned function.

(2) *Estimates.* Taxpayers should refer to normal industry practice in estimating the normal construction period of particular items. A different period may be used if special circumstances exist making it impractical to make the estimate on the basis of normal industry practice. The estimate must be based on information available at the close of the taxable year in which physical work on construction of the property begins, or, if later, at the close of the first taxable year for which an election under section 46(d) is in effect for the taxpayer. If the estimate is reasonable when made, the actual time it

takes to complete the work is, in general, irrelevant in determining whether property is progress expenditure property. However, if there is a significant error in estimating the normal construction period, it may be evidence that the estimate was unreasonable when made. For taxable years ending after April 1, 1988, a taxpayer not relying or normal industry practice to estimate the normal construction period of particular property must attach to the tax return for the taxable year in which physical work on construction of the property begins (or, if later, the first taxable year for which an election under section 46(d) is in effect) a statement of the basis relied upon in estimating the normal construction period of the property.

(3) *Integrated unit.* (i) In determining whether property has a normal construction period of 2 years or more, property that will be placed in service separately is to be considered separately. For example, if two ships are contracted for at the same time, each ship is considered separately under this paragraph. However, for property that will be placed in service as an integrated unit, the taxpayer must determine the normal construction period of the integrated unit. If the normal construction period of the integrated unit is 2 years or more, the normal construction period of each item of new section 38 property that is a part of the integrated unit is considered to be 2 years or more. Thus, the normal construction period of an integrated unit may be 2 years or more even if no part of the unit has a normal construction period of 2 years or more.

(ii) Property is part of an integrated unit only if the operation of that item is essential to the performance of the function to which the unit is assigned. Property essential to the performance of the function to which the unit is assigned includes property the use of which is significantly connected to that function and which effects the safe, proper, or efficient performance of the unit. Generally, property must be placed in service at the same time to be considered part of the same integrated unit. Properties are not an integrated unit, however, solely because they are to be placed in service at the same time.

(iii) The normal construction period for an integrated unit begins on the date the normal construction period of the first item of new section 38 property that is part of the unit begins. It is not necessary that physical work commence at the main construction site of the integrated unit.

The period ends on the date the last item of new section 38 property that is part of that unit is available to be placed in service. Property that is not new section 38 property, such as a building, is not considered part of an integrated unit for purposes of determining the normal construction period of that unit. For example, if a manufacturing plant has a normal construction period of two years or more but the equipment (*i.e.,* new section 38 property) to be installed in the plant has a normal construction period of less than two years, the plant and the equipment do not constitute an integrated unit with a construction period of two years or more and the equipment is not progress expenditure property.

(4) *Examples.* The following examples illustrate this paragraph (e).

Example 1. On July 1, 1974, corporation X begins physical work on construction of a machine with an estimated useful life when placed in service of more than 7 years. For its taxable year ending June 30, 1975, X makes an election under section 46(d). For purposes of determining on June 30, 1975, whether the machine is ‘‘progress expenditure property’’, the normal construction period is treated as having begun on January 22, 1975. Thus, the machine will be considered to be progress expenditure property on June 30, 1975, only if the estimated time required to complete construction after June 30 is at least 18 months and 22 days (*i.e.,* 2 years less the period January 22, 1975, through June 30, 1975).

Example 2. (i) Corporation X constructs a pipeline in two sections and simultaneously begins physical work on construction of each section on January 1, 1976. One section extends from city M to city N. The other extends from city N to city O. Oil will be transferred to storage tanks at both city N and city O. Corporation X also begins construction on January 1, 1976, of a pumping station necessary to the operation of the pipeline from city M to city N. Construction of a pumping station necessary to the operation of the pipeline from city N to city O begins on June 30, 1977. For 1976, corporation X makes an election under section 46(d).

(ii) The section of pipeline from city M to city N and the associated pumping station will be available to be placed in service on January 1, 1977. Construction of the section of the pipeline from city N to city O will be completed on June 30, 1977. However, that section of the pipeline will not be available to be placed in service until completion of the associated pumping station on January 1, 1978.

(iii) The section of pipeline from city M to city N and the section from city N to city O must be considered separately in determining the normal construction period of the property. Each section will be placed in service separately. However, each section of the pipeline and the associated pumping station may be considered an integrated unit. The pumping stations are essential to the operation of each section of pipeline. Each section of pipeline and the associated pumping station are placed in service at the same time.

(iv) The section of pipeline from city M to city N and the associated pumping station are not progress expenditure property, because the normal construction period of that unit is only 1 year (January 1, 1976 to January 1, 1977).

(v) The section of pipeline from city N to city O and the associated pumping station are progress expenditure property, because the normal construction of that integrated unit is 2 years (January 1, 1976 to January 1, 1978). It is immaterial that neither the construction period of that section of pipeline (January 1, 1976 to June 30, 1977) nor the construction period of the associated pumping station (June 30, 1977 to January 1, 1978) is 2 years.

(vi) Assume the pumping station associated with the pipeline from city N to city O includes backup pumping equipment that will be used only if the primary pumping equipment fails. The backup equipment is part of the integrated unit because it serves to effect the safe or efficient performance of the unit.

(f) *New section 38 property with a 7-year useful life*—(1) *In general.* The taxpayer must determine if property will be new section 38 property with a useful life of 7 years or more when placed in service. The determination must be made at the close of the taxable year in which construction begins or, if later, at the close of the first taxable year to which an election under section 46(d) applies for the taxpayer.

(2) *Determination based on reasonably expected use.* The determination of whether property will be ‘‘new section 38 property’’ (within the meaning of §§ 1.48–1 and 1.48–2 when placed in service must be based on the reasonably expected use of the property by the taxpayer. There is a presumption that property will be new section 38 property if it would be new section 38 property if placed in service by the taxpayer when the determination is made. For example, in determining if property is an integral part of manufacturing under section 48(a)(1)(B)(i), it will be presumed that property will be new section 38 property if the taxpayer is engaged in manufacturing when the determination is made. Also, significant steps taken to establish a trade or business will be evidence the taxpayer will be engaged in that trade or business when the property is placed in service.

(3) *Estimated useful life.* The determination of whether property will have an estimated useful life of 7 years or more when placed in service must be made by applying the principles of § 1.46–3(e). If the estimated useful life is less than 7 years when the property is actually placed in service, the credit previously allowed under section 46(d) must be recomputed under section 47(a)(3)(B).

(g) *Definition of qualified progress expenditures*—(1) *In general.* A taxpayer’s qualified progress expenditures are the sum of qualified progress expenditures for self-constructed property (determined under paragraph (h) of this section), plus qualified progress expenditures for non-self-constructed property (determined under paragraph (j) of this section). Only amounts includible under § 1.46–3(c) in the basis of new section 38 property may be considered as qualified progress expenditures.

(2) *Excluded amounts.* Qualified progress expenditures do not include:

(i) In the case of non-self-constructed property, amounts incurred (whether or not paid)—

(A) Before the normal construction period begins, or

(B) Before the later of January 22, 1975, or the first day of the first taxable year for which an election under section 46(d) applies for the taxpayer;

(ii) In the case of self-constructed property, amounts chargeable to capital account—

(A) Before the normal construction period begins, or

(B) Before the later of January 22, 1975, or the first day of the first taxable year for which an election under section 46(d) applies for the taxpayer,

(See, however, section 46(d)(4)(A) and paragraph (h)(3)(i) of this section, relating to the time when amounts for component parts and materials are properly chargeable to capital account);

(iii) Expenditures with respect to particular property in the earlier of—

(A) The taxable year in which the property is placed in service, or

(B) The taxable year in which the taxpayer must recapture investment credit under section 47(a)(3) for the property or any subsequent year;

(iv) Expenditures for construction, reconstruction, or erection of property that is not section 38 property; or

(v) Amounts treated as an expense and deducted in the year paid or accrued.

(h) *Qualified progress expenditures for self-constructed property*—(1) *In general.* Qualified progress expenditures for self-constructed property (as defined in paragraph (k) of this section) are amounts properly chargeable to capital account in connection with that property. In general, amounts paid or incurred are chargeable to capital account if under the taxpayer's method of accounting they are properly includible in computing basis under §1.46–3. Qualified progress expenditures for self-constructed property include both direct costs (*e.g.*, labor, material, parts) and indirect costs (*e.g.*, overhead, insurance) associated with construction of property to the extent those costs are properly chargeable to capital account.

(2) *Property partially non-self constructed.* If an item of property is self-constructed because more than half of the construction expenditures are made directly by the taxpayer, then any expenditures (whether or not made directly by the taxpayer) for construction of that item of property are not subject to the limitations of section 46(d)(3)(B) and paragraph (j) of this section (relating to actual payment and progress in construction).

(3) *Time when amounts paid or incurred are properly chargeable to capital account.* (i) In general, expenditures for component parts and materials to be used in construction of self-constructed property are not properly chargeable to capital account until consumed or physically attached in the construction process. Component parts and materials that have been neither consumed nor physically attached in the construction process, but which have been irrevocably allocated to construction of that property are properly chargeable to capital account. Component parts and materials designed specifically for the self-constructed property may be considered irrevocably allocated to construction of that property at the time of manufacture of the component parts and materials. Component parts and materials not designed specifically for the property may be considered irrevocably allocated to construction at the time of delivery to the construction site if they would be economically impractical to remove. For example, pumps delivered to sites of construction of a tundra pipeline may be treated as irrevocably allocated to that pipeline on the date of delivery, even if they would be usable, but for their location on the tundra, in connection with other property. Component parts and materials are not to be considered irrevocably allocated to use in self-constructed property until physical work on construction of that property has begun (as determined under paragraph (e)(1)(ii) of this section). Mere bookkeeping notations are not sufficient evidence that the necessary allocation has been made.

(ii) A taxpayer's procedure for determining the time when an expenditure is properly chargeable to capital account for self-constructed property is a method of accounting. Under section 446(e), the method of accounting, once adopted, may not be changed without consent of the Secretary.

(4) *Records requirement.* The taxpayer shall maintain detailed records which permit specific identification of the amounts properly chargeable by the taxpayer during each taxable year to capital account for each item of self-constructed property.

(i) [Reserved]

(j) *Qualified progress expenditures for non-self-constructed property*—(1) *In general.* Qualified progress expenditures for non-self-constructed property (as defined in paragraph (l) of this section) are amounts actually paid by the taxpayer to another person for construction of the property, but only to the extent progress is made in construction. For example, such expenditures may include payments to the manufacturer of an item of progress expenditure property, payments to a contractor building progress expenditure property, or payments for engineering designs or blueprints that are drawn up during the normal construction period.

(2) *Property partially self-constructed.* If an item of property is non-self-constructed, but a taxpayer uses its own employees to construct a portion of the property, expenditures for construction of that portion are made directly by the taxpayer (see § 1.46–5(h)(1)). Subject to the limitations of paragraph (g) of this section, those expenditures are qualified progress expenditures for non-self-constructed property if they satisfy the requirements of paragraphs (j) (4), (5), and (6) of this section. Wages actually paid to the taxpayer's employees are presumed to correspond to progress in construction. Other amounts, including expenditures for materials, parts, and overhead, must be actually paid, not borrowed from the payee, and attributable to progress made in construction by the taxpayer.

(3) *Property constructed by more than one person.* The percentage of completion limitation (as prescribed in paragraph (j)(6) of this section), including the presumption of ratable progress in construction, applies to an item of progress expenditure property as a whole. However, if several manufacturers or contractors do work in connection with the same property, the progress that each person makes toward completion of construction of the property must be determined separately. Section 46(d)(3)(B) is then applied separately to amounts paid to each manufacturer or contractor based on each person's progress in construction. For example, assume the taxpayer contracts with three persons to build an item of equipment. The taxpayer contracts with A to build the frame, B to build the motor, and C to assemble the frame and motor. Assume each contract represents 33⅓ percent of the construction costs of the property. If, within the taxable year in which construction begins, A and B each complete 50 percent of the construction of the frame and motor, respectively, amounts paid to A during that taxable year not in excess of 16⅔ percent of the overall cost of the property, and amounts paid to B during that taxable year not in excess of 16⅔ percent of the overall cost of the property, are qualified progress expenditures. Section 46(d)(3)(B) does not apply, however, to persons, such as lower-tier subcontractors, that do not have a direct contractual relationship with the taxpayer. If, in the above example, A engages a subcontractor to construct part of the frame, section 46(d)(3)(B) is applied only to amounts paid by the taxpayer to A, B, and C, but the portion of construction completed by A during a taxable year includes the portion completed by A's subcontractor.

(4) *Requirement of actual payment.* Qualified progress expenditures for non-self-constructed property must be actually paid and not merely incurred. Amounts paid during the taxable year to another person for construction of non-self-constructed property may be in the form of money or property (*e.g.*, materials). However, property given as payment may be considered only to the extent it will be includible under § 1.46–3(c) in the basis of the non-self-constructed property when it is placed in service.

(5) *Certain borrowing disregarded.* Qualified progress expenditures for non-self-constructed property do not include any amount paid to another person (the ''payee'') for construction if the amount is paid out of funds borrowed directly or indirectly from the payee. Amounts borrowed directly or indirectly from the payee by any person that is related to the taxpayer (within the meaning of section 267) or that is a member of the same controlled group of corporations (as defined in section 1563(a)) will be considered borrowed indirectly from the payee. Similarly, amounts borrowed under any financing arrangement that has the effect of making the payee a

surety will be considered amounts borrowed indirectly by the taxpayer from the payee.

(6) *Percentage of completion limitation.* (i) Under section 46(d)(3)(B)(ii), payments made in any taxable year may be considered qualified progress expenditures for non-self-constructed property only to the extent they are attributable to progress made in construction (percentage of completion limitation). Progress will generally be measured in terms of the manufacturer's incurred cost, as a fraction of the anticipated cost (as adjusted from year to year). Architectural or engineering estimates will be evidence of progress made in construction. Cost accounting records also will be evidence of progress. Progress will be presumed to occur not more rapidly than ratably over the normal construction period. However, the taxpayer may rebut the presumption by clear and convincing evidence of a greater percentage of completion.

(ii) If, after the first year of construction, there is a change in either the total cost to the taxpayer or the total cost of construction by another person, the taxpayer must recompute the percentage of completion limitation on the basis of revised cost. However, the recomputation will affect only amounts allowed as qualified progress expenditures in the taxable year in which the change occurs and in subsequent taxable years. The recomputation remains subject to the presumption of pro rata completion.

(iii) If, for any taxable year, the amount paid to another person for construction of an item of property under section 46(d)(3)(B)(i) exceeds the percentage of completion limitation in section 46(d)(3)(B)(ii), the excess is treated as an amount paid to the other person for construction for the succeeding taxable year. If for any taxable year the percentage of completion limitation for an item of property exceeds the amount paid to another during the taxable year for construction, the excess is added to the percentage of completion limitation for that property for the succeeding taxable year.

(iv) The taxpayer must maintain detailed records which permit specific identification of the amounts paid to each person for construction of each item of property and the percentage of construction completed by each person for each taxable year.

(7) *Example.* The following example illustrates paragraph (j)(6) of this section.

Example. (i) Corporation X agrees to build an airplane for corporation Y, a calendar year taxpayer. The airplane is non-self-constructed progress expenditure property. Physical work on construction begins on January 1, 1980. The normal construction period for the airplane is five years and the airplane is delivered and placed in service on December 31, 1984.

(ii) The cost of construction to corporation X is $500,000. The contract price is $550,000. Corporation Y makes a $110,000 payment in each of the years 1980 and 1981, an $85,000 payment in 1982, a $135,000 payment in 1983, and a $110,000 payment in 1984.

(iii) For 1980, corporation Y makes an election under section 46(d). Progress is presumed to occur ratably over the 5-year construction period, which is 20 percent in each year. Twenty percent of the contract price is $110,000. The percentage of completion limitation for each year, thus, is $110,000.

(iv) For each of the years 1980 and 1981, the $110,000 payments may be treated as qualified progress expenditures. The payments equal the percentage of completion limitation.

(v) For 1982, the $85,000 payment may be treated as a qualified progress expenditure, because it is less than the percentage of completion limitation. The excess of the percentage of completion limitation ($110,000) over the 1982 payment ($85,000) is added to the percentage of completion limitation for 1983. One hundred and ten thousand dollars minus $85,000 equals $25,000. Twenty-five thousand dollars plus $110,000 equals $135,000, which is the percentage of completion limitation for 1983.

(vi) For 1983, the entire $135,000 payment may be treated as a qualified progress expenditure. The payment equals the percentage of completion limitation for 1983.

(vii) For 1984, no qualified progress expenditures may be taken into account, because the airplane is placed in service in that year.

(viii) See example 2 of paragraph (r)(4) of this section for the result if Y sells its contract rights to the property on December 31, 1982.

(k) *Definition of self-constructed property*—(1) *In general.* Property is self-constructed property if it is reasonable to believe that more than half of the construction expenditures for the property will be made directly by the taxpayer. Construction expenditures made directly by the taxpayer include direct costs such as wages and materials and indirect costs such as overhead attributable to construction of the property. Expenditures for direct and indirect costs of construction will be treated as construction expenditures made directly by the taxpayer only to the extent that the expenditures directly benefit the construction of the property by employees of the taxpayer. Thus, wages paid to taxpayers's employees and expenditures for basic construction materials, such as sheet metal, lumber, glass, and nails, which are used by employees of the taxpayer to construct progress expenditure property, will be considered made directly by the taxpayer. Construction expenditures made by the taxpayer to a contractor or manufacturer, in general, will not be considered made directly by the taxpayer. Thus, the cost of component parts, such as boilers and turbines, which are purchased and merely installed or assembled by the taxpayer, will not be considered expenditures made directly by the taxpayer for construction. (*See* paragraph (h)(3) of this section to determine when such cost is properly chargeable to capital account.)

(2) *Time when determination made.* The determination of whether property is self-constructed is to be made at the close of the taxable year in which physical work on construction of the property begins, or, if later, the close of the first taxable year to which an election under this section applies. Once it is reasonably estimated that more than half of construction expenditures will be made directly by the taxpayer, the fact the taxpayer actually makes half, or less than half, of the expenditures directly will not affect classification of the property as self-constructed property. Similarly, once a determination has been made, classification of property as self-constructed property is not affected by a change in circumstances in a later taxable year. However, a significant error unrelated to a change in circumstances may be evidence that the estimate was unreasonable when made.

(3) *Determination based on certain expenditures.* For purposes of determining whether more than half of the expenditures for construction of an item of property will be made directly by the taxpayer, the taxpayer may take into account only expenditures properly includable by the taxpayer in the basis of the property under the provisions of § 1.46–3(c). Thus, property is self-constructed property only if more than half of the estimated basis of the property to be used for purposes of determining the credit allowed by section 38 is attributable to expenditures made directly by the taxpayer.

(l) *Definition of non-self-constructed property.* Non-self-constructed property is property that is not self-constructed property. Thus, property is non-self-constructed property if it is reasonable to believe that only half, or less than half, of the expenditures for construction will be made directly by the taxpayer.

(m) *Alternative limitations for public utility, railroad, or airline property.* The alternative limitations on qualified investment under section 46(a) (7) and (8) for public utility, railroad, or airline property (whichever applies) apply in determining the credit for qualified progress expenditures. The determination of whether progress expenditure property will be public utility, railroad, or airline property (whichever applies) when placed in service must be made at the close of the taxable year in which physical work on construction begins or, if later, at the close of the first taxable year for which an election under section 46(d) is in effect. If, at that time, the taxpayer is in a trade or business as a public utility, railroad, or airline (as described in section 46(c)(3)(B) and 46(a)(8) (D) and (E), respectively), it is evidence the property will be public utility, railroad, or airline property when placed in service.

(n) *Leased property.* A lessor of progress expenditure property may not elect under section 48(d) to treat a lessee (or a person who will be a lessee) as having made qualified progress expenditures.

(o) *Election*—(1) In *general.* The election under section 46(d)(6) to increase qualified investment by qualified progress expenditures may be made for any taxable year ending after December 31, 1974. Except as provided in paragraph (o)(2) of this section, the election is effective for the first taxable year for which it is made and for all taxable years thereafter unless it is revoked with the consent of the Commissioner. Except as provided in paragraphs (o) (2) and (3) of this section, the election applies to all qualified progress expenditures made by the taypayer during the taxable year for construction of any progress expenditure property. Thus, the taxpayer may not make the election for one item of progress expenditure property and not for other items. If progress expenditure property is being constructed by or for a partnership, S corporation (as defined in section 1361(a)), trust, or estate, an election under section 46(d)(6) must be made separately by each partner or shareholder, or each beneficiary if the beneficiary, in determining his tax liability, would be allowed investment credit under section 38 for property subject to the election. The election may not be made by a partnership or S corporation, and may be made by a trust or estate only if the trust or estate, in determining its tax liability, would be allowed investment credit under section 38 for property subject to the election. The election of any partner, shareholder, beneficiary, trust, or estate will be effective for that person, even if a related partner, shareholder, beneficiary, trust, or estate does not make the election. An election made by a partner, shareholder, beneficiary, trust, or estate applies to all progress expenditure property of that person. For example, an election made by corporation X, which is a partner in the XYZ partnership, applies to progress expenditure property the corporation holds in its own capacity and also to its interest in progress expenditure property of the partnership.

(2) *Time and manner of making election.* An election under section 46(d)(6) must be made on Form 3468 and filed with the original income tax return for the first taxable year ending after December 31, 1974 to which the election will apply. An election made before March 2, 1988, by filing a written statement (whether or not attached to the income tax return) will be considered valid. The election may not be made on an amended return filed after the time prescribed for filing the original return (including extensions) for that taxable year. However, an election under this section may be made or revoked by filing a statement with an amended return filed on or before May 31, 1988, if the due date for filing a return for the first taxable year to which the election applies is before May 31, 1988.

(3) *Carryover of election in certain transactions.* In general, and election under section 46(d)(6) does not carry over to the transferee of progress expenditure property (or an interest therein). However, if under section 47(b) the property does not cease to be progress expenditure property because of the transfer, the election will carry over to the transferee. If so, the election will apply only to the property transferred. For rules relating to the determination of qualified progress expenditures of the transferee, see paragraph (r) of this section.

(p) *Partnerships, S corporations, trusts, or estates*—(1) *In general.* Each partner, shareholder, trust, estate, or beneficiary of a trust or estate that makes an election under section 46(d) shall take into account its share of qualified progress expenditures (determined under paragraph (p)(2) of this section) made by the partnership, S corporation, trust, or estate. In determining qualified investment for the year in which the property is placed in service, the basis of the property is apportioned as provided in §§1.46–3(f), 1.48–6, or 1.48–5 (whichever applies). Each partner, shareholder, trust, estate, or beneficiary that made the election must reduce qualified investment under section 46(c)(4) for the year the property is placed in service by qualified progress expenditures taken into account by that person.

(2) *Determination of share of qualified progress expenditures.* The share of qualified progress expenditures of each partner, shareholder, trust, estate, or beneficiary that makes an election under section 46(d) must be determined in accordance with the same ratio used under §§1.46–3(f)(2), 1.48–5(a)(1), or 1.48–6(a)(1) (whichever applies) to determine its share of basis (or cost). The last sentence of §1.46–3(f)(2)(i) must be applied by referring to the date on which qualified progress expenditures are

paid or chargeable to capital amount (whichever is applicable).

(3) *Examples.* The followng examples illustrate this paragraph (p).

Example 1. (i) Corporation X contracts to build a ship for partnership AB that qualifies as progress expenditure property. The contract price is $100,000. Physical work on construction of the ship begins on January 1, 1980. The ship is placed in service on December 31, 1983.

(ii) The AB partnership reports income on the calendar year basis. Partners A and B share profits equally. For A's taxable year ending December 31, 1980, A makes an election under section 46(d) B does not make the election.

(iii) For each of the years 1980, 1981, 1982, and 1983, the AB partnership makes $25,000 payments to corporation X. The payments made in 1980, 1981, and 1982 are qualified progress expenditures. The 1983 payment is not a qualified progress expenditure, because the ship is placed in service in that year.

(iv) For each of the years 1980, 1981, and 1982, A may take into account qualified progress expenditures of $12,500 because A had a 50 percent partnership interest in each of those years.

(v) For 1983, qualified investment for the ship is $100,000. A and B's share are $50,000 each, because each had a 50 percent partnership interest in 1983. However, A must reduce its $50,000 share for 1983 by $37,500, the amount of qualified progress expenditures taken into account by A. B's share is not reduced, because B did not take into account qualified progess expenditures.

Example 2. (i) The facts are the same as in example 1 except that on June 30, 1983, the partnership agreement is amended to admit a new partner, C. The partners agree to share profits equally. There is no special allocation in effect under section 704 with respect to the ship.

(ii) For each of the years 1980, 1981, and 1982, A may take into account qualified progress expenditures of $12,500 because A has a 50 percent partnership interest in those years.

(iii) For 1983, A, B, and C's share of qualified investment is $33,333 each, because each had a 33⅓ percent partnership interest in that year. A must reduce its share to zero, because it took $37,500 into account as qualified progress expenditures. In addition, the excess of the $37,500 over the $33,333 applied as a reduction is subject to recapture under section 47(a)(3)(B). B and C's shares are not reduced, because neither taxpayer took into account qualified progress expenditures.

(q) *Limitation on qualified progress expenditures for taxable years beginning before 1980*—(1) *In general.* (i) Under section 46(d)(7), qualified progress expenditures for any taxable year beginning before January 1, 1980, are limited. The taxpayer must apply the limitation under section 46(d)(7) on an item by item basis. In general, the taxpayer may take into account the applicable percentage (as determined under the table in section 46(d)(7)(A)) of qualified progress expenditures for each of those years. In addition, the taxpayer may take into account for each of those years 20 percent of qualified investment for each of the preceding taxable years determined without applying the limitations of section 46(d)(7).

(ii) The applicable percentage under section 46(d)(7)(A) may be applied only for one taxable year that ends within a calendar year in determining qualified investment for an item of progress expenditure property. For example, calendar year partners of a calendar year partnership may increase qualified investment for 1976 by 20 percent of qualified progress expenditures made in 1975 for an item of property. If the partnership incorporates in 1976 and the taxable year of the corporation begins on July 1, 1976, and ends on June 30, 1977, qualified investment of the corporation for its taxable year beginning on July 1, 1976, cannot be increased by 20 percent of the 1975 expenditure.

(2) *Example.* The following example illustrates this paragraph (q).

Example. (i) Corporation X contracts with A on January 1, 1976, to build an electric generator that qualifies as non-self-constructed progress expenditure property. A will build the generator at a cost of $125,000. Corporation X agrees to pay A $150,000. Corporation X reports income on the calendar year basis. Corporation X makes an election under section 46(d) for 1976. Physical work on construction begins on January 1, 1976. Corporation X makes payments of $30,000 to A for construction of the generator in each of the years 1976, 1977, 1978, 1979, and 1980. A incurs a cost of $25,000 in each of those years for construction of the property. The property is placed in service in 1980.

(ii) For 1976, X may increase qualified investment by $12,000, 40 percent of the payment made in 1976.

(iii) For 1977, corporation X may increase qualified investment by $24,000. Eighteen thousand dollars of that amount is 60 percent of the 1977 payment. The remaining $6,000 is 20 percent of the $30,000 payment made in 1976.

(iv) For 1978, corporation X may increase qualified investment by $36,000. Twenty-four thousand dollars of that amount is 80 percent of the 1978 payment. The remaining

$12,000 is 20 percent of the $30,000 payment made in 1976, plus 20 percent of the $30,000 payment made in 1977.

(v) For 1979, corporation X may increase qualified investment by $48,000. Thirty thousand dollars of that amount is 100 percent of the 1979 payment. The remaining $18,000 of that amount is 20 percent of the $30,000 payments made in each of the years 1976, 1977, and 1978.

(vi) Qualified investment for corporation X for 1980 is $30,000. The $30,000 is the basis (or cost) of the generator ($150,000), reduced by qualified progress expenditures allowed with respect to that property ($120,000).

(r) *Special rules for transferred property*—(1) *In general.* A transferee of progress expenditure property (or an interest therein) may take into account qualified progress expenditures for the property only if—

(i) The property is progress expenditure property in the hands of the transferee, and

(ii) The transferee makes an election under section 46(d) or the election made by the transferor (or its predecessor) carries over to the transferee under paragraph (o)(3) of this section.

(2) *Status as progress expenditure property.* (i) If the transfer requires recapture under section 47(a)(3) and §1.47–1(g) (or would require recapture if the transferor had made an election under section 46(d)), then—

(A) For purposes of determining if the property is progress expenditure property in the hands of the transferee, the normal construction period for the property begins on the date of the transfer, or, if later, on the first day of the first taxable year for which the transferee makes an election under section 46(d), and

(B) For purposes of determining whether the property is self-constructed or non-self-constructed in the hands of the transferee, the amount paid or incurred for the transfer of the property will not be considered a construction expenditure made directly by the transferee.

(ii) If the transfer does not require recapture under section 47(a)(3) and §1.47–1(g), and the election carries over to the taxpayer under paragraph (o)(3) of this section, the property does not lose its status as progress expenditure property because of the transfer.

(3) *Amount of qualified progress expenditures for transferee.* (i) If the transfer does not require recapture under section 47(a)(3) and §147–1(g), and the election carries over to the taxpayer under paragraph (o)(3) of this section, the transferee must determine its qualified progress expenditures—

(A) By using the same normal construction period used by the transferor,

(B) By treating the property as having the same status as self-constructed or non-self-constructed as the property had in the hands of the transferor, and

(C) In the case of non-self-constructed property, by taking into account any excess described in section 46(d)(4)(C)(i) (relating to the excess of payments over the percentage-of-completion limitation) or section 46(d)(4)(C)(ii) (relating to the excess of the percentage-of-completion limitation over the amount of payments) that the transferor would have taken into account with respect to that property.

(ii) If the transfer requires recapture under section 47(a)(3) and §1.47–1(g) (or would require recapture if the transferor had made an election under section 46(d)), the amount paid or incurred for the transfer will be considered a payment for construction of that property to the extent that—

(A) It is properly includible in the basis of the property under §1.46–3(c),

(B) The taxpayer can show the amount is attributable to construction costs paid or chargeable to capital account by the transferor or other person after physical work on construction of the property began, and

(C) It does not exceed the amount by which the transferor has increased qualified investment for qualified progress expenditures incurred with respect to the property (or would have increased qualified investment but for the ‘‘lesser of’’ limitation of section 46(d)(3)(B) or the absence of an election under section 46(d)), plus any amount that would have been treated as a qualified progress expenditure by the transferor had the property not been transferred.

Once the status of the property as self-constructed or non-self-constructed property in the hands of the transferee has been determined, all rules under this section for determining the amount of qualified progress expenditures for that type of property apply. For example, if the property is non-self-constructed in the hands of the transferee, amounts merely incurred (but not paid) for the transfer are not taken into account as qualified progress expenditures. Actual payment is necessary (see paragraph (j)(3) of this section). In applying section 46(d)(3)(B)(ii), the amount paid or incurred for the transfer (to the extent that it qualifies as a payment for construction under the first sentence of this paragraph (r)(3)(ii)) is considered to be part of the overall cost to the transferee of construction by another person, and the portion of construction which is completed during the taxable year is determined by taking into account construction that was completed before the constructed property was acquired by the transferee. If the transferee makes an election under section 46(d) and this section for the taxable year in which the transfer occurs, then for purposes of applying the presumption in section 46(d)(4)(D) that construction is deemed to occur not more rapidly than ratably over the normal construction period, the transferee's normal construction period is considered to have begun on the date on which physical work on construction of the acquired property began.

(4) *Examples.* The following examples illustrate this paragraph (r).

Example 1. Corporation X begins physical work on construction of progress expenditure property for corporation Y on January 1, 1976. Y accurately estimates a 3-year normal construction period and elects under section 46(d) on its return for its taxable year ending December 31, 1976. On January 1, 1978, Y sells the contract rights for construction of the property to corporation Z, which uses a fiscal year ending June 30. Qualified progress expenditures allowed to Y in 1976 and 1977 are subject to recapture under section 47(a)(3). Because Z's normal construction period for the property is less than 2 years (January 1, 1978 to January 1, 1979), the property is not progress expenditure property in Z's hands. Z may not elect progress expenditure treatment for the property.

Example 2. (i) Assume the same facts as in the example in paragraph (j)(7) of this section, except, on December 31, 1982, Y sells its contract rights to the property for $340,000 to corporation Z, which also uses the calendar year. Z pays Y the full $340,000 on that date. The property is still to be placed in service on December 31, 1984, and will not be available for placing in service at an earlier date. Z makes payments to X of $135,000 on December 31, 1983, and $110,000 on December 31, 1984.

(ii) The investment credit allowed Y in 1980 and 1981 for qualified progress expenditures is subject to recapture under section 47(a)(3) and Y may not treat its $85,000 payment in 1982 as a qualified progress expenditure.

(iii) For purposes of determining if the airplane is qualified progress expenditure property with respect to Z, the normal construction period for the property for Z begins on December 31, 1982, the date of transfer. Since the remaining construction period is two years, the property is progress expenditure property if it otherwise qualifies in Z's hands.

(iv) Only $305,000 of the $340,000 payment to Y can qualify as a qualified progress expenditure, because only that amount is attributable to construction costs paid by Y and does not exceed the sum of the amount by which Y increased qualified investment in 1980 and 1981 for qualified progress expenditures ($220,000) and the amount that Y would have treated as a qualified progress expenditure in 1982 ($85,000).

(v) Assume that Z cannot establish that progress in construction has been completed more rapidly than ratably. If Z makes an election under section 46(d) for 1982, then for purposes of applying the percentage of completion limitation, Z's normal construction period is considered to begin on January 1, 1980. Progress is presumed to occur ratably over the 5-year construction period, which is 20 percent in each year.

(vi) For 1982, Z may treat the full $305,000 as a qualified progress expenditure because it is less than the percentage of completion limitation, $330,000 ($110,000 a year for 1980, 1981, and 1982).

(vii) For 1983, Z may treat the entire $135,000 payment as a qualified progress expenditure, since it does not exceed the percentage of completion limitation for that year, $135,000 ($110,000 plus the $25,000 excess from 1982).

(viii) For Z's taxable year ending December 31, 1984, no qualified progress expenditures may be taken into account because the property is placed in service during that year.

[T.D. 8183, 53 FR 6618, Mar. 2, 1988; 53 FR 11162, Apr. 5, 1988]

§ 1.46–6 Limitation in case of certain regulated companies.

(a) *In general*—(1) *Scope of section.* This section does not reflect amendments made to section 46 after enactment of the Revenue Act of 1971, other than the redesignation of section 46(e) as section 46(f) by the Tax Reduction Act of 1975.

(2) *Disallowance of credit.* Under section 46(f), a credit otherwise allowable under section 38 (''credit'') will be disallowed in certain cases with respect to ''section 46(f) property'' as defined in paragraph (b)(1) of this section. Paragraph (f) of this section describes circumstances under which a determination put into effect by a regulatory body will result in the disallowance of the credit. Such a determination will result in a disallowance only if section 46(f) (1) or (2) applies to such property and such determination affects the taxpayer's cost of service or rate base in a manner inconsistent with section 46(f) (1) or (2) (whichever is applicable).

(3) *General rules.* The provisions of section 46(f) (1) and (2) are limitations on the treatment of the credit for ratemaking purposes and for purposes of the taxpayer's regulated books of account only. Under the provisions of section 46(f)(1), the credit may not be flowed through to income (*i.e.*, used to reduce taxpayer's cost of service) but in certain circumstances may be used to reduce rate base (provided that such reduction is restored not less rapidly than ratably). If an election is made under section 46(f)(2), the credit may be flowed through to income (but not more rapidly than ratably) and there may not be any reduction in rate base. If an election is made under section 46(f)(3), none of the limitations of section 46(f) (1) or (2) apply to certain section 46(f) property of the taxpayer. Thus, under the provisions of section 46(f)(3), no credit is disallowed if the credit is treated in any manner for ratemaking purposes, including any manner of treatment permitted under the limitations of section 46(f) (1) or (2).

(4) *Elections.* For rules relating to the manner of making, on or before March 9, 1972, the three elections listed in section 46(f) (1), (2), and (3), see 26 CFR 12.3. For rules relating to the application of such elections, see paragraph (h) of this section.

(5) *Cross references.* For rules with respect to the treatment of corporate reorganizations, asset acquisitions, and taxpayers subject to the jurisdiction of more than one regulatory body, etc., see paragraph (j) of this section.

(6) *Nonapplication of prior law.* Under section 105 (e) of the Revenue Act of 1971, section 203 (e) of the Revenue Act of 1964, 78 Stat. 35, does not apply to section 46(f) property.

(b) *Definitions.* For purposes of this section, the following definitions apply:

(1) *Section 46(f) property.* ''Section 46(f) property'' is property described in section 50 that is—

(i) Public utility property within the meaning of section 46(c)(3)(B) (other than nonregulated communication property described in §1.46–3(g)(2)(iv)) or

(ii) Property used predominantly in the trade or business of the furnishing or sale of steam through a local distribution system or of the transportation of gas or steam by pipeline, if the rates for the trade or business are regulated within the meaning of §1.46–3(g)(2)(iii).

For purposes of determining whether property is used predominantly in the trade or business of transportation of gas by pipeline (or of transportation of gas by pipeline and of furnishing or sale of gas through a local distribution system), the rules prescribed in §1.46–3(g)(4) apply except that accounts 365 through 371 inclusive (Transmission Plant) are added to the accounts listed in §1.46–3(g)(4)(i).

(2) *Cost of service.* (i)(A) For purposes of this section, ''cost of service'' is the amount required by a taxpayer to provide regulated goods or services. Cost of service includes operating expenses (including salaries, cost of materials, etc.) maintenance expenses, depreciation expenses, tax expenses, and interest expenses. For purposes of this section, any effect on a taxpayer's permitted return on investment that results from a reduction in the taxpayer's rate base does not constitute a reduction in cost of service, even though, as a technical ratemaking term, ''cost of service'' ordinarily includes a permitted return on investment. In addition, taking into account a deduction for the additional interest that the taxpayer would pay or accrue if the credit were unavailable in determining Federal income tax expense

(''synchronization of interest'') does not constitute a reduction in cost of service for purposes of section 46(f)(2). This adjustment to Federal income tax expense may be taken into account in determining cost of service for the regulated accounting period or periods that include the taxable year to which the adjustment relates or for any subsequent regulated accounting period.

(B) See paragraph (b)(3)(ii)(B) of this section for rules relating to the amount of additional interest that the taxpayer would pay or accrue if the credit were unavailable.

(ii) In determining whether, or to what extent, a credit has been used to reduce cost of service, reference shall be made to any accounting treatment that affects cost of service. Examples of such treatment include reducing by all or a portion of the credit the amount of Federal income tax expense taken into account for ratemaking purposes and reducing the depreciable bases of property by all or a portion of the credit for ratemaking purposes.

(3) *Rate base.* (i) For purposes of this section, ''rate base'' is the monetary amount that is multiplied by a rate of return to determine the permitted return on investment.

(ii)(A) In determining whether, or to what extent, a credit has been used to reduce rate base, reference shall be made to any accounting treatment that affects rate base. In addition, in those cases in which the rate of return is based on the taxpayer's cost of capital, reference shall be made to any accounting treatment that reduces the permitted return on investment by treating the credit less favorably than the capital that would have been provided if the credit were unavailable. Thus, the credit may not be assigned a ''cost of capital'' rate that is less than the overall cost of capital rate, determined on the basis of a weighted average, for the capital that would have been provided if the credit were unavailable.

(B) For purposes of determining the cost of capital rate assigned to the credit and the amount of additional interest that the taxpayer would pay or accrue, the composition of the capital that would have been provided if the credit were unavailable may be determined—

(*1*) On the basis of all the relevant facts and circumstances; or

(*2*) By assuming for both such purposes that such capital would be provided solely by common shareholders, preferred shareholders, and long-term creditors in the same proportions and at the same rates of return as the capital actually provided to the taxpayer by such shareholders and creditors.

For purposes of this section, capital provided by long-term creditors does not include deferred taxes as described in section 167(e)(3)(G) or 168(e)(3)(B)(ii).

(C) If a taxpayer's overall rate of return is based on a deemed or hypothetical capital structure, paragraph (b)(3)(ii)(B) of this section shall be applied by treating the deemed or hypothetical capital as if it were the capital actually provided to the taxpayer and determining the composition of the capital that would have been provided if the credit were unavailable in a manner consistent with such treatment.

(iii) Whether, or to what extent, a credit has been used to reduce rate base for any period to which pre-June 23, 1986 rates apply will be determined under 26 CFR 1.46–6(b) (3) and (4) (revised as of April 1, 1985) if such a determination avoids disallowance of a credit that would be disallowed under paragraph (b)(3)(ii) or (4)(ii) of this section. For this purpose, a period of which pre-June 23, 1986 rates apply is any period for which the effect of the credit on rate base for ratemaking purposes is established under a determination put into effect (within the meaning of paragraph (f) of this section) before June 23, 1986.

(4) *Indirect reductions to cost of service or rate base.* (i) Cost of service or rate base is also considered to have been reduced by reason of all or a portion of a credit if such reduction is made in an indirect manner.

(ii) One type of such indirect reduction is any ratemaking decision in which the credit is treated as operating income (subject to ratemaking regulation) or is treated less favorably than the capital that would have been provided if the credit were unavailable. For example, if the credit is accounted for as nonoperating income on a company's regulated books of account but a ratemaking decision has the effect of treating the credit as operating income in determining rate of return to common shareholders, then cost of service has been indirectly reduced by reason of the credit.

(iii) A second type of indirect reduction is any ratemaking decision intended to achieve an effect similar to a direct reduction to cost of service or rate base. In determining whether a ratemaking decision is intended to achieve this effect, consideration is given to all the relevant facts and circumstances of each case, including, but not limited to—

(A) The record of the proceeding,

(B) The regulatory body's orders or opinions (including any dissenting views), and

(C) The anticipated effect of the ratemaking decision on the company's revenues in comparison to a direct reduction to cost of service or rate base by reason of the investment tax credits available to the regulated company.

(iv) This paragraph (b)(4)(iv) describes a situation that is not an indirect reduction to cost of service or rate base by reason of all or a portion of a credit. The ratemaking treatment of credits may affect the financial condition of a company, including the company's ability to attract new capital, the cost of that capital, the company's future financial requirements, the market price of the company's securities, and the degree of risk attributable to investment in those securities. The financial condition may be reflected in certain customary financial indicators such as the comparative capital structure of the company, coverage ratios, price/earnings ratios, and price/book ratios. Under the facts and circumstances test of paragraph (b)(4)(iii) of this section, the consideration of a company's financial condition by a regulatory body is not an indirect reduction to cost of service or rate base, even though such condition, as affected by the ratemaking treatment of the company's investment tax credits, is considered in the development of a reasonable rate of return on common shareholders' investment.

(c) *General rule*—(1) *In general.* Section 46(f)(1) applies to all of the taxpayer's section 46(f) property except property to which an election under section 46(f) (2) or (3) applies. Under section 46(f)(1), the credit for the taxpayer's section 46(f) property will be disallowed if—

(i) The taxpayer's cost of service for ratemaking purposes is reduced by reason of any portion of such credit, or

(ii) The taxpayer's rate base is reduced by reason of any portion of the credit and such reduction in rate base is not restored or is restored less rapidly than ratably within the meaning of paragraph (g) of this section.

(2) *Insufficient natural domestic supply.* The provisions of paragraph (c)(1)(ii) of this section shall not apply to permit any reduction in taxpayer's rate base with respect to its ''short supply property'' if it made an election under the last sentence of section 46(f)(1) on or before March 9, 1972.

(3) *Short supply property.* For purposes of this section, section 46(f) property is ''short supply property'' if—

(i) The property is described in paragraph (b)(1)(ii) of this section,

(ii) The regulatory body described in section 46(c)(3)(B) that has jurisdiction for ratemaking purposes with respect to such trade or business is an agency or instrumentality of the United States, and

(iii) This regulatory body makes a short supply determination and the determination is in effect on the date such property is placed in service.

(4) *Short supply determination.* A short supply determination is made or revoked on the date of its publication in the FEDERAL REGISTER. It is a determination that the natural domestic supply of gas or steam is insufficient to meet the present and future requirements of the domestic economy.

(5) *Dates short supply determination in effect.* (i) A short supply determination is considered to be in effect with respect to section 46(f) property placed in service at any time before the determination is revoked. However, a short supply determination made after June 20, 1979 is not considered to be in effect with respect to section 46(f) property placed in service before such determination was made.

(d) *Special rule for ratable flow-through.* If an election was made under section 46(f)(2) on or before March 9, 1972, section 46(f)(2) applies to all of the taxpayer's section 46(f) property except property to which an election under section 46(f)(3) applies. Under section 46(f)(2), the credit for the taxpayer's section 46(f) property will be disallowed if—

(1) The taxpayer's cost of service, for ratemaking purposes or in its regulated books of account, is reduced by more than a ratable portion of such credit within the meaning of paragraph (g) of this section or

(2) The taxpayer's rate base is reduced by reason of any portion of such credit.

(e) *Flow-through property.* If a taxpayer made an election under section 46(f)(3) on or before March 9, 1972, section 46(f) (1) and (2) do not apply to the taxpayer's section 46(f) property to which section 167(l)(2)(C) applies. In the case of an election under section 46(f)(3), a credit will not be disallowed, notwithstanding a determination by a regulatory body having jurisdiction over such taxpayer that reduces the taxpayer's cost of service or rate base by reason of such credit. In general, section 167(l)(2)(C) applies to property with respect to which a taxpayer may use a flow-through method of accounting (within the meaning of section 167(l)(3)(H)) to take into account the allowance for depreciation under section 167(a). Section 167(l)(2)(C) applies to property even though the taxpayer does not use a flow-through method of accounting with respect to the property. Section 167(l)(2)(C) does not apply to property if the taxpayer can not use a flow-through method of accounting with respect to the property. For example, section 167(l)(2)(C) does not apply to property with respect to which an election under section 167(l)(4)(A) applies. Thus, such property does not qualify for an election under section 46(f)(3).

(f) *Limitations*—(1) *In general.* This paragraph provides rules relating to limitations on the disallowance of credits under section 46(f)(4). Key terms are defined in paragraphs (f) (7), (8), and (9) of this section.

(2) *Disallowance postponed.* There is no disallowance of a credit before the first final inconsistent determination is put into effect for the taxpayer's section 46(f) property.

(3) *Time of disallowance.* A credit is disallowed—

(i) When the first final inconsistent determination is put into effect and

(ii) When any inconsistent determination (whether or not final) is put into effect after the first final inconsistent determination is put into effect.

(4) *Credits disallowed.* A credit is disallowed for section 46(f) property placed in service (within the meaning of § 1.46–3(d)) by the taxpayer—

(i) Before the date any inconsistent determination described in paragraph (f)(2) of this section is put into effect and

(ii) On or after such date and before the date a subsequent consistent determination (whether or not final) is put into effect.

(5) *Barred years.* No amount of credit for a taxable year is disallowed under paragraph (f)(3) of this section if, for such year, assessment of a deficiency is barred by any law or rule of law.

(6) *Notification and other requirements.* The taxpayer shall notify the district director of a disallowance of a credit under paragraph (f)(3) of this section within 30 days of the date that the applicable determination is put into effect. In the case of such a disallowance, the taxpayer shall recompute its tax liability for any affected taxable year, and such recomputation shall be made in the form of an amended return where necessary.

(7) *Determinations.* For purposes of this paragraph, the term ''determination'' refers to a determination made with respect to section 46(f) property (other than property to which an election under section 46(f)(3) applies) by a regulatory body described in section 46(c)(3)(B) that determines the effect of the credit—

(i) For purposes of section 46(f)(1), on the taxpayer's cost of service or rate base for ratemaking purposes or

(ii) In the case of a taxpayer that made an election under section 46(f)(2), on the taxpayer's cost of service, for ratemaking purposes or in its regulated books of account, or on the taxpayer's rate base for ratemaking purposes.

A regulatory body does not have to take affirmative action to make a determination. Thus, a regulatory body's failure to take action on a rate schedule filed by a taxpayer is a determination if the rates can be put into effect without further action by the regulatory body.

(8) *Types of determinations.* For purposes of this paragraph—

(i) The term ''inconsistent'' refers to a determination that is inconsistent with section 46(f) (1) or (2) (as the case may be). Thus, for example, a determination to reduce the taxpayer's cost of service by more than a ratable portion of the credit would be a determination that is inconsistent with section 46(f)(2). As a further example, such a determination would also be inconsistent if section 46(f)(1) applied because no reduction in cost of service is permitted under section 46(f)(1).

(ii) The term ''consistent'' refers to a determination that is consistent with section 46(f) (1) or (2) (as the case may be).

(iii) The term ''final determination'' means a determination with respect to which all rights to appeal or to request a review, a rehearing, or a redetermination have been exhausted or have lapsed.

(iv) The term ''first final inconsistent determination'' means the first final determination put into effect after December 10, 1971, that is inconsistent with section 46(f) (1) or (2) (as the case may be).

(9) *Put into effect.* A determination is put into effect on the latter of—

(i) The date it is issued (or, if a first final inconsistent determination, the date it becomes final) or

(ii) The date it becomes operative.

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

Example 1. Corporation X, a calendar-year taxpayer engaged in a public utility activity is subject to the jurisdiction of regulatory body A. On September 15, 1971, X purchases section 46(f) property and places it in service on that date. For 1971, X takes the credit allowable by section 38 with respect to such property. X does not make any election permitted by section 46(f). On October 9, 1972, A makes a determination that X must account for the credit allowable under section 38 in a manner inconsistent with section 46(f)(1). The determination, which was the first determination by A after December 10, 1971, becomes final on January 1, 1973, and holds that X must retroactively adjust the manner in which it accounted for the credit allowable under section 38 starting with the taxable year that began on January 1, 1972. Since, under the provisions of paragraph (f)(8) of this section, the determination by A is put into effect on January 1, 1973 (the date it becomes final), the credit is retroactively disallowed with respect to any of X's section 46(f) property placed in service before January 1, 1973, on any date which occurs during a taxable year with respect to which an assessment of a deficiency has not been barred by any law or rule of law. In addition, the credit is disallowed with respect to X's section 46(f) property placed in service on or after January 1, 1973, and before the date that a subsequent determination by A, which as to X is consistent with section 46(f)(1), is put into effect. Thus, X must amend its income tax return for 1971 to reflect the retroactive disallowance of the credit otherwise allowable under section 38 with respect to the section 46(f) property placed in service on September 15, 1971.

Example 2. The facts are the same as in example 1, except that the first inconsistent determination by A becomes final on April 5, 1972, and requires X to account for the credit for all taxable years beginning on or after January 1, 1973, in a manner inconsistent with section 46(f)(1). Under the provisions of paragraph (f)(8) of this section, the determination was put into effect on January 1, 1973 (the date it became operative). The result is the same as in example 1.

Example 3. The facts are the same as in example 1, except that on June 1, 1975, A issues a determination that X shall retroactively account for the credit allowable by section 38 in a manner consistent with the provisions of section 46(f)(1) for taxable years beginning on or after January 1, 1971. The determination becomes final on January 5, 1976, in the same form as originally issued. The result is the same as in example 1 with respect to property X places in service before June 1, 1975. The credit is allowed with respect to property X places in service on or after June 1, 1975 (the date that the consistent determination is put into effect).

(g) *Ratable methods*—(1) *In general.* Under this paragraph (g), rules are prescribed for purposes of determining whether or not, under section 46(f)(1), a reduction in the taxpayer's rate base with respect to the credit is restored less rapidly than ratably and whether or not under section 46(f)(2) the taxpayer's cost of service for ratemaking purposes is reduced by more than a ratable portion of such credit.

(2) *Regulated depreciation expense.* What is ''ratable'' is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. ''Regulated depreciation expense'' is the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes. Such period of time shall be expressed in units of years (or shorter periods), units of production, or machine hours and shall be determined in accordance with the individual useful life system or composite (or other group asset) account system actually used in computing the taxpayer's regulated depreciation expense. A method of restoring, or reducing, is ratable if the amount to be restored to rate base, or to reduce cost of service (as the case may be), is allocated ratably in proportion to the number of such units. Thus, for example, assume that the regulated depreciation expense is computed under the straight line method by applying a composite annual percentage rate to ''original cost'' (as defined for purposes of computing regulated depreciation expense). If, with respect to an item of section 46(f) property, the amount to be restored annually to rate base is computed by applying a composite annual percentage rate to the amount by which the rate base was reduced, then the restoration is ratable. Similarly, if cost of service is reduced annually by an amount computed by applying a composite annual percentage rate to the amount of the credit, cost of service is reduced by a ratable portion. If such composite annual percenage rate were revised for purposes of computing regulated depreciation expense beginning with a particular accounting period, the computation of ratable restoration or ratable portion (as the case may be) must also be revised beginning with such period. A composite annual percentage rate is determined solely by reference to the period of time actually used by the taxpayer in computing its regulated depreciation expense without reduction for salvage or other items such as over and under accruals. A composite annual percentage rate determined by taking into account salvage value or other items shall be considered to be ratable in the case of a determination (whether or not final) issued before March 22, 1979, and any rate order (whether or not final) that is entered into before June 20, 1979, in response to a rate case filed before April 23, 1979. For this purpose, the term ''rate order'' does not include an order by a regulatory body that perfunctorily adopts rates as filed if such rates are suspended or subject to rebate.

(h) *Elections*—(1) *Applicability of elections.* (i) Any election under section 46(f) applies to all of the taxpayer's property eligible for the election, whether or not the taxpayer is regulated by more than one regulatory body.

(ii) Section 46(f)(1) applies to all of the taxpayer's section 46(f) property in the absence of an election under either section 46(f) (2) or (3). If an election is made under section 46(f)(2), section 46(f)(1) does not apply to any of the taxpayer's section 46(f) property.

(iii) An election made under the last sentence of section 46(f)(1) applies to that portion of the taxpayer's section 46(f) property to which section 46(f)(1) applies and which is short supply property within the meaning of paragraph (c)(2) of this section.

(iv) If a taxpayer makes an election under section 46(f)(2) and makes no election under section 46(f)(3), the election under section 46(f)(2) applies to all of the taxpayer's section 46(f) property.

(v) If a taxpayer makes an election under section 46(f)(3), such election applies to all of the taxpayer's section 46(f) property to which section 167(l)(2)(C) applies. Section 46(f) (1) or (2) (as the case may be) applies to that portion of the taxpayer's section 46(f) property that is not property to which section 167(f)(2)(C) applies. Thus, for example, if a taxpayer makes an election under section 46(f)(2) and also makes an election under section 46(f)(3), section 46(f)(3) applies to all of the taxpayer's section 46(f) property to which section 167(l)(2)(C) applies, and section 46(f)(2) applies to the remainder of the taxpayer's section 46(f) property.

(2) *Method of making elections.* See 26 CFR 12.3 for rules relating to the method of making the elections described in section 46(f) (1), (2), or (3).

(i) [Reserved]

(j) *Reorganizations, asset acquisitions, multiple regulation, etc.*—(1) *Taxpayers not entirely subject to jurisdiction of one regulatory body.* (i) If a taxpayer is required by a regulatory body having jurisdiction over less than all of its property to account for the credit under a determination that is inconsistent with section 46(f) (1) or (2) (as the case may be), such credit shall be disallowed only with respect to property subject to the jurisdiction of such regulatory body.

(ii) For purposes of this paragraph (j), a regulatory body is considered to have jurisdiction over property of a taxpayer if the property is included in the rate base for which the regulatory body determines an allowable rate of return for ratemaking purposes or if expenses with respect to the property are included in cost of service as determined by the regulatory body for ratemaking purposes. For example, if regulatory body A, having jurisdiction over 60 percent of an item of corporation X's section 46(f) property, makes a determination which is inconsistent with section 46(f), and if regulatory body B, having jurisdiction over the remaining 40 percent of such item of property, makes a consistent determination (or if the remaining 40 percent is not subject to the jurisdiction of any regulatory body), then 60 percent of the credit for such item will be disallowed. For a further example, if regulatory body A, having jurisdiction over 60 percent of X's section 46(f) property, has jurisdiction over 100 percent of a particular generator, 100 percent of the credit for such generator will be disallowed.

(iii) For rules which provide that the 3 elections under section 46(f) may not be made with respect to less than all of the taxpayer's property eligible for the election, see paragraph (h)(1)(i) of this section.

[T.D. 7602, 44 FR 17668, Mar. 23, 1979, as amended by T.D. 8089, 51 FR 18777, May 22, 1986]

§1.46–7 Statutory provisions; plan requirements for taxpayers electing additional investment credit, etc.

As amended by sections 802(b)(7), and 803 (c), (d), and (e) of the Tax Reform Act of 1976 (90 Stat. 1520), section 301 (d), (e), and (f) of the Tax Reduction Act of 1975 (89 Stat. 38) provides as follows:

Sec. 301. Increase in investment credit * * *

(d) *Plan requirements for taxpayers electing additional credit.* In order to meet the requirements of this subsection—

(1) Except as expressly provided in subsections (e) and (f), a corporation (hereinafter in this subsection referred to as the "employer") must establish an employee stock ownership plan (described in paragraph (2)) which is funded by transfers of employer securities in accordance with the provisions of paragraph (6) and which meets all other requirements of this subsection.

(2) The plan referred to in paragraph (1) must be a defined contribution plan established in writing which—

(A) Is a stock bonus plan, a stock bonus and a money purchase pension plan, or a profit-sharing plan,

(B) Is designed to invest primarily in employer securities, and

(C) Meets such other requirements (similar to requirements applicable to employee stock ownership plans as defined in section 4975(e)(7) of the Internal Revenue Code of 1954) as the Secretary of the Treasury or his delegate may prescribe.

(3) The plan must provide for the allocation of all employer securities transferred to it or purchased by it (because of the requirements of section 46(a)(2)(B) of the Internal Revenue Code of 1954) to the account of each participant (who was a participant at any time during the plan year, whether or not he is a participant at the close of the plan year) as of the close of each year in an amount which bears substantially the same proportion to the amount of all such securities allocated to all participants in the plan for that plan year as the amount of compensation paid to such participant (disregarding any compensation in excess of the first $100,000 per year) bears to the compensation paid to all such participants during that year (disregarding any compensation in excess of the first $100,000 with respect to any participant). Notwithstanding the first sentence of this paragraph, the allocation to participants' accounts may be extended over whatever period may be necessary to comply with the requirements of section 415 of the Internal Revenue Code of 1954. For purposes of this paragraph, the amount of compensation paid to a participant for a year is the amount of such participant's compensation

within the meaning of section 415(c)(3) of such Code for such year.

(4) The plan must provide that each participant has a nonforfeitable right to any stock allocated to his account under paragraph (3), and that no stock allocated to a participant's account may be distributed from that account before the end of the eighty-fourth month beginning after the month in which the stock is allocated to the account except in the case of separation from the service, death, or disability.

(5) The plan must provide that each participant is entitled to direct the plan as to the manner in which any employer securities allocated to the account of the participant are to be voted.

(6) On making a claim for credit, adjustment, or refund under section 38 of the Internal Revenue Code of 1954, the employer states in such claim that it agrees, as a condition of receiving any such credit, adjustment, or refund—

(A) In the case of a taxable year beginning before January 1, 1977, to transfer employer securities forthwith to the plan having an aggregate value at the time of the claim of 1 percent of the amount of the qualified investment (as determined under section 46 (c) and (d) of such Code) of the taxpayer for the taxable year, and

(B) In the case of a taxable year beginning after December 31, 1976—

(i) To transfer employer securities to the plan having an aggregate value at the time of the claim of 1 percent of the amount of the qualified investment (as determined under section 46 (c) and (d) of such Code) of the employer for the taxable year,

(ii) Except as provided in clause (iii), to effect the transfer not later than 30 days after the time (including extensions) for filing its income tax return for a taxable year, and

(iii) In the case of an employer whose credit (as determined under section 46(a)(2)(B) of such Code) for a taxable year beginning after December 31, 1976, exceeds the limitations of paragraph (3) of section 46(a) of such Code—

(I) To effect that portion of the transfer allocable to investment credit carrybacks of such excess credit at the time required under clause (ii) for the unused credit year (within the meaning of section 46(b) of such Code), and

(II) To effect that portion of the transfer allocable to investment credit carryovers of such excess credit at the time required under clause (ii) for the taxable year to which such portion is carried over.

For purposes of meeting the requirements of this paragraph, a transfer of cash shall be treated as a transfer of employer securities if the cash is, under the plan, used to purchase employer securities.

(7) Notwithstanding any other provision of law to the contrary, if the plan does not meet the requirements of section 401 of the Internal Revenue Code of 1954—

(A) Stock transferred under paragraph (6) or subsection (e)(3) and allocated to the account of any participant under paragraph (3) and dividends thereon shall not be considered income of the participant or his beneficiary under the Internal Revenue Code of 1954 until actually distributed or made available to the participant or his beneficiary and, at such time, shall be taxable under section 72 of such Code (treating the participant or his beneficiary as having a basis of zero in the contract),

(B) No amount shall be allocated to any participant in excess of the amount which might be allocated if the plan met the requirements of section 401 of such Code, and

(C) The plan must meet the requirements of sections 410 and 415 of such Code.

(8)(A) Except as provided in subparagraph (B)(iii), if the amount of the credit determined under section 46(a)(2)(B) of the Internal Revenue Code of 1954 is recaptured or redetermined in accordance with the provisions of such Code, the amounts transferred to the plan under this subsection and subsection (e) and allocated under the plan shall remain in the plan or in participant accounts, as the case may be, and continue to be allocated in accordance with the plan.

(B) If the amount of the credit determined under section 46(a)(2)(B) of the Internal Revenue Code of 1954 is recaptured in accordance with the provisions of such Code—

(i) The employer may reduce the amount required to be transferred to the plan under paragraph (6) of this subsection, or under paragraph (3) of subsection (e), for the current taxable year or any succeeding taxable years by the portion of the amount so recaptured which is attributable to the contribution to such plan,

(ii) Notwithstanding the provisions of paragraph (12), the employer may deduct such portion, subject to the limitations of section 404 of such Code (relating to deductions for contributions to an employees' trust or plan), or

(iii) If the requirements of subsection (f)(1) are met, the employer may withdraw from the plan an amount not in excess of such portion.

(C) If the amount of the credit claimed by an employer for a prior taxable year under section 38 of the Internal Revenue Code of 1954 is reduced because of a redetermination which becomes final during the taxable year, and the employer transferred amounts to a plan which were taken into account for purposes of this subsection for that prior taxable year, then—

(i) The employer may reduce the amount it is required to transfer to the plan under paragraph (6) of this subsection, or under paragraph (3) of subsection, (e), for the taxable year or any succeeding taxable year by the portion of the amount of such reduction in the credit or increase in tax which is attributable to the contribution to such plan, or

(ii) Notwithstanding the provisions of paragraph (12), the employer may deduct such portion subject to the limitations of section 404 of such Code.

(9) For purposes of this subsection, the term—

(A) ''Employer securities'' means common stock issued by the employer or a corporation which is a member of a controlled group of corporations which includes the employer (within the meaning of section 1563 (a) of the Internal Revenue Code of 1954, determined without regard to section 1563 (a)(4) and (e)(3)(C) of such Code) with voting power and dividend rights no less favorable than the voting power and dividend rights of other common stock issued by the employer or such controlling corporation, or securities issued by the employer or such controlling corporation, convertible into such stock, and

(B) ''Value'' means the average of closing prices of the employer's securities, as reported by a national exchange on which securities are listed, for the 20 consecutive trading days immediately preceding the date of transfer or allocation of such securities or, in the case of securities not listed on a national exchange, the fair market value as determined in good faith and in accordance with regulations issued by the Secretary of the Treasury or his delegate.

(10) The Secretary of the Treasury or his delegate shall prescribe such regulations and require such reports as may be necessary to carry out the provisions of this subsection and subsections (e) and (f).

(11) If the employer fails to meet any requirement imposed under this subsection or subsection (e) or (f) or under any obligation undertaken to comply with the requirement of this subsection or subsection (e) or (f), he is liable to the United States for a civil penalty of an amount equal to the amount involved in such failure. The preceding sentence shall not apply if the taxpayer corrects such failure (as determined by the Secretary of the Treasury or his delegate) within 90 days after notice thereof. For purposes of this paragraph, the term ''amount involved'' means an amount determined by the Secretary or his delegate, but not in excess of 1 percent of the qualified investment of the taxpayer for the taxable year under section 46(a)(2)(B) and not less than the product of one-half of one percent of such amount multiplied by the number of months (or parts thereof) during which such failure continues. The amount of such penalty may be collected by the Secretary of the Treasury in the same manner in which a deficiency in the payment of Federal income tax may be collected.

(12) Notwithstanding any provision of the Internal Revenue Code of 1954 to the contrary, no deductions shall be allowed under section 162, 212, or 404 of such Code for amounts transferred to an employee stock ownership plan and taken into account under this subsection.

(13)(A) As reimbursement for the expense of establishing the plan, the employer may withhold from amounts due the plan for the taxable year for which the plan is established, or the plan may pay, so much of the amounts paid or incurred in connection with the establishment of the plan as does not exceed the sum of 10 percent of the first $100,000 that the employer is required to transfer to the plan for that taxable year under paragraph (6) (including any amounts transferred under subsection (e)(3)) and 5 percent of any amount in excess of the first $100,000 of such amount.

(B) As reimbursement for the expense of administering the plan, the employer may withhold from amounts due the plan, or the plan may pay, so much of the amounts paid or incurred during the taxable year as expenses of administering the plan as does not exceed the smaller of—

(i) The sum of 10 percent of the first $100,000 and 5 percent of any amount in excess of $100,000 of the income from dividends paid to the plan with respect to stock of the employer during the plan year ending with or within the employer's taxable year, or

(ii) $100,000.

(14) The return of a contribution made by an employer to an employee stock ownership plan designed to satisfy the requirements of this subsection or subsection (e) (or a provision for such a return) does not fail to satisfy the requirements of this subsection, subsection (e), section 401(a) of the Internal Revenue Code of 1954, or section 403(c)(1) of the Employee Retirement Income Security Act of 1974 if—

(A) The contribution is conditioned under the plan upon determination by the Secretary of the Treasury that such plan meets the applicable requirements of this subsection, subsection (e), or section 401(a) of such Code.

(B) The application for such a determination is filed with the Secretary not later than 90 days after the date on which the credit under section 38 is allowed, and

(C) The contribution is returned within one year after the date on which the Secretary issues notice to the employer that such plan does not satisfy the requirements of this subsection, subsection (e), or section 401(a) of such Code.

(e) *Plan requirements for taxpayers electing additional one-half percent credit.*

(1) *General rule.* For purposes of clause (ii) of section 46(a)(2)(B) of the Internal Revenue Code of 1954, the amount determined under this subsection for a taxable year is an

amount equal to the sum of the matching employee contributions for the taxable year which meet the requirements of this subsection.

(2) *Election; basic plan requirements.* No amount shall be determined under this subsection for the taxable year unless the corporation elects to have this subsection apply for that year. A corporation may not elect to have the provisions of this subsection apply for a taxable year unless the corporation meets the requirements of subsection (d) and the requirements of this subsection.

(3) *Employer contribution.* On making a claim for credit, adjustment, or refund under section 38 of the Internal Revenue Code of 1954, the employer shall state in such claim that the employer agrees, as a condition of receiving any such credit, adjustment, or refund attributable to the provisions of section 46(a)(2)(B)(ii) of such Code, to transfer at the time described in subsection (d)(6)(B) employer securities (as defined in subsection (d)(9)(A)) to the plan having an aggregate value at the time of the transfer of not more than one-half of one percent of the amount of the qualified investment (as determined under subsections (c) and (d) of section 46 of such Code) of the taxpayer for the taxable year. For purposes of meeting the requirements of this paragraph, a transfer of cash shall be treated as a transfer of employer securities if the cash is, under the plan, used to purchase employer securities.

(4) *Requirements relating to matching employee contributions.*

(A) An amount contributed by an employee under a plan described in subsection (d) for the taxable year may not be treated as a matching employee contribution for that taxable year under this subsection unless—

(i) Each employee who participates in the plan described in subsection (d) is entitled to make such a contribution,

(ii) The contribution is designated by the employee as a contribution intended to be used for matching employer amounts transferred under paragraph (3) to a plan which meets the requirements of this subsection, and

(iii) The contribution is in the form of an amount paid in cash to the employer or plan administrator not later than 24 months after the close of the taxable year in which the portion of the credit allowed by section 38 of such Code (and determined under clause (ii) of section 46 (a)(2)(B) of such Code which the contribution is to match) is allowed, and is invested forthwith in employer securities (as defined in subsection (d)(9)(A)).

(B) The sum of the amounts of matching employee contributions taken into account for purposes of this subsection for any taxable year may not exceed the value (at the time of transfer) of the employer securities transferred to the plan in accordance with the requirements of paragraph (3) for the year for which the employee contributions are designated as matching contributions.

(C) The employer may not make participation in the plan a condition of employment and the plan may not require matching employee contributions as a condition of participation in the plan.

(D) Employee contributions under the plan must meet the requirements of section 401(a)(4) of such Code (relating to contributions).

(5) A plan must provide for allocation of all employer securities transferred to it or purchased by it under this subsection to the account of each participant (who was a participant at any time during the plan year, whether or not he is a participant at the close of the plan year) as of the close of the plan year in an amount equal to his matching employee contributions for the year. Matching employee contributions and amounts so allocated shall be deemed to be allocated under subsection (d)(3).

(f) *Recapture.*

(1) *General rule.* Amounts transferred to a plan under subsection (d)(6) or (e)(3) may be withdrawn from the plan by the employer if the plan provides that while subject to recapture—

(A) Amounts so transferred with respect to a taxable year are segregated from other plan assets, and

(B) Separate accounts are maintained for participants on whose behalf amounts so transferred have been allocated for a taxable year.

(2) *Coordination with other law.* Notwithstanding any other law or rule of law, an amount withdrawn by the employer will neither fail to be considered to be nonforfeitable nor fail to be for the exclusive benefit of participants or their beneficiaries merely because of the withdrawal from the plan of—

(A) Amounts described in paragraph (1), or

(B) Employer amounts transferred under subsection (e)(3) to the plan which are not matched by matching employee contributions or which are in excess of the limitations of section 415 of such Code,

nor will the withdrawal of any such amount be considered to violate the provisions of section 403(c)(1) of the Employee Retirement Income Security Act of 1974.

[Sec. 301(d) of the Tax Reduction Act of 1975 (89 Stat. 38) as amended by sec. 802(b)(7) and sec. 803 (c) and (e) of the Tax Reform Act of 1976 (90 Stat. 1520); sec. 301 (e) and (f) of the Tax Reduction Act of 1975 as added by sec. 803(d) of the Tax Reform Act of 1976]

(Sec. 301(d)(2)(C) of the Tax Reduction Act of 1975; sec. 7805 of the Internal Revenue Code of 1954 (89 Stat. 38, 68A Stat. 917; 26 U.S.C. 7805)

[T.D. 7857 47 FR 54793, Dec. 6, 1982]

§1.46–8 Requirements for taxpayers electing additional one-percent investment credit (TRASOP's).

(a) *Introduction*—(1) *In general.* A corporation may elect under section 46(a)(2)(B) of the Code to obtain an additional investment credit for property described in section 46(a)(2)(D). This section provides rules for electing to have the provisions of section 46(a)(2)(B) apply and for implementing an employee stock ownership plan under section 301(d) of the Tax Reduction Act of 1975 (''1975 TRA''). The plan must meet the formal requirements of paragraph (d), and the operational requirements of paragraph (e), of this section. An additional credit may be obtained for the periods described in section 46(a)(2)(D). Unless otherwise indicated, statutory references in this section are to the Internal Revenue Code of 1954 as in effect prior to the amendments made by the Revenue Act of 1978.

(2) *Reports.* The returns required by section 6058(a) must be filed on behalf of a plan established under paragraph (c)(7) of this section, whether or not the plan is qualified under section 401(a).

(3) *Cross-references.* The following table indicates where in this section provisions appear relating to each provision of section 301 (d) and (f) of the 1975 TRA.

Section 301	Section 1.46–8	Subject
(d)(1)	(c)(7)(i), (c)(8)(i).	Establishing a TRASOP, in general; funding a TRASOP, in general.
(2)(A)	(c)(7)(ii)	Type of plan.
(B)	(d)(3), (e)(10)	Investment design.
(C)	(d)(1)	Plan requirements, in general.
(3)	(d)(6)	Allocation.
	(b)(8)	Compensation, definition.
(4)	(d)(7)	Nonforfeitability.
	(d)(9)	Distributions.
(5)	(d)(8)	Voting rights.
(6)	(c)	Procedures for additional credit.
(7)(A)	(c)(7)(ii)	Taxability, non-401(a) TRASOP.
(B)	(e)(3)	Allocations under 401(a).
(C)	(e)(3)	Section 410 and section 415 requirements.
(8)	(e)(9)	Reductions of investment credit.
(9)(A)	(b)(4)	Employer securities, definition.
	(e)(10), (f)	Employer securities, requirements.
(B)	(b)(7)	Value, definition.
(10)	(a)(2)	Reporting requirements.
(11)	(h)	Failure to comply.
(12)	(c)(10)	Deductibility.
(13)	(e) (6) and (7)	Reimbursement for expenses.
(14)	(c)(8)(v) and (d)(7)(i).	Contingent contributions.
(f)	(d)(7), (e)(8)(vii), (f).	Withdrawals of TRASOP securities.

(b) *Definitions.* When used in this section, the terms listed below have the indicated meanings:

(1) *TRASOP.* A ''TRASOP'' is an employee stock ownership plan that meets the requirements of section 301(d) of the 1975 TRA. See §1.46–7. It is a type of plan described in paragraph (d)(1) of this section and may, but need not, be an ESOP under §54.4975–11 of this chapter (Pension Excise Tax Regulations). See §1.46–8(d)(5) concerning use of TRASOP assets as collateral for debts and expenses of the plan.

(2) *Additional credit.* An ''additional credit'' is the additional one-percent investment credit under section 46(a)(2)(B)(i).

(3) *Employer.* An ''employer'' is a corporation that establishes a TRASOP.

(4) *Employer securities*—(i) *In general.* ''Employer securities'' are common stock, and securities convertible into common stock, of the employer or of a corporation that is a member of a controlled group of corporations including the employer. Employer securities must meet the requirements of paragraph (g) of this section. Membership in a controlled group for purposes of this section is determined under section 414(b) of the Code.

(ii) *Pre-1977 employer securities.* In addition, employer securities acquired by a TRASOP before January 1, 1977, include common stock, and securities convertible into common stock, of a corporation in control of the employer within the meaning of section 368(c).

(iii) *Caution.* An employer security under this section is not necessarily a qualifying employer security as defined in section 407(d)(5) of the Employee Retirement Income Security Act of 1974 (ERISA) or section 4975(e)(8). Moreover, sections 406, 407, and 408 of ERISA in certain cases limit the acquisition and disposition of qualifying employer securities as defined in section 407(d)(5) of ERISA.

(5) *TRASOP securities.* ''TRASOP securities'' are employer securities that—

(i) Are transferred to a TRASOP, or acquired with cash transferred to a TRASOP, to obtain an additional credit, and

(ii) Except as provided under paragraphs (g) (4) and (5) of this section, or as required by applicable law, are subject to no other put, call, or other option, or buy-sell or similar arrangement while held by the plan.

(6) *Publicly traded.* The term ''publicly traded'' has the meaning specified in § 54.4975–7(b)(1)(iv) of this chapter.

(7) *Value*—(i) *In general.* With respect to the transfer of TRASOP securities by a corporation to a TRASOP or the acquisition of TRASOP securities with cash transferred by a corporation to a TRASOP, ''value'' means fair market value determined in good faith and based on all relevant factors as of the date of transfer or acquisition of the TRASOP securities. If the plan acquires TRASOP securities from other than a disqualified person within the meaning of section 4975(e)(2), a good faith determination of value includes a determination of fair market value based on an appraisal independently arrived at by a person who customarily makes such appraisals and who is independent of any person from whom the TRASOP securities are acquired.

(ii) *Twenty-day average rule.* A special 20-day average valuation rule applies to certain publicly traded securities transferred by a corporation to a TRASOP. It does not apply to securities acquired with cash transferreed by a corporation to a TRASOP. Under the special rule, the term ''value'' refers to an average of daily closing prices for a security, as reported on any national securities exchange or as quoted on any system sponsored by a national securities association, over the 20 consecutive trading days immediately preceding the applicable last day described in paragraph (c)(8)(i) of this section. The average is based on the closing prices for each day when the security is in fact traded during the 20-day period. However, the special rule does not apply unless the security is in fact traded for at least 10 of the 20 days.

(iii) *20-day average transitional exception.* If a TRASOP security is transferred before March 20, 1979, the plan may value the security on the basis of the 20 consecutive trading days preceding the date on which the security is transferred or the date as of which the security is allocated to a participant's account.

(8) *Compensation.* ''Compensation'' means ''participant's compensation'' under section 415(c)(3) and § 1.415–2(d). However, except for purposes of applying section 415, compensation must be determined for a plan year, not a limitation year.

(c) *Procedures for additional credit*—(1) *Applicable year*—(i) *General rule.* With respect to a qualified investment, the ''applicable year'' of a corporation is generally the taxable year in which the investment is made. For purposes of this section, an investment is made either in a year when section 38 property is placed in service or in a year when qualified progress expenditures are incurred.

(ii) *Carryover option.* A corporation may determine the applicable years for qualified investments made in any taxable year beginning after December 31, 1976, under the following method: The first applicable year with respect to the additional credit for a given year's qualified investment is the year the qualified investment is made or, if later, the first taxable year for which any additional credit is allowable if claimed for that qualified investment. If there is an investment credit carryover from the first applicable year, each taxable year to which any part of the additional credit for that qualified investment is carried over is also an applicable year. If the carryover treatment is elected for the additional credit attributable to a year's qualified investment, all applicable years for the additional credit attributable to that investment must be determined under the carryover option.

(iii) *Increased credit.* A taxable year in which a corporation's additional credit is increased because of a redetermination is also an applicable year. See paragraph (c)(9)(iv) of this section.

(iv) *Illustration.* To illustrate the application of paragraphs (c)(1) (i) and (ii) of this section, assume that a calendar-year corporation makes a qualified investment in 1977 and that 1977 is an unused credit year described in section 46(b)(1). If the general rule is applied, 1977 is an applicable year. However, because 1977 is an unused credit year (at least with respect to the additional credit), if the corporation does not elect to treat 1977 as an applicable year but carries over its entire additional credit for 1977 to 1978 and uses it in 1978, then 1978 is an applicable year. If part of the additional credit is carried over further to 1979, the year 1979 is also an applicable year.

(v) *Change in method.* The choice between the general rule and carryover option methods of determining the additional credit attributable to applicable years is made with respect to each year's qualified investment, and does not bind the corporation with respect to selection of methods for the additional credit attributable to other years' qualified investment. A failure to comply does not occur merely because a corporation elects to apply either method for the additional credit attributable to separate years' qualified investment.

(2) *Time and manner of electing.* A corporation with a qualified investment must elect to be eligible for an additional credit by attaching a statement of election—

(i) To its income tax return, filed on or before the due date including extensions of time, for a taxable year not later than its first applicable year with respect to a qualified investment, or

(ii) In the case of a return filed before December 31, 1975, to an amended return filed on or before December 31, 1975.

(3) *Statement of election.* The statement of election must contain the name and taxpayer identification number of the corporation. Also, it must declare in the following words, or in words having substantially the same meaning, that:

(i) The corporation elects to have section 46(a)(2)(B)(i) of the Internal Revenue Code of 1954 apply; and

(ii) The corporation agrees to implement (or continue to implement, as appropriate) a TRASOP and to claim the additional credit as required by §1.46–8 of the Income Tax Regulations.

(4) *Separate election.* A separate election must be made for each taxable year's qualified investment to obtain an additional credit for that qualified investment. If a corporation does not make a timely election to obtain an additional credit for a taxable year, it may not subsequently make the election on an amended return or otherwise.

(5) *No partial election.* An election to obtain an additional credit applies to a corporation's entire qualified investment for a taxable year. Thus, a corporation may not elect to obtain a partial additional credit for any year's qualified investment. However, the partial disallowance of an additional credit will not result in an election being treated as a partial election. Also, an election by a member of a controlled group of corporations that applies only to the electing member's qualified investment is not a partial election. See §1.46–8(h)(9) with respect to transitional rules for elections made before January 19, 1979.

(6) *No revocation of election.* After the time for electing the additional credit has expired for a taxable year, a corporation may not revoke its election for that year.

(7) *Establishing a TRASOP*—(i) *In general.* A corporation electing to obtain an additional credit must establish a TRASOP with accompanying trust on or before the last day for making the election regardless of when in fact the election is made. A TRASOP is considered to be in existence on a particular date if it meets the requirements of §1.410(a)–2(c)(1). A new plan need not be established if an existing plan qualifies as a TRASOP, or is amended to meet the requirements of this section, on or before the last day for making the election. The requirements of this section are not satisfied merely by establishing and crediting a separate "TRASOP" account on the corporation's books.

(ii) *Type of plan.* A TRASOP need not meet the requirements of section 401(a). However, it must be a stock bonus plan, a combination stock bonus plan and money purchase pension plan, or a profit-sharing plan under §1.401–

1(b)(1) of this chapter. See section 301(d)(7)(A) of the 1975 TRA for the tax consequences relating to a TRASOP that does not meet the requirements of section 401(a). See also Title I of ERISA for additional provisions applicable to a TRASOP as an employee pension benefit plan under section 3(2) of ERISA.

(8) *Funding a TRASOP*—(i) *In general.* A corporation electing to obtain an additional credit must fund its TRASOP by transferring TRASOP securities or cash to it no later than 30 days after the applicable last day. That day is the last day for electing the additional credit, irrespective of when the election is actually made. However, in the case of an investment credit that was carried over and claimed in a subsequent applicable year by reason of paragraph (c)(1)(ii) of this section, that day is the last day (including extensions) for filing its income tax return for the subsequent applicable year. TRASOP securities may be transferred to a plan at any time during the applicable year, but not before the first day of an applicable year. If TRASOP securities are transferred to the plan within the permissible time period after the close of the applicable year, they are treated as transferred during that applicable year first until all TRASOP securities required by this paragraph (c) for that applicable year are transferred to, and taken into account under, the TRASOP. Thus, for example, assume that on a return filed on September 17, 1979 (with extensions, the last day for filing a return for 1978), a calendar-year corporation claims an additional credit of $5,000 for 1978, an applicable year under the TRASOP. No contributions were made in 1978 on account of the 1978 credit, but TRASOP securities with a value of $6,000 were contributed in 1979. The corporation also expects to be able to claim an additional credit of $10,000 for 1979. TRASOP securities transferred between January 1, 1979, and October 17, 1979, must be taken into account under the plan for 1978 before they are taken into account for 1979. Accordingly, securities having a value of $5,000 are applied against the obligation for 1978, and $1,000 of the contribution is retained to be applied to the eventual obligation for 1979.

(ii) *Cash transfers.* A corporation may transfer cash to the TRASOP instead of TRASOP securities only if the TRASOP uses the cash to acquire TRASOP securities no later than 30 days after the time for funding the TRASOP.

(iii) *Valuation.* The value of the TRASOP securities for an applicable year must equal one percent of the corporation's qualified investment for that year. However, if paragraph (c)(1)(ii) of this section is followed by a corporation, the value of TRASOP securities for an applicable year must equal the amount of additional credit claimed for that year.

(iv) *Cash reserve.* The value of TRASOP securities acquired with cash transferred by a corporation may be reduced by two items. The first item is an amount not more than the value of fractional shares allocable to participants entitled to receive an immediate distribution at the time of the transfer. The second item is start-up expenses and administrative expenses to the extent permitted under section 301(d)(13) of the 1975 TRA and paragraphs (e) (6) and (7) of this section.

(v) *Conditional funding.* The funding of a TRASOP may be conditional if the TRASOP satisfies the provisions of section 301(d)(14) of the 1975 TRA. For purposes of section 301(d)(14), an investment credit is considered to be allowed on the date the election for the applicable year is made under paragraph (c)(2) of this section.

(vi) *Certain benefit offset mechanisms.* A TRASOP will be deemed to be not funded to the extent that TRASOP securities are used to offset benefits under a defined benefit plan.

(9) *Claiming additional credit*—(i) *In general.* Section 46(a)(3) subjects the amount of investment credit earned with respect to a taxpayer's qualified investment for a taxable year to a limitation based on the corporation's tax liability.

(ii) *Unused credit year.* Section 46(a)(1) provides a first-in-first-out rule for the investment credit in a taxable year. Section 46(b)(1) provides for the carryback and carryover of unused credits. If less than all of a taxpayer's credit earned for a taxable year is allowable, the 10-percent credit determined under section 46(a)(2)(A) earned for a particular year is allowed first. Any portion of the additional credit for a taxable year that is not allowable may be carried back or carried over to the extent permitted by section 46(b)(1). However, an additional credit which is allowed for a taxable year is not reduced by a carryback to that year of an unused credit from a succeeding taxable year.

(iii) *Example.* Paragraph (c)(9)(ii) of this section is illustrated by the following example:

Example. A calendar-year corporation begins operation and establishes a TRASOP in 1975. The facts and treatment relating to the corporation's qualified investments and investment tax credits for 1975 and 1976 are as follows:

	1975	1976
Facts:		
1. Qualified investment	$500,000	$500,000
2. Credits earned:		
a. 10% credit	50,000	50,000
b. Additional credit	5,000	5,000
c. Carryover of additional credit from prior year, line 5	....	3,000
3. Sec. 46(a)(3) limitation	52,000	47,000
Treatment of credits:		
4. Credits allowed:		
a. Carryover of additional credit	....	3,000
b. Current 10% credit	50,000	44,000
c. Current additional credit	2,000	0
5. Unused credits:		
a. 10% credit	0	6,000
b. Additional credit	3,000	5,000

Thus, in 1975 the section 46(a)(3) limitation ($52,000) is applied first to allow all of the 10-percent investment credit ($50,000). Accordingly only $2,000 of the additional credit earned is allowed in 1975 and $3,000 of the additional credit is carried forward to 1976. In 1976, section 46(a)(1) requires that this $3,000 of additional credit is allowed first, and then only $44,000 of the 10-percent credit earned in 1976 is allowed since the section 46(a)(3) limitation for that year is $47,000. The unused credits from 1976 cannot be carried back since 1975, the only prior year, is an unused credit year.

(iv) *Redeterminations increasing credit.* If a corporation's allowable additional credit is increased because of a redetermination, the increase is treated as if it were an unused credit carryover for purposes of paragraphs (c)(1)(ii) and (c)(8)(i) of this section. For purposes of this subdivision (iv), the date of the increase is determined under paragraph (e)(9)(iii) of this section as if it were the date of a reduction. Thus, for example, assume that a calendar-year corporation claims an additional credit of $100,000 in 1978 because of a qualified investment in that year. In 1980, the additional credit attributable to 1978 qualified investment is redetermined to be $110,000. With respect to the 1978 qualified investment, 1980 is also an applicable year to the extent of $10,000. The increased credit is reflected on the employer's return for 1980. The corporation must fund the TRASOP with this $10,000 under paragraph (c)(8) of this section.

(v) *Redeterminations increasing tax liability.* If a corporation's tax liability for a year is increased such that an additional credit carried forward and claimed in a later year is allowable in the earlier year, the claim of the additional credit will be considered timely if it was otherwise timely under this section. Thus, for example, assume that a calendar-year corporation makes qualified investment of $5,000,000 in 1978 but, based on its income tax liability, is unable to use any of the credit until 1979, when the entire $50,000 additional credit can be used. The corporation adopts the TRASOP, elects the full $50,000 credit and funds in a timely manner for tax year 1979. However, as a result of a 1981 redetermination of the 1978 tax liability, the corporation is able to use $30,000 of the additional credit in 1978 and the remaining $20,000 in 1979. The allowable credit for 1978 is increased by $30,000 and the increase is treated as an unused credit carryover, for which the year of redetermination, 1981, is the applicable year. Assuming that no other credits are available, the 1979 credit is reduced from $50,000 to $20,000, and this reduction is taken into account in the redetermination year by offsetting the reduction against amounts due the plan or by deducting the amount of the reduction. The adoption of the TRASOP for 1979, rather than 1978, is considered timely.

(10) *Deductions at expiration of carryover period.* Under paragraph (c)(1)(i) of this section, a corporation that uses no additional credit in the year of a qualifed investment may nonetheless treat the year in which the qualified investment is made as the first applicable year. If the carryover period under section 46(b)(1)(B) expires before the corporation uses the entire additional credit with respect to the qualified investment, contributions attributable to the unused credit are deductible, subject to the limitations of section 404(a), as if made in the taxable year when the carryover period expires. The amount deductible is the dollar amount of the unused credit irrespective of the current value of the securities contributed with respect to the credit.

(d) *Formal plan requirements*—(1) *In general.* To be a TRASOP, a plan must meet the formal requirements of this paragraph (d).

(2) *Plan year.* To be a TRASOP, a plan must specify a plan year that begins with or within the corporation's taxable year.

(3) *Designed to invest primarily in employer securities.* To be a TRASOP, a plan must state that it is designed to invest primarily in employer securities. A TRASOP intended to qualify as an ESOP under § 54.4975–11 must state that it is designed to invest primarily in employer securities. See paragraph (e)(10) of this section concerning the requirement that a plan invest in employer securities on an ongoing basis.

(4) *Separate accounting.* To be a TRASOP, a plan must state that TRASOP securities are to be accounted for separately from any other contributions to the plan.

(5) *Debts and expenses of the TRASOP.* To be a TRASOP, a plan must state that TRASOP securities cannot be used to satisfy a loan made to the TRASOP or be used as collateral for a loan made to a TRASOP. However, if the plan so provides, to the extent permitted under section 301(d)(13) of the 1975 TRA and paragraphs (e) (6) and (7) of this section, certain amounts may be used for the TRASOP's start-up expenses and administrative expenses.

(6) *Allocation of TRASOP securities*—(i) *General rules.* To be a TRASOP, a plan must provide for the allocation of TRASOP securities under section 301(d)(3) of the 1975 TRA and this subparagraph (6).

(ii) *Timing.* TRASOP securities are allocated as of the last day of the plan year beginning with or within the appropriate applicable year.

(iii) *Participants.* Each employee who is a participant at any time during the plan year for which allocation is made must receive an allocation as of the end of that year even though not then employed by the employer. However, to receive allocations, employees must satisfy the minimum participation requirements of the plan (for example, 1,000 hours of service).

(iv) *Compensation considered.* Under section 301(d)(3) of the 1975 TRA, allocations must be based on the proportion that each participant's compensation bears to all participants' compensation. Compensation in excess of $100,000 must be disregarded in making these allocations. A plan may have a lower stated ceiling on compensation (from $0 to $100,000) and if the plan has such a lower ceiling, compensation in excess of this ceiling must likewise be disregarded. Also, allocations must be based on a participant's compensation while actually employed, not just while actually participating, in the plan year.

(v) *Section 415 priority rule; transitional rule.* For purposes of section 415, this subdivision (v) applies only to limitation years beginning after November 30, 1982. If a TRASOP security is not allocated to a participant's account for a plan year because of section 415 and section 301(d)(3) of the 1975 TRA, no other amount may be allocated for that participant under any defined contribution plan of the same employer after the actual allocation date for that TRASOP plan year, until all unallocated TRASOP securities have been allocated as provided in paragraphs (d)(6) (vi) and (vii) of this section. This subdivision (v) applies to a TRASOP when, under section 415(f)(1)(B), the TRASOP is treated along with an employer's other defined contribution plans as one plan for purposes of section 415.

(vi) *Unallocated amounts.* Under section 301(d)(3) of the 1975 TRA, TRASOP securities unallocated for a plan year to participants' accounts because of section 415 must be allocated proportionately to the accounts of other participants until the addition to the account of each participant reaches the limits of section 415.

(vii) *Suspense account.* If, after these allocations, TRASOP securities remain unallocated, they must be held in an unallocated suspense account under the TRASOP. Any income produced by these securities must also be held in the account. A plan with such an account will not fail to qualify under section 401(a) merely because of the account. In each successive TRASOP plan year (whether or not an applicable year), the unallocated assets are released from this account for allocation on a first-in-first-out basis. They are then allocated to the participants' accounts proportionately under paragraph (d)(6) (i) through (vi) of this section for each later year until no TRASOP securities remain unallocated. Value for this allocation is determined under paragraph (b)(7) of this section as of the date of transfer from the suspense account or, if the special 20-day average rule applies, the value is determined on the basis of the 20 consecutive trading days immediately preceding the date of transfer from the suspense account.

(viii) *Escrow account.* A TRASOP may provide for the establishment of an escrow account instead of a suspense account. The escrow account must satisfy paragraph (d)(6)(vii) of this section. The beneficiary of the escrow account is to be the TRASOP. The corporation may establish the escrow account and contribute stock or cash to it. In such a case, the escrow agent must transfer assets to the plan each year equal to the amount to be allocated proportionately under paragraph (d)(6)(i)–(vi) of this section. Assets held in an escrow account are plan assets.

(ix) *Treatment of certain plan terminations.* To be a TRASOP, a plan must provide that, if a plan terminates because the corporation ceases to exist, unallocated amounts described in paragraph (d)(6)(vi) of this section must be allocated to the extent possible under section 415 for the year of termination. The remaining unallocated amounts must then be withdrawn. These unallocated amounts are treated as recaptured under all the rules of paragraph (e)(9)(vii) of this section except its last sentence. See paragraph (d)(9)(i) of this section concerning distributions of allocated TRASOP securities.

(x) *No integration.* No TRASOP may be integrated, directly or indirectly, with contributions or benefits under Title II of the Social Security Act or any other state or federal law.

(xi) *Fractional securities.* Participants' accounts are to be allocated fractional securities or fractional rights to securities.

(xii) *Accounting for amounts withheld by employer or paid by plan as start-up or administrative expenses.* An employer may withhold certain start-up and administrative expenses from TRASOP securities due the plan. Also, a plan may reduce amounts to be allocated to the extent that certain plan assets are used to reimburse the employer, for example for salaries of employees providing services to the plan, or to pay fees directly to independent contractors for expenses. These expenses do not reduce the amount of additional credit claimed and are not allowable as expenses in computing taxable income. Additional rules concerning these expenses are in paragraphs (e) (6) and (7) of this section.

(7) *Nonforfeitability.* To be a TRASOP, a plan must state that each participant has a nonforfeitable right to allocated TRASOP securities. For purposes of this section, forfeitures described in section 411(a)(3) are not permitted. However, amounts shall not fail to be considered to be nonforfeitable if the plan provides for their return to the corporation—

(i) In the case of conditional contributions, under section 301(d)(14) of the 1975 TRA and paragraph (c)(8)(v) of this section, and

(ii) In the case of investment credit recapture or an event deemed to be a recapture, under section 301(f) of the 1975 TRA and paragraph (f) of this section.

(8) *Voting rights*—(i) *Provision for pass-through.* To be a TRASOP, a plan must state that each participant is entitled to direct a designated fiduciary how to

exercise any voting rights on TRASOP securities allocated to the account of the participant. The plan need not permit participants to direct the voting of unallocated TRASOP or other securities held by the trust. It may authorize the designated fiduciary to exercise voting rights for unallocated securities.

(ii) *Notification by the employer.* To be a TRASOP, the plan must obligate the corporation to furnish the designated fiduciary and participants with notices and information statements when voting rights are to be exercised. The time and manner for furnishing participants with a notice or information statement must comply with both applicable law and the corporation's charter and bylaws as generally applicable to security holders. In general, the content of the statement must be the same for plan participants as for other security holders.

(iii) *Fractional securities.* To be a TRASOP, the plan must allow the participants to vote any allocated fractional securities or fractional rights to securities. This requirement is met if the designated fiduciary votes the combined fractional securities or rights to the extent possible to reflect the direction of the voting participants.

(iv) *Unexercised voting rights.* To be a TRASOP, the plan may not permit the designated fiduciary to exercise voting rights which a participant fails to exercise. However, the plan may permit the solicitation and exercise of participants' voting rights by management and others under a proxy provision applicable to all security holders.

(9) *Distributions*—(i) *In general.* To be a TRASOP, a plan must permit the distribution of allocated TRASOP securities only as provided under section 301(d)(4) of the 1975 TRA. Also, under § 1.401–1(b)(1)(i) of this chapter, to the extent that a TRASOP is a money purchase pension plan, it can only provide for a distribution in the case of separation from service, death, or disability. No TRASOP may provide for the distribution of TRASOP securities upon plan termination within the 84–month holding period. For purposes of section 301(d)(4) of the 1975 TRA, the 84–month holding period begins on the date as of which TRASOP securities are allocated.

(ii) *Certain fractional securities.* A stock bonus TRASOP may distribute cash instead of fractional securities.

(e) *Operational plan requirements*—(1) *General rule.* To be a TRASOP, a plan in operation must meet the requirements of this paragraph (e). However, the provisions under paragraph (e)(8) of this section apply only to TRASOPs qualified under section 401(a).

(2) *Compliance with plan provisions.* To be a TRASOP, a plan must operate in compliance with its provisions. Failure to operate in compliance with plan provisions constitutes an operational failure to comply. See paragraph (h)(5)(iii) of this section.

(3) *Compliance with certain Code provisions.* To be a TRASOP, a plan must meet the requirements of section 301(d)(7) of the 1975 TRA. Thus, whether or not it is qualified under section 401(a), a TRASOP must meet the requirements of section 401(a) with respect to allocations, section 410 with respect to participation, and section 415 with respect to limitations on contributions and benefits. However, these requirements are modified by paragraph (d)(6) of this section, relating to allocations and section 415.

(4) *Employee contributions.* Under a TRASOP, the participants' receipt of benefits attributable to TRASOP securities contributed for the additional credit (but not the extra additional credit) must not depend on contributions by participants. If a corporation has a plan in existence which requires employee contributions, a portion of the plan may be a TRASOP if employee contributions are not required with respect to that portion of the plan.

(5) *Controlled group of corporations, etc.* Whether or not a TRASOP is qualified under section 401(a), all employees who by reason of section 414 (b) and (c) are treated as employees of an electing corporation are treated as employed by the corporation in determining whether the plan satisfies the requirements of sections 301(d)(7) (B) and (C) of the 1975 TRA. A member of a controlled group under paragraph (b)(4)(i) of this section with a qualified investment but with no actual employees may obtain an additional credit even though the

only participants in the corporation's TRASOP are actually employed by another member of the controlled group.

(6) *Start-up expenses*—(i) *In general.* For purposes of this section, the term "start-up expense" means any ordinary and necessary amount of a nonrecurring nature paid or incurred by the corporation or by the plan in connection with the establishment of a TRASOP under paragraph (c)(7) of this section. Thus, for example, start-up expenses may include expenses relating to: the drafting or amending of plan documents to establish a TRASOP under section 301(d) or (e) of the 1975 TRA, the seeking of agency approval for these documents and related transactions, the obtaining of shareholder approval for establishing a TRASOP, and the registering of securities for initial funding of a TRASOP.

(ii) *Treatment of start-up expenses.* Start-up expenses may be withheld by the employer from amounts that would otherwise be due the plan under paragraph (c)(8) of this section, to the extent that these amounts are known by the employer when funding first occurs for an applicable year. To the extent that these amounts are not withheld by the employer, the plan may pay remaining amounts from plan assets within a reasonable time after the amounts are known by the plan.

(iii) *Ceiling on start-up expenses.* Reimbursement for start-up expenses is limited to a ceiling. This ceiling is the sum of 10 percent of the first $100,000 that an employer is first required to transfer under paragraph (c)(8) of this section for an applicable year and 5 percent of that amount in excess of $100,000. If this first year is an unused credit year from which there is a carryover, amounts required to be transferred in subsequent years for claiming carryovers from this first year are considered in determining this ceiling. Thus, for example, assume that a calendar-year corporation first earns an additional credit in 1977 of $9,000 and that $3,000 of this amount is claimed on the income tax return for 1977, for 1978 and for 1979. The corporation's ceiling on start-up expenses is $300 when its 1977 return is filed. The total ceiling increases to $600 when its 1978 return is filed and to $900 when its 1979 return is filed, with the claiming of an additional $3,000 credit for each of the three years.

(iv) *Special rule for taxable years ending before January 1, 1977.* Special treatment is available for expenses paid or incurred before January 1, 1977, that were not taken into account in the manner provided by section 301(d)(13) of the 1975 TRA. These expenses may be withdrawn under paragraph (e)(9)(vii) of this section in the same manner as reductions in the corporation's additional credit caused by a recapture. This withdrawal may only be made during the first taxable year ending after March 20, 1979. It is subject to the ceiling of section 301(d)(13) of the 1975 TRA. Expenses previously deducted by a corporation must be reduced on a timely-filed amended return by the amount of this withdrawal.

(7) *Administrative expenses*—(i) *In general.* For purposes of this section, the term "administrative expense" means any amount, other than a start-up expense, paid or incurred by the corporation or by the plan that is ordinary and necessary in maintaining the TRASOP. Thus, for example, administrative expenses may include expenses relating to: compensating plan fiduciaries and administrators, leasing office space and equipment, reproducing and mailing information to participants and beneficiaries, and filing reports, returns, and amendments relating to a TRASOP. Paragraph (e)(6) (ii) and (iv), relating to treatment of start-up expenses and to a special rule for taxable years ending before January 1, 1977, also applies to administrative expenses.

(ii) *Ceiling on administrative expenses.* Reimbursement for administrative expenses under paragraph (e)(6)(ii) of this section is limited to the smaller of two amounts for each plan year. The first amount is $100,000. The second amount is the sum of 10 percent of the first $100,000 of dividend income paid with respect to TRASOP securities held by the plan during the plan year ending with or within the corporation's taxable year and 5 percent of any such dividend income in excess of $100,000.

(8) *TRASOP qualification under section 401(a)*—(i) *Permanence.* A TRASOP is not required to be a qualified plan

under section 401(a). However, to meet the requirements of section 401(a), a TRASOP must be a permanent plan, as described in § 1.401–1(b)(2) of this chapter. Under section 401(a)(21), a plan will not fail to be considered permanent merely because the amount of employer contributions under the plan is determined solely by reference to the amount of additional credit allowable under this section. Thus, for example, it will not fail to be considered permanent merely because employer contributions are not made for a year for which an additional credit is not available by reason of no qualified investment for which an additional credit can be obtained. Section 401(a)(21) applies only to the extent the TRASOP is funded with TRASOP securities and cash in lieu of TRASOP securities.

(ii) *Partial discontinuance of contributions.* A plan that meets the requirements of section 401(a) may receive contributions of TRASOP securities as well as other contributions. If the other contributions continue on a permanent basis, the plan's qualification under section 401(a) will not be adversely affected merely because TRASOP securities cease to be contributed to it. The discontinuance of TRASOP contributions does not alter the requirement that past TRASOP contributions remain invested in employer securities. See paragraph (e)(10) of this section.

(iii) *Income distribution.* Income paid with respect to employer securities acquired by a TRASOP may be distributed at any time after receipt by the plan to participants on whose behalf such securities have been allocated without adversely affecting the qualified status of the plan under section 401(a). (See the last sentence of section 803(h), Tax Reform Act of 1976.) However, under a TRASOP that is a stock bonus or profit-sharing plan, income held by the plan for a 2-year period or longer must be distributed under rules generally applicable to stock bonus and profit-sharing plans qualified under section 401(a). Income distributed by a TRASOP is not subject to the partial exclusion of dividends provided in section 116, whether or not the income is held by the plan for two or more years.

(9) *Reductions in investment credit*—(i) *General rule.* Certain reductions in a corporation's investment credit result from either a recapture under section 47 of the corporation's investment credit or a redetermination of the allowable credit. If these reductions are taken into account under a TRASOP, the plan may only use one or more of the methods described in paragraphs (e)(9), (v), (vi), and (vii) of this section for taking into account these reductions. Thus, for example, more than one method is permitted upon a recapture with respect to a qualified investment made in a particular year. However, the method described in paragraphs (e)(9)(vii) of this section applies only to a recapture and not to a redetermination.

(ii) *Ratable reduction.* A reduction is allocated ratably between the 10-percent credit and the additional credit. Thus, for example, if a calendar-year corporation claims a $33,000 investment credit for 1976, including $3,000 additional credit, and $11,000 of the total credit is recaptured in 1978, the $3,000 additional credit is reduced by $1,000. This subdivision (ii) does not apply to a reduction solely of the additional credit as could occur, for example, in the case of a redetermination caused by a mathematical error in computing the additional credit or in the case of a recapture caused by a bad faith failure to comply under paragraph (h) of this section.

(iii) *Date of reduction.* A reduction in investment credit occurs under this paragraph (e)(9) on the earliest of these dates: (A) The date an income tax return (or an amended return) is filed reflecting the reduction; (B) the date a judicial determination affecting the amount of the reduction becomes final; and (C) the date specified in a closing agreement made under section 7121 that is approved by the Commissioner. For purposes of this subdivision (iii), a judicial determination becomes final at the time prescribed in § 1.547–2(b)(1) (ii) or (iii), relating to personal holding company tax.

(iv) *Year for taking reduction into account.* A reduction in investment credit must be taken into account in the earliest year or years possible under the applicable method beginning no later than the year in which the date of the reduction falls.

(v) *Decrease future contributions.* The reduction may be taken into account as a decrease in the value of TRASOP securities to be transferred to the plan. The amount of the decrease is equal to the dollar amount of the reduction.

(vi) *Deduct under section 404.* On the date of the reduction, the amount of the reduction may be treated as an amount paid to the TRASOP for purposes of, and as a deduction to the extent allowed under, section 404.

(vii) *Withdraw TRASOP securities.* If an additional credit allowed for a taxable year is recaptured, the corporation may withdraw from the plan TRASOP securities transferred to, or acquired by, the plan for claiming that year's credit. The withdrawal must only be from assets segregated under paragraph (f)(2) of this section and must be first from assets accounted for in an unallocated suspense account for the particular year. The amount of assets actually withdrawn bears the same proportion to the amount of assets subject to withdrawal as the amount of additional credit recaptured bears to the amount of additional credit claimed. Thus, for example, if the assets subject to withdrawal consist of 300 shares of one class of employer stock and one-third of the additional credit is recaptured, 100 shares of the stock are withdrawn. However, if the current value of the assets subject to withdrawal exceeds the dollar amount of the additional credit claimed, assets may be withdrawn only to the extent that their current value does not exceed the dollar amount of the recaptured portion of the additional credit. Thus, for example, if the 300 segregated shares in the prior example have a current value of $9,000 and the dollar value of the additional credit claimed is $4,500, when one-third of the additional credit is recaptured, only 50 shares, not 100 shares, are withdrawn. Current value is determined under paragraph (b)(7) of this section as of the withdrawal date or, if the special 20-day average rule is applied, it is based on the 20 consecutive trading days immediately preceding the withdrawal date. Withdrawals from an individual's account for the year with respect to which recapture occurs must bear the same ratio to the total amount withdrawn for that year as the individual's TRASOP account balance for that year bears to the total TRASOP account balances for that year. In the case of a TRASOP security acquired after March 20, 1979, the corporation may not withdraw it unless the plan meets the requirements of paragraph (d)(7)(ii) of this section when the plan acquires the TRASOP security.

(viii) *Prior distribution rule.* If a TRASOP distributes an amount allocated with respect to an investment credit for a taxable year and the credit for that year is later recaptured, withdrawals may not reduce participants' accounts below the level to which they would have been reduced had the prior distribution not occurred. Recaptured amounts above this level may only be deducted under paragraph (e)(9)(vi) of this section. They may not be used to decrease future contributions under paragraph (e)(9)(v).

(ix) *Illustration.* The operation of paragraph (e)(9)(viii) of this section is illustrated as follows:

Example. For 1977, a calendar-year corporation claims an additional credit of $10,000. The corporation's TRASOP meets the requirements of section 301(f) of the 1975 TRA. Each of 10 participants under the plan for that year receives an equal allocation of 10 shares valued at $1,000. In 1978, one participant terminates employment and receives a distribution of 10 shares. In 1979, a recapture reduces the 1977 additional credit by $2,000. The value of employer securities has not changed from the allocation date. If the 10 shares had not been distributed, 20 shares would be available for withdrawal, 2 shares from each participant's account. Since 9 participants remain from 1977, only 18 shares are available for withdrawal (2 shares x 9 remaining participants). If these 18 shares are withdrawn, the corporation may take into account 2 shares by deducting their value to the extent permitted under paragraph (e)(9)(vi) of this section.

(10) *Continued investment in employer securities.* The requirement that a plan be designed to invest primarily in employer securities is a continuing obligation. Therefore, a transaction changing the status of a corporation as an employer may require the conversion of certain plan assets into other securities. See paragraphs (d)(9) and (g)(6) of this section. In general, cash or other

assets derived from the disposition of employer securities must be reinvested in employer securities not later than the 90th day following the date of disposition. However, the Commissioner may grant an extension of the period for reinvestment in employer securities depending on the facts and circumstances of each case.

(f) *Section 301(f) withdrawals*—(1) *In general.* No assets may be withdrawn by a corporation under section 301(f) of the 1975 TRA unless the assets are either TRASOP securities or plan assets into which TRASOP securities have been converted (''withdrawal assets''). See paragraph (e)(10) concerning restrictions on investment of TRASOP assets in assets other than employer securities. Withdrawal assets must meet the segregated accounting requirements of this paragraph. The physical segregation of assets is not required.

(2) *Segregated accounting.* The segregated accounting requirements are that—

(i) Withdrawal assets must be segregated from other plan assets on a taxable-year-by-taxable-year basis; and

(ii) Separate accounts must be maintained on a taxable-year-by-taxable-year basis for each participant on whose behalf withdrawal assets are allocated.

(3) *Aggregate plan year accounting.* Withdrawal assets for taxable years beginning before October 4, 1976, also meet the segregated accounting requirements if they are aggregated and accounted for in one separate account apart from withdrawal assets in separate accounts for later taxable years.

(g) *Requirements for employer securities*—(1) *General rules.* The term ''employer security'' does not include stock rights, warrants and options. An employer security that is not common stock must at all times be immediately convertible into common stock that is an employer security at a conversion price which is no greater than the fair market value of that common stock at the time the plan acquires the security.

(2) *Common stock*—(i) *In general.* To be an employer security, common stock must meet certain voting power and dividend right requirements. For purposes of this paragraph (g), stock held by the TRASOP is not treated as outstanding.

(ii) *Dividend right limitations.* If dividend rights are subject to a limitation, then stock representing at least 50 percent of the fair market value of the employer's outstanding common stock at the time the commmon stock is transferred to or purchased by the TRASOP must be subject to the same limitation. However, common stock that satisfies paragraph (g)(3)(ii) of this section is not subject to this subdivision (ii).

(3) *Voting power and dividend rights.* To be an employer security, common stock must have voting power and dividend rights which, when taken together, are ''no less favorable'' than the voting power and dividend rights of any other common stock issued by the employer. Common stock which meets one of the following tests is ''no less favorable''.

(i) *Ten-percent shareholder test.* The stock is part of, or identical to, a class of outstanding stock of which at least 50 percent is not owned by 10-percent shareholders. For this purpose, a 10-percent shareholder is one who owns at least 10 percent of the outstanding shares in a class, including shares constructively owned under section 318.

(ii) *Substantial proportionality test.* More than one class of common stock is outstanding and an identical percentage of shares from each class is transferred to the TRASOP.

(iii) *Voting power test.* The stock is part of, or identical to, the existing class of stock having the greatest number of votes per unit of fair market value. For example, assume there are only two classes of common stock, Class A and Class B. Their fair market values per share are $1 and $.50, respectively, and the owner of each share of each class is entitled to one vote per share. Thus, Class B has two votes per $1 and Class A has one vote per $1. Accordingly, the Class B stock has the greatest number of votes per unit of fair market value.

(4) *Right of first refusal.* TRASOP securities may, but need not, be subject to a right of first refusal. However, whether or not the plan is an ESOP,

any such right must meet the requirements of §54.4975–7(b)(9) of this chapter.

(5) *Put option.* A TRASOP security that is transferred to a TRASOP after September 30, 1976, must be subject to a put option if it is not publicly traded when distributed or if it is subject to a trading limitation when distributed. The provisions of §54.4975–7(b)(10)–(12) and §54.4975–11(a)(3) of this chapter apply to such securities whether or not the plan is an ESOP.

(6) *Change of employer security status.* In general, a transaction changing the status of a corporation as an employer, or as a member of a controlled group of corporations including the employer, adversely affects the status as employer securities of common stock and securities held by a plan (''old employer securities''). However, to the extent that the transaction causing the change in status of the old employer securities does not result in a recapture under section 47 of any investment credit underlying the transfer to, or acquisition by, the plan of the old employer securities, common stock and securities (''new employer securities'') substituted for old employer securities are treated as if they were the old employer securities if—

(i) The plan is not terminated,

(ii) The old employer securities and the new employer securities are of equal value at the time of the transaction changing the status of the old employer securities, and

(iii) The new employer securities otherwise meet the requirements of this section.

(h) *Failure to comply*—(1) *General rule*—(i) *Effect of failure.* If a corporation elects under paragraphs (c)(2) through (5) of this section to obtain an additional credit and fails to comply with respect to that credit at any time, it is liable to the United States for a civil penalty equal to the amount involved in the failure to comply. If the corporation fails to comply with respect to an additional credit during the 84-month period described in section 301(d)(4) of the 1975 TRA, the credit is also recaptured. A separate failure to comply occurs for each taxable year in which a failure continues to exist.

(ii) *Illustration of continuing failure's effect.* Assume that in 1975 an additional credit is allowed and a failure to comply occurs in 1975 with respect to that credit. Assume also that in 1976 the 1975 failure continues uncorrected, another additional credit is allowed, and a failure to comply occurs with respect to the 1976 credit. Under these circumstances, on the last day of 1976 three separate failures to comply exist: (A) The 1975 failure with respect to the 1975 credit, (B) the 1976 failure with respect to the 1975 credit, and (C) the 1976 failure with respect to the 1976 credit.

(2) *Assessment and collection.* The civil penalty must be assessed and collected in the same manner in which a deficiency in the payment of federal income tax is assessed and collected.

(3) *Exception.* If a failure to comply is corrected within the correction period described in paragraph (h)(5) of this section—

(i) The corporation is not liable for a civil penalty; and

(ii) If the corporation establishes that at the time of the failure a good faith effort to comply was made, its additional credit is not disallowed.

(4) *Failure to comply (penalty classifications)*—(i) *In general.* An electing corporation fails to comply if a defect described in paragraphs (h)(4) (ii) through (iv) of this section occurs with respect to an additional credit allowed for a particular taxable year. The characterization of the defect in this subparagraph (4) determines the amount involved under paragraph (h)(8) of this section for the purpose of assessing the civil penalty.

(ii) *Funding defect.* A funding defect occurs if a corporation or its TRASOP fails to satisfy the requirements of paragraph (c) (8) or (9) of this section, relating to funding a TRASOP and claiming an additional credit.

(iii) *Special operational defect.* A special operational defect occurs if a TRASOP fails in operation to satisfy the requirements described in paragraphs (d) (5) through (9) of this section, relating to debts and expenses of a TRASOP, allocation of TRASOP securities, nonforfeitability, voting rights, and distributions, or paragraph (e)(3) of this section, relating to compliance with certain Code provisions.

(iv) *De minimis defect.* A de minimis defect occurs if a corporation or its

TRASOP fails to satisfy any requirement of this section other than those enumerated either in paragraph (h)(4) (ii) and (iii) of this section or in paragraphs (a)(2) and (c) (2) through (5) of this section. A failure to comply under this subdivision (iv) may be formal or operational in nature.

(5) *Failure to comply (correction rules classifications)*—(i) *In general.* If for an electing corporation a defect described in paragraph (h)(4) of this section occurs, the procedure for correcting the failure to comply depends upon whether the failure is classified as a ''formal'' failure or an ''operational'' failure under this subparagraph (5).

(ii) *Formal failure to comply.* Formal failures are corrected by retroactive amendment. If a formal plan requirement is not met, the plan must be retroactively amended by no later than the expiration of the correction period under paragraph (h)(6) of this section. A plan fails to meet a formal plan requirement of paragraph (d) of this section if, for example, it does not state, as required by paragraph (d)(3) of this section, that it is designed to invest primarily in employer securities.

(iii) *Operational failure to comply.* Operational failures are corrected by undoing the defective transaction and by making the plan and the participants whole. If the value of TRASOP securities transferred to the TRASOP is less than the amount of the additional credit, the corporation must make up any resulting funding deficiency within the correction period. This is done, for example, by contributing additional TRASOP securities plus an amount equal to the dividends or interest that would have been paid between the time that the TRASOP securities should have been transferred and the actual time for the transfer. The contribution of additional TRASOP securities is based on their value under paragraph (b)(7) of this section as of the date by which they were required to be transferred to the plan. An electing corporation fails to meet an obligation undertaken under this section if, for example, it fails to comply with paragraph (c)(8) of this section.

(6) *Correction period*—(i) *In general.* For purposes of this paragraph (h), the ''correction period'' begins when the failure to comply occurs and ends 90 days after receipt by the corporation of a notice of deficiency under section 6212 with respect to the civil penalty and the investment credit.

(ii) *Extensions of correction period.* Extensions of the correction period are determined under § 53.4941(e)–1(d)(2) (i), (ii), and (iv) of this chapter (Foundation Excise Tax Regulations). For this purpose, a failure to comply is treated as an act of self-dealing, the corporation is treated as a foundation, and a civil penalty is treated as a tax under section 4941(a)(1).

(7) *Good faith.* The corporation has the burden of establishing under paragraph (h)(3)(ii) of this section that it made a good faith effort to comply. For example, if a corporation shows that it has made a good faith effort to establish the fair market value of the employer securities transferred to the TRASOP, it may be entitled to the additional credit even if, on later examination of the return, it is determined that more securities should have been transferred. For purposes of this paragraph (h)(7), reasonable reliance on Technical Information Release 1413 (1975–50 I.R.B. 16), questions and answers relating to ESOP's, is a good faith effort to comply.

(8) *Amount involved*—(i) *In general.* The amount involved in a failure to comply is an amount described in this subparagraph (8). A maximum amount and a minimum amount are determined with respect to an additional credit allowed for a particular taxable year.

(ii) *Maximum amount involved.* Notwithstanding any other rule in this paragraph (h), all amounts involved with respect to an additional credit allowed for a particular taxable year may not exceed the amount of that credit.

(iii) *Minimum amount involved.* The minimum amount is ½ of one percent of the additional credit times the number of full months, or parts of full months, during which the failure to comply exists. ''Full month'' has the meaning assigned in § 1.1250–1(d)(4) (realty depreciation recapture).

(iv) *Funding amount involved.* The amount involved for a funding defect is the greater of the minimum amount involved or the amount required to place the plan in the position it would have been in if no funding defect had occurred.

(v) *Special operational amount involved.* The amount involved for a special operational defect is the maximum amount involved.

(vi) *De minimis amount involved.* The amount involved for a de minimis defect is the minimum amount involved.

(9) *Certain permissible actions*—(i) *Elections prior to January 19, 1979.* A corporation does not fail to comply (within the meaning of this paragraph (h)) merely because it revokes an election made prior to January 19, 1979, under the general rule described in paragraph (c)(1)(i) of this section and with respect to which no additional credit was claimed in the taxable year for which the election was made. Such a revocation is permitted irrespective of whether the carryover option described in paragraph (c)(1)(ii) is elected with respect to qualified investment made in a year for which a general rule election is revoked.

(ii) *Pro rata use of credit.* A corporation does not fail to comply merely because, for an applicable year ending prior to January 19, 1979, it provides for pro rata use of the regular 10-percent credit and the 1-percent additional credit to the extent that less than all of a taxpayer's credit earned for a taxable year is allowable.

(iii) *Transitional rule.* The Commissioner, based on the particular facts and circumstances of individual cases, may determine that a good faith failure to comply before January 19, 1979, with a final or temporary rule adopted under this section on or after that date does not require retroactive correction under paragraph (h)(5)(ii) of this section.

(Sec. 301(d)(2)(C) of the Tax Reduction Act of 1975; sec. 7805 of the Internal Revenue Code of 1954 (89 Stat. 38, 68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7857, 47 FR 54795, Dec. 6, 1982]

§1.46–9 Requirements for taxpayers electing an extra one-half percent additional investment credit.

(a) *Introduction*—(1) *In general.* A corporation that qualifies for an additional credit under §1.46–8 may elect under section 46(a)(2)(B)(ii) of the Code to obtain an extra one-half percent additional investment credit for property described in section 46(a)(2)(D). Paragraph (c) of this section provides additional procedures for electing this extra credit. This section also provides rules for implementing an employee stock ownership plan that meets the requirements of sections 301 (d) and (e) of the Tax Reduction Act of 1975 (''1975 TRA''). The plan must meet the additional formal requirements of paragraph (d), and the additional operational requirements of paragraph (e) of this section. Unless otherwise indicated, statutory references in this section are to the Internal Revenue Code of 1954, as applicable for the year in which a qualified investment is made.

(2) *Applicability of one-percent TRASOP provisions.* Subject to the exceptions and additional rules of this section, the provisions of §1.46–8 apply to an election made, and to a plan implemented, under this section. However, this section does not change the requirements of §1.46–8 for purposes of obtaining an additional one-percent credit.

(3) *Effective date.* This section applies only to taxable years beginning after December 31, 1976. See section 803(j)(2)(A) of the Tax Reform Act of 1976.

(b) *Definitions*—(1) *One-percent terms.* When used in this section, the terms listed below have the same meanings as in §1.46–8(b):

(i) TRASOP. See §1.46–8(b)(1).

(ii) Employer. See §1.46–8(b)(3).

(iii) Employer securities. See §1.46–8(b)(4).

(iv) TRASOP securities. See §1.46–8(b)(5).

(v) Publicly traded. See §1.46–8(b)(6).

(vi) Value. See §1.46–8(b)(7).

(vii) Compensation. See §1.46–8(b)(8).

(2) *Additional credit.* An ''additional credit'' or ''extra additional credit'' is the extra one-half percent additional investment credit under section 46(a)(2)(B)(ii)—

(i) For purposes of applying this section, and

(ii) When the context requires, for purposes of applying §1.46–8 to this extra credit.

(3) *Matching employee contribution.* A ‘‘matching employee contribution’’ is a contribution that meets the requirements of paragraph (f) of this section.

(4) *Basic amount.* A ‘‘basic amount’’ is a matching employee contribution which is equal to the maximum credit multiplied by a fraction. The numerator of this fraction is a participant's compensation for the plan year. (See § 1.46–9(f)(3)(ii), concerning disregarded compensation.) The denominator is the aggregate of all participants' compensation for the plan year. The ‘‘maximum credit’’ is the estimated value of all employer contributions under paragraph (c)(4)(i) of this section for the applicable year, determined as if the maximum possible matching employee contributions were made.

(5) *Supplemental contribution.* A ‘‘supplemental contribution’’ is a matching employee contribution made in addition to a basic amount.

(c) *Special procedures for extra additional credit*—(1) *Statement of election.* A corporation's statement of election described in § 1.46–8(c)(3) must contain the name and taxpayer identification number of the corporation. Also, it must declare in the following words, or in words having substantially the same meaning, that:

(i) The corporation elects to have section 46(a)(2)(B) (i) and (ii) of the Internal Revenue Code of 1954 apply; and

(ii) The corporation agrees to implement (or continue to implement, as appropriate) a TRASOP and to claim the additional credit as required by § 1.46–8 and § 1.46–9 of the Income Tax Regulations.

(2) *Separate election.* A separate election must be made for each year's qualified investment to obtain the extra additional credit for the qualified investment. If a corporation does not make a timely election to obtain an extra additional credit for a taxable year, it may not subsequently make the election on an amended return or otherwise.

(3) *No partial election.* To reduce administrative costs, a plan may establish a ceiling on matching employee contributions. Thus, for example, it may provide for the contribution of only a basic amount without supplemental contributions under paragraph (f)(2)(iv) of this section. Such a ceiling that in effect limits the additional credit to less than one-half percent of the qualified investment is not a partial election prohibited by § 1.46–8(c)(5).

(4) *Funding a TRASOP*—(i) *Employer contributions.* The carryover option under § 1.46–8(c)(1)(ii) is available for both the one-percent and one-half percent additional credits or for the one-half percent additional credit alone. In applying § 1.46–8(c)(8)(iii), the value of TRASOP securities, other than those acquired with matching employee contributions, for an applicable year must equal one-half percent of the corporation's qualified investment for that year or, if less, the amount of matching employee contributions received (including pledges, where permitted by the plan) by the time the election for that year is made. However, if a corporation exercises the carryover option in § 1.46–8(c)(1)(ii), the value of these TRASOP securities for an applicable year must equal the amount of additional credit claimed for that year determined after being reduced, if necessary, to equal contributions received (including pledges, if permitted) by the time the credit is claimed for that year. The value of these TRASOP securities, but not the amount of credit claimed, is further reduced to the extent that the employer withholds TRASOP securities to take into account start-up and administrative expenses under paragraph (e)(1) of this section or an investment tax credit reduction under paragraph (e)(2) of this section.

(ii) *Employee contributions.* Paragraph (f)(4) of this section, but not § 1.46–8(c)(8) (i) through (iii), applies to TRASOP securities acquired with matching employee contributions.

(5) *Claiming additional credit.* In applying § 1.46–8(c)(9)(ii), if less than all of a corporation's credit earned for a taxable year is allowed, the extra additional credit under this section for that year is allowed last.

(d) *Additional formal plan requirements*—(1) *Contributions by employees*—(i) *In general.* The plan must contain statements relating to matching employee contributions as required under paragraph (f) of this section.

(ii) *Aggregate floor.* A plan may provide for the return of all matching employee contributions for a year if the aggregate amount of such contributions is not at least equal to an amount stated in the plan. See also §1.46–9(f)(3)(iv).

(2) *Separate accounting.* The plan must state that employer contributions and matching employee contributions respectively described in paragraph (c)(4)(i) and (ii) of this section are accounted for separately from each other as well as from other contributions, including those described in §1.46–8(c)(8).

(3) *Allocation of TRASOP securities contributed by employer.* The plan must provide for the allocation under section 301(e)(5) of the 1975 TRA and this subparagraph (3) of TRASOP securities contributed by the employer. These allocations reflect a ratable reduction for TRASOP securities withheld by the employer under paragraph (c)(4)(i) of this section. TRASOP securities so allocated are deemed to be allocated under section 301(d) of the 1975 TRA. In applying §1.46–8(d)(6) to this section, only subdivisions (ii), (iv), (ix), (x), (xi) and (xii) thereof apply to allocations under this section.

(4) *Effect of section 415.* In applying the limitations of section 415 to limitation years beginning after January 19, 1979, allocations of TRASOP securities are considered in the following order: first, allocations under §1.46–8; second, allocations under this section. See §1.46–8(d)(6)(v) concerning the allocation of amounts under any other defined contribution plan. No suspense or escrow account may be maintained to hold contributions under this section that are unallocated because of section 415. Thus, section 415 in effect limits the availability of an extra additional credit in a particular year. However, if the plan so provides, a potential extra additional credit is treated as an investment credit carryover under the carryover option described in §1.46–8(c)(1)(ii) to the extent that it is not used in a particular year because of section 415.

(5) *Nonforfeitability.* Employer contributions are also not considered to be forfeitable under §1.46–8(d)(7) merely because the plan provides for their return to the corporation in an amount equal to the excess of employer contributions under this section over matching employee contributions or in the case of discriminatory operation under paragraph (f)(3) of this section. See paragraph (f)(3)(iv).

(6) *Distributions.* Notwithstanding §1.46–8(d)(9)(i), a plan may not distribute from a participant's employer contribution account cash or employer securities attributable to unpaid pledges of the participant.

(e) *Additional operational plan requirements*—(1) *Start-up and administrative expenses*—(i) *In general.* The expense of establishing plan features relating to the extra additional credit is a start-up expense. The expense of collecting matching employee contributions is an administrative expense.

(ii) *Payment.* Under §1.46–8(e) (6) and (7), an employee may withhold or a plan may use, to the extent not withheld, TRASOP securities for start-up and administrative expense payments. However, withdrawals must be either limited to employer contributions under §1.46–8(c)(8) or reasonably apportioned between these employer contributions and contributions under paragraph (c)(4)(i) of this section. An example of reasonable apportionment is earmarking expenses attributable to each of the additional credits and allocating any remaining non-earmarked expenses on either a 2:1 or 1:1 ratio between the additional credits. Another example is simply apportioning expenses between the additional credits on a 2:1 or 1:1 ratio basis without earmarking. However, if one-percent and one-half percent start-up expenses are attributable to different qualified investments, withdrawals for one-half percent expenses are limited to employer contributions under paragraph (c)(4)(i) of this section.

(iii) *Ceiling.* In determining the ceiling on start-up expenses under §1.46–8(e)(6)(iii), only employer contributions under §1.46–8(c)(8) and paragraph (c)(4)(i) of this section are considered. In determining the ceiling on administrative expenses under §1.46–8(e)(7)(ii), dividends on all TRASOP securities, including those acquired with matching employee contributions, are considered.

(2) *Redeterminations and recaptures.* A reduction in investment credit because of a redetermination or recapture is allocated ratably under the principles of §1.46–8(e)(9)(ii) among the 10-percent credit, the one-percent credit, and the one-half percent credit for a particular year. However, as illustrated in §1.46–8(e)(9)(ii), this subparagraph (3) does not apply to a redetermination solely of one or both of the additional credits.

(3)*Withdrawal asset segregation.* The segregated accounting provisions of §1.46–8(f) apply independently to withdrawal assets attributable to TRASOP securities under §1.46–8 and to TRASOP securities under this section.

(f) *Matching employee contributions*—(1) *Designation by employee.* The plan must state that each employee on whose behalf an allocation is made under §1.46–8(d)(6) for an applicable year is eligible to designate and contribute an amount to the TRASOP for that year as a matching employee contribution.

(2) *Form and timing of contribution*—(i) *Cash.* A participant may contribute in a manner provide under the plan a designated amount in cash directly to the plan or indirectly by the employer's withholding from amounts otherwise due the participant. The full amount, or pledge in lieu of an amount, for an applicable year must be contributed by the applicable last day described in §1.46–8(c)(8)(i).

(ii) *Optional pledges in lieu of cash.* The plan need not permit a pledge. However, when permitted by the plan, an irrevocable written pledge made in good faith by a participant is treated as a matching employee contribution of cash, whether or not the pledge is in fact contractually binding. The pledge must be to contribute, by no later than a time specified in the TRASOP, a designated amount in cash directly to the plan or indirectly by authorizing the employer to withhold from compensation otherwise due a participant. The specified time may not be later than 24 months after the close of the applicable year for which the amount is treated as a matching employee contribution.

(iii) *Transitional rule.* A plan may provide for the receipt of employee pledges at any time before the later of the applicable last day or January 15, 1980. If the last day for receipt of pledges for an applicable year is January 15, 1980, the one-half percent TRASOP credit for the applicable year may be elected on an amended return filed not later than that date, and employer contributions for the applicable year must be made by that date. A plan may provide that pledges which otherwise would have been payable on or before December 31, 1979 may be paid on or before January 15, 1980.

(iv) *Basic and supplemental contributions.* A plan formula may limit a matching employee contribution to a basic amount. It may also permit matching employee contributions of supplemental amounts to the extent that total basic amount contributions do not equal the amount of the additional credit claimed under this section. Employees may make supplemental contributions covering unpaid pledges only after the employer has disclosed the value of securities and income attributable to the unpaid pledge.

(3) *Prohibited discrimination*—(i) *General rule.* Matching employee contributions must be based on a formula stated in the plan that does not result in prohibited discrimination under section 401(a)(4) either in form or in operation. Thus, for example, a flat dollar amount required as a matching employee contribution to qualify for employer-provided benefits under this section may not be too high for lower paid employees to contribute under the plan. Further, lower paid employees must participate to such an extent that allocations under this section do not result in prohibited discrimination

(ii) *Compensation disregarded.* Compensation disregarded in allocations under §1.46–8(d)(6)(iv) is disregarded under this paragraph and for purposes of determining basic amounts as defined in paragraph (b)(4) of this section.

(iii) *Former employees.* A TRASOP must give all participants a reasonable opportunity to make matching employee contributions. However, neither a former employee who is a participant at the end of the plan year by reason of §1.46–8(d)(6)(iii), nor the estate of a deceased employee, need have the same options as are available to other participants. Thus, for example, a former employee may be limited to cash contributions even though other participants are permitted to make pledges. Also, if former employees of estates of deceased employees fail to make matching employee contributions, they are not considered in determining whether or not a TRASOP is discriminatory.

(iv) *Return of contributions.* A plan may provide for the return of employee and employer contributions for a year to the extent that plan operation would otherwise result in prohibited discrimination.

(4) *Investment in employer securities*—(i) *General rule.* Matching employee contributions must be invested in TRASOP securities no later than 30 days after the time for funding a TRASOP under §1.46–8(c)(8)(ii) or, if later, the time specified under the special rule for pledges.

(ii) *Special rule for pledges.* Cash contributed to pay a pledge permitted by paragraph (f)(2)(ii) of this section must be invested in employer securites so that the cash is not held more than 3 months. The 3-month period includes the period, if any, that the cash is held by the employer.

(5) *Reduction of matching employee contribution*—(i) *In general.* Matching employee contributions must be reduced in three cases. First, they are reduced to the extent that there are no corresponding employer contributions described in paragraph (c)(4)(i) of this section. This occurs, for example, when the aggregate of the basic amounts of matching employee contributions exceeds the allowable credit. Second, they are reduced to the extent that corresponding employer contributions matching them under paragraph (c)(4)(i) of this section are withdrawn under section 301(f) of the 1975 TRA. Third, they are reduced by the amount of any pledge unpaid at the time specified in paragraph (f)(2)(ii) of this section.

(ii) *Apportioning reductions.* Generally, the account of each contributor under this section for an applicable year is reduced by a percentage of the account. This percentage equals the total reduction of all matching employee contributions for that year divided by the total, before the reduction, of all matching employee contributions. However, if a reduction is directly attributable to a particular contributor, only that contributor's account is reduced. A reduction is directly attributable to a particular contributor when, for example, the limits of section 415 prohibit a full allocation of employer contributions equal to the contributor's matching employee contribution for an applicable year or when a contributor fails to pay a pledge. A reduction may not yield a negative balance in a participant's account.

(iii) *Disposing of reductions.* If a participant's matching employee contribution is reduced, the amount of the reduction must either be treated as a voluntary contribution or returned to the participant by the later of two dates. The first date is 30 days after the time for investing in TRASOP securities under paragraph (f)(4) of this section. The second date is the 30th day after the date on which the withdrawal of employer contributions occurs that causes the reduction. It may be treated as a voluntary contribution only if, as stated in the plan, the participant so indicates in writing when making the matching employee contribution.

(iv) *Supplemental contributions covering unpaid pledges.* Notwithstanding the timing requirements of paragraph (f)(2) of this section, supplemental contributions covering unpaid pledges must be made no later than 60 days after accounting for the corresponding reduction under paragraph (f)(5)(ii) of this section.

(v) *Effect of reduction on credit.* For the purpose of applying section 415 to an additional allocation to the account of a participant attributable to a supplemental contribution covering an unpaid pledge, the contribution is treated as an annual addition to the supplemental contributor's account in the applicable year for which the reduction occurred. An amount in excess of the contribution may be allocated in equal amounts for each year from the applicable year to the year of the reduction. The employer's credit is reduced only to the extent that a proportionate transfer of assets is not made from the account of the participant to whom the reduction is attributable to the accounts of supplemental contributors.

(vi) *Example.* The rules contained in paragraphs (f) (2) and (5) of this section are illustrated by the following example:

Example. Assume that A is an employee of corporation M, a calendar year taxpayer that maintains a TRASOP. A has pledged $100 as a matching employee contribution for 1977, the first applicable year of M's TRASOP. M has transferred employer securitites valued at $100 that have been allocated to A's account under the Plan. The TRASOP provides that pledges must be paid no later then 24 months after the end of the applicable year. Thus, A's $100 pledge must be paid by December 31, 1979. As of December 31, 1979, the employer securities attributable to A's pledge have a value of $90 and have produced undistributed dividend income of $13. Thus, the value of the portion of A's account attributable to the unpaid pledge is $103. After December 31, 1979, the value of this portion of A's account is disclosed to participants, and employee B chooses to pay off A's unpaid pledge, as provided in the plan, by making a $100 supplemental contribution. The full amount of the securities and dividend income attributable to the unpaid pledge are transferred from A's account to that of B as of December 31, 1979. M's credit for 1977 is not reduced. The $100 supplemental contribution is an annual addition to B's account for purposes of applying section 415 in 1979. Income attributable to the pledge in excess of the supplemental contribution, $3 ($103–$100), may be allocated and treated as an annual addition by spreading this excess amount over the years from the applicable year to the year of the reduction (1977, 1978, 1979).

(g) *Failure to comply*—(1) *General rule.* If a corporation elects under § 1.46–8(c) (2) through (5) and paragraph (c)(1) of this section to obtain an additional credit, § 1.46–8(h) (1), (2), (3), (5), (6), and (7) as modified by this paragraph (g) apply.

(2) *Failure to comply (penalty classifications)*—(i) *In general.* A corporation fails to comply with an extra additional credit election if a defect described in paragraph (g)(2) (ii)–(iv) of this section occurs in a taxable year.

(ii) *Funding defect.* A funding defect occurs under this section if a corporation or its TRASOP fails to satisfy the requirements of § 1.46–8(c) (8) or (9) or paragraph (c)(4) of this section, as they apply directly to the extra additional credit.

(iii) *Special operational defect.* A special operational defect occurs if a TRASOP fails in operation to satisfy the requirements decribed in § 1.46–8(d) (5) through (9) (except (6) (i), (iii), and (v) through (viii)) or (e)(3), or paragraphs (d) (5), (6), and (e)(3) of this section, as they apply directly to the extra additional credit.

(iv) *De minimis defect.* A *de minimis* defect occurs if a corporation or its TRASOP fails to satisfy the requirements, other than those enumerated in paragraphs (c) (1) and (2) and (g)(2) (ii) and (iii), of this section or of § 1.46–8 other than those excluded under § 1.46–8(h)(4)(iv).

(3) *Amount involved.* The amount involved in a failure to comply under this section is based upon the extra additional credit within the meaning of section 46(a)(2)(B)(ii).

(4) *Coordination of civil penalties.* The civil penalties under § 1.46–8 and this section are determined separately. In no case may the amount involved with respect to a particular failure to comply in one year exceed under both sections the full additional credit within the meaning of section 46(a)(2)(B) (i) and (ii).

[T.D. 7856, 47 FR 54805, Dec. 6, 1982]

§ 1.46–10 [Reserved]

§ 1.46–11 Commuter highway vehicles.

(a) *In general.* Section 46(c)(6) provides that the applicable percentage to determine qualified investment under section 46(c)(1) for a qualifying commuter highway vehicle is 100 percent. A qualifying commuter highway vehicle is a vehicle (defined in paragraph (b) of this section)—

(1) Which is acquired by the taxpayer on or after November 9, 1978,

(2) Which is placed in service by the taxpayer before January 1, 1986, and

(3) With respect to which the taxpayer makes an election under paragraph (g) of this section.

(b) *Definition of commuter highway vehicle.* A commuter highway vehicle is a highway vehicle that meets the following requirements:

(1) The vehicle is section 38 property in the hands of the taxpayer. The rule of section 48(d), allowing a lessor to elect to treat the lessee of new section

38 property as having acquired the property, applies to commuter highway vehicles. If the vehicle is leased and that

election is made, the lessee is treated as the taxpayer under this section. However, if that election is not made. the lessor, and not the lessee, is treated as the taxpayer under this section.

(2) The vehicle must meet the seating capacity requirement of paragraph (c) of this section; and

(3) The taxpayer reasonably expects to meet the commuter use requirement of paragraph (d) of this section for at least the first 36 months after the vehicle is placed in service.

(c) *Seating capacity.* A commuter highway vehicle must have a seating capacity of a least 8 adults in addition to the driver's seat.

(d) *Commuter use requirement.* A vehicle meets the commuter use requirement only if at least 80 percent of the miles the vehicle is driven are for trips to transport the taxpayer's employees between their residences and their places of employment. A trip for this purpose includes driving the vehicle before or after employees are in the vehicle, so long as the mileage driven is necessary either to pick up or drop off passengers or to park the vehicle in its regular parking space. A trip does not include miles driven solely for maintenance or to refuel the vehicle. A trip is not considered to transport the taxpayer's employees between their residences and their places of employment unless at least one-half the seating capacity (defined in paragraph (c) of this section) is used to seat employees of the taxpayer. In no event is the driver counted as an employee of the taxpayer.

(e) *Definition of employee.* An employee in this section is the same as in section 3121 (d) (definition of employee for withholding purposes).

(f) *Transportation between employee's residence and place of employment.* An employee is transported between that employee's residence and place of employment even if that place of employment is not the same as any of the other employees transported, and even if picked up or dropped off at some central point between that residence and place of employment. An employee is not transported between that employee's residence and place of employment if the transportation is of the type for which a deduction would be allowed under §1.162–2 were the employee providing it, such as the transportation from one work site to another after beginning work for the day.

(g) *Election.* A taxpayer must elect to have the vehicle treated as a qualifying commuter highway vehicle on the return for the taxable year in which the vehicle is placed in service. The election may be made only if the vehicle actually meets the commuter use requirement under paragraph (d) of this section for that taxable year. It must be made on or before the due date (including extensions) of that return. The election is effective as of that due date.

[T.D. 8035, 50 FR 29370, July 19, 1985]

§1.47–1 Recomputation of credit allowed by section 38.

(a) *General rule*—(1) *In general.* (i) If during the taxable year any section 38 property the basis (or cost) of which was taken into account, under paragraph (a) of §1.46–3, in computing the taxpayer's qualified investment is disposed of, or otherwise ceases to be section 38 property or becomes public utility property (as defined in paragraph (g) of §1.46–3) or is a qualifying commuter highway vehicle (as defined in paragraph (a) of §1.46–11) which undergoes a change in use (as defined in paragraph (m)(2) of this section) with respect to the taxpayer, before the close of the estimated useful life (as determined under subparagraph (2)(i) of this paragraph) which was taken into account in computing such qualified investment, then the credit earned for the credit year (as defined in subdivision (ii) *(a)* of this subparagraph) shall be recomputed under the principles of paragraph (a) of §1.46–1 and paragraph (a) of §1.46–3 substituting, in lieu of the estimated useful life of the property that was taken into account originally in computing qualified investment, the actual useful life of the property as determined under subparagraph (2)(ii) of this paragraph. There shall also be recomputed under the principles of §§1.46–1 and 1.46–2 the credit allowed for the credit year and for any other taxable year affected by reason of the reduction in credit earned for the credit year, giving effect to such reduction in the computation of carryovers or carrybacks of unused credit. If the recomputation described in the preceding sentence results in the aggregate in a decrease (taking into account any recomputations under this paragraph in respect of prior recapture years, as defined in subdivision (ii)*(b)* of this subparagraph) in the credits allowed for the credit year and for any other taxable year affected by the reduction in credit earned for the credit year, then the income tax for the recapture year shall be increased by the amount of such decrease in credits allowed. For treatment of such increase in tax, see paragraph (b) of this section. For rules relating to ''disposition'' and ''cessation'', see § 1.47–2. For rules relating to certain exceptions to the application of this section, see § 1.47–3. For special rules in the case of an electing small business corporation (as defined in section 1371(b)), an estate or trust, or a partnership, see respectively, §§ 1.47–4, 1.47–5, or 1.47–6. For rules applicable to energy property, see paragraph (h) of this section. For special rules relating to recomputation of credit allowed by section 38 if progress expenditure property (as defined in § 1.46–5(d)) ceases to be progress expenditure property with respect to the taxpayer, see paragraph (g) of this section.

(ii) For purposes of this section and §§ 1.47–2 through 1.47–6—

(a) The term ''credit year'' means the taxable year in which section 38 property was taken into account in computing a taxpayer's qualified investment.

(b) The term ''recapture year'' means the taxable year in which section 38 property the basis (or cost) of which was taken into account in computing a taxpayer's qualified investment is disposed of, or otherwise ceases to be section 38 property or becomes public utility property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing such qualified investment.

(c) The term ''recapture determination'' means a recomputation made under this paragraph.

(2) *Rules for applying subparagraph (1).* For purposes of subparagraph (1) of this paragraph—

(i) In determining whether section 38 property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing the taxpayer's qualified investment, the term ''estimated useful life'' means the shortest life of the useful life category within which falls the estimated useful life which was assigned to such property under paragraph (e) of § 1.46–3. Thus, section 38 property which is assigned, under paragraph (e) of § 1.46–3, an estimated useful life of 6 years shall not be treated, for purposes of subparagraph (1) of this paragraph, as having been disposed of before the close of its estimated useful life if such property is sold 5 years (that is, the shortest life of the 5 years or more but less than 7 years useful life category) after the date on which it was placed in service. Likewise, section 38 property with an estimated useful life of 15 years which is placed in service on January 1, 1972, shall not be treated as having been disposed of before the close of its estimated useful life if such property is sold at any time after January 1, 1979 (that is, 7 years or more after the date on which it was placed in service).

(ii) In determining the recomputed qualified investment with respect to property which is disposed of or otherwise ceases to be section 38 property the term ''actual useful life'' means, except as otherwise provided in this section and §§ 1.47–2 through 1.47–6, the period beginning with the date on which the property was placed in service by the taxpayer and ending with the date of such disposition or cessation. See paragraph (c) of this section.

(iii) In determining the recomputed qualified investment with respect to property which ceases to be section 38 property with respect to the taxpayer after August 15, 1971, or which becomes public utility property after such date, such property shall be treated as if it were property described in section 50 at the time it was placed in service (whether or not it was property described in section 50 at such time).

Thus, if property was placed in service on October 15, 1968, and was assigned an estimated useful life of 4 years, there would be no increase in tax under section 47 if the property were disposed of at any time after October 14, 1971, that is, 3 years or more after the property was placed in service.

(b) *Increase in income tax and reduction of investment credit carryover*—(1) *Increase in tax.* Except as provided in subparagraph (2) of this paragraph, any increase in income tax under this section shall be treated as income tax imposed on the taxpayer by chapter 1 of the Code for the recapture year notwithstanding that without regard to such increase the taxpayer has no income tax liability, has a net operating loss for such taxable year, or no income tax return was otherwise required for such taxable year.

(2) *Special rule.* Any increase in income tax under this section shall not be treated as income tax imposed on the taxpayer by chapter 1 of the Code for purposes of determining the amount of the credits allowable to such taxpayer under—

(i) Section 33 (relating to taxes of foreign countries and possessions of United States),

(ii) Section 34 (relating to dividends received by individuals before January 1, 1965),

(iii) Section 35 (relating to partially tax-exempt interest received by individuals),

(iv) Section 37 (relating to retirement income), and

(v) Section 38 (relating to investment in certain depreciable property).

(3) *Reduction in credit allowed as a result of a net operating loss carryback.* (i) If a net operating loss carryback from the recapture year or from any taxable year subsequent to the recapture year reduces the amount allowed as a credit under section 38 for any taxable year up to and including the recapture year, then there shall be a new recapture determination under paragraph (a) of this section for each recapture year affected, taking into account the reduced amount of credit allowed after application of the net operating loss carryback.

(ii) Subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. (a) X Corporation, which makes its return on the basis of a calendar year, acquired and placed in service on January 1, 1962, an item of section 38 property with a basis of $10,000 and an estimated useful life of 8 years. The amount of qualified investment with respect to such asset was $10,000. For the taxable year 1962, X Corporation's credit earned of $700 (7 percent of $10,000) was allowed under section 38 as a credit against its liability for tax of $700. In 1963 and 1964 X Corporation had no liability for tax and placed in service no section 38 property. On January 3, 1963, such item of section 38 property was sold to Y Corporation. Since the actual useful life of such item was only 1 year, there was a recapture determination under paragraph (a) of this section. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1963 was increased by the $700 decrease in its credit earned for the taxable year 1962 (that is, the $700 original credit earned minus zero recomputed credit earned).

(b) For the taxable year 1965, X Corporation has a net operating loss which is carried back to the taxable year 1962 and reduces its liability for tax, as defined in paragraph (c) of §1.46–1, for such taxable year to $200. As a result of such net operating loss carryback, X Corporation's credit allowed under section 38 for the taxable year 1962 is limited to $200 and the excess of $500 ($700 credit earned minus $200 limitation based on amount of tax) is an investment credit carryover to the taxable year 1963.

(c) For 1965, there is a recapture determination under subdivision (i) of this subparagraph for the 1963 recapture year. The $700 increase in the income tax imposed on X Corporation for the taxable year 1963 is redetermined to be $200 (that is, the $200 credit allowed after taking into account the 1965 net operating loss minus zero credit which would have been allowed taking into account the 1963 recapture determination). In addition, X Corporation's $500 investment credit carryover to the taxable year 1963 is reduced by $500 ($700 minus $200) to zero and X Corporation is entitled to a $500 refund of the tax paid as a result of the 1963 determination.

Example 2. (a) X Corporation, which makes its returns on the basis of a calendar year, acquired and placed in service on January 1, 1962, an item of section 38 property with a basis of $10,000 and an estimated useful life of 8 years. The amount of qualified investment with respect to such asset was $10,000. For the taxable year 1962, X Corporation's credit earned of $700 (7 percent of $10,000) was allowed under section 38 as a credit against its liability for tax of $700. In 1963 and in 1964 X Corporation had no liability for tax and placed in service no section 38 property. On January 3, 1965, such item of section 38 property is sold to Y Corporation. For the taxable year 1965, X Corporation has a net operating loss which is carried back to the taxable year 1962 and reduces its liability for tax, as defined in paragraph (c) of § 1.46–1, for such taxable year to $100.

(b) As a result of such net operating loss carryback, X Corporation's credit allowed under section 38 for the taxable year 1962 is limited to $100 and the excess of $600 ($700 credit earned minus $100 limitation based on amount of tax) is an investment credit carryover to the taxable year 1963.

(c) Since the actual useful life of the item of section 38 property sold to Y Corporation was only 3 years, there is a recapture determination under paragraph (a) of this section. X Corporation's $600 investment credit carryover to 1963 is reduced by $600 to zero. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1965 is increased by the $100 reduction in credit allowed by section 38 for 1962.

(4) *Statement of recomputation.* The taxpayer shall attach to his income tax return for the recapture year a separate statement showing in detail the computation of the increase in income tax imposed on such taxpayer by chapter 1 of the Code and the reduction in any investment credit carryovers.

(c) *Date placed in service and date of disposition or cessation*—(1) *General rule.* For purposes of this section and §§ 1.47–2 through 1.47–6, in determining the actual useful life of section 38 property—

(i) Such property shall be treated as placed in service on the first day of the month in which such property is placed in service. The month in which property is placed in service shall be determined under the principles of paragraph (d) of § 1.46–3.

(ii) If during the taxable year such property ceases to be section 38 property with respect to the taxpayer—

(a) As a result of the occurrence of an event on a specific date (for example, a sale, transfer, retirement or other disposition), such cessation shall be treated as having occurred on the actual date of such event.

(b) For any reason other than the occurrence of an event on a specific date (for example, because such property is used predominantly in connection with the furnishing of lodging during such taxable year), such cessation shall be treated as having occurred on the first day of such taxable year.

(2) *Special rule.* Notwithstanding subparagraph (1) of this paragraph, if a taxpayer uses an averaging convention (see § 1.167(a)(10)) in computing depreciation with respect to section 38 property, then, for purposes of this section and §§ 1.47–2 through 1.47–6, he may use the assumed dates of additions and retirements in determining the actual useful life of such property provided such assumed dates are used consistently for purposes of subpart B of part IV of subchapter A of chapter 1 of the Code with respect to all section 38 property for which such convention is used for purposes of depreciation. This subparagraph shall not apply in any case fwhere from all the facts and circumstances it appears that the use of such assumed dates results in a substantial distortion of the investment credit allowed by section 38. Thus, for example, if the taxpayer computes depreciation under a convention under which the average of the beginning and ending balances of the asset account for the taxable year are taken into account, he may use July 1 as the assumed date of all additions and retirements to such account. Similarly, if the taxpayer computes depreciation under a convention under which the average of the beginning and ending balances of the asset account for each month is taken into account, he may use the date determined by reference to the weighted average of the monthly averages as the assumed date of all additions and retirements to such account.

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

Example. Assume that section 38 property is placed in service (within the meaning of paragraph (d) of § 1.46–3) on December 1, 1965 (thus, the credit is treated as being earned in 1965) but under the taxpayer's depreciation practice the period for depreciation with respect to such property begins on January 1, 1966, and that the property is actually retired on December 2, 1970. Under the general rule of subparagraph (1) of this paragraph, the property is treated as placed in service on December 1, 1965, and as ceasing to be section 38 property with respect to the taxpayer on December 2, 1970, even though under the taxpayer's depreciation practice the period for depreciation with respect to such property begins on January 1, 1966, and terminates on January 1, 1971. However, under the special rule of subparagraph (2) of this paragraph the taxpayer may determine the actual useful life of the property by reference to the assumed dates of January 1, 1966, and January 1, 1971.

(d) *Examples.* Paragraphs (a) through (c) of this section may be illustrated by the following examples:

Example 1. (i) X Corporation, which makes its returns on the basis of the calendar year, acquired and placed in service on January 1, 1962, three items of section 38 property each with a basis of $12,000 and an estimated useful life of 15 years. The amount of qualified investment with respect to each such asset was $12,000. For the taxable year 1962, X Corporation's credit earned of $2,520 was allowed under section 38 as a credit against its liability for tax of $4,000. On December 2, 1965, one of the items of section 38 property is sold to Y Corporation.

(ii) The actual useful life of the item of property which is sold on December 2, 1965, is three years and eleven months. The recomputed qualified investment with respect to such item of property is zero ($12,000 basis multiplied by zero applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $1,680 (7 percent of $24,000). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1965 is increased by the $840 decrease in its credit earned for the taxable year 1962 (that is, $2,520 original credit earned minus $1,680 recomputed credit earned).

Example 2. (i) The facts are the same as in example 1 and in addition on December 2, 1966, a second item of section 38 property placed in service in the taxable year 1962 is sold to Y Corporation.

(ii) The actual useful life of the item of property which is sold on December 2, 1966, is four years and eleven months. The recomputed qualified investment with respect to such item of property is $4,000 ($12,000 basis multiplied by 33⅓ percent applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $1,120 (7 percent of $16,000). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1966 is increased by $560 (that is, $1,400 ($2,520 original credit earned minus $1,120 recomputed credit earned) reduced by the $840 increase in tax for 1965).

Example 3. (i) The facts are the same as in example 1 except that for the taxable year 1962 X Corporation's liability for tax under section 46(a)(3) is only $1,520. Therefore, for such taxable year X Corporation's credit allowed under section 38 is limited to $1,520 and the excess of $1,000 ($2,520 credit earned minus $1,520 limitation based on amount of tax) is an unused credit. Of such $1,000 unused credit, $100 is allowed as a credit under section 38 for the taxable year 1963, $100 is allowed for 1964, and $800 is carried to the taxable year 1965.

(ii) The actual useful life of the item of property which is sold on December 2, 1965, is three years and eleven months. The recomputed qualified investment with respect to such item of property is zero ($12,000 basis multiplied by zero applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $1,680 (7 percent of $24,000). If such $1,680 recomputed credit earned had been taken into account in place of the $2,520 original credit earned, X's credit allowed for 1962 would have been $1,520, and of the $160 unused credit from 1962 $100 would have been allowed as a credit under section 38 for 1963, and $60 would have been allowed for 1964. X Corporation's $800 investment credit carryover to the taxable year 1965 is reduced by $800 to zero. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1965 is increased by $40 (that is, the aggregate reduction in the credits allowed by section 38 for 1962, 1963, and 1964).

Example 4. (i) X Corporation, which makes its returns on the basis of the calendar year, acquired and placed in service on November 1, 1962, an item of section 38 property with a basis of $12,000 and an estimated useful life of 10 years. The amount of qualified investment with respect to such property was $12,000. For the taxable year 1962, X Corporation's credit earned of $840 was allowed under section 38 as a credit against its liability for tax of $840. For each of the taxable years 1963 and 1964 X Corporation's liability for tax was zero and its credit earned was $400; therefore, for each of such years its unused credit was $400. For the taxable year 1965 its liability for tax was $200 and its credit earned was zero; therefore, $200 of the $400 unused credit from 1963 was allowed as credit for 1965 and $600 ($200 from 1963 and $400 from 1964) is an investment credit carryover to 1966. On February 2, 1966, such item of section 38 property is sold to Y Corporation.

(ii) The actual useful life of such item of property is three years and three months. The recomputed qualified investment with respect to such property is zero ($12,000 basis multipled by zero) and X Corporation's recomputed credit earned for the taxable year 1962 is zero. If such zero recomputed credit earned had been taken into account in place of the $840 original credit earned, the entire $400 unused credit from 1963 (including the $200 portion which was originally allowed as a credit for 1965) and the $400 unused credit from 1964 would have been allowed as investment credit carrybacks against X Corporation's liability for tax of $840 for 1962. (See § 1.46–2 for rules relating to the carryback of unused credits.)

(iii) Therefore, the $600 carryover from 1963 and 1964 to 1966 is eliminated and the income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1966 is increased by the $240 aggregate reduction in the credits allowed by section 38 for the taxable years 1962 and 1965 (that is, $1,040 credit allowed minus $800 which would have been allowed).

Example 5. (i) X Corporation, which makes its returns on the basis of the calendar year, acquired and placed in service on November 1, 1962, an item of section 38 property with a basis of $10,000 and an estimated useful life of 8 years. The amount of qualified investment with respect to such asset was $10,000. For the taxable year 1962, X Corporation's credit earned of $700 was allowed as a credit against its liability for tax. For each of the taxable years 1963, 1964, and 1965 X had no taxable income. On July 3, 1966, the item of section 38 property is sold to Y Corporation. For the taxable year 1966 X Corporation has a net operating loss of $3,000.

(ii) The actual useful life of the item of property is three years and eight months. The recomputed qualified investment with respect to such item of property is zero and X Corporation's recomputed credit earned for the taxable year 1962 is zero. Notwithstanding the $3,000 net operating loss for the taxable year 1966, the income tax imposed by chapter 1 of the Code on X Corporation for such year is $700 (that is, the decrease in its credit earned for the taxable year 1962).

(e) *Identification of property*—(1) *General rule*—(i) *Record requirements.* In general, the taxpayer must maintain records from which he can establish, with respect to each item of section 38 property, the following facts:

(a) The date the property is disposed of or otherwise ceases to be section 38 property,

(b) The estimated useful life which was assigned to the property under paragraph (e) of § 1.46–3,

(c) The month and the taxable year in which the property was placed in service, and

(d) The basis (or cost), actually or reasonably determined, of the property.

(ii) *Recapture determination.* For purposes of determining whether section 38 property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of its estimated useful life, and for purposes of determining recomputed qualified investment, the taxpayer must establish from his records the facts required by subdivision (i) of this subparagraph.

(iii) *Examples.* If the taxpayer fails to maintain records from which he can establish the facts required by subdivision (i) of this subparagraph, then this section shall be applied to the taxpayer in the manner indicated in the following examples:

Example 1. Corporation X, organized on January 1, 1964, files its income tax return on the basis of a calendar year. During the years 1964 and 1965, X places in service several items of machinery to which it assigns estimated useful lives of 8 years. X places the items of machinery in a composite account for purposes of computing depreciation. When X's 1966 return is being audited, X is unable to establish whether the items placed in service in 1964 and 1965 were still on hand at the end of 1966. Therefore, for purposes of paragraph (a) of this section, X is treated as having disposed of, in 1966, all of the items of machinery placed in service in 1964 and 1965.

Example 2. Corporation Y, organized on January 1, 1960, files its income tax return on the basis of a calendar year. During each of the years 1960 through 1965, Y places in service four items of machinery to each of which it assigns an estimated useful life of 8 years for depreciation purposes (and for purposes of computing qualified investment for relevant years). Y places the items of machinery in a composite account for purposes of computing depreciation (and for purposes of computing qualified investment for relevant years). When Y's 1965 return is being audited, Y can establish that it retired during 1965 only six items of this machinery. However, Y cannot establish the date on which these six items were placed in service, nor can Y establish that the items placed in service in 1963 or 1964 are still on hand as of the end of 1965. No previous recapture has taken place with respect to any of the items placed in service in 1963 or 1964. Assuming that paragraph (e) (2) and (3) of this section is not applicable, Y is treated, for purposes of paragraph (a) of this section, as having disposed of, in 1965, the four items placed in service in 1964, the most recent year before 1965 in which such property was placed in service, and two items from 1963, the next most recent year.

Example 3. The facts are the same as in example 2 except that when Y's 1966 return is being audited, Y can establish from its records that all four items placed in service in 1965 are still on hand and that only three items were retired in 1966. For purposes of paragraph (a) of this section, Y is treated as having disposed of, in 1966, the two remaining items of machinery placed in service in 1963, and one of the items placed in service in 1962.

(2) *Treatment of ''mass assets''.* (i) If, in the case of mass assets (as defined in subparagraph (4) of this paragraph), it is impracticable for the taxpayer to maintain records from which he can establish with respect to each item of section 38 property the facts required by subparagraph (1) of this paragraph, and if he adopts other reasonable recordkeeping practices, consonant with good accounting and engineering practices, and consistent with his prior recordkeeping practices, then he may substitute data from an appropriate mortality dispersion table. An appropriate mortality dispersion table must be based on an acceptable sampling of the taxpayer's actual experience or other acceptable statistical or engineering techniques. In lieu of such mortality dispersion table, the taxpayer may use a standard mortality dispersion table prescribed by the Commissioner. If the taxpayer uses such standard mortality dispersion table for any taxable year, it must be used for all subsequent taxable years unless the taxpayer obtains the consent of the Commissioner to change. If mass assets are placed in a multiple asset account and if the depreciation rate for such account is based on the maximum expected life of the longest lived asset in such account, in applying a mortality dispersion table (including a standard mortality dispersion table) the average expected useful life of the mass assets in such account must be used.

(ii) Subdivision (i) of this subparagraph shall not apply with respect to assets placed in service in a taxable year ending on or after June 30, 1967, and beginning before January 1, 1971, or with respect to assets placed in service for a taxable year beginning after December 31, 1970, for which the taxpayer has not made the election provided by section 167(m), unless the estimated useful lives which were assigned to such assets for purposes of determining qualified investment—

(a) Were separate lives based on the estimated range of years taken into account in establishing the average useful life of assets similar in kind under paragraph (e)(3)(ii)*(b)* of §1.46–3, and

(b) Were determined by use of a mortality dispersion table (including a standard mortality dispersion table).

(iii) Any standard mortality dispersion table prescribed by the Commissioner shall be based on average useful life categories and with respect to each category shall contain five columns, the first four of which shall state the percentage of property assumed to have a useful life of—

Column (1): Less than 4 years,
Column (2): 4 years or more but less than 6 years,
Column (3): 6 years or more but less than 8 years, and
Column (4): 8 years or more.

The fifth column shall show the total qualified investment as a percentage and shall be used in connection with the determination to be made under §1.46–3(e)(3)(iii). In the case of a table which is to apply to property which is described in section 50 or to property which is treated as property described in section 50 under paragraph (a)(2)(iii) of this section, this subdivision shall be applied by substituting ''3 years'' for ''4 years'', ''5 years'' for ''6 years'', and ''7 years'' for ''8 years''.

(iv) Whenever the standard mortality dispersion table is used for a taxable year under subdivision (i) of this subparagraph (whether or not such table was used in determining qualified investment), the percentage of property shown in column (1) of the table shall (for purposes of section 47, this section, and §§1.47–2 through 1.47–6) be deemed to have been disposed of on the day before the expiration of the 4-year period beginning on the date on which it was considered as placed in service under §1.47–1(c); the percentage of property shown in column (2) of the table shall be deemed to have been disposed of on the day before the expiration of the 6-year period beginning on the date on which it was so considered as placed in service; and the percentage of property shown in column (3) shall be deemed to have been disposed of on the day before the expiration of the 8-year period beginning on the date on which it was so considered as placed in service. In applying this subdivision for purposes of recomputing qualified investment, the proper average useful life category shall be used whether or not such category was used in determining qualified investment. In the case of property which is described in section 50 or property which is treated as property described in section 50 under paragraph (a)(2)(iii) of this section (other than property the qualified investment with respect to which was determined by use of the standard or an appropriate mortality dispersion table), this subdivision shall be applied by substituting ''3-year period'' for ''4-year period'', ''5-year period'' for ''6-year period'', and ''7-year period'' for ''8-year period''.

(v) In lieu of using subdivision (iv) of this subparagraph for purposes of recomputing qualified investment, a taxpayer may, for the first recapture year (as defined in paragraph (a)(1)(ii)*(b)* of this section) to which such subdivision (iv) would otherwise apply with respect to any mass asset account, recompute qualified investment on the basis of the difference between *(a)* the proper total qualified investment based on the percentage shown in column (5) of the table, and *(b)* the total qualified investment actually claimed by the taxpayer for the year in which the property was placed in service.

Example. Assume that the taxpayer places in service during 1963 mass assets costing him $100,000, that he places these assets in a multiple asset account for which he properly claims a useful life of 6 years and a qualified investment of $66,667 (⅔× $100,000), and that he is allowed an investment credit of $4,667.67. When the taxpayer's 1967 return is being audited he is unable to establish that any of the mass assets placed in service in 1963 were still on hand at the end of 1967.

The taxpayer elects to use the standard mortality dispersion table prescribed by the Commissioner to determine the amount of recapture with respect to these mass assets. Assume that the table prescribed by the Commissioner shows with respect to mass assets with an average useful life of 6 years the following:

Percent of property assumed to have a useful life of—				Total qualified investment (percent)
Less than 4 years	4 years or more, but less than 6 years	6 years or more, but less than 8 years	8 years or more	
(1)	(2)	(3)	(4)	(5)
15.87	34.13	34.13	15.87	50.00

(a) Under these circumstances 15.87 percent of the mass assets placed in service in 1963 are deemed to have been disposed of during 1967. With respect to these assets, the amount of qualified investment for 1963 was $10,580 ($15,870×⅔) and the amount of credit earned was $740.60 (7 percent of $10,580), whereas the recomputed qualified investment is zero and the recomputed credit earned is zero. Thus, the tax imposed by chapter 1 of the Code for 1967 is increased by $740.60.

(b) No recapture determination is required for 1968 since no assets are deemed to have been disposed of in that year. During 1969, 34.13 percent of the mass assets placed in service in 1963 are deemed to have been disposed of. With respect to these assets, the amount of qualified investment for 1963 was $22,753.34 ($34,130×⅔) and the amount of credit earned was $1,592.73 (7 percent of $22,753.34), whereas the recomputed qualified investment is $11,376.67 ($34,130×⅓) and the recomputed credit earned is $796.37 (7 percent of $11,376.67). Thus, the tax imposed by chapter 1 of the Code for 1969 is increased by $796.36 ($1,592.73 minus $796.37).

(c) If the taxpayer chooses to recompute qualified investment by using the method provided in subdivision (v) of this subparagraph, the increase in tax for 1967 (the first recapture year) would be $1,167.67, i.e., the original credit earned, $4,667.67, minus the recomputed credit earned, $3,500 (50 percent, the percentage shown in column (5), of $100,000 multiplied by 7 percent). As long as the same average useful life category reflects the taxpayer's experience for subsequent years, no recapture determination will be required for any future year, except as provided by subparagraph (3)(iv) of this paragraph.

(vi) Subdivision (i) of this subparagraph shall not apply with respect to section 38 property to which an election under section 167(m) applies unless the taxpayer assigns actual retirements of such section 38 property for all taxable years to the same vintage account for purposes of section 47 and for purposes of computing the allowance for depreciation under section 167. The assignment of actual retirements of section 38 property for a taxable year to particular vintage accounts may be made on the basis of an appropriate mortality dispersion table (based on an acceptable sampling of the taxpayer's actual experience or other statistical or engineering techniques) or on the basis of a standard mortality dispersion table prescribed by the Commissioner. If the taxpayer assigns actual retirements for any taxable year to particular vintage accounts on the basis of such standard mortality dispersion table, actual retirements for all subsequent taxable years must be assigned to particular vintage accounts on the basis of such table. Actual retirements of section 38 property for a taxable year shall be assigned to particular vintage accounts by—

(a) Determining the expected retirements for such taxable year from each vintage account containing such section 38 property, and

(b) Ratably allocating such actual retirements to each vintage account containing such section 38 property.

However, the unadjusted basis of retired assets assigned to any particular vintage account shall not exceed the unadjusted basis of the property contained in such account.

(3) *Special rules.* (i) Taxpayers who properly determine estimated useful lives under §1.46–3(e)(3) (ii)*(b)* or (iii) may treat such assets as having been disposed of or having ceased to be section 38 assets in the order of the estimated useful lives that were assigned to such assets. Thus, the asset that is first disposed of or first ceases to be section 38 property may be treated as the asset to which there was assigned the shortest estimated useful life; the next asset disposed of or ceasing to be section 38 property may be treated as the asset to which there was assigned the second shortest life, etc.

(ii) In the case of taxpayers who use the rule of subdivision (i) of this subparagraph with respect to mass assets for which the estimated useful life was determined under §1.46–3(e)(3)(iii), if the dispersion shown by the mortality dispersion table effective for a taxable year subsequent to the credit year is the same as the dispersion shown by the mortality table that was effective for the credit year (for example, if the same average useful life on the standard mortality dispersion table reflects the taxpayer's experience for both such years), no recapture determination is required for such subsequent taxable year.

(iii) Notwithstanding subdivision (i) of this subparagraph, taxpayers who, for purposes of determining qualified investment, do not use a mortality dispersion table with respect to certain section 38 assets similar in kind but who consistently assign under paragraph (e)(3)(ii) *(b)* of §1.46–3 to such assets separate lives based on the estimated range of years taken into consideration in establishing the average useful life of such assets, may select the order in which such assets shall be considered as having been disposed of, regardless of the taxable years in which such assets were placed in service. If a taxpayer uses the method provided in this subdivision to determine that any asset is considered as having been disposed of, then, in addition to complying with the record requirements of subparagraph (1)(i) of this paragraph, such taxpayer must maintain records from which he can establish to the satisfaction of the district director that such asset has not previously been considered as having been disposed of. In addition, if, for any taxable year, a taxpayer uses the method provided in this subdivision for any asset, he must use for such year and for each subsequent taxable year (unless he obtains the district director's consent to change) with respect to all assets similar in kind to such asset—

(a) The method of determining estimated useful lives described in paragraph (e)(3)(ii)(b) of §1.46–3, and

(b) The method he has selected under this subdivision for determining the order in which such assets are considered as having been disposed of.

A request by a taxpayer to obtain the district director's consent to change a system or method described in this subdivision with respect to assets similar in kind must be submitted to the district director on or before the last day of the taxable year with respect to which the change is sought.

(iv) Notwithstanding subdivisions (i), (ii), and (iii) of this subparagraph, there shall be taken into account separately any abnormal retirement of section 38 property of substantial value for which the estimated useful life was determined under § 1.46–3(e)(3) (ii)*(b)* or (iii). For definition of abnormal retirement, see paragraph (b) of § 1.167(a)–8.

(4) [Reserved]

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

Example. (i) Taxpayer A uses numerous small returnable containers in his business. It is impracticable for A to keep individual detailed records with respect to such containers which are mass assets. In 1965, A places in service 10 million containers purchased for $1 million, and reasonably determines that each of such containers has a basis of 10 cents. A places such containers in a multiple asset account to which is assigned a 5-year average useful life for purposes of computing depreciation. A has conducted an appropriate mortality study which shows that the containers have the following estimated useful lives:

Percent of assets	Useful life (years)
10	3
20	6
40	5
20	6
10	7

A assigns separate lives to such assets based on the estimated range of years taken into account in establishing the average useful life of such containers. The qualified investment with respect to such containers is $400,000 computed as follows:

Useful life	Basis	Applicable percentage	Qualified investment
4	$200,000	33⅓	$66,666
5	400,000	33⅓	133,334
6	200,000	66⅔	133,334
7	100,000	66⅔	66,666
			400,000

A's credit earned for 1965 of $28,000 (7 percent times $400,000) is allowed as a credit under section 38 against A's liability for tax of $2 million. (For purposes of this example the computations of investment credit and recapture with respect to containers placed in service in years other than 1965 are omitted.) The mortality studies effective for 1966 and 1967 show that none of the containers placed in service in 1965 was retired.

(ii) A's mortality study effective with respect to 1968 shows that the containers are being retired as follows:

Percent of assets	Useful life (years)
30	3
20	4
30	5
10	6
10	7

Thus, the 1968 study shows that 30 percent of the 10 million containers placed in service in 1965 were retired in 1968. Under the rule of subparagraph (3)(i) of this paragraph, the 3 million containers are treated as consisting of the 1 million containers to which was assigned a 3-year useful life and the 2 million containers to which was assigned a 4-year useful life. Taking into account only the fact that 30 percent of the containers placed in service in 1965 had an actual life of less than 4 years, A's recomputed qualified investment for 1965 is $333,333 and his recomputed credit earned is $23,333. A's income tax for 1968 is increased by $4,667 ($28,000 original credit earned minus $23,333 recomputed credit earned).

(iii) The mortality study effective for 1969 shows the same results as the mortality study effective for 1968. Thus, it shows that 2 million containers were retired in 1969 (an actual life of 4 years). Under the rule of subparagraph (3)(i) of this paragraph such 2 million containers are treated as having been among 4 million containers to which were assigned a 5-year useful life. Therefore, no recapture determination is required for 1969.

(iv) The mortality study effective for 1970 shows the same results as the mortality study effective for 1968. Thus, it shows that 3 million containers were retired in 1970 (an actual life of 5 years). Under the rule of subparagraph (3)(i) of this paragraph, the 3 million are treated as having been assigned useful lives as follows: 2 million as having been assigned a useful life of 5 years, and 1 million as having been assigned a useful life of 6 years. Taking into account only the fact that 10 percent of the containers placed in service in 1965 had an actual life of 5 years rather than the 6 years estimated useful life assigned to them, A's recomputed qualified investment is $300,000 and A's credit earned for 1965 is $21,000. Thus, taking into account the 1968 recapture determination A's income tax for 1970 is increased by $2,333.

(f) *Public utility property*—(1) *Recomputed qualified investment.* In recomputing qualified investment with respect to section 38 property which becomes public utility property (as defined in paragraph (g) of § 1.46–3)—

(i) If such property becomes public utility property less than 3 years from the date on which it was placed in service, then such property shall be treated as public utility property for its entire useful life.

(ii) If such property becomes public utility property 3 years or more but less than 5 years from the date on which it was placed in service, then such property shall be treated as section 38 property which is not public utility property for the first 3 years of its estimated useful life and as public utility property for the remaining period of its estimated useful life.

(iii) If such property becomes public utility property 5 years or more but less than 7 years from the date on which it was placed in service, then such property shall be treated as section 38 property which is not public utility property for the first 5 years of its estimated useful life and as public utility property for the remaining period of its estimated useful life.

If property becomes public utility property before August 16, 1971, this subparagraph shall be applied by substituting ‘‘4 years’’ for ‘‘3 years’’, ‘‘6 years’’ for ‘‘5 years’’, and ‘‘8 years’’ for ‘‘7 years’’.

(2) *Examples.* Subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. (i) X Corporation, which makes its returns on the basis of the calendar year, acquired and placed in service on January 1, 1969, an item of section 38 property with a basis of $12,000 and an estimated useful life of 8 years. The amount of qualified investment with respect to such property was $12,000. For the taxable year 1969, X Corporation’s credit earned was $840 (7 percent of $12,000) and for such taxable year X Corporation was allowed under section 38 a credit of $840 against its liability for tax. During the taxable year 1972 such property becomes public utility property (as defined in paragraph (g) of § 1.46–3) with respect to X Corporation.

(ii) Such item of section 38 property is treated as section 38 property which is not public utility property for the first 3 years of its 8-year estimated useful life and is treated as public utility property for the remaining 5 years. The recomputed qualified investment with respect to such item of section 38 property is $7,428, computed as follows:

$12,000 basis×33⅓ percent applicable percentage	$4,000
$12,000 basis× 3/7 ×66⅔ percent applicable percentage	3,428
Total recomputed qualified investment	7,428

X Corporation’s recomputed credit earned for the taxable year 1969 is $520 (7 percent of $7,428). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1972 is increased by the $320 decrease in its credit earned for the taxable year 1969 (that is, $840 original credit earned minus $520 recomputed credit earned).

Example 2. (i) The facts are the same as in example 1 and in addition the item of section 38 property which became public utility property in 1972 is sold to Y Corporation on January 2, 1975.

(ii) The actual useful life of such item of property is 6 years. For the first 3 years of its 8-year estimated useful life such item is treated as section 38 property which is not public utility property and for the remaining 3 years is treated as public utility property. The recomputed qualified investment with respect to such item of property is $5,714, computed as follows:

$12,000 basis×33⅓ percent applicable percentage	$4,000
$12,000 basis× 3/7 ×33⅓ percent applicable percentage	1,714
Total recomputed qualified investment	5,714

X Corporation’s recomputed credit earned for the taxable year 1969 is $400 (7 percent of $5,714). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1975 is increased by $120 (that is, $440 ($840 original credit earned minus $400 recomputed credit earned) minus $320 increase in tax for 1969).

(g) *Special rules for progress expenditure property.* Under section 47(a)(3), a recapture determination is required if property ceases to be progress expenditure property (as defined in § 1.46–5(d)). Property ceases to be progress expenditure property if it is sold or otherwise disposed of before it is placed in service. For example, cancellation of the contract for progress expenditure property or abandonment of the project by the taxpayer will be considered a ‘‘disposition’’ within the meaning of § 1.47–2. A cessation occurs if progress expenditure property ceases to be property that will be section 38 property with a useful life of 7 years or more when placed in service. In general, a sale and leaseback is treated as a cessation. However, see paragraph (g)(2) of § 1.47–3 for special rules for certain sale and leaseback transactions. Recapture determinations for progress expenditure property are to be made in a way similar to that provided under §§ 1.47–1 through 1.47–6. Reduction of qualified investment must begin with the most recent credit year (*i.e.*, the most recent taxable year the property is taken into account in computing qualified investment under §1.46–3 or 1.46–5).

(h) *Special rules for energy property*—(1) *In general.* A recapture determination is required for the investment credit attributable to the energy percentage (energy credit) if property is (i) disposed of or (ii) otherwise ceases to be energy property (as defined in section 48(l)) with regard to the taxpayer before the close of the estimated useful life (as determined under paragraph (a)(2)(i) of this section) which was taken into account in computing qualified investment.

(2) *Dispositions.* The term ''disposition'' is described in §1.47–2(a)(1). A transfer of energy property that is a ''disposition'' requiring a recapture determination for the investment credit attributable to the regular percentage (regular credit) and the ESOP percentage (ESOP credit) will also be a ''disposition'' requiring a recapture determination for the energy credit.

(3) *Cessation.* (i) The term ''cessation'' is described in §1.47–2(a)(2). For energy property, a cessation occurs during a taxable year if, by reason of a change in use or otherwise, the property would not have qualified for an energy credit if placed in service during that year. A change in use will not require a recapture determination for the regular or ESOP credit unless, by reason of the change, the property would not have qualified for the regular or ESOP credit if placed in service during that year.

(ii) A qualified intercity bus described in §1.48–9(q) must meet the predominant use test (of §1.48–9(q)(7)) for the remainder of the taxable year from the date it is placed in service and for each taxable year thereafter. A cessation occurs in any taxable year in which the bus is no longer a qualifying bus under §1.48–9(q)(6). A qualified intercity bus does not cease to be energy property for a taxable year subsequent to the one in which it was placed in service by reason of a decrease in operating capacity (see §1.48–9(q)(9)) for that year compared to any prior taxable year.

(4) *Recordkeeping requirement.* For recordkeeping requirements with respect to dispositions or cessations, the rules of paragraph (e)(1) of this section apply. For example, the taxpayer must maintain records for each recycling facility indicating the percentage of virgin materials used each year. See, §1.48–9(g)(5)(ii).

(5) *Examples.* The following examples illustrate this paragraph (h).

Example 1. (a) In 1980, corporation X, a calendar year taxpayer, acquires and places in service a computer that will perform solely energy conserving functions in connection with an existing industrial process. Assume the computer has a 10 year useful life and qualifies for both the regular and energy credits. In 1981, a change is made in the industrial process (within the meaning of §1.48–9(l)(2)). However, for 1981 the computer continues to perform solely energy conserving functions. In 1982, the computer ceases to perform energy conserving functions and begins to perform a production related function.

(b) For 1981, a recapture determination is not required. For 1982, the entire energy credit must be recaptured, although none of the regular credit is recaptured. If in 1989 the computer first ceased to perform an energy conserving function, no part of the energy credit would be recaptured.

Example 2. Assume the same facts and conclusion as in example 1. Assume further that X sells the computer in 1985. A recapture determination is required for the regular credit.

Example 3. In 1981, corporation Y, a calendar year taxpayer, acquires and places in service recycling equipment. Assume the equipment has a 7-year useful life and qualifies for both the regular credit and energy credit. During the course of 1982, more than 10 percent of the material recycled is virgin material. The energy credit is recaptured in its entirety, although none of the regular credit is recaptured. See §1.48–9(g)(5)(B)(ii).

Example 4. In 1980, corporation Z, a calendar year taxpayer, acquires and places in service a boiler the primary fuel for which is an alternate substance. The boiler has a 7-year useful life. Assume the boiler is a structural component of a building within the meaning of §1.48–1(e)(2). Assume further that the boiler is not a part of a qualified rehabilitated building (as defined in section 48(g)(1)) or a single purpose agricultural or horticultural structure (as defined in section 48(p)). Z is allowed only an energy credit since the boiler is a structural component of a building. In 1984, Z modifies the boiler to use oil as the primary fuel. A recapture determination is required for the energy credit. See §1.48–9(c)(3).

(i)—(l) [Reserved]

(m) *Commuter highway vehicles*—(1) *Recomputed qualified investment.* (i) If a qualifying commuter highway vehicle (as defined in §1.46–11(a) undergoes a change in use but does not cease to be section 38 property, qualified investment for that vehicle is recomputed as if the vehicle was section 38 property which is not a qualifying commuter highway vehicle for its entire useful life.

(ii) The following example illustrates this paragraph (m)(1).

Example. X Corporation, a calendar year taxpayer, acquired and placed in service on January 1, 1982, a qualifying commuter highway vehicle with a basis of $10,000 and which qualified as three year recovery property under section 168(c)(2)(A)(i). The amount of qualified investment for the vehicle under section 46(c) (1) and (6) is $10,000. For the taxable year 1982, X Corporation's credit earned was $1,000 (10 percent of $10,000) and X Corporation was allowed under section 38 a $1,000 credit against its 1982 tax liability. During the taxable year 1984, the vehicle undergoes a change in use but does not cease to be section 38 property. The vehicle is treated as section 38 property which is not a qualifying commuter highway vehicle for its entire useful life. The recomputed qualified investment for the vehicle is $6,000 (60 percent of $10,000) and X Corporation's recomputed credit earned is $600 (10 percent of $6,000). The income tax imposed by chapter 1 of the Code on X Corporation for 1984 is increased by the $400 decrease in its credit earned for 1982 ($1,000 − $600).

(2) *Change in use*—(i) A qualifying commuter highway vehicle undergoes a change in use if the vehicle does not meet the commuter use requirement (as defined in §1.46–11(d)) for each computation period.

(ii) Each of the following is a computation period:

(A) The period beginning on the date the vehicle was placed in service and ending on the last day of the taxpayer's taxable year in which the vehicle was placed in service;

(B) Each of the taxpayer's taxable years beginning after the date the vehicle was placed in service and ending before the end of the first 36 months after the vehicle was placed in service; and

(C) The period ending at the end of the first 36 months after the vehicle was placed in service and beginning on the first day of the taxpayer's taxable year in which the end of those first 36 months falls.

(iii) The following example illustrates this paragraph (m)(2).

Example. (*a*) Z Corporation, a calendar year taxpayer, acquired and placed in service a qualifying commuter highway vehicle on January 15, 1979. Z Corporation used the vehicle as set forth in the following table:

Taxable year ending	Total miles	Commuter miles	Ratio
1979	10,000	9,000	.90
1980	10,000	8,000	.80
1981	10,000	8,000	.80
1982 (1–14)	1,000	100	.10

(*b*) The first computation period begins on the date the vehicle is placed in service, in this example 1–15–79, and ends 12–31–79. In that computation period, the ratio of commuter miles to total miles is .90 (9,000 miles÷10,000 miles). Therefore, the vehicle meets the commuter use requirement for that period and has not undergone a change in use. Similar calculations for the computation periods 1–1–80 to 12–31–80 and 1–1–81 to 12–31–81 produce the same result.

(*c*) As of the computation period beginning 1–1–82 and ending 1–14–82, the ratio of commuter use to total mileage is .10 (100 miles ÷1,000 miles). Since that ratio is less than .80, the vehicle does not meet the commuter use requirement for the period and the vehicle has undergone a change in use.

(secs. 38(b) (76 Stat. 963, 26 U.S.C. 38(b)), 48(l)(16) (94 Stat. 264, 26 U.S.C. 48(l)(16)), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6931, 32 FR 14027, Oct. 10, 1967, as amended by T.D. 7203, 37 FR 17127, Aug. 25, 1972; T.D. 7765, 46 FR 7291, Jan. 23, 1981; T.D. 7982, 49 FR 39541, Oct. 9, 1984; T.D. 8035, 50 FR 29370, July 19, 1985; T.D. 8183, 53 FR 6625, Mar. 2, 1988; T.D. 8474, 58 FR 25557, Apr. 27, 1993]

§1.47–2 "Disposition" and "cessation".

(a) *General rule*—(1) *''Disposition''.* For purposes of this section and §1.47–1 and §§1.47–3 through 1.47–6, the term ''disposition'' includes a sale in a sale-and-leaseback transaction, a transfer upon the foreclosure of a security interest and a gift, but such term does not include a mere transfer of title to a creditor upon creation of a security interest. See paragraph (g) of § 1.47–3 for treatment of certain sale-and-lease-back transactions.

(2) *''Cessation''.* (i) A determination of whether section 38 property ceases to be section 38 property with respect to the taxpayer must be made for each taxable year subsequent to the credit year. Thus, in each such taxable year the taxpayer must determine, as if such property were placed in service in such taxable year, whether such property would qualify as section 38 property (within the meaning of § 1.48–1) in the hands of the taxpayer for such taxable year.

(ii) Section 38 property does not cease to be section 38 property with respect to the taxpayer in any taxable year subsequent to the credit year merely because under the taxpayer's depreciation practice no deduction for depreciation with respect to such property is allowable to the taxpayer for the taxable year, provided that the property continues to be used in the taxpayer's trade or business (or in the production of income) and otherwise qualifies as section 38 property with respect to the taxpayer.

(iii) This subparagraph may be illustrated by the following examples:

Example 1. A, an individual who makes his returns on the basis of the calendar year, on January 1, 1962, acquired and placed in service in his trade or business an item of section 38 property with an estimated useful life of eight years. On January 1, 1965, A removes the item of section 38 property from use in his trade or business by converting such item to personal use. Therefore no deduction for depreciation with respect to such item of property is allowable to A for the taxable year 1965. On January 1, 1965, such item of property ceases to be section 38 property with respect to A.

Example 2. On January 1, 1965, A placed in service an item of section 38 property with a basis of $10,000 and an estimated useful life of 4 years. A depreciates such item, which has a salvage value of $2,000 (after taking into account section 167(f)), on the declining balance method at a rate of 50 percent (that is, twice the straight line rate of 25 percent). With respect to such item, A is allowed deductions for depreciation of $5,000 for 1965, $2,500 for 1966, and $500 for 1967. A is not allowed a deduction for depreciation for 1968 although he continues to use such item in his trade or business. Such item does not cease to be section 38 property with respect to A in 1968.

(b) *Leased property*—(1) *In general.* For purposes of paragraph (a) of § 1.47–1, generally the mere leasing of section 38 property by a lessor who took the basis of such property into account in computing his qualified investment for the credit year shall not be considered to be a disposition. However, in a case where a lease is treated as a sale for income tax purposes such transaction is considered to be a disposition. Leased section 38 property ceases to be section 38 property with respect to the lessor if, in any taxable year subsequent to the credit year, such property would not qualify as section 38 property (as defined in § 1.48–1) in the hands of the lessor, the lessee, or any sublessee. Thus, if, in a taxable year subsequent to the credit year, a lessee uses the property predominantly outside the United States, such property shall be considered to have ceased to be section 38 property with respect to the lessor.

(2) *Where lessor elects to treat lessee as purchaser.* For purposes of paragraph (a) of § 1.47–1, if, under § 1.48–4, the lessor of new section 38 property made a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, the following rules apply in determining whether such property is disposed of, or otherwise ceases to be section 38 property with respect to the lessee:

(i) Generally, a mere disposition by the lessor of property subject to a lease shall not be considered to be a disposition by the lessee.

(ii) If the lessor makes a disposition of property subject to a lease to a person who may not, under § 1.48–4, make a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by section 38 (such as a person described in paragraph (a)(5) of § 1.48–4), such property shall be considered to have ceased to be section 38 property with respect to the lessee on the date of such disposition.

(iii) If a lease is terminated and the property is transferred by the lessee to the lessor or to any other person, such transfer shall be considered to be a disposition by the lessee.

(iv) If the lessee actually purchases such property in the credit year or in a taxable year subsequent to the credit year, such purchase shall not be considered to be a disposition.

(v) The property ceases to be section 38 property with respect to the lessee if in any taxable year subsequent to the credit year such property would not qualify as section 38 property (as defined in §1.48–1) in the hands of the lessor, the lessee, or any sublessee. Thus, for example, if, in a taxable year subsequent to the credit year, a sublessee uses the property predominantly outside the United States, the property ceases to be section 38 property with respect to the lessee.

(c) *Reduction in basis of section 38 property*—(1) *General rule.* If, in the credit year or in any taxable year subsequent to the credit year, the basis (or cost) of section 38 property is reduced, for example, as a result of a refund of part of the cost of the property, then such section 38 property shall be treated as having ceased to be section 38 property with respect to the taxpayer to the extent of the amount of such reduction in basis (or cost) on the date the refund which results in such reduction in basis (or cost) is received or accrued, except that for purposes of §1.47–1(a) the actual useful life of the property treated as having ceased to be section 38 property shall be considered to be less than 3 years.

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

Example. (i) On January 1, 1962, A, a cash basis taxpayer, acquired from X Cooperative an item of section 38 property with a basis of $100 and an estimated useful life of 10 years which he placed in service on such date. The amount of qualified investment with respect to such asset was $100. For the taxable year 1962 A was allowed under section 38 a credit of $7 against his liability for tax. On June 1, 1963, A receives a $10 patronage dividend from X Cooperative with respect to such asset. Under paragraph (c)(2)(i) of §1.1385–1, the basis of the asset in A's hands is reduced by $10.

(ii) Under subparagraph (1) of this paragraph, on June 1, 1963, the item of section 38 property ceases to be section 38 property with respect to A to the extent of $10 of the original $100 basis.

(d) *Retirements.* A retirement of section 38 property, including a normal retirement (as defined in paragraph (b) of §1.167(a)–8, relating to definition of normal and abnormal retirements), whether from a single asset account or a multiple asset account, and an abandonment, are dispositions for purposes of paragraph (a) of §1.47–1.

(e) *Conversion of section 38 property to personal use.* (1) If, for any taxable year subsequent to the credit year—

(i) A deduction for depreciation is allowable to the taxpayer with respect to only a part of section 38 property because such property is partially devoted to personal use, and

(ii) The part of the property (expressed as a percentage of its total basis (or cost)) with respect to which a deduction for depreciation is allowable for such taxable year is less than the part of the property with respect to which a deduction for depreciation was allowable in the credit year,

then such property shall be considered as having ceased to be section 38 property with respect to the taxpayer to such extent. Further, property ceases to be section 38 property with respect to the taxpayer to the extent that a deduction for depreciation thereon is disallowed under section 274 (relating to disallowance of certain entertainment, etc., expenses).

(2) *Examples.* Subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. (i) A, a calendar-year taxpayer, acquired and placed in service on January 1, 1962, an automobile with a basis of $2,400 and an estimated useful life of four years. In the taxable year 1962 the automobile was used by A 80 percent of the time in his trade or business and was used 20 percent of the time for personal purposes. Thus, for the taxable year 1962 only 80 percent of the basis of the automobile qualified as section 38 property since a deduction for depreciation was allowable to A only with respect to 80 percent of the basis of the automobile. In the taxable year 1963 the automobile is used by A only 60 percent of the time in his trade or business. Thus, for the taxable year 1963 a deduction for depreciation is allowable to A only with respect to 60 percent of the basis of the automobile.

(ii) Under subparagraph (1) of this paragraph, on January 1, 1963, the automobile ceases to be section 38 property with respect to A to the extent of 20 percent (80 percent minus 60 percent) of the $2,400 basis of the automobile.

Example 2. (i) The facts are the same as in example 1 and in addition for the taxable year 1964 a deduction for depreciation is allowable to A only with respect to 40 percent of the basis of the property.

(ii) Under subparagraph (1) of this paragraph, on January 1, 1964, the automobile ceases to be section 38 property with respect to A to the extent of 20 percent (60 percent minus 40 percent) of the $2,400 basis of the automobile.

[T.D. 6931, 32 FR 14032, Oct. 10, 1967, as amended by T.D. 7203, 37 FR 17128, Aug. 25, 1972]

§ 1.47–3 Exceptions to the application of § 1.47–1.

(a) *In general.* Notwithstanding the provisions of § 1.47–2, relating to ''disposition'' and ''cessation,'' paragraph (a) of § 1.47–1 shall not apply if paragraph (b) of this section (relating to transfers by reason of death), paragraph (c) of this section (relating to property destroyed by casualty), paragraph (d) of this section (relating to reselection of used section 38 property), paragraph (e) of this section (relating to transactions to which section 381(a) applies), paragraph (f) of this section (relating to mere change in form of conducting a trade or business), paragraph (g) of this section (relating to sale-and-leaseback transactions), or paragraph (h) of this section (relating to certain property replaced after Apr. 18, 1969) applies with respect to such disposition or cessation.

(b) *Transfers by reason of death*— (1) *General rule.* Notwithstanding the provisions of § 1.47–2, relating to ''disposition'' and ''cessation'', paragraph (a) of § 1.47–1 shall not apply to a transfer of section 38 property by reason of the death of the taxpayer. Thus, for example, with respect to section 38 property held in joint tenancy, paragraph (a) of § 1.47–1 shall not apply to the transfer of the deceased taxpayer's interest to the surviving joint tenant. If, under § 1.48–4, the lessor of new section 38 property made a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, paragraph (a) of § 1.47–1 does not apply if, by reason of the death of the lessee, there is a termination of the lease and transfer of the leased property to the lessor, or there is an assignment of the lease and transfer of the leased property to another person. Moreover, paragraph (a) of § 1.47–1 does not apply to the transfer of a partner's interest in a partnership, a beneficiary's interest in an estate or trust, or shares of stock of a shareholder of an electing small business corporation (as defined in section 1371(b)) by reason of the death of such partner, beneficiary, or shareholder. Paragraph (a) of § 1.47–1 shall not apply to property prior to his death even if the value of such gift is included in his gross estate for estate tax purposes (such as, a gift in contemplation of death under section 2035). The effect of this subparagraph is that any section 38 property held by a taxpayer at the time of his death is deemed to have been held by him for its entire estimated useful life.

(2) *Examples.* Subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. (i) A, an individual, acquired and placed in service on January 1, 1962, an item of section 38 property with a basis of $10,000 and an estimated useful life of eight years. On April 28, 1963, A dies and, as a result of A's death, his interest in such item of section 38 property is transferred to a testamentary trust pursuant to A's will, and on February 1, 1967, the trust is terminated and the item of section 38 property is transferred to the beneficiaries of the trust.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of § 1.47–1 does not apply to the transfer, as a result of A's death, of his interest in such item of section 38 property to the testamentary trust. Moreover, paragraph (a) of § 1.47–1 does not apply to the February 1, 1967, transfer of such item of section 38 property by the trust to its beneficiaries.

Example 2. (i) X Corporation, an electing small business corporation (as defined in section 1371(b)) which makes its returns on the basis of a calendar year, acquired and placed in service during 1962 an item of section 38 property. On December 31, 1962, X Corporation had 10 shares of stock outstanding which were owned as follows: A owned eight shares and B owned two shares. On December 31, 1962, 80 percent of the basis of the item of section 38 property was apportioned to A and 20 percent to B. On June 1, 1964, A dies and, as a result of A's death, his eight shares of stock in X Corporation are transferred to his wife. On July 10, 1965, X Corporation sells the item of section 38 property to Y Corporation.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of §1.47–1 does not apply to the transfer, as a result of A's death, of his eight shares of stock in X Corporation to his wife. Moreover, with respect to the July 10, 1965, sale paragraph (a) of §1.47–1 applies only to the 20 percent of the basis of the item of section 38 property which was apportioned to B.

(c) *Property destroyed by casualty*— (1) *Dispositions after April 18, 1969.* Notwithstanding the provisions of §1.47–2, relating to ''disposition'' and ''cessation'', paragraph (a) of §1.47–1 shall not apply to property which, after April 18, 1969, and before August 16, 1971, is disposed of or otherwise ceases to be section 38 property with respect to the taxpayer on account of its destruction or damage by fire, storm, shipwreck, or other casualty, or by reason of its theft.

(2) *Dispositions before April 19, 1969.* (i) In the case of property which, before April 19, 1969, is disposed of or otherwise ceases to be section 38 property with respect to the taxpayer on account of its destruction or damage by fire, storm, shipwreck or other casualty, or by reason of its theft, paragraph (a) of §1.47–1 shall apply except to the extent provided in subdivisions (ii) and (iii) of this subparagraph.

(ii) Paragraph (a) of §1.47–1 shall not apply if—

(a) Section 38 property is placed in service by the taxpayer to replace (within the meaning of paragraph (h) of §1.46–3) the destroyed, damaged, or stolen property, and

(b) The basis (or cost) of the section 38 property which is placed in service by the taxpayer to replace the destroyed, damaged, or stolen property is reduced under paragraph (h) of §1.46–3.

(iii) If property which would be section 38 property but for section 49 is placed in service by the taxpayer to replace the destroyed, damaged, or stolen property, then the provisions of paragraph (h) of this section (other than the requirement that the replacement take place within 6 months after the disposition) shall apply.

(3) *Examples.* The provisions of subparagraph (2)(ii) of this paragraph may be illustrated by the following examples:

Example 1. (i) A acquired and placed in service on January 1, 1962, machine No. 1 which qualified as section 38 property with a basis of $30,000 and an estimated useful life of 6 years. The amount of qualified investment with respect to such machine was $20,000. For the taxable year 1962 A's credit earned of $1,400 was allowed under section 38 as a credit against its liability for tax. On January 1, 1963, machine No. 1 is completely destroyed by fire. On January 1, 1963, the adjusted basis of machine No. 1 in A's hands is $24,500. A receives $23,000 in insurance proceeds as compensation for the destroyed machine, and on February 15, 1964, A acquires and places in service machine No. 2, which qualifies as section 38 property, with a basis of $41,000 and an estimated useful life of 6 years to replace machine No. 1.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of §1.47–1 does not apply with respect to machine No. 1 since machine No. 2 is placed in service to replace machine No. 1 and the $41,000 basis of machine No. 2 is reduced, under paragraph (h) of §1.46–3, by $23,000. (See example 1 of paragraph (h)(3) of §1.46–3.)

Example 2. (i) The facts are the same as in example 1 except that A receives only $19,000 in insurance proceeds as compensation for the destroyed machine.

(ii) Although machine No. 2 is placed in service to replace machine No. 1, subparagraph (1) of this paragraph does not apply with respect to machine No. 1 since the basis of machine No. 2 is not reduced under paragraph (h) of §1.46–3. Paragraph (a) of §1.47–1 applies with respect to the January 1, 1963, destruction of machine No. 1. The actual useful life of machine No. 1 is 1 year. The recomputed qualified investment with respect to such machine is zero ($30,000 basis multiplied by zero applicable percentage) and A's recomputed credit earned for the taxable year 1962 is zero. The income tax imposed by chapter 1 of the Code on A for the taxable year 1963 is increased by $1,400.

(d) *Reselection of used section 38 property*—(1) *Reselection.* If—

(i) Used section 38 property (as defined in §1.48–3) the cost of which was taken into account in computing the taxpayer's qualified investment is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing such qualified investment, and

(ii) For the taxable year in which the property described in subdivision (i) of this subparagraph was placed in service, the sum of *(a)* the cost of used section 38 property placed in service by the taxpayer, and *(b)* the cost of used section 38 property apportioned to such taxpayer exceeded $50,000,

then such taxpayer may treat the cost of any used section 38 property (regardless of its estimated useful life) which was not originally selected, under paragraph (c)(4) of § 1.48–3, to be taken into account in computing qualified investment for such taxable year (or previously reselected under this subparagraph) as having been selected (in accordance with the principles of paragraph (c)(4)(ii) of § 1.48–3) in place of the cost of the used section 38 property described in subdivision (i) of this subparagraph. Hereinafter such reselected property is referred to as ''newly selected used section 38 property''. For purposes of this subparagraph, the cost of used section 38 property apportioned to a taxpayer means the sum of the cost of used section 38 property apportioned to him by a trust, estate, or electing small business corporation (as defined in section 1371(b)), and his share of the cost of partnership used section 38 property, with respect to the taxable year of such trust, estate, corporation or partnership ending with or within such taxpayer's taxable year. In the case of a taxpayer to whom paragraph (c)(2) of § 1.48–3 applied for the taxable year in which the property described in subdivision (i) of this subparagraph was placed in service, a $25,000 amount shall be substituted for the $50,000 amount referred to in subdivision (ii)*(b)* of this subparagraph, and in the case of a member of an affiliated group (as defined in subparagraph (6) of § 1.48–3(e)) the amount apportioned to such member under paragraph (e) of § 1.48–3 shall be substituted for such $50,000 amount.

(2) *Application of paragraph (a) of § 1.47–1.* (i) If a taxpayer treats, under subparagraph (1) of this paragraph, the cost of any used section 38 property which was not originally selected as having been selected in place of the cost of used section 38 property described in subparagraph (1)(i) of this paragraph, then, not withstanding the provisions of § 1.47–2 (relating to ''disposition'' and ''cessation''), paragraph (a) of § 1.47–1 shall not apply to the property described in subparagraph (1)(i) of this paragraph to the extent of the cost of the newly selected used section 38 property.

(ii) If the cost of the used section 38 property described in subparagraph (1)(i) of this paragraph exceeds the cost of the newly selected used section 38 property, then the property described in subparagraph (1)(i) of this paragraph shall cease to be section 38 property with respect to the taxpayer to the extent of such excess.

(iii) If the newly selected used section 38 property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life of the property described in subparagraph (1)(i) of this paragraph, then, unless he reselects other used section 38 property, paragraph (a) of § 1.47–1 shall apply with respect to such newly selected used section 38 property. For purposes of recomputing qualified investment with respect to such newly selected used section 38 property the actual useful life shall be deemed to be the period beginning with the date on which the property described in subparagraph (1)(i) of this paragraph was placed in service by the taxpayer and ending with the date of the disposition or cessation with respect to such newly selected used section 38 property. See paragraph (c) of § 1.47–1, relating to date placed in service and date of disposition or cessation.

(3) *Information requirement.* (i) If in any taxable year this paragraph applies to a taxpayer, such taxpayer shall attach to his income tax return for such taxable year a statement containing the information required by subdivision (ii) of this subparagraph.

(ii) The statement referred to in subdivision (i) of this subparagraph shall contain the following information:

(a) The taxpayer's name, address and taxpayer account number; and

(b) With respect to the originally selected used section 38 property and the newly selected used section 38 property, the month and year placed in service, cost, and estimated useful life.

(4) *Examples.* This paragraph may be illustrated by the following examples:

Example 1. (i) X Corporation purchased and placed in service on January 1, 1962, machines No. 1 and No. 2, which qualified as used section 38 property, each with a cost of

$50,000 and an estimated useful life of eight years. The aggregate cost of used section 38 property taken into account by X Corporation in computing its qualified investment for the taxable year 1962 could not exceed $50,000; therefore, under paragraph (c)(4) of §1.48–3, X selected the $50,000 cost of machine No. 1 to be taken into account in computing its qualified investment for the taxable year 1962. The qualified investment with respect to machine No. 1 was $50,000. For the taxable year 1962 X's credit earned of $3,500 was allowed under section 38 as a credit against its liability for tax. On January 2, 1965, X Corporation sells machine No. 1 to Y Corporation.

(ii) Under subparagraph (1) of this paragraph, X Corporation treats the $50,000 cost of machine No. 2 as having been selected to be taken into account in computing its qualified investment for the taxable year 1962 in place of the $50,000 cost of machine No. 1. Therefore, under subparagraph (2)(i) of this paragraph, paragraph (a) of §1.47–1 does not apply to the January 2, 1965, disposition of machine No. 1.

Example 2. (i) The facts are the same as in example 1 and in addition X Corporation, on December 2, 1966, sells machine No. 2 to Z Corporation.

(ii) Under subparagraph (2)(iii) of this paragraph, paragraph (a) of §1.47–1 applies with respect to the December 2, 1966, disposition of machine No. 2. The actual useful life of machine No. 2 is four years and eleven months (that is, the period beginning on January 1, 1962, and ending on December 2, 1966). The recomputed qualified investment with respect to machine No. 2 is $16,667 ($50,000 cost multiplied by 33⅓ percent applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $1,167. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1966 is increased by the $2,333 decrease in its credit earned for the taxable year 1962 (that is, $3,500 original credit earned minus $1,167 recomputed credit earned).

Example 3. (i) The facts are the same as in example 1 except that machine No. 2 had a cost of $30,000.

(ii) Under subparagraph (1) of this paragraph, X Corporation treats the $30,000 cost of machine No. 2 as having been selected to be taken into account in computing its qualified investment for the taxable year 1962 in place of the $50,000 cost of machine No. 1. Therefore, under subparagraph (2)(i) of this paragraph, paragraph (a) of §1.47–1 does not apply to the January 2, 1965, disposition of machine No. 1 to the extent of $30,000 of the $50,000 cost of machine No. 1. However, under subparagraph (2)(ii) of this paragraph, paragraph (a) of §1.47–1 applies to the January 2, 1965, disposition of machine No. 1 to the extent of $20,000 (that is, $50,000 cost of machine No. 1 minus $30,000 cost of machine No. 2). The actual useful life of such $20,000 portion of machine No. 1 is three years (that is, the period beginning on January 1, 1962, and ending on January 2, 1965). The recomputed qualified investment with respect to the $20,000 portion of the cost of machine No. 1 is zero ($20,000 portion of the cost multiplied by zero applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $2,100 (7 percent of $30,000). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1965 is increased by the $1,400 decrease in its credit earned for the taxable year 1962 (that is, $3,500 original credit earned minus $2,100 recomputed credit earned).

(e) *Transactions to which section 381(a) applies*—(1) *General rule.* Notwithstanding the provisions of §1.47–2, relating to ''disposition'' and ''cessation'', paragraph (a) of §1.47–1 shall not apply to a disposition of section 38 property in a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies. If the section 38 property described in the preceding sentence is disposed of, or otherwise ceases to be section 38 property with respect to the acquiring corporation, before the close of the estimated useful life which was taken into account in computing the transferor corporation's qualified investment, then paragraph (a) of §1.47–1 shall apply to the acquiring corporation with respect to such section 38 property. For purposes of recomputing qualified investment with respect to such property its actual useful life shall be the period beginning with the date on which it was placed in service by the transferor corporation and ending with the date of the disposition by, or cessation with respect to, the acquiring corporation.

(2) *Examples.* This paragraph may be illustrated by the following examples:

Example 1. (i) X Corporation, a wholly owned subsidiary of Y Corporation, acquired and placed in service on January 1, 1962, an item of section 38 property with a basis of $12,000 and an estimated useful life of eight years. Both X and Y make their returns on the basis of a calendar year. The qualified investment with respect to such item was $12,000. For the taxable year 1962 X Corporation's credit earned of $840 was allowed under section 38 as a credit against its liability for tax. On January 15, 1967, X Corporation is liquidated under section 332 and all of its properties, including the item of section 38 property, are transferred to Y Corporation. The bases of the properties in the hands of Y Corporation are determined under section 334(b)(1).

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of § 1.47–1 does not apply to the January 15, 1967, transfer to Y Corporation.

Example 2. (i) The facts are the same as in example 1 and in addition on February 2, 1968, Y Corporation sells the item of section 38 property to Z Corporation.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of § 1.47–1 does not apply to the January 15, 1967, transfer to Y Corporation. However, paragraph (a) of § 1.47 applies to the February 2, 1968, sale of the property by Y Corporation. The actual useful life of the property is six years and one month (that is, the period beginning on January 1, 1962, and ending on February 2, 1968).

(f) *Mere change in form of conducting a trade or business*—(1) *General rule.* (i) Notwithstanding the provisions of § 1.47–2, relating to ‘‘disposition’’ and ‘‘cessation’’, paragraph (a) of § 1.47–1 shall not apply to section 38 property which is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing the taxpayer’s qualified investment by reason of a mere change in the form of conducting the trade or business in which such section 38 property is used provided that the conditions set forth in subdivision (ii) of this subparagraph are satisfied.

(ii) The conditions referred to in subdivision (i) of this subparagraph are as follows:

(a) The section 38 property described in subdivision (i) of this subparagraph is retained as section 38 property in the same trade or business,

(b) The transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partner, beneficiary, or shareholder) of such section 38 property retains a substantial interest in such trade or business,

(c) Substantially all the assets (whether or not section 38 property) necessary to operate such trade or business are transferred to the transferee to whom such section 38 property is transferred, and

(d) The basis of such section 38 property in the hands of the transferee is determined in whole or in part by reference to the basis of such section 38 property in the hands of the transferor. This subparagraph shall not apply to the transfer of section 38 property if paragraph (e) of this section, relating to transactions to which section 381 applies, applies with respect to such transfer.

(2) *Substantial interest.* For purposes of this paragraph, a transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partner, beneficiary, or shareholder) shall be considered as having retained a substantial interest in the trade or business only if, after the change in form, his interest in such trade or business—

(i) Is substantial in relation to the total interest of all persons, or

(ii) Is equal to or greater than his interest prior to the change in form.

Thus, where a taxpayer owns a 5-percent interest in a partnership, and, after the incorporation of that partnership, the taxpayer retains at least a 5-percent interest in the corporation, the taxpayer will be considered as having retained a substantial interest in the trade or business as of the date of the change in form.

(3) *Property held for the production of income.* Subparagraph (1)(i) of this paragraph applies to section 38 property held for the production of income (within the meaning of section 167(a)(2)) as well as to section 38 property used in a trade or business.

(4) *Leased property.* In a case where a lessor of new section 38 property made a valid election, under § 1.48–4, to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, in determining whether subparagraph (1)(i) of this paragraph applies to an assignment of the lease and transfer of possession of such property, the condition contained in subparagraph (1)(ii) *(d)* of this paragraph is not applicable.

(5) *Disposition or cessation.* (i) If section 38 property described in subparagraph (1)(i) of this paragraph is disposed of by the transferee, or otherwise ceases to be section 38 property with respect to the transferee, before the

close of the estimated useful life which was taken into account in computing the qualified investment of the transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the qualified investment of the partners, beneficiaries, or shareholders) then under paragraph (a) of §1.47–1 such property ceases to be section 38 property with respect to the transferor (or such partners, beneficiaries, or shareholders), and a recapture determination shall be made with respect to such property. For purposes of recomputing qualified investment with respect to such property, the actual useful life shall be the period beginning with the date on which it was placed in service by the transferor and ending with the date of the disposition by, or cessation with respect to, the transferee.

(ii) If in any taxable year the transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partner, beneficiary, or shareholder) of the section 38 property described in subparagraph (1)(i) of this paragraph does not retain a substantial interest in the trade or business directly or indirectly (through ownership in other entities provided that such other entities' bases in such interest are determined in whole or in part by reference to the basis of such interest in the hands of the transferor) then, under paragraph (a) of §1.47–1, such property ceases to be section 38 property with respect to the transferor and he (or the partner, beneficiary, or shareholder) shall make a recapture determination. For purposes of recomputing qualified investment with respect to property described in this subdivision, its actual useful life shall be the period beginning with the date on which it was placed in service by the transferor and ending with the first date on which the transferor (or the partner, beneficiary, or shareholder) does not retain a substantial interest in the trade or business. Any taxpayer who seeks to establish his interest in a trade or business under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in such trade or business after any such transfer or transfers.

(iii) In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determinations with respect to the transferor in connection with the same property.

(iv) Notwithstanding subparagraph (1) of this paragraph and subdivision (ii) of this subparagraph in the case of a mere change in the form of a trade or business, if the interest of a taxpayer in the trade or business is reduced but such taxpayer has retained a substantial interest in such trade or business, paragraph (a)(2) of §1.47–4 (relating to electing small business corporations), paragraph (a)(2) of §1.47–5 (relating to estates or trusts) or paragraph (a)(2) of §1.47–6 (relating to partnerships) shall apply, as the case may be.

(6) *Examples.* This paragraph may be illustrated by the following examples in each of which it is assumed that the transfer satisfies the conditions of subparagraphs (1)(ii) *(a), (c),* and *(d)* of this paragraph.

Example 1. (i) On January 1, 1962, A, an individual, acquired and placed in service in his sole proprietorship an item of section 38 property with a basis of $12,000 and an estimated useful life of eight years. The qualified investment with respect to such item was $12,000. For the taxable year 1962 A's credit earned of $840 was allowed under section 38 as a credit against his liability for tax. On March 15, 1963, A transfers all of the assets used in his sole proprietorship to X Corporation, a newly formed corporation, in exchange for 45 percent of the stock of X Corporation.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of §1.47–1 does not apply to the March 15, 1963, transfer to X Corporation.

Example 2. (i) The facts are the same as in example 1 and in addition on February 2, 1964, X Corporation sells the item of section 38 property to Y Corporation.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of §1.47–1 does not apply to the March 15, 1963, transfer to X Corporation. However, under subparagraph (5)(i) of this paragraph, paragraph (a) of §1.47–1 applies to the February 2, 1964, sale of the item of section 38 property by X Corporation to Y Corporation. The actual useful life of the property is two years and one month (that is, the period beginning on January 1, 1962, and ending on February 2, 1964). The recomputed qualified investment with respect to such property is zero ($12,000 basis multiplied by zero applicable percentage) and A's recomputed credit earned for the taxable year 1962 is zero. The income tax imposed by chapter 1 of the Code on A for 1964 is increased by the $840 decrease in his credit earned for the taxable year 1962 (that is, $840 credit earned minus zero recomputed credit earned).

Example 3. (i) On January 1, 1962, partnership ABC, which makes its returns on the basis of a calendar year, acquired and placed in service on item of section 38 property with a basis of $20,000 and an estimated useful life of eight years. Partnership ABC has 10 partners who make their returns on the basis of a calendar year and share partnership profits equally. Each partner's share of the basis of such item of section 38 property is 10 percent, that is, $2,000. On March 15, 1963, partnership ABC transfers all of the assets used in its trade or business to the X Corporation, a newly formed corporation, in exchange for all of the stock of X Corporation and immediately thereafter transfers 10 percent of such stock to each of the 10 partners.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.47–1 does not apply to the March 15, 1963 transfer by the ABC Partnership to X Corporation.

Example 4. (i) The facts are the same as in example 3 except that partnership ABC transfers 10 percent of the stock in X Corporation to each of 8 partners, 20 percent to partner A, and cash to partner B.

(ii) Under subparagraph (1)(i) of this paragraph, with respect to all of the partners (including partner A) except partner B, paragraph (a) of § 1.47–1 does not apply to the March 15, 1963, transfer by the ABC Partnership to X Corporation. Paragraph (a) of § 1.47–1 applies with respect to partner B's $2,000 share of the item of section 38 property. See paragraph (a)(1) of § 1.47–6.

Example 5. (i) X Corporation operates a manufacturing business and a separate personal service business. On January 1, 1962, X acquired and placed in service a truck, which qualified as section 38 property, in its manufacturing business. The truck had a basis of $10,000 and an estimated useful life of 8 years. On February 10, 1965, X transfers all the assets used in its manufacturing business to Partnership XY in exchange for a 50-percent interest in such partnership.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.47–1 does not apply to the February 10, 1965, transfer to Partnership XY.

(g) *Sale-and-leaseback transactions*—(1) *In general.* Notwithstanding the provisions of § 1.47–2, relating to ''disposition'' and ''cessation'', paragraph (a) of § 1.47–1 shall not apply where section 38 property is disposed of and as part of the same transaction is leased back to the vendor even though gain or loss is recognized to the vendor-lessee and the property ceases to be subject to depreciation in his hands. If paragraph (a) of § 1.47–1 applies with respect to such property subsequent to the transaction, the actual useful life shall begin with the date on which such property was first placed in service by the vendor-lessee as owner.

(2) *Special rule for progress expenditure property.* The sale and leaseback (or agreement or contract to leaseback) of progress expenditure property (including any contract rights to the property), in general, will be treated as a cessation described in section 47(a)(3)(A) with respect to the seller-lessee. However, a sale and leaseback (or agreement or contract to leaseback) will not be treated as a cessation to the extent qualified investment passed through to the lessee under section 48(d) in the year the property is placed in service equals or exceeds qualified progress expenditures for the property taken into account by the lessee. If a sale-leaseback transaction is treated as a cessation, qualified investment must be reduced and the credit recomputed, beginning with the most recent credit year (*i.e.,* the most recent year property is taken into account in computing qualified investment under § 1.46–3 or 1.46–5). The amount of the reduction is the amount, if any, by which qualified progress expenditures taken into account by the lessee in all prior years exceeds qualified investment passed through to the lessee under section 48(d). This paragraph (g)(2) does not apply to any progress expenditure property that has been placed in service by a vendor-lessee (as described in paragraph (g)(1) of this section) prior to a sale-leaseback of that property in a transaction described in paragraph (g)(1) of this section.

(h) *Certain property replaced after April 18, 1969*—(1) *In general.* (i) If section 38 property is disposed of and property which is, for purposes of section 1033 and the regulations thereunder, similar or related in service or use to the property disposed of and which would be section 38 property but for the application of section 49 is placed in service to replace the property disposed of, the increase in income tax and adjustment of investment credit carryovers and carrybacks resulting from the recomputation under paragraph (a) of §1.47–1 shall be reduced (but not below zero) by the credit that would be allowed for the qualified investment of the replacement property (determined as if such property were section 38 property). The preceding sentence shall not apply unless the replacement takes place within 6 months after the disposition. If property otherwise qualifies as replacement property, it is immaterial that it is placed in service (for example, to undergo testing) before the replaced property is disposed of. The assignment by the taxpayer in his return of an estimated useful life to the replacement property in computing its qualified investment will be considered a representation by the taxpayer that he expects to retain the replacement property for its entire estimated useful life. If such property is disposed of before the end of such life, then the circumstances surrounding the replacement will be examined to determine whether the taxpayer's representation was in good faith and, if appropriate, the qualified investment of the replacement property will be recomputed for the year of replacement using the actual useful life of such property.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On January 1, 1967, A, a calendar year taxpayer, acquired and placed in service a new machine with a basis of $100 and an estimated useful life of 8 years. A's qualified investment was $100 and his credit earned was $7, which was allowed as a credit against tax for 1967. On January 15, 1971. A disposed of the machine and replaced it with a similar new machine costing $75 and having an estimated useful life of 8 years. The new machine would be section 38 property but for section 49. Since the actual useful life of the original machine was at least 4 but less than 6 years, the recomputed qualified investment of the machine is $33.33 (33⅓ percent of $100) and under paragraph (a) of §1.47–1 the amount of recapture tax would be $4.67 ($7, the original credit earned, minus $2.33, the recomputed credit earned). However, under the provisions of this paragraph, the recapture tax is reduced (but not below zero) by the credit that would be allowed for the replacement property (determined as if such property were section 38 property). Under these facts the recapture tax is zero ($4.67, the recapture tax with respect to the original machine, minus $5.25, the credit that would be allowed on the new machine).

(2) *Leased property.* Property disposed of may be replaced with property leased from another, provided (i) an election with respect to the newly leased property could be made under section 48(d) but for section 49, and (ii) the lessee obtains the lessor's written statement that he will not claim such property as replacement property under this paragraph. The statement of the lessor shall contain the information specified in subdivisions (i) through (vii) of §1.48–4(f)(1) and the statement (or a copy thereof) shall be retained in the records of the lessor and the lessee for a period of at least 3 years after the property is transferred to the lessee.

[T.D. 6931, 32 FR 14033, Oct. 10, 1967, as amended by T.D. 7126, 36 FR 11192, June 10, 1971; T.D. 7203; 37 FR 17128, Aug. 25, 1972; T.D. 8183, 53 FR 6625, Mar. 2, 1988]

§1.47–4 Electing small business corporation.

(a) *In general*—(1) *Disposition or cessation in hands of corporation.* If an electing small business corporation (as defined in section 1371(b)) or a former electing small business corporation disposes of any section 38 property (or if any section 38 property otherwise ceases to be section 38 property in the hands of the corporation) before the close of the estimated useful life which was taken into account in computing qualified investment with respect to such property, a recapture determination shall be made with respect to each shareholder who is treated, under §1.48–5, as a taxpayer with respect to such property. Each such recapture determination shall be made with respect to the pro rata share of the basis (or cost) of such property taken into account by such shareholder in computing his qualified investment. For purposes of each such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the electing small business corporation and ending with the date of the disposition or cessation. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determinations made with respect to the shareholder in connection with the same property. For definition of ''recapture determination'' see paragraph (a)(1) of §1.47–1.

(2) *Disposition of shareholder's interest.* (i) If—

(a) The basis (or cost) of section 38 property is apportioned, under §1.48–5, to a shareholder of an electing small business corporation who takes such basis (or cost) into account in computing his qualified investment, and

(b) After the end of the shareholder's taxable year in which such apportionment was taken into account and before the close of the estimated useful life of the property, such shareholder's proportionate stock interest in such corporation is reduced (for example, by a sale or redemption, or by the issuance of additional shares) below the percentage specified in subdivision (ii) of this subparagraph,

then, on the date of such reduction such section 38 property ceases to be section 38 property with respect to such shareholder to the extent of the actual reduction in such shareholder's proportionate stock interest. (For example, if $100 of the basis of section 38 property was apportioned to a shareholder and if his proportionate stock interest is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then such property shall be treated as having ceased to be section 38 property to the extent of $50.) Accordingly, a recapture determination shall be made with respect to such shareholder. For purposes of such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the electing small business corporation and ending with the date on which it is treated as having ceased to be section 38 property with respect to the shareholder. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determination made with respect to the shareholder in connection with the same property.

(ii) The percentage referred to in subdivision (i)*(b)* of this subparagraph is 66⅔ percent of the shareholder's proportionate stock interest in the corporation on the date of the apportionment under §1.48–5. However, once property has been treated under this subparagraph as having ceased to be section 38 property to any extent the percentage referred to shall be 33⅓ percent of the shareholder's proportionate stock interest in the corporation on the date of the apportionment under §1.48–5.

(iii) In determining a shareholder's proportionate stock interest in a former electing small business corporation for purposes of this subparagraph, the shareholder shall be considered to own stock in such corporation which he owns directly or indirectly (through ownership in other entities provided such other entities' bases in such stock are determined in whole or in part by reference to the basis of such stock in the hands of the transferor). For example, if A, who owns all of the 100 shares of the outstanding stock of corporation X, a corporation which was formerly an electing small business corporation, transfers on November 1, 1966, 70 shares of X stock to corporation Y in exchange for 90 percent of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own 93 percent of the stock of X, 30 percent directly and 63 percent indirectly (i.e., 90 percent of 70). Any taxpayer who seeks to establish his interest in the stock of a former electing small business corporation under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the corporation after any such transfer or transfers.

(b) *Election of a small business corporation under section 1372*—(1) *General rule.* If a corporation makes a valid election under section 1372 to be an electing small business corporation (as defined in section 1371(b)), then on the last day of the taxable year immediately preceding the first taxable year for which such election is effective, any section 38 property the basis (or cost) of which was taken into account in computing the corporation's qualified investment in taxable years prior to the first taxable year for which the election is effective (and which has not been disposed of or otherwise ceased to be section 38 property with respect to the corporation prior to such last day) shall be considered as having ceased to be section 38 property with respect to such corporation and §1.47–1 shall apply. However, if the corporation and each of the persons who are shareholders of the corporation on the first day of the first taxable year for which the election under section 1372 is to be effective, or on the date of such election, whichever is later, execute the agreement specified in subparagraph (2) of this paragraph, §1.47–1 shall not apply to any such section 38 property by reason of the election by the corporation under section 1372.

(2) *Agreement of shareholders and corporation.* (i) The agreement referred to in subparagraph (1) of this paragraph shall be signed by the shareholders and the corporation, and shall recite that, in the event the section 38 property described in subparagraph (1) of this paragraph is later disposed of by, or ceases to be section 38 property with respect to, the corporation during a taxable year of the corporation for which the election under section 1372 is effective, each such signer agrees *(a)* to notify the district director of such disposition or cessation, and *(b)* to be jointly and severally liable to pay to the district director an amount equal to the increase in tax provided by section 47. The amount of such increase shall be determined as if such property had ceased to be section 38 property as of the last day of the taxable year immediately preceding the first taxable year for which the election under section 1372 is effective, except that the actual useful life (within the meaning of paragraph (a) of §1.47–1) of the property shall be considered to have ended on the date of the actual disposition by, or cessation in the hands of, the electing small business corporation.

(ii) The agreement shall set forth the name, address, and taxpayer account number of each party and the internal revenue district in which each such party files his or its income tax return for the taxable year which includes the last day of the corporation’s taxable year immediately preceding the first taxable year for which the election under section 1372 is effective. The agreement may be signed on behalf of the corporation by any person who is duly authorized. The agreement shall be filed with the district director with whom the corporation files its income tax return for its taxable year immediately preceding the first taxable year for which the election under section 1372 is effective and shall be filed on or before the due date (including extensions of time) of such return. However, if the due date (including extensions of time) of such income tax return is on or before September 1, 1967, the agreement may be filed on or before December 31, 1967. For purposes of the two preceding sentences, the district director may, if good cause is shown, permit the agreement to be filed on a later date.

(c) *Examples.* This section may be illustrated by the following examples in each of which it is assumed that X Corporation, an electing small business corporation which makes its returns on the basis of the calendar year, acquired and placed in service on June 1, 1962, three items of section 38 property. The basis and estimated useful life of each item of section 38 property are as follows:

Asset No.	Basis	Estimated useful life (Years)
1	$30,000	4
2	30,000	6
3	30,000	8

On December 31, 1962, X Corporation had 20 shares of stock outstanding which were owned equally by A and B who make their returns on the basis of a calendar year. Under §1.48–5, the total bases of section 38 properties was apportioned to the shareholders of X Corporation as follows:

	Useful life category		
	4 to 6 years	6 to 8 years	8 years or more
Total bases	$30,000	$30,000	$30,000
Shareholder A (10/20)	15,000	15,000	15,000
Shareholder B (10/20)	15,000	15,000	15,000

Assuming that during 1962 shareholders A and B did not place in service any section 38 property and that they did not own any interests in other electing small business corporations, partnerships, estates, or trusts, the qualified investment of each shareholder is $30,000, computed as follows:

Basis	Applicable percentage	Qualified investment
$15,000	33⅓	$5,000
$15,000	66⅔	10,000
$15,000	100	15,000
		30,000

For the taxable year 1962, each shareholder's credit earned of $2,100 (7 percent of $30,000) was allowed under section 38 as a credit against his liability for tax.

Example 1. (i) On December 2, 1965, X Corporation sells asset No. 3 to Y Corporation.

(ii) The actual useful life of asset No. 3 is three years and six months. The recomputed qualified investment with respect to each shareholder's share of the basis of asset No. 3 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962 each shareholder's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on each of the shareholders for the taxable year 1965 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

Example 2. (i) On December 3, 1964, shareholder A sells 5 of his 10 shares of stock in X Corporation to C, and on December 3, 1965, A sells his remaining 5 shares of stock to D. In addition, on January 2, 1966, X Corporation sells asset No. 3 to Y Corporation.

(ii) Under paragraph (a)(2) of this section, on December 3, 1964, 50 percent of the share of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to shareholder A since immediately after the December 3, 1964, sale A's proportionate stock interest in X Corporation is reduced to 50 percent of the proportionate stock interest in X Corporation which he held on December 31, 1962. The actual useful life of the share of the bases of the section 38 properties which cease to be section 38 property with respect to A is two years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1964). A's recomputed qualified investment with respect to such properties is $15,000, computed as follows:

Basis	Applicable percentage	Recomputed qualified investment
$7,500	33⅓	$2,500
$7,500	66⅔	5,000
$7,500	100	7,500
		15,000

For the taxable year 1962 shareholder A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on shareholder A for the taxable year 1964 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

(iii) Under paragraph (a)(2) of this section, on December 3, 1965, the remaining 50 percent of the share of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to shareholder A since immediately after the December 3, 1965, sale A's proportionate stock interest in X Corporation is reduced to zero. The actual useful life of the share of the bases of the section 38 properties which cease to be section 38 property with respect to A is three years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1965). A's recomputed qualified investment with respect to such properties is zero. For the taxable year 1962 shareholder A's recomputed credit earned is zero. The income tax imposed by chapter 1 of the Code on shareholder A for the taxable year 1965 is increased by $1,050 (that is, $2,100 ($2,100 original credit earned minus zero recomputed credit earned) reduced by the $1,050 increase in tax for 1964).

(iv) The actual useful life of asset No. 3 which was sold on January 2, 1966, is three years and seven months. The recomputed qualified investment with respect to B's share of the basis of asset No. 3 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962, B's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on shareholder B for the taxable year 1966 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 ($2,100 original credit earned minus $1,050 recomputed credit earned). The sale of asset No. 3 on January 2, 1966, by X Corporation has no effect on A.

(d) *Termination or revocation of an election under section 1372.* Section 38 property shall not be considered to be disposed of or to have ceased to be section 38 property solely by reason of a termination or revocation of a corporation's election under section 1372.

[T.D. 6931, 32 FR 14035, Oct. 10, 1967]

§1.47–5 Estates and trusts.

(a) *In general*—(1) *Disposition or cessation in hands of estate or trust.* If an estate or trust disposes of any section 38 property (or if any section 38 property otherwise ceases to be section 38 property in the hands of the estate or trust) before the close of the estimated useful life which was taken into account in computing qualified investment with respect to such property, a recapture determination shall be made with respect to the estate or trust, and each beneficiary who is treated, under §1.48–6, as a taxpayer with respect to such property. Each such recapture determination shall be made with respect to the share of the basis (or cost) of such property taken into account by such estate or trust and such beneficiary in computing its or his each such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the estate or trust and ending with the date of the disposition or cessation. In making a recapture determination under this subparagraph with respect to a taxpayer there shall be taken into account any prior recapture determinations made with respect to such taxpayer in connection with the same property. For definition of ‘‘recapture determination’’ see paragraph (a)(1) of §1.47–1.

(2) *Disposition of interest.* (i) If—

(a) The basis (or cost) of section 38 property is apportioned, under §1.48–6, to an estate or trust which, or to a beneficiary of an estate or trust who, takes such basis (or cost) into account in computing his qualified investment, and

(b) After the date on which such section 38 property was placed in service by the estate or trust and before the close of the estimated useful life of the property, such estate’s, trust’s, or such beneficiary’s proportionate interest in the income of the estate or trust is reduced (for example, by a sale, or by the terms of the estate or trust instrument) below the percentage specified in subdivision (ii) of this subparagraph, then, on the date of such reduction, such section 38 property ceases to be section 38 property with respect to such estate, trust, or beneficiary to the extent of the actual reduction in such estate’s, trust’s, or beneficiary’s proportionate interest in the income of the estate or trust. (For example, if $100 of the basis of section 38 property was apportioned to a beneficiary and if his proportionate interest in the income of the estate or trust is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then such property shall be treated as having ceased to be section 38 property to the extent of $50). Accordingly, a recapture determination shall be made with respect to such estate, trust, or beneficiary. For purposes of such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the estate or trust and ending with the date on which it is treated as having ceased to be section 38 property with respect to the estate, trust, or beneficiary. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determination made with respect to the estate, trust, or beneficiary in connection with the same property.

(ii) The percentage referred to in subdivision (i)*(b)* of this subparagraph is 66⅔ percent of the estate’s, trust’s, or beneficiary’s proportionate interest in the income of the estate or trust for the taxable year of the apportionment under §1.48–6. However, once property has been treated under this subparagraph as having ceased to be section 38 property to any extent the percentage referred to shall be 33⅓ percent of the estate’s, trust’s, or beneficiary’s proportionate interest in the income of the estate or trust for the taxable year of the apportionment under §1.48–6.

(iii) In determining a beneficiary’s proportionate interest in the income of an estate or trust for purposes of this subparagraph, the beneficiary shall be considered to own any interest in such an estate or trust which he owns directly or indirectly (through ownership in other entities provided such other entities’ bases in such interest are determined in whole or in part by reference to the basis of such interest in the hands of the beneficiary). For example, if A, whose proportionate interest in the income of trust X is 30 percent, transfers all of such interest to corporation Y in exchange for all of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own a 30-percent interest in trust X. Any taxpayer who seeks to establish his interest in an estate or trust under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the estate or trust after any such transfer or transfers.

(b) *Examples.* Paragraph (a) of this section may be illustrated by the following examples in each of which it is assumed that XYZ Trust, which makes its returns on the basis of the calendar year, acquired and placed in service on June 1, 1962, three items of section 38 property. The basis and estimated useful life of each item of section 38 property are as follows:

Asset No.	Basis	Estimated useful life (Years)
1	$30,000	4
2	30,000	6
3	30,000	8

For the taxable year 1962 the income of XYZ Trust is $20,000, which is allocable equally to XYZ Trust and beneficiary A. Beneficiary A makes his returns on the basis of a calendar year. Under § 1.48–6, the total bases of the section 38 properties was apportioned to XYZ Trust and beneficiary A as follows:

		Useful life category		
		4 to 6 years	6 to 8 years	8 years or more
Total bases		$30,000	$30,000	$30,000
	($10,000)	15,000	15,000	15,000
XYZ Trust	($20,000)			
Beneficiary A	($10,000)	15,000	15,000	15,000
	($20,000)			

Assuming that during 1962 beneficiary A did not place in service any section 38 property and that he did not own any interests in other estates, trusts, electing small business corporations, or partnerships, the qualified investment of XYZ Trust and of beneficiary A is $30,000 each, computed as follows:

Basis	Applicable percentage	Qualified investment
$15,000	33⅓	$5,000
$15,000	66⅔	10,000
$15,000	100	15,000
		30,000

For the taxable year 1962, XYZ Trust and beneficiary A each had a credit earned of $2,100 (7 percent of $30,000). Each such credit earned was allowed under section 38 as a credit against the liability for tax.

Example 1. (i) On December 2, 1965, XYZ Trust sells asset No. 3 to X Corporation.

(ii) The actual useful life of asset No. 3 is three years and six months. The recomputed qualified investment with respect to XYZ Trust's and beneficiary A's share of the basis of asset No. 3 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962, XYZ Trust's and beneficiary A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on XYZ Trust and on beneficiary A for the taxable year 1965 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

Example 2. (i) On December 3, 1964, beneficiary A sells 50 percent of his interest in the income of XYZ Trust to B, and on December 3, 1965, A sells his remaining 50 percent interest to C. In addition, on January 2, 1966, XYZ Trust sells asset No. 3 to Y Corporation.

(ii) Under paragraph (a)(2) of this section, on December 3, 1964, 50 percent of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to beneficiary A since immediately after the December 3, 1964, sale A's proportionate interest in the income of XYZ Trust is reduced to 50 percent of his proportionate interest in the income of XYZ Trust for the taxable year 1962. The actual useful life of the share of the bases of the section 38 properties which cease to be section 38 property with respect to A is two years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1964). Beneficiary A's recomputed qualified investment with respect to such properties is $15,000, computed as follows:

Basis	Applicable percentage	Qualified investment
$7,500	33⅓	$2,500
$7,500	66⅔	5,000
$7,500	100	7,500
		15,000

For the taxable year 1962 beneficiary A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on beneficiary A for the taxable year 1964 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

(iii) Under paragraph (a)(2) of this section, on December 3, 1965, the remaining 50 percent of the share of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to beneficiary A since immediately after the December 3, 1965, sale A's proportionate interest in the income of XYZ Trust is reduced to zero. The actual useful life of the share of the basis of the section 38 properties which cease to be section 38 property with respect to A is three years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1965). A's recomputed qualified investment with respect to such properties is zero. For the taxable year 1962 beneficiary A's recomputed credit earned is zero. The income tax imposed by chapter 1 of the Code on beneficiary A for the taxable year 1965 is increased by $1,050 (that is, $2,100 ($2,100 original credit earned minus zero recomputed credit earned) reduced by the $1,050 increase in tax for 1964).

(iv) The actual useful life of asset No. 3 which was sold on January 2, 1966, is three years and seven months. The recomputed qualified investment with respect to XYZ Trust's share of the basis of asset No. 3 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962, XYZ Trust's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on XYZ Trust for the taxable year 1966 is increased by the $1,050 decrease in its credit earned for the taxable year 1962 ($2,100 original credit earned minus $1,050 recomputed credit earned). The sale of asset No. 3 on January 2, 1966, has no effect on A.

[T.D. 6931, 32 FR 14037, Oct. 10, 1967]

§1.47–6 Partnerships.

(a) *In general*—(1) *Disposition or cessation in hands of partnership.* If a partnership disposes of any partnership section 38 property (or if any partnership section 38 property otherwise ceases to be section 38 property in the hands of the partnership) before the close of the estimated useful life which was taken into account in computing qualified investment with respect to such property, a recapture determination shall be made with respect to each partner who is treated, under paragraph (f) of §1.46–3, as a taxpayer with respect to such property. Each such recapture determination shall be made with respect to the share of the basis (or cost) of such property taken into account by such partner in computing his qualified investment. For purposes of each such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the partnership and ending with the date of the disposition or cessation. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determinations made with respect to the partner in connection with the same property. For definition of "recapture determination" see paragraph (a)(1) of §1.47–1.

(2) *Disposition of partner's interest.* (i) If—

(a) The basis (or cost) of partnership section 38 property is taken into account by a partner in computing his qualified investment, and

(b) After the date on which such partnership section 38 property was placed in service by the partnership and before the close of the estimated useful life of the property, such partner's proportionate interest in the general profits of the partnership (or in the particular item of property) is reduced (for example, by a sale, by a change in the partnership agreement, or by the admission of a new partner) below the percentage specified in subdivision (ii) of this subparagraph, then, on the date of such reduction such partnership section 38 property ceases to be section 38 property with respect to such partner to the extent of the actual reduction in such partner's proportionate interest

in the general profits of the partnership (or in the particular item of property). (For example, if $100 of the basis of section 38 property was taken into account by a partner and if his proportionate interest in the general profits of the partnership is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then such property shall be treated as having ceased to be section 38 property to the extent of $50.) Accordingly, a recapture determination shall be made with respect to such partner. For purposes of such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the partnership and ending with the date on which it is treated as having ceased to be section 38 property with respect to the partner. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determination made with respect to the partner in connection with the same property.

(ii) The percentage referred to in subdivision (i)*(b)* of this subparagraph is 66⅔ percent of the partner's proportionate interest in the general profits of the partnership (or in the particular item of property) for the year in which such property was placed in service. However, once property has been treated under this subparagraph as having ceased to be section 38 property to any extent the percentage referred to shall be 33⅓ percent of the partner's proportionate interest in the general profits of the partnership (or in the particular item of property) for the year in which such property was placed in service.

(iii) In determining a partner's proportionate interest in the general profits of a partnership for purposes of this subparagraph, the partner shall be considered to own any interest in such a partnership which he owns directly or indirectly (through ownership in other entities provided the other entities' bases in such interest are determined in whole or in part by reference to the basis of such interest in the hands of the partner). For example, if A, whose proportionate interest in the general profits of partnership X is 20 percent, transfers all of such interest to corporation Y in exchange for all of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own a 20-percent interest in partnership X. Any taxpayer who seeks to establish his interest in a partnership under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the partnership after any such transfer or transfers.

(b) *Examples.* Paragraph (a) of this section may be illustrated by the following examples in each of which it is assumed that ABC Partnership, which makes its returns on the basis of the calendar year, acquired and placed in service on June 1, 1962, three items of section 38 property. The basis and estimated useful life of each item of section 38 property are as follows:

Asset No.	Basis	Estimated useful life Years
1	$30,000	4
2	30,000	6
3	30,000	8

Partners A and B, who make their returns on the basis of a calendar year, share the profits and losses of ABC Partnership equally. Under paragraph (f)(2) of § 1.46–3, each partner's share of the basis of the partnership section 38 property is as follows:

Asset No.	Estimated useful life (years)	Basis	Partners share of basis	
			A 50 percent	B 50 percent
1	4	$30,000	$15,000	$15,000
2	6	30,000	15,000	15,000
3	8	30,000	15,000	15,000

Assuming that during 1962 partners A and B did not place in service any section 38 property and that they did not own any interests in other partnerships, electing small business corporations, estates, or trusts, the qualified investment of each partner is $30,000, computed as follows:

Partnership asset No.	Share of basis	Applicable percentage	Qualified investment
1	$15,000	33⅓	$5,000
2	15,000	66⅔	10,000
3	15,000	100	15,000
			30,000

For the taxable year 1962, each partner's credit earned of $2,100 (7 percent of $30,000) was allowed under section 38 as a credit against his liability for tax.

Example 1. (i) On December 2, 1965, ABC Partnership sells asset No. 3 to X Corporation.

(ii) The actual useful life of asset No. 3 is three years and six months. The recomputed qualified investment with respect to each partner's share of the basis of asset No. 3 is zero ($15,000 shares of basis multiplied by zero applicable percentage) and for the taxable year 1962, each partner's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on each of the partners for the taxable year 1965 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

Example 2. (i) On December 3, 1964, partner A sells one-half of his 50 percent interest in ABC Partnership to C, and on December 3, 1965, A sells the remaining one- half of his interest to D. In addition, on January 2, 1966, ABC Partnership sells asset No. 3 to X Corporation.

(ii) Under paragraph (a)(2) of this section, on December 3, 1964, 50 percent of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to partner A since immediately after the December 3, 1964, sale A's proportionate interest in the general profits of ABC Partnership is reduced to 50 percent of his proportionate interest in the general profits of ABC Partnership for 1962. The actual useful life of the share of the basis of each of the section 38 properties which cease to be section 38 property with respect to A is two years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1964). Partner A's recomputed qualified investment with respect to such properties is $15,000, computed as follows:

Partnership asset No.	Share of basis	Applicable percentage	Qualified investment
1	$7,500	33⅓	$2,500
2	7,500	66⅔	5,000
3	7,500	100	7,500
			15,000

For the taxable year 1962 partner A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on partner A for the taxable year 1964 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

(iii) Under paragraph (a)(2) of this section, on December 3, 1965, the remaining 50 percent of the share of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to partner A since immediately after the December 3, 1965, sale A's proportionate interest in the general profits of ABC Partnership is reduced to zero. The actual useful life of the share of the bases of the section 38 properties which cease to be section 38 property with respect to A is three years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1965). A's recomputed qualified investment with respect to such properties is zero. For the taxable year 1962 partner A's recomputed credit earned is zero. The income tax imposed by chapter 1 of the Code on partner A for the taxable year 1965 is increased by $1,050 (that is, $2,100 ($2,100 original credit earned minus zero recomputed credit earned) reduced by the $1,050 increase in tax for 1964).

(iv) The actual useful life of asset No. 3 which was sold on January 2, 1966, is three years and seven months. The recomputed qualified investment with respect to partner B's share of the basis of asset No. 3 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962, partner B's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on partner B for the taxable year 1966 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 ($2,100 original credit earned minus $1,050 recomputed credit earned). The sale of asset No. 3 on January 2, 1966, has no effect on A.

[T.D. 6931, 32 FR 14039, Oct. 10, 1967]

§1.48–1 Definition of section 38 property.

(a) *In general.* Property which qualifies for the credit allowed by section 38 is known as ''section 38 property''. Except as otherwise provided in this section, the term ''section 38 property'' means property (1) with respect to which depreciation (or amortization in lieu of depreciation) is allowable to the taxpayer, (2) which has an estimated useful life of 3 years or more (determined as of the time such property is placed in service), and (3) which is (i) tangible personal property, (ii) other tangible property (not including a building and its structural components) but only if such other property is used as an integral part of manufacturing, production, or extraction, or an an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or is a research or storage facility used in connection with any of the foregoing activities, (iii) an elevator or escalator which satisfies the conditions of section 48(a)(1)(C), or (iv) in the case of a qualified rehabilitated building, that portion of the basis which is attributable to qualified rehabilitation expenditures. The determination of whether property qualifies as section 38 property in the hands of the taxpayer for purposes of the credit allowed by section 38 must be made with respect to the first taxable year in which such property is placed in service by the taxpayer. See paragraph (d) of § 1.46–3. For the meaning of ''estimated useful life'', see paragraph (e) of § 1.46–3. In the case of property which is not described in section 50, this paragraph shall be applied by substituting ''4 years'' for ''3 years''.

(b) *Depreciation allowable.* (1) Property (with the exception of property described in section 48(a)(1)(F) and paragraph (p) of this section) is not section 38 property unless a deduction for depreciation (or amortization in lieu of depreciation) with respect to such property is allowable to the taxpayer for the taxable year. A deduction for depreciation is allowable if the property is of a character subject to the allowance for depreciation under section 167 and the basis (or cost) of the property is recovered through a method of depreciation, including, for example, the unit of production method and the retirement method as well as methods of depreciation which measure the life of the property in terms of years. If property is placed in service (within the meaning of paragraph (d) of § 1.46–3) in a trade or business (or in the production of income), but under the taxpayer's depreciation practice the period for depreciation with respect to such property begins in a taxable year subsequent to the taxable year in which such property is placed in service, then a deduction for depreciation shall be treated as allowable with respect to such property in the earlier taxable year (or years). Thus, for example, if a machine is placed in service in a trade or business in 1963, but the period for depreciation with respect to such machine begins in 1964, because the taxpayer uses an averaging convention (see § 1.167(a)–10) in computing depreciation, then, for purposes of determining whether the machine qualifies as section 38 property, a deduction for depreciation shall be treated as allowable in 1963.

(2) If, for the taxable year in which property is placed in service, a deduction for depreciation is allowable to the taxpayer only with respect to a part of such property, then only the proportionate part of the property with respect to which such deduction is allowable qualifies as section 38 property for the purpose of determining the amount of credit allowable under section 38. Thus, for example, if property is used 80 percent of the time in a trade or business and is used 20 percent of the time for personal purposes, only 80 percent of the basis (or cost) of such property qualifies as section 38 property. Further, property does not qualify to the extent that a deduction for depreciation thereon is disallowed under section 274 (relating to disallowance of certain entertainment, etc., expenses).

(3) If the cost of property is not recovered through a method of depreciation but through a deduction of the full cost in one taxable year, for purposes of subparagraph (1) of this paragraph a deduction for depreciation with respect to such property is not allowable to the taxpayer. However, if an adjustment with respect to the income tax return for such taxable year requires the cost of such property to be recovered through a method of depreciation, a deduction for depreciation will be considered as allowable to the taxpayer.

(4) If depreciation sustained on property is not an allowable deduction for the taxable year but is added to the basis of property being constructed, reconstructed, or erected by the taxpayer, for purposes of subparagraph (1) of this paragraph a deduction for depreciation shall be treated as allowable for the taxable year with respect to the property on which depreciation is sustained. Thus, if $1,000 of depreciation sustained with respect to property No. 1, which is placed in service in 1964 by taxpayer A, is not allowable to A as a deduction for 1964 but is added to the basis of property being constructed by

A (property no. 2), for purposes of subparagraph (1) of this paragraph a deduction for depreciation shall be treated as allowable to A for 1964 with respect to property no. 1. However, the $1,000 amount is not included in the basis of property no. 2 for purposes of determining A's qualified investment with respect to property no. 2. See paragraph (c)(1) of §1.46–3.

(c) *Definition of tangible personal property.* If property is tangible personal property it may qualify as section 38 property irrespective of whether it is used as an integral part of an activity (or constitutes a research or storage facility used in connection with such activity) specified in paragraph (a) of this section. Local law shall not be controlling for purposes of determining whether property is or is not ''tangible'' or ''personal''. Thus, the fact that under local law property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of the investment credit even though under local law the property is considered to be a fixture and therefore real property. For purposes of this section, the term ''tangible personal property'' means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38. Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property.

(d) *Other tangible property*—(1) *In general.* In addition to tangible personal property, any other tangible property (but not including a building and its structural components) used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or which constitutes a research or storage facility used in connection with any of the foregoing activities, may qualify as section 38 property.

(2) *Manufacturing, production, and extraction.* For purposes of the credit allowed by section 38, the terms ''manufacturing'', ''production'', and ''extraction'' include the construction, reconstruction, or making of property out of scrap, salvage, or junk material, as well as from new or raw material, by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles, and include the cultivation of the soil, the raising of livestock, and the mining of minerals. Thus, section 38 property would include, for example, property used as an integral part of the extracting, processing, or refining of metallic and nonmetallic minerals, including oil, gas, rock, marble, or slate; the construction of roads, bridges, or housing; the processing of meat, fish or other foodstuffs; the cultivation of orchards, gardens, or nurseries; the operation of sawmills, the production of lumber, lumber products or other building materials; the fabrication or treatment of textiles, paper, leather goods, or glass; and the rebuilding, as distinguished from the mere repairing, of machinery.

(3) *Transportation and communications businesses.* Examples of transportation businesses include railroads, airlines, bus companies, shipping or trucking companies, and oil pipeline companies. Examples of communications businesses include telephone or telegraph

companies and radio or television broadcasting companies.

(4) *Integral part.* In order to qualify for the credit, property (other than tangible personal property and research or storage facilities used in connection with any of the activities specified in subparagraph (1) of this paragraph) must be used as an integral part of one or more of the activities specified in subparagraph (1) of this paragraph. Property such as pavements, parking areas, inherently permanent advertising displays or inherently permanent outdoor lighting facilities, or swimming pools, although used in the operation of a business, ordinarily is not used as an integral part of any of such specified activities. Property is used as an integral part of one of the specified activities if it is used directly in the activity and is essential to the completeness of the activity. Thus, for example, in determining whether property is used as an integral part of manufacturing, all properties used by the taxpayer in acquiring or transporting raw materials or supplies to the point where the actual processing commences (such as docks, railroad tracks and bridges), or in processing raw materials into the taxpayer's final product, would be considered as property used as an integral part of manufacturing. Specific examples of property which normally would be used as an integral part of one of the specified activities are blast furnaces, oil and gas pipelines, railroad tracks and signals, telephone poles, broadcasting towers, oil derricks, and fences used to confine livestock. Property shall be considered used as an integral part of one of the specified activities if so used either by the owner of the property or by the lessee of the property.

(5) *Research or storage facilities.* (i) If property (other than a building and its structural components) constitutes a research or storage facility and if it is used in connection with an activity specified in subparagraph (1) of this paragraph, such property may qualify as section 38 property even though it is not used as an integral part of such activity. Examples of research facilities include wind tunnels and test stands. Examples of storage facilities include oil and gas storage tanks and grain storage bins. Although a research or storage facility must be used in connection with, for example, a manufacturing process, the taxpayer-owner of such facility need not be engaged in the manufacturing process.

(ii) In the case of property described in section 50, property will constitute a storage facility only if the facility is used principally for the bulk storage of fungible commodities. Bulk storage means the storage of a commodity in a large mass prior to its consumption or utilization. Thus, if a facility is used to store oranges that have been sorted and boxed, it is not used for bulk storage.

(e) *Definition of building and structural components.* (1) Generally, buildings and structural components thereof do not qualify as section 38 property. See, however, section 48(a)(1)(E) and (g), and § 1.48–11 (relating to investment credit for qualified rehabilitated building). The term ''building'' generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. Such term includes any such structure constructed by, or for, a lessee even if such structure must be removed, or ownership of such structure reverts to the lessor, at the termination of the lease. Such term does not include (i) a structure which is essentially an item of machinery or equipment, or (ii) a structure which houses property used as an integral part of an activity specified in section 48(a)(1)(B)(i) if the use of the structure is so closely related to the use of such property that the structure clearly can be expected to be replaced when the property it initially houses is replaced. Factors which indicate that a structure is closely related to the use of the property it houses include the fact that the structure is specifically designed to provide for the stress and other demands of such property and the fact that the structure could not be economically used for other purposes.

Thus, the term ‘‘building’’ does not include such structures as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnaces, basic oxygen furnaces, coke ovens, brick kilns, and coal tipples.

(2) The term ‘‘structural components’’ includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building. However, the term ‘‘structural components’’ does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the ‘‘sole justification’’ test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential. For example, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term ‘‘structural components’’. For special rules with respect to an elevator or escalator, the construction, reconstruction, or erection of which is completed by the taxpayer after June 30, 1963, or which is acquired after June 30, 1963, and the original use of which commences with the taxpayer and commences after such date, see section 48(a)(1)(C) and paragraph (m) of this section.

(f) *Intangible property.* Intangible property, such as patents, copyrights, and subscription lists, does not qualify as section 38 property. The cost of intangible property, in the case of a patent or copyright, includes all costs of purchasing or producing the item patented or copyrighted. Thus, in the case of a motion picture or television film or tape, the cost of the intangible property includes manuscript and screenplay costs, the cost of wardrobe and set design, the salaries of cameramen, actors, directors, etc., and all other costs properly includible in the basis of such film or tape. In the case of a book, the cost of the intangible property includes all costs of producing the original copyrighted manuscript, including the cost of illustration, research, and clerical and stenographic help. However, if tangible depreciable property is used in the production of such intangible property, see paragraph (b)(4) of this section.

(g) *Property used outside the United States*—(1) *General rule.* (i) Except as provided in subparagraph (2) of this paragraph, the term ‘‘section 38 property’’ does not include property which is used predominantly outside the United States (as defined in section 7701(a)(9)) during the taxable year. The determination of whether property is used predominantly outside the United States during the taxable year shall be made by comparing the period of time in such year during which the property is physically located outside the United States with the period of time in such year during which the property is physically located within the United States. If the property is physically located outside the United States during more than 50 percent of the taxable year, such property shall be considered used predominantly outside the United States during that year. If property is placed in service after the first day of the taxable year, the determination of whether such property is physically located outside the United States during more than 50 percent of the taxable year shall be made with respect to the period beginning on the date on which the property is placed in service and ending on the last day of such taxable year.

(ii) Since the determination of whether a credit is allowable to the taxpayer with respect to any property may be made only with respect to the taxable year in which the property is placed in service by the taxpayer, property used predominantly outside the United States during the taxable year in which it is placed in service cannot qualify as section 38 property with respect to such taxpayer, regardless of the fact that the property is permanently returned to the United States in a later year. Furthermore, if property is used predominantly in the United States in the year in which it is placed in service by the taxpayer, and a credit under section 38 is allowed with respect to such property, but such property is thereafter in any one year used predominantly outside the United States, such property ceases to be section 38 property with respect to the taxpayer and is subject to the application of section 47.

(iii) This subparagraph applies whether property is used predominantly outside the United States by the owner of the property, or by the lessee of the property. If property is leased and if the lessor makes a valid election under §1.48–4 to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, the determination of whether such property is physically located outside the United States during more than 50 percent of the taxable year shall be made with respect to the taxable year of the lessee; however, if the lessor does not make such an election, such determination shall be made with respect to the taxable year of the lessor.

(2) *Exceptions.* The provisions of subparagraph (1) of this paragraph do not apply to—

(i) Any aircraft which is registered by the Administrator of the Federal Aviation Agency, and which *(a)* is operated, whether on a scheduled or nonscheduled basis, to and from the United States, or *(b)* is placed in service by the taxpayer during a taxable year ending after March 9, 1967, and is operated under contract with the United States: *Provided,* That use of the aircraft under the contract constitutes its principal use outside the United States during the taxable year. The term ‘‘to and from the United States’’ is not intended to exclude an aircraft which makes flights from one point in a foreign country to another such point, as long as such aircraft returns to the United States with some degree of frequency;

(ii) Rolling stock, of a domestic railroad corporation subject to part I of the Interstate Commerce Act, which is used within and without the United States. For purposes of this subparagraph, the term ‘‘rolling stock’’ means locomotives, freight and passenger train cars, floating equipment, and miscellaneous transportation equipment on wheels, the expenditures for which are chargeable (or, in the case of leased property, would be chargeable) to the equipment investment accounts in the uniform system of accounts for railroad companies prescribed by the Interstate Commerce Commission;

(iii) Any vessel documented under the laws of the United States which is operated in the foreign or domestic commerce of the United States. A vessel is documented under the laws of the United States if it is registered, enrolled, or licensed under the laws of the United States by the Commandant, U.S. Coast Guard. Vessels operated in the foreign or domestic commerce of the United States include those documented for use in foreign trade, coastwise trade, or fisheries;

(iv) Any motor vehicle of a United States person (as defined in section 7701(a)(30)) which is operated to and from the United States with some degree of frequency;

(v) Any container of a United States person which is used in the transportation of property to and from the United States;

(vi) Any property (other than a vessel or an aircraft) of a U.S. person which is used for the purpose of exploring for, developing, removing, or transporting resources from the outer Continental Shelf (within the meaning of section 2 of the Outer Continental Shelf Lands Act, as amended and supplemented; 43 U.S.C. 1331). Thus for example, offshore drilling equipment may be section 38 property;

(vii) Any property placed in service after December 31, 1965 which *(a)* is owned by a domestic corporation (other than a corporation entitled to the benefits of section 931 or 934(b)) or by a United States citizen (other than a citizen entitled to the benefits of section 931, 932, 933, or 934(c)), and *(b)* is used predominantly in a possession of the United States during the taxable year by such a corporation or such a citizen, or by a corporation created or organized in, or under the law of, a possession of the United States. Thus, property placed in service after December 31, 1965, which is owned by a domestic corporation not entitled to the benefits of section 931 or 934(b), which is leased to a corporation organized under the laws of a U.S. possession, and which is used by such lessee predominantly in a possession of the United States may qualify as section 38 property. However, property which is owned by a corporation not entitled to the benefits of section 931 or 934(b) but which is leased to a domestic corporation entitled to such benefits would not qualify as section 38 property. The determination of whether property is used predominantly in a possession of the United States during the taxable year shall be made under principles similar to those described in subparagraph (1) of this paragraph. For example, if a machine is placed in service in a possession of the United States on July 1, 1966, by a calendar year taxpayer and if it is physically located in such a possession during more than 50 percent of the period beginning on July 1, 1966 and ending on December 31, 1966, then such machine shall be considered used predominantly in a possession of the United States during the taxable year 1966;

(viii) Any communications satellite (as defined in section 103(3) of the Communications Satellite Act of 1962, 47 U.S.C., sec. 702(3)), or any interest therein, of a U.S. person;

(ix) Any cable which is property described in section 50, or any interest therein, of a domestic corporation engaged in furnishing telephone service to which section 46(c)(3)(B)(iii) applies (or of a wholly owned domestic subsidiary of such corporation), if such cable is part of a submarine cable system which constitutes part of a communications link exclusively between the United States and one or more foreign countries; and

(x) Any property described in section 50 (other than a vessel or an aircraft) of a U.S. person which is used in international or territorial waters for the purpose of exploring for, developing, removing, or transporting resources from ocean waters or deposits under such waters.

(h) *Property used for lodging*—(1) *In general.* (i) Except as provided in subparagraph (2) of this paragraph, the term ‘‘section 38 property’’ does not include property which is used predominantly to furnish lodging or is used predominantly in connection with the furnishing of lodging during the taxable year. Property used in the living quarters of a lodging facility, including beds and other furniture, refrigerators, ranges, and other equipment, shall be considered as used predominantly to furnish lodging. The term ‘‘lodging facility’’ includes an apartment house, hotel, motel, dormitory, or any other facility (or part of a facility) where sleeping accommodations are provided and let, except that such term does not include a facility used primarily as a means of transportation (such as an aircraft, vessel, or a railroad car) or used primarily to provide medical or convalescent services, even though sleeping accommodations are provided.

(ii) Property which is used predominantly in the operation of a lodging facility or in serving tenants shall be considered used in connection with the furnishing of lodging, whether furnished by the owner of the lodging facility or another person. Thus, for example, lobby furniture, office equipment, and laundry and swimming pool facilities used in the operation of an apartment house or in serving tenants would be considered used predominantly in connection with the furnishing of lodging. However, property which is used in furnishing, to the management of a lodging facility or its tenants, electrical energy, water, sewage disposal services, gas, telephone service, or other similar services shall not be treated as property used in connection with the furnishing of lodging. Thus, such items as gas and electric meters, telephone poles and lines, telephone station and switchboard equipment, and water and gas mains, furnished by a public utility would not be considered as property used in connection with the furnishing of lodging.

(iii) Notwithstanding any other provision of this paragraph (h), in the case of a qualified rehabilitated building (within the meaning of section 48(g)(1) and § 1.48–12(b)), expenditures for property resulting in basis described in section 48(a)(1)(E) shall not be treated as section 38 property to the extent that such property is attributable to a portion of the building that is used for lodging or in connection with lodging. For example, if expenditures are incurred to rehabilitate a five story qualified rehabilitated building, three floors of which are used for apartments and two floors of which are used as commercial office space, the portion of the basis of the building attributable to qualified rehabilitated expenditures attributable to the commercial part of the building shall not be considered to be expenditures for property, or in connection with property, used predominantly for lodging. Allocation of expenditures between the two portions of the building are to be made using the principles contained in § 1.48–12(C)(10)(ii).

(2) *Exceptions*—(i) *Nonlodging commercial facility.* A nonlodging commercial facility which is available to persons not using the lodging facility on the same basis as it is available to the tenants of the lodging facility shall not be treated as property which is used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging. Examples of nonlodging commercial facilities include restaurants, drug stores, grocery stores, and vending machines located in a lodging facility.

(ii) *Property used by a hotel or motel.* Property used by a hotel, motel, inn, or other similar establishment, in connection with the trade or business of furnishing lodging shall not be considered as property which is used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging, provided that the predominant portion of the living accommodations in the hotel, motel, etc., is used by transients during the taxable year. For purposes of the preceding sentence, the term ‘‘predominant portion’’ means ‘‘more than one-half’’. Thus, if more than one-half of the living quarters of a hotel, motel, inn, or other similar establishment is used during the taxable year to accommodate tenants on a transient basis, none of the property used by such hotel, motel, etc., in the trade or business of furnishing lodging shall be considered as property which is used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging. Accommodations shall be considered used on a transient basis if the rental period is normally less than 30 days.

(iii) *Coin-operated machines.* In the case of property which is described in section 50, coin-operated vending machines and coin-operated washing machines and dryers shall not be considered as property which is used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging.

(iv) *Certified historic structures.* For purposes of this paragraph (h), regardless of the actual use of a certified historic structure, that portion of the basis of such certified historic structure which is attributable to qualified rehabilitation expenditures (as defined in § 1.48–12(c)) shall not be considered as property which is either used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging. Accordingly, such portion of the basis may qualify as section 38 property. (For the definition of ‘‘certified historic structure,’’ see section 48(g)(3) and § 1.48–12(d).)

(i) [Reserved]

(j) *Property used by certain tax-exempt organizations.* The term ‘‘section 38 property’’ does not include property used by an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 of the Code unless such property is used predominantly in an unrelated trade or business the income of which is subject to tax under section 511. If such property is debt-financed property as defined in section 514(b), the basis or cost of such property for purposes of computing qualified investment under section 46(c) shall include only that percentage of the basis or cost which is the same percentage as is used under section 514(a), for the year the property is placed in service, in computing the amount of gross income to be taken into account during such taxable year with respect to such property. The term ‘‘property used by an organization’’ means (1) property owned by the organization (whether or not leased to another person), and (2) property leased to the organization. Thus, for example, a data processing or copying machine which is leased to an organization exempt from tax would be considered as property used by such organization. Property (unless used predominantly in an unrelated trade or business) leased by another person to an organization exempt from tax or leased by such an organization to another person is not section 38 property to either the lessor or the lessee, and in either case the lessor may not elect under §1.48–4 to treat the lessee of such property as having purchased such property for purposes of the credit allowed by section 38. This paragraph shall not apply to property leased on a casual or short-term basis to an organization exempt from tax.

(k) *Property used by governmental units.* The term ‘‘section 38 property’’ does not include property used by the United States, any State (including the District of Columbia) or political subdivision thereof, any international organization (as defined in section 7701(a)(18)) other than the International Telecommunications Satellite Consortium or any successor organization, or any agency or instrumentality of the United States, of any State or political subdivision thereof, or of any such international organization. The term ‘‘property used by the United States, etc.’’ means (1) property owned by any such governmental unit (whether or not leased to another person), and (2) property leased to any such governmental unit. Thus, for example, a data processing or copying machine which is leased to any such governmental unit would be considered as property used by such governmental unit. Property leased by another person to any such governmental unit or leased by such governmental unit to another person is not section 38 property to either the lessor or the lessee, and in either case the lessor may not elect under §1.48–4 to treat the lessee of such property as having purchased such property for purposes of the credit allowed by section 38. This paragraph shall not apply to property leased on a casual or short-term basis to any such governmental unit.

(l) [Reserved]

(m) *Elevators and escalators*—(1) *In general.* Under section 48(a)(1)(C), an elevator or escalator qualifies as section 38 property if—

(i) The construction, reconstruction, or erection of the elevator or escalator is completed by the taxpayer after June 30, 1963, or

(ii) The elevator or escalator is acquired after June 30, 1963, and the original use of such elevator or escalator commences with the taxpayer and commences after such date.

In the case of construction, reconstruction, or erection of an elevator or escalator commenced before January 1, 1962, and completed after June 30, 1963, there shall be taken into account in determining the qualified investment under section 46(c) only that portion of the basis which is properly attributable to construction, reconstruction, or erection after December 31, 1961. Further, if the construction, reconstruction, or erection of such property is commenced after December 31, 1961, and is completed after June 30, 1963, the entire basis of the elevator or escalator shall be taken into account in determining qualified investment under section 46(c). Also, if an elevator or escalator is reconstructed by the taxpayer after June 30, 1963, the basis attributable to such reconstruction may be taken into account in determining the qualified investment under section 46(c), irrespective of the fact that the original construction or erection of such elevator or escalator may have occurred before January 1, 1962. Paragraph (b) of §1.48–2 shall be applied in determining the date of acquisition, original use, and basis attributable to construction, reconstruction, or erection.

(2) *Definition of elevators and escalators.* For purposes of this section the term ‘‘elevator’’ means a cage or platform and its hoisting machinery for conveying persons or freight to or from different levels and functionally related equipment which is essential to

its operation. The term includes, for example, guide rails and cables, motors and controllers, control panels and landing buttons, and elevator gates and doors, which are essential to the operation of the elevator. The term ''elevator'' does not, however, include a structure which is considered a building for purposes of the investment credit. The term ''escalator'' means a moving staircase and functionally related equipment which is essential to its operation. For purposes of determining qualified investment under section 46(c) and § 1.46–3, the basis of an elevator or escalator does not include the cost of any structural alterations to the building, such as the cost of constructing a shaft or of making alterations to the floor, walls, or ceiling, even though such alterations may be necessary in order to install or modernize the elevator or escalator.

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

Example 1. If an elevator with a total basis of $100,000 is completed after June 30, 1963, and the portion attributable to construction by the taxpayer after December 31, 1961, is determined by engineering estimates or by cost accounting records to be $30,000, only the $30,000 portion may be taken into account as an investment in new section 38 property in computing qualified investment.

Example 2. If construction of an elevator with a total basis of $90,000 is commenced by the taxpayer after December 31, 1961, and is completed after June 30, 1963, the entire basis of $90,000 may be taken into account as an investment in new section 38 property.

Example 3. The facts are the same as in example 2 except that construction of the elevator was completed before June 30, 1963. The elevator is not considered to be section 38 property.

Example 4. In 1964, a taxpayer reconditions an elevator, which had been constructed and placed in service in 1962 and which had an adjusted basis in 1964 of $75,000. The cost of reconditioning amounts to an additional $50,000. The basis of the elevator which may be taken into account in computing qualified investment in section 38 property is $50,000, irrespective of whether the taxpayer contracts to have it reconditioned or reconditions it himself, and irrespective of whether the materials used in the process are new in use.

(n) *Amortized property.* Any property with respect to which an election under 167(k), 169, 184, 187, or 188 applies shall not be treated as section 38 property. In the case of any property to which section 169 applies, the preceding sentence shall apply only to so much of the adjusted basis of the property as (after the application of section 169(f)) constitutes the amortizable basis for purposes of section 169. This paragraph shall not apply to property with respect to which an election under section 167(k), 184, 187, or 188 applies unless such property is described in section 50.

(o) [Reserved]

(p) *Qualified timber property.* (1) Qualified timber property (within the meaning of section 194(c)(1)) shall be treated as section 38 property to the extent of the portion of the basis of such property which is the amortizable basis (as defined in § 1.194–3(b)) acquired during the taxable year and taken into account under section 194 (after applying the limitation of section 194(b)(1)). Such amortizable basis shall qualify as section 38 property whether or not an election is made under section 194. However, any portion of such amortizable basis which is attributable to property which otherwise qualifies as section 38 property shall not be treated as section 38 property under section 48(a)(1)(F) and this paragraph. For example, amortizable basis attributable to depreciation on equipment would not qualify as section 38 property under this paragraph if such equipment qualifies as section 38 property under sections 48(a)(1) (A) or (B). In determining the portion of amortizable basis which qualifies as section 38 property under this paragraph, the reduction in amortizable basis to account for depreciation sustained with respect to property used in the reforestation process (which otherwise qualifies as section 38 property) shall be applied before the $10,000 limitation on eligible costs under section 194(b)(1). For example, if in a taxable year a taxpayer incurs qualifying reforestation costs resulting in $12,000 of amortizable basis with respect to property for which an election is in effect, and $2,000 of these costs are attributable to depreciation of the taxpayer's equipment, such $12,000 would first be reduced by the $2,000 of depreciation, and the $10,000 limitation under section 194(b)(1) would be applied following such reduction.

(2) If a taxpayer makes an election to amortize reforestation expenditures under section 194, and allocates the $10,000 limitation among more than one property under §1.194–2(b)(2), then such allocation shall apply for purposes of determining the amortizable basis that qualifies as section 38 property under paragraph (p)(1) of this section. If no election is made under section 194, the taxpayer may select the manner in which the $10,000 limitation is to be allocated among the qualified timber properties.

(Sec. 38(b), 76 Stat. 963; 26 U.S.C. 38; secs. 194 (94 Stat. 1989; 26 U.S.C. 194) and 7805 (68A Stat. 917, 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 6731, 29 FR 6073, May 8, 1964, as amended by T.D. 6838, 30 FR 9060, July 20, 1965; T.D. 6958, 33 FR 9171, June 21, 1968; T.D. 6971, 33 FR 12899, Sept. 12, 1968; T.D. 7203, 37 FR 17129, Aug. 25, 1972; T.D. 7229, 37 FR 28142, Dec. 21, 1972; T.D. 7927, 48 FR 55849, Dec. 16, 1983; T.D. 8031, 50 FR 26697, June 28, 1985; T.D. 8233, 53 FR 39592, Oct. 11, 1988; T.D. 8474, 58 FR 25557, Apr. 27, 1993; 59 FR 1476, Jan. 11, 1994]

§1.48–2 New section 38 property.

(a) *In general.* Section 48(b) defines ‘‘new section 38 property’’ as section 38 property—

(1) The construction, reconstruction, or erection of which is completed by the taxpayer after December 31, 1961, or

(2) Which is acquired by the taxpayer after December 31, 1961, provided that the original use of such property commences with the taxpayer and commences after such date.

In the case of construction, reconstruction, or erection of such property commenced before January 1, 1962, and completed after December 31, 1961, there shall be taken into account as the basis of new section 38 property in determining qualified investment only that portion of the basis which is properly attributable to contruction, reconstruction, or erection after December 31, 1961. See §1.48–1 for the definition of section 38 property.

(b) *Special rules for determining date of acquisition, original use, and basis attributable to construction, reconstruction, or erection.* For purposes of paragraph (a) of this section, the principles set forth in paragraphs (a) (1) and (2) of §1.167(c)–1 shall be applied. Thus, for example, the following rules are applicable:

(1) Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications.

(2) The portion of the basis of property attributable to construction, reconstruction, or erection after December 31, 1961, consists of all costs of construction, reconstruction, or erection allocable to the period after December 31, 1961, including the cost or other basis of materials entering into such work (but not including, in the case of reconstruction of property, the adjusted basis of the reconstructed property as of the time such reconstruction is commenced).

(3) It is not necessary that materials entering into construction, reconstruction, or erection be acquired after December 31, 1961, or that they be new in use.

(4) If construction or erection by the taxpayer began after December 31, 1961, the entire cost or other basis of such construction or erection may be taken into account as the basis of new section 38 property.

(5) Construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(6) Property shall be deemed to be acquired when reduced to physical possession, or control.

(7) The term ‘‘original use’’ means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. For example, a reconditioned or rebuilt machine acquired by the taxpayer will not be treated as being put to original use by the taxpayer. The question of whether property is reconditioned or rebuilt property is a question of fact. Property will not be treated as reconditioned or rebuilt merely because it contains some used parts.

If the cost of reconstruction may properly either be capitalized and recovered through depreciation or charged against the depreciation reserve, such cost may be taken into account as the basis of new section 38 property even though it is charged against the depreciation reserve.

(c) *Examples.* This section may be illustrated by the following examples:

Example 1. If a machine with a total cost of $100,000 is completed after December 31, 1961, and the portion attributable to construction by the taxpayer after December 31, 1961, is determined by engineering estimates or by cost accounting records to be $30,000, the $30,000 amount shall be taken into account by the taxpayer in computing qualified investment in new section 38 property.

Example 2. In 1965, a taxpayer reconditions a machine, which he constructed and placed in service in 1962 and which has an adjusted basis in 1965 of $10,000. The cost of reconditioning amounts to an additional $20,000. The basis of the machine which shall be taken into account in computing qualified investment in new section 38 property for 1965 is $20,000, whether he contracts to have it reconditioned or reconditions it himself, and irrespective of whether the materials used for reconditioning are new in use.

Example 3. In 1961, a taxpayer pays the entire purchase price of $10,000 for section 38 property to be delivered in 1962. In 1962 he takes possession of the property and commences the original use of the asset in that year. The $10,000 amount shall be taken into account in computing qualified investment in new section 38 property for 1962.

Example 4. A taxpayer, instead of reconditioning his old machine, buys a ‘‘factory reconditioned’’ or ‘‘rebuilt’’ machine in 1962 to replace it. The reconditioned or rebuilt machine is not new section 38 property since such taxpayer is not the first user of the machine. See, however, § 1.48–3 (relating to used section 38 property).

Example 5. In 1962, a taxpayer buys from X for $20,000 an item of section 38 property which has been previously used by X. The taxpayer in 1962 makes an expenditure on the property of $5,000 of the type that must be capitalized. Regardless of whether the $5,000 is added to the basis of such property or is capitalized in a separate account, such amount shall be taken into account by the taxpayer in computing qualified investment in new section 38 property for 1962. No part of the $20,000 purchase price may be taken into account for such purpose. See, however, § 1.48–3 (relating to used section 38 property).

(d) *Special rule for qualified rehabilitated buildings.* Notwithstanding the rules in paragraphs (a) through (c) of this section, that portion of the basis of a qualified rehabilitated building attributable to qualified rehabilitation expenditures is treated as new section 38 property. See section 48(a)(1)(E) and (g), and § 1.48–11.

[T.D. 6731, 29 FR 6076, May 8, 1964, as amended by T.D. 8031, 50 FR 26698, June 28, 1985]

§ 1.48–3 Used section 38 property.

(a) *In general.* (1) Section 48(c) provides that ‘‘used section 38 property’’ means section 38 property acquired by purchase after December 31, 1961, which is not ‘‘new section 38 property.’’ See §§ 1.48–1 and 1.48–2, respectively, for definitions of section 38 property and new section 38 property. In determining whether property is acquired by purchase, the provisions of paragraph (c)(1) of § 1.179–3 shall apply, except that (i) ‘‘1961’’ shall be substituted for ‘‘1957’’, and (ii) the definition of ‘‘component member’’ of a controlled group of corporations in paragraph (d)(4) of this section shall be substituted for the definition of such term in paragraph (e) of § 1.179–3.

(2)(i) Property shall not qualify as used section 38 property if, after its acquisition by the taxpayer, it is used by *(a)* a person who used such property before such acquisition, or *(b)* a person who bears a relationship described in section 179(d)(2) (A) or (B) to a person who used such property before such acquisition. Thus, for example, if property is used by a person and is later sold by him under a sale and lease-back arrangement, such property in the hands of the purchaser-lessor is not used section 38 property because the property, after its acquisition, is being used by the same person who used it before its acquisition. Similarly, where a lessee has been leasing property and subsequently purchases it (whether or not the lease contains an option to purchase), such property is not used section 38 property with respect to the purchaser because the property is being used by the same person who used it before its acquisition. In addition, if property owned by a lessor is sold subject to the lease, or is sold upon the termination of the lease, the property will not qualify as used section 38 property with respect to the purchaser if, after the purchase, the property is used by a person who used the property as a lessee before the purchase.

(ii) For purposes of applying subdivision (i) of this subparagraph, property shall not be considered as used by a person before its acquisition if such property was used only on a casual basis by such person.

(iii) In determining whether a person bears a relationship described in section 179(d)(2) (A) or (B) to a person who used property before its acquisition by the taxpayer, the provisions of paragraphs (c)(1) (i) and (ii) of §1.179–3 shall apply, except that the definition of ‘‘component member’’ of a controlled group of corporations in paragraph (d)(4) of this section shall be substituted for the definition of such term in paragraph (e) of §1.179–3.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example 1. Corporation P acquires properties 1 and 2 in 1960 and uses them in its trade or business until 1962. In 1962, corporation P sells such properties to corporation Y, which leases back property 1 to corporation P and leases property 2 to corporation S, a wholly owned subsidiary of corporation P. Property 1 is not used section 38 property in the hands of corporation Y because, after its acquisition by corporation Y, it is used by a person (corporation P) who used it prior to such acquisition. Property 2 is not used section 38 property because, after its acquisition by corporation Y, it is used by a person (corporation S) who is related, within the meaning of section 179(d)(2)(B), to a person (corporation P) who used it before such acquisition.

Example 2. In 1962, corporation L leases property from corporation M. In 1964, corporation L acquires the property that it previously had been leasing. The property acquired by corporation L is not used section 38 property because such property is used after such acquisition by the same person (corporation L) who used the property before its acquisition (corporation L).

Example 3. Corporation X buys property in 1962 and leases such property to corporation Y. Corporation X in 1965 sells the property to A subject to the lease. The property acquired by A is not used section 38 property if such property continues to be used by corporation Y, because corporation Y used the property before its acquisition by A.

Example 4. A owns a bulldozer which he rents out to a number of different users, including B. In 1962, B used the bulldozer from February 16 to March 12 and again on October 15 and 16. B purchases the bulldozer from A on December 1, 1962. The prior use of the property by B does not disqualify such property as used section 38 property to B, because he used such property only on a casual basis prior to its purchase.

(b) *Cost.* (1) The cost of used section 38 property is equal to the basis of such property, but does not include so much of such basis as is determined by reference to the adjusted basis of other property (whether or not section 38 property) held at any time by the taxpayer acquiring such used section 38 property.

(2) If property (whether or not section 38 property) is disposed of by the taxpayer (other than by reason of its destruction or damage by fire, storm, shipwreck, or other casualty, or its theft) and used section 38 property similar or related in service or use is acquired as a replacement therefor in a transaction in which the basis of the replacement property is not determined by reference to the adjusted basis of the property replaced, then the cost of the used section 38 property so acquired shall be its basis reduced by the adjusted basis of the property replaced. The preceding sentence shall apply only if the taxpayer acquires (or enters into a contract to acquire) the replacement property within a period of 60 days before or after the date of the disposition.

(3) Notwithstanding subparagraphs (1) and (2) of this paragraph, the cost of used section 38 property shall not be reduced with respect to the adjusted basis of any property disposed of if, by reason of section 47, such disposition resulted in an increase of tax or a reduction of investment credit carrybacks or carryovers described in section 46(b).

(4) The provisions of this paragraph may be illustrated by the following examples:

Example 1. In 1972, A acquires machine 2 (an item of used section 38 property which has a sales price of $5,600) by trading in machine 1 (an item of section 38 property acquired in 1962), and by paying an additional $4,000 cash. The adjusted basis of machine 1 is $1,600. Under the provisions of sections 1012 and 1031(d), the basis of machine 2 is $5,600 ($1,600 adjusted basis of machine 1 plus cash expended of $4,000). The cost of machine 2 which may be taken into account in computing qualified investment for 1972 is $4,000 (basis of $5,600 less $1,600 adjusted basis of machine 1).

Example 2. The facts are the same as in example 1 except that machine 2 has a sales price of $6,000. The trade-in allowance on machine 1 is $2,000. The result is the same as in example 1, that is, the basis of machine 2 is $5,600 ($1,600 plus $4,000); therefore, the cost of machine 2 which may be taken into account in computing qualified investment for 1972 is $4,000 (basis of $5,600 less $1,600 adjusted basis of machine 1).

Example 3. On September 18, 1962, B sells truck 1, which he acquired in 1961 and which has an adjusted basis in his hands of $1,200. On October 15, 1962, he purchases for $2,000 truck 2 (an item of used section 38 property) as a replacement therefor. The cost of truck 2 which may be taken into account in computing qualified investment is $800 ($2,000 less $1,200).

Example 4. In 1962, C acquires property 1, an item of new section 38 property with a basis of $12,000 and a useful life of eight years or more. He is allowed a credit under section 38 of $840 (7 percent of $12,000) with respect to such property. In 1968, C acquires property 2 (an item of used section 38 property) by trading in property 1 and by paying an additional amount in cash. Section 47(a) applies to the disposition of property 1 and C's tax liability for 1968 is increased by $280. Since the application of section 47(a) results in an increase in tax, for purposes of computing qualified investment the cost of property 2 is not reduced by any part of the adjusted basis of the property traded in.

(c) *Dollar limitation*—(1) *In general.* Section 48(c)(2) provides that the aggregate cost of used section 38 property which may be taken into account for any taxable year in computing qualified investment under section 46(c)(1)(B) shall not exceed $50,000. If the total cost of used section 38 property exceeds $50,000, there must be selected, in the manner provided in subparagraph (4) of this paragraph, the particular items of used section 38 property the cost of which is to be taken into account in computing qualified investment. The cost of used section 38 property that may be taken into account by a person in applying the $50,000 limitation for any taxable year includes not only the cost of used section 38 property placed in service by such person during such taxable year, but also the cost of used section 38 property apportioned to such person. For purposes of this section, the cost of used section 38 property apportioned to any person means the cost of such property apportioned to him by a trust, estate, or electing small business corporation (as defined in section 1371(b)), and his share of the cost of partnership used section 38 property, with respect to the taxable year of such trust, estate, corporation or partnership ending with or within such person's taxable year. Thus, if an individual places in service during his taxable year used section 38 property with a cost of $25,000, if the cost of used section 38 property apportioned to him by an electing small business corporation for such year is $30,000, and if his share for such year of the cost of used section 38 property placed in service by a partnership is $20,000, he may select from the used section 38 property with a total cost of $75,000 the particular used section 38 property the cost of which he wishes to take into account. No part of the excess of $25,000 ($75,000 cost minus $50,000 annual limitation) may be taken into account in any other taxable year. For determining the amount of the cost to be apportioned by an electing small business corporation, see paragraph (a)(2) of § 1.48–5; in the case of estates and trusts, see paragraph (a)(2) of § 1.48–6. See paragraph (e) of this section for application of $50,000 limitation in the case of affiliated groups.

(2) *Married individuals filing separate returns.* In the case of a husband or wife who files a separate return, the aggregate cost of used section 38 property which may be taken into account for the taxable year to which such return relates cannot exceed $25,000. The preceding sentence shall not apply, however, unless the taxpayer's spouse places in service (or is apportioned the cost of) used section 38 property for the taxable year of such spouse which ends with or within the taxpayer's taxable year. Thus, if a husband and wife who file separate returns on a calendar year basis both place in service used section 38 property during the taxable year, the maximum cost of used section 38 property which may be taken into account by each is $25,000. However, in such case, if only one spouse places in service (or is apportioned the cost of) used section 38 property during the taxable year, such spouse may take into account a maximum of $50,000 for

such year. The determination of whether an individual is married shall be made under the principles of section 143 and the regulations thereunder.

(3) *Partnerships.* In the case of a partnership, the aggregate cost of used section 38 property placed in service by the partnership (or apportioned to the partnership) which may be taken into account by the partners with respect to any taxable year of the partnership may not exceed $50,000. If such aggregate cost exceeds $50,000, the partnership must make a selection in the manner provided in subparagraph (4) of this paragraph. The $50,000 limitation applies to each partner, as well as to the partnership.

(4) *Selection of $50,000 cost.* (i) If the sum of *(a)* the cost of used section 38 property placed in service during the taxable year by any person, *(b)* such person's share of the cost of partnership used section 38 property placed in service during the taxable year of a partnership ending with or within such person's taxable year, and *(c)* the cost of used section 38 property apportioned to such person for such taxable year by an electing small business corporation, estate, or trust, exceeds $50,000, such person must make a selection for such taxable year in the manner provided in subdivision (ii) of this subparagraph.

(ii) For purposes of computing qualified investment (or, in the case of a partnership, electing small business corporation, estate, or trust, for purposes of selecting used section 38 property the cost of which may be taken into account by the partners, shareholders, or estate or trust and its beneficiaries) any person to whom subdivision (i) of this subparagraph applies must select a total cost of $50,000 from *(a)* the cost of specific used section 38 property placed in service by such person, *(b)* such person's share of the cost of specific used section 38 property placed in service by a partnership and *(c)* the cost of used section 38 property apportioned to such person by an electing small business corporation, estate, or trust. When a particular property is selected, the entire cost (or entire share of cost of a particular property in the case of partnership property) of such property must be taken into account unless, as a result of the selection of such particular property, the $50,000 limitation is exceeded. Likewise, in the case of an apportionment from an electing small business corporation, estate, or trust, when the cost in a particular useful life category is selected, the entire cost in such category must be taken into account unless, as a result of the selection of such cost, the $50,000 limitation is exceeded. Thus, if a person places in service during the taxable year three items of used section 38 property, each with a cost of $20,000, he must select the entire cost of two of the items and only $10,000 of the cost of the third item; he may not select a portion of the cost of each of the three items. The selection by any person shall be made by taking the cost of used section 38 property into account in computing qualified investment (or in selecting the used section 38 property the cost of which may be taken into account by the partners, etc.), and if such property was placed in service by such person, he must maintain records which permit specific identification of any item of used section 38 property selected.

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

Example 1. H, who operates a sole proprietorship, purchases and places in service in 1963 used section 38 property with a cost of $60,000. His spouse, W, is a shareholder in an electing small business corporation which purchases and places in service during its fiscal year ending June 30, 1963, used section 38 property with a cost of $50,000. Both spouses file separate returns on a calendar year basis. W, as a 60 percent shareholder on the last day of the taxable year of the corporation, is apportioned $30,000 (60 percent of $50,000) of the cost of the used section 38 property placed in service by the corporation. The cost of used section 38 property that may be taken into account by H on his separate return is $25,000. The cost of used section 38 property that may be taken into account by W on her separate return is $25,000. On the other hand, if the corporation had made no investment in used section 38 property, H could take $50,000 of the $60,000 cost into account.

Example 2. Partners X, Y, and Z share the profits and losses of partnership XYZ in the ratio of 50 percent, 30 percent, and 20 percent, respectively. The partnership and each partner make returns on the basis of the calendar year. Each partner also operates a sole proprietorship. In 1963, the partnership and the partners purchase and place in service the following used section 38 property:

Property	Estimated useful life (years)	Cost
Partnership XYZ		
Property No. 1	9	$10,000
Property No. 2	7	50,000
Property No. 3	7	50,000
Property No. 4	5	30,000
Partner X		
Property No. 5	6	30,000
Partner Y		
Property No. 6	10	60,000
Partner Z		
Property No. 7	4	36,000

(i) *Selection by partnership.* In accordance with subparagraph (4)(ii) of this paragraph, the partnership selects property No. 1 and $40,000 of the cost of property No. 2 to be taken into account. Therefore, each partner's share of cost of the property selected by the partnership is as follows:

Property No.	Estimated useful life (years)	Selected cost	Partner's share of cost		
			X (50%)	Y (30%)	Z (20%)
1	9	$10,000	$5,000	$3,000	$2,000
2	7	40,000	20,000	12,000	8,000
Total	....	50,000	25,000	15,000	10,000

(ii) *Selection by partners.* In accordance with subparagraph (4)(ii) of this paragraph, the partners make the following selections: Partner X selects property No. 5 ($30,000), his share of the cost of property No. 1 ($5,000), and $15,000 of his share of the cost of property No. 2. Partner Y selects $50,000 of the cost of property No. 6, and no part of his share of the cost of partnership property. Partner Z, having an aggregate cost of used section 38 property of only $46,000 (partnership property of $10,000 and individually owned property of $36,000), takes into account the entire $46,000.

(iii) *Qualified investment of partner X.* X's total qualified investment in used section 38 property for 1963 is $35,000, computed as follows:

Property No.	Estimated useful life (years)	Selected cost	Applicable percentage	Qualified investment
1	9	$5,000	100	$5,000
2	7	15,000	66⅔	10,000
5	6	30,000	66⅔	20,000
Total	....	50,000	....	35,000

(iv) *Qualified investment of partner Y.* Y's total qualified investment in used section 38 property for 1963 is $50,000 (100 percent of $50,000) since he selected $50,000 of the cost of property No. 6 which has a useful life of 8 years or more.

(v) *Qualified investment of partner Z.* Z's total qualified investment in used section 38 property for 1963 is $19,333, computed as follows:

Property No.	Estimated useful life (years)	Selected cost	Applicable percentage	Qualified investment
1	9	$2,000	100	$2,000
2	7	8,000	66⅔	5,333
7	4	36,000	33⅓	12,000
Total	....	46,000	....	19,333

(d) *Dollar limitation for component members of a controlled group*—(1) *In general.* (i) Section 48(c)(2)(C) provides that the $50,000 limitation on the cost of used section 38 property which may be taken into account for any taxable year shall, in the case of component members of a controlled group (as defined in subparagraph (4) of this paragraph) on a particular December 31, be reduced for each such member by apportioning the $50,000 amount among such component members for their taxable years that include such December 31 in accordance with their respective amounts of used section 38 property which may be taken into account, that is, in accordance with the total cost of used section 38 property placed in service by each such member during its taxable year (without regard to the $50,000 limitation or the applicable percentages to be applied in computing qualified investment).

(ii) Except as otherwise provided in this paragraph, the $50,000 amount shall be apportioned among those corporations which are component members of the controlled group on a December 31. For the taxable year of each such member which includes such December 31, the cost of used section 38 property taken into account in computing qualified investment under section 46(c)(1)(B) shall not exceed the amount which bears the same ratio to $50,000 as the cost of used section 38 property placed in service by such member for such taxable year bears to the total cost of used section 38 property placed in service by all component members of the controlled group for their taxable years which include such December 31.

(iii) If a component member of the group makes its income tax return on the basis of a 52–53-week taxable year, the principles of section 441(f)(2)(A)(ii) and paragraph (b)(1) of §1.441–2 apply in determining the last day of such a taxable year.

(2) *Statement by the ''filing member''.* For purposes of this paragraph, the term ''filing member'' with respect to a particular December 31 means the member (or members) of a controlled group which has, among those members of the group which are apportioned part of the $50,000 amount for their taxable years which include such December 31, the taxable year including such December 31 which ends on the earliest date. The filing member of the group shall attach to its income tax return a statement containing the name, address, and employer identification number of each component member of the controlled group on such December 31 and a schedule showing the computation of the apportionment of the $50,000 amount among the component members of the group. Each such other member shall retain as part of its records a copy of the statement containing the apportionment schedule. Except as otherwise provided in subparagraph (3)(ii) of this paragraph, each member which is apportioned part of the $50,000 amount shall take such apportioned amount into account in filing its return for its taxable year which includes such December 31.

(3) *Estimate of used section 38 property to be placed in service.* (i) For purposes of subparagraphs (1) and (2) of this paragraph, if on the date (including extensions of time) for filing the income tax return of the filing member of the group with respect to a particular December 31, the total cost of used section 38 property actually placed in service by any component member of the group during such member's taxable year that includes such December 31 is not known, then such member shall estimate such cost. The estimate shall be made on the basis of the facts and circumstances known as of the time of the estimate. Any such estimate shall also be used in determining the total cost of used section 38 property placed in service by all component members for their taxable years including such December 31.

(ii) If an estimate is used by any component member of a controlled group pursuant to subdivision (i) of this subparagraph, each member may later file an original or amended return in which the apportionment of the $50,000 amount is based upon the cost of used section 38 property actually placed in service by all component members of the group during their taxable year which include such December 31. Such amended apportionment shall be made only if each component member of the group whose limitation would be changed files an original or amended return which reflects the amended apportionment based upon the cost of the used section 38 property actually placed in service by component members of the group. In such case, the new statement reflecting the amended apportionment shall be attached to the amended return of the filing member of the group, and a copy of such statement shall be retained by each such member pursuant to the requirements of subparagraph (2) of this paragraph.

(4) *Definitions of controlled group of corporations and component member of controlled group.* For purposes of this section, the terms ''controlled group of corporations'' and ''component member'' of a controlled group of corporations shall have the same meaning assigned to those terms in section 1563 (a) and (b), except that the phrase ''more than 50 percent'' shall be substituted for the phrase ''at least 80 percent'' each place it appears in section 1563(a)(1). For purposes of applying § 1.1563–1(b)(2)(ii)*(c),* an electing small business corporation shall be treated as an excluded member whether or not it is subject to the tax imposed by section 1378.

(5) *Members of controlled group filing a consolidated return.* For the purpose of apportioning the $50,000 amount in the case of component members of a controlled group which join in filing a consolidated return, all such members shall be treated as though they were a single component member of the controlled group. Thus, in determining the limitation on the cost of used section 38 property which may be taken into account by the group filing the consolidated return, the apportionment provided in subparagraph (1)(ii) of this paragraph shall be made by using the aggregate cost of such property placed in service by all members of the group filing the consolidated return. If all component members of the controlled group join in filing a consolidated return, the group may select the items to be taken into account to the extent of an aggregate cost of $50,000; if some component members of the controlled group do not join in filing the consolidated return, then the members of the group which join in filing the consolidated return may select the items to be taken into account to the extent of the amount apportioned to such members under subparagraph (1)(ii) of this paragraph.

(6) *Examples.* This paragraph may be illustrated by the following examples:

Example 1. (i) On December 31, 1970, corporations M, N, and O are component members of the same controlled group. The taxable years of M, N, and O end, respectively, on January 31, March 31, and April 30. During the respective taxable years of each corporation which include December 31, 1970, M places in service no used section 38 property, and N and O place in service used section 38 property with respective costs of $100,000 and $150,000. N is the ''filing member'' of the group since N, among the members (N and O) which are apportioned part of the $50,000 amount for their taxable years which include such December 31, has the taxable year ending on the earliest date.

(ii) The cost of used section 38 property taken into account by N for its taxable year ending March 31, 1971, may not exceed $20,000, that is, an amount which bears the same ratio to $50,000 as the cost of used section 38 property placed in service by N for its taxable year ($100,000) bears to the total cost of used section 38 property placed in service by all component members of the controlled group (M, N, and O) for their taxable years which include December 31, 1970 ($250,000). Similarly, the cost of used section 38 property taken into account by O for its taxable year ending April 30, 1971, may not exceed $30,000.

Example 2. (i) On December 31, 1971, corporations S and T are component members of the same controlled group. The taxable years of corporations S and T end, respectively, on January 31 and June 30. On April 15, 1972, S files an income tax return for its taxable year ending January 31, 1972, during which year it places in service used section 38 property costing $100,000. T estimates that it will place in service used section 38 property costing $150,000 during its taxable year ending June 30, 1972.

(ii) S, the ''filing member'' of the group, must file an apportionment schedule under which it may take into account as the cost of used section 38 property an amount not in excess of $20,000 ($100,000/$250,000× $50,000). If T actually places in service during its taxable year used section 38 property costing more or less than $150,000, its income tax return for its taxable year ending June 30, 1972, may reflect the amended apportionment of the $50,000 limitation based upon the cost of used section 38 property actually placed in service by the group, provided that S attaches a new apportionment schedule to an amended return to reflect the amended apportionment. For example, if T places in service used section 38 property costing $200,000, the cost of used section 38 property taken into account by S and T for their respective taxable years could not exceed $16,667 ($100,000/$300,000×$50,000) and $33,333 ($200,000/$300,000×$50,000), respectively, under an amended apportionment.

(Secs. 38(b) and 7805 of the Internal Revenue Code of 1954 (76 Stat. 962, U.S.C. 38(b); 68A Stat. 917; 26 U.S.C. 7805)

[T.D. 6731, 29 FR 6076, May 8, 1964, as amended by T.D. 7181, 37 FR 8064, Apr. 25, 1972; T.D. 7820, 47 FR 25139, June 10, 1982]

§1.48–4 Election of lessor of new section 38 property to treat lessee as purchaser.

(a) *In general*—(1) *Lessee treated as purchaser.* Under section 48(d), a lessor of property may elect to treat the lessee of such property as having purchased such property (or, in the case of short-term lease property described in subparagraph (2) of this paragraph, a portion of such property) for purposes of the credit allowed by section 38 if the following conditions are satisfied:

(i) The property must be ‘‘section 38 property’’ in the hands of the lessor; that is, it must be property with respect to which depreciation (or amortization in lieu of depreciation) is allowable to the lessor, it must have a useful life of 3 years (4 years in the case of property which is not described in section 50) or more in his hands, and in every other respect it must meet the requirements of §1.48–1. Thus, for example, property leased by a municipality to a taxpayer for use in what is commonly known as an ‘‘industrial park’’ is not eligible for the election since, under paragraph (k) of §1.48–1, property used by a governmental unit is not section 38 property. In addition, property used by the lessee predominantly outside the United States is not eligible for the election since, under paragraph (g) of §1.48–1, such property is not section 38 property. For purposes of this subdivision, if the lessor is an estate or trust, depreciation (or amortization in lieu of depreciation) will be considered allowable to the estate or trust even if it is apportioned to the beneficiaries or other persons.

(ii) The property must be ‘‘new section 38 property’’ (within the meaning of §1.48–2) in the hands of the lessor, and the original use of such property must commence with the lessor. See paragraph (b) of this section for the application of the rules relating to ‘‘original use’’ in the case of leased property.

(iii) The property would constitute ‘‘new section 38 property’’ to the lessee if such lessee had actually purchased the property. Thus, the election is not available if the lessee is not the original user of the property. See paragraph (b) of this section for the application of the rules relating to ‘‘original use’’ in the case of leased property. See paragraph (d) of this section for the determination of the estimated useful life of leased property in the hands of the lessee.

(iv) A statement of election to treat the lessee as a purchaser has been filed in the manner and within the time provided in paragraph (f) or (g) of this section.

(v) The lessor is not a person referred to in section 46(d)(1), that is, a mutual savings bank, cooperative bank, or domestic building and loan association to which section 593 applies; a regulated investment company or real estate investment trust subject to taxation under subchapter M, chapter 1 of the Code; or a cooperative organization described in section 1381(a).

The election may be made on a property-by-property basis or a general election may be made with respect to each taxable year of a particular lessee. If the conditions of this subparagraph have been met, the lessee shall be treated as though he were the actual owner of all or a portion of the property for purposes of the credit allowed by section 38. Thus, the lessee shall be entitled to a credit allowed by section 38 with respect to such property for the taxable year in which he places such property in service, and the lessor shall not be entitled to a credit allowed by section 38 with respect to such property unless the property is short-term lease property (as defined in subparagraph (2) of this paragraph). Moreover, if the leased property is disposed of, or if it otherwise ceases to be section 38 property, the property will be subject to the provisions of section 47 (relating to early dispositions, etc.).

(2) *Short-term lease property.* For purposes of this section, the term ''short-term lease property'' means property which—

(i) Is new section 38 property;

(ii) Has a class life (determined under section 167(m)) in excess of 14 years;

(iii) Is leased under a lease entered into after November 8, 1971, for a period which is less than 80 percent of the class life of such property; and

(iv) Is not leased subject to a net lease within the meaning of section 57(c)(1)(B) and the regulations thereunder.

The class life of property shall be determined under section 167(m) and the regulations prescribed in connection with that section, except that such class life shall be determined without regard to any variance from the class life permitted under such section. If a class life has not been prescribed for property under section 167(m) on the date such property is leased, the class life of the property shall be the estimated useful life used to compute the allowance for depreciation with respect to such property under section 167. For purposes of subdivision (iii) of this subparagraph, the period for which a lease is entered into shall be determined without regard to any option on the part of the lessee to extend or renew such lease, and without regard to any option on the part of the lessee to cancel the lease after a specified period if under the terms of such lease, such a cancellation would result in the imposition of a substantial penalty upon the lessee. Generally, a penalty equal to 25 percent of the total remaining rental payments due under the lease will be regarded as substantial.

(b) *Original use.* For purposes of this section only, the lessor and the lessee may both be considered as the original users of an item of leased property. The determination of whether the lessor qualifies as the original user of leased property shall be made under paragraph (b)(7) of § 1.48–2. The determination of whether the lessee qualifies as the original user of leased property shall be made, under paragraph (b)(7) of § 1.48–2, as if the lessee actually purchased the property. Thus, the lessee would not be considered the original user of the property if it has been previously used by the lessor or another person, or if it is reconstructed, rebuilt, or reconditioned property. However, the lessee would be considered the original user if he is the first person to use the property for its intended function. Thus, the fact that the lessor may have, for example, tested, stored, or attempted to lease the property to other persons will not preclude the lessee from being considered the original user.

(c) *Qualified investment*—(1) *In general.* If a valid election is made under this section, the amount of qualified investment under section 46(c) with respect to the leased property shall be determined under this paragraph and paragraphs (d) and (e) of this section.

(2) *Nonshort-term lease property.* In the case of property which is not short-term lease property, the lessee is treated as having acquired the entire property for an amount equal to—

(i) The fair market value of such property on the date possession is transferred to the lessee, or

(ii) If the property is leased by a component member of a controlled group to another component member of the same controlled group (within the meaning of paragraph (f)(4) of § 1.46–1) on the date possession of the property is transferred to the lessee, the basis of the property in the hands of the lessor.

(3) *Short-term lease property.* (i) In the case of short-term lease property, the lessee is treated as having acquired a portion of such property. The amount for which the lessee is treated as having acquired such portion is an amount equal to a fraction, the numerator of which is the term of the lease and the denominator of which is the class life of the property leased, of the amount for which the lessee would be treated as having acquired the property under subparagraph (2) of this paragraph if the property were not short-term lease property.

(ii) In the case of short-term lease property, the qualified investment of the lessor is an amount equal to his qualified investment in such property determined under section 46(c) multiplied by a fraction, the numerator of which is the class life of the property leased minus the term of the lease and the denominator of which is the class life of such property.

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

Example. (a) On December 1, 1971, X corporation completed construction of an item of new section 38 property with a basis of $10,000. Under section 167(m), the property has a class life of 16 years. On December 1, 1971, X leases the property to individual A for 4 years and A immediately places the property in service. The lease is not a net lease within the meaning of section 57(c)(1)(B). On the date of the lease, the fair market value of the property is $12,000. The property would qualify as new section 38 property in A's hands if it had been purchased by A. Under this section, the property is short-term lease property. X makes the election under this section to treat A as having acquired a portion of the property.

(b) A is treated as having acquired from X a portion of the property for $3,000 (the fair market value of the property, $12,000, multiplied by a fraction, 4/16 , the numerator of which is the term of the lease and the denominator of which is the class life of the leased property). Since under paragraph (d) of this section the useful life of such property in the hands of A is the same as the useful life of such property in the hands of X, and such useful life is at least 7 years, A's qualified investment with respect to the property is $3,000.

(c) The qualified investment of X is $7,500 (the qualified investment of X under section 46(c), $10,000, multiplied by a fraction, 12⁄16, the numerator of which is the class life of the leased property, 16, minus the term of the lease, 4, and the denominator of which is the class life of the property).

(d) *Estimated useful life of leased property.* The estimated useful life to the lessee of property subject to the election shall be deemed to be the estimated useful life in the hands of the lessor for purposes of computing depreciation, regardless of the term of the lease. The lessor shall determine the estimated useful life of each leased property on an individual basis even though multiple asset accounts are used. However, in the case of assets similar in kind contained in a multiple asset account, the lessor shall assign to each of such assets the average useful life of such assets used in computing depreciation. Thus, for example, if during a taxable year a lessor leases 10 similar trucks with an average estimated useful life for depreciation purposes of 6 years, based on an estimated range of 5 to 7 years, he must assign a useful life of 6 years to each of the 10 trucks.

(e) *Lessor itself a lessee*—(1) *In general.* If the lessee of property is treated, under this section, as having purchased all or a portion of such property and if such lessee leases such property to a sublessee, the qualified investment with respect to such property in the hands of the sublessee shall be determined under paragraphs (c) and (d) of this section as if the original lessor had leased the property directly to the sublessee for the term of the sublessee's lease on the date possession of the property is transferred to the sublessee. For this purpose, property which is short-term lease property in the hands of the lessee shall be treated as short-term lease property in the hands of the sublessee regardless of whether such property is leased to the sublessee subject to a net lease (within the meaning of section 57(c)(1)(B)). In the case of property which is short-term lease property in the hands of the sublessee, the amount for which the lessee is treated as having acquired such property under paragraph (c) of this section shall be reduced by an amount equal to such amount multiplied by a fraction, the numerator of which is the term of the lease of the sublessee and the denominator of which is the term of the lease of the lessee.

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

Example. (a) On December 1, 1971, corporation X completes construction of a machine at a cost of $10,000. The machine has a class life under section 167(m) of 20 years. On December 1, 1971, X leases the machine to corporation Y for 12 years, and Y immediately subleases the machine to individual A for 8 years. X and Y are component members of the same controlled group. The lease between X and Y is not a net lease within the meaning of section 57(c)(1)(B). The fair market value of the property on December 1, 1971, is $16,000. Both X and Y make valid elections under this section.

(b) The property is short-term lease property and this paragraph applies.

(c) The qualified investment of A is $6,400. Such amount is determined by multiplying $16,000, the amount for which A would be treated under paragraph (c)(2) of this section as having acquired the property if it were not short-term lease property, by 8⁄20.

(d) The qualified investment of Y is $2,000. Such amount is determined by multiplying $10,000, the amount for which Y would be treated under paragraph (c)(2) of this section as having acquired the property if it were not short-term lease property, by 12⁄20, and by reducing the amount so determined ($6,000) by 8⁄12 of such amount ($4,000) to $2,000.

(e) The qualified investment of X is $4,000. Such amount is determined by multiplying the amount of X's qualified investment determined under section 46(c) without regard to this section ($10,000) by 8⁄20.

(f) *Property-by-property election*— (1) *Manner of making election.* The election of a lessor with respect to a particular property (or properties) shall be made by filing a statement with the lessee, signed by the lessor and including the written consent of the lessee, containing the following information:

(i) The name, address, and taxpayer account number of the lessor and the lessee;

(ii) The district director's office with which the income tax returns of the lessor and the lessee are filed;

(iii) A description of each property with respect to which the election is being made;

(iv) The date on which possession of the property (or properties) is transferred to the lessee;

(v) The estimated useful life category of the property (or properties) in the hands of the lessor, that is, 3 years or more but less than 5 years, 5 years or more but less than 7 years, or 7 years or more;

(vi) The amount for which the lessee (or sublessee) is treated as having acquired the leased property under paragraph (c)(2) or (3) of this section; and

(vii) If the lessor is itself a lessee, the name, address, and taxpayer account number of the original lessor, and the district director's office with which the income tax return of such original lessor is filed.

(2) *Time for making election.* The statement referred to in subparagraph (1) of this paragraph shall be filed with the lessee on or before the due date (including any extensions of time) of the lessee's return for the lessee's taxable year during which possession of the property is transferred to the lessee, except that if such taxable year ends after March 31, 1971, and before December 11, 1971, the statement shall be filed with the lessee on or before the due date (including any extensions of time) of the lessee's return for such taxable year, or on or before October 24, 1972, whichever is later.

(3) *Election is irrevocable.* An election under this paragraph shall be irrevocable as of the time the statement referred to in subparagraph (1) of this paragraph is filed with the lessee.

(g) *General election*—(1) *In general.* In lieu of making elections on a property-by-property basis in the manner and time prescribed in paragraph (f) of this section, a lessor may, with respect to a particular taxable year of a particular lessee, make a general election to treat such lessee as having purchased all properties possession of which is transferred under lease by the lessor to the lessee during such taxable year of the lessee.

(2) *Manner and time for making general election.* The general election of a lessor with respect to a taxable year of a lessee shall be made by filing a statement with the lessee, signed by the lessor and including the written consent of the lessee, on or before the due date (including any extensions of time) of the lessee's return for such taxable year, except that if such taxable year ends after March 31, 1971, and before December 11, 1971, the statement shall be filed with the lessee on or before the due date (including any extensions of time) of the lessee's return for such taxable year, or on or before October 24, 1972, whichever is later. Such statement of general election shall contain:

(i) The name, address, and taxpayer account number of the lessor and the lessee;

(ii) The taxable year of the lessee with respect to which such general election is made;

(iii) The district director's office with which the income tax returns of the lessor and the lessee are filed;

(iv) If the lessor is itself a lessee, the name, address, and taxpayer account number of the original lessor, and the district director's office with which the income tax return of such original lessor is filed.

(3) *Election is irrevocable.* A general election under this paragraph shall be

irrevocable as of the time the statement referred to in subparagraph (2) of this paragraph is filed with the lessee and shall be binding on the lessor and the lessee for the entire taxable year of the lessee with respect to which such general election is made.

(4) *Information requirement.* If a lessor, with respect to a taxable year of the lessee, makes a general election under this paragraph, such lessor shall provide such lessee, on or before the date required for filing the statement under subparagraph (2) of this paragraph, with a statement (or statements) containing the information required by paragraphs (f)(1) (iii), (iv), (v), and (vi) of this section with respect to all properties possession of which is transferred under lease by the lessor to the lessee during such taxable year.

(h) *Signature.* The statement referred to in paragraph (f)(1) or (g)(2) of this section shall not be valid unless signed by both the lessor and the lessee. The signature of the lessee shall constitute the consent of the lessee to the election. The statement shall be signed by the taxpayer or a duly authorized agent of the taxpayer. For purposes of this section, a facsimile signature may be used in lieu of a signature manually executed and, if used, shall be as binding as a signature manually executed.

(i) [Reserved]

(j) *Record requirements.* The lessor and the lessee shall keep as a part of their records the statement referred to in paragraph (f)(1), or the statements referred to in paragraphs (g)(2) and (g)(4), of this section. The lessor shall attach to his income tax return a summary statement of all property leased during his taxable year with respect to which an election is made. In the case of a taxable year ending after March 31, 1971, and before December 11, 1971, a summary statement may be filed on or before the due date (including any extensions of time) of the return or on or before October 24, 1972, whichever is later, with the Internal Revenue Service Center with which the return has been filed. Such summary statement shall contain the following information: (1) The name, address, and taxpayer account number of the lessor; and (2) in numerical account number order, each lessee's account number, name, and address, the estimated useful life category of the property (or, if applicable, the estimated useful life expressed in years), and the basis or fair market value of the property, whichever is applicable.

(k) *Adjustment of rental deductions*—(1) *In general.* The rules of this paragraph apply only to section 38 property placed in service before January 1, 1964, and with respect to any such property only for taxable years of a lessee beginning before January 1, 1964. If a lessor makes a valid election under this section with respect to property placed in service by the lessee before January 1, 1964, section 48(g) and §1.48–7 (relating to adjustments to basis of property) shall not apply to the lessor with respect to such property. Thus, the lessor is not required to reduce under section 48(g)(1) the basis of such property. However, if such an election is made, the deductions otherwise allowable under section 162 to the lessee for amounts paid or accrued to the lessor under the lease shall be adjusted in the manner provided in this paragraph. For special adjustment for taxable years beginning after December 31, 1963, see paragraph (m) of this section.

(2) *Decrease in rental deduction.* (i) The deductions otherwise allowable under section 162 to the lessee for amounts paid or accrued to the lessor under the lease with respect to leased property placed in service before January 1, 1964, shall be decreased under subdivision (ii) or (iii) of this subparagraph, whichever is applicable, by an amount determined by reference to the credit earned on the leased property. The "credit earned" on the leased property is determined by multiplying the qualified investment (as defined in section 46(c)) with respect to such property by 7 percent. Thus, the credit earned (and the decrease in deductions) is determined without regard to the limitation based on tax which, under section 46(a)(2), may limit the amount of the credit the lessee may take into account in any one year.

(ii) If, in the case of property placed in service before January 1, 1964, the lessor, under paragraph (f)(1)(v) of this section, supplies the lessee with the useful life of such property expressed in years, then for each taxable year beginning before January 1, 1964, any part of which falls within a period beginning with the month in which the leased property is placed in service by the lessee and ending with the close of the estimated useful life of such property (as determined under paragraph (d) of this section), the lessee shall decrease the deduction otherwise allowable under section 162 for each such taxable year with respect to such property. The decrease for each such taxable year shall be equal to *(a)* the credit earned, divided by *(b)* the estimated useful life of the property (expressed in months), multiplied by *(c)* the number of calendar months in which the leased property was held by the lessee during such taxable year. Thus, if leased property with a basis of $27,000 in the hands of a calendar-year lessee, and with an estimated useful life of 10 years, is placed in service by the lessee on July 15, 1963, the lessee must decrease his section 162 deduction with respect to the leased property for the taxable year 1963 by $94.50 ($1,890 credit earned, divided by 120, multiplied by 6).

(iii) If, in the case of property placed in service before January 1, 1964, the lessor, under paragraph (f)(1)(v) of this section, supplies the lessee with the useful life category of such property, then for each taxable year beginning before January 1, 1964, during a period equal to the shortest life of the useful life category used by the lessee in computing qualified investment under section 46(c) with respect to the leased property, the lessee shall decrease the deduction otherwise allowable under section 162 for such taxable year with respect to such property. The decrease for each such taxable year shall be equal to the credit earned divided by such shortest life, that is, 4, 6, or 8. Such decreases shall begin with the taxable year during which the lessee places the property in service. Thus, if leased property with a basis of $30,000 to the lessee, and an estimated useful life falling within the 4 years or more but less than 6 years useful life category, is placed in service by the lessee within the lessee's taxable year ending December 31, 1962, the lessee must decrease his section 162 deduction with respect to the leased property for each of the taxable years 1962 and 1963 by $175 ($700 credit earned divided by 4).

(iv) To the extent that a required decrease, under subdivision (ii) or (iii) of this subparagraph, is not taken into account for any taxable year beginning before January 1, 1964, because the deduction otherwise allowable under section 162 for such taxable year with respect to the leased property is less than the required decrease for such taxable year, then the balance of the required decrease not taken into account for such taxable year shall decrease the amount otherwise allowable as a deduction under section 162 with respect to such property for the next succeeding taxable year (or years) beginning before January 1, 1964, if any, for which a deduction is allowable with respect to such property. Thus, if the required decrease with respect to leased property is $200 for 1962 but the lessee's deduction otherwise allowable under section 162 for such taxable year with respect to such property is only $50, the balance of $150 must be applied in 1963 to decrease the deduction otherwise allowable to the lessee with respect to the leased property for such taxable year.

(v) See paragraph (b) of § 1.48–7 for reduction of basis in the case of an actual purchase of leased property by a lessee (in a taxable year of such lessee beginning before January 1, 1964) who has been treated as a purchaser of such property under this section.

(3) *Increase in rental deductions on account of early disposition, etc.* (i) If, as a result of an early disposition, etc., in a taxable year beginning before January 1, 1964, with respect to leased property placed in service before such date, the lessee's tax is increased under section 47(a) (1) or (2), or an adjustment in a carryback or carryover is made under section 47(a)(3) by reduction of an unused credit, the rental deductions (if any) otherwise allowable under section 162 to such lessee for amounts paid or accrued to the lessor under the lease with respect to such property shall be increased in an amount equal to the total decreases previously made in the lessee's rental deductions under subparagraph (2) of this paragraph.

(ii) Except as provided in subdivision (iii) of this subparagraph, the increase in rental deductions described in subdivision (i) of this subparagraph shall be taken into account as an increase in rental deductions otherwise allowable under section 162 for the taxable year in which the early disposition, etc., occurred.

(iii) If, after the event which caused section 47(a) (1), (2), or (3) to apply the lessee continues the use of the property in a trade or business or in the production of income, the increase in rental deductions described in subdivision (i) of this subparagraph shall be taken into account ratably over the remaining portion of the useful life of the property which was used in making the decreases in rental deductions with respect to the property under subparagraph (2) of this paragraph.

(iv) If subdivision (iii) of this subparagraph applies, and if, prior to the expiration of the useful life of the property used in making the decreases in rental deductions, the lease is terminated other than by actual purchase of the property by the lessee, any increase in rental deductions not previously taken into account shall be taken into account as an increase in rental deductions for the taxable year in which the lease is terminated. In the case of an actual purchase of the property by the lessee, see paragraph (e) of §1.48–7.

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

Example 1. X Corporation is engaged in the business of manufacturing and leasing new and reconstructed equipment which in its hands has an estimated useful life of 12 years. After December 31, 1961, X Corporation constructs machine no. 1 at a cost of $20,000 and reconstructs machine no. 2 at a cost of $5,000. On February 15, 1962, Y Corporation, a calendar-year taxpayer, leases both machines from X Corporation and places them in service. The fair market value of machine no. 1 on the date on which possession is transferred to Y is $25,200. Machine no. 1 would qualify as new section 38 property in Y's hands if it had been purchased by Y. If X elects to treat Y as the purchaser of machine no. 1, under paragraph (c)(2)(ii) of this section such machine will have a basis of $25,200 in Y's hands. Under paragraph (f)(1)(v) of this section, X supplies Y with an estimated useful life of 12 years (expressed in years rather than useful life category) with respect to machine no. 1 for purposes of determining Y's qualified investment. Y's credit earned with respect to the property is $1,764 (7 percent of $25,200). Under paragraph (k)(2)(ii) of this section, Y's deduction attributable to the leased property for 1962 will be decreased by $134.75 (credit earned of $1,764, divided by 144, multiplied by 11), and for 1963 such deduction will be decreased by $147 ($1,764, divided by 144, multiplied by 12). The election is not available with respect to machine no. 2 since a reconstructed machine would not constitute new section 38 property if Y had purchased it. In such case, while X cannot make the election to treat Y as a purchaser, X would be entitled to a credit under section 38 based on its expenditure of $5,000 as an investment in new section 38 property, since such amount represents cost of reconstruction after December 31, 1961.

Example 2. Assume the same facts as in example 1 except that under paragraph (f)(1)(v) of this section, X supplies Y with an estimated useful life category of 8 years or more (rather than an estimated useful life expressed in years) with respect to machine no. 1 for purposes of determining Y's qualified investment. Under paragraph (k)(2)(iii) of this section, Y's deduction attributable to the leased property will be decreased by $220.50 (credit earned of $1,764, divided by 8) for each of its taxable years 1962 and 1963.

Example 3. Assume the same facts as in example 1 except that the lessee disposes of his interest in the lease on January 1, 1963, and that there is an increase in Y's tax for 1963 under section 47(a)(1) in the amount of $1,764. Under paragraph (k)(2) of this section, Y's deductions attributable to the leased property are decreased only in 1962, and the amount of such decrease is $134.75. In 1963 there shall be an increase of $134.75 in the deductions otherwise allowable under section 162 for such taxable year with respect to the leased property.

Example 4. Assume the same facts as in example 1 except that during the year 1963 the property was used by Y predominantly outside the United States within the meaning of paragraph (g) of §1.48–1, and thereafter was used in Y's trade or business. Under paragraph (k)(3) of this section, the increase of $134.75 described in example 3 is taken into account ratably as an increase in rental deductions otherwise allowable under section 162 in the amount of $12.25 ($134.75 divided by 11 years) for 1963 and each of the 10 succeeding years.

(m) *Increase in rental deductions on account of section 203(a)(2)(B) of the Revenue Act of 1964*—(1) *In general.* (i) Under section 203(a)(2)(B) of the Revenue Act of 1964, if, for any taxable year of a lessee beginning before January 1, 1964, the rental deductions otherwise allowable under section 162 to such lessee for amounts paid or accrued to the lessor under the lease with respect to leased property placed in service before January 1, 1964, were decreased under paragraph (k)(2) of this section, such rental deductions shall be increased.

(ii) The increase in rental deductions described in subdivision (i) of this subparagraph shall be in an amount equal to the total decreases in the lessee's rental deductions previously made under paragraph (k)(2) of this section less any increases in rental deductions made under paragraph (k)(3) of this section.

(iii) Except as provided in subdivision (iv) of this subparagraph, the increase in rental deductions described in subdivision (i) of this subparagraph shall be taken into account ratably over the remaining portion of the useful life of the property commencing with the first day of the first taxable year beginning after December 31, 1963. For this purpose, the useful life of the property shall be the useful life used in making the decreases in rental deductions with respect to the property under paragraph (k)(2) of this section.

(iv) If the lease is terminated other than by the lessee's actual purchase of the property during a taxable year beginning after December 31, 1963, and before the end of the remaining useful life of the property used in making the decreases in rental deductions, the amount of the increase in rental deductions described in subdivision (i) of this subparagraph and not previously taken into account shall be allowed as a deduction for the taxable year in which such termination occurs.

(v) The rental deductions with respect to any section 38 property are not to be increased under this paragraph if the lessee dies in a taxable year beginning before January 1, 1964.

(vi) The increase in rental deductions described in subdivision (i) of this subparagraph shall ordinarily be taken into account by the lessee treated as the purchaser, that is, the lessee entitled to the credit. However, if the property under the lease is transferred by the lessee to a successor lessee in a transaction described in section 47(b) (other than a transfer by reason of death) under which the successor lessee assumes the lessee's obligations under the lease, such increase in rental deductions shall be taken into account by the successor lessee in the manner prescribed in this paragraph.

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

Example 1. (a) X Corporation acquired on January 1, 1962, an item of new section 38 property with a basis of $24,000 and with a useful life to the lessor of 10 years. Y Corporation, which makes its returns on the basis of a calendar year, leased such property from X Corporation and placed it in service on January 2, 1962. Under this section, X Corporation made a valid election to treat Y Corporation as having purchased such property for purposes of the credit allowed by section 38 and supplied the lessee with information that the property had a useful life of 10 years. The amount of the credit earned with respect to such property was $1,680 (7 percent of $24,000). For each of the taxable years 1962 and 1963, Y Corporation decreased, under paragraph (k)(2) of this section, its deductions otherwise allowable under section 162 with respect to such property by $168 ($1,680 multiplied by 12/120).

(b) For each of the taxable years 1964 through 1971, Y Corporation increases its deductions otherwise allowable under section 162 for amounts paid to X Corporation under the lease by $42 ($336 (that is, $168 multiplied by 2) divided by the remaining useful life of 8 years).

Example 2. (a) The facts are the same as in example 1 except that the lease is terminated on January 3, 1965.

(b) For the taxable year 1964, Y Corporation increases its deductions otherwise allowable under section 162 by $42.

(c) For the taxable year 1965, Y Corporation increases its deductions otherwise allowable under section 162 for the portion of the increase which had not been taken into account as of the time of the termination of the lease. Thus, the amount of such increase for the taxable year 1965 is $294 ($336 minus $42).

(Sec. 38, 76 Stat. 963; 26 U.S.C. 38)

[T.D. 6731, 29 FR 6080, May 8, 1964; 29 FR 7671, June 16, 1964, as amended by T.D. 6838, 30 FR 9060, July 20, 1965; T.D. 7203, 37 FR 17131, 17132, Aug. 25, 1972]

§ 1.48–5 Electing small business corporations.

(a) *In general.* (1) In the case of an electing small business corporation (as defined in section 1371(b)), the basis of ‘‘new section 38 property’’ and the cost of ‘‘used section 38 property’’ placed in service during the taxable year shall be apportioned pro rata among the persons who are shareholders of such corporation on the last day of such corporation’s taxable year. Section 38 property shall not (by reason of such apportionment) lose its character as new section 38 property or used section 38 property, as the case may be. The estimated useful life of such property in the hands of a shareholder shall be deemed to be the estimated useful life of such property in the hands of the electing small business corporation. The bases of all new section 38 properties which have a useful life falling within a particular useful life category shall be aggregated; likewise, the cost of all used section 38 properties which have a useful life falling within a particular useful life category shall be aggregated. The total bases of new section 38 properties within each useful life category and the total cost of used section 38 properties within each useful life category shall be apportioned separately. The useful life categories are:

(i) 3 years or more but less than 5 years; (ii) 5 years or more but less than 7 years; and (iii) 7 years or more. There shall be apportioned to each person who is a shareholder of the electing small business corporation on the last day of the taxable year of such corporation, for his taxable year in which or with which the taxable year of such corporation ends, his pro rata share of the total bases of new section 38 properties within each useful life category, and his pro rata share of the total cost of used section 38 properties within each useful life category. In determining who are shareholders of an electing small business corporation on the last day of its taxable year, the rules of paragraph (d)(1) of §1.1371–1 and of paragraph (a)(2) of §1.1373–1 shall apply.

(2) The total cost of used section 38 property that may be apportioned by an electing small business corporation to its shareholders for any taxable year of such corporation shall not exceed $50,000. If the total cost of used section 38 property placed in service during the taxable year by the electing small business corporation exceeds $50,000 such corporation must select, under paragraph (c)(4) of §1.48–3, the used section 38 property the cost of which is to be apportioned to its shareholders.

(3) A shareholder to whom the basis (or cost) of section 38 property is apportioned shall, for purposes of the credit allowed by section 38, be treated as the taxpayer with respect to such property. Thus, the total cost of used section 38 property apportioned to him by the electing small business corporation must be taken into account as cost of used section 38 property in determining whether the $50,000 limitation on the cost of used section 38 property which may be taken into account by the shareholder in computing qualified investment for any taxable year is exceeded. If a shareholder takes into account in determining his qualified investment any portion of the basis (or cost) of section 38 property placed in service by an electing small business corporation and if such property subsequently is disposed of or otherwise ceases to be section 38 property in the hands of the corporation, such shareholder shall be subject to the provisions of section 47. See §1.47–4.

(b) *Summary statement.* An electing small business corporation shall attach to its return a statement showing the apportionment to each shareholder of the total bases of new, and the total cost of used, section 38 properties within each useful life category.

(c) *Example.* This section may be illustrated by the following example:

Example. 1 X Corporation, an electing small business corporation which makes its return on the basis of the calendar year, acquires and places in service on June 1, 1962, three new assets which qualify as new section 38 property and three used assets which qualify as used section 38 property. The basis of each new, and the cost of each used, section 38 property and the estimated useful life of each property are as follows:

Asset No.	Basis (or cost)	Estimated useful life
1 (new)	$30,000	4 years.
2 (new)	30,000	4 years.
3 (new)	30,000	8 years.
4 (used)	12,000	6 years.
5 (used)	12,000	6 years.
6 (used)	12,000	8 years.

On December 31, 1962, X Corporation has 10 shares of stock outstanding which are owned as follows: A owns 3 shares, B owns 2 shares, and C owns 5 shares.

(2) Under this section, the total bases of the new, and the total cost of the used, section 38 properties are apportioned to the shareholders of X Corporation as follows:

Useful life category	New—4 to 6 years	New—8 years or more	Used—6 to 8 years	Used—8 years or more
Total bases or total cost	$60,000	$30,000	$24,000	$12,000
Shareholder A (3⁄10)	18,000	9,000	7,200	3,600
Shareholder B (2⁄10)	12,000	6,000	4,800	2,400
Shareholder C (5⁄10)	30,000	15,000	12,000	6,000

Assume that shareholders A, B and C did not place in service during their taxable years in which falls December 31, 1962 (the last day of X Corporation's taxable year) any section 38 property and that such shareholders did not own any interests in other electing small business corporations, partnerships, estates, or trusts. Under section 46(c), the qualified investment of shareholder A is $23,400, of shareholder B is $15,600, and of shareholder C is $39,000, computed as follows:

Basis (or cost)	Applicable percentage	Qualified investment
SHAREHOLDER A		
$18,000 (new)	33⅓	$6,000
$9,000 (new)	100	9,000
$7,200 (used)	66⅔	4,800
$3,600 (used)	100	3,600
Total	....	23,400
SHAREHOLDER B		
$12,000 (new)	33⅓	$4,000
$6,000 (new)	100	6,000
$4,800 (used)	66⅔	3,200
$2,400 (used)	100	2,400
Total	....	15,600
SHAREHOLDER C		
$30,000 (new)	33⅓	$10,000
$15,000 (new)	100	15,000
$12,000 (used)	66⅔	8,000
$6,000 (used)	100	6,000
Total		39,000

[T.D. 6731, 29 FR 6082, May 8, 1964, as amended by T.D. 6931, 32 FR 14040, Oct. 10, 1967; T.D. 7203, 37 FR 17133, Aug. 25, 1972]

§ 1.48–6 Estates and trusts.

(a) *In general.* (1) In the case of an estate or trust, the basis of ''new section 38 property'' and the cost of ''used section 38 property'' placed in service during the taxable year shall be apportioned among the estate or trust and its beneficiaries on the basis of the income of such estate or trust allocable to each. Section 38 property shall not (by reason of such apportionment) lose its character as new section 38 property or used section 38 property, as the case may be. The estimated useful life of such property in the hands of a beneficiary shall be deemed to be the estimated useful life of such property in the hands of the estate or trust. The bases of all new section 38 properties which have a useful life falling within a particular useful life category shall be aggregated; likewise, the cost of all used section 38 properties which have a useful life falling within a particular useful life category shall be aggregated. The total bases of new section 38 properties within each useful life category and the total cost of used section 38 properties within each useful life category shall be apportioned separately. The useful life categories are:

(i) 3 years or more but less than 5 years; (ii) 5 years or more but less than 7 years; and (iii) 7 years or more. There shall be apportioned to the estate or trust for its taxable year, and to each beneficiary of such estate or trust for his taxable year in which or with which the taxable year of such estate or trust ends, his share (as determined under paragraph (b) of this section) of the total bases of new section 38 properties within each useful life category, and his share of the total cost of used section 38 properties within each useful life category.

(2) The total cost of used section 38 property that may be apportioned

among an estate or trust and its beneficiaries for any taxable year of such estate or trust shall not exceed $50,000. If the total cost of used section 38 property placed in service during the taxable year by the estate or trust exceeds $50,000, such estate or trust must select, under paragraph (c)(4) of §1.48–3, the used section 38 property the cost of which is to be apportioned among such estate or trust and its beneficiaries.

(3) A beneficiary to whom the basis (or cost) of section 38 property is apportioned shall, for purposes of the credit allowed by section 38, be treated as the taxpayer with respect to such property. Thus, the total cost of used section 38 property apportioned to him by the estate or trust must be taken into account as cost of used section 38 property in determining whether the $50,000 limitation on the cost of used property which may be taken into account by the beneficiary in computing qualified investment for any taxable year is exceeded. If a beneficiary takes into account in determining his qualified investment any portion of the basis (or cost) of section 38 property placed in service by an estate or trust and if such property subsequently is disposed of or otherwise ceases to be section 38 property in the hands of estate or trust, such beneficiary shall be subject to the provisions of section 47. See §1.47–5.

(4) For purposes of this section, the term ''beneficiary'' includes heir, legatee, and devisee.

(5) If during the taxable year of an estate or trust a beneficiary's interest in the income of such estate or trust terminates, the basis (or cost) of section 38 property placed in service by such estate or trust after such termination shall not be apportioned to such beneficiary.

(b) *Share.* A trust's, estate's, or beneficiary's share of the total bases of new section 38 properties, and the total cost of used section 38 properties, within a useful life category shall be—

(1) The total bases of new (or the total cost of used) section 38 properties which have a useful life falling within such useful life category placed in service in the taxable year of the estate or trust, multiplied by

(2) The amount of income allocable to such estate or trust or to such beneficiary for such taxable year, divided by

(3) The sum of the amounts of income allocable to such estate or trust and all its beneficiaries taken into account under subparagraph (2) of this paragraph.

(c) *Limitation based on amount of tax.* In the case of an estate or trust, the $25,000 amount specified in section 46(a)(2), relating to limitation based on amount of tax, shall be reduced for the taxable year to—

(1) $25,000, multiplied by

(2) The qualified investment with respect to the total bases of new section 38 properties plus the qualified investment with respect to the total cost of used section 38 properties, apportioned to such estate or trust under paragraph (a) of this section, divided by

(3) The qualified investment with respect to the total bases of all new section 38 properties plus the qualified investment with respect to the total cost of all used section 38 properties, apportioned among such estate or trust and its beneficiaries.

For purposes of subparagraph (3) of this paragraph, cost of used section 38 property shall not be considered as apportioned to any beneficiary to the extent that such cost is not taken into account by such beneficiary in computing qualified investment in used section 38 property.

(d) *Summary statement.* An estate or trust shall attach to its return a statement showing the apportionment to such estate or trust and to each beneficiary of the total bases of new, and the total cost of used, section 38 properties within each useful life category.

(e) *Example.* This section may be illustrated by the following example:

Example. 1 XYZ Trust, which makes its return on the basis of the calendar year, acquires and places in service on June 1, 1962, three new assets which qualify as new section 38 property and three used assets which qualify as used section 38 property. The basis of the new, and the cost of the used, section 38 property and the estimated useful life of each property are as follows:

Asset No.	Basis (or cost)	Estimated useful life
1 (new)	$30,000	4 years.

Asset No.	Basis (or cost)	Estimated useful life
2 (new)	30,000	4 years.
3 (new)	30,000	8 years.
4 (used)	12,000	6 years.
5 (used)	12,000	6 years.
6 (used)	12,000	8 years.

For the taxable year 1962 the income of XYZ Trust is $20,000 which is allocable as follows: $10,000 to XYZ Trust, $6,000 to beneficiary A, and $4,000 to beneficiary B. Beneficiaries A and B make their returns on the basis of a calendar year.

(2) Under this section, the total bases of the new, and the total cost of the used, section 38 properties are apportioned to XYZ Trust and its beneficiaries as follows:

Useful life category	New—4 to 6 years	New—8 years or more	Used—6 to 8 years	Used—8 years or more
Total bases or total cost	$60,000	$30,000	$24,000	$12,000
XYZ Trust ($10,000÷20,000)	30,000	15,000	12,000	6,000
Beneficiary A ($6,000÷20,000)	18,000	9,000	7,200	3,600
Beneficiary B ($4,000÷20,000)	12,000	6,000	4,800	2,400

Assume that beneficiary A placed in service during his taxable year 1962 new section 38 property with a basis of $10,000 and an estimated useful life of 8 years. Also, assume that beneficiary B did not place in service during his taxable year 1962 any section 38 property and that beneficiaries A and B did not own any interests in other trusts, estates, partnerships, or electing small business corporations. Under section 46(c), the qualified investment of XYZ Trust is $39,000, of beneficiary A is $33,400, and of beneficiary B is $15,600, computed as follows:

Basis (or cost)	Applicable percentage	Qualified investment
XYZ TRUST		
$30,000 (new)	33⅓	$10,000
$15,000 (new)	100	15,000
$12,000 (used)	66⅔	8,000
$6,000 (used)	100	6,000
Total	....	39,000
BENEFICIARY A		
$18,000 (new)	33⅓	$6,000
$9,000 (new)	100	9,000
$7,200 (used)	66⅔	4,800
$3,600 (used)	100	3,600
		23,400
$10,000 (new)	100	10,000
Total	....	33,400
BENEFICIARY B		
$12,000 (new)	33⅓	$4,000
$6,000 (new)	100	6,000
$4,800 (used)	66⅔	3,200
$2,400 (used)	100	2,400
Total	....	15,600

(3) In the case of XYZ Trust, the $25,000 amount specified in section 46(a)(2) is reduced to $12,500, computed as follows: (i) $25,000, multiplied by (ii) $39,000 (qualified investment apportioned to the trust), divided by (iii) $78,000 (total qualified investment apportioned among such trust ($39,000), beneficiary A ($23,400), and beneficiary B ($15,600)).

[T.D. 6731, 29 FR 6083, May 8, 1964, as amended by T.D. 6931, 32 FR 14040, Oct. 10, 1967; T.D. 6958, 33 FR 9171, June 21, 1968; T.D. 7203, 37 FR 17133, Aug. 25, 1972]

§ 1.48–9 Definition of energy property.

(a) *General rule*—(1) *In general.* Under section 48(l)(2), energy property means property that is described in at least one of 6 categories of energy property and that meets the other requirements of this section. If property is described in more than one of these categories, or is described more than once in a single category, only a single energy investment credit is allowed. In that case, the energy investment credit will be allowed under the category the taxpayer chooses by indicating the chosen category on Form 3468, Schedule B. The 6 categories of energy property are:

(i) Alternative energy property,

(ii) Solar or wind energy property,

(iii) Specially defined energy property,

(iv) Recycling equipment,

(v) Shale oil equipment, and

(vi) Equipment for producing natural gas from geopressured brine.

(2) *Depreciable property with 3-year useful life.* Property is not energy property unless depreciation (or amortization in lieu of depreciation) is allowable and the property has an estimated

useful life (determined at the time when the property is placed in service) of 3 years or more.

(3) *Effective date rules.* To be energy property—

(i) If property is constructed, reconstructed or erected by the taxpayer, the construction, reconstruction, or erection must be completed after September 30, 1978, or

(ii) If the property is acquired, the original use of the property must (A) commence with the taxpayer and (B) commence after September 30, 1978, and before January 1, 1983.

For transitional rules, see section 48(m).

(4) *Cross references.* (i) To determine if depreciation (or amortization in lieu of depreciation) is allowable for property, see §1.48–1(b).

(ii) For the meaning of ‘‘estimated useful life’’, see §1.46–3(e)(7).

(iii) The meaning of ‘‘acquired’’, ‘‘original use’’, ‘‘construction’’, ‘‘reconstruction’’, and ‘‘erection’’ is determined under the principles of §1.48–2(b).

(iv) For the definition of energy investment credit (energy credit), see section 48(o)(2).

(v) For special rules relating to public utility property, see paragraph (n) of this section.

(b) *Relationship to section 38 property*—(1) *In general.* (i) Energy property is treated under section 48(l)(1) as meeting the general requirements for section 38 property set forth in section 48(a)(1). For example, structural components of a building may qualify for the energy credit. In addition, the exclusion from section 38 property under section 48(a)(3) (lodging limitation) does not apply to energy property. For purposes of the energy credit, energy property is treated as section 38 property solely by reason of section 48(l)(1). For example, if property ceases to be energy property, it ceases to be section 38 property for all purposes relating to the energy credit and, thus, if subject to recapture under section 47. See §1.47–1(h).

(ii) See the effective date rules under paragraph (a)(3) of this section for limitations on the eligibility of property as energy property.

(iii) Section 48(l)(1) does not affect the character of property under sections of the Code outside the investment credit provisions. For example, structural components of a building that are treated as section 38 property under section 48(l)(1) remain section 1250 property and are not section 1245 property.

(2) *Other section 48 rules apply.* (i) In general, section 48(a) otherwise applies in determining if energy property is section 38 property. Thus, energy property excluded from the definition of section 38 property under section 48(a) (except by reason of section 48(a)(1) or (a)(3)) is not eligible for the energy credit. For example, energy property used predominantly outside the United States (section 48(a)(2)) or used by tax exempt organizations (section 48(a)(4)), in general, is not treated as section 38 property for any purpose and thus, is not eligible for the energy credit.

(ii) Other rules of section 48, such as those for leased property under section 48(d), also apply to energy property.

(3) *Regular credit denied for certain energy property.* In computing the amount of credit under section 46(a)(2), the regular percentage does not apply to any energy property which, but for section 48(l)(1), would not be section 38 property. See section 46(a)(2)(D). For example, energy property used for lodging (section 48(a)(3)) and, in general, structural components of a building (section 48(a)(1)(B)) re not eligible for the regular credit even though they may be eligible for the energy credit. However, a structural component of a qualified rehabilitated building (as defined in section 48(g)(1)) or a single purpose agricultural or horticultural structure (as defined in section 48(p)) may qualify for the regular credit without regard to section 48(l)(1).

(c) *Alternative energy property*—(1) *In general.* Alternative energy property means property described in paragraphs (c)(3) through (10) of this section. In general alternative energy property includes certain property that uses an alternate substance as a fuel or feedstock or converts an alternate substance to a synthetic fuel and certain associated equipment.

(2) *Alternate substance.* (i) An alternate substance is any substance or

combination of substances other than an oil or gas substance. Alternate substances include coal, wood, and agricultural, industrial, and municipal wastes or by-products. Alternate substances do not include synthetic fuels or other products that are produced from an alternate substance and that have undergone a chemical change as described in paragraph (c)(5)(ii) of this section. For example, methane produced from landfills is not an alternate substance; rather it is a synthetic fuel produced from an alternate substance. However, preparing an alternate substance for use as a fuel or feedstock or for conversion into a fuel does not create a new product if no chemical change occurs. For example, pelletizing, drying, compacting, and liquefying do not result in a new product if no chemical change occurs.

(ii) The term ''oil or gas substance'' means—

(A) Oil or gas and

(B) Any primary product of oil or gas.

(iii) For the definition of primary product of oil or gas, see § 1.993–3(g)(3)(i), (ii), and (vi). Thus, petrochemicals are not primary products of oil or gas.

(3) *Boiler.* (i) A boiler that uses an alternate substance as its primary fuel is alternative energy property.

(ii) A boiler is a device for producing vapor from a liquid. Boilers, in general, have a burner in which fuel is burned. A boiler includes a fire box, boiler tubes, the containment shell, pumps, pressure and operating controls, and safety equipment, but not pollution control equipment (as defined in paragraph (c)(8) of this section).

(iii) A ''primary fuel'' is a fuel comprising more than 50 percent of the fuel requirement of an item of equipment, measured in terms of Btu's for the remainder of the taxable year from the date the equipment is placed in service and for each taxable year thereafter. Electricity and waste heat are not fuels. For example, electric boilers do not qualify as alternative energy property even if the electricity is derived from an alternate substance.

(4) *Burners.* (i) A burner for a combustor other than a burner described in paragraph (c)(3)(ii) of this section is alternative energy property if the burner uses an alternate substance as its primary fuel (as defined in paragraph (c)(3)(iii) of this section).

(ii) A burner is the part of a combustor that produces a flame. A combustor is a process heater which includes ovens, kilns, and furnaces.

(iii) A burner includes equipment (such as conveyors, flame control devices, and safety monitoring devices) located at the site of the burner and necessary to bring the alternate substance to the burner.

(5) *Synthetic fuel production equipment.* (i) Equipment (synthetic fuel equipment) that converts an alternate substance into a synthetic solid, liquid, or gaseous fuel (other than coke or coke gas) is alternative energy property. Synthetic fuel production equipment does not include equipment, such as an oxygen plant, that is not directly involved in the treatment of an alternate substance, but produces a substance that is, like the alternate substance, a basic feedstock or catalyst used in the conversion process. Equipment is not eligible if it is used beyond the point at which a substance usable as a fuel has been produced. Equipment is eligible only to the extent of the equipment's cost or basis allocable to the annual production of substances used as a fuel or used in the production of a fuel. For example, assume for the taxable year that 50 percent of the output of equipment is used to produce alcohol for production of whiskey and 50 percent is used to produce alcohol for use in a fuel mixture, such as gasohol. The alcohol production equipment qualifies as synthetic fuel equipment but only to the extent of one-half of its cost or basis. If, in a later taxable year, the equipment is used exclusively to produce whiskey, all of the equipment ceases to be synthetic fuel equipment.

(ii) A fuel is a material that produces usable heat upon combustion. To be ''synthetic'', the fuel either must differ significantly in chemical composition, as opposed to physical composition, from the alternate substance used to produce it or, in the case of solid fuel produced from biomass, the chemical change must consist of defiberization.

Examples of synthetic fuels include alcohol derived from coal, peat, and vegetative matter, such as wood and corn, and methane from landfills.

(iii) Synthetic fuel equipment includes coal gasification equipment, coal liquefaction equipment, equipment for recovering methane from landfill, and equipment that converts biomass to a synthetic fuel.

(iv) Synthetic fuel equipment does not include equipment that merely mixes an alternate substance with another substance. For example, synthetic fuel equipment includes neither equipment that mixes coal and water to produce a slurry nor equipment that mixes alcohol and gasoline to produce gasohol. Equipment used to produce coke or coke gas, such as coke ovens, is also ineligible.

(6) *Modification equipment.* (i) Alternative energy property includes equipment (modification equipment) designed to modify existing equipment. For the definition of ‘‘existing,’’ see paragraph (l)(1)(i) of this section. To be eligible, the modification must result in a substitution for the remainder of the taxable year from the date the equipment is placed in service and for each taxable year thereafter of the items in paragraph (c)(6)(ii)(A) or (B) of this section for all or a portion of the oil or gas substance used as a fuel or feedstock. As a result of the modification, the substituted alternate substance must comprise at least 25 percent of the fuel or feedstock (determined on the basis of Btu equivalency). If the modification also increases the capacity of the equipment, only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies.

(ii) The substitutes for an oil or gas substance are—

(A) An alternate substance or

(B) A mixture of oil and an alternate substance.

(iii) Modification equipment does not include replacements or a boiler of burner. If the boiler or burner is replaced, the items must be described in paragraph (c) (3) or (4) of this section to qualify as alternative energy property. Modification may include, however, replacements of components of a boiler or burner, such as a heat exchanger.

(iv) The following examples illustrate this paragraph (c)(6).

Example 1. On January 1, 1980, corporation X is using oil to fuel its boiler. On June 1, 1980, X modifies the boiler to permit substitution of a coal and oil mixture for 40 percent of X’s oil fuel needs. The mixture consists 75 percent of oil and 25 percent of coal. The equipment modifying the boiler does not qualify as modification equipment because the alternate substance comprises only 10 percent of the fuel.

Example 2. Assume the same facts as in example 1 except 75 percent of the mixture is coal. The equipment modifying the boiler qualifies.

Example 3. Assume the same facts as in example 2 except, instead of substituting an oil and coal mixture for 40 percent of X’s oil fuel needs, X uses the modification to expand the boiler’s fuel capacity by 40 percent using the mixture as additional fuel. The additional fuel mixture comprises only 28 percent of X’s total fuel needs. Thus, even though 75 percent of the additional fuel mixture is an alternate substance, the boiler does not qualify as modification equipment because the alternate substance comprises only 21 percent of the total fuel.

(7) *Equipment using coal as feedstock.* Equipment that uses coal (including lignite) to produce a feedstock for the manufacture of chemicals, such as petrochemicals, or other products is alternative energy property. Equipment is not eligible if it is not directly involved in the treatment of coal or a coal product, but produces a substance that is, like coal, a basic feedstock or catalyst used in the coal conversion process. Equipment is not eligible if it is used beyond the point at which the first product marketable as a feedstock has been produced. Equipment used to produce coke or coke gas, such as coke ovens, is ineligible.

(8) *Pollution control equipment.* (i) Pollution control equipment is alternative energy property. Eligible equipment is limited to property or equipment to the extent it qualifies as a pollution control facility under section 103(b)(4)(F) and the regulations thereunder except that, if control of pollution is not the only significant purpose (within the meaning of those regulations), only the incremental cost (as

defined in paragraph (k) of this section) of the equipment qualifies. However, if a Treasury decision changes the regulations under section 103(b)(4)(F) and, thus, the rules reflected in this subdivision (i), the rules as changed will apply as of the effective date of the Treasury decision.

(ii) To be eligible, the equipment must be required by a Federal, State, or local government regulation to be installed on, or used in connection with, eligible alternative energy property (as defined in paragraph (c)(8)(v) of this section).

(iii) Under section 48(l)(3)(D) equipment is not eligible if required by a Federal, State, or local government regulation in effect on October 1, 1978, to be installed on, or in connection with, property using coal (including lignite) as of October 1, 1978.

(iv) Under this subparagraph (8), pollution control equipment is required by regulation if it would be necessary to install the equipment to satisfy the requirements of any applicable law, including nuisance law. The pollution control equipment need not be specifically identified in the applicable law. If several different types of equipment may be used to comply with the applicable law, each type of equipment is considered necessary to satisfy the requirements of the law. An order permitting a taxpayer to delay compliance with any applicable law is disregarded.

(v) Under this subparagraph (8) ‘‘eligible alternative energy property’’ is energy property (as defined in section 48 (l)(2)) described in paragraphs (c) (3) through (7) of this section. If equipment otherwise qualifying as pollution control equipment is installed on, or used in connection with, both eligible alternative energy property and property other than eligible alternative energy property, only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies.

(vi) *Examples.* The following examples illustrate this subparagraph (8). Assume that the property or equipment in the examples are described in § 1.103–8(g)(2)(ii) and that their only purpose is control of pollution.

Example 1. On October 1, 1978, corporation X acquires and places in service in State A a paper mill. The facility includes a boiler the primary fuel for which is wood chips. The facility includes equipment necessary to comply with pollution control standards in effect on October 1, 1978 in State A. This equipment qualifies as pollution control equipment.

Example 2. On October 1, 1978, corporation Y was burning coal at its facility in State B. The emissions from the facility exceeded State air pollution control requirements in effect on October 1, 1978. On January 1, 1979, X installed cyclone separators to comply with the State pollution control requirements. The cyclone separators do not qualify as pollution control equipment.

Example 3. Assume the same facts as in example 2 except that Y installs a baghouse instead of cyclone separators to meet more stringent standards that take effect on December 31, 1978. The baghouse qualifies as pollution control equipment because the baghouse was not necessary to meet the standards in effect on October 1, 1978.

Example 4. On October 1, 1978, corporation Z is burning coal at its facility in State C. The emissions from that facility exceed State air pollution control standards in effect on October 1, 1978. C orders Z to install cyclone separators before January 1, 1979. However, C allows Z to operate its facility until January 1, 1979, under less stringent interim standards applicable only to Z. The separators do not qualify as pollution control equipment. The delayed compliance order is disregarded.

(9) *Handling and preparation equipment.* (i) Alternative energy property includes equipment (handling and preparation equipment) used for unloading, transfer, storage, reclaiming from storage, or preparation of an alternate substance for use in eligible alternative energy property (as defined in paragraph (c)(9)(ii) of this section). Handling and preparation equipment must be located at the site the alternate substance is used as a fuel or feedstock. For example, equipment used to screen and prepare coal for use at a power plant qualifies if located at the plant. However, similar equipment located at the coal mine would not qualify.

(ii) Under this subparagraph (9), ‘‘eligible alternative energy property’’ is energy property (as defined in section 48(l)(2)) described in paragraphs (c) (3) through (8) of this section. If equipment otherwise qualifying as handling and preparation equipment is installed on, or used in connection with, property other than eligible alternative energy property, only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies.

(iii) The term ‘‘preparation’’ includes washing, crushing, drying, compacting, and weighing of an alternate substance. Handling and preparation equipment also includes equipment for shredding, chopping, pulverizing, or screening agricultural or forestry byproducts at the site of use.

(iv) Handling and preparation equipment does not include equipment, such as coal slurry pipelines and railroad cars, that transports a fuel or a feedstock to the site of its use.

(10) *Geothermal equipment*—(i) Alternative energy property includes equipment (geothermal equipment) that produces, distributes, or uses energy derived from a geothermal deposit (as defined in §1.44C–2(h)).

(ii) In general, production equipment includes equipment necessary to bring geothermal energy from the subterranean deposit to the surface, including well-head and downhole equipment (such as screening or slotting liners, tubing, downhole pumps, and associated equipment). Reinjection wells required for production also may qualify. Production does not include exploration and development.

(iii) Distribution equipment includes equipment that transports geothermal steam or hot water from a geothermal deposit to the site of ultimate use. If geothermal energy is used to generate electricity, distribution equipment includes equipment that transports hot water from the geothermal deposit to a power plant. Distribution equipment also includes components of a heating system, such as pipes and ductwork that distribute within a building the energy derived from the geothermal deposit.

(iv) Geothermal equipment includes equipment that uses energy derived both from a geothermal deposit and from sources other than a geothermal deposit (dual use equipment). Such equipment, however, is geothermal equipment (A) only if its use of energy from sources other than a geothermal deposit does not exceed 25 percent of its total energy input in an annual measuring period and (B) only to the extent of its basis or cost allocable to its use of energy from a geothermal deposit during an annual measuring period. An ‘‘annual measuring period’’ for an item of dual use equipment is the 365 day period beginning with the day it is placed in service or a 365 day period beginning the day after the last day of the immediately preceding annual measuring period. The allocation of energy use required for purposes of paragraph (c)(10)(iv) (A) and (B) of this section may be made by comparing, on a Btu basis, energy input to dual use equipment from the geothermal deposit with energy input from other sources. However, the Commissioner may accept any other method that, in his opinion, accurately establishes the relative annual use by dual use equipment of energy derived from a geothermal deposit and energy derived from other sources.

(v) The existence of a backup system designed for use only in the event of a failure in the system providing energy derived from a geothermal deposit will not disqualify any other equipment. If geothermal energy is used to generate electricity, equipment using geothermal energy includes the electrical generating equipment, such as turbines and generators. However, geothermal equipment does not include any electrical transmission equipment, such as transmission lines and towers, or any equipment beyond the electrical transmission stage, such as transformers and distribution lines.

(vi) *Examples.* The following examples illustrate this subparagraph (10):

Example 1. On October 1, 1979, corporation X, a calendar year taxpayer, places in service a system which heats its office building by circulating hot water heated by energy derived from a geothermal deposit through the building. Geothermal equipment includes the circulation system, including the pumps and pipes which circulate the hot water through the building.

Example 2. The facts are the same as in Example 1, except that corporation X also places in service a boiler to produce hot water for heating the building exclusively in the event of a failure of the geothermal equipment. Such a boiler is not geothermal equipment, but the existence of such a backup system does not serve to disqualify property eligible in Example 1.

Example 3. The facts are the same as in Example 1, except that the water heated by energy derived from a geothermal deposit is not hot enough to provide sufficient heat for the building. Therefore, the system includes an electric boiler in which the water is heated before being circulated in the heating system. Assume that, on a Btu basis, eighty percent of the total energy input to the circulating system during the 365 day period beginning on October 1, 1979, is energy derived from a geothermal deposit. The boiler is not geothermal equipment. For the 1979 taxable year, eighty percent of the circulating system is geothermal equipment because eighty percent of its basis or cost is allocable to use of energy from a geothermal deposit. If, in a subsequent taxable year, the basis or cost allocable to use of energy from a geothermal deposit falls below eighty percent, recapture may be required under section 47 and § 1.47–1(h). Thus, if, on a Btu basis, only 70 percent of the total energy input to the circulating system for the 365 day period beginning October 1, 1980, is energy derived from a geothermal deposit, then there will be complete recapture of the credit during the 1980 taxable year. If, however, for that 365 day period, the portion of the total energy input that is derived from a geothermal deposit is less than 80 percent but greater than or equal to 75 percent, then only a proportional amount of credit will be recaptured during the 1980 taxable year. No additional credit is allowable in a subsequent taxable year, however, if the portion of the basis or cost allocable to use of energy from a geothermal deposit increases above what it was for a previous taxable year (see § 1.46–3(d)(4)(i)).

Example 4. Corporation Y acquires a commercial vegetable dehydration system in 1981. The system operates by placing fresh vegetables on a conveyor belt and moving them through a dryer. The conveyor belt is powered by electricity. The dryer uses solely energy derived from a geothermal deposit. The dryer is geothermal equipment while the equipment powered by electricity does not qualify.

(d) *Solar energy property*—(1) *In general.* Energy property includes solar energy property. The term ‘‘solar energy property’’ includes equipment and materials (and parts related to the functioning of such equipment) that use solar energy directly to (i) generate electricity, (ii) heat or cool a building or structure, or (iii) provide hot water for use within a building or structure. Generally, those functions are accomplished through the use of equipment such as collectors (to absorb sunlight and create hot liquids or air), storage tanks (to store hot liquids), rockbeds (to store hot air), thermostats (to activate pumps or fans which circulate the hot liquids or air), and heat exchangers (to utilize hot liquids or air to create hot air or water). Property that uses, as an energy source, fuel or energy derived indirectly from solar energy, such as ocean thermal energy, fossil fuel, or wood, is not considered solar energy property.

(2) *Passive solar excluded*—(i) Solar energy property excludes the materials and components of ‘‘passive solar systems,’’ even if combined with ‘‘active solar systems.’’

(ii) An active solar system is based on the use of mechanically forced energy transfer, such as the use of fans or pumps to circulate solar generated energy.

(iii) A passive system is based on the use of conductive, convective, or radiant energy transfer. Passive solar property includes greenhouses, solariums, roof ponds, glazing, and mass or water trombe walls.

(3) *Electric generation equipment.* Solar energy property includes equipment that uses solar energy to generate electricity, and includes storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items. In general, this process involves the transformation of sunlight into electricity through the use of such devices as solar cells or other collectors. However, solar energy property used to generate electricity includes only equipment up to (but not including) the stage that transmits or uses electricity.

(4) *Pipes and ducts.* Pipes and ducts that are used exclusively to carry energy derived from solar energy are solar energy property. Pipes and ducts that are used to carry both energy derived from solar energy and energy derived from other sources are solar energy property (i) only if their use of energy other than solar energy does not exceed 25 percent of their total energy input in an annual measuring period and (ii) only to the extent of their basis or cost allocable to their use of solar energy during an annual measuring period. (See paragraph (d)(6) of this section for the definition of ‘‘annual measuring period’’ and for rules relating to the method of allocation.)

(5) *Specially adapted equipment.* Equipment that uses solar energy beyond the

distribution stage is eligible only if specially adapted to use solar energy.

(6) *Auxiliary equipment.* Solar energy property does not include equipment (auxiliary equipment), such as furnaces and hot water heaters, that use a source of power other than solar or wind energy to provide usable energy. Solar energy property does include equipment, such as ducts and hot water tanks, which is utilized by both auxiliary equipment and solar energy equipment (dual use equipment). Such equipment is solar energy property (i) only if its use of energy from sources other than solar energy does not exceed 25 percent of its total energy input in an annual measuring period and (ii) only to the extent of its basis of cost allocable to its use of solar or wind energy during an annual measuring period. An ‘‘annual measuring period’’ for an item of dual use equipment is the 365 day period beginning with the day it is placed in service or a 365 day period beginning the day after the last day of the immediately preceding annual measuring period. The allocation of energy use required for purposes of paragraphs (d)(6) (i) and (ii) of this section may be made by comparing, on a Btu basis, energy input to dual use equipment from solar energy with energy input from other sources. However, the Commissioner may accept any other method that, in his opinon, accurately establishes the relative annual use by dual use equipment of solar energy and energy derived from other sources.

(7) *Solar process heat equipment.* Solar energy property does not include equipment that uses solar energy to generate steam at high temperatures for use in industrial or commercial processes (solar process heat).

(8) *Example.* The following example illustrates this paragraph (d).

Example. (a) In 1979, corporation X, a calendar year taxpayer, constructs an apartment building and purchases equipment to convert solar energy into heat for the building. Corporation X also installs an oil-fired water heater and other equipment to provide a backup source of heat when the solar energy equipment cannot meet the energy needs of the building. For purposes of this example, all equipment is placed in service on October 1, 1979. On a Btu basis, eighty percent of the total energy input to the dual use equipment during the 365 day period beginning October 1, 1979, is from solar energy.

(b) The items purchased, in addition to the water heater, include a roof solar collector, a heat exchanger, a hot water tank, a control component, pumps, pipes, fan-coil units, and valves. Assume the fan-coil units could be used with energy derived from an oil or gas substance without significant modification. All items are depreciable and have a useful life of three years or more. The use of the equipment to heat the building is the first use to which the equipment has been put.

(c) Water is pumped from the basement through pipes to the roof solar collector. Heated water returns through pipes to a heat exchanger which transfers heat to the water in the hot water tank.

(d) The hot water tank and the oil-fired water heater utilize the same distribution pipe. Pumps and valves at the points of connection between the hot water tank, the oil-fired water heater, and the distribution pipe regulate the auxiliary energy supply use. They also prevent the oil-fired water heater from heating water in the hot water tank.

(e) An integrated control component determines whether hot water from the hot water tank or from the oil-fired water heater is distributed to fan-coil units located throughout the building.

(f) The roof solar collector is solar energy property. The pump that moves the water to the roof collector and the pipes between the roof collector and the hot water tank qualify because they are solely related to transporting solar heated water. The hot water tank qualifies because it stores water heated solely by solar radiation. The heat exchanger also qualifies.

(g) The oil-fired water heater does not qualify as solar energy property because it is auxiliary equipment.

(h)(1) Because the distribution pipe, the control component, and the pumps and valves serve the oil-fired water heater as well as the solar energy equipment; they qualify only to the extent of eighty percent of their cost or basis, the portion allocable to use of solar energy. If, in a subsequent taxable year, the basis or cost allocable to their use of solar energy falls below eighty percent, recapture may be required under section 47 and §1.47–1(h). Thus, if, on a Btu basis, only 70 percent of the total energy input to that equipment for the 365 day period beginning October 1, 1980, is from solar energy, then there will be complete recapture of the credit during the 1980 taxable year. If, however, for that 365 day period, the portion of that equipment's total energy input that is from solar energy is less than 80 percent but greater than or equal to 75 percent, then only a proportional amount of credit will be recaptured during the 1980 taxable year. No additional credit is allowable for the equipment in a subsequent taxable year, however, if the portion of its basis or cost allocable to use of solar energy increases above what it was for a previous taxable year (see § 1.46–3 (d)(4)(i)).

(2) The fan-coil units do not qualify as solar energy property because they are not specially adapted to use energy derived from solar energy.

(e) *Wind energy property*—(1) *In general.* Energy property includes wind energy property. Wind energy property is equipment (and parts related to the functioning of that equipment) that performs a function described in paragraph (e)(2) of this section. In general, wind energy property consists of a windmill, wind-driven generator, storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items. Wind energy property does not include equipment that transmits or uses electricity derived from wind energy. In addition, limitations apply similar to those set forth in paragraphs (d) (5), (6), and (8) of this section. For example, if equipment is used by both auxiliary equipment and wind energy equipment, such equipment is wind energy property only if its use of energy other than wind energy does not exceed 25 percent of its total energy input in an annual measuring period and only to the extent of its basis or cost allocable to its use of wind energy during an annual measuring period.

(2) *Eligible functions.* Wind energy property is limited to equipment (and parts related to the functioning of that equipment) that—

(i) Uses wind energy to heat or cool, or provide hot water for use in, a building or structure, or

(ii) Uses wind energy to generate electricity (but not mechanical forms of energy).

(f) *Specially defined energy property*—(1) *In general.* Specially defined energy property means only those items described in paragraphs (f) (4) through (14) of this section that meet the requirements of paragraph (f)(2) of this section. The items described in paragraphs (f) (4) through (14) of this section also consist of related equipment, such as fans, pumps, ductwork, piping, and controls, the installation of which is necessary for the specified item to reduce the energy consumed or heat wasted by the process.

(2) *General requirements.* To be eligible, each item described in paragraphs (f) (4) through (14) of this section must be installed in connection with an existing industrial or commercial facility. In addition, the principal purpose of each of those items must be reduction of energy consumed or heat wasted in any existing industrial or commercial process. See section 48(l)(10) and paragraph (l) of this section. If an item performs more than one function, only the incremental cost (as defined in paragraph (k) of this section) of the equipment qualifies.

(3) *Industrial or commercial process.* (i) A process is a means or method of producing a desired result by chemical, physical, or mechanical action. For example, equipment installed in connection with retail sales, general office use, and residential use are not used in a process within the meaning of this paragraph (f)(3).

(ii) An industrial process includes agricultural processes and thermal processes relating to production or manufacture, such as those involving boilers and furnaces.

(iii) A commercial process includes laundering and food preparation.

(iv) More than one process may be conducted in a single facility. The fact that several processes involved in the production of a product are integrated does not cause such integrated processes to be treated as one process. For example, in a food canning facility, producing prepared food from fresh vegetables is not one process but rather an integration of several processes including washing, cooking and canning.

(v) The following example illustrates this paragraph (f)(3).

Example. Corporation X, an advertising agency, acquires an automatic energy control system designed to reduce energy consumed by heating and cooling its office building. Although the use of an office for X's business is a commercial activity, heating or cooling an office is not an industrial or commercial process. The automatic energy control system does not qualify because it does not reduce energy consumed in an industrial or commercial process.

(4) *Recuperators.* Recuperators recover energy, usually in the form of waste heat from combustion exhaust

gases, hot exiting product, or product cooling air, that is used to heat incoming combustion air, raw materials, or fuel. Recuperators are configurations of equipment consisting in part of fixed heat transfer surfaces between two gas flows, and include related baffles, dividers, entrance flanges, transition sections, and shells or cases enclosing the other components of the recuperator. In general, a fixed heat transfer surface absorbs heat from a gas or liquid flow or dissipates heat to the gas or liquid flow.

(5) *Heat wheels.* Heat wheels recover energy, usually in the form of waste heat, from exhaust gases to preheat incoming gases. Heat wheels are items of equipment consisting in part of regenerators (which rotate between two gas flows) and related drive components, wiper seals, entrance flanges, and transition sections.

(6) *Regenerators.* Regenerators are devices, such as clinker columns or chains, that recover energy by efficiently storing heat while exposed to high temperature gases and releasing heat while exposed to low temperature gases, fluids, or solids.

(7) *Heat exchangers.* Heat exchangers recover energy, usually in the form of waste heat, from high temperature gases, liquids, or solids for transfer to low temperature gases, liquids, or solids. Heat exchangers consist in part of fixed heat transfer surfaces (described in paragraph (f)(4) of this section) separating two media. Heat exchange equipment does not include fluidized bed combustion equipment.

(8) *Waste heat boilers.* Waste heat boilers use waste heat, usually in the form of combustion exhaust gases, as a substantial source of energy. A substantial source of energy is one that comprises more than 20 percent of the energy requirement on the basis of Btu's during the course of each taxable year (including the start-up year).

(9) *Heat pipes.* Heat pipes recover energy, usually in the form of waste heat, from high temperature fluids to heat low temperature fluids. A heat pipe consists in part of sealed heat transfer chambers and a capillary structure. In general, the heat transfer chambers alternatively vaporize and condense a working fluid as it passes from one end of the chamber to the other.

(10) *Automatic energy control systems.* Automatic energy control systems automatically reduce energy consumed in an industrial or commercial process for such purposes as environmental space conditioning (*i.e.,* lighting, heating, cooling or ventilating, etc.). Automatic energy control systems include, for example, automatic equipment settings controls, load shedding devices, and relay devices used as part of such system. Property such as computer hardware installed as a part of the energy control system also qualifies, but only to the extent of its incremental cost (as defined in paragraph (k) of this section).

(11) *Turbulators.* Turbulators increase the rate of transfer of heat from combustion gases to heat exchange surfaces by increasing the turbulence in the gases. A turbulator is a baffle placed in a boiler firetube or in a heat exchange tube in industrial process equipment to deflect gases to the heat transfer surface.

(12) *Preheaters.* Preheaters recover energy, usually in the form of waste heat, from either combustion exhaust gases or steam, to preheat incoming combustion air or boiler feedwater. A preheater consists in part of fixed heat transfer surfaces (described in paragraph (f)(4) of this section) separating two fluids.

(13) *Combustible gas recovery systems.* Combustible gas recovery systems are items of equipment used to recover unburned fuel from combustion exhaust gases.

(14) *Economizers.* Economizers are configurations of equipment used to reduce energy demand or recover energy from combustion exhaust gases and other high temperature sources to preheat boiler feedwater.

(15) *Other property added by the Secretary.* [Reserved]

(g) *Recycling equipment*—(1) *In general.* Recycling equipment is equipment used exclusively to sort and prepare, or recycle, solid waste (other than animal waste) to recover usable raw materials (''recovery equipment''), or to convert solid waste (including animal waste) into fuel or other useful forms of energy (‘‘conversion equipment’’). Recycling equipment may include certain other onsite related equipment.

(2) *Recovery equipment.* Recovery equipment includes equipment that—

(i) Separates solid waste from a mixture of waste,

(ii) Applies a thermal, mechanical, or chemical treatment to solid waste to ensure the waste will properly respond to recycling, or

(iii) Recycles solid waste to recover usable raw materials, but not beyond occurrence of the first of the following:

(A) The point at which a material has been created that can be used in beginning the fabrication of an end-product in the same way as materials from a virgin substance. Examples are the fiber stage in textile recycling, the newsprint or paperboard stage in paper recycling, and the ingot stage for other metals (other than iron and steel). In the case of recycling iron or steel, recycling equipment does not include any equipment used to reduce solid waste to a molten state or any process thereafter.

(B) The point at which the material is a marketable product (*i.e.,* has a value other than for recycling) even if the material is not marketed by the taxpayer at that point.

(3) *Conversion equipment.* Conversion equipment includes equipment that converts solid waste into a fuel or other usable energy, but not beyond the point at which a fuel, steam, electricity, hot water, or other useful form of energy has been created. Thus, combustors, boilers, and similar equipment may be eligible if used for a conversion process, but steam and heat distribution systems between the combustor or boiler and the point of use are not eligible.

(4) *On-site related equipment.* Recycling equipment also includes onsite loading and transportation equipment, such as conveyors, integrally related to other recycling equipment. This equipment may include equipment to load solid waste into a sorting or preparation machine and also a conveyor belt system that transports solid waste from preparation equipment to other equipment in the recycling process.

(5) *Solid waste.* (i) The term ‘‘solid waste’’ has the same meaning as in §1.103–8(f)(2)(ii)(*b*), subject to the following exceptions and the other rules of this subparagraph (5):

(A) The date the equipment is placed in service is substituted in the first sentence of §1.103–8(f)(2)(ii)(*b*) for the date of issue of the obligations, and

(B) Material that has a market value at the place it is located only by reason of its value for recycling is not considered to have a market value.

(ii) Solid waste may include a nominal amount of virgin materials, liquids, or gases, not to exceed 10 percent. If more than 10 percent of the material recycled during the course of any taxable year (including the ‘‘start up’’ year) consists of virgin material, liquids, or gases, the equipment ceases to be energy property and is subject to recapture under section 47. The determination of the portion of virgin material, liquids, or gases used is based on volume, weight, or Btu’s whichever is appropriate.

(6) *Ineligible equipment.* Transportation equipment, such as trucks, that transfer solid waste between geographically separated sites (*e.g.,* the collection point and the recycling point) is not eligible. Steam and heat distribution systems are also ineligible.

(7) *Increased recycling capacity.* If the equipment both replaces recycling capacity and increases that capacity at a particualr site, only the incremental cost (as defined in paragraph (k) of this section) of increasing the capacity qualifies. Recycling capacity is determined by the ability to produce a product not previously produced by the taxpayer, or more of an existing product, in a way that does not lower overall production.

(8) *Examples.* The following examples illustrate this paragraph (g).

Example 1. Corporation W recycles aluminum scrap metal. W owns a junk yard where it collects and crushes the metal into compact units. W’s trucks bring the scrap metal from the junk yard to its main plant located 3 miles away. W’s furnace equipment at the main plant reduces the scrap to the molten state and W’s rolling equipment rolls the aluminum into sheets. The furnace qualifies, but for two separate reasons the rolling equipment does not qualify. First, the molten aluminum would be a marketable product if reduced to ingots prior to rolling. It is not necessary that W actually reduce the molten aluminum to ingots. Second, the molten aluminum could be used in the same way as virgin material.

Example 2. Corporation X manufactures newsprint using wood chips discarded during X's lumber operations. Assume X could sell the wood chips to other companies located a short distance from X's mill for use as a fuel. None of the equipment used to manufacture the newsprint qualifies.

Example 3. Assume the same facts as in example 2 except X uses old newspapers which have no value except for recycling in the area where X's mill is located. The equipment qualifies.

Example 4. Corporation Y recycles municipal waste. Assume the municipal waste is ''solid waste'' under paragraph (g)(5) of this section. During the first taxable year Y operates the equipment, Y uses 8,500 pounds of municipal waste and 1,500 pounds of virgin material and liquids. No energy credit is allowed for the equipment.

Example 5. Corporation Z owns a waste recovery facility. The corrugated paper portion of the waste stream is picked off a conveyor as it enters the facility. The corrugated paper is baled and sold as a secondary paper product. Z acquires shredding and air-classification equipment. Corrugated paper that is not removed from the conveyor belt enters the new equipment for production as a fuel. Z increases the input of corrugated paper so that the same amount of corrugated paper is removed from the conveyor to be baled. The excess paper that is not removed for baling enters the shredding and air-classification equipment. The new equipment qualifies.

(h) *Shale oil equipment*—(1) *In general.* Shale oil equipment used in mining or either surface or *in situ* processing qualifies as energy property. Shale oil equipment means equipment used exclusively to mine, or produce or extract oil from, shale rock.

(2) *Eligible processes.* In general, processing equipment qualifies if used in or after the mining stage and up through the retorting process. Thus, eligible processes include crushing, loading into the retort, and retorting, but not hydrogenation, refining, or any process subsequent to retorting. However, with respect to *in situ* processing, eligible processes include creating the underground cavity.

(3) *Eligible equipment.* Shale oil equipment includes—

(i) Heading jumbos, bulldozers, and scaling and bolting rigs used to create an underground cavity for *in situ* processing,

(ii) On-site water supply and treatment equipment and handling equipment for spent shale.

(iii) Crushing and screening plant equipment, such as hoppers, feeders, vibrating screens, and conveyors,

(iv) Briquetting plant equipment, such as hammer mills and vibratory pan feeders, and

(v) Retort equipment, including direct cooling and condensing equipment.

(i) [Reserved]

(j) *Natural gas from geopressured brine.* Equipment used exclusively to extract natural gas from geopressured brine described in section 613A(b)(3)(C)(i) is energy property. Eligible equipment includes equipment used to separate the gas from saline water and remove other impurities from the gas. Equipment is eligible only up to the point the gas may be introduced into a pipeline.

(k) *Incremental cost.* The term ''incremental cost'' means the excess of the total cost of equipment over the amount that would have been expended for the equipment if the equipment were not used for a qualifying purpose. For example, assume equipment costing $100 performs a pollution control function and another function. Assuming it would cost $60 solely to perform the nonqualifying function, the incremental cost would be $40.

(l) *Existing*—(1) *In general.* For purposes of section 48(l), the term ''existing'' means—

(i) When used in connection with a facility or equipment, 50 percent or more of the basis of that facility or equipment is attributable to construction, reconstruction, or erection before October 1, 1978, or

(ii) When used in connection with an industrial or commercial process, that process was carried on in the facility as of October 1, 1978.

(2) *Industrial or commercial process.* (i) A process will be considered the same as the process carried on in the facility as of October 1, 1978, unless and until capitalizable expenditures are paid or incurred for modification of the process. The expenditures need not be capitalized in fact; it is sufficient if the

taxpayer has an option or may elect to capitalize. In general, the date of change will be the date the expenditures are properly chargeable to capital account. If the taxpayer properly elects to expense a capitalizable expenditure, the date of change will be the date the expenditure could have been properly chargeable to capital account if the expenditure had been capitalized. Recapture will not occur by reason of a change in a process unless the process change also changes the use of the equipment. See example (1) of § 1.47–1(h)(5).

(m) *Quality and performance standards*—(1) *In general.* Energy property must meet quality and performance standards, if any, that have been prescribed by the Secretary (after consultation with the Secretary of Energy) and are in effect at the time of acquisition.

(2) *Time of acquisition.* Under this paragraph (m) the time of acquisition is—

(i) The date the taxpayer enters into a binding contract to acquire the property or

(ii) For property constructed, reconstructed, or erected by the taxpayer, (A) the earlier of the date it begins construction, reconstruction, or erection of the property, or (B) the date the taxpayer and another person enter into a binding contract requiring each to construct, reconstruct, or erect property and place the property in service for an agreed upon use. See example under paragraph (m)(4) of this section.

(3) *Binding contract.* Under this paragraph (m), a binding contract to construct, reconstruct, or erect property, or to acquire property, is a contract that is binding at all times on the taxpayer under applicable State or local law. A binding contract to construct, reconstruct, or erect property or to acquire property, does not include a contract for preparation of architect's sketches, blueprints, or performance of any other activity not involving the beginning of physical work.

(4) *Example.* The following example illustrates this paragraph (m).

Example. Corporation X owns a junk yard. Corporation Y manufactures recycling equipment and operates several recycling facilities. On January 1, 1979, X and Y enter into a written contract that is binding on both parties on that date and at all times thereafter. Under the contract's terms X will supply scrap metals to Y and Y agrees in return to build a recycling facility on land adjacent to the junk yard. Y will own and operate the facility using the scrap metal supplied by X. Y may treat the agreement as a binding contract under paragraph (m) (2) and (3) of this section.

(n) *Public utility property*—(1) *Inclusions.* Public utility property is included in both of the following categories of energy property:

(i) Shale oil equipment and

(ii) Equipment for producing natural gas from geopressured brine.

(2) *Exclusions.* Public utility property is excluded from each of the following categories of energy property:

(i) Alternative energy property,

(ii) Specially defined energy property,

(iii) Solar or wind energy property, and

(iv) Recycling equipment.

(3) *Public utility property.* The term ''public utility property'' has the meaning given in section 46(f)(5).

(o)—(p) [Reserved]

(q) *Qualified intercity buses*—(1) *In general.* This paragraph (q) prescribes rules and definitions for purposes of section 48(l)(2)(A)(ix) and (16). Energy property includes qualified intercity buses of an eligible taxpayer, but only to the extent of the increase in the taxpayer's total operating seating capacity (operating capacity) under paragraphs (q) (9), (10), and (11) of this section. For application of recapture rules see § 1.47–1(h)(3)(ii).

(2) *Eligible taxpayer.* A taxpayer is an eligible taxpayer only if it is determined to be both—

(i) A common carrier regulated by the Interstate Commerce Commission or an appropriate State agency and

(ii) Engaged in the trade or business of furnishing intercity transportation by bus.

(3) *Common carrier.* The taxpayer is a common carrier only if the taxpayer holds itself out to the general public as providing passenger bus transportation for compensation over regular or irregular routes, or both.

(4) *Appropriate State agency.* A State agency is appropriate only if it has both—

(i) Power to regulate intrastate transportation provided by a motor carrier, within the meaning of section 10521(b)(1) of the Revised Interstate Commerce Act (49 U.S.C. 10521(b)(1)), and

(ii) Power to initiate an exemption proceeding under section 1025(b) of that Act (49 U.S.C. 10525(b)).

(5) *Intercity transportation.* Intercity transportation means intercity passenger transportation or intercity passenger charter service. Intercity transportation does not include transportation provided entirely within a municipality, contiguous municipalities, or within a zone that is adjacent to, and commercially a part of, the municipality or municipalities (within the meaning of section 10526(b)(1) of the Revised Interstate Commerce Act (49 U.S.C. 10526(b)(1)). See 49 CFR part 1048 (regulations defining commercial zones under that statute).

(6) *Definition of qualified intercity bus.* A qualified intercity bus (qualifying bus) is an automobile bus—

(i) The chassis and body of which are exempt (under section 4063(a)(6)) from the 10-percent excise tax generally imposed under section 4061(a) on trucks and buses.

(ii) With a seating capacity of at least 36 passengers (in addition to the driver).

(iii) With one or more baggage compartments, in an area separated from the passenger area, with an aggregate capacity of at least 200 cubic feet, and

(iv) Which meets the predominant use test.

(7) *Predominant use test.* (i) A bus meets the predominant use test for a taxable year only if it meets the following conditions:

(A) It is used on a full-time basis during the taxable year, and

(B) At least 70 percent of the total miles driven are driven while furnishing intercity transportation.

(ii) A bus driven from the end point of one trip to the beginning point of another trip (‘‘deadheading’’), both of which furnish intercity transportation of passengers, will be considered to have been driven while furnishing intercity transportation of passengers, even if no passengers are carried.

(iii) A bus is considered used on a full-time basis in a taxable year if it was driven 10,000 miles in that year. If available, the best evidence of annual mileage is the difference between odometer readings at the beginning and end of each taxable year. If the bus was placed in service during the taxable year, or for a short taxable year described in section 441(b)(3), that 10,000 mile figure is prorated on a daily basis.

(iv) If a qualifying bus fails to meet the predominant use test in a taxable year, a cessation occurs in that taxable year. See §1.47–1(h)(3)(ii).

(v) The following examples illustrate this paragraph (q)(7):

Example 1. X, a bus company, used a bus for trips between city M and city N, a distance of 100 miles. These trips qualify as furnishing intercity transportation. During the taxable year, 300 round trips were run carrying passengers both ways and 75 trips were run carrying passengers from city M to city N immediately after each of which the bus was returned to city M for the next trip. The bus was also driven 20,000 miles to furnish passenger service which was local transportation. During the taxable year, the bus was driven a total of 100,000 miles. X makes the following calculations to determine if it met the predominant use test for the taxable year.

1. Total miles driven	100,000
2. Intercity miles driven:	
a. Passenger round trips (100 x 2 X 300)	60,000
b. Passenger one-way (75 x 100)	7,500
c. Non-passenger return trips (75 x 100) ...	7,500
3. Total intercity passenger miles (sum of lines 2 a, b, and c)	75,000
4. 79% of line 1	70,000

Since line 1 is not less than 10,000 miles, the full-time use requirement is met. Since line 3 is greater than line 4, the 70 percent intercity mileage test is met. Thus, for the taxable year, the bus meets the predominant use test in paragraph (q)(7)(i) of this section.

Example 2. The facts are the same as in example 1, except that the bus was placed in service on the last day of the taxable year. The bus was used only to run one round trip, carrying passengers, between cities M and N. 10,000 miles X one day ÷365 days=27.4 miles. Because, for the one day of the taxable year that the bus was in service, the bus was driven more than 27.4 miles, and all these miles were driven to furnish intercity transportation, it met the predominant use test for the taxable year.

(8) *Leased buses.* (i) A bus which is leased is energy property only if it meets the requirements of paragraphs

(q)(6) (i), (ii), and (iii) of this section, the lessee is an eligible taxpayer, and the bus meets the predominant use test in the hands of the lessee. If a leased bus is energy property, the energy credit is available only to the lessee unless paragraph (q)(8)(ii) of this section applies. The lessor must elect under section 48(d) for the lessee to claim the energy credit.

(ii) If a leased bus is energy property and, on or before October 9, 1984, either (A) the lessor and lessee enter into a lease and the lessee places the bus in service, or (B) the bus is not placed in service but the lessor and lessee enter into a binding contract under which the amount of the lease payments cannot be modified, then the energy credit is available to the lessor even if the lessor is not an eligible taxpayer.

(iii) Notwithstanding § 1.47–2(b)(1) (relating to the effect of a disposition by the lessee on the credit claimed by the lessor), if, by reason of a lease or the termination of a lease, a bus is used in a taxable year subsequent to the credit year by a person other than the one whose increase in operating capacity determined the amount of qualified investment for the energy credit, a disposition of the bus under § 1.47–1(h)(2) results. However, if the energy credit for a bus was earned in a taxable year and a lease of the bus which qualifies under section 168(f)(8) (safe-harbor lease) is entered into in a subsequent taxable year, the safe-harbor lease is not a disposition of the bus and the lessee under that lease is treated as the lessee for purposes of this paragraph (q)(8). For the requirement to file an amended return if the energy credit was allowed in a prior taxable year, see § 5c.168(f)(8)–6(b)(2)(ii) (Temporary Income Tax Regulations under the Economic Recovery Tax Act of 1981). For the rule for determining whose operating capacity determines qualified investment for the energy credit, see paragraph (q)(9)(ii) of this section. For the rule for leases to related taxpayers, see paragraph (q)(10)(ii) of this section.

(9) *Operating capacity*. (i) Qualified investment for a qualifying bus is taken into account for the energy credit only to the extent the bus increases the taxpayer's operating capacity. To increase operating capacity, a bus must be counted in operating capacity. The increase in a taxpayer's operating capacity is the excess of the taxpayer's operating capacity for the current taxable year over its operating capacity for the immediately preceding taxable year. Related taxpayers determine operating capacity on a group basis under paragraph (q)(10) of this section.

(ii) Operating capacity for a particular taxable year is determined by adding together the seating capacities of all intercity buses used by the taxpayer in that year and still owned by the taxpayer at the end of that year. An intercity bus is a bus which meets the chassis and body test and the predominant use test in paragraph (q)(6) of this section whether or not the bus is still in use at the end of the taxable year. In the case of a leased bus to which paragraph (q)(8) of this section applies, the lessee's operating capacity determines qualified investment for the energy credit.

(iii) The qualified investment for the energy credit for a qualifying bus is the bus's qualified investment for the regular credit multiplied by a fraction. The numerator of the fraction is the increase in the taxpayer's operating capacity for the taxable year. The denominator is the added operating capacity for the taxable year. Added operating capacity for the taxable year is determined for a taxpayer by adding together the seating capacities of the taxpayer's intercity buses included in operating capacity for the taxable year which were not included in operating capacity for the immediately preceding taxable year.

(iv) In the case of a partnership, each partner's qualified investment for the energy credit for a qualifying bus is the partner's qualified investment for the regular credit (determined under § 1.46–3(f) multiplied by the fraction referred to in paragraph (q)(9)(iii) of this section for the partnership, as determined for the partnership taxable year in which the bus is placed in service.

(v) The following example illustrates this paragraph (q)(9):

Example. Corporation Y is a calendar year bus company that is an eligible taxpayer under paragraph (q)(2) of this section. Based upon the facts as set forth in the following table, Y makes the following calculations to determine the energy credit earned in 1981:

1. 1980 operating capacity determined as of 12/31/80:	
a. 5 intercity buses×50 seats each	250
b. Total 1980 operating capacity	250
2. 1981 operating capacity determined as of 12/31/8:	
a. 2 1980 buses used on a full-time basis in 1981	100
b. 1981 added capacity:	
i. Qualifying buses:	
Bus 1	45
Bus 2	55
Bus 3	50
ii. Intercity bus not a qualifying bus	50
iii. Total 1981 added capacity	200
c. Total 1981 operating capacity	300
3. 1981 increase in operating capacity (line 2c – line 1b)	50
4. Fraction for determining qualified investment attributable to increase in capacity (line 3+line 2 (b)(iii))	¼

Accordingly, the energy credit earned in 1981 for each of the qualifying buses is determined as follows:

Qualified investment for the regular credit	×	Line 4	×	Energy percentage	=	Energy credit earned
Bus 1: $15,000		¼		10		$375
Bus 2: $20,000		¼		10		500
Bus 3: $25,000		¼		10		625
Total energy credit earned in 1981		....		....		1,500

(10) *Related taxpayers.* (i) Related taxpayers are treated as one taxpayer in determining the increase in operating capacity under paragraph (q)(9)(ii) of this section and in determining the qualified investment in qualified intercity buses for the energy credit under paragraph (q)(9)(iii) of this section. Related taxpayers are members of a group of trades or businesses that are under common control (as defined in §1.52–1(b)).

(ii) Related taxpayers make all computations relating to operating capacity on a group basis. Also, the determination of whether a bus meets the predominant use test is made on a group basis by aggregating bus usage by each member of the group. For example, if a bus is acquired by one member and used by that member for part of a taxable year and used by other members for the remainder, the combined usage is aggregated in determining whether the predominant use test is met. In addition, all related taxpayers are treated as one person in applying paragraph (q)(8) of this section (relating to leasing).

(iii) The energy credit earned for a qualifying bus is allocated to the member which acquired (or is a lessee treated under section 48(d) as having acquired) the bus whether or not that member had a separate increase in operating capacity for the taxable year.

(iv) Each member must make its own computation of the group's increase in operating capacity for the period comprising its taxable year. A member will make this computation as of the end of its taxable year ignoring different taxable years of other members. For the period comprising its taxable year, the member makes all calculations relating to group operating capacity, including the determination of full-time use by other members.

(v) Each member determines the composition of the group as of the end of that member's taxable year. For example, if X uses the calendar year and makes its computation as of December 31, 1981, and Y is a member of X's group at that time, Y's operating capacity determined as of the end of X's immediately preceding taxable year (December 31, 1980) is taken into account by X for 1980 even if Y was not a member of the group for any day prior to December 31, 1981.

(vi) The following example illustrates this paragraph (q)(10):

Example (a). Corporations X and Y are related taxpayers. In this example, each bus is a qualifying bus with a seating capacity of 50. Each bus owned at the close of either X's or Y's taxable year was used on a full-time basis for the relevant period corresponding to X's or Y's taxable year. Other facts are set forth in the following table:

	X	Y
Taxable year ends	Dec. 31	June 30.
Operating capacity for 1979.	5 buses	10 buses.
Buses added	3 buses Mar. 1, 1980.	3 buses May 15, 1981.
Buses sold	2 buses Mar. 31, 1981.	2 buses Sept. 30, 1980.
Cost of each added bus.	$40,000	$60,000.

(b) X makes the following calculations to determine the energy credit earned for calendar year 1980.

1. 1979 operating capacity determined as of 12/31/79:	
a. Attributable to X (5 buses×50 seats)	250
b. Attributable to Y (10 buses×50 seats)	500
c. Total 1979 operating capacity	750
2. 1980 operating capacity determined as of 12/31/80:	
a. X's 5 and Y's 8 1979 buses used on a full-time basis in 1980 and still owned on 12/31/80	650
b. 1980 added capacity (X's 3 buses×50 seats)	150
c. Total 1980 operating capacity	800
3. 1980 increase in operating capacity (line 2c − line 1c)	50
4. Fraction in paragraph (q)(9)(iii) of this section (line 3÷line 2b)	⅓

Accordingly, X earned an energy credit of $4,000 in 1980 ($40,000×⅓×10%×3 buses).

(c) Since in calendar year 1981 X placed no qualifying buses in service, X earned no energy credit in 1981.

(d) Since in the taxable year 7/1/79–6/30/80 Y placed no qualifying buses in service, Y earned no energy credit in that taxable year.

(e) Y makes the following calculations to determine the energy credit earned in the taxable year 7/1/80—6/30/81.

1. Operating capacity for the taxable year ending 6/30/80 determined as of the close of that year:	
a. Attributable to X (8 buses×50 seats)	400
b. Attributable to Y (10 buses×50 seats)	500
c. Total operating capacity for that year	900
2. Operating capacity for the taxable year ending 6/30/81 determined as of the close of that year:	
a. X's 6 and Y's 8 buses from prior taxable year used on a full-time basis during current taxable year and still owned on 6/30/81	700
b. Capacity added during current taxable year (Y's 3 buses×50 seats)	150
c. Total operating capacity for that year	850
3. Increase in operating capacity for taxable year ending 6/30/81 (line 2c − line 1c)	(50)

As determined for Y's taxable year ending 6/30/81 the group experienced a decrease in operating capacity. Thus, no energy credit is available for the buses Y placed in service in its taxable year ending 6/30/81.

(11) *Section 381(a) transactions.* (i) In the case of a transaction described in section 381(a), the operating capacity of each transferor or distributor corporation, determined as of the date of distribution or transfer (within the meaning of § 1.381(b)–1(b)), shall reduce the operating capacity of the acquiring corporation (determined without this paragraph (q)(11)) for its first taxable year ending on or after that date for purposes of determining the acquiring corporation's energy credit for that year. This paragraph (q)(11) shall not apply to any case to which paragraph (q)(10) of this section (dealing with related taxpayers) applies.

(ii) The following example illustrates this paragraph (q)(11):

Example. X and Y are unrelated corporations which use the calendar year. For 1981, each has an operating capacity of 250 seats (5 buses×50 seats). X merges into Y on January 1, 1982. On May 1, 1982, Y retires and sells two buses and acquires four 50-seat qualifying buses at a cost of $40,000 each. All buses owned by Y on December 31, 1982, are included in operating capacity. Y makes the following calculations to determine the energy credit earned in taxable year 1982.

1. Y's 1981 operating capacity determined as of 12/31/81	250
2.1982 operating capacity determined as of 12/31/82 without this paragraph (q)(11):	
a. X's 5 buses plus Y's 5 1981 buses less 2 retired buses (8 buses×50 seats)	400
b. 1982 added capacity (4 buses×50 seats)	200
c. Total	600
3. Operating capacity of transferor (X) on 1/1/82	250
4. Y's 1982 operating capacity (line 2c − line 3)	350
5. 1982 increase in operating capacity (line 4 − line 1)	100
6. Fraction in paragraph (q)(9)(iii) of this section (line 5÷ line 2b)	½
7. Energy credit earned in 1982 ($40,000×½×10%×4 buses)	$8,000

(Secs. 7805 (68A Stat. 917, 26 U.S.C. 7805) and 38 (b) (76 Stat. 962, 26 U.S.C. 38) of the Internal Revenue Code of 1954; secs. 38(b) (76 Stat. 963, 26 U.S.C. 38(b)), 48(l)(16) (94 Stat. 264, 26 U.S.C. 48(l)(16)), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7291, 46 FR 7291, Jan. 23, 1981, as amended by T.D. 7982, 49 FR 39542, Oct. 9, 1984; 49 FR 41246, Oct. 22, 1984; T.D. 8014, 50 FR 11853, Mar. 26, 1985; T.D. 8147, 52 FR 27337, July 21, 1987]

§ 1.48–10 Single purpose agricultural or horticultural structures.

(a) *In general*—(1) *Scope.* Under section 48(a)(1)(D), "section 38 property" includes single purpose agricultural and horticultural structures, as defined in section 48 (p) and paragraphs (b) and (c) of this section. These structures are subject to a special rule for recapture of the credit. See paragraph (g) of this section. For the relation of this section to section 48(a)(1)(B) (other tangible property) and to sections 1245 and 1250 (depreciation recapture), see paragraph (h) of this section.

(2) *Effective date.* The provisions of section 48(a)(1)(D) and this section

apply to open taxable years ending after August 15, 1971.

(b) *Definition of single purpose agricultural structure*—(1) *In general.* Under section 48(p)(2), a single purpose agricultural structure is any structure or enclosure that meets all of the following requirements:

(i) It is specifically designed and constructed for permissible purposes (as defined in paragraph (b)(2) of this section). See paragraph (d) of this section for the rule regarding ''specifically designed and constructed''.

(ii) It is specifically used exclusively for those permissible purposes. See paragraph (e) of this section for the rules regarding ''specifically used''.

(iii) It houses equipment necessary to house, raise, and feed livestock and their produce. See paragraphs (b)(3) and (4) of this section.

(2) *Permissible purposes.* The following are the only permissible purposes for a single purpose agricultural structure:

(i) Housing, raising, and feeding a particular type of livestock and, at the taxpayer's option, its produce. The term ''housing, raising, and feeding'' includes the full range of livestock breeding and raising activities, including ancillary post-production activities (as defined in paragraph (f) of this section). Thus, for example, use of a structure for breeding livestock, or for producing eggs or livestock, is permitted. The structure may also be used for storing feed or machinery, but more than strictly incidental use for these purposes will disqualify the structure. See paragraph (e)(1) of this section. For the special rule concerning the permissible purposes for a milking parlor, see paragraph (b)(2)(iii) of this section.

(ii) Housing required equipment (including any replacements) as defined in paragraph (b)(4) of this section.

(iii) If the structure is a dairy facility, it will qualify if it is used for: (A) activities consisting of the production of milk or of the production of milk and the housing, raising, or feeding dairy cattle, and (B) housing equipment (including any replacements) necessary for these activities. The term ''housing, raising, or feeding'' includes the full range of dairy cattle breeding and raising activities including ancillary post-production activities (as defined in paragraph (f) of this section). The structure may also be used for storing feed or machinery, but, more than incidental use for these purposes will disqualify the structure. See paragraph (e)(1) of this section.

(3) *Livestock; particular type of livestock*—(i) *Livestock.* Livestock qualifying as ''section 38 property'' under §1.48–1(l) constitutes livestock for purposes of this section. Thus, for example, horses are not livestock for purposes of this section since they do not qualify as ''section 38 property'' under §1.48–1(l). Under section 48(p)(6) poultry constitutes livestock for purposes of section 48(a)(1)(D). The term ''livestock'' includes the offspring of livestock. ''Livestock'' is distinguished from the produce of livestock, such as milk and eggs held for sale. For purposes of this section, eggs held for hatching and newborn livestock are considered livestock. A structure used solely to house produce of livestock or equipment necessary to house produce of livestock will not qualify as a single purpose agricultural structure. Thus, for example, a dairy facility used solely for storing milk will not qualify.

(ii) *Particular type of livestock.* A structure qualifies as a single purpose agricultural structure only if it is specifically designed, constructed, and used exclusively for permissible purposes with respect to one particular type of livestock. For purposes of this section, each species is a different type except that all species of poultry are considered to be of a single type. Thus, for example, a structure specifically designed and constructed as a single purpose hog-raising facility will not qualify if it is used to raise dairy cows, but a structure specifically designed, constructed, and used to raise poultry may house, raise, and feed both chickens and turkeys.

(4) *Required equipment rule.* (i) A single purpose agricultural structure must also house equipment necessary to house, raise, and feed the livestock (''required equipment''). Required equipment must be an integral part of the structure, and includes, but is not limited to, equipment necessary to contain the livestock, to provide them with water or feed, and to control the temperature, lighting, and humidity of

the interior of the structure. For purposes of this section, equipment is an integral part of the structure if it is physically attached to or a part of the structure. The useful life of the structure, however, need not be contemporaneous with the life of the equipment it houses. A structure without required equipment is not a single purpose agricultural structure.

(ii) A single purpose agricultural structure may, but is not required to, house equipment (for example, loading chutes) necessary to the conduct of ancillary post-production activities as defined in paragraph (f) of this section.

(5) *Livestock structure.* In section 48(p)(2), the terms ''single purpose livestock structure'' and ''single purpose agricultural structure'' are interchangeable.

(c) *Definition of single purpose horticultural structure*—(1) *In general.* Under section 48(p)(3), a single purpose horticultural structure is any structure that meets both of the following requirements:

(i) It is a greenhouse or other structure specifically designed and constructed for permissible purposes (as defined in paragraph (c)(2) of this section). See paragraph (d) of this section for the rule regarding ''specifically designed and constructed.''

(ii) It is specifically used exclusively for those permissible purposes. See paragraph (e) of this section for the rules regarding ''specifically used.''

(2) *Permissible purposes.* The following are the only permissible purposes for a single purpose horticultural structure:

(i) The commercial production of plants (including plant products such as flowers, vegetables, or fruit) in a greenhouse.

(ii) The commercial production of mushrooms.

(iii) A single purpose horticultural structure also may, but is not required to, house equipment necessary to carry out these permissible purposes listed in paragraphs (c)(2) (i) and (ii) of this section.

(3) *Ancillary post-production activities.* The terms ''commercial production of plants'' and ''commercial production of mushrooms'' include ancillary post-production activities (as defined in paragraph (f) of this section).

(d) *Specifically designed and constructed.* A structure is specifically designed and constructed if it is not economic to design and construct the structure for the intended qualifying purpose and then use the structure for a different purpose. For example, if a hog raising structure is designed and constructed in accordance with a standard set of plans for such a structure provided by the Department of Agriculture, it would not be economic to use the structure for purposes other than hog raising.

(e) *Specifically used.* There are two aspects of the specific use requirement—exclusive use and actual use.

(1) *Exclusive use.* (i) A structure qualifies as a single purpose agricultural or horticultural structure only if it is used exclusively for the permitted purposes by reason of which it qualified for the credit. Thus—

(A) The structure may not be used for any nonpermissible purposes (for example, processing, marketing, or more than incidental use for storing feed or equipment) and

(B) It may not be put to any use other than the specific use by reason of which it qualifies for the credit.

(ii) For purposes of this section, the term ''incidental use'' means a use which is both related and subordinate to the qualifying purpose. Thus, for example, if feed is stored in an agricultural structure which will be used for raising hogs, the feed must be used only for the hogs in order to be related to the qualifying purpose. In determining whether use of the structure for feed storage is subordinate to the qualifying purpose, all of the facts and circumstances must be considered, including, with respect to feed storage, the following:

(A) Type of animal involved;

(B) Number of, and consumption rate for, each animal;

(C) Climate of area;

(D) Total volume of storage area; and

(E) Percentage of structure's total volume devoted to storage.

(iii) It will be presumed that the storage function is not subordinate to the qualifying purpose of the structure if more than one-third of the structure's total usable volume is devoted to storage. This presumption may be rebutted with clear and convincing evidence.

(iv) A structure may fail the exclusive use test if either of the requirements of paragraph (e)(1)(i) of this section is not met. Thus, for example, a horticultural structure that contains an area for processing plants or plant products will fail the exclusive use test because there is a nonpermissible use. An agricultural structure that is used to house more than one particular type of livestock fails the exclusive use test for the same reason. A change in the use of an agricultural structure from one species of livestock to another will cause the structure to fail the exclusive use test when the change occurs. Thus, for example, a hog-raising facility which qualified for the credit when it was placed in service cannot later be modified and used for producing broiler chickens even if the structure would have qualified for the credit if it had been originally designed, constructed, and used exclusively for producing broiler chickens.

(2) *Actual use.* (i) A single purpose agricultural or horticultural structure also must actually be used for the permissible purpose by reason of which it qualifies for the credit. ‘‘Actual use’’ means ‘‘placed in service’’ (as defined in §1.46–3(d)). Mere vacancy, on a temporary basis, will not disqualify the structure. Thus, for example, a structure that is designed and constructed as a hog-raising structure will not qualify if it is never placed in service for raising hogs. However, a turkey-raising facility will not be disqualified if the turkeys are all sent to a packing plant in November and the structure remains vacant until the next spring when newly hatched turkeys are placed in the structure to be raised.

(ii) For purposes of this section, ‘‘vacancy on a temporary basis’’ includes temporary vacancy caused by market fluctuations or other economic considerations and vacancy on a seasonal basis.

(f) *Work space; ancillary post-production activities*—(1) *Permissible work space.* Under section 48(p)(4), a single purpose agricultural or horticultural structure may contain work space only if it is used for—

(i) Stocking, caring for, or collecting livestock, plants, or mushrooms,

(ii) Maintenance of the structure, or

(iii) Maintenance or replacement of the equipment or stock enclosed by or contained in the structure. Thus, for example, an eligible structure may not contain space devoted to processing or marketing or other nonpermissible purposes.

(2) *Ancillary post-production activities.* The term ‘‘stocking, caring for, or collecting’’ the livestock, plants, or mushrooms includes ancillary post-production activities. These activities, therefore, constitute permissible purposes when carried on in conjunction with other permissible purposes, and a qualifying structure may contain work space devoted to such activities. Ancillary post-production activities include gathering, sorting, and loading livestock, plants, and mushrooms and packing unprocessed plants, mushrooms, and the live offspring and unprocessed produce of the livestock. Ancillary post-production activities do not include processing activities, such as slaughtering or packing meat, nor do they include marketing activities.

(g) *Special rule for recapture under section 47.* Under section 48(p)(5), if a structure which qualifies for the credit under this section becomes ineligible because it ceases to be held for the specific use by reason of which it qualified (or it is used for other than that qualifying use) before the end of the applicable estimated useful life or period specified in section 47(a), then the investment credit previously allowed with respect to the structure may be partially or entirely recaptured under section 47. Unlike other property to which section 47 applies, single purpose structures may not be converted from one permissible use to another without recapture. See subparagraph (e)(2) of this section.

(h) *Relationship to other sections*—(1) *Relation to section 48(a)(1)(B).* All structures satisfying the requirements of section 48(a)(1)(B) and (a)(1)(D) will be considered to qualify under either provision.

(2) *Relationship to sections 1245 and 1250.* For purposes of depreciation recapture, property to which section 48(a)(1)(D) applies is section 1245 property, except that property placed in

service prior to January 1, 1981, may, at the option of the taxpayer, be treated as section 1250 property if depreciation deductions allowed were not under one of the methods authorized only for section 1245 property.

(i) [Reserved]

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

Example 1. A constructs a rectangular structure for use as an egg-producing facility. The structure has no windows. The walls and roof are made of corrugated steel and there is a door which is 4 feet wide and 8 feet tall at each end of the structure. At the end of each wall are louvered openings approximately 4 feet high and 8 feet long. These openings house thermostatically controlled fans. In the center of the walls are manually operated fresh-air openings. Corrugated steel ''curtains'' hang from the top of the openings so that the openings can be completely closed in cold weather, but the curtains can be propped open to admit fresh air. The building is well insulated. A has reinforced the roof with extra trusses and rafters and reinforced the building with extra wall studs. Two rows of cages are suspended from the rafters by thin steel girders and wires. The floor of the structure is a sloping concrete slab pierced with long troughs which run the length of the structure beneath the cages. The troughs are used for collection and disposal of chicken wastes. When this structure is placed in service it will qualify for an investment credit under this section.

Example 2. B constructs a greenhouse for the commercial production of plants. The greenhouse is a rectangular structure with translucent fiberglass walls and roof. The structure is equipped with an automatic temperature and humidity control system. Pipes were installed to carry water and liquid fertilizer to the plants and to release minute amounts of carbon dioxide into the air. When the structure was originally placed in service B used the entire structure for growing flowers commercially. In September 1978, B began to use the structure for growing tomatoes. Because of the success of the venture, in January 1979, B began to use the entire structure for growing tomatoes. In February 1980, B set up a small counter with a cash register at one end of the structure so that workers could sell tomatoes to customers at the greenhouse. Until February 1980, the structure would qualify for the credit under this section. The change in use from growing flowers to growing tomatoes will not affect the eligibility of the structure. Once the cash register is installed, however, the structure fails to meet both the exclusive use test of paragraph (e)(1) of this section and the work space rule of paragraph (f) of this section since a single purpose structure may not be used for marketing activities.

Example 3. C purchases a prefabricated structure and makes modifications so that the structure will meet C's requirements. C adds gates and constructs a partition which divides the structure into two parts. One part of the structure constitutes less than one-third of the total usable volume of the structure and is used to house feeder cattle while they are fed with hay. This part of the structure has a sloping concrete floor. The other part of the structure constitutes more than two-thirds of the total usable volume of the structure and is used to store the hay used to feed the cattle. This structure will not qualify for the credit since it fails the required equipment test. The structure does not contain equipment which is an integral part of the structure. This structure also fails the ''specifically designed and constructed'' test of paragraph (d) of this section since it would be economic to use the structure for purposes other than housing, raising, and feeding cattle (such as a general purpose barn, for example). Finally, the structure fails the incidental use test of paragraph (e) of this section because the storage function is presumptively not subordinate to the qualifying purpose since more than two-thirds of the structure's total usable volume is devoted to storage and none of the facts will serve to rebut the presumption.

(Secs. 7805 (68A Stat. 917, 26 U.S.C. 7805) and 38 (b) (76 Stat. 926, 26 U.S.C. 38))

[T.D. 7900, 48 FR 32768, July 19, 1983; 48 FR 36448, Aug. 11, 1983]

§ 1.48–11 Qualified rehabilitated building; expenditures incurred before January 1, 1982.

(a) *In general.* Under section 48(a)(1)(E), that portion of the basis of a qualified rehabilitated building which is attributable to qualified rehabilitation expenditures qualifies as section 38 property. In general, property which is treated as section 38 property by reason of section 48(a)(1)(E) is treated as new section 38 property and therefore is not subject to the used property limitation. See § 1.48–2(d). Section 48(g)(1) and paragraph (b) of this section define the term ''qualified rehabilitated building''. Section 48(g)(2) and paragraph (c) of this section define the term ''qualified rehabilitation expenditure''. Paragraph (d) of this section provides guidance for coordination of these provisions with other sections of the Code.

(b) *Definition of qualified rehabilitated building*—(1) *In general.* The term ‘‘qualified rehabilitated building’’ means any building and its structural components—

(i) Which has been rehabilitated (within the meaning of paragraph (b)(3) of this section),

(ii) Which was placed in service (within the meaning of §1.46–3(d)) by any person at any time before the beginning of the rehabilitation,

(iii) 75 percent or more of the existing external walls of which are retained in place as external walls (within the meaning of paragraph (b)(4) of this section) in the rehabilitation process, and

(iv) Which meets the twenty-year requirement in paragraph (b)(2) of this section.

In addition, a major portion of a building may be treated as a separate building for purposes of this paragraph if the requirements of paragraph (b)(5) of this section are met.

(2) *Twenty-year requirement*—(i) *In general.* A building is considered a qualified rehabilitated building only if a period of at least 20 years has elapsed between the date physical work on the rehabilitation of the building began, and the later of—

(A) The date the building was first placed in service (see §1.46–3(d)) by any person as a building, or

(B) The date the building was placed in service by any taxpayer in connection with a prior rehabilitation with respect to which a credit was allowed by reason of section 48(a)(1)(E).

(ii) *Vacant periods.* The 20-year period includes periods during which a building was vacant or devoted to a personal use and is computed without regard to the number of owners or the identity of owners during the period.

(iii) *Physical work on a rehabilitation.* For purposes of this section, ‘‘physical work on a rehabilitation’’ begins when actual construction begins. The term ‘‘physical work on a rehabilitation’’ does not include preliminary activities such as planning, designing, securing financing, exploring, researching, developing plans and specifications, or stabilizing a building to prevent deterioration (*e.g.*, placing boards over broken windows).

(iv) *Special rule.* If a part of a building meets the twenty-years requirement in subdivision (i) of this subparagraph and a part (for example, an addition) does not, a rehabilitation of that part that meets the requirement may qualify for a credit only if that part constitutes a major portion (as defined in paragraph (b)(5) of this section) of the building.

(3) *Rehabilitation*—(i) *In general.* For purposes of this paragraph, rehabilitation includes renovation, restoration, or reconstruction. However, the term ‘‘rehabilitation’’ does not include enlargement (within the meaning of paragraph (c)(7)(ii) of this section), new construction, or the completion of new construction after a building has been placed in service. For purposes of this paragraph (b)(3), whether expenditures are attributable to the rehabilitation of an existing building, or to new construction, is determined upon all the facts and circumstances.

(ii) *Substantial rehabilitation.* For a building to be considered rehabilitated, the rehabilitation must be substantial. Whether a rehabilitation is substantial is determined upon the basis of all the facts and circumstances. In general, to be substantial, the rehabilitation must do one of the following:

(A) Materially extend the useful life of the building;

(B) Significantly upgrade its usefulness (for either the same or a new use); or

(C) Preserve it in a way that significantly improves its condition or enhances its historic value.

A substantial rehabilitation may vary in degree from gutting and extensive reconstruction of a building’s major structural components to the cure of a substantial accumulation of major disrepairs. It may also include renovation, alteration, or remodelling for the conversion of a structurally sound building to a design and condition required for a new use. Cosmetic improvements alone, however, do not qualify as a substantial rehabilitation.

(iii) *Aggregation of rehabilitation.* In the case where qualified rehabilitation expenditures are incurred with respect to a rehabilitation of a building by more than one person (*e.g.*, a lessor and a lessee, several lessees, or several condominium owners), the substantial rehabilitation requirement in this paragraph (b)(3) shall be applied by aggregating all the rehabilitation work done by such persons.

(iv) *Special rule by qualified rehabilitation expenditures treated as incurred by the taxpayer.* In the case where qualified rehabilitation expenditures are treated as having been incurred by a taxpayer because of the application of paragraph (c)(3)(ii) of this section, the substantial rehabilitation test in paragraph (b)(3)(ii) of this section will be applied by aggregating the rehabilitation work done by the transferor and the transferee.

(v) *Examples.* The provisions of this subparagraph (3) may be illustrated by the following examples:

Example 1. Taxpayer A is the owner of a 30-year old building. The building is air conditioned by means of window air conditioning units. A replaces the window units with a central air conditioning system and no other rehabilitation is performed by A. The expenditures incurred by A did not materially extend the building's useful life, significantly upgrade its usefulness, or preserve it in a manner that significantly improves its condition or enhances its historic value. Although expenditures for replacement of window units with a central air conditioning system may constitute qualified expenditures as part of an overall rehabilitation, alone they do not qualify as a substantial rehabilitation and the building is not considered rehabilitated within the meaning of this subparagraph.

Example 2. Taxpayer B is the owner of a 10 story office building that is 35 years old. The building is in substantial disrepair and in order to modernize it as an office building B installs new plumbing, electrical wiring, and heating and air conditioning systems. In addition, the layout of each floor is changed by means of tearing down many existing interior walls and partitions and building new walls, partitions, and doors. Old plaster is removed from many walls and replaced by new wall covering. New windows and new flooring are installed throughout the building. The improvements made by B materially extend the useful life of the building and significantly upgrade its usefulness. The building is considered rehabilitated within the meaning of the facts and circumstances test in this subparagraph.

Example 3. Taxpayer C is the owner of a 100-year old building that has substantial historic character, although the building is not a certified historic structure (as defined in section 191(d)(1) and the regulations thereunder). C uncovers and restores the original woodwork, wall coverings and moldings throughout the building. The windows and doors are replaced with replicas of the original. The improvements made by C significantly preserve the building and significantly enhance its historic value. Thus, the building is considered rehabilitated within the meaning of this subparagraph.

(4) *Retention of 75 percent of external walls*—(i) *In general.* A building meets the requirements set forth in paragraph (b)(1)(iii) only if 75 percent or more of the existing external walls (as measured by the total area of the existing external walls) are retained in place as external walls in the rehabilitation process. For this purpose, the area of existing external walls includes the area of windows and doors.

(ii) *External wall.* For purposes of this paragraph (b)(4), a wall includes both the supporting elements of the wall and the nonsupporting elements (*e.g.*, a curtain) of the wall. Except as otherwise provided in this paragraph (b)(4), the term ''external wall'' includes any wall that has one face exposed to the weather, earth, or an abutting wall erected on an adjacent property. An external wall also includes a shared wall (*i.e.*, a single wall shared with an adjacent building), generally referred to as a ''party wall''.

(iii) *Alternative rule.* Notwithstanding the definition of external wall contained in paragraph (b)(4)(ii) of this section, in any case in which the building being rehabilitated would fail to meet the requirements of a qualified rehabilitation building if the definition of external wall in paragraph (b)(4)(ii) of this section were used, then the term ''external wall'' shall be defined as a wall, including its supporting elements, with one face exposed to the weather or earth, and a common wall shall not be treated as an external wall.

(iv) *Retained in place.* An existing external wall is retained in place if the supporting elements of the wall are retained in place. An existing external wall is not retained in place if the supporting elements of the wall are replaced by new supporting elements. An external wall is retained in place, however, if the supporting elements are reinforced in the rehabilitation, provided that such supporting elements of the external wall are retained in place. An external wall is retained in place even though it is covered (e.g., with new siding). Moreover, the existing curtain may be replaced with a new curtain provided that the structural framework that provides for the support of the existing curtain is retained in place. An external wall is retained in place notwithstanding that the existing doors and windows in the wall are modified, eliminated, or replaced. A wall may be disassembled and reassembled so long as the same supporting elements are used when the wall is reassembled. Thus, for example, in the case of the brick wall, the wall is considered retained in place even though the original bricks are removed (for cleaning, *etc.*) and put back to form the wall.

(v) *Retention as an external wall.* For purposes of meeting the 75 percent requirement of this subparagraph (4), an existing external wall must be retained in place as an external wall. If an addition is made that results in an existing external wall being converted into an internal wall, the wall is not retained in place as an external wall.

(vi) *Special rule.* Solely for the purpose of meeting the 75 percent requirement of this subparagraph (4), the walls of an uncovered internal shaft designed solely to bring light or air into the center of a building which are completely surrounded by external walls of the building and which enclose space not designated for occupancy or other use by people (other than for maintenance or emergency) are not considered external walls. Thus, a wall of a light well in the center of an office building is not an external wall. However, walls surrounding an uncovered courtyard which is usable by the building's occupants, (*e.g.*, at lunch time) are external walls.

(vii) *Examples.* The provisions of this subparagraph (4) may be illustrated by the following examples:

Example 1. Taxpayer A rehabilitated a building all of the walls of which consisted of wood siding attached to gypsum board sheets (which covered the studs). A covered the existing wood siding with aluminum siding in a part of a rehabilitation that otherwise qualified under this subparagraph. A satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls.

Example 2. Taxpayer B rehabilitated a building the external walls of which had a masonry curtain. The masonry on the wall face was replaced with a glass curtain. The steel beam and girders supporting the existing curtain were retained in place. B satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls.

Example 3. Taxpayer C rehabilitated a building which has two external walls measuring 75′ x 20′ and two other external walls measuring 100′ x 20′. C tore down one of the larger walls, including its supporting elements, which accounted for more than 25% of the building's external walls and constructed a new wall. C has not satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls.

Example 4. The facts are the same as in example 3, except C does not tear down any walls, but makes an addition that results in one of the smaller walls becoming an internal wall. In addition, C enlarged 8 of the existing windows on the larger walls, increasing them from a size of 3′ x 4′ to 6′ x 8′. Since the smaller wall accounts for less than 25 percent of the total wall area, C has satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls in the rehabilitation process. The enlargement of the existing windows on the larger wall does not change the result.

(5) *Major portion treated as separate building*—(i) *In general.* Where there is a separate rehabilitation of a major portion of a building, such major portion shall be treated as a separate building. Thus, such major portion may qualify as a qualified rehabilitated building if the requirements of this paragraph are met with respect to such major portion. Expenditures for property that services both a major portion of a building and another portion must be specifically allocated to each portion to the extent possible. If it is not possible to make such an allocation, the expenditures must be allocated to each portion on some reasonable basis. What constitutes a reasonable basis for an allocation depends on factors such as the type of improvement and how the improvement relates functionally to

the building. For example, in the case of expenditures for an air conditioning system or a roof, a reasonable basis for allocating the expenditures would be the volume of the major portion served by the improvement relative to the volume of the other portion of the building served by the improvement.

(ii) *Major portion defined.* Whether a part of a building constitutes a major portion of the building is determined upon the basis of all the facts and circumstances. A major portion must generally consist of clearly identifiable parts of a building (*e.g.*, a wing of a building or the first 5 stories of a 7 story building). The following factors shall be taken into account:

(A) Whether the portion comprises an entire leasehold interest or an entire ownership (*e.g.*, condominium) interest;

(B) Whether the portion (as measured by volume) is sufficiently large that it would be reasonable to treat it as a separate building; and

(C) Whether the portion is functionally different from other parts of the building.

(6) *Special rule for rehabilitation done in phases.* If rehabilitation which is not continuous is determined under this subparagraph to be a single rehabilitation done in phases, the requirements of this paragraph (b) are to be applied with respect to the overall rehabilitation and not merely to a phase of the rehabilitation. In such case, a phase of a single overall rehabilitation will not be considered as ‘‘prior rehabilitation’’ for purposes of subparagraph (2)(i)(B) of this paragraph (b). Whether rehabilitation which is not continuous is a single rehabilitation that is done in phases is determined on the basis of all the facts and circumstances. Generally, however, to constitute a single rehabilitation that is done in phases, there must exist, prior to the time any rehabilitation work is commenced, a set of written plans describing generally all phases of the rehabilitation of the building and a reasonable expectation that all phases of the rehabilitation will be completed. Such written plans are not required to contain detailed working drawings or detailed specifications of the material to be used. In addition, the period between the time that physical work on the first phase of the overall rehabilitation begins and physical work on the last phase of the overall rehabilitation begins must be reasonable. In determining whether the rehabilitation is completed within a reasonable time, the fact that a building is occupied during the rehabilitation, the necessity of acquiring a lease (of additional portions of the building), and unforeseen delays shall be taken into account. Other factors that are relevant in determining whether rehabilitation is a single rehabilitation include the length of time between each phase of rehabilitation activities and the extent of rehabilitation activity in each phase.

(7) *Special rule for adjoining buildings that are combined.* For purposes of this paragraph (b), if as part of a rehabilitation process two or more adjoining buildings are combined and placed in service as a single building after the rehabilitation process, then all of the requirements of a qualified rehabilitated building in section 48(g)(1) and this section may be applied to the constituent adjoining buildings in the aggregate. Any party walls or abutting walls between the constitutent buildings that would otherwise be treated as external walls (within the meaning of paragraph (b)(4)(ii) of this section) would not be treated as external walls of the building; the substantial rehabilitation test in paragraph (b)(3)(ii) of this section would be applied to the aggregate rehabilitation work with respect to all of the constitutent buildings.

(c) *Definition of qualified rehabilitation expenditures*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the term ‘‘qualified rehabilitation expenditure’’ means any amount—

(i) Properly chargeable to capital account (as described in subparagraph (2) of this paragraph),

(ii) Incurred after October 31, 1978, for depreciable or amortizable property (or additions or improvements to property) with a useful life of five years or more, and

(iii) Made in connection with the rehabilitation of a qualified rehabilitated building.

(2) *Chargeable to capital account.* For purposes of paragraph (c)(1)(i) of this section, amounts paid or incurred are

chargeable to capital account if under the taxpayer's method of accounting they are property includible in computing basis under §1.46–3. Amounts treated as an expense and deducted in the year they are paid or incurred are not chargeable to capital account.

(3) *Incurred by the taxpayer*—(i) *In general.* Generally, to qualify for a credit under section 48 (a)(1)(E), qualified rehabilitation expenditures must be incurred by the taxpayer after October 31, 1978. An expenditure is incurred for purposes of this paragraph on the date such expenditure would be considered incurred under the accrual method of accounting, regardless of the method of accounting used by the taxpayer with respect to other items of income and expense. If qualified rehabilitation expenditures are treated as having been incurred by a taxpayer under paragraph (c)(3)(ii)) of this section, the taxpayer shall be treated as having incurred the expenditures on the date such expenditures were incurred by the transferor.

(ii) *Qualified rehabilitation expenditures treated as incurred by the taxpayer.* (A) Where rehabilitation expenditures are incurred with respect to a building by a person (or persons) other than the taxpayer and the taxpayer acquires the building, or a portion of the building to which the expenditures are allocable, the taxpayer acquiring such property will be treated as having incurred the rehabilitation expenditures actually incurred by the transferor (or treated as incurred by the transferor under this paragraph (c)(3)(ii)) with respect to the acquired property, provided that—

(*1*) The building, or the portion of the building, acquired by the taxpayer was not used after the rehabilitation expenditures were incurred and prior to the date of acquisition by the taxpayer, and

(*2*) No credit with respect to such qualified rehabilitation expenditures is claimed by anyone other than the taxpayer acquiring the property.

For purposes of this paragraph (c)(3)(ii), use shall mean actual use, whether personal or business.

(B) The amount of qualified rehabilitation expenditures treated as incurred by the taxpayer under this paragraph is the lesser of—

(*1*) The qualified rehabilitation expenditures incurred before the date on which the taxpayer acquired the building (or portion thereof), to which the expenditures are attributable, or

(*2*) That portion of the taxpayer's cost or other basis for the property which is attributable to the qualified rehabilitation expenditures described in paragraph (c)(3)(B)(*1*) of this section incurred before such date.

For purposes of paragraph (c)(6)(ii) of this section, the amount of rehabilitation expenditures treated as incurred by the taxpayer under this paragraph (c)(3)(ii) shall not be considered to be part of the cost of acquiring a building or any interest in the building. The portion of the cost of acquiring a building (or an interest therein) which is not treated under this paragraph as qualified rehabilitation expenditures incurred by the taxpayer is not eligible for a rehabilitation investment credit. See paragraph (c)(6)(ii) of this section.

(C) See paragraph (b)(2)(iv) of this section for rules concerning the application of the substantial rehabilitation test to expenditures treated as incurred by the taxpayer.

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

Example 1. In 1978, taxpayer A, a cash basis taxpayer, commenced the rehabilitation of a 30-year old building. In June 1978, A signed contract with a plumbing contractor for replacement of the plumbing in the building. A agreed to pay the contractor as soon as the work was completed. The work was completed in September 1978, but A did not pay the amount due until November 1, 1978. The expenditures for the plumbing are not qualified rehabilitation expenditures because they were not incurred after October 31, 1978.

Example 2. B incurred qualified rehabilitation expenditures of $300,000 with respect to an existing building between January 1, 1980, and May 15, 1980, and then sold the building to C on June 1, 1980. If the property attributable to the expenditures was not placed in service by A during the period from January 1, 1980, to June 1, 1980, C will be treated as having incurred the expenditures.

(4) *Incurred for 5-year property.* An expenditure is incurred for depreciable or amortizable property if the amount of the expenditure is added to the basis of

property which is depreciable or amortizable under section 167. The determination of whether property has a useful life of five years or more is made by applying the principles of § 1.46–3(e). In the case of expenditures for property made by a lessee, see sections 167 and 178 and the regulations thereunder for rules relating to whether improvements made to leased property are depreciable or amortizable.

(5) *Made in connection with the rehabilitation of a qualified rehabilitated building.* Expenditures attributable to work done to facilities related to a building (*e.g.,* sidewalk, parking lot, landscaping) are not considered made in connection with a rehabilitation of a qualified rehabilitated building.

(6) *Certain expenditures excluded from qualified rehabilitation expenditures.* The term ‘‘qualified rehabilitation expenditures’’ does not include the following expenditures:

(i) An expenditure for property which is ‘‘section 38 property’’ (determined without regard to section 48(a)(1) (E) and (l)).

(ii) The cost of acquiring a building or any interest in a building (including a leasehold interest) except as provided in paragraph (c)(3)(ii) of this section.

(iii) An expenditure attributable to enlargement of a building (as defined in paragraph (c)(7) of this section).

(iv) An expenditure attributable to rehabilitation of a certified historic structure (as defined in section 191(d)(1) and the regulations thereunder), unless the rehabilitation is a certified rehabilitation (as defined in paragraph (c)(8) of this section).

(7) *Expenditures for enlargement distinguished*—(i) *In general.* Expenditures attributable to an enlargement of an existing building do not qualify as qualified rehabilitated expenditures. A building is enlarged to the extent that the total volume of the building is increased. An increase in floor space resulting from interior remodeling is not considred an enlargement. Generally, the total volume of a building is equal to the product of the floor area of the base of the building and the height from the underside of the lowest floor (including the basement) to the average height of the finished roof (as it exists or existed). For this purpose, floor area is measured from the exterior faces of external walls (other than shared walls that are external walls) and from the centerline of shared walls that are external walls. In addition, a building is enlarged to the extent of any construction outside the exterior faces of the existing external wall of the building.

(ii) *Rehabilitation which includes enlargement.* If expenditures for property only partially qualify as qualified rehabilitation expenditures because some of the expenditures are also attributable to the enlargement of the building, the expenditures must be apportioned between the original portion of the building and the enlargement. This allocation should be made using the principles contained in paragraph (b)(5)(i) of this section.

(8) *Certified rehabilitation*—(i) *In general.* For the purpose of this paragraph (c) of this section, the term ‘‘certified rehabilitation’’ means any rehabilitation of a certified historic building in a registered historic district which the Secretary of the Interior has certified to the Secretary as being consistent with the historic character of such building or the district in which such building is located.

(ii) *Revoked or invalidated certifications.* If the Department of Interior revokes or otherwise invalidates a certification after it has been provided to a taxpayer, the decertified property will cease to be section 38 property described in section 48(a)(1)(e). Such cessation shall be effective as of the date the activity giving rise to the revocation or invalidation occurred. See section 47 for the rules applicable to property that ceases to be section 38 property.

(d) *Coordination with other provisions of the Code*—(1) *Credit by lessees*—(i) *Rehabilitation performed by lessor.* A lessee may take the credit for rehabilitation performed by the lessor if the requirements of this section and section 48(d) are satisfied. For purposes of applying section 48(d), the fair market value of section 38 property described in section 48(a)(1)(E) shall be equal to that portion of the lessor’s basis in a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures.

(ii) *Rehabilitation performed by lessee.* A lessee may take the credit for rehabilitation performed by the lessee, provided that the property (or improvements or additions to property) for which the rehabilitation expenditures are made is depreciable (or amortizable) by the lessee (see sections 167 and 178, and the regulations thereunder) and the requirements of this section are satisfied.

(2) *When credit may be claimed.* The investment credit for qualified rehabilitation expenditures is allowed generally in the taxable year in which the property to which the rehabilitation expenditures is attributable is placed in service, provided the building is a qualified rehabilitated building for the taxable year. See §1.46–3(d). Under certain circumstances, however, the credit may be available prior to the date the property is placed in service. See section 46(d) and §1.46–5 (relating to qualified progress expenditures).

(3) *Recapture.* If property described in section 48(a)(1)(E) is disposed of by the taxpayer, or otherwise ceases to be ‘‘section 38 property,’’ recapture may result under section 47. Property will cease to be section 38 property, and therefore recapture may occur under section 47, in any case where the Department of Interior revokes or otherwise invalidates a certification of rehabilitation (see section 48(g)(2)(C)) after the property is placed in service because, for example, the taxpayer made modifications to the building inconsistent with Department of Interior standards.

(e) *Effective date*—(1) *General rule.* Except as provided in paragraph (e)(2) of this section, this §1.48–11 shall not apply to expenditures incurred after December 31, 1981.

(2) *Transitional rule.* This §1.48–11 shall continue to apply to expenditures incurred after December 31, 1981, for the rehabilitation of a building if—

(i) The physical work on the rehabilitation began before January 1, 1982, and

(ii) The building does not meet the requirements of section 48(g)(1) of the Code as amended by the Economic Recovery Tax Act of 1981.

[T.D. 8031, 50 FR 26698, June 28, 1985]

§1.48–12 Qualified rehabilitated building; expenditures incurred after December 31, 1981.

(a) *General rule*—(1) *In general.* Under section 48(a)(1)(E), the portion of the basis of a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures (within the meaning of section 48(g) and this section) is section 38 property. Property that is section 38 property by reason of section 48(a)(1)(E) is treated as new section 38 property and, therefore, is not subject to the used property limitation in section 48(c). Section 48(g)(1) and paragraph (b) of this section define the term ‘‘qualified rehabilitated building.’’ Section 48(g)(2) and paragraph (c) of this section define the term ‘‘qualified rehabilitation expenditure.’’ Section 48(g) (2)(B)(iv) and (3) and paragraph (d) of this section describe the rules applicable to ‘‘certified historic structures.’’ Section 48(q) and paragraph (e) of this section provide rules concerning an adjustment to the basis of the rehabilitated building. Paragraph (f) of this section provides guidance for coordination of these provisions with other sections of the Code, including rules for determining when the rehabilitation credit may be claimed.

(2) *Effective dates and transition rules*—(i) *In general.* Except as otherwise provided in this paragraph (a)(2)(i), this section applies to expenditures incurred after December 31, 1981, in connection with the rehabilitation of a qualified rehabilitated building. (See paragraph (c)(3)(i) of this section for rules concerning the determination of when an expenditure is incurred.) If, however, physical work on the rehabilitation began before January 1, 1982, and the building does not meet the requirements of paragraph (b) of this section, the rules in §1.48–11 shall apply to the expenditures incurred after December 31, 1981, in connection with such rehabilitation. (See paragraph (b)(6)(i) of this section for rules determining when physical work on a rehabilitation begins.)

(ii) *Transition rules concerning ACRS lives.* (A) For property placed in service before March 16, 1984, and any property subject to the exception set forth in section 111(g)(2) of Pub. L. 98–369 (Deficit Reduction Act of 1984), the references to ‘‘19 years’’ in paragraph (c)(4)(ii) and (7)(v) shall be replaced with ‘‘15 years’’ and the reference to ‘‘19-year real property’’ in paragraph (c)(4)(ii) shall be replaced with ‘‘15-year real property.’’

(B) Except as otherwise provided in paragraph (a)(2)(ii)(A) of this section, for property placed in service before May 9, 1985, and any property subject to the exception set forth in section 105(b) (2) and (5) of Pub. L. 99–121 (99 Stat. 501, 511), the reference to ‘‘19 years’’ in paragraph (c)(4)(ii) and (7)(v) shall be replaced with ‘‘18 years’’ and the references to ‘‘19-years real property’’ in paragraph (c)(4)(ii) shall be replaced with ‘‘18-year real property.’’

(iii) *Transition rule concerning external wall definition.* Notwithstanding the definition of external wall contained in paragraph (b)(3)(ii) of this section, in any case in which the written plans and specifications for a rehabilitation were substantially completed on or before June 28, 1985, and the building being rehabilitated would fail to meet the requirement of paragraph (b)(1)(iii) of this section if the definition of external wall in paragraph (b)(3)(ii) of this section were used, the term ‘‘external wall’’ shall be defined as a wall, including its supporting elements, with one face exposed to the weather or earth, and a common wall shall not be treated as an external wall. See paragraph (b)(2)(v) of this section for the definition of written plans and specifications.

(iv) *Transition rules concerning amendments made by the Tax Reform Act of 1986*—(A) *In general.* Except as otherwise provided in section 251(d) of the Tax Reform Act of 1986 and this paragraph (a)(2)(iv), the amendments made by section 251 of the Tax Reform Act of 1986 shall apply to property placed in service after December 31, 1986, in taxable years ending after that date, regardless of when the rehabilitation expenditures attributable to such property were incurred. If property attributable to qualified rehabilitation expenditures is incurred with respect to a rehabilitation to a building placed in service in segments or phases and some segments are placed in service before January 1, 1987, and the remaining segments are placed in service after December 31, 1986, the amendments under the Tax Reform Act would not apply to the property placed in service before January 1, 1987, but would apply to the segments placed in service after December 31, 1986, unless one of the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section applies.

(B) *General transition rule.* The amendments made by sections 251 and 201 of the Tax Reform Act of 1986 shall not apply to property that qualifies under section 251(d) (2), (3), or (4) of the Tax Reform Act of 1986. Property qualifies for the general transition rule in section 251(d)(2) of the Act if such property is placed in service before January 1, 1994, and if such property is placed in service as part of—

(*1*) A rehabilitation that was completed pursuant to a written contract that was binding on March 1, 1986, or

(*2*) A rehabilitation incurred in connection with property (including any leasehold interest) acquired before March 2, 1986, or acquired on or after such date pursuant to a written contract that was binding on March 1, 1986, if—

(*i*) Parts 1 and 2 of the Historic Preservation Certificate Application were filed with the Department of the Interior (or its designee) before March 2, 1986, or

(*ii*) The lesser of $1,000,000 or 5 percent of the cost of the rehabilitation is incurred before March 2, 1986, or is required to be incurred pursuant to a written contract which was binding on March 1, 1986.

(C) *Specific rehabilitations.* See section 251(d) (3) and (4) of the Tax Reform Act of 1986 for additional rehabilitations that are exempted from the amendments made by sections 251 and 201 of the Tax Reform Act of 1986.

(b) *Definition of qualified rehabilitated building*— (1) *In general.* The term ‘‘qualified rehabilitated building’’ means any building and its structural components—

(i) That has been substantially rehabilitated (within the meaning of paragraph (b)(2) of this section) for the taxable year,

(ii) That was placed in service (within the meaning of §1.46–3(d)) as a building by any person before the beginning of the rehabilitation, and

(iii) That meets the applicable existing external wall retention test or the existing external wall and internal structural framework retention test in accordance with paragraph (b)(3) of this section.

The requirement in paragraph (b)(1)(iii) of this section does not apply to a certified historic structure. See paragraphs (b) (4) and (5) of this section for additional requirements related to the definition of a qualified rehabilitated building.

(2) *Substantially rehabilitated building*—(i) *Substantial rehabilitation test.* A building shall be treated as having been substantially rehabilitated for a taxable year only if the qualified rehabilitation expenditures (as defined in paragraph (c) of this section) incurred during any 24-month period selected by the taxpayer ending with or within the taxable year exceed the greater of—

(A) The adjusted basis of the building (and its structural components), or (B) $5,000.

(ii) *Date to determine adjusted basis of the building*—(A) *In general.* The adjusted basis of the building (and its structural components) shall be determined as of the beginning of the first day of the 24-month period selected by the taxpayer or the first day of the taxpayer's holding period of the building (within the meaning of section 1250(e)), whichever is later. For purposes of determining the holding period under section 1250(e), any reconstruction that is part of the rehabilitation shall be disregarded.

(B) *Special rules.* In the event that a building is not owned by the taxpayer, the adjusted basis of the building shall be determined as of the date that would have been used if the owner had been the taxpayer. The adjusted basis of a building that is being rehabilitated by a taxpayer other than the owner shall thus be determined as of the beginning of the first day of the 24-month period selected by the taxpayer or the first day of the owner's holding period, whichever is later. Therefore, if a building that is being rehabilitated by a lessee is sold subject to the lease prior to the date that the lessee has substantially rehabilitated the building, the lessee's adjusted basis is determined as of the beginning of the first day of the new lessor's holding period or the beginning of the first day of the 24-month period selected by the lessee (the taxpayer), whichever is later. If, therefore, the first day of the new lessor's holding period were later than the first day of the 24-month period selected by the lessee (the taxpayer), the lessee's adjusted basis for purposes of the substantial rehabilitation test would be the same as the adjusted basis of the new lessor as determined under paragraph (b)(2)(vii) of this section. If a building is sold after the date that a lessee has substantially rehabilitated the building with respect to the original lessor's adjusted basis, however, the lessee's basis may be determined as of the first day of the 24-month period selected by the lessee or the first day of the original lessor's holding period, whichever is later, and the transfer of the building will not affect the adjusted basis for purposes of the substantial rehabilitation test. The preceding sentence shall not apply, however, if the building is sold to the lessee or a related party within the meaning of section 267(b) or section 707(b)(1).

(iii) *Adjusted basis of the building*—(A) *In general.* The term ''adjusted basis of the building'' means the aggregate adjusted basis (within the meaning of section 1011(a)) in the building (and its structural components) of all the parties who have an interest in the building.

(B) *Special rules.* In the case of a building that is leased to one or more tenants in whole or inpart, the adjusted basis of the building is determined by adding the adjusted basis of the owner (lessor) in the building to the adjusted basis of the lessee (or lessees) in the leasehold and any leasehold improvements that are structural components of the building. Similarly, in the case of a building that is divided into condominium units, the adjusted basis of the building means the aggregate adjusted basis of all of the respective condominium owners (including the basis of any lessee in the leasehold and leasehold improvements) in the building (and its structural components). If the adjusted basis of a building would be determined in whole or in part by reference to the adjusted basis of a person or persons other than the taxpayer (*e.g.*, a rehabilitation by a lessee) and the taxpayer is unable to obtain the required information, the taxpayer must establish by clear and convincing evidence that the adjusted basis of such person or persons in the building on the date specified in paragraph (b)(2)(ii) of this section is an amount that is less than the amount of qualified rehabilitation expenditures incurred by the taxpayer. If no such amount can be so established, the adjusted basis of the building will be deemed to be the fair market value of the building on the relevant date. For purposes of determining the adjusted basis of a building, the portion of the adjusted basis of a building that is allocable to an addition (within the meaning of paragraph (b)(4)(ii) of this section) to the building that does not meet the age requirement in paragraph (b)(4)(i) of this section shall be disregarded. (See paragraph (b)(2)(vii) of this section for the rule applicable to the determination of the adjusted basis of a building when qualified rehabilitation expenditures are treated as incurred by the taxpayer.)

(iv) *Rehabilitation.* Rehabilitation includes renovation, restoration, or reconstruction of a building, but does not include an enlargement (within the meaning of paragraph (c)(10) of this section) of new construction. The determination of whether expenditures are attributable to the rehabilitation of an existing building or to new construction shall be based upon all the facts and circumstances.

(v) *Special rule for phased rehabilitation.* In the case of any rehabilitation that may reasonably be expected to be completed in phases set forth in written architectural plans and specifications completed before the physical work on the rehabilitation begins, paragraphs (b)(2) (i), (ii), and (vii) of this section shall be applied by substituting ‘‘60-month period’’ for ‘‘24-month period.’’ A rehabilitation may reasonably be expected to be completed in phases if it consists of two or more distinct stages of development. The determination of whether a rehabilitation consists of distinct stages and therefore may reasonably be expected to be completed in phases shall be made on the basis of all the relevant facts and circumstances in existence before physical work on the rehabilitation begins. For purposes of this paragraph and paragraph (a)(2)(iii) of this section, written plans that describe generally all phases of the rehabilitation process shall be treated as written architectural plans and specifications. Such written plans are not required to contain detailed working drawings or detailed specifications of the materials to be used. In addition, the taxpayer may include a description of work to be done by lessees in the written plans. For example, where the owner of a vacant four story building plans to rehabilitate two floors of the building and plans to require, as a condition of any lease, that tenants of the other two floors must rehabilitate those floors, the requirements of this paragrpah (b)(2)(v) shall be met if the owner provides written plans for the rehabilitation work to be done by the owner and a description of the rehabilitation work that the tenants will be required to complete. The work required of the tenants may be described in the written plans in terms of minimum specifications (*e.g.*, as to lighting, wiring, materials, appearance) that must be met by such tenants. See paragraph (b)(6)(i) of this section for the definition of physical work on a rehabilitation.

(vi) *Treatment of expenses incurred by persons who have an interest in the building.* For purposes of the substantial rehabilitation test in paragraph (b)(2)(i) of this section, the taxpayer may take into account qualified rehabilitation expenditures incurred during the same rehabilitation process by any other person who has an interest in the building. Thus, for example, to determine whether a building has been substantially rehabilitated, a lessee may include the expenditures of the lessor and of other lessees; a condominium owner may include the expenditures incurred by other condominium owners; and an owner may include the expenditures of the lessees.

(vii) *Special rules when qualified rehabilitation expenditures are treated as incurred by the taxpayer.* In the case where qualified rehabilitation expenditures are treated as having been incurred by a taxpayer under paragraph (c)(3)(ii) of this section, the transferee shall be treated as having incurred the expenditures incurred by the transferor on the date that the transferor incurred the expenditures within the meaning of paragraph (c)(3)(i) of this section. For purposes of the substantial rehabilitation test in paragrpah (b)(2)(i) of this section, the transferee's adjusted basis in the building shall be determined as of the beginning of the first day of a 24-month period, or the first day of the transferee's holding period, whichever is later, as provided in paragraph (b)(2)(ii) of this section. The transferee's basis as of the first day of the transferee's holding period for purposes of the substantial rehabilitation test in paragraph (b)(2)(i) of this section, however, shall be considered to be equal to the transferee's basis in the building on such date less—

(A) The amount of any qualified rehabilitation expenditures incurred (or treated as having been incurred) by the transferor during the 24-month period that are treated as having been incurred by the transferee under paragraph (c)(3)(ii) of this section, and

(B) The amount of qualified rehabilitation expenditures incurred before the transfer and during the 24-month period by any other person who has an interest in the building (*e.g.*, a lessee of the transferor). The preceding sentence shall not apply, however, unless the transferee's basis in the building is determined with reference to (*1*) the transferee's cost of the building (including the rehabilitation expenditures), (*2*) the transferor's basis in the building (where such basis includes the amount of the expenditures), or (*3*) any other amount that includes the cost of the rehabilitation expenditures. In the event that the transferee's basis is determined with reference to an amount not described above (*e.g.*, transferee's basis in one building is determined with reference to the transferee's basis in another building under section 1031(d)), the amount of the expenditures incurred by the transferor and treated as having been incurred by the transferee are not deducted from the transferee's basis for purposes of the substantial rehabilitation test. If a transferee's basis is determined under section 1014, any expenditures incurred by the decedent within the measuring period that are treated as having been incurred by the transferee under paragraph (c)(3)(ii) of this section shall decrease the transferee's basis for purposes of the substantial rehabilitation test.

(viii) *Statement of adjusted basis, measuring period, and qualified rehabilitation expenditures.* In the case of any tax return filed after August 27, 1985, on which an investment tax credit for property, described in section 48(a)(1)(E) is claimed, the taxpayer shall indicate by way of a marginal notation on, or a supplemental statement attached to, Form 3468—

(A) The beginning and ending dates for the measuring period selected by the taxpayer under section 48(g)(1)(C)(i) and paragraph (b)(2) of this section,

(B) The adjusted basis of the building (within the meaning of paragraph (b)(2)(iii) or (vii) of this section) as of the beginning of such measuring period, and

(C) The amount of qualified rehabilitation expenditures incurred, and treated as incurred, respectively, during such measuring period.

Furthermore, for returns filed after August 27, 1985, if the adjusted basis of the building for purposes of the substantial rehabilitation test is determined in whole or in part by reference to the adjusted basis of a person, or persons, other than the taxpayer (*e.g.*, a rehabilitation by a lessee), the taxpayer must attach to the Form 3468 filed with the tax return on which the credit is claimed a statement addressed to the District Director, signed by such third party, that states the first day of the third party's holding period and the amount of the adjusted basis of such third party in the building at the beginning of the measuring period or the first day of the holding period, whichever is later. If the taxpayer is unable to obtain the required information, that fact should be indicated and the taxpayer should state the manner in which the adjusted basis was determined and, if different, the fair market value of the building on the relevant date.

(ix) *Partnerships and S corporations.* If a building is owned by a partnership (*i.e.,* the building is partnership property) or an S corporation, the substantial rehabilitation test shall be determined at the entity level. Thus, the entity shall compare the amount of qualified rehabilitation expenditures incurred during the measuring period against its basis in the building at the beginning of its holding period or the beginning of its measuring period, whichever is later. (See section 1223(2) for rules concerning the determination of a partnership's holding period in the case of a contribution of property to the partnership meeting the requirements of section 721.) The adjusted basis of the building to a partnership shall be determined by taking into account any adjustments to the basis of the building made under section 743 and section 734. Any adjustments to the building's basis that are made under section 743 or section 734 after the beginning of the partnership's holding period, but before the end of the measuring period, shall be deemed for purposes of the substantial rehabilitation test to have been made on the first day of the partnership's holding period. However, in such case, the partnership's basis in the building shall be reduced by the amount of qualified rehabilitation expenditures incurred by the partnership. In the case of any tax return filed after January 9, 1989 on which a credit is claimed by a partner or a shareholder of an S corporation for rehabilitation expenditures incurred by a partnership or an S corporation, the partner or shareholder shall indicate on the Form 3468 on which the credit is claimed the name, address, and identification number of the partnership or S corporation that incurred the rehabilitation expenditures, and the partnership or S corporation shall, by way of a marginal notation on or a supplemental statement attached to the entity's return, provide the information required by paragraph (b)(2)(viii) of this section.

(x) *Examples.* The following examples illustrate the application of the substantial rehabilitation test in this paragraph (b)(2):

Example 1. Assume that A, a calendar year taxpayer, purchases a building for $140,000 on January 1, 1982, incurs qualified rehabilitation expenditures in the amount of $48,000 (at the rate of $4,000 per month) in 1982, $100,000 in 1983, and $20,000 (at the rate of $2,000 per month) in the first ten months of 1984, and places the rehabilitated building in service on October 31, 1984. Assume that A did not have written architectural plans and specifications describing a phased rehabilitation within the meaning of paragraph (b)(2)(v) of this section in existence prior to the beginning of physical work on the rehabilitation. For purposes of the substantial rehabilitation test in paragraph (b)(2) of this section, A may select any 24-consecutive-month measuring period that ends in 1984, the taxable year in which the rehabilitated building was placed in service. Assume that on A's 1984 return, A selects a measuring period beginning on February 1, 1982, and ending on January 31, 1984, and specifies that A's basis in the building (within the meaning of section 1011(a)) was $144,000 on February 1, 1982 ($140,000+$4,000). (The $4,000 of rehabilitation expenditures incurred during January 1982 are included in A's basis under section 1011 even though such property has not been placed in service.) The amount of qualified rehabilitation expenditures incurred during the measuring period was $146,000 ($44,000 from February 1 to December 31, 1982, plus $100,000 in 1983, plus $2,000 in January 1984). The building shall be treated as "substantially rehabilitated" within the meaning of this paragraph (b)(2) for A's 1984 taxable year because the $146,000 of expenditures incurred by A during the measuring period exceeded A's adjusted basis of $144,000 at the beginning of the period. If the other requirements of section 48(g)(1) and this paragraph are met, the building is treated as a qualified rehabilitated building, and A can treat as qualified rehabilitation expenditures the amount of $168,000 (*i.e.,* $146,000 of expenditures incurred during the measuring period, $4,000 of expenditures incurred prior to the beginning of the measuring period as part of the rehabilitation process, and $18,000 of expenditures incurred after the measuring period during the taxable year within which the measuring period ends (See paragraph (c)(6) of this section.)). The result would generally be the same if the property attributable to the rehabilitation expenditures was placed in service as the expenditures were incurred, but A would have $148,000 of qualified rehabilitation expenditures for 1983 and $20,000 of qualified rehabilitation expenditures for 1984. (See paragraph (f)(2) of this section).

Example 2. Assume the same facts as in example 1, except that additional rehabilitation expenditures are incurred after the portion of the basis of the building attributable to qualified rehabilitation expenditures was placed in service on October 31, 1984. Such expenditures are incurred through the end of 1984 and in 1985 when the portion of the basis attributable to the additional expenditures is placed in service. The fact that the building qualified as a substantially rehabilitated building for A's 1984 taxable year has no effect on whether the building is a qualified rehabilitated building for property placed in service in A's 1985 taxable year. In order to determine whether the building is a qualified rehabilitated building for A's 1985 taxable year, A must select a measuring period that ends in 1985 and compare the expenditures incurred within that period with the adjusted basis as of the beginning of the period. Solely for the purpose of determining whether the building was substantially rehabilitated for A's 1985 taxable year, expenditures incurred during 1983 and 1984, even though considered in determining whether the building was substantially rehabilitated in 1984, may also be used to determine whether the building was substantially rehabilitated for A's 1985 taxable year, provided the expenditures were incurred during any 24-month measuring period selected by A that ends in 1985.

Example 3. (i) Assume the B purchases a building for $100,000 on January 1, 1982, and leases the building to C who rehabilitates the building. Assume that C, a calendar year taxpayer, places the property with respect to which rehabilitation expenditures were made in service in 1982 and selects December 31, 1982, as the end of the measuring period for purposes of the substantial rehabilitation test. The beginning of the measuring period is January 2, 1982, the beginning of B's holding period under section 1250(e), and the adjusted basis of the building is $100,000. Accordingly, if C incurred more than $100,000 of qualified rehabilitation expenditures during 1982, the building would be substantially rehabilitated within the meaning of paragraph (b)(2)(i) of this section.

(ii) Assume the facts of example 3(i), except that after C begins physical work on the rehabilitation, but before C incurs $100,000 of expenditures, D acquires the building, subject to C's lease, from B for $200,000. D's holding period under section 1250(e) begins on the day after D acquired the building, and C's adjusted basis for purposes of the substantial rehabilitation test is $200,000, less the amount of expenditures incurred by C before the transfer. (See paragraphs (b)(2) (ii) and (vii) of this section.) Accordingly, if C incurred more than $200,000 (less the amount of expenditures incurred prior to the transfer) of qualified rehabilitation expenditures during 1982, the building would be substantially rehabilitated within the meaning of paragraph (b)(2) of this section. Under paragraph (b)(2)(ii)(B) of this section, however, C's adjusted basis for purposes of the substantial rehabilitation test would be $100,000 if C had substantially rehabilitated the building (*i.e.*, incurred more than $100,000 in rehabilitation expenditures) prior to B's sale to D.

Example 4. E owns a building with a basis of $10,000 and E incurs $5,000 of rehabilitation expenditures. Before completing the rehabilitation project, E sells the building to F for $30,000. Assume that F is treated under paragraph (c)(3)(ii) of this section as having incurred the $5,000 of rehabilitation expenditures actually incurred by E. Because F's basis in the building is determined under section 1011 with reference to F's $30,000 cost of the building (which includes the property attributable to E's rehabilitation expenditures), F's basis for purposes of the substantial rehabilitation test is $25,000 ($30,000 cost basis less $5,000 rehabilitation expenditures treated as if incurred by F). (See paragraph (b)(2)(vii) of this section.) F would thus be required to incur more than $20,000 of rehabilitation expenditures (in addition to the $5,000 incurred by E and treated as having been incurred by F) during a measuring period selected by F to satisfy the substantial rehabilitation test.

Example 5. G owns Building I with a basis of $10,000 and a fair market value of $20,000. H owns Building II with a basis of $5,000 and a fair market value of $20,000, with respect to which H has incurred $1,000 of rehabilitation expenditures. G and H exchange their buildings in a transaction that qualifies for nonrecognition treatment under section 1031. Assume that G is treated under paragraph (c)(3)(ii) of this section as having incurred $1,000 of rehabilitation expenditures. G's basis in Building II, computed under section 1031(d), is $10,000. G's basis in Building II is not determined with reference to (A) the cost of Building II, (B) H's basis in Building II (including the cost of the rehabilitation expenditures) or (C) any other amount that includes the cost of expenditures, but is instead determined with reference to G's basis in other property (Building I). Therefore, G's basis in Building II for purposes of the substantial rehabilitation test is not reduced by the $1,000 of rehabilitation expenditures treated as if incurred by G. (See paragraph (b)(2)(vii) of this section.) Accordingly, G's basis in Building II for purposes of the substantial rehabilitation test is $10,000, and G must incur additional rehabilitation expenditures in excess of $9,000 within a measuring period selected by G to satisfy the test.

(3) *Retention of existing external walls and internal structural framework*—(i) *In general*—(A) *Property placed in service after December 31, 1986.* Except in the case of property that qualifies for the transition rules in paragraphs (a)(2)(iv) (B) and (C) of this section, in the case

of property that is placed in service after December 31, 1986, a building (other than a certified historic structure) meets the requirement in paragraph (b)(1)(iii) of this section only if in the rehabilitation process—

(*1*) 50 percent or more of the existing external walls of such building are retained in place as external walls;

(*2*) 75 percent or more of the existing external walls of such building are retained in place as internal or external walls; and

(*3*) 75 percent or more of the internal structural framework of such building (as defined in paragraph (b)(3)(iii) of this section) is retained in place.

(B) *Expenditures incurred before January 1, 1984, for property placed in service before January 1, 1987.* With respect to rehabilitation expenditures incurred before January 1, 1984, for property that is either placed in service before January 1, 1987, or that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, a building meets the requirement in paragraph (b)(1)(iii) of this section only if 75 percent or more of the existing external walls of the building are retained in place as external walls in the rehabilitation process. If an addition to a building is not treated as part of a qualified rehabilitated building because it does not meet the 30-year requirement in paragraph (b)(4)(i)(B) of this section, then the external walls of such addition shall not be considered to be existing external walls of the building for purposes of section 48(g)(1)(A)(iii) (as in effect prior to enactment of the Tax Reform Act of 1986), and this section.

(C) *Expenditures incurred after December 31, 1983, for property placed in service before January 1, 1987.* With respect to expenditures incurred after December 31, 1983, for property that is either placed in service before January 1, 1987, or that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, the requirement of paragraph (b)(1)(iii) of this section is satisfied only if in the rehabilitation process either the existing external wall retention requirement in paragraph (b)(3)(i) (B) of this section is satisfied, or:

(1) 50 percent or more of the existing external walls of the building are retained in place as external walls,

(2) 75 percent or more of the existing external walls are retained in place as internal or external walls, and

(3) 75 percent or more of the existing internal structural framework of such building is retained in place.

(D) *Area of external walls and internal structural framework.* The determinations required by paragraphs (b)(3)(i) (A), (B), and (C) of this section shall be based upon the area of the external walls or internal structural framework that is retained in place compared to the total area of each prior to the rehabilitation. The area of the existing external walls and internal structural framework of a building shall be determined prior to any destruction, modification, or construction of external walls or internal structural framework that is undertaken by any party in anticipation of the rehabilitation.

(ii) *Definition of external wall.* For purposes of this paragraph (b), a wall includes both the supporting elements of the wall and the nonsupporting elements, *(e.g.,* a curtain, windows or doors) of the wall. Except as otherwise provided in this paragraph (b)(3), the term '''external wall'' includes any wall that has one face exposed to the weather, earth, or an abutting wall of an adjacent building. The term ''external wall'' also includes a shared wall *(i.e.,* a single wall shared with an adjacent building), generally referred to as a ''party wall,'' provided that the shared wall has no windows or doors in any portion of the wall that does not have one face exposed to the weather, earth, or an abutting wall. In general, the term ''external wall'' includes only those external walls that form part of the outline or perimeter of the building or that surround an uncovered courtyard. Therefore, the walls of an uncovered internal shaft, designed solely to bring light or air into the center of a building, which are completely surrounded by external walls of the building and which enclose space not designated for occupancy or other use by people (other than for maintenance or emergency), are not considered external walls. Thus, for example, a wall of a light well in the center of a building is not an external wall. However, walls surrounding an outdoor space which is usable by people, such as a courtyard, are external walls.

(iii) *Definition of internal structural framework.* For purposes of this section, the term ''internal structural framework'' includes all load-bearing internal walls and any other internal structural supports, including the columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building.

(iv) *Retained in place.* An existing external wall is retained in place if the supporting elements of the wall are retained in place. An existing external wall is not retained in place if the supporting elements of the wall are replaced by new supporting elements. An external wall is retained in place, however, if the supporting elements are reinforced in the rehabilitation, provided that such supporting elements of the external wall are retained in place. An external wall also is retained in place if it is covered (*e.g.,* with new siding). Moreover, an external wall is retained in place if the existing curtain is replaced with a new curtain, provided that the structural framework that provides for the support of the existing curtain is retained in place. An external wall is retained in place notwithstanding that the existing doors and windows in the wall are modified, eliminated, or replaced. An external wall is retained in place if the wall is disassembled and reassembled, provided the same supporting elements are used when the wall is reassembled and the configuration of the external walls of the building after the rehabilitation is the same as it was before the rehabilitation process commenced. Thus, for example, a brick wall is considered retained in place even though the original bricks are removed (for cleaning, *etc.*) and replaced to form the wall. The principles of this paragraph (b)(3)(iv) shall also apply to determine whether internal structural framework of the building is retained in place.

(v) *Effect of additions.* If an existing external wall is converted into an internal wall (*i.e.,* a wall that is not an external wall), the wall is not retained in place as an external wall for purposes of this section.

(vi) *Examples.* The provisions of this paragraph (b)(3) may be illustrated by the following examples:

Example 1. Taxpayer A rehabilitated a building all of the walls of which consisted of wood siding attached to gypsum board sheets (which covered the supporting elements of the wall, *i.e.,* studs). A covered the existing wood siding with aluminum siding as part of a rehabilitation that otherwise qualified under this subparagraph. The addition of the aluminum siding does not affect the status of the existing external walls as external walls and they would be considered to have been retained in place.

Example 2. Taxpayer B rehabilitated a building, the external walls of which had a masonry curtain. The masonry on the wall face was replaced with a glass curtain. The steel beam and girders supporting the existing masonry curtain were retained in place. The walls of the building are considered to be retained in place as external walls, notwithstanding the replacement of the curtain.

Example 3. Taxpayer C rehabilitated a building that has two external walls measuring 75′ x 20′ and two other external walls measuring 100′ x 20′. C demolished one of the larger walls, including its supporting elements and constructed a new wall. Because one of the larger walls represents more than 25 percent of the area of the building's external walls, C has not satisfied the requirements that 75 percent of the existing external walls must be retained in place as either internal or external walls. If however, C had not demolished the wall, but had converted it into an internal wall (*e.g.,* by building a new external wall), the building would satisfy the external wall requirements.

Example 4. The facts are the same as in example 3, except that C does not tear down any walls, but builds an addition that results in one of the smaller walls becoming an internal wall. In addition, C enlarged 8 of the existing windows on one of the larger walls, increasing them from a size of 3′ x 4′ to 6′ x 8′. Since the smaller wall accounts for less than 25 percent of the total wall area, C has satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls in the rehabilitation process. The enlargement of the existing windows on the larger wall does not affect its status as an external wall.

Example 5. Taxpayer D rehabilitated a building that was in the center of a row of three buildings. The building being rehabilitated by D shares its side walls with the buildings on either side. The shared walls measure 100′ x 20′ and the rear and front walls measure 75′ x 20′. As part of a rehabilitation, D tears down and replaces the front wall. Because the shared walls as well as the front and back walls are considered external walls and the front wall accounts for less than 25 percent of the total external wall area (including the shared walls), D has satisfied the requirement that 75 percent of the existing external walls must be retained in place as external walls in the rehabilitation process.

(4) *Age requirement*—(i) *In general*—(A) *Property placed in service after December 31, 1986.* Except in the case of property that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, a building other than a certified historic structure shall not be considered a qualified rehabilitated building unless the building was first placed in service (within the meaning of §1.46–3(d)) before January 1, 1936.

(B) *Property placed in service before January 1, 1987, and property qualifying under a transition rule.* In the case of property placed in service before January 1, 1987, and property that qualifies under the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, a building other than a certified historic structure is considered a qualified rehabilitated building only if a period of at least 30 years has elasped between the date physical work on the rehabilitation of the building began and the date the building was first placed in service (within the meaning of §1.46–3(d)) as a building by any person.

(ii) *Additions.* A building that was first placed in service before 1936 in the case described in paragraph (b)(4)(i)(A) of this section, or at least 30 years before physical work on the rehabilitation began in the case described in paragraph (b)(4)(i)(B) of this section, will not be disqualified because additions to such building have been added since 1936 in the case described in paragraph (b)(4)(i)(A) of this section, or are less than 30 years old in the case described in paragraph (b)(4)(i)(B) of this section. Such additions, however, shall not be treated as part of the qualified rehabilitated building. The term ''addition'' means any construction that resulted in any portion of an external wall becoming an internal wall, that resulted in an increase in the height of the building, or that increased the volume of the building.

(iii) *Vacant periods.* The determinations required by paragraph (b)(4)(i) of this section include periods during which a building was vacant or devoted to a personal use and is computed without regard to the number of owners or the identify of owners during the period.

(5) *Location at which the rehabilitation occurs.* A building, other than a certified historic structure is not a qualified rehabilitated building unless it has been located where it is rehabilitated since before 1936 in the case described in paragraph (b)(4)(i)(A) of this section. Similarly, in the case described in paragraph (b)(4)(i)(B) of this section, a building, other than a certified historic structure, is not a qualified rehabilitation building unless it has been located where it is rehabilitated for the thirty-year period immediately preceding the date physical work on the rehabilitation began in the case of a ''30-year building'' or the forty-year period immediately preceding the date physical work on the rehabilitation began in the case of a ''40-year building.'' (See §1.46–1(q)(1)(iii) for the definitions of ''30-year building'' and ''40-year building.'')

(6) *Definition and special rule*—(i) *Physical work on a rehabilitation.* For purposes of this section, ''physical work on a rehabilitation'' begins when actual construction, or destruction in preparation for construction, begins. The term ''physical work on a rehabilitation,'' however, does not include preliminary activities such as planning, designing, securing financing, exploring, researching, developing plans and specifications, or stabilizing a building to prevent deterioration (*e.g.,* placing boards over broken windows).

(ii) *Special rule for adjoining buildings that are combined.* For purposes of this paragraph (b), if as part of a rehabilitation process two or more adjoining buildings are combined and placed in service as a single building after the rehabilitation process, then, at the election of the taxpayer, all of the requirements for a qualified rehabilitated building in section 48(g)(1) and this section may be applied to the constituent adjoining buildings in the aggregate. For example, if such requirements are applied in the aggregate, any shared walls or abutting walls between the constituent buildings that would otherwise be treated as external walls (within the meaning of paragraph (b)(3) of this section) would not be treated as external walls of the building, and the substantial rehabilitation test in paragraph (b)(2) of this section would be applied to the aggregate expenditures with respect to all of the constituent buildings and to the aggregate adjusted basis of all of the constituent buildings. A taxpayer shall elect the special rule of this paragraph (b)(6)(ii) for adjoining buildings by indicating by way of a marginal notation on, or a supplemental statement attached to, the Form 3468 on which a credit is first claimed for qualified rehabilitation expenditures with respect to such buildings that such buildings are a single qualified rehabilitated building because of the application of the special rule in this paragraph (b)(6)(ii).

(c) *Definition of qualified rehabilitation expenditures*—(1) *In general.* Except as otherwise provided in paragraph (c)(7) of this section, the term ‘‘qualified rehabilitation expenditure’’ means any amount that is—

(i) Properly chargeable to capital account (as described in paragraph (c)(2) of this section),

(ii) Incurred by the taxpayer after December 31, 1981 (as described in paragraph (c)(3) of this section),

(iii) For property for which depreciation is allowable under section 168 and which is real property described in paragraph (c)(4) of this section, and

(iv) Made in connection with the rehabilitation of a qualified rehabilitated building (as described in paragraph (c)(5) of this section).

(2) *Chargeable to capital account.* For purposes of paragraph (c)(1) of this section, amounts are chargeable to capital account if they are properly includible in computing basis of real property under §1.46–3(c). Amounts treated as an expense and deducted in the year they are paid or incurred or amounts that are otherwise not added to the basis of real property described in paragraph (c)(4) of this section do not qualify. For purposes of this paragraph (c), amounts incurred for architectural and engineering fees, site survey fees, legal expenses, insurance premiums, development fees, and other construction related costs, satisfy the requirement of this paragraph (c)(2) if they are added to the basis of real property that is described in paragraph (c)(4) of this section. Construction period interest and taxes that are amortized under section 189 (as in effect prior to its repeal by the Tax Reform Act of 1986) do not satisfy the requirement of this paragraph (c)(2). If, however, such interest and taxes are treated by the taxpayer as chargeable to capital account with respect to property described in paragraph (c)(4) of this section, they shall be treated in the same manner as other costs described in this paragraph (c)(2). Any construction period interest or taxes or other fees or costs incurred in connection with the acquisition of a building, any interest in a building, or land, are subject to paragraph (c)(7)(ii) of this section. See paragraph (c)(9) of this section for additional rules concerning interest.

(3) *Incurred by the taxpayer*—(i) *In general.* Qualified rehabilitation expenditures are incurred by the taxpayer for purposes of this section on the date such expenditures would be considered incurred under an accrual method of accounting, regardless of the method of accounting used by the taxpayer with respect to other items of income and expense. If qualified rehabilitation expenditures are treated as having been incurred by a taxpayer under paragraph (c)(3)(ii) of this section, the taxpayer shall be treated as having incurred the expenditures on the date such expenditures were incurred by the transferor.

(ii) *Qualified rehabilitation expenditures treated as incurred by the taxpayer*—(A) Where rehabilitation expenditures are incurred with respect to a building by a person (or persons) other than the taxpayer and the taxpayer subsequently acquires the building, or a portion of the building to which some or all of the expenditures are allocable (*e.g.*, a condominium unit to which rehabilitation expenditures have been allocated), the taxpayer acquiring such property shall be treated as having incurred the rehabilitation expenditures actually incurred by the transferor (or treated as incurred by the transferor under this paragraph (c)(3)(ii)) allocable to the acquired property, provided that—

(*1*) The building, or the portion of the building, acquired by the taxpayer was not used (or, if later, was not placed in service (as defined in paragraph (f)(2) of this section)) after the rehabilitation expenditures were incurred and prior to the date of acquisition, and

(*2*) No credit with respect to such qualified rehabilitation expenditures is claimed by anyone other than the taxpayer acquiring the property. For purposes of this paragraph (c)(3)(ii), use shall mean actual use, whether personal or business. In the case of a building that is divided into condominium units, expenditures attributable to the common elements shall be allocable to the individual condominium units in accordance with the principles of paragraph (c)(10)(ii) of this section. Furthermore, for purpose of this paragraph (c)(3)(ii), a condominium unit's share of the common elements shall not be considered to have been used (or placed in service) prior to the time that the particular condominium unit is used.

(B) The amount of rehabilitation expenditures described in paragraph (c)(3)(ii)(A) of this section treated as incurred by the taxpayer under this paragraph shall be the lesser of—

(*1*) The amount of rehabilitation expenditures incurred before the date on which the taxpayer acquired the building (or portion thereof) to which the rehabilitation expenditures are attributable, or

(*2*) The portion of the taxpayer's cost or other basis for the property that is properly allocable to the property resulting from the rehabilitation expenditures described in paragraph (c)(3)(ii)(B)(*1*) of this section.

(C) For purposes of this paragraph (c)(3)(ii), the amount of rehabilitation expenditures treated as incurred by the taxpayer under this paragraph (c) shall not be treated as costs for the acquisition of a building. The portion of the cost of acquiring a building (or an interest therein) that is not treated under this paragraph as qualified rehabilitation expenditures incurred by the taxpayer is not treated as section 38 property in the hands of the acquiring taxpayer. (See paragraph (c)(7)(ii) of this section.) (See paragraph (b)(2)(vii) for rules concerning the application of the substantial rehabilitation test when expenditures are treated as incurred by the taxpayer.)

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

Example 1. In 1981, A, a taxpayer using the cash receipts and disbursements method of accounting, commenced the rehabilitation of a 30-year old building. In June 1981, A signed a contract with a plumbing contractor for replacement of the plumbing in the building. A agreed to pay the contractor as soon as the work was completed. The work was completed in December 1981, but A did not pay the amount due until January 15, 1982. The expenditures for the plumbing are not qualified rehabilitation expenditures (within the meaning of this paragraph (c)) because they were not incurred under an accrual method of accounting after December 31, 1981.

Example 2. B incurred qualified rehabilitation expenditures of $300,000 with respect to an existing building between January 1, 1982, and May 15, 1982, and then sold the building to C on June 1, 1982. The portion of the building to which the expenditures were allocable was not used by B or any other person during the period from January 1, 1982, to June 1, 1982, and neither B nor any other person claimed the credit. Consequently, C will be treated as having incurred the expenditures on the dates that B incurred the expenditures.

Example 3. D, a taxpayer using the cash receipts and disbursements method of accounting, begins the rehabilitation of a building on January 11, 1982. Prior to May 1, 1982, D makes rehabilitation expenditures of $16,000. On May 3, 1982, D sells the building, the land, and the property attributable to the rehabilitation expenditures to E for $35,000. The purchase price is properly allocable as follows:

Land	$5,000
Existing building	11,000
Property attributable to rehabilitation expenditures	19,000
Total purchase price	35,000

The property attributable to the rehabilitation expenditures is placed in service by E on September 5, 1982. E may treat a portion of the $35,000 purchase price as rehabilitation expenditures paid or incurred by him. Since the rehabilitation expenditures paid by D ($16,000) are less than the portion of the purchase price properly allocable to property attributable to these expenditures ($19,000), E may treat only $16,000 as rehabilitation expenditures paid or incurred by him. The excess of the purchase price allocable to rehabilitation expenditures ($19,000) over the rehabilitation expenditures paid by D ($16,000), or $3,000, is treated as the cost of acquiring an interest in the building and is not a qualified rehabilitation expenditure treated as incurred by E.

Example 4. The facts are the same as in example 3, except that the purchase price properly allocable to the property attributable to rehabilitation expenditures is $15,000. Under these circumstances, E may treat only $15,000 of D's $16,000 expenditures as rehabilitation expenditures paid by D. The excess of the rehabilitation expenditures paid by D ($16,000) over the purchase price allocable to rehabilitation expenditures ($15,000), or $1,000, is treated as the cost of acquiring an interest in the building and is not a qualified rehabilitation expenditure treated as incurred by E.

(4) *Incurred for depreciable real property*—(i) *Property placed in service after December 31, 1986.* Except as otherwise provided in paragraph (c)(4)(ii) of this section (relating to certain property that qualifies under a transition rule), in the case of property placed in service after December 31, 1986, an expenditure is incurred for depreciable real property for purposes of paragraph (c)(1)(iii) of this section, only if it is added to the depreciable basis of depreciable property which is—

(A) Nonresidential real property,

(B) Residential rental property,

(C) Real property which has a class life of more than 12.5 years, or

(D) An addition or improvement to property described in paragraph (c)(4)(i) (A), (B), or (C) of this section.

For purposes of this paragraph (c)(4)(i), the terms ‘‘nonresidential real property’’, ‘‘residential rental property’’, and ‘‘class life’’ have the respective meanings given to such terms by section 168 and the regulations thereunder.

(ii) *Property placed in service before January 1, 1987, and property that qualifies under a transition rule.* In the case of property placed in service before January 1, 1987, and property placed in service after December 31, 1986, that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, an expenditure attributable to such property shall be a qualified rehabilitation expenditure only if such expenditure is incurred for property that is real property (or additions or improvements to real property) with a recovery period (within the meaning of section 168 as in effect prior to its amendment by the Tax Reform Act of 1986) of 19 years (15 years for low-income housing) and if the other requirements of this paragraph (c) are met. For purposes of this section, an expenditure is incurred for recovery property having a recovery period of 19 years only if the amount of the expenditure is added to the basis of property which is 19-year real property or 15-year real property in the case of low-income housing. For purposes of this section, the term ‘‘low-income housing’’ has the meaning given such term by section 168(c)(2)(F) (as in effect prior to the amendments made by the Tax Reform Act of 1986).

(5) *Made in connection with the rehabilitation of a qualified rehabilitated building.* In order for an expenditure to be a qualified rehabilitation expenditure, such expenditure must be incurred in connection with a rehabilitation (as defined in paragraph (b)(2)(iv) of this section) of a qualified rehabilitated building. Expenditures attributable to work done to facilities related to a building (*e.g.*, sidewalk, parking lot, landscaping) are not considered made in connection with the rehabilitation of a qualified rehabilitated building.

(6) *When expenditures may be incurred.* An expenditure is a qualified rehabilitation expenditure only if the building with respect to which the expenditures are incurred is substantially rehabilitated (within the meaning of paragraph (b)(2) of this section) for the taxable year in which the property attributable to the expenditures is placed in service (*i.e.*, the building is substantially rehabilitated during a measuring period ending with or within the taxable year in which a credit is claimed). (See paragraph (f)(2) of this section for rules relating to when property is placed in service.) Once the substantial rehabilitation test is met for a taxable year, the amount of qualified rehabilitation expenditures upon which a credit can be claimed for the taxable year is limited to expenditures incurred:

(i) Before the beginning of a measuring period during which the building was substantially rehabilitated that ends with or within the taxable year, provided that the expenditures were incurred in connection with the rehabilitation process that resulted in the substantial rehabilitation of the building;

(ii) Within a measuring period during which the building was substantially rehabilitated that ends with or within the taxable year, and

(iii) After the end of a measuring period during which the building was substantially rehabilitated but prior to the end of the taxable year with or within which the measuring period ends.

(7) *Certain expenditures excluded from qualified rehabilitation expenditures.* The term ''qualified rehabilitation expenditures'' does not include the following expenditures:

(i) Except as otherwise provided in paragraph (c)(8) of this section, any expenditure with respect to which the taxpayer does not use the straight line method over a recovery period determined under section 168 (c) and (g).

(ii) The cost of acquiring a building, any interest in a building (including a leasehold interest), or land, except as provided in paragraph (c)(3)(ii) of this section.

(iii) Any expenditure attributable to an enlargement of a building (within the meaning of paragraph (c)(10) of this section).

(iv) Any expenditure attributable to the rehabilitation of a certified historic structure or a building located in a registered historic district, unless the rehabilitation is a certified rehabilitation. (See paragraph (d) of this section which contains definitions and special rules applicable to rehabilitations of certified historic structures and buildings located in registered historic districts.)

(v) Any expenditure of a lessee of a building or a portion of a building, if, on the date the rehabilitation is completed with respect to property placed in service by such lessee, the remaining term of the lease (determined without regard to any renewal period) is less than the recovery period determined under section 168(c) (or 19 years in the case of property placed in service before January 1, 1987, and property placed in service that qualifies under the transition rules in paragraph (a)(2)(iv)(B) or (C) of this section).

(vi) Any expenditure allocable to that portion of a building which is (or may reasonably be expected to be) tax-exempt use property (within the meaning of section 168 and the regulations thereunder), except that the exclusion in this paragraph (c)(7)(vi) shall not apply for purposes of determining whether the building is a substantially rehabilitated building under paragraph (b)(2) of this section.

(8) *Requirement to use straight line depreciation*—(i) *Property placed in service after December 31, 1986.* The requirement in section 48(g)(2)(B)(i) and paragraph (c)(7)(i) of this section to use straight line cost recovery does not apply to any expenditure to the extent that the alternative depreciation system of section 168(g) applies to such expenditure by reason of section 168(g)(1) (B) or (C). In addition, the requirement in section 48(g)(2)(B)(i) and paragraph (c)(7)(i) of this section applies only to the depreciation of the portion of the basis of a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures.

(ii) *Property placed in service before January 1, 1987, and property placed in service after December 31, 1986, that qualifies for a transition rule.* In the case of expenditures attributable to property placed in service before January 1, 1987, and property that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, the term ''qualified rehabilitation expenditure'' does not include an expenditure with respect to which an election was not made under section 168(b)(3) as in effect prior to its amendment by the Tax Reform Act of 1986, to use the straight line method of depreciation. In such case, the requirement that an election be made to use straight line cost recovery applies only to the cost recovery of the portion of the basis of a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures. See section 168(f)(1), as in effect prior to its amendment by the Tax Reform Act of 1986, for rules relating to the use of different methods of cost recovery for different components of a building. In addition, such requirement shall not apply to any expenditure to the extent that section 168(f)(12) or (j), as in effect prior to the amendments made by the Tax Reform Act of 1986, applied to such expenditure.

(9) *Cost of acquisition.* For purposes of paragraph (c)(7)(ii) of this section, cost of acquisition includes any interest incurred on indebtedness the proceeds of which are attributable to the acquisition of a building, an interest in a building, or land open which a building exists. Interest incurred on a construction loan the proceeds of which are used for qualified rehabilitation expenditures, however, is not treated as a cost of acquisition.

(10) *Enlargement defined*—(i) *In general.* A building is enlarged to the extent that the total volume of the building is increased. An increase in floor space resulting from interior remodeling is not considered an enlargement. The total volume of a building is generally equal to the product of the floor area of the base of the building and the height from the underside of the lowest floor (including the basement) to the average height of the finished roof (as it exists or existed). For this purpose, floor area is measured from the exterior faces of external walls (other than shared walls that are external walls) and from the centerline of shared walls that are external walls.

(ii) *Rehabilitation that includes enlargement.* If expenditures for property only partially qualify as qualified rehabilitation expenditures because some of the expenditures are attributable to the enlargement of the building, the expenditures must be apportioned between the original portion of the building and the enlargement. The expenditures must be specifically allocated between the original portion of the building and the enlargement to the extent possible. If it is not possible to make a specific allocation of the expenditures, the expenditures must be allocated to each portion on some reasonable basis. The determination of a reasonable basis for an allocation depends on factors such as the type of improvement and how the improvement relates functionally to the building. For example, in the case of expenditures for an air-conditioning system or a roof, a reasonable basis for allocating the expenditures among the two portions generally would be the volume of the building, excluding the enlargement, served by the air-conditioning system or the roof relative to the volume of the enlargement served by the improvement.

(d) *Rules applicable to rehabilitations of certified historic structures*—(1) *Definition of certified historic structure.* The term ‘‘certified historic structure’’ means any building (and its structural components) that is—

(i) Listed in the National Register of Historic Places (‘‘National Register’’); or

(ii) Located in a registered historic district and certified by the Secretary of the Interior to the Internal Revenue Service as being of historic significance to the district.

For purposes of this section, a building shall be considered to be a certified historic structure at the time it is placed in service if the taxpayer reasonably believes on that date the building will be determined to be a certified historic structure and has requested on or before that date a determination from the Department of Interior that such building is a certified historic structure within the meaning of this paragraph (d)(1)(i) or (ii) and the Department of Interior later determines that the building is a certified historic structure.

(2) *Definition of registered historic district.* The term ‘‘registered historic district’’ means any district that is—

(i) Listed in the National Register, or

(ii) (A) Designated under a statute of the appropriate State or local government that has been certified by the Secretary of the Interior to the Internal Revenue Service as containing criteria that will substantially achieve the purpose of preserving and rehabilitating buildings of historic significance to the district, and (B) certified by the Secretary of the Interior as meeting substantially all of the requirements for the listing of districts in the National Register.

(3) *Definition of certified rehabilitation.* The term ‘‘certified rehabilitation’’ means any rehabilitation of a certified historic structure that the Secretary of

the Interior has certified to the Internal Revenue Service as being consistent with the historic character of the building and, where applicable, the district in which such building is located. The determination of the scope of a rehabilitation shall be made on the basis of all the facts and circumstances surrounding the rehabilitation and shall not be made solely on the basis of ownership. The Secretary of the Interior shall take all of the rehabilitation work performed as part of a single rehabilitation, including any post-certification work, into account in determining whether the rehabilitation complies with the Department of Interior standards for rehabilitation and whether the certification should be granted, revoked, or otherwise invalidated.

(4) *Revoked or invalidated certification.* If the Department of Interior revokes or otherwise invalidates a certification after it has been issued to a taxpayer, the basis attributable to rehabilitation of the decertified property shall cease to be section 38 property described in section 48(a)(1)(E). Such cessation shall be effective as of the date the activity giving rise to the revocation or invalidation commenced. See section 47 for the rules applicable to property that ceases to be section 38 property.

(5) *Special rule for certain buildings located in registered historic districts.* The exclusion in paragraph (c)(7)(iv) of this section does not apply to a building in a registered historic district if—

(i) Such building was not a certified historic structure during the rehabilitation process; and

(ii) The Secretary of the Interior certified to the Internal Revenue Service that such building was not of historic significance to the district.

In general, the certification referred to in paragraph (d)(5)(ii) of this section must be requested by the taxpayer prior to the time that physical work on the rehabilitation began. If, however, the certification referred to in paragraph (d)(5)(ii) of this section is requested by the taxpayer after physical work on the rehabilitation of the building has begun, the taxpayer must certify to the Internal Revenue Service that, prior to the date that physical work on the rehabilitation began, the taxpayer in good faith was not aware of the requirement of paragraph (d)(5)(ii) of this section. The certification referred to in the previous sentence must be attached to the Form 3468 filed with the tax return for the year in which the credit is claimed.

(6) *Special rule for certain rehabilitations begun before an area is designated as a registered historic district.* In general, the exclusion from the definition of qualified rehabilitation expenditure in paragraph (c)(7)(iv) of this section applies to any rehabilitation expenditures that are incurred after a building becomes a certified historic structure within the meaning of section 48 (g)(3)A) and paragraph (d)(1) of this section or the area in which a building is located becomes a registered historic district within the meaning of section 48 (g)(3)(B) and paragraph (d)(2) of this section. Rehabilitation expenditures incurred prior to such date, however, are not disqualified. In addition, rehabilitation expenditures made after the date the area in which a building is located becomes a registered historic district shall not be disqualified under paragraph (c)(7)(iv) of this section in any case in which physical work on the rehabilitation of a building begins prior to the date the taxpayer knows or has reason to know of an intention to nominate the area in which such building is located as a registered historic district. For purposes of this paragraph (d)(6), the taxpayer knows or has reason to know of such an intention if there is (A) a communication (written or oral) to the owner of any building within the district from the Department of the Interior, or any agency or instrumentality of the appropriate state or local government (or a designee of such agency or instrumentality) that the district in which the building is located is being considered for designation as a registered historic district, (B) a legal notice of such consideration published in a newspaper, or (C) a public meeting held to discuss such consideration. In order to take advantage of the special rule of this paragraph (d)(6), the taxpayer must attach to the Form 3468 filed for the taxable year in which the credit is claimed a statement that the taxpayer in good faith did not know, or have reason to

know, of an intention to nominate the area in which the building is located as a registered historic district.

(7) *Notice of certification*—(i) *In general.* Except as otherwise provided in paragraph (d)(7)(ii) of this section, a taxpayer claiming the credit for rehabilitation of a certified historic structure (within the meaning of section 48(g)(3) and paragraph (d)(1) of this section) must attach to the Form 3468 filed with the tax return for the taxable year in which the credit is claimed a copy of the final certification of completed work by the Secretary of the Interior, and for returns filed after January 9, 1989, evidence that the building is a certified historic structure.

(ii) *Late certification.* If the final certification of completed work has not been issued by the Secretary of the Interior at the time the tax return is filed for a year in which the credit is claimed, a copy of the first page of the Historic Preservation Certification Application—Part 2—Description of Rehabilitation (NPS Form 10–168a), with an indication that it has been received by the Department of the Interior or its designate, together with proof that the building is a certified historic structure (or that such status has been requested), must be attached to the Form 3468 filed with the return. A notice from the Department of the Interior or the State Historic Preservation Officer, stating that the nomination or application has been received, or a date-stamped nomination or application shall be sufficient indication that the nomination or application has been received. The building need not be either listed in the National Register or be determined to be of historic significance to a registered historic district at the time the return is filed for the year in which the credit is claimed. (See paragraph (d)(1) of this section.) The taxpayer must submit a copy of the final certification as an attachment to Form 3468 with the first income tax return filed after the receipt by the taxpayer of the certification. If the final certification is denied by the Department of Interior, the credit will be disallowed for any taxable year in which it was claimed. If the taxpayer fails to receive final certification of completed work prior to the date that is 30 months after the date that the taxpayer filed the tax return on which the credit was claimed, the taxpayer must submit a written statement to the District Director stating such fact prior to the last day of the 30th month, and the taxpayer shall be requested to consent to an agreement under section 6501(c)(4) extending the period of assessment for any tax relating to the time for which the credit was claimed. The procedure permitted by the preceding sentence shall be used whenever the entire rehabilitation project is not fully completed by the date that is 30 months after the taxpayer filed the tax return upon which the credit was claimed (*e.g.* a phased rehabilitation) and the Secretary of the Interior has thus not yet certified the rehabilitation.

(e) *Adjustment to basis*—(1) *General rule.* Except as otherwise provided by this paragraph (e), if a credit is allowed with respect to property attributable to qualified rehabilitation expenditures incurred in connection with the rehabilitation of a qualified rehabilitated building, the increase in the basis of the rehabilitated property that would otherwise result from the qualified rehabilitation expenditures must be reduced by the amount of the credit allowed. See section 48(q) and the regulations there under for other rules concerning adjustments to basis in the case of section 38 property.

(2) *Special rule for certain property relating to certified historic structures.* If a rehabilitation investment credit is allowed with respect to property that is placed in service before January 1, 1987, or property that qualifies for the transition rules in paragraph (a)(2)(iv) (B) or (C) of this section, and such property is attributable to qualified rehabilitation expenditures incurred in connection with the rehabilitation of a certified historic structure, the increase in the basis of the rehabilitated property that would otherwise result from the qualified rehabilitation expenditures must be reduced by one-half of the amount of the credit allowed.

(3) *Recapture of rehabilitation investment credit.* If during any taxable year there is a recapture amount determined with respect to any credit that resulted in a basis adjustment under

paragraph (e) (1) or (2) of this section, the basis of such building (immediately before the event resulting in such recapture) shall be increased by an amount equal to such recapture amount. For purposes of the preceding sentence, the term ''recapture amount'' means any increase in tax (or adjustment in carrybacks or carryovers) determined under section 47(a)(5).

(f) *Coordination with other provisions of the Code*—(1) *Credit claimed by lessee for rehabilitation performed by lessor.* A lessee may take the credit for rehabilitation performed by the lessor if the requirements of this section and section 48(d) are satisfied. For purposes of applying section 48(d), the fair market value of section 38 property described in section 48(a)(1)(E) shall be limited to that portion of the lessor's basis in the qualified rehabilitated building that is attributable to qualified rehabilitation expenditures. In the case of a portion of a building that is divided into more than one leasehold interest, the qualified rehabilitation expenditures attributable to the common elements shall be allocated to the individual leasehold interests in accordance with the principles of paragraph (c)(10)(ii) of this section. Furthermore, a leasehold interest's share of the common elements shall not be considered to have been placed in service prior to the time that the particular leasehold interest is placed in service.

(2) *When the credit may be claimed*—(i) *In general.* The investment credit for qualified rehabilitation expenditures is generally allowed in the taxable year in which the property attributable to the expenditure is placed in service, provided the building is a qualified rehabilitated building for the taxable year. See paragraph (b) of this section and section 46(c) and § 1.46–3(d). Under certain circumstances, however, the credit may be available prior to the date the property is placed in service. See section 46(d) and § 1.46–5 (relating to qualified progress expenditures). Solely for purposes of section 46(c), property attributable to qualified rehabilitation expenditures will not be treated as placed in service until the building with respect to which the expenditures are made meets the definition of a qualified rehabilitated building (as defined in section 48(g)(1) and paragraph (b) of this section) for the taxable year. Accordingly, in the first taxable year for which the building becomes a qualified rehabilitated building, the property described in section 48(a)(1)(E) attributable to expenditures described in paragraph (c) of this section, shall be considered to be placed in service, if such property was considered placed in service under section 46(c) and the regulations thereunder without regard to this paragraph (f)(2)(i) in that taxable year or a prior taxable year. For purposes of the preceding sentence, the requirement of section 48(g)(1)(A)(iii) and paragraph (b)(3) of this section, relating to the definition of a qualified rehabilitated building shall be deemed to be met if the taxpayer reasonably expects that no rehabilitation work undertaken during the remainder of the rehabilitation process will result in a failure to satisfy the requirements of paragraph (b)(3) of this section. If the requirements of paragraph (b)(3) of this section, are not satisfied, however, the credit shall be disallowed for the taxable year in which it was claimed. If a taxpayer fails to complete physical work on the rehabilitation prior to the date that is 30 months after the date that the taxpayer filed a tax return on which the credit is claimed, the taxpayer must submit a written statement to the District Director stating such fact prior to the last day of the 30th month, and shall be requested to consent to an agreement under section 6501(c)(4) extending the period of assessment for any tax relating to the item for which the credit was claimed.

(ii) *Section 38 property described in section 48(a)(1)(E).* In the case of section 38 property described in section 48(a)(1)(E), the section 38 property is not the building. Instead, the section 38 property is the portion of the basis of the building that is attributable to qualified rehabilitation expenditures. Therefore, for example, for purposes of the determination of when such section 38 property is placed in service, a determination must be made regarding when property attributable to the portion of the basis of the building attributable to qualified rehabilitation expenditures is placed in service. The issue of when the building is placed in service is thus not relevant. In fact, under this test, the building itself may never have been taken out of service during the rehabilitation process. If the building is rehabilitated over several years in stages (*e.g.*, by floors), section 38 property attributable to qualified rehabilitation expenditures to a qualified rehabilitated building placed in service in each taxable year shall, generally, be treated as a separate item of section 38 property.

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

Example. Assume that A, a calendar year taxpayer, purchases a four-story building on January 1, 1983, for $100,000, and incurs $10,000 of qualified rehabilitation expenditures in 1983 to rehabilitate floor one, $50,000 of qualified rehabilitation expenditures in 1984 to rehabilitate floor two, $70,000 of qualified rehabilitation expenditures in 1985 to rehabilitate floor three, and $60,000 of qualified rehabilitation expenditures in 1986 to rehabilitate floor four. Assume further that A places the property attributable to these expenditures in service on the last day of the year in which the respective expenditures were incurred and that the building is never taken out of service since as each floor is rehabilitated, the other three floors are occupied by tenants. Under the rule in this paragraph (f)(2), the portion of the basis of the building that is attributable to qualified rehabilitation expenditures incurred with respect to floor one and two are deemed to be placed in service in 1985, because that is the first year that the substantial rehabilitation test described in paragraph (b) of this section is met ($120,000 of expenditures incurred by A during a measuring period ending on December 31, 1985 is greater than the $110,000 basis at the beginning of the period). Assume that as of December 31, 1985, at least 75 percent of the external walls of the building have been retained during the rehabilitation process and that A has a reasonable expectation that no work during the remainder of the rehabilitation process will result in less than 75 percent of the external walls being retained. A may claim a credit for A's 1985 taxable year on $130,000 of qualified rehabilitation expenditures ($10,000 in 1983, $50,000 in 1984, and $70,000 in 1985). (See paragraph (c)(6) of this section for rules applicable to when qualified expenditures may be incurred. In addition, see section 46 (d) and § 1.46–5 for rules relating to qualified progress expenditures.) The fact that the building was a qualified rehabilitated building for A's 1985 taxable year, however, has no effect on whether the building is a qualified rehabilitated building for A's 1986 taxable year. In order to determine whether A is entitled to claim a credit on A's 1986 return for the $60,000 of qualified rehabilitation expenditures incurred in 1986, A must select a measuring period ending in 1986 and must determine whether the building is a qualified rehabilitated building for that year. Solely for purposes of determining whether the building was substantially rehabilitated, expenditures incurred in 1984 and 1985, even though considered in determining whether the building was substantially rehabilitated for A's 1985 taxable year, may be used in addition to the expenditures incurred in 1986 to determine whether the building was substantially rehabilitated for A's 1986 taxable year, provided the expenditures were incurred during any measuring period selected by A that ends in 1986.

(3) *Coordination with section 47.* If property described in section 48(a)(1)(E) is disposed of by the taxpayer, or otherwise ceases to be ''section 38 property,'' section 47 may apply. Property will cease to be section 38 property, and therefore section 47 may apply, in any case in which the Department of Interior revokes or otherwise invalidates a certification of rehabilitation after the property is placed in service or a building (other than a certified historic structure) is moved from the place where it is rehabilitated after the property is placed in service. If, for example, the taxpayer made modifications to the building inconsistent with Department of Interior standards, the Secretary of the Interior might revoke the certification. In addition, if all or a portion of a substantially rehabilitated building becomes tax-exempt use property (see paragraph (c)(7)(vi) of this section) for the first time within five years after the credit is claimed, the credit will be recaptured under section 47 at that time as if the building or portion of the building which becomes tax-exempt use property had then been sold.

[T.D. 8233, 53 FR 39592, Oct. 11, 1988; 53 FR 43866, Oct. 31, 1988]

§ 1.48–12T Tax-exempt entity leasing (Temporary).

In general. For certain investment tax credit consequences for property which is tax-exempt use property under section 168(j), see § 1.168(j)–1T.

[T.D. 8033, 50 FR 27223, July 2, 1985]

§ 1.50–1 Restoration of credit.

(a) *In general.* Section 49(a) (relating to termination of credit) does not apply to property—

(1) The construction, reconstruction, or erection of which by the taxpayer—

(i) Is completed after August 15, 1971, or

(ii) Is begun after March 31, 1971, or

(2) Which is acquired by the taxpayer—

(i) After August 15, 1971, or

(ii) After March 31, 1971, and before August 16, 1971, pursuant to an order which the taxpayer establishes was placed after March 31, 1971.

(b) *Transitional rule.* In the case of property (other than pretermination property) the construction, reconstruction, or erection of which by the taxpayer is begun before April 1, 1971, and completed after August 15, 1971, there shall be taken into account as the basis of new section 38 property in determining qualified investment only that portion of the basis which is properly attributable to construction, reconstruction, or erection after August 15, 1971.

(c) *Principles to be applied.* The principles of § 1.48–2 (b) and (c) shall be applied in determining when property is acquired and in determining that portion of the basis of property properly attributable to construction, reconstruction, or erection after August 15, 1971.

[T.D. 7203, 37 FR 17133, Aug. 25, 1972]

RULES FOR COMPUTING CREDIT FOR EXPENSES OF WORK INCENTIVE PROGRAMS

§ 1.50A–1 Determination of amount.

(a) *In general.* Except as otherwise provided in this section and in § 1.50A–2, the amount of the work incentive program (WIN) credit allowed by section 40 for the taxable year is equal to 20 percent of the taxpayer's WIN expenses (as determined under paragraph (a) of § 1.50B–1). The amount equal to 20 percent of the WIN expenses shall be referred to in this section and §§ 1.50A–2 through 1.50B–5 as the ''credit earned.''

(b) *Limitation based on amount of tax.* Notwithstanding the amount of the credit earned for the taxable year, under section 50A(a)(2) the credit allowed by section 40 for the taxable year is limited to—

(1) If the liability for tax (as defined in paragraph (c) of this section) is $25,000 or less, the liability for tax; or

(2) If the liability for tax is more than $25,000, then, the first $25,000 of the liability for tax plus 50 percent of the liability for tax in excess of $25,000. However, such $25,000 amount may be reduced in the case of certain married individuals filing separate returns (see paragraph (e) of this section); corporations which are members of a controlled group (see paragraph (f) of this section); estates and trusts (see paragraph (c) of § 1.50B–3); and organizations to which section 593 applies, regulated investment companies or real estate investment trusts subject to taxation under subchapter M, chapter 1 of the Code, and cooperative organizations described in section 1381(a) (see § 1.50B–5). The excess of the credit earned for the taxable year over the limitations described in this paragraph for such taxable year is an unused credit which may be carried back or forward to other taxable years in accordance with § 1.50A–2.

(c) *Liability for tax.* For the purpose of computing the limitation based on amount of tax, section 50A(a)(3) defines the liability for tax as the income tax imposed for the taxable year by chapter 1 of the Code, reduced by the sum of the credits allowable under—

(1) Section 33 (relating to taxes of foreign countries and possessions of the United States,

(2) Section 37 (relating to credit for the elderly),

(3) Section 38 (relating to investment in certain depreciable property), and

(4) Section 41 (relating to contributions to candidates for public office).

For purposes of this paragraph, the tax imposed for the taxable year by section 56 (relating to imposition of minimum tax for tax preferences), section 72(m)(5)(B) (relating to 10 percent tax on premature distributions to owner-employees), section 402(e) (relating to tax on lump sum distributions), section 408(f) (relating to additional tax on income from certain retirement accounts), section 531 (relating to imposition of accumulated earnings tax), section 541 (relating to imposition of personal holding company tax), or section 1378 (relating to tax on certain capital gains of subchapter S corporations), and any additional tax imposed for the taxable year by section 1351(d)(1) (relating to recoveries of foreign expropriation losses), shall not be considered tax imposed by chapter 1 of the Code for such year. Thus, the liability for tax for purposes of computing the limitation based on amount of tax for the taxable year is determined without regard to any tax imposed by sections 56, 72(m)(5)(B), 402(e), 408(f), 531, 541, 1351(d)(1) or 1378 of the Code. In addition, any increase in tax resulting from the application of section 50A (c) and (d) and §1.50A–3 (relating to recomputation of credit allowed due to early termination of employment by employer, or failure to pay comparable wages) shall not be treated as tax imposed by chapter 1 of the Code for purposes of computing the liability for tax. See section 50A (c)(3) and (d)(2).

(d) *Example.* The application of paragraphs (a), (b), and (c) of this section may be illustrated by the following example:

Example. X Corporation's WIN expenses for its taxable year ending December 31, 1973, are $500,000. X's credit earned for its taxable year is $100,000 (20 percent of $500,000). X's income tax for such year, computed without regard to credits against tax and without regard to any tax imposed by section 56, 531, 541, 1351(d)(1) or 1378, is $190,000. That amount includes $5,000 resulting from the application of section 50A(c)(3) and §1.50 A–3. X is allowed under section 33 a foreign tax credit of $50,000. X's liability for tax is computed as follows:

Income tax (including increase in tax under section 50A(c)(3), but before any credits and without regard to any tax imposed by section 56, 531, 541, 1351(d)(1) or 1378)		$190,000
Less:		
Increase in tax resulting from application of section 50A(c)(3)	$5,000	
Foreign tax credit	50,000	
		55,000
Liability for tax		135,000

Under section 50A(a)(2) and paragraph (b) of this section, X's limitation based on amount of tax for the taxable year is $80,000 ($25,000 plus 50 percent of $110,000). X Corporation's credit allowed by section 40 for the taxable year therefore is $80,000. X has an unused credit for the year of $20,000 ($100,000 less $80,000) which it may carry back or forward to other taxable years in accordance with §1.50A–2.

(e) *Married individuals.* If a separate return is filed by a husband or wife, the limitation based on amount of tax under paragraph (b) of this section shall be computed by substituting a $12,500 amount for the $25,000 amount in applying such paragraph (b). However, this reduction of the $25,000 amount to $12,500 applies only if the taxpayer's spouse is entitled to a credit under section 40 for the taxable year of such spouse which ends with, or within, the taxpayer's taxable year. The taxpayer's spouse is entitled to a credit under section 40 either because of incurring WIN expenses for such taxable year of the spouse (whether directly incurred by such spouse or whether apportioned to such spouse, for example, from an electing small business corporation, as defined in section 1371(b)), or because of a credit carryback or carryover to such taxable year under §1.50A–2. The determination of whether an individual is married shall be made under the principles of section 143 and the regulations thereunder.

(f) *Apportionment of $25,000 amount among component members of a controlled group*—(1) *In general.* In determining the limitation based on amount of tax under section 50A(a)(2) in the case of corporations which are component members of a controlled group of corporations on a December 31, only one $25,000 amount is available to such component members for their taxable years that include such December 31. See subparagraph (2) of this paragraph for apportionment of such amount among such component members. See subparagraph (3) of this paragraph for the definition of ''component member.''

(2) *Manner of apportionment.* (i) In the case of corporations which are component members of a controlled group on a particular December 31, the $25,000 amount may be apportioned among such members for their taxable years

that include such December 31 in any manner the component members may select, provided that each such member less than 100 percent of whose stock is owned, in the aggregate, by the other component members of the group on such December 31 consents to an apportionment plan. The consent of a component member to an apportionment plan with respect to a particular December 31 shall be made by means of a statement signed by a person duly authorized to act on behalf of the consenting member, stating that such member consents to the apportionment plan with respect to such December 31. The statement shall set forth the name, address, employer identification number, and taxable year of each component member of the group on such December 31, the amount apportioned to each such member under the plan, and the location of the Internal Revenue Service center where the statement is to be filed. The consent of more than one component member may be incorporated in a single statement. The statement shall be timely filed with the Internal Revenue Service center where the component member having the taxable year first ending on or after such December 31 files its return for such taxable year and shall be irrevocable after such filing. If two or more component members have the same such taxable year, a statement of consent may be filed by any one of such members. Such statement shall be considered as timely filed if filed on or before the due date (including any extensions of time) of such member's income tax return which includes such December 31. However, if the due date (including any extensions of time) of the return of such member is on or before December 15, 1972, the required statement shall be considered as timely filed if filed on or before March 15, 1973. Each component member of the group on such December 31 shall keep as a part of its records a copy of the statement containing all the required consents.

(ii) An apportionment plan adopted by a controlled group with respect to a particular December 31 shall be valid only for the taxable year of each member of the group which includes such December 31. Thus, a controlled group must file a separate consent to an apportionment plan with respect to each taxable year which includes a December 31 as to which an apportionment plan is desired.

(iii) If an apportionment plan is not timely filed, the $25,000 amount specified in section 50A(a)(2) shall be reduced for each component member of the controlled group, for its taxable year which includes a December 31, to an amount equal to $25,000 divided by the number of component members of each group on such December 31.

(iv) If a component member of the controlled group makes its income tax return on the basis of a 52–53 week taxable year, the principles of section 441(f)(2)(A)(ii) and paragraph (b)(1) of § 1.441–2 apply in determining the last day of such taxable year.

(3) *Definitions of controlled group of corporations and component member of controlled group.* For the purpose of this paragraph, the terms ''controlled group of corporations'' and ''component member'' of a controlled group of corporations shall have the same meaning assigned to those terms in section 1563 (a) and (b) and the regulations thereunder. For purposes of applying § 1.1563–1(b)(2)(ii)*(c),* an electing small business corporation shall be treated as an excluded member whether or not it is subject to the tax imposed by section 1378.

(4) *Members of a controlled group filing a consolidated return.* If some component members of a controlled group join in filing a consolidated return pursuant to § 1.1502–3(a)(3), and other component members do not join, then, unless a consent is timely filed apportioning the $25,000 amount among the group filing the consolidated return and the other component members of the controlled group, each component member of the controlled group (including each component member which joins in filing the consolidated return) shall be treated as a separate corporation for purposes of equally apportioning the $25,000 amount under subparagraph (2)(iii) of this paragraph. In such case, the limitation based on the amount of tax for the group filing the consolidated return shall be computed by substituting for the $25,000 amount the total of the amount apportioned to

each component member which joins in filing the consolidated return. If the affiliated group, filing the consolidated return and the other component members of the controlled group adopt an apportionment plan, the affiliated group shall be treated as a single member for the purpose of applying subparagraph (2)(i) of this paragraph. Thus, for example, only one consent executed by the common parent to the apportionment plan is required for the group filing the consolidated return. If any component member of the controlled group which joins in the filing of the consolidated return is an organization to which section 593 applies or a cooperative organization described in section 1381(a), rules similar to the rules contained in paragraph (a)(3)(ii) of §1.1502–3 are applicable.

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

Example 1. At all times during 1972 Smith, an individual, owns all the stock of corporations X, Y, and Z. Corporation X files an income tax return on a calendar year basis. Corporation Y files an income tax return on the basis of a fiscal year ending June 30. Corporation Z files an income tax return on the basis of a fiscal year ending September 30. On December 31, 1972, X, Y, and Z are component members of the same controlled group. X, Y, and Z all consent to an apportionment plan in which the $25,000 amount is apportioned entirely to Y for its taxable year ending June 30, 1973 (Y's taxable year which includes December 31, 1972). Such consent is timely filed. For purposes of computing the credit under section 40, Y's limitation based on amount of tax for its taxable year ending June 30, 1973, is so much of Y's liability for tax as does not exceed $25,000, plus 50 percent of Y's liability for tax in excess of $25,000. X's and Z's limitations for their taxable years ending December 31, 1972, and September 30, 1973, respectively, are equal to 50 percent of X's liability for tax and 50 percent of Z's liability for tax. On the other hand, if an apportionment plan is not timely filed, X's limitation would be so much of X's liability for tax as does not exceed $8,333.33, plus 50 percent of X's liability in excess of $8,333.33, and Y's and Z's limitations would be computed similarly.

Example 2. At all times during 1972, Jones, an individual, owns all the outstanding stock of corporations P, Q, and R. Corporations Q and R both file returns for taxable year ending December 31, 1972. P files a consolidated return as a common parent for its fiscal year ending June 30, 1973, with its wholly owned subsidiaries N and O. On December 31, 1972, N, O, P, Q, and R are component members of the same controlled group. No consent to an apportionment plan is filed. Therefore, each member is apportioned $5,000 of the $25,000 amount ($25,000 divided equally among the five members). The limitation based on the amount of tax for the group filing the consolidated return (P, N, and O) for the year ending June 30, 1973 (the consolidated taxable year within which December 31, 1972, falls), is computed by using $15,000 instead of the $25,000 amount. The $15,000 is arrived at by adding together the $5,000 amounts apportioned to P, N, and O.

[38 FR 6152, Mar. 7, 1973, as amended by T.D. 7636, 44 FR 47049, Aug. 10, 1979]

§1.50A–2 Carryback and carryover of unused credit.

(a) *Allowance of unused credit as carryback or carryover*—(1) *In general.* Section 50A(b)(1) provides for carrybacks and carryovers of any unused credit. An unused credit is the excess of the credit earned for the taxable year (as determined under paragraph (a) of §1.50A–1) over the limitation based on amount of tax for such taxable year (as determined under paragraph (b) of §1.50A–1). Subject to the limitation contained in paragraph (b) of this section, an unused credit shall be added to the amount allowable as a credit under section 40 for the years to which the unused credit can be carried. The year with respect to which an unused credit arises shall be referred to in this section as the ‘‘unused credit year.’’

(2) *Taxable years to which unused credit may be carried.* An unused credit shall be a work incentive program (WIN) credit carryback to each of the 3 taxable years preceding the unused credit year and a WIN credit carryover to each of the 7 taxable years succeeding the unused credit year, except that an unused credit shall be a carryback only to taxable years beginning after December 31, 1971. An unused credit must be carried first to the earliest of the taxable years to which it may be carried, and then to each of the other taxable years (in order of time) to the extent that the unused credit may not be added (because of the limitation contained in paragraph (b) of this section) to the amount allowable as a credit under section 40 for a prior taxable year.

(b) *Limitation on allowance of unused credit.* The amount of the unused credit from any particular unused credit year which may be added to the amount allowable as a credit under section 40 for any of the preceding or succeeding taxable years to which such credit may be carried shall not exceed the amount by which the limitation based on amount of tax for such preceding or succeeding taxable year exceeds the sum of (1) the credit earned for such preceding or succeeding year, and (2) other unused credits carried to such preceding or succeeding year which are attributable to unused credit years prior to the particular unused credit year.

(c) *Corporate acquisitions.* For the carryover of unused credits in the case of certain corporate acquisitions, see section 381(c)(24) and the regulations thereunder. [§ 1.381(c)(24)–1]

(d) *Periods of less than 12 months.* A fractional part of a year which is considered as a taxable year under sections 441(b) and 7701(a)(23) shall be treated as a preceding or a succeeding taxable year for the purpose of determining under section 50A(b) and this section the taxable years to which an unused credit may be carried.

(e) *Example.* The provisions of paragraphs (a) through (d) of this section may be illustrated by the following example:

Example. Corporation X files its income tax return on the basis of the calendar year. X's credit earned and its limitation based on amount of tax for each of its taxable years 1972 through 1978 are as follows:

	Credit earned	Limitation based on amount of tax
1972	$175,000	$200,000
1973	250,000	160,000
1974	200,000	210,000
1975	210,000	230,000
1976	220,000	260,000
1977	260,000	220,000
1978	270,000	280,000

(i) Corporation X's credit earned for 1972, $175,000, is allowable in full as a credit under section 40 for 1972 since such amount is less than the limitation based on amount of tax for such year, $200,000. Since the limitation based on amount of tax for 1973 is $160,000, only $160,000 of the $250,000 credit earned for such year is allowable under section 40 as a credit for 1973. The unused credit for 1973 of $90,000 ($250,000 less $160,000) is a WIN credit carryback to 1972 and a WIN credit carryover to 1974 and subsequent years up to and including 1980. The portion of the $90,000 unused credit which shall be added to the amount allowable as a credit under section 40 for 1972 and 1974 and subsequent years is computed as follows:

(a) 1972. The portion of the unused credit for 1973 ($90,000) which is allowable as a credit for 1972 is $25,000. This amount shall be added to the amount allowable as a credit for 1972. The balance of the unused credit for 1973 to be carried to 1974 is $65,000. These amounts are computed as follows:

Carryback to 1972			$90,000
1972 limitation based on tax		$200,000	
Less: Credit earned for 1972	$175,000		
Unused credits attributable to years preceding 1973	0		
		175,000	
Limit on amount of 1973 unused credit which may be added as a credit for 1972			25,000
Balance of 1973 unused credit to be carried to 1974			65,000

(b) 1974. The portion of the balance of the unused credit for 1973 ($65,000) allowable as a credit for 1974 is $10,000. This amount shall be added to the amount allowable as a credit for 1974. The balance of the unused credit for 1973 to be carried to 1975 is $55,000. These amounts are computed as follows:

Carryover to 1974			$65,000
1974 limitation based on tax		$210,000	
Less: Credit earned for 1974	$200,000		
Unused credits attributable to years preceding 1973	0		
		200,000	
Limit on amount of 1973 unused credit which may be added as a credit for 1974			10,000
Balance of 1973 unused credit to be carried to 1975			55,000

(c) 1975. The portion of the balance of the unused credit for 1973 ($55,000) allowable as a credit for 1975 is $20,000. This amount shall be added to the amount allowable as a credit for 1975. The balance of the unused credit for 1973 to be carried to 1976 is $35,000.

These amounts are computed as follows:

Carryover to 1975			$55,000
1975 limitation based on tax		$230,000	
Less: Credit earned for 1975	$210,000		
Unused credits attributable to years preceding 1973	0		
		210,000	
Limit on amount of 1973 unused credit which may be added as a credit for 1975			$20,000
Balance of 1973 unused credit to be carried to 1976			35,000

(d) 1976. The entire balance of the unused credit for 1973 ($35,000) is allowable as a credit for 1976, since the limitation based on amount of tax for 1976 exceeds the sum of the credit earned for 1976 and unused credits attributable to years prior to 1973 by an amount in excess of $35,000. Since the balance of the unused credit for 1973 has been fully allowed, no portion thereof remains to be carried to subsequent taxable years. This is illustrated as follows:

Carryover to 1976			$35,000
1976 limitation based on tax		$260,000	
Less: Credit earned for 1976	$220,000		
Unused credits attributable to years preceding 1973	0		
		220,000	
Limit on amount of 1973 unused credit which may be added as a credit for 1976			40,000
Balance of 1973 unused credit to be carried to 1977			0

(ii) Since the limitation based on amount of tax for 1977 is $220,000, only $220,000 of the $260,000 credit earned for such year is allowable as a credit for 1977. The unused credit for 1977 of $40,000 ($260,000 less $220,000) is a WIN credit carryback to 1974, 1975, and 1976 and a WIN credit carryover to 1978 and subsequent years. The portions of the $40,000 unused credit which shall be added to the amount allowable as a credit for such years are computed as follows:

(a) 1974. The portion of the unused credit for 1977 ($40,000) allowable as a credit for 1974 is zero. The balance of the unused credit for 1977 to be carried to 1975 is $40,000. These amounts are computed as follows:

Carryback to 1974			$40,000
1974 limitation based on tax		$210,000	
Less: Credit earned for 1974	$200,000		
Unused credits attributable to years preceding 1977 (unused credit from 1973)	10,000		
		$210,000	
Limit on amount of 1977 unused credit which may be added as a credit for 1974			0
Balance of 1977 unused credit to be carried to 1975			40,000

(b) 1975. The portion of the unused credit for 1977 ($40,000) allowable as a credit for 1975 is zero. The balance of the unused credit for 1977 to be carried to 1976 is $40,000. These amounts are computed as follows:

Carryback to 1975			$40,000
1975 limitation based on tax		$230,000	
Less: Credit earned for 1975	$210,000		
Unused credits attributable to years preceding 1977 (unused credit from 1973)	20,000		
		230,000	
Limit on amount of 1977 unused credit which may be added as a credit for 1975			0
Balance of 1977 unused credit to be carried to 1976			40,000

(c) 1976. The portion of the unused credit for 1977 ($40,000) allowable as a credit for 1976 is $5,000. This amount shall be added to the amount allowable as a credit for 1976. The balance of the unused credit for 1977 to be carried to 1978 is $35,000. These amounts are computed as follows:

Carryback to 1976			$40,000
1976 limitation based on tax		$260,000	
Less: Credit earned for 1976	$220,000		
Unused credits attributable to years preceding 1977 (unused credit from 1973)	35,000		

	———	255,000	
Limit on amount of 1977 unused credit which may be added as a credit for 1976			5,000
Balance of 1977 unused credit to be carried to 1978			35,000

(d) 1978. The portion of the balance of the unused credit for 1977 ($35,000) allowable as a credit for 1978 is $10,000. This amount shall be added to the amount allowable as a credit for 1978. The balance of the unused credit for 1977 to be carried to 1979 and subsequent years is $25,000. These amounts are computed as follows:

Carryover to 1978			$35,000
1978 limitation based on tax		$280,000	
Less: Credit earned for 1978	$270,000		
Unused credits attributable to years preceding 1977	0		
	———	$270,000	
Limit on amount of 1977 unused credit which may be added as a credit for 1978			$10,000
Balance of 1977 unused credit to be carried to 1979			25,000

(f) *Electing small business corporation.* An unused credit of a corporation which arises in an unused credit year for which the corporation is not an electing small business corporation (as defined in section 1371(b)) and which is a carryback or carryover to a taxable year for which the corporation is an electing small business corporation shall not be added to the amount allowable as a credit under section 40 to the shareholders of such corporation for any taxable year. However, a taxable year for which the corporation is an electing small business corporation shall be counted as a taxable year for purposes of determining the taxable years to which such unused credit may be carried.

[38 FR 6153, Mar. 7, 1973]

§ 1.50A–3 Recomputation of credit allowed by section 40.

(a) *General rule*—(1) *Early termination of employment by employer*—(i) *In general.* If the employment of any employee, with respect to whom work incentive program (WIN) expenses (as defined in paragraph (a) of § 1.50B–1) are taken into account under paragraph (a) of § 1.50A–1, is terminated by the taxpayer at any time during the first 12 months of such employment (whether or not consecutive) or before the close of the 12th calendar month after the calendar month in which such employee completes the first 12 months of employment (whether or not consecutive) with the taxpayer, then subparagraph (3) of this paragraph shall apply. See paragraph (c) of this section for rules relating to the determination of the first 12 months of employment (whether or not consecutive). See § 1.50A–4 for rules relating to other circumstances under which a termination of employment will not be treated as a termination of employment to which the provisions of subparagraph (3) of this paragraph are applicable.

(ii) *Rules for determining whether a termination of employment has occurred.* For purposes of this section, the taxpayer is deemed to have terminated the employment of any WIN employee (as defined in paragraph (h) of § 1.50B–1) if the employment relationship (as determined under common law principles) has terminated. A layoff for any reason is considered a termination of employment for purposes of the preceding sentence. However, a temporary suspension of employment of any WIN employee necessitated by the installation of new equipment or by the retooling of existing equipment (such as for a model changeover in the automobile industry) shall not be deemed to be a termination of employment if such suspension is for a period of time no longer than 60 days. For purposes of this section, the death of the taxpayer is considered a termination of the employment relationship between the taxpayer and any WIN employee.

(2) *Failure to pay comparable wages*—(i) *In general.* If, at any time during the period described in subparagraph (1)(i) of this paragraph, the taxpayer pays wages (as defined in section 50B(b) and paragraph (b) of § 1.50B–1) to an employee, with respect to whom WIN expenses are taken into account under paragraph (a) of § 1.50A–1, which are less than the wages paid to other employees of the taxpayer who perform comparable services, then subparagraph (3) of this paragraph shall apply.

(ii) *Comparable services. (a)* For purposes of subdivision (i) of this subparagraph, the term ‘‘comparable services’’ refers to services performed in work positions which require similar education, training, and skills. Comparable services are those associated with other work positions which require similar levels of judgment and responsibility, which make similar physical and mental demands of an employee, and which could easily be performed by the employee without substantial additional training or experience.

(b) If substantial training, skill, or experience are material to the performance of a particular job, a taxpayer may pay wages to a WIN employee which are less than those paid to other employees of the taxpayer who possess such training, skill, or experience. However, there must be a reasonable relationship between the lower wages or salary of such WIN employee and his relative lack of training, skill, or experience.

(3) *Recomputation of credit earned.* (i) If, by reason of subparagraph (1) or (2) of this paragraph, this subparagraph (3) is applicable, then the credit earned for all credit years (as defined in subdivision (ii)*(a)* of this subparagraph) shall be recomputed under the principles of paragraph (a) of §1.50A–1 by not taking into account WIN expenses with respect to the employee (or employees) described in subparagraph (1) or (2) of this paragraph. There shall be recomputed under the principles of §§1.50A–1 and 1.50A–2 the credit allowed for all credit years and for any other taxable year affected by reason of the reduction in credit earned for such credit year or years, giving effect to such reduction in the computation of carrybacks or carryovers of unused credit from any taxable year. If the recomputation described in the preceding sentence results, in the aggregate, in a decrease (taking into account any recomputation under this paragraph in respect of prior recapture years, as defined in subdivision (ii)*(b)* of this subparagraph) in the credits allowed for any credit year and for any other taxable year affected by the reduction in credit earned for any credit year, then the income tax for the recapture year shall be increased by the amount of such decrease in credits allowed. For treatment of such increase in tax, see paragraph (b) of this section. For special rules in the case of an electing small business corporation (as defined in section 1371(b)), an estate or trust, or a partnership, see respectively, §1.50A–5, §1.50A–6 or §1.50A–7.

(ii) For purposes of this section and §§1.50A–4 through 1.50B–6—

(a) The term ‘‘credit year’’ means a taxable year in which WIN expenses with respect to the employee described in subparagraph (1) or (2) of this paragraph are taken into account under paragraph (a) of §1.50A–1.

(b) The term ‘‘recapture year’’ means a taxable year in which a termination of employment (within the meaning of subparagraph (1) of this paragraph) or a failure to pay comparable wages (within the meaning of subparagraph (2) of this paragraph) occurs by reason of which the rule of subparagraph (3) of this paragraph becomes applicable.

(c) The term ‘‘recapture determination’’ means a recomputation made under this paragraph.

(b) *Increase in income tax and reduction of WIN credit carryback and carryover*—(1) *Increase in tax.* Except as provided in subparagraph (2) of this paragraph, any increase in income tax under this section shall be treated as income tax imposed on the taxpayer by chapter 1 of the Code for the recapture year notwithstanding that without regard to such increase the taxpayer has no income tax liability, has a net operating loss for such taxable year, or no income tax return was otherwise required for such taxable year.

(2) *Special rule.* Any increase in income tax under this section shall not be treated as income tax imposed on the taxpayer by chapter 1 of the Code for purposes of determining the amount of the credits allowable to such taxpayer under—

(i) Section 33 (relating to taxes of foreign countries and possessions of the United States),

(ii) Section 35 (relating to partially tax-exempt interest received by individuals),

(iii) Section 37 (relating to retirement income),

(iv) Section 38 (relating to investment in certain depreciable property),

(v) Section 39 (relating to certain uses of gasoline, special fuels, and lubricating oil),

(vi) Section 40 (relating to expenses of work incentive programs), and

(vii) Section 41 (relating to contributions to candidates for public office).

(3) *Reduction in credit allowed as a result of a net operating loss carryback.* (i) If a net operating loss carryback from the recapture year or from any taxable year subsequent to the recapture year reduces the amount allowed as a credit under section 40 for any taxable year up to and including the recapture year, then there shall be a new recapture determination under paragraph (a) of this section for each recapture year affected, taking into account the reduced amount of credit allowed after application of the net operating loss carryback.

(ii) Subdivision (i) of this subparagraph may be illustrated by the following example:

Example. (a) X Corporation, which makes its returns on the basis of a calendar year, hired WIN employees on March 1, 1972, and incurred $10,000 in WIN expenses with respect to these employees for the year. For the taxable year 1972, X Corporation's credit earned of $2,000 (20 percent of $10,000) was allowed under section 40 as a credit against its liability for tax of $2,000. In 1973 and 1974 X Corporation had no liability for tax and had no WIN expenses. In January 1974, X Corporation terminated the employees for whom the WIN expenses had been incurred. Since these terminations were not subject to the exceptions provided by § 1.50A–4, there was a recapture determination under paragraph (a) of this section. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1974 was increased by the $2,000 decrease in its credit earned for the taxable year 1972 (that is, the $2,000 original credit earned minus zero recomputed credit earned).

(b) For the taxable year 1975, X Corporation has a net operating loss which is carried back to the taxable year 1972 and reduces its liability for tax, as defined in paragraph (c) of § 1.50A–1, for such taxable year to $800. As a result of such net operating loss carryback, X Corporation's credit allowed under section 40 for the taxable year 1972 is limited to $800 and the excess of $1,200 ($2,000 credit earned minus the $800 limitation based on amount of tax) is a WIN credit carryover to the taxable year 1973.

(c) For 1975 there is a recapture determination under subdivision (i) of this subparagraph for the 1974 recapture year. The $2,000 increase in the income tax imposed on X Corporation for the taxable year 1974 is redetermined to be $800 (that is, the $800 credit allowed after taking into account the 1975 net operating loss minus zero credit which would have been allowed taking into account the 1974 recapture determination). In addition, X Corporation's $1,200 WIN credit carryover to the taxable year 1973 is reduced by $1,200 ($2,000 minus $800) to zero and X Corporation is entitled to a $1,200 refund of the $2,000 tax paid as a result of the 1974 recapture determination.

(4) *Statement of recomputation.* The taxpayer shall attach to his income tax return for the recapture year a separate statement showing in detail the computation of the increase in income tax imposed on such taxpayer by chapter 1 of the Code and the reduction in any WIN credit carryovers.

(c) *Period of employment*—(1) *Initial date of employment.* For purposes of this section and §§ 1.50A–4 through 1.50B–6, the initial date of employment (for purposes of applying paragraph (a) (1) and (2) of this section and paragraphs (a)(1) and (f) of § 1.50B–1) is the date the WIN employee reports to the taxpayer (or in the case where the taxpayer is a partner of a partnership, a beneficiary of an estate or trust, or a shareholder of an electing small business corporation, to such partnership, estate, trust, or electing small business corporation) for work.

(2) *Computation of the first 12 months of employment (whether or not consecutive).* For purposes of computing the first 12 months of employment (whether or not consecutive), the first month of employment shall begin with the initial date of employment (as defined in subparagraph (1) of this paragraph) of the WIN employee, the second month of employment shall begin with the corresponding date in the following month, the third month of employment shall begin with the corresponding date in the next following month, and so forth. If the WIN employee performs

any services during any such month (as determined under the preceding sentence), that month shall be counted in computing the WIN employee's ''first 12 months of employment (whether or not consecutive)''. If the WIN employee performs no services during any such month, that month shall not be counted in computing the WIN employee's ''first 12 months of employment (whether or not consecutive)''. Thus, if the initial date of employment of a WIN employee is June 15, the first month of employment of such employee shall be the period beginning June 15, and ending July 14. The second month of employment is the period beginning July 15 and ending August 14. If during such second month of employment the employee performs no services for the taxpayer, that month is not counted in determining the employee's first 12 months of employment (whether or not consecutive).

[38 FR 6154, Mar. 7, 1973]

§1.50A–4 Exceptions to the application of §1.50A–3.

(a) *In general.* Notwithstanding the provisions of paragraph (a) of §1.50A–3, a termination of employment shall not be deemed to occur if paragraph (b) (relating to voluntary termination of employment), paragraph (c) (relating to termination of employment due to disability), paragraph (d) (relating to termination of employment due to misconduct), paragraph (f) (relating to transactions to which section 381(a) applies), or paragraph (g) (relating to mere change in form of conducting a trade or business) applies.

(b) *Voluntary termination of employment.* A termination of employment shall not be deemed to occur for purposes of paragraph (a) of §1.50A–3 if the employee voluntarily leaves the employment of the taxpayer. If the taxpayer makes the working conditions of the employee so untenable that the employee is, in effect, compelled by the taxpayer to quit, or if the employee is coerced into quitting, the employee will not be deemed to have voluntarily left the employment of the taxpayer. For purposes of the preceding sentence, a substantial reduction in the benefits of employment of an employee (such as a substantial decrease in the hours of the employee's working week) shall constitute untenable working conditions. An employee has voluntarily left the employment of the taxpayer if he leaves for any reason external to his employment, such as sickness or death in the employee's family which the employee feels necessitates his quitting work with the taxpayer to remain at home. Any employee who participates in an authorized strike (as finally determined by a court, labor relations administrative body, or arbiter) will not be deemed to have voluntarily left the employment of the taxpayer.

(c) *Termination of employment due to death or disability.* A termination of employment shall not be deemed to occur for purposes of paragraph (a) of §1.50A–3 if, after the initial date of employment (as defined in paragraph (c)(1) of §1.50A–3) and before the close of the period referred to in paragraph (a)(1) of §1.50A–3, the employee becomes disabled, by reason of illness or injury (including a disability relating to the employment), to perform the services required by such employment, unless, before the close of such period:

(1) Such disability is removed,

(2) The employer knows of the removal of the disability, and

(3) The employer fails to offer reemployment to such employee.

The death of an employee shall not be deemed a termination of employment for purposes of paragraph (a) of §1.50A–3.

(d) *Termination of employment due to misconduct.* A termination of employment shall not be deemed to occur for purposes of paragraph (a) of §1.50A–3 if it is determined by the appropriate State administrative agency or State court that under the applicable State unemployment compensation law such termination was due to the misconduct of the WIN employee. If the WIN employee is not covered by the applicable State unemployment compensation law (or if the employee did not work for the minimum period required to qualify for unemployment compensation or if the employee did not apply for unemployment compensation), a termination of employment shall not be deemed to occur for purposes of paragraph (a) of § 1.50A–3 if the taxpayer demonstrates by convincing evidence that, were such employee covered by the applicable State unemployment compensation law (or if the employee had worked for such minimum period or if the employee had applied for unemployment compensation), he could reasonably have been found by such administrative agency or court to have been terminated for misconduct.

(e) *Recordkeeping requirement.* A taxpayer who is claiming that a termination of employment falls within the provisions of paragraph (b), (c), or (d) of this section shall maintain sufficient records to support his claim until the expiration of the pertinent period of limitations.

(f) *Transactions to which section 381(a) applies*—(1) *General rule.* The employment relationship between the taxpayer and a WIN employee (as defined in paragraph (h) of § 1.50B–1) shall not be deemed terminated for purposes of paragraph (a) of § 1.50A–3 in the case of a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies. If there is a termination of employment (within the meaning of paragraph (a) of § 1.50A–3 and this section) by the acquiring corporation with respect to the WIN employee described in the preceding sentence, or if the acquiring corporation fails to pay comparable wages to such employee (within the meaning of paragraph (a)(2) of § 1.50A–3), then paragraph (a)(3) of § 1.50A–3 shall apply to the acquiring corporation with respect to the credit allowed the acquired corporation as well as the credit allowed the acquiring corporation with respect to such employee. For purposes of the preceding sentence, the initial date of employment (as defined in paragraph (c)(1) of § 1.50A–3) of such employee with respect to the acquired corporation shall be deemed to be the initial date of employment of such employee with respect to the acquiring corporation and employment by the acquired corporation shall be deemed employment by the acquiring corporation.

(2) *Examples.* This paragraph may be illustrated by the following examples:

Example 1. (i) X Corporation, a wholly owned subsidiary of Y Corporation, incurred WIN expenses of $12,000 for its taxable year ending December 31, 1972, with respect to WIN employees hired on March 1, 1972. Both X and Y made their returns on the basis of a calendar year. For the taxable year 1972 X Corporation's credit earned of $2,400 (20 percent of $12,000) was allowed under section 40 as a credit against its liability for tax. On December 15, 1973, X Corporation is liquidated under section 332 and all of its assets and liabilities are transferred to Y Corporation in a transaction to which section 334(b)(2) is not applicable. In addition, Y Corporation continues the employment of the WIN employees which were employed by X Corporation and with respect to which X Corporation was allowed the credit for its taxable year 1972.

(ii) Under subparagraph (1) of this paragraph, a termination of employment of the WIN employees shall not be deemed to occur for purposes of paragraph (a)(1) of § 1.50A–3 due to the liquidation of X Corporation on December 15, 1973. Thus, no recapture determination under paragraph (a)(3) of § 1.50A–3 shall be made with respect to X Corporation.

Example 2. (i) The facts are the same as in Example 1 and, in addition, on February 2, 1974, Y Corporation terminates the employment of the employees with respect to whom X Corporation had incurred WIN expenses. The termination is a termination for purposes of paragraph (a)(1) of § 1.50A–3. For purposes of applying the period described in paragraph (a)(1) of § 1.50A–3, the date the employees reported for work at X Corporation is deemed to be the initial date of employment of the employees with respect to Y Corporation.

(ii) Under subparagraph (1) of this paragraph, a termination of employment of the WIN employees shall not be deemed to occur for purposes of paragraph (a)(1) of § 1.50A–3 due to the liquidation of X Corporation on December 15, 1973. However, a termination of employment of the WIN employees is deemed to occur for purposes of paragraph (a)(1) of § 1.50A–3 on February 2, 1974. Thus, Y Corporation shall make a recapture determination under paragraph (a) of § 1.50A–3 with respect to the credit allowed X Corporation with respect to the WIN employees.

(g) *Mere change in form of conducting a trade or business*—(1) *General rule.* (i) The employment relationship between the taxpayer and a WIN employee (as defined in paragraph (h) of § 1.50B–1) shall not be deemed terminated for purposes of paragraph (a) of § 1.50A–3 in the case of a mere change in the form of conducting the trade or business in which such employment occurs, provided that the conditions set forth in subdivision (ii) of this subparagraph are satisfied.

(ii) The conditions referred to in subdivision (i) of this subparagraph are as follows:

(a) The WIN employee described in subdivision (i) of this subparagraph is retained in the same trade or business,

(b) The taxpayer retains a substantial ownership interest in such trade or business,

(c) Substantially all the assets necessary to operate such trade or business are transferred to the transferee who continues the employment of the WIN employee described in subdivision (i) of this subparagraph, and

(d) The basis of the assets described in *(c)* of this subdivision in the hands of the transferee is determined in whole or in part by reference to the basis of such assets in the hands of the transferor.

This subparagraph shall not apply if paragraph (e) of this section (relating to transactions to which section 381(a) applies) is applicable with respect to such transfer.

(2) *Substantial interest.* For purposes of this paragraph, the taxpayer shall be considered as having retained a substantial ownership interest in the trade or business only if, after the change in form, the ownership interest in such trade or business by such taxpayer—

(i) Is substantial in relation to the total ownership interests of all persons, or

(ii) Is equal to or greater than the ownership interest prior to the change in form.

Thus, where a taxpayer owns a 5-percent interest in a partnership, and, after the incorporation of that partnership, the taxpayer retains at least a 5-percent interest in the corporation, the taxpayer will be considered as having retained a substantial interest in the trade or business as of the date of the change in form because of the application of the rule contained in subdivision (ii) of this subparagraph.

(3) *Termination of employment.* (i) If employment of a WIN employee described in subparagraph (1)(i) of this paragraph is terminated by the transferee, the employment of such employee shall be deemed terminated by the taxpayer for purposes of paragraph (a) of §1.50A–3. For purposes of determining the period described in paragraph (a)(1) of §1.50A–3 with respect to such taxpayer employment by the transferee shall be deemed employment by the transferor.

(ii) If in any taxable year the taxpayer does not retain a substantial ownership interest in the trade or business directly or indirectly (through ownership in other entities provided that such other entities' bases in such interest are determined in whole or in part by reference to the basis of such interest in the hands of the taxpayer) then, for purposes of paragraph (a)(1) of §1.50A–3, there shall be deemed to be a termination of employment of the WIN employees described in subparagraph (1)(i) of this paragraph on the first date on which such taxpayer does not retain a substantial interest in the trade or business. For purposes of determining the period described in paragraph (a)(1) of §1.50A–3, employment by the transferee shall be deemed employment by the transferor. Any taxpayer who seeks to establish his interest in a trade or business under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in such trade or business after any such transfer or transfers.

(iii) Notwithstanding subparagraph (1) of this paragraph and subdivision (ii) of this subparagraph in the case of a mere change in the form of a trade or business, if the interest of a taxpayer in the trade or business is reduced but such taxpayer has retained a substantial interest in such trade or business, paragraph (a)(2) of §1.50A–5 (relating to electing small business corporations), paragraph (a)(2) of §1.50A–6 (relating to estates or trusts), or paragraph (a)(2)(ii) of §1.50A–7 (relating to partnerships) shall apply, as the case may be.

(4) *Failure to pay comparable wages.* If the transferee fails to pay comparable wages (within the meaning of paragraph (a)(2) of §1.50A–3) to the WIN employee within the period described in paragraph (a)(1) of §1.50A–3, then such failure shall be deemed to be a failure of the transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partners, beneficiaries, or shareholders), and a recapture determination shall be made with respect to

such WIN employee as provided in § 1.50A–3. For purposes of determining the period described in paragraph (a)(1) of § 1.50A–3 with respect to such transferor (or such partners, beneficiaries, or shareholders), employment by the transferee shall be deemed employment by such transferor. For special rules in the case of an electing small business corporation (as defined in section 1371(b)), an estate or trust, or a partnership, see respectively, § 1.50A–5, § 1.50A–6, or § 1.50A–7.

(5) *Examples.* This paragraph may be illustrated by the following examples in each of which it is assumed that the transfer satisfies the conditions of subparagraphs (1)(ii) *(a), (c)* and *(d)* of this paragraph.

Example 1. (i) On January 1, 1972, A, an individual, employed WIN employees in his sole proprietorship. A incurred WIN expenses with respect to these employees of $12,000 for the taxable year ending December 31, 1972. For the taxable year 1972 A's credit earned of $2,400 (20 percent of $12,000) was allowed under section 40 as a credit against his liability for tax. On March 15, 1973, A transferred all of the assets used in his sole proprietorship to X Corporation, a newly formed corporation, in exchange for 45 percent of the stock of X Corporation.

(i) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.50A–3 does not apply to the March 15, 1973, transfer to X Corporation.

Example 2. (i) The facts are the same as in Example 1 and in addition on June 1, 1973, X Corporation terminates the employment of WIN employees with respect to whom 50 percent of the WIN expenses were incurred during A's 1972 taxable year.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.50A–3 does not apply to the March 15, 1973, transfer to X Corporation. However, under subparagraph (3)(i) of this paragraph, paragraph (a) of § 1.50A–3 applies to the June 1, 1973, termination of WIN employees by X Corporation. The actual period of employment of such WIN employees is 1 year and 5 months (that is, the period beginning on January 1, 1972, and ending on June 1, 1973). For taxable year 1972, A's recomputed credit earned is $1,200 (20 percent of $6,000). The income tax imposed by chapter 1 of the Code on A for the taxable year 1973 is increased by the $1,200 decrease in his credit earned for the taxable year 1972 (that is, $2,400 original credit earned minus $1,200 recomputed credit earned).

Example 3. (i) The facts are the same as in Example 1 and in addition on April 1, 1973, X Corporation begins paying wages to the employees referred to in Example 1 which are less than the wages paid to its other employees who perform comparable services.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a)(1) of § 1.50A–3 does not apply to the March 15, 1973, transfer to X Corporation. However, under subparagraph (4) of this paragraph, paragraph (a) of § 1.50A–3 applies to the failure of X Corporation to pay wages to the WIN employees which are equal to the wages paid to its other employees who perform comparable services. For taxable year 1972, A's recomputed credit earned is zero. The income tax imposed by chapter 1 of the Code on A for the taxable year 1973 is increased by the $2,400 decrease in his credit earned for the taxable year 1972.

Example 4. (i) On January 1, 1972, partnership ABC, which makes its returns on the basis of a calendar year, employed WIN employees. Partnership ABC incurred WIN expenses with respect to these employees of $20,000 for the taxable year. Partnership ABC has 10 partners who make their returns on the basis of a calendar year and share partnership profits equally. Each partner's share of the WIN expenses is 10 percent, that is, $2,000. On March 15, 1973, partnership ABC transfers all of the assets used in its trade or business to the X Corporation, a newly formed corporation, in exchange for its stock and immediately thereafter transfers 10 percent of the stock to each of the 10 partners.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a)(1) of § 1.50A–1 does not apply to the March 15, 1973, transfer by the ABC Partnership to X Corporation.

Example 5. (i) The facts are the same as in Example 4 except that partnership ABC transfers 10 percent of the stock in X Corporation to each of eight partners, 20 percent to partner A, and cash to partner B.

(ii) Under subparagraph (1)(i) of this paragraph, with respect to all of the partners (including partner A) except partner B, paragraph (a)(1) of § 1.50A–3 does not apply to the March 15, 1973, transfer by the ABC Partnership. Paragraph (a)(1) of § 1.50A–3 applies with respect to partner B's $2,000 share of the WIN expenses. See paragraph (a)(2) of § 1.50A–7.

Example 6. (i) X Corporation operates a manufacturing business and a separate retail sales business. During the month of January 1972, X incurred WIN expenses in its manufacturing business. On February 10, 1973, X transfers all the assets used in its manufacturing business to Partnership XY in exchange for a 50 percent interest in such partnership.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a)(1) of § 1.50A–3 does not apply to the February 10, 1973, transfer to Partnership XY.

[T.D. 7263, 38 FR 6156, Mar. 7, 1973; 38 FR 8656, Apr. 5, 1973]

§1.50A–5 Electing small business corporations.

(a) *In general*—(1) *Termination of employment by a corporation.* If an electing small business corporation (as defined in section 1371(b)) or a former electing small business corporation terminates (in a termination subject to the provisions of paragraph (a) of §1.50A–3) the employment of any WIN employee with respect to whom WIN expenses have been paid or incurred, a recapture determination shall be made under §1.50A–3 with respect to each shareholder who is treated, under paragraph (a) of §1.50B–2 as a taxpayer who paid or incurred such expenses. Each such recapture determination shall be made with respect to the pro rata share of the WIN expenses of such employee which were taken into account by such shareholder under paragraph (a) of §1.50B–2. For purposes of each such recapture determination the period of employment of such employee or employees shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of §1.50A–3) with respect to the electing small business corporation and ending with the date of such employee's termination (as defined in paragraph (a)(1)(ii) of §1.50A–3). For the definition of the term ''recapture determination'' see paragraph (a)(3) of §1.50A–3.

(2) *Disposition of shareholder's interest.* (i) If—

(a) WIN expenses are apportioned to a shareholder of an electing small business corporation who takes such expenses into account in computing his WIN expenses, and

(b) After the end of the shareholder's taxable year in which such apportionment was taken into account and before the close of the period to which paragraph (a)(1) of §1.50A–3 applies with respect to the employee to which such WIN expenses relate, such shareholder's proportionate stock interest in such corporation is reduced (for example, by a sale or redemption, or by the issuance of additional shares) below the percentage specified in subdivision (ii) of this subparagraph,

then, on the date of such reduction the employment of such employee shall be deemed terminated with respect to such shareholder to the extent of the actual reduction in such shareholder's proportionate stock interest. (For example, if $100 of WIN expenses were apportioned to a shareholder and if his proportionate stock interest is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then the employment of the employee to which such WIN expenses relate shall be deemed terminated as to that shareholder to the extent of $50.) Accordingly, a recapture determination shall be made with respect to such shareholder. For purposes of such recapture determination the period of employment of any employee or employees with respect to whom WIN expenses were paid or incurred shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of §1.50A–3) with respect to the electing small business corporation and ending with the date on which such reduction occurs.

(ii) The percentage referred to in subdivision (i)*(b)* of this subparagraph is 66⅔ percent of the shareholder's proportionate stock interest in the corporation on the date of the apportionment under paragraph (a) of §1.50B–2. However, once employment of an employee has been treated under this subparagraph as having terminated with respect to the shareholder to any extent, the percentage referred to shall be 33⅓ percent of the shareholder's proportionate stock interest in the corporation on the date of apportionment under paragraph (a) of §1.50B–2.

(iii) In determining a shareholder's proportionate stock interest in a former electing small business corporation for purposes of this subparagraph, the shareholder shall be considered to own stock in such corporation which he owns directly or indirectly (through ownership in other entities provided such other entities' bases in such stock are determined in whole or in part by reference to the basis of such stock in the hands of the shareholder). For example, if A, who owns all of the 100 shares of the outstanding stock of corporation X, a corporation which was formerly an electing small business corporation, transfers on November 1, 1973, 70 shares of X stock to corporation Y in exchange for 90 percent of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own 93 percent of the stock of X, 30 percent directly and 63 percent indirectly (i.e., 90 percent of 70). Any taxpayer who seeks to establish his interest in the stock of a former electing small business corporation under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the corporation after any such transfer or transfers.

(3) *Computation of the first 12 months of employment.* The period described in paragraph (a)(1) of § 1.50A–3 shall not be affected by a change in the shareholders in such corporation and shall not be affected by a reduction in any shareholder's proportionate stock interest in such corporation (for example, by a sale or redemption or by the issuance of additional shares). Thus, the first 12 months of employment (whether or not consecutive) of any WIN employee shall be the same with respect to any shareholder who is allowed a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee. Also, such first 12 months of employment and the period described in section 50B(c)(4) with respect to any WIN employee shall not be deemed to begin again in the case of a corporation making a valid election under section 1372.

(b) *Election of a small business corporation under section 1372*—(1) *General rule.* If a corporation makes a valid election under section 1372 to be an electing small business corporation (as defined in section 1371(b)), then on the last day of the first taxable year immediately preceding the taxable year for which such election is effective, the employment of any WIN employees whose initial date of employment (as defined in paragraph (c)(1) of § 1.50A–3) occurred in taxable years prior to the first taxable year for which the election is effective (and whose employment has not been terminated prior to such last day) shall be considered as having been terminated on such last day with respect to the WIN expenses paid or incurred by such corporation and § 1.50A–3 shall apply to such corporation. However, if the corporation and each of the persons who are shareholders of the corporation on the first day of the first taxable year for which the election under section 1372 is to be effective, or on the date of such election, whichever is later, execute the agreement specified in subparagraph (2) of this paragraph, § 1.50A–3 shall not apply with respect to any such WIN expenses by reason of the election by the corporation under section 1372.

(2) *Agreement of shareholders and corporation.* (i) The agreement referred to in subparagraph (1) of this paragraph shall be signed by the shareholders and by the corporation. The agreement shall recite that:

(a) In the event the employment of any WIN employee described in subparagraph (1) of this paragraph is later terminated (in a termination subject to the rules contained in paragraph (a) of § 1.50A–3) during a taxable year of the corporation for which the election under section 1372 is effective, each signer agrees to notify the district director or the director of the Internal Revenue service center of such termination, and agrees to be jointly and severally liable to pay to the district director or the director of the Internal Revenue service center an amount equal to the increase in tax which would have been imposed by § 1.50A–3 on the corporation but for the agreement under this paragraph.

(b) In the event any WIN employee described in subparagraph (1) of this paragraph is paid wages (as defined in section 50B(b) and paragraph (b) of § 1.50B–1) by such electing corporation, which are less than the wages paid to other employees of such electing corporation who perform comparable services (as defined in paragraph (a)(2)(ii) of § 1.50A–3), during a taxable year of the corporation for which the election under section 1372 is effective, each signer agrees to notify the district director or the director of the Internal Revenue service center of such failure to pay equal wages for comparable services, and agrees to be jointly and

severally liable to pay to the district director or the director of the Internal Revenue service center an amount equal to the increase in tax which would have been imposed by §1.50A–3 on the corporation as a result of such failure but for the election under section 1372.

For purposes of computing the period described in paragraph (a)(1) of §1.50A–3, the period of employment by the corporation before the election under section 1372 shall be added to the period of employment by the electing small business corporation after such election.

(ii) The agreement shall set forth the name, address, and taxpayer account number of each party and the internal revenue district or service center in which each such party files his or its income tax return for the taxable year which includes the last day of the corporation's taxable year immediately preceding the first taxable year for which the election under section 1372 is effective. The agreement may be signed on behalf of the corporation by any person who is duly authorized. The agreement shall be filed with the district director or the director of the Internal Revenue service center with whom the corporation files its income tax return for its taxable year immediately preceding the first taxable year for which the election under section 1372 is effective and shall be filed on or before the due date (including extensions of time) of such return. For purposes of the preceding sentence, the district director or the director of the Internal Revenue service center may, if good cause is shown, permit the agreement to be filed on a later date.

(c) *Examples.* This section may be illustrated by the following examples:

Example 1. (i) X Corporation, an electing small business corporation which makes its returns on the basis of the calendar year, hired employees under a WIN program on July 1, 1972, and incurred expenses for such employees during the following 12 months at an initial rate of $10,000 per month. For taxable year 1972, X Corporation had 20 shares of stock outstanding which were owned equally by A and B who make their returns on the basis of a calendar year. Under paragraph (a) of this section, the WIN expenses were apportioned to the shareholders of X Corporation as follows:

	Period ending Dec. 31, 1973
Total WIN expenses for the taxable year	$60,000
Shareholder A (10/20)	30,000
Shareholder B (10/20)	30,000

Assuming that during 1972 shareholders A and B did not directly incur any WIN expenses and that they did not own any interest in other electing small business corporations, partnerships, estates, or trusts incurring WIN expenses, the WIN expenses attributable to each shareholder is $30,000. For the taxable year 1972, each shareholder's credit earned of $6,000 (20 percent of $30,000) was allowed under section 40 as a credit against his liability for tax.

(ii) On January 1, 1973, X Corporation terminates the employment of the employees accounting for 50 percent of its WIN expenses incurred to that date, or $30,000 in salaries and wages. The actual period of employment for these WIN employees was 6 months. For taxable year 1972, each shareholder's recomputed credit is $3,000 (20 percent of $15,000). The income tax imposed by chapter 1 of the Code on each of the shareholders for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

Example 2. (i) The facts are the same as in subdivision (i) of example 1, except that on January 1, 1973, shareholder A sells five of his 10 shares of stock in X Corporation to C. No other changes in stock ownership occurred during 1973. Under paragraph (a)(2) of this section, the WIN expenses of X Corporation were apportioned on December 31, 1973, to the shareholders of X Corporation as follows:

	Period ending Dec. 31, 1972
Total WIN expenses for the taxable year	$60,000
Shareholder A (5/20)	15,000
Shareholder B (10/20)	30,000
Shareholder C (5/20)	15,000

(ii) Under paragraph (a)(2) of this section, on January 1, 1973, the employment of these WIN employees shall be deemed terminated by shareholder A with respect to 50 percent of the WIN expenses allocated to him since immediately after the January 1, 1973, sale A's proportionate stock interest in X Corporation is reduced to 50 percent of the proportionate stock interest in X Corporation which he held for taxable year 1972. The actual period of employment of the WIN employees accounting for the 50 percent of the WIN expenses originally allocated to A is 6 months (that is, the period beginning with July 1, 1972, and ending with January 1, 1973). The income tax imposed by chapter 1 of the Code on shareholder A for the taxable year

1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

(d) *Termination or revocation of an election under section 1372.* The employment of employees with respect to whom WIN expenses were paid or incurred shall not be considered to have been terminated solely by reason of a termination or revocation of a corporation's election under section 1372.

[38 FR 6158, Mar. 7, 1973]

§ 1.50A–6 Estates and trusts.

(a) *In general*—(1) *Termination of employment by an estate or trust.* If an estate or trust terminates (in a termination subject to the provisions of paragraph (a) of § 1.50A–3) the employment of any employee with respect to whom WIN expenses have been paid or incurred, a recapture determination shall be made under § 1.50A–3 with respect to the estate or trust, and each beneficiary who is treated, under paragraph (a) of § 1.50B–3 as a taxpayer who paid or incurred such expenses. For purposes of each such recapture determination the period of employment of such employees shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of § 1.50A–3) with respect to the estate or trust and ending with the date of such employee or employees' termination (as defined in paragraph (a)(1)(ii) of § 1.50A–3). For definition of ''recapture determination'' see paragraph (a)(3) of § 1.50A–3.

(2) *Disposition of interest.* (i) If—

(a) WIN expenses are apportioned to an estate or trust, or to a beneficiary of an estate or trust who takes such expenses into account in computing his WIN expenses, and

(b) After the end of the estate's, trust's, or beneficiary's taxable year in which such apportionment was taken into account and before the close of the period to which paragraph (a)(1) of § 1.50A–3 applies with respect to the employees to which such WIN expenses relate, such estate's, trust's, or such beneficiary's proportionate interest in the income of the estate or trust is reduced (for example, by a sale, or by the terms of the estate or trust instrument) below the percentage specified in subdivision (ii) of this subparagraph,

then, on the date of such reduction, the employment of such employee shall be deemed terminated with respect to such estate, trust, or beneficiary to the extent of the actual reduction in such estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust. (For example, if $100 of WIN expenses were apportioned to a beneficiary and if his proportionate interest in the income of the estate or trust is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then the employment of the employee to which such WIN expenses relates shall be deemed terminated as to that beneficiary to the extent of $50.) Accordingly, a recapture determination shall be made with respect to such estate, trust, or beneficiary. For purposes of such recapture determination the period of employment of any employee or employees with respect to whom WIN expenses were paid or incurred shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of § 1.50A–3) with respect to the estate or trust and ending with the date on which such reduction occurs.

(ii) The percentage referred to in subdivision (i)*(b)* of this subparagraph is 66⅔ percent of the estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust for the taxable year of the apportionment under paragraph (a) of § 1.50B–3. However, once employment of an employee has been treated under this subparagraph as having terminated with respect to the estate, trust, or beneficiary to any extent, the percentage referred to shall be 33⅓ percent of the estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust for the taxable year of the apportionment under paragraph (a) of § 1.50B–3.

(iii) In determining a beneficiary's proportionate interest in the income of an estate or trust for purposes of this subparagraph, the beneficiary shall be considered to own any interest in such an estate or trust which he owns directly or indirectly (through ownership in other entities provided such other entities' bases in such interests are determined in whole or in part by reference to the basis of such interest in the hands of the beneficiary). For example, if A, whose proportionate interest in the income of trust X is 30 percent, transfers all of such interest to corporation Y in exchange for all of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own a 30-percent interest in trust X. Any taxpayer who seeks to establish his interest in an estate or trust under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the estate or trust after any such transfer or transfers.

(b) *Computation of the first 12 months of employment.* The period described in paragraph (a)(1) of §1.50A–3 shall not be affected by a change in the beneficiaries of an estate or trust and shall not be affected by a reduction or a termination of a beneficiary's interest in the income of such estate or trust. Thus, the period described in paragraph (a)(1) of §1.50A–3 for any WIN employee shall be the same with respect to a trust or estate and any beneficiary of such trust or estate which is allowed a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee. Also, such period with respect to any WIN employee shall not be deemed to begin again as the result of the acquisition of the interest by another.

(c) *Examples.* Paragraph (a) of this section may be illustrated by the following examples:

Example 1. (i) XYZ Trust, which makes its returns on the basis of the calendar year, hired employees under the WIN program on July 1, 1972, and incurred expenses for such employees during the following 12 months at an initial rate of $10,000 per month. For the taxable year 1972 the income of XYZ Trust is $60,000, which is allocated equally to XYZ Trust and beneficiary A. Beneficiary A makes his returns on the basis of a calendar year. Under paragraph (a) of this section, the WIN expenses were apportioned to XYZ Trust and to beneficiary A as follows:

	Period ending Dec. 31, 1972
Total WIN expenses for the taxable year	$60,000
XYZ Trust ($30,000/$60,000)	30,000
Beneficiary A ($30,000/$60,000)	30,000

Assuming that during 1972 beneficiary A did not directly incur any WIN expenses and that he did not own any interest in other estates, trusts, electing small business corporations, or partnerships incurring WIN expenses, the WIN expenses incurred by XYZ Trust and by beneficiary A are $30,000 each. For the taxable year 1972, XYZ Trust and beneficiary A each had a credit earned of $6,000. Each credit earned was allowed under section 40 as a credit against the liability for tax.

(ii) On January 1, 1973, XYZ Trust terminates the employment of its employees accounting for 50 percent of its WIN expenses incurred to that date, or $30,000 in salaries and wages. The actual period of employment for these WIN employees was 6 months. For the taxable year 1972, XYZ Trust's and beneficiary A's recomputed credit is $3,000 (20 percent of $15,000). The income tax imposed by chapter 1 of the Code on XYZ Trust and on beneficiary A for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

Example 2. (i) The facts are the same as in subdivision (i) of example 1, except that on January 1, 1973, beneficiary A sells 50 percent of his interest in the income of XYZ Trust to B. No other changes in income interest occurred during 1973. Under paragraph (a)(2) of §1.50B–4, each beneficiary's share and the trust's share of the WIN expenses are apportioned as follows:

	Period ending Dec. 31, 1972
Total WIN expenses for the taxable year	$60,000
XYZ Trust ($30,000/$60,000)	30,000
Beneficiary A ($15,000/$60,000)	15,000
Beneficiary B ($15,000/$60,000)	15,000

(ii) Under paragraph (a)(2) of this section, on January 1, 1973, the employment of these WIN employees shall be deemed terminated by beneficiary A with respect to 50 percent of the WIN expenses allocated to him since immediately after the January 1, 1973, sale A's proportionate interest in the income of XYZ Trust is reduced to 50 percent of his proportionate interest in the income of XYZ Trust for the taxable year 1972. The period of employment of the WIN employees accounting for the 50 percent of the WIN expense originally allocated to A is 6 months (that is, the period beginning with July 1, 1972, and ending with December 31, 1972). For the taxable year 1972 beneficiary A's recomputed credit earned is $3,000 (20 percent of $15,000). The income tax imposed by chapter 1 of the Code on beneficiary A for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is,

$6,000 original credit earned minus $3,000 recomputed credit earned).

[38 FR 6159, Mar. 7, 1973]

§ 1.50A–7 Partnerships.

(a) *In general*—(1) *Termination of employment by a partnership.* If a partnership terminates (in a termination subject to the provisions of paragraph (a) of § 1.50A–3) the employment of any WIN employee with respect to whom WIN expenses have been paid or incurred, a recapture determination shall be made under § 1.50A–3 with respect to each partner who is treated, under paragraph (a) of § 1.50B–4, as a taxpayer with respect to such expenses. Each such recapture determination shall be made with respect to the share of the WIN expenses with respect to such employee which were taken into account by such partner under paragraph (a) of § 1.50B–4. For purposes of each such recapture determination the period of employment of any such employee shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of § 1.50A–3) with respect to the partnership and ending with the date of such employee's termination (as defined in paragraph (a)(1)(ii) of § 1.50A–3). For the definition of ''recapture determination'' see paragraph (a)(3) of § 1.50A–3.

(2) *Disposition of partner's interest.* (i) If—

(a) WIN expenses are allocated to a partner of a partnership who takes such expenses into account in computing his WIN expenses, and

(b) After the end of the partner's taxable year in which such allocation was taken into account and before the close of the period to which paragraph (a)(1) of § 1.50A–3 applies with respect to the employee to which such WIN expenses relate, such partner's proportionate interest in the general profits of the partnership (or in the particular expenses) is reduced (for example, by a sale, by a change in the partnership agreement, or by the admission of a new partner) below the percentage specified in subdivision (ii) of this subparagraph,

then, on the date of such reduction the employment of such employee shall be deemed terminated with respect to such partner to the extent of the actual reduction in such partner's proportionate interest in the general profits (or in the particular expenses) of the partnership. (For example, if $100 of WIN expenses were taken into account by a partner and if his proportionate interest in the general profits of the partnership is reduced from 60 percent to 30 percent (that is, 50 percent of his original interest), then the employment of the employee to which such WIN expenses relate shall be deemed terminated as to that partner to the extent of $50.) Accordingly, a recapture determination shall be made with respect to such partner. For purposes of such recapture determination the period of employment of any employee or employees with respect to whom WIN expenses were paid or incurred shall be the period beginning with the initial date of employment (as defined in paragraph (c)(1) of § 1.50A–3) with respect to the partnership and ending with the date on which such reduction occurs.

(ii) The percentage referred to in subdivision (i) *(b)* of this subparagraph is 66⅔ percent of the partner's proportionate interest in the general profits (or in the WIN expenses) of the partnership for the year of the apportionment under § 1.50B–4(a). However, once employment of an employee has been treated under this subparagraph as having terminated with respect to the partner to any extent, the percentage referred to shall be 33⅓ percent of the partner's proportionate interest in the general profits (or in the WIN expenses) of the partnership for the taxable year of the apportionment under paragraph (a) of § 1.50B–4.

(iii) In determining a partner's proportionate interest in the general profits (or in the WIN expenses) of a partnership for purposes of this subparagraph, the partner shall be considered to own any interest in such a partnership which he owns directly or indirectly (through ownership in other entities provided the other entities' bases in such interests are determined in whole or in part by reference to the basis of such interest in the hands of the partner). For example, if A, whose proportionate interest in the general profits of partnership X is 20 percent, transfers all of such interest to Corporation Y in exchange for all of the stock of Y in a transaction to which section 351 applies then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own a 20 percent interest in partnership X. Any taxpayer who seeks to establish his interest in a partnership under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the partnership after any such transfer or transfers.

(3) *Computation of the first 12 months of employment.* The period described in paragraph (a)(1) of §1.50A–3 shall not be affected by a change in the partners of such partnership and shall not be affected by a change in the ratio in which the partners divide the general profits (or the WIN expenses) of the partnership. Thus, such period for any WIN employee shall be the same with respect to any partner claiming a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee.

(b) *Examples.* Paragraph (a) of this section may be illustrated by the following examples:

Example 1. (i) AB partnership, which makes its returns on the basis of the calendar year, hired employees under the WIN program on July 1, 1972, and incurred expenses for such employees during the following 12 months at an initial rate of $10,000 per month. Partners A and B, who make their returns on the basis of a calendar year, share the profits and losses of AB partnership equally. Under paragraph (a)(2) of this section, each partner's share of the WIN expenses was approportioned as follows:

	Period ending Dec. 31, 1972
Total WIN expenses for the taxable year	$60,000
Partner A's share (50 percent)	30,000
Partner B's share (50 percent)	30,000

Assuming that during 1972 A and B did not directly incur any WIN expenses and that they did not own any interest in other partnerships, electing small business corporations, estates, or trusts incurring WIN expenses, each partner's share of the WIN expenses is $30,000. For the taxable year 1972, each partner's credit earned of $6,000 (20 percent of $30,000) was allowed under section 40 as a credit against his liability for tax.

(ii) On January 1, 1973, AB partnership terminates the employment of its employees accounting for 50 percent of its WIN expenses incurred to that date, or $30,000 in salaries and wages. The actual period of employment for these WIN employees was 6 months. For the taxable year 1972, each partner's recomputed credit earned is $3,000 (20 percent of $15,000). The income tax imposed by chapter 1 of the Code on each of the partners for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

Example 2. (i) The facts are the same as in subdivision (i) of example 1, except that on January 1, 1973, partner A sells one-half of his 50 percent interest in AB partnership to C, to form the ABC partnership. No other changes in the partners' proportionate interest in the general profits of the partnership occurred during 1973. Under paragraph (a)(2) of this section, each partner's share of the WIN expenses was apportioned on December 31, 1973, as follows:

	Period ending Dec. 31, 1973
Total WIN expenses for the taxable year	$60,000
Partner A's share (25 percent)	15,000
Partner B's share (50 percent)	30,000
Partner C's share (25 percent)	15,000

(ii) Under paragraph (a)(2) of this section, on January 1, 1973, the employment of these WIN employees shall be deemed terminated by partner A with respect to 50 percent of the WIN expenses allocated to him since immediately after the January 1, 1973, sale, A's proportionate interest in the general profits of ABC partnership is reduced to 50 percent of his proportionate interest in the general profits of AB partnership for 1972. The period of employment of the WIN employees accounting for the 50 percent of the WIN expenses originally allocated to A is 6 months (that is, the period beginning with July 1, 1972, and ending with December 31, 1972). For the taxable year 1972 partner A's recomputed credit earned is $3,000 (20 percent of $15,000). The income tax imposed by chapter 1 of the Code on partner A for the taxable year 1973 is increased by the $3,000 decrease in his credit earned for the taxable year 1972 (that is, $6,000 original credit earned minus $3,000 recomputed credit earned).

[38 FR 6160, Mar. 7, 1973]

§1.50B–1 Definitions of WIN expenses and WIN employees.

(a) *WIN expenses*—(1) *In general.* Except as otherwise provided in paragraphs (b) through (g) of this section, for purposes of §§1.50A–1 through 1.50B–5, the term ''work incentive program expenses'' (referred to in §§1.50A–1 through 1.50B–5 as ''WIN expenses'') means the salaries and wages paid or incurred by the taxpayer for services rendered during the first 12 months of employment (whether or not consecutive) by an employee who is certified by the Secretary of Labor as—

(i) Having been placed in employment by the taxpayer (or if the taxpayer is a partner of a partnership, beneficiary of an estate or trust, or a shareholder of an electing small business corporation, by such partnership, estate, trust, or electing small business corporation) under a work incentive (WIN) program established under section 432(b)(1) of the Social Security Act (42 U.S.C. 632(b)(1)), and

(ii) Not having displaced any individual from employment.

The term ''WIN expenses'' includes only salaries and wages paid or incurred in taxable years beginning after December 31, 1971. See paragraph (c) of § 1.50A–3 for rules relating to the determination of the first 12 months of employment (whether or not consecutive).

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

Example 1. X Corporation, an accrual basis taxpayer which files its return on the basis of the calendar year, hired an employee on July 1, 1971, who was certified by the Secretary of Labor under this paragraph. The first 12 months of employment were continuous. X is entitled to the credit provided by section 40 with respect to the salaries or wages incurred during its taxable year beginning January 1, 1972, for services rendered by that employee during the period beginning July 1, 1971, and ending June 30, 1972.

Example 2. Y, a cash basis taxpayer who files his return on the basis of the calendar year, employed A, an employee certified by the Secretary of Labor under this paragraph, on July 1, 1971. A's first 12 months of employment were continuous. Y paid A on the basis of a semimonthly payroll period, but paid his payroll 2 days after the close of the payroll period during which the wages were earned. Thus, Y paid A on January 2, 1972, for services rendered between December 16, 1971, and December 31, 1971. Y is entitled to the credit provided by section 40 with respect to the wages paid for services rendered by A during the period beginning December 16, 1971, and ending June 30, 1972, because those wages were paid by Y in a taxable year beginning after December 31, 1971.

(b) *Salaries and wages.* For purposes of this section, the term ''salaries and wages'' means only cash remuneration including a check. Amounts deducted and withheld from the employee's pay (for example, taxes and contributions to health and retirement plans) shall be deemed to be cash remuneration even though not actually paid directly to the employee.

(c) *Trade or business expenses.* The term ''WIN expenses'' includes only salaries and wages which are paid or incurred in a trade or business of the taxpayer and which are deductible in computing taxable income. Thus, salaries and wages paid to domestic employees in a private home are not ''WIN expenses''.

(d) *Reimbursed expenses*—(1) *In general.* The term ''WIN expenses'' does not include salaries and wages to the extent that the taxpayer is reimbursed for such salaries or wages from any source.

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

Example. X Company, which makes its return on the basis of the calendar year, hired WIN employees on January 1, 1972. X Company has a cost-plus construction contract with the Federal Government. The fact that X has a construction contract with the Federal Government or anyone else does not change its character from a normal business transaction in which there has been a sale of materials and services. Thus, the salaries or wages paid or incurred for services rendered by these WIN employees would not be reimbursed expenses, and X would be entitled to the credit provided by section 40.

(e) *Geographical limitation*—(1) *In general.* The term ''WIN expenses'' does not include salaries and wages paid or incurred for services rendered outside the United States (as defined in sections 638 (relating to Continental Shelf areas) and 7701(a)(9). However, services rendered by any WIN employee outside the United States (as defined in sections 638 (relating to Continental Shelf areas) and 7701(a)(9)) shall contribute to such employee's first 12 months of employment (whether or not consecutive) for purposes of paragraph (a) of § 1.50A–3 and paragraph (a) of this section.

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

Example. X Corporation, which files its return on the basis of the calendar year, hired A, a WIN employee, on January 1, 1972, and continuously employed him for the following 24-month period. During January and February of 1972, X paid A's wages while he received training conducted in Puerto Rico. For the remainder of the calendar year A performed services for X within the United States. For purposes of paragraph (a) of §1.50A–3 and paragraph (a) of this section, A's first 12 months of employment are January 1, 1972, to December 31, 1972. Under subparagraph (1) of this paragraph no wages paid to A for services rendered during the months of January and February of 1972 may be taken into account by X under paragraph (a) of this section as WIN expenses because the services were rendered outside the United States. However, X may take into account wages he has incurred with respect to A for the period March 1, 1972, to December 31, 1972.

(f) *Maximum period of training or instruction.* The term ''WIN expenses'' does not include salaries and wages paid or incurred for services rendered by a WIN employee after the end of the 24-month period beginning with the date of initial employment (as defined in paragraph (c)(1) of §1.50A–3) of the WIN employee.

(g) *Ineligible individuals.* The term ''WIN expenses'' does not include salaries and wages paid or incurred for services rendered by a WIN employee who—

(1) Bears any of the relationships described in paragraphs (1) through (8) of section 152(a) of the Code to the taxpayer, or, if the taxpayer is a corporation, to an individual who owns, directly or indirectly, more than 50 percent in value of the outstanding stock of the corporation (determined with the application of section 267(c) of the Code),

(2) If the taxpayer is an estate or trust, is a grantor, beneficiary, or fiduciary of the estate or trust, or is an individual who bears any of the relationships described in paragraphs (1) through (8) of section 152(a) of the Code to a grantor, beneficiary, or fiduciary of the estate or trust, or

(3) Is a dependent (described in section 152(a)(9) of the Code) of the taxpayer, or, if the taxpayer is a corporation, of an individual described in subparagraph (1), or, if the taxpayer is an estate or trust, of a grantor, beneficiary, or fiduciary of the estate or trust.

(h) *WIN employee.* For purposes of §§1.50A–1 through 1.50B–5 the term ''WIN employee'' means an employee who is certified by the Secretary of Labor as meeting the requirements of paragraphs (a)(1) (i) and (ii) of this section.

(i) [Reserved]

(j) *Special rule applicable to transactions to which section 381(a) applies and transactions involving a mere change in form of conducting a trade or business.* The first 12 months of employment (whether or not consecutive) and the period described in section 50B (c)(4) of any WIN employee, for purposes of determining the amount of WIN expenses (as defined in paragraph (a) of §1.50B–1), shall not be affected by transactions to which the rule contained in paragraph (f) (relating to transaction to which section 381(a) (relating to certain corporate acquisitions) applies), or paragraph (g) (relating to a mere change in form of conducting a trade or business) of §1.50A–4 applies.

[38 FR 6161, Mar. 7, 1973]

§1.50B–2 Electing small business corporations.

(a) *General rule*—(1) *In general.* In the case of an electing small business corporation (as defined in section 1371 (b)), WIN expenses (as defined in paragraph (a) of §1.50B–1) shall be apportioned pro rata among the persons who are shareholders of such corporation on the last day of such corporation's taxable year, and shall be taken into account for the taxable years of such shareholders within which or with which the taxable year of such corporation ends. The WIN expenses for each employee shall be apportioned separately. In determining who are shareholders of an electing small business corporation on the last day of its taxable year, the rules of paragraph (d)(1) of §1.1371–1 and of paragraph (a)(2) of §1.1373–1 shall apply.

(2) *Shareholder as taxpayer.* A shareholder to whom WIN expenses are apportioned shall, for purposes of the credit allowed by section 40, be treated as the taxpayer who paid or incurred the expenses allocated to him. If a shareholder takes into account in determining his WIN expenses any WIN

expenses with respect to an employee of an electing small business corporation, and if the employment of such employee is terminated in a termination subject to the rules contained in paragraph (a) of § 1.50A–3, or if the electing small business corporation fails to pay comparable wages and such failure is subject to the rules contained in paragraphs (a) (2) and (3) of § 1.50A–3, then such shareholder shall make a recapture determination under the provisions of section 50A (c) and (d) of the Code and § 1.50A–3. See § 1.50A–5.

(3) *Computation of the first 12 months of employment.* The first 12 months of employment (whether or not consecutive) and the period described in section 50B(c)(4) of any WIN employee for purposes of determining the amount of WIN expenses (as defined in paragraph (a) of § 1.50B–1) shall not be affected by a change in the shareholders in such corporation and shall not be affected by a reduction in any shareholder's proportionate stock interest in such corporation (for example, by a sale or redemption or by the issuance of additional shares). Thus, the first 12 months of employment (whether or not consecutive) of any WIN employee shall be the same with respect to any shareholder claiming a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee. Also, such first 12 months of employment and the period described in section 50B(c)(4), with respect to any WIN employee, shall not be deemed to begin again because of the making of a valid election under section 1372.

(b) *Summary statement.* An electing small business corporation shall attach to its return a statement showing the apportionment to each shareholder of its WIN expenses with respect to each WIN employee.

(c) *Examples.* Paragraph (a) of this section may be illustrated by the following examples:

Example 1. (i) X Corporation, an electing small business corporation which files its returns on the basis of the calendar year, hired WIN employees on July 1, 1972, whose employment was continuous for the next 24 months. A, a shareholder, has a 10 percent interest in X Corporation. X Corporation incurred $24,000 in wages with respect to these WIN employees in calendar year 1972, and $48,000 in calendar year 1973. Assuming that during 1972 shareholder A did not directly incur any other WIN expenses and did not own any other interest in other electing small business corporations, partnerships, estates, or trusts that incurred WIN expenses, for taxable year 1972 shareholder A's credit earned of $480 (10 percent (A's ownership interest) multiplied by $24,000 of WIN expenses multiplied by 20 percent) was allowed under section 40 as a credit against his liability for tax.

(ii) On March 1, 1973, shareholder A sold all of his interest to B, a new shareholder. Therefore, the employment of the WIN employees is deemed terminated for purposes of paragraph (a) of § 1.50A–3 with respect to shareholder A. For taxable year 1972, A's recomputed credit is zero because the termination occurred before the end of the period described in paragraph (a)(1) of § 1.50A–3. The income tax imposed by chapter 1 of the Code on A for the taxable year 1973 is increased by the $480 decrease in his credit earned for the taxable year 1972 (that is, $480 original credit earned minus zero recomputed credit earned). Under paragraph (a) of this section A has no credit earned for 1973.

(iii) Under paragraph (a)(1) of this section, assuming that during 1973 shareholder B did not directly incur any other WIN expenses and that he did not own any interest in other electing small business corporations, partnerships, estates, or trusts that incurred WIN expenses, shareholder B's credit earned is $480 (10 percent (B's ownership interest) multiplied by $24,000 of WIN expenses multiplied by 20 percent) and is allowable under section 40 as a credit against his liability for tax. Under paragraph (a)(3) for purposes of determining the period of employment that may be taken into account by B the initial date of employment of these WIN employees relates back to the date they were first employed, *i.e.,* July 1, 1972. Thus, the first 12 months of employment ends on June 30, 1973.

Example 2. (i) Y Corporation, an electing small business corporation which files its return on the basis of the calendar year, hires five WIN employees in 1972. The WIN expenses incurred with respect to each employee are as follows:

WIN employee No.	WIN expenses
1	$6,000
2	5,000
3	4,000
4	4,000
5	3,000
Total	22,000

On December 31, 1972, Y Corporation has 10 shares of stock outstanding which are owned as follows: A owns 3 shares, B owns 2 shares, and C owns 5 shares.

(ii) Under this section, the WIN expenses are apportioned to the shareholders of Y Corporation as follows:

WIN employees	1	2	3	4	5	Total
Total WIN expenses ..	$6,000	$5,000	$4,000	$4,000	$3,000	....
Shareholder A (3/10)	1,800	1,500	1,200	1,200	900	6,600
Shareholder B (2/10)	1,200	1,000	800	800	600	4,400
Shareholder C (5/10)	3,000	2,500	2,000	2,000	1,500	11,000

Assume that shareholders A, B, and C did not directly incur any other WIN expenses during their taxable year in which falls December 31, 1972 (the last day of Y Corporation's taxable year), and that such shareholders did not own any interest in other electing small business corporations, partnerships, estates or trust that incurred WIN expenses. The total WIN expenses of shareholder A are $6,600, of shareholder B are $4,400, and of shareholder C are $11,000.

[38 FR 6162, Mar. 7, 1973]

§1.50B–3 Estates and trusts.

(a) *General rule*—(1) *In general.* In the case of an estate or trust, WIN expenses (as defined in paragraph (a) of §1.50B–1) shall be apportioned among the estate or trust and its beneficiaries on the basis of the income of such estate or trust allocable to each. There shall be apportioned to the estate or trust for its taxable year, and to each beneficiary of such estate or trust for his taxable year in which or with which the taxable year of such estate or trust ends, his share (as determined under paragraph (b) of this section) of the total WIN expenses. The WIN expenses for each employee shall be apportioned separately.

(2) *Beneficiary as taxpayer.* A beneficiary to whom WIN expenses are apportioned shall, for purposes of the credit allowed by section 40, be treated as the taxpayer who paid or incurred such WIN expenses allocated to him. If a beneficiary takes into account in determining his WIN expenses any portion of the WIN expenses paid or incurred by an estate or trust and if the employee with respect to which the WIN expenses were paid or incurred is terminated in a termination subject to the rules in paragraph (a) of §1.50A–3, or if there is a failure (which is subject to the rules is paragraphs (a) (2) and (3) of §1.50A–3) to pay such employee comparable wages then such beneficiary shall make a recapture determination under the provisions of section 50A (c) and (d) of the Code and §1.50A–3. See §1.50A–6.

(3) *Beneficiary.* For purposes of this section, the term ''beneficiary'' includes heir, legatee, and devisee.

(4) *Special rule for termination of interest.* If during the taxable year of an estate or trust a beneficiary's interest in the income of such estate or trust terminates, WIN expenses paid or incurred by such estate or trust after such termination shall not be apportioned to such beneficiary.

(b) *Share.* A trust's, estate's, or beneficiary's share of the WIN expenses with respect to each employee shall be:

(1) The total WIN expenses incurred in the taxable year of the estate or trust with respect to such employee, multiplied by

(2) The amount of income allocable to such estate or trust or to such beneficiary for such taxable year, divided by

(3) The sum of the amounts of income allocable to such estate or trust and all its beneficiaries taken into account under subparagraph (2) of this paragraph.

(c) *Limitation based on amount of tax.* In the case of an estate or trust, the $25,000 amount specified in section 50A(a)(2), relating to limitation based on amount of tax, shall be reduced for the taxable year to—

(1) $25,000, multiplied by

(2) The WIN expenses apportioned to such estate or trust under paragraph (a) of this section, divided by

(3) The WIN expenses apportioned among such estate or trust and its beneficiaries.

(d) *Computation of the first 12 months of employment.* The first 12 months of employment (whether or not consecutive) and the period described in section 50B(c)(4) of any WIN employee for purposes of determining the amount of WIN expenses (as defined in paragraph (a) of § 1.50B–1) shall not be affected by a change in the beneficiaries of an estate or trust and shall not be affected by a reduction or a termination of a beneficiary's interest in the income of such estate or trust. Thus, the first 12 months of employment (whether or not consecutive) of any WIN employee shall be the same with respect to trust or estate, and any beneficiary of such trust or estate claiming a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee.

(e) *Summary statement.* An estate or trust shall attach to its return a statement showing the apportionment of WIN expenses with respect to each employee to such estate or trust and to each beneficiary.

(f) *Examples.* This section may be illustrated by the following examples:

Example 1. (1) XYZ trust, which makes its return on the basis of the calendar year, hires five WIN employees in 1972. The WIN expenses incurred with respect to each employee are as follows:

WIN employee No.	WIN expenses
1	$6,000
2	5,000
3	4,000
4	4,000
5	3,000
Total	22,000

For the taxable year 1972 the income of XYZ trust is $10,000 which is allocable as follows: $5,000 to XYZ trust, $2,000 to beneficiary A, and $3,000 to beneficiary B. Beneficiaries A and B make their returns on the basis of a calendar year.

(2) Under this section, the WIN expenses are apportioned to XYZ trust and to its beneficiaries as follows:

WIN employees	1	2	3	4	5	Total
Total WIN expenses	$6,000	$5,000	$4,000	$4,000	$3,000	
XYZ Trust: $5,000/10,000	3,000	2,500	2,000	2,000	1,500	$11,000
Beneficiary A: $2,000/10,000	1,200	1,000	800	800	600	4,400
Beneficiary B: $3,000/10,000	1,800	1,500	1,200	1,200	900	6,600

Assume that beneficiary A hired a WIN employee during his taxable year 1972 and incurred $6,000 in wages. Also, assume that beneficiary B did not hire WIN employees during his taxable year 1972 and that beneficiaries A and B did not own any interests in other trusts, estates, partnerships, or electing small business corporations that hired WIN employees. The WIN expenses of XYZ trust are $11,000, of beneficiary A are $10,400, and of beneficiary B are $6,600.

(3) In the case of XYZ trust, the $25,000 amount specified in section 50A(a)(2) is reduced to $12,500, computed as follows: (i) $25,000 multiplied by (ii) $11,000 (WIN expense apportioned to the trust), divided by (iii) $22,000 (total WIN expenses apportioned among such trust ($11,000), beneficiary A ($4,400), and beneficiary B ($6,600)).

Example 2. The facts are the same as in example 1 except that beneficiary A's interest is reduced to zero. Under paragraph (a)(2) for purposes of determining the period of employment that may be taken into account by XYZ trust and by beneficiary B, the initial date of employment of the WIN employees relates back to the date they were first employed.

[38 FR 6163, Mar. 7, 1973]

§ 1.50B–4 Partnerships.

(a) *General rule*—(1) *In general.* In the case of a partnership, each partner shall take into account separately, for his taxable year with or within which the partnership taxable year ends, his share (as determined under subparagraph (3) of this paragraph) of the WIN expenses (as defined in paragraph (a) of § 1.50B–1) of employees employed by the partnership during such partnership's taxable year. The WIN expenses for each employee shall be allocated separately.

(2) *Partner as taxpayer.* Each partner shall be treated as the taxpayer who paid or incurred the share of the WIN expenses allocated to him. If a partner takes into account in determining his WIN expenses the WIN expenses of an employee of a partnership, and if the

employment of such employee is terminated in a termination subject to the rules contained in paragraph (a) of §1.50A–3, or if the partnership fails to pay comparable wages and such failure is subject to the rules contained in paragraphs (a) (2) and (3) of §1.50A–3, then such partner shall make a recapture determination under the provisions of section 50A (c) and (d) of the Code and §1.50A–3. See §1.50A–7.

(3) *Determination of partner's share.* (i) Each partner's share of the WIN expenses shall be determined in accordance with the ratio in which the partners divide the general profits of the partnership (that is, the taxable income of the partnership as described in section 702 (a)(9)) regardless of whether the partnership has a profit or a loss for the taxable year during which the WIN expenses are paid or incurred. However, if the ratio in which the partners divide the general profits of the partnership changes during the taxable year of the partnership, the ratio effective for the date on which the WIN expenses are paid or incurred shall apply.

(ii) Notwithstanding subdivision (i) of this subparagraph, if the deduction with respect to any WIN expenses is specially allocated and if such special allocation is recognized under section 704 (a) and (b) and paragraph (b) of §1.704–1, then each partner's share of the WIN expenses shall be determined by reference to such special allocation effective for the date on which the WIN expenses are paid or incurred.

(4) *Computation of the first 12 months of employment.* The first 12 months of employment (whether or not consecutive) and the period described in section 50B(c)(4) with respect to any WIN employee for purposes of determining the amount of WIN expenses (as defined in paragraph (a) of §1.50B–1) shall not be affected by a change in the partners of such partnership and shall not be affected by a change in the ratio in which the partners divide the general profits of the partnership. Thus, the first 12 months of employment (whether or not consecutive) and the 24-month period described in section 50B(c)(4) of any WIN employee shall be the same with respect to any partner claiming a credit under section 40 for salaries and wages paid or incurred for services rendered by such employee.

(b) *Summary statement.* A partnership shall attach to its return a statement showing the allocation to each partner of its WIN expenses with respect to each WIN employee.

(c) *Examples.* Paragraph (a) of this section may be illustrated by the following examples:

Example 1. Partnership ABCD hires a WIN employee on January 1, 1972, and hires a second WIN employee on September 1, 1972. The ABCD partnership and each of its partners reports income on the basis of the calendar year. Partners A, B, C, and D share partnership profits equally. Each partner's share of the WIN expenses incurred with respect to these employees is 25 percent.

Example 2. Assume the same facts as in example 1 and the following additional facts: A dies on June 30, 1972, and B purchases A's interest as of such date. Each partner's share of the profits from January 1 to June 30 is 25 percent. From July 1 to December 31, B's share of the profits is 50 percent, and C and D's share of the profits is 25 percent each. B shall take into account 25 percent of the WIN expenses incurred during the period beginning January 1 and ending June 30 and 50 percent of the WIN expenses incurred during the remainder of the year with respect to the employee hired on January 1, 1972. Also, B shall take into account 50 percent of the WIN expenses incurred with respect to the employee hired on September 1, C and D shall each take into account 25 percent of the WIN expenses incurred with respect to the employees employed by the partnership in 1972. Under paragraph (a)(3), for purposes of determining the period of employment that may be taken into account by B, the initial date of employment of the WIN employee hired on January 1 relates back to the date he was first employed, *i.e.*, January 1, 1972.

Example 3. Partnership SH is engaged in manufacturing. Under the terms of the partnership agreements deductions attributable to the employment of WIN employees are specially allocated 70 percent to partner S and 30 percent to partner H. In all other respects S and H share profits and losses equally. If the special allocation with respect to the WIN expenses is recognized under section 704 (a) and (b) and paragraph (b) of §1.704–1, the WIN expenses shall be taken into account, 70 percent by S and 30 percent by H.

Example 4. (i) LMN partnership, which files its return on the basis of the calendar year, hires five WIN employees in 1973. The WIN expenses incurred with respect to each employee are as follows:

WIN employee No.	WIN expenses
1	$6,000
2	5,000
3	4,000
4	4,000
5	3,000
Total	22,000

On December 31, 1973, the ratio in which the partners divide the general profits of the LMN partnership is as follows: L receives three-tenths of the general profits, M receives two-tenths of the general profits, and N receives five-tenths of the general profits.

(ii) Under this section the WIN expenses are apportioned to the partners of LMN partnership as follows:

WIN employees	1	2	3	4	5	Total
Total WIN expenses	$6,000	$5,000	$4,000	$4,000	$3,000	$22,000
Partner L (3/10)	1,800	1,500	1,200	1,200	900	6,600
Partner M (2/10)	1,200	1,000	800	800	600	4,400
Partner N (5/10)	3,000	2,500	2,000	2,000	1,500	11,000

Assume that partners L, M, and N did not directly incur any other WIN expenses during their taxable year in which falls December 31, 1973 (the last day of LMN partnership's taxable year) and that such partners did not own any interest in other partnerships, electing small business corporations, estates, or trusts that incurred WIN expenses. The total WIN expenses of partner L are $6,600, of partner M are $4,400, and of partner N are $11,000.

[38 FR 6164, Mar. 7, 1973]

§ 1.50B–5 Limitations with respect to certain persons.

(a) *Mutual savings institutions.* In the case of an organization to which section 593 applies (that is, a mutual savings bank, a cooperative bank, or a domestic building and loan association)—

(1) WIN expenses shall be 50 percent of the amount otherwise determined under paragraph (a) of § 1.50B–1, and

(2) The $25,000 amount specified in section 50A(a)(2), relating to limitation based on amount of tax, shall be reduced by 50 percent of such amount.

For example, a domestic building and loan association incurs $30,000 in WIN expenses (as determined under paragraph (a) of § 1.50B–1) during its taxable year. However, under this paragraph such amount is reduced to $15,000 (50 percent of $30,000). If an organization to which section 593 applies is a member of a controlled group (as defined in section 50A(a)(5)), the $25,000 amount specified in section 50A(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of § 1.50A–1 before such amount is further reduced under this paragraph.

(b) *Regulated investment companies and real estate investment trusts.* (1) In the case of a regulated investment company or a real estate investment trust subject to taxation under subchapter M, chapter 1 of the Code—

(i) The WIN expenses determined under paragraph (a) of § 1.50B–1, and

(ii) The $25,000 amount specified in section 50A(a)(2), relating to limitation based on amount of tax,

shall be reduced to such person's ratable share of each such amount. If a regulated investment company or a real estate investment trust is a member of a controlled group (as defined in section 50A (a)(5)), the $25,000 amount specified in section 50A(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of § 1.50A–1 before such amount is further reduced under this paragraph.

(2) A person's ratable share of the amount described in subparagraph (1)(i) and the amount described in subparagraph (1)(ii) of this paragraph shall be the ratio which—

(i) Taxable income for the taxable year, bears to,

(ii) Taxable income for the taxable year plus the amount of the deduction for dividends paid taken into account under section 852(b)(2)(D) in computing investment company taxable income, or under section 857(b)(2)(B) (section 857(b)(2)(C), as then in effect, for taxable years ending before October 5, 1976) in computing real estate investment trust taxable income, as the case may be.

For purposes of the preceding sentence, the term ''taxable income'' means, in the case of a regulated investment company, its investment company taxable income (within the meaning of section 852(b)(2)) and, in the case of a real estate investment trust its real estate investment trust, taxable income (within the meaning of section 857(b)(2)). In the case of a taxable year ending after October 4, 1976, real estate investment trust taxable income, for purposes of this paragraph, is determined by excluding any net capital gain, and by computing the deduction for dividends paid without regard to capital gains dividends (as defined in section 857(b)(3)(C)). The amount of the deduction for dividends paid includes the amount of deficiency dividends (other than capital gains deficiency dividends) taken into account in computing investment company taxable income or real estate investment trust taxable income for the taxable year. See section 860(f) for the definition of deficiency dividends.

(3) This paragraph may be illustrated by the following example:

Example. (i) Corporation X, a regulated investment company subject to taxation under section 852 of the Code, which makes its return on the basis of the calendar year, incurs WIN expenses of $30,000 during the year 1974. Corporation X's investment company taxable income under section 852 (b)(2) is $10,000 after taking into account a deduction for dividends paid of $90,000.

(ii) Under this paragraph, Corporation X's WIN expenses for the taxable year 1974 is $3,000, computed as follows: *(a)* $30,000 (WIN expenses), multiplied by *(b)* $10,000 (taxable income), divided by *(c)* $100,000 (taxable income plus the deduction for dividends paid). For 1974, the $25,000 amount specified in section 50A(a)(2) is reduced to $2,500.

(c) *Cooperatives.* (1) In the case of a cooperative organization described in section 1381(a)—

(i) The WIN expenses determined under paragraph (a) of §1.50B–1, and

(ii) The $25,000 amount specified in section 50A(a)(2), relating to limitation based on amount of tax,

shall be reduced to such cooperative's ratable share of each such amount (as determined under subparagraph (2) of this paragraph). If a cooperative organization described in section 1381(a) is a member of a controlled group (as defined in section 50A(a)(5)), the $25,000 amount specified in section 50A(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of §1.50A–1 before such amount is further reduced under this paragraph.

(2) A cooperative's ratable share of the amount described in subparagraph (1)(i) and the amount described in subparagraph (1)(ii) of this paragraph shall be the ratio which—

(i) Taxable income for the taxable year, bears to

(ii) Taxable income for the taxable year plus the sum of *(a)* the amount of the deductions allowed under section 1382(b), and *(b)* the amount of the deductions allowed under section 1382(c), and *(c)* amounts similar to the amounts described in *(a)* and *(b)* of this subdivision the tax treatment of which is determined without regard to subchapter T, chapter 1 of the Code and the regulations thereunder.

(3) This paragraph may be illustrated by the following example:

Example. (i) Cooperative X, an organization described in section 1381(a) which makes its return on the basis of the calendar year, incurs WIN expenses of $30,000 for the taxable year 1972. Cooperative X's taxable income is $10,000 after taking into account deductions of $30,000 allowed under section 1382(b), and deductions of $60,000 allowed under section 1382(c).

(ii) Under this paragraph, Cooperative X's WIN expenses for the taxable year 1972 are $3,000, computed as follows: *(a)* $30,000 (WIN expenses), multiplied by *(b)* $10,000 (taxable income), divided by *(c)* $100,000 (taxable income plus the sum of deductions allowed under sections 1382(b) and 1382(c)). For 1972, the $25,000 amount specified in section 50A(a)(2) is reduced to $2,500.

(Sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)); sec. 7805 (68A Stat. 917, 26 U.S.C. 7805))

[38 FR 6164, Mar. 7, 1973, as amended by T.D. 7767, 46 FR 11262, Feb. 6, 1981; T.D. 7936, 49 FR 2105, Jan. 18, 1984]

§1.51–1 Amount of credit.

(a) *Determination of amount*—(1) *General rule.* Except as provided in paragraph (a)(2) of this section, the amount of the targeted jobs credit for purposes of section 38 (formerly designated section 44B) for the taxable year equals 50 percent of the qualified first-year wages (minus any qualified first-year wages paid to individuals while such individuals are qualified summer youth employees) plus 25 percent of the qualified second-year wages.

(2) *Special rule for employment of qualified summer youth employees.* In the case of an employer who pays or incurs qualified wages after April 30, 1983, to a qualified summer youth employee beginning work for the employer after such date, the amount of the targeted jobs credit for the taxable year is equal to the amount determined under paragraph (a)(1) of this section plus an amount equal to 85 percent of the first $3,000 of qualified wages paid to each qualified summer youth employee during the taxable year. Such wages must be attributable to services tendered by the qualified summer youth employee during any 90-day period beginning on or after May 1 and ending on or before September 15.

(3) *Limitation.* See section 38(c) for rules limiting the amount of the credit to a percentage of the amount of the taxpayer's net tax liability.

(b) *Definitions*—(1) *Qualified wages.* The term ''qualified wages'' means wages (as defined in paragraph (b)(4)) paid or incurred by the employer during the taxable year to individuals who are members of a targeted group (within the meaning of section 51(d)).

(2) *Qualified first-year wages*—(i) *General rule.* Except in the case of qualified summer youth employees, the term ''qualified first-year wages'' means the first $6,000 of wages (as defined in paragraph (b)(4) of this section) attributable to service rendered by a member of a targeted group during the 1-year period beginning with the day the individual first begins work for the employer. In the case of a vocational rehabilitation referral (as defined in section 51(d)(2)) who begins work for the employer before July 19, 1984, the one-year period begins with the day the individual begins work for the employer on or after the beginning of such individual's rehabilitation plan. However, with the exception of vocational rehabilitation referrals for whom the employer claimed a credit under section 44B (as in effect prior to enactment of the Revenue Act of 1978) for a taxable year beginning before January 1, 1979, members of a targeted group who are first hired after September 26, 1978, and before January 1, 1979, will be treated as if they first began work for the employer on January 1, 1979. The date on which the wages are paid is not determinative of whether the wages are first-year wages; rather, the wages must be attributed to the period during which the work was performed. See paragraph (f)(1) of this section for an additional limitation on the term ''qualified first-year wages''. (See examples 1, 2, 3, 4, 5, and 6 in paragraph (j) of this section for examples illustrating the application of the rules in this paragraph (b)(2)).

(ii) *Special rule for qualified summer youth employees.* In the case of a qualified summer youth employee, qualified first-year wages for purposes of the 85 percent credit referred to in paragraph (a)(2) of this section include only wages attributable to services rendered by a qualified summer youth employee during any 90-day period beginning on or after May 1 and ending on or before September 15. If the individual is retained by the employer after the 90-day period and recertified as a member of another targeted group, the term ''qualified first-year wages'' for purposes of the 50 percent credit described by section 51(a)(1) has the meaning assigned that term in paragraph (b)(2)(i) of this section except that the $6,000 limitation for qualified first-year wages shall be reduced by wages up to, but not more than, $3,000 attributable to services rendered during the 90-day period.

(3) *Qualified second-year wages.* The term ''qualified second-year wages'' means the first $6,000 of wages attributable to services rendered by a member of a targeted group, other than a qualified summer youth employee, during the 1-year period beginning on the day after the last day of the period for qualified first-year wages. The date on which the wages are paid is not determinative of whether the wages are second-year wages; rather, the wages must be attributed to the period during which the work was performed.

(4) *Wages*—(i) *General rule.* Except as otherwise provided in paragraphs (b)(4) (ii) and (iii) of this section, the term ''wages'' shall only include amounts paid or incurred after December 31, 1978, for taxable years ending after December 31, 1978. For purposes of this

section, the term ''wages'' has the meaning assigned such term by section 3306(b) (determined without regard to any dollar limitation contained in such subsection).

(ii) *Special rules.* In the case of agricultural labor or railway labor, the term ''wages'' means unemployment insurance wages within the meaning of subparagraph (A) or (B) of section 51(h)(1). The term ''wages'' shall not include any amounts paid or incurred by an employer for any pay period to any individual for whom the employer receives federally funded payments for on-the-job training for such individual for such pay period. (See example 7 in paragraph (j) of this section.) The amount of wages which would otherwise be qualified wages under this section with respect to an individual for a taxable year shall be reduced by an amount equal to the amount of payments made to the employer (however utilized by such employer) with respect to such individual for such taxable year under a program established under section 414 of the Social Security Act. In addition, the term ''wages'' shall not include any amount paid or incurred by the employer in a taxable year beginning before January 1, 1982, to an individual with respect to whom the employer claims a credit under section 40 (relating to expenses of work incentive programs). For youths participating in a qualified cooperative education program:

(A) Section 3306(c)(10)(C) (relating to the definition of employment for certain students) does not apply in determining wages under this section; and

(B) The term ''wages'' shall include only those amounts paid or incurred by the employer that are attributable to services rendered by the individual while he or she meets the conditions specified in section 51(d)(8)(A). For purposes of the preceding sentence, an employee who met the requirement in section 51(d)(8)(A)(iv), dealing with economically disadvantaged status, when hired, shall be deemed to continuously meet the requirement in section 51(d)(8)(A)(iv) during the time the employee is in the cooperative education program. See also paragraph (e) of this section for rules relating to the exclusion of wages paid to certain individuals.

(iii) *Termination.* The term ''wages'' shall not include any amount paid or incurred to an individual who begins work for the employer after December 31, 1985.

(5) *Special rule for eligible work incentive employees.* In the case of an eligible work incentive employee (as defined in §1.51–1(c)(4)), this paragraph (b) shall be applied for taxable years beginning after December 31, 1981, as if such employee had been a member of a targeted group for taxable years beginning before January 1, 1982. (See example 8 in paragraph (j) of this section.)

(c) *Members of targeted groups*—(1) *In general.* An individual is a member of a targeted group if the individual is certified as (i) a vocational rehabilitation referral, (ii) an economically disadvantaged youth, (iii) an economically disadvantaged Vietnam-era veteran, (iv) an SSI recipient, (v) a general assistance recipient, (vi) a youth participating in a cooperative education program, (vii) an economically disadvantaged ex-convict, (viii) an eligible work incentive employee, (ix) a qualified summer youth employee, or (x) an involuntarily terminated CETA employee. Except as provided below, see section 51(d) of this section for a definition of these groups. See paragraph (d) of this section for rules concerning the certification of individuals as members of one of these targeted groups.

(2) *Youths participating in a qualified cooperative education Program*—(i) *Student requirements.* For an individual to qualify as a youth participating in a qualified cooperative education program, the individual must meet each of the following conditions (A) through (D)—

(A) The youth must have attained the age of 16 but not 20. (An individual reaching 19 will be treated as a youth participating in a qualified cooperative education program only for wages paid or incurred after November 26, 1979.)

(B) The youth must not have graduated from a high school or vocational school.

(C) The youth must be enrolled in and actively pursuing a qualified cooperative education program (as defined in paragraph (c)(2)(iii) of this section).

(D) With respect to wages paid or incurred after December 31, 1981, the youth must be a member of an economically disadvantaged family when initially hired.

(ii) *Economically disadvantaged family.* See section 51(d)(11) for the rules relating to the determination of whether an individual is a member of an economically disadvantaged family.

(iii) *Qualified cooperative education program.* The term ''qualified cooperative education program'' means a program of vocational education for individuals who (through written cooperative arrangements between a qualified school and one or more employers) receive instruction (including required academic instruction) by alternation of study in school with a job in any occupational field (but only if these two experiences are planned by the school and employer so that each contributes to the student's education and employability). See section 51(d)(8)(C) for the definition of a ''qualified school.'' For purposes of this paragraph, the term ''program of vocational education'' means an organized educational program which is directly related to the preparation of individuals for employment, or for additional preparation for a career requiring other than a baccalaureate or advanced degree. An ''organized educational program'' means only instruction related to the occupation or occupations for which the students are in training or instruction necessary for students to benefit from such training. The student's employment contributes to his or her education and employability only if it is related to the occupation, or a cluster of closely related occupations, for which the student is in training in school. However, the student's employment need not be directly related to or in the same technical field as the training the student receives in school. For example, a student studying carpentry does not have to work as a carpenter for the program to constitute a ''qualified cooperative education program.'' The program will qualify if, for example, the student works at a hardware store because the student's work would familiarize the student with the materials and tools used by carpenters. The program would not qualify, however, if the student works at a restaurant and generally performs tasks in such employment not related to carpentry.

(iv) *Actively pursuing.* For purposes of this paragraph (c)(2), a youth will not be considered to be ''actively pursuing'' a school's qualified cooperative education program (within the meaning of paragraph (c)(2)(iii) of this section) during summer vacation unless that school program continues during the summer vacation. Whether the school program continues during the summer vacation will be determined by examining the written agreement between the school and the employer. Thus, if a written agreement specifically covers the summer vacation period and provides for a significant degree of involvement by school personnel to provide supervision for the students in the program during that period, the school program will be considered to continue during the summer, regardless of whether classes are held during the vacation period.

(3) *General assistance recipients.* In order for an individual to qualify as a general assistance recipient, the individual, or another member of the assistance unit (within the meaning of 45 CFR 205.40(a)(1)) that the individual is a member of, must receive assistance for a period of not less than 30 days ending within the preemployment period (as defined in section 51(d)(13)) from a qualified general assistance program. A qualified general assistance program is a program of a State or a political sudivision of a State that the Secretary (after consultation with the Secretary of Health and Human Services) has designated as providing general assistance (or similar assistance) which is based on need and consists of money payments or voucher or scrip. For purposes of the preceding sentences, a program qualifying as a general assistance program by reason of non-cash assistance (*i.e.,* voucher or scrip) shall be so treated only with respect to amounts paid or incurred after July 1, 1982, to individuals beginning work for the employer after such date. For purposes of this subparagraph, the term ''money'' means cash or an instrument convertible into cash (*e.g.,* a check).

(4) *Eligible work incentive employees.* An eligible work incentive employee means an individual who has been certified by the designated local agency (as defined in paragraph (d)(10) of this section) as—

(i) Being eligible for financial assistance under part A of title IV of the Social Security Act and as having continuously received such financial assistance during the 90-day period which immediately precedes the date on which such individual is hired by the employer, or

(ii) Having been placed in employment under a work incentive program established under section 432(b)(1) or 445 of the Social Security Act.

The provisions of this paragraph (c)(4) are effective with respect to taxable years of the employer beginning after December 31, 1981. (See paragraph (b)(5) of this section for a special rule relating to eligible work incentive employees.)

(5) *Involuntarily terminated CETA employees*—(i) *In general.* An involuntarily terminated CETA employee is an individual who first began work for an employer after August 13, 1981, in taxable years of the employer ending after August 13, 1981, and is certified by the designated local agency (as defined in paragraph (d)(10) of this section) as having been involuntarily terminated after December 31, 1980, from employment financed in whole, or in part, under a program under part D of title II or title VI of the Comprehensive Employment and Training Act.

(ii) *Termination.* Section 51(d)(10) and this paragraph (c)(5) shall not apply to any individual who begins work for the employer after December 31, 1982.

(d) *Certification*—(1) *General rule.* Except as otherwise provided in this paragraph, an individual shall not be treated as a member of a targeted group unless, on or before the day on which such individual begins work for the employer, the employer has received, or has requested in writing, a certification that the individual is a member of a targeted group from the designated local agency (as defined in paragraph (d)(10) of this section). In addition, the employer must receive a certification before the targeted jobs credit can be claimed. However, with respect to individuals who began work for the employer on or before May 11, 1982, the certification will be timely only if requested or received before the day the individual began work for the employer. In the case of a request in writing mailed via the United States Postal Service, the request shall be deemed to be made on the date of the postmark stamped on the cover in which such request was mailed to the designated local agency provided the request is mailed in accordance with the mailing requirements in §301.7502–1(c) and delivered in accordance with the delivery requirements in §301.7502–1(d). In the case of a deadline that but for this sentence would fall on a Saturday, Sunday, or a legal holiday, the deadline for making a timely request in writing for a certification or receiving a timely certification shall be the next succeeding day which is not a Saturday, Sunday, or legal holiday. (See section 7503 for the definition of ''legal holiday.'') See paragraph (d)(2) of this section for transitional rules applicable to certain employees who began work for the employer before September 26, 1981. See paragraph (d)(3) of this section for special rules applicable to cooperative education students and paragraph (d)(4) of this section for special rules applicable to eligible work incentive employees.

(2) *Timeliness of certification in the case of an individual to whom a written preliminary eligibility determination has been issued.* If on or before the day on which an individual begins work for the employer, such individual has received from a designated local agency (or other agency or organization designated pursuant to a written agreement with such designated local agency) a written preliminary determination that such individual is a member of a targeted group, then such individual may be treated as a member of a targeted group if on or before the fifth day after the day such individual begins work for the employer such employer receives, or requests in writing, from the designated local agency a certification that such individual is a member of a targeted group. This paragraph (d)(2) only applies to individuals who begin work for the employer after July 18, 1984.

(3) *Transitional rules for certain employees who began work for the employer on or before September 26, 1981.* In the case of an individual, other than a cooperative education student, who began work for the employer before June 29, 1981, the employer must either receive, or request in writing, a certification before July 23, 1981. In the case of an individual, other than a cooperative education student, who began work for the employer after June 28, 1981, and on or before September 26, 1981, the employer must either receive, or request in writing, a certification before September 26, 1981.

(4) *Cooperative education students.* In the case of cooperative education students, the school administering the cooperative education program must issue the certification. Form 6199 is provided for this purpose. If the student begins work for the employer after September 26, 1981, see the general rule in § 1.51–1(d)(1) for the date when this certification must be received or requested. If the student begins work for the employer on or before September 26, 1981, the employer must receive the certification or request it in writing before September 26, 1981. In order for an employer to claim a credit on wages paid or incurred to a cooperative education student after December 31, 1981, the employer must receive or request in writing a determination that the student is a member of an economically disadvantaged family. A request for economic eligibility determination for a cooperative education student must be made in writing by the employer to the participating school. If the student begins work for the employer on or before September 26, 1981, the employer must receive or request in writing such determination before September 26, 1981. However, a request in writing on or after August 13, 1981, to a participating school for certification will be deemed to include a request for an economic eligibility determination. In addition, any certification issued by a school after August 13, 1981, will be deemed to be issued in response to a request for certification which includes a request for an economic eligibility determination. The rule in the preceding sentence does not eliminate the requirement that the employer receive a certification that includes an economic eligibility determination in order to claim a credit for wages paid or incurred after December 31, 1981. If a certification issued by a school after August 13, 1984, does not contain an economic eligibility determination and the employer wishes to claim a credit for wages paid or incurred after December 31, 1981, the employer must receive a completed certification before the date on which the credit is claimed.

(5) *Eligible work incentive employees.* In the case of eligible work incentive employees, the employer must either receive, or request in writing, a certification within the time requirements of paragraph (d) (1), (2), or (3) of this section, whichever is applicable. Before October 12, 1981 (the date the Economic Recovery Tax Act of 1981 codified the State employment security agency as the designated local agency for certifying targeted groups), a certificate may be received or requested in writing from either the designated local agency (as defined in paragraph (d)(10) of this section) or the office or agency that properly issued certifications under former section 50B(h)(1) (relating to the work incentive credit).

(6) *Certifications that are not timely.* Any certification that is not timely received or requested by the employer in accordance with the rules of this paragraph will be treated as invalid. Thus, the employer will not be allowed to claim a credit under section 51 with respect to any wages paid or incurred to an employee whose certification or request for certification is not timely. A timely request for certification does not eliminate the need for the employer to receive a certification before claiming the credit. In the case of a request for certification that was denied, resubmitted, and then approved, the timeliness of the request shall be determined by the timeliness of the first request.

(7) *Incorrect certification*—(i) *In general.* Except as otherwise provided in paragraph (d)(7)(ii) of this section, if an individual has been certified as a member of a targeted group, and such certification is based on false information provided by such individual, the certification shall be revoked and wages paid by the employer after the date on

which notice of revocation is received by the employer shall not be treated as qualified wages. For purposes of this paragraph, a certification will be revoked only if the individual would not have been certified had correct information been provided to the issuer of the certification. Thus, false information that is not material to an individual's eligibility as a member of a targeted group will not invalidate an otherwise valid certification.

(ii) *Employer's knowledge that the certification was incorrect.* In the case of an employer who knew, or had reason to know, at the time of certification that the information provided to the designated local agency was false, none of the wages paid by such employer to an individual to whom an incorrect certification has been issued will be qualified wages.

(8) *Certifications issued to certain rehires.* This paragraph (d)(8) applies in the case of an employee who first began work for the employer before August 13, 1981, and was dismissed and rehired by the employer. A certification received or requested by an employer with respect to such an employee will be considered timely only if there was a valid business reason, unrelated to the availability of the credit, for the dismissal and rehire and if the employer did not dismiss and then rehire the employee in order to meet the timing requirement with respect to certification. An individual who is dismissed and then rehired for the purpose described in the preceding sentence will be considered for purposes of section 51(d)(16) and this paragraph to have been continuously employed by the employer during the time between the dismissal and the rehire. Whether the employer was motivated by reason of the certification rules in section 51(d)(16) and this paragraph to dismiss and then rehire an employee is a question of fact to be determined from all the circumstances surrounding the dismissal and rehire. (See paragraph (e)(2) of this section for a separate rule disallowing the credit in the case of nonqualifying rehires.)

(9) *Individuals who continue to be employed by the same employer but as a member of another targeted group.* This paragraph (d)(9) applies in the case of an employee who continues to be employed by the same employer but no longer qualifies as a member of the targeted group for which such employee was first certified (*e.g.*, the employee was orginally certified as a qualified summer youth employee with respect to a ninety-day period between May 1 and September 15, but such ninety-day period has ended). In such case, the employer may request a certification that the employee is a member of another targeted group, and if any wages paid to such individual are qualified first-year wages or qualified second-year wages, the employer may be entitled to a targeted jobs credit with respect to such wages. The second certification will not be invalid merely because it was requested or received after the individual began work for the employer; only the first certification (for example, the certification with respect to an individual hired first as a qualified summer youth employee) must meet the requirement of section 51(d)(16) that a certification must be requested or received by an employer on or before the day on which the individual begins work for the employer. In the case of a former qualified summer youth employee or a youth participating in a qualified cooperative education program who is recertified as an economically disadvantaged youth, the term ''hiring date'' in section 51(d)(3)(B) does not mean the day the individual is hired by the employer but means the day the individual is certified as a member of the new targeted group. Accordingly, the age requirement of section 51(d)(3)(B) shall be applied as of the day the individual is certified as a member of the second targeted group. In addition, see section 51(d)(11) for rules concerning the viability of the original economic eligibility determination.

(10) *Certification where a trade or business has been transferred to a new employer.* In the case of a transfer of a trade or business in which an individual who is a member of a targeted group is retained as an employee in the trade or business, the certification obtained for such employee by the transferor-employer will apply with respect to the transferee-employer.

(11) *Designated local agency*—(i) *In general.* For the period before October 12, 1981, the term ''designated local agency'' means the agency for any locality designated jointly by the Secretary and the Secretary of Labor to perform certifications of employees for employers in that locality. On or after October 12, 1981, the term ''designated local agency'' means a State employment security agency established in accordance with the Act of June 6, 1933, as amended (29 U.S.C. 49 through 49n).

(ii) *Jurisdiction.* The designated local agency is the agency that has, pursuant to its charter, jurisdiction over the individual that is sought to be certified. Thus, any certification that is issued with respect to an individual who is not within the jurisdiction of the designated local agency that issued the certification will be invalid. Notwithstanding any other provision of this section, a request in writing for certification to the appropriate designated local agency that is made before January 23, 1984, will be considered to be timely if it is made after an otherwise timely request in writing for certification was made to a designated local agency that does not have jurisdiction over the individual sought to be certified.

(e) *Certain ineligible individuals*—(1) *Related individuals.* For purposes of section 51(a), ''qualified wages'' does not include any amounts paid or incurred by a taxpayer to any of the following individuals:

(i) An individual who is related (within the meaning of any of paragraphs (1) through (8) of section 152 (a)) to the taxpayer;

(ii) An individual who is a dependent (within the meaning of section 152(a)(9)) of the taxpayer;

(iii) An individual who is related (within the meaning of any of paragraphs (1) through (8) of section 152(a)) to a shareholder who owns (within the meaning of section 267(c)) more than 50 percent in value of the outstanding stock of the taypayer, if the taxpayer is a corporation;

(iv) An individual who is a dependent (within the meaning of section 152(a)(9)) of a shareholder described in paragraph (e)(1)(iii) of this section;

(v) An individual who is a grantor, beneficiary or fiduciary of the taxpayer, if the taxpayer is an estate or trust;

(vi) An individual who is a dependent (within the meaning of section 152(a)(9)) of an individual described in paragraph (e)(1)(v) of this section; or

(vii) An individual who is related (within the meaning of any of paragraphs (1) through (8) of section 152(a)) to an individual described in paragraph (e)(1)(v) of this section.

(2) *Nonqualifying rehires.* For purposes of section 51(a), ''qualified wages'' does not include wages paid to an employee who had been employed by the employer prior to the current hiring date of the employee if at any time during such prior employment the employee was not a member of a targeted group. The preceding sentence shall not apply to an employee who was previously timely certified as a member of a targeted group with respect to the same employer. An employee shall be treated as not having been a member of a targeted group if the certification requirements of section 51(d)(16) were not met. (See example 8 in paragraph (j) of this section.)

(3) *Effective date.* The provisions of this paragraph (e) are effective with respect to employees first beginning work for an employer after August 13, 1981.

(f) *Limitations*—(1) *Limitation on qualified first-year wages.* With respect to taxable years beginning before January 1, 1982, the amount of the qualified first-year wages which may be taken into account for purposes of the targeted jobs credit for any taxable year shall not exceed 30 percent of the aggregate unemployment insurance wages paid by the employer during the calendar year ending in such taxable year. In the case of a group of trades or businesses under common control (as defined in § 1.52–1(b)), the qualified first-year wages cannot exceed 30 percent of the aggregate unemployment insurance wages paid to all employees of that group of trades or businesses under common control during the calendar year ending in such taxable year. For this purpose, the term ''unemployment insurance wages'' has the same meaning given to the term ''wages'' as defined in §1.51–1(b)(4). In this case of agricultural or railway labor, see section 51(h)(1) for the applicable definition of unemployment insurance wages. (See examples 13 and 14 in paragraph (j) of this section.)

(2) *Remuneration must be for trade or business employment.* Remuneration paid by an employer to an employee during any taxable year shall be taken into account only if more than one-half of the remuneration paid by the employer to an employee is for services in a trade or business of the employer. This determination shall be made by each employer without regard to section 52 (a) or (b). Accordingly, employees of corporations that are members of a controlled group or employees of partnerships, proprietorships, and other trades or businesses (whether or not incorporated) which are under common control will be treated as being employed by each separate employer for this purpose. For this purpose, the term ''year'' means the taxable year of the employer. (See example 15 in paragraph (j) of this section.)

(g) *Election not to claim the targeted jobs credit.* The election under section 51(j) (as amended by section 474(p) of the Tax Reform Act of 1984) not to claim the targeted jobs credit is available for taxable years beginning after December 31, 1983, and shall be made for the taxable year in which such credit is available by not claiming such credit on an original return or amended return at any time before the expiration of the 3-year period beginning on the last date prescribed by law for filing the return for the taxable year (determined without regard to extensions). The election may be revoked within the 3-year period by filing an amended return on which the credit is claimed.

(h) *Treatment of successor-employers.* In the case of a successor-employer referred to in section 3306(b)(1), the determination of the amount of credit under this section with respect to wages paid by such successor-employer shall be made in the same manner as if such wages were paid by the predecessor-employer referred to in such section. Thus, the 1-year period referred to in §1.51–1(b)(2)(i) will be considered to begin with the day the employee first began work for the transferor-employer, and the amount of qualified first-year wages and qualified second-year wages paid or incurred with respect to the employee must be reduced by the amount of any such wages paid or incurred by the transferor-employer. (See examples 10 and 11 in paragraph (j) of this section.) Also, see paragraph (d)(10) of this section for rules concerning the viability of the employee's certification.

(i) *Treatment of employees performing services for other persons.* No credit shall be determined under this section with respect to remuneration paid by an employer to an employee for services performed by such employee for another person unless the amount reasonably expected to be received by the employer for such services from such other person exceeds the remuneration paid by the employer to such employee for such services.

(j) *Examples.* The application of this section may be illustrated by the following examples which, except as otherwise stated, assume that the limitations imposed by §§1.51–1(f)(2) and 1.53–3 are inapplicable:

Example 1. Corporation M is a calendar year, cash receipts and disbursements method taxpayer. A, an economically disadvantaged youth, first began work for Corporation M on October 1, 1978. Qualified first-year wages with respect to A are wages attributable to the period beginning on January 1, 1979 (since A was first hired after September 26, 1978, he is treated as having begun work on January 1, 1979) and ending on December 31, 1979. In the 1979 taxable year, Corporation M pays A $5,000 of qualified first-year wages attributable to services performed in 1979. Corporation M's allowable credit is equal to $2,500 (50 percent of $5,000).

Example 2. Assume the same facts as in example 1, except that in 1980 Corporation M pays to A $100 of wages attributable to services rendered in 1979. These wages will still be considered as qualified first-year wages, but the credit may not be claimed until the 1980 taxable year.

Example 3. Corporation O is a calendar year, cash receipts and disbursements method taxpayer. C, a vocational rehabilitation referral, first began work for Corporation O on July 1, 1978. Corporation O claimed a credit under section 44B (as in effect prior to enactment of the Revenue Act of 1978) for $3,000 of wages paid to C in the 1978 taxable year. Corporation O paid C $6,000 for services performed from January 1, 1979 to June 30, 1979. The period during which qualified first-year wages are determined begins on July 1, 1978, and ends on June 30, 1979. Amounts paid before January 1, 1979, however, are not taken into consideration in determining the amount of qualified first-year wages. Accordingly, only the wages attributable to services performed from January 1, 1979, through June 30, 1979, are considered as qualified first-year wages. Corporation O's allowable credit is equal to $3,000 (50 percent of $6,000).

Example 4. I first began work for Corporation Q, a cash receipts and disbursements method taxpayer, on January 1, 1981, and was not a member of a targeted group. On March 1, 1981, I was convicted of a felony and sentenced to prison. I quit working for Corporation Q, and served the prison sentence. On November 1, 1981, I again was hired by Corporation Q and began work on that date. On the November 1, 1981 hiring date, I was an economically disadvantaged ex-convict for whom Corporation Q received a certificate. Corporation Q paid I $500 of wages for services performed from November 1, 1981, to December 31, 1981, and $6,000 of wages for services performed during 1982. The $500 of wages paid for services performed from November 1, 1981, to December 31, 1981, would be qualified first-year wages because these qualified wages were paid for services performed during the 1-year period beginning on the date I first began work for Corporation Q (January 1, 1981). The $6,000 of wages paid for services performed during 1982 would be qualified second-year wages because these qualified wages were paid for services performed during the 1-year period beginning on the day after the first 1-year period. Accordingly, Corporation Q has an allowable credit of $250 attributable to qualified first-year wages and $1,500 attributable to qualified second-year wages.

Example 5. Assume the same facts as in example 4, except that all dates are 1 year later. Thus, I first began work for Corporation Q on January 1, 1982, was convicted on March 1, 1982, and was rehired on November 1, 1982. Under these facts, Q is not entitled to take a targeted jobs credit with respect to I's wages because I is a nonqualifying rehire.

Example 6. J, an economically disadvantaged youth, first began work for Corporation R, a calendar year cash receipts and disbursements method taxpayer, on December 1, 1979. On July 1, 1980, J was laid off by Corporation R and began work for Corporation S, which is unrelated to Corporation R, on July 2, 1980. On November 1, 1980, J again began work for Corporation R and continued working for Corporation R until January 1, 1982. At the time J first began work for Corporation S, J no longer met the qualifications of an economically disadvantaged youth. Corporation S may not claim a credit for wages paid to J because J was not a member of a targeted group at the time he began work for Corporation S. Corporation R, however, may claim a credit for wages paid to J because J was a member of a targeted group when he was hired by Corporation R. Corporation R's qualified first-year wages paid to J are the wages paid for services performed by J from December 1, 1979, to July 1, 1980, and from November 1, 1980, to November 30, 1980. Corporation R's qualified second-year wages paid to J are wages paid for services performed by J from December 1, 1980, to November 30, 1981. Corporation R may not claim a credit for wages paid for services performed by J after November 30, 1981.

Example 7. K, a member of a targeted group, first began work for Corporation T on January 1, 1979. For the pay periods from January 1, 1979, to March 31, 1979, Corporation T received federally funded payments for on-the-job training for K and paid wages of $2,000 to K. During the remainder of 1979 Corporation T paid wages of $7,000 to K. Corporation T may claim a credit on $6,000 of qualified first-year wages. Amounts paid to K by Corporation T during the pay periods for which Corporation T received federally funded payments for on-the-job training for K are not considered wages for purposes of the credit. However, Corporation T may consider $6,000 of the total $7,000 of wages paid after March 31, 1979, as qualified first-year wages.

Example 8. P first began work for Corporation X on January 1, 1981, as an individual who was certified to be an eligible employee for purposes of the WIN credit provided in section 40. Corporation X paid P $6,000 of wages during its taxable year beginning on January 1, 1981, and $6,000 of wages during its taxable year beginning on January 1, 1982. X can claim a targeted jobs credit for the wages paid in 1982 if the requirements of section 51 are met. For purposes of section 51 (a), P's qualified first-year wages are the wages paid from January 1, 1981, to December 31, 1981, and P's qualified second-year wages are the wages paid from January 1, 1982, to December 31, 1982. Thus, Corporation X is only entitled to claim a targeted job credit based on P's qualified second-year wages.

Example 9. (i) L, 15 years of age, first began work for Corporation U on August 1, 1979. On September 3, 1979, L began her junior year in high school and enrolled in a qualified cooperative education program that was to run for her junior and senior years. On October 1, 1979, when L turned 16, she met all the requirements of § 1.51–1(c)(2)(i) and qualified as a youth participating in a qualified cooperative education program. Corporation U is entitled to claim a credit on wages paid or incurred for services performed by L after September 30, 1979, so long as L meets the requisite requirements. L's summer vacation began on June 1, 1980. Assume that the cooperative education program L was enrolled in did not continue during the summer vacation (*i.e.*, the written agreement between the employer and the school did not cover the summer vacation). Thus, during her summer vacation, L did not meet the requirement of actively pursuing a qualified cooperative education program. Accordingly, Corporation U may not claim a credit on wages paid for services performed by L during L's summer vacation. On September 2, 1980, L began her senior year, and again met all the requirements of §1.51–1(c)(2)(i). She continued to meet these requirements until June 5, 1981, when she graduated from high school. Accordingly, Corporation U may claim a credit on wages paid for services performed after September 1, 1980, and before June 5, 1981.

(ii) Assume the same facts as in (i), above, except that all dates are 3 years later. Under these facts, U is not entitled to claim a targeted jobs credit with respect to any of L's wages because L has not been timely certified under section 51(d)(16) and §1.51–1(d)(3).

Example 10. D began work for a drugstore owned by E as a sole proprietor on January 1, 1979, and was certified as a member of a targeted group with respect to E. On June 1, 1979, E sold the drugstore where D worked to F, who continued to operate the drugstore with D as an employee. D's qualification as a member of a targeted group is not required to be redetermined in order for F to qualify for the targeted jobs credit. F will take into account the certification of D's eligibility that was provided to E. F will have qualified first-year wages consisting of the first $6,000 of wages paid or incurred to D by E and F from January 1, 1979 to December 31, 1979 (reduced by any qualified wages paid or incurred by E to D from January 1, 1979, to May 31, 1979). F's qualified second-year wages will consist of the first $6,000 of wages paid or incurred to D by F from January 1, 1980, to December 31, 1980.

Example 11. G began work in a machine shop owned by H as a sole proprietor on January 1, 1979, and was certified as a member of a targeted group with respect to H. On June 1, 1980, H transferred all the assets of the machine shop to newly formed Corporation P. Corporation P retained G as an employee in the machine shop. G's qualification as a member of a targeted group is not required to be redetermined in order for P to qualify for the targeted jobs credit. H has qualified first-year wages in the amount of the first $6,000 of wages paid or incurred to G by H from January 1, 1979, to December 31, 1979. Corporation P has qualified second-year wages in the amount of the first $6,000 of wages paid or incurred to G by H and Corporation P from January 1, 1980, to December 31, 1980 (reduced by any qualified second-year wages paid by H to G).

Example 12. W operates a retail store as a sole proprietor. On June 1, 1982, W hires S after receiving a written determination from a local community organization that S meets the requirements of an economically disadvantaged youth. W does not request a certification from the State employment security agency as to S's eligibility. W is not entitled to claim a credit with respect to wages paid to S because W did not receive, or request in writing, a certification from the State employment security agency as to S's eligibility on or before the day on which S began work for W.

Example 13. Corporation V is a cash receipts and disbursements method taxpayer with a July 1 through June 30 taxable year. In the taxable year ending June 30, 1980, the aggregate unemployment insurance wages paid by V were $150,000. In calendar year 1979 the aggregate unemployment insurance wages paid by Corporation V were $110,000. Corporation V's qualified first-year wages are limited to 30 percent of the aggregate unemployment insurance wages paid by it in calendar year 1979 or $33,000 (30 percent of $110,000), even though the aggregate unemployment insurance wages paid by it in the taxable year ending June 30, 1980, were $150,000.

Example 14. Assume the same facts as in example 13, except that all dates are 3 years later. Since the limitation on qualified first-year wages does not apply to taxable years beginning after December 31, 1981, Corporation V's qualified first-year wages are $150,000.

Example 15. M operates a retail store as a sole proprietor. N and O, both members of a targeted group, first began work for M on January 1, 1979. M paid N total qualified first-year wages of $6,000 in 1979. Three thousand one hundred dollars of those wages were for services in M's retail store, and $2,900 of those wages were for services as M's maid. M paid O total qualified first-year wages of $6,000 in 1979. Three thousand dollars of those wages were for services in M's store and $3,000 of those wages were for services as M's chauffeur. M has an allowable credit of $3,000 in 1979 on all $6,000 of qualified first-year wages paid to N because more than one-half of the remuneration paid by M to N was for services in M's trade or business. M may not take into account the wages paid to O because not more than one-half of the remuneration paid by M to O was for services in

M's trade or business. Acordingly, M may not claim a credit on wages paid to O.

[T.D. 8062, 50 FR 45998, Nov. 6, 1985]

TAX SURCHARGE

§ 1.52–1 Trades or businesses that are under common control.

(a) *Apportionment of jobs credit among members of a group of trades or businesses that are under common control*—(1) *Targeted jobs credit.* (i) In the case of a group of trades or businesses that are under common control (within the meaning of paragraph (b) of this section) at any time during the calendar year, the amount of the targeted jobs credit (computed under section 51 as if all the organizations that are under common control are one trade or business) under section 4–1B must be apportioned among the members of the group on the basis of each member's proportionate share of the wages giving rise to such credit. If the group of trades or businesses that are under common control have different taxable years, the credit shall be computed as if all the organizations have the same taxable year as the organization for which a determination of the proportionate share of the credit is being made. For taxable years beginning before January 1, 1982, the amount of the qualified first-year wages cannot exceed 30 percent of the aggregate unemployment insurance wages paid by the group of trades or businesses under common control during the calendar year ending in the taxable year of the organization for which a determination of the proportionate share of the credit is being made. The limitations in section 53 and the regulations thereunder apply to each organization individually (although, in applying these limitations, an affiliated group of corporations electing to make a consolidated return shall be treated as one organization).

(ii) The application of the subparagraph may be illustrated by the following examples:

Example 1. (a) Corporation M and its three subsidiaries, Corporations N, O, and P, are a group of businesses that are under common control and each uses the cash receipts and disbursements method of accounting and has a calendar year taxable year. Corporations M, N, O, and P paid out the following amounts in unemployment insurance wages, qualified first-year wages and qualified second-year wages during 1980.

	Unemployment insurance wages	Qualified 1st-Year wages	Qualified 2d-year wages
Corporation:			
M	$600,000	$184,000	$75,000
N	300,000	85,000	90,000
O	360,000	120,000	115,000
P	24,000	24,000	0
Total	1,284,000	413,000	280,000

(b) Since Corporations M, N, O, and P are under common control, the amount of qualified first-year wages paid by the group is limited to 30 percent of the aggregate unemployment insurance wages paid by the group in the calendar year ending in the group's taxable year. Since the qualified first-year wages of $413,000 exceeds 30% of the aggregate unemployment insurance wages, the group is limited to qualified first-year wages of $385,200 (30% of $1,284,000). The amount of the targeted jobs credit attributable to qualified first-year wages is equal to $192,600 (50% of $385,200). The amount of the credit attributable to qualified second-year wages is equal to $70,000 (25% of $280,000).

(c) The credit is apportioned among Corporations M, N, O, and P on the basis of their proportionate share of the qualified first-year wages or qualified second-year wages giving rise to the credit. Each corporation's share of the credit attributable to qualified first-year wages would be computed as follows:

Corporation: Amount of credit

$$\text{M} \ldots\ \$192{,}600 \times \frac{\$184{,}000}{\$413{,}000} = \$85{,}807.26$$

$$\text{N} \ldots\ \$192{,}600 \times \frac{\$85{,}000}{\$413{,}000} = \$39{,}639.23$$

$$\text{O} \ldots\ \$192{,}600 \times \frac{\$120{,}000}{\$413{,}000} = \$55{,}961.26$$

$$\text{P} \ldots\ \$192{,}600 \times \frac{\$24{,}000}{\$413{,}000} = \$11{,}192.25$$

Each corporation's share of the credit attributable to qualified second-year wages is computed as follows:

Corporation:	Amount of credit
M .... $\$70{,}000\times\frac{\$75{,}000}{\$280{,}000}=$	$18,750
N .... $\$70{,}000\times\frac{\$90{,}000}{\$280{,}000}=$	$22,500
O .... $\$70{,}000\times\frac{\$115{,}000}{\$280{,}000}=$	$28,750
P .... $\$70{,}000\times\frac{0}{\$280{,}000}=$	0

Example 2. Assume the facts in example 1 with these additional facts. A, a member of a targeted group, worked for more than one of the members of the controlled group in the taxable year. A first began work for Corporation M on January 1, 1980, and later worked for Corporations N and O during 1980. For services rendered by A during 1980, the following wages were paid to A: Corporation M paid A $2,500 of qualified first-year wages: Corporation N paid A $1,500 of qualified first-year wages; Corporation O paid A $3,000 of qualified first-year wages. Corporations M, N, and O paid A a total of $7,000 of wages during 1980. Only $6,000 of qualified first-year wages per year per employee may be taken into account for purposes of the credit. See §1.51–1(d)(1). Since Corporations M, N, and O are treated as a single employer under section 52(a), the maximum $6,000 of qualified first-year wages paid A by the group must be apportioned among Corporations M, N, and O as follows:

Corporation:	Qualified 1st year wages
M .... $\$6{,}000\times\frac{\$2{,}500}{\$7{,}000}=$	$2,142.86
N .... $\$6{,}000\times\frac{\$1{,}500}{\$7{,}000}=$	$1,285.71
O .... $\$6{,}000\times\frac{\$3{,}000}{\$7{,}000}=$	$2,571.43

Example 3. (a) Corporation Q and its two subsidiaries, Corporations R and S, are a group of businesses that are under common control and each uses the cash receipts and disbursements method of accounting. Corporation Q has a calendar year taxable year. Corporation R has a July 1 through June 30 taxable year. Corporation S has an October 1 through September 30 taxable year. For purposes of determining Corporation R's proportionate share of the credit, the credit is computed as if Corporations Q and S have the same taxable year as Corporation R. Accordingly, Corporation R would compute its share of the credit for its 1979–1980 taxable year as set forth below.

	Unemployment insurance wages, 1979	Qualified wages paid from July 1, 1979, to June 30, 1980	
		1st year wages	2d year wages
Corporation:			
Q	$500,000	$150,000	$80,000
R	300,000	110,000	50,000
S	100,000	25,000	10,000
Total	900,000	285,000	140,000

(b) Since Corporations Q, R, and S are under common control, the amount of qualified first-year wages is limited to 30 percent of the aggregate unemployment insurance wages paid by the group during the calendar year ending in Corporation R's taxable year. Since the qualified first-year wages of $285,000 exceeds 30 percent of the aggregate unemployment insurance wages, the group is limited to qualified first-year wages of $270,000 (30% of $900,000). The amount of the targeted jobs credit attributable to qualified first-year wages paid by members of the group during the period of the taxpayer's taxable year is $135,000 (50% of $270,000). The amount of the credit attributable to qualified second-year wages paid or incurred by members of the group during the period of the taxpayer's taxable year is $35,000 (25% of $140,000).

(c) The credit is apportioned to Corporation R on the basis of its proportionate share of the qualified first-year wages and qualified second-year wages giving rise to the credit. Corporation R's share of the credit attributable to qualified first-year wages is $52,105.26

$$\$135{,}000\times\frac{\$110{,}000}{\$285{,}000}$$

Corporation R's share of the credit attributable to qualified second-year wages is $12,500

$$\$35{,}000\times\frac{\$50{,}000}{\$140{,}000}$$

Corporation R's share of the credit for its 1979–1980 taxable year is $64,605.26 ($52,105.26+$12,500).

(2) *New jobs credit.* In the case of a group of trades or businesses that are under common control at any time during the calendar year, the amount

of the new jobs credit (computed under section 51 as if all the organizations that are under common control are one trade or business) under section 44B (as in effect prior to enactment of the Revenue Act of 1978) must be apportioned among the members of the group on the basis of each member's proportionate contribution to the increase in unemployment insurance wages for the entire group. The limitations in section 53 (as in effect prior to enactment of the Revenue Act of 1978) and the regulations thereunder apply to each organization individually (although, in applying these limitations, an affiliated group of corporations electing to make a consolidated return shall be treated as one organization). The application of this subparagraph may be illustrated by the following example:

Example. (a) Corporation T and its three subsidiaries, U, V, and W, are a group of businesses that are under common control and each has a calendar year taxable year. Corporations T, U, V, and W have paid out the following amounts in unemployment insurance wages during 1976 and 1977:

	1976	1977	Increase in FUTA wages in 1977 over 1976
Corporation.			
T	$1,000,000	$1,015,000	+$15,000
U	500,000	650,000	+150,000
V	600,000	580,000	−20,000
W	40,000	100,000	+60,000
Total	2,140,000	2,345,000	205,000

(b) Since all employees of trades or, businesses that are under common control are treated as employed by a single employer, the computations in section 51 are performed as if all the organizations which are under common control are one trade or business. Consequently, the amounts of the total unemployment insurance wages of the group in 1976 (*i.e.,* $2,140,000) and 1977 (*i.e.,* $2,345,000) are used to determine the increase in unemployment insurance wages in 1977 over the 1976 wage base. Since the amount equal to 102 percent of the 1976 unemployment insurance wages ($2,182,800) is greater than the amount equal to 50 percent of the 1977 unemployment insurance wages ($1,172,500), the increase in unemployment insurance wages in 1977 over the 1976 wage base is $162,200 ($2,345,000–$2,182,800). The limitations in section 51(c), (d), and (g) (as in effect prior to enactment of the Revenue Act of 1978) must also be computed as though all the organizations under common control are one trade or business. For purposes of this example, it is assumed that none of those limitations reduce the amount of increase in unemployment insurance wages. As a result, the amount of the new jobs credit allowed to the group of business is $81,100 (50% of $162,200).

(c) The credit is apportioned among Corporations T, U, and W on the basis of their proportionate contributions to the increase in unemployment insurance wages. No credit would be allowed to Corporation V because it did not contribute to the increase in the group's unemployment insurance wages. Corporation T's share of the credit would be $5,406.66 ($81,100×($15,000÷$225,000 (*i.e.,* $15,000+$150,000+$60,000))), Corporation U's share would be $54,066.67 ($81,100×($150,000÷225,000)), and Corporation W's share would be $21,626.67 ($81,100×($60,000÷$225,000)).

(b) *Trades or businesses that are under common control.* For purposes of this section, the term ''trades or businesses that are under common control'' means any group of trades or businesses that is either a ''parent-subsidiary group under common control'' as defined in paragraph (c) of this section, a ''brother-sister group under common control'' as defined in paragraph (d) of this section, or a ''combined group under common control'' as defined in paragraph (e) of this section. For purposes of this section and §§ 1.52–2 and 1.52–3, the term ''organization'' means a sole proprietorship, a partnership, a trust, an estate, or a corporation. An organization may be a member of only one group of trades or businesses under common control. If, without the application of this paragraph, an organization would be a member of more than one such group, that organization shall indicate in its timely filed return the group in which it is being included. If the organization does not so indicate, then the district director with audit jurisdiction of the organization's return will determine the group in which the organization is to be included.

(c) *Parent-subsidiary group under common control*—(1) *In general.* The term ''parent-subsidiary group under common control'' means one or more chains of organizations conducting trades or businesses that are connected through ownership of a controlling interest with a common parent organization if—

(i) A controlling interest in each of the organizations, except the common parent organization, is owned (directly and with the application of §1.414(c)–4(b)(1), relating to options) by one or more of the other organizations; and

(ii) The common parent organization owns (directly and with the application of §1.414(c)–4(b)(1), relating to options) a controlling interest in at least one of the other organizations, excluding, in computing the controlling interest, any direct ownership interest by the other organizations.

(2) *Controlling interest defined.* For purposes of this paragraph, the term ''controlling interest'' means:

(i) In the case of a corporation, ownership of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of the shares of all classes of stock of the corporation;

(ii) In the case of a trust or estate, ownership of an actuarial interest (determined under paragraph (f) of this section) of more than 50 percent of the trust or estate;

(iii) In the case of a partnership, ownership of more than 50 percent of the profit interest or capital interest of the partnership; and

(iv) In the case of a sole proprietorship, ownership of the sole proprietorship.

(d) *Brother-sister group under common control*—(1) *In general.* The term ''brother-sister group under common control'' means two or more organizations conducting trades or businesses if—

(i) The same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of §1.414(c)–4(b)(1)), a controlling interest of each organization; and

(ii) Taking into account the ownership of each person only to the extent that person's ownership is identical with respect to each organization, such persons are in effective control of each organization.

The five or fewer persons whose ownership is considered for purposes of the controlling interest requirement for each organization must be the same persons whose ownership is considered for purposes of the effective control requirement.

(2) *Controlling interest defined.* For purposes of this paragraph, the term ''controlling interest'' means:

(i) In the case of a corporation, ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of the shares of all classes of stock of the corporation;

(ii) In case of a trust or estate, ownership of an actuarial interest (determined under paragraph (f) of this section) of a least 80 percent of the trust or estate;

(iii) In the case of a partnership, ownership of at least 80 percent of the profit interest or capital interest of the partnership; and

(iv) In the case of a sole proprietorship, ownership of the sole proprietorship.

(3) *Effective control defined.* For purposes of this paragraph ''effective control'' means:

(i) In the case of a corporation, ownership of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of the shares of all classes of stock of the corporation;

(ii) In the case of a trust or estate, ownership of an actuarial interest (determined under paragraph (f) of this section) of more than 50 percent of the trust or estate;

(iii) In the case of a partnership, ownership of more than 50 percent of the profit interest or capital interest of the partnership; and

(iv) In the case of a sole proprietorship, ownership of the sole proprietorship.

(e) *Combined group under common control.* The term ''combined group under common control'' means a group of three or more organizations, in which (1) each organization is a member of either a parent-subsidiary group under common control or brother-sister group under common control, and (2) at least one organization is the common parent organization of a parent-subsidiary group under common control and also a member of a brother-sister group under common control.

(f) *Actuarial interest.* For purposes of this section, the actuarial interest of each beneficiary of a trust or estate shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of the beneficiary. The factors and method prescribed in § 20.2031–7 or, for certain prior periods, 20.2031–7A of this chapter (Estate Tax Regulations) for use in ascertaining the value of an interest in property for estate tax purposes will be used to determine a beneficiary's actuarial interest.

(g) *Exclusion of certain interests and stock in determining control.* In determining control under this paragraph, the term ''interest'' and the term ''stock'' do not include an interest that is treated as not outstanding under § 1.414(c)–3. In addition, the term ''stock'' does not include treasury stock or nonvoting stock that is limited and preferred regarding dividends.

(h) *Transitional rule*—(1) *In general.* Paragraph (d) of this section, as amended by T.D. 8179, applies to all taxable years to which section 52(b) applies.

(2) *Election.* In the case of taxable years ending before March 2, 1988.

(i) If, pursuant to paragraph (b) of this section, an organization indicated in a timely filed return that it chose to be a member of a brother-sister group under common control, and it is not a member of such group because of the amendments to paragraph (d) of this section made by T.D. 8179 such organization may make the choice described in paragraph (b) of this section by filing an amended return on or before September 2, 1988 if such organization would otherwise still be a member of more than one group of trades or businesses under common control, and

(ii) If an organization—

(A) Is a member of a brother-sister group of trades or businesses under common control under § 1.52–1(d)(1) as in effect before amendment by T.D. 8179 (''old group''), for such taxable year, and

(B) Is not such a member for such taxable year because of the amendments made by such Treasury decision,

such organization (whether or not a corporation) nevertheless will be treated as a member of such old group if all the organizations (whether or not corporations) that are members of the old group meet all the requirements of § 1.1563–1(d)(3) with respect to such taxable year.

(Secs. 44B, 381, and 7805 of the Internal Revenue Code of 1954 (92 Stat. 2834, 26 U.S.C. 44B); 91 Stat. 148, 26 U.S.C. 381(c)(26); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7553, 43 FR 31322, July 21, 1978, as amended by T.D. 7921, 48 FR 52904, Nov. 23, 1983; T.D. 7955, 49 FR 19975, May 11, 1984; T.D. 8179, 53 FR 6605, Mar. 2, 1988; 53 FR 8302, Mar. 14, 1988; 53 FR 16408, May 9, 1988; T.D. 8540, 59 FR 30102, June 10, 1994]

§ 1.52–2 Adjustments for acquisitions and dispositions.

(a) *General rule.* The provisions in this section only apply to the computation of the new jobs credit. If, after December 31, 1975, an employer acquires the major portion of a trade or business or the major portion of a separate unit of a trade or business, then, for purposes of computing the new jobs credit for any calendar year ending after the acquisition, both the amount of unemployment insurance wages and the amount of total wages considered to have been paid by the acquiring employer, for both the year in which the acquisition occurred and the preceding year, must be increased, respectively, by the amount of unemployment insurance wages and the amount of total wages paid by the predecessor employer that are attributable to the acquired portion of the trade or business or separate unit. If the predecessor employer informs the acquiring employer in writing of the amount of unemployment insurance wages and the amount of total wages attributable to the acquired portion of the trade or business that have been paid during the periods preceding the acquisition, then, for purposes of computing the credit for any calendar year ending after the acquisition the amount of unemployment insurance wages and the amount of total wages considered paid by the predecessor employer shall be decreased by those amounts. Regardless of whether the predecessor employer so informs the acquiring employer, the predecessor employer shall not be allowed a credit for the amount of any increase in the employment insurance wages or the total wages in the calendar year of the acquisition attributable to the acquired portion of the trade or business over the amount of such wages in the calendar year preceding the acquisition.

(b) *Meaning of terms*—(1) *Acquisition*. (i) For the purposes of this section, the term ‘‘acquisition’’ includes a lease agreement if the effect of the lease is to transfer the major portion of the trade or business or of a separate unit of the trade or business for the period of the lease. For instance, if one company leases a factory (including equipment) to another company for a 2-year period, the employees are retained by the second company, and the factory is used for the same general purposes as before, then for purposes of this section the lessee has acquired the lessor's trade or business for the period of the lease.

(ii) Neither the major portion of a trade or business nor the major portion of a separate unit of a trade or business is acquired merely by acquiring physical assets. The acquisition must transfer a viable trade or business.

(iii) Subdivision (ii) of this subparagraph may be illustrated by the following examples:

Example 1. R Co., a restaurant, sells its building and all its restaurant equipment to S Co. and moves into a larger, more modern building across the street. R Co. purchases new equipment, retains its name and continues to operate as a restaurant. S Co. opens a new restaurant in the old R Co. building. S Co. has merely acquired the old R Co. assets; it has not acquired any portion of R Co.'s business.

Example 2. The facts are the same as in *Example 1,* except that R Co. also sells its name and goodwill to S Co. and ceases to operate a restaurant business. S Co. operates its restaurant using the old R Co. name. In this situation, S Co. has acquired R Co.'s business.

(2) *Separate unit.* (i) A separate unit is a segment of a trade or business capable of operating as a self-sustaining enterprise with minor adjustments. The allocation of a portion of the goodwill of a trade or business to one of its segments is a strong indication that that segment is a separate unit.

(ii) The following examples are illustrations of the acquisition of a separate unit of a trade or business:

Example 1. The M Corp., which has been engaged in the sale and repair of boats, leases the repair shop building and all the property used in its boat repair operations to the N Co. for four years and gives the N Co. a covenant not to compete in the boat repair business for the period of the lease. The N Co. is considered to have acquired a separate unit of M Corp.'s business for the period of the lease.

Example 2. (a) The P Co. is engaged in the operation of a chain of department stores. There are eight divisions, each division is located in a different metropolitan area of the country, and each division operates under a different name. Although certain buying and merchandising functions are centralized, each division's day-to-day operations are independent of the others. The Q Corp. acquires all of the physical and intangible assets of one of the divisions, including the division's name. Other than making those minor adjustments necessary to give the division buying and merchandising departments, the Q Corp. allows the division to continue doing business in the same manner as it had been operating prior to the acquisition. The Q Corp. has acquired a separate unit of the P Co.'s business.

(b) The facts are the same as in paragraph (a) of example 2, except that Q Corporation buys the division merely to obtain its store locations. Before the Q Corporation takes over, the division liquidates its inventory in a going-out-of-business sale. The Q Corporation has merely acquired assets in this transaction, not a separate unit of P Company's business.

Example 3. The R Company processes and distributes meat products. Both the processing division and the distributorship are self-sustaining, profitable operations. The acquisition of either the meat processing division or the distributorship would be an acquisition of a separate unit of the R Company's business.

Example 4. The S Corporation is engaged in the manufacture and sale of steel and steel products. S Corporation also owns a coal mine, which it operates for the sole purpose of supplying its coal requirements for its steel manufacturing operations. The acquisition of the coal mine would be an acquisition of a separate unit of the S company's business.

Example 5. The T Company, which is engaged in the business of operating a chain of drug stores, sells its only downtown drug store to the V Company and agrees not to open another T Company store in the downtown area for five years. Included in the purchase price is an amount that is charged for the goodwill of the store location. The V

Company has acquired a separate unit of the T Company's business.

Example 6. The W Company, which is engaged in the business of operating a chain of drug stores sells one of its stores to the X Company, but continues to operate another drug store three blocks away. The X Company opens the store doing business under its own name. The X Company has not acquired a separate unit of the W Company's business.

Example 7. (a) The Y Corporation, which is engaged in the manufacture of mattresses, sells one of its three factories to the Z Company. At the time of the sale, the factory is capable of profitably manufacturing mattresses on its own. Z Company has acquired a separate unit of the Y Corporation.

(b) The facts are the same as in (a) above, except that a profitable manufacturing operation cannot be conducted in the factory standing on its own. Z Company has not acquired a separate unit of the Y Corporation.

Example 8. The O Construction Company is owned by A, B, and C, who are unrelated individuals. It owns equipment valued at 1.5 million dollars and construction contracts valued at 6 million dollars. A, wishing to start his own company, exchanges his interest in O Company for 2 million dollars of contracts and a sufficient amount of equipment to enable him to begin business immediately. A has acquired a separate unit of the O Company's business.

(3) *Major portion.* All the facts and circumstances surrounding the transaction shall be taken into account in determining what constitutes a major portion of a trade or business (or separate unit). Factors to be considered include:

(i) The fair market value of the assets in the portion relative to the fair market value of the other assets of the trade or business (or separate unit);

(ii) The proportion of goodwill attributable to the portion of the trade or business (or separate unit);

(iii) The proportion of the number of employees of the trade or business (or separate unit) attributable to the portion in the periods immediately preceding the transaction; and

(iv) The proportion of the sales or gross receipts, net income, and budget of the trade or business (or separate unit) attributable to the portion.

(Secs. 44B, 381, and 7805 of the Internal Revenue Code of 1954 (92 Stat. 2834, 26 U.S.C. 44B); 91 Stat. 148, 26 U.S.C. 381(c)(26); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7553, 43 FR 31323, July 21, 1978, as amended by T.D. 7921, 48 FR 52906, Nov. 23, 1983]

§ 1.52–3 Limitations with respect to certain persons.

(a) *Mutual savings institutions.* In the case of an organization to which section 593 applies (that is, a mutual savings bank, a cooperative bank or a domestic building and loan association), the amount of the targeted jobs credit (new jobs credit in the case of wages paid before 1979) allowable under section 44B shall be 50 percent of the amount otherwise determined under section 51, or, in the case of an organization under common control, under § 1.52–1 (a) and (b).

(b) *Regulated investment companies and real estate investment trusts.* In the case of a regulated investment company or a real estate investment trust subject to taxation under subchapter M, chapter 1 of the Code, the amount of the targeted jobs credit (new jobs credit in the case of wages paid before 1979) allowable under section 44B shall be reduced to the company's or trust's ratable share of the credit. The ratable share shall be determined in accordance with rules similar to the rules provided in section 46(e)(2)(B) and the regulations thereunder. For purposes of computing the ratable share, the reduction of the deduction for wage or salary expenses under § 1.280C–1 shall not be taken into account.

(c) *Cooperatives*—(1) *Taxable years ending after October 31, 1978.* For taxable years ending after October 31, 1978, in the case of a cooperative organization described in section 1381(a), rules similar to rules provided in section 46(h) and the regulations thereunder shall apply in determining the distribution of the amount of the targeted jobs credit (new jobs credit in the case of wages paid before 1979) allowable to the cooperative organization and its patrons under section 44B.

(2) *Taxable years ending before November 1, 1978.* For taxable years ending before November 1, 1978, in the case of a cooperative organization described in section 1381(a), the amount of new jobs credit allowable under section 44B shall

be reduced to the cooperative's ratable share of the credit. The ratable share shall be the ratio which the taxable income of the cooperative for the taxable year bears to its taxable income increased by the amount of the deductions allowed under section 1382 (b) and (c). For purposes of computing the ratable share, the reduction of the deduction for wage or salary expenses under §1.280C–1 shall not be taken into account.

(Secs. 44B, 381, and 7805 of the Internal Revenue Code of 1954 (92 Stat. 2834, 26 U.S.C. 44B); 91 Stat. 148, 26 U.S.C. 381(c)(26); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7921, 48 FR 52906, Nov. 23, 1983]

§1.53–1 Limitation based on amount of tax.

(a) *General rule*—(1) *Targeted jobs credit*. For taxable years beginning after December 31, 1978, the amount of the targeted jobs credit allowed by section 44B (as amended by the Revenue Act of 1978) shall not exceed 90 percent of the tax imposed by chapter 1, reduced by the credits enumerated in section 53(a).

(2) *New jobs credit*. For taxable years beginning before January 1, 1979, the amount of the new jobs credit allowed by section 44B (as in effect prior to enactment of the Revenue Act of 1978) shall not exceed the tax imposed by chapter 1, reduced by the credits enumerated in section 53(a).

(b) *Special rule for 1978–79 fiscal year*. In the case of a taxable year beginning before January 1, 1979, and ending after that date, the sum of the targeted jobs credit (determined without regard to the tax liability limitation in paragraph (a)(1) of this section) and the new jobs credit (determined without regard to the tax liability limitation in (a)(2) of this section) shall not exceed the tax imposed by chapter 1, reduced by the credits enumerated in section 53(a).

(Secs. 44B, 381, and 7805 of the Internal Revenue Code of 1954 (92 Stat. 2834, 26 U.S.C. 44B); 91 Stat. 148, 26 U.S.C. 381(c)(26); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7921, 48 FR 52906, Nov. 23, 1983]

§1.53–2 Carryback and carryover of unused credit.

(a) *Allowance of unused credit as a carryback or carryover*—(1) *In general*. Section 53(b) (formerly designated as section 53(c) for taxable years beginning before 1979) provides for carrybacks and carryovers of unused targeted jobs credit (new jobs credit in the case of wages paid before 1979). An unused credit is the excess of the credit determined under section 51 for the taxable year over the limitation provided by §1.53–1 for such taxable year. Subject to the limitations contained in paragraph (b) of this section and paragraph (f) of §1.53–3, an unused credit shall be added to the amount allowable as a credit under section 44B for the years to which an unused credit can be carried. The year with respect to which an unused credit arises shall be referred to in this section as the ''unused credit year.''

(2) *Taxable years to which unused credit may be carried*. An unused targeted jobs credit (new jobs credit in the case of wages paid before 1979) shall be a new employee credit carryback to each of the 3 taxable years preceding the unused credit year and a new employee credit carryover to each of the 15 taxable years succeeding the unused credit year. An unused credit must be carried first to the earliest of the taxable years to which it may be carried, and then to each of the other taxable years (in order of time) to the extent that the unused credit may not be added (because of the limitation contained in paragraph (b) of this section) to the amount allowable as a credit under section 44B for a prior taxable year.

(b) *Limitations on allowance of unused credit*—(1) *In general*. The amount of the unused targeted jobs credit (new jobs credit in the case of wages paid before 1979) from any particular unused credit year which may be added under section 53(b)(1) (section 53(c)(1) in the case of a new jobs credit) to the amount allowable as a credit under section 44B for any of the preceding or succeeding taxable years to which such credit may be carried shall not exceed the amount by which the limitation in §1.53–1 for such preceding or succeeding taxable year exceeds the sum of (i) the credit allowable under section 44B for such preceding or succeeding taxable year, and (ii) other unused credits carried to such preceding or succeeding taxable year which are attributable to unused credit years prior to the particular unused credit year. Thus, in determining the amount, if any, of an unused credit from a particular unused credit year which shall be added to the amount allowable as a credit for any preceding or succeeding taxable year, the credit earned for such preceding or succeeding taxable year, plus any unused credits originating in taxable years prior to the particular unused credit year, shall first be applied against the limitation based on amount of tax for such preceding or succeeding taxable year. To the extent the limitation based on amount of tax for the preceding or succeeding year exceeds the sum of the credit earned for such year and other unused credits attributable to years prior to the particular unused credit year, the unused credit from the particular unused credit year shall be added to the amount allowable as a credit under section 44B for such preceding or succeeding year. If any portion of the unused credit is a carryback to a taxable year beginning before January 1, 1977, section 44B shall be deemed to have been in effect for such taxable year for purposes of allowing such carryback as a credit under section 44B. To the extent that an unused credit cannot be added for a particular preceding or succeeding taxable year because of the limitation contained in this paragraph, such unused credit shall be available as a carryback or carryover to the next succeeding taxable year to which it may be carried.

(2) *Special rules for an electing small business corporation.* An unused targeted jobs credit (new jobs credit in the case of wages paid before 1979) under section 44B of a corporation which arises in an unused credit year for which the corporation is not an electing small business corporation (as defined in section 1371(b)) and which is a carryback or carryover to a taxable year for which the corporation is an electing small business corporation shall not be added to the amount allowable as a credit under section 44B to the shareholders of such corporation for any taxable year. However, a taxable year for which the corporation is an electing small business corporation shall be counted as a taxable year for purposes of determining the taxable years to which such unused credit may be carried.

(3) *Corporate acquisitions.* For the carryover of unused credits under section 44B in the case of certain corporate acquisitions, see section 381(c)(26) and § 1.381(c)(26)–1.

(4) *Examples.* This paragraph may be illustrated by the following examples.

Example 1. In 1978, A, a calendar year taxpayer, had an unused new jobs credit of $2,000. In 1979, A has a targeted jobs credit of $2,000 and a tax liability imposed by chapter 1 of the Code of $4,000 after all credits listed in section 53(a) have been taken into account. The amount of A's targeted jobs credit allowable under section 44B for 1979 is 90 percent of A's tax liability. The amount of the new jobs credit that may be carried to 1979 is limited to $1,600 ($3,600 [90% of $4,000] − $2,000).

Example 2. In 1979, B, a calendar year taxpayer, has a tax liability imposed by chapter 1 of the Code of $10,000 after all credits listed in section 53(a) have been taken. B's targeted jobs credit for that taxable year is limited to 90 percent of his income tax liability or $9,000. B had a $15,000 targeted jobs credit in 1979 resulting in an unused targeted jobs credit of $5,000 for that year. In 1976 and 1977 B had tax liabilities imposed by chapter 1 of the Code of $3,000 and $4,000 respectively after all credits listed in section 53(a) had been taken. For purposes of carrying back an unused targeted jobs credit to a taxable year beginning before January 1, 1977, section 44B as amended by the Revenue Act of 1978 is deemed to have been in effect for such taxable year. Accordingly, the applicable tax liability limitation for 1976 would be governed by section 53(a) (as amended by the Revenue Act of 1978) which limits the amount of targeted jobs credit allowed to 90 percent of the tax imposed by chapter 1 of the Code after all credits listed in section 53(a) have been taken. B may carry back $2,700 (90% of $3,000) of the 1979 unused targeted jobs credit to 1976. B may carry back $4,000 of the unused targeted jobs credit to 1977 because section 53(a) as it applied to the 1977 taxable year limited the amount of the credit to 100 percent of the taxpayer's tax liability imposed by chapter 1 of the Code after all credits listed in section 53(a) had been taken.

(Secs. 44B, 381, and 7805 of the Internal Revenue Code of 1954 (92 Stat. 2834, 26 U.S.C. 44B); 91 Stat. 148, 26 U.S.C. 381(c)(26); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7921, 48 FR 52906, Nov. 23, 1983]

§1.53–3 Separate rule for pass-through of jobs credit.

(a) *In general.* Under section 53(b), in the case of a new jobs credit or targeted jobs credit earned under section 44B by a partnership, estate or trust, or subchapter S corporation, the amount of the credit that may be taken into account by a partner, beneficiary, or shareholder may not exceed a limitation under section 53(b) separately computed with respect to the partner's, beneficiary's, or shareholder's interest in the entity. A credit is subject to the limitation of section 53(b) with respect to a partner, beneficiary, or shareholder if it is earned by a partnership, estate or trust, or subchapter S corporation in a taxable year ending within, or ending before, a taxable year beginning before January 1, 1979 of the partner, beneficiary, or shareholder. See paragraph (f) of this section for rules on carryback or carryover of a credit subject to separate limitation. This section prescribes rules, under the authority of section 44B(b), relating to the computation of the separate limitation. For purposes of this section, references to section 53(a) and (b) are to that section as it existed before it was amended by the Revenue Act of 1978. This paragraph may be illustrated by the following examples:

Example 1. A, a calendar year taxpayer, is a partner in P, a calendar year partnership. A's pro rata portion of the credit earned by P in 1978 is $200. The $200 credit to be claimed on A's 1978 return is subject to the separate limitation in section 53(b) because the limitation applies to taxable years of the taxpayer beginning before January 1, 1979.

Example 2. B, a calendar year taxpayer, is a shareholder in Corporation M, a subchapter S corporation with a July to June fiscal year. B's pro rata portion of the credit earned by Corporation M in its taxable year beginning in 1978 is $100. The $100 credit to be claimed on B's 1979 return is not subject to the separate limitation requirement of section 53(b) because the limitation only applies to taxable years of the taxpayer beginning before 1979, notwithstanding the credit was earned by Corporation M before 1979.

(b) *Application of credit earned.* A credit earned under section 44B by a partnership, estate or trust, or subchapter S corporation shall be applied by a partner, beneficiary, or shareholder, to the extent allowed under section 53(b), before applying any other credit earned under section 44B. For example, if an individual has a new jobs credit from a proprietorship of $2,000 and from a partnership (after applying section 53(b)) of $1,800, but the credit must be limited under section 53(a) to $3,000, the entire $1,800 credit from the partnership would be applied before any part of the $2,000 amount is applied.

(c) *Amount of separate limitation.* The amount of the separate limitation is equal to the partner's, beneficiary's, or shareholder's limitation under section 53(a) for the taxable year multiplied by a fraction. The numerator of the fraction is the portion of the taxpayer's taxable income for the year attributable to the taxpayer's interest in the entity. The denominator of the fraction is the taxpayer's total taxable income for the year reduced by the zero bracket amount, if any.

(d) *Portion of taxable income attributable to an interest in a partnership, estate or trust, or subchapter S corporation*—(1) *General rule.* The portion of a taxpayer's taxable income attributable to an interest in a partnership, estate or trust, or subchapter S corporation is the amount of income from that entity the taxpayer is required to include in gross income, reduced by—

(i) The amount of the deductions allowed to the taxpayer that are attributable to the taxpayer's interest in the entity; and

(ii) A proportionate share of the deductions allowed to the taxpayer not attributable to a specific activity (as defined in paragraph (e)).

If a deduction comprises both an item that is attributable to the taxpayer's interest in the entity and an item or items that are not attributable to the interest in the entity, and if the deduction is limited by a provision of the Code (such as section 170(b), relating to limitations on charitable contributions), the deduction must be prorated among the items taken into account in computing the deduction. For example, if an individual makes a charitable contribution of $5,000 and his distributive share of a partnership includes $2,000 in charitable contributions made by the partnership, and if the charitable contribution deduction is limited to $3,500 under section 170(b), then the portion of the deduction allowed to the taxpayer that is not attributable to a specific activity is $2,500 ($3,500×($5,000÷$7,000)) and the portion of the deduction allowed to the taxpayer that is attributable to the interest in the partnership is $1,000 ($3,500×($2,000÷$7,000)).

(2) *Deductions attributable to an interest in an entity.* Examples of deductions that are attributable to the taxpayer's interest in an entity include (but are not limited to) a deduction under section 1202 attributable to a net capital gain passed through the entity, and a deduction attributable to a deductible item (such as a charitable contribution) that has been passed through the entity.

(3) *Computation of the proportionate share of deductions not attributable to a specific activity.* The proportionate share of a deduction of the taxpayer not attributable to a specific activity is obtained by multiplying the amount of the deduction by a fraction. The numerator of the fraction is the income from the entity that the taxpayer is required to include in gross income, reduced by the amount of the deductions of the taxpayer that are attributable to the taxpayer's interest in the entity. The denominator is the taxpayer's gross income reduced by the amount of all the deductions attributable to specific activities.

(4) *Examples.* The method of determining the amount of taxable income attributable to an interest in a partnership, estate or trust, or subchapter S corporation is illustrated by the following examples:

Example 1. (a) A, a single individual, is a shareholder in S Corporation, a subchapter S corporation. A is required to include the following amounts from S corporation is his gross income:

Salary	$3,000
Undistributed taxable income:	
Ordinary income	8,000
Net capital gain	2,000
Total	10,000
Total	13,000

A has income from other activities:

Ordinary income	6,000
Net capital gain	4,000
Total	10,000

(b) In order to determine the taxable income attributable to A's interest in S Corporation, it is necessary to reduce the amount of income from S Corporation that A is required to include in gross income by the amount of A's deductions attributable to the interest in S Corporation and by a proportionate share of A's deductions not attributable to a specific activity. These computations are made in paragraph (c) of this example. However, before the computation reducing A's income by a proportionate share of the deductions not attributable to a specific activity can be made, the ratio described in subparagraph (3) of this paragraph (d) must be determined. The numerator of the ratio (the amount of income from S Corporation that A is required to include in gross income, reduced by the amount of the deductions attributable to A's interest in S Corporation) is obtained in paragraph (c) of this example in the process of computing A's taxable income attributable to the interest in S Corporation. The determination of the denominator (A's gross income reduced by the amount of all deductions attributable to specific activities), however, require a separate computation, which follows:

Gross income:	
Income from S Corporation	$13,000
Income from other sources	10,000
Total	23,000
Less: Deductions attributable to specific activities:	
Section 1202 deduction (50 percent. of $6,000)	3,000
A's gross income reduced by the amount of the deductions attributable to specific activities (denominator of the ratio for determining the proportionate share of deductions not attributable to a specific activity)	20,000

(c) Computation of the amount of A's taxable income attributable to the interest in S Corporation:

Income from S Corporation that A is required to include in gross income:	
Ordinary income	$11,000
Net capital gain	2,000
Total	13,000
Less: Deductions of the taxpayer attributable to the interest in S Corporation:	
Section 1202 deduction (50 pct. of $2,000)	1,000

(Numerator of the ratio for determining the proportionate share of deductions not attributable to a specific activity)	12,000
Less: Proportionate share of the deductions of the taxpayer not attributable to a specific activity:	
Personal exemption deduction ($750×$12,000/$20,000)	450
Zero bracket amount ($2,200×$12,000/$20,000)	1,320
Total	1,770
Portion of A's taxable income attributable to interest in S Corporation.	10,230

Example 2. (a) C, a married individual with two children, is a partner in the CD Company. C's distributive share of the CD Company consists of the following:

Ordinary income (other than guaranteed payment)	$38,420
Guaranteed payment	20,000
Net long-term capital gain	6,000
Net short-term capital loss	2,000
Dividends qualifying for exclusion	100
Charitable contributions	500

C also has items of income from other sources and deductions, as follows:

Ordinary income	$21,680
Short-term capital gain	2,000
Dividends qualifying for exclusion	400
Deductions:	
Deductible medical expenses	16,000
Charitable contributions	4,000
Alimony	18,000
Interest and taxes on home	8,000
Loss relating to another specific activity	4,000

(b) In order to determine C's taxable income attributable to the interest in the partnership, it is necessary to reduce the amount of income from the partnership that C is required to include in gross income by the amount of C's deductions attributable to the interest in the partnership and by a proportionate share of C's deductions not attributable to a specific activity. These computations are made in paragraph (c) of this example. However, before the computation reducing C's income by a proportionate share of the deductions not attributable to a specific activity can be made, the ratio described in paragraph (d)(3) of this section must be determined. The numerator of the ratio is determined in paragraph (c) of this example in the process of computing C's taxable income attributable to the interest in the partnership. The denominator, however, requires a separate computation, reducing C's gross income by the amount of all deductions attributable to specific activities. This computation is as follows:

Gross income: Income from the partnership:		
Ordinary income	$58,420	
Net long-term capital gain	6,000	
Dividends	100	
Less: Proportionate share of dividend exclusion ($100×$100/$500)	20	
	80	
	64,500	
Income from other sources:		
Ordinary income	21,680	
Net short/term capital gain	2,000	
Dividends	400	
Less: Proportionate share of dividend exclusion ($100×$400/$500)	$80	
	320	
	24,000	
	88,500	
Less: Deductions attributable to specific activities:		
Net short-term capital loss passed through the partnership	2,000	
Loss related to another specific activity	4,000	
Section 1202 deduction attributable to the interest in the partnership	2,000	
Charitable contribution deduction passed through the partnership	500	
	8,500	
C's gross income, reduced by the amount of the deductions attributable to specific activities (denominator of the ratio for determining the proportionate share of deductions not attributable to a specific activity)	80,000	

(c) Computation of the amount of C's taxable income attributable to the interest in the partnership:

Distributive share of ordinary income (other than guaranteed payments)	$38,420
Guaranteed payment	20,000
Distributive share of dividends less share of exclusion	80
Distributive share of net long-term capital gain	6,000
	64,500
Section 1202 deduction (50 pct. of $4,000)	2,000
Charitable contribution passed through the partnership	500
Net short-term capital loss passed through the partnership	2,000
	4,500
(Numerator of the ratio for determining the proportionate share of deductions not attributable to a specific activity)	60,000
Section 1202 deduction ($1,000×$60,000/$80,000)	750
Deductible medical expenses ($16,000×$60,000/$80,000)	12,000

Charitable contributions ($4,000×$60,000/$80,000)	3,000
Alimony ($18,000×$60,000/$80,000)	13,500
Interest and taxes on home ($8,000×$60,000/$80,000)	6,000
Personal exemption deduction ($3,000×$60,000/$80,000)	2,250
Total	37,500
Portion of C's taxable income attributable to the interest in the partnership	22,500

C has a deduction under section 1202 of $3,000. Of that deduction, $2,000 is attributable directly to C's interest in the partnership (50 percent of the net capital gain that would result from offsetting the $6,000 net long-term capital gain and the $2,000 net short-term capital loss that are attributable to C's interest in the partnership). Since the remaining $1,000 deduction under section 1202 cannot be attributed directly to either C's income from the partnership or any other specific activity, it must be treated as a deduction not attributable to a specific activity.

(e) *Deductions not attributable to a specific activity*—(1) *Specific activity defined.* A specific activity means a course of continuous conduct involving a particular line of endeavor, whether or not the activity is carried on for profit. Examples of a specific activity are:

(i) A trade or business carried on by the taxpayer;

(ii) A trade or business carried on by an entity in which the taxpayer has an interest;

(iii) An activity with respect to which the taxpayer is entitled to a deduction under section 212;

(iv) The operation of a farm as a hobby.

(2) *Types of deductions not attributable to a specific activity.* Examples of deductions not attributable to a specific activity include charitable contributions made by the partner, beneficiary, or shareholder; medical expenses; alimony; interest on personal debts of the partner, beneficiary, or shareholder; and real estate taxes on the personal residence of the partner, beneficiary, or shareholder. For purposes of this section, in cases in which deductions are not itemized, the zero bracket amount is considered to be a deduction not attributable to a specific activity.

(f) *Carryback or carryover of credit subject to separate limitation.* A credit subject to the separate limitation under section 53(b) that is carried back or carried over to a taxable year beginning before January 1, 1979, is also subject to the separate limitation in the carryback or carryover year. For purposes of the preceding sentence, a credit that is earned by a partnership, a trust, or estate, or a subchapter S corporation in a taxable year of such entity ending within, or after, the taxable year of a partner beneficiary or shareholder beginning after December 31, 1978, will not be subject to the separate limitation in section 53(b) with respect to such partner, beneficiary, or shareholder. The taxpayer to whom the credit has been passed through shall not be prevented from applying the unused portion in a carryback or carryover year merely because the entity that earned the credit changes its form of conducting business if the nature of its trade or business essentially remains the same. The computation of the separate limitation in such a case shall reflect the income attributable to the taxpayer's interest in the entity in its revised form. Thus, a shareholder carrying over a credit from a subchapter S corporation may include dividends declared by that corporation after the subchapter S election had been terminated as income attributable to that person's interest in the entity. Similarly, if a partnership incorporates in a carryover year, any income attributable to an interest in the corporation will be regarded, for purposes of computing the separate limitation under section 53(b), as income attributable to an interest in the entity. This paragraph may be illustrated by the following examples:

Example 1. A, a calendar year taxpayer, is a shareholder in Corporation M, a subchapter S corporation. In 1977, A's pro rata share of the new jobs credit earned by Corporation M was $10,000. A could only use $2,000 of the credit in 1977 because of the separate limitation under section 53(b). In 1978, A carries the unused credit over from 1977. The carryover credit is subject to the separate limitation under section 53(b).

Example 2. Assume the same facts as in example 1 except that the unused credit is carried over to 1979. The carryover credit is not subject to the separate limitation under section 53(b) because that limitation does not apply to taxable years of a taxpayer beginning after December 31, 1978.

Example 3. B, a calendar year taxpayer, is a shareholder in Corporation W, a subchapter S corporation. In 1979, B's pro rata share of the targeted jobs credit covered by Corporation W was $5,000 but B could only use $3,000 of the credit in 1979. B carries back the unused credit to 1978. The carryback credit is not subject to the separate limitation under section 53(b).

(Secs. 44B, 381, and 7805 of the Internal Revenue Code of 1954 (92 Stat. 2834, 26 U.S.C. 44B); 91 Stat. 148, 26 U.S.C. 381(c)(26); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7560, 43 FR 60445, Dec. 28, 1978. Redesignated and amended by T.D. 7921, 48 FR 52906, 52907, Nov. 23, 1983]

§1.55–1 Alternative minimum taxable income.

(a) *General rule for computing alternative minimum taxable income.* Except as otherwise provided by statute, regulations, or other published guidance issued by the Commissioner, all Internal Revenue Code provisions that apply in determining the regular taxable income of a taxpayer also apply in determining the alternative minimum taxable income of the taxpayer.

(b) *Items based on adjusted gross income or modified adjusted gross income.* In determining the alternative minimum taxable income of a taxpayer other than a corporation, all references to the taxpayer's adjusted gross income or modified adjusted gross income in determining the amount of items of income, exclusion, or deduction must be treated as references to the taxpayer's adjusted gross income or modified adjusted gross income as determined for regular tax purposes.

(c) *Effective date.* These regulations are effective for taxable years beginning after December 31, 1993.

[T.D. 8569, 59 FR 60557, Nov. 25, 1994]

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[T.D. 8307, 55 FR 33675, Aug. 17, 1990]

§1.56–1 Adjustment for the book income of corporations.

(a) *Computation of the book income adjustment*—(1) *In general.* For taxable years beginning in 1987, 1988, and 1989, the alternative minimum taxable income of any taxpayer is increased by the book income adjustment described in this paragraph (a)(1). The book income adjustment is 50 percent of the excess, if any, of—

(i) The adjusted net book income (as defined in paragraph (b) of this section) of the taxpayer, over

(ii) The pre-adjustment alternative minimum taxable income for the taxable year.

For purposes of this section, pre-adjustment alternative minimum taxable income is alternative minimum taxable income, determined without regard to the book income adjustment or the alternative tax net operating loss determined under section 56(a)(4). See paragraph (a)(4) of this section for examples relating to the computation of the income adjustment.

(2) *Taxpayers subject to the book income adjustment.* The book income adjustment is applicable to any corporate taxpayer that is not an S corporation, regulated investment company (RIC), real estate investment trust (REIT), or real estate mortgage investment company (REMIC).

(3) *Consolidated returns.* In the case of a taxpayer that is a consolidated group, the book income adjustment equals 50 percent of the amount, if any, by which its consolidated adjusted net book income (as defined in paragraph (b)(3)(i) of this section) exceeds its consolidated pre-adjustment alternative minimum taxable income (as defined in paragraph (b)(3)(iii) of this section). See paragraph (a)(4), Example 4 of this section. For purposes of this section, with respect to any taxable year the term ‘‘consolidated group’’ has the same meaning as in §1.1502–1T. See paragraph (d)(6) of this section for rules relating to adjustments attributable to related corporations.

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

Example 1. Corporation A has adjusted net book income of $200 and pre-adjustment alternative minimum taxable income of $100. A must increase its pre-adjustment alternative minimum taxable income by $50 (($200–$100) × .50).

Example 2. Corporation B has adjusted net book income of $200 and pre-adjustment alternative minimum taxable income of $300. B does not have a book income adjustment for the taxable year because its adjusted net book income does not exceed its pre-adjustment alternative minimum taxable income.

Example 3. Corporation C has adjusted net book income of negative $200 and pre-adjustment alternative minimum taxable income of negative $300. C must increase its pre-adjustment alternative minimum taxable income by $50 ((−$200 − (−$300)) × .50). Thus, C’s alternative minimum taxable income determined after the book income adjustment, but without regard to the alternative tax net operating loss, is negative $250 (−$300 + $50).

Example 4. Corporations D and E are a consolidated group for tax purposes. D and E do not have a consolidated financial statement. On their separate financial statements D and E have adjusted net book income of $100 and $50 respectively, and pre-adjustment alternative minimum taxable income of $50 and $80 respectively. Assuming there are no intercompany transactions, DE’s consolidated adjusted net book income (as defined in paragraph (b)(3)(i) of this section) is $150 and its consolidated pre-adjustment alternative minimum taxable income (as defined in paragraph (b)(3)(iii) of this section) is $130. DE must increase its consolidated pre-adjustment alternative minimum taxable income by $10 (($150 − $130) × .50).

(b) *Adjusted net book income*—(1) *In general.* ‘‘Adjusted net book income’’ means the net book income (as defined in paragraph (b)(2) of this section) adjusted as provided in paragraph (d) of this section. Except as provided in paragraph (d) of this section, a taxpayer may not make any adjustments to net book income.

(2) *Net book income*—(i) *In general.* ‘‘Net book income’’ means the income or loss for a taxpayer reported in the taxpayer’s applicable financial statement (as defined in paragraph (c) of this section). Net book income must take into account all items of income, expense, gain and loss of the taxable year, including extraordinary items, income or loss from discontinued operations, and cumulative adjustments resulting from accounting method changes. Net book income is not reduced by any distributions to shareholders. See paragraph (b)(5)(i) of this

section for a similar rule for corporations using current earnings and profits to compute net book income.

(ii) *Measures of net book income.* Except as described in paragraph (b)(5) of this section, net book income is disclosed on the income statement included in a taxpayer's applicable financial statement. Such income statement must reconcile with the balance sheet, if any, that is included in the applicable financial statement and must be used in computing changes in owner's equity reflected in the applicable financial statement. See paragraph (c) of this section for the definition of an applicable financial statement.

(iii) *Tax-free transactions and tax-free income.* Net book income includes income or loss that is reported on a taxpayer's applicable financial statement regardless of whether such income or loss is recognized, realized or otherwise taken into account for other Federal income tax purposes. See paragraph (b)(7), Examples 1, 2 and 3 of this section.

(iv) *Treatment of dividends and other amounts.* The adjusted net book income of a taxpayer shall include the earnings of other corporations not filing a consolidated Federal income tax return with the taxpayer only to the extent that amounts are required to be included in the taxpayer's gross income under chapter 1 of the Code with respect to the earnings of such other corporation (*e.g.,* dividends received from such corporation and amounts included under subpart A). See paragraph (b)(7), Examples 4 and 5 of this section.

(3) *Additional rules for consolidated groups*—(i) *Consolidated adjusted net book income.* ''Consolidated adjusted net book income'' means the consolidated net book income (as defined in paragraph (b)(3)(ii) of this section), after taking into account the adjustments under the rules of paragraph (d) of this section.

(ii) *Consolidated net book income.* Consolidated net book income is the income or loss of a consolidated group as reported on its applicable financial statement as defined in paragraph (c)(5) of this section.

(iii) *Consolidated pre-adjustment alternative minimum taxable income.* Consolidated pre-adjustment alternative minimum taxable income is the taxable income of the consolidated group for the taxable year, determined with the adjustments provided in sections 56 and 58 (except for the book income adjustment and the alternative tax net operating loss determined under section 56(a)(4)) and increased by the preference items described in section 57.

(iv) *Cross references.* See paragraph (c)(5) of this section for rules relating to the applicable financial statement of related corporations and paragraph (d)(6) of this section for rules relating to adjustments attributable to related corporations.

(4) *Computation of adjusted net book income when taxable year and financial accounting year differ*—(i) *In general.* If a taxpayer's applicable financial statement is prepared on the basis of a financial accounting year that differs from the year that the taxpayer uses for filing its Federal income tax return, adjusted net book income must be computed either—

(A) By including a pro rata portion of the adjusted net book income for each financial accounting year that includes any part of the taxpayer's taxable year (see paragraph (b)(7), Example 6 of this section), or

(B) In accordance with the election described in paragraph (b)(4)(iii) of this section.

(ii) *Estimating adjusted net book income.* If a taxpayer is using the pro rata approach described in paragraph (b)(4)(i)(A) of this section and an applicable financial statement for part of the taxpayer's taxable year is not available when the taxpayer files its Federal income tax return, the taxpayer must make a reasonable estimate of adjusted net book income for the pro rata portion of the taxable year. If the actual pro rata portion of adjusted net book income that results from the taxpayer's applicable financial statement for the financial accounting year exceeds the estimate of adjusted net book income used on the original tax return and results in additional tax liability, the taxpayer must file an amended Federal income tax return reflecting such additional liability. The amended return must be filed within 90 days of the date the previously unavailable applicable financial statement is available.

(iii) *Election to compute adjusted net book income based on the financial statement for the year ending within the taxable year*—(A) *In general.* If a taxpayer's accounting year ends five or more months after the end of its taxable year, the taxpayer may elect to compute adjusted net book income based on the net book income reported on the applicable financial statement prepared for the financial accounting year ending within the taxpayer's taxable year. See paragraph (b)(7), Examples 7 and 8 of this section. For purposes of this paragraph (b)(4)(iii)(A), if a taxpayer uses a 52–53 week year for financial accounting or Federal income tax purposes, the last day of such year shall be deemed to occur on the last day of the calendar month ending closest to the end of such year.

(B) *Time of making election.* An election under this paragraph (b)(4)(iii) is made by attaching the statement described in paragraph (b)(4)(iii)(C) of this section to the taxpayer's Federal income tax return for the first taxable year in which the taxpayer is eligible to make the election. An election under this paragraph (b)(4)(iii) that is made prior to the first taxable year in which the taxpayer is eligible to make the election (as determined under paragraph (b)(4)(iii)(C) of this section) is valid unless revoked pursuant to paragraph (b)(4)(iii)(D) of this section.

(C) *Eligibility to make and manner of making election.* A taxpayer is eligible to make the election specified in paragraph (b)(4)(iii)(A) of this section in the first taxable year beginning after 1986 in which—

(*1*) The taxpayer has an accounting year ending five or more months after the end of its taxable year,

(*2*) The use of the pro rata approach described in paragraph (b)(4)(i)(A) of this section produces an excess of adjusted net book income over pre-adjustment alternative minimum taxable income, as defined in paragraph (a)(1) of this section, and

(*3*) The taxpayer has an excess of tentative minimum tax over regular tax for the taxable year, as defined in section 55(a), or is liable for the environmental tax imposed by section 59A.

Thus, a taxpayer is not required to evaluate the merits of an election to compute its adjusted net book income based on the applicable financial statement prepared for the financial accounting year ending within the taxpayer's taxable year unless the taxpayer, when using the pro rata approach described in paragraph (b)(4)(i)(A) of this section, either has an excess of tentative minimum tax over its regular tax or is liable for the environmental tax imposed by section 59A. The election statement must set forth the electing taxpayer's name, address, taxpayer identification number, taxable year and financial accounting year. An election under this paragraph (b)(4)(iii) will apply for the taxable year when initially made and for all subsequent years until revoked with the consent of the District Director.

(D) *Election or revocation of election made on an amended return.* An election under paragraph (b)(4)(iii) of this section may be made by attaching the statement described in paragraph (b)(4)(iii)(C) to an amended return for the first taxable year in which the taxpayer is eligible to make the election. An election under paragraph (b)(4)(iii) of this section that was made prior to the first taxable year in which the taxpayer was eligible to make the election, as determined under paragraph (b)(4)(iii)(C) of this section, may be revoked by filing an amended return for the taxable year in which the election was initially made. However, an election made or revoked on an amended return under paragraph (b)(4)(iii) of this section will be allowed only if the amended return is filed no later than December 14, 1990.

(iv) *Quarterly statement filed with the Securities and Exchange Commission (SEC).* A taxpayer with different financial accounting and taxable years that is required to file both annual and quarterly financial statements with the SEC may not aggregate quarterly statements filed with the SEC in order to obtain a statement covering the taxpayer's taxable year. See paragraph (b)(7), Example 9 of this section. See paragraph (c)(3)(iv)(B)(*1*) of this section for priority rules relating to statements required to be filed with the SEC.

(5) *Computation of net book income using current earnings and profits*—(i) *In general.* If a taxpayer does not have an applicable financial statement, or only has a statement described in paragraph (c)(1)(iv) of this section and makes the election described in paragraph (c)(2) of this section, net book income for purposes of this section is equal to the taxpayer's current earnings and profits for its taxable year. Generally, a taxpayer's current earnings and profits is computed under the rules of section 312 and the regulations thereunder. Current earnings and profits therefore is reduced by Federal income tax expense and any foreign tax expense for foreign taxes eligible for the foreign tax credit under section 27 of the Code. Current earnings and profits is then adjusted as described in paragraph (d) of this section to arrive at adjusted net book income. No adjustment is made under paragraph (d) of this section, however, for any adjustment that is already reflected in current earnings and profits. See paragraph (d)(3) of this section for adjustments to net book income with respect to certain taxes. For purposes of this section, current earnings and profits is not reduced by any distribution to shareholders. See paragraph (d)(3)(iv), Example 5 of this section.

(ii) *Current earnings and profits of a consolidated group.* For purposes of this paragraph (b)(5), the current earnings and profits of a consolidated group is the aggregate of the current earnings and profits of each member of the group, as determined pursuant to paragraph (d)(4)(iii) of this section.

(6) *Additional rules for computation of net book income of a foreign corporate taxpayer*—(i) *Adjusted net book income of a foreign taxpayer.* Adjusted net book income of a foreign corporate taxpayer (''foreign taxpayer'') means the effectively connected net book income (as defined in paragraph (b)(6)(ii) of this section) of the foreign taxpayer, after taking into account the adjustments under the rules of paragraph (d) of this section.

(ii) *Effectively connected net book income of a foreign taxpayer*—(A) *In general.* Effectively connected net book income of a foreign taxpayer is the income or loss reported in its applicable financial statement (as defined in paragraph (c)(5)(ii) of this section), but only to the extent that such amount is attributable to items of income or loss that would be treated as effectively connected with the conduct of a trade or business in the United States by the foreign taxpayer as determined under either the principles of section 864(c) and the regulations thereunder, or any other applicable provision of the Internal Revenue Code of 1986. Thus, if for tax purposes an item of income or loss is treated as effectively connected with the conduct of a trade or business in the United States, then the income or loss reported on the foreign taxpayer's applicable financial statement attributable to such item is effectively connected net book income. See paragraph (b)(7), Examples 11, 12 and 13 of this section.

(B) *Certain exempt amounts.* Effectively connected net book income does not include any amount attributable to an item that is exempt from United States taxation under sections 883, 892, 894 or 895 of the Internal Revenue Code of 1986. See paragraph (b)(7), Examples 14 and 15 of this section.

(iii) *Computation of net book income of a foreign taxpayer using current earnings and profits.* If a foreign taxpayer does not have an applicable financial statement or only has a statement described in paragraph (c)(1)(iv) of this section and makes the election described in paragraph (c)(2) of this section, net book income for purposes of this section is equal to the foreign taxpayer's current earnings and profits that are attributable to income or loss that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States. Effectively connected current earnings and profits are computed under the rules of section 884(d) and the regulations thereunder, relating to effectively connected earnings and profits for purposes of computing the branch profits tax, but without regard to the exceptions set forth under section 884(d)(2)(B) through (E). For purposes of this section, effectively connected current earnings and profits are not reduced by any remittances or distributions. Effectively connected current earnings and profits takes into account Federal income tax expense and any foreign tax expense; however, see paragraph (d)(3) of this section for adjustments to net book income with respect to certain taxes.

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

Example 1. Corporation A owns 100 percent of corporation B and the AB affiliated group files a consolidated Federal income tax return. AB uses a calendar year for both financial accounting and tax purposes. During 1987, A transfers all of its stock in B for stock on an acquiring corporation in a transaction described in section 368(a)(1)(B). Although AB recognizes no taxable gain on the transfer pursuant to section 354, gain from the transfer is reported on AB's 1987 applicable financial statement. Pursuant to paragraph (b)(2)(iii) of this section, AB's net book income includes the book gain attributable to the transfer.

Example 2. Corporation C uses a calendar year for both financial accounting and tax purposes. C adopted a plan of liquidation prior to August 1, 1986. On June 1, 1987, C makes a bulk sale of all of its assets subject to liabilities and completely liquidates. Pursuant to section 633(c) of the Tax Reform Act of 1986 (the Act), section 337, as in effect prior to its amendment by the Act, applies. Thus, C will generally not recognize taxable gain upon the bulk sale. However, C's applicable financial statement for the period January 1, 1987 through June 1, 1987, reports net book income of $500, $400 of which is attributable to the bulk sale of assets on June 1, 1987. Pursuant to paragraph (b)(2)(iii) of this section, C's net book income includes the amount attributable to the bulk sale. Thus, assuming C has no other adjustments to net book income, its adjusted net book income for the period January 1, 1987 through June 1, 1987, is $500.

Example 3. Corporation Z has a large inventory of marketable securities. On its applicable financial statement, Z marks these securities to market, i.e., as they appreciate in value, Z restates their value on its balance sheet to their fair market value, and increases the income on its income statement by that amount. Pursuant to paragraph (b)(2)(iii) of this section, the adjusted net book income of Z includes the income from the valuation adjustment.

Example 4. Corporation D owns 100 percent of E, a controlled foreign corporation as defined in section 957. Both D and E use a calendar year for financial accounting and tax purposes. D's applicable financial statement includes E. Pursuant to section 951, D includes $100 of E's subpart F income in its gross income for 1987. Although D's applicable financial statement is adjusted to eliminate E's income, pursuant to paragraph (b)(2)(iv) of this section, D's adjusted net book income for 1987 includes the $100 of gross income included under section 951.

Example 5. Corporation F owns 20 percent of G, a foreign corporation. Both F and G use a calendar year for financial accounting and tax purposes. During 1987, G pays F a $100 dividend. F's applicable financial statement accounts for F's investment in G by the equity method. F is eligible for a deemed paid foreign tax credit of $30 with respect to the dividend from G and must include the $130 in gross income pursuant to section 78 of the Code. Although F's applicable financial statement is adjusted to eliminate F's income from G under the equity method, pursuant to paragraph (b)(2)(iv) of this section, F's adjusted net book income for 1987 includes the $130 of gross income recognized with respect to the dividend from G.

Example 6. Corporation H files its Federal income tax return on a calendar year basis. However, its applicable financial statement is based on a fiscal year ending June 30. H does not make the election described in paragraph (b)(4)(iii) of this section. Pursuant to paragraph (b)(4)(i) of this section, H's adjusted net book income for calendar year 1987 is computed by adding 50 percent of adjusted net book income from the applicable financial statement for the year ending June 30, 1987 and 50 percent of adjusted net book income from the applicable financial statement for the year ending June 30, 1988.

Example 7. Corporation J files its Federal income tax returns for 1987, 1988, and 1989 on a calendar year basis. However, its applicable financial statement is based on a year ending May 31. Pursuant to paragraph (b)(4)(iii) of this section, J elects in 1987 to compute its adjusted net book income by using the applicable financial statement for the fiscal year ending May 31, 1987. Unless the District Director consents to revocation of the election, for calendar year 1988 or 1989, J's adjusted net book income for 1988 and 1989 is determined from its applicable financial statements for the years ending May 31, 1988 and May 31, 1989, respectively.

Example 8. The facts are the same as in Example 7, except that J's applicable financial statement is based on a year ending April 30. Since April 30, is less than 5 months after December 31, the end of J's taxable year, J is not permitted to make the election described in paragraph (b)(4)(iii) of this section.

Example 9. The facts are the same as in Example 8, except H files quarterly and annual financial statements with the Securities and Exchange Commission (SEC). The fourth quarter statement is included as a footnote to the annual statement that it files with the SEC. Pursuant to paragraph (b)(4)(iv) of this section, H may not determine its net book income by aggregating its four quarterly statements for 1987. Thus, H's net book income is computed as described in Example 8.

Example 10. Corporation I is a United States corporation with a 100 percent owned subsidiary, J, a foreign sales corporation (FSC). I uses a calendar year for both financial accounting and tax purposes. Income from J is consolidated in I's applicable financial statement. I and J do not file a consolidated tax return. In 1987, J pays a dividend to I of $100 out of J's earnings and profits. For purposes of this example, it is assumed that the distribution is made out of the profits attributable solely to foreign trade income determined through use of the administrative pricing rules of section 925(a) (1) and (2). Accordingly, the distribution is eligible for the 100 percent dividends received deduction under section 245(c). Although I's applicable financial statement is adjusted to eliminate income or loss attributable to J, the entire amount of the dividend distribution must be included in I's adjusted net book income pursuant to paragraph (b)(2)(iv) of this section.

Example 11. Corporation K is a foreign corporation incorporated under the laws of country X. K uses a calendar year for both financial accounting and tax purposes. In 1987, K actively conducts a real estate business, L, in the United States. The financial statement that is used as K's applicable financial statement (as determined under paragraph (c)(5)(ii) of this section) discloses total net income of $150. Of this amount, $100 is attributable to L's real estate business and $50 is attributable to dividends paid to L from its investment in certain securities. The securities investment is not connected with L's real estate business. Under the rules of section 864, only $100 is effectively connected to the conduct of a trade or business in the United States. Thus, K's effectively connected net book income for 1987 equals $100.

Example 12. Assume the same facts as in Example 11 except that K's applicable financial statement also discloses $75 attributable to investment real property located in the United States, so that the net income amount reported on the financial statement equals $225. The $75 of income is not effectively connected with the conduct of a trade or business in the United States. K, for regular tax purposes, makes an election under section 882(d) to treat this income as effectively connected with the conduct of a trade or business in the United States. As a result, K's effectively connected net book income for 1987 equals $175 ($100+$75).

Example 13. Corporation M is a foreign corporation that actively conducts a manufacturing business, N, in the United States. M is a calendar year taxpayer for both financial accounting and tax purposes. In 1987, the financial statement that is used as M's applicable financial statement (as determined under paragraph (c)(5)(ii) of this section) reflects an anticipated loss from the sale of a division of N. For Federal income tax purposes the loss is not recognized in 1987, but rather is recognized in 1988 when M sells the division. In determining M's effectively connected net book income for 1987, the anticipated loss reported on M's 1987 applicable financial statement is taken into account because the reported loss is effectively connected to the conduct of a trade or business in the United States under the principles of section 864.

Example 14. Corporation O is a foreign corporation that is engaged in the international shipping business. O is incorporated under the laws of X. O is a calendar year taxpayer for both financial accounting and tax purposes. In 1987, O actively conducts a shipping business, P, within the United States. The statement that is used in 1987 as O's applicable financial statement (as determined under paragraph (c)(5)(ii) of this section) discloses income of $100 that is attributable to P's operation of ships in international traffic. Under section 864, $50 is effectively connected with the conduct of a trade or business in the United States. However, the United States income tax treaty with X exempts from United States income tax any income derived by a resident of X from the operation of ships in international traffic. Thus, pursuant to paragraph (b)(6)(ii)(B) of this section, no amount of P's income is includible in O's effectively connected net book income.

Example 15. Assume the same facts as in Example 14 except that there is no United States income tax treaty with X. However, X by statute exempts United States citizens and United States corporations from tax imposed by X on gross income derived from the operation of a ship or ships in international traffic. Under section 883(a), P's income of $50 that is effectively connected with the conduct of a trade or business in the United States is exempt from United States taxation. Thus, pursuant to paragraph (b)(6)(ii)(B) of this section, no amount of P's income is includible in O's effectively connected net book income.

(c) *Applicable Financial Statement*—(1) *In general.* A taxpayer's applicable financial statement is the statement described in this paragraph (c)(1) that has the highest priority, as determined under paragraph (c)(3) of this section. Generally, an applicable financial statement includes an income statement, a balance sheet (listing assets, liabilities, and owner's equity including changes thereto), and other appropriate information. An income statement alone may constitute an applicable financial statement for purposes of this section if the other materials described in this paragraph are not prepared or used by the taxpayer. However, an income statement that does not reconcile with financial materials otherwise issued will not qualify as an applicable financial statement. For purposes of determining the book income adjustment, the following may be considered applicable financial statements (subject to the rules relating to priority among statements under paragraph (c)(3) of this section)—

(i) *Statement required to be filed with the Securities and Exchange Commission (SEC).* A financial statement that is required to be filed with the Securities and Exchange Commission.

(ii) *Certified audited financial statement.* A certified audited financial statement that is used for credit purposes, for reporting to shareholders or for any other substantial non-tax purpose. Such a statement must be accompanied by the report of an independent (as defined in the American Institute of Certified Public Accountants Professional Standards, Code of Professional Conduct, Rule 101 and its interpretations and rulings) Certified Public Accountant or, in the case of a foreign corporation, a similarly qualified and independent professional who is licensed in any foreign country. A financial statement is ''certified audited'' for purposes of this section if it is—

(A) Certified to be fairly presented (an unqualified or ''clean'' opinion),

(B) Subject to a qualified opinion that such financial statement is fairly presented subject to a concern about a contingency (a qualified ''subject to'' opinion),

(C) Subject to a qualified opinion that such financial statement is fairly presented, except for a method of accounting with which the accountant disagrees (a qualified ''except for'' opinion), or

(D) Subject to an adverse opinion, but only if the accountant discloses the amount of the disagreement with the statement.

Any other statement or report, such as a review statement or a compilation report that is not subject to a full audit is not a certified audited statement. See paragraph (c)(3)(iv)(B)(*2*) of this section for a special rule for a statement accompanied by a review report when there are statements of equal priority. See also paragraph (d)(5)(iii) of this section for rules relating to adjustments for information disclosed in an accountant's opinion to a certified audited statement.

(iii) *Financial statement provided to a government regulator.* A financial statement that is required to be provided to the Federal government or any agency thereof (other than the Securities and Exchange Commission), a state government or any agency thereof, or a political subdivision of a state or any agency thereof. An income tax return, franchise tax return or other tax return prepared for the purpose of determining any tax liability that is filed with a Federal, state or local government or agency cannot be an applicable financial statement.

(iv) *Other financial statements.* A financial statement that is used for credit purposes, for reporting to shareholders, or for any other substantial non-tax purpose, even though such financial statement is not described in paragraphs (c)(1)(i) through (c)(1)(iii) of this section.

(v) *Required use of current earnings and profits.* If a taxpayer does not have a financial statement described in paragraphs (c)(1)(i) through (c)(1)(iv) of this section, the taxpayer does not have an applicable financial statement. In that case, net book income for the taxable year will be treated as being equal to the taxpayer's current earnings and profits for the taxable year. See paragraph (b)(5) of this section for rules relating to the computation of current earnings and profits for the taxable year. See paragraph (c)(4) of this section for rules relating to use of a financial statement for a substantial non-tax purpose.

(2) *Election to treat net book income as equal to current earnings and profits for*

the taxable year—(i) *In general.* If a taxpayer's only financial statement is a statement described in paragraph (c)(1)(iv) of this section, the taxpayer may elect to treat net book income as equal to the taxpayer's current earnings and profits for all taxable years in which the taxpayer is eligible to make the election.

(ii) *Time of making election.* An election under this paragraph (c)(2) is made by attaching the statement described in paragraph (c)(2)(iii) of this section to the taxpayer's Federal income tax return for the first taxable year the taxpayer is eligible to make the election. An election under this paragraph (c)(2), which is made prior to the first taxable year in which the taxpayer is eligible to make the election, as determined under paragraph (c)(2)(iii) of this section, is valid unless revoked pursuant to paragraph (c)(2)(iv) of this section.

(iii) *Eligibility to make and manner of making election.* A taxpayer is eligible to make the election in the first taxable year in which—

(A) The taxpayer has an applicable financial statement described in paragraph (c)(1)(iv) of this section;

(B) The use of this applicable financial statement produces an excess of adjusted net book income over preadjustment alternative minimum taxable income, as defined in paragraph (a)(1) of this section, and

(C) The taxpayer has, as determined under section 55(a), an excess of tentative minimum tax over regular tax for the taxable year, or is liable for the environmental tax imposed by section 59A.

Thus, a taxpayer is not required to evaluate the merits of an election to use its current earnings and profits as its net book income unless the taxpayer, when using an applicable financial statement described in paragraph (c)(1)(iv) of this section, has an excess of tentative minimum tax over its regular tax or is liable for the environmental tax imposed by section 59A. The election statement must set forth the electing taxpayer's name, address and taxpayer identification number, state that the election is being made under the provisions of section 56(f)(3)(B), and state that the only financial statement of the taxpayer is a financial statement described in paragraph (c)(1)(iv) of this section. An election under this paragraph (c)(2) is effective for every taxable year in which the taxpayer does not have a financial statement described in paragraphs (c)(1)(i) through (c)(1)(iii) of this section and may be revoked only with the consent of the District Director. See paragraph (c)(6), Example 1 of this section.

(iv) *Election or revocation of election made on an amended return.* An election under paragraph (c)(2) of this section may be made by attaching the statement described in paragraph (c)(2)(iii) to an amended return for the first taxable year in which the taxpayer is eligible to make the election. An election under paragraph (c)(2) of this section that was made prior to the first taxable year in which the taxpayer was eligible to make the election, as determined under paragraph (c)(2)(iii) of this section, may be revoked by filing an amended return for the taxable year in which the election was initially made. However, an election made or revoked on an amended return will be allowed only if the amended return is filed no later than December 14, 1990.

(v) *Election by common parent of consolidated group.* The election by the common parent of a consolidated group to treat net book income as equal to current earnings and profits shall bind all members of the group. This rule shall not apply in the case of any taxpayer that first, has made the election on a return filed before August 16, 1990, second, applied the election only to those members of the group that are themselves eligible to make the election, and third, properly consolidated the adjusted net book income of the group. In order to change its election to apply to all members of the group, a taxpayer must attach a statement to an amended return for the first taxable year the taxpayer is eligible to make the election. However, an election made on an amended return under this paragraph (c)(2)(iv) will be allowed only if the amended return is filed no later than December 14, 1990. See paragraph (b)(5)(ii) of this section regarding the current earnings and profits of a consolidated group. See paragraph (d)(4)(iii) of this section for adjustments that apply when a consolidated group uses current earnings and profits to compute its net book income.

(3) *Priority among statements*—(i) *In general.* If a taxpayer has more than one financial statement described in paragraphs (c)(1)(i) through (c)(1)(iv) of this section, the taxpayer's applicable financial statement is the statement with the highest priority. Priority is determined in the following order—

(A) A financial statement described in paragraph (c)(1)(i) of this section.

(B) A certified audited statement described in paragraph (c)(1)(ii) of this section.

(C) A financial statement required to be provided to a Federal or other government regulator described in paragraph (c)(1)(iii) of this section.

(D) Any other financial statement described in paragraph (c)(1)(iv) of this section.

For example, corporation A, which uses a calendar year for both financial accounting and tax purposes, prepares a financial statement for calendar year 1987 that is provided to a state regulator and an unaudited financial statement that is provided to A's creditors. The statement provided to the state regulator is A's financial statement with the highest priority and thus is A's applicable financial statement.

(ii) *Special priority rules for use of certified audited financial statements and other financial statements.* In the case of financial statements described in paragraphs (c)(1)(ii) and (c)(1)(iv) of this section, within each of these categories the taxpayer's applicable financial statement is determined according to the following priority—

(A) A statement used for credit purposes,

(B) A statement used for disclosure to shareholders, and

(C) Any other statement used for other substantial non-tax purposes.

For example, corporation B uses a calendar year for both financial accounting and tax purposes. B prepares a financial statement for calendar year 1987 that it uses for credit purposes and prepares another financial statement for calendar year 1987 that it uses for disclosure to shareholders. Both financial statements are unaudited. The statement used for credit purposes is B's financial statement with the highest priority and thus is B's applicable financial statement.

(iii) *Priority among financial statements provided to a government regulator.* In the case of two or more financial statements described in paragraph (c)(1)(iii) of this section (relating to financial statements required to be provided to a Federal or other governmental regulator) that are of equal priority, the taxpayer's applicable financial statement is determined according to the following priority—

(A) A statement required to be provided to the Federal government or any of its agencies,

(B) A statement required to be provided to a State government or any of its agencies, and

(C) A statement required to be provided to any subdivision of a state or any agency of a subdivision.

(iv) *Statements of equal priority*—(A) *In general.* Except as provided in paragraph (c)(3)(iv)(B) and paragraph (c)(5)(i)(B) of this section, if a taxpayer has two or more financial statements of equal priority (determined under paragraphs (c)(3)(i), (c)(3)(ii) and (c)(3)(iii) of this section), the taxpayer's applicable financial statement is the statement that results in the greatest amount of adjusted net book income.

(B) *Exceptions to the general rule in paragraph (c)(3)(iv)(A)*—(*1*) In the case of two or more financial statements described in paragraph (c)(1)(i) of this section (relating to financial statements required to be filed with the SEC) that are of equal priority, a certified audited financial statement has a higher priority than an unaudited financial statement.

(*2*) In the case of two or more financial statements described in paragraph (c)(1)(iv) of this section (relating to other financial statements) that are of equal priority, a financial statement accompanied by an auditor's ‘‘review report’’ has a higher priority than another financial statement of otherwise equal priority. For purposes of this section, an auditor's review report is defined in the American Institute of Certified Public Accountant Professional

Standards, AR section 100.32. See paragraph (c)(6), Examples and 3 of this section.

(4) *Use of financial statement for a substantal non-tax purpose.* In order to be an applicable financial statement for purposes of computing the book income adjustment, a financial statement described in paragraph (c)(1)(ii) or (c)(1)(iv) must be used by the taxpayer for credit purposes, for disclosure to shareholders, or for any other substantial non-tax purpose. A financial statement is used by a taxpayer if the taxpayer reasonably anticipates that users of the statement will rely on it for non-tax purposes. Thus, a financial statement used for the purpose of computing the book income adjustment is not an applicable financial statement even if it is provided to shareholders or creditors, unless the taxpayer reasonably anticipates that users of the statement will rely on it for non-tax purposes. See paragraph (c)(6), Examples 4, 5, 19 and 20 of this section.

(5) *Special rules*—(i) *Applicable financial statement of related corporations*—(A) *Applicable financial statement of a consolidated group.* The applicable financial statement of a consolidated group (as defined in paragraph (a)(3) of this section) is the financial statement of the common parent (within the meaning of section 1504(a)(1)) of the consolidated group that has the highest priority under the rules of paragraphs (c)(3)(i), (c)(3)(ii) and (c)(5)(i)(B) of this section. See paragraph (d)(6)(i) of this section for rules relating to adjustments to net book income of a consolidated group. See paragraph (c)(6), Example 7 of this section. See paragraph (c)(2)(iv) of this section for rules relating to the election by the common parent of a consolidated group to use current earnings and profits to compute net book income.

(B) *Special rule for statements of equal priority.* If a consolidated group has two or more financial statements of equal priority (determined under paragraphs (c)(3)(i) and (c)(3)(ii) of this section and this paragraph (c)(5)), the consolidated group's applicable financial statement is determined under either paragraph (c)(5)(i)(B) (*1*) or (*2*), whichever is applicable.

(*1*) *Two or more financial statements reporting on the same corporations.* If two or more financial statements of equal priority report on the same corporations, the consolidated group's applicable financial statement is determined under the rules of paragraph (c)(3)(iv) of this section. Thus, the financial statement that results in the greatest consolidated adjusted net book income is the consolidated group's applicable financial statement.

(*2*) *Two or more financial statements reporting on different corporations.* If two or more financial statements of equal priority report on different corporations, the consolidated group's applicable financial statement is—

(*i*) The statement that reflects the greatest amount of gross receipts attributable to members of the consolidated group, or

(*ii*) The statement that reflects the greatest amount of gross receipts (including gross receipts attributable to corporations that are not members of the consolidated group), but only if the consolidated group has financial statements of equal priority after applying the rules of paragraph (c)(5)(i)(B)(*2*)(*i*).

If after applying the rules of paragraphs (c)(5)(i)(B)(*2*) (*i*) and (*ii*) of this section, the consolidated group still has financial statements of equal priority, the rules of paragraph (c)(3)(iv) of this section apply. See paragraph (c)(6), Examples 7 and 8 of this section.

(C) *Special rule for related corporations.* If any portion of the net book income of a corporation (the ''first corporation'') is included on the applicable financial statement of a second corporation, but the first and second corporations are not members of the same consolidated group, the applicable financial statement of the second corporation is disregarded when determining the applicable financial statement of the first corporation. Thus, the applicable financial statement of the first corporation is the financial statement of highest priority determined under the rules of paragraph (c)(3) of this section without regard to the financial statement of the second corporation. Pursuant to paragraph (c)(1)(iv) of this section, if a separate financial statement is not prepared by the first corporation, the rules of paragraph (b)(5) (relating to current earnings and profits) apply. See paragraph (c)(6), Examples 9 and 10 of this section.

(D) *Anti-abuse rule.* The special rules of this paragraph (c)(5)(i) will not apply if the taxpayer rearranges its corporate structure or modifies its financial reporting and the principal purpose of such action is to use the special rules of this paragraph (c)(5)(i) to reduce the amount of the book income adjustment. In such cases, the District Director may, based upon all the facts and circumstances, determine the taxpayer's applicable financial statement. See paragraph (c)(6), Examples 13 and 14 of this section.

(ii) *Applicable financial statement of a foreign corporation with a United States trade or business*—(A) *In general.* The applicable financial statement of a foreign taxpayer conducting one or more trades or businesses in the United States is the financial statement prepared by any such trade or business (or attributable to more than one such trades or businesses) that has the highest priority as determined under paragraph (c)(3) of this section. See paragraph (c)(6), Example 15 of this section.

(B) *Special rules for applicable financial statement of a trade or business of a foreign taxpayer*—(*1*) *Financial statement prepared under foreign generally accepted accounting principles.* Subject to the rules of this section, a financial statement prepared by a United States trade or business using generally accepted accounting principles of a foreign country may be an applicable financial statement under this paragraph (c). See paragraph (c)(6), Example 16 of this section.

(*2*) *Financial statement denominated in United States dollars.* Except as provided in paragraph (c)(5)(ii)(D) of this section, the financial statement of a United States trade or business must be denominated in United States dollars in order to be considered the applicable financial statement of the foreign taxpayer under this paragraph (c). See paragraph (c)(6), Example 17 of this section.

(C) *Special rule for statements of equal priority.* If a foreign taxpayer has two or more financial statements of equal priority (determined under paragraphs (c)(3)(i) and (c)(3)(ii) of this section and this paragraph (c)(5)(ii)), the foreign taxpayer's applicable financial statement is determined under either paragraph (c)(5)(ii)(C) (*1*) or (*2*) of this section, whichever is applicable.

(*1*) *Two or more financial statements reporting on the same trades or businesses.* If two or more financial statements of equal priority report on the same United States trades or businesses, the applicable financial statement of the foreign taxpayer is determined under the rule of paragraph (c)(3)(iv) of this section. In applying this rule, adjusted net book income (as defined under paragraph (b)(6) of this section) shall be used. Thus, the financial statement that results in the greatest amount of adjusted net book income is the foreign taxpayer's applicable financial statement.

(*2*) *Two or more financial statements reporting on different trades or businesses.* If two or more financial statements of equal priority report on different United States trades or businesses, the foreign taxpayer's applicable financial statement is—

(*i*) The financial statement that reflects the greatest amount of gross receipts attributable to United States trades or businesses, or

(*ii*) If after applying the rules of paragraph (c)(5)(ii)(C)(*2*)(*i*) of this section, the foreign taxpayer still has financial statements of equal priority, the financial statement determined under the rules of paragraph (c)(3)(iv) of this section (using effectively connected adjusted net book income).

See paragraph (c)(6), Example 18 of this section.

(D) *Anti-abuse rules.* The special rules of this paragraph (c)(5)(ii) will not apply if a trade or business conducted in the United States by a foreign taxpayer modifies its financial reporting and the principal purpose of such action is to reduce the amount of the book income adjustment. In such cases, the District Director may, based upon all the facts and circumstances, determine the taxpayer's applicable financial statement. See paragraph (c)(6), Example 21, of this section.

(iii) *Supplement or amendment to an applicable financial statement*—(A) *Excluding a restatement of net book income.*

An applicable financial statement includes any supplement or amendment thereto (excluding a restatement of net book income) for the taxable year that is prepared and used for a substantial non-tax purpose (within the meaning of paragraph (c)(4) of this section) prior to the date the taxpayer's Federal income tax return for the taxable year would be due if the time for filing were extended under section 6081. For example, a calendar year taxpayer's applicable financial statement includes any supplement or amendment prepared and used prior to September 15 of the year immediately following its taxable year. If a taxpayer files its Federal income tax return before the issuance of a supplement or amendment to the applicable financial statement and before the extended due date for filing under section 6081, the taxpayer must file an amended Federal income tax return reporting any additional tax that results from treating the supplement or amendment as part of the applicable financial statement. A supplement or amendment (excluding restatements of net book income) to an applicable financial statement after the date specified in section 6081 is disregarded for purposes of the book income adjustment.

(B) *Restatement of net book income.* If a taxpayer restates net book income in what otherwise would have been its applicable financial statement (its ''original financial statement''), referred to in this section as a ''restatement of net book income,'' prior to the date that the taxpayer's Federal income tax return for such taxable year would be due if the time for filing were extended under section 6081, then—

(*1*) If the financial statement that includes the restated net book income is of a higher priority than the original financial statement, the restated financial statement is the taxpayer's applicable financial statement.

(*2*) If the financial statement that includes the restated net book income is of equal priority to the original financial statement and—

(*i*) The restatement is attributable to an error (as described in Accounting Principles Board Opinion No. 20, paragraph 13), the restated financial statement is the taxpayer's applicable financial statement, or

(*ii*) The restatement is not attributable to an error, the original and restated financial statements will be considered of equal priority, and paragraph (c)(3)(iv) will apply. Thus, the taxpayer's applicable financial statement is the financial statement that results in the greatest amount of adjusted net book income.

See paragraph (d)(4)(iv) of this section for rules that apply to restatements occurring after the due date (including the extension under section 6081) of the return for the taxable year to which the applicable financial statement relates. See paragraph (c)(6), Examples 11 and 12 of this section.

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

Example 1. In 1987, Corporation A only has a financial statement described in paragraph (c)(1)(iv) of this section and elects to treat net book income as equal to its current earnings and profits. In 1988, A has a certified audited financial statement (as described in paragraph (c)(1)(ii) of this section). In 1989, A only has a statement described in paragraph (c)(1)(iv) of this section. In 1988, A's certified audited financial statement is its applicable financial statement. However, in 1989, A is bound by the election it made in 1987 (unless revoked with the consent of the District Director) and must treat net book income as equal to its current earnings and profits.

Example 2. Corporation B prepares two unaudited financial statements. Both statements are distributed to creditors and are used for substantial non-tax purposes. The first financial statement is accompanied by an auditor's review report while the second statement has no auditor's review report. B has no other financial statement. Pursuant to paragraph (c)(3)(iv)(B)(*2*) of this section, the financial statement accompanied by the auditor's review report is B's applicable financial statement.

Example 3. Assume the same facts as in Example (2), except the financial statement accompanied by an auditor's review report is distributed to shareholders while the other statement is distributed to creditors, and both statements are used for substantial non-tax purposes. Pursuant to paragraph (c)(3)(ii) of this section, B's applicable financial statement is the statement distributed to its creditors. Paragraph (c)(3)(iv)(B)(*2*) of this section does not apply because the two statements are not of equal priority after applying paragraphs (c)(3) (i) and (ii) of this section.

Example 4. Corporation C is a closely held corporation with two shareholders. Both shareholders participate in the business on a day-to-day basis and are aware of the financial status of the business. C prepares a financial statement that is used by C's two shareholders to calculate bonuses. The financial statement prepared by C is used for a substantial non-tax purpose.

Example 5. Corporation D prepares a financial statement that it only sends to banks with which D is neither currently doing business nor negotiating. D does not reasonably anticipate that the financial statement will be relied on by the banks for any non-tax purpose, and therefore, for purposes of computing net book income, the financial statement is not used for a substantial non-tax purpose. The result would be the same if D sent the statement to a bank whose only relationship to D is that it holds a mortgage on D's property and D's rights and obligations under the mortgage are not affected by changes in its financial condition. The result would also be the same if D sent the statement to a bank with which D is doing business, and the statement is not reasonably expected to come to the attention of the bank's employees who are responsible for D's account.

Example 6. Corporation E and its subsidiaries, F and G are a consolidated group. Certified audited financial statements are prepared by EF and by FG. Both statements are used for substantial non-tax purposes. Pursuant to paragraph (c)(5)(i)(A) of this section, the financial statement that is prepared by EF is the applicable financial statement of the consolidated group. However, pursuant to paragraph (d)(6)(i)(B) of this section, an adjustment will be required to include the adjusted net book income attributable to G. The result would be the same even if the financial statement prepared by FG is of higher priority (under the rules of paragraph (c)(3) of this section) than the statement prepared by E and F.

Example 7. Corporation H and its subsidiaries I, J, and K are a consolidated group. Certified audited financial statements are prepared by H and I and by H, J, and K. Both statements are used for substantial non-tax purposes. The financial statement prepared by H, J, and K includes the greater amount of gross receipts attributable to members of the consolidated group and thus, pursuant to paragraph (c)(5)(i)(B)(*2*)(*i*) of this section, it is the consolidated group's applicable financial statement.

Example 8. Corporation L and its subsidiary M are a consolidated group. Corporation L also owns 100 percent of N, a foreign corporation that is not part of the consolidated group. A certified audited financial statement prepared by L, M and N discloses gross receipts of $200, of which $150 is attributable to L and M, and a separate certified audited financial statement prepared by L and M discloses gross receipts of $150. Both statements are used for substantial non-tax purposes. Pursuant to paragraph (c)(5)(i)(B) of this section, the consolidated group's applicable financial statement is the statement prepared by L, M and N.

Example 9. Corporation O is 60 percent owned by corporation P and 40 percent owned by corporation Q. Both P and Q prepare financial statements that are required to be filed with the SEC reflecting their respective interests in O. O also separately prepares a certified audited financial statement, or uses a summary of its books and records for credit purposes. Under paragraph (c)(5)(i)(C), O's separate statement is its applicable financial statement.

Example 10. Assume the same facts as in Example 9 except that O does not prepare a separate financial statement or a summary of its books and records for credit purposes. Pursuant to paragraph (c)(5)(i)(C) of this section, O must treat its net book income as equal to its current earnings and profits.

Example 11. Corporation R uses a calendar year for both financial accounting and tax purposes. Initially, R issues its calendar year 1987 financial statement on March 1, 1988. R's adjusted net book income resulting from this statement is $80. This would be R's applicable financial statement for 1987, but for the restatement described in the next sentence. On September 1, 1988, R restates its 1987 financial statement to correct an error (as described in Accounting Principles Board Opinion No. 20, paragraph 13). The restated financial statement is of the same priority as the initial financial statement. The restatement results in adjusted net book income for calendar year 1987 of $50. Pursuant to paragraph (c)(5)(iii)(B)(*2*)(*i*) of this section, the restated financial statement is treated as R's 1987 applicable financial statement.

Example 12. Assume the same facts as in Example (11), except that R restates its financial statement in order to reflect a change in accounting method. Since the restatement does not result from an error, paragraph (c)(5)(iii)(B)(*2*)(*i*) of this section does not apply. Pursuant to paragraph (c)(5)(iii)(B)(*2*)(*ii*) of this section, R's 1987 applicable financial statement is the financial statement for 1987 that results in the greater amount of adjusted net book income. Thus, R's March 1, 1988 financial statement is treated as its 1987 applicable financial statement.

Example 13. Corporation S, which is not a member of an affiliated group, uses a calendar year for both financial accounting and tax purposes. S's 1987 applicable financial statement is a certified audited financial statement. On January 1, 1988, S transfers all of its assets subject to liabilities to T, a newly created subsidiary that is 100 percent owned by S. The principal purpose of the transfer is to use the special rules of paragraph (c)(5)(i) of this section to reduce the adjusted net book income of S. For calendar year 1988, T prepares and uses a certified audited financial statement. Since S's only asset is its investment in T, S does not prepare a financial statement for calendar year 1988. In addition, since S is only a holding company, T's 1988 certified audited financial statement reports the same net book income that would have been reported on a consolidated ST financial statement. If paragraph (c)(5)(i)(D) of this section does not apply, ST's 1988 applicable financial statement is the financial statement of S (the parent of the consolidated group) with the highest priority. Under paragraph (c)(1) of this section, since S does not have a financial statement in 1988, the net book income of the ST consolidated group is ordinarily deemed to equal the aggregate earnings and profits of the members of the consolidated group. However, given these facts, the District Director may determine that the 1988 certified audited financial statement of T is the 1988 applicable financial statement of the ST consolidated group.

Example 14. The facts are the same as in Example 13, except that S has owned 100 percent of T for several years prior to calendar year 1987. In addition, prior to 1987, ST prepared a consolidated certified audited financial statement. For calendar year 1987, ST does not prepare a consolidated certified audited financial statement. Instead, T prepares and uses a certified audited financial statement while S does not prepare a financial statement. The principal purpose of the change in financial reporting is to use the special rules of paragraph (c)(5)(i) of this section to reduce the adjusted net book income of the ST consolidated group. Given these facts, the District Director may determine that the 1987 certified audited financial statement of T is the 1987 applicable financial statement of the ST consolidated group.

Example 15. Corporation U is a foreign corporation incorporated in A. U is a calendar year taxpayer for both financial accounting and tax purposes. U actively conducts three real estate businesses, X, Y and Z, in the United States. In 1987, X prepares a certified audited financial statement that it provides to its United States creditor. In addition, in 1987, X, Y and Z each prepare unaudited financial statements that they provide to U for incorporation in U's worldwide financial statement. Under paragraph (c)(5)(ii)(A) of this section, U's applicable financial statement is the certified audited financial statement prepared by X. However, pursuant to paragraph (d)(7) of this section, an adjustment is required to include any of U's effectively connected net book income that is not included in X's certified audited financial statement (*i.e.*, the effectively connected net book income attributable to Y and Z).

Example 16. Corporation A is a foreign corporation incorporated in Z. A is a calendar year taxpayer for both financial accounting and tax purposes. A actively conducts a real estate business, B, in the United States. B prepares a certified audited financial statement for 1987 using the accounting principles of Z that it provides to A for incorporation into A's worldwide financial statement. In addition, B prepares a review statement for 1987 using United States generally accepted accounting principles that it provides to its United States creditors. Both the certified statement and the review statement are denominated in United States dollars. Under paragraphs (c)(5)(ii)(A) and (c)(5)(ii)(B)(*1*) of this section, the financial statement prepared under the accounting principles of Z is the applicable financial statement.

Example 17. Assume the same facts as in Example (16) except that amounts are reported on B's certified audited financial statement in the currency of Z and amounts are reported on B's review statement in United States dollars. Since the review statement is denominated in United States dollars, under paragraph (c)(5)(ii)(B)(*2*) of this section, it is the applicable financial statement.

Example 18. Corporation C is a foreign corporation incorporated in Z. C is a calendar year taxpayer for both financial accounting and tax purposes. C actively conducts two real estate businesses, D and E, in the United States. D and E each separately prepare a certified audited financial statement for 1987 that they provide to their United States creditors. D's financial statement reports gross receipts of $100. E's financial statement reports gross receipts of $200. Under paragraph (c)(5)(ii)(C)(*2*) of this section, E's certified audited financial statement is the applicable financial statement and must be adjusted under the rules of paragraph (d)(7) of this section to include effectively connected book income attributable to D.

Example 19. F is a foreign corporation incorporated in X. F is a calendar year taxpayer for both financial accounting and tax purposes. F actively conducts a banking business, G, in the United States. G has been engaged in business in the United States since 1977. For the years 1977 through 1986, G did not prepare a separate financial statement. However, each year G provided F with its books, records and other raw financial data. F used this data in preparing its worldwide financial statement. G provides F with its 1987 books and records on January 5, 1988, in accordance with its historic practice. On February 15, 1988, G prepares an unaudited financial statement for calendar year 1987 that it provides to F. The principal purpose of creating this financial statement is to reduce net book income. Under these facts, the financial statement provided by G is not intended to be reasonably relied upon by F in preparing its worldwide financial statement. Therefore, for purposes of computing net book income, G's financial statement has not been used for a substantial non-tax purpose.

Example 20. Assume the same facts as in Example 19 except that for purposes of preparing F's 1987 worldwide financial statement, G does not provide F with any raw financial data, and G only provides F with an audited financial statement that is prepared for a substantial non-tax purpose. Under these facts, the financial statement provided by G is intended to be relied upon by F in preparing its worldwide financial statement. Therefore, for purposes of computing net book income, G's financial statement has been used for a substantial non-tax purpose.

Example 21. Corporation H is a foreign corporation incorporated in I. H is a calendar year taxpayer for both financial accounting and tax purposes. H actively conducts a real estate business, J, in the United States. For the years 1976 through 1986, J prepared a certified audited financial statement using United States dollars that it provided to H. In 1987, J prepares a certified audited financial statement using the currency of I. The principal purpose of the modification of J's financial reporting is to reduce the amount of the book income adjustment. Given these facts, the District Director may determine that J's 1987 certified audited financial statement prepared in the currency of I is J's applicable financial statement for 1987, and such statement must be converted into United States dollars based upon the translation used to prepare the certified audited financial statement in the currency of I. Accordingly, the effectively connected net book income of J for 1987 is the effectively connected net book income reported on the financial statement that has been converted into United States dollars.

(d) *Adjustments to net book income*—(1) *In general.* Adjusted net book income is computed by making the adjustments described in this paragraph (d) to net book income (as defined in paragraph (b)(2) of this section). No adjustment may be made to net book income except as provided in this paragraph (d).

(2) *Definitions*—(i) *Historic practice.* For purposes of this paragraph (d), historic practice is defined as an accounting practice that—

(A) Was used consistently by the taxpayer for each of the 2 years immediately preceding its first taxable year beginning after 1986, and

(B) Was used on the financial statement that would have been the taxpayer's applicable financial statement (as determined under paragraph (c) of this section) for each of the 2 years immediately preceding its first taxable year beginning after 1986 if section 56(f), as amended by the Tax Reform Act of 1986, had been in effect.

Thus, in order for a calendar year corporation to have an historic practice in 1987, the corporation must have used the accounting practice in its 1985 and 1986 financial statements. However, to be treated as used for purposes of this paragraph, an accounting practice must have been used prior to April 23, 1987. For example, an accounting practice that is first used after April 23, 1987, in a restatement of a taxpayer's 1985 and 1986 financial statements is not the taxpayer's historic practice.

(ii) *Accounting literature.* For purposes of this paragraph (d), the term "accounting literature" means—

(A) Generally accepted accounting principles (GAAP) as defined in the American Institute of Certified Public Accountants Professional Standards, AU § 411.05, paragraphs (a) through (c), and

(B) Pronouncements by the SEC including, but not limited to, Regulations S–X, SEC Financial Reporting Releases, and SEC Staff Accounting Bulletins,

that are effective for the accounting period covered by the applicable financial statement.

(3) *Adjustments for certain taxes*—(i) *In general.* Net book income for purposes of this paragraph (d) must be adjusted to disregard (for example, by adding back) any Federal income taxes or income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States that are directly or indirectly taken into account on the taxpayer's applicable financial statement. No adjustment is

made for taxes not described in the preceding sentence. Taxes directly or indirectly taken into account consist of the taxpayer's total income tax expense that includes both current and deferred income tax expense. In addition, items of income and expense, including extraordinary items that are stated net of tax, must be adjusted to disregard the taxes described in this paragraph (d)(3)(i). See paragraph (d)(4)(vii) of this section for an adjustment for certain deferred foreign taxes.

(ii) *Exception for certain foreign taxes.* Net book income is not adjusted to disregard taxes imposed by a foreign country or possession of the United States if the taxpayer does not choose to take the benefits of section 901 (relating to the foreign tax credit) with respect to these taxes for the taxable year. The rule in the preceding sentence only applies to the amount of taxes the taxpayer deducts in the current taxable year under section 164(a). See paragraph (d)(3)(iv), Example 4 of this section. Net book income also is not adjusted to disregard foreign taxes that cannot be claimed as a credit (other than by virtue of a foreign tax credit limitation). Thus, a taxpayer does not add back to net book income any taxes it is not allowed to claim as a credit against its United States income tax liability because of section 245(a)(8), 901(j), 907(b) or 908 of the Code.

(iii) *Certain valuation adjustments.* Income tax expense under paragraph (d)(3)(i) of this section does not include valuation adjustments such as the valuation adjustments related to purchase accounting described in Accounting Principles Board (APB) Opinion No. 16, paragraph 89. However, income tax expense does include the tax associated with any gain or loss on the sale or other disposition of any asset the basis of which was adjusted under paragraph 89 of Opinion 16. See paragraph (d)(3)(iv), Example 6 of this section.

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

Example 1. Corporation A has $120 of net book income. In calculating net book income, A has deducted $20 of state income tax expense and $60 of Federal income tax expense. Assuming there are no other adjustments to net book income, A's adjusted net book income is $180 ($120 of net book income + $60 of Federal income tax expense). Pursuant to paragraph (d)(3)(i) of this section, no adjustment is made for the state income tax expense.

Example 2. Assume the same facts as in Example 1, except that A also has a net extraordinary item of $40. Thus, A has net book income of $160 ($120 + $40). The $40 net extraordinary item is composed of a $70 gross extraordinary item less $30 of Federal income tax expense. Assuming there are no other adjustments to net book income, A's adjusted net book income is $250 ($160 of net book income + $60 of Federal income tax expense on book income other than the extraordinary item + $30 of Federal income tax expense on the extraordinary item).

Example 3. Assume the same facts as in Example 1, except that in calculating A's $120 of net book income, A has $50 of Federal income tax expense and $10 of foreign income tax expense. The $10 of foreign income tax expense results from a foreign branch and is composed of $7 of current foreign income tax expense and $3 of deferred foreign income tax expense. A chooses to take the benefits of the foreign tax credit under section 901 for the current taxable year. Assuming there are no other adjustments to net book income, A's adjusted net book income is $180 ($120 of net book income + $50 of Federal income tax expense + $10 of foreign income tax expense).

Example 4. Assume the same facts as in Example 3, except that A does not choose to take the benefits of the foreign tax credit in the current taxable year and instead deducts the $7 of current foreign income tax paid. Pursuant to paragraph (d)(3)(ii) of this section, net book income is not adjusted for the $7 of current foreign income tax expense. However, net book income is adjusted for the $3 of deferred foreign income tax expense. Thus, assuming there are no other adjustments to net book income, D's adjusted net book income is $173 ($120 of net book income + $50 of Federal income tax expense + $3 of deferred foreign income tax expenses).

Example 5. In 1987, corporation B only has a financial statement described in paragraph (c)(1)(iv) of this section. B elects pursuant to paragraph (c)(2) of this section to treat net book income as equal to its current earnings and profits. B's current earnings and profits in 1987 is $60, after reduction for $40 of Federal income tax (see paragraph (b)(5)(i) of this section). Pursuant to paragraph (d)(3) of this section, B must make a $40 adjustment to net book income. Thus, assuming no other adjustments to net book income, B's 1987 adjusted net book income is $100 ($60 of net book income + $40 adjustment for Federal income taxes).

Example 6. Corporation A acquires assets from corporation B in a transaction where the tax basis of B's assets will carry over to A. For financial accounting purposes, A will account for the acquisition in accordance with Accounting Principles Board (APB) Opinion No. 16. One of the assets acquired from B has an appraised value of $10,000. However, because the tax basis of B's assets will carry over to A, A's tax basis in the asset is only $7,000. Given these facts, APB Opinion No. 16, paragraph 89 requires that the asset be recorded at $10,000 less the tax effect of the difference between the appraised value and the tax basis. Assuming a 30 percent tax rate for A, the asset would be recorded at $9,100 ($10,000 appraised value—($3,000 difference between the appraised value and the tax basis × 30 percent)). If A sells the asset for $10,000, A will recognize a book gain of $900 with respect to the sale (assuming the asset is not amortized for book purposes). However, A will also have income tax expense of $900 (($10,000 sales proceeds—$7,000 tax basis) × 30 percent) with respect to the sale. Thus, A will have no net book income from the sale. Pursuant to paragraph (d)(3)(iii) of this section, A's income tax expense includes the $900 of income tax expense attributable to the effects of the valuation adjustment made in accordance with APB Opinion No. 16, paragraph 89. As a result, A's adjusted net book income with respect to its asset sale is $900 ($0 of net book income + $900 adjustment for income tax expense).

(4) *Adjustments to prevent omission or duplication*—(i) *In general.* In order to prevent omissions or duplications, net book income must be adjusted for the items described in paragraph (d)(4)(ii) through (d)(4)(vii) of this section and for such other items as approved or required by the Commissioner in published guidance. Except as provided in this paragraph (d), a taxpayer may not adjust net book income to prevent omission or duplication of items. See paragraph (d)(4)(viii), Example 1 of this section.

(ii) *Special rule for depreciating an asset below its cost.* Net book income must be adjusted to exclude depreciation or amortization expense to the extent such expense exceeds the asset's financial accounting historical cost (''excess depreciation''). However, no adjustment is required if excess depreciation has been the taxpayer's historic practice (as defined in paragraph (d)(2)(i) of this section) or if the excess depreciation is properly attributable to negative salvage value (*i.e.*, where the cost of removal or clean-up exceeds the salvage value).

(iii) *Consolidated group using current earnings and profits.* In the case of a consolidated group that uses its aggregate current earnings and profits as net book income (as determined under the rules of paragraph (b)(5)(ii) of this section), the current earnings and profits of the group is the aggregate of the current earnings and profits of each member of the group. In determining aggregate current earnings and profits, the adjustments described in §1.1502–33 apply except for the adjustment for intercompany distributions with respect to stock and obligations or members of the group described in §1.1502–33(c)(1) and the investment adjustment described in §1.1502–33(c)(4)(ii)(*a*).

(iv) *Restatement of a prior year's applicable financial statement*—(A) *In general.* If a taxpayer restates an applicable financial statement and as a result, the net book income for a taxable year is restated after the last date that the taxpayer could have filed its Federal income tax return for such taxable year (if it had obtained an extension of time under section 6081 of the Code), net book income for the first successor year (as defined in paragraph (d)(4)(iv)(D) of this section) must be adjusted by that part of the cumulative effect of the restatement on net book income attributable to taxable years beginning after 1986. To the extent that the cumulative effect of the restatement on net book income includes a tax component, paragraph (d)(3) of this section may apply. See paragraph (c)(5)(iii) of this section for rules relating to the restatement of an applicable financial statement prior to the date the taxpayer's return for the taxable year would be due if the time for filing the return is extended.

(B) *Reconciliation of owner's equity in applicable financial statements.* If—

(*1*) The beginning balance of owner's equity on the taxpayer's applicable financial statement for the current taxable year is different than the ending balance of owner's equity on the taxpayer's applicable financial statement for the preceding taxable year, and

(*2*) The taxpayer is not otherwise subject to the restatement rules in paragraph (d)(4)(iv)(A) of this section, the taxpayer will be deemed to have restated its applicable financial statement for the preceding year and paragraph (d)(4)(iv)(A) of this section will apply.

(C) *Use of different priority applicable financial statements in consecutive taxable years.* If the priority of a taxpayer's applicable financial statement (as determined under the rules of paragraph (c)(3) of this section) for the current taxable year is different than the priority of the taxpayer's applicable financial statement for the preceding taxable year, the taxpayer shall be required to adjust net book income to the extent required under the rules of either paragraph (d)(4)(iv) (A) or (B) of this section.

(D) *First successor year defined.* The ''first successor year'' is the first taxable year for which the taxpayer could have timely filed a return if it had obtained an extension of time under section 6081 of the Code after the restatement occurs. For example, if a calendar year corporation restates and uses its 1987 applicable financial statement between September 16, 1988 and September 15, 1989, any adjustment resulting from the restatement will be made in the taxpayer's 1988 Federal income tax return. If the restatement occurs prior to September 15, 1988, the rules of paragraph (c)(5)(iii) of this section will apply.

(E) *Exceptions.* (*1*) No adjustment is made under paragraph (d)(4)(iv)(A) of this section for a restatement prepared in accordance with APB Opinion No. 16, paragraph 53, requiring restatements of financial statements to reflect the combined operation of corporations combined in a pooling transaction.

(*2*) In order to prevent duplication of an adjustment, an adjustment otherwise required under paragraph (d)(4)(iv)(A) of this section may be decreased to take into account an adjustment previously made under the disclosure rules described in paragraph (d)(5) of the section. See paragraph (d)(4)(viii), Example 3 of this section.

(v) *Adjustment for items previously taxed as subpart F income.* Net book income does not include any item excluded from regular taxable income under section 959 if the item was included in adjusted net book income in a prior taxable year under the provisions of paragraph (b)(2)(iv) of this section and due to section 951. A taxpayer may not adjust net book income under this paragraph (d)(4)(v) to the extent any portion of the subpart F income was recognized during taxable years beginning before 1987. See Example 5 of paragraph (d)(4)(viii) of this section.

(vi) *Adjustment for poolings of interests.* In a business combination accounted for as a pooling of interests under paragraph 50 of APB Opinion 16, net book income does not include the income of a separate corporation for that part of the taxable year preceding the combination of that corporation with the taxpayer, to the extent the separate corporation included this income in its net book income for the taxable year preceding the business combination. A taxpayer may not adjust net book income under this paragraph (d)(4)(vi) to the extent the separate corporation's income is attributable to taxable years beginning before 1987.

(vii) *Adjustment for certain deferred foreign taxes.* In the case of deferred foreign taxes that were previously added back to net book income in accordance with paragraph (d)(3) of this section, a deduction is allowed in computing adjusted net book income for the taxable year in which the deferred foreign taxes are deducted under section 164(a). A taxpayer may not adjust net book income under this paragraph (d)(4)(vii) to the extent the foreign taxes were deferred during taxable years beginning before 1987.

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

Example 1. Corporation A uses a calendar year for both financial accounting and tax purposes. In 1986, A's financial statement included a $100 financial accounting loss for a plant shutdown. A could not deduct the loss on its 1986 Federal income tax return. In 1987, A deducts the loss from the 1986 plant shutdown in its 1987 Federal income tax return. As a result, A's 1987 adjusted net book income exceeds its 1987 pre-adjustment alternative minimum taxable income by $100 (an amount equal to the deduction for the 1986 plant shutdown). Pursuant to paragraph (d)(4)(i) of this section, A cannot make an adjustment to net book income.

Example 2. Corporation B uses a calendar year for both financial accounting and tax purposes. B issues its calendar year 1987 applicable financial statement on March 1, 1988. The applicable financial statement reports net book income for the calendar years 1985 through 1987 of $50, $70, and $80, respectively. On March 1, 1989 when it issues its calendar year 1988 applicable financial statement, B restates its 1985, 1986, and 1987 applicable financial statements. The restatement results from a change in accounting method that is made during calendar year 1988. After restatement, B's net book income for 1985, 1986, and 1987 is $60, $80, and $90, respectively. Based upon these facts, the cumulative effect of the restatement on B's net book income for years prior to 1988 is $30. However, since $20 of the cumulative effective is attributable to years beginning before 1987, B's 1988 net book income is increased by only $10 ($30−$20). If the cumulative effect includes a tax adjustment, see paragraph (d)(3) of this section

Example 3. Assume the same facts for Corporation B as in Example 2, except that B's 1987 net book income of $80 is increased by $10 for purposes of B's 1987 Federal income tax return. The $10 adjustment is made pursuant to paragraph (d)(5)(iii) of this section relating to disclosure in the accountant's opinion. Specifically, the accountant's opinion on B's 1987 applicable financial statement disclosed that if D had used a certain accounting method, B's 1987 net book income would have been $90 rather than $80. The restatement of B's 1987 applicable financial statement on March 1, 1988 results entirely from B changing to the accounting method referred to in the 1987 accountant's opinion. Pursuant to paragraph (d)(4)(iv)(E)(*2*) of this section, no adjustment is made to B's 1988 net book income as a result of the restatement of B's 1987 applicable financial statement.

Example 4. Assume the same facts as in Example 1, except that when A issues its 1987 applicable financial statement it also restates the net book income reported on its 1986 financial statement to exclude the $100 loss attributable to the plant shutdown. Furthermore, the $100 loss from the plant shutdown is included in A's 1987 net book income as reported on its 1987 applicable financial statement. Pursuant to paragraph (d)(4) of this section, no adjustment is made to A's 1987 net book income as a result of the restatement of A's 1986 net book income.

Example 5. Corporation D is a domestic corporation. D owns ten percent of the issued and outstanding stock of corporation F, a foreign corporation. D and F file separate financial statements and federal income tax returns, both on a calendar-year basis. F is a controlled foreign corporation as defined in section 957. In 1987, D includes ten percent of F's subpart F income in its income under section 951. F makes no actual distributions to D in that year, and D's applicable financial statement includes the earnings of F only when actual distributions are made. See paragraph (d)(6)(i)(A) of this section. In 1987, D must adjust its net book income under paragraph (b)(2)(iv) of this section to include ten percent of F's subpart F income. In 1988, F makes an actual distribution to D which qualifies for the exclusion of section 959. D includes this actual distribution as income on its applicable financial statement for 1987. Pursuant to paragraph (d)(4)(v) of this section, D must adjust its net book income for 1988 to exclude the actual distribution from F.

(5) *Adjustments resulting from disclosure*—(i) *Adjustment for footnote disclosure or other supplementary information*—(A) *In general.* Except as described in this paragraph (d)(5)(i), net book income must be increased by any amount disclosed in a footnote or other supplementary information to the applicable financial statement if the disclosure supports a calculation of a net book income amount that would be greater than the net book income reported on the taxpayer's applicable financial statement. However, net book income will not be increased if the disclosure—

(*1*) Is specifically authorized by the accounting literature described in paragraph (d)(2)(ii) of this section, or

(*2*) Is in accordance with the taxpayer's historic practice as defined in paragraph (d)(2)(i) of this section.

See paragraph (d)(5)(v), Examples 1 and 2 of this section.

(B) *Disclosures not specifically authorized in the accounting literature.* The following footnote or other supplementary disclosure will not be considered specifically authorized in the accounting literature—

(*1*) Disclosure of what the taxpayer's net book income would have if GAAP had been used in preparing the applicable financial statement instead of tax accounting rules (or disclosure of the adjustment necessary to determine net book income on a GAAP basis), and

(*2*) Disclosure of what the taxpayer's net book income would have been if the accrual method had been used in preparing the applicable financial statement instead of the cash method (or disclosure of the adjustment necessary to determine net book income on the accrual method).

(ii) *Equity adjustments*—(A) *In general.* Except as described in this paragraph (d)(5)(ii), net book income must be increased by the amount of any equity adjustment (as defined in paragraph (d)(5)(ii)(B) of this section) included in the applicable financial statement if the equity adjustment increases owner's equity as reported on the taxpayer's applicable financial statement and the increase is attributable to the taxpayer or a member of the taxpayer's consolidated group. However, net book income will not be increased if the equity adjustment—

(*1*) Is specifically authorized by the accounting literature described in paragraph (d)(2)(ii) of this section, or

(*2*) Is in accordance with the taxpayer's historic practice as defined in paragraph (d)(2)(i) of this section.

See paragraph (d)(5)(v), Examples 3 and 4 of this section.

(*B*) *Definition of equity adjustment.* An equity adjustment is any reconciling item between beginning and ending owner's equity as reported on the taxpayer's applicable financial statement for the current taxable year. However, if properly accounted for, the following reconciling items are not considered equity adjustments and do not require adjustment under paragraph (d)(5)(ii)(A) of this section—

(*1*) Net book income,

(*2*) Non-liquidating dividend distributions, and

(*3*) Contributions to capital.

(iii) *Amounts disclosed in an accountant's opinion.* Net book income must be increased by the amount of any item disclosed in the accountant's opinion (as described in paragraphs (c)(1)(ii)(C) and (c)(1)(ii)(D) of this section) if the disclosure supports a calculation of a net book income amount that would be greater than the net book income reported on the taxpayer's applicable financial statement. However, net book income will not be increased if the disclosure is in accordance with the taxpayer's historic practice, as defined in paragraph (d)(2)(i) of this section.

(iv) *Accounting method changes that result in cumulative adjustments to the current year's applicable financial statement*——(A) *In general.* If net book income for the current taxable year includes a cumulative adjustment attributable to an accounting method change and the amount of the cumulative adjustment may be determined upon review of the applicable financial statement (including footnotes) or other supplementary disclosure, net book income for the current taxable year shall be adjusted to exclude that portion of the cumulative adjustment attributable to taxable years beginning before 1987. To the extent the cumulative adjustment is reported net of a tax, paragraph (d)(3) of this section may apply. See paragraph (d)(5)(V), Example 5 of this section. If an accounting method change results in a restatement of an applicable financial statement, paragraphs (c)(5)(iii) or (d)(4)(iv)(A) of this section may apply.

(B) *Exception.* In order to prevent duplication of an adjustment, the adjustment required under paragraph (d)(5)(iv)(A) of this section may be decreased to take into account any adjustment for the accounting method change previously made under the rules described in paragraph (d)(5) of this section (relating to adjustments resulting from disclosure).

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

Example 1. Corporation A uses a calendar year for both financial accounting and tax purposes. For calendar years 1984 through 1986, A used the cash method of accounting on its financial statement and disclosed in a footnote the net income or loss that would have resulted if the accrual method of accounting had been used. A's 1987 net book income, as reported on its 1987 applicable financial statement, is $100 and is calculated on the cash method of accounting. In addition, a footnote in A's 1987 applicable financial statement states that A's 1987 net book income would have been $30 greater had the accrual method of accounting been used. Pursuant to paragraph (d)(5)(i)(B)(*2*) of this section, A's 1987 footnote disclosure is not considered specifically authorized by the accounting literature. However, since A made such disclosure for calendar years 1985 and 1986, the 1987 disclosure is in accordance with A's historic practice, as defined in paragraph (d)(2)(i) of this section. Since A satisfies the exception described in paragraph (d)(5)(i)(A)(*2*) of this section, no adjustment is made to A's 1987 net book income for the footnote disclosure.

Example 2. Assume the same facts for corporation B as in Example (1), except that B's 1985 and 1986 financial statements did not disclose the amount of income or loss that would result if the accrual method of accounting (rather than the cash method of accounting) were used. Since B does not satisfy either of the exceptions described in paragraph (d)(5)(i)(A) of this section, B's 1987 adjusted net book income is $130 ($100 of net book income plus $30 adjustment for footnote disclosure).

Example 3. Corporation C uses a calendar year for both financial accounting and tax purposes. C's 1987 net book income, as reported on its 1987 applicable financial statement, is $200. However, as specifically authorized in FASB Statement of Standards No. 52, C's 1987 applicable financial statement also includes a $50 equity adjustment (as defined in paragraph (d)(5)(ii)(B) of this section) for foreign currency translation gains. Since the equity adjustment is specifically authorized in the accounting literature, C satisfies the exception described in paragraph (d)(5)(ii)(A)(*1*) of this section, and no adjustment is made to C's 1987 net book income for the $50 equity adjustment.

Example 4. Assume the same facts for coporation D as in Example (3), except that D's equity adjustment is for foreign currency transaction gains instead of foreign currency translation gains. Pursuant to FASB Statement of Financial Accounting Standards No. 52, foreign currency transaction gains (as compared with foreign currency translation gains) are included in the income statement rather than in equity. In addition, in 1985 and 1986, D included foreign currency transaction gains in its income statement. Since D does not satisfy either of the exceptions described in paragraph (d)(5)(ii)(A) of this section, D's 1987 adjusted net book income is $250 ($200 of net book income plus $50 equity adjustment).

Example 5. Corporation E uses a calendar year for both financial accounting and tax purposes. E's net book income for 1988 is $100. The $100 of net book income includes $30 of financial accounting loss attributable to a cumulative adjustment as of January 1, 1988, resulting from a change in E's accounting method. The $30 cumulative loss is disclosed in E's 1988 applicable financial statement. If E had made the accounting method change in calendar year 1987, the cumulative loss as of January 1, 1987 would have been $20. Based upon the above facts, E must increase net book income by $20 to disregard that portion of the cumulative adjustment attributable to years beginning before 1987. Thus, assuming no other adjustments to net book income, E's adjusted net book income for 1988 is $120 ($100 plus $20).

(6) *Adjustments applicable to related corporations*—(i) *Consolidated returns*—(A) *In general.* Pursuant to paragraphs (a)(3) and (b)(3) of this section, the book income adjustment with respect to a consolidated group (as described under paragraph (a)(3) of this section) is computed based on the consolidated adjusted net book income (as defined in paragraph (b)(3)(i) of this section). In the case of any corporation that is not included in the consolidated group, consolidated adjusted net book income of the consolidated group shall include only the sum of the dividends received from such other corporation and other amounts includible in gross income under this chapter with respect to the earnings of such other corporation. See paragraph (d)(6)(v), Example 4 of this section.

(B) *Corporations included in the consolidated Federal income tax return but excluded from the applicable financial statement—(1) In general.* Consolidated net book income reported on the applicable financial statement (as determined under paragraph (c)(5) of this section) shall be adjusted to include net book income attributable to a corporation that is included in the consolidated group but is not included in the applicable financial statement. Net book income for the corporation not included in the applicable financial statement of the consolidated group is the net book income reported on such corporation's applicable financial statement (determined under the rules of paragraph (c) of this section and adjusted under the rules of this paragraph (d)). The adjusted net book income of such corporation must be consolidated with the adjusted net book income of other members of the consolidated group and appropriate adjustments, including consolidating elimination entries, must be made.

(*2*) *Adjustments to net book income for minority interests.* Consolidated net book income must be adjusted to include income or loss allocated to minority interests in members of the consolidated group. Failure to include income or loss allocated to minority interests shall be treated as an omission of net book income. See paragraph (d)(6)(v), Example 1 of this section.

(*3*) *Corporations included in the consolidated group that are accounted for under the equity method of accounting.* No adjustment is required to consolidated net book income for income or loss of a member of the consolidated group that is reported in the applicable financial statement under the equity method of accounting (as described in APB Opinion No. 18, paragraph (6)). However, consolidated adjusted net book income (as defined in paragraph (b)(3)(i) of this section) must include 100 percent of the net book income attributable to such member. See paragraph (d)(6)(i)(B)(*2*) of this section. For example, if consolidated net book income (as defined in paragraph (b)(3)(ii) of this section) only includes 85 percent of the equity income attributable to a member of the consolidated group, an adjustment will be required to include the 15 percent of equity income excluded from consolidated net book income. In addition, to the extent the equity income reflects an adjustment for tax expense or benefit, paragraph (d)(3) may apply. See paragraph (d)(6)(v), Examples 2 and 3 of this section.

(C) *Corporations included in the applicable financial statement but excluded from the consolidated tax return.* Net book income or consolidated net book income must be adjusted to eliminate the income or loss of a corporation that is included in the applicable financial statement, but is not included in the consolidated group. When net book income attributable to a corporation that is not a member of the consolidated group is removed from the computation of net book income in the applicable financial statement, consolidating elimination entries attributable to the excluded member must also be removed.

(ii) *Adjustment under the principles of section 482.* In order to fairly allocate items relating to intercompany transactions between corporations that are owned or controlled directly or indirectly by the same interests but are not members of a consolidated group, adjustments must be made to the net book income reported on the applicable financial statement of each corporation under the principles of section 482 and the regulations thereunder (relating to allocation of income and deductions among related taxpayers). For example, assume corporation A owns 100 percent of F, a foreign subsidiary, but A and F are not members of a consolidated group. However, A and F prepare a consolidated financial statement. In adjusting A's applicable financial statement to eliminate the net book income attributable to F, A must apply the principles of section 482. If a corporation fails to make appropriate adjustments to its applicable financial statement under the rules of this paragraph (d)(6)(ii), the District Director may make such adjustments under the principles of section 482 and the regulations thereunder.

(iii) *Adjustment for dividends received from section 936 corporations*—(A) *In general.* Any dividend received from a corporation eligible for the credit provided by section 936 (relating to the possession tax credit) shall be included in adjusted net book income. For example, assume corporation A owns 100 percent of B, a section 936 corporation, and B pays a $100 dividend to A. Furthermore, assume that of the $100 dividend, $15 of withholding tax is paid to a possession of the United States, so that A only receives $85 from the dividend. Given these facts, A's adjusted net book income includes $100 with respect to the dividend from B.

(B) *Treatment as foreign taxes.* Fifty percent of any withholding tax paid to a possession of the United States with respect to dividends referred to in paragraph (d)(6)(iii)(A) of this section may be treated for purposes of the alternative minimum foreign tax credit as a tax paid to a foreign country by the corporation receiving the dividend. However, if the aggregate of these dividends exceeds the excess referred to in paragraph (a)(1) of this section, the amount treated as a tax paid to the foreign country shall not exceed 50 percent of the aggregate amount of the tax withheld multiplied by a fraction.

(*1*) The numerator of which is the excess referred to in paragraph (a)(1) of this section; and

(*2*) The denominator numerator of which is the aggregate amount of these dividends.

(C) *Treatment of taxes imposed on section 936 corporations.* Taxes paid by any corporation eligible for the credit provided under section 936 shall be treated as a withholding tax paid with respect to any dividend paid by such corporation, and thus subject to the rules of this paragraph (d)(6)(iii), but only to the extent such taxes would be treated as paid by the corporation receiving the dividend under rules similar to the rules of section 902.

(iv) *Adjustment to net book income on sale of certain investments.* If a taxpayer accounts for an investment under any method equivalent to the equity method of accounting (as described in APB Opinion No. 18, paragraph 6) and pursuant to paragraphs (b)(2)(iv) or (d)(6)(i) of this section the taxpayer excludes net book income attributable to that investment, the taxpayer must adjust its net book income in the year the investment is sold (or partially sold). The adjustment equals the amount of net book income previously excluded under paragraphs (b)(2)(iv) or (d)(6)(i)(A) of this section). See paragraph (d)(6)(v), Example 4 of this section.

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

Example 1. Corporation A and its 100 percent owned subsidiary B and its 90 percent owned subsidiary C are a consolidated group. A also owns 100 percent of D, a foreign corporation. ABC's applicable financial statement is a certified audited financial statement that includes A, B, C and D. The net book income reported on the statement excludes $10 of C's net book income that is attributable to the 10 percent minority interest in C held outside of the consolidated group. Pursuant to paragraph (d)(6)(i)(B)(*2*) of this section, net book income of the consolidated group must be adjusted to include the $10 of net book income attributable to the minority interest in C. In addition, pursuant to paragraph (d)(6)(i)(C) of this section, net book income shown on the applicable financial statement must be adjusted to eliminate the net book income attributable to D.

Example 2. Corporation E owns 100 percent of F, a finance subsidiary, and EF are a consolidated group. Since F is a finance subsidiary E's applicable financial statement accounts for F under the equity method of accounting. F also prepares a separate financial statement that is of equal or higher priority than E's applicable financial statement. In 1987, E's applicable financial statement includes $60 of equity income from F. The $60 of equity income reflects a reduction for $40 of Federal income tax expense. Thus, E's equity income from F prior to the reduction for Federal income tax expense, is $100 ($60 + $40). Since E's applicable financial statement includes E's equity income in F, F's separate financial statement is not relevant for determining the adjusted net book income of the EF consolidated group. However, pursuant to paragraphs (d)(3) and (d)(6)(i)(B)(*3*) of this section, E is required to adjust its equity income in F by the $40 of Federal income tax expense attributable to F. Thus, assuming there are no other adjustments, E's adjusted net book income with respect to F is $100.

Example 3. The facts are the same as Example (2), except that E reports its equity income in F without reduction for F's Federal income tax expense. The $40 of Federal income tax expense attributable to F is combined with E's Federal income tax expense. Assuming no other adjustments, E's adjusted net book income with respect to F is $100. Thus, E's adjusted net book income with respect to F will be the same regardless of whether E's equity income in F is reported before or after taxes.

Example (4). A, a domestic corporation, uses a calendar year for both financial accounting and tax purposes. On January 1, 1987, A purchases 100 percent of F, a foreign corporation, for $100. F does not file a Federal income tax return and A does not recognize any taxable income with respect to F under section 951 (relating to controlled foreign corporations). In its applicable financial statement, A accounts for its investment in F under the equity method of accounting. Thus, A's initial investment in F is $100. During calendar year 1987, F has $50 of net book income but makes no dividend payments to A. Under the equity method of accounting, A's net book income includes the $50 of net book income attributable to A's net book investment in F. Thus, A's investment in F is increased to $150. Pursuant to paragraph (d)(6)(i)(C) of this section, A's net book income is adjusted to eliminate the $50 of net book income attributable to F. On January 1, 1988, A sells F for $150. Since A's investment in F under the equity method of accounting is $150, A's net book income for 1988 will not include any gain on the sale of F. However, pursuant to paragraph (d)(6)(iv), A's 1988 net book income must be increased by $50, the amount of net book income previously eliminated with respect to A's investment in F. The result would be the same if instead of accounting for its investment in F under the equity method of accounting, A and F prepare a consolidated financial statement.

(7) *Adjustments for foreign taxpayers with a United States trade or business*—(i) *In general.* Pursuant to paragraph (b)(6)

of this section, the book income adjustment with respect to a foreign taxpayer with a United States trade or business is computed based on the effectively connected net book income of the foreign taxpayer (as defined in paragraph (b)(6)(ii) of this section). The net book income amount reported on the applicable financial statement of the foreign taxpayer (as determined under paragraph (c)(5)(ii) of this section) must be adjusted to—

(A) Include effectively connected net book income attributable to a trade or business conducted in the United States by the foreign taxpayer that is not reported on the applicable financial statement. Such amounts shall be determined from a financial statement (determined under paragraph (c) of this section and adjusted under the rules of this paragraph (d)) that would have qualified as an applicable financial statement of such excluded trade or business or upon effectively connected earnings and profits (if the rules of section (b)(6)(iii) of this section apply), and

(B) Exclude any amount reported on such applicable financial statement that does not qualify as effectively connected net book income.

See the example in paragraph (d)(7)(ii) of this section.

(ii) *Example.* The provisions of this paragraph may be illustrated by the following example.

Example. Foreign corporation A, a calendar year taxpayer for financial accounting and tax purposes, is incorporated in X. A actively conducts two real estate businesses, B and C, in the United States. B prepares a certified audited financial statement that it provides to its United States creditor. C does not prepare a financial statement. The certified audited financial statement prepared by B is treated as A's applicable financial statement under paragraph (c)(5)(ii) of this section. B's certified audited financial statement, in addition to amounts related to the conduct of its real estate business, also reports income received from its investment in United States securities, unrelated to its conduct of business in the United States that does not qualify as effectively connected net book income. In order to determine A's effectively connected net book income from the net book income reported on the applicable financial statement, such statement must be adjusted to exclude amounts attributable to the securities. In addition, book income or loss attributable to C, to the extent effectively connected to its business in the United States, must be included in the effectively connected net book income reported on B's financial statement. Since C does not have a financial statement, C's effectively connected net book income is determined by computing its effectively connected earnings and profits under paragraph (b)(6)(iii) of this section.

(8) *Adjustment for corporations subject to subchapter F.* A corporation subject to tax under subchapter F of chapter 1 of the Code shall adjust its book income to exclude all items of income, loss or expense other than those relating to the calculation of unrelated business taxable income for purposes of section 512(a).

(e) *Special rules*—(1) *Cooperatives.* For purposes of computing the book income adjustment, net book income of a cooperative to which section 1381 applies is reduced by patronage dividends and per-unit retain allocations under section 1382(b) that are paid by the cooperative to the extent such amounts are deductible for regular income tax and general alternative minimum tax purposes under section 1382, and not otherwise taken into account in determining adjusted net book income.

(2) *Alaska Native Corporations.* In computing the net book income of an Alaska Native Corporation, cost recovery and depletion are computed using the asset basis determined under section 21(c) of the Alaska Native Claims Settlement Act (43 U.S.C. 1620(c)). In addition, net book income is reduced by expenses payable under either section 7(i) or section 7(j) of the Alaska Native Claims Settlement Act (43 U.S.C. 1606 (i) and (j)) only when deductions for such expenses are allowed for tax purposes.

(3) *Insurance companies.* In the case of an insurance company whose applicable financial statement is a statement describing in paragraph (c)(1)(iii) of this section (relating to statements provided to a government regulator), net book income for purposes of the book income adjustment is the net income or loss from operations, after reduction for dividends paid to policyholders, but without reduction for Federal income taxes.

(4) *Estimating the book income adjustment for purposes of the estimated tax liability.* See §1.6655–7 for special rules for estimating the corporate alternative minimum tax book income adjustment under the annualization exception.

[T.D. 8307, 55 FR 33676, Aug. 17, 1990]

REGULATIONS APPLICABLE TO TAXABLE YEARS BEGINNING IN 1969 AND ENDING IN 1970

§1.56A–1 Imposition of tax.

(a) *In general.* Section 56(a) imposes an income tax on the items of tax preference (as defined in §1.57–1) of all persons other than persons specifically exempt from the taxes imposed by chapter 1. The items of tax preference represent income of a person which either is not subject to current taxation by reason of temporary exclusion (such as stock options) or by reason of an acceleration of deductions (such as accelerated depreciation) or is sheltered from full taxation by reason of certain deductions (such as percentage depletion) or by reason of a special rate of tax (such as the rate of tax on corporate capital gains). The tax imposed by section 56 is in addition to the other taxes imposed by chapter 1.

(b) *Computation of tax.* The amount of such tax is 10 percent of the excess (referred to herein as ‘‘the minimum tax base’’) of—

(1) The sum of the taxpayer’s items of tax preference for such year in excess of the taxpayer’s minimum tax exemption (determined under §1.58–1) for such year, over

(2) The sum of:

(i) The taxes imposed for such year under chapter 1 other than the taxes imposed by section 56 (relating to minimum tax for tax preferences), by section 531 (relating to accumulated earnings tax), or by section 541 (relating to personal holding company tax), reduced by the sum of the credits allowable under—

(*a*) Section 33 (relating to taxes of foreign countries and possessions of the United States),

(*b*) Section 37 (relating to retirement income),

(*c*) Section 38 (relating to investment credit),

(*d*) Section 40 (relating to expenses of work incentive programs), and

(*e*) Section 41 (relating to contributions to candidates for public office, and

(ii) The tax carryovers to such taxable year (as described in §1.56A–5).

(c) *Special rule.* For purposes of paragraph (b) of this section where for any taxable year in which a tax is imposed under section 667 (relating to treatment of amounts deemed distributed by a trust in preceding years), that portion of the section 667 tax representing an increase in an earlier year’s chapter 1 taxes (as recomputed), which taxes are allowed as a reduction in any such earlier year’s minimum tax base, is not allowable as a reduction in the minimum tax base for the current taxable year. The remaining portion of the section 667 tax, representing the taxes imposed by section 56, section 531, and section 541, is not allowable as a reduction in the minimum tax base for any taxable year. Similarly, taxes imposed under section 614(c)(4) (relating to increase in tax with respect to aggregation of certain mineral interests) or under section 1351(d) (relating to recoveries of foreign expropriation losses) for any taxable year are not allowed as a reduction in the minimum tax base for such taxable year to the extent they represent chapter 1 taxes which are allowed as a reduction in a minimum tax base for an earlier taxable year for purposes of the computations under section 614(c)(4) or section 1351(d) or to the extent they represent an increase in the tax imposed by section 56, section 531, or section 541 in an earlier taxable year.

[T.D. 7564, 43 FR 40466, Sept. 12, 1978. Redesignated and amended by T.D. 8138, 52 FR 15309, Apr. 28, 1987]

§1.56A–2 Deferral of tax liability in case of certain net operating losses.

(a) *In general.* Section 56(b) provides for the deferral of liability for the minimum tax where, for the taxable year, the taxpayer has—

(1) A net operating loss for such taxable year any portion of which (under sec. 172) remains as a net operating loss carryover to a succeeding taxable year, and

(2) Items of tax preference in excess of the minimum tax exemptions (hereinafter referred to as ‘‘excess tax preferences’’).

In such a case, an amount of tax equal to the lesser of the tax imposed under section 56(a) (after allowance of the retirement income credit to the extent that such credit cannot be used against the other taxes imposed by chapter 1) or 10 percent of the amount of the net operating loss carryover described in subparagraph (1) of this paragraph is deferred. Such amount is not treated as tax imposed in such taxable year, but is treated as tax imposed in the succeeding taxable year or years in which the net operating loss is used as provided in paragraphs (b) and (c) of this section. Deferral will result in the above case regardless of the character of the tax preference items. Thus, for example, if the taxpayer has $1,030,000 of items of tax preference, including the stock option item of tax preference, and a $750,000 net operating loss available for carryover to subsequent taxable years, the amount of tax imposed for the taxable year under section 56(a) is $100,000 and $75,000 is deferred by application of section 56(b). Therefore, only $25,000 is treated as tax imposed for the taxable year. The provisions of this section are applicable in the case of a net operating loss or comparable item such as an operations loss under section 812 and an unused loss as defined in section 825(b).

(b) *Year of liability.* In any taxable year in which any portion of a net operating loss carryover attributable to the amount of excess tax preferences reduces taxable imcome (in the form of a net operating loss deduction), section 56(b)(2) treats as tax liability imposed in such taxable year an amount equal to 10 percent of such reduction. For this purpose, the portion of such net operating loss which is considered attributable to the amount of excess tax preferences is an amount equal to the lesser of such excess or the amount of the net operating loss carryover described in paragraph (a)(1) of this section. In no case, however, shall the total amount of tax imposed by reason of section 56(b) in subsequent years exceed the amount of the tax that was deferred in the loss year.

(c) *Priority of reduction.* (1) If a portion of a net operating loss is attributable to an amount of excess tax preferences, such portion is considered to reduce taxable income in succeeding taxable years only after the other portion (if any) of such net operating loss is used to reduce taxable income. Accordingly, if the amount of a net operating loss which may be carried to succeeding taxable years is reduced because of a modification required to be made pursuant to section 172(b)(2), such reduction is to be considered to be first from that portion of the net operating loss that is attributable to excess tax preferences. If a portion of a net operating loss carryover which is attributable to an amount of excess tax preferences is not used to reduce taxable income in any succeeding taxable year, no minimum tax will be imposed with respect to such portion.

(2) In the case of taxpayers with deductions attributable to foreign sources which are suspense preferences (as defined in paragraphs (c) (1)(ii) and (2)(ii) of §1.58–7), the amount of such deductions is not included in the portion of the net operating loss not attributable to excess tax preferences. The portion of the net operating loss attributable to excess tax preferences is increased by the amount of suspense preferences which are, in accordance with the provisions of §1.58–7(c), converted to actual items of tax preference (and not used against the minimum tax exemption of the loss year) in subsequent taxable years. The other portion of the net operating loss is increased by the amount of suspense preferences which reduce taxable income in subsequent taxable years but are not converted to actual items of tax preference (or are so converted but used against the minimum tax exemption of the loss year). See §1.58–7(c)(1)(iii) example 4.

(d) *Multiple net operating loss carryovers.* In determining whether a net operating loss is used to reduce taxable income in a taxable year to which two or more net operating losses are carried, the ordering rules of section 172(b) and the regulations thereunder are to be applied. Thus, for example, the portion of a net operating loss carried over from an earlier taxable year which is attributable to an amount of excess tax preference is used to reduce taxable income in the carryover year before any portion of any other net operating loss carried over or back from a taxable year subsequent to the earlier taxable year.

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

Example 1. In 1970, A, a calendar year taxpayer, who is a single individual, has $180,000 of items of tax preference, a $150,000 net operating loss of which $100,000 may be carried forward, and no tax liability under chapter 1 without regard to the minimum tax. His minimum tax computed under section 56(a) is $15,000 (10 percent times ($180,000 minus $30,000)). Under section 56(b)(1) an amount equal to the lesser of the amount determined under section 56(a) ($15,000) or 10 percent of the net operating loss which may be carried forward ($10,000) is treated as a deferred liability. Thus, his minimum tax liability for 1970 is $5,000 ($15,000 minimum tax under section 56(a) minus $10,000 deferred tax liability under section 56(b)). If, in 1971, he has $80,000 of taxable income before the deduction for the 1970 net operating loss, his minimum tax liability is $8,000 (10 percent of the amount by which the net operating loss carryforward from 1970 reduces taxable income) plus any minimum tax liability resulting from items of tax preference arising in 1971. If, by reason of the modifications provided by section 172(b)(2), no portion of the 1970 net operating loss remains as a carryover from 1971, no further minimum tax liability will result from the items of tax preference arising in 1970.

Example 2. In 1970, A, a calendar year taxpayer who is a single individual, has $90,000 of items of tax preference, a $100,000 net operating loss available for carryover to future taxable years, no net operating loss carryovers from prior taxable years, and no tax liability under chapter 1 without regard to the minimum tax. His minimum tax computed under section 56(a) is $6,000 (10 percent times ($90,000 minus $30,000)). Under section 56(b)(1) an amount equal to the lesser of the amount determined under section 56(a) ($6,000) or 10 percent of the net operating loss subject to carryforward ($10,000) is treated as a deferred liability. Thus, A owes no minimum tax in 1970 and the entire $6,000 of minimum tax liability is deferred. Under section 56(b)(2), the portion of the net operating loss attributable to the excess tax preferences described in section 56(b)(1)(B) is $60,000.

(a) In 1971, A has $25,000 of taxable income before the deduction for the 1970 net operating loss. Thus, in 1971, A has no minimum tax liability attributable to the items of tax preference arising in 1970 since, by application of section 56(b)(3), the portion of the 1970 net operating loss carryforward not attributable to the excess described in section 56(b)(1)(B), or $40,000, is considered applied against taxable income before the remaining portion.

(b) In 1972, A has $50,000 of taxable income before the deduction for the remaining 1970 net operating loss. Thus, the first $15,000 of reduction in taxable income is considered as from the portion of the 1970 net operating loss carryforward not attributable to the excess tax preferences described in section 56(b)(1)(B) and the remaining $35,000 of reduction in taxable income is considered attributable to such excess. A's 1972 minimum tax attributable to items of tax preference arising in 1970 is, therefore, $3,500 (10 percent times $35,000).

(c) In 1973, A has $80,000 of taxable income before the deduction for the 1970 net operating loss. The remaining $25,000 of the 1970 net operating loss carryforward is used to reduce taxable income in 1973. Thus, A's 1973 minimum tax liability attributable to items of tax preference arising in 1970 is $2,500 (10 percent times $25,000).

Example 3. In 1971, M Corporation, a Western Hemisphere trade corporation (as defined in sec. 921), reporting on a calendar year basis has $20,000 of taxable income after all deductions including the Western Hemisphere trade deduction allowable under section 922 in the amount of $30,000. In 1970, M Corporation had a net operating loss of $100,000 all of which was available for carryover to 1971 and $60,000 of which was attributable to excess tax preferences. In computing the amount of the 1970 net operating loss carried over to 1972 pursuant to section 172(b), the 1971 Western Hemisphere trade corporation deduction is not taken into account. Thus, M Corporation's recomputed income under section 172(b) is $50,000 ($20,000 taxable income plus $30,000 Western Hemisphere trade corporation deduction). Pursuant to paragraph (c)(1) of this section, $20,000 of the $40,000 portion of the 1970 net operating loss not attributable to excess tax preferences is considered to reduce taxable income in 1971 and $30,000 of the $60,000 portion of the 1970 net operating loss attributable to excess tax preferences is considered reduced pursuant to section 172(b)(2). Thus, M Corporation has no 1971 minimum tax attributable to items of tax preference arising in 1970. Of the $50,000 remaining of the 1970 net operating loss, $30,000 is attributable to excess tax preference.

Example 4. In 1972, A, a calendar year taxpayer who is a single individual, has $25,000 of taxable income resulting from $50,000 of net long-term capital gains. In 1971, A had a net operating loss of $100,000 all of which is available to carryover to 1972 and $60,000 of which is attributable to excess tax preferences. By application of section 172(b) only $50,000 of the 1971 net operating loss is carried over to 1973. Pursuant to paragraph (c) of this section, $25,000 of the $40,000 portion of the 1971 net operating loss not attributable to excess tax preferences is considered to reduce taxable income in 1972. Of the $50,000 remaining of the 1971 net operating loss, $15,000 is not attributable to excess tax preferences and $35,000 is attributable to excess tax preferences. Thus, the $25,000 section 1202 deduction, in effect, reduces the portion of the 1971 net operating loss attributable to excess tax preferences. Because a net operating loss carryover is reduced to the extent of any section 1202 deduction, section 1202 deductions do not normally produce a tax benefit in such circumstances and, pursuant to § 1.57–4, would not be treated as items of tax preference. However, in this case, to the extent the portion of the 1971 net operating loss carryover attributable to excess tax preferences is reduced by reason of the section 1202 deduction, such deduction does result in a tax benefit to the taxpayer and is, therefore, treated as an item of tax preference in 1971. See § 1.57–4(b)(2).

[T.D. 7564, 43 FR 40467, Sept. 12, 1978. Redesignated by T.D. 8138, 52 FR 15309, Apr. 28, 1987]

§ 1.56A–3 Effective date.

(a) *In general.* The minimum tax is effective for taxable years ending after December 31, 1969.

(b) *Taxable year beginning in 1969 and ending in 1970.* In the case of a taxable year beginning in 1969 and ending in 1970, the amount of the minimum tax shall be an amount equal to the amount determined under section 56 multiplied by the following fraction:

Number of days in the taxable year ending after December 31, 1969÷Number of days in the entire taxable year.

Where, by reason of section 56(b) and § 1.56A–2, tax initially imposed in a 1969–70 fiscal year is deferred until a subsequent taxable year or years, the amount of such tax liability in any subsequent taxable year is determined by application of the above fraction. Section 21, relating to computation of tax in years where there is a change in rates, is not applicable to the initial imposition of the minimum tax for tax preferences. The applications of this paragraph may be illustrated by the following example:

Example. The taxpayer uses a June 30 fiscal year. For fiscal 1969–1970 the taxpayer has $180,000 of items of tax preference and a $50,000 net operating loss. In fiscal year 1970–1971, the taxpayer uses the full net operating loss carryover from 1969–1970 to reduce his taxable income by $50,000. Thus, without regard to the proration rules applicable under this section, the taxpayer's minimum tax liability for items of tax preference arising in 1969–1970 is $15,000, i.e., 10 percent×($180,000−$30,000), of which $5,000, i.e., 10 percent×$50,000, is deferred until 1970–1971 under the principles of section 56(b) and section 1.56A–2. By application of the above formula the taxpayer's actual minimum tax liability is $4,958.90 in 1969–1970 and $2,479.45 in 1970–1971 determined as follows:

1969–1970: 181/365×$10,000
1970–1971: 181/365×$5,000

[T.D. 7564, 43 FR 40468, Sept. 12, 1978. Redesignated and amended by T.D. 8138, 52 FR 15309, Apr. 28, 1987]

§ 1.56A–4 Certain taxpayers.

For application of the minimum tax in the case of estates and trusts, electing small business corporations, common trust funds, regulated investment companies, real estate investment trusts, and partnerships, see §§ 1.58–2 through 1.58–6.

[T.D. 7564, 43 FR 40468, Sept. 12, 1978. Redesignated by T.D. 8138, 52 FR 15309, Apr. 28, 1987]

§ 1.56A–5 Tax carryovers.

(a) *In general.* Section 56(c) provides a 7–year carryover of the excess of the taxes described in paragraph (1) of such section imposed during the taxable year over the items of tax preference described in paragraph (2) of such section for such taxable year for the purpose of reducing the amount subject to tax under section 56(a) in subsequent taxable years.

(b) *Computation of amount of carryover.* The amount of tax carryover described in section 56(c) is the excess (if any) of—

(1) The taxes imposed for the taxable year under chapter 1 other than taxes imposed by section 56 (relating to minimum tax for tax preferences), by section 531 (relating to accumulated earnings tax), or by section 541 (relating to personal holding company tax), reduced by the sum of the credits allowable under—

(i) Section 33 (relating to taxes of foreign countries and possessions of the United States),

(ii) Section 37 (relating to retirement income,

(iii) Section 38 (relating to investment credit),

(iv) Section 40 (relating to expenses of work incentive programs), and

(v) Section 41 (relating to contributions to candidates for public office), over

(2) The sum of the taxpayer's items of tax preference for such year in excess of the taxpayer's minimum tax exemption (determined under §1.58–1) for such year.

For purposes of section 56(c) and this section, taxes imposed in a taxable year ending on or before December 31, 1969, are not included in the taxes described in subparagraph (1) of this paragraph. In addition, the rules of paragraph (c) of §1.56A–1 are applicable in determining the taxable year for which taxes are imposed under chapter 1 for purposes of paragraph (a)(1) of this section.

(c) *Operation of carryover.* Tax carryovers attributable to the taxable year shall be carried over to each of the 7 succeeding taxable years as follows:

(1) To the first such succeeding taxable year to reduce in the manner described in paragraph (d) of this section the amount subject to tax under section 56(a) for such first succeeding taxable year and

(2) To the extent such amount is not used as a reduction in the amount subject to tax under section 56(a) for such taxable year, such amount (if any) is carried over to each of the succeeding 6 taxable years but only to the extent such amount is not used to reduce the amount subject to tax under section 56(a) in taxable years intervening between the taxable year to which such amount is attributable and the taxable year to which such amount may otherwise be carried over.

(d) *Priority of reduction.* Where tax carryovers attributable to two or more taxable years are carried over to a subsequent taxable year such amounts attributable to the earliest taxable year shall be used to reduce the amount subject to tax under section 56(a) for such subsequent taxable year before any such amounts attributable to a later taxable year.

(e) *Special rules*—(1) *Periods of less than 12 months.* A fractional part of a year which is a taxable year under section 441(b) or 7701(a)(23) is a taxable year for purposes of section 56(c) and this section.

(2) *Electing small business corporations.* A taxable year for which a corporation is an electing small business corporation (as defined in section 1371(b)) shall be counted as a taxable year for purposes of determining the taxable years to which amounts which are available as a carryover under paragraph (a) of this section may be carried whether or not such carryovers arose in a year in which an election was in effect.

(3) *Husband and wife*—(i) *From joint to separate return.* If a joint return is filed by a husband and wife in a taxable year or years to which a tax carryover is attributable but separate returns are filed in any subsequent taxable year to which such carryover may be carried over to reduce the amount subject to tax under section 56(a), such carryover described in paragraph (b) of this section shall be allocated between husband and wife for purposes of reducing the amount subject to tax under section 56(a) for such subsequent taxable year in accordance with the principles of §1.172–7(d).

(ii) *From separate to joint return.* If separate returns are filed by a husband and wife in a taxable year or years in which a tax carryover is attributable but a joint return is filed in any subsequent taxable year to which such carryover may be carried over to reduce the amount subject to tax under section 56(a), such carryover shall be aggregated for purposes of reducing the amount subject to tax under section 56(a), for such subsequent taxable year.

(4) *Estates and trusts.* In the case of the termination of an estate or trust, tax carryovers attributable to the estate or trust shall not be allowed to the beneficiaries succeeding to the property of the estate or trust.

(5) *Corporate acquisitions.* In the case of a transaction to which section 381(a) applies, the acquiring corporation shall succeed to and take into account, as of the close of the date transfer the tax

carryovers attributable to the distributor or distribution or transferor corporation. The portion of such carryovers which may be taken into account under paragraph (b)(2)(ii) of § 1.56A–1 for any taxable year shall not exceed the excess of (i) the sum of the items of tax preference for such year resulting from the continuation of the business in which the distributor or transferor corporation was engaged at the time of such transaction and the items of tax preference not related to the continuation of such business which are directly attributable to the assets acquired from the distributor or transferor corporation over (ii) an amount which bears the same ratio to the acquiring corporation's minimum tax exemption for such year as the items of tax preference described in subdivision (i) of this subparagraph bears to all of the acquiring corporation's items of tax preference for such year. This item shall be taken into account by the acquiring corporation subject to the rules in section 381(b) and the regulations thereunder.

(f) *Suspense preferences.* Where an item of tax preference which is a suspense preference (as defined in § 1.58–7) arises in a taxable year in which tax carryovers may be used to reduce the minimum tax base (or in which such carryovers arise the minimum tax liability for that year and the tax carryovers to subsequent taxable years shall be recomputed upon the conversion of the suspense preference in a subsequent year. In lieu of the above, in all cases, since there is no difference in tax consequence, the recomputation may be accomplished by recomputing the minimum tax liability of the taxable year in which the suspense preference arose without reduction of the minimum tax base for the tax carryovers which have been used as a reduction in the minimum tax base in intervening taxable years. If such method is used, the minimum tax liability of the intervening year is not recomputed and any tax carryovers carried from the taxable year in which the suspense preference arose which remain as a carryover in the year of conversion are reduced, in the priority provided in paragraph (d) of this section, to the extent used to reduce an increase in the minimum tax base for the earlier year resulting from the conversion of the suspense preference.

(g) *Taxes imposed in a taxable year beginning in 1969 and ending in 1970.* In the case of a taxable year beginning in 1969 and ending in 1970 the amount of the carryover determined under paragraph (b) of this section is reduced to an amount equal to the amount of such carryover (without regard to this paragraph) multiplied by the following fraction:

Number of days in taxable year ending after December 31, 1969 ÷Number of days in the entire taxable year.

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

Example 1. A is a single individual who uses a June 30 fiscal year. For fiscal 1968–1969, A had income tax liability under chapter 1 in the amount of $100,000. For fiscal 1969–1970, A had items of tax preference in the amount of $212,500 and income tax liability under chapter 1 (other than taxes imposed under sections 56, 531, and 541) of $365,000.

(a) The chapter 1 tax attributable to fiscal 1968–1969 is not available as a carryover under section 56(c) to reduce the amount subject to tax under section 56(a) since this tax arose in a taxable year ending on or before December 31, 1969.

(b) A portion of the excess of chapter 1 tax over the amount subject to tax under section 56(a) attributable to fiscal year 1969–1970 is available as a carryover as provided in section 56(c) to reduce the amount subject to tax under section 56(a). The amount of this carryover is $91,000 computed as follows:

1. Carryover under paragraph (b) of this section:	
Chapter 1 taxes	$365,000
Items of tax preference in excess of exemption	182,500
Total	182,500
2. Reduction pursuant to paragraph (g) of this section:	

182/365×$182,500=$91,000

Example 2. A is a calendar year taxpayer who is a single individual. In 1972, A had chapter 1 income tax liability (other than taxes imposed under sections 56, 531, and 541) of $200,000 and $50,000 of items of tax preference. In 1973, A had chapter 1 income tax liability (other than taxes imposed under sections 56, 531, and 541) of $120,000 and $40,000 of items of tax preference. In 1974, A had

$400,000 of items of tax preference and no liability for tax under chapter 1 other than under section 56(a). Under section 56(c), the excess of the taxes described in paragraph (1) of that section arising in an earlier taxable year not used to reduce the amount subject to tax under section 56(a) for such taxable year can be carried over as provided in section 56(c) to reduce the amount subject to tax under section 56(a).

(a) The amount of the carryover from 1972 is $180,000 computed as follows:

Carryover under paragraph (b) of this section:	
Chapter 1 taxes	$200,000
Items of tax preference in excess of exemption	20,000
Total	180,000

(b) The amount of the carryover from 1973 is $110,000 computed as follows:

Carryover under paragraph (b) of this section:	
Chapter 1 taxes	$120,000
Items of tax preference in excess of exemption	10,000
Total	110,000

(c) For 1974, the excess of taxes in the preceding taxable years is used to reduce the amount subject to tax under section 56(a). The amount of carryover attributable to excess taxes arising in 1972 is used before such excess arising in 1973. The amount of tax under section 56(a) is $8,000 computed as follows:

1974 tax preferences	$400,000
Less exemption	30,000
	370,000
Less 1972 carryover	180,000
	190,000
Less 1973 carryover	110,000
1974 minimum tax base	80,000
1974 minimum tax ($80,000×10%)	8,000

Example 3. The facts are the same as in example 2 except that in 1974 A had $300,000 of items of tax preference. The amount of the carryover for taxable years after 1974 is computed as follows:

1974 tax preferences	$300,000
Less exemption	30,000
	270,000
Less 1972 carryover	180,000
	90,000
Less 1973 carryover	90,000
Minimum tax base	0
1973 carryover	110,000
Amount used in 1974	90,000
Amount available for taxable years after 1974	20,000

The $20,000 remaining of the 1973 carryover is available to reduce the amount subject to tax under section 56(a) in 1975 or other future taxable years as provided in section 56(c).

Example 4. M Corporation is a calendar year taxpayer. N Corporation uses a June 30 fiscal year. For the fiscal year 1970–1971, N Corporation had excess chapter 1 tax liability as described in paragraph (a) of this section in the amount of $75,000. On January 1, 1972, M Corporation acquired N Corporation in a reorganization described in section 368(a)(1)(A). N Corporation does not use any of such excess chapter 1 tax liability to reduce the amount subject to tax under section 56(a) for the short taxable year beginning on July 1, 1971, and ending on December 31, 1971. Thus, the excess chapter 1 tax liability is available to M Corporation as a carryover under paragraph (a) of this section to reduce the amount subject to tax for the next 6 succeeding taxable years beginning with taxable year 1972 as provided in this section. In applying the carryover to 1972 and succeeding taxable years, the carryover of N Corporation subject to the limitation of § 1.56A–5(e)(4) is combined with any carryovers originating with M Corporation in 1970.

[T.D. 7564, 43 FR 40468, Sept. 12, 1978. Redesignated and amended by T.D. 8138, 52 FR 15309, Apr. 28, 1987]

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§1.56(g)–1 Adjusted current earnings.

(a) *Adjustment for adjusted current earnings*—(1) *Positive adjustment.* For taxable years beginning after December 31, 1989, the alternative minimum taxable income of any taxpayer described in paragraph (a)(4) of this section is increased by the adjustment for adjusted current earnings. The adjustment for adjusted current earnings is 75 percent of the excess, if any, of—

(i) The adjusted current earnings (as defined in paragraph (a)(6)(ii) of this section) of the taxpayer for the taxable year over.

(ii) The pre-adjustment alternative minimum taxable income (as defined in paragraph (a)(6)(i) of this section) of the taxpayer for the taxable year.

(2) *Negative adjustment*—(i) *In general.* For taxable years beginning after December 31, 1989, the alternative minimum taxable income of any taxpayer is decreased, subject to the limitation of paragraph (a)(2)(ii) of this section, by 75 percent of the excess, if any, of pre-adjustment alternative minimum taxable income (as defined in paragraph (a)(6)(i) of this section), over adjusted current earnings (as defined in paragraph (a)(6)(ii) of this section).

(ii) *Limitation on negative adjustments.* The amount of the negative adjustment for any taxable year is limited to the excess, if any, of—

(A) The aggregate increases in alternative minimum taxable income in prior years under paragraph (a)(1) of this section over

(B) The aggregate decreases in alternative minimum taxable income in prior years under this paragraph (a)(2).

Any excess of pre-adjustment alternative minimum taxable income over adjusted current earnings that is not allowed as a negative adjustment for the taxable year because of the limitation in this paragraph (a)(2)(ii) is not applied to reduce any positive adjustment in any other taxable year.

(iii) *Example.* The following example illustrates the provisions of this paragraph (a)(2):

(A) Corporation P is a calendar-year taxpayer and has pre-adjustment alternative minimum taxable income and adjusted current earnings in the following amounts for 1990 through 1993:

Year	Pre-adjustment alternative minimum taxable income	Adjusted current earnings
1990	$800,000	$700,000
1991	600,000	900,000
1992	500,000	400,000
1993	500,000	100,000

(B) Under these facts, corporation P has the following positive and negative adjustments for adjusted current earnings:

Year	Negative adjustment	Positive adjustment
1990	0	0
1991	0	$225,000
1992	$75,000	0
1993	150,000	0

(C) In 1990, P has a potential negative adjustment (before the cumulative limitation) of $75,000 (75 percent of the $100,000 excess of pre-adjustment alternative minimum taxable income over adjusted current earnings). Nonetheless, P is not permitted a negative adjustment because P had no prior increases in its alternative minimum taxable income due to an adjustment for adjusted current earnings.

(D) In 1991, P has a positive adjustment of $225,000 (75 percent of the $300,000 excess of adjusted current earnings over pre-adjustment alternative minimum taxable income). P is not allowed to use the prior year's excess of pre-adjustment alternative minimum taxable income over adjusted current earnings to reduce its 1991 positive adjustment.

(E) In 1992, P is permitted a negative adjustment of $75,000, the full amount of 75 percent of the $100,000 excess of pre-adjustment alternative minimum taxable income over adjusted current earnings for the taxable year. This is because P's prior cumulative increases in alternative minimum taxable income due to the positive adjustments for adjusted current earnings exceed the negative adjustment for the year.

(F) In 1993, P has a potential negative adjustment (before the cumulative limitation) of $300,000 (75 percent of the $400,000 excess of pre-adjustment alternative minimum taxable income over adjusted current earnings). P's net cumulative increases in alternative minimum taxable income due to the adjustment for adjusted current earnings are $150,000 ($225,000 increase in 1991, less $75,000 decrease in 1992). Thus, P's negative adjustment in 1993 is limited to $150,000. P may not use the remaining portion ($150,000) of the negative adjustment for 1993 to reduce positive adjustments in other taxable years.

(3) *Negative amounts.* In determining whether an excess exists under paragraph (a)(1) or (a)(2) of this section, a positive amount exceeds a negative amount by the sum of the absolute numbers, and a smaller negative amount exceeds a larger negative amount by the difference between the absolute numbers. Thus, for example, a positive amount of adjusted current earnings of $30 exceeds a negative amount (or loss) of pre-adjustment AMTI of $10 by the sum of the absolute numbers, or $40 (30+10). Accordingly, the adjustment for adjusted current earnings would be 75 percent of $40, or $30. In contrast, a negative amount of adjusted current earnings of $10 exceeds a negative amount (or loss) of pre-adjustment alternative minimum taxable income of $30 by the difference between the absolute numbers, or $20 (30−10). Accordingly, the adjustment for adjusted current earnings would be 75 percent of $20, or $15.

(4) *Taxpayers subject to adjustment for adjusted current earnings.* The adjustment for adjusted current earnings applies to any corporation other than—

(i) An S corporation as defined in section 1361,

(ii) A regulated investment company as defined in section 851,

(iii) A real estate investment trust as defined in section 856, or

(iv) A real estate mortgage investment conduit as defined in section 860A.

(5) *General rule for applying Internal Revenue Code provisions in determining adjusted current earnings*—(i) *In general.* Except as otherwise provided by regulations or other guidance issued by the Internal Revenue Service, all Internal Revenue Code provisions that apply in determining the regular taxable income of a taxpayer also apply in determining adjusted current earnings. For example, the rules of part V of subchapter P (relating to original issue discount and similar matters) of the Code apply in determining the amount (and the timing) of any interest income included in adjusted current earnings under this section. In applying Code provisions, however, the adjustments of section 56(g) and this section are also taken into account. For example, in applying the capitalization provisions of section 263A, the amount of depreciation to be capitalized is based on the amount of depreciation allowed in computing adjusted current earnings.

(ii) *Example.* The following example illustrates the provisions of this paragraph (a)(5):

(A) Corporation N is a calendar year manufacturer of golf clubs. N places new manufacturing equipment in service in 1990. The regular tax depreciation allowable for this equipment is $80,000; the pre-adjustment alternative minimum taxable income depreciation is $60,000; and the adjusted current earnings depreciation is $40,000. All of the golf clubs N produces in 1990 are unsold and are in ending inventory.

(B) Pursuant to section 263A and §1.263A–1(e)(3)(ii)(I), N must capitalize the depreciation allowed for the year for the new manufacturing equipment in the ending inventory of golf clubs. Thus, when N sells the golf clubs (or is deemed to have sold them under its normal method of accounting), the cost of goods sold attributable to the capitalized depreciation will be $80,000 in computing regular taxable income; $60,000 in computing pre-adjustment alternative minimum taxable income; and $40,000 in computing adjusted current earnings.

(6) *Definitions.* The following terms have the following meanings for purpose of this section.

(i) *Pre-adjustment alternative minimum taxable income.* Pre-adjustment alternative minimum taxable income is the alternative minimum taxable income of the taxpayer for the taxable year, determined under section 55(b)(2), but without the adjustment for adjusted current earnings under section 56(g) and this section, without the alternative tax net operating loss deduction under section 56(a)(4), and without the alternative tax energy preference deduction under section 56(h).

(ii) *Adjusted current earnings.* Adjusted current earnings is the pre-adjustment alternative minimum taxable income of the taxpayer for the taxable year, adjusted as provided in section 56(g) and this section. To the extent an amount is included (or deducted) in computing pre-adjustment alternative minimum taxable income for the taxable year (whether because an adjustment is made under section 56 or 58, because of a tax preference item under section 57, or because the item is reflected in taxable income), that amount is not again included (or deducted) in computing adjusted current earnings for the taxable year.

(iii) *Earnings and profits.* Earnings and profits means current earnings and profits within the meaning of section 316(a)(2), that is, earnings and profits for the taxable year computed as of the close of the taxable year of the corporation without diminution by reason of any distributions made during the taxable year.

(7) *Application to foreign corporations.* See paragraph (m) of this section for rules relating to the application of this section to foreign corporations.

(b) *Depreciation allowed.* The depreciation deduction allowed in computing adjusted current earnings is determined under the rules of this paragraph (b). Generally, the rules for computing the adjusted current earnings depreciation deduction differ depending on the taxable year in which the property is placed in service and the method used in computing the depreciation deduction for taxable income purposes. See §1.168(i)–1(k) for an election to use general asset accounts.

(1) *Property placed in service after 1989.* The depreciation deduction for property placed in service in a taxable year beginning after December 31, 1989, is the amount determined by using the alternative depreciation system of section 168(g). This paragraph (b)(1) does not apply to property to which paragraph (b)(4) of this section applies (relating to certain property described in sections 168 (f)(1) through (f)(4)).

(2) *Property subject to new ACRS*—(i) *In general.* This paragraph (b)(2) provides the rules for computing the depreciation deduction for property to which the amendments made by section 201 of the Tax Reform Act of 1986 (new ACRS) apply (generally property placed in service after December 31, 1986), and that is placed in service in a taxable year beginning before January 1, 1990. This paragraph (b)(2) does not apply to property described in paragraph (b)(4) of this section (relating to certain property described in sections 168 (f)(1) through (f)(4)) or to property described in paragraph (b)(5)(i) of this section (relating to certain churning transactions described in section 168(f)(5)).

(ii) *Rules for computing the depreciation deduction.* The depreciation deduction for property described in this paragraph (b)(2) is the amount determined by using—

(A) The adjusted basis of the property as determined in computing alternative minimum taxable income as of the close of the last taxable year beginning before January 1, 1990,

(B) The straight-line method, and

(C) The recovery period that consists of the remainder of the recovery period applicable to the property under the alternative depreciation system of section 168(g).

Thus, the recovery period begins on the first day of the first taxable year beginning after December 31, 1989, and ends on the last day of the recovery period that would have applied had the recovery period for the property originally been determined under section 168(g). In determining the recovery period that would have applied, the property is deemed placed in service on the date it was considered placed in service under the depreciation convention that would have applied to the property under section 168(d).

(iii) *Example.* The following example illustrates the provisions of this paragraph (b)(2).

Example. Corporation X, a calendar-year taxpayer, purchases and places in service on August 1, 1987, computer-based telephone central office switching equipment. This is the only item of depreciable property X places in service during 1987. Thus, the applicable convention under section 168(d) is the half-year convention. As of December 31, 1989, the adjusted basis of the property used in computing alternative minimum taxable income is $42,000. The recovery period that would have applied to the property under section 168(g)(2) is 9.5 years (from July 1, 1987 to December 31, 1996). Thus, the recovery period for computing adjusted current earnings under section 56(g)(4)(A)(ii) and this paragraph (b)(2) begins on January 1, 1990, and ends on December 31, 1996. X's 1990 depreciation deduction for computing adjusted current earnings is $6,000, determined under the straight-line method by dividing $42,000 (adjusted basis) by 7 (recovery period).

(3) *Property subject to original ACRS*—(i) *In general.* This paragraph (b)(3) provides the rules for computing the depreciation deduction for property to which section 168 as in effect on the day before the date of enactment of the Tax Reform Act of 1986 (original ACRS) applies and that is placed in service in a taxable year beginning before January 1, 1990 (generally property that was placed in service after December 31, 1980 and before January 1, 1987). In determining whether original ACRS applies to property, the fact that the unadjusted basis of the property is reduced or eliminated under section 168(d)(4)(A)(i) of original ACRS is not taken into account. This paragraph (b)(3) does not apply to property described in paragraph (b)(4) or (b)(5)(i) of this section (relating to certain section 168(f) property).

(ii) *Rules for computing the depreciation deduction.* The depreciation deduction for property described in this paragraph (b)(3) is the amount determined by using—

(A) The adjusted basis of the property as determined in computing taxable income as of the close of the last taxable year beginning before January 1, 1990,

(B) The straight-line method, and

(C) The recovery period that consists of the remainder of the recovery period applicable to the property under the alternative depreciation system of section 168(g). Thus, the recovery period begins on the first day of the first taxable year beginning after December 31, 1989, and ends on the last day of the recovery period that would have applied had the recovery period for the property originally been determined under section 168(g)(2). In determining the recovery period that would have applied, the property is deemed placed in service on the date it was considered placed in service under the depreciation convention that would have applied to the property under section 168(d) (without regard to section 168(d)(3)).

(iii) *Example.* The following example illustrates the provisions of this paragraph (b)(3).

Example. Corporation Y, a calendar-year taxpayer, purchases and places in service on December 1, 1986, computer-based telephone central office switching equipment. The depreciation convention that would have applied to this property under section 168(d) (without regard to section 168(d)(3)) is the half-year convention. As of Decembert 31, 1989, the adjusted basis of the property used in computing taxable income is $21,000. The recovery period for the property under section 168(g)(2) is 9.5 years (from July 1, 1986 to December 31, 1995). Thus, the recovery period for computing adjusted current earnings under section 56(g)(4)(A)(iii) and this paragraph (b)(3) begins on January 1, 1990, and ends on December 31, 1995. Y's 1990 depreciation deduction for computing adjusted current earnings is $3,500, determined under the straight-line method by dividing $21,000 (adjusted basis) by 6 (recovery period).

(4) *Special rule for certain section 168(f) property.* The depreciation or amortization deduction for property described

in section 168(f) (1) through (4) is determined in the same manner as used in computing taxable income, without regard to when the property is placed in service.

(5) *Certain property not subject to ACRS.* The depreciation or amortization deduction for property not described in paragraphs (b) (1) through (4) of this section is determined in the same manner as used in computing taxable income. Thus, this paragraph (b)(5) applies to—

(i) Property placed in service after December 31, 1980, in a taxable year beginning before January 1, 1990, and that is excluded from the application of original ACRS or new ACRS by section 168(e)(4) of original ACRS or section 168(f)(5)(A)(i) of new ACRS, and

(ii) Property placed in service before January 1, 1981.

(c) *Inclusion in adjusted current earnings of items included in earnings and profits*—(1) *In general.* Except as otherwise provided in paragraph (c)(4) of this section, adjusted current earnings includes all income items that are permanently excluded from (*i.e.*, not taken into account in determining) pre-adjustment alternative minimum taxable income but that are taken into account in determining earnings and profits. An income item is considered taken into account in determining pre-adjustment alternative minimum taxable income without regard to the timing of its inclusion. Thus, this paragraph (c)(1) does not apply to any income item that is, has been, or will be included in pre-adjustment alternative minimum taxable income. For example, a taxpayer eligible to use the completed contract method of accounting for long-term construction contracts does not take income (or expenses) into account in determining pre-adjustment alternative minimum taxable income for taxable years before the taxable year the contract is completed. The taxpayer is required under section 312(n)(6) to include income (and expenses) in earnings and profits throughout the term of the contract under the percentage of completion method. This paragraph (c)(1) does not require the income on the contract to be included in adjusted current earnings, however, because the income will be taken into account in the taxable year the contract is completed and therefore is considered to be taken into account in determining pre-adjustment alternative minimum taxable income.

(2) *Certain amounts not taken into account in determining whether an item is permanently excluded.* The fact that proceeds from an income item may eventually be reflected in pre-adjustment alternative minimum taxable income of another taxpayer on the liquidation or disposal of a business, or similar circumstances, is not taken into account in determining whether the item is permanently excluded from pre-adjustment alternative minimum taxable income. Thus, for example, a corporation's adjusted current earnings include interest excluded from pre-adjustment alternative minimum taxable income under section 103 even though the interest might eventually be reflected in the pre-adjustment alternative minimum taxable income of a corporate shareholder as gain on the liquidation of the corporation.

(3) *Allowance of offsetting deductions.* In determining adjusted current earnings under this paragraph (c), a deduction is allowed for all items that relate to income required to be included in adjusted current earnings under this paragraph (c) and that would be deductible in computing pre-adjustment alternative minimum taxable income if the income items to which the items of deduction relate were included in pre-adjustment alternative minimum taxable income for any taxable year. For example, deductions disallowed under section 265(a)(2) for the costs of carrying tax-exempt obligations, the interest on which is excluded from pre-adjustment alternative minimum taxable income under section 103 but is included in adjusted current earnings under this paragraph (c), are generally allowed as deductions in computing adjusted current earnings. Amounts deductible under this paragraph (c)(3) are taken into account using the taxpayer's method of accounting and are subject to any provisions or limitations of the Code that would have applied if the amounts had been deductible in determining pre-adjustment alternative minimum taxable income.

For example, section 267(a)(2) may affect the timing of a deduction otherwise disallowed under section 265(a)(2).

(4) *Special rules.* Adjusted current earnings does not include the following amounts.

(i) *Income from the discharge of indebtedness.* Amounts that are excluded from gross income under section 108 of the Internal Revenue Code of 1986 or any corresponding provision of prior law (including the Bankruptcy Tax Act of 1980, case law, income tax regulations and administrative pronouncements).

(ii) *Federal income tax refunds.* Refunds of federal income taxes.

(iii) *Income earned on behalf of states and municipalities.* Amounts that are excluded from gross income under section 115.

(5) *Treatment of life insurance contracts*—(i) *In general.* This paragraph (c)(5) addresses the treatment of life insurance contracts in determining adjusted current earnings. These rules apply to life insurance contracts as defined in section 7702. Generally, death benefits under a life insurance contract are included in adjusted current earnings, and all other distributions (including surrenders) are taxed in accordance with the principles of section 72(e), taking into account the taxpayer's basis in the contract for purposes of adjusted current earnings. If the adjusted basis in the contract for purposes of adjusted current earnings exceeds the amount of death benefits received or the amount received when the contract is surrendered (increased by the amount of any outstanding policy loan), the resulting loss is allowed as a deduction under paragraph (c)(3) of this section in computing adjusted current earnings for the taxable year. In addition, undistributed income on the contract is included in adjusted current earnings as provided in paragraph (c)(5)(ii) of this section. Paragraph (c)(5)(vi)(A) of this section provides special rules for term insurance that has no net surrender value.

(ii) *Inclusion of inside buildup.* Income on a life insurance contract with respect to a taxable year (or any shorter period either ending or beginning with the date of a distribution from the contract) is included in adjusted current earnings for the taxable year. Thus, income on the contract is calculated from the beginning of a taxable year to the date of any distribution, from immediately after any distribution to the date of the next distribution, and from the last distribution during the taxable year through the end of the taxable year. Income on a life insurance contract is not included in adjusted current earnings for any taxable year in which the insured dies or the contract is completely surrendered for its entire net surrender value. Solely for purposes of computing adjusted current earnings, the taxpayer's adjusted basis in the contract (as determined under section 72(e)(6)) is increased to reflect any positive income on the contract included in adjusted current earnings under this paragraph (c)(5)(ii). The manner in which the income on the contract is determined for adjusted current earnings purposes is prescribed in paragraph (c)(5)(iii) of this section. If the income on the contract determined under paragraph (c)(5)(iii) of this section is a negative amount, income on the contract is not included in adjusted current earnings and no deduction from adjusted current earnings is allowed for the negative amount.

(iii) *Calculation of income on the contract.* For purposes of determining adjusted current earnings, the income on a life insurance contract for any period, including a taxable year, is the excess, if any, of—

(A) The sum of the contract's net surrender value (as defined in section 7702(f)(2)(B)) at the end of the period, and any distributions under the contract during the period that, in accordance with the principles of section 72(e), are not taxed because they represent recoveries of the taxpayer's basis in the contract for adjusted current earnings, over

(B) The sum of the contract's net surrender value at the end of the preceding period, and any premiums paid under the contract during the period.

(iv) *Treatment of distributions under the life insurance contract.* Any distribution under a life insurance contract (whether a partial withdrawal or an amount received on complete surrender of the contract) is included in adjusted current earnings in accordance with the principles of section 72(e), taking into account the taxpayer's basis in the contract for purposes of computing adjusted current earnings. The taxpayer's basis in the contract is equal to the basis at the end of the immediately preceding period plus any premiums paid before the distribution. The taxpayer's basis in the contract for purposes of adjusted current earnings is reduced, in accordance with the principles of section 72(e), to the extent that the distribution is not included in adjusted current earnings because it represents a recovery of that basis.

(v) *Treatment of death benefits.* The excess of the contractual death benefit of a life insurance contract over the taxpayer's adjusted basis in the contract for purposes of computing adjusted current earnings at the time of the insured's death is included in adjusted current earnings as provided by paragraph (c)(6)(i) of this section. The amount of the death benefit that is taken into account for adjusted current earnings includes the amount of any outstanding policy loan treated as forgiven or discharged by the insurance company upon the death of the insured.

(vi) *Other rules*—(A) *Term life insurance contract without net surrender values.* Except as provided in this paragraph (c)(5)(vi), the requirements of paragraph (c)(5) of this section do not apply to term life insurance contracts that provide no net surrender value. Adjusted current earnings are reduced by any premiums paid under such a contract that are allocable to the taxable year. Any premiums paid that are not allocable to the taxable year must be included in the basis of the contract. The death benefit under such a term insurance contract is included in adjusted current earnings as provided by paragraph (c)(5)(v) of this section.

(B) *Life insurance contracts involving divided ownership.* If the ownership of a life insurance contract is divided between different persons (for example, a split-dollar arrangement), the requirements of paragraph (c)(5) of this section apply to the separate ownership interests as though each interest were a separate contract.

(vii) *Examples.* The following examples illustrate the provisions of this paragraph (c)(5).

Example 1. (i) On January 1, 1987, corporation X, a calendar year taxpayer, purchased a flexible premium life insurance contract with a death benefit of $100,000 and planned annual gross premiums of $2,200 payable on January 1 of each year. The net surrender value of the contract at the end of 1987 and subsequent years, together with the cumulative premiums for the contract at the end of each year, are set forth in the following table:

Year	Cumulative premiums paid	Year-end net surrender value
1987	$2,200	$2,420
1988	4,400	5,082
1989	6,600	8,010
1990	8,800	11,231
1991	11,000	14,774

(ii) Under paragraph (c)(5)(ii) of this section, X must include $1,021 in adjusted current earnings for 1990. The inclusion is computed by subtracting from the net surrender value of the contract at the end of the taxable year ($11,231) the sum of the net surrender value of the contract at the end of the preceding taxable year ($8,010) plus the premiums paid during the taxable year ($2,200). See paragraph (c)(5)(iii) of this section. For purposes of determining adjusted current earnings, X's adjusted basis in the contract would be increased at the end of 1990 from $8,800 to $9,821 to reflect the $1,021 inclusion. See paragraph (c)(5)(ii) of this section. The income under the contract attributable to taxable years prior to 1990 does not increase X's adjusted basis in the contract.

(iii) For 1991, the income on the contract included in adjusted current earnings is determined in the same manner as the preceding year, and there is a corresponding increase in X's adjusted basis in the contract. Thus, for 1991, the income on the contract is $1,343, which is determined by subtracting from the net surrender value of the contract at the end of the taxable year ($14,774) the sum of the net surrender value at the end of the preceding taxable year ($11,231) plus the premiums paid during the taxable year ($2,200). At the end of 1991, X's adjusted basis in the contract for adjusted current earnings is $13,364, which reflects the basis of the contract at the beginning of 1991, increased by the premium paid during the year ($2,200) and the income on the contract that has been included in adjusted current earnings for the taxable year ($1,343).

Example 2. The facts are the same as in example 1, except that, after the payment of the premium for 1991, the insured dies and X receives the $100,000 death benefit under the contract. Under paragraph (c)(5)(ii) of this section, no amount is included in adjusted current earnings for income on the contract for the taxable year in which the insured dies. Instead, under paragraph (c)(5)(v) of this section, X must include the adjusted current earnings for 1991 the excess of the death benefit ($100,000) over the adjusted basis in the contract for purposes of computing adjusted current earnings at the time of the insured's death ($12,021), which equals X's adjusted basis in the contract at the end of 1990 ($9,821), increased by X's premium payment for 1991 ($2,200).

Example 3. (i) The facts are the same as in example 1, except that in addition to making the $2,200 planned premium payment for 1992, X receives a $16,200 distribution under the contract on February 1, 1992, leaving a net surrender value of $915 immediately following the distribution. On March 1, 1992, X pays an additional premium of $5,000 under the contract. The net surrender value of the contract at the end of 1992 is $6,417.

(ii) Treatment of the distribution. Under paragraph (c)(5)(iv) of this section, the $16,200 distribution in 1992 is included in adjusted current earnings as an amount taxable in accordance with the principles of section 72(e) to the extent that the distribution ($16,200) exceeds X's adjusted basis for adjusted current earnings, as determined at the end of the immediately preceding period, and including premiums paid through the period ending on the date of the distribution ($15,564). Thus, X must include $636 in adjusted current earnings for 1992 as an amount taxable in accordance with the principles of section 72(e).

(iii) Determination of the income on the contract. Under paragraph (c)(5)(iii) of this section, for 1992, the income on the contract must be separately determined for the period beginning with the first day of the taxable year to the date of the distribution and for the period beginning immediately after the distribution to the end of the taxable year, using the contract's net surrender values at the beginning and end of each of these periods. The income on the contract for the period beginning on January 1, 1992 and ending on February 1, 1992 (the date of the distribution) is equal to the excess, if any, of (A) the sum of the net surrender value at the end of the period ($915) and the amount of the distribution that is allocable to X's basis in the contract for adjusted current earnings ($15,564), over (B) the sum of the net surrender value at the end of the preceding taxable year ($14,774) plus any premiums paid on the contract during the period ($2,200). Because the net result of this computation is a negative amount (($915+$15,564) − ($14,774+$2,200)= − 495), no income on the contract for the period ending with the date of the distribution is included in adjusted current earnings for 1992.

(iv) Under paragraph (c)(5)(ii), X must also determine the income on the contract for the period beginning immediately after the distribution through the end of the taxable year. The income on the contract for this period is $502, which is equal to the excess of the net surrender value at the end of the taxable year ($6,417) over the sum of the net surrender value at the end of the preceding period ($915), plus any premiums paid during the period ($5,000). At the end of 1992, X's adjusted basis in the contract for adjusted current earnings is $5,502, determined by adding the income on the contract ($502) and the premiums paid during the period ($5,000) to the basis at the end of the preceding period ($0).

(v) Thus, X must include a total of $1,138 ($636+502) in adjusted current earnings for 1992. This inclusion reflects both the undistributed income on the contract for the taxable year plus the amount of income from distributions under the contract that is taxed in accordance with the principles of section 72(e) using X's adjusted basis in the contract for adjusted current earnings.

(6) *Partial list of income items excluded from gross income but included in earnings and profits.* The following is a partial list of items that are permanently excluded from pre-adjustment alternative minimum taxable income but that are included in earnings and profits, and are therefore included in adjusted current earnings under this paragraph (c).

(i) Proceeds of life insurance contracts that are excluded under section 101, to the extent provided in paragraph (c)(5)(v) or (c)(5)(vi) of this section.

(ii) Interest that is excluded under section 103.

(iii) Amounts received as compensation for injuries or sickness that are excluded under section 104.

(iv) Income taxes of a lessor of property that are paid by a lessee and are excluded under section 110.

(v) Income attributable to the recovery of an item deducted in computing earnings and profits in a prior year that is excluded under section 111.

(vi) Amounts received as proceeds from sports programs that are excluded under section 114.

(vii) Cost-sharing payments that are excluded under section 126, to the extent section 126(e) does not apply.

(viii) Interest on loans used to acquire employer securities that is excluded under section 133.

(ix) Financial assistance that is excluded under section 597.

(x) Amounts that are excluded from pre-adjustment alternative minimum taxable income as a result of an election under section 831(b) (allowing certain insurance companies to compute their pre-adjustment alternative minimum taxable income using only their investment income).

Items described in paragraph (c)(1) of this section must be included in earnings and profits (and therefore in adjusted current earnings) even if they are not identified in this paragraph (c)(6). The Commissioner may identify additional items described in paragraph (c)(1) in other published guidance.

(7) *Partial list of items excluded from both pre-adjustment alternative minimum taxable income and adjusted current earnings.* The following is a partial list of items that are excluded from both pre-adjustment alternative minimum taxable income and adjusted current earnings, and for which no adjustment is allowed under this section.

(i) The value of improvements made by a lessee to a lessor's property that is excluded from the lessor's income under section 109.

(ii) contributions to the capital of a corporation by a non-shareholder that are excluded from the corporation's income under section 118.

The Commissioner may identify additional items described in this paragraph (c)(7) in other published guidance.

(d) *Disallowance of items not deductible in computing earnings and profits*—(1) *In general.* Except as otherwise provided in this paragraph (d), no deduction is allowed in computing adjusted current earnings for any items that are not taken into account in determining earnings and profits for any taxable year, even if the items are taken into account in determining pre-adjustment alternative minimum taxable income. These items therefore increase adjusted current earnings to the extent they are deducted in computing pre-adjustment alternative minimum taxable income. An item of deduction is considered taken into account without regard to the timing of its deductibility in computing earnings and profits. Thus, to the extent an item is, has been, or will be deducted for purposes of determining earnings and profits, it does not increase adjusted current earnings in the taxable year in which it is deducted for purposes of determining pre-adjustment alternative minimum taxable income. For example, a deduction allowed (in determining pre-adjustment alternative minimum taxable income) under section 196 for unused research credits allowable under section 41 is taken into account in computing earnings and profits because the costs that gave rise to the credit were deductible in computing earnings and profits when incurred. Therefore, the deduction does not increase adjusted current earnings. As a further example, payments by a United States parent corporation with respect to employees of certain foreign subsidiaries, which are deductible under section 176, are considered contributions to the capital of the foreign subsidiary for purposes of computing earnings and profits. Although the payments are not deductible in computing the earnings and profits of the United States parent corporation in the year incurred, the payments do increase the parent's basis in its stock in the foreign subsidiary. This basis increase will reduce any gain the parent may later realize for purposes of computing earnings and profits on the disposition of the stock of the foreign subsidiary. Therefore, the amount of the payment by the parent is considered taken into account in computing the earnings and profits of the parent and does not increase adjusted current earnings. Thus, only deduction items that are never taken into account in computing earnings and profits are disallowed in computing adjusted current earnings under this paragraph (d).

(2) *Deductions for certain dividends received*—(i) *Certain amounts deducted under sections 243 and 245.* Paragraph (d)(1) of this section does not apply to, and adjusted current earnings therefore are not increased by, amounts deducted under sections 243 and 245 that qualify as 100-percent deductible dividends under sections 243(a), 245(b) or 245(c), or to any dividend received from a 20-percent owned corporation (as defined in section 243(c)(2)), to the extent that the dividend giving rise to the deductions is attributable to earnings of the paying corporation that are subject

to federal income tax. Earnings are considered subject to federal income tax return (that is filed or, if not, that should be filed) of an entity subject to United States taxation, even if there is no resulting United States tax liability (*e.g.*, because of net operating losses or tax credits, other than the credit provided for in section 936).

(ii) *Special rules*—(A) *Dividends received from a foreign sales corporation.* The portion of a dividend received from a foreign sales corporation (FSC) that is classified as a 100-percent deductible dividend attributable to earnings of the FSC subject to federal income tax is that portion of the dividend distributed out of earnings and profits of the FSC attributable to non-exempt foreign trade income determined under either of the administrative pricing methods of section 925(a) (1) or (2), and to non-exempt foreign trade income determined under section 925(a)(3) that is effectively connected with the conduct of a trade or business in the United States (determined without regard to section 921). If the FSC is a 20-percent owned corporation (as defined in section 243(c)(2)), an additional portion of that dividend is classified as being attributable to earnings of the FSC subject to federal income tax to the extent that the dividend is distributed out of earnings and profits of the FSC attributable to effectively connected income (as defined in section 245(c)(4)(B)). A FSC is defined in section 922 and, for purposes of this paragraph, includes a small FSC and a former FSC. The ordering rules for distributions from a FSC set forth in § 1.926(a)–1T(b)(1) apply to determine the classification of earnings and profits out of which a distribution has been made.

(B) *Dividends received from a section 936 corporation.* For example, assume that a section 936 corporation earns $100 of income in its current taxable year, $10 of which is not eligible for the credit under section 936. If the section 936 corporation makes a distribution of $50 during that year, $5 of that distribution ($10 of income not eligible for the section 936 credit divided by $100 of income, times $50 distributed) is deemed to be attributable to earnings of the paying corporation that are subject to federal income tax.

(iii) *Special rule for certain dividends received by certain cooperatives.* Paragraph (d)(1) of this section does not apply to, and adjusted current earnings do not include, any dividend received by any organization to which part I of subchapter T of the Code applies and that is engaged in the marketing of agricultural or horticultural products, if the dividend is paid by a FSC and is allowable as a deduction under section 245(c).

(3) *Partial list of items not deductible in computing earnings and profits.* The following is a partial list of items that are not taken into account in computing earnings and profits and thus are not deductible in computing adjusted current earnings.

(i) Unrecovered losses attributable to certain damages that are deductible under section 186, to the extent those damages were previously deducted in computing earnings and profits.

(ii) The deduction for small life insurance companies allowed under section 806.

(iii) Dividends deductible under the following sections of the Code:

(A) Dividends received by corporations that are deductible under section 243, to the extent paragraph (d)(2)(i) of this section does not apply.

(B) Dividends received on certain preferred stock that are deductible under section 244.

(C) Dividends received from certain foreign corporations that are deductible under section 245, to the extent neither paragraph (d)(2)(i) nor (d)(2)(iii) of this section applies.

(D) Dividends paid on certain preferred stock of public utilities that are deductible under section 247.

(E) Dividends paid to an employee stock ownership plan that are deductible under section 404(k).

(F) Non-patronage dividends that are paid and deductible under section 1382(c)(1).

Items described in paragraph (d)(1) of this section are not taken into account in computing earnings and profits (and thus are not deductible in computing adjusted current earnings) even if they are not identified in this paragraph (d)(3). The Commissioner may identify additional items described in paragraph (d)(1) of this section in other published guidance.

(4) *Partial list of items deductible for purposes of computing both pre-adjustment alternative minimum taxable income and adjusted current earnings.* The following is a partial list of items that are deductible for purposes of computing both pre-adjustment alternative minimum taxable income and adjusted current earnings, and for which no adjustment is allowed under this section.

(i) Payments by a United States corporation with respect to employees of certain foreign corporations that are deductible under section 176.

(ii) Dividends paid on deposits by thrift institutions that are deductible under section 591.

(iii) Life insurance policyholder dividends that are deductible under section 808.

(iv) Dividends paid by cooperatives that are deductible under sections 1382(b) or 1382(c)(2) and that are not paid with respect to stock.

The Commissioner may identify additional items described in this paragraph (d)(4) in other published guidance.

(e) *Treatment of income items included, and deduction items not allowed, in computing pre-adjustment alternative minimum taxable income.* Adjusted current earnings includes any income item that is included in pre-adjustment alternative minimum taxable income, even if that income item is not included in earnings and profits for the taxable year. Except as specifically provided in paragraph (c)(3) or (c)(5) of this section, no deduction is allowed for an item in computing adjusted current earnings if the item is not deductible in computing pre-adjustment alternative minimum taxable income for the taxable year, even if the item is deductible in computing earnings and profits for the year. Thus, for example, capital losses in excess of capital gains for the taxable year are not deductible in computing adjusted current earnings for the taxable year.

(f) *Certain other earnings and profits adjustments*—(1) *Intangible drilling costs.* For purposes of computing adjusted current earnings, the amount allowable as a deduction for intangible drilling costs (as defined in section 263(c)) for amounts paid or incurred in taxable years beginning after December 31, 1989, is determined as provided in section 312(n)(2)(A). See section 56(h) for an additional adjustment to alternative minimum taxable income based on energy preferences for taxable years beginning after 1990.

(2) *Certain amortization provisions do not apply.* For purposes of computing adjusted current earnings, sections 173 (relating to circulation expenditures) and 248 (relating to organizational expenditures) do not apply to amounts paid or incurred in taxable years beginning after December 31, 1989. If an election is made under section 59(e) to amortize circulation expenditures described in section 173 over a three-year period, the expenditures to which the election applies are deducted ratably over the three-year period for purposes of computing taxable income, pre-adjustment alternative minimum taxable income, and adjusted current earnings.

(3) *LIFO recapture adjustment*—(i) *In general.* Adjusted current earnings are generally increased or decreased by the increase or decrease in the taxpayer's LIFO recapture amount (as defined in paragraph (f)(3)(iii)(A) of this section) as of the close of each taxable year.

(ii) *Beginning LIFO and FIFO inventory.* For purposes of computing the increase or decrease in the LIFO recapture amount, the beginning LIFO and FIFO inventory amounts for the first taxable year beginning after December 31, 1989, are—

(A) The ending LIFO inventory amount used in computing pre-adjustment alternative minimum taxable income for the last year beginning before January 1, 1990; and

(B) The ending FIFO inventory amount for the last year beginning before January 1, 1990, computed with the adjustments described in section 56 (other than the adjustment described in section 56(g)) and section 58, the items of tax preference described in section 57 and using the methods used in computing pre-adjustment alternative minimum taxable income.

(iii) *Definitions*—(A) *LIFO recapture amount*—(*1*) *Definition.* The taxpayer's LIFO recapture amount is the excess, if any, of—

(*i*) the inventory amount of its assets under the FIFO method, computed using the rules of this section; over

(*ii*) the inventory amount of its assets under the LIFO method, computed using the rules of this section.

(*2*) *Assets included.* Only the assets for which the taxpayer uses the LIFO method to compute pre-adjustment alternative minimum taxable income are taken into account in determining the LIFO recapture amount.

(B) *FIFO Method.* For purposes of this paragraph, the LIFO method is the first in, first out method described in section 471, determined by using—

(*1*) The retail method if that is the method the taxpayer uses in computing pre-adjustment alternative minimum taxable income; or

(*2*) The lower of cost or market method for all other taxpayers.

(C) *LIFO method.* The LIFO method is the last in, first out method authorized by section 472.

(D) *Inventory amounts.* Except as otherwise provided, inventory amounts are computed using the methods used in computing pre-adjustment alternative minimum taxable income. To the extent inventory is treated as produced or acquired during taxable years beginning after December 31, 1989, the inventory amount is determined with the adjustments described in sections 56 and 58 and the items of tax preference described in section 57. Thus, for example, the amount of depreciation to be capitalized under section 263A with respect to inventory produced in taxable years beginning after December 31, 1989, is based on the depreciation allowed under the rules of paragraph (b) of this section. See paragraph (a)(5) of this section.

(iv) *Exchanges under sections 351 and 721.* For purposes of this section, any decrease in a transferor's LIFO recapture amount that occurs as a result of a transfer of inventories in an exchange to which section 351 or section 721 applies cannot be used to decrease the adjusted current earnings of the transferor. A decrease that is disallowed under the preceding sentence is instead carried over to reduce any LIFO recapture adjustment that the transferee (or its corporate partners, if section 721 applies) would otherwise make (in the absence of this paragraph (f)(3)(iv)) solely by reason of its carryover basis in inventories received in the section 351 or section 721 exchange. Nothing in this paragraph (f)(3)(iv), however, alters the computation of the LIFO recapture amount of the transferor or transferee as of the close of any taxable year.

(v) *Examples.* The following examples illustrate the provisions of this paragraph (f)(3).

Example 1. M Corporation, a calendar-year taxpayer, uses the LIFO method of accounting for its inventory for purposes of computing pre-adjustment alternative minimum taxable income. M's ending LIFO inventory for all of its pools for purposes of computing pre-adjustment alternative minimum taxable income on December 31, 1989, is $300. M computes a $500 FIFO inventory amount on that date, after applying the provisions of section 263A along with the adjustments and preferences required in computing pre-adjustment alternative minimum taxable income. M's FIFO and LIFO ending inventory amounts at the close of its taxable years, its LIFO reserves, and its adjustment under this paragraph (f)(3), are as follows:

	1989	1990	1991	1992
Ending inventory:				
A. FIFO	[1] $500	$360	$560	$600
B. LIFO	[2] 300	180	320	440
LIFO recapture amount:				
A – B	200	180	240	160
Change in LIFO recapture amount and adjustment under paragraph (f)(3)	....	(20)	60	(80)

[1] Beginning FIFO inventory amount under paragraph (f)(3)(ii).
[2] Beginning LIFO inventory amount under paragraph (f)(3)(ii).

Example 2. (A) X Corporation, a calendar-year taxpayer, uses the LIFO method for purposes of computing pre-adjustment alternative minimum taxable income. X's LIFO recapture amount is $300 as of December 31, 1992, and is $200 as of December 31, 1993. Immediately prior to calculating its LIFO recapture amount as of December 31, 1993, X transfers inventory with an adjusted current earnings (ACE) basis of $500 to Y Corporation in an exchange to which section 351 applies. X determines that the $100 decrease in its LIFO recapture amount occurred as a result of its transfer of inventories to Y in the section 351 exchange. Thus, under paragraph (f)(3)(iv) of this section, X cannot decrease its adjusted current earnings by that amount. In computing its 1994 LIFO recapture adjustment, X will use $200 as its LIFO recapture amount as of December 31, 1993, even though it was not entitled to reduce adjusted current earnings by the $100 decrease in its LIFO recapture amount in 1993.

(B) For purposes of computing its ACE, Y takes a $500 carryover basis in the inventories received from X. If Y, a newly formed calendar-year taxpayer, engages in no other inventory transactions in 1993 and adopts the LIFO inventory method on its 1993 tax return, it will have a LIFO recapture amount of $0 as of December 31, 1993 (because its FIFO inventory amount and its LIFO inventory amount are both $500). Assume that at December 31, 1994, Y has a LIFO recapture amount of $200 ($1,000 FIFO inventory amount−$800 LIFO inventory amount). Under paragraph (f)(3)(i) of this section, Y computes a LIFO recapture adjustment for 1994 of $200 ($200−$0). If any portion of Y's $200 LIFO recapture adjustment occurs solely by reason of its carryover basis in the inventories it received from X, Y reduces its $200 LIFO recapture adjustment by that portion under paragraph (f)(3)(iv). In any event, however, Y will use its $200 LIFO recapture amount as of December 31, 1994, in computing its 1995 LIFO recapture adjustment.

(vi) *Effective date.* Paragraph (f)(3) is effective for taxable years beginning after December 18, 1992. A taxpayer may choose to apply this paragraph, however, to all taxable years beginning after December 31, 1989.

(4) *Installment sales*—(i) *In general.* Adjusted current earnings are computed without regard to the installment method, except as provided in this paragraph (f)(4).

(ii) *Exception for prior dispositions.* Paragraph (f)(4)(i) of this section does not apply to any disposition in a taxable year beginning before January 1, 1990, that is taken into account under the installment method for purposes of computing pre-adjustment alternative minimum taxable income. Thus, for any disposition in a taxable year beginning before January 1, 1990, the installment method applies in computing adjusted current earnings for taxable years beginning after December 31, 1989, to the same extent it applies in determining pre-adjustment alternative minimum taxable income for the taxable year.

(iii) *Special rules for obligations to which section 453A applies*—(A) *In general.* The following special rules apply to any installment sale occurring in a taxable year beginning after December 31, 1989, that results in an installment obligation to which section 453A(a)(1) applies and with respect to which preadjustment alternative minimum taxable income is determined under the installment method. As explained in paragraph (f)(4)(iii)(B) of this section, for purposes of computing adjusted current earnings, a portion of the contract price is eligible for the installment method, and the remainder of the contract price is not eligible for the installment method. Payments under the obligation are allocated pro-rata between the two accounting methods.

(B) *Limitation on application of installment method.* Only a portion of the contract price of an installment sale described in paragraph (f)(4)(iii)(A) of this section is eligible to be accounted for under the installment method for purposes of computing adjusted current earnings. The portion eligible for the installment method is equal to the total contract price of the sale multiplied by the applicable percentage (as determined under section 453A(c)(4)) for the taxable year of the sale. The remainder of the contract price is not eligible to be accounted for under the installment method for purposes of computing adjusted current earnings. The gross profit ratio is determined without regard to this bifurcated treatment of the sale.

(C) *Treatment of the ineligible portion.* The gain on the sale that is taken into account in the taxable year of the sale for purposes of computing adjusted current earnings is equal to the gross profit ratio multiplied by the entire portion of the contract price that is ineligible for the installment method.

(D) *Treatment of the eligible portion.* For purposes of calculating adjusted current earnings, the amount of gain recognized in a taxable year on the portion of the contract price that is eligible for the installment method is equal to—

(*1*) The amount of payments received during the taxable year, multiplied by

(*2*) The applicable percentage for the taxable year of the sale, multiplied by

(*3*) The gross profit ratio.

(E) *Coordination with the pledge rule.* For purposes of determining the amount of payments received during the taxable year under paragraph (f)(4)(iii)(D), the rules of section 453A(d) (relating to the treatment of certain pledge proceeds as payments) apply. This includes the rules under section 453A(d)(3) that relate to treating later payments as receipts of amounts on which tax has already been paid.

(F) *Example.* The following example illustrates the provisions of this paragraph (f)(4)(iii):

(*1*) On January 1, 1990, corporation A, a calendar-year taxpayer, sells a building with an adjusted basis for purposes of computing adjusted current earnings of $10 million, for $5 million and an installment obligation bearing adequate stated interest with a principal amount of $20 million. The installment obligation calls for 4 annual payments of $5 million on January 1 of 1991, 1992, 1993, and 1994. A does not elect out of the installment method, and disposes of no other property under the installment method during 1990. No gain with respect to the sale is recaptured pursuant to section 1250.

(*2*) The gross profit percentage for purposes of computing adjusted current earnings on the sale is 60 percent, computed as follows: gross profit of $15 million ($25 million contract price less $10 million adjusted basis) divided by $25 million contract price. The applicable percentage on the sale is 75 percent, computed as follows: $15 million ($20 million of installment obligations arising during and outstanding at the end of 1990 less $5 million) divided by $20 million of installment obligations arising during and outstanding at the end of 1990. See section 453A(c)(4). The portion of the contract price eligible for accounting under the installment method for purposes of computing adjusted current earnings is $18.75 million, or $25 million total contract price times applicable percentage of 75 percent. The portion of the contract price ineligible for the installment method is $6.25 million, or $25 million less $18.75 million.

(*3*) In computing adjusted current earnings for 1990, A must include $3.75 million of the gain on the sale. This amount is equal to the portion of the contract price that is ineligible for the installment method times the gross profit ratio, or $6.25 million times 60 percent. A must also include $2.25 million of gain from the $5 million payment received in 1990. This amount is computed as follows: the eligible portion of the payment, $3.75 million ($5 million payment times the applicable percentage of 75 percent), times the gross profit ratio of 60 percent. Thus, the total amount of gain from the sale that A must include in adjusted current earnings for 1990 is $6 million ($3.75 million of gain from the portion of the contract price that is not eligible for the installment method, plus $2.25 million of gain from the 1990 payment).

(*4*) A does not pledge or otherwise accelerate payments on the note in any other taxable year. In computing adjusted current earnings for 1991, 1992, 1993, and 1994, A therefore includes $2.25 million of gain on the installment sale, computed as follows: $5 million payment times the applicable percentage of 75 percent, times the gross profit ratio of 60 percent.

(g) *Disallowance of loss on exchange of debt pools. [Reserved]*

(h) *Policy acquisition expenses of life insurance companies*—(1) *In general.* This paragraph (h) addresses the treatment of policy acquisition expenses of life insurance companies in determining adjusted current earnings. Policy acquisition expenses are those expenses that, under generally accepted accounting principles in effect at the time the expenses are incurred, are considered to vary with and to be primarily related to the acquisition of new and renewal insurance policies. Generally, these acquisition expenses must be capitalized and amortized for purposes of adjusted current earnings over the reasonably estimated life of the acquired policy, using a method that provides a reasonable allowance for amortization. This method of amortization is treated as if it applied to all taxable years in determining the amount of policy acquisition expenses deducted for adjusted current earnings. The rules in this paragraph (h) apply to any life insurance company, as defined in section 816(a).

(2) *Reasonably estimated life.* The reasonably estimated life of an acquired policy is determined based on the facts with respect to each policy (such as the age, sex, and health of the insured), and the company’s experience (such as mortality, lapse rate and renewals) with similar policies. A company may treat as the reasonably estimated life

of an acquired policy the period for amortizing expenses of the acquired policy that would be required by the Financial Accounting Standards Board (FASB) at the time the acquisition expenses are incurred. If the FASB has not established such a period, the period for amortizing acquisition expense of an acquired policy under guidelines issued by the American Institute of Certified Public Accountants in effect at the time the acquisition expenses are incurred may be treated as the reasonably estimated life of the acquired policy.

(3) *Reasonable allowance for amortization.* For purposes of determining a reasonable allowance for amortization, a company may use a method that amortizes acquisition expenses in the same proportion that gross premiums and gross investment income for the taxable year bear to total anticipated receipts of gross premiums (including anticipated renewal premiums) and gross investment income to be realized over the reasonably estimated life of the policy.

(4) *Safe harbor for public financial statements.* Any company that is required to file with the Securities and Exchange Commission (SEC) a financial statement with respect to the taxable year will be treated as having complied with paragraph (h)(1) of this section if it accounts for acquisition expenses for adjusted current earnings purposes in the same manner as it accounts for those expenses on its financial statements filed with the SEC.

(i) [Reserved]

(j) *Depletion.* For purposes of computing adjusted current earnings, the allowance for depletion with respect to any property placed in service in a taxable year beginning after December 31, 1989 is determined under the cost depletion method of section 611.

(k) *Treatment of certain ownership changes*—(1) *In general.* In the case of any corporation that has an ownership change as defined in paragraph (k)(2) of this section in a taxable year beginning after December 31, 1989, and that also has a net unrealized built-in loss (as defined in paragraph (k)(3) of this section) immediately before the ownership change, the adjusted basis of each asset of the corporation for purposes of computing adjusted current earnings following the ownership change shall be its proportionate share (determined on the basis of the respective fair market values of each asset) of the fair market value of the assets of the corporation immediately before the ownership change. The rules of §1.338(b)–2T(b), if otherwise applicable to the transaction, are applied in making this allocation of basis. If such rules apply, the limitations of §§1.338(b)–2T(c) (1) and (2) also apply in allocating basis under this paragraph (k)(1).

(2) *Definition of ownership change.* A corporation has an ownership change for purposes of section 56(g)(4)(G)(i) and this paragraph (k) if there is an ownership change under section 382(g) for purposes of computing the corporation's amount of taxable income that may be offset by pre-change losses or the regular tax liability that may be offset by pre-change credits. See §1.382–2T for rules to determine whether a corporation has an ownership change. Accordingly, in order for an ownership change to occur for purposes of this paragraph (k), a corporation must be a loss corporation as defined in §1.382–2(a)(1). In determining whether the corporation is a loss corporation, the determination of whether there is a net unrealized built-in loss is made by using the aggregate adjusted basis of the assets of the corporation used in computing taxable income. The aggregate adjusted basis of the corporation's assets for purposes of computing adjusted current earnings is not relevant in determining whether the corporation is a loss corporation. See part (iv) of the example in paragraph (k)(4) of this section.

(3) *Determination of net unrealized built-in loss immediately before an ownership change.* In order to determine whether it has a net unrealized built-in loss for purposes of section 56(g)(4)(G)(ii) and paragraph (k)(1) of this section, a corporation that has an ownership change as defined in paragraph (k)(2) of this section must use the aggregate adjusted basis of its assets that it uses in computing its adjusted current earnings. The rules of section 382 (including sections 382(h)(3)(B)(i) and 382(h)(8)) otherwise

apply in determining whether the corporation has a net unrealized built-in loss.

(4) *Example.* The following example illustrates the provisions of this paragraph (k):

(i) Individual A has owned all the issued and outstanding stock of corporation L for the past 5 years. A sells all of his stock in L to unrelated individual B. On the date of the sale, L owns the following assets (all numbers are in millions):

Asset	Adjusted basis for computing taxable income	Adjusted basis for computing adjusted current earnings	Fair market value
x	$45	$50	$50
y	55	60	30
z	10	10	20
	$110	$120	$100

For purposes of computing taxable income, L has a $500 million net operating loss carryforward to the taxable year in which the sale occurs. Therefore, L is a loss corporation. As a result of the transfer of shares of L from A to B, L has had an ownership change.

(ii) L has no net unrealized built-in loss for purposes of computing taxable income because the amount by which the aggregate adjusted basis of its assets for that purpose exceeds their fair market value is $10 million, which is less than 15 percent of their fair market value and is not greater than $10 million. See section 381(h)(3)(B)(i). L, however, does have a net unrealized built-in loss for purposes of computing adjusted current earnings because the aggregate adjusted basis of its assets for the purpose exceeds their fair market value by $20 million, and that amount is greater than $10 million.

(iii) Under paragraph (k)(1) of this section, L must restate the adjusted basis of its assets for purposes of computing adjusted current earnings to their fair market values, as follows (all numbers are in millions):

Asset	New adjusted basis
x	$50
y	30
z	20

L must use these new adjusted bases for all purposes in determining adjusted current earnings, including computing depreciation and any gain or loss on disposition.

(iv) If L did not have the net operating loss carryforward, and had no other loss or credit carryovers or other attributes described in §1.382–2(a)(1) for purposes of computing the amount of its taxable income that may be offset by pre-change losses or its regular tax liability that may be offset by pre-change credits, it would not have been a loss corporation on the date of the sale and therefore would not be treated as having had an ownership change for purposes of computing adjusted current earnings. This would be true even though L had a net unrealized built-in loss for purposes of computing adjusted current earnings. Therefore, this paragraph (k) would not have applied.

(l) [Reserved]

(m) *Adjusted current earnings of a foreign corporation*—(1) *In general.* The alternative minimum taxable income of a foreign corporation is increased by 75 percent of the excess of—

(i) Its effectively connected adjusted current earnings for the taxable year; over

(ii) Its effectively connected pre-adjustment alternative minimum taxable income for the taxable year.

(2) *Definitions*—(i) *Effectively connected pre-adjustment alternative minimum taxable income.* Effectively connected pre-adjustment alternative minimum taxable income is the effectively connected taxable income of the foreign corporation for the taxable year, determined with the adjustments under sections 56 and 58 (except for the adjustment for adjusted current earnings, the alternative tax net operating loss and the alternative tax energy preference deduction) and increased by the tax preference items of section 57, but taking into account only items of income of the foreign corporation that are effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States, and any expense, loss or deduction that is properly allocated and apportioned to that income.

(ii) *Effectively connected adjusted current earnings.* Effectively connected adjusted current earnings is the effectively connected pre-adjustment alternative minimum taxable income of the foreign corporation for the taxable year, adjusted under section 56(g) and this section, but taking into account only items of income of the foreign corporation that are effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States, and any expense, loss or deduction that is properly allocated and apportioned to that income.

(3) *Rules to determine effectively connected pre-adjustment alternative minimum taxable income and effectively connected adjusted current earnings.* The principles of section 864 (c) (and the regulations thereunder) and any other applicable provision of the Internal Revenue Code apply to determine whether items of income of the foreign corporation are effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States, and whether any expense, loss or deduction is properly allocated and apportioned to that income.

(4) *Certain exempt amounts.* Effectively connected adjusted current earnings and effectively connected pre-adjustment alternative minimum taxable income do not include any item of income, or any expense, loss or deduction that is properly allocated and apportioned to income that is exempt from United States taxation under section 883 or an applicable income tax treaty. See section 894.

(n) *Adjustment for adjusted current earnings of consolidated groups*—(1) *Positive adjustments.* For taxable years beginning after December 31, 1989, the alternative minimum taxable income of a consolidated group (as defined in §1.1502–1T) is increased by 75 percent of the excess, if any, of—

(i) The consolidated adjusted current earnings for the taxable year, over

(ii) The consolidated pre-adjustment alternative minimum taxable income for the taxable year.

(2) *Negative adjustments*—(i) *In general.* The alternative minimum taxable income of a consolidated group is decreased, subject to the limitation of paragraph (n)(2)(ii) of this section, by 75 percent of the excess, if any, of the consolidated pre-adjustment alternative minimum taxable income over consolidated adjusted current earnings.

(ii) *Limitation on negative adjustments.* The amount of the negative adjustment for any taxable year shall be limited to the excess, if any, of—

(A) The aggregate increases in the alternative minimum taxable income of the group in prior years under this section, over

(B) The aggregate decreases in the alternative minimum taxable income of the group in prior years under this section.

(3) *Definitions*—(i) *Consolidated pre-adjustment alternative minimum taxable income.* Consolidated pre-adjustment alternative minimum taxable income is the consolidated taxable income (as defined in §1.1502–11) of a consolidated group for the taxable year, determined with the adjustments provided in sections 56 and 58 (except for the adjustment for adjusted current earnings and the alternative tax net operating loss determined under section 56(a)(4)) and increased by the preference items described in section 57.

(ii) *Consolidated adjusted current earnings.* The consolidated adjusted current earnings of a consolidated group is the consolidated pre-adjustment alternative minimum taxable income of the consolidated group for the taxable year, adjusted as provided in section 56(g) and this section.

(4) *Example.* The following example illustrates the provisions of this paragraph (n):

(i) P is the common parent of a consolidated group. In 1990, the group has consolidated pre-adjustment alternative minimum taxable income of $1,400,000 and consolidated adjusted current earnings of $1,600,000. Thus, the group has a consolidated adjustment for adjusted current earnings for 1990 of $150,000 (75 percent of the $200,000 excess of consolidated adjusted current earnings over consolidated pre-adjustment alternative minimum taxable income), and alternative minimum taxable income of $1,550,000 ($1,400,000 plus $150,000).

(ii) In 1991, the group has consolidated pre-adjustment alternative minimum taxable income of $1,500,000 and consolidated adjusted current earnings of $1,100,000. Thus, the group can reduce its alternative minimum taxable income by $150,000. The potential negative adjustment of $300,000 (75 percent of the $400,000 excess of consolidated pre-adjustment alternative minimum taxable income over consolidated adjusted current earnings) is limited to the $150,000 consolidated adjustment for adjusted current earnings taken into account in 1990.

(o) [Reserved]

(p) *Effective dates for corporate partners in partnerships*—(1) *In general.* The provisions of this section apply to a corporate partner's distributive share of items of income and expense from a partnership for any taxable year of the partnership ending within or with any taxable year of the corporate partner beginning after December 31, 1989.

(2) *Application of effective dates.* Solely for purposes of the effective date provisions of this section, a partnership event (such as placing property in service, paying or incurring a cost, or closing an installment sale) is deemed to occur on the last day of the partnership's taxable year.

(3) *Example.* The following example illustrates the provisions of this paragraph (p):

(i) X is a calendar-year corporation that is a partner in P, an accrual-basis partnership with a taxable year ending March 31. During P's taxable year ending March 31, 1990, P earned ratably throughout the year interest income on tax-exempt obligations. In addition, P incurred intangible drilling costs in November 1989 and in February 1990.

(ii) X's adjusted current earnings for 1990 includes X's distributive share of the interest on the tax-exempt obligations earned by P for its taxable year ending March 31, 1990. This is true even though P earned a portion of the interest prior to January 1, 1990.

(iii) For purposes of computing X's adjusted current earnings for 1990, the adjustment provided in paragraph (f)(1) of this section applies to X's distributive share of P's November 1989 and February 1990 intangible drilling costs.

(q) *Treatment of distributions of property to shareholders*—(1) *In general.* If a distribution of an item of property by a corporation with respect to its stock gives rise to more than one adjustment to earnings and profits under section 312, all of the adjustments with respect to that item of property (including the adjustment described in section 312(c) with respect to liabilities to which the item is subject or which are assumed in connection with the distribution) are combined for purposes of determining the corporation's adjusted current earnings for the taxable year. If the amount included in pre-adjustment alternative minimum taxable income with respect to a distribution of an item of property exceeds the net increase in earnings and profits caused by the distribution, pre-adjustment alternative minimum taxable income is not reduced in computing adjusted current earnings. If the net increase in earnings and profits caused by a distribution of an item of property exceeds the amount included in pre-adjustment alternative minimum taxable income with respect to the distribution, that excess is added to pre-adjustment alternative minimum taxable income in computing adjusted current earnings.

(2) *Examples.* The following examples illustrate the provisions of this paragraph (q).

(i) *Example 1.* K corporation distributes property with a fair market value of $150 and an adjusted basis of $100. The adjusted basis is the same for purposes of computing taxable income, pre-adjustment alternative minimum taxable income, adjusted current earnings, and earnings and profits. Under section 312(a)(3), as modified by section 312(b)(2), K decreases its earnings and profits by the fair market value of the property, or $150. Under section 312(b)(1), K increases its earnings and profits by the excess of the fair market value of the property over its adjusted basis, or $50. As a result of the distribution, there is a net decrease in K's earnings and profits of $100. K recognizes $50 of gain under section 311(b) as a result of the distribution as if K sold the property for $150. K thus has no amount permanently excluded from pre-adjustment alternative minimum taxable income that is taken into account in determining current earnings and profits, and thus has no adjustment under paragraph (c)(1) of this section.

(ii) *Example 2.* The facts are the same as in example 1, except that the distribution shareholder assumes a $190 liability in connection with the disribution. Under section 312(c)(1), K must adjust the adjustments to its earnings and profits under section 312 (a) and (b) to account for the liability the shareholder assumes. K adjusts the $100 net decrease in its earnings and profits to reflect the $190 liability, resulting in an increase in its earnings and profits of $90. Because section 311(b)(2) makes the rules of section 336(b) apply, the fair market value of the property is not less than the amount of the liability, or $190. K therefore is treated as if it sold the property for $190, recognizing $90 of gain. K thus has no amount permanently excluded from pre-adjustment alternative minimum taxable income that is taken into account in determining current earnings and profits, and thus has no adjustment under paragraph (c)(1) of this section.

(r) *Elections to use simplified inventory methods to compute alternative minimum tax*—(1) *In general.* If a taxpayer makes an election under this paragraph (r) (and does not make the election in paragraph (r)(5) of this section), the rules of paragraph (r)(2) of this section apply in computing the taxpayer's pre-adjustment alternative minimum taxable income and adjusted current earnings.

(2) *Effect of election*—(i) *Inventories.* The taxpayer's inventory amounts as determined for purposes of computing taxable income are used for purposes of computing pre-adjustment alternative minimum taxable income and adjusted current earnings. Subject to the further modification described in paragraph (r)(2)(ii) of this section, the taxpayer's cost of sales as determined for purposes of computing taxable income is also used for purposes of computing pre-adjustment alternative minimum taxable income and adjusted current earnings.

(ii) *Modifications required*—(A) *In general.* If a taxpayer makes an election under this paragraph (r), pre-adjustment alternative minimum taxable income and adjusted current earnings are computed with the modifications described in this paragraph. The items of adjustment under sections 56 and 58 and the items of tax preference under section 57 are computed without regard to the portion of those adjustments and preferences which, but for the election described in this paragraph, would have been capitalized in ending inventory. For example, pre-adjustment alternative minimum taxable income is increased by the excess of the depreciation allowable for the taxable year under section 168 for purposes of computing taxable income (determined without regard to section 263A) over the depreciation allowable for the taxable year under section 56(a)(1) and section 57 for purposes of computing pre-adjustment alternative minimum taxable income (determined without regard to section 263A). Similarly, adjusted current earnings is further increased by the excess of the depreciation allowable for the taxable year under section 56(a)(1) and section 57 for purposes of computing pre-adjustment alternative minimum taxable income (determined without regard to section 263A) over the depreciation allowable for the taxable year under section 56(g)(4)(A) for purposes of computing adjusted current earnings (determined without regard to section 263A). Thus, the modifications described in the preceding sentence do not duplicate amounts that are taken into account in computing pre-adjustment alternative minimum taxable income. See paragraph (a)(6)(ii) of this section.

(B) *Negative modifications allowed.* An election under this paragraph (r) does not affect the taxpayer's ability to make negative adjustments. Thus, if an election is made under this paragraph (r) and the amount of any adjustment under section 56 or 58, determined after modification under paragraph (r)(2)(ii)(A) of this section, is a negative amount, then this amount reduces pre-adjustment alternative minimum taxable income or adjusted current earnings. However, no negative adjustment under this paragraph (r)(2)(ii)(B) is allowed for the items of tax preference under section 57.

(iii) *LIFO recapture adjustment.* If a taxpayer makes an election under this paragraph (r) and uses the LIFO method for some assets, for purposes of computing the LIFO recapture adjustment under paragraph (f)(3) of this section for taxable years beginning after December 31, 1989—

(A) The LIFO inventory amount as determined for purposes of computing taxable income is used in lieu of the LIFO inventory amount as determined under paragraph (f)(3)(iii) of this section;

(B) The FIFO inventory amount is computed without regard to the adjustments under sections 56 (including the adjustments of section 56(g)(4)) and 58 and the items of tax preference of section 57; and

(C) The beginning LIFO and FIFO inventory amounts under paragraph (f)(3)(ii) of this section are the ending LIFO inventory amount as determined for purposes of computing taxable income and the ending FIFO inventory amount computed without regard to the adjustments under sections 56 (including the adjustments of sections 56(g)(4)) and 58 and the items of tax preference of section 57 for the last taxable year beginning before January 1, 1990.

(3) *Time and manner of making election*—(i) *Prospective election.* (A) A prospective election under this paragraph (r) may be made by any taxpayer—

(*1*) That has computed pre-adjustment alternative minimum taxable income and adjusted current earnings for all prior taxable years in accordance with the method described in this paragraph (r); or

(*2*) That has not computed pre-adjustment alternative minimum taxable income and adjusted current earnings for all prior tax years in accordance with the method described in this paragraph (r), but for which the use of the method described in this paragraph (r) for all prior taxable years would not have changed the taxpayer's tax liability (as shown on returns filed as of the date the election is made) for any prior taxable year for which the period of limitations under section 6501(a) has not expired (as of the date the election is made).

(B) A prospective election under this paragraph (r) may only be made by attaching a statement to the taxpayer's timely filed (including extensions) original Federal income tax return for any taxable year that is no later than its first taxable year to which this paragraph (r) applies and in which the taxpayer's tentative minimum tax (computed under the provisions of this paragraph (r)) exceeds its regular tax. However, in the case of a taxpayer described in paragraph (r)(3)(i)(A)(*1*) of this section that had tentative minimum tax in excess of its regular tax for any prior taxable year, the election may only be made by attaching a statement to its timely filed (including extensions) original Federal income tax return for the first taxable year ending after December 18, 1992. The statement must—

(*1*) Give the name, address and employer identification number of the taxpayer; and

(*2*) Identify the election as made under this paragraph (r).

(C) The determination of whether a taxpayer is described in paragraph (r)(3)(i)(A)(*2*) of this section is to be made as of the time the taxpayer makes a prospective election in accordance with the procedures in paragraph (r)(3)(i)(B) of this section.

(D) Any taxpayer described in paragraph (r)(3)(i)(A)(*2*) of this section that makes a prospective election will be deemed to have used the method described in this paragraph (r) in computing pre-adjustment alternative minimum taxable income and adjusted current earnings for all prior taxable years.

(ii) *Retroactive election*—(A) A retroactive election under this paragraph (r) may be made by any taxpayer not described in paragraph (r)(3)(i)(A) (*1*) or (*2*) of this section. Except as provided in paragraph (r)(3)(iii) of this section, a retroactive election may only be made by attaching a statement to the taxpayer's amended Federal income tax return for the earliest taxable year for which the period of limitations under section 6501(a) has not expired and which begins after December 31, 1986. The amended return to which the election under this paragraph (r)(3)(ii) is attached must be filed no later than June 21, 1993.

(B) The amended return must contain the statement described in paragraph (r)(3)(i)(B) of this section. In addition, the statement must contain a representation that the taxpayer will modify its pre-adjustment alternative minimum taxable income and adjusted current earnings for all open taxable years in accordance with paragraph (r)(2) of this section. Upon this change in method of accounting, the taxpayer must include the entire adjustment required under section 481(a), if any, in preadjustment alternative minimum taxable income and adjusted current earnings on the amended return for the year of the election. The taxpayer must also reflect the method of accounting described in paragraph (r)(2) of this section on amended returns filed for all taxable years after the year of the election for which returns were originally filed before making the election (and for which the period of limitations under section 6501(a) has not expired).

(C) Provided a taxpayer meets the requirements of this paragraph (r), any change in method of accounting arising as a result of making a retroactive election will be treated as made with the advance consent of the Commissioner.

(D) Any retroactive election under this paragraph (r) that is made without filing amended returns required under this paragraph (r)(3)(ii) shall constitute a change in method of accounting made without the consent of the Commissioner.

(iii) *Taxpayers under examination*—(A) *In general.* A taxpayer that wishes to make a retroactive election under section (r)(3)(ii) of this section may use the procedures in paragraph (r)(3)(iii)(A) (*1*) or (*2*) in lieu of filing an amended return for any taxable year that is under examination by the Internal Revenue Service.

(*1*) *Year of change under examination.* If the year of the change is under examination at the time the taxpayer timely makes the election, the taxpayer may (in lieu of filing an amended return for the year of the change) furnish the written statement described in paragraph (r)(3)(iii)(B) of this section to the revenue agent responsible for examining the taxpayer's return no later than June 21, 1993. It is the taxpayer's responsibility to make a timely election either by furnishing the statement to the revenue agent or by filing amended returns by June 21, 1993.

(*2*) *Other open years under examination.* If any other year for which the taxpayer must modify its pre-adjustment alternative minimum taxable income and adjusted current earnings (see paragraph (r)(3)(ii)(B) of this section) is examined, the taxpayer may (in lieu of filing an amended return) furnish the amount of the conforming adjustment to the revenue agent responsible for examining the taxpayer's return. It is the taxpayer's responsibility to timely modify its pre-adjustment alternative minimum taxable income and adjusted current earnings for each year other than the year of change, either by furnishing the amount of the adjustment to the revenue agent or by filing amended returns.

(B) *Statement required.* The statement required under paragraph (r)(3)(iii)(A)(*1*) of this section must include all of the items required under paragraph (r)(3)(ii)(B) of this section, as well as—

(*1*) The caption ''Election to use regular tax inventories for AMT purposes;''

(*2*) A description of the nature and amount of all items that would result in adjustments and that the taxpayer would have reported if the taxpayer had used the method described in this paragraph (r) for all prior taxable years for which the period of limitations under section 6501(a) has not expired and which begin after December 31, 1986; and

(*3*) The following declaration signed by the person authorized to sign the return for the taxpayer: ''Under penalties of perjury, I declare that I have examined this written statement, and to the best of my knowledge and belief this written statement is true, correct, and complete.''

(C) *Year of change.* The year of change is the earliest taxable year for which the period of limitations under section 6501(a) has not expired at the time the statement is submitted to the appropriate revenue agent and that begins after December 31, 1986. Thus, the adjustments required to be included on the statement must include any adjustment under section 481(a) determined as if the method described in this paragraph (r) had been used in all taxable years prior to the year of change that begin after December 31, 1986.

(D) *Treatment of additional tax liability.* Any additional tax liability that results from the adjustments identified in the written statement described in paragraph (r)(3)(iii)(B) of this section is treated as an additional amount of tax shown on an amended return.

(iv) *Election as method of accounting.* The elections provided in paragraphs (r)(3) (i) and (ii) of this section constitute either adoptions of, or changes in, methods of accounting. These elections, once made, may be revoked only with the consent of the Commissioner in accordance with the rules of section 446(e) and §1.446–1(e).

(v) *Untimely election to use simplified inventory method.* If a taxpayer makes an election described in this paragraph (r) after the times set forth in paragraph (r)(3) (i) or (ii) of this section, the taxpayer must comply with the requirements of §1.446–1(e)(3) in order to secure the consent of the Commissioner to change to the method of accounting prescribed in this paragraph (r). The taxpayer generally will be subject to terms and conditions designed to place the taxpayer in a position no more favorable than a taxpayer that timely complied with paragraph (r)(3)

(i) and (ii) of this section, whichever is applicable.

(4) *Example.* The following example illustrates the provisions of this paragraph (r).

Example. (i) Corporation L is a calendar year manufacturer of baseball bats and uses the LIFO method of accounting for inventories. During 1987, 1988, and 1989, L's cost of goods sold in computing taxable income was as follows:

	1987	1988	1989
Beginning LIFO inventory	$3,000	$4,000	$5,000
Purchases and other costs	9,000	9,000	9,000
Ending LIFO inventory	(4,000)	(5,000)	(6,000)
Cost of goods sold	8,000	8,000	8,000

(ii) L has no preferences under section 57 during 1987, 1988, and 1989. L's sole adjustment in computing alternative minimum tax during 1987, 1988, and 1989 was the depreciation adjustment under section 56(a)(1). Depreciation determined for both production and non-production assets under section 168 and under section 56(a)(1) during 1987, 1988, and 1989 was as follows:

	1987	1988	1989
Section 168 depreciation	$1,800	$1,800	$1,800
Section 56(a)(1) depreciation	(900)	(900)	(900)
Depreciation difference	900	900	900
Portion of difference capitalized in the increase in inventory	(100)	(100)	(100)
Adjustment required under section 56(a)(1)	800	800	800

(iii) In computing taxable income, a portion of each year's section 168 depreciation attributable to production assets is deducted currently and a portion is capitalized into the increase in ending inventory. For 1987, 1988, and 1989, L computed alternative minimum tax by deducting the cost of goods sold which was reflected in taxable income ($8,000) in accordance with paragraph (r)(2)(i) of this section. For 1987, 1988, and 1989, L also modified its adjustments under sections 56 and 58 and its preferences under section 57 to disregard the portion of any adjustment or preference that was capitalized in inventory. Thus, under section 56(a)(1), L increased alternative minimum taxable income during each year by $900.

(iv) L is eligible to make the election under paragraph (r)(1) of this section in accordance with paragraph (r)(3)(i) of this section (a prospective election).

(v) L must compute its LIFO recapture adjustment for each year by reference to—

(A) The FIFO inventory amount after applying the provisions of section 263A but before applying the adjustments of sections 56 and 58 and the items of preference in section 57; and

(B) The LIFO inventory amount used in computing taxable income.

(5) *Election to use alternative minimum tax inventories to compute adjusted current earnings.* A taxpayer may elect under this paragraph (r)(5) to use the inventory amounts used to compute pre-adjustment alternative minimum taxable income in computing its adjusted current earnings. Rules similar to those of paragraphs (r)(2) and (r)(3) of this section apply for purposes of this election.

(s) *Adjustment for alternative tax energy preference deduction*—(1) *In general.* For purposes of computing adjusted current earnings, any taxpayer claiming a deduction under section 56(h) must properly decrease basis by the portion of the deduction allowed under section 56(h) which is attributable to adjustments under section 56(g)(4). In taxable years following the taxable year in which the section 56(h) deduction is claimed, basis recovery (including amortization, depletion, and gain on sale) must properly take into account this basis reduction.

(2) *Example.* The following example illustrates the provisions of this paragraph (s):

Example. Corporation A, a calendar year taxpayer, incurs $100 of intangible drilling costs on January 1, 1994 and as a result of these intangible drilling costs A claims a deduction under section 56(h) of $40. Assume that $20 of A's deduction under section 56(h) is attributable to the adjustment under paragraph (f)(1) of this section. A must reduce by $20 the amount of intangible drilling costs to be amortized under paragraph (f)(1) of this section in 1995 through 1998 (the balance of the 60-month amortization period).

[T.D. 8340, 56 FR 11084, Mar. 15, 1991, as amended by T.D. 8352, 56 FR 29433, June 27, 1991; T.D. 8454, 57 FR 60477, Dec. 21, 1992; T.D. 8482, 58 FR 42207, Aug. 9, 1993; T.D. 8566, 59 FR 51371, Oct. 11, 1994]

Tax Preference Regulations

§1.57–0 Scope.

For purposes of the minimum tax for tax preferences (subtitle A, chapter I, part VI), the items of tax preference are:

(a) Excess investment interest,

(b) The excess of accelerated depreciation on section 1250 property over straight line depreciation,

(c) The excess of accelerated depreciation on section 1245 property subject to a net lease over straight line depreciation,

(d) The excess of the amortization deduction for certified pollution control facilities over the depreciation otherwise allowable,

(e) The excess of the amortization deduction for railroad rolling stock over the depreciation otherwise allowable,

(f) The excess of the fair market value of a share of stock received pursuant to a qualified or restricted stock option over the exercise price,

(g) The excess of the addition to the reserve for losses on bad debts of financial institutions over the amount which have been allowable based on actual experience,

(h) The excess of the percentage depletion deduction over the adjusted basis of the property, and

(i) The capital gains deduction allowable under section 1202 or an equivalent amount in the case of corporations.

Accelerated depreciation on section 1245 property subject to a net lease and excess investment interest are not items of tax preference in the case of a corporation, other than a personal holding company (as defined in section 542) and an electing small business corporation (as defined in section 1371(b)). In addition, excess investment interest is an item of tax preference only for taxable years beginning before January 1, 1972. Rules for the determination of the items of tax preference are contained in §§1.57–1 through 1.57–5. Generally, in the case of a nonresident alien or foreign corporation, the application of §§1.57–1 through 1.57–5 will be limited to cases in which the taxpayer has income effectively connected with the conduct of a trade or business within the United States. Special rules for the treatment of items of tax preference in the case of certain entities and the treatment of items of tax preference relating to income from sources outside the United States are provided in section 58 and in §§1.58–1 through 1.58–8.

[T.D. 7564, 43 FR 40470, Sept. 12, 1978]

§1.57–1 Items of tax preference defined.

(a) [Reserved]

(b) *Accelerated depreciation on section 1250 property*—(1) *In general.* Section 57(a)(2) provides that, with respect to each item of section 1250 property (as defined in section 1250(c)), there is to be included as an item of tax preference the amount by which the deduction allowable for the taxable year for depreciation or amortization exceeds the deduction which would have been allowable for the taxable year if the taxpayer had depreciated the property under the straight line method for each year of its useful life for which the taxpayer has held the property. The determination of the excess under section 57(a)(2) is made with respect to each separate item of section 1250 property. Accordingly, where the amount of depreciation which would have been allowable with respect to one item of section 1250 property if the taxpayer had originally used the straight line method exceeds the allowable depreciation or amortization with respect to such property, such excess may not be used to reduce the amount of the item of tax preference resulting from another item of section 1250 property.

(2) *Separate items of section 1250 property.* The determination of what constitutes a separate item of section 1250 property is to be made on the facts and circumstances of each individual case. In general, each building (or component thereof, if the taxpayer uses the

component method of computing depreciation) is a separate item of section 1250 property. However, for purposes of this section, assets placed in a group, classified, or composite account are to be treated as a single item by a taxpayer, provided that such account contains only property placed in service during a single taxable year. In addition, two or more items may be treated as one item of section 1250 property for purposes of this paragraph where, with respect to each such item:

(i) The period for which depreciation is taken begins on the same date, (ii) the same estimated useful life has continually been used for purposes of taking depreciation or amortization, and (iii) the same method (and rate) of depreciation or amortization has continually been used. For example, assume a taxpayer constructed a 40-unit rental townhouse development and began taking declining balance depreciation on all 40 units as of January 1, 1970, at a uniform rate and has consistently taken depreciation on all 40 units on this same basis. Although each townhouse is a separate item of section 1250 property, all 40 townhouses may be treated as one item of section 1250 property for purposes of the minimum tax since the conditions of subdivisions (i), (ii), and (iii) of this subparagraph are met. This would be true even if the 40 townhouses comprised two 20-unit developments located apart from each other. However, if the taxpayer constructed an additional development or new section on the existing development for which he began taking depreciation on July 1, 1970, at a uniform rate for all the additional units, the additional units and the original units may not be treated as one item of section 1250 property since the condition of subdivision (i) of this subparagraph is not met. Where a portion of an item of section 1250 property has been depreciated or amortized under a method (or rate) which is different from the method (or rate) under which the other portion or portions of such item have been depreciated or amortized, such portion is considered a separate item of section 1250 property for purposes of this paragraph.

(3) *Allowable depreciation or amortization.* The phrase ‘‘deduction allowable for the taxable year for exhaustion, wear and tear, obsolescence, or amortization’’ and references in this paragraph to ‘‘allowable depreciation or amortization’’ include deductions allowable for the taxable year under sections 162, 167, 212, or 611 for the depreciation or amortization of section 1250 property. Such phrase does not include depreciation allowable in the year in which the section 1250 property is disposed of. For the determination of ‘‘allowable depreciation or amortization’’ for taxable years in which the taxpayer has taken no deduction, see §1.1016–3(a)(2).

(4) *Straight line depreciation.* (i) For purposes of computing the depreciation which would have been allowable for the taxable year if the taxpayer had depreciated the property under the straight line method for each taxable year of its useful life, the taxpayer must use the same useful life and salvage value as was used for the first taxable year in which the taxpayer depreciated or amortized the property (subject to redeterminations made pursuant to §1.167(a)–1 (b) and (c)). If, however, for any taxable year, no useful life was used under the method of depreciation or amortization used or an artificial period was used, such as, for example, by application of section 167(k), or salvage value was not taken into account in determining the annual allowances, such as, for example, under the declining balance method, then, for purposes of computing the depreciation which would have been allowable under the straight line method for the taxable year—

(a) There is to be used the useful life and salvage value which would have been proper if depreciation had actually been determined under the straight line method (without reference to an artificial life) throughout the period the property was held, and

(b) Such useful life and such salvage value is to be determined by taking into account for each taxable year the same facts and circumstances as would have been taken into account if the taxpayer had used such method throughout the period the property was held.

If an election under §1.167(a)–11(f), §1.167(a)–12(e), or §1.167(a)–12(f) is applicable to the property, the salvage value of the property shall be determined in accordance with such election, and the asset depreciation period (or asset guideline period) applicable to the property pursuant to such election shall be considered to be the useful life of the property for the purposes of this section.

(ii) Where the taxpayer acquires property in a transaction to which section 381(a) applies or from another member of an affiliated group during a consolidated return year and an ''accelerated'' method of depreciation as described in section 167(b) (2), (3), or (4) or section 167(j)(1) (B) or (C) is permitted (see §1.381(c)(6)–1 and §1.1502–12(g)), the depreciation which would have been allowable under the straight line method is determined as if the property had been depreciated under the straight line method since depreciation was first taken on the property by the transferor of such property. In such cases, references in this paragraph to the period for which the property is held or useful life of the property are treated as including the period beginning with the commencement of the original use of the property.

(iii) For purposes of section 57(a)(2), the straight line method includes the method of depreciation described in §1.167(b)–1 or any other method which provides for a uniform proration of the cost or other basis (less salvage value) of the property over the estimated useful life of the property to the taxpayer (in terms of years, hours of use, or other similar time units) or estimated number of units to be produced over the life of the property to the taxpayer. If a method other than the method described in §1.167(b)–1 is used, the estimated useful life or estimated units of production shall be determined in a manner consistent with subdivision (i) of this subparagraph.

(iv) In the case of property constructed by or improvements made by a lessee, the useful life is to be determined in accordance with §1.167(a)–4.

(5) *Application for partial period.* If an item is section 1250 property for less than the entire taxable year, the allowable depreciation or amortization includes only the depreciation or amortization for that portion of the taxable year during which the item is section 1250 property and the amount of the depreciation which would have been allowable under the straight line method is determined only with regard to such portion of the taxable year.

(6) *No section 1250 and basis adjustment.* No adjustment is to be made as a result of the minimum tax either to the basis of section 1250 property or with respect to computations under section 1250.

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

Example. The taxpayer's only item of section 1250 property is an office building with respect to which operations were commenced on January 1, 1971. The taxpayer depreciates the component parts of the building on the declining balance method. The useful life and costs of the component parts for depreciation purposes are as follows:

Asset	Useful life	Cost	Salvage value
Building shell	50	$400,000	$50,000
Partitions and walls	10	40,000	....
Ceilings	10	20,000	....
Electrical system	25	40,000	2,500
Heating and air-conditioning system	25	60,000	2,500

For purposes of computing the item of tax preference under this paragraph for the taxpayer, the partitions, walls, and ceilings may be grouped together and the electrical, heating, and air-conditioning systems may be grouped together since the period for which depreciation is taken began with respect to the assets within these two groups on the same date and the assets within each group have continually had the same useful life and have continually been depreciated under the same method (and rate).

(a) The taxpayer's 1971 item of tax preference under this paragraph would be determined as follows:

(1)	(2)	(3)	(4)
Item of 1250 property	Declining balance depreciation	Straight line depreciation	Excess of (2) over (3)
1. Shell	$12,000	$7,000	$5,000
2. Partitions, walls, ceilings	9,000	6,000	3,000
3. Electrical, heating and air-conditioning systems	6,000	3,800	2,200
1971 preference			10,200

(b) Assuming the above facts are the same for 1974, the taxpayer's 1974 item of tax preference under this paragraph would be determined as follows:

(1)	(2)	(3)	(4)
Item of 1250 property	Declining balance depreciation	Straight line depreciation	Excess of (2) over (3)
1. Shell	$10,952	$7,000	$3,952
2. Partitions, walls, ceilings	5,529	6,000	None
3. Electrical, heating and air-conditioning systems	4,983	3,800	1,183
1974 preference			5,135

(c) *Accelerated depreciation on section 1245 property subject to a net lease*—(1) *In general.* Section 57(a)(3) provides that, with respect to each item of section 1245 property (as defined in section 1245(a)(3)) which is the subject of a net lease for the taxable year, there is to be included as an item of tax preference the amount by which the deduction allowable for the taxable year for depreciation or amortization exceeds the deduction which would have been allowable for the taxable year if the taxpayer had depreciated the property under the straight line method for each year of its useful life for which the taxpayer has held the property. Except as provided in paragraph (b)(1)(ii) of this section, the determination of the excess under section 57(a)(3) is made with respect to each separate item of section 1245 property. Accordingly, where the amount of depreciation which would have been allowable with respect to one item of section 1245 property if the taxpayer had originally used the straight line method exceeds the allowable depreciation or amortization with respect to such property, such excess may not be used to reduce the amount of the item of tax preference resulting from another item of section 1245 property.

(2) *Separate items of property.* The determination of what constitutes a separate item of section 1245 property must be made on the facts and circumstances of each individual case. Such determination shall be made in a manner consistent with the principles expressed in paragraph (b)(2) of this section.

(3) *Allowable depreciation or amortization.* The phrase ''deduction allowable for the taxable year for exhaustion, wear and tear, obsolescence, or amortization'' and references in this paragraph to ''allowable depreciation or amortization'' include deductions allowable for the taxable year under sections 162, 167 (including depreciation allowable under section 167 by reason of section 179), 169, 184, 185, 212, or 611 for the depreciation or amortization of section 1245 property. Such phrase does not include depreciation allowable in the year in which the section 1245 property is disposed of. Amortization of certified pollution control facilities under section 169, and amortization of railroad rolling stock under section 184 are not to be treated as amortization for purposes of section 57(a)(3) to the extent such amounts are treated as an item of tax preference under section 57(a) (4) or (5) (see paragraphs (d) and (e) of this section). For the determination of ''allowable depreciation or amortization'' for taxable years in which the taxpayer has taken no deduction, see § 1.1016–3(a)(2).

(4) *Straight line method of depreciation.* The determination of the depreciation which would have been allowable under

the straight line method shall be made in a manner consistent with paragraph (b)(4) of this section. Such amount shall include any amount allowable under section 167 by reason of section 179 (relating to additional first-year depreciation for small business).

(5) *Application for partial period.* If an item is section 1245 property for less than the entire taxable year or subject to a net lease for less than the entire taxable year the allowable depreciation or amortization includes only the depreciation or amortization for that portion of the taxable year during which the item was both section 1245 property and subject to a net lease and the amount of the depreciation which would have been allowable under the straight line method is to be determined only with regard to such portion of the taxable year.

(6) *Net lease.* Section 57(a)(3) applies only if the section 1245 property is the subject of a net lease for all or part of the taxable year. See §1.57–3 for the determination of when an item is considered the subject of a net lease. p

(7) *No section 1245 and basis adjustment.* No adjustment is to be made as a result of the minimum tax either to the basis of section 1245 property or with respect to computations under section 1245.

(8) *Nonapplicability to corporations.* Section 57(a)(3) does not apply to a corporation other than an electing small business corporation (as defined in section 1371(b)) and a personal holding company (as defined in section 542).

(d) *Amortization of certified pollution control facilities*—(1) *In general.* Section 57(a)(4) provides that, with respect to each certified pollution control facility for which an election is in effect under section 169, there is to be included as an item of tax preference the amount by which the deduction allowable for the taxable year under such section exceeds the depreciation deduction which would otherwise be allowable under section 167. The determination under section 57(a)(4) is made with respect to each separate certified pollution control facility. Accordingly, where the amount of the depreciation deduction which would otherwise be allowable under section 167 with respect to one facility exceeds the allowable amortization deduction under section 169 with respect to such facility, such excess may not be used to offset an item of tax preference resulting from another facility.

(2) *Separate facilities.* The determination of what constitutes a separate facility must be made on the facts and circumstances of each individual case. Generally, each facility with respect to which a separate election is in effect under section 169 shall be treated as a separate facility for purposes of this paragraph. However, if the depreciation or amortization which would have been allowable without regard to section 169 with respect to any part of a facility is based on a different useful life, date placed in service, or method of depreciation or amortization from the other part or parts of such facility, such part is considered a separate facility for purposes of this paragraph. For example, if a building constitutes a certified pollution control facility and various component parts of the building have different useful lives, each group of component parts with the same useful life would be treated as a separate facility for purposes of this paragraph. Two or more facilities may be treated as one facility for purposes of this paragraph where, with respect to each such facility: (i) The initial amortization under section 169 commences on the same date, (ii) the facility is placed in service on the same date, (iii) the estimated useful life which would be the basis for depreciation or amortization other than under section 169 has continually been the same, and (iv) the method of depreciation or amortization which could have been used without regard to section 169 could have continually been the same.

(3) *Amount allowable under section 169.* For purposes of the determination of the amount of the deduction allowable under section 169, see section 169 and the regulations thereunder. Such amount, however, does not include amortization allowable in the year in which the pollution control facility is disposed of.

(4) *Otherwise allowable deduction.* (i) The determination of the amount of the depreciation deduction otherwise allowable under section 167 is made as if the taxpayer had depreciated the

property under section 167 for each year of its useful life for which the property has been held. This amount may be determined under § 1.167(a)–(11)(c) if the property is eligible property (as defined in § 1.167(a)–11(b)(2)) and, during the taxable year in which the property was first placed in service, the taxpayer—

(*a*) Has made an election under § 1.167(a)–11(f) with respect to eligible property first placed in service in such taxable year, or

(*b*) Has placed no eligible property in service other than property described in § 1.167(a)–11(b)(5) (iii), (iv), or (v).

The amount determined pursuant to the preceding sentence shall be determined as if the taxpayer had depreciated the property in accordance with § 1.167(a)–11 for all years to which such section applies and during which the taxpayer held the property. This amount may be determined under § 1.167(a)–12(a)(5) if the property is qualified property (as defined in § 1. 167(a)–12 (a)(3)) and the taxpayer has made an election with respect to such property under § 1.167(a)–12(e). If the taxpayer has made an election under § 1.167(a)–12(f)(1) for a taxable year ending before January 1, 1971, this amount shall be determined for such year in accordance with such election. For purposes of this determination, any method selected by the taxpayer which would have been permissible under section 167 for such taxable year, including accelerated methods, may be used. Any additional amount which would have been allowable by reason of section 179 (relating to additional first-year depreciation for small business) may be included provided such amount is reflected in the determination made under this paragraph in subsequent years.

(ii) If a deduction for depreciation has not been taken by the taxpayer in any taxable year under section 167 with respect to the facility—

(*a*) There is to be used the useful life and salvage value which would have been proper under section 167.

(*b*) Such useful life and salvage value is determined by taking into account for each taxable year the same facts and circumstances as would have been taken into account if the taxpayer had used such method throughout the period the property has been held, and

(*c*) The date the property is placed in service is, for purposes of this section, deemed to be the first day of the first month for which the amortization deduction is taken with respect to the facility under section 169.

If, prior to the date amortization begins under section 169, a deduction for depreciation has been taken by the taxpayer in any taxable year under section 167 with respect to the facility, the useful life, salvage value, etc., used for that purpose is deemed to be the appropriate useful life, salvage value, etc., for purposes of this paragraph, with such adjustments as are appropriate in light of the facts and circumstances which would have been taken into account since the time the last such depreciation deduction was taken, unless it is established by clear and convincing evidence that some other useful life, salvage value, or date the property is placed in service is more appropriate.

(iii) For purposes of section 57(a)(4) and this paragraph, if the deduction for amortization or depreciation which would have been allowable had no election been made under section 169 would have been—

(*a*) An amortization deduction based on the term of a leasehold or

(*b*) A depreciation deduction determined by reference to section 611,

such deduction is to be deemed to be a deduction allowable under section 167.

(iv) If a facility is subject to amortization under section 169 for less than the entire taxable year, the otherwise allowable depreciation deduction under section 167 shall be determined only with regard to that portion of the taxable year during which the election under section 169 is in effect.

(v) If less than the entire adjusted basis of a facility is subject to amortization under section 169, the otherwise allowable depreciation deduction under section 167 shall be determined only with regard to that portion of the adjusted basis subject to amortization under section 169.

(5) *No section 1245 and basis adjustment.* No adjustment is to be made as a result of the minimum tax either to

the basis of a certified pollution control facility or with respect to computations under sections 1245.

(6) *Relationship to section 57(a)(3).* See paragraph (c)(3) with respect to an adjustment in the amount treated as amortization under that provision where both paragraphs (3) and (4) of section 57(a) are applicable to the same item of property.

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

Example. A calendar year taxpayer has a certified pollution control facility on which an election is in effect under section 169 commencing with January 1, 1971. No part of the facility is section 1250 property. The original basis of the facility is $100,000 of which $75,000 constitutes amortizable basis. The useful life of the facility is 20 years. The taxpayer depreciates the $25,000 portion of the facility which is not amortizable basis under the double declining method and began taking depreciation on January 1, 1971.

(a) The taxpayer's 1971 item of tax preference under this paragraph would be determined as follows:

1. Amortization deduction	$15,000
2. Depreciation deduction on amortizable basis (double declining method)	7,500
1971 preference (excess of 1 over 2)	7,500

(b) If the taxpayer terminated his election under section 169 in 1972 effective as of July 1, 1972, the taxpayer's 1972 item of tax preference would be determined as follows:

1. Amortization deduction	$7,500
2. Depreciation deduction on amortizable basis:	
Full year ($75,000 (original basis) less $7,500 ("depreciation" to 1–1–72) equals adjusted basis of $67,500; multiplied by 0.10 (double declining rate))	6,750
Portion of full year's depreciation attributable to amortization period (one-half)	3,375
1972 preference (excess of 1 over 2)	4,125

(e) *Amortization of railroad rolling stock*—(1) *In general.* Section 57(a)(5) provides that, with respect to each unit of railroad rolling stock for which an election is in effect under section 184, there is to be included as an item of tax preference the amount by which the deduction allowable for the taxable year under such section exceeds the depreciation deduction which would otherwise be allowable under section 167. The determination under section 57(a)(5) is made with respect to each separate unit of rolling stock. Accordingly, where the amount of the depreciation deduction which would otherwise be allowable under section 167 with respect to one unit exceeds the allowable amortization deduction under section 184 with respect to such unit, such excess may not be used to offset an item of tax preference resulting from another unit.

(2) *Separate units of rolling stock.* The determination of what constitutes a separate unit of rolling stock must be made on the facts and circumstances of each individual case. Such determination shall be made in a manner consistent with the manner in which the comparable determination is made with respect to separate certified pollution control facilities under paragraph (d) (2) of this section.

(3) *Amount allowable under section 184.* For purposes of the determination of the amount of the deduction allowable under section 184, see section 184. Such amount, however, does not include amortization allowable in the year in which the rolling stock is disposed of.

(4) *Otherwise allowable deduction.* The determination of the amount of the depreciation deduction otherwise allowable under section 167 is to be made in a manner consistent with the manner in which the comparable deduction with respect to certified pollution control facilities is determined under paragraph (d)(4) of this section.

(5) *No section 1245 or basis adjustment.* No adjustment is to be made as a result of the minimum tax either to the basis of a unit of railroad rolling stock or with respect to computations under section 1245.

(6) *Relationship to section 57(a)*(3). See paragraph (c)(3) of this section with respect to an adjustment in the amount treated as amortization under that provision where both paragraphs (3) and (5) of section 57(a) are applicable to the same item.

(f) *Stock options*—(1) *In general.* Section 57(a)(6) provides that with respect to each transfer of a share of stock pursuant to the exercise of a qualified stock option or a restricted stock option, there shall be included by the transferee as an item of tax preference the amount by which the fair market value of the share at the time of exercise exceeds the option price. The stock option item of tax preference is subject to tax under section 56(a) in the taxable year of the transferee in which the transfer is made.

(2) *Definitions.* See generally § 1.421–7 (e), (f), and (g) for the definitions of ''option price,'' ''exercise,'' and ''transfer,'' respectively; however, in the case of a transfer of a share of stock pursuant to the exercise of a qualified stock option or a restricted stock option after the death of an employee by the estate of the decedent (or by a person who acquired the right to exercise such option by bequest or inheritance or by reason of the death of the decedent), the term ''option price'' shall, for purposes of this paragraph, include both the consideration paid by the estate (or such person) for such share of stock and so much of the basis of the option as is attributable to such share of stock. For the definition of a qualified stock option see section 422(b) and § 1.422–2. For the definition of a restricted stock option see section 424(b) and § 1.424–2. The definitions and special rules contained in section 425 and the regulations thereunder are applicable to this paragraph.

(3) *Fair market value.* In accordance with the principles of section 83(a)(1), the fair market value of a share of stock received pursuant to the exercise of a qualified or restricted stock option is to be determined without regard to restrictions (other than nonlapse restrictions within the meaning of § 1.83–3(h)). Notwithstanding any valuation date given in section 83(a)(1), for purposes of this section, fair market value is determined as of the date the option is exercised.

(4) *Foreign source options.* In the case of an option attributable to sources within any foreign country or possession, see section 58(g) and § 1.58–8.

(5) *Inapplicability in certain cases.* (i) Section 57(a)(6) is inapplicable if during the same taxable year in which stock is transferred pursuant to the exercise of an option, the transferee makes a disposition (within the meaning of section 425(c)) of such stock. In the case of a nonresident alien, section 57(a)(6) is inapplicable to the extent the stock option is attributable (in accordance with the principles of sections 861 through 863 and the regulations thereunder) to sources without the United States.

(ii) Section 57(a)(6) is inapplicable if section 421(a) does not apply to the transfer because of employment requirements of section 422(a)(2) or 424(a)(2).

(6) *Proportionate applicability.* Where, by reason of section 422 (b)(7) and (c)(3) (relating to percentage ownership limitations), only a portion of a transfer qualifies for application of section 421, the fair market value and option price shall be determined only with regard to that portion of the transfer which so qualifies.

(7) *No basis adjustment.* No adjustment shall be made to the basis of the stock received pursuant to the exercise of a qualified or restricted stock option as a result of the minimum tax.

(g) *Reserves for losses on bad debts of financial institutions*—(1) *In general.* Section 57(a)(7) provides that, in the case of a financial institution to which section 585 or 593 (both relating to reserves for losses on loans) applies, there shall be included as an item of tax preference the amount by which the deduction allowable for the taxable year for a reasonable addition to a reserve for bad debts exceeds the amount that would have been allowable had the institution maintained its bad debt reserve for all taxable years on the basis of the institution's actual experience.

(2) *Taxpayers covered.* Section 57(a)(7) applies only to an institution (or organization) to which section 585 or 593 applies. See sections 585(a) and 593(a) and the regulations thereunder for a description of those institutions.

(3) *Allowable deduction.* For purposes of this paragraph, the amount of the deduction allowable for the taxable year for a reasonable addition to a reserve for bad debts is the amount of the deduction allowed under section 166(c) by reference to section 585 or 593.

(4) *Actual experience.* (i) For purposes of this paragraph, the determination of the amount which would have been allowable had the institution maintained its reserve for bad debts on the basis of actual experience is the amount determined under section 585(b)(3)(A) and the regulations thereunder. For this purpose, the beginning balance for the first taxable year ending in 1970 is the

amount which bears the same ratio to loans outstanding at the beginning of the taxable year as (*a*) the total bad debts sustained during the 5 preceding taxable years, adjusted for recoveries of bad debts during such period, bears to (*b*) the sum of the loans outstanding at the close of such 5 taxable years. The taxpayer may, however, select a more appropriate balance based on its actual experience during a shorter period subject to the approval of the district director upon examination of the return provided there are unusual circumstances which indicate that such period is more indicative of the taxpayer's actual loss experience. Any such selection and approval shall be made in a manner consistent with the selection and approval of a bad debt reserve method under §1.166–1(b). In the case of an institution which has been in existence for less than 5 taxable years as of the beginning of the first taxable year ending in 1970, the above formula for determining the beginning balance is applied by substituting the number of taxable years for which the institution has been in existence as of the beginning of the taxable year for ''5'' each time it appears. If any taxable year utilized in the above formula for determining the beginning balance is a short taxable year the amount of the bad debts, adjusted for recoveries, for such taxable year is modified by dividing such amount by the number of days in the taxable year and multiplying the resulting amount by 365. The beginning balance for any subsequent taxable year is the amount of the beginning balance of the preceding taxable year, decreased by bad debt losses during such year, increased by recoveries of bad debts during such year and increased by the lower of the maximum amount determined under section 585(b)(3)(A) for such year or the amount of the deduction allowed for such year. The application of this subdivision (i) may be illustrated by the following example:

Example. The Y Bank, a calendar year taxpayer, uses the reserve method of acounting for bad debts. On December 31, 1969, Y determines the balance of its reserve for bad debts to be $70,000 under the percentage method. On the same date Y's 5-year moving average is $52,000. Y incurs net bad debt losses (bad debt losses less recoveries of bad debts) of $3,000 for each of the years 1970, 1971, and 1972, which it charges to its reserve for bad debts. Y's 6-year moving averages computed under section 585(b)(3)(A) at the close of 1970, 1971, and 1972 are $50,000, $49,000, and $51,000, respectively. Y's preference items are computed as follows based upon additional facts assumed:

	1970	1971	1972
1. Bad debt reserve—percentage method:			
(a) Balance beginning of year (closing balance prior year)	$70,000	$70,000	$68,000
(b) Net bad debts charged to reserve	3,000	3,000	3,000
(c) Subtotal	67,000	67,000	65,000
(d) Deduction allowed	3,000	1,000	4,000
(e) Balance end of year	70,000	68,000	69,000
2. Bad debt reserve—''actual experience'':			
(a) Beginning balance (for 1970, 5-year moving average; for other years, closing balance prior year)	52,000	50,000	48,000
(b) Net bad debts charged to reserve	3,000	3,000	3,000
(c) Subtotal	49,000	47,000	45,000
(d) Maximum amount under section 585 (b)(3)(A) (6-year moving average minus (c))	1,000	2,000	6,000
(e) Deduction allowed (line 1(d))	3,000	1,000	4,000
(f) Lower of (d) or (e)	1,000	1,000	4,000
(g) Closing balance (line (c) + (f))	50,000	48,000	49,000
3. Preference item under section 57(a)(7):			
(a) Deduction allowed	3,000	1,000	4,000
(b) Maximum amount under section 585(b)(3)(A)	1,000	2,000	6,000
(c) Preference item (excess of (a) over (b))	2,000	0	0

(ii) In the case of a new institution whose first taxable year ends after 1969, its beginning balance for its reserve for bad debts, for purposes of this paragraph, is zero and its reasonable addition to the reserve for such taxable year is determined on the basis of the actual experience of similar institutions located in the area served by the taxpayer.

(h) *Depletion*—(1) *In general.* Section 57(a)(8) provides that with respect to each property (as defined in section 614), there is to be included as an item of tax preference the amount by which the deduction allowable for the taxable year under section 611 for depletion for the property exceeds the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for that taxable year). The determination under section 57(a)(8) is made with respect to each separate property. Thus, for example, if one mineral property has an adjusted basis remaining at the end of the taxable year, such basis may not be used to reduce the amount of an item of tax preference resulting from another mineral property.

(2) *Allowable depletion.* For the determination of the amount of the deduction for depletion allowable for the taxable year see section 611 and the regulations thereunder.

(3) *Adjusted basis.* For the determination of the adjusted basis of the property at the end of the taxable year see section 1016 and the regulations thereunder.

(4) *No basis adjustment.* No adjustment is to be made to the basis of property subject to depletion as a result ot the minimum tax.

(i) *Capital gains*—(1) *Taxpayers other than corporations.* Section 57(a)(9)(A) provides that, in the case of a taxpayer other than a corporation, there is to be included as an item of tax preference one-half of the amount by which the taxpayer's net long-term capital gain for the taxable year exceeds the taxpayer's net short-term capital loss for the taxable year. For this purpose, for taxable years beginning after December 31, 1971, the taxpayer's net long-term capital gain does not include an amount equal to the deduction allowable under section 163 (relating to interest expense) by reason of subsection (d)(1)(C) of that section, and the excess described in the preceding sentence is reduced by an amount equal to the reduction of disallowed interest expense by reason of section 163(d)(2)(B). Furthermore, the net long-term capital gain of an estate or trust does not include capital gains described in section 642(c)(4). Included in the computation of the taxpayer's capital gains item of tax preference are amounts reportable by the taxpayer as distributive shares of gain or loss from partnerships, estates or trusts, electing small business corporations, common trust funds, etc. See section 58 and the regulations thereunder with respect to the above entities.

Example. For 1971, A, a calendar year individual taxpayer, recognized $50,000 from the sale of securities held for more than 6 months. In addition, A received a $15,000 dividend from X Fund, a regulated investment company, $12,000 of which was designated as a capital gain dividend by the company pursuant to section 852(b)(3)(C). The AB partnership recognized a gain of $20,000 from the sale of section 1231 property held by the partnership. The AB partnership agreement provides that A is entitled to 50 percent of the income and gains of the partnership. A had net short-term capital loss for the year of $10,000. A's 1971 capital gains item of tax preference is computed as follows:

Capital gain recognized from securities	$50,000
Capital gain dividend from regulated investment company	12,000
Distributive share of partnership capital gain	10,000
Total net long-term capital gain	72,000
Less: net short-term capital loss	(10,000)
Excess of net long-term capital gain over net short-term capital loss	62,000
One-half of above excess	31,000

(2) *Corporations.* (i) Section 57(a)(9)(B) provides that in the case of corporations there is to be included as an item of tax preference with respect to a corporation's net section 1201 gain an amount equal to the product obtained by multiplying the excess of the net long-term capital gain over the net short-term capital loss by a fraction. The numerator of this fraction is the sum of the normal tax rate and the surtax rate under section 11 minus the alternative tax rate under section 1201(a) for the taxable year, and the denominator of the fraction is the sum of the normal tax rate and the surtax rate under section 11 for the taxable year. Included in the above computation are

amounts reportable by the taxpayer as distributive shares of gain or loss from partnerships, estates or trusts, common trust funds, etc. In certain cases the amount of the net section 1201 gain which results in preferential treatment will be less than the amount determined by application of the statutory formula. Therefore, in lieu of the statutory formula, the capital gains item of tax preference for corporations may in all cases be determined by dividing—

(*a*) The amount of tax which would have been imposed under section 11 if section 1201(a) did not apply minus—

(*b*) The amount of the taxes actually imposed

by the sum of the normal tax rate plus the surtax rate under section 11. In case of foreign source capital gains and losses which are not taken into account pursuant to sections 58(g)(2)(B) and 1.58–8, the amount determined in the preceding sentence shall be multiplied by a fraction the numerator of which is the corporation's net section 1201 gain without regard to such gains and losses which are not taken into account and the denominator of which is the corporation's net section 1201 gain. The computation of the corporate capital gains item of tax preference may be illustrated by the following examples:

Example 1. For 1971, A, a calendar year corporate taxpayer, has ordinary income of $10,000 and net section 1201 gain of $50,000, none of which is subsection (d) gain (as defined in sec. 1201(d)) and none of which is attributable to foreign sources. A's 1971 capital gain item of tax preference may be computed as follows:

1. Tax under section 11:		
Normal tax (0.22×$60,000)		$13,200
Surtax (0.26×$35,000)		9,100
		22,300
2. Tax under section 1201:		
(a) Normal tax on ordinary income (0.22×$10,000)		$2,200
Tax on net section 1201 gain (0.30×$50,000)	$15,000	$17,200
3. Excess		5,100
4. Normal tax rate plus surtax rate		.48
5. Capital gains preference (line 3 divided by line 4)		10,625

Example 2. For 1971, A, a calendar year corporate taxpayer, has a loss from operations of $30,000 and net section 1201 gain of $150,000, none of which is subsection (d) gain (as defined in section 1201(d)) and none of which is attributable to foreign sources. A's 1971 capital gain item of tax preference may be computed as follows:

1. Tax under section 11:		
Normal tax (0.22×$120,000)		$26,400
Surtax (0.26×$95,000)		24,700
		51,100
2. Tax under section 1201(a):		
Normal tax on ordinary income	None	
Tax on net section 1201 gain (0.30×$150,000)	45,000	45,000
3. Excess		6,100
4. Normal tax rate plus surtax rate		.48
5. Capital gain preference (line 3 divided by line 4)		12,708

(ii) In the case of organizations subject to the tax imposed by section 511(a), mutual savings banks conducting a life insurance business (see section 594), life insurance companies (as defined in section 801), mutual insurance companies to which part II of subchapter L applies, insurance companies to which part III of subchapter L applies, regulated investment companies subject to tax under part I of subchapter M, real estate investment trusts subject to tax under part II of subchapter M, or any other corporation not subject to the taxes imposed by sections 11 and 1201(a), the capital gains item of tax preference may be computed in accordance with subdivision (i) of this subparagraph except that, in lieu of references to section 11, there is to be substituted the section which imposes the tax comparable to the tax imposed by section 11 and, in lieu of references to section 1201(a), there is to be substituted the section which imposes the alternative or special tax applicable to the capital gains of such corporation.

(iii) For purposes of this paragraph, where the net section 1201 gain is not in any event subject to the tax comparable to the normal tax and the surtax under section 11, such as in the case of regulated investment companies subject to tax under subchapter M, such comparable tax shall be computed as if it were applicable to net section 1201 gain to the extent such gain is subject to the tax comparable to the alternative tax under section 1201(a). Thus, in the case of a regulated investment company subject to tax under subchapter M, the tax comparable to the normal tax and the surtax would be the tax computed under section 852(b)(1) determined as if the amount subject to tax under section 852(b)(3) were included in investment company taxable income. The principles of this subdivision (iii) may be illustrated by the following example:

Example. M, a calendar year regulated investment company, in 1971, has investment company taxable income (subject to tax under sec. 852(b)(1)) of $125,000 and net long-term capital gain of $800,000. M company has no net short-term capital loss but has a deduction for dividends paid (determined with reference to capital gains only) of $700,000, M's 1971 capital gains item of tax preference is computed as follows:

1. Section 852(b)(1) tax computed as if it were applicable to all income including capital gains:			
Amount subject to section 852(b)(1)		$125,000	
Net section 1201 gain	$800,000		
Less: Dividends paid deduction	700,000		
Net section 1201 gain subject to tax at the company level		100,000	
		225,000	
Normal tax (0.22×$225,000)			$49,500
Surtax (0.26×200,000)			52,000
			101,500
2. Tax comparable to section 1201(a) tax section 852(b)(1) tax:			
Normal tax (0.22×125,000)	$27,500		
Surtax (0.26×100,000)	26,000	$53,500	
Section 852(b)(3) tax (0.30×100,000)		30,000	
			$83,500
3. Excess			18,000
4. Normal tax rate plus surtax rate			.48
5. Capital gains preference (line 3 divided by line 4)			37,500

(iv) For the computation of the capital gains item of tax preference in the case of an electing small business corporation (as defined in section 1371(b)), see § 1.58–4(c).

(3) *Nonresident aliens, foreign corporations.* In the case of a nonresident alien individual or foreign corporation, there shall be included in computing the capital gains item of tax preference under section 57(a)(9) only those capital gains and losses included in the computation of income effectively connected with the conduct of a trade or business within the United States as provided in section 871(b) or 882.

[T.D. 7564, 43 FR 40470, Sept. 12, 1978]

§§ 1.57–2—1.57–3 [Reserved]

§ 1.57–4 Limitation on amounts treated as items of tax preference for taxable years beginning before January 1, 1976.

(a) *In general.* If in any taxable year beginning before January 1, 1976, a taxpayer has deductions in excess of gross income and all or a part of any item of tax preference described in § 1.57–1 results in no tax benefit due to modifications required under section 172(c) or section 172(b)(2) in computing the amount of the net operating loss or the net operating loss to be carried to a succeeding taxable year, then, for purposes of section 56(a)(1), the sum of the items of tax preference determined under section 57(a) (and § 1.57–1) is to be limited as provided in paragraph (b) of this section.

(b) *Limitation.* The sum of the items of tax preference, for purposes of section 56(a)(1) and § 1.56A–1(a), is limited to an amount determined under subparagraphs (1) and (2) of this paragraph.

(1) *Loss year.* If the taxpayer has no taxable income for the taxable year without regard to the net operating loss deduction, the amount of the limitation is equal to—

(i) In cases where the taxpayer does not have a net operating loss for the taxable year, the amount of the recomputed income (as defined in paragraph (c) of this section) or

(ii) In cases where the taxpayer has a net operating loss for the taxable year, the amount of the net operating loss (expressed as a positive amount) increased by the recomputed income or decreased by the recomputed loss for the taxable year (as defined in paragraph (c) of this section,

plus the amount of the taxpayer's stock option item of tax preference (as described in §1.57–1(f)).

(2) *Loss carryover and carryback years.* Except in cases to which subparagraph (1)(ii) of this paragraph applies, if, in any taxable year to which a net operating loss is carried, a capital gains deduction is disallowed under section 172(b)(2) in computing the amount of such net operating loss which may be carried to succeeding taxable years, the amount of the limitation is equal to the amount, if any, by which the sum of the items of tax preference (computed with regard to subparagraph (1)(i) of this paragraph) exceeds the lesser of—

(i) The amount by which such loss is reduced because of a disallowance of the capital gains deduction in such taxable year, or

(ii) The capital gains deduction.

The amount determined pursuant to the preceding sentence shall be increased by the amount, if any, that such reduction is attributable to that portion of such a net operating loss described in section 56(b)(1)(B) and §1.56A–2(a)(2) (relating to excess tax preferences).

(c) *Recomputed income or loss.* For purposes of this section, the phrase ''recomputed income or loss'' means the taxable income or net operating loss for the taxable year computed without regard to the amounts described in §1.57–1 except paragraph (i)(2) of that section (relating to corporate capital gains) and without regard to the net operating loss deduction. For this purpose, the reference to the amounts described in §1.57–1 is a reference to that portion of the deduction allowable in computing taxable income under the appropriate section equal to the amount which is determined in each paragraph of §1.57–1. For example, the amount described in §1.57–1(h) (relating to excess of percentage depletion over basis) is that portion of the deduction allowable for depletion under section 611 which is equal to the amount determined under §1.57–1(h). For purposes of this paragraph, the amount described in §1.57–1(i)(1) (relating to capital gains) is to be considered as the amount of the deduction allowable for the taxable year under section 1202.

(d) *Determination of preferences reduced.* When, pursuant to paragraph (b)(1) of this section, the sum of the items of tax preference (determined without regard to this section) are reduced, such reduction is first considered to be from the capital gains item of tax preference (described in §1.57–1(i)(1)) and each item of tax preference relating to a deduction disallowed in computing the net operating loss pursuant to section 172(d), pro rata. The balance of the reduction, if any, is considered to be from the remaining items of tax preference, pro rata. For purposes of this subparagraph, deductions not attributable to the taxpayer's trade or business which do not relate to items of tax preference are considered as being applied in reducing gross income not derived from such trade or business before such deductions which do relate to items of tax preferences.

(e) *Examples.* The principles of this section may be illustrated by the following examples in each of which the deduction for the personal exemption is disregarded and the taxpayer is an individual who is a calendar year taxpayer.

Example 1. The taxpayer has the following items of income and deduction for 1970:

Gross income (all business income)	$120,000
Deductions:	
Nonbusiness deductions	30,000
Items of tax preference (excess accelerated depreciation on real property held in taxpayer's business)	80,000
Other business deductions	50,000

Based on the above figures, the taxpayer has a net operating loss of $10,000 (business deductions of $130,000 less business income of $120,000, the nonbusiness deductions having been disallowed by reason of section 172(d)(4)). The limitation on the amount treated as items of tax preference is computed as follows:

Tax preferences			$80,000
Net operating loss		$10,000	
Recomputed income or loss:			
Gross income	$120,000		
Deductions other than tax preference items	80,000		
Recomputed income		40,000	
Sum of net operating loss and recomputed income		50,000	
Stock options preference		0	
Limitation		50,000	

Thus, the minimum tax computed under section 56(a) would be 10 percent of $20,000 (items of tax preference of $50,000 less the minimum tax exemption of $30,000), $1,000 of which would be deferred tax liability pursuant to section 56(b).

Example 2. Assume the same facts as in example 1 except that the other business deductions are $130,000, resulting in a net operating loss of $90,000. The limitation on the amount treated as items of tax preference is computed as follows:

Tax preferences			$80,000
Net operating loss		$90,000	
Recomputed income or loss:			
Gross income	$120,000		
Deductions other than tax preference items	160,000		
	(40,000)		
Disallowance of nonbusiness deductions under sec. 172(d)	30,000		
Recomputed loss		10,000	
Net operating loss less recomputed loss		80,000	
Stock options preference		0	
Limitation			80,000

Thus, the minimum tax computed under section 56(a) would be 10 percent of $50,000 (items of tax preference of $80,000 less the minimum tax exemption of $30,000), all of which will be deferred tax liability pursuant to section 56(b).

Example 3. The taxpayer has the following items of income and deduction for 1970:

Gross income (all from business):			
Ordinary			$50,000
Net section 1201 gains			120,000
Deductions:			
Items of tax preference:			
Excess amortization of certified pollution control facilities		$45,000	
Capital gains deduction		60,000	105,000
Other business deductions			75,000

In addition, the taxpayer has a $55,000 item of tax preference resulting from qualified stock options. Based on the above figures, the taxpayer has no taxable income and no net operating loss as the capital gains deduction is disallowed in determining the net operating loss pursuant to section 172(d). The limitation on the amount treated as items of tax preference is computed as follows:

Tax preferences			$160,000
Net operating loss		0	
Recomputed income or loss:			
Gross income	$170,000		
Deductions other than tax preference items	75,000		
Recomputed income		$95,000	
Plus: Stock options preference		55,000	
Limitation			150,000

Thus, the minimum tax computed under section 56 would be 10 percent of $120,000 (items of tax preference of $150,000 less the minimum tax exemption of $30,000).

Example 4. Assume the same facts as in example (3) except that the taxpayer has a net operating loss carryover from 1969 of $80,000. The taxpayer has $160,000 of tax preferences which are limited to $150,000 pursuant to §1.57–4(b)(1). In order to determine the amount of the 1969 net operating loss which remains as a carryover to 1971, the 1970 taxable income is redetermined in accordance with section 172(b)(2) and the regulations thereunder, as follows:

Gross income—1970	$170,000	
Deductions:		
Capital gains deduction disallowed business deductions	$120,000	120,000
Taxable income for section 172(b)(2)		50,000

Thus, the 1969 net operating loss which remains as a carryover to 1971 is $30,000. Pursuant to paragraph (b)(2) of this section, the limitation on the amount treated as items of tax preference is computed as follows:

Items of tax preference computed with regard to §1.57–4(b)(1) (per example (3))	$150,000
Less: Lesser of capital gains deduction ($60,000) or amount of reduction in carryover due to its disallowance ($50,000)	50,000
Limitation	100,000

Thus, the minimum tax computed under section 56 would be 10 percent of $70,000 (items of tax preference of $100,000 less the minimum tax exemption of $30,000).

Example 5. The taxpayer has the following items of income and deduction for the taxable year 1970 without regard to any net operating loss deduction:

Gross income (all from business):		
Ordinary	$50,000	
Net section 1201 gain	40,000	
		$90,000
Deductions:		
Capital gains deduction	20,000	
Medical expenses ($4,100 actually paid but allowable only to the extent in excess of 3 percent of adjusted gross income of $70,000)	2,000	
Other itemized deductions	40,000	
		62,000
Taxable income (before net operating loss deduction)		28,000

In addition, the taxpayer has an item of tax preference of $35,000 resulting from qualified stock options. In 1973, the taxpayer has a net operating loss of $60,000 (no portion of which is attributable to excess tax preferences pursuant to §1.56A–2) which is carried back to 1970 resulting in no taxable income in 1970. In order to determine the amount of the 1973 net operating loss which remains as a carryover to 1971, the 1970 taxable income is redetermined, in accordance with section 172(b)(2) and the regulations thereunder, as follows:

Gross income		$90,000
Deductions:		
Capital gains deduction disallowed.		
Medical expenses ($4,100 actually paid but allowable only to the extent in excess of 3 percent of adjusted gross income of $90,000)	$1,400	
Other itemized deductions	40,000	
		$41,400
Taxable income for section 172(b)(2)		48,600

The limitation on the amount treated as items of tax preference is computed as follows:

Items of tax preference:	
Capital gains	$20,000
Stock options	35,000
	55,000
Less:	
Lesser of capital gains deduction ($20,000) or amount of reduction in carryover due to its disallowance ($20,600)	(20,000)
Limitation	35,000

Thus, the minimum tax for 1970 under section 56 would be 10 percent of $5,000 (items of tax preference of $35,000 less the minimum tax exemption of $30,000).

Example 6. Assume the same facts as in example (5) except that the 1973 net operating loss was $45,000. In this case, the $20,600 increase in the 1970 taxable income as redetermined, results in a decrease of $17,000 (i.e., the remaining 1973 net operating loss after an initial decrease of $28,000 resulting from the 1970 taxable income before redetermination). The limitation on the amount treated as items of tax preference is computed as follows:

Items of tax preference computed without regard to this section	$55,000
Less: Lesser of capital gains deduction ($20,000) or amount of reduction in carryover due to its disallowance ($17,000)	(17,000)
Limitation	38,000

Thus, the minimum tax for 1970 under section 56 would be 10 percent of $8,000 (items of tax preference of $38,000 less the minimum tax exemption of $30,000).

Example 7. The taxpayer has the following items of income and deduction for 1973 without regard to any net operating loss deduction:

Gross income (all from business):		
Ordinary	$100,000	
Net section 1201 gains	120,000	
		$220,000
Deductions:		
Items of tax preference:		
Excess amortization of certified pollution control facilities	45,000	
Capital gains deduction	60,000	
	105,000	
Other business deductions	75,000	
		$180,000
Taxable income (before net operating loss deduction)		40,000

In 1972, the taxpayer had a net operating loss of $70,000 which is carried forward to 1973; $20,000 of this net operating loss is attributable to excess tax preferences. In order to determine the amount of the 1972 net operating loss which remains as a carryover to 1974, the 1973 taxable income is redetermined, in accordance with section 172(b)(2) and the regulations thereunder, as follows:

Gross income	$220,000
Deductions:	
Capital gains deduction	Disallowed
Business deductions	120,000
Taxable income per section 172(b)(2)	100,000

In this case, the $60,000 increase in the 1972 taxable income as redetermined and the $30,000 decrease in the amount of the 1973 net operating loss remaining as a carryover to 1974 (i.e., the remaining 1972 net operating loss after an initial decrease of $40,000 resulting from the 1973 taxable income before redetermination) is entirely attributable to the disallowance of the capital gains deduction. The limitation on the amount treated as items of tax preference is computed as follows:

Items of tax preference computed without regard to this section:	
Capital gains	$60,000
Excess amortization of certified pollution control facilities	45,000
	105,000
Less: Lesser of capital gains deduction (60,000) or amount of reduction in carryover due to its disallowance ($30,000)	(30,000)
	75,000
Plus: Amount of reduction of carryover (due to disallowance of capital gains deduction) attributable to excess tax preferences	20,000
Limitation	95,000

[T.D. 7564, 43 FR 40476, Sept. 12, 1978, as amended by T.D. 8138, 52 FR 15309, Apr. 28, 1987]

§ 1.57–5 Records to be kept.

(a) *In general.* The taxpayer shall have available permanent records of all the facts necessary to determine with reasonable accuracy the amounts described in § 1.57–1. Such records shall include:

(1) In the case of amounts described in paragraph (a) of § 1.57–1: the amount and nature of indebtedness outstanding for the taxable year and the date or dates on which each such indebtedness was incurred or renewed in any form; the amount expended for property held for investment during any taxable year during which such indebtedness was incurred or renewed; and the manner in which it was determined that property was or was not held for investment.

(2) In the case of amounts described in paragraphs (b), (c), (d), (e), and (h) of § 1.57–1:

(i) The dates, and manner in which, the property was acquired and placed in service,

(ii) The taxpayer's basis on the date the property was acquired and the manner in which the basis was determined,

(iii) An estimate of the useful life (in terms of months, hours of use, etc., whichever is appropriate) of the property on the date placed in service or an estimate of the number of units to be produced by the property on the date the property is placed in service, whichever is appropriate, and the manner in which such estimate was determined,

(iv) The amount and date of all adjustments by the taxpayer to the basis of the property and an explanation of the nature of such adjustments, and

(v) In the case of property which has an adjusted basis reflecting adjustments taken by another taxpayer with respect to the property or taken by the taxpayer with respect to other property, the information described in paragraph (a)(2)(i) through (iv) of this section, with respect to such other property or other taxpayer.

(3) In the case of amounts described in paragraph (f) of §1.57–1, the fair market value of the shares of stock at the date of exercise of the option and the option price and the manner in which each was determined.

(4) In the case of amounts described in paragraph (g) of §1.57–1, the amount of debts written off and the amount of the loans outstanding for the taxable year and the 5 preceding taxable years or such shorter or longer period as is appropriate.

(b) *Net operating losses.* The taxpayer shall have available permanent records for the first taxable year in which a portion of a net operating loss was attributable to items of tax preference (within the meaning of §1.56A–2 (b)) and each succeeding taxable year in which there is a net operating loss or a net operating loss carryover a portion of which is so attributable. Such records shall include all the facts necessary to determine with reasonable accuracy the amount of deferred tax liability under section 56, including the amount of the net operating loss in each taxable year in which there are items of tax preference in excess of the minimum tax exemption (as determined under §1.58–1), the amount of the items of tax preference for each such taxable year, the amount by which each such net operating loss reduces taxable income in any taxable year, and the amount by which each such net operating loss is reduced in any taxable year.

[T.D. 7564, 43 FR 40479, Sept. 12, 1978, as amended by T.D. 8138, 52 FR 15309, Apr. 28, 1987]

§1.58–1 Minimum tax exemption.

(a) *In general.* For purposes of the minimum tax for tax preferences (subtitle A, chapter 1A, part VI), the minimum tax exemption is $30,000 except as otherwise provided in this section.

(b) *Husband and wife.* In the case of a married individual filing a separate return, section 58(a) provides that the minimum tax exemption is $15,000. This rule applies without regard to whether the married individual is living together with or apart from his spouse and without regard to whether or not his spouse has any items of tax preference.

(c) *Members of controlled groups*—(1) *Amount of exemption*—(i) *General rule.* Under section 58(b), if a corporation is a component member of a controlled group of corporations on December 31 (as defined in section 1563 (a) and (b) and the regulations thereunder), the minimum tax exemption for such taxable year which includes such December 31 is an amount equal to—

(*a*) $30,000 divided by the number of corporations which are component members of such group on December 31, or

(*b*) If an apportionment plan is adopted under subparagraph (3) of this paragraph, such portion of the $30,000 as is apportioned to such member in accordance with such plan.

(ii) *Consolidated returns.* The minimum tax exemption of a controlled group all of whose component members join in the filing of a consolidated return is $30,000. If there are component members of the controlled group which do not join in the filing of a consolidated return, and there is no apportionment plan effective under subparagraph (3) of this paragraph apportioning the $30,000 among the component members filing the consolidated return and the other component members of the controlled group, each component member of the controlled group (including each component member which joins in filing the consolidated return) is treated as a separate corporation for purposes of equally apportioning the $30,000 amount under subdivision (i)(*a*) of this subparagraph. In such case, the minimum tax exemption of the corporations filing the consolidated return is the sum of the amounts apportioned to each component member which joins in the filing of the consolidated return.

(2) *Certain short taxable years.* If the return of a corporation is for a short period which does not include a December 31, and such corporation is a component member of a controlled group of corporations with respect to such short period, the minimum tax exemption of such corporation for such short period is an amount equal to $30,000 divided by the number of corporations which are component members of such group on

the last day of such short period. The minimum tax exemption so determined is also subject to the rules of section 443(d) (relating to reduction in the amount of the exemption for short periods) and the regulations thereunder. For purposes of this subparagraph, the term ''short period'' does not include any period if the income for such period is required to be included in a consolidated return under § 1.1502–76(b). The determination of whether a corporation is a component member of a controlled group of corporations on the last day of a short period is made by applying the definition of ''component member'' contained in section 1563(b) and § 1.1563–1 as if the last day of such short period were a December 31.

(3) *Apportionment of minimum tax exemption*—(i) *Apportionment plan— (a) In general.* In the case of corporations which are component members of a controlled group of corporations on a December 31, a single minimum tax exemption may be apportioned among such members if all such members consent, in the manner provided in subdivision (ii) of this subparagraph, to an apportionment plan with respect to such December 31. Such plan must provide for the apportionment of a fixed dollar amount to one or more of such members, but in no event may the sum of the amount so apportioned exceed $30,000. An apportionment plan is not considered as adopted with respect to a particular December 31 until each component member which is required to consent to the plan under subdivision (ii)(*a*) of this subparagraph files the original of a statement described in such subdivision (or, the original of a statement incorporating its consent is filed on its behalf). In the case of a return filed before a plan is adopted, the minimum tax exemption for purposes of such return is to be equally apportioned in accordance with subparagraph (1) of this paragraph. If a valid apportionment plan is adopted after the return is filed and within the time prescribed in (*b*) of this subdivision (i), such return must be amended (or a claim for refund should be made) to reflect the change from equal apportionment.

(b) Time for adopting plan. A controlled group may adopt an apportionment plan with respect to a particular December 31 only if, at the time such plan is sought to be adopted, there is at least 1 year remaining in the statutory period (including any extensions thereof) for the assessment of the deficiency against any corporation the tax liability of which would be increased by the adoption of such plan. If there is less than 1 year remaining with respect to any such corporation, the district director or the director of the service center with whom such corporation files its income tax return will ordinarily, upon request, enter into an agreement to extend such statutory period for the limited purpose of assessing any deficiency against such corporation attributable to the adoption of such apportionment plan.

(c) Years for which effective. (*1*) The amount apportioned to a component member of a controlled group of corporations in an apportionment plan adopted with respect to a particular December 31 constitutes such member's minimum tax exemption for its taxable year including the particular December 31, and for all taxable years including succeeding December 31's, unless the apportionment plan is amended in accordance with subdivision (iii) of this subparagraph or is terminated under paragraph (*c*)(*2*) of this subdivision (i). Thus, the apportionment plan (including any amendments thereof) has a continuing effect and need not be renewed annually.

(*2*) If an apportionment plan is adopted with respect to a particular December 31, such plan terminates with respect to a succeeding December 31, if: the controlled group goes out of existence with respect to such succeeding December 31 within the meaning of paragraph (b) of § 1.1562–5, any corporation which was a component member of such group on the particular December 31 is not a component member of such group on such succeeding December 31, or any corporation which was not a component member of such group on the particular December 31 is a component member of such group on such succeeding December 31. An apportionment plan, once terminated with respect to a December 31, is no longer effective. Accordingly, unless a new apportionment plan is adopted, the minimum tax exemption of the component members of the controlled group for their taxable years which include such December 31 and all December 31's thereafter will be determined under subparagraph (1) of this paragraph.

(*3*) If an apportionment plan is terminated with respect to a particular December 31 by reason of the addition or withdrawal of a component member, each corporation which is a component member of the controlled group on such particular December 31 must, on or before the date it files its income tax return for the taxable year which includes such particular December 31, notify the district director or the director of the service center with whom it files such return to such termination. If an apportionment plan is terminated with respect to a particular December 31 by reason of the controlled group going out of existence, each corporation which was a component member of the controlled group on the preceding December 31 must, on or before the date it files its income tax return for the taxable year which includes such particular December 31, notify the district director or the director of the service center with whom it files such return to such termination.

(ii) *Consents to plan*—(*a*) *General rule. (1)* The consent of a component member (other than a wholly-owned subsidiary) to an apportionment plan with respect to a particular December 31 is to be made by means of a statement, signed by any person who is duly authorized to act on behalf of the consenting member, stating that such member consents to the apportionment plan with respect to such December 31. The statement must set forth the name, address, taxpayer identification number, and taxable year of the consenting component member, the amount apportioned to such member under the plan, and the internal revenue district or service center where the original of the statement is to be filed. The consent of more than one component member may be incorporated in a single statement. The original of a statement of consent is to be filed with the district director or the director of the service center with whom the component member of the group on such December 31 which has the taxable year ending first on or after such date filed its return for such taxable year. If two or more component members have the same such taxable year, a statement of consent may be filed with the district director or the director of the service center with whom the return for any such taxable year is filed. The original of a statement of consent is to have attached thereto information (referred to in this subdivision as ‘‘group identification’’) setting forth the name, address, taxpayer identification number, and taxable year of each component member of the controlled group on such December 31 (including wholly-owned subsidiaries) and the amount apportioned to each such member under the plan. If more than one original statement is filed, a statement may incorporate the group identification by reference to the name, address, taxpayer identification number, and taxable year of the component member of the group which has attached such group identification to the original of its statement.

(*2*) Each component member of the group on such December 31 (other than wholly-owned subsidiaries) must attach a copy of its consent (or a copy of the statement incorporating its consent) to the income tax return, amended return, or claim for refund filed with its district director or director of the service center for the taxable year including such date. Such copy must either have attached thereto information on group identification or must incorporate such information by reference to the name, address, taxpayer identification number, and taxable year of the component member of the group which has attached such information to its income tax return, amended return, or claim for refund filed with the same district director or director of the service center for the taxable year including such date.

(b) Wholly-owned subsidiaries. (1) Each component member of a controlled group which is a wholly-owned subsidiary of such group with respect to a

December 31 is deemed to consent to an apportionment plan with respect to such December 31, provided each component member of the group which is not a wholly-owned subsidiary consents to the plan. For purposes of this paragraph, a component member of a controlled group is considered to be a wholly-owned subsidiary of the group with respect to a December 31, if, on each day preceding such date and during its taxable year which includes such date, all of its stock is owned directly by one or more corporations which are component members of the group on such December 31.

(2) Each wholly-owned subsidiary of a controlled group with respect to a December 31 must attach a statement containing the information which is required to be set forth in a statement of consent to an apportionment plan with respect to such December 31 to the income tax return, amended return, or claim for refund filed with its district director or director of the service center for the taxable year which includes such date. Such statement must either have attached thereto information on group identification or incorporate such information by reference to the name, address, taxpayer identification number, and taxable year of a component member of the group which has attached such information to its income tax return, amended return, or claim for refund filed with the same district director or director of the service center for the taxable year including such date.

(iii) *Amendment of plan.* An apportionment plan adopted with respect to a December 31 by a controlled group of corporations may be amended with respect to such December 31 or with respect to any succeeding December 31 for which the plan is effective under subdivision (i)(*c*) of this subparagraph. An apportionment plan must be amended with respect to a particular December 31 and the amendments to the plan are effective only if adopted in accordance with the rules prescribed in this paragraph for the adoption of an original plan with respect to such December 31.

(iv) *Component members filing consolidated return.* If the component members of a controlled group of corporations on a December 31 include corporations which join the filing of a consolidated return, the corporations filing the consolidated return are treated as a single component member for purposes of this subparagraph. Thus, for example, only one consent executed by the common parent to an apportionment plan filed pursuant to this section is required on behalf of the component members filing the consolidated return.

(d) *Estates and trusts.* Section 58(c)(2) provides that, in the case of an estate or trust, the minimum tax exemption applicable to such estate or trust is an amount which bears the same ratio to $30,000 as the portion of the sum of the items of tax preference apportioned to the estate or trust bears to the full sum before apportionment. For example, if one-third of the sum of the items of tax preference of a trust are subject to tax at the trust level after apportionment under section 58(c)(1) and § 1.58–3, the trust's minimum tax exemption is $10,000. See § 1.58–3 for rules with respect to the apportionment of items of tax preference of an estate or trust.

(e) *Short taxable year.* See section 443(d) and § 1.443–1(d) with respect to reduction in the amount of the minimum tax exemption in the case of a short taxable year.

[T.D. 7564, 43 FR 40479, Sept. 12, 1978]

§ 1.58–2 General rules for conduit entities; partnerships and partners.

(a) *General rules for conduit entities.* Sections 1.58–3 through 1.58–6 provide rules under which items of tax preference of an estate, trust, electing small business corporation, common trust fund, regulated investment company, or real estate investment trust (referred to in this paragraph as the ''conduit entity'') are treated as items of tax preference of the beneficiaries, shareholders, participants, etc. (referred to in this paragraph as the ''distributees''). Where an item of tax preference of a conduit entity is so apportioned to a distributee, the item of tax preference retains its character in the hands of the distributee and is adjusted to reflect:

(1) The separate items of income and deduction of the distributee and (2) the

tax status of the distributee as an individual, corporation, etc. For example, if a trust has $100,000 of capital gains for the taxable year, all of which are distributed to A, an individual, the item of tax preference apportioned to A under section 57(a)(9) (and §1.57–1(i)(1)) is $50,000. If, however, A had a net capital loss for the taxable year of $60,000 without regard to the distribution from the trust, the trust tax preference would be adjusted in the hands of A to reflect the separate items of income and deduction passed through to the distributee, or, in this case, to reflect the net section 1201 gain to A of $40,000. Thus, A's capital gains items of tax preference would be $20,000. By application of this rule, A, in effect, treats capital gains distributed to him from the trust the same as his other capital gains in computing his capital gains item of tax preference. If A had been a corporation, the trust tax preference would be adjusted both to reflect the capital loss and to reflect A's tax status by recomputing the capital gains item of tax preference (after adjustment for the capital loss) under section 57(a)(9)(B) and §1.57–1(i)(2). Similarly, if depreciation on section 1245 property subject to a net lease (as defined in section 57(a)(3) and §1.57–1(c)) is apportioned from a conduit entity to a corporation (other than a personal holding company or electing small business corporation), the amount so apportioned to the corporation is not treated as an item of tax preference to such corporation since such item is not an item of tax preference in the case of a corporation (other than a personal holding company or an electing small business corporation).

(b) *Partnerships and partners.* (1) Section 701 provides that a partnership as such is not subject to the income tax imposed by chapter 1. Thus, a partnership as such is not subject to the minimum tax for tax preferences. Section 702 provides that, in determining his income tax, each partner is to take into account separately his distributive share of certain items of income, deductions, etc. of the partnership and other items of income, gain, loss, deduction, or credit of the partnership to the extent provided by regulations prescribed by the Secretary or his delegate. Accordingly, each partner, in computing his items of tax preference, must take into account separately those items of income and deduction of the partnership which enter into the computation of the items of tax preference in accordance with subparagraph (2) of this paragraph.

(2) Pursuant to section 702, each partner must, solely for purposes of the minimum tax for tax preferences (to the extent not otherwise required to be taken into account separately under section 702 and the regulations thereunder), take into account separately in the manner provided in subchapter K and the regulations thereunder those items of income and deduction of the partnership which enter into the computation of the items of tax preference specified in section 57 and the regulations thereunder. A partner must, for this purpose, take into account separately his distributive share of:

(i) Investment interest expense (as defined in section 57(b)(2)(D) determined at the partnership level;

(ii) Investment income (as defined in section 57(b)(2)(B) determined at the partnership level;

(iii) Investment expenses (as defined in section 57(b)(2)(C)) determined at the partnership level;

(iv) With respect to each section 1250 property (as defined in section 1250(c)), the amount of the deduction allowable for the taxable year for exhaustion, wear and tear, obsolescence, or amortization and the deduction which would have been allowable for the taxable year had the property been depreciated under the straight line method each taxable year of its useful life (determined without regard to section 167(k)) for which the partnership has held the property;

(v) With respect to each item of section 1245 property (as defined in section 1245(a)(3)) which is subject to a net lease, the amount of the deduction allowable for exhaustion, wear and tear, obsolescence, or amortization and the deduction which would have been allowable for the taxable year had the property been depreciated under the straight line method for each taxable year of its useful life for which the partnership has held the property;

(vi) With respect to each certified pollution control facility for which an election is in effect under section 169, the amount of the deduction allowable for the taxable year under such section and the deduction which would have been allowable under section 167 had no election been in effect under section 169;

(vii) With respect to each unit of railroad rolling stock for which an election is in effect under section 184, the amount of the deduction allowable for the taxable year under such section and the deduction which would have been allowable under section 167 had no election been in effect under section 184;

(viii) In the case of a partnership which is a financial institution to which section 585 or 593 applies, the amount of the deduction allowable for the taxable year for a reasonable addition to a reserve for bad debts and the amount of the deduction that would have been allowable for the taxable year had the institution maintained its bad debt reserve for all taxable years on the basis of actual experience; and

(ix) With respect to each mineral property, the deduction for depletion allowable under section 611 for the taxable year and the adjusted basis of the property at the end of the taxable year (determined without regard to the depreciation deduction for the taxable year).

If, pursuant to section 743 (relating to optional adjustment to basis), the basis of partnership property is adjusted with respect to a transferee partner due to an election being in effect under section 754 (relating to manner of electing optional adjustment), items representing amortization, depreciation, depletion, gain or loss, and the adjusted basis of property subject to depletion, described above, shall be adjusted to reflect the basis adjustment under section 743.

(3) The minimum tax is effective for taxable years ending after December 31, 1969. Thus, subparagraph (2) of this paragraph is inapplicable in the case of items of income or deduction paid or accrued in a partnership's taxable year ending on or before December 31, 1969.

[T.D. 7564, 43 FR 40481, Sept. 12, 1978]

§ 1.58–3 Estates and trusts.

(a) *In general.* (1) Section 58(c)(1) provides that the sum of the items of tax preference of an estate or trust shall be apportioned between the estate or trust and the beneficiary on the basis of the income of the estate or trust allocable to each. Income for this purpose is the income received or accrued by the trust or estate which is not subject to current taxation either in the hands of the trust or estate or the beneficiary by reason of an item of tax preference. The character of the amounts distributed is determined under section 652(b) or 662(b) and the regulations thereunder.

(2) Additional computations required by reason of excess distributions are to be made in accordance with the principles of sections 665 through 669 and the regulations thereunder.

(3) In the case of a charitable remainder annuity trust (as defined in section 664(d)(1) and § 1.664–2) or a charitable remainder unitrust (as defined in section 664(d)(2) and § 1.664–3), the determination of the income not subject to current taxation by reason of an item of tax preference is to be made as if such trust were generally subject to taxation. Where income of such a trust is not subject to current taxation in accordance with this section and is distributed to a beneficiary in a taxable year subsequent to the taxable year in which the trust received or accrued such income, the items of tax preference relating to such income are apportioned to the beneficiary in such subsequent year (without credit for minimum tax paid by the trust with respect to items of tax preference which are subject to the minimum tax by reason of section 664(c)).

(4) Items of tax preference apportioned to a beneficiary pursuant to this section are to be taken into account by the beneficiary in his taxable year within or with which ends the taxable year of the estate or trust during which it has such items of tax preference.

(5) Where a trust or estate has items of income or deduction which enter into the computation of the excess investment interest item of tax preference, but such items do not result in an item of tax preference at the trust or estate level, each beneficiary must

take into account, in computing his excess investment interest, the portion of such items distributed to him. The determination of the portion of such items distributed to each beneficiary is made in accordance with the character rules of section 652(b) or 662(b) and the regulations thereunder.

(6) Where, pursuant to subpart E of part 1 of subchapter J (sections 671 through 678), the grantor of a trust or another person is treated as the owner of any portion of the trust, there shall be included in computing the items of tax preference of such person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent such items are taken into account under section 671 and the regulations thereunder. Any remaining portion of the trust is subject to the provisions of this section.

(b) *Examples.* The principles of this section may be illustrated by the following examples in each of which it is assumed that none of the distributions are accumulation distributions (see sections 665 through 669 and the regulations thereunder):

Example 1. Trust A, with one income beneficiary, has the following items of income and deduction without regard to the deduction for distributions:

Income:	
Business income	$200,000
Investment income	20,000
	220,000
Deductions:	
Business deductions (nonpreference)	100,000
Investment interest expense	80,000
	180,000

Based on the above figures, the trust has $100,000 of taxable income without regard to items which enter into the computation of excess investment interest and the deduction for distributions. The trust also has $60,000 of excess investment interests, resulting in $40,000 of distributable net income. Thus, $60,000 of the $100,000 of noninvestment income is not subject to current taxation by reason of the excess investment interest.

(a) If $40,000 is distributed to the beneficiary, the beneficiary will normally be subject to tax on the full amount received and the ‘‘sheltered’’ portion of the income will remain at the trust level. Thus, none of the excess investment interest item of tax preference is apportioned to the beneficiary.

(b) If the beneficiary receives $65,000 from the trust, the beneficiary is still subject to tax on only $40,000 (the amount of the distributable net income) and thus, is considered to have received $25,000 of business income ‘‘sheltered’’ by excess investment interest. Thus, $25,000 of the $60,000 of excess investment interest of the trust is apportioned to the beneficiary.

Example 2. Trust B has $150,000 of net section 1201 gain.

(a) If none of the gain is distributed to the beneficiaries, none of the capital gains item of tax preference is apportioned to the beneficiaries.

(b) If all or a part of the gain is distributed to the beneficiaries, a proportionate part of the capital gains item of tax preference is apportioned to the beneficiaries. If any of the beneficiaries are corporations the capital gains item of tax preference is adjusted in the hands of the corporations as provided in §1.58–2(a).

Example 3. Trust C has taxable income of $200,000 computed without regard to depreciation on section 1250 property and the deduction for distributions. The depreciation on section 1250 property held by the trust is $160,000. The trust instrument provides for income to be retained by the trust in an amount equal to the depreciation on the property determined under the straight line method (which method has been used for this purpose for the entire period the trust has held the property) which, in this case is equal to $100,000. The $60,000 excess of the accelerated depreciation of $160,000 over the straight line amount which would have resulted had the property been depreciated under that method for the entire period for which the trust has held the property is an item of tax preference pursuant to section 57(a)(2). Of the remaining $100,000 of net income of the trust (after the reserve for depreciation), 80 percent is distributed to the beneficiaries. Pursuant to sections 167(h) and 642(e), 80 percent of the remaining $60,000 of depreciation deduction (or $48,000) is taken as a deduction directly by the beneficiaries and ‘‘shelters’’ the income received by the beneficiaries. Thus, the full $48,000 deduction taken by the beneficiaries is ‘‘excess accelerated depreciation’’ on section 1250 property and is an item of tax preference in the hands of the beneficiaries. None of the remaining $12,000 of ‘‘excess accelerated depreciation’’ is apportioned to the beneficiaries since this amount ‘‘shelters’’ income retained at the trust level.

Example 4. G creates a trust the ordinary income of which is payable to his adult son. Ten years from the date of the transfer, corpus is to revert to G. G retains no other right or power which would cause him to be treated as an owner under subpart E of part 1 of subchapter J (section 671 and following). Under the terms of the trust instrument and applicable local law capital gains must be applied to corpus. During the taxable year 1970 the trust has $200,000 income from dividends and interest and a net long-term capital gain of $100,000. Since the capital gain is held or accumulated for future distribution to G, he is treated under section 677(a)(2) as an owner of a portion of the trust to which the gain is attributable. Therefore, he must include the capital gain in the computation of his taxable income in 1970 and the capital gain item of tax preference is treated as being directly received by G. Accordingly, no adjustment is made to the trust's minimum tax exemption by reason of the capital gain.

Example 5. For its taxable year 1971 the trust referred to in example (4) has taxable income of $200,000 computed without regard to depreciation on section 1250 property and the deduction for distributions. The depreciation on section 1250 property held by the trust is $160,000. The trust instrument provides for income to be retained by the trust in an amount equal to the depreciation on the property determined for purposes of the Federal income tax. If the property had been depreciated under the straight line method for the entire period for which the trust held the property the resulting depreciation deduction would have been $100,000. The $60,000 excess is, therefore, an item of tax preference pursuant to section 57(a)(2) and § 1.57–1(d). Since this amount of ''income'' is held or accumulated for future distributions to G, he is treated under section 677(a)(2) as an owner of a portion of the trust to which such income is attributable. Therefore, section 671 requires that in computing the tax liability of the grantor the income, deductions, and credits against tax of the trust which are attributable to such portion shall be taken into account. Thus, the grantor has received $160,000 of income and is entitled to a depreciation deduction in the same amount. The $60,000 item of tax preference resulting from the excess depreciation is treated as being directly received by G as he has directly received the income sheltered by that preference. Accordingly, no adjustment is made to the trust's minimum tax exemption by reason of such depreciation.

[T.D. 7564, 43 FR 40482, Sept. 12, 1978]

§ 1.58–3T Treatment of non-alternative tax itemized deductions by trusts and estates and their beneficiaries in taxable years beginning after December 31, 1982 (temporary).

For purposes of section 58(c), in taxable years beginning after December 31, 1982, itemized deductions of a trust or estate which are not alternative tax itemized deductions (as defined in section 55(e)(1)), shall be treated as items of tax preference and apportioned between trusts and their beneficiaries, and estates and their beneficiaries.

[T.D. 8083, 51 FR 15320, Apr. 23, 1986]

§ 1.58–4 Electing small business corporations.

(a) *In general.* Section 58(d)(1) provides rules for the apportionment of the items of tax preference of an electing small business corporation among the shareholders of such corporation. Section 58(d)(2) provides rules for the imposition of the minimum tax on an electing small business corporation with respect to certain capital gains. For purposes of section 58(d) and this section, the items of tax preference are computed at the corporate level as if section 57 generally applied to the corporation. However, the items of tax preference so computed are treated as items of tax preference of the shareholders of such corporation and not as items of tax preference of such corporation (except as provided in paragraph (c) of this section). The items of tax preference specified in section 57(a)(1) and § 1.57–1(a) (excess investment interest) and section 57(a)(3) and § 1.57–1(c) (accelerated depreciation on section 1245 property subject to a net lease), while generally inapplicable to corporations, are included as items of tax preference in the case of an electing small business corporation.

(b) *Apportionment to shareholders.* (1) The items of tax preference of an electing small business corporation, other than the capital gains item of tax preference described in paragraph (c) of this section, are apportioned pro rata among the shareholders of such corporation in a manner consistent with section 1374(c)(1). Thus, with respect to the items of tax preference of the electing small business corporation, there is to be treated as items of tax preference of each shareholder a pro rata share of such items computed as follows:

(i) Divide the total amount of such items of tax preference of the corporation by the number of days in the taxable year of the corporation, thus determining the daily amount of such items of tax preference.

(ii) Determine for each day the shareholder's portion of the daily amount of each such item of tax preference by applying to such amount the ratio which the stock owned by the shareholder on that day bears to the total stock outstanding on that day.

(iii) Total the shareholder's daily portions of each such item of tax preference of the corporation for it taxable year.

Amounts taken into account by shareholders in accordance with this paragraph are considered to consist of a pro rata share of each item of tax preference of the corporation. Thus, for example, if the corporation has $50,000 of excess investment interest and $150,000 of excess accelerated depreciation on section 1250 property and a shareholder, in accordance with this paragraph, takes into account $60,000 of the total $200,000 of tax preference items of the corporation, one-fourth ($50,000÷$200,000) of the $60,000, or $15,000, taken into account by the shareholder is considered excess investment interest and three-fourths of the $60,000, or $45,000, is considered excess accelerated depreciation on section 1250 property.

(2) Items of tax preference apportioned to a shareholder pursuant to subparagraph (1) of this paragraph are taken into account by the shareholder for the shareholder's taxable year in which or with which the taxable year of the corporation ends, except that, in the case of the death of a shareholder during any taxable year of the corporation (during which the corporation is an electing small business corporation), the items of tax preference of the corporation for such taxable year are taken into account for the final taxable year of the shareholder.

(c) *Capital gains.* (1) Capital gains of an electing small business corporation, other than those capital gains subject to tax under section 1378, do not result in an item of tax preference at the corporate level since, in applying the formula specified in sections 57(a)(9)(B) and §1.57–1(i)(2), the rate of tax on capital gains (and the resulting tax) at the corporate level is zero. Under section 1375 (a) shareholders of an electing small business corporation take into account the capital gains of the corporation (including capital gains subject to tax under section 1378). Therefore, the computation of the capital gains item of tax preference at the shareholder level, with respect to such capital gains, is taken into account automatically by operation of section 57(a)(9) and §1.57–1(i). To avoid double inclusion of the capital gains item of tax preference by a shareholder with respect to capital gains subject to tax under section 1378, the capital gains item of tax preference which results at the corporate level by reason of section 58 (d)(2) is not treated under section 58 (d)(1) as an item of tax preference of the shareholders of the corporation.

(2) The capital gains item of tax preference of an electing small business corporation subject to the tax imposed by section 1378 is the excess of the amount of tax computed under section 1378(b)(2) over the sum of—

(i) The amount of tax that would be computed under section 1378(b)(2) if the following amount were excluded:

(*a*) That portion of the net section 1201 gain of the corporation described in section 1378(b)(1), or

(*b*) If section 1378(c)(3) applies, that portion of the net section 1201 gain attributable to the property described in section 1378(c)(3), and

(ii) The amount of tax imposed under section 1378 divided by the sum of the normal tax rate and the surtax rate under section 11 for the taxable year.

(3) The principles of this paragraph may be illustrated by the following example.

Example. Corporation X is a calendar year taxpayer and an electing small business corporation. For its taxable year 1971 the corporation has net section 1201 gain of $650,000 and taxable income of $800,000 (including the net section 1201 gain). Although X's election under section 1372(a) has been in effect for its three immediately preceding taxable years, X is subject to the tax imposed by section 1378 for 1971 since it has net section 1201 gain (in the amount of $200,000) attributable to property with a substituted basis. The tax computed under section 1378(b)(1) is $187,500 (30 percent of ($650,000 minus $25,000)) and under section 1378(b)(2) is $377,500 (22 percent of $800,000 plus 26 percent of $775,000). By reason of the limitation imposed by section 1378(c) the tax actually imposed by section 1378 is $60,000 (30 percent of $200,000, the net section 1201 gain). The tax computed under section 1378(b)(2) with the modification required under subparagraph (2)(i) of this paragraph is $281,500 (22 percent of $600,000 plus 26 percent of $575,000). Thus, the 1971 capital gains item of tax preference X is $75,000 computed as follows:

1. Tax computed under 1378(b) (2)	$377,500
2. Tax computed under 1378(b) (2) with modification	281,500
3. Excess	96,000
4. Tax actually imposed under 1378	60,000
5. Difference	36,000
6. Normal tax rate plus surtax rate	.48
7. Tax preference (line 5 divided by line 6)	$75,000

In addition each shareholder of X will take into account his distributive share of the $650,000 of net section 1201 gain of X less the taxes paid by X under sections 56 and 1378 on the gain

[T.D. 7564, 43 FR 40483, Sept. 12, 1978]

§ 1.58–5 Common trust funds.

Section 58(e) provides that each participant in a common trust fund (as defined in section 584 and the regulations thereunder) is to treat as items of tax preference his proportionate share of the items of tax preference of the fund computed as if the fund were an individual subject to the minimum tax. The participant's proportionate share of the items of tax preference of the fund is determined as if the participant had realized, or incurred, his pro rata share of items of income, gain, loss, or deduction of the fund directly from the source from which realized or incurred by the fund. The participant's pro rata share of such items is determined in a manner consistent with section 1.584–2(c). Items of tax preference apportioned to a participant pursuant to this paragraph are taken into account by the participant for the participant's taxable year in which or with which the taxable year of the trust ends.

[T.D. 7564, 43 FR 40484, Sept. 12, 1978]

§ 1.58–6 Regulated investment companies; real estate investment trusts.

(a) *In general.* Section 58(f) provides rules with respect to the determination of the items of tax preference of regulated investment companies (as defined in section 851) and their shareholders and real estate investment trusts (as defined in section 856) and their shareholders, or holders of beneficial interest. In general, the items of tax preference of such companies and such trusts are determined at the company or trust level and the items of tax preference so determined (other than the capital gains item of tax preference (sections 57(a)(9) and § 1.57–1(i)) and, in the case of a real estate investment trust, accelerated depreciation on section 1250 property (sections 57(a)(2) and § 1.57–1(b)) are treated as items of tax preference of the shareholders, or holders of beneficial interest, in the same proportion that the dividends (other than capital gains dividends) paid to each such shareholder, or holder of beneficial interest, bear to the taxable income of such company or such trust determined without regard to the deduction for dividends paid. In no case, however, is such proportion to be considered in excess of 100 percent. For example, if a regulated investment company has items of tax preference of $500,000 for the taxable year, none of which resulted from capital gains, and distributes dividends in an amount equal to 90 percent of its taxable income, each shareholder treats his share of 90 percent of the company's items of tax preference, or (a proportionate share of) $450,000, as items of tax preference of the shareholder. The remaining $50,000 constitutes items of tax preference of the company. Amounts treated under this paragraph as items of tax preference of the shareholders, or holders of beneficial interest, are deemed to be derived proportionately from each item of tax preference of the company or trust, other than the capital gains item of tax preference and, in the case of a real estate investment trust, accelerated depreciation on section 1250 property. Such amounts are taken into account by the shareholders, or holders of beneficial interest, in the same taxable year in which the dividends on which the apportionment is based are includible in income. The minimum tax exemption of the trust or company shall not be reduced because a portion of the trust's or company's items of tax preference are allocated to the shareholders or holders of beneficial interests.

(b) *Capital gains.* Section 58(g)(1) provides that a regulated investment company or real estate investment trust does not treat as an item of tax preference the capital gains item of tax preference under section 57(a)(9) (and §1.57–1(i)) to the extent that such item is attributable to amounts taken into income by the shareholders of such company under section 852(b)(3) or by the shareholders or holders of beneficial interest of such trust under section 857(b)(3). Thus, such a company or trust computes its capital gains item of tax preference on the basis of its net section 1201 gain less the sum of (1) the capital gains dividend (as defined in section 852(b)(3)(C) or 857(b)(3)(C)) for the taxable year of the company or trust plus (2), in the case of a regulated investment company, that portion of the undistributed capital gains designated, pursuant to section 852(b)(3)(D) and the regulations thereunder, by the company to be includible in the shareholder's return as long-term capital gains for the shareholders's taxable year in which the last day of the company's taxable years falls. Amounts treated under section 852(b)(3) or 857(b)(3) as long-term capital gains of shareholders, or holders of beneficial interest, are automatically included, pursuant to sections 57(a)(9) and 1.57–1(i), in the computation of the capital gains item of tax preference of the shareholders, or holders of beneficial interest.

(c) *Accelerated depreciation on section 1250 property.* In the case of a real estate investment trust, all of the items of tax preference resulting from accelerated depreciation on section 1250 property held by the trust (section 57(a)(2) and §1.57–1(b)) are treated as items of tax preference of the trust, and, thus, none are treated as items of tax preference of the shareholder, or holder of beneficial interest.

[T.D. 7564, 43 FR 40484, Sept. 12, 1978]

§1.58–7 Tax preferences attributable to foreign sources; preferences other than capital gains and stock options.

(a) *In general.* Section 58(g)(1) provides that except in the case of the stock options item of tax preference (section 57(a)(6) and §1.57–1(f)) and the capital gains item of tax preference (section 57(a)(9) and §1.57–1(i)), items of tax preference which are attributable to sources within any foreign country or possession of the United States shall, for purposes of section 56, be taken into account only to the extent that such items reduce the tax imposed by chapter 1 (other than the minimum tax under section 56) on income derived from sources within the United States. Items of tax preference from sources within any foreign country or possession of the United States reduce the chapter 1 tax on income from sources within the United States to the extent the deduction relating to such preferences, in combination with other foreign deductions, exceed the income from such sources and, in effect, offset income from sources within the United States. Items of tax preference, for this purpose, are determined after application of §1.57–4 (relating to limitation on amounts treated as items of tax preference). In the case of a taxpayer who deducted foreign taxes under section 164 for a taxable year, the provisions of this section shall be applied (without regard to section 275(a)(4)) as if he had elected the overall foreign tax credit limitation under section 904(a)(2) for such year.

(b) *Preferences attributable to foreign sources*—(1) *Preferences other than excess investment interest.* Except in the case of excess investment interest (see subparagraph (2) of this paragraph), an item of tax preference to which this section applies is attributable to sources within a foreign country or possession of the United States to the extent such item is attributable to a deduction properly allocable or apportionable to an item or class of gross income from sources within a foreign country or possession of the United States under the principles of section 862(b), or section 863, and the regulations thereunder. Where, in the case of income partly from sources within the United States and partly from sources within a foreign country or possession of the United States, taxable income is computed before apportionment to domestic and foreign sources, and is then apportioned by processes or formulas of general apportionment (pursuant to section 863(b) and the regulations thereunder), deductions attributable to such taxable income are considered to be proportionately from sources within the United States and within the foreign country or possession of the United States on the same basis as taxable income.

(2) *Excess investment interest—(* i) *Per-country limitation. (a)* In the case of a taxpayer on the per-country foreign tax credit limitation under section 904(a) for the taxable year, excess investment interest (as defined in section 57(b)(1)), and the resulting item of tax preference, is attributable to sources within a foreign country or a possession of the United States to the extent that investment interest expense attributable to income from sources within such foreign country or possession of the United States exceeds the net investment income from sources within such foreign country or such possession. For this purpose, net investment income from within a foreign country or possession of the United States is the excess (if any) of the investment income from sources within such country or possession over the investment expenses attributable to income from sources within such country or such possession. For the definition of investment interest expense see section 57(b)(2)(D); for the definition of investment income see section 57(b)(2)(B); for the definition of investment expense see section 57(b)(2)(C).

(b) If the taxpayer's excess investment interest computed on a worldwide basis is less than the taxpayer's total separately determined excess investment interest (as defined in this subdivision *(b)),* the amount of the taxpayer's excess investment interest from each foreign country or possession is the amount which bears the same relationship to the taxpayer's excess investment interest from each such country or possession, determined without regard to this subdivision *(b),* as the taxpayer's worldwide excess investment interest bears to the taxpayer's total separately determined excess investment interest. For purposes of this subdivision *(b),* the taxpayer's total separately determined excess investment interest is the sum of the total excess investment interest determined without regard to this subdivision *(b)* plus the taxpayer's excess investment interest from sources within the United States determined in a manner consistent with *(a)* of this subdivision (i).

(ii) *Overall limitation.* In the case of a taxpayer who has elected the overall foreign tax credit limitation under section 904(a)(2) for the taxable year, excess investment interest (as defined in section 57(b)(1)), and the resulting item of tax preference, is attributable to sources within any foreign country or possession of the United States to the extent that investment interest expense attributable to income from such sources exceeds the sum of *(a)* the net investment income from such sources plus *(b)* the excess, if any, of net investment income from sources within the United States over investment interest expense attributable to sources within the United States. For this purpose, net investment income from sources within any foreign country or possession of the United States is the excess (if any) of the investment income from all such sources over the investment expenses attributable to income from such sources. For the definition of investment interest expense see section 57(b)(2)(D) for the definition of investment income see section 57(b)(2)(B); for the definition of investment expense see section 57(b)(2)(C).

(iii) *Allocation of expenses.* The determination of the investment interest expense and investment expenses attributable to a foreign country or possession of the United States is made in a manner consistent with subparagraph (1) of this paragraph.

(iv) *Attribution of certain interest deductions to foreign sources.* Where net investment income from sources within any foreign country or possession has the effect of offsetting investment interest expense attributable to income from sources within the United States, the deductions for the investment interest expense so offset are, for purposes of § 1.58–7(c) (relating to reduction in taxes on United States source income), treated as deductions attributable to income from sources within the foreign country or possession from which such net investment income is derived. Such an offset will occur where there is an excess of investment interest expense attributable to income from sources within the United States over net investment income from such sources and *(a)* in the case of a taxpayer on the per-country foreign tax credit limitation, an excess of net investment income from sources within a foreign country or possession of the United States over investment interest expense from within such foreign country or possession, or *(b)* in the case of a taxpayer who has elected the overall foreign tax credit limitation, there is an excess of net investment income from sources within foreign countries or possessions of the United States over investment interest expense attributable to income from within such sources.

(v) *Separate limitation on interest income.* Where a taxpayer has income described in section 904(f)(2) (relating to interest income subject to the separate foreign tax credit limitation) or expenses attributable to such income, the determination of the excess investment interest resulting therefrom must be determined separately with respect to such income and the expenses properly allocable or apportionable thereto in the same manner as such determination is made in the case of a taxpayer on the per-country foreign tax credit limitation for the taxable year (see subdivision (i) of this subparagraph).

(vi) *Examples.* The principles of this subparagraph may be illustrated by the following examples in each of which the taxpayer is an individual and a citizen of the United States:

Example 1. The taxpayer's only items of income and deduction relating to excess investment interest are as follows:

	United States	France	Germany	Total
Investment income from sources within	$150,000	$120,000	$180,000	$450,000
Investment expenses relating to income from sources within	(100,000)	(90,000)	(120,000)	(310,000)
Net investment income	50,000	30,000	60,000	140,000
Investment interest expense relating to income from sources within	(110,000)	(70,000)	(50,000)	(230,000)
(Excess) of investment interest expense over net investment income	(60,000)	(40,000)	*10,000	(90,000)

*Excess of net investment income over investment interest expense.

(a) If the taxpayer has elected the overall foreign tax creditlimitation, his excess investment interest from sources within any foreign countries or possessions of the United States determined under subdivision (ii) of this subparagraph is computed as follows:

Investment interest:			
French	($70,000)		
German	(50,000)		($120,000)
Net investment income:			
Investment income:			
French	120,000		
German	180,000	$300,000	
Less:			
Investment expenses:			
French	(90,000)		
German	(120,000)	(210,000)	90,000
Excess of U.S. net income over investment interest expenses:			
Total foreign excess investment interest			(30,000)

(b) If the taxpayer is on the per-country foreign tax credit limitation, his excess investment interest from France and Germany determined under subdivision (i)(*a*) of this subparagraph is $40,000 and zero, respectively. Since the taxpayer's worldwide excess investment interest ($90,000) is less than his total separately determined excess investment interest ($60,000 (United States) plus $40,000 (French) plus zero (German), or $100,000), the limitation in subdivision (i) (*b*) of this subparagraph applies and the excess investment interest attributable to France is limited as follows:

Total worldwide excess ($90,000)/Total separately determined excess ($100,000) × French excess ($40,000)=$36,000

The taxpayer's total excess investment interest attributable to sources within any foreign country or possession of the United States is, thus, $36,000 ($36,000 (French) plus zero (German)). The taxpayer's excess investment interest attributable to sources within the United States is $54,000

($90,000/$100,000×$60,000).

Since, in making the latter determination, $6,000 of the $60,000 of U.S. investment interest expense in excess of U.S. net investment income is, in effect, offset by German net investment income, for purposes of § 1.58–7(c), $6,000 of interest deductions attributable to income from sources within the United States are, pursuant to subdivision (iv) of this subparagraph, treated as deductions attributable to income from sources within Germany.

Example 2. Assume the same facts as in example (1) except that the items of income and deduction in Germany and the United States are reversed. The worldwide excess investment interest, thus, remains $90,000 and the items of income and deduction relating to excess investment interest are as follows:

	United States	France	Germany	Total
Investment income from sources within	$180,000	$120,000	$150,000	$450,000
Investment expenses relating to income from sources within	(120,000)	(90,000)	(100,000)	(310,000)
Net investment income	60,000	30,000	50,000	140,000
Investment interest expense relating to income from sources within	(50,000)	(70,000)	(110,000)	(230,000)
(Excess) of investment interest expense over net investment income	10,000	(40,000)	(60,000)	(90,000)

(a) If the taxpayer has elected the overall limitation, his excess investment interest from sources within any foreign countries or possessions of the United States determined under subdivision (ii) of this subparagraph is determined as follows:

Foreign investment interest:			
French	($70,000)		
German	(110,000)		($180,000)
Foreign net investment income:			
French	120,000		
German	150,000	$270,000	
Less:			
Investment expenses:			
French	(90,000)		
German	(100,000)	(190,000)	80,000
Excess of U.S. net investment income over U.S. investment interest expense			10,000
Excess investment interest attributable to foreign sources			(90,000)

(b) If the taxpayer has not elected the overall foreign tax credit limitation, his excess investment interest from France and Germany determined under subdivision (i) of this subparagraph (without regard to the limitation to worldwide excess investment interest) is $40,000 and $60,000 respectively, and his total separately determined excess investment interest is, thus, $10,000. Since the total separately determined excess would exceed the worldwide excess, the limitation to the worldwide excess in subdivision (i) applies and the excess investment interest is determined as follows:

France:

$90,000/$100,000×$40,000=$36,000

Germany:

$90,000/$100,000×$60,000=$54,000

Total excess investment interest attributable to sources within any foreign countries and possessions—$90,000.

Example 3. Assume the same facts as in example (1) except that the taxpayer, in addition has investment income, investment expenses, and investment interest subject to the separate limitation under section 904(f).

(a) If the taxpayer has elected the overall foreign tax credit limitation, his excess investment interest from sources within any foreign countries or possessions of the United States determined under subdivision (ii) of this subparagraph is the same as in (a) of example (1) of this subdivision (vi). He then treats such amount as separately determined excess investment interest attributable to a single foreign country as determined under subdivision (i) of this subparagraph and proceeds as in (b) of example (1) of this subdivision (vi) treating items of income and deduction subject to section 904(f) and from each separate foreign country or possession separately in making the additional determinations under subdivisions (i) and (iv) of this subparagraph.

(b) If the taxpayer has not elected the overall foreign tax credit limitation, his excess investment interest from sources within any foreign country or possession of the United States would be determined in the same manner as in (b) of example (1) treating items of income and deduction which are subject to section 904(f) and from each separate foreign country or possession separately in making the determinations under subdivisions (i) and (iv) of this subparagraph.

(c) *Reduction in taxes on United States source income*—(1) *Overall limitation*—(i) *In general.* If a taxpayer is on the overall foreign tax credit limitation under section 904(a)(2), the items of tax preference determined to be attributable to foreign sources under paragraph (b) of this section reduce the tax imposed by chapter 1 (other than the minimum tax imposed under section 56) on income from sources within the United States for the taxable year to the extent of the smallest of the following three amounts:

(*a*) Items of tax preference (other than stock options and capital gains) attributable to sources within a foreign country or possession of the United States,

(*b*) The excess (if any) of the total deductions properly allocable or apportionable to items or classes of gross income from sources within foreign countries and possessions of the United States over the gross income from such sources, or

(*c*) Taxable income from sources within the United States.

See §1.58–7(b)(2)(iv) with respect to the attribution of certain interest deductions to foreign sources in cases involving the excess investment interest item of tax preference.

(ii) *Net operating loss.* Where there is an overall net operating loss for the taxable year, to the extent that the lesser of the amounts determined under (*a*) or (*b*) of subdivision (i) of this subparagraph exceeds the taxpayer's taxable income from sources within the United States (and, therefore do not offset taxable income from sources within the United States for the taxable year) the amount of such excess is treated as "suspense preferences." Suspense preferences are converted to actual items of tax preference, arising in the loss year and subject to the provisions of section 56, as the net operating loss is used in other taxable years, in the form of a net operating loss deduction under section 172, to offset taxable income from sources within the United States. Suspense preferences which, in other taxable years, reduce taxable income from sources within any foreign country or possession of the United States lose their character as suspense preferences and, thus, are never converted into actual items of tax preference. The amount of the suspense preferences which are converted into actual items of tax preference is equal to that portion of the net operating loss attributable to the suspense preferences which offset taxable income from sources within the United States in taxable years other than the loss year. The determination of the component parts of the net operating loss and the determination of the amount by which the portion of the net operating loss attributable to suspense preferences offsets taxable income from sources within the United States is made on a year-by-year basis in the same order as the net operating loss is used in accordance with section 172(b). Such determination is made by applying deductions attributable to U.S. source income first against such income and deductions attributable to foreign source income first against such foreign source income and in accordance with the following principles:

(*a*) Deductions attributable to items or classes of gross income from sources within the United States offset taxable income from sources within the United States before any remaining portion of the net operating loss;

(*b*) Deductions attributable to items or classes of gross income from sources within foreign countries or possessions of the United States offset taxable income from such sources before any remaining portion of the net operating loss;

(*c*) Deductions described in (*b*) of the subdivision (ii) which are not suspense preferences (referred to in this subparagraph as "other foreign deductions") offset taxable income from sources within foreign countries and possessions of the United States before suspense preferences; and

(*d*) Suspense preferences offset taxable income from sources within the United States before other foreign deductions.

For purposes of the above computations, taxable income is computed with the modifications specified in section 172(b)(2) or section 172(c), whichever is applicable. However, the amount of suspense preferences which are converted into actual items of tax preference in accordance with the above principles is reduced to the extent suspense preferences offset increases in taxable income from sources within the United States due to the modifications specified in section 172(b)(2) or section 172(c). For this purpose, suspense preferences are considered to offset an increase in taxable income due to the section 172(b)(2) modifications only after reducing taxable income computed before the section 172(b)(2) or section 172(c) modifications.

(iii) *Examples.* The principles of this subparagraph may be illustrated by the following examples. In each example the taxpayer is an individual citizen of the United States and has elected the overall foreign tax credit limitation. Personal deductions and exemptions are disregarded for purposes of these examples.

Example 1. In 1974, the taxpayer has the following items of income and deduction:

United States taxable income:			
Gross income	....	$750,000	
Deductions	....	(250,000)	$500,000
Foreign source loss:			
Gross income	....	200,000	
Deductions:			
Preference items (excess of percentage depletion over basis)	$550,000		
Other	50,000	(600,000)	(400,000)
Overall taxable income	....	....	100,000

Pursuant to subdivision (i) of this subparagraph the smallest of (a) the items of tax preference attributable to the foreign sources ($550,000), (b) the foreign source loss ($400,000), or (c) the taxable income from sources within the United States ($500,000) reduces the tax imposed by chapter 1 (other than the minimum tax) on income from sources within the United States. Thus, $400,000 of the $550,000 of excess depletion is treated as an item of tax preference in 1974 subject to the minimum tax.

Example 2. Assume the same facts as in example (1) except that the gross income from sources within the United States is $350,000 resulting in U.S. taxable income of $100,000 and an overall net operating loss of $300,000. Pursuant to subdivision (i) of this subparagraph, $100,000 of the $550,000 excess depletion would be treated as an item of tax preference in 1974 subject to the minimum tax. In addition, pursuant to subdivision (ii) of this subparagraph, the excess of the items of tax preference from foreign sources ($550,000) or the foreign source loss ($400,000), whichever is less, over the U.S. taxable income ($100,000), or, in this example, $300,000, is treated as suspense preferences.

(a) If, in 1971, the taxpayer's total items of income and deduction result in $350,000 of taxable income all of which is from sources within the United States, the entire $300,000 net operating loss, all of which is attributable to suspense preferences, is used to offset U.S. taxable income. Accordingly, the full $300,000 of suspense preferences are converted into actual items of tax preference arising in 1974 and are subject to tax under section 56.

(b) If the $350,000 in 1971 is modified taxable income resulting from the denial of a section 1202 capital gains deduction of $175,000 by reason of section 172(b)(2), the $300,000, otherwise treated as actual items of tax preference, is reduced by $125,000, i.e., the extent to which the suspense preferences offset U.S. taxable income attributable to the increase in taxable income resulting from the denial of the section 1202 deduction.

Example 3. In 1974, the taxpayer has the following items of income and deduction:

United States loss:		
Gross income	....	$75,000

Deductions	....	(225,000)	
	....		($150,000)
Foreign loss:			
Gross income	....	400,000	
Deductions:			
Preference items (excess of accelerated depreciation on sec. 1250 property over straight-line amount)	$200,000		
Other	550,000	(750,000)	(350,000)
Overall net operating loss	....	....	(500,000)

Since the nonpreference deductions reduce the foreign source income before the preference portion, the $350,000 foreign source loss consists of $200,000 of suspense preferences and $150,000 of other deductions. In 1971, 1972, and 1973 the taxpayer had taxable income from sources within the United States of $100,000, $200,000, and $300,000, respectively and taxable income from sources within foreign countries of $80,000 each year. Of the $200,000 of suspense preferences, $150,000 are converted into actual items of tax preference, subject to the minimum tax in 1974, determined as follows:

[In thousands of dollars]

Year—Explanation	Taxable income		U.S. deductions	Foreign deductions	
	U.S. source	Foreign source		Suspense preferences	Other
1971 End of year balance before section 58(g) computations	100	80	150	200	150
1. U.S. deductions against U.S. income	(100)	....	....	....	....
	....	....	(100)	....	....
2. Other foreign deductions against foreign income	....	(80)	....	....	(80)
1972 End of year balance before section 58(g) computations	200	80	50	200	70
1. U.S. deductions against U.S. income	(50)	....	(50)	....	....
2. Other foreign deductions against foreign income	....	(70)	....	....	(70)
3. Suspense preferences against foreign income	....	(10)	....	(10)	....
4. Suspense preferences against U.S. income	*(150)	....	....	*(150)	....
1973 End of year balance before section 58(g) computations	300	80	....	40	....
1. U.S. deductions against U.S. income	....	....	Not applicable	....	....
2. Other foreign deductions against foreign income	....	....	Not applicable	....	....
3. Suspense preference against foreign income	....	(40)	....	(40)	....
4. Suspense preferences against U.S. income			Not applicable		
Balances	300	40	....	....	....

*Suspense preferences converted to actual items of tax preference.

Example 4. In 1970, the taxpayer's total items of income and deduction, all of which are attributable to foreign sources, are as follows:

Foreign loss:		
Gross income		$400,000
Deductions:		
Preferences (excess of accelerated depreciation on section 1250 property over straight-line)	$200,000	
Net operating loss		350,000

Pursuant to subdivision (i) of this subparagraph, none of the preferences attributable to foreign sources reduce the tax imposed by chapter 1 (other than the minimum tax) on taxable income from sources within the United States. Pursuant to subdivision (ii) of this subparagraph, the $200,000 portion of the net operating loss resulting from the excess accelerated depreciation constitutes suspense preferences. No part of the net operating loss that is carried back to previous years is reduced in such previous years. In 1971 and 1972, the taxpayer's income (before the net operating loss deduction) consists of the following:

1971 taxable income:	
United States	$160,000
Foreign	70,000
Total	230,000
1972 taxable income:	
United States	25,000
Foreign	105,000
Total	130,000

(a) In 1971, the conversion of suspense preferences into actual items of tax preference under section 58(g) (and this paragraph) and the imposition of the minimum tax on 1970 items of tax preference under section 56(b) and (§ 1.56A–2) are determined as follows:

Conversion of suspense preferences:

1970 NET OPERATING LOSS

[In thousands of dollars]

	U.S. taxable income	Foreign taxable income	U.S. deductions	Suspense preferences	Other foreign deductions
	$160	$70	....	$200	$150
1. U.S. deductions against U.S. income			Not applicable		
2. Other foreign deductions against foreign income.	....	70	....	....	(70)
3. Suspense preference against foreign income.			Not applicable		
4. Suspense preference against U.S. income	*(160)	....	....	(160)	....
Balance to 1972				40	80

*Suspense preferences converted into actual items of tax preference.

Imposition of minimum tax on 1970 items of tax preference:

1970 NET OPERATING LOSS

[In thousands of dollars]

	1971 taxable income	Nonpreference portion	Preference portion	Suspense portion
	$230	$150	....	$200
1. 1971 conversion of suspense preferences pursuant to sec. 58(g)	....	[1] 30	$130	(160)
Adjusted NOL	....	180	130	40
2. Nonpreference portion against taxable income	(180)	(180)	....	....
3. Preference portion against taxable income	[2] (50)	....	(50)	....
Balance to 1972			80	40

[1] Represents the 1970 minimum tax exemption.

[2] Imposition of 1970 minimum tax (10 pct×$50,000=$5,000).

(b) In 1972, the conversion of suspense preferences into actual items of tax preferences under section 58(g) (and this paragraph) and the imposition of the minimum tax on 1970 items of tax preference under section 56(b) (and § 1.56A–2) are determined as follows:

Conversion of suspense preferences:

1970 NET OPERATING LOSS

[In thousands of dollars]

	U.S. taxable income	Foreign taxable income	U.S. deductions	Suspense preferences	Other foreign deductions
	$25	$105		$40	$80
1. U.S. deduction against U.S. income			Not applicable		
2. Other foreign deductions against foreign income		(80)			(80)
3. Suspense preferences against foreign income		(25)		(25)	
4. Suspense preference against U.S. income	[1] (15)			(15)	
Balance	10				

[1] Suspense preferences converted into actual items of tax preference.

Imposition of minimum tax on 1970 items of tax preference:

1970 NET OPERATING LOSS

[In thousands of dollars]

	1972 taxable income	Nonpreference portion	Preference portion	Suspense portion
	$130		$80	$40
1. 1972 conversion of suspense preferences pursuant to sec. 58(g)		$25	15	(40)
Adjusted NOL		25	95	
2. Nonpreference portion against taxable income	(25)	(25)		
3. Preference portion against taxable income	[1] (95)		(95)	
Balance	10			

[1] Imposition of 1970 minimum tax (10 pct×$95,000=$9,500).

(2) *Per-country limitation*—(i) *In general.* If a taxpayer is on the per-country foreign tax credit limitation for the taxable year, the amount by which the items of tax preference to which this section applies reduce the tax imposed by chapter 1 (other than the minimum tax under section 56) on income from sources within the United States is determined separately with respect to each foreign country or possession of the United States. Such determination is made in a manner consistent with subparagraph (1) of this paragraph as modified in subdivision (ii) of this subparagraph. In applying subparagraph (1)(i) of this paragraph to a taxpayer on the per-country limitation, if the total potential preference amounts (as defined in this subdivision (i)) exceed the taxpayer's taxable income from sources within the United States, then, for purposes of subparagraph (1)(i)(*c*) of this paragraph (relating to the U.S. taxable income limitation on the amount treated as a reduction of U.S. taxable income), the taxable income from sources within the United States which is reduced by potential preference amounts with respect to each foreign country or possession is an amount which bears the same relationship to such income as the potential preference amount with respect to such foreign country or possession bears to the total of the potential preference amounts with respect to all foreign countries and possessions. For purposes of this subparagraph, the potential preference amount with respect to a foreign country or possession is the lesser of the amount of foreign source preference (described in subparagraph (1)(i)(*a*) of this paragraph) attributable to such country or possession or the amount of foreign source loss (described in subparagraph (1)(i)(*b*) of this paragraph) attributable to such country or possession.

(ii) *Net operating loss.* Where there is an overall net operating loss for the taxable year and the total of the potential preference amounts with respect to all foreign countries and possessions exceeds the taxpayer's taxable income from sources within the United States, the amount of such excess is treated as ''suspense preferences''. The suspense preferences are converted into actual items of tax preference, arising in the loss year and subject to the provisions of section 56, as the net operating loss is used in other taxable years, in the form of a net operating loss deduction under section 172, to offset taxable income from sources within the United States. Suspense preferences attributable to a foreign country or possession which, in other taxable years, reduce taxable income from sources within such country or possession or offset taxable income from sources within any other foreign country or possession lose their character as suspense preferences and, thus, are never converted into actual items of tax preference. The amount of the suspense preferences which are converted into actual items of tax preference is equal to that portion of the net operating loss attributable to the suspense preferences which offsets taxable income from sources within the United States in taxable years other than the loss year. The determination of the component parts of the net operating loss and the determination of the amount by which the portion of the net operating loss attributable to the suspense preferences offsets taxable income from sources within the United States is made on a year-by-year basis in the same order as the net operating loss is used in accordance with section 172(b). Such determination is made by applying deductions attributable to United States source income first against such income and applying deductions attributable to income from sources within a foreign country or possession of the United States first against income from sources within such country or possession and in accordance with the following principles:

(*a*) Deductions attributable to items or classes of gross income from sources within the United States offset taxable income from sources within the United States before any remaining deductions;

(*b*) Deductions attributable to items or classes of gross income from sources within any foreign country or possession of the United States which are not suspense preferences (referred to in this paragraph as ''other foreign deductions'') offset taxable income from sources within such country or possession before any remaining deductions;

(*c*) Suspense preferences attributable to items or classes of gross income from sources within a foreign country or possession offset any remaining taxable income from sources within such foreign country or possession after application of (*b*) of this subdivision (ii) before any remaining deductions;

(*d*) Suspense preferences from each foreign country and possession (remaining after application of (*c*) of this subdivision (ii)) offset taxable income from sources within the Unted States (remaining after application of (*a*) of this subdivision (ii)) before other foreign deductions pro rata on the basis of the total of such suspense preferences;

(*e*) Other foreign deductions from each foreign country and possession (remaining after application of (*b*) of this subdivision (ii)) offset taxable income from sources within the United States (remaining after application (*a*) and (*b*) of this subdivision (ii)) pro rata on the basis of the total of such other foreign deductions;

(*f*) Deductions attributable to income from sources within the United States (remaining after application of (*a*) of this subdivision (ii)) offset taxable income from sources within any foreign country or possession before any foreign deductions;

(*g*) Other foreign deductions from each foreign country and possession (remaining after application of (*b*) and (*e*) of this subdivision (ii)) offset taxable income from sources within any other foreign countries or possessions (remaining after application of (*f*) of this subdivision (ii)) pro rata on the basis of the total of such other foreign deductions; and

(*h*) Suspense preferences (remaining after the application of (*c*) and (*d*) of this subdivision (ii)) offset taxable income from sources within any foreign country or possession (remaining after the application of paragraphs (*f*) and (*g*) of this subdivision (ii)) pro rata on the basis of the total of such suspense preferences.

For purposes of the above computations, taxable income is computed with the modifications specifed in section 172(b)(2) or section 172(c), whichever is applicable. However, the amount of suspense preferences which are converted into actual items of tax preference in accordance with the above principles is reduced to the extent the suspense preferences offset increases in taxable income from sources within the United States due to the modifications specified in section 172(b)(2) or section 172(c). For this purpose, suspense preferences are considered to offset an increase in taxable income due to section 172(b)(2) or section 172(c) modifications only after reducing taxable income computed before such modifications.

(iii) *Examples.* The principles of this subparagraph may be illustrated by the following examples in each of which the per-country foreign tax credit limitation is applicable. For purposes of these examples, personal deductions and exemptions are disregarded.

Example (1). The taxpayer has the following items of income and deduction for the taxable year 1971:

	United States	France	Germany	United Kingdom
Gross income	$180,000	$165,000	$50,000	$75,000
Deductions:				
Preference	....	....	....	(45,000)
Other	(120,000)	(125,000)	(80,000)	(100,000)
Taxable income (or loss)	60,000	40,000	(30,000)	(70,000)

(a) Pursuant to subdivision (i) of this subparagraph, the potential preference amount in the case of the United Kingdom is the lesser of the preferences attributable to the United Kingdom ($45,000) or the excess of deductions over gross income from sources within the United Kingdom ($70,000) and the potential preference amounts in the case of France and Germany are zero in both cases since the preferences attributable to both countries are zero. Since the total potential preference amounts ($45,000) is less than the taxable income from sources within the United States ($60,000), no modification of U.S. taxable income is required. Thus, the amount by which the U.K. preferences reduce the tax on taxable income from sources within the United States, determined in a manner consistent with subparagraph (1)(i) of this paragraph, is the smallest of (1) the items of tax preference attributable to the United Kingdom ($45,000), (2) the excess of deductions over gross income attributable to the United Kingdom ($70,000), or (3) taxable income from sources within the United States ($60,000). The full $45,000 of U.K. preference items are, therefore, taken into account as items of tax preference in 1971 and subject to the minimum tax. Since there is no net operating loss, subdivision (ii) of this subparagraph does not apply.

(b) If the French taxable income is $15,000 instead of $40,000, a $25,000 net operating loss (on a worldwide basis) results. The determination of the foreign preference items taken into account pursuant to subdivision (i) of this subparagraph is the same as in (a) of this example. Subdivision (ii) of this subparagraph again does not apply since the total potential preference amounts ($45,000) is less than the U.S. taxable income ($60,000).

Example 2. For the taxable year 1972, the taxpayer has a net operating loss of $35,000 consisting of the following items of income and deduction:

	United States	France	Germany	United Kingdom	Belgium
Gross income	$250,000	$50,000	$60,000	$5,000	$45,000
Deductions:					
Preferences	....	(35,000)	(70,000)	(95,000)	....
Other	(100,000)	(75,000)	(30,000)	....	(40,000)
Taxable income (or loss)	150,000	(60,000)	(40,000)	(90,000)	5,000

(a) Pursuant to subdivision (i) of this subparagraph the potential preference amount with respect to each country is the lesser of the amount shown as preferences with respect to such country or the amount of the loss from such country. Thus, the potential preference amounts in this case are:

France	$35,000
Germany	40,000
United Kingdom	90,000
Belgium	0
Total	165,000

Since the total of the potential preference amounts exceeds the U.S. taxable income, in applying the principles of subparagraph (1)(i) of this paragraph, U.S. taxable income which is reduced by potential preference amounts with respect to each country is a pro-rata amount based on the total potential preference amounts as follows:

France	(35,000/165,000×$150,000)—$31,818
Germany	(40,000/165,000×$150,000)—$36,364
United Kingdom	(90,000/165,000×$150,000)—$81,818
Belgium	(0/165,000×$150,000)—$0
Total	$150,000

The amount by which the foreign preference items offset U.S. taxable income pursuant to subdivision (i) of this subparagraph is then determined as follows:

	(a)	(b)	(c)	(d)
	Preferences	Loss	U.S. taxable income	Smallest of (a), (b), or (c)
France	$35,000	$60,000	$81,818	$31,818
Germany	70,000	40,000	36,364	36,364
United Kingdom	95,000	90,000	81,818	81,818
Belgium				
Total				150,000

Thus, $150,000 of the total foreign preference items will be taken into account pursuant to subdivision (i) of this subparagraph as items of tax preference in 1972 and subject to the provisions of section 56.

(b) Pursuant to subdivision (ii) of this subparagraph, the 1972 net operating loss of $35,000 will consist of suspense preferences of $15,000 and other foreign deductions of $20,000 attributable to each foreign country as shown below and determined as follows:

Explanation	Deductions						
	United States	France		Germany		United Kingdom preferences	Belgium other
		Preferences	Other	Preferences	Other		
	$100,000	$35,000	$75,000	$70,000	$30,000	$95,000	$40,000
1. U.S. deductions against U.S. income ($250,000)	(100,000)						
2. Other foreign deductions against foreign income (per-country) [1]			(50,000)		(30,000)		(40,000)
3. Suspense preferences against remaining foreign income (per-country)				(30,000)		(5,000)	
4. Suspense preferences against remaining U.S. income:							
France (35,000/165,000× $150,000)		(31,818)					
Germany (40,000/165,000× $150,000)				(36,364)			
U.K. (90,000/ 165,000×$150,000)						(81,818)	
5. Other foreign deductions against remaining U.S. income (0)	([2])	([2])	([2])	([2])	([2])	([2])	([2])
6. U.S. deductions against other foreign income	([2])	([2])	([2])	([2])	([2])	([2])	([2])
7. Other foreign deductions against remaining foreign income ($5,000)			(5,000)				

Explanation	Deductions						
	United States	France		Germany		United Kingdom preferences	Belgium other
		Preferences	Other	Preferences	Other		
8. Suspense preferences against remaining foreign income (0):	([2])	([2])	([2])	([2])	([2])	([2])	([2])
Balance (components of NOL)	....	3,182	20,000	3,636	....	8,182	....

[1] Foreign income amounts before step 2 are: France—$50,000; Germany—$60,000; United Kingdom—$5,000; Belgium—$45,000.
[2] Not applicable.

Example 3. In 1973, the taxpayer has taxable income (computed without regard to the net operating loss deduction) from the following sources and in the following amounts:

United States	France	Germany	United Kingdom
$100,000	$60,000	$20,000	$30,000

In addition, the taxpayer has a net operating loss deduction of $235,000 resulting from a 1972 net operating loss consisting of the following amounts:

Deductions attributable to income from sources within the United States	$25,000
Suspense preferences attributable to income from sources within France	$75,000
Deductions other than suspense preferences attributable to income from sources within France	$85,000
Deductions other than suspense preferences attributable to sources within the Netherlands	$50,000

(*a*) Pursuant to subdivision (ii) of this subparagraph, the converted suspense preferences and the remaining portions of the 1972 net operating loss carried over to 1974 are computed as follows:

[In thousands of dollars]

	1973 income				1972 net operating loss			
	United States	France	Germany	United Kingdom	United States	French suspense preferences	French other deductions	Dutch other deductions
	100	60	20	30	25	75	85	50
U.S. deductions against U.S. income	(25)	....	....	....	(25)	....	....	....
Other foreign deductions against foreign income (per-country)	....	(60)	....	....	....	....	(60)	....
Suspense preferences against remaining foreign income (per-country)	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])
Suspense preferences against remaining U.S. income	([1] 75)	....	....	....	....	(75)	....	....
Other foreign deductions against remaining U.S. income	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])
U.S. deductions against remaining foreign income	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])
Other foreign deductions against remaining foreign income:								
French (25,000/75,000 × $50,000)	....	....	(16.7)	....	....	....	(16.7)	....
Dutch (50,000/75,000 × $50,000)	....	....	(33.3)	....	....	....	....	(33.3)
Suspense preferences against remaining foreign income	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])
Balance (1972 carryover to 1974)..	....	....	....	....	....	....	8.3	16.7

[1] Suspense preferences converted to actual items of tax preference.
[2] Not applicable.

(*b*) If, in 1972, there had been no items of tax preference without regard to the suspense preferences, the conversion of the suspense preferences in 1973 would result in a 1972 minimum tax liability under section 56(a) of $4,500 (10 percent × ($75,000 − $30,000)), all of which would have been deferred by reason of section 56(b). Further, by application of section 56(b) and § 1.56A–2, $20,000 of the $45,000 preference portion of the 1972 net operating loss would be treated as having reduced taxable income in 1973 resulting in the imposition in 1973 of $2,000 of the deferred 1972 minimum tax liability.

(3) *Separate limitation under section 904(f).* In the case of a taxpayer subject to the separate limitation on interest income under section 904(f), the provisions of this paragraph shall be applied in the same manner as in subparagraph (2) of this paragraph. If the taxpayer has elected the overall foreign tax credit limitation, subparagraph (2) of this paragraph shall be applied as if all income from sources within any foreign countries or possessions of the United States and deductions relating to income from such sources other than income or deductions subject to the separate limitation under section 904(f) were from a single foreign country.

(4) *Carryover of excess taxes.* For rules relating to carryover of excess taxes described in paragraph (1) of section 56(c) when suspense preferences are converted to actual items of tax preference, see § 1.56A–5(f).

(5) *Character of amounts.* Where the amounts from sources within a foreign country or possession of the United States (or all such countries or possessions in the case of a taxpayer who has elected the overall foreign tax credit limitation) which are treated as reducing chapter 1 tax on income from sources within the United States or as suspense preferences are less than the total items of tax preference described in subparagraph (1)(i)(*a*) of this paragraph attributable to such sources, the amounts so treated are considered derived proportionately from each such item of tax preference.

[T.D. 7564, 43 FR 40484, Sept. 12, 1978, as amended by T.D. 8138, 52 FR 15309, Apr. 28, 1987]

§ 1.58–8 Capital gains and stock options.

(a) *In general.* Section 58(g)(2) provides that the items of tax preference specified in section 57(a)(6), and § 1.57–1(b) (stock options), and section 57(a)(9), and § 1.57–1(i) (capital gains), which are attributable to sources within any foreign country or possession of the United States shall not be taken into account as items of tax preference if, under the tax laws of such country or possession, preferential treatment is not accorded:

(1) In the case of stock options, to the gain, profit, or other income realized from the transfer of shares of stock pursuant to the exercise of an option which is under United States tax law a qualified or restricted stock option (under section 422 or section 424); and

(2) In the case of capital gains, to gain from the sale or exchange of capital assets (or property treated as capital assets under United States tax law).

Where capital gains are not accorded preferential treatment within a foreign country, capital losses as well as capital gains from such country are not taken into account for purposes of the minimum tax.

(b) *Source of capital gains and stock options.* Generally, in determining whether the capital gain or stock option item of tax preference is attributable to sources within any foreign country or possession of the United States, the principles of sections 861–863 and the regulations thereunder are applied. Thus, the stock option item of tax preference, representing compensation for personal services, is attributable, in accordance with § 1.861–4, to sources within the country in which the personal services were performed. Where the capital gain item of tax preference represents gain from the purchase and sale of personal property, such gain is attributable, in accordance with § 1.861–7, entirely to sources within the country in which the property is sold. In accordance with paragraph (c) of § 1.861–7, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

(c) *Preferential treatment.* For purposes of this section, gain, profit, or other income is accorded preferential treatment by a foreign country or possession of the United States if (1) recognition of the income, for foreign tax purposes, is deferred beyond the taxpayer's taxable year or comparable period for foreign tax purposes which coincides with the taxpayer's U.S. taxable year in cases where other items of profit, gain, or other income may not be deferred; (2) it is subject to tax at a lower effective rate (including no rate of tax) than other items of profit, gain, or other income, by means of a special rate of tax, artifical deductions, exemptions, exclusions, or similar reductions in the amount subject to tax; (3) it is subject to no significant amount of tax; or (4) the laws of the foreign country or possession by any other method provide tax treatment for such profit, gain, or other income more beneficial than the tax treatment otherwise accorded income by such country or possession. For the purpose of the preceding sentence, gain, profit, or other income is subject to no significant amount of tax if the amount of taxes imposed by the foreign country or possession of the United States is equal to less than 2.5 percent of the gross amount of such income.

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

Example 1. The Bahamas imposes no income tax on individuals or corporations, whether resident or nonresident. Since capital gains are subject to no tax in the Bahamas, capital gains are considered to be accorded preferential treatment and will be taken into account for purposes of the minimum tax.

Example 2. In France, except in certain cases involving the sale of large blocks of stock, a nonresident individual is not subject to tax on isolated capital gains transactions. Since such capital gains are not subject to tax in France, they are considered to be accorded preferential treatment irrespective of the treatment accorded other capital gains in France and such gains will be taken into account for purposes of the minimum tax.

Example 3. In Germany, in the case of the sale within 1 taxable year of 1 percent or more of the shares of a corporation in which an individual taxpayer is regarded as holding a substanital interest, the gains on the sale of the large block of stock will be taxed as extraordinary income at one-half the ordinary income tax rate. Since these gains are taxed as a reduced rate of tax in comparison to other income, they are considered to be accorded preferential treatment and will be taken into account for purposes of the minimum tax.

Example 4. In Belgium, gains derived by an individual in the course of regular speculative transactions are taxed as ordinary income, but with an upper limit of 30 percent. Rates of tax on individuals in Belgium range from approximately 30 percent to approximately 60 percent. Since the gains on speculative transactions are taxed at a maximum rate which is more beneficial then the rates accorded to other income, such gains are considered to be accorded preferential treatment and will be taken into account for purposes of the minimum tax.

Example 5. In France, gains derived by a company on the sale of fixed assets held for less than 2 years are treated as short-term gains. The excess of short-term gains in any fiscal year is taxed at the full company tax rate of 50 percent. However, this tax may be paid in equal portions over the 5 years immediately following the realization of such short-term gains. Since recognition of the short-term gains for tax purposes is subject to deferral over a 5-year period, such gains are considered to be accorded preferential treatment and will be taken into account for purposes of the minimum tax.

Example 6. Also in France, in the case of the sale or exchange by a company of depreciable assets and nondepreciable asset owned for at least 2 years, the excess of long-term capital gains over long-term capital losses in a fiscal year is subject to an immediate tax at the reduced rate of 10 percent. Such excess, reduced by the 10-percent tax, is carried in a special reserve account on the taxpayer's books. If the excess is reinvested in other fixed asset within a stated period, no further tax is due. If the amounts in the special reserve are distributed, they will be treated as ordinary income for the fiscal year in which the distribution is made. Since such gains (other than those distributed in the same fiscal year they are realized) are subject to deferral or a reduced rate of tax, they are (except to the extent distributed in the year of realization) considered to be accorded preferential treatment and are taken into account for purposes of the minimum tax.

Example 7. In Sweden, in the case of gains derived by an individual on the sale of shares or bonds held for 5 years or less, 25 percent of the gains are taxed if the holding period is 4 to 5 years, 50 percent of the gain is taxed if the holding period is 3 to 4 years, and 75 percent of the gain is taxed if the holding period is 2 to 3 years. The gain is fully taxable at ordinary income rates if held for less than 2 years. Thus, gains on shares or bonds held for 2 years or more are considered accorded preferential treatment in Sweden since they are either subject to exemption or treatment comparable to the U.S. capital gains deduction and are taxed at a reduced rate. Thus, such gains are taken into account for purposes of the minimum tax.

Example 8. Pursuant to Article XIV of the United States-United Kingdom Income Tax Convention, a resident of the United States is exempt from United Kingdom tax on most capital gains. Since such capital gains are exempt from United Kingdom taxation, they are considered to be accorded preferential treatment and are taken into account for purposes of the minimum tax.

Example 9. An individual resident of the United States, is desirous of selling his stock in a corporation listed on the New York Stock Exchange. He requests the stock certificates from his broker in the United States, travels to a foreign country, delivers the certificates to a broker in that country, and has the foreign broker execute the sale which takes place on the New York Stock Exchange. Since the sale was consummated in the United States, pursuant to paragraph (b) of this section and § 1.861–7, the resulting capital gain item of tax preference is attributable to sources within the United States.

Example 10. Two individuals, both residing in the United States, negotiate and reach agreement in New York City for the sale of stock of a closed corporation. Prior to the transfer of the stock, in order to avoid imposition of the minimum tax, both individuals travel to a foreign country which does not accord preferential treatment to capital gains, but imposes a 5-percent rate of income tax which would be fully creditable against U.S. tax under sections 901 and 904 if the capital gains were sourced in that country. The stock is actually transferred and consideration paid in the foreign country. Since the primary purpose of consummating the sale in the foreign country was the avoidance of tax, pursuant to paragraph (b) of this section, and § 1.861–7(c), the resulting capital gain item of tax preference will be considered attributable to sources within the country in which the substance of sale took place or, in this case, the United States.

[T.D. 7564, 43 FR 40492, Sept. 12, 1978]

§ 1.58–9 Application of the tax benefit rule to the minimum tax for taxable years beginning prior to 1987.

(a) *In general.* For purposes of computing the minimum tax liability imposed under section 56 of the Internal Revenue Code of 1954 (Code), taxpayers are not liable for minimum tax on tax preference items that do not reduce the taxpayer's tax liability under subtitle A of the Code for the taxable year. In general, tax preference items that do not reduce tax liability under subtitle A for the taxable year are those from which no current tax benefit is derived because available credits would have reduced or eliminated the taxpayer's regular tax liability if the preference items had not been allowed in computing taxable income. However, any credits that, because of such preference items, are not needed for use against regular tax (''freed-up credits''), are required to be reduced under the rules of paragraph (c) of this section. For purposes of this section, a taxpayer's regular tax is the Federal income tax liability under subchapter A of chapter 1 of the Code, not including the minimum tax imposed by section 56. Unless otherwise noted, all references to Internal Revenue Code sections refer to the Internal Revenue Code of 1954.

(b) *Effective date.* The rules of this section are effective May 5, 1992, but only as they affect tax preference items that arise in taxable years beginning after December 31, 1976, and before January 1, 1987.

(c) *Adjustment of carryover credits*—(1) *In general.* A taxpayer's freed-up credits must be reduced by the additional minimum tax that would have been imposed if a current tax benefit had been derived from preference items that did not actually produce a current tax benefit. The amount of this reduction shall be calculated in the following manner—

(i) Determine the amount of freed-up credits;

(ii) Determine the amount of tax preference items (if any) from which a current tax benefit was derived for the taxable year (''beneficial preferences''), and the amount of preferences from which no current tax benefit was derived for the taxable year (''non-beneficial preferences''); and

(iii) Determine the portion of the total minimum tax on all tax preference items for the taxable year that is attributable to the non-beneficial preferences.

The freed-up credits are then reduced by an amount equal to such portion of the minimum tax.

(2) *Determine freed-up credits.* (i) To determine the freed-up credits for the

taxable year, first determine the regular tax that would have been imposed for the taxable year if preference items had not been allowed in computing taxable income (''non-preference regular tax''). In the case of a taxpayer with the capital gain preference described in section 57(a)(9)(B), non-preference regular tax is computed without regard to section 1201 and without adding the section 57(a)(9)(B) preference amount to taxable income. Second, compute the amount of credits that would have been allowed to reduce the non-preference regular tax. The credits available to reduce non-preference regular tax shall include any freed-up credits from other taxable years, as reduced under paragraph (c)(5) of this section, that are carried to the current taxable year. Third, subtract the amount of credits that were actually allowed to reduce the regular tax for such taxable year from the amount of credits that would have been allowed to reduce non-preference regular tax. The result is the amount of the freed-up credits.

(ii) The following examples illustrate the determination of freed-up credits. The first two examples assume that the foreign tax credits being used do not exceed the limitation under section 904.

Example 1. In 1982 Corporation B has $17.6 million dollars in foreign tax credits available for the taxable year. If preference items were not allowed in determining regular tax, the regular tax would have been $10.2 million and foreign tax credits used to reduce regular tax would have been $10.2 million. Because of tax preference items, however, B's regular tax is $6.3 million and the amount of foreign tax credits actually used to reduce the regular tax is $6.3 million. The amount of freed-up foreign tax credits is $3.9 million ($10.2 million minus $6.3 million).

Example 2. Assume the same facts as in *Example 1* of paragraph (c)(2)(ii) of this section except that Corporation B has $7.2 million dollars in foreign tax credits. If preference items were not allowed, the non-preference regular tax would have been $10.2 million and the foreign tax credits used to reduce the regular tax would have been $7.2 million. Because of tax preference items, however, B's regular tax is $6.3 million, and the amount of foreign tax credits actually used to reduce the regular tax is $6.3 million. The amount of freed-up foreign tax credits is $.9 million ($7.2 million minus $6.3 million).

Example 3. In 1983 Corporation C has $500,000 of investment tax credits available. If preference items were not allowed, non-preference regular tax would have been $690,000 and all $500,000 of investment tax credits would have been allowed to reduce non-preference regular tax liability. Because of tax preferences, however, C's actual regular tax is $439,750. As a result of the limitation under section 38(c), only $377,537 of the investment tax credits are allowed to reduce the actual regular tax. Freed-up credits are $122,463 ($500,000 minus $377,537).

Example 4. In 1984 Corporation B has ordinary income of $20,000 and net section 1201 gain of $300,000, none of which is attributable to foreign sources. B has no other items of tax preference in 1984. B's non-preference regular tax for 1984 is $126,950, the amount of tax that would be imposed without regard to section 1201.

(3) *Determination of beneficial and non-beneficial preferences*—(i) *In general.* The amount of tax preferences from which a current tax benefit is derived (''beneficial preferences'') and the amount from which no current tax benefit is derived (''non-beneficial preferences'') for the taxable year are determined as set forth below.

(ii) *Regular tax liability is the same regardless of preference items.* (A) If the taxpayer's tax liability (after credits) would be the same regardless of whether preference items were allowed to reduce taxable income, then all of the taxpayer's preference items are non-beneficial preference items.

(B) The following example illustrates the rule set forth in paragraph (c)(3)(ii)(A) of this section. This example assumes that foreign tax credits being used do not exceed the limitation under section 904.

Example. (i) In 1982 Corporation B has $17.6 million dollars in foreign tax credits available for the taxable year. If preference items were not allowed in determining regular tax, the regular tax would have been $10.2 million and foreign tax credits used to reduce regular tax would have been $10.2 million. Because of tax preference items, however, B's regular tax is $6.3 million and the amount of foreign tax credits actually used to reduce the regular tax is $6.3 million. The amount of freed-up foreign tax credits is $3.9 million ($10.2 million minus $6.3 million).

(ii) The total amount of B's tax preference items is $8.4 million. B's non-preference regular tax is $10.2 million and, reduced by foreign tax credits, is zero. B's actual regular tax is $6.3 million and, reduced by foreign tax credits, is zero. Since the amount of credits that would have been allowed to offset the non-preference regular tax would have reduced such tax to an amount ($0) equal to the actual regular tax liability ($0), B received a tax benefit from none of the $8.4 million of tax preferences and therefore all of these preferences are non-beneficial preferences.

(iii) *Regular tax liability differs because of preference items.* If tax liability (after credits) is less because preference items are allowed to reduce taxable income, then some of these preference items have provided a current tax benefit. In such cases, the amount of beneficial and non-beneficial preferences are determined as follows:

(A) *Non-beneficial preferences.* (*1*) The non-beneficial preferences are determined by converting the freed-up credits for such taxable year into an amount of taxable income. To make this conversion, freed-up credits are ‘‘grossed up’’ (*i.e.,* divided by the regular tax marginal rate at which such credits would have offset non-preference regular tax) to determine the amount of tax preferences that freed up such credits. For purposes of this calculation, the 5-percent addition to tax provided by section 11(b) shall be included in determining the marginal rate. The aggregate of these grossed-up amounts is the total amount of non-beneficial preferences for the taxable year.

(*2*) The freed-up credits shall be grossed up beginning at the lowest marginal tax rate that would have applied to the additional taxable income arising if tax preferences were not allowed. Thus, the marginal tax rates at which the actual regular tax was imposed shall not be taken into account in grossing up freed-up credits, even if all or a portion of such tax is not offset by credits because of limitations on the allowance of such credits (such as the section 904 limit on foreign tax credits or the section 38(c) limit on investment tax credits). For example, if the first dollar of additional non-preference taxable income would have been taxed at a rate of 46 percent, then freed-up credits shall be grossed up at 46 percent, even if regular tax imposed on taxable income at a 40-percent rate was not offset by credits because of the limitations on investment tax credits under section 38(c). *See Examples 1* and *2* in paragraph (d) of this section for illustrations of the gross up of freed-up credits in cases where limitations apply to the amount of credit allowed to offset actual regular tax.

(*3*) The following example illustrates the gross up of freed-up credits to determine non-beneficial preferences. This example assumes that foreign tax credits being used do not exceed the limitation under section 904.

Example. (i) Corporation L has the following items for the 1985 taxable year:

Actual taxable income		$90,000
Regular tax		21,750
Available credits:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	25,000	
Investment tax credits carried forward from 1984	20,000	
		60,000
Credit allowed to offset actual regular tax:		
Foreign tax credits for 1985	15,000	
Foreign tax credits carried forward from 1984	6,750	
		21,750
Actual regular tax liability		0
Preferences		110,000
Taxable income for 1985 determined as though preferences were not allowed		200,000
Non-preference regular tax		71,750
Credits allowed to offset non-preference regular tax:		
Foreign tax credits for 1985	15,000	
Foreign tax credits carried forward from 1984	25,000	
Investment tax credits carried forward from 1984	20,000	
		60,000
Non-preference regular tax liability		11,750

(ii) The freed-up credits for 1985 are $38,250 ($60,000 minus $21,750). The non-preference regular tax of $71,750 is determined by applying the regular tax rates set forth in section 11(b) to the $200,000 of taxable income as follows:

Taxable income		Rate		Tax
$25,000	X	.15	=	$3,750
25,000	X	.18	=	4,500
25,000	X	.30	=	7,500
25,000	X	.40	=	10,000
100,000	X	.46	=	46,000
$200,000				$71,750

(iii) Thus, for purposes of determining the non-beneficial preferences, freed-up credits are grossed up as follows: The credits allowed against the regular tax and the freed-up credits are treated as offsetting non-preference regular tax in the same order as such credits would have been allowed to offset such tax, beginning at the lowest marginal tax rate. The freed-up credits are grossed up beginning at the lowest marginal tax rate at which additional taxable income would have been taxed if preferences were not allowed. Thus, in this example freed-up credits are grossed up beginning at 40 percent, and the amount of L's non-beneficial preferences for the 1985 taxable year is $84,456.

Type	Credit allowed against regular tax	Freed-up credit	Divided by tax rate		Non-beneficial preferences
FTC (85)	$3,750		.15		
Do	4,500		.18		
Do	6,750		.30		
FTC (84)	750		.30		
Do	6,000		.40		
Do		$4,000	.40	=	$10,000
Do		14,250	.46	=	30,978
ITC (84)		20,000	.46	=	43,478
	$21,750	$38,250			$84,456

Foreign tax credit = FTC (year)

Investment tax credit = ITC (year)

(B) *Beneficial preferences.* The amount of beneficial preferences for the taxable year is computed by subtracting the non-beneficial preferences for the taxable year from the total amount of tax preferences for such year. This rule may be illustrated by the following example:

Example. Assume the same facts as in the *Example* in paragraph (c)(3)(iii)(A)(3) of this section. The amount of L's beneficial preferences for 1985 is $25,544 (total preferences of $110,000, minus non-beneficial preferences of $84,456).

(4) *Determine the minimum tax attributable to non-beneficial preferences.* (i) The portion of the minimum tax that is attributable to the non-beneficial preferences is computed as follows—

(A) Compute the minimum tax that would be imposed on all tax preference items for the taxable year if all of the preferences had produced a tax benefit.

(B) Compute the minimum tax that would be imposed on the beneficial preferences if these were the taxpayer's only preferences. (This is the amount of minimum tax actually imposed for the taxable year.)

(C) Subtract the amount computed in paragraph (c)(4)(i)(B) of this section from the amount computed in paragraph (c)(4)(i)(A) of this section. The result is the minimum tax attributable to the non-beneficial preferences for the taxable year. This amount is sometimes referred to hereinafter as the "credit reduction amount".

(ii) The following examples illustrate determination of the credit reduction amount. These examples assume that foreign tax credits being used do not exceed the limitation under section 904.

Example 1. (i) In 1982 Corporation B has $17.6 million dollars in foreign tax credits available for the taxable year. If preference items were not allowed in determining regular tax, the regular tax would have been $10.2 million and foreign tax credits used to reduce regular tax would have been $10.2 million. Because of tax preference items, however, B's regular tax is $6.3 million and the amount of foreign tax credits actually used to reduce the regular tax is $6.3 million. The amount of freed-up foreign tax credits is $3.9 million ($10.2 million minus $6.3 million).

(ii) The total amount of B's tax preference items is $8.4 million. B's non-preference regular tax is $10.2 million and, reduced by foreign tax credits, is zero. B's actual regular tax is $6.3 million and, reduced by foreign tax credits, is zero. Since the amount of credits that would have been allowed to offset the non-preference regular tax would have reduced such tax to an amount ($0) equal to the actual regular tax liability ($0), B received a tax benefit from none of the $8.4 million of tax preferences and therefore all of these preferences are non-beneficial preferences.

(iii) Since B has $8.4 million in total preference items and no regular tax liability, the minimum tax on that amount would be $1,258,500 (($8.4 million minus $10,000) multiplied by .15). None of the preference items is a beneficial preference. Thus, the minimum tax attributable to non-beneficial preferences (and therefore, the credit reduction amount) is $1,258,500.

Example 2. (i) Corporation L has the following items for the 1985 taxable year:

Actual taxable income		$90,000
Regular tax		21,750
Available credits:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	25,000	
Investment tax credits carried forward from 1984	20,000	
		$60,000
Credit allowed to offset actual regular tax:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	6,750	
		$21,750
Actual regular tax liability		0
Preferences		110,000
Taxable income for 1985 determined as though preferences were not allowed		200,000
Non-preference regular tax		71,750
Credits allowed to offset non-preference regular tax:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	25,000	
Investment tax credits carried forward from 1984	20,000	
		$60,000
Non-preference regular tax liability		11,750

(ii) The freed-up credits for 1985 are $38,250 ($60,000 minus $21,750). The non-preference regular tax is $71,750. The amount of L's non-beneficial preferences for the 1985 taxable year is $84,456.

(iii) The minimum tax on L's total preference items of $110,000 would be $15,000 (($110,000 minus $10,000) multiplied by .15). Since the amount of non-beneficial preferences is $84,456, the amount of L's beneficial preferences for 1985 is $25,544 ($110,000 minus $84,456). The minimum tax on L's beneficial preferences of $25,544 is $2,332 (($25,544 minus $10,000) multiplied by .15). (This is the amount of minimum tax imposed for 1985.) The minimum tax attributable to non-beneficial preference items (and therefore, the credit reduction amount) is $12,668 ($15,000 minus $2,332).

(5) *Reduction of freed-up credits*—(i) *In general.* The freed-up credits are reduced by an amount equal to the minimum tax attributable to the non-beneficial preferences (''credit reduction amount''). If the taxpayer has only one type of freed-up credit (*i.e.,* only investment tax credit or only foreign tax credit) and that credit was earned in only one year (the current year or a carryover year), then the credit is reduced by the credit reduction amount. This rule may be illustrated by the following example. This example assumes that foreign tax credits being used do not exceed the limitation under section 904.

Example. (i) In 1982 Corporation B has $17.6 million dollars in foreign tax credits available for the taxable year. If preference items were not allowed in determining regular tax, the regular tax would have been $10.2 million and foreign tax credits used to reduce regular tax would have been $10.2 million. Because of tax preference items, however, B's regular tax is $6.3 million and the amount of foreign tax credits actually used to reduce the regular tax is $6.3 million. The amount of freed-up foreign tax credits is $3.9 million ($10.2 million minus $6.3 million).

(ii) The total amount of B's tax preference items is $8.4 million. B's non-preference regular tax is $10.2 million and, reduced by foreign tax credits, is zero. B's actual regular tax is $6.3 million and, reduced by foreign tax credits, is zero. Since the amount of credits that would have been allowed to offset the non-preference regular tax would have reduced such tax to an amount ($0) equal to the actual regular tax liability ($0), B received a tax benefit from none of the $8.4 million of tax preferences and therefore all of these preferences are non-beneficial preferences.

(iii) Since B has $8.4 million in total preference items and no regular tax liability, the minimum tax on that amount would be $1,258,500 (($8.4 million minus $10,000) multiplied by .15). None of the preference items is a beneficial preference. Thus, the minimum tax attributable to nonbeneficial preferences (and therefore, the credit reduction amount is $1,258,500.

(iv) All of the $3.9 million of freed-up credits are foreign tax credits that arise in the same year and that otherwise would be carried forward. Since the entire amount of B's tax preferences are non-beneficial preferences, the minimum tax of $1,258,500 that would be imposed on the total tax preferences is the credit reduction amount. Thus, B's $3.9 million of freed-up foreign tax credits is reduced by $1,258,500. The foreign tax credit carryforward from 1982 is $10,041,500. This amount is the sum of $2,641,500 (the freed-up foreign tax credit of $3,900,000, reduced by the credit reduction amount of $1,258,500), plus $7.4 million (the foreign tax credit that would have been carried over even if tax preference items had not been allowed).

However, if the taxpayer has more than one type of freed-up credit, or the taxpayer's freed-up credits are from more than one taxable year, then the credit reduction amount must be allocated under the exact method described in paragraph (c)(5)(ii) of this section, unless an election is made under paragraph (c)(5)(iii) of this section to use the simplified method.

(ii) *Exact method.* For each type of freed-up credits and for each taxable year within such type from which any such credits are earned, the amount of credit reduction shall be equal to the amount of minimum tax attributable to the non-beneficial preferences that freed up the credits for that type and taxable year. The amount of the credit reduction is computed by multiplying the amount of non-beneficial preferences which freed up credits for each type and taxable year by the minimum tax rate. For purposes of this computation, if the amount of the taxpayer's minimum tax exemption for the taxable year (as determined under section 56(a)) exceeds the amount of the taxpayer's beneficial preferences, such excess exemption shall reduce the amount of non-beneficial preferences to be multiplied by the minimum tax rate. The non-beneficial preferences shall be reduced by any such excess exemption in the same order in which the credits that were freed up by such preferences would have been allowed to offset tax. Thus, for example, any excess exemption shall first reduce non-beneficial preferences that freed up foreign tax credits. Any such excess exemption remaining after reducing non-beneficial preferences that freed up foreign tax credits to zero would then be used to reduce the non-beneficial preferences that freed up investment tax credits.

(iii) *Simplified method*—(A) *Description of method.* In lieu of the exact credit reduction method described in paragraph (c)(5)(ii) of this section, taxpayers may elect to use the simplified credit reduction method. Under the simplified credit reduction method, the amount of freed-up credits for each type of credit and for each taxable year in which such credit is earned is multiplied by a fraction. The numerator of the fraction is the total credit reduction amount as determined in paragraph (c)(4)(i)(C) of this section. The denominator is the total amount of freed-up credits as determined in paragraph (c)(2)(i) of this section. The product of this multiplication is the amount of credit reduction for each type and taxable year of freed-up credit.

(B) *Election to use simplified method.* A taxpayer may elect to use the simplified credit reduction method for all taxable years to which this section applies by attaching a statement indicating such an election on the amended Federal income tax return or returns applying the adjustments of this section. If an election is made for any taxable year, it must be made for all taxable years. Once an election has been made, it can be revoked only with the permission of the Commissioner. Similarly, once returns have been filed applying the exact credit reduction method, an election to apply the simplified method can be made only with the consent of the Commissioner.

(iv) *Effect of credit reduction on credit carryovers.* Under both the exact method and the simplified method, the determination of credit carryovers to other taxable years is made on the basis of freed-up credits remaining after such reduction, plus any other unused credits. Thus, an amount of freed-up credits that is equal to the credit reduction amount shall not be allowed to reduce tax liability in any taxable year. Such disallowance is without regard to whether such credits would otherwise be allowed as a carryover. The freed-up credits, as reduced under this paragraph (c)(5), shall be carried over or carried back in applying this section in a carryover or carryback year. No minimum tax liability shall be due with respect to the non-beneficial preferences for any taxable year.

(v) *Examples.* The following examples illustrate reduction of freed-up credits.

Example 1. (i) Corporation L has the following items for the 1985 taxable year:

Actual taxable income		$90,000
Regular tax		21,750
Available credits:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	25,000	
Investment tax credits carried forward from 1984	20,000	
		60,000
Credit allowed to offset actual regular tax:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	6,750	
		21,750
Actual regular tax liability		21,750
Preferences		110,000
Taxable income for 1985 determined as though preferences were not allowed		200,000
Non-preference regular tax		71,750
Credits allowed to offset non-preference regular tax:		
Foreign tax credits for 1985	$15,000	
Foreign tax credits carried forward from 1984	$25,000	
Investment tax credits carried forward from 1984	20,000	
		60,000
Non-preference regular tax liability		11,750

(ii) The freed-up credits for 1985 are $38,250 ($60,000 minus $21,750). The non-preference regular tax is $71,750. The amount of L's non-beneficial preferences for the 1985 taxable year is $84.456.

(iii) The credit reduction amount for 1985 is $12,668, the amount of minimum tax attributable to L's non-beneficial preferences. This amount is allocated to reduce each category of freed-up credit and to each year from which such credit is carried over. L's $38,250 of freed-up credits consists of $18,250 of foreign tax credits carried forward from 1984, which were freed up by $40,978 of non-beneficial preferences, and $20,000 of investment tax credits carried forward from 1984, which were freed up by $43,478 of non-beneficial preferences.

(iv) The apportionment of this credit reduction amount to each category of freed-up credit and each taxable year from which such credits are carried over is determined as follows under the exact credit reduction method:

(A) Foreign tax credits carried forward from 1984:

Non-beneficial preferences that freed up 1984 FTC×.15=Credit reduction of 1984 FTC

$40,978×.15=$6,146

(B) Investment tax credits carried forward from 1984:

Non-beneficial preferences that freed up 1984 ITC×.15=Credit reduction of 1984 ITC

$43,478×.15=$6,522

Thus, the foreign tax credits from 1984 that are carried forward to 1986 are $12,104 ($18,250 minus $6,146). The investment tax credits from 1984 that are carried forward to 1986 are $13,478 ($20,000 minus $6,522).

(v) The reduction of the freed-up credit under the simplified credit reduction method is as follows:

(A) Foreign tax credit carried forward from 1984:

$$\begin{array}{c}\text{Freed-up foreign tax}\\ \text{credits from 1984}\end{array} \times \frac{\text{Credit reduction amount}}{\text{Total freed-up credit}} = \begin{array}{c}\text{Credit reduction allocated to}\\ \text{freed-up foreign tax credits}\\ \text{carried forward from 1984}\end{array}$$

$$\$18{,}250 \times \frac{\$12{,}668}{\$38{,}250} = \$6{,}044$$

(B) Investment tax credits carried forward from 1984:

$$\text{Freed-up investment tax credits from 1984} \times \frac{\text{Credit reduction amount}}{\text{Total freed-up credit}} = \text{Credit reduction allocated to freed-up investment tax credit carried forward from 1984}$$

$$\$20{,}000 \times \frac{\$12{,}668}{\$38{,}250} = \$6{,}624$$

Thus, under the simplified credit reduction method, L has $12,206 of foreign tax credits for 1984 ($18,250 minus $6,044) that are carried forward to 1986, and $13,376 of investment tax credits for 1984 ($20,000 minus $6,624) that are carried forward to 1986.

Example 2. Assume the same facts as in *Example 1* of this paragraph (c)(5)(v), except that the foreign tax credits available for use in 1985 include $10,750 in credits carried forward from 1980 and $14,250 in credits carried forward from 1984, rather than $25,000 carried forward from 1984. Thus, $4,000 of the freed-up foreign tax credit is carried over from 1980. The other $14,250 of freed-up foreign tax credit is carried over from 1984. The non-beneficial preferences that freed up the 1980 foreign tax credit are $10,000. The non-beneficial preferences that freed up the 1984 foreign tax credit are $30,978. Under the exact credit reduction method, the credit reduction amounts for each of these credits are determined as follows:

(i) Foreign tax credit carried forward from 1980:

$10,000×.15=$1,500

(ii) Foreign tax credit carried forward from 1984:

$30,978×.15=$4,646

Thus, the foreign tax credit from 1984 that is carried forward to 1986 is $9,604 ($14,250 minus $4,646). Since the foreign tax credit from 1980 expires after 1985, none of that credit is carried forward to 1986.

(d) *Examples.* The following examples are comprehensive illustrations of the adjustments described in paragraph (c) of this section:

Example 1. (i) This example illustrates the operation of the credit reduction adjustment when the amount of foreign tax credit allowed is subject to the overall limitation under section 904. For purposes of this example, assume that Corporation × has the following items for the 1984 taxable year:

Taxable income (determined as though preferences were not allowed)	$140,000
From foreign sources	70,000
Foreign tax credits from 1984	5,000
Foreign tax credits from 1983	7,000
Actual taxable income	50,000
From foreign sources	25,000

(ii) The credit reduction adjustment and minimum tax liability for the taxable year are determined as follows:

1. Taxable income (determined as though preferences were not allowed)			$140,000
2. Tax preferences for 1984			90,000
3. Taxable income (line 1 minus line 2)			50,000
4. Regular tax on line 3 amount (actual regular tax) before credits: $25,000×.15=$3,750 25,000×.18=4,500			8,250
5. Foreign tax credits allowed against regular tax (limited to 50% of actual regular tax under sec. 904)—1984 foreign tax credits			4,125
6. Regular tax after credits (line 4 minus line 5)			4,125
7. Regular tax on line 1 amount (non-preference regular tax) before credits 25,000×.15=$3,750. 25,000×.18=4,500. 25,000×.3=7,500. 25,000×.4=10,000. 40,000×.46=18,400			44,150
8. Foreign tax credits allowed against non-preference regular tax: $5,000 (1984 foreign tax credits) 7,000 (1983 foreign tax credits)			12,000
(the allowed credits do not exceed the section 904 limitation of $22,075)			
9. Non-preference regular tax after credits (line 7 minus line 8)			32,150
10. Freed-up credits (line 8 minus line 5):			
1984 foreign tax credits	$5,000 (4,125)		

		$875
1983 foreign tax credits	$7,000 0	7,000
Total		$7,875

11. Non-beneficial preferences are computed as set forth in the table below. Under this computation, non-beneficial preferences are considered to free up credits that would have offset non-preference regular tax beginning at the lowest tax rates at which income that was offset by tax preferences otherwise would have been subjet to regular tax. In this case, income that was offset by tax preferences would have been taxed beginning at the 30 per cent marginal tax rate.

Type	Freed-up credit	Divided by tax rate	Non-beneficial preferences
FTC (84)	$875	.30	$2,917
FTC (83)	6,625	.30	22,083
Do	375	.40	938
	7,875		25,938
Total non-beneficial preferences			25,938

12. Beneficial preferences (line 2 minus line 11) 64,062

13. Minimum tax on total tax preferences ((line 2 minus the greater of line 6 or $10,000)×.15) 12,000

14. Minimum tax on beneficial preferences ((line 12 minus the greater of line 6 or $10,000)×.15) 8,109

15. Credit reduction amount (line 13 minus line 14) 3,891

16. Reduction of freed-up credits under the exact method (subtotals of line 11 multiplied by .15):

(a) 1984 foreign tax credits:
$2,917×.15=$438

(b) 1983 foreign tax credits:
($22,083+$938)
×.15=$3,453

(c) Total credit reduction 3,891

NOTE: If X had elected to use the simplified credit reduction method, the amount of credit reduction would be determined by multiplying the amount of freed-up credit in each category and taxable year by the following ratio:

$$\frac{\text{credit reduction amount}}{\text{total freed-up credit}} = \frac{\$3,891}{\$7,875} = .494$$

(d) Under this method, the 1984 freed-up foreign tax credits would be reduced by $433 ($875×.494)and the 1983 freed-up foreign tax credits would be reduced by $3,458 ($7,000×.494).

17. Freed-up credits after reduction under the exact method (line 10 subtotal minus line 16 subtotals):

(a) 1984 foreign tax credits ($874 minus $438) ... 437

(b) 1983 foreign tax credits ($7,000 minus $3,453) 3,547

Thus, assuming that Corporation X did not elect to use the simplified method, Corporation X will carryover $437 of 1984 foreign tax credits to 1985 and $3,547 of 1983 foreign tax credits to 1985. Had Corporation X elected to use the simplified method, freed-up credits after reduction would be as follows:

(a) 1984 foreign tax credits ($875 minus $433) ... 442

(b) 1983 foreign tax credits ($7,000 minus $3,458) 3,542

Example 2. (i) Corporation X has the following items for its 1985 taxable year:

Taxable income (determined as though preferences were not allowed)	$1,500,000
1984 investment tax credits	400,000
1985 investment tax credits	100,000
Actual taxable income	1,000,000

(ii) The credit reduction and minimum tax of X for 1985 are determined as follows:

1. Taxable income determined as though $1,500,000

2. Tax preferences for 1985 500,000

3. Taxable income (line 1 minus line 2)	1,000,000
4. Regular tax on line 3 amount (actual regular tax) before credits:. $25,000×.15=$3,750 25,000×.18=4,500 25,000×.30=7,500 25,000×.40=10,000 900,000×.46=414,000	439,750
5. Investment tax credits allowed (limited under section 38 (c) to $25,000 of net tax liability, plus 85 percent of net tax liability in excess of $25,000	377,537
6. Regular tax after credits (line 4 minus line 5)	62,212
7. Regular tax on line 1 amount (non-preference regular tax) before credits: 25,000×.15=$3,750 25,000×.18=4,500 25,000×.30=7,500 25,000×.40=10,000 900,000×.46=414,000 405,000×.51=206,550 95,000×.46=43,700	690,000
8. Investment tax credits allowed against non-preference regular tax	500,000
9. Non-preference regular tax after credits (line 7 minus line 8)	190,000
10. Freed-up credits (line 8 minus line 5):	
1984 investment tax credit	$400,000 (377,537)
	22,463
1985 investment tax credit	$100,000 —0—
	100,000
Total	$122,463

11. Non-beneficial preferences are computed as set forth in the table below. Under this computation, non-beneficial preferences are considered to free up credits that would have offset non-preference regular tax beginning at the lowest tax rates at which income that was offset by tax preferences otherwise would have been subject to regular tax. In this case, income that was offset by tax preferences would have been taxed beginning at the 51 percent marginal tax rate. Although some of the income offset by preferences would be taxed at the 46 percent marginal rate (because taxable income in excess of $1,405,000 is not subject to the 5 percent addition to tax on taxable income in excess of $1 million), the 51 percent marginal rate is taken into account first.

Type	Freed-up credit	Divided by tax rate	Non-beneficial preferences
ITC (84)	$22,463	.51	$44,045
ITC (85)	100,000	.51	196,078
	122,463		240,123
Total non-beneficial preferences			240,123

12. Beneficial preferences (line 2 minus line 11)	259,877
13. Minimum tax on total tax preferences ((line 2 minus the greater of line 6 or $10,000) X .15)	65,668
14. Minimum tax on beneficial preferences ((line 12 minus the greater of line 6 or $10,000) X .15	29,650
15. Credit reduction amount (line 13 minus line 14)	36,018
16. Reduction of freed-up credits under the exact method (subtotals of line 11 multiplied by .15):	
(a) 1984 investment tax credits: $44,045 × .15=$6,607	
(b) 1985 investment tax credits: $196,078 × .15=$29,411	
(c) Total credit reduction	36,018
17. Fixed-up credits after reduction (assuming that Corporation X does not elect the simplified method):	
(a) 1984 investment credit ($22,463 minus $6,607)	15,856
(b) 1985 investment credit ($100,000 minus $29,411)	70,589

(e) *Miscellaneous rules*—(1) *Investment Credit Recapture.* If during any taxable year property to which section 47 applies is disposed of, then for purposes of determining any increase in tax under section 47 for such year, the amount of any reduction under this section of freed-up section 38 credit which was earned in the year the property was placed in service shall be treated as a credit that was allowed in a prior taxable year.

Example. Corporation D places property in service in 1983 that generates investment tax credits of $10,000. D earns no other investment tax credits in 1983. None of the investment tax credits are used to reduce tax liability in 1983 or any prior years. In 1984, D uses $1,000 of this credit to reduce regular tax liability. In addition, D has items of tax preferences in 1984. However, under section 58(h), D is not liable for minimum tax on any of these preference items because none of these preference items produces a tax benefit in 1984. As a result, an adjustment is made under the provisions of § 1.58-9 and the investment tax credit carryforward from 1983 is reduced by $4,000. Thus, D has an investment tax credit carryforward of $5,000 that is attributable to the property placed in service in 1983. In 1986, the property is disposed of and the investment tax credits earned in 1983 are recomputed as required under section 47. This recomputation results in a reduction of $6,000 of the investment tax credits earned in 1983. D must now adjust its 1983 investment tax credit carryforward under section 47(a)(6) by reducing this carryforward to zero. In addition, D has an additional tax liability of $1,000 for 1986.

(2) *Period of limitations; adjustments to tax liability.* The adjustments described in this section shall, in general, apply for purposes of assessing deficiencies or claiming refunds of tax for any taxable year for which the tax liability is affected by the adjustments of this section, provided that the period of limitations under section 6501 has not expired for such taxable year. Therefore, these adjustments generally apply for purposes of assessing deficiencies and refunding any overpayment of tax for all years for which the period of limitations has not expired regardless of whether the period of limitations has expired for the taxable year in which the non-beneficial preferences arose. However, the adjustments of this section do not apply to reduce otherwise allowable credits that were freed up by such non-beneficial preferences where:

(i) The taxpayer paid minimum tax on all tax preference items arising in the taxable year in which the non-beneficial preferences arose;

(ii) The taxpayer has not made a claim for a credit or refund for such minimum tax; and

(iii) The period of limitations for claiming a credit or refund under section 6511 has expired for such taxable year.

(A) Further, if—

(*1*) the taxpayer never paid minimum tax attributable to non-beneficial preferences;

(*2*) credits that were freed up by such preferences were used to reduce tax liability for a taxable year for which the period of limitations has expired; and

(*3*) credits so used exceed the amount of credits that would have been available if the credit reduction required under this section with respect to such preferences had been made,

(B) Then, the taxpayer shall be liable for the minimum tax equal to the amount of credits so used, provided the period of limitations has not expired for the taxable year in which preferences arose.

(3) *Claims for credit or refund.* A taxpayer may claim a credit or refund of minimum tax that was made on non-beneficial preferences. However, such a claim for a credit or refund shall be disallowed to the extent that the taxpayer has reduced tax liability in a taxable year for which the period of limitations has expired by using freed-up credits in excess of the amount that would have been available if the credit reduction required under this section had been made. Such claim must be made by filing an amended return for the taxable year for which such minimum tax was paid. Further, if a claim for credit or refund is filed, amended returns must also be filed for any taxable year for which tax liability would be affected as a result of the reduction, under this section, of credits freed up by such non-beneficial preferences. See section 6511 and the regulations thereunder regarding the period of limitations for claiming a credit or refund.

(4) *Carryovers of foreign tax credit to taxable years after 1986.* In the case of foreign tax credit carryforwards to taxable years beginning after December 31, 1986, reductions in such credits required under this section shall apply for purposes of computing the alternative minimum tax foreign tax credit under section 59(a) of the Internal Revenue Code of 1986 as well as for purposes of computing the foreign tax credit for regular tax purposes.

(5) *Credit Carrybacks.* If credit carrybacks increase the amount of credits for a taxable year, the adjustments described in this section shall be recomputed taking into account the additional credits. This rule may be illustrated by the following examples:

Example 1. (i) In 1981 corporation D has actual taxable income of $72,500 and regular tax before credits of $15,000. In computing actual regular taxable income, D made use of $36,739 of tax preference items, so that D's taxable income determined as though preference were not allowed would be $109,239. D's non-preference regular tax before credits is $30,000. D earns $25,000 of foreign tax credits in 1981, none of which exceed the limitation under section 904 determined using either actual regular taxable income or the non-preference taxable income. These credits reduce actual regular tax to zero ($0) and would have reduced non-preference regular tax to $5,000 ($30,000 minus $25,000). Thus, D has freed-up foreign tax credits from 1981 of $10,000 ($25,000 minus $15,000). Pursuant to the adjustments required under this section, D determines that its credit reduction amount is $3,843 and reduces its freed-up credit (and its credit carryover) from 1981 to $6,157 ($10,000 minus $3,843). D also pays minimum tax of $167 on $11,114 of beneficial preferences (($11,114 minus $10,000) multiplied by .15).

(ii) In 1982 D earns additional foreign tax credits. After application of the foreign tax credit carryback rules, D would have $5,000 of 1982 foreign tax credits available for use in 1981. D must recalculate the adjustments required under this section by treating $5,000 of foreign tax credit from 1982 as carried back and (assuming that these credits do not exceed the limitation under section 904) used to reduce non-preference regular tax liability in 1981 to zero ($0). That is, $5,000 of the foreign tax credits earned in 1982 are treated as credits freed up because of D's tax preference items in 1981. Pursuant to the rules set forth herein, D must take into account the foreign tax credits from both 1981 and 1982 in determining to what extent a tax benefit was derived from the preference items used to determine actual regular tax liability in 1981 and in computing the credit reduction amount. When the $5,000 of foreign tax credits from 1982 are considered, all preferences become non-beneficial preferences, and the credit reduction amount is $4,010. Assuming that D elects the simplified method, the 1981 freed-up credits and the 1982 freed-up credits will each be reduced by the following percentage:

$$\frac{\$4{,}010\ (\text{credit reduction amount})}{\$15{,}000\ (\text{total freed - up credits})} = .2673$$

The 1981 freed-up foreign tax credits of $10,000 are thus reduced by $2,673 ($10,000 multiplied by .2673), to $7,327 and the 1982 freed-up foreign tax credits of $5,000 are reduced by $1,334 ($5,000 multiplied by .2673) to $3,666. D also files a claim for credit or refund of the $167 of minimum tax paid in 1981.

Example 2. In 1985 corporation E's non-preference regular taxable income was $25,000. E had no available credits. It paid zero in regular tax, however, because of $25,000 in preference items. E paid $2,250 of minimum tax on these preferences (($25,000 minus $10,000) multiplied by .15). In 1986, E has additional investment tax credits. After application of the investment tax credit carryback rules, E would have $1,000 investment tax credit from 1986 available for use in 1985. E must recompute the adjustments required under this section by treating $1,000 of these 1986 investment tax credits as carried back and used to reduce non-preference regular tax liability for 1985. Pursuant to the rules of this section, all of these $1,000 of credits are freed-up credits. Non-beneficial preferences are $6,667 ($1,000 grossed up at a 15 percent regular tax rate). Beneficial preferences are $18,333 ($25,000 minus $6,667). Minimum tax on all preferences would be $2,250 (($25,000 minus $10,000) multiplied by .15); minimum tax on beneficial preferences would be $1,250 (($18,333 minus $10,000) multiplied by .15). Minimum tax attributable to the non-beneficial preferences is thus $1,000 ($2,250 minus $1,250), which is the credit reduction amount. E thus reduces the $1,000 of credits carried back to 1985 to zero. Under the rules of this section, the amount of minimum tax due for 1985 is redetermined. It is equal to the minimum tax on beneficial preferences, which, as described above, is $1,250. Because E paid minimum tax of $2,250 in 1985, E files a claim for credit or refund for $1,000 of the minimum tax paid in 1985.

(f) *Treatment of net operating losses.* [Reserved]

[T.D. 8416, 57 FR 19255, May 5, 1992; 57 FR 24848, June 11, 1992]

§§ 1.59—1.60 [Reserved]

SUBCHAPTER A—INCOME TAX

PART 1—INCOME TAXES

COMPUTATION OF TAXABLE INCOME

Definition of Gross Income, Adjusted Gross Income, and Taxable Income

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AUTHORITY: 26 U.S.C. 7805, unless otherwise noted.

Section 1.61–2T also issued under 26 U.S.C. 61.
Section 1.61–21 also issued under 26 U.S.C. 61.
Sections 1.62–1T and 1.62–2 also issued under 26 U.S.C. 62;
Sections 1.67–2T and 1.67–3T also issued under 26 U.S.C. 67(c);
Section 1.67–3 also issued under 26 U.S.C. 67(c).
Sections 1.72–4, 1.72–5, 1.72–6, 1.72–7, 1.72–8, and 1.72–11 also issued under 26 U.S.C. 72(c).
Section 1.101–7 also issued under 26 U.S.C. 101(d)(2)(B)(ii);
Section 1.103–10 also issued under 26 U.S.C. 103(b)(6);
Section 1.103A–2 also issued under 26 U.S.C. 103A(j);
Section 1.108–1 also issued under 26 U.S.C. 108(e)(8) and 108(e)(10(B);
Section 1.108–2 also issued under 26 U.S.C. 108;
Section 1.108–3 also issued under 26 U.S.C. 108, 267, and 1502.
Section 1.108–4 also issued under 26 U.S.C. 108.
Section 1.108–5 also issued under 26 U.S.C. 108.
Section 1.108(c)–1 also issued under the authority of 26 U.S.C. 108(d)(9);
Sections 1.132–0 through 1.132–8T also issued under 26 U.S.C. 132;
Sections 1.148–0 through 1.148–11 also issued under 26 U.S.C. 148 (f), (g), and (i);
Sections 1.148–6 also issued under 26 U.S.C. 148 (f), (g), and (i);
Section 1.149(b)–1 also issued under 26 U.S.C. 149(b)(3)(B) (v);
Section 1.149(d)–1 also issued under 26 U.S.C. 149(d)(7);
Section 1.149(e)–1 also issued under 26 U.S.C. 149(e);
Section 1.149(g)–1 also issued under 26 U.S.C. 149(g)(5);
Sections 1.150–4 also issued under 26 U.S.C. 150 (c)(5);
Section 1.163–8T also issued under 26 U.S.C. 469(k)(4);
Section 1.163–9T also issued under 26 U.S.C. 163(h)(3)(D);
Section 1.163–11T is also issued under 26 U.S.C. 163(h);
Section 1.165–12 also issued under 26 U.S.C. 165(j)(3);
Section 1.166–10 also issued under 26 U.S.C. 166(f);
Section 1.168(d)–1 also issued under 26 U.S.C. 168(d)(3);
Section 1.168(f)(8)–1T also added under sec. 112(c), Black Lung Benefits Revenue Act of 1981 (Pub. L. 97–119);
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Section 1.168(i)–2 also issued under 26 U.S.C. 168.
Section 1.168(j)–1T also added under 26 U.S.C. 168(j)(10);

SOURCE: T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, unless otherwise noted.

COMPUTATION OF TAXABLE INCOME

DEFINITION OF GROSS INCOME, ADJUSTED GROSS INCOME, AND TAXABLE INCOME

§ 1.61–1 Gross income.

(a) *General definition.* Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash. Section 61 lists the more common items of gross income for purposes of illustration. For purposes of further illustration, § 1.61–14 mentions several miscellaneous items of gross income not listed specifically in section 61. Gross income, however, is not limited to the items so enumerated.

(b) *Cross references.* Cross references to other provisions of the Code are to be found throughout the regulations under section 61. The purpose of these cross references is to direct attention to the more common items which are included in or excluded from gross income entirely, or treated in some special manner. To the extent that another section of the Code or of the regulations thereunder, provides specific treatment for any item of income, such other provision shall apply notwithstanding section 61 and the regulations thereunder. The cross references do not cover all possible items.

(1) For examples of items specifically included in gross income, see Part II (section 71 and following), Subchapter B, Chapter 1 of the Code.

(2) For examples of items specifically excluded from gross income, see part III (section 101 and following), Subchapter B, Chapter 1 of the Code.

(3) For general rules as to the taxable year for which an item is to be included in gross income, see section 451 and the regulations thereunder.

§1.61–2 Compensation for services, including fees, commissions, and similar items.

(a) *In general.* (1) Wages, salaries, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses (including Christmas bonuses), termination or severance pay, rewards, jury fees, marriage fees and other contributions received by a clergyman for services, pay of persons in the military or naval forces of the United States, retired pay of employees, pensions, and retirement allowances are income to the recipients unless excluded by law. Several special rules apply to members of the Armed Forces, National Oceanic and Atmospheric Administration, and Public Health Service of the United States; see paragraph (b) of this section.

(2) The Code provides special rules including the following items in gross income:

(i) Distributions from employees' trusts, see sections 72, 402, and 403, and the regulations thereunder;

(ii) Compensation for child's services (in child's gross income), see section 73 and the regulations thereunder;

(iii) Prizes and awards, see section 74 and the regulations thereunder.

(3) Similarly, the Code provides special rules excluding the following items from gross income in whole or in part:

(i) Gifts, see section 102 and the regulations thereunder;

(ii) Compensation for injuries or sickness, see section 104 and the regulations thereunder;

(iii) Amounts received under accident and health plans, see section 105 and the regulations thereunder;

(iv) Scholarship and fellowship grants, see section 117 and the regulations thereunder;

(v) Miscellaneous items, see section 122.

(b) *Members of the Armed Forces, National Oceanic and Atmospheric Administration, and Public Health Service.* (1) Subsistence and uniform allowances granted commissioned officers, chief warrant officers, warrant officers, and enlisted personnel of the Armed Forces, National Oceanic and Atmospheric Administration, and Public Health Service of the United States, and amounts received by them as commutation of quarters, are excluded from gross income. Similarly, the value of quarters or subsistence furnished to such persons is excluded from gross income.

(2) For purposes of this section, quarters or subsistence includes the following allowances for expenses incurred after December 31, 1993, by members of the Armed Forces, members of the commissioned corps of the National Oceanic and Atmospheric Administration, and members of the commissioned corps of the Public Health Service, to the extent that the allowances are not otherwise excluded from gross income under another provision of the Internal Revenue Code: a dislocation allowance, authorized by 37 U.S.C. 407; a temporary lodging allowance, authorized by 37 U.S.C. 405; a temporary lodging expense, authorized by 37 U.S.C. 404a; and a move-in housing allowance, authorized by 37 U.S.C. 405. No deduction is allowed under this chapter for any expenses reimbursed by such excluded allowances. For the exclusion from gross income of—

(i) Disability pensions, see section 104(a)(4) and the regulations thereunder;

(ii) Miscellaneous items, see section 122.

(3) The per diem or actual expense allowance, the monetary allowance in lieu of transportation, and the mileage allowance received by members of the Armed Forces, National Oceanic and Atmospheric Administration, and the Public Health Service, while in a travel status or on temporary duty away from their permanent stations, are included

in their gross income except to the extent excluded under the accountable plan provisions of § 1.62–2.

(c) *Payment to charitable, etc., organization on behalf of person rendering services.* The value of services is not includible in gross income when such services are rendered directly and gratuitously to an organization described in section 170(c). Where, however, pursuant to an agreement or understanding, services are rendered to a person for the benefit of an organization described in section 170(c) and an amount for such services is paid to such organization by the person to whom the services are rendered, the amount so paid constitutes income to the person performing the services.

(d) *Compensation paid other than in cash*—(1) *In general.* Except as otherwise provided in paragraph (d)(6)(i) of this section (relating to certain property transferred after June 30, 1969), if services are paid for in property, the fair market value of the property taken in payment must be included in income as compensation. If services are paid for in exchange for other services, the fair market value of such other services taken in payment must be included in income as compensation. If the services are rendered at a stipulated price, such price will be presumed to be the fair market value of the compensation received in the absence of evidence to the contrary. For special rules relating to certain options received as compensation, see §§ 1.61–15, 1.83–7, and section 421 and the regulations thereunder. For special rules relating to premiums paid by an employer for an annuity contract which is not subject to section 403(a), see section 403(c) and the regulations thereunder and § 1.83–8(a). For special rules relating to contributions made to an employees' trust which is not exempt under section 501, see section 402(b) and the regulations thereunder and § 1.83–8(a).

(2) *Property transferred to employee or independent contractor.* (i) Except as otherwise provided in section 421 and the regulations thereunder and § 1.61–15 (relating to stock options), and paragraph (d)(6)(i) of this section, if property is transferred by an employer to an employee or if property is transferred to an independent contractor, as compensation for services, for an amount less than its fair market value, then regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value at the time of the transfer is compensation and shall be included in the gross income of the employee or independent contractor. In computing the gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of such difference included in gross income

(ii)*(a) Cost of life insurance on the life of the employee.* Generally, life insurance premiums paid by an employer on the life of his employee where the proceeds of such insurance are payable to the beneficiary of such employee are part of the gross income of the employee. However, the amount includible in the employee's gross income is determined with regard to the provisions of section 403 and the regulations thereunder in the case of an individual contract issued after December 31, 1962, or a group contract, which provides incidental life insurance protection and which satisfies the requirements of section 401(g) and § 1.401–9, relating to the nontransferability of annuity contracts. For the special rules relating to the includibility in an employee's gross income of an amount equal to the cost of certain group term life insurance on the employee's life which is carried directly or indirectly by his employer, see section 79 and the regulations thereunder. For special rules relating to the exclusion of contributions by an employer to accident and health plans for the employee, see section 106 and the regulations thereunder.

(*b*) *Cost of group-term life insurance on the life of an individual other than an employee.* The cost (determined under paragraph (d)(2) of § 1.79–3) of group-term life insurance on the life of an individual other than an employee (such as the spouse or dependent of the employee) provided in connection with the performance of services by the employee is includible in the gross income of the employee.

(3) *Meals and living quarters.* The value of living quarters or meals which

an employee receives in addition to his salary constitutes gross income unless they are furnished for the convenience of the employer and meet the conditions specified in section 119 and the regulations thereunder. For the treatment of rental value of parsonages or rental allowance paid to ministers, see section 107 and the regulations thereunder; for the treatment of statutory subsistence allowances received by police, see section 120 and the regulations thereunder.

(4) *Stock and notes transferred to employee or independent contractor.* Except as otherwise provided by section 421 and the regulations thereunder and §1.61–15 (relating to stock options), and paragraph (d)(6)(i) of this section, if a corporation transfers its own stock to an employee or independent contractor as compensation for services, the fair market value of the stock at the time of transfer shall be included in the gross income of the employee or independent contractor. Notes or other evidences of indebtedness received in payment for services constitute income in the amount of their fair market value at the time of the transfer. A taxpayer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest, shall treat as income as of the time of receipt its fair discounted value computed at the prevailing rate. As payments are received on such a note, there shall be included in income that portion of each payment which represents the proportionate part of the discount originally taken on the entire note.

(5) *Property transferred on or before June 30, 1969, subject to restrictions.* Notwithstanding paragraph (d) (1), (2), or (4) of this section, if any property is transferred after September 24, 1959, by an employer to an employee or independent contractor as compensation for services, and such property is subject to a restriction which has a significant effect on its value at the time of transfer, the rules of §1.421–6(d)(2) shall apply in determining the time and the amount of compensation to be included in the gross income of the employee or independent contractor. This (5) is also applicable to transfers subject to a restriction which has a significant effect on its value at the time of transfer and to which §1.83–8(b) (relating to transitional rules with respect to transfers of restricted property) applies. For special rules relating to options to purchase stock or other property which are issued as compensation for services, see §1.61–15 and section 421 and the regulations thereunder.

(6) *Certain property transferred, premiums paid, and contributions made in connection with the performance of services after June 30, 1969*—(i) *Exception.* Paragraph (d) (1), (2), (4), and (5) of this section and §1.61–15 do not apply to the transfer of property (as defined in §1.83–3(e)) after June 30, 1969, unless §1.83–8 (relating to the applicability of section 83 and transitional rules) applies. If section 83 applies to a transfer of property, and the property is not subject to a restriction that has a significant effect on the fair market value of such property, then the rules contained in paragraph (d) (1), (2), and (4) of this section and §1.61–15 shall also apply to such transfer to the extent such rules are not inconsistent with section 83.

(ii) *Cross references.* For rules relating to premiums paid by an employer for an annuity contract which is not subject to section 403(a), see section 403(c) and the regulations thereunder. For rules relating to contributions made to an employees' trust which is not exempt under section 501(a), see section 402(b) and the regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6696, 28 FR 13450, Dec. 12, 1963; T.D. 6856, 30 FR 13316, Oct. 20, 1965; T.D. 7544, 43 FR 31913, July 24, 1978; T.D. 7623, 44 FR 28800, May 17, 1979; T.D. 8256, 54 FR 28582, July 6, 1989; T.D. 8607, 60 FR 40076, Aug. 7, 1995]

§1.61–2T Taxation of fringe benefits—1985 through 1988 (temporary).

(a) *Fringe benefits*—(1) *In general.* Section 61(a)(1) provides that, except as otherwise provided in subtitle A, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. Examples of fringe benefits include: an employer-provided automobile, a flight on an employer-provided aircraft, an employer-provided free or discounted commercial airline flight, an employer-provided vacation, and employer-provided discount on property or services, and emkployer-provided membership in a country club or other social club, and an employer-provided ticket to an entertainment or sporting event.

(2) *Fringe benefits excluded from income.* To the extent that a particular fringe benefit is specifically excluded from gross income pursuant to another section of subtitle A, that section shall govern the treatment of the fringe benefit. Thus, if the requirements of the governing section are satisfied, the fringe benefits may be excludable from gross income. Examples of excludable fringe benefits are qualified tuition reductions provided to an employee (section 177(d)); meals and lodging furnished to an employee for the convenience of the employer (section 119); and benefits provided under a dependent care assistance program (section 129). Similarly, the value of the use by an employee of an employer-provided vehicle or a flight provided to an employee on an employer-provided aircraft may be excludable from income under section 105 (because, for example, the trnsportation is provided for medical reasons) if and to the extent that the requirements of that section are satisfied. Section 61 and the regulations thereunder shall apply, however, to the extent that they are not inconsistent with such other section. For example, many fringe benefits specifically addressed in other sections of subtitle A are excluded from gross income only to the extent that they do not exceed specific dollar or percentage limits, or only if certain other requirements are met. If the limits are exceeded or the requirements are not met, some or all of the fringe benefit may be includible in gross income. See paragraph (b)(3) of this section.

(3) *Compensation for services.* A fringe benefit provided in connection with the performance of services shall be considered to have been provided as compensation for servcies. Refraining from the performance of services (such as pursuant to a covenant not to compete) is deemed to be the performance of services for purposes of this section.

(4) *Recipient of a fringe benefit*—(i) *Definition.* A fringe benefit is included in the income of the ‘‘recipient’’ of the fringe benefit. The recipient of a fringe benefit is the person performing the services in connection with which the fringe benefit is provided. Thus, a person may be considered to be a recipient, even though that person did not actually receive the fringe benefit. For example, a fringe benefit provided to any person is connection with the performance of services by another person is considered to have been provided to the person who performs the services and not the person who receives the fringe benefit. In addition, if a fringe benefit is provided to a person, but taxable to a second person as the recipient, such benefit is referred to as provided to the second person and use by the first person is considered use by the second person. For example, provision of an automobile to an employee’s spouse by the employer is taxable to the employee as the recipient. The automobile is referred to as available to the employee and use by the employee’s spouse is considered use by the employee.

(ii) *Recipient may be other than an employee.* The recipient of a fringe benefit need not be an employee of the provider of the fringe benefit, but may be a partner, director, or an independent contractor. For convenience, the term ‘‘employee’’ includes a reference to any recipient of a fringe benefit, unless otherwise specifically provided in this section.

(5) *Provider of a fringe benefit.* The ‘‘provider’’ of a fringe benefit is that person for whom the services are performed, regardless of whether that person actually provides the fringe benefit to the recipient. The provider of a fringe benefit need not be the employer of the recipient of the fringe benefit, but may be, for example, a client or customer of an independent contractor. For convenience, the term ‘‘employer’’ includes a reference to any provider of a fringe benefit, unless otherwise specifically provided in this section.

(6) *Effective date.* This section is effective from January 1, 1985, to December 31, 1988, with respect to fringe benefits

furnished before January 1, 1989. No inference may be drawn from the promulgation or terms of this section concerning the application of law in effect prior to January 1, 1985.

(b) *Valuation of fringe benefits*—(1) *In general.* An employee must include in gross income the amount by which the fair market value of the fringe benefit exceeds the sum of (i) the amount, if any, paid for the benefit, and (ii) the amount, if any, specifically excluded from gross income by some other section of subtitle A. Therefore, for example, if the employee pays fair market value for what is received, no amount is includible in the gross income of the employee.

(2) *Fair market value.* In general, fair market value is determined on the basis of all the facts and circumstances. Specifically, the fair market value of a fringe benefit is that amount a (hypothetical person would have to pay a hypothetical third party to obtain (i.e., purchase or lease) the particular fringe benefit. Thus, for example, the effect of any special relationship that may exist between the employer and the employee must be disregarded. This also means that an employee's subjective perception of the value of a fringe benefit is not relevant to the determination of a fringe benefit's fair market value. In addition, the cost incurred by the employer is not determinative of the fair market value of the fringe benefit. For special rules relating to the valuation of certain fringe benefits, see paragraph (c) of this section.

(3) *Exclusion from income based on cost.* If a statutory exclusion phrased in terms of cost applies to the provision of a fringe benefit, section 61 does not require the inclusion in the recipient's gross income of the difference between the fair market value and the excludable cost of that fringe benefit. For example, section 129 provides an exclusion from an employee's gross income for amounts paid or incurred by an employer to provide dependent care assistance to employees. Even if the fair market value of the dependent care assistance exceeds the employer's cost, the excess is not subject to inclusion under section 61 and this section. If the statutory cost exclusion is a limited amount, however, then the fair market value of the fringe benefit attributable to any excess cost is subject to inclusion.

(4) *Fair market value of the availability of an employer-provided vehicle.* If the vehicle special valuation rules of paragraph (d), (e), or (f) of this section are not used by a taxpayer entitled to use such rules, the value of the availability of an employer-provided vehicle is determined under the general valuation principles set forth in this section. In general, such valuation must be determined by reference to the cost to a hypothetical person of leasing from a hypothetical third party the same or comparable vehicle on the same or comparable terms in the geographic area in which the vehicle is available for use. Unless the employee can substantiate that the same or comparable vehicle could have been leased on a cents-per-mile basis, the value of the availability of the vehicle cannot be determined by reference to a cents-per-mile rate applied to the number of miles the vehicle is driven. An example of a comparable lease term is the amount of time that the vehicle is available to the employee for use, e.g., a one-year period.

(5) *Fair market value of a flight on an employer-provided aircraft.* If the non-commercial flight special valuation rule of paragraph (g) of this section is not used (or is not properly used) by a taxpayer entitled to use such rule, the value of a flight on an employer-provided aircraft is determined under the general valuation principles set forth in this section. An example of how the general valuation principles would apply is that if an employee whose flight is primarily personal controls the use of an aircraft with respect to such flight, such flight is valued by reference to how much it would cost a hypothetical person to charter the same or comparable aircraft for the same or comparable flight. The cost to charter the aircraft must be allocated among all employees on board the aircraft based on all the facts and circumstances, including which employees controlled the use of the aircraft. Notwithstanding the allocation required by the preceding sentence, no additional amount shall be included in

the income of any employee whose flight is properly valued under the special valuation rule of paragraph (g) of this section.

(c) *Special valuation rules*—(1) *In general.* Paragraphs (d) through (j) of this section provide special valuation rules that may be used under certain circumstances for certain commonly provided fringe benefits. Paragraph (d) provides a lease valuation rule relating to employer-provided automobiles. Paragraph (e) provides a cents-per-mile valuation rule relating to employer-provided vehicles. Paragraph (f) provides a commuting valuation rule relating to employer-provided vehicles. Paragraph (g) provides a flight valuation rule relating to flights on employer-provided aircraft. Paragraph (h) provides a flight valuation rule relating to flights on commercial airlines. Paragraph(i) is reserved. Paragraph (j) provides a meal valuation rule relating to employer-operated eating facilities for employees. For general rules relating to the valuation of fringe benefits not eligible for valuation under the special valuation rules, see paragraph (d) of this section.

(2) *Use of the special valuation rules*—(i) *In general.* The Special valuation rules may be used for income, employment tax, and reporting purposes. Use of any of the special valuation rules is optional. An employer need not use the same vehicle special valuation rule for all vehicles provided to all employees. For example, an employer may use the automobile lease valuation rule for automobiles provided to some employees, and the commuting and vehicle cents-per-mile valuation rules for automobiles provided to other employees. Except as otherwise provided, however, if either the commercial flight valuation rule or the noncommercial flight valuation rule is used, such rule must be used by an employer to value all flights taken by employees in a calendar year. Effective January 1, 1986, if an employer uses one of the special rules to value the benefit provided to an employee, the employee may not use another special rule to value that benefit. The employee may, however, use general valuation rules based on facts and circumstances (see paragraph (b) of this section). Effective January 1, 1986, an employee may only use a special valuation rule if the employer uses the rule. If a special rule is used, it must be used for all purposes. If an employer properly uses a special rule and the employee uses the special rule, the employee must include in gross income the amount determined by the employer under the special rule less any amount reimbursed by the employee to the employer. The employer and the employee may use the special rules to determine the amount of the reimbursement due the employer by the employee. If an employer properly uses a special rule and properly determines the amount of an employee's working condition fringe under section 132 and § 1.132–1T (under the general rule or under a special rule), and the employee uses the special valuation rule, the employee must include in gross income the amount determined by the employer less any amount reimbursed by the employee to the employer.

(ii) *Transitional rules*—(A) *Use of vehicle special valuation rules for 1985 and 1986.* For purposes of valuing the use or availability of a vehicle, the consistency rules provided in paragraphs (d)(6) and (e)(5) of this section (relating to the automobile lease valuation rule and the vehicle cents-per-mile valuation rule, respectively) apply for 1987 and thereafter. Therefore, for 1985 and 1986 an employer (and employee, subject to paragraph (c)(2)(i) of this section) may use any applicable special valuation rule (or no special valuation rule) to value the use or availability of a vehicle, subject to paragraph (c)(2)(ii)(B) of this section.

(B) *Consistency Rules for 1985 and 1986.* If an employer uses the automobile lease valuation rule of paragraph (d) of this section in 1985 or 1986 with respect to an automobile, such rule must be used for the entire calendar year with respect to the automobile except for any period during which the commuting valuation rule of paragraph (f) of this section is properly used. If an employer uses the vehicle cents-per-mile valuation rule of pararaph (e) of this section in 1985 or 1986 with respect to a vehicle, such rule must be used for the entire calendar year with respect to the vehicle except for any period during which the commuting valuation rule of paragraph (f) of this section is properly used. The rules of this paragraph (c)(2)(ii)(B) also apply to employees using the special valuation rules of paragraphs (d) or (e) of this section.

(C) *Employee's use of special valuation rules for 1985.* An employee may use a special valuation rule (other than the rule in paragraph (e) of this section relating to the vehicle cents-per-mile valuation rule) during 1985 even if the employer does not use the same special valuation rule during 1985. An employee's use of a special valuation rule in 1986 and thereafter must be consistent with his employer's use of the rule as required under paragraph (c)(2)(i) of this section.

(D) *Examples.* The following examples illustrate the rules of paragraph (c)(2)(ii) of this section:

Example (1). Assume that an employer properly uses the automobile lease valuation rule in 1985. The employer may use the vehicle cents-per-mile valuation rule in 1986 if the requirements of the vehicle cents-per-mile valuation rule are satisfied.

Example (2). Assume that an employer does not use a special valuation rule to value the availability of an automobile in 1985. The employer may use any of the special valuation rules in 1986 if the requirements of the rule chosen are satisfied. The same applies for 1987.

Example (3). Assume that an employer properly uses the vehicle cents-per-mile valuation rule in 1985. The employer may continue to use to the rule or use any of the other special valuation rules to value the benefit provided in 1986 if the requirements of the rule chosen are satisfied. Alternatively, the employer may use none of the special valuation rules in 1986 but use any of the rules in 1987 if the requirements of the rule chosen are satisfied.

Example (4). Assume that an employee properly uses the automobile lease valuation rule in 1985. In 1986 and thereafter the employee may use a special valuation rule only if the employee's employer uses the same special valuation rule. The employee may use general valuation principles to value the benefit provided in 1986 and thereafter.

(3) *Election to use the special valuation rules*—A particular special valuation rule is deemed to have been elected by the employer (and, if applicable, by the employee), if the employer (and, if applicable, the employee) determines the value of the fringe benefit provided by applying the special valuation rule and treats such value as the fair market value of the fringe benefit for income, employment tax, and reporting purposes. Neither the employer nor the employee is required to notify the Internal Revenue Service of the election.

(4) *Application of section 414 to employers.* For purposes of paragraphs (c) through (j) of this section, except as otherwise provided therein, the term ‘‘employer’’ includes all entities required to be treated as a single employer under section 414 (b), (c), or (m).

(5) *Valuation formulas contained in the special valuation rules.* The valuation formulas contained in the special valuation rules are provided only for use in connection with such rules. Thus, when a special valuation rule is properly applied to a fringe benefit, the Commissioner will accept the value calculated pursuant to the rule as the fair market value of that fringe benefit. However, when a special valuation rule is not properly applied to a fringe benefit (see, for example, paragraph (g)(11) of this section), or when a special valuation rule is not used to value a fringe benefit by a taxpayer entitled to use the rule, the fair market value of that fringe benefit may not be determined by reference to any value calculated under any special valuation rule. Under the circumstances described in the preceding sentence, the fair market value of the fringe benefit must be determined pursuant to paragraph (b) of this section.

(6) *Modification of the special valuation rules.* The Commissioner may, if he deems it necessary, add, delete, or modify the special valuation rules, including the valuation formulas contained herein, on a prospective basis.

(7) *Special Accounting Period.* If the employer is using the special accounting rule provided in Announcement 85–113 (1985–31 I.R.B., August 5, 1985) (relating to the reporting of and withholding on the value of noncash fringe benefits), benefits which are deemed provided in a subsequent calendar year pursuant to such rule are considered as provided in such subsequent calendar year for purposes of the special valuation rules. Thus, if a particular special valuation rule is in effect for a calendar year, it applies to benefits deemed provided during such calendar year under the special accounting rule.

(d) *Automobile lease valuation rule*—(1) *In general*—(i) *Annual Lease Value.* Under the special valuation rule of this paragraph (d), if an employer provides an employee with an automobile that is available to the employee for an entire calendar year, the value of the benefit provided in the Annual Lease Value (determined under paragraph (d)(2) of this section) of that automobile. Except as otherwise provided, for an automobile that is available to an employee for less than an entire calendar year, the value of the benefit provided is either a pro-rated Annual Lease Value or the Daily Lease Value (as defined in paragraph (d)(4) of this section), whichever is applicable. Absent any statutory exclusion relating to the employer-provided automobile (see, for example, section 132(a)(3) and § 1.132–5T(b)), the amount of the Annual Lease Value (or a pro-rated Annual Lease Value or the Daily Lease Value, as applicable) is included in the gross income of the employee.

(ii) *Definition of automobile.* For purposes of this paragraph (d), the term ‘‘automobile’’ means any four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways.

(2) *Calculation of Annual Lease Value*—(i) *In general.* The Annual Lease Value of a particular automobile is calculated as follows:

(A) Determine the fair market value of the automobile as of the first date on which the automobile is made available to any employee of the employer for personal use. For an automobile first made available to any employee for personal use prior to January 1, 1985, determine the fair market value as of January 1, 1985. For rules relating to determination of the fair market value of an automobile for purposes of this paragraph (d), see paragraph (d)(5) of this section.

(B) Select the dollar range in column 1 of the Annual Lease Value Table, set forth in paragraph (d)(2)(iii) of this section, corresponding to the fair market value of the automobile. Except as otherwise provided in paragraphs (d)(2) (iv) and (v) of this section, the Annual Lease Value for each year of availability of the automobile is the corresponding amount in column 2 of the Table.

(ii) *Use by employee only in 1985.* If the employee, but not the employer, is using the special rule of this paragraph (d), the employee may calculate the Annual Lease Value in the same manner as described in paragraph (d)(2)(i)(A) of this section, except that the fair market value of the automobile is determined as of the first date on which the automobile is made available to the employee for personal use or, for an automobile made available to the employee for personal use prior to January 1, 1985, by determining the fair market value as of January 1, 1985. If the employer is also using the special rule of this paragraph (d), however, then the employee to whom the automobile is made available must use the special rule, if at all, by using the Annual Lease Value calculated by the employer. The rules of this paragraph (d)(2)(ii) apply only for 1985.

(iii) *Annual Lease Value Table.*

Automobile fair market value (1)	Annual lease value (2)
$0 to $999	$600
$1,000 to $1,999	850
$2,000 to $2,999	1,100
$3,000 to $3,999	1,350
$4,000 to $4,999	1,600
$5,000 to $5,999	1,850
$6,000 to $6,999	2,100
$7,000 to $7,999	2,350
$8,000 to $8,999	2,600
$9,000 to $9,999	2,850
$10,000 to $10,999	3,100
$11,000 to $11,999	3,350
$12,000 to $12,999	3,600
$13,000 to $13,999	3,850
$14,000 to $14,999	4,100
$15,000 to $15,999	4,350
$16,000 to $16,999	4,600
$17,000 to $17,999	4,850
$18,000 to $18,999	5,100
$19,000 to $19,999	5,350
$20,000 to $20,999	5,600
$21,000 to $21,999	5,580
$22,000 to $22,999	6,100
$23,000 to $23,999	6,350
$24,000 to $24,999	6,600
$25,000 to $25,999	6,850
$26,000 to $27,999	7,250
$28,000 to $29,999	7,750
$30,000 to $31,999	8,250
$32,000 to $33,999	8,750
$34,000 to $35,999	9,250
$36,000 to $37,999	9,750
$38,000 to $39,999	10,250
$40,000 to $41,999	10,750
$42,000 to $43,999	11,250
$44,000 to $45,999	11,750
$46,000 to $47,999	12,250

Automobile fair market value (1)	Annual lease value (2)
$48,000 to $49,999	12,750
$50,000 to $51,999	13,250
$52,000 to $53,999	13,750
$54,000 to $55,999	14,250
$56,000 to $57,999	14,750
$58,000 to $59,999	15,250

For vehicles having a fair market value in excess of $59,999, the Annual Lease Value is equal to: (.25 X the fair market value of the automobile) + $500.

(iv) *Recalculation of annual lease value.* The Annual Lease Values determined under the rules of this paragraph (d) are based on a four-year lease term. Therefore, except as otherwise provided in paragraph (d)(2)(v) of this section, the Annual Lease Value calculated by applying paragraph (d)(2) (i) or (ii) of this section shall remain in effect for the period that begins with the first date the special valuation rule of paragraph (d) of this section is applied by the employer to the automobile and ends on December 31 of the fourth full calendar year following that date. The Annual Lease Value for each subsequent four-year period is calculated by determining the fair market value of the automobile as of the January 1 following the period described in the previous sentence and selecting the amount in column 2 of the Annual Lease Value Table corresponding to the appropriate dollar range in column 1 of the Table. If, however, the employer is using the special accounting rule provided in Announcement 85–113 (1985–31 I.R.B., August 5, 1985) (relating to the reporting of and withholding on the value of noncash fringe benefits), the employer may calculate the Annual Lease Value for each subsequent four-year period as of the beginning of the special accounting period that begins immediately prior to the January 1 described in the previous sentence. For example, assume that pursuant to Announcement 85–113, an employer uses the special accounting rule. Assume further that beginning on November 1, 1985, the special accounting period is November 1 to October 31 and that the employer elects to use the special valuation rule of this paragraph (d) as of January 1, 1985. The employer may recalculate the Annual Lease Value as of November 1, 1988, rather than as of January 1, 1989.

(v) *Transfer of the automobile to another employee.* Unless the primary purpose of the transfer is to reduce Federal taxes, if an employer transfers an automobile from one employee to another employee, the employer may recalculate the Annual Lease Value based on the fair market value of the automobile as of January 1 of the year of transfer. If, however, the employer is using the special accounting rule provided in Announcement 85–113 (1985–31 I.R.B., August 5, 1985) (relating to the reporting of and withholding on the value of noncash fringe benefits), the employer may recalculate the Annual Lease Value based on the fair market value of the automobile as of the beginning of the special accounting period in which the transfer occurs. If the employer does not recalculate the Annual Lease Value, and the employee to whom the automobile is transferred uses the special valuation rule, the employee may not recalculate the Annual Lease Value.

(3) *Services included in, or excluded from, the Annual Lease Value Table*—(i) *Maintenance and insurance included.* The Annual Lease Values contained in the Annual Lease Value Table include the fair market value of maintenance of, and insurance for, the automobile. Neither an employer nor an employee may reduce the Annual Lease Value by the fair market value of any service included in the Annual Lease Value that is not provided by the employer, such as reducing the Annual Lease Value by the fair market value of a maintenance service contract or insurance. An employer or employee may take into account the services actually provided with respect to the automobile by valuing the availability of the automobile under the general valuation rules of paragraph (b) of this section.

(ii) *Fuel excluded*—(A) *In general.* The Annual Lease Values do not include the fair market value of fuel provided by the employer, regardless of whether fuel is provided in kind or its cost is reimbursed by or charged to the employer.

(B) *Valuation of fuel provided in kind.* The provision of fuel in kind may be valued at fair market value based on all the facts and circumstances or, in the alternative, it may be valued at 5.5 cents per mile for all miles driven by the employee. However, the provision of fuel in kind may not be valued at 5.5 cents per mile for miles driven outside the United States, Canada, and Mexico. For purposes of this section, the United States includes the United States and its territories.

(C) *Valuation of fuel where cost reimbursed by or charged to employer.* The fair market value of fuel, the cost of which is reimbursed by or charged to an employer, is generally the amount of the actual reimbursement or the amount charged, provided the purchase of the fuel is at arm's length. If an employer with a fleet of at least 20 automobiles that meet the requirements of paragraph (d)(5)(v)(C) of this section reimburses employees for the cost of fuel or allows employees to charge the employer for the cost of the fuel, however, the fair market value of fuel provided to those automobiles may be determined by reference to the employer's fleet-average cents-per-mile fuel cost. The fleet-average cents-per-mile fuel cost in equal to the fleet-average per-gallon fuel cost divided by the fleet-average miles-per-gallon rate. The averages described in the preceding sentence must be determined by averaging the per-gallon fuel costs and miles-per-gallon rates of a representative sample of the automobiles in the fleet equal to the greater of ten percent of the automobiles in the fleet or 20 automobiles for a representative period, such as a two month period.

(iii) *All other services excluded.* The fair market value of any service not specifically identified in paragraph (d)(3)(i) of this section that is provided by the employer with respect to an automobile (such as the services of a chauffeur) must be added to the Annual Lease Value of the automobile in determining the fair market value of the benefit provided.

(4) *Availability of an automobile for less than an entire calendar year*—(i) *Prorated Annual Lease Value used for continuous availability of 30 or more days.* Except as otherwise provided in paragraph (d)(4)(iv) of this section, for periods of continuous availability of 30 or more days, but less than an entire calendar year, the value of the availability of the employer-provided automobile is the pro-rated Annual Lease Value. The pro-rated Annual Lease Value is calculated by multiplying the applicable Annual Lease Value by a fraction, the numerator of which is the number of days of availability and the denominator of which is 365.

(ii) *Daily Lease Value used for continuous availability of less than 30 days.* Except as otherwise provided in paragraph (d)(4)(iii) of this section, for periods of continuous availability of one or more but less than 30 days, the value of the availability of the employer-provided automobile is the Daily Lease Value. The Daily Lease Value is calculated by multiplying the applicable Annual Lease Value by a fraction, the numerator of which is four times the number of days of availability and the denominator of which is 365.

(iii) *Election to treat all periods as periods of at least 30 days.* A pro-rated Annual Lease Value may be applied with respect to a period of continuous availability of less than 30 days, by treating the automobile as if it had been available for 30 days, if to do so would result in a lower valuation than applying the Daily Lease Value to the shorter period of actual availability.

(iv) *Periods of unavailability*—(A) *General rule.* In general, a pro-rated Annual Lease Value (as provided in paragraph (d)(4)(i) of this section) is used to value the availability of an employer-provided automobile when the automobile is available to an employee for a period of continuous availability of at least 30 days but less than the entire calendar year. Neither an employer nor an employee may use a pro-rated Annual Lease Value when the reduction of Federal taxes is the primary reason the automobile is unavailable to an employee during the calendar year.

(B) *Unavailability for personal reasons of the employee.* If an automobile is unavailable to an employee because of personal reasons of the employee, such as while the employee is on vacation, a pro-rated Annual Lease Value may not be used. For example, assume an automobile is available to an employee during the first five months of the year and during the last five months of the year. Assume further that the period of unavailability occurs because the employee is on vacation. The Annual Lease Value, if it is applied, must be applied with respect to the entire 12 month period. The Annual Lease Value may not be pro-rated to take into account the two-month period of unavailability.

(5) *Fair market value*—(i) *In general.* For purposes of determining the Annual Lease Value of an automobile under the Annual Lease Value Table, the fair market value of an automobile is that amount a hypothetical person would have to pay a hypothetical third party to purchase the particular automobile provided. Thus, for example, any special relationship that may exist between the employee and the employer must be disregarded. Also, the employee's subjective perception of the value of the automobile is not relevant to the determination of the automobile's fair market value. In addition, except as provided in paragraph (d)(5)(ii) of this section, the cost incurred by the employer of either purchasing of leasing the automobile is not determinative of the fair market value of the automobile.

(ii) *Safe-harbor valuation rule.* For purposes of calculating the Annual Lease Value of an automobile under this paragraph (d), the safe-harbor value of the automobile may be used as the fair market value of the automobile For an automobile owned by the employer, the safe-harbor value of the automobile is the employer's cost of purchasing the automobile, provided the purchase is made at arm's length. For an automobile leased by the employer, the safe-harbor value of the automobile is the value determined under paragraph (d)(5)(iii) of this section.

(iii) *Use of nationally recognized pricing guides.* The fair market value of an automobile that is (A) provided to an employee prior to January 1, 1985, (B) being revalued pursuant to paragraphs (d)(2) (iv) or (v) of this section, or (C) is a leased automobile being valued pursuant to paragraph (d)(5)(ii) of this section, may be determined by using the retail value of such automobile as reported in a nationally recognized publication that regularly reports new or used automobile retail values, whichever is applicable. The values contained in (and obtained from) the publication must be reasonable with respect to the automobile being valued.

(iv) *Fair market value of special equipment*—(A) *Certain equipment excluded.* The fair market value of an automobile does not include the fair market value of any telephone or any specialized equipment that is added to or carried in the automobile if the presence of such equipment is necessitated by, and attributable to, the business needs of the employer.

(B) *Use of specialized equipment outside of employer's business.* The value of specialized equipment must be included, however, if the employee to whom the automobile is available uses the specialized equipment in a trade of business of the employee other than the employee's trade or business of being an employee of the employer.

(C) *Equipment susceptible to personal use.* The exclusion rule provided in this paragraph (d)(5)(iv) does not apply to specialized equipment susceptible to personal use.

(v) *Fleet-average valuation rule*—(A) *In general.* An employer with a fleet of 20 or more automobiles may use a fleet-average value for purposes of calculating the Annual Lease Values of the automobiles in the fleet. The fleet-average value is the average of the fair market values of each automobile in the fleet. The fair market value of each automobile in the fleet shall be determined, pursuant to the rules of paragraphs (d)(5) (i) through (iv) of this section, as of the later of January 1, 1985, or the first date on which the automobile is made available to any employee of the employer for personal use.

(B) *Period for use of rule.* The fleet-average valuation rule of this paragraph (d)(5)(v) may be used by an employer as of January 1 of any calendar year following the calendar year in which the employer acquires a fleet of 20 or more automobiles. The Annual Lease Value calculated for the automobiles in the fleet, based on the fleet-average value, shall remain in effect for the period that begins with the first January 1 the fleet-average valuation rule of this paragraph (d)(5)(v) is applied by the employer to the automobiles in the fleet and ends on December 31 of the subsequent calendar year. The Annual Lease Value for each subsequent two year period is calculated by determining the fleet-average value of the automobiles in the fleet as of the first January 1 of such period. An employer may cease using the fleet-average valuation rule as of any January 1. The fleet-average valuation rule does not apply as of January 1 of the year in which the number of automobiles in the employer's fleet declines to fewer than 20. If, however, the employer is using the special accounting rule provided in Announcement 85–113 (I.R.B. No. 31, August 5, 1985), the employer may apply the rules of this paragraph (d)(5)(v)(B) on the basis of the special accounting period rather than the calendar year. (This is accomplished by substituting (1) the beginning of the special accounting period that begins immediately prior to the January 1 described in this paragraph (d)(5)(v)(B) for January 1 wherever it appears in this paragraph (d)(5)(v)(B) and (2) the end of such accounting period for December 31.) The revaluation rules of paragraph (d)(2) (iv) and (v) of this section do not apply to automobiles valued under this paragraph (d)(5)(v).

(C) *Limitations on use of fleet-average rule.* The rule provided in this paragraph (d)(5)(v) may not be used for any automobile whose fair market value (determined pursuant to paragraphs (d)(5) (i) through (iv) of this section as of either the first date on which the automobile is made available to any employee of the employer for personal use or, if later, January 1, 1985) exceeds $16,500. In addition, the rule provided in this paragraph (d)(5)(v) may only be used for automobiles that the employer reasonably expects will regularly be used in the employer's trade or business. Infrequent use of the vehicle, such as for trips to the airport or between the employer's multiple business premises, does not constitute regular use of the vehicle in the employer's trade or business.

(D) *Additional automobiles added to the fleet.* If the rule provided in this paragraph (d)(5)(v) is used by an employer, it must be used for every automobile included in or added to the fleet that meets the requirements of paragraph (d)(5)(v)(C) of this section. The fleet-average value in effect at the time an automobile is added to the fleet is treated as the fair market value of the automobile for purposes of determining the Annual Lease Value of the automobile until the fleet-average value changes pursuant to paragraph (d)(5)(v)(B) of this section.

(E) *Use of the fleet-average rule by employees.* An employee can only use the fleet-average value if it is used by the employer. If an employer uses the fleet-average value, and the employee uses the special valuation rule of paragraph (d) of this section, the employee must use the fleet-average value.

(6) *Consistency rules*—(i) *Use of the automobile lease valuation rule by an employer.* Except as provided in paragraph (d)(5) (v)(B) of this section, an employer may adopt the automobile lease valuation rule of this paragraph (d) for an automobile only if the rule is adopted with respect to the later of the period that begins on January 1, 1987, or the first period in which the automobile is made available to an employee of the employer for personal use or, if the commuting valuation rule of paragraph (f) of this section is used when the automobile is first made available to an employee of the employer for personal use, the first period in which the commuting valuation rule is not used.

(ii) *An employer must use the automobile lease valuation rule for all subsequent periods.* Once the automobile lease valuation rule has been adopted for an automobile by an employer, the rule must be used by the employer for all subsequent periods in which the employer makes the automobile available to any employee, except that the employer may, for any period during which use of the automobile qualifies for the commuting valuation rule of paragraph (f) of this section, use the commuting valuation rule with respect to the automobile.

(iii) *Use of the automobile lease valuation rule by an employee.* Except as provided in paragraph (c)(2)(ii)(C) of this section, an employee may adopt the automobile lease valuation rule for an automobile only if the rule is adopted (A) by the employer and (B) with respect to the first period in which the automobile for which the employer (consistent with paragraph (d)(6)(i) of this section) adopted the rule is made available to that employee for personal use, or, if the commuting valuation rule of paragraph (f) of this section is used when the automobile is first made available to that employee for personal use, the first period in which the commuting valuation rule is not used.

(iv) *An employee must use the automobile lease valuation rule for all subsequent periods.* Once the automobile lease valuation rule has been adopted for an automobile by an employee, the rule must be used by the employee for all subsequent periods in which the automobile for which the rule is used is available to the employee, except that the employee may, for any period during which use of the automobile qualifies for use of the commuting valuation rule of paragraph (f) of this section and for which the employer uses the rule, use the commuting valuation rule with respect to the automobile.

(v) *Replacement automobiles.* Notwithstanding anything in this paragraph (D)(6) to the contrary, if the automobile lease valuation rule is used by an employer, or by an employer and an employee, with respect to a particular automobile, and a replacement automobile is provided to the employee for the primary purpose of reducing Federal taxes, then the employer, or the employer and the employee, using the rule must continue to use the rule with respect to the replacement automobile.

(e) *Vehicle cents-per-mile valuation rule*—(1) *In general*—(i) *General rule.* Under the vehicle cents-per-mile valuation rule of this paragraph (e), if an employer provides an employee with the use of a vehicle that (A) the employer reasonably expects will be regularly used in the employer's trade or business throughout the calendar year (or such shorter period as the vehicle may be owned or leased by the employer) or (B) satisfies the requirements of paragraph (e)(1)(ii) of this section, the value of the benefit provided in the calendar year is the standard mileage rate provided in the applicable Revenue Ruling or Revenue Procedure (“cents-per-mile rate”) multiplied by the total number of miles the vehicle is driven by the employee for personal purposes. For 1985, the standard mileage rate is 21 cents per mile for the first 15,000 miles and 11 cents per mile for all miles over 15,000. See Rev. Proc. 85–49. The standard mileage rate must be applied to personal miles independent of business miles. Thus, for example, if an employee drives 20,000 personal miles and 35,000 business miles in 1985, the value of the personal use of the vehicle is $3,700 (15,000×$.21+5,000×$.11). For purposes of this section, the use of a vehicle for personal purposes is any use of the vehicle other than use in the employee's trade or business of being an employee of the employer. Infrequent use of the vehicle, such as for trips to the airport or between the employer's multiple business premises, does not constitute regular use of the vehicle in the employer's trade or business.

(ii) *Mileage rule.* A vehicle satisfies the requirements of this paragraph (e)(1)(ii) in a calendar year if (A) it is actually driven at least 10,000 miles in the year, and (B) use of the vehicle during the year is primarily by employees. For example, if a vehicle is used by only one employee during the year and that employee drives a vehicle at least 10,000 miles in a calendar year, such vehicle satisfies the requirements of this paragraph (e)(1)(ii) even if all miles driven by the employee are personal. The requirements of this paragraph (e)(1)(ii), however, will not be satisfied if during the year the vehicle is transferred among employees in such a way which enables an employee whose use was at a rate significantly less that 10,000 miles per year to meet the 10,000 mile threshold. Assume that an employee uses a vehicle for the first six months of the year and drives 2,000 miles, and that vehicle is then used by other employees who drive the vehicle 8,000 miles in the last six months of the year. Because the rate at which miles were driven in the first six months of the year would result in only 4,000 miles being driven in the year, and because the first employee did not use the vehicle during the last six months of the year, the requirements of this paragraph (e)(1)(ii) are not satisfied. The requirement of paragraph (e)(1)(ii)(B) of this section is deemed satisfied if employees use the vehicle on a consistent basis for commuting. If the employer does not own or lease the vehicle during a portion of the year, the 10,000 mile threshold is to be reduced proportionately to reflect the periods when the employer owned or leased the vehicle. For purposes of this paragraph (e)(1)(ii), use of the vehicle by an individual (other than the employee) whose use would be taxed to the employee is not considered use by the employee.

(iii) *Limitation on use of the vehicle cents-per-mile valuation rule.* The value of the use of an automobile (as defined in paragraph (d)(1)(ii) of this section) may not be determined under the vehicle cents-per-mile valuation rule of this paragraph (e) if the fair market value of the automobile (determined pursuant to paragraphs (d)(5) (i) through (iv) of this section as of the later of January 1, 1985, or the first date on which the automobile is made available to any employee of the employer for personal use) exceeds $12,800. No inference may be drawn from the promulgation or terms of this section concerning the application of law in effect prior to January 1, 1985.

(2) *Definition of vehicle.* For purposes of this paragraph (e), the term ‘‘vehicle’’ means any motorized wheeled vehicle manufactured primarily for use on public streets, roads, and highways. The term ‘‘vehicle’’ includes an automobile as defined in paragraph (d)(1)(ii) of this section.

(3) *Services included in, or excluded from, the cents-per-mile rate*—(i) *Maintenance and insurance included.* The cents-per-mile rate includes the fair market value of maintenance of, and insurance for, the vehicle. An employer may not reduce the cents-per-mile rate by the fair market value of any service included in the cents-per-mile rate but not provided by the employer. An employer or employee may take into account the services provided with respect to the automobile by valuing the availability of the automobile under the general valuation rules of paragraph (b) of this section.

(ii) *Fuel provided by the employer*—(A) *Miles driven in the United States, Canada, and Mexico.* With respect to miles driven in the United States, Canada, and Mexico, the cents-per-mile rate includes the fair market value of fuel provided by the employer. If fuel is not provided by the employer, the cents-per-mile rate may be reduced by no more than 5.5 cents or the amount specified in any applicable Revenue Ruling or Revenue Procedure. For purposes of this section, the United States includes the United States and its territories.

(B) *Miles driven outside the United States, Canada, and Mexico.* With respect to miles driven outside the United States, Canada, and Mexico, the fair market value of fuel provided by the employer is not reflected in the cents-per-mile rate. Accordingly, the cents-per-mile rate may be reduced but by no more than 5.5 cents or the amount specified in any applicable Revenue Ruling or Revenue Procedure. If the employer provides the fuel in kind, it must be valued based on all the facts and circumstances. If the employer reimburses the employee for the cost of fuel or allows the employee to charge the employer for the cost of fuel, the fair market value of the fuel is generally the amount of the actual reimbursement or the amount charged, provided the purchase of fuel is at arm’s length.

(4) *Valuation of personal use only.* The vehicle cents-per-mile valuation rule of this paragraph (e) may only be used to value the miles driven for personal purposes. Thus, the employer must include an amount in an employee’s income with respect to the use of a vehicle that is equal to the product of the number of personal miles driven by the employee and the appropriate cents-per-mile rate. The employer may not include in income a greater or lesser amount; for example, the employer may not include in income 100 percent (all business and personal miles) of the value of the use of the vehicle. The term ‘‘personal miles’’ means all miles driven by the employee except miles

driven by the employee is the employee's trade or business of being an employee of the employer.

(5) *Consistency rules*—(i) *Use of the vehicle cents-per-mile valuation rule by an employer.* An employer must adopt the vehicle cents-per-mile valuation rule of this paragraph (e) for a vehicle by the later of the period that begins on January 1, 1987, or the first period in which the vehicle is used by an employee of the employer for personal use or, if the commuting valuation rule of paragraph (f) of this section is used when the vehicle is first used by an employee of the employer for personal use, the first period in which the commuting valuation rule is not used.

(ii) *An employer must use the vehicle cents-per-mile valuation rule for all subsequent periods.* Once the vehicle cents-per-mile valuation rule has been adopted for a vehicle by an employer, the rule must be used by the employer for all subsequent periods in which the vehicle qualifies for use of the rule, except that (A) the employer may, for any period during which use of the vehicle qualifies for the commuting valuation rule of paragraph (f) of this section, use the commuting valuation rule with respect to the vehicle, and (B) if the employer elects to use the automobile lease valuation rule of paragraph (d) of this section for a period in which the vehicle does not qualify for use of the vehicle cents-per-mile valuation rule, then the employer must comply with the requirements of paragraph (d)(6) of this section. If the vehicle fails to qualify for use of the vehicle cents-per-mile valuation rule during a subsequent period, the employer may adopt for such subsequent period and thereafter any other special valuation rule for which the vehicle then qualifies. For purposes of paragraph (d)(6) of this section, the first day on which an automobile with respect to which the vehicle cents-per-mile rule had been used fails to qualify for use of the vehicle cents-per-mile valuation rule may be deemed to be the first day on which the automobile is available to an employee of the employer for personal use.

(iii) *Use of the vehicle cents-per-mile valuation rule by an employee.* An employee may adopt the vehicle cents-per-mile valuation rule for a vehicle only if the rule is adopted (A) by the employer and (B) with respect to the first period in which the vehicle for which the employer (consistent with paragraph (e)(5)(i) of this section) adopted the rule is available to that employee for personal use or, if the commuting valuation rule of paragraph (f) of this section is used by both the employer and the employee when the vehicle is first used by an employee for personal use, the first period in which the commuting valuation rule is not used.

(iv) *An employee must use the vehicle cents-per-mile valuation rule for all subsequent periods.* Once the vehicle cents-per-mile valuation rule has been adopted for a vehicle by an employee, the rule must be used by the employee for all subsequent periods of personal use of the vehicle by the employee for which the rule is used by the employer, except that the employee may, for any period during which use of the vehicle qualifies for use of the commuting valuation rule of paragraph (f) of this section and for which such rule is used by the employer, use the commuting valuation rule with respect to the vehicle.

(v) *Replacement vehicles.* Notwithstanding anything in this paragraph (e)(5) to the contrary, if the vehicle cents-per-mile valuation rule is used by an employer, or by an employer and an employee, with respect to a particular vehicle, and a replacement vehicle is provided to the employee for the primary purpose of reducing Federal taxes, then the employer, or the employer and the employee, using the rule must continue to use the rule with respect to the replacement vehicle if the replacement vehicle qualifies for use of the rule.

(f) *Commuting valuation rule*—(1) *In general.* Under the commuting valuation rule of this paragraph (f), the value of the commuting use of an employer-provided vehicle may be determined pursuant to paragraph (f)(3) of this section if the following criteria are met by the employer and employees with respect to the vehicle:

(i) The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business and is used in the employer's trade or business;

(ii) For bona fide noncompensatory business reasons, the employer requires the employee to commute to and/or from work in the vehicle;

(iii) The employer has established a written policy under which the employee may not use the vehicle for personal purposes, other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home);

(iv) Except for de minimis personal use, the employee does not use the vehicle for any personal purpose other than commuting; and

(v) The employee required to use the vehicle for commuting is not a control employee of the employer (as defined in paragraphs (f) (5) and (6) of this section).

If the vehicle is a chauffeur-driven vehicle, the commuting valuation rule of this paragraph (f) may not be used to value the commuting use of any passenger who commutes in the vehicle. The rule may be used, however, to value the commuting use of the chauffeur. Personal use of a vehicle is all use of the vehicle by the employee that is not used in the employee's trade or business of being an employee of the employer.

(2) *Special rules.* Notwithstanding anything in paragraph (f)(1) of this section to the contrary, the following special rules apply—

(i) *Written policy not required in 1985.* The policy described in paragraph (f)(1)(iii) of this section prohibiting personal use need not be written with respect to the commuting use which occurs prior to January 1, 1986;

(ii) *Commuting use during 1985.* For commuting use that occurs after December 31, 1984, but before January 1, 1986, the restrictions of paragraph (f)(1)(v) of this section shall be applied by substituting ''an employee who is an officer or a five-percent owner of the employer'' in lieu of ''a control employee''. For purposes of determining who is a five-percent owner, any individual who owns (or is considered as owning) five or more percent of the fair market value of an entity (the ''owned entity'') is considered a five-percent owner of all entities that would be aggregated with the owned entity under the rules of section 414 (b), (c), or (m). An employee who is an officer of an employer shall be treated as an officer of all entities treated as a single employer pursuant to section 414 (b), (c), or (m). The definitions provided in paragraphs (f)(5)(i) and (f)(6) of this section may be used to define an officer; and

(iii) *Control employee exception.* If the vehicle in which the employee is required to commute is not an automobile as defined in paragraph (d)(1)(ii) of this section, the restrictions of paragraph (f)(1)(v) of this section do not apply.

(3) *Commuting value*—(i) *$1.50 per one-way commute.* If the requirements of this paragraph (f) are satisfied, the value of the commuting use of an employer-provided vehicle is $1.50 per one-way commute (e.g., from home to work or from work to home).

(ii) *Value per employee.* If there is more than one employee who commutes in the vehicle, such as in the case of an employer-sponsored car pool, the amount includible in the income of each employee is $1.50 per one-way commute. Thus, the amount includible for each round-trip commute is $3.00 per employee.

(4) *Definition of vehicle.* For purposes of this paragraph (f), the term ''vehicle'' means any motorized wheeled vehicle manufactured primarily for use on public streets, roads, and highways. The term ''vehicle'' includes an automobile as defined in paragraph (d)(1)(ii) of this section.

(5) *Control employee defined—Non-government employer.* For purposes of this paragraph (f), a control employee of a non-government employer is any employee—

(i) Who is a Board- or shareholder-appointed, confirmed, or elected officer of the employer,

(ii) Who is a director of the employer, or

(iii) Who owns a one-percent or greater equity, capital, or profits interest in the employer.

For purposes of determining who is a one-percent owner under paragraph (f)(5)(iii) of this section, any individual who owns (or is considered as owning under section 318(a) or principles similar to section 318(a) for entities other than corporations) one percent or more of the fair market value of an entity (the ‘‘owned entity’’) is considered a one-percent owner of all entities which would be aggregated with the owned entity under the rules of section 414 (b), (c), or (m). An employee who is an officer of an employer shall be treated as an officer of all entities treated as a single employer pursuant to section 414 (b), (c) or (m).

(6) *Control employee defined—Government employer.* For purposes of this paragraph (f), a control employee of a government employer if any—

(i) Elected official,

(ii) Federal employee who is appointed by the President and confirmed by the Senate. In the case of commissioned officers of the United States Armed Forces, an officer is any individual with the rank of brigadier general or above or the rank of rear admiral (lower half) or above; or

(iii) State or local executive officer comparable to the individuals described in paragraph (f)(6) (i) and (ii) of this section.

For purposes of this paragraph (f), the term ‘‘government’’ includes any Federal, state, or local governmental unit, and any agency or instrumentality thereof.

(g) *Non-commercial flight valuation rule*—(1) *In general.* Under the non-commercial flight valuation rule of this paragraph (g), if an employee is provided with a flight on an employer-provided aircraft, the value of the flight is calculated using the aircraft valuation formula provided in paragraph (g)(5) of this section. Except as otherwise provided, for purposes of this paragraph (g), a flight provided to a person whose flight would be taxable to an employee as the recipient is referred to as provided to the employee, and a flight taken by such person is considered a flight taken by the employee.

(2) *Eligible flights and eligible aircraft.* The valuation rule of this paragraph (g) may be used to value flights on all employer-provided aircraft, including helicopters. The valuation rule of this paragraph (g) may be used to value international as well as domestic flights. The valuation rule of this paragraph (g) may not be used to value a flight on any commercial aircraft on which air transportation is sold to the public on a per-seat basis. For a special valuation rule relating to certain flights on commercial aircraft, see paragraph (h) of this section.

(3) *Definition of a flight*—(i) *General rule.* Except as otherwise provided in paragraph (g)(3)(iii) of this section (relating to intermediate stops), for purposes of this paragraph (g), an individual’s flight is the distance (in statute miles) between the place at which the individual boards the aircraft and the place at which the individual deplanes.

(ii) *Valuation of each flight.* Under the valuation rule of this paragraph (g), value is determined separately for each flight. Thus, a round-trip is comprised of at least two flights. For example, an employee who takes a personal trip on an employer-provided aircraft from New York, New York to Denver, Colorado, Denver to Los Angeles, California, and Los Angeles to New York has taken three flights and must apply the aircraft valuation formula separately to each flight. The value of a flight must be determined on a passenger-by-passenger basis. For example, if an individual accompanies an employee and the flight taken by the individual would be taxed to the employee, the employee would be taxed on the special rule value of the flight by the employee and by the individual.

(iii) *Intermediate stop.* If the primary purpose of a landing is necessitated by weather conditions, by an emergency, for purposes of refueling or obtaining other services relating to the aircraft, or for purposes of the employer’s business unrelated to the employee whose flight is being valued (‘‘an intermediate stop’’), the distance between the place at which the trip originates and the place at which the intermediate stop occurs is not considered a flight. For example, assume that an employee’s trip originates in St. Louis, Missouri, on route to Seattle, Washington, but, because of weather conditions, the aircraft lands in Denver, Colorado, and the employee stays in Denver overnight. Assume further that the next day the aircraft flies to Seattle where the employee deplanes. The employee's flight is the distance between the airport in St. Louis and the airport in Seattle. Assume that a trip originates in New York, New York, with five passengers and makes an intermediate stop in Chicago, Illinois, before going on to Los Angeles, California. If one of the five passengers deplanes in Chicago, the distance of that passenger's flight would be the distance between the airport in New York and the airport in Chicago. The intermediate stop is disregarded when measuring the flights taken by each of the other passengers. Their flights would be the distance between the airport in New York and the airport in Los Angeles.

(4) *Personal and non-personal flights*—(i) *In general.* The valuation rule of this paragraph (g) applies to personal flights on employer-provided aircraft. A personal flight is one the value of which is not excludable under another section of subtitle A, such as under section 132(d) (relating to a working condition fringe). However, solely for purposes of paragraphs (g)(4)(ii) and (g)(4)(iii) of this section, references to personal flights do not include flights a portion of which would not be excludable by reason of section 274.(c).

(ii) *Trip primarily for employer's business.* If an employee combines, in one trip, personal and business flights on an employer-provided aircraft and the employee's trip is primarily for the employer's business (see § 1.162–2(b)(2)), the employee must include in income the excess of the value of all the flights that comprise the trip over the value of the flights that would have been taken had there been no personal flights but only business flights. For example, assume that an employee flies on an employer-provided aircraft from Chicago, Illinois to Miami, Florida, for the employer's business and that from Miami the employee flies on the employer-provided aircraft to Orlando, Florida, for personal purposes and then flies back to Chicago. Assume further that the primary purpose of the trip is for the employer's business. The amount includible in income is the excess of the value of the three flights (Chicago to Miami, Miami to Orlando, and Orlando to Chicago), over the value of the flights that would have been taken had there been no personal flights but only business flights (Chicago to Miami and Miami to Chicago).

(iii) *Primarily personal trip.* In an employee combines, in one trip, personal and business flights on an employer-provided aircraft and the aircraft's trip is primarily personal (see § 1.162–2(b)(2)), the amount includible in the employee's income is the value of the personal flights that would have been taken had there been no business flights but only personal flights. For example, assume that an employee flies on an employer-provided aircraft from San Francisco, California, to Los Angeles, California, for the employer's business and that from Los Angeles the employee flies on an employer-provided aircraft to Palm Springs, California, primarily for personal reasons and then flies back to San Francisco. Assume further that the primary purpose of the trip is personal. The amount includible in the employee's income is the value of personal flights that would have been taken had there been no business flights but only personal flights (San Francisco to Palm Springs and Palm Springs to San Francisco).

(iv) *Application of section 274(c).* The value of employer-provided travel outside the United States away from home may not be excluded from the employee's gross income as a working condition fringe, by either the employer or the employee, to the extent not deductible by reason of section 274(c). The valuation rule of this paragraph (g) applies to that portion of the value of any flight not excludable by reason of section 274(c). Such value must be included in income in addition to the amounts determined under paragraphs (g)(4)(ii) and (g)(4)(iii) of this section.

(v) *Flight by individuals who are not personal guests.* If an individual who is not an employee of the employer providing the aircraft is on a flight, and the individual is not the personal guest of any employee, the flight by the individual is not taxable to any employee of the employer providing the aircraft. The rule in the preceding sentence applies where the individual is provided the flight by the employer for non-compensatory business reasons of the employer. For example, assume that G, and employee of company Y, accompanies A, an employee of company X, on company X's aircraft for the purpose of inspecting land under consideration for purchase by company X from company Y. The flight by G is not taxable to A.

(5) *Aircraft valuation formula.* Under the valuation rule of this paragraph (g), the value of a flight is determined by multiplying the base aircraft valuation formula for the period during which the flight was taken by the appropriate aircraft multiple (as provided in paragraph (g)(7) of this section) and then adding the applicable terminal charge. The base aircraft valuation formula (also known as the Standard Industry Fare Level formula or SIFL) in effect on June 30, 1985, is as follows: ($.1402 per mile for the first 500 miles, $.1069 per mile for miles between 501 and 1500, and $.1028 per mile for miles over 1500). The terminal charge in effect on June 30, 1985, is $25.62. The SIFL cents-per-mile rates in the formula and the terminal charge are calculated by the Department of Transportation and are revised semi-annually.

(6) *SIFL formula in effect for a particular flight.* For purposes of this paragraph (g), in determining the value of a particular flight during the first six months of a calendar year, the SIFL formula (and terminal charge) in effect on December 31 of the preceding year applies, and in determining the value of a particular flight during the last six months of a calendar year, the SIFL formula (and terminal charge) in effect on June 30 of that year applies. The following is the SIFL formula in effect on December 31, 1984: ($.1480 per mile for the first 500 miles, $.1128 per mile for miles between 501 and 1500, and $.1085 per mile for miles over 1500). The terminal charge in effect on December 31, 1984, is $27.05.

(7) *Aircraft multiples*—(i) *In general.* The aircraft multiples are based on the maximum certified takeoff weight of the aircraft. For purposes of applying the aircraft valuation formula described in paragraph (g)(5) of this section, the aircraft multiples are as follows:

[In percent]

Maximum certified takeoff weight of the aircraft	Aircraft multiple for a—	
	Control employee	Non-control employee
6,000 lbs. or less	62.5	15.6
6,001 to 10,000 lbs	125.0	23.4
10,001 to 25,000 lbs	300.0	31.3
25,001 lbs. or more	400.0	31.3

(ii) *Flights treated as provided a to control employee.* Except as provided in paragraph (g)(10) of this section, any flight provided to an individual whose flight would be taxable to a control employee (as defined in paragraph (g)(8) and (9) of this section) as the recipient shall be valued as if such flight has been provided to that control employee. For example, assume that the chief executive officer of an employer, his spouse, and his two children fly on an employer-provided aircraft for personal purposes. Assume further that the maximum certified takeoff weight of the aircraft is 12,000 lbs. The amount includible in the employee's income is 4 x ((300 percent x base aircraft valuation formula) plus the applicable terminal charge).

(8) *Control employee defined—Non-government employer.* For purposes of this paragraph (g), a control employee of a non-government employer is any employee—

(i) Who is a Board- or shareholder-appointed, confirmed, or elected officer of the employer, limited to the lesser of (A) one-percent of all employees (increased to the next highest integer, if not an integer) or (B) ten employees;

(ii) Whose compensation equals or exceeds the compensation of the top one percent most highly-paid employees of the employer (increased to the next highest integer, if not an integer) limited to a maximum of 25 employees;

(iii) Who owns a ten-percent or greater equity, capital or profits interest in the employer; or

(iv) Who is a director of the employer.

For purposes of this paragraph (g), any employee who is a family member (within the meaning of section 267(c)(4)) of a control employee is also a control employee. Pursuant to this paragraph (g)(8), an employee may be a control employee under more than one of the requirements listed in paragraphs (g)(8) (i) through (iv) of this section. For example, an employee may be both an officer under paragraph (g)(8)(i) of this section and a highly-paid employee under paragraph (g)(8)(ii) of this section. In this case, for purposes of the officer limitation rule of paragraph (g)(8)(i) of this section and the highly-paid employee limitation rule of paragraph (g)(8)(ii) of this section, the employee would be counted as reducing both such limitation rules. In no event shall an employee whose compensation is less than $50,000 be a control employee under paragraph (g)(8)(ii) of this section. For purposes of determining who is a ten-percent owner under paragraph (g)(8)(iii) of this section, any individual who owns (or is considered as owning under section 318(a) or principles similar to section 318(a) for entities other than corporations) ten percent or more of the fair market value of an entity (the ''owned entity'') is considered a ten-percent owner of all entities which would be aggregated with the owned entity under the rules of section 414 (b), (c), or (m). For purposes of determining who is an officer under paragraph (g)(8)(i) of this section, notwithstanding anything in this section to the contrary, if the employer would be aggregated with other employers under the rules of section 414 (b), (c), or (m), the officer definition and the limitations are applied to each separate employer rather than to the aggregated employer. If applicable, the officer limitation rule of paragraph (g)(8)(i) of this section is applied to employees in descending order of their compensation. Thus, if an employer has 11 board-appointed officers, the employee with the least compensation of those officers would not be an officer under paragraph (g)(8)(i) of this section. For purposes of this paragraph (g), the term ''compensation'' means the amount reported on a Form W–2 as income for the prior calendar year. Compensation includes all amounts received from all entities treated as a single employer under section 414 (b), (c), or (m).

(9) *Control employee defined—Government.* For purposes of this paragraph (g), a control employee of a government employer is any—

(i) Elected officials;

(ii) Federal employee who is appointed by the President and confirmed by the Senate. In the case of commissioned officers of the United States Armed Forces, an officer is any individual with the rank or brigadier general or above or the rank of rear admiral (lower half) or above; or

(iii) State or local executive officer comparable to the individuals in paragraph (g)(9)(i) and (ii) of this section.

For purposes of this paragraph (g), the term ''government'' includes any Federal, state, or local government unit, and any agency or instrumentality thereof.

(10) *Seating capacity rule*—(i) *In general.* Where 50 percent of more of the regular passenger seating capacity of an aircraft (as used by the employer) is occupied by individuals whose flights are primarily for the employer's business (and whose flights are excludable from income under section 132(d)), the value of a flight on that aircraft by any employee who is not flying primarily for the employer's business (or who is flying primarily for the employer's business but the value of whose flight is not excludable under section 132(d) by reason of section 274(c)) is deemed to be zero. See § 1.132–5T which limits the exclusion under section 132(d) to situations where the employee receives the flight in connection with the performance of services for the employer providing the aircraft. For purposes of this paragraph (g)(10), the term ''employee'' includes only employees and partners of the employer providing the aircraft and does not include independent contractors and directors of the employer.

For purposes of this paragraph (g)(10), the second sentence of paragraph (g)(1) of this section will not apply. Instead, a flight taken by an individual who is either treated as an employee pursuant to section 132(f)(1) or whose flight is treated as a flight taken by an employee pursuant to section 132(f)(2) is considered a flight taken by an employee. If (A) a flight is considered taken by an individual other than an employee (as defined in this paragraph (g)(10)), (B) the value of that individual's flight is not excludable under section 132(d), and (C) the seating capacity rule of this paragraph (g)(10) otherwise applies, then the value of the flight provided to such an individual is the value of a flight provided to a non-control employee (even if the individual who would be taxed on the value of such individual's flight is a control employee).

(ii) *Application of 50-percent test to multiple flights.* The seating capacity rule of this paragraph (g)(10) must be met both at the time the individual whose flight is being valued boards the aircraft and at the time the individual deplanes. For example, assume that employee A boards an employer-provided aircraft for personal purposes in New York, New York, and that at that time 80 percent of the regular passenger seating capacity of the aircraft is occupied by individuals whose flights are primarily for the employer's business (and whose flights are excludable from income under section 132(d)) (''the business passengers''). If the aircraft flies directly to Hartford, Connecticut where all of the passengers, including A, deplane, the requirements of the seating capacity rule of this paragraph (g)(10) have been satisfied. If instead, some of the passengers, including A, remain on the aircraft in Hartford and the aircraft continues on to Boston, Massachusetts, where they all deplane, the requirements of the seating capacity rule of this paragraph (g)(10) will not be satisfied unless at least 50 percent of the seats comprising the aircraft's regular passenger seating capacity were occupied by the business passengers at the time A deplanes in Boston.

(iii) *Regular passenger seating capacity.* The regular passenger seating capacity of an aircraft is the maximum number of seats that have at any time been on the aircraft (while owned or leased by the employer). Except to the extent excluded pursuant to paragraph (g)(10)(v) of this section, regular seating capacity includes all seats which may be occupied by members of the flight crew. It is irrelevant that on a particular flight, less than the maximum number of seats are available for use, because, for example, some of the seats are removed. When determining the maximum number of seats, those seats that cannot at any time be legally used during takeoff and are not any time used during takeoff are not counted.

(iv) *Examples.* The rules of paragraph (g)(10)(iii) of this section are illustrated by the following examples:

Example (1). Employer A and employer B order the same aircraft, except that A orders it with 10 seats and B orders it with eight seats. A always uses its aircraft as a 10-seat aircraft; B always uses its aircraft as an eight-seat aircraft. The regular passenger seating capacity of A's aircraft is 10 and of B's aircraft is eight.

Example (2). Assume the same facts as in example (1), except that whenever A's chief executive officer and spouse use the aircraft eight seats are removed. Even if substantially all of the use of the aircraft is by the chief executive officer and spouse the regular passenger seating capacity of the aircraft is 10.

Example (3). Assume the same facts as in example (1), except that whenever more than eight people want to fly in B's aircraft, two extra seats are added. Even if substantially all of the use of the aircraft occurs with eight seats, the regular passenger seating capacity of the aircraft is 10.

(v) *Seats occupied by flight crew.* When determining the regular passenger seating capacity of an aircraft, any seat occupied by a member of the flight crew (whether or not such individual is an employee of the employer providing the aircraft) shall not be counted, unless the purpose of the flight by such individual is not primarily to serve as a member of the flight crew. If the seat occupied by a member of the flight crew is not counted as a passenger seat pursuant to the previous sentence, such member of the flight crew is disregarded in applying the 50 percent test described in the first sentence of paragraph (g)(10)(i) of this section. For example, assume that, prior to the application of this paragraph (g)(10)(v), the regular passenger seating capacity of an aircraft is two seats.

Assume further that an employee pilots the aircraft and that the employee's flight is not primarily for the employer's business. If the employee's spouse occupies the other seat for personal purposes, the seating capacity rule is not met and the value of both flights must be included in the employee's income. If, however, the employee's flight were primarily for the employer's business (unrelated to serving as a member of the flight crew), then the seating capacity rule is met and the value of the flight for the employee's spouse is deemed to be zero. If the employee's flight were primarily to serve as a member of the flight crew, then the seating capacity rule is not met and the value of a flight by any passenger for primarily personal reasons is not deemed to be zero.

(11) *Erroneous use of the non-commercial flight valuation rule*—(i) *In general.* If the non-commercial flight valuation rule of this paragraph (g) is used by an employer or a control employee, as the case may be, on a return as originally filed, on the grounds that either the control employee is not in fact a control employee, or that the aircraft is within a specific weight classification, and either position is subsequently determined to be erroneous, the valuation rule of this paragraph (g) (including paragraph (g)(13) of this section) is not available to value the flight taken by that control employee by the person or persons taking the erroneous position. With respect to the weight classifications, the previous sentence does not apply if the position taken is that the weight of the aircraft is greater than it is subsequently determined to be. If, with respect to a flight by a control employee, the seating capacity rule of paragraph (g)(10) of this section is used by an employer or the control employee, as the case may be, on a return as originally filed, and it is subsequently determined that the requirements of paragraph (g)(10) of this section were not met, the valuation rule of this paragraph (g) (including paragraph (g)(13) of this section) is not available to value the flight taken by that control employee by the person or persons taking the erroneous position.

(ii) *Value of flight excluded as a working condition fringe.* If either an employer or an employee, on a return as originally filed, excludes from the employee's income or wages the value of a flight on the grounds that the flight was excludable as a working condition fringe under section 132, and that position is subsequently determined to be erroneous, the valuation rule of this paragraph (g) (including paragraph (g)(13) of this section) is not available to value the flight taken by that employee by the person or persons taking the erroneous position.

(12) *Consistency rules*—(i) *Use by the employer.* Except as otherwise provided in paragraphs (g)(11) and (g)(13)(iv) of this section, if the non-commercial flight valuation rule of this paragraph (g) is used by an employer to value flights provided in a calendar year, the rule must be used to value all flights provided in the calendar year.

(ii) *Use by the employee.* Except as otherwise provided in paragraphs (g)(11) and (g)(13)(iv) of this section, if the non-commercial flight valuation rule of this paragraph (g) is used by an employee to value a flight taken in a calendar year, the rule must be used to value all flights taken in the calendar year.

(13) *Transitional valuation rule*—(i) *In general.* If the value of a flight determined under this paragraph (g)(13) is lower than the value of the flight otherwise determined under paragraph (g) of this section, the value of the flight is the lower amount. The transitional valuation rule of this paragraph (g)(13) is available only for flights provided after December 31, 1984, and before January 1, 1986.

(ii) *Transitional valuation rule aircraft multiples.* The appropriate aircraft multiples under the transitional valuation rule are as follows:

(A) 125 percent of the base aircraft valuation formula, plus the applicable terminal charge, for any flight by any employee who is not a key employee (as defined in paragraph (g)(13)(iii) of this section.)

(B) 125 percent of the base aircraft valuation formula, plus the applicable terminal charge, for a flight by a key employee if there is a primary business purpose of the trip by the aircraft. For purposes of this paragraph (g)(13)(ii)(B), entertaining an employee or other individual is not a business purpose.

(C) 600 percent of the base aircraft valuation formula, plus the applicable terminal charge, for a flight by a key employee if there is not primary business for the trip by the aircraft.

Where there is no business purpose for the trip by the aircraft, the alternative valuation rule may not be used to value a flight by a key employee. For purposes of this section, compensating an employee is not a business purpose.

(iii) *Key employee defined.* A ‘‘key employee’’ is any employee who is a five-percent owner or an officer of the employer, or who, with respect to a particular trip by the aircraft, controls the use of the aircraft. For purposes of determining who is a five-percent owner, any individual who owns (or is considered as owning) five or more percent of the fair market value of an entity (the ‘‘owned entity’’) is considered a five-percent owner of all entities that would be aggregated with the owned entity under the rules of section 414(b), (c), or (m).

(iv) *Erroneous use of transitional valuation rule.* If the transitional valuation rule is used by an employer or a key employee, as the case may be, on a return as originally filed, on the grounds that—

(A) The key employee is not in fact a key employee,

(B) An aircraft trip had a primary business purpose, or

(C) An aircraft trip had some business purpose,

and such position is subsequently determined to be erroneous, neither the transitional valuation rule nor the non-commercial flight valuation rule of this paragraph (g) is available to value such flight taken by that key employee by the person or persons taking the erroneous position.

(h) *Commercial flight valuation rule*—(1) *In general.* Under the commercial flight valuation rule of this paragraph (h), the value of a space-available flight (as defined in paragraph (h)(2) of this section) on a commercial aircraft is 25 percent of the actual carrier’s highest unrestricted coach fare in effect for the particular flight taken.

(2) *Space-available flight.* The commercial flight valuation rule of this paragraph (h) is available to value a space-available flight. The term ‘‘space-available flight’’ means a flight on a commercial aircraft (i) for which the airline (the acutal carrier) incurs no substantial additional cost (including forgone revenue) determined without regard to any amount paid for the flight and (ii) which is subject to the same types of restrictions customarily associated with flying on an employee ‘‘standby’’ or ‘‘space-available’’ basis. A flight may be a space-available flight even if the airline that is the actual carrier is not the employer of the employee.

(3) *Commercial aircraft.* If the actual carrier does not offer, in the ordinary course of its business, air transportation to customers on a per-seat basis, the commercial flight valuation rule of this paragraph (h) is not available. Thus, if, in the ordinary course of its line of business, the employer only offers air transportation to customers on a charter basis, the commerical flight valuation rule of this paragraph (h) may not be used to value a space-available flight on the employer’s aircraft. Similarly, if, in the ordinary course of its line of business, an employer only offers air transportation to customers for the transport of cargo, the commercial flight valuation rule of this paragraph (h) may not be used to value a space-available flight on the employer’s aircraft.

(4) *Timing of inclusion.* The date that the flight is taken is the relevant date for purposes of applying section 61(a)(1) and this section to a space-available flight on a commercial aircraft. The date of purchase or issuance of a pass or ticket is not relevant. Thus, this section applies to a flight taken on or after January 1, 1985, regardless of the date on which the pass or ticket for the flight was purchased or issued.

(5) *Consistency rules*—(i) *Use by employer.* If the commercial flight valuation rule of this paragraph (h) is used by an employer to value flights provided in a calendar year, the rule must be used to value all flights provided in the calendar year.

(ii) *Use by employee.* If the commercial flight valuation rule of this paragraph (h) is used by an employee to value a flight taken in a calendar year, the rule must be used to value all flights taken by such employee in the calendar year.

(i) [Reserved]

(j) *Valuation of meals provided at an employer-operated eating facility for employees*—(1) *In general.* The valuation rule of this paragraph (j) may be used to value a meal provided at an employer-operated eating facility for employees (as defined in §1.132–7T). For rules relating to an exclusion for the value of meals provided at an employer-operated eating facility for employees, see § 1.132–7T.

(2) *Valuation formula*—(i) *In general.* The value of all meals provided at an employer-operated eating facility for employees during a calendar year is 150 percent of the direct operaitng costs of the eating facility (''total meal value''). For purposes of this paragraph (j), the definition of direct operating costs provided in § 1.132–7T applies. The taxable value of meals provided at an eating facility may be determined in two ways. The ''individual meal subsidy'' may be treated as the taxable value of a meal provided at the eating facility (see paragraph (j)(2)(ii) of this section). Alternatively, the employer may allocate the ''total meal subsidy'' among employees (see paragraph (j)(2)(iii) of this section).

(ii) *''Individual meal subsidy'' defined.* The ''individual meal subsidy'' is determined by multiplying the price charged for a particular meal by a fraction, the numerator of which is the total meal value and the denominator of which is the gross receipts of the eating facility, and then subtracting the amount paid for the meal. The taxable value of meals provided to a particular employee during a calendar year, therefore, is the sum of the individual meal subsidies provided to the employee during the calendar year.

(iii) *Allocation of ''total meal subsidy.''* Instead of using the individual meal value method, the employer may allocate the ''total meal subsidy'' (total meal value less the gross receipts of the facility) among employees in any manner reasonable under the circumstances.

[T.D. 8063, 50 FR 52285, Dec. 23, 1985, as amended by T.D. 8256, 54 FR 28582, July 6, 1989; T.D. 8457, 57 FR 62195, Dec. 30, 1992]

§ 1.61–3 Gross income derived from business.

(a) *In general.* In a manufacturing, merchandising, or mining business, ''gross income'' means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Gross income is determined without subtraction of depletion allowances based on a percentage of income to the extent that it exceeds cost depletion which may be required to be included in the amount of inventoriable costs as provided in § 1.471–11 and without subtraction of selling expenses, losses or other items not ordinarily used in computing costs of goods sold or amounts which are of a type for which a deduction would be disallowed under section 162 (c), (f), or (g) in the case of a business expense. The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer. Thus, for example, an amount cannot be taken into account in the computation of cost of goods sold any earlier than the taxable year in which economic performance occurs with respect to the amount (see § 1.446–1(c)(1)(ii)).

(b) *State contracts.* The profit from a contract with a State or political subdivision thereof must be included in gross income. If warrants are issued by a city, town, or other political subdivision of a State, and are accepted by the contractor in payment for public work done, the fair market value of such warrants should be returned as income. If, upon conversion of the warrants into cash, the contractor does not receive and cannot recover the full value of the warrants so returned, he may deduct any loss sustained from his gross income for the year in which the warrants are so converted. If, however, he realizes more than the value of the warrants so returned, he must include the excess in his gross income for the year in which realized.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7207, 37 FR 20767, Oct. 5, 1972; T.D. 7285, 38 FR 26184, Sept. 19, 1973; T.D. 8408, 57 FR 12419, Apr. 10, 1992]

§ 1.61–4 Gross income of farmers.

(a) *Farmers using the cash method of accounting.* A farmer using the cash receipts and disbursements method of accounting shall include in his gross income for the taxable year—

(1) The amount of cash and the value of merchandise or other property received during the taxable year from the sale of livestock and produce which he raised,

(2) The profits from the sale of any livestock or other items which were purchased,

(3) All amounts received from breeding fees, fees from rent of teams, machinery, or land, and other incidental farm income,

(4) All subsidy and conservation payments received which must be considered as income, and

(5) Gross income from all other sources.

The profit from the sale of livestock or other items which were purchased is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale of purchased animals held for draft, breeding, or dairy purposes, the profits shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation allowed or allowable (determined in accordance with the rules applicable under section 1016(a) and the regulations thereunder). However, see section 162 and the regulations thereunder with respect to the computation of taxable income on other than the crop method where the cost of seeds or young plants purchased for further development and cultivation prior to sale is involved. Crop shares (whether or not considered rent under State law) shall be included in gross income as of the year in which the crop shares are reduced to money or the equivalent of money. See section 263A for rules regarding costs that are required to be capitalized.

(b) *Farmers using an accrual method of accounting.* A farmer using an accrual method of accounting must use inventories to determine his gross income. His gross income on an accrual method is determined by adding the total of the items described in subparagraphs (1) through (5) of this paragraph and subtracting therefrom the total of the items described in subparagraphs (6) and (7) of this paragraph. These items are as follows:

(1) The sales price of all livestock and other products held for sale and sold during the year;

(2) The inventory value of livestock and products on hand and not sold at the end of the year;

(3) All miscellaneous items of income, such as breeding fees, fees from the rent of teams, machinery, or land, or other incidental farm income;

(4) Any subsidy or conservation payments which must be considered as income;

(5) Gross income from all other sources;

(6) The inventory value of the livestock and products on hand and not sold at the beginning of the year; and

(7) The cost of any livestock or products purchased during the year (except livestock held for draft, dairy, or breeding purposes, unless included in inventory).

All livestock raised or purchased for sale shall be added in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Livestock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory (see subparagraphs (2), (6), and (7) of this paragraph) instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. When any livestock included in an inventory are sold, their cost must not be taken as an additional deduction in computing taxable income, because such deduction is reflected in the inventory. See the regulations under section 471. See section 263A for rules regarding costs that are required to be capitalized. Crop shares (whether or not considered rent under State law) shall be included in gross income as of the year in which the crop shares are reduced to money or the equivalent of money.

(c) *Special rules for certain receipts.* In the case of the sale of machinery, farm equipment, or any other property (except stock in trade of the taxpayer, or property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business), any excess of the proceeds of the sale over the adjusted basis of such property shall be included in the taxpayer's gross income for the taxable year in which such sale is made. See, however, section 453 and the regulations thereunder for special rules relating to certain installment sales. If farm produce is exchanged for merchandise, groceries, or the like, the market value of the article received in exchange is to be included in gross income. Proceeds of insurance, such as hail or fire insurance on growing crops, should be included in gross income to the extent of the amount received in cash or its equivalent for the crop injured or destroyed. See section 451(d) for special rule relating to election to include crop insurance proceeds in income for taxable year following taxable year of destruction. For taxable years beginning after July 12, 1972, where a farmer is engaged in producing crops and the process of gathering and disposing of such crops is not completed within the taxable year in which such crops are planted, the income therefrom may, with the consent of the Commissioner (see section 446 and the regulations thereunder), be computed upon the crop method. For taxable years beginning on or before July 12, 1972, where a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income therefrom may, with the consent of the Commissioner (see section 446 and the regulations thereunder), be computed upon the crop method. In any case in which the crop method is used, the entire cost of producing the crop must be taken as a deduction for the year in which the gross income from the crop is realized, and not earlier.

(d) *Definition of ''farm''.* As used in this section, the term ''farm'' embraces the farm in the ordinarily accepted sense, and includes stock, dairy, poultry, fruit, and truck farms; also plantations, ranches, and all land used for farming operations. All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated as farmers. For more detailed rules with respect to the determination of whether or not an individual is engaged in farming, see §1.175–3. For rules applicable to persons cultivating or operating a farm for recreation or pleasure, see sections 162 and 165, and the regulations thereunder.

(e) *Cross references.* (1) For election to include Commodity Credit Corporation loans as income, see section 77 and regulations thereunder.

(2) For definition of gross income derived from farming for purposes of limiting deductibility of soil and water conservation expenditures, see section 175 and regulations thereunder.

(3) For definition of gross income from farming in connection with declarations of estimated income tax, see section 6073 and regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7198, 37 FR 13679, July 13, 1972; T.D. 8729, 62 FR 44546, Aug. 22, 1997]

§1.61–5 Allocations by cooperative associations; per-unit retain certificates—tax treatment as to cooperatives and patrons.

(a) *In general.* Amounts allocated on the basis of the business done with or for a patron by a cooperative association, whether or not entitled to tax treatment under section 522, in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice or in some other manner disclosing to the patron the dollar amount allocated, shall be included in the computation of the gross income of such patron for the taxable year in which received to the extent prescribed in paragraph (b) of this section, regardless of whether the allocation is deemed, for the purpose of section 522, to be made at the close of a preceding taxable year of the cooperative association. The determination of the extent of taxability of such amounts is in no way dependent upon the method of accounting employed by the patron or upon the method, cash, accrual, or otherwise, upon which the taxable income of such patron is computed.

(b) *Extent of taxability.* (1) Amounts allocated to a patron on a patronage basis by a cooperative association with respect to products marketed for such patron, or with respect to supplies, equipment, or services, the cost of which was deductible by the patron under section 162 or section 212, shall be included in the computation of the gross income of such patron, as ordinary income, to the following extent:

(i) If the allocation is in cash, the amount of cash received.

(ii) If the allocation is in merchandise, the amount of the fair market value of such merchandise at the time of receipt by the patron.

(iii) If the allocation is in the form of revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or similar documents, the amount of the fair market value of such document at the time of its receipt by the patron. For purposes of this subdivision, any document containing an unconditional promise to pay a fixed sum of money on demand or at a fixed or determinable time shall be considered to have a fair market value at the time of its receipt by the patron, unless it is clearly established to the contrary. However, for purposes of this subdivision, any document which is payable only in the discretion of the cooperative association, or which is otherwise subject to conditions beyond the control of the patron, shall be considered not to have any fair market value at the time of its receipt by the patron, unless it is clearly established to the contrary.

(iv) If the allocation is in the form of capital stock, the amount of the fair market value, if any, of such capital stock at the time of its receipt by the patron.

(2) If any allocation to which subparagraph (1) of this paragraph applies is received in the form of a document of the type described in subparagraph (1) (iii) or (iv) of this paragraph and is redeemed in full or in part or is otherwise disposed of, there shall be included in the computation of the gross income of the patron, as ordinary income, in the year of redemption or other disposition, the excess of the amount realized on the redemption or other disposition over the amount previously included in the computation of gross income under such subparagraph.

(3)(i) Amounts which are allocated on a patronage basis by a cooperative association with respect to supplies, equipment, or services, the cost of which was not deductible by the patron under section 162 or section 212, are not includible in the computation of the gross income of such patron. However, in the case of such amounts which are allocated with respect to capital assets (as defined in section 1221) or property used in the trade or business within the meaning of section 1231, such amounts shall, to the extent set forth in subparagraph (1) of this paragraph, be taken into account by such patron in determining the cost of the property to which the allocation relates. Notwithstanding the preceding sentence, to the extent that such amounts are in excess of the unrecovered cost of such property, and to the extent that such amounts relate to such property which the patron no longer owns, they shall be included in the computation of the gross income of such patron.

(ii) If any patronage dividend is allocated to the patron in the form of a document of the type described in subparagraph (1) (iii) or (iv) of this paragraph, and if such allocation is with respect to capital assets (as defined in section 1221) or property used in the trade or business within the meaning of section 1231, any amount realized on the redemption or other disposition of such document which is in excess of the amount which was taken into account upon the receipt of the document by the patron shall be taken into account by such patron in the year of redemption or other disposition as an adjustment to basis or as an inclusion in the computation of gross income, as the case may be.

(iii) Any adjustment to basis in respect of an amount to which subdivision (i) or (ii) of this subparagraph applies shall be made as of the first day of the taxable year in which such amount is received.

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

Example (1). On July 1, 1959, P, a patron of a cooperative association, purchases a tractor for use in his farming business from such association for $2,200. The tractor has an estimated useful life of five years and an estimated salvage value of $200. P files his income tax returns on a calendar year basis and claims depreciation on the tractor for the year 1959 of $200 pursuant to his use of the straight-line method at the rate of $400 per year. On July 1, 1960, the cooperative association allocates to P with respect to his purchase of the tractor a dividend of $300 in cash. P will reduce his depreciation allowance with respect to the tractor for 1960 (and subsequent taxable years) to $333.33, determined as follows:

Cost of tractor, July 1, 1959		$2,200
Less:		
Depreciation for 1959 (6 mos.)	$200	
Adjustment as of Jan. 1, 1960, for cash patronage dividend	300	
Salvage value	200	
	700	
Basis for depreciation for the remaining 4½ years of estimated life		1,500
Basis for depreciation divided by the 4½ years of remaining life		333.33

Example (2). Assume the same facts as in example (1), except that on July 1, 1960, the cooperative association allocates a dividend to P with respect to his purchase of the tractor in the form of a revolving fund certificate having a face amount of $300. The certificate is redeemable in cash at the discretion of the directors of the association and is subject to diminution by any future losses of the association, and has no fair market value when received by P. Since the certificate had no fair market value when received by P, no amount with respect to such certificate was taken into account by him in the year 1960. In 1965, P receives $300 cash from the association in full redemption of the certificate. Prior to 1965, he had recovered through depreciation $2,000 of the cost of the tractor, leaving an unrecovered cost of $200 (the salvage value). For the year 1965, the redemption proceeds of $300 are applied against the unrecovered cost of $200, reducing the basis to zero, and the balance of the redemption proceeds, $100, is includible in the computation of P's gross income.

Example (3). Assume the same facts as in example (2), except that the certificate is redeemed in full on July 1, 1962. The full $300 received on redemption of the certificate will be applied against the unrecovered cost of the tractor as of January 1, 1962, computed as follows:

Cost of tractor, July 1, 1959		$2,200
Less:		
Depreciation for 1959 (6 mos.)	$200	
Depreciation for 1960	400	
Depreciation for 1961	400	
	1,000	
Unrecovered cost on Jan. 1, 1962		1,200
Adjustment as of Jan. 1, 1962, for proceeds of the redemption of the revolving fund certificate		300
Unrecovered cost on Jan. 1, 1962, after adjustment		900
Less: Salvage value		200
Basis for depreciation on Jan. 1, 1962		700

If P uses the tractor in his business until June 30, 1964, he would be entitled to the following depreciation allowances with respect to the tractor:		
For 1962	280	
For 1963	280	
For 1964 (6 mos.)	140	
	700	
Balance to be depreciated		0

Example (4). Assume the same facts as in example (3), except that P sells the tractor in 1961. The entire $300 received in 1962 in redemption of the revolving fund certificate is includible in the computation of P's gross income for the year 1962.

(c) *Special rule.* If, for any taxable year ending before December 3, 1959, a taxpayer treated any patronage dividend received in the form of a document described in paragraph (b) (1) (iii) or (iv) of this section in accordance with the regulations then applicable (whether such dividend is subject to paragraph (b) (1) or (3) of this section), such taxpayer is not required to change the treatment of such patronage dividends for any such prior taxable year. On the other hand, the taxpayer may, if he so desires, amend his income tax returns to treat the receipt of such patronage dividend in accordance with the provisions of this section, but no provision in this paragraph shall be construed as extending the period of limitations within which a claim for credit or refund may be filed under section 6511.

(d) *Per-unit retain certificates; tax treatment of cooperative associations; distribution and reinvestment alternative.* (1)(i) In the case of a taxable year to which this paragraph applies to a cooperative association, such association shall, in computing the amount paid or returned to a patron with respect to products marketed for such patron, take into account the stated dollar amount of any per-unit retain certificate (as defined in paragraph (g) of this section)—

(a) Which is issued during the payment period for such year (as defined in subparagraph (3) of this paragraph) with respect to such products,

(b) With respect to which the patron is a qualifying patron (as defined in subparagraph (2) of this paragraph), and

(c) Which clearly states the fact that the patron has agreed to treat the stated dollar amount thereof as representing a cash distribution to him which he has reinvested in the cooperative association.

(ii) No amount shall be taken into account by a cooperative association by reason of the issuance of a per-unit retain certificate to a patron who was not a qualifying patron with respect to such certificate. However, any amount paid in redemption of a per-unit retain certificate which was issued to a patron who was not a qualifying patron with respect to such certificate shall be taken into account by the cooperative in the year of redemption, as an amount paid or returned to such patron with respect to products marketed for him. This subdivision shall apply only to per-unit retain certificates issued with respect to taxable years of the cooperative association to which this paragraph applied to the association (that is, taxable years with respect to which per-unit retain certificates were issued to one or more patrons who are qualifying patrons).

(2)(i) A patron shall be considered to be a ‘‘qualifying patron’’ with respect to a per-unit retain certificate if there is in effect an agreement between the cooperative association and such patron which clearly provides that such patron agrees to treat the stated dollar amounts of all per-unit retain certificates issued to him by the association as representing cash distributions which he has constructively received and which he has, of his own choice, reinvested in the cooperative association. Such an agreement may be included in a by-law of the cooperative which is adopted prior to the time the products to which the per-unit retain certificates relate are marketed. However, except where there is in effect a ‘‘written agreement’’ described in subdivision (ii) of this subparagraph, a patron shall not be considered to be a ‘‘qualifying patron’’ with respect to a per-unit retain certificate if it has been established by a determination of the Tax Court of the United States, or any other court of competent jurisdiction, which has become final, that the stated dollar amount of such certificate, or of a similar certificate issued under similar circumstances to such patron or any other patron by the cooperative association, is not required to be included (as ordinary income) in the gross income of such patron, or such other patron, for the taxable year of the patron in which received.

(ii) The ‘‘written agreement’’ referred to in subdivision (i) of this subparagraph is an agreement in writing, signed by the patron, on file with the cooperative association, and revocable as provided in this subdivision. Unless such an agreement specifically provides to the contrary, it shall be effective for per-unit retain certificates issued with respect to the taxable year of the cooperative association in which the agreement is received by the association, and unless revoked, for per-unit retain certificates issued with respect to all subsequent taxable years. A ‘‘written agreement’’ must be revocable by the patron at any time after the close of the taxable year in which it is made. To be effective, a revocation must be in writing, signed by the patron, and furnished to the cooperative association. A revocation shall be effective only for per-unit retain certificates issued with respect to taxable years of the cooperative association following the taxable year in which it is furnished to the association. Notwithstanding the preceding sentence, a revocation shall not be effective for per-unit retain certificates issued with respect to products marketed for the patron under a pooling arrangement in which such patron participated before such revocation. The following is an example of an agreement which would meet the requirements of this subparagraph:

> I agree that, for purposes of determining the amount I have received from this cooperative in payment for my goods, I shall treat the face amount of any per-unit retain certificates issued to me on and after ———— as representing a cash distribution which I have constructively received and which I have reinvested in the cooperative.
>
> ————————————————
>
> *(Signed)*

(3) For purposes of this paragraph and paragraph (e) of this section, the payment period for any taxable year of the cooperative is the period beginning

with the first day of such taxable year and ending with the 15th day of the 9th month following the close of such year.

(4) This paragraph shall apply to any taxable year of a cooperative association if, with respect to such taxable year, the association has issued per-unit retain certificates to one or more of its patrons who are qualifying patrons with respect to such certificates within the meaning of subparagraph (2) of this paragraph.

(e) *Tax treatment of cooperative association; taxable years for which paragraph (d) does not apply.* (1) In the case of a taxable year to which paragraph (d) of this section does not apply to a cooperative association, such association shall, in computing the amount paid or returned to a patron with respect to products marketed for such patron, take into account the fair market value (at the time of issue) of any per-unit retain certificates which are issued by the association with respect to such products during the payment period for such taxable year.

(2) An amount paid in redemption of a per-unit retain certificate issued with respect to a taxable year of the cooperative association for which paragraph (d) of this section did not apply to the association, shall, to the extent such amount exceeds the fair market value of the certificate at the time of its issue, be taken into account by the association in the year of redemption, as an amount paid or returned to a patron with respect to products marketed for such patron.

(3) For purposes of this paragraph and paragraph (f)(2) of this section, any per-unit retain certificate containing an unconditional promise to pay a fixed sum of money on demand or at a fixed or determinable time shall be considered to have a fair market value at the time of its issue, unless it is clearly established to the contrary. On the other hand, any per-unit retain certificate (other than capital stock) which is redeemable only in the discretion of the cooperative association, or which is otherwise subject to conditions beyond the control of the patron, shall be considered not to have any fair market value at the time of its issue, unless it is clearly established to the contrary.

(f) *Tax treatment of patron.* (1) The following rules apply for purposes of computing the amount includible in gross income with respect to a per-unit retain certificate which was issued to a patron by a cooperative association with respect to a taxable year of such association for which paragraph (d) of this section applies.

(i) If the patron is a qualifying patron with respect to such certificate (within the meaning of paragraph (d)(2) of this section), he shall, in accordance with his agreement, include (as ordinary income) the stated dollar amount of the certificate in gross income for his taxable year in which the certificate is received by him.

(ii) If the patron is not a qualifying patron with respect to such certificate, no amount is includible in gross income on the receipt of the certificate; however, any gain on the redemption, sale, or other disposition of such certificate shall, to the extent of the stated dollar amount thereof, be considered as gain from the sale or exchange of property which is not a capital asset.

(2) The amount of the fair market value of a per-unit retain certificate which is issued to a patron by a cooperative association with respect to a taxable year of the association for which paragraph (d) of this section does not apply shall be included, as ordinary income, in the gross income of the patron for the taxable year in which the certificate is received. Any gain on the redemption, sale, or other disposition of such a per-unit retain certificate shall, to the extent its stated dollar amount exceeds its fair market value at the time of issue, be treated as gain on the redemption, sale, or other disposition of property which is not a capital asset.

(g) *''Per-unit retain certificate'' defined.* For purposes of paragraphs (d), (e), and (f), of this section, the term ''per-unit retain certificate'' means any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice—

(1) Which is issued to a patron with respect to products marketed for such patron;

(2) Which discloses to the patron the stated dollar amount allocated to him

on the books of the cooperative association; and

(3) The stated dollar amount of which is fixed without reference to net earnings.

(h) *Effective date.* This section shall not apply to any amount the tax treatment of which is prescribed in section 1385 and §1.1385–1. Paragraphs (d), (e), and (f) of this section shall apply to per-unit retain certificates as defined in paragraph (g) of this section issued by a cooperative association during taxable years of the association beginning after April 30, 1966, with respect to products marketed for patrons during such years.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6855, 30 FR 13134, Oct. 15, 1965]

§1.61–6 Gains derived from dealings in property.

(a) *In general.* Gain realized on the sale or exchange of property is included in gross income, unless excluded by law. For this purpose property includes tangible items, such as a building, and intangible items, such as goodwill. Generally, the gain is the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged. The specific rules for computing the amount of gain or loss are contained in section 1001 and the regulations thereunder. When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of. This rule may be illustrated by the following examples:

Example (1). A, a dealer in real estate, acquires a 10-acre tract for $10,000, which he divides into 20 lots. The $10,000 cost must be equitably apportioned among the lots so that on the sale of each A can determine his taxable gain or deductible loss.

Example (2). B purchases for $25,000 property consisting of a used car lot and adjoining filling station. At the time, the fair market value of the filling station is $15,000 and the fair market value of the used car lot is $10,000. Five years later B sells the filling station for $20,000 at a time when $2,000 has been properly allowed as depreciation thereon. B's gain on this sale is $7,000, since $7,000 is the amount by which the selling price of the filling station exceeds the portion of the cost equitably allocable to the filling station at the time of purchase reduced by the depreciation properly allowed.

(b) *Nontaxable exchanges.* Certain realized gains or losses on the sale or exchange of property are not ‘‘recognized’’, that is, are not included in or deducted from gross income at the time the transaction occurs. Gain or loss from such sales or exchanges is generally recognized at some later time. Examples of such sales or exchanges are the following:

(1) Certain formations, reorganizations, and liquidations of corporations, see sections 331, 333, 337, 351, 354, 355, and 361;

(2) Certain formations and distributions of partnerships, see sections 721 and 731;

(3) Exchange of certain property held for productive use or investment for property of like kind, see section 1031;

(4) A corporation's exchange of its stock for property, see section 1032;

(5) Certain involuntary conversions of property if replaced, see section 1033;

(6) Sale or exchange of residence if replaced, see section 1034;

(7) Certain exchanges of insurance policies and annuity contracts, see section 1035; and

(8) Certain exchanges of stock for stock in the same corporation, see section 1036.

(c) *Character of recognized gain.* Under Subchapter P, Chapter 1 of the Code, relating to capital gains and losses, certain gains derived from dealings in property are treated specially, and under certain circumstances the maximum rate of tax on such gains is 25 percent, as provided in section 1201. Generally, the property subject to this treatment is a ‘‘capital asset’’, or treated as a ‘‘capital asset’’. For definition of such assets, see sections 1221 and 1231, and the regulations thereunder. For some of the rules either granting or denying this special treatment, see the following sections and the regulations thereunder:

(1) Transactions between partner and partnership, section 707;

(2) Sale or exchange of property used in the trade or business and involuntary conversions, section 1231;

(3) Payment of bonds and other evidences of indebtedness, section 1232;

(4) Gains and losses from short sales, section 1233;

(5) Options to buy or sell, section 1234;

(6) Sale or exchange of patents, section 1235;

(7) Securities sold by dealers in securities, section 1236;

(8) Real property subdivided for sale, section 1237;

(9) Amortization in excess of depreciation, section 1238;

(10) Gain from sale of certain property between spouses or between an individual and a controlled corporation, section 1239;

(11) Taxability to employee of termination payments, section 1240.

§ 1.61–7 Interest.

(a) *In general.* As a general rule, interest received by or credited to the taxpayer constitutes gross income and is fully taxable. Interest income includes interest on savings or other bank deposits; interest on coupon bonds; interest on an open account, a promissory note, a mortgage, or a corporate bond or debenture; the interest portion of a condemnation award; usurious interest (unless by State law it is automatically converted to a payment on the principal); interest on legacies; interest on life insurance proceeds held under an agreement to pay interest thereon; and interest on refunds of Federal taxes. For rules determining the taxable year in which interest, including interest accrued or constructively received, is included in gross income, see section 451 and the regulations thereunder. For the inclusion of interest in income for the purpose of the retirement income credit, see section 37 and the regulations thereunder. For credit of tax withheld at source on interest on tax-free covenant bonds, see section 32 and the regulations thereunder. For rules relating to interest on certain deferred payments, see section 483 and the regulations thereunder.

(b) *Interest on Government obligations*—(1) *Wholly tax-exempt interest.* Interest upon the obligations of a State, Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia, is wholly exempt from tax. Interest on certain United States obligations issued before March 1, 1941, is exempt from tax to the extent provided in the acts of Congress authorizing the various issues. See section 103 and the regulations thereunder.

(2) *Partially tax-exempt interest.* Interest earned on certain United States obligations is partly tax exempt and partly taxable. For example, the interest on United States Treasury bonds issued before March 1, 1941, to the extent that the principal of such bonds exceeds $5,000, is exempt from normal tax but is subject to surtax. See sections 35 and 103, and the regulations thereunder.

(3) *Fully taxable interest.* In general, interest on United States obligations issued on or after March 1, 1941, and obligations issued by any agency or instrumentality of the United States after that date, is fully taxable; but see section 103 and the regulations thereunder. A taxpayer using the cash receipts and disbursements method of accounting who owns United States savings bonds issued at a discount has an election as to when he will report the interest; see section 454 and the regulations thereunder.

(c) *Obligations bought at a discount; bonds bought when interest defaulted or accrued.* When notes, bonds, or other certificates of indebtedness are issued by a corporation or the Government at a discount and are later redeemed by the debtor at the face amount, the original discount is interest, except as otherwise provided by law. See also paragraph (b) of this section for the rules relating to Government bonds. If a taxpayer purchases bonds when interest has been defaulted or when the interest has accrued but has not been paid, any interest which is in arrears but has accrued at the time of purchase is not income and is not taxable as interest if subsequently paid. Such payments are returns of capital which reduce the remaining cost basis. Interest which accrues after the date of purchase, however, is taxable interest income for the year in which received or accrued (depending on the method of accounting used by the taxpayer).

(d) *Bonds sold between interest dates; amounts received in excess of original issue discount; interest on life insurance.* When bonds are sold between interest dates, part of the sales price represents interest accrued to the date of the sale and must be reported as interest income. Amounts received in excess of the original issue discount upon the retirement or sale of a bond or other evidence of indebtedness may under some circumstances constitute capital gain instead of ordinary income. See section 1232 and the regulations thereunder. Interest payments on amounts payable as employees' death benefits (whether or not section 101(b) applies thereto) and on the proceeds of life insurance policies payable by reason of the insured's death constitute gross income under some circumstances. See section 101 and the regulations thereunder for details. Where accrued interest on unwithdrawn insurance policy dividends is credited annually and is subject to withdrawal annually by the taxpayer, such interest credits constitute gross income to such taxpayer as of the year of credit. However, if under the terms of the insurance policy the interest on unwithdrawn policy dividends is subject to withdrawal only on the anniversary date of the policy (or some other date specified therein), then such interest shall constitute gross income to the taxpayer for the taxable year in which such anniversary date (or other specified date) falls.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6723, 29 FR 5342, Apr. 21, 1964; T.D. 6873, 31 FR 941, Jan. 25, 1966]

§1.61–8 Rents and royalties.

(a) *In general.* Gross income includes rentals received or accrued for the occupancy of real estate or the use of personal property. For the inclusion of rents in income for the purpose of the retirement income credit, see section 37 and the regulations thereunder. Gross income includes royalties. Royalties may be received from books, stories, plays, copyrights, trademarks, formulas, patents, and from the exploitation of natural resources, such as coal, gas, oil, copper, or timber. Payments received as a result of the transfer of patent rights may under some circumstances constitute capital gain instead of ordinary income. See section 1235 and the regulations thereunder. For special rules for certain income from natural resources, see Subchapter I (section 611 and following), Chapter 1 of the Code, and the regulations thereunder.

(b) *Advance rentals; cancellation payments.* Gross income includes advance rentals, which must be included in income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer. An amount received by a lessor from a lessee for cancelling a lease constitutes gross income for the year in which it is received, since it is essentially a substitute for rental payments. As to amounts received by a lessee for the cancellation of a lease, see section 1241 and the regulations thereunder.

(c) *Expenditures by lessee.* As a general rule, if a lessee pays any of the expenses of his lessor such payments are additional rental income of the lessor. If a lessee places improvements on real estate which constitute, in whole or in part, a substitute for rent, such improvements constitute rental income to the lessor. Whether or not improvements made by a lessee result in rental income to the lessor in a particular case depends upon the intention of the parties, which may be indicated either by the terms of the lease or by the surrounding circumstances. For the exclusion from gross income of income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by a lessee, see section 109 and the regulations thereunder. For the exclusion from gross income of a lessor corporation of certain of its income taxes on rental income paid by a lessee corporation under a lease entered into before January 1, 1954, see section 110 and the regulations thereunder.

§ 1.61–9 Dividends.

(a) *In general.* Except as otherwise specifically provided, dividends are included in gross income under sections 61 and 301. For the principal rules with respect to dividends includible in gross income, see section 316 and the regulations thereunder. As to distributions made or deemed to be made by regulated investment companies, see sections 851 through 855, and the regulations thereunder. As to distributions made by real estate investment trusts, see sections 856 through 858, and the regulations thereunder. See section 116 for the exclusion from gross income of $100 ($50 for dividends received in taxable years beginning before January 1, 1964) of dividends received by an individual, except those from certain corporations. Furthermore, dividends may give rise to a credit against tax under section 34, relating to dividends received by individuals (for dividends received on or before December 31, 1964), and under section 37, relating to retirement income.

(b) *Dividends in kind; stock dividends; stock redemptions.* Gross income includes dividends in property other than cash, as well as cash dividends. For amounts to be included in gross income when distributions of property are made, see section 301 and the regulations thereunder. A distribution of stock, or rights to acquire stock, in the corporation making the distribution is not a dividend except under the circumstances described in section 305(b). However, the term ''dividend'' includes a distribution of stock, or rights to acquire stock, in a corporation other than the corporation making the distribution. For determining when distributions in complete liquidation shall be treated as dividends, see section 333 and the regulations thereunder. For rules determining when amounts received in exchanges under section 354 or exchanges and distributions under section 355 shall be treated as dividends, see section 356 and the regulations thereunder.

(c) *Dividends on stock sold.* When stock is sold, and a dividend is both declared and paid after the sale, such dividend is not gross income to the seller. When stock is sold after the declaration of a dividend and after the date as of which the seller becomes entitled to the dividend, the dividend ordinarily is income to the seller. When stock is sold between the time of declaration and the time of payment of the dividend, and the sale takes place at such time that the purchaser becomes entitled to the dividend, the dividend ordinarily is income to him. The fact that the purchaser may have included the amount of the dividend in his purchase price in contemplation of receiving the dividend does not exempt him from tax. Nor can the purchaser deduct the added amount he advanced to the seller in anticipation of the dividend. That added amount is merely part of the purchase price of the stock. In some cases, however, the purchaser may be considered to be the recipient of the dividend even though he has not received the legal title to the stock itself and does not himself receive the dividend. For example, if the seller retains the legal title to the stock as trustee solely for the purpose of securing the payment of the purchase price, with the understanding that he is to apply the dividends received from time to time in reduction of the purchase price, the dividends are considered to be income to the purchaser.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6777, 29 FR 17807, Dec. 16, 1964]

§ 1.61–10 Alimony and separate maintenance payments; annuities; income from life insurance and endowment contracts.

(a) *In general.* Alimony and separate maintenance payments, annuities, and income from life insurance and endowment contracts in general constitute gross income, unless excluded by law. Annuities paid by religious, charitable, and educational corporations are generally taxable to the same extent as other annuities. An annuity charged upon devised land is taxable to the donee-annuitant to the extent that it becomes payable out of the rents or other income of the land, whether or not it is a charge upon the income of the land.

(b) *Cross references.* For the detailed rules relating to—

(1) Alimony and separate maintenance payments, see section 71 and the regulations thereunder;

(2) Annuities, certain proceeds of endowment and life insurance contracts, see section 72 and the regulations thereunder;

(3) Life insurance proceeds paid by reason of death of insured, employees' death benefits, see section 101 and the regulations thereunder;

(4) Annuities paid by employees' trusts, see section 402 and the regulations thereunder;

(5) Annuities purchased for employee by employer, see section 403 and the regulations thereunder.

§1.61–11 Pensions.

(a) *In general.* Pensions and retirement allowances paid either by the Government or by private persons constitute gross income unless excluded by law. Usually, where the taxpayer did not contribute to the cost of a pension and was not taxable on his employer's contributions, the full amount of the pension is to be included in his gross income. But see sections 72, 402, and 403, and the regulations thereunder. When amounts are received from other types of pensions, a portion of the payment may be excluded from gross income. Under some circumstances, amounts distributed from a pension plan in excess of the employee's contributions may constitute long-term capital gain, rather than ordinary income.

(b) *Cross references.* For the inclusion of pensions in income for the purpose of the retirement income credit, see section 37 and the regulations thereunder. Detailed rules concerning the extent to which pensions and retirement allowances are to be included in or excluded from gross income are contained in other sections of the Code and the regulations thereunder. Amounts received as pensions or annuities under the Social Security Act (42 U.S.C. ch. 7) or the Railroad Retirement Act (45 U.S.C. ch. 9) are excluded from gross income. For other partial and total exclusions from gross income, see the following:

(1) Annuities in general, section 72 and the regulations thereunder;

(2) Employees' annuities, sections 402 and 403 and the regulations thereunder;

(3) References to other acts of Congress exempting veterans' pensions and railroad retirement annuities and pensions, section 122.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6856, 30 FR 13316, Oct. 20, 1965]

§1.61–12 Income from discharge of indebtedness.

(a) *In general.* The discharge of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, the debtor realizes income in the amount of the debt as compensation for his services. A taxpayer may realize income by the payment or purchase of his obligations at less than their face value. In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.

(b) *Proceedings under Bankruptcy Act.* (1) Income is not realized by a taxpayer by virtue of the discharge, under section 14 of the Bankruptcy Act (11 U.S.C. 32), of his indebtedness as the result of an adjudication in bankruptcy, or by virtue of an agreement among his creditors not consummated under any provision of the Bankruptcy Act, if immediately thereafter the taxpayer's liabilities exceed the value of his assets. Furthermore, unless one of the principal purposes of seeking a confirmation under the Bankruptcy Act is the avoidance of income tax, income is not realized by a taxpayer in the case of a cancellation or reduction of his indebtedness under—

(i) A plan of corporate reorganization confirmed under Chapter X of the Bankruptcy Act (11 U.S.C., ch. 10);

(ii) An ‘‘arrangement’’ or a ‘‘real property arrangement’’ confirmed under Chapter XI or XII, respectively, of the Bankruptcy Act (11 U.S.C., ch. 11, 12); or

(iii) A ‘‘wage earner's plan’’ confirmed under Chapter XIII of the Bankruptcy Act (11 U.S.C., ch. 13).

(2) For adjustment of basis of certain property in the case of cancellation or reduction of indebtedness resulting from a proceeding under the Bankruptcy Act, see the regulations under section 1016.

(c) *Issuance and repurchase of debt instruments*—(1) *Issuance.* An issuer does not realize gain or loss upon the issuance of a debt instrument. For rules relating to an issuer's interest deduction for a debt instrument issued with bond issuance premium, see § 1.163–13.

(2) *Repurchase*—(i) *In general.* An issuer does not realize gain or loss upon the repurchase of a debt instrument. However, if a debt instrument provides for payments denominated in, or determined by reference to, a nonfunctional currency, an issuer may realize a currency gain or loss upon the repurchase of the instrument. See section 988 and the regulations thereunder. For purposes of this paragraph (c)(2), the term *repurchase* includes the retirement of a debt instrument, the conversion of a debt instrument into stock of the issuer, and the exchange (including an exchange under section 1001) of a newly issued debt instrument for an existing debt instrument.

(ii) *Repurchase at a discount.* An issuer realizes income from the discharge of indebtedness upon the repurchase of a debt instrument for an amount less than its adjusted issue price (within the meaning of § 1.1275–1(b)). The amount of discharge of indebtedness income is equal to the excess of the adjusted issue price over the repurchase price. See section 108 and the regulations thereunder for additional rules relating to income from discharge of indebtedness. For example, to determine the repurchase price of a debt instrument that is repurchased through the issuance of a new debt instrument, see section 108(e)(10).

(iii) *Repurchase at a premium.* An issuer may be entitled to a repurchase premium deduction upon the repurchase of a debt instrument for an amount greater than its adjusted issue price (within the meaning of § 1.1275–1(b)). See § 1.163–7(c) for the treatment of repurchase premium.

(iv) *Effective date.* This paragraph (c)(2) applies to debt instruments repurchased on or after March 2, 1998.

(d) *Cross references.* For exclusion from gross income of—

(1) Income from discharge of indebtedness in certain cases, see sections 108 and 1017, and regulations thereunder;

(2) Forgiveness of Government payments to encourage exploration, development, and mining for defense purposes, see section 621 and regulations thereunder.

(e) *Cross reference.* For rules relating to the treatment of liabilities on the sale or other disposition of encumbered property, see § 1.1001–2.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6984, 33 FR 19174, Dec. 24, 1968; T.D. 7741, 45 FR 81745, Dec. 12, 1980; T.D. 8746, 62 FR 68175, Dec. 31, 1997]

§ 1.61–13 Distributive share of partnership gross income; income in respect of a decedent; income from an interest in an estate or trust.

(a) *In general.* A partner's distributive share of partnership gross income (under section 702(c)) constitutes gross income to him. Income in respect of a decedent (under section 691) constitutes gross income to the recipient. Income from an interest in an estate or trust constitutes gross income under the detailed rules of Part I (section 641 and following), Subchapter J, Chapter 1 of the Code. In many cases, these sections also determine who is to include in his gross income the income from an estate or trust.

(b) *Creation of sinking fund by corporation.* If a corporation, for the sole purpose of securing the payment of its bonds or other indebtedness, places property in trust or sets aside certain amounts in a sinking fund under the control of a trustee who may be authorized to invest and reinvest such sums from time to time, the property or fund thus set aside by the corporation and held by the trustee is an asset of the corporation, and any gain arising therefrom is income of the corporation and shall be included as such in its gross income.

§1.61–14 Miscellaneous items of gross income.

(a) *In general.* In addition to the items enumerated in section 61(a), there are many other kinds of gross income. For example, punitive damages such as treble damages under the antitrust laws and exemplary damages for fraud are gross income. Another person's payment of the taxpayer's income taxes constitutes gross income to the taxpayer unless excluded by law. Illegal gains constitute gross income. Treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession.

(b) *Cross references.* (1) Prizes and awards, see section 74 and regulations thereunder;

(2) Damages for personal injury or sickness, see section 104 and the regulations thereunder;

(3) Income taxes paid by lessee corporation, see section 110 and regulations thereunder;

(4) Scholarships and fellowship grants, see section 117 and regulations thereunder;

(5) Miscellaneous exemptions under other acts of Congress, see section 122;

(6) Tax-free covenant bonds, see section 1451 and regulations thereunder.

(7) Notional principal contracts, see §1.446–3.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6856, 30 FR 13316, Oct. 20, 1965; T.D. 8491, 58 FR 53127, Oct. 14, 1993]

§1.61–15 Options received as payment of income.

(a) *In general.* Except as otherwise provided in §1.61–2(d)(6)(i) (relating to certain restricted property transferred after June 30, 1969), if any person receives an option in payment of an amount constituting compensation of such person (or any other person), such option is subject to the rules contained in §1.421–6 for purposes of determining when income is realized in connection with such option and the amount of such income. In this regard, the rules of §1.421–6 apply to an option received in payment of an amount constituting compensation regardless of the form of the transaction. Thus, the rules of §1.421–6 apply to an option transferred for less than its fair market value in a transaction taking the form of a sale or exchange if the difference between the amount paid for the option and its fair market value at the time of transfer is the payment of an amount constituting compensation of the transferee or any other person. This section, for example, makes the rules of §1.421–6 applicable to options granted in whole or partial payment for services of an independent contractor. If an amount of money or property is paid for an option to which this paragraph applies, then the amount paid shall be part of the basis of such option.

(b) *Options to which paragraph (a) does not apply.* (1) Paragraph (a) of this section does not apply to:

(i) An option which is subject to the rules contained in section 421; and

(ii) An option which is not granted as the payment of an amount constituting compensation, such as an option which is acquired solely as an investment (including an option which is part of an investment unit described in paragraph (b) of §1.1232–3). For rules relating to the taxation of options described in this subdivision, see section 1234 and the regulations thereunder.

(2) If a person acquires an option which is not subject to the rules contained in section 421, and if such option has a readily ascertainable fair market value, such person may establish that such option was not acquired as payment of an amount constituting compensation by showing that the amount of money or its equivalent paid for the option equaled the readily ascertainable fair market value of the option. If a person acquires an option which is not subject to the rules contained in section 421, and if such option does not have a readily ascertainable fair market value, then to establish that such option was not acquired as payment of an amount constituting compensation, such person must show that, from an examination of all the surrounding circumstances, there was no reason for the option to have been granted as the payment of an amount constituting compensation. For example, such person must show that he had neither rendered nor was obligated to render substantial services in consideration for

the granting of the option. In determining whether an option, such as an option acquired in connection with an obligation as part of an investment unit, has been granted as compensation for services, the ordinary services performed by an investor in his own self-interest in connection with his investing activities will not be treated as the consideration for the grant of the option. For example, if a small business investment company takes an active part in the management of its debtor small business company, the rendering of such management services will not be treated as the consideration for the granting of the option, provided such services are rendered for an independent consideration, or are merely protective of the small business investment company's investment in the borrower. See paragraph (c) of § 1.421–6 for the meaning of the term ''readily ascertainable fair market value.''

(c) *Statement required in connection with certain options.* (1) Any person acquiring any option to purchase securities (other than an option described in subparagraph (2) of this paragraph) shall attach a statement to his income tax return for the taxable year in which the option was acquired. For the definition of the term ''securities'', see section 165(g)(2).

(2) The statement otherwise required by subparagraph (1) of this paragraph shall not be required with respect to the following options:

(i) Options subject to the rules contained in section 305(a) or section 421;

(ii) Options acquired as part of an investment unit consisting of an option and a debenture, note, or other similar obligation—

(a) If such unit is acquired as part of a public offering and the amount of money or its equivalent paid for such unit is not less than the public offering price, or

(b) If such unit is actively traded on an established market and the amount of money or its equivalent paid for such unit is not less than the price paid for such unit in contemporaneous purchases of such unit by persons independent of both the seller and the taxpayer;

(iii) Options acquired as part of a public offering, if the amount of money or its equivalent paid for such option is not less than the public offering price; and

(iv) Options which are actively traded on an established market and which are acquired for money or its equivalent at a price not less than the price paid for such options in contemporaneous purchases of such options by persons independent of both the seller and the taxpayer.

(3) The statement required by subparagraph (1) of this paragraph shall contain the following information:

(i) Name and address of the taxpayer;

(ii) Description of the securities subject to the option (including number of shares of stock);

(iii) Period during which the option is exercisable;

(iv) Whether the option had a readily ascertainable fair market value at date of grant; and

(v) Whether the option is subject to paragraph (a) of this section.

(4) If the statement required by subparagraph (1) of this paragraph indicates either that the option is not subject to paragraph (a) of this section, or that the option is subject to paragraph (a) of this section but that such option had a readily ascertainable fair market value at date of grant, then such statement shall contain the following additional information:

(i) Option price;

(ii) Value at date of grant of securities subject to the option;

(iii) Restrictions (if any) on exercise or transfer of option;

(iv) Restrictions (if any) on transfer of securities subject to the option;

(v) Value of the option (if readily ascertainable);

(vi) How value of option was determined;

(vii) Amount of money (or its equivalent) paid for the option;

(viii) Person from whom the option was acquired;

(ix) A concise description of the circumstances surrounding the acquisition of the option and any other factors relied upon by the taxpayer to establish that the option is not subject to paragraph (a) of this section, or, if the option is treated by the taxpayer as subject to paragraph (a) of this section, that the option had a readily ascertainable fair market value at date of grant.

(d) *Effective date.* This section shall apply to options granted after July 11, 1963, other than options required to be granted pursuant to the terms of a written contract entered into on or before such date.

[T.D. 6696, 28 FR 13450, Dec. 12, 1963, as amended by T.D. 6706, 29 FR 2911, Mar. 3, 1964; T.D. 6984, 33 FR 19175, Dec. 24, 1968; T.D. 7554, 43 FR 31913, July 24, 1978]

§1.61–21 Taxation of fringe benefits.

(a) *Fringe benefits*—(1) *In general.* Section 61(a)(1) provides that, except as otherwise provided in subtitle A of the Internal Revenue Code of 1986, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. For an outline of the regulations under this section relating to fringe benefits, see paragraph (a)(7) of this section. Examples of fringe benefits include: an employer-provided automobile, a flight on an employer-provided aircraft, an employer-provided free or discounted commercial airline flight, an employer-provided vacation, an employer-provided discount on property or services, an employer-provided membership in a country club or other social club, and an employer-provided ticket to an entertainment or sporting event.

(2) *Fringe benefits excluded from income.* To the extent that a particular fringe benefit is specifically excluded from gross income pursuant to another section of subtitle A of the Internal Revenue Code of 1986, that section shall govern the treatment of that fringe benefit. Thus, if the requirements of the governing section are satisfied, the fringe benefits may be excludable from gross income. Examples of excludable fringe benefits include qualified tuition reductions provided to an employee (section 117(d)); meals or lodging furnished to an employee for the convenience of the employer (section 119); benefits provided under a dependent care assistance program (section 129); and no-additional-cost services, qualified employee discounts, working condition fringes, and de minimis fringes (section 132). Similarly, the value of the use by an employee of an employer-provided vehicle or a flight provided to an employee on an employer-provided aircraft may be excludable from income under section 105 (because, for example, the transportation is provided for medical reasons) if and to the extent that the requirements of that section are satisfied. Section 134 excludes from gross income ‘‘qualified military benefits.’’ An example of a benefit that is not a qualified military benefit is the personal use of an employer-provided vehicle. The fact that another section of subtitle A of the Internal Revenue Code addresses the taxation of a particular fringe benefit will not preclude section 61 and the regulations thereunder from applying, to the extent that they are not inconsistent with such other section. For example, many fringe benefits specifically addressed in other sections of subtitle A of the Internal Revenue Code are excluded from gross income only to the extent that they do not exceed specific dollar or percentage limits, or only if certain other requirements are met. If the limits are exceeded or the requirements are not met, some or all of the fringe benefit may be includible in gross income pursuant to section 61. See paragraph (b)(3) of this section.

(3) *Compensation for services.* A fringe benefit provided in connection with the performance of services shall be considered to have been provided as compensation for such services. Refraining from the performance of services (such as pursuant to a covenant not to compete) is deemed to be the performance of services for purposes of this section.

(4) *Person to whom fringe benefit is taxable*—(i) *In general.* A taxable fringe benefit is included in the income of the person performing the services in connection with which the fringe benefit is furnished. Thus, a fringe benefit may be taxable to a person even though that person did not actually receive the fringe benefit. If a fringe benefit is furnished to someone other than the service provider such benefit is considered in this section as furnished to the service provider, and use by the other person is considered use by the service provider. For example, the provision of an automobile by an employer to an employee’s spouse in connection with

the performance of services by the employee is taxable to the employee. The automobile is considered available to the employee and use by the employee's spouse is considered use by the employee.

(ii) *All persons to whom benefits are taxable referred to as employees.* The person to whom a fringe benefit is taxable need not be an employee of the provider of the fringe benefit, but may be, for example, a partner, director, or an independent contractor. For convenience, the term ''employee'' includes any person performing services in connection with which a fringe benefit is furnished, unless otherwise specifically provided in this section.

(5) *Provider of a fringe benefit referred to as an employer.* The ''provider'' of a fringe benefit is that person for whom the services are performed, regardless of whether that person actually provides the fringe benefit to the recipient. The provider of a fringe benefit need not be the employer of the recipient of the fringe benefit, but may be, for example, a client or customer of the employer or of an independent contractor. For convenience, the term ''employer'' includes any provider of a fringe benefit in connection with payment for the performance of services, unless otherwise specifically provided in this section.

(6) *Effective date.* Except as otherwise provided, this section is effective as of January 1, 1989 with respect to fringe benefits provided after December 31, 1988. See §1.61–2T for rules in effect from January 1, 1985, to December 31, 1988.

(7) *Outline of this section.* The following is an outline of the regulations in this section relating to fringe benefits:

§1.61–21 (a) *Fringe benefits.*

(1) In general.
(2) Fringe benefits excluded from income.
(3) Compensation for services.
(4) Person to whom fringe benefit is taxable.
(5) Provider of a fringe benefit referred to as an employer.
(6) Effective date.
(7) Outline of this section.

§1.61–21 (b) *Valuation of fringe benefits*

(1) In general.
(2) Fair market value.
(3) Exclusion from income based on cost.
(4) Fair market value of the availability of an employer-provided vehicle.
(5) Fair market value of chauffeur services.
(6) Fair market value of a flight on an employer-provided piloted aircraft.
(7) Fair market value of the use of an employer-provided aircraft for which the employer does not furnish a pilot.

§1.61–21 (c) *Special valuation rules.*

(1) In general.
(2) Use of the special valuation rules.
(3) Additional rules for using special valuation.
(4) Application of section 414 to employers.
(5) Valuation formulae contained in the special valuation rules.
(6) Modification of the special valuation rules.
(7) Special accounting rule.

§1.61–21 (d) *Automobile lease valuation rule.*

(1) In general.
(2) Calculation of Annual Lease Value.
(3) Services included in, or excluded from, the Annual Lease Value Table.
(4) Availability of an automobile for less than an entire calendar year.
(5) Fair market value.
(6) Special rules for continuous availability of certain automobiles.
(7) Consistency rules.

§1.61–21 (e) *Vehicle cents-per-mile valuation rule.*

(1) In general.
(2) Definition of vehicle.
(3) Services included in, or excluded from, the cents-per-mile rate.
(4) Valuation of personal use only.
(5) Consistency rules.

§1.61–21 (f) *Commuting valuation rule.*

(1) In general.
(2) Special rules.
(3) Commuting value.
(4) Definition of vehicle.
(5) Control employee defined—Non-government employer.
(6) Control employee defined—Government employer.
(7) ''Compensation'' defined.

§1.61–21 (g) *Non-commercial flight valuation rule.*

(1) In general.
(2) Eligible flights and eligible aircraft.
(3) Definition of a flight.
(4) Personal and non-personal flights.
(5) Aircraft valuation formula.
(6) Discretion to provide new formula.
(7) Aircraft multiples.
(8) Control employee defined—Non-government employer.
(9) Control employee defined—Government employer.
(10) ''Compensation'' defined.
(11) Treatment of former employees.
(12) Seating capacity rule.
(13) Erroneous use of the non-commercial flight valuation rule.
(14) Consistency rules.

§1.61–21 (h) *Commercial flight valuation rule.*
(1) In general.
(2) Space-available flight.
(3) Commercial aircraft.
(4) Timing of inclusion.
(5) Consistency rules.
§1.61–21 (i) *[Reserved]*
§1.61–21 (j) *Valuation of meals provided at an employer-operated eating facility for employees.*
(1) In general.
(2) Valuation formula.
§1.61–21 (k) *Commuting valuation rule for certain employees.*
(1) In general.
(2) Trip-by-trip basis.
(3) Commuting value.
(4) Definition of employer-provided transportation.
(5) Unsafe conditions.
(6) Qualified employee defined.
(7) Examples.
(8) Effective date.

(b) *Valuation of fringe benefits*—(1) *In general.* An employee must include in gross income the amount by which the fair market value of the fringe benefit exceeds the sum of—

(i) The amount, if any, paid for the benefit by or on behalf of the recipient, and

(ii) The amount, if any, specifically excluded from gross income by some other section of subtitle A of the Internal Revenue Code of 1986.

Therefore, for example, if the employee pays fair market value for what is received, no amount is includible in the gross income of the employee. In general, the determination of the fair market value of a fringe benefit must be made before subtracting out the amount, if any, paid for the benefit and the amount, if any, specifically excluded from gross income by another section of subtitle A. See paragraphs (d)(2)(ii) and (e)(1)(iii) of this section.

(2) *Fair market value.* In general, fair market value is determined on the basis of all the facts and circumstances. Specifically, the fair market value of a fringe benefit is the amount that an individual would have to pay for the particular fringe benefit in an arm's-length transaction. Thus, for example, the effect of any special relationship that may exist between the employer and the employee must be disregarded. Similarly, an employee's subjective perception of the value of a fringe benefit is not relevant to the determination of the fringe benefit's fair market value nor is the cost incurred by the employer determinative of its fair market value. For special rules relating to the valuation of certain fringe benefits, see paragraph (c) of this section.

(3) *Exclusion from income based on cost.* If a statutory exclusion phrased in terms of cost applies to the provision of a fringe benefit, section 61 does not require the inclusion in the recipient's gross income of the difference between the fair market value and the excludable cost of that fringe benefit. For example, section 129 provides an exclusion from an employee's gross income for amounts contributed by an employer to a dependent care assistance program for employees. Even if the fair market value of the dependent care assistance exceeds the employer's cost, the excess is not subject to inclusion under section 61 and this section. However, if the statutory cost exclusion is a limited amount, the fair market value of the fringe benefit attributable to any excess cost is subject to inclusion. This would be the case, for example, where an employer pays or incurs a cost of more than $5,000 to provide dependent care assistance to an employee.

(4) *Fair market value of the availability of an employer-provided vehicle*—(i) *In general.* If the vehicle special valuation rules of paragraph (d), (e), or (f) of this section do not apply with respect to an employer-provided vehicle, the value of the availability of that vehicle is determined under the general valuation principles set forth in this section. In general, that value equals the amount that an individual would have to pay in an arm's-length transaction to lease the same or comparable vehicle on the same or comparable conditions in the geographic area in which the vehicle is available for use. An example of a comparable condition is the amount of time that the vehicle is available to the employee for use, e.g., a one-year period. Unless the employee can substantiate that the same or comparable vehicle could have been leased on a cents-per-mile basis, the value of the availability of the vehicle cannot be computed by applying a cents-per-mile

rate to the number of miles the vehicle is driven.

(ii) *Certain equipment excluded.* The fair market value of a vehicle does not include the fair market value of any specialized equipment not susceptible to personal use or any telephone that is added to or carried in the vehicle, provided that the presence of that equipment or telephone is necessitated by, and attributable to, the business needs of the employer. However, the value of specialized equipment must be included, if the employee to whom the vehicle is available uses the specialized equipment in a trade or business of the employee other than the employee's trade or business of being an employee of the employer.

(5) *Fair market value of chauffeur services*—(i) *Determination of value*—(A) *In general.* The fair market value of chauffeur services provided to the employee by the employer is the amount that an individual would have to pay in an arm's-length transaction to obtain the same or comparable chauffeur services in the geographic area for the period in which the services are provided. In determining the applicable fair market value, the amount of time, if any, the chauffeur remains on-call to perform chauffeur services must be included. For example, assume that A, an employee of corporation M, needs a chauffeur to be on-call to provide services to A during a twenty-four hour period. If during that twenty-four hour period, the chauffeur actually drives A for only six hours, the fair market value of the chauffeur services would have to be the value of having a chauffeur on-call for a twenty-four hour period. The cost of taxi fare or limousine service for the six hours the chauffeur actually drove A would not be an accurate measure of the fair market value of chauffeur services provided to A. Moreover, all other aspects of the chauffeur's services (including any special qualifications of the chauffeur (e.g., training in evasive driving skills) or the ability of the employee to choose the particular chauffeur) must be taken into consideration.

(B) *Alternative valuation with reference to compensation paid.* Alternatively, the fair market value of the chauffeur services may be determined by reference to the compensation (as defined in paragraph (b)(5)(ii) of this section) received by the chauffeur from the employer.

(C) *Separate valuation for chauffeur services.* The value of chauffeur services is determined separately from the value of the availability of an employer-provided vehicle.

(ii) *Definition of compensation*—(A) *In general.* For purposes of this paragraph (b)(5)(ii), the term ''compensation'' means compensation as defined in section 414(q)(7) and the fair market value of nontaxable lodging (if any) provided by the employer to the chauffeur in the current year.

(B) *Adjustments to compensation*—For purposes of this paragraph (b)(5)(ii), a chauffeur's compensation is reduced proportionately to reflect the amount of time during which the chauffeur performs substantial services for the employer other than as a chauffeur and is not on-call as a chauffeur. For example, assume a chauffeur is paid $25,000 a year for working a ten-hour day, five days a week and also receives $5,000 in nontaxable lodging. Further assume that during four hours of each day, the chauffeur is not on-call to perform services as a chauffeur because that individual is performing secretarial functions for the employer. Then, for purposes of determining the fair market value of this chauffeur's services, the employer may reduce the chauffeur's compensation by 4⁄10 or $12,000 (.4× ($25,000+$5,000)=$12,000). Therefore, in this example, the fair market value of the chauffeur's services is $18,000 ($30,000 −$12,000). However, for purposes of this paragraph (b)(5)(ii), a chauffeur's compensation is not to be reduced by any amounts paid to the chauffeur for time spent ''on-call,'' even though the chauffeur actually performs other services for the employer during such time. For purposes of this paragraph (b)(5)(ii), a determination that a chauffeur is performing substantial services for the employer other than as a chauffeur is based upon the facts and circumstances of each situation. An employee will be deemed to be performing substantial services for the employer other than as a chauffeur if a certain portion of each working day is regularly spent performing other services for the employer.

(iii) *Calculation of chauffeur services for personal purposes of the employee.* The fair market value of chauffeur services provided to the employee for personal purposes may be determined by multiplying the fair market value of chauffeur services, as determined pursuant to paragraph (b)(5)(i) (A) or (B) of this section, by a fraction, the numerator of which is equal to the sum of the hours spent by the chauffeur actually providing personal driving services to the employee and the hours spent by the chauffeur in ''personal on-call time,'' and the denominator of which is equal to all hours the chauffeur spends in driving services of any kind paid for by the employer, including all hours that are ''on-call.''

(iv) *Definition of on-call time.* For purposes of this paragraph, the term ''on-call time'' means the total amount of time that the chauffeur is not engaged in the actual performance of driving services, but during which time the chauffeur is available to perform such services. With respect to a round-trip, time spent by a chauffeur waiting for an employee to make a return trip is generally not treated as on-call time; rather such time is treated as part of the round-trip.

(v) *Definition of personal on-call time.* For purposes of this paragraph, the term ''personal on-call time'' means the amount of time outside the employee's normal working hours for the employer when the chauffeur is available to the employee to perform driving services.

(vi) *Presumptions.* (A) An employee's normal working hours will be presumed to consist of a ten hour period during which the employee usually conducts business activities for that employer.

(B) It will be presumed that if the chauffeur is on-call to provide driving services to an employee during the employee's normal working hours, then that on-call time will be performed for business purposes.

(C) Similarly, if the chauffeur is on-call to perform driving services to an employee after normal working hours, then that on-call time will be presumed to be ''personal on-call time.''

(D) The presumptions set out in paragraph (b)(5)(vi) (A), (B), and (C) of this section may be rebutted. For example, an employee may demonstrate by adequate substantiation that his or her normal working hours consist of more than ten hours. Furthermore, if the employee keeps adequate records and is able to substantiate that some portion of the driving services performed by the chauffeur after normal working hours is attributable to business purposes, then personal on-call time may be reduced by an amount equal to such personal on-call time multiplied by a fraction, the numerator of which is equal to the time spent by the chauffeur after normal working hours driving the employee for business purposes, and the denominator of which is equal to the total time spent by the chauffeur driving the employee after normal working hours for all purposes.

(vii) *Examples.* The rules of this paragraph (b)(5) may be illustrated by the following examples:

Example (1). An employer makes available to employee A an automobile and a full-time chauffeur B (who performs no other services for A's employer) for an entire calendar year. Assume that the automobile lease valuation rule of paragraph (d) of this section is used and that the Annual Lease Value of the automobile is $9,250. Assume further that B's compensation for the year is $12,000 (as defined in section 414(q)(7)) and that B is furnished lodging with a value of $3,000 that is excludable from B's gross income. The maximum amount subject to inclusion in A's gross income for use of the automobile and chauffeur is therefore $24,250 ($12,000+$3,000+$9,250). If 70 percent of the miles placed on the automobile during the year are for A's employer's business, then $6,475 is excludable from A's gross income with respect to the automobile as a working condition fringe ($9,250×.70). Thus, $2,775 is includible in A's gross income with respect to the automobile ($9,250−$6,475). With respect to the chauffeur, if 20 percent of the chauffeur's time is spent actually driving A or being on-call to drive A for personal purposes; then $3,000 is includible in A's income (.20×$15,000). Eighty percent of $15,000, or $12,000, is excluded from A's income as a working condition fringe.

Example (2). Assume the same facts as in example (1) except that in addition to providing chauffeur services, B is responsible for performing substantial non-chauffeur-related duties (such as clerical or secretarial functions) during which time B is not ''on-call'' as a chauffeur. If B spends only 75 percent of the time performing chauffeur services, then the maximum amount subject to inclusion in A's gross income for use of the automobile and chauffeur is $20,500 (($15,000×.75)+$9,250). If B is actually driving A for personal purposes or is on-call to drive A for personal purposes for 20 percent of the time during which B is available to provide chauffeur services, then $2,250 is includible in A's gross income (.20×$11,250). The income inclusion with respect to the automobile is the same as in example (1).

Example (3). Assume the same facts as in example (2) except that while B is performing non-chauffeur-related duties, B is on call as A's chauffeur. No part of B's compensation is excluded when determining the value of the benefit provided to A. Thus, as in example (1), $3,000 is includible in A's gross income with respect to the chauffeur.

(6) *Fair market value of a flight on an employer-provided piloted aircraft*—(i) *In general.* If the non-commercial flight special valuation rule of paragraph (g) of this section does not apply, the value of a flight on an employer-provided piloted aircraft is determined under the general valuation principles set forth in this paragraph.

(ii) *Value of flight.* If an employee takes a flight on an employer-provided piloted aircraft and that employee's flight is primarily personal (see §1.162–2(b)(2)), the value of the flight is equal to the amount that an individual would have to pay in an arm's-length transaction to charter the same or a comparable piloted aircraft for that period for the same or a comparable flight. A flight taken under these circumstances may not be valued by reference to the cost of commercial airfare for the same or a comparable flight. The cost to charter the aircraft must be allocated among all employees on board the aircraft based on all the facts and circumstances unless one or more of the employees controlled the use of the aircraft. Where one or more employees control the use of the aircraft, the value of the flight shall be allocated solely among such controlling employees, unless a written agreement among all the employees on the flight otherwise allocates the value of such flight. Notwithstanding the allocation required by the preceding sentence, no additional amount shall be included in the income of any employee whose flight is properly valued under the special valuation rule of paragraph (g) of this section. For purposes of this paragraph (b)(6), ''control'' means the ability of the employee to determine the route, departure time and destination of the flight. The rules provided in paragraph (g)(3) of this section will be used for purposes of this section in defining a flight. Notwithstanding the allocation required by the preceding sentence, no additional amount shall be included in the income of an employee for that portion of any such flight which is excludible from income pursuant to section 132(d) or §1.132–5 as a working condition fringe.

(iii) *Examples.* The rules of paragraph (b)(6) of this section may be illustrated by the following examples:

Example (1). An employer makes available to employees A and B a piloted aircraft in New York, New York. A wants to go to Los Angeles, California for personal purposes. B needs to go to Chicago, Illinois for business purposes, and then wants to go to Los Angeles, California for personal purposes. Therefore, the aircraft first flies to Chicago, and B deplanes and then boards the plane again. The aircraft then flies to Los Angeles, California where A and B deplane. The value of the flight to employee A will be no more than the amount that an individual would have to pay in an arm's length transaction to charter the same or a comparable piloted aircraft for the same or comparable flight from New York City to Los Angeles. No amount will be imputed to employee A for the stop at Chicago. As to employee B, the value of the personal flight will be no more than the value or the flight from Chicago to Los Angeles. Pursuant to the rules set forth in §1.132–5(k), the flight from New York to Chicago will not be included in employee B's income since that flight was taken solely for business purposes. The charter cost must be allocated between A and B, since both employees controlled portions of the flight. Assume that the employer allocates according to the relative value of each employee's flight. If the charter value of A's flight from New York City to Los Angeles is $1,000 and the value of B's flight from Chicago to Los Angeles is $600 and the value of the actual flight from New York to Chicago to Los Angeles is $1,200, then the amount to be allocated to employee A is $750 ($1,000/($1,000+$600)×$1,200) and the amount to be allocated to employee B is $450 ($600/($1000+$600)×$1,200).

Example (2). Assume the same facts as in example (1), except that employee A also deplanes at Chicago, Illinois, but for personal purposes. The value of the flight to employee A then becomes the value of a flight from New York to Chicago to Los Angeles, i.e., $1,200. Therefore, the amount to be allocated to employee A is $800 ($1,200/($1,200+$600)×$1,200) and the amount to be allocated to employee B is $400 ($600/($1,200+$600)× $1,200).

(7) *Fair market value of the use of an employer-provided aircraft for which the employer does not furnish a pilot.* (i) *In general.* If the non-commercial flight special valuation rule of paragraph (g) of this section does not apply and if an employer provides an employee with the use of an aircraft without a pilot, the value of the use of the employer-provided aircraft is determined under the general valuation principles set forth in this paragraph (b)(7).

(ii) *Value of flight.* In general, if an employee takes a flight on an employer-provided aircraft for which the employer does not furnish a pilot, the value of that flight is equal to the amount that an individual would have to pay in an arm's-length transaction to lease the same or comparable aircraft on the same or comparable terms for the same period in the geographic area in which the aircraft is used. For example, if an employer makes its aircraft available to an employee who will pilot the aircraft for a two-hour flight, the value of the use of the aircraft is the amount that an individual would have to pay in an arm's-length transaction to rent a comparable aircraft for that period in the geographic area in which the aircraft is used. As another example, assume that an employee uses an employer-provided aircraft to commute between home and work. The value of the use of the aircraft is the amount that an individual would have to pay in an arm's-length transaction to rent a comparable aircraft for commuting in the geographic area in which the aircraft is used. If the availability of the flight is of benefit to more than one employee, then such value shall be allocated among such employees on the basis of the relevant facts and circumstances.

(c) *Special valuation rules*—(1) *In general.* Paragraphs (d) through (k) of this section provide special valuation rules that may be used under certain circumstances for certain commonly provided fringe benefits. For general rules relating to the valuation of fringe benefits not eligible for valuation under the special valuation rules or fringe benefits with respect to which the special valuation rules are not used, see paragraph (b) of this section.

(2) *Use of the special valuation rules*—(i) *For benefits provided before January 1, 1993.* The special valuation rules may be used for income tax, employment tax, and reporting purposes. The employer has the option to use any of the special valuation rules. However, an employee may only use a special valuation rule if the employer uses the rule. Moreover, an employee may only use the special rule that the employer uses to value the benefit provided; the employee may not use another special rule to value that benefit. The employee may always use general valuation rules based on facts and circumstances (see paragraph (b) of this section) even if the employer uses a special rule. If a special rule is used, it must be used for all purposes. If an employer properly uses a special rule and the employee uses the special rule, the employee must include in gross income the amount determined by the employer under the special rule reduced by the sum of—

(A) Any amount reimbursed by the employee to the employer, and

(B) Any amount excludable from income under another section of subtitle A of the Internal Revenue Code of 1986. If an employer properly uses a special rule and properly determines the amount of an employee's working condition fringe under section 132 and §1.132–5 (under the general rule or under a special rule), and the employee uses the special valuation rule, the employee must include in gross income the amount determined by the employer less any amount reimbursed by the employee to the employer. The employer and employee may use the special rules to determine the amount of the reimbursement due the employer by the employee. Thus, if an employee reimburses an employer for the value of a benefit as determined under a special valuation rule, no amount is includable in the employee's gross income with respect to the benefit. The provisions of this paragraph are effective for benefits provided before January 1, 1993.

(ii) *For benefits provided after December 31, 1992.* The special valuation rules may be used for income tax, employment tax, and reporting purposes. The employer has the option to use any of the special valuation rules. An employee may use a special valuation rule only if the employer uses that rule or the employer does not meet the condition of paragraph (c)(3)(ii)(A) of this section, but one of the other conditions of paragraph (c)(3)(ii) of this section is met. The employee may always use general valuation rules based on facts and circumstances (see paragraph (b) of this section) even if the employer uses a special rule. If a special rule is used, it must be used for all purposes. If an employer properly uses a special rule and the employee uses the special rule, the employee must include in gross income the amount determined by the employer under the special rule reduced by the sum of—

(A) Any amount reimbursed by the employee to the employer; and

(B) Any amount excludable from income under another section of subtitle A of the Internal Revenue Code of 1986. If an employer properly uses a special rule and properly determines the amount of an employee's working condition fringe under section 132 and § 1.132–5 (under the general rule or under a special rule), and the employee uses the special valuation rule, the employee must include in gross income the amount determined by the employer less any amount reimbursed by the employee to the employer. The employer and employee may use the special rules to determine the amount of the reimbursement due the employer by the employee. Thus, if an employee reimburses an employer for the value of a benefit as determined under a special valuation rule, no amount is includible in the employee's gross income with respect to the benefit. The provisions of this paragraph are effective for benefits provided after December 31, 1992.

(iii) *Vehicle special valuation rules*—(A) *Vehicle by vehicle basis.* Except as provided in paragraphs (d)(7)(v) and (e)(5)(v) of this section, the vehicle special valuation rules of paragraphs (d), (e), and (f) of this section apply on a vehicle by vehicle basis. An employer need not use the same vehicle special valuation rule for all vehicles provided to all employees. For example, an employer may use the automobile lease valuation rule for automobiles provided to some employees, and the commuting and vehicle cents-per-mile valuation rules for automobiles provided to other employees. For purposes of valuing the use or availability of a vehicle, the consistency rules provided in paragraphs (d)(7) and (e)(5) of this section (relating to the automobile lease valuation rule and the vehicle cents-per-mile valuation rule, respectively) apply.

(B) *Shared vehicle usage.* If an employer provides a vehicle to employees for use by more than one employee at the same time, such as with an employer-sponsored vehicle commuting pool, the employer may use any of the special valuation rules that may be applicable to value the use of the vehicle by the employees. The employer must use the same special valuation rule to value the use of the vehicle by each employee who shares such use. The employer must allocate the value of the use of the vehicle based on the relevant facts and circumstances among the employees who share use of the vehicle. For example, assume that an employer provides an automobile to four of its employees and that the employees use the automobile in an employer-sponsored vehicle commuting pool. Assume further that the employer uses the automobile lease valuation rule of paragraph (d) of this section and that the Annual Lease Value of the automobile is $5,000.

The employer must treat $5,000 as the value of the availability of the automobile to the employees, and must apportion the $5,000 value among the employees who share the use of the automobile based on the relevant facts and circumstances. Each employee's share of the value of the availability of the automobile is then to be reduced by the amount, if any, of each employee's working condition fringe exclusion and the amount reimbursed by the employee to the employer.

(iv) *Commercial and noncommercial flight valuation rules.* Except as otherwise provided, if either the commercial flight valuation rule or the non-commercial flight valuation rule is used, that rule must be used by an employer to value all eligible flights taken by all employees in a calendar year. See paragraph (g)(14) of this section for the applicable consistency rules.

(3) *Additional rules for using special valuation*—(i) *Election to use special valuation rules for benefits provided before January 1, 1993.* A particular special valuation rule is deemed to have been elected by the employer (and, if applicable, by the employee), if the employer (and, if applicable, the employee) determines the value of the fringe benefit provided by applying the special valuation rule and treats that value as the fair market value of the fringe benefit for income, employment tax, and reporting purposes. Neither the employer nor the employee must notify the Internal Revenue Service of the election. The provisions of this paragraph are effective for benefits provided before January 1, 1993.

(ii) *Conditions on the use of special valuation rules for benefits provided after December 31, 1992.* Neither the employer nor the employee may use a special valuation rule to value a benefit provided after December 31, 1992, unless one of the following conditions is satisfied—

(A) The employer treats the value of the benefit as wages for reporting purposes within the time for filing the returns for the taxable year (including extensions) in which the benefit is provided;

(B) The employee includes the value of the benefit in income within the time for filing the returns for the taxable year (including extensions) in which the benefit is provided;

(C) The employee is not a control employee as defined in paragraphs (f)(5) and (f)(6) of this section; or

(D) The employer demonstrates a good faith effort to treat the benefit correctly for reporting purposes.

(4) *Application of section 414 to employers.* For purposes of paragraphs (c) through (k) of this section, except as otherwise provided therein, the term ‘‘employer’’ includes all entities required to be treated as a single employer under section 414 (b), (c), (m), or (o).

(5) *Valuation formulae contained in the special valuation rules.* The valuation formula contained in the special valuation rules are provided only for use in connection with those rules. Thus, when a special valuation rule is properly applied to a fringe benefit, the Commissioner will accept the value calculated pursuant to the rule as the fair market value of that fringe benefit. However, when a special valuation rule is not properly applied to a fringe benefit (see, for example, paragraph (g)(13) of this section), or when a special valuation rule is used to value a fringe benefit by a taxpayer not entitled to use the rule, the fair market value of that fringe benefit may not be determined by reference to any value calculated under any special valuation rule. Under the circumstances described in the preceding sentence, the fair market value of the fringe benefit must be determined pursuant to the general valuation rules of paragraph (b) of this section.

(6) *Modification of the special valuation rules.* The Commissioner may, to the extent necessary for tax administration, add, delete, or modify any special valuation rule, including the valuation formulae contained herein, on a prospective basis by regulation, revenue ruling or revenue procedure.

(7) *Special accounting rule.* If the employer is using the special accounting rule provided in Announcement 85–113 (1985–31 I.R.B. 31, August 5, 1985) (see §601.601(d)(2)(ii)(*b*) of this chapter) (relating to the reporting of and withholding on the value of noncash fringe benefits), benefits which are deemed provided in a subsequent calendar year pursuant to that rule are considered as provided in that subsequent calendar year for purposes of the special valuation rules. Thus, if a particular special valuation rule is in effect for a calendar year, it applies to benefits deemed provided during that calendar year under the special accounting rule.

(d) *Automobile lease valuation rule*—(1) *In general*—(i) *Annual Lease Value.* Under the special valuation rule of this paragraph (d), if an employer provides an employee with an automobile that is available to the employee for an entire calendar year, the value of the benefit provided is the Annual Lease

Value (determined under paragraph (d)(2) of this section) of that automobile. Except as otherwise provided, for an automobile that is available to an employee for less than an entire calendar year, the value of the benefit provided is either a pro-rated Annual Lease Value or the Daily Lease Value (both as defined in paragraph (d)(4) of this section), whichever is applicable. Absent any statutory exclusion relating to the employer-provided automobile (see, for example, section 132(a)(3) and §1.132–5(b)), the amount of the Annual Lease Value (or a pro-rated Annual Lease Value or the Daily Lease Value, as applicable) is included in the gross income of the employee.

(ii) *Definition of automobile.* For purposes of this paragraph (d), the term ''automobile'' means any four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways.

(2) *Calculation of Annual Lease Value*—(i) *In general.* The Annual Lease Value of a particular automobile is calculated as follows:

(A) Determine the fair market value of the automobile as of the first date on which the automobile is made available to any employee of the employer for personal use. For an automobile first made available to any employee for personal use prior to January 1, 1985, determine the fair market value as of January l of the first year the special valuation rule of this paragraph (d) is used with respect to the automobile. For rules relating to determination of the fair market value of an automobile for purposes of this paragraph (d), see paragraph (d)(5) of this section.

(B) Select the dollar range in column 1 of the Annual Lease Value Table, set forth in paragraph (d)(2)(iii) of this section corresponding to the fair market value of the automobile. Except as otherwise provided in paragraphs (d)(2) (iv) and (v) of this section, the Annual Lease Value for each year of availability of the automobile is the corresponding amount in column 2 of the Table.

(ii) *Calculation of Annual Lease Value of automobile owned or leased by both an employer and an employee*—(A) *Purchased automobiles.* Notwithstanding anything in this section to the contrary, if an employee contributes an amount toward the purchase price of an automobile in return for a percentage ownership interest in the automobile, the Annual Lease Value or the Daily Lease Value, whichever is applicable, is determined by reducing the fair market value of the employer-provided automobile by the lesser of—

(*1*) The amount contributed, or

(*2*) An amount equal to the employee's percentage ownership interest multiplied by the unreduced fair market value of the automobile.

If the automobile is subsequently revalued, the revalued amount (determined without regard to this paragraph (d)(2)(ii)(A)) is reduced by an amount which is equal to the employee's percentage ownership interest in the vehicle). If the employee does not receive an ownership interest in the employer-provided automobile, then the Annual Lease Value or the Daily Lease Value, whichever is applicable, is determined without regard to any amount contributed. For purposes of this paragraph (d)(2)(ii)(A), an employee's ownership interest in an automobile will not be recognized unless it is reflected in the title of the automobile. An ownership interest reflected in the title of an automobile will not be recognized if under the facts and circumstances the title does not reflect the benefits and burdens of ownership.

(B) *Leased automobiles.* Notwithstanding anything in this section to the contrary, if an employee contributes an amount toward the cost to lease an automobile in return for a percentage interest in the automobile lease, the Annual Lease Value or the Daily Lease Value, whichever is applicable, is determined by reducing the fair market value of the employer-provided automobile by the amount specified in the following sentence. The amount specified in this sentence is the unreduced fair market value of a vehicle multiplied by the lesser of—

(*1*) The employee's percentage interest in the lease, or

(*2*) A fraction, the numerator of which is the amount contributed and the denominator of which is the entire lease cost.

If the automobile is subsequently revalued, the revalued amount (determined without regard to this paragraph (d)(2)(ii)(B)) is reduced by an amount which is equal to the employee's percentage interest in the lease) multiplied by the revalued amount. If the employee does not receive an interest in the automobile lease, then the Annual Lease Value or the Daily Lease Value, whichever is applicable, is determined without regard to any amount contributed. For purposes of this paragraph (d)(2)(ii)(B), an employee's interest in an automobile lease will not be recognized unless the employee is a named co-lessee on the lease. An interest in a lease will not be recognized if under the facts and circumstances the lease does not reflect the true obligations of the lessees.

(C) *Example.* The rules of paragraph (d)(2)(ii) (A) and (B) of this section are illustrated by the following example:

Example. Assume that an employer pays $15,000 and an employee pays $5,000 toward the purchase of an automobile. Assume further that the employee receives a 25 percent interest in the automobile and is named as a co-owner on the title to the automobile. Under the rule of paragraph (d)(2)(ii)(A) of this section, the Annual Lease Value of the automobile is determined by reducing the fair market value of the automobile ($20,000) by the $5,000 employee contribution. Thus, the Annual Lease Value of the automobile under the table in paragraph (d)(2)(iii) of this section is $4,350. If the employee in this example does not receive an ownership interest in the automobile and is provided the use of the automobile for two years, the Annual Lease Value would be determined without regard to the $5,000 employee contribution. Thus, the Annual Lease Value would be $5,600. The $5,000 employee contribution would reduce the amount includible in the employee's income after taking into account the amount, if any, excluded from income under another provision of subtitle A of the Internal Revenue Code, such as the working condition fringe exclusion. Thus, if the employee places 50 percent of the mileage on the automobile for the employer's business each year, then the amount includible in the employee's income in the first year would be ($5,600–2,800–2,800), or $0, the amount includible in the employee's income in the second year would be ($5,600–2,800–2,200 ($5,000–2,800)) or $600 and the amount includible in the third year would be ($5,600–2,800) or $2,800 since the employee's contribution has been completely used in the first two years.

(iii) *Annual Lease Value Table.*

Automobile fair market value	Annual lease value
(1)	(2)
$0 to 999	$600
1,000 to 1,999	850
2,000 to 2,999	1,100
3,000 to 3,999	1,350
4,000 to 4,999	1,600
5,000 to 5,999	1,850
6,000 to 6,999	2,100
7,000 to 7,999	2,350
8,000 to 8,999	2,600
9,000 to 9,999	2,850
10,000 to 10,999	3,100
11,000 to 11,999	3,350
12,000 to 12,999	3,600
13,000 to 13,999	3,850
14,000 to 14,999	4,100
15,000 to 15,999	4,350
16,000 to 16,999	4,600
17,000 to 17,999	4,850
18,000 to 18,999	5,100
19,000 to 19,999	5,350
20,000 to 20,999	5,600
21,000 to 21,999	5,850
22,000 to 22,999	6,100
23,000 to 23,999	6,350
24,000 to 24,999	6,600
25,000 to 25,999	6,850
26,000 to 27,999	7,250
28,000 to 29,999	7,750
30,000 to 31,999	8,250
32,000 to 33,999	8,750
34,000 to 35,999	9,250
36,000 to 37,999	9,750
38,000 to 39,999	10,250
40,000 to 41,999	10,750
42,000 to 43,999	11,250
44,000 to 45,999	11,750
46,000 to 47,999	12,250
48,000 to 49,999	12,750
50,000 to 51,999	13,250
52,000 to 53,999	13,750
54,000 to 55,999	14,250
56,000 to 57,999	14,750
58,000 to 59,999	15,250

For vehicles having a fair market value in excess of $59,999, the Annual Lease Value is equal to: (.25 × the fair market value of the automobile) + $500.

(iv) *Recalculation of Annual Lease Value.* The Annual Lease Values determined under the rules of this paragraph (d) are based on four-year lease terms. Therefore, except as otherwise provided in paragraph (d)(2)(v) of this section, the Annual Lease Value calculated by applying paragraph (d)(2) (i) or (ii) of this section shall remain in effect for the period that begins with the first date the special valuation rule of paragraph (d) of this section is applied by the employer to the automobile and ends on December 31 of the fourth full calendar year following that date. The

Annual Lease Value for each subsequent four-year period is calculated by determining the fair market value of the automobile as of the first January 1 following the period described in the previous sentence and selecting the amount in column 2 of the Annual Lease Value Table corresponding to the appropriate dollar range in column 1 of the Table. If, however, the employer is using the special accounting rule provided in Announcement 85–113 (1985–31 I.R.B. 31, August 5, 1985) (relating to the reporting of and withholding on the value of noncash fringe benefits), the employer may calculate the Annual Lease Value for each subsequent four-year period as of the beginning of the special accounting period that begins immediately prior to the January 1 described in the previous sentence. For example, assume that pursuant to Announcement 85–113, an employer uses the special accounting rule. Assume further that beginning on November 1, 1988, the special accounting period is November 1 to October 31 and that the employer elects to use the special valuation rule of this paragraph (d) as of January 1, 1989. The employer may recalculate the Annual Lease Value as of November 1, 1992, rather than as of January 1, 1993.

(v) *Transfer of the automobile to another employee.* Unless the primary purpose of the transfer is to reduce Federal taxes, if an employer transfers the use of an automobile from one employee to another employee, the employer may recalculate the Annual Lease Value based on the fair market value of the automobile as of January 1 of the calendar year of transfer. If, however, the employer is using the special accounting rule provided in Announcement 85–113 (1985–31 I.R.B. 31, August 5, 1985) (relating to the reporting of and withholding on the value of noncash fringe benefits), the employer may recalculate the Annual Lease Value based on the fair market value of the automobile as of the beginning of the special accounting period in which the transfer occurs. If the employer does not recalculate the Annual Lease Value, and the employee to whom the automobile is transferred uses the special valuation rule, the employee may not recalculate the Annual Lease Value.

(3) *Services included in, or excluded from, the Annual Lease Value Table*—(i) *Maintenance and insurance included.* The Annual Lease Values contained in the Annual Lease Value Table include the fair market value of maintenance of, and insurance for, the automobile. Neither an employer nor an employee may reduce the Annual Lease Value by the fair market value of any service included in the Annual Lease Value that is not provided by the employer, such as reducing the Annual Lease Value by the fair market value of a maintenance service contract or insurance. An employer or employee who wishes to take into account only the services actually provided with respect to an automobile may value the availability of the automobile under the general valuation rules of paragraph (b) of this section.

(ii) *Fuel excluded*—(A) *In general.* The Annual Lease Values do not include the fair market value of fuel provided by the employer, whether fuel is provided in kind or its cost is reimbursed by or charged to the employer. Thus, if an employer provides fuel, the fuel must be valued separately for inclusion in income.

(B) *Valuation of fuel provided in kind.* The provision of fuel in kind may be valued at fair market value based on all the facts and circumstances or, in the alternative, it may be valued at 5.5 cents per mile for all miles driven by the employee. However, the provision of fuel in kind may not be valued at 5.5 cents per mile for miles driven outside the United States, Canada or Mexico. For purposes of this section, the United States includes the United States, its possessions and its territories.

(C) *Valuation of fuel where cost reimbursed by or charged to an employer.* The fair market value of fuel, the cost of which is reimbursed by or charged to an employer, is generally the amount of the actual reimbursement or the amount charged, provided the purchase of the fuel is at arm's-length.

(D) *Fleet-average cents-per-mile fuel cost.* If an employer with a fleet of at least 20 automobiles that meets the requirements of paragraph (d)(5)(v)(D) of this section reimburses employees for the cost of fuel or allows employees to charge the employer for the cost of fuel, the fair market value of fuel provided to those automobiles may be determined by reference to the employer's fleet-average cents-per-mile fuel cost. The fleet-average cents-per-mile fuel cost is equal to the fleet-average per-gallon fuel cost divided by the fleet-average miles-per-gallon rate. The averages described in the preceding sentence must be determined by averaging the per-gallon fuel costs and miles-per-gallon rates of a representative sample of the automobiles in the fleet equal to the greater of ten percent of the automobiles in the fleet or 20 automobiles for a representative period, such as a two-month period. In lieu of determining the fleet-average cents-per-mile fuel cost, if an employer is using the fleet-average valuation rule of paragraph (d)(5)(v) of this section and if determining the amount of the actual reimbursement or the amount charged for the purchase of fuel would impose unreasonable administrative burdens on the employer, the provision of fuel may be valued under the rule provided in paragraph (d)(3)(ii)(B) of this section.

(iii) *Treatment of other services.* The fair market value of any service not specifically identified in paragraph (d)(3)(i) of this section that is provided by the employer with respect to an automobile (other than the services of a chauffeur) must be added to the Annual Lease Value of the automobile in determining the fair market value of the benefit provided. See paragraph (b)(5) of this section for rules relating to the valuation of chauffeur services.

(4) *Availability of an automobile for less than an entire calendar year*—(i) *Pro-rated Annual Lease Value used for continuous availability of at least 30 days.*—(A) *In general.* Except as otherwise provided in paragraph (d)(4)(iv) of this section, for periods of continuous availability of at least 30 days, but less than an entire calendar year, the value of the availability of an automobile provided by an employer electing to use the automobile lease valuation rule of this paragraph (d) is the pro-rated Annual Lease Value. The pro-rated Annual Lease Value is calculated by multiplying the applicable Annual Lease Value by a fraction, the numerator of which is the number of days of availability and the denominator of which is 365.

(B) *Special rule for continuous availability of at least 30 days that straddles two reporting years.* If an employee is provided with the continuous availability of an automobile for at least 30 days, but the continuous period straddles two calendar years (or two special accounting periods if the special accounting rule of Announcement 85–113 (1985–31 I.R.B. 31, August 5, 1985) (relating to the reporting of and withholding on noncash fringe benefits) is used), the pro-rated Annual Lease Value, rather than the Daily Lease Value, may be applied with respect to such period of continuous availability.

(ii) *Daily Lease Value used for continuous availability of less than 30 days.* Except as otherwise provided in paragraph (d)(4)(iii) of this section, for periods of continuous availability of one or more but less than 30 days, the value of the availability of the employer-provided automobile is the Daily Lease Value. The Daily Lease Value is calculated by multiplying the applicable Annual Lease Value by a fraction, the numerator of which is four times the number of days of availability and the denominator of which is 365.

(iii) *Election to treat all periods as periods of at least 30 days.* The value of the availability of an employer-provided automobile for a period of continuous availability of less than 30 days may be determined by applying the pro-rated Annual Lease Value by treating the automobile as if it had been available for 30 days, if doing so would result in a lower valuation than applying the Daily Lease Value to the shorter period of actual availability.

(iv) *Periods of unavailability*—(A) *General rule.* In general, a pro-rated Annual Lease Value (as provided in paragraph (d)(4)(i) of this section) is used to value the availability of an employer-provided automobile when the automobile is available to an employee for a continuous period of at least 30 days but less than the entire calendar year. Neither an employer nor an employee, however, may use a pro-rated Annual Lease Value when the reduction of Federal taxes is the primary reason the automobile is unavailable to an employee at certain times during the calendar year.

(B) *Unavailability for personal reasons of the employee.* If an automobile is unavailable to an employee because of personal reasons of the employee, such as while the employee is on vacation, a pro-rated Annual Lease Value, if used, must not take into account such periods of unavailability. For example, assume that an automobile is available to an employee during the first five months of the year and during the last five months of the year. Assume further that the period of unavailability occurs because the employee is on vacation. The Annual Lease Value, if it is applied, must be applied with respect to the entire 12-month period. The Annual Lease Value may not be pro-rated to take into account the two-month period of unavailability.

(5) *Fair market value*—(i) *In general.* For purposes of determining the Annual Lease Value of an automobile under the Annual Lease Value Table, the fair market value of an automobile is the amount that an individual would have to pay in an arm's-length transaction to purchase the particular automobile in the jurisdiction in which the vehicle is purchased or leased. That amount includes all amounts attributable to the purchase of an automobile such as sales tax and title fees as well as the purchase price of the automobile. Any special relationship that may exist between the employee and the employer must be disregarded. Also, the employee's subjective perception of the value of the automobile is not relevant to the determination of the automobile's fair market value, and, except as provided in paragraph (d)(5)(ii) of this section, the cost incurred by the employer in connection with the purchase or lease of the automobile is not determinative of the fair market value of the automobile.

(ii) *Safe-harbor valuation rule*—(A) *General rule.* For purposes of calculating the Annual Lease Value of an automobile under this paragraph (d), the safe-harbor value of the automobile may be used as the fair market value of the automobile.

(B) *Automobiles owned by the employer.* For an automobile owned by the employer, the safe-harbor value of the automobile is the employer's cost of purchasing the automobile (including sales tax, title, and other expenses attributable to such purchase), provided the purchase is made at arm's-length. Notwithstanding the preceding sentence, the safe-harbor value of this paragraph (d)(5)(ii)(B) is not available with respect to an automobile manufactured by the employer. Thus, for example, if one entity manufactures an automobile and sells it to an entity with which it is aggregated pursuant to paragraph (c)(4) of this section, this paragraph (d)(5)(ii)(B) does not apply to value the automobile by the aggregated employer. In this case, value must be determined under paragraph (d)(5)(i) of this section.

(C) *Automobiles leased by the employer.* For an automobile leased but not manufactured by the employer, the safe-harbor value of the automobile is either the manufacturer's suggested retail price of the automobile less eight percent (including sales tax, title, and other expenses attributable to such purchase), or the value determined under paragraph (d)(5)(iii) of this section.

(iii) *Use of nationally recognized pricing sources.* The fair market value of an automobile that is—

(A) Provided to an employee prior to January 1, 1985,

(B) Being revalued pursuant to paragraph (d)(2) (iv) or (v) of this section, or

(C) A leased automobile being valued pursuant to paragraph (d)(5)(ii) of this section, may be determined by reference to the retail value of such automobile as reported by a nationally recognized pricing source that regularly reports new or used automobile retail values, whichever is applicable. That retail value must be reasonable with respect to the automobile being valued. Pricing sources consist of publications and electronic data bases.

(iv) *Fair market value of special equipment.* When determining the fair market value of an automobile, the employer may exclude the fair market value of any specialized equipment or telephone that is added to or carried in the automobile provided that the presence of that equipment or telephone is necessitated by, and attributable to, the business needs of the employer. The value of the specialized equipment must be included if the employee to whom the automobile is available uses the specialized equipment in a trade or business of the employee other than the employee's trade or business of being an employee of the employer.

(v) *Fleet-average valuation rule*—(A) *In general.* An employer with a fleet of 20 or more automobiles meeting the requirements of this paragraph (d)(5)(v) (including the business-use and fair market value conditions of paragraph (d)(5)(v)(D) of this section) may use a fleet-average value for purposes of calculating the Annual Lease Values of the automobiles in the fleet. The fleet-average value is the average of the fair market values of all automobiles in the fleet. The fair market value of each automobile in the fleet shall be determined, pursuant to the rules of paragraphs (d)(5) (i) through (iv) of this section, as of the date described in paragraph (d)(2)(i)(A) of this section.

(B) *Period for use of rule.* The fleet-average valuation rule of this paragraph (d)(5)(v) may be used by an employer as of January 1 of any calendar year following the calendar year in which the employer acquires a sufficient number of automobiles to total a fleet of 20 or more automobiles. The Annual Lease Value calculated for the automobiles in the fleet, based on the fleet-average value, shall remain in effect for the period that begins with the first January 1 the fleet-average valuation ru1e of this paragraph (d)(5)(v) is applied by the employer to the automobiles in the fleet and ends on December 31 of the subsequent calendar year. The Annual Lease Value for each subsequent two-year period is calculated by determining the fleet-average value of the automobiles in the fleet as of the first January 1 of such period. An employer may cease using the fleet-average valuation rule as of any January 1. If, however, the employer is using the special accounting rule provided in Announcement 85–113 (1985–31 I.R.B. 31, August 5, 1985) (relating to the reporting of and withholding on noncash fringe benefits), the employer may apply the rules of this paragraph (d)(5)(v)(B) on the basis of the special accounting period rather than the calendar year. (This is accomplished by substituting (*1*) the beginning of the special accounting period that begins immediately prior to the January 1 described in this paragraph (d)(5)(v)(B) for January 1 wherever it appears in this paragraph (d)(5)(v) (B) and (*2*) the end of such accounting period for December 31.) If the number of qualifying automobiles in the employer's fleet declines to fewer than 20 for more than 50 percent of the days in a year, then the fleet-average valuation rule does not apply as of January 1 of such year. In this case, the Annual Lease Value must be determined separately for each remaining automobile. The revaluation rules of paragraphs (d)(2) (iv) and (v) of this section do not apply to automobiles valued under this paragraph (d)(5)(v).

(C) *Automobiles included in the fleet.* An employer may include in a fleet any automobile that meets the requirements of this paragraph (d)(5)(v) and is available to any employee of the employer for personal use. An employer may include in the fleet only automobiles the availability of which is valued under the automobile lease valuation rule of this paragraph (d). An employer need not include in the fleet all automobiles valued under the automobile lease valuation rule. An employer may have more than one fleet for purposes of the fleet-average rule of this paragraph (d)(5)(v). For example, an employer may group automobiles in a fleet according to their physical type or use.

(D) *Limitations on use of fleet-average rule.* The rule provided in this paragraph (d)(5)(v) may not be used for any automobile the fair market value of which (determined pursuant to paragraphs (d)(5) (i) through (iv) of this section as of either the first date on which the automobile is made available to any employee of the employer for personal use or, if later, January 1, 1985) exceeds $16,500. The fair market value limitation of $16,500 shall be adjusted pursuant to section 280F(d)(7) of the Internal Revenue Code of 1986. The first such adjustment shall be for calendar year 1989 (substitute October 1986 for October 1987 in applying the formula). In addition, the rule provided in this paragraph (d)(5)(v) may only be used for automobiles that the employer reasonably expects will regularly be used in the employer's trade or business. For rules concerning when an automobile is regularly used in the employer's business, see paragraph (e)(1)(iv) of this section.

(E) *Additional automobiles added to the fleet.* The fleet-average value in effect at the time an automobile is added to a fleet is treated as the fair market value of the additional automobile for purposes of determining the Annual Lease Value of the automobile until the fleet-average value changes pursuant to paragraph (d)(5)(v)(B) of this section.

(F) *Use of the fleet-average rule by employees.* An employee may only use the fleet-average rule if it is used by the employer. If an employer uses the fleet-average rule, and the employee uses the special valuation rule of paragraph (d) of this section, the employee must use the fleet-average value determined by the employer.

(6) *Special rules for continuous availability of certain automobiles*—(i) *Fleet automobiles.* If an employer is using the fleet-average valuation ru1e of paragraph (d)(5)(v) of this section and the employer provides an employee with the continuous availability of an automobile from the same fleet during a period (though not necessarily the same fleet automobile for the entire period), the employee is treated as having the use of a single fleet automobile for the entire period, e.g., an entire calendar year. Thus, when applying the automobile lease valuation rule of this paragraph (d), the employer may treat the fleet-average value as the fair market value of the automobile deemed available to the employee for the period for purposes of calculating the Annual Lease Value, (or pro-rated Annual Lease Value or Daily Lease Value whichever is applicable) of the automobile. If an employer provides an employee with the continuous availability of more than one fleet automobile during a period, the employer may treat the fleet-average value as the fair market value of each automobile provided to the employee provided that the rules of paragraph (d)(5)(v)(D) of this section are satisfied.

(ii) *Demonstration automobiles*—(A) *In general.* If an automobile dealership provides an employee with the continuous availability of a demonstration automobile (as defined in § 1.132–5(o)(3)) during a period (though not necessarily the same demonstration automobile for the entire period), the employee is treated as having the use of a single demonstration automobile for the entire period, e.g., an entire calendar year. If an employer provides an employee with the continuous availability of more than one demonstration automobile during a period, the employer may treat the value determined under paragraph (d)(6)(ii)(B) of this section as the fair market value of each automobile provided to the employee. For rules relating to the treatment as a working condition fringe of the qualified automobile demonstration use of a demonstration automobile by a full-time automobile salesman, see § 1.132–5(o).

(B) *Determining the fair market value of a demonstration automobile.* When applying the automobile lease valuation rule of this paragraph (d), the employer may treat the average of the fair market values of the demonstration automobiles which are available to an employee and held in the dealership's inventory during the calendar year as the fair market value of the demonstration automobile deemed available to the employee for the period for purposes of calculating the Annual Lease Value of the automobile. If under the facts and circumstances it is inappropriate to take into account, with respect to an employee, certain models of demonstration automobiles, the value of the benefit is determined without reference to the fair market values of such models. For example, assume that an employee has the continuous availability for an entire calendar year of one demonstration automobile, although not the same one for the entire year. Assume further that the fair market values of the automobiles in the dealership inventory during the year range from $8,000 to $20,000. If there is not a substantial period (such as three months) during the year when the employee uses demonstration automobiles valued at less than $16,000, then those automobiles are not considered in determining the value of the benefit provided to the employee. In this case, the average of the fair market values of the demonstration automobiles in the dealership's inventory valued at $16,000 or more is treated as the fair market value of the automobile deemed available to the employee for the calendar year for purposes of calculating the Annual Lease Value of the automobile.

(7) *Consistency rules*—(i) *Use of the automobile lease valuation rule by an employer.* Except as provided in paragraph (d)(5)(v)(B) of this section, an employer may adopt the automobile lease valuation rule of this paragraph (d) for an automobile only if the rule is adopted to take effect by the later of—

(A) January 1, 1989, or

(B) The first day on which the automobile is made available to an employee of the employer for personal use (or, if the commuting valuation rule of paragraph (f) of this section is used when the automobile is first made available to an employee of the employer for personal use, the first day on which the commuting valuation rule is not used).

(ii) *An employer must use the automobile lease valuation rule for all subsequent years.* Once the automobile lease valuation rule has been adopted for an automobile by an employer, the rule must be used by the employer for all subsequent years in which the employer makes the automobile available to any employee except that the employer may, for any year during which (or for any employee for whom) use of the automobile qualifies for the commuting valuation rule of paragraph (f) of this section, use the commuting valuation rule with respect to the automobile.

(iii) *Use of the automobile lease valuation rule by an employee.* An employee may adopt the automobile lease valuation rule for an automobile only if the rule is adopted—

(A) By the employer, and

(B) Beginning with the first day on which the automobile for which the employer (consistent with paragraph (d)(7)(i) of this section) adopted the rule is made available to that employee for personal use (or, if the commuting valuation rule of paragraph (f) of this section is used when the automobile is first made available to that employee for personal use, the first day on which the commuting valuation rule is not used).

(iv) *An employee must use the automobile lease valuation rule for all subsequent years.* Once the automobile lease valuation rule has been adopted for an automobile by an employee, the rule must be used by the employee for all subsequent years in which the automobile for which the rule is used is available to the employee. However, the employee may, for any year during which use of the automobile qualifies for use of the commuting valuation rule of paragraph (f) of this section and for which the employer uses such rule, use the commuting valuation rule with respect to the automobile.

(v) *Replacement automobiles.* Notwithstanding anything in this paragraph (d)(7) to the contrary, if the automobile lease valuation rule is used by an employer, or by an employer and an employee, with respect to a particular automobile, and a replacement automobile is provided to the employee for the primary purpose of reducing Federal taxes, then the employer, or the employer and the employee, using the rule must continue to use the rule with respect to the replacement automobile.

(e) *Vehicle cents-per-mile valuation rule*—(1) *In general*—(i) *General rule.* Under the vehicle cents-per-mile valuation rule of this paragraph (e), if an employer provides an employee with the use of a vehicle that—

(A) The employer reasonably expects will be regularly used in the employer's trade or business throughout the calendar year (or such shorter period as the vehicle may be owned or leased by the employer), or

(B) Satisfies the requirements of paragraph (e)(1)(ii) of this section, the value of the benefit provided in the calendar year is the standard mileage rate provided in the applicable Revenue Ruling or Revenue Procedure (''cents-per-mile rate'') multiplied by the total number of miles the vehicle is driven by the employee for personal purposes. The cents-per-mile rate is to be applied prospectively from the first day of the taxable year following the date of publication of the applicable Revenue Ruling or Revenue Procedure. An employee who uses an employer-provided vehicle, in whole or in part, for a trade or business other than the employer's trade or business, may take a deduction for such business use based upon the vehicle cents-per-mile rule as long as such deduction is at the same standard mileage rate as that used in calculating the employee's income inclusion. The standard mileage rate must be applied to personal miles independent of business miles. Thus, for example, if the standard mileage rate were 24 cents per mile for the first 15,000 miles and 11 cents per mile for all miles over 15,000 and an employee drives 20,000 personal miles and 45,000 business miles in a year, the value of the personal use of the vehicle is $4,150 ((15,000×$.24)+(5,000×$.11)). For purposes of this section, the use of a vehicle for personal purposes is any use of the vehicle other than use in the employee's trade or business of being an employee of the employer.

(ii) *Mileage rule.* A vehicle satisfies the requirements of this paragraph (e)(1)(ii) for a calendar year if—

(A) It is actually driven at least 10,000 miles in that year; and

(B) Use of the vehicle during the year is primarily by employees. For example, if a vehicle is used by only one employee during the calendar year and that employee drives the vehicle at least 10,000 miles during the year, the vehicle satisfies the requirements of this paragraph (e)(1)(ii) even if all miles driven by the employee are personal. A vehicle is considered used during the year primarily by employees in accordance with the requirement of paragraph (e)(1)(ii)(B) of this section if employees use the vehicle on a consistent basis for commuting. If the employer does not own or lease the vehicle during a portion of the year, the 10,000 mile threshold is to be reduced proportionately to reflect the periods when the employer did not own or lease the vehicle. For purposes of this paragraph (e)(1)(ii), use of the vehicle by an individual (other than the employee) whose use would be taxed to the employee is not considered use by the employee.

(iii) *Limitation on use of the vehicle cents-per-mile valuation rule*—(A) *In general.* Except as otherwise provided in the last sentence of this paragraph (e)(1)(iii)(A), the value of the use of an automobile (as defined in paragraph (d)(1)(ii) of this section) may not be determined under the vehicle cents-per-mile valuation rule of this paragraph (e) for a calendar year if the fair market value of the automobile (determined pursuant to paragraphs (d)(5) (i) through (iv) of this section as of the later of January 1, 1985, or the first date on which the automobile is made available to any employee of the employer for personal use) exceeds the sum of the maximum recovery deductions allowable under section 280F(a)(2) for a five-year period for an automobile first placed in service during that calendar year (whether or not the automobile is actually placed in service during that year) as adjusted by section 280F(d)(7). With respect to a vehicle placed in service prior to January 1, 1989, the limitation on value will be not less than $12,800. With respect to a vehicle placed in service in or after 1989, the limitation on value is $12,800 as adjusted by section 280F(d)(7).

(B) *Application of limitation with respect to a vehicle owned by both an employer and an employee.* If an employee contributes an amount towards the purchase price of a vehicle in return for a percentage ownership interest in the vehicle, for purposes of determining whether the limitation of this paragraph (e)(1)(iii) applies, the fair market value of the vehicle is reduced by the lesser of—

(*1*) The amount contributed, or

(*2*) An amount equal to the employee's percentage ownership interest multiplied by the unreduced fair market value of the vehicle. If the employee does not receive an ownership interest in the employer-provided vehicle, then the fair market value of the vehicle is determined without regard to any amount contributed. For purposes of this paragraph (e)(1)(iii)(B), an employee's ownership interest in a vehicle will not be recognized unless it is reflected in the title of the vehicle. An ownership interest reflected in the title of a vehicle will not be recognized if under the facts and circumstances the title does not reflect the benefits and burdens of ownership.

(C) *Application of limitation with respect to a vehicle leased by both an employer and employee.* If an employee contributes an amount toward the cost to lease a vehicle in return for a percentage interest in the vehicle lease, for purposes of determining whether the limitation of this paragraph (e)(1)(iii) applies, the fair market value of the vehicle is reduced by the amount specified in the following sentence. The amount specified in this sentence is the unreduced fair market value of a vehicle multiplied by the lesser of—

(*1*) The employee's percentage interest in the lease, or

(*2*) A fraction, the numerator of which is the amount contributed and the denominator of which is the entire lease cost. If the employee does not receive an interest in the vehicle lease, then the fair market value is determined without regard to any amount contributed. For purposes of this paragraph (e)(1)(iii)(C), an employee's interest in a vehicle lease will not be recognized unless the employee is a named co-lessee on the lease. An interest in a lease will not be recognized if under the facts and circumstances, the lease does not reflect the true obligations of the lessees.

(iv) *Regular use in an employer's trade or business.* Whether a vehicle is regularly used in an employer's trade or business is determined on the basis of all facts and circumstances. A vehicle is considered regularly used in an employer's trade or business for purposes of paragraph (e)(1)(i)(A) of this section if one of the following safe harbor conditions is satisfied:

(A) At least 50 percent of the vehicle's total annual mileage is for the employer's business; or

(B) The vehicle is generally used each workday to transport at least three employees of the employer to and from work in an employer-sponsored commuting vehicle pool. Infrequent business use of the vehicle, such as for occasional trips to the airport or between the employer's multiple business premises, does not constitute regular use of the vehicle in the employer's trade or business.

(v) *Application of rule to shared usage.* If an employer regularly provides a vehicle to employees for use by more than one employee at the same time, such as with an employer-sponsored vehicle commuting pool, the employer may use the vehicle cents-per-mile valuation rule to value the use of the vehicle by each employee who shares such use. See §1.61–21(c)(2)(ii)(B) for provisions relating to the allocation of the value of an automobile to more than one employee.

(2) *Definition of vehicle.* For purposes of this paragraph (e), the term ''vehicle'' means any motorized wheeled vehicle manufactured primarily for use on public streets, roads, and highways. The term ''vehicle'' includes an automobile as defined in paragraph (d)(1)(ii) of this section.

(3) *Services included in, or excluded from, the cents-per-mile rate*—(i) *Maintenance and insurance included.* The cents-per-mile rate includes the fair market value of maintenance of, and insurance for, the vehicle. The cents-per-mile rate may not be reduced by the fair market value of any service included in the cents-per-mile rate but not provided by the employer. An employer or employee who wishes to take into account only the particular services provided with respect to a vehicle may value the availability of the vehicle under the general valuation rules of paragraph (b) of this section.

(ii) *Fuel provided by the employer*—(A) *Miles driven in the United States, Canada, or Mexico.* With respect to miles driven in the United States, Canada, or Mexico, the cents-per-mile rate includes the fair market value of fuel provided by the employer. If fuel is not provided by the employer, the cents-per-mile rate may be reduced by no more than 5.5 cents or the amount specified in any applicable Revenue Ruling or Revenue Procedure. For purposes of this section, the United States includes the United States, its possessions and its territories.

(B) *Miles driven outside the United States, Canada, or Mexico.* With respect to miles driven outside the United States, Canada, or Mexico, the fair market value of fuel provided by the employer is not reflected in the cents-per-mile rate. Accordingly, the cents-per-mile rate may be reduced but by no more than 5.5 cents or the amount specified in any applicable Revenue Ruling or Revenue Procedure. If the employer provides the fuel in kind, it must be valued based on all the facts and circumstances. If the employer reimburses the employee for the cost of fuel or allows the employee to charge the employer for the cost of fuel, the fair market value of the fuel is generally the amount of the actual reimbursement or the amount charged, provided the purchase of fuel is at arm's length.

(iii) *Treatment of other services.* The fair market value of any service not specifically identified in paragraph (e)(3)(i) of this section that is provided by the employer with respect to a vehicle is not reflected in the cents-per-mile rate. See paragraph (b)(5) of this section for rules relating to valuation of chauffeur services.

(4) *Valuation of personal use only.* The vehicle cents-per-mile valuation rule of this paragraph (e) may only be used to value the miles driven for personal purposes. Thus, the employer must include an amount in an employee's income with respect to the use of a vehicle that is equal to the product of the number of personal miles driven by the employee and the appropriate cents-per-mile rate. The term ''personal miles'' means all miles for which the employee used the automobile except miles driven in the employee's trade or business of being an employee of the employer. Unless additional services are provided with respect to the vehicle (see paragraph (e)(3)(iii) of this section), the employer may not include in income a greater amount; for example, the employer may not include in income 100 percent (all business and personal miles) of the value of the use of the vehicle.

(5) *Consistency rules*—(i) *Use of the vehicle cents-per-mile valuation rule by an employer.* An employer must adopt the vehicle cents-per-mile valuation rule of this paragraph (e) for a vehicle to take effect by the later of—

(A) January 1, 1989, or

(B) The first day on which the vehicle is used by an employee of the employer for personal use (or, if the commuting valuation rule of paragraph (f) of this section is used when the vehicle is first used by an employee of the employer for personal use, the first day on which the commuting valuation rule is not used).

(ii) *An employer must use the vehicle cents-per-mile valuation rule for all subsequent years.* Once the vehicle cents-per-mile valuation rule has been adopted for a vehicle by an employer, the rule must be used by the employer for all subsequent years in which the vehicle qualifies for use of the rule, except that the employer may, for any year during which use of the vehicle qualifies for the commuting valuation rule of paragraph (f) of this section, use the commuting valuation rule with respect to the vehicle. If the vehicle fails to qualify for use of the vehicle cents-per-mile valuation rule during a subsequent year, the employer may adopt for such subsequent year and thereafter any other special valuation rule for which the vehicle then qualifies. If the employer elects to use the automobile lease valuation rule of paragraph (d) of this section for a period in which the automobile does not qualify for use of the vehicle cents-per-mile valuation rule, then the employer must comply with the requirements of paragraph (d)(7) of this section. For purposes of paragraph (d)(7) of this section, the first day on which the automobile with respect to which the vehicle cents-per-mile rule had been used fails to qualify for use of the vehicle cents-per-mile valuation rule may be deemed to be the first day on which the automobile is available to an employee of the employer for personal use.

(iii) *Use of the vehicle cents-per-mile valuation rule by an employee.* An employee may adopt the vehicle cents-per-mile valuation rule for a vehicle only if the rule is adopted—

(A) By the employer, and

(B) Beginning with respect to the first day on which the vehicle for which the employer (consistent with paragraph (e)(5)(i) of this section) adopted the rule is available to that employee for personal use (or, if the commuting valuation rule of paragraph (f) of this section is used when the vehicle is first used by an employee for personal use, the first day on which the commuting valuation rule is not used).

(iv) *An employee must use the vehicle cents-per-mile valuation rule for all subsequent years.* Once the vehicle cents-per-mile valuation rule has been adopted for a vehicle by an employee, the rule must be used by the employee for all subsequent years of personal use of the vehicle by the employee for which the rule is used by the employer. However, see paragraph (f) of this section for rules relating to the use of the commuting valuation rule for a subsequent year.

(v) *Replacement vehicles.* Notwithstanding anything in this paragraph (e)(5) to the contrary, if the vehicle cents-per-mile valuation rule is used by an employer, or by an employer and an employee, with respect to a particular vehicle. and a replacement vehicle is provided to the employee for the primary purpose of reducing Federal taxes, then the employer, or the employer and the employee, using the rule must continue to use the rule with respect to the replacement vehicle if the replacement vehicle qualifies for use of the rule.

(f) *Commuting valuation rule*—(1) *In general.* Under the commuting valuation rule of this paragraph (f), the value of the commuting use of an employer-provided vehicle may be determined pursuant to paragraph (f)(3) of this section if the following criteria are met by the employer and employees with respect to the vehicle:

(i) The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business and is used in the employer's trade or business;

(ii) For bona fide noncompensatory business reasons, the employer requires the employee to commute to and/or from work in the vehicle;

(iii) The employer has established a written policy under which neither the employee, nor any individual whose use would be taxable to the employee, may use the vehicle for personal purposes, other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home);

(iv) Except for de minimis personal use, the employee does not use the vehicle for any personal purpose other than commuting; and

(v) The employee required to use the vehicle for commuting is not a control employee of the employer (as defined in paragraphs (f) (5) and (6) of this section).

Personal use of a vehicle is all use of the vehicle by an employee that is not used in the employee's trade or business of being an employee of the employer. An employer-provided vehicle that is generally used each workday to transport at least three employees of the employer to and from work in an employer-sponsored commuting vehicle pool is deemed to meet the requirements of paragraphs (f)(1) (i) and (ii) of this section.

(2) *Special rules.* Notwithstanding anything in paragraph (f)(1) of this section to the contrary, the following special rules apply—

(i) *Chauffeur-driven vehicles.* If a vehicle is chauffeur-driven, the commuting valuation rule of this paragraph (f) may not be used to value the commuting use of any person (other than the chauffeur) who rides in the vehicle. (See paragraphs (d) and (e) of this section for other vehicle special valuation rules.) The special rule of this paragraph (f) may be used to value the commuting-only use of the vehicle by the chauffeur if the conditions of paragraph (f)(1) of this section are satisfied. For purposes of this paragraph (f)(2), an individual will not be considered a chauffeur if he or she performs non-driving services for the employer, is not available to perform driving services while performing such other services and whose only driving services consist of driving a vehicle used for commuting by other employees of the employer.

(ii) *Control employee exception.* If the vehicle in which the employee is required to commute is not an automobile as defined in paragraph (d)(1)(ii) of this section, the restriction of paragraph (f)(1)(v) of this section (relating to control employees) does not apply.

(3) *Commuting value*—(i) *$1.50 per one-way commute.* If the requirements of this paragraph (f) are satisfied, the value of the commuting use of an employer-provided vehicle is $1.50 per one-way commute (e.g., from home to work

or from work to home). The value provided in this paragraph (f)(3) includes the value of any goods or services directly related to the vehicle (e.g., fuel).

(ii) *Value per employee.* If there is more than one employee who commutes in the vehicle, such as in the case of an employer-sponsored commuting vehicle pool, the amount includible in the income of each employee is $1.50 per one-way commute. Thus, the amount includible for each round-trip commute is $3.00 per employee. See paragraphs (d)(7)(vi) and (e)(5)(vi) of this section for use of the automobile lease valuation and vehicle cents-per-mile valuation special rules for valuing the use or availability of the vehicle in the case of an employer-sponsored vehicle or automobile commuting pool.

(4) *Definition of vehicle.* For purposes of this paragraph (f), the term ‘‘vehicle’’ means any motorized wheeled vehicle manufactured primarily for use on public streets, roads, and highways. The term ‘‘vehicle’’ includes an automobile as defined in paragraph (d)(1)(ii) of this section.

(5) *Control employee defined—Non-government employer.* For purposes of this paragraph (f), a control employee of a non-government employer is any employee—

(i) Who is a Board- or shareholder-appointed, confirmed, or elected officer of the employer whose compensation equals or exceeds $50,000,

(ii) Who is a director of the employer,

(iii) Whose compensation equals or exceeds $100,000, or

(iv) Who owns a one-percent or greater equity, capital, or profits interest in the employer.

For purposes of determining who is a one-percent owner under paragraph (f)(5)(iv) of this section, any individual who owns (or is considered as owning under section 318(a) or principles similar to section 318(a) for entities other than corporations) one percent or more of the fair market value of an entity (the ‘‘owned entity’’) is considered a one-percent owner of all entities which would be aggregated with the owned entity under the rules of section 414 (b), (c), (m), or (o). For purposes of determining who is an officer or director with respect to an employer under this paragraph (f)(5), notwithstanding anything in this section to the contrary, if an entity would be aggregated with other entities under the rules of section 414 (b), (c), (m), or (o), the officer definition (but not the compensation requirement) and the director definition apply to each such separate entity rather tha to the aggregated employer. An employee who is an officer or a director of an entity (the ‘‘first entity’’) shall be treated as an officer or a director of all entities aggregated with the first entity under the rules of section 414 (b), (c), (m), or (o). Instead of applying the control employee definition of this paragraph (f)(5), an employer may treat all, and only, employees who are ‘‘highly compensated’’ employees (as defined in § 1.132–8(g)) as control employees for purposes of this paragraph (f).

(6) *Control employee defined—Government employer.* For purposes of this paragraph (f), a control employee of a government employer is any—

(i) Elected official, or

(ii) Employee whose compensation equals or exceeds the compensation paid to a Federal Government employee holding a position at Executive Level V, determined under Chapter 11 of title 2, United States Code, as adjusted by section 5318 of Title 5 United States Code.

For purposes of this paragraph (f), the term ‘‘government’’ includes any Federal, state or local governmental unit, and any agency or instrumentality thereof. Instead of applying the control employee definition of paragraph (f)(6), an employer may treat all and only employees who are ‘‘highly compensated’’ employees (as defined in § 1.132–8(f)) as control employees for purposes of this paragraph (f).

(7) *‘‘Compensation’’ defined.* For purposes of this paragraph (f), the term ‘‘compensation’’ has the same meaning as in section 414(q)(7). Compensation includes all amounts received from all entities treated as a single employer under section 414 (b), (c), (m), or (o). Levels of compensation shall be adjusted at the same time and in the same manner as provided in section 415(d). The first such adjustment shall be for calendar year 1988.

(g) *Non-commercial flight valuation rule*—(1) *In general.* Under the non-commercial flight valuation rule of this paragraph (g), except as provided in paragraph (g)(12) of this section, if an employee is provided with a flight on an employer-provided aircraft, the value of the flight is calculated using the aircraft valuation formula of paragraph (g)(5) of this section. For purposes of this paragraph (g), the value of a flight on an employer-provided aircraft by an individual who is less than two years old is deemed to be zero. See paragraph (b)(1) of this section for rules relating to the amount includible in income when an employee reimburses the employee's employer for all or part of the fair market value of the benefit provided.

(2) *Eligible flights and eligible aircraft.* The valuation rule of this paragraph (g) may be used to value flights on all employer-provided aircraft, including helicopters. The valuation rule of this paragraph (g) may be used to value international as well as domestic flights. The valuation rule of this paragraph (g) may not be used to value a flight on any commercial aircraft on which air transportation is sold to the public on a per-seat basis. For a special valuation rule relating to certain flights on commercial aircraft, see paragraph (h) of this section.

(3) *Definition of a flight*—(i) *General rule.* Except as otherwise provided in paragraph (g)(3)(iii) of this section (relating to intermediate stops), for purposes of this paragraph (g), a flight is the distance (in statute miles, i.e., 5,280 feet per statute mile) between the place at which the individual boards the aircraft and the place at which the individual deplanes.

(ii) *Valuation of each flight.* Under the valuation rule of this paragraph (g), value is determined separately for each flight. Thus, a round-trip is comprised of at least two flights. For example, an employee who takes a personal trip on an employer-provided aircraft from New York City to Denver, then Denver to Los Angeles, and finally Los Angeles to New York City has taken three flights and must apply the aircraft valuation formula separately to each flight. The value of a flight must be determined on a passenger-by-passenger basis. For example, if an individual accompanies an employee and the flight taken by the individual would be taxed to the employee, the employee would be taxed on the special rule value of the flight by the employee and the flight by the individual.

(iii) *Intermediate stop.* If a landing is necessitated by weather conditions, by an emergency, for purposes of refueling or obtaining other services relating to the aircraft or for any other purpose unrelated to the personal purposes of the employee whose flight is being valued, that landing is an intermediate stop. Additional mileage attributable to an intermediate stop is not considered when determining the distance of an employee's flight.

(iv) *Examples.* The rules of paragraph (g)(3)(iii) of this section may be illustrated by the following examples:

Example (1). Assume that an employee's trip originates in St. Louis, Missouri, with Seattle, Washington as its destination, but, because of weather conditions, the aircraft lands in Denver, Colorado, and the employee stays in Denver overnight. Assume further that the next day the aircraft flies to Seattle where the employee deplanes. The employee's flight is the distance between the airport in St. Louis and the airport in Seattle.

Example (2). Assume that a trip originates in New York, New York, with five passengers and that the aircraft makes a stop in Chicago, Illinois, so that one of the passengers can deplane for a purpose unrelated to the personal purposes of the other passengers whose flights are being valued. The aircraft then goes on to Los Angeles, California, where the other four passengers will deplane. The flight of the passenger who deplaned in Chicago is the distance between the airport in New York and the airport in Chicago. The stop in Chicago is disregarded as an intermediate stop, however, when measuring the flights taken by each of the other four passengers. Their flights would be the distance between the airport in New York and the airport in Los Angeles.

(4) *Personal and non-personal flights*—(i) In *general.* The valuation rule of this paragraph (g) applies to personal flights on employer-provided aircraft. A personal flight is one the value of which is not excludable under another section of subtitle A of the Internal Revenue Code of 1986, such as under section 132(d) (relating to a working condition fringe). However, solely for purposes of paragraphs (g)(4)(ii) and

(g)(4)(iii) of this section, references to personal flights do not include flights a portion of which would not be excludable from income by reason of section 274(c).

(ii) *Trip primarily for employer's business.* If an employee combines, in one trip, personal and business flights on an employer-provided aircraft and the employee's trip is primarily for the employer's business (see § 1.162–2(b)(2)), the employee must include in income the excess of the value of all the flights that comprise the trip over the value of the flights that would have been taken had there been no personal flights but only business flights. For example, assume that an employee flies on an employer-provided aircraft from Chicago, Illinois, to Miami, Florida, for the employer's business and that from Miami the employee flies on the employer-provided aircraft to Orlando, Florida, for personal purposes and then flies back to Chicago. Assume further that the primary purpose of the trip is for the employer's business. The amount includible in income is the excess of the value of the three flights (Chicago to Miami, Miami to Orlando, and Orlando to Chicago), over the value of the flights that would have been taken had there been no personal flights but only business flights (Chicago to Miami and Miami to Chicago).

(iii) *Primarily personal trip.* If an employee combines, in one trip, personal and business flights on an employer-provided aircraft and the employee's trip is primarily personal (see § 1.162–2(b)(2)), the amount includible in the employee's income is the value of the personal flights that would have been taken had there been no business flights but only personal flights. For example, assume that an employee flies on an employer-provided aircraft from San Francisco, California, to Los Angeles, California, for the employer's business and that from Los Angeles the employee flies on an employer-provided aircraft to Palm Springs, California, primarily for personal reasons and then flies back to San Francisco. Assume further that the primary purpose of the trip is personal. The amount includible in the employee's income is the value of personal flights that would have been taken had there been no business flights but only personal flights (San Francisco to Palm Springs and Palm Springs to San Francisco).

(iv) *Application of section 274(c).* The value of employer- provided travel outside the United States away from home may not be excluded from the employee's gross income as a working condition fringe, by either the employer or the employee, to the extent not deductible by reason of section 274(c). The valuation rule of this paragraph (g) applies to that portion of the value any flight not excludable by reason of section 274(c). Such value is includible in income in addition to the amounts determined under paragraphs (g)(4)(ii) and (g)(4)(iii) of this section.

(v) *Flights by individuals who are not personal guests.* If an individual who is not an employee of the employer providing the aircraft is on a flight, and the individual is not the personal guest of any employee of the employer, the flight by the individual is not taxable to any employee of the employer providing the aircraft. The rule in the preceding sentence applies where the individual is provided the flight by the employer for noncompensatory business reasons of the employer. For example, assume that G, an employee of company Y, accompanies A, an employee of company X, on company X's aircraft for the purpose of inspecting land under consideration for purchase by company X from company Y. The flight by G is not taxable to A. No inference may be drawn from this paragraph (g)(4)(v) concerning the taxation of a flight provided to an individual who is neither an employee of the employer nor a personal guest of any employee of the employer.

(5) *Aircraft valuation formula.* Under the valuation rule of this paragraph (g), the value of a flight is determined under the base aircraft valuation formula (also known as the Standard Industry Fare Level formula or SIFL) by multiplying the SIFL cents-per-mile rates applicable for the period during which the flight was taken by the appropriate aircraft multiple (as provided in paragraph (g)(7) of this section) and then adding the applicable terminal charge. The SIFL cents-per-mile rates in the formula and the terminal charge are calculated by the Department of

Transportation and are revised semiannually. The base aircraft valuation formula in effect from January 1, 1989 through June 30, 1989, is as follows: a terminal charge of $26.48 plus ($.1449 per mile for the first 500 miles, $.1105 per mile for miles between 501 and 1500, and $.1062 per mile for miles over 1500). For example, if a flight taken on January 15, 1989, by a non-control employee on an employer-provided aircraft with a maximum certified takeoff weight of 26,000 lbs. is 2,000 miles long, the value of the flight determined under this paragraph (g)(5) is: $100.36 ((.313×(($.1449×500)+($.1105×1,000)+ ($.1062×500)))+$26.48). The aircraft valuation formula applies separately to each flight being valued under this paragraph (g). Therefore, the number of miles an employee has flown on employer-provided aircraft flights prior to the flight being valued does not affect the determination of the value of the flight.

(6) *Discretion to provide new formula.* The Commissioner may prescribe a different base aircraft valuation formula by regulation, Revenue Ruling or Revenue Procedure in the event that the calculation of the Standard Industry Fare Level is discontinued.

(7) *Aircraft multiples*—(i) *In general.* The aircraft multiples are based on the maximum certified takeoff weight of the aircraft. When applying the aircraft valuation formula to a flight, the appropriate aircraft multiple is multiplied by the product of the applicable SIFL cents-per-mile rates multiplied by the number of miles in the flight and then the terminal charge is added to the product. For purposes of applying the aircraft valuation formula described in paragraph (g)(5) of this section, the aircraft multiples are as follows:

Maximum certified take-off weight of the aircraft	Aircraft multiple for a control employee (percent)	Aircraft multiple for a non-control employee (percent)
6,000 lbs. or less	62.5	15.6
6,001–10,000 lbs.	125	23.4
10,001–25,000 lbs.	300	31.3
25,001 lbs. or more	400	31.3

(ii) *Flights treated as provided to a control employee.* Except as provided in paragraph (g)(12) of this section, any flight provided to an individual whose flight would be taxable to a control employee (as defined in paragraphs (g) (8) and (9) of this section) as the recipient shall be valued as if such flight had been provided to that control employee. For example, assume that the chief executive officer of an employer, his spouse, and his two children fly on an employer-provided aircraft for personal purposes. Assume further that the maximum certified takeoff weight of the aircraft is 12,000 lbs. The amount includible in the employee's income is 4×((300 percent×the applicable SIFL cents-per-mile rates provided in paragraph (g)(5) of this section multiplied by the number of miles in the flight) plus the applicable terminal charge).

(8) *Control employee defined—Non-government employer*—(i) *Definition.* For purposes of this paragraph (g), a control employee of a non-government employer is any employee—

(*A*) Who is a Board- or shareholder-appointed, confirmed, or elected officer of the employer, limited to the lesser of—

(*1*) One percent of all employees (increased to the next highest integer, if not an integer) or

(*2*) Ten employees;

(B) Who is among the top one percent most highly-paid employees of the employer (increased to the next highest integer, if not an integer) limited to a maximum of 50;

(C) Who owns a five-percent or greater equity, capital, or profits interest in the employer; or

(D) Who is a director of the employer.

(ii) *Special rules for control employee definition*—(A) *In general.* For purposes of this paragraph (g), any employee who is a family member (within the meaning of section 267(c)(4)) of a control employee is also a control employee. For purposes of paragraph (g)(8)(i)(B) of this section, the term ''employee'' does not include any individual unless such individual is a common-law employee, partner, or one-percent or greater shareholder of the employer. Pursuant to this paragraph (g)(8), an employee may be a control employee under more than one of the requirements listed in paragraphs (g)(8)(i) (A) through (D) of this section. For example, an employee may be both an officer under paragraph (g)(8)(i)(A) of this section and a highly-paid employee under paragraph (g)(8)(i)(B) of this section. In this case, for purposes of the officer limitation rule of paragraph (g)(8)(i)(A) of this section and the highly-paid employee limitation rule of paragraph (g)(8)(i)(B) of this section, the employee would be counted in applying both limitations. For purposes of determining the one-percent limitation under paragraphs (g)(8)(i) (A) and (B) of this section, an employer shall exclude from consideration employees described in § 1.132–8(b)(3). Instead of applying the control employee definition of this paragraph (g)(8), an employer may treat all (and only) employees who are ''highly compensated'' employees (as defined in § 1.132–8(f)) as control employees for purposes of this paragraph (g).

(B) *Special rules for officers, owners, and highly-paid control employees.* In no event shall an employee whose compensation is less than $50,000 be a control employee under paragraph (g)(8)(i) (A) or (B) of this section. For purposes of determining who is a five-percent (or one-percent) owner under this paragraph (g)(8), any individual who owns (or is considered as owning under section 318(a) or principles similar to section 318(a) for entities other than corporations) five percent (or one-percent) or more of the fair market value of an entity (the ''owned entity'') is considered a five-percent (or one-percent) owner of all entities which would be aggregated with the owned entity under the rules of section 414(b), (c), (m), or (o). For purposes of determining who is an officer or director with respect to an employer under this paragraph (g)(8), notwithstanding anything in this section to the contrary, if the employer would be aggregated with other employers under the rules of section 414 (b), (c), (m), or (o), the officer definition and the limitations and the director definition are applied to each such separate employer rather than to the aggregated employer. An employee who is an officer or director of one employer (the ''first employer'') shall not be counted as an officer or a director of any other employer aggregated with the first employer under the rules of section 414 (b), (c), or (m). If applicable, the officer limitations rule of paragraph (g)(8)(i)(A) of this section is applied to employees in descending order of their compensation. Thus, if an employer has 11 board-appointed officers and the limit imposed under paragraph (g)(8)(i)(A) of this section is 10 officers, the employee with the least compensation of those officers would not be a control employee under paragraph (g)(8)(i)(A) of this section.

(9) *Control employee defined—Government employer.* For purposes of this paragraph (g), a control employee of a government employer is any—

(i) Elected official, or

(ii) Employee whose compensation equals or exceeds the compensation paid to a Federal Government employee holding a position at Executive Level V, determined under Chapter 11 of title 2, United States Code, as adjusted by section 5318 of title 5 United States Code.

For purposes of paragraph (f), the term ''government'' includes any Federal, state or local governmental unit, and any agency or instrumentality thereof. lnstead of applying the control employee definition of paragraph (f)(6), an employer may treat all and only employees who are ''highly compensated'' employees (as defined in § 1.132–8(f)) as control employees for purposes of this paragraph (f).

(10) *''Compensation'' defined.* For purposes of this paragraph (g), the term ''compensation'' has the same meaning as in section 414(q)(7). Compensation includes all amounts received from all entities treated as a single employer under section 414 (b), (c), (m), or (o). Levels of compensation shall be adjusted at the same time and in the same manner as provided in section 415(d). The first such adjustment was for calendar year 1988.

(11) *Treatment of former employees.* For purposes of this paragraph (g), an employee who was a control employee of the employer (as defined in this paragraph (g)) at any time after reaching age 55, or within three years of separation from the service of the employer, is a control employee with respect to flights taken after separation from the service of the employer. An individual who is treated as a control employee under this paragraph (g)(11) is not

counted when determining the limitation of paragraph (g)(8)(i) (A) and (B) of this section. Thus, the total number of individuals treated as control employees under such paragraphs may exceed the limitations of such paragraphs to the extent that this paragraph (g)(11) applies.

(12) *Seating capacity rule*—(i) *In general*—(A) *General rule.* Where 50 percent or more of the regular passenger seating capacity of an aircraft (as used by the employer) is occupied by individuals whose flights are primarily for the employer's business (and whose flights are excludable from income under section 132(d)), the value of a flight on that aircraft by any employee who is not flying primarily for the employer's business (or who is flying primarily for the employer's business but the value of whose flight is not excludable under section 132(d) by reason of section 274(c)) is deemed to be zero. See §1.132–5 which limits the working condition fringe exclusion under section 132(d) to situations where the employee receives the flight in connection with the performance of services for the employer providing the aircraft.

(B) *Special rules*—(*1*) *Definition of ''employee.''* For purposes of this paragraph (g)(12), the term ''employee'' includes only employees of the employer, including a partner of a partnership, providing the aircraft and does not include independent contractors and directors of the employer. A flight taken by an individual other than an ''employee'' as defined in the preceding sentence is considered a flight taken by an employee for purposes of this paragraph (g)(12) only if that individual is treated as an employee pursuant to section 132(f)(1) or that individual's flight is treated as a flight taken by an employee pursuant to section 132(f)(2). If—

(*i*) A flight by an individual is not considered a flight taken by an employee (as defined in this paragraph (g)(12)(i)),

(*ii*) The value of that individual's flight is not excludable under section 132(d), and

(*iii*) The seating capacity rule of this paragraph (g) (12) otherwise applies, then the value of the flight provided to such an individual is the value of a flight provided to a non-control employee pursuant to paragraph (g)(5) of this section (even if the individual who would be taxed on the value of the flight is a control employee).

(*2*) *Example.* The special rules of paragraph (g)(12)(i)(B)(*1*) of this section are illustrated by the following example:

Example. Assume that 60 percent of the regular passenger seating capacity of an employer's aircraft is occupied by individuals whose flights are primarily for the employer's business and are excludable from income under section 132(d). If a control employee, his spouse, and his dependent child fly on the employer's aircraft for primarily personal reasons, the value of the three flights is deemed to be zero. If, however, the control employee's cousin were provided a flight on the employer's aircraft, the value of the flight taken by the cousin is determined by applying the aircraft valuation formula of paragraph (g)(5) of this section (including the terminal charge) and the non-control employee aircraft multiples of paragraph (g)(7) of this section.

(ii) *Application of 50-percent test to multiple flights.* The seating capacity rule of this paragraph (g)(12) must be met both at the time the individual whose flight is being valued boards the aircraft and at the time the individual deplanes. For example, assume that employee A boards an employer-provided aircraft for personal purposes in New York, New York, and that at that time 80 percent of the regular passenger seating capacity of the aircraft is occupied by individuals whose flights are primarily for the employer's business (and whose flights are excludable from income under section 132(d)) (''the business passengers''). If the aircraft flies directly to Hartford, Connecticut where all of the passengers, including A, deplane, the requirements of the seating capacity rule of this paragraph (g)(12) have been satisfied. If instead, some of the passengers, including A, remain on the aircraft in Hartford and the aircraft continues on to Boston, Massachusetts, where they all deplane, the requirements of the seating capacity rule of this paragraph (g)(12) will not be satisfied with respect to A's flight from New York to Boston unless at least 50 percent of the seats comprising the aircraft's regular passenger seating capacity were occupied by the business passengers at the time A deplanes in Boston.

(iii) *Regular passenger seating capacity.* (A) *General rule.* Except as otherwise provided, the regular passenger seating capacity of an aircraft is the maximum number of seats that have at any time on or prior to the date of the flight been on the aircraft (while owned or leased by the employer). Except to the extent excluded pursuant to paragraph (g)(12)(v) of this section, regular seating capacity includes all seats which may be occupied by members of the flight crew. It is irrelevant that, on a particular flight, less than the maximum number of seats are available for use because, for example, some of the seats are removed.

(B) *Special rules.* When determining the maximum number of seats that have at any time on or prior to the date of the flight been on the aircraft (while owned or leased by the employer), seats that could not at any time be legally used during takeoff and have not at any time been used during takeoff are not counted. As of the date an employer permanently reduces the seating capacity of an aircraft, the regular passenger seating capacity is the reduced number of seats on the aircraft. The previous sentence shall not apply if at any time within 24 months after such reduction any seats are added in the aircraft. Unless the conditions of this paragraph (g)(12)(iii)(B) are satisfied, jumpseats and removable seats used solely for purposes of flight crew training are counted for purposes of the seating capacity rule of this paragraph (g)(12).

(iv) *Examples.* The rules of paragraph (g)(12)(iii) of this section are illustrated by the following examples:

Example (1). Employer A and employer B order the same aircraft, except that A orders it with 10 seats and B orders it with eight seats. A always uses its aircraft as a 10-seat aircraft; B always uses its aircraft as an eight-seat aircraft. The regular passenger seating capacity of A's aircraft is 10 and of B's aircraft is eight.

Example (2). Assume the same facts as in example (1), except that whenever A's chief executive officer and spouse use the aircraft eight seats are removed. Even if substantially all of the use of the aircraft is by the chief executive officer and spouse, the regular passenger seating capacity of the aircraft is 10.

Example (3). Assume the same facts as in example (1), except that whenever more than eight people want to fly in B's aircraft, two extra seats are added. Even if substantially all of the use of the aircraft occurs with eight seats, the regular passenger seating capacity of the aircraft is 10.

Example (4). Employer C purchases an aircraft with 12 seats. Three months later C remodels the interior of the aircraft and permanently removes four of the seats. Upon completion of the remodeling, the regular passenger seating capacity of the aircraft is eight. If, however, any seats are added within 24 months after the remodeling, the regular seating capacity of the aircraft is treated as 12 throughout the entire period.

(v) *Seats occupied by flight crew.* When determining the regular passenger seating capacity of an aircraft, any seat occupied by a member of the flight crew (whether or not such individual is an employee of the employer providing the aircraft) shall not be counted, unless the purpose of the flight by such individual is not primarily to serve as a member of the flight crew. If the seat occupied by a member of the flight crew is not counted as a passenger seat pursuant to the previous sentence, such member of the flight crew is disregarded in applying the 50-percent test described in the first sentence of paragraph (g)(12)(i) of this section. For example, assume that prior to application of this paragraph (g)(12)(v) the regular passenger seating capacity of an aircraft is one. Assume further that an employee pilots the aircraft and that the employee's flight is nor primarily for the employer's business. If the employee's spouse occupies the other seat for personal purposes, the seating capacity rule is not met and the value of both flights must be included in the employee's income. If, however, the employee's flight were primarily for the employer's business (unrelated to serving as a member of the flight crew), then the seating capacity rule is met and the value of the flight for the employee's spouse is deemed to be zero. If the employee's flight were primarily to serve as a member of the flight crew, then the seating capacity rule is not met and the value of a flight by any passenger for primarily personal reasons is not deemed to be zero.

(13) *Erroneous use of the non-commercial flight valuation rule*—(i) *Certain errors in the case of a flight by a control employee.* If—

(A) The non-commercial flight valuation rule of this paragraph (g) is applied by an employer or a control employee, as the case may be, on a return as originally filed or on an amended return on the grounds that either—

(*1*) The control employee is not in fact a control employee, or

(*2*) The aircraft is within a specific weight classification, and

(B) Either position is subsequently determined to be erroneous, the valuation rule of this paragraph (g) is not available to value the flight taken by that control employee by the person or persons taking the erroneous position. With respect to the weight classifications, the previous sentence does not apply if the position taken is that the weight of the aircraft is greater than it is subsequently determined to be. If, with respect to a flight by a control employee, the seating capacity rule of paragraph (g)(12) of this section is used by an employer or the control employee, as the case may be, on a return as originally filed or on an amended return, the valuation rule of this paragraph (g) is not available to value the flight taken by that control employee by the person or persons taking the erroneous position.

(ii) *Value of flight excluded as a working condition fringe.* If either an employer or an employee, on a return as originally filed or on an amended return, excludes from the employee's income or wages all or any part of the value of a flight on the grounds that the flight was excludable as a working condition fringe under section 132, and that position is subsequently determined to be erroneous, the valuation rule of this paragraph (g) is not available to value the flight taken by that employee by the person or persons taking the erroneous position. Instead, the general valuation rules of paragraphs (b) (5) and (6) of this section apply.

(14) *Consistency rules*—(i) *Use by the employer.* Except as otherwise provided in paragraph (g)(13) of this section or §1.132–5 (m)(4), if the non-commercial flight valuation rule of this paragraph (g) is used by an employer to value any flight provided to an employee in a calendar year, the rule must be used to value all flights provided to all employees in the calendar year.

(ii) *Use by the employee.* Except as otherwise provided in paragraph (g)(13) of this section or §1.132–5 (m)(4), if the non-commercial flight valuation rule of this paragraph (g) is used by an employee to value a flight provided by an employer in a calendar year, the rule must be used to value all flights provided to the employee by that employer in the calendar year.

(h) *Commercial flight valuation rule*—(1) *In general.* Under the commercial flight valuation rule of this paragraph (h), the value of a space-available flight (as defined in paragraph (h) (2) of this section) on a commercial aircraft is 25 percent of the actual carrier's highest unrestricted coach fare in effect for the particular flight taken. The rule of this paragraph (h) is available only to an individual described in §1.132–1(b)(1).

(2) *Space-available flight.* The commercial flight valuation rule of this paragraph (h) is available to value a space-available flight. The term ''space-available flight'' means a flight on a commercial aircraft—

(i) Which is subject to the same types of restrictions customarily associated with flying on an employee ''stand-by'' or ''space-available'' basis, and

(ii) Which meets the definition of a no-additional-cost service under section 132(b), except that the flight is provided to an individual other than the employee or an individual treated as the employee under section 132(f). Thus, a flight is not a space-available flight if the employer guarantees the employee a seat on the flight or if the nondiscrimination requirements of section 132(h)(1) and §1.132–8 are not satisfied. A flight may be a space-available flight even if the airline that is the actual carrier is not the employer of the employee.

(3) *Commercial aircraft.* If the actual carrier does not offer, in the ordinary course of its business, air transportation to customers on a per-seat basis, the commercial flight valuation rule of this paragraph (h) is not available. Thus, if, in the ordinary course of its line of business, the employer only offers air transportation to customers on a charter basis, the commercial flight valuation rule of this paragraph (h)

may not be used to value a space-available flight on the employer's aircraft. If the commercial flight valuation rule is not available, the flight may be valued under the non-commercial flight valuation rule of paragraph (g) of this section.

(4) *Timing of inclusion.* The date that the flight is taken is the relevant date for purposes of applying section 61(a)(1) and this section to a space-available flight on a commercial aircraft. The date of purchase or issuance of a pass or ticket is not relevant. Thus, this section applies to a flight taken on or after January 1, 1989, regardless of the date on which the pass or ticket for the flight was purchased or issued.

(5) *Consistency rules*—(i) *Use by employer.* If the commercial flight valuation rule of this paragraph (h) is used by an employer to value any flight provided in a calendar year, the rule must be used to value all flights eligible for use of the rule provided in the calendar year.

(ii) *Use by employee.* If the commercial flight valuation rule of this paragraph (h) is used by an employee to value a flight provided by an employer in a calendar year, the rule must be used to value all flights provided by that employer eligible for use of the rule taken by such employee in the calendar year.

(i) [Reserved.]

(j) *Valuation of meals provided at an employer-operated eating facility for employees*—(1) *In general.* The valuation rule of this paragraph (j) may be used to value a meal provided at an employer-operated eating facility for employees (as defined in § 1.132–7). For rules relating to an exclusion for the value of meals provided at an employer-operated eating facility for employees, see section 132(e)(2) and § 1.132–7.

(2) *Valuation formula*—(i) *In general.* The value of all meals provided at an employer-operated eating facility for employees during a calendar year (''total meal value'') is 150 percent of the direct operating costs of the eating facility determined separately with respect to such eating facility whether or not the direct operating costs test is applied separately to such eating facility under § 1.132–7(b)(2). For purposes of this paragraph (j), the definition of direct operating costs provided in § 1.132–7(b) and the adjustments specified in § 1.132–7(a)(2) apply. The taxable value of meals provided at an eating facility may be determined in two ways. The ''individual meal subsidy'' may be treated as the taxable value of a meal provided at the eating facility (see paragraph (j)(2)(ii) of this section) to a particular employee. Alternatively, the employer may allocate the ''total meal subsidy'' among employees (see paragraph (j)(2)(iii) of this section).

(ii) *''Individual meal subsidy'' defined.* The ''individual meal subsidy'' is determined by multiplying the amount paid by the employee for a particular meal by a fraction, the numerator of which is the total meal value and the denominator of which is the gross receipts of the eating facility for the calendar year and then subtracting the amount paid by the employee for the meal. The taxable value of meals provided to a particular employee during a calendar year, therefore, is the sum of the individual meal subsidies provided to the employee during the calendar year. This rule is available only if there is a charge for each meal selection and if each employee is charged the same price for any given meal selection.

(iii) *Allocation of ''total meal subsidy.''* Instead of using the individual meal subsidy method provided in paragraph (j)(2)(ii) of this section, the employer may allocate the ''total meal subsidy'' (total meal value less the gross receipts of the facility) among employees in any manner reasonable under the circumstances. It will be presumed reasonable for an employer to allocate the total meal subsidy on a per-employee basis if the employer has information that would substantiate to the satisfaction of the Commissioner that each employee was provided approximately the same number of meals at the facility.

(k) *Commuting valuation rule for certain employees*—(1) *In general.* Under the rule of this paragraph (k), the value of the commuting use of employer-provided transportation may be determined under paragraph (k)(3) of this section if the following criteria are met by the employer and employee with respect to the transportation:

(i) The transportation is provided, solely because of unsafe conditions, to an employee who would ordinarily walk or use public transportation for commuting to or from work;

(ii) The employer has established a written policy (e.g., in the employer's personnel manual) under which the transportation is not provided for the employee's personal purposes other than for commuting due to unsafe conditions and the employer's practice in fact corresponds with the policy;

(iii) The transportation is not used for personal purposes other than commuting due to unsafe conditions; and

(iv) The employee receiving the employer-provided transportation is a qualified employee of the employer (as defined in paragraph (k)(6) of this section).

(2) *Trip-by-trip basis.* The special valuation rule of this paragraph (k) applies on a trip-by-trip basis. If an employer and employee fail to meet the criteria of paragraph (k)(1) of this section with respect to any trip, the value of the transportation for that trip is not determined under paragraph (k)(3) of this section and the amount includible in the employee's income is determined by reference to the fair market value of the transportation.

(3) *Commuting value*—(i) *$1.50 per one-way commute.* If the requirements of this paragraph (k) are satisfied, the value of the commuting use of the employer-provided transportation is $1.50 per one-way commute (i.e., from home to work or from work to home).

(ii) *Value per employee.* If transportation is provided to more than one qualified employee at the same time, the amount includible in the income of each employee is $1.50 per one-way commute.

(4) *Definition of employer-provided transportation.* For purposes of this paragraph (k), ''employer-provided transportation'' means transportation by vehicle (as defined in paragraph (f)(4) of this section) that is purchased by the employer (or that is purchased by the employee and reimbursed by the employer) from a party that is not related to the employer for the purpose of transporting a qualified employee to or from work. Reimbursements made by an employer to an employee to cover the cost of purchasing transportation (e.g., hiring cabs) must be made under a bona fide reimbursement arrangement.

(5) *Unsafe conditions.* Unsafe conditions exist if a reasonable person would, under the facts and circumstances, consider it unsafe for the employee to walk to or from home, or to walk to or use public transportation at the time of day the employee must commute. One of the factors indicating whether it is unsafe is the history of crime in the geographic area surrounding the employee's workplace or residence at the time of day the employee must commute.

(6) *Qualified employee defined*—(i) *In general.* For purposes of this paragraph (k), a qualified employee is one who meets the following requirements with respect to the employer:

(A) The employee performs services during the current year, is paid on an hourly basis, is not claimed under section 213(a)(1) of the Fair Labor Standards Act of 1938 (as amended), 29 U.S.C. 201–219 (FLSA), to be exempt from the minimum wage and maximum hour provisions of the FLSA, and is within a classification with respect to which the employer actually pays, or has specified in writing that it will pay, compensation for overtime equal to or exceeding one and one-half times the regular rate as provided by section 207 of the FLSA; and

(B) The employee does not receive compensation from the employer in excess of the amount permitted by section 414(q)(1)(C) of the Code.

(ii) *''Compensation'' and ''paid on an hourly basis'' defined.* For purposes of this paragraph (k), ''compensation'' has the same meaning as in section 414(q)(7). Compensation includes all amounts received from all entities treated as a single employer under section 414 (b), (c), (m), or (o). Levels of compensation shall be adjusted at the same time and in the same manner as provided in section 415(d). If an employee's compensation is stated on an annual basis, the employee is treated as ''paid on an hourly basis'' for purposes of this paragraph (k) as long as the employee is not claimed to be exempt from the minimum wage and maximum hour provisions of the FLSA and is paid overtime wages either equal to or exceeding one and one-half the employee's regular hourly rate of pay.

(iii) *FLSA compliance required.* An employee will not be considered a qualified employee for purposes of this paragraph (k), unless the employer is in compliance with the recordkeeping requirements concerning that employee's wages, hours, and other conditions and practices of employment as provided in section 211(c) of the FLSA and 29 CFR part 516.

(iv) *Issues arising under the FLSA.* If questions arise concerning an employee's classification under the FLSA, the pronouncements and rulings of the Administrator of the Wage and Hour Division, Department of Labor are determinative.

(v) *Non-qualified employees.* If an employee is not a qualified employee within the meaning of this paragraph (k)(6), no portion of the value of the commuting use of employer-provided transportation is excluded under this paragraph (k).

(7) *Examples.* This paragraph (k) is illustrated by the following examples:

Example 1. A and B are word-processing clerks employed by Y, an accounting firm in a large metropolitan area, and both are qualified employees under paragraph (k)(6) of this section. The normal working hours for A and B are from 11:00 p.m. until 7:00 a.m. and public transportation, the only means of transportation available to A or B, would be considered unsafe by a reasonable person at the time they are required to commute from home to work. In response, Y hires a car service to pick up A and B at their homes each evening for purposes of transporting them to work. The amount includible in the income of both A and B is $1.50 for the one-way commute from home to work.

Example 2. Assume the same facts as in *Example 1,* except that Y also hires a car service to return A and B to their homes each morning at the conclusion of their shifts and public transportation would not be considered unsafe by a reasonable person at the time of day A and B commute to their homes. The value of the commute from work to home is includible in the income of both A and B by reference to fair market value since unsafe conditions do not exist for that trip.

Example 3. C is an associate for Z, a law firm in a metropolitan area. The normal working hours for C's law firm are from 9 a.m. until 6 p.m., but C's ordinary office hours are from 10 a.m. until 8 p.m. Public transportation, the only means of transportation available to C at the time C commutes from work to home during the evening, would be considered unsafe by a reasonable person. In response, Z hires a car service to take C home each evening. C does not receive annual compensation from Z in excess of the amount permitted by section 414(q)(1)(C) of the Code. However, C is treated as an employee exempt from the provisions of the FLSA and, accordingly, is not paid overtime wages. Therefore, C is not a qualified employee within the meaning of paragraph (k)(6) of this section. The value of the commute from work to home is includible in C's income by reference to fair market value.

(8) *Effective date.* This paragraph (k) applies to employer-provided transportation provided to a qualified employee on or after July 1, 1991.

[T.D. 8256, 54 FR 28582, July 6, 1989, as amended by T.D. 8389, 57 FR 1870, Jan. 16, 1992; T.D. 8457, 57 FR 62195, Dec. 30, 1992]

§ 1.62–1 Adjusted gross income.

(a) [Reserved]

(b) [Reserved]

(c) *Deductions allowable in computing adjusted gross income.* The deductions specified in section 62(a) for purposes of computing adjusted gross income are—

(1) Deductions set forth in § 1.62–1T(c); and

(2) Deductions allowable under part VI, subchapter B, chapter 1 of the Internal Revenue Code, (section 161 and following) that consist of expenses paid or incurred by the taxpayer in connection with the performance of services as an employee under a reimbursement or other expense allowance arrangement (as defined in § 1.62–2) with his or her employer. For the rules pertaining to expenses paid or incurred in taxable years beginning before January 1, 1989, see § 1.62–1T (c)(2) and (f) (as contained in 26 CFR part 1 (§§ 1.61 to 1.169) revised April 1, 1992).

(d) through (h) [Reserved]

(i) *Effective date.* Paragraph (c) of this section is effective for taxable years beginning on or after January 1, 1989.

[T.D. 8451, 57 FR 57668, Dec. 7, 1992; 57 FR 60568, Dec. 21, 1992]

§ 1.62–1T Adjusted gross income (temporary).

(a) *Basis for determining the amount of certain deductions.* The term ''adjusted gross income'' means the gross income computed under section 61 minus such of the deductions allowed by chapter 1 of the Code as are specified in section 62(a). Adjusted gross income is used as the basis for determining the following:

(1) The limitation on the amount of miscellaneous itemized deductions (under section 67).

(2) The limitation on the amount of the deduction for casualty losses (under section 165(h)(2)),

(3) The limitation on the amount of the deduction for charitable contributions (under section 170(b)(1)),

(4) The limitation on the amount of the deduction for medical and dental expenses (under section 213),

(5) The limitation on the amount of the deduction for qualified retirement contributions for active participants in certain pension plans (under section 219(g)), and

(6) The phase-out of the exemption from the disallowance of passive activity losses and credits (under section 469(i)(3)).

(b) *Double deduction not permitted.* Section 62 (a) merely specifies which of the deductions provided in chapter 1 of the Code shall be allowed in computing adjusted gross income. It does not create any new deductions. The fact that a particular item may be described in more than one of the paragraphs under section 62(a) does not permit the item to be deducted twice in computing adjusted gross income or taxable income.

(c) *Deductions allowable in computing adjusted gross income.* The deductions specified in section 62(a) for purposes of computing adjusted gross income are:

(1) Deductions allowable under chapter 1 of the Code (other than by part VII (section 211 and folllowing), subchapter B of such chapter) that are attributable to a trade or business carried on by the taxpayer not consisting of services performed as an employee;

(2) [Reserved]

(3) For taxable years beginning after December 31, 1986, deductions allowable under section 162 that consist of expenses paid or incurred by a qualified performing artist (as defined in section 62(b)) in connection with the performance by him or her of services in the performing arts as an employee;

(4) Deductions allowable under part VI as losses from the sale or exchange of property;

(5) Deductions allowable under part VI, section 212, or section 611 that are attributable to property held for the production of rents or royalties;

(6) Deductions for depreciation or depletion allowable under sections 167 or 611 to a life tenant of property or to an income beneficiary of property held in trust or to an heir, legatee, or devisee of an estate;

(7) Deductions allowed by section 404 for contributions on behalf of a self-employed individual;

(8) Deductions allowed by section 219 for contributions to an individual retirement account described in section 408(a), or for an individual retirement annuity described in section 408(b);

(9) Deductions allowed by section 402(e)(3) with respect to a lump-sum distribution;

(10) For taxable years beginning after December 31, 1972, deductions allowed by section 165 for losses incurred in any transaction entered into for profit though not connected with a trade or business, to the extent that such losses include amounts forfeited to a bank, mutual savings bank, savings and loan association, building and loan association, cooperative bank or homestead association as a penalty for premature withdrawal of funds from a time savings account, certificate of deposit, or similar class of deposit;

(11) For taxable years beginning after December 31, 1976, deductions for alimony and separate maintenance payments allowed by section 215;

(12) Deductions allowed by section 194 for the amortization of reforestation expenditures; and

(13) Deductions allowed by section 165 for the repayment (made in a taxable year beginning after December 28, 1980) to a trust described in paragraph (9) or (17) of section 501(c) of supplemental unemployment compensation benefits received from such trust if such repayment is required because of the receipt of trade readjustment allowances under section 231 or 232 of the Trade Act of 1974 (19 U.S.C. 2291 and 2292).

(d) *Expenses directly related to a trade or business.* For the purpose of the deductions specified in section 62, the performance of personal services as an employee does not constitute the carrying on of a trade or business, except as otherwise expressly provided. The practice of a profession, not as an employee, is considered the conduct of a trade or business within the meaning of such section. To be deductible for the purposes of determining adjusted gross income, expenses must be those directly, and not those merely remotely, connected with the conduct of a trade or business. For example, taxes are deductible in arriving at adjusted gross income only if they constitute expenditures directly attributable to a trade or business or to property from which rents or royalties are derived. Thus, property taxes paid or incurred on real property used in a trade or business are deductible, but state taxes on net income are not deductible even though the taxpayer's income is derived from the conduct of a trade or business.

(e) *Reimbursed and unreimbursed employee expenses*—(1) *In general.* Expenses paid or incurred by an employee that are deductible from gross income under part VI in computing taxable income (determined without regard to section 67) and for which the employee is reimbursed by the employer, its agent, or third party (for whom the employee performs a benefit as an employee of the employer) under an express agreement for reimbursement or pursuant to an *express* expense allowance arrangement may be deducted from gross income in computing adjusted gross income. Except as provided in paragraphs (e)(2) and (e)(4) of this section, for taxable years beginning after December 31, 1986, if the amount of a reimbursement made by an employer, its agent, or third party to an employee is less than the total amount of the business expenses paid or incurred by the employee, the determination of to which of the employee's business expenses the reimbursement applies and the amount of each expense that is covered by the reimbursement is made on the basis of all of the facts and circumstances of the particular case.

(2) *Facts and circumstances unclear on business expenses for meals and entertainment.* If—

(i) The facts and circumstances do not make clear—

(A) That a reimbursement does not apply to business expenses for meals or entertainment, or

(B) The amount of business expenses for meals or entertainment that is covered by the reimbursement, and

(ii) The employee pays or incurs business expenses for meals or entertainment,

the amount of the reimbursement that applies to such expenses (or portion thereof with respect to which the facts and circumstances are unclear) shall be determined by multiplying the amount of the employee's business expenses for meals and entertainment (or portion thereof with respect to which the facts and circumstances are unclear) by a fraction, the numerator of which is the total amount of the reimbursement (or portion thereof with respect to which the facts and circumstances are unclear) and the denominator of which is the aggregate amount of all the business expenses of the employee (or portion thereof with respect to which the facts and circumstances are unclear).

(3) *Deductibility of unreimbursed expenses.* The amount of expenses that is determined not to be reimbursed pursuant to paragraph (e) (1) or (2) of this section is deductible from adjusted gross income in determining the employee's taxable income subject to the limitations applicable to such expenses (*e.g.*, the 2-percent floor of section 67 and the 80-percent limitation on meal and entertainment expenses provided for in section 274(n)).

(4) *Unreimbursed expenses of State legislators.* For taxable years beginning after December 31, 1986, any portion of the amount allowed as a deduction to State legislators pursuant to section 162(h)1)(B) that is not reimbursed by the State or a third party shall be allocated between lodging and meals in the same ratio as the amounts allowable for lodging and meals under the Federal per diem applicable to the legislator's State capital at the end of the legislator's taxable year (see Appendix 1–A of the Federal Travel Regulations (FTR), which as of March 28, 1988, are contained in GSA Bulletin FPMR A–40, Supplement 20). For purposes of this paragraph (e)(4), the amount allowable for meals under the Federal per diem shall be the amount of the Federal per

diem allowable for meals and incidental expenses reduced by $2 per legislative day (or other amount allocated to incidental expenses in 1–7.5(a)(2) of the FTR). The unreimbursed portion of each type of expense is deductible from adjusted gross income in determining the State legislator's taxable income subject to the limitations applicable to such expenses. For example, the unreimbursed portion allocable to meals shall be reduced by 20 percent pursuant to section 274(n) before being subjected to the 2-percent floor of section 67 for purposes of computing the taxable income of a State legislator. See § 1.67–1T(a)(2).

(5) *Expenses paid directly by an employer, its agent, or third party.* In the case of an employer, its agent, or a third party who provides property or services to an employee or who pays an employee's expenses directly instead of reimbursing the employee, see section 132 and the regulations thereunder for the income tax treatment of such expenses.

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

Example (1). During 1987, A, an employee, while on business trips away from home pays $300 for travel fares, $200 for lodging and $100 for meals. In addition, A pays $50 for business meals in the area of his place of employment (''local meals''), $250 for continuing education courses, and $100 for business-related entertainment (other than meals). The total amount of the reimbursements received by A for his employee expenses from his employer is $750, and it is assumed that A's expenses meet the deductibility requirements of sections 162 and 274. A includes the amount of the reimbursement in his gross income. A's employer designates the reimbursement to cover in full A's expenses for travel fares, lodging, and meals while away from home, local meals, and entertainment, and no facts or circumstances indicate a contrary intention of the employer. Because the facts and circumstances make clear the amount of A's business expenses for meals and entertainment that is covered by the reimbursement, the reimbursement will be allocated to these expenses. In determining his adjusted gross income under section 62, A may deduct the full amount of the reimbursement for travel fares, lodging, and meals while away from home, local meals, and entertainment. In determining his taxable income under section 63, A may deduct his expenses for continuing education courses to the extent allowable by sections 67 and 162.

Example (2). Assume the facts are the same as in example (1) except that the facts and circumstances make clear that the reimbursement covers all types of deductible expenses but they do not make clear the amount of each type of expense that is covered by the reimbursement. The amount of the reimbursement that is allocated to A's business expenses for meals and entertainment is $187.50. This amount is determined by multiplying the total amount of A's business expenses for meals and entertainment ($250) by the ratio of A's total reimbursement to A's total business expenses ($750/ $1,000). The remaining amount of the reimbursement, $562.50 ($750 − $187.50), is allocated to A's business expenses other than meal and entertainment expenses. Therefore, in determining his adjusted gross income under section 62, A may deduct $750 for reimbursed business expenses (including meals and entertainment). In determining his taxable income under section 63, A may deduct (subject to the limitations and conditions of sections 67, 162, and 274) the unreimbursed portion of his expenses for meals and entertainment ($62.50 ($250 − $187.50), and other employee business expenses ($187.50 ($750 − $562.50)).

Example (3). Assume the facts are the same as in example (1) except that the amount of the reimbursement is $500. Assume further that the facts and circumstances make clear that the reimbursement covers $100 of expenses for meals and that the remaining $400 of the reimbursement covers all types of deductible expenses (including any expenses for meals in excess of the $100 already designated) other than expenses for entertainment. The amount of the reimbursement that is allocated to A's business expenses for meals and entertainment is $125. This amount is equal to the sum of the amount of the reimbursement that clearly applies to meals ($100) and the amount of the reimbursement with respect to which the facts are unclear that is allocated to meals ($25). The latter amount is determined by multiplying the total amount of A's business expenses for meals and entertainment with respect to which the facts are unclear ($50) by the ratio of A's total reimbursement with respect to which the facts are unclear to A's total business expenses with respect to which the facts are unclear ($400/$800). The remaining amount of the reimbursement, $375 ($500 − $125) is allocated to A's business expenses other than meals and entertainment. Therefore, in determining his adjusted gross income under section 62, A may deduct $500 for reimbursed business expenses (including meals). In determining his taxable income under section 63, A may deduct (subject to the limitations and conditions of sections 67, 162, and 274) the unreimbursed portion of his expenses for meals ($25 ($150 − $125)), entertainment ($100), and other employee business expenses ($375 ($750 − $375)).

Example (4). During 1987 B, a research scientist, is employed by Corporation X. B gives a speech before members of Association Y, a professional organization of scientists, describing her most recent research findings. Pursuant to a reimbursement arrangement, Y reimburses B for the full amount of her travel fares to the site of the speech and for the full amount of her expenses for lodging and meals while there. B includes the amount of the reimbursement in her gross income. B may deduct the full amount of her travel expenses pursuant to section 62(a)(2)(A) in computing her adjusted gross income.

(f) [Reserved]

(g) *Moving expenses.* For taxable years beginning after December 31, 1986, a taxpayer described in section 217(a) shall not take into account the deduction described in section 217 relating to moving expenses in computing adjusted gross income under section 62 even if the taxpayer is reimbursed for his or her moving expenses. Such a taxpayer shall include the amount of any reimbursement for moving expenses in income pursuant to section 82. The deduction described in section 217 shall be taken into account in computing the taxable income of the taxpayer under section 63. Pursuant to section 67(b)(6), the 2-percent floor described in section 67(a) does not apply to moving expenses.

(h) *Cross-reference.* See 26 CFR 1.62–1 (Rev. as of April 1, 1986) with respect to pre-1987 deductions for travel, meal, lodging, transportation, and other trade or business expenses of an employee, reimbursed expenses of an employee, expenses of an outside salesperson, long-term capital gains, contributions described in section 405(c) to a bond purchase plan on behalf of a self-employed individual, moving expenses, amounts not received as benefits pursuant to section 1379(b)(3), and retirement bonds described in section 409 (allowed by section 219).

[T.D. 8189, 53 FR 9873, Mar. 28, 1988, as amended by T.D. 8276, 54 FR 51024, Dec. 12, 1989; T.D. 8324, 55 FR 51691, Dec. 17, 1990; T.D. 8451, 57 FR 57668, Dec. 7, 1992]

§ 1.62–2 Reimbursements and other expense allowance arrangements.

(a) *Table of contents.* The contents of this section are as follows:

(a) Table of contents.
(b) Scope.
(c) Reimbursement or other expense allowance arrangement.
(1) Defined.
(2) Accountable plans.
(i) In general.
(ii) Special rule for failure to return excess.
(3) Nonaccountable plans.
(i) In general.
(ii) Special rule for failure to return excess.
(4) Treatment of payments under accountable plans.
(5) Treatment of payments under nonaccountable plans.
(d) Business connection.
(1) In general.
(2) Other bona fide expenses.
(3) Reimbursement requirement.
(i) In general.
(ii) Per diem allowances.
(e) Substantiation.
(1) In general.
(2) Expenses governed by section 274(d).
(3) Expenses not governed by section 274(d).
(f) Returning amounts in excess of expenses.
(1) In general.
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(*4*) Special rules.
(ii) Nonaccountable plans.
(i) Application.
(j) Examples.
(k) Anti-abuse provision.
(l) Cross references.
(m) Effective dates.

(b) *Scope.* For purposes of determining "adjusted gross income," section 62(a)(2)(A) allows an employee a deduction for expenses allowed by part VI (section 161 and following), subchapter B, chapter 1 of the Code, paid by the employee, in connection with the performance of services as an employee of the employer, under a reimbursement or other expense allowance arrangement with a payor (the employer, its agent, or a third party). Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of section 62(a)(2)(A) if—

(1) Such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) Such arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

This section prescribes rules relating to the requirements of section 62(c).

(c) *Reimbursement or other expense allowance arrangement*—(1) *Defined.* For purposes of §§1.62–1, 1.62–1T, and 1.62–2, the phrase ''reimbursement or other expense allowance arrangement'' means an arrangement that meets the requirements of paragraphs (d) (business connection, (e) (substantiation), and (f) (returning amounts in excess of expenses) of this section. A payor may have more than one arrangement with respect to a particular employee, depending on the facts and circumstances. See paragraph (d)(2) of this section (payor treated as having two arrangements under certain circumstances).

(2) *Accountable plans*—(i) *In general.* Except as provided in paragraph (c)(2)(ii) of this section, if an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, all amounts paid under the arrangement are treated as paid under an ''accountable plan.''

(ii) *Special rule for failure to return excess.* If an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, but the employee fails to return, within a reasonable period of time, any amount in excess of the amount of the expenses substantiated in accordance with paragraph (e) of this section, only the amounts paid under the arrangement that are not in excess of the substantiated expenses are treated as paid under an accountable plan.

(3) *Nonaccountable plans*—(i) *In general.* If an arrangement does not satisfy one or more of the requirements of paragraphs (d), (e), or (f) of this section, all amounts paid under the arrangement are treated as paid under a ''nonaccountable plan.'' If a payor provides a nonaccountable plan, an employee who receives payments under the plan cannot compel the payor to treat the payments as paid under an accountable plan by voluntarily substantiating the expenses and returning any excess to the payor.

(ii) *Special rule for failure to return excess.* If an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, but the employee fails to return, within a reasonable period of time, any amount in excess of the amount of the expenses substantiated in accordance with paragraph (e) of this section, the amounts paid under the arrangement that are in excess of the substantiated expenses are treated as paid under a nonaccountable plan.

(4) *Treatment of payments under accountable plans.* Amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W–2, and are exempt from the withholding and payment of employment taxes (Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), Railroad Retirement Tax Act (RRTA), Railroad Unemployment Repayment Tax (RURT), and income tax.) See paragraph (l) of this section for cross references.

(5) *Treatment of payments under nonaccountable plans.* Amounts treated as paid under a nonaccountable plan are included in the employee's gross income, must be reported as wages or other compensation on the employee's Form W–2, and are subject to withholding and payment of employment taxes (FICA, FUTA, RRTA, RURT, and income tax). See paragraph (h) of this section. Expenses attributable to amounts included in the employee's gross income may be deducted, provided the employee can substantiate the full amount of his or her expenses (i.e., the amount of the expenses, if any, the reimbursement for which is

treated as paid under an accountable plan as well as those for which the employee is claiming the deduction) in accordance with §§ 1.274–5T and 1.274(d)–1 or § 1.162–17, but only as a miscellaneous itemized deduction subject to the limitations applicable to such expenses (e.g., the 80-percent limitation on meal and entertainment expenses provided in section 274(n) and the 2-percent floor provided in section 67).

(d) *Business connection*—(1) *In general.* Except as provided in paragraphs (d)(2) and (d)(3) of this section, an arrangement meets the requirements of this paragraph (d) if it provides advances, allowances (including per diem allowances, allowances only for meals and incidental expenses, and mileage allowances), or reimbursements only for business expenses that are allowable as deductions by part VI (section 161 and the following), subchapter B, chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee of the employer. The payment may be actually received from the employer, its agent, or a third party for whom the employee performs a service as an employee of the employer, and may include amounts charged directly or indirectly to the payor through credit card systems or otherwise. In addition, if both wages and the reimbursement or other expense allowance are combined in a single payment, the reimbursement or other expense allowance must be identified either by making a separate payment or by specifically identifying the amount of the reimbursement or other expense allowance.

(2) *Other bona fide expenses.* If an arrangement provides advances, allowances, or reimbursements for business expenses described in paragraph (d)(1) of this section (i.e., deductible employee business expenses) and for other bona fide expenses related to the employer's business (e.g., travel that is not away from home) that are not deductible under part VI (section 161 and the following), subchapter B, chapter 1 of the Code, the payor is treated as maintaining two arrangements. The portion of the arrangement that provides payments for the deductible employee business expenses is treated as one arrangement that satisfies this paragraph (d). The portion of the arrangement that provides payments for the nondeductible employee expenses is treated as a second arrangement that does not satisfy this paragraph (d) and all amounts paid under this second arrangement will be treated as paid under a nonaccountable plan. See paragraphs (c)(5) and (h) of this section.

(3) *Reimbursement requirement*—(i) *In general.* If a payor arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) business expenses of a type described in paragraph (d)(1) or (d)(2) of this section, the arrangement does not satisfy this paragraph (d) and all amounts paid under the arrangement are treated as paid under a nonaccountable plan. See paragraphs (c)(5) and (h) of this section.

(ii) *Per diem allowances.* An arrangement providing a per diem allowance for travel expenses of a type described in paragraph (d)(1) or (d)(2) of this section that is computed on a basis similar to that used in computing the employee's wages or other compensation (e.g., the number of hours worked, miles traveled, or pieces produced) meets the requirements of this paragraph (d) only if, on December 12, 1989, the per diem allowance was identified by the payor either by making a separate payment or by specifically identifying the amount of the per diem allowance, or a per diem allowance computed on that basis was commonly used in the industry in which the employee is employed. See section 274(d) and § 1.274(d)–1. A per diem allowance described in this paragraph (d)(3)(ii) may be adjusted in a manner that reasonably reflects actual increases in employee business expenses occurring after December 12, 1989.

(e) *Substantiation*—(1) *In general.* An arrangement meets the requirements of this paragraph (e) if it requires each business expense to be substantiated to the payor in accordance with paragraph (e)(2) or (e)(3) of this section, whichever is applicable, within a reasonable period of time. See § 1.274–5T or § 1.162–17.

(2) *Expenses governed by section 274(d).* An arrangement that reimburses travel, entertainment, use of a passenger

automobile or other listed property, or other business expenses governed by section 274(d) meets the requirements of this paragraph (e)(2) if information sufficient to satisfy the substantiation requirements of section 274(d) and the regulations thereunder is submitted to the payor. See §1.274–5T. Under section 274(d), information sufficient to substantiate the requisite elements of each expenditure or use must be submitted to the payor. For example, with respect to travel away from home, §1.274–5T(b)(2) requires that information sufficient to substantiate the amount, time, place, and business purpose of the expense must be submitted to the payor. Similarly, with respect to use of a passenger automobile or other listed property, §1.274–5T(b)(6) requires that information sufficient to substantiate the amount, time, use, and business purpose of the expense must be submitted to the payor. See §1.274(d)–1, however, which grants the Commissioner authority to prescribe rules permitting the amount of certain expenses to be deemed substantiated to the payor (in lieu of substantiating the actual amount of such expenses) where an arrangement provides for a reimbursement, a per diem allowance, or a mileage allowance for travel away from home or transportation expenses. See also §1.274–5T(j), which grants the Commissioner the authority to establish a method under which a taxpayer may elect to use a specified amount for meals while traveling away from home in lieu of substantiating the actual cost of meals. Substantiation of the amount of a business expense in accordance with rules prescribed pursuant to the authority granted by §1.274(d)–1 or §1.274–5T(j) will be treated as substantiation of the amount of such expense for purposes of this section.

(3) *Expenses not governed by section 274(d).* An arrangement that reimburses business expenses not governed by section 274(d) meets the requirements of this paragraph (e)(3) if information is submitted to the payor sufficient to enable the payor to identify the specific nature of each expense and to conclude that the expense is attributable to the payor's business activities. Therefore, each of the elements of an expenditure or use must be substantiated to the payor. It is not sufficient if an employee merely aggregates expenses into broad categories (such as ''travel'') or reports individual expenses through the use of vague, nondescriptive terms (such as ''miscellaneous business expenses''). See §1.162–17(b).

(f) *Returning amounts in excess of expenses—(1) In general.* Except as provided in paragraph (f)(2) of this section, an arrangement meets the requirements of this paragraph (f) if it requires the employee to return to the payor within a reasonable period of time may amount paid under the arrangement in excess of the expenses substantiated in accordance with paragraph (e) of this section. The determination of whether an arrangement requires an employee to return amounts in excess of substantiated expenses will depend on the facts and circumstances. An arrangement whereby money is advanced to an employee to defray expenses will be treated as satisfying the requirements of this paragraph (f) only if the amount of money advanced is reasonably calculated not to exceed the amount of anticipated expenditures, the advance of money is made on a day within a reasonable period of the day that the anticipated expenditures are paid or incurred, and any amounts in excess of the expenses substantiated in accordance with paragraph (e) of this section are required to be returned to the payor within a reasonable period of time after the advance is received.

(2) *Per diem or mileage allowances.* The Commissioner may, in his discretion, prescribe rules in pronouncements of general applicability under which a reimbursement or other expense allowance arrangement that provides per diem allowances providing for ordinary and necessary expenses of traveling away from home (exclusive of transportation costs to and from destination) or mileage allowances providing for ordinary and necessary expenses of local travel and tranportation while traveling away from home will be treated as satisfying the requirements of this paragraph (f), even though the arrangement does not require the employee to return the portion of such an allowance that relates to the days or miles of

travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under section 274(d), provided the allowance is paid at a rate for each day or mile of travel that is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return to the payor within a reasonable period of time any portion of such allowance which relates to days or miles of travel not substantiated in accordance with paragraph (e) of this section.

(g) *Reasonable period*—(1) *In general.* The determination of a reasonable period of time will depend on the facts and circumstances.

(2) *Safe harbors*—(i) *Fixed date method.* An advance made within 30 days of when an expense is paid or incurred, an expense substantiated to the payor within 60 days after it is paid or incurred, or an amount returned to the payor within 120 days after an expense is paid or incurred will be treated as having occurred within a reasonable period of time.

(ii) *Periodic statement method.* If a payor provides employees with periodic statements (no less frequently than quarterly) stating the amount, if any, paid under the arrangement in excess of the expenses the employee has substantiated in accordance with paragraph (e) of this section, and requesting the employee to substantiate any additional business expenses that have not yet been substantiated (whether or not such expenses relate to the expenses with respect to which the original advance was paid) and/or to return any amounts remaining unsubstantiated within 120 days of the statement, an expense substantiated or an amount returned within that period will be treated as being substantiated or returned within a reasonable period of time.

(3) *Pattern of overreimbursements.* If, under a reimbursement or other expense allowance arrangement, a payor has a plan or practice to provide amounts to employees in excess of expenses substantiated in accordance with paragraph (e) of this section and to avoid reporting and withholding on such amounts, the payor may not use either of the safe harbors provided in paragraph (g)(2) of this section for any years during which such plan or practice exists.

(h) *Withholding and payment of employment taxes*—(1) *When excluded from wages.* If an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, the amounts paid under the arrangement that are not in excess of the expenses substantiated in accordance with paragraph (e) of this section (i.e., the amounts treated as paid under an accountable plan) are not wages and are not subject to withholding and payment of employment taxes. If an arrangement provides advances, allowances, or reimbursements for meal and entertainment expenses and a portion of the payment is treated as paid under a nonaccountable plan under paragraph (d)(2) of this section due solely to section 274(n), then notwithstanding paragraph (h)(2)(ii) of this section, these nondeductible amounts are neither treated as gross income nor subject to withholding and payment of employment taxes.

(2) *When included in wages*—(i) *Accountable plans*—(A) *General rule.* Except as provided in paragraph (h)(2)(i)(B) of this section, if the expenses covered under an arrangement that meets the requirements of paragraphs (d), (e), and (f) of this section are not substantiated to the payor in accordance with paragraph (e) of this section within a reasonable period of time or if any amounts in excess of the substantiated expenses are not returned to the payor in accordance with paragraph (f) of this section within a reasonable period of time, the amount which is treated as paid under a nonaccountable plan under paragraph (c)(3)(ii) of this section is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. A payor may treat any amount not substantiated or returned within the periods specified in paragraph (g)(2) of this section as not substantiated or returned within a reasonable period of time.

(B) *Per diem or mileage allowances*—(*1*) *In general.* If a payor pays a per diem or mileage allowance under an arrangement that meets the requirements of the paragraphs (d), (e), and (f) of this section, the portion, if any, of the allowance paid that relates to days or miles of travel substantiated in accordance with paragraph (e) of this section and that exceeds the amount of the employee's expenses deemed substantiated for such travel pursuant to rules prescribed under section 274(d) and §1.274(d)–1 or §1.274–5T(j) is treated as paid under a nonaccountable plan. See paragraph (c)(3)(ii) of this section. Because the employee is not required to return this excess portion, the reasonable period of time provisions of paragraph (g) of this section (relating to the return of excess amounts) do not apply to this excess portion.

(*2*) *Reimbursements.* Except as provided in paragraph (h)(2)(i)(B)(*4*) of this section, in the case of a per diem or mileage allowance paid as a reimbursement at a rate for each day or mile of travel that exceeds the amounts of the employee's expenses deemed substantiated for a day or mile of travel, the excess portion described in paragraph (h)(2)(i) of this section is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the days or miles of travel substantiated in accordance with paragraph (e) of this section.

(*3*) *Advances.* Except as provided in paragraph (h)(2)(i)(B)(*4*) of this section, in the case of a per diem or mileage allowance paid as an advance at a rate for each day or mile of travel that exceeds the amount of the employee's expenses deemed substantiated for a day or mile of travel, the excess portion described in paragraph (h)(2)(i) of this section is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the expenses with respect to which the advance was paid (i.e., the days or miles of travel) are substantiated in accordance with paragraph (e) of this section. The expenses with respect to which the advance was paid must be substantiated within a reasonable period of time. See paragraph (g) of this section.

(*4*) *Special rules.* The Commissioner may, in his discretion, prescribe special rules in pronouncements of general applicability regarding the timing of withholding and payment of employment taxes on per diem and mileage allowances.

(ii) *Nonaccountable plans.* If an arrangement does not satisfy one or more of the requirements of paragraphs (d), (e), or (f) of this section, all amounts paid under the arrangement are wages and are subject to withholding and payment of employment taxes when paid.

(i) *Application.* The requirements of paragraphs (d) (business connection), (e) (substantiation), and (f) (returning amounts in excess of expenses) of this section will be applied on an employee-by-employee basis. Thus, for example, the failure by one employee to substantiate expenses under an arrangement in accordance with paragraph (e) of this section will not cause amounts paid to other employees to be treated as paid under a nonaccountable plan.

(j) *Examples.* The rules contained in this section may be illustrated by the following examples:

Example (1). *Reimbursement requirement.* Employer S pays its engineers $200 a day. On those days that an engineer travels away from home on business for Employer S, Employer S designates $50 of the $200 as paid to reimburse the engineer's travel expenses. Because Employer S would pay an engineer $200 a day regardless of whether the engineer was traveling away from home, the arrangement does not satisfy the reimbursement requirement of paragraph (d)(3)(i) of this section. Thus, no part of the $50 Employer S designated as a reimbursement is treated as paid under an accountable plan. Rather, all payments under the arrangement are treated as paid under a nonaccountable plan. Employer S must report the entire $200 as wages or other compensation on the employees' Forms W–2 and must withhold and pay employment taxes on the entire $200 when paid.

Example (2). *Reimbursement requirement, multiple arrangements.* Airline T pays all its employees a salary. Airline T also pays an allowance under an arrangement that otherwise meets the requirements of paragraphs (d), (e), and (f) of this section to its pilots and flight attendants who travel away from their home base airports, whether or not they are ‘‘away from home.’’ Because the allowance is paid only to those employees who incur (or are reasonably expected to incur) expenses of a type described in paragraph (d)(1) or (d)(2) of this section, the arrangement satisfies the reimbursement requirement of paragraph (d)(3)(i) of this section.

Under paragraph (d)(2) of this section, Airline T is treated as maintaining two arrangements. The portion of the arrangement providing the allowances for away from home travel is treated as an accountable plan. The portion of the arrangement providing the allowances for non-away from home travel is treated as a nonaccountable plan. Airline T must report the non-away from home allowances as wages or other compensation on the employees' Forms W–2 and must withhold and pay employment taxes on these payments when paid.

Example (3). *Reimbursement requirement.* Corporation R pays all its salespersons a salary. Corporation R also pays a travel allowance under an arrangement that otherwise meets the requirements of paragraphs (d), (e), and (f) of this section. This allowance is paid to all salespersons, including salespersons that Corporation R knows, or has reason to know, do not travel away from their offices on Corporation R business and would not be reasonably expected to incur travel expenses. Because the allowance is not paid only to those employees who incur (or are reasonably expected to incur) expenses of a type described in paragraph (d)(1) or (d)(2) of this section, the arrangement does not satisfy the reimbursement requirement of paragraph (d)(3)(i) of this section. Thus, no part of the allowance Corporation R designated as a reimbursement is treated as paid under an accountable plan. Rather, all payments under the arrangement are treated as paid under a nonaccountable plan. Corporation R must report all payments under the arrangement as wages or other compensation on the employees' Forms W–2 and must withhold and pay employment taxes on the payments when paid.

Example (4). *Separate arrangement, miscellaneous expenses.* Under an arrangement that meets the requirements of paragraphs (d), (e), and (f) of this section, County U reimburses its employees for lodging and meal expenses incurred when they travel away from home on County U business. For its own convenience, County U also separately pays certain of its employees a $25 monthly allowance to cover the cost of small miscellaneous office expenses. County U does not require its employees to substantiate these miscellaneous expenses and does not require them to return the amounts by which the monthly allowance exceeds the miscellaneous expenses. The monthly allowance arrangement is a nonaccountable plan. County U must report the monthly allowances as wages or other compensation on the employees' Forms W–2 and must withhold and pay employment taxes on the monthly allowances when paid. The nonaccountable plan providing the monthly allowances is treated as separate from the accountable plan providing reimbursements for lodging and meal expenses incurred for travel away from home on County U business.

Example (5). *Excessive advances.* In anticipation of employee business expenses that Corporation V does not reasonably expect to exceed $400 in any quarter, Corporation V nonetheless advances $1,000 to Employee A for such expenses. Whenever Employee A substantiates an expense in accordance with paragraph (e) of this section, Corporation V provides an additional advance in an amount equal to the amount substantiated, thereby providing a continuing advance of $1,000. Because the amounts advanced under this arrangement are not reasonably calculated so as not to exceed the amount of anticipated expenditures and because the advance of money is not made on a day within a reasonable period of the day that the anticipated expenditures are paid or incurred, the arrangement is a nonaccountable plan. The arrangement fails to satisfy the requirements of paragraphs (d) (business connection) and (f) (reasonable calculation of advances) of this section. Thus, Corporation V must report the entire amount of each advance as wages or other compensation and must withhold and pay employment taxes on the entire amount of each advance when paid.

Example (6). *Excess mileage advance.* Under an arrangement that meets the requirements of paragraphs (d), (e), and (f) of this section, Employer W pays its employees a mileage allowance at a rate of 30 cents per mile (when the amount deemed substantiated for each mile of travel substantiated is 26 cents per mile) to cover automobile business expenses. The allowance is paid at a rate for each mile of travel that is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses. Employer W does not require the return of the portion of the mileage allowance (4 cents) that exceeds the amount deemed substantiated for each mile of travel substantiated in accordance with paragraph (e) of this section. In June, Employer W advances Employee B $150 for 500 miles to be traveled by Employee B during the month. In July, Employee B substantiates 500 miles of business travel. The amount deemed substantiated by Employee B is $130. However, Employer W does not require Employee B to return the remaining $20 of the advance. No later than the first payroll period following the payroll period in which the business miles of travel are substantiated, Employer W must withhold and pay employment taxes on $20 (500 miles × 4 cents per mile).

Example (7). *Excess per diem reimbursement.* Under an arrangement that meets the requirements of paragraphs (d), (e), and (f) of this section, Employer X pays its employees a per diem allowance to cover lodging, meal, and incidental expenses incurred for travel away from home on Employer X business at a rate equal to 120 percent of the amount deemed substantiated for each day of travel to the localities to which the employees travel. Employer X does not require the employees to return the 20 percent by which the reimbursement for those expenses exceeds the amount deemed substantiated for each day of travel substantiated in accordance with paragraph (e) of this section. Employee C substantiates six days of business travel away from home: Two days in a locality for which the amount deemed substantiated is $100 a day and four days in a locality for which the amount deemed substantiated is $125 a day. Employer X reimburses Employee C $840 for the six days of travel away from home (2×(120%×$100)+4×(120%×$125)), and does not require Employee C to return the excess portion ($140 excess portion=(2 days×$20 ($120−$100)+4 days×$25 ($150-$125)). For the payroll period in which Employer X reimburses the expenses, Employer X must withhold and pay employment taxes on $140.

Example (8). *Return Requirement.* Employer Y provides expense allowances to certain of its employees to cover business expenses of a type described in paragraph (d)(1) of this section under an arrangement that requires the employees to substantiate their expenses within a reasonable period of time and to return any excess amounts within a reasonable period of time. Each time an employee returns an excess amount to Employer Y, however, Employer Y pays the employee a ‘‘bonus’’ equal to the amount returned by the employee. The arrangement fails to satisfy the requirements of paragraph (f) (returning amounts in excess of expenses) of this section. Thus, Employer Y must report the entire amount of the expense allowance payments as wages or other compensation and must withhold and pay employment taxes on the payments when paid. Compare example (6) (where the employee is not required to return the portion of the mileage allowance that exceeds the amount deemed substantiated for each mile of travel substantiated).

Example (9). *Timely substantiation.* Employer Z provides a $500 advance to Employee D for a trip away from home on Employer Z business. Employee D incurs $500 in business expenses on the trip. Employer Z uses the periodic statement method safe harbor. At the end of the quarter during which the trip occurred, Employer Z sends a quarterly statement to Employee D stating that $500 was advanced to Employee D during the quarter and that no expenses were substantiated and no excess amounts returned. The statement advises Employee D that Employee D must substantiate any additional business expenses within 120 days of the date of the statement, and must return any unsubstantiated excess within the 120-day period. Employee D fails to substantiate any expenses or to return the excess within the 120-day period. Employer Z treats the $500 as wages and withholds and pays employment taxes on the $500. After the 120-day period has expired, Employee D substantiates the $500 in travel expenses in accordance with paragraph (e) of this section. Employer Z properly reported and withheld and paid employment taxes on the $500 and no adjustments may be made. Employee D must include the $500 in gross income and may deduct the $500 of expenses as a miscellaneous itemized deduction subject to the 2-percent floor provided in section 67.

(k) *Anti-abuse provision.* If a payor’s reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of section 62(c) and this section, all payments made under the arrangement will be treated as made under a nonaccountable plan.

(l) *Cross references.* For employment tax regulations relating to reimbursement and expense allowance arrangements, see §§31.3121 (a)–3, 31.3231(e)–(3), 31.3306(b)–2, and 31.3401(a)–4, which generally apply to payments made under reimbursement or other expense allowance arrangements received by an employee on or after July 1, 1990 with respect to expenses paid or incurred on or after July 1, 1990. For reporting requirements, see §1.6041–3(i), which generally applies to payments made under reimbursement or other expense allowance arrangements received by an employee on or after January 1, 1989 with respect to expenses paid or incurred on or after January 1, 1989.

(m) *Effective dates.* This section generally applies to payments made under reimbursement or other expense allowance arrangements received by an employee in taxable years of the employee beginning on or after January 1, 1989, with respect to expenses paid or incurred in taxable years beginning on or after January 1, 1989. Paragraph (h) of this section generally applies to payments made under reimbursement or other expense allowance arrangements received by an employee on or after July 1, 1990 with respect to expenses paid or incurred on or after July 1, 1990. Paragraphs (d)(3)(ii) and (h)(2)(i)(B) of this section apply to payments made under reimbursement or other expense allowance arrangements received by an employee on or after January 1, 1991 with respect to expenses paid or incurred on or after January 1, 1991. Paragraph (e)(2) of this section applies to payments made under reimbursement or other expense allowance arrangements received by an employee with respect to expenses paid or incurred on or before December 31, 1997. For payments with respect to expenses paid or incurred after December 31, 1997, see § 1.62–2T(e)(2).

[T.D. 8324, 55 FR 51691, Dec. 17, 1990; 56 FR 8911, Mar. 4, 1991, as amended by T.D. 8451, 57 FR 57668, Dec. 7, 1992; T.D. 8666, 61 FR 27005, May 30, 1996; T.D. 8784, 63 FR 52600, Oct. 1, 1998]

§ 1.62–2T Reimbursement and other expense allowance arrangements (temporary).

(a) through (e)(1) [Reserved]. For further guidance, see § 1.62–2(a) through (e)(1).

(e)(2) *Expenses governed by section 274(d).* For further guidance, see § 1.62–2(e)(2) except that each reference to § 1.274(d)–1 is deemed to be a reference to § 1.274(d)–1T.

(e)(3) through (l) [Reserved]. For further guidance, see § 1.62–2(e)(3) through (l).

(m) *Effective dates.* Paragraph (e)(2) of this section applies to payments made under reimbursement or other expense allowance arrangements received by an employee with respect to expenses paid or incurred after December 31, 1997. For payments with respect to expenses paid or incurred on or before December 31, 1997, see § 1.62–2(e)(2).

[T.D. 8784, 63 FR 52600, Oct. 1, 1998]

§ 1.63–1 Change of treatment with respect to the zero bracket amount and itemized deductions.

(a) *In general.* An individual who files a return on which the individual itemizes deductions in accordance with section 63(g) may later make a change of treatment by recomputing taxable income for the taxable year to which that return relates without itemizing deductions. Similarly, an individual who files a return on which the individual computes taxable income without itemizing deductions may later make a change of treatment by itemizing deductions in accordance with section 63(g) in recomputing taxable income for the taxable year to which that return relates.

(b) *No extension of time for claiming credit or refund.* A change of treatment described in paragraph (a) of this section does not extend the period of time prescribed in section 6511 within which the taxpayer may make a claim for credit or refund of tax.

(c) *Special requirements if spouse filed separate return*—(1) *Requirements.* If the spouse of the taxpayer filed a separate return for a taxable year corresponding to the taxable year of the taxpayer, the taxpayer may not make a change of treatment described in paragraph (a) of this section for that year unless—

(i) The spouse makes a change of treatment on the separate return consistent with the change of treatment sought by the taxpayer; and

(ii) The taxpayer and the taxpayer's spouse file a consent in writing to the assessment of any deficiency of either spouse to the extent attributable to the change of treatment, even though the assessment of the deficiency would otherwise be prevented by the operation of any law or rule of law. The consent must be filed with the district director for the district in which the taxpayer applies for the change of treatment, and the period during which a deficiency may be assessed shall be established by agreement of the spouses and the district director.

(2) *Corresponding taxable year.* A taxable year of one spouse corresponds to a taxable year of the other spouse if both taxable years end in the same calendar year. If the taxable year of one spouse ends with death, however, the corresponding taxable year of the surviving spouse is that in which the death occurs.

(d) *Inapplicable if tax liability has been compromised.* The taxpayer may not make a change of treatment described in paragraph (a) of this section for any taxable year if—

(1) The tax liability of the taxpayer for the taxable year has been compromised under section 7122; or

(2) The tax liability of the taxpayer's spouse for a taxable year corresponding to the taxable year of the taxpayer has been compromised under section 7122. See paragraph (c)(2) of this section for the determination of a corresponding taxable year.

(e) *Effective date.* This section applies to taxable years beginning after 1976.

[T.D. 7585, 44 FR 1105, Jan. 4, 1979]

§1.63–2 Cross reference.

For rules with respect to charitable contribution deductions for nonitemizing taxpayers, see section 63 (b)(1)(C) and (i) and section 170(i) of the Internal Revenue Code of 1954.

(Secs. 170(a)(1) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 58, 26 U.S.C. 170(a)(1); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 8002, 49 FR 50666, Dec. 31, 1984]

§1.67–1T 2-percent floor on miscellaneous itemized deductions (temporary).

(a) *Type of expenses subject to the floor*—(1) *In general.* With respect to individuals, section 67 disallows deductions for miscellaneous itemized deductions (as defined in paragraph (b) of this section) in computing taxable income (*i.e.*, so-called ‘‘below-the-line’’ deductions) to the extent that such otherwise allowable deductions do not exceed 2 percent of the individual’s adjusted gross income (as defined in section 62 and the regulations thereunder). Examples of expenses that, if otherwise deductible, are subject to the 2-percent floor include but are not limited to—

(i) Unreimbursed employee expenses, such as expenses for transportation, travel fares and lodging while away from home, business meals and entertainment, continuing education courses, subscriptions to professional journals, union or professional dues, professional uniforms, job hunting, and the business use of the employee’s home.

(ii) Expenses for the production or collection of income for which a deduction is otherwise allowable under section 212 (1) and (2), such as investment advisory fees, subscriptions to investment advisory publications, certain attorneys’ fees, and the cost of safe deposit boxes,

(iii) Expenses for the determination of any tax for which a deduction is otherwise allowable under section 212(3), such as tax counsel fees and appraisal fees, and

(iv) Expenses for an activity for which a deduction is otherwise allowable under section 183.

See section 62 with respect to deductions that are allowable in computing adjusted gross income (*i.e.*, so-called ‘‘above-the-line’’ deductions).

(2) *Other limitations.* Except as otherwise provided in paragraph (d) of this section, to the extent that any limitation or restriction is placed on the amount of a miscellaneous itemized deduction, that limitation shall apply prior to the application of the 2-percent floor. For example, in the case of an expense for food or beverages, only 80 percent of which is allowable as a deduction because of the limitations provided in section 274(n), the otherwise deductible 80 percent of the expense is treated as a miscellaneous itemized deduction and is subject to the 2-percent limitation of section 67.

(b) *Definition of miscellaneous itemized deductions.* For purposes of this section, the term ‘‘miscellaneous itemized deductions’’ means the deductions allowable from adjusted gross income in determining taxable income, as defined in section 63, other than—

(1) The standard deduction as defined in section 63(c),

(2) Any deduction allowable for impairment-related work expenses as defined in section 67(d),

(3) The deduction under section 72(b)(3) (relating to deductions if annuity payments cease before the investment is recovered),

(4) The deductions allowable under section 151 for personal exemptions,

(5) The deduction under section 163 (relating to interest),

(6) The deduction under section 164 (relating to taxes),

(7) The deduction under section 165(a) for losses described in subsection (c)(3) or (d) of section 165,

(8) The deduction under section 170 (relating to charitable contributions and gifts),

(9) The deduction under section 171 (relating to deductions for amortizable bond premiums),

(10) The deduction under section 213 (relating to medical and dental expenses),

(11) The deduction under section 216 (relating to deductions in connection

with cooperative housing corporations),

(12) The deduction under section 217 (relating to moving expenses),

(13) The deduction under section 691(c) (relating to the deduction for estate taxes in the case of income in respect of the decedent),

(14) The deduction under 1341 (relating to the computation of tax if a taxpayer restores a substantial amount held under claim of right), and

(15) Any deduction allowable in connection with personal property used in a short sale.

(c) *Allocation of expenses.* If a taxpayer incurs expenses that relate to both a trade or business activity (within the meaning of section 162) and a production of income or tax preparation activity (within the meaning of section 212), the taxpayer shall allocate such expenses between the activities on a reasonable basis.

(d) *Members of Congress*—(1) *In general.* With respect to the deduction for living expenses of Members of Congress referred to in section 162(a), the 2-percent floor described in section 67 and paragraph (a) of this section shall be applied to the deduction before the application of the $3,000 limitation on deductions for living expenses referred to in section 162(a). (For purposes of this paragraph (d), the term ''Member(s) of Congress'' includes any Delegate or Resident Commissioner.) The amount of miscellaneous itemized deductions of a Member of Congress that is disallowed pursuant to section 67 and paragraph (a) of this section shall be allocated between deductions for living expenses (within the meaning of section 162(a)) and other miscellaneous itemized deductions. The amount of deductions for living expenses of a Member of Congress that is disallowed pursuant to section 67 and paragraph (a) of this section is determined by multiplying the aggregate amount of such living expenses (determined without regard to the $3,000 limitation of section 162(a) but with regard to any other limitations) by a fraction, the numerator of which is the aggregate amount disallowed pursuant to section 67 and paragraph (a) of this section with respect to miscellaneous itemized deductions of the Member of Congress and the denominator of which is the amount of miscellaneous itemized deductions (including deductions for living expenses) of the Member of Congress (determined without regard to the $3,000 limitation of section 162(a) but without regard to any other limitations). The amount of deductions for miscellaneous itemized deductions (other than deductions for living expenses) of a Member of Congress that are disallowed pursuant to section 67 and paragraph (a) of this section is determined by multiplying the amount of miscellaneous itemized deductions (other than deductions for living expenses) of the Member of Congress (determined with regard to any limitations) by the fraction described in the preceding sentence.

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

Example For 1987 A, a Member of Congress, has adjusted gross income of $100,000, and miscellaneous itemized deductions of $10,750 of which $3,750 is for meals, $3,000 is for other living expenses, and $4,000 is for other miscellaneous itemized deductions (none of which is subject to any percentage limitations other than the 2-percent floor of section 67). The amount of A's business meal expenses that are disallowed under section 274(n) is $750 ($3,750×20%). The amount of A's miscellaneous itemized deductions that are disallowed under section 67 is $2,000 ($100,000×2%). The portion of the amount disallowed under section 67 that is allocated to A's living expenses is $1,200. This portion is equal to the amount of A's deductions for living expenses allowable after the application of section 274(n) and before the application of section 67 ($6,000) multiplied by the ratio of A's total miscellaneous itemized deductions disallowed under section 67 to A's total miscellaneous itemized deductions, determined without regard to the $3,000 limitation of section 162(a) ($2,000/$10,000). Thus, after application of section 274(n) and section 67, A's deduction for living expenses is $4,800 ($6,750 − $750 − $1,200). However, pursuant to section 162(a), A may deduct only $3,000 of such expenses. The amount of A's other miscellaneous itemized deductions that are disallowed under section 67 is $800 ($4,000×$2,000/ $10,000). Thus, $3,200 ($4,000 − $800) of A's miscellaneous itemized deductions (other than deductions for living expenses) are allowable after application of section 67. A's total allowable miscellaneous itemized deductions are $6,200 ($3,000+$3,200).

(e) *State legislators.* See §1.62–1T(e)(4) with respect to rules regarding state legislator's expenses.

[T.D. 8189, 53 FR 9875, Mar. 28, 1988]

§1.67–2T Treatment of pass-through entities (temporary).

(a) *Application of section 67.* This section provides rules for the application of section 67 to partners, shareholders, beneficiaries, participants, and others with respect to their interests in pass-through entities (as defined in paragraph (g) of this section). In general, an affected investor (as defined in paragraph (h) of this section) in a pass-through entity shall separately take into account as an item of income and as an item of expense an amount equal to his or her allocable share of the affected expenses (as defined in paragraph (i) of this section) of the pass-through entity for purposes of determining his or her taxable income. Except as provided in paragraph (e)(1)(ii)(B) of this section, the expenses so taken into account shall be treated as paid or incurred by the affected investor in the same manner as paid or incurred by the pass-through entity. For rules regarding the application of section 67 to affected investors in—

(1) Partnerships, S corporations, and grantor trusts, see paragraph (b) of this section,

(2) Real estate mortgage investment conduits, see paragraph (c) of this section,

(3) Common trust funds, see paragraph (d) of this section,

(4) Nonpublicly offered regulated investment companies, see paragraph (e) of this section, and

(5) Publicly offered regulated investment companies, see paragraph (p) of this section.

(b) *Partnerships, S corporations, and grantor trusts*—(1) *In general.* Pursuant to section 702(a) and 1366(a) of the Code and the regulations thereunder, each partner of a partnership or shareholder of an S corporation shall take into account separately his or her distributive or pro rata share of any items of deduction of such partnership or corporation that are defined as miscellaneous itemized deductions pursuant to section 67(b). The 2-percent limitation described in section 67 does not apply to the partnership or corporation with respect to such deductions, but such deductions shall be included in the deductions of the partner or shareholder to which that limitation applies. Similarly, the limitation applies to the grantor or other person treated as the owner of a grantor trust with respect to items that are paid or incurred by a grantor trust and are treated as miscellaneous itemized deductions of the grantor or other person pursuant to Subpart E, Part 1, Subchapter J, Chapter 1 of the Code, but not to the trust itself. The 2-percent limitation applies to amounts otherwise deductible in taxable years of partners, shareholders, or grantors beginning after December 31, 1986, regardless of the taxable year of the partnership, corporation, or trust.

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

Example. P, a partnership, incurs $1,000 in expenses to which section 212 applies during its taxable year. A, an individual, is a partner in P. A's distributive share of the expenses to which section 212 applies is $20, determined without regard to the 2-percent limitation of section 67. Pursuant to section 702(a), A must take $20 of expenses to which section 212 applies into account in determining his income tax. Pursuant to section 67, in determining his taxable income A may deduct his miscellaneous itemized deductions (including his $20 distributive share of deductions from P) to the extent the total amount exceeds 2 percent of his adjusted gross income.

(c) *Real estate mortgage investment conduit.* See §1.67–3T for rules regarding the application of section 67 to holders of interests in REMICs.

(d) *Common trust funds*—(1) *In general.* For purposes of determining the taxable income of an affected investor that is a participant in a common trust fund—

(i) The ordinary taxable income and ordinary net loss of the common trust fund shall be computed under section 584(d)(2) without taking into account any affected expenses, and

(ii) Each affected investor shall be treated as having paid or incurred an expense described in section 212 in an amount equal to the affected investor's proportionate share of the affected expenses.

The 2-percent limitation described in section 67 applies to amounts otherwise deductible in taxable years of participants beginning after December 31, 1986, regardless of the taxable year of the common trust fund.

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

Example. During 1987, the gross income and deductions of common trust fund C, a calendar year taxpayer, consist of the following items: (i) $50,000 of short-term capital gains; (ii) $150,000 of long-term capital gains; (iii) $1,000,000 of dividend income; (iv) $10,000 of deductions that are not affected expenses; and (v) $60,000 of deductions that are affected expenses. The proportionate share of Trust T in the income and losses of C is one percent. In computing its taxable income for 1987, T, a calendar year taxpayer, shall take into account the following items: (A) $500 of short-term capital gains (one percent of $50,000, C's short-term capital gains); (B) $1,500 of long-term capital gains (one percent of $150,000, C's long-term capital gains); (C) $9,900 of ordinary taxable income (one percent of $990,000, the excess of $100,000, C's gross income after excluding capital gains and losses, over $10,000, C's deductions that are not affected expenses); (D) $600 of expenses described in section 212 (one percent of $60,000, C's affected expenses).

(e) *Nonpublicly offered regulated investment companies*—(1) *In general.* For purposes of determining the taxable income of an affected investor that is a shareholder of a nonpublicly offered regulated investment company (as defined in paragraph (g)(3) of this section) during a calendar year—

(i) The current earnings and profits of the nonpublicly offered regulated investment company shall be computed without taking into account any affected RIC expenses that are allocated among affected investors, and

(ii) The affected investor shall be treated—

(A) As having received or accrued a dividend in an amount equal to the affected investor's allocable share of the affected RIC expenses of the nonpublicly offered regulated investment company for the calendar year, and

(B) As having paid or incurred an expense described in section 212 (or section 162 in the case of an affected investor that is a nonpublicly offered regulated investment company) in an amount equal to the affected investor's allocable share of the affected RIC expenses of the nonpublicly offered regulated investment company for the calendar year

in the affected investor's taxable year with which (or within which) the calendar year with respect to which the expenses are allocated ends. An affected investor's allocable share of the affected RIC expenses is the amount allocated to that affected investor pursuant to paragraph (k) of this section.

(2) *Shareholders that are not affected investors.* A shareholder of a nonpublicly offered regulated investment company that is not an affected investor shall not take into account in computing its taxable income any amount of income or expense with respect to its allocable share of affected RIC expenses.

(3) *Example.* The provisions of this paragraph (e) may be illustrated by the following example:

Example. During calendar year 1987, nonpublicly offered regulated investment company M distributes to individual shareholder A, a calendar year taxpayer, capital gain dividends of $1,000 and other dividends of $5,000. A's allocable share of the affected RIC expenses of M is $200. In computing A's taxable income for 1987, A shall take into account the following items: (i) $1,000 of long-term capital gains (the capital gain dividends received by A); (ii) $5,200 of dividend income (the sum of the other dividends received by A and A's allocable share of the affected RIC expenses of M); and (iii) $200 of expenses described in section 212 (A's allocable share of the affected RIC expenses of M). A is allowed a deduction for miscellaneous itemized deductions (including A's $200 allocable share of the affected RIC expenses of M, which is treated as an expense described in section 212) for 1987 only to the extent the aggregate of such deductions exceeds 2 percent of A's adjusted gross income for 1987.

(f) *Cross-reference.* See § 1.67–1T with respect to limitations on deductions for expenses described in section 212 (including amounts treated as such expenses under this section).

(g) *Pass-through entity*—(1) *In general.* Except as provided in paragraph (g)(2) of this section, for purposes of section 67(c) and this section, a pass-through entity is—

(i) A trust (or any portion thereof) to which Subpart E, Part 1, Subchapter J, Chapter 1 of the Code applies,

(ii) A partnership,

(iii) An S corporation,

(iv) A common trust fund described in section 584,

(v) A nonpublicly offered regulated investment company,

(vi) A real estate mortgage investment conduit, and

(vii) Any other person—

(A) Which is not subject to the income tax imposed by Subtitle A, Chapter 1, or which is allowed a deduction in computing such tax for distributions to owners or beneficiaries, and

(B) The character of the income of which may affect the character of the income recognized with respect to that person by its owners or beneficiaries.

Entities that do not meet the requirements of paragraph (g)(1)(vii) (A) and (B) of this section, such as qualified pension plans, individual retirement accounts, and insurance companies holding assets in separate asset accounts to fund variable contracts defined in section 817(d), are not described in this paragraph (g)(1).

(2) *Exception.* For purposes of section 67(c) and this section, a pass-through entity does not include:

(i) An estate;

(ii) A trust (or any portion thereof) not described in paragraph (g)(1)(i) of this section,

(iii) A cooperative described in section 1381(a)(2), determined without regard to subparagraphs (A) and (C) thereof, or

(iv) A real estate investment trust.

(3) *Nonpublicly offered regulated investment company—(i) In general.* For purposes of this section, the term ‘‘nonpublicly offered regulated investment company’’ means a regulated investment company to which Part I of Subchapter M of the Code applies that is not a publicly offered regulated investment company.

(ii) *Publicly offered regulated investment company.* For purposes of this section, the term ‘‘publicly offered regulated investment company’’ means a regulated investment company to which Part I of Subchapter M of the Code applies the shares of which are—

(A) Continuously offered pursuant to a public offering (within the meaning of section 4 of the Securities Act of 1933, as amended (15 U.S.C. 77a to 77aa)),

(B) Regularly traded on an established securities market, or

(C) Held by or for no fewer than 500 persons at all times during the taxable year.

(h) *Affected investor*—(1) *In general.* For purposes of this section, the term ‘‘affected investor’’ means a partner, shareholder, beneficiary, participant, or other interest holder in a pass-through entity at any time during the pass-through entity's taxable year that is—

(i) An individual (other than a nonresident alien whose income with respect to his or her interest in the pass-through entity is not effectively connected with the conduct of a trade or business within the United States),

(ii) A person, including a trust or estate, that computes its taxable income in the same manner as in the case of an individual; or

(iii) A pass-through entity if one or more of its partners, shareholders, beneficiaries, participants, or other interest holders is (A) a pass-through entity or (B) a person described in paragraph (h)(1) (i) or (ii) of this section.

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

Example (1). Corporation X holds shares of nonpublicly offered regulated investment company R in its capacity as a nominee or custodian for individual A, the beneficial owner of the shares. Because the owner of the shares for Federal income tax purposes is an individual, the shares are owned by an affected investor.

Example (2). Individual retirement account I owns shares of a nonpublicly offered regulated investment company. Because an individual retirement account is not a person described in paragraph (h)(1) of this section, the shares are not owned by an affected investor.

(i) *Affected expenses—(1) In general.* In general, for purposes of this section, the term ‘‘affected expenses’’ means expenses that, if paid or incurred by an individual, would be deductible, if at all, as miscellaneous itemized deductions as defined in section 67(b).

(2) *Special rule for nonpublicly offered regulated investment companies.* In the case of a nonpublicly offered regulated investment company, the term ‘‘affected expenses’’ means only affected RIC expenses.

(j) *Affected RIC expenses*—(1) *In general.* In general, for purposes of this section the term ‘‘affected RIC expenses’’ means the excess of—

(i) The aggregate amount of the expenses (other than expenses described in sections 62(a)(3) and 67(b) and § 1.67–1T(b)) paid or incurred in the calendar year that are allowable as a deduction in determining the investment company taxable income (without regard to section 852(b)(2)(D)) of the nonpublicly offered regulated investment company for a taxable year that begins or ends with or within the calendar year, over

(ii) The amount of expenses taken into account under paragraph (j)(1)(i) of this section that are allocable to the following items (whether paid separately or included as part of a fee paid to an investment advisor or other person for a variety of services):

(A) Registration fees;

(B) Directors' or trustees' fees;

(C) Periodic meetings of directors, trustees, or shareholders;

(D) Transfer agent fees;

(E) Legal and accounting fees (other than fees for income tax return preparation or income tax advice); and

(F) Shareholder communications required by law (*e.g.* the preparation and mailing of prospectuses and proxy statements).

Expenses described in paragraph (j)(1)(ii) (A) through (F) of this section do not include, for example, expenses allocable to investment advice, marketing activities, shareholder communications and other services not specifically described in paragraph (j)(1)(ii) (A) through (F) of this section, and custodian fees.

(2) *Safe harbor.* If a nonpublicly offered regulated investment company makes an election under this paragraph (j)(2), the affected RIC expenses for a calendar year shall be treated as equal to 40 percent of the amount determined under paragraph (j)(1)(i) of this section for that calendar year. The nonpublicly offered regulated investment company shall make the election by attaching to its income tax return for the taxable year that includes the last day of the first calendar year for which the nonpublicly offered regulated investment company makes the election a statement that it is making an election under paragraph (j)(2) of this section. An election made pursuant to this paragraph (j)(2) shall remain in effect for all subsequent calendar years unless revoked with the consent of the Commissioner.

(3) *Reduction for unused RIC expenses.* The amount determined under paragraph (j)(1)(i) of this section shall be reduced by the nonpublicly offered regulated investment company's net operating loss, if any, for the taxable year ending with or within the calendar year. In computing the nonpublicly offered regulated investment company's net operating loss for purposes of this section, the deduction for dividends paid shall not be allowed and any net capital gain for the taxable year shall be excluded.

(4) *Exception.* The affected RIC expenses of a nonpublicly offered regulated investment company will be treated as zero if the amount of its gross income for the calendar year (determined without regard to capital gain net income) is not greater than 1 percent of the sum of (i) such gross income and (ii) the amount of its interest income for the calendar year that is not includible in gross income pursuant to section 103.

(k) *Allocation of expenses among nonpublicly offered regulated investment company shareholders*—(1) *General rule.* A nonpublicly offered regulated investment company shall allocate to each of its affected investors that is a shareholder at any time during the calendar year, the affected investor's allocable share of the affected RIC expenses of the nonpublicly offered regulated investment company for that calendar year. (See paragraph (m) of this section for rules regarding estimates with respect to the amount of an affected investor's share of affected RIC expenses upon which certain persons can rely for certain purposes.) A nonpublicly offered regulated investment company may use any reasonable method to make the allocation. A method of allocation shall not be reasonable if—

(i) The method can be expected to have the effect, if applied to all affected RIC expenses and all shareholders (whether or not affected investors), of allocating to the shareholders an amount of affected RIC expenses that is less than the affected RIC expenses of the nonpublicly offered regulated investment company for the calendar year,

(ii) The method can be expected to have the effect of allocating a disproportionately high share of the affected RIC expenses of the nonpublicly offered regulated investment company to shareholders that are not affected investors or affected investors, the amount of whose miscellaneous itemized deductions (including their allocable share of affected RIC expenses) exceeds the 2-percent floor described in section 67, or

(iii) A principal purpose of the method of allocation is to avoid allocating affected RIC expenses to persons described in paragraph (h)(1) (i) or (ii) of this section whose miscellaneous itemized deductions (inclusive of their allocable share of affected RIC expenses) may not exceed the 2-percent floor described in section 67.

(2) *Reasonable allocation method described*—(i) *In general.* The allocation method described in this paragraph (k)(2) shall be treated as a reasonable allocation method. Under the method described in this paragraph, an affected investor's allocable share of the affected RIC expenses of a nonpublicly offered regulated investment company is the amount that bears the same ratio to the amount of affected RIC expenses of the nonpublicly offered regulated investment company for the calendar year as—

(A) The amount of dividends paid to the affected investor during the calendar year, bears to

(B) The sum of—

(*1*) The aggregate amount of dividends paid by the nonpublicly offered regulated investment company during the calendar year to all shareholders, and

(*2*) Any amount on which tax is imposed under section 852(b)(1) for any taxable year of the nonpublicly offered regulated investment company ending within or with the calendar year.

(ii) *Exception.* Paragraph (k)(2)(i) of this section does not apply if the amount of the deduction for dividends paid during the calendar year is zero.

(iii) *Dividends paid.* For purposes of this paragraph (k)(2)—

(A) Dividends that are treated as paid during a calendar year pursuant to section 852(b)(7) are treated as paid during that calendar year and not during the succeeding calendar year.

(B) The term ''dividends paid'' does not include capital gain dividends (as defined in section 852(b)(3)(C)), exempt-interest dividends (as defined in section 852(b)(5)(A)), or any amount to which section 302(a) applies.

(C) The dividends paid during a calendar year is determined without regard to section 855(a).

(3) *Reasonable allocation made by District Director.* If a nonpublicly offered regulated investment company does not make a reasonable allocation of affected RIC expenses to its affected investors as required by paragraph (k)(1) of this section, a reasonable allocation shall be made by the District Director of the internal revenue district in which the principal place of business or principal office or agency of the nonpublicly offered regulated investment company is located.

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

Example (1). Nonpublicly offered regulated investment company M, in calculating its investment company taxable income, claims a dividends paid deduction for a portion of redemption distributions (to which section 302(a) applies) to shareholders, as well as for nonredemption distributions. M allocates affected expenses among shareholders who have received nonredemption distributions by multiplying the amount of nonredemption distributions distributed to each shareholder by a fraction, the numerator of which is the affected RIC expenses of M and the denominator of which is M's investment company taxable income, determined on a calendar year basis and without regard to deductions described in section 852(b)(2)(D). No affected RIC expenses are allocated with respect to the redemption distributions. This allocation method can be expected to have the effect of allocating among the shareholders an amount of expenses that is less than the total amount of affected RIC expenses of M. Accordingly, the allocation method is not reasonable.

Example (2). Nonpublicly offered regulated investment company N has two classes of stock, a ''capital'' class and an ''income'' class. Owners of the capital class receive the benefit of all capital appreciation on the stocks owned by N, and bear the burden of certain capital expenditures of N; owners of the income class receive the benefit of all other income of N, and bear the burden of all expenses of N that are deductible under section 162. M allocates all affected RIC expenses among shareholders of the income class shares under a method that would be reasonable if the income class were the only class of N stock. Corporations and other shareholders that are not affected investors own a higher proportion of income class shares than of capital class shares. The affected RIC expenses of N are properly allocated among the shareholders who bear the burden of those expenses. Accordingly, the allocation method does not have the effect of allocating a disproportionately high share of the affected RIC expenses of N to shareholders that are not affected investors merely because a disproportionate share of income class shares are owned by shareholders that are not affected investors. The allocation method is reasonable.

Example (3). Nonpublicly offered regulated investment company O has two classes of stock, Class A and Class B. Shares of Class A, which may be purchased without payment of a sales or brokerage commission, are charged with the expenses of a Rule 12b–1 distribution plan of O. Shares of Class B, which may be purchased only upon payment of a sales or brokerage commission, are not charged with the expenses of the Rule 12b–1 distribution plan of O. O allocates all affected RIC expenses among shareholders of Class A and Class B shares under a method that would be reasonable if Class A or Class B shares, respectively, were the only class of O stock. The affected RIC expenses attributable to the Rule 12b–1 plan are allocated to the shareholders of Class A shares. Shareholders that are not affected investors own a higher proportion of Class A shares than of Class B shares. The affected RIC expenses of O are properly allocated among the shareholders who bear the burden of those expenses. Accordingly, the allocation method does not have the effect of allocating a disproportionately high share of the affected RIC expenses of O to shareholders that are not affected investors merely because a disproportionately high share of Class A shares are owned by persons that are not affected investors. The allocation method is reasonable.

Example (4). Assume the facts are the same as in example (3) except that a portion of the affected RIC expenses attributable to the Rule 12b–1 plan are allocated to the shareholders of Class B shares, and shareholders that are not affected investors own a higher proportion of Class B shares than of Class A shares. Thus, the affected RIC expenses are not allocated among the class of shareholders that bear the burden of the expenses. Accordingly, the allocation method has the effect of allocating a disproportionate share of the affected RIC expenses of O to the shareholders of Class B shares. Because shareholders that are not affected investors own a higher proportion of Class B shares than Class A shares, the method can be expected to allocate a disproportionately high share of the affected RIC expenses of O to shareholders that are not affected investors. Accordingly, the allocation method is not reasonable.

(l) *Affected RIC expenses not subject to backup withholding.* The amount of dividend income that an affected investor in a nonpublicly offered regulated investment company is treated as having received or accrued under paragraph (e)(1)(ii) of this section is not subject to backup withholding under section 3406.

(m) *Reliance by nominees and pass-through investors on notices*—(1) *General rule.* Persons described in paragraph (m)(3) of this section may, for the purposes described in that paragraph (m)(3), treat an affected investor's allocable share of the affected RIC expenses of a nonpublicly offered regulated investment company as being equal to an amount determined by the nonpublicly offered regulated investment company on the basis of a reasonable estimate (*e.g.*, of allocable expenses as a percentage of dividend distributions or allocable expenses per share) that is (i) reported in writing by the nonpublicly offered regulated investment company to the person or (ii) reported in a newspaper or financial publication having a nationwide circulation (*e.g.*, the *Wall Street Journal* or *Standard and Poor's Weekly Dividend Record*).

(2) *Estimates must be reasonable.* In general, for purposes of paragraph (m)(1) of this section, estimates of affected RIC expenses of a nonpublicly offered regulated investment company will be treated as reasonable only if the nonpublicly offered regulated investment company makes a reasonable effort to offset material understatements (or overstatements) of affected RIC expenses for a period by increasing (or decreasing) estimates of affected RIC expenses for a subsequent period. Understatements or overstatements of affected RIC expenses that are not material may be corrected by making offsetting adjustments in future periods,

provided that understatements and overstatements are treated consistently.

(3) *Application.* Paragraph (m)(1) of this section shall apply to the following persons for the following purposes:

(i) A nominee who, pursuant to section 6042(a)(1)(B) and paragraph (n)(2) of this section, is required to report dividends paid by a nonpublicly offered regulated investment company to the Internal Revenue Service and to the person to whom the payment is made, for purposes of reporting to the Internal Revenue Service and the person to whom the payment is made the amount of affected RIC expenses allocated to such person.

(ii) An affected investor to whom a nominee (to which paragraph (m)(3)(i) of this section applies) reports, for purposes of calculating the affected investor's taxable income and the amount of its affected expenses.

(iii) A shareholder that is a pass-through entity, for purposes of calculating its taxable income and the amount of its affected expenses.

(n) *Return of information and reporting to affected investors by a nonpublicly offered regulated investment company*—(1) *In general*—(i) *Return of information.* A nonpublicly offered regulated investment company shall make an information return (*e.g.,* Form 1099–DIV, Dividends and Distributions, for 1987) with respect to each affected investor to which an allocation of affected RIC expenses is required to be made pursuant to paragraph (k) of this section and for which the nonpublicly offered regulated investment company is required to make an information return to the Internal Revenue Service pursuant to section 6042 (or would be required to make such information return but for the $10 threshold described in section 6042 (a)(1) (A) and (B). The nonpublicly offered regulated investment company shall make the information return for each calendar year and shall state separately on such return—

(A) The amount of affected RIC expenses required to be allocated to the affected investor for the calendar year pursuant to paragraph (k) of this section,

(B) The sum of—

(*1*) The aggregate amount of the dividends paid to the affected investor during the calendar year, and

(*2*) The amount of the affected RIC expenses required to be allocated to the affected investor for the calendar year pursuant to paragraph (k) of this section, and

(C) Such other information as may be specified by the form or its instructions.

(ii) *Statement to be furnished to affected investors.* A nonpublicly offered regulated investment company shall provide to each affected investor for each calendar year (whether or not the nonpublicly offered regulated investment company is required to make an information return with respect to the affected investor pursuant to section 6042), a written statement showing the following information:

(A) The information described in paragraph (n)(1)(i) of this section with respect to the affected investor;

(B) The name and address of the nonpublicly offered regulated investment company;

(C) The name and address of the affected investor; and

(D) If the nonpublicly offered regulated investment company is required to report the amount of the affected investor's allocation of affected RIC expense to the Internal Revenue Service pursuant to paragraph (n)(1)(i) of this section a statement to that effect.

(iii) *Affected investor's shares held by a nominee.* If an affected investor's shares in a nonpublicly offered regulated investment company are held in the name of a nominee, the nonpublicly offered regulated investment company may make the information return described in paragraph (n)(1)(i) of this section with respect to the nominee in lieu of the affected investor and may provide the written statement described in paragraph (n)(1)(ii) of this section to such nominee in lieu of the affected investor.

(2) *By a nominee*—(i) *In general.* Except as otherwise provided for in paragraph (n)(2)(iii) of this section, in any case in which a nonpublicly offered regulated investment company provides, pursuant to paragraph (n)(1)(iii) of this section, a written statement to

the nominee of an affected investor for a calendar year, the nominee shall—

(A) If the nominee is required to make an information return pursuant to section 6042 (or would be required to make an information return but for the $10 threshold described in section 6042(a)(1) (A) and (B), make an information return (*e.g.,* Form 1099–DIV, Dividends and Distributions, for 1987) for the calendar year with respect to each affected investor and state separately on such information return the information described in paragraph (n)(1)(i) of this section, and

(B) Furnish each affected investor with a written statement for the calendar year showing the information required by paragraph (n)(2)(ii) of this section (whether or not the nominee is required to make an information return with respect to the affected investor pursuant to section 6042).

(ii) *Form of statement.* The written statement required to be furnished for a calendar year pursuant to paragraph (n)(2)(i)(B) of this section shall show the following information:

(A) The affected investor's proportionate share of the items described in paragraph (n)(1)(i) of this section for the calendar year,

(B) The name and address of the nominee,

(C) The name and address of the affected investor, and

(D) If the nominee is required to report the affected investor's share of the allocable investment expenses to the Internal Revenue Service pursuant to paragraph (n)(2)(i)(A) of this section, a statement to that effect.

(iii) *Return not required.* A nominee is not required to make an information return with respect to an affected investor pursuant to paragraph (n)(2)(i)(A) of this section if the nominee is excluded from the requirements of section 6042 pursuant to § 1.6042–2(a)(1) (ii) or (iii).

(iv) *Statement not required.* A nominee is not required to furnish a written statement to an affected investor pursuant to paragraph (n)(2)(i)(B) of this section if the nonpublicly offered regulated investment company furnishes the written statement to the affected investor pursuant to an agreement with the nominee described in § 1.6042–2(a)(1)(iii).

(v) *Special rule.* Paragraph (n)(1) (i) and (ii) of this section applies to a nonpublicly offered regulated investment company that agrees with the nominee to satisfy the requirements of section 6042 as described in § 1.6042–2(a)(1)(iii) with respect to the affected investor.

(3) *Time and place for furnishing returns.* The returns required by paragraph (n)(1)(i) and (2)(i)(A) of this section for any calendar year shall be filed at the time and place that a return required under section 6042 is required to be filed. See § 1.6042–2(c) .

(4) *Time for furnishing statements.* The statements required by paragraph (n)(1)(ii) and (2)(i)(B) of this section to be furnished by a nonpublicly offered regulated investment company and a nominee, respectively, to an affected investor for a calendar year shall be furnished to such affected investor on or before January 31 of the following year.

(5) *Duplicative returns and statements not required*—(i) *Information return.* The requirements of paragraph (n)(1)(i) and (2)(i)(A) of this section for the making of an information return shall be met by the timely filing of an information return pursuant to section 6042 that contains the information required by paragraph (n)(1)(i).

(ii) *Written statement.* The requirements of paragraph (n)(1)(ii) and (2)(i)(B) of this section for the furnishing of a written statement (including the statement required by paragraph (n)(1)(ii)(D) and (2)(ii)(D) of this section) shall be met by furnishing the affected investor a copy of the information return to which section 6042 applies (whether or not the nonpublicly offered regulated investment company or nominee is required to file an information return with respect to the affected investor pursuant to section 6042) that contains the information required by paragraph (n)(1)(ii) or (2)(ii), whichever is applicable, of this section. Nonpublicly offered regulated investment companies and nominees may use a substitute form that contains provisions substantially similar to those of the prescribed form if the nonpublicly offered regulated investment company or nominee complies with all revenue procedures relating to substitute forms in effect at the time. The statement shall be furnished either in person or in a statement mailed by first-class mail that includes adequate notice that the statement is enclosed. A statement shall be considered to be furnished to an affected investor within the meaning of this section if it is mailed to such affected investor at its last known address.

(o) *Return of information by a common trust fund.* With respect to each affected investor to which paragraph (d) of this section applies, the common trust fund shall state on the return it is required to make pursuant to section 6032 for its taxable year, the following information:

(1) The amount of the affected investor's proportionate share of the affected expenses for the taxable year as described in paragraph (d)(1)(ii) of this section.

(2) The amount of the affected investor's proportionate share of ordinary taxable income or ordinary net loss for the taxable year determined pursuant to paragraph (d)(1)(i) of this section, and

(3) Such other information as may be specified by the form or its instructions.

(p) *Publicly offered regulated investment companies.* [Reserved]

[T.D. 8189, 53 FR 9876, Mar. 28, 1988; 53 FR 13464, Apr. 25, 1988]

§1.67–3 Allocation of expenses by real estate mortgage investment conduits.

(a) *Allocation of allocable investment expenses.* [Reserved]

(b) *Treatment of allocable investment expenses.* [Reserved]

(c) *Computation of proportionate share.* [Reserved]

(d) *Example.* [Reserved]

(e) *Allocable investment expenses not subject to backup withholding.* [Reserved]

(f) *Notice to pass-through interest holders*—(1) *Information required.* A REMIC must provide to each pass-through interest holder to which an allocation of allocable investment expense is required to be made under §1.67–3T(a)(1) notice of the following—

(i) If, pursuant to paragraph (f)(2)(i) or (ii) of this section, notice is provided for a calendar quarter, the aggregate amount of expenses paid or accrued during the calendar quarter for which the REMIC is allowed a deduction under section 212;

(ii) If, pursuant to paragraph (f)(2)(ii) of this section, notice is provided to a regular interest holder for a calendar year, the aggregate amount of expenses paid or accrued during each calendar quarter that the regular interest holder held the regular interest in the calendar year and for which the REMIC is allowed a deduction under section 212; and

(iii) The proportionate share of these expenses allocated to that pass-through interest holder, as determined under §1.67–3T(c).

(2) *Statement to be furnished*—(i) *To residual interest holder.* For each calendar quarter, a REMIC must provide to each pass-through interest holder who holds a residual interest during the calendar quarter the notice required under paragraph (f)(1) of this section on Schedule Q (Form 1066), as required in §1.860F–4(e).

(ii) *To regular interest holder.* For each calendar year, a single-class REMIC (as described in §1.67–3T(a)(2)(ii)(B)) must provide to each pass-through interest holder who held a regular interest during the calendar year the notice required under paragraph (f)(1) of this section. Quarterly reporting is not required. The information required to be included in the notice may be separately stated on the statement described in §1.6049–7(f) instead of on a separate statement provided in a separate mailing. See §1.6049–7(f)(4). The separate statement provided in a separate mailing must be furnished to each pass-through interest holder no later than the last day of the month following the close of the calendar year.

(3) *Returns to the Internal Revenue Service*—(i) *With respect to residual interest holders.* Any REMIC required under paragraphs (f)(1) and (2)(i) of this section to furnish information to any pass-through interest holder who holds a residual interest must also furnish such information to the Internal Revenue Service as required in §1.860F–4(e)(4).

(ii) *With respect to regular interest holders.* A single-class REMIC (as described in § 1.67–3T(a)(2)(ii)(B)) must make an information return on Form 1099 for each calendar year, with respect to each pass-through interest holder who holds a regular interest to which an allocation of allocable investment expenses is required to be made pursuant to § 1.67–3T(a)(1) and (2)(ii). The preceding sentence applies with respect to a holder for a calendar year only if the REMIC is required to make an information return to the Internal Revenue Service with respect to that holder for that year pursuant to section 6049 and § 1.6049–7(b)(2)(i) (or would be required to make an information return but for the $10 threshold described in section 6049(a)(1) and § 1.6049–7(b)(2)(i)). The REMIC must state on the information return—

(A) The sum of—

(*1*) The aggregate amounts includible in gross income as interest (as defined in § 1.6049–7(a)(1)(i) and (ii)), for the calendar year; and

(*2*) The sum of the amount of allocable investment expenses required to be allocated to the pass-through interest holder for each calendar quarter during the calendar year pursuant to § 1.67–3T(a); and

(B) Any other information specified by the form or its instructions.

(4) *Interest held by nominees and other specified persons*—(i) *Pass-through interest holder's interest held by a nominee.* If a pass-through interest holder's interest in a REMIC is held in the name of a nominee, the REMIC may make the information return described in paragraphs (f)(3)(i) and (ii) of this section with respect to the nominee in lieu of the pass-through interest holder and may provide the written statement described in paragraphs (f)(2)(i) and (ii) of this section to that nominee in lieu of the pass-through interest holder.

(ii) *Regular interests in a single-class REMIC held by certain persons.* If a person specified in § 1.6049–7(e)(4) holds a regular interest in a single-class REMIC (as described in § 1.67–3T(a)(2)(ii)(B)), then the single-class REMIC must provide the information described in paragraphs (f)(1) and (f)(3)(ii)(A) and (B) of this section to that person with the information specified in § 1.6049–7(e)(2) as required in § 1.6049–7(e).

(5) *Nominee reporting*—(i) *In general.* In any case in which a REMIC provides information pursuant to paragraph (f)(4) of this section to a nominee of a pass-through interest holder for a calendar quarter or, as provided in paragraph (f)(2)(ii) of this section, for a calendar year—

(A) The nominee must furnish each pass-through interest holder with a written statement described in paragraph (f)(2)(i) or (ii) of this section, whichever is applicable, showing the information described in paragraph (f)(1) of this section; and

(B) The nominee must make an information return on Form 1099 for each calendar year, with respect to the pass-through interest holder and state on this information return the information described in paragraphs (f)(3)(ii)(A) and (B) of this section, if—

(*1*) The nominee is a nominee for a pass-through interest holder who holds a regular interest in a single-class REMIC (as described in § 1.67–3T(a)(2)(ii)(B)); and

(*2*) The nominee is required to make an information return pursuant to section 6049 and § 1.6049–7 (b)(2)(i) and (b)(2)(ii)(B) (or would be required to make an information return but for the $10 threshold described in section 6049(a)(2) and § 1.6049–7(b)(2)(i)) with respect to the pass-through interest holder.

(ii) *Time for furnishing statement.* The statement required by paragraph (f)(5)(i)(A) of this section to be furnished by a nominee to a pass-through interest holder for a calendar quarter or calendar year must be furnished to this holder no later than 30 days after receiving the written statement described in paragraph (f)(2)(i) or (ii) of this section from the REMIC. If, however, pursuant to paragraph (f)(2)(ii) of this section, the information is separately stated on the statement described in § 1.6049–7(f), then the information must be furnished to the pass-through interest holder in the time specified in § 1.6049–7(f)(5).

(6) *Special rules*—(i) *Time and place for furnishing returns.* The returns required by paragraphs (f)(3)(ii) and (f)(5)(i)(B) of this section for any calendar year must

be filed at the time and place that a return required under section 6049 and §1.6049–7(b)(2) is required to be filed. See §1.6049–4(g) and §1.6049–7(b)(2)(iv).

(ii) *Duplicative returns not required.* The requirements of paragraphs (f)(3)(ii) and (f)(5)(i)(B) of this section for the making of an information return are satisfied by the timely filing of an information return pursuant to section 6049 and §1.6049–7(b)(2) that contains the information required by paragraph (f)(3)(ii) of this section.

[T.D. 8431, 57 FR 40321, Sept. 3, 1992]

§1.67–3T Allocation of expenses by real estate mortgage investment conduits (temporary).

(a) *Allocation of allocable investment expenses*—(1) *In general.* A real estate mortgage investment conduit or REMIC (as defined in section 860D) shall allocate to each of its pass-through interest holders that holds an interest at any time during the calendar quarter the holder's proportionate share (as determined under paragraph (c) of this section) of the aggregate amount of allocable investment expenses of the REMIC for the calendar quarter.

(2) *Pass-through interest holder*—(i) *In general*—(A) *Meaning of term.* Except as provided in paragraph (a)(2)(ii) of this section, the term ''pass-through interest holder'' means any holder of a REMIC residual interest (as definition in section 860G(a)(2)) that is—

(*1*) An individual (other than a nonresident alien whose income with respect to his or her interest in the REMIC is not effectively connected with the conduct of a trade or business within the United States),

(*2*) A person, including a trust or estate, that computes its taxable income in the same manner as in the case of an individual, or

(*3*) A pass-through entity (as defined in paragraph (a)(3) of this section) if one or more of its partners, shareholders, beneficiaries, participants, or other interest holders is (*i*) a pass-through entity or (*ii*) a person described in paragraph (a)(2)(i)(A) (*1*) or (*2*) of this section.

(B) *Examples.* The provisions of this paragraph (a)(2)(i) may be illustrated by the following examples:

Example (1). Corporation X holds a residual interest in REMIC R in its capacity as a nominee or custodian for individual A, the beneficial owner of the interest. Because the owner of the interest for Federal income tax purposes is an individual, the interest is owned by a pass-through interest holder.

Example (2). Individual retirement account I holds a residual interest in a REMIC. Because an individual retirement account is not a person described in paragraph (a)(2)(i)(A) of this section, the interest is not held by a pass-through interest holder.

(ii) *Single-class REMIC*—(A) *In general.* In the case of a single-class REMIC, the term ''pass-through interest holder'' means any holder of either—

(*1*) A REMIC regular interest (as defined in section 860G(a)(1)), or

(*2*) A REMIC residual interest, that is described in paragraph (a)(2)(i)(A) (*1*), (*2*), or (*3*) of this section.

(B) *Single-class REMIC.* For purposes of paragraph (a)(2)(ii)(A) of this section, a single-class REMIC IS either—

(*1*) A REMIC that would be classified as an investment trust under §301.7701–4(c)(1) but for its qualification as a REMIC under section 860D and §1.860D–1T, or

(*2*) A REMIC that—

(*i*) Is substantially similar to an investment trust under §301.7701–4(c)(1), and

(*ii*) Is structured with the principal purpose of avoiding the requirement of paragraphs (a)(1) and (2)(ii)(A) of this section to allocate allocable investment expenses to pass-through interest holders that hold regular interests in the REMIC.

For purposes of this paragraph (a)(2)(ii)(B), in determining whether a REMIC would be classified as an investment trust or is substantially similar to an investment trust, all interests in the REMIC shall be treated as ownership interests in the REMIC, without regard to whether or not they would be classified as debt for Federal income tax purposes in the absence of a REMIC election.

(C) *Examples.* The provisions of paragraph (a)(2)(ii) of this section must be illustrated by the following examples:

Example (1). Corporation M transfers mortgages to a bank under a trust agreement as described in Example (2) of §301.7701–4(c)(2). There are two classes of certificates. Holders of class C certificates are entitled to receive 90 percent of the payment of principal and interest on the mortgages; holders of class D certificates are entitled to receive the remaining 10 percent. The two classes of certificates are identical except that, in the event of a default on the underlying mortgages, the payment rights of class D certificates holders are subordinated to the rights of class C certificate holders. M sells the class C certificates to investors and retains the class D certificates. The trust would be classified as an investment trust under § 301.7701–4(c)(1) but for its qualification a REMIC under section 860D the class C certificates represent regular interests in the REMIC and the class D certificates represent residual interest in the REMIC. The REMIC is a single-class REMIC within the meaning of paragraph (a)(2)(ii)(B)(*1*) of this section and, accordingly, holders of both the class C and class D certificates who are described in paragraph (a)(2)(i)(A) (*1*), (*2*), or (*3*) of this section are treated as pass-through interest holders.

Example (2). Assume that the facts are the same as in Example (1) except that M structures the REMIC to include a second regular interest represented by class E certificates. The principal purpose of M in structuring the REMIC to include class E certificates is to avoid allocating allocable investment expenses to class C certificate holders. The class E certificate holders are entitled to receive the payments otherwise due the class D certificate holders until they have been paid a stated amount of principal plus interest. The fair market value of the class E certificate is ten percent of the fair market value of the class D certificate and, therefore, less than one percent of the fair market value of the REMIC. The REMIC would not be classified as an investment trust under § 301.7701–4(c)(1) because the existence of the class E certificates is not incidental to the trust's purpose of facilitating direct investment in the assets of the trust. Nevertheless, because the fair market value of the class E certificates is de minimis, the REMIC is substantially similar to an investment trust under § 301.7701–4(c)(1). In addition, avoidance of the requirement to allocate allocable investment expenses to regular interest holders is the principal purpose of M in structuring the REMIC to include class E certificates. Therefore, the REMIC is a single-class REMIC within the meaning of paragraph (a)(2)(ii)(B)(*2*) of this section, and, accordingly, holders of both residual and regular interests who are described in paragraph (a)(2)(i)(A) (*1*), (*2*), or (*3*) of this section are treated as pass-through interest holders.

(3) *Pass-through entity*—(i) *In general.* Except as provided in paragraph (a)(3)(ii) of this section, for purposes of this section, a pass-through entity is—

(A) A trust (or any portion thereof) to which Subpart E, Part 1, Subchapter J, Chapter 1 of the Code applies,

(B) A partnership,

(C) An S corporation,

(D) A common trust fund described in section 584,

(E) A nonpublicly offered regulated investment company (as defined in paragraph (a)(5)(i) of this section),

(F) A REMIC, and

(G) Any other person—

(*1*) Which is not subject to income tax imposed by Subtitle A, Chapter 1, or which is allowed a deduction in computing such tax for distributions to owners or beneficiaries, and

(*2*) The character of the income of which may affect the character of the income recognized with respect to that person by its owners or beneficiaries.

Entities that do not meet the requirements of paragraphs (a)(3)(i)(G) (*1*) and (*2*), such as qualified pension plans, individual retirement accounts, and insurance companies holding assets in separate asset accounts to fund variable contracts defined in section 817(d), are not described in this paragraph (a)(3)(i).

(ii) *Exception.* For purposes of this section, a pass-through entity does not include—

(A) An estate,

(B) A trust (or any portion thereof) not described in paragraph (a)(3)(i)(A) of this section,

(C) A cooperative described without regard to subparagraphs (A) and (C) thereof, or

(D) A real estate investment trust.

(4) *Allocable investment expenses.* The term ''allocable investment expenses'' means the aggregate amount of the expenses paid or accrued in the calendar quarter for which a deduction is allowable under section 212 in determining the taxable income of the REMIC for the calendar quarter.

(5) *Nonpublicly offered regulated investment company*—(i) *In general.* For purposes of this section, the term ''nonpublicly offered regulated investment company'' means a regulated investment company to which Part I of Subchapter M of the Code applies that is not a publicly offered regulated investment company.

(ii) *Publicly offered regulated investment company.* For purposes of this section, the term ''publicly offered regulated investment company'' means a regulated investment company to which Part I of subchapter M of the Code applies, the shares of which are—

(A) Continuously offered pursuant to a public offering (within the meaning of section 4 of the Securities Act of 1933, as amended (15 U.S.C. 77a to 77aa)),

(B) Regularly traded on an established securities market, or

(C) Held by or for no fewer than 500 persons at all times during the taxable year.

(b) *Treatment of allocable investment expenses*—(1) *By pass-through interest holders*—(i) *Taxable year ending with calendar quarter.* A pass-through interest holder whose taxable year is the calendar year or ends with a calendar quarter shall be treated as having—

(A) Received or accrued income, and

(B) Paid or incurred an expense described in section 212 (or section 162 in the case of a pass-through interest holder that is a regulated investment company), in an amount equal to the pass-through interest holder's proportionate share of the allocable investment expenses of the REMIC for those calendar quarters that fall within the holder's taxable year.

(ii) *Taxable year not ending with calendar quarter.* A pass-through interest holder whose taxable year does not end with a calendar quarter shall be treated as having—

(A) Received or accrued income, and

(B) Paid or incurred an expense described in section 212 (or section 162 in the case of a pass-through interest holder that is a regulated investment company), in an amount equal to the sum of—

(C) The pass-through interest holder's proportionate share of the allocable investment expenses of the REMIC for those calendar quarters that fall within the holder's taxable year, and

(D) For each calendar quarter that overlaps the beginning or end of the taxable year, the sum of the daily amounts of the allocable investment expenses allocated to the holder pursuant to paragraph (c)(1)(ii) of this section for the days in the quarter that fall within the holder's taxable year.

(2) *Proportionate share of allocable investment expenses.* For purposes of paragraph (b) of this section, a pass-through interest holder's proportionate share of the allocable investment expenses is the amount allocated to the pass-through interest holder pursuant to paragraph (a)(1) of this section.

(3) *Cross-reference.* See §1.67–1T with respect to limitations on deductions for expenses described in section 212 (including amounts treated as such expenses under this section).

(4) *Interest income to holders of regular interests in certain REMICs.* Any amount allocated under this section to the holder of a regular interest in a single-class REMIC (as described in paragraph (a)(2)(ii)(B) of this section) shall be treated as interest income.

(5) *No adjustment to basis.* The basis of any holder's interest in a REMIC shall not be increased or decreased by the amount of the holder's proportionate share of allocable investment expenses.

(6) *Interest holders other than pass-through interest holders.* An interest holder of a REMIC that is not a pass-through interest holder shall not take into account in computing its taxable income any amount of income or expense with respect to its proportionate share of allocable investment expenses.

(c) *Computation of proportionate share*—(1) *In general.* For purposes of paragraph (a)(1) of this section, a REMIC shall compute a pass-through interest holder's proportionate share of the REMIC's allocable investment expenses by—

(i) Determining the daily amount of the allocable investment expenses for the calendar quarter by dividing the total amount of such expenses by the number of days in that calendar quarter.

(ii) Allocating the daily amount of the allocable investment expenses to the pass-through interest holder in proportion to its respective holdings on that day, and

(iii) Totaling the interest holder's daily amounts of allocable investment expenses for the calendar quarter.

(2) *Other holders taken into account.* For purposes of paragraph (c)(1)(ii) of this section, a pass-through interest

holder's proportionate share of the daily amount of the allocable investment expenses is determined by taking into account all holders of residual interests in the REMIC, whether or not pass-through interest holders.

(3) *Single-class REMIC*—(i) *Daily allocation*. In lieu of the allocation specified in paragraph (c)(1)(ii) of this section, a single-class REMIC (as described in paragraph (a)(2)(ii)(B) of this section) shall allocate the daily amount of the allocable investment expenses to each pass-through interest holder in proportion to the amount of income accruing to the holder with respect to its interest in the REMIC on that day.

(ii) *Other holders taken into account*. For purposes of paragraph (c)(3)(i) of this section, the amount of the allocable investment expenses that is allocated on any day to each pass-through interest holder shall be determined by multiplying the daily amount of allocable investment expenses (determined pursuant to paragraph (c)(1)(i) of this section) by a fraction, the numerator of which is equal to the amount of income that accrues (but not less than zero) to the pass-through interest holder on that day and the denominator of which is the total amount of income (as determined under paragraph (c)(3)(iii) of this section) that accrues to all regular and residual interest holders, whether or not pass-through interest holders, on that day.

(iii) *Total income accruing*. The total amount of income that accrues to all regular and residual interest holders is the sum of—

(A) The amount includible under section 860B in the gross income (but not less than zero) of the regular interest holders, and

(B) The amount of REMIC taxable income (but not less than zero) taken into account under section 860C by the residual interest holders.

(4) *Dates of purchase and disposition*. For purposes of this section, a pass-through interest holder holds an interest on the date of its purchase but not on the date of its disposition.

(d) *Example*. The provisions of this section may be illustrated by the following example:

Example (i) During the calendar quarter ending March 31, 1989, REMIC X, which is not a single-class REMIC, incurs $900 of allocable investment expenses. At the beginning of the calendar quarter, X has 4 residual interest holders, who hold equal proportionate shares, and 10 regular interest holders. The residual interest holders, all of whom have calendar-year taxable years, are as follows:

A, an individual,

C, a C corporation that is a nominee for individual I.

S, an S corporation, and

M, a C corporation that is not a nominee.

(ii) Except for A, all of the residual interest holders hold their interests in X for the entire calendar quarter. On January 31, 1989, A sells his interest to S. Thus, for the first month of the calendar quarter, each residual interest holder holds a 25 percent interest (100%/4 interest holders) in X. For the last two months, S's holding is increased to 50 percent and A's holding is decreased to zero. The daily amount of allocable investment expenses for the calendar quarter is $10 ($900/90 days).

(iii) The amount of allocable investment expenses apportioned to the residual interest holders is as follows:

(A) $75 ($10 × 25% × 30 days) is allocated to A for the 30 days that A holds an interest in X during the calendar quarter. A includes $75 in gross income in calendar year 1989. The amount of A's expenses described in section 212 is increased by $75 in calendar year 1989. A's deduction under section 212 (including the $75 amount of the allocation) is subject to the limitations contained in section 67.

(B) $225 ($10 × 25% × 90 days) is allocated to C. Because C is a nominee for I, C does not include $225 in gross income or increase its deductible expenses by $225. Instead, I includes $225 in gross income in calendar year 1989, her taxable year. The amount of I's expenses described in section 212 is increased by $225. I's deduction under section 212 (including the $225 amount of the allocation) is subject to the limitations contained in section 67.

(C) $375 (($10 × 25% × 30 days) + ($10 × 50% × 60 days)) is allocated to S. S includes in gross income $375 of allocable investment expenses in calendar year 1989. The amount of S's expenses described in section 212 for that taxable year is increased by $375. S allocates the $375 to its shareholders in accordance with the rules described in sections 1366 and 1377 in calendar year 1989. Thus, each shareholder of S includes its pro rata share of the $375 in gross income in its taxable year in which or with which calendar year 1989 ends. The amount of each shareholder's expenses described in section 212 is increased by the amount of the shareholder's allocation for the shareholder's taxable year in which or with which calendar year 1989 ends. The shareholder's deduction under section 212 (including the allocation under this section) is subject to the limitations contained in section 67.

(D) No amount is allocated to M. However, M's interest is taken into account for purposes of determining the proportionate share of those residual interest holders to whom an allocation is required to be made.

(iv) No allocation is made to the 10 regular interest holders pursuant to paragraph (a) of this section. In addition, the interests held by these interest holders are not taken into account for purposes of determining the proportionate share of the residual interest holders to whom an allocation is required to be made.

(e) *Allocable investment expenses not subject to backup withholding.* The amount of allocable investment expenses required to be allocated to a pass-through interest holder pursuant to paragraph (a)(1) of this section is not subject to backup withholding under section 3406.

(f) *Notice to pass-through interest holders*—(1) *Information required.* A REMIC must provide to each pass-through interest holder to which an allocation of allocable investment expense is required to be made under paragraph (a)(1) of this section notice of the following—

(i) If, pursuant to paragraph (f)(2) (i) or (ii) of this section, notice is provided for a calendar quarter, the aggregate amount of expenses paid or accrued during the calendar quarter for which the REMIC is allowed a deduction under section 212;

(ii) If, pursuant to paragraph (f)(2)(ii) of this section, notice is provided to a regular interest holder for a calendar year, the aggregate amount of expenses paid or accrued during each calendar quarter that the regular interest holder held the regular interest in the calendar year and for which the REMIC is allowed a deduction under section 212; and

(iii) The proportionate share of these expenses allocated to that pass-through interest holder, as determined under paragraph (c) of this section.

(2) *Statement to be furnished*—(i) *To residual interest holder.* For each calendar quarter, a REMIC shall provide to each pass-through interest holder who holds a residual interest during the calendar quarter the notice required under paragraph (f)(1) of this section on Schedule Q (Form 1066), as required in §1.860F–4(e).

(ii) *To regular interest holder*—(A) *In general.* For each calendar year, a single-class REMIC (as described in paragraph (a)(2)(ii)(B) of this section) must provide to each pass-through interest holder who held a regular interest during the calendar year the notice required under paragraph (f)(1) of this section. Quarterly reporting is not required. The information required to be included in the notice may be separately stated on the statement described in §1.6049–7(f) instead of on a separate statement provided in a separate mailing. See §1.6049–7(f)(4). The separate statement provided in a separate mailing must be furnished to each pass-through interest holder no later than the last day of the month following the close of the calendar year.

(B) *Special rule for 1987.* The information required under paragraph (f)(2)(ii)(A) of this section for any calendar quarter of 1987 shall be mailed (or otherwise delivered) to each pass-through interest holder who holds a regular interest during that calendar quarter no later than March 28, 1988.

(3) *Returns to the Internal Revenue Service*—(i) *With respect to residual interest holders.* Any REMIC required under paragraphs (f)(1) and (2)(i) of this section to furnish information to any pass-through interest holder who holds a residual interest shall also furnish such information to the Internal Revenue Service as required in §1.860F–4(e)(4).

(ii) *With respect to regular interest holders.* A single-class REMIC (as described in paragraph (a)(2)(ii)(B) of this section) shall make an information return on Form 1099 for each calendar year beginning after December 31, 1987, with respect to each pass-through interest holder who holds a regular interest to which an allocation of allocable investment expenses is required to be made pursuant to paragraphs (a)(1) and (2)(ii) of this section. The preceding sentence applies with respect to a holder for a calendar year only if the REMIC is required to make an information return to the Internal Revenue Service with respect to that holder for that year pursuant to section 6049 and §1.6049–7(b)(2)(i) (or would be required to make an information return but for the $10 threshold described in section 6049(a)(1) and § 1.6049–7(b)(2)(i)). The REMIC shall state on the information return—

(A) The sum of—

(*1*) The aggregate amounts includible in gross income as interest (as defined in § 1.6049–7(a)(1) (i) and (ii)), for the calendar year, and

(*2*) The sum of the amount of allocable investment expenses required to be allocated to the pass-through interest holder for each calendar quarter during the calendar year pursuant to paragraph (a) of this section, and

(B) Any other information specified by the form or its instructions.

(4) *Interest held by nominees and other specified persons*—(i) *Pass-through interest holder's interest held by a nominee.* If a pass-through interest holder's interest in a REMIC is held in the name of a nominee, the REMIC may make the information return described in paragraphs (f)(3) (i) and (ii) of this section with respect to the nominee in lieu of the pass-through interest holder and may provide the written statement described in paragraphs (f)(2) (i) and (ii) of this section to that nominee in lieu of the pass-through interest holder.

(ii) *Regular interests in a single-class REMIC held by certain persons.* For calendar quarters and calendar years after December 31, 1991, if a person specified in § 1.6049–7(e)(4) holds a regular interest in a single-class REMIC (as described in paragraph (a)(2)(ii)(B) of this section), then the single-class REMIC must provide the information described in paragraphs (f)(1) and (f)(3)(ii) (A) and (B) of this section to that person with the information specified in § 1.6049–7(e)(2) as required in § 1.6049–7(e).

(5) *Nominee reporting*—(i) *In general.* In any case in which a REMIC provides information pursuant to paragraph (f)(4) of this section to a nominee of a pass-through interest holder for a calendar quarter or, as provided in paragraph (f)(2)(ii) of this section, for a calendar year—

(A) The nominee shall furnish each pass-through interest holder with a written statement described in paragraph (f)(2) (i) or (ii) of this section, whichever is applicable, showing the information described in paragraph (f)(1) of this section, and

(B) If—

(*1*) The nominee is a nominee for a pass-through interest holder who holds a regular interest in a single-class REMIC (as described in paragraph (a)(2)(ii)(B) of this section), and

(*2*) The nominee is required to make an information return pursuant to section 6049 and § 1.6049–7(b)(2)(i) and (b)(2)(ii)(B) (or would be required to make an information return but for the $10 threshold described in section 6049(a)(2) and § 1.6049–7(b)(2)(i)) with respect to the pass-through interest holder,

the nominee shall make an information return on Form 1099 for each calendar year beginning after December 31, 1987, with respect to the pass-through interest holder and state on this information return the information described in paragraph (f)(3)(ii) (A) and (B) of this section.

(ii) *Time for furnishing statement.* The statement required by paragraph (f)(5)(i)(A) of this section to be furnished by a nominee to a pass-through interest holder for a calendar quarter or calendar year shall be furnished to this holder no later than 30 days after receiving the written statement described in paragraph (f)(2) (i) or (ii) of this section from the REMIC. If, however, pursuant to paragraph (f)(2)(ii) of this section, the information is separately stated on the statement described in § 1.6049–7(f), then the information must be furnished to the pass-through interest holder in the time specified in § 1.6049–7(f)(5).

(6) *Special rules*—(i) *Time and place for furnishing returns.* The returns required by paragraphs (f)(3)(ii) and (f)(5)(i)(B) of this section for any calendar year shall be filed at the time and place that a return required under section 6049 and § 1.6049–7(b)(2) is required to be filed. See § 1.6049–4(g) and § 1.6049–7(b)(2)(iv).

(ii) *Duplicative returns not required.* The requirements of paragraphs (f)(3)(ii) and (f)(5)(i)(B) of this section for the making of an information return shall be met by the timely filing of an information return pursuant to section 6049 and § 1.6049–7(b)(2) that contains the information required by paragraph (f)(3)(ii) of this section.

[T.D. 8186, 53 FR 7507, Mar 9, 1988, as amended by T.D. 8366, 56 FR 49515, Sept. 30, 1991]

§1.67–4T Allocation of expenses by nongrantor trusts and estates (temporary). [Reserved]

ITEMS SPECIFICALLY INCLUDED IN GROSS INCOME

§1.71–1 Alimony and separate maintenance payments; income to wife or former wife.

(a) *In general.* Section 71 provides rules for treatment in certain cases of payments in the nature of or in lieu of alimony or an allowance for support as between spouses who are divorced or separated. For convenience, the payee spouse will hereafter in this section be referred to as the ‘‘wife’’ and the spouse from whom she is divorced or separated as the ‘‘husband.’’ See section 7701(a)(17). For rules relative to the deduction by the husband of periodic payments not attributable to transferred property, see section 215 and the regulations thereunder. For rules relative to the taxable status of income of an estate or trust in case of divorce, etc., see section 682 and the regulations thereunder.

(b) *Alimony or separate maintenance payments received from the husband*—(1) *Decree of divorce or separate maintenance.* (i) In the case of divorce or legal separation, paragraph (1) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her after a decree of divorce or of separate maintenance. Such periodic payments must be made in discharge of a legal obligation imposed upon or incurred by the husband because of the marital or family relationship under a court order or decree divorcing or legally separating the husband and wife or a written instrument incident to the divorce status or legal separation status.

(ii) For treatment of payments attributable to property transferred (in trust or otherwise), see paragraph (c) of this section.

(2) *Written separation agreement.* (i) Where the husband and wife are separated and living apart and do not file a joint income tax return for the taxable year, paragraph (2) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her pursuant to a written separation agreement executed after August 16, 1954. The periodic payments must be made under the terms of the written separation agreement after its execution and because of the marital or family relationship. Such payments are includable in the wife’s gross income whether or not the agreement is a legally enforceable instrument. Moreover, if the wife is divorced or legally separated subsequent to the written separation agreement, payments made under such agreement continue to fall within the provisions of section 71(a)(2).

(ii) For purposes of section 71(a)(2) any written separation agreement executed on or before August 16, 1954, which is altered or modified in writing by the parties in any material respect after that date will be treated as an agreement executed after August 16, 1954, with respect to payments made after the date of alteration or modification.

(iii) For treatment of payments attributable to property transferred (in trust or otherwise), see paragraph (c) of this section.

(3) *Decree for support.* (i) Where the husband and wife are separated and living apart and do not file a joint income tax return for the taxable year, paragraph (3) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her after August 16, 1954, from her husband under any type of court order or decree (including an interlocutory decree of divorce or a decree of alimony pendente lite) entered after March 1, 1954, requiring the husband to make the payments for her support or maintenance. It is not necessary for the wife to be legally separated or divorced from her husband under a court order or decree; nor is it necessary for the order or decree for support to be for the purpose of enforcing a written separation agreement.

(ii) For purposes of section 71(a)(3), any decree which is altered or modified by a court order entered after March 1, 1954, will be treated as a decree entered after such date.

(4) *Scope of section 71(a).* Section 71(a) applies only to payments made because of the family or marital relationship in recognition of the general obligation to support which is made specific by the decree, instrument, or agreement. Thus, section 71(a) does not apply to that part of any periodic payment which is attributable to the repayment by the husband of, for example, a bona fide loan previously made to him by the wife, the satisfaction of which is specified in the decree, instrument, or agreement as a part of the general settlement between the husband and wife.

(5) *Year of inclusion.* Periodic payments are includible in the wife's income under section 71(a) only for the taxable year in which received by her. As to such amounts, the wife is to be treated as if she makes her income tax returns on the cash receipts and disbursements method, regardless of whether she normally makes such returns on the accrual method. However, if the periodic payments described in section 71(a) are to be made by an estate or trust, such periodic payments are to be included in the wife's taxable year in which they are includible according to the rules as to income of estates and trusts provided in sections 652, 662, and 682, whether or not such payments are made out of the income of such estates or trusts.

(6) *Examples.* The foregoing rules are illustrated by the following examples in which it is assumed that the husband and wife file separate income tax returns on the calendar year basis:

Example (1). W files suit for divorce from H in 1953. In consideration of W's promise to relinquish all marital rights and not to make public H's financial affairs, H agrees in writing to pay $200 a month to W during her lifetime if a final decree of divorce is granted without any provision for alimony. Accordingly, W does not request alimony and no provision for alimony is made under a final decree of divorce entered December 31, 1953. During 1954, H pays W $200 a month, pursuant to the promise. The $2,400 thus received by W is includible in her gross income under the provisions of section 71(a)(1). Under section 215, H is entitled to a deduction of $2,400 from his gross income.

Example (2). During 1945, H and W enter into an antenuptial agreement, under which, in consideration of W's relinquishment of all marital rights (including dower) in H's property, and, in order to provide for W's support and household expenses, H promises to pay W $200 a month during her lifetime. Ten years after their marriage, W sues H for divorce but does not ask for or obtain alimony because of the provision already made for her support in the antenuptial agreement. Likewise, the divorce decree is silent as to such agreement and H's obligation to support W. Section 71(a) does not apply to such a case. If, however, the decree were modified so as to refer to the antenuptial agreement, or if reference had been made to the antenuptial agreement in the court's decree or in a written instrument incident to the divorce status, section 71(a)(1) would require the inclusion in W's gross income of the payments received by her after the decree. Similarly, if a written separation agreement were executed after August 16, 1954, and incorporated the payment provisions of the antenuptial agreement, section 71(a)(2) would require the inclusion in W's income of payments received by W after W begins living apart from H, whether or not the divorce decree was subsequently entered and whether or not W was living apart from H when the separation agreement was executed, provided that such payments were made after such agreement was executed and pursuant to its terms. As to including such payments in W's income, if made by a trust created under the antenuptial agreement, regardless of whether referred to in the decree or a later instrument, or created pursuant to the written separation agreement, see section 682 and the regulations thereunder.

Example (3). H and W are separated and living apart during 1954. W sues H for support and on February 1, 1954, the court enters a decree requiring H to pay $200 a month to W for her support and maintenance. No part of the $200 a month support payments is includible in W's income under section 71(a)(3) or deductible by H under section 215. If, however, the decree had been entered after March 1, 1954, or had been altered or modified by a court order entered after March 1, 1954, the payments received by W after August 16, 1954, under the decree as altered or modified would be includible in her income under section 71(a)(3) and deductible by H under section 215.

Example (4). W sues H for divorce in 1954. On January 15, 1954, the court awards W temporary alimony of $25 a week pending the final decree. On September 1, 1954, the court grants W a divorce and awards her $200 a month permanent alimony. No part of the $25 a week temporary alimony received prior to the decree is includible in W's income under section 71(a), but the $200 a month received during the remainder of 1954 by W is includible in her income for 1954. Under section 215, H is entitled to deduct such $200 payments from his income. If, however, the decree awarding W temporary alimony had been entered after March 1, 1954, or had been altered or modified by a court order entered after March 1, 1954, temporary alimony received by her after August 16, 1954, would be includible in her income under section 71(a)(3) and deductible by H under section 215.

(c) *Alimony and separate maintenance payments attributable to property.* (1)(i) In the case of divorce or legal separation, paragraph (1) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) attributable to property transferred, in trust or otherwise, and received by her after a decree of divorce or of separate maintenance. Such property must have been transferred in discharge of a legal obligation imposed upon or incurred by the husband because of the marital or family relationship under a decree of divorce or separate maintenance or under a written instrument incident to such divorce status or legal separation status.

(ii) Where the husband and wife are separated and living apart and do not file a joint income tax return for the taxable year, paragraph (2) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her which are attributable to property transferred, in trust or otherwise, under a written separation agreement executed after August 16, 1954. The property must be transferred because of the marital or family relationship. The periodic payments attributable to the property must be received by the wife after the written separation agreement is executed.

(iii) The periodic payments received by the wife attributable to property transferred under subdivisions (i) and (ii) of this subparagraph and includible in her gross income are not to be included in the gross income of the husband.

(2) The full amount of periodic payments received under the circumstances described in section 71(a) (1), (2), and (3) is required to be included in the gross income of the wife regardless of the source of such payments. Thus, it matters not that such payments are attributable to property in trust, to life insurance, endowment, or annuity contracts, or to any other interest in property, or are paid directly or indirectly by the husband from his income or capital. For example, if in order to meet an alimony or separate maintenance obligation of $500 a month the husband purchases or assigns for the benefit of his wife a commercial annuity contract paying such amount, the full $500 a month received by the wife is includible in her income, and no part of such amount is includible in the husband's income or deductible by him. See section 72(k) and the regulations thereunder. Likewise, if property is transferred by the husband, subject to an annual charge of $5,000, payable to his wife in discharge of his alimony or separate maintenance obligation under the divorce or separation decree or written instrument incident to the divorce status or legal separation status or if such property is transferred pursuant to a written separation agreement and subject to a similar annual charge, the $5,000 received annually is, under section 71(a) (1) or (2), includible in the wife's income, regardless of whether such amount is paid out of income or principal of the property.

(3) The same rule applies to periodic payments attributable to property in trust. The full amount of periodic payments to which section 71(a) (1) and (2) applies is includible in the wife's income regardless of whether such payments are made out of trust income. Such periodic payments are to be included in the wife's income under section 71(a) (1) or (2) and are to be excluded from the husband's income even though the income of the trust would otherwise be includible in his income under Subpart E, Part I, Subchapter J, Chapter 1 of the Code, relating to trust income attributable to grantors and others as substantial owners. As to periodic payments received by a wife attributable to property in trust in cases to which section 71(a) (1) or (2) does not apply because the husband's obligation is not specified in the decree or an instrument incident to the divorce status or legal separation status or the property was not transferred under a written separation agreement,

see section 682 and the regulations thereunder.

(4) Section 71(a) (1) or (2) does not apply to that part of any periodic payment attributable to that portion of any interest in property transferred in discharge of the husband's obligation under the decree or instrument incident to the divorce status or legal separation status, or transferred pursuant to the written separation agreement, which interest originally belonged to the wife. It will apply, however, if she received such interest from her husband in contemplation of or as an incident to the divorce or separation without adequate and full consideration in money or money's worth, other than the release of the husband or his property from marital obligations. An example of the first rule is a case where the husband and wife transfer securities, which were owned by them jointly, in trust to pay an annuity to the wife. In this case, the full amount of that part of the annuity received by the wife attributable to the husband's interest in the securities transferred in discharge of his obligation under the decree, or instrument incident to the divorce status or legal separation status, or transferred under the written separation agreement, is taxable to her under section 71(a) (1) or (2), while that portion of the annuity attributable to the wife's interest in the securities so transferred is taxable to her only to the extent it is out of trust income as provided in Part I (sections 641 and following), Subchapter J, Chapter 1 of the Code. If, however, the husband's transfer to his wife is made before such property is transferred in discharge of his obligation under the decree or written instrument, or pursuant to the separation agreement in an attempt to avoid the application of section 71(a) (1) or (2) to part of such payments received by his wife, such transfers will be considered as a part of the same transfer by the husband of his property in discharge of his obligation or pursuant to such agreement. In such a case, section 71(a) (1) or (2) will be applied to the full amount received by the wife. As to periodic payments received under a joint purchase of a commercial annuity contract, see section 72 and the regulations thereunder.

(d) *Periodic and installment payments.* (1) In general, installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree, instrument, or agreement are not considered ''periodic payments'' and therefore are not to be included under section 71(a) in the wife's income.

(2) An exception to the general rule stated in subparagraph (1) of this paragraph is provided, however, in cases where such principal sum, by the terms of the decree, instrument, or agreement, may be or is to be paid over a period ending more than 10 years from the date of such decree, instrument, or agreement. In such cases, the installment payment is considered a periodic payment for the purposes of section 71(a) but only to the extent that the installment payment, or sum of the installment payments, received during the wife's taxable year does not exceed 10 percent of the principal sum. This 10-percent limitation applies to installment payments made in advance but does not apply to delinquent installment payments for a prior taxable year of the wife made during her taxable year.

(3)(i) Where payments under a decree, instrument, or agreement are to be paid over a period ending 10 years or less from the date of such decree, instrument, or agreement, such payments are not installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree, instrument, or agreement (and are considered periodic payments for the purposes of section 71(a)) only if such payments meet the following two conditions:

(a) Such payments are subject to any one or more of the contingencies of death of either spouse, remarriage of the wife, or change in the economic status of either spouse, and

(b) Such payments are in the nature of alimony or an allowance for support.

(ii) Payments meeting the requirements of subdivision (i) are considered periodic payments for the purposes of section 71(a) regardless of whether—

(a) The contingencies described in subdivision (i)*(a)* of this subparagraph are set forth in the terms of the decree,

instrument, or agreement, or are imposed by local law, or

(b) The aggregate amount of the payments to be made in the absence of the occurrence of the contingencies described in subdivision (i)*(a)* of this subparagraph is explicitly stated in the decree, instrument, or agreement or may be calculated from the face of the decree, instrument, or agreement, or

(c) The total amount which will be paid may be calculated actuarially.

(4) Where payments under a decree, instrument, or agreement are to be paid over a period ending more than ten years from the date of such decree, instrument, or agreement, but where such payments meet the conditions set forth in subparagraph (3)(i) of this paragraph, such payments are considered to be periodic payments for the purpose of section 71 without regard to the rule set forth in subparagraph (2) of this paragraph. Accordingly, the rules set forth in subparagraph (2) of this paragraph are not applicable to such payments.

(5) The rules as to periodic and installment payments are illustrated by the following examples:

Example (1). Under the terms of a written instrument, H is required to make payments to W which are in the nature of alimony, in the amount of $100 a month for nine years. The instrument provides that if H or W dies the payments are to cease. The payments are periodic.

Example (2). The facts are the same as in example (1) except that the written instrument explicitly provides that H is to pay W the sum of $10,800 in monthly payments of $100 over a period of nine years. The payments are periodic.

Example (3). Under the terms of a written instrument, H is to pay W $100 a month over a period of nine years. The monthly payments are not subject to any of the contingencies of death of H or W, remarriage of W, or change in the economic status of H or W under the terms of the written instrument or by reason of local law. The payments are not periodic.

Example (4). A divorce decree in 1954 provides that H is to pay W $20,000 each year for the next five years, beginning with the date of the decree, and then $5,000 each year for the next ten years. Assuming the wife makes her returns on the calendar year basis, each payment received in the years 1954 to 1958, inclusive, is treated as a periodic payment under section 71(a)(1), but only to the extent of 10 percent of the principal sum of $150,000. Thus, for such taxable years, only $15,000 of the $20,000 received is includible under section 71(a)(1) in the wife's income and is deductible by the husband under section 215. For the years 1959 to 1968, inclusive, the full $5,000 received each year by the wife is includible in her income and is deductible from the husband's income.

(e) *Payments for support of minor children.* Section 71(a) does not apply to that part of any periodic payment which, by the terms of the decree, instrument, or agreement under section 71(a), is specifically designated as a sum payable for the support of minor children of the husband. The statute prescribes the treatment in cases where an amount or portion is so fixed but the amount of any periodic payment is less than the amount of the periodic payment specified to be made. In such cases, to the extent of the amount which would be payable for the support of such children out of the originally specified periodic payment, such periodic payment is considered a payment for such support. For example, if the husband is by terms of the decree, instrument, or agreement required to pay $200 a month to his divorced wife, $100 of which is designated by the decree, instrument, or agreement to be for the support of their minor children, and the husband pays only $150 to his wife, $100 is nevertheless considered to be a payment by the husband for the support of the children. If, however, the periodic payments are received by the wife for the support and maintenance of herself and of minor children of the husband without such specific designation of the portion for the support of such children, then the whole of such amounts is includible in the income of the wife as provided in section 71(a). Except in cases of a designated amount or portion for the support of the husband's minor children, periodic payments described in section 71(a) received by the wife for herself and any other person or persons are includible in whole in the wife's income, whether or not the amount or portion for such other person or persons is designated.

§1.71–1T Alimony and separate maintenance payments (temporary).

(a) *In general.*

Q–1 What is the income tax treatment of alimony or separate maintenance payments?

A–1 Alimony or separate maintenance payments are, under section 71, included in the gross income of the payee spouse and, under section 215, allowed as a deduction from the gross income of the payor spouse.

Q–2 What is an alimony or separate maintenance payment?

A–2 An alimony or separate maintenance payment is any payment received by or on behalf of a spouse (which for this purpose includes a former spouse) of the payor under a divorce or separation instrument that meets all of the following requirements:

(a) The payment is in cash (see A–5).

(b) The payment is not designated as a payment which is excludible from the gross income of the payee and nondeductible by the payor (see A–8).

(c) In the case of spouses legally separated under a decree of divorce or separate maintenance, the spouses are not members of the same household at the time the payment is made (see A–9).

(d) The payor has no liability to continue to make any payment after the death of the payee (or to make any payment as a substitute for such payment) and the divorce or separation instrument states that there is no such liability (see A–10).

(e) The payment is not treated as child support (see A–15).

(f) To the extent that one or more annual payments exceed $10,000 during any of the 6-post-separation years, the payor is obligated to make annual payments in each of the 6-post-separation years (see A–19).

Q–3 In order to be treated as alimony or separate maintenance payments, must the payments be ‘‘periodic’’ as that term was defined prior to enactment of the Tax Reform Act of 1984 or be made in discharge of a legal obligation of the payor to support the payee arising out of a marital or family relationship?

A–3 No. The Tax Reform Act of 1984 replaces the old requirements with the requirements described in A–2 above. Thus, the requirements that alimony or separate maintenance payments be ‘‘periodic’’ and be made in discharge of a legal obligation to support arising out of a marital or family relationship have been eliminated.

Q–4 Are the instruments described in section 71(a) of prior law the same as divorce or separation instruments described in section 71, as amended by the Tax Reform Act of 1984?

A–4 Yes.

(b) *Specific requirements.*

Q–5 May alimony or separate maintenance payments be made in a form other than cash?

A–5 No. Only cash payments (including checks and money orders payable on demand) qualify as alimony or separate maintenance payments. Transfers of services or property (including a debt instrument of a third party or an annuity contract), execution of a debt instrument by the payor, or the use of property of the payor do not qualify as alimony or separate maintenance payments.

Q–6 May payments of cash to a third party on behalf of a spouse qualify as alimony or separate maintenance payments if the payments are pursuant to the terms of a divorce or separation instrument?

A–6 Yes. Assuming all other requirements are satisfied, a payment of cash by the payor spouse to a third party under the terms of the divorce or separation instrument will qualify as a payment of cash which is received ‘‘on behalf of a spouse’’. For example, cash payments of rent, mortgage, tax, or tuition liabilities of the payee spouse made under the terms of the divorce or separation instrument will qualify as alimony or separate maintenance payments. Any payments to maintain property owned by the payor spouse and used by the payee spouse (including mortgage payments, real estate taxes and insurance premiums) are not payments on behalf of a spouse even if those payments are made pursuant to the terms of the divorce or separation instrument. Premiums paid by the payor spouse for term or whole life insurance on the payor’s life made under the terms of the divorce or separation instrument will qualify as payments on behalf of the payee spouse to the extent that the payee spouse is the owner of the policy.

Q–7 May payments of cash to a third party on behalf of a spouse qualify as alimony or separate maintenance payments if the payments are made to the third party at the written request of the payee spouse?

A–7 Yes. For example, instead of making an alimony or separate maintenance payment directly to the payee, the payor spouse may make a cash payment to a charitable organization if such payment is pursuant to the written request, consent or ratification of the payee spouse. Such request, consent or ratification must state that the parties intend the payment to be treated as an alimony or separate maintenance payment to the payee spouse subject to the rules of section 71, and must be received by the payor spouse prior to the date of filing of the payor's first return of tax for the taxable year in which the payment was made.

Q–8 How may spouses designate that payments otherwise qualifying as alimony or separate maintenance payments shall be excludible from the gross income of the payee and nondeductible by the payor?

A–8 The spouses may designate that payments otherwise qualifying as alimony or separate maintenance payments shall be nondeductible by the payor and excludible from gross income by the payee by so providing in a divorce or separation instrument (as defined in section 71(b)(2)). If the spouses have executed a written separation agreement (as described in section 71(b)(2)(B)), any writing signed by both spouses which designates otherwise qualifying alimony or separate maintenance payments as nondeductible and excludible and which refers to the written separation agreement will be treated as a written separation agreement (and thus a divorce or separation instrument) for purposes of the preceding sentence. If the spouses are subject to temporary support orders (as described in section 71(b)(2)(C)), the designation of otherwise qualifying alimony or separate payments as nondeductible and excludible must be made in the original or a subsequent temporary support order. A copy of the instrument containing the designation of payments as not alimony or separate maintenance payments must be attached to the payee's first filed return of tax (Form 1040) for each year in which the designation applies.

Q–9 What are the consequences if, at the time a payment is made, the payor and payee spouses are members of the same household?

A–9 Generally, a payment made at the time when the payor and payee spouses are members of the same household cannot qualify as an alimony or separate maintenance payment if the spouses are legally separated under a decree of divorce or of separate maintenance. For purposes of the preceding sentence, a dwelling unit formerly shared by both spouses shall not be considered two separate households even if the spouses physically separate themselves within the dwelling unit. The spouses will not be treated as members of the same household if one spouse is preparing to depart from the household of the other spouse, and does depart not more than one month after the date the payment is made. If the spouses are not legally separated under a decree of divorce or separate maintenance, a payment under a written separation agreement or a decree described in section 71(b)(2)(C) may qualify as an alimony or separate maintenance payment notwithstanding that the payor and payee are members of the same household at the time the payment is made.

Q–10 Assuming all other requirements relating to the qualification of certain payments as alimony or separate maintenance payments are met, what are the consequences if the payor spouse is required to continue to make the payments after the death of the payee spouse?

A–10 None of the payments before (or after) the death of the payee spouse qualify as alimony or separate maintenance payments.

Q–11 What are the consequences if the divorce or separation instrument fails to state that there is no liability for any period after the death of the payee spouse to continue to make any payments which would otherwise qualify as alimony or separate maintenance payments?

A–11 If the instrument fails to include such a statement, none of the payments, whether made before or after the death of the payee spouse, will qualify as alimony or separate maintenance payments.

Example (1). A is to pay B $10,000 in cash each year for a period of 10 years under a divorce or separation instrument which does not state that the payments will terminate upon the death of B. None of the payments will qualify as alimony or separate maintenance payments.

Example (2). A is to pay B $10,000 in cash each year for a period of 10 years under a divorce or separation instrument which states that the payments will terminate upon the death of B. In addition, under the instrument, A is to pay B or B's estate $20,000 in cash each year for a period of 10 years. Because the $20,000 annual payments will not terminate upon the death of B, these payments will not qualify as alimony or separate maintenance payments. However, the separate $10,000 annual payments will qualify as alimony or separate maintenance payments.

Q–12 Will a divorce or separation instrument be treated as stating that there is no liability to make payments after the death of the payee spouse if the liability to make such payments terminates pursuant to applicable local law or oral agreement?

A–12 No. Termination of the liability to make payments must be stated in the terms of the divorce or separation instrument.

Q–13 What are the consequences if the payor spouse is required to make one or more payments (in cash or property) after the death of the payee spouse as a substitute for the continuation of pre-death payments which would otherwise qualify as alimony or separate maintenance payments?

A–13 If the payor spouse is required to make any such substitute payments, none of the otherwise qualifying payments will qualify as alimony or separate maintenance payments. The divorce or separation instrument need not state, however, that there is no liability to make any such substitute payment.

Q–14 Under what circumstances will one or more payments (in cash or property) which are to occur after the death of the payee spouse be treated as a substitute for the continuation of payments which would otherwise qualify as alimony or separate maintenance payments?

A–14 To the extent that one or more payments are to begin to be made, increase in amount, or become accelerated in time as a result of the death of the payee spouse, such payments may be treated as a substitute for the continuation of payments terminating on the death of the payee spouse which would otherwise qualify as alimony or separate maintenance payments. The determination of whether or not such payments are a substitute for the continuation of payments which would otherwise qualify as alimony or separate maintenance payments, and of the amount of the otherwise qualifying alimony or separate maintenance payments for which any such payments are a substitute, will depend on all of the facts and circumstances.

Example (1). Under the terms of a divorce decree, A is obligated to make annual alimony payments to B of $30,000, terminating on the earlier of the expiration of 6 years or the death of B. B maintains custody of the minor children of A and B. The decree provides that at the death of B, if there are minor children of A and B remaining, A will be obligated to make annual payments of $10,000 to a trust, the income and corpus of which are to be used for the benefit of the children until the youngest child attains the age of majority. These facts indicate that A's liability to make annual $10,000 payments in trust for the benefit of his minor children upon the death of B is a substitute for $10,000 of the $30,000 annual payments to B. Accordingly, $10,000 of each of the $30,000 annual payments to B will not qualify as alimony or separate maintenance payments.

Example (2). Under the terms of a divorce decree, A is obligated to make annual alimony payments to B of $30,000, terminating on the earlier of the expiration of 15 years or the death of B. The divorce decree provides that if B dies before the expiration of the 15 year period, A will pay to B's estate the difference between the total amount that A would have paid had B survived, minus the amount actually paid. For example, if B dies at the end of the 10th year in which payments are made, A will pay to B's estate $150,000 ($450,000–$300,000). These facts indicate that A's liability to make a lump sum payment to B's estate upon the death of B is a substitute for the full amount of each of the annual $30,000 payments to B. Accordingly, none of the annual $30,000 payments to B will qualify as alimony or separate maintenance payments. The result would be the same if the lump sum payable at B's death were discounted by an appropriate interest factor to account for the prepayment.

(c) *Child support payments.*

Q–15 What are the consequences of a payment which the terms of the divorce or separation instrument fix as payable for the support of a child of the payor spouse?

A–15 A payment which under the terms of the divorce or separation instrument is fixed (or treated as fixed) as payable for the support of a child of the payor spouse does not qualify as an alimony or separate maintenance payment. Thus, such a payment is not deductible by the payor spouse or includible in the income of the payee spouse.

Q–16 When is a payment fixed (or treated as fixed) as payable for the support of a child of the payor spouse?

A–16 A payment is fixed as payable for the support of a child of the payor spouse if the divorce or separation instrument specifically designates some sum or portion (which sum or portion may fluctuate) as payable for the support of a child of the payor spouse. A payment will be treated as fixed as payable for the support of a child of the payor spouse if the payment is reduced (a) on the happening of a contingency relating to a child of the payor, or (b) at a time which can clearly be associated with such a contingency. A payment may be treated as fixed as payable for the support of a child of the payor spouse even if other separate payments specifically are designated as payable for the support of a child of the payor spouse.

Q–17 When does a contingency relate to a child of the payor?

A–17 For this purpose, a contingency relates to a child of the payor if it depends on any event relating to that child, regardless of whether such event is certain or likely to occur. Events that relate to a child of the payor include the following: the child's attaining a specified age or income level, dying, marrying, leaving school, leaving the spouse's household, or gaining employment.

Q–18 When will a payment be treated as to be reduced at a time which can clearly be associated with the happening of a contingency relating to a child of the payor?

A–18 There are two situations, described below, in which payments which would otherwise qualify as alimony or separate maintenance payments will be presumed to be reduced at a time clearly associated with the happening of a contingency relating to a child of the payor. In all other situations, reductions in payments will not be treated as clearly associated with the happening of a contingency relating to a child of the payor.

The first situation referred to above is where the payments are to be reduced not more than 6 months before or after the date the child is to attain the age of 18, 21, or local age of majority. The second situation is where the payments are to be reduced on two or more occasions which occur not more than one year before or after a different child of the payor spouse attains a certain age between the ages of 18 and 24, inclusive. The certain age referred to in the preceding sentence must be the same for each such child, but need not be a whole number of years.

The presumption in the two situations described above that payments are to be reduced at a time clearly associated with the happening of a contingency relating to a child of the payor may be rebutted (either by the Service or by taxpayers) by showing that the time at which the payments are to be reduced was determined independently of any contingencies relating to the children of the payor. The presumption in the first situation will be rebutted conclusively if the reduction is a complete cessation of alimony or separate maintenance payments during the sixth post-separation year (described in A–21) or upon the expiration of a 72-month period. The presumption may also be rebutted in other circumstances, for example, by showing that alimony payments are to be made for a period customarily provided in the local jurisdiction, such as a period equal to one-half the duration of the marriage.

Example: A and B are divorced on July 1, 1985, when their children, C (born July 15, 1970) and D (born September 23, 1972), are 14 and 12, respectively. Under the divorce decree, A is to make alimony payments to B of $2,000 per month. Such payments are to be reduced to $1,500 per month on January 1, 1991 and to $1,000 per month on January 1, 1995. On January 1, 1991, the date of the first reduction in payments, C will be 20 years 5 months and 17 days old. On January 1, 1995, the date of the second reduction in payments, D will be 22 years 3 months and 9 days old. Each of the reductions in payments is to occur not more than one year before or after a different child of A attains the age of 21 years and 4 months. (Actually, the reductions are to occur not more than one year before or after C and D attain *any* of the ages 21 years 3 months and 9 days through 21 years 5 months and 17 days.) Accordingly, the reductions will be presumed to clearly be associated with the happening of a contingency relating to C and D. Unless this presumption is rebutted, payments under the divorce decree equal to the sum of the reduction ($1,000 per month) will be treated as fixed for the support of the children of A and therefore will not qualify as alimony or separate maintenance payments.

(d) *Excess front-loading rules.*

Q–19 What are the excess front-loading rules?

A–19 The excess front-loading rules are two special rules which may apply to the extent that payments in any calendar year exceed $10,000. The first rule is a minimum term rule, which must be met in order for any annual payment, to the extent in excess of $10,000, to qualify as an alimony or separate maintenance payment (see A–2(f)). This rule requires that alimony or separate maintenance payments be called for, at a minimum, during the 6 ‘‘post-separation years’’. The second rule is a recapture rule which characterizes payments retrospectively by requiring a recalculation and inclusion in income by the payor and deducation by the payee of previously paid alimony or separate maintenance payment to the extent that the amount of such payments during any of the 6 ‘‘post-separation years’’ falls short of the amount of payments during a prior year by more than $10,000.

Q–20 Do the excess front-loading rules apply to payments to the extent that annual payments never exceed $10,000?

A–20 No. For example, A is to make a single $10,000 payment to B. Provided that the other requirements of section 71 are met, the payment will qualify as an alimony or separate maintenance payment. If A were to make a single $15,000 payment to B, $10,000 of the payment would qualify as an alimony or separate maintenance payment and $5,000 of the payment would be disqualified under the minimum term rule because payments were not to be made for the minimum period.

Q–21 Do the excess front-loading rules apply to payments received under a decree described in section 71(b)(2)(C)?

A–21 No. Payments under decrees described in section 71(b)(2)(C) are to be disregarded entirely for purposes of applying the excess front-loading rules.

Q–22 Both the minimum term rule and the recapture rule refer to 6 ‘‘post-separation years’’. What are the 6 ‘‘post separation years’’?

A–22 The 6 ‘‘post-separation years’’ are the 6 consecutive calendar years beginning with the first calendar year in which the payor pays to the payee an alimony or separate maintenance payment (except a payment made under a decree described in section 71(b)(2)(C)). Each year within this period is referred to as a ‘‘post-separation year’’. The 6-year period need not commence with the year in which the spouses separate or divorce, or with the year in which payments under the divorce or separation instrument are made, if no payments during such year qualify as alimony or separate maintenance payments. For example, a decree for the divorce of A and B is entered in October, 1985. The decree requires A to make monthly payments to B commencing November 1, 1985, but A and B are members of the same household until February 15, 1986 (and as a result, the payments prior to January 16, 1986, do not qualify as alimony payments). For purposes of applying the excess front-loading rules to payments from A to B, the 6 calendar years 1986 through 1991 are post-separation years. If a spouse has been making payments pursuant to a divorce or separation instrument described in section 71(b)(2) (A) or (B), a modification of the instrument or the substitution of a new instrument (for example, the substitution of a divorce decree for a written separation agreement) will not result in the creation of additional post-separation years. However, if a spouse has been making payments pursuant to a divorce or separation instrument described in section 71(b)(2)(C), the 6-year period does not begin until the first calendar year in which alimony or separate maintenance payments are made under a divorce or separation instrument described in section 71(b)(2) (A) or (B).

Q–23 How does the minimum term rule operate?

A–23 The minimum term rule operates in the following manner. To the extent payments are made in excess of $10,000, a payment will qualify as an alimony or separate maintenance payment only if alimony or separate maintenance payments are to be made in each of the 6 post-separation years. For example, pursuant to a divorce decree, A is to make alimony payments to B of $20,000 in each of the 5 calendar years 1985 through 1989. A is to make no payment in 1990. Under the minimum term rule, only $10,000 will qualify as an alimony payment in each of the calendar years 1985 through 1989. If the divorce decree also required A to make a $1 payment in 1990, the minimum term rule would be satisfied and $20,000 would be treated as an alimony payment in each of the calendar years 1985 through 1989. The recapture rule would, however, apply for 1990. For purposes of determining whether alimony or separate maintenance payments are to be made in any year, the possible termination of such payments upon the happening of a contingency (other than the passage of time) which has not yet occurred is ignored (unless such contingency may cause all or a portion of the payment to be treated as a child support payment).

Q–24 How does the recapture rule operate?

A–24 The recapture rule operates in the following manner. If the amount of alimony or separate maintenance payments paid in any post-separation year (referred to as the ‘‘computation year’’) falls short of the amount of alimony or separate maintenance payments paid in any prior post-separation year by more than $10,000, the payor must compute an ‘‘excess amount’’ for the computation year. The excess amount for any computation year is the sum of excess amounts determined with respect to each prior post-separation year. The excess amount determined with respect to a prior post-separation year is the excess of (1) the amount of alimony or separate maintenance payments paid by the payor spouse during such prior post-separation year, over (2) the amount of the alimony or separate maintenance payments paid by the payor spouse during the computation year plus $10,000. For purposes of this calculation, the amount of alimony or separate maintenance payments made by the payor spouse during any post-separation year preceding the computation year is reduced by any excess amount previously determined with respect to such year. The rules set forth above may be illustrated by the following example. A makes alimony payments to B of $25,000 in 1985 and $12,000 in 1986. The excess amount with respect to 1985 that is recaptured in 1986 is $3,000 ($25,000−($12,000+$10,000)). For purposes of subsequent computation years, the amount deemed paid in 1985 is $22,000. If A makes alimony payments to B of $1,000 in 1987, the excess amount that is recaptured in 1987 will be $12,000. This is the sum of an $11,000 excess amount with respect to 1985 ($22,000−$1,000+$10,000)) and a $1,000 excess amount with respect to 1986 ($12,000−($1,000+$10,000)). If, prior to the end of 1990, payments decline further, additional recapture will occur. The payor spouse must include the excess amount in gross income for his/her taxable year begining with or in the computation year. The payee spouse is allowed a deduction for the excess amount in computing adjusted gross income for his/her taxable year beginning with or in the computation year. However, the payee spouse must compute the excess amount by reference to the date when payments were made and not when payments were received.

Q–25 What are the exceptions to the recapture rule?

A–25 Apart from the $10,000 threshold for application of the recapture rule, there are three exceptions to the recapture rule. The first exception is for payments received under temporary support orders described in section 71(b)(2)(C) (see A–21). The second exception is for any payment made pursuant to a continuing liability over the period of the post-separation years to pay a fixed portion of the payor’s income from a business or property or from compensation for employment or self-employment. The third exception is where the alimony or separate manitenance payments in any post-separation year cease by reason of the death of the payor or payee or the remarriage (as defined under applicable local law) of the payee before the close of the computation year. For example, pursuant to a divorce decree, A is to make cash payments to B of $30,000 in each of the calendar years 1985 through 1990. A makes cash payments of $30,000 in 1985 and $15,000 in 1986, in which year B remarries and A's alimony payments cease. The recapture rule does not apply for 1986 or any subsequent year. If alimony or separate maintenance payments made by A decline or cease during a post-separation year for any other reason (including a failure by the payor to make timely payments, a modification of the divorce or separation instrument, a reduction in the support needs of the payee, or a reduction in the ability of the payor to provide support) excess amounts with respect to prior post-separation years will be subject to recapture.

(e) *Effective dates.*

Q–26 When does section 71, as amended by the Tax Reform Act of 1984, become effective?

A–26 Generally, section 71, as amended, is effective with respect to divorce or separation instruments (as defined in section 71(b)(2)) executed after December 31, 1984. If a decree of divorce or separate maintenance executed after December 31, 1984, incorporates or adopts without change the terms of the alimony or separate maintenance payments under a divorce or separation instrument executed before January 1, 1985, such decree will be treated as executed before January 1, 1985. A change in the amount of alimony or separate maintenance payments or the time period over which such payments are to continue, or the addition or deletion of any contingencies or conditions relating to such payments is a change in the terms of the alimony or separate maintenance payments. For example, in November 1984, A and B executed a written separation agreement. In February 1985, a decree of divorce is entered in substitution for the written separation agreement. The decree of divorce does not change the terms of the alimony A pays to B. The decree of divorce will be treated as executed before January 1, 1985 and hence alimony payments under the decree will be subject to the rules of section 71 prior to amendment by the Tax Reform Act of 1984. If the amount or time period of the alimony or separate maintenance payments are not specified in the pre-1985 separation agreement or if the decree of divorce changes the amount or term of such payments, the decree of divorce will not be treated as executed before January 1, 1985, and alimony payments under the decree will be subject to the rules of section 71, as amended by the Tax Reform Act of 1984.

Section 71, as amended, also applies to any divorce or separation instrument executed (or treated as executed) before January 1, 1985 that has been modified on or after January 1, 1985, if such modification expressly provides that section 71, as amended by the Tax Reform Act of 1984, shall apply to the instrument as modified. In this case, section 71, as amended, is effective with respect to payments made after the date the instrument is modified.

(Secs. 1041(d)(4) (98 Stat. 798, 26 U.S.C. 1041(d)(4), 152(e)(2)(A) (98 Stat. 802, 26 U.S.C. 152(e)(2)(A), 215(c) (98 Stat. 800, 26 U.S.C. 215(c)) and 7805 (68A Stat. 917, 26 U.S.C. 7805) of the Internal Revenue Code of 1954.

[T.D. 7973, 49 FR 34455, Aug. 31, 1984; 49 FR 36645, Sept. 19, 1984]

§ 1.71–2 Effective date; taxable years ending after March 31, 1954, subject to the Internal Revenue Code of 1939.

Pursuant to section 7851(a)(1)(C), the regulations prescribed in § 1.71–1, to the extent that they relate to payments under a written separation agreement executed after August 16, 1954, and to the extent that they relate to payments under a decree for support received after August 16, 1954, under a decree entered after March 1, 1954, shall also apply to taxable years beginning before January 1, 1954, and ending after August 16, 1954, although such years are subject to the Internal Revenue Code of 1939.

§1.72–1 Introduction.

(a) *General principle.* Section 72 prescribes rules relating to the inclusion in gross income of amounts received under a life insurance, endowment, or annuity contract unless such amounts are specifically excluded from gross income under other provisions of Chapter 1 of the Code. In general, these rules provide that amounts subject to the provisions of section 72 are includible in the gross income of the recipient except to the extent that they are considered to represent a reduction or return of premiums or other consideration paid.

(b) *Amounts to be considered as a return of premiums.* For the purpose of determining the extent to which amounts received represent a reduction or return of premiums or other consideration paid, the provisions of section 72 distinguish between ‘‘amounts received as an annuity’’ and ‘‘amounts not received as an annuity’’. In general, ‘‘amounts received as an annuity’’ are amounts which are payable at regular intervals over a period of more than one full year from the date on which they are deemed to begin, provided the total of the amounts so payable or the period for which they are to be paid can be determined as of that date. See paragraph (b) (2) and (3) of §1.72–2. Any other amounts to which the provisions of section 72 apply are considered to be ‘‘amounts not received as an annuity’’. See §1.72–11.

(c) *‘‘Amounts received as an annuity.’’* (1) In the case of ‘‘amounts received as an annuity’’ (other than certain employees’ annuities described in section 72(d) and in §1.72–13), a proportionate part of each amount so received is considered to represent a return of premiums or other consideration paid. The proportionate part of each annuity payment which is thus excludable from gross income is determined by the ratio which the investment in the contract as of the date on which the annuity is deemed to begin bears to the expected return under the contract as of that date. See §1.72–4.

(2) In the case of employees’ annuities of the type described in section 72(d), no amount received as an annuity in a taxable year to which the Internal Revenue Code of 1954 applies is includible in the gross income of a recipient until the aggregate of all amounts received thereunder and excluded from gross income under the applicable income tax law exceeds the consideration contributed (or deemed contributed) by the employee under §1.72–8. Thereafter, all amounts so received are includible in the gross income of the recipient. See §1.72–13.

(d) *‘‘Amounts not received as an annuity’’.* In the case of ‘‘amounts not received as an annuity’’, if such amounts are received after an annuity has begun and during its continuance, amounts so received are generally includible in the gross income of the recipient. Amounts not received as an annuity which are received at any other time are generally includible in the gross income of the recipient only to the extent that such amounts, when added to all amounts previously received under the contract which were excludable from the gross income of the recipient under the income tax law applicable at the time of receipt, exceed the premiums or other consideration paid (see §1.72–11). However, if the aggregate of premiums or other consideration paid for the contract includes amounts for which a deduction was allowed under section 404 as contributions on behalf of an owner-employee, the amounts received under the circumstances of the preceding sentence shall be includible in gross income until the amount so included equals the amount for which the deduction was so allowed. See paragraph (b) of §1.72–17.

(e) *Classification of recipients.* For the purpose of the regulations under section 72, a recipient shall be considered an ‘‘annuitant’’ if he receives amounts under an annuity contract during the period that the annuity payments are to continue, whether for a term certain or during the continuing life or lives of the person or persons whose lives measure the duration of such annuity. However, a recipient shall be considered a ‘‘beneficiary’’ rather than an ‘‘annuitant’’ if the amounts he receives under a contract are received after the term of the annuity for a life or lives has expired and such amounts are paid by reason of the fact that the contract guarantees that payments of some minimum amount or for some minimum period shall be made. For special rules with respect to beneficiaries, see paragraphs (a)(1)(iii) and (c) of § 1.72–11.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10134, Sept. 17, 1963]

§ 1.72–2 Applicability of section.

(a) *Contracts.* (1) The contracts under which amounts paid will be subject to the provisions of section 72 include contracts which are considered to be life insurance, endowment, and annuity contracts in accordance with the customary practice of life insurance companies. For the purposes of section 72, however, it is immaterial whether such contracts are entered into with an insurance company. The term ''endowment contract'' also includes the ''face-amount certificates'' described in section 72(1).

(2) If two or more annuity obligations or elements to which section 72 applies are acquired for a single consideration, such as an obligation to pay an annuity to A for his life accompanied by an obligation to pay an annuity to B for his life, there being a single consideration paid for both obligations (whether paid by one or more persons in equal or different amounts, and whether paid in a single sum or otherwise), such annuity elements shall be considered to comprise a single contract for the purpose of the application of section 72 and the regulations thereunder. For rules relating to the allocation of investment in the contract in the case of annuity elements payable to two or more persons, see paragraph (b) of § 1.72–6.

(3)(i) Sections 402 and 403 provide that certain distributions by employees' trusts and certain payments under employee plans are taxable under section 72. For taxable years beginning before January 1, 1964, section 72(e)(3), as in effect before such date, does not apply to such distributions or payments. For purposes of applying section 72 to such distributions and payments (other than those described in subdivision (iii) of this subparagraph), each separate program of the employer consisting of interrelated contributions and benefits shall be considered a single contract. Therefore, all distributions or payments (other than those described in subdivision (iii) of this subparagraph) which are attributable to a separate program of interrelated contributions and benefits are considered as received under a single contract. A separate program of interrelated contributions and benefits may be financed by the purchase from an insurance company of one or more group contracts or one or more individual contracts, or may be financed partly by the purchase of contracts from an insurance company and partly through an investment fund, or may be financed completely through an investment fund. A program may be considered separate for purposes of section 72 although it is only a part of a plan which qualifies under section 401. There may be several trusts under one separate program, or several separate programs may make use of a single trust. See, however, subdivision (iii) of this subparagraph for rules relating to what constitutes a ''contract'' for purposes of applying section 72 to distributions commencing before October 20, 1960.

(ii) The following types of benefits, and the contributions used to provide them, are examples of separate programs of interrelated contributions and benefits:

(a) Definitely determinable retirement benefits.

(b) Definitely determinable benefits payable prior to retirement in case of disability.

(c) Life insurance.

(d) Accident and health insurance.

However, retirement benefits and life insurance will be considered part of a single separate program of interrelated contributions and benefits to the extent they are provided under retirement income, endowment, or other contracts providing life insurance protection. See examples (6), (7), and (8) contained in subdivision (iv) of this subparagraph for illustrations of the principles of this subdivision. See, also, § 1.72–15 for rules relating to the taxation of amounts received under an employee plan which provides both retirement benefits and accident and health benefits.

(iii) If any amount which is taxable under section 72 by reason of section 402 or 403 is actually distributed or made available to any person under an employees' trust or plan (other than the Civil Service Retirement Act, 5 U.S.C. ch. 14) before October 20, 1960, section 72 shall, notwithstanding any other provisions in this subparagraph, be applied to all the distributions with respect to such person (or his beneficiaries) under such trust or plan (whether received before or after October 20, 1960) as though such distributions were provided under a single contract. For purposes of applying section 72 to distributions to which this subdivision applies, therefore, the term ''contract'' shall be considered to include the entire interest of an employee in each trust or plan described in sections 402 and 403 to the extent that distributions thereunder are subject to the provisions of section 72. Section 72 shall be applied to distributions received under the Civil Service Retirement Act in the manner prescribed in subdivision (i) of this subparagraph (see example (4) in subdivision (iv) of this subparagraph).

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

Example (1). On January 1, 1961, X Corporation established a noncontributory profit-sharing plan for its employees providing that the amount standing to the account of each participant will be paid to him at the time of his retirement and also established a contributory pension plan for its employees providing for the payment to each participant of a lifetime pension after retirement. The profit-sharing plan is designed to enable the employees to participate in the profits of X Corporation; the amount of the contributions to it are determined by reference to the profits of X Corporation; and the amount of any distribution is determined by reference to the amount of contributions made on behalf of any participant and the earnings thereon. On the other hand, the pension plan is designed to provide a lifetime pension for a retired employee; the amount of the pension is to be determined by a formula set forth in the plan; and the amount of contributions to the plan is the amount necessary to provide such pensions. In view of the fact that each of these plans constitutes a separate program of interrelated contributions and benefits, the distributions from each shall be treated as received under a separate contract. If these plans had been established before October 20, 1960, then, in the case of an employee who receives a distribution under the plans before October 20, 1960, the determination as to whether that distribution and all subsequent distributions to such employee are received under a single contract or under more than one contract shall be made by applying the rules in subdivision (iii) of this subparagraph. On the other hand, in the case of an employee who does not receive any distribution under these plans before October 20, 1960, the determination as to whether distributions to him are received under a single contract or under more than one contract shall be made in accordance with the rules illustrated by this example.

Example (2). On January 1, 1961, Z Corporation established a profit-sharing plan for its employees providing that any employee may make contributions, not in excess of 6 percent of his compensation, to a trust and that the employer would make matching contributions out of profits. Under the plan, a participant may receive a periodic distribution of the amount standing in his account during any period that he is absent from work due to a personal injury or sickness. On separation from service, the participant is entitled to receive a distribution of the balance standing in his account in accordance with one of several options. One option provides for the immediate distribution of one-half of the account and for the periodic distribution of the remaining one-half of the account. In addition, any participant may, after the completion of five years of participation, withdraw any part of his account, but in the case of such a withdrawal, the participant forfeits his rights to participate in the plan for a period of two years. Thus, a participant may receive distributions before separation from service; he may receive a distribution of a lump sum upon separation from service; he may also receive periodic distributions upon separation from service. However, since it is the total amount received under all the options that is interrelated with the contributions to the plan and not the amount received under any one option, this profit-sharing plan consists of only one separate program of interrelated contributions and benefits and all distributions under the plan (regardless of the option under which received) are treated as received under one contract. However, if, instead of providing that the amount standing in an employee's account would be paid to him during any period that he is absent from work due to a personal injury or sickness, the plan provided that a portion of the amount in the employee's account would be used to purchase incidental accident and health insurance, this plan would consist of two separate programs of interrelated contributions and benefits. The accident and health insurance, and the contributions used to purchase it, would be considered as one separate program of interrelated contributions and benefits and, therefore, a separate contract; whereas, the remaining contributions and benefits would be considered another separate program of interrelated contributions and benefits and, consequently, another separate contract.

Example (3). On January 1, 1961, N Corporation established a profit-sharing plan for its employees providing that the employees may make contributions, not in excess of 6 percent of their compensation, to a trust and that N Corporation would make matching contributions out of its profits. Under the plan, the employee may elect each year to have his and the employer's contributions for such year placed in either a savings arrangement or a retirement arrangement. Such an election is irrevocable. Under the savings arrangement, contributions to such arrangement for any one year and the earnings thereon will be distributed five years later. The retirement arrangement provides that all contributions thereto and the earnings thereon will be distributed when the employee is separated from the service of N Corporation. Since the distributions under the retirement arrangement are attributable solely to the contributions made to such arrangement and are not affected in any manner by contributions or distributions under the savings arrangement or any other plan, such distributions are treated as received under a separate program of interrelated contributions and benefits. Similarly, since distributions during any year under the savings arrangement are attributable only to contributions to such arrangement made during the fifth preceding year and are not affected in any manner by any other contributions to or distributions from such arrangement or any other plan, the savings arrangement constitutes a series of separate programs of interrelated contributions and benefits. The contributions to the savings arrangement for any year and the distribution in a subsequent year based thereon constitute a separate contract for purposes of section 72.

Example (4). The Civil Service Retirement Act (5 U.S.C. Ch. 14) which provides retirement benefits for participating employees, consists of a compulsory program and a voluntary program. Under the compulsory program, all participating employees are required to make certain contributions and, upon retirement, are provided retirement benefits computed on the basis of compensation and length of service. Under the voluntary program, such participating employees are permitted to make contributions in addition to those required under the compulsory program and, upon retirement, are provided additional retirement benefits computed on the basis of their voluntary contributions. Distributions received under the Act constitute distributions from two separate contracts for purposes of section 72. Distributions received under the compulsory program are considered as received under a separate program of interrelated contributions and benefits since they are computed solely under the compulsory program and are not affected by any contributions or distributions under the voluntary program or under any other plan. For similar reasons, distributions which are attributable to the voluntary contributions are considered as received under a separate program of interrelated contributions and benefits.

Example (5). On January 1, 1961, M Corporation established a contributory pension plan for its employees and created a trust to which it makes contributions to fund such plan. The plan provides that each participant will receive after age 65 a pension of 1½ percent of his compensation for each year of service performed subsequent to the establishment of such plan. In order to fund part of the benefits under the plan, the trustee purchased a group annuity contract. The remaining part of the benefits are to be paid out of a separate investment fund. This pension plan constitutes a single program of interrelated contributions and benefits and, therefore, all distributions received by an employee under the plan are considered as received under a single contract for purposes of section 72.

Example (6). On January 1, 1961, Y Corporation established a noncontributory pension plan (including incidental death benefits) for its employees and created a trust to which it makes contributions to fund such plan. The plan provides that each participant will receive after age 65 a pension of 1½ percent of his compensation for each year of service performed subsequent to the establishment of such plan. In addition, such plan provides for the payment of a death benefit if the employee dies before age 65. The trustee funded the death benefits through the purchase of a group term insurance policy and funded the retirement benefits through the purchase of a group annuity contract. Because of a subsequent change in funding from the deferred annuity method to the deposit administration method, the trustee purchased a second group annuity contract to provide the retirement benefits under the plan accruing after the effective date of the change in method of funding. Thus, retirement benefits distributed to an employee whose service with Y Corporation commenced before the effective date of the change in method of funding will be attributable to both group annuity contracts. This pension plan includes two separate programs of interrelated contributions and benefits. The death benefits, and the contributions required to provide them, are considered as one separate program of interrelated contributions and benefits; whereas, the retirement benefits, and the contributions required to provide them, are considered as another separate program of interrelated contributions and benefits. Therefore, any retirement benefits received by an employee, whether attributable to one or both of the group annuity contracts, shall be considered as received under a single contract for purposes of section 72. In determining the tax treatment of any such retirement benefits under section 72, no amount of the premiums used to purchase the group term insurance policy shall be taken into account, since such premiums, and the death benefits which they purchased, constitute a separate program of interrelated contributions and benefits.

Example (7). Assume the same facts as in example (6) except that, in lieu of funding the benefits in the manner described in that example, the trustee purchased individual retirement income contracts from an insurance company. Additional individual retirement income contracts are purchased in order to fund any increase in benefits resulting from increases in salary. Therefore, distributions to a particular employee may be attributable to a single retirement income contract or to more than one such contract. All distributions received by an employee under the pension plan, whether attributable to one or more retirement income contracts and whether made directly from the insurance company to the employee or made through the trustee, are considered as received under a single contract for purposes of section 72. For rules relating to the tax treatment of contributions and distributions under retirement income, endowment, or other life insurance contracts purchased by a trust described in section 401(a) and exempt under section 501(a), see paragraph (a) (2), (3), and (4) of §1.402(a)–1.

Example (8). Assume the same facts as in example (6) except that, in lieu of funding the benefits in the manner described in that example, the trustee funded the death benefits and part of the retirement benefits by purchasing individual retirement income contracts from an insurance company. The remaining part of the retirement benefits (such as any increase in benefits resulting from increases in salary) are to be paid out of a separate investment fund. This pension plan includes, with respect to each participant, two separate contracts for purposes of section 72. The retirement income contract purchased by the trust for each participant is a separate program of interrelated contributions and benefits and all distributions attributable to such contract (whether made directly from the insurance company to the employee or made through the trustee) are considered as received under a single contract. For rules relating to the tax treatment of contributions and distributions under retirement income, endowment, or other life insurance contracts purchased by a trust described in section 401(a) and exempt under section 501(a), see paragraph (a) (2), (3), and (4) of §1.402(a)–1. The remaining distributions under the plan are considered as received under another separate program of interrelated contributions and benefits.

(b) *Amounts.* (1)(i) In general, the amounts to which section 72 applies are any amounts received under the contracts described in paragraph (a)(1) of this section. However, if such amounts are specifically excluded from gross income under other provisions of Chapter 1 of the Code, section 72 shall not apply for the purpose of including such amounts in gross income. For example, section 72 does not apply to amounts received under a life insurance contract if such amounts are paid by reason of the death of the insured and are excludable from gross income under section 101(a). See also sections 101(d), relating to proceeds of life insurance paid at a date later than death, and 104(a)(4), relating to compensation for injuries or sickness.

(ii) Section 72 does not exclude from gross income any amounts received under an agreement to hold an amount and pay interest thereon. See paragraph (a) of §1.72–14. However, section 72 does apply to amounts received by a surviving annuitant under a joint and survivor annuity contract since such amounts are not considered to be paid by reason of the death of an insured. For a special deduction for the estate tax attributable to the inclusion of the value of the interest of a surviving annuitant under a joint and survivor annuity contract in the estate of the deceased primary annuitant, see section 691(d) and the regulations thereunder.

(2) Amounts subject to section 72 in accordance with subparagraph (1) of this paragraph are considered ‘‘amounts received as an annuity’’ only in the event that all of the following tests are met:

(i) They must be received on or after the ‘‘annuity starting date’’ as that term is defined in paragraph (b) of §1.72–4;

(ii) They must be payable in periodic installments at regular intervals (whether annually, semiannually, quarterly, monthly, weekly, or otherwise) over a period of more than one full year from the annuity starting date; and

(iii) Except as indicated in subparagraph (3) of this paragraph, the total of the amounts payable must be determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both, in conjunction with such terms and in accordance with sound actuarial theory.

For the purpose of determining whether amounts subject to section 72(d) and § 1.72–13 are ''amounts received as an annuity'', however, the provisions of subdivision (i) of this subparagraph shall be disregarded. In addition, the term ''amounts received as an annuity'' does not include amounts received to which the provisions of paragraph (b) or (c) of § 1.72–11 apply, relating to dividends and certain amounts received by a beneficiary in the nature of a refund. If an amount is to be paid periodically until a fund plus interest at a fixed rate is exhausted, but further payments may be made thereafter because of earnings at a higher interest rate, the requirements of subdivision (iii) of this subparagraph are met with respect to the payments determinable at the outset by means of computations involving the fixed interest rate, but any payments received after the expiration of the period determinable by such computations shall be taxable as dividends received after the annuity starting date in accordance with paragraph (b)(2) of § 1.72–11.

(3)(i) Notwithstanding the requirement of subparagraph (2)(iii) of this paragraph, if amounts are to be received for a definite or determinable time (whether for a period certain or for a life or lives) under a contract which provides:

(a) That the amount of the periodic payments may vary in accordance with investment experience (as in certain profit-sharing plans), cost of living indices, or similar fluctuating criteria, or

(b) For specified payments the value of which may vary for income tax purposes, such as in the case of any annuity payable in foreign currency,

each such payment received shall be considered as an amount received as an annuity only to the extent that it does not exceed the amount computed by dividing the investment in the contract, as adjusted for any refund feature, by the number of periodic payments anticipated during the time that the periodic payments are to be made. If payments are to be made more frequently than annually, the amount so computed shall be multiplied by the number of periodic payments to be made during the taxable year for the purpose of determining the total amount which may be considered received as an annuity during such year. To this extent, the payments received shall be considered to represent a return of premium or other consideration paid and shall be excludable from gross income in the taxable year in which received. See paragraph (d) (2) and (3) of § 1.72–4. To the extent that the payments received under the contract during the taxable year exceed the total amount thus considered to be received as an annuity during such year, they shall be considered to be amounts not received as an annuity and shall be included in the gross income of the recipient. See section 72(e) and paragraph (b)(2) of § 1.72–11.

(ii) For purposes of subdivision (i) of this subparagraph, the number of periodic payments anticipated during the time payments are to be made shall be determined by multiplying the number of payments to be made each year *(a)* by the number of years payments are to be made, or *(b)* if payments are to be made for a life or lives, by the multiple found by the use of the appropriate tables contained in § 1.72–9, as adjusted in accordance with the table in paragraph (a)(2) of § 1.72–5.

(iii) For an example of the computation to be made in accordance with this subparagraph and a special election which may be made in a taxable year subsequent to a taxable year in which the total payments received under a contract described in this subparagraph are less than the total of the amounts excludable from gross income in such year under subdivision (i) of this subparagraph, see paragraph (d)(3) of § 1.72–4.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6497, 25 FR 10019, Oct. 20, 1960; T.D. 6885, 31 FR 7798, June 2, 1966]

§1.72–3 Excludable amounts not income.

In general, amounts received under contracts described in paragraph (a)(1) of §1.72–2 are not to be included in the income of the recipient to the extent that such amounts are excludable from gross income as the result of the application of section 72 and the regulations thereunder.

§1.72–4 Exclusion ratio.

(a) *General rule.* (1)(i) To determine the proportionate part of the total amount received each year as an annuity which is excludable from the gross income of a recipient in the taxable year of receipt (other than amounts received under (*a*) certain employee annuities described in section 72(d) and §1.72–13, or (*b*) certain annuities described in section 72(o) and §1.122–1), an exclusion ratio is to be determined for each contract. In general, this ratio is determined by dividing the investment in the contract as found under §1.72–6 by the expected return under such contract as found under §1.72–5. Where a single consideration is given for a particular contract which provides for two or more annuity elements, an exclusion ratio shall be determined for the contract as a whole by dividing the investment in such contract by the aggregate of the expected returns under all the annuity elements provided thereunder. However, where the provisions of paragraph (b)(3) of §1.72–2 apply to payments received under such a contract, see paragraph (b)(3) of §1.72–6. In the case of a contract to which §1.72–6(d) (relating to contracts in which amounts were invested both before July 1, 1986, and after June 30, 1986) applies, the exclusion ratio for purposes of this paragraph (a) is determined in accordance with §1.72–6(d) and, in particular, §1.72–6(d)(5)(i).

(ii) The exclusion ratio for the particular contract is then applied to the total amount received as an annuity during the taxable year by each recipient. See, however, paragraph (e)(3) of §1.72–5. Any excess of the total amount received as an annuity during the taxable year over the amount determined by the application of the exclusion ratio to such total amount shall be included in the gross income of the recipient for the taxable year of receipt.

(2) The principles of subparagraph (1) may be illustrated by the following example:

Example Taxpayer A purchased an annuity contract providing for payments of $100 per month for a consideration of $12,650. Assuming that the expected return under this contract is $16,000 the exclusion ratio to be used by A is $12,650÷16,000; or 79.1 percent (79.06 rounded to the nearest tenth). If 12 such monthly payments are received by A during his taxable year, the total amount he may exclude from his gross income in such year is $949.20 ($1,200x79.1 percent).The balance of $250.80 ($1,200 less $949.20) is the amount to be included in gross income. If A instead received only five such payments during the year, he should exclude $395.50 (500x79.1 percent) of the total amounts received.

For examples of the computation of the exclusion ratio in cases where two annuity elements are acquired for a single consideration, see paragraph (b)(1) of §1.72–6.

(3) The exclusion ratio shall be applied only to amounts received as an annuity within the meaning of that term under paragraph (b) (2) and (3) of §1.72–2. Where the periodic payments increase in amount after the annuity starting date in a manner not provided by the terms of the contract at such date, the portion of such payments representing the increase is not an amount received as an annuity. For the treatment of amounts not received as an annuity, see section 72(e) and §1.72–11. For special rules where paragraph (b)(3) of §1.72–2 applies to amounts received, see paragraph (d)(3) of this section.

(4) After an exclusion ratio has been determined for a particular contract, it shall be applied to any amounts received as an annuity thereunder unless or until one of the following occurs:

(i) The contract is assigned or transferred for a valuable consideration (see section 72(g) and paragraph (a) of §1.72–10);

(ii) The contract matures or is surrendered, redeemed, or discharged in accordance with the provisions of paragraph (c) or (d) of §1.72–11;

(iii) The contract is exchanged (or is considered to have been exchanged) in a manner described in paragraph (e) of §1.72–11.

(b) *Annuity starting date.* (1) Except as provided in subparagraph (2) of this paragraph, the annuity starting date is the first day of the first period for which an amount is received as an annuity, except that if such date was before January 1, 1954, then the annuity starting date is January 1, 1954. The first day of the first period for which an amount is received as an annuity shall be whichever of the following is the later:

(i) The date upon which the obligations under the contract became fixed, or

(ii) The first day of the period (year, half-year, quarter, month, or otherwise, depending on whether payments are to be made annually, semiannually, quarterly, monthly, or otherwise) which ends on the date of the first annuity payment.

(2) Notwithstanding the provisions of paragraph (b)(1) of this section, the annuity starting date shall be determined in accordance with whichever of the following provisions is appropriate:

(i) In the case of a joint and survivor annuity contract described in section 72(i) and paragraph (b)(3) of § 1.72–5, the annuity starting date is January 1, 1954, or the first day of the first period for which an amount is received as an annuity by the surviving annuitant, whichever is the later;

(ii) In the case of the transfer of an annuity contract for a valuable consideration, as described in section 72(g) and paragraph (a) of § 1.72–10, the annuity starting date shall be January 1, 1954, or the first day of the first period for which the transferee received an amount as an annuity, whichever is the later;

(iii) If the provisions of paragraph (e) of § 1.72–11 apply to an exchange of one contract for another, or to a transaction deemed to be such an exchange, the annuity starting date of the contract received (or deemed received) in exchange shall be January 1, 1954, or the first day of the first period for which an amount is received as an annuity under such contract, whichever is the later; and

(iv) In the case of an employee who has retired from work because of personal injuries or sickness, and who is receiving amounts under a plan that is a wage continuation plan under section 105(d) and § 1.105–4, the annuity starting date shall be the date the employee reaches mandatory retirement age, as defined in § 1.105–4(a)(3)(i)(B). (See also §§ 1.72–15 and 1.105–6 for transitional and other special rules.)

(c) *Fiscal year taxpayers.* Fiscal year taxpayers receiving amounts as annuities in a taxable year to which the Internal Revenue Code of 1954 applies shall determine the annuity starting date in accordance with section 72(c)(4) and this section. The annuity starting date for fiscal year taxpayers receiving amounts as an annuity in a taxable year to which the Internal Revenue Code of 1939 applies shall be January 1, 1954, except where the first day of the first period for which an amount is received by such a taxpayer as an annuity is subsequent thereto and before the end of a fiscal year to which the Internal Revenue Code of 1939 applied. In such case, the latter date shall be the annuity starting date. In all cases where a fiscal year taxpayer received an amount as an annuity in a taxable year to which the Internal Revenue Code of 1939 applied and subsequent to the annuity starting date determined in accordance with the provisions of this paragraph, such amount shall be disregarded for the purposes of section 72 and the regulations thereunder.

(d) *Exceptions to the general rule.* (1) Where the provisions of section 72 would otherwise require an exclusion ratio to be determined, but the investment in the contract (determined under § 1.72–6) is an amount of zero or less, no exclusion ratio shall be determined and all amounts received under such a contract shall be includible in the gross income of the recipient for the purposes of section 72.

(2) Where the investment in the contract is equal to or greater than the total expected return under such contract found under § 1.72–5, the exclusion ratio shall be considered to be 100 percent and all amounts received as an annuity under such contract shall be excludable from the recipient's gross income. See, for example, paragraph (f)(1) of § 1.72–5. In the case of a contract to which § 1.72–6(d) (relating to contracts in which amounts were invested both before July 1, 1986, and after June 30,

1986) applies, this paragraph (d)(2) is applied in the manner prescribed in §1.72–6(d) and, in particular, §1.72–6(d)(5)(ii).

(3)(i) If a contract provides for payments to be made to a taxpayer in the manner described in paragraph (b)(3) of §1.72–2, the investment in the contract shall be considered to be equal to the expected return under such contract and the resulting exclusion ratio (100%) shall be applied to all amounts received as an annuity under such contract. For any taxable year, payments received under such a contract shall be considered to be amounts received as an annuity only to the extent that they do not exceed the portion of the investment in the contract which is properly allocable to that year and hence excludable from gross income as a return of premiums or other consideration paid for the contract. The portion of the investment in the contract which is properly allocable to any taxable year shall be determined by dividing the investment in the contract (adjusted for any refund feature in the manner described in paragraph (d) of §1.72–7) by the applicable multiple (whether for a term certain, life, or lives) which would otherwise be used in determining the expected return for such a contract under §1.72–5. The multiple shall be adjusted in accordance with the provisions of the table in paragraph (a)(2) of §1.72–5, if any adjustment is necessary, before making the above computation. If payments are to be made more frequently than annually and the number of payments to be made in the taxable year in which the annuity begins are less than the number of payments to be made each year thereafter, the amounts considered received as an annuity (as otherwise determined under this subdivision) shall not exceed, for such taxable year (including a short taxable year), an amount which bears the same ratio to the portion of the investment in the contract considered allocable to each taxable year as the number of payments to be made in the first year bears to the number of payments to be made in each succeeding year. Thus, if payments are to be made monthly, only seven payments will be made in the first taxable year, and the portion of the investment in the contract allocable to a full year of payments is $600, the amounts considered received as an annuity in the first taxable year cannot exceed $350 ($600×7⁄12). See subdivision (iii) of this subparagraph for an example illustrating the determination of the portion of the investment in the contract allocable to one taxable year of the taxpayer.

(ii) If subdivision (i) of this subparagraph applies to amounts received by a taxpayer and the total amount of payments he receives in a taxable year is less than the total amount excludable for such year under subdivision (i) of this subparagraph, the taxpayer may elect, in a succeeding taxable year in which he receives another payment, to redetermine the amounts to be received as an annuity during the current and succeeding taxable years. This shall be computed in accordance with the provisions of subdivision (i) of this subparagraph except that:

(*a*) The difference between the portion of the investment in the contract allocable to a taxable year, as found in accordance with subdivision (i) of this subparagraph, and the total payments actually received in the taxable year prior to the election shall be divided by the applicable life expectancy of the annuitant (or annuitants), found in accordance with the appropriate table in §1.72–9 (and adjusted in accordance with paragraph (a)(2) of §1.72–5), or by the remaining term of a term certain annuity, computed as of the first day of the first period for which an amount is received as an annuity in the taxable year of the election; and

(*b*) The amount determined under (*a*) of this subdivision shall be added to the portion of the investment in the contract allocable to each taxable year (as otherwise found). To the extent that the total periodic payments received under the contract in the taxable year of the election or any succeeding taxable year does not equal this total sum, such payments shall be excludable from the gross income of the recipient. To the extent such payments exceed the sum so found, they shall be fully includible in the recipient's gross income. See subdivision (iii) of this subparagraph for an example illustrating the redetermination of amounts to be received as an annuity and subdivision (iv) of this subparagraph for the method of making the election provided by this subdivision.

(iii) The application of the principles of paragraph (d)(3) (i) and (ii) of this section may be illustrated by the following example:

Example. Taxpayer A, a 64 year old male, files his return on a calendar year basis and has a life expectancy of 15.6 years on June 30, 1954, the annuity starting date of a contract to which § 1.72–2(b)(3) applies and which he purchased for $20,000. The contract provides for variable annual payments for his life. He receives a payment of $1,000 on June 30, 1955, but receives no other payment until June 30, 1957. He excludes the $1,000 payment from his gross income for the year 1955 since this amount is less than $1,324.50, the amount determined by dividing his investment in the contract ($20,000) by his life expectancy adjusted for annual payments, 15.1 (15.6–0.5), as of the original annuity starting date. Taxpayer A may elect, in his return for the taxable year 1957, to redetermine amounts to be received as an annuity under his contract as of June 30, 1956. For the purpose of determining the extent to which amounts received in 1957 or thereafter shall be considered amounts received as an annuity (to which a 100 percent exclusion ratio shall apply) he shall add $118.63 to the $1,324.50 originally determined to be receivable as an annuity under the contract, making a total of $1,443.13. This is determined by dividing the difference between what was excludable in 1955 and 1956, $2,649 (2×$1,324.50) and what he actually received in those years ($1,000) by his life expectancy adjusted for annual payments, 13.9 (14.4–0.5), as of his age at his nearest birthday (66) on the first day of the first period for which he received an amount as an annuity in the taxable year of election (June 30, 1956). The result, $1,443.13, is excludable in that year and each year thereafter as an amount received as an annuity to which the 100% exclusion ratio applies. It will be noted that in this example the taxpayer received amounts less than the excludable amounts in two successive years and deferred making his election until the third year, and thus was able to accumulate the portion of the investment in the contract allocable to each taxable year to the extent he failed to receive such portion in both years. Assuming that he received $1,500 in the taxable year of his election, he would include $56.87 in his gross income and exclude $1,443.13 therefrom for that year.

(iv) If the taxpayer chooses to make the election described in subdivision (ii) of this subparagraph, he shall file with his return a statement that he elects to make a redetermination of the amounts excludable from gross income under his annuity contract in accordance with the provisions of paragraph (d)(3) of § 1.72–4. This statement shall also contain the following information:

(*a*) The original annuity starting date and his age on that date,

(*b*) The date of the first day of the first period for which he received an amount in the current taxable year,

(*c*) The investment in the contract originally determined (as adjusted for any refund feature), and

(*d*) The aggregate of all amounts received under the contract between the date indicated in (*a*) of this subdivision and the day after the date indicated in (*b*) of this subdivision to the extent such amounts were excludable from gross income.

He shall include in gross income any amounts received during the taxable year for which the return is made in accordance with the redetermination made under this subparagraph.

(v) In the case of a contract to which § 1.72–6(d) (relating to contracts in which amounts were invested both before July 1, 1986, and after June 30, 1986) applies, this paragraph (d)(3) is applied in the manner prescribed in § 1.72–6(d) and, in particular, § 1.72–6(d)(5)(iii). This application may be illustrated by the following example:

Example B, a male calendar year taxpayer, purchases a contract which provides for variable annual payments for life and to which § 1.72–2(b)(3) applies. The annuity starting date of the contract is June 30, 1990, when B is 64 years old. B receives a payment of $1,000 on June 30, 1991, but receives no other payment until June 30, 1993. B's total investment in the contract is $25,000. B's pre-July 1986 investment in the contract is $12,000. If B makes the election described in § 1.72–6(d)(6), separate computations are required to determine the amounts received as an annuity and excludable from gross income with respect to the pre-July 1986 investment in the contract and the post-June 1986 investment in the contract. In the separate computations, B first determines the applicable portions of the total payment received which are allocable to the pre-July 1986 investment in the contract and the post-June 1986 investment in the contract. The portion of the payment received allocable to the pre-July 1986 investment in the contract is $480 ($12,000/$25,000 × $1,000). The portion of the payment received allocable to the post-June 1986 investment in the contract is $520 ($13,000/$25,000 × $1,000).

Second, B determines the pre-July 1986 investment in the contract and the post-June 1986 investment in the contract allocable to the taxable year by dividing the pre-July 1986 and post-June 1986 investments in the contract by the applicable life expectancy multiple. The life expectancy multiple applicable to pre-July 1986 investment in the contract is B's life expectancy as of the original annuity starting date adjusted for annual payments and is determined under Table I of §1.72–9 [15.1 (15.6–0.5)]. The life expectancy multiple applicable to post-June 1986 investment in the contract is determined under Table V of §1.72–9 (20.3 (20.8–0.5)). Thus, the pre-July 1986 investment in the contract allocable to each taxable year is $794.70 ($12,000÷15.1), and the post-June 1986 investment in the contract so allocable is $640.39 ($13,000÷20.3). Because the applicable portions of the total payment received in 1991 under the contract ($480 allocable to the pre-July 1986 investment in the contract and $520 allocable to the post-June 1986 investment in the contract) are treated as amounts received as an annuity and are excludable from gross income to the extent they do not exceed the portion of the corresponding investment in the contract allocable to 1991 ($794.70 pre-July 1986 investment in the contract and $640.39 post-June 1986 investment in the contract), the entire amount of each applicable portion of the total payment is excludable from gross income. B may elect, in the return filed for taxable year 1993, to redetermine amounts to be received as an annuity under the contract as of June 30, 1992. The extent to which the amounts received in 1993 or thereafter shall be considered amounts received as an annuity is determined as follows:

Pre-July 1986 investment in the contract allocable to taxable years 1991 and 1992 ($794.70 × 2)	$1,589.40
Less: Portion of total payments allocable to pre-July 1986 investment in the contract actually received as an annuity in taxable years 1991 and 1992	480.00
	1,109.40
Divided by: Life expectancy multiple applicable to pre-July 1986 investment in the contract for B, age 66 (14.4—0.5)	13.9
	79.81
Plus: Amount originally determined with respect to pre-July 1986 investment in the contract	794.70
Pre-July 1986 amount	874.51

Post-June 1986 investment in the contract allocable to taxable years 1991 and 1992 ($640.39 × 2)	$1,280.78
Less: Portion of total payments allocable to post-June 1986 investment in the contract actually received as an annuity in taxable years 1991 and 1992	520.00
	760.78
Divided by: Life expectancy multiple applicable to post-June 1986 investment in the contract for B, age 66 (19.2 − 0.5)	18.7
	40.68
Plus: Amount originally determined with respect to post-June 1986 investment in the contract	640.39
Post-June 1986 amount	681.07

(vi) The method of making an election to perform the separate computations illustrated in paragraph (d)(3)(v) of this section is described in §1.72–6(d)(6).

(e) *Exclusion ratio in the case of two or more annuity elements acquired for a single consideration.* (1)(i) Where two or more annuity elements are provided under a contract described in paragraph (a)(2) of §1.72–2, an exclusion ratio shall be determined for the contract as a whole and applied to all amounts received as an annuity under any of the annuity elements. To obtain this ratio, the investment in the contract determined in accordance with §1.72–6 shall be divided by the aggregate of the expected returns found with respect to each of the annuity elements in accordance with §1.72–5. For this purpose, it is immaterial that payments under one or more of the annuity elements involved have not commenced at the time when an amount is first received as an annuity under one or more of the other annuity elements.

(ii) The exclusion ratio found under subdivision (i) of this subparagraph does not apply to:

(*a*) An annuity element payable to a surviving annuitant under a joint and survivor annuity contract to which section 72(i) and paragraphs (b)(3) and (e)(3) of §1.72–5 apply, or to (*b*) A contract under which one or more of the constituent annuity elements provides for payments described in paragraph (b)(3) of §1.72–2.

For rules with respect to a contract providing for annuity elements described in (*b*) of this subdivision, see subparagraph (2) of this paragraph.

(2) If one or more of the annuity elements under a contract described in paragraph (a)(2) of §1.72–2 provides for payments to which paragraph (b)(3) of §1.72–2 applies:

(i) With respect to the annuity elements to which paragraph (b)(3) of §1.72–2 does not apply, an exclusion ratio shall be determined by dividing the portion of the investment in the entire contract which is properly allocable to all such elements (in the manner provided in paragraph (b)(3)(ii) of §1.72–6) by the aggregate of the expected returns thereunder and such ratio shall be applied in the manner described in subdivision (i) of subparagraph (1); and

(ii) With respect to the annuity elements to which paragraph (b)(3) of §1.72–2 does apply, the investment in the entire contract shall be reduced by the portion thereof found in subdivision (i) of this subparagraph and the resulting amount shall be used to determine the extent to which the aggregate of the payments received during the taxable year under all such elements is excludable from gross income. The amount so excludable shall be allocated to each recipient under such elements in the same ratio that the total of payments he receives each year bears to the total of the payments received by all such recipients during the year. The exclusion ratio with respect to the amounts so allocated shall be 100 percent. See paragraph (f)(2) of §1.72–5 and paragraph (b)(3) of §1.72–6.

(iii) In the case of a contract to which §1.72–6(d) (relating to contracts in which amounts were invested both before July 1, 1986, and after June 30, 1986) applies, this paragraph (e) is applied in the manner prescribed in §1.72–6(d) and, in particular, §1.72–6(d)(5)(iv).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7352, 40 FR 16663, Apr. 14, 1975; T.D. 8115, 51 FR 45691, Dec. 19, 1986; 52 FR 10223, Mar. 31, 1987]

§1.72–5 Expected return.

(a) *Expected return for but one life.* (1) If a contract to which section 72 applies provides that one annuitant is to receive a fixed monthly income for life, the expected return is determined by multiplying the total of the annuity payments to be received annually by the multiple shown in Table I or V (whichever is applicable) of §1.72–9 under the age (as of the annuity starting date) and, if applicable, sex of the measuring life (usually the annuitant's). Thus, where a male purchases a contract before July 1, 1986, providing for an immediate annuity of $100 per month for his life and, as of the annuity starting date (in this case the date of purchase), the annuitant's age at his nearest birthday is 66, the expected return is computed as follows:

Monthly payment of $100×12 months equals annual payment of	$1,200
Multiple shown in Table I, male, age 66	14.4
Expected return (1,200×14.4)	17,280

If, however, the taxpayer had purchased the contract after June 30, 1986, the expected return would be $23,040, determined by multiplying 19.2 (multiple shown in Table V, age 66) by $1,200.

(2)(i) If payments are to be made quarterly, semiannually, or annually, an adjustment of the applicable multiple shown in Table I or V (whichever is applicable) may be required. A further adjustment may be required where the interval between the annuity starting date and the date of the first payment is less than the interval between future payments. Neither adjustment shall be made, however, if the payments are to be made more frequently than quarterly. The amount of the adjustment, if any, is to be found in accordance with the following table:

If the number of whole months from the annuity starting date to the first payment date is—	0–1	2	3	4	5	6	7	8	9	10	11	12
And the payments under the contract are to be made:												
Annually	+0.5	+0.4	+0.3	+0.2	+0.1	0	0	−0.1	−0.2	−0.3	−0.4	−0.5
Semiannually	+.2	+.1	0	0	−.1	−.2	....	....	....	....	....	....
Quarterly	+.1	0	−.1	....	....	....	....	....	....	....	....	....

Thus, for a male, age 66, the multiple found in Table I, adjusted for quarterly payments the first of which is to be made one full month after the annuity starting date, is 14.5 (14.4+0.1); for semiannual payments the first of which is to be made six full months from the annuity starting date, the adjusted multiple is 14.2 (14.4−0.2); for annual payments the first of which is to be made one full month from the annuity starting date, the adjusted multiple is 14.9 (14.4+0.5). If the annuitant in the example shown in subparagraph (1) of this paragraph were to receive an annual payment of $1,200 commencing 12 full months after his annuity starting date, the amount of the expected return would be $16,680 ($1,200×13.9 [14.4−0.5]). Similarly, for an annuitant, age 50, the multiple found in Table V, adjusted for quarterly payments the first of which is to be made one full month after the annuity starting date, is 33.2 (33.1+0.1); for semiannual payments the first of which is to be made six full months from the annuity starting date, the adjusted multiple is 32.9 (33.1−0.2); for annual payments the first of which is to be made one full month from the annuity starting date, the adjusted multiple is 33.6 (33.1+0.5).

(ii) Notwithstanding the table in subdivision (i) of this subparagraph, adjustments of multiples for early or other than monthly payments determined prior to February 19, 1956, under the table prescribed in paragraph 1(b)(4) of T.D. 6118 (19 FR 9897, C.B. 1955–1, 699), approved December 30, 1954, need not be redetermined.

(3) If the contract provides for fixed payments to be made to an annuitant until death or until the expiration of a specified limited period, whichever occurs earlier, the expected return of such temporary life annuity is determined by multiplying the total of the annuity payments to be received annually by the multiple shown in Table IV or VIII (whichever is applicable) of §1.72–9 for the age (as of the annuity starting date) and, if applicable, sex of the annuitant and the nearest whole number of years in the specified period. For example, if a male annuitant, age 60 (at his nearest birthday), is to receive $60 per month for five years or until he dies, whichever is earlier, and there is no post-June 1986, investment in the contract, the expected return under such a contract is $3,456, computed as follows:

Monthly payments of $60×12 months equals annual payment of	$720
Multiple shown in Table IV for male, age 60, for term of 5 years ...	4.8
Expected return for 5 year temporary life annuity of $720 per year ($720×4.8)	$3,456

If the annuitant purchased the same contract after June 30, 1986, the expected return under the contract would be $3,528, computed as follows:

Monthly payments of $60×12 months equals annual payment of	$720.00
Multiple shown in Table VIII for annuitant, age 60, for term of 5 years	4.9
Expected return for 5-year temporary life annuity of $720 per year ($720×4.9)	$3,528.00

The adjustment provided by subparagraph (2) of this paragraph shall not be made with respect to the multiple found in Table IV or VIII (whichever is applicable).

(4) If the contract provides for payments to be made to an annuitant for the annuitant's lifetime, but the amount of the annual payments is to

be decreased after the expiration of a specified limited period, the expected return is computed by considering the contract as a combination of a whole life annuity for the smaller amount plus a temporary life annuity for an amount equal to the difference between the larger and the smaller amount. For example, if a male annuitant, age 60, is to receive $150 per month for five years or until his earlier death, and is to receive $90 per month for the remainder of his lifetime after such five years, the expected return is computed as if the annuitant's contract consisted of a whole life annuity for $90 per month plus a five year temporary life annuity of $60 per month. In such circumstances, the expected return if there is no post-June 1986 investment in the contract is computed as follows:

Monthly payments of $90×12 months equals annual payment of	$1,080
Multiple shown in Table I for male, age 60	18.2
Expected return for whole life annuity of $1,080 per year	$19,656
Expected return for 5-year temporary life annuity of $720 per year (as found in subparagraph (3) of this paragraph (a))	$3,456
Total expected return	$23,112

If the annuitant purchased the same contract after June 30, 1986, the expected return would be $29,664, computed as follows:

Monthly payments of $90×12 months equals annual payment of	$1,080
Multiple shown in Table V for annuitant, age 60	24.2
Expected return for whole life annuity of $1,080 per year	$26,136
Plus: Expected return for 5-year temporary life annuity of $720 per year (as found in subparagraph (3) of this paragraph (a))	$3,528
Total expected return	$29,664

If payments are to be made quarterly, semiannually, or annually, an appropriate adjustment of the multiple found in Table I or V (whichever is applicable) for the whole life annuity should be made in accordance with subparagraph (2) of this paragraph.

(5) If the contract described in subparagraph (4) of this paragraph provided that the amount of the annual payments to the annuitant were to be increased (instead of decreased) after the expiration of a specified limited period, the expected return would be computed as if the annuitant's contract consisted of a whole life annuity for the larger amount minus a temporary life annuity for an amount equal to the difference between the larger and smaller amount. Thus, if the annuitant described in subparagraph (4) of this paragraph were to receive $90 per month for five years or until his earlier death, and to receive $150 per month for the remainder of his lifetime after such five years, the expected return would be computed by subtracting the expected return under a five year temporary life annuity of $60 per month from the expected return under a whole life annuity of $150 per month. In such circumstances, the expected return if there is no post-June 1986 investment in the contract is computed as follows:

Monthly payments of $150×12 months equals annual payment of	$1,800
Multiple shown in Table 1 (male, age 60)	18.2
Expected return for annuity for whole life of $1,800 per year	$32,760
Less expected return for 5-year temporary life annuity of $720 per year (as found in subparagraph (3))	$3,456
Net expected return	$29,304

If the annuitant purchased the same contract after June 30, 1986, the expected return would be $40,032, computed as follows:

Monthly payments of $150×12 months equals annual payments of	$1,800
Multiple shown in Table V (age 60)	24.2
Expected return for annuity for whole life of $1,800 per year	$43,560

Less expected return for 5-year temporary life annuity of $720 per year (as found in subparagraph (3) of this paragraph (a))	$3,528
Net expected return	$40,032

If payments are to be made quarterly, semiannually, or annually, an appropriate adjustment of the multiple found in Table I or V (whichever is applicable) for the whole life annuity should be made in accordance with subparagraph (2) of this paragraph.

(b) *Expected return under joint and survivor and joint annuities.* (1) In the case of a joint and survivor annuity contract involving two annuitants which provides the first annuitant with a fixed monthly income for life and, after the death of the first annuitant, provides an identical monthly income for life to a second annuitant, the expected return shall be determined by multiplying the total amount of the payments to be received annually by the multiple obtained from Table II or VI (whichever is applicable) of §1.72–9 under the ages (as of the annuity starting date) and, if applicable, sexes of the living annuitants. For example, a husband purchases a joint and survivor annuity contract providing for payments of $100 per month for life and, after his death, for the same amount to his wife for the remainder of her life. As of the annuity starting date his age at his nearest birthday is 70 and that of his wife at her nearest birthday is 67. If there is no post-June 1986 investment in the contract, the expected return is computed as follows:

Monthly payments of $100×12 months equals annual payment of	$1,200
Multiple shown in Table II (male, age 70, female, age 67)	19.7
Expected return ($1,200×19.7)	$23,640

If the annuitants purchased the same contract after June 30, 1986, the expected return would be $26,400, computed as follows:

Monthly payments of $100×12 months equals annual payment of	$1,200
Multiple shown in Table VI (ages 70, 67)	22.0
Expected return ($1,200×22.0)	$26,400

If payments are to be made quarterly, semiannually, or annually, an appropriate adjustment of the multiple found in Table II or VI (whichever is applicable) should be made in accordance with paragraph (a)(2) of this section.

(2) If a contract of the type described in subparagraph (1) of this paragraph provides that a different (rather than an identical) monthly income is payable to the second annuitant, the expected return is computed in the following manner. The applicable multiple in Table II or VI (whichever is applicable) is first found as in the example in subparagraph (1) of this paragraph. The multiple applicable to the first annuitant is then found in Table I or V (whichever is applicable) as though the contract were for a single life annuity. The multiple from Table I or V is then subtracted from the multiple obtained from Table II or VI and the resulting multiple is applied to the total payments to be received annually under the contract by the second annuitant. The result is the expected return with respect to the second annuitant. The portion of the expected return with respect to payments to be made during the first annuitant's life is then computed by applying the multiple found in Table I or V to the total annual payments to be received by such annuitant under the contract. The expected returns with respect to each of the annuitants separately are then aggregated to obtain the expected return under the entire contract.

Example (1). A husband purchases a joint and survivor annuity providing for payments of $100 per month for his life and, after his death, payments to his wife of $50 per month for her life. As of the annuity starting date his age at his nearest birthday is 70 and that of his wife at her nearest birthday is 67. There is no post-June 1986 investment in the contract.

Multiple from Table II (male, age 70, female, age 67)	19.7
Multiple from Table I (male, age 70)	12.1
Difference (multiple applicable to second annuitant)	7.6
Portion of expected return, second annuitant ($600×7.6)	$4,560

Portion of expected return, first annuitant ($1,200×12.1)	$14,520
Expected return under the contract	$19,080

The expected return thus found, $19,080, is to be used in computing the amount to be excluded from gross income. Thus, if the investment in the contract in this example is $14,310, the exclusion ratio is $14,310÷$19,080; or 75 percent. The amount excludable from each monthly payment made to the husband is 75 percent of $100, or $75, and the remaining $25 of each payment received by him shall be included in his gross income. After the husband's death, the amount excludable by the second annuitant (the surviving wife) would be 75 percent of each monthly payment of $50, or $37.50, and the remaining $12.50 of each payment shall be included in her gross income.

Example (2). If the same contract were purchased after June 30, 1986, the expected return would be $22,800, computed as follows:

Multiple from Table VI (ages 70, 67)	22.0
Multiple from Table V (age 70)	16.0
Difference (multiple applicable to second annuitant)	6.0
Portion of expected return, second annuitant ($600×6.0)	$3,600
Plus: Portion of expected return, first annuitant ($1,200×16.0)	$19,200
Expected return under the contract	$22,800

If the investment in the contract is $14,310, the exclusion ratio is $14,310÷$22,800, or 62.8 percent. Thus, the husband would exclude $62.80 of each $100 payment received by him. After his death, his wife would exclude 62.8 percent, or $31.40, of each $50 monthly payment.

Example (3). If amounts were invested in the same contract both before July 1, 1986, and after June 30, 1986, and the election described in § 1.72–6(d)(6) were made, two exclusion ratios would be determined pursuant to § 1.72–6(d). Assume that the husband's total investment in the contract is $14,310 and that $7,310 is the pre-July 1986 investment in the contract. The pre-July 1986 exclusion ratio would be $7,310÷$19,080, or 38.3 percent. The post-June 1986 exclusion ratio would be $7,000÷$22,800, or 30.7 percent. The husband would exclude $69.00 ($38.30+$30.70) of the $100 monthly payment received by him. The remaining $31.00 would be included in his gross income. After the husband's death, the amount excludable by his wife would be $34.50 (38.3 percent of $50 plus 30.7 percent of $50). The remaining $15.50 would be included in gross income.

The same method is used if the payments are to be increased after the death of the first annuitant. Thus, if the payments to be made until the husband's death were $50 per month and his widow were to receive $100 per month thereafter until her death, the 7.6 multiple in example (1) above would be applied to the $100 payments, yielding an expected return with respect to this portion of the annuity contract of $9,120 ($1,200×7.6). An expected return of $7,260 ($600×12.1) would be obtained with respect to the payments to be made to the husband, yielding a total expected return under the contract of $16,380 ($9,120 plus $7,260). If payments are to be made quarterly, semiannually, or annually, an appropriate adjustment of the multiples found in Tables I and II or Tables V and VI (whichever are applicable) should be made in accordance with paragraph (a)(2) of this section.

(3) In the case of a joint and survivor annuity contract in respect of which the first annuitant died in 1951, 1952, or 1953, and the basis of the surviving annuitant's interest in the contract was determinable under section 113(a)(5) of the Internal Revenue Code of 1939, such basis shall be considered the ''aggregate of premiums or other consideration paid'' by the surviving annuitant for the contract. (For rules governing this determination, see 26 CFR (1939) 39.22(b)(2)–2 and 39.113(a)(5)–1 (Regulations 118).) In determining such an annuitant's investment in the contract, such aggregate shall be reduced by any amounts received under the contract by the surviving annuitant before the annuity starting date, to the extent such amounts were excludable from his gross income at the time of receipt. The expected return of the surviving annuitant in such cases shall be determined in the manner prescribed in paragraph (a) of this section, as though the surviving annuitant alone were involved. For this purpose, the appropriate multiple for the survivor shall

be obtained from Table I as of the annuity starting date determined in accordance with paragraph (b)(2)(i) of §1.72–4.

(4) If a contract involving two annuitants provides for fixed monthly payments to be made as a joint life annuity until the death of the first annuitant to die (in other words, only as long as both remain alive), the expected return under such contract shall be determined by multiplying the total of the annuity payments to be received annually under the contract by the multiple obtained from Table IIA or VIA (whichever is applicable) of §1.72–9 under the ages (as of the annuity starting date) and, if applicable, sexes of the annuitants. If, however, payments are to be made under the contract quarterly, semiannually, or annually, an appropriate adjustment of the multiple found in Table IIA or VIA shall be made in accordance with paragraph (a)(2) of this section.

(5) If a joint and survivor annuity contract involving two annuitants provides that a specified amount shall be paid during their joint lives and a different specified amount shall be paid to the survivor upon the death of whichever of the annuitants is the first to die, the following preliminary computation shall be made in all cases preparatory to determining the expected return under the contract:

(i) From Table II or VI (whichever is applicable), obtain the multiple under both of the annuitants' ages (as of the annuity starting date) and, if applicable, their appropriate sexes;

(ii) From Table IIA or VIA (whichever is applicable), obtain the multiple applicable to both annuitants' ages (as of the annuity starting date) and, if applicable, their appropriate sexes;

(iii) Apply the multiple found in subdivision (i) of this subparagraph to the total of the amounts to be received annually after the death of the first to die; and

(iv) Apply the multiple found in subdivision (ii) of this subparagraph to the difference between the total of the amounts to be received annually before and the total of the amounts to be received annually after the death of the first to die.

If the original annual payment is in excess of the annual payment to be made after the death of the first to die, the expected return is the sum of the amounts determined under subdivisions (iii) and (iv) of this subparagraph. This may be illustrated by the following examples:

Example (1). A husband purchases a joint and survivor annuity providing for payments of $100 a month for as long as both he and his wife live, and, after the death of the first to die, payments to the survivor of $75 a month for life. As of the annuity starting date, his age at his nearest birthday is 70 and that of his wife at her nearest birthday is 67. If there is no post-June 1986 investment in the contract, the expected return under the contract is computed as follows:

Multiple from Table II (male age 70, female age 67)	19.7
Multiple from Table IIA (male age 70, female age 67)	9.3
Portion of expected return ($900×19.7—sum per year after first death)	$17,730
Plus: Portion of expected return ($300×9.3—amount of change in sum at first death)	$2,790
Expected return under the contract	$20,520

The total expected return in this example, $20,520, is to be used in computing the amount to be excluded from gross income. Thus, if the investment in the contract is $17,887, the exclusion ratio is $17,887÷$20,520, or 87.2 percent. The amount excludable from each monthly payment made while both are alive is 87.2 percent of $100, or $87.20, and the remaining $12.80 of each payment shall be included in gross income. After the death of the first to die, the amount excludable by the survivor shall be 87.2 percent of each monthly payment of $75, or $65.40, and the remaining $9.60 of each payment shall be included in gross income.

Example (2). Assume the same facts as in example (1), except that the contract is purchased after June 30, 1986.

The expected return under the contract is computed as follows:

Multiple from Table VI (ages 70, 67)	22.0
Multiple from Table VIA (ages 70, 67)	12.4
Portion of expected return ($900×22.0—sum per year after first death)	$19,800
Plus: Portion of expected return ($300×12.4—amount of change in sum at first death)	$3,720

Expected return under the contract	$23,520

Thus, if the investment in the contract is $17,887, the exclusion ratio is $17,887÷$23,520, or 76.1 percent. The amount excludable from each monthly payment made while both are alive would be 76.1 percent of $100, or $76.10, and the remaining $23.90 of each payment would be included in gross income. After the death of the first to die, the amount excludable by the survivor would be 76.1 percent of each monthly payment of $75, or $57.08, and the remaining $17.92 of each payment would be included in gross income.

Example (3). Assume the same facts as in examples (1) and (2), except that the total investment in the contract is $17,887, and that the pre-July 1986 investment in the contract is $8,000. Assume also that one of the annuitants makes the election described in § 1.72–6(d)(6). Separate computations shall be performed pursuant to § 1.72–6(d) to determine the amount excludable from gross income. The pre-July 1986 exclusion ratio would be $8,000÷$20,520, or 39 percent. The post-June 1986 exclusion ratio would be $9,887÷$23,520, or 42 percent. The amount excludable from each monthly payment made while both are alive would be $81 ((.39×100)+(.42×100)), and the remaining $19 would be included in gross income. After the death of the first to die, the amount excludable by the survivor would be $60.75 ((.39×75)+(.42×75)), and the remaining $14.25 would be included in gross income.

If the original annual payment is less than the annual payment to be made after the death of the first to die, the expected return is the difference between the amounts determined under subdivisions (iii) and (iv) of this subparagraph. If, however, payments are to be made quarterly, semiannually, or annually under the contract, the multiples obtained from both Tables II and IIA or Tables VI and VIA (whichever are applicable) shall first be adjusted in a manner prescribed in paragraph (a)(2) of this section.

(6) If a contract provides for the payment of life annuities to two persons during their respective lives and, after the death of one (without regard to which one dies first), provides that the survivor shall receive for life both his own annuity payments and the payments made formerly to the deceased person, the expected return shall be determined in accordance with paragraph (e)(4) of this section.

(7) If paragraph (b)(3) of § 1.72–2 applies to payments provided under a contract and this paragraph applies to such payments, the principles of this paragraph shall be used in making the computations described in paragraph (d)(3) of § 1.72–4. This may be illustrated by the following examples, examples (1) through (3) of which assume that there is no post-June 1986 investment in the contract:

Example (1). Taxpayer A, a male age 63, pays $24,000 for a contract which provides that the proceeds (both income and return of capital) from eight units of an investment fund shall be paid monthly to him for his life and that after his death the proceeds from six such units shall be paid monthly to B, a female age 55, for her life. The portion of the investment in the contract allocable to each taxable year of A is $955.20 and that allocable to each taxable year of B is $716.40. This is determined in the following manner:

Multiple from Table II (male, age 63, and female, age 55)	28.1
Number of units to be paid, in effect, as a joint and survivor annuity	×6
Number of total annual unit payments anticipatable with respect to the joint and survivor annuity element	168.6
Multiple from Table I (male, age 63)	16.2
Number of units to be paid, in effect, as a single life annuity	×2
Number of total annual unit payments anticipatable with respect to A alone	32.4
Total number of unit payments anticipatable	201
Portion of investment in the contract allocable to unit payments ($24,000÷201) on an annual basis	$119.40
Number of units payable to A while he continues to live	×8
Portion of the investment in the contract allocable to each taxable year of A	$955.20
Portion of investment in the contract allocable to unit payments ($24,000÷201) on an annual basis	$119.40
Number of units payable to B for her life after A’s death	×6
Portion of the investment in the contract allocable to each taxable year of B	$716.40

For the purpose of the above computation it is immaterial whether or not A lives to or beyond the life expectancy shown for him in Table I.

Example (*2*). Assume that Taxpayer A in example (1) receives payments for five years which are at least as large as the portion of the investment in the contract allocable to such years, but in the sixth year he receives a total of only $626.40 rather than the $955.20 allocable to such year. A is 69 and B is 61 at the beginning of the first monthly period for which an amount is payable in the seventh taxable year. A makes the election in that year provided under paragraph (d)(3) of §1.72–4. The difference between the portion of the investment in the contract allocable to the sixth year and the amount actually received in that year is $328.80 ($955.20 less $626.40). In this case, 139.2 unit payments are anticipatable (on an annual basis), since the appropriate multiple from Table II of §1.72–9, 23.2, multiplied by the number of units payable, in effect, as a joint and survivor annuity yields this result (6×23.2). A's appropriate multiple from Table I of §1.72–9 for the two units which will cease to be paid at his death is 12.6, and the total number of unit payments anticipatable (on an annual basis) is, therefore, 164.4 (2×12.6 plus 139.2). Dividing the difference previously found ($328.80) by the total number of unit payments thus determined (164.4) indicates that A will have an additional allocation of the investment in the contract of $16 to the seventh and every succeeding full taxable year (8 units×$2), and B will have an additional allocation of the investment in the contract of $12 (6 units×$2) to each taxable year in which she receives 12 monthly payments subsequent to the death of A. The total allocable to each taxable year of A is, therefore, $971.20, and that allocable to each taxable year of B will be $728.40.

Example (*3*). If, in example (2), A had died at the end of the fifth year, in the sixth year B would have received a payment of $469.80 (that portion of the $626.40 that A would have received which is in the same ratio that 6 units bear to 8 units) and would thus have received $246.60 less than the portion of the investment in the contract originally determined to be allocable to each of her taxable years. In these circumstances, B would be entitled to elect to redetermine the portion of the investment in the contract allocable to the taxable year of election and all subsequent years. The new amount allocable thereto would be found by dividing the $246.60 difference by her life expectancy as of the first day of the first period for which she received an amount as an annuity in the seventh year of the annuity contract, and adding the result to her originally determined allocation of $716.40.

Example (4). On July 1, 1986, Taxpayer C, age 60, pays $28,000 for a contract which provides that the proceeds (both income and return of capital) from 10 units of an investment fund shall be paid monthly to C for C's life and that after C's death the proceeds from 4 such units shall be paid monthly to D, age 57, for D's life. The portion of the investment in the contract allocable to each taxable year of C is $1,037.00 and that allocable to each taxable year of D is $414.80. This is determined as follows:

Multiple from Table VI (ages 60, 57)	31.2
Number of units to be paid, in effect, as a joint and survivor annuity	×4
Number of total annual unit payments anticipatable with respect to the joint and survivor annuity element	124.8
Multiple from Table V (age 60)	24.2
Number of units to be paid, in effect, as a single life annuity	×6
Number of total annual unit payments anticipatable with respect to C alone	145.2
Total number of unit payments anticipatable	270
Portion of investment in the contract allocable to unit payments ($28,000÷270) on an annual basis	103.70
Number of units payable to C while C continues to live	×10
Portion of the investment in the contract allocable to each taxable year of C	$1,037.00
Portion of investment in the contract allocable to unit payments ($28,000÷270) on an annual basis	$103.70
Number of units payable to D for D's life after C's death	×4
Portion of the investment in the contract allocable to each taxable year of D	$414.80

For purposes of the above computation it is immaterial whether or not C lives to or beyond the life expectancy shown in Table V.

Example (5). Assume the same facts as in example (4), except that C's total investment in the contract is $28,000, and C's pre-July 1986 investment in the contract is $16,000. If C makes the election described in §1.72–6(d)(6), separate computations are required to determine the amount excludable from gross income with respect to the pre-July

1986 investment in the contract and the post-June 1986 investment in the contract. The annuitant shall apply the appropriate pre-July 1986 and post-June 1986 life expectancy multiples to the applicable portions of the units to be paid as a joint and survivor annuity, and as a single life annuity.

Pre-July 1986 Computation (all references to unit payments are to the pre-July 1986 applicable portion of such payments):

Multiple from Table II (male, age 60, female, age 57)	27.6
Number of units to be paid, in effect, as a joint and survivor annuity	×4
Number of total annual unit payments anticipatable with respect to the joint and survivor annuity element	110.40
Multiple from Table I (male, age 60)	18.2
Number of units to be paid, in effect, as a single life annuity	×6
Number of total annual unit payments anticipatable with respect to C alone	109.20
Total number of unit payments anticipatable	219.6
Portion of pre-July 1986 investment in the contract allocable to unit payments ($16,000÷219.60) on an annual basis	$72.86
Number of units payable to C while C continues to live	×10
Portion of pre-July 1986 investment in the contract allocable to each taxable year of C	728.60
Portion of pre-July 1986 investment in the contract allocable to unit payments ($16,000÷219.60) on an annual basis	72.86
Number of units payable to D for D's life after C's death	×4
Portion of pre-July 1986 investment in the contract allocable to each taxable year of D	$291.44

Post-June 1986 Computation (all references to unit payments are to the post-June 1986 applicable portion of such payments):

Multiple from Table VI (ages 60, 57)	31.2
Number of units to be paid, in effect, as a joint and survivor annuity	x4
Number of total annual unit payments anticipatable with respect to the joint and survivor annuity element	124.80
Multiple from Table V (age 60)	24.2
Number of units to be paid, in effect, as a single life annuity	×6
Number of total annual unit payments anticipatable with respect to C alone	145.20
Total number of unit payments anticipatable	270
Portion of post-June 1986 investment in the contract allocable to unit payments ($12,000÷270) on an annual basis	$44.44
Number of units payable to C while C continues to live	×10
Portion of post-June 1986 investment in the contract allocable to each taxable year of C	$444.40
Portion of post-June 1986 investment in the contract allocable to unit payments ($12,000÷270) on an annual basis	44.44
Number of units payable to D for D's life after C's death	×4
Portion of post-June 1986 investment in the contract allocable to each taxable year of D	$177.78

Total computation:

Total portion of the investment in the contract allocable to each taxable year of C ($728.60+$444.40)	$1,173.00
Total portion of the investment in the contract allocable to each taxable year of D ($291.44+$177.78)	$469.22

Example (6). Assume that taxpayer C in example (4) receives payments for four years which are at least as large as the portion of the investment in the contract allocable to such years, but in the fifth year receives a total of only $600 rather than the $1,037 allocable to such year. C is 65 and D is 62 at the beginning of the first monthly period for which an amount is payable in the sixth taxable year. C makes the election in that year provided under paragraph (d)(3) of §1.72–4. The difference between the portion of the investment in the contract allocable to the fifth year and the amount actually received in that year is $437 ($1,037 − $600). In this case, 106 unit payments are anticipatable with respect to the joint and survivor annuity element, since the appropriate multiple from Table VI of §1.72–9, 26.5, multiplied by the number of units payable, in effect, as a joint and survivor annuity yields this result (4 × 26.0). C's appropriate multiple from Table V of §1.72–9 for the six units which will cease to be paid at C's death is 20.0, and the number of unit payments anticipatable with respect to C alone is 120 (6 × 20). The total number of unit payments anticipatable is, therefore, 226 (120 plus 106). Dividing the difference previously found ($437) by the total number of unit payments thus determined (226) indicates that C will have an additional allocation of the investment in the contract of $19.30 to the sixth and every succeeding full taxable year (10 units × $1.93), and D will have an additional allocation of the investment in the contract of $7.72 (4 units × $1.93) to each taxable year in which D receives 12 monthly payments subsequent to the death of C. The total allocable to each taxable year of C is, therefore, $1,056.30, and that allocable to each taxable year of D will be $422.52.

Example (7). If, in example (6), C had died at the end of the fourth year, in the fifth year D would have received a payment of $240 (that portion of the $600 that C would have received which is in the same ratio that 4 units bear to 10 units) and would thus have received $174.80 less than the portion of the investment in the contract allocable to each of D's taxable years. In these circumstances, D would be entitled to elect to redetermine the portion of the investment in the contract allocable to the taxable year of election and all subsequent years. The new amount allocable thereto would be found by dividing the $174.80 difference by D's life expectancy as of the first day of the first period for which D received an amount as an annuity in the sixth year of the annuity contract, and adding the result to D's originally determined allocation of $414.80.

(c) *Expected return for term certain.* In the case of a contract providing for specific periodic payments which are to be paid for a term certain such as a fixed number of months or years, without regard to life expectancy, the expected return is determined by multiplying the fixed number of years or months for which payments are to be made on or after the annuity starting date by the amount of the payment provided in the contract for each such period.

(d) *Expected return with respect to amount certain.* In the case of contracts involving no life or lives as a measurement of their duration, but under which a determinable total amount is to be paid in installments of lesser amounts paid at periodic intervals, the expected return shall be the total amount guaranteed. If an amount is to be paid periodically until a fund plus interest at a fixed rate is exhausted, but further payments may be made thereafter because of earnings at a higher interest rate, this paragraph shall apply to the total amount anticipatable as a result of the amount of the fund plus the fixed interest thereon. Any amount which may be paid as the result of earnings at a greater interest rate shall be disregarded in determining the expected return. If such an amount is later received, it shall be considered an amount not received as an annuity after the annuity starting date. See paragraph (b)(2) of §1.72–11.

(e) *Expected return where two or more annuity elements providing for fixed payments are acquired for a single consideration.* (1) In the case of a contract described in paragraph (a)(2) of §1.72–2, which provides for specified payments to be made under two or more annuity elements, the expected return shall be found for the contract as a whole by aggregating the expected returns found with respect to each annuity element. If individual life annuity elements are involved (including joint and survivor annuities where the primary annuitant died before January 1, 1954) the expected return for each of them shall be determined in the manner prescribed in paragraph (a) of this section. If joint and survivor annuity elements are involved, the expected return for such elements shall be determined under the appropriate subparagraph of paragraph (b) of this section. If terms certain or amounts certain are involved, the expected returns for such elements shall be determined under paragraph (c) or (d) of this section, respectively.

(2) The aggregate expected return found in accordance with the rules set forth in subparagraph (1) of this paragraph shall constitute the expected return for the contract as a whole. The

investment in the contract shall be divided by the amount thus determined to obtain the exclusion ratio for the contract as a whole, This exclusion ratio shall be applied to all amounts received as a annuity under the contract by any recipient (in accordance with the provisions of § 1.72–4), except in the case of amounts received by a surviving annuitant under a joint and survivor annuity element to which the provisions of section 72(i) and paragraph (b)(3) of this section would apply if it were a separate contract. See subparagraph (3) of this paragraph.

(3) In the case of a contract providing two or more annuity elements, one of which is a joint and survivor annuity element of the type described in section 72(i) and paragraph (b)(3) of this section, the general exclusion ratio for the contract as a whole, for the purpose of computations with respect to all the other annuity elements shall be determined in accordance with the principles of subparagraphs (1) and (2) of this paragraph. A special exclusion ratio shall thereafter be determined for the surviving annuitant receiving payments under the annuity element described in section 72(i) and paragraph (b)(3) of this section by using the investment in the contract and the expected return determined in accordance with the provisions of paragraph (b)(3) of this section.

(4) In the case of a contract providing for payments to be made to two persons in the manner described in paragraph (b)(6) of this section, the expected return is to be computed as though there were two joint and survivor annuities under the same contract, in the following manner. First, the multiple appropriate to the ages (as of the annuity starting date) and, if applicable, sexes of the annuitants involved shall be found in Table II or VI (whichever is applicable) of § 1.72–9 and adjusted, if necessary, in the manner described in paragraph (a)(2) of this section. Second, the multiple so found shall be applied to the sum of the payments to be made each year to both annuitants. The result is the expected return for the contract as a whole.

(5) For rules relating to expected return where two or more annuity elements are acquired for a single consideration and one or more of such elements does not specify a fixed payment for each period, see paragraph (f) of this section.

(f) *Expected return with respect to obligations providing for payments described in paragraph (b)(3) of § 1.72–2.* (1) If a contract to which section 72 applies provides only for payments to be made in a manner described in paragraph (b)(3) of § 1.72–2, the expected return for such contract as a whole shall be an amount equal to the investment in the contract found in accordance with section 72(c)(1) and § 1.72–6, as adjusted for any refund feature in accordance with § 1.72–7.

(2) If a contract to which section 72 applies provides for annuity elements, one or more of which (but not all) provide for payments to be made in a manner described in paragraph (b)(3) of § 1.72–2:

(i) With respect to the portion of the contract providing for annuity elements to which paragraph (b)(3) of § 1.72–2 does not apply, the expected return shall be the aggregate of the expected returns found for each of such elements in accordance with the appropriate paragraph of this section; and

(ii) With respect to all annuity elements to which paragraph (b)(3) of § 1.72–2 does apply, the expected return for all such elements shall be an amount equal to the portion of the investment in the contract allocable to such elements in accordance with the provisions of paragraph (e)(2)(ii) of § 1.72–4 and paragraph (b)(3)(ii)(*b*) of § 1.72–6.

(g) *Expected return with respect to contracts subject to § 1.72–6(d).* In the case of a contract to which § 1.72–6(d) (relating to contracts in which amounts were invested both before July 1, 1986, and after June 30, 1986) applies, an expected return is computed using the multiples in Tables I through IV of § 1.72–9 with respect to the pre-July 1986 investment in the contract and a second expected return is computed using the multiples in Tables V through VIII of § 1.72–9 with respect to the post-June 1986 investment in the contract.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 8115, 51 FR 45694, Dec. 19, 1986]

§1.72–6 Investment in the contract.

(a) *General rule.* (1) For the purpose of computing the ''investment in the contract'', it is first necessary to determine the ''aggregate amount of premiums or other consideration paid'' for such contract. See section 72(c)(1). This determination is made as of the later of the annuity starting date of the contract or the date on which an amount is first received thereunder as an annuity. The amount so found is then reduced by the sum of the following amounts in order to find the investment in the contract:

(i) The total amount of any return of premiums or dividends received (including unrepaid loans or dividends applied against the principal or interest on such loans) on or before the date on which the foregoing determination is made, and

(ii) The total of any other amounts received with respect to the contract on or before such date which were excludable from the gross income of the recipient under the income tax law applicable at the time of receipt.

Amounts to which subdivision (ii) of this subparagraph applies shall include, for example, amounts considered to be return of premiums or other consideration paid under section 22(b)(2) of the Internal Revenue Code of 1939 and amounts considered to be an employer-provided death benefit under section 22(b)(1)(B) of such Code. For rules relating to the extent to which an employee or his beneficiary may include employer contributions in the aggregate amount of premiums or other consideration paid, see §1.72–8. If the aggregate amount of premiums or other consideration paid for the contract includes amounts for which deductions were allowed under section 404 as contributions on behalf of a self-employed individual, such amounts shall not be included in the investment in the contract.

(2) For the purpose of subparagraph (1) of this paragraph, amounts received subsequent to the receipt of an amount as an annuity or subsequent to the annuity starting date, whichever is the later, shall be disregarded. See, however, §1.72–11.

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

Example (1). In 1950, B purchased an annuity contract for $10,000 which was to provide him with an annuity of $1,000 per year for life. He received $1,000 in each of the years 1950, 1951, 1952, and 1953, prior to the annuity starting date (January 1, 1954). Under the Internal Revenue Code of 1939, $300 of each of these payments (3 percent of $10,000) was includible in his gross income, and the remaining $700 was excludable therefrom during each of the taxable years mentioned. In computing B's investment in the contract as of January 1, 1954, the total amount excludable from his gross income during the years 1950 through 1953 ($2,800) must be subtracted from the consideration paid ($10,000). Accordingly, B's investment in the contract as of January 1, 1954, is $7,200 ($10,000 less $2,800).

Example (2). In 1945, C contracted for an annuity to be paid to him beginning December 31, 1960. In 1945 and in each successive year until 1960, he paid a premium of $5,000. Assuming he receives no payments of any kind under the contract until the date on which he receives the first annual payment as an annuity (December 31, 1960), his investment in the contract as of the annuity starting date (December 31, 1959) will be $75,000 ($5,000 paid each year for the 15 years from 1945 to 1959, inclusive).

Example (3). Assume the same facts as in example (2), except that prior to the annuity starting date C has already received from the insurer dividends of $1,000 each in 1949, 1954, and 1959, such dividends not being includible in his gross income in any of those years. C's investment in the contract, as of the annuity starting date, will then be $72,000 ($75,000–$3,000).

(b) *Allocation of the investment in the contract where two or more annuity elements are acquired for a single consideration.* (1) In the case of a contract described in §1.72–2(a)(2) which provides for two or more annuity elements, the investment in the contract determined under paragraph (a) shall be allocated to each of the annuity elements in the ratio that the expected return under each annuity element bears to the aggregate of the expected returns under all the annuity elements. The exclusion ratio for the contract as a whole shall be determined by dividing the investment in the contract (after adjustment for the present value of any or all refund features) by the aggregate of the expected returns under all the annuity elements. This may be illustrated by the following examples:

Example (1). If a contract provides for annuity payments of $1,000 per year for life (with no refund feature) to both A and B, a male and female, respectively, each 70 years of age as of the annuity starting date, such contract is acquired for consideration of $19,575 (without regard to whether paid by A, B, or both), and there is no post-June 1986 investment in the contract, the investment in the contract shall be allocated by determining the exclusion ratio for the contract as a whole in the following manner:

Expectancy of A under Table I and §1.72–5(a)(2), 11.6 (12.1–0.5), multiplied by $1,000	$11,600
Plus: Expectancy of B computed in a similar manner ($1,000×14.5 [15.0−0.5])	14,500
Total expected return	26,100

The exclusion ratio for both A and B is then $19,575÷$26,100, or 75 percent. A and B shall each exclude from gross income three-fourths ($750) of each $1,000 annual payment received and shall include the remaining one-fourth ($250) of each $1,000 annual payment received in gross income.

Example (2). Assume the same facts as in example (1) except that of the total investment in the contract of $19,575, the pre-July 1986 investment in the contract is $10,000. If the election described in §1.72–6(d)(6) is made with respect to the contract, the investment in the contract shall be allocated by determining an exclusion ratio for the contract as a whole based on separately computed exclusion ratios with respect to the pre-July 1986 investment in the contract and the post-June 1986 investment in the contract in the following manner:

Expectancy of A under Table I and §1.72–5(a)(2), 11.6 (12.1–0.5), multiplied by $1,000	$11,600
Plus: Expectancy of B under Table I and §1.72–5(a)(2), 14.5 (15.0–0.5), multiplied by $1,000	$14,500
Pre-July 1986 expected return	$26,100
Expectancy of A under Table V and §1.72–5(a)(2), 15.5 (16.0–0.5), multiplied by $1,000	$15,500
Plus: Expectancy of B under Table V and §1.72–5(a)(2), 15.5 (16.0–0.5), multiplied by $1,000	$15,500
Post-June 1986 expected return	$31,000
Pre-July 1986 exclusion ratio ($10,000÷$26,100)	38.3
Post-June 1986 exclusion ratio ($9,575÷31,000)	30.9

A and B shall each exclude from gross income $692 (38.3 percent of $1,000+30.9 percent of $1,000) of each $1,000 payment and include the remaining $308 in gross income

(2) In the case of a contract providing for specified annual annuity payments to be made to two persons during their joint lives and the payment of the aggregate of the two individual payments to the survivor for his life, the investment in the contract shall be allocated in accordance with the provisions of subparagraph (1) of this paragraph. For this purpose, the investment in the contract (without regard to the fact that differing amounts may have been contributed by the two annuitants) shall be divided by the expected return determined in accordance with paragraph (e)(4) of §1.72–5. The resulting exclusion ratio shall then be applied to any amounts received as an annuity by either annuitant.

(3) In the case of a contract providing two or more annuity elements, one or more of which provides for payments to be made in a manner described in paragraph (b)(3) of §1.72–2, the investment in the contract shall be allocated to the various annuity elements in the following manner.

(i) If all the annuity elements provide for payments to be made in the manner described in paragraph (b)(3) of §1.72–2, the investment in the contract shall be allocated on the basis of the amounts received by each recipient by apportioning the amount determined to be excludable under that section to each recipient in the same ratio as the total of the amounts received by him in the taxable year bears to the total of the amounts received by all recipients during the same period; and

(ii) If one or more, but not all, of the annuity elements provide for payments to be made in a manner described in paragraph (b)(3) of §1.72–2:

(*a*) With respect to all annuity elements to which that section does not apply, the investment in the contract for all such elements shall be the portion of the investment in the contract as a whole (found in accordance with the provisions of this section) which is properly allocable to all such elements; and (*b*) With respect to all annuity elements to which paragraph (b)(3) of §1.72–2 does apply, the investment in the contract for all such elements shall be the investment in the contract as a whole (found in accordance with the provisions of this section) as reduced by the portion thereof determined under (*a*) of this subdivision.

For the purpose of determining, pursuant to (*a*) of this subdivision, the portion of the investment in the contract as a whole properly allocable to a particular annuity element, reference shall be made to the present value of such annuity element determined in accordance with paragraph (e)(1)(iii) (*b*) of §1.101–2.

(iii) In the case of a contract to which paragraph (d) of this section applies, this paragraph (b) is applied in the manner prescribed in paragraph (d) and, in particular, paragraph (d)(5)(v) of this section.

(c) *Special rules.* (1) For the special rule for determining the investment in the contract for a surviving annuitant in cases where the prior annuitant of a joint and survivor annuity contract died in 1951, 1952, or 1953, see paragraph (b)(3) of §1.72–5.

(2) For special rules relating to the determination of the investment in the contract where employer contributions are involved, see §1.72–8. See also paragraph (b) of §1.72–16 for a special rule relating to the determination of the premiums or other consideration paid for a contract where an employee is taxable on the premiums paid for life insurance protection that is purchased by and considered to be a distribution from an exempt employees' trust.

(3) For the determination of an adjustment in investment in the contract in cases where a contract contains a refund feature, see §1.72–7.

(4) In the case of ''face-amount certificates'' described in section 72(1), the amount of consideration paid for purposes of computing the investment in the contract shall include any amount added to the holder's basis by reason of section 1232(a)(3)(E) (relating to basis adjustment for amount of original issue discount ratably included in gross income as interest under section 1232(a)(3)).

(d) *Pre-July 1986 and post-June 1986 investment in the contract.* (1) This paragraph (d) applies to an annuity contract if:

(i) The investment in the contract includes a pre-July 1986 investment in the contract and a post-June 1986 investment in the contract (both as defined in §1.72–6(d)(3));

(ii) The use of a multiple found in Tables I through VIII of §1.72–9 is required to determine the expected return under the contract; and

(iii) The election described in paragraph (d)(6) of this section is made with respect to the contract.

(2) In the case of annuity contract to which this paragraph (d) applies—

(i) All computations required to determine the amount excludable from gross income shall be performed separately with respect to the pre-July 1986 investment in the contract and the post-June 1986 investment in the contract as if each such amount were the entire investment in the contract;

(ii) The multiples in Tables I through IV shall be used for computations involving the pre-July 1986 investment in the contract and the multiples in Tables V through VIII shall be used for computations involving the post-June 1986 investment in the contract; and

(iii) The amount excludable from gross income shall be the sum of the amounts determined under the separate computations required by paragraph (d)(2)(i) of this section.

(3) For purposes of the regulations under section 72, the pre-July 1986 investment in the contract and post-June 1986 investment in the contract are determined in accordance with the following rules:

(i)(A) Except as provided in §1.72–9, if the annuity starting date of the contract occurs before July 1, 1986, the pre-July 1986 investment in the contract is the total investment in the contract as of the annuity starting date;

(B) Except as provided in §1.72–9, if the annuity starting date of the contract occurs after June 30, 1986, and the contract does not provide for a disqualifying form of payment or settlement, the pre-July 1986 investment in the contract is the investment in the contract computed as of June 30, 1986, as if June 30, 1986, had been the later of the annuity starting date of the contract or the date on which an amount is first received thereunder as an annuity;

(C) If the annuity starting date of the contract occurs after June 30, 1986, and the contract provides, at the option of the annuitant or of any other person (including, in the case of an employee's annuity, an option exercisable only by, or with the consent of, the employer), for a disqualifying form of payment or settlement, the pre-July 1986 investment in the contract is zero (i.e., the total investment in the contract is post-June 1986 investment in the contract).

(ii) The post-June 1986 investment in the contract is the amount by which the total investment in the contract as of the annuity starting date exceeds the pre-July 1986 investment in the contract.

(iii) For purposes of paragraph (d)(3)(i) of this section, a disqualifying form of payment or settlement is any form of payment or settlement (whether or not selected) that permits the receipt of amounts under the contract in a form other than a life annuity. For example, each of the following options provides for a disqualifying form of payment or settlement:

(A) An option to receive a lump sum in full discharge of the obligation under the contract.

(B) An option to receive an amount under the contract after June 30, 1986, and before the annuity starting date.

(C) An option to receive an annuity for a period certain.

(D) An option to receive payments under a refund feature (within the meaning of paragraphs (b) and (c) of §1.72–7) that is substantially equivalent to an annuity for a period certain.

(E) An option to receive a temporary life annuity (within the meaning of §1.72–5 (a)(3)) that is substantially equivalent to an annuity for a period certain.

An option to receive alternative forms of life annuity is not a disqualifying option for purposes of paragraph (d)(3)(i) of this section. Thus, if the sole options provided under a contract are a single life annuity and a joint and survivor life annuity, paragraph (d)(3)(i)(C) of this section does not apply to such contract.

(iv) For purposes of paragraph (d)(3)(iii) of this section, a refund feature is substantially equivalent to an annuity for a period certain if its value determined under Table VII of §1.72–9 exceeds 50 percent. Similarly, a temporary life annuity is substantially equivalent to an annuity for a period certain if the multiple determined under Table VIII of §1.72–9 exceeds 50 percent of the maximum duration of the annuity.

(4) In any separate computation under this paragraph (d), only the applicable portion of other amounts (such as the total expected return under the contract, or the total amount guaranteed under the contract as of the annuity starting date) shall be taken into account if the use of the entire amount in such computation is inconsistent with the use in the computation of only a portion of the investment in the contract. For example, such use is generally inconsistent if the computation requires a comparison of the investment in the contract and such other amount for the purpose of using the greater (or lesser) amount or the difference between the two. For purposes of the first sentence of this paragraph (d)(4), the applicable portion is the amount that bears the same ratio to the entire amount as the pre-July 1986, investment in the contract or the post-June 1986 investment in the contract, whichever is applicable, bears to the total investment in the contract as of the annuity starting date.

(5) *Application to particular computations.* (i) In the case of a contract to which this paragraph (d) applies, the exclusion ratio for purposes of §1.72–4 (a) is the sum of the exclusion ratios separately computed in accordance with this paragraph (d). The exclusion ratio with respect to the pre-July 1986 investment in the contract is determined by dividing the pre-July 1986 investment in the contract by the expected return as found under §1.72–5 by applying the appropriate multiples of Tables I through IV of §1.72–9. Similarly, the exclusion ratio with respect to the post-June 1986 investment in the contract is determined by dividing the

post-June 1986 investment in the contract by the expected return as found under §1.72–5 by applying the appropriate multiples in Tables V through VIII of §1.72–9.

(ii) The applicability of §1.72–4(d)(2) to a contract to which this paragraph (d) applies shall be determined separately with respect to the post-June 1986 investment in the contract and the pre-July 1986 investment in the contract and in each such determination only the applicable portion of the total expected return under the contract shall be taken into account. If §1.72–4(d)(2) applies with respect to either such investment in the contract, the separately computed exclusion ratio shall be considered to be the applicable portion of 100 percent.

(iii) If §1.72–4(d)(3) applies to a contract to which this paragraph (d) applies—

(A) The applicable portions (as defined in paragraph (d)(4) of this section) of payments received under the contract for a taxable year shall be separately computed;

(B) The pre-July 1986 investment in the contract and the post-June 1986 investment in the contract shall be separately allocated to the taxable year; and

(C) The separate applicable portions of the payments received under the contract for the taxable year shall be considered to be amounts received as an annuity (for which the exclusion ratio is 100 percent) only to the extent they do not exceed the portions of the corresponding investments in the contract which are properly allocable to that year.

See the example in §1.72–4(d)(3)(v).

(iv) If §1.72–4(e) applies to a contract to which this paragraph (d) applies, the exclusion ratio shall be separately computed with respect to the pre-July 1986 investment in the contract and the post-June 1986 investment in the contract. For purposes of the separate computations under §1.72–4(e)(2)(ii), only the applicable portion of payments received shall be taken into account and the exclusion ratio (100%) shall be applied to the separately computed portion allocated to each participant.

(v) If paragraph (b)(3) of this section applies to a contract to which this paragraph (d) applies, separate allocations are required with respect to the pre-July 1986 investment in the contract and the post-June 1986 investment in the contract.

For purposes of the separate computations required to determine the portion of the investment in the contract properly allocable to a particular annuity element, only the applicable portion of the present value of the annuity element determined in accordance with §1.101–2(e)(1)(iii)(b) is taken into account.

(vi) If §1.72–7 applies to a contract to which this paragraph (d) applies, separate computations are required to determine the adjustment to the pre-July 1986 investment in the contract and the post-June 1986 investment in the contract. For purposes of such separate computations, only the applicable portions of the amounts described in §1.72–7 (b)(3)(ii), (c)(1)(ii)(B), (c)(2)(vii)(B), and (d)(1)(ii) are taken into account. Similarly, in the case of computations with respect to the guarantee of a specified amount under §1.72–7(d)(1), only the applicable portion of such amount is taken into account.

(6) This paragraph (d) applies to a contract only if the first taxpayer to receive an amount as an annuity under the contract elects to perform separate computations with respect to the pre-July 1986 investment in the contract and the post-June 1986 investment in the contract as if each such amount were the entire investment in contract. If two or more annuitants receive an amount as an annuity under the contract at the same time (such as under a joint-and-last-survivorship annuity contract), an election by one of the annuitants is treated as an election by each of the annuitants. The election is made by attaching a statement to the first return filed by the taxpayer for the first taxable year in which an amount is received as an annuity under the contract. The statement must indicate that the taxpayer is electing to apply the provisions of paragraph (d) of §1.72–6, and must also contain the name, address, and taxpayer identification number of each annuitant under the contract, and the amount of the

pre-July 1986 investment in the contract.

(7) If the investment in the contract includes a post-June 1986 investment in the contract and the election described in paragraph (d)(6) of this section is not made—

(i) The amount excludable from gross income shall be determined without regard to the separate computations described in this paragraph (d); and

(ii) Only the multiples found in Tables V through VIII shall be used in determining the amount excludable from gross income.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10134, Sept. 17, 1963; T.D. 7311, 39 FR 11880, Apr. 1, 1974; T.D. 8115, 51 FR 45700, Dec. 19, 1986; 52 FR 10223, Mar. 31, 1987]

§ 1.72–7 Adjustment in investment where a contract contains a refund feature.

(a) *Definition of a contract containing a refund feature.* A contract to which section 72 applies, contains a refund feature if:

(1) The total amount receivable as an annuity under such contract depends, in whole or in part, on the continuing life of one or more persons,

(2) The contract provides for payments to be made to a beneficiary or the estate of an annuitant on or after the death of the annuitant if a specified amount or a stated number of payments has not been paid to the annuitant or annuitants prior to death, and

(3) Such payments are in the nature of a refund of the consideration paid. See paragraph (c)(1) of § 1.72–11.

(b) *Adjustment of investment for the refund feature in the case of a single life annuity.* Where a single life annuity contract to which section 72 applies contains a refund feature and the special rule of paragraph (d) of this section does not apply, the investment in the contract shall be adjusted in the following manner:

(1) Determine the number of years necessary for the guaranteed amount to be fully paid by dividing the maximum amount guaranteed as of the annuity starting date by the amount to be received annually under the contract to the extent such amount reduces the guaranteed amount. The number of years should be stated in terms of the nearest whole year, considering for this purpose a fraction of one-half or more as an additional whole year.

(2) Consult Table III or VII (whichever is applicable) of § 1.72–9 for the appropriate percentage under the whole number of years found in subparagraph (1) of this paragraph and the age (as of the annuity starting date) and, if applicable, sex of the annuitant.

(3) Multiply the percentage found in subparagraph (2) of this paragraph by whichever of the following is the smaller: (i) The investment in the contract found in accordance with § 1.72–6 or (ii) the total amount guaranteed as of the annuity starting date.

(4) Subtract the amount found in subparagraph (3) of this paragraph from the investment in the contract found in accordance with § 1.72–6.

The resulting amount is the investment in the contract adjusted for the present value of the refund feature without discount for interest and is to be used in determining the exclusion ratio to be applied to the payments received as an annuity. The percentage found in Tables III or VII shall not be adjusted in a manner described in paragraph (a)(2) of § 1.72–5. These principles may be illustrated by the following examples:

Example (1). On January 1, 1954, a husband, age 65, purchased for $21,053, an immediate installment refund annuity payable $100 per month for life. The contract provided that in the event the husband did not live long enough to recover the full purchase price, payments were to be made to his wife until the total payments under the contract equaled the purchase price. The investment in the contract adjusted for the purpose of determining the exclusion ratio is computed in the following manner:

Cost of the annuity contract (investment in the contract, unadjusted)	$21,053
Amount to be received annually	$1,200
Number of years for which payment guaranteed ($21,053 divided by $1,200)	17.5
Rounded to nearest whole number of years	18
Percentage located in Table III for age 65 (age of the annuitant as of the annuity starting date) and 18 (the number of whole years) (percent)	30

Subtract value of the refund feature to the nearest dollar (30 percent of $21,053)	$6,316
Investment in the contract adjusted for the present value of the refund feature without discount for interest	$14,737

Example (2). Assume the same facts as in example (1), except that the total investment in the contract was made after June 30, 1986. The investment in the contract adjusted for the purpose of determining the exclusion ratio is computed as follows:

Cost of the annuity contract (investment in the contract, unadjusted)	$21,053
Amount to be received annually	$1,200
Number of years for which payment guaranteed ($21,053÷$1,200)	17.5
Rounded to nearest whole number of years	18
Percentage in Table VII for age 65 and 18 years (percent)	15
Subtract value of the refund feature to the nearest dollar (15 percent of $21,053)	$3,158
Investment in the contract adjusted for the present value of the refund feature without discount for interest	$17,895

Example (3). Assume the same facts as in example (1), except that the pre-July 1986 investment in the contract is $10,000 and the post-June 1986 investment in the contract is $11,053. If the annuitant makes the election described in §1.72–6(d)(6), separate computations must be performed pursuant to §1.72–6(d) to determine the adjusted investment in the contract. The pre-July 1986 investment in the contract and the post-June 1986 investment in the contract adjusted for the purpose of determining the exclusion ratios are, respectively, $7,000 and $9,395, determined as follows:

Pre-July 1986 investment in the contract (unadjusted)	$10,000
Pre-July 1986 portion of the amount to be received annually ($10,000/$21,053×$1,200)	$570.00
Number of years for which payment guaranteed ($10,000÷$570)	17.50
Rounded to nearest whole number of years	18
Percentage in Table III for age 65 and 18 years (percent)	30
Subtract value of the refund feature to the nearest dollar (30 percent of $10,000)	$3,000
Pre-July 1986 investment in the contract adjusted for the present value of the refund feature without discount for interest	$7,000
Post-June 1986 investment in the contract (unadjusted)	$11,053
Post-June 1986 portion of the amount to be received annually ($11,053/$21,053×$1,200)	$630
Number of years for which payment guaranteed ($11,053÷$630)	17.54
Rounded to nearest whole number of years	18
Percentage in Table VII for age 65 and 18 years (percent)	15
Subtract value of the refund feature to the nearest dollar (15 percent of $11,053)	$1,658
Post-June 1986 investment in the contract adjusted for the present value of the refund feature without discount for interest	$9,395

If, in the above examples, the guaranteed amount had exceeded the investment in the contract (or applicable portion thereof), the percentage found in Table III or VII (whichever is applicable) should have been applied to the lesser of these amounts since any excess of the guaranteed amount over the investment in the contract (as found under §1.72–6) would not have constituted a refund of premiums or other consideration paid. In such a case, however, a different multiple might have been obtained from Table III or VII (whichever is applicable) since the number of years for which payments were guaranteed would have been greater.

(c) *Adjustment of investment for the refund feature in the case of a joint and survivor annuity.* (1) Except as provided in paragraph (c)(2) of this section, if a joint and survivor annuity contract described in paragraph (b) (1), (2) or (6) of §1.72–5 contains a refund feature and the special rule of paragraph (d) of this section does not apply, the investment in the contract shall be adjusted in the following manner:

(i) Find the percentage determined under the following formula:

$$V = \frac{\sum_{t=0}^{N-1} \frac{d_{x+t}}{l_x}\left[\left(N - \tfrac{1}{2} - t\right) - P\left(\frac{T_{y+t+1} - T_{y+t+M+1}}{l_y}\right)\right]}{N}$$

In which:

V=The percentage, rounded to the nearest whole percent,

x=The age at the nearest birthday of the primary annuitant,

y=The age at the nearest birthday of the survivor annuitant,

N=The guaranteed amount divided by the annual annuity payable to the primary annuitant, rounded to the nearest integer,

P=The annual annuity continued to the survivor annuitant divided by the annual annuity payable to the primary annuitant,

$$M = \frac{N - {}^{1}{}_{2} - t,}{P}$$

l_x=The number of survivors at age x, $d{=}l_x{-}l_{x+1}$, and

$$T_x = \sum_{s=0}^{\infty} \tfrac{1}{2}\left(l_{x+s} + l_{x+s+1}\right).$$

(ii) Multiply the percentage found in paragraph (c)(1)(i) of this section by the lesser of (A) the investment in the contract found in accordance with § 1.72–6, or (B) the total amount guaranteed as of the annuity starting date.

(iii) Subtract the amount found in paragraph (c)(1)(ii) of this section from the investment in the contract found in accordance with § 1.72–6.

In the case of a contract providing for payments to be made to two persons in the manner described in paragraph (b)(6) of § 1.72–5, this paragraph (c)(1) is applied as though the older person were the primary annuitant and the younger person were the survivor annuitant. For purposes of this paragraph (c)(1), the number of survivors at age$_x$ (l_x) is determined under the following table:

x	lx
5	1000000.
6	999729.
7	999493.
8	999284.
9	999069.
10	998849.
11	998620.
12	998382.
13	998135.
14	997876.
15	997606.
16	997322.
17	997025.
18	996714.
19	996387.
20	996044.
21	995684.
22	995304.
23	994905.
24	994484.
25	994041.
26	993573.
27	993080.
28	992563.
29	992024.
30	991461.
31	990876.
32	990269.
33	989638.
34	988984.
35	988303.
36	987593.
37	986846.
38	986055.
39	985210.
40	984298.
41	983310.
42	982230.
43	981046.
44	979742.
45	978302.
46	976709.
47	974945.
48	972992.
49	970832.
50	968447.
51	966000.

x	lx
52	963313.
53	960375.
54	957175.
55	953705.
56	949954.
57	945912.
58	941568.
59	936908.
60	931903.
61	926451.
62	920540.
63	914090.
64	907011.
65	899221.
66	890428.
67	880797.
68	870298.
69	858904.
70	846565.
71	832316.
72	816861.
73	800078.
74	781837.
75	762012.
76	740743.
77	717689.
78	692780.
79	665977.
80	637260.
81	607339.
82	575531.
83	541919.
84	506647.
85	469931.
86	432459.
87	394138.
88	355393.
89	316712.
90	278663.
91	242020.
92	207150.
93	174602.
94	144828.
95	118151.
96	94871.7
97	74863.6
98	58042.2
99	44176.1
100	32956.4
101	24044.8
102	17104.1
103	11815.5
104	7886.75
105	5054.94
106	3086.95
107	1778.82
108	955.465
109	470.955
110	208.668
111	80.7899
112	26.2340
113	6.69620
114	1.19385
115	.111460

(2) If the multiples in Tables I through IV of §1.72–9 are used to determine any portion of the expected return under a contract described in paragraph (c)(1) of this section, only the post-June 1986 investment in the contract (if any) shall be adjusted in the manner described in paragraph (c)(1) of this section, and the pre-July 1986 investment in the contract shall, in the case of a contract described in paragraph (b) (1) or (6) of §1.72–5, be adjusted in the following manner:

(i) Determine the number of years necessary for the guaranteed amount to be fully paid by dividing the maximum amount guaranteed as of the annuity starting date by the amount to be received annually under the contract. The number of years should be stated in terms of the nearest whole year, considering for this purpose a fraction of one-half or more as an additional whole year.

(ii) Consult Table III of §1.72–9 for the appropriate percentages under the whole number of years found in subdivision (i) of this subparagraph and the age (as of the annuity starting date) and sex of each annuitant. If the annuitants are not of the same sex, substitute for the female annuitant a male annuitant 5 years younger, or for the male annuitant a female annuitant 5 years older, so that Table III will be entered in both cases with the ages of annuitants of the same sex.

(iii) Find the sum of the two percentages found in accordance with subdivision (ii) of this subparagraph.

(iv) To the age of the elder of the two annuitants (as determined under subdivision (ii) of this subparagraph), add the number of years (indicated in the table below) opposite the number of years by which such annuitants' ages differ:

Number of years difference in age (2 male annuitants or 2 female annuitants)	Addition to older age in years
0 to 1, inclusive	9
2 to 3, inclusive	8
4 to 5, inclusive	7
6 to 8, inclusive	6
9 to 11, inclusive	5
12 to 15, inclusive	4
16 to 20, inclusive	3
21 to 27, inclusive	2
28 to 42, inclusive	1
Over 42	0

(v) Consult Table III for the appropriate percentage under the whole number of years found in subdivision (i) of this subparagraph and the age and sex of the elder annuitant as adjusted under subdivision (iv) of this subparagraph.

(vi) Subtract the percentage obtained in subdivision (v) of this subparagraph from the sum of the percentages found under subdivision (iii) of this subparagraph. If the result is less than one, subdivisions (vii) and (viii) of this subparagraph shall be disregarded and no adjustment made to the investment in the contract.

(vii) Multiply the percentage found in subdivision (vi) of this subparagraph by whichever of the following is the smaller: (A) the investment in the contract found in accordance with § 1.72–6 or (B) the total amount guaranteed as of the annuity starting date.

(viii) Subtract the amount found in subdivision (vii) of this subparagraph from the investment in the contract found in accordance with § 1.72–6.

(3) The principles of this paragraph (c) may be illustrated by the following examples:

Example (1). Prior to July 1, 1986, Taxpayer A, a 70-year-old male, purchases a joint and last survivor annuity for $33,050. The contract provides for payments of $100 a month to be paid first to himself for life and then to B, his 40-year-old daughter, if she survives him. The contract further provides that in the event both die before ten years' payments have been made, payments will be continued to C, a beneficiary, or to C's estate, until ten years' payments have been made. If there is no post-June 1986 investment in the contract, the investment in the contract adjusted for the purpose of determining the exclusion ratio is computed in the following manner:

Cost of the annuity contract (investment in the contract unadjusted)	$33,050
Guaranteed amount ($1,200×10)	$12,000
Percentage in Table III for male, age 70 (or female, age 75) for duration of the guarantee (10)	21
Percentage in Table III for female, age 40 (or male, age 35) for duration of the guarantee (10)	2
Sum of percentages obtained	23
Difference in years of age between two males, aged 70 and 35 (or 2 females, aged 75 and 40)	35
Addition, in years, to older age	1
Percentage in Table III for male one year older than A	22
Difference between percentages obtained (23 percent less 22 percent)	1
Value of the refund feature to the nearest dollar (1 percent of $12,000)	$120
Investment in the contract adjusted for present value of the refund feature	$32,930

Example (2). The facts are the same as in example (1), except that the total investment in the contract was made after June 30, 1986, A is 73 years of age, and B is A's 70 year old spouse. The percentage determined under the formula in paragraph (c)(1)(i) of this section is two percent. Thus, the amount determined under paragraph (c)(1)(ii) of this section is $240 (2 percent of $12,000), and the investment in the contract adjusted for the present value of the refund feature is $32,810 ($33,050—$240).

(4) If an annuity described in paragraph (b) of § 1.72–5 contains a refund feature and the manner of determining the adjustment to the investment in the contract (or to any part of such investment) is not prescribed or requires use of the formula in paragraph (c)(1)(i) of this section, the Commissioner will determine the amount of the adjustment upon request. The request must contain the date of birth of each annuitant, the guaranteed amount, the annual annuity payable to each annuitant, and the annuity starting date. Send the request to the Commissioner of Internal Revenue, Attention: OP:E:EP:GA, Washington, D.C. 20224.

(d) *Adjustment of investment in the contract where paragraph (b)(3) of § 1.72–2 applies to payments.* (1) If paragraph (b)(3) of § 1.72–2 applies to payments to be made under a contract and this section also applies because of the provision for a refund feature, an adjustment shall be made to the investment in the contract in accordance with this paragraph before making the computations required by paragraph (d)(3) of § 1.72–4 and paragraph (d)(7) of § 1.72–5. In the case of the guarantee of a specified amount, the adjustment shall be made by applying the appropriate multiple from Table III or VII (whichever is applicable), as otherwise determined under this section, to the investment in the contract or the guranteed amount, whichever is the lesser. The guarantee period shall be found by dividing the amount guaranteed by the amount determined by placing the payments received during the first taxable year (to guaranteed amount) on an annual basis. Thus, if monthly payments are first received by a taxpayer on a calendar year basis in August, his total payments (to the extent that they reduce the guaranteed amount) for the taxable year would be divided by 5 and multiplied by 12. The guaranteed amount would then be divided by the result of this computation to obtain the guarantee period. If the contract merely guarantees that proceeds from a unit or units of a fund shall be paid for a fixed number of years or the life (or lives) of an annuitant (or annuitants), whichever is the longer, the fixed number of years is the guarantee period. The appropriate percentage in Table III or VII shall be applied to whichever of the following is the smaller: (i) the investment in the contract; or (ii) the product of the payments received in the first taxable year, placed on an annual basis, multiplied by the number of years for which payment of the proceeds of a unit or units is guaranteed.

(2) The principles of this paragraph may be illustrated by the following examples:

Example (1). Taxpayer A, a 50-year-old male purchases for $25,000 a contract which provides for variable monthly payments to be paid to him for his life. The contract also provides that if he should die before receiving payments for fifteen years, payments shall continue according to the original formula to his estate or beneficiary until payments have been made for that period. Beginning with the month of September, A receives payments which total $450 for the first taxable year of receipt. This amount, placed on an annual basis, is $1,350 ($450 divided by 4, or $112.50; $112.50 multiplied by 12, or $1,350). If there is no post-June 1986 investment in the contract, the guaranteed amount is considered to be $20,250 ($1,350×15), and the multiple from Table III (found in the same manner as in paragraph (b) of this section), 9 percent, applied to $20,250 (since this amount is less than the investment in the contract), results in a refund adjustment of $1,822,50. The latter amount, subtracted from the investment in the contract of $25,000, results in an adjusted investment in the contract of $23,177.50. If A dies before receiving payments for 15 years and the remaining payments are made to B, his beneficiary, B shall exclude the entire amount of such payments from his gross income until the amounts so received by B, together with the amount received by A and excludable from A's gross income, equal or exceed $25,000. Any excess and any payments thereafter received by B shall be fully includible in gross income.

Example (2). Assume the same facts as in example (1), except that the total investment in the contract was made after June 30, 1986. The applicable multiple found in Table VII is 3 percent. When this is applied to the guaranteed amount of $20,250, it results in a refund adjustment of $607.50. The adjusted investment in the contract in $24,392.50 ($25,000—$607.50).

(e) *Adjustment of the investment in the contract where more than one annuity element is provided for a single consideration.* In the case of contracts to which paragraph (b) of §1.72–6 applies for the purpose of allocating the investment in the contract to two or more annuity elements which are provided for a single consideration, if one or more of such elements involves a refund feature, the portion of the investment in the contract properly allocable to each such element shall be adjusted for the refund feature before aggregating all the investments in order to obtain the exclusion ratio which is to apply to the contract as a whole.

Example (1). If taxpayer A, an insured 70 years of age, upon maturity of an endowment policy which cost him a net amount of $86,000, elected a dual settlement consisting of (1) monthly payments for his life aggregating $4,146 per year with 10 years' payments certain, and (2) monthly payments for his 60-year-old brother, B, aggregating $2,820 per year with 20 years' payments certain, the exclusion ratio to be used by both A and B if there is no post-June 1986 investment in the contract would be determined in the following manner:

A's expected return (A's payments per year of $4,146 multiplied by his life expectancy from Table 1 of 12.1)	$50,166.60
B's expected return (B's payments per year of $2,820 multiplied by his life expectancy from Table 1 of 18.2)	$51,324.00
Sum of expected returns to be used in determining exclusion ratio	$101,490.60
Percentage of total expected return attributable to A's expectancy of life ($50,166.60÷$101,490.60)	49.4

Percentage of total expected return attributable to B's expectancy of life ($51,324÷$101,490.60)	50.6
Portion of investment in the contract allocable to A's annuity (49.4 percent of $86,000)	$42,484.00
Portion of investment in the contract allocable to B's annuity (50.6 percent of $86,000)	$43,516.00
Value of the refund feature with respect to A's annuity (percentage from Table III for male, age 70, and duration 10, or 21 percent, multiplied by lesser of guaranteed amount and allocable portion of investment in the contract, $41,460)	$8,707.00
A's allocable portion of the investment in the contract adjusted for refund feature ($42,484 less $8,707.00)	$33,777.00
Value of the refund feature with respect to B's annuity (percentage from Table III for male, age 60, and duration 20, or 25 percent, multiplied by lesser of guaranteed amount and allocable portion of investment in the contract, $43,516)	$10,879.00
B's allocable portion of the investment in the contract adjusted for refund feature ($43,516 less $10,879.00)	$32,637.00
Sum of A's and B's allocable portions of the investment in the contract after adjustment for the refund feature	$66,414.00
Exclusion ratio for the contract as a whole (total adjusted investment in the contract, $66,414, divided by the total expected return from above, $101,490.60) (percent)	65.4

Example (2). Assume the same facts as in example (1) except that the total investment in the contract was made after June 30, 1986. The exclusion ratio to be used by both A and B would be 56.9 percent, determined as follows:

A's expected return (A's payments per year of $4,146 multiplied by his life expectancy from Table V of 16.0)	$66,336.00
B's expected return (B's payments per year of $2,820 multiplied by his life expectancy from Table V of 24.2)	$68,244.00
Sum of expected returns to be used in determining exclusion ratio	$134,580.00
Percentage of total expected return attributable to A's expectancy of life ($66,336.00÷$134,580.00)	49.3
Percentage of total expected return attributable to B's expectancy of life ($68,244.00÷$134,580.00)	50.7
Portion of investment in the contract allocable to A's annuity (49.3 percent of $86,000)	$42,398.00
Portion of investment in the contract allocable to B's annuity (50.7 percent of $86,000)	$43,602.00
Value of the refund feature with respect to A's annuity (percentage from Table VII for age 70 and duration 10, or 11 percent, multiplied by lesser of the guaranteed amount and allocable portion of investment in the contract, $41,460)	$4,560.60
A's allocable portion of the investment in the contract adjusted for refund feature ($42,398 less $4,560.60)	$37,837.40
Value of the refund feature with respect to B's annuity (percentage from Table VII for age 60 and duration 20, or 11 percent, multiplied by lesser of guaranteed amount and allocable portion of investment in the contract, $43,602)	$4,796.22
B's allocable portion of the investment in the contract adjusted for refund feature ($43,602 less $4,796.22)	$38,805.78
Sum of A's and B's allocable portions of the investment in the contract after adjustment for the refund feature	$76,643.18
Exclusion ratio for the contract as a whole (total adjusted investment in the contract, $76,643.18, divided by the total expected return from above, $134,580.00) (percent)	56.9

(f) *Adjustment of investment in the contract with respect to contracts subject to §1.72–6(d).* In the case of a contract to which §1.72–6(d) (relating to contracts in which amounts were invested both before July 1, 1986, and after June 30, 1986) applies, this section is applied in the manner prescribed in §1.72–6(d) and, in particular, §1.72–6(d)(5)(vi).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 8115, 51 FR 45702, Dec. 19, 1986]

§1.72–8 Effect of certain employer contributions with respect to premiums or other consideration paid or contributed by an employee.

(a) *Contributions in the nature of compensation*—(1) *Amounts includible in gross income of employee under subtitle A of the Code or prior income tax laws.* Section 72(f) provides that for the purposes of section 72 (c), (d), and (e), amounts contributed by an employer for the benefit of an employee or his beneficiaries shall constitute consideration paid or contributed by the employee to the extent that such amounts were includible in the gross income of the employee under subtitle A of the Code or prior income tax laws. Amounts to which this paragraph applies include, for example, contributions made by an employer to or under a trust or plan which fails to qualify under the provisions of section 401(a), provided that the employee's rights to such contributions are nonforfeitable at the time the contributions are made. See sections 402(b) and 403(c) and the regulations thereunder. This subparagraph also applies to premiums paid by an employer (other than premiums paid on behalf of an owner-employee) for life insurance protection for an employee if such premiums are includible in the gross income of the employee when paid. See §1.72–16. However, such premiums shall only be considered as premiums and other consideration paid by the employee with respect to any benefits attributable to the contract providing the life insurance protection. See §1.72–16.

(2) *Amounts not includible in gross income of employee at time contributed if paid directly to employee at that time.* Except as provided in subparagraph (3) of this paragraph, section 72(f) provides that for the purposes of section 72 (c), (d), and (e), amounts contributed by an employer for the benefit of an employee or his beneficiaries shall constitute consideration paid or contributed by the employee to the extent that such amounts would not have been includible in the gross income of the employee at the time contributed had they been paid directly to the employee at that time. Amounts to which this subparagraph applies include, for example, contributions made by an employer after December 31, 1950, and before January 1, 1963, if made on account of foreign services rendered by an employee during a period in which the employee qualified as a bona fide resident of a foreign country under section 911(a) of the Internal Revenue Code of 1954, or under section 116(a) of the Internal Revenue Code of 1939. In such a case, it would be immaterial whether such contributions were made under a qualified plan or otherwise. See subparagraph (4) of this paragraph for rules governing the determination of the amount of employer foreign service contributions to which this subparagraph applies. On the other hand, if contributions are made by an employer to a qualified plan at a time when compensation paid directly to the employee concerned with respect to the same services rendered would have been includible in the gross income of the employee, such as in the case of an employee of a State government where contributions are made in 1955 with respect to services rendered by the employee prior to the year 1939, this subparagraph does not apply to such contributions.

(3) *Limitation*—(i) *In general.* Except as provided in subdivision (ii) of this subparagraph, the provisions of subparagraph (2) of this paragraph shall not apply to amounts which were contributed by the employer after December 31, 1962, and which would not have been includible in the gross income of the employee by reason of the application of section 911, if such amounts had been paid directly to the employee at the time of contribution. Employer contributions attributable to foreign services performed by the employee after December 31, 1962, do not constitute, for purposes of section 72 (c),

(d), and (e), consideration paid or contributed by the employee.

(ii) *Exception.* The provisions of subdivision (i) of this subparagraph shall not apply to amounts which were contributed by the employer to provide pension or annuity credits (determined in accordance with the provisions of subparagraph (4) of this paragraph) to the extent such credits are—

(a) Attributable to foreign services performed before January 1, 1963, with respect to which the employee qualified for the benefits of section 911(a) (or corresponding provisions of prior revenue laws), and

(b) Provided pursuant to pension or annuity plan provisions in existence on March 12, 1962, and on that date applicable to such services.

Amounts described in this subdivision constitute, for purposes of section 72 (c), (d), and (e), consideration paid or contributed by the employee even though such amounts are contributed by the employer after December 31, 1962.

(4) *Determination of employer foreign service contributions which constitute consideration paid or contributed by employee.* For purposes of subparagraphs (2) and (3)(ii) of this paragraph, employer foreign service contributions which constitute, for purposes of section 72 (c), (d), and (e), consideration paid or contributed by the employee shall be determined as follows:

(i) *Treatment of identifiable contributions.* If, under the terms of the pension or annuity plan under which employer contributions were made, such contributions may be identified as—

(a) Attributable to foreign services performed before January 1, 1963, with respect to which the employee qualified for the benefits of section 911(a) (or corresponding provisions of prior revenue laws), and

(b) Made under pension or annuity plan provisions in existence on March 12, 1962, which were applicable to the services referred to in *(a)* of this subdivision on that date,

the amount of employer contributions so identified shall be considered paid or contributed by the employee.

(ii) *Alternative rule for unidentifiable contributions.* If employer contributions may not be identified in the manner described in subdivision (i) of this subparagraph, the amount of employer contributions attributable to foreign services performed before January 1, 1963, and considered paid or contributed by the employee shall be determined on the basis of an estimated allocation which is reasonable and consistent with the circumstances and the provisions of the pension or annuity plan under which such contributions are made. For example, if an employee's benefits under a pension or annuity plan, which is unchanged after March 12, 1962, are determined with respect to his basic compensation during his entire period of credited service, the amount of employer contributions considered paid or contributed by the employee shall be an amount which bears the same ratio to total employer contributions for such employee under the pension or annuity plan as his basic compensation attributable to foreign services performed before January 1, 1963, with respect to which he qualified for the benefits of section 911(a) (or corresponding provisions of prior revenue laws) bears to his total basic compensation. On the other hand, if an employee's benefits under a pension or annuity plan, which is unchanged after March 12, 1962, are determined with respect to his basic compensation during his final five years of credited service, the amount of employer contributions considered paid or contributed by the employee shall be an amount which bears the same ratio to total employer contributions for such employee as his number of years of credited service before January 1, 1963, with respect to which he qualified for the benefits of section 911(a) (or corresponding provisions of prior revenue laws) bears to his total number of years of credited service.

(5) *Amounts not includible in gross income of employee under subtitle A of the Code or prior income tax laws.* Amounts contributed by an employer which were not includible in the gross income of the employee under Subtitle A of the Code or prior income tax laws, but which would have been includible therein had they been paid directly to the employee, do not constitute consideration paid or contributed by the employee for the purposes of section 72.

For example, contributions made by an employer under a qualified employees' trust or plan, which contributions would have been includible in the gross income of the employee had such contributions been paid to him directly as compensation, do not constitute consideration paid or contributed by the employee. Accordingly, the aggregate amount of premiums or other consideration paid or contributed by an employee, insofar as compensatory employer contributions are concerned, consists solely of the (i) sum of all amounts actually contributed by the employee, plus (ii) contributions in the nature of compensation which are deemed to be paid or contributed by the employee under this paragraph.

(b) *Contributions in the nature of death benefits.* In the case of an employee's beneficiary, the aggregate amount of premiums or other consideration paid or deemed to be paid or contributed by the employee shall also include:

(1) Amounts (other than amounts paid as an annuity) to the extent such amounts are excludable from the beneficiary's gross income as a death benefit under section 101(b), and

(2) Any amount or amounts of death benefits which are treated as additional consideration contributed by the employee under section 101(b)(2)(D) and the regulations thereunder, or which were excludable from the beneficiary's gross income as a death benefit under section 22(b)(1)(B) of the Internal Revenue Code of 1939 and the regulations thereunder.

Accordingly, in the case of an employee's beneficiary, any such amount shall be added to any amount or amounts deemed paid or contributed by the employee under paragraph (a)(1) of this section and to any amounts actually contributed by the employee for the purpose of finding the aggregate amount of premiums or other consideration paid or contributed by the employee.

(c) *Amounts ''made available'' to an employee or his beneficiary.* Any amount which, although not actually paid, is made available to and includable in the gross income of an employee or his beneficiary under the rules of sections 402 and 403 and the regulations thereunder, shall be considered an amount contributed by the employee and shall be aggregated with amounts, if any, to which paragraphs (a) and (b) of this section apply for the purpose of determining the aggregate amount of premiums or other consideration paid by the employee.

(d) *Amounts includable in gross income of employee when his rights under annuity contract change to nonforfeitable rights.* Any amount which, by reason of section 403(d) and after the application of paragraph (b) of §1.403 (b)–1, is required to be included in an employee's gross income for the year when his rights under an annuity contract change from forfeitable to nonforfeitable rights shall be considered an amount contributed by the employee and shall be aggregated with amounts, if any, to which paragraphs (a), (b), and (c) of this section apply for the purpose of determining the aggregate amount of premiums or other consideration paid or contributed by the employee for such annuity contract. In other words, if, under section 403(d), an employee of an organization exempt from tax under section 501(a) or 521(a) is required to include an amount in gross income by reason of his rights under an annuity contract changing from forfeitable to nonforfeitable rights, such amount, to the extent it is not excludable from gross income under paragraph (b) of §1.403 (b)–1, shall be considered an amount contributed by such employee for the annuity contract.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6665, 28 FR 7245, July 16, 1963; T.D. 6783, 29 FR 18356, Dec. 24, 1964]

§1.72–9 Tables.

The following tables are to be used in connection with computations under section 72 and the regulations thereunder. Tables I, II, IIA, III, and IV are to be used if the investment in the contract does not include a post-June 1986 investment in the contract (as defined in §1.72–6(d)(3)). Tables V, VI, VIA, VII, and VIII are to be used if the investment in the contract includes a post-June 1986 investment in the contract (as defined in §1.72–6(d)(3)).

In the case of a contract under which amounts are received as an annuity after June 30, 1986, a taxpayer receiving such amounts may elect to treat the entire investment in the contract as post-June 1986 investment in the contract and thus apply Tables V through VIII. A taxpayer may make the election for any taxable year in which such amounts are received by attaching to the taxpayer's return for such taxable year a statement that the taxpayer is electing under § 1.72–9 to treat the entire investment in the contract as post-June 1986 investment in the contract. The statement must contain the taxpayer's name, address, and taxpayer identification number. The election is irrevocable and applies with respect to all amounts that the taxpayer receives as an annuity under the contract in the taxable year for which the election is made or in any subsequent taxable year. (Note that for purposes of the examples in §§ 1.72–4 through 1.72–11 the election described in this section is disregarded (i.e., it assumed that the taxpayer does not make an election under this section).) See also § 1.72–6(d)(3) for rules treating the entire investment in a contract as post-June 1986 investment in a contract if the annuity starting date of the contract is after June 30, 1986, and the contract provides for a disqualifying form of payment or settlement, such as an option to receive a lump sum in full discharge of the obligation under the contract. In addition, see § 1.72–6(d) for special rules concerning the tables to be used and the separate computations required if the investment in the contract includes both a pre-July 1986 investment in the contract and a post-June 1986 investment in the contract and the election described in § 1.72–6(d)(6) is made with respect to the contract.

TABLE I—ORDINARY LIFE ANNUITIES—ONE LIFE—EXPECTED RETURN MULTIPLES

Ages		Multiples
Male	Female	
6	11	65.0
7	12	64.1
8	13	63.2
9	14	62.3
10	15	61.4
11	16	60.4
12	17	59.5
13	18	58.6
14	19	57.7
15	20	56.7
16	21	55.8
17	22	54.9
18	23	53.9
19	24	53.0
20	25	52.1
21	26	51.1
22	27	50.2
23	28	49.3
24	29	48.3
25	30	47.4
26	31	46.5
27	32	45.6
28	33	44.6
29	34	43.7
30	35	42.8
31	36	41.9
32	37	41.0
33	38	40.0
34	39	39.1
35	40	38.2
36	41	37.3
37	42	36.5
38	43	35.6
39	44	34.7
40	45	33.8
41	46	33.0
42	47	32.1
43	48	31.2
44	49	30.4
45	50	29.6
46	51	28.7
47	52	27.9
48	53	27.1
49	54	26.3
50	55	25.5
51	56	24.7
52	57	24.0
53	58	23.2
54	59	22.4
55	60	21.7
56	61	21.0
57	62	20.3
58	63	19.6
59	64	18.9
60	65	18.2
61	66	17.5
62	67	16.9
63	68	16.2
64	69	15.6
65	70	15.0
66	71	14.4
67	72	13.8
68	73	13.2
69	74	12.6
70	75	12.1
71	76	11.6
72	77	11.0
73	78	10.5

TABLE I—ORDINARY LIFE ANNUITIES—ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

Ages		Multiples
Male	Female	
74	79	10.1
75	80	9.6
76	81	9.1
77	82	8.7
78	83	8.3
79	84	7.8
80	85	7.5
81	86	7.1
82	87	6.7
83	88	6.3
84	89	6.0
85	90	5.7
86	91	5.4
87	92	5.1
88	93	4.8
89	94	4.5
90	95	4.2
91	96	4.0
92	97	3.7
93	98	3.5
94	99	3.3
95	100	3.1
96	101	2.9
97	102	2.7
98	103	2.5
99	104	2.3
100	105	2.1
101	106	1.9
102	107	1.7
103	108	1.5
104	109	1.3
105	110	1.2
106	111	1.0
107	112	.8
108	113	.7
109	114	.6
110	115	.5
111	116	0

TABLE II—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES

Male	Female	Ages														
		Male 6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
		Female 11	12	13	14	15	16	17	18	19	20	21	22	23	24	25
6	11	73.5	73.0	72.6	72.2	71.8	71.4	71.0	70.7	70.4	70.0	69.7	69.5	69.2	68.9	68.7
7	12	73.0	72.6	72.1	71.7	71.3	70.9	70.5	70.1	69.8	69.4	69.1	68.8	68.5	68.3	68.0
8	13	72.6	72.1	71.6	71.2	70.8	70.4	70.0	69.6	69.2	68.9	68.5	68.2	67.9	67.6	67.3
9	14	72.2	71.7	71.2	70.7	70.3	69.9	69.4	69.0	68.7	68.3	67.9	67.6	67.3	67.0	66.7
10	15	71.8	71.3	70.8	70.3	69.8	69.4	68.9	68.5	68.1	67.7	67.4	67.0	66.7	66.4	66.1
11	16	71.4	70.9	70.4	69.9	69.4	68.9	68.5	68.0	67.6	67.2	66.8	66.5	66.1	65.8	65.4
12	17	71.0	70.5	70.0	69.4	68.9	68.5	68.0	67.5	67.1	66.7	66.3	65.9	65.5	65.2	64.8
13	18	70.7	70.1	69.6	69.0	68.5	68.0	67.5	67.1	66.6	66.2	65.8	65.4	65.0	64.6	64.2
14	19	70.4	69.8	69.2	68.7	68.1	67.6	67.1	66.6	66.1	65.7	65.3	64.8	64.4	64.0	63.7
15	20	70.0	69.4	68.9	68.3	67.7	67.2	66.7	66.2	65.7	65.2	64.8	64.3	63.9	63.5	63.1
16	21	69.7	69.1	68.5	67.9	67.4	66.8	66.3	65.8	65.3	64.8	64.3	63.8	63.4	63.0	62.6
17	22	69.5	68.8	68.2	67.6	67.0	66.5	65.9	65.4	64.8	64.3	63.8	63.4	62.9	62.5	62.0
18	23	69.2	68.5	67.9	67.3	66.7	66.1	65.5	65.0	64.4	63.9	63.4	62.9	62.4	62.0	61.5
19	24	68.9	68.3	67.6	67.0	66.4	65.8	65.2	64.6	64.0	63.5	63.0	62.5	62.0	61.5	61.0
20	25	68.7	68.0	67.3	66.7	66.1	65.4	64.8	64.2	63.7	63.1	62.6	62.0	61.5	61.0	60.6

Male	Female	Ages														
		Male 21	22	23	24	25	26	27	28	29	30	31	32	33	34
		Female 26	27	28	29	30	31	32	33	34	35	36	37	38	39
6	11	68.4	68.2	68.0	67.8	67.6	67.5	67.3	67.1	67.0	66.8	66.7	66.6	66.5	66.4
7	12	67.8	67.5	67.3	67.1	66.9	66.7	66.5	66.4	66.2	66.1	65.9	65.8	65.7	65.6
8	13	67.1	66.8	66.6	66.4	66.2	66.0	65.8	65.6	65.4	65.3	65.1	65.0	64.9	64.7
9	14	66.4	66.2	65.9	65.7	65.4	65.2	65.0	64.8	64.7	64.5	64.3	64.2	64.1	63.9
10	15	65.8	65.5	65.2	65.0	64.7	64.5	64.3	64.1	63.9	63.7	63.6	63.4	63.3	63.1
11	16	65.1	64.8	64.6	64.3	64.1	63.8	63.6	63.4	63.2	63.0	62.8	62.6	62.5	62.3
12	17	64.5	64.2	63.9	63.6	63.4	63.1	62.9	62.7	62.4	62.2	62.0	61.9	61.7	61.5
13	18	63.9	63.6	63.3	63.0	62.7	62.4	62.2	61.9	61.7	61.5	61.3	61.1	60.9	60.8
14	19	63.3	63.0	62.7	62.3	62.0	61.8	61.5	61.2	61.0	60.8	60.6	60.4	60.2	60.0
15	20	62.7	62.4	62.0	61.7	61.4	61.1	60.8	60.6	60.3	60.1	59.8	59.6	59.4	59.2
16	21	62.2	61.8	61.4	61.1	60.8	60.5	60.2	59.9	59.6	59.4	59.1	58.9	58.7	58.5
17	22	61.6	61.2	60.9	60.5	60.2	59.8	59.5	59.2	58.9	58.7	58.4	58.2	57.9	57.7
18	23	61.1	60.7	60.3	59.9	59.6	59.2	58.9	58.6	58.3	58.0	57.7	57.5	57.2	57.0
19	24	60.6	60.2	59.7	59.4	59.0	58.6	58.3	57.9	57.6	57.3	57.0	56.8	56.5	56.3
20	25	60.1	59.6	59.2	58.8	58.4	58.0	57.7	57.3	57.0	56.7	56.4	56.1	55.8	55.6

21	26	59.6	59.1	58.7	58.3	57.9	57.5	57.1	56.7	56.4	56.0	55.7	55.4	55.1	54.9
22	27	59.1	58.7	58.2	57.7	57.3	56.9	56.5	56.1	55.8	55.4	55.1	54.8	54.5	54.2
23	28	58.7	58.2	57.7	57.2	56.8	56.4	55.9	55.5	55.2	54.8	54.4	54.1	53.8	53.5
24	29	58.3	57.7	57.2	56.8	56.3	55.8	55.4	55.0	54.6	54.2	53.8	53.5	53.2	52.8
25	30	57.9	57.3	56.8	56.3	55.8	55.3	54.9	54.4	54.0	53.6	53.2	52.9	52.5	52.2
26	31	57.5	56.9	56.4	55.8	55.3	54.8	54.4	53.9	53.5	53.1	52.7	52.3	51.9	51.6
27	32	57.1	56.5	55.9	55.4	54.9	54.4	53.9	53.4	53.0	52.5	52.1	51.7	51.3	50.9
28	33	56.7	56.1	55.5	55.0	54.4	53.9	53.4	52.9	52.4	52.0	51.6	51.1	50.7	50.3
29	34	56.4	55.8	55.2	54.6	54.0	53.5	53.0	52.4	52.0	51.5	51.0	50.6	50.2	49.3
30	35	56.0	55.4	54.8	54.2	53.6	53.1	52.5	52.0	51.5	51.0	50.5	50.1	49.6	49.2
31	36	55.7	55.1	54.4	53.8	53.2	52.7	52.1	51.6	51.0	50.5	50.0	49.5	49.1	48.7
32	37	55.4	54.8	54.1	53.5	52.9	52.3	51.7	51.1	50.6	50.1	49.5	49.1	48.6	48.1
33	38	55.1	54.5	53.8	53.2	52.5	51.9	51.3	50.7	50.2	49.6	49.1	48.6	48.1	47.6
34	39	54.9	54.2	53.5	52.8	52.2	51.6	50.9	50.3	49.8	49.2	48.7	48.1	47.6	47.1

Male	Female	Ages														
		Male 35	36	37	38	39	40	41	42	43	44	45	46	47	48	49
		Female 40	41	42	43	44	45	46	47	48	49	50	51	52	53	54
6	11	66.3	66.2	66.1	66.0	65.9	65.9	65.8	65.7	65.7	65.6	65.6	65.5	65.5	65.5	65.4
7	12	65.4	65.3	65.3	65.2	65.1	65.0	64.9	64.9	64.8	64.8	64.7	64.7	64.6	64.6	64.5
8	13	64.6	64.5	64.4	64.3	64.2	64.2	64.1	64.0	64.0	63.9	63.8	63.8	63.7	63.7	63.7
9	14	63.8	63.7	63.6	63.5	63.4	63.3	63.2	63.2	63.1	63.0	63.0	62.9	62.9	62.8	62.8
10	15	63.0	62.9	62.8	62.7	62.6	62.5	62.4	62.3	62.2	62.2	62.1	62.0	62.0	61.9	61.9
11	16	62.2	62.1	61.9	61.8	61.7	61.6	61.5	61.4	61.4	61.3	61.2	61.2	61.1	61.0	61.0
12	17	61.4	61.3	61.1	61.0	60.9	60.8	60.7	60.6	60.5	60.4	60.4	60.3	60.2	60.2	60.1
13	18	60.6	60.5	60.3	60.2	60.1	60.0	59.9	59.8	59.7	59.6	59.5	59.4	59.4	59.3	59.2
14	19	59.8	59.7	59.5	59.4	59.3	59.1	59.0	58.9	58.8	58.7	58.6	58.6	58.5	58.4	58.4
15	20	59.0	58.9	58.7	58.6	58.4	58.3	58.2	58.1	58.0	57.9	57.8	57.7	57.6	57.6	57.5
16	21	58.3	58.1	57.9	57.8	57.6	57.5	57.4	57.2	57.1	57.0	56.9	56.8	56.8	56.7	56.6
17	22	57.5	57.3	57.2	57.0	56.8	56.7	56.6	56.4	56.3	56.2	56.1	56.0	55.9	55.8	55.7
18	23	56.8	56.6	56.4	56.2	56.0	55.9	55.7	55.6	55.5	55.4	55.2	55.1	55.1	55.0	54.9
19	24	56.0	55.8	55.6	55.4	55.3	55.1	54.9	54.8	54.7	54.5	54.4	54.3	54.2	54.1	54.0
20	25	55.3	55.1	54.9	54.7	54.5	54.3	54.1	54.0	53.8	53.7	53.6	53.5	53.4	53.3	53.2
21	26	54.6	54.4	54.1	53.9	53.7	53.5	53.4	53.2	53.0	52.9	52.8	52.6	52.5	52.4	52.3
22	27	53.9	53.6	53.4	53.2	53.0	52.8	52.6	52.4	52.2	52.1	51.9	51.8	51.7	51.6	51.5
23	28	53.2	52.9	52.7	52.5	52.2	52.0	51.8	51.6	51.5	51.3	51.1	51.0	50.9	50.7	50.6
24	29	52.5	52.3	52.0	51.7	51.5	51.3	51.1	50.9	50.7	50.5	50.3	50.2	50.0	49.9	49.8
25	30	51.9	51.6	51.3	51.0	50.8	50.5	50.3	50.1	49.9	49.7	49.6	49.4	49.2	49.1	49.0
26	31	51.2	50.9	50.6	50.3	50.1	49.8	49.6	49.4	49.2	49.0	48.8	48.6	48.4	48.3	48.1
27	32	50.6	50.3	50.0	49.7	49.4	49.1	48.9	48.6	48.4	48.2	48.0	47.8	47.6	47.5	47.3

Male	Female	Ages														
		Male 35	36	37	38	39	40	41	42	43	44	45	46	47	48	49
		Female 40	41	42	43	44	45	46	47	48	49	50	51	52	53	54
28	33	50.0	49.6	49.3	49.0	48.7	48.4	48.2	47.9	47.7	47.5	47.2	47.1	46.9	46.7	46.5
29	34	49.4	49.0	48.7	48.3	48.0	47.7	47.5	47.2	47.0	46.7	46.5	46.3	46.1	45.9	45.7
30	35	48.8	48.4	48.1	47.7	47.4	47.1	46.8	46.5	46.2	46.0	45.8	45.5	45.3	45.2	45.0
31	36	48.2	47.8	47.5	47.1	46.8	46.4	46.1	45.8	45.6	45.3	45.0	44.8	44.6	44.4	44.2
32	37	47.7	47.3	46.9	46.5	46.1	45.8	45.5	45.2	44.9	44.6	44.3	44.1	43.9	43.7	43.4
33	38	47.2	46.7	46.3	45.9	45.5	45.2	44.8	44.5	44.2	43.9	43.7	43.4	43.2	42.9	42.7
34	39	46.7	46.2	45.8	45.4	45.0	44.6	44.2	43.9	43.6	43.3	43.0	42.7	42.5	42.2	42.0

Male	Female	Ages													
		Male 50	51	52	53	54	55	56	57	58	59	60	61	62	63
		Female 55	56	57	58	59	60	61	62	63	64	65	66	67	68
6	11	65.4	65.4	65.3	65.3	65.3	65.3	65.3	65.2	65.2	65.2	65.2	65.2	65.2	65.2
7	12	64.5	64.5	64.4	64.4	64.4	64.4	64.3	64.3	64.3	64.3	64.3	64.3	64.3	64.2
8	13	63.6	63.6	63.5	63.5	63.5	63.5	63.4	63.4	63.4	63.4	63.4	63.4	63.3	63.3
9	14	62.7	62.7	62.7	62.6	62.6	62.6	62.5	62.5	62.5	62.5	62.5	62.4	62.4	62.4
10	15	61.8	61.8	61.8	61.7	61.7	61.7	61.6	61.6	61.6	61.6	61.6	61.5	61.5	61.5
11	16	61.0	60.9	60.9	60.8	60.8	60.8	60.7	60.7	60.7	60.7	60.6	60.6	60.6	60.6
12	17	60.1	60.0	60.0	59.9	59.9	59.9	59.8	59.8	59.8	59.8	59.7	59.7	59.7	59.7
13	18	59.2	59.1	59.1	59.0	59.0	59.0	58.9	58.9	58.9	58.9	58.8	58.8	58.8	58.8
14	19	58.3	58.2	58.2	58.2	58.1	58.1	58.0	58.0	58.0	57.9	57.9	57.9	57.9	57.9
15	20	57.4	57.4	57.3	57.3	57.2	57.2	57.1	57.1	57.1	57.0	57.0	57.0	57.0	56.9
16	21	56.5	56.5	56.4	56.4	56.3	56.3	56.2	56.2	56.2	56.1	56.1	56.1	56.1	56.0
17	22	55.7	55.6	55.5	55.5	55.4	55.4	55.3	55.3	55.3	55.2	55.2	55.2	55.1	55.1
18	23	54.8	54.7	54.7	54.6	54.6	54.5	54.5	54.4	54.4	54.3	54.3	54.3	54.2	54.2
19	24	53.9	53.9	53.8	53.7	53.7	53.6	53.6	53.5	53.5	53.4	53.4	53.4	53.3	53.3
20	25	53.1	53.0	52.9	52.8	52.8	52.7	52.7	52.6	52.6	52.5	52.5	52.4	52.4	52.4
21	26	52.2	52.1	52.0	52.0	51.9	51.8	51.8	51.7	51.7	51.6	51.6	51.5	51.5	51.5
22	27	51.4	51.3	51.2	51.1	51.0	51.0	50.9	50.8	50.8	50.7	50.7	50.6	50.6	50.6
23	28	50.5	50.4	50.3	50.2	50.2	50.1	50.0	50.0	49.9	49.8	49.8	49.7	49.7	49.7
24	29	49.7	49.6	49.5	49.4	49.3	49.2	49.1	49.1	49.0	49.0	48.9	48.9	48.8	48.8
25	30	48.8	48.7	48.6	48.5	48.4	48.3	48.3	48.2	48.1	48.1	48.0	48.0	47.9	47.9
26	31	48.0	47.9	47.8	47.7	47.6	47.5	47.4	47.3	47.3	47.2	47.1	47.1	47.0	47.0
27	32	47.2	47.1	46.9	46.8	46.7	46.6	46.5	46.5	46.4	46.3	46.2	46.2	46.1	46.1
28	33	46.4	46.3	46.1	46.0	45.9	45.8	45.7	45.6	45.5	45.4	45.4	45.3	45.2	45.2
29	34	45.6	45.4	45.3	45.2	45.1	44.9	44.8	44.7	44.7	44.6	44.5	44.4	44.4	44.3
30	35	44.8	44.6	44.5	44.4	44.2	44.1	44.0	43.9	43.8	43.7	43.6	43.6	43.5	43.4
31	36	44.0	43.9	43.7	43.6	43.4	43.3	43.2	43.1	43.0	42.9	42.8	42.7	42.6	42.0
32	37	43.3	43.1	42.9	42.8	42.6	42.5	42.4	42.2	42.1	42.0	41.9	41.9	41.8	41.7
33	38	42.5	42.3	42.1	42.0	41.8	41.7	41.5	41.4	41.3	41.2	41.1	41.0	40.9	40.8
34	39	41.8	41.6	41.4	41.2	41.0	40.9	40.7	40.6	40.5	40.4	40.3	40.2	40.1	40.0

Male	Female	Ages														
		Male 64	65	66	67	68	69	70	71	72	73	74	75	76	77	78
		Female 69	70	71	72	73	74	75	76	77	78	79	80	81	82	83
6	11	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1
7	12	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.1	64.1
8	13	63.3	63.3	63.3	63.3	63.3	63.3	63.3	63.3	63.3	63.2	63.2	63.2	63.2	63.2	63.2
9	14	62.4	62.4	62.4	62.4	62.4	62.4	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3
10	15	61.5	61.5	61.5	61.5	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4
11	16	60.6	60.6	60.6	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5
12	17	59.7	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.5	59.5
13	18	58.8	58.7	58.7	58.7	58.7	58.7	58.7	58.7	58.7	58.7	58.6	58.6	58.6	58.6	58.6
14	19	57.8	57.8	57.8	57.8	57.8	57.8	57.8	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7
15	20	56.9	56.9	56.9	56.9	56.9	56.8	56.8	56.8	56.8	56.8	56.8	56.8	56.8	56.8	56.8
16	21	56.0	56.0	56.0	56.0	55.9	55.9	55.9	55.9	55.9	55.9	55.9	55.9	55.9	55.9	55.8
17	22	55.1	55.1	55.1	55.0	55.0	55.0	55.0	55.0	55.0	55.0	55.0	54.9	54.9	54.9	54.9
18	23	54.2	54.2	54.1	54.1	54.1	54.1	54.1	54.1	54.0	54.0	54.0	54.0	54.0	54.0	54.0
19	24	53.3	53.2	53.2	53.2	53.2	53.2	53.2	53.1	53.1	53.1	53.1	53.1	53.1	53.1	53.1
20	25	52.4	52.3	52.3	52.3	52.3	52.2	52.2	52.2	52.2	52.2	52.2	52.2	52.2	52.1	52.1
21	26	51.4	51.4	51.4	51.4	51.3	51.3	51.3	51.3	51.3	51.3	51.3	51.2	51.2	51.2	51.2
22	27	50.5	50.5	50.5	50.5	50.4	50.4	50.4	50.4	50.4	50.3	50.3	50.3	50.3	50.3	50.3
23	28	49.6	49.6	49.6	49.5	49.5	49.5	49.5	49.5	49.4	49.4	49.4	49.4	49.4	49.4	49.4
24	29	48.7	48.7	48.7	48.6	48.6	48.6	48.6	48.5	48.5	48.5	48.5	48.5	48.5	48.4	48.4
25	30	47.8	47.8	47.8	47.7	47.7	47.7	47.6	47.6	47.6	47.6	47.6	47.5	47.5	47.5	47.5
26	31	46.9	46.9	46.8	46.8	46.8	46.8	46.7	46.7	46.7	46.7	46.6	46.6	46.6	46.6	46.6
27	32	46.0	46.0	45.9	45.9	45.9	45.8	45.8	45.8	45.8	45.7	45.7	45.7	45.7	45.7	45.7
28	33	45.1	45.1	45.1	45.0	45.0	44.9	44.9	44.9	44.9	44.8	44.8	44.8	44.8	44.8	44.8
29	34	44.3	44.2	44.2	44.1	44.1	44.0	44.0	44.0	44.0	43.9	43.9	43.9	43.9	43.9	43.8
30	35	43.4	43.3	43.3	43.2	43.2	43.1	43.1	43.1	43.1	43.0	43.0	43.0	43.0	42.9	42.9
31	36	42.5	42.4	42.4	42.3	42.3	42.3	42.2	42.2	42.2	42.1	42.1	42.1	42.1	42.0	42.0
32	37	41.6	41.6	41.5	41.5	41.4	41.4	41.3	41.3	41.3	41.2	41.2	41.2	41.2	41.1	41.1
33	38	40.8	40.7	40.7	40.6	40.5	40.5	40.5	40.4	40.4	40.3	40.3	40.3	40.3	40.2	40.2
34	39	39.9	39.9	39.8	39.7	39.7	39.6	39.6	39.5	39.5	39.5	39.4	39.4	39.4	39.3	39.3

Male	Female	Ages													
		Male 79	80	81	82	83	84	85	86	87	88	89	90	91	92
		Female 84	85	86	87	88	89	90	91	92	93	94	95	96	97
6	11	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.0	65.0	65.0	65.0	65.0
7	12	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1
8	13	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2
9	14	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3

10	15	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4
11	16	60.5	60.5	60.5	60.5	60.5	60.5	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4
12	17	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5
13	18	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6
14	19	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7
15	20	56.8	56.8	56.8	56.8	56.8	56.8	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7
16	21	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8
17	22	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9
18	23	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	53.9
19	24	53.1	53.1	53.1	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0
20	25	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1
21	26	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2
22	27	50.3	50.3	50.3	50.3	50.3	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2
23	28	49.4	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3
24	29	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4
25	30	47.5	47.5	47.5	47.5	47.5	47.5	47.5	47.5	47.4	47.4	47.4	47.4	47.4	47.4
26	31	46.6	46.6	46.6	46.6	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5
27	32	45.7	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6
28	33	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7
29	34	43.8	43.8	43.8	43.8	43.8	43.8	43.8	43.8	43.8	43.7	43.7	43.7	43.7	43.7
30	35	42.9	42.9	42.9	42.9	42.9	42.9	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8
31	36	42.0	42.0	42.0	42.0	42.0	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9
32	37	41.1	41.1	41.1	41.1	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0
33	38	40.2	40.2	40.2	40.2	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1
34	39	39.3	39.3	39.3	39.3	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2

Male	Female	Ages															
		Male 93	94	95	96	97	98	99	100	101	102	103	104	105	106	107	108
		Female 98	99	100	101	102	103	104	105	106	107	108	109	110	111	112	113
6	11	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0
7	12	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1
8	13	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2
9	14	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3
10	15	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4
11	16	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4
12	17	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5
13	18	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6
14	19	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7
15	20	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7
16	21	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8

Male	Female	Ages															
		Male 93	94	95	96	97	98	99	100	101	102	103	104	105	106	107	108
		Female 98	99	100	101	102	103	104	105	106	107	108	109	110	111	112	113
17	22	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9
18	23	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9
19	24	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0
20	25	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1
21	26	51.2	51.2	51.2	51.2	51.2	51.2	51.1	51.1	51.1	51.1	51.1	51.1	51.1	51.1	51.1	51.1
22	27	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2
23	28	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3
24	29	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.3	48.3
25	30	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4
26	31	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5
27	32	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6
28	33	44.7	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6
29	34	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7
30	35	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8
31	36	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9
32	37	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0
33	38	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.0
34	39	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.1	39.1	39.1	39.1	39.1

Male	Female	Ages												
		Male 35	36	37	38	39	40	41	42	43	44	45	46	47
		Female 40	41	42	43	44	45	46	47	48	49	50	51	52
35	40	46.2	45.7	45.3	44.8	44.4	44.0	43.6	43.3	43.0	42.6	42.3	42.0	41.8
36	41	45.7	45.2	44.8	44.3	43.9	43.5	43.1	42.7	42.3	42.0	41.7	41.4	41.1
37	42	45.3	44.8	44.3	43.8	43.4	42.9	42.5	42.1	41.8	41.4	41.1	40.7	40.4
38	43	44.8	44.3	43.8	43.3	42.9	42.4	42.0	41.6	41.2	40.8	40.5	40.1	39.8
39	44	44.4	43.9	43.4	42.9	42.4	41.9	41.5	41.0	40.6	40.2	39.9	39.5	39.2
40	45	44.0	43.5	42.9	42.4	41.9	41.4	41.0	40.5	40.1	39.7	39.3	38.9	38.6
41	46	43.6	43.1	42.5	42.0	41.5	41.0	40.5	40.0	39.6	39.2	38.8	38.4	38.0
42	47	43.3	42.7	42.1	41.6	41.0	40.5	40.0	39.6	39.1	38.7	38.2	37.8	37.5
43	48	43.0	42.3	41.8	41.2	40.6	40.1	39.6	39.1	38.6	38.2	37.7	37.3	36.9
44	49	42.6	42.0	41.4	40.8	40.2	39.7	39.2	38.7	38.2	37.7	37.2	36.8	36.4
45	50	42.3	41.7	41.1	40.5	39.9	39.3	38.8	38.2	37.7	37.2	36.8	36.3	35.9
46	51	42.0	41.4	40.7	40.1	39.5	38.9	38.4	37.8	37.3	36.8	36.3	35.9	35.4
47	52	41.8	41.1	40.4	39.8	39.2	38.6	38.0	37.5	36.9	36.4	35.9	35.4	35.0

Male	Female	Ages												
		Male 48	49	50	51	52	53	54	55	56	57	58	59	60
		Female 53	54	55	56	57	58	59	60	61	62	63	64	65
35	40	41.5	41.3	41.0	40.8	40.6	40.4	40.3	40.1	40.0	39.8	39.7	39.6	39.5
36	41	40.8	40.6	40.3	40.1	39.9	39.7	39.5	39.3	39.2	39.0	38.9	38.8	38.6
37	42	40.2	39.9	39.6	39.4	39.2	39.0	38.8	38.6	38.4	38.3	38.1	38.0	37.9
38	43	39.5	39.2	39.0	38.7	38.5	38.3	38.1	37.9	37.7	37.5	37.3	37.2	37.1
39	44	38.9	38.6	38.3	38.0	37.8	37.6	37.3	37.1	36.9	36.8	36.6	36.4	36.3
40	45	38.3	38.0	37.7	37.4	37.1	36.9	36.6	36.4	36.2	36.0	35.9	35.7	35.5
41	46	37.7	37.3	37.0	36.7	36.5	36.2	36.0	35.7	35.5	35.3	35.1	35.0	34.8
42	47	37.1	36.8	36.4	36.1	35.8	35.6	35.3	35.1	34.8	34.6	34.4	34.2	34.1
43	48	36.5	36.2	35.8	35.5	35.2	34.9	34.7	34.4	34.2	33.9	33.7	33.5	33.3
44	49	36.0	35.6	35.3	34.9	34.6	34.3	34.0	33.8	33.5	33.3	33.0	32.8	32.6
45	50	35.5	35.1	34.7	34.4	34.0	33.7	33.4	33.1	32.9	32.6	32.4	32.2	31.9
46	51	35.0	34.6	34.2	33.8	33.5	33.1	32.8	32.5	32.2	32.0	31.7	31.5	31.3
47	52	34.5	34.1	33.7	33.3	32.9	32.6	32.2	31.9	31.6	31.4	31.1	30.9	30.6
48	53	34.0	33.6	33.2	32.8	32.4	32.0	31.7	31.4	31.1	30.8	30.5	30.2	30.0
49	54	33.6	33.1	32.7	32.3	31.9	31.5	31.2	30.8	30.5	30.2	29.9	29.6	29.4
50	55	33.2	32.7	32.3	31.8	31.4	31.0	30.6	30.3	29.9	29.6	29.3	29.0	28.8
51	56	32.8	32.3	31.8	31.4	30.9	30.5	30.1	29.8	29.4	29.1	28.8	28.5	28.2
52	57	32.4	31.9	31.4	30.9	30.5	30.1	29.7	29.3	28.9	28.6	28.2	27.9	27.6
53	58	32.0	31.5	31.0	30.5	30.1	29.6	29.2	28.8	28.4	28.1	27.7	27.4	27.1
54	59	31.7	31.2	30.6	30.1	29.7	29.2	28.8	28.3	27.9	27.6	27.2	26.9	26.5
55	60	31.4	30.8	30.3	29.8	29.3	28.8	28.3	27.9	27.5	27.1	26.7	26.4	26.0
56	61	31.1	30.5	29.9	29.4	28.9	28.4	27.9	27.5	27.1	26.7	26.3	25.9	25.5
57	62	30.8	30.2	29.6	29.1	28.6	28.1	27.6	27.1	26.7	26.2	25.8	25.4	25.1
58	63	30.5	29.9	29.3	28.8	28.2	27.7	27.2	26.7	26.3	25.8	25.4	25.0	24.6
59	64	30.2	29.6	29.0	28.5	27.9	27.4	26.9	26.4	25.9	25.4	25.0	24.6	24.2
60	65	30.0	29.4	28.8	28.2	27.6	27.1	26.5	26.0	25.5	25.1	24.6	24.2	23.8

Male	Female	Ages												
		Male 61	62	63	64	65	66	67	68	69	70	71	72	73
		Female 66	67	68	69	70	71	72	73	74	75	76	77	78
35	40	39.4	39.3	39.2	39.1	39.0	38.9	38.9	38.8	38.8	38.7	38.7	38.6	38.6
36	41	38.5	38.4	38.3	38.2	38.2	38.1	38.0	38.0	37.9	37.9	37.8	37.8	37.7
37	42	37.7	37.6	37.5	37.4	37.3	37.3	37.2	37.1	37.1	37.0	36.9	36.9	36.9
38	43	36.9	36.8	36.7	36.6	36.5	36.4	36.4	36.3	36.2	36.2	36.1	36.0	36.0
39	44	36.2	36.0	35.9	35.8	35.7	35.6	35.5	35.5	35.4	35.3	35.3	35.2	35.2
40	45	35.4	35.3	35.1	35.0	34.9	34.8	34.7	34.6	34.6	34.5	34.4	34.4	34.3
41	46	34.6	34.5	34.4	34.2	34.1	34.0	33.9	33.8	33.8	33.7	33.6	33.5	33.5

Male	Female	Ages												
		Male 61	62	63	64	65	66	67	68	69	70	71	72	73
		Female 66	67	68	69	70	71	72	73	74	75	76	77	78
42	47	33.9	33.7	33.6	33.5	33.4	33.2	33.1	33.0	33.0	32.9	32.8	32.7	32.7
43	48	33.2	33.0	32.9	32.7	32.6	32.5	32.4	32.3	32.2	32.1	32.0	31.9	31.9
44	49	32.5	32.3	32.1	32.0	31.8	31.7	31.6	31.5	31.4	31.3	31.2	31.1	31.1
45	50	31.8	31.6	31.4	31.3	31.1	31.0	30.8	30.7	30.6	30.5	30.4	30.4	30.3
46	51	31.1	30.9	30.7	30.5	30.4	30.2	30.1	30.0	29.9	29.8	29.7	29.6	29.5
47	52	30.4	30.2	30.0	29.8	29.7	29.5	29.4	29.3	29.1	29.0	28.9	28.8	28.7
48	53	29.8	29.5	29.3	29.2	29.0	28.8	28.7	28.5	28.4	28.3	28.2	28.1	28.0
49	54	29.1	28.9	28.7	28.5	28.3	28.1	28.0	27.8	27.7	27.6	27.5	27.4	27.3
50	55	28.5	28.3	28.1	27.8	27.6	27.5	27.3	27.1	27.0	26.9	26.7	26.6	26.5
51	56	27.9	27.7	27.4	27.2	27.0	26.8	26.6	26.5	26.3	26.2	26.0	25.9	25.8
52	57	27.3	27.1	26.8	26.6	26.4	26.2	26.0	25.8	25.7	25.5	25.4	25.2	25.1
53	58	26.8	26.5	26.2	26.0	25.8	25.6	25.4	25.2	25.0	24.8	24.7	24.6	24.4
54	59	26.2	25.9	25.7	25.4	25.2	25.0	24.7	24.6	24.4	24.2	24.0	23.9	23.8
55	60	25.7	25.4	25.1	24.9	24.6	24.4	24.1	23.9	23.8	23.6	23.4	23.3	23.1
56	61	25.2	24.9	24.6	24.3	24.1	23.8	23.6	23.4	23.2	23.0	22.8	22.6	22.5
57	62	24.7	24.4	24.1	23.8	23.5	23.3	23.0	22.8	22.6	22.4	22.2	22.0	21.9
58	63	24.3	23.9	23.6	23.3	23.0	22.7	22.5	22.2	22.0	21.8	21.6	21.4	21.3
59	64	23.8	23.5	23.1	22.8	22.5	22.2	21.9	21.7	21.5	21.2	21.0	20.9	20.7
60	65	23.4	23.0	22.7	22.3	22.0	21.7	21.4	21.2	20.9	20.7	20.5	20.3	20.1
61	66	23.0	22.6	22.2	21.9	21.6	21.3	21.0	20.7	20.4	20.2	20.0	19.8	19.6
62	67	22.6	22.2	21.8	21.5	21.1	20.8	20.5	20.2	19.9	19.7	19.5	19.2	19.0
63	68	22.2	21.8	21.4	21.1	20.7	20.4	20.1	19.8	19.5	19.2	19.0	18.7	18.5
64	69	21.9	21.5	21.1	20.7	20.3	20.0	19.6	19.3	19.0	18.7	18.5	18.2	18.0
65	70	21.6	21.1	20.7	20.3	19.9	19.6	19.2	18.9	18.6	18.3	18.0	17.8	17.5
66	71	21.3	20.8	20.4	20.0	19.6	19.2	18.8	18.5	18.2	17.9	17.6	17.3	17.1
67	72	21.0	20.5	20.1	19.6	19.2	18.8	18.5	18.1	17.8	17.5	17.2	16.9	16.7
68	73	20.7	20.2	19.8	19.3	18.9	18.5	18.1	17.8	17.4	17.1	16.8	16.5	16.2
69	74	20.4	19.9	19.5	19.0	18.6	18.2	17.8	17.4	17.1	16.7	16.4	16.1	15.8
70	75	20.2	19.7	19.2	18.7	18.3	17.9	17.5	17.1	16.7	16.4	16.1	15.8	15.5
71	76	20.0	19.5	19.0	18.5	18.0	17.6	17.2	16.8	16.4	16.1	15.7	15.4	15.1
72	77	19.8	19.2	18.7	18.2	17.8	17.3	16.9	16.5	16.1	15.8	15.4	15.1	14.8
73	78	19.6	19.0	18.5	18.0	17.5	17.1	16.7	16.2	15.8	15.5	15.1	14.8	14.4

Male	Female	Ages											
		Male 74	75	76	77	78	79	80	81	82	83	84	85
		Female 79	80	81	82	83	84	85	86	87	88	89	90
35	40	38.6	38.5	38.5	38.5	38.4	38.4	38.4	38.4	38.4	38.4	38.3	38.3
36	41	37.7	37.6	37.6	37.6	37.6	27.5	37.5	37.5	37.5	37.5	37.5	37.4
37	42	36.8	36.8	36.7	36.7	36.7	36.7	36.6	36.6	36.6	36.6	36.6	36.6
38	43	36.0	35.9	35.9	35.9	35.8	35.8	35.8	35.8	35.7	35.7	35.7	35.7
39	44	35.1	35.1	35.0	35.0	35.0	34.9	34.9	34.9	34.9	34.8	34.8	34.8
40	45	34.3	34.2	34.2	34.1	34.1	34.1	34.1	34.0	34.0	34.0	34.0	34.0
41	46	33.4	33.4	33.3	33.3	33.3	33.2	33.2	33.2	33.2	33.1	33.1	33.1
42	47	32.6	32.6	32.5	32.5	32.4	32.4	32.4	32.3	32.3	32.3	32.3	32.3
43	48	31.8	31.8	31.7	31.7	31.6	31.6	31.5	31.5	31.5	31.5	31.4	31.4
44	49	31.0	30.9	30.9	30.8	30.8	30.8	30.7	30.7	30.7	30.6	30.6	30.6
45	50	30.2	30.1	30.1	30.0	30.0	29.9	29.9	29.9	29.8	29.8	29.8	29.8
46	51	29.4	29.4	29.3	29.2	29.2	29.2	29.1	29.1	29.0	29.0	29.0	28.9
47	52	28.7	28.6	28.5	28.5	28.4	28.4	28.3	28.3	28.2	28.2	28.2	28.1
48	53	27.9	27.8	27.8	27.7	27.6	27.6	27.5	27.5	27.5	27.4	27.4	27.4
49	54	27.2	27.1	27.0	26.9	26.9	26.8	26.8	26.7	26.7	26.6	26.6	26.6
50	55	26.4	26.3	26.3	26.2	26.1	26.1	26.0	26.0	25.9	25.9	25.8	25.8
51	56	25.7	25.6	25.5	25.5	25.4	25.3	25.3	25.2	25.2	25.1	25.1	25.0
52	57	25.0	24.9	24.8	24.7	24.7	24.6	24.5	24.5	24.4	24.4	24.3	24.3
53	58	24.3	24.2	24.1	24.0	23.9	23.9	23.8	23.7	23.7	23.6	23.6	23.5
54	59	23.6	23.5	23.4	23.3	23.2	23.2	23.1	23.0	23.0	22.9	22.9	22.8
55	60	23.0	22.9	22.8	22.7	22.6	22.5	22.4	22.3	22.3	22.2	22.2	22.1
56	61	22.3	22.2	22.1	22.0	21.9	21.8	21.7	21.6	21.6	21.5	21.5	21.4
57	62	21.7	21.6	21.5	21.3	21.2	21.1	21.1	21.0	20.9	20.8	20.8	20.7
58	63	21.1	21.0	20.8	20.7	20.6	20.5	20.4	20.3	20.2	20.2	20.1	20.0
59	64	20.5	20.4	20.2	20.1	20.0	19.9	19.8	19.7	19.6	19.5	19.4	19.4
60	65	19.9	19.8	19.6	19.5	19.4	19.3	19.1	19.0	19.0	18.9	18.8	18.7
61	66	19.4	19.2	19.1	18.9	18.8	18.7	18.5	18.4	18.3	18.3	18.2	18.1
62	67	18.8	18.7	18.5	18.3	18.2	18.1	18.0	17.8	17.7	17.7	17.6	17.5
63	68	18.3	18.1	18.0	17.8	17.6	17.5	17.4	17.3	17.2	17.1	17.0	16.9
64	69	17.8	17.6	17.4	17.3	17.1	17.0	16.8	16.7	16.6	16.5	16.4	16.3
65	70	17.3	17.1	16.9	16.7	16.6	16.4	16.3	16.2	16.0	15.9	15.8	15.8
66	71	16.9	16.6	16.4	16.3	16.1	15.9	15.8	15.6	15.5	15.4	15.3	15.2
67	72	16.4	16.2	16.0	15.8	15.6	15.4	15.3	15.1	15.0	14.9	14.8	14.7
68	73	16.0	15.7	15.5	15.3	15.1	15.0	14.8	14.6	14.5	14.4	14.3	14.2
69	74	15.6	15.3	15.1	14.9	14.7	14.5	14.3	14.2	14.0	13.9	13.8	13.7
70	75	15.2	14.9	14.7	14.5	14.3	14.1	13.9	13.7	13.6	13.4	13.3	13.2
71	76	14.8	14.5	14.3	14.1	13.8	13.6	13.5	13.3	13.1	13.0	12.8	12.7
72	77	14.5	14.2	13.9	13.7	13.5	13.2	13.0	12.9	12.7	12.5	12.4	12.3

Male	Female	Ages											
		Male 74	75	76	77	78	79	80	81	82	83	84	85
		Female 79	80	81	82	83	84	85	86	87	88	89	90
73	78	14.1	13.8	13.6	13.3	13.1	12.9	12.7	12.5	12.3	12.1	12.0	11.8
74	79	13.8	13.5	13.2	13.0	12.7	12.5	12.3	12.1	11.9	11.7	11.6	11.4
75	80	13.5	13.2	12.9	12.6	12.4	12.2	11.9	11.7	11.5	11.4	11.2	11.0
76	81	13.2	12.9	12.6	12.3	12.1	11.8	11.6	11.4	11.2	11.0	10.8	10.7
77	82	13.0	12.6	12.3	12.1	11.8	11.5	11.3	11.1	10.8	10.7	10.5	10.3
78	83	12.7	12.4	12.1	11.8	11.5	11.2	11.0	10.7	10.5	10.3	10.1	10.0
79	84	12.5	12.2	11.8	11.5	11.2	11.0	10.7	10.5	10.2	10.0	9.8	9.6
80	85	12.3	11.9	11.6	11.3	11.0	10.7	10.4	10.2	10.0	9.7	9.5	9.3
81	86	12.1	11.7	11.4	11.1	10.7	10.5	10.2	9.9	9.7	9.5	9.3	9.1
82	87	11.9	11.5	11.2	10.8	10.5	10.2	10.0	9.7	9.4	9.2	9.0	8.8
83	88	11.7	11.4	11.0	10.7	10.3	10.0	9.7	9.5	9.2	9.0	8.7	8.5
84	89	11.6	11.2	10.8	10.5	10.1	9.8	9.5	9.3	9.0	8.7	8.5	8.3
85	90	11.4	11.0	10.7	10.3	10.0	9.6	9.3	9.1	8.8	8.5	8.3	8.1

Male	Female	Ages											
		Male 86	87	88	89	90	91	92	93	94	95	96	97
		Female 91	92	93	94	95	96	97	98	99	100	101	102
35	40	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3
36	41	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4
37	42	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5
38	43	35.7	35.7	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6
39	44	34.8	34.8	34.8	34.8	34.8	34.8	34.7	34.7	34.7	34.7	34.7	34.7
40	45	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9
41	46	33.1	33.1	33.1	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0
42	47	32.2	32.2	32.2	32.2	32.2	32.2	32.2	32.2	32.2	32.1	32.1	32.1
43	48	31.4	31.4	31.4	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3
44	49	30.6	30.5	30.5	30.5	30.5	30.5	30.5	30.5	30.5	30.5	30.5	30.4
45	50	29.7	29.7	29.7	29.7	29.7	29.7	29.7	29.6	29.6	29.6	29.6	29.6
46	51	28.9	28.9	28.9	28.9	28.9	28.8	28.8	28.8	28.8	28.8	28.8	28.8
47	52	28.1	28.1	28.1	28.1	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0
48	53	27.3	27.3	27.3	27.3	27.2	27.2	27.2	27.2	27.2	27.2	27.2	27.2
49	54	26.5	26.5	26.5	26.5	26.5	26.4	26.4	26.4	26.4	26.4	26.4	26.4
50	55	25.8	25.7	25.7	25.7	25.7	25.7	25.6	25.6	25.6	25.6	25.6	25.6
51	56	25.0	25.0	24.9	24.9	24.9	24.9	24.9	24.9	24.8	24.8	24.8	24.8
52	57	24.3	24.2	24.2	24.2	24.1	24.1	24.1	24.1	24.1	24.1	24.1	24.0
53	58	23.5	23.5	23.4	23.4	23.4	23.4	23.4	23.3	23.3	23.3	23.3	23.3
54	59	22.8	22.7	22.7	22.7	22.7	22.6	22.6	22.6	22.6	22.6	22.6	22.5

55	60	22.1	22.0	22.0	22.0	21.9	21.9	21.9	21.9	21.8	21.8	21.8	21.8
56	61	21.4	21.3	21.3	21.3	21.2	21.2	21.2	21.1	21.1	21.1	21.1	21.1
57	62	20.7	20.6	20.6	20.6	20.5	20.5	20.5	20.4	20.4	20.4	20.4	20.4
58	63	20.0	19.9	19.9	19.9	19.8	19.8	19.8	19.8	19.7	19.7	19.7	19.7
59	64	19.3	19.3	19.2	19.2	19.2	19.1	19.1	19.1	19.0	19.0	19.0	19.0

Male	Female	Ages										
		Male 98	99	100	101	102	103	104	105	106	107	108
		Female 103	104	105	106	107	108	109	110	111	112	113
35 ...	40 ...	38.3	38.3	38.3	38.3	38.3	38.3	38.2	38.2	38.2	38.2	38.2
36 ...	41 ...	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.3
37 ...	42 ...	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5
38 ...	43 ...	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6
39 ...	44 ...	34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7
40 ...	45 ...	33.9	33.8	33.8	33.8	33.8	33.8	33.8	33.8	33.8	33.8	33.8
41 ...	46 ...	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0
42 ...	47 ...	32.1	32.1	32.1	32.1	32.1	32.1	32.1	32.1	32.1	32.1	32.1
43 ...	48 ...	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3
44 ...	49 ...	30.4	30.4	30.4	30.4	30.4	30.4	30.4	30.4	30.4	30.4	30.4
45 ...	50 ...	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6
46 ...	51 ...	28.8	28.8	28.8	28.8	28.8	28.8	28.8	28.8	28.8	28.8	28.7
47 ...	52 ...	28.0	28.0	28.0	28.0	28.0	28.0	28.0	27.9	27.9	27.9	27.9
48 ...	53 ...	27.2	27.2	27.2	27.2	27.2	27.1	27.1	27.1	27.1	27.1	27.1
49 ...	54 ...	26.4	26.4	26.4	26.4	26.4	26.3	26.3	26.3	26.3	26.3	26.3
50 ...	55 ...	25.6	25.6	25.6	25.6	25.6	25.6	25.6	25.6	25.5	25.5	25.5
51 ...	56 ...	24.8	24.8	24.8	24.8	24.8	24.8	24.8	24.8	24.8	24.8	24.7
52 ...	57 ...	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0
53 ...	58 ...	23.3	23.3	23.3	23.3	23.3	23.3	23.2	23.2	23.2	23.2	23.2
54 ...	59 ...	22.5	22.5	22.5	22.5	22.5	22.5	22.5	22.5	22.5	22.5	22.5
55 ...	60 ...	21.8	21.8	21.8	21.8	21.8	21.8	21.8	21.8	21.8	21.7	21.7
56 ...	61 ...	21.1	21.1	21.1	21.1	21.1	21.0	21.0	21.0	21.0	21.0	21.0
57 ...	62 ...	20.4	20.4	20.4	20.3	20.3	20.3	20.3	20.3	20.3	20.3	20.3
58 ...	63 ...	19.7	19.7	19.7	19.6	19.6	19.6	19.6	19.6	19.6	19.6	19.6
59 ...	64 ...	19.0	19.0	19.0	19.0	19.0	18.9	18.9	18.9	18.9	18.9	18.9

Male	Female	Ages											
		Male 86	87	88	89	90	91	92	93	94	95	96	97
		Female 91	92	93	94	95	96	97	98	99	100	101	102
60	65	18.7	18.6	18.6	18.5	18.5	18.5	18.4	18.4	18.4	18.4	18.3	18.3
61	66	18.1	18.0	17.9	17.9	17.9	17.8	17.8	17.8	17.7	17.7	17.7	17.7
62	67	17.4	17.4	17.3	17.3	17.2	17.2	17.1	17.1	17.1	17.1	17.0	17.0
63	68	16.8	16.8	16.7	16.7	16.6	16.6	16.5	16.5	16.5	16.4	16.4	16.4
64	69	16.2	16.2	16.1	16.1	16.0	16.0	15.9	15.9	15.9	15.8	15.8	15.8
65	70	15.7	15.6	15.5	15.5	15.4	15.4	15.3	15.3	15.3	15.2	15.2	15.2
66	71	15.1	15.0	15.0	14.9	14.8	14.8	14.7	14.7	14.7	14.6	14.6	14.6
67	72	14.6	14.5	14.4	14.4	14.3	14.2	14.2	14.1	14.1	14.1	14.1	14.0
68	73	14.1	14.0	13.9	13.8	13.8	13.7	13.6	13.6	13.6	13.5	13.5	13.5
69	74	13.6	13.5	13.4	13.3	13.2	13.2	13.1	13.1	13.0	13.0	13.0	12.9
70	75	13.1	13.0	12.9	12.8	12.7	12.7	12.6	12.5	12.5	12.5	12.4	12.4
71	76	12.6	12.5	12.4	12.3	12.2	12.2	12.1	12.1	12.0	12.0	11.9	11.9
72	77	12.1	12.0	11.9	11.8	11.8	11.7	11.6	11.6	11.5	11.5	11.4	11.4
73	78	11.7	11.6	11.5	11.4	11.3	11.2	11.2	11.1	11.0	11.0	11.0	10.9
74	79	11.3	11.2	11.1	11.0	10.9	10.8	10.7	10.7	10.6	10.6	10.5	10.5
75	80	10.9	10.8	10.7	10.5	10.5	10.4	10.3	10.2	10.2	10.1	10.1	10.0
76	81	10.5	10.4	10.3	10.2	10.1	10.0	9.9	9.8	9.7	9.7	9.7	9.6
77	82	10.2	10.0	9.9	9.8	9.7	9.6	9.5	9.4	9.3	9.3	9.2	9.2
78	83	9.8	9.7	9.5	9.4	9.3	9.2	9.1	9.0	9.0	8.9	8.9	8.8
79	84	9.5	9.3	9.2	9.2	8.9	8.8	8.8	8.7	8.6	8.5	8.5	8.4
80	85	9.2	9.0	8.9	8.7	8.6	8.5	8.4	8.3	8.3	8.2	8.1	8.1
81	86	8.9	8.7	8.6	8.4	8.3	8.2	8.1	8.0	7.9	7.9	7.8	7.7
82	87	8.6	8.4	8.3	8.1	8.0	7.9	7.8	7.7	7.6	7.5	7.5	7.4
83	88	8.3	8.2	8.0	7.9	7.7	7.6	7.5	7.4	7.3	7.2	7.2	7.1
84	89	8.1	7.9	7.8	7.6	7.5	7.3	7.2	7.1	7.0	7.0	6.9	6.8

Male	Fe-male	Ages										
		Male 98	99	100	101	102	103	104	105	106	107	108
		Female 103	104	105	106	107	108	109	110	111	112	113
60 ...	65 ...	18.3	18.3	18.3	18.3	18.3	18.3	18.3	18.2	18.2	18.2	18.2
61 ...	66 ...	17.7	17.7	17.6	17.6	17.6	17.6	17.6	17.6	17.6	17.6	17.5
62 ...	67 ...	17.0	17.0	17.0	17.0	17.0	17.0	16.9	16.9	16.9	16.9	16.9
63 ...	68 ...	16.4	16.4	16.4	16.3	16.3	16.3	16.3	16.3	16.3	16.3	16.2
64 ...	69 ...	15.8	15.8	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.6
65 ...	70 ...	15.2	15.2	15.1	15.1	15.1	15.1	15.1	15.1	15.1	15.0	15.0
66 ...	71 ...	14.6	14.6	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.4	14.4
67 ...	72 ...	14.0	14.0	14.0	14.0	13.9	13.9	13.9	13.9	13.9	13.9	13.8
68 ...	73 ...	13.5	13.4	13.4	13.4	13.4	13.4	13.3	13.3	13.3	13.3	13.2
69 ...	74 ...	12.9	12.9	12.9	12.8	12.8	12.8	12.8	12.8	12.8	12.7	12.7
70 ...	75 ...	12.4	12.4	12.3	12.3	12.3	12.3	12.3	12.2	12.2	12.2	12.1
71 ...	76 ...	11.9	11.9	11.8	11.8	11.8	11.8	11.7	11.7	11.7	11.7	11.6
72 ...	77 ...	11.4	11.4	11.3	11.3	11.3	11.3	11.2	11.2	11.2	11.2	11.1
73 ...	78 ...	10.9	10.9	10.9	10.8	10.8	10.8	10.7	10.7	10.7	10.7	10.6
74 ...	79 ...	10.5	10.4	10.4	10.4	10.3	10.3	10.3	10.3	10.2	10.2	10.1
75 ...	80 ...	10.0	10.0	9.9	9.9	9.9	9.8	9.8	9.8	9.8	9.7	....
76 ...	81 ...	9.6	9.5	9.5	9.5	9.4	9.4	9.4	9.4	9.3	9.3	....
77 ...	82 ...	9.2	9.1	9.1	9.1	9.0	9.0	9.0	8.9	8.9	8.9	....
78 ...	83 ...	8.8	8.7	8.7	8.7	8.6	8.6	8.5	8.5	8.5	8.4	....
79 ...	84 ...	8.4	8.4	8.3	8.3	8.2	8.2	8.2	8.1	8.1	8.0	....
80 ...	85 ...	8.0	8.0	7.9	7.9	7.9	7.8	7.8	7.7	7.7	7.6	....
81 ...	86 ...	7.7	7.6	7.6	7.6	7.5	7.5	7.4	7.4	7.3	7.3	....
82 ...	87 ...	7.4	7.3	7.3	7.2	7.2	7.1	7.1	7.0	7.0	6.9	....
83 ...	88 ...	7.1	7.0	6.9	6.9	6.8	6.8	6.7	6.7	6.7	6.6	....
84 ...	89 ...	6.8	6.7	6.6	6.6	6.5	6.5	6.4	6.4	6.3	....	....

Male	Fe-male	Ages										
		Male 86	87	88	89	90	91	92	93	94	95	96
		Female 91	92	93	94	95	96	97	98	99	100	101
85 ...	90 ...	7.9	7.7	7.5	7.4	7.2	7.1	7.0	6.9	6.8	6.7	6.6
86 ...	91 ...	7.7	7.5	7.3	7.1	7.0	6.8	6.7	6.6	6.5	6.4	6.4
87 ...	92 ...	7.5	7.3	7.1	6.9	6.8	6.6	6.5	6.4	6.3	6.2	6.1
88 ...	93 ...	7.3	7.1	6.9	6.7	6.6	6.4	6.3	6.2	6.1	6.0	5.9
89 ...	94 ...	7.1	6.9	6.7	6.5	6.4	6.2	6.1	6.0	5.9	5.8	5.7
90 ...	95 ...	7.0	6.8	6.6	6.4	6.2	6.1	5.9	5.8	5.7	5.6	5.5
91 ...	96 ...	6.8	6.6	6.4	6.2	6.1	5.9	5.8	5.7	5.5	5.4	5.3
92 ...	97 ...	6.7	6.5	6.3	6.1	5.9	5.8	5.6	5.5	5.4	5.3	5.2
93 ...	98 ...	6.6	6.4	6.2	6.0	5.8	5.7	5.5	5.4	5.2	5.1	5.0
94 ...	99 ...	6.5	6.3	6.1	5.9	5.7	5.5	5.4	5.2	5.1	5.0	4.9
95 ...	100	6.4	6.2	6.0	5.8	5.6	5.4	5.3	5.1	5.0	4.9	4.7
96 ...	101	6.4	6.1	5.9	5.7	5.5	5.3	5.2	5.0	4.9	4.7	4.6
97 ...	102	6.3	6.1	5.8	5.6	5.4	5.2	5.1	4.9	4.8	4.6	4.5
98 ...	103	6.2	6.0	5.8	5.5	5.3	5.1	5.0	4.8	4.7	4.5	4.4
99 ...	104	6.2	5.9	5.7	5.5	5.2	5.1	4.9	4.7	4.6	4.4	4.3

Male	Female	Ages									
		Male 97	98	99	100	101	102	103	104	105	106
		Female 102	103	104	105	106	107	108	109	110	111
85	90	6.6	6.5	6.4	6.4	6.3	6.2	6.2	6.1	6.1	6.0
86	91	6.3	6.2	6.2	6.1	6.0	6.0	5.9	5.9	5.8	5.7
87	92	6.1	6.0	5.9	5.8	5.8	5.7	5.6	5.6	5.5	5.4
88	93	5.8	5.8	5.7	5.6	5.5	5.5	5.4	5.3	5.3	5.1
89	94	5.6	5.5	5.5	5.4	5.3	5.2	5.2	5.1	5.0	....
90	95	5.4	5.3	5.2	5.2	5.1	5.0	4.9	4.9	4.8	....
91	96	5.2	5.1	5.1	5.0	4.9	4.8	4.7	4.6	4.5	....
92	97	5.1	5.0	4.9	4.8	4.7	4.6	4.5	4.4	....	....
93	98	4.9	4.8	4.7	4.6	4.5	4.4	4.3	4.2	....	....
94	99	4.8	4.7	4.6	4.5	4.4	4.3	4.1	....	....	....

Male	Female	Ages									
		Male 97	98	99	100	101	102	103	104	105	106
		Female 102	103	104	105	106	107	108	109	110	111
95	100	4.6	4.5	4.4	4.3	4.2	4.1	4.0	....	....	....
96	101	4.5	4.4	4.3	4.2	4.1	3.9	....	....	....	....
97	102	4.4	4.3	4.1	4.0	3.9	3.7	....	....	....	....
98	103	4.3	4.1	4.0	3.9	3.7	....	....	....	....	....
99	104	4.1	4.0	3.9	3.7	....	....	....	....	....	....

TABLE IIA—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES

Male	Female	Ages														
		Male 6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
		Female 11	12	13	14	15	16	17	18	19	20	21	22	23	24	25
6	11	56.6	56.1	55.7	55.1	54.6	54.1	53.5	52.9	52.3	51.7	51.1	50.5	49.8	49.1	48.4
7	12	56.1	55.7	55.2	54.7	54.2	53.7	53.1	52.6	52.0	51.4	50.8	50.2	49.5	48.9	48.2
8	13	55.7	55.2	54.8	54.3	53.8	53.3	52.8	52.2	51.6	51.1	50.5	49.9	49.2	48.6	47.9
9	14	55.1	54.7	54.3	53.8	53.3	52.9	52.3	51.8	51.3	50.7	50.1	49.5	48.9	48.3	47.7
10	15	54.6	54.2	53.8	53.3	52.9	52.4	51.9	51.4	50.9	50.3	49.8	49.2	48.6	48.0	47.4
11	16	54.1	53.7	53.3	52.9	52.4	52.0	51.5	51.0	50.5	50.0	49.4	48.8	48.3	47.7	47.1
12	17	53.5	53.1	52.8	52.3	51.9	51.5	51.0	50.6	50.1	49.6	49.0	48.5	47.9	47.3	46.7
13	18	52.9	52.6	52.2	51.8	51.4	51.0	50.6	50.1	49.6	49.1	48.6	48.1	47.5	47.0	46.4
14	19	52.3	52.0	51.6	51.3	50.9	50.5	50.1	49.6	49.2	48.7	48.2	47.7	47.2	46.6	46.1
15	20	51.7	51.4	51.1	50.7	50.3	50.0	49.6	49.1	48.7	48.2	47.8	47.3	46.8	46.2	45.7
16	21	51.1	50.8	50.5	50.1	49.8	49.4	49.0	48.6	48.2	47.8	47.3	46.8	46.3	45.8	45.3
17	22	50.5	50.2	49.9	49.5	49.2	48.8	48.5	48.1	47.7	47.3	46.8	46.4	45.9	45.4	44.9
18	23	49.8	49.5	49.2	48.9	48.6	48.3	47.9	47.5	47.2	46.8	46.3	45.9	45.4	45.0	44.5
19	24	49.1	48.9	48.6	48.3	48.0	47.7	47.3	47.0	46.6	46.2	45.8	45.4	45.0	44.5	44.0
20	25	48.4	48.2	47.9	47.7	47.4	47.1	46.7	46.4	46.1	45.7	45.3	44.9	44.5	44.0	43.6

Male	Female	Ages														
		Male 21	22	23	24	25	26	27	28	29	30	31	32	33	34	
		Female 26	27	28	29	30	31	32	33	34	35	36	37	38	39	
6	11	47.7	47.0	46.3	45.6	44.8	44.1	43.3	42.5	41.8	41.0	40.2	39.4	38.6	37.8	
7	12	47.5	46.8	46.1	45.4	44.6	43.9	43.2	42.4	41.6	40.9	40.1	39.3	38.5	37.7	
8	13	47.3	46.6	45.9	45.2	44.5	43.7	43.0	42.2	41.5	40.7	39.9	39.2	38.4	37.6	
9	14	47.0	46.3	45.6	45.0	44.2	43.5	42.8	42.1	41.3	40.6	39.8	39.0	38.3	37.5	
10	15	46.7	46.1	45.4	44.7	44.0	43.3	42.6	41.9	41.1	40.4	39.7	38.9	38.1	37.4	
11	16	46.4	45.8	45.1	44.5	43.8	43.1	42.4	41.7	41.0	40.2	39.5	38.8	38.0	37.2	
12	17	46.1	45.5	44.9	44.2	43.6	42.9	42.2	41.5	40.8	40.1	39.3	38.6	37.9	37.1	
13	18	45.8	45.2	44.6	43.9	43.3	42.6	42.0	41.3	40.6	39.9	39.2	38.4	37.7	37.0	
14	19	45.5	44.9	44.3	43.7	43.0	42.4	41.7	41.0	40.4	39.7	39.0	38.3	37.5	36.8	
15	20	45.1	44.6	44.0	43.4	42.7	42.1	41.5	40.8	40.1	39.5	38.8	38.1	37.4	36.6	
16	21	44.8	44.2	43.6	43.0	42.4	41.8	41.2	40.5	39.9	39.2	38.6	37.9	37.2	36.5	
17	22	44.4	43.8	43.3	42.7	42.1	41.5	40.9	40.3	39.6	39.0	38.3	37.7	37.0	36.3	
18	23	44.0	43.5	42.9	42.4	41.8	41.2	40.6	40.0	39.4	38.7	38.1	37.4	36.8	36.1	
19	24	43.6	43.1	42.5	42.0	41.4	40.9	40.3	39.7	39.1	38.5	37.8	37.2	36.5	35.9	
20	25	43.1	42.6	42.1	41.6	41.1	40.5	40.0	39.4	38.8	38.2	37.6	36.9	36.3	35.7	
21	26	42.7	42.2	41.7	41.2	40.7	40.2	39.6	39.1	38.5	37.9	37.3	36.7	36.1	35.4	

22	27	42.2	41.8	41.3	40.8	40.3	39.8	39.3	38.7	38.2	37.6	37.0	36.4	35.8	35.2
23	28	41.7	41.3	40.8	40.4	39.9	39.4	38.9	38.4	37.8	37.3	36.7	36.1	35.5	34.9
24	29	41.2	40.8	40.4	39.9	39.5	39.0	38.5	38.0	37.5	36.9	36.4	35.8	35.2	34.6
25	30	40.7	40.3	39.9	39.5	39.0	38.6	38.1	37.6	37.1	36.6	36.0	35.5	34.9	34.4
26	31	40.2	39.8	39.4	39.0	38.6	38.1	37.7	37.2	36.7	36.2	35.7	35.2	34.6	34.1
27	32	39.6	39.3	38.9	38.5	38.1	37.7	37.2	36.8	36.3	35.8	35.3	34.8	34.3	33.7
28	33	39.1	38.7	38.4	38.0	37.6	37.2	36.8	36.3	35.9	35.4	34.9	34.5	33.9	33.4
29	34	38.5	38.2	37.8	37.5	37.1	36.7	36.3	35.9	35.5	35.0	34.6	34.1	33.6	33.1
30	35	37.9	37.6	37.3	36.9	36.6	36.2	35.8	35.4	35.0	34.6	34.1	33.7	33.2	32.7
31	36	37.3	37.0	36.7	36.4	36.0	35.7	35.3	34.9	34.6	34.1	33.7	33.3	32.8	32.3
32	37	36.7	36.4	36.1	35.8	35.5	35.2	34.8	34.5	34.1	33.7	33.3	32.9	32.4	32.0
33	38	36.1	35.8	35.5	35.2	34.9	34.6	34.3	33.9	33.6	33.2	32.8	32.4	32.0	31.6
34	39	35.4	35.2	34.9	34.6	34.4	34.1	33.7	33.4	33.1	32.7	32.3	32.0	31.6	31.1

Male	Female	Ages														
		Male 35	36	37	38	39	40	41	42	43	44	45	46	47	48	49
		Female 40	41	42	43	44	45	46	47	48	49	50	51	52	53	54
6	11	37.0	36.2	35.4	34.6	33.8	33.0	32.2	31.4	30.6	29.8	29.0	28.2	27.5	26.7	25.9
7	12	36.9	36.1	35.3	34.5	33.7	32.9	32.1	31.3	30.5	29.8	29.0	28.2	27.4	26.7	25.9
8	13	36.8	36.0	35.2	34.4	33.7	32.9	32.1	31.3	30.5	29.7	28.9	28.2	27.4	26.6	25.9
9	14	36.7	35.9	35.1	34.4	33.6	32.8	32.0	31.2	30.4	29.7	28.9	28.1	27.3	26.6	25.8
10	15	36.6	35.8	35.1	34.3	33.5	32.7	31.9	31.2	30.4	29.6	28.8	28.1	27.3	26.5	25.8
11	16	36.5	35.7	34.9	34.2	33.4	32.6	31.9	31.1	30.3	29.5	28.8	28.0	27.3	26.5	25.7
12	17	36.4	35.6	34.8	34.1	33.3	32.5	31.8	31.0	30.2	29.5	28.7	28.0	27.2	26.4	25.7
13	18	36.2	35.5	34.7	34.0	33.2	32.4	31.7	30.9	30.2	29.4	28.7	27.9	27.1	26.4	25.7
14	19	36.1	35.3	34.6	33.8	33.1	32.3	31.6	30.8	30.1	29.3	28.6	27.8	27.1	26.3	25.6
15	20	35.9	35.2	34.5	33.7	33.0	32.2	31.5	30.7	30.0	29.3	28.5	27.8	27.0	26.3	25.6
16	21	35.8	35.0	34.3	33.6	32.9	32.1	31.4	30.6	29.9	29.2	28.4	27.7	27.0	26.2	25.5
17	22	35.6	34.9	34.2	33.4	32.7	32.0	31.3	30.5	29.8	29.1	28.3	27.6	26.9	26.2	25.4
18	23	35.4	34.7	34.0	33.3	32.6	31.9	31.2	30.4	29.7	29.0	28.3	27.5	26.8	26.1	25.4
19	24	35.2	34.5	33.8	33.1	32.4	31.7	31.0	30.3	29.6	28.9	28.2	27.4	26.7	26.0	25.3
20	25	35.0	34.3	33.7	33.0	32.3	31.6	30.9	30.2	29.5	28.8	28.1	27.3	26.6	25.9	25.2
21	26	34.8	34.1	33.5	32.8	32.1	31.4	30.7	30.0	29.3	28.6	27.9	27.2	26.5	25.8	25.1
22	27	34.5	33.9	33.3	32.6	31.9	31.3	30.6	29.9	29.2	28.5	27.8	27.1	26.4	25.7	25.1
23	28	34.3	33.7	33.0	32.4	31.7	31.1	30.4	29.7	29.1	28.4	27.7	27.0	26.3	25.6	25.0
24	29	34.0	33.4	32.8	32.2	31.5	30.9	30.2	29.6	28.9	28.2	27.6	26.9	26.2	25.5	24.9
25	30	33.8	33.2	32.6	32.0	31.3	30.7	30.1	29.4	28.8	28.1	27.4	26.8	26.1	25.4	24.8
26	31	33.5	32.9	32.3	31.7	31.1	30.5	29.9	29.2	28.6	27.9	27.3	26.6	26.0	25.3	24.6
27	32	33.2	32.6	32.1	31.5	30.9	30.3	29.6	29.0	28.4	27.8	27.1	26.5	25.8	25.2	24.5
28	33	32.9	32.3	31.8	31.2	30.6	30.0	29.4	28.8	28.2	27.6	27.0	26.3	25.7	25.0	24.4
29	34	32.6	32.0	31.5	30.9	30.4	29.8	29.2	28.6	28.0	27.4	26.8	26.2	25.5	24.9	24.3

Male	Female	Ages														
		Male 35	36	37	38	39	40	41	42	43	44	45	46	47	48	49
		Female 40	41	42	43	44	45	46	47	48	49	50	51	52	53	54
30	35	32.2	31.7	31.2	30.6	30.1	29.5	29.0	28.4	27.8	27.2	26.6	26.0	25.4	24.7	24.1
31	36	31.9	31.4	30.9	30.3	29.8	29.3	28.7	28.1	27.6	27.0	26.4	25.8	25.2	24.6	24.0
32	37	31.5	31.0	30.5	30.0	29.5	29.0	28.4	27.9	27.3	26.8	26.2	25.6	25.0	24.4	23.8
33	38	31.1	30.7	30.2	29.7	29.2	28.7	28.2	27.6	27.1	26.5	26.0	25.4	24.8	24.2	23.6
34	39	30.7	30.3	29.8	29.3	28.9	28.4	27.9	27.3	26.8	26.3	25.7	25.2	24.6	24.0	23.5

Male	Female	Ages													
		Male 50	51	52	53	54	55	56	57	58	59	60	61	62	63
		Female 55	56	57	58	59	60	61	62	63	64	65	66	67	68
6	11	25.2	24.4	23.7	22.9	22.2	21.5	20.8	20.1	19.4	18.7	18.0	17.4	16.7	16.1
7	12	25.1	24.4	23.6	22.9	22.2	21.5	20.8	20.1	19.4	18.7	18.0	17.4	16.7	16.1
8	13	25.1	24.4	23.6	22.9	22.2	21.4	20.7	20.0	19.4	18.7	18.0	17.4	16.7	16.1
9	14	25.1	24.3	23.6	22.9	22.1	21.4	20.7	20.0	19.3	18.7	18.0	17.3	16.7	16.1
10	15	25.0	24.3	23.6	22.8	22.1	21.4	20.7	20.0	19.3	18.6	18.0	17.3	16.7	16.1
11	16	25.0	24.3	23.5	22.8	22.1	21.4	20.7	20.0	19.3	18.6	18.0	17.3	16.7	16.1
12	17	25.0	24.2	23.5	22.8	22.1	21.4	20.7	20.0	19.3	18.6	18.0	17.3	16.7	16.0
13	18	24.9	24.2	23.5	22.7	22.0	21.3	20.6	19.9	19.3	18.6	17.9	17.3	16.7	16.0
14	19	24.9	24.1	23.4	22.7	22.0	21.3	20.6	19.9	19.2	18.6	17.9	17.3	16.6	16.0
15	20	24.8	24.1	23.4	22.7	22.0	21.3	20.6	19.9	19.2	18.5	17.9	17.3	16.6	16.0
16	21	24.8	24.0	23.3	22.6	21.9	21.2	20.5	19.9	19.2	18.5	17.9	17.2	16.6	16.0
17	22	24.7	24.0	23.3	22.6	21.9	21.2	20.5	19.8	19.2	18.5	17.8	17.2	16.6	16.0
18	23	24.7	23.9	23.2	22.5	21.8	21.1	20.5	19.8	19.1	18.5	17.8	17.2	16.6	15.9
19	24	24.6	23.9	23.2	22.5	21.8	21.1	20.4	19.8	19.1	18.4	17.8	17.2	16.5	15.9
20	25	24.5	23.8	23.1	22.4	21.7	21.1	20.4	19.7	19.1	18.4	17.8	17.1	16.5	15.9
21	26	24.4	23.7	23.1	22.4	21.7	21.0	20.3	19.7	19.0	18.4	17.7	17.1	16.5	15.9
22	27	24.4	23.7	23.0	22.3	21.6	21.0	20.3	19.6	19.0	18.3	17.7	17.1	16.5	15.9
23	28	24.3	23.6	22.9	22.2	21.6	20.9	20.2	19.6	18.9	18.3	17.7	17.0	16.4	15.8
24	29	24.2	23.5	22.8	22.2	21.5	20.8	20.2	19.5	18.9	18.3	17.6	17.0	16.4	15.8
25	30	24.1	23.4	22.8	22.1	21.4	20.8	20.1	19.5	18.8	18.2	17.6	17.0	16.4	15.8
26	31	24.0	23.3	22.7	22.0	21.4	20.7	20.1	19.4	18.8	18.2	17.5	16.9	16.3	15.7
27	32	23.9	23.2	22.6	21.9	21.3	20.6	20.0	19.4	18.7	18.1	17.5	16.9	16.3	15.7
28	33	23.8	23.1	22.5	21.8	21.2	20.6	19.9	19.3	18.7	18.1	17.4	16.8	16.2	15.6
29	34	23.6	23.0	22.4	21.7	21.1	20.5	19.8	19.2	18.6	18.0	17.4	16.8	16.2	15.6
30	35	23.5	22.9	22.3	21.6	21.0	20.4	19.8	19.1	18.5	17.9	17.3	16.7	16.1	15.6
31	36	23.4	22.7	22.1	21.5	20.9	20.3	19.7	19.1	18.5	17.9	17.3	16.7	16.1	15.5
32	37	23.2	22.6	22.0	21.4	20.8	20.2	19.6	19.0	18.4	17.8	17.2	16.6	16.0	15.5

33	38	23.1	22.5	21.9	21.3	20.7	20.1	19.5	18.9	18.3	17.7	17.1	16.5	16.0	15.4
34	39	22.9	22.3	21.7	21.1	20.5	20.0	19.4	18.8	18.2	17.6	17.0	16.5	15.9	15.3

		Ages													
Male	Female	Male 64	65	66	67	68	69	70	71	72	73	74	75	76	77	78
		Female 69	70	71	72	73	74	75	76	77	78	79	80	81	82	83
6	11	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.6	9.1	8.7	8.2
7	12	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.6	9.1	8.7	8.2
8	13	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.6	9.1	8.7	8.2
9	14	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.7	8.2
10	15	15.4	14.8	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.7	8.2
11	16	15.4	14.8	14.2	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.7	8.2
12	17	15.4	14.8	14.2	13.7	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
13	18	15.4	14.8	14.2	13.6	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
14	19	15.4	14.8	14.2	13.6	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
15	20	15.4	14.8	14.2	13.6	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
16	21	15.4	14.8	14.2	13.6	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
17	22	15.4	14.8	14.2	13.6	13.0	12.5	12.0	11.5	10.9	10.5	10.0	9.5	9.1	8.6	8.2
18	23	15.3	14.7	14.2	13.6	13.0	12.5	12.0	11.4	10.9	10.4	10.0	9.5	9.1	8.6	8.2
19	24	15.3	14.7	14.1	13.6	13.0	12.5	12.0	11.4	10.9	10.4	10.0	9.5	9.1	8.6	8.2
20	25	15.3	14.7	14.1	13.6	13.0	12.5	11.9	11.4	10.9	10.4	10.0	9.5	9.0	8.6	8.2
21	26	15.3	14.7	14.1	13.5	13.0	12.5	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
22	27	15.3	14.7	14.1	13.5	13.0	12.4	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
23	28	15.2	14.6	14.1	13.5	13.0	12.4	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
24	29	15.2	14.6	14.0	13.5	12.9	12.4	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
25	30	15.2	14.6	14.0	13.5	12.9	12.4	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
26	31	15.1	14.6	14.0	13.4	12.9	12.4	11.9	11.3	10.8	10.4	9.9	9.4	9.0	8.6	8.2
27	32	15.1	14.5	14.0	13.4	12.9	12.4	11.8	11.3	10.8	10.4	9.9	9.4	9.0	8.6	8.2
28	33	15.1	14.5	13.9	13.4	12.9	12.3	11.8	11.3	10.8	10.3	9.9	9.4	9.0	8.6	8.1
29	34	15.0	14.5	13.9	13.4	12.8	12.3	11.8	11.3	10.8	10.3	9.9	9.4	9.0	8.5	8.1
30	35	15.0	14.4	13.9	13.3	12.8	12.3	11.8	11.3	10.8	10.3	9.8	9.4	9.0	8.5	8.1
31	36	14.9	14.4	13.8	13.3	12.8	12.2	11.7	11.2	10.8	10.3	9.8	9.4	8.9	8.5	8.1
32	37	14.9	14.3	13.8	13.3	12.7	12.2	11.7	11.2	10.7	10.3	9.8	9.4	8.9	8.5	8.1
33	38	14.8	14.3	13.8	13.2	12.7	12.2	11.7	11.2	10.7	10.2	9.8	9.3	8.9	8.5	8.1
34	39	14.8	14.2	13.7	13.2	12.7	12.2	11.7	11.2	10.7	10.2	9.8	9.3	8.9	8.5	8.1

Male	Female	Ages														
		Male 79	80	81	82	83	84	85	86	87	88	89	90	91	92	93
		Female 84	85	86	87	88	89	90	91	92	93	94	95	96	97	98
6	11	7.8	7.4	7.1	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
7	12	7.8	7.4	7.1	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
8	13	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
9	14	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
10	15	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
11	16	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
12	17	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
13	18	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.1	4.8	4.5	4.2	4.0	3.7	3.5
14	19	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
15	20	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
16	21	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
17	22	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
18	23	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
19	24	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
20	25	7.8	7.4	7.0	6.7	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
21	26	7.8	7.4	7.0	6.7	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
22	27	7.8	7.4	7.0	6.7	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
23	28	7.8	7.4	7.0	6.6	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
24	29	7.8	7.4	7.0	6.6	6.3	6.0	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
25	30	7.8	7.4	7.0	6.6	6.3	6.0	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
26	31	7.8	7.4	7.0	6.6	6.3	6.0	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
27	32	7.7	7.4	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
28	33	7.7	7.4	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
29	34	7.7	7.3	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
30	35	7.7	7.3	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
31	36	7.7	7.3	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
32	37	7.7	7.3	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
33	38	7.7	7.3	6.9	6.6	6.2	5.9	5.6	5.3	5.0	4.7	4.5	4.2	3.9	3.7	3.5
34	39	7.7	7.3	6.9	6.6	6.2	5.9	5.6	5.3	5.0	4.7	4.4	4.2	3.9	3.7	3.5

Male	Female	Ages														
		Male 94	95	96	97	98	99	100	101	102	103	104	105	106	107	108
		Female 99	100	101	102	103	104	105	106	107	108	109	110	111	112	113
6	11	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
7	12	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
8	13	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
9	14	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7

10	15	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
11	16	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
12	17	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
13	18	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
14	19	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
15	20	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
16	21	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
17	22	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
18	23	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
19	24	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
20	25	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
21	26	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
22	27	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
23	28	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
24	29	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
25	30	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
26	31	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
27	32	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
28	33	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
29	34	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
30	35	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
31	36	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
32	37	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
33	38	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
34	39	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7

Male	Female	Ages												
		Male 35	36	37	38	39	40	41	42	43	44	45	46	47
		Female 40	41	42	43	44	45	46	47	48	49	50	51	52
35	40	30.3	29.9	29.4	29.0	28.5	28.0	27.5	27.0	26.5	26.0	25.5	24.9	24.4
36	41	29.9	29.5	29.0	28.6	28.2	27.7	27.2	26.7	26.2	25.7	25.2	24.7	24.2
37	42	29.4	29.0	28.6	28.2	27.8	27.3	26.9	26.4	25.9	25.5	25.0	24.4	23.9
38	43	29.0	28.6	28.2	27.8	27.4	27.0	26.5	26.1	25.6	25.2	24.7	24.2	23.7
39	44	28.5	28.2	27.8	27.4	27.0	26.6	26.2	25.8	25.3	24.8	24.4	23.9	23.4
40	45	28.0	27.7	27.3	27.0	26.6	26.2	25.8	25.4	25.0	24.5	24.1	23.6	23.1
41	46	27.5	27.2	26.9	26.5	26.2	25.8	25.4	25.0	24.6	24.2	23.8	23.3	22.9
42	47	27.0	26.7	26.4	26.1	25.8	25.4	25.0	24.6	24.2	23.8	23.4	23.0	22.6
43	48	26.5	26.2	25.9	25.6	25.3	25.0	24.6	24.2	23.9	23.5	23.1	22.7	22.2
44	49	26.0	25.7	25.5	25.2	24.8	24.5	24.2	23.8	23.5	23.1	22.7	22.3	21.9
45	50	25.5	25.2	25.0	24.7	24.4	24.1	23.8	23.4	23.1	22.7	22.4	22.0	21.6

Male	Female	Ages												
		Male 35	36	37	38	39	40	41	42	43	44	45	46	47
		Female 40	41	42	43	44	45	46	47	48	49	50	51	52
46	51	24.9	24.7	24.4	24.2	23.9	23.6	23.3	23.0	22.7	22.3	22.0	21.6	21.2
47	52	24.4	24.2	23.9	23.7	23.4	23.1	22.9	22.6	22.2	21.9	21.6	21.2	20.9

Male	Female	Ages												
		Male 48	49	50	51	52	53	54	55	56	57	58	59	60
		Female 53	54	55	56	57	58	59	60	61	62	63	64	65
35	40	23.8	23.3	22.7	22.1	21.6	21.0	20.4	19.8	19.3	18.7	18.1	17.5	17.0
36	41	23.6	23.1	22.5	22.0	21.4	20.8	20.3	19.7	19.1	18.6	18.0	17.4	16.9
37	42	23.4	22.9	22.3	21.8	21.2	20.7	20.1	19.6	19.0	18.4	17.9	17.3	16.8
38	43	23.2	22.6	22.1	21.6	21.1	20.5	20.0	19.4	18.9	18.3	17.8	17.2	16.7
39	44	22.9	22.4	21.9	21.4	20.9	20.3	19.8	19.3	18.7	18.2	17.7	17.1	16.6
40	45	22.7	22.2	21.7	21.2	20.7	20.1	19.6	19.1	18.6	18.0	17.5	17.0	16.5
41	46	22.4	21.9	21.4	20.9	20.4	19.9	19.4	18.9	18.4	17.9	17.4	16.9	16.3
42	47	22.1	21.6	21.2	20.7	20.2	19.7	19.2	18.7	18.2	17.7	17.2	16.7	16.2
43	48	21.8	21.4	20.9	20.5	20.0	19.5	19.0	18.6	18.1	17.6	17.1	16.6	16.1
44	49	21.5	21.1	20.6	20.2	19.8	19.3	18.8	18.4	17.9	17.4	16.9	16.4	15.9
45	50	21.2	20.8	20.4	19.9	19.5	19.1	18.6	18.1	17.7	17.2	16.7	16.3	15.8
46	51	20.9	20.5	20.1	19.7	19.2	18.8	18.4	17.9	17.5	17.0	16.6	16.1	15.6
47	52	20.5	20.1	19.8	19.4	19.0	18.5	18.1	17.7	17.3	16.8	16.4	15.9	15.5
48	53	20.2	19.8	19.4	19.1	18.7	18.3	17.9	17.5	17.0	16.6	16.2	15.7	15.3
49	54	19.8	19.5	19.1	18.8	18.4	18.0	17.6	17.2	16.8	16.4	16.0	15.5	15.1
50	55	19.4	19.1	18.8	18.4	18.1	17.7	17.3	16.9	16.6	16.2	15.8	15.3	14.9
51	56	19.1	18.8	18.4	18.1	17.8	17.4	17.0	16.7	16.3	15.9	15.5	15.1	14.7
52	57	18.7	18.4	18.1	17.8	17.4	17.1	16.8	16.4	16.0	15.7	15.3	14.9	14.5
53	58	18.3	18.0	17.7	17.4	17.1	16.8	16.4	16.1	15.8	15.4	15.1	14.7	14.3
54	59	17.9	17.6	17.3	17.0	16.8	16.4	16.1	15.8	15.5	15.1	14.8	14.4	14.1
55	60	17.5	17.2	16.9	16.7	16.4	16.1	15.8	15.5	15.2	14.9	14.5	14.2	13.9
56	61	17.0	16.8	16.6	16.3	16.0	15.8	15.5	15.2	14.9	14.6	14.3	13.9	13.6
57	62	16.6	16.4	16.2	15.9	15.7	15.4	15.1	14.9	14.6	14.3	14.0	13.7	13.4
58	63	16.2	16.0	15.8	15.5	15.3	15.1	14.8	14.5	14.3	14.0	13.7	13.4	13.1
59	64	15.7	15.5	15.3	15.1	14.9	14.7	14.4	14.2	13.9	13.7	13.4	13.1	12.8
60	65	15.3	15.1	14.9	14.7	14.5	14.3	14.1	13.9	13.6	13.4	13.1	12.8	12.6

Male	Female	Ages												
		Male 61	62	63	64	65	66	67	68	69	70	71	72	73
		Female 66	67	68	69	70	71	72	73	74	74	76	77	78
35	40	16.4	15.8	15.3	14.7	14.2	13.7	13.1	12.6	12.1	11.6	11.1	10.7	10.2
36	41	16.3	15.8	15.2	14.7	14.1	13.6	13.1	12.6	12.1	11.6	11.1	10.6	10.2
37	42	16.2	15.7	15.1	14.6	14.1	13.6	13.0	12.5	12.0	11.5	11.1	10.6	10.1
38	43	16.1	15.6	15.1	14.5	14.0	13.5	13.0	12.5	12.0	11.5	11.0	10.6	10.1
39	44	16.0	15.5	15.0	14.5	13.9	13.4	12.9	12.4	11.9	11.5	11.0	10.5	10.1
40	45	15.9	15.4	14.9	14.4	13.9	13.4	12.9	12.4	11.9	11.4	11.0	10.5	10.0
41	46	15.8	15.3	14.8	14.3	13.8	13.3	12.8	12.3	11.8	11.4	10.9	10.5	10.0
42	47	15.7	15.2	14.7	14.2	13.7	13.2	12.7	12.3	11.8	11.3	10.9	10.4	10.0
43	48	15.6	15.1	14.6	14.1	13.6	13.1	12.7	12.2	11.7	11.3	10.8	10.4	9.9
44	49	15.5	15.0	14.5	14.0	13.5	13.1	12.6	12.1	11.7	11.2	10.8	10.3	9.9
45	50	15.3	14.8	14.4	13.9	13.4	13.0	12.5	12.0	11.6	11.1	10.7	10.3	9.8
46	51	15.2	14.7	14.2	13.8	13.3	12.9	12.4	12.0	11.5	11.1	10.6	10.2	9.8
47	52	15.0	14.6	14.1	13.7	13.2	12.8	12.3	11.9	11.4	11.0	10.6	10.1	9.7
48	53	14.9	14.4	14.0	13.5	13.1	12.6	12.2	11.8	11.3	10.9	10.5	10.1	9.7
49	54	14.7	14.3	13.8	13.4	13.0	12.5	12.1	11.7	11.3	10.8	10.4	10.0	9.6
50	55	14.5	14.1	13.7	13.3	12.8	12.4	12.0	11.6	11.2	10.7	10.3	9.9	9.5
51	56	14.3	13.9	13.5	13.1	12.7	12.3	11.9	11.5	11.1	10.7	10.3	9.9	9.5
52	57	14.1	13.7	13.3	12.9	12.5	12.1	11.7	11.3	10.9	10.6	10.2	9.8	9.4
53	58	13.9	13.6	13.2	12.8	12.4	12.0	11.6	11.2	10.8	10.5	10.1	9.7	9.3
54	59	13.7	13.4	13.0	12.6	12.2	11.9	11.5	11.1	10.7	10.3	10.0	9.6	9.2
55	60	13.5	13.2	12.8	12.4	12.1	11.7	11.3	11.0	10.6	10.2	9.9	9.5	9.1
56	61	13.3	12.9	12.6	12.2	11.9	11.5	11.2	10.8	10.5	10.1	9.8	9.4	9.0
57	62	13.0	12.7	12.4	12.1	11.7	11.4	11.0	10.7	10.3	10.0	9.6	9.3	8.9
58	63	12.8	12.5	12.2	11.8	11.5	11.2	10.9	10.5	10.2	9.8	9.5	9.2	8.8
59	64	12.6	12.3	11.9	11.6	11.3	11.0	10.7	10.4	10.0	9.7	9.4	9.1	8.7
60	65	12.3	12.0	11.7	11.4	11.1	10.8	10.5	10.2	9.9	9.6	9.3	8.9	8.6
61	66	12.0	11.8	11.5	11.2	10.9	10.6	10.3	10.0	9.7	9.4	9.1	8.8	8.5
62	67	11.8	11.5	11.2	11.0	10.7	10.4	10.1	9.8	9.6	9.3	9.0	8.7	8.4
63	68	11.5	11.2	11.0	10.7	10.5	10.2	9.9	9.7	9.4	9.1	8.8	8.5	8.2
64	69	11.2	11.0	10.7	10.5	10.2	10.0	9.7	9.5	9.2	8.9	8.7	8.4	8.1
65	70	10.9	10.7	10.5	10.2	10.0	9.8	9.5	9.3	9.0	8.8	8.5	8.2	8.0
66	71	10.6	10.4	10.2	10.0	9.8	9.5	9.3	9.1	8.8	8.6	8.3	8.1	7.8
67	72	10.3	10.1	9.9	9.7	9.5	9.3	9.1	8.9	8.6	8.4	8.1	7.9	7.7
68	73	10.0	9.8	9.7	9.5	9.3	9.1	8.9	8.6	8.4	8.2	8.0	7.7	7.5
69	74	9.7	9.6	9.4	9.2	9.0	8.8	8.6	8.4	8.2	8.0	7.8	7.6	7.3
70	75	9.4	9.3	9.1	8.9	8.8	8.6	8.4	8.2	8.0	7.8	7.6	7.4	7.2
71	76	9.1	9.0	8.8	8.7	8.5	8.3	8.1	8.0	7.8	7.6	7.4	7.2	7.0
72	77	8.8	8.7	8.5	8.4	8.2	8.1	7.9	7.7	7.6	7.4	7.2	7.0	6.8

Male	Female	Ages												
		Male 61	62	63	64	65	66	67	68	69	70	71	72	73
		Female 66	67	68	69	70	71	72	73	74	74	76	77	78
73	78	8.5	8.4	8.2	8.1	8.0	7.8	7.7	7.5	7.3	7.2	7.0	6.8	6.7

Male	Female	Ages												
		Male 74	75	76	77	78	79	80	81	82	83	84	85	86
		Female 79	80	81	82	83	84	85	86	87	88	89	90	91
35	40	9.7	9.3	8.9	8.5	8.1	7.7	7.3	6.9	6.6	6.2	5.9	5.6	5.3
36	41	9.7	9.3	8.9	8.4	8.0	7.7	7.3	6.9	6.6	6.2	5.9	5.6	5.3
37	42	9.7	9.3	8.8	8.4	8.0	7.6	7.3	6.9	6.5	6.2	5.9	5.6	5.3
38	43	9.7	9.2	8.8	8.4	8.0	7.6	7.2	6.9	6.5	6.2	5.9	5.6	5.3
39	44	9.6	9.2	8.8	8.4	8.0	7.6	7.2	6.9	6.5	6.2	5.9	5.6	5.3
40	45	9.6	9.2	8.8	8.4	8.0	7.6	7.2	6.9	6.5	6.2	5.9	5.5	5.2
41	46	9.6	9.2	8.7	8.3	7.9	7.6	7.2	6.8	6.5	6.2	5.8	5.5	5.2
42	47	9.5	9.1	8.7	8.3	7.9	7.5	7.2	6.8	6.5	6.2	5.8	5.5	5.2
43	48	9.5	9.1	8.7	8.3	7.9	7.5	7.2	6.8	6.5	6.1	5.8	5.5	5.2
44	49	9.5	9.0	8.6	8.2	7.9	7.5	7.1	6.8	6.4	6.1	5.8	5.5	5.2
45	50	9.4	9.0	8.6	8.2	7.8	7.5	7.1	6.8	6.4	6.1	5.8	5.5	5.2
46	51	9.4	9.0	8.6	8.2	7.8	7.4	7.1	6.7	6.4	6.1	5.8	5.5	5.2
47	52	9.3	8.9	8.5	8.1	7.8	7.4	7.1	6.7	6.4	6.1	5.8	5.5	5.2
48	53	9.3	8.9	8.5	8.1	7.7	7.4	7.0	6.7	6.4	6.0	5.7	5.4	5.1
49	54	9.2	8.8	8.4	8.1	7.7	7.3	7.0	6.7	6.3	6.0	5.7	5.4	5.1
50	55	9.1	8.8	8.4	8.0	7.7	7.3	7.0	6.6	6.3	6.0	5.7	5.4	5.1
51	56	9.1	8.7	8.3	8.0	7.6	7.3	6.9	6.6	6.3	6.0	5.7	5.4	5.1
52	57	9.0	8.6	8.3	7.9	7.6	7.2	6.9	6.6	6.2	5.9	5.6	5.4	5.1
53	58	8.9	8.6	8.2	7.9	7.5	7.2	6.9	6.5	6.2	5.9	5.6	5.3	5.1
54	59	8.9	8.5	8.2	7.8	7.5	7.1	6.8	6.5	6.2	5.9	5.6	5.3	5.0
55	60	8.8	8.4	8.1	7.7	7.4	7.1	6.8	6.4	6.1	5.8	5.6	5.3	5.0
56	61	8.7	8.4	8.0	7.7	7.3	7.0	6.7	6.4	6.1	5.8	5.5	5.3	5.0
57	62	8.6	8.3	7.9	7.6	7.3	7.0	6.7	6.4	6.1	5.8	5.5	5.2	5.0
58	63	8.5	8.2	7.9	7.5	7.2	6.9	6.6	6.3	6.0	5.7	5.5	5.2	4.9
59	64	8.4	8.1	7.8	7.5	7.1	6.8	6.5	6.3	6.0	5.7	5.4	5.2	4.9
60	65	8.3	8.0	7.7	7.4	7.1	6.8	6.5	6.2	5.9	5.6	5.4	5.1	4.9
61	66	8.2	7.9	7.6	7.3	7.0	6.7	6.4	6.1	5.9	5.6	5.3	5.1	4.8
62	67	8.1	7.8	7.5	7.2	6.9	6.6	6.4	6.1	5.8	5.5	5.3	5.0	4.8
63	68	8.0	7.7	7.4	7.1	6.8	6.6	6.3	6.0	5.7	5.5	5.2	5.0	4.7
64	69	7.8	7.6	7.3	7.0	6.7	6.5	6.2	5.9	5.7	5.4	5.2	4.9	4.7
65	70	7.7	7.4	7.2	6.9	6.6	6.4	6.1	5.9	5.6	5.4	5.1	4.9	4.7

66	71	7.6	7.3	7.1	6.8	6.5	6.3	6.0	5.8	5.5	5.3	5.1	4.8	4.6
67	72	7.4	7.2	6.9	6.7	6.4	6.2	6.0	5.7	5.5	5.2	5.0	4.8	4.6
68	73	7.3	7.0	6.8	6.6	6.3	6.1	5.9	5.6	5.4	5.2	4.9	4.7	4.5
69	74	7.1	6.9	6.7	6.4	6.2	6.0	5.8	5.5	5.3	5.1	4.9	4.7	4.5
70	75	7.0	6.8	6.5	6.3	6.1	5.9	5.7	5.4	5.2	5.0	4.8	4.6	4.4
71	76	6.8	6.6	6.4	6.2	6.0	5.8	5.6	5.3	5.1	4.9	4.7	4.5	4.3
72	77	6.6	6.4	6.3	6.1	5.9	5.7	5.5	5.3	5.0	4.9	4.7	4.5	4.3
73	78	6.5	6.3	6.1	5.9	5.7	5.5	5.3	5.1	5.0	4.8	4.6	4.4	4.2
74	79	6.3	6.1	6.0	5.8	5.6	5.4	5.2	5.0	4.9	4.7	4.5	4.3	4.1
75	80	6.1	6.0	5.8	5.6	5.5	5.3	5.1	4.9	4.8	4.6	4.4	4.2	4.1
76	81	6.0	5.8	5.6	5.5	5.3	5.2	5.0	4.8	4.7	4.5	4.3	4.1	4.0
77	82	5.8	5.6	5.5	5.3	5.2	5.0	4.9	4.7	4.5	4.4	4.2	4.1	3.9
78	83	5.6	5.5	5.3	5.2	5.0	4.9	4.7	4.6	4.4	4.3	4.1	4.0	3.8
79	84	5.4	5.3	5.2	5.0	4.9	4.7	4.6	4.5	4.3	4.2	4.0	3.9	3.7
80	85	5.2	5.1	5.0	4.9	4.7	4.6	4.5	4.3	4.2	4.1	3.9	3.8	3.6
81	86	5.0	4.9	4.8	4.7	4.6	4.5	4.3	4.2	4.1	3.9	3.8	3.7	3.6
82	87	4.9	4.8	4.7	4.5	4.4	4.3	4.2	4.1	4.0	3.8	3.7	3.6	3.5
83	88	4.7	4.6	4.5	4.4	4.3	4.2	4.1	3.9	3.8	3.7	3.6	3.5	3.4
84	89	4.5	4.4	4.3	4.2	4.1	4.0	3.9	3.8	3.7	3.6	3.5	3.4	3.3
85	90	4.3	4.2	4.1	4.1	4.0	3.9	3.8	3.7	3.6	3.5	3.4	3.3	3.2
86	91	4.1	4.1	4.0	3.9	3.8	3.7	3.6	3.6	3.5	3.4	3.3	3.2	3.1

Male	Female	Ages										
		Male 87	88	89	90	91	92	93	94	95	96	97
		Female 92	93	94	95	96	97	98	99	100	101	102
35 ...	40 ...	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.9	2.7
36 ...	41 ...	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.9	2.7
37 ...	42 ...	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.9	2.7
38 ...	43 ...	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.8	2.6
39 ...	44 ...	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.0	2.8	2.6
40 ...	45 ...	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.0	2.8	2.6
41 ...	46 ...	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.2	3.0	2.8	2.6
42 ...	47 ...	4.9	4.7	4.4	4.2	3.9	3.7	3.5	3.2	3.0	2.8	2.6
43 ...	48 ...	4.9	4.7	4.4	4.1	3.9	3.7	3.5	3.2	3.0	2.8	2.6
44 ...	49 ...	4.9	4.7	4.4	4.1	3.9	3.7	3.4	3.2	3.0	2.8	2.6
45 ...	50 ...	4.9	4.6	4.4	4.1	3.9	3.7	3.4	3.2	3.0	2.8	2.6
46 ...	51 ...	4.9	4.6	4.4	4.1	3.9	3.7	3.4	3.2	3.0	2.8	2.6
47 ...	52 ...	4.9	4.6	4.4	4.1	3.9	3.7	3.4	3.2	3.0	2.8	2.6
48 ...	53 ...	4.9	4.6	4.4	4.1	3.9	3.6	3.4	3.2	3.0	2.8	2.6
49 ...	54 ...	4.9	4.6	4.3	4.1	3.9	3.6	3.4	3.2	3.0	2.8	2.6
50 ...	55 ...	4.8	4.6	4.3	4.1	3.9	3.6	3.4	3.2	3.0	2.8	2.6
51 ...	56 ...	4.8	4.6	4.3	4.1	3.8	3.6	3.4	3.2	3.0	2.8	2.6
52 ...	57 ...	4.8	4.5	4.3	4.1	3.8	3.6	3.4	3.2	3.0	2.8	2.6
53 ...	58 ...	4.8	4.5	4.3	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6
54 ...	59 ...	4.8	4.5	4.3	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6
55 ...	60 ...	4.7	4.5	4.3	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6
56 ...	61 ...	4.7	4.5	4.2	4.0	3.8	3.6	3.3	3.1	2.9	2.8	2.6
57 ...	62 ...	4.7	4.5	4.2	4.0	3.8	3.5	3.3	3.1	2.9	2.7	2.6
58 ...	63 ...	4.7	4.4	4.2	4.0	3.7	3.5	3.3	3.1	2.9	2.7	2.5
59 ...	64 ...	4.6	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.9	2.7	2.5

Male	Female	Ages										
		Male 98	99	100	101	102	103	104	105	106	107	108
		Female 103	104	105	106	107	108	109	110	111	112	113
35 ...	40 ...	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
36 ...	41 ...	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
37 ...	42 ...	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
38 ...	43 ...	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
39 ...	44 ...	2.4	2.3	2.1	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
40 ...	45 ...	2.4	2.2	2.1	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
41 ...	46 ...	2.4	2.2	2.1	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
42 ...	47 ...	2.4	2.2	2.0	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
43 ...	48 ...	2.4	2.2	2.0	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
44 ...	49 ...	2.4	2.2	2.0	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
45 ...	50 ...	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	0.8	0.7
46 ...	51 ...	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	0.8	0.7
47 ...	52 ...	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	0.8	0.7
48 ...	53 ...	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	0.8	0.7
49 ...	54 ...	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	0.8	0.7
50 ...	55 ...	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7
51 ...	56 ...	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7
52 ...	57 ...	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7
53 ...	58 ...	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7
54 ...	59 ...	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7
55 ...	60 ...	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	1.0	0.8	0.7
56 ...	61 ...	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	1.0	0.8	0.7
57 ...	62 ...	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	0.9	0.8	0.7
58 ...	63 ...	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	0.9	0.8	0.7
59 ...	64 ...	2.3	2.2	2.0	1.8	1.6	1.4	1.3	1.1	0.9	0.8	0.7

Male	Female	Ages										
		Male 87	88	89	90	91	92	93	94	95	96	97
		Female 92	93	94	95	96	97	98	99	100	101	102
60 ...	65 ...	4.6	4.4	4.1	3.9	3.7	3.5	3.3	3.1	2.9	2.7	2.5
61 ...	66 ...	4.6	4.3	4.1	3.9	3.7	3.5	3.3	3.1	2.9	2.7	2.5
62 ...	67 ...	4.5	4.3	4.1	3.9	3.7	3.5	3.3	3.1	2.9	2.7	2.5
63 ...	68 ...	4.5	4.3	4.1	3.8	3.6	3.4	3.2	3.0	2.9	2.7	2.5
64 ...	69 ...	4.5	4.2	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.7	2.5
65 ...	70 ...	4.4	4.2	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6	2.5
66 ...	71 ...	4.4	4.2	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6	2.4
67 ...	72 ...	4.3	4.1	3.9	3.7	3.5	3.3	3.1	3.0	2.8	2.6	2.4
68 ...	73 ...	4.3	4.1	3.9	3.7	3.5	3.3	3.1	2.9	2.8	2.6	2.4
69 ...	74 ...	4.2	4.0	3.8	3.6	3.5	3.3	3.1	2.9	2.7	2.6	2.4
70 ...	75 ...	4.2	4.0	3.8	3.6	3.4	3.2	3.1	2.9	2.7	2.5	2.4
71 ...	76 ...	4.1	3.9	3.8	3.6	3.4	3.2	3.0	2.9	2.7	2.5	2.3
72 ...	77 ...	4.1	3.9	3.7	3.5	3.3	3.2	3.0	2.8	2.7	2.5	2.3
73 ...	78 ...	4.0	3.8	3.7	3.5	3.3	3.1	3.0	2.8	2.6	2.5	2.3
74 ...	79 ...	3.9	3.8	3.6	3.4	3.3	3.1	2.9	2.8	2.6	2.4	2.3
75 ...	80 ...	3.9	3.7	3.5	3.4	3.2	3.0	2.9	2.7	2.6	2.4	2.2
76 ...	81 ...	3.8	3.6	3.5	3.3	3.2	3.0	2.8	2.7	2.5	2.4	2.2
77 ...	82 ...	3.7	3.6	3.4	3.3	3.1	3.0	2.8	2.6	2.5	2.3	2.2
78 ...	83 ...	3.7	3.5	3.4	3.2	3.1	2.9	2.7	2.6	2.4	2.3	2.1
79 ...	84 ...	3.6	3.4	3.3	3.1	3.0	2.8	2.7	2.5	2.4	2.2	2.1
80 ...	85 ...	3.5	3.4	3.2	3.1	2.9	2.8	2.6	2.5	2.3	2.2	2.0
81 ...	86 ...	3.4	3.3	3.1	3.0	2.9	2.7	2.6	2.4	2.3	2.1	2.0
82 ...	87 ...	3.3	3.2	3.1	2.9	2.8	2.7	2.5	2.4	2.2	2.1	2.0
83 ...	88 ...	3.2	3.1	3.0	2.9	2.7	2.6	2.5	2.3	2.2	2.0	1.9
84 ...	89 ...	3.1	3.0	2.9	2.8	2.7	2.5	2.4	2.3	2.1	2.0	1.9

Male	Female	Ages										
		Male 98	99	100	101	102	103	104	105	106	107	108
		Female 103	104	105	106	107	108	109	110	111	112	113
60 ...	65 ...	2.3	2.1	2.0	1.8	1.6	1.4	1.3	1.1	0.9	0.8	0.7
61 ...	66 ...	2.3	2.1	2.0	1.8	1.6	1.4	1.2	1.1	0.9	0.8	0.7
62 ...	67 ...	2.3	2.1	1.9	1.8	1.6	1.4	1.2	1.1	0.9	0.8	0.7
63 ...	68 ...	2.3	2.1	1.9	1.7	1.6	1.4	1.2	1.1	0.9	0.8	0.7
64 ...	69 ...	2.3	2.1	1.9	1.7	1.6	1.4	1.2	1.1	0.9	0.8	0.7
65 ...	70 ...	2.3	2.1	1.9	1.7	1.6	1.4	1.2	1.1	0.9	0.8	0.7
66 ...	71 ...	2.3	2.1	1.9	1.7	1.5	1.4	1.2	1.1	0.9	0.8	0.7
67 ...	72 ...	2.2	2.1	1.9	1.7	1.5	1.4	1.2	1.0	0.9	0.7	0.7
68 ...	73 ...	2.2	2.0	1.9	1.7	1.5	1.4	1.2	1.0	0.9	0.7	0.7
69 ...	74 ...	2.2	2.0	1.8	1.7	1.5	1.3	1.2	1.0	0.9	0.7	0.6
70 ...	75 ...	2.2	2.0	1.8	1.7	1.5	1.3	1.2	1.0	0.9	0.7	0.6
71 ...	76 ...	2.2	2.0	1.8	1.6	1.5	1.3	1.2	1.0	0.9	0.7	0.6
72 ...	77 ...	2.1	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7	0.6
73 ...	78 ...	2.1	1.9	1.8	1.6	1.4	1.3	1.1	1.0	0.8	0.7	0.6
74 ...	79 ...	2.1	1.9	1.7	1.6	1.4	1.3	1.1	1.0	0.8	0.7	0.6
75 ...	80 ...	2.1	1.9	1.7	1.6	1.4	1.3	1.1	1.0	0.8	0.7	....
76 ...	81 ...	2.0	1.9	1.7	1.5	1.4	1.2	1.1	0.9	0.8	0.7	....
77 ...	82 ...	2.0	1.8	1.7	1.5	1.4	1.2	1.1	0.9	0.8	0.7	....
78 ...	83 ...	2.0	1.8	1.6	1.5	1.3	1.2	1.0	0.9	0.8	0.7	....
79 ...	84 ...	1.9	1.8	1.6	1.5	1.3	1.2	1.0	0.9	0.8	0.7	....
80 ...	85 ...	1.9	1.7	1.6	1.4	1.3	1.1	1.0	0.9	0.7	0.7	....
81 ...	86 ...	1.8	1.7	1.5	1.4	1.3	1.1	1.0	0.8	0.7	0.6	....
82 ...	87 ...	1.8	1.7	1.5	1.4	1.2	1.1	1.0	0.8	0.7	0.6	....
83 ...	88 ...	1.8	1.6	1.5	1.3	1.2	1.1	0.9	0.8	0.7	0.6	....
84 ...	89 ...	1.7	1.6	1.4	1.3	1.2	1.0	0.9	0.8	0.7	....	....

Male	Female	Ages									
		Male 87	88	89	90	91	92	93	94	95	96
		Female 92	93	94	95	96	97	98	99	100	101
85	90	3.1	2.9	2.8	2.7	2.6	2.5	2.3	2.2	2.1	1.9
86	91	3.0	2.8	2.7	2.6	2.5	2.4	2.3	2.1	2.0	1.9
87	92	2.9	2.8	2.6	2.5	2.4	2.3	2.2	2.1	1.9	1.8
88	93	2.8	2.7	2.6	2.4	2.3	2.2	2.1	2.0	1.9	1.7
89	94	2.6	2.6	2.5	2.4	2.2	2.1	2.0	1.9	1.8	1.7
90	95	2.5	2.4	2.4	2.3	2.2	2.0	1.9	1.8	1.7	1.6
91	96	2.4	2.3	2.2	2.2	2.1	2.0	1.9	1.7	1.6	1.5
92	97	2.3	2.2	2.1	2.0	2.0	1.9	1.8	1.7	1.6	1.5
93	98	2.2	2.1	2.0	1.9	1.9	1.8	1.7	1.6	1.5	1.4
94	99	2.1	2.0	1.9	1.8	1.7	1.7	1.6	1.5	1.4	1.3
95	100	1.9	1.9	1.8	1.7	1.6	1.6	1.5	1.4	1.3	1.2
96	101	1.8	1.7	1.7	1.6	1.5	1.5	1.4	1.3	1.2	1.1
97	102	1.7	1.6	1.6	1.5	1.4	1.4	1.3	1.2	1.1	1.1
98	103	1.6	1.5	1.4	1.4	1.3	1.3	1.2	1.1	1.0	1.0
99	104	1.4	1.4	1.3	1.3	1.2	1.1	1.1	1.0	1.0	0.9

Male	Female	Ages									
		Male 97	98	99	100	101	102	103	104	105	106
		Female 102	103	104	105	106	107	108	109	110	111
85	90	1.8	1.7	1.5	1.4	1.3	1.1	1.0	0.9	0.8	0.7
86	91	1.7	1.6	1.5	1.3	1.2	1.1	1.0	0.8	0.7	0.7
87	92	1.7	1.6	1.4	1.3	1.2	1.1	0.9	0.8	0.7	0.6
88	93	1.6	1.5	1.4	1.3	1.1	1.0	0.9	0.8	0.7	0.6
89	94	1.6	1.4	1.3	1.2	1.1	1.0	0.9	0.7	0.7	....
90	95	1.5	1.4	1.3	1.2	1.0	0.9	0.8	0.7	0.6	....
91	96	1.4	1.3	1.2	1.1	1.0	0.9	0.8	0.7	0.6	....
92	97	1.4	1.3	1.1	1.0	0.9	0.8	0.7	0.7	....	....
93	98	1.3	1.2	1.1	1.0	0.9	0.8	0.7	0.6	....	....
94	99	1.2	1.1	1.0	0.9	0.8	0.7	0.7	....	....	....
95	100	1.1	1.0	1.0	0.9	0.8	0.7	0.6	....	....	....
96	101	1.1	1.0	0.9	0.8	0.7	0.7	....	....	....	....
97	102	1.0	0.9	0.8	0.7	0.7	0.6	....	....	....	....
98	103	0.9	0.8	0.7	0.7	0.6	....	....	....	....	....
99	104	0.8	0.7	0.7	0.6	....	....	....	....	....	....

TABLE III—PERCENT VALUE OF REFUND FEATURE

Ages		Duration of guaranteed amount—[Years]												
Male	Female	1	2	3	4	5	6	7	8	9	10	11	12	13
6	11	....	....	....	....	....	....	....	....	1	1	1	1	1
7	12	....	....	....	....	....	....	....	....	1	1	1	1	1
8	13	....	....	....	....	....	....	....	1	1	1	1	1	1
9	14	....	....	....	....	....	....	....	1	1	1	1	1	1
10	15	....	....	....	....	....	....	....	1	1	1	1	1	1
11	16	....	....	....	....	....	....	....	1	1	1	1	1	1
12	17	....	....	....	....	....	....	....	1	1	1	1	1	1
13	18	....	....	....	....	....	....	....	1	1	1	1	1	1
14	19	....	....	....	....	....	....	....	1	1	1	1	1	1
15	20	....	....	....	....	....	....	....	1	1	1	1	1	1
16	21	....	....	....	....	....	....	....	1	1	1	1	1	1
17	22	....	....	....	....	....	....	....	1	1	1	1	1	1
18	23	....	....	....	....	....	....	....	1	1	1	1	1	1
19	24	....	....	....	....	....	....	....	1	1	1	1	1	1
20	25	....	....	....	....	....	....	....	1	1	1	1	1	1
21	26	....	....	....	....	....	....	....	1	1	1	1	1	1
22	27	....	....	....	....	....	....	1	1	1	1	1	1	1
23	28	....	....	....	....	....	....	1	1	1	1	1	1	1
24	29	....	....	....	....	....	....	1	1	1	1	1	1	1
25	30	....	....	....	....	....	....	1	1	1	1	1	1	1
26	31	....	....	....	....	....	1	1	1	1	1	1	1	1
27	32	....	....	....	....	....	1	1	1	1	1	1	1	1
28	33	....	....	....	....	....	1	1	1	1	1	1	1	1
29	34	....	....	....	....	....	1	1	1	1	1	1	1	2
30	35	....	....	....	....	1	1	1	1	1	1	1	2	2
31	36	....	....	....	....	1	1	1	1	1	1	1	2	2
32	37	....	....	....	....	1	1	1	1	1	1	2	2	2
33	38	....	....	....	1	1	1	1	1	1	1	2	2	2
34	39	....	....	....	1	1	1	1	1	1	2	2	2	2
35	40	....	....	....	1	1	1	1	1	2	2	2	2	2
36	41	....	....	....	1	1	1	1	1	2	2	2	2	3
37	42	....	....	1	1	1	1	1	2	2	2	2	3	3
38	43	....	....	1	1	1	1	1	2	2	2	2	3	3
39	44	....	....	1	1	1	1	2	2	2	2	3	3	3
40	45	....	....	1	1	1	1	2	2	2	3	3	3	4
41	46	....	....	1	1	1	1	2	2	2	3	3	3	4
42	47	....	....	1	1	1	2	2	2	3	3	3	4	4

TABLE III—PERCENT VALUE OF REFUND FEATURE—Continued

Ages		Duration of guaranteed amount—[Years]												
Male	Female	1	2	3	4	5	6	7	8	9	10	11	12	13
43	48	....	1	1	1	1	2	2	2	3	3	4	4	4
44	49	....	1	1	1	1	2	2	3	3	3	4	4	5
45	50	....	1	1	1	2	2	2	3	3	4	4	5	5
46	51	....	1	1	1	2	2	3	3	3	4	4	5	5
47	52	....	1	1	1	2	2	3	3	4	4	5	5	6
48	53	....	1	1	2	2	2	3	3	4	5	5	6	6
49	54	....	1	1	2	2	3	3	4	4	5	5	6	7
50	55	....	1	1	2	2	3	3	4	5	5	6	7	7
51	56	....	1	1	2	3	3	4	4	5	6	6	7	8
52	57	1	1	2	2	3	3	4	5	5	6	7	8	8
53	58	1	1	2	2	3	4	4	5	6	7	7	8	9
54	59	1	1	2	2	3	4	5	5	6	7	8	9	10
55	60	1	1	2	3	3	4	5	6	7	8	8	9	10
56	61	1	1	2	3	4	4	5	6	7	8	9	10	11
57	62	1	1	2	3	4	5	6	7	8	9	10	11	12
58	63	1	2	2	3	4	5	6	7	8	9	10	12	13
59	64	1	2	3	4	5	6	7	8	9	10	11	12	14
60	65	1	2	3	4	5	6	7	8	10	11	12	13	15
61	66	1	2	3	4	5	6	8	9	10	12	13	14	16
62	67	1	2	3	4	6	7	8	10	11	12	14	15	17
63	68	1	2	4	5	6	7	9	10	12	13	15	16	18
64	69	1	3	4	5	7	8	9	11	13	14	16	17	19
65	70	1	3	4	6	7	9	10	12	13	15	17	19	20
66	71	1	3	4	6	8	9	11	13	14	16	18	20	22
67	72	2	3	5	6	8	10	12	14	15	17	19	21	23
68	73	2	3	5	7	9	11	13	14	16	18	21	23	25
69	74	2	4	6	7	9	11	13	16	18	20	22	24	26
70	75	2	4	6	8	10	12	14	17	19	21	23	26	28
71	76	2	4	6	9	11	13	15	18	20	22	25	27	29
72	77	2	5	7	9	12	14	16	19	21	24	26	29	31
73	78	2	5	7	10	12	15	18	20	23	25	28	30	33
74	79	3	5	8	11	13	16	19	22	24	27	30	32	35
75	80	3	6	8	11	14	17	20	23	26	29	31	34	37
76	81	3	6	9	12	15	18	21	24	27	30	33	36	39
77	82	3	7	10	13	16	20	23	26	29	32	35	38	41
78	83	4	7	11	14	17	21	24	28	31	34	37	40	43
79	84	4	8	11	15	19	22	26	29	33	36	39	42	45

80	85	4	8	12	16	20	24	27	31	34	38	41	44	47
81	86	4	9	13	17	21	25	29	33	36	40	43	46	49
82	87	5	9	14	18	23	27	31	35	38	42	45	48	51
83	88	5	10	15	19	24	28	33	37	40	44	47	50	53
84	89	5	11	16	21	26	30	34	38	42	46	49	52	55
85	90	6	11	17	22	27	32	36	41	44	48	51	55	57

Ages		Duration of guaranteed amount—[Years]												
Male	Female	14	15	16	17	18	19	20	21	22	23	24	25	26
6	11	1	1	1	1	1	1	1	1	1	1	2	2	2
7	12	1	1	1	1	1	1	1	1	1	1	2	2	2
8	13	1	1	1	1	1	1	1	1	1	1	2	2	2
9	14	1	1	1	1	1	1	1	1	1	1	2	2	2
10	15	1	1	1	1	1	1	1	1	1	2	2	2	2
11	16	1	1	1	1	1	1	1	1	1	2	2	2	2
12	17	1	1	1	1	1	1	1	1	1	2	2	2	2
13	18	1	1	1	1	1	1	1	1	2	2	2	2	2
14	19	1	1	1	1	1	1	1	1	2	2	2	2	2
15	20	1	1	1	1	1	1	1	1	2	2	2	2	2
16	21	1	1	1	1	1	1	1	2	2	2	2	2	2
17	22	1	1	1	1	1	1	1	2	2	2	2	2	2
18	23	1	1	1	1	1	1	2	2	2	2	2	2	2
19	24	1	1	1	1	1	2	2	2	2	2	2	2	2
20	25	1	1	1	1	1	2	2	2	2	2	2	2	3
21	26	1	1	1	1	2	2	2	2	2	2	2	3	3
22	27	1	1	1	1	2	2	2	2	2	2	3	3	3
23	28	1	1	1	2	2	2	2	2	2	2	3	3	3
24	29	1	1	2	2	2	2	2	2	2	3	3	3	3
25	30	1	1	2	2	2	2	2	2	3	3	3	3	3
26	31	1	2	2	2	2	2	2	3	3	3	3	3	4
27	32	2	2	2	2	2	2	3	3	3	3	3	4	4
28	33	2	2	2	2	2	3	3	3	3	3	4	4	4
29	34	2	2	2	2	2	3	3	3	3	4	4	4	5
30	35	2	2	2	2	3	3	3	3	4	4	4	5	5
31	36	2	2	2	3	3	3	3	4	4	4	5	5	5
32	37	2	2	3	3	3	3	4	4	4	5	5	5	6
33	38	2	3	3	3	3	4	4	4	5	5	5	6	6
34	39	3	3	3	3	4	4	4	5	5	5	6	6	7
35	40	3	3	3	4	4	4	5	5	5	6	6	7	7
36	41	3	3	4	4	4	5	5	5	6	6	7	7	8
37	42	3	3	4	4	4	5	5	6	6	7	7	8	8

Ages		Duration of guaranteed amount—[Years]												
Male	Female	14	15	16	17	18	19	20	21	22	23	24	25	26
38	43	3	4	4	4	5	5	6	6	7	7	8	8	9
39	44	4	4	4	5	5	6	6	7	7	8	8	9	9
40	45	4	4	5	5	6	6	7	7	8	8	9	9	10
41	46	4	5	5	6	6	7	7	8	8	9	9	10	11
42	47	5	5	5	6	6	7	8	8	9	9	10	11	12
43	48		5	6	6	7	8	8	9	9	10	11	12	12
44	49	5	6	6	7	7	8	9	9	10	11	12	12	13
45	50	6	6	7	7	8	9	9	10	11	12	12	13	14
46	51	6	7	7	8	9	9	10	11	12	12	13	14	15
47	52	7	7	8	9	9	10	11	12	12	13	14	15	16
48	53	7	8	8	9	10	11	12	12	13	14	15	16	17
49	54	8	8	9	10	11	11	12	13	14	15	16	17	18
50	55	8	9	10	11	11	12	13	14	15	16	17	18	20
51	56	9	10	10	11	12	13	14	15	16	17	18	20	21
52	57	9	10	11	12	13	14	15	16	17	18	20	21	22
53	58	10	11	12	13	14	15	16	17	19	20	21	22	24
54	59	11	12	13	14	15	16	17	18	20	21	22	24	25
55	60	11	13	14	15	16	17	18	20	21	22	24	25	26
56	61	12	13	15	16	17	18	20	21	22	24	25	27	28
57	62	13	14	16	17	18	20	21	22	24	25	27	28	30
58	63	14	15	17	18	19	21	22	24	25	27	28	30	31
59	64	15	16	18	19	21	22	24	25	27	28	30	31	33
60	65	16	18	19	20	22	24	25	27	28	30	32	33	35
61	66	17	19	20	22	23	25	27	28	30	32	33	35	37
62	67	18	20	22	23	25	27	28	30	32	33	35	37	38
63	68	20	21	23	25	26	28	30	32	33	35	37	39	40
64	69	21	23	24	26	28	30	32	33	35	37	39	41	42
65	70	22	24	26	28	30	32	33	35	37	39	41	42	44
66	71	24	26	28	29	31	33	35	37	39	41	43	44	46
67	72	25	27	29	31	33	35	37	39	41	43	45	46	48
68	73	27	29	31	33	35	37	39	41	43	45	47	48	50
69	74	28	30	33	35	37	39	41	43	45	47	48	50	52
70	75	30	32	34	37	39	41	43	45	47	49	50	52	54
71	76	32	34	36	39	41	43	45	47	49	51	52	54	56
72	77	34	36	38	41	43	45	47	49	51	53	54	56	58
73	78	35	38	40	43	45	47	49	51	53	55	56	58	59
74	79	37	40	42	45	47	49	51	53	55	57	58	60	61
75	80	39	42	44	47	49	51	53	55	57	58	60	62	63
76	81	41	44	46	49	51	53	55	57	59	60	62	63	65

77	82	43	46	48	51	53	55	57	59	61	62	64	65	66
78	83	45	48	50	53	55	57	59	61	62	64	65	67	68
79	84	48	50	53	55	57	59	61	63	64	66	67	68	70
80	85	50	52	55	57	59	61	63	64	66	67	69	70	71
81	86	52	54	57	59	61	63	65	66	68	69	70	72	73
82	87	54	56	59	61	63	65	66	68	69	71	72	73	74
83	88	56	58	61	63	65	66	68	70	71	72	73	74	75
84	89	58	60	63	65	67	68	70	71	73	74	75	76	77
85	90	60	62	65	67	68	70	71	73	74	75	76	77	....

Ages		Duration of guaranteed amount—[Years]								
Male	Female	27	28	29	30	31	32	33	34	35
6	11	2	2	2	2	2	2	2	2	2
7	12	2	2	2	2	2	2	2	2	3
8	13	2	2	2	2	2	2	2	2	3
9	14	2	2	2	2	2	2	2	3	3
10	15	2	2	2	2	2	2	3	3	3
11	16	2	2	2	2	2	2	3	3	3
12	17	2	2	2	2	2	3	3	3	3
13	18	2	2	2	2	2	3	3	3	3
14	19	2	2	2	2	3	3	3	3	3
15	20	2	2	2	3	3	3	3	3	3
16	21	2	2	3	3	3	3	3	3	4
17	22	2	2	3	3	3	3	3	4	4
18	23	2	3	3	3	3	3	4	4	4
19	24	3	3	3	3	3	4	4	4	4
20	25	3	3	3	3	4	4	4	4	5
21	26	3	3	3	4	4	4	4	5	5
22	27	3	3	4	4	4	4	5	5	5
23	28	3	3	4	4	4	5	5	5	5
24	29	3	4	4	4	5	5	5	5	6
25	30	4	4	4	5	5	5	6	6	6
26	31	4	4	5	5	5	6	6	6	7
27	32	4	5	5	5	6	6	6	7	7
28	33	5	5	5	6	6	6	7	7	8
29	34	5	5	6	6	6	7	7	8	8
30	35	5	6	6	6	7	7	8	8	9
31	36	6	6	6	7	7	8	8	9	9
32	37	6	7	7	7	8	8	9	10	10
33	38	7	7	7	8	8	9	10	10	11
34	39	7	8	8	9	9	10	10	11	12
35	40	8	8	9	9	10	10	11	12	12

Ages		Duration of guaranteed amount—[Years]								
Male	Female	27	28	29	30	31	32	33	34	35
36	41	8	9	9	10	10	11	12	13	13
37	42	9	9	10	11	11	12	13	13	14
38	43	9	10	11	11	12	13	13	14	15
39	44	10	11	11	12	13	14	14	15	16
40	45	11	11	12	13	14	15	15	16	17
41	46	11	12	13	14	15	16	16	17	18
42	47	12	13	14	15	16	17	18	18	19
43	48	13	14	15	16	17	18	19	20	21
44	49	14	15	16	17	18	19	20	21	22
45	50	15	16	17	18	19	20	21	22	23
46	51	16	17	18	19	20	21	22	24	25
47	52	17	18	19	20	21	23	24	25	26
48	53	18	19	20	22	23	24	25	26	28
49	54	19	21	22	23	24	25	27	28	29
50	55	21	22	23	24	26	27	28	29	31
51	56	22	23	25	26	27	28	30	31	32
52	57	23	25	26	27	29	30	31	33	34
53	58	25	26	28	29	30	32	33	34	36
54	59	26	28	29	31	32	33	35	36	38
55	60	28	29	31	32	34	35	36	38	39
56	61	29	31	32	34	35	37	38	40	41
57	62	31	33	34	36	37	39	40	41	43
58	63	33	34	36	37	39	40	42	43	45
59	64	35	36	38	39	41	42	44	45	47
60	65	36	38	40	41	43	44	46	47	48
61	66	38	40	41	43	44	46	47	49	50
62	67	40	42	43	45	46	48	49	51	52
63	68	42	44	45	47	48	50	51	52	54
64	69	44	46	47	49	50	52	53	54	55
65	70	46	47	49	50	52	53	55	56	57
66	71	48	49	51	52	54	55	56	58	59
67	72	50	51	53	54	56	57	58	59	61
68	73	52	53	55	56	57	59	60	61	62
69	74	53	55	56	58	59	60	62	63	64
70	75	55	57	58	60	61	62	62	64	65
71	76	57	59	60	61	63	64	65	66	67
72	77	59	60	62	63	64	65	66	67	68
73	78	61	62	64	65	66	67	68	69	70

74	79	63	64	65	66	67	68	69	70	71
75	80	64	66	67	68	69	70	71	72	72
76	81	66	67	68	69	70	71	72	73	....
77	82	68	69	70	71	72	73	74	....	....
78	83	69	70	71	72	73	74	....	....	....
79	84	71	72	73	74	75	....	....	....	....
80	85	72	73	74	75	....	....	....	....	....
81	86	74	75	75	....	....	....	....	....	....
82	87	75	76	....	....	....	....	....	....	....
83	88	76	....	....	....	....	....	....	....	....
84	89	....	....	....	....	....	....	....	....	....
85	90	....	....	....	....	....	....	....	....	....

Ages		Duration of guaranteed amount—[Years]													
Male	Female	1	2	3	4	5	6	7	8	9	10	11	12	13	14
86	91	6	12	18	24	29	34	38	43	47	50	54	57	59	62
87	92	7	13	19	25	31	36	40	45	49	52	56	59	61	64
88	93	7	14	21	27	32	38	42	47	51	55	58	61	63	66
89	94	8	15	22	28	34	40	45	49	53	57	60	63	65	68
90	95	8	16	23	30	36	42	47	51	55	59	62	65	67	70
91	96	9	17	25	32	38	44	49	53	57	61	64	67	69	71
92	97	9	18	26	34	40	46	51	55	59	63	66	69	71	73
93	98	10	20	28	36	42	48	53	58	62	65	68	70	73	75
94	99	11	21	30	37	44	50	55	60	64	67	70	72	74	76
95	100	12	22	31	39	46	52	58	62	66	69	72	74	76	78
96	101	12	24	33	42	49	55	60	64	68	71	73	76	78	79
97	102	13	25	35	44	51	57	62	66	70	73	75	77	79	....
98	103	14	27	37	46	54	60	65	69	72	75	77	79	....	....
99	104	15	29	40	49	56	62	67	71	74	77	79	....	....	....
100	105	17	31	43	52	59	65	70	74	76	79	....	....	....	....
101	106	18	33	46	55	63	68	73	76	79	....	....	....	....	....
102	107	20	36	49	59	66	71	75	78	....	....	....	....	....	....
103	108	22	40	53	62	69	74	78	....	....	....	....	....	....	....
104	109	24	43	57	66	73	77	....	....	....	....	....	....	....	....
105	110	27	48	61	70	76	....	....	....	....	....	....	....	....	....
106	111		53	66	74	....	....	....	....	....	....	....	....	....	....
107	112	35	53	71	....	....	....	....	....	....	....	....	....	....	....
108	113	40	64	....	....	....	....	....	....	....	....	....	....	....	....

Ages		Duration of guaranteed amount—[Years]										
Male	Female	15	16	17	18	19	20	21	22	23	24	25
86	91	64	66	68	70	72	73	74	75	76	77	....
87	92	66	68	70	72	73	74	76	77	78	....	....
88	93	68	70	72	73	75	76	77	78	....	....	....
89	94	70	72	73	75	76	77	78	....	....	....	....
90	95	72	73	75	76	77	79	....	....	....	....	....
91	96	73	75	76	78	79	....	....	....	....	....	....
92	97	75	76	78	79	....	....	....	....	....	....	....
93	98	76	78	79	....	....	....	....	....	....	....	....
94	99	78	79	....	....	....	....	....	....	....	....	....
95	100	79	....	....	....	....	....	....	....	....	....	....

TABLE IV—TEMPORARY LIFE ANNUITIES [1]—ONE LIFE—EXPECTED RETURN MULTIPLES

[See footnote at end of table]

Ages		Temporary period—maximum duration of annuity—[Years]									
Male	Female	1	2	3	4	5	6	7	8	9	10
0 to 8	0 to 13	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
9	14	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
10	15	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
11	16	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
12	17	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
13	18	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
14	19	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
15	20	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
16	21	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
17	22	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
18	23	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
19	24	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
20	25	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
21	26	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
22	27	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
23	28	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
24	29	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
25	30	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
26	31	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
27	32	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
28	33	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
29	34	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
30	35	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9

31	36	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
32	37	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
33	38	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
34	39	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.9	9.8
35	40	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.9	9.8
36	41	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.9	9.8
37	42	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.8	9.8
38	43	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.8	9.8
39	44	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.9	8.8	9.8
40	45	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
41	46	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
42	47	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
43	48	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
44	49	1.0	2.0	3.0	4.0	4.9	5.9	6.8	7.8	8.7	9.7
45	50	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.8	8.7	9.6
46	51	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.8	8.7	9.6
47	52	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.7	8.7	9.6
48	53	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.7	8.6	9.5
49	54	1.0	2.0	3.0	3.9	4.9	5.8	6.8	7.7	8.6	9.5
50	55	1.0	2.0	3.0	3.9	4.9	5.8	6.8	7.7	8.6	9.5
51	56	1.0	2.0	3.0	3.9	4.9	5.8	6.7	7.7	8.6	9.4
52	57	1.0	2.0	3.0	3.9	4.9	5.8	6.7	7.6	8.5	9.4
53	58	1.0	2.0	2.9	3.9	4.9	5.8	6.7	7.6	8.5	9.3
54	59	1.0	2.0	2.9	3.9	4.8	5.8	6.7	7.6	8.4	9.3
55	60	1.0	2.0	2.9	3.9	4.8	5.8	6.7	7.5	8.4	9.2
56	61	1.0	2.0	2.9	3.9	4.8	5.7	6.6	7.5	8.4	9.2
57	62	1.0	2.0	2.9	3.9	4.8	5.7	6.6	7.5	8.3	9.1
58	63	1.0	2.0	2.9	3.9	4.8	5.7	6.6	7.4	8.3	9.1
59	64	1.0	2.0	2.9	3.9	4.8	5.7	6.5	7.4	8.2	9.0
60	65	1.0	2.0	2.9	3.8	4.8	5.6	6.5	7.3	8.1	8.9
61	66	1.0	2.0	2.9	3.8	4.7	5.6	6.5	7.3	8.1	8.8
62	67	1.0	2.0	2.9	3.8	4.7	5.6	6.4	7.2	8.0	8.8
63	68	1.0	2.0	2.9	3.8	4.7	5.6	6.4	7.2	7.9	8.7
64	69	1.0	1.9	2.9	3.8	4.7	5.5	6.3	7.1	7.9	8.6
65	70	1.0	1.9	2.9	3.8	4.6	5.5	6.3	7.1	7.8	8.5
66	71	1.0	1.9	2.9	3.8	4.6	5.4	6.2	7.0	7.7	8.4
67	72	1.0	1.9	2.9	3.7	4.6	5.4	6.2	6.9	7.6	8.3
68	73	1.0	1.9	2.8	3.7	4.6	5.4	6.1	6.8	7.5	8.2
69	74	1.0	1.9	2.8	3.7	4.5	5.3	6.1	6.8	7.4	8.0
70	75	1.0	1.9	2.8	3.7	4.5	5.3	6.0	6.7	7.3	7.9
71	76	1.0	1.9	2.8	3.7	4.5	5.2	5.9	6.6	7.2	7.8

TABLE IV—TEMPORARY LIFE ANNUITIES [1]—ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

[See footnote at end of table]

Ages		Temporary period—maximum duration of annuity—[Years]									
Male	Female	1	2	3	4	5	6	7	8	9	10
72	77	1.0	1.9	2.8	3.6	4.4	5.2	5.8	6.5	7.1	7.6
73	78	1.0	1.9	2.8	3.6	4.4	5.1	5.8	6.4	7.0	7.5
74	79	1.0	1.9	2.8	3.6	4.3	5.0	5.7	6.3	6.8	7.3
75	80	1.0	1.9	2.7	3.5	4.3	5.0	5.6	6.2	6.7	7.1
76	81	1.0	1.9	2.7	3.5	4.2	4.9	5.5	6.1	6.5	7.0
77	82	1.0	1.9	2.7	3.5	4.2	4.8	5.4	5.9	6.4	6.8
78	83	1.0	1.9	2.7	3.4	4.1	4.7	5.3	5.8	6.2	6.6
79	84	1.0	1.8	2.7	3.4	4.1	4.7	5.2	5.7	6.1	6.4
80	85	1.0	1.8	2.6	3.4	4.0	4.6	5.1	5.5	5.9	6.2
81	86	1.0	1.8	2.6	3.3	3.9	4.5	5.0	5.4	5.7	6.0
82	87	1.0	1.8	2.6	3.3	3.9	4.4	4.8	5.2	5.6	5.8
83	88	.9	1.8	2.6	3.2	3.8	4.3	4.7	5.1	5.4	5.6
84	89	.9	1.8	2.5	3.2	3.7	4.2	4.6	4.9	5.2	5.4
85	90	.9	1.8	2.5	3.1	3.6	4.1	4.5	4.8	5.0	5.2
86	91	.9	1.8	2.5	3.1	3.6	4.0	4.3	4.6	4.8	5.0

Ages		Temporary period—maximum duration of annuity—[Years]									
Male	Female	11	12	13	14	15	16	17	18	19	20
0 to 8	0 to 13	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
9	14	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
10	15	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
11	16	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
12	17	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
13	18	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
14	19	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
15	20	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.7	19.7
16	21	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.8	18.7	19.7
17	22	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.8	18.7	19.7
18	23	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.8	18.7	19.7
19	24	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.7	18.7	19.7
20	25	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.7	18.7	19.7
21	26	10.9	11.9	12.9	13.8	14.8	15.8	16.8	17.7	18.7	19.6
22	27	10.9	11.9	12.9	13.8	14.8	15.8	16.7	17.7	18.7	19.6
23	28	10.9	11.9	12.9	13.8	14.8	15.8	16.7	17.7	18.7	19.6
24	29	10.9	11.9	12.9	13.8	14.8	15.8	16.7	17.7	18.6	19.6
25	30	10.9	11.9	12.8	13.8	14.8	15.7	16.7	17.7	18.6	19.6

26	31	10.9	11.9	12.8	13.8	14.8	15.7	16.7	17.6	18.6	19.5
27	32	10.9	11.9	12.8	13.8	14.8	15.7	16.7	17.6	18.6	19.5
28	33	10.9	11.8	12.8	13.8	14.7	15.7	16.6	17.6	18.5	19.5
29	34	10.9	11.8	12.8	13.8	14.7	15.7	16.6	17.6	18.5	19.4
30	35	10.9	11.8	12.8	13.7	14.7	15.6	16.6	17.5	18.4	19.4
31	36	10.8	11.8	12.8	13.7	14.7	15.6	16.5	17.5	18.4	19.3
32	37	10.8	11.8	12.7	13.7	14.6	15.6	16.5	17.4	18.4	19.3
33	38	10.8	11.8	12.7	13.7	14.6	15.6	16.5	17.4	18.3	19.2
34	39	10.8	11.8	12.7	13.6	14.6	15.5	16.4	17.4	18.3	19.2
35	40	10.8	11.7	12.7	13.6	14.6	15.5	16.4	17.3	18.2	19.1
36	41	10.8	11.7	12.7	13.6	14.5	15.4	16.3	17.2	18.1	19.0
37	42	10.8	11.7	12.6	13.6	14.5	15.4	16.3	17.2	18.1	18.9
38	43	10.7	11.7	12.6	13.5	14.4	15.3	16.2	17.1	18.0	18.9
39	44	10.7	11.6	12.6	13.5	14.4	15.3	16.2	17.1	17.9	18.8
40	45	10.7	11.6	12.5	13.5	14.4	15.2	16.1	17.0	17.8	18.7
41	46	10.7	11.6	12.5	13.4	14.3	15.2	16.1	16.9	17.8	18.6
42	47	10.6	11.6	12.5	13.4	14.3	15.1	16.0	16.8	17.7	18.5
43	48	10.6	11.5	12.4	13.3	14.2	15.1	15.9	16.7	17.6	18.4
44	49	10.6	11.5	12.4	13.3	14.1	15.0	15.8	16.7	17.5	18.3
45	50	10.5	11.4	12.3	13.2	14.1	14.9	15.7	16.6	17.4	18.1
46	51	10.5	11.4	12.3	13.2	14.0	14.8	15.7	16.5	17.2	18.0
47	52	10.5	11.4	12.2	13.1	13.9	14.7	15.6	16.3	17.1	17.8
48	53	10.4	11.3	12.2	13.0	13.8	14.7	15.4	16.2	17.0	17.7
49	54	10.4	11.3	12.1	12.9	13.8	14.6	15.3	16.1	16.8	17.5
50	55	10.3	11.2	12.0	12.9	13.7	14.5	15.2	16.0	16.7	17.4
51	56	10.3	11.1	12.0	12.8	13.6	14.3	15.1	15.8	16.5	17.2
52	57	10.2	11.1	11.9	12.7	13.5	14.2	14.9	15.6	16.3	17.0
53	58	10.2	11.0	11.8	12.6	13.4	14.1	14.8	15.5	16.1	16.8
54	59	10.1	10.9	11.7	12.5	13.2	14.0	14.6	15.3	15.9	16.5
55	60	10.1	10.9	11.6	12.4	13.1	13.8	14.5	15.1	15.7	16.3
56	61	10.0	10.8	11.5	12.3	13.0	13.7	14.3	14.9	15.5	16.1
57	62	9.9	10.7	11.4	12.2	12.8	13.5	14.1	14.7	15.3	15.8
58	63	9.8	10.6	11.3	12.0	12.7	13.3	13.9	14.5	15.0	15.5
59	64	9.8	10.5	11.2	11.9	12.5	13.2	13.7	14.3	14.8	15.3
60	65	9.7	10.4	11.1	11.7	12.4	13.0	13.5	14.0	14.5	15.0
61	66	9.6	10.3	11.0	11.6	12.2	12.8	13.3	13.8	14.2	14.7
62	67	9.5	10.2	10.8	11.4	12.0	12.5	13.1	13.5	14.0	14.3
63	68	9.4	10.0	10.7	11.3	11.8	12.3	12.8	13.2	13.7	14.0
64	69	9.3	9.9	10.5	11.1	11.6	12.1	12.5	13.0	13.3	13.7
65	70	9.1	9.8	10.3	10.9	11.4	11.9	12.3	12.7	13.0	13.3
66	71	9.0	9.6	10.2	10.7	11.2	11.6	12.0	12.4	12.7	13.0

Ages		Temporary period—maximum duration of annuity—[Years]									
Male	Female	11	12	13	14	15	16	17	18	19	20
67	72	8.9	9.5	10.0	10.5	10.9	11.3	11.7	12.0	12.3	12.6
68	73	8.7	9.3	9.8	10.3	10.7	11.1	11.4	11.7	12.0	12.2
69	74	8.6	9.1	9.6	10.0	10.4	10.8	11.1	11.4	11.6	11.8
70	75	8.4	8.9	9.4	9.8	10.2	10.5	10.8	11.0	11.2	11.4
71	76	8.3	8.7	9.2	9.6	9.9	10.2	10.4	10.7	10.9	11.0
72	77	8.1	8.6	8.9	9.3	9.6	9.9	10.1	10.3	10.5	10.6
73	78	7.9	8.3	8.7	9.0	9.3	9.6	9.8	9.9	10.1	10.2
74	79	7.7	8.1	8.5	8.8	9.0	9.2	9.4	9.6	9.7	9.8
75	80	7.6	7.9	8.2	8.5	8.7	8.9	9.1	9.2	9.3	9.4
76	81	7.4	7.7	8.0	8.2	8.4	8.6	8.7	8.8	8.9	9.0
77	82	7.1	7.5	7.7	7.9	8.1	8.3	8.4	8.5	8.5	8.6
78	83	6.9	7.2	7.4	7.6	7.8	7.9	8.0	8.1	8.2	8.2
79	84	6.7	7.0	7.2	7.3	7.5	7.6	7.7	7.7	7.8	7.8
80	85	6.5	6.7	6.9	7.1	7.2	7.3	7.3	7.4	7.4	7.4
81	86	6.3	6.5	6.6	6.8	6.9	6.9	7.0	7.0	7.1	....
82	87	6.0	6.2	6.4	6.5	6.5	6.6	6.7	6.7	....	....
83	88	5.8	6.0	6.1	6.2	6.2	6.3	6.3	....	....	....
84	89	5.6	5.7	5.8	5.9	5.9	6.0	....	....	....	....
85	90	5.3	5.5	5.5	5.6	5.6	....	....	....	....	....
86	91	5.1	5.2	5.3	5.3	....	....	....	....	....	....

Ages		Temporary period—maximum duration of annuity—[Years]									
Male	Female	21	22	23	24	25	26	27	28	29	30
0 to 8	0 to 13	20.7	21.7	22.7	23.6	24.6	25.6	26.5	27.5	28.4	29.4
9	14	20.7	21.7	22.7	23.6	24.6	25.5	26.5	27.5	28.4	29.4
10	15	20.7	21.7	22.7	23.6	24.6	25.5	26.5	27.5	28.4	29.4
11	16	20.7	21.7	22.6	23.6	24.6	25.5	26.5	27.4	28.4	29.3
12	17	20.7	21.7	22.6	23.6	24.6	25.5	26.5	27.4	28.4	29.3
13	18	20.7	21.7	22.6	23.6	24.6	25.5	26.5	27.4	28.4	29.3
14	19	20.7	21.7	22.6	23.6	24.5	25.5	26.4	27.4	28.3	29.3
15	20	20.7	21.6	22.6	23.6	24.5	25.5	26.4	27.4	28.3	29.2
16	21	20.7	21.6	22.6	23.6	24.5	25.5	26.4	27.3	28.3	29.2
17	22	20.7	21.6	22.6	23.5	24.5	25.4	26.4	27.3	28.2	29.2
18	23	20.7	21.6	22.6	23.5	24.5	25.4	26.3	27.3	28.2	29.1
19	24	20.6	21.6	22.5	23.5	24.4	25.4	26.3	27.2	28.1	29.1
20	25	20.6	21.6	22.5	23.5	24.4	25.3	26.3	27.2	28.1	29.0
21	26	20.6	21.5	22.5	23.4	24.4	25.3	26.2	27.1	28.0	28.9
22	27	20.6	21.5	22.5	23.4	24.3	25.3	26.2	27.1	28.0	28.9

23	28	20.6	21.5	22.4	23.4	24.3	25.2	26.1	27.0	27.9	28.8
24	29	20.5	21.5	22.4	23.3	24.2	25.2	26.1	27.0	27.8	28.7
25	30	20.5	21.4	22.4	23.3	24.2	25.1	26.0	26.9	27.8	28.6
26	31	20.5	21.4	22.3	23.2	24.1	25.0	25.9	26.8	27.7	28.5
27	32	20.4	21.3	22.3	23.2	24.1	25.0	25.8	26.7	27.6	28.4
28	33	20.4	21.3	22.2	23.1	24.0	24.9	25.8	26.6	27.5	28.3
29	34	20.3	21.2	22.1	23.0	23.9	24.8	25.7	26.5	27.4	28.2
30	35	20.3	21.2	22.1	23.0	23.8	24.7	25.6	26.4	27.2	28.1
31	36	20.2	21.1	22.0	22.9	23.8	24.6	25.5	26.3	27.1	27.9
32	37	20.2	21.1	21.9	22.8	23.7	24.5	25.4	26.2	27.0	27.8
33	38	20.1	21.0	21.9	22.7	23.6	24.4	25.2	26.0	26.8	27.6
34	39	20.0	20.9	21.8	22.6	23.5	24.3	25.1	25.9	26.7	27.4
35	40	20.0	20.8	21.7	22.5	23.3	24.2	25.0	25.7	26.5	27.2
36	41	19.9	20.7	21.6	22.4	23.2	24.0	24.8	25.6	26.3	27.0
37	42	19.8	20.6	21.5	22.3	23.1	23.9	24.6	25.4	26.1	26.8
38	43	19.7	20.5	21.4	22.2	23.0	23.7	24.5	25.2	25.9	26.6
39	44	19.6	20.4	21.2	22.0	22.8	23.6	24.3	25.0	25.7	26.4
40	45	19.5	20.3	21.1	21.9	22.6	23.4	24.1	24.8	25.5	26.1
41	46	19.4	20.2	21.0	21.7	22.5	23.2	23.9	24.6	25.2	25.9
42	47	19.3	20.1	20.8	21.6	22.3	23.0	23.7	24.3	25.0	25.6
43	48	19.2	19.9	20.7	21.4	22.1	22.8	23.4	24.1	24.7	25.3
44	49	19.0	19.8	20.5	21.2	21.9	22.6	23.2	23.8	24.4	25.0
45	50	18.9	19.6	20.3	21.0	21.7	22.3	22.9	23.5	24.1	24.6
46	51	18.7	19.4	20.1	20.8	21.5	22.1	22.7	23.2	23.8	24.3
47	52	18.6	19.3	19.9	20.6	21.2	21.8	22.4	22.9	23.4	23.9
48	53	18.4	19.1	19.7	20.4	21.0	21.5	22.1	22.6	23.1	23.5
49	54	18.2	18.9	19.5	20.1	20.7	21.2	21.7	22.2	22.7	23.1
50	55	18.0	18.7	19.3	19.8	20.4	20.9	21.4	21.9	22.3	22.7
51	56	17.8	18.4	19.0	19.6	20.1	20.6	21.1	21.5	21.9	22.3
52	57	17.6	18.2	18.7	19.3	19.8	20.2	20.7	21.1	21.5	21.8
53	58	17.4	17.9	18.5	19.0	19.4	19.9	20.3	20.7	21.0	21.3
54	59	17.1	17.7	18.2	18.7	19.1	19.5	19.9	20.2	20.6	20.8
55	60	16.9	17.4	17.9	18.3	18.7	19.1	19.5	19.8	20.1	20.3
56	61	16.6	17.1	17.5	18.0	18.4	18.7	19.0	19.3	19.6	19.8
57	62	16.3	16.8	17.2	17.6	18.0	18.3	18.6	18.9	19.1	19.3
58	63	16.0	16.5	16.9	17.2	17.6	17.9	18.1	18.4	18.6	18.8
59	64	15.7	16.1	16.5	16.8	17.1	17.4	17.7	17.9	18.1	18.2
60	65	15.4	15.8	16.1	16.4	16.7	17.0	17.2	17.4	17.5	17.7
61	66	15.1	15.4	15.7	16.0	16.3	16.5	16.7	16.9	17.0	17.1
62	67	14.7	15.0	15.3	15.6	15.8	16.0	16.2	16.3	16.4	16.5
63	68	14.4	14.6	14.9	15.1	15.3	15.5	15.7	15.8	15.9	16.0
64	69	14.0	14.3	14.5	14.7	14.9	15.0	15.2	15.3	15.3	15.4

Ages		Temporary period—maximum duration of annuity—[Years]									
Male	Female	21	22	23	24	25	26	27	28	29	30
65	70	13.6	13.8	14.1	14.2	14.4	14.5	14.6	14.7	14.8	14.9
66	71	13.2	13.4	13.6	13.8	13.9	14.0	14.1	14.2	14.2	14.3
67	72	12.8	13.0	13.2	13.3	13.4	13.5	13.6	13.7	13.7	13.7
68	73	12.4	12.6	12.7	12.8	12.9	13.0	13.1	13.1	13.2	13.2
69	74	12.0	12.1	12.3	12.4	12.4	12.5	12.6	12.6	12.6	12.6
70	75	11.6	11.7	11.8	11.9	12.0	12.0	12.0	12.1	12.1	12.1
71	76	11.2	11.3	11.3	11.4	11.5	11.5	11.5	11.6	11.6	....
72	77	10.7	10.8	10.9	10.9	11.0	11.0	11.0	11.0	....	....
73	78	10.3	10.4	10.4	10.5	10.5	10.5	10.5	....	....	....
74	79	9.9	9.9	10.0	10.0	10.1	10.1	....	....	....	....
75	80	9.5	9.5	9.6	9.6	9.6	....	....	....	....	....
76	81	9.1	9.1	9.1	9.1	....	....	....	....	....	....
77	82	8.6	8.7	8.7	....	....	....	....	....	....	....
78	83	8.2	8.3	....	....	....	....	....	....	....	....
79	84	7.8	....	....	....	....	....	....	....	....	....

Footnote to Table IV:

[1] The multiples in this table are not applicable to annuities for a term certain; for such cases see paragraph (c) of §1.72–5.

TABLE V—ORDINARY LIFE ANNUITIES ONE LIFE—EXPECTED RETURN MULTIPLES

Age	Multiple
5	76.6
6	75.6
7	74.7
8	73.7
9	72.7
10	71.7
11	70.7
12	69.7
13	68.8
14	67.8
15	66.8
16	65.8
17	64.8
18	63.9
19	62.9
20	61.9
21	60.9
22	59.9
23	59.0
24	58.0
25	57.0
26	56.0
27	55.1
28	54.1
29	53.1
30	52.2
31	51.2
32	50.2
33	49.3
34	48.3
35	47.3
36	46.4
37	45.4
38	44.4
39	43.5
40	42.5
41	41.5
42	40.6
43	39.6
44	38.7
45	37.7
46	36.8
47	35.9
48	34.9
49	34.0
50	33.1
51	32.2
52	31.3
53	30.4
54	29.5
55	28.6
56	27.7
57	26.8
58	25.9
59	25.0
60	24.2
61	23.3
62	22.5
63	21.6
64	20.8
65	20.0
66	19.2
67	18.4
68	17.6
69	16.8
70	16.0
71	15.3
72	14.6
73	13.9
74	13.2
75	12.5
76	11.9
77	11.2
78	10.6
79	10.0
80	9.5
81	8.9
82	8.4
83	7.9
84	7.4
85	6.9
86	6.5
87	6.1
88	5.7
89	5.3
90	5.0
91	4.7
92	4.4
93	4.1
94	3.9
95	3.7
96	3.4
97	3.2
98	3.0
99	2.8
100	2.7
101	2.5
102	2.3
103	2.1
104	1.9
105	1.8
106	1.6
107	1.4
108	1.3
109	1.1
110	1.0
111	.9
112	.8
113	.7
114	.6
115	.5

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	5	6	7	8	9	10	11	12	13	14
5	83.8	83.3	82.8	82.4	82.0	81.6	81.2	80.9	80.6	80.3
6	83.3	82.8	82.3	81.8	81.4	81.0	80.6	80.3	79.9	79.6
7	82.8	82.3	81.8	81.3	80.9	80.4	80.0	79.6	79.3	78.9
8	82.4	81.8	81.3	80.8	80.3	79.9	79.4	79.0	78.6	78.3
9	82.0	81.4	80.9	80.3	79.8	79.3	78.9	78.4	78.0	77.6
10	81.6	81.0	80.4	79.9	79.3	78.8	78.3	77.9	77.4	77.0
11	81.2	80.6	80.0	79.4	78.9	78.3	77.8	77.3	76.9	76.4

Table VI—Ordinary Joint Life and Last Survivor Annuities; Two Lives—Expected Return Multiples—Continued

Ages	5	6	7	8	9	10	11	12	13	14
12	80.9	80.3	79.6	79.0	78.4	77.9	77.3	76.8	76.3	75.9
13	80.6	79.9	79.3	78.6	78.0	77.4	76.9	76.3	75.8	75.3
14	80.3	79.6	78.9	78.3	77.6	77.0	76.4	75.9	75.3	74.8
15	80.0	79.3	78.6	77.9	77.3	76.6	76.0	75.4	74.9	74.3
16	79.8	79.0	78.3	77.6	76.9	76.3	75.6	75.0	74.4	73.9
17	79.5	78.8	78.0	77.3	76.6	75.9	75.3	74.6	74.0	73.4
18	79.3	78.5	77.8	77.0	76.3	75.6	74.9	74.3	73.6	73.0
19	79.1	78.3	77.5	76.8	76.0	75.3	74.6	73.9	73.3	72.6
20	78.9	78.1	77.3	76.5	75.8	75.0	74.3	73.6	72.9	72.3
21	78.7	77.9	77.1	76.3	75.5	74.8	74.0	73.3	72.6	71.9
22	78.6	77.7	76.9	76.1	75.3	74.5	73.8	73.0	72.3	71.6
23	78.4	77.6	76.7	75.9	75.1	74.3	73.5	72.8	72.0	71.3
24	78.3	77.4	76.6	75.7	74.9	74.1	73.3	72.6	71.8	71.1
25	78.2	77.3	76.4	75.6	74.8	73.9	73.1	72.3	71.6	70.8
26	78.0	77.2	76.3	75.4	74.6	73.8	72.9	72.1	71.3	70.6
27	77.9	77.1	76.2	75.3	74.4	73.6	72.8	71.9	71.1	70.3
28	77.8	76.9	76.1	75.2	74.3	73.4	72.6	71.8	70.9	70.1
29	77.7	76.8	76.0	75.1	74.2	73.3	72.5	71.6	70.8	70.0
30	77.7	76.8	75.9	75.0	74.1	73.2	72.3	71.5	70.6	69.8
31	77.6	76.7	75.8	74.9	74.0	73.1	72.2	71.3	70.5	69.6
32	77.5	76.6	75.7	74.8	73.9	73.0	72.1	71.2	70.3	69.5
33	77.5	76.5	75.6	74.7	73.8	72.9	72.0	71.1	70.2	69.3
34	77.4	76.5	75.5	74.6	73.7	72.8	71.9	71.0	70.1	69.2
35	77.3	76.4	75.5	74.5	73.6	72.7	71.8	70.9	70.0	69.1
36	77.3	76.3	75.4	74.5	73.5	72.6	71.7	70.8	69.9	69.0
37	77.2	76.3	75.4	74.4	73.5	72.6	71.6	70.7	69.8	68.9
38	77.2	76.2	75.3	74.4	73.4	72.5	71.6	70.6	69.7	68.8
39	77.2	76.2	75.3	74.3	73.4	72.4	71.5	70.6	69.6	68.7
40	77.1	76.2	75.2	74.3	73.3	72.4	71.4	70.5	69.6	68.6
41	77.1	76.1	75.2	74.2	73.3	72.3	71.4	70.4	69.5	68.6
42	77.0	76.1	75.1	74.2	73.2	72.3	71.3	70.4	69.4	68.5
43	77.0	76.1	75.1	74.1	73.2	72.2	71.3	70.3	69.4	68.5
44	77.0	76.0	75.1	74.1	73.1	72.2	71.2	70.3	69.3	68.4
45	77.0	76.0	75.0	74.1	73.1	72.2	71.2	70.2	69.3	68.4
46	76.9	76.0	75.0	74.0	73.1	72.1	71.2	70.2	69.3	68.3
47	76.9	75.9	75.0	74.0	73.1	72.1	71.1	70.2	69.2	68.3
48	76.9	75.9	75.0	74.0	73.0	72.1	71.1	70.1	69.2	68.2
49	76.9	75.9	74.9	74.0	73.0	72.0	71.1	70.1	69.1	68.2
50	76.9	75.9	74.9	73.9	73.0	72.0	71.0	70.1	69.1	68.2
51	76.8	75.9	74.9	73.9	73.0	72.0	71.0	70.1	69.1	68.1
52	76.8	75.9	74.9	73.9	72.9	72.0	71.0	70.0	69.1	68.1
53	76.8	75.8	74.9	73.9	72.9	71.9	71.0	70.0	69.0	68.1
54	76.8	75.8	74.8	73.9	72.9	71.9	71.0	70.0	69.0	68.1
55	76.8	75.8	74.8	73.9	72.9	71.9	70.9	70.0	69.0	68.0
56	76.8	75.8	74.8	73.8	72.9	71.9	70.9	69.9	69.0	68.0
57	76.8	75.8	74.8	73.8	72.9	71.9	70.9	69.9	69.0	68.0
58	76.8	75.8	74.8	73.8	72.8	71.9	70.9	69.9	68.9	68.0
59	76.7	75.8	74.8	73.8	72.8	71.9	70.9	69.9	68.9	68.0
60	76.7	75.8	74.8	73.8	72.8	71.8	70.9	69.9	68.9	67.9
61	76.7	75.7	74.8	73.8	72.8	71.8	70.9	69.9	68.9	67.9
62	76.7	75.7	74.8	73.8	72.8	71.8	70.8	69.9	68.9	67.9
63	76.7	75.7	74.8	73.8	72.8	71.8	70.8	69.9	68.9	67.9
64	76.7	75.7	74.7	73.8	72.8	71.8	70.8	69.8	68.9	67.9
65	76.7	75.7	74.7	73.8	72.8	71.8	70.8	69.8	68.9	67.9
66	76.7	75.7	74.7	73.7	72.8	71.8	70.8	69.8	68.9	67.9
67	76.7	75.7	74.7	73.7	72.8	71.8	70.8	69.8	68.8	67.9
68	76.7	75.7	74.7	73.7	72.8	71.8	70.8	69.8	68.8	67.9
69	76.7	75.7	74.7	73.7	72.7	71.8	70.8	69.8	68.8	67.8
70	76.7	75.7	74.7	73.7	72.7	71.8	70.8	69.8	68.8	67.8
71	76.7	75.7	74.7	73.7	72.7	71.8	70.8	69.8	68.8	67.8
72	76.7	75.7	74.7	73.7	72.7	71.8	70.8	69.8	68.8	67.8
73	76.7	75.7	74.7	73.7	72.7	71.7	70.8	69.8	68.8	67.8
74	76.7	75.7	74.7	73.7	72.7	71.7	70.8	69.8	68.8	67.8
75	76.7	75.7	74.7	73.7	72.7	71.7	70.8	69.8	68.8	67.8
76	76.6	75.7	74.7	73.7	72.7	71.7	70.8	69.8	68.8	67.8
77	76.6	75.7	74.7	73.7	72.7	71.7	70.8	69.8	68.8	67.8
78	76.6	75.7	74.7	73.7	72.7	71.7	70.7	69.8	68.8	67.8
79	76.6	75.7	74.7	73.7	72.7	71.7	70.7	69.8	68.8	67.8
80	76.6	75.7	74.7	73.7	72.7	71.7	70.7	69.8	68.8	67.8
81	76.6	75.7	74.7	73.7	72.7	71.7	70.7	69.8	68.8	67.8
82	76.6	75.7	74.7	73.7	72.7	71.7	70.7	69.8	68.8	67.8

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	5	6	7	8	9	10	11	12	13	14
83	76.6	75.7	74.7	73.7	72.7	71.7	70.7	69.8	68.8	67.8
84	76.6	75.7	74.7	73.7	72.7	71.7	70.7	69.8	68.8	67.8
85	76.6	75.7	74.7	73.7	72.7	71.7	70.7	69.8	68.8	67.8
86	76.6	75.7	74.7	73.7	72.7	71.7	70.7	69.8	68.8	67.8
87	76.6	75.7	74.7	73.7	72.7	71.7	70.7	69.8	68.8	67.8
88	76.6	75.7	74.7	73.7	72.7	71.7	70.7	69.8	68.8	67.8
89	76.6	75.7	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
90	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
91	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
92	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
93	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
94	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
95	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
96	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
97	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
98	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
99	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
100	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
101	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
102	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
103	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
104	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
105	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
106	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
107	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
108	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
109	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
110	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
111	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
112	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
113	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
114	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8
115	76.6	75.6	74.7	73.7	72.7	71.7	70.7	69.7	68.8	67.8

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	15	16	17	18	19	20	21	22	23	24
15	73.8	73.3	72.9	72.4	72.0	71.6	71.3	70.9	70.6	70.3
16	73.3	72.8	72.3	71.9	71.4	71.0	70.7	70.3	70.0	69.6
17	72.9	72.3	71.8	71.3	70.9	70.5	70.0	69.7	69.3	69.0
18	72.4	71.9	71.3	70.8	70.4	69.0	69.5	69.9	68.7	68.3
19	72.0	71.4	70.9	70.4	69.8	69.4	68.9	68.5	68.1	67.7
20	71.6	71.0	70.5	69.9	69.4	68.8	68.4	67.9	67.5	67.1
21	71.3	70.7	70.0	69.5	68.9	68.4	67.9	67.4	66.9	66.5
22	70.9	70.3	69.7	69.0	68.5	67.9	67.4	66.9	66.4	65.9
23	70.6	70.0	69.3	68.7	68.1	67.5	66.9	66.4	65.9	65.4
24	70.3	69.6	69.0	68.3	67.7	67.1	66.5	65.9	65.4	64.9
25	70.1	69.3	68.6	68.0	67.3	66.7	66.1	65.5	64.9	64.4
26	69.8	69.1	68.3	67.6	67.0	66.3	65.7	65.1	64.5	63.9
27	69.6	68.8	68.1	67.3	66.7	66.0	65.3	64.7	64.1	63.5
28	69.3	68.6	67.8	67.1	66.4	65.7	65.0	64.3	63.7	63.1
29	69.1	68.4	67.6	66.8	66.1	65.4	64.7	64.0	63.3	62.7
30	69.0	68.2	67.4	66.6	65.8	65.1	64.4	63.7	63.0	62.3
31	68.8	68.0	67.2	66.4	65.6	64.8	64.1	63.4	62.7	62.0
32	68.6	67.8	67.0	66.2	65.4	64.6	63.8	63.1	62.4	61.7
33	68.5	67.6	66.8	66.0	65.2	64.4	63.6	62.8	62.1	61.4
34	68.3	67.5	66.6	65.8	65.0	64.2	63.4	62.6	61.9	61.1
35	68.2	67.4	66.5	65.6	64.8	64.0	63.2	62.4	61.6	60.9
36	68.1	67.2	66.4	65.5	64.7	63.8	63.0	62.2	61.4	60.6
37	68.0	67.1	66.2	65.4	64.5	63.7	62.8	62.0	61.2	60.4
38	67.9	67.0	66.1	65.2	64.4	63.5	62.7	61.8	61.0	60.2
39	67.8	66.9	66.0	65.1	64.2	63.4	62.5	61.7	60.8	60.0
40	67.7	66.8	65.9	65.0	64.1	63.3	62.4	61.5	60.7	59.9
41	67.7	66.7	65.8	64.9	64.0	63.1	62.3	61.4	60.5	59.7
42	67.6	66.7	65.7	64.8	63.9	63.0	62.2	61.3	60.4	59.6
43	67.5	66.6	65.7	64.8	63.8	62.9	62.1	61.2	60.3	59.4
44	67.5	66.5	65.6	64.7	63.8	62.9	62.0	61.1	60.2	59.3
45	67.4	66.5	65.5	64.6	63.7	62.8	61.9	61.0	60.1	59.2

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	15	16	17	18	19	20	21	22	23	24
46	67.4	66.4	65.4	64.6	63.6	62.7	61.8	60.9	60.0	59.1
47	67.3	66.4	65.4	64.5	63.6	62.6	61.7	60.8	59.9	59.0
48	67.3	66.3	65.4	64.4	63.5	62.6	61.6	60.7	59.8	58.9
49	67.2	66.3	65.3	64.4	63.5	62.5	61.6	60.7	59.7	58.8
50	67.2	66.2	65.3	64.3	63.4	62.5	61.5	60.6	59.7	58.8
51	67.2	66.2	65.3	64.3	63.4	62.4	61.5	60.5	59.6	58.7
52	67.1	66.2	65.2	64.3	63.3	62.4	61.4	60.5	59.6	58.6
53	67.1	66.2	65.2	64.2	63.3	62.3	61.4	60.4	59.5	58.6
54	67.1	66.1	65.2	64.2	63.2	62.3	61.3	60.4	59.5	58.5
55	67.1	66.1	65.1	64.2	63.2	62.3	61.3	60.4	59.4	58.5
56	67.0	66.1	65.1	64.1	63.2	62.2	61.3	60.3	59.4	58.4
57	67.0	66.1	65.1	64.1	63.2	62.2	61.2	60.3	59.3	58.4
58	67.0	66.0	65.1	64.1	63.1	62.2	61.2	60.3	59.3	58.4
59	67.0	66.0	65.0	64.1	63.1	62.1	61.2	60.2	59.3	58.3
60	67.0	66.0	65.0	64.1	63.1	62.1	61.2	60.2	59.2	58.3
61	67.0	66.0	65.0	64.0	63.1	62.1	61.1	60.2	59.2	58.3
62	66.9	66.0	65.0	64.0	63.1	62.1	61.1	60.2	59.2	58.2
63	66.9	66.0	65.0	64.0	63.0	62.1	61.1	60.1	59.2	58.2
64	66.9	65.9	65.0	64.0	63.0	62.1	61.1	60.1	59.2	58.2
65	66.9	65.9	65.0	64.0	63.0	62.0	61.1	60.1	59.1	58.2
66	66.9	65.9	64.9	64.0	63.0	62.0	61.1	60.1	59.1	58.2
67	66.9	65.9	64.9	64.0	63.0	62.0	61.1	60.1	59.1	58.1
68	66.9	65.9	64.9	64.0	63.0	62.0	61.0	60.1	59.1	58.1
69	66.9	65.9	64.9	63.9	63.0	62.0	61.0	60.0	59.1	58.1
70	66.9	65.9	64.9	63.9	63.0	62.0	61.0	60.0	59.1	58.1
71	66.9	65.9	64.9	63.9	62.9	62.0	61.0	60.0	59.1	58.1
72	66.9	65.9	64.9	63.9	62.9	62.0	61.0	60.0	59.0	58.1
73	66.8	65.9	64.9	63.9	62.9	62.0	61.0	60.0	59.0	58.1
74	66.8	65.9	64.9	63.9	62.9	62.0	61.0	60.0	59.0	58.1
75	66.8	65.9	64.9	63.9	62.9	61.9	61.0	60.0	59.0	58.1
76	66.8	65.9	64.9	63.9	62.9	61.9	61.0	60.0	59.0	58.0
76	66.8	65.9	64.9	63.9	62.9	61.9	61.0	60.0	59.0	58.0
77	66.8	65.9	64.9	63.9	63.9	62.9	61.0	60.0	59.0	58.0
78	66.8	65.8	64.9	63.9	62.9	61.9	61.0	60.0	59.0	58.0
79	66.8	65.8	64.9	63.9	62.9	61.9	61.0	60.0	59.0	58.0
80	66.8	65.9	64.9	63.9	62.9	61.9	60.9	60.0	59.0	58.0
81	66.8	65.8	64.9	63.9	62.9	61.9	60.9	60.0	59.0	58.0
82	66.8	65.8	64.9	63.9	62.9	61.9	60.9	60.0	59.0	58.0
83	66.8	65.8	64.9	63.9	62.9	61.9	60.9	60.0	59.0	58.0
84	66.8	65.8	64.8	63.9	62.9	61.9	60.9	60.0	59.0	58.0
85	66.8	65.8	64.8	63.9	62.9	61.9	60.9	60.0	59.0	58.0
86	66.8	65.8	64.8	63.9	62.9	61.9	60.9	60.0	59.0	58.0
87	66.8	65.8	64.8	63.9	62.9	61.9	60.9	60.0	59.0	58.0
88	66.8	65.8	64.8	63.9	62.9	61.9	60.9	60.0	59.0	58.0
89	66.8	65.8	64.8	63.9	62.9	61.9	60.9	60.0	59.0	58.0
90	66.8	65.8	64.8	63.9	62.9	61.9	60.9	60.0	59.0	58.0
91	66.8	65.8	64.8	63.9	62.9	61.9	60.9	60.0	59.0	58.0
92	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
93	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
94	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
95	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
96	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
97	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
98	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
99	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
100	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
101	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
102	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
103	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
104	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
105	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
106	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
107	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
108	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
109	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
110	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
111	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
112	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
113	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
114	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0
115	66.8	65.8	64.8	63.9	62.9	61.9	60.9	59.9	59.0	58.0

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	25	26	27	28	29	30	31	32	33	34
25	63.9	63.4	62.9	62.5	62.1	61.7	61.3	61.0	60.7	60.4
26	63.4	62.9	62.4	61.9	61.5	61.1	60.7	60.4	60.0	59.7
27	62.9	62.4	61.9	61.4	60.9	60.5	60.1	59.7	59.4	59.0
28	62.5	61.9	61.4	60.9	60.4	60.0	59.5	59.1	58.7	58.4
29	62.1	61.5	60.9	60.4	59.9	59.4	59.0	58.5	58.1	57.7
30	61.7	61.1	60.5	60.0	59.4	58.9	58.4	58.0	57.5	57.1
31	61.3	60.7	60.1	59.5	59.0	58.4	57.9	57.4	57.0	56.5
32	61.0	60.4	59.7	59.1	58.5	58.0	57.4	56.9	56.4	56.0
33	60.7	60.0	59.4	58.7	58.1	57.5	57.0	56.4	55.9	55.5
34	60.4	59.7	59.0	58.4	57.7	57.1	56.5	56.0	55.5	54.9
35	60.1	59.4	58.7	58.0	57.4	56.7	56.1	55.6	55.0	54.5
36	59.9	59.1	58.4	57.7	57.0	56.4	55.8	55.1	54.6	54.0
37	59.6	58.9	58.1	57.4	56.7	56.0	55.4	54.8	54.2	53.6
38	59.4	58.6	57.9	57.9	56.4	55.7	55.1	54.4	53.8	53.2
39	59.2	58.4	57.7	56.9	56.2	55.4	54.7	54.1	53.4	52.8
40	59.0	58.2	57.4	56.7	55.9	55.2	54.5	53.8	53.1	52.4
41	58.9	58.0	57.2	56.4	55.7	54.9	54.2	53.5	52.8	52.1
42	58.7	57.9	57.1	56.2	55.5	54.7	53.9	53.2	52.5	51.8
43	58.6	57.7	56.9	56.1	55.3	54.5	53.7	52.9	52.2	51.5
44	58.4	57.6	56.7	55.9	55.1	54.3	53.5	52.7	52.0	51.2
45	58.3	57.4	56.6	55.7	54.9	54.1	53.3	52.5	51.7	51.0
46	58.2	57.3	56.5	55.6	54.8	53.9	53.1	52.3	51.5	50.7
47	58.1	57.2	56.3	55.5	54.6	53.8	52.9	52.1	51.3	50.5
48	58.0	57.1	56.2	55.3	54.5	53.6	52.8	51.9	51.1	50.3
49	57.9	57.0	56.1	55.2	54.4	53.5	52.6	51.8	51.0	50.1
50	57.8	56.9	56.0	55.1	54.2	53.4	52.5	51.7	50.8	50.0
51	57.8	56.9	55.9	55.0	54.1	53.3	52.4	51.5	50.7	49.8
52	57.7	56.8	55.9	55.0	54.1	53.2	52.3	51.4	50.5	49.7
53	57.6	56.7	55.8	54.9	54.0	53.1	52.2	51.3	50.4	49.6
54	57.6	56.7	55.7	54.8	53.9	53.0	52.1	51.2	50.3	49.4
55	57.5	56.6	55.7	54.7	53.8	52.9	52.0	51.1	40.2	49.3
56	57.5	56.5	55.6	54.7	53.8	52.8	51.9	51.0	50.1	49.2
57	57.4	56.5	55.6	54.6	53.7	52.8	51.9	50.9	50.0	49.1
58	57.4	56.5	55.5	54.6	53.6	52.7	51.8	50.9	50.0	49.1
59	57.4	56.4	55.5	54.5	53.6	52.7	51.7	50.8	49.9	49.0
60	57.3	56.4	55.4	54.5	53.6	52.6	51.7	50.8	49.8	48.9
61	57.3	56.4	55.4	54.5	53.5	52.6	51.6	50.7	49.8	48.9
62	57.3	56.3	55.4	54.4	53.5	52.5	51.6	50.7	49.7	48.8
63	57.3	56.3	55.3	54.4	53.4	52.5	51.6	50.6	49.7	48.7
64	57.2	56.3	55.3	54.4	53.4	52.5	51.5	50.6	49.6	48.7
65	57.2	56.3	55.3	54.3	53.4	52.4	51.5	50.5	49.6	48.7
66	57.2	56.2	55.3	54.3	53.4	52.4	51.5	50.5	49.6	48.6
67	57.2	56.2	55.3	54.3	53.3	52.4	51.4	50.5	49.5	48.6
68	57.2	56.2	55.2	54.3	53.3	52.4	51.4	50.4	49.5	48.6
69	57.1	56.2	55.2	54.3	53.3	52.3	51.4	50.4	49.5	48.5
70	57.1	56.2	55.2	54.2	53.3	52.3	51.4	50.4	49.4	48.5
71	57.1	56.2	55.2	54.2	53.3	52.3	51.3	50.4	49.4	48.5
72	57.1	56.1	55.2	54.2	53.2	52.3	51.3	50.4	49.4	48.5
73	57.1	56.1	55.2	54.2	53.2	52.3	51.3	50.3	49.4	48.4
74	57.1	56.1	55.2	54.2	53.2	52.3	51.3	50.3	49.4	48.4
75	57.1	56.1	55.1	54.2	53.2	52.2	51.3	50.3	49.4	48.4
76	57.1	56.1	55.1	54.2	53.2	52.2	51.3	50.3	49.3	48.4
77	57.1	56.1	55.1	54.2	53.2	52.2	51.3	50.3	49.3	48.4
78	57.1	56.1	55.1	54.2	53.2	52.2	51.3	50.3	49.3	48.4
79	57.1	56.1	55.1	54.1	53.2	52.2	51.2	50.3	49.3	48.4
80	57.1	56.1	55.1	54.1	53.2	52.2	51.2	50.3	49.3	48.3
81	57.0	56.1	55.1	54.1	53.2	52.2	51.2	50.3	49.3	48.3
82	57.0	56.1	55.1	54.1	53.2	52.2	51.2	50.3	49.3	48.3
83	57.0	56.1	55.1	54.1	53.2	52.2	51.2	50.3	49.3	48.3
84	57.0	56.1	55.1	54.1	53.2	52.2	51.2	50.3	49.3	48.3
85	57.0	56.1	55.1	54.1	53.2	52.2	51.2	50.2	49.3	48.3
86	57.0	56.1	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
87	57.0	56.1	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
88	57.0	56.1	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
89	57.0	56.1	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
90	57.0	56.1	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
91	57.0	56.1	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
92	57.0	56.1	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
93	57.0	56.1	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
94	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
95	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	25	26	27	28	29	30	31	32	33	34
96	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
97	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
98	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
99	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
100	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
101	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
102	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
103	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
104	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
105	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
106	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
107	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
108	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
109	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
110	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
111	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
112	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
113	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
114	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3
115	57.0	56.0	55.1	54.1	53.1	52.2	51.2	50.2	49.3	48.3

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	35	36	37	38	39	40	41	42	43	44
35	54.0	53.5	53.0	52.6	52.2	51.8	51.4	51.1	50.8	50.5
36	53.5	53.0	52.5	52.0	51.6	51.2	50.8	50.4	50.1	49.8
37	53.0	52.5	52.0	51.5	51.0	50.6	50.2	49.8	49.5	49.1
38	52.6	52.0	51.5	51.0	50.5	50.0	49.6	49.2	48.8	48.5
39	52.2	51.6	51.0	50.5	50.0	49.5	49.1	48.6	48.2	47.8
40	51.8	51.2	50.6	50.0	49.5	49.0	48.5	48.1	47.6	47.2
41	51.4	50.8	50.2	49.6	49.1	48.5	48.0	47.5	47.1	46.7
42	51.1	50.4	49.8	49.2	48.6	48.1	47.5	47.0	46.6	46.1
43	50.8	50.1	49.5	48.8	48.2	47.6	47.1	46.6	46.0	45.6
44	50.5	49.8	49.1	48.5	47.8	47.2	46.7	46.1	45.6	45.1
45	50.2	49.5	48.8	48.1	47.5	46.9	46.3	45.7	45.1	44.6
46	50.0	49.2	48.5	47.8	47.2	46.5	45.9	45.3	44.7	44.1
47	49.7	49.0	48.3	47.5	46.8	46.2	45.5	44.9	44.3	43.7
48	49.5	48.8	48.0	47.3	46.6	45.9	45.2	44.5	43.9	43.3
49	49.3	48.5	47.8	47.0	46.3	45.6	44.9	44.2	43.6	42.9
50	49.2	48.4	47.6	46.8	46.0	45.3	44.6	43.9	43.2	42.6
51	49.0	48.2	47.4	46.6	45.8	45.1	44.3	43.6	42.9	44.2
52	48.8	48.0	47.2	46.4	45.6	44.8	44.1	43.3	42.6	41.9
53	48.7	47.9	47.0	46.2	45.4	44.6	43.9	43.1	42.4	41.7
54	48.6	47.7	46.9	46.0	45.2	44.4	43.6	42.9	42.1	41.4
55	48.5	47.6	46.7	45.9	45.1	44.2	43.4	42.7	41.9	41.2
56	48.3	47.5	46.6	45.8	44.9	44.1	43.3	42.5	41.7	40.9
57	48.3	47.4	46.5	45.6	44.8	43.9	43.1	42.3	41.5	40.7
58	48.2	47.3	46.4	45.5	44.7	43.8	43.0	42.1	41.3	40.5
59	48.1	47.2	46.3	45.4	44.5	43.7	42.8	42.0	41.2	40.4
60	48.0	47.1	46.2	45.3	44.4	43.6	42.7	41.9	41.0	40.2
61	47.9	47.0	46.1	45.2	44.3	43.5	42.6	41.7	40.9	40.0
62	47.9	47.0	46.0	45.1	44.2	43.4	42.5	41.6	40.8	39.9
63	47.8	46.9	46.0	45.1	44.2	43.3	42.4	41.5	40.6	39.8
64	47.8	46.8	45.9	45.0	44.1	43.2	42.3	41.4	40.5	39.7
65	47.7	46.8	45.9	44.9	44.0	43.1	42.2	41.3	40.4	39.6
66	47.7	46.7	45.8	44.9	44.0	43.1	42.2	41.3	40.4	39.5
67	47.6	46.7	45.8	44.8	43.9	43.0	42.1	41.2	40.3	39.4
68	47.6	46.7	45.7	44.8	43.9	42.9	42.0	41.1	40.2	39.3
69	47.6	46.6	45.7	44.8	43.8	42.9	42.0	41.1	40.2	39.3
70	47.5	46.6	45.7	44.7	43.8	42.9	41.9	41.0	40.1	39.2
71	47.5	46.6	45.6	44.7	43.8	42.8	41.9	41.0	40.1	39.1
72	47.5	46.6	45.6	44.7	43.7	42.8	41.9	40.9	40.0	39.1
73	47.5	46.5	45.6	44.6	43.7	42.8	41.8	40.9	40.0	39.0
74	47.5	46.5	45.6	44.6	43.7	42.7	41.8	40.9	39.9	39.0
75	47.4	46.5	45.5	44.6	43.6	42.7	41.8	40.8	39.9	39.0
76	47.4	46.5	45.5	44.6	43.6	42.7	41.7	40.8	39.9	38.9
77	47.4	46.5	45.5	44.6	43.6	42.7	41.7	40.8	39.8	38.9
78	47.4	46.4	45.5	44.5	43.6	42.6	41.7	40.7	39.8	38.9

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	35	36	37	38	39	40	41	42	43	44
79	47.4	46.4	45.5	44.5	43.6	42.6	41.7	40.7	39.8	38.9
80	47.4	46.4	45.5	44.5	43.6	42.6	41.7	40.7	39.8	38.8
81	47.4	46.4	45.5	44.5	43.5	42.6	41.6	40.7	39.8	38.8
82	47.4	46.4	45.4	44.5	43.5	42.6	41.6	40.7	39.7	38.8
83	47.4	46.4	45.4	44.5	43.5	42.6	41.6	40.7	39.7	38.8
84	47.4	46.4	45.4	44.5	43.5	42.6	41.6	40.7	39.7	38.8
85	47.4	46.4	45.4	44.5	43.5	42.6	41.6	40.7	39.7	38.8
86	47.3	46.4	45.4	44.5	43.5	42.5	41.6	40.6	39.7	38.8
87	47.3	46.4	45.4	44.5	43.5	42.5	41.6	40.6	39.7	38.7
88	47.3	46.4	45.4	44.5	43.5	42.5	41.6	40.6	39.7	38.7
89	47.3	46.4	45.4	44.4	43.5	42.5	41.6	40.6	39.7	38.7
90	47.3	46.4	45.4	44.4	43.5	42.5	41.6	40.6	39.7	38.7
91	47.3	46.4	45.4	44.4	43.5	42.5	41.6	40.6	39.7	39.7
92	47.3	46.4	45.4	44.4	44.4	43.5	42.5	41.6	40.6	38.7
93	47.3	46.4	45.4	43.5	42.5	41.6	40.6	39.7	39.7	38.7
94	47.3	46.4	45.4	44.4	43.5	42.5	41.6	40.6	39.7	38.7
95	47.3	46.4	45.4	44.4	43.5	42.5	41.6	40.6	39.7	38.7
96	47.3	46.4	45.4	44.4	43.5	42.5	41.6	40.6	39.7	38.7
97	47.3	46.4	45.4	44.4	43.5	42.5	41.6	40.6	39.6	38.7
98	47.3	46.4	45.4	44.4	43.5	42.5	41.6	40.6	39.6	38.7
99	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
100	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
101	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
102	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
103	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
104	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
105	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
106	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
107	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
108	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
109	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
110	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
111	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
112	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
113	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
114	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
114	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7
115	47.3	46.4	45.4	44.4	43.5	42.5	41.5	40.6	39.6	38.7

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	45	46	47	48	49	50	51	52	53	54
45	44.1	43.6	43.2	42.7	42.3	42.0	41.6	41.3	41.0	40.7
46	43.6	43.1	42.6	42.2	41.8	41.4	41.0	40.6	40.3	40.0
47	43.2	42.6	42.1	41.7	41.2	40.8	40.4	40.0	39.7	39.3
48	42.7	42.2	41.7	41.2	40.7	40.2	39.8	39.4	39.0	38.7
49	42.3	41.8	41.2	40.7	40.2	39.7	39.3	38.8	38.4	38.1
50	42.0	41.4	40.8	40.2	39.7	39.2	38.7	38.3	37.9	37.5
51	41.6	41.0	40.4	39.8	39.3	38.7	38.2	37.8	37.3	36.9
52	41.3	40.6	40.0	39.4	38.8	38.3	37.8	37.3	36.8	36.4
53	41.0	40.3	39.7	39.0	38.4	37.9	37.3	36.8	36.3	35.8
54	40.7	40.0	39.3	38.7	38.1	37.5	36.9	36.4	35.8	35.3
55	40.4	39.7	39.0	38.4	37.7	37.1	36.5	35.9	35.4	34.9
56	40.2	39.5	38.7	38.1	37.4	36.8	36.1	35.6	35.0	34.4
57	40.0	39.2	38.5	37.8	37.1	36.4	35.8	35.2	34.6	34.0
58	39.7	39.0	38.2	37.5	36.8	36.1	35.5	34.8	34.2	33.6
59	39.6	38.8	38.0	37.3	36.6	35.9	35.2	34.5	33.9	33.3
60	39.4	38.6	37.8	37.1	36.3	35.6	34.9	34.2	33.6	32.9
61	39.2	38.4	37.6	36.9	36.1	35.4	34.6	33.9	33.3	32.6
62	39.1	38.3	37.5	36.7	35.9	35.1	34.4	33.7	33.0	32.3
63	38.9	38.1	37.3	36.5	35.7	34.9	34.2	33.5	32.7	32.0
64	38.8	38.0	37.2	36.3	35.5	34.8	34.0	33.2	32.5	31.8
65	38.7	37.9	37.0	36.2	35.4	34.6	33.8	33.0	32.3	31.6
66	38.6	37.8	36.9	36.1	35.2	34.4	33.6	32.9	32.1	31.4
67	38.5	37.7	36.8	36.0	35.1	34.3	33.5	32.7	31.9	31.2
68	38.4	37.6	36.7	35.8	35.0	34.2	33.4	32.5	31.8	31.0
69	38.4	37.5	36.6	35.7	34.9	34.1	33.2	32.4	31.6	30.8
70	38.3	37.4	36.5	35.7	34.8	34.0	33.1	32.3	31.5	30.7

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	45	46	47	48	49	50	51	52	53	54
71	38.2	37.3	36.5	35.6	34.7	33.9	33.0	32.2	31.4	30.5
72	38.2	37.3	36.4	35.5	34.6	33.8	32.9	32.1	31.2	30.4
73	38.1	37.2	36.3	35.4	34.6	33.7	32.8	32.0	31.1	30.3
74	38.1	37.2	36.3	35.4	34.5	33.6	32.8	31.9	31.1	30.2
75	38.1	37.1	36.2	35.3	34.5	33.6	32.7	31.8	31.0	30.1
76	38.0	37.1	36.2	35.3	34.4	33.5	32.6	31.8	30.9	30.1
77	38.0	37.1	36.2	35.3	34.4	33.5	32.6	31.7	30.8	30.0
78	38.0	37.0	36.1	35.2	34.3	33.4	32.5	31.7	30.8	29.9
79	37.9	37.0	36.1	35.2	34.3	33.4	32.5	31.6	30.7	29.9
80	37.9	37.0	36.1	35.2	34.2	33.4	32.5	31.6	30.7	29.8
81	37.9	37.0	36.0	35.1	34.2	33.3	32.4	31.5	30.7	29.8
82	37.9	36.9	36.0	35.1	34.2	33.3	32.4	31.5	30.6	29.7
83	37.9	36.9	36.0	35.1	34.2	33.3	32.4	31.5	30.6	29.7
84	37.8	36.9	36.9	35.0	34.2	33.2	32.3	31.4	30.6	29.7
85	37.8	36.9	36.0	35.1	34.1	33.2	32.3	31.4	30.5	29.6
86	38.8	36.9	36.0	35.0	34.1	33.2	32.3	31.4	30.5	29.6
87	37.8	36.9	35.9	35.0	34.1	33.2	32.3	31.4	30.5	29.6
88	37.8	36.9	35.9	35.0	34.1	33.2	32.3	31.4	30.5	29.6
89	37.8	36.9	35.9	35.0	34.1	33.2	32.3	31.4	30.5	29.6
90	37.8	36.9	35.9	35.0	34.1	33.2	32.3	31.3	30.5	29.6
91	37.8	36.8	35.9	35.0	34.1	33.2	32.2	31.3	30.4	29.5
92	37.8	36.8	35.9	35.0	34.1	33.2	32.2	31.3	30.4	29.5
93	37.8	36.8	35.9	35.0	34.1	33.1	32.2	31.3	30.4	29.5
94	37.8	36.8	35.9	35.0	34.1	33.1	32.2	31.3	30.4	29.5
95	37.8	36.8	35.9	35.0	34.0	33.1	32.2	31.3	30.4	29.5
96	37.8	36.8	35.9	35.0	34.0	33.1	32.2	31.3	30.4	29.5
97	37.8	36.8	35.9	35.0	34.0	33.1	32.2	31.3	30.4	29.5
98	37.8	36.8	35.9	35.0	34.0	33.1	32.2	31.3	30.4	29.5
99	37.8	36.8	35.9	35.0	34.0	33.1	32.2	31.3	30.4	29.5
101	37.8	36.8	35.9	35.0	34.0	33.1	32.2	31.3	30.4	29.5
102	37.8	36.8	35.9	35.0	34.0	33.1	32.2	31.3	30.4	29.5
103	37.7	36.8	35.9	34.9	34.0	33.1	32.2	31.3	30.4	29.5
104	37.7	36.8	35.9	34.9	34.0	33.1	32.2	31.3	30.4	29.5
105	37.7	36.8	35.9	34.9	34.0	33.1	32.2	31.3	30.4	29.5
106	37.7	36.8	35.9	34.9	34.0	33.1	32.2	31.3	30.4	29.5
107	37.7	36.8	35.9	34.9	34.0	33.1	32.2	31.3	30.4	29.5
108	37.7	36.8	35.9	34.9	34.0	33.1	32.2	31.3	30.4	29.5
109	37.7	36.8	35.9	34.9	34.0	33.1	32.2	31.3	30.4	29.5
110	37.7	36.8	35.9	34.9	34.0	33.1	32.2	31.3	30.4	29.5
111	37.7	36.8	35.9	34.9	34.0	33.1	32.2	31.3	30.4	29.5
112	37.7	36.8	35.9	34.9	34.0	33.1	32.2	31.3	30.4	29.5
113	37.7	36.8	35.9	34.9	34.0	33.1	32.2	31.3	30.4	29.5
114	37.7	36.8	35.9	34.9	34.0	33.1	32.2	31.3	30.4	29.5
115	37.7	36.8	35.9	34.9	34.0	33.1	32.2	31.3	30.4	29.5

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	55	56	57	58	59	60	61	62	63	64
55	34.4	33.9	33.5	33.1	32.7	32.3	32.0	31.7	31.4	31.1
56	33.9	33.4	33.0	32.5	32.1	31.7	31.4	31.0	30.7	30.4
57	33.5	33.0	32.5	32.0	31.6	31.2	30.8	30.4	30.1	29.8
58	33.1	32.5	32.0	31.5	31.1	30.6	30.2	29.9	29.5	29.2
59	32.7	32.1	31.6	31.1	30.6	30.1	29.7	29.3	28.9	28.6
60	32.3	31.7	31.2	30.6	30.1	29.7	29.2	28.8	28.4	28.0
61	32.0	31.4	30.8	30.2	29.7	29.2	28.7	28.3	27.8	27.4
62	31.7	31.0	30.4	29.9	29.3	28.8	28.3	27.8	27.3	26.9
63	31.4	30.7	30.1	29.5	28.9	28.4	27.8	27.3	26.9	26.4
64	31.1	30.4	29.8	29.2	28.6	28.0	27.4	26.9	26.4	25.9
65	30.9	30.2	29.5	28.9	28.2	27.6	27.1	26.5	26.0	25.5
66	30.6	29.9	29.2	28.6	27.9	27.3	26.7	26.1	25.6	25.1
67	30.4	29.7	29.0	28.3	27.6	27.0	26.4	25.8	25.2	24.7
68	30.2	29.5	28.8	28.1	27.4	26.7	26.1	25.5	24.9	24.3
69	30.1	29.3	28.6	27.8	27.1	26.5	25.8	25.2	24.6	24.0
70	29.9	29.1	28.4	27.6	26.9	26.2	25.6	24.9	24.3	23.7
71	29.7	29.0	28.2	27.5	26.7	26.0	25.3	24.7	24.0	23.4
72	29.6	28.8	28.1	27.3	26.5	25.8	25.1	24.4	23.8	23.1
73	29.5	28.7	27.9	27.1	26.4	25.6	24.9	24.2	23.5	22.9
74	29.4	28.6	27.8	27.0	26.2	25.5	24.7	24.0	23.3	22.7

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	55	56	57	58	59	60	61	62	63	64
75	29.3	28.5	27.7	26.9	26.1	25.3	24.6	23.8	23.1	22.4
76	29.2	28.4	27.6	26.8	26.0	25.2	24.4	23.7	23.0	22.3
77	29.1	28.3	27.5	26.7	25.9	25.1	24.3	23.6	22.8	22.1
78	29.1	28.2	27.4	26.6	25.8	25.0	24.2	23.4	22.7	21.9
79	29.0	28.2	27.3	26.5	25.7	24.9	24.1	23.3	22.6	21.8
80	29.0	28.1	27.3	26.4	25.6	24.8	24.0	23.2	22.4	21.7
81	28.9	28.1	27.2	26.4	25.5	24.7	23.9	23.1	22.3	21.6
82	28.9	28.0	27.2	26.3	25.5	24.6	23.8	23.0	22.3	21.5
83	28.8	28.0	27.1	26.3	25.4	24.6	23.8	23.0	22.2	21.4
84	28.8	27.9	27.1	26.2	25.4	24.5	23.7	22.9	22.1	21.3
85	28.8	27.9	27.0	26.2	25.3	24.5	23.7	22.8	22.0	21.3
86	28.7	27.9	27.0	26.1	25.3	24.5	23.6	22.8	22.0	21.2
87	28.7	27.8	27.0	26.1	25.3	24.4	23.6	22.8	21.9	21.1
88	28.7	27.8	27.0	26.1	25.2	24.4	23.5	22.7	21.9	21.1
89	28.7	27.8	26.9	26.1	25.2	24.4	23.5	22.7	21.9	21.1
90	28.7	27.8	26.9	26.1	25.2	24.3	23.5	22.7	21.8	21.0
91	28.7	27.8	26.9	26.0	25.2	24.3	23.5	22.6	21.8	21.0
92	28.6	27.8	26.9	26.0	25.2	24.3	23.5	22.6	21.8	21.0
93	28.6	27.8	26.9	26.0	25.1	24.3	23.4	22.6	21.8	20.9
94	28.6	27.7	26.9	26.0	25.1	24.3	23.4	22.6	21.7	20.9
95	28.6	27.7	26.9	26.0	25.1	24.3	23.4	22.6	21.7	20.9
96	28.6	27.7	26.9	26.0	25.1	24.2	23.4	22.6	21.7	20.9
97	28.6	27.7	26.8	26.0	25.1	24.2	23.4	22.5	21.7	20.9
98	28.6	27.7	26.8	26.0	25.1	24.2	23.4	22.5	21.7	20.9
99	28.6	27.7	26.8	26.0	25.1	24.2	23.4	22.5	21.7	20.9
100	28.6	27.7	26.8	26.0	25.1	24.2	23.4	22.5	21.7	20.8
101	28.6	27.7	26.8	25.9	25.1	24.2	23.4	22.5	21.7	20.8
102	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.7	20.8
103	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.7	20.8
104	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.6	20.8
105	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.6	20.8
106	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.6	20.8
107	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.6	20.8
108	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.6	20.8
109	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.6	20.8
110	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.6	20.8
111	28.6	27.7	26.8	25.9	25.0	24.2	23.3	22.5	21.6	20.8
112	28.6	27.7	26.8	25.9	25.0	24.2	23.3	22.5	21.6	20.8
113	28.6	27.7	26.8	25.9	25.0	24.2	23.3	22.5	21.6	20.8
114	28.6	27.7	26.8	25.9	25.0	24.2	23.3	22.5	21.6	20.8
115	28.6	27.7	26.8	25.9	25.0	24.2	23.3	22.5	21.6	20.8

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	65	66	67	68	69	70	71	72	73	74
65	25.0	24.6	24.2	23.8	23.4	23.1	22.8	22.5	22.2	22.0
66	24.6	24.1	23.7	23.3	22.9	22.5	22.2	21.9	21.6	21.4
67	24.2	23.7	23.2	22.8	22.4	22.0	21.7	21.3	21.0	20.8
68	23.8	23.3	22.8	22.3	21.9	21.5	21.2	20.8	20.5	20.2
69	23.4	22.9	22.4	21.9	21.5	21.1	20.7	20.3	20.0	19.6
70	23.1	22.5	22.0	21.5	21.1	20.6	20.2	19.8	19.4	19.1
71	22.8	22.2	21.7	21.2	20.7	20.2	19.8	19.4	19.0	18.6
72	22.5	21.9	21.3	20.8	20.3	19.8	19.4	18.9	18.5	18.2
73	22.2	21.6	21.0	20.5	20.0	19.4	19.0	18.5	18.1	17.7
74	22.0	21.4	20.8	20.2	19.6	19.1	18.6	18.2	17.7	17.3
75	21.8	21.1	20.5	19.9	19.3	18.8	18.3	17.8	17.3	16.9
76	21.6	20.9	20.3	19.7	19.1	18.5	18.0	17.5	17.0	16.5
77	21.4	20.7	20.1	19.4	18.8	18.3	17.7	17.2	16.7	16.2
78	21.2	20.5	19.9	19.2	18.6	18.0	17.5	16.9	16.4	15.9
79	21.1	20.4	19.7	19.0	18.4	17.8	17.2	16.7	16.1	15.6
80	21.0	20.2	19.5	18.9	18.2	17.6	17.0	16.4	15.9	15.4
81	20.8	20.1	19.4	18.7	18.1	17.4	16.8	16.2	15.7	15.1
82	20.7	20.0	19.3	18.6	17.9	17.3	16.6	16.0	15.5	14.9
83	20.6	19.9	19.2	18.5	17.8	17.1	16.5	15.9	15.3	14.7
84	20.5	19.8	19.1	18.4	17.7	17.0	16.3	15.7	15.1	14.5
85	20.5	19.7	19.0	18.3	17.6	16.9	16.2	15.6	15.0	14.4
86	20.4	19.6	18.9	18.2	17.5	16.8	16.1	15.5	14.8	14.2
87	20.4	19.6	18.8	18.1	17.4	16.7	16.0	15.4	14.7	14.1

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	65	66	67	68	69	70	71	72	73	74
88	20.3	19.5	18.8	18.0	17.3	16.6	15.9	15.3	14.6	14.0
89	20.3	19.5	18.7	18.0	17.2	16.5	15.8	15.2	14.5	13.9
90	20.2	19.4	18.7	17.9	17.2	16.5	15.8	15.1	14.5	13.8
91	20.2	19.4	18.6	17.9	17.1	16.4	15.7	15.0	14.4	13.7
92	20.2	19.4	18.6	17.8	17.1	16.4	15.7	15.0	14.3	13.7
93	20.1	19.3	18.6	17.8	17.1	16.3	15.6	14.9	14.3	13.6
94	20.1	19.3	18.5	17.8	17.0	16.3	15.6	14.9	14.2	13.6
95	20.1	19.3	18.5	17.8	17.0	16.3	15.6	14.9	14.2	13.5
96	20.1	19.3	18.5	17.7	17.0	16.2	15.5	14.8	14.2	13.5
97	20.1	19.3	18.5	17.7	17.0	16.2	15.5	14.8	14.1	13.5
98	20.1	19.3	18.5	17.7	16.9	16.2	15.5	14.8	14.1	13.4
99	20.0	19.2	18.5	17.7	16.9	16.2	15.5	14.7	14.1	13.4
100	20.0	19.2	18.4	17.7	16.9	16.2	15.4	14.7	14.0	13.4
101	20.0	19.2	18.4	17.7	16.9	16.1	15.4	14.7	14.0	13.3
102	20.0	19.2	18.4	17.6	16.9	16.1	15.4	14.7	14.0	13.3
103	20.0	19.2	18.4	17.6	16.9	16.1	15.4	14.7	14.0	13.3
104	20.0	19.2	18.4	17.6	16.9	16.1	15.4	14.7	14.0	13.3
105	20.0	19.2	18.4	17.6	16.8	16.1	15.4	14.6	13.9	13.3
106	20.0	19.2	18.4	17.6	16.8	16.1	15.3	14.6	13.9	13.3
107	20.0	19.2	18.4	17.6	16.8	16.1	15.3	14.6	13.9	13.2
108	20.0	19.2	18.4	17.6	16.8	16.1	15.3	14.6	13.9	13.2
109	20.0	19.2	18.4	17.6	16.8	16.1	15.3	14.6	13.9	13.2
110	20.0	19.2	18.4	17.6	16.8	16.1	15.3	14.6	13.9	13.2
111	20.0	19.2	18.4	17.6	16.8	16.0	15.3	14.6	13.9	13.2
112	20.0	19.2	18.4	17.6	16.8	16.0	15.3	14.6	13.9	13.2
113	20.0	19.2	18.4	17.6	16.8	16.0	15.3	14.6	13.9	13.2
114	20.0	19.2	18.4	17.6	16.8	16.0	15.3	14.6	13.9	13.2
115	20.0	19.2	18.4	17.6	16.8	16.0	15.3	14.6	13.9	13.2

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	75	76	77	78	79	80	81	82	83	84
75	16.5	16.1	15.8	15.4	15.1	14.9	14.6	14.4	14.2	14.0
76	16.1	15.7	15.4	15.0	14.7	14.4	14.1	13.9	13.7	13.5
77	15.8	15.4	15.0	14.6	14.3	14.0	13.7	13.4	13.2	13.0
78	15.4	15.0	14.6	14.2	13.9	13.5	13.2	13.0	12.7	12.5
79	15.1	14.7	14.3	13.9	13.5	13.2	12.8	12.5	12.3	12.0
80	14.9	14.4	14.0	13.5	13.2	12.8	12.5	12.2	11.9	11.6
81	14.6	14.1	13.7	13.2	12.8	12.5	12.1	11.8	11.5	11.2
82	14.4	13.9	13.4	13.0	12.5	12.2	11.8	11.5	11.1	10.9
83	14.2	13.7	13.2	12.7	12.3	11.9	11.5	11.1	10.8	10.5
84	14.0	13.5	13.0	12.5	12.0	11.6	11.2	10.9	10.5	10.2
85	13.8	13.3	12.8	12.3	11.8	11.4	11.0	10.6	10.2	9.9
86	13.7	13.1	12.6	12.1	11.6	11.2	10.8	10.4	10.0	9.7
87	13.5	13.0	12.4	11.9	11.4	11.0	10.6	10.1	9.8	9.4
88	13.4	12.8	12.3	11.8	11.3	10.8	10.4	10.0	9.6	9.2
89	13.3	12.7	12.2	11.6	11.1	10.7	10.2	9.8	9.4	9.0
90	13.2	12.6	12.1	11.5	11.0	10.5	10.1	9.6	9.2	8.8
91	13.1	12.5	12.0	11.4	10.9	10.4	9.9	9.5	9.1	8.7
92	13.1	12.5	11.9	11.3	10.8	10.3	9.8	9.4	8.9	8.5
93	13.0	12.4	11.8	11.3	10.7	10.2	9.7	9.3	8.8	8.4
94	12.9	12.3	11.7	11.2	10.6	10.1	9.6	9.2	8.7	8.3
95	12.9	12.3	11.7	11.1	10.6	10.1	9.6	9.1	8.6	8.2
96	12.9	12.2	11.6	11.1	10.5	10.0	9.5	9.0	8.5	8.1
97	12.8	12.2	11.6	11.0	10.5	9.9	9.4	8.9	8.5	8.0
98	12.8	12.2	11.5	11.0	10.4	9.9	9.4	8.9	8.4	8.0
99	12.7	12.1	11.5	10.9	10.4	9.8	9.3	8.8	8.3	7.9
100	12.7	12.1	11.5	10.9	10.3	9.8	9.2	8.7	8.3	7.8
101	12.7	12.1	11.4	10.8	10.3	9.7	9.2	8.7	8.2	7.8
102	12.7	12.0	11.4	10.8	10.2	9.7	9.2	8.7	8.2	7.7
103	12.6	12.0	11.4	10.8	10.2	9.7	9.1	8.6	8.1	7.7
104	12.6	12.0	11.4	10.8	10.2	9.6	9.1	8.6	8.1	7.6
105	12.6	12.0	11.3	10.7	10.2	9.6	9.1	8.5	8.0	7.6
106	12.6	11.9	11.3	10.7	10.1	9.6	9.0	8.5	8.0	7.5
107	12.6	11.9	11.3	10.7	10.1	9.6	9.0	8.5	8.0	7.5
108	12.6	11.9	11.3	10.7	10.1	9.5	9.0	8.5	8.0	7.5
109	12.6	11.9	11.3	10.7	10.1	9.5	9.0	8.4	7.9	7.5
110	12.6	11.9	11.3	10.7	10.1	9.5	9.0	8.4	7.9	7.4

Table VI—Ordinary Joint Life and Last Survivor Annuities; Two Lives—Expected Return Multiples—Continued

Ages	75	76	77	78	79	80	81	82	83	84
111	12.5	11.9	11.3	10.7	10.1	9.5	8.9	8.4	7.9	7.4
112	12.5	11.9	11.3	10.6	10.1	9.5	8.9	8.4	7.9	7.4
113	12.5	11.9	11.2	10.6	10.0	9.5	8.9	8.4	7.9	7.4
114	12.5	11.9	11.2	10.6	10.0	9.5	8.9	8.4	7.9	7.4
115	12.5	11.9	11.2	10.6	10.0	9.5	8.9	8.4	7.9	7.4

Table VI—Ordinary Joint Life and Last Survivor Annuities; Two Lives—Expected Return Multiples

Ages	85	86	87	88	89	90	91	92	93	94
85	9.6	9.3	9.1	8.9	8.7	8.5	8.3	8.2	8.0	7.9
86	9.3	9.1	8.8	8.6	8.3	8.2	8.0	7.8	7.7	7.6
87	9.1	8.8	8.5	8.3	8.1	7.9	7.7	7.5	7.4	7.2
88	8.9	8.6	8.3	8.0	7.8	7.6	7.4	7.2	7.1	6.9
89	8.7	8.3	8.1	7.8	7.5	7.3	7.1	6.9	6.8	6.6
90	8.5	8.2	7.9	7.6	7.3	7.1	6.9	6.7	6.5	6.4
91	8.3	8.0	7.7	7.4	7.1	6.9	6.7	6.5	6.3	6.2
92	8.2	7.8	7.5	7.2	6.9	6.7	6.5	6.3	6.1	5.9
93	8.0	7.7	7.4	7.1	6.8	6.5	6.3	6.1	5.9	5.8
94	7.9	7.6	7.2	6.9	6.6	6.4	6.2	5.9	5.8	5.6
95	7.8	7.5	7.1	6.8	6.5	6.3	6.0	5.8	5.6	5.4
96	7.7	7.3	7.0	6.7	6.4	6.1	5.9	5.7	5.5	5.3
97	7.6	7.3	6.9	6.6	6.3	6.0	5.8	5.5	5.3	5.1
98	7.6	7.2	6.8	6.5	6.2	5.9	5.6	5.4	5.2	5.0
99	7.5	7.1	6.7	6.4	6.1	5.8	5.5	5.3	5.1	4.9
100	7.4	7.0	6.6	6.3	6.0	5.7	5.4	5.2	5.0	4.8
101	7.3	6.9	6.6	6.2	5.9	5.6	5.3	5.1	4.9	4.7
102	7.3	6.9	6.5	6.2	5.8	5.5	5.3	5.0	4.8	4.6
103	7.2	6.8	6.4	6.1	5.8	5.5	5.2	4.9	4.7	4.5
104	7.2	6.8	6.4	6.0	5.7	5.4	5.1	4.8	4.6	4.4
105	7.1	6.7	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.3
106	7.1	6.7	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2
107	7.1	6.6	6.2	5.9	5.5	5.2	4.9	4.6	4.4	4.2
108	7.0	6.6	6.2	5.8	5.5	5.2	4.9	4.6	4.3	4.1
109	7.0	6.6	6.2	5.8	5.5	5.1	4.8	4.5	4.3	4.1
110	7.0	6.6	6.2	5.8	5.4	5.1	4.8	4.5	4.3	4.0
111	7.0	6.5	6.1	5.7	5.4	5.1	4.8	4.5	4.2	4.0
112	7.0	6.5	6.1	5.7	5.4	5.0	4.7	4.4	4.2	3.9
113	6.9	6.5	6.1	5.7	5.4	5.0	4.7	4.4	4.2	3.9
114	6.9	6.5	6.1	5.7	5.3	5.0	4.7	4.4	4.1	3.9
115	6.9	6.5	6.1	5.7	5.3	5.0	4.7	4.4	4.1	3.9

Table VI—Ordinary Joint Life and Last Survivor Annuities; Two Lives—Expected Return Multiples

Ages	95	96	97	98	99	100	101	102	103	104
95	5.3	5.1	5.0	4.8	4.7	4.6	4.5	4.4	4.3	4.2
96	5.1	5.0	4.8	4.7	4.5	4.4	4.3	4.2	4.1	4.0
97	5.0	4.8	4.7	4.5	4.4	4.3	4.1	4.0	3.9	3.8
98	4.8	4.7	4.5	4.4	4.2	4.1	4.0	3.9	3.8	3.7
99	4.7	4.5	4.4	4.2	4.1	4.0	3.8	3.7	3.6	3.5
100	4.6	4.4	4.3	4.1	4.0	3.8	3.7	3.6	3.5	3.3
101	4.5	4.3	4.1	4.0	3.8	3.7	3.6	3.4	3.3	3.2
102	4.4	4.2	4.0	3.9	3.7	3.6	3.4	3.3	3.2	3.1
103	4.3	4.1	3.9	3.8	3.6	3.5	3.3	3.2	3.0	2.9
104	4.2	4.0	3.8	3.7	3.5	3.3	3.2	3.1	2.9	2.8
105	4.1	3.9	3.7	3.6	3.4	3.2	3.1	2.9	2.8	2.7
106	4.0	3.8	3.6	3.5	3.3	3.1	3.0	2.8	2.7	2.5
107	4.0	3.8	3.6	3.4	3.2	3.1	2.9	2.7	2.6	2.4
108	3.9	3.7	3.5	3.3	3.1	3.0	2.8	2.7	2.5	2.3
109	3.8	3.6	3.4	3.3	3.1	2.9	2.7	2.6	2.4	2.3
110	3.8	3.6	3.4	3.2	3.0	2.8	2.7	2.5	2.3	2.2
111	3.8	3.5	3.3	3.2	3.0	2.8	2.6	2.4	2.3	2.1
112	3.7	3.5	3.3	3.1	2.9	2.8	2.6	2.4	2.2	2.1
113	3.7	3.5	3.3	3.1	2.9	2.7	2.5	2.4	2.2	2.0
114	3.7	3.5	3.3	3.1	2.9	2.7	2.5	2.3	2.1	2.0

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	95	96	97	98	99	100	101	102	103	104
115	3.7	3.4	3.2	3.0	2.8	2.7	2.5	2.3	2.1	1.9

TABLE VI—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	105	106	107	108	109	110	111	112	113	114	115
105	2.5	2.4	2.3	2.2	2.1	2.0	2.0	1.9	1.8	1.8	1.8
106	2.4	2.3	2.2	2.1	2.0	1.9	1.8	1.7	1.7	1.6	1.6
107	2.3	2.2	2.1	1.9	1.8	1.7	1.7	1.6	1.5	1.5	1.4
108	2.2	2.1	1.9	1.8	1.7	1.6	1.5	1.5	1.4	1.3	1.3
109	2.1	2.0	1.8	1.7	1.6	1.5	1.4	1.3	1.3	1.2	1.1
110	2.0	1.9	1.7	1.6	1.5	1.4	1.3	1.2	1.1	1.1	1.0
111	2.0	1.8	1.7	1.5	1.4	1.3	1.2	1.1	1.0	.9	.9
112	1.9	1.7	1.6	1.5	1.3	1.2	1.1	1.0	.9	.8	.8
113	1.8	1.7	1.5	1.4	1.3	1.1	1.0	.9	.8	.7	.7
114	1.8	1.6	1.5	1.3	1.2	1.1	.9	.8	.7	.6	.6
115	1.8	1.6	1.4	1.3	1.1	1.0	.9	.8	.7	.6	.5

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	5	6	7	8	9	10	11	12	13	14
5	69.5	69.0	68.4	67.9	67.3	66.7	66.1	65.5	64.8	64.1
6	69.0	68.5	68.0	67.5	66.9	66.4	65.8	65.1	64.5	63.8
7	68.4	68.0	67.5	67.0	66.5	66.0	65.4	64.8	64.2	63.5
8	67.9	67.5	67.0	66.6	66.1	65.5	65.0	64.4	63.8	63.2
9	67.3	66.9	66.5	66.1	65.6	65.1	64.6	64.0	63.4	62.8
10	66.7	66.4	66.0	65.5	65.1	64.6	64.1	63.6	63.0	62.5
11	66.1	65.8	65.4	65.0	64.6	64.1	63.6	63.1	62.6	62.1
12	65.5	65.1	64.8	64.4	64.0	63.6	63.1	62.7	62.2	61.7
13	64.8	64.5	64.2	63.8	63.4	63.0	62.6	62.2	61.7	61.2
14	64.1	63.8	63.5	63.2	62.8	62.5	62.1	61.7	61.2	60.7
15	63.4	63.1	62.9	62.6	62.2	61.9	61.5	61.1	60.7	60.2
16	62.7	62.4	62.2	61.9	61.6	61.3	60.9	60.5	60.1	59.7
17	61.9	61.7	61.5	61.2	60.9	60.6	60.3	59.9	59.6	59.2
18	61.2	61.0	60.7	60.5	60.2	60.0	59.7	59.3	59.0	58.6
19	60.4	60.2	60.0	59.8	59.5	59.3	59.0	58.7	58.4	58.0
20	59.6	59.4	59.2	59.0	58.8	58.6	58.3	58.0	57.7	57.4
21	58.8	58.7	58.5	58.3	58.1	57.8	57.6	57.3	57.1	56.8
22	58.0	57.8	57.7	57.5	57.3	57.1	56.9	56.6	56.4	56.1
23	57.2	57.0	56.9	56.7	56.5	56.4	56.1	55.9	55.7	55.4
24	56.3	56.2	56.1	55.9	55.8	55.6	55.4	55.2	55.0	54.7
25	55.5	55.4	55.2	55.1	55.0	54.8	54.6	54.4	54.2	54.0
26	54.6	54.5	54.4	54.3	54.1	54.0	53.8	53.7	53.5	53.3
27	53.8	53.7	53.6	53.4	53.3	53.2	53.0	52.9	52.7	52.5
28	52.9	52.8	52.7	52.6	52.5	52.4	52.2	52.1	51.9	51.7
29	52.0	51.9	51.8	51.7	51.6	51.5	51.4	51.3	51.1	51.0
30	51.1	51.0	51.0	50.9	50.8	50.7	50.6	50.4	50.3	50.2
31	50.2	50.2	50.1	50.0	49.9	49.8	49.7	49.6	49.5	49.3
32	49.3	49.3	49.2	49.1	49.0	49.0	48.9	48.8	48.6	48.5
33	48.4	48.4	48.3	48.2	48.2	48.1	48.0	47.9	47.8	47.7
34	47.5	47.5	47.4	47.4	47.3	47.2	47.1	47.0	47.0	46.8
35	46.6	46.6	46.5	46.5	46.4	46.3	46.3	46.2	46.1	46.0
36	45.7	45.7	45.6	45.6	45.5	45.4	45.4	45.3	45.2	45.1
37	44.8	44.7	44.7	44.6	44.6	44.5	44.5	44.4	44.3	44.3
38	43.9	43.8	43.8	43.7	43.7	43.6	43.6	43.5	43.5	43.4
39	42.9	42.9	42.9	42.8	42.8	42.7	42.7	42.6	42.6	42.5
40	42.0	42.0	42.0	41.9	41.9	41.8	41.8	41.7	41.7	41.6
41	41.1	41.1	41.0	41.0	41.0	40.9	40.9	40.8	40.8	40.7
42	40.2	40.1	40.1	40.1	40.1	40.0	40.0	39.9	39.9	39.8
43	39.2	39.2	39.2	39.2	39.1	39.1	39.1	39.0	39.0	39.0
44	38.3	38.3	38.3	38.3	38.2	38.2	38.2	38.1	38.1	38.1
45	37.4	37.4	37.4	37.3	37.3	37.3	37.3	37.2	37.2	37.2
46	36.5	36.5	36.5	36.4	36.4	36.4	36.4	36.3	36.3	36.3
47	35.6	35.6	35.5	35.5	35.5	35.5	35.5	35.4	35.4	35.4
48	34.7	34.7	34.6	34.6	34.6	34.6	34.6	34.5	34.5	34.5
49	33.8	33.8	33.7	33.7	33.7	33.7	33.7	33.7	33.6	33.6
50	32.9	32.9	32.8	32.8	32.8	32.8	32.8	32.8	32.7	32.7

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	5	6	7	8	9	10	11	12	13	14
51	32.0	32.0	31.9	31.9	31.9	31.9	31.9	31.9	31.9	31.8
52	31.1	31.1	31.1	31.0	31.0	31.0	31.0	31.0	31.0	30.9
53	30.2	30.2	30.2	30.2	30.1	30.1	30.1	30.1	30.1	30.1
54	29.3	29.3	29.3	29.3	29.3	29.2	29.2	29.2	29.2	29.2
55	28.4	28.4	28.4	28.4	28.4	28.4	28.4	28.3	28.3	28.3
56	27.5	27.5	27.5	27.5	27.5	27.5	27.5	27.5	27.5	27.5
57	26.7	26.7	26.7	26.6	26.6	26.6	26.6	26.6	26.6	26.6
58	25.8	25.8	25.8	25.8	25.8	25.8	25.8	25.7	25.7	25.7
59	24.9	24.9	24.9	24.9	24.9	24.9	24.9	24.9	24.9	24.9
60	24.1	24.1	24.1	24.1	24.1	24.0	24.0	24.0	24.0	24.0
61	23.2	23.2	23.2	23.2	23.2	23.2	23.2	23.2	23.2	23.2
62	22.4	22.4	22.4	22.4	22.4	22.4	22.3	22.3	22.3	22.3
63	21.5	21.5	21.5	21.5	21.5	21.5	21.5	21.5	21.5	21.5
64	20.7	20.7	20.7	20.7	20.7	20.7	20.7	20.7	20.7	20.7
65	19.9	19.9	19.9	19.9	19.9	19.9	19.9	19.9	19.9	19.9
66	19.1	19.1	19.1	19.1	19.1	19.1	19.1	19.1	19.1	19.1
67	18.3	18.3	18.3	18.3	18.3	18.3	18.3	18.3	18.3	18.3
68	17.5	17.5	17.5	17.5	17.5	17.5	17.5	17.5	17.5	17.5
69	16.8	16.8	16.8	16.7	16.7	16.7	16.7	16.7	16.7	16.7
70	16.0	16.0	16.0	16.0	16.0	16.0	16.0	16.0	16.0	16.0
71	15.3	15.3	15.3	15.3	15.3	15.3	15.3	15.3	15.3	15.2
72	14.6	14.6	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.5
73	13.9	13.9	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8
74	13.2	13.2	13.2	13.2	13.2	13.2	13.2	13.2	13.2	13.2
75	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5
76	11.9	11.9	11.8	11.8	11.8	11.8	11.8	11.8	11.8	11.8
77	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2
78	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6
79	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
80	9.5	9.5	9.5	9.5	9.5	9.5	9.5	9.5	9.4	9.4
81	8.9	8.9	8.9	8.9	8.9	8.9	8.9	8.9	8.9	8.9
82	8.4	8.4	8.4	8.4	8.4	8.4	8.4	8.4	8.4	8.4
83	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9
84	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4
85	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9
86	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5
87	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1
88	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7
89	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3
90	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
91	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
92	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4
93	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
94	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9
95	3.7	3.7	3.7	3.7	3.7	3.7	3.6	3.6	3.6	3.6
96	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
97	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
98	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
99	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
100	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
101	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
102	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
103	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
104	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
105	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
106	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
107	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
108	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
109	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
110	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
111	.9	.9	.9	.9	.9	.9	.9	.9	.9	.9
112	.8	.8	.8	.8	.8	.8	.8	.8	.8	.8
113	.7	.7	.7	.7	.7	.7	.7	.7	.7	.7
114	.6	.6	.6	.6	.6	.6	.6	.6	.6	.6
115	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	15	16	17	18	19	20	21	22	23	24
15	59.8	59.3	58.8	58.2	57.6	57.0	56.4	55.8	55.1	54.5

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	15	16	17	18	19	20	21	22	23	24
16	59.3	58.8	58.3	57.8	57.2	56.7	56.1	55.5	54.8	54.2
17	58.8	58.3	57.8	57.3	56.8	56.3	55.7	55.1	54.5	53.9
18	58.2	57.8	57.3	56.9	56.4	55.9	55.3	54.7	54.2	53.5
19	57.6	57.2	56.8	56.4	55.9	55.4	54.9	54.4	53.8	53.2
20	57.0	56.7	56.3	55.9	55.4	54.9	54.5	53.9	53.4	52.8
21	56.4	56.1	55.7	55.3	54.9	54.5	54.0	53.5	53.0	52.4
22	55.8	55.5	55.1	54.7	54.4	53.9	53.5	53.0	52.5	52.0
23	55.1	54.8	54.5	54.2	53.8	53.4	53.0	52.5	52.1	51.6
24	54.5	54.2	53.9	53.5	53.2	52.8	52.4	52.0	51.6	51.1
25	53.8	53.5	53.2	52.9	52.6	52.2	51.9	51.5	51.1	50.6
26	53.0	52.8	52.5	52.3	52.0	51.6	51.3	50.9	50.5	50.1
27	52.3	52.1	51.8	51.6	51.3	51.0	50.7	50.3	50.0	49.6
28	51.5	51.3	51.1	50.9	50.6	50.3	50.0	49.7	49.4	49.0
29	50.8	50.6	50.4	50.2	49.9	49.7	49.4	49.1	48.8	48.4
30	50.0	49.8	49.6	49.4	49.2	49.0	48.7	48.4	48.1	47.8
31	49.2	49.0	48.9	48.7	48.5	48.3	48.0	47.8	47.5	47.2
32	48.4	48.2	48.1	47.9	47.7	47.5	47.3	47.1	46.8	46.5
33	47.6	47.4	47.3	47.1	47.0	46.8	46.6	46.3	46.1	45.9
34	46.7	46.6	46.5	46.3	46.2	46.0	45.8	45.6	45.4	45.2
35	45.9	45.8	45.7	45.5	45.4	45.2	45.1	44.9	44.7	44.4
36	45.0	44.9	44.8	44.7	44.6	44.4	44.3	44.1	43.9	43.7
37	44.2	44.1	44.0	43.9	43.8	43.6	43.5	43.3	43.2	43.0
38	43.3	43.2	43.1	43.0	42.9	42.8	42.7	42.5	42.4	42.2
39	42.4	42.4	42.3	42.2	42.1	42.0	41.9	41.7	41.6	41.4
40	41.6	41.5	41.4	41.3	41.2	41.1	41.0	40.9	40.8	40.6
41	40.7	40.6	40.5	40.5	40.4	40.3	40.2	40.1	40.0	39.8
42	39.8	39.7	39.7	39.6	39.5	39.4	39.4	39.3	39.1	39.0
43	38.9	38.9	38.8	38.7	38.7	38.6	38.5	38.4	38.3	38.2
44	38.0	38.0	37.9	37.9	37.8	37.7	37.7	37.6	37.5	37.4
45	37.1	37.1	37.0	37.0	36.9	36.9	36.8	36.7	36.6	36.5
46	36.2	36.2	36.2	36.1	36.1	36.0	35.9	35.9	35.8	35.7
47	35.3	35.3	35.3	35.2	35.2	35.1	35.1	35.0	34.9	34.9
48	34.5	34.4	34.4	34.4	34.3	34.3	34.2	34.2	34.1	34.0
49	33.6	33.5	33.5	33.5	33.4	33.4	33.4	33.3	33.2	33.2
50	32.7	32.7	32.6	32.6	32.6	32.5	32.5	32.4	32.4	32.3
51	31.8	31.8	31.8	31.7	31.7	31.7	31.6	31.6	31.5	31.5
52	30.9	30.9	30.9	30.9	30.8	30.8	30.8	30.7	30.7	30.6
53	30.0	30.0	30.0	30.0	30.0	29.9	29.9	29.9	29.8	29.8
54	29.2	29.2	29.1	29.1	29.1	29.1	29.0	29.0	29.0	28.9
55	28.3	28.3	28.3	28.3	28.2	28.2	28.2	28.2	28.1	28.1
56	27.4	27.4	27.4	27.4	27.4	27.3	27.3	27.3	27.3	27.2
57	26.6	26.6	26.5	26.5	26.5	26.5	26.5	26.5	26.4	26.4
58	25.7	25.7	25.7	25.7	25.7	25.6	25.6	25.6	25.6	25.6
59	24.9	24.8	24.8	24.8	24.8	24.8	24.8	24.8	24.7	24.7
60	24.0	24.0	24.0	24.0	24.0	23.9	23.9	23.9	23.9	23.9
61	23.2	23.2	23.1	23.1	23.1	23.1	23.1	23.1	23.1	23.0
62	22.3	22.3	22.3	22.3	22.3	22.3	22.3	22.2	22.2	22.2
63	21.5	21.5	21.5	21.5	21.5	21.4	21.4	21.4	21.4	21.4
64	20.7	20.7	20.7	20.6	20.6	20.6	20.6	20.6	20.6	20.6
65	19.9	19.8	19.8	19.8	19.8	19.8	19.8	19.8	19.8	19.8
66	19.1	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0
67	18.3	18.3	18.3	18.3	18.2	18.2	18.2	18.2	18.2	18.2
68	17.5	17.5	17.5	17.5	17.5	17.5	17.5	17.5	17.4	17.4
69	16.7	16.7	16.7	16.7	16.7	16.7	16.7	16.7	16.7	16.7
70	16.0	16.0	16.0	16.0	16.0	16.0	15.9	15.9	15.9	15.9
71	15.2	15.2	15.2	15.2	15.2	15.2	15.2	15.2	15.2	15.2
72	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.5
73	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8
74	13.2	13.1	13.1	13.1	13.1	13.1	13.1	13.1	13.1	13.1
75	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5
76	11.8	11.8	11.8	11.8	11.8	11.8	11.8	11.8	11.8	11.8
77	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2
78	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6
79	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
80	9.4	9.4	9.4	9.4	9.4	9.4	9.4	9.4	9.4	9.4
81	8.9	8.9	8.9	8.9	8.9	8.9	8.9	8.9	8.9	8.9
82	8.4	8.4	8.4	8.4	8.4	8.4	8.4	8.4	8.4	8.4
83	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.8	7.8
84	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4
85	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9
86	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	15	16	17	18	19	20	21	22	23	24
87	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1
88	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7
89	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3
90	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
91	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
92	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4
93	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
94	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9
95	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6
96	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
97	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
98	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
99	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
100	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
101	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
102	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
103	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
104	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
105	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
106	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
107	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
108	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
109	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
110	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
111	.9	.9	.9	.9	.9	.9	.9	.9	.9	.9
112	.8	.8	.8	.8	.8	.8	.8	.8	.8	.8
113	.7	.7	.7	.7	.7	.7	.7	.7	.7	.7
114	.6	.6	.6	.6	.6	.6	.6	.6	.6	.6
115	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	25	26	27	28	29	30	31	32	33	34
25	50.2	49.7	49.2	48.6	48.1	47.5	46.9	46.2	45.6	44.9
26	49.7	49.2	48.7	48.2	47.7	47.1	46.5	45.9	45.3	44.6
27	49.2	48.7	48.3	47.8	47.3	46.7	46.2	45.6	45.0	44.3
28	48.6	48.2	47.8	47.3	46.8	46.3	45.8	45.2	44.6	44.0
29	48.1	47.7	47.3	46.8	46.4	45.9	45.4	44.8	44.3	43.7
30	47.5	47.1	46.7	46.3	45.9	45.4	44.9	44.4	43.9	43.3
31	46.9	46.5	46.2	45.8	45.4	44.9	44.5	44.0	43.5	42.9
32	46.2	45.9	45.6	45.2	44.8	44.4	44.0	43.5	43.0	42.5
33	45.6	45.3	45.0	44.6	44.3	43.9	43.5	43.0	42.6	42.1
34	44.9	44.6	44.3	44.0	43.7	43.3	42.9	42.5	42.1	41.6
35	44.2	44.0	43.7	43.4	43.1	42.7	42.4	42.0	41.6	41.1
36	43.5	43.3	43.0	42.7	42.4	42.1	41.8	41.4	41.0	40.6
37	42.8	42.5	42.3	42.1	41.8	41.5	41.2	40.8	40.5	40.1
38	42.0	41.8	41.6	41.4	41.1	40.8	40.6	40.2	39.9	39.5
39	41.3	41.1	40.9	40.7	40.4	40.2	39.9	39.6	39.3	39.0
40	40.5	40.3	40.1	39.9	39.7	39.5	39.2	39.0	38.7	38.4
41	39.7	39.5	39.4	39.2	39.0	38.8	38.5	38.3	38.0	37.7
42	38.9	38.8	38.6	38.4	38.3	38.1	37.8	37.6	37.4	37.1
43	38.1	38.0	37.8	37.7	37.5	37.3	37.1	36.9	36.7	36.4
44	37.3	37.2	37.0	36.9	36.7	36.6	36.4	36.2	36.0	35.8
45	36.5	36.3	36.2	36.1	36.0	35.8	35.6	35.5	35.3	35.1
46	35.6	35.5	35.4	35.3	35.2	35.0	34.9	34.7	34.5	34.4
47	34.8	34.7	34.6	34.5	34.4	34.3	34.1	34.0	33.8	33.6
48	34.0	33.9	33.8	33.7	33.6	33.5	33.4	33.2	33.1	32.9
49	33.1	33.0	33.0	32.9	32.8	32.7	32.6	32.4	32.3	32.2
50	32.3	32.2	32.1	32.1	32.0	31.9	31.8	31.7	31.5	31.4
51	31.4	31.4	31.3	31.2	31.2	31.1	31.0	30.9	30.8	30.6
52	30.6	30.5	30.5	30.4	30.3	30.3	30.2	30.1	30.0	29.9
53	29.7	29.7	29.6	29.6	29.5	29.5	29.4	29.3	29.2	29.1
54	28.9	28.9	28.8	28.8	28.7	28.6	28.6	28.5	28.4	28.3
55	28.1	28.0	28.0	27.9	27.9	27.8	27.8	27.7	27.6	27.5
56	27.2	27.2	27.1	27.1	27.0	27.0	26.9	26.9	26.8	26.7
57	26.4	26.3	26.3	26.3	26.2	26.2	26.1	26.1	26.0	25.9
58	25.5	25.5	25.5	25.4	25.4	25.4	25.3	25.3	25.2	25.1
59	24.7	24.7	24.6	24.6	24.6	24.5	24.5	24.5	24.4	24.3
60	23.9	23.8	23.8	23.8	23.8	23.7	23.7	23.6	23.6	23.5

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	25	26	27	28	29	30	31	32	33	34
61	23.0	23.0	23.0	23.0	22.9	22.9	22.9	22.8	22.8	22.7
62	22.2	22.2	22.2	22.1	22.1	22.1	22.1	22.0	22.0	21.9
63	21.4	21.4	21.3	21.3	21.3	21.3	21.3	21.2	21.2	21.2
64	20.6	20.6	20.5	20.5	20.5	20.5	20.5	20.4	20.4	20.4
65	19.8	19.8	19.7	19.7	19.7	19.7	19.7	19.6	19.6	19.6
66	19.0	19.0	19.0	18.9	18.9	18.9	18.9	18.9	18.8	18.8
67	18.2	18.2	18.2	18.2	18.2	18.1	18.1	18.1	18.1	18.1
68	17.4	17.4	17.4	17.4	17.4	17.4	17.4	17.3	17.3	17.3
69	16.7	16.7	16.7	16.6	16.6	16.6	16.6	16.6	16.6	16.6
70	15.9	15.9	15.9	15.9	15.9	15.9	15.9	15.9	15.8	15.8
71	15.2	15.2	15.2	15.2	15.2	15.2	15.2	15.1	15.1	15.1
72	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.4	14.4	14.4
73	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.7	13.7
74	13.1	13.1	13.1	13.1	13.1	13.1	13.1	13.1	13.1	13.1
75	12.5	12.5	12.5	12.4	12.4	12.4	12.4	12.4	12.4	12.4
76	11.8	11.8	11.8	11.8	11.8	11.8	11.8	11.8	11.8	11.8
77	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.1
78	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.5
79	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
80	9.4	9.4	9.4	9.4	9.4	9.4	9.4	9.4	9.4	9.4
81	8.9	8.9	8.9	8.9	8.9	8.9	8.9	8.9	8.9	8.9
82	8.4	8.4	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3
83	7.8	7.8	7.8	7.8	7.8	7.8	7.8	7.8	7.8	7.8
84	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4
85	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9
86	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5
87	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1
88	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7
89	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3
90	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
91	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
92	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4
93	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
94	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9
95	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6
96	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
97	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
98	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
99	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
100	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
101	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
102	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
103	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
104	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
105	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
106	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
107	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
108	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
109	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
110	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
111	.9	.9	.9	.9	.9	.9	.9	.9	.9	.9
112	.8	.8	.8	.8	.8	.8	.8	.8	.8	.8
113	.7	.7	.7	.7	.7	.7	.7	.7	.7	.7
114	.6	.6	.6	.6	.6	.6	.6	.6	.6	.6
115	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	35	36	37	38	39	40	41	42	43	44
35	40.7	40.2	39.7	39.2	38.6	38.0	37.4	36.8	36.2	35.5
36	40.2	39.7	39.3	38.7	38.2	37.7	37.1	36.5	35.9	35.2
37	39.7	39.3	38.8	38.3	37.8	37.3	36.7	36.2	35.6	34.9
38	39.2	38.7	38.3	37.9	37.4	36.9	36.3	35.8	35.2	34.6
39	38.6	38.2	37.8	37.4	36.9	36.4	35.9	35.4	34.9	34.3
40	38.0	37.7	37.3	36.9	36.4	36.0	35.5	35.0	34.5	34.0
41	37.4	37.1	36.7	36.3	35.9	35.5	35.1	34.6	34.1	33.6
42	36.8	36.5	36.2	35.8	35.4	35.0	34.6	34.1	33.7	33.2
43	36.2	35.9	35.6	35.2	34.9	34.5	34.1	33.7	33.2	32.8
44	35.5	35.2	34.9	34.6	34.3	34.0	33.6	33.2	32.8	32.3

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	35	36	37	38	39	40	41	42	43	44
45	34.8	34.6	34.3	34.0	33.7	33.4	33.0	32.7	32.3	31.8
46	34.1	33.9	33.7	33.4	33.1	32.8	32.5	32.1	31.8	31.4
47	33.4	33.2	33.0	32.8	32.5	32.2	31.9	31.6	31.2	30.8
48	32.7	32.5	32.3	32.1	31.8	31.6	31.3	31.0	30.7	30.3
49	32.0	31.8	31.6	31.4	31.2	30.9	30.7	30.4	30.1	29.8
50	31.3	31.1	30.9	30.7	30.5	30.3	30.0	29.8	29.5	29.2
51	30.5	30.4	30.2	30.0	29.8	29.6	29.4	29.2	28.9	28.6
52	29.7	29.6	29.5	29.3	29.1	28.9	28.7	28.5	28.3	28.0
53	29.0	28.9	28.7	28.6	28.4	28.2	28.1	27.9	27.6	27.4
54	28.2	28.1	28.0	27.8	27.7	27.5	27.4	27.2	27.0	26.8
55	27.4	27.3	27.2	27.1	27.0	26.8	26.7	26.5	26.3	26.1
56	26.7	26.6	26.5	26.3	26.2	26.1	26.0	25.8	25.6	25.4
57	25.9	25.8	25.7	25.6	25.5	25.4	25.2	25.1	24.9	24.8
58	25.1	25.0	24.9	24.8	24.7	24.6	24.5	24.4	24.2	24.1
59	24.3	24.2	24.1	24.1	24.0	23.9	23.8	23.6	23.5	23.4
60	23.5	23.4	23.4	23.3	23.2	23.1	23.0	22.9	22.8	22.7
61	22.7	22.6	22.6	22.5	22.4	22.4	22.3	22.2	22.1	22.0
62	21.9	21.9	21.8	21.7	21.7	21.6	21.5	21.4	21.3	21.2
63	21.1	21.1	21.0	21.0	20.9	20.8	20.8	20.7	20.6	20.5
64	20.3	20.3	20.2	20.2	20.1	20.1	20.0	20.0	19.9	19.8
65	19.6	19.5	19.5	19.4	19.4	19.3	19.3	19.2	19.1	19.1
66	18.8	18.8	18.7	18.7	18.6	18.6	18.5	18.5	18.4	18.4
67	18.0	18.0	18.0	17.9	17.9	17.9	17.8	17.8	17.7	17.6
68	17.3	17.3	17.2	17.2	17.2	17.1	17.1	17.0	17.0	16.9
69	16.5	16.5	16.5	16.5	16.4	16.4	16.4	16.3	16.3	16.2
70	15.8	15.8	15.8	15.7	15.7	15.7	15.6	15.6	15.6	15.5
71	15.1	15.1	15.1	15.0	15.0	15.0	15.0	14.9	14.9	14.9
72	14.4	14.4	14.4	14.3	14.3	14.3	14.3	14.2	14.2	14.2
73	13.7	13.7	13.7	13.7	13.7	13.6	13.6	13.6	13.6	13.5
74	13.1	13.0	13.0	13.0	13.0	13.0	13.0	12.9	12.9	12.9
75	12.4	12.4	12.4	12.4	12.3	12.3	12.3	12.3	12.3	12.2
76	11.8	11.8	11.7	11.7	11.7	11.7	11.7	11.7	11.6	11.6
77	11.1	11.1	11.1	11.1	11.1	11.1	11.1	11.1	11.0	11.0
78	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.4
79	10.0	10.0	9.9	9.9	9.9	9.9	9.9	9.9	9.9	9.9
80	9.4	9.4	9.4	9.4	9.4	9.4	9.4	9.3	9.3	9.3
81	8.9	8.8	8.8	8.8	8.8	8.8	8.8	8.8	8.8	8.8
82	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3
83	7.8	7.8	7.8	7.8	7.8	7.8	7.8	7.8	7.8	7.8
84	7.3	7.3	7.3	7.3	7.3	7.3	7.3	7.3	7.3	7.3
85	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9
86	6.5	6.5	6.5	6.5	6.4	6.4	6.4	6.4	6.4	6.4
87	6.1	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
88	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.6	5.6	5.6
89	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3
90	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
91	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.6	4.6
92	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4
93	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
94	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9
95	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6
96	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
97	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
98	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
99	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
100	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.6	2.6
101	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
102	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
103	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
104	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
105	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
106	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
107	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
108	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
109	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
110	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
111	.9	.9	.9	.9	.9	.9	.9	.9	.9	.9
112	.8	.8	.8	.8	.8	.8	.8	.8	.8	.8
113	.7	.7	.7	.7	.7	.7	.7	.7	.7	.7
114	.6	.6	.6	.6	.6	.6	.6	.6	.6	.6
115	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	45	46	47	48	49	50	51	52	53	54
45	31.4	30.9	30.5	30.0	29.4	28.9	28.3	27.7	27.1	26.5
46	30.9	30.5	30.0	29.6	29.1	28.5	28.0	27.4	26.9	26.3
47	30.5	30.0	29.6	29.2	28.7	28.2	27.7	27.1	26.6	26.0
48	30.0	29.6	29.2	28.7	28.3	27.8	27.3	26.8	26.3	25.7
49	29.4	29.1	28.7	28.3	27.9	27.4	26.9	26.5	25.9	25.4
50	28.9	28.5	28.2	27.4	27.4	27.0	26.5	26.1	25.6	25.1
51	28.3	28.0	27.7	27.3	26.9	26.5	26.1	25.7	25.2	24.7
52	27.7	27.4	27.1	26.8	26.5	26.1	25.7	25.3	24.8	24.4
53	27.1	26.9	26.6	26.3	25.9	25.6	25.2	24.8	24.4	24.0
54	26.5	26.3	26.0	25.7	25.4	25.1	24.7	24.4	24.0	23.6
55	25.9	25.7	25.4	25.1	24.9	24.6	24.2	23.9	23.5	23.2
56	25.2	25.0	24.8	24.6	24.3	24.0	23.7	23.4	23.1	22.7
57	24.6	24.4	24.2	24.0	23.7	23.5	23.2	22.9	22.6	22.2
58	23.9	23.7	23.5	23.3	23.1	22.9	22.6	22.4	22.1	21.7
59	23.2	23.1	22.9	22.7	22.5	22.3	22.1	21.8	21.5	21.2
60	22.5	22.4	22.2	22.1	21.9	21.7	21.5	21.2	21.0	20.7
61	21.8	21.7	21.6	21.4	21.2	21.1	20.9	20.6	20.4	20.2
62	21.1	21.0	20.9	20.7	20.6	20.4	20.2	20.0	19.8	19.6
63	20.4	20.3	20.2	20.1	19.9	19.8	19.6	19.4	19.2	19.0
64	19.7	19.6	19.5	19.4	19.3	19.1	19.0	18.8	18.6	18.5
65	19.0	18.9	18.8	18.7	18.6	18.5	18.3	18.2	18.0	17.9
66	18.3	18.2	18.1	18.0	17.9	17.8	17.7	17.6	17.4	17.3
67	17.6	17.5	17.4	17.3	17.3	17.2	17.1	16.9	16.8	16.7
68	16.9	16.8	16.7	16.7	16.6	16.5	16.4	16.3	16.2	16.1
69	16.2	16.1	16.1	16.0	15.9	15.8	15.8	15.7	15.6	15.4
70	15.5	15.4	15.4	15.3	15.3	15.2	15.1	15.0	14.9	14.8
71	14.8	14.8	14.7	14.7	14.6	14.5	14.5	14.4	14.3	14.2
72	14.1	14.1	14.1	14.0	14.0	13.9	13.8	13.8	13.7	13.6
73	13.5	13.5	13.4	13.4	13.3	13.3	13.2	13.2	13.1	13.0
74	12.8	12.8	12.8	12.7	12.7	12.7	12.6	12.6	12.5	12.4
75	12.2	12.2	12.2	12.1	12.1	12.1	12.0	12.0	11.9	11.9
76	11.6	11.6	11.6	11.5	11.5	11.5	11.4	11.4	11.3	11.3
77	11.0	11.0	11.0	10.9	10.9	10.9	10.8	10.8	10.8	10.7
78	10.4	10.4	10.4	10.4	10.3	10.3	10.3	10.2	10.2	10.2
79	9.9	9.8	9.8	9.8	9.8	9.8	9.7	9.7	9.7	9.6
80	9.3	9.3	9.3	9.3	9.2	9.2	9.2	9.2	9.1	9.1
81	8.8	8.8	8.7	8.7	8.7	8.7	8.7	8.7	8.6	8.6
82	8.3	8.2	8.2	8.2	8.2	8.2	8.2	8.2	8.1	8.1
83	7.8	7.8	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.6
84	7.3	7.3	7.3	7.3	7.3	7.2	7.2	7.2	7.2	7.2
85	6.8	6.8	6.8	6.8	6.8	6.8	6.8	6.8	6.8	6.7
86	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.3	6.3
87	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	5.9
88	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6
89	5.3	5.3	5.3	5.3	5.3	5.3	5.2	5.2	5.2	5.2
90	5.0	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9
91	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6
92	4.4	4.4	4.4	4.3	4.3	4.3	4.3	4.3	4.3	4.3
93	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
94	3.9	3.9	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8
95	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6
96	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
97	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
98	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
99	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
100	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6
101	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
102	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
103	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
104	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
105	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
106	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
107	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
108	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
109	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
110	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
111	.9	.9	.9	.9	.9	.9	.9	.9	.9	.9
112	.8	.8	.8	.8	.8	.8	.8	.8	.8	.8
113	.7	.7	.7	.7	.7	.7	.7	.7	.7	.7
114	.6	.6	.6	.6	.6	.6	.6	.6	.6	.6
115	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	55	56	57	58	59	60	61	62	63	64
55	22.7	22.3	21.9	21.4	20.9	20.4	19.9	19.4	18.8	18.3
56	22.3	21.9	21.5	21.1	20.6	20.1	19.6	19.1	18.6	18.0
57	21.9	21.5	21.1	20.7	20.3	19.8	19.3	18.8	18.3	17.8
58	21.4	21.1	20.7	20.3	19.9	19.5	19.0	18.5	18.0	17.5
59	20.9	20.6	20.3	19.9	19.5	19.1	18.7	18.2	17.7	17.3
60	20.4	20.1	19.8	19.5	19.1	18.7	18.3	17.9	17.4	17.0
61	29.9	19.6	19.3	19.0	18.7	18.3	17.9	17.5	17.1	16.7
62	19.4	19.1	18.8	18.5	18.2	17.9	17.5	17.1	16.8	16.3
63	18.8	18.6	18.3	18.0	17.7	17.4	17.1	16.8	16.4	16.0
64	18.3	18.0	17.8	17.5	17.3	17.0	16.7	16.3	16.0	15.6
65	17.7	17.5	17.3	17.0	16.8	16.5	16.2	15.9	15.6	15.3
66	17.1	16.9	16.7	16.5	16.3	16.0	15.8	15.5	15.2	14.9
67	16.5	16.3	16.2	16.0	15.8	15.5	15.3	15.0	14.7	14.5
68	15.9	15.8	15.6	15.4	15.2	15.0	14.8	14.6	14.3	14.0
69	15.3	15.2	15.0	14.9	14.7	14.5	14.3	14.1	13.9	13.6
70	14.7	14.6	14.5	14.3	14.2	14.0	13.8	13.6	13.4	13.2
71	14.1	14.0	13.9	13.8	13.6	13.5	13.3	13.1	12.9	12.7
72	13.5	13.4	13.3	13.2	13.1	12.9	12.8	12.6	12.4	12.3
73	13.0	12.9	12.8	12.7	12.5	12.4	12.3	12.1	12.0	11.8
74	12.4	12.3	12.2	12.1	12.0	11.9	11.8	11.6	11.5	11.3
75	11.8	11.7	11.7	11.6	11.5	11.4	11.3	11.1	11.0	10.9
76	11.2	11.2	11.1	11.0	10.9	10.9	10.8	10.6	10.5	10.4
77	10.7	10.6	10.6	10.5	10.4	10.3	10.3	10.2	10.0	9.9
78	10.1	10.1	10.0	10.0	9.9	9.8	9.8	9.7	9.6	9.5
79	9.6	9.6	9.5	9.5	9.4	9.3	9.3	9.2	9.1	9.0
80	9.1	9.0	9.0	9.0	8.9	8.9	8.8	8.7	8.7	8.6
81	8.6	8.5	8.5	8.5	8.4	8.4	8.3	8.3	8.2	8.1
82	8.1	8.1	8.0	8.0	8.0	7.9	7.9	7.8	7.8	7.7
83	7.6	7.6	7.6	7.5	7.5	7.5	7.4	7.4	7.3	7.3
84	7.2	7.1	7.1	7.1	7.1	7.0	7.0	7.0	6.9	6.9
85	6.7	6.7	6.7	6.7	6.6	6.6	6.6	6.5	6.5	6.5
86	6.3	6.3	6.3	6.3	6.2	6.2	6.2	6.2	6.1	6.1
87	5.9	5.9	5.9	5.9	5.9	5.8	5.8	5.8	5.8	5.7
88	5.6	5.5	5.5	5.5	5.5	5.5	5.5	5.4	5.4	5.4
89	5.2	5.2	5.2	5.2	5.2	5.1	5.1	5.1	5.1	5.1
90	4.9	4.9	4.9	4.9	4.9	4.8	4.8	4.8	4.8	4.8
91	4.6	4.6	4.6	4.6	4.6	4.5	4.5	4.5	4.5	4.5
92	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.2	4.2	4.2
93	4.1	4.1	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
94	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.7
95	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.5	3.5
96	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.3	3.3	3.3
97	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.1	3.1
98	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
99	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
100	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6
101	2.5	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4
102	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.2
103	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
104	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
105	1.8	1.8	1.8	1.8	1.8	1.8	1.7	1.7	1.7	1.7
106	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
107	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
108	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
109	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
110	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
111	.9	.9	.9	.9	.9	.9	.9	.9	.9	.9
112	.8	.8	.8	.8	.8	.8	.8	.8	.8	.8
113	.7	.7	.7	.7	.7	.7	.7	.7	.7	.7
114	.6	.6	.6	.6	.6	.6	.6	.6	.6	.6
115	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	65	66	67	68	69	70	71	72	73	74
65	14.9	14.5	14.1	13.7	13.3	12.9	12.5	12.0	11.6	11.2
66	14.5	14.2	13.8	13.4	13.1	12.6	12.2	11.8	11.4	11.0
67	14.1	13.8	13.5	13.1	12.8	12.4	12.0	11.6	11.2	10.8
68	13.7	13.4	13.1	12.8	12.5	12.1	11.7	11.4	11.0	10.6
69	13.3	13.1	12.8	12.5	12.1	11.8	11.4	11.1	10.7	10.4

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	65	66	67	68	69	70	71	72	73	74
70	12.9	12.6	12.4	12.1	11.8	11.5	11.2	10.8	10.5	10.1
71	12.5	12.2	12.0	11.7	11.4	11.2	10.9	10.5	10.2	9.9
72	12.0	11.8	11.6	11.4	11.1	10.8	10.5	10.2	9.9	9.6
73	11.6	11.4	11.2	11.0	10.7	10.5	10.2	9.9	9.7	9.4
74	11.2	11.0	10.8	10.6	10.4	10.1	9.9	9.6	9.4	9.1
75	10.7	10.5	10.4	10.2	10.0	9.8	9.5	9.3	9.1	8.8
76	10.3	10.1	9.9	9.8	9.6	9.4	9.2	9.0	8.8	8.5
77	9.8	9.7	9.5	9.4	9.2	9.0	8.8	8.6	8.4	8.2
78	9.4	9.2	9.1	9.0	8.8	8.7	8.5	8.3	8.1	7.9
79	8.9	8.8	8.7	8.6	8.4	8.3	8.1	8.0	7.8	7.6
80	8.5	8.4	8.3	8.2	8.0	7.9	7.8	7.6	7.5	7.3
81	8.0	8.0	7.9	7.9	7.7	7.5	7.4	7.3	7.1	7.0
82	7.6	7.5	7.5	7.4	7.3	7.2	7.1	6.9	6.8	6.7
83	7.2	7.1	7.1	7.0	6.9	6.8	6.7	6.6	6.5	6.4
84	6.8	6.7	6.7	6.6	6.5	6.4	6.4	6.3	6.2	6.0
85	6.4	6.4	6.3	6.2	6.2	6.1	6.0	5.9	5.8	5.7
86	6.0	6.0	5.9	5.9	5.8	5.8	5.7	5.6	5.5	5.4
87	5.7	5.6	5.6	5.6	5.5	5.4	5.4	5.3	5.2	5.2
88	5.3	5.3	5.3	5.2	5.2	5.1	5.1	5.0	5.0	4.9
89	5.0	5.0	5.0	4.9	4.9	4.8	4.8	4.7	4.7	4.6
90	4.7	4.7	4.7	4.6	4.6	4.6	4.5	4.5	4.4	4.4
91	4.5	4.4	4.4	4.4	4.3	4.3	4.3	4.2	4.2	4.1
92	4.2	4.2	4.1	4.1	4.1	4.1	4.0	4.0	3.9	3.9
93	3.9	3.9	3.9	3.9	3.9	3.8	3.8	3.8	3.7	3.7
94	3.7	3.7	3.7	3.7	3.6	3.6	3.6	3.6	3.5	3.5
95	3.5	3.5	3.5	3.5	3.4	3.4	3.4	3.4	3.3	3.3
96	3.3	3.3	3.3	3.3	3.3	3.2	3.2	3.2	3.2	3.1
97	3.1	3.1	3.1	3.1	3.1	3.1	3.0	3.0	3.0	3.0
98	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.8	2.8
99	2.8	2.8	2.8	2.7	2.7	2.7	2.7	2.7	2.7	2.6
100	2.6	2.6	2.6	2.6	2.6	2.5	2.5	2.5	2.5	2.5
101	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.3	2.3
102	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
103	2.1	2.1	2.1	2.1	2.1	2.0	2.0	2.0	2.0	2.0
104	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	.19	1.9
105	1.7	1.7	1.7	1.7	.17	1.7	1.7	1.7	1.7	1.7
106	1.6	1.6	.16	1.6	1.6	1.6	1.6	1.6	1.5	1.5
107	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
108	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
109	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
110	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
111	.9	.9	.9	.9	.9	.9	.9	.9	.9	.9
112	.8	.8	.8	.8	.8	.8	.8	.8	.8	.8
113	.7	.7	.7	.7	.7	.6	.6	.6	.6	.6
114	.6	.6	.6	.6	.6	.6	.5	.5	.5	.5
115	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	75	76	77	78	79	80	81	82	83	84
75	8.6	8.3	8.0	7.7	7.4	7.1	6.8	6.5	6.2	5.9
76	8.3	8.0	7.8	7.5	7.2	6.9	6.7	6.4	6.1	5.8
77	8.0	7.8	7.5	7.3	7.0	6.8	6.5	6.2	5.9	5.7
78	7.7	7.5	7.3	7.0	6.8	6.6	6.3	6.0	5.8	5.5
79	7.4	7.2	7.0	6.8	6.6	6.3	6.1	5.9	5.6	5.4
80	7.1	6.9	6.8	6.6	6.3	6.1	5.9	5.7	5.5	5.2
81	6.8	6.7	6.5	6.3	6.1	5.9	5.7	5.5	5.3	5.1
82	6.5	6.4	6.2	6.0	5.9	5.7	5.5	5.3	5.1	4.9
83	6.2	6.1	5.9	5.8	5.6	5.5	5.3	5.1	4.9	4.7
84	5.9	5.8	5.7	5.5	5.4	5.2	5.1	4.9	4.7	4.6
85	5.6	5.5	5.4	5.3	5.2	5.0	4.9	4.7	4.6	4.4
86	5.4	5.3	5.1	5.0	4.9	4.8	4.7	4.5	4.4	4.2
87	5.1	5.0	4.9	4.8	4.7	4.6	4.4	4.3	4.2	4.1
88	4.8	4.7	4.6	4.5	4.4	4.3	4.2	4.1	4.0	3.9
89	4.5	4.5	4.4	4.3	4.2	4.1	4.0	3.9	3.8	3.7
90	4.3	4.2	4.2	4.1	4.0	3.9	3.8	3.8	3.7	3.5
91	4.1	4.0	4.0	3.9	3.8	3.7	3.7	3.6	3.5	3.4
92	3.9	3.8	3.7	3.7	3.6	3.6	3.5	3.4	3.3	3.2
93	3.7	3.6	3.6	3.5	3.4	3.4	3.3	3.2	3.2	3.1

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	75	76	77	78	79	80	81	82	83	84
94	3.5	3.4	3.4	3.3	3.3	3.2	3.2	3.1	3.0	3.0
95	3.3	3.2	3.2	3.2	3.1	3.1	3.0	3.0	2.9	2.8
96	3.1	3.1	3.0	3.0	3.0	2.9	2.9	2.8	2.8	2.7
97	2.9	2.9	2.9	2.9	2.8	2.8	2.7	2.7	2.6	2.6
98	2.8	2.8	2.7	2.7	2.7	2.6	2.6	2.6	2.5	2.5
99	2.6	2.6	2.6	2.6	2.5	2.5	2.5	2.4	2.4	2.3
100	2.5	2.5	2.4	2.4	2.4	2.4	2.3	2.3	2.3	2.2
101	2.3	2.3	2.3	2.3	2.2	2.2	2.2	2.2	2.1	2.1
102	2.2	2.1	2.1	2.1	2.1	2.1	2.0	2.0	2.0	2.0
103	2.0	2.0	2.0	2.0	1.9	1.9	1.9	1.9	1.9	1.8
104	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.7	1.7	1.7
105	1.7	1.7	1.7	1.7	1.6	1.6	1.6	1.6	1.6	1.6
106	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.4
107	1.4	1.4	1.4	1.4	1.4	1.4	1.3	1.3	1.3	1.3
108	1.3	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
109	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
110	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
111	.9	.9	.9	.9	.9	.9	.9	.9	.8	.8
112	.8	.8	.8	.7	.7	.7	.7	.7	.7	.7
113	.6	.6	.6	.6	.6	.6	.6	.6	.6	.6
114	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5
115	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	85	86	87	88	89	90	91	92	93	94
85	4.2	4.1	3.9	3.8	3.6	3.4	3.3	3.2	3.0	2.9
86	4.1	3.9	3.8	3.6	3.5	3.3	3.2	3.1	2.9	2.8
87	3.9	3.8	3.6	3.5	3.4	3.2	3.1	3.0	2.8	2.7
88	3.8	3.6	3.5	3.4	3.2	3.1	3.0	2.9	2.8	2.6
89	3.6	3.5	3.4	3.2	3.1	3.0	2.9	2.8	2.7	2.6
90	3.4	3.3	3.2	3.1	3.0	2.9	2.8	2.7	2.6	2.5
91	3.3	3.2	3.1	3.0	2.9	2.8	2.7	2.6	2.5	2.4
92	3.2	3.1	3.0	2.9	2.8	2.7	2.6	2.5	2.4	2.3
93	3.0	2.9	2.8	2.8	2.7	2.6	2.5	2.4	2.3	2.3
94	2.9	2.8	2.7	2.6	2.6	2.5	2.4	2.3	2.3	2.2
95	2.8	2.7	2.6	2.5	2.5	2.4	2.3	2.2	2.2	2.1
96	2.6	2.6	2.5	2.4	2.4	2.3	2.2	2.2	2.1	2.0
97	2.5	2.5	2.4	2.3	2.3	2.2	2.2	2.1	2.0	2.0
98	2.4	2.4	2.3	2.2	2.2	2.1	2.1	2.0	2.0	1.9
99	2.3	2.2	2.2	2.1	2.1	2.0	2.0	1.9	1.9	1.8
100	2.2	2.1	2.1	2.0	2.0	1.9	1.9	1.9	1.8	1.8
101	2.1	2.0	2.0	1.9	1.9	1.9	1.8	1.8	1.7	1.7
102	1.9	1.9	1.9	1.8	1.8	1.8	1.7	1.7	1.6	1.6
103	1.8	1.8	1.8	1.7	1.7	1.7	1.6	1.6	1.5	1.5
104	1.7	1.7	1.6	1.6	1.6	1.5	1.5	1.5	1.5	1.4
105	1.6	1.5	1.5	1.5	1.5	1.4	1.4	1.4	1.4	1.3
106	1.4	1.4	1.4	1.4	1.4	1.3	1.3	1.3	1.3	1.2
107	1.3	1.3	1.3	1.3	1.2	1.2	1.2	1.2	1.2	1.2
108	1.2	1.2	1.2	1.1	1.1	1.1	1.1	1.1	1.1	1.1
109	1.1	1.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
110	.9	.9	.9	.9	.9	.9	.9	.9	.9	.9
111	.8	.8	.8	.8	.8	.8	.8	.8	.8	.8
112	.7	.7	.7	.7	.7	.7	.7	.7	.7	.7
113	.6	.6	.6	.6	.6	.6	.6	.6	.6	.6
114	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5
115	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	95	96	97	98	99	100	101	102	103	104
95	2.0	2.0	1.9	1.8	1.8	1.7	1.6	1.6	1.5	1.4
96	2.0	1.9	1.9	1.8	1.7	1.7	1.6	1.5	1.5	1.4
97	1.9	1.9	1.8	1.7	1.7	1.6	1.6	1.5	1.4	1.3
98	1.8	1.8	1.7	1.7	1.6	1.6	1.5	1.5	1.4	1.3
99	1.8	1.7	1.7	1.6	1.6	1.5	1.5	1.4	1.4	1.3
100	1.7	1.7	1.6	1.6	1.5	1.5	1.4	1.4	1.3	1.3

TABLE VIA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	95	96	97	98	99	100	101	102	103	104
101	1.6	1.6	1.6	1.5	1.5	1.4	1.4	1.3	1.3	1.2
102	1.6	1.5	1.5	1.5	1.4	1.4	1.3	1.3	1.2	1.2
103	1.5	1.5	1.4	1.4	1.4	1.3	1.3	1.2	1.2	1.1
104	1.4	1.4	1.3	1.3	1.3	1.3	1.2	1.2	1.1	1.1
105	1.3	1.3	1.3	1.2	1.2	1.2	1.2	1.1	1.1	1.0
106	1.2	1.2	1.2	1.2	1.1	1.1	1.1	1.1	1.0	1.0
107	1.1	1.1	1.1	1.1	1.1	1.0	1.0	1.0	1.0	9
108	1.0	1.0	1.0	1.0	1.0	1.0	1.0	.9	.9	.9
109	1.0	.9	.9	.9	.9	.9	.9	.9	.8	.8
110	.9	.9	.8	.8	.8	.8	.8	.8	.8	.8
111	.8	.8	.8	.8	.8	.7	.7	.7	.7	.7
112	.7	.7	.7	.7	.7	.7	.7	.7	.6	.6
113	.6	.6	.6	.6	.6	.6	.6	.6	.6	.6
114	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5
115	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5

TABLE VIAA—ANNUITIES FOR JOINT LIFE ONLY; TWO LIVES—EXPECTED RETURN MULTIPLES

Ages	105	106	107	108	109	110	111	112	113	114	115
105	1.0	1.0	.9	.9	.8	.7	.7	.6	.6	.5	.5
106	1.0	.9	.9	.8	.8	.7	.7	.6	.6	.5	.5
107	.9	.9	.8	.8	.7	.7	.7	.6	.6	.5	.5
108	.9	.8	.8	.8	.7	.7	.6	.6	.5	.5	.5
109	.8	.8	.7	.7	.7	.7	.6	.6	.5	.5	.5
110	.7	.7	.7	.7	.7	.6	.6	.6	.5	.5	.5
111	.7	.7	.7	.6	.6	.6	.6	.5	.5	.5	.5
112	.6	.6	.6	.6	.6	.6	.5	.5	.5	.5	.5
113	.6	.6	.6	.5	.5	.5	.5	.5	.5	.5	.5
114	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5
115	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5

TABLE VII—PERCENT VALUE OF REFUND FEATURE; DURATION OF GUARANTEED AMOUNT

Age	Years—									
	1	2	3	4	5	6	7	8	9	10
5	0	0	0	0	0	0	0	0	0	0
6	0	0	0	0	0	0	0	0	0	0
7	0	0	0	0	0	0	0	0	0	0
8	0	0	0	0	0	0	0	0	0	0
9	0	0	0	0	0	0	0	0	0	0
10	0	0	0	0	0	0	0	0	0	0
11	0	0	0	0	0	0	0	0	0	0
12	0	0	0	0	0	0	0	0	0	0
13	0	0	0	0	0	0	0	0	0	0
14	0	0	0	0	0	0	0	0	0	0
15	0	0	0	0	0	0	0	0	0	0
16	0	0	0	0	0	0	0	0	0	0
17	0	0	0	0	0	0	0	0	0	0
18	0	0	0	0	0	0	0	0	0	0
19	0	0	0	0	0	0	0	0	0	0
20	0	0	0	0	0	0	0	0	0	0
21	0	0	0	0	0	0	0	0	0	0
22	0	0	0	0	0	0	0	0	0	0
23	0	0	0	0	0	0	0	0	0	0
24	0	0	0	0	0	0	0	0	0	0
25	0	0	0	0	0	0	0	0	0	0
26	0	0	0	0	0	0	0	0	0	0
27	0	0	0	0	0	0	0	0	0	0
28	0	0	0	0	0	0	0	0	0	0
29	0	0	0	0	0	0	0	0	0	0
30	0	0	0	0	0	0	0	0	0	0
31	0	0	0	0	0	0	0	0	0	0
32	0	0	0	0	0	0	0	0	0	0
33	0	0	0	0	0	0	0	0	0	0
34	0	0	0	0	0	0	0	0	0	0
35	0	0	0	0	0	0	0	0	0	0

TABLE VII—PERCENT VALUE OF REFUND FEATURE; DURATION OF GUARANTEED AMOUNT—Continued

Age	Years—									
	1	2	3	4	5	6	7	8	9	10
36	0	0	0	0	0	0	0	0	0	0
37	0	0	0	0	0	0	0	0	0	1
38	0	0	0	0	0	0	0	0	0	1
39	0	0	0	0	0	0	0	0	1	1
40	0	0	0	0	0	0	0	1	1	1
41	0	0	0	0	0	0	0	1	1	1
42	0	0	0	0	0	0	1	1	1	1
43	0	0	0	0	0	0	1	1	1	1
44	0	0	0	0	0	1	1	1	1	1
45	0	0	0	0	0	1	1	1	1	1
46	0	0	0	0	1	1	1	1	1	1
47	0	0	0	0	1	1	1	1	1	1
48	0	0	0	0	1	1	1	1	1	1
49	0	0	0	1	1	1	1	1	1	2
50	0	0	0	1	1	1	1	1	1	2
51	0	0	0	1	1	1	1	1	2	2
52	0	0	0	1	1	1	1	1	2	2
53	0	0	1	1	1	1	1	2	2	2
54	0	0	1	1	1	1	1	2	2	2
55	0	0	1	1	1	1	2	2	2	2
56	0	0	1	1	1	1	2	2	2	3
57	0	0	1	1	1	2	2	2	3	3
58	0	1	1	1	1	2	2	2	3	3
59	0	1	1	1	1	2	2	3	3	4
60	0	1	1	1	2	2	2	3	3	4
61	0	1	1	1	2	2	3	3	4	4
62	0	1	1	2	2	2	3	4	4	5
63	0	1	1	2	2	3	3	4	5	5
64	0	1	1	2	2	3	4	4	5	6
65	0	1	2	2	3	3	4	5	6	6
66	1	1	2	2	3	4	5	5	6	7
67	1	1	2	3	3	4	5	6	7	8
68	1	1	2	3	4	5	6	7	8	9
69	1	1	2	3	4	5	6	7	8	10
70	1	2	3	4	5	6	7	8	9	11
71	1	2	3	4	5	6	8	9	10	12
72	1	2	3	4	6	7	8	10	11	13
73	1	2	4	5	6	8	9	11	13	14
74	1	3	4	5	7	9	10	12	14	16
75	1	3	4	6	8	9	11	13	15	17
76	2	3	5	7	9	10	12	15	17	19
77	2	4	5	7	9	12	14	16	18	21
78	2	4	6	8	10	13	15	18	20	23
79	2	4	7	9	11	14	17	19	22	25
80	2	5	7	10	13	15	18	21	24	27
81	3	5	8	11	14	17	20	23	26	29
82	3	6	9	12	15	19	22	25	28	32
83	3	7	10	13	17	20	24	27	31	34
84	4	7	11	15	19	22	26	30	33	37
85	4	8	12	16	20	24	28	32	36	40
86	4	9	13	18	22	27	31	35	39	42
87	5	10	15	20	24	29	33	37	41	45
88	5	11	16	21	26	31	36	40	44	48
89	6	12	18	23	28	33	38	43	47	50
90	7	13	19	25	31	36	41	45	49	53
91	7	14	21	27	33	38	43	48	52	55
92	8	15	22	29	35	40	45	50	54	58
93	9	17	24	31	37	43	48	52	56	60
94	9	18	26	33	39	45	50	54	58	62
95	10	19	27	35	41	47	52	57	60	64
96	11	20	29	36	43	49	54	59	62	66
97	11	21	30	38	45	51	56	61	64	68
98	12	23	32	40	47	53	58	63	66	69
99	13	24	34	42	49	55	60	65	68	71
100	14	26	36	44	52	58	63	67	70	73
101	14	27	38	47	54	60	65	69	72	75
102	15	29	40	49	56	62	67	71	74	77
103	17	31	42	52	59	65	69	73	76	78
104	18	33	45	55	62	67	72	75	78	80

TABLE VII—PERCENT VALUE OF REFUND FEATURE; DURATION OF GUARANTEED AMOUNT—Continued

Age	Years—									
	1	2	3	4	5	6	7	8	9	10
105	19	36	48	58	65	70	74	77	80	82
106	21	38	51	61	68	73	77	79	82	84
107	23	42	55	64	71	75	79	81	84	85
108	25	45	58	67	73	78	81	83	85	87
109	28	49	62	71	76	80	83	85	87	88
110	31	52	66	74	79	82	85	87	88	89
111	34	57	70	77	82	85	87	88	90	91
112	37	61	73	80	84	87	88	90	91	92
113	41	66	77	83	86	88	90	91	92	93
114	45	70	80	85	88	90	92	93	93	94
115	50	75	83	88	90	92	93	94	94	95

TABLE VII—PERCENT VALUE OF REFUND FEATURE; DURATION OF GUARANTEED AMOUNT

Age	Years—									
	11	12	13	14	15	16	17	18	19	20
5	0	0	0	0	0	0	0	0	0	0
6	0	0	0	0	0	0	0	0	0	0
7	0	0	0	0	0	0	0	0	0	0
8	0	0	0	0	0	0	0	0	0	0
9	0	0	0	0	0	0	0	0	0	0
10	0	0	0	0	0	0	0	0	0	0
11	0	0	0	0	0	0	0	0	0	0
12	0	0	0	0	0	0	0	0	0	0
13	0	0	0	0	0	0	0	0	0	0
14	0	0	0	0	0	0	0	0	0	0
15	0	0	0	0	0	0	0	0	0	0
16	0	0	0	0	0	0	0	0	0	0
17	0	0	0	0	0	0	0	0	0	0
18	0	0	0	0	0	0	0	0	0	0
19	0	0	0	0	0	0	0	0	0	0
20	0	0	0	0	0	0	0	0	0	1
21	0	0	0	0	0	0	0	0	0	1
22	0	0	0	0	0	0	0	0	1	1
23	0	0	0	0	0	0	0	1	1	1
24	0	0	0	0	0	0	0	1	1	1
25	0	0	0	0	0	0	1	1	1	1
26	0	0	0	0	0	0	1	1	1	1
27	0	0	0	0	0	1	1	1	1	1
28	0	0	0	0	1	1	1	1	1	1
29	0	0	0	0	1	1	1	1	1	1
30	0	0	0	1	1	1	1	1	1	1
31	0	0	0	1	1	1	1	1	1	1
32	0	0	1	1	1	1	1	1	1	1
33	0	0	1	1	1	1	1	1	1	1
34	0	1	1	1	1	1	1	1	1	1
35	0	1	1	1	1	1	1	1	1	1
36	1	1	1	1	1	1	1	1	1	1
37	1	1	1	1	1	1	1	1	1	1
38	1	1	1	1	1	1	1	1	1	2
39	1	1	1	1	1	1	1	1	2	2
40	1	1	1	1	1	1	1	2	2	2
41	1	1	1	1	1	1	2	2	2	2
42	1	1	1	1	1	2	2	2	2	2
43	1	1	1	1	2	2	2	2	2	3
44	1	1	1	2	2	2	2	2	3	3
45	1	1	2	2	2	2	2	3	3	3
46	1	2	2	2	2	2	3	3	3	3
47	1	2	2	2	2	2	3	3	3	4
48	2	2	2	2	2	3	3	3	4	4
49	2	2	2	2	3	3	3	4	4	4
50	2	2	2	3	3	3	3	4	4	5
51	2	2	3	3	3	3	4	4	4	5
52	2	2	3	3	3	4	4	5	5	5
53	2	3	3	3	4	4	5	5	5	6
54	3	3	3	4	4	4	5	5	6	7
55	3	3	4	4	4	5	5	6	7	7

TABLE VII—PERCENT VALUE OF REFUND FEATURE; DURATION OF GUARANTEED AMOUNT—Continued

Age	Years—									
	11	12	13	14	15	16	17	18	19	20
56	3	3	4	4	5	5	6	7	7	8
57	3	4	4	5	5	6	6	7	8	9
58	4	4	5	5	6	6	7	8	9	9
59	4	5	5	6	6	7	8	9	9	10
60	4	5	6	6	7	8	9	10	10	11
61	5	6	6	7	8	9	10	10	11	13
62	5	6	7	8	9	10	11	12	13	14
63	6	7	8	9	10	11	12	13	14	15
64	7	8	8	9	10	12	13	14	15	17
65	7	8	9	10	12	13	14	15	17	18
66	8	9	10	12	13	14	15	17	18	20
67	9	10	11	13	14	15	17	18	20	22
68	10	11	13	14	15	17	19	20	22	24
69	11	12	14	15	17	19	20	22	24	26
70	12	14	15	17	19	20	22	24	26	28
71	13	15	17	18	20	22	24	26	28	30
72	15	17	18	20	22	24	26	28	30	32
73	16	18	20	22	24	26	28	31	33	35
74	18	20	22	24	26	28	31	33	35	37
75	19	22	24	26	28	31	33	35	38	40
76	21	24	26	28	31	33	36	38	40	43
77	23	26	28	31	33	36	38	41	43	45
78	25	28	31	33	36	38	41	43	46	48
79	28	30	33	36	38	41	44	46	48	51
80	30	33	36	38	41	44	46	49	51	53
81	32	35	38	41	44	47	49	51	54	56
82	35	38	41	44	47	49	52	54	56	58
83	38	41	44	47	49	52	54	57	59	61
84	40	44	47	49	52	55	57	59	61	63
85	43	46	49	52	55	57	59	62	63	65
86	46	49	52	55	57	60	62	64	66	67
87	48	52	55	57	60	62	64	66	68	69
88	51	54	57	60	62	64	66	68	70	71
89	54	57	60	62	65	67	68	70	72	73
90	56	59	62	64	67	69	70	72	74	75
91	59	62	64	67	69	71	72	74	75	76
92	61	64	66	69	71	72	74	75	77	78
93	63	66	68	70	72	74	75	77	78	79
94	65	68	70	72	74	75	77	78	79	80
95	67	69	72	74	75	77	78	79	81	82
96	69	71	73	75	77	78	80	81	82	83
97	70	73	75	77	78	80	81	82	83	84
98	72	74	76	78	79	81	82	83	84	85
99	74	76	78	79	81	82	83	84	85	86
100	75	78	79	81	82	83	84	85	86	86
101	77	79	81	82	83	84	85	86	87	87
102	79	81	82	83	84	85	86	87	88	88
103	80	82	83	85	86	87	87	88	89	89
104	82	84	85	86	87	88	88	89	90	90
105	84	85	86	87	88	89	89	90	90	91
106	85	86	87	88	89	90	90	91	91	92
107	87	88	89	89	90	91	91	92	92	93
108	88	89	90	90	91	92	92	93	93	93
109	89	90	91	92	92	93	93	93	94	94
110	90	91	92	92	93	93	94	94	94	95
111	92	92	93	93	94	94	95	95	95	95
112	93	93	94	94	95	95	95	96	96	96
113	94	94	95	95	95	96	96	96	96	97
114	95	95	95	96	96	96	97	97	97	97
115	95	96	96	96	97	97	97	97	97	98

TABLE VII—PERCENT VALUE OF REFUND FEATURE; DURATION OF GUARANTEED AMOUNT

Age	Years—									
	21	22	23	24	25	26	27	28	29	30
5	0	0	0	0	0	0	0	0	0	0
6	0	0	0	0	0	0	0	0	0	0

TABLE VII—PERCENT VALUE OF REFUND FEATURE; DURATION OF GUARANTEED AMOUNT—Continued

Age	Years—									
	21	22	23	24	25	26	27	28	29	30
7	0	0	0	0	0	0	0	0	0	0
8	0	0	0	0	0	0	0	0	0	1
9	0	0	0	0	0	0	0	0	1	1
10	0	0	0	0	0	0	0	1	1	1
11	0	0	0	0	0	0	1	1	1	1
12	0	0	0	0	0	0	1	1	1	1
13	0	0	0	0	0	1	1	1	1	1
14	0	0	0	0	1	1	1	1	1	1
15	0	0	0	1	1	1	1	1	1	1
16	0	0	1	1	1	1	1	1	1	1
17	0	0	1	1	1	1	1	1	1	1
18	0	1	1	1	1	1	1	1	1	1
19	1	1	1	1	1	1	1	1	1	1
20	1	1	1	1	1	1	1	1	1	1
21	1	1	1	1	1	1	1	1	1	1
22	1	1	1	1	1	1	1	1	1	1
23	1	1	1	1	1	1	1	1	1	1
24	1	1	1	1	1	1	1	1	1	1
25	1	1	1	1	1	1	1	1	1	1
26	1	1	1	1	1	1	1	1	1	1
27	1	1	1	1	1	1	1	1	1	2
28	1	1	1	1	1	1	1	1	2	2
29	1	1	1	1	1	1	1	2	2	2
30	1	1	1	1	1	1	2	2	2	2
31	1	1	1	1	1	2	2	2	2	2
32	1	1	1	1	2	2	2	2	2	2
33	1	1	1	2	2	2	2	2	2	2
34	1	1	2	2	2	2	2	2	2	3
35	1	2	2	2	2	2	2	2	3	3
36	2	2	2	2	2	2	2	3	3	3
37	2	2	2	2	2	2	3	3	3	3
38	2	2	2	2	2	3	3	3	3	4
39	2	2	2	2	3	3	3	3	4	4
40	2	2	3	3	3	3	3	4	4	4
41	2	3	3	3	3	3	4	4	4	5
42	3	3	3	3	3	4	4	4	5	5
43	3	3	3	4	4	4	4	5	5	6
44	3	3	4	4	4	4	5	5	6	6
45	3	4	4	4	5	5	5	6	6	7
46	4	4	4	5	5	5	6	6	7	7
47	4	4	5	5	5	6	6	7	7	8
48	4	5	5	5	6	6	7	7	8	9
49	5	5	5	6	6	7	8	8	9	10
50	5	5	6	6	7	8	8	9	10	10
51	5	6	6	7	8	8	9	10	11	11
52	6	7	7	8	8	9	10	11	11	12
53	7	7	8	8	9	10	11	12	13	14
54	7	8	8	9	10	11	12	13	14	15
55	8	9	9	10	11	12	13	14	15	16
56	9	9	10	11	12	13	14	15	16	18
57	9	10	11	12	13	14	15	17	18	19
58	10	11	12	13	14	16	17	18	19	21
59	11	12	13	15	16	17	18	20	21	22
60	12	14	15	16	17	19	20	21	23	24
61	14	15	16	17	19	20	22	23	25	26
62	15	16	18	19	20	22	23	25	27	28
63	16	18	19	21	22	24	25	27	29	30
64	18	19	21	23	24	26	28	29	31	33
65	20	21	23	25	26	28	30	31	33	35
66	21	23	25	27	28	30	32	34	35	37
67	23	25	27	29	31	32	34	36	38	40
68	25	27	29	31	33	35	37	38	40	42
69	28	29	31	33	35	37	39	41	43	44
70	30	32	34	36	38	40	42	43	45	47
71	32	34	36	38	40	42	44	46	47	49
72	35	37	39	41	43	45	46	48	50	51
73	37	39	41	43	45	47	49	51	52	54
74	40	42	44	46	48	50	51	53	54	56
75	42	44	46	48	50	52	54	55	57	58

TABLE VII—PERCENT VALUE OF REFUND FEATURE; DURATION OF GUARANTEED AMOUNT—Continued

Age	Years—									
	21	22	23	24	25	26	27	28	29	30
76	45	47	49	51	53	54	56	58	59	60
77	47	50	51	53	55	57	58	60	61	62
78	50	52	54	56	57	59	61	62	63	64
79	53	55	56	58	60	61	63	64	65	66
80	55	57	59	60	62	63	65	66	67	68
81	58	59	61	63	64	66	67	68	69	70
82	60	62	63	65	66	68	69	70	71	72
83	62	64	66	67	68	70	71	72	73	74
84	65	66	68	69	70	71	72	73	74	75
85	67	68	70	71	72	73	74	75	76	77
86	69	70	72	73	74	75	76	77	77	78
87	71	72	73	75	76	76	77	78	79	80
88	73	74	75	76	77	78	79	80	80	81
89	74	76	77	78	79	79	80	81	81	82
90	76	77	78	79	80	81	81	82	83	83
91	78	79	79	80	81	82	83	83	84	84
92	79	80	81	82	82	83	84	84	85	85
93	80	81	82	83	83	84	85	85	86	86
94	81	82	83	84	84	85	85	86	86	87
95	82	83	84	85	85	86	86	87	87	88
96	83	84	85	86	86	87	87	88	88	88
97	84	85	86	86	87	87	88	88	89	89
98	85	86	87	87	88	88	89	89	89	90
99	86	87	87	88	88	89	89	90	90	90
100	87	88	88	89	89	90	90	90	91	91
101	88	89	89	90	90	90	91	91	91	92
102	89	89	90	90	91	91	91	92	92	92
103	90	90	91	91	91	92	92	92	93	93
104	91	91	91	92	92	92	93	93	93	93
105	91	92	92	92	93	93	93	94	94	94
106	92	93	93	93	93	94	94	94	94	95
107	93	93	94	94	94	94	95	95	95	95
108	94	94	94	94	95	95	95	95	95	96
109	94	95	95	95	95	95	96	96	96	96
110	95	95	95	96	96	96	96	96	96	96
111	96	96	96	96	96	96	97	97	97	97
112	96	96	96	97	97	97	97	97	97	97
113	97	97	97	97	97	97	97	98	98	98
114	97	97	97	98	98	98	98	98	98	98
115	98	98	98	98	98	98	98	98	98	98

TABLE VII—PERCENT VALUE OF REFUND FEATURE; DURATION OF GUARANTEED AMOUNT

Age	Years—									
	31	32	33	34	35	36	37	38	39	40
5	0	1	1	1	1	1	1	1	1	1
6	0	1	1	1	1	1	1	1	1	1
7	1	1	1	1	1	1	1	1	1	1
8	1	1	1	1	1	1	1	1	1	1
9	1	1	1	1	1	1	1	1	1	1
10	1	1	1	1	1	1	1	1	1	1
11	1	1	1	1	1	1	1	1	1	1
12	1	1	1	1	1	1	1	1	1	1
13	1	1	1	1	1	1	1	1	1	1
14	1	1	1	1	1	1	1	1	1	1
15	1	1	1	1	1	1	1	1	1	1
16	1	1	1	1	1	1	1	1	1	1
17	1	1	1	1	1	1	1	1	1	1
18	1	1	1	1	1	1	1	1	1	2
19	1	1	1	1	1	1	1	1	2	2
20	1	1	1	1	1	1	1	2	2	2
21	1	1	1	1	1	1	2	2	2	2
22	1	1	1	1	1	2	2	2	2	2
23	1	1	1	2	2	2	2	2	2	2
24	1	1	2	2	2	2	2	2	2	2
25	1	2	2	2	2	2	2	2	2	3
26	2	2	2	2	2	2	2	2	3	3

TABLE VII—PERCENT VALUE OF REFUND FEATURE; DURATION OF GUARANTEED AMOUNT—Continued

Age	Years—									
	31	32	33	34	35	36	37	38	39	40
27	2	2	2	2	2	2	2	3	3	3
28	2	2	2	2	2	2	3	3	3	3
29	2	2	2	2	2	3	3	3	3	4
30	2	2	2	3	3	3	3	3	4	4
31	2	2	3	3	3	3	3	4	4	4
32	2	3	3	3	3	3	4	4	4	5
33	3	3	3	3	3	4	4	4	5	5
34	3	3	3	3	4	4	4	5	5	5
35	3	3	3	4	4	4	5	5	5	6
36	3	4	4	4	4	5	5	5	6	6
37	4	4	4	4	5	5	6	6	6	7
38	4	4	5	5	5	6	6	7	7	8
39	4	5	5	5	6	6	7	7	8	8
40	5	5	5	6	6	7	7	8	8	9
41	5	5	6	6	7	7	8	9	9	10
42	6	6	6	7	7	8	9	9	10	11
43	6	7	7	8	8	9	9	10	11	12
44	7	7	8	8	9	10	10	11	12	13
45	7	8	8	9	10	10	11	12	13	14
46	8	9	9	10	11	11	12	13	14	15
47	9	9	10	11	12	12	13	14	15	16
48	9	10	11	12	13	14	15	16	17	18
49	10	11	12	13	14	15	16	17	18	19
50	11	12	13	14	15	16	17	18	20	21
51	12	13	14	15	16	17	19	20	21	22
52	13	14	15	17	18	19	20	21	23	24
53	15	16	17	18	19	20	22	23	24	26
54	16	17	18	19	21	22	23	25	26	28
55	17	18	20	21	22	24	25	27	28	30
56	19	20	21	23	24	26	27	29	30	32
57	20	22	23	25	26	28	29	31	32	34
58	22	24	25	27	28	30	31	33	34	36
59	24	25	27	28	30	32	33	35	36	38
60	26	27	29	31	32	34	35	37	38	40
61	28	29	31	33	34	36	37	39	40	42
62	30	32	33	35	36	38	40	41	42	44
63	32	34	35	37	39	40	42	43	45	46
64	34	36	38	39	41	42	44	45	47	48
65	37	38	40	42	43	45	46	47	49	50
66	39	41	42	44	45	47	48	50	51	52
67	41	43	45	46	48	49	50	52	53	54
68	44	45	47	48	50	51	52	54	55	56
69	46	48	49	51	52	53	54	56	57	58
70	48	50	51	53	54	55	57	58	59	60
71	51	52	54	55	56	57	59	60	61	62
72	53	54	56	57	58	59	60	62	62	63
73	55	57	58	59	60	61	62	63	64	65
74	57	59	60	61	62	63	64	65	66	67
75	59	61	62	63	64	65	66	67	68	69
76	62	63	64	65	66	67	68	69	69	70
77	64	65	66	67	68	69	70	70	71	72
78	66	67	68	69	70	70	71	72	73	73
79	67	68	69	70	71	72	73	73	74	75
80	69	70	71	72	73	74	74	75	76	76
81	71	72	73	74	74	75	76	76	77	78
82	73	74	74	75	76	77	77	78	78	79
83	74	75	76	77	77	78	79	79	80	80
84	76	77	77	78	79	79	80	80	81	81
85	78	78	79	79	80	81	81	82	82	83
86	79	80	80	81	81	82	82	83	83	84
87	80	81	81	82	83	83	83	84	84	85
88	82	82	83	83	84	84	85	85	85	86
89	83	83	84	84	85	85	85	86	86	87
90	84	84	85	85	86	86	86	87	87	87
91	85	85	86	86	87	87	87	88	88	88
92	86	86	87	87	87	88	88	88	89	89
93	87	87	87	88	88	88	89	89	89	90
94	87	88	88	88	89	89	89	90	90	90
95	88	88	89	89	89	90	90	90	91	91

TABLE VII—PERCENT VALUE OF REFUND FEATURE; DURATION OF GUARANTEED AMOUNT—Continued

Age	Years—									
	31	32	33	34	35	36	37	38	39	40
96	89	89	89	90	90	90	91	91	91	91
97	89	90	90	90	91	91	91	91	92	92
98	90	90	91	91	91	91	92	92	92	92
99	91	91	91	92	92	92	92	92	93	93
100	91	92	92	92	92	92	93	93	93	93
101	92	92	92	93	93	93	93	93	94	94
102	92	93	93	93	93	94	94	94	94	94
103	93	93	93	94	94	94	94	94	94	95
104	94	94	94	94	94	95	95	95	95	95
105	94	94	95	95	95	95	95	95	95	95
106	95	95	95	95	95	95	96	96	96	96
107	95	95	96	96	96	96	96	96	96	96
108	96	96	96	96	96	96	96	96	97	97
109	96	96	96	97	97	97	97	97	97	97
110	97	97	97	97	97	97	97	97	97	97
111	97	97	97	97	97	97	98	98	98	98
112	97	97	98	98	98	98	98	98	98	98
113	98	98	98	98	98	98	98	98	98	98
114	98	98	98	98	98	98	98	98	98	99
115	98	98	98	99	99	99	99	99	99	99

TABLE VIII—TEMPORARY LIFE ANNUITIES; [1] ONE LIFE—EXPECTED RETURN MULTIPLES

[See footnote at end of tables]

Temporary Period—Maximum Duration of Annuity

Age	Years—									
	1	2	3	4	5	6	7	8	9	10
5	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
6	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
7	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
8	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
9	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
10	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
11	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
12	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
13	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
14	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
15	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
16	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
17	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
18	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
19	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
20	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
21	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
22	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
23	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
24	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
25	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
26	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
27	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
28	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
29	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
30	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
31	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
32	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
33	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
34	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
35	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
36	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
37	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	9.9
38	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	9.9
39	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	9.9
40	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
41	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
42	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
43	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9

TABLE VIII—TEMPORARY LIFE ANNUITIES; [1] ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

[See footnote at end of tables]

Temporary Period—Maximum Duration of Annuity

Age	Years—									
	1	2	3	4	5	6	7	8	9	10
44	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
45	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
46	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
47	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
48	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
49	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.8
50	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.9	9.8
51	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.9	9.8
52	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.8	9.8
53	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.8	9.8
54	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.9	8.8	9.8
55	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
56	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
57	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
58	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.7	9.7
59	1.0	2.0	3.0	4.0	4.9	5.9	6.8	7.8	8.7	9.6
60	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.8	8.7	9.6
61	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.7	8.7	9.6
62	1.0	2.0	3.0	3.9	4.9	5.8	6.8	7.7	8.6	9.5
63	1.0	2.0	3.0	3.9	4.9	5.8	6.8	7.7	8.6	9.5
64	1.0	2.0	3.0	3.9	4.9	5.8	6.7	7.6	8.5	9.4
65	1.0	2.0	3.0	3.9	4.9	5.8	6.7	7.6	8.5	9.3
66	1.0	2.0	2.9	3.9	4.8	5.8	6.7	7.6	8.4	9.3
67	1.0	2.0	2.9	3.9	4.8	5.7	6.6	7.5	8.4	9.2
68	1.0	2.0	2.9	3.9	4.8	5.7	6.6	7.5	8.3	9.1
69	1.0	2.0	2.9	3.9	4.8	5.7	6.6	7.4	8.2	9.0
70	1.0	2.0	2.9	3.9	4.8	5.6	6.5	7.3	8.1	8.9
71	1.0	2.0	2.9	3.8	4.7	5.6	6.5	7.3	8.1	8.8
72	1.0	2.0	2.9	3.8	4.7	5.6	6.4	7.2	8.0	8.7
73	1.0	2.0	2.9	3.8	4.7	5.5	6.3	7.1	7.9	8.6
74	1.0	1.9	2.9	3.8	4.6	5.5	6.3	7.0	7.7	8.4
75	1.0	1.9	2.9	3.8	4.6	5.4	6.2	6.9	7.6	8.3
76	1.0	1.9	2.8	3.7	4.6	5.4	6.1	6.8	7.5	8.1
77	1.0	1.9	2.8	3.7	4.5	5.3	6.0	6.7	7.3	7.9
78	1.0	1.9	2.8	3.7	4.5	5.2	5.9	6.6	7.2	7.7
79	1.0	1.9	2.8	3.6	4.4	5.1	5.8	6.4	7.0	7.5
80	1.0	1.9	2.8	3.6	4.4	5.1	5.7	6.3	6.8	7.3
81	1.0	1.9	2.8	3.6	4.3	5.0	5.6	6.1	6.6	7.0
82	1.0	1.9	2.7	3.5	4.2	4.9	5.4	6.0	6.4	6.8
83	1.0	1.9	2.7	3.5	4.1	4.8	5.3	5.8	6.2	6.5
84	1.0	1.8	2.7	3.4	4.1	4.6	5.2	5.6	6.0	6.3
85	1.0	1.8	2.6	3.3	4.0	4.5	5.0	5.4	5.7	6.0
86	1.0	1.8	2.6	3.3	3.9	4.4	4.8	5.2	5.5	5.7
87	.9	1.8	2.5	3.2	3.8	4.3	4.7	5.0	5.3	5.5
88	.9	1.8	2.5	3.1	3.7	4.1	4.5	4.8	5.0	5.2
89	.9	1.8	2.5	3.1	3.6	4.0	4.3	4.6	4.8	4.9
90	.9	1.7	2.4	3.0	3.4	3.8	4.1	4.4	4.5	4.7
91	.9	1.7	2.4	2.9	3.3	3.7	4.0	4.2	4.3	4.4
92	.9	1.7	2.3	2.8	3.2	3.5	3.8	4.0	4.1	4.2
93	.9	1.7	2.3	2.7	3.1	3.4	3.6	3.8	3.9	4.0
94	.9	1.6	2.2	2.7	3.0	3.3	3.5	3.6	3.7	3.8
95	.9	1.6	2.2	2.6	2.9	3.1	3.3	3.4	3.5	3.6
96	.9	1.6	2.1	2.5	2.8	3.0	3.2	3.3	3.3	3.4
97	.9	1.6	2.1	2.4	2.7	2.9	3.0	3.1	3.2	3.2
98	.9	1.5	2.0	2.4	2.6	2.8	2.9	3.0	3.0	3.0
99	.9	1.5	2.0	2.3	2.5	2.6	2.7	2.8	2.8	2.8
100	.9	1.5	1.9	2.2	2.4	2.5	2.6	2.6	2.6	2.7
101	.8	1.4	1.8	2.1	2.3	2.4	2.4	2.5	2.5	2.5
102	.8	1.4	1.8	2.0	2.1	2.2	2.3	2.3	2.3	2.3
103	.8	1.4	1.7	1.9	2.0	2.1	2.1	2.1	2.1	2.1
104	.8	1.3	1.6	1.8	1.9	1.9	1.9	1.9	1.9	1.9
105	.8	1.3	1.5	1.7	1.7	1.8	1.8	1.8	1.8	1.8
106	.8	1.2	1.4	1.5	1.6	1.6	1.6	1.6	1.6	1.6
107	.7	1.1	1.3	1.4	1.4	1.4	1.4	1.4	1.4	1.4
108	.7	1.1	1.2	1.3	1.3	1.3	1.3	1.3	1.3	1.3
109	.7	1.0	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
110	.7	.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
111	.6	.8	.9	.9	.9	.9	.9	.9	.9	.9

TABLE VIII—TEMPORARY LIFE ANNUITIES; [1] ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

[See footnote at end of tables]

Temporary Period—Maximum Duration of Annuity

Age	Years—									
	1	2	3	4	5	6	7	8	9	10
112	.6	.7	.8	.8	.8	.8	.8	.8	.8	.8
113	.6	.6	.7	.7	.7	.7	.7	.7	.7	.7
114	.5	.6	.6	.6	.6	.6	.6	.6	.6	.6
115	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5

TABLE VIII—TEMPORARY LIFE ANNUITIES;[1] ONE LIFE—EXPECTED RETURN MULTIPLES

[See footnote at end of tables]

Temporary Period—Maximum Duration of Annuity

Age	Years—									
	11	12	13	14	15	16	17	18	19	20
5	11.0	12.0	13.0	14.0	15.0	16.0	17.0	18.0	19.0	19.9
6	11.0	12.0	13.0	14.0	15.0	16.0	17.0	18.0	19.0	19.9
7	11.0	12.0	13.0	14.0	15.0	16.0	17.0	18.0	19.0	19.9
8	11.0	12.0	13.0	14.0	15.0	16.0	17.0	18.0	18.9	19.9
9	11.0	12.0	13.0	14.0	15.0	16.0	17.0	18.0	18.9	19.9
10	11.0	12.0	13.0	14.0	15.0	16.0	17.0	18.0	18.9	19.9
11	11.0	12.0	13.0	14.0	15.0	16.0	17.0	17.9	18.9	19.9
12	11.0	12.0	13.0	14.0	15.0	16.0	17.0	17.9	18.9	19.9
13	11.0	12.0	13.0	14.0	15.0	16.0	17.0	17.9	18.9	19.9
14	11.0	12.0	13.0	14.0	15.0	16.0	16.9	17.9	18.9	19.9
15	11.0	12.0	13.0	14.0	15.0	16.0	16.9	17.9	18.9	19.9
16	11.0	12.0	13.0	14.0	15.0	16.0	16.9	17.9	18.9	19.9
17	11.0	12.0	13.0	14.0	15.0	15.9	16.9	17.9	18.9	19.9
18	11.0	12.0	13.0	14.0	15.0	15.9	16.9	17.9	18.9	19.9
19	11.0	12.0	13.0	14.0	15.0	15.9	16.9	17.9	18.9	19.9
20	11.0	12.0	13.0	14.0	14.9	15.9	16.9	17.9	18.9	19.9
21	11.0	12.0	13.0	14.0	14.9	15.9	16.9	17.9	18.9	19.9
22	11.0	12.0	13.0	14.0	14.9	15.9	16.9	17.9	18.9	19.9
23	11.0	12.0	13.0	13.9	14.9	15.9	16.9	17.9	18.9	19.9
24	11.0	12.0	13.0	13.9	14.9	15.9	16.9	17.9	18.9	19.9
25	11.0	12.0	13.0	13.9	14.9	15.9	16.9	17.9	18.9	19.9
26	11.0	12.0	12.9	13.9	14.9	15.9	16.9	17.9	18.9	19.9
27	11.0	12.0	12.9	13.9	14.9	15.9	16.9	17.9	18.9	19.9
28	11.0	12.0	12.9	13.9	14.9	15.9	16.9	17.9	18.9	19.8
29	11.0	12.0	12.9	13.9	14.9	15.9	16.9	17.9	18.9	19.8
30	11.0	11.9	12.9	13.9	14.9	15.9	16.9	17.9	18.8	19.8
31	11.0	11.9	12.9	13.9	14.9	15.9	16.9	17.9	18.8	19.8
32	11.0	11.9	12.9	13.9	14.9	15.9	16.9	17.8	18.8	19.8
33	11.0	11.9	12.9	13.9	14.9	15.9	16.9	17.8	18.8	19.8
34	10.9	11.9	12.9	13.9	14.9	15.9	16.8	17.8	18.8	19.8
35	10.9	11.9	12.9	13.9	14.9	15.9	16.8	17.8	18.8	19.7
36	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
37	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.7	19.7
38	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.8	18.7	19.7
39	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.7	18.7	19.6
40	10.9	11.9	12.9	13.8	14.8	15.8	16.7	17.7	18.7	19.6
41	10.9	11.9	12.9	13.8	14.8	15.8	16.7	17.7	18.6	19.6
42	10.9	11.9	12.8	13.8	14.8	15.7	16.7	17.6	18.6	19.5
43	10.9	11.9	12.8	13.8	14.8	15.7	16.7	17.6	18.6	19.5
44	10.9	11.8	12.8	13.8	14.7	15.7	16.6	17.6	18.5	19.4
45	10.9	11.8	12.8	13.8	14.7	15.7	16.6	17.5	18.5	19.4
46	10.9	11.8	12.8	13.7	14.7	15.6	16.6	17.5	18.4	19.3
47	10.8	11.8	12.8	13.7	14.7	15.6	16.5	17.5	18.4	19.3
48	10.8	11.8	12.7	13.7	14.6	15.6	16.5	17.4	18.3	19.2
49	10.8	11.8	12.7	13.7	14.6	15.5	16.4	17.4	18.3	19.2
50	10.8	11.7	12.7	13.6	14.6	15.5	16.4	17.3	18.2	19.1
51	10.8	11.7	12.7	13.6	14.5	15.4	16.3	17.2	18.1	19.0
52	10.8	11.7	12.6	13.6	14.5	15.4	16.3	17.2	18.0	18.9
53	10.7	11.7	12.6	13.5	14.4	15.3	16.2	17.1	18.0	18.8
54	10.7	11.6	12.6	13.5	14.4	15.3	16.2	17.0	17.9	18.7
55	10.7	11.6	12.5	13.4	14.3	15.2	16.1	16.9	17.8	18.6
56	10.7	11.6	12.5	13.4	14.3	15.1	16.0	16.8	17.6	18.4
57	10.6	11.5	12.4	13.3	14.2	15.1	15.9	16.7	17.5	18.3
58	10.6	11.5	12.4	13.3	14.1	15.0	15.8	16.6	17.4	18.1

TABLE VIII—TEMPORARY LIFE ANNUITIES;[1] ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

[See footnote at end of tables]

Temporary Period—Maximum Duration of Annuity

Age	Years—									
	11	12	13	14	15	16	17	18	19	20
59	10.6	11.4	12.3	13.2	14.0	14.9	15.7	16.4	17.2	17.9
60	10.5	11.4	12.3	13.1	13.9	14.7	15.5	16.3	17.0	17.7
61	10.5	11.3	12.2	13.0	13.8	14.6	15.4	16.1	16.8	17.5
62	10.4	11.3	12.1	12.9	13.7	14.5	15.2	15.9	16.6	17.2
63	10.3	11.2	12.0	12.8	13.6	14.3	15.0	15.7	16.3	17.0
64	10.3	11.1	11.9	12.7	13.4	14.1	14.8	15.5	16.1	16.7
65	10.2	11.0	11.8	12.5	13.2	13.9	14.6	15.2	15.8	16.3
66	10.1	10.9	11.6	12.4	13.1	13.7	14.4	14.9	15.5	16.0
67	10.0	10.8	11.5	12.2	12.9	13.5	14.1	14.7	15.2	15.6
68	9.9	10.6	11.4	12.0	12.7	13.3	13.8	14.3	14.8	15.3
69	9.8	10.5	11.2	11.8	12.4	13.0	13.5	14.0	14.4	14.8
70	9.6	10.3	11.0	11.6	12.2	12.7	13.2	13.7	14.0	14.4
71	9.5	10.2	10.8	11.4	11.9	12.4	12.9	13.3	13.6	13.9
72	9.4	10.0	10.6	11.2	11.7	12.1	12.5	12.9	13.2	13.5
73	9.2	9.8	10.4	10.9	11.4	11.8	12.1	12.5	12.7	13.0
74	9.0	9.6	10.1	10.6	11.0	11.4	11.7	12.0	12.3	12.5
75	8.8	9.4	9.9	10.3	10.7	11.0	11.3	11.6	11.8	12.0
76	8.6	9.1	9.6	10.0	10.3	10.6	10.9	11.1	11.3	11.4
77	8.4	8.9	9.3	9.7	10.0	10.2	10.5	10.6	10.8	10.9
78	8.2	8.6	9.0	9.3	9.6	9.8	10.0	10.2	10.3	10.4
79	7.9	8.3	8.7	9.0	9.2	9.4	9.5	9.7	9.8	9.8
80	7.7	8.0	8.3	8.6	8.8	9.0	9.1	9.2	9.3	9.3
81	7.4	7.7	8.0	8.2	8.4	8.5	8.6	8.7	8.8	8.8
82	7.1	7.4	7.6	7.8	8.0	8.1	8.2	8.2	8.3	8.3
83	6.8	7.1	7.3	7.4	7.5	7.6	7.7	7.8	7.8	7.8
84	6.5	6.7	6.9	7.0	7.1	7.2	7.3	7.3	7.3	7.4
85	6.2	6.4	6.6	6.7	6.7	6.8	6.8	6.9	6.9	6.9
86	5.9	6.1	6.2	6.3	6.4	6.4	6.4	6.5	6.5	6.5
87	5.6	5.8	5.9	5.9	6.0	6.0	6.0	6.1	6.1	6.1
88	5.3	5.4	5.5	5.6	5.6	5.6	5.7	5.7	5.7	5.7
89	5.1	5.1	5.2	5.3	5.3	5.3	5.3	5.3	5.3	5.3
90	4.8	4.9	4.9	4.9	5.0	5.0	5.0	5.0	5.0	5.0
91	4.5	4.6	4.6	4.6	4.7	4.7	4.7	4.7	4.7	4.7
92	4.3	4.3	4.3	4.4	4.4	4.4	4.4	4.4	4.4	4.4
93	4.0	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
94	3.8	3.8	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9
95	3.6	3.6	3.6	3.6	3.7	3.7	3.7	3.7	3.7	3.7
96	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
97	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
98	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
99	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
100	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
101	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
102	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
103	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
104	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
105	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
106	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
107	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
108	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
109	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
110	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
111	.9	.9	.9	.9	.9	.9	.9	.9	.9	.9
112	.8	.8	.8	.8	.8	.8	.8	.8	.8	.8
113	.7	.7	.7	.7	.7	.7	.7	.7	.7	.7
114	.6	.6	.6	.6	.6	.6	.6	.6	.6	.6
115	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5

TABLE VIII—TEMPORARY LIFE ANNUITIES;[1] ONE LIFE—EXPECTED RETURN MULTIPLES

[See footnote at end of tables]

Temporary Period—Maximum Duration of Annuity

Age	Years—									
	21	22	23	24	25	26	27	28	29	30
5	20.9	21.9	22.9	23.9	24.9	25.9	26.9	27.9	28.9	29.9

TABLE VIII—TEMPORARY LIFE ANNUITIES; [1] ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

[See footnote at end of tables]

Temporary Period—Maximum Duration of Annuity

Age	Years—									
	21	22	23	24	25	26	27	28	29	30
6	20.9	21.9	22.9	23.9	24.9	25.9	26.9	27.9	28.9	29.9
7	20.9	21.9	22.9	23.9	24.9	25.9	26.9	27.9	28.9	29.9
8	20.9	21.9	22.9	23.9	24.9	25.9	26.9	27.9	28.9	29.8
9	20.9	21.9	22.9	23.9	24.9	25.9	26.9	27.9	28.9	29.8
10	20.9	21.9	22.9	23.9	24.9	25.9	26.9	27.9	28.8	29.8
11	20.9	21.9	22.9	23.9	24.9	25.9	26.9	27.9	28.8	29.8
12	20.9	21.9	22.9	23.9	24.9	25.9	26.9	27.8	28.8	29.8
13	20.9	21.9	22.9	23.9	24.9	25.9	26.9	27.8	28.8	29.8
14	20.9	21.9	22.9	23.9	24.9	25.9	26.8	27.8	28.8	29.8
15	20.9	21.9	22.9	23.9	24.9	25.9	26.8	27.8	28.8	29.8
16	20.9	21.9	22.9	23.9	24.9	25.8	26.8	27.8	28.8	29.8
17	20.9	21.9	22.9	23.9	24.9	25.8	26.8	27.8	28.8	29.8
18	20.9	21.9	22.9	23.9	24.8	25.8	26.8	27.8	28.8	29.7
19	20.9	21.9	22.9	23.9	24.8	25.8	26.8	27.8	28.8	29.7
20	20.9	21.9	22.9	23.8	24.8	25.8	26.8	27.8	28.7	29.7
21	20.9	21.9	22.9	23.8	24.8	25.8	26.8	27.8	28.7	29.7
22	20.9	21.9	22.8	23.8	24.8	25.8	26.8	27.7	28.7	29.7
23	20.9	21.9	22.8	23.8	24.8	25.8	26.7	27.7	28.7	29.7
24	20.9	21.8	22.8	23.8	24.8	25.8	26.7	27.7	28.7	29.6
25	20.9	21.8	22.8	23.8	24.8	25.7	26.7	27.7	28.6	29.6
26	20.8	21.8	22.8	23.8	24.8	25.7	26.7	27.7	28.6	29.6
27	20.8	21.8	22.8	23.8	24.7	25.7	26.7	27.6	28.6	29.5
28	20.8	21.8	22.8	23.7	24.7	25.7	26.6	27.6	28.6	29.5
29	20.8	21.8	22.8	23.7	24.7	25.7	26.6	27.6	28.5	29.5
30	20.8	21.8	22.7	23.7	24.7	25.6	26.6	27.5	28.5	29.4
31	20.8	21.8	22.7	23.7	24.6	25.6	26.6	27.5	28.4	29.4
32	20.8	21.7	22.7	23.7	24.6	25.6	26.5	27.5	28.4	29.3
33	20.8	21.7	22.7	23.6	24.6	25.5	26.5	27.4	28.4	29.3
34	20.7	21.7	22.7	23.6	24.6	25.5	26.4	27.4	28.3	29.2
35	20.7	21.7	22.6	23.6	24.5	25.5	26.4	27.3	28.2	29.2
36	20.7	21.6	22.6	23.5	24.5	25.4	26.3	27.3	28.2	29.1
37	20.7	21.6	22.6	23.5	24.4	25.4	26.3	27.2	28.1	29.0
38	20.6	21.6	22.5	23.4	24.4	25.3	26.2	27.1	28.0	28.9
39	20.6	21.5	22.5	23.4	24.3	25.2	26.1	27.0	27.9	28.8
40	20.6	21.5	22.4	23.3	24.3	25.2	26.1	27.0	27.8	28.7
41	20.5	21.4	22.4	23.3	24.2	25.1	26.0	26.9	27.7	28.6
42	20.5	21.4	22.3	23.2	24.1	25.0	25.9	26.8	27.6	28.5
43	20.4	21.3	22.2	23.2	24.0	24.9	25.8	26.6	27.5	28.3
44	20.4	21.3	22.2	23.1	24.0	24.8	25.7	26.5	27.3	28.2
45	20.3	21.2	22.1	23.0	23.9	24.7	25.6	26.4	27.2	28.0
46	20.2	21.1	22.0	22.9	23.8	24.6	25.4	26.2	27.0	27.8
47	20.2	21.1	21.9	22.8	23.6	24.5	25.3	26.1	26.8	27.6
48	20.1	21.0	21.8	22.7	23.5	24.3	25.1	25.9	26.6	27.4
49	20.0	20.9	21.7	22.6	23.4	24.2	25.0	25.7	26.4	27.1
50	19.9	20.8	21.6	22.4	23.2	24.0	24.8	25.5	26.2	26.9
51	19.8	20.7	21.5	22.3	23.1	23.8	24.6	25.3	25.9	26.6
52	19.7	20.6	21.4	22.1	22.9	23.6	24.3	25.0	25.7	26.3
53	19.6	20.4	21.2	22.0	22.7	23.4	24.1	24.7	25.3	25.9
54	19.5	20.3	21.0	21.8	22.5	23.2	23.8	24.4	25.0	25.6
55	19.3	20.1	20.8	21.6	22.2	22.9	23.5	24.1	24.6	25.2
56	19.2	19.9	20.6	21.3	22.0	22.6	23.2	23.7	24.3	24.7
57	19.0	19.7	20.4	21.1	21.7	22.3	22.8	23.4	23.8	24.3
58	18.8	19.5	20.2	20.8	21.4	21.9	22.5	22.9	23.4	23.8
59	18.6	19.3	19.9	20.5	21.1	21.6	22.0	22.5	22.9	23.2
60	18.4	19.0	19.6	20.2	20.7	21.2	21.6	22.0	22.4	22.7
61	18.1	18.7	19.3	19.8	20.3	20.7	21.1	21.5	21.8	22.1
62	17.8	18.4	18.9	19.4	19.9	20.3	20.6	21.0	21.2	21.5
63	17.5	18.1	18.5	19.0	19.4	19.8	20.1	20.4	20.6	20.8
64	17.2	17.7	18.1	18.6	18.9	19.3	19.5	19.8	20.0	20.2
65	16.8	17.3	17.7	18.1	18.4	18.7	18.9	19.2	19.3	19.5
66	16.5	16.9	17.3	17.6	17.9	18.1	18.3	18.5	18.7	18.8
67	16.1	16.4	16.8	17.1	17.3	17.5	17.7	17.9	18.0	18.1
68	15.6	16.0	16.3	16.5	16.7	16.9	17.1	17.2	17.3	17.4
69	15.2	15.5	15.7	16.0	16.1	16.3	16.4	16.5	16.6	16.7
70	14.7	15.0	15.2	15.4	15.5	15.7	15.8	15.8	15.9	15.9
71	14.2	14.4	14.6	14.8	14.9	15.0	15.1	15.2	15.2	15.2
72	13.7	13.9	14.1	14.2	14.3	14.4	14.4	14.5	14.5	14.5
73	13.2	13.3	13.5	13.6	13.7	13.7	13.8	13.8	13.8	13.9

TABLE VIII—TEMPORARY LIFE ANNUITIES; [1] ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

[See footnote at end of tables]

Temporary Period—Maximum Duration of Annuity

Age	Years—									
	21	22	23	24	25	26	27	28	29	30
74	12.6	12.8	12.9	13.0	13.0	13.1	13.1	13.1	13.2	13.2
75	12.1	12.2	12.3	12.4	12.4	12.5	12.5	12.5	12.5	12.5
76	11.5	11.6	11.7	11.8	11.8	11.8	11.8	11.9	11.9	11.9
77	11.0	11.1	11.1	11.2	11.2	11.2	11.2	11.2	11.2	11.2
78	10.4	10.5	10.5	10.6	10.6	10.6	10.6	10.6	10.6	10.6
79	9.9	9.9	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
80	9.4	9.4	9.4	9.4	9.5	9.5	9.5	9.5	9.5	9.5
81	8.8	8.9	8.9	8.9	8.9	8.9	8.9	8.9	8.9	8.9
82	8.3	8.4	8.4	8.4	8.4	8.4	8.4	8.4	8.4	8.4
83	7.8	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9
84	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4
85	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9
86	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5
87	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1
88	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7
89	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3
90	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
91	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
92	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4
93	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
94	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9
95	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7
96	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
97	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
98	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
99	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
100	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
101	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
102	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
103	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
104	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
105	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
106	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
107	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
108	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
109	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
110	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
111	.9	.9	.9	.9	.9	.9	.9	.9	.9	.9
112	.8	.8	.8	.8	.8	.8	.8	.8	.8	.8
113	.7	.7	.7	.7	.7	.7	.7	.7	.7	.7
114	.6	.6	.6	.6	.6	.6	.6	.6	.6	.6
115	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5

TABLE VIII—TEMPORARY LIFE ANNUITIES; [1] ONE LIFE—EXPECTED RETURN MULTIPLES

[See footnote at end of tables]

Temporary Period—Maximum Duration of Annuity

Age	Years—									
	31	32	33	34	35	36	37	38	39	40
5	30.8	31.8	32.8	33.8	34.8	35.8	36.8	37.7	38.7	39.7
6	30.8	31.8	32.8	33.8	34.8	35.8	36.8	37.7	38.7	39.7
7	30.8	31.8	32.8	33.8	34.8	35.8	36.7	37.7	38.7	39.7
8	30.8	31.8	32.8	33.8	34.8	35.7	36.7	37.7	38.7	39.7
9	30.8	31.8	32.8	33.8	34.8	35.7	36.7	37.7	38.7	39.6
10	30.8	31.8	32.8	33.8	34.7	35.7	36.7	37.7	38.6	39.6
11	30.8	31.8	32.8	33.8	34.7	35.7	36.7	37.7	38.6	39.6
12	30.8	31.8	32.8	33.7	34.7	35.7	36.7	37.6	38.6	39.6
13	30.8	31.8	32.7	33.7	34.7	35.7	36.6	37.6	38.6	39.5
14	30.8	31.8	32.7	33.7	34.7	35.7	36.6	37.6	38.6	39.5
15	30.8	31.7	32.7	33.7	34.7	35.6	36.6	37.6	38.5	39.5
16	30.8	31.7	32.7	33.7	34.6	35.6	36.6	37.5	38.5	39.4
17	30.7	31.7	32.7	33.7	34.6	35.6	36.5	37.5	38.5	39.4
18	30.7	31.7	32.7	33.6	34.6	35.6	36.5	37.5	38.4	39.4
19	30.7	31.7	32.6	33.6	34.6	35.5	36.5	37.4	38.4	39.3
20	30.7	31.7	32.6	33.6	34.5	35.5	36.4	37.4	38.3	39.3

TABLE VIII—TEMPORARY LIFE ANNUITIES;[1] ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

[See footnote at end of tables]

Temporary Period—Maximum Duration of Annuity

Age	Years—									
	31	32	33	34	35	36	37	38	39	40
21	30.7	31.6	32.6	33.6	34.5	35.5	36.4	37.4	38.3	39.2
22	30.6	31.6	32.6	33.5	34.5	35.4	36.4	37.3	38.2	39.2
23	30.6	31.6	32.5	33.5	34.4	35.4	36.3	37.3	38.2	39.1
24	30.6	31.5	32.5	33.5	34.4	35.3	36.3	37.2	38.1	39.0
25	30.6	31.5	32.5	33.4	34.3	35.3	36.2	37.1	38.1	39.0
26	30.5	31.5	32.4	33.4	34.3	35.2	36.2	37.1	38.0	38.9
27	30.5	31.4	32.4	33.3	34.2	35.2	36.1	37.0	37.9	38.8
28	30.5	31.4	32.3	33.3	34.2	35.1	36.0	36.9	37.8	38.7
29	30.4	31.4	32.3	33.2	34.1	35.0	35.9	36.8	37.7	38.6
30	30.4	31.3	32.2	33.1	34.1	35.0	35.8	36.7	37.6	38.5
31	30.3	31.2	32.2	33.1	34.0	34.9	35.8	36.6	37.5	38.3
32	30.3	31.2	32.1	33.0	33.9	34.8	35.6	36.5	37.4	38.2
33	30.2	31.1	32.0	32.9	33.8	34.7	35.5	36.4	37.2	38.0
34	30.1	31.0	31.9	32.8	33.7	34.6	35.4	36.2	37.1	37.9
35	30.1	31.0	31.8	32.7	33.6	34.4	35.3	36.1	36.9	37.7
36	30.0	30.9	31.7	32.6	33.5	34.3	35.1	35.9	36.7	37.4
37	29.9	30.8	31.6	32.5	33.3	34.1	34.9	35.7	36.5	37.2
38	29.8	30.7	31.5	32.3	33.2	34.0	34.7	35.5	36.2	37.0
39	29.7	30.5	31.4	32.2	33.0	33.8	34.5	35.3	36.0	36.7
40	29.6	30.4	31.2	32.0	32.8	33.6	34.3	35.0	35.7	36.4
41	29.4	30.2	31.0	31.8	32.6	33.3	34.1	34.7	35.4	36.0
42	29.3	30.1	30.9	31.6	32.4	33.1	33.8	34.4	35.1	35.7
43	29.1	29.9	30.7	31.4	32.1	32.8	33.5	34.1	34.7	35.3
44	28.9	29.7	30.5	31.2	31.9	32.5	33.2	33.8	34.3	34.9
45	28.8	29.5	30.2	30.9	31.6	32.2	32.8	33.4	33.9	34.4
46	28.5	29.3	30.0	30.6	31.3	31.9	32.4	33.0	33.5	33.9
47	28.3	29.0	29.7	30.3	30.9	31.5	32.0	32.5	33.0	33.4
48	28.1	28.7	29.4	30.0	30.6	31.1	31.6	32.1	32.5	32.9
49	27.8	28.4	29.0	29.6	30.2	30.7	31.1	31.5	31.9	32.3
50	27.5	28.1	28.7	29.2	29.7	30.2	30.6	31.0	31.4	31.7
51	27.2	27.8	28.3	28.8	29.3	29.7	30.1	30.4	30.7	31.0
52	26.8	27.4	27.9	28.4	28.8	29.2	29.5	29.8	30.1	30.3
53	26.5	27.0	27.4	27.9	28.3	28.6	28.9	29.2	29.4	29.6
54	26.1	26.5	27.0	27.4	27.7	28.0	28.3	28.5	28.7	28.9
55	25.6	26.1	26.5	26.8	27.1	27.4	27.6	27.8	28.0	28.1
56	25.2	25.6	25.9	26.2	26.5	26.7	26.9	27.1	27.2	27.3
57	24.7	25.0	25.3	25.6	25.8	26.0	26.2	26.3	26.5	26.5
58	24.1	24.4	24.7	25.0	25.2	25.3	25.5	25.6	25.7	25.7
59	23.6	23.8	24.1	24.3	24.4	24.6	24.7	24.8	24.9	24.9
60	23.0	23.2	23.4	23.6	23.7	23.8	23.9	24.0	24.0	24.1
61	22.3	22.5	22.7	22.9	23.0	23.1	23.1	23.2	23.2	23.3
62	21.7	21.9	22.0	22.1	22.2	22.3	22.3	22.4	22.4	22.4
63	21.0	21.1	21.3	21.4	21.4	21.5	21.5	21.6	21.6	21.6
64	20.3	20.4	20.5	20.6	20.6	20.7	20.7	20.7	20.8	20.8
65	19.6	19.7	19.8	19.8	19.9	19.9	19.9	19.9	19.9	20.0
66	18.9	19.0	19.0	19.1	19.1	19.1	19.1	19.1	19.1	19.1
67	18.2	18.2	18.3	18.3	18.3	18.3	18.3	18.3	18.4	18.4
68	17.4	17.5	17.5	17.5	17.5	17.6	17.6	17.6	17.6	17.6
69	16.7	16.7	16.8	16.8	16.8	16.8	16.8	16.8	16.8	16.8
70	16.0	16.0	16.0	16.0	16.0	16.0	16.0	16.0	16.0	16.0
71	15.3	15.3	15.3	15.3	15.3	15.3	15.3	15.3	15.3	15.3
72	14.6	14.6	14.6	14.6	14.6	14.6	14.6	14.6	14.6	14.6
73	13.9	13.9	13.9	13.9	13.9	13.9	13.9	13.9	13.9	13.9
74	13.2	13.2	13.2	13.2	13.2	13.2	13.2	13.2	13.2	13.2
75	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5
76	11.9	11.9	11.9	11.9	11.9	11.9	11.9	11.9	11.9	11.9
77	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2
78	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6
79	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
80	9.5	9.5	9.5	9.5	9.5	9.5	9.5	9.5	9.5	9.5
81	8.9	8.9	8.9	8.9	8.9	8.9	8.9	8.9	8.9	8.9
82	8.4	8.4	8.4	8.4	8.4	8.4	8.4	8.4	8.4	8.4
83	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9
84	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4
85	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9
86	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5
87	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1
88	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7

TABLE VIII—TEMPORARY LIFE ANNUITIES;[1] ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

[See footnote at end of tables]

Temporary Period—Maximum Duration of Annuity

Age	Years—									
	31	32	33	34	35	36	37	38	39	40
89	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3
90	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
91	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
92	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4
93	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
94	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9
95	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7
96	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
97	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
98	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
99	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
100	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
101	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
102	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
103	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
104	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
105	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
106	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
107	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
108	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
109	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
110	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
111	.9	.9	.9	.9	.9	.9	.9	.9	.9	.9
112	.8	.8	.8	.8	.8	.8	.8	.8	.8	.8
113	.7	.7	.7	.7	.7	.7	.7	.7	.7	.7
114	.6	.6	.6	.6	.6	.6	.6	.6	.6	.6
115	.5	.5	.5	.5	.5	.5	.5	.5	.5	.5

[1] The multiples in this table are not applicable to annuities for a term certain; for such cases see paragraph (c) of § 1.72–5.

If (a) the terms of the contract involve a life or lives, and are such that the above tables cannot be correctly applied, and (b) the amounts received under the contract are at least partly ‘‘amounts received as an annuity’’ under a contract to which section 72 applies, the taxpayer may submit with his return an actuarial computation based upon the applicable annuity table (described below) with ages set back one year, showing the appropriate factors applied in his case, subject to the approval of the Commissioner upon examination of such return. The applicable annuity table is the 1937 Standard Annuity Table (if the investment in the contract does not include a post-June 1986 investment in the contract) or the gender-neutral version of the 1983 Basic Table (if the investment in the contract includes a post-June 1986 investment in the contract). In the case of a contract to which § 1.72–6(d) (relating to contracts in which amounts were invested both before July 1, 1986, and after June 30, 1986) applies, the actuarial computation shall be based on both tables in accordance with the principles of § 1.72–6(d). Computations involving factors to compensate for the effects of contingencies other than mortality, such as marriage or remarriage, re-employment, recovery from disability, or the like, will not be approved.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 8115, 51 FR 45706, Dec. 19, 1986; T.D. 8115, 60 FR 16381, Mar. 30, 1995]

§ 1.72–10 Effect of transfer of contracts on investment in the contract.

(a) If a contract to which section 72 applies, or any interest therein, is transferred for a valuable consideration, by assignment or otherwise, only the actual value of the consideration given for such transfer and the amount of premiums or other consideration subsequently paid by the transferee shall be included in the transferee’s aggregate of premiums or other consideration paid. In accordance with the provisions of section 72(g)(3) and paragraph (b) of § 1.72–4, an annuity starting date shall be determined for the transferee without regard to the annuity starting date, if any, of the transferor. In determining the transferee's investment in the contract, the aggregate amount of premiums or other consideration paid shall be reduced by all amounts received by the transferee before the receipt of an amount as an annuity or before the annuity starting date, whichever is the later, to the extent that such amounts were excludable from his gross income under the applicable income tax law at the time of receipt. For the treatment of amounts received by the transferee subsequent to both the annuity starting date and the date of receipt of a payment as an annuity, but not received as annuity payments, see §1.72–11. For a limitation on adjustments to the basis of annuity contracts sold, see section 1021.

(b) In the case of a transfer of such a contract without valuable consideration, the annuity starting date and the expected return under the contract shall be determined as though no such transfer had taken place. See paragraph (b) of §1.72–4. The transferee shall include the aggregate of premiums or other consideration paid or deemed to have been paid by his transferor in the aggregate of premiums or other consideration as though paid by him. In determining the transferee's investment in the contract, the transferee's aggregate amount of premiums or other consideration paid (as so found) shall be reduced by all amounts either received or deemed to have been received by himself or his transferor before the annuity starting date, or before the date on which an amount is first received as an annuity, whichever is the later, to the extent that such amounts were excludable from the gross income of the actual recipient under the applicable income tax law at the time of receipt. For treatment of amounts received subsequent to both the above dates by such transferee, but not received as annuity payments, see §1.72–11.

§1.72–11 Amounts not received as annuity payments.

(a) *Introductory.* (1) This section applies to amounts received under a contract to which section 72 applies if either:

(i) Paragraph (b) of §1.72–2 is inapplicable to such amounts.

(ii) Paragraph (b) of §1.72–2 is applicable but the annuity payments received differ either in amount, duration, or both, from those originally provided under the contract, or

(iii) Paragraph (b) of §1.72 is applicable, but such annuity payments are received by a beneficiary after the death of an annuitant (or annuitants) in full discharge of the obligation under the contract and solely because of a guarantee.

The payments referred to in subdivision (i) of this subparagraph include all amounts other than ''amounts received as an annuity'' as that term is defined in paragraphs (b) (2) and (3) of §1.72–2. If such amounts are received as dividends or payments in the nature of dividends, or as a return of premiums, see paragraph (b) of this section. If such amounts are paid in full discharge of the obligation under the contract and are in the nature of a refund of the consideration, see paragraph (c) of this section. If such amounts are paid upon the surrender, redemption, or maturity of the contract, see paragraph (d) of this section. The payments referred to in subdivision (ii) of this subparagraph include all annuity payments which are paid as the result of a modification or an exchange of the annuity obligations originally provided under a contract for different annuity obligations (whether or not such modification or exchange is accompanied by the payment of an amount to which subdivision (i) of this subparagraph applies). If the duration of the new annuity obligations differs from the duration of the old annuity obligations, paragraph (e) of this section applies to the new annuity obligations and paragraph (d) of this section applies to any lump sum payment received. If, however, the duration of the new annuity obligations is the same as the duration of the old obligations, paragraph (f) of this section applies to the new obligations and to any lump sum received in connection therewith. The annuity payments referred to in subdivision (iii) of this subparagraph are annuity payments which are made to a beneficiary after the death of annuitant (or annuitants) in full discharge of the obligations under a contract because of a provision in the contract requiring the payment of a guaranteed amount or minimum number of payments for a fixed period; see paragraph (c) of this section.

(2) The principles of this section apply, to the extent appropriate thereto, to amounts paid which are taxable under section 72 (except, for taxable years beginning before January 1, 1964, section 72(e)(3)) in accordance with sections 402 and 403 and the regulations thereunder. However, if contributions used to purchase the contract include amounts for which a deduction was allowed under section 404 as contributions on behalf of an owner-employee, the rules of this section are modified by the rules of paragraph (b) of § 1.72–17. Further, in applying the provisions of this section, the aggregate premiums or other consideration paid shall not include contributions on behalf of self-employed individuals to the extent that deductions were allowed under section 404 for such contributions. Nor, shall the aggregate of premiums or other consideration paid include amounts used to purchase life, accident, health, or other insurance protection for an owner-employee. See paragraph (b)(4) of § 1.72–16 and paragraph (c) of § 1.72–17. The principles of this section also apply to payments made in the manner described in paragraph (b)(3)(i) of § 1.72–2.

(b) *Amounts received in the nature of dividends or similar distributions.* (1) If dividends (or payments in the nature of dividends or a return of premiums or other consideration) are received under a contract to which section 72 applies and such payments are received before the annuity starting date or before the date on which an amount is first received as an annuity, whichever is the later, such payments are includible in the gross income of the recipient only to the extent that they, taken together with all previous payments received under the contract which were excludable from the gross income of the recipient under the applicable income tax law, exceed the aggregate of premiums or other consideration paid or deemed to have been paid by the recipient. Such payments shall also be subtracted from the consideration paid (or deemed paid) both for the purpose of determining an exclusion ratio to be applied to subsequent amounts paid as an annuity and for the purpose of determining the applicability of section 72(d) and § 1.72–13, relating to employee contributions recoverable in three years.

(2) If dividends or payments in the nature of dividends are paid under a contract to which section 72 applies and such payments are received on or after the annuity starting date or the date on which an amount is first received as an annuity, whichever is later, such payments shall be fully includible in the gross income of the recipient. The receipt of such payments shall not affect the aggregate of premiums or other consideration paid nor the amounts contributed or deemed to have been contributed by an employee as otherwise calculated for purposes of section 72. Since the investment in the contract and the expected return are not affected by a payment which is fully includible in the gross income of the recipient under this rule, the exclusion ratio will not be affected by such payment and will continue to be applied to amounts received as annuity payments in the future as though such payment had not been made. This subparagraph shall apply to amounts received under a contract described in paragraph (b)(3)(i) of § 1.72–2 to the extent that the amounts received exceed the portion of the investment in the contract allocable to each taxable year in accordance with paragraph (d)(3) of § 1.72–4. Hence, such excess is fully includible in the gross income of the recipient.

(c) *Amounts received in the nature of a refund of the consideration under a contract and in full discharge of the obligation thereof.* (1) Any amount received under a contract to which section 72 applies, if it is at least in part a refund of the consideration paid, including amounts payable to a beneficiary after the death of an annuitant by reason of a provision in the contract for a life annuity with minimum period of payments certain or with a minimum amount which must be paid in any event, shall be considered an amount received in the nature of a refund of the consideration paid for such contract. If such an amount is in full discharge of an obligation to pay a fixed amount (whether in a lump sum or otherwise) or to pay amounts for a fixed number of years (including amounts described in paragraph (b)(3)(i) of §1.72–2), it shall be included in the gross income of the recipient only to the extent that it, when added to amounts previously received under the contract which were excludable from gross income under the law applicable at the time of receipt, exceeds the aggregate of premiums or other consideration paid. See section 73(e)(2)(A). This paragraph shall not apply if the total of the amounts to be paid in discharge of the obligation can in any event exceed the total of the annuity payments which would otherwise fully discharge the obligation. For rules to be applied in such a case, see paragraph (e) of this section.

(2) The principles of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). A, a male employee, retired on December 31, 1954, at the age of 60. A life annuity of $75 per month was payable to him beginning January 31, 1955. The annuity contract guaranteed that if A did not live for at least ten years after his retirement his beneficiary, B, would receive the monthly payments for any balance of such ten-year period which remained at the date of A's death. Under section 72, A was deemed to have paid $3,600 toward the cost of the annuity. A lived for five years after his retirement receiving a total of $4,500 in annuity payments. After A's death, B began receiving the monthly payments of $75 beginning with the January 31, 1960 payment. B will exclude such payments from his gross income throughout 1960, 1961, and 1962, and will exclude only $18 of the first payment in 1963 from his gross income for that year. Thereafter, B will include the entire amount of all such payments in his gross income for the taxable year of receipt. This result is determined as follows:

A's investment in the contract (unadjusted)		$3,600
Multiple from Table III of §1.72–9 for male, age 60, where duration of guaranteed amount is 10 years (percent)	11	
Subtract value of the refund feature to the nearest dollar (11 percent of $3,600)		396
Investment in the contract adjusted for the present value of the refund feature without discount for interest		3,204
Aggregate of premiums or other consideration paid		3,600
A's exclusion ratio ($3,204÷$16,380 [$900×18.2]) (percent)	19.6	
Subtract amount excludable during five years A received payments (19.6 percent of $4,500 [$900×5])		882
Remainder of aggregate of premiums or other consideration paid excludable from gross income of B under section 72(e)		2,718

As a result of the above computation, the number of payments to B which will exhaust the remainder of consideration paid which is excludable from gross income of the recipient is 36$\frac{6}{25}$ ($2,718÷$75) and B will exclude the payments from his gross income for three years, then exclude only $18 of the first payment for the fourth year from his gross income, and thereafter include the entire amount of all payments he receives in his gross income.

Example (2). The facts are the same as in example (1), except that B, the beneficiary, elects to receive $50 per month for his life in lieu of the payments guaranteed under the original contractual obligation. Since such amounts will be received as an annuity and may, because of the length of time B may live, exceed the amount guaranteed, they are not amounts to which this paragraph applies. See paragraph (e) of this section.

Example (3). The facts are the same as in example (1), except that B, the beneficiary, elects to receive the remaining guaranteed amount in installments which are larger or smaller than the $75 per month provided until, under the terms of the contract, the guaranteed amount is exhausted. The rule of subparagraph (1) of this paragraph and the computation illustrated in example (1) apply to such installments since the total of such installments will not exceed the original amount guaranteed to be paid at A's death in any event.

Example (4). C pays $12,000 for a contract providing that he is to be paid an annuity of $1,000 per year for 15 years. His exclusion ratio is therefore 80 percent ($12,000÷$15,000). He directs that the annuity is to be paid to D, his beneficiary, if he should die before the full 15-year period has expired. C dies after 5 years and D is paid $1,000 in 1960. D will include $200 ($1,000−$800 [80 percent of $1,000]) in his gross income for the taxable year in which he receives the $1,000 since section 72(e) and this section do not apply to the annuity payments made in accordance with the provisions and during the term of the contract. D will continue with the same exclusion ratio used by C (80 percent).

Example (5). In 1954, E paid $50,000 into a fund and was promised an annual income for life the amount of which would depend in part upon the earnings realized from the investment of the fund in accordance with an agreed formula. The contract also specified that if E should die before ten years had elapsed, his beneficiary, F, would be paid the amounts determined annually under the formula until ten payments had been received by E and F together. E died in 1960, having received five payments totaling $30,000. Assuming that $22,000 of this amount was properly excludable from E's gross income prior to his death, F will exclude from his gross income the payments he receives until the taxable year in which his total receipts from the fund exceed $28,000 ($50,000−$22,000). F will include any excess over the $28,000 in his gross income for that taxable year. Thereafter, F will include in his gross income the entire amount of any payments made to him from the fund.

Example (6). Assume the facts are the same as in example (1), except that the total investment in the contract is made after June 30, 1986, that A is to receive payments under the life annuity contract beginning on January 31, 1987, and that B will begin to receive the monthly payments on January 31, 1992. B will exclude the $75 monthly payments from gross income throughout 1992, 1993, and 1994. B will exclude only the first two monthly payments and $21 of the third monthly payment in 1995. This is determined as follows:

A's investment in the contract (unadjusted)	$3,600
Multiple from Table VII, age 60, 10 years (percent)	4
Subtract value of the refund feature (4 percent of $3,600	$144
Investment in the contract adjusted for the present value of the refund feature without discount for interest	$3,456
Aggregate of premiums or other consideration paid	$3,600.00
A's exclusion ratio ($3,456÷$21,780 [$900×24.2]) (percent)	15.9
Subtract amount excludable during five years A received payments (15.9 percent of $4,500 [$900×5])	$715.50
Remainder of aggregate of premiums or other consideration paid excludable from gross income of B under section 72(e)	$2,884.50

As a result of the above computation, the number of payments to B which will exhaust the remainder of consideration paid which is excludable from gross income of the recipient is 38 23/50 ($2,884.50÷75) and B will exclude the payments from gross income for three years, then exclude only the first two monthly payments and $34.50 of the third. Thereafter B shall include the entire amount of all payments received in gross income.

(3) For the purpose of applying the rule contained in subparagraph (1) of this paragraph, it is immaterial whether the recipient of the amount received in full discharge of the obligation is the same person as the recipient of amounts previously received under the contract which were excludable from gross income, except in the case of a contract transferred for a valuable consideration, with respect to which see paragraph (a) of § 1.72–10. For the limit on the tax, for taxable years beginning before January 1, 1964, attributable to the receipt of a lump sum to which this paragraph applies, see paragraph (g) of this section.

(d) *Amounts received upon the surrender, redemption, or maturity of a contract.* (1) Any amount received upon the surrender, redemption, or maturity of a contract to which section 72 applies, which is not received as an annuity under the regulations of paragraph (b) of § 1.72–2, shall be included in the gross income of the recipient to the extent that it, when added to amounts previously received under the contract and which were excludable from the gross income of the recipient under the law applicable at the time of receipt, exceeds the aggregate of premiums or other consideration paid. See section 72(e)(2)(B). If amounts are to be received as an annuity, whether in lieu of or in addition to amounts described in the preceding sentence, such amounts shall be included in the gross income of the recipient in accordance with the provisions of paragraph (e) or (f) of this section, whichever is applicable. The rule stated in the first sentence of this paragraph shall not apply to payments received as an annuity or otherwise after the date of the first receipt of an amount as an annuity subsequent to the maturity, redemption, or surrender of the original contract. If amounts are so received and are other than amounts received as an annuity, they are includible in the gross income of the recipient. See section 72(e)(1)(A) and paragraph (b)(2) of this section.

(2) For the purpose of applying the rule contained in subparagraph (1) of this paragraph, it is immaterial whether the recipient of the amount received upon the surrender, redemption, or maturity of the contract is the same as the recipient of amounts previously received under the contract which were excludable from gross income, except in the case of a contract transferred for a valuable consideration, with respect to which see paragraph (a) of §1.72–10. For the limit on the amount of tax, for taxable years beginning before January 1, 1964, attributable to the receipt of certain lump sums to which this paragraph applies, see paragraph (g) of this section.

(e) *Periodic payments received for a different term.* If, after the date on which an amount is first received as an annuity under a contract to which section 72 applies, the terms of the contract are modified or the annuity obligations are exchanged so that periodic payments are to be received for a different term than originally provided under the contract (whether or not accompanied by the receipt of a lump sum to which paragraph (d) of this section applies), the rules of this paragraph shall apply to such payments. Hence, the provisions of section 72(e) and paragraphs (b), (c), (d), and (f) of this section are inapplicable for the purpose of determining the includibility of such payments in gross income and the general principles of section 72 with respect to the use of an exclusion ratio shall be applied to such payments as if they were provided under a new contract received in exchange for the contract providing the original annuity payments. If such payments are received as the result of the surrender, redemption, or discharge of a contract to which section 72 applies, they shall be considered to be received as an annuity under a contract exchanged for the contract whose redemption, surrender, or discharge was involved. For the purpose of determining the extent to which the payments so received are to be included in the gross income of the recipient, an exclusion ratio shall be determined for such contract as of the later of January 1, 1954, or the first day of the first period for which an amount is received as an annuity thereunder, whichever is the later. See paragraph (b) of §1.72–4. In determining the investment in the contract for this purpose, any lump sum amount received at the time of the exchange shall not be considered an amount to which paragraph (a)(2) of §1.72–6 applies. However, such lump sum shall be subtracted from the aggregate of premiums or other consideration paid to the extent it is excludable as an amount not received as an annuity under this section as if it were an amount received before the annuity starting date of the contract obtained in exchange.

(f) *Periodic payments received for the same term after a lump sum withdrawal.* (1) If, after the date of the first receipt of a payment as an annuity, the annuitant receives a lump sum and is thereafter to receive annuity payments in a reduced amount under the contract for the same term, life, or lives as originally specified in the contract, a portion of the contract shall be considered to have been surrendered or redeemed in consideration of the payment of such lump sum and the exclusion ratio originally determined for the contract shall continue to apply to the amounts received as an annuity without regard to the fact that such amounts are less than the original amounts which were to be paid periodically. The lump sum shall be includible in the gross income of the recipient in accordance with the provisions of subparagraph (2) of this paragraph. However, except in the case of amounts to which sections 402 and 403 apply, the tax, for taxable years beginning before January 1, 1964, attributable to the inclusion of all or part of the lump sum in gross income shall not exceed the amount determined under section 72(e)(3) and paragraph (g) of this section. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(2) There shall be excluded from gross income that portion of the lump sum which bears the same ratio to the aggregate premiums or other consideration paid for the contract, as reduced by all amounts previously received under the contract and excludable from

the gross income of the recipient under the applicable income tax law, as:

(i) In the case of payments to be made in the manner described in paragraph (b)(2) of § 1.72–2, the amount of the reduction in the annuity payments to be made thereafter bears to the annuity payments originally provided under the contract, or

(ii) In the case of a contract providing for payments to be made in the manner described in paragraph (b)(3)(i) of § 1.72–2, the amount of the reduction in the number of units per period to be paid thereafter bears to the number of units per period payable under the contract immediately before the lump sum withdrawal.

(3) This paragraph may be illustrated by the following examples:

Example (1). Taxpayer A pays $20,000 for an annuity contract providing for payments to him of $100 per month for his life. At the annuity starting date he has a life expectancy of 20 years. His expected return is therefore $24,000 and the exclusion ratio is five-sixths. He continues to receive the original annuity payments for 5 years, receiving a total of $6,000, and properly excludes a total of $5,000 from his gross income in his income tax returns for those years. At the beginning of the next year, A agrees with the insurer to take a reduced annuity of $75 per month and a lump sum payment of $4,000 in cash. Of the lump sum he receives, he will include $250 and exclude $3,750 from his gross income for his taxable year of receipt, determined as follows:

Aggregate of premiums or other consideration paid	$20,000
Less amounts received as an annuity to the extent they were excludable from A’s income	$5,000
Remainder of the consideration	$15,000
Ratio of the reduction in the amount of the annuity payments to the original annuity payments	25/$100 or ¼
Lump sum received	$4,000
Less one-fourth of the remainder of the consideration (¼ of $15,000)	$3,750
Portion of the lump sum includible in gross income	$250

For taxable years beginning before January 1, 1964, the limit on tax of section 72(e)(3), as in effect before such date, applies to the portion of the lump sum includible in gross income. For taxable years beginning after December 31, 1963, such portion may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). If, in this example, the annuity were a pension payable to A as a retired employee, but the facts were otherwise the same (assuming that, for instance, the $20,000 aggregate of premiums or other consideration paid were A’s contributions as determined under section 72(f) and § 1.72–8) the result would be the same except that the tax attributable to the inclusion of the $250 in A’s gross income, for taxable years beginning before January 1, 1964, would not be limited by section 72(e)(3), as in effect before such date. If such a lump sum is received in a taxable year beginning after December 31, 1963, the portion of such sum includible in gross income may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

Example (2). Taxpayer B pays $30,000 for a contract providing for monthly payments to be made to him for 15 years with respect to the principal and earnings of 10 units of an investment fund. B receives $12,000 during the first 5 years of participation and of this amount he has properly excluded a total of $10,000 from his gross income in his income returns for the taxable years, since $2,000 of $2,400 he received in each such year represented his investment divided by the term of the annuity ($30,000÷15). At the beginning of the 6th year, B agrees to take $11,000 in a lump sum and thereafter to accept the payments arising with respect to five units for the remaining 10 years of payments in full discharge of the original obligations of the contract. B shall include $1,000 in his gross income for the 6th year as the result of the lump sum he receives and allocates $1,000 of his original investment in the contract to each of the remaining 10 years with respect to the payments which will continue, determined as follows:

Aggregate of premiums or other consideration paid	$30,000
Total amount received and excludable from gross income	$10,000
Remainder of the consideration	$20,000
Ratio of units discontinued to the total units originally provided	5⁄10 or ½
Lump sum received at the time of reduction in the number of units to be paid	$11,000
Less one-half of the remainder of the consideration (½ of $20,000)	$10,000
Portion of the lump sum received and includible in gross income	$1,000
Remainder of the consideration less the portion of such remainder attributable to the excludable portion of the lump sum ($20,000 − $10,000)	$10,000
Remainder of the consideration properly allocable to each taxable year for the remaining 10 years ($10,000÷10)	$1,000

For the taxable years beginning before January 1, 1964, the limit on tax of section 72(e)(3), as in effect before such date, applies to the portion of the lump sum received and includible in gross income. For taxable years beginning after December 31, 1963, such portion may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(g) *Limit on tax attributable to the receipt of a lump sum.* (1) For taxable years beginning before January 1, 1964, if the entire amount of the proceeds received upon the redemption, maturity, surrender, or discharge of a contract to which section 72 applies is received in a lump sum and paragraph (c), (d), or (f) of this section is applicable in determining the portion of such amount which is includible in gross income, the tax attributable to such portion shall not exceed the tax which would have been attributable thereto had such portion been received ratably in the taxable year in which received and the 2 preceding taxable years. The amount of tax attributable to the includible portion of the lump sum received shall be the lesser of:

(i) The difference between the amount of tax for the taxable year of receipt computed by including such portion in gross income and the amount of tax for such taxable year computed by excluding such portion from gross income; or

(ii) The difference between the total amount of tax for the taxable year of receipt and the 2 preceding taxable years computed by including one-third of such portion in gross income for each of the 3 taxable years, and the total amount of the tax for the taxable year of receipt and the 2 preceding taxable years computed by entirely excluding such portion from the gross income of all 3 taxable years.

For the definition of ‘‘taxable year’’, see section 441(b). This subparagraph shall not apply, for taxable years beginning before January 1, 1964, to payments excepted from the application of section 72(e)(3), as in effect before such date, under the provisions of section 402 or 403. See paragraph (a) of §1.72–2 and paragraph (d) of §1.72–14.

(2) For taxable years beginning after December 31, 1963, any amount includible in gross income to which this section relates may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(h) *Amounts deemed to be paid or received by a transferee.* Amounts deemed to have been paid or received by a transferee for the purposes of §1.72–10 shall also be deemed to have been so paid or received by such transferee for the purposes of this section. Thus, if a donee is deemed to have paid the premiums or other consideration actually paid by his transferor for the purposes of section 72(g) and paragraph (b) of §1.72–10, such consideration shall be deemed premiums or other consideration paid by the donee for the purposes of this section.

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§1.72–12 Effect of taking an annuity in lieu of a lump sum upon the maturity of a contract.

If a contract to which section 72 applies provides for the payment of a lump sum in full discharge of the obligation thereunder and the obligee entitled thereto, prior to receiving any portion of such lump sum and within 60 days after the date on which such lump sum first becomes payable, exercises an option or irrevocably agrees with the obligor to take, in lieu thereof, payments which will constitute ‘‘amounts received as an annuity’’, as that term is defined in paragraph (b) of §1.72–2, no part of such lump sum shall be deemed to have been received by the obligee at the time he was first entitled thereto merely because he would have been entitled to such amount had he not exercised the option or made such an agreement with the obligor.

§1.72–13 Special rule for employee contributions recoverable in three years.

(a) *Amounts received as an annuity.* (1) Section 72(d) provides a special rule for the treatment of amounts received as an annuity by an employee (or by the beneficiary or beneficiaries of an employee) under a contract to which section 72 applies. This special rule is applicable only in the event that:

(i) At least part of the consideration paid for the contract is contributed by the employer, and

(ii) The aggregate amount receivable as an annuity under such contract by the employee (or by his beneficiary or beneficiaries if the employee died before any amount was received as an annuity under the contract) within the 3-year period beginning on the date (whether or not before January 1, 1954) on which an amount is first received as an annuity equals or exceeds the total consideration contributed (or deemed contributed under section 72(f) and § 1.72–8) by the employee as of such date as reduced by all amounts previously received and excludable from the gross income of the recipient under the applicable income tax law.

In such an event, section 72(d) provides that all amounts received as an annuity under the contract during a taxable year to which the Code applies shall be excluded from gross income until the total of the amounts excluded under that section plus all amounts excluded under prior income tax laws equals or exceeds the consideration contributed (or deemed contributed) by the employee. The excess, if any, and all amounts received by any recipient thereafter (whether or not received as an annuity), shall be fully included in gross income. See paragraph (b) of this section.

(2) If the aggregate amount receivable as an annuity under the contract within three years from the date on which an amount is first received as an annuity thereunder will not equal or exceed the consideration contributed (or deemed contributed) by the employee in accordance with the provisions of § 1.72–8, computed as of such date, the special rule of section 72(d) shall not apply to amounts received as an annuity under the contract and the general rules of section 72 shall apply thereto.

(3) The aggregate of the amounts receivable as an annuity within the prescribed 3-year period shall be the total of all annuity payments anticipatable by an employee (or a beneficiary or beneficiaries of an employee, if the employee died before any amount was received as an annuity) under the contract as a whole as defined in paragraph (a) of § 1.72–2. See paragraph (a)(3) of § 1.72–2 for rules for determining what constitutes ''the contract'' in the case of distributions from an employees' trust or plan.

(4) If subparagraphs (1) and (3) of this paragraph apply to amounts received as an annuity under a contract, the rule prescribed in subparagraph (1) of this paragraph shall apply to all amounts so received thereunder regardless of the fact that they may be payable (i) to more than one beneficiary, (ii) for the same or different intervals, (iii) in different sums, or (iv) for a different period certain, life, or lives.

(5) For purposes of section 72(d), contributions which are made with respect to a self-employed individual and which are allowed as a deduction under section 404(a) are not considered contributions by the employee, but such contributions are considered contributions by the employer. A contribution which is deemed paid in a prior taxable year under the provisions of section 404(a)(6) shall be considered made with respect to a self-employed individual if the individual on whose behalf the contribution is made was self-employed for the taxable year in which the contribution is deemed paid, whether or not such individual is self-employed at the time the contribution is actually paid. Contributions with respect to a self-employed individual who is an owner-employee used to purchase life, accident, health, or other insurance protection for such owner-employee shall not be treated as consideration for the contract contributed by the employee in computing the employee contributions for purposes of section 72(d).

(b) *Amounts not received as an annuity.* If the rule of paragraph (a) of this section applies to a contract and, after the date on which an annuity payment is first received, amounts are received other than as an annuity under such contract in a taxable year to which the Code applies, they shall be included in the gross income of the recipient in accordance with the provisions of § 1.72–11. Thus, if such amounts are received as a dividend or a similar distribution after the date on which an amount is first received as an annuity under the contract, they shall be included in the gross income of the recipient (in accordance with section 72(e)(1)(A) and paragraph (b)(2) of § 1.72–11. All other amounts not received as an annuity shall be included in the gross income of the recipient in accordance with the provisions of section 72(e)(1)(B) and paragraph (c), (d), or (f), whichever is applicable, of §1.72–11. See section 72(e)(2).

(c) *Amounts received after the exhaustion of employee contributions.* (1) Amounts received under a contract to which the rule of paragraph (a) of this section applies (whether or not such amounts are received as an annuity) shall be included in the gross income of the recipient if such amounts are received after the date on which the aggregate of all amounts excluded from gross income by the recipients under section 72(d) and prior income tax laws equalled or exceeded the consideration contributed (or deemed contributed) by the employee.

(2) If the rule of paragraph (a) of this section applies to amounts received by an employee (or his beneficiary or beneficiaries) under a joint and survivor annuity contract, payments made to a prior annuitant may entirely exhaust the amounts excludable from gross income. In such case, amounts paid to the surviving annuitant (or annuitants) shall be included in gross income by such recipients.

(d) *Application of section 72(d) to a contract, trust, or plan providing for payments in a manner described in paragraph (b)(3)(i) of §1.72–2.* For the purpose of applying section 72(d) and this section, any amount received in the nature of a periodic payment under a contract, trust, or plan which provides for the payment of amounts in a manner described in paragraph (b)(3)(i) of §1.72–2 shall be considered an amount received as an annuity notwithstanding the provisions of any other section of the regulations under section 72. The special exclusion rule of section 72(d) and paragraph (a) of this section shall apply to all amounts so received if the first amount received, when multiplied by the number of periodic payments to be made within the three years beginning on the date of its receipt, results in an amount in excess of the aggregate premiums or other consideration contributed (or deemed contributed) by the employee as of that date. If more than one series of periodic payments is to be paid under the same contract, trust, or plan, all payments anticipatable, whether because fixed in amount or determinable in the manner described in the preceding sentence, shall be aggravated for the purpose of determining the applicability of section 72 (d) to the contract, trust, or plan as a whole.

(e) *Inapplicability of section 72(d) and this section.* Section 72(d) and this section do not apply to:

(1) Amounts received as proceeds of a life insurance contract to which section 101(a) applies, nor to

(2) Amounts paid to a surviving annuitant under a joint and survivor annuity contract to which paragraph (b)(3) of §1.72–5 applies, nor to

(3) Amounts paid to an annuitant under Chapter 73 of Title 10 of the United States Code with respect to which section 72(o) and §1.122–1 apply.

See also paragraph (d) of §1.72–14.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6497, 25 FR 10021, Oct. 20, 1960; T.D. 6676, 28 FR 10135, Sept. 17, 1963; T.D. 7043, 35 FR 8477, June 2, 1970]

§1.72–14 Exceptions from application of principles of section 72.

(a) *Payments of interest.* If any amount is received under an agreement to pay interest on a sum or sums held by the obligor, such amount shall not be excludable from the gross income of the recipient under the provisions of section 72 to the extent that it is an actual interest payment. See section 72(j). An amount shall be considered to be held under an agreement to pay interest thereon if the amount payable after the term of the annuity (whether for a term certain or for a life or lives) is substantially equal to or larger than the aggregate amount of premiums or other consideration paid therefor. For this purpose, however, the aggregate amount of premiums or other consideration paid shall include all contributions made by an employer and not merely those to which section 72(f) applies.

(b) *Alimony payments.* To the extent that payments made to a wife are includable in her gross income by reason of either or both section 71 and 682, they shall not be excluded from the wife's gross income under the principles of section 72 although made under a contract to which that section applies. However, section 72 shall apply in the case of amounts received under such a contract if a husband and wife are entitled to make and do make a single return jointly.

(c) *Certain ''face-amount certificates.''* The principles of section 72 do not apply to ''face-amount certificates'' described in section 72(1) which were issued before January 1, 1955.

(d) *Employer plans.* The provisions of §§ 1.72–1 to 1.72–13, inclusive, shall be disregarded to the extent that they are inconsistent with the treatment of amounts received provided in section 402 (relating to the taxability of a beneficiary of an employees' trust), section 403 (relating to the taxation of employee annuities), or the regulations under either of such sections.

§ 1.72–15 Applicability of section 72 to accident or health plans.

(a) *Applicability of section.* This section provides the rules for determining the taxation of amounts received from an employer-established plan which provides for distributions that are taxable under section 72 (or for distributions that are taxable under section 402 (a)(2) or (e), or section 403(a)(2), in the case of lump sum distributions) and which also provides for distributions that may be excludable from gross income under section 104 or 105 as accident or health benefits. For example, this section will apply to a pension plan described in section 401 and exempt under section 501 which provides for the payment of pensions at retirement and the payment of an earlier pension in the event of permanent disability. This section will also apply to a profit-sharing plan described in section 401 and exempt under section 501 which provides for periodic distribution of the amount standing to the account of a participant during any period that the participant is absent from work due to a personal injury or sickness and for the distribution of any balance standing to the account of the participant upon his separation from service. For purposes of this section, the term ''contributions of the employee'' includes contributions by the employer which were includible in the employee's gross income. For special rules for taxable years ending before January 27, 1975, relating to certain accident or health benefits which were treated as distributions to which section 72 applied, see paragraph (i) of this section.

(b) *General rule.* Section 72 does not apply to any amount received as an accident or health benefit, and the tax treatment of any such amount shall be determined under sections 104 and 105. See paragraphs (c) and (d) of this section, paragraph (d) of § 1.104–1, and §§ 1.105–1 through 1.105–5. Section 72 (or, in the case of certain total distributions, section 402(a)(2) or section 403(a)(2)) does apply to any amount which is received under a plan to which this section applies and which is not an accident or health benefit. See paragraph (e) of this section.

(c) *Accident or health benefits attributable to employee contributions.* (1) If a plan to which this section applies provides that any portion of the accident or health benefits is attributable to the contributions of the employee to such plan, then such portion of such benefits is excludable from gross income under section 104(a)(3) and paragraph (d) of § 1.104–1. Neither section 72 nor section 105 applies to any accident or health benefits (whether paid before or after retirement) attributable to contributions of the employee. Since such portion is excludable under section 104(a)(3), such portion is not subject to the dollar limitation of section 105(d) and if such portion is payable after the retirement of the employee, it is excludable without regard to the provisions of § 1.105–4 and section 72.

(2) In determining the taxation of any amounts received as accident or health benefits from a plan to which this secton applies, the first step is to determine the portion, if any, of the contributions of the employee which is used to provide the accident or health benefits and the portion of the accident or health benefits attributable to such portion of the employee's contributions. If such a plan expressly provides that the accident or health benefits are provided in whole or in part by employee contributions and the portion of employee contributions to be used for such purpose, the contributions so used will be treated as used to provide accident or health benefits. However, if the plan does not expressly provide that the accident or health benefits are to

be provided with employee contributions and the portion of employee contributions to be used for such purpose, it will be presumed that none of the employee contributions is used to provide such benefits. Thus, in the case of a contributory pension plan, it will be presumed that the disability pension is provided by employer contributions, unless the plan expressly provides otherwise, or in the case of a contributory profit-sharing plan providing that a portion of the amount standing to the account of each participant will be used to purchase accident or health insurance, it will be presumed that such insurance is purchased with employer contributions, unless the plan expressly provides otherwise. Similarly, unless the plan expressly provides otherwise, it will be presumed that if a contributory profit-sharing plan provides for periodic distributions from the account of a participant during any absence from work because of a personal injury or sickness, all such distributions which do not exceed the contributions of the employer plus earnings thereon are provided by employer contributions.

(3) Any employee contributions that are treated under subparagraph (2) of this paragraph as used to provide accident or health benefits shall not be included for any purpose under section 72 as employee contributions or as aggregate premiums or other consideration paid. Thus, in the case of a pension plan, or in the case of a profit-sharing plan providing that a portion of the amount standing to the account of each participant will be used to purchase accident or health insurance, any employee whose contributions are so used must make the adjustment provided by this subparagraph irrespective of whether such employee receives any accident or health benefits under such plan. However, in the case of a profit-sharing plan providing for periodic distributions from the account of a participant during any absence from work because of a personal injury or sickness, an adjustment under this subparagraph is required only when an employee receives distributions in excess of the employer contributions and earnings thereon or receives distributions consisting in whole or in part of his own contributions.

(4) If any of the employee contributions are treated under subparagraph (2) of this paragraph as used to provide any of the accident or health benefits, the portion of the benefits attributable to employee contributions shall be determined in accordance with §1.105–1. Any accident or health benefits that are excludable under section 104(a)(3) shall not be included in the expected return for purposes of section 72.

(d) *Accident or health benefits attributable to employer contributions.* Any amounts received as accident or health benefits and not attributable to contributions of the employee are includable in gross income except to the extent that such amounts are excludable from gross income under section 105 (b), (c), or (d) and the regulations thereunder. Thus, such amounts may be excludable under section 105(d) as payments under a wage continuation plan. However, if such payments, when added to other such payments attributable to employer contributions, exceed the limitations of section 105(d), then the excess is includable in gross income under section 105(a). Such excess is not excludable under section 72. See, however, paragraph (i) of this section, for special rules for taxable years ending before January 27, 1975, relating to certain accident or health benefits which were treated as distributions to which section 72 applied.

(e) *Other benefits under the plan.* The taxability of amounts that are received under a plan to which this section applies and that are not accident or health benefits is determined under section 72 (or, in the case of certain total distributions, under section 402(a)(2) or section 403(a)(2)) without regard to any exclusion or inclusion of accident or health benefits under sections 104 and 105. For example, the investment in the contract or aggregate premiums paid is determined without regard to the exclusion of any amount under section 104 or 105, and the annuity starting date is determined without regard to the receipt of any accident or health benefits. However, if any employee contributions are used to provide any accident or health benefits, the investment in the contract or aggregate premiums paid must be adjusted as provided in paragraph (c)(3) of this section.

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

Example (1). A, an employee, is a participant in a contributory pension plan described in section 401(a) and exempt under section 501(a). Such plan provides for the payment of a pension to each participant when he retires at age 65 or when he retires earlier if the retirement is due to permanent and total disability. In 1964, A, who was age 52, became totally and permanently disabled because of an injury, was hospitalized, and commenced to receive a pension of $74 a week under this plan. The weekly amounts received by A do not exceed 75 percent of his ''regular weekly rate of wages'' under section 105(d). A had contributed $11,500 to the plan. The plan does not expressly provide that any portion of the disability pension is purchased with employee contributions. Accordingly, it is presumed that no portion of the disability pension is purchased with A's contributions. The disability pension which A receives qualifies as payments under a wage continuation plan for purposes of section 105(d) and § 1.105–4, and if such payments are the only accident or health benefits which are attributable to the contributions of his employer, such payments are entirely excludable under section 105(d) until A reaches age 65, his mandatory retirement age under the plan. The payments which A receives after he becomes age 65 are taxable under section 72. The payments which A receives do constitute an annuity as defined in paragraph (b) of § 1.72–2, but since the amounts which he will receive during the first three years after attaining age 65 exceed his contributions, he shall exclude under § 1.72–13 the entire amount of all payments that he receives as an annuity after attaining age 65 until such amounts equal his contributions to the plan, or $11,500. Thereafter, the payments that he receives under the plan are includible in gross income.

Example (2). B, an employee, is a participant in a contributory profit-sharing plan described in section 401(a) and exempt under section 501(a). Such plan provides that, in the event a participant is absent from work because of a personal injury or sickness, he will be paid $125 a week out of his account in such plan. Such weekly amount does not exceed 75 percent of B's ''regular weekly rate of wages'' under section 105(d). Any amount standing to the account of a participant at the time of his separation from service will be paid to him at such time. During 1964, B incurred a personal injury, was hospitalized, and as a result was absent from work for nine weeks. He received nine weekly payments of $125, or a total of $1,125, on account of such absence from work. At the time B was injured, he had contributed $5,000 to the plan. The plan did not expressly provide that a participant's contributions are to be used to provide for the distributions during disability. Accordingly, it is presumed that B's contributions were not used to provide the accident or health benefits under the plan. Since these weekly payments are paid because of B's absence from work due to the injury, and since such payments are considered as attributable to contributions of his employer, such payments are required under section 105(a) to be included in B's gross income except to the extent that they are excludable under section 105(d). If B receives no other payments under a wage continuation plan attributable to contributions of his employer, during the first 30 days in the period of absence $75 of each weekly payment is excludable from gross income under section 105(d), but $50 of each weekly payment is includable in gross income under section 105(a). Amounts attributable to the period of absence in excess of 30 days are excludable from gross income under section 105(d) to the extent of $100 a week and includible in gross income under section 105(a) to the extent of $25 a week. The excludable portion of payments does not reduce B's investment in the contract or the amount of premiums considered to have been paid by B for purposes of any subsequent computations under section 72.

Example (3). The facts are the same as in example (2) except that B was absent from work for 130 weeks. At the time B was injured, his employer had contributed $10,000 to the plan on his account, and $6,000 of earnings of the plan had been allocated to his account. Thus, at the time he was injured, B's account included $21,000, and $14,000 of such amount consists of employer contributions of $10,000 plus earnings of $4,000 thereon. The first 112 weekly payments (totaling $14,000) which B receives are treated in the manner set forth in example (2). However, since the remaining payments exceed the employer contributions plus earnings thereon, such remaining payments are considered to be distributions of B's contributions plus earnings thereon. Since the total of such payments, or $2,250, is less than B's contributions to the plan, $5,000, the entire amount of such payments is excludable from B's gross income, but a corresponding adjustment with respect to the return of B's contributions shall be made to his consideration in determining the taxation of any lump sum paid to B upon separation from service.

(g) *Payments to or on behalf of a self-employed individual.* A self-employed individual is not considered an employee for purposes of section 105, relating to amounts received by employees under accident and health plans, nor for purposes of excluding under section 104(a)(3) amounts received by him under an accident and health plan as referred to in section 105(e). See section 105(g) and paragraph (a) of §1.105–1. Therefore, the other paragraphs of this section are not applicable to amounts received by or on behalf of a self-employed individual. Except where accident or health benefits are provided through an insurance contract or an arrangement having the effect of insurance, all amounts received by or on behalf of a self-employed individual from a plan described in section 401(a) and exempt under section 501(a) or a plan described in section 403(a) shall be taxed as otherwise provided in section 72, 402, or 403. If the accident or health benefits are paid under an insurance contract or under an arrangement having the effect of insurance, section 104(a)(3) shall apply. Section 72 shall not apply to any amounts received under such circumstances. For the treatment of the amounts paid for such accident or health benefits, see section 404(e)(3) and paragraph (f) of §1.404(e)–1.

(h) *Medical benefits for retired employees, etc.* Employer contributions to provide medical benefits described in section 401(h) under a qualified pension or annuity plan are not includible in the gross income of the employee on whose behalf such contributions were made. Similarly, if the trustee of a trust forming a part of a qualified pension plan applies employer contributions which have been contributed to provide medical benefits described in section 401(h) or earnings thereon, to purchase insurance contracts which provide such benefits, the amount so applied is not includible in the gross income of the employee on whose behalf such insurance was purchased. The payment of medical benefits described in section 401(h) as defined in paragraph (a) of §1.401–14 under a plan established by an employer shall be treated in the same manner as the payment of any other accident or health benefits under an employer-established plan. See paragraphs (b), (c), and (d) of this section.

(i) *Special rules.* (1) Special rule for taxable years ending before January 27, 1975. A taxpayer who has reached retirement age, as defined in §1.79–2(b)(3) (hereinafter referred to as ‘‘initial retirement age’’), before January 27, 1975, and who has received payments under a plan described in paragraph (a) of this section, which are wage continuation benefits to which section 105(d) and this section apply, or which are treated as such by reason of the employee having so agreed under §1.105–6, shall be entitled to an exclusion, in taxable years ending before January 27, 1975, with respect to payments received after initial retirement age but before mandatory retirement age, as defined in §1.105–4(a)(3)(i)(B), which is the greater of:

(i) The amount actually excluded on an original return under section 72 (b) or (d) with respect to payments received after initial retirement age, to the extent such amount does not exceed an amount properly excludable under section 72 (b) or (d) if this paragraph and paragraph (b) of this section did not apply; or

(ii) The amount that would have been properly excludable under section 105(d) during the same period.

(2) *Investment in the annuity contract.* A taxpayer described in paragraph (i)(1) of this section, shall redetermine his investment in, consideration for, or basis of his annuity contract (hereinafter referred to in this paragraph as the ‘‘investment in the contract’’) in accordance with the applicable rules of section 72 and the regulations thereunder, and the rules of this paragraph. In making such redetermination the taxpayer’s investment in his contract shall be decreased, by the excess (if any) of the amount which the taxpayer is entitled to exclude under paragraph (i)(1) of this section over the amount which could have been excluded under section 105(d) (subject to the limitations contained in such provision). Such investment in the contract shall be decreased only by the excess of the amount excluded under section 72 in taxable years ending before January 27, 1975, over the amount which could have been excluded under section 105(d) during the same period. For example, the investment in the contract shall not be decreased in the case of an individual who was retired from work on account

of injury or sickness or a full taxable year, if the amount excluded under section 72 was less than $5,200, since the entire amount could have been excluded under section 105(d). On the other hand, if the amount excluded under section 72 was equal to or greater than $5,200 for a full taxable year, for example, $6,000 for the full taxable year, then $5,200 shall be treated as excluded under section 105(d) and the investment in the contract shall be reduced by $800 ($6,000 − $5,200).

(3) *Surviving annuitants and beneficiaries.* (i) The rights of a surviving annuitant or beneficiary, with respect to the application of the rules of section 72, shall be based on the employee's investment in his annuity contract, as adjusted in accordance with the provisions of this paragraph. Thus, where an employee dies after having recomputed his investment as provided in paragraph (i)(2) of this section, and his contract provided a survivorship element, the survivor would assume the employee's recomputed investment for purposes of determining excludability of amounts under section 72.

(ii) Where a beneficiary failed to increase the amount treated as an employee's contribution toward his annuity contract to reflect the employee death benefit under section 101(b) and §1.72–8(b), because the employee had treated his initial retirement age as his annuity starting date, such beneficiary may apply section 101(b) as if the appropriate addition to basis had been made in the year of the employee's death, but only if the employee had not reached his mandatory retirement age (as defined in section §1.105–4(a)(3)(i)(B)). For purposes of this paragraph, the amount treated as the secton 101(b) death benefit would be valued as of the date of the employee's death.

(4) *Records.* (i) For purposes of section 72 (b) and (d), and this section, the taxpayer shall maintain such records as are necessary to substantiate the amount treated as his investment in his annuity contract.

(ii) The Commissioner may prescribe a form and instructions with respect to the taxpayer's past and current treatment of amounts received under section 72 or 105, and the taxpayer's computation, or recomputation, of his investment in his annuity contract. Such form may be required to be filed with the taxpayer's returns for years in which amounts are excluded under section 72 or 105.

(5) *Cross references.* (i) See section 72(b)(4) and §1.72–4(b) with respect to annuity starting dates.

(ii) See §§1.72–8(b) and 1.101–2(a)(2) with respect to treating certain amounts received by an estate or beneficiary as employee death benefits.

(iii) See §1.105–4(a)(3)(i)(B) for the definition of ‘‘mandatory retirement age.’’

(iv) See §1.105–6 with respect to the application of section 105(d) to certain amounts received as retirement annuities before January 27, 1975, where the employee would otherwise have been eligible for benefits to which section 105(d) applies.

(6) *Examples.* The provisions of this paragraph may be illustrated by the following examples. In such examples assume that the plan does not expressly provide that any portion of the disability pension is purchased with employee contributions. Accordingly, it is presumed that no portion of the disability pension is purchased with employee contributions. Also, assume that in each case the taxpayer retired only after he had been absent from work for at least 30 days on account of personal injuries or sickness:

Example (1). A, a calendar year taxpayer, retired because of disability on January 1, 1968, his 58th birthday, receiving $80 per week ($4,160 per year) under a plan which qualifies as a wage continuation plan under section 105(d) and §1.105–4. Under the plan, A's initial retirement age is age 60 (January 1, 1970), and his mandatory retirement age is 65 (January 1, 1975). A's consideration for the contract was $10,000. For payments received in 1968 and 1969 A excluded the entire amount under section 105(d). Payments received with respect to periods after A's initial retirement age (January 1, 1970) were excluded under section 72(d) until his entire $10,000 consideration for his contract had been excluded. Thus, A applied section 72(d) to exclude $4,160 each year for taxable years 1970 and 1971, and $1,680 ($10,000 − ($4,160+$4,160)) for 1972. In late 1974 A realized that he was entitled to treat the full amount received under his annuity as excludable under secton 105(d) rather than section 72 for the taxable years 1970 through 1974. Consequently, A filed amended returns for 1972 and 1973 excluding an additional $2,480 ($4,160 − $1,680) and $4,160, respectively, claiming refunds based upon such additional exclusions. Moreover, A's annuity starting date is January 1, 1975 (A's mandatory retirement age), and he excludes under section 72(d) for 1975, 1976, and 1977, $4,160, $4,160 and $1,680 ($10,000 − ($4,160+$4,160)), respectively.

Example (2). B, a calendar year taxpayer retired because of disability, July 1, 1970, on his 58th birthday, receiving $1,000 per month under a plan which qualifies as a wage continuation plan for purposes of section 105(d) and § 1.105–4. Under the plan, B's initial retirement age is age 60 (July 1, 1972), and his mandatory retirement age is 65 (July 1, 1977). B's consideration for the contract was $25,000. For payments received in 1970 and 1971 B excluded under section 105(d) $2,600 and $5,200, respectively, of the $6,000 (6×$1,000) and $12,000 (12×$1,000) received under the plan. For the period January 1, 1972, through June 30, 1972, B excluded an additional $2,600 under section 105(d). For the period July 1, 1972, through December 31, 1972, B excluded under section 72(d)(1) the entire $6,000 in payments received under the plan. Similarly, under section 72(d)(1), B excluded the entire $12,000 in payments received under the plan in 1973, and in 1974 B excluded the remaining $7,000 of his annuity basis. In 1975, B realized that he will be entitled to take full advantage of the exclusion under section 105(d) for periods through June 30, 1977, when he would reach age 65. B need not file amended returns for 1972, 1973, and 1974, even though the amounts he excluded under section 72(d) (exceeded the amount he was entitled to exclude under section 105(d)). He must, however, recompute the amount that will be treated as his investment in his annuity contract. Thus, on July 1, 1977, B's annuity starting date, his investment in his annuity contract would be $13,000, recomputed as follows:

B's original investment	$25,000
Less amounts excluded under section 72 to the extent they exceed amounts that would have been excludable during the same period under section 105(d):	
1972 ($6,000 − 2,600)	3,400
1973 ($12,000 − 5,200)	6,800
1974 ($7,000 − 5,200)	1,800
Total	12,000
B's recomputed investment in his annuity contract	$13,000

Example (3). Assume the same facts as in example (2) except that B's investment in his annuity contract is $37,000, and he excluded under section 72(b) 16.9 percent, or $2,028, of the $12,000 received per year. Thus, for the period July 1, 1972, through December 31, 1972, B excluded under section 72(b) $1,014 (16.9 percent of $6,000), and $2,028 in both 1973 and 1974. B files amended returns for 1972, 1973 and 1974 claiming the exclusion under section 105(d). Thus, B restored to income $1,014 for 1972, and $2,028 for both 1973 and 1974, claiming $2,600 ($5,200 − $2,600) exclusion under section 105(d) for 1972 and a $5,200 exclusion in both 1973 and 1974. Thus, for 1972 B is entitled to an additional exclusion of $1,586 ($2,600 − $1,014), and, for both 1973 and 1974, an additional exclusion of $3,172 ($5,200 − $2,028). On July 1, 1977, B's investment in the contract is $37,000.

Example (4). C, a calendar year taxpayer, retired because of disability on January 1, 1965, his 58th birthday, receiving payments of $500 per month under a plan which qualifies as a wage continuation plan for purposes of section 105(d) and § 1.105–4. C had contributed $18,000 toward the cost of his annuity contract. Under the plan, C's initial retirement age is age 60 (January 1, 1967) and C's mandatory retirement age is age 70 (January 1, 1977). For taxable years 1965 and 1966 C excluded from gross income under section 105(d) $5,200 of the $6,000 (12×$500) he received from his employer as wage continuation benefits. On January 1, 1967, C began excluding all of the benefits C received in accordance with the rules of section 72(d). Thus, for 1967, 1968 and 1969, C excluded 100 percent of the annuity payments. For his taxable years 1970 through 1973, C included in his gross income all annuity payments. In 1974, C realized that he will be entitled to use the exclusion under section 105(d) through December 31, 1976 (until he reaches age 70). In 1974, C filed a timely claim for refund for his taxable years 1971, 1972, and 1973 (refunds for taxable year 1970 and prior years were barred by the statute of limitations), and continues to claim the exclusion under section 105(d) for 1974, 1975, and 1976. For 1977, C treats January 1, 1977, as the annuity starting date, and treats $15,600 as the investment in the contract. The $15,600 represents the $18,000 original investment in the contract reduced by the excess, $2,400, of the amount excluded under section 72 for 1967, 1968 and 1969 ($18,000) over the amount excludable under section 105(d) ($5,200×3) for such years.

Example (5). (i) D, a calendar year taxpayer, retired because of disability on June 30, 1965, receiving $100 per month under a plan which qualifies as a wage continuation plan for purposes of section 105(d) and § 1.105–4. Under the plan, the initial retirement age of D, whose birthday is January 1, is age 60 (January 1, 1967), and D's mandatory retirement age is age 70 (January 1, 1977). D had contributed $6,000 toward the cost of the annuity contract under such plan. For 1965 and 1966, D excluded under section 105(d) the entire amount received under the plan ($1600 and $1,200 respectively). For 1967 through 1973, D excluded $330 per year under section 72(b), or 27.5 percent of the $1,200 payment received under the plan per year.

(ii) In 1974, D realized that he will be entitled to use the exclusion provided in section

105(d) up until January 1, 1977, when he reaches his mandatory retirement age, and that he improperly applied section 72 to payments received in the years 1967 through 1973. In 1974, D filed a timely claim for refund with respect to the section 105(d) wage continuation benefits, for 1971, 1972 and 1973 (refunds for taxable year 1970 and prior years were barred by the statute of limitations), and continues to claim the section 105(d) exclusion for 1974, 1975 and 1976. D is entitled to an additional exclusion of $870 ($1,200 − $330) for each of the years 1971, 1972 and 1973.

(iii) Upon reaching mandatory retirement age on January 1, 1977, D treats such date as the annuity starting date, and treats $6,000 as the investment in the contract. The investment in the contract is not reduced, because the amount excluded under section 72(b) for 1967 through 1970 ($330 per year) does not exceed the amount excludable under section 105(d) ($1,200 per year), and the $330 per year excluded for 1971, 1972, and 1973 were restored to the investment in the contract. Therefore, assuming that D would be entitled to exclude 41.3 percent of the payments under the plan if the annuity starting date is January 1, 1977, D would be entitled to exclude $495.60 (41.3 percent of $1,200) per annum.

Example (6). Assume the facts stated in example (5) except that D's investment in his annuity contract is $100,000 and he received payments equaling $10,000 per year. Assume also, that D had excluded under section 72(b) 54.9 percent of the payments received under the plan through 1974. Consequently, he excluded $5,490 (54.9 percent of $10,000) from his gross income for the years 1967 through 1974. D need not file amended returns for 1971, 1972, 1973, and 1974, even though the amount he excluded under section 72(b) exceeded the amounts he was entitled to exclude under section 105(d). He must, however, recompute the amount that will be treated as his investment in his annuity contract. Thus, on January 1, 1977, D's annuity starting date, his investment in his annuity contract would be $97,680. This figure represents the original investment ($100,000) reduced by the amount excluded under section 72(b) for the years 1967–1974 (8×$5,490=$43,920) over the amount properly excludable during those years under section 105(d) ($5,200×8=$41,600).

Example (7). Assume the same facts as in example (6) except that D's mandatory retirement age is 63 (January 1, 1970). D would redetermine his exclusion ratio for purposes of section 72(b) as of January 1, 1970, since D's mandatory retirement age is D's annuity starting date. D would treat $99,130 as his investment in his annuity contract as of such date for purposes of section 72(b). Assuming refunds for 1970 and prior taxable years were barred by the statute of limitations, the $99,130 represents the original investment of $100,000 reduced by the excess of the amount excluded under section 72(b) for 1967, 1968, and 1969 ($5,490×3=$16,470) over the amount otherwise excludable during those years under section 105(d) ($5,200×3=$15,600). Therefore, assuming that D would be entitled to exclude 61.2 of the payments received under the plan if the annuity starting date is January 1, 1970, D would be entitled to exclude $6,120 (61.2 percent of the $10,000 received under the plan) per annum for 1971 and subsequent years. However, D is not entitled to exclude the additional $630 ($6,120 − $5,490) for 1970, because credit or refund for 1970 and prior years is barred by the statute of limitations.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10135, Sept. 17, 1963; T.D. 6722, 29 FR 5069, Apr. 14, 1964; T.D. 6770, 29 FR 15366, Nov. 17, 1964; T.D. 7352, 40 FR 16664, Apr. 14, 1975]

§ 1.72–16 Life insurance contracts purchased under qualified employee plans.

(a) *Applicability of section.* This section provides rules for the tax treatment of premiums paid under qualified pension, annuity, or profit-sharing plans for the purchase of life insurance contracts and rules for the tax treatment of the proceeds of such a life insurance contract and of annuity contracts purchased under such plans. For purposes of this section, the term ''life insurance contract'' means a retirement income, an endowment, or other contract providing life insurance protection. The rules of this section apply to plans covering only common-law employees as well as to plans covering self-employed individuals.

(b) *Treatment of cost of life insurance protection.* (1) The rules of this paragraph are applicable to any life insurance contract—

(i) Purchased as a part of a plan described in section 403(a), or

(ii) Purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) if the proceeds of such contract are payable directly or indirectly to a participant in such trust or to a beneficiary of such participant.

The proceeds of a contract described in subdivision (ii) of this subparagraph will be considered payable indirectly to a participant or beneficiary of such participant where they are payable to the trustee but under the terms of the plan the trustee is required to pay over all of such proceeds to the beneficiary.

(2) If under a plan or trust described in subparagraph (1) of this paragraph, amounts which were allowed as a deduction under section 404, or earnings of the trust, are applied toward the purchase of a life insurance contract described in subparagraph (1) of this paragraph, the cost of the life insurance protection under such contract shall be included in the gross income of the participant for the taxable year or years in which such contributions or earnings are so applied.

(3) If the amount payable upon death at any time during the year exceeds the cash value of the insurance policy at the end of the year, the entire amount of such excess is considered current life insurance protection. The cost of such insurance will be considered to be a reasonable net premium cost, as determined by the Commissioner, for such amount of insurance for the appropriate period.

(4) The amount includible in the gross income of the employee under this paragraph shall be considered as premiums or other consideration paid or contributed by the employee only with respect to any benefits attributable to the contract (within the meaning of paragraph (a)(3) of § 1.72–2) providing the life insurance protection. However, if under the rules of this paragraph an owner-employee is required to include any amounts in his gross income, such amounts shall not in any case be treated as part of his investment in the contract.

(5) The determination of the cost of life insurance protection may be illustrated by the following example:

Example. An annual premium policy purchased by a qualified trust for a common-law employee provides an annuity of $100 per month upon retirement at age 65, with a minimum death benefit of $10,000. The insurance payable if death occurred in the first year would be $10,000. The cash value at the end of the first year is 0. The net insurance is therefore $10,000 minus 0, or $10,000. Assuming that the Commissioner has determined that a reasonable net premium cost for the employee's age is $5.85 per $1,000, the premium for $10,000 of life insurance is therefore $58.50, and this is the amount to be reported as income by the employee for his taxable year in which the premium is paid. The balance of the premium is the amount contributed for the annuity, which is not taxable to the employee under a plan meeting the requirements of section 401(a), except as provided under section 402(a). Assuming that the cash value at the end of the second year is $500, the net insurance would then be $9,500 for the second year. With a net 1-year term rate of $6.30 for the employee's age in the second year, the amount to be reported as income to the employee would be $59.85.

(6) This paragraph shall not apply if the trust has a right under any circumstances to retain any part of the proceeds of the life insurance contract. But see paragraph (c)(4) of this section relating to the taxability of the distribution of such proceeds to a beneficiary.

(c) *Treatment of proceeds of life insurance and annuity contracts.* (1) If under a qualified pension, annuity, or profit-sharing plan, there is purchased either—

(i) A life insurance contract described in paragraph (b)(1) of this section, and the employee either paid the cost of the insurance or was taxable on the cost of the insurance under paragraph (b) of this section, or

(ii) An annuity contract,

the amounts payable under any such contract by reason of the death of the employee are taxable under the rules of subparagraph (2) of this paragraph, except in the case of a joint and survivor annuity.

(2)(i) In the case of an annuity contract, the death benefit is the accumulation of the premiums (plus earnings thereon) which is intended to fund pension or other deferred benefits under a pension, annuity, or profit-sharing plan. Such death benefits are not in the nature of life insurance and are not excludable from gross income under section 101(a).

(ii) In the case of a life insurance contract under which there is a reserve accumulation which is intended to fund pension or other deferred benefits under a pension, annuity, or profit-sharing plan, such reserve accumulation constitutes the source of the cash value of the contract and approximates the amount of such cash value. The portion of the proceeds paid upon the death of the insured employee which is equal to the cash value immediately before death is not excludable from gross income under section 101(a). The remaining portion, if any, of the proceeds paid to the beneficiary by reason of the death of the insured employee—that is, the amount in excess of the cash value—constitutes current insurance protection and is excludable under section 101(a).

(iii) The death benefit under an annuity contract, or the portion of the death proceeds under a life insurance contract which is equal to the cash value of the contract immediately before death, constitutes a distribution under the plan consisting in whole or in part of deferred compensation and is taxable to the beneficiary in accordance with section 72(m)(3) and the provisions of this paragraph, except to the extent that the limited exclusion from income provided in section 101(b) is applicable.

(iv) In the case of a life insurance contract under which the benefits are paid at a date or dates later than the death of the employee, section 101(d) is applicable only to the portion of the benefits which is attributable to the amount excludable under section 101(a). The portion of such benefits which is attributable to the cash value of the contract immediately before death is taxable under section 72, and in such case, any amount excludable under section 101(b) is treated as additional consideration paid by the employee in accordance with section 101(b)(2)(D).

(3) The application of the rules under subparagraph (2) of this paragraph with respect to the taxability of proceeds of a life insurance contract paid by reason of the death of an insured common-law employee who has paid no contributions under the plan is illustrated by the following examples:

Example (1).

Total face amount of the contract payable in a lump sum at time of death	$25,000
Cash value of the contract immediately before death	11,000
Excess over cash value, excludable under section 101(a)	14,000
Cash value subject to limited exclusion under section 101(b)	11,000
Excludable under section 101(b) (assuming that there is no other death benefit paid by or on behalf of any employer with respect to the employee)	5,000
Balance taxable in accordance with section 402(a)(2) or 403(a)(2) (assuming a total distribution in one taxable year of the distributee)	6,000
Portion of premiums taxed to employee under the provisions of paragraph (b) of this section and considered as contributions of the employee	940
Balance taxable as long-term capital gain	5,060

Example (2). The facts are the same as in example (1), except that the contract provides that the beneficiary may elect within 60 days after the death of the employee either to take the $25,000 or to receive 10 annual installments of $3,000 each, and the beneficiary elects to receive the 10 installments. In addition, the employee's rights to the cash value immediately before his death were forfeitable at least to the extent of $5,000. Section 101(d) is applicable to the amount excludable under section 101(a), that is, $14,000. The portion of each annual installment of $3,000 which is attributable to this $14,000 is determined by allocating each installment in accordance with the ratio which this $14,000 bears to the total amount which was payable at death ($25,000). Accordingly, the portion of each annual installment which is subject to section 101(d) is $1,680 (14/25 of $3,000), of which $1,400 (1/10 of $14,000) is excludable under section 101(a), and the remaining $280 is includible in the gross income of the beneficiary. However, if the beneficiary is a surviving spouse as defined in section 101(d)(3), the exclusion provided by section 101(d)(1)(B) is applicable to such $280. The remaining portion of each annual $3,000 installment, $1,320, is attributable to the cash value of the contract and is treated under section 72, as follows:

Amount actually contributed by the employee	0
Amount considered contributed by employee by reason of section 101(b)	$5,000
Portion of premiums taxed to employee under the provisions of paragraph (b) of this section and considered as contributions of the employee	$940
Investment in the contract	$5,940
Expected return, 10×$1,320	$13,200
Exclusion ratio, $5,940÷$13,200	0.45
Annual exclusion, 0.45×$1,320	$594

Accordingly, $594 of the $1,320 portion of each annual installment is excludable each year under section 72, and the remaining $726 is includible. Thus, if the beneficiary is not a surviving spouse, a total of $1,006 ($280 plus $726) of each annual $3,000 installment is includible in income each year. If the beneficiary is a surviving spouse, and can exclude all of the $280 under section 101(d)(1)(B), the amount includible in gross income each year is $726 of each annual $3,000 installment.

(4) If an employee neither paid the total cost of the life insurance protection provided under a life insurance contract, nor was taxable under paragraph (b) of this section with respect

thereto, no part of the proceeds of such a contract which are paid to the beneficiaries of the employee as a death benefit is excludable under section 101(a). The entire distribution is taxable to the beneficiaries under section 402(a) or 403(a) except to the extent that a limited exclusion may be allowable under section 101(b).

[T.D. 6676, 28 FR 10135, Sept. 17, 1963]

§1.72–17 Special rules applicable to owner-employees.

(a) *In general.* Under section 401(c) and section 403(a), certain self-employed individuals may participate in qualified pension, annuity, and profit-sharing plans, and the amounts received by such individuals from such plans are taxable under section 72. Section 72(m) and this section contain special rules for the taxation of amounts received from qualified pension, profit-sharing, or annuity plans covering an owner-employee. For purposes of section 72 and the regulations thereunder, the term ‘‘employee’’ shall include the self-employed individual who is treated as an employee by section 401(c)(1) (see paragraph (b) of §1.401–10), and the term ‘‘owner-employee’’ has the meaning assigned to it in section 401(c)(3) (see paragraph (d) of §1.401–10). See also paragraph (a)(2) of §1.401–10 for the rule for determining when a plan covers an owner-employee. For purposes of this section, a self-employed individual may not treat as consideration for the contract contributed by the employee any contributions under the plan for which deductions were allowed under section 404 and which, consequently, are considered employer contributions.

(b) *Certain amounts received before annuity starting date.* (1) The rules of this paragraph are applicable to amounts received from a qualified pension, profit-sharing, or annuity plan by an employee (or his beneficiary) who is or was an owner-employee with respect to such plan when such amounts—

(i) Are received before the annuity starting date; and

(ii) Are not received as an annuity.

For the definition of annuity starting date, see paragraph (b) of §1.72–4 and subparagraph (4) of this paragraph. As to what constitutes amounts not received as an annuity, see paragraphs (c) and (d) of §1.72–11.

(2) Amounts to which this paragraph applies shall be included in the recipient’s gross income for the taxable year in which received. However, the sum of the amounts so included under this subparagraph in all taxable years shall not exceed the aggregate deductions allowed under section 404 for premiums or other consideration paid under the plan on behalf of the employee while he was an owner-employee, including any such deductions taken in the taxable year of receipt.

(3) Any amounts to which this paragraph applies and which are not includible in gross income under the rules of subparagraph (2) of this paragraph shall be subject to the provisions of section 72(e) and §1.72–11. However, for taxable years beginning before January 1, 1964, section 72(e)(3), as in effect before such date, shall not apply to such amounts. For taxable years beginning after December 31, 1963, such amounts (other than amounts subject to a penalty under section 72(m)(5) and paragraph (e) of this section) may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(4) Under section 401(d)(4), a qualified pension, profit-sharing, or annuity plan may not provide for distributions to an owner-employee before he reaches age 59½ years, except in the case of his earlier disability. Therefore, in the case of a distribution from a qualified plan to an individual for whom contributions have been made to the plan as an owner-employee, the annuity starting date cannot be prior to the time such individual attains the age 59½ years unless he is entitled to benefits before reaching such age because of his disability. For taxable years beginning after December 31, 1966, see section 72(m)(7) and paragraph (f) of this section for the meaning of disabled. For taxable years beginning before January 1, 1967, see section 213(g)(3) for the meaning of disabled.

(5) The rules of this paragraph are not applicable to amounts credited to an individual in his capacity as a policy-holder of an annuity, endowment, or life insurance contract which are in the nature of a dividend or refund of

premium, and which are applied in accordance with paragraph (a)(4) of § 1.404(a)–8 towards the purchase of benefits under the policy.

(6) The rules of this paragraph may be illustrated by the following example:

Example. B, a self-employed individual, received $8,000 as a distribution under a qualified pension plan before the annuity starting date. At the time of such distribution, $10,000 had been contributed (the whole amount being allowed as a deduction) under the plan on behalf of such individual while he was a common-law employee and $5,000 had been contributed under the plan on his behalf while he was an owner-employee, of which $2,500 was allowed as a deduction. In addition, B had contributed $1,000 on his own behalf as an employee under the plan. Of the $8,000, $2,500 (the amount allowed as a deduction with respect to contributions on behalf of the individual while he was an owner-employee) is includable in gross income under subparagraph (2) of this paragraph. With respect to the remaining $5,500, B has a basis of $3,500, consisting of the $2,500 contributed on his behalf while he was an owner-employee which was not allowed as a deduction and the $1,000 which B contributed as an employee. The difference between the $5,500 and B's basis of $3,500, or $2,000, is includable in gross income under section 72(e).

(c) *Amounts paid for life, accident, health, or other insurance.* Amounts used to purchase life, accident, health, or other insurance protection for an owner-employee shall not be taken into account in computing the following:

(1) The aggregate amount of premiums or other consideration paid for the contract for purposes of determining the investment in the contract under section 72(c)(1)(A) and § 1.72–6;

(2) The consideration for the contract contributed by the employee for purposes of section 72(d)(1) and § 1.72–13, which provide the method of taxing employees' annuities where the employee's contributions will be recoverable within 3 years; and

(3) The aggregate premiums or other consideration paid for purposes of section 72(e)(1)(B) and § 1.72–11, which provide the rules for taxing amounts not received as annuities prior to the annuity starting date.

The cost of such insurance protection will be considered to be a reasonable net premium cost, as determined by the Commissioner, for the appropriate period.

(d) *Amounts constructively received.* (1) If during any taxable year an owner-employee assigns or pledges (or agrees to assign or pledge) any portion of his interest in a trust described in section 401(a) which is exempt from tax under section 501(a), or any portion of the value of a contract purchased as part of a plan described in section 403(a), such portion shall be treated as having been received by such owner-employee as a distribution from the trust or as an amount received under the contract during such taxable year.

(2) If during any taxable year an owner-employee receives, either directly or indirectly, any amount from any insurance company as a loan under a contract purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) or purchased as part of a plan described in section 403(a), and issued by such insurance company, such amount shall be treated as an amount received under the contract during such taxable year. An owner-employee will be considered to have received an amount under a contract if a premium, which is otherwise in default, is paid by the insurance company in the form of a loan against the cash surrender value of the contract. Further, an owner-employee will be considered to have received an amount to which this subparagraph applies if an amount is received from the issuer of a face-amount certificate as a loan under such a certificate purchased as part of a qualified trust or plan.

(e) *Penalties applicable to certain amounts received by owner-employees.* (1)(i) The rules of this paragraph are applicable to amounts, to the extent includable in gross income, received from a trust described in section 401(a) or under a plan described in section 403(a) by or on behalf of an individual who is or has been an owner-employee with respect to such plan or trust—

(a) Which are received before the owner-employee reaches the age 59½ years and which are attributable to contributions paid on behalf of such owner-employee (whether or not paid by him) while he was an owner-employee (see subdivision (ii) of this subparagraph),

(b) Which are in excess of the benefits provided for such owner-employee under the plan formula (see subdivision (iii) of this subparagraph), or

(c) Which are received by reason of a distribution of the owner-employee's entire interest under the provisions of section 401(e)(2)(E), relating to excess contributions on behalf of an owner-employee which are willfully made.

(ii) The amounts referred to in subdivision (i)*(a)* of this subparagraph do not include—

(a) Amounts received by reason of the owner-employee becoming disabled, or

(b) Amounts received by the owner-employee in his capacity as a policyholder of an annuity, endowment, or life insurance contract which are in the nature of a dividend or similar distribution.

Amounts attributable to contributions paid on behalf of an owner-employee and which are paid to a person other than the owner-employee before the owner-employee dies or reaches the age 59½ shall be considered received by the owner-employee for purposes of this paragraph. For taxable years beginning after December 31, 1966, see section 72(m)(7) and paragraph (f) of this section for the meaning of disabled. For taxable years beginning before January 1, 1967, see section 213(g)(3) for the meaning of disabled. For taxable years beginning after December 31, 1968, if an amount is not included in the amounts referred to in subdivision (i)*(a)* of this subparagraph solely by reason of the owner-employee becoming disabled and if a penalty would otherwise be applicable with respect to all or a portion of such amount, then for the taxable year in which such amount is received, there must be submitted with the owner-employee's income tax return a doctor's statement as to the impairment, and a statement by the owner-employee with respect to the effect of such impairment upon his substantial gainful activity and the date such impairment occurred. For taxable years which are subsequent to the first taxable year beginning after December 31, 1968, with respect to which the statements referred to in the preceding sentence are submitted, the owner-employee may, in lieu of such statements, submit a statement declaring the continued existence (without substantial diminution) of the impairment and its continued effect upon his substantial gainful activity.

(iii) This paragraph applies to amounts described in subdivision (i)*(b)* of this subparagraph (relating to excess benefits) even though a portion of such amounts may be attributable to contributions made on behalf of an individual while he was not an owner-employee and even though the amounts are received by his successor. However, these amounts do not include the portion of a distribution to which section 402(a)(2) or 403(a)(2) (relating to certain total distributions in one taxable year) applies.

(iv)*(a)* For purposes of subdivision (i)*(a)* of this subparagraph, the portion of any distribution or payment attributable to contributions on behalf of an employee-participant while he was an owner-employee includes the contributions made on his behalf while he was an owner-employee and the increments in value attributable to such contributions.

(b) The increments in value of an individual's account may be allocated to contributions on his behalf while he was an owner-employee either by maintaining a separate account, or an accounting, which reflects the actual increment attributable to such contributions, or by the method described in *(c)* of this subdivision.

(c) Where an individual is covered under the same plan both as an owner-employee and as a nonowner-employee, the portion of the increment in value of his interest attributable to contributions made on his behalf while he was an owner-employee may be determined by multiplying the total increment in value in his account by a fraction. The numerator of the fraction is the total contributions made on behalf of the individual as an owner-employee, weighted for the number of years that each contribution was in the plan. The denominator is the total contributions made on behalf of the individual, whether or not an owner-employee, weighted for the number of years each contribution was in the plan. The contributions are weighted for the number of years in the plan by multiplying

each contribution by the number of years it was in the plan. For purposes of this computation, any forfeiture allocated to the account of the individual is treated as a contribution to the account made at the time so allocated.

(d) The method described in *(c)* of this subdivision may be illustrated by the following example:

Example. B was a member of the XYZ Partnership and a participant in the partnership's profit-sharing plan which was created in 1963. Until the end of 1967, B's interest in the partnership was less than 10 percent. On January 1, 1968, B obtained an interest in excess of 10 percent in the partnership and continued to participate in the profit-sharing plan until 1972. During 1972, prior to the time he attained the age of 59½ years and during a time when he was not disabled, B withdrew his entire interest in the profit-sharing plan. At that time his interest was $15,000, $9,600 contributions and $5,400 increment attributable to the contributions. The portion of the increment attributable to contributions while B was an owner-employee is $667.80, determined as follows:

	A	B	C
	Contribution	Number of years contribution was in trust—	Contribution weighted for years in trust (A×B)
1972	$1,000	0	0
1971	800	1	800
1970	1,200	2	2,400
1969	600	3	1,800
1968	200	4	800
1967	400	5	2,000
1966	2,000	6	12,000
1965	1,000	7	7,000
1964	1,500	8	12,000
1963	900	9	8,100
Total	$9,600		46,900

Total weighted contributions as owner-employee (1968–1972)—5,800.

Total weighted contributions—46,900.

$5,400×(5,800÷46,900)=$667.80

(2)(i) If the aggregate of the amounts to which this paragraph applies received by any person in his taxable year equals or exceeds $2,500 the tax with respect to such amount shall be the greater of—

(a) The increase in tax attributable to the inclusion of the amounts so received in his gross income for the taxable year in which received, or

(b) 110 percent of the aggregate increase in taxes, for such taxable year and the four immediately preceding taxable years, which would have resulted if such amounts had been included in such person's gross income ratably over such taxable years. However, if deductions were allowed under section 404 for contributions to the plan on behalf of the individual as an owner-employee for less than four prior taxable years (whether or not consecutive), the number of immediately preceding taxable years taken into account shall be the number of prior taxable years in which such deductions were allowed.

(ii) If the aggregate of the amounts to which this paragraph applies received by any person in his taxable year is less than $2,500, the tax with respect to such amounts shall be 110 percent of the increase in tax which results from including such amounts in the person's gross income for the taxable year in which received.

(3)(i) For purposes of making the ratable inclusion computations of subparagraph (2)(i) of this paragraph, the taxable income of the recipient for each taxable year involved (notwithstanding section 63, relating to definition of taxable income) shall be treated as being not less than the amount required to be treated as includible in the taxable year pursuant to the ratable inclusion.

(ii) For purposes of subparagraph (2)(i)*(a)* and (ii) of this paragraph, the recipient's taxable income (notwithstanding section 63, relating to definition of taxable income) shall be treated as being not less than the aggregate of the amounts to which this paragraph applies reduced by the deductions allowed the recipient for such taxable year under section 151 (relating to deductions for personal exemptions).

(iii) In any case in which the application of subdivision (i) or (ii) of this subparagraph results in an increase in taxable income for any taxable year, the resulting increase in taxes imposed by section 1 or 3 for such taxable year shall be reduced by the credits against tax provided by section 31 (tax withheld on wages) and section 39 (certain uses of gasoline and lubricating oil), but shall not be reduced by any other credits against tax.

(4) The application of the rules of subparagraph (2)(i) and (3) of this paragraph may be illustrated by the following example:

Example. B, a sole proprietor and a calendar-year basis taxpayer, established a qualified pension trust to which he made annual contributions for 10 years of 10 percent of his earned income. B withdrew his entire interest in the trust during 1973 when he was 55 years old and not disabled and for which, without regard to the distribution, he had a net operating loss and for which he is allowed under section 151 a deduction for one personal exemption. The portion of the distribution includible in B's gross income is $25,750. In addition, B had a net operating loss for 1972. The other 3 taxable years involved in the computation under subparagraph (2)(i) of this paragraph were years of substantial income. For purposes of determining B's increase in tax attributable to the receipt of the $25,750 (before the application of the provisions of subparagraph (2)(i)*(b)* of this paragraph), B's taxable income for the year he received the $25,750 is treated, under subparagraph (3)(ii) of this paragraph, as being $25,000 ($25,750 minus $750, the amount of the deduction allowed for each personal exemption under section 151 for 1973). For purposes of determining whether 110 percent of the aggregate increase in taxes which would have resulted if 20 percent of the amount of the withdrawal had been included in B's gross income for the year of receipt and for each of the 4 preceding taxable years is greater (and thus is the amount of his increase in tax attributable to the receipt of the $25,750), B's taxable income for the taxable year of receipt, and for the immediately preceding taxable year, is treated, under subparagraph (3)(i) of this paragraph, as being $5,150 ($25,750 divided by 5).

(f) *Meaning of disabled.* (1) For taxable years beginning after December 31, 1966, section 72(m)(7) provides that an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. In determing whether an individual's impairment makes him unable to engage in any substantial gainful activity, primary consideration shall be given to the nature and severity of his impairment. Consideration shall also be given to other factors such as the individual's education, training, and work experience. The substantial gainful activity to which section 72(m)(7) refers is the activity, or a comparable activity, in which the individual customarily engaged prior to the arising of the disability (or prior to retirement if the individual was retired at the time the disability arose).

(2) Whether or not the impairment in a particular case constitutes a disability is to be determined with reference to all the facts in the case. The following are examples of impairments which would ordinarily be considered as preventing substantial gainful activity:

(i) Loss of use of two limbs;

(ii) Certain progressive diseases which have resulted in the physical loss or atrophy of a limb, such as diabetes, multiple sclerosis, or Buerger's disease;

(iii) Diseases of the heart, lungs, or blood vessels which have resulted in major loss of heart or lung reserve as evidenced by X-ray, electrocardiogram, or other objective findings, so that despite medical treatment breathlessness, pain, or fatigue is produced on slight exertion, such as walking several blocks, using public transportation, or doing small chores;

(iv) Cancer which is inoperable and progressive;

(v) Damage to the brain or brain abnormality which has resulted in severe loss of judgment, intellect, orientation, or memory;

(vi) Mental diseases (e.g. psychosis or severe psychoneurosis) requiring continued institutionalization or constant supervision of the individual;

(vii) Loss or diminution of vision to the extent that the affected individual has a central visual acuity of no better than 20/200 in the better eye after best correction, or has a limitation in the fields of vision such that the widest diameter of the visual fields subtends an angle no greater than 20 degrees;

(viii) Permanent and total loss of speech;

(ix) Total deafness uncorrectible by a hearing aid.

The existence of one or more of the impairments described in this subparagraph (or of an impairment of greater severity) will not, however, in and of itself always permit a finding that an individual is disabled as defined in section 72(m)(7). Any impairment, whether of lesser or greater severity, must be evaluated in terms of whether it does in fact prevent the individual from engaging in his customary or any comparable substantial gainful activity.

(3) In order to meet the requirements of section 72(m)(7), an impairment must be expected either to continue for a long and indefinite period or to result in death. Ordinarily, a terminal illness because of disease or injury would result in disability. Indefinite is used in the sense that it cannot reasonably be anticipated that the impairment will, in the foreseeable future, be so diminished as no longer to prevent substantial gainful activity. For example, an individual who suffers a bone fracture which prevents him from working for an extended period of time will not be considered disabled, if his recovery can be expected in the foreseeable future; if the fracture persistently fails to knit, the individual would ordinarily be considered disabled.

(4) An impairment which is remediable does not constitute a disability within the meaning of section 72(m)(7). An individual will not be deemed disabled if, with reasonable effort and safety to himself, the impairment can be diminished to the extent that the individual will not be prevented by the impairment from engaging in his customary or any comparable substantial gainful activity.

(g) *Years to which this section applies.* This section applies to taxable years ending before September 3, 1974. For taxable years ending after September 2, 1974, see § 1.72–17A.

[T.D. 6676, 28 FR 10136, Sept. 17, 1963, as amended by T.D. 6885, 31 FR 7800, June 2, 1966; T.D. 6985, 33 FR 19811, Dec. 27, 1968; T.D. 7114, 36 FR 9018, May 18, 1971; T.D. 7636, 44 FR 47049, Aug. 10, 1979]

§ 1.72–17A Special rules applicable to employee annuities and distributions under deferred compensation plans to self-employed individuals and owner-employees.

(a) *In general.* Section 72(m) and this section contain special rules for the taxation of amounts received from qualified pension, profit-sharing, or annuity plans covering an owner-employee. This section applies to such amounts for taxable years of the recipient ending after September 2, 1974, unless another date is specified. For purposes of this section, the term ‘‘employee’’ shall include the self-employed individual who is treated as an employee by section 401(c)(1), and the term ‘‘owner-employee’’ has the meaning assigned to it in section 401(c)(3). Paragraph (b) of this section provides rules dealing with the computation of consideration paid by self-employed individuals and paragraph (c) of this section provides rules dealing with such computation when insurance is purchased for owner-employees. Paragraph (d) of this section provides rules for constructive receipt and, for purposes of these rules, treats as an owner-employee an individual for whose benefit an individual retirement account or annuity described in section 408 (a) or (b) is maintained after December 31, 1974. Paragraph (e) of this section provides rules for penalties provided by section 72(m)(5) with respect to certain distributions received by owner-employees or their successors. Paragraph (f) of this section provides rules for determining whether a person is disabled within the meaning of section 72(m)(7). See § 1.72–16, relating to life insurance contracts purchased under qualified employee plans, for rules under section 72(m)(3).

(b) *Computation of consideration paid by self-employed individuals.* Under section 72(m)(2), consideration paid or contributed for the contract by any self-employed individual shall for purposes of section 72 be deemed not to include any contributions paid or contributed under a plan described in paragraph (a), or any other plan of deferred compensation described in section 404(a) (whether or not qualified), if the contributions are—

(1) Paid under such plan with respect to a time during which the employee was an employee only by reason of sections 401(c)(1) and 404(a)(8), and

(2) Deductible under section 404 by the employer, including an employer within the meaning of sections 401(c)(4) and 404(a)(8), of such self-employed individual at the time of such payment, or subsequent to such time of payment.

For purposes of this paragraph the term ‘‘consideration paid or contributed for the contract’’ has the same meaning as under subparagraphs (1), (2), and (3) of paragraph (c) of this section.

(c) *Amounts paid for life, accident, health, or other insurance.* Under section 72(m)(2), amounts used to purchase life, accident, health, or other insurance protection for an owner-employee shall not be taken into account in computing the following:

(1) The aggregate amount of premiums or other consideration paid for the contract for purposes of determining the investment in the contract under section 72(c)(1)(A) and §1.72–6;

(2) The consideration for the contract contributed by the employee for purposes of section 72(d)(1) and §1.72–13, which provide the method of taxing employee's annuities where the employee's contributions will be recoverable within 3 years; and

(3) The aggregate premiums or other consideration paid for purposes of section 72(e)(1)(B) and §1.72–11, which provide the rules for taxing amounts not received as annuities prior to the annuity starting date.

The cost of such insurance protection will be considered to be a reasonable net premium cost, as determined by the Commissioner, for the appropriate period.

(d) *Amounts constructively received.* (1) Under section 72(m)(4)(A), if during any taxable year an owner-employee assigns or pledges (or agrees to assign or pledge) any portion of his interest in a trust described in section 401(a) which is exempt from tax under section 501(a), or any portion of the value of a contract purchased as part of a plan described in section 403(a), such portion shall be treated as having been received by such owner-employee as a distribution from the trust or as an amount received under the contract during such taxable year.

(2)(i) Under paragraphs (4)(A) and (6) of section 72(m), if after December 31, 1974, during any taxable year an individual for whose benefit an individual retirement account or annuity described in section 408 (a) or (b) is maintained assigns or pledges (or agrees to assign or pledge) any portion of his interest in such account or annuity, such portion shall be treated as having been received by such individual as a distribution from such account or trust during such taxable year. See subsections (d) and (f) of section 408 and the regulations thereunder for the tax treatment of an amount treated as a distribution under this subparagraph.

(ii) Notwithstanding subdivision (i) of this subparagraph, if an individual retirement account or annuity, or portion thereof, is subject to the additional tax imposed by section 408(f), that amount shall be deemed not to be a distribution under section 72(m)(4)(A) and subdivision (i) of this subparagraph.

(3) Under section 72(m)(4)(B), if during any taxable year an owner-employee receives, either directly or indirectly, any amount from any insurance company as a loan under a contract purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) or purchased as part of a plan described in section 403(a), and issued by such insurance company, such amount shall be treated as an amount received under the contract during such taxable year. An owner-employee will be considered to have received an amount under a contract if a premium, which is otherwise in default, is paid by the insurance company in the form of a loan against the cash surrender value of the contract. Further, an owner-employee will be considered to have received an amount to which this subparagraph applies if an amount is received from the issuer of a face-amount certificate as a loan under such a certificate purchased as part of a qualified trust or plan.

(e) *Penalties applicable to certain amounts received with respect to owner-employees under section 72(m)(5).* (1)(i) For taxable years of the recipient beginning after December 31, 1975, if any person receives an amount to which subparagraph (2) of this paragraph applies, his tax under Chapter 1 for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of the amount so received which is includible in his gross income for such taxable year.

(ii) For taxable years of the recipient beginning before January 1, 1976, see subparagraph (3) of this paragraph.

(2)(i) This subparagraph is applicable to amounts, to the extent includible in gross income, received from a qualified trust described in section 401(a) or under a plan described in section 403(a) by or on behalf of an individual who is or has been an owner-employee with respect to such trust or plan—

(A) Which are received before the owner-employee reaches the age of 59½ years, and which are attributable to contributions paid on behalf of such owner-employee by his employer (that is employer contributions within the meaning of section 401(c)(5)(A) and the increments in value attributable to such employer contributions) and the increments in value attributable to contributions made by him as an owner-employee while he was an owner-employee (that is, the increments attributable to owner-employee contributions within the meaning of section 401(c)(5)(B), but not such contributions; see subdivision (ii) of this subparagraph).

(B) Which are in excess of the benefits provided for such owner-employee under the plan formula (see subdivision (iii) of this subparagraph), or

(C) Which are subject to the transitional rules with respect to willful excess contributions made on behalf of an owner-employee in his employer's taxable years which begin before January 1, 1976 (see subdivision (v) of this subparagraph).

(ii) The amounts referred to in subdivision (i)(A) of this subparagraph do not include—

(A) Amounts received by reason of the owner-employee becoming disabled (see paragraph (f) of this section).

(B) Amounts received by the owner-employee in his capacity as a policyholder of an annuity, endowment, or life insurance contract which are in the nature of a dividend or similar distribution, or

(C) Amounts attributable to contributions (and increments in value thereon) made for years for which the recipient was not an owner-employee.

If an amount is not included in the amounts referred to in subdivision (i)(A) of this subparagraph solely by reason of the owner-employee's becoming disabled and if a penalty would otherwise be applicable with respect to all or a portion of such amount, then for the owner-employee's taxable year in which such amount is received, there must be submitted with his income tax return a doctor's statement as to the impairment, and a statement by the owner-employee with respect to the effect of such impairment upon his substantial gainful activity and the date such impairment occurred. For taxable years which are subsequent to the first taxable year with respect to which the statements referred to in the preceding sentence are submitted, the owner-employee may, in lieu of such statements, submit a statement declaring the continued existence (without substantial diminution) of the impairment and its continued effect upon his substantial gainful activity.

(iii) This subparagraph applies to amounts described in subdivision (i)(B) of this subparagraph (relating to benefits in excess of the plan formula) even though a portion of such amounts may be attributable to contributions made on behalf of an individual while he was not an owner-employee and even if he is deceased and the amounts are received by his successor.

(iv)(A) The rules described in subdivisions (i)(A) and (iii) of this subparagraph, relating to the treatment under section 72(m)(5)(A)(i) of certain premature distributions, may be illustrated by the following example:

Example. (1) A was a member of the X partnership, consisting of partners A through I, and a participant in the partnership's qualified profit-sharing plan which was established on January 1, 1972. A's taxable years, the X partnership's taxable years, the plan years, and other relevant years are all calendar years at all relevant times. For the three calendar years, 1972 through 1974, A was an owner-employee in the X partnership. On January 1, 1975, new partners J and K became partners in the X partnership, and as of that date, each of partners A through K held a ¹⁄₁₁ interest in the capital and profits of the X partnership. On that date, A became a partner who was not an owner-employee. A continued in this status for the 2 calendar years 1975 and 1976. On January 1, 1977, when A was 50 years old and not disabled, he liquidated his interest in the X partnership and became an employee of an unrelated employer. On that date, A received a distribution representing his entire interest in the X partnership's plan of $54,000 cash in violation of the plan provision required by section 401(d)(4)(B). As of that date, the distribution was attributable to the following sources and times, computed by the plan in a manner consistent with the subparagraph:

	A	B	C	D
Calendar years	X contributions on behalf of A deductible under sec. 404	A's contributions made as an employee	Increments in value attributable to column A yearly contributions	Increments in value attributable to column B yearly contributions
1977	0	0	0	0
1976	$7,500	$2,500	$900	$300
1975	7,500	2,500	4,000	1,300
1974	7,500	2,500	1,800	700
1973	2,500	2,500	1,200	1,200
1972	2,500	2,500	1,300	1,300
Totals	27,500	12,500	9,200	4,800

(*2*) The amount of the $54,000 distribution to which subdivision (i)(A) of this subparagraph applies is $20,000, computed as follows:

X contributions on behalf of A made in years A was an owner-employee:	
1974	$7,500
1973	2,500
1972	2,500
Total	12,500
Increments in value attributable to such contributions:	
1974	1,800
1973	1,200
1972	1,300
Total	4,300
Increments in value attributable to contributions made by A as an employee for years in which he was an owner-employee:	
1974	700
1973	1,200
1972	1,300
Total	3,200
Grand total	20,000

In this example, the $20,000 amount computed above would be includible in A's gross income for 1977 and would be subject to the 10 percent tax described in subparagraph (1)(i) of this paragraph.

(*3*) Subdivision (i)(A) of this subparagraph does not apply to the contributions made by X on behalf of A for 1976 and 1975 ($7,500 each year, totaling $15,000) nor to the increments in value attributable to those contributions ($900 for 1976 and $4,000 for 1975, totaling $4,900), because A was not an owner-employee with respect to these two years, 1976 and 1975, on account of which these employer contributions were made. For the same reason, subdivision (i)(A) of this subparagraph does not apply to the increments in value attributable to A's contributions for 1976 and 1975 ($300 and $1,300, respectively, totaling $1,600).

See section 4972(c) for the amount of employee contributions which is permitted to be contributed by an owner-employee (as an employee) without subjecting an owner-employee to the tax on excess contributions.

(*4*) Subdivision (i)(A) of this subparagraph does not apply to the contributions made by A, as an employee during the years when he was an owner-employee ($2,500 during each of the years 1972, 1973, and 1974, totaling $7,500), because the distribution was received in a taxable year of A ending after September 2, 1974; see subparagraph (3) of this paragraph. Furthermore, because the distribution of the amount of A's contributions ($12,500) constitutes consideration for the contract paid by A for purposes of section 72, the $7,500 amount described in the preceding sentence is not includible in his gross income, and that amount is not subject to the rules of this subparagraph; see subdivision (i) of this subparagraph, and paragraphs (b) and (c) of this section.

(B) The increments in value of an individual's account may be allocated to contributions on his behalf, by his employer or by such individual as an owner-employee, while he was an owner-employee either by maintaining a separate account, or an accounting, which reflects the actual increment attributable to such contributions, or by the method described in (C) of this subdivision.

(C) Where an individual is covered under the same plan both as an owner-employee and as a non-owner-employee, the portion of the increment in value of his interest attributable to contributions made on his behalf while he was an owner-employee may be determined by multiplying the total increment in value in his account by a fraction. The numerator of the fraction is the total contributions made on behalf of the individual as an owner-employee, weighted for the number of years that each contribution was in the plan. The denominator is the total contributions made on behalf of the individual, whether or not as an owner-employee, weighted for the number of years each contribution was in the plan. The contributions are weighted for the number of years in the plan by multiplying each contribution by the number of years it was in the plan. For purposes of this computation, any forfeiture allocated to the account of the individual is treated as a contribution to the account made at the time so allocated. For purposes of this computation, where the individual has received a prior distribution from such account, an appropriate adjustment must be made to reflect such prior distribution.

(D) The method described in (C) of this subdivision may be illustrated by the following example:

Example. B was a member of the XYZ Partnership and a participant in the partnership's profit-sharing plan which was created in 1973. Until the end of 1977, B's interest in the partnership was less than 10 percent. On January 1, 1978, B obtained an interest in excess of 10 percent in the partnership and continued to participate in the profit-sharing plan until 1982. During 1982, prior to the time he attained the age of 59½ years and during a time when he was not disabled, B, who had not received any prior plan distributions, withdrew his entire interest in the profit-sharing plan. At the time his interest was $15,000, $9,600 contributions and $5,400 increment attributable to the contributions. The portion of the increment attributable to contributions while B was an owner-employee is $667.80, determined as follows:

	A	B	C
	Contribution	Number of years contribution was in trust	Contribution weighted for years in trust (A×B)
1982	$1,000	0	0
1981	800	1	800
1980	1,200	2	2,400
1979	600	3	1,800
1978	200	4	800
1977	400	5	2,000
1976	2,000	6	12,000
1975	1,000	7	7,000
1974	1,500	8	12,000
1973	900	9	8,100
Total	9,600	....	46,900

Total weighted contributions as owner-employee (1978–1982) = $5,800.

Total weighted contributions = $46,900.

$$\$5{,}400 \times (5{,}800 \div 46{,}900) = \$667.80$$

(E)(*1*) The rules set forth in subdivision (iv)(E)(*2*) of this subparagraph shall be used to determine the amounts to which subdivision (i)(A) of this subparagraph applies in the case of a distribution of less than the entire balance of the employee's account from a plan in which he has been covered at different times as owner-employee or as an employee other than an owner-employee.

(*2*) Distributions or payments from a plan for any employee taxable year shall be deemed to be attributable to contributions to the plan, and increments thereon, in the following order—

(*i*) Excess contributions, within the meaning of section 4972 (b), designated as such by the trustee;

(*ii*) Employee contributions;

(*iii*) Employer contributions, other than those described in(*i*), and the increments in value attributable to the employee's own contributions and his employer's contributions on the basis of the taxable years of his employer in succeeding order of time whether or not the employee was an owner-employee for any such year.

For purposes of (*iii*) of this subdivision, the time of contributions made on the basis of any employer taxable year shall take into account the rule specified in section 404(a)(6), relating to time when contributions deemed made.

(v) The amounts referred to in subdivision (i)(C) of this subparagraph are amounts which are received by reason of a distribution of the owner-employee's entire interest under the provisions of section 401(e)(2)(E), as in effect on September 1, 1974, relating to excess contributions on behalf of an owner-employee which are willfully made. Notwithstanding the preceding sentence, an owner-employee's entire interest in all plans with respect to which he is an owner-employee (within the meaning of subsections (d)(8)(C) and (e)(2)(E)(ii) of section 401, as in effect on September 1, 1974) does not include any distribution or payment attributable to his employer's contributions or his own contributions made with respect to his employer's taxable years beginning after December 31, 1975. However, his entire interest in all plans does include all of the distribution or payment attributable to his employer's contributions and his own contributions made with respect to all of his employer's taxable years beginning before January 1, 1976, if any portion thereof is attributable in whole or in part to such a willful excess contribution and such entire interest is received because of a willful excess contribution pursuant to section 401(e)(2)(E)(ii). A distribution or payment is described in the preceding sentence even though it is received in an owner-employee's taxable year beginning after December 31, 1975. For purposes of computing the increments in value attributable to employer taxable years which begin before January 1, 1976, and such increments attributable to such years beginning after December 31, 1975, the rules specified in subdivision (iv)(B), (C), (D), and (E) of this subparagraph shall be applied to the extent applicable. See §1.401(e)–4(c) for transitional rules with respect to contributions described in this subdivision.

(3)(i) For taxable years of the recipient beginning before January 1, 1976, the tax with respect to amounts to which subparagraph (2) of this paragraph applies shall be computed under subparagraphs (B), (C), (D), and (E) of section 72(m)(5) as such subparagraphs were in effect prior to the amendments made by subsections (g)(1) and (2)(A) of section 2001 of the Employee Retirement Income Security Act of 1974 (88 Stat. 957) except as provided in subdivisions (ii) and (iii) of this subparagraph (see paragraph (e) of §1.72–17). For purposes of the preceding sentence, amounts to which subparagraph (2) of this paragraph applies in the case of an amount described in section 72(m)(5)(A)(i) shall be determined under subdivisions (i)(*a*) and (ii) of §1.72–17(e)(1), except as provided in subdivision (ii) of this subparagraph. For purposes of the first sentence of this subdivision, amounts to which subparagraph (2) of this paragraph applies in the case of an amount described in section 72(m)(5)(A)(ii) shall be determined under subdivisions (i)(*b*) and (iii) of §1.72–17(e)(1), except as provided in subdivision (iii) of this subparagraph.

(ii) For purposes of applying section 72(m)(5)(A)(i), after the amendment made by section 2001(h)(3) of such Act, and subdivisions (i)(*a*) and (ii) of §1.72–17(e)(1), to a distribution or payment received in recipient taxable years ending after September 2, 1974, and beginning before January 1, 1976, with respect to contributions made on behalf of an owner-employee which were made by him as an owner-employee (that is, employee contributions within the meaning of section 401(c)(5)(B)) the portion of any distribution or payment attributable to such contributions shall not include such contributions but shall include the increments in value attributable to such contributions.

(iii) For purposes of applying section 72(m)(5)(D) and subdivisions (i)(*b*) and (iii) of §1.72–17(e)(1) to recipient taxable years beginning after December 31, 1973, and beginning before January 1, 1976, in the case of distributions or payments made after December 31, 1973, the amounts to which section 402 (a)(2) or 403(a)(2) applies after the amendments made by section 2005(b) (1) and (2) of such Act (88 Stat. 990 and 991) (which are amounts to which subdivision (i)(*b*) of §1.72–17(e)(1) does not apply) shall be deemed to be the amount which is treated as a gain from the sale or exchange of a capital asset held for more than 6 months under either of such sections.

(f) *Meaning of disabled.* (1) Section 72(m)(7) provides that an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. In determining whether an individual's impairment makes him unable to engage in any substantial gainful activity, primary consideration shall be given to the nature and severity of his impairment. Consideration shall also be given to other factors such as the individual's education, training, and work experience. The substantial gainful activity to which section 72(m)(7) refers is the activity, or a comparable activity, in which the individual customarily engaged prior to the arising of the disability or prior to retirement if the individual was retired at the time the disability arose.

(2) Whether or not the impairment in a particular case constitutes a disability is to be determined with reference to all the facts in the case. The following are examples of impairments which would ordinarily be considered as preventing substantial gainful activity:

(i) Loss of use of two limbs;

(ii) Certain progressive diseases which have resulted in the physical loss or atrophy of a limb, such as diabetes, multiple sclerosis, or Buerger's disease;

(iii) Diseases of the heart, lungs, or blood vessels which have resulted in major loss of heart or lung reserve as evidenced by X-ray, electrocardiogram, or other objective findings, so that despite medical treatment breathlessness, pain, or fatigue is produced on slight exertion, such as walking several blocks, using public transportation, or doing small chores;

(iv) Cancer which is inoperable and progressive;

(v) Damage to the brain or brain abnormality which has resulted in severe loss of judgment, intellect, orientation, or memory;

(vi) Mental diseases (e.g. psychosis or severe psychoneurosis) requiring continued institutionalization or constant supervision of the individual;

(vii) Loss or diminution of vision to the extent that the affected individual has a central visual acuity of no better than 20/200 in the better eye after best correction, or has a limitation in the fields of vision such that the widest diameter of the visual fields subtends an angle no greater than 20 degrees;

(viii) Permanent and total loss of speech;

(ix) Total deafness uncorrectible by a hearing aid.

The existence of one or more of the impairments described in this subparagraph (or of an impairment of greater severity) will not, however, in and of itself always permit a finding that an individual is disabled as defined in section 72(m)(7). Any impairment, whether of lesser or greater severity, must be evaluated in terms of whether it does in fact prevent the individual from engaging in his customary or any comparable substantial gainful activity.

(3) In order to meet the requirements of section 72(m)(7), an impairment must be expected either to continue for a long and indefinite period or to result in death. Ordinarily, a terminal illness because of disease or injury would result in disability. The term ''indefinite'' is used in the sense that it cannot reasonably be anticipated that the impairment will, in the foreseeable future, be so diminished as no longer to prevent substantial gainful activity. For example, an individual who suffers a bone fracture which prevents him from working for an extended period of time will not be considered disabled, if his recovery can be expected in the foreseeable future; if the fracture persistently fails to knit, the individual would ordinarily be considered disabled.

(4) An impairment which is remediable does not constitute a disability within the meaning of section 72(m)(7). An individual will not be deemed disabled if, with reasonable effort and safety to himself, the impairment can be diminished to the extent that the individual will not be prevented by the impairment from engaging in his customary or any comparable substantial gainful activity.

[T.D. 7636, 44 FR 47049, Aug. 10, 1979]

§ 1.72–18 Treatment of certain total distributions with respect to self-employed individuals.

(a) *In general.* The Self-Employed Individuals Tax Retirement Act of 1962 permits self-employed individuals to be treated as employees for purposes of participation in pension, profit-sharing, and annuity plans described in sections 401(a) and 403(a). In general, amounts received by a distributee or payee which are attributable to contributions made on behalf of a participant while he was self-employed are taxed in the same manner as amounts which are attributable to contributions made on behalf of a common-law employee. However, such amounts which are paid in one taxable year representing the total distributions payable to a distributee or payee with respect to an employee are not eligible for the capital gains treatment of section 402(a)(2) or 403(a)(2). This section sets forth the treatment of such distributions, except where such a distribution is subject to the penalties of section 72(m)(5) and paragraph (e) of §1.72–17.

(b) *Distributions to which this section applies.* (1)(i) Except as provided in subparagraphs (2) and (3) of this paragraph, this section applies to amounts distributed to a distributee in one taxable year of the distributee in the case of an employees' trust described in section 401(a) which is exempt under section 501(a), or to amounts paid to a payee in one taxable year of the payee in the case of an annuity plan described in section 403(a), which constitute the total distributions payable, or the total amounts payable, to the distributee or payee with respect to an employee.

(ii) For the total distributions or amounts payable to a distributee or payee to be considered paid within one taxable year of the distributee or payee for purposes of this section, all amounts to the credit of the employee-participant through the end of such taxable year which are payable to the distributee or payee must be distributed or paid within such taxable year. Thus, the provisions of this section are not applicable to a distribution or payment to a distributee or payee if the trust or plan retains any amounts after the close of such taxable year which are payable to the same distributee or payee even though the amounts retained may be attributable to contributions on behalf of the employee-participant while he was a common-law employee in the business with respect to which the plan was established.

(iii) For purposes of this section, the total amounts payable to a distributee or the amounts to the credit of the employee do not include United States Retirement Plan Bonds held by a trust to the credit of the employee. Thus, a distribution to a distributee by a qualified trust may constitute a distribution to which this section applies even though the trust retains retirement plan bonds registered in the name of the employee on whose behalf the distribution is made which are to be distributed to the same distributee. Moreover, the proceeds of a retirement bond received as part of a distribution which constitutes the total distributions payable to the distributee are not entitled to the special tax treatment of this section. See section 405(d) and paragraph (a)(1) of §1.405–3.

(iv) If the amounts payable to a distributee from a qualified trust with respect to an employee-participant includes an annuity contract, such contract must be distributed along with all other amounts payable to the distributee in order to have a distribution to which this section applies. However, the proceeds of an annuity contract received in a total distribution will not be entitled to the tax treatment of this section unless the contract is surrendered in the taxable year of the distributee in which the total distribution was received.

(v) In the case of a qualified annuity plan, the term ‘‘total amounts’’ means all annuities payable to a payee. If more than one annuity contract is received under the plan by a distributee, this section shall not apply to an amount received on surrender of any such contracts unless all contracts under the plan payable to the payee are surrendered within one taxable year of the payee.

(vi)*(a)* The provisions of this section are applicable where the total amounts payable to a distributee or payee are paid within one taxable year of the distributee or payee whether or not a portion of the employee-participant's interest which is payable to another distributee or payee is paid within the same taxable year. However, a distributee or payee who, in prior taxable years received amounts (except amounts described in *(b)* of this subdivision) after the employee-participant ceases to be eligible for additional contributions to be made on his behalf, does not receive a distribution or payment to which this section applies, even though the total amount remaining to be paid to such distributee or payee with respect to such employee is paid within one taxable year. On the other hand, a distribution to a distributee or payee prior to the time that the employee-participant ceases to be eligible for additional contributions on his behalf does not preclude the application of this section to a later distribution to the same distributee or payee.

(b) The receipt of an amount which constitutes—

(1) A payment in the nature of a dividend or similar distribution to an individual in his capacity as a policyholder of an annuity, endowment, or life insurance contract, or

(2) A return of excess contributions which were not willfully made,

does not prevent the application of this section to a total distribution even though the amount is received after the employee-participant ceases to be eligible for additional contributions and in a taxable year other than the taxable year in which the total amount is received.

(vii) For purposes of this section, the total amounts payable to a distributee or payee, or the amounts to the credit of the employee, do not include any amounts which have been placed in a separate account for the funding of medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401–14. Thus, a distribution by a qualified trust or annuity plan may constitute a distribution to which this section applies even though amounts attributable to the funding of section 401(h) medical benefits as defined in paragraph (a) of § 1.401–14 are not so distributed.

(2) This section shall apply—

(i) Only if the distribution or payment is made—

(a) On account of the employee's death at any time,

(b) After the employee has attained the age 59½ years, or

(c) After the employee has become disabled; and

(ii) Only to so much of the distribution or payment as is attributable to contributions made on behalf of an employee while he was a self-employed individual in the business with respect to which the plan was established. Any distribution or payment, or any portion thereof, which is not so attributable shall be subject to the rules of taxation which apply to any distribution or payment that is attributable to contributions on behalf of common-law employees.

For taxable years beginning after December 31, 1966, see section 72(m)(7) and paragraph (f) of § 1.72–17 for the meaning of disabled. For taxable years beginning before January 1, 1967, see section 213(g)(3) for the meaning of disabled. For taxable years beginning after December 31, 1968, if this section is applicable by reason of the distribution or payment being made after the employee has become disabled, then for the taxable year in which the amounts to which this section applies are distributed or paid, there shall be submitted with the recipient's income tax return a doctor's statement as to the nature and effect of the employee's impairment.

(3) This section shall not apply to—

(i) Distributions or payments to which the penalty provisions of section 72(m)(5) and paragraph (e) of § 1.72–17 apply,

(ii) Distributions or payments from a trust or plan made to or on behalf of an individual prior to the time such individual ceases to be eligible for additional contributions (except the contribution attributable to the last year of service) to be made to the trust or plan on his behalf as a self-employed individual, and

(iii) Distributions or payments made to the employee from a plan or trust unless contributions which were allowed as a deduction under section 404 have been made on behalf of such employee as a self-employed individual under such trust or plan for 5 or more taxable years (whether or not consecutive) prior to the taxable year in which such distributions or payments are made. Distributions or payments to which this section does not apply by reason of this subdivision are taxed as otherwise provided in section 72. However, for taxable years beginning before January 1, 1964, section 72(e)(3), as in effect before such date, is not applicable. For taxable years beginning after December 31, 1963, such distributions or payments may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(4) The portion of any distribution or payment attributable to contributions on behalf of an employee-participant while he was self-employed includes the contributions made on his behalf while he was self-employed and the increments in value attributable to such contributions. Where the amounts to the credit of an employee-participant include amounts attributable to contributions on his behalf while he was a self-employed individual and amounts attributable to contributions on his behalf while he was a common-law employee, the increment in value attributable to the employee-participant's interest shall be allocated to the contributions on his behalf while he was self-employed either by maintaining a separate account, or an accounting, which reflects the actual increment attributable to such contributions, or by the method described in paragraph (e)(1)(iv)*(c)* of §1.72–17. However, if the latter method is used, the numerator of the fraction is the total contributions made on behalf of the individual as a self-employed individual, weighted for the number of years that each contribution was in the plan.

(c) *Amounts includible in gross income.* (1) Where a total distribution or payment to which this section applies is made to one distributee or payee and includes the total amount remaining to the credit of the employee-participant on whose behalf the distribution or payment was made, the distributee or payee shall include in gross income an amount equal to the portion of the distribution or payment which exceeds the employee-participant's investment in the contract. For purposes of this paragraph, the investment in the contract shall be reduced by any amounts previously received from the plan or trust by or on behalf of the employee-participant which were excludable from gross income as a return of the investment in the contract.

(2) In the case of a distribution to which this section applies and which is made to more than one distributee or payee, each element of the amounts to the credit of an employee-participant shall be allocated among the several distributees or payees on the basis of the ratio of the value of the distributee's or payee's distribution or payment to the total amount to the credit of the employee-participant. The elements to be so allocated include the investment in the contract, the increments in value, and the portion of the amounts to the credit of the employee-participant which is attributable to the contributions on behalf of the employee-participant while he was a self-employed individual.

(d) *Computation of tax.* (1) The tax attributable to the amounts to which this section applies for the taxable year in which such amounts are received is the greater of—

(i) 5 times the increase in tax which would result from the inclusion in gross income of the recipient of 20 percent of so much of the amount so received as is includible in gross income, or

(ii) 5 times the increase which would result if the taxable income of the recipient for such taxable year equaled 20 percent of the excess of the aggregate of the amounts so received and includible in gross income over the amount of the deductions allowed the recipient for such taxable year under section 151 (relating to deduction for personal exemptions).

In any case in which the application of subdivision (ii) of this subparagraph results in an increase in taxable income for any taxable year, the resulting increase in taxes imposed by section 1 or 3 for such taxable year shall be reduced by the credit against tax provided by section 31 (tax withheld on wages), but shall not be reduced by any other credits against tax.

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

Example. B, a sole proprietor and a calendar-year basis taxpayer, established a qualified pension trust to which he made annual contributions for 10 years of 10 percent of his earned income. B withdrew his entire interest in the trust during 1973, for which year, without regard to the distribution, he had a net operating loss and is allowed under section 151 a deduction for one personal exemption. At the time of the withdrawal, B was 64 years old. The amount of the distribution that is includible in his gross income is $25,750. Because of B's net operating loss, the tax attributable to the distribution is determined under the rule of subparagraph (1)(ii) of this paragraph. For purposes of determining the tax attributable to the $25,750, B's taxable income for 1973 is treated, under subparagraph (1)(ii) of this paragraph, as being 20 percent of $25,000 ($25,750 minus $750, the amount of the deduction allowed for each personal exemption under section 151 for 1973). Thus, under subparagraph (1) of this paragraph, the tax attributable to the $25,750 would be 5 times the increase which would result if the taxable income of B for the taxable year he received such amount equaled $5,000. B has had no amounts withheld from wages and thus is not entitled to reduce the increase in taxes by the credit against tax provided in section 31 and may not reduce the increase in taxes by any other credits against tax.

[T.D. 6676, 28 FR 10138, Sept. 17, 1963, as amended by T.D. 6722, 29 FR 5070, Apr. 14, 1964, T.D. 6885, 31 FR 7800, June 2, 1966, T.D. 6985, 33 FR 19812, Dec. 27, 1968; T.D. 7114, 36 FR 9018, May 18, 1971]

§ 1.72(e)–1T Treatment of distributions where substantially all contributions are employee contributions. (temporary)

Q–1: How did the Tax Reform Act (TRA) of 1984 change the law with regard to the treatment of non-annuity distributions (i.e., amounts distributed prior to the annuity starting date and not received as annuities) from a qualified plan that is treated as a single contract under section 72 and under which substantially all of the contributions are employee contributions?

A–1: (a) Prior to the amendment of section 72(e) by the TRA of 1984, non-annuity distributions from such a qualified plan generally were allocable, first, to nondeductible employee contributions and thus were not includible in gross income. After distributions equaled the balance of nondeductible employee contributions, further non-annuity distributions generally were includible in gross income.

(b) Pursuant to section 72(e)(7), as added by the TRA of 1984, non-annuity distributions from such a qualified plan that are allocable to investment in the plan after August 13, 1982 (as determined in accordance with section 72(e)(5)(B)), generally will be treated, first, as allocable to income and, second, as allocable to nondeductible employee contributions. Distributions allocable to income are includible in gross income. Distributions allocable to nondeductible employee contributions are not includible in gross income.

Q–2: To which qualified plans and contracts does section 72(e)(7) apply?

A–2: Section 72(e)(7) applies to any plan or contract under which substantially all of the contributions are employee contributions if—

(a) Such plan is described in section 401(a) and the related trust or trusts are exempt from tax under section 501(a); or

(b) Such contract is—

(1) Purchased by a trust described in (a) above,

(2) Purchased as part of a plan described in section 403(a), or

(3) Described in section 403(b).

Q–3: What is the definition of a qualified plan or contract under which substantially all of the contributions are employee contributions?

A–3: (a) A qualified plan or contract under which substantially all of the contributions are employee contributions is a plan or contract with respect to which 85 percent or more of the total contributions during the ''representative period'' are employee contributions. The ''representative period'' means the five-plan-year period preceding the plan year during which a distribution occurs. However, if less than 85 percent of the total contributions for all plan years during which the plan or contract is in existence prior to the plan year of distribution are employee contributions, then the plan or contract is not one with respect to which substantially all of the contributions are employee contributions.

(b) For purposes of the 85 percent test, contributions made to a predecessor plan or contract are aggregated with contributions made to the plan or contract to which the 85 percent test is being applied (the successor plan or contract). For purposes of the preceding sentence, a predecessor plan or contract is a plan or contract the terms of which are substantially the same as the successor plan or contract.

Q–4: What is the definition of employee contributions for purposes of section 72(e)(7)?

A–4: For purposes of section 72(e)(7), employee contributions are those amounts contributed by the employee and those amounts considered contributed by the employee under section 72(f). For example, amounts contributed to a section 401(k) qualified cash or deferred arrangement, pursuant to an employee's election to defer such amounts, are employer contributions to the extent that such amounts are not currently includible in gross income. In addition, deductible employee contributions under section 72(o) are disregarded in their entirety (i.e., treated as neither employee contributions nor employer contributions) in determining whether substantially all the contributions are employee contributions.

Q–5: How is the 85 percent test of section 72(e)(7) applied to a qualified plan or contract?

A–5: (a) Except as provided in paragraphs (b), (c), and (d), the 85 percent test is applied separately with respect to each contract under section 72.

(b) If a single qualified plan described in section 401(a) or section 403(a) comprises more than one contract under section 72, regardless of whether such plan includes multiple trusts or combinations of profit-sharing and pension features, these contracts are aggregated for purposes of applying the 85 percent test. Thus, if substantially all of the contributions under a qualified plan comprising two contracts under section 72 are employee contributions, section 72(e)(5)(D) shall not apply to non-annuity distributions under either of the contracts.

(c) With respect to the plans maintained by the Federal Government or by instrumentalities of the Federal Government, the 85 percent test shall be applied by aggregating all such plans. This aggregation rule applies only to those plans that are actively administered by the Federal Government or an instrumentality thereof. Thus, if a plan of the Federal Government is administered by a commercial financial institution, it would not be aggregated with other plans of the Federal Government and its instrumentalities for purposes of applying the 85 percent test.

(d) In the case of a contract described in section 403(b), the 85 percent test is applied separately to each such contract.

Q–6: Is a loan from a qualified plan or contract described in section 72(e)(7) treated as a distribution under section 72(e)(4)(A)?

A–6: Yes. Pursuant to section 72(e)(4)(A), if an employee receives, either directly or indirectly, any amount as a loan from a qualified plan or contract described in section 72(e)(7), such amount shall be treated as a distribution from the plan or contract of an amount not received as an annuity. Similarly, if an employee assigns or pledges, or agrees to assign or pledge, any portion of the value of any qualified plan or contract, such portion shall be treated as a distribution from the plan or contract of an amount not received as an annuity.

Q–7: Does the five percent penalty for premature distributions from annuity contracts, as described in section 72(q), apply to distributions from a qualified plan or contract described in section 72(e)(7)?

A–7: No.

Q–8: When is section 72(e)(7) effective?

A–8: Section 72(e)(7) is effective for amounts received or loans made on or after October 17, 1984. For purposes of this effective date provision, loan amounts outstanding on October 16, 1984, which are renegotiated, extended, renewed, or revised after that date generally are treated as loans made on the date of the renegotiation, etc.

[T.D. 8073, 51 FR 4314, Feb. 4, 1986; 51 FR 7262, Mar. 3, 1986]

§1.73–1 Services of child.

(a) Compensation for personal services of a child shall, regardless of the provisions of State law relating to who is entitled to the earnings of the child, and regardless of whether the income is in fact received by the child, be deemed to be the gross income of the child and not the gross income of the parent of the child. Such compensation, therefore, shall be included in the gross income of the child and shall be reflected in the return rendered by or for such child. The income of a minor child is not required to be included in the gross income of the parent for income tax purposes. For requirements for making the return by such child, or for such child by his guardian, or other person charged with the care of his person or property, see section 6012.

(b) In the determination of taxable income or adjusted gross income, as the case may be, all expenditures made by the parent or the child attributable to amounts which are includible in the gross income of the child and not of the parent solely by reason of section 73 are deemed to have been paid or incurred by the child. In such determination, the child is entitled to take deductions not only for expenditures made on his behalf by his parent which would be commonly considered as business expenses, but also for other expenditures such as charitable contributions made by the parent in the name of the child and out of the child's earnings.

(c) For purposes of section 73, the term ''parent'' includes any individual who is entitled to the services of the child by reason of having parental rights and duties in respect of the child. See section 6201(c) and the regulations in Part 301 of this chapter (Procedure and Administration) for assessment of tax against the parent in certain cases.

§ 1.74–1 Prizes and awards.

(a) *Inclusion in gross income.* (1) Section 74(a) requires the inclusion in gross income of all amounts received as prizes and awards, unless such prizes or awards qualify as an exclusion from gross income under subsection (b), or unless such prize or award is a scholarship or fellowship grant excluded from gross income by section 117. Prizes and awards which are includible in gross income include (but are not limited to) amounts received from radio and television giveaway shows, door prizes, and awards in contests of all types, as well as any prizes and awards from an employer to an employee in recognition of some achievement in connection with his employment.

(2) If the prize or award is not made in money but is made in goods or services, the fair market value of the goods or services is the amount to be included in income.

(b) *Exclusion from gross income.* Section 74(b) provides an exclusion from gross income of any amount received as a prize or award, if (1) such prize or award was made primarily in recognition of past achievements of the recipient in religious, charitable, scientific, educational, artistic, literary, or civic fields; (2) the recipient was selected without any action on his part to enter the contest or proceedings; and (3) the recipient is not required to render substantial future services as a condition to receiving the prize or award. Thus, such awards as the Nobel prize and the Pulitzer prize would qualify for the exclusion. Section 74(b) does not exclude prizes or awards from an employer to an employee in recognition of some achievement in connection with his employment.

(c) *Scholarships and fellowship grants.* See section 117 and the regulations thereunder for provisions relating to scholarships and fellowship grants.

§ 1.75–1 Treatment of bond premiums in case of dealers in tax-exempt securities.

(a) *In general.* (1) Section 75 requires certain adjustments to be made by dealers in securities with respect to premiums paid on municipal bonds which are held for sale to customers in the ordinary course of the trade or business. The adjustments depend upon the method of accounting used by the taxpayer in computing the gross income from the trade or business. See paragraphs (b) and (c) of this section.

(2) The term ''municipal bond'' under section 75 means any obligation issued by a government or political subdivision thereof if the interest on the obligation is excludable from gross income under section 103. However, such term does not include an obligation—

(i) If the earliest maturity or call date of the obligation is more than 5 years from the date of acquisition by the taxpayer or the obligation is sold or otherwise disposed of by the taxpayer within 30 days after the date of acquisition by him, and

(ii) If, in case of an obligation acquired after December 31, 1957, the amount realized upon its sale (or, in the case of any other disposition, its fair market value at the time of disposition) is higher than its adjusted basis.

For purposes of this subparagraph, the amount realized on the sale of the obligation, or the fair market value of the obligation, shall not include any amount attributable to interest, and the adjusted basis shall be computed without regard to any adjustment for amortization of bond premium required under section 75 and section 1016(a)(6). For purposes of determining whether the obligation is sold or otherwise disposed of by the taxpayer within 30 days after the date of its acquisition by him, it is immaterial whether or not such 30-day period is entirely within one taxable year.

(3) The term ‘‘cost of securities sold’’ means the amount ascertained by subtracting the inventory value of the closing inventory of a taxable year from the sum of the inventory value of the opening inventory for such year and the cost of securities and other property purchased during such year which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

(b) *Inventories not valued at cost.* (1) In the case of a dealer in securities who computes gross income from his trade or business by the use of inventories and values such inventories on any basis other than cost, the adjustment required by section 75 is, except as provided in subparagraph (2) of this paragraph, the reduction of ‘‘cost of securities sold’’ by the amount equal to the amortizable bond premium which would be disallowed as a deduction under section 171(a)(2) with respect to the municipal bond if the dealer were an ordinary investor holding such bond. Such amortizable bond premium is computed under section 171(b) by reference to the cost or other original basis of the bond on the date of acquisition (determined without regard to section 1013, relating to inventory value on a subsequent date).

(2) With respect to an obligation acquired after December 31, 1957, which has as its earliest maturity or call date a date more than five years from the date on which it was acquired by the taxpayer, the following rules shall apply:

(i) If the taxpayer holds the obligation at the end of the taxable year, he is not required by section 75 to reduce the ‘‘cost of securities sold’’ for such year with respect to the obligation.

(ii) If the taxpayer sells or otherwise disposes of the obligation during the taxable year, he shall reduce the ‘‘cost of securities sold’’ for the taxable year of the sale or disposition unless he sold the obligation for more than its adjusted basis or otherwise disposed of it when its fair market value was more than its adjusted basis. For purposes of determining whether or not the taxpayer sold the obligation for more than its adjusted basis, or otherwise disposed of it when its fair market value was more than its adjusted basis, the amount realized on the sale of the obligation, or the fair market value of the obligation, shall not include any amount attributable to interest, and the adjusted basis shall be computed without regard to any adjustment for amortization of bond premium required under sections 75 and 1016(a)(6). The amount of the reduction referred to in the first sentence of this subdivision is the total amount by which the adjusted basis of the obligation would be required to be reduced under section 1016(a)(5) were the obligation subject to the amortizable bond premium provisions of section 171; that is, the amount of the amortizable bond premium attributable to the period during which the obligation was held which would be disallowed as a deduction under section 171(a)(2) if the taxpayer were an ordinary investor.

(3) This paragraph may be illustrated by the following examples:

Example (1). X, a dealer in securities who values his inventories on a basis other than cost, makes his income tax returns on the calendar year basis. On July 1, 1954, he bought, for $1,060 each, three municipal bonds (A, B, an C) having a face obligation of $1,000, and maturing on July 1, 1959. Bond A is sold on December 31, 1954, bond B is sold on December 31, 1955, and bond C is sold on June 30, 1956. For each bond the amortizable bond premium to maturity is $60, the period from date of acquisition to maturity is 60 months, and the amortizable bond premium per month is $1. The adjustment for each of the years 1954, 1955, and 1956 is as follows:

Bond	Date acquired	Date sold	Adjustment to "cost of securities sold" for—		
			1954	1955	1956
A	July 1, 1954	Dec. 31, 1954	$6		
B	July 1, 1954	Dec. 31, 1955	6	$12	
C	July 1, 1954	Jun. 30, 1956	6	12	$6
Total			18	24	6

Example (2). Y is a dealer in securities who values his inventories on a basis other than cost. He makes his income tax returns on the calendar year basis. On January 1, 1958, Y bought five bonds (D, E, F, G, and H) issued by various municipalities. Each bond has a face obligation of $1,000 and was purchased for $1,060. The interest on each is excludable from gross income under section 103. Bonds D, E, and F mature on December 31, 1962, and bonds G and H mature on December 31, 1967. The amortizable bond premium per month is $1 with respect to bonds D, E, and F, and is $.50 with respect to bonds G and H. The following table indicates the reduction in ''cost of securities sold'' which Y should make for the years shown, assuming that he sells the bonds on the dates and for the prices set forth:

Bond	Date sold	Sale price	Adjustment to "cost of securities sold" for—		
			1958	1959	1960
D	Feb. 1, 1959	$1,090	$12	$1	
E	Jan. 30, 1958	1,100	None		
F	Jan. 30, 1958	1,000	1		
G	Dec. 31, 1960	1,065	None	None	None
H	Dec. 31, 1960	1,050	None	None	$18
Total			13	1	18

An adjustment to ''cost of securities sold'' must be made with respect to bond D (even though it was ultimately sold at a gain) because the bond neither had an earliest maturity or call date of more than 5 years from the date on which Y acquired it, nor was it disposed of within 30 days after such date. An adjustment must be made for the years 1958 and 1959 since section 75(a)(1) requires that an adjustment be made with respect to such a bond at the close of each taxable year in which it is held. On the other hand, since bonds E, F, G, and H either were disposed of within 30 days after the date of such acquisition or had an earliest maturity or call date more than 5 years from the date of acquisition, and were acquired after December 31, 1957, it is necessary to determine whether Y disposed of them at a loss so as to require an adjustment under section 75. No adjustment is necessary with respect to bonds E and G because they were sold at a gain. An adjustment to ''cost of securities sold'' is required with respect to bonds F and H because they were sold at a loss. As in the case of bond D, an adjustment with respect to bond F is made in 1958 in accordance with section 75(a)(1); however, the adjustment with respect to bond H is made entirely in 1960, the taxable year in which Y sold that bond, in accordance with the last sentence of section 75(a). If Y had acquired bonds before January 1, 1958, it would be unnecessary to determine whether they were disposed of at a loss since that factor is significant only with respect to bonds acquired on or after that date.

(c) *Inventories not used or inventories valued at cost.* (1) In the case of a dealer in securities who computes gross income from his trade or business without the use of inventories or by use of inventories valued at cost, the adjustment required by section 75 is a reduction of the adjusted basis of each municipal bond sold or otherwise disposed of during the taxable year. The amount of such reduction is the total amount by which the adjusted basis of the bond would be required to be reduced under section 1016(a)(5) were the bond subject to the amortizable bond premium provisions of section 171; that is, the amount of the amortizable bond premium attributable to the period during which the bond was held which would be disallowed as a deduction under section 171(a)(2) if the taxpayer were an ordinary investor.

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Z, a dealer in securities who values his inventories on the basis of cost, makes his income tax returns on the calendar year basis. On January 1, 1954, he buys, for $1,060 each, three municipal bonds (I, J, and K) having a face obligation of $1,000, and maturing on January 1, 1959. Bond I is sold on December 31, 1954, bond J is sold on June 30, 1955, and bond K is sold on December 31, 1956. For each bond, the amortizable bond premium to maturity is $60, the period from the date of acquisition to maturity is 60 months, and the amortizable bond premium per month is $1.

Bond	Date acquired	Date sold	Adjustment for—		
			1954	1955	1956
I	Jan. 1, 1954	Dec. 31, 1954	$12		
J	Jan. 1, 1954	June 30, 1955	None	$18	
K	Jan. 1, 1954	Dec. 31, 1956	None	None	$36

(d) *Bonds acquired before July 1, 1950.* Under section 203(c) of the Revenue Act of 1950, adjustment is required for a municipal bond acquired before July 1, 1950, only with respect to taxable years beginning on or after that date. Accordingly, if the municipal bond was acquired before July 1, 1950, then for purposes of section 75 the amortizable bond premium under section 171 must be computed after adjusting the bond premium to the extent proper to reflect unamortized bond premium for so much of the holding period (as determined under section 1223) as precedes the taxable year of the dealer beginning on or after July 1, 1950. Thus, in example (1) of paragraph (b) and in the example in paragraph (c) of this section, the first taxable year beginning on or after July 1, 1950, is, for each dealer, the taxable year beginning January 1, 1951. If each dealer had purchased for $1,060 on April 1, 1950, a municipal bond having a face obligation of $1,000 and maturing April 1, 1955, and had sold such bond on February 28, 1955, the adjustment under section 75 would be computed as follows:

	Dealer *X*	Dealer *Z*
Bond premium	$60	$60
Adjustment for holding period prior to Jan. 1, 1951	9	9
Amortizable bond premium to maturity, as adjusted	51	51
Amortizable bond premium per month	1	1
Total adjustments under sec. (o), 1939 Code, for years 1951–53	36	None
Adjustment under sec. 75 for 1954	12	None
Adjustment under sec. 75 for 1955	2	50

[T.D. 6647, 28 FR 3519, Apr. 11, 1963]

§1.77–1 Election to consider Commodity Credit Corporation loans as income.

A taxpayer who receives a loan from the Commodity Credit Corporation may, at his election, include the amount of such loan in his gross income for the taxable year in which the loan is received. If a taxpayer makes such an election (or has made such an election under section 123 of the Internal Revenue Code of 1939 or under section 223(d) of the Revenue Act of 1939 (53 Stat. 897)), then for subsequent taxable years he shall include in his gross income all amounts received during those years as loans from the Commodity Credit Corporation, unless he secures the permission of the Commissioner to change to a different method of accounting. Application for permission to change such method of accounting and the basis upon which the return is made shall be filed with the Commission of Internal Revenue, Washington, D.C. 20224, within 90 days after the beginning of the taxable year to be covered by the return.

§1.77–2 Effect of election to consider commodity credit loans as income.

(a) If a taxpayer elects or has elected under section 77, section 123 of the Internal Revenue Code of 1939, or section 223(d) of the Revenue Act of 1939 (53 Stat. 897), as amended, to include in his gross income the amount of a loan from the Commodity Credit Corporation for the taxable year in which it is received, then—

(1) No part of the amount realized by the Commodity Credit Corporation

upon the sale or other disposition of the commodity pledged for such loan shall be recognized as income to the taxpayer, unless the taxpayer receives an amount in addition to that advanced to him as the loan, in which event such additional amount shall be included in the gross income of the taxpayer for the taxable year in which it is received, and

(2) No deductible loss to the taxpayer shall be recognized on account of any deficiency realized by the Commodity Credit Corporation on such loan if the taxpayer was relieved from liability for such deficiency.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example. A, a taxpayer who elected for his taxable year 1952 to include in gross income amounts received as loans from the Commodity Credit Corporation, received as loans $500 in 1952, $700 in 1953, and $900 in 1954. In 1956 all the pledged commodity was sold by the Commodity Credit Corporation for an amount $100 and $200 less than the loans with respect to the commodity pledged in 1952 and 1953, respectively, and for an amount $150 greater than the loan with respect to the commodity pledged in 1954. A, in making his return for 1956, shall include in gross income the sum of $150 if it is received during that year, but will not be allowed a deduction for the deficiencies of $100 and $200 unless he is required to satisfy such deficiencies and does satisfy them during that year.

§ 1.78–1 Dividends received from certain foreign corporations by certain domestic corporations choosing the foreign tax credit.

(a) *Taxes deemed paid by certain domestic corporations treated as a section 78 dividend.* Any reduction under section 907(a) of the foreign income taxes deemed to be paid with respect to foreign oil and gas extraction income does not affect the amount treated as a section 78 dividend. If a domestic corporation chooses to have the benefits of the foreign tax credit under section 901 for any taxable year, an amount which is equal to the foreign income taxes deemed to be paid by such corporation for such year under section 902(a) in accordance with §§ 1.902–1 and 1.902–2 and § 1.902(b)(2), or under section 960(a)(1) in accordance with § 1.960–7, shall, to the extent provided by this section, be treated as a dividend (hereinafter referred to as a section 78 dividend) received by such domestic corporation from the foreign corporation described in section 902(a) in accordance with §§ 1.902–1 and 1.902–2 or section 960(c)(1) in accordance with § 1.960–7, as the case may be. A section 78 dividend shall be treated as a dividend for all purposes of the Code, except that it shall not be treated as a dividend under section 245, relating to dividends received from certain foreign corporations, or increase the earnings and profits of the domestic corporation. For purposes of determining the source of a section 78 dividend in computing the limitation on the foreign tax credit under section 904, see § 1.902(h)(1) and the regulations under section 960. For special rules relating to the determination of the foreign tax credit under section 902 with respect to certain minimum distributions received from controlled foreign corporations and the effect of such rules upon the gross-up under section 78, see paragraph (c) of § 1.963–4. For rules respecting the reduction of foreign income taxes under section 6038(b) in applying section 902(a) in accordance with §§ 1.902–1 and 1.902–2 or section 960(c)(1) in accordance with § 1.960–7, where there has been a failure to furnish certain information and for an illustration of the effect of such reduction upon the amount of a section 78 dividend, see paragraph (l) of § 1.6038–2.

(b) *Certain taxes not treated as a section 78 dividend.* Foreign income taxes deemed paid by a domestic corporation under section 902(a) in accordance with §§ 1.902–1 and 1.902–2 or section 960(c)(1) in accordance with § 1.960–7, shall not, to the extent provided by paragraph (b) of § 1.960–3, be treated as a section 78 dividend where such taxes are imposed on certain distributions from the earnings and profits of a controlled foreign corporation attributable to an amount which is, or has been, included in gross income of the domestic corporation under section 951.

(c) *United Kingdom income tax included in gross income under treaty.* Any amount of United Kingdom income tax appropriate to a dividend paid by a corporation which is a resident of the United Kingdom shall not be treated as a section 78 dividend by a domestic corporation to the extent that such tax is included in the gross income of such domestic corporation in accordance with Article XIII (1) of the income tax convention between the United States and the United Kingdom, as amended by Article II of the supplementary protocol between such Governments signed on August 19, 1957 (9 UST 1331). See §507.117 of this chapter, relating to credit against United States tax liability for income tax paid or deemed to have been paid to the United Kingdom.

(d) *Taxable year in which section 78 dividend is received.* A section 78 dividend shall be considered received in the taxable year of a domestic corporation in which—

(1) The corporation receives the dividend by reason of which there are deemed paid under section 902(a) in accordance with §§1.902–1 and 1.902–2 the foreign income taxes which give rise to such section 78 dividend, or

(2) The corporation includes in gross income under section 951(a) the amounts by reason of which there are deemed paid under section 960(a)(1) in accordance with §1.960–7 the foreign income taxes which give rise to such section 78 dividend, notwithstanding that such foreign income taxes may be carried back or carried over to another taxable year under section 904(d) and are deemed to be paid or accrued in such other taxable year.

(e) *Effective dates for the application of section 78*—(1) *In general.* This section shall apply to amounts of foreign income taxes deemed paid under section 902(a) in accordance with §§1.902–1 and 1.902–2, or under section 960(a)(1) in accordance with §1.960–7, by reason of a distribution received by a domestic corporation—

(i) After December 31, 1964, or

(ii) Before January 1, 1965, in a taxable year of such domestic corporation beginning after December 31, 1962, but only to the extent that such distribution is made out of the accumulated profits of a foreign corporation for a taxable year of such foreign corporation beginning after December 31, 1962.

For special rules relating to determination of accumulated profits for such purposes, see the regulation under section 902.

(2) *Amounts under section 951 treated as distributions.* For purposes of this paragraph, any amount attributable to the earnings and profits for the taxable year of a first-tier corporation (as defined in paragraph (b)(1) of §1.960–1) which is included in the gross income of a domestic corporation under section 951(a) shall be treated as a distribution received by such domestic corporation on the last day in such taxable year on which such first-tier corporation is a controlled foreign corporation.

(f) *Illustrations.* The application of this section may be illustrated by the examples provided in §1.902–1, §1.904–5, §1.960–3, §1.960–4, and §1.963–4.

[T.D. 6805, 30 FR 3208, Mar. 9, 1965, as amended by T.D. 7120, 36 FR 10859, June 4, 1971; 36 FR 11924, June 23, 1971; T.D. 7481, 42 FR 20130, Apr. 18, 1977; T.D. 7490; 42 FR 30497, June 15, 1977; 42 FR 32536, June 27, 1977; T.D. 7649, 44 FR 60086, Oct. 18, 1979; T.D. 7961, 49 FR 26225, June 27, 1984]

§1.79–0 Group-term life insurance—definitions of certain terms.

The following definitions apply for purposes of section 79, this section, and §§1.79–1, 1.79–2, and 1.79–3.

Carried directly or indirectly. A policy of life insurance is ‘‘carried directly or indirectly’’ by an employer if—

(a) The employer pays any part of the cost of the life insurance directly or through another person; or

(b) The employer or two or more employers arrange for payment of the cost of the life insurance by their employees and charge at least one employee less than the cost of his or her insurance, as determined under Table I of §1.79–3(d)(2), and at least one other employee more than the cost of his or her insurance, determined in the same way.

Employee. An ‘‘employee’’ is—

(a) A person who performs services if his or her relationship to the person for whom services are performed is the legal relationship of employer and employee described in §31.3401(c)–1; or

(b) A full-time life insurance salesperson described in section 7701(a)(20); or

(c) A person who formerly performed services as an employee.

A person who formerly performed services as an employee and currently performs services for the same employer as an independent contractor is considered an employee only with respect to insurance provided because of the person's former services as an employee.

Group of employees. A ''group of employees'' is all employees of an employer, or less than all employees if membership in the group is determined solely on the basis of age, marital status, or factors related to employment. Examples of factors related to employment are membership in a union some or all of whose members are employed by the employer, duties performed, compensation received, and length of service. Ordinarily the purchase of something other than group-term life insurance is not a factor related to employment. For example, if an employer provides credit life insurance to all employees who purchase automobiles, these employees are not a ''group of employees'' because membership is not determined solely on the basis of age, marital status, or factors related to employment. On the other hand, participation in an employer's pension, profit-sharing or accident and health plan is considered a factor related to employment even if employees are required to contribute to the cost of the plan. Ownership of stock in the employer corporation is not a factor related to employment. However, participation in an employer's stock bonus plan may be a factor related to employment and a ''group of employees'' may include employees who own stock in the employer corporation.

Permanent benefit. A ''permanent benefit'' is an economic value extending beyond one policy year (for example, a paid-up or cash surrender value) that is provided under a life insurance policy. However, the following features are not permanent benefits:

(a) A right to convert (or continue) life insurance after group life insurance coverage terminates;

(b) Any other feature that provides no economic benefit (other than current insurance protection) to the employee; or

(c) A feature under which term life insurance is provided at a level premium for a period of five years or less.

Policy. The term ''policy'' includes two or more obligations of an insurer (or its affiliates) that are sold in conjunction. Obligations that are offered or available to members of a group of employees are sold in conjunction if they are offered or available because of the employment relationship. The actuarial sufficiency of the premium charged for each obligation is not taken into account in determining whether the obligations are sold in conjunction. In addition, obligations may be sold in conjunction even if the obligations are contained in separate documents, each document is filed with and approved by the applicable state insurance commission, or each obligation is independent of any other obligation. Thus, a group of individual contracts under which life insurance is provided to a group of employees may be a policy. Similarly, two benefits provided to a group of employees, one term life insurance and the other a permanent benefit, may be a policy, even if one of the benefits is provided only to employees who decline the other benefit. However, an employer may elect to treat two or more obligations each of which provides no permanent benefits as separate policies if the premiums are properly allocated among such policies. An employer also may elect to treat an obligation which provides permanent benefits as a separate policy if—

(a) The insurer sells the obligation directly to the employee who pays the full cost thereof;

(b) The participation of the employer with respect to sales of the obligation to employees is limited to selection of the insurer and the type of coverage and to sales assistance activities such as providing employee lists to the insurer, permitting the insurer to use the employer's premises for solicitation, and collecting premiums through payroll deduction;

(c) The insurer sells the obligation on the same terms and in substantial amounts to individuals who do not purchase (and whose employers do not purchase) any other obligation from the insurer; and

(d) No employer-provided benefit is conditioned on purchase of the obligation.

[T.D. 7623, 44 FR 28797, May 17, 1979, as amended by T.D. 7917, 48 FR 45762, Oct. 7, 1983]

§1.79–1 Group-term life insurance—general rules.

(a) *What is group-term life insurance?* Life insurance is not group-term life insurance for purposes of section 79 unless it meets the following conditions:

(1) It provides a general death benefit that is excludable from gross income under section 101(a).

(2) It is provided to a group of employees.

(3) It is provided under a policy carried directly or indirectly by the employer.

(4) The amount of insurance provided to each employee is computed under a formula that precludes individual selection. This formula must be based on factors such as age, years of service, compensation, or position. This condition may be satisfied even if the amount of insurance provided is determined under a limited number of alternative schedules that are based on the amount each employee elects to contribute. However, the amount of insurance provided under each schedule must be computed under a formula that precludes individual selection.

(b) *May group-term life insurance be combined with other benefits?* No part of the life insurance provided under a policy that provides a permanent benefit is group-term life insurance unless—

(1) The policy or the employer designates in writing the part of the death benefit provided to each employee that is group-term life insurance; and

(2) The part of the death benefit that is provided to an employee and designated as the group-term life insurance benefit for any policy year is not less than the difference between the total death benefit provided under the policy and the employee's deemed death benefit (DDB) at the end of the policy year determined under paragraph (d)(3) of this section.

(c) *May a group include fewer than 10 employees?* (1) As a general rule, life insurance provided to a group of employees cannot qualify as group-term life insurance for purposes of section 79 unless, at some time during the calendar year, it is provided to at least 10 full-time employees who are members of the group of employees. For purposes of this rule, all life insurance provided under policies carried directly or indirectly by the employer is taken into account in determining the number of employees to whom life insurance is provided.

(2) The general rule of paragraph (c)(1) of this section does not apply if the following conditions are met:

(i) The insurance is provided to all full-time employees of the employer or, if evidence of insurability affects eligibility, to all full-time employees who provide evidence of insurability satisfactory to the insurer.

(ii) The amount of insurance provided is computed either as a uniform percentage of compensation or on the basis of coverage brackets established by the insurer. However, the amount computed under either method may be reduced in the case of employees who do not provide evidence of insurability satisfactory to the insurer. In general, no bracket may exceed 2½ times the next lower bracket and the lowest bracket must be at least 10 percent of the highest bracket. However, the insurer may establish a separate schedule of coverage brackets for employees who are over age 65, but no bracket in the over-65 schedule may exceed 2½ times the next lower bracket and the lowest bracket in the over-65 schedule must be at least 10 percent of the highest bracket in the basic schedule.

(iii) Evidence of insurability affecting employee's eligibility for insurance or the amount of insurance provided to that employee is limited to a medical questionnaire completed by the employee that does not require a physical examination.

(3) The general rule of paragraph (c)(1) of this section does not apply if the following conditions are met:

(i) The insurance is provided under a common plan to the employees of two or more unrelated employers.

(ii) The insurance is restricted to, but mandatory for, all employees of the employer who belong to or are represented by an organization (such as a union) that carries on substantial activities in addition to obtaining insurance.

(iii) Evidence of insurability does not affect an employee's eligibility for insurance or the amount of insurance provided to that employee.

(4) For purposes of paragraph (c) (2) and (3) of this section, employees are not taken into account if they are denied insurance for the following reasons:

(i) They are not eligible for insurance under the terms of the policy because they have not been employed for a waiting period, specified in the policy, which does not exceed six months.

(ii) They are part-time employees. Employees whose customary employment is for not more than 20 hours in any week, or 5 months in any calendar year, are presumed to be part-time employees.

(iii) They have reached the age of 65.

(5) For purposes of paragraph (c) (1) and (2) of this section, insurance is considered to be provided to an employee who elects not to receive insurance unless, in order to receive the insurance, the employee is required to contribute to the cost of benefits other than term life insurance. Thus, if an employee could receive term life insurance by contributing to its cost, the employee is taken into account in determining whether the insurance is provided to 10 or more employees even if such employee elects not to receive the insurance. However, an employee who must contribute to the cost of permanent benefits to obtain term life insurance is not taken into account in determining whether the term life insurance is provided to 10 or more employees unless the term life insurance is actually provided to such employee.

(d) *How much must an employee receiving permanent benefits include in income?*—(1) *In general.* If an insurance policy that meets the requirements of this section provides permanent benefits to an employee, the cost of the permanent benefits reduced by the amount paid for permanent benefits by the employee is included in the employee's income. The cost of the permanent benefits is determined under the formula in paragraph (d)(2) of this section.

(2) *Formula for determining cost of the permanent benefits.* In each policy year the cost of the permanent benefits for any particular employee must be no less than:

$X(DDB_2—DDB_1)$

where

DDB_2 is the employee's deemed death benefit at the end of the policy year:

DDB_1 is the employee's deemed death benefit at the end of the preceding policy year; and

X is the net single premium for insurance (the premium for one dollar of paid-up whole-life insurance) at the employee's attained age at the beginning of the policy year.

(3) *Formula for determining deemed death benefit.* The deemed death benefit (DDB) at the end of any policy year for any particular employee is equal to:

R/Y

where

R is the net level premium reserved at the end of that policy year for all benefits provided to the employee by the policy or, if greater, the cash value of the policy at the end of that policy year; and

Y is the net single premium for insurance (the premium for one dollar of paid-up whole life insurance) at the employee's age at the end of that policy year.

(4) *Mortality tables and interest rates used.* For purposes of paragraph (d) (2) and (3) of this section, the net level premium reserve (R) and the net single premium (X or Y) shall be based on the 1958 CSO Mortality Table and 4 percent interest.

(5) *Dividends.* If an insurance policy that meets the requirements of this section provides permanent benefits, part or all of the dividends under the policy may be includible in the employee's income. If the employee pays nothing for the permanent benefits, all dividends under the policy that are actually or constructively received by the employee are includible in the employee's income. In all other cases, the amount of dividends included in the employee's income is equal to

$(D+C)—(PI+DI+AP)$

where

D is the total amount of dividends actually or constructively received under the policy by the employee in the current and all preceding taxable years of the employee;

C is the total cost of the permanent benefits for the current and all preceding taxable years of the employee determined under the formulas in paragraph (d) (2) and (6) of this section:

PI is the total amount of premium included in the employee's income under paragraph (d)(1) of this section for the current and all preceding taxable years of the employee;

DI is the total amount of dividends included in the employee's income under this paragraph (d)(5) in all preceding taxable years of the employee; and

AP is the total amount paid for permanent benefits by the employee in the current and all preceding taxable years of the employee.

(6) *Different policy and taxable years.* (i) If a policy year begins in one employee taxable year and ends in another employee taxable year, the cost of the permanent benefits, determined under the formula in paragraph (d)(2) of this section, is allocated between the employee taxable years.

(ii) The cost of permanent benefits for a policy year is allocated first to the employee taxable year in which the policy year begins. The cost of permanent benefits allocated to that policy year is equal to:

$F \times C$

where

F is the fraction of the premium for that policy year that is paid on or before the last day of the employee taxable year; and

C is the cost of permanent benefits for the policy year determined under the formula in paragraph (d)(2) of this section.

(iii) Any part of the cost of permanent benefits that is not allocated to the employee taxable year in which the policy year begins is allocated to the subsequent employee taxable year.

(iv) The cost of permanent benefits for an employee taxable year is the sum of the costs of permanent benefits allocated to that year under paragraph (d)(6) (ii) and (iii) of this section.

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

Example. An employer provides insurance to employee A under a policy that meets the requirements of this section. Under the policy; A, who is 47 years old, received $70,000 of group-term life insurance and elects to receive a permanent benefit under the policy. A pays $2 for each $1,000 of group-term life insurance through payroll deductions and the employer pays the remainder of the premium for the group-term life insurance. The employer also pays one-half of the premium specified in the policy for the permanent benefit. A pays the other one-half of the premium for the permanent benefit through payroll deductions. The policy specifies that the annual premium paid for the permanent benefit is $300. However, the amount of premium allocated to the permanent benefit by the formula in paragraph (d)(2) of this section is $350. A is a calendar year taxpayer, the policy year begins on January 1. In 1980, $200 is includible in A's income because of insurance provided by the employer. This amount is completed as follows:

(1) Cost of permanent benefits	$350
(2) Amounts considered paid by A for permanent benefits (½×$300)	150
(3) Line (1) minus line (2)	200
(4) Cost of $70,000 of group-term life insurance under Table 1 of §1.79–3	243.60
(5) Cost of $50,000 of group-term life insurance under Table 1 of §1.79–3	174
(6) Cost of group-term life insurance in excess of $50,000 (line (4) minus line (5))	69.60
(7) Amount considered paid by A for group-term life insurance (70×$2)	140
(8) Line (6) minus line (7) (but not less than 0)	0
(9) Amount includible in income (line (3) plus line (8))	200

(e) *What is the effect of State law limits?* Section 79 does not apply to life insurance in excess of the limits under applicable state law on the amount of life insurance that can be provided to an employee under a single contract of group-term life insurance.

(f) *Cross references.* (1) See section 79(b) and §1.79–2 for rules relating to group-term life insurance provided to certain retired individuals.

(2) See section 61(a) and the regulations thereunder for rules relating to life insurance not meeting the requirements of section 79, this section, or §1.79–2, such as insurance provided on the life of a non-employee (for example, an employee's spouse), insurance not provided as compensation for personal services performed as an employee, insurance not provided under a policy carried directly or indirectly by the employer, or permanent benefits.

(3) See sections 106 and §1.106–1 for rules relating to certain insurance that does not provide general death benefits, such as travel insurance or accident and health insurance (including amounts payable under a double indemnity clause or rider).

(g) [Reserved]

(h) *Effective date.* Section 1.79–0 applies to insurance provided in employee taxable years beginning on or after January 1, 1977 (except as provided in

26 CFR 1.79–1(g) (revised as of April 1, 1983) with respect to insurance provided in employee taxable years beginning in 1977). Sections 1.79–1 through 1.79–3 apply to insurance provided in employee taxable years beginning after December 31, 1982. See 26 CFR 1.79–1 through 1.79–3 (revised as of April 1, 1983) for rules applicable to insurance provided in employee taxable years beginning before January 1, 1983.

(Secs. 79(c) and 7805 of the Internal Revenue Code of 1954 (78 Stat. 36, 26 U.S.C. 79(c); 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7623, 44 FR 28797, May 17, 1979, as amended by T.D. 7917, 48 FR 45762, Oct. 7, 1983; T.D. 7924, 48 FR 54595, Dec. 6, 1983]

§ 1.79–2 Exceptions to the rule of inclusion.

(a) *In general.* (1) Section 79(b) provides exceptions for the cost of group-term life insurance provided under certain policies otherwise described in section 79(a). The policy or policies of group-term life insurance which are described in section 79(a) but which qualify for one of the exceptions set forth in section 79(b) are described in paragraphs (b) through (d) of this section. Paragraph (b) of this section discusses the exception provided in section 79(b)(1); paragraph (c) of this section discusses the exception provided in section 79(b)(2); and paragraph (d) of this section discusses the exception provided in section 79(b)(3).

(2)(i) If a policy of group-term life insurance qualifies for an exception provided by section 79(b), then the amount equal to the cost of such insurance is excluded from the application of the provisions of section 79(a).

(ii) If a policy, or portion of a policy of group-term life insurance qualifies for an exception provided by section 79(b), the amount (if any) paid by the employee toward the purchase of such insurance is not to be taken into account as an amount referred to in section 79 (a)(2). In the case of a policy or policies of group-term life insurance which qualify for an exception provided by section 79(b) (1) or (3), the amount paid by the employee which is not to be taken into account as an amount referred to in section 79(a) (2) is the amount paid by the employee for the particular policy or policies of group-term life insurance which qualify for an exception provided under such section. If the exception provided in section 79(b)(2) is applicable only to a portion of the group-term life insurance on the employee's life, the amount considered to be paid by the employee toward the purchase of such portion is the amount equal to the excess of the cost of such portion of the insurance over the amount otherwise includible in the employee's gross income with respect to the group-term life insurance on his life carried directly or indirectly by such employer.

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

Example. A is an employee of X Corporation and is also an employee of Y Corporation, a subsidiary of X Corporation. A is provided, under a separate plan arranged by each of his employers, group-term life insurance on his life. During his taxable year, under the group-term life insurance plan of X Corporation, A is provided $60,000 of group-term life insurance on his life, and A pays $360.00 toward the purchase of such insurance. Under the group-term life insurance plan of Y Corporation, A is provided $65,000 of group-term life insurance on his life, but does not pay any part of the cost of such insurance. At the beginning of his taxable year, A terminates his employment with the X Corporation after he has reached the retirement age with respect to such employer, and the policy carried by the X Corporation qualifies for the exception provided by section 79(b)(1). For that taxable year, the cost of the group-term life insurance on A's life which is provided under the plan of X Corporation is not taken into account in determining the amount includible in A's gross income under section 79(a), and A may not take into account as an amount described in section 79(a)(2) the $360.00 he pays toward the purchase of such insurance.

(b) *Retired and disabled employees*—(1) *In general.* Section 79(b)(1) provides an exception for the cost of group-term life insurance on the life of an individual which is provided under a policy or policies otherwise described in section 79(a) if the individual has terminated his employment (as defined in subparagraph (2) of this paragraph) with such employer and either has reached the retirement age with respect to such employer (as defined in subparagraph (3) of this paragraph), or has become disabled (as defined in subparagraph (4)(i) of this paragraph). If an individual who has terminated his employment attains retirement age or has become disabled during his taxable year, or if an employee who has attained retirement age or has become disabled terminates his employment during the taxable year, the exception provided by section 79(b)(1) applies only to the portion of the cost of group-term life insurance which is provided subsequent to the happening of the last event which qualifies the policy of insurance on the employee's life for the exception provided in such section.

(2) *Termination of employment.* For purposes of section 79(b)(1), an individual has terminated his employment with an employer providing such individual group-term life insurance when such individual no longer renders services to that employer as an employee of such employer.

(3) *Retirement age.* For purposes of section 79(b)(1) and this section, the meaning of the term ''retirement age'' is determined in accordance with the following rules—

(i)*(a)* If the employee is covered under a written pension or annuity plan of the employer providing such individual group-term life insurance on his life (whether or not such plan is qualified under section 401(a) or 403(a)), then his retirement age shall be considered to be the earlier of—

(1) The earliest age indicated by such plan at which an active employee has the right (or an inactive individual would have the right had he continued in employment) to retire without disability and without the consent of his employer and receive immediate retirement benefits computed at either the full rate or a rate proportionate to completed service as set forth in the normal retirement formula of the plan, i.e., without actuarial or similar reduction because of retirement before some later specified age, or

(2) The age at which it has been the practice of the employer to terminate, due to age, the services of the class of employees to which he last belonged.

(b) For purposes of *(a)* of this subdivision, if an employee is covered under more than one pension or annuity plan of the employer, his retirement age shall be determined with regard to that plan which covers that class of employees of the employer to which the employee last belonged. If the class of employees to which the employee last belonged is covered under more than one pension or annuity plan, then the employee's retirement age shall be determined with regard to that plan which covers the greatest number of the employer's employees.

(ii) In the absence of a written employee's pension or annuity plan described in subdivision (i) of this subparagraph, retirement age is the age, if any, at which it has been the practice of the employer to terminate, due to age, the services of the class of employees to which the particular employee last belonged, provided such age is reasonable in view of all the pertinent facts and circumstances.

(iii) If neither subdivision (i) or (ii) of this subparagraph applies, the retirement age is considered to be age 65.

(4) *Disabled.* (i) For taxable years beginning after December 31, 1966, an individual is considered disabled for purposes of section 79(b)(1) and subparagraph (1) of this paragraph if he is disabled within the meaning of section 72(m)(7) and paragraph (f) of §1.72–17. For taxable years beginning before January 1, 1967, an individual is considered disabled for purposes of section 79(b)(1) and subparagraph (1) of this paragraph if he is disabled within the meaning of section 213(g)(3), relating to the meaning of disabled, but the determination of the individual's status shall be made without regard to the provisions of section 213(g)(4), relating to the determination of status.

(ii)*(a)* In any taxable year in which an individual seeks to apply the exception set forth in section 79(b)(1) by reason of his being disabled within the meaning of subdivision (i) of this subparagraph, and in which the aggregate amount of insurance on the individual's life subject to the rule of inclusion set forth in section 79(a), but determined without regard to the amount of any insurance subject to any exception set forth in section 79(b), is greater than $50,000 of such insurance, the substantiation required by *(b)* or *(c)* of this subdivision must be submitted with the individual's tax return.

(b) For the first taxable year for which the individual seeks to apply the exception set forth in section 79(b)(1) by reason of his being disabled within the meaning of subdivision (i) of this subparagraph, there must be submitted with his income tax return a doctor's statement as to his impairment. There must also be submitted with the return a statement by the individual with respect to the effect of the impairment upon his substantial gainful activity, and the date such impairment occurred. For subsequent taxable years, the taxpayer may, in lieu of such statements, submit a statement declaring the continued existence (without substantial diminution) of the impairment and its continued effect upon his substantial gainful activity.

(c) In lieu of the substantiation required to be submitted by *(b)* of this subdivision for the taxable year, the individual may submit a signed statement issued to him by the insurer to the effect that the individual is disabled within the meaning of subdivision (i) of this paragraph. Such statement must set forth the basis for the insurer's determination that the individual was so disabled, and, for the first taxable year in which the individual is so disabled, the date such disability occurred.

(c) *Employer or charity a beneficiary*—(1) *General rule.* Section 79(b)(2) provides an exception with respect to the amounts referred to in section 79 (a) for the cost of any portion of the group-term life insurance on the life of an employee provided during part or all of the taxable year of the employee under which the employer is directly or indirectly the beneficiary, or under which a person described in section 170(c) (relating to definition of charitable contributions) is the sole beneficiary, for the entire period during such taxable year for which the employee receives such insurance.

(2) *Employer is a beneficiary.* For purposes of section 79(b)(2) and subparagraph (1) of this paragraph, the determination of whether the employer is directly or indirectly the beneficiary under a policy or policies of group-term life insurance depends upon the facts and circumstances of the particular case. Such determination is not made solely with regard to whether the employer possesses all the incidents of ownership in the policy. Thus, for example, if the employer is the nominal beneficiary under a policy of group-term life insurance on the life of his employee but there is an arrangement whereby the employer is required to pay over all (or a portion) of the proceeds of such policy to the employee's estate or his beneficiary, the employer is not considered a beneficiary under such policy (or such portion of the policy).

(3) *Charity a beneficiary.* (i) For purposes of section 79(b)(2) and subparagraph (1) of this paragraph, a person described in section 170(c) is a beneficiary under a policy providing group-term life insurance if such person is designated the beneficiary under the policy by any assignment or designation of beneficiary under the policy which, under the law of the jurisdiction which is applicable to the policy, has the effect of making such person the beneficiary under such policy (whether or not such designation is revocable during the taxable year). Such a designation may be made by the employee with respect to any portion of the group-term life insurance on his life. However, no deduction is allowed under section 170, relating to charitable, etc., contributions and gifts, with respect to any such assignment or designation.

(ii) A person described in section 170(c) must be designated the sole beneficiary under the policy or portion of the policy. Such requirement is satisfied if the person described in section 170(c) is the beneficiary under such policy or portion of the policy, and there is no contingent or similar beneficiary under such policy or such portion other than a person described in section 170(c). A general ‘‘preference beneficiary clause’’ in a policy governing payment where there is no designated beneficiary in existence at the death of the employee will not of itself be considered to create a contingent or similar beneficiary. A person described in section 170(c) may be designated the beneficiary under a portion of the policy if such person is designated the sole beneficiary under a beneficiary designation which is expressed, for example, as a fraction of the amount of insurance on the insured's life.

(iii) If a person described in section 170(c) is designated, before May 1, 1964, the beneficiary under the policy (or portion thereof) and such person remains the beneficiary for the period beginning May 1, 1964, and ending with the close of the first taxable year of the employee ending after April 30, 1964, such person shall be treated as the beneficiary under the policy (or the portion thereof) for the period beginning January 1, 1964, and ending April 30, 1964.

(d) *Insurance contracts purchased under qualified employee plans.* (1) Section 79(b)(3) provides an exception with respect to the cost of any group-term life insurance which is provided under a life insurance contract purchased as a part of a plan described in section 403(a), or purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) if the proceeds of such contract are payable directly or indirectly to a participant in such trust or to a beneficiary of such participant. The provisions of section 72(m)(3) and §1.72–16 apply to the cost of such group-term life insurance, and, therefore, no part of such cost is excluded from the gross income of the employee by reason of the provisions of section 79.

(2) Whether the life insurance protection on an employee's life is provided under a qualified employee plan referred to in subparagraph (1) of this paragraph depends upon the provisions of such plan. In determining whether a pension, profit-sharing, stock bonus, or annuity plan satisfies the requirements for qualification set forth in sections 401(a) or 403(a), only group-term life insurance which is provided under such plan is taken into account.

[T.D. 6888, 31 FR 9201, July 6, 1966, as amended by T.D. 6919, 32 FR 7390, May 18, 1967; T.D. 6985, 33 FR 19812, Dec. 27, 1968; T.D. 7623, 44 FR 28800, May 17, 1979]

§1.79–3 Determination of amount equal to cost of group-term life insurance.

(a) *In general.* This section prescribes the rules for determining the amount equal to the cost of group-term life insurance on an employee's life which is to be included in his gross income pursuant to the rule of inclusion set forth in section 79(a). Such amount is determined by—

(1) Computing the cost of the portion of the group-term life insurance on the employee's life to be taken into account (determined in accordance with the rules set forth in paragraph (b) of this section) for each "period of coverage" (as defined in paragraph (c) of this section) and aggregating the costs so determined, then

(2) Reducing the amount determined under subparagraph (1) of this paragraph by the amount determined in accordance with the rules set forth in paragraph (e) of this section, relating to the amount paid by the employee toward the purchase of group-term life insurance.

(b) *Determination of the portion of the group-term life insurance on the employee's life to be taken into account.* (1) For each "period of coverage" (as defined in paragraph (c) of this section), the portion of the group-term life insurance to be taken into account in computing the amount includible in an employee's gross income for purposes of paragraph (a)(1) of this section is the sum of the proceeds payable upon the death of the employee under each policy, or portion of a policy, of group-term life insurance on such employee's life to which the rule of inclusion set forth in section 79(a) applies, less $50,000 of such insurance. Thus, the amount of any proceeds payable under a policy, or portion of a policy, which qualifies for one of the exceptions to the rule of inclusion provided by section 79(b) is not taken into account. For the regulations relating to such exceptions to the rule of inclusion, see §1.79–2.

(2) For purposes of making the computation required by subparagraph (1) of this paragraph in any case in which the amount payable under the policy, or portion thereof, varies during the period of coverage, the amount payable under such policy during such period is considered to be the average of the amount payable under such policy at the beginning and the end of such period.

(3)(i) For purposes of making the computation required by subparagraph (1) of this paragraph in any case in which the amount payable under the policy is not payable as a specific amount upon the death of the employee in full discharge of the liability of the insurer, and such form of payment is not one of alternative methods of payment, the amount payable under such policy is the present value of the agreement by the insurer under the policy to make the payments to the beneficiary or beneficiaries entitled to such amounts upon the employee's death. For each period of coverage, such present value is to be determined as if the first and last day of such period is the date of death of the employee.

(ii) The present value of the agreement by the insurer under the policy to make payments shall be determined by the use of the mortality tables and interest rate employed by the insurer with respect to such a policy in calculating the amount held by the insurer (as defined in section 101(d)(2)), unless the Commissioner otherwise determines that a particular mortality table and interest rate, representative of the mortality table and interest rate used by commercial insurance companies with respect to such policies, shall be used to determine the present value of the policy for purposes of this subdivision.

(iii) For purposes of making the computation required by subdivision (i) of this subparagraph in any case in which it is necessary to determine the age of an employee's beneficiary and such beneficiary remains the same (under the policy, or the portion of the policy, with respect to which the determination of the present value of the agreement of the insurer to pay benefits is being made) for the entire period during the employee's taxable year for which such policy is in effect, the age of such beneficiary is such beneficiary's age at his nearest birthday on June 30th of the calendar year.

(iv) If the policy of group-term life insurance on the employee's life is such that the present value of the agreement by the insurer under the policy to pay benefits cannot be determined by the rules prescribed in this subparagraph, the taxpayer may submit with his return a computation of such present value, consistent with the actuarial and other assumptions set forth in this subparagraph, showing the appropriate factors applied in his case. Such computation shall be subject to the approval of the Commissioner upon examination of such return.

(c) *Period of coverage.* For purposes of this section, the phrase ''period of coverage'' means any one calendar month period, or part thereof, during the employee's taxable year during which the employee is provided group-term life insurance on his life to which the rule of inclusion set forth in section 79(a) applies. The phrase ''part thereof'' as used in the preceding sentence means any continuous period which is less than the one calendar month period referred to in the preceding sentence for which premiums are charged by the insurer.

(d) *The cost of the portion of the group-term life insurance on an employee's life.* (1) This paragraph sets forth the rules for determining the cost, for each period of coverage, of the portion of the group-term life insurance on the employee's life to be taken into account in computing the amount includible in the employee's gross income for purposes of paragraph (a)(1) of this section. The portion of the group-term life insurance on the employee's life to be taken into account is determined in accordance with the provisions of paragraph (b) of this section. Table I, which is set forth in subparagraph (2) of this paragraph, determines the cost for each $1,000 of such portion of the group-term life insurance on the employee's life for each one-month period. The cost of the portion of the group-term life insurance on the employee's life for each period of coverage of one month is obtained by multiplying the number of thousand dollars of such insurance computed to the nearest tenth which is provided during such period by the appropriate amount set forth in Table I. In any case in which group-term life insurance is provided for a period of coverage of less than one month, the amount set forth in Table I is prorated over such period of coverage.

(2) For the cost of group-term life insurance provided after December 31, 1988, the following table sets forth the cost of $1,000 of group-term life insurance provided for one month, computed on the basis of 5-year age brackets. For purposes of Table I, the age of the employee is the employee's attained age on the last day of the employee's taxable year.

TABLE I.—UNIFORM PREMIUMS FOR $1,000 OF GROUP-TERM LIFE INSURANCE PROTECTION

5-year age bracket	Cost per $1,000 of protection for 1-month
Under 30	$0.08
30 to 34	.09
35 to 39	.11
40 to 44	.17
45 to 49	.29
50 to 54	.48
55 to 59	.75
60 to 64	1.17
65 to 69	2.10
70 and above	3.76

(3) The net premium cost of group-term life insurance as provided in Table I of subparagraph (2) of this paragraph applies only to the cost of group-term life insurance subject to the rule of inclusion set forth in section 79(a). Therefore, such net premium cost is not applicable to the determination of the cost of group-term life insurance provided under a policy which is not subject to such rule of inclusion.

(e) *Amount paid by the employee toward the purchase of group-term life insurance.* (1) Except as otherwise provided in subparagraph (2) of this paragraph, if an employee pays any amount toward the purchase of group-term life insurance provided for a taxable year which is subject to the rule of inclusion set forth in paragraph (a)(2) of §1.79–1, the sum of all such amounts is the amount referred to in section 79(a)(2) and paragraph (a)(2) of this section. The rule of the preceding sentence applies even though the payments made by the employee are made with respect to a period of coverage during which no portion of the group-term life insurance on his life is taken into account under paragraph (b)(1) of this section.

(2) In determining the amount paid by the employee for purposes of section 79(a)(2) and paragraph (a)(2) of this section, there is not taken into account any amounts paid by the employee for group-term life insurance provided (or to be provided) for a different taxable year (other than amounts applicable to regular pay periods extending into the next taxable year). Thus, for example, if part of an employee's payment during a taxable year represents a prepayment for insurance to be provided after his retirement, such part does not reduce the amount includible in his gross income for the current taxable year. Furthermore, in determining such amount, there is not taken into account any amount paid by an employee toward the purchase of group-term life insurance which qualifies for one of the exceptions described in section 79(b). The amount paid by an employee toward the purchase of group-term life insurance which qualifies for one of the exceptions described in section 79(b) is determined under the rules of paragraph (a)(2) of §1.79–2.

(3) If payments are made by the employer and his employees to provide group-term life insurance which is subject to the rule of inclusion set forth in section 79(a) as well as to provide other benefits for the employees, and if the amount paid by the employee toward the purchase of such insurance cannot be determined by the provisions of the policy or plan under which such benefits are provided, then the determination of the portion of the cost of group-term life insurance (computed in accordance with the provisions of this section) which is attributable to the contributions of the employee shall be made in accordance with the provisions of this subparagraph. The amount paid by the employee toward the purchase of all the group-term life insurance on his life for his taxable year (or for the portion of his taxable year if such portion is the basis of the computation) under such group policy shall be an amount determined first by ascertaining the total amount paid by all employees who are covered for multiple benefits which is allocable toward the purchase of group-term life insurance on their lives for the year, and then by ascertaining the pro rata portion of such total amount attributable to the individual employee. The total amount paid by all employees who are

covered for multiple benefits which is allocable toward the purchase of group-term life insurance on their lives with respect to such year shall be an amount which bears the same ratio to the total amount paid by all employees for multiple benefits with respect to such year as the aggregate premiums paid to the insurer for group-term life insurance on such employees' lives with respect to such year bears to the aggregate premiums paid to the insurer for such multiple benefits with respect to such year. The pro rata portion of such total amount attributable to the individual employee for the cost of group-term life insurance on his life shall be an amount which bears the same ratio to the total amount paid by all employees which is allocable toward the purchase of group-term insurance on their lives with respect to such year as the amount of group-term life insurance on the life of the employee at a specified time during the year, as determined by the employer, bears to the total amount of group-term life insurance on the lives of all employees insured for such multiple benefits at such time.

(f) *Effect of provision of other benefits*—(1) *In general.* This paragraph discusses the effect of the provision of certain benefits other than group-term life insurance on the life of the employee if the provision of such benefits is contingent upon the underwriting of group-term life insurance on the employee's life to which the rule of inclusion set forth in section 79(a) applies.

(2) *Dependent coverage.* An amount equal to the cost of group-term life insurance on the life of the spouse or other family member of the employee which is provided under a policy of group-term life insurance carried directly or indirectly by his employer is not subject to the provisions of section 79 since it is not on the life of the employee. See paragraph (d)(2)(ii)*(b)* of §1.61–2 for rules regarding the tax treatment of such insurance.

(3) *Disability provisions.* Payments made for disability benefits provided under a group-term life insurance contract are considered to constitute payments made for accident and health insurance. Thus, employer contributions to provide such benefits are excluded from gross income by reason of the provisions of section 106.

(4) *Cost of other benefits.* If a benefit described in this paragraph is provided under a policy under which both the employer and his employees contribute, then, except as otherwise provided in this subparagraph, the employer and the employees will be treated as contributing toward the payment of such benefit at the same rate as they contribute toward the cost of group-term life insurance on the employees' lives. A separate allocation of employer and employee contributions for such benefits is permissible only if—

(i) Such separate allocation is set forth in the group policy and is applicable to all the employees covered under such policy;

(ii) Such separate allocation is followed in transactions between the insurer and the group-policyholder; and

(iii) The allocation set forth in the policy satisfies the requirements of the law of the jurisdiction which is applicable to the contract regarding any minimum or maximum contribution rate by the employer or the employees.

(Secs. 79(c) and 7805 of the Internal Revenue Code of 1954 (78 Stat. 36, 26 U.S.C. 79(c); 68A Stat. 917, 28 U.S.C. 7805))

[T.D. 6888, 31 FR 9203, July 6, 1966, as amended by T.D. 7623, 44 FR 28800, May 17, 1979; T.D. 7924, 48 FR 54595, Dec. 6, 1983; T.D. 8273, 54 FR 47979, Nov. 20, 1989; T.D. 8424, 57 FR 33635, July 30, 1992]

§ 1.79–4T Questions and answers relating to the nondiscrimination requirements for group-term life insurance (temporary).

Q–1: When does section 79, as amended by the Tax Reform Act of 1984, become effective?

A–1: (a) Generally, section 79, as amended, applies to taxable years (of the employee receiving insurance coverage) beginning after December 31, 1983. There are, however, several exceptions to this effective date where there is coverage under a group-term life insurance plan of the employer that was in existence on January 1, 1984, or a comparable successor to such a plan maintained by the employer or a successor employer.

(b) First, the new rules of section 79 (b) and (e), that require the inclusion in income of a retired employee of amounts attributable to the cost of group-term life insurance in excess of $50,000 and that include former employees within the definition of the term ‘‘employee,’’ will not apply to any employee who retired from employment on or before January 1, 1984.

(c) Second, in the case of an individual who retires after January 1, 1984, and before January 1, 1987, the new rules of section 79 (b) and (e) do not apply if (1) the individual attained age 55 on or before January 1, 1984, and (2) the plan was maintained by the same employer who employed the individual during 1983, or by a successor employer.

(d) Third, in the case of an individual who retires after December 31, 1986, the new rules of section 79 (b) and (e) do not apply if (1) the individual attained age 55 on or before January 1, 1984, (2) the plan was maintained by the same employer who employed the individual during 1983, or by a successor employer, and (3) the plan is not, after December 31, 1986, a discriminatory group-term life insurance plan (not taking into account any group-term life insurance coverage provided to employees who retired before January 1, 1987).

(e) For purposes of determining whether a plan is, after December 31, 1986, a discriminatory group-term life insurance plan, there shall be ignored any insurance coverage provided pursuant to a state law requirement that an insurer continue to provide insurance coverage for a period of time not in excess of two months following the termination of a policy.

Q–2: What is meant by a ‘‘group-term life insurance plan of the employer that was in existence on January 1, 1984’’?

A–2: A group-term life insurance plan of the employer was in existence on January 1, 1984, only if the group policy or policies providing group-term life insurance benefits under the plan were executed on or before January 1, 1984, and were not terminated prior to such date. The applicability of section 79, as amended, to an employee will not be affected by the transfer of the employee between employers treated as a single employer under section 79(d)(7) if the employee continues, after the transfer, to be provided with group-term life insurance benefits under a plan that is comparable (determined under the principles set forth in Q&A 3) to the plan provided by the former employer.

Q–3: When is a plan of group-term life insurance a ‘‘comparable successor’’ to another such plan?

A–3: A plan of group-term life insurance will be a comparable successor to another plan of group-term life insurance (the first plan) only if the plan does not differ from the first plan in any significant aspect with respect to individuals who are potentially eligible for benefits provided under the grandfather provisions in Q&A 1. These individuals consist of those persons who are covered under a plan of group-term life insurance of the employer that was in existence on January 1, 1984, or a comparable successor to such a plan maintained by the employer or a successor employer, and who either retired on or before January 1, 1984, or who both attained age 55 on or before January 1, 1984, and were employed by the employer maintaining the plan (or a predecessor of that employer) during the year 1983. Accordingly, if significant additional or reduced benefits are provided only to individuals who are not described in the preceding sentence, the plan will be considered a comparable successor plan. A plan will not fail to be a comparable successor plan merely because the employer purchases a policy or policies identical to the employer’s first plan from a different insurance company. If the new plan provides significant additional or reduced benefits (either as to the type or amount available) to employees, or provides benefits to a category of employees that was formerly excluded from participating in the plan, the plan is generally not a comparable successor to the first plan. However, a plan will not be considered as providing significant additional or reduced benefits merely because a participant’s coverage is based on a percentage of compensation and the participant’s compensation for the taxable year has been increased or decreased. Furthermore, a plan will not be considered a non-comparable successor plan merely because it is amended, either to decrease benefits provided to key employees or to increase benefits provided to non-key employees, solely in order to comply with the nondiscrimination requirements of section 79(d). Finally, a plan will not be considered a non-comparable successor plan merely because a policy that is part of a discriminatory plan is terminated in order to end discriminatory coverage.

Q–4: For purposes of determining the effective date of section 79, as amended by the Tax Reform Act of 1984, what is a ''successor employer''?

A–4: A successor employer is an employer who employs a group of individuals formerly employed by another employer as a result of a business merger, acquisition or division.

Q–5: Under what circumstances will separate policies of group-term life insurance of an employer be considered to be a single plan in determining whether the employer's plan of group-term life insurance is discriminatory?

A–5: All policies providing group-term life insurance to a common key employee or key employees (as defined in this Q&A) carried directly or indirectly by an employer (or by a group of employers described in section 79(d)(7)) will be considered as a single plan for purposes of determining whether an employer's group-term life insurance plan is discriminatory. For example, if a key employee receives $50,000 of group-term life insurance coverage under one policy and the same key employee receives an additional $250,000 of coverage under a separate group-term life insurance policy, the two policies will be treated as a single plan in determining whether the group-term life insurance provided by the employer is discriminatory. If it is discriminatory, the key employees covered by either policy will not receive the benefit of section 79(a)(1) or section 79(c) for either policy. The result is the same even if each policy, considered alone, would be nondiscriminatory. A policy that provides group-term life insurance to a key employee and a policy under which the same key employee is eligible to receive group-term life insurance upon separation from service will be considered to provide group-term life insurance to a common key employee. In addition, an employer may treat two or more policies that do not provide group-term life insurance to a common key employee as constituting a single plan for purposes of satisfying the nondiscrimination provisions of section 79(d). For example, if the employer provides group-term life insurance coverage for non-key employees under one policy and provides group-term life insurance coverage for key employees under a second policy, the two policies may be considered together in determining whether the requirements of section 79(d) are satisfied with regard to the second policy. For purposes of this section, the term ''key employee'' has the meaning given to such term by paragraph (1) of section 416(i), except that subparagraph (A)(iv) of such paragraph shall be applied by not taking into account employees described in section 79(d)(3)(B) who are not participants in the plan. For purposes of this section, all references to ''plan year'' or ''plan years'' in section 416(g)(4)(C) and section 416(i) shall be deleted and replaced with ''taxable year of the employer'' or ''taxable years of the employer,'' respectively.

Q–6: In the case of a discriminatory group-term life insurance plan, what amounts should be included in the gross income of a key employee?

A–6: (a) In the case of a discriminatory group-term life insurance plan, each key employee must include in gross income for the taxable year the cost of his or her insurance benefit for that year provided by the employer under the plan.

(b) The cost of group-term life insurance coverage provided by an employer for a key employee during the employee's taxable year is determined by apportioning the net premium (group premium less policy dividends, premium refunds or experience rating credits) allocable to the group-term life insurance coverage during the key employee's taxable year, less the actual cost allocated to other key employees pursuant to the method described in the subparagraph (d) of this answer, if applicable, among the covered employees. In the event that the employer has other forms and types of coverage with the same insurer, the employer must make a reasonable allocation of the total premiums paid to the insurer. For example, where an employer has both health insurance coverage and a plan of group-term life insurance with the same insurer, and there is no volume discount, the net premium for the plan of group-term life insurance must include the excess, if any, of the payments the employer makes for the health insurance coverage over the payments the employer would make for such coverage if the plan of group-term life insurance for which this calculation is being made did not exist.

(c) In general, the portion of the net premium for group-term life insurance that should be apportioned to a key employee, other than a key employee to whom the method in subparagraph (d) of this answer is applicable, is determined by: (1) Calculating a ''tabular'' premium for the entire group (with the exception of all key employees to whom the method in subparagraph (d) of this answer is applicable), in the manner described below, (2) determining the ratio of the total actual net premium (less the actual cost allocated to key employees pursuant to the method in the subparagraph (d) of this answer) to the total tabular premium and (3) multiplying the tabular premium for the key employee at his or her attained age by such ratio. Thus, if the total actual net premium is 125 percent of the total tabular premium for all covered employees and the tabular premium at the key employee's attained age is $2.00 per thousand per month, the cost for such employee would be $2.50 per thousand per month ($2.00 times 125 percent). For these purposes the table used to calculate tabular premiums will be determined as follows:

(i) If the group policy contains a reasonable table (based on recognized mortality assumptions) of premium rates on an attained age basis (which table may use age brackets not exceeding five years) with reference to which the group premium is determined, such table will be used;

(ii) If such table is not available, the 1960 Basic Group Table published by the Society of Actuaries will be used.

(d) In cases where the mortality charge for group-term life insurance coverage provided to a key employee is calculated separately by the insurer (for example, where the charge for the coverage provided to a key employee is based on a medical examination) and the amount of such mortality charge plus a proportionate share of the loading charge for the coverage provided to the group is higher than the amount that would be allocable to such employee under the allocation method in subparagraph (c) the cost of group-term life insurance coverage for that employee shall be that higher amount.

Q–7: Must all active and former employees be considered in applying the coverage tests in section 79(d)(3) to determine whether or not a plan of group-term life insurance is discriminatory with respect to coverage?

A–7: No. Generally, a plan of group-term life insurance which covers both active and former employees will not satisfy the nondiscrimination requirements of section 79(d) unless the coverage tests in section 79(d)(3) are satisfied with respect to both the active and the former employees of the employer, except to the extent they are excluded from tests for discrimination by application of the grandfather provisions set forth in Q&A 1. However, for purposes of determining whether a plan is discriminatory with respect to coverage, the coverage tests must be applied separately to active and former employees. In addition, if the plan limits participation by former employees to employees who retired from employment with the employer, then only retired employees must be considered in applying the coverage tests to former employees. Also, in applying the coverage tests in section 79(d)(3), the employer may make reasonable mortality assumptions regarding former employees who are not covered under the plan but must be considered in applying the coverage tests. Furthermore, only those former employees who terminated employment on or after the earliest date of termination from employment for any former employee covered by the plan must be considered. Finally, for purposes of determining whether a plan of group-term life insurance of the employer (or a successor employer) that was in existence on January 1, 1984 (or a comparable successor to such a plan) is discriminatory, after December 31, 1986, with respect to group-term life insurance coverage for former employees, coverage provided to employees who retired on or before December 31, 1986, shall not be taken into account.

Q–8: Will a group-term life insurance plan be considered discriminatory if active employees receive greater benefits as a percentage of compensation than former employees, or vice versa?

A–8: No. For purposes of determining whether a plan is discriminatory with respect to the type and amount of benefits available, insurance coverage for former employees must be tested separately from insurance coverage for active employees. For example, a group-term life insurance plan that provides group-term life insurance benefits equal to 200 percent of compensation for all active employees and 100 percent of final compensation (based on the average annual compensation for the final five years) for all former employees would satisfy the nondiscrimination requirements of section 79(d). However, a group-term life insurance plan that provides group-term life insurance benefits equal to 200 percent of compensation for all active employees and 100 percent of final compensation (based on the average annual compensation for the final five years) only for key employees who are no longer employed by the employer (or a successor employer) would not satisfy the nondiscrimination requirement of section 79(d)(2)(A).

Q–9: Under what circumstances will the amount of benefits available under a plan of group-term life insurance be considered not to discriminate in favor of participants who are key employees?

A–9: A plan of group-term life insurance will be considered not to discriminate in favor of participants who are key employees, as to the amount of benefits available, if the plan provides a fixed amount of insurance which is the same for all covered employees. In other circumstances, the determination of whether a plan is nondiscriminatory will be based on all of the facts and circumstances. Such plans will be considered not to discriminate in favor of participants who are key employees, as to the amount of benefits available, if the plan contains no group of employees described in the following sentence that, if tested separately, would fail to satisfy the requirements of section 79(d)(2)(A). The group subject to separate testing under the preceding sentence consists of a key employee and all other participants (including other key employees) who receive, under the plan, an amount of insurance (as a multiple of compensation (either total compensation or the basic or regular rate of compensation)) that is equal to or greater than the amount of insurance received by such key employee. As described in Q&As 7&8, active and former employees are tested separately under section 79(d)(2)(A).

Example: Assume that a plan of group-term life insurance has 500 participants, 10 of whom are key employees. Under the plan, 400 of the non-key employees receive an amount of insurance equal to 100 percent of compensation, while all of the key employees and 90 of the non-key employees receive an amount of insurance equal to 200 percent of compensation. The plan will be considered not to discriminate in favor of the participants who are key employees because, tested separately, the group of participants receiving an amount of insurance equal to or greater than 200 percent of compensation would satisfy the requirements of section 79(d)(2)(A) (by reason of section 79(d)(3)(A)(ii)). If one of the key employees received an amount of insurance equal to 300 percent of compensation, the plan would be considered to discriminate in favor of participants who are key employees, because, tested separately, the group consisting of the single key employee receiving an amount of insurance equal to or greater than 300 percent of compensation would fail to satisfy the requirements of section 79(d)(2)(A).

In determining the groups of employees that are tested separately for this purpose, allowance shall be made for reasonable differences in amount of insurance (as a multiple of compensation) due to rounding, the use of compensation brackets or other similar factors. Thus, if a plan bases group-term life insurance coverage on ‘‘compensation brackets,’’ it is not intended that any participants will be treated as receiving an amount of insurance (as a multiple of compensation) that is greater (or less) than that of any other participant merely because the first participant’s compensation is at the lower (or higher) end of a compensation bracket while the second participant’s compensation is at the higher (or lower) end of a compensation bracket. However, any compensation brackets utilized by a plan will be examined to determine if the brackets, or compensation groupings, result in discrimination in favor of key employees. In addition, a plan does not meet the requirements for nondiscrimination as to the type and amount of benefits available under the plan unless all types of benefits (including permanent benefits) and all terms and conditions with respect to such benefits which are available to any participant who is a key employee are also available on a nondiscriminatory basis to non-key employee participants.

Q–10: How is additional coverage purchased by employees under a plan of group-term life insurance treated for purposes of determining whether a plan of group-term life insurance is discriminatory?

A–10: (a) The extent to which employees purchase additional coverage under a plan of group-term life insurance is not taken into account for purposes of determining whether a plan of group-term life insurance is discriminatory. For example, a plan providing insurance to all employees of 1 times annual compensation, which gives all employees the option to purchase additional insurance of 1 times annual compensation at their own expense, would not be considered discriminatory as to the type and amount of benefits available, even if the group (or groups) of participants who purchase additional insurance, if tested separately, would not satisfy the requirements of section 79(d)(2)(A). Solely for this purpose, the choice of an amount of group-term life insurance as a benefit under a cafeteria plan will be treated as the purchase of group-term life insurance by an employee. If additional insurance coverage is available to any key employee that is not available, on a nondiscriminatory basis, to non-key employees, the plan will be considered discriminatory, even if the full cost of such additional insurance coverage is paid by the employee(s) electing such benefits.

(b) If the employer bears a part of the expense of any additional coverage that is purchased by an employee under a plan of group-term life insurance, the additional insurance shall be treated, in part, as an amount of insurance provided by the employer under the plan and, in part, as an amount of insurance purchased by the employee. Except to the extent provided in subparagraph (a) above, the portion of insurance treated as an amount of insurance purchased by the employee is not taken into account for purposes of determining whether the plan is discriminatory. Whether such insurance (together with any other insurance provided by the employer under the plan) will cause the plan to be considered to discriminate in favor of participants who are key employees is determined under the rules of Q&A 9.

Q–11: What effect do the provisions of section 79(d)(1) have if a plan of group-term life insurance is discriminatory for only part of a year?

A–11: If a plan of group-term life insurance is discriminatory at any time during the key employee's taxable year, then it is a discriminatory group-term life insurance plan for that taxable year and the provisions of section 79(d)(1) will be applicable with respect to all group-term life insurance costs allocable to that employee for that year.

Q–12: Are the section 79(d) provisions independent from the requirements contained in Treas. Reg. §1.79–1?

A–12: Yes. Treasury regulation §1.79–1(c)(1) provides that life insurance provided to a group of employees cannot qualify as group-term life insurance if it is provided to less than ten full-time employees unless certain requirements are satisfied. The satisfaction of these requirements does not guarantee that the plan will be nondiscriminatory, and vice versa. Treasury regulation §1.79–1(a)(4) provides that life insurance is not group-term life insurance unless the amount of insurance provided to each employee is computed under a formula that precludes individual selection. The mere fact that a life insurance policy is nondiscriminatory is not determinative as to whether the policy precludes individual selection, and vice versa.

[T.D. 8073, 51 FR 4315, Feb. 4, 1986; 51 FR 7262, Mar. 3, 1986]

§ 1.82–1 Payments for or reimbursements of expenses of moving from one residence to another residence attributable to employment or self-employment.

(a) *Reimbursements in gross income*—(1) *In general.* Any amount received or accrued, directly or indirectly, by an individual as a payment for or reimbursement of expenses of moving from one residence to another residence attributable to employment or self-employment is includible in gross income under section 82 as compensation for services in the taxable year received or accrued. For rules relating to the year a deduction may be allowed for expenses of moving from one residence to another residence, see section 217 and the regulations thereunder.

(2) *Amounts received or accrued as reimbursement or payment.* For purposes of this section, amounts are considered as being received or accrued by an individual as reimbursement or payment whether received in the form of money, property, or services. A cash basis taxpayer will include amounts in gross income under section 82 when they are received or treated as received by him. Thus, for example, if an employer moves an employee's household goods and personal effects from the employee's old resident to his new residence using the employer's facilities, the employee is considered as having received a payment in the amount of the fair market value of the services furnished at the time the services are furnished by the employer. If the employer pays a mover for moving the employee's household goods and personal effects, the employee is considered as having received the payment at the time the employer pays the mover, rather than at the time the mover moves the employee's household goods and personal effects. Where an employee receives a loan or advance from an employer to enable him to pay his moving expenses, the employee will not be deemed to have received a reimbursement of moving expenses until such time as he accounts to his employer if he is not required to repay such loan or advance and if he makes such accounting within a reasonable time. Such loan or advance will be deemed to be a reimbursement of moving expenses at the time of such accounting to the extent used by the employee for such moving expenses.

(3) *Direct or indirect payments or reimbursements.* For purposes of this section amounts are considered as being received or accrued whether received directly (paid or provided to an individual by an employer, a client, a customer, or similar person) or indirectly (paid to a third party on behalf of an individual by an employer, a client, a customer, or similar person). Thus, if an employer pays a mover for the expenses of moving an employee's household goods and personal effects from one residence to another residence, the employee has indirectly received a payment which is includible in his gross income under section 82.

(4) *Expenses of moving from one residence to another residence.* An expense of moving from one residence to another residence is any expenditure, cost, loss, or similar item paid or incurred in connection with a move from one residence to another residence. Moving expenses include (but are not limited to) any expenditure, cost, loss, or similar item directly or indirectly resulting from the acquisition, sale, or exchange of property, the transportation of goods or property, or travel (by the taxpayer or any other person) in connection with a change in residence. Such expenses include items described in section 217(b) (relating to the definition of moving expenses), irrespective of the dollar limitations contained in section 217(b)(3) and the conditions contained in section 217(c), as well as items not described in section 217 (b), such as a loss sustained on the sale or exchange of personal property, storage charges, taxes, or expenses of refitting rugs or draperies.

(5) *Attributable to employment or self-employment.* Any amount received or accrued from an employer, a client, a customer, or similar person in connection with the performance of services for such employer, client, customer, or similar person, is attributable to employment or self-employment. Thus, for example, if an employer reimburses an employee for a loss incurred on the sale of the employee's house, reimbursement is attributable to the performance of services if made because of

the employer-employee relationship. Similarly, if an employer in order to prevent an employee's sustaining a loss on a sale of a house acquires the property from the employee at a price in excess of fair market value, the employee is considered to have received a payment attributable to employment to the extent that such payment exceeds the fair market value of the property.

(b) *Effective date*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, paragraph (a) of this section is applicable only to amounts received or accrued in taxable years beginning after December 31, 1969.

(2) *Election with respect to payments or reimbursements for expenses paid or incurred before January 1, 1971.* Paragraph (a) of this section does not apply with respect to moving expenses paid or incurred before January 1, 1971, in connection with the commencement of work by an employee at a new principal place of work where such employee had been notified by his employer on or before December 19, 1969, of such move and the employee makes an election under paragraph (h) of §1.217–2.

[T.D. 7195, 37 FR 13533, July 11, 1972, as amended by T.D. 7578, 43 FR 59355, Dec. 20, 1978]

§1.83–1 Property transferred in connection with the performance of services.

(a) *Inclusion in gross income*—(1) *General rule.* Section 83 provides rules for the taxation of property transferred to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services by such employee or independent contractor. In general, such property is not taxable under section 83(a) until it has been transferred (as defined in §1.83–3(a)) to such person and become substantially vested (as defined in §1.83–3(b)) in such person. In that case, the excess of—

(i) The fair market value of such property (determined without regard to any lapse restriction, as defined in §1.83–3(i)) at the time that the property becomes substantially vested, over

(ii) The amount (if any) paid for such property, shall be included as compensation in the gross income of such employee or independent contractor for the taxable year in which the property becomes substantially vested. Until such property becomes substantially vested, the transferor shall be regarded as the owner of such property, and any income from such property received by the employee or independent contractor (or beneficiary thereof) or the right to the use of such property by the employee or independent contractor constitutes additional compensation and shall be included in the gross income of such employee or independent contractor for the taxable year in which such income is received or such use is made available. This paragraph applies to a transfer of property in connection with the performance of services even though the transferor is not the person for whom such services are performed.

(2) *Life insurance.* The cost of life insurance protection under a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection is taxable generally under section 61 and the regulations thereunder during the period such contract remains substantially nonvested (as defined in §1.83–3(b)). The cost of such life insurance protection is the reasonable net premium cost, as determined by the Commissioner, of the current life insurance protection (as defined in §1.72–16(b)(3)) provided by such contract.

(3) *Cross references.* For rules concerning the treatment of employers and other transferors of property in connection with the performance of services, see section 83(h) and §1.83–6. For rules concerning the taxation of beneficiaries of an employees' trust that is not exempt under section 501(a), see section 402(b) and the regulations thereunder.

(b) *Subsequent sale, forfeiture, or other disposition of nonvested property.* (1) If substantially nonvested property (that has been transferred in connection with the performance of services) is subsequently sold or otherwise disposed of to a third party in an arm's length transaction while still substantially nonvested, the person who performed such services shall realize compensation in an amount equal to the excess of—

(i) The amount realized on such sale or other disposition, over

(ii) The amount (if any) paid for such property.

Such amount of compensation is includible in his gross income in accordance with his method of accounting. Two preceding sentences also apply when the person disposing of the property has received it in a non-arm's length transaction described in paragraph (c) of this section. In addition, section 83(a) and paragraph (a) of this section shall thereafter cease to apply with respect to such property.

(2) If substantially nonvested property that has been transferred in connection with the performance of services to the person performing such services is forfeited while still substantially nonvested and held by such person, the difference between the amount paid (if any) and the amount received upon forfeiture (if any) shall be treated as an ordinary gain or loss. This paragraph (b)(2) does not apply to property to which § 1.83–2(a) applies.

(3) This paragraph (b) shall not apply to, and no gain shall be recognized on, any sale, forfeiture, or other disposition described in this paragraph to the extent that any property received in exchange therefor is substantially nonvested. Instead, section 83 and this section shall apply with respect to such property received (as if it were substituted for the property disposed of).

(c) *Dispositions of nonvested property not at arm's length.* If substantially nonvested property (that has been transferred in connection with the performance of services) is disposed of in a transaction which is not at arm's length and the property remains substantially nonvested, the person who performed such services realizes compensation equal in amount to the sum of any money and the fair market value of any substantially vested property received in such disposition. Such amount of compensation is includible in his gross income in accordance with his method of accounting. However, such amount of compensation shall not exceed the fair market value of the property disposed of at the time of disposition (determined without regard to any lapse restriction), reduced by the amount paid for such property. In addition, section 83 and these regulations shall continue to apply with respect to such property, except that any amount previously includible in gross income under this paragraph (c) shall thereafter be treated as an amount paid for such property. For example, if in 1971 an employee pays $50 for a share of stock which has a fair market value of $100 and is substantially monvested at that time and later in 1971 (at a time when the property still has a fair market value of $100 and is still substantially nonvested) the employee disposes of, in a transaction not at arm's length, the share of stock to his wife for $10, the employee realizes compensation of $10 in 1971. If in 1972, when the share of stock has a fair market value of $120, it becomes substantially vested, the employee realizes additional compensation in 1972 in the amount of $60 (the $120 fair market value of the stock less both the $50 price paid for the stock and the $10 taxed as compensation in 1971). For purposes of this paragraph, if substantially nonvested property has been transferred to a person other than the person who performed the services, and the transferee dies holding the property while the property is still substantially nonvested and while the person who performed the services is alive, the transfer which results by reason of the death of such transferee is a transfer not at arm's length.

(d) *Certain transfers upon death.* If substantially nonvested property has been transferred in connection with the performance of services and the person who performed such services dies while the property is still substantially nonvested, any income realized on or after such death with respect to such property under this section is income in respect of a decedent to which the rules of section 691 apply. In such a case the income in respect of such property shall be taxable under section 691 (except to the extent not includible under section 101(b)) to the estate or beneficiary of the person who performed the services, in accordance with section 83 and the regulations thereunder. However, if an item of income is realized upon such death before July 21, 1978, because the property became substantially vested upon death, the person responsible for filing decedent's income tax return for decedent's last taxable year may elect to treat such item as includible in gross income for decedent's last taxable year by including such item in gross income on the return or amended return filed for decedent's last taxable year.

(e) *Forfeiture after substantial vesting.* If a person is taxable under section 83(a) when the property transferred becomes substantially vested and thereafter the person's beneficial interest in such property is nevertheless forfeited pursuant to a lapse restriction, any loss incurred by such person (but not by a beneficiary of such person) upon such forfeiture shall be an ordinary loss to the extent the basis in such property has been increased as a result of the recognition of income by such person under section 83(a) with respect to such property.

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

Example (1). On November 1, 1978, X corporation sells to E, an employee, 100 shares of X corporation stock at $10 per share. At the time of such sale the fair market value of the X corporation stock is $100 per share. Under the terms of the sale each share of stock is subject to a substantial risk of forfeiture which will not lapse until November 1, 1988. Evidence of this restriction is stamped on the face of E's stock certificates, which are therefore nontransferable (within the meaning of §1.83–3(d)). Since in 1978 E's stock is substantially nonvested, E does not include any of such amount in his gross income as compensation in 1978. On November 1, 1988, the fair market value of the X corporation stock is $250 per share. Since the X corporation stock becomes substantially vested in 1988, E must include $24,000 (100 shares of X corporation stock × $250 fair market value per share less $10 price paid by E for each share) as compensation for 1988. Dividends paid by X to E on E's stock after it was transferred to E on November 1, 1973, are taxable to E as additional compensation during the period E's stock is substantially nonvested and are deductible as such by X.

Example (2). Assume the facts are the same as in example (1), except that on November 1, 1985, each share of stock of X corporation in E's hands could as a matter of law be transferred to a bona fide purchaser who would not be required to forfeit the stock if the risk of forfeiture materialized. In the event, however, that the risk materializes, E would be liable in damages to X. On November 1, 1985, the fair market value of the X corporation stock is $230 per share. Since E's stock is transferable within the meaning of §1.83–3(d) in 1985, the stock is substantially vested and E must include $22,000 (100 shares of X corporation stock × $230 fair market value per share less $10 price paid by E for each share) as compensation for 1985.

Example (3). Assume the facts are the same as in example (1) except that, in 1984 E sells his 100 shares of X corporation stock in an arm's length sale to I, an investment company, for $120 per share. At the time of this sale each share of X corporation's stock has a fair market value of $200. Under paragraph (b) of this section, E must include $11,000 (100 shares of X corporation stock × $120 amount realized per share less $10 price paid by E per share) as compensation for 1984 notwithstanding that the stock remains nontransferable and is still subject to a substantial risk of forfeiture at the time of such sale. Under §1.83–4(b)(2), I's basis in the X corporation stock is $120 per share.

[T.D. 7554, 43 FR 31913, July 24, 1978]

§1.83–2 Election to include in gross income in year of transfer.

(a) *In general.* If property is transferred (within the meaning of §1.83–3(a)) in connection with the performance of services, the person performing such services may elect to include in gross income under section 83(b) the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any lapse restriction, as defined in §1.83–3(i)) over the amount (if any) paid for such property, as compensation for services. The fact that the transferee has paid full value for the property transferred, realizing no bargain element in the transaction, does not preclude the use of the election as provided for in this section. If this election is made, the substantial vesting rules of section 83(a) and the regulations thereunder do not apply with respect to such property, and except as otherwise provided in section 83(d)(2) and the regulations thereunder (relating to the cancellation of a nonlapse restriction), any subsequent appreciation in the value of the property is not taxable as compensation to the person who performed the services. Thus, property with respect to which this election is made shall be includible in gross income as of the time of transfer, even though such property is substantially nonvested (as defined in § 1.83–3(b)) at the time of transfer, and no compensation will be includible in gross income when such property becomes substantially vested (as defined in § 1.83–3(b)). In computing the gain or loss from the subsequent sale or exchange of such property, its basis shall be the amount paid for the property increased by the amount included in gross income under section 83(b). If property for which a section 83(b) election is in effect is forfeited while substantially nonvested, such forfeiture shall be treated as a sale or exchange upon which there is realized a loss equal to the excess (if any) of—

(1) The amount paid (if any) for such property, over,

(2) The amount realized (if any) upon such forfeiture.

If such property is a capital asset in the hands of the taxpayer, such loss shall be a capital loss. A sale or other disposition of the property that is in substance a forfeiture, or is made in contemplation of a forfeiture, shall be treated as a forfeiture under the two immediately preceding sentences.

(b) *Time for making election.* Except as provided in the following sentence, the election referred to in paragraph (a) of this section shall be filed not later than 30 days after the date the property was transferred (or, if later, January 29, 1970) and may be filed prior to the date of transfer. Any statement filed before February 15, 1970, which was amended not later than February 16, 1970, in order to make it conform to the requirements of paragraph (e) of this section, shall be deemed a proper election under section 83(b).

(c) *Manner of making election.* The election referred to in paragraph (a) of this section is made by filing one copy of a written statement with the internal revenue office with whom the person who performed the services files his return. In addition, one copy of such statement shall be submitted with this income tax return for the taxable year in which such property was transferred.

(d) *Additional copies.* The person who performed the services shall also submit a copy of the statement referred to in paragraph (c) of this section to the person for whom the services are performed. In addition, if the person who performs the services and the transferee of such property are not the same person, the person who performs the services shall submit a copy of such statement to the transferee of the property.

(e) *Content of statement.* The statement shall be signed by the person making the election and shall indicate that it is being made under section 83(b) of the Code, and shall contain the following information:

(1) The name, address and taxpayer identification number of the taxpayer;

(2) A description of each property with respect to which the election is being made;

(3) The date or dates on which the property is tansferred and the taxable year (for example, ‘‘calendar year 1970’’ or ‘‘fiscal year ending May 31, 1970’’) for which such election was made;

(4) The nature of the restriction or restrictions to which the property is subject;

(5) The fair market value at the time of transfer (determined without regard to any lapse restriction, as defined in § 1.83–3(i)) of each property with respect to which the election is being made;

(6) The amount (if any) paid for such property; and

(7) With respect to elections made after July 21, 1978, a statement to the effect that copies have been furnished to other persons as provided in paragraph (d) of this section.

(f) *Revocability of election.* An election under section 83(b) may not be revoked except with the consent of the Commissioner. Consent will be granted only in the case where the transferee is under a mistake of fact as to the underlying transaction and must be requested within 60 days of the date on which the mistake of fact first became known to the person who made the election. In any event, a mistake as to the value, or decline in the value, of the property with respect to which an election under section 83(b) has been made or a failure to perform an act contemplated at the time of transfer of such property does not constitute a mistake of fact.

[T.D. 7554, 43 FR 31915, July 24, 1978]

§1.83–3 Meaning and use of certain terms.

(a) *Transfer*—(1) *In general.* For purposes of section 83 and the regulations thereunder, a transfer of property occurs when a person acquires a beneficial ownership interest in such property (disregarding any lapse restriction, as defined in §1.83–3(i)).

(2) *Option.* The grant of an option to purchase certain property does not constitute a transfer of such property. However, see §1.83–7 for the extent to which the grant of the option itself is subject to section 83. In addition, if the amount paid for the transfer of property is an indebtedness secured by the transferred property, on which there is no personal liability to pay all or a substantial part of such indebtedness, such transaction may be in substance the same as the grant of an option. The determination of the substance of the transaction shall be based upon all the facts and circumstances. The factors to be taken into account include the type of property involved, the extent to which the risk that the property will decline in value has been transferred, and the likelihood that the purchase price will, in fact, be paid. See also §1.83–4(c) for the treatment of forgiveness of indebtedness that has constituted an amount paid.

(3) *Requirement that property be returned.* Similarly, no transfer may have occurred where property is transferred under conditions that require its return upon the happening of an event that is certain to occur, such as the termination of employment. In such a case, whether there is, in fact, a transfer depends upon all the facts and circumstances. Factors which indicate that no transfer has occurred are described in paragraph (a) (4), (5), and (6) of this section.

(4) *Similarity to option.* An indication that no transfer has occurred is the extent to which the conditions relating to a transfer are similar to an option.

(5) *Relationship to fair market value.* An indication that no transfer has occurred is the extent to which the consideration to be paid the transferee upon surrendering the property does not approach the fair market value of the property at the time of surrender. For purposes of paragraph (a) (5) and (6) of this section, fair market value includes fair market value determined under the rules of §1.83–5(a)(1), relating to the valuation of property subject to nonlapse restrictions. Therefore, the existence of a nonlapse restriction referred to in §1.83–5(a)(1) is not a factor indicating no transfer has occurred.

(6) *Risk of loss.* An indication that no transfer has occurred is the extent to which the transferee does not incur the risk of a beneficial owner that the value of the property at the time of transfer will decline substantially. Therefore, for purposes of this (6), risk of decline in property value is not limited to the risk that any amount paid for the property may be lost.

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

Example (*1*). On January 3, 1971, X corporation sells for $500 to S, a salesman of X, 10 shares of stock in X corporation with a fair market value of $1,000. The stock is nontransferable and subject to return to the corporation (for $500) if S’s sales do not reach a certain level by December 31, 1971. Disregarding the restriction concerning S’s sales (since the restrictions is a lapse restriction), S’s interest in the stock is that of a beneficial owner and therefore a transfer occurs on January 3, 1971.

Example (*2*). On November 17, 1972, W sells to E 100 shares of stock in W corporation with a fair market value of $10,000 in exchange for a $10,000 note without personal liability. The note requires E to make yearly payments of $2,000 commencing in 1973. E collects the dividends, votes the stock and pays the interest on the note. However, he makes no payments toward the face amount of the note. Because E has no personal liability on the note, and since E is making no payments towards the face amount of the note, the likelihood of E paying the full purchase price is in substantial doubt. As a result E has not incurred the risks of a beneficial owner that the value of the stock will decline. Therefore, no transfer of the stock has occurred on November 17, 1972, but an option to purchase the stock has been granted to E.

Example (*3*). On January 3, 1971, X corporation purports to transfer to E, an employee, 100 shares of stock in X corporation. The X stock is subject to the sole restriction that E must sell such stock to X on termination of employment for any reason for an amount which is equal to the excess (if any) of the book value of the X stock at termination of employment over book value on January 3, 1971. The stock is not transferable by E and the restrictions on transfer are stamped on the certificate. Under these facts and circumstances, there is no transfer of the X stock within the meeting of section 83.

Example (4). Assume the same facts as in example (3) except that E paid $3,000 for the stock and that the restriction required E upon termination of employment to sell the stock to M for the total amount of dividends that have been declared on the stock since September 2, 1971, or $3,000 whichever is higher. Again, under the facts and circumstances, no transfer of the X stock has occurred.

Example (5). On July 4, 1971, X corporation purports to transfer to G, an employee, 100 shares of X stock. The stock is subject to the sole restriction that upon termination of employment G must sell the stock to X for the greater of its fair market value at such time or $100, the amount G paid for the stock. On July 4, 1971 the X stock has a fair market value of $100. Therefore, G does not incur the risk of a beneficial owner that the value of the stock at the time of transfer ($100) will decline substantially. Under these facts and circumstances, no transfer has occurred.

(b) *Substantially vested and substantially nonvested property*. For purposes of section 83 and the regulations thereunder, property is substantially nonvested when it is subject to a substantial risk of forfeiture, within the meaning of paragraph (c) of this section, and is nontransferable, within the meaning of paragraph (d) of this section. Property is substantially vested for such purposes when it is either transferable or not subject to a substantial risk of forfeiture.

(c) *Substantial risk of forfeiture*—(1) *In general.* For purposes of section 83 and the regulations thereunder, whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.

Property is not transferred subject to a substantial risk of forfeiture to the extent that the employer is required to pay the fair market value of a portion of such property to the employee upon the return of such property. The risk that the value of property will decline during a certain period of time does not constitute a substantial risk of forfeiture. A nonlapse restriction, standing by itself, will not result in a substantial risk of forfeiture.

(2) *Illustrations of substantial risks of forfeiture.* The regularity of the performance of services and the time spent in performing such services tend to indicate whether services required by a condition are substantial. The fact that the person performing services has the right to decline to perform such services without forfeiture may tend to establish that services are insubstantial. Where stock is transferred to an underwriter prior to a public offering and the full enjoyment of such stock is expressly or impliedly conditioned upon the successful completion of the underwriting, the stock is subject to a substantial risk of forfeiture. Where an employee receives property from an employer subject to a requirement that it be returned if the total earnings of the employer do not increase, such property is subject to a substantial risk of forfeiture. On the other hand, requirements that the property be returned to the employer if the employee is discharged for cause or for committing a crime will not be considered to result in a substantial risk of forfeiture. An enforceable requirement that the property be returned to the employer if the employee accepts a job with a competing firm will not ordinarily be considered to result in a substantial risk of forfeiture unless the particular facts and circumstances indicate to the contrary. Factors which may be taken into account in determining whether a convenant not to compete constitutes a substantial risk of forfeiture are the age of the employee, the availability of alternative employment opportunities, the likelihood of the employee's obtaining such other employment, the degree of skill possessed by the employee, the employee's health, and the practice (if any) of the employer to enforce such covenants. Similarly, rights in property

transferred to a retiring employee subject to the sole requirement that it be returned unless he renders consulting services upon the request of his former employer will not be considered subject to a substantial risk of forfeiture unless he is in fact expected to perform substantial services.

(3) *Enforcement of forfeiture condition.* In determining whether the possibility of forfeiture is substantial in the case of rights in property transferred to an employee of a corporation who owns a significant amount of the total combined voting power or value of all classes of stock of the employer corporation or of its parent corporation, there will be taken into account (i) the employee's relationship to other stockholders and the extent of their control, potential control and possible loss of control of the corporation, (ii) the position of the employee in the corporation and the extent to which he is subordinate to other employees, (iii) the employee's relationship to the officers and directors of the corporation, (iv) the person or persons who must approve the employee's discharge, and (v) past actions of the employer in enforcing the provisions of the restrictions. For example, if an employee would be considered as having received rights in property subject to a substantial risk of forfeiture, but for the fact that the employee owns 20 percent of the single class of stock in the transferor corporation, and if the remaining 80 percent of the class of stock is owned by an unrelated individual (or members of such an individual's family) so that the possibility of the corporation enforcing a restriction on such rights is substantial, then such rights are subject to a substantial risk of forfeiture. On the other hand, if 4 percent of the voting power of all the stock of a corporation is owned by the president of such corporation and the remaining stock is so diversely held by the public that the president, in effect, controls the corporation, then the possibility of the corporation enforcing a restriction on rights in property transferred to the president is not substantial, and such rights are not subject to a substantial risk of forfeiture.

(4) *Examples.* The rules contained in paragraph (c)(1) of this section may be illustrated by the following examples. In each example it is assumed that, if the conditions on transfer are not satisfied, the forfeiture provision will be enforced.

Example (1). On November 1, 1971, corporation X transfers in connection with the performance of services to E, an employee, 100 shares of corporation X stock for $90 per share. Under the terms of the transfer, E will be subject to a binding commitment to resell the stock to corporation X at $90 per share if he leaves the employment of corporation X for any reason prior to the expiration of a 2-year period from the date of such transfer. Since E must perform substantial services for corporation X and will not be paid more than $90 for the stock, regardless of its value, if he fails to perform such services during such 2-year period, E's rights in the stock are subject to a substantial risk of forfeiture during such period.

Example (2). On November 10, 1971, corporation X transfers in connection with the performance of services to a trust for the benefit of employees, $100*x*. Under the terms of the trust any child of an employee who is an enrolled full-time student at an accredited educational institution as a candidate for a degree will receive an annual grant of cash for each academic year the student completes as a student in good standing, up to a maximum of four years. E, an employee, has a child who is enrolled as a full-time student at an accredited college as a candidate for a degree. Therefore, E has a beneficial interest in the assets of the trust equalling the value of four cash grants. Since E's child must complete one year of college in order to receive a cash grant, E's interest in the trust assets are subject to a substantial risk of forfeiture to the extent E's child has not become entitled to any grants.

Example (3). On November 25, 1971, corporation X gives to E, an employee, in connection with his performance of services to corporation X, a bonus of 100 shares of corporation X stock. Under the terms of the bonus arrangement E is obligated to return the corporation X stock to corporation X if he terminates his employment for any reason. However, for each year occurring after November 25, 1971, during which E remains employed with corporation X, E ceases to be obligated to return 10 shares of the corporation X stock. Since in each year occurring after November 25, 1971, for which E remains employed he is not required to return 10 shares of corporation X's stock, E's rights in 10 shares each year for 10 years cease to be subject to a substantial risk of forfeiture for each year he remains so employed.

Example (4). (a) Assume the same facts as in example (3) except that for each year occurring after November 25, 1971, for which E remains employed with corporation X, X agrees to pay, in redemption of the bonus shares given to E if he terminates employment for any reason, 10 percent of the fair market value of each share of stock on the date of such termination of employment. Since corporation X will pay E 10 percent of the value of his bonus stock for each of the 10 years after November 25, 1971, in which he remains employed by X, and the risk of a decline in value is not a substantial risk of forfeiture, E's interest in 10 percent of such bonus stock becomes substantially vested in each of those years.

(b) The following chart illustrates the fair market value of the bonus stock and the fair market value of the portion of bonus stock that becomes substantially vested on November 25, for the following years:

Year	Fair market value of	
	All stock	Portion of stock that becomes vested
1972	$200	$20
1973	300	30
1974	150	15
1975	150	15
1976	100	10

If E terminates his employment on July 1, 1977, when the fair market value of the bonus stock is $100, E must return the bonus stock to X, and X must pay, in redemption of the bonus stock, $50 (50 percent of the value of the bonus stock on the date of termination of employment). E has recognized income under section 83(a) and § 1.83–1(a) with respect to 50 percent of the bonus stock, and E's basis in that portion of the stock equals the amount of income recognized, $90. Under § 1.83–1(e), the $40 loss E incurred upon forfeiture ($90 basis less $50 redemption payment) is an ordinary loss.

Example (5). On January 7, 1971, corporation X, a computer service company, transfers to E, 100 shares of corporation X stock for $50. E is a highly compensated salesman who sold X's products in a three-state area since 1960. At the time of transfer each share of X stock has a fair market value of $100. The stock is transferred to E in connection with his termination of employment with X. Each share of X stock is subject to the sole condition that E can keep such share only if he does not engage in competition with X for a 5-year period in the three-state area where E had previously sold X's products. E, who is 45 years old, has no intention of retiring from the work force. In order to earn a salary comparable to his current compensation, while preventing the risk of forfeiture from arising, E will have to expend a substantial amount of time and effort in another industry or market to establish the necessary business contacts. Thus, under these facts and circumstances E's rights in the stock are subject to a substantial risk of forfeiture.

(d) *Transferability of property.* For purposes of section 83 and the regulations thereunder, the rights of a person in property are transferable if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the rights in such property of such transferee are not subject to a substantial risk of forfeiture. Accordingly, property is transferable if the person performing the services or receiving the property can sell, assign, or pledge (as collateral for a loan, or as security for the performance of an obligation, or for any other purpose) his interest in the property to any person other than the transferor of such property and if the transferee is not required to give up the property or its value in the event the substantial risk of forfeiture materializes. On the other hand, property is not considered to be transferable merely because the person performing the services or receiving the property may designate a beneficiary to receive the property in the event of his death.

(e) *Property.* For purposes of section 83 and the regulations thereunder, the term ''property'' includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. The term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account. See, however, § 1.83–8(a) with respect to employee trusts and annuity plans subject to section 402(b) and section 403(c). In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value of the contract is considered to be property. Where rights in a contract providing life insurance protection are substantially nonvested, see § 1.83–1(a)(2) for rules relating to taxation of the cost of life insurance protection.

(f) *Property transferred in connection with the performance of services.* Property transferred to an employee or an independent contractor (or beneficiary thereof) in recognition of the performance of, or the refraining from performance of, services is considered transferred in connection with the performance of services within the meaning of section 83. The existence of other persons entitled to buy stock on the same terms and conditions as an employee, whether pursuant to a public or private offering may, however, indicate that in such circumstances a transfer to the employee is not in recognition of the performance of, or the refraining from performance of, services. The transfer of property is subject to section 83 whether such transfer is in respect of past, present, or future services.

(g) *Amount paid.* For purposes of section 83 and the regulations thereunder, the term ''amount paid'' refers to the value of any money or property paid for the transfer of property to which section 83 applies, and does not refer to any amount paid for the right to use such property or to receive the income therefrom. Such value does not include any stated or unstated interest payments. For rules regarding the calculation of the amount of unstated interest payments, see §1.483–1(c). When section 83 applies to the transfer of property pursuant to the exercise of an option, the term ''amount paid'' refers to any amount paid for the grant of the option plus any amount paid as the exercise price of the option. For rules regarding the forgiveness of indebtedness treated as an amount paid, see §1.83–4(c).

(h) *Nonlapse restriction.* For purposes of section 83 and the regulations thereunder, a restriction which by its terms will never lapse (also referred to as a ''nonlapse restriction'') is a permanent limitation on the transferability of property—

(1) Which will require the transferee of the property to sell, or offer to sell, such property at a price determined under a formula, and

(2) Which will continue to apply to and be enforced against the transferee or any subsequent holder (other than the transferor).

A limitation subjecting the property to a permanent right of first refusal in a particular person at a price determined under a formula is a permanent nonlapse restriction. Limitations imposed by registration requirements of State or Federal security laws or similar laws imposed with respect to sales or other dispositions of stock or securities are not nonlapse restrictions. An obligation to resell or to offer to sell property transferred in connection with the performance of services to a specific person or persons at its fair market value at the time of such sale is not a nonlapse restriction. See §1.83–5(c) for examples of nonlapse restrictions.

(i) *Lapse restriction.* For purposes of section 83 and the regulations thereunder, the term ''lapse restriction'' means a restriction other than a nonlapse restriction as defined in paragraph (h) of this section, and includes (but is not limited to) a restriction that carries a substantial risk of forfeiture.

(j) *Sales which may give rise to suit under section 16(b) of the Securities Exchange Act of 1934*—(1) *In general.* For purposes of section 83 and the regulations thereunder if the sale of property at a profit within six months after the purchase of the property could subject a person to suit under section 16(b) of the Securities Exchange Act of 1934, the person's rights in the property are treated as subject to a substantial risk of forfeiture and as not transferable until the earlier of (i) the expiration of such six-month period, or (ii) the first day on which the sale of such property at a profit will not subject the person to suit under section 16(b) of the Securities Exchange Act of 1934. However, whether an option is ''transferable by the optionee'' for purposes of §1.83–7(b)(2)(i) is determined without regard to section 83(c)(3) and this paragraph (j).

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

Example (1). On January 1, 1983, X corporation sells to P, a beneficial owner of 12% of X corporation stock, in connection with P's performance of services, 100 shares of X corporation stock at $10 per share. At the time of the sale the fair market value of the X corporation stock is $100 per share. P, as a beneficial owner of more 10% of X corporation stock, is liable to suit under section 16(b) of the Securities Exchange Act of 1934 for recovery of any profit from any sale and purchase or purchase and sale of X corporation stock within a six-month period, but no other restrictions apply to the stock. Because the section 16(b) restriction is applicable to P, P's rights in the 100 shares of stock purchased on January 1, 1983, are treated as subject to a substantial risk of forfeiture and as not transferable through June 29, 1983. P chooses not to make an election under section 83 (b) and therefore does not include any amount with respect to the stock purchase in gross income as compensation on the date of purchase. On June 30, 1983, the fair market value of X corporation stock is $250 per share. P must include $24,000 (100 shares of X corporation stock × $240 ($250 fair market value per share less $10 price paid by P for each share)) in gross income as compensation on June 30, 1983. If, in this example, restrictions other than section 16(b) applied to the stock, such other restrictions (but not section 16(b)) would be taken into account in determining whether the stock is subject to a substantial risk of foreiture and is nontransferable for periods after June 29, 1983.

Example (2). Assume the same facts as in example (1) except that P is not an insider on or after May 1, 1983, and the section 16(b) restriction does not apply beginning on that date. On May 1, 1983, P must include in gross income as compensation the difference between the fair market value of the stock on that date and the amount paid for the stock.

Example (3). Assume the same facts as in example (1) except that on June 1, 1983, X corporation sells to P an additional 100 shares of X corporation stock at $20 per share. At the time of the sale the fair market value of the X corporation stock is $150 per share. On June 30, 1983, P must include $24,000 in gross income as compensation with respect to the January 1, 1983 purchase. On November 30, 1983, the fair market value of X corporation stock is $200 per share. Accordingly, on that date P must include $18,000 (100 shares of X corporation stock × $180 ($200 fair market value per share less $20 price paid by P for each share)) in gross income as compensation with respect to the June 1, 1983 purchase.

(3) *Effective date.* This paragraph applies property transferred after December 31, 1981.

(k) *Special rule for certain accounting rules.* (1) For purposes of section 83 and the regualtions thereunder, property is subject to substantial risk of forfeiture and is not transferable so long as the property is subject to a restriction on transfer to comply with the ''Pooling-of-Interests Accounting'' rules set forth in Accounting Series Release Numbered 130 ((10/5/72) 37 FR 20937; 17 CFR 211.130) and Accounting Series Release Numbered 135 ((1/18/73) 38 FR 1734; 17 CFR 211.135).

(2) *Effective date.* This paragraph applies to property transferred after December 31, 1981.

[T.D. 7554, 43 FR 31916, July 24, 1978, as amended by T.D. 8042, 50 FR 31713, Aug. 6, 1985; 50 FR 39664, Sept. 30, 1985]

§ 1.83–4 Special rules.

(a) *Holding period.* Under section 83(f), the holding period of transferred property to which section 83(a) applies shall begin just after such property is substantially vested. However, if the person who has performed the services in connection with which property is transferred has made an election under section 83(b), the holding period of such property shall begin just after the date such property is transferred. If property to which section 83 and the regulations thereunder apply is transferred at arm's length, the holding period of such property in the hands of the transferee shall be determined in accordance with the rules provided in section 1223.

(b) *Basis.* (1) Except as provided in paragraph (b)(2) of this section, if property to which section 83 and the regulations thereunder apply is acquired by any person (including a person who acquires such property in a subsequent transfer which is not at arm's length), while such property is still substantially nonvested, such person's basis for the property shall reflect any amount paid for such property and any amount includible in the gross income of the person who performed the services (including any amount so includible as a result of a disposition by the person who acquired such property.) Such basis shall also reflect any adjustments to basis provided under sections 1015 and 1016.

(2) If property to which § 1.83–1 applies is transferred at arm's length, the basis of the property in the hands of the transferee shall be determined under section 1012 and the regulations thereunder.

(c) *Forgiveness of indebtedness treated as an amount paid.* If an indebtedness that has been treated as an amount paid under § 1.83–1(a)(1)(ii) is subsequently cancelled, forgiven or satisfied for an amount less than the amount of such indebtedness, the amount that is not, in fact, paid shall be includible in the gross income of the service provider in the taxable year in which such cancellation, forgiveness or satisfaction occurs.

[T.D. 7554, 43 FR 31918, July 24, 1978]

§1.83–5 Restrictions that will never lapse.

(a) *Valuation.* For purposes of section 83 and the regulations thereunder, in the case of property subject to a nonlapse restriction (as defined in §1.83–3(h)), the price determined under the formula price will be considered to be the fair market value of the property unless established to the contrary by the Commissioner, and the burden of proof shall be on the commissioner with respect to such value. If stock in a corporation is subject to a nonlapse restriction which requires the transferee to sell such stock only at a formula price based on book value, a reasonable multiple of earnings or a reasonable combination thereof, the price so determined will ordinarily be regarded as determinative of the fair market value of such property for purposes of section 83. However, in certain circumstances the formula price will not be considered to be the fair market value of property subject to such a formula price restriction, even though the formula price restriction is a substantial factor in determining such value. For example, where the formula price is the current book value of stock, the book value of the stock at some time in the future may be a more accurate measure of the value of the stock than the current book value of the stock for purposes of determining the fair market value of the stock at the time the stock becomes substantially vested.

(b) *Cancellation*—(1) *In general.* Under section 83(d)(2), if a nonlapse restriction imposed on property that is subject to section 83 is cancelled, then, unless the taxpayer establishes—

(i) That such cancellation was not compensatory, and

(ii) That the person who would be allowed a deduction, if any, if the cancellation were treated as compensatory, will treat the transaction as not compensatory, as provided in paragraph (c)(2) of this section, the excess of the fair market value of such property (computed without regard to such restriction) at the time of cancellation, over the sum of—

(iii) The fair market value of such property (computed by taking the restriction into account) immediately before the cancellation, and

(iv) The amount, if any, paid for the cancellation, shall be treated as compensation for the taxable year in which such cancellation occurs. Whether there has been a noncompensatory cancellation of a nonlapse restriction under section 83(d)(2) depends upon the particular facts and circumstances. Ordinarily the fact that the employee or independent contractor is required to perform additional services or that the salary or payment of such a person is adjusted to take the cancellation into account indicates that such cancellation has a compensatory purpose. On the other hand, the fact that the original purpose of a restriction no longer exists may indicate that the purpose of such cancellation is noncompensatory. Thus, for example, if a so-called ‘‘buy-sell’’ restriction was imposed on a corporation’s stock to limit ownership of such stock and is being cancelled in connection with a public offering of the stock, such cancellation will generally be regarded as noncompensatory. However, the mere fact that the employer is willing to forego a deduction under section 83(h) is insufficient evidence to establish a noncompensatory cancellation of a nonlapse restriction. The refusal by a corporation or shareholder to repurchase stock of the corporation which is subject to a permanent right of first refusal will generally be treated as a cancellation of a nonlapse restriction. The preceding sentence shall not apply where there is no nonlapse restriction, for example, where the price to be paid for the stock subject to the right of first refusal is the fair market value of the stock. Section 83(d)(2) and this (1) do not apply where immediately after the cancellation of a nonlapse restriction the property is still substantially nonvested and no section 83(b) election has been made with respect to such property. In such a case the rules of section 83(a) and §1.83–1 shall apply to such property.

(2) *Evidence of noncompensatory cancellation.* In addition to the information necessary to establish the factors described in paragraph (b)(1) of this section, the taxpayer shall request the employer to furnish the taxpayer with a written statement indicating that the employer will not treat the cancellation of the nonlapse restriction as a compensatory event, and that no deduction will be taken with respect to such cancellation. The taxpayer shall file such written statement with his income tax return for the taxable year in which or with which such cancellation occurs.

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

Example (1). On November 1, 1971, X corporation whose shares are closely held and not regularly traded, transfers to E, an employee, 100 shares of X corporation stock subject to the condition that, if he desires to dispose of such stock during the period of his employment, he must resell the stock to his employer at its then existing book value. In addition, E or E's estate is obligated to offer to sell the stock at his retirement or death to his employer at its then existing book value. Under these facts and circumstances, the restriction to which the shares of X corporation stock are subject is a nonlapse restriction. Consequently, the fair market value of the X stock is includible in E's gross income as compensation for taxable year 1971. However, in determining the fair market value of the X stock, the book value formula price will ordinarily be regarded as being determinative of such value.

Example (2). Assume the facts are the same as in example (1), except that the X stock is subject to the condition that if E desires to dispose of the stock during the period of his employment he must resell the stock to his employer at a multiple of earnings per share that is in this case a reasonable approximation of value at the time of transfer to E. In addition, E or E's estate is obligated to offer to sell the stock at his retirement or death to his employer at the same multiple of earnings. Under these facts and circumstances, the restriction to which the X corporation stock is subject is a nonlapse restriction. Consequently, the fair market value of the X stock is includible in E's gross income for taxable year 1971. However, in determining the fair market value of the X stock, the multiple-of-earnings formula price will ordinarily be regarded as determinative of such value.

Example (3). On January 4, 1971, X corporation transfers to E, an employee, 100 shares of stock in X corporation. Each such share of stock is subject to an agreement between X and E whereby E agrees that such shares are to be held solely for investment purposes and not for resale (a so-called investment letter restriction). E's rights in such stock are substantially vested upon transfer, causing the fair market value of each share of X corporation stock to be includible in E's gross income as compensation for taxable year 1971. Since such an investment letter restriction does not constitute a nonlapse restriction, in determining the fair market value of each share, the investment letter restriction is disregarded.

Example (4). On September 1, 1971, X corporation transfers to B, an independent contractor, 500 shares of common stock in X corporation in exchange for B's agreement to provide services in the construction of an office building on property owned by X corporation. X corporation has 100 shares of preferred stock outstanding and an additional 500 shares of common stock outstanding. The preferred stock has a liquidation value of $1,000*x*, which is equal to the value of all assets owned by X. Therefore, the book value of the common stock in X corporation is $0. Under the terms of the transfer, if B wishes to dispose of the stock, B must offer to sell the stock to X for 150 percent of the then existing book value of B's common stock. The stock is also subject to a substantial risk of forfeiture until B performs the agreed-upon services. B makes a timely election under section 83(b) to include the value of the stock in gross income in 1971. Under these facts and circumstances, the restriction to which the shares of X corporation common stock are subject is a nonlapse restriction. In determining the fair market value of the X common stock at the time of transfer, the book value formula price would ordinarily be regarded as determinative of such value. However, the fair market value of X common stock at the time of transfer, subject to the book value restriction, is greater than $0 since B was willing to agree to provide valuable personal services in exchange for the stock. In determining the fair market value of the stock, the expected book value after construction of the office building would be given great weight. The likelihood of completion of construction would be a factor in determining the expected book value after completion of construction.

[T.D. 7554, 43 FR 31918, July 24, 1978]

§ 1.83–6 Deduction by employer.

(a) *Allowance of deduction*—(1) *General rule.* In the case of a transfer of property in connection with the performance of services, or a compensatory cancellation of a nonlapse restriction described in section 83(d) and § 1.83–5, a deduction is allowable under section

162 or 212 to the person for whom the services were performed. The amount of the deduction is equal to the amount included as compensation in the gross income of the service provider under section 83 (a), (b), or (d)(2), but only to the extent the amount meets the requirements of section 162 or 212 and the regulations thereunder. The deduction is allowed only for the taxable year of that person in which or with which ends the taxable year of the service provider in which the amount is included as compensation. For purposes of this paragraph, any amount excluded from gross income under section 79 or section 101(b) or subchapter N is considered to have been included in gross income.

(2) *Special Rule.* For purposes of paragraph (a)(1) of this section, the service provider is deemed to have included the amount as compensation in gross income if the person for whom the services were performed satisfies in a timely manner all requirements of section 6041 or section 6041A, and the regulations thereunder, with respect to that amount of compensation. For purposes of the preceding sentence, whether a person for whom services were performed satisfies all requirements of section 6041 or section 6041A, and the regulations thereunder, is determined without regard to §1.6041–3(c) (exception for payments to corporations). In the case of a disqualifying disposition of stock described in section 421(b), an employer that otherwise satisfies all requirements of section 6041 and the regulations thereunder will be considered to have done so timely for purposes of this paragraph (a)(2) if Form W–2 or Form W–2c, as appropriate, is furnished to the employee or former employee, and is filed with the federal government, on or before the date on which the employer files the tax return claiming the deduction relating to the disqualifying disposition.

(3) *Exceptions.* Where property is substantially vested upon transfer, the deduction shall be allowed to such person in accordance with his method of accounting (in conformity with sections 446 and 461). In the case of a transfer to an employee benefit plan described in §1.162–10(a) or a transfer to an employees' trust or annuity plan described in section 404(a)(5) and the regulations thereunder, section 83(h) and this section do not apply.

(4) *Capital expenditure, etc.* No deduction is allowed under section 83(h) to the extent that the transfer of property constitutes a capital expenditure, an item of deferred expense, or an amount properly includible in the value of inventory items. In the case of a capital expenditure, for example, the basis of the property to which such capital expenditure relates shall be increased at the same time and to the same extent as any amount includible in the employee's gross income in respect of such transfer. Thus, for example, no deduction is allowed to a corporation in respect of a transfer of its stock to a promoter upon its organization, notwithstanding that such promoter must include the value of such stock in his gross income in accordance with the rules under section 83.

(5) *Effective date.* Paragraphs (a)(1) and (2) of this section apply to deductions for taxable years beginning on or after January 1, 1995. However, taxpayers may also apply paragraphs (a)(1) and (2) of this section when claiming deductions for taxable years beginning before that date if the claims are not barred by the statute of limitations. Paragraphs (a) (3) and (4) of this section are effective as set forth in §1.83–8(b).

(b) *Recognition of gain or loss.* Except as provided in section 1032, at the time of a transfer of property in connection with the performance of services the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor's basis in the property. In addition, at the time a deduction is allowed under section 83(h) and paragraph (a) of this section, gain or loss is recognized to the extent of the difference between (1) the sum of the amount paid plus the amount allowed as a deduction under section 83(h), and (2) the sum of the taxpayer's basis in the property plus any amount recognized pursuant to the previous sentence.

(c) *Forfeitures.* If, under section 83(h) and paragraph (a) of this section, a deduction, an increase in basis, or a reduction of gross income was allowable (disregarding the reasonableness of the amount of compensation) in respect of a transfer of property and such property is subsequently forfeited, the amount of such deduction, increase in basis or reduction of gross income shall be includible in the gross income of the person to whom it was allowable for the taxable year of forfeiture. The basis of such property in the hands of the person to whom it is forfeited shall include any such amount includible in the gross income of such person, as well as any amount such person pays upon forfeiture.

(d) *Special rules for transfers by shareholders*—(1) *Transfers.* If a shareholder of a corporation transfers property to an employee of such corporation or to an independent contractor (or to a beneficiary thereof), in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the corporation to the employee or independent contractor under paragraphs (a) and (b) of this section. For purposes of this (1), such a transfer will be considered to be in consideration for services performed for the corporation if either the property transferred is substantially nonvested at the time of transfer or an amount is includible in the gross income of the employee or independent contractor at the time of transfer under § 1.83–1(a)(1) or § 1.83–2(a). In the case of such a transfer, any money or other property paid to the shareholder for such stock shall be considered to be paid to the corporation and transferred immediately thereafter by the corporation to the shareholder as a distribution to which section 302 applies.

(2) *Forfeiture.* If, following a transaction described in paragraph (d)(1) of this section, the transferred property is forfeited to the shareholder, paragraph (c) of this section shall apply both with respect to the shareholder and with respect to the corporation. In addition, the corporation shall in the taxable year of forfeiture be allowed a loss (or realize a gain) to offset any gain (or loss) realized under paragraph (b) of this section. For example, if a shareholder transfers property to an employee of the corporation as compensation, and as a result the shareholder's basis of $200*x* in such property is allocated to his stock in such corporation and such corporation recognizes a short-term capital gain of $800*x*, and is allowed a deduction of $1,000*x* on such transfer, upon a subsequent forfeiture of the property to the shareholder, the shareholder shall take $200*x* into gross income, and the corporation shall take $1,000*x* into gross income and be allowed a short-term capital loss of $800*x*.

(e) *Options.* [Reserved]

(f) *Reporting requirements.* [Reserved]

[T.D. 7554, 43 FR 31919, July 24, 1978, as amended by T.D. 8599, July 19, 1995]

§ 1.83–7 Taxation of nonqualified stock options.

(a) *In general.* If there is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services, an option to which section 421 (relating generally to certain qualified and other options) does not apply, section 83(a) shall apply to such grant if the option has a readily ascertainable fair market value (determined in accordance with paragraph (b) of this section) at the time the option is granted. The person who performed such services realizes compensation upon such grant at the time and in the amount determined under section 83(a). If section 83(a) does not apply to the grant of such an option because the option does not have a readily ascertainable fair market value at the time of grant, sections 83(a) and 83(b) shall apply at the time the option is exercised or otherwise disposed of, even though the fair market value of such option may have become readily ascertainable before such time. If the option is exercised, sections 83(a) and 83(b) apply to the transfer of property pursuant to such exercise, and the employee or independent contractor realizes compensation upon such transfer at the time and in the amount determined under section 83(a) or 83(b). If the option is sold or otherwise disposed of in an arm's length transaction, sections 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as sections 83(a) and 83(b) would have applied to the transfer of property pursuant to an exercise of the option.

(b) *Readily ascertainable defined*—(1) *Actively traded on an established market.* Options have a value at the time they are granted, but that value is ordinarily not readily ascertainable unless the option is actively traded on an established market. If an option is actively traded on an established market, the fair market value of such option is readily ascertainable for purposes of this section by applying the rules of valuation set forth in §20.2031–2.

(2) *Not actively traded on an established market.* When an option is not actively traded on an established market, it does not have a readily ascertainable fair market value unless its fair market value can otherwise be measured with reasonable accuracy. For purposes of this section, if an option is not actively traded on an established market, the option does not have a readily ascertainable fair market value when granted unless the taxpayer can show that all of the following conditions exist:

(i) The option is transferable by the optionee;

(ii) The option is exerciseable immediately in full by the optionee;

(iii) The option or the property subject to the option is not subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) which has a significant effect upon the fair market value of the option; and

(iv) The fair market value of the option privilege is readily ascertainable in accordance with paragraph (b)(3) of this section.

(3) *Option privilege.* The option privilege in the case of an option to buy is the opportunity to benefit during the option's exercise period from any increase in the value of property subject to the option during such period, without risking any capital. Similarly, the option privilege in the case of an option to sell is the opportunity to benefit during the exercise period from a decrease in the value of property subject to the option. For example, if at some time during the exercise period of an option to buy, the fair market value of the property subject to the option is greater than the option's exercise price, a profit may be realized by exercising the option and immediately selling the property so acquired for its higher fair market value. Irrespective of whether any such gain may be realized immediately at the time an option is granted, the fair market value of an option to buy includes the value of the right to benefit from any future increase in the value of the property subject to the option (relative to the option exercise price), without risking any capital. Therefore, the fair market value of an option is not merely the difference that may exist at a particular time between the option's exercise price and the value of the property subject to the option, but also includes the value of the option privilege for the remainder of the exercise period. Accordingly, for purposes of this section, in determining whether the fair market value of an option is readily ascertainable, it is necessary to consider whether the value of the entire option privilege can be measured with reasonable accuracy. In determining whether the value of the option privilege is readily ascertainable, and in determining the amount of such value when such value is readily ascertainable, it is necessary to consider—

(i) Whether the value of the property subject to the option can be ascertained;

(ii) The probability of any ascertainable value of such property increasing or decreasing; and

(iii) The length of the period during which the option can be exercised.

(c) *Reporting requirements.* [Reserved]

[T.D. 7554, 43 FR 31920, July 24, 1978]

§1.83–8 Applicability of section and transitional rules.

(a) *Scope of section 83.* Section 83 is not applicable to—

(1) A transaction concerning an option to which section 421 applies;

(2) A transfer to or from a trust described in section 401(a) for the benefit of employees or their beneficiaries, or a transfer under an annuity plan that meets the requirements of section 404(a)(2) for the benefit of employees or their beneficiaries;

(3) The transfer of an option without a readily ascertainable fair market value (as defined in §1.83–7(b)(1)); or

(4) The transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value at the date of grant. Section 83 applies to a transfer to or from a trust or under an annuity plan for the benefit of employees, independent contractors, or their beneficiaries (except as provided in paragraph (a)(2) of this section), but to the extent a transfer is subject to section 402(b) or 403(c), section 83 applies to such a transfer only as provided for in section 402(b) or 403(c).

(b) *Transitional rules*—(1) *In general.* Except as otherwise provided in this paragraph, section 83 and the regulations thereunder shall apply to property transferred after June 30, 1969.

(2) *Binding written contracts.* Section 83 and the regulations thereunder shall not apply to property transferred pursuant to a binding written contract entered into before April 22, 1969. For purposes of this paragraph, a binding written contract means only a written contract under which the employee or independent contractor has an enforceable right to compel the transfer of property or to obtain damages upon the breach of such contract. A contract which provides that a person's right to such property is contingent upon the happening of an event (including the passage of time) may satisfy the requirements of this paragraph. However, if the event itself, or the determination of whether the event has occurred, rests with the board of directors or any other individual or group acting on behalf of the employer (other than an arbitrator), the contract will not be treated as giving the person an enforceable right for purposes of this paragraph.

The fact that the board of directors has the power (either expressly or impliedly) to terminate employment of an officer pursuant to a contract that contemplates the completion of services over a fixed or ascertainable period does not negate the existence of a binding written contract. Nor will the binding nature of the contract be negated by a provision in such contract which allows the employee or independent contractor to terminate the contract for any year and receive cash instead of property if such election would cause a substantial penalty, such as a forfeiture of part or all of the property received in connection with the performance of services in an earlier year.

(3) *Options granted before April 22, 1969.* Section 83 shall not apply to property received upon the exercise of an option granted before April 22, 1969.

(4) *Certain written plans.* Section 83 shall not apply to property transferred (whether or not by the exercise of an option) before May 1, 1970, pursuant to a written plan adopted and approved before July 1, 1969. A plan is to be considered as having been adopted and approved before July 1, 1969, only if prior to such date the transferor of the property undertook an ascertainable course of conduct which under applicable State law does not require further approval by the board of directors or the stockholders of any corporation. For example, if a corporation transfers property to an employee in connection with the performance of services pursuant to a plan adopted and approved before July 1, 1969, by the board of directors of such corporation, it is not necessary that the stockholders have adopted or approved such plan if State law does not require such approval. However, such approval is necessary if required by the articles of incorporation or the bylaws or if, by its terms, such plan will not become effective without such approval.

(5) *Certain options granted pursuant to a binding written contract.* Section 83 shall not apply to property transferred before January 1, 1973, upon the exercise of an option granted pursuant to a binding written contract (as defined in paragraph (b)(2) of this section) entered into before April 22, 1969, between a corporation and the transferor of such property requiring the transferor to grant options to employees of such corporation (or a subsidiary of such corporation) to purchase a determinable number of shares of stock of such corporation, but only if the transferee was an employee of such corporation (or a subsidiary of such corporation) on or before April 22, 1969.

(6) *Certain tax free exchanges.* Section 83 shall not apply to property transferred in exchange for (or pursuant to the exercise of a conversion privilege

contained in) property transferred before July 1, 1969, or in exchange for property to which section 83 does not apply (by reason of paragraphs (1), (2), (3), or (4) of section 83(i)), if section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applies, or if gain or loss is not otherwise required to be recognized upon the exercise of such conversion privilege, and if the property received in such exchange is subject to restrictions and conditions substantially similar to those to which the property given in such exchange was subject.

[T.D. 7554, 43 FR 31921, July 24, 1978]

§1.84–1 Transfer of appreciated property to political organizations.

(a) *Transfer defined.* A transfer after May 7, 1974, of property to a political organization (as defined in section 527(e)(1), and including a newsletter fund to the extent provided under section 527(g)) is treated as a sale of the property to the political organization if the fair market value of the property exceeds its adjusted basis. The transferor is treated as having realized an amount equal to the fair market value of the property on the date of the transfer. For purposes of this section, a transfer is any assignment, conveyance, or delivery of property other than a bona fide sale for an adequate and full consideration in money or money's worth, whether the transfer is in trust or otherwise, whether the transfer is direct or indirect and whether the property is real or personal, tangible or intangible. Thus, for example, a sale at less than fair market value (other than an ordinary trade discount), or a receipt of property by a political organization under an agency agreement entitling the organization to sell the property and retain all or a portion of the proceeds of the sale, is a transfer within the meaning, of this section. The term ''transfer'' also includes an illegal contribution of property.

(b) *Amount realized.* A transferor to whom this section applies realizes an amount equal to the fair market value of the property on the date of the transfer. For purposes of this section, the definition of fair market value set forth in §1.170A–1(c) (2) and (3) is incorporated by reference.

(c) *Amount recognized.* A transferor to whom this section applies is treated as having sold the property to the political organization on the date of the transfer. Therefore, the rules of chapter 1 of subtitle A (relating to income tax) apply to the gain realized under this section as if this gain were an amount realized upon the sale of the property. These rules include those of section 55 and section 56 (relating to minimum tax for tax preference), section 306 (relating to disposition of certain stock), section 1201 (relating to the alternative tax on certain capital gains), section 1245 (relating to gain from dispositions of certain depreciable property), and section 1250 (relating to gain from dispositions of certain depreciable realty).

(d) *Holding period.* The holding period of property transferred to a political organization to which this section applies begins on the day after the date of acquisition of the property by the political organization.

[T.D. 7671, 45 FR 8003, Feb. 6, 1980]

§1.85–1 Unemployment compensation.

(a) *Introduction.* Section 85 prescribes rules relating to the inclusion in gross income of unemployment compensation (as defined in paragraph (b)(1) of this section) paid in taxable years beginning after December 31, 1978, pursuant to governmental programs. In general, these rules provide that unemployment compensation paid pursuant to governmental programs is includible in the gross income of a taxpayer if the taxpayer's modified adjusted gross income (as defined in paragraph (b)(2) of this section) exceeds a statutory base amount (as defined in paragraph (b)(3) of this section). If there is such an excess, however, the amount included in gross income is limited under paragraph (c)(1) of this section to the lesser of one-half of such excess or the amount of the unemployment compensation. If such taxpayer's modified adjusted gross income does not exceed the applicable statutory base amount, none of the unemployment compensation is included in the taxpayer's gross income.

(b) *Definitions*—(1) *Unemployment compensation*—(i) *General rule.* Except as provided in paragraph (b)(1)(iii) of this section, the term ''unemployment compensation'' means any amount received under a law of the United States, or of a State, which is in the nature of unemployment compensation. Thus, section 85 applies only to unemployment compensation paid pursuant to governmental programs and does not apply to amounts paid pursuant to private nongovernmental unemployment compensation plans (which are includible in income without regard to section 85). Generally, unemployment compensation programs are those designed to protect taxpayers against the loss of income caused by involuntary layoff. Ordinarily, unemployment compensation is paid in cash and on a periodic basis. The amount of the payments is usually computed in accordance with formula based on the taxpayer's length of prior employment and wages. Such payments, however, may be made in a lump sum or other than in cash or on some other basis.

(ii) *Disability and worker's compensation payments.* Amounts in the nature of unemployment compensation also include cash disability payments made pursuant to a governmental program as a substitute for case unemployment payments to an unemployed taxpayer who is ineligible for such payments solely because of the disability. Usually these disability payments are paid in the same weekly amount and for the same period as the unemployment compensation benefits to which the unemployed taxpayer otherwise would have been entitled. Amounts received under workmen's compensation acts as compensation for personal injuries or sickness are not amounts in the nature of unemployment compensation. See section 104(a)(1) relating to the exclusion from gross income of such amounts.

(iii) *Employee contributions to a governmental plan.* If a governmental unemployment compensation program is funded in part by an employee's contribution which is not deductible by the employee, an amount paid to such employee under the program is not to be considered unemployment compensation until an amount equal to the total nondeductible contributions paid by the employee to such program has been paid to such employee.

(iv) *Examples of governmental unemployment compensation programs.* Governmental unemployment compensation programs include (but are not limited to) programs established under:

(A) A State law approved by the Secretary of Labor pursuant to section 3304 of the Internal Revenue Code of 1954.

(B) Chapter 85 of title 5, United States Code, relating to unemployment compensation for Federal employees generally and for ex-servicemen.

(C) Trade Act of 1974, sections 231 and 232 (19 U.S.C. 2291 and 2292).

(D) Disaster Relief Act of 1974, section 407 (42 U.S.C. 5177).

(E) The Airline Deregulation Act of 1978 (49 U.S.C. 1552(b)).

(F) The Railroad Unemployment Insurance Act, section 2 (45 U.S.C. 352).

(2) *Modified adjusted gross income.* The term ''modified adjusted gross income'' means the sum of the following amounts:

(i) Adjusted gross income (as defined in section 62);

(ii) All disability payments of the type that are eligible for exclusion from gross income under section 105(d); and

(iii) All amounts of unemployment compensation (as defined in paragraph (b)(1) of this section).

(3) *Base amount.* The term ''base amount'' means—

(i) $25,000 in the case of a joint return under section 6013.

(ii) Zero in the case of a taxpayer who—

(A) Is married (within the meaning of section 143) at the close of the taxable year,

(B) Does not file a joint return for such taxable year, and

(C) Does not live apart (as defined in paragraph (b)(4) of this section) from his or her spouse at all times during the taxable year.

(iii) $20,000 in the case of all other taxpayers.

(4) *Living apart.* A taxpayer does not ''live apart'' from his or her spouse at all times during a taxable year if for any period during the taxable year the taxpayer is a member of the same

household as such taxpayer's spouse. A taxpayer is a member of a household for any period, including temporary absences due to special circumstances, during which the household is the taxpayer's place of abode. A temporary absence due to special circumstances includes a nonpermanent absence caused by illness, education, business, vacation, or military service.

(c) *Limitations*—(1) *General rule.* If for a taxable year, a taxpayer's modified adjusted gross income does not exceed the applicable statutory base amount, no amount of unemployment compensation is included in gross income for the taxable year. If there is such an excess, the taxpayer includes in gross income for the taxable year the lesser of the following:

(i) One-half of the excess of the taxpayer's modified adjusted gross income over such taxpayer's base amount, or

(ii) The amount of unemployment compensation.

(2) *Exception for fraudulently received unemployment compensation.* If a taxpayer fraudulently receives unemployment compensation under any governmental unemployment compensation program, then the entire amount of such fraudulently received unemployment compensation must be included in the taxpayer's gross income for the taxable year in which the benefits were received. Thus, the limitation in section 85 and in paragraph (c)(1) of this section, does not apply to such amounts.

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

Example (1). H and W are married taxpayers who for calendar year 1979 file a joint income tax return. During 1979 H receives $4,500 of disability income that is eligible for an exclusion under section 105(d). W works for part of 1979 and receives $20,000 as compensation and also receives $5,000 of unemployment compensation in 1979. Assume that H and W's adjusted gross income is $20,000. The modified adjusted gross income of H and W is $29,500 ($4,500 + $20,000 + $5,000). Since their modified adjusted gross income ($29,500) is greater than their base amount ($25,000), some of the unemployment compensation received by W must be included in their gross income on their 1979 joint income tax return. Under paragraph (c)(1) of this section, of the $5,000 which is unemployment compensation, the lesser of $2,250 (($29,500—$25,000)÷2) or $5,000 must be included in their gross income. Thus, $2,250 of the $5,000 received by W in 1979 is included in the gross income of H and W on their joint income tax return for 1979.

Example (2). Assume the same facts in example (1) except H received $5,000 of disability income that is eligible for an exclusion under section 105(d) and W receives $28,000 as compensation, and $4,000 which is unemployment compensation. Assume that H and W's adjusted gross income is $28,000. The modified adjusted gross income of H and W is $37,000 ($4,000 + $28,000 + $5,000). Since their modified adjusted gross income ($37,000) is greater than their base amount ($25,000), all of the unemployment compensation received by W must be included in their gross income on their 1979 joint income tax return. Under paragraph (c)(1) of this section, of the $4,000 which is unemployment compensation, the lesser of $6,000 (($37,000—$25,000)÷2) or $4,000 must be included in their gross income. Thus, all of the $4,000 unemployment compensation received by W is included in the gross income of H and W on their joint income tax return for 1979.

(d) *Cross reference.* See section 6050B, relating to the requirement that every person who makes payments of unemployment compensation aggregating $10 or more to any individual during any calendar year file an information return with the Internal Revenue Service.

[T.D. 7705, 45 FR 46069, July 9, 1980]

§1.88–1 Nuclear decommissioning costs.

(a) *In general.* Section 88 provides that the amount of nuclear decommissioning costs directly or indirectly charged to the customers of a taxpayer that is engaged in the furnishing or sale of electric energy generated by a nuclear power plant must be included in the gross income of such taxpayer in the same manner as amounts charged for electric energy. For this purpose, decommissioning costs directly or indirectly charged to the customers of a taxpayer include all decommissioning costs that consumers are liable to pay by reason of electric energy furnished by the taxpayer during the taxable year, whether payable to the taxpayer, a trust, State government, or other entity, and even though the taxpayer may not control the investment or current expenditure of the amount and the amount may not be paid to the taxpayer at the time decommissioning costs are incurred. However, decommissioning costs payable to a taxpayer holding a qualified leasehold interest (as described in paragraph (b)(2)(ii) of § 1.468A–1) are included in the gross income of such taxpayer, and not in the gross income of the lessor.

(b) *Examples.* The following examples illustrate the application of the principles of paragraph (a) of this section:

Example (1). X corporation, an accrual method taxpayer engaged in the sale of electric energy generated by a nuclear power plant owned by X, is authorized by the public utility commission of State A to collect nuclear decommissioning costs from ratepayers residing in State A. With respect to the sale of electric energy, X includes in income amounts that have been billed to customers as well as estimated unbilled amounts that relate to energy provided by X after the previous billing but before the end of the taxable year (''accrued unbilled amounts''). The decommissioning costs are included in the monthly bills provided by X to its ratepayers and the entire amount billed is remitted directly to X. Under paragraph (a) of this section, the decommissioning costs must be included in the gross income of X in the same manner as amounts charged for electric energy (*i.e.*, by including in income decommissioning costs that relate to amounts billed as well as decommissioning costs that relate to accrued unbilled amounts). The same rule would apply if the decommissioning costs charged to ratepayers were separately billed and the amounts billed were remitted to State A to be held in trust for the purpose of decommissioning the nuclear power plant owned by X. In that case, X must include in gross income decommissioning costs that relate to amounts billed as well as decommissioning costs that relate to accrued unbilled amounts.

Example (2). Assume the same facts as in Example (1), except that X and M, a municipality located in State A, have entered into a life-of-unit contract pursuant to which (i) M is entitled to 20 percent of the electric energy generated by the nuclear power plant owned by X, and (ii) M is obligated to pay 20 percent of the plant operating costs, including decommissioning costs, incurred by X. Under paragraph (a) of this section, the decommissioning costs that relate to electric energy consumed or distributed by M during any taxable year must be included in the gross income of X for such taxable year. The result contained in this example would be the same if M was a State or an agency or instrumentality of a State or a political subdivision thereof.

(c) *Cross reference.* For special rules relating to the deduction for amounts paid to a nuclear decommissioning fund, see § 1.468A–1 through § 1.468A–5, 1.468A–7, 1.468A–8.

(d) *Effective date.* (1) Section 88 and this section apply to nuclear decommissioning costs directly or indirectly charged to the customers of a taxpayer on or after July 18, 1984, and with respect to taxable years ending on or after such date.

(2) If the amount of nuclear decommissioning costs directly or indirectly charged to the customers of a taxpayer before July 18, 1984, was includible in gross income in a different manner than amounts charged for electric energy, such amount must be included in gross income for the taxable year in which includible in gross income under the method of accounting of the taxpayer that was in effect when such amount was charged to customers.

[T.D. 8184, 53 FR 6804, Mar. 3, 1988]

ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME

§ 1.101–1 Exclusion from gross income of proceeds of life insurance contracts payable by reason of death.

(a)(1) *In general.* Section 101(a)(1) states the general rule that the proceeds of life insurance policies, if paid by reason of the death of the insured, are excluded from the gross income of the recipient. Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, are covered by this provision. For provisions relating to death benefits paid by or on behalf of employers, see section 101(b) and § 1.101–2. The exclusion from gross income allowed by section 101(a) applies whether payment is made to the estate of the insured or to any beneficiary (individual, corporation, or partnership) and whether it is made directly or in trust. The extent to which this exclusion applies in cases where life insurance policies have been transferred for a valuable consideration is stated in section 101(a)(2) and in paragraph (b) of this section. In cases where the proceeds of a life insurance policy, payable by reason of the death of the insured, are paid other than in a single sum at the time of such death, the amounts to be excluded from gross income may be affected by the provisions of section 101 (c) (relating to amounts held under agreements to pay interest) or section 101(d) (relating to amounts payable at a date later than death). See §§1.101–3 and 1.101–4. However, neither section 101(c) nor section 101(d) applies to a single sum payment which does not exceed the amount payable at the time of death even though such amount is actually paid at a date later than death.

(2) *Cross references.* For rules governing the taxability of insurance proceeds constituting benefits payable on the death of an employee—

(i) Under pension, profit-sharing, or stock bonus plans described in section 401(a) and exempt from tax under section 501(a), or under annuity plans described in section 403(a), see section 72 (m)(3) and paragraph (c) of §1.72–16;

(ii) Under annuity contracts to which paragraph (a) or (b) of §1.403(b)–1 applies, see paragraph (c)(3) of §1.403(b)–1; or

(iii) Under eligible State deferred compensation plans described in section 457(b), see paragraph (c) of §1.457–1.

For the definition of a life insurance company, see section 801.

(b) *Transfers of life insurance policies.* (1) In the case of a transfer, by assignment or otherwise, of a life insurance policy or any interest therein for a valuable consideration, the amount of the proceeds attributable to such policy or interest which is excludable from the transferee's gross income is generally limited to the sum of (i) the actual value of the consideration for such transfer, and (ii) the premiums and other amounts subsequently paid by the transferee (see section 101(a)(2) and example (1) of subparagraph (5) of this paragraph). However, this limitation on the amount excludable from the transferee's gross income does not apply (except in certain special cases involving a series of transfers), where the basis of the policy or interest transferred, for the purpose of determining gain or loss with respect to the transferee, is determinable, in whole or in part, by reference to the basis of such policy or interest in the hands of the transferor (see section 101(a)(2)(A) and examples (2) and (4) of subparagraph (5) of this paragraph). Neither does the limitation apply where the policy or interest therein is transferred to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer (see section 101(a)(2)(B)). For rules relating to gratuitous transfers, see subparagraph (2) of this paragraph. For special rules with respect to certain cases where a series of transfers is involved, see subparagraph (3) of this paragraph.

(2) In the case of a gratuitous transfer, by assignment or otherwise, of a life insurance policy or any interest therein, as a general rule the amount of the proceeds attributable to such policy or interest which is excludable from the transferee's gross income under section 101(a) is limited to the sum of (i) the amount which would have been excludable by the transferor (in accordance with this section) if no such transfer had taken place, and (ii) any premiums and other amounts subsequently paid by the transferee. See example (6) of subparagraph (5) of this paragraph. However, where the gratuitous transfer in question is made by or to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, the entire amount of the proceeds attributable to the policy or interest transferred shall be excludable from the transferee's gross income (see section 101(a)(2)(B) and example (7) of subparagraph (5) of this paragraph).

(3) In the case of a series of transfers, if the last transfer of a life insurance policy or an interest therein is for a valuable consideration—

(i) The general rule is that the final transferee shall exclude from gross income, with respect to the proceeds of such policy or interest therein, only the sum of—

(a) The actual value of the consideration paid by him, and

(b) The premiums and other amounts subsequently paid by him;

(ii) If the final transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer, the final transferee shall exclude the entire amount of the proceeds from gross income;

(iii) Except where subdivision (ii) of this subparagraph applies, if the basis of the policy or interest transferred, for the purpose of determining gain or loss with respect to the final transferee, is determinable, in whole or in part, by reference to the basis of such policy or interest therein in the hands of the transferor, the amount of the proceeds which is excludable by the final transferee is limited to the sum of—

(a) The amount which would have been excludable by his transferor if no such transfer had taken place, and

(b) Any premiums and other amounts subsequently paid by the final transferee himself.

(4) For the purposes of section 101(a)(2) and subparagraphs (1) and (3) of this paragraph, a ‘‘transfer for a valuable consideration’’ is any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance policy. Thus, the creation, for value, of an enforceable contractual right to receive all or a part of the proceeds of a policy may constitute a transfer for a valuable consideration of the policy or an interest therein. On the other hand, the pledging or assignment of a policy as collateral security is not a transfer for a valuable consideration of such policy or an interest therein, and section 101 is inapplicable to any amounts received by the pledgee or assignee.

(5) The application of this paragraph may be illustrated by the following examples:

Example (1). A pays premiums of $500 for an insurance policy in the face amount of $1,000 upon the life of B, and subsequently transfers the policy to C for $600. C receives the proceeds of $1,000 upon the death of B. The amount which C can exclude from his gross income is limited to $600 plus any premiums paid by C subsequent to the transfer.

Example (2). The X Corporation purchases for a single premium of $500 an insurance policy in the face amount of $1,000 upon the life of A, one of its employees, naming the X Corporation as beneficiary. The X Corporation transfers the policy to the Y Corporation in a tax-free reorganization (the policy having a basis for determining gain or loss in the hands of the Y Corporation determined by reference to its basis in the hands of the X Corporation). The Y Corporation receives the proceeds of $1,000 upon the death of A. The entire $1,000 is to be excluded from the gross income of the Y Corporation.

Example (3). The facts are the same as in example (2) except that, prior to the death of A, the Y Corporation transfers the policy to the Z Corporation for $600. The Z Corporation receives the proceeds of $1,000 upon the death of A. The amount which the Z Corporation can exclude from its gross income is limited to $600 plus any premiums paid by the Z Corporation subsequent to the transfer of the policy to it.

Example (4). The facts are the same as in example (3) except that, prior to the death of A, the Z Corporation transfers the policy to the M Corporation in a tax-free reorganization (the policy having a basis for determining gain or loss in the hands of the M Corporation determined by reference to its basis in the hands of the Z Corporation). The M Corporation receives the proceeds of $1,000 upon the death of A. The amount which the M Corporation can exclude from its gross income is limited to $600 plus any premiums paid by the Z Corporation and the M Corporation subsequent to the transfer of the policy to the Z Corporation.

Example (5). The facts are the same as in example (3) except that, prior to the death of A, the Z Corporation transfers the policy to the N Corporation, in which A is a shareholder. The N Corporation receives the proceeds of $1,000 upon the death of A. The entire $1,000 is to be excluded from the gross income of the N Corporation.

Example (6). A pays premiums of $500 for an insurance policy in the face amount of $1,000 upon his own life, and subsequently transfers the policy to his wife B for $600. B later transfers the policy without consideration to C, who is the son of A and B. C receives the proceeds of $1,000 upon the death of A. The amount which C can exclude from his gross income is limited to $600 plus any premiums paid by B and C subsequent to the transfer of the policy to B.

Example (7). The facts are the same as in example (6) except that, prior to the death of A, C transfers the policy without consideration to A, the insured. A’s estate receives the proceeds of $1,000 upon the death of A. The entire $1,000 is to be excluded from the gross income of A’s estate.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6783, 29 FR 18356, Dec. 24, 1964; T.D. 7836, 47 FR 42337, Sept. 27, 1982]

§1.101–2 Employees' death benefits.

(a) *In general.* (1) Section 101(b) states the general rule that amounts up to $5,000 which are paid to the beneficiaries or the estate of an employee, or former employee, by or on behalf of an employer and by reason of the death of the employee shall be excluded from the gross income of the recipient. This exclusion from gross income applies whether payment is made to the estate of the employee or to any beneficiary (individual, corporation, or partnership), whether it is made directly or in trust, and whether or not it is made pursuant to a contractual obligation of the employer. The exclusion applies whether payment is made in a single sum or otherwise, subject to the provisions of section 101 (c), relating to amounts held under an agreement to pay interest thereon (see §1.101–3). The exclusion from gross income also applies to any amount not actually paid which is otherwise taxable to a beneficiary of an employee because it was made available as a distribution from an employee's trust.

(2) The exclusion does not apply to amounts constituting income payable to the employee during his life as compensation for his services, such as bonuses or payments for unused leave or uncollected salary, nor to certain other amounts with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living (see section 101(b)(2)(B) and paragraph (d) of this section). Further, the exclusion does not apply to amounts received as an annuity under a joint and survivor annuity obligation where the employee was the primary annuitant and the annuity starting date occurred before the death of the employee (see section 101 (b)(2)(C) and paragraph (e)(1)(ii) of this section). In the case of amounts received by a beneficiary as an annuity (but not as a survivor under a joint and survivor annuity with respect to which the employee was the primary annuitant), the exclusion is applied indirectly by means of the provisions of section 72 and the regulations thereunder (see section 101(b)(2)(D) and paragraph (e)(1) (iii) and (iv) of this section). Thus, for example, the exclusion applies to amounts which are received by a survivor of an employee retired on disability under the provisions of the Civil Service retirement law (5 U.S.C. 8301 or any former corresponding provisions of law) or the Retired Serviceman's Family Protection Plan or Survivor Benefit Plan (10 U.S.C. 1431 et seq.), provided such employee dies before attaining mandatory retirement age (as defined in §1.105–4 (a)(3)(i)(B)).

(3) The total amount excludable with respect to any employee may not exceed $5,000, regardless of the number of employers or the number of beneficiaries. For allocation of the exclusion among beneficiaries, see paragraph (c) of this section. For rules governing the taxability of benefits payable on the death of an employee under pension, profitsharing, or stock bonus plans described in section 401(a) and exempt under section 501(a), under annuity plans described in section 403(a), or under annuity contracts to which paragraph (a) or (b) of §1.403(b)–1 applies, see sections 72(m)(3), 402(a), and 403 and the regulations thereunder.

(b) *Payments under certain employee benefit plans*—(1) *In general.* Where a payment is made by reason of the death of an employee by an employer-provided welfare fund or a trust, including a stock bonus, pension, or profitsharing trust described in section 401 (a), or by an insurance company (if such payment does not constitute ''life insurance'' within the purview of section 101(a), the payment shall be considered to have been made by or on behalf of the employer to the extent that it exceeds amounts contributed by, or deemed contributed by, the deceased employee.

(2) *Cross references.* For provisions governing the taxability of distributions payable on the death of an employee participant—

(i) Under a trust described in section 401(a) and exempt from tax under section 501(a), see paragraph (c) of §1.72–16 and paragraph (a)(5) of §1.402 (a)–1;

(ii) Under an annuity plan described in section 403(a), see paragraph (c) of §1.72–16 and paragraph (c) of §1.403 (a)–1;

(iii) Under annuity contracts to which paragraph (a) or (b) of §1.403 (b)–

1 applies, see paragraph (c) (2) and (3) of § 1.403(b)–1;

(iv) Under eligible State deferred compensation plans described in section 457 (b), see paragraph (c) of § 1.457–1.

(c) *Allocation of the exclusion.* (1) Where the aggregate payments by or on behalf of an employer or employers as death benefits to the beneficiaries or the estate of a deceased employee exceed $5,000, the $5,000 exclusion shall be apportioned among them in the same proportion as the amount received by or the present value of the amount payable to each bears to the total death benefits paid or payable by or on behalf of the employer or employers.

(2) The application of the rule in subparagraph (1) of this paragraph may be illustrated by the following example:

Example. The M Corporation, the employer of A, a deceased employee who died November 30, 1954, makes payments in 1955 to the beneficiaries of A as follows: $5,000 to W, A's widow, $2,000 to B, the son of A, and $3,000 to C, the daughter of A. No other amounts are paid by any other employer of A to his estate or beneficiaries. By application of the apportionment rule stated above, W, the widow, will exclude $2,500 ($5,000/$10,000, or one-half, of $5,000); B, the son, will exclude $1,000 ($2,000/$10,000, or one-fifth, of $5,000); and C, the daughter, will exclude $1,500 ($3,000/$10,000, or three-tenths, of $5,000).

(d) *Nonforfeitable rights.* (1) Except as provided in subparagraphs (3) and (4) of this paragraph, the exclusion provided by section 101(b) does not apply to amounts with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living. Section 101(b)(2)(B). For the purpose of section 101(b) and this paragraph, an employee shall be considered to have had a nonforfeitable right with respect to—

(i) Any amount to which he would have been entitled—

(a) If he had made an appropriate election or demand, or

(b) Upon termination of his employment (see examples (5) and (6) of subparagraph (2) of this paragraph); or

(ii) The present value (immediately before his death) of—

(a) Amounts payable as an annuity (as defined in paragraph (b) of § 1.72–2, whether immediate or deferred) by or on behalf of the employer (see example (1) of subparagraph (2) of this paragraph), or

(b) Amounts which would have been so payable if the employee had terminated his employment and continued to live;

or

(iii) Any amount to the extent it is paid in lieu of amounts described in either subdivision (i) or (ii) of this subparagraph. See examples (2), (3), and (4) of subparagraph (2) of this paragraph.

For purposes of subdivision (iii) of this subparagraph, any amount paid in discharge of an obligation which arose solely because of the existence of a particular fact or circumstance subsequent to the employee's death shall not be considered an amount paid in lieu of amounts described in subdivision (i) or (ii) of this subparagraph. Subdivision (iii) of this subparagraph shall apply, however, to the extent indicated therein, to amounts payable without regard to any such contingency (to the extent that such amounts are equal to or less than those described in subdivision (i) and (ii) of this subparagraph which are not paid). See paragraph (e)(1)(iii)*(b)* of this section for rules with respect to finding the present value of an annuity immediately before the employee's death.

(2) The application of paragraph (d)(1) of this section may be illustrated by the following examples, in which it is assumed that the plans are not "qualified plans" and that no employer is an organization referred to in section 170(b)(1)(A) (ii) or (vi) or a religious organization (other than a trust) which is exempt from tax under section 501(a):

Example (1). A, who was a participant under the X Company pension plan, retired on December 31, 1953. He had made no contributions to the plan. Upon his retirement, he became entitled to monthly payments of $100 payable for life, or 120 months certain. A died on October 31, 1954, having received 10 monthly payments of $100 each. After his death, the monthly payments became payable to his estate for the remaining 110 months certain. No exclusion from gross income is allowed to A's estate (or any beneficiary who receives the right to such payments from the estate), since the employee's right to the monthly payments was nonforfeitable at the date of his death. It will be noted that in this example it is unnecessary to consider the present value of the annuity to A just before his death since the payments to be made include only those certain to be made in any event under the plan whether or not A continued to live.

Example (2). C, a participant under the Y Company pension plan, died on December 15, 1954, while actively in the employment of the company, survived by a widow and minor children. Because of his years of service, he would have been entitled to an annuity for life, his own contributions to the plan and interest thereon being guaranteed, if he had retired or terminated his employment at a time immediately before his death. The plan further provides that—(a) if, but only if, an employee is survived by a widow and minor children, his widow is to receive an annuity for her life without regard to whether or not the employee had begun his annuity; (b) any payments made with respect to his widow's annuity are to reduce the guaranteed amount to an equal extent; and (c) if the employee is not so survived, the guaranteed amount is payable to his beneficiary or estate, but no amount is payable to anyone with respect to what would have been the widow's annuity. In view of these provisions, that portion of the present value of the annuity payable to C's widow which exceeds the guaranteed amount shall be considered paid neither as an amount, nor in lieu of an amount, which C had a nonforfeitable right to receive while living. The reason for this result is that the payment of such excess is contingent upon C's being survived by a widow and minor children, a circumstance existing subsequent to his death. Conversely, to the extent that the present value of the annuity payable to C's widow does not exceed the guaranteed amount, annuity payments attributable to such present value shall be considered paid in lieu of an amount which C had a nonforfeitable right to receive while living.

Example (3). D, a participant under the Y Company pension plan, died on January 1, 1955, while actively in the employment of the company. The Y Company plan provides that where an employee dies in service, the present value of the accumulated credits which he could have obtained at that time if he had instead separated from the service shall be paid in a single sum to his surviving spouse or to his estate if no widow survives him. The present value of D's accumulated credits, at the time of his death, was $10,000. However, the plan also provides that a surviving spouse may elect to take, in lieu of a single sum, an annuity the present value of which exceeds such sum by $2,500. D's widow elects to receive an annuity (the present value of which is $12,500). Therefore, $2,500 is an amount to which the exclusion of section 101(b) and this section shall apply.

Example (4). A, an employee of the X Company, continues to work after reaching the normal retirement age of 60 years, although he could have retired at that age and obtained an annuity of $3,000 per year for his life. A is not entitled to any part of the annuity while he is employed and receiving compensation. A dies at the age of 67 while still in active employment. Since he had passed normal retirement age, his additional years of service did not entitle him to a larger annuity at age 67 than that which he could have obtained at age 60. However, the plan of the X Company provides that in the event of an employee's death prior to separation from the service, his widow is to be paid an annuity for her life in the same amount per year as that which the employee could have obtained if he had instead retired; but if no widow survives him, the present value of the annuity which the employee could have obtained at a time just before his death is to be paid to a named beneficiary or the estate of the employee. Assuming that the present value of the annuity to A's widow, whose age is 61, is $36,000 and the present value of the annuity which would have been payable to A at age 67 if he had then retired is $23,500, the present value of the widow's annuity, to the extent of $23,500, is an amount which is payable in lieu of amounts which the employee had a nonforfeitable right to receive while living because it does not exceed the value of his nonforfeitable rights and is not otherwise paid. On the other hand, the $12,500 excess of the value of the widow's annuity ($36,000) over the value of the employee's annuity ($23,500) is an amount to which section 101(b) applies since the employee had no right to any part of it. If no other death benefits are payable, a $5,000 exclusion is available (see section 101(b)(2)(D) and paragraph (e) of this section).

Example (5). The trustee of the X Corporation noncontributory profit-sharing plan is required under the provisions of the plan to pay to the beneficiary of B, an employee of the X Corporation who died on July 1, 1955, the benefit due on account of the death of B. The provisions of the profit-sharing plan give each participating employee in case of termination of employment a 10-percent vested interest in the amount accumulated in his account for each year of participation in the plan. In case of death, the entire credit in the participant's account is to be paid to his beneficiary. At the time of B's death, he had been a participant for three years and the accumulation in his account was $8,000. After his death this amount is paid to his beneficiary. At the time of B's death, the amount distributable to him on account of termination of employment would have been $2,400 (30 percent of $8,000). The difference of $5,600 ($8,000 minus $2,400), payable to the beneficiary of B, is an amount payable solely by reason of B's death. Accordingly, $5,000 of the $5,600 may be excluded from the gross income of the beneficiary receiving such payment (assuming no other death benefits are involved). However, if it is assumed that the facts are the same as above, except that at the time of his death B has been a participant for 6 years, the amount distributable to him on account of termination of employment would have been $4,800 (60 percent of $8,000). The difference of $3,200 ($8,000 minus $4,800), payable to B's beneficiary, is an amount payable solely by reason of B's death. Accordingly, only $3,200 may be excluded from the gross income of the beneficiary receiving such payment (assuming no other death benefits are involved).

Example (6). The X Corporation instituted a trust, forming part of a pension plan, for its employees, the cost thereof being borne entirely by the corporation. The plan provides, in part, that after 10 or more years of service and attaining the age of 55, an employee can elect to retire and receive benefits before the normal retirement date contingent upon the employer's approval. If he retires without the employer's consent, or voluntarily leaves the company, no benefits are or will be payable. The plan further provides that if the employee is involuntarily separated or dies before retirement, he or his beneficiary, respectively, will receive a percentage of the reserve provided for the employee in the trust fund on the following basis: 10 to 15 years of service, 25 percent; 15 to 20 years of service, 50 percent; 20 to 25 years of service, 75 percent; 25 or more years of service, 100 percent. A, an employee of the X Corporation for 17 years, died at the age of 56 while in the employ of the corporation. At the time of his death, $15,000 was the reserve provided for him in the trust. His beneficiary receives $7,500, an amount equal to 50 percent of the reserve provided for A's retirement; accordingly, $5,000 of the $7,500 may be excluded from the gross income of the beneficiary receiving such payment (assuming no other death benefits are involved) since A, prior to his death, had only a forfeitable right to receive $7,500.

(3)(i) Notwithstanding the rule stated in subparagraph (1) of this paragraph and illustrated in subparagraph (2) of this paragraph, the exclusion from gross income provided by section 101(b) applies to the receipt of certain amounts, paid under ''qualified'' plans, with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living (see section 101(b)(2)(B) (i) and (ii)). The payments to which this exclusion applies are—

(a) ''Total distributions payable'' by a stock bonus, pension, or profit-sharing trust described in section 401(a) which is exempt from tax under section 501(a), and

(b) ''Total amounts'' paid under an annuity contract under a plan described in section 403(a), provided such distributions or amounts are paid in full within one taxable year of the distributee (see example (3) of subdivision (ii) of this subparagraph). For the purposes of applying section 101(b), ''Total distributions payable'' means the balance to the credit of an employee which becomes payable to a distributee on account of the employee's death, either before or after separation from the service (see section 402(a)(3)(C), the regulations thereunder, and examples (2) and (4) of subdivision (ii) of this subparagraph); and ''total amounts'' means the balance to the credit of an employee which becomes payable to the payee by reason of the employee's death, either before or after separation from the service (see section 403(a)(2)(B), the regulations thereunder, and example (1) of subdivision (ii) of this subparagraph). See subparagraph (4) of this paragraph relating to the exclusion of amounts which are received under annuity contracts purchased by certain exempt organizations and with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living.

(ii) The application of the provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). The widow of an employee elects, under a noncontributory ''qualified'' plan, to receive in a lump sum the present value of the annuity which C, the deceased employee, could have obtained at a time just before his death if he had retired at that time. Such present value is $6,000. Of this amount, $5,000 is excludable from the widow's gross income despite the fact that C had a nonforfeitable right to the amount in lieu of which the payment is made, since such payment is an amount to which subdivision (i) of this subparagraph applies (assuming no other death benefits are involved).

Example (2). The trustee of the X Corporation noncontributory, ''qualified'', profit-sharing plan is required under the provisions of the plan to pay to the beneficiary of B, an employee of the X Corporation who died on

July 1, 1955, the benefit due on account of the death of B. The provisions of the profit-sharing plan give each participating employee, in case of termination of employment, a 10 percent vested interest in the amount accumulated in his account for each year of participation in the plan, but, in case of death, the entire credit to the participant's account is to be paid to his beneficiary. At the time of B's death, he had been a participant for five years. The accumulation in his account was $8,000, and the amount which would have been distributable to him in the event of termination of employment was $4,000 (50 percent of $8,000). After his death, $8,000 is paid to his beneficiary in a lump sum. (It may be noted that these are the same facts as in example (5) of subparagraph (2) of this paragraph except that the employee has been a participant for five years instead of three and the plan is a ‘‘qualified'' plan.) It is immaterial that the employee had a nonforfeitable right to $4,000, because the payment of the $8,000 to the beneficiary is the payment of the ‘‘total distributions payable'' within one taxable year of the distributee to which subdivision (i) of this subparagraph applies. Assuming no other death benefits are involved, the beneficiary may exclude $5,000 of the $8,000 payment from gross income.

Example (3). The facts are the same as in example (2) except that the beneficiary is entitled to receive only the $4,000 to which the employee had a nonforfeitable right and elects, 30 days after B's death, to receive it over a period of ten years. Since the ‘‘total distributions payable'' are not paid within one taxable year of the distributee, no exclusion from gross income is allowable with respect to the $4,000.

Example (4). The X Corporation instituted a trust, forming part of a ‘‘qualified'' profit-sharing plan for its employees, the cost thereof being borne entirely by the corporation. The plan provides, in part, that if, after 10 or more years of service, an employee leaves the employ of the corporation, either voluntarily or involuntarily, before retirement, a percentage of the reserve provided for the employee in the trust fund will be paid to the employee as follows: 10 to 15 years of service, 25 percent; 15 to 20 years of service, 50 percent; 20 to 25 years of service, 75 percent; 25 or more years of service, 100 percent. The plan further provides that if an employee dies before reaching retirement age, his beneficiary will receive a percentage of the reserve provided for the employee in the trust fund, on the same basis as shown in the preceding sentence. A, an employee of the X Corporation for 17 years, died before attaining retirement age while in the employ of the corporation. At the time of his death, $15,000 was the reserve provided for him in the trust fund. His beneficiary receives $7,500 in a lump sum, an amount equal to 50 percent of the reserve provided for A's retirement. The beneficiary may exclude from gross income (assuming no other death benefits are involved) $5,000 of the $7,500, since the latter amount constitutes ‘‘total distributions payable'' paid within one taxable year of the distributee, to which subdivision (i) of this subparagraph applies.

(4)(i) Notwithstanding the rule stated in subparagraph (1) of this paragraph and illustrated in subparagraph (2) of this paragraph, the exclusion from gross income under section 101(b) also applies (but only to the extent provided in the next sentence) to amounts with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living—

(a) If such amounts are paid under an annuity contract purchased by an employer which is an organization referred to in section 170(b)(1)(A) (ii) or (vi) or which is a religious organization (other than a trust) and which is exempt from tax under section 501(a).

(b) If such amounts are paid as part of a ‘‘total payment'' with respect to the deceased employee; and

(c) If such ‘‘total payment'' is paid in full within one taxable year of the payee beginning after December 31, 1957.

However, the amount that is excludable under section 101(b) by reason of this subparagraph shall not exceed an amount which bears the same ratio to the amount which would be includible in the payee's gross income if it were not for the second sentence of section 101(b)(2)(B) and this subparagraph, as the amount contributed by the employer for the annuity contract that was excludable from the deceased employee's gross income under paragraph (b) of §1.403(b)–1 bears to the total amount contributed by the employer for the annuity contract. See section 101(b)(2)(B)(iii). For purposes of this subparagraph, a ‘‘total payment'' means a payment of the balance to the credit of an employee with respect to all ‘‘section 403(b) annuities'' purchased by the employer which becomes payable to the payee by reason of the employee's death, either before or after separation from the service. An annuity contract will be regarded as a ‘‘section 403(b) annuity'' if any amount contributed (or considered as contributed under paragraph (b)(2) of § 1.403(b)–1) by the employer for such contract was excludable from the employee's gross income under paragraph (b) of § 1.403(b)–1. Under this definition, therefore, an annuity contract may be regarded as a ''section 403(b) annuity'' even though some of the employer's contributions for the contract were not excludable from the employee's gross income under paragraph (b) of § 1.403(b)–1 because, for example, the employer was not an exempt organization when such contributions were paid. For purposes of computing the ratio described in this subdivision in such a case, the total amount contributed by the employer for the contract includes the amounts contributed by the employer when it was not an exempt organization.

(ii) This subparagraph does not relate to any amounts with respect to which the deceased employee did not possess, immediately before his death, a nonforfeitable right to receive the amounts while living. Such amounts are excludable under the provisions of section 101(b) without regard to section 101(b)(2)(B) and this subparagraph. Thus, if a ''total payment'' received by a beneficiary of a deceased employee under an annuity contract purchased by an organization described in subdivision (i)*(a)* of this subparagraph consists both of amounts with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living and of amounts with respect to which the deceased employee did not possess such a nonforfeitable right, only those amounts with respect to which the deceased employee possessed such a nonforfeitable right are amounts to which this subparagraph applies. Therefore, for purposes of computing the ratio described in subdivision (i) of this subparagraph in such a case, there shall be taken into account only the employer contributions attributable to those amounts with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living. See example (3) of subdivision (v) of this subparagraph. In no event, however, may the total amount excludable under section 101(b) with respect to any employee exceed $5,000 (See paragraph (a)(3) of this section).

(iii)*(a)* In any case when the deceased employee's interest in the employer's contributions for an annuity contract was forfeitable at the time the contributions were made but, at a subsequent date prior to his death, such interest changed to a nonforfeitable interest, then, for purposes of computing the ratio described in subdivision (i) of this subparagraph, the cash surrender value of the contract on the date of the change (except to the extent attributable to employee contributions) shall be considered as the amount contributed by the employer for the contract. In such a case, if only part of the deceased employee's interest in the annuity changed from a forfeitable to a nonforfeitable interest, then only the corresponding part of the cash surrender value of the contract on the date of the change shall be considered as the amount contributed by the employer for the contract. Similarly, if part of the deceased employee's interest in the annuity contract changed from a forfeitable to a nonforfeitable interest on a particular date and another part of his interest so changed on a subsequent date, it is necessary, in order to compute the amount contributed by the employer for the contract, to first determine (under the rules in the preceding sentence) the amount that is considered as the amount contributed by the employer with respect to each change, and then to add these amounts together. For purposes of computing the ratio described in subdivision (i) of this subparagraph in all of the above cases, the amount contributed by the employer that was excludable from the employee's gross income under paragraph (b) of § 1.403(b)–1 is that amount which, under paragraph (b)(2) of such section, was considered as employer contributions and which, under such paragraph (b) of § 1.403(b)–1, was excludable from the deceased employee's gross income for the taxable year in which the change occurred.

(b) This subdivision (iii) may be illustrated by the following examples:

Example (1). X Organization contributed $4,000 toward the purchase of an annuity contract for A, an employee who died in 1970. At the time they were made, A's interest in such contributions was forfeitable. A made no contributions toward the purchase of the annuity contract. On January 1, 1960, A's entire interest in the annuity contract changed to a nonforfeitable interest. At the time of such change, the cash surrender value of the contract was $5,000. For purposes of the ratio described in subdivision (i) of this subparagraph, the total amount contributed by X Organization for the annuity contract is $5,000. If any part of such $5,000 was excludable under paragraph (b) of §1.403(b)–1 from A's gross income for his taxable year in which the change occurred, the amount so excludable shall be considered as the amount contributed for the contract by the employer that was excludable from the employee's gross income under paragraph (b) of §1.403(b)–1.

Example (2). Assume the same facts as in example (1) except that only one-half of A's interest in the annuity contract changed to a nonforfeitable interest on January 1, 1960, and that no other part of his interest so changed during his lifetime. For purposes of the ratio described in subdivision (i) of this subparagraph, the total amount contributed by X Organization for the annuity contract is $2,500 (½ of the cash surrender value of the annuity contract on the date of the change). To the extent such $2,500 was, under paragraph (b) of §1.403(b)–1, excludable from A's gross income for the taxable year of the change, it is considered as the amount contributed by the employer that was excludable under paragraph (b) of §1.403(b)–1.

Example (3). Assume the same facts as in example (1) except that one-half of A's interest in the annuity contract changed to a nonforfeitable interest on January 1, 1960, and the other half of his interest changed to a nonforfeitable interest on January 1, 1965. On January 1, 1965, the cash surrender value of the annuity contract was $6,000. For purposes of the ratio described in subdivision (i) of this subparagraph, the total amount contributed by X organization for the annuity contract is $5,500 (*i.e.*, ½×$5,000 plus ½×$6,000). The amount contributed by the employer that was excludable from A's gross income under paragraph (b) of §1.403(b)–1 is an amount equal to the sum of the amount that was, under such paragraph, excludable from A's gross income for the taxable year during which the first change occurred and the amount that was, under such paragraph, excludable from A's gross income for the taxable year in which the second change occurred.

(iv) For purposes of this subparagraph, an annuity contract will be considered to have been purchased by an employer which is an organization referred to in section 170(b)(1)(A) (ii) or (vi) or which is a religious organization (other than a trust) and which is exempt from tax under section 501(a), if any of the contributions paid toward the purchase price of such contract by the employer were paid at a time when the employer was such an organization. Thus an annuity contract may be regarded as purchased by such an organization even though part of the organization's contributions for such annuity contract were paid at a time when the organization was not such an exempt organization.

(v) The application of this subparagraph may be illustrated by the following examples:

Example (1). The widow of A, a deceased employee, elects, under an annuity contract purchased for A by X Organization, to receive in a lump sum the present value of such annuity contract as of the date of A's death. Such present value is $6,000 and is received by the widow in a taxable year beginning after December 31, 1957. X Organization contributed $3,000 toward the purchase of the annuity contract and A contributed $2,000 toward such purchase. A's interest in X Organization's contributions was nonforfeitable at the time such contributions were made. Thus, just before his death, A's entire interest in the annuity contract was a nonforfeitable interest and, if he had retired at that time, he could have received the present value of $6,000. The whole amount of the $3,000 contributed by X Organization for the annuity contract was excludable from A's gross income under paragraph (b) of §1.403(b)–1. This annuity contract was the only annuity contract purchased by X Organization for A and was not purchased as part of a qualified plan. However, all the contributions paid by X Organization were paid at a time when X Organization was an organization referred to in section 170(b)(1)(A)(ii) and exempt from tax under section 501(a). The amount that A's widow may exclude from gross income (assuming no other death benefits) is computed in the following manner:

(a) Amount includible in gross income without regard to second sentence of section 101(b)(2)(B) ($6,000 minus $2,000 contributed for contract by A)	$4,000
(b) Total employer contributions for the contract	$3,000
(c) Amount of employer contributions for the contract that was excludable under paragraph (b) of §1.403(b)–1	$3,000
(d) Percent of total employer contributions for the contract that were excludable under paragraph (b) of §1.403(b)–1 *((c) ÷ (b))*	100%
(e) Amount to which section 101(b) exclusion applies *((d) × (a))*	$4,000

Example (2). The facts are the same as in example (1) except that only $2,000 of X Organization's contributions for the annuity contract was excludable from A's gross income under paragraph (b) of § 1.403(b)–1 and that the remaining $1,000 was includible in A's gross income for the taxable years during which such amounts were contributed by X Organization. The amount that A's widow may exclude from gross income (assuming no other death benefits) is computed in the following manner:

(a) Amount includible in gross income without regard to second sentence of section 101(b)(2)(B) ($6,000 minus $2,000 contributed for contract by A and $1,000 of X Organization's contributions includible in A's gross income)	$3,000
(b) Total employer contributions for the contract	$3,000
(c) Amount of employer contributions for the contract that was excludable under paragraph (b) of § 1.403(b)–1	$2,000
(d) Percent of total employer contributions for the contract that were excludable under paragraph (b) of § 1.403(b)–1 *((c) ÷ (b))*	67%
(e) Amount to which section 101(b) exclusion applies *((d) × (a))*	$2,000

Example (3). The widow of B, a deceased employee, elects, under an annuity contract purchased for B by Y Organization, to receive in a lump sum the present value of such annuity contract as of the date of B's death. Such present value is $6,000 and is received by the widow in a taxable year beginning after December 31, 1957. Y Organization contributed $4,000 toward the purchase of the contract; whereas B made no contributions toward the purchase of the contract. This annuity contract was the only annuity contract purchased by Y Organization for B and was not purchased as part of a "qualified" plan. However, all the contributions paid by Y Organization were paid at a time when it was an organization referred to in section 170(b)(1)(A)(ii) and exempt from tax under section 501(a). B's interest in Y Organization's contributions was, at the time they were paid, forfeitable. However, prior to his death, one-half of B's interest in the annuity contract changed from a forfeitable to a nonforfeitable interest. Therefore, just before his death, B could have obtained $3,000 under the annuity contract if he had retired at that time. On the date of the change, the cash surrender value of the annuity contract was $5,000. As a result of the change, $1,500 was, under paragraph (b) of § 1.403(b)–1, excludable from B's gross income, and $600 was includible in his gross income for the taxable year in which the change occurred. Part of the value of the annuity contract on the date of the change was attributable to contributions made by Y Organization prior to January 1, 1958, and, consequently, was neither excludable from B's gross income under paragraph (b) of § 1.403(b)–1 nor includible in B's gross income (see paragraph (b) of § 1.403(d)–1). The amount that B's widow may exclude from gross income (assuming no other death benefits) is computed in the following manner:

(a) Amount of "total payment" with respect to which A had a forfeitable right at time of death. (½×$6,000)	$3,000
(b) Amount includible in gross income without regard to second sentence of section 101(b)(2)(B) (½×$6,000 less $600 includible in B's gross income for year when his rights changed to nonforfeitable rights)	$2,400
(c) Total employer contributions for the contract (½ of cash surrender value of contract on date B's rights changed to nonforfeitable rights)	$2,500
(d) Amount of employer contributions for the contract that was excludable under paragraph (b) of § 1.403(b)–1	$1,500
(e) Percent of total employer contributions for the contract that were excludable under paragraph (b) of § 1.403(b)–1 *((d÷(c))*	60%
(f) Amount to which section 101(b) exclusion applies by reason of the second sentence of section 101(b)(2)(B) *((e)×(b))*	$1,440
(g) Total amount to which section 101(b) exclusion applies *((a)+(f))*	$4,440

(e) *Annuity payments.* (1) Where death benefits are paid in the form of annuity payments, the following rules shall govern for purposes of the exclusion provided in section 101(b):

(i) The exclusion from gross income provided by section 101(b) does not apply to amounts, paid as an annuity, with respect to which the employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living, or to amounts paid as an annuity in lieu thereof. See paragraph (d) of this section.

(ii) Under section 101(b)(2)(C), no exclusion is allowable for amounts received by a surviving annuitant under a joint and survivor's annuity contract if the annuity starting date (as defined in section 72(c)(4) and paragraph (b) of § 1.72–4) occurs before the death of the employee. If the annuity starting date occurs after the death of the employee, the joint and survivor's annuity contract shall be treated as an annuity to which section 101(b)(2)(D) applies. See subdivision (iii) of this subparagraph.

(iii)*(a)* Subject to the other limitations stated in section 101(b) and in this section (see section 101(b)(2)(D)), the amount to which the exclusion of section 101(b) shall apply, with respect to "amounts received as an annuity" (as defined in paragraph (b) of § 1.72–2) shall be the amount by which the present value of the annuity to be paid to the beneficiary, computed as of the date of the employee's death, exceeds the value (if any) of whichever of the following is the larger:

(1) Amounts contributed by the employee (determined in accordance with the provisions of section 72 and the regulations thereunder), or

(2) Amounts with respect to which the employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living, or amounts paid in lieu thereof (see paragraph (d) of this section).

(b) The present value of an annuity (immediately before the death of the employee), to the employee, or (immediately after the death of the employee), to his estate or beneficiary, shall be determined as follows:

(*1*) In the case of an annuity paid by an insurance company or by an organization (other than an insurance company) regularly engaged in issuing annuity contracts with an insurance company as the coinsurer or reinsurer of the obligations under the contract, by use of the discount interest rates and mortality tables used by the insurance company involved to determine the installment benefits; and

(*2*) In the case of an annuity issued after November 23, 1984, to which paragraph (e)(1)(iii)(*b*)(*1*) of this section is not applicable, by use of the appropriate tables in §20.2031–7 of this chapter (Estate Tax Regulations).

(iv) Any amount subject to section 101(b)(2)(D) which is excludable under section 101(b) (see subdivision (iii) of this subparagraph) shall, for purposes of section 72, be treated as additional consideration paid by the employee. See paragraph (b) of §1.72–8.

(v) Where more than one beneficiary, or more than one death benefit, is involved, the exclusion provided by section 101(b) shall be apportioned to the various beneficiaries and benefits in accordance with the proportion that the present value of each benefit bears to the total present value of all the benefits.

(2) The application of the principles of this paragraph may be illustrated by the following examples:

Example (1). (i) A died on January 1, 1969. Under the plan of the X Corporation, W, who is the widow of employee A, and who is 55 years old at the time of A's death, is entitled to an immediate annuity of $2,000 per year during her life and C, the minor child of A, is entitled to receive $1,000 per year for 15 years. A made no contributions under the plan and died while still employed by the X Corporation. At the time of A's death, the amount in his account is $18,000. Under the terms of the plan, this amount would have been distributable to him on account of voluntary termination of employment, but would not have been payable after his death except in the form of the annuities just described. This amount, accordingly, constitutes a nonforfeitable interest in lieu of which the annuities are paid. The exclusion does not apply, except to the extent that the present value of the annuities exceeds $18,000, whether or not the plan is ‘‘qualified’’, since the total of the amount in A's account will not be paid within one taxable year of the distributees. See subparagraph (1)(i) of this paragraph.

(ii) The computation of the exclusion applicable to the interests of W and C (assuming that the payments will not be made by an insurance company or some other organization regularly engaged in issuing annuity contracts) is, by application of the tables in §20.2031–7 of this chapter (Estate Tax Regulations), as follows: The present value of W's interest is $26,243.60, determined by multiplying the annual payment of $2,000 by 13.1218 (the factor in Table I for a person aged 55); the present value of C's interest is $11,517.40, determined by multiplying the yearly payment of $1,000 by 11.5174 (the factor in Table II for payments for a term certain of 15 years). The present value of both annuities is $37,761 and (assuming no other death benefits are involved), the total amount excludable is $5,000, because the total present value of the annuities exceeds the employee's nonforfeitable interest by more than $5,000 ($37,761 minus $18,000 equal $19,761). The exclusion allocable to W's interest is $26,243.60/$37,761 times $5,000, or $3,474.96; the exclusion allocable to C's interest is $11,517.40/$37,761 times $5,000, or $1,525.04. That portion of the death benefit exclusion as so determined for each beneficiary is to be treated as consideration paid by the employee for purposes of section 72.

Example (2). The facts are the same as in example (1), except that the nonforfeitable interest of A, at the time of his death, amounted to $33,761. Since the present value of both annuities ($37,761) exceeds the value of such nonforfeitable interest by only $4,000, the latter amount is the total amount excludable from the gross income of the beneficiaries. This $4,000 exclusion is to be divided in the same proportions as those indicated in example (1). Thus, the exclusion allocable to W's interest is $26,243.60/$37,761 times $4,000, or $2,779.97; and the exclusion allocable to the interest of C is $11,517.40/$37,761 times $4,000, or $1,220.03. That portion of the death benefit exclusion as so determined for each beneficiary is to be treated as consideration paid by the employee for purposes of section 72.

(f) *Distributions on behalf of a self-employed individual.* (1) Under sections 401(c)(1) and 403(a)(3), certain self-employed individuals may be covered by a pension or profit-sharing plan described in section 401(a) and exempt under section 501(a) or under an annuity plan described in section 403(a). However, a payment pursuant to the provisions of any such plan by reason of the death of an individual who participated in such a plan as a self-employed individual immediately before his retirement or death to the beneficiary or estate of such individual does not qualify for the exclusion provided by section 101(b).

(2) The application of this paragraph may be illustrated by the following examples:

Example (1). From 1950 to 1965, A was an employee of B, a sole proprietor. In 1963, B established a qualified pension plan covering A and all other persons who had been employed by B for more than 3 years. In 1965, A acquired from B a 40-percent interest in the capital and profits of the business. A continued to participate in the pension plan as a self-employed individual. In 1970, A died and his widow, in compliance with one of the provisions of the pension plan, elected to receive all of the benefits accrued to A prior to his death in a lump-sum distribution. As A participated in the plan as a self-employed individual immediately prior to his death, A's widow may not exclude any portion of such distribution from her gross income under section 101(b).

Example (2). A, an attorney, is employed by the X Company in their legal department. He is covered by the pension plan that X has established for its employees. Under the terms of A's contract of employment with X, A is permitted to carry on the private practice of law in his off-duty hours. A establishes his own pension plan with respect to his earnings from his private practice. On A's death, his widow elected to receive a lump-sum distribution with respect to any benefits accrued to A under both X's pension plan and A's own pension plan. To the extent that such payment otherwise complies with the requirements of section 101(b), up to $5,000 of the amount paid by X may be excluded from her gross income. No part of the distribution from A's own pension plan may be excluded from her gross income under section 101(b) because A participated in the plan as a self-employed individual immediately before his death.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6722, 29 FR 5070, Apr. 14, 1964; T.D. 6783, 29 FR 18357, Dec. 24, 1964; T.D. 7352, 40 FR 16666, Apr. 14, 1975; T.D. 7428, 41 FR 34619, Aug. 16, 1976; T.D. 7836, 47 FR 42337, Sept. 27, 1982; T.D. 7955, 49 FR 19975, May 11, 1984; T.D. 8540, 59 FR 30102, 30103, June 10, 1994]

§ 1.101–3 Interest payments.

(a) *Applicability of section 101(c).* Section 101(c) provides that if any amount excluded from gross income by section 101(a) (relating to life insurance proceeds) or section 101(b) (relating to employees' death benefits) is held under an agreement to pay interest thereon, the interest payments shall be included in gross income. This provision applies to payments made (either by an insurer or by or on behalf of an employer) of interest earned on any amount so excluded from gross income which is held without substantial diminution of the principal amount during the period when such interest payments are being made or credited to the beneficiaries or estate of the insured or the employee. For example, if a monthly payment is $100, of which $99 represents interests and $1 represents diminution of the principal amount, the principal amount shall be considered held under an agreement to pay interest thereon and the interest payment shall be included in the gross income of the recipient. Section 101(c) applies whether the election to have an amount held under an agreement to pay interest thereon is made by the insured or employee or by his beneficiaries or estate, and whether or not an interest rate is explicitly stated in the agreement. Section 101(d), relating to the payment of life insurance proceeds at a date later than death, shall not apply to any amount to which section 101(c) applies. See section 101(d)(4). However, both section 101(c) and section 101(d) may apply to payments received under a single life insurance contract. For provisions relating to the application of this rule to payments received under a permanent life insurance policy with a family income rider attached, see paragraph (h) of § 1.101–4.

(b) *Determination of ''present value''.* For the purpose of determining whether section 101(c) or section 101(d) applies, the present value (at the time of the insured's death) of any amount which is to be paid at a date later than death shall be determined by the use of the interest rate and mortality tables used by the insurer in determining the size of the payments to be made.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6577, 26 FR 10127, Oct. 28, 1961]

§1.101–4 Payment of life insurance proceeds at a date later than death.

(a) *In general.* (1)(i) Section 101(d) states the provisions governing the exclusion from gross income of amounts (other than those to which section 101(c) applies) received under a life insurance contract and paid by reason of the death of the insured which are paid to a beneficiary on a date or dates later than the death of the insured. However, if the amounts payable as proceeds of life insurance to which section 101(a)(1) applies cannot in any event exceed the amount payable at the time of the insured's death, such amounts are fully excludable from the gross income of the recipient (or recipients) without regard to the actual time of payment and no further determination need be made under this section. Section 101(d)(1)(A) provides an exclusion from gross income of any amount determined by a proration, under applicable regulations, of ''an amount held by an insurer with respect to any beneficiary''. The quoted phrase is defined in section 101(d)(2). For the regulations governing the method of computation of this proration, see paragraphs (c) through (f) of this section. The prorated amounts are to be excluded from the gross income of the beneficiary regardless of the taxable year in which they are actually received (see example (2) of subparagraph (2) of this paragraph).

(ii) Section 101(d)(1)(B) provides an additional exclusion where life insurance proceeds are paid to the surviving spouse of an insured. For purposes of this exclusion, the term ''surviving spouse'' means the spouse of the insured as of the date of death, including a spouse legally separated, but not under a decree of absolute divorce (section 101(d)(3)). To the extent that the total payments, under one or more agreements, made in excess of the amounts determined by proration under section 101(d)(1)(A) do not exceed $1,000 in the taxable year of receipt, they shall be excluded from the gross income of the surviving spouse (whether or not payment of any part of such amounts is guaranteed by the insurer). Amounts excludable under section 101(d)(1)(B) are not ''prorated'' amounts.

(2) The principles of this paragraph may be illustrated by the following examples:

Example (1). A surviving spouse elects to receive all of the life insurance proceeds with respect to one insured, amounting to $150,000, in ten annual installments of $16,500 each, based on a certain guaranteed interest rate. The prorated amount is $15,000 ($150,000÷10). As the second payment, the insurer pays $17,850, which exceeds the guaranteed payment by $1,350 as the result of earnings of the insurer in excess of those required to pay the guaranteed installments. The surviving spouse shall include $1,850 in gross income and exclude $16,000—determined in the following manner:

Fixed payment (including guaranteed interest)	$16,500
Excess interest	1,350
Total payment	17,850
Prorated amount	15,000
Excess over prorated amount	2,850
Annual excess over prorated amount excludable under section 101(d)(1)(B)	1,000
Amount includible in gross income	1,850

Example (2). Assume the same facts as in example (1), except that the third and fourth annual installments, totalling $33,000 (2×$16,500), are received in a single subsequent taxable year of the surviving spouse. The prorated amount of $15,000 of each annual installment, totalling $30,000, shall be excluded even though the spouse receives more than one annual installment in the single subsequent taxable year. However, the surviving spouse is entitled to only one exclusion of $1,000 under section 101(d)(1)(B) for each taxable year of receipt. The surviving spouse shall include $2,000 in her gross income for the taxable year with respect to the above installment payments ($33,000 less the sum of $30,000 plus $1,000).

Example (3). Assume the same facts as in example (1), except that the surviving spouse dies before receiving all ten annual installments and the remaining installments are paid to her estate or beneficiary. In such a case, $15,000 of each installment would continue to be excludable from the gross income of the recipient, but any amounts received in excess thereof would be fully includible.

(b) *Amount held by an insurer.* (1) For the purpose of the proration referred to in section 101(d)(1), an ''amount held by an insurer with respect to any beneficiary'' means an amount equal to the present value to such beneficiary (as of the date of death of the insured) of an agreement by the insurer under a life insurance policy (whether as an option or otherwise) to pay such beneficiary an amount or amounts at a date or dates later than the death of the insured (section 101(d)(2)). The present value of such agreement is to be computed as if the agreement under the life insurance policy had been entered into on the date of death of the insured, except that such value shall be determined by the use of the mortality table and interest rate used by the insurer in calculating payments to be made to the beneficiary under such agreement. Where an insurance policy provides an option for the payment of a specific amount upon the death of the insured in full discharge of the contract, such lump sum is the amount held by the insurer with respect to all beneficiaries (or their beneficiaries) under the contract. See, however, paragraph (e) of this section.

(2) In the case of two or more beneficiaries, the ''amount held by the insurer'' with respect to each beneficiary depends on the relationship of the different benefits payable to such beneficiaries. Where the amounts payable to two or more beneficiaries are independent of each other, the ''amount held by the insurer with respect to each beneficiary'' shall be determined and prorated over the periods involved independently. Thus, if a certain amount per month is to be paid to A for his life, and, concurrently, another amount per month is to be paid to B for his life, the ''amount held by the insurer'' shall be determined and prorated for both A and B independently, but the aggregate shall not exceed the total present value of such payments to both. On the other hand, if the obligation to pay B was contingent on his surviving A, the ''amount held by the insurer'' shall be considered an amount held with respect to both beneficiaries simultaneously. Furthermore, it is immaterial whether B is a named beneficiary or merely the ultimate recipient of payments for a term of years. For the special rules governing the computation of the proration of the ''amount held by an insurer'' in determining amounts excludable under the provisions of section 101(d), see paragraphs (c) to (f), inclusive, of this section.

(3) Notwithstanding any other provision of this section, if the policy was transferred for a valuable consideration, the total ''amount held by an insurer'' cannot exceed the sum of the consideration paid plus any premiums or other consideration paid subsequent to the transfer if the provisions of section 101(a)(2) and paragraph (b) of § 1.101–1 limit the excludability of the proceeds to such total.

(c) *Treatment of payments for life to a sole beneficiary.* If the contract provides for the payment of a specified lump sum, but, pursuant to an agreement between the beneficiary and the insurer, payments are to be made during the life of the beneficiary in lieu of such lump sum, the lump sum shall be divided by the life expectancy of the beneficiary determined in accordance with the mortality table used by the insurer in determining the benefits to be paid. However, if payments are to be made to the estate or beneficiary of the primary beneficiary in the event that the primary beneficiary dies before receiving a certain number of payments or a specified total amount, such lump sum shall be reduced by the present value (at the time of the insured's death) of amounts which may be paid by reason of the guarantee, in accordance with the provisions of paragraph (e) of this section, before making this calculation. To the extent that payments received in each taxable year do not exceed the amount found from the above calculation, they are ''prorated amounts'' of the ''amount held by an insurer'' and are excludable from the gross income of the beneficiary without regard to whether he lives beyond the life expectancy used in making the calculation. If the contract in question does not provide for the payment of a specific lump sum upon the death of the insured as one of the alternative methods of payment, the present value (at the time of the death of the insured) of the payments to be made the beneficiary, determined in accordance with the interest rate and mortality table used by the insurer in determining the benefits to be paid, shall be used in the above calculation in lieu of a lump sum.

(d) *Treatment of payments to two or more beneficiaries*—(1) *Unrelated payments.* If payments are to be made to two or more beneficiaries, but the payments to be made to each are to be made without regard to whether or not payments are made or continue to be made to the other beneficiaries, the present value (at the time of the insured's death) of such payments to each beneficiary shall be determined independently for each such beneficiary. The present value so determined shall then be divided by the term for which the payments are to be made. If the payments are to be made for the life of the beneficiary, the divisor shall be the life expectancy of the beneficiary. To the extent that payments received by a beneficiary do not exceed the amount found from the above calculation, they are ''prorated amounts'' of the ''amount held by an insurer'' with respect to such beneficiary and are excludable from the gross income of the beneficiary without regard to whether he lives beyond any life expectancy used in making the calculation. For the purpose of the calculation described above, both the ''present value'' of the payments to be made periodically and the ''life expectancy'' of the beneficiary shall be determined in accordance with the interest rate and mortality table used by the insurer in determining the benefits to be paid. If payments are to be made to the estate or beneficiary of a primary beneficiary in the event that such beneficiary dies before receiving a certain number of payments or a specified total amount, the ''present value'' of payments to such beneficiary shall not include the present value (at the time of the insured's death) of amounts which may be paid by reason of such a guarantee. See paragraph (e) of this section.

(2) *Related payments.* If payments to be made to two or more beneficiaries are in the nature of a joint and survivor annuity (as described in paragraph (b) of §1.72–5), the present value (at the time of the insured's death) of the payments to be made to all such beneficiaries shall be divided by the life expectancy of such beneficiaries as a group. To the extent that the payments received by a beneficiary do not exceed the amount found from the above calculation, they are ''prorated amounts'' of the ''amount held by an insurer'' with respect to such beneficiary and are excludable from the gross income of the beneficiary without regard to whether all the beneficiaries involved live beyond the life expectancy used in making the calculation. For the purpose of the calculation described above, both the ''present value'' of the payments to be made periodically and the ''life expectancy'' of all the beneficiaries as a group shall be determined in accordance with the interest rate and mortality table used by the insurer in determining the benefits to be paid. If the contract provides that certain payments are to be made in the event that all the beneficiaries of the group die before a specified number of payments or a specified total amount is received by them, the present value of payments to be made to the group shall not include the present value (at the time of the insured's death) of amounts which may be paid by reason of such a guarantee. See paragraph (e) of this section.

(3) *Payments to secondary beneficiaries.* Payments made by reason of the death of a beneficiary (or beneficiaries) under a contract providing that such payments shall be made in the event that the beneficiary (or beneficiaries) die before receiving a specified number of payments or a specified total amount shall be excluded from the gross income of the recipient to the extent that such payments are made solely by reason of such guarantee.

(e) *Treatment of present value of guaranteed payments.* In the case of payments which are to be made for a life or lives under a contract providing that further amounts shall be paid upon the death of the primary beneficiary (or beneficiaries) in the event that such beneficiary (or beneficiaries) die before receiving a specified number of payments or a specified total amount, the present value (at the time of the insured's death) of all payments to be made under the contract shall not include, for purposes of prorating the amount held by the insurer, the present value of the payments which may be made to the estate or beneficiary of the primary beneficiary. In such a case, any lump sum amount used to measure the value of the amount held by an insurer with respect to the primary beneficiary must be reduced by the value at the time of the insured's death of any amounts which may be paid by reason of the guarantee provided for a secondary beneficiary or the estate of the primary beneficiary before prorating such lump sum over the life or lives of the primary beneficiaries. Such present value (of the guaranteed payment) shall be determined by the use of the interest rate and mortality tables used by the insurer in determining the benefits to be paid.

(f) *Treatment of payments not paid periodically.* Payments made to beneficiaries other than periodically shall be included in the gross income of the recipients, but only to the extent that they exceed amounts payable at the time of the death of the insured to each such beneficiary or, where no such amounts are specified, the present value of such payments at that time.

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

Example (1). A life insurance policy provides for the payment of $20,000 in a lump sum to the beneficiary at the death of the insured. Upon the death of the insured, the beneficiary elects an option to leave the proceeds with the company for five years and then receive payment of $24,000, having no claim of right to any part of such sum before the entire five years have passed. Upon the payment of the larger sum, $24,000, the beneficiary shall include $4,000 in gross income and exclude $20,000 therefrom. If it is assumed that the same insurer has determined the benefits to be paid, the same result would obtain if no lump sum amount were provided for at the death of the insured and the beneficiary were to be paid $24,000 five years later. In neither of these cases would the surviving spouse be able to exclude any additional amount from gross income since both cases involve an amount held by an insurer under an agreement to pay interest thereon to which section 101(c) applies, rather than an amount to be paid periodically after the death of the insured to which section 101(d) applies.

Example (2). A life insurance policy provides that $1,200 per year shall be paid the sole beneficiary (other than a surviving spouse) until a fund of $20,000 and interest which accrues on the remaining balance is exhausted. A guaranteed rate of interest is specified, but excess interest may be credited according to the earnings of the insurer. Assuming that the fund will be exhausted in 20 years if only the guaranteed interest is actually credited, the beneficiary shall exclude $1,000 of each installment received ($20,000 divided by 20) and any installments received, whether by the beneficiary or his estate or beneficiary, in excess of 20 shall be fully included in the gross income of the recipient. If, instead, the excess interest were to be paid each year, any portion of each installment representing an excess over $1,000 would be fully includible in the recipient's gross income. Thus, if an installment of $1,350 were received, $350 of it would be included in gross income.

Example (3). Assume that the sole life insurance policy of a decedent provides only for the payment of $5,000 per year for the life of his surviving spouse, beginning with the insured's death. If the present value of the proceeds, determined by reference to the interest rate and the mortality table used by the insurance company, is $60,000, and such beneficiary's life expectancy is 20 years, $3,000 of each $5,000 payment ($60,000 divided by 20) is excludable as the prorated portion of the ''amount held by an insurer''. For each taxable year in which a payment is made, an additional $1,000 is excludable from the gross income of the surviving spouse. Hence, if she receives only one $5,000 payment in her taxable year, only $1,000 is includible in her gross income in that year with respect to such payment ($5,000 less the total amount excludable, $4,000). Assuming that the policy also provides for payments of $2,000 per year for 10 years to the daughter of the insured, the present value of the payments to the daughter is to be computed separately for the purpose of determining the excludable portion of each payment to her. Assuming that such present value is $15,000, $1,500 of each payment of $2,000 received by the daughter is excludable from her gross income ($15,000 divided by 10). The remaining $500 shall be included in the gross income of the daughter.

Example (4). Beneficiaries A and B, neither of whom is the surviving spouse of the insured, are each to receive annual payments of $1,800 for each of their respective lives upon the death of the insured. The contract does not provide for payments to be made in any other manner. Assuming that the present value of the payments to be made to

A, whose life expectancy according to the insurer's mortality table is 30 years, is $36,000, A shall exclude $1,200 of each payment received ($36,000 divided by 30). Assuming that the present value of the payments to be made to B, whose life expectancy according to the insurer's mortality table is 20 years, is $27,000, B shall exclude $1,350 of each payment received ($27,000 divided by 20).

Example (5). A life insurance policy provides for the payment of $76,500 in a lump sum to the beneficiary, A, at the death of the insured. Upon the insured's death, however, A selects an option for the payment of $2,000 per year for her life and for the same amount to be paid after her death to B, her daughter, for her life. Assuming that since A is 51 years of age and her daughter is 28 years of age, the insurer determined the amount of the payments by reference to a mortality table under which the life expectancy for the lives of both A and B, joint and survivor, is 51 years, $1,500 of each $2,000 payment to either A or B ($76,500 divided by 51, or $1,500) shall be excluded from the gross income of the recipient. However, if A is the surviving spouse of the insured and no other contracts of insurance whose proceeds are to be paid to her at a date later than death are involved, A shall exclude the entire payment of $2,000 in any taxable year in which she receives but one such payment because of the additional exclusion under section 101(d)(1)(B).

Example (6). Beneficiaries A and B, neither of whom is the surviving spouse of the insured, are each to receive annual payments of $1,800 for each of their respective lives upon the death of the insured, but after the death of either, the survivor is to receive the payments formerly made to the deceased beneficiary until the survivor dies. Assuming that the life expectancy, joint and survivor, of A and B in accordance with the mortality table used by the insurer is 32 years and assuming that the total present value of the benefits to both (determined in accordance with the interest rate used by the insurer) is $80,000, A and B shall each exclude $1,250 of each installment of $1,800 ($80,000 divided by the life expectancy, 32, multiplied by the fraction of the annual payment payable to each, one-half) until the death of either. Thereafter, the survivor shall exclude $2,500 of each installment of $3,600 ($80,000 divided by 32).

Example (7). A life insurance policy provides for the payment of $75,000 in a lump sum to the beneficiary, A, at the death of the insured. A, upon the insured's death, however, selects an option for the payment of $4,000 per year for life, with a guarantee that any part of the $75,000 lump sum not paid to A before his death shall be paid to B (or his estate). A's beneficiary. Assuming that, under the criteria used by the insurer in determining the benefits to be paid, the present value of the guaranteed amount to B is $13,500 and that A's life expectancy is 25 years, the lump sum shall be reduced by the present value of the guarantee to B ($75,000 less $13,500, or $61,500) and divided by A's life expectancy ($61,500 divided by 25, or $2,460). Hence, $2,460 of each $4,000 payment is excludable from A's gross income. If A is the surviving spouse of the insured and no other contracts of insurance whose proceeds are to be paid to her at a date later than death are involved, A shall exclude $3,460 of each $4,000 payment from gross income in any taxable year in which but one such payment is received. Under these facts, if any amount is paid to B by reason of the fact that A dies before receiving a total of $75,000, the residue of the lump sum paid to B shall be excluded from B's gross income since it is wholly in lieu of the present value of such guarantee plus the present value of the payments to be made to the first beneficiary, and is therefore entirely an ''amount held by an insurer'' paid at a date later than death (see paragraph (d)(3) of this section).

Example (8). Assume that an insurance policy does not provide for the payment of a lump sum, but provides for the payment of $1,200 per year for a beneficiary's life upon the death of the insured, and also provides that if ten payments are not made to the beneficiary before death a secondary beneficiary (whether named by the insured or by the first beneficiary) shall receive the remainder of the ten payments in similar installments. If, according to the criteria used by the insurance company in determining the benefits, the present value of the payments to the first beneficiary is $12,000 and the life expectancy of such beneficiary is 15 years, $800 of each payment received by the first beneficiary is excludable from gross income. Assuming that the same figures obtain even though the payments are to be made at the rate of $100 per month, the yearly exclusion remains the same unless more or less than twelve months' installments are received by the beneficiary in a particular taxable year. In such a case two-thirds of the total received in the particular taxable year with respect to such beneficiary shall be excluded from gross income. Under either of the above alternatives, any amount received by the second beneficiary by reason of the guarantee of ten payments is fully excludable from the beneficiary's gross income since it is wholly in lieu of the present value of such guarantee plus the present value of the payments to be made to the first beneficiary and is therefore entirely an ''amount held by an insurer'' paid at a date later than death (see paragraph (d)(3) of this section).

(h) *Applicability of both section 101(c) and 101(d) to payments under a single life insurance contract*—(1) *In general.* Section 101(d) shall not apply to interest payments on any amount held by an insurer under an agreement to pay interest thereon (see sections 101(c) and 101(d)(4) and § 1.101–3). On the other hand, both section 101(c) and section 101(d) may be applicable to payments received under a single life insurance contract, if such payments consist both of interest on an amount held by an insurer under an agreement to pay interest thereon and of amounts held by the insurer and paid on a date or dates later than the death of the insured. One instance when both section 101(c) and section 101(d) may be applicable to payments received under a single life insurance contract is in the case of a permanent life insurance policy with a family income rider attached. A typical family income rider is one which provides additional term insurance coverage for a specified number of years from the register date of the basic policy. Under the policy with such a rider, if the insured dies at any time during the term period, the beneficiary is entitled to receive (i) monthly payments of a specified amount commencing as of the date of death and continuing for the balance of the term period, and (ii) a lump sum payment of the proceeds under the basic policy to be paid at the end of the term period. If the insured dies after the expiration of the term period, the beneficiary receives only the proceeds under the basic policy. If the insured dies before the expiration of the term period, part of each monthly payment received by the beneficiary during the term period consists of interest on the proceeds of the basic policy (such proceeds being retained by the insurer until the end of the term period). The remaining part consists of an installment (principal plus interest) of the proceeds of the terms insurance purchased under the family income rider. The amount of term insurance which is provided under the family income rider is, therefore, that amount which, at the date of the insured's death, will provide proceeds sufficient to fund such remaining part of each monthly payment. Since the proceeds under the basic policy are held by the insurer until the end of the term period, that portion of each monthly payment which consists of interest on such proceeds is interest on an amount held by an insurer under an agreement to pay interest thereon and is includible in gross income under section 101(c). On the other hand, since the remaining portion of each monthly payment consists of an installment payment (principal plus interest) of the proceeds of the term insurance, it is a payment of an amount held by the insurer and paid on a date later than the death of the insured to which section 101(d) and this section applies (including the $1,000 exclusion allowed the surviving spouse under section 101(d)(1)(B)). The proceeds of the basic policy, when received in a lump sum at the end of the term period, are excludable from gross income under section 101(a).

(2) *Example of tax treatment of amounts received under a family income rider.* The following example illustrates the application of the principles contained in subparagraph (1) of this paragraph to payments received under a permanent life insurance policy with a family income rider attached:

Example. The sole life insurance policy of the insured provides for the payment of $100,000 to the beneficiary (the insured's spouse) on his death. In addition, there is attached to the policy a family income rider which provides that, if the insured dies before the 20th anniversary of the basic policy, the beneficiary shall receive (i) monthly payments of $1,000 commencing on the date of the insured's death and ending with the payment prior to the 20th anniversary of the basic policy, and (ii) a single payment of $100,000 payable on the 20th anniversary of the basic policy. On the date of the insured's death, the beneficiary (surviving spouse of the insured) is entitled to 36 monthly payments of $1,000 and to the single payment of $100,000 on the 20th anniversary of the basic policy. The value of the proceeds of the term insurance at the date of the insured's death is $28,409.00 (the present value of the portion of the monthly payments to which section 101(d) applies computed on the basis that the interest rate used by the insurer in determining the benefits to be paid under the contract is 2¼ percent). The amount of each monthly payment of $1,000 which is includible in the beneficiary's gross income is determined in the following manner:

(a) Total amount of monthly payment	$1,000.00
(b) Amount includible in gross income under section 101(c) as interest on the $100,000 proceeds under the basic policy held by the insurer until 20th anniversary of the basic policy (computed on the basis that the interest rate used by the insurer in determining the benefits to be paid under the contract is 2¼ percent)	185.00

(c) Amount to which section 101(d) applies ((a) minus (b))	815.00
(d) Amount excludable from gross income under section 101(d) ($28,409÷36)	789.14
(e) Amount includible in gross income under section 101(d) without taking into account the $1,000 exclusion allowed the beneficiary as the surviving spouse ((c) minus (d))	25.86

The beneficiary, as the surviving spouse of the insured, is entitled to exclude the amounts otherwise includible in gross income under section 101(d) (item *(e)*) to the extent such amounts do not exceed $1,000 in the taxable year of receipt. This exclusion is not applicable, however, with respect to the amount of each payment which is includible in gross income under section 101(c) (item *(b)*). In this example, therefore, the beneficiary must include $185 of each monthly payment in gross income (amount includible under section 101(c)), but may exclude the $25.86 which is otherwise includible under section 101(d). The payment of $100,000 which is payable to the beneficiary on the 20th anniversary of the basic policy will be entirely excludable from gross income under section 101(a).

(3) *Limitation on amount considered to be an ''amount held by an insurer''.* See paragraph (b)(3) of this section for a limitation on the amount which shall be considered an ''amount held by an insurer'' in the case of proceeds of life insurance which are paid subsequent to the transfer of the policy for a valuable consideration.

(4) *Effective date.* The provisions of this paragraph are applicable only with respect to amounts received during taxable years beginning after October 28, 1961, irrespective of the date of the death of the insured.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6577, 26 FR 10127, Oct. 28, 1961; 26 FR 10275, Nov. 2, 1961]

§1.101–5 Alimony, etc., payments.

Proceeds of life insurance policies paid by reason of the death of the insured to his separated wife, or payment excludable as death benefits under section 101(b) paid to a deceased employee's separated wife, if paid to discharge legal obligations imposed by a decree of divorce or separate maintenance, by a written separation agreement executed after August 16, 1954, or by a decree of support entered after March 1, 1954, shall be included in the gross income of the separated wife if section 71 or 682 is applicable to the payments made. For definition of ''wife'', see section 7701(a)(17) and the regulations thereunder.

§1.101–6 Effective date.

(a) Except as otherwise provided in paragraph (h)(4) of §1.101–4, the provisions of section 101 of the Internal Revenue Code of 1954 and §§1.101–1, 1.101–2, 1.101–3, 1.101–4, and 1.101–5 are applicable only with respect to amounts received by reason of the death of an insured or an employee occurring after August 16, 1954. In the case of such amounts, these sections are applicable even though the receipt of such amounts occurred in a taxable year beginning before January 1, 1954, to which the Internal Revenue Code of 1939 applies.

(b) Section 22(b)(1) of the Internal Revenue Code of 1939 and the regulations pertaining thereto shall apply to amounts received by reason of the death of an insured or an employee occurring before August 17, 1954, regardless of the date of receipt.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6577, 26 FR 10128, Oct. 28, 1961]

§1.101–7 Mortality table used to determine exclusion for deferred payments of life insurance proceeds.

(a) *Mortality table.* Notwithstanding any provision of §1.101–4 that otherwise would permit the use of a mortality table not described in this section, the mortality table set forth in §1.72–7(c)(1) must be used to determine—

(1) The amount held by an insurer with respect to a beneficiary for purposes of section 101(d)(2) and §1.101–4; and

(2) The period or periods with respect to which payments are to be made for purposes of section 101(d)(1) and §1.101–4.

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

Example (1). A life insurance policy provides only for the payment of $5,000 per year for the life of the beneficiary, A, beginning with the insured's death. If A is 59 years of age at the time of the insured's death, the period with respect to which the payments are to be made is 25 years. This period is determined by using the mortality table set forth in §1.72–7(c)(1), and is shown in Table V of § 1.72–9 (which contains life expectancy tables determined using this mortality table). If the present value of the proceeds, determined by reference to the interest rate used by the insurance company and the mortality table set forth in § 1.72–7(c)(1), is $75,000, $3,000 of each $5,000 payment ($75,000 divided by 25) is excluded from the gross income of A.

Example (2). A life insurance policy provides for the payment of $82,500 in a lump sum to the beneficiary, A, at the death of the insured. Upon the insured's death, however, A selects an option for the payment of $2,000 per year for life and for the same amount to be paid after A's death to B for B's life. If A is 51 years of age and B is 28 years of age at the death of the insured, the period with respect to which the payments are to be made is 55 years. This period is determined by using the mortality table set forth in § 1.72–7(c)(1), and is shown in Table VI of § 1.72–9 (which contains life expectancy tables determined using this mortality table). Accordingly $1,500 of each $2,000 payment ($82,500 divided by 55) is excluded from the gross income of the recipient.

(c) *Effective date.* This section applies to amounts received with respect to deaths occurring after October 22, 1986, in taxable years ending after October 22, 1986.

[T.D. 8161, 52 FR 35415, Sept. 21, 1987. Redesignated and amended by T.D. 8272, 54 FR 47980, Nov. 20, 1989]

§ 1.102–1 Gifts and inheritances.

(a) *General rule.* Property received as a gift, or received under a will or under statutes of descent and distribution, is not includible in gross income, although the income from such property is includible in gross income. An amount of principal paid under a marriage settlement is a gift. However, see section 71 and the regulations thereunder for rules relating to alimony or allowances paid upon divorce or separation. Section 102 does not apply to prizes and awards (see section 74 and § 1.74–1) nor to scholarships and fellowship grants (see section 117 and the regulations thereunder).

(b) *Income from gifts and inheritances.* The income from any property received as a gift, or under a will or statute of descent and distribution shall not be excluded from gross income under paragraph (a) of this section.

(c) *Gifts and inheritances of income.* If the gift, bequest, devise, or inheritance is of income from property, it shall not be excluded from gross income under paragraph (a) of this section. Section 102 provides a special rule for the treatment of certain gifts, bequests, devises, or inheritances which by their terms are to be paid, credited, or distributed at intervals. Except as provided in section 663(a)(1) and paragraph (d) of this section, to the extent any such gift, bequest, devise, or inheritance is paid, credited, or to be distributed out of income from property, it shall be considered a gift, bequest, devise, or inheritance of income from property. Section 102 provides the same treatment for amounts of income from property which is paid, credited, or to be distributed under a gift or bequest whether the gift or bequest is in terms of a right to payments at intervals (regardless of income) or is in terms of a right to income. To the extent the amounts in either case are paid, credited, or to be distributed at intervals out of income, they are not to be excluded under section 102 from the taxpayer's gross income.

(d) *Effect of Subchapter J.* Any amount required to be included in the gross income of a beneficiary under sections 652, 662, or 668 shall be treated for purposes of this section as a gift, bequest, devise, or inheritance of income from property. On the other hand, any amount excluded from the gross income of a beneficiary under section 663(a)(1) shall be treated for purposes of this section as property acquired by gift, bequest, devise, or inheritance.

(e) *Income taxed to grantor or assignor.* Section 102 is not intended to tax a donee upon the same income which is taxed to the grantor of a trust or assignor of income under section 61 or sections 671 through 677, inclusive.

§ 1.103–1 Interest upon obligations of a State, territory, etc.

(a) Interest upon obligations of a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof (hereinafter collectively or individually referred to as ''State or local governmental unit'') is not includable in gross income, except as provided under section 103 (c) and (d) and the regulations thereunder.

(b) Obligations issued by or on behalf of any State or local governmental unit by constituted authorities empowered to issue such obligations are the obligations of such a unit. However, section 103(a)(1) and this section do not apply to industrial development bonds except as otherwise provided in section 103(c). See section 103(c) and §§1.103–7 through 1.103–12 for the rules concerning interest paid on industrial development bonds. See section 103(d) for rules concerning interest paid on arbitrage bonds. Certificates issued by a political subdivision for public improvements (such as sewers, sidewalks, streets, etc.) which are evidence of special assessments against specific property, which assessments become a lien against such property and which the political subdivision is required to enforce, are, for purposes of this section, obligations of the political subdivision even though the obligations are to be satisfied out of special funds and not out of general funds or taxes. The term ''political subdivision'', for purposes of this section denotes any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit. As thus defined, a political subdivision of any State or local governmental unit may or may not, for purposes of this section, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of any such unit.

[T.D. 7199, 37 FR 15486, Aug. 3, 1972]

§1.103–2 Dividends from shares and stock of Federal agencies or instrumentalities.

(a) *Issued before March 28, 1942.* (1) Section 26 of the Federal Farm Loan Act of July 17, 1916 (12 U.S.C. 931), provides that Federal land banks and Federal land bank associations, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate. Section 7 of the Federal Reserve Act of December 23, 1913 (12 U.S.C. 531), provides that Federal reserve banks, including the capital stock and surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate. Section 13 of the Federal Home Loan Bank Act (12 U.S.C. 1433) provides that the Federal Home Loan Bank including its franchise, its capital, reserves, and surplus, its advances, and its income shall be exempt from all taxation, except taxes upon real estate. Section 5(h) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(h)) provides that shares of Federal savings and loan associations shall, both as to their value and the income therefrom, be exempt from all taxation (except surtaxes, estate, inheritance, and gift taxes) imposed by the United States. Under the above-mentioned provisions, income consisting of dividends on stock of Federal land banks, Federal land bank associations, Federal home loan banks, and Federal reserve banks is not, in the case of stock issued before March 28, 1942, includable in gross income. Income consisting of dividends on share accounts of Federal savings and loan associations is includable in gross income but, in the case of shares issued before March 28, 1942, is not subject to the normal tax on income. For taxability of such income in the case of such stock or shares issued on or after March 28, 1942, see section 6 of the Public Debt Act of 1942 (31 U.S.C. 742a) and paragraph (b) of this section. For the time at which a stock or share is issued within the meaning of this section, see paragraph (b) of this section.

(2) Regardless of the exemption from income tax of dividends paid on the stock of Federal reserve banks, dividends paid by member banks are treated like dividends of ordinary corporations.

(3) Dividends on the stock of the central bank for cooperatives, the production credit corporations, production credit associations, and banks for cooperatives, organized under the provisions of the Farm Credit Act of 1933 (12 U.S.C. 1138), constitute income to the recipients, subject to both the normal tax and surtax (see section 63 of the Farm Credit Act of 1933 (12 U.S.C. 1138c)).

(b) *Issued on or after March 28, 1942.* (1) By virtue of the provisions of section 6 of the Public Debt Act of 1942 (31 U.S.C.

742a), the tax exemption provisions set forth in paragraph (a) of this section with respect to income consisting of dividends on stock of the Federal land banks, Federal land bank associations, and Federal reserve banks, or on share accounts of Federal savings and loan associations, are not applicable in the case of dividends on such stock or shares issued on or after March 28, 1942.

(2) For the purposes of this section, a stock or share is deemed to be issued at the time and to the extent that payment therefor is made to the agency or instrumentality. The date of issuance of the certificate or other evidence of ownership of such stock or share is not determinative if payment is made at an earlier or later date. Where old stock is retired in exchange for new stock of a different character or preference, the new stock shall be deemed to have been issued at the time of the exchange rather than when the old stock was paid for. These rules may be illustrated by the following examples:

Example (1). A, the owner of an investment share account, consisting of 10 shares, in a Federal savings and loan association, has a single certificate issued before March 28, 1942, evidencing such ownership. In order that A may dispose of half of such shares, the association at his request issues, after March 27, 1942, two 5-share certificates in substitution for the 10-share certificate. The shares evidenced by the two new certificates are deemed to have been issued before March 28, 1942, the shares having been paid for before such date.

Example (2). The X Bank, a member of a Federal reserve bank, owns 50 shares of Federal reserve bank stock, evidenced by a single stock certificate issued before March 28, 1942. On December 31, 1942, the X Bank reduces the amount of its capital stock, as a result of which it is required to reduce the amount of its Federal reserve bank stock to 40 shares. It surrenders the 50-share certificate to the Federal reserve bank and receives a new 40-share certificate. The 40 shares evidenced by such certificate are deemed to have been issued before March 28, 1942. On December 31, 1943, the X Bank increases the amount of its capital stock, as a result of which it is required to purchase 10 additional shares of the Federal reserve bank stock. The Federal reserve bank issues a 10-share certificate evidencing ownership of the new shares. Of the 50 shares then owned by the X Bank, 40 were issued prior to March 28, 1942, and 10 were issued after March 27, 1942.

Example (3). A, the owner of a savings share account in the amount of $100 in a Federal savings and loan association, has a passbook containing a certificate issued prior to March 28, 1942, evidencing such ownership. Subsequent to March 27, 1942, A deposits $10,000 in the account. With respect to the $10,000 deposit, the share is deemed to have been issued after March 27, 1942.

§1.103–3 Interest upon notes secured by mortgages executed to Federal agencies or instrumentalities.

Section 26 of the Federal Farm Loan Act (12 U.S.C. 931), and section 210 of such act, as added by section 2 of the act of March 4, 1923 (12 U.S.C. 1111), provide that first mortgages executed to Federal land banks, joint-stock land banks, or Federal intermediate credit banks, and the income derived therefrom, shall be exempt from taxation. Accordingly, income consisting of interest on promissory notes held by such banks and secured by such first mortgages is not subject to the income tax.

§1.103–4 Interest upon United States obligations.

(a) *Issued before March 1, 1941.* (1) Interest upon obligations of the United States issued on or before September 1, 1917, is exempt from tax. In the case of obligations issued by the United States after September 1, 1917, and in the case of obligations of a corporation organized under act of Congress, if such corporation is an instrumentality of the United States, the interest is exempt from tax only if and to the extent provided in the acts authorizing the issue thereof, as amended and supplemented.

(2) Interest on Treasury bonds issued before March 1, 1941, is exempt from Federal income taxes except surtaxes imposed upon the income or profits of individuals, associations, or corporations. However, interest on an aggregate of not exceeding $5,000 principal amount of such bonds is also exempt from surtaxes. Interest in excess of the interest on an aggregate of not exceeding $5,000 principal amount of such bonds is subject to surtax and must be included in gross income.

(3) Interest credited to postal savings accounts upon moneys deposited before March 1, 1941, in postal savings banks is wholly exempt from income tax.

(b) *Issued on or after March 1, 1941.* (1) Under the provisions of sections 4 and 5 of the Public Debt Act of 1941 (31 U.S.C. 742a), interest upon obligations issued on or after March 1, 1941, by the United States, or any agency or instrumentality thereof, shall not have any exemption, as such, from Federal income tax except in respect of any such obligations which the Federal Maritime Board and Maritime Administration (formerly United States Maritime Commission) or the Federal Housing Administration has, before March 1, 1941, contracted to issue at a future date. The interest on such obligations so contracted to be issued shall bear such tax-exemption privileges as were at the time of such contract provided in the law authorizing their issuance. For the purposes hereof, under section 4(a) of the Public Debt Act of 1941, a Territory and a possession of the United States (or any political subdivisions thereof), and the District of Columbia, and any agency or instrumentality of any one or more of the foregoing, shall not be considered as an agency or instrumentality of the United States.

(2) In the case of obligations issued as the result of a refunding operation, as, for example, where a corporation exchanges bonds for previously issued bonds, the refunding obligations are deemed, for the purposes of this section, to have been issued at the time of the exchange rather than at the time the original bonds were issued.

§1.103–5 Treasury bond exemption in the case of trusts or partnerships.

(a) When the income of a trust is taxable to beneficiaries, as in the case of a trust the income of which is to be distributed to the beneficiaries currently, each beneficiary is entitled to exemption as if he owned directly a proportionate part of the Treasury bonds held in trust. When, on the other hand, income is taxable to the trustee, as in the case of a trust the income of which is accumulated for the benefit of unborn or unascertained persons, the trust, as the owner of the bonds held in trust, is entitled to the exemption on account of such ownership. In general, see sections 652(b) and 662(b) and the regulations thereunder.

(b) As the income of a partnership is taxable to the individual partners, each partner is entitled to exemption as if he owned directly a proportionate part of the bonds held by the partnership. For rules relating to partially tax-exempt interest see section 702(a)(7) and the regulations thereunder.

§1.103–6 Interest upon United States obligations in the case of nonresident aliens and foreign corporations, not engaged in business in the United States.

By virtue of section 4 of the Victory Liberty Loan Act of March 3, 1919 (31 U.S.C. 750), amending section 3 of the Fourth Liberty Bond Act of July 9, 1918 (31 U.S.C. 750), the interest received on and after March 3, 1919, on bonds, notes, and certificates of indebtedness of the United States while beneficially owned by a nonresident alien individual, or a foreign corporation, partnership, or association, if such individual, corporation, partnership, or association is not engaged in business in the United States, is exempt from income taxes. Such exemption applies only to such bonds, notes, or certificates as have been issued before March 1, 1941. Interest derived by a nonresident alien individual, or by a foreign corporation, partnership, or association on such bonds, notes, or certificates issued on or after March 1, 1941, is subject to tax as in the case of taxpayers generally as provided in paragraph (b) of §1.103–4.

§1.103–7 Industrial development bonds.

(a) *In general.* Under section 103(c)(1) and this section, an industrial development bond issued after April 30, 1968, shall be treated as an obligation not described in section 103(a)(1) and §1.103–1. Accordingly, interest paid on such a bond is includable in gross income unless the bond was issued by a State, or local governmental unit to finance certain exempt facilities (see section 103(c)(4) and §1.103–8), to finance an industrial park (see section 103(c)(5) and §1.103–9), or as part of an exempt small issue (see section 103(c)(6) and §1.103–10). For applicable rules when an industrial development bond is held by a substantial user (or a person related to a substantial user) of such an exempt facility, or an industrial park, or a facility financed with the proceeds of such an exempt small issue, see section 103(c)(7) and § 1.103–11. See also § 1.103–12 for the transitional provisions concerning the interest paid on certain industrial development bonds issued before January 1, 1969, and certain other industrial development bonds. Even if section 103(c) does not prevent a bond from being treated as an obligation described in section 103(a)(1) and § 1.103–1, such bond shall nevertheless be treated as an obligation which is not described in section 103(a)(1) and § 1.103–1 if under section 103(d) it is an arbitrage bond. For purposes of section 103(c), the term ''issue'' includes a single obligation such as a single note issued in connection with a bank loan as well as a series of notes or bonds.

(b) *Industrial development bonds*—(1) *Definition.* For purposes of this section, the term ''industrial development bond'' means any obligation—

(i) Which is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly in any trade or business carried on by any person who is not an exempt person (as defined in subparagraph (2) of this paragraph), and

(ii) The payment of the principal or interest on which, under the terms of such obligation or any underlying arrangement (as described in subparagraph (4) of this paragraph), is in whole or in major part (i.e., major portion)—

(a) Secured by any interest in property used or to be used in a trade or business,

(b) Secured by any interest in payments in respect of property used or to be used in a trade or business, or

(c) To be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business.

See subparagraphs (3) and (4) of this paragraph for the trade or business test and the security interest test respectively. See § 1.103–8(a)(6) to determine the amount of proceeds of an issue for which the amount payable during each annual period over the term of the issue is less than the amount of interest accruing thereon in such period, *e.g.*, in the case of an issue sold by the issuer for less than its face amount.

(2) *Exempt person.* The term ''exempt person'' means a governmental unit as defined in this subparagraph, or an organization which is described in section 501(c)(3) and this subparagraph and is exempt from taxation under section 501(a). For purposes of this subparagraph, the term ''governmental unit'' means a State or local governmental unit (as defined in § 1.103–1). For purposes of this subparagraph, the term ''governmental unit'' also includes the United States of America (or an agency or instrumentality of the United States of America), but only in the case of obligations (i) issued on or before August 3, 1972, or (ii) issued after August 3, 1972, with respect to which a bond resolution or any other official action was taken and in reliance on such action either *(a)* construction of such facility to be financed with such obligations commenced or *(b)* a binding contract was entered into, or an irrevocable bid was submitted, prior to August 3, 1972, or (iii) issued after August 3, 1972, with respect to a program approved by Congress prior to such date but only if *(a)* a portion of such program has been financed by obligations issued prior to such date, to which section 103(a) applied pursuant to a ruling issued by the Commissioner or his delegate prior to such date and *(b)* construction of one or more facilities comprising a part of such program commenced prior to such date. For purposes of this subparagraph, a tax-exempt organization is an exempt person only with respect to a trade or business it carries on which is not an unrelated trade or business. Whether a particular trade or business carried on by a tax-exempt organization is an unrelated trade or business is determined by applying the rules of section 513(a) (relating to general rule for unrelated trade or business) and the regulations thereunder to the tax-exempt organization without regard to whether the organization is an organization subject to the tax imposed by section 511 (relating to imposition of tax on unrelated business income of charitable, etc., organizations).

(3) *Trade or business test.* (i) The trade or business test relates to the use of the proceeds of a bond issue. The test is

met if all or a major portion of the proceeds of a bond issue is used in a trade or business carried on by a nonexempt person. For example, if all or a major portion of the proceeds of a bond issue is to be loaned to one or more private business users, or is to be used to acquire, construct, or reconstruct facilities to be leased or sold to such private business users, and such proceeds or facilities are to be used in trades or businesses carried on by them, such proceeds are to be used in a trade or business carried on by persons who are not exempt persons, and the debt obligations comprising the bond issue satisfy the trade or business test. If, however, less than a major portion of the proceeds of an issue is to be loaned to nonexempt persons or is to be used to acquire or construct facilities which will be used in a trade or business carried on by a nonexempt person, the debt obligations will not be industrial development bonds. Also, when publicly-owned facilities which are intended for general public use, such as toll roads or bridges, are constructed with the proceeds of a bond issue and used by nonexempt persons in their trades or businesses on the same basis as other members of the public, such use does not constitute a use in the trade or business of a nonexempt person for purposes of the trade or business test.

(ii) In determining whether a debt obligation meets the trade or business test, the indirect, as well as the direct, use of the proceeds is to be taken into account. For example, the debt obligations comprising a bond issue do not fail to satisfy the trade or business test merely because the State or local governmental unit uses the proceeds to engage in a series of financing transactions for property to be used by private business users in trades or businesses carried on by them. Similarly, if such proceeds are to be used to construct facilities to be leased or sold to any nonexempt person for use in a trade or business it carries on, such proceeds are to be used in a trade or business carried on by a nonexempt person and the debt obligations comprising such issue satisfy the trade or business test. If such proceeds are to be used to construct facilities to be leased or sold to an exempt person who will, in turn, lease or sell the facilities to a nonexempt person for use in a trade or business, such proceeds are to be used in a trade or business carried on by a nonexempt person and the debt obligations comprising such issue satisfy the trade or business test. In addition, proceeds will be treated as being used in the trade or business of a nonexempt person in situations involving other arrangements, whether in a single transaction or in a series of transactions, whereby a nonexempt person uses property acquired with the proceeds of a bond issue in its trade or business.

(iii) The use of more than 25 percent of the proceeds of an issue of obligations in the trades or businesses of nonexempt persons will constitute the use of a major portion of such proceeds in such manner. In the case of the direct or indirect use of the proceeds of an issue of obligations or the direct or indirect use of a facility constructed, reconstructed, or acquired with such proceeds, the use by all nonexempt persons in their trades or businesses must be aggregated to determine whether the trade or business test is satisfied. If more than 25 percent of the proceeds of a bond issue is used in the trades or businesses of nonexempt persons, the trade or business test is satisfied. For special rules with respect to the acquisition of the output of facilities, see subparagraph (5) of this paragraph.

(4) *Security interest test.* The security interest test relates to the nature of the security for, and the source of, the payment of either the principal or interest on a bond issue. The nature of the security for, and the source of, the payment may be determined from the terms of the bond indenture or on the basis of an underlying arrangement. An underlying arrangement to provide security for, or the source of, the payment of the principal or interest on an obligation may result from separate agreements between the parties or may be determined on the basis of all the facts and circumstances surrounding the issuance of the bonds. The property which is the security for, or the source of, the payment of either the principal or interest on a debt obligation need not be property acquired with bond proceeds. The security interest test is

satisfied if, for example, a debt obligation is secured by unimproved land or investment securities used, directly or indirectly, in any trade or business carried on by any private business user. A pledge of the full faith and credit of a State or local governmental unit will not prevent a debt obligation from otherwise satisfying the security interest test. For example, if the payment of either the principal or interest on a bond issue is secured by both a pledge of the full faith and credit of a State or local governmental unit and any interest in property used or to be used in a trade or business, the bond issue satisfies the security interest test. For rules with respect to the acquisition of the output of facilities see subparagraph (5) of this paragraph.

(5) *Trade or business test and security interest test with respect to certain output contracts.* (i) The use by one or more nonexempt persons of a major portion of the subparagraph (5) output of facilities such as electric energy, gas, or water facilities constructed, reconstructed, or acquired with the proceeds of an issue satisfies the trade or business test and the security interest test if such use has the effect of transferring to nonexempt persons the benefits of ownership of such facilities, and the burdens of paying the debt service on governmental obligations used directly or indirectly to finance such facilities, so as to constitute the indirect use by them of a major portion of such proceeds. Such benefits and burdens are transferred and a major portion of the proceeds of an issue is used indirectly by the users of the subparagraph (5) output of such a facility which is owned and operated by an exempt person where—

(a)(1) One nonexempt person agrees pursuant to a contract to take, or to take or pay for, a major portion (more than 25 percent) of the subparagraph (5) output (within the meaning of subdivision (ii) of this subparagraph) of such a facility (whether or not conditional upon the production of such output) or (*2)* two or more nonexempt persons, each of which pays annually a guaranteed minimum payment exceeding 3 percent of the average annual debt service with respect to the obligations in question, agree, pursuant to contracts, to take, or to take or pay for, a major portion (more than 25 percent) of the subparagraph (5) output of such a facility (whether or not conditioned upon the production of such output), and

(b) Payment made or to be made with respect to such contract or contracts by such nonexempt person or persons exceeds a major part (more than 25 percent) of the total debt service with respect to such issue of obligations.

(ii) For purposes of this subparagraph—

(a) Where a contract described in subdivision (i) of this subparagraph may be extended by the issuer of obligations described therein, the term of the contract shall be considered to include the period for which such contract may be so extended.

(b) The subparagraph (5) output of a facility shall be determined by multiplying the number of units produced or to be produced by the facility in 1 year by the number of years in the contract term of the issue of obligations issued to provide such facility. The number of units produced or to be produced by a facility in 1 year shall be determined by reference to its nameplate capacity (or where there is no nameplate capacity, its maximum capacity) without any reduction for reserves or other unutilized capacity. The contract term of an issue begins on the date the output of a facility is first taken, pursuant to a take or a take or pay contract, by a nonexempt person and ends on the latest maturity date of any obligation of the issue (determined without regard to any optional redemption dates). If, however, on or before the date of issue of a prior issue of governmental obligations issued to provide a facility, the issuer makes a commitment in the bond indenture or related document to refinance such prior issue with one or more subsequent issues of governmental obligations, then the contract term of the issue shall be determined with regard to the latest redemption date of any obligation of the last such refinancing issue with respect to such facility (determined without regard to any optional redemption dates). Where it appears that the term of an issue (or the terms of two or more issues) is extended for purposes of extending the

contract term of an issue and thereby increasing the subparagraph (5) output of the facility provided by such issue, the subparagraph (5) output of such facility shall be determined by the Commissioner without regard to the provisions of this subdivision *(b).*

(c) The total debt service with respect to an issue of obligations shall be the total dollar amount (excluding any penalties) payable with respect to such issue over its entire term. The entire term of an issue begins on its date of issue and ends on the latest maturity date of any obligation of the issue (determined without regard to any optional redemption dates). If, however, on or before the date of issue of a prior issue of governmental obligations the issuer makes a commitment in the bond indenture or related document to refinance such prior issue with one or more subsequent issues of governmental obligations, the entire term of the issue shall be determined with regard to the latest redemption date of any obligation of the last such refinancing issue (determined without regard to any optional redemption dates).

(d) Two or more nonexempt persons who are related persons (within the meaning of section 103(c)(6)(C)) shall be treated as one nonexempt person.

(c) *Examples.* The application of the rules contained in section 103(c) (2) and (3) and paragraph (b) of this section are illustrated by the following examples:

Example (1). State A and corporation X enter into an arrangement under which A is to provide a factory which X will lease for 20 years. The arrangement provides (1) that A will issue $10 million of bonds, (2) that the proceeds of the bond issue will be used to purchase land and to construct and equip a factory in accordance with X's specifications, (3) that X will rent the facility (land, factory, and equipment) for 20 years at an annual rental equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds, and (4) that such payments by X and the facility itself will be the security for the bonds. The bonds are industrial development bonds since they are part of an issue of obligations (1) all of the proceeds of which are to be used (by purchasing land and constructing and equipping the factory) in a trade or business by a nonexempt person, and (2) the payment of the principal and interest on which is secured by the facility and payments to be made with respect thereto.

Example (2). The facts are the same as in example (1) except that (1) X will purchase the facility, and (2) annual payments equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds will be made by X. The bonds are industrial development bonds for the reasons set forth in example (1).

Example (3). State B and corporation X enter into an arrangement under which B is to loan $10 million to X. The arrangement provides (1) that B will issue $10 million of bonds, (2) that the proceeds of the bond issue will be loaned to X to provide additional working capital and to finance the acquisition of certain new machinery, (3) that X will repay the loan in annual installments equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds, and (4) that the payments on the loan and the machinery will be the security for only the payment of the principal on the bonds. The bonds are industrial development bonds since they are part of an issue of obligations (1) all of the proceeds of which are to be used in a trade or business by a nonexempt person, and (2) the payment of the principal on which is secured by payments to be made in respect of property to be used in a trade or business. The result would be the same if only the payment of the interest on the bonds were secured by payments on the loan and machinery.

Example (4). The facts are the same as in example (1), (2), or (3) except that the annual payments required to be made by corporation X exceed the amount necessary to amortize the principal and pay the interest on the outstanding bonds. The bonds are industrial development bonds for the reasons set forth in such examples. The fact that corporation X is required to pay an amount in excess of the amount necessary to pay the principal and interest on the bonds does not affect their status as industrial development bonds. Similarly, if the annual payments required to be made by corporation X were sufficient to pay only a major portion of either the principal or the interest on the outstanding bonds, the bonds would be industrial development bonds for the reasons set forth in such examples.

Example (5). The facts are the same as in example (1), (2), (3), or (4) except that the issuer is a political subdivision which has taxing power and the bonds are general obligation bonds. Since both the trade or business and the security interest tests are met, the bonds are industrial development bonds notwithstanding the fact that they constitute an unconditional obligation of the issuer payable from its general revenues.

Example (6). (a) State C issues its general obligation bonds to purchase land and construct a hotel for use by the general public (i.e., tourists, visitors, travelers on business, etc.). The bond indenture provides (1) that C will own and operate the project for the period required to redeem the bonds, and (2) that the project itself and the revenues derived therefrom are the security for the bonds. The bonds are not industrial development bonds since (1) the proceeds are to be used by an exempt person in a trade or business carried on by such person, and (2) a major portion of such proceeds is not to be used, directly or indirectly, in a trade or business carried on by a nonexempt person. Use of the hotel by hotel guests who are travelling in connection with trades or businesses of nonexempt persons is not an indirect use of the hotel by such nonexempt persons for purposes of section 103(c).

(b) The facts are the same as in paragraph (a) of this example except that corporation Y enters into a long-term agreement with C that Y will rent more than one-fourth of the rooms on an annual basis for a period approximately equal to one half of the term of the bonds. The bonds are industrial development bonds because (1) a major portion of the proceeds used to construct the hotel is to be used in the trade or business of corporation Y (a nonexempt person) and (2) a major portion of the principal and interest on such issue will be derived from payments in respect of the property used in the trade or business of Y.

Example (7). (a) State D and corporation Y enter into an agreement under which Y will lease for 20 years three floors of a 12- story office building to be constructed by D on land which it will acquire. D will occupy the grade floor and the remaining eight floors of the building. The portion of the costs of acquiring the land and constructing the building which are allocated to the space to be leased by Y is not in excess of 25 percent of the total costs of acquiring the land and constructing the building. Such costs, whether attributable to the acquisition of land or the construction of the building, were allocated to leased space in the same proportion that the reasonable rental value of such leased space bears to the reasonable rental value of the entire building. From the facts and circumstances presented, it is determined that such allocation was reasonable. The arrangement between D and Y provides that D will issue $10 million of bonds, that the proceeds of the bond issue will be used to purchase land and construct an office building, that Y will lease the designated floor space for 20 years at its reasonable rental value, and that such rental payments and the building itself shall be security for the bonds. The bonds are not industrial development bonds since a major portion of the proceeds is not to be used, directly or indirectly, in the trade or business of a nonexempt person.

(b) The facts are the same as in paragraph (a) of this example except that corporation Y will lease four floors, and the costs allocated to these floors are in excess of 25 percent of D's investment in the land and building. The bonds are industrial development bonds because (1) a major portion of the building is to be used in the trade or business of a nonexempt person, and (2) a major portion of the principal and interest on such issue is secured by the rental payments on the building.

Example (8). The facts are the same as in paragraph (b) of example (7) except that, instead of leasing any space to corporation Y, State D will lease the four floors to numerous unrelated private business users to be used in their trades or businesses. No lease will have a term exceeding 2 years. A major portion of the principal and interest will be paid from the revenues that D will derive from such leases. The fact that the activities of D, an exempt person, may amount to a trade or business of leasing property is not material, and the bonds are industrial development bonds for the reasons set forth in paragraph (b) of example (7). The result would be the same in the case of long-term leases.

Example (9). State E issues its obligations to finance the construction of dormitories for educational institution Z which is an organization described in section 501(c)(3) and exempt from tax under section 501(a). The dormitories are to be owned and operated by Z and their operation does not constitute an unrelated trade or business. The bonds are not industrial development bonds since the proceeds are to be used by an exempt person in a trade or business carried on by such person which is not an unrelated trade or business, as determined by applying section 513(a) to Z.

Example (10). State F issues its obligations to finance the construction of a toll road and the cost of erecting related facilities such as gasoline service stations and restaurants. Such related facilities represent less than 25 percent of the total cost of the project and are to be leased or sold to nonexempt persons. The toll road is to be owned and operated by F. The revenues from the toll road and from the rental of related facilities are the security for the bonds. The bonds are not industrial development bonds since a major portion of the proceeds is not to be used, directly or indirectly, in the trades or businesses of nonexempt persons. The fact that vehicles owned by nonexempt persons engaged in their trades or businesses may use the road in common with, or as a part of, the general public is not material.

Example (11). City G issues its obligations to finance the construction of a municipal auditorium which it will own and operate. The use of the auditorium will be open to anyone who wishes to use it for a short period of time on a rate-scale basis. The rights of such a user are only those of a transient occupant rather than the full legal possessory interests of a lessee. It is anticipated that the auditorium will be used by schools, church groups, and fraternities, and numerous commercial organizations. The revenues from the rentals of the auditorium and the auditorium building itself will be the security for the bonds. The bonds are not industrial development bonds because such use is not a use in the trade or business of a nonexempt person.

Example (12). The facts are the same as in example (11) except that one nonexempt person will have a 20-year rental agreement providing for exclusive use of the entire auditorium for more than 3 months of each year at a rental comparable to that charged short-term users. The bonds are industrial development bonds since such use is a use in the trade or business of a nonexempt person and, therefore, a major portion of the proceeds of the issue will be used in the trade or business of a nonexempt person and a major portion of the principal or interest on such issue will be secured by a facility used in such trade or business and by payments with respect to such facility.

Example (13). In order to construct an electric generating facility of a size sufficient to take advantage of the economies of scale: (1) City H will issue $50 million of its 25-year bonds and Z (a privately owned electric utility) will use $100 million of its funds for construction of a facility they will jointly own as tenants in common. (2) Each of the participants will share in the ownership, output, and operating expenses of the facility in proportion to its contribution to the cost of the facility, that is, one-third by H and two-thirds by Z. (3) H's bonds will be secured by H's ownership in the facility and by revenues to be derived from the sale of H's share of the annual output of the facility. (4) Because H will need only 50 percent of its share of the annual output of the facility, it agrees to sell to Z 25 percent of its share of such annual output for a period of 20 years pursuant to a contract under which Z agrees to take or pay for such power in all events. The facility will begin operation, and Z will begin to receive power, 4 years after the City H obligations are issued. The contract term of the issue will, therefore, be 21 years. (5) H also agrees to sell the remaining 25 percent of its share of the annual output to numerous other private utilities under a prevailing rate schedule including demand charges. (6) No contracts will be executed obligating any person other than Z to purchase any specified amount of the power for any specified period of time and no one such person (other than Z) will pay a demand charge or other minimum payment under conditions which, under paragraph (b)(5) of this section, result in a transfer of the benefits of ownership and the burdens of paying the debt service on obligations used directly or indirectly to provide such facilities. The bonds are not industrial development bonds because H's one-third interest in the facility (financed with bond proceeds) shall be treated as a separate property interest and, although 25 percent of H's interest in the annual output of the facility will be used directly or indirectly in the trade or business of Z, a nonexempt person, under the rule of paragraph (b)(5) of this section, such portion constitutes less than a major portion of the subparagraph (5) output of the facility. If more than 25 percent of the subparagraph (5) output of the facility were to be sold to Z pursuant to the take or pay contract, the bonds would be industrial development bonds since they would be secured by H's ownership in the facility and revenues therefrom, and under the rules of paragraph (b)(5) of this section a major portion of the proceeds of the bond issue would be used in the trade or business of Z, a nonexempt person.

Example (14). J, a political subdivision of a State, will issue several series of bonds from time to time and will use the proceeds to rehabilitate urban areas. More than 25 percent of the proceeds of each issue will be used for the rehabilitation and construction of buildings which will be leased or sold to nonexempt persons for use in their trades or businesses. There is no limitation either on the number of issues or the aggregate amount of bonds which may be outstanding. No group of bondholders has any legal claim prior to any other bondholders or creditors with respect to specific revenues of J, and there is no arrangement whereby revenues from a particular project are paid into a trust or constructive trust, or sinking fund, or are otherwise segregated or restricted for the benefit of any group of bondholders. There is, however, an unconditional obligation by J to pay the principal and interest on each issue of bonds. Further, it is apparent that J requires the revenues from the lease or sale of buildings to nonexempt persons in order to pay in full the principal and interest on the bonds in question. The bonds are industrial development bonds because a major portion of the proceeds will be used in the trades or businesses of nonexempt persons and, pursuant to an underlying arrangement, payment of the principal and interest is, in major part, to be derived from payments in respect of property or borrowed money used in the trades or businesses of nonexempt persons.

Example (15). Power Authority K, a political subdivision created by the legislature in State X to own and operate certain power generating facilities, sells all of the power from its existing facilities to four private utility systems under contracts executed in 1970, whereby such four systems are required to take or pay for specified portions of the total power output until the year 2000. Currently, existing facilities supply all of the present needs of the four utility systems but their future power requirements are expected to increase substantially. K issues 20-year general obligation bonds to construct a large nuclear generating facility. A fifth private utility system contracts with K to take or pay for 30 percent of the subparagraph (5) output of the new facility. The balance of the power output of the new facility will be available for sale as required, but initially it is not anticipated there will be any need for such power. The revenues from the contract with the fifth private utility system will be sufficient to pay less than 25 percent of the principal or interest on the bonds. The balance, which will exceed 25 percent of the principal or interest on such bonds, will be paid from revenues from the contracts with the four systems from sale of power produced by the old facilities. The bonds will be industrial development bonds because a major portion of the proceeds will be used in the trade or business of a nonexempt person, and payment of the principal and interest, pursuant to an underlying arrangement, will be derived in major part from payments in respect of property used in the trades or businesses of nonexempt persons.

(d) *Certain refunding issues*—(1) *General rule.* In the case of an issue of obligations issued to refund the outstanding face amount of an issue of obligations, the proceeds of the refunding issue will be considered to be used for the purpose for which the proceeds of the issue to be refunded were used. The rules of this subparagraph shall apply regardless of the date of issuance of the issue to be refunded and shall apply to refunding issues to be issued to refund prior refunding issues.

(2) *Obligations issued prior to effective date.* In the case of an issue of obligations issued to refund the outstanding face amount of an issue of obligations issued on or before April 30, 1968 (or before January 1, 1969, if the transitional rules of § 1.103–12 are applicable) which would have been industrial development bonds within the meaning of section 103(c)(2) had they been issued after such date, the refunding issue shall not be considered to be an issue of industrial development bonds if it does not make funds available for any purpose other than the debt service on the obligations. For rules as to arbitrage bonds, see section 103(d).

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

Example (1). In 1969, State A issued $20 million of 20-year revenue bonds the proceeds of which were used to contruct a sports facility which qualifies as an exempt facility described in section 103(c)(4)(B) and paragraph (c) of § 1.103–8. The sports facility will be owned and operated by X, a nonexempt person, for the use of the general public. In 1975, A issues $15 million of revenue bonds in order to refund the outstanding face amount of the 1969 issue. Since the proceeds of the 1969 issue were used for an exempt facility, the proceeds of the 1975 refunding issue will be considered to be used for the same purposes and section 103(c)(1) shall not apply to the 1975 refunding issue. The result would have been the same if the original issue had been issued in 1965. For rules as to a refunding obligation held by substantial users of facilities constructed with the proceeds of the issue refunded, see section 103(c)(7) and § 1.103–11.

Example (2). In 1967, prior to the effective date of section 103(c), city B issued $10 million of revenue bonds the proceeds of which were used to construct a manufacturing facility for corporation Y, a nonexempt person. Lease payments by Y were security for the bonds. In 1975, B issue $7 million of revenue bonds in order to retire the outstanding face amount of the 1967 issue. The interest rate of the 1975 issue is one and one-half percentage points lower than the interest rate on the 1967 issue. Both issues sold at par. All of the terms of the 1975 issue are the same as the terms of the 1967 issue with the exception of the interest rate. The 1975 refunding issue will not be considered to be an issue of industrial development bonds since the refunding issue will not make funds available for any purpose other than the debt service on the outstanding obligations.

Example (3). The facts are the same as in example (2) except that the interest rate on the refunding issue is the same as the interest rate on the issue to be refunded. Assume further that city B issued the 1975 refunding issue in order to extend the term of the obligations issued in 1967 as the result of its inability to pay such obligations due to insufficient revenues. The results will be the same as in example (2) for the reasons stated therein.

[T.D. 7199, 37 FR 15486, Aug. 3, 1972; 37 FR 16177, Aug. 11, 1972, as amended by T.D. 7869, 48 FR 1708, Jan. 14, 1983]

§ 1.103–8 Interest on bonds to finance certain exempt facilities.

(a) *In general*—(1) *General rule.* (i) Under section 103(b)(4), interest paid on an issue of obligations issued by a State or local governmental unit (as defined in §1.103–1) is not includable in gross income if substantially all of the proceeds of such issue is to be used to provide one or more of the exempt facilities listed in subparagraphs (A) through (J) of section 103(b)(4) and in this section. However, interest on an obligation of such issue is includable in gross income if the obligation is held by a substantial user or a related person (as described in section 103(b)(13) and §1.103–11). If substantially all of the proceeds of a bond issue is to be used to provide such exempt facilities, the debt obligations are treated as obligations described in section 103(a)(1) and §1.103–1 even though such obligations are industrial development bonds as defined in section 103(b)(2) and §1.103–7. Substantially all of the proceeds of an issue of governmental obligations are used to provide an exempt facility if 90 percent or more of such proceeds are so used. For purposes of this ‘‘substantially all’’ test, two rules apply. First, proceeds are reduced by amounts properly allocable on a pro rata basis between providing the exempt facility and other uses of the proceeds. Second, amounts used to provide an exempt facility include amounts paid or incurred which are chargeable to the facility's capital account or would be so chargeable either with a proper election by a taxpayer (for example, under section 266) or but for a proper election by a taxpayer to deduct such amounts. In the event the amount payable with respect to an issue during each annual period over its term is less than the amount of interest accruing thereon in such period, *e.g.*, in the case of an issue sold by the issuer for less than its face amount, see paragraph (a)(6) of this section to determine the amount of proceeds of the issue.

(ii) The provisions of subdivision (i) of this subparagraph shall also apply to an issue of obligations substantially all of the proceeds of which is to be used to provide exempt facilities described in this section and for either or both of the following purposes: *(a)* To acquire or develop land as the site for an industrial park described in section 103(b)(5) and §1.103–9, *(b)* to provide facilities to be used by an exempt person.

(iii) Section 103(b)(4) only becomes applicable where the bond issue meets both the trade or business and the security interest tests so that obligations are industrial development bonds within the meaning of section 103(b)(2). For rules as to exempt facilities including property functionally related and subordinate to such facilities, see subparagraph (3) of this paragraph. For rules with respect to the ultimate use of proceeds of obligations, see subparagraph (4) of this paragraph. For rules which limit the application of the provisions of this section see subparagraph (5) of this paragraph. For the interrelationship of the rules provided in this section and the exemption for certain small issues provided in section 103(b)(6), see §1.103–10.

(2) *Public use requirement.* To qualify under section 103(b)(4) and this section as an exempt facility, a facility must serve or be available on a regular basis for general public use, or be a part of a facility so used, as contrasted with similar types of facilities which are constructed for the exclusive use of a limited number of nonexempt persons in their trades or businesses. For example, a private dock or wharf owned by or leased to, and serving only a single manufacturing plant would not qualify as a facility for general public use, but a hangar or repair facility at a municipal airport, or a dock or a wharf, would qualify even if it is owned by, or leased or permanently assigned to, a nonexempt person provided that such nonexempt person directly serves the general public, such as a common passenger carrier or freight carrier. Similarly, an airport owned or operated by a nonexempt person for general public use is a facility for public use, as is a dock or wharf which is a part of a public port. However, a landing strip which, by reason of a formal or informal agreement or by reason of geographic location, will not be available for general public use does not satisfy the public use requirement. Sewage or solid waste disposal facilities and air or water pollution control facilities, described in sections 103(b)(4) (E) and (F) and paragraphs (f) and (g) of this section, will be treated in all events as serving a general public use although

they may be part of a nonpublic facility such as a manufacturing facility used in the trade or business of a nonexempt user.

(3) *Functionally related and subordinate.* An exempt facility includes any land, building, or other property functionally related and subordinate to such facility. Property is not functionally related and subordinate to a facility if it is not of a character and size commensurate with the character and size of such facility. Since substantially all of the proceeds of a bond issue must be used for the exempt facility (or for any combination of exempt facilities, industrial parks, and facilities to be used by exempt persons), including property functionally related and subordinate thereto, an insubstantial amount of the proceeds of a bond issue may be used for facilities which are neither exempt facilities (or a combination of exempt facilities, industrial parks and facilities to be used by exempt persons) nor functionally related and subordinate to exempt facilities. Thus, for example, where substantially all of the proceeds of an urban redevelopment bond issue are to be used by a State urban redevelopment agency for residential real property for family units within the meaning of section 103(b)(4)(A) and paragraph (b) of this section, an insubstantial amount may be used for an industrial or commercial project or for any other purpose that is not functionally related and subordinate to the residential real property for family units.

(4) *Ultimate use of proceeds.* The question whether substantially all of the proceeds of an issue of obligations are to be used to provide one or more of the exempt facilities listed in subparagraphs (A) through (J) of section 103(b)(4) and in this section is to be resolved by reference to the ultimate use of such proceeds. For example, such proceeds will be treated as used to provide residential rental property whether the State or local governmental unit (i) constructs such property and leases or sells it to any person who is not an exempt person for use in such person's trade or business of leasing such property; (ii) lends the proceeds to any such person for such purpose; or (iii) lends the proceeds to banks or other financial institutions in order to increase the supply of funds for mortgage lending under conditions requiring such banks or other financial institutions to use such proceeds only for further lending for residential rental property.

(5) *Limitation.* (i) A facility qualifies under this section only to the extent that there is a valid reimbursement allocation under § 1.150–2 with respect to expenditures that are incurred before the issue date of the bonds to provide the facility and that are to be paid with the proceeds of the issue. In addition, if the original use of the facility begins before the issue date of the bonds, the facility does not qualify under this section if any person that was a substantial user of the facility at any time during the 5-year period before the issue date or any related person to that user receives (directly or indirectly) 5 percent or more of the proceeds of the issue for the user's interest in the facility and is a substantial user of the facility at any time during the 5-year period after the issue date, unless—

(A) An official intent for the facility is adopted under § 1.150–2 within 60 days after the date on which acquisition, construction, or reconstruction of that facility commenced; and

(B) For an acquisition, no person that is a substantial user or related person after the acquisition date was also a substantial user more than 60 days before the date on which the official intent was adopted.

(ii) A facility, the original use of which commences (or the acquisition of which occurs) on or after the issue date of bonds to provide that facility, qualifies under this section only to the extent that an official intent for the facility is adopted under § 1.150–2 by the issuer of the bonds within 60 days after the commencement of the construction, reconstruction, or acquisition of that facility. Temporary construction or other financing of a facility prior to the issuance of the bonds to provide that facility will not cause that facility to be one that does not qualify under this paragraph (a)(5)(ii).

(iii) For purposes of paragraph (a)(5)(i) of this section, *substantial user* has the meaning used in section 147(a)(1), *related person* has the meaning used in section 144(a)(3), and a user that is a governmental unit within the meaning of §1.103–1 is disregarded.

(iv) Except to the extent provided in §§1.142–4(d), 1.148–11A(i), and 1.150–2(j), this paragraph (a)(5) applies to bonds issued after June 30, 1993, and sold before July 8, 1997. See §1.142–4(d) for rules relating to bonds sold on or after July 8, 1997.

(6) *Deep discount obligations.* (i) Except as otherwise provided in paragraph (a)(7) of this section, the proceeds of any issue of obligations sold by the issuer after June 4, 1982, shall include any imputed proceeds of the issue. The imputed proceeds of an issue equal the sum of the amounts of imputed proceeds for each annual period (hereinafter, bond year) over the term of the issue.

(ii) The amount of imputed proceeds for a bond year equals—

(*a*) The sum of the amounts of interest that will accrue with respect to each obligation that is part of the issue in such year, reduced (but not below zero) by

(*b*) The sum of the amounts of principal and interest that become payable with respect to the issue in that bond year.

(iii) Interest will be deemed to accrue with respect to an obligation on an amount that, as of the commencement of that year, is equal to the sum of—

(*a*) The purchase price (as defined in §1.103–13(d)(2)) allocable to the obligation and

(*b*) The aggregate of the amounts of interest accruing in each prior bond year with respect to the obligation, reduced by all amounts that became payable with respect to the obligation in prior bond years. Any amount that becomes payable during the 30 day period following any bond year will be deemed to have become payable in such bond year. Thus, to the extent interest on an obligation accruing during a bond year does not become payable within 30 days from the end of such year, it is treated as reinvested under the same terms as the obligation. For purposes of this subparagraph (6), the rate at which such interest accrues is equal to the yield of the obligation. Yield is computed in the same manner as set forth in §1.103–13(c)(1)(ii) for computing yield on governmental obligations (assuming annual compounding of interest). Such computations shall be made without regard to optional call dates.

(7) *Deep discount obligations; special rules.* (i) There are no imputed proceeds with respect to an obligation if—

(*a*) The obligation does not have a stated interest rate (determinable at the date of issue) that increases over the term of the obligation, and

(*b*) The purchase price of the obligation is at least 95 percent of its face amount.

At the option of the issuer, any obligation described in the preceding sentence may be disregarded in computing the imputed proceeds of the issue. Payments with respect to such obligations are also disregarded in determining the amount payable with respect to the issue in that bond year. If each obligation which is part of an issue is described in this subdivision (i), there are no imputed proceeds with respect to the issue.

(ii) If the actual rate at which interest is to accrue over the term of an obligation is indeterminable at the date of issue then, in computing the yield of the obligation for purposes of this paragraph, such rate shall be determined as if the conditions as of the date of issue will not change over the term of the obligation. Thus, for example, if interest on an obligation is to be paid semiannually at a rate equal to 80 percent of the yield on six month Treasury bills at the most recent public sale immediately prior to the corresponding interest payment date and the yield on six month Treasury bills sold immediately preceding the issue date is 10 percent, then the six month Treasury bill rate is deemed to be a constant 10 percent for purposes of determining the amount of imputed proceeds of the issue. Therefore, all interest payments on the obligation would be deemed to be made at a rate of 8 percent.

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

Example (1). State A issues its bonds and plans to use substantially all of the proceeds from such bond issue to purchase land and build a facility which will be used for one of the purposes described in section 103(b)(4) and this section. The arrangement provides that (1) A will issue bonds with a face amount of $21 million and with all accrued interest payable annually, the proceeds of which (after deducting bond election costs, costs of publishing notices, attorneys' fees, printing costs, trustees' fees for fiscal agents, and similar expenses) will be $20 million; (2) $18 million of the proceeds of the bond issue will be used to purchase land and to construct such facility; (3) $2 million of the proceeds will be used for an unrelated facility which will be used by X, a nonexempt person, in a separate trade or business and for a purpose not described in section 103(b) (4) or (5); (4) X will rent both facilities for 20 years at an annual rental equal to the amount necessary to amortize the principal and pay the interest annually on the outstanding bonds; and (5) such payments by X and the facilities will be the security for the bonds. On these facts, substantially all of the proceeds will be used in connection with an exempt facility described in section 103(b)(4) and this section. Accordingly, section 103(b)(1) does not apply to the bonds unless such bonds are thereafter held by a person who is a substantial user of the facilities or a related person within the meaning of section 103(b)(13) and § 1.103–11.

Example (2). On July 1, 1982, State B sells an issue of its obligations to an underwriter in anticipation of a public offering. The initial offering price is $18,627,639.69 of which $17,000,000 is to be used to construct a pollution control facility described in section 103(b)(4)(F). X Corporation, a nonexempt person, is to use the facility and, in exchange, is obligated to pay an amount equal to the face amount of the issue when it becomes due. The obligations are issued on August 1, 1982. The face amount of the issue is $30,000,000. The issue is a term issue with all obligations maturing on August 1, 1987. The issue bears no stated rate of interest; there are no interest coupons on the obligations. The bonds are industrial development bonds with a yield (based upon annual compounding) of ten percent. Based on these facts, the amount of imputed proceeds with respect to the issue is determined as follows:

Date	Purchase price plus accumulated interest	Interest	Imputed proceeds
Aug. 1, 1983	$18,627,639.69	$1,862,763.97	$1,862,763.97
Aug. 1, 1984	20,490,403.68	2,049,040.37	2,049,040.37
Aug. 1, 1985	22,539,444.03	2,253,944.40	2,253,944.40
Aug. 1, 1986	24,793,388.43	2,479,338.84	2,479,338.84
Aug. 1, 1987	27,272,727.27	2,727,272.73	0
Total imputed proceeds			8,645,087.58

Therefore, proceeds of the issue equal $27,272,727.27 less issuance costs. Substantially all of the bond proceeds are not used to provide an exempt facility, and section 103(b)(1) applies to the issue.

Example (3). The facts are the same as example (2) except that the issue has a face amount and purchase price of $18,500,000. The issue also provides for one payment in addition to the redemption payment, in the amount of $10,267,668 payable on or after August 1, 1986, one year before maturity. Section 103(b)(1) applies to the issue.

Example (4). On July 1, 1982, City E sells an issue of industrial development bonds to provide for a convention facility, as described in section 103(b)(4)(C). Assume that the bonds are issued on that date as well. The issue has a face amount of $15,240,000 and a purchase price of $11,929,382.53. The estimated cost of the facility is $11,000,000. The bonds are ''zero coupon'' bonds, *i.e.*, there are no interest coupons. Each series is initially offered for less than 95 percent of its face amount. The issue matures serially over a five year period, with each series being allocated a part of the purchase price of the issue. The following chart indicates the purchase price and yield for each series and debt service for the issue:

[Amount allocable to each series]

Date	1983 series at 8 percent	1984 series at 8.5 percent	1985 series at 8.75 percent	1986 series at 9.25 percent	1987 series at 9.75 percent	Interest accruing on issue*	Amount due	Imputed proceeds
July 1, 1983	2,939,814.82	2,697,020.54	2,468,629.60	2,228.732.51	1,595,185.06	....	....	0
	235,185.18	229,246.75	216,005.09	206,157.76	155,530.54	1,042,125.32	3,175,000	....
July 1, 1984	....	2,926,267.29	2,684,634.69	2,434,890.27	1,750,715.60	....	....	0
	....	248,732.71	234,905.54	225,227.35	170,694.77	879,560.37	3,175,000	....
July 1, 1985	....	....	2,919,540.23	2,660,117.62	1,921,410.37	....	....	0
	....	....	255,459.77	246,060.88	187,337.51	688,858.16	3,175,000	....
July 1, 1986	....	....	....	2,906,178.50	2,108,747.88	....	....	0
	....	....	....	268,821.50	205,602.92	474,424.42	3,175,000	....
July 1, 1987	....	....	....	....	2,314,350.80	....	....	0
	....	....	....	....	225,649.20	225,649.20	2,540,000	....
Total	....	....	....	....	....	....	15,240,000	....

*This column (interest accruing on the issue) contains the sums of the interest that accrues on each series in each bond year. The amount of interest accruing on the issue is computed by adding the amount of interest accruing on each series outstanding for that bond year (the bottom number in the line for each bond year). The amount of interest annually accruing on each series also is added to the purchase price of the series to determine the amount of interest accruing in subsequent years, inasmuch as there are no payments with respect to the outstanding series prior to maturity. Thus, the ''principal'' amount, of the top of the two numbers given in such line for each bond year, is the purchase price allocable to that series plus the amount of interest that accrued on that series in prior years.

There are no imputed proceeds because the amount payable on the issue in each bond year exceeds the total amount of interest accruing on the issue during such bond year. Section 103(b)(1) does not apply to the bonds unless such bonds are held by a person who is a substantial user of the facility or a related person within the meaning of section 103(b)(13) and § 1.103–11.

Example (5). On July 1, 1982, City C issues industrial development bonds in the face amount of $30 million to construct a sports facility described in section 103(b)(4)(B) to be leased to D, a nonexempt person, with payments on the bonds secured by the lease. C receives $30 million in exchange for the bonds which will be used to provide the facility. The bonds mature on July 1, 2002. Each bond provides for an annual interest payment equal to ten percent of the face amount of the bond, with the last payment thereon (on July 1, 2002) including a return of the principal amount of the bond. The proceeds of the issue are $30 million. Section 103(b)(1) does not apply to the bonds unless such bonds are held by a person who is a substantial user of the facility or a related person within the meaning of section 103(b)(13) and § 1.103–11.

Example (6). The facts are the same as example (5) except that each bond provides for an annual interest payment equal to nine percent of its face amount and is sold with the option to tender the bond to D for purchase at par 5 years after the sale date of July 1, 1982 (*i.e.*, the bonds are sold with a ‘‘put’’ option). Such bonds also provide a put option annually thereafter. There are no imputed proceeds (without regard to § 1.103–8(a)(7)), and the result is the same as example (5).

Example (7). On July 1, 1982, City F sells an issue of industrial development bonds in the face amount of $20 million to acquire a parking facility as described in section 103(b)(4)(D). The estimated cost of the facility is $17,800,000. The issue is issued on the same date and will mature serially over the following ten years. Each bond that is part of the issue bears annual interest coupons, each of which is in an amount equal to ten percent of the face amount of the bond. Each maturity has a face amount of $2,000,000. The issue is initially offered to the public for $19,700,000, allocable to each maturity as follows:

Maturity	Purchase price
July 1, 1983	$1,990,000
July 1, 1984	$1,980,000
July 1, 1985	$1,980,000
July 1, 1986	$1,970,000
July 1, 1987	$1,970,000
July 1, 1988	$1,970,000
July 1, 1989	$1,960,000
July 1, 1990	$1,960,000
July 1, 1991	$1,960,000
July 1, 1992	$1,960,000

Based on the foregoing issue proceeds equal $19,700,000 less issuance costs. There are no imputed proceeds with respect to this issue inasmuch as each bond pays interest at a constant rate in each bond year and the purchase price of each bond is at least 95 percent of its face amount. Substantially all of the proceeds are to be used to provide the exempt facility. Accordingly, section 103(b)(1) does not apply to the bonds unless such bonds are thereafter held by a person who is a substantial user of the facility or a related person within the meaning of section 103(b)(13) and § 1.103–11.

(b) *Residential rental property*—(1) *General rule for obligations issued after April 24, 1979.* Section 103(b)(1) shall not apply to any obligation which is issued after April 24, 1979, and is part of an issue substantially all of the proceeds of which are to be used to provide a residential rental project in which 20 percent or more of the units are to be occupied by individuals or families of low or moderate income (as defined in paragraph (b)(8)(v) of this section). In the case of a targeted area project, the minimum percentage of units which are to be occupied by individuals of low or moderate income is 15 percent. See generally § 1.103–7 for rules relating to refunding issues.

(2) *Registration requirement.* Any obligation (including any refunding obligation) issued after December 31, 1981, to provide a residential rental project must be issued as part of an issue, each obligation of which is in registered form (as defined in paragraph (b)(8)(ii) of this section).

(3) *Transitional rule.* For purposes of this section, obligations issued after April 24, 1979, may be treated as issued before April 25, 1979, if the transitional requirements of section 1104 of the Mortgage Subsidy Bond Tax Act of 1980 (94 Stat. 2670) are satisfied.

(4) *Residential rental project.* (i) *In general.* A residential rental project is a building or structure, together with any functionally related and subordinate facilities, containing one or more similarly constructed units—

(*a*) Which are used on other than a transient basis, and (*b*) Which satisfy the requirements of paragraph (b)(5)(i) of this section and are available to members of the general public in accordance with the requirement of paragraph (a)(2) of this section.

Substantially all of each project must contain such units and functionally related and subordinate facilities. Hotels, motels, dormitories, fraternity and sorority houses, rooming houses, hospitals, nursing homes, sanitariums, rest homes, and trailer parks and courts for use on a transient basis are not residential rental projects.

(ii) *Multiple buildings.* (*a*) Proximate buildings or structures (hereinafter ''buildings'') which have similarly constructed units are treated as part of the same project if they are owned for Federal tax purposes by the same person and if the buildings are financed pursuant to a common plan.

(*b*) Buildings are proximate if they are located on a single tract of land. The term ''tract'' means any parcel or parcels of land which are contiguous except for the interposition of a road, street, stream or similar property. Otherwise, parcels are contiguous if their boundaries meet at one or more points.

(*c*) A common plan of financing exists if, for example, all such buildings are provided by the same issue or several issues subject to a common indenture.

(iii) *Functionally related and subordinate facilities.* Under paragraph (a)(3) of this section, facilities that are functionally related and subordinate to residential rental projects include facilities for use by the tenants, for example, swimming pools, other recreational facilities, parking areas, and other facilities which are reasonably required for the project, for example, heating and cooling equipment, trash disposal equipment or units for resident managers or maintenance personnel.

(iv) *Owner-occupied residences.* For purposes of section 103 (b)(4)(A) and this paragraph (b), the term ''residential rental project'' does not include any building or structure which contains fewer than five units, one unit of which is occupied by an owner of the units.

(5) *Requirement must be continuously satisfied*—(i) *Rental requirement.* Once available for occupancy, each unit (as defined in paragraph (b)(8)(i) of this section) in a residential rental project must be rented or available for rental on a continuous basis during the longer of—

(*a*) The remaining term of the obligation, or

(*b*) The qualified project period (as defined in paragraph (b)(7) of this section).

(ii) *Low or moderate income occupancy requirement.* Individuals or families of low or moderate income must occupy that percentage of completed units in such project applicable to the project under paragraph (b)(1) of this section continuously during the qualified project period. For this purpose, a unit occupied by an individual or family who at the commencement of the occupancy is of low or moderate income is treated as occupied by such an individual or family during their tenancy in such unit, even though they subsequently cease to be of low or moderate income. Moreover, such unit is treated as occupied by an individual or family of low or moderate income until reoccupied, other than for a temporary period, at which time the character of the unit shall be redetermined. In no event shall such temporary period exceed 31 days.

(6) *Effect of post-issuance noncompliance*—(i) *In general.* Unless corrected within a reasonable period, noncompliance with the requirements of this paragraph (b) shall cause the project to be treated as other than a project described in section 103 (b)(4)(A) and this paragraph (b) as of the date of issue. After an issue to provide such project ceases to qualify, subsequent conformity with the requirements will not alter the taxable status of such issue.

(ii) *Correction of noncompliance.* If the issuer corrects any noncompliance arising from events occurring after the issuance of the obligation within a reasonable period, such noncompliance (*e.g.,* an unauthorized sublease) shall not cause the project to be a project not described in this paragraph (b). A reasonable period is at least 60 days after such error is first discovered or would have been discovered by the exercise of reasonable diligence.

(iii) *Involuntary loss.* (*a*) The requirements of paragraph (b) shall cease to apply to a project in the event of involuntary noncompliance caused by fire, seizure, requisition, foreclosure, transfer of title by deed in lieu of foreclosure, change in a Federal law or an action of a Federal agency after the date of issue which prevents an issuer from enforcing the requirements of this paragraph, or condemnation or similar event but only if, within a reasonable period, either the obligation used to provide such project is retired or amounts received as a consequence of such event are used to provide a project which meets the requirement of section 103 (b)(4)(A) and this paragraph (b).

(*b*) The provisions of paragraph (b)(6)(iii)(*a*) of this section shall cease to apply to a project subject to foreclosure, transfer of title by deed in lieu of foreclosure or similar event if, at anytime during that part of the qualified project period subsequent to such event, the obligor on the acquired purpose obligation (as defined in § 1.103–13(b)(4)(iv)(*a*)) or a related person (as defined in § 1.103–10(e)) obtains an ownership interest in such project for tax purposes.

(7) *Qualified project period.* The term ''qualified project period'' means—

(i) For obligations issued after April 24, 1979, and prior to September 4, 1982, a period of 20 years commencing on the later of the date that the project becomes available for occupancy or the date of issue of the obligations. The requirement of paragraph (b)(5)(ii) of this section shall be deemed met if the owner of the project contracts with a Federal or state agency to maintain at least 20 percent (or 15 percent in the case of targeted areas) of the units for low or moderate income individuals or families (as defined in paragraph (b)(8)(v) of this section) for 20 years in consideration for rent subsidies for such individuals or families for such period.

(ii) For obligations issued after September 3, 1982, a period beginning on the later of the first day on which at least 10 percent of the units in the project are first occupied or the date of issue of an obligation described in section 103(b)(4)(A) and this paragraph and ending on the later of the date—

(*a*) Which is 10 years after the date on which at least 50 percent of the units in the project are first occupied,

(*b*) Which is a qualified number of days after the date on which any of the units in the project is first occupied, or

(*c*) On which any assistance provided with respect to the project under section 8 of the United States Housing Act of 1937 terminates.

For purposes of this paragraph (b)(7)(ii), the term ''qualified number of days'' means 50 percent of the total number of days comprising the term of the obligation with the longest maturity in the issue used to provide the project. In the case of a refunding of such an issue, the longest maturity is equal to the sum of the period the prior issue was outstanding and the longest term of any refunding obligations.

(8) *Other definitions.* For purposes of this paragraph—

(i) *Unit.* The term ''unit'' means any accommodation containing separate and complete facilities for living, sleeping, eating, cooking, and sanitation. Such accommodations may be served by centrally located equipment, such as air conditioning or heating. Thus, for example, an apartment containing a living area, a sleeping area, bathing and sanitation facilities, and cooking facilities equipped with a cooking range, refrigerator, and sink, all of which are separate and distinct from other apartments, would constitute a unit.

(ii) *In registered form.* The term ''in registered form'' has the same meaning as in section 6049. With respect to obligations issued after December 31, 1982, such term shall have the same meaning as prescribed in section 103(j) (including the regulations thereunder).

(iii) *Targeted area project.* The term ''targeted area project'' means a project located in a qualified census tract (as defined in § 6a.103A–2(b)(4)) or an area of chronic economic distress (as defined in § 6a.103A–2(b)(5)).

(iv) *Building or structure.* The term ''building or structure'' generally means a discrete edifice or other manmade construction consisting of an independent foundation, outer walls, and roof. A single unit which is not an entire building but is merely a part of a building is not a building or structure within the meaning of this section. As such, while single townhouses are not buildings if their foundation, outer walls, and roof are not independent, detached houses and rowhouses are buildings.

(v) *Low or moderate income.* Individuals and families of low or moderate income shall be determined in a manner consistent with determinations of lower income families under section 8 of the United States Housing Act of 1937, as amended, except that the percentage of median gross income which qualifies as low or moderate income shall be 80 percent. Therefore, occupants of a unit are considered individuals or families of low or moderate income only if their adjusted income (computed in the manner prescribed with §1.167(k)–3(b)(3)) does not exceed 80 percent of the median gross income for the area. Notwithstanding the foregoing, the occupants of a unit shall not be considered to be of low or moderate income if all the occupants are students (as defined in section 151(e)(4)), no one of whom is entitled to file a joint return under section 6013. The method of determining low or moderate income in effect on the date of issue will be determinative for such issue, even if such method is subsequently changed. In the event programs under section 8(f) of the Housing Act of 1937, as amended, are terminated prior to the date of issue, the applicable method shall be that in effect immediately prior to the date of such termination.

(9) *Examples.* The following examples illustrate the application of this paragraph (b).

Example (1). In August 1982, City X issues $10 million of registered bonds with a term of 20 years to be used to finance the construction of an apartment building to be available to members of the general public. X loans the proceeds of the bonds to Corporation M, the tax owner of the project. The loan is secured by a promissory note from M and a mortgage on the project. The mortgage requires annual payments sufficient to amortize the principal and interest on the bonds. Corporation M maintains 20 percent of the units in the project for low or moderate income individuals and meets all of the requirements of this section until 2002, at which time M converts the project to offices. The bonds are industrial development bonds, but because the proceeds are used for construction of residential rental property, which is an exempt facility under section 103(b)(4)(A) and paragraph (b) of this section, section 103(b)(1) does not apply.

Example (2). The facts are the same as in example (1), except that the building is constructed adjacent to a factory, and the factory employees are to be given preference in selecting tenants. The bonds are industrial development bonds and the facility is not an exempt facility under section 103(b)(4)(A) and paragraph (b) of this section because it is not a facility constructed for use by the general public.

Example (3). The facts are the same as in example (1), except that the proceeds of the obligation are provided to N, a cooperative housing corporation, to finance the construction of a cooperative housing project. N sells stock in such cooperative to shareholders, some of whom occupy the units in the cooperative and some of whom rent the units to other persons. Such project is not a residential rental project within the meaning of section 103(b)(4)(A) and §1.103–8(b) because less than all of the units in the building are used for rental. Further, the bonds are mortgage subsidy bonds under section 103A because more than a significant portion of the proceeds are used to provide financing for residences, some of which are owner-occupied and some of which are used in the trade or business of rental.

Example (4). On February 1, 1984, County Z issues registered obligations with a term of 3 years and loans the proceeds to Corporation V to construct a garden apartment project for tenants who are 65 years or older. The mortgage on the project secures the loan. At the end of 3 years, V obtains permanent financing for the project from a commercial lender. The project is not a targeted area project. V has not contracted with any Federal or State agency to provide rental assistance under section 8 of the United States Housing Act of 1937. As a condition for providing financing for construction, Z requires that the deed to the project contain a covenant that requires the project be used for elderly tenants and restricts occupancy of 20 percent of the units in the project to individuals or families of low or moderate income. Further, the deed provides that ‘‘Such covenant shall run with and bind the land, from the date that ten percent of the units in the project are first occupied until ten years after the date that at least half the units are first occupied. The right to enforce these restrictions is vested in County Z.’’ In 1990, however, less than 20 percent of the units are occupied by families or individuals of low or moderate incomes, and three months after learning of this condition County Z had not commenced enforcement of the covenant. Although on the date of issue the proceeds of the obligation were used to provide a residential rental project, the obligation will not be treated as providing a residential rental project within the meaning of section 103(b)(4)(A) as of February 1, 1984, because the project did not meet the requirements of this paragraph for at least 10 years after at least 50 percent of the units are first occupied.

Example (5). On January 15, 1983, State X issues registered obligations with a term of 15 years, the proceeds of which are loaned to Corporation P to construct an apartment building. The project will be a ''targeted area project'', within the meaning of § 1.103–8(b)(8)(iii). Corporation P intends to rent all the units to individuals for their residences, maintaining 15 percent of the units in the project for individuals having low or moderate incomes, for 15 years. In 1988, however, Corporation P converts 80 percent of the units to condominiums. Corporation P repays the loan to State X which, in turn, redeems the obligations. The obligations are not used to provide a residential rental project within the meaning of section 103(b)(4)(A), and all the interest paid or to be paid on such obligations will be includable in gross income.

Example (6). On January 15, 1984, State Z issues registered obligations with a term of 15 years the proceeds of which will be used to acquire and renovate a residential apartment building. Z sells the project to Corporation U and receives a 30-year mortgage. On June 1, 1985, the first occupants of the project commence their tenancies. At least 50 percent of the units in the project are occupied on July 1, 1985. On January 15, 1988, Z issues 35-year refunding bonds the proceeds of which are used to retire the obligations issued in 1984. The prior issue will be discharged by March 15, 1988. In order to meet the requirement of § 1.103–8(b)(5)(ii), at least 20 percent of such units must be occupied by individuals of low or moderate income until January 1, 2005.

Example (7). The facts are the same as in example (6) except that in 1987, the apartment building is substantially destroyed by fire. The building was insured at its fair market value. U does not intend to reconstruct the building but uses a portion of the insurance proceeds to repay the unpaid balance of the mortgage. Z uses this amount to redeem the outstanding bonds at the first available call date. Since the project was substantially destroyed by fire and the outstanding bonds are retired at the first available call date, the requirements of section 103(b)(4)(A) and this paragraph (b) are satisfied with respect to the obligations.

Example (8). The facts are the same as in example (6) except that in 1987 U defaults on the mortgage, and Z obtains title to the project without instituting foreclosure proceedings. Z sells the project to S and uses the proceeds to retire the outstanding bonds. Since S did not obtain the project with obligations described in section 103(b)(4), S is not required to meet the requirements of section 103(b)(4)(A) and this paragraph. Further, the 1984 obligations are obligations described in section 103(b)(4)(A).

Example (9). In September 1983, State W issues $10 million of registered bonds with a term of 3 years, the proceeds of which are to be loaned to Corporation V to finance the construction of an apartment building in a rural community. At the end of 3 years, V obtains permanent financing from Federal Agency T. Agency T will not allow the deed to contain any restrictive covenant relating to the use of the project. Under Federal law, however, T requires that V maintain all of the units in the project for rental to low-income farmworkers for the term of the mortgage, which is 20 years. Further, the mortgage between T and V provides that if T determines that low-income housing is no longer required in the community in which the project is constructed then the repayment of the mortgage may be accelerated. T determines as of the date of issue that low-income housing will be needed in the community for at least 20 years. In 1987, the project fails to meet the requirements of section 1.103–8(b)(5)(ii), relating to occupancy by individuals or families of low or moderate income. Further, T does not require V to correct the failure. Based on the foregoing, the bonds issued by W will be treated as described in section 103(b)(4)(A).

Example (10). The facts are the same as in example (9) except that in 1987, the Federal law is amended to provide that Agency T may not enforce its low-income occupancy requirement. The result is the same.

Example (11). The facts are the same as in example (9) except that in 1987 Agency T determines that due to a change in circumstances in the community in which the project is located low-income rental housing is no longer required. As such, T requires V to repay the mortgage. Since the obligations have been repaid, W has no legal right to enforce the requirements of paragraph (b) with respect to the project. Subsequent nonconformity of the project with the requirements of § 1.103–8(b) under these circumstances will not cause the obligations issued by W to be industrial development bonds within the meaning of section 103(b)(1).

(10) *Obligations issued before April 25, 1979*—(i) *General rules.* Section 103(b)(1) shall not apply to obligations issued before April 25, 1979, which are part of an issue substantially all of the proceeds of which are to be used to provide residential real property for family units. In order to qualify under this

paragraph (b) as an exempt facility, the facility must satisfy the public use requirement of paragraph (a)(2) of this section by being available for use by members of the general public.

(ii) *Family units defined.* For purposes of this paragraph (b) the term ‘‘family unit’’ means a building or any portion thereof which contains complete living facilities which are to be used on other than a transient basis by one or more persons, and facilities functionally related and subordinate thereto. Thus, an apartment which is to be used on other than a transient basis as a residence by a single person or by a family and which contains complete facilities for living, sleeping, eating, cooking, and sanitation, constitutes a family unit. Such a unit may be served by centrally located machinery and equipment as in a typical apartment building. To qualify as a family unit, the living facilities must be a separate, self-contained building or constitute one unit in a building substantially all of which consists of similar units, together with functionally related and subordinate facilities and areas. Hotels, motels, dormitories, fraternity and sorority houses, rooming houses, hospitals, sanitariums, rest homes, and trailer parks and courts for use on a transient basis do not constitute residential real property for family units.

(iii) *Functionally related and subordinate facilities.* Under paragraph (a)(3) of this section, facilities which are functionally related and subordinate to residential real property actually used for family units include, for example, facilities for use by the occupants such as a swimming pool, a parking area, and recreational facilities.

(c) *Sports facilities*—(1) *General rule.* Section 103(b)(4)(B) provides that section 103(b)(1) shall not apply to obligations issued by a State or local governmental unit which are part of an issue substantially all of the proceeds of which are to be used to provide sports facilities. In order to qualify as an exempt facility under section 103(b)(4)(B) and this paragraph, the facility must satisfy the public use requirement of paragraph (a)(2) of this section by being available for use by members of the general public either as participants or as spectators.

(2) *Sports facility defined.* (i) For purposes of section 103(b)(4)(B) and this paragraph, the term ‘‘sports facilities’’ includes both outdoor and indoor facilities. The facility may be designed either as a spectator or as a participation facility. For example, the term includes both indoor and outdoor stadiums for baseball, football, ice hockey, or other sports events, as well as facilities for the participation of the general public in sports activities, such as golf courses, ski slopes, swimming pools, tennis courts, and gymnasiums. The term does not include, however, facilities such as a golf course, swimming pool, or tennis court, which are constructed for use by members of a private club or as integral or subordinate parts of a hotel or motel, or the use of which will be restricted to a special class or group or to guests of a particular hotel or motel, since they are not facilities for the use of the general public as required by paragraph (a)(2) of this section.

(ii) Under paragraph (a)(3) of this section, facilities which are functionally related and subordinate to a sports facility, such as a parking lot, clubhouse, ski slope warming house, bath house, or ski tow, are considered to be part of a sports facility. A ski lodge which consists primarily of overnight accommodations is not functionally related and subordinate to a sports facility.

(d) *Convention or trade show facilities*—(1) *General rule.* Section 103(b)(4)(C) provides that section 103(b)(1) shall not apply to obligations issued by a State or local governmental unit which are a part of an issue substantially all of the proceeds of which are to be used to provide convention or trade show facilities. In order to qualify under section 103(b)(4)(C) and this paragraph as an exempt facility, the facility must satisfy the public use requirement of paragraph (a)(2) of this section by being available for an appropriate charge or rental, on a rate scale basis, for use by members of the general public. The public use requirement is not satisfied if the use of a convention or trade show facility is limited by long-term leases to a single user or group of users.

(2) *Convention or trade show facilities defined.* For purposes of section 103(b)(4)(C) and this paragraph, the

term ‘‘convention or trade show facilities’’ means special-purpose buildings or structures, such as meeting halls and display areas, which are generally used to house a convention or trade show, including, under paragraph (a)(3) of this section, facilities functionally related and subordinate to such facilities such as parking lots or railroad sidings. A hotel or motel which is available to the general public, whether or not it is intended primarily to house persons attending or participating in a convention or trade show, is neither a convention or trade show facility nor functionally related and subordinate thereto.

(e) *Certain transportation facilities*—(1) *General rule.* Section 103(b)(4)(D) provides that section 103(b)(1) shall not apply to obligations issued by a State or local governmental unit which are part of an issue substantially all of the proceeds of which are to be used to provide (i) airports, docks, wharves, mass commuting facilities, or public parking facilities, or (ii) storage or training facilities directly related to any such facility. In order to qualify under section 103(b)(4)(D) and this paragraph as an exempt facility, the facility must satisfy the public use requirement of paragraph (a)(2) of this section by being available for use by members of the general public or for use by common carriers or charter carriers which serve members of the general public. A dock or wharf which is part of a public port (or a public port to be constructed in accordance with a plan which has been finally adopted on the date the obligations in question are issued) satisfies the public use test. A parking lot will be available for use by the general public unless more than an insubstantial portion thereof will be used exclusively by or for the benefit of a nonexempt person by reason of a formal or informal agreement or by reason of the remote geographic location of the facility.

(2) *Definitions.* For purposes of section 103(b)(4)(D) and this paragraph—

(i) With respect to bonds sold at or before 5:00 p.m. EST on December 29, 1978, an airport includes service accommodations for the public such as terminals, retail stores in such terminals, runways, hangars, loading facilities, repair shops, parking areas, and facilities which, under paragraph (a)(3) of this section, are functionally related and subordinate to the airport, such as facilities for the preparation of in-flight meals, restaurants, and accommodations for temporary or overnight use by passengers, and other facilities functionally related to the needs or convenience of passengers, shipping companies, and airlines. The term ‘‘airport’’ does not include a landing strip which, by reason of a formal or informal agreement, or by reason of geographic location, will not be available for general public use.

(ii) With respect to bonds sold after 5:00 p.m. EST on December 29, 1978—

(*a*) An airport includes facilities which are directly related and essential to—

(*1*) Servicing aircraft or enabling aircraft to take off and land, or

(*2*) Transferring passengers or cargo to or from aircraft.

A facility does not satisfy either of the foregoing requirements if the facility need not be located at, or in close proximity to, the take-off and landing area in order to perform its function. Examples of facilities which satisfy those requirements are terminals, runways, hangars, loading facilities, repair shops, and land-based navigation aids such as radar installation.

(*b*) Under paragraph (a)(3) of this section, an airport includes facilities other than those described in paragraph (e)(2)(ii)(*a*) only if they are functionally related and subordinate to an airport (as defined in paragraph (e)(2)(ii)(*a*)). A facility (or part thereof) is not functionally related and subordinate to an airport if the facility (or part thereof)—

(*1*) Is not of a character and size commensurate with the character and size of the airport at or adjacent to which the facility is located, or

(*2*) Is not located at or adjacent to that airport.

A facility may satisfy the character and size requirement although it provides minimal benefits to other airports. For example, a facility for the preparation of in-flight meals which has capacity sufficient to prepare all in-flight meals for aircraft departing the airport where the facility is located qualifies although some meals may be consumed in transit between other airports. Other examples of facilities functionally related and subordinate to an airport are restaurants and retail stores located in terminals, ground transportation parking areas, and accommodations for temporary or overnight use by passengers. Unimproved land (including agricultural land) that is adjacent to an airport and that is impaired by a significant level of airport noise is functionally related and subordinate to the airport if after its acquisition that land will not be converted to a use that is incompatible with the level of airport noise. Adjacent land with existing improvements also may be functionally related and subordinate to an airport by reason of impairment by a significant level of airport noise but only if the use of such land before its acquisition is incompatible with the airport noise level, its use after acquisition is to be compatible, and the post-acquisition use will be essentially different from the pre-acquisition use. Notwithstanding the foregoing, an interest in such improved land acquired solely to mitigate damages attributable to airport noise is treated as functionally related and subordinate to the airport. Thus, for example, amounts allocated to imposing a servitude on improved land adjacent to an airport restricting its future use to uses compatible with airport noise are treated as amounts allocated to property functionally related and subordinate to an airport. For the purpose of determining whether land is impaired by a significant level of airport noise, any generally accepted noise estimating methodology may be used. For example, a Noise Exposure Forecast (NEF), a method for composite noise rating recommended by the Federal Aviation Administration to measure the impact of airport noise, may be used for this purpose. Compatibility may be determined by reference to regulations or general guidelines published by the Federal Aviation Administration under section 102 of the Aviation Safety and Noise Abatement Act of 1979 (49 U.S.C. 2102), or sections 11(3)(C) and 18(a)(4) of the Airport and Airway Development Act of 1970, as amended (49 U.S.C. 1711(3)(C) and 1718(a)(4)), concerning uses of land impaired by a significant level of airport noise, or, where available, by reference to the airport compatibility plan specifically addressing what constitutes a compatible use of that land.

(*c*) As an illustration of the rules of this paragraph (e)(2)(ii), an office building (or office space within a building) or a computer facility, either of which serves a system-wide or regional function of an airline, is not considered part of an airport since that facility is not described in either paragraph (e)(2)(ii)(*a*) or (*b*). However, a maintenance or overhaul facility which services aircraft is considered part of an airport under paragraph (e)(2)(ii)(*a*) since that facility is directly related and essential to servicing aircraft and must be located where aircraft take off and land in order to perform its function.

(*d*) A hotel located at or adjacent to an airport satisfies the requirements of paragraph (e)(2)(ii)(*b*), that is, it is of a character and size commensurate with the character and size of the airport at or adjacent to which it is located, if the number of guest rooms in the hotel is reasonable for the size of the airport, taking into account the current and projected passenger usage of the terminal facility. If the hotel contains meeting rooms, the number and size of these rooms must be in reasonable proportion to the number of guest rooms in the hotel. Limited recreational facilities will not prevent the hotel from being of a character and size commensurate with the character and size of the airport.

(iii) A dock or wharf includes property which, under paragraph (a)(3) of this section, is functionally related and subordinate to a dock or wharf such as the structure alongside which a vessel docks, the equipment needed to receive and to discharge cargo and passengers from the vessel, such as cranes and conveyors, related storage, handling, office, and passenger areas, and similar facilities.

(iv) A mass commuting facility includes real property together with improvements and personal property used therein, such as machinery, equipment, and furniture, serving the general public commuting on a day-to-day basis by bus, subway, rail, ferry, or other conveyance which moves over prescribed routes. Such property also includes terminals and facilities which, under paragraph (a)(3) of this section, are functionally related and subordinate to the mass commuting facility, such as parking garages, car barns, and repair shops. Use of mass commuting facilities by noncommuters in common with commuters is immaterial. Thus, a terminal leased to a common carrier bus line which serves both commuters and long distance travelers would qualify as an exempt facility.

(3) *Related storage or training facility.* Section 103 (b)(4)(D) includes only those storage and training facilities which are both (i) directly related to a facility to which subparagraph (1)(i) or (ii) of this paragraph applies and (ii) physically located on or adjacent to such a facility. For example, a storage facility would include a grain elevator, silo, warehouse, or oil and gas storage tank used in connection with a dock or wharf and located on or adjacent to such dock or wharf. Similarly, a training facility would include a building located at or adjacent to an airport for the training of flight personnel or a paved area immediately adjoining a bus garage used to train bus drivers.

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

Example (*1*). B Airport Authority, a political subdivision of State A, owns and operates B Airport. B Airport Authority adds several runways. In view of the expanded area impaired by significant levels of airport noise, the Authority proposes to issue bonds the proceeds of which are to be used to acquire a hospital located adjacent to the airport. The noise level on the acquired property is 40 NEF. By reference to a noise exposure map setting forth noncompatible land uses and by reference to guidelines published by the Federal Aviation Administration, it is established that continued use of the land for a hospital is not compatible with the noise level. Prior to issuing the bonds, B contracts to lease the property to Corporation C to be used for warehouse space. Within 18 months of the bonds' issuance C will remodel the hospital (previously owned by D, who is unrelated to C) with its own funds and rent the facility as a warehouse. Use as a warehouse is determined to be compatible with the level of airport noise impairing the land. The improved land and prospective revenues from the facility's rental are security for the proposed issuance. Based on the foregoing, the acquired land satisfies the public use test. Furthermore, it is functionally related and subordinate to the airport because the improvements are to be used in an essentially different manner than prior to the land's acquisition. The bonds are industrial development bonds. However, section 103(b)(1) does not apply unless the provisions of section 103(b)(13) and § 1.103–11 apply.

Example (*2*). The facts are the same as in Example (1) except that a substantial portion of the proceeds of the bond issue is allocated to the acquisition of a limited interest in an additional tract of land (also impaired by airport noise measured at 40 NEF) on which an office building stands. The limited interest holds B harmless for damages caused by airport noise and restricts uses of the tract after the building is retired to those compatible with noise levels caused by the airport. Based on the foregoing, such interest satisfies the public use test. Furthermore, the interest is functionally related and subordinate to the airport because it is solely to mitigate damage attributable to airport noise, in part by restricting future land uses. The bonds are industrial development bonds. However, section 103(b)(1) does not apply unless the provisions of section 103(b)(13) or § 1.103–11 apply.

Example (3). On June 1, 1982, M Airport Authority, a political subdivision of State O, issues obligations, the proceeds of which are loaned to X Corporation, a nonexempt person. X uses the proceeds to construct a hotel adjacent to the main terminal building at M Airport. X will be unconditionally liable for repayment of the proposed obligations. The hotel will be used to provide temporary and overnight accommodations for airline passengers using M Airport. The number of rooms in the hotel is reasonable for an airport of M's size, taking into account the current and projected passenger usage of the terminal facility. In addition to guest rooms, the hotel will contain a restaurant, small retail stores (such as a gift shop and newstand), and limited recreation facilities (such as a swimming pool). The hotel will also contain several multipurpose rooms suitable for use as meeting rooms. The number and size of these rooms will be in reasonable proportion to the number and size of the guest rooms in the hotel. Use of the guest rooms, restaurant and stores, recreational facilities, and meeting rooms by air passengers arriving at or departing from M Airport will be incidental to the use of the hotel by air passengers for temporary and overnight accommodations. The hotel is of a character and size commensurate with the character and size of M Airport. Consequently, applying the provisions of § 1.103–8(e)(2), the hotel is functionally related and subordinate to M Airport. The obligations are industrial development bonds. Section

103(b)(1) does not apply to the obligations, however, unless the provisions of section 103(b)(10) and §1.103–11 apply.

Example (4). On June 1, 1982, N Airport Authority, a political subdivision of State P, issues obligations the proceeds of which are loaned to Y Corporation, a nonexempt person. Y uses the proceeds to construct a hotel adjacent to the main terminal building at N Airport. Y Corporation will be unconditionally liable for repayment of the proposed obligations. The hotel will contain extensive recreational facilities, including a large roof-top swimming pool, tennis courts, and a health club. In addition, facilities for conferences consisting of a ballroom-sized meeting room capable of being partitioned by movable panels and several smaller meeting rooms will be constructed. The number of rooms in the hotel will substantially exceed the number which is reasonably based on the current and projected passenger usage of the terminal facility. Because of the presence of extensive recreational and conference facilities, as well as the presence of on excessive number of rooms at the hotel, the hotel fails to be of a character and size commensurate with the character and size of N Airport. The result would be the same if the hotel did not have extensive recreational facilities. Consequently, the hotel is not functionally related and subordinate to N Airport under §1.103–8(e)(2). The obligations are industrial development bonds and interest thereon is not excluded from gross income by reason of subsection (a)(1) or (b)(4) of section 103.

(f) *Certain public utility facilities*—(1) *General rule.* (i) Section 103(b)(4)(E) provides that section 103(b)(1) shall not apply to obligations issued by a State or local governmental unit which are part of an issue substantially all of the proceeds of which are to be used to provide sewage disposal facilities, solid waste disposal facilities, or facilities for the local furnishing of electric energy or gas. In order to qualify under section 103(b)(4)(E) as an exempt facility, the facility must satisfy the public use requirement of paragraph (a)(2) of this section. A public utility facility described in this subparagraph (with the exception of sewage and solid waste disposal facilities which will be treated in all events as serving the general public) will satisfy the public use requirement only if such facility, or the output thereof, is available for use by members of the general public.

(ii) A facility for the local furnishing of electric energy or gas is, for purposes of applying the public use test in paragraph (a)(2) of this section, available for use by members of the general public if *(a)* the owner or operator of the facility is obligated, by a legislative enactment, local ordinance, regulation, or the equivalent thereof, to furnish electric energy or gas to all persons who desire such services and who are within the service area of the owner or operator of such facility, and *(b)* it is reasonably expected that such facility will serve or be available to a large segment of the general public in such service area. For rules with respect to facilities for the furnishing of water, see paragraph (h) of this section.

(2) *Definitions.* For purposes of section 103(b)(4)(E) and this paragraph—

(i) The term ‘‘sewage disposal facilities’’ means any property used for the collection, storage, treatment, utilization, processing, or final disposal of sewage.

(ii)*(a)* The term ‘‘solid waste disposal facilities’’ means any property or portion thereof used for the collection, storage, treatment, utilization, processing, or final disposal of solid waste. Only expenditures for that portion of property which is a solid waste disposal facility qualify as expenditures for solid waste disposal facilities. The fact that a facility which otherwise qualifies as a solid waste disposal facility operates at a profit will not, of itself, disqualify the facility as an exempt facility. However, whether a collection or storage facility qualifies as a solid waste disposal facility depends upon all of the facts and circumstances. Thus, land and facilities for the collection of materials to form a slag heap which is not preliminary to the recycling or other final disposal of such materials within a reasonable period of time will not qualify. The term does not include facilities for collection, storage, or disposal of liquid or gaseous waste except where such facilities are facilities which, under paragraph (a)(3) of this section, are functionally related and subordinate to a solid waste disposal facility.

(b) The term ‘‘solid waste’’ shall have the same meaning as in section 203(4) of the Solid Waste Disposal Act (42 U.S.C. 3252(4)), except that for purposes of this paragraph, material will not qualify as solid waste unless, on the date of issue of the obligations issued

to provide the facility to dispose of such waste material, it is property which is useless, unused, unwanted, or discarded solid material, which has no market or other value at the place where it is located. Thus, where any person is willing to purchase such property, at any price, such material is not waste. Where any person is willing to remove such property at his own expense but is not willing to purchase such property at any price, such material is waste. Section 203(4) of the Solid Waste Disposal Act provides that:

> (4) The term ''solid waste'' means garbage, refuse, and other discarded solid materials, including solid-waste materials resulting from industrial, commercial, and agricultural operations, and from community activities, but does not include solids or dissolved material in domestic sewage or other significant pollutants in water resources, such as silt, dissolved or suspended solids in industrial waste water effluents, dissolved materials in irrigation return flows or other common water pollutants.

(c) A facility which disposes of solid waste by reconstituting, converting, or otherwise recycling it into material which is not waste shall also qualify as a solid waste disposal facility if solid waste (within the meaning of *(b)* of this subdivision (ii) constitutes at least 65 percent, by weight or volume, of the total materials introduced into the recycling process. Such a recycling facility shall not fail to qualify as a solid waste disposal facility solely because it operates at a profit.

(d) For rules relating to property which has both a solid waste disposal function and a function other than the disposal of solid waste, see § 17.1 of this chapter.

(iii) The term ''facilities for the local furnishing of electric energy or gas'' means property which—

(a) Is either property of a character subject to the allowance for depreciation provided in section 167 or land,

(b) Is used to produce, collect, generate, transmit, store, distribute, or convey electric energy or gas.

(c) Is used in the trade or business of furnishing electric energy or gas, and

(d) Is a part of a system providing service to the general populace of one or more communities or municipalities, but in no event more than 2 contiguous counties (or a political equivalent) whether or not such counties are located in one State.

For purposes of this subdivision, a city which is not within, or does not consist of, one or more counties (or a political equivalent) shall be treated as a county (or a political equivalent). A facility for the generation of electric energy otherwise qualifying under this subdivision will not be disqualified because it is connected to a system for interconnection with other public utility systems for the emergency transfer of electric energy. The facilities need not be located in the area served by them. Also, the term ''facilities for the local furnishing of electric energy or gas'' does not include coal, oil, gas, nuclear cores, or other materials performing a similar function.

(g) *Air or water pollution control facilities*—(1) *General rule.* Section 103(b)(4)(F) provides that section 103(b)(1) shall not apply to obligations issued by a State or local governmental unit which are part of an issue substantially all of the proceeds of which are to be used to provide air or water pollution control facilities. Such facilities are in all events treated as serving the general public and, thus, satisfy the public use requirement of paragraph (a)(2) of this section.

(2) *Definitions.* (i) For purposes of section 103(b)(4)(F) and this paragraph, property is a pollution control facility to the extent that the test of either subdivision (iii) or (iv) of this subparagraph is satisfied, but only if—

(a) It is property which is described in subdivision (ii) of this subparagraph and is either of a character subject to the allowance for depreciation provided in section 167 or land, and

(b) Either *(1)* a Federal, State, or local agency exercising jurisdiction has certified that the facility, as designed, is in furtherance of the purpose of abating or controlling atmospheric pollutants or contaminants, or water pollution, as the case may be, or *(2)* the facility is designed to meet or exceed applicable Federal, State, and local requirements for the control of atmospheric pollutants or contaminants, or water pollution, as the case may be, in effect at the time the obligations, the proceeds of which are to be used to provide such facilities, are issued.

(ii) Property is described in this subdivision if it is property to be used, in whole or in part, to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, or storing pollutants, contaminants, wastes, or heat. In the case of property to be used to control water pollution, such property includes the necessary intercepting sewers, pumping, power, and other equipment, and their appurtenances. For rules relating to facilities which remove pollutants from fuel or certain other items, see subdivision (vi) of this subparagraph.

(iii) In the case of an expenditure for property which is designed for no significant purpose other than the control of pollution, the total expenditure for such property satisfies the test of this subdivision. Thus, where property which is to serve no function other than the control of pollution is to be added to an existing manufacturing or production facility, the total expenditure for such property satisfies the test of this subdivision. Also, if an expenditure for property would not be made but for the purpose of controlling pollution, and if the expenditure has no significant purpose other than the purpose of pollution control, the total expenditure for such property satisfies the test of this subdivision even though such property serves one or more functions in addition to its function as a pollution control facility.

(iv) In the case of property to be placed in service for the purpose of controlling pollution and for a significant purpose other than controlling pollution, only the incremental cost of such facility satisfies the test of this subdivision. The ‘‘incremental cost’’ of property is the excess of its total cost over that portion of its cost expended for a purpose other than the control of pollution.

(v) An expenditure has a significant purpose other than the control of pollution if it results in an increase in production or capacity, or in a material extension of the useful life of a manufacturing or production facility or a part thereof.

(h) *Water facilities*—(1) *General rule.* Section 103(b)(4)(G) provides that section 103(b)(1) shall not apply to obligations issued by a State or local governmental unit which are part of an issue substantially all of the proceeds of which are to be used to provide facilities for the furnishing of water which are available, on reasonable demand, to members of the general public. A water facility will satisfy the public use test of paragraph (a)(2) of this section if it will provide water, on reasonable demand, to any member of the general public within the service area of the water system of which such facility is a part.

(2) *Definition.* For purposes of section 103(b)(4)(G) and this paragraph, the ‘‘water facilities’’ include artesian wells, reservoirs, dams, related equipment and pipelines, and other facilities used to furnish water for domestic, industrial, irrigation, or other purposes.

(3) *Effective date.* The provisions of this paragraph apply in the case of facilities provided by obligations issued after January 1, 1969. In the case of facilities provided by obligations issued on or before such date to which section 103(b) is applicable, the provisions of paragraph (f) of this section shall apply. For such purposes, wherever the term ‘‘local furnishing of electric energy or gas’’ appears in paragraph (f) of this section, such term shall be deemed to read ‘‘local furnishing of electric energy, gas, or water.’’

(i) *Examples.* The application of section 103(b)(4) and this section are illustrated by the following examples:

Example (1). City B plans to issue $10 million of bonds to be used to construct a sports stadium. The revenues from the facility and the facility itself will be the security for the bonds. A professional football team rents the facility on a long-term leasee for part of the year and a professional baseball team rents the sports facility for the remainder of the year. Tickets are sold by the teams to the general public. The bonds are industrial development bonds, but since the proceeds are used for a spectator facility for general public use, which is an exempt facility under section 103(b)(4)(B) and paragraph (c) of this section, section 103(b)(1) does not apply unless the provisions of section 103(b)(13) and §1.103–11 apply.

Example (2). City C plans to issue $10 million of bonds to be used to construct a convention hall which it will own. City C plans to lease the convention hall for 25 years to corporation Y, a nonexempt person, which will operate and maintain it. The terms of the lease obligate Y to make the convention hall generally available for civic, business, and recreational shows, meetings, performances, and similar activities serving or benefiting the community. Lease payments from Y and the facility will be security for the bonds. The bonds are industrial development bonds, but since the proceeds are to be used for a facility for general public use, which is an exempt facility under section 103(b)(4)(C) and paragraph (d) of this section, section 103(b)(1) does not apply unless the provisions of section 103(b)(13) and § 1.103–11 apply.

Example (3). City D issues $100 million of its bonds and uses the proceeds to finance construction of an airport for the use of the general public. D will own and operate the airport. A major portion of the rentable space in the terminal building is leased on a long-term basis to common carrier and non-scheduled airlines. The bonds will be secured by the airport landing and runway charges and by payments with respect to such long-term leases from such commercial airlines. Such commercial airline payments are expected to constitute more than 50 percent of the total revenues from the airport. The bonds are industrial development bonds, but since the proceeds are to be used for an airport for use by the general public and by carriers serving the general public, which is an exempt facility under section 103(b)(4)(D) and paragraph (e) of this section, section 103(b)(1) does not apply unless the provisions of section 103(b)(13) and § 1.103–11 apply. The result would be the same if D hired an airport management firm to operate the airport.

Example (4). City E issues $6 million of its bonds and uses the proceeds to finance construction of a landing strip for airplanes to be located adjacent to the factories of corporations Y and Z. The landing strip will be used in the trades or businesses of Y and Z and by any member of the general public wishing to use it. However, due to its location, general public use will be negligible. The lease payments by Y and Z for the use of the facility are the security for the bonds. The bonds are industrial development bonds and the facility is not an exempt facility under section 103(b)(4)(D) and paragraph (c) of this section because it is not a facility constructed for general public use.

Example (5). State F and corporation Z enter into an arrangement which provides that F will issue $10 million of its bonds and use the proceeds to construct a facility for Z the only purpose of which is to control air and water pollution at Z's plant. The principal and interest on the bonds will be secured by the charges which F will impose on Z. The bonds are industrial development bonds, but since the proceeds are to be used for air and water pollution facilities designed to abate pollution by private persons, such facilities are for the benefit of the general public and are exempt facilities under section 103(b)(4)(F) and paragraph (g) of this section. Accordingly, section 103(b)(1) does not apply unless the provisions of section 103(b)(13) and § 1.103–11 apply.

Example (6). City G issues $20 million of its bonds and will use $6 million to finance residential rental property which qualifies as an exempt facility under section 103(b)(4)(A) and paragraph (b) of this section, $9 million to finance construction of a stadium which qualifies as an exempt facility under section 103(b)(4)(B) and paragraph (c) of this section, and $5 million for convention facilities which qualify as exempt facilities under section 103(b)(4)(C) and paragraph (d) of this section. The facilities will be used in the trades or businesses of nonexempt persons and rental payments with respect to such facilities and the facilities themselves will be the security for the bonds. The bonds are industrial development bonds, but since all the proceeds are to be used for facilities which are exempt facilities under section 103(b)(4), section 103(b)(1) does not apply unless the provisions of section 103(b)(10) and § 1.103–11 apply. The result would be the same, if; instead of using $9 million to finance construction of a stadium, the $9 million were used to finance construction of a capitol building. [Reg. § 1.103–8].

[T.D. 7199, 37 FR 15490, Aug. 3, 1972]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.103–8, see the List of CFR Sections Affected in the Finding Aids section of this volume.

§ 1.103–9 Interest on bonds to finance industrial parks.

(a) *General rule.* (1) Under section 103(c)(5), interest paid on an issue of obligations issued by a State or local governmental unit (as defined in § 1.103–1) is not includable in gross income if substantially all of the proceeds of such issue is to be used to finance the acquisition or development of land as the site for an industrial park (referred to in this section as ‘‘industrial park bonds’’). However, interest on an obligation of such an issue is includable in gross income if the obligation is held by a substantial user or a related person (as described in section 103(c)(7) and § 1.103–11). If substantially all of the proceeds of a bond issue is to be so used to finance an industrial park, the debt obligations are treated as obligations described in section 103(a)(1) and § 1.103–1 even though such obligations are industrial development bonds within the meaning of section 103(c)(2) and § 1.103–7. Whether substantially all of the proceeds of an issue of governmental obligations are used to finance an industrial park is determined consistently with the rules for exempt facilities in §1.103–8(a)(1)(i).

(2) The provisions of subparagraph (1) of this paragraph shall also apply to an issue of obligations substantially all of the proceeds of which is to be used to acquire or develop land as the site for an industrial park described in section 103(c)(5) and this section and for either or both of the following purposes: (i) To finance exempt facilities described in section 103(c)(4) and §1.103–8, (ii) to finance facilities to be used by an exempt person.

(3) Section 103(c)(5) only becomes applicable where the bond issue meets both the trade or business and the security interest tests so that the obligations are industrial development bonds within the meaning of section 103(c)(2). For the interrelationship of the rules provided in this section and the exemption for certain small issues provided in section 103(c)(6), see §1.103–10.

(b) *Definition of an industrial park.* For purposes of section 103(c)(5) and this section, the term ''industrial park'' means a tract of land, other than a tract of land intended for use by a single enterprise, suitable primarily for use as building sites by a group of enterprises engaged in industrial, distribution, or wholesale businesses if either—

(1) The control and administration of the tract is vested in an exempt person (within the meaning of paragraph (b)(2) of §1.103–7), or

(2) The uses of the tract are normally (i) regulated by protective minimum restrictions, ordinarily including the size of individual sites, parking and loading regulations, and building setback lines, and (ii) designed to be compatible, under a comprehensive plan, with the community in which the industrial park is located and with the uses of the surrounding land.

(c) *Development of land defined.* For purposes of section 103(c)(5) and this section, the term ''development of land'' includes the provision of certain improvements to an industrial park site if such improvements are incidental to the use of the land as an industrial park. Such incidental improvements include the building or installation of incidental water, sewer, sewage and waste disposal, drainage, or similar facilities (whether surface, subsurface, or both). Such incidental improvements include the provision of incidental transportation facilities, such as hard-surface roads (including curbs and gutters) and railroad spurs and sidings; power distribution facilities, such as gas and electric lines; and communication facilities. The provision of structures or buildings of any kind is not included within the meaning of the term ''development of land,'' except for those structures or buildings which are necessary in connection with the incidental improvements encompassed by the term, such as, for example, a water pumphouse and storage tank needed in connection with the incidental provision of water facilities in an industrial park.

(d) *Examples.* The application of the rules contained in section 103(c)(5) and this section are illustrated by the following examples:

Example (1). City A and corporations X, Y, and Z (unrelated companies) enter into an arrangement under which A is to acquire a tract of land suitable for use as an industrial park. The arrangement provides that: (1) A will issue $10 million of bonds to be used for the acquisition and development of a suitable tract of land; (2) the tract will be controlled and administered by A, pursuant to a comprehensive zoning plan, for the use of a group of enterprises; (3) A will install necessary water, sewer, and drainage facilities on the tract; (4) A will sell substantial portions of the developed tract to X for use as a factory site and to Y for use as a warehouse site; (5) A will lease a sizeable portion of the tract to Z for 20 years as a distribution center site; and (6) the developed tract and the proceeds from the sale or lease of parts of the tract will be the security for the bonds. The bonds are industrial development bonds. Since, however, the proceeds of the issue are to be used for the acquisition and development of a tract of land as the site for an industrial park under section 103(c)(5), section 103(c)(1) does not apply unless the provisions of section 103(c)(7) and §1.103–11 apply.

Example (2). The facts are the same as in example (1) except that $1 million of the proceeds of the $10 million issue are to be used for the construction of a factory by corporation W or X. The bonds are industrial development bonds. Under these circumstances, substantially all of the proceeds are treated as used or to be used for the acquisition and development of a tract of land as the site for an industrial park described in section

103(c)(5). Accordingly, section 103(c)(1) does not apply unless the provisions of section 103(c)(7) and § 1.103–11 apply.

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§ 1.103–10 Exemption for certain small issues of industrial development bonds.

(a) *In general.* Section 103(b)(6) applies to certain industrial development bond issues (referred to in this section as ''exempt small issues'') and bonds issued to refund certain issues (referred to in this section as ''exempt small refunding issues''). If an issue is an exempt small issue or an exempt small refunding issue, then under the requirements of section 103(b)(6) and this section the interest paid on the debt obligations is not includable in gross income, and the obligations are treated as obligations described in section 103(a)(1) and § 1.103–1, even though such obligations are industrial development bonds as defined in section 103(b)(2) and § 1.103–7. However, interest on an obligation of such an issue is includable in gross income if the obligation is held by a substantial user of the financed facilities or a related person (as described in section 103(b)(7) and § 1.103–11). Section 103(b)(6) only becomes applicable where the bond issue meets both the trade or business and the security interest tests so that the obligations are industrial development bonds within the meaning of section 103(b)(2). For bonds issued before January 1, 1979, in taxable years ending before such date, and for capital expenditures made before January 1, 1979, with respect to such bonds, paragraphs (b), (c), and (d) of this section shall be applied by substituting $5 million for $10 million.

(b) *Small issue exemption*—(1) *$1 million or less.* Section 103(b)(6)(A) provides that section 103(b)(1) shall not apply to any debt obligation issued by a State or local governmental unit as part of an issue where—

(i) The aggregate authorized face amount of such issue (determined by aggregating the outstanding face amount of any prior exempt small issues described in paragraph (d) of this section and the face amount of the issue of obligations in question) is $1 million or less; and

(ii) Substantially all of the proceeds of such issue is to be used for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation under section 167. Proceeds which are loaned to a borrower for use as working capital or to finance inventory are not used in the manner described in the preceding sentence. Whether substantially all of the proceeds of an issue of governmental obligations are used in such manner is determined consistently with the rules for exempt facilities in § 1.103–8(a)(1)(i). Any obligation which is an industrial development bond within the meaning of section 103(b)(2) and which satisfies the $1 million small issue exemption requirements is an exempt small issue. See paragraph (c)(1) of this section for the treatment of refunding issues of $1 million or less.

(2) *$10 million or less.* (i) Under section 103(b)(6)(D), the issuing State or local governmental unit may elect to have an aggregate authorized face amount of $10 million or less, in lieu of the $1 million exemption otherwise provided for in section 103(b)(6)(A), with respect to issues of obligations that are industrial development bonds (within the meaning of section 103(b)(2)) issued after October 24, 1968. If the election is made in a timely manner, the bonds will be treated as obligations of a State or local governmental unit described in section 103(a)(1) and § 1.103–1 if the sum of—

(*a*) The aggregate face amount of the issue including the aggregate outstanding face amount of any prior $1 million or $10 million exempt small issues taken into account under section 103(b)(6)(B) and paragraph (d) of this section, and

(*b*) The aggregate amount of ''section 103(b)(6)(D) capital expenditures'' (within the meaning of paragraph (b)(2)(ii) of this section),

is $10 million or less. In the case of an issue of obligations that qualified for exemption under section 103(b)(6)(A) and this paragraph, if a section 103(b)(6)(D) capital expenditure made after the date of issue has the effect of making taxable the interest on the issue, under section 103(b)(6)(G) the loss of tax exemption for the interest shall begin only with the date on which the expenditure that caused the issue to cease to qualify under the $10 million limit was paid or incurred. See paragraph (b)(2)(vi) of this section for the time and manner in which the issuer may elect the $10 million exemption. See section 103(b)(6)(H) and paragraph (c)(2) of this section for the treatment of certain refinancing issues of $10 million of less.

(ii) The term "section 103(b)(6)(D) capital expenditure" is defined in this subdivision. Special rules for applying such definition in the case of certain expenditures paid or incurred by a State or local governmental unit are prescribed in subdivision (iii) of this subparagraph. Except as excluded by subdivision (iv) or (v) of this subparagraph, an expenditure (regardless of how paid, whether in cash, notes, or stock in a taxable or nontaxable transaction) is a section 103(b)(6)(D) capital expenditure if—

(*a*) The capital expenditure was financed other than out of the proceeds of issues to the extent such issues are taken into account under paragraph (b)(2)(i)(*a*) of this section.

(b) The capital expenditures were paid or incurred during the 6-year period which begins 3 years before the date of issuance of the issue in question and ends 3 years after such date,

(c) The principal user of the facility in connection with which the property resulting from the capital expenditures is used and the principal user of the facility financed by the proceeds of the issue in question is the same person or are two or more related persons (as defined in section 103(b)(6)(C) and paragraph (e) of this section),

(d) Both facilities referred to in *(c)* of this subdivision were (during the period described in *(b)* of this subdivision or a part thereof) located in the same incorporated municipality or in the same county outside of the incorporated municipalities in such county), and

(e) The capital expenditures were properly chargeable to the capital account of any person or State or local governmental unit (whether or not such person is the principal user of the facility or a related person) determined, for this purpose, without regard to any rule of the Code which permits expenditures properly chargeable to capital account to be treated as current expenses. With respect to obligations issued on or after August 8, 1972, determinations under the preceding sentence shall be made by including any expenditure which may, under any rule or election under the Code, be treated as a capital expenditure (whether or not such expenditure is so treated). With respect to obligations issued on or after August 8, 1972, for purposes of this subparagraph, capital expenditures made with respect to a contiguous or integrated facility which is located on both sides of a border between two or more political jurisdictions are made with respect to a facility located in all such jurisdictions and, therefore, shall be treated as if they were made in each such political jurisdiction.

(iii) Amounts properly chargeable to capital account under subdivision (ii) *(e)* of this subparagraph include capital expenditures made by a State or local governmental unit with respect to an exempt facility or an industrial park, within the 6-year period described in subdivision (ii)*(b)* of this subparagraph, out of the proceeds of bond issues to which section 103(b)(1) did not apply by reason of section 103(b) (4) or (5) (relating to certain exempt activities and industrial parks). Thus, for example, the cost to the lessor of a leased plantsite financed out of the proceeds of an issue for an exempt air pollution control facility under section 103(b)(4)(F) and paragraph (g) of § 1.103–8 would constitute a section 103(b)(6)(D) capital expenditure. However, in the case of an industrial park, only the land costs allocated on an area basis to the plantsite and the actual cost of any improvements made on the plantsite, or to be used principally in connection with the actual plantsite occupied by a principal user or a related person, shall be taken into account as capital expenditures. Where the actual amount of capital expenditures made with respect to a facility by a person (including a State or local governmental unit) other than the user of such facility (or a related person) cannot be ascertained, the fair market value of the property with respect to which the capital expenditures were made, at the time of such capital expenditures, shall be deemed to be the amount of such capital expenditures. In the case of a transaction which is not in form a purchase but which is treated as a purchase for Federal income tax purposes, the purchase price for Federal income tax purposes shall constitute a capital expenditure.

(iv) A section 103(b)(6)(D) capital expenditure shall not include any ''excluded expenditure'' described in *(a)* through *(e)* of this subdivision (iv).

(a) A capital expenditure is an excluded expenditure if either it is made by a public utility company which is not the principal user of the facility financed by the proceeds of the issue in question (or a related person) with respect to property of such company, or it is made by a State or local governmental unit with respect to property of such unit, and if in either case it meets all of the following three conditions: Such property of such company or unit (as the case may be) must be used to provide gas, water, sewage disposal services, electric energy, or telephone service. Such property must be installed in, or connected to, the facility but must not consist of property which is such an integral part of the facility that the cost of such property is ordinarily included as part of the acquisition, construction, or reconstruction cost of such facility. Such property must be of a type normally paid for by the user (or a related person) in the form of periodic fees based upon time or use.

(b) A capital expenditure is an excluded expenditure if it is made by a person other than the user, a related person, or a State or local governmental unit and if it is made with respect to tangible personal property (within the meaning of paragraph (c) of § 1.48–1), or intangible personal property, leased to the user (or a related person) of a facility. However, the preceding sentence shall apply only if such personal property is leased by the manufacturer of such tangible or intangible personal property, or by a person in the trade or business of leasing property the same as, or similar to, such personal property, and only if, pursuant to general business practice, property of such type is ordinarily the subject of a lease.

(c) A capital expenditure is an excluded expenditure if it is made to replace property damaged or destroyed by fire, storm, or other casualty, to the extent that these expenditures do not exceed in dollar amount the fair market value (determined immediately before the casualty) of the property replaced.

(d) A capital expenditure is an excluded expenditure if it is required by a change made after the date of issue in a Federal or State law, or a local ordinance which has general application, or if it is required by a change made after such date in rules and regulations of general application issued under such law or ordinance.

(e) A capital expenditure is an excluded expenditure if it is required by or arises out of circumstances which could not reasonably be foreseen on the date of issue or which arise out of a mistake of law or fact. However, the aggregate dollar amount taken into account under this subdivision *(e)* with respect to any issue may not exceed $1 million. With respect to expenditures incurred prior to December 11, 1971, the dollar amount specified in the preceding sentence shall be $250,000.

(v)*(a)* If the assets of a corporation are acquired by another corporation in a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies, the exchange of consideration by the acquiring corporation for such assets is not a section 103(b)(6)(D) capital expenditure by such acquiring corporation.

(b) However, if an exchange referred to in *(a)* of this subdivision occurs during the 6-year period beginning 3 years before the date of issuance of an issue of obligations and ending 3 years after such date, the transferor and transferee shall be treated as having been related persons for the portion of such 6-year period preceding the date of the exchange for purposes of determining whether section 103(b)(6)(D) capital expenditures have been made. For purposes of this subdivision *(b),* the date of an exchange to which section 381 applies shall be the date of distribution or transfer within the meaning of paragraph (b) of § 1.381(b)–1.

(c) If section 351(a) applies to a transfer of property to a corporation solely in exchange for its stock or securities, the issuance of such stock or securities in such exchange is not a section 103(b)(6)(D) capital expenditure by such corporation.

(d) However, if such a transfer referred to in *(c)* of this subdivision occurs during the 6-year period beginning 3 years before the date of issuance of an issue of obligations and ending 3 years after such date, and if, with respect to the property transferred, expenditures made within such period would have been section 103(b)(6)(D) capital expenditures if the transferor and transferee had been related persons for such period, then such expenditures shall be considered to be section 103(b)(6)(D) capital expenditures made by the transferee. In addition, if a transferor and transferee are related persons immediately following such transfer, such transferor and transferee shall also be treated as having been related persons for the portion of such 6-year period preceding the date of such transfer.

(e) For purposes of this subdivision (v), the term ''issue of obligations'' means an issue being tested for purposes of qualifying or continuing to qualify under an election pursuant to section 103(b)(6)(D) as to which an amount which would be a section 103(b)(6)(D) capital expenditure solely by reason of *(b)* or *(d)* of this subdivision must be taken into account.

(f) If with respect to an issue of obligations an expenditure would not have been a section 103(b)(6)(D) capital expenditure but for the application of *(b)* or *(d)* of this subdivision, and if such section 103(b)(6)(D) capital expenditure has the effect of making taxable the interest on an issue of obligations which qualified for exemption under section 103(b)(6)(A) and this paragraph, the loss of tax exemption for such interest shall begin not earlier than the date of such exchange or transfer referred to in this subdivision (v).

(vi) The issuer may make the election provided by section 103(b)(6)(D) and this paragraph (b)(2) (assuming that the bonds otherwise qualify under section 103(b)(6) by noting the election affirmatively at or before the time of issuance of the issue in question on its books or records with respect to the issue. The term ''books or records'' includes the bond resolution or other similar legislation for the issue in question as well as the bond transcript or other compilation of bond and bond-related documents. If the issuer fails to make an election at the time and in the manner prescribed in this paragraph (b)(2), the issue will not be treated as described in section 103(b)(6)(D), and interest thereon will be includible in gross income.

(c) *Refunding or refinancing issue exemption*—(1) *$1 million or less refunding issue.* Section 103(b)(6)(A) also provides that section 103(b)(1) shall not apply to any debt obligation issued by a State or local governmental unit as part of an issue the aggregate authorized face amount of which is $1 million or less, if substantially all of the proceeds of such issue are to be used—

(i) To redeem part of all of a prior issue substantially all of the proceeds of which were used to acquire, construct, reconstruct, or improve land or property of a character subject to the allowance for depreciation, or

(ii) To redeem part or all of a prior exempt small refunding issue.

(2) *10 million or less refinancing issue.* Section 103(b)(6)(H) provides that section 103(b)(1) shall not apply to any debt obligation issued by a governmental unit as part of an issue which is $10 million or less if the condition of section 103(b)(6)(H) is met and if substantially all of the proceeds are to be used—

(i) To redeem part or all of one or more prior exempt small issues, or

(ii) To redeem part or all of one or more prior exempt small refunding issues.

The condition of section 103(b)(6)(H) is that an election by the issuer of the $10 million exemption in lieu of the $1 million limit for a refunding issue may be made only if each prior issue being redeemed is an issue which qualified either for the $1 million exemption or, by reason of an election under section 103(b)(6)(D), for the $10 million exemption. In addition, in applying the capital expenditures test under section 103(b)(6)(D)(ii) and paragraph (b)(2)(i)*(b)* of this section to refinancing issues, section 103(b)(6)(D) capital expenditures are taken into account only for purposes of determining whether prior issues which were made under the section 103(b)(6)(D) election qualified under section 103(b)(6)(A) and would have continued to qualify under that section but for the redemption.

(d) *Certain prior issues taken into account*—(1) *In general.* Section 103(b)(6)(B) provides, in effect, that if (i) a prior issue specified in subparagraph (2) of this paragraph is an exempt small issue (including for this purpose an exempt small refunding issue) under section 103(b)(6)(A) and this section, and (ii) such prior issue is outstanding at the time of issuance of a subsequent issue, then in determining the aggregate face amount of such subsequent issue (for purposes of determining whether such issue is a $1 million or $10 million exempt small issue under section 103(b)(6)(A) and this section) there shall be taken into account the outstanding face amount of such prior exempt small issue. For purposes of this paragraph, the outstanding face amount of a prior exempt small issue does not include the face amount of any obligation which is to be redeemed from the proceeds of such subsequent issue.

(2) *Prior issues specified.* The face amount of an outstanding prior exempt small issue is taken into account under subparagraph (1) of this paragraph if—

(i) The proceeds of both the prior exempt small issue and of the subsequent issue (whether or not the State or local governmental unit issuing such obligation is the same unit for each such issue) are or will be used primarily with respect to facilities located or to be located in the same incorporated municipality or located or to be located in the same county outside of an incorporated municipality in such county (and, for purposes of this subdivision, on or after August 8, 1972, a contiguous or integrated facility which is located on both sides of a border between two or more political jurisdictions shall be treated as if it is entirely within each such political jurisdiction), and

(ii) The principal user of the financed facilities referred to in subdivision (i) of this subparagraph is or will be the same person or two or more related persons (as defined in section 103(b)(6)(C) and paragraph (e) of this section).

(3) *Rules of application.* The rules of this paragraph shall apply—

(i) Only in the case of outstanding prior exempt small issues which are industrial development bonds to which section 103(b)(1) would have applied but for the provisions of section 103(b)(6). Thus, for example, the provisions of this paragraph do not apply in respect of a prior issue of obligations issued on or before April 30, 1968. In addition, the provisions of this paragraph do not apply in respect of a prior issue for an exempt facility under section 103(b)(4) and § 1.103–8, or for an industrial park under section 103(b)(5) and § 1.103–9, whether or not the issue might also have qualified as an exempt small issue under section 103(b)(6)(A) and this section.

(ii) To all prior exempt small issues which meet the requirements of this paragraph. Thus, for example, in determining the aggregate face amount of an issue under section 103(b)(6)(A), the outstanding face amount of prior $1 million or $10 million exempt small issues which meet the requirements of this paragraph shall be taken into account in determining the aggregate face amount of a subsequent issue being tested for the $1 million small issue exemption. Similarly, in determining the aggregate face amount of an issue under section 103(b)(6)(A) and (D), the outstanding face amount of prior $1 million or $10 million exempt small issues which meet the requirements of this paragraph shall be taken into account in determining the aggregate face amount of a subsequent issue being tested for the $10 million small issue exemption.

(e) *Related persons.* For purposes of section 103(b) and §§ 1.103–7 through 1.103–11, the term ‘‘related person’’ means a person who is related to another person if, on the date of issue of an issue of obligations—

(1) The relationship between such persons would result in a disallowance of losses under section 267 (relating to

disallowance of losses, etc., between related taxpayers) and section 707(b) (relating to losses disallowed, etc., between partners and controlled partnerships) and the regulations thereunder, or

(2) Such persons are members of the same controlled group of corporations, as defined in section 1563(a), relating to definition of controlled group of corporations (except that ''more than 50 percent'' shall be substituted for ''at least 80 percent'' each place it appears in section 1563(a)) and the regulations thereunder.

(f) *Disqualification of certain small issues.* (1) Section 103(b)(6) shall not apply to any obligation issued after April 24, 1979, which is part of an issue, a significant portion of the proceeds of which are to be used directly or indirectly to provide residential real property for family units. For purposes of the preceding sentence, the term ''residential real property for family units'' means residential rental projects (within the meaning of § 1.103–8(b)) and owner-occupied residences (within the meaning of section 103A).

(2) For purposes of paragraph (f)(1), a significant portion of the proceeds of an issue are used to provide residential real property for family units if 5 percent or more of the proceeds are so used.

(g) *Examples.* The application of the rules contained in section 103(b)(6) and this section are illustrated by the following examples:

Example (1). County A and corporation X enter into an arrangement under which the county will provide a factory which X will lease for 25 years. The arrangement provides (1) that A will issue $1 million of bonds on March 1, 1970, (2) that the proceeds of the bond issue will be used to acquire land in County A (but not in an incorporated municipality) and to construct and equip a factory on such land in accordance with X's specifications, (3) that X will rent the facility for 25 years at an annual rental equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds, and (4) that such payments by X and the facility itself shall be the security for the bonds. Although the bonds issued are industrial development bonds, the bonds are an exempt small issue under section 103(b)(6)(A) and this section since the aggregate authorized face amount of the bond issue is $1 million or less and all of the proceeds of the bond issue are to be used to acquire and improve land and acquire and construct depreciable property. The result would be the same if the arrangement provided that X would purchase the facility from A.

Example (2). The facts are the same as in example (1) except that, instead of acquiring land and constructing a new factory, the arrangement provides that A will acquire a vacant existing factory building and rebuild and equip the building in accordance with X's specifications. The bonds are an exempt small issue for the same reasons as in example (1).

Example (3). The facts are the same as in example (1) or (2) except that the financed facilities are additions to facilities which were financed by an issue of bonds to which section 103(b)(1) does not apply because such bonds were issued prior to May 1, 1968, or were subject to the transitional provisions of § 1.103–12. The bonds are an exempt small issue since neither of the prior bond issues are taken into account under section 103(b)(6)(B) and this section in determining the status of industrial development bonds which are issued after April 30, 1968, and which are not subject to the transitional provisions of § 1.103–12.

Example (4). The facts are the same as in example (1) except that, subsequently, corporation X proposes to County A that A build a $400,000 warehouse located in Town M (an unincorporated town located in County A) for X under terms similar to the factory arrangement described in example (1). On the proposed issue date of the subsequent bond issue, $600,000 of the first exempt small issue will be outstanding. If A issues $400,000 of bonds for such purposes, the bonds will be an exempt small issue under section 103(b)(6) and this section since, under the rules of section 103(b)(6)(B) and paragraph (d) of this section, if the aggregate authorized face amount of the new issue and the outstanding prior exempt small issue will be $1 million or less, the new issue will be an exempt small issue. If, however, the aggregate authorized face amount of the prior issue outstanding on the date of the subsequent issue were in excess of $600,000, the subsequent issue would not qualify as an exempt small issue because (1) the combined aggregate face amount of the outstanding prior issue and the new issue would be in excess of $1 million, (2) the facilities financed by both issues are to be located in unincorporated areas in the same county, (3) the same taxpayer will be the principal user of both facilities, and (4) but for the rules of section 103(b)(6)(B) and paragraph (d) of this section the prior issue would be an exempt small issue.

Example (5). The facts are the same as in example (1) except that subsequently corporation X proposes to City P and City R (incorporated municipalities located in County A) that P and R each issue bonds and each build $1 million facilities to be located in Cities P and R for the use of X under terms similar to the arrangement in example (1). Each of the $1 million issues will be an exempt small issue because each proposed facility is located within a different incorporated municipality and the proceeds of the prior outstanding exempt small issue were used to construct facilities outside of an incorporated area.

Example (6). The facts are the same as in example (1) except that $95,000 of the $1 million will be used by the corporation as working capital. The bonds are an exempt small issue for the same reason as in example (1) since substantially all of the proceeds will be used for the acquisition of land and the construction of depreciable property.

Example (7). The facts are the same as in example (1) except that on November 1, 1969, County A issued $10 million of industrial development bonds, all of the proceeds of which were issued for the acquisition of land as the site for an industrial park within the meaning of section 103(b)(5) and § 1.103–9. The proceeds of the $1 million of bonds issued in 1970 will be used to construct a factory for corporation X to be located in the industrial park. The bonds issued in 1970 are industrial development bonds within the meaning of section 103(b)(2) and § 1.103–7. Since, however, the prior 1969 issue is not an issue to which section 103(b)(6)(A) applied (see paragraph (d)(3)(i) of this section), the bonds issued in 1970 are an exempt small issue for the reasons stated in example (1).

Example (8). County B enters into three separate arrangements with three unrelated corporations whereby the county will provide separate storage facilities for each corporation. The arrangement provides (1) that the county will issue bonds and loan to each corporation $250,000 of the proceeds which will be used to acquire land in the county and to construct the facilities, (2) that the rental payments by the corporations will be equal to the amount necessary to amortize the principal and pay the interest on any outstanding bonds issued by the county, and (3) that the payments by the corporations and the facilities themselves shall be the security for the industrial development bonds. For convenience, the county issues one series of bonds in the face amount of $750,000 rather than three separate series of bonds of $250,000 each. The issue is an exempt small issue under section 103(b)(6)(A) and paragraph (b)(1) of this section since the aggregate authorized face amount of the bond issue is $1 million or less, and all of the proceeds of the bond issue are to be used to acquire and improve land and acquire and construct depreciable property.

Example (9). City C and corporation Y enter into an arrangement under which C will provide a factory which Y will lease for 25 years. The arrangement provides (1) that C will issue $4 million of bonds on March 1, 1969, after making the election under section 103(b)(6)(D) and paragraph (b)(2) of this section, (2) that the proceeds of the bond issue will be used to acquire land in the city and to construct and equip a factory on such land in accordance with Y's specifications, (3) that Y will rent the facilities for 25 years at an annual rental equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds, (4) that such payments by Y and the facility itself shall be the security for the bonds, and (5) that, if corporation Y pays or incurs capital expenditures in excess of $1 million within 3 years from the date of issue which disqualify the bonds as an exempt small issue under section 103(b)(6)(D), it will either furnish funds to C to redeem such bonds at par or at a premium, or increase the rental payments to C in an amount sufficient to pay a premium interest rate. Although the bonds issued are industrial development bonds, they are an exempt small issue under section 103(b)(6)(A) by reason of the election under section 103(b)(6)(D) and paragraph (b)(2) of this section, since the aggregate authorized face amount of the bond issue is $5 million or less and all of the proceeds of the bond issue are to be used to acquire and improve land and acquire and construct depreciable property. The provisions for redemption of the bonds or an increase in rental if the bonds are disqualified as an exempt small issue under section 103(b)(6)(A) will not disqualify an otherwise valid election under section 103(b)(6)(D) and paragraph (b)(2) of this section.

Example (10). The facts are the same as in example (9) except that corporation Y subsequently proposed to the city that it build a $1 million warehouse next to the plant for the use of Y under terms similar to the factory arrangement. Assume further that the factory building was completed by March 1, 1970, and that on January 15, 1972, the proposed issue date of the subsequent bond issue, $2 million of the first exempt small issue will be outstanding. In determining the aggregate authorized face amount of the new issue, the original face amount of a prior outstanding issue must be reduced by that portion which is to be redeemed before it is added to the face amount of the new issue. Therefore, if the city issues $3 million of bonds to redeem the remaining $2 million of bonds and to construct the warehouse the bonds will be an exempt small issue under section 103(b)(6)(A) if an election is made under section 103(b)(6)(D) and paragraph (b)(2) of this section since (1) the face amount of the new issue ($3 million), plus (2) the face amount of the prior outstanding exempt small issue minus the amount of such issue to be refunded ($2 million minus $2 million), plus (3) capital expenditures during the preceding 3 years financed other than out of the proceeds of outstanding issues to which section 103(b)(6)(A) and paragraph (b) of this section applied ($2 million), do not exceed $5 million. If, however, the amount of the January 15, 1972, issue were $3½ million, the issue would not qualify as an exempt small issue under section 103(b)(6)(A) and paragraph (b)(2) of this section.

Example (11). The facts are the same as in example (9), except that on June 15, 1971, Y purchases from an unrelated motor carrier business a warehouse terminal in the same city at a cost of $250,000 and tractor-trailers and other automotive equipment based at the terminal at a cost of $1 million. This subsequent expenditure by Y has the effect of making the interest on the city C bonds includable in the gross income of the holders of such bonds as of June 15, 1971, because the face amount of the March 1, 1969, issue ($4 million) plus the subsequent capital expenditures within 3 years of the date of issue ($1,250,000) exceed $5 million. (See section 103(b)(6)(D) and paragraph (b)(2)(i) of this section.)

Example (12). The facts are the same as in example (9), except that in March, 1970, Y will move $3 million of additional used machinery and equipment into the factory from its factory in another city. The expenditures for such machinery and equipment were incurred by Y more than 3 years prior to the date of issue of the bonds. The transfer of such used equipment into city C does not constitute a section 103(b)(6)(D) capital expenditure within the meaning of paragraph (b)(2)(ii) of this section since the expenditures with respect to such property were incurred more than 3 years prior to the date of issue of the bonds. Had the capital expenditures with respect to such property been incurred during the 6-year period beginning 3 years before the date of issue of the bonds and in the 3 years after such date, they would constitute section 103(b)(6)(D) capital expenditures.

Example (13). The facts are the same as in example (9), except that in March 1970, corporation Y enters into an arrangement with respect to machinery and equipment to be used in the facility. The arrangement is labeled by the parties as a lease but is treated as a sale for Federal income tax purposes. The amount treated as the purchase price of the machinery and equipment is a section 103(b)(6)(D) capital expenditure.

Example (14). On February 1, 1970, city D issues $5 million of its bonds to finance construction of an addition to the manufacturing plant of corporation Z. The bonds will be secured by the facility and lease payments to be made by Z which will be sufficient to pay the principal and interest on such bonds. Assume that the bonds qualify as an exempt small issue under section 103(b)(6)(A) pursuant to an election under section 103(b)(6)(D) and paragraph (b)(2) of this section. On February 1, 1971, D plans to issue $1 million of its bonds to construct a pollution control facility to be leased to Z for use at its manufacturing plant. The rental payments from the lease will be sufficient to pay the principal and interest on the bonds. The bonds will be secured by such facility and the lease payments. Capital expenditures for the pollution control facility will be paid or incurred beginning before February 1, 1973. Although the pollution control facility is an exempt facility under section 103(b)(4)(F) and paragraph (g) of § 1.103–8, amounts used for the pollution control facility shall be considered to be a section 103(b)(6)(D) capital expenditure and the interest on the February 1, 1970, issue will become taxable as of the date such capital expenditure began to be paid or incurred. See section 103(b)(6)(G) and paragraph (b)(2)(i) of this section.

Example (15). On February 1, 1970, City E issues $500,000 of its bonds to acquire and develop an industrial park within the meaning of section 103(b)(5) and paragraph (b) of § 1.103–9. The park consists of 100 acres and is divided into one 50 acre plantsite and 4 smaller sites. The aggregate acquisition cost of the undeveloped land is $150,000 or an average per acre cost of $1,500. Roads, sidewalks, sewers, utilities, sewage, and waste disposal facilities serving the entire industrial park cost $300,000. On September 1, 1970, E leases to corporation Y for 30 years the 50 acre plantsite (with an allocated cost of $75,000) and a railroad spur track from the railroad right of way to Y's plantsite for Y's exclusive use. The spur track was constructed using $50,000 of the proceeds of the industrial park bond issue. E also proposes to issue on September 1, 1970, $4,875,000 of its bonds to construct and equip a building on the leased plantsite to be leased to Y at an additional rental sufficient to pay the principal and interest on this issue of bonds. The September 1, 1970, issue will be an exempt small issue under section 103(b)(6)(A) pursuant to an election under section 103(b)(6)(D) and paragraph (b)(2) of this section since the sum of the amount of the second issue ($4,875,000) and the capital expenditures allocated to the plantsite ($75,000 for 50 acres of land plus $50,000 for the railroad spur tract, totaling $125,000) does not exceed $5 million. The sum of $300,000 which was spent in development of the industrial park provided facilities which will serve or benefit the users generally and hence under paragraph (b)(2)(iii) of this section is not considered to have provided facilities as to which Y will be the principal user.

Example (16). On June 1, 1970, corporation Z simultaneously enters into separate arrangements with City F and City G under which each city will issue a $5 million exempt small issue of bonds the proceeds of which will be used by Z to construct separate facilities in each city. By June 1, 1971, the facilities have been completed in the respective cities. On January 1, 1972, Cities F and G, through a valid legal proceeding, merge into a new City FG. Since in this case F and G were separate cities on June 1, 1970 (the date of the bond issues), the factories are not considered to be located in the same incorporated municipality. Accordingly, each $5 million issue by City F and G will continue to qualify as an exempt small issue.

Example (17). On June 1, 1973, City H issues an exempt small issue of $4.75 million to finance a facility of corporation S to be located in City H. On October 1, 1974, S and corporation T, previously unrelated to S, consummated a statutory merger which qualifies as a reorganization described in section 368(a)(1)(A) and thus as a transaction described in section 381(a). In the transaction, T transferred to S assets with a fair market value of $1.5 million in exchange for stock of S, $300,000 of securities of S, and $100,000 cash. On March 23, 1971, T made $400,000 of capital expenditures for an addition to its factory located in City H. For purposes of testing the H issue of June 1, 1973, such expenditures would have been section 103(b)(6)(D) capital expenditures if T and S had been related persons. Under the provisions of paragraph (b)(2)(v)*(a)* of this section, the exchange of $1.5 million of stock, securities, and cash by S does not constitute a section 103(b)(6)(D) capital expenditure. Since, however, S and T are treated as related persons starting 3 years prior to the date of issue of the obligations, the $400,000 of expenditures by T constitute section 103(b)(6)(D) capital expenditures. Thus, the interest on the June 1, 1973, issue of obligations would become taxable (since the $5 million limit would be exceeded) on the date of the merger.

Example (18). In 1965 City I issues $10 million of industrial development bonds to construct and equip a factory for corporation Z. In 1975 the remaining principal amount of the bonds outstanding is $4.1 million. If I issues $4.5 million of bonds to redeem the balance of the prior issue, and for other purposes, such issue cannot qualify as an exempt small issue under section 103(b)(6)(D) and paragraph (b)(2) of this section even though at the time of issue the interest on the 1965 bonds was tax-exempt since the prior issue must be one which qualified under section 103(b)(6)(A) and this section. Further, the 1975 issue will be an issue of industrial development bonds notwithstanding the provisions of paragraph (d)(2) of § 1.103–7 which provides that certain bonds issued to refund an issue of obligations issued on or before April 30, 1968 (or January 1, 1969, in certain cases) will not be so treated. Paragraph (d)(2) of § 1.103–7 is not applicable because the 1975 issue makes funds available for a purpose other than the debt service obligation on the 1965 bonds.

Example (19). In 1969 City J issues $4 million of industrial development bonds which qualify as an exempt small issue under section 103(b)(6)(A) pursuant to an election under section 103(b)(6)(D) and paragraph (b)(2) of this section. In 1971, by reason of a $2 million addition to the factory built with the proceeds of the issue, the 1969 exempt small issue loses its tax-exempt status. In 1972, the city issues a $5 million issue to redeem the prior 1969 issue. The redemption issue will not qualify as an exempt small issue since the prior 1969 issue did not continue to qualify under section 103(b)(6)(A) and this section.

[T.D. 7199, 37 FR 15494, Aug. 3, 1972; 37 FR 16177, Aug. 11, 1972; 37 FR 17826, Sept. 1, 1972, as amended by T.D. 7511, 42 FR 54285, Oct. 5, 1977; T.D. 7840, 47 FR 46084, Oct. 15, 1982; 51 FR 16299, May 2, 1986]

§ 1.103–11 Bonds held by substantial users.

(a) *In general.* Section 103(c) (4), (5), or (6) (relating respectively to interest on bonds to finance certain exempt facilities, interest on bonds to finance industrial parks, and the exemption for certain small issues of industrial development bonds) does not apply, as provided in section 103(c)(7), with respect to any obligation for any period during which such obligation is held either by a person who is a substantial user of the facilities with respect to which the proceeds of such obligation were used or by a related person (within the meaning of section 103(c)(6)(C) and paragraph (e) of § 1.103–10). Therefore, in such a case, interest paid on such an obligation is includable in the gross income of a substantial user (or related person) for any period during which such obligation is held by such user (or related person).

(b) *Substantial user.* In general, a substantial user of a facility includes any nonexempt person who regularly uses a part of such facility in his trade or business. However, unless a facility, or a part thereof, is constructed, reconstructed, or acquired specifically for a nonexempt person or persons, such a nonexempt person shall be considered to be a substantial user of a facility only if (1) the gross revenue derived by such user with respect to such facility is more than 5 percent of the total revenue derived by all users of such facility or (2) the amount of area of the facility occupied by such user is more than 5 percent of the entire usable area of the facility. Under certain facts and circumstances, where a nonexempt person has a contractual or preemptive right to the exclusive use of property or a portion of property, such person may be a substantial user of such property. A substantial user may also be a lessee or sublessee of all or any portion of the facility. A licensee or similar person may also be a substantial user where his use is regular and is not merely a casual, infrequent, or sporadic use of the facility. Absent special circumstances, individuals who are physically present on or in the facility as employees of a substantial user shall not be deemed to be substantial users.

(c) *Examples.* The application of section 103(c)(7) and this section are illustrated by the following examples:

Example (1). Pursuant to an arrangement with corporation X, County A issues $4 million of its bonds (an exempt small issue under section 103(c)(6)(A) pursuant to an election under section 103(c)(6)(D) and paragraph (b)(2) of §1.103–10) and will use the proceeds to finance construction of a manufacturing facility which is to be leased to X for an annual rental of $500,000. X subleases space to a restaurant operator at an annual rental of $25,000 for the operation of a canteen and lunch counter for the convenience of X's employees. The canteen is required to be open at least 5 days each week (except holidays) from 8:30 a.m. to 5 p.m., and the lunch counter must be in operation during the noon hour. The canteen regularly sells cigarettes, candy, and soft drinks, and uses advertising displays and dispensers with product names. The space physically occupied and the amount of revenue derived by the restaurant operator are more than 5 percent of the respective amounts with respect to the entire facility. Both X and the restaurant operator are substantial users. However, absent special circumstances none of X's employees, the employees of the restaurant operator, or the customers or salesmen who regularly visit the premises to do business either with X or the restaurant operator are substantial users. Similarly, the manufacturers, distributors, and dealers of products sold in the canteen ordinarily are not substantial users.

Example (2). The facts are the same as in example (1) except that X rents food and beverage vending machines from a local dealer. The machines are regularly serviced by the local dealer under a contract with X. Title to and ownership of the machines are retained by the dealer. The local dealer is not deemed to be a substantial user if the revenue derived by such dealer from, and the space occupied by, such machines do not exceed 5 percent of the respective amounts with respect to the entire facility.

Example (3). City B proposes to issue $2 million of bonds which qualify as an exempt small issue under section 103(c)(6)(A) pursuant to an election under section 103(c)(6)(D) and paragraph (b)(2) of §1.103–10 in order to construct a medical building for certain physicians and dentists. The facility will contain 30 offices to be leased on equal terms and for the same rental rates to each physician or dentist for use in his trade or business. Each physician or dentist will be a substantial user of the facility since the facility is being constructed specifically for such physicians and dentists. The result would be the same in the case of an office building for general commercial use.

Example (4). City C proposes to expand the airport it owns and operates with the proceeds of its bonds which qualify as bonds issued for an exempt facility under section 103(c)(4)(D) and paragraph (e) of §1.103–8 and which are secured by a pledge of airport revenues. The airport is serviced by several commercial airlines which have long-term agreements with C for the use of runways, terminal space, and hangar and storage facilities. Each of the airlines either occupies more than 5 percent of the usable space of, or derives more than 5 percent of the revenue derived with respect to, the airport. C also leases counter and vehicle servicing and parking areas to car rental companies, space for restaurants, kiosks for the sale of newspapers and magazines, and space for the operations of a charter plane company. The latter operates its own planes, offers flying lessons and services, and stores private planes for local businesses and individuals. An airport limousine company has an exclusive franchise for passenger pickup at the terminal. Other taxi, transfer, freight, and express companies regularly deliver passengers and freight to the terminal but do not have space regularly assigned to them, nor do they have operating agreements with C. Various business concerns have advertising product displays in the terminal building. In addition to regular telephone service, coin-operated telephones, provided by the telephone company, are located throughout the terminal, at locations specified by C. None of the above exceed the 5-percent limitations of paragraph (b) of this section and the bond proceeds will not be specifically used for any of them. Only the commercial airlines, which violate the 5-percent limitations, are substantial users of the airport.

Example (5). City D issues $25 million of its revenue bonds and will use $10 million of the proceeds to finance construction of a sports facility which qualifies as an exempt facility under section 103(c)(4)(B) and paragraph (c) of § 1.103–8, $8 million to acquire and develop land as the site for an industrial park within the meaning of section 103(c)(5) and § 1.103–9, and $7 million to finance the construction of an office building to be used exclusively by the city, an exempt person. The revenues from the sports facility and the industrial park and all the facilities themselves will be the security for the bonds. The sports facility and the industrial park sites will be used in the trades of businesses of nonexempt persons. The bonds are industrial development bonds, but under the provisions of paragraph (a)(1) of § 1.103–8 and paragraph (a) of § 1.103–9, the interest on the $25 million issue will not be includable in gross income. However, the interest on bonds held shall be includable in the gross income of a substantial user of either the sports facility or the industrial park if such substantial user holds any of the obligations of the $25 million issue. The 5-percent limitations of paragraph (b) of this section are applied separately with respect to each facility.

Example (6). Authority E issues $4 million of bonds which qualify as an exempt small issue under section 103(c)(6)(A) pursuant to an election under section 103(c)(6)(D) and paragraph (b)(2) of § 1.103–10 in order to construct a bank building on the grounds of an airport. In addition, E issues $40 million to expand the airport. The bank will not derive revenue in excess of 5 percent of the revenue derived with respect to the airport nor will it occupy more than 5 percent of the usable area of such airport. The bank will be a substantial user of the bank building constructed with the proceeds of the $4 million issue since the facility was constructed specifically for the bank. However, the bank will not be a substantial user with respect to the airport because it does not exceed the 5-percent limitations of paragraph (b) of this section. Had E issued one issue of $44 million in order to expand the airport and construct a bank building, the bank would be a substantial user of the entire facility since the $44 million issue was being used to construct a facility a portion of which was specifically for the bank.

[T.D. 7199, 37 FR 15499, Aug. 3, 1972; 37 FR 16177, Aug. 11, 1972]

§ 1.103–16 Obligations of certain volunteer fire departments.

(a) *General rule.* An obligation of a volunteer fire department issued after December 31, 1980, shall be treated as an obligation of a political subdivision of a State for purposes of section 103(a)(1) if—

(1) The volunteer fire department is a qualified volunteer fire department within the meaning of paragraph (b) of this section, and

(2) Substantially all of the proceeds of the issue of which the obligation is a part are to be used for the acquisition, construction, reconstruction, or improvement of a fire house or fire truck used or to be used by the qualified volunteer fire department.

An obligation of a volunteer fire department shall not be treated as an obligation of a political subdivision of a State for purposes of section 103(a)(1) unless both conditions set forth in this paragraph (a) are satisfied. Thus, for example, if an obligation is issued by an ambulance and rescue squad that is a qualified volunteer fire department as required by paragraph (a)(1) of this section, but substantially all of the proceeds of the issue of which the obligation is a part are to be used for the furnishing of emergency medical services, rather than for the purposes specified in paragraph (a)(2) of this section, the obligation shall not be treated as an obligation of a political subdivision of a State for purposes of section 103(a)(1).

(b) *Definition of qualified volunteer fire department.* For purposes of this section, the term ‘‘qualified volunteer fire department’’ means an organization—

(1) That is organized and operated to provide firefighting services or emergency medical services in an area within the jurisdiction of a political subdivision, and

(2) That is required to furnish firefighting services by written agreement with the political subdivision, and

(3) That serves persons in an area within the jurisdiction of the political subdivision that is not provided with any other firefighting services.

The requirement of paragraph (b)(2) of this section that a qualified volunteer fire department be required to furnish firefighting services by written agreement with the political subdivision may be satisfied by an ordinance or statute of the political subdivision that establishes, regulates, or funds the volunteer fire department. A volunteer fire department does not fail to satisfy the requirement of pargraph (b)(3) of this section by furnishing or receiving firefighting services on an emergency basis, or by cooperative agreement with other fire departments, to or from areas outside of the area that the volunteer fire department is organized and operated to serve. The fact that tax revenues of a political subdivision served by a volunteer fire department contribute toward the support of the volunteer fire department in the form of salary, purchase of equipment, or other defrayment of expenses will not prevent the volunteer fire department from being a ''qualified volunteer fire department'' within the meaning of this paragraph (b). Moreover, an obligation of a volunteer fire department receiving such support may qualify as an obligation of a political subdivision within the meaning of section 103(a)(1) independently of section 103(i) and this section if the requirements of section 103(a)(1) are satisfied. See § 1.103–1(b) for rules relating to qualification under section 103(a)(1).

(c) *''Substantially all'' test.* Substantially all of the proceeds of an issue are used for the purposes specified in paragraph (a)(2) of this section if 90 percent or more of the proceeds are so used. Thus, for example, if more than 10 percent of the proceeds of an obligation issued by a qualified volunteer fire department are used for the purchase of an ambulance or for rescue equipment not to be used in providing fire fighting services, interest on the obligation is not exempt from tax under section 103(i) and this section. In computing this percentage—

(1) Costs are allocated between providing a firehouse or firetruck and other uses of the proceeds on a pro rata basis; and

(2) The rules set forth in § 1.103–8(a)(1)(i), relating to amounts allocable to exempt and nonexempt uses and amounts chargeable to capital account, apply.

(d) *Refunding issues.* An obligation which is part of an issue issued by a qualified volunteer fire department after December 31, 1980, part or all of the proceeds of which issue are used directly or indirectly to pay principal, interest, call premium, or reasonable incidental costs of refunding a prior issue qualifies as an obligation of a political subdivision under section 103(i) and this section only if—

(1) The prior issue was issued by a qualified volunteer fire department;

(2) Substantially all of the proceeds of the prior issue were used for the purposes described in paragraph (a)(2) of this section;

(3) The prior issue was issued after December 31, 1980; and

(4) The refunding issue is issued not more than 180 days before the date on which the last obligation of the prior issue is discharged (within the meaning of § 1.103–13)(b)(11)).

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

Example (1). The County M Volunteer Fire and Rescue Association provides firefighting, ambulance, and emergency medical services in County M. The board of county commissioners of County M contracts with the County M Volunteer Fire and Rescue Association for these services, and County M is not served by any other firefighting association. On August 1, 1981, the Association issues an obligation for funds to purchase a new fire truck, a new ambulance, and rescue equipment not to be used for fighting fires. Funds to be used for the purchase of the ambulance and rescue equipment constitute more than 10 percent of the proceeds of the obligation. Thus, substantially all of the proceeds of the obligations are not used for one of the purposes described in paragraph (a)(2) of this section. Although the County M Volunteer Fire and Rescue Association is a qualified volunteer fire department under paragraph (b) of this section because it provides firefighting and emergency medical services in an area within County M which is not provided with any other firefighting services and is required to provide these services by written agreement with County M, the August 1, 1981, obligation of County M Volunteer Fire and Rescue Association will not be treated as an obligation of a political subdivision of a State under section 103(i) and paragraph (a) of this section because substantially all of the proceeds of the obligation are not to be used for a purpose described in section 103(i)(l)(B) and paragraph (a)(2) of this section. Accordingly, interest on the August 1, 1981, obligation of County M Volunteer Fire and Rescue Association is not exempt from gross income under section 103(a)(1).

Example (2). County N Volunteer Fire Department provides firefighting services in County N by contract with the county, which is not served by any other firefighting association. On June 15, 1982, County N Volunteer Fire Department issues its obligation for funds to construct an addition to its firehouse to house a rescue squad, the rescue squad's vehicle, and rescue equipment not to be used in firefighting. Although the County

N Volunteer Fire Department is a qualified volunteer fire department under paragraph (b) of this section, interest on its June 15, 1982, obligation will not be exempt from tax under section 103(i) and this section because the proceeds of this obligation will not be used for the purposes described in paragraph (a) of this section.

Example (3). The County O Volunteer Fire and Rescue Association provides firefighting, ambulance, and emergency medical services in County O. The board of county commissioners of County O contracts with the County O Volunteer Fire and Rescue Association for these services, and County O is not served by any other firefighting association. On September 1, 1983, the Association issues its obligations for funds to construct a new building to house its firefighting, ambulance, and rescue functions. Although the ambulance and rescue equipment will occupy space in the projected facility, the cost allocable on a pro rata basis to providing housing for the ambulance and rescue equipment represents less than 10 percent of the proceeds of the obligations. Thus, substantially all of the proceeds of the obligations are used for one of the purposes described in paragraph (a)(2) of this section. The County O Volunteer Fire and Rescue Association is a qualified volunteer fire department under paragraph (b) of this section because it provides firefighting and emergency medical services in an area within County O which is not provided with any other firefighting services and is required to provide these services by written agreement with County O. The obligations of County O Volunteer Fire and Rescue Association will be treated as obligations of a political subdivision of a State under section 103(i) and paragraph (a) of this section because the obligations are those of a qualified volunteer fire department and because substantially all of the proceeds of the obligations are to be used for a purpose described in section 103(i)(1)(B) and paragraph (a)(2) of this section. Accordingly, interest on the September 1, 1983, issue of obligations of County O Volunteer Fire and Rescue Association is exempt from gross income under section 103(a)(1).

[T.D. 7901, 48 FR 32981, July 20, 1983]

§ 1.103(n)–1T Limitation on aggregrate amount of private activity bonds (temporary).

Q–1: What does section 103(n) provide?

A–1: Interest on an issue of private activity bonds will not be tax exempt unless the aggregrate amount of bonds issued pursuant to that issue, when added to (i) the aggregate amount of private activity bonds previously issued by the issuing authority during the calendar year and (ii) the portion of that year's private activity bond limit that the issuing authority has elected to carry forward to a future year, does not exceed the issuing authority's private activity bond limit for that calendar year. See A–4 of § 1.103(n)–4T with respect to private activity bonds issued under a carryforward election.

Q–2: What is the effective date of section 103(n)?

A–2: In general, section 103(n) applies to private activity bonds issued after December 31, 1983. Section 103(n) does not apply to any issue of obligations, however, if there was an inducement resolution (or other comparable preliminary approval) for the project before June 19, 1984, and the issue for such project is issued before January 1, 1985. An issue of obligations will be considered to be issued for the project pursuant to the inducement resolution in existence before June 19, 1984, to the extent that the nature, character, and purpose of the facility has not changed in any material way, and to the extent that the capacity of the facility has not increased materially; in addition, the issue of obligations must be for the same or a related initial owner, manager, or operator. See § 1.103–10(e) for the definition of related persons. See A–16 of § 1.103(n)–3T with respect to certain projects preliminarily approved before October 19, 1983. The transitional rules provided by section 631(c) of the Tax Reform Act of 1984 do not apply to section 103(n). See § 1.103–13(b)(6) for the rules relating to the date of issue of obligations.

Q–3: If an issue of private activity bonds causes the issuer's private activity bond limit to be exceeded, what is the effect on that issue?

A–3: If an issue of private activity bonds causes the issuing authority's private activity bond limit to be exceeded, no portion of that issue will be treated as obligations described in section 103(a), and interest paid on the issue will be subject to Federal income taxation.

Q–4: If an issue of private activity bonds causes the issuer's private activity bond limit to be exceeded, what is the effect on previous issues of private activity bonds that met the requirements of section 103(n) when issued?

A–4: Private activity bonds issued as part of an issue that met the private activity bond limit when issued continue to meet the requirements of section 103(n) even though a subsequent issue causes the aggregate amount of private activity bonds issued by an issuing authority to exceed the authority's private activity bond limit for the calendar year.

Example. The following example illustrates the provisions of A–3 and A–4 of this §1.103(n)–1T:

Example. The State ceiling for State Z for 1986 is $200 million. City M, within the State, and State Z itself are authorized to issue private activity bonds. Under the allocation formula provided by the Governor of State Z, City M has a private activity bond limit of $50 million; the balance of the State ceiling is allocated to State Z. On June 1, 1986, City M issues a $75 activity bonds. On September 1, 1986, State Z issues a $150 million issue of private activity bonds. Based on these facts, the obligations of City M do not meet the requirements of section 103(n) since the aggregate amount of private activity bonds issued by City M in 1986 exceeded its private activity bond limit for such year; thus, such obligations are not described in section 103(a). That the State Z issue caused the aggregate amount of private activity bonds issued in the State during 1986 to exceed the State ceiling does not cause such obligations to fail to meet the requirements of section 103(n).

Q–5: What is the aggregate amount of private activity bonds issued as part of an issue?

A–5: The aggregate amount of private activity bonds issued as part of an issue is the face amount of the issue.

(Secs. 103(n) and 7805 of the Internal Revenue Code of 1954 (98 Stat. 916, 26 U.S.C. 103(n); 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7981, 49 FR 39316, Oct. 5, 1984]

§1.103(n)–2T Private activity bond defined (temporary).

Q–1: What is the definition of the term ''private activity bond''?

A–1: In general, for purposes of §§1.103(n)–1T through 1.103(n)–6T, the term ''private activity bond'' means any industrial development bond or student loan bond the interest on which is exempt from tax under section 103(a) (without application of section 103(n)). See §1.103–7(b) for the definition of the term ''industrial development bond.'' See A–17 of this §1.103(n)–2T for the definition of the term ''student loan bond.'' There are five exceptions to the general definition of the term ''private activity bond''; the exceptions include the exception for the Texas Veterans' Bond Program, the residential rental property exception, the exception for certain facilities described in section 103(b)(4) (C) or (D), and the refunding obligation exception. These exceptions are described in A–2 through A–16 of this §1.103(n)–2T. In addition, the term ''private activity bond'' does not include any issue of obligations if there was an inducement resolution (or other comparable preliminary approval) for the project before June 19, 1984, and the issue for that project is issued before January 1, 1985. See A–2 of §1.103(n)–1T.

Q–2: To which obligations does the exception for the Texas Veterans' Bond Program apply?

A–2: The term ''private activity bond'' does not include general obligation bonds issued under the Texas Veterans' Bond Program if the proceeds of the issue, other than an amount that is not a major portion of the proceeds, are used to make loans of up to $20,000 for the purchase of land for purposes authorized by such program as in effect on June 19, 1984. The use of the proceeds may be established by the affidavit of the veteran receiving the loan. For purposes of this exception to the definition of the term ''private activity bond,'' the use of more than 25 percent of the proceeds of an issue of obligations will constitute the use of a major portion of such proceeds.

Q–3: To which obligations does the residential rental property exception apply?

A–3: The term ''private activity bond'' does not include any obligation issued to provide projects for residential rental property (including property functionally related and subordinate to any such facility), as described in section 103(b)(4)(A) and §1.103–8(b). In addition, the term ''private activity bond'' does not include any housing program obligation under section 11(b) of the United States Housing Act of 1937.

Q–4: To which obligations does the exception for certain facilities described in section 103(b)(4) (C) or (D) apply?

A–4: Section 103(n)(7)(C) provides that the term ''private activity bond'' does not include any obligation issued as part of an issue to provide convention or trade show facilities, as described in section 103(b)(4)(C) and § 1.103–8(d) (including property functionally related and subordinate to any such facilities), if the property so described is owned by, or on behalf of, a governmental unit. In addition, the term ''private activity bond'' does not include any obligation issued as part of an issue to provide airports, docks, wharfs, mass commuting facilities, or storage or training facilities directly related to any of the foregoing facilities, as described in section 103(b)(4)(D) and § 1.103–8(e) (including property functionally related and subordinate to any such facilities), if the property so described is owned by, or on behalf of, a governmental unit. See § 1.103–8(a)(3), in general, for the definition of the term ''functionally related and subordinate.'' For purposes of this exception to the definition of the term ''private activity bond,'' the term ''mass commuting facilities'' includes ''qualified mass commuting vehicles,'' as defined in section 103(b)(9), that are associated with a mass commuting facility described in § 1.103–8(e)(2)(iv). Obligations issued as part of an issue to provide parking facilities, as described in section 103(b)(4)(D), are not excepted from the definition of the term ''private activity bond;'' however, parking facilities may be functionally related and subordinate to another facility described in section 103(b)(4) (C) or (D).

Q–5: When is property described in section 103(b)(4) (C) or (D) owned by, or on behalf of, a governmental unit?

A–5: In general, property described in section 103(b)(4) (C) or (D) will be considered to be owned by a governmental unit if a governmental unit is the owner of the property for Federal income tax purposes generally. See A–5 of § 1.103(n)–3T for the definition of the term ''governmental unit''. In general, property described in section 103(b)(4) (C) or (D) will be considered to be owned on behalf of a governmental unit if a constituted authority empowered to issue obligations on behalf of a governmental unit is the owner of the property for Federal income tax purposes generally. Whether the property is owned by, or on behalf of, a governmental unit will be determined on the basis of the facts and circumstances of each particular case. The fact that the governmental unit's or constituted authority's obligation to pay principal and interest on an obligation is limited to revenues from fees collected from users of the property provided with the proceeds of such obligation will not, in itself, cause such property to be treated as not owned by, or on behalf of, the governmental unit. In order to qualify for the exception described in section 103(n)(7)(C), the property must be owned by, or on behalf of, the governmental unit throughout the term of the issue. See A–10 of this § 1.103(n)–2T with respect to the consequences of a transfer of ownership.

Q–6: Will property described in section 103(b)(4) (C) or (D) that is leased to a non-governmental entity be treated as owned by, or on behalf of, a governmental unit if the lessee is the owner of the property for Federal income tax purposes generally solely by reason of the length of the lease?

A–6: If property, or any portion thereof, is leased to a non-governmental entity and if, for Federal income tax purposes generally, the lessee is the owner of the property solely by reason of the length of the lease, then, for purposes of §§ 1.103(n)–1T through 1.103(n)–6T (but not for other Federal income tax purposes, such as whether payments under the lease constitute deductible rental payments), the governmental unit will be treated as the owner of the property if the lessee elects not to claim depreciation or an investment credit with respect to such property. See A–7 of this § 1.103(n)–2T for the rules describing the method of making this election. For purposes of §§ 1.103(n)–1T through 1.103(n)–6T, the term ''non-governmental entity'' means a person other than a governmental unit or a constituted authority empowered to issue obligations on behalf of a governmental unit. The fact that a non-governmental entity lessee elects not to claim depreciation or an investment credit with respect to property does not, however, ensure that the property will be treated as owned by, or on behalf of a governmental unit for purposes of §§ 1.103(n)–1T through 1.103(n)–6T. Thus, for example, if the lessee is the owner of the property for Federal income tax purposes generally other than solely because of the length of the lease, the obligations issued as part of the issue are private activity bonds notwithstanding that the lessee elected not to claim depreciation or an investment credit with respect to the property.

Similarly, even if a governmental unit is the owner of property for Federal income tax purposes generally, the property will not be treated as owned by, or on behalf of, a governmental unit for purposes of §§ 1.103(n)–1T through 1.103(n)–6T if the lease under which such property is leased to a nongovernmental entity provides for significant front end loading of rental accruals or payments. See A–12 of this § 1.103(n)–2T with respect to significant front end loading of rental accruals or payments.

Q–7: What must a lessee do in order to elect not to take depreciation or an investment credit with respect to property described in section 103(b)(4) (C) or (D)?

A–7: The lessee must make the election at the time the lease is executed. The election must include a description of the property with respect to which the election is being made; the name, address, and TIN of the issuing authority; the name, address, and TIN of the lessee; and the date and face amount of the issue the proceeds of which are to be used to provide the property. The election must be signed by the lessee, if a natural person, or by a duly authorized official of the lessee. The issuing authority must be provided with a copy of the election. The issuing authority and the lessee must retain copies of the election in their respective records for the entire term of the lease. In addition, the lease, and any publicly recorded document recorded in lieu of such lease, must state that neither the lessee nor any successor in interest under the lease may claim depreciation or an investment credit with respect to such property. This election may be made with respect to property whether or not such property otherwise would be eligible for depreciation or an investment tax credit. See section 7701(a)(41) for the definition of the term ‘‘TIN’’.

Q–8: Is the election not to claim depreciation or an investment credit revocable?

A–8: No, the election is irrevocable. In addition, the election is binding on all successors in interest under the lease regardless of whether the obligations remain outstanding. If a successor in interest claims depreciation or an investment credit with respect to property for which such an election has been made, such property will be considered transferred to a non-governmental entity. See A–10 of this § 1.103(n)–2T with respect to the consequences of such a transfer.

Q–9: Where obligations are issued to provide all or any portion of a facility described in section 103(b)(4) (C) or (D), must all of the property described in section 103(b)(4) (C) or (D) that is part of such facility be owned by, or on behalf of, a governmental unit in order for such obligations to qualify for the exception to the definition of the term ‘‘private activity bond’’ provided in section 103(n)(7)(C)?

A–9: Generally, yes. If obligations are issued to provide all or any portion of a facility described in section 103(b)(4) (C) or (D), the obligations comprising such issue will not qualify for the exception to the definition of the term ‘‘private activity bond’’ provided in section 103(n)(7)(C) unless all of the property described in section 103(b)(4) (C) or (D) that is part of (or functionally related and subordinate to) the facility being financed is owned by, or on behalf of, a governmental unit throughout the term of the issue. For this purpose, the facility being financed will be construed to include the entire airport, dock, etc., under consideration and not merely the part of the facility being provided with the proceeds of the issue. For example, the term facility, when used in reference to an airport, will be considered to include all property that is part of, or included in, that airport under § 1.103–8(e)(2)(ii)(*a*), including all property functionally related and subordinate thereto under §1.103—8 (a)(3) and (e)(2)(ii)(*b*). Thus, if the proceeds of an issue are used to provide a hangar at an airport described in section 103(b)(4)(D), that airport is considered as being financed with such issue, and if any portion of that airport, including property functionally related and subordinate thereto, is treated as owned by a non-governmental entity, that issue does not qualify for the exception of the definition of the term ''private activity bond'' provided in section 103(n)(7)(C).

There are three exceptions to this rule, however. First, if any property otherwise would be considered part of the facility financed and such property was not provided with proceeds of any obligation described in section 103(a), such property will not be considered part of the facility being financed.

Second, if any property otherwise would be considered part of the facility being financed and such property was part of such facility on or before October 5, 1984, such property will not be considered part of the facility being financed. For this purpose, property will be considered part of the facility on or before October 5, 1984, if any person was under a binding contract to acquire or construct such property to be a part of such facility on October 5, 1984.

Third, property will not be considered part of the facility being financed if such property (i) is land, a building, a structural component of a building, or other structure (other than tangible personal property (other than an air conditioning or heating unit)) and such property is not physically supported by, does not physically support, and is not physically connected to any property provided with the proceeds of obligations that qualify for the exception to the definition of the term ''private activity bond'' provided in section 103(n)(7)(C), or (ii) is tangible personal property (other than an air conditioning or heating unit). For this purpose, contiguous parcels of land will not be considered to support, to be supported by, or to be physically connected to each other, and insignificant physical connections (such as a connection by a sidewalk) will be disregarded. For purposes of this A–9, the term ''tangible personal property'' shall have the meaning given to it under section 48(a)(1)(A) and §1.48–1(c). Examples. The following examples illustrate the provisions of A–9 of this §1.103(n)–2T:

Example (1). On January 1, 1986, Governmental Unit M issues industrial development bonds to provide an airport, as described in section 103(b)(4)(D), which will consist of land, runways, a terminal and a functionally related and subordinate hotel. The hotel will be leased to N, a non-governmental entity. The lease does not call for significant front end loading of rental accruals or payments. For Federal income tax purposes generally, M will own the entire airport except that N will be the owner of the hotel solely by reason of the length of the lease. N properly elects not to claim depreciation of an investment credit with respect to the hotel. The industrial development bonds are not private activity bonds.

Example (2). The facts are the same as in Example (1) except that N does not make the election and claims depreciation with respect to the hotel. The entire issue of industrial development bonds is treated as an issue of private activity bonds.

Example (3). The facts are the same as in Example (2) except that the hotel is provided other than with the proceeds of an obligation described in section 103(a). The issue for the remainder of the airport qualifies for the exception to the definition of the term ''private activity bond'' provided in section 103(n)(7)(C).

Example (4). The facts are the same as in Example (2) except that the hotel, including the hotel parking lot, the hotel grounds, and the parcel of land on which they rest, are provided with a separate issue of industrial development bonds. There are no significant connections between the hotel and the airport. The issue for the hotel is an issue of private activity bonds. The issue for the remainder of the airport qualifies for the exception to the definition of the term ''private activity bonds'' provided in section 103(n)(7)(C).

Example (5). The facts are the same as Example (4) except that the hotel is constructed upon land provided with the proceeds of the issue used to provide the remainder of the airport. Both issues are treated as issues of private activity bonds.

Example (6). On June 30, 1983, construction began on the City NN airport, which consists of land, runways, a terminal, and hangars. Corporation XX (a non-governmental entity) owns for Federal income tax purposes generally several of the hangars, which it financed with obligations described in section 103(a) issued on June 30, 1983. On March 1, 1985, at a time when XX still owns the hangars, City NN issues an issue of obligations described in section 103(b)(4)(D) to enlarge the terminal at the City NN airport. City NN will own the addition to the terminal for Federal income tax purposes generally. The obligations comprising the March 1, 1985, issue will not be private activity bonds.

Q–10: What are the consequences if a governmental unit ceases to be treated as owning property described in section 103(b)(4) (C) or (D) where the property was provided by obligations that were not private activity bonds on the date of issue due to the exception provided in section 103(n)(7)(C)?

A–10: The obligations outstanding on the date such ownership ceases are private activity bonds and are treated as if they are the last private activity bonds issued by the issuer in the calendar year in which the transfer of ownership occurs. Thus, if the aggregate amount of bonds issued pursuant to such issue, when added to the aggregate amount of the other private activity bonds actually issued or treated as issued under this A–10 by the issuer during such year and the amount of any carryforward elections made during the year, exceeds the issuer's private activity bond limit for such year, the obligations are not described in section 103(a) as of the date on which transfer of ownership occurs; if such obligations do not comply with the requirements of section 103(n), the obligations will be treated as not described in section 103(a) as of the date such ownership ceases. However, if on the date of issue the issuer intended to transfer ownership of such property to a non-governmental entity during the term of the issue, then the obligations are treated as the last private activity bonds actually issued or treated as issued under this A–10 by the issuer during the year in which such obligations were actually issued; if such obligations do not comply with the requirements of section 103(n), the obligations will be treated as not described in section 103(a) as of the date of issue. The exception to the definition of the term ‘‘private activity bond'' for facilities described in section 103(b)(4) (C) and (D) only applies if the property is owned by, or on behalf of, a governmental unit while all or any part of the issue or any refunding issue remains outstanding.

If all or a portion of the property is sold to a non-governmental entity for its fair market value and all of the proceeds from the sale (except for a de minimis amount less than $5,000) are used within six months to redeem outstanding obligations, the obligations will not be treated as private entity bonds.

Q–11: What are the consequences if private activity bonds are issued to provide additions to a facility that was provided with obligations that were not private activity bonds when issued by virtue of the exception provided in section 103(n)(7)(C) and such additions are not treated as owned by a governmental unit?

A–11: In order to qualify for the exception to the definition of the term ‘‘private activity bond'' for obligations described in section 103(b)(4) (C) or (D), all of the property described in section 103(b)(4) (C) or (D) that is part of the facility provided with the proceeds generally must be owned by, or on behalf of, a governmental unit. See A–9 of this §1.103 (n)–2T. However, if the proceeds of an issue of private activity bonds are used to make additions to a facility (other than additions that are not considered to be part of the facility under A–9 of this §1.103(n)–2T) that was provided with another issue of industrial development bonds that were not private activity bonds when issued by virtue of the exception provided in section 103(n)(7)(C), then the prior issue will not cease to qualify for that exception. Nevertheless, for purposes of determining the aggregate amount of private activity bonds issued during the year that the issue to provide the addition to the previously financed facility is issued, the portion of the prior issue outstanding on the date of issue of the issue to provide the addition will be treated as part of the issue to provide the addition.

Example. The following example illustrates the provisions of A–11 of this §1.103 (n)–2T:

Example. On March 1, 1986, City P issues a $100 million issue of industrial development bonds to provide an airport, as described in section 103(b)(4)(D). City P uses substantially all of the proceeds to acquire land and to construct runways and a terminal on that land. No other property is constructed on the land. City P is the owner of the land and the terminal for Federal income tax purposes generally. Thus, the obligations comprising the March 1, 1986, issue are not private activity bonds when issued. On September 1, 1988, City P leases a portion of the land adjacent to the terminal to Corporation V (a non-governmental entity) under a true lease for Federal income tax purposes. City P's private activity bond limit for 1988 is $100 million, and as of September 30, 1988, City P has not issued any private activity bond during 1988. On September 30, 1988, City P issues a $20 million issue of industrial development bonds, the proceeds of which are to be used to construct a hotel that is functionally related and subordinate to the airport. The hotel is to be constructed on the land that P leased to Corporation V. The hotel will be owned by Corporation V for Federal income tax purposes generally. On September 30, 1988, the outstanding face amount of the March 1, 1986, issue is $100 million. Although the obligations comprising the March 1, 1986, issue will not become private activity bonds as a result of the subsequent issue, on September 30, 1988, City P is treated as issuing a $120 million issue of private activity bonds. Since that amount exceeds City P's private activity bond limit, the $20 million issue of private activity bonds issued on September 30, 1988, does not meet the requirements of section 103(n). In addition, any subsequent issuance of private activity bonds by City P during 1988 will fail to meet the requirements of section 103(n). The March 1, 1986, issue continues to be described in section 103(a).

Q–12: Section 103(n)(7)(C)(iv) provides that the exception for certain facilities described in section 103(b)(4) (C) or (D) shall not apply in any case where the facility is leased under a lease that has significant front end loading of rental accruals or payments. What does ''significant front end loading of rental accruals or payments'' mean?

A–12: Where a lease requires rental payments that are significantly higher in the early years of the lease than in later years, the lease calls for significant front end loading of rental accruals or payments. A lease that provides for flat rental payments during the entire lease term does not violate the prohibition against significant front end loading of rent. In addition, a lease may provide for adjustments in rent for inflation or deflation, provided that such adjustments are to be made on the basis of a generally recognized price index. In addition, a lease may provide that rental payments are to be determined, in whole or part, based on a percentage of income, production, etc., provided that the percentage rate is kept constant (or increases) over the term of the lease and that the threshold, if any, above which the percentage applies is kept constant (or decreases) over the term of the lease. Thus, for example, a lease that requires rental payments throughout the term of the lease of $100,000 per year plus 5 percent of the gross income from the facility in excess of $500,000 does not violate the prohibition against significant front end loading of rent.

Examples. The following examples illustrate the provisions of A–4 through A–12 of this § 1.103(n)–2T:

Example (1). On February 1, 1985, County Z issues obligations with a term of 30 years. Substantially all of the proceeds of the obligations are to be used to provide a trade show facility as described in section 103(b)(4)(C). Z leases the entire facility to Corporation S. For Federal income tax purposes generally, S is treated as the owner of the facility solely by reason of the length of the lease. The lease provides that the lessee will elect not to claim depreciation or an investment credit with respect to the facility and that S will provide Z with a copy of the election. S makes the election, retains it in its records, and provides County Z with a copy. The lease provides that neither the lessee nor any successor in interest will claim a deduction for depreciation or an investment credit with respect to such facility. The obligations are not private activity bonds on the date of issue, provided that the lease does not call for significant front end loading of rental accruals or payments.

Example (2). The facts are the same as in Example (1) except that on February 1, 1986, S assigns the lease to Corporation T. For its taxable year ending March 31, 1986, Corporation T claims depreciation with respect to the trade show facility. The obligations outstanding on the date Corporation T claims depreciation on its Federal income tax return are treated as the last private activity bonds actually issued or treated as issued by County Z during 1986, and such obligations must comply with the requirements of section 103(n). In addition, Corporation T is not entitled to claim depreciation or an investment credit with respect to the trade show facility during the balance of the term of the lease and will be subject to the applicable penalties for so claiming depreciation.

Example (3). The facts are the same as in Example (1) except that the obligations are redeemed on January 31, 1998; on January 31, 1999, S assigns the lease to Corporation X; and on its Federal income tax return for calendar year 1999, Corporation X claims depreciation with respect to the facility. The obligations are not private activity bonds provided that the lease does not call for significant front end loading of rental accruals or payments. However, X is not entitled to claim depreciation or an investment credit with respect to the trade show facility during the balance of the term of the lease and will be subject to the applicable penalties for so claiming those items.

Q–13: To which obligations does the refunding obligation exception apply?

A–13: The term ‘‘private activity bond’’ does not include any refunding obligation to the extent specified in this A–13. The term ‘‘refunding obligation’’ means an obligation that is part of an issue of obligations the proceeds of which are used to pay any principal or interest on any other issue of obligations described in section 103(a) (referred to as the prior issue). The term ‘‘refunding obligation’’ does not include any obligations issued more than 180 days before the prior issue is discharged (‘‘advance refundings’’). The exception for refunding obligations only applies to the extent that the aggregate amount of the refunding issue does not exceed the outstanding face amount of the prior issue, or portion thereof, being refunded. Thus, for example, in the case of an obligation part of the proceeds of which are to be used to refund a prior issue of private activity bonds and part of the proceeds of which are to be used to provide a pollution control facility under section 103(b)(4)(F), those proceeds to be used to refund all or any part of the principal amount of the prior issue are not the proceeds of a private activity bond; the balance of the proceeds are the proceeds of a private activity bond. The refunding obligation exception does not apply to obligations to the extent that amounts are used to pay the costs of issuing refunding obligations. If an issue of obligations consists of both obligations that qualify for the refunding obligation exception and private activity bonds that do not meet the requirements of section 103(n), the entire issue is treated as consisting of obligations not described in section 103(a).

Q–14: Does the refunding obligation exception apply to obligations issued to refund a prior issue of student loan bonds?

A–14: In the case of any student loan bond, the refunding obligation exception applies only if, in addition to the requirements stated in A–13 of this §1.103(n)–2T, the maturity date of the funding obligation is not later than the later of (i) the maturity date of the obligation to be refunded, or (ii) the date 17 years after the date on which the refunded obligation was issued (or, in the case of a series of refundings, the date on which the original obligation was issued).

Q–15: What is the ‘‘maturity date’’ of an obligation?

A–15: For purposes of section 103(n), the ‘‘maturity date’’ of an obligation is the date on which interest ceases to accrue and the obligation may either be paid or redeemed without penalty. The date is determined without regard to optional redemption dates (including those at the option of holders). If the issuer is required by the obligations or the indenture to redeem portions of obligations or to make payments of principal with respect to obligations in specified amounts and at specified times, such mandatory redemptions or payments shall be treated as separate obligations.

Q–16: Where private activity bonds are refunded with other obligations described in section 103(a), does the refunding obligation exception apply to the extent that the aggregate amount of the refunding obligations exceeds the outstanding principal amount of the prior issue due to the use of a portion of the proceeds of the refunding issue to fund a reasonably required reserve or replacement fund?

A–16: Whether the prior issue was issued prior to January 1, 1984, or thereafter, the refunding obligation exception to the definition of the term ‘‘private activity bond’’ only applies to the extent that the aggregate amount of the refunding obligation does not exceed the outstanding principal amount of the prior issue. Thus, the additional obligations issued to provide for a reasonably required reserve or replacement fund are private activity bonds.

Q–17: What is a ‘‘student loan bond’’?

A–17: The term ‘‘student loan bond’’ means an obligation that is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly to finance loans to individuals for educational expenses. For purposes of this A–17, the use of more than 25 percent of the proceeds of an issue of obligations to finance loans to individuals for educational expenses will constitute the use of a major portion of such proceeds in such manner.

(Secs. 103(n) and 7805 of the Internal Revenue Code of 1954 (98 Stat. 916, 26 U.S.C.103(n); 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7981, 49 FR 39316, Oct. 5, 1984]

§1.103(n)–3T Private activity bond limit (temporary).

Q–1: What is the ''State ceiling''?

A–1: In general, the State ceiling applicable to each State and the District of Columbia for any calendar year prior to 1987 shall be the greater of $200 million or an amount equal to $150 multiplied by the State's (or the District of Columbia's) population. In the case of any territory or possession of the United States, the State ceiling for any calendar year prior to 1987 shall be an amount equal to $150 multiplied by the population of such territory or possession. In the case of calendar years after 1986, the two preceding sentences shall be applied by substituting ''$100'' for ''$150.'' In the case of any State that had an excess bond amount for 1983, the State ceiling for calendar year 1984 shall be the sum of the State ceiling determined under the general rule plus 50 percent of the excess bond amount for 1983. The excess bond amount for 1983 is the excess (if any) of (i) the aggregate amount of private activity bonds issued by issuing authorities in such State during the first 9 months of calendar year 1983 multiplied by 4⁄3, over (ii) the State ceiling determined under the general rule for 1984. For purposes of determining the State ceiling amount applicable to any any State for calendar year 1984, an issuer may rely upon the State ceiling amount published by the Treasury Department for such calender year. However, an issuer may compute a different excess bond amount for 1983 where the issuer or the State in which the issuer is located has made a more accurate determination of the amount of private activity bonds issued by issuing authorities in the issuer's State during 1983. See A–7 of this §1.103(n)–3T for rules regarding a State containing constitutional home rule cities.

Q–2: What is the private activity bond limit for a State agency?

A–2: Under section 103(n)(2) the private activity bond limit for any agency of the State authorized to issue private activity bonds for any calendar year shall be 50 percent of the State ceiling for such year unless the State provides for a different allocation. For this purpose, the State is considered an agency. See, however, A–17 of this §1.103(n)–3T with respect to the penalty for failure to comply with the requirements of section 631(a)(3) of the Tax Reform Act of 1984.

Q–3: How is private activity bond limit determined where a State has more than one agency?

A–3: If any State has more than one agency (including the State) authorized to issue private activity bonds, all such agencies shall be treated as a single agency for purposes of determining the aggregate private activity bond limit available for all such agencies. Each of the State agencies is treated as having jurisdiction over the entire State. Therefore, under A–8 of this §1.103(n)–3T the aggregate private activity bond limit for all the State agencies is allocated to the State since it possesses the broadest sovereign powers of any of the State agencies. Each other State agency's private activity bond limit is zero until it is assigned part of the private activity bond limit of another governmental unit pursuant to these regulations.

Q–4: What is a State agency?

A–4: A State agency is an agency authorized by a State to issue private activity bonds on behalf of the State. In addition, a special purpose governmental unit that derives its sovereign powers from the State and may exercise its sovereign powers throughout the State is a State agency. See A–5 of this §1.103(n)–3T for the definition of the term ''special purpose governmental unit.'' The term ''State agency'' does not include issuing authorities empowered by a State at the request of another governmental unit within the State to issue private activity bonds to provide facilities within the jurisdiction of such other governmental unit. For example, if County O requests the legislature of State P to create an issuing authority empowered to issue obligations to provide pollution control facilities in County O, the authority is not a State agency.

Examples. The following examples illustrate the provisions of A–3 and A–4 of this § 1.103(n)–3T:

Example (1). For 1987 State Q has a State ceiling of $200 million. Neither the Governor nor the legislature of State Q has provided a formula for allocating the State ceiling different from that provided by section 103(n) (2) and (3). State Q has authorized the following State agencies to issue private activity bonds on its behalf: Authority M, Authority N, and Authority O. The aggregate private activity bond limit available for State agencies of State Q is $100 million. As of January 1, 1987, none of this aggregate private activity bond limit has been assigned to any of Authorities M, N, or O. On January 1, 1987, Authority M issues $25 million of private activity bonds. During 1987, the duly authorized official designated by State Q to allocate the aggregate private activity bond limit among the three authorities does not allocate any of the State's private activity bond limit to Authority M. The January 1, 1987, issue does not meet the requirements of section 103(n) since Authority M has no private activity bond limit for 1987.

Example (2). Under the laws of State U, only the State legislature can create constituted authorities empowered to issue private activity bonds on behalf of governmental units within State U. Authority R was created by the State U legislature at the request of County X. Authority R is a constituted authority empowered to issue private activity bonds on behalf of County X to provide facilities located in County X. Authority S was created by the legislature to issue private activity bonds to provide pollution control facilities throughout the State. Authority S is a State agency as defined in A–4 of this § 1.103(n)–3T. Authority R it is not a State agency.

Q–5: What is a governmental unit?

A–5: The term ''governmental unit'' has the meaning given such term by § 1.103–1. For purposes of §§ 1.103(n)–1T through 1.103(n)–6T, a governmental unit is either a general purpose governmental unit or a special purpose governmental unit. The term ''general purpose governmental unit'' means a State, territory, possession of the United States, the District of Columbia, or any general purpose political subdivision thereof. The term ''general purpose political subdivision'' denotes any division of government that possesses the right to exercise police powers, the power to tax, and the power of eminent domain and that is governed, at least in part, by popularly elected officials (*e.g.*, county, city, town, township, parish, village). The term ''special purpose governmental unit'' means any governmental unit as defined in § 1.103–1 other than a general purpose governmental unit. For example, a sewer authority with the power of eminent domain but without police powers is a special purpose governmental unit. A constituted authority empowered to issue private activity bonds on behalf of a governmental unit is not a governmental unit.

Q–6: What is the private activity bond limit for a general purpose governmental unit other than a State, the District of Columbia, a territory, or a possession?

A–6: The private activity bond limit for any such general purpose governmental unit for any calendar year is an amount equal to the general purpose governmental unit's proportionate share of 50 percent of the State ceiling amount for such calendar year. See A–10 of this § 1.103(n)–3T with respect to the rules for providing a different allocation. The proportionate share of a general purpose governmental unit is an amount that bears the same ratio to 50 percent of the State ceiling for such year as the population of the jurisdiction of such general purpose governmental unit bears to the population of the entire State, District of Columbia, territory, or possession in which its jurisdiction falls. See, however, A–17 of this § 1.103(n)–3T with respect to the penalty for failure to comply with the requirements of section 631(a)(3) of the Tax Reform Act of 1984. See A–9 of this § 1.103(n)–3T with respect to the private activity bond limit of issuing authorities other than general purpose governmental units.

Q–7: What is the private activity bond limit for a general purpose governmental unit in a State with one or more constitutional homes rule cities?

A–7: The private activity bond limit for a constitutional home rule city for any calendar year is an amount equal to the constitutional home rule city's proportionate share of 100 percent of the State ceiling amount for the calendar year. The proportionate share of a constitutional home rule city is an amount that bears the same ratio to the State ceiling for such year as the population of the jurisdiction of such constitutional home rule city bears to the population of the entire State. The private activity bond limit for issuers other than constitutional home rule cities is computed in the manner described in A–2 through A–6 of this § 1.103(n)–3T, except that in computing the private activity bond limit for issuers other than such constitutional home rule cities, the State ceiling amount for any calendar year shall be reduced by the aggregate private activity bond limit for all constitutional home rule cities in the State. The term ''constitutional home rule city'' means, with respect to any calendar year, any political subdivision of a State that, under a State constitution that was adopted in 1970 and effective on July 1, 1971, had home rule powers on the first day of the calendar year. See, however, A–17 of this § 1.103(n)–3T with respect to the penalty for failure to comply with the requirements of section 631(a)(3) of the Tax Reform Act of 1984.

Q–8: How is the private activity bond limit of an issuing authority determined under section 103(n)(3) when there are overlapping jurisdictions?

A–8: If an area is within the jurisdiction of two or more governmental units, that area will be treated as only within the jurisdiction of the governmental unit having jurisdiction over the smallest geographical area. However, the governmental unit with jurisdiction over the smallest geographical area may enter into a written agreement to allocate all or a designated portion of such overlapping area to the governmental unit having jurisdiction over the next smallest geographical area. Where two or more issuing authorities, whether governmental units or constituted authorities, have authority to issue private activity bonds and both issuing authorities have jurisdiction over the identical geographical area, that area will be treated as only within the jurisdiction of the one having the broadest sovereign powers. However, the issuing authority having the broadest sovereign powers may enter into a written agreement to allocate all or a designated portion of such area to the one with the narrower sovereign powers. All written agreements entered into pursuant to this A–8 must be retained by the assignee in its records for the term of all private activity bonds it issues in each calendar year to which such agreement applies. See A–9 of this § 1.103(n)–3T with respect to the private activity bond limit of issuing authorities other than general purpose governmental units.

Q–9: What is the private activity bond limit of an issuing authority (other than a State agency) that is not a general purpose governmental unit?

A–9: A constituted authority empowered to issue private activity bonds on behalf of a governmental unit is treated as having jurisdiction over the same geographical area as the governmental unit on behalf of which it is empowered to issue private activity bonds. Since a governmental unit has broader sovereign powers than a constituted authority empowered to issue private activity bonds on its behalf, a constituted authority has a private activity bond limit under section 103(n) (2) and (3) of zero. Similarly, a special purpose governmental unit is treated for purposes of section 103(n) as having jurisdiction over the same geographical area as that of the general purpose governmental unit or units from which the special purpose governmental unit derives its sovereign powers. Since a general purpose governmental unit has broader sovereign powers than a special purpose governmental unit, a special purpose governmental unit has a private activity bond limit under section 103(n) (2) and (3) of zero. An issuer of qualified scholarship funding bonds, as defined in section 103(e), is treated for purposes of section 103(n) as issuing on behalf of the State or politicial subdivision or subdivisions that requested its organization or its exercise of power to issue bonds. See A–13 and A–14 of this § 103(n)–3T with respect to assignments of private activity bond limit. For purposes of §§ 1.103(n)–1T through

1.103(n)–6T, a special purpose governmental unit shall be considered to derive its authority from the smallest general purpose governmental unit that—

(i) Enacts a specific law (e.g., a provision of a State constitution, charter, or statute) by or under which the special purpose governmental unit is created, or

(ii) Otherwise empowers, approves, or requests the creation of the special purpose governmental unit, or

(iii) Appoints members to the governing body of the special purpose governmental unit,

and within which general purpose governmental unit falls the entire area in which such special purpose governmental unit may exercise its sovereign powers. If no one general purpose governmental unit meets such criteria (e.g., a regional special purpose governmental unit that exercises its sovereign powers within three counties pursuant to a separate ordinance adopted by each such county), such special purpose governmental unit shall be considered to derive its sovereign powers from each of the general purpose governmental units comprising the combination of smallest general purpose governmental units within which falls the entire area in which such special purpose governmental unit may exercise its sovereign powers and each of which meets (i), (ii), or (iii) above.

Q–10: Does the issue comply with the requirements of section 103 (n) under the following circumstances? Based on the most recent estimate of the resident population of State Y published by the Bureau of the Census before the beginning of 1988, the State ceiling for State Y is $200 million. Based on the same estimate, the population of City Q is one-fourth of the population of State Y. No part of the geographical area within the jurisidiction of City Q is within the jurisdiction of any other governmental unit with jurisdiction over a smaller geographical area. There are no consitutional home rule cities in State Y. Neither the Governor nor the legislature of State Y has provided a different formula for allocating the State ceiling than that provided by section 103(n) (2) and (3); thus, City Q's private activity bond limit for 1988 is $25 million (.25 × .50 × $200 million). As of March 1, 1988, City Q has issued $15 million of private activity bonds during calender year 1988, none of which were issued pursuant to a carryforward election made in a prior year. On March 1, 1988, City Q will issue $5 million of private activity bonds to provide a pollution control facility as described in section 103(b)(4) (F). C, a duly authorized official of City Q responsible for issuing the bonds, provides a statement that will be included in the bond indenture or a related document providing that—

(i) Under section 103(n) (2) and (3) of the Internal Revenue Code, City Q has a private activity bond limit of $25 million for calendar year 1988 (.25 × .50 × $200 million), none of which has been assigned to it by another governmental unit,

(ii) State Y has not provided a different method of allocating the State ceiling,

(iii) City Q has not assigned any portion of its private activity bond limit to a constituted authority empowered to issue private activity bonds on its behalf, or to any other governmental unit,

(iv) City Q has not elected to carry forward any of its private activity bond limit for 1988 to another calendar year, nor has City Q in any prior year made a carryforward election for the pollution control facility,

(v) The aggregate amount of private activity bonds issued by City Q during 1988 is $15 million, and

(vi) The issuance of $5 million of private activity bonds on March 1, 1988, will not violate the requirements of section 103 (n) and the regulations thereunder.

In addition, C provides the certification described in section 103 (n) (12) (A).

A–10: Based on these facts, the issue meets the requirements of section 103(n) and §§1.103(n)–1T through 1.103(n)–6T. See §1.103–13(b)(8) for the definition of the terms ‘‘bond indenture’’ and‘‘related documents.’’

Q–11: May a State provide a different formula for allocating the state ceiling?

A–11: A State, by law enacted at any time, may provide a different formula for allocating the State ceiling among the governmental units in the State (other than constitutional home rule cities) having authority to issue private activity bonds, subject to the limitation provided in A–12 of this § 1.103(n)–3T. The governor of a State may proclaim a different formula for allocating the State ceiling among the governmental units in such State having authority to issue private activity bonds. The authority of the governor to proclaim a different formula shall not apply after the earlier of (i) the first day of the first calendar year beginning after the legislature of the State has met in regular session for more than 60 days after July 18, 1984, and (ii) the effective date of any State legislation dealing with the allocation of the State ceiling. If, on or before either date, the governor of any State exercises the authority to provide a different allocation, such allocation shall be effective until the date specified in (ii) of the immediately preceding sentence. Unless otherwise provided in a State constitutional amendment or by a law changing the home rule provisions adopted in the manner provided by the State constitution, the allocation of that portion of the State ceiling that is allocated to any constitutional home rule city may not be changed by the governor or State legislature unless such city agrees to such different allocation.

Q–12: Where a State provides an allocation formula different from that provided in section 103 (n) (2) and (3), which allocation formula applies to obligations issued prior to the adoption of the different allocation formula?

A–12: Where a State provides a different allocation formula, the determination as to whether a particular bond issue meets the requirements of section 103(n) will be based upon the allocation formula in effect at the time such bonds were issued. The amount that may be reallocated pursuant to the later allocation formula is limited to the State ceiling for such year reduced by the amount of private activity bonds issued under the prior allocation formula in effect for such year.

Q–13: May an issuing authority assign a portion of its private activity bond limit to another issuing authority if the governor or legislature has not provided for an allocation formula different from that provided in section 103(n) (2) and (3)?

A–13: Except as provided in this A–13 or in A–8, A–14, or A–15 of this § 1.103(n)–3T, no issuing authority may assign, directly or indirectly, all or any portion of its private activity bond limit to any other issuing authority, and no such attempted assignment will be effective. However, a general purpose governmental unit may assign a portion of its private activity bond limit to (i) a constituted authority empowered to issue private activity bonds on behalf of the assigning governmental unit, and (ii) a special purpose governmental unit deriving sovereign powers from the governmental unit making the assignment. In addition, a State may assign a portion of its private activity bond limit to a constituted authority empowered to issue private activity bonds on behalf of any governmental unit within such State and to any governmental unit within such State. Finally, an issuing authority that is assigned all or a portion of the private activity bond limit of a governmental unit pursuant to the immediately preceding two sentences may assign such amount or any part thereof to the governmental unit from which it received the assignment. None of these permissible types of assignments shall be effective, however, unless made in writing by a duly authorized official of the governmental unit making the assignment and a record of the assignment is maintained by the assignee for the term of all private activity bonds it issues in each calendar year to which such assignment applies. None of these permissible types of assignments shall be effective if made retroactively; provided, however, that retroactive assignments may be made during 1984. In addition, except as provided in A–15 of this § 1.103(n)–3T, a purported assignment by a governmental unit of a portion of its private activity bond limit to an issuing authority will be ineffective to the extent that private activity bonds issued by such authority provide facilities not located within the jurisdiction of the governmental unit making the assignment, unless the sole beneficiary of the facility is the governmental unit attempting to make the assignment. Similarly, except as provided in A–15 of this §1.103(n)–3T, a governmental unit may not allocate a portion of its private activity bond limit to an issue of obligations to provide a facility not located within the jurisdiction of that governmental unit unless the sole beneficiary of the facility is the governmental unit attempting to allocate its private activity bond limit to the issue. If an issuing authority issues an issue of obligations a portion of the proceeds of which are to be used to provide a facility not within its jurisdiction other than one described in the immediately preceding sentence, that issue will not meet the requirements of section 103(n) unless an issuing authority within the jurisdiction of which the facility is to be located specifically allocates a portion of its private activity bond limit to such issue equal to the amount of proceeds to be used to provide such facility.

Q–14: May an issuing authority assign a portion of its private activity bond limit to another issuing authority if the governor or legislature has provided for an allocation formula different from that provided in section 103(n) (2) and (3)?

A–14: Yes, under certain conditions. In providing a different formula for allocating the State ceiling, a State may permit an issuing authority to assign all or a portion of its private activity bond limit to other issuing authorities within the State, provided that such assignment is made in writing and a record of that assignment is maintained by the assignee in its records for the term of all private activity bonds it issues in each calendar year to which such assignment applies and a record of that assignment is maintained during such period by the public official responsible for making allocations of the State ceiling to issuing authorities within the State. The preceding sentence will only apply where the different formula expressly permits such assignments. Notwithstanding this A–14, no assignments may be made to regional authorities without compliance with the provisions of A–15 of this §1.103(n)–3T.

Q–15: May a general purpose governmental unit assign a portion of its private activity bond limit to a regional authority empowered to issue private activity bonds on behalf of two or more general purpose governmental units?

A–15: Yes, under certain conditions. In order for an issue of private activity bonds issued by such a regional authority to meet the requirements of section 103(n), each of the governmental units on behalf of which the regional authority issues private activity bonds must assign to the regional authority a portion of its private activity bond limit based on the ratio of its population to the aggregate population of all such governmental units. The governmental unit within the jurisdiction of which the facility to be provided by the private activity bonds will be located, however, may elect to treat the regional authority as if it were a constituted authority empowered to issue such obligations solely on behalf of that governmental unit and, therefore, may assign a portion of its limit to the authority solely to provide the facility within its jurisdiction. Similarly, if a facility will solely benefit one governmental unit, that governmental unit may make the election described in the preceding sentence. In addition, any of the governmental units on behalf of which the regional authority issues private activity bonds, other than the governmental unit within the jurisdiction of which the facility will be located, may elect to be treated as if it had not empowered the authority to issue that issue of private activity bonds on its behalf. In providing a different formula for allocating the State ceiling, a State may permit a governmental unit to assign all or a portion of its private activity bond limit to a constituted authority empowered to issue private activity bonds on behalf of two or more governmental units, all of which are located within the State. The preceding sentence will only apply where the different formula expressly so provides. The principles of this A–15 shall not apply to any regional authority created with a principal purpose of avoiding the restrictions provided in A–13 or A–14 of this §1.103(n)–3T. The principles of this A–15 shall also apply to a special purpose governmental unit providing facilities located within the jurisdiction of two or more general purpose governmental units from which it derives sovereign powers.

Examples. The following examples illustrate the provisions of A–8 through A–15 of this section:

Example (1). Authority ZZ is empowered by City Y to issue obligations on its behalf to provide financing for pollution control facilities located within the jurisdiction of City Y and the geographical area within 10 miles of the limits of City Y. Authority ZZ has no sovereign powers. Although the authority of Authority ZZ to issue obligations enables it to provide facilities located outside of the jurisdiction of City Y, Authority ZZ is treated as having jurisdiction over the same geographical area as City Y. Since City Y has broader sovereign powers than Authority ZZ, under section 103(n)(3) Authority ZZ has a private activity bond limit of zero. On March 31, 1985, Authority ZZ issues $5 million of private activity bonds. City Y has not assigned any portion of its private activity bond limit to Authority ZZ. Thus, the March 31, 1985, issue of private activity bonds is treated as an issue of obligations not described in section 103(a), and the interest on such obligations is subject to Federal income taxation.

Example (2). In 1972, State S, State T, and State V empowered Authority Z to issue industrial development bonds on behalf of the three States and to provide port facilities in a harbor serving residents of all three States. S, T, and V have populations of 1,000,000, 2,000,000, and 7,000,000, respectively. Authority Z will issue $100 million of private activity bonds on September 1, 1985, to finance construction of a dock to be located in State S. The obligations will not meet the requirements of section 103(n) unless S, T, and V assign a portion of their private activity bond limits to Authority Z pursuant to one of three methods. First, S, T, and V may assign $10 million, $20 million, and $70 million, respectively, of their private activity bond limits to Authority Z for this issue. Second, S, T, and V may assign $100 million, $0, and $0, respectively, of their private activity bond limits to Authority Z for this issue. Third, either T or V (but not S) may allocate $0 of its private activity bond limit to Authority Z for purposes of this issue, and the remaining two States may allocate the $100 million based upon their respective populations. For instance, if T were to allocate $0 for purposes of this issue, S and V must allocate $12.5 million and $87.5 million, respectively, of their private activity bond limits to Authority Z.

Q–16: Must an issuing authority allocate any of its private activity bond limit to certain preliminarily approved projects?

A–16: Yes. Section 631(a)(3) of the Tax Reform Act of 1984 provides that, with respect to certain projects preliminarily approved by an issuing authority before October 19, 1983, the issuing authority shall allocate its share of the private activity bond limit for the calendar year during which the obligations are to be issued first to those projects. For purposes of this A–16 and A–17 and A–18 of this § 1.103(n)–3T, a general purpose governmental unit will be treated as having preliminarily approved a project if the project was preliminarily approved by it, by a constituted authority empowered to issue private activity bonds on its behalf, or by a special purpose governmental unit treated as having jurisdiction over the same geographical area as the general purpose governmental unit. Thus, if a project was approved by a constituted authority, the governmental unit on behalf of which such issue is to be issued must assign a portion of its private activity bond limit to the authority pursuant to section 631(a)(3) of the Act. If a project was preliminarily approved by a constituted authority empowered to issue private activity bonds on behalf or more than one general purpose governmental unit or a special purpose governmental unit that derives its sovereign powers from more than one general purpose governmental unit, the project will be considered approved by each of such general purpose governmental units in proportion to their relative populations. The projects that receive priority under section 631(a)(3) of the Act and this A–16 are those with respect to which—

(i) There was an inducement resolution (or other comparable preliminary approval) for a project before October 19, 1983, by an issuing authority,

(ii) A substantial user of the project notified such issuing authority—

(A) By August 17, 1984, that it intended to claim its rights under section 631(a)(3) of the Tax Reform Act of 1984, and

(B) By December 31, 1984, as to the calendar year in which it expects the obligations to provide the project to be issued, and

(iii) Construction of such project began before October 19, 1983, or a substantial user was under a binding obligation on that date to incur significant expenditures with respect to the project.

For purposes of the preceding sentence, the term ‘‘significant expenditures’’ means expenditures that equal or exceed the lesser of $15 million or 20 percent of the estimated cost of the facilities. An issuing authority may require, as part of the submission required by (ii)(B) of this A–16, that a substantial user specify the aggregate amount of private activity bonds necessary for the project. Section 631(a)(3) does not apply to a project to the extent that the aggregate amount of obligations required for such project exceeds the amount, if any, provided for in the inducement resolution or resolutions in existence with respect to such project before October 19, 1983, or in the statement that may be required by the issuing authority as part of the submission required by (ii)(B) of this A–16. Similarly, section 631(a)(3) does not apply to a project to the extent of any material change in its nature, character, purpose, or capacity. Section 631(a)(3) does not apply to a project if the owner, operator, or manager of such project is not the same (or a related person) as the owner, operator, or manager named in the latest inducement resolution with respect to such project in existence before October 19, 1983. Section 631(a)(3) of the Act does not apply to any project if the obligations to provide the project are not issued in the year specified in the submission required by (ii)(B) of this A–16. In addition, section 631(a)(3) of the Act does not apply to any project to the extent that the amount of obligations to be issued for such project exceeds the share of the State ceiling to which the issuing authority that authorized the project is entitled as determined under section 103(n) (2) and (3) without regard to any alternative formula for allocating the State ceiling. The requirements of section 631(a)(3) will not apply where a State statute specifically so provides.

Q–17: What is the penalty for failure to comply with the requirements of section 631(a)(3) of the Act?

A–17: If any issuing authority fails to comply with the requirements of section 631(a)(3) of the Act, its private activity bond limit for the calendar year following the year in which the failure occurs shall be reduced by the amount of private activity bonds with respect to which the failure occurs. This penalty applies whether the issuing authority’s private activity bond limit is determined under the formula provided under section 103(n) (2) and (3) or a different formula provided under section 103(n)(6). The penalty is imposed on the issuing authority that failed to comply with the requirements of section 631(a)(3) or, if in the year in which the penalty is imposed the issuing authority does not have a sufficient private activity bond limit to absorb the entire penalty, on the general purpose governmental unit treated as having jurisdiction over the same geographical area as the issuing authority. For purposes of this A–17, the general purpose governmental unit’s private activity bond limit includes the private activity bond limit of each issuing authority treated as having preliminarily approved the project under A–16 of this §1.103(n)–3T. Thus, for example, if a governmental unit failed to comply with the requirements of section 631(a)(3) of the Act with respect to a $5 million issue to be issued in 1985, and that governmental unit is assigned $15 million of the State ceiling for 1986 pursuant to a formula provided under section 103(n)(6), that governmental unit has a private activity bond limit of $10 million for 1986. Similarly, where a project that was preliminarily approved by an issuing authority that is not a governmental unit qualifies for $10 million of priority under section 631(a)(3) of the Act is not allocated a total of $10 million by the governmental unit on behalf of which the issuing authority is empowered to issue private activity bonds, the issuing authority’s private activity bond limit, if any, for the year following this failure is reduced by $10 million; if the issuing authority’s private activity bond limit for the year following the failure is less than $10 million, the private activity bond limit of the governmental unit on behalf of which the private activity bonds would have been issued had the failure not occurred (including if necessary, on a proportionate basis, the private activity bond limit purported to have been assigned to each of the other constituted authorities empowered to issue private activity bonds on behalf of the governmental unit and each special purpose governmental unit deriving all or part of its sovereign powers from the governmental unit) is reduced by the difference between $10 million and the reduction made in the issuing authority's private activity bond limit with respect to such failure.

Q–18: Will a penalty be assessed for failure to allocate private activity bond limit to all projects that meet the requirements section 631(a)(3) if the amount of obligations required by all such projects preliminarily approved by (or treated as having been preliminarily approved by) an issuing authority exceeds the private activity bond limit of such issuing authority?

A–18: No penalty will be assessed if priority is given to those eligible projects for which substantial expenditures were incurred before October 19, 1983. An issuer may define the term ''substantial expenditures'' in any reasonable manner based on the relevant facts and circumstances and its private activity bond limit.

Examples. The following examples illustrate the provisions of A–16 through A–18:

Example (1). On October 1, 1983, County S approved an inducement resolution for the issuance of up to $30 million of industrial development bonds to provide a pollution control facility described in section 103(b)(4)(F) for Corporation R. On October 5, 1983, R contracted with Corporation Q to begin construction of the pollution control facility immediately, and construction began on October 10, 1983. Not later than August 17, 1984, Corporation R notified County S that it intended to seek priority under section 631(a)(3) of the Tax Reform Act of 1984. In addition, prior to December 31, 1984, Corporation R notified County S that it expected the County to issue $25 million of industrial development bonds for its project during calendar year 1985. Under section 103(n)(3), County S has a private activity bond limit of $50 million for calendar year 1985, and neither the Governor nor the legislature of the State has provided a different allocation formula under section 103(n)(6). There are no other projects approved by County S that have rights under section 631(a)(3). On March 1, 1985, County S issues $25 million of industrial development bonds for the pollution control facility for Corporation R. If County S allocates less than $25 million of its private activity bond limit to that project, its private activity bond limit for 1986 will be reduced by the difference between $25 million and the amount County S actually allocates to the project.

Example (2). The facts are the same as in Example (1) except that during 1984 Corporation R fails to notify County S of the year in which it expects the obligations to be issued. Upon such failure the pollution control facility no longer qualifies for priority under section 631(a)(3), and County S will not be penalized if it does not not allocate any of its private activity bond limit for 1985, or any future year, to that project.

Example (3). The facts are the same as in Example (1) except that under section 103(n)(3) County S has a private activity bond limit of $10 million for 1985. County S will not be penalized if it allocates $10 million of its private activity bond limit to the project.

Example (4). The facts are the same as in Example (3) except that on December 31, 1984, the Governor of the State provides a different allocation from that provided under section 103(n) (2) and (3). (The State has not enacted a statute specifically providing that section 631(a)(3) does not apply.) The different allocation provides that the entire State ceiling is allocated to the State and that the State will allocate the State ceiling to issuing authorities for specific projects on a first-come, first-served basis. Corporation R qualifies for the special rights granted by section 631(a)(3) of the Tax Reform Act to the extent of County S's private activity bond limit as determined under section 103(n)(3), *i.e.,* $10 million. If the State fails to assign to County S $10 million of the State ceiling or if County S, after receiving such assignment, fails to allocate $10 million of private activity bond limit to the project, County S's private activity bond limit (if any) for 1986 will be reduced by the difference between $10 million and the amount of private activity bond limit allocated to the project.

Example (5). The facts are the same as in Example (1) except that Corporation R notifies County S that it only requires $15 million for the pollution control facility, County S only issues $15 million of private activity bonds for the pollution control facility, and County S only allocates $15 million of its private activity bond limit to such obligations. County S will not be penalized for not allocating more than $15 million of its private activity bond limit to Corporation R even though the original inducement resolution provided for up to $25 million.

(Secs. 103(n) and 7805 of the Internal Revenue Code of 1954 (98 Stat. 916, 26 U.S.C.103(n); 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7981, 49 FR 39320, Oct. 5, 1984]

§1.103(n)–4T Elective carryforward of unused private activity bond limit (temporary).

Q–1: May an issuing authority carry forward any of its unused private activity bond limit for a calendar year?

A–1: In any calendar year after 1983 in which an issuing authority's private activity bond limit exceeds the aggregate amount of private activity bonds issued during such calendar year by such issuing authority, such issuing authority may elect to treat all, or any portion, of such excess as a carryforward for any one or more projects described in A–5 of this §1.103(n)–4T (carryforward projects).

Q–2: How is the election to carry forward an issuing authority's unused private activity bond limit made?

A–2: (i) An issuing authority may make the election by means of a statement, signed by an authorized public official responsible for making allocations of such issuing authority's private activity bond limit, that the issuing authority elects to carry forward its unused private activity bond limit. The statement shall be filed with the Internal Revenue Service Center, Philadelphia, Pennsylvania 19255. Except with respect to elections to carry forward any unused private activity bond limit for calendar year 1984, the election must be filed prior to the end of the calendar year with respect to which the issuing authority has the unused private activity bond limit; elections with respect to unused private activity bond limit for calendar year 1984 must be filed prior to February 26, 1985. The statement is to be titled ''Carryforward election under section 103(n)''.

(ii) The statement required by (i) of this A–2 shall contain the following information:

(A) The name, address, and TIN of the issuing authority,

(B) The issuing authority's private activity bond limit for the calendar year,

(C) The aggregate amount of private activity bonds issued by the issuing authority during the calendar year for which the election is being made,

(D) The unused private activity bond limit of the issuing authority, and

(E) For each carryforward project—

(*1*) A description of the project, including its address (by its street address or, if none, by a general description designed to indicate its specific location) and the general type of facility (*e.g.*, an airport described in section 103(b)(4)(D)),

(*2*) The name, address, and TIN of the initial owner, operator, or manager, and

(*3*) The amount to be carried forward for the project.

(iii) For purposes of (ii)(E) of this A–2, in the case of a carryforward project for which the initial owner, operator, or manager is to be selected pursuant to a competitive bidding process, the election may include up to 3 prospective addresses for the project and the name, address, and TIN of more than one prospective initial owner, operator, or manager, if prior to the end of the calendar year for which the election is made—

(A) In the case of elections for calendar years other than 1984, the issuing authority has taken preliminary official action approving the undertaking of the carryforward project,

(B) All persons included as prospective owners, operators, or managers have met all applicable conditions (if any) to submit proposals to provide the project, and

(C) The issuing authority has expended (or has entered into binding contracts to expend) in connection with the planning and construction of the carryforward project the lesser of $500,000 or 2½ percent of the carryforward amount.

(iv) For purposes of (ii) of this A–2, in the case of a carryforward election for the purpose of issuing student loan bonds, the statement need not include the address of a facility or the name, address, and TIN of an initial owner, operator, or manager of a project but shall state that the carryforward election is for the purpose of issuing student loan bonds.

Q–3: Is a carryforward election revocable?

A–3: Any carryforward election, and any specification contained therein, shall be irrevocable after the last day of the calendar year in which the election is made. Thus, for example, obligations issued to finance a carryforward project with a different initial owner, operator, or manager from the owner, operator, or manager specified in the carryforward election shall not be issued purusant to such carryforward election. An insubstantial deviation from a specification contained in a carryforward election shall not prevent obligations from being issued pursuant to such carryforward election. In addition, where a carryforward election is made with respect to more than one carryforward project, a substantial deviation with respect to one carryforward project shall not prevent obligations from being issued pursuant to such carryforward election with respect to the other carryforward projects.

Q–4: How is a carryforward used?

A–4: Any private activity bonds issued during the three calendar years (six calendar years in the case of a project described in section 103(b)(4)(F)) following the calendard year in which the carryforward election was first made with respect to a carryforward project shall not be taken into account in determining whether the issue meets the requirements of section 103(n). If, however, the amount of private activity bonds issued for the carryforward project exceeds the amount of the carryforward elected with respect to the project, then the portion of the issue that exceeds the carryforward shall be taken into account in determining whether the issue meets with the requirements of section 103(n); if that portion of the issue does not meet the requirements of section 103(n) then the entire issue is treated as consisting of obligations not described in section 103(a). Carryforwards elected with respect to any project shall be used in the order of the calendar years in which they arose. Thus, for example, if an issuing authority makes carryforward elections in 1986 and 1988 for a carryforward project and issues private activity bonds for that project in 1989 and 1990, the obligations issued in 1989 will be applied to the 1986 carryforward election to the extent thereof.

Q–5: For what projects may a carryforward election be made?

A–5: A carryforward election may be made for any project described in section 103(b) (4) or (5), and for the purpose of issuing student loan bonds. Thus, for example, an issuing authority may elect to carry forward its unused private activity bond limit in order to provide a sports facility described in section 103(b)(4)(B). In addition, a governmental unit may elect to carry forward its unused private activity bond limit in order to issue qualified scholarship funding bonds. An issuing authority may not, however, elect to carry forward its unused private activity bond limit in order to issue an exempt small issue of industrial development bonds under section 103(b)(6).

(Secs. 103(n) and 7805 of the Internal Revenue Code of 1954 (98 Stat. 916, 26 U.S.C.103(n); 68A Stat. 917, 26 U.S.C. 7805); sec. 644(b) of the Tax Reform Act of 1984 (98 Stat. 940); secs. 103(n) and 7805 of the Internal Revenue Code of 1954 (98 Stat. 915, 26 U.S.C. 103(n); 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7981, 49 FR 39325, Oct. 5, 1984, as amended by T.D. 8001, 49 FR 50389, Dec. 28, 1984]

§1.103(n)–5T Certification of no consideration for allocation (temporary).

Q–1: Who must certify that there was no consideration for an allocation?

A–1: Section 103(n)(12)(A) provides that, with respect to any private activity bond allocated any portion of the State ceiling, the private activity bond will not be described under section 103(a) unless the public official, if any, responsible for such allocation (‘‘responsible public official’’) certifies under penalties of perjury that to the best of his knowledge the allocation of the State ceiling to that private activity bond was not made in consideration of any bribe, gift, gratuity, or direct or indirect contribution to any political campaign. With respect to any issue of private activity bonds, the responsible public official is the official or officer of the issuing authority that in fact is responsible for choosing which individual projects will be allocated a portion of the State ceiling. If a body of several individuals is responsible for such choices, any one member of such body qualifies as the responsible public official.

Q–2: What is the penalty for willfully making an allocation in consideration of any bribe, gift, gratuity, or direct or indirect contribution to any political campaign?

A–2: Section 103(n)(12)(B) provides that any person willfully making an allocation of any portion of the State ceiling in consideration of any bribe, gift, gratuity, or direct or indirect contribution to any political campaign will be subject to criminal penalty as though the allocation were a willful attempt to evade tax imposed by the Internal Revenue Code.

(Secs. 103(n) and 7805 of the Internal Revenue Code of 1954 (98 Stat. 916, 26 U.S.C.103(n); 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7981, 49 FR 39326, Oct. 5, 1984]

§1.103(n)–6T Determinations of population (temporary).

Q–1: What is the proper method for determining population?

A–1: All determinations of population must be made with respect to any calendar year on the basis of the most recent census estimate (whether final or provisional) of the resident population of the State or other governmental unit published by the Bureau of the Census in the ‘‘Current Population Reports’’ series before the beginning of the calendar year.

However, determinations of the population of a general purpose governmental unit (other than a State, territory, or possession) within a State, territory, or possession may not be based on estimates that do not contain estimates for all of the general purpose governmental units within such State, territory, or possession. Thus, a county may not determine its population on the basis of a census estimate that does not provide an estimate of the population of the other general purpose governmental units within the State (*e.g.*, cities, towns). If no census estimate is available for all such general purpose governmental units, the most recent decennial census of population may be relied on.

Example: The following example illustrates the provisions of A–1 of this §1.103(n)–6T:

Example. County Q is located within State R. There are no constitutional home rule cities in State R. State R has not adopted a formula for allocating the State ceiling different from the formula provided in section 103(n) (2) and (3). The geographical area within the jurisdiction of County Q is not within the jurisdiction of any other governmental unit having jurisdiction over a smaller geographical area. As of December 31, 1984, the Bureau of the Census has published the following estimates of resident population: ‘‘Current Population Reports; Series P–25: Population Estimates and Projections, Estimates of the Population of States: July 1, 1981–1983’’ and ‘‘Current Population Reports; Series P–26: Local Population Estimates: Population of State R, Counties, Incorporated Places, and Minor Civil Divisions: July 1, 1981–1982.’’ The most recent population estimate for State R available prior to 1985 provides population estimates as of July 1, 1983. The most recent population extimates for County Q available prior to 1985 is the estimate for July 1, 1982. Assuming that the State ceiling for State R for 1985 is in excess of $200 million (*i.e.*, $150 multiplied by the estimated population of State R as of July 1, 1983, exceeds $200 million), County Q may determine its private activity bond limit by using the following formula:

P=$150×.5×W×Y/Z, where,
P=County Q’s private activity bond limit,
W=the July 1, 1983, population estimate for State R,
Y=the July 1, 1982, population estimate for County Q, and
Z=the July 1, 1982, population estimate for State R.

If the State ceiling for State R is not in excess of $200 million, County Q may determine its private activity bond limit by using the following formula:

P=$200,000,000×.5×Y/Z, where
P, Y, and Z have the same meaning as above.

(Secs. 103(n) and 7805 of the Internal Revenue Code of 1954 (98 Stat. 916, 26 U.S.C.103(n); 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7981, 49 FR 39326, Oct. 5, 1984]

§1.103(n)–7T Election to allocate State ceiling to certain facilities for local furnishing of electricity (temporary).

(a) *Election*—(1) *In general.* The issuing authorities of the State of New York (‘‘New York’’) may elect to use in

1984 up to one-half of the amount that would have been New York's State ceiling (as defined in section 103(n)(4) and A–1 of § 1.103(n)–3T) for calendar years 1985, 1986, and 1987 for the purpose of issuing obligations to provide facilities for the local furnishing of electric energy described in section 644(a) of the Tax Reform Act of 1984 (the ''Act''). For purposes of this paragraph, New York's State ceiling for calendar years 1985, 1986, and 1987 is considered equal to the State ceiling for 1984 (without taking into account any increase in the State ceiling for 1984 as a result of an election under section 644(b) and this section).

(2) *Procedure.* The election shall be made by filing the statement described in this paragraph (a)(2) with the Internal Revenue Service Center, Philadelphia, Pennsylvania, on or before December 31, 1984. The statement shall be titled ''Allocation election under section 644 of the Tax Reform Act of 1984,'' shall be signed by the Governor of New York or his authorized representative, and shall contain the following information:

(i) The name, address, and TIN of the issuing authority (or authorities) that is expected to issue the obligations for the facilities described in section 644(a) of the Act pursuant to the election described in section 644(b) of the Act and this section, and

(ii) The amount of the State ceiling for each of calendar years 1985, 1986, and 1987 with respect to which the election is made.

(b) *Effect of election*—(1) *In 1984.* The amount of the State ceiling for calendar years 1985, 1986, and 1987 with respect to which the election is made will be considered part of New York's State ceiling for calendar year 1984. For purposes of section 644(b) of the Act, such amount will be considered used in 1984 only to the extent that obligations are issued in 1984 to provide facilities for the local furnishing of electric energy described in section 644(a) of the Act, or to the extent that a proper election is made on or before December 31, 1984 (and is not revoked or amended between the time it is made and the end of 1984) pursuant to section 103(n)(10) and § 1.103(n)–4T to carry forward all or part of such amount to provide such facilities during the carryforward period applicable to calendar year 1984 State ceiling.

(2) *In 1985, 1986, and 1987.* An election under section 644(b) of the Act and this section to use in calendar year 1984 an amount of New York's State ceiling for a subsequent calendar year reduces the State ceiling for such subsequent calendar year by the amount with respect to which the election is made, whether or not such amount is considered used in 1984 pursuant to this paragraph (b). Thus, no obligations may be issued pursuant to the election described in section 644(b) of the Act and this section to provide a facility other than the facilities for the furnishing of electric energy described in section 644(a) of the Act.

(3) *Other effects.* An election or the failure to make an election under section 644(b) of the Act and this section shall not affect any otherwise applicable rule that permits an issuing authority, for any calendar year, to—

(i) Allocate a portion of its private activity bond limit,

(ii) Issue obligations within its private activity bond limit, or

(iii) Elect under section 103(n)(10) and § 1.103(n)–4T to carry forward any portion of its private activity bond limit,

in order to issue obligations to provide a facility described in section 644(a) of the Act.

(c) *Revocation of election.* An election made under section 644(b) of the Act and this section may not be revoked or amended. An insubstantial deviation from a specification contained in an election under section 644(b) of the Act and this section shall not prevent obligations from being issued pursuant to such election.

(Sec. 644(b) of the Tax Reform Act of 1984 (98 Stat. 940); secs. 103(n) and 7805 of the Internal Revenue Code of 1954 (98 Stat. 915, 26 U.S.C. 103(n); 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 8001, 49 FR 50389, Dec. 28, 1984]

§ 1.103A–2 Qualified mortgage bond.

(a)–(j) [Reserved]

(k) *Information reporting requirement*—(1) *In general.* An issue meets the requirements of this paragraph only if the issuer in good faith attempted to meet the information reporting requirements of this paragraph. Except as otherwise provided in paragraph (k)(5)(iv) of this section, the requirements of this paragraph apply to qualified veterans' mortgage bonds issued after July 18, 1984, and to qualified mortgage bonds issued after December 31, 1984. With respect to bonds issued after December 31, 1986, see the regulations under section 149(e).

(2) *Information required.* (i) The issuer must, based on information and reasonable expectations determined as of the date of issue, submit on Form 8038 the information required therein; the issuer need not however, include the information required by Form 8038 that is relevant only to obligations described in section 103(l)(1) and the regulations thereunder. The information that must be submitted includes—

(A) The name, address, and employer identification number of the issuer,

(B) The date of issue,

(C) The face amount of each obligation which is part of the issue,

(D) The total purchase price of the issue,

(E) The amount allocated to a reasonably required reserve or replacement fund,

(F) The amount of lendable proceeds,

(G) The stated interest rate of each maturity,

(H) The term of each maturity,

(I) In the case of an issue of qualified mortgage bonds, whether the issuer has elected under §6a.103A–2(i)(4)(v) to pay arbitrage to the United States,

(J) In the case of an issue of qualified mortgage bonds, the issuer's market limitation as of the date of issue (as defined in §6a.103A–2(g)), the amount of qualified mortgage bonds that the issuer has elected not to issue under section 25(c)(2) and the regulations thereunder, and the aggregate amount of qualified mortgage bonds issued to date by the issuer during the calendar year, and

(K) In the case of an issue of qualified veterans' mortgage bonds, the issuer's State veterans limit (as defined in section 103A(o)(3)(B) and the regulations thereunder) and the aggregate amount of qualified veterans' mortgage bonds issued to date by the issuer during the calendar year and prior to the date of issue of the issue for which the Form 8038 is being submitted.

(ii) With respect to issues issued after December 31, 1984, the issuer must submit a report containing information on the borrowers of the original proceeds of such issues. The report must be filed for each reporting period in which the original proceeds of any of such issues are used to provide mortgages. The issuer is not responsible for false information provided by a borrower if the issuer did not know or have reason to know that the information was false. The report must be filed on the form prescribed by the Internal Revenue Service. If no form is prescribed, or if the form prescribed is not readily available, the issuer may use its own form provided that such form is in the format set forth in paragraph (k)(3) of this section and contains the information required by this paragraph (k)(2)(ii). The report must be titled ''Qualified Mortgage Bond Information Report'' or ''Qualified Veterans' Mortgage Bond Information Report'', and must include the name, address, and TIN of the issuer, the reporting period for which the information is provided, and the following tables containing information concerning the borrowers of the original proceeds of the issues subject to the requirements of this paragraph (k)(2)(ii) with respect to mortgages provided during the reporting period for which the report is filed:

(A) A table titled ''Number of Mortgage Loans by Income and Acquisition Cost'' showing the number of mortgage loans (other than those issued in connection with qualified home improvement and rehabilitation loans) made during the reporting period according to the annualized gross income of the borrowers (categorized in the following intervals of income:

$0–$9,999

$10,000–$19,999

$20,000–$29,999

$30,000–$39,999

$40,000–$49,999

$50,000–$74,999

$75,000 or more)

and according to the acquisition cost of each residence being financed (categorized in the following intervals of acquisition cost:

$0–$19,999

$20,000–$39,999

$40,000–$59,999

$60,000–$79,999

$80,000–$99,999

$100,000–$119,999

$120,000–$149,999

$150,000–$199,999

$200,000 or more)

For each interval of income and acquisition cost the table must also be categorized according to the number of borrowers that—

(*1*) Did not have a present ownership interest in a principal residence at any time during the 3-year period ending on the date the mortgage is executed (*i.e.*, satisfied the 3-year requirement) and purchased residences in targeted areas,

(*2*) Satisfied the 3-year requirement and purchased residences not located in targeted areas,

(*3*) Did have a present ownership interest in a principal residence at any time during the 3-year period ending on the date the mortgage is executed (*i.e.*, did not satisfy the 3-year requirement) and purchased residences in targeted areas, and

(*4*) Did not satisfy the 3-year requirement and purchased residences not located in targeted areas.

With respect to issues of qualified veterans' mortgage bonds, for each interval of income and acquisition cost the table need only be categorized according to the number of borrowers that satisfied the 3-year requirement and the number of borrowers that failed to satisfy the 3-year requirement.

(B) A table titled ''Volume of Mortgage Loans by Income and Acquisition Cost'' showing the total principal amount of the mortgage loans (other than qualified home improvement and rehabilitation loans) provided during the reporting period according to annualized gross income (categorized in the same intervals of income as the preceding table) and according to the acquisition cost of the residences acquired (categorized in the same acquisition cost intervals as the preceding table). For each interval of income and acquisition cost the table must also be categorized according to the total principal amount of the mortgage loans of borrowers that—

(*1*) Satisfied the 3-year requirement and purchased residences in targeted areas,

(*2*) Satisfied the 3-year requirement and purchased residences not located in targeted areas,

(*3*) Did not satisfy the 3-year requirement and purchased residences in targeted areas, and

(*4*) Did not satisfy the 3-year requirement and purchased residences not located in targeted areas.

With respect to issues of qualified verterans' mortgage bonds, for each interval of income and acquisition cost the table need only be categorized according to the total principal amount of the mortgage loans of borrowers that satisified the 3-year requirement and the total principal amount of the mortgage loans of borrowers that did not satisfy the 3-year requirement.

(C) For issues other than qualified veterans' mortgage bonds, a table titled ''Mortgage Subsidy Bonds for Qualified Home Improvement and Rehabilitation Loans'' showing the number of borrowers obtaining qualified home improvement loans and qualified rehabilitation loans and the total of the principal amounts of such loans; the information contained in the table must also be categorized according to whether the residences with respect to which the loans were provided are located in targeted areas.

(3) *Format.* (i) With respect to the report required by paragraph (k)(2)(ii) of this section, if no form is prescribed by

the Internal Revenue Service, or if the prescribed form is not readily available, the issuer must submit the report in the format specified in this paragraph (k)(3).

(ii) With respect to issues of qualified mortgage bonds, the format of the report specified in this paragraph (k)(3) is the following:

QUALIFIED MORTGAGE BOND INFORMATION REPORT

Name of issuer:
Address of issuer:
TIN of issuer:
Reporting period:

NUMBER OF MORTGAGE LOANS BY INCOME AND ACQUISITION COST

3-year requirement: Annualized gross monthly income of borrowers	Satisfied		Not Satisfied		Totals
	Nontargeted area	Targeted area	Nontargeted area	Targeted area	
$0 to $9,999.					
$10,000 to $19,999.					
$20,000 to $29,999.					
$30,000 to $39,999.					
$40,000 to $49,999.					
$50,000 to $74,999.					
$75,000 or more.					
Total.					
Acquisition Cost					
$0 to $19,999.					
$20,000 to $39,999.					
$40,000 to $59,999.					
$60,000 to $79,999.					
$80,000 to $99,999.					
$100,000 to $119,999.					
$120,000 to $149,999.					
$150,000 to $199,999.					
$200,000 or more.					
Total.					

VOLUME OF MORTGAGE LOANS BY INCOME AND ACQUISITION COST

3-year requirement: Annualized gross monthly income of borrowers	Satisfied		Not Satisfied		Totals
	Nontargeted area	Targeted area	Nontargeted area	Targeted area	
$0 to $9,999.					
$10,000 to $19,999.					
$20,000 to $29,999.					
$30,000 to $39,999.					
$40,000 to $49,999.					
$50,000 to $74,999.					
$75,000 or more.					
Total.					
Acquisition Cost					
$0 to $19,999.					
$20,000 to $39,999.					
$40,000 to $59,999.					
$60,000 to $79,999.					
$80,000 to $99,999.					
$100,000 to $119,999.					
$120,000 to $149,999.					
$150,000 to $199,999.					
$200,000 or more.					
Total.					

MORTGAGE SUBSIDY BONDS FOR QUALIFIED HOME IMPROVEMENT AND REHABILITATION LOANS

	Nontargeted area	Targeted area	Totals
Number of qualified home improvement loans.			
Volume of qualified home improvement loans.			
Number of qualified rehabilitation loans.			
Volume of qualified rehabilitation loans.			

(iii) The format of the report specified in this paragraph (k)(3) for qualified veterans' mortgage bonds is the following:

QUALIFIED VETERANS' MORTGAGE BOND INFORMATION REPORT

Name of issuer:
Address of issuer:
TIN of issuer:
Reporting period:

NUMBER OF MORTGAGE LOANS BY INCOME AND ACQUISITION COST

3-year requirement: annualized gross monthly income of borrowers	Satisfied	Not satisfied	Totals
$0 to $9,999.			
$10,000 to $19,999.			
$20,000 to $29,999.			
$30,000 to $39,999.			
$40,000 to $49,999.			
$50,000 to $74,999.			
$75,000 or more.			
Total.			
Acquistion Cost			
$0 to $19,999.			
$20,000 to $39,999.			
$40,000 to $59,999.			
$60,000 to $79,999.			
$80,000 to $99,999.			
$100,000 to $119,999.			
$120,000 to $149,999.			
$150,000 to $199,999.			
$200,000 or more.			
Total.			

NUMBER OF MORTGAGE LOANS BY INCOME AND ACQUISITION COST

3-year requirement: annualized gross monthly income of borrowers	Satisfied	Not satisfied	Totals
$0 to $9,999.			
$10,000 to $19,999.			
$20,000 to $29,999.			
$30,000 to $39,999.			
$40,000 to $49,999.			
$50,000 to $74,999.			
$75,000 or more.			
Total.			
Acquistion Cost			
$0 to $19,999.			
$20,000 to $39,999.			
$40,000 to $59,999.			
$60,000 to $79,999.			
$80,000 to $99,999.			
$100,000 to $119,999.			
$120,000 to $149,999.			
$150,000 to $199,999.			
$200,000 or more.			
Total.			

(4) *Definitions and special rules.* (i) For purposes of this paragraph the term ''annualized gross income'' means the borrower's gross monthly income muliplied by 12. Gross monthly income is the sum of monthly gross pay, any additional income from investments, pensions, Veterans Administration (VA) compensation, part-time employment, bonuses, dividends, interest, current overtime pay, net rental income, etc., and other income (such as alimony and child support, if the borrower has chosen to disclose such income). Information with respect to gross monthly income may be obtained from available loan documents, *e.g.*, the sum of lines 23D and 23E on the Application for VA or FmHA Home Loan Guaranty or for HUD/FHA Insured Mortgage (VA Form 26–1802a, HUD 92900, Jan. 1982), or the total line from the Gross Monthly Income section of FHLMC Residential Loan Application form (FHLMC 65 Rev. 8/78). With respect to obligations issued prior to October 1, 1985, issuers may submit data based on annualized gross income or, instead, based on the adjusted income (as defined in § 1.167(k)–3(b)(3)) of the mortgagor's family for the previous calendar year. If data is submitted based on adjusted income, the issuer must note this fact in the report.

(ii) For purposes of this paragraph, the term ''reporting period'' means the following periods:

(A) The period beginning January 1, 1985, and ending on September 30, 1985,

(B) The period beginning on October 1, 1985, and ending on June 30, 1986, and

(C) After June 30, 1986, each 1-year period beginning July 1 and ending June 30.

(iii) See the regulations under section 103(l) for the definitions of the terms ''date of issue'', ''maturity'', and ''term of issue''.

(iv) For purposes of this paragraph, verification of information concernig a borrower's gross monthly income with other available information concerning the borrower's income (*e.g.*, Federal income tax returns) is not required. In determining whether a borrower acquiring a residence in a targeted area satisfies the 3-year requirement, the issuer may rely on a statement signed by the borrower.

(5) *Time for filing.* (i) The report required by paragraph (k)(2)(i) of this section shall be filed not later than the 15th day of the second calendar month after the close of the calendar quarter in which the obligation is issued. The statement may be filed at any time before such date but must be complete

based on facts and reasonable expectations as of the date of issue. The statement need not be amended to report information learned subsequent to the date of issue or to reflect changed circumstances with respect to the issuer.

(ii) The report required by paragraph (k)(2)(ii) of this section (relating to use of proceeds) shall be filed not later than the 15th day of the second calendar month after the close of the reporting period, except that the report for the reporting period ending September 30, 1985, is due not later than February 15, 1986. The report may be filed at any time before such date but must be complete based on facts and reasonable expectations as of the date the report is filed. The report need not be amended to reflect information learned subsequent to the date the report is filed or to reflect changed circumstances with respect to any borrower.

(iii) The Commissioner may grant an extension of time for the filing of a report required by paragraph (k)(2) (i) or (ii) of this section if there is reasonable cause for the failure to file such report in a timely fashion.

(iv) An issue of qualified veterans' mortgage bonds issued after July 18, 1984, and prior to January 1, 1985, will be treated as satisfying the information reporting requirement of this paragraph if a Form 8038 with respect to the issue is properly filed not later than February 15, 1985; the report described in paragraph (k)(2)(ii) of this section need not be filed with respect to such issues.

(6) *Place for filing.* The reports required by paragraph (k)(2) (i) and (ii) of this section are to be filed at the Internal Revenue Service Center, Philadelphia, Pennsylvania 19255.

(l) *Policy statement*—(1) *In general.* (i) For obligations issued after December 31, 1984, an issue meets the requirements of this paragraph only if the applicable elected representative of the governmental unit which is the issuer (or on behalf of which the issuing authority is empowered to issue qualified mortgage bonds) has published (after a public hearing following reasonable public notice) the report described in paragraph (l)(3) of this section by the last day of the year preceding the year in which such issue is issued and a copy of such report has been submitted to the Commissioner on or before such last day. The Commissioner may grant an extension of time for publishing and filing the report if there is reasonable cause for the failure to publish or file such report in a timely fashion. The requirements of this paragraph will be treated as met if the issuer in good faith attempted to meet the policy statement requirements of this paragraph.

(ii) With respect to reports required by paragraph (l)(1)(i) of this section to be published and submitted to the Commissioner not later than December 31, 1984, the Commissioner has determined that there is reasonable cause for the failure to publish or file such reports in a timely fashion; such a report will be considered published and filed in a timely fashion if, not later than March 11, 1985, the report is published (after a public hearing following reasonable public notice) and a copy is submitted to the Commissioner. In addition, any report submitted not later than December 31, 1984, with respect to which an issuer in good faith attempted to satisfy the requirements of section 103A(j)(5) shall be treated as substantially satisfying the requirements of this paragraph. For example, with respect to a report submitted not later than December 31, 1984, an issuer shall not be treated as failing to satisfy the requirements of section 103A(j)(5) based on the fact that (A) the notice of public hearing failed to state the manner in which affected residents may obtain copies of the proposed report prior to the hearing, or (B) the proposed report was not available prior to or at the public hearing. With respect to reports required to be published and submitted to the Commissioner not later than December 31, 1986, the Commissioner has determined that there is a reasonable cause for the failure to publish and file such reports in a timely fashion; such reports will be considered published and filed in a timely fashion if, not later than December 31, 1987, the report is published (after having a public hearing following reasonable public notice) and a copy is submitted to the Commissioner.

(2) *Definitions and special rules.* (i) In the case of an issuer that issues qualified mortgage bonds on behalf of one or more governmental units, a single report may be filed provided that such report is signed (A) by the applicable elected representative of each governmental unit on whose behalf obligations have been issued during any preceding calendar year or (B) by the Governor of the State in which the issuer is located.

(ii) See notice 103(k)(2)(E) and the regulations thereunder for the definition of the term ‘‘applicable elected representative’’.

(iii) In the case of qualified mortgage bonds issued by, or on behalf of, a governmental unit that did not reasonably expect during the preceding calendar year to issue (or have issued on its behalf by any other issuer) qualified mortgage bonds during the current calendar year, the requirements of this paragraph will be treated as met if the applicable governmental unit which is the issuer (or on behalf of which the issuing authority is empowered to issue qualified mortgage bonds) has published (after a public hearing following reasonable public notice) the report described in paragraph (l)(3) of this section prior to the issuance of any qualified mortgage bonds and a copy of such report has been submitted to the Commissioner prior to such issuance.

(iv) For purposes of this paragraph a report will be considered to be ‘‘published’’ when the applicable elected representative of the governmental unit has made copies of the report available for distribution to the public. Reasonable public notice of the manner in which copies of the report may be obtained must be provided; such notice may be included as part of the public notice required by paragraph (l)(4) of this section.

(3) *Report.* (i) A report is described in this paragraph (l)(3) if it contains the issuer’s name, TIN, and the title ‘‘Policy Report Under Section 103A’’ stated on the cover page of the report and if it includes—

(A) A statement of the policies of the issuer with respect to housing, development, and low-income housing assistance which such issuer is to follow in issuing qualified mortgage bonds and mortgage credit certificates, and

(B) An assessment of the compliance of such issuer during the 1-year period preceding the date of the report with—

(*1*) The statement of policy on qualified mortgage bonds and mortgage credit certificates that was set forth in the previous report, if any, of the issuer, and

(*2*) The intent of Congress that State and local governments are expected to use their authority to issue qualified mortgage bonds and mortgage credit certificates to the greatest extent feasible (taking into account prevailing interest rates and conditions in the housing market) to assist lower income families to afford home ownership before assisting higher income families.

(ii) For example, a report described in this paragraph (l)(3) may (but is not required to) contain—

(A) A specific statement of the policies with respect to housing, development, and low-income housing assistance which the issuer is to follow in issuing qualified mortgage bonds and mortgage credit certificates, including, for example, a statement as to—

(*1*) With respect to housing policies, (*i*) whether the proceeds will be used to provide financing for the acquisition of residences, to provide qualified home improvement loans, or to provide qualified rehabilitation loans; (*ii*) whether all or a portion of the proceeds will be targeted to new, existing, or any other particular class or type of housing; (*iii*) how the existence of a need or absence of a need for such targeting has been determined; (*iv*) the method by which the proceeds will be targeted; (*v*) any other pertinent information relating to the issuer’s housing policies; and (*vi*) how the housing policies relate to the issuer’s development and low-income housing assistance policies;

(*2*) With respect to development policies, (*i*) whether all or a portion of the proceeds will be targeted to specific areas (including targeted areas as described in § 6a.103A–2(b)(3)); (*ii*) a description of the areas to which the proceeds will be targeted; (*iii*) the reasons for selecting such areas; (*iv*) whether proceeds targeted to each area are to be used to finance redevelopment of existing housing or new construction; (*v*) any other pertinent information relating to the issuer's development policies; and (*vi*) how the development policies relate to the issuer's low-income housing assistance policies; and

(*3*) With respect to low-income housing assistance policies, (*i*) whether all or a portion of the proceeds will be targeted to low-income (*i.e.*, 80 percent of median income), moderate-income (*i.e.*, 100 percent of median income), or any other class of borrowers; (*ii*) the method by which the proceeds will be targeted to such borrowers; and (*iii*) any other pertinent information relating to the issuer's low-income housing assistance policies;

(B) An assessment of the compliance of the governmental unit or issuing authority during the twelve-month period ending with the date of the report with the statement of housing, development, and low-income housing assistance policies with respect to qualified mortgage bonds and mortgage credit certificates that were set forth in the report, if any, published in the preceding year with respect to such governmental unit, including, for example, a statement as to whether the governmental unit or issuing authority successfully implemented its policies and, if not, an analysis of the reasons for such failure; and

(C) An assessment of the compliance of the governmental unit or issuing authority during the twelve-month period ending with the date of the report with the intent of Congress that State and local governments are expected to use their authority to issue qualified mortgage bonds and mortgage credit certificates to the greatest extent feasible (taking into account prevailing interest rates and conditions in the housing market) to assist lower income families to afford home ownership before assisting higher income families, including, for example, a description of (*1*) the method used by the governmental unit or issuing authority to distribute proceeds, (*2*) whether and how that method enabled the governmental unit or issuing authority to assist lower income families before higher income families, and (*3*) any income levels that have been defined and used by the governmental unit or issuing authority in connection with distribution of the proceeds (no specific definition of lower income and higher income is imposed on governmental units or issuing authorities).

(*iii*) For purposes of the assessments of compliance required by paragraph (l)(3)(i)(B) of this section to be included in the report, the ''date of the report'' means June 30. For purposes of the report required to be filed prior to January 1, 1986, an issuer need not perform these assessments of compliance with respect to any period prior to January 1, 1985.

(iv) An issuer that fails to establish policies with respect to the criteria provided in paragraph (l)(3)(i) of this section will not be treated as failing to satisfy the requirements of this paragraph. Thus, for example, an issuer may state in its report that none of the proceeds of the issue will be targeted to specific areas. Similarly, an issuer that fails to successfully implement its policies will not be treated as failing to satisfy the requirements of this paragraph.

(4) *Public hearing.* The public hearing required by paragraph (l)(1) of this section means a forum providing a reasonable opportunity for interested individuals to express their views, both orally and in writing, on the report that the applicable representative proposes to publish to satisfy the requirements of this paragraph (l). A public hearing held prior to January 1, 1985, will not fail to satisfy the requirements of this paragraph (l)(4) merely because the proposed policy statement was not available prior to the public hearing. In general, a governmental unit may select its own procedure for the hearing, provided that interested individuals have a reasonable opportunity to express their views. Thus, it may impose reasonable requirements on persons who wish to participate in the hearing, such as a requirement that persons desiring to speak at the hearing so request in writing at least 24 hours before the hearing or that they limit their oral remarks to 10 minutes. For purposes of this public hearing requirement, it is not necessary that the applicable elected representative who will publish the report be present at

the hearing, that a report on the hearing be submitted to that official, or that State administrative procedural requirements for public hearings in general be observed. However, compliance with such State procedural requirements (except those at variance with a specific requirement set forth in this paragraph) will generally assure that the hearing satisfies the requirements of this paragraph. The hearing may be conducted by any individual appointed or employed to perform such function by the governmental unit, its agencies, or by the issuer. Thus, for example, for a report to be issued by an issuing authority that acts on behalf of a county, the hearing may be conducted by the issuing authority, the county, or an appointee or employee of either.

(5) *Reasonable public notice.* (i) The reasonable public notice required by paragraph (l)(1) of this section means published notice which is reasonably designed to inform residents of the geographical area within the jurisdiction of the governmental unit that will publish the report. The notice must state the time and place for the hearing and contain the information required by paragraph (l)(5)(ii) of this section. Notice is presumed reasonable if published no fewer than 14 days before the hearing. Notice is presumed reasonably designed to inform affected residents only if published in one or more newspapers of general circulation available to residents of that locality or if announced by radio or televison broadcast to those residents.

(ii) The notice of hearing described in this paragraph (l)(5) must state—

(A) The time and place for the hearing,

(B) Any applicable limitations regarding participation in the hearing,

(C) With respect to any notice of hearing published after December 31, 1984, the manner in which affected residents may obtain copies of the proposed report prior to the hearing, and

(D) With respect to any notice of hearing published after December 31, 1984, that the hearing will involve the issuer's policies with respect to housing, development, and low-income housing assistance which the issuer is to follow in issuing qualified mortgage bonds and mortgage credit certificates.

(6) *Procedure for public hearings of multiple jurisdiction issuers.* In the case of an issuer that issues qualified mortgage bonds on behalf of two or more governmental units (''multiple jurisdiction issuer''), each governmental unit on whose behalf the issuer reasonably expects to issue qualified mortgage bonds during the succeeding calendar year must hold a public hearing following reasonable public notice prior to the publication of the report required by this paragraph. A multiple jurisdiction issuer may hold a combined hearing as long as the combined hearing is a joint undertaking that provides all residents of the participating governmental units (*i.e.*, each governmental unit on whose behalf qualified mortgage bonds were issued by the authority and each governmental unit on whose behalf the authority reasonably expects to issue qualified mortgage bonds during the succeeding calendar year) a reasonable opportunity to be heard. The location of any combined hearing is presumed to provide a reasonable opportunity for all affected residents to be heard if it is no farther than 100 miles from the seat of government of each participating governmental unit beyond whose geographic jurisdiction the hearing is conducted.

(7) *Place for filing.* The report is to be filed with the Internal Revenue Service Center, Philadelphia, Pennsylvania 19255.

(m) *State certification requirements*—(1) *In general.* An issue meets the requirements of this paragraph only if the issuer in good faith attempted to meet the State certification requirements of this paragraph. The requirements of this paragraph apply to obligations issued after December 31, 1984; see section 149(e) and the regulations thereunder with respect to obligations issued after December 31, 1986.

(2) *Certification.* (i) An issue satisfied the requirements of section 103A(j)(4) and this paragraph (m)(2) only if the State official designated by law (or, if there is no State official, the Governor) certifies on or before the later of the date of issue or October 3, 1985, following a request for such certification

by the issuer, that, as of the date the certification is executed, the issue meets the requirements of section 103A(g) and the regulations thereunder (relating to volume limitation). In the case of any constitutional home rule city, the certification shall be made by the chief executive officer of the city. To the extent consistent with State and local law, the Governor (or the chief executive officer of any constitutional home rule city) may delegate the responsibility to execute the certification required by this paragraph.

(ii) The certifying official need not perform an independent investigation in order to determine whether the issue meets the requirements of section 103A(g). In determining the aggregate amount of qualified mortgage bonds previously issued by an issuer during a calendar year, the certifying official may rely on copies of the reports submitted, to date, by the issuer pursuant to section 103A(j)(3) for other issues of qualified mortgage bonds issued during that year and copies of any elections previously made pursuant to section 25(c)(2) not to issue qualified mortgage bonds, together with an affidavit executed by an officer of the issuer responsible for issuing the bonds stating that the issuer has not, to date during the calendar year, issued any other qualified mortgage bonds, the amount, if any, of the issuer's market limitation that it has, to date during the calendar year, surrendered to other issuing authorities, and that it has not, to date during the calendar year, made any other elections not to issue qualified mortgage bonds. If, based on such information, the certifying official determines that, as of the date the certification is executed, the issue will not exceed the issuer's market limitation for the year, the official may certify that the issue meets the requirements of section 103A(g).

(3) *Special rule.* If 15 days elapse after the issuer files a proper request for the certification described in paragraph (m)(2) of this section and the issuer has not received from the State official designated by law (or, if there is no State official, the Governor) certification that the issue meets the requirements of section 103A(g) and §6a.103A–2(g) or, in the alternative, a statement that the issue does not meet such requirements, the issuer may, instead, submit an affidavit executed by an officer of the issuer responsible for issuing the bonds stating that—

(i) The issue meets the requirements of section 103(A)(g) and §6a.103A–2(g),

(ii) At least 15 days before the execution of the affidavit the issuer filed a proper request for the certification described in paragraph (m)(2) of this section, and

(iii) The State official designated by law (or, if there is no State official, the Governor) has not provided the certification described in paragraph (m)(2) of this section.

In the case of obligations issued prior to October 4, 1985 the preceding sentence shall be applied by substituting ''30 days'' for ''15 days''. For purposes of this paragraph, a request for certification is proper if the request includes the reports and affidavits described in paragraph (m)(2)(ii) of this section.

(4) *Filing.* The certification (or affidavit) required by this paragraph shall be filed with the Internal Revenue Service Center, Philadelphia, PA 19255. The certification (or affidavit) shall be submitted with the Form 8038 required to be filed by section 103A(j)(3) and paragraph (k) of this §1.103A–2. The Commissioner may grant an extension of time for filing the certification (or affidavit) if there is a reasonable cause for the failure to file such statement in a timely fashion.

(5) *Effect of certification.* The fact that an issuer obtains the certification (or affidavit) described in this paragraph does not ensure that the requirements of paragraph (g) of §6a.103A–2 are met. Obligations that do not meet the requirements of paragraph (g) of §6a.103A–2 are not described in section 103(a).

[T.D. 8049, 50 FR 35542, Sept. 3, 1985, as amended by T.D. 8129, 52 FR 7410, Mar. 11, 1987]

§1.104–1 Compensation for injuries or sickness.

(a) *In general.* Section 104(a) provides an exclusion from gross income with respect to certain amounts described in paragraphs (b), (c), (d) and (e) of this section, which are received for personal injuries or sickness, except to the extent that such amounts are attributable to (but not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year. See section 213 and the regulations thereunder.

(b) *Amounts received under workmen's compensation acts.* Section 104(a)(1) excludes from gross income amounts which are received by an employee under a workmen's compensation act (such as the Longshoremen's and Harbor Workers' Compensation Act, 33 U.S.C., c. 18), or under a statute in the nature of a workmen's compensation act which provides compensation to employees for personal injuries or sickness incurred in the course of employment. Section 104(a)(1) also applies to compensation which is paid under a workmen's compensation act to the survivor or survivors of a deceased employee. However, section 104(a)(1) does not apply to a retirement pension or annuity to the extent that it is determined by reference to the employee's age or length of service, or the employee's prior contributions, even though the employee's retirement is occasioned by an occupational injury or sickness. Section 104(a)(1) also does not apply to amounts which are received as compensation for a nonoccupational injury or sickness nor to amounts received as compensation for an occupational injury or sickness to the extent that they are in excess of the amount provided in the applicable workmen's compensation act or acts. See, however, §§ 1.105–1 through 1.105–5 for rules relating to exclusion of such amounts from gross income.

(c) *Damages received on account of personal injuries or sickness.* Section 104(a)(2) excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. The term ''damages received (whether by suit or agreement)'' means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.

(d) *Accident or health insurance.* Section 104(a)(3) excludes from gross income amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee, to the extent that such amounts (1) are attributable to contributions of the employer which were not includible in the gross income of the employee, or (2) are paid by the employer). Similar treatment is also accorded to amounts received under accident or health plans and amounts received from sickness or disability funds. See section 105(e) and § 1.105–5. If, therefore, an individual purchases a policy accident or health insurance out of his own funds, amounts received thereunder for personal injuries or sickness are excludable from his gross income under section 104(a)(3). See, however, section 213 and the regulations thereunder as to the inclusion in gross income of amounts attributable to deductions allowed under section 213 for any prior taxable year. Section 104(a)(3) also applies to amounts received by an employee for personal injuries or sickness from a fund which is maintained exclusively by employee contributions. Conversely, if an employer is either the sole contributor to such a fund, or is the sole purchaser of a policy of accident or health insurance for his employees (on either a group or individual basis), the exclusion provided under section 104(a)(3) does not apply to any amounts received by his employees through such fund or insurance. If the employer and his employees contribute to a fund or purchase insurance which pays accident or health benefits to employees, section 104(a)(3) does not apply to amounts received thereunder by employees to the extent that such amounts are attributable to the employer's contributions. See § 1.105–1 for rules relating to the determination of the amount attributable to employer contributions. Although amounts paid by or on behalf of an employer to an employee for personal injuries or sickness are not excludable from the employee's gross income under section 104(a)(3), they may be excludable therefrom under section 105. See §§ 1.105–1 through 1.105–5, inclusive. For treatment of accident or health benefits paid to or on behalf of a self- employed individual by a trust described in section 401(a) which is exempt under section 501(a) or under a plan described in section 403(a), see paragraph (g) of §1.72–15.

(e) *Amounts received as pensions, etc., for certain personal injuries or sickness.* (1) Section 104(a)(4) excludes from gross income amounts which are received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country, or in the Coast and Geodetic Survey, or the Public Health Service. For purposes of this section, that part of the retired pay of a member of an armed force, computed under formula No. 1 or 2 of 10 U.S.C. 1401, or under 10 U.S.C. 1402(d), on the basis of years of service, which exceeds the retired pay that he would receive if it were computed on the basis of percentage of disability is not considered as a pension, annuity, or similar allowance for personal injury or sickness, resulting from active service in the armed forces of any country, or in the Coast and Geodetic Survey, or the Public Health Service (see 10 U.S.C. 1403 (formerly 37 U.S.C. 272(h), section 402(h) of the Career Compensation Act of 1949)). See paragraph (a)(3)(i)*(a)* of §1.105–4 for the treatment of retired pay in excess of the part computed on the basis of percentage of disability as amounts received through a wage continuation plan. For the rules relating to certain reduced uniformed services retirement pay, see paragraph (c)(2) of §1.122–1. For rules relating to a waiver by a member or former member of the uniformed services of a portion of disability retired pay in favor of a pension or compensation receivable under the laws administered by the Veterans Administration (38 U.S.C. 3105), see §1.122–1(c)(3). For rules relating to a reduction of the disability retired pay of a member or former member of the uniformed services under the Dual Compensation Act of 1964 (5 U.S.C. 5531) by reason of Federal employment, see §1.122–1(c)(4).

(2) Section 104(a)(4) excludes from gross income amounts which are received by a participant in the Foreign Service Retirement and Disability System in a taxable year of such participant ending after September 8, 1960, as a disability annuity payable under the provisions of section 831 of the Foreign Service Act of 1946, as amended (22 U.S.C. 1081; 60 Stat. 1021). However, if any amount is received by a survivor of a disabled or incapacitated participant, such amount is not excluded from gross income by reason of the provisions of section 104(a)(4).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6722, 29 FR 5070, Apr. 14, 1964; T.D. 7043, 35 FR 8477, June 2, 1970]

§1.105–1 Amounts attributable to employer contributions.

(a) *In general.* Under section 105(a), amounts received by an employee through accident or health insurance for personal injuries or sickness must be included in his gross income to the extent that such amounts (1) are attributable to contributions of the employer which were not includible in the gross income of the employee, or (2) are paid by the employer, unless such amounts are excluded therefrom under section 105(b), (c), or (d). For purposes of this section, the term ‘‘amounts received by an employee through an accident or health plan’’ refers to any amounts received through accident or health insurance, and also to any amounts which, under section 105(e), are treated as being so received. See §1.105–5. In determining the extent to which amounts received for personal injuries or sickness by an employee through an accident or health plan are subject to the provisions of section 105(a), rather than section 104(a)(3), the provisions of paragraphs (b), (c), (d), and (e) of this section shall apply. A self-employed individual is not an employee for purposes of section 105 and §§1.105–1 through 1.105–5. See paragraph (g) of §1.72–15. Thus, such an individual will not be treated as an employee with respect to benefits described in section 105 received from a plan in which he participates as an employee within the meaning of section 401(c)(1) at the time he, his spouse, or any of his dependents becomes entitled to receive such benefits.

(b) *Noncontributory plans.* All amounts received by employees through an accident or health plan which is financed solely by their employer, either by payment of premiums on an accident or health insurance policy (whether on a group or individual basis), by contributions to a fund which pays accident or health benefits, or by direct payment of the benefits under the plan, are subject to the provisions of section 105(a), except to the extent that they are excludable under section 105(b), (c), or (d). This rule may be illustrated by the following examples:

Example (1). Employer A maintains a plan for his employees which provides that he will continue to pay regular wages to employees who are absent from work due to sickness or personal injuries. Employees make no contributions to the plan and all benefits are paid by the employer. Amounts received by employees under the plan are subject to section 105(a), and must be included in gross income unless excluded therefrom under section 105(b), (c), or (d).

Example (2). Pursuant to a State nonoccupational disability benefits law, employer B maintains an accident and health plan for his employees. Although under the State law B is authorized to withhold from his employees' wages a specified amount for employee contributions to the State fund, in actual practice B does not so withhold and makes all contributions out of his own funds. All amounts received by B's employees from the State fund are subject to section 105(a), and must be included in gross income unless excluded therefrom under section 105 (b), (c), or (d).

(c) *Contributory plans.* (1) In the case of amounts received by an employee through an accident or health plan which is financed partially by his employer and partially by contributions of the employee, section 105(a) applies to the extent that such amounts are attributable to contributions of the employer which were not includible in the employee's gross income. The portion of such amounts which is attributable to such contributions of the employer shall be determined in accordance with paragraph (d) of this section in the case of an insured plan, or paragraph (e) of this section in the case of a noninsured plan. As used in this section, the phrase ''contributions of the employer'' means employer contributions which were not includible in the gross income of the employee. See section 106 for the exclusion from an employee's gross income of employer contributions to accident or health plans.

(2) A separate determination of the portion of the amounts received under the accident or health plan which is attributable to the contributions of the employer shall be made with respect to each class of employees in any case where the plan provides that some classes of covered employees contribute but others do not, or that the employer will make different contributions for different classes of employees, or that different classes of employees will make different contributions, and where in any such case both the contributions of the employer on account of each such class of employees and the contributions of such class of employees can be ascertained. For example, if employees contribute during the first year of employment but not thereafter, there will have to be a separate determination for first year employees, provided that the amount of the contributions of the employer on account of first-year employees and the contributions of such first-year employees can be ascertained for the required periods to apply the rules of paragraph (d) or (e) of this section. If in such a case the contributions of the employer to the plan on account of first-year employees are not distinguishable from his other contributions to the plan, then the determination shall be made for all employees under the plan, and such determination shall be used by all employees under the plan.

(3) Except as provided in paragraph (c)(2) of § 1.72–15, if the plan provides accident or health benefits as well as other benefits for the employees, and if the respective contributions made by the employer and the employees to provide the accident or health benefits cannot be ascertained, the determination of the portion of the accident or health benefits received under such plan which is attributable to the contributions of the employer shall be made in accordance with the rules of paragraph (d) or (e) of this section on the basis of the contributions of the employer and of the employees to the entire plan.

(4) A determination of the portion attributable to the contributions of the employer, once made in accordance with the rules of this section, shall as

to such portion be used for all purposes. For example, if an employee receives amounts under a wage continuation plan during the month of January and terminates his services during February, the portion of such amounts which is attributable to the contributions of the employer may be determined in order to provide the employee with such information at the time he is provided his Form W-2. The determination made for such purpose will also be used by the employee to report his income for his taxable year in which such amounts are received, without regard to the experience under the plan for the rest of the year.

(d) *Insured plans*—(1) *Individual policies.* If an amount is received from an insurance company by an employee under an individual policy of accident or health insurance purchased by contributions of the employer and the employee, the portion of the amount received which is attributable to the employer's contributions shall be an amount which bears the same ratio to the amount received as the portion of the premiums paid by the employer for the current policy year bears to the total premiums paid by the employer and the employee for that year. This rule may be illustrated by the following example:

Example. Employer A maintains a plan whereby he pays two-thirds of the annual premium cost on individual policies of accident and health insurance for his employees. The remainder of each employee's premium is paid by a payroll deduction from the wages of the employee. The annual premium for employee X is $24, of which $16 is paid by the employer. Thus, 16/24 or two-thirds of all amounts received by X under such insurance policy are attributable to the contributions of the employer and are subject to section 105(a), and the remaining one-third of such amounts is excludable from X's gross income under section 104(a)(3).

(2) *Group policies.* If the accident or health coverage is provided under or is a part of a group insurance policy purchased by contributions of the employer and of the employees, and the net premiums for such coverage for a period of at least three policy years are known at the beginning of the calendar year, the portion of any amount received by an employee which is attributable to the contributions of the employer for such coverage shall be an amount which bears the same ratio to the amount received as the portion of the net premiums contributed by the employer for the last three policy years which are known at the beginning of the calendar year, bears to the total of the net premiums contributed by the employer and all employees for such policy years. If the net premiums for such coverage for a period of at least three policy years are not known at the beginning of the calendar year but are known for at least one policy year, such determination shall be made by using the net premiums for such coverage which are known at the beginning of the calendar year. If the net premiums for such coverage are not known at the beginning of the calendar year for even one policy year, such determination shall be made by using either (i) a reasonable estimate of the net premiums for the first policy year, or (ii) if the net premiums for a policy year are ascertained during the calendar year, by using such net premiums. These rules may be illustrated by the following example:

Example. An employer maintains a plan under which a portion of the cost of a group policy of accident and health insurance for his employees is paid through payroll deductions from wages of the employees. The remainder of the cost is borne by the employer. The policy year begins on November 1 and ends on October 31. The net premium for the policy year ended October 31, 1954, is not known on January 1, 1955, because certain retroactive premium adjustments, such as dividends and credits, are not determinable until after January 1. Therefore, for purposes of this computation the last three policy years are the policy years ended October 31, 1951, 1952, and 1953. The net premium for the policy year ended October 31, 1953, was $8,000, of which the employer contributed $3,000; the net premium for the policy year ended October 31, 1952, was $9,000, of which the employer contributed $3,500; and the net premium for the policy year ended October 31, 1951, was $7,000, of which the employer contributed $1,500. The portion of any amount received under the policy by an employee at any time during 1955 which is attributable to the contributions of the employer is to be determined by using the ratio of $8,000 ($3,000 plus $3,500 plus $1,500) to $24,000 ($8,000 plus $9,000 plus $7,000. Thus, $8,000 ÷ $24,000 or one-third, of the amounts received by an employee at any time during

1955 is attributable to contributions of the employer.

(e) *Noninsured plans.* If the accident or health benefits are a part of a noninsured plan to which the employer and the employees contribute, and such plan has been in effect for at least three years before the beginning of the calendar year, the portion of the amount received which is attributable to the employer's contributions shall be an amount which bears the same ratio to the amount received as the contributions of the employer for the period of three calendar years next preceding the year of receipt bear to the total contributions of the employer and all the employees for such period. If, at the beginning of the calendar year of receipt, such plan has not been in effect for three years but has been in effect for at least one year, such determination shall be based upon the contributions made during the 1-year or 2-year period during which the plan has been in effect. If such plan has not been in effect for one full year at the beginning of the calendar year of receipt, such determination may be based upon the portion of the year of receipt preceding the time when the determination is made, or such determination may be made periodically (such as monthly or quarterly) and used throughout the succeeding period. For example, if an employee terminates his services on April 15, 1955, and 1955 is the first year the plan has been in effect, such determination may be based upon the contributions of the employer and the employees during the period beginning with January 1 and ending with April 15, or during the month of March, or during the quarter consisting of January, February, and March.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6722, 29 FR 5071, Apr. 14, 1964]

§ 1.105–2 Amounts expended for medical care.

Section 105(b) provides an exclusion from gross income with respect to the amounts referred to in section 105(a) (see § 1.105–1) which are paid, directly or indirectly, to the taxpayer to reimburse him for expenses incurred for the medical care (as defined in section 213(e)) of the taxpayer, his spouse, and his dependents (as defined in section 152). However, the exclusion does not apply to amounts which are attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year. See section 213 and the regulations thereunder. Section 105(b) applies only to amounts which are paid specifically to reimburse the taxpayer for expenses incurred by him for the prescribed medical care. Thus, section 105(b) does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether or not he incurs expenses for medical care. For example, if under a wage continuation plan the taxpayer is entitled to regular wages during a period of absence from work due to sickness or injury, amounts received under such plan are not excludable from his gross income under section 105(b) even though the taxpayer may have incurred medical expenses during the period of illness. Such amounts may, however, be excludable from his gross income under section 105(d). See § 1.105–4. If the amounts are paid to the taxpayer solely to reimburse him for expenses which he incurred for the prescribed medical care, section 105(b) is applicable even though such amounts are paid without proof of the amount of the actual expenses incurred by the taxpayer, but section 105(b) is not applicable to the extent that such amounts exceed the amount of the actual expenses for such medical care. If the taxpayer incurs an obligation for medical care, payment to the obligee in discharge of such obligation shall constitute indirect payment to the taxpayer as reimbursement for medical care. Similarly, payment to or on behalf of the taxpayer's spouse or dependents shall constitute indirect payment to the taxpayer.

§ 1.105–3 Payments unrelated to absence from work.

Section 105(c) provides an exclusion from gross income with respect to the amounts referred to in section 105(a) to the extent that such amounts (a) constitute payments for the permanent loss or permanent loss of use of a member or function of the body, or the permanent disfigurement, of the taxpayer, his spouse, or a dependent (as defined in section 152), and (b) are computed with reference to the nature of the injury without regard to the period the employee is absent from work. Loss of use or disfigurement shall be considered permanent when it may reasonably be expected to continue for the life of the individual. For purposes of section 105(c), loss or loss of use of a member or function of the body includes the loss or loss of use of an appendage of the body, the loss of an eye, the loss of substantially all of the vision of an eye, and the loss of substantially all of the hearing in one or both ears. The term ‘‘disfigurement’’ shall be given a reasonable interpretation in the light of all the particular facts and circumstances. Section 105(c) does not apply if the amount of the benefits is determined by reference to the period the employee is absent from work. For example, if an employee is absent from work as a result of the loss of an arm, and under the accident and health plan established by his employer, he is to receive $125 a week so long as he is absent from work for a period not in excess of 52 weeks, section 105(c) is not applicable to such payments. See, however, section 105(d) and §1.105–4. However, for purposes of section 105(c), it is immaterial whether an amount is paid in a lump sum or in installments. Section 105(c) does not apply to amounts which are treated as workmen’s compensation under paragraph (b) of §1.104–1, or to amounts paid by reason of the death of the employee (see section 101).

§1.105–4 Wage continuation plans.

(a) *In general.* (1) Subject to the limitations provided in this section, section 105(d) provides an exclusion from gross income with respect to amounts referred to in section 105(a) which are paid to an employee through a wage continuation plan and which constitute wages or payments in lieu of wages for a period during which the employee is absent from work on account of personal injuries or sickness.

(2)(i) Section 105(d) is applicable only if the wages or payments in lieu of wages are paid pursuant to a wage continuation plan. (See §1.105–6 for special rules for employees retired before January 27, 1975). The term ‘‘wage continuation plan’’ means an accident or health plan, as defined in §1.105–5, under which wages, or payments in lieu of wages, are paid to an employee for a period during which he is absent from work on account of a personal injury or sickness. Such term includes plans under which payments are continued as long as the employee is absent from work on account of personal injury or sickness. It includes plans under which there is a limitation on the period for which benefits will be paid, such as 13 or 26 weeks, and also plans under which benefits are continued until the employee is either able to return to work or reaches mandatory retirement age. Such term also includes a plan under which wages or payments in lieu of wages are paid to an employee who is absent from work on account of personal injury or sickness, even though the plan also provides that wages or payments in lieu of wages may be paid to an employee who is absent from work for reasons other than a personal injury or sickness.

(ii) Section 105(d) is applicable if, and only if, the employee is absent from work and such absence is due to a personal injury or sickness. Thus, if an employer has a plan for continuing the wages of employees when they are absent from work, regardless of the cause of the absence from work, section 105(d) is applicable to any payments made under this plan to an employee whose absence from work is in fact due to a personal injury or sickness. On the other hand, although the terms of a plan provide that benefits are to be continued only as long as the employee is absent from work on account of a personal injury or sickness, section 105(d) does not apply to payments made to an employee for a period of absence from work where such absence is not in fact due to a personal injury or sickness.

(3)(i)(A) Section 105(d) applies only to amounts attributable to periods during which the employee would be at work were it not for a personal injury or sickness. Thus, an employee is not absent from work if he is not expected to work because, for example, he has reached mandatory retirement age. If a plan provides that an employee, who is absent from work on account of a personal injury or sickness, will receive a disability pension or annuity as long as he is disabled, section 105(d) is applicable to any payments that he receives under this plan before reaching mandatory retirement age, as defined in paragraph (a)(3)(i)(B) of this section. Thus, section 105(d) would not apply to the payments that an employee receives after reaching mandatory retirement age. The disability retired pay received by a member on the retired list pursuant to section 402 of the Career Compensation Act of 1949 (63 Stat. 802) or chapter 61 of title 10, United States Code (10 U.S.C. 1201 *et seq.*) which is in excess of the amounts excludable under section 104(a)(4) and paragraph (e) of § 1.104–1 shall be excluded from gross income subject to the limitations of section 105(d) and this section, if such pay is received before the member reaches mandatory retirement age. See § 1.72–15 for additional rules relating to the tax treatment of disability pensions. For the rules relating to certain reduced uniformed services retirement pay, see paragraph (c)(2) of § 1.122–1. For rules relating to a waiver by a member or former member of the uniformed services of a portion of disability retired pay in favor of a pension or compensation receivable under the laws administered by the Veterans Administration (38 U.S.C. 3105), see § 1.122–1(c)(3).

(B) The term ‘‘mandatory retirement age’’ as used in paragraph (a)(3)(i)(A) of this section means the age set by an employer for the mandatory retirement of employees in the class to which the taxpayer last belonged, unless such age has been set at an age higher than that at which it has been the practice of the employer to terminate, due to age, the services of such employees, or for purposes of tax avoidance. Where no age is set for mandatory retirement, such term means age 65, or, if higher, the age at which it has been the practice of the employer to terminate, due to age, the services of the class of employees to which the taxpayer last belonged.

(ii) Similarly, an employee who incurs a personal injury or sickness during his paid vacation is not allowed to exclude under section 105(d) any of the vacation pay which he receives, since he is not absent from work on account of the personal injury or sickness. Likewise, a teacher who becomes sick during the summer or other vacation period when he is not expected to teach, is not entitled to any exclusion under section 105(d) for the summer or vacation period. However, if an employee who would otherwise be at work during a particular period is absent from work and his absence is in fact due to a personal injury or sickness, a payment which he receives for such period under a wage continuation plan is subject to section 105(d).

(4) A period of absence from work shall commence the moment the employee first becomes absent from work and shall end the moment the employee first returns to work. However, the exclusion provided under section 105(d) is applicable only to payments attributable to a period of absence from work which is due to a personal injury or sickness, and to payments attributable to a period when the employee would have been at work but for such personal injury or sickness.

(5) For the purpose of section 105(d), whether an employee is absent from work depends upon all the circumstances. For example, an employee, who is a farm hand and who lives upon the premises of his employer, is absent from work when he is unable to work even though he remains on the premises of his employer. A member of the Armed Forces, who on a particular day has no assigned duties but to stand ready for duty, is absent from work if he is unable to answer any duty call that may be made upon him. An employee is not absent from work when he performs any services for his employer at his usual place or places of employment, whether or not the services are the usual services performed by the employee. Furthermore, the employee is not absent from work when he performs substantial services for his employer, even though they are performed at a place other than his usual place of employment. Thus, if an employee returns to his usual place or places of employment and performs any services for his employer, he has

returned to work, but if he merely holds occasional short conferences concerning his work with other employees or clients while hospitalized or at home recuperating, such conferences do not constitute a return to work.

(b) *Determination of amount attributable to period of absence.* The amount which is paid to an employee as wages or payments in lieu of wages for a period of absence from work due to a personal injury or sickness shall be determined by reference to the plan under which the amount is paid, and to the contract, statute, or regulation which provides the terms of the employment. However, unless the plan, contract, statute, or regulation provides otherwise, it will be presumed that no wages or plan benefits are attributable to days (or portions of days) which are not normal working days for the particular employee. Also, section 105(d) does not apply to amounts earned prior to or subsequent to the period of absence from work, even though received during such period. These rules may be illustrated by the following examples:

Example (1). Employee A, who receives regular wages of $70 per week, normally works five days (Monday through Friday) during each week. A is absent from work on a Friday and the succeeding Monday (two working days) on account of a personal injury, but receives his regular wages with respect to such period of absence under his employer's accident and health plan. Unless the plan of A's employer, or the contract, statute, or regulation under which A is employed, provides otherwise, it will be presumed that A is not paid with respect to nonworking days (Saturday and Sunday). Therefore, the amount received by A with respect to his period of absence from work due to injury is $28, which is two days regular wages. If the plan, or the employment contract, statute, or regulation had provided that wages were paid on a 7-day per week basis and that A must be available for call to work on Saturday and Sunday, A's daily wage would have been $10, and the amount attributable to the period of absence would have been $40 ($10 per day for four days).

Example (2). Employee B is a salesman who is paid on a commission basis. The employer purchases for B an accident and health insurance policy which provides that B shall receive $50 per week during any period (after a 7-day waiting period) that he is unable to work due to personal injuries or sickness. B incurs a personal injury and is incapacitated for two weeks. He receives $50 under the insurance policy with respect to the second week of absence. In addition, during the 2-week period of absence he receives a check for $40 from his employer as his commission on a sale which he made before becoming incapacitated. Section 105(d) applies to the $50 received through the insurance policy, but does not apply to the $40 commission which B earned prior to the period of absence from work.

(c) *Limitation in the case of absence from work due to sickness for periods commencing prior to January 1, 1964.* (1) In the case of a period of absence from work on account of sickness commencing prior to January 1, 1964, the exclusion provided by section 105(d) does not apply to amounts attributable to the first seven calendar days of each such period, unless the employee is hospitalized on account of sickness for at least one day during the period of absence from work. This 7-day rule applies to each period of absence from work because of sickness, regardless of the frequency of such absences or the closeness in time to any prior period of absence from work because of sickness. For example, employee A becomes absent from work because of sickness on Friday, October 4, 1963, and returns to work on the morning of Monday, October 14, 1963. He suffers a relapse and again becomes absent from work on the afternoon of Monday, October 14, 1963. A's return to work on the morning of Monday, October 14, 1963, terminates the first period of absence from work because of sickness, and a new period of absence from work because of sickness begins on the afternoon of Monday, October 14, 1963. The 7-day limitation does not apply if the absence from work is due to personal injury. These rules may be illustrated by the following examples:

Example (1). Employee C normally works five days (Monday through Friday) during each week. On Saturday, October 5, 1963 (a nonworking day), C becomes sick and as a result, he does not return to work until Thursday, October 17, 1963. The period of absence from work due to sickness commences on Monday, October 7, 1963, and terminates when C returns to work on Thursday, October 17, 1963. If C is not hospitalized during such period of absence from work, section 105(d) does not apply to amounts which C receives under his employer's wage continuation plan attributable to the 7-day period commencing Monday, October 7, 1963, and ending Sunday, October 13, 1963, inclusive.

Example (2). Employee D incurs a personal injury which causes him to be absent from work two days. His regular wages are continued during this period in accordance with the wage continuation plan of his employer. Since D's absence from work was due to a personal injury, rather than a sickness, the 7-day waiting period does not apply, and, subject to the other requirements of section 105(d), D is entitled to an exclusion with respect to the amounts received under the employer's plan attributable to the 2-day period of absence.

(2) For the purpose of starting the 7-day waiting period, if the period of absence due to sickness commences after the start of a working day, the amount received with respect to the portion of such day that the employee is absent from work shall be considered the amount attributable to the first calendar day of the period of absence from work due to sickness. This rule may be illustrated by the following example:

Example. Employee E normally works from 9 a.m. until 5:30 p.m. on five days (Monday through Friday) during each week. From noon on Friday, September 6, 1963, until noon on Monday, September 16, 1963, E is absent from work on account of sickness but is not hospitalized at any time during this period. Section 105(d) does not apply to amounts received by E under his employer's wage continuation plan which are attributable to the calendar period beginning September 6, 1963, and ending September 12, 1963, inclusive. However, if the other requirements of section 105(d) are met, E may exclude from gross income amounts attributable to the period beginning September 13, 1963, and ending at noon on September 16, 1963, inclusive.

(3) If the absence from work is due to sickness, the amount attributable to the first seven calendar days of such absence includes all amounts paid for such seven calendar days, regardless of the number of work days included in such seven calendar days. For example, if one of such seven calendar days an employee would have worked two 8-hour shifts, the amount he is paid for the two shifts is considered to be an amount attributable to only one calendar day.

(4) An employee is considered to be hospitalized for one day only if he is admitted to and confined in a hospital as a bed patient for at least one hospital day. Entry into a hospital as an in-and-out patient does not constitute hospitalization for purposes of section 105(d). The same applies to mere entry into the outpatient ward or the emergency ward of a hospital.

(d) *Exclusion not applicable to the extent that amounts exceed a weekly rate of $100 for periods of absence commencing prior to January 1, 1964*—(1) *In general.* Amounts received under a wage continuation plan, attributable to periods of absence commencing before January 1, 1964, which are not excludable from gross income as being attributable to contributions of the employee (see § 1.105–1) must be included in gross income under section 105(d) to the extent that the weekly rate of such amounts exceeds $100. Thus, an employee, who receives $50 under his employer's wage continuation plan on account of his being absent from work for two days due to a personal injury, cannot exclude the entire $50 under section 105(d) if the weekly rate of such benefits exceeds $100. If an employee receives payments under a wage continuation plan for less than a full pay period, the excludability of such payments shall be determined under subparagraph (2) of this paragraph. In all other cases, the weekly rate and excludability of such payments under a wage continuation plan shall be determined under subparagraph (3) of this paragraph. If, with respect to any pay period or portion thereof, the employee receives amounts under two or more wage continuation plans (whether such plans are maintained by or for the same employer or by different employers), the weekly rate and excludability of amounts received under each plan shall be determined under subparagraph (3) of this paragraph and the weekly rate for purposes of section 105(d) shall be the sum of all such weekly rates. This rule may be illustrated by the following examples:

Example (1). An employee whose weekly salary is $120 is covered by two wage continuation plans maintained by his employer. Plan A is a contributory insured plan to which the employee contributes 60 percent of the premiums and which provides a weekly payment of $30. Plan B is a salary continuation plan completely financed by the employer. Since 60 percent of the cost of plan A is contributed by the employee, 60 percent of the weekly payment of $30 ($18) is excluded from gross income under section 104(a)(3). The remainder of each weekly payment ($12) is the weekly rate of plan A. Since the employer pays the entire cost of plan B, the weekly rate of this plan is the total amount paid per week. In the case of an employee whose weekly wages of $120 are continued under plan B, the weekly rate for the employee for purposes of section 105(d) is $132 ($120 from plan B, plus $12 from plan A).

Example (2). Assume in Example (1) that plan A provides a waiting period of four calendar days while plan B is effective immediately. For the first four days of absence the weekly rate for purposes of section 105(d) is $120, and for periods after the first four days the weekly rate for purposes of section 105(d) is $132.

(2) *Daily exclusion.* If an employee receives payments under a wage continuation plan for less than a full pay period, the extent to which such benefits are excludable under section 105(d) shall be determined by computing the daily rate of the benefits which can be excluded under section 105(d). Such daily rate is determined by dividing the weekly rate at which wage continuation payments are excludable ($100) by the number of work days in a normal work week. This rule may be illustrated by the following example:

Example. Employee E is covered by a wage continuation plan maintained by his employer providing that E's regular salary of $220 semimonthly will be continued in case he is absent from work on account of a personal injury or sickness. E is absent from work on account of a personal injury for three days and under the plan he received $66 as wage continuation payments. The extent to which the $66 is excludable under section 105(d) shall be determined by dividing $100 by 5, the number of work days in a normal work week for E, resulting in a daily exclusion of $20 and a total exclusion of $60.

(3) *Determination of weekly rate at which amounts are paid under a wage continuation plan.* (i) For purposes of this subparagraph the pay period of a particular wage continuation plan shall be determined by reference to such plan. If, in the usual operation of the plan, benefits are paid for the same periods as regular wages, then the pay period of such benefits shall be the period for which a payment of wages is ordinarily made to the employee by the employer. If plan benefits are ordinarily paid for different periods than regular wages then the pay period of such benefits shall be the period for which payment of such benefits is ordinarily made.

(ii) The weekly rate shall be determined in accordance with the following rules:

(a) Weekly pay period. If benefits are paid on the basis of a weekly pay period, the weekly rate at which such benefits are paid shall be the weekly amount of such benefits.

(b) Biweekly pay period. If benefits are paid on the basis of a biweekly pay period, the weekly rate at which such benefits are paid shall be one-half of the biweekly rate.

(c) Semimonthly pay period. If benefits are paid on the basis of a semimonthly pay period, the weekly rate at which such benefits are paid shall be the semimonthly rate multiplied by 24 and divided by 52.

(d) Monthly pay period. If benefits are paid on the basis of a monthly pay period, the weekly rate at which such benefits are paid shall be the monthly rate multiplied by 12 and divided by 52.

(e) Other pay periods. If benefits are paid on the basis of a period other than a period described in *(a)* through *(d)*, of this subdivision the weekly rate at which such benefits are paid shall be determined by ascertaining the annual rate at which such benefits are paid and dividing such annual rate by 52.

(f) Examples. The operation of the rules of this subdivision may be illustrated by the following examples:

Example (1). A's employer maintains a noncontributory plan which provides for the continuation of regular salary during periods of absence from work due to personal injury or sickness. A, an office employee, receives regular salary of $520 per month, and he is paid on the basis of a monthly pay period. Since benefits under the salary continuation plan are paid for the same periods as regular salary, the pay period of the plan is monthly. For purposes of section 105(d), the weekly rate at which benefits are paid to A under the plan is $120, determined as follows:

$520 (monthly rate)×12	$6,240 (annual rate).
$6,240÷52	$120 (weekly rate).

Example (2). B, a factory employee of the same employer, is paid regular wages on the basis of a 10-day pay period. B's regular wages are $200 per pay period. If B is absent from work for 15 days, the weekly rate of the amount he receives under his employer's plan will be determined as follows:

365×$200÷10	$7,300 (annual rate).
$7,300÷52	$140.38 (weekly rate).

(iii) If the weekly rate for purposes of section 105(d) (as determined in subdivision (ii) of this subparagraph) does not exceed $100, the amount received which is not attributable to the 7-day waiting period described in paragraph (c) of this section is fully excludable from gross income. If the weekly rate for purposes of section 105(d) (as determined in subdivision (ii) of this subparagraph) exceeds $100, the amount received which is not attributable to the 7-day waiting period provided in paragraph (c) of this section is only partially excludable. The excludable portion of such amount shall bear the same ratio to such amount as $100 bears to the weekly rate for purposes of section 105(d). This rule may be illustrated by the following example:

Example. The weekly rate of benefits in the case of employee A in example (1) of subdivision (ii) of this subparagraph was $120. If A does not receive amounts under any other plan, this is the weekly rate for purposes of section 105(d). Assume that A is absent from work on account of a personal injury for one full month and receives full pay of $520 for such period of absence. Since there is no waiting period requirement, the exclusion is $433.33 computed as follows:

$100÷$120×$520 or $433.33.

(e) *Limitation in the case of absence from work on account of personal injury or sickness for periods commencing after December 31, 1963.* (1) In the case of periods of absence from work on account of sickness or personal injury commencing after December 31, 1963, the exclusion provided by section 105(d) does not apply to amounts attributable to the first 30 calendar days of each such period, if such amounts are at a rate which exceeds 75 percent of the employee's ''regular weekly rate of wages'', as determined under subparagraph (5) of this paragraph. If the amounts are at a rate of 75 percent or less of the employee's ''regular weekly rate of wages'', the exclusion provided by section 105(d) does not apply to amounts attributable to the first 7 calendar days of each such period, unless the employee is hospitalized on account of personal injury or sickness for at least one day during the period of absence from work. The 7- or 30-day waiting period (whichever is applicable) applies to each period of absence from work because of personal injury or sickness, regardless of the frequency of such absences or the closeness in time to any prior period of absence from work because of personal injury or sickness. The waiting period is to be counted by beginning with the first work day for which the employee was absent. These rules may be illustrated by the following examples:

Example (1). Employee A is absent from work because of sickness on Tuesday, January 7, 1964, and returns to work on the morning of Thursday, February 13, 1964. He suffers a relapse and again becomes absent from work on the afternoon of Thursday, February 13, 1964. A's return to work on the morning of Thursday, February 13, 1964, terminates the first period of absence from work because of sickness, and a new period of absence from work because of sickness begins on the afternoon of Thursday, February 13, 1964.

Example (2). Employee B normally works five days (Monday through Friday) during each week. On Saturday, January 11, 1964 (a nonworking day), B becomes sick or injured and as a result he does not return to work until Monday, February 17, 1964. The period of absence from work commences on Monday, January 13, 1964, and terminates when B returns to work on Monday, February 17, 1964. Assuming B receives amounts under his employer's wage continuation plan at a rate exceeding 75 percent of his ''regular weekly rate of wages'' (as determined under subparagraph (5) of this paragraph), the exclusion provided by section 105(d) does not apply to amounts B receives under his employer's wage continuation plan which are attributable to the 30-day period commencing Monday, January 13, 1964, and ending Tuesday, February 11, 1964, inclusive. If B receives amounts under his employer's wage continuation plan at a rate which is 75 percent or less of his ''regular weekly rate of wages'' and he is not hospitalized during the period of absence from work, the exclusion provided by section 105(d) does not apply to amounts B receives which are attributable to the 7-day period commencing Monday, January 13, 1964, and ending Sunday, January 19, 1964, inclusive.

Example (3). Employee C is sick or incurs a personal injury which causes him to be absent from work for two weeks. He receives amounts under his employer's wage continuation plan at a rate which is 75 percent or less of his ''regular weekly rate of wages'' (as determined under subparagraph (5) of this paragraph) and is hospitalized from the eighth through the eleventh day of his absence. Since C was hospitalized on account of personal injury or sickness for at least one day during the period of absence, the 7-day waiting period does not apply, and, subject to the other requirements of section 105(d), C is entitled to an exclusion with respect to the amounts received under his employer's plan attributable to the two- week period of absence. If C were receiving amounts under his employer's wage continuation plan at a rate exceeding 75 percent of his ''regular weekly rate of wages'', he would not be entitled to an exclusion under section 105(d).

(2) For the purpose of starting the 7- or 30-day waiting period, whichever is applicable, if the period of absence commences after the start of a working day, the amount received with respect to the portion of such day that the employee is absent from work shall be considered an amount attributable to the first calendar day of the period of absence from work. This rule may be illustrated by the following example:

Example. Employee D normally works from 9 a.m. until 5:30 p.m. on five days (Monday through Friday) during each week. From noon on Wednesday, January 8, 1964, until noon on Monday, February 17, 1964, D is absent from work on account of personal injury or sickness but is not hospitalized at any time during this period. D receives amounts under his employer's wage continuation plan at a rate not exceeding 75 percent of his ''regular weekly rate of wages'' (as determined under subparagraph (5) of this paragraph). Section 105(d) does not apply to amounts received by D under his employer's wage continuation plan which are attributable to the calendar period beginning January 8, 1964, and continuing through January 14, 1964, inclusive. However, if the other requirements of section 105(d) are met, D may exclude from gross income amounts attributable to the remainder of the period of absence, ending at noon on Monday, February 17, 1964.

(3) If the exclusion is subject to a 7- or 30-calendar-day waiting period, any amount attributable to such 7- or 30-calendar-day waiting period includes all amounts paid therefor, regardless of the number of work days included in such 7 or 30 calendar days. For example, if on one of the days included in the waiting period, an employee would have worked two 8-hour shifts, the amount he is paid for the two shifts is considered to be attributable to only one calendar day.

(4) An employee is considered to be hospitalized for one day only if he is admitted to and confined in a hospital as a bed patient for at least one hospital day. Entry into a hospital as an in-and-out-patient does not constitute hospitalization for purposes of section 105(d). The same applies to mere entry into the out-patient ward or the emergency ward of a hospital.

(5)(i) In general, the ''regular weekly rate of wages'', for purposes of section 105(d), shall be the average weekly wages paid for the last four weekly periods falling within a full pay period or full pay periods immediately preceding the commencement of the period of absence. If the employee was absent from work for three or more normal working days during any such pay period, and the amount of wages paid for such pay period was less than the amount of wages paid for the immediately preceding pay period during which the employee was not absent from work for three or more normal working days, then the amount of wages paid for the weekly period or weekly periods falling wholly or partly within the pay period during which each such absence occurred shall not be used in the determination of ''regular weekly rate of wages''. In such a case, there shall be substituted the amount of wages paid for the last weekly period or weekly periods falling within the pay period or pay periods immediately preceding the pay period or pay periods in which such absence or absences occurred during which the employee was not absent from work for three or more normal working days.

(a) In order to compute wages paid for the last four weekly periods falling within a full pay period or full pay periods immediately preceding the commencement of the period of absence, or any substituted weekly periods therefor, it will be necessary to convert the wages paid for any pay period other than a weekly pay period into a weekly rate or weekly rates of payment of such wages in accordance with the rules stated in subdivision (iv) of this subparagraph. Such weekly rate or weekly rates of wage payments are then used in determining the wages for the last four weekly periods falling within a full pay period or full pay periods immediately preceding the commencement of the period of absence, or any substituted weekly periods therefor.

(b) If the employee does not have four weekly periods falling within a full pay period or full pay periods preceding his absence during which he was not absent from work for three or more normal working days, then the greatest number of available weekly periods shall be used, consistent with the rules set forth in this subdivision (i), in determining the ''regular weekly rate of wages.''

(c) If the employee has been employed for a full pay period or more preceding his absence, and has worked for the number of days in a normal work week, but was absent from work for three or more normal working days during each of the pay periods preceding his absence, then the ''regular weekly rate of wages'' shall be determined by multiplying the employee's actual wages paid for the total number of normal working days in the pay period immediately preceding the employee's absence by the number of days that the employee is expected to work in a normal work week, and by dividing the product by the number of normal work days in such pay period for which wages were paid.

(d) If the employee has not been employed for a full pay period preceding his absence, and has worked for the number of days in a normal work week, the ''regular weekly rate of wages'' shall be determined by multiplying the employee's actual wages paid for the total number of normal working days preceding the employee's absence by the number of days that the employee is expected to work in a normal work week, and by dividing the product by the number of normal work days for which wages were paid.

(e) If the employee has not worked the number of days in a normal work week, then there is no ''regular weekly rate of wages,'' and the employee will not be permitted an exclusion under section 105(d) for amounts attributable to the first 30 calendar days in the period of absence.

(f) Wages paid by a former employer shall not be used in the determination of ''regular weekly rate of wages'' as described in this subparagraph.

(ii) In the case of a wage continuation plan of an employer under which the benefits are computed as a specified percentage of average wages, the formula for computing the employee's average wages included in the plan may be used (in lieu of the formula provided in subdivision (i) of this subparagraph) for determining the ''regular weekly rate of wages'' for purposes of section 105(d), if under the plan—

(a) The definition of wages does not include any items which are not considered ''wages'' as defined in subdivision (iii) of this subparagraph,

(b) The period for computing average wages is not less than twenty-eight successive calendar days, does not end earlier than five months preceding the date on which the period of absence commences, and is one in which the employee was at work at least 35 percent of the normal working time, and

(c) The period and formula for computing average wages are applied uniformly with respect to all employees eligible to receive benefits under the plan. A plan will not fail to meet the conditions of this subdivision merely because different portions of the employee's wages are averaged over different periods for purposes of computing his average wages, so long as each such period meets the requirements in *(b)* and *(c)* of this subdivision.

(iii) For the purpose of determining ''regular weekly rate of wages'' under subdivision (i) or (ii) of this subparagraph, whichever is applicable, an employee's wages shall comprise basic salary, fees, commissions, tips, gratuities, overtime, and any other type of taxable compensation which is normally paid for services. However, wages shall not include any type of compensation which is not normally paid, such as bonuses and incentive payments. An employee's compensation, for the purpose of determining his ''regular weekly rate of wages'', will not include any compensation which is not currently includible in gross income. For example, an employee's wages for the purpose of this subdivision shall not include deferred compensation paid by the employer which is not includible in gross income until received by the employee, such as employer contributions to a qualified annuity under section 403(a), or employer contributions to an accident or health plan excluded under section 106.

(iv) The following rules shall be used to convert wages for pay periods other than weekly pay periods into weekly rates of wage payments to be used in determining ‘‘regular weekly rate of wages’’ as described in subdivision (i) of this subparagraph.

(a) If wages are paid biweekly, the weekly rate of wage payments shall be one-half of the biweekly wages paid.

(b) If the employee is paid semimonthly, the weekly rate of wage payments shall be the semimonthly wages paid multiplied by 24 and divided by 52.

(c) If wages are paid monthly, the weekly rate of wage payments shall be the monthly wages paid multiplied by 12 and divided by 52.

(d) If wages are paid on the basis of a pay period other than a period described in *(a)* through *(c)* of this subdivision, the weekly rate of wage payments shall be determined by ascertaining the annual rate of wage payments and dividing by 52.

(e) For the purpose of this subparagraph, if separate portions of an employee’s wages are paid on the basis of different pay periods, the weekly rate or weekly rates of wage payments of each portion of wages paid with respect to each pay period shall first be determined under the rules set forth in *(a)* through *(d)* of this subdivision and the average weekly rate of each portion of wages, determined in accordance with the rules set forth in subdivision *(i)* of this subparagraph, shall be aggregated to determine the employee’s ‘‘regular weekly rate of wages’’ for purposes of section 105(d).

(v) The provisions of subdivisions (i), (iii) and (iv) of this subparagraph may be illustrated by the following examples:

Example (1). Employee A is a salesman who is paid a basic salary of $60 per week and, in addition, is paid commissions on a weekly basis. A became ill and did not report for work beginning Monday, February 17, 1964. For the four-week period preceding the commencement of the period of absence, A was paid the following:

Week of—	Basic salary	Commissions	Total weekly wages
Jan. 20, 1964	$60	$10	$70
Jan. 27, 1964	60	50	110
Feb. 3, 1964	60	30	90
Feb. 10, 1964	60	40	100
Total 4-week wages			370

A’s wages, under the rules set forth in subdivision (iii) of this subparagraph, consist of basic salary plus commissions. Since the amount of A’s average weekly wages paid for the last four weekly periods falling within the four pay periods immediately preceding the commencement of his period of absence from work is $92.50 ($370÷4), such amount is considered as the ‘‘regular weekly rate of wages’’ (as computed under subdivision (i) of this subparagraph) for purposes of section 105(d).

Example (2). Assume, in example (1), that A normally works five days during each week (Monday through Friday) and that he was also absent from work for any reason from Monday, February 3, 1964, through Wednesday, February 5, 1964. Since A was absent from work for three normal working days during the pay period of February 3, 1964, and was paid a lesser amount of wages for such pay period than in the immediately preceding pay period during which he was not absent from work (week of January 27), the weekly pay period beginning January 27, 1964 is substituted for the weekly pay period beginning February 3, 1964 in the determination of ‘‘regular weekly rate of wages’’ (as computed under subdivision (i) of this subparagraph) for purposes of section 105(d). The ‘‘regular weekly rate of wages’’ is calculated to be $97.50, as follows:

Week of		Total wages
February 10	$100	
January 27 (substitute for week of Feb. 3)	110	
January 27	110	
January 20	70	

390÷4=$97.50

Example (3). Employee B is a salesman who is paid a basic salary of $75 and, in addition, is paid commissions for semi-monthly periods ending on the 15th day and the last day of each month. He was absent from work on account of a personal injury beginning Monday, February 17, 1964. He was paid the following amounts:

Pay period	Salary	Commissions	Total wages
Feb. 1–15, 1964	$75	$60	$135
Jan. 16–31, 1964	75	50	125

The four weekly periods falling within full pay periods preceding the commencement of the period of absence are the weeks beginning February 9, February 2, January 26, and January 19. B's wages are converted to weekly rates of wage payments per pay period in accordance with the rule set forth in subdivision (iv)*(b)* of this subparagraph as follows:

From February 1, 1964—February 15, 1964, inclusive:

$$\$135 \times 24 = \$3240.00 \text{ (annual rate)}$$

$$\frac{\$3240.00}{52} = \$62.31 \text{ (weekly rate)}$$

From January 16–31, inclusive:

$$\$125 \times 24 = \$3000.00 \text{ (annual rate)}$$

$$\frac{\$3000.00}{52} = \$57.69 \text{ (weekly rate)}$$

$125×24=$3000.00 (annual rate)

$3000.00 / 52E =$57.69 (weekly rate)

The weekly rates are then used in determining the wages for four weekly periods falling within the pay periods immediately preceding the commencement of B's absence. B's "regular weekly rate of wages" (as computed under subdivision (i) of this subparagraph) is calculated to be $60.17, as follows:

Feb. 9–15, inclusive	$62.31
February 2–8, inclusive	62.31
January 26–February 1, inclusive (6⁄7×$57.69+1⁄7×$62.31)	58.35
January 19–25, inclusive	57.69

240.66÷4=$60.17

Example (4). Employee C is paid semimonthly on the 5th and 20th of each month and he began working for his present employer at the beginning of the semi-monthly pay period commencing Tuesday, January 21, 1964. C received total wages of $200 for the pay period of January 21, 1964 through February 5, 1964, inclusive. He was not absent during that pay period. C became sick and was absent from work beginning February 7, 1964. Since employee C does not have four weekly periods falling within a full pay period or full pay periods preceding his absence, the average wages for the last two weekly periods falling within such full pay period will be C's "regular weekly rate of wages" (as computed under subdivision (i) of this subparagraph) for purposes of section 105(d), determined to be $92.31, as follows:

$200×24=$4800 (annual rate)
$4800÷52=$92.31 (weekly rate)

Example (5).

Example (5). Employee D, an office worker, is paid weekly and is expected to work five days during each week. He has been employed by his present employer for three weeks, but has been absent from work for three normal work days in each of the weeks preceding his illness. He became ill and was absent from work on Monday, February 17, 1964. During the weekly pay period immediately preceding his absence (week of February 10) D was paid $48 salary. He was paid for two working days during such weekly pay period. D's "regular weekly rate of wages" (as computed under subdivision (i) of this subparagraph), is calculated to be $120.00, determined as follows:

$$\frac{\$48 \text{ (total wages)} \times 5 \text{ (normal work days in week)}}{2 \text{ (number of work days for which wages were paid)}} = \$120.00$$

Example (6). Employee E is an hourly worker who is paid a salary of $1.25 per hour. E is paid basic salary on a bi-weekly basis for the periods beginning every other Thursday and ending every other Wednesday. E is also paid monthly for his overtime work and is compensated for such work at one and one-half times the hourly rate. E worked 16 hours of overtime for his employer during the month of January. E was injured and could not report for work on Friday, February 21, 1964. E returned to work on Monday, March 16, 1964. E was paid as follows for the pay periods indicated:

Pay period	Hours		Salary per hour		Total salary
	Regular	Overtime	Regular	Overtime	
Month of January 1964		16		$1.875	$30
Jan. 23–Feb. 5, 1964, inclusive	80		$1.25		100

Pay period	Hours		Salary per hour		Total salary
	Regular	Overtime	Regular	Overtime	
Feb. 6–19, 1964, inclusive	80	....	1.25	....	100

Under the rule set forth in subdivision (iv)*(e)* of this subparagraph, the weekly rates of payment of salary and overtime must be determined separately. Since basic salary is paid biweekly, the weekly rate of payment is determined to be one-half of $100.00, or $50.00. The full pay period immediately preceding the commencement of E's absence for overtime compensation ended on January 31, 1964. E's overtime earnings are converted to a weekly rate for such period, as follows:

$30.00 (overtime pay)×12=$360.00
(annual rate)
$360.00÷52=$6.93 (weekly rate)

The average wages for the last four weekly periods falling within pay periods immediately preceding the commencement of E's absence with respect to basic salary (weeks of February 13, 6, January 30, and 23) is $50.00. The average wages for the last four weekly periods falling within the pay period immediately preceding the commencement of E's absence with respect to overtime compensation (weeks of January 25, 18, 11, and 4) is $6.93. Accordingly, E's ''regular weekly rate of wages'' (as computed under subdivision (i) of this subparagraph) for the purpose of section 105(d) is $56.93.

(6)(i) Amounts paid under a wage continuation plan must be converted to a weekly rate in order to determine the percentage of benefits paid in relation to the employee's ''regular weekly rate of wages'', since such percentage is used in determining the waiting period, if any, after which an exclusion is allowable under section 105(d). In order to calculate the weekly rate at which benefits are being paid, reference is made to the particular wage continuation plan. If, in the usual operation of the plan, benefits are paid for the same periods as regular wages, then the pay period of such benefits shall be the period for which a payment of wages is ordinarily made to the employee by the employer. If plan benefits are ordinarily paid for different periods than regular wages, then the pay period of such benefits shall be the period for which payment of such benefits is ordinarily made.

(ii) The weekly rate at which the benefits are paid under a wage continuation plan shall be determined in accordance with the following rules:

(a) If benefits are paid on the basis of a weekly pay period, the weekly rate at which such benefits are paid shall be the weekly amount of such benefits.

(b) If benefits are paid on the basis of a biweekly pay period, the weekly rate at which such benefits are paid shall be one-half of the biweekly rate.

(c) If benefits are paid on the basis of a semimonthly pay period, the weekly rate at which such benefits are paid shall be the semimonthly rate multiplied by 24 and divided by 52.

(d) If benefits are paid on the basis of a monthly pay period, the weekly rate at which such benefits are paid shall be the monthly rate multiplied by 12 and divided by 52.

(e) If benefits are paid on the basis of a period other than a period described in *(a)* through *(d)* of this subdivision the weekly rate at which such benefits are paid shall be determined by ascertaining the annual rate at which such benefits are paid and dividing such annual rate by 52.

(iii) The principles of subdivisions (i) and (ii) of this subparagraph may be illustrated by the following example:

Example. A's employer maintains a noncontributory plan which provides for a monthly benefit of $400 during periods of absence from work due to personal injury or sickness. A, a salesman, receives regular salary of $520 per calendar month plus commissions, depending upon the amount of sales made by A during the month. During the month of January 1964, A was paid commissions of $180. A received a total benefit of $200 for an absence of two weeks because of illness occurring in February 1964. He was not hospitalized. Since benefits under the salary continuation plan are paid for the same period as regular wages, the pay period of the plan is monthly. A's ''regular weekly rate of wages'', determined in accordance with the rules set forth in subparagraph (5)(i) of this paragraph is $161.54. ($700×12)÷52.

For purposes of determining the percentage of benefits paid in relation to A's ''regular weekly rate of wages'', the weekly rate of the benefits are calculated to be $92.31, as follows:

$400 (monthly rate)×12=$4,800 (annual rate)
$4,800÷52=$92.31 (weekly rate)

Since $92.31 does not exceed 75 percent of A's ''regular weekly rate of wages'', A is entitled to an exclusion under section 105(d) for the second week of absence, subject to the other limitations provided in this section.

(iv) For the purpose of determining whether or not the rate of benefits paid under a wage continuation plan for a period of absence exceeds 75 percent of the employee's ''regular weekly rate of wages'' (as determined under subparagraph (5) of this paragraph), it is necessary to ascertain the average percentage of benefits paid in relation to the employee's ''regular weekly rate of wages'' for the first 30 calendar days in the period of absence. Such percentage is derived from a fraction, the numerator of which is the sum of benefits paid (attributable to employer contributions) for the period of absence occurring within the first 30 calendar days, and the denominator of which is the collective sum of the employee's ''regular weekly rate of wages'' during such period. This rule may be illustrated by the following examples:

Example (1). Employee A is paid a semimonthly basic salary of $150 plus commissions. He normally works five days during each week (Monday through Friday). During the month of January 1964, A received wages of $150 plus commissions of $66.67 for each of the semimonthly pay periods. A became ill on Monday, February 3, 1964, and as a result was absent from work until Monday, February 17, 1964, but was not hospitalized. Under the noncontributory wage continuation plan of A's employer, A received no benefits for the first three working days' absence (Monday through Wednesday) and was paid benefits at the rate of $100 a week thereafter. A's ''regular weekly rate of wages,'' determined under the rules set forth in subparagraph (5) of this paragraph, is $100. A is considered to have received average benefits at a rate of 70 percent of his ''regular weekly rate of wages'', computed as follows:

(1)	(2)	(3)
Week of absence	Benefits paid	Regular weekly rate of wages
1–Feb. 3	$40	$100
2–Feb. 10	100	100
Total	140	200

Average percentage of benefits paid— 140/200 =70%. Accordingly, A may exclude amounts attributable to the second week of absence, subject to the other limitations of section 105(d).

Example (2). Assume, in example (1), that A did not return to work until Thursday, February 20, 1964. A is considered to have received average benefits at the rate of 76.92 percent of his ''regular weekly rate of wages'', computed as follows:

(1)	(2)	(3)
Week of absence	Benefits paid	Regular weekly rate of wages
1–Feb. 3	$40	$100
2–Feb. 10	100	100
2⅗—Feb. 17	[1] 60	[1] 60
Total	200	260

[1] Three-fifths of 100.

Average percentage of benefits paid— 200/260=76.92%. Accordingly, A would not be permitted any exclusion under section 105(d).

(v) If with respect to any pay period or portion thereof the employee receives amounts under two or more wage continuation plans (whether such plans are maintained by or for the same employers or by different employers), the weekly rate for purposes of section 105(d) shall be the sum of the weekly rates received under all plans. This rule may be illustrated by the following example:

Example. An employee who is absent because of personal injuries or sickness receives $100 biweekly under wage continuation plan A maintained by his employer. He contributes one-half of the premiums for maintenance of the plan. Under wage continuation plan B maintained by his employer the employee receives $400 monthly. Plan B is noncontributory. The weekly rate at which benefits are paid for the purpose of section 105(d) is computed as follows:

Plan A—	$\frac{\$100}{2}$	=$50.00	(weekly rate)
		25.00	(less amount attributable to employee con- tributions (½))
		25.00	(weekly rate of Plan A)
Plan B—	$\frac{\$400\times12}{52}$	=92.31	(weekly rate of Plan B)
		$117.31	(combined weekly rate at which benefits are paid)

The $25 attributable to contributions made by the employee under Plan A would be subject to section 104(a)(3).

(f) *Amount of exclusion for periods of absence commencing after December 31, 1963*—(1) *In general.* Amounts received under a wage continuation plan attributable to periods of absence commencing after December 31, 1963, and which are not excludable from gross income as being attributable to contributions of the employee (see §1.105–1) are excludable from gross income of the employee to the extent that such amounts do not exceed—

(i) A weekly rate of $75, during the first 30 calendar days in the period of absence; and

(ii) A weekly rate of $100, after the first 30 calendar days in the period of absence.

For example, an employee who normally works five days during each week is absent from work for two days, is hospitalized during his absence, and receives $75 under his employer's wage continuation plan, which amount is at a rate of 75 percent of his ''regular weekly rate of wages''. The employee cannot exclude the entire $75 under section 105(d), if the weekly rate of such benefits exceeds $75.

(2) *Daily exclusion.* An employee receiving payments under a wage continuation plan must, in order to determine the amount of the exclusion under section 105(d), compute the daily rate of the benefits. Such daily rate is determined, for amounts attributable to the first 30 calendar days in the period of absence, by dividing the weekly rate at which benefits are paid (as determined under paragraph (e)(6)(ii) of this section), or the maximum weekly rate at which wage continuation payments are excludable ($75), whichever is lower, by the number of work days in a normal work week. In the case of amounts attributable to days in a period of absence after the first 30 calendar days, the daily rate for such period is determined by dividing the weekly rate at which benefits are paid (as determined under paragraph (e)(6)(ii) of this section), or the maximum weekly rate at which wage continuation payments are excludable ($100), whichever is lower, by the number of work days in a normal work week. The daily rate or daily rates of exclusion are then multiplied by the number of normal work days in the period of absence for which an exclusion is allowable in order to determine the total allowable exclusion. These rules may be illustrated by the following examples:

Example (1). Employee A is a salesman receiving salary and commissions on a weekly basis. His employer maintains a noncontributory wage continuation plan which provides for the continuation of A's basic salary of $80 per week during periods of absence. A was absent from work on account of sickness from Monday, February 3, 1964, through Sunday, March 15, 1964, but was not hospitalized. His normal work week is from Monday through Friday. The weekly amount of benefits paid to A ($80) does not exceed 75 percent of his ''regular weekly rate of wages'' as defined in paragraph (e)(5) of this section. Under section 105(d), the daily rate of exclusion for amounts attributable to the first 30 calendar days in the period of absence, excluding the first 7 days thereof (Monday, February 10, 1964, through Tuesday, March 3, 1964, inclusive) is limited to $15 ($75, maximum weekly rate of exclusion divided by 5 (number of normal work days in week)). The daily rate of exclusion for amounts attributable to the period of absence in excess of 30 calendar days (Wednesday, March 4, 1964, through Sunday, March 15, 1964, inclusive) is limited to $16 ($80, weekly rate of benefits divided by 5). Thus, the total exclusion permitted to employee A by section 105(d) is $383.00 ($15 × 17 work days ($255) + $16 × 8 work days ($128)).

Example (2). Assume the facts in example (1) except that A is paid benefits at the rate of $500 a month during periods of absence. The weekly rate of the benefits computed under the rules stated in paragraph (e)(6)(ii) of this section is $115.38, which amount does not exceed 75 percent of his ''regular weekly rate of wages'' as defined in paragraph (e)(5) of this section. Under section 105(d), the daily rate of exclusion for amounts attributable to the first 30 calendar days in the period of absence, excluding the first 7 days thereof (Monday, February 10, 1964, through Tuesday, March 3, 1964, inclusive) is limited to $15 ($75, maximum weekly rate of exclusion divided by 5). The daily rate of exclusion for amounts attributable to the period of absence in excess of 30 calendar days (Wednesday, March 4, 1964, through Sunday, March 15, 1964, inclusive) is limited to $20 ($100, maximum weekly rate of exclusion divided by 5). Thus, the total exclusion permitted to employee A by section 105(d) is $415.00 ($15 × 17 work days ($255) + $20 × 8 work days ($160)).

Example (3). Employee B, an office worker works five days during each week (Monday through Friday) and receives a salary of $85 per week. His employer maintains a noncontributory wage continuation plan which provides for no benefits during the first three days of absence, the continuation of full salary for one week thereafter and benefits at the rate of $65 per week thereafter. B was absent from work on account of sickness from Monday, March 16, 1964, through Tuesday, March 31, 1964, and was hospitalized from Wednesday, March 18, through Tuesday, March 24. B received total benefits of $137 for the period of absence, which does not exceed 75 percent of his ''regular weekly rate of wages'' as determined under paragraph (e)(5) of this section. B is permitted an exclusion under section 105(d) of $127 calculated as follows:

Period of absence	Weekly rate of benefits	Maximum weekly rate of exclusion	Daily rate of exclusion	Days of absence in period	Maximum exclusion
Mar. 16–18	0	$75	0	3	0
Mar. 19–25	$85	75	$15	5	$75
Mar. 26–31	65	75	13	4	52
Total exclusion					$127

(g) *Definitions.* The term ''personal injury'' as used in this section, means an externally caused sudden hurt or damage to the body brought about by an identifiable event. The term ''sickness'' as used in this section, means mental illnesses and all bodily infirmities and disorders other than ''personal injuries''. Diseases, whether resulting from the occupation or otherwise, are not considered personal injuries, but they are treated as a sickness.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6770, 29 FR 15366, Nov. 17, 1964; T.D. 7352, 40 FR 16666, Apr. 14, 1975]

§ 1.105–5 Accident and health plans.

(a) *In general.* Sections 104(a)(3) and 105 (b), (c), and (d) exclude from gross income certain amounts received through accident or health insurance. Section 105(e) provides that for purposes of sections 104 and 105 amounts received through an accident or health plan for employees, and amounts received from a sickness and disability fund for employees maintained under the law of a State, a Territory, or the District of Columbia, shall be treated as amounts received through accident or health insurance. In general, an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness. A plan may cover one or more employees, and there may be different plans for different employees or classes of employees. An accident or health plan may be either insured or noninsured, and it is not necessary that the plan be in writing or that the employee's rights to benefits under the plan be enforceable. However, if the employee's rights are not enforceable, an amount will be deemed to be received under a plan only if, on the date the employee became sick or injured, the employee was covered by a plan (or a program, policy, or custom having the effect of a plan) providing for the payment of amounts to the employee in the event of personal injuries or sickness, and notice or knowledge of such plan was reasonably available to the employee. It is immaterial who makes payment of the benefits provided by the plan. For example, payment may be made by the employer, a welfare fund, a State sickness or disability benefits fund, an association of employers or employees, or by an insurance company.

(b) *Self-employed individuals.* Under section 105(g), a self-employed individual is not treated as an employee for purposes of section 105. Therefore, for example, benefits paid under an accident or health plan as referred to in section 105(e) to or on behalf of an individual who is self-employed in the business with respect to which the plan is established will not be treated as received through accident and health insurance for purposes of sections 104(a)(3) and 105.

[T.D. 6722, 29 FR 5071, Apr. 14, 1964]

§1.105–6 Special rules for employees retired before January 27, 1975.

(a) *Application of section 105(d) to amounts received as retirement annuities.* An employee who retired from work before January 27, 1975, receiving payments under his employer-established plan (to which §1.72–15(a) applies) which payments were not treated as amounts received under a wage continuation plan for purposes of section 105(d), may, as of the date the employee retired, treat such plan as such a wage continuation plan to the extent such payments are received prior to mandatory retirement age (as described in §1.105–4(a)(3)(i)(B)), if—

(1) His employer had in operation at the time of his retirement a program providing accident and health benefits under a wage continuation plan to which section 105(d) would apply;

(2) The employer certifies, under procedures approved in advance under paragraph (c) of this section, that the employee would have been eligible for wage continuation benefits, under the terms and conditions of his employer's plan, because of personal injuries or sickness;

(3) At the time of the employee's retirement there was no substantive difference between the benefits being actually received and the benefits he would have received had he retired under his employer's wage continuation plan; and

(4) The employee agrees to the adjustments and conditions required by the Commissioner with respect to amounts excluded under section 72 (b) or (d) in taxable years ending before January 27, 1975.

(b) *Filing requirements.* (1) The certification required in paragraph (a)(2) and the agreement required in paragraph (a)(4) of this section shall be filed on or before April 15, 1977, with the return, or timely amended return or claim, made for the taxable year in which the employee reached retirement age as described in §1.79–2(b)(3), or, for the first taxable year for which the taxpayer files an income tax return claiming an exclusion under section 105(d), as provided in paragraph (a) of this section.

(2) The Commissioner may prescribe a form and instructions with respect to the agreement provided for in paragraph (a)(4) of this section.

(c) *Employer certification*—(1) *Advance approval of procedures.* Any reasonable and consistently applied procedures, approved in advance by the Internal Revenue Service, which require the employee to provide the employer or the insurer with medical documentation sufficient to show that an illness or disability existed as of the date of the employee's retirement, which would have entitled him to retire on account of personal injuries or sickness alone, are sufficient for purposes of this paragraph.

(2) *Place of submission.* Request for advance approval of procedures for certification shall be submitted to the district director.

(d) *Cross reference.* For special rules pertaining to taxpayers retired on disability before January 27, 1975, see §1.72–15(i).

[T.D. 7352, 40 FR 16666, Apr. 14, 1975]

§1.105–11 Self-insured medical reimbursement plan.

(a) *In general.* Under section 105(a), amounts received by an employee through a self-insured medical reimbursement plan which are attributable to contributions of the employer, or are paid by the employer, are included in the employee's gross income unless such amounts are excludable under section 105(b). For amounts reimbursed to a highly compensated individual to be fully excludable from such individual's gross income under section 105(b), the plan must satisfy the requirements of section 105(h) and this section. Section

105(h) is not satisfied if the plan discriminates in favor of highly compensated individuals as to eligibility to participate or benefits. All or a portion of the reimbursements or payments on behalf of such individuals under a discriminatory plan are not excludable from gross income under section 105(b). However, benefits paid to participants who are not highly compensated individuals may be excluded from gross income if the requirements of section 105(b) are satisfied, even if the plan is discriminatory.

(b) *Self-insured medical reimbursement plan*—(1) *General rule*—(i) *Definition.* A self-insured medical reimbursement plan is a separate written plan for the benefit of employees which provides for reimbursement of employee medical expenses referred to in section 105(b). A plan or arrangement is self-insured unless reimbursement is provided under an individual or group policy of accident or health insurance issued by a licensed insurance company or under an arrangement in the nature of a prepaid health care plan that is regulated under federal or state law in a manner similar to the regulation of insurance companies. Thus, for example, a plan of a health maintenance organization, established under the Health Maintenance Organization Act of 1973, would qualify as a prepaid health care plan. In addition, this section applies to a self-insured medical reimbursement plan, determined in accordance with the rules of this section, maintained by an employee organization described in section 501(c)(9).

(ii) *Shifting of risk.* A plan underwritten by a policy of insurance or a prepaid health care plan that does not involve the shifting of risk to an unrelated third party is considered self-insured for purposes of this section. Accordingly, a cost-plus policy or a policy which in effect merely provides administrative or bookkeeping services is considered self-insured for purposes of this section. However, a plan is not considered self-insured merely because one factor the insurer uses in determining the premium is the employer's prior claims experience.

(iii) *Captive insurance company.* A plan underwritten by a policy of insurance issued by a captive insurance company is not considered self-insured for purposes of this section if for the plan year the premiums paid by companies unrelated to the captive insurance company equal or exceed 50 percent of the total premiums received and the policy of insurance is similar to policies sold to such unrelated companies.

(2) *Other rules.* The rules of this section apply to a self-insured portion of an employer's medical plan or arrangement even if the plan is in part underwritten by insurance. For example, if an employer's medical plan reimburses employees for benefits not covered under the insured portion of an overall plan, or for deductible amounts under the insured portions, such reimbursement is subject to the rules of this section. However, a plan which reimburses employees for premiums paid under an insured plan is not subject to this section. In addition, medical expense reimbursements not described in the plan are not paid pursuant to a plan for the benefit of employees, and therefore are not excludable from gross income under section 105(b). Such reimbursements will not affect the determination of whether or not a plan is discriminatory.

(c) *Prohibited discrimination*—(1) *In general.* A self-insured medical reimbursement plan does not satisfy the requirements of section 105(h) and this paragraph for a plan year unless the plan satisfies subparagraphs (2) and (3) of this paragraph. However, a plan does not fail to satisfy the requirements of this paragraph merely because benefits under the plan are offset by benefits paid under a self-insured or insured plan of the employer or another employer, or by benefits paid under Medicare or other Federal or State law or similar foreign law. A self-insured plan may take into account the benefits provided under another plan only to the extent that the type of benefit subject to reimbursement is the same under both plans. For example, an amount reimbursed to an employee for a hospital expense under a medical plan maintained by the employer of the employee's spouse may be offset against the self-insured benefit where the self-insured plan covering the employee provides the same type of hospital benefit.

(2) *Eligibility to participate*—(i) *Percentage test.* A plan satisfies the requirements of this subparagraph if it benefits—

(A) Seventy percent or more of all employees, or

(B) Eighty percent or more of all the employees who are eligible to benefit under the plan if 70 percent or more of all employees are eligible to benefit under the plan.

(ii) *Classification test.* A plan satisfies the requirements of this subparagraph if it benefits such employees as qualify under a classification of employees set up by the employer which is found by the Internal Revenue Service not to be discriminatory in favor of highly compensated individuals. In general, this determination will be made based upon the facts and circumstances of each case, applying the same standards as are applied under section 410(b)(1)(B) (relating to qualified pension, profit-sharing and stock bonus plans), without regard to the special rules in section 401(a)(5) concerning eligibility to participate.

(iii) *Exclusion of certain employees.* Under section 105(h)(3), for purposes of this subparagraph (2), there may be excluded from consideration:

(A) Employees who have not completed 3 years of service prior to the beginning of the plan year. For purposes of this section years of service may be determined by any method that is reasonable and consistent. A determination made in the same manner as (and not requiring service in excess of how) a year of service is determined under section 410(a)(3) shall be deemed to be reasonable. For purposes of the 3-year rule, all of an employee's years of service with the employer prior to a separation from service are not taken into account. For purposes of the 3-year rule, an employee's years of service prior to age 25, as a part-time or seasonal employee, as a member of a collective bargaining unit, or as a nonresident alien, as each is described in this subdivision, are not excluded by reason of being so described from counting towards satisfaction of the rule. In addition, if the employer is a predecessor employer (determined in a manner consistent with section 414(a)), service for such predecessor is treated as service for the employer.

(B) Employees who have not attained age 25 prior to the beginning of the plan year.

(C) Part-time employees whose customary weekly employment is less than 35 hours, if other employees in similar work with the same employer (or, if no employees of the employer are in similar work, in similar work in the same industry and location) have substantially more hours, and seasonal employees whose customary annual employment is less than 9 months, if other employees in similar work with the same employer (or, if no employees of the employer are in similar work, in similar work in the same industry and location) have substantially more months. Notwithstanding the preceding sentence, any employee whose customary weekly employment is less than 25 hours or any employee whose customary annual employment is less than 7 months may be considered as a part-time or seasonal employee.

(D) Employees who are included in a unit of employees covered by an agreement between employee representatives and one or more employers which the Commissioner finds to be a collective bargaining agreement, if accident and health benefits were the subject of good faith bargaining between such employee representatives and such employer or employers. For purposes of determining whether such bargaining occurred, it is not material that such employees are not covered by another medical plan or that the plan was not considered in such bargaining.

(E) Employees who are nonresident aliens and who receive no earned income (within the meaning of section 911(b) and the regulations thereunder) from the employer which constitutes income from sources within the United States (within the meaning of section 861(a)(3) and the regulations thereunder).

(3) *Nondiscriminatory benefits*—(i) *In general.* In general, benefits subject to reimbursement under a plan must not discriminate in favor of highly compensated individuals. Plan benefits will not satisfy the requirements of this subparagraph unless all the benefits

provided for participants who are highly compensated individuals are provided for all other participants. In addition, all the benefits available for the dependents of employees who are highly compensated individuals must also be available on the same basis for the dependents of all other employees who are participants. A plan that provides optional benefits to participants will be treated as providing a single benefit with respect to the benefits covered by the option provided that (A) all eligible participants may elect any of the benefits covered by the option and (B) there are either no required employee contributions or the required employee contributions are the same amount. This test is applied to the benefits subject to reimbursement under the plan rather than the actual benefit payments or claims under the plan. The presence or absence of such discrimination will be determined by considering the type of benefit subject to reimbursement provided highly compensated individuals, as well as the amount of the benefit subject to reimbursement. A plan may establish a maximum limit for the amount of reimbursement which may be paid a participant for any single benefit, or combination of benefits. However, any maximum limit attributable to employer contributions must be uniform for all participants and for all dependents of employees who are participants and may not be modified by reason of a participant's age or years of service. In addition, if a plan covers employees who are highly compensated individuals, and the type or the amount of benefits subject to reimbursement under the plan are in proportion to employee compensation, the plan discriminates as to benefits.

(ii) *Discriminatory operation.* Not only must a plan not discriminate on its face in providing benefits in favor of highly compensated individuals, the plan also must not discriminate in favor of such employees in actual operation. The determination of whether plan benefits discriminate in operation in favor of highly compensated individuals is made on the basis of the facts and circumstances of each case. A plan is not considered discriminatory merely because highly compensated individuals participating in the plan utilize a broad range of plan benefits to a greater extent than do other employees participating in the plan. In addition, if a plan (or a particular benefit provided by a plan) is terminated, the termination would cause the plan benefits to be discriminatory if the duration of the plan (or benefit) has the effect of discriminating in favor of highly compensated individuals. Accordingly, the prohibited discrimination may occur where the duration of a particular benefit coincides with the period during which a highly compensated individual utilizes the benefit.

(iii) *Retired employees.* To the extent that an employer provides benefits under a self-insured medical reimbursement plan to a retired employee that would otherwise be excludible from gross income under section 105(b), determined without regard to section 105(h), such benefits shall not be considered a discriminatory benefit under this paragraph (c). The preceding sentence shall not apply to a retired employee who was a highly compensated individual unless the type, and the dollar limitations, of benefits provided retired employees who were highly compensated individuals are the same for all other retired participants. If this subdivision applies to a retired participant, that individual is not considered an employee for purposes of determining the highest paid 25 percent of all employees under paragraph (d) of this section solely by reason of receiving such plan benefits.

(4) *Multiple plans, etc.*—(i) *General rule.* An employer may designate two or more plans as constituting a single plan that is intended to satisfy the requirements of section 105(h)(2) and paragraph (c) of this section, in which case all plans so designated shall be considered as a single plan in determining whether the requirements of such section are satisfied by each of the separate plans. A determination that the combination of plans so designated does not satisfy such requirements does not preclude a determination that one or more of such plans, considered separately, satisfies such requirements. A single plan document may be utilized by an employer for two or more separate plans provided that

the employer designates the plans that are to be considered separately and the applicable provisions of each separate plan.

(ii) *Other rules.* If the designated combined plan discriminates as to eligibility to participate or benefits, the amount of excess reimbursement will be determined under the rules of section 105(h)(7) and paragraph (e) of this section by taking into account all reimbursements made under the combined plan.

(iii) *H.M.O. participants.* For purposes of section 105(h)(2)(A) and paragraph (c)(2) of this section, a self-insured plan will be deemed to benefit an employee who has enrolled in a health maintenance organization (HMO) that is offered on an optional basis by the employer in lieu of coverage under the self-insured plan if, with respect to that employee, the employer's contributions to the HMO plan equal or exceed those that would be made to the self-insured plan, and if the HMO plan is designated in accordance with subdivision (i) with the self-insured plan as a single plan. For purposes of section 105(h) and this section, except as provided in the preceding sentence, employees covered by, and benefits under, the HMO plan are not treated as part of the self-insured plan.

(d) *Highly compensated individuals defined.* For purposes of section 105(h) and this section, the term ''highly compensated individual'' means an individual who is—

(1) One of the 5 highest paid officers,

(2) A shareholder who owns (with the application of section 318) more than 10 percent in value of the stock of the employer, or

(3) Among the highest paid 25 percent of all employees (including the 5 highest paid officers, but not including employees excludable under paragraph (c)(2)(iii) of this section who are not participants in any self-insured medical reimbursement plan of the employer, whether or not designated as a single plan under paragraph (c)(4) of this section, or in a health maintenance organization plan).

The status of an employee as an officer or stockholder is determined with respect to a particular benefit on the basis of the employee's officer status or stock ownership at the time during the plan year at which the benefit is provided. In calculating the highest paid 25 percent of all employees, the number of employees included will be rounded to the next highest number. For example, if there are 5 employees, the top two are in the highest paid 25 percent. The level of an employee's compensation is determined on the basis of the employee's compensation for the plan year. For purposes of the preceding sentence, fiscal year plans may determine employee compensation on the basis of the calendar year ending within the plan year.

(e) *Excess reimbursement of highly compensated individual*—(1) *In general.* For purposes of section 105(h) and this section, a reimbursement paid to a highly compensated individual is an excess reimbursement if it is paid pursuant to a plan that fails to satisfy the requirements of paragraph (c)(2) or (c)(3) for the plan year. The amount reimbursed to a highly compensated individual which constitutes an excess reimbursement is not excludable from such individual's gross income under section 105(b).

(2) *Discriminatory benefit.* In the case of a benefit available to highly compensated individuals but not to all other participants (or which otherwise discriminates in favor of highly compensated individuals as opposed to other participants), the amount of excess reimbursement equals the total amount reimbursed to the highly compensated individual with respect to the benefit.

(3) *Discriminatory coverage.* In the case of benefits (other than discriminatory benefits described in subparagraph (2)) paid to a highly compensated individual under a plan which fails to satisfy the requirements of paragraph (c)(2) relating to nondiscrimination in eligibility to participate, the amount of excess reimbursement is determined by multiplying the total amount reimbursed to the individual by a fraction. The numerator of the fraction is the total amount reimbursed during that plan year to all highly compensated individuals. The denominator of the fraction is the total amount reimbursed during that plan year to all participants. In computing the fraction and

the total amount reimbursed to the individual, discriminatory benefits described in subparagraph (2) are not taken into account. Accordingly, any amount which is included in income by reason of the benefit's not being available to all other participants will not be taken into account.

(4) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). Corporation M maintains a self-insured medical reimbursement plan which covers all employees. The plan provides the following maximum limits on the amount of benefits subject to reimbursement: $5,000 for officers and $1,000 for all other participants. During a plan year Employee A, one of the 5 highest paid officers, received reimbursements in the amount of $4,000. Because the amount of benefits provided for highly compensated individuals is not provided for all other participants, the plan benefits are discriminatory. Accordingly, Employee A received an excess reimbursement of $3,000 ($4,000 − $1,000) which constitutes a benefit available to highly compensated individuals, but not to all other participants.

Example (2). Corporation N maintains a self-insured medical reimbursement plan which covers all employees. The plan provides a broad range of medical benefits subject to reimbursement for all participants. However, only the 5 highest paid officers are entitled to dental benefits. During the plan year Employee B, one of the 5 highest paid officers, received dental payments under the plan in the amount of $300. Because dental benefits are provided for highly compensated individuals, and not for all other participants, the plan discriminates as to benefits. Accordingly, Employee B received an excess reimbursement in the amount of $300.

Example (3). Corporation O maintains a self-insured medical reimbursement plan which discriminates as to eligibility by covering only the highest paid 40% of all employees. Benefits subject to reimbursement under the plan are the same for all participants. During a plan year Employee C, a highly compensated individual, received benefits in the amount of $1,000. The amount of excess reimbursement paid Employee C during the plan year will be calculated by multiplying the $1,000 by a fraction determined under subparagraph (3).

Example (*4*). Corporation P maintains a self-insured medical reimbursement plan for its employees. Benefits subject to reimbursement under the plan are the same for all plan participants. However, the plan fails the eligibility tests of section 105(h)(3)(A) and thereby discriminates as to eligibility. During the 1980 plan year Employee D, a highly compensated individual, was hospitalized for surgery and incurred medical expenses of $4,500 which were reimbursed to D under the plan. During that plan year the Corporation P medical plan paid $50,000 in benefits under the plan, $30,000 of which constituted benefits paid to highly compensated individuals. The amount of excess reimbursement not excludable by D under section 105(b) is $2,700:

$$\$4500 \times \frac{\$30,000}{\$50,000}$$

Example (*5*). Corporation Q maintains a self-insured medical reimbursement plan for its employees. The plan provides a broad range of medical benefits subject to reimbursement for participants. However, only the five highest paid officers are entitled to dental benefits. In addition, the plan fails the eligibility test of section 105(h)(3)(A) and thereby discriminates as to eligibility. During the calendar 1981 plan year, Employee E, a highly compensated individual, received dental benefits under the plan in the amount of $300, and no other employee received dental benefits. In addition, Employee E was hospitalized for surgery and incurred medical expenses, reimbursement for which was available to all participants, of $4,500 which were reimbursed to E under the plan. Because dental benefits are only provided for highly compensated individuals, Employee E received an excess reimbursement under paragraph (e)(2) above in the amount of $300. For the 1981 plan year, the Corporation Q medical plan paid $50,300 in total benefits under the plan, $30,300 of which constituted benefits paid to highly compensated individuals. In computing the fraction under paragraph (e)(3), discriminatory benefits described in paragraph (e)(2) are not taken into account. Therefore, the amount of excess reimbursement not excludable to Employee E with respect to the $4,500 of medical expenses incurred is $2,700:

$$\$4500 \times \frac{\$30,000}{\$50,000}$$

and the total amount of excess reimbursements includable in E's income for 1981 is $3,000.

Example (*6*). (i) Corporation R maintains a calendar year self-insured medical reimbursement plan which covers all employees. The type of benefits subject to reimbursement under the plan include all medical care expenses as defined in section 213(e). The amount of reimbursement available to any employee for any calendar year is limited to 5 percent of the compensation paid to each employee during the calendar year. The amount of compensation and reimbursement paid to Employees A–F for the calendar year is as follows:

Employee	Compensation	Reimbursable amount paid
A	$100,000	$5,000
B	25,000	1,250
C	15,000	750
D	10,000	500
E	10,000	500
F	8,000	400
		8,400

(ii) Because the amount of benefits subject to reimbursement under the plan is in proportion to employee compensation the plan discriminates as to benefits. In addition, Employees A and B are highly compensated individuals. The amount of excess reimbursement paid Employees A and B during the plan year will be determined under paragraph (e)(2). Because benefits in excess of $400 (Employee F's maximum benefit) are provided for highly compensated individuals and not for all other participants, Employees A and B received, respectively, an excess reimbursement of $4,600 and $850.

(f) *Certain controlled groups.* For purposes of applying the provisions of section 105(h) and this section, all employees who are treated as employed by a single employer under section 414 (b) and (c), and the regulations thereunder (relating to special rules for qualified pension, profit-sharing and stock bonus plans), shall be treated as employed by a single employer.

(g) *Exception for medical diagnostic procedures*—(1) *In general.* For purposes of applying section 105(h) and this section, reimbursements paid under a plan for medical diagnostic procedures for an employee, but not a dependent, are not considered to be a part of a plan described in this section. The medical diagnostic procedures include routine medical examinations, blood tests, and X-rays. Such procedures do not include expenses incurred for the treatment, cure or testing of a known illness or disability, or treatment or testing for a physical injury, complaint or specific symptom of a bodily malfunction. For example, a routine dental examination with X-rays is a medical diagnostic procedure, but X-rays and treatment for a specific complaint are not. In addition, such procedures do not include any activity undertaken for exercise, fitness, nutrition, recreation, or the general improvement of health unless they are for medical care as defined in section 213(e). The diagnostic procedures must be performed at a facility which provides no services (directly or indirectly) other than medical, and ancillary, services. For purposes of the preceding sentence, physical proximity between a medical facility and nonmedical facilities will not for that reason alone cause the medical facility not to qualify. For example, an employee's annual physical examination conducted at the employee's personal physician's office is not considered a part of the medical reimbursement plan and therefore is not subject to the nondiscrimination requirements. Accordingly, the amount reimbursed may be excludable from the employee's income if the requirements of section 105(b) are satisfied.

(2) *Transportation, etc. expenses.* Transportation expenses primarily for an allowable diagnostic procedure are included within the exception described in this paragraph, but only to the extent they are ordinary and necessary. Transportation undertaken merely for the general improvement of health, or in connection with a vacation, is not within the scope of this exception, nor are any incidental expenses for food or lodging; therefore, amounts reimbursed for such expenses may be excess reimbursements under paragraph (e).

(h) *Time of inclusion.* Excess reimbursments (determined under paragraph (e)) paid to a highly compensated individual for a plan year will be considered as received in the taxable year of the individual in which (or with which) the plan year ends. The particular plan year to which reimbursements relate shall be determined under the plan provisions. In the absence of plan provisions reimbursements shall be attributed to the plan year in which payment is made. For example, under a calendar year plan an excess reimbursement paid to A in 1981 on account of an expense incurred and subject to reimbursement for the 1980 plan year under the terms of the plan will be considered as received in 1980 by A.

(i) *Self-insured contributory plan.* A medical plan subject to this section may provide for employer and employee contributions. See § 1.105–1(c). The tax treatment of reimbursements attributable to employee contributions is determined under section 104(a)(3). The tax treatment of reimbursements attributable to employer contributions is determined under section 105. The amount of reimbursements which are attributable to contributions of the employer shall be determined in accordance with § 1.105–1(e).

(j) *Effective date.* Section 105(h) and this section are effective for taxable years beginning after December 31, 1979 and for amounts reimbursed after December 31, 1979. In determining plan discrimination and the taxability of excess reimbursements made for a plan year beginning in 1979 and ending in 1980, a plan's eligibility and benefit requirements as well as actual reimbursements made in the plan year during 1979, will not be taken into account. In addition, this section does not apply to expenses which are incurred in 1979 and paid in 1980.

(k) *Special rules*—(1) *Relation to cafeteria plans.* If a self-insured medical reimbursement plan is included in a cafeteria plan as described in section 125, the rules of this section will determine the status of a benefit as a taxable or nontaxable benefit, and the rules of section 125 will determine whether an employee is taxed as though he elected all available taxable benefits (including taxable benefits under a discriminatory medical reimbursement plan). This rule is illustrated by the following example:

Example. Corporation M maintains a cafeteria plan described in section 125. Under the plan an officer of the corporation may elect to receive medical benefits provided by a self-insured medical reimbursement plan which is subject to the rules of this section. However, the self-insured medical reimbursement plan fails the nondiscrimination rules under paragraph (c) of this section. Accordingly, the amount of excess reimbursement is taxable to the officer participating in the medical reimbursement plan pursuant to section 105(h) and this section. Therefore, the self-insured medical reimbursement plan will be considered a taxable benefit under section 125 and the regulations thereunder.

(2) *Benefit subject to reimbursement.* For purposes of this section, a benefit subject to reimbursement is a benefit described in the plan under which a claim for reimbursement or for a payment directly to the health service provider may be filed by a plan participant. It does not refer to actual claims or benefit reimbursements paid under a plan.

[T.D. 7754, 46 FR 3505, Jan. 15, 1981]

§ 1.106–1 Contributions by employer to accident and health plans.

The gross income of an employee does not include contributions which his employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by him, his spouse, or his dependents, as defined in section 152. The employer may contribute to an accident or health plan either by paying the premium (or a portion of the premium) on a policy of accident or health insurance covering one or more of his employees, or by contributing to a separate trust or fund (including a fund referred to in section 105(e)) which provides accident or health benefits directly or through insurance to one or more of his employees. However, if such insurance policy, trust, or fund provides other benefits in addition to accident or health benefits, section 106 applies only to the portion of the employer's contribution which is allocable to accident or health benefits. See paragraph (d) of § 1.104–1 and §§ 1.105–1 through 1.105–5, inclusive, for regulations relating to exclusion from an employee's gross income of amounts received through accident or health insurance and through accident or health plans.

§ 1.107–1 Rental value of parsonages.

(a) In the case of a minister of the gospel, gross income does not include (1) the rental value of a home, including utilities, furnished to him as a part of his compensation, or (2) the rental allowance paid to him as part of his compensation to the extent such allowance is used by him to rent or otherwise provide a home. In order to qualify for the exclusion, the home or rental allowance must be provided as remuneration for services which are ordinarily the duties of a minister of the gospel. In general, the rules provided in § 1.1402(c)–5 will be applicable to such determination. Examples of specific services the performance of which will be considered duties of a minister for purposes of section 107 include the performance of sacerdotal functions, the conduct of religious worship, the administration and maintenance of religious organizations and their integral agencies, and the performance of teaching and administrative duties at theological seminaries. Also, the service performed by a qualified minister as an employee of the United States (other than as a chaplain in the Armed Forces, whose service is considered to be that of a commissioned officer in his capacity as such, and not as a minister in the exercise of his ministry), or a State, Territory, or possession of the United States, or a political subdivision of any of the foregoing, or the District of Columbia, is in the exercise of his ministry provided the service performed includes such services as are ordinarily the duties of a minister.

(b) For purposes of section 107, the term ''home'' means a dwelling place (including furnishings) and the appurtenances thereto, such as a garage. The term ''rental allowance'' means an amount paid to a minister to rent or otherwise provide a home if such amount is designated as rental allowance pursuant to official action taken prior to January 1, 1958, by the employing church or other qualified organization, or if such amount is designated as rental allowance pursuant to official action taken in advance of such payment by the employing church or other qualified organization when paid after December 31, 1957. The designation of an amount as rental allowance may be evidenced in an employment contract, in minutes of or in a resolution by a church or other qualified organization or in its budget, or in any other appropriate instrument evidencing such official action. The designation referred to in this paragraph is a sufficient designation if it permits a payment or a part thereof to be identified as a payment of rental allowance as distinguished from salary or other remuneration.

(c) A rental allowance must be included in the minister's gross income in the taxable year in which it is received, to the extent that such allowance is not used by him during such taxable year to rent or otherwise provide a home. Circumstances under which a rental allowance will be deemed to have been used to rent or provide a home will include cases in which the allowance is expended (1) for rent of a home, (2) for purchase of a home, and (3) for expenses directly related to providing a home. Expenses for food and servants are not considered for this purpose to be directly related to providing a home. Where the minister rents, purchases, or owns a farm or other business property in addition to a home, the portion of the rental allowance expended in connection with the farm or business property shall not be excluded from his gross income.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6691, 28 FR 12817, Dec. 3, 1963]

§1.108–1 Stock-for-debt exception not to apply in de minimis cases.

(a) *Overview.* Section 108(e)(8) provides that the common law stock-for-debt exception does not apply if stock issued for indebtedness is nominal or token or if a proportionality test is not met. Paragraph (b) of this section provides rules for the nominal or token determination under section 108(e)(8)(A). Paragraph (c) of this section provides rules for the proportionality test under section 108(e)(8)(B). Paragraph (d) of this section provides certain general rules and definitions. Paragraph (e) of this section provides an effective date.

(b) *Issuance of nominal or token stock.* Under section 108(e)(8)(A), the common law stock-for-debt exception does not apply to indebtedness discharged for stock that is nominal or token. All relevant facts and circumstances must be considered in making this determination. If common and preferred stock are issued for indebtedness, the determination is made separately with respect to the common stock and the preferred stock. The determination of whether common stock issued for unsecured indebtedness is nominal or token is made on an aggregate basis with respect to all common stock issued for unsecured indebtedness in the title 11 case or insolvency workout. Preferred stock issued for unsecured indebtedness is also tested on an aggregate basis with respect to all preferred stock issued for unsecured indebtedness in the title 11 case or insolvency workout.

(c) *Issuance of a disproportionately small amount of stock for unsecured indebtedness*—(1) *Common stock issued for unsecured indebtedness*—(i) *In general.* The common law stock-for-debt exception does not apply to an unsecured indebtedness discharged for common stock in a title 11 case or insolvency workout if the individual common stock ratio does not equal at least one-half of the group common stock ratio.

(ii) *Individual common stock ratio defined.* The individual common stock ratio is the ratio of the value of the common stock issued for an unsecured indebtedness to the amount of the unsecured indebtedness allocated to that common stock. The amount of unsecured indebtedness allocated to the common stock is the amount of the indebtedness for which the common stock is issued (as defined in paragraph (d)(5) of this section), reduced by the amount of other consideration, if any, transferred in exchange for the indebtedness, including—

(A) The amount of any money;

(B) The issue price (determined under section 1273 or 1274) of any new indebtedness;

(C) With respect to any preferred stock, the amount of indebtedness allocated to the preferred stock under paragraph (c)(2)(ii) of this section; and

(D) The value of any other property, including any disqualified stock.

(iii) *Group common stock ratio defined.* The group common stock ratio is the ratio of the aggregate value of all common stock issued for unsecured indebtedness in the title 11 case or insolvency workout to the aggregate amount of unsecured indebtedness allocated to that common stock. The amount of unsecured indebtedness allocated to the common stock is the aggregate amount of all unsecured indebtedness exchanged for stock or cancelled in the title 11 case or insolvency workout, reduced by the amount of other consideration, if any, issued for that indebtedness, including—

(A) The amount of any money;

(B) The issue price (determined under section 1273 or 1274) of any new indebtedness;

(C) With respect to any preferred stock, the amount of indebtedness allocated to the preferred stock under paragraph (c)(2)(iii) of this section; and

(D) The value of any other property, including any disqualified stock.

(iv) *Example.* The following example illustrates these provisions.

Example. (A) X Corporation has three outstanding debts, Debt 1, Debt 2, and Debt 3. Debts 1 and 2 are unsecured and each has an adjusted issue price of $100,000. Debt 3 is also unsecured, and it has an adjusted issue price of $90,000 and accrued but unpaid interest of $10,000. In a title 11 case, Debt 1 is exchanged for $50,000 cash and $20,000 of common stock, Debt 2 is exchanged for $10,000 cash, and Debt 3 is exchanged for $5,000 common stock. The individual common stock ratio for Debt 1 is 40 percent, which is determined by comparing the value of the common stock issued for the indebtedness ($20,000) to the amount of unsecured indebtedness allocated to that stock ($100,000 adjusted issue price less $50,000 cash received). The individual common stock ratio for Debt 2 is 0 percent because no stock is received in exchange for the indebtedness. The individual common stock ratio for Debt 3 is 5 percent, which is determined by comparing the value of the common stock issued for the indebtedness ($5,000) to the amount of unsecured indebtedness allocated to that stock ($100,000=$90,000 adjusted issue price and $10,000 of accrued but unpaid interest).

(B) The group common stock ratio is 10.4 percent, which is determined by comparing the value of all of the common stock issued for unsecured indebtedness in the title 11 case ($25,000) to the amount of unsecured indebtedness allocated to the stock ($290,000 aggregate adjusted issue price of all indebtedness exchanged for stock or cancelled in the title 11 case plus $10,000 accrued but unpaid interest less $60,000 cash received). Accordingly, section 108(e)(8)(B) is satisfied only with respect to the common stock issued for Debt 1. The stock-for-debt exception does not apply to Debt 2 or Debt 3.

(2) *Preferred stock issued for unsecured indebtedness*—(i) *In general.* The common law stock-for-debt exception does not apply to an unsecured indebtedness discharged for preferred stock in a title 11 case or insolvency workout if the individual preferred stock ratio does not equal at least one-half of the group preferred stock ratio.

(ii) *Individual preferred stock ratio defined.* The individual preferred stock ratio is the ratio of the value of the preferred stock issued for an unsecured indebtedness to the amount of the unsecured indebtedness allocated to the preferred stock. The amount of the unsecured indebtedness allocated to preferred stock is equal to the lesser of the lowest redemption price (if any) or lowest liquidation preference (if any) of the preferred stock (determined at issuance). However, the allocable indebtedness may not be less than the fair market value of the preferred stock or greater than the amount of the unsecured indebtedness.

(iii) *Group preferred stock ratio defined.* The group preferred stock ratio is the ratio of the aggregate value of all preferred stock issued for unsecured indebtedness in the title 11 case or insolvency workout to the aggregate amount of unsecured indebtedness allocated to the preferred stock under paragraph (c)(2)(ii) of this section.

(d) *Definitions and special rules.* For purposes of this section:

(1) *Common stock.* Common stock is all stock other than disqualified stock and preferred stock.

(2) *Disqualified stock.* Disqualified stock is disqualified stock as defined in section 108(e)(10)(B)(ii).

(3) *Liquidation preference.* A liquidation preference exists if the stock's right to share in liquidation proceeds is limited and preferred.

(4) *Preferred stock.* Preferred stock is any stock (other than disqualified stock) that has a limited or fixed redemption price or liquidation preference and does not upon issuance have a right to participate in corporate growth to a meaningful extent. Preferred stock that is convertible into common stock is not treated as preferred stock if the conversion right represents, in substance, a meaningful right to participate in corporate growth. Solely for purposes of this paragraph (d)(4), a right to participate in corporate growth is not established by the fact that the redemption price or liquidation preference exceeds the fair market value of the preferred stock.

(5) *Amount of indebtedness.* Generally, the *amount of indebtedness* is the adjusted issue price of the indebtedness. Appropriate adjustments are made for accrued but unpaid stated interest. (See the example in paragraph (c)(1)(iv) of this section.)

(6) *Undersecured indebtedness*—(i) *General rule.* If an indebtedness is secured by property with a value less than its adjusted issue price, the indebtedness is considered to be two separate debts: a secured indebtedness with an adjusted issue price equal to the value of the property, and an unsecured indebtedness with an adjusted issue price equal to the remainder. Absent strong evidence to the contrary, the value of the property securing the indebtedness is presumed to be equal to the issue price of any new secured indebtedness received for the indebtedness plus the value of any other consideration (except stock or new unsecured indebtedness) received for the indebtedness. A valuation of that property by a court in a title 11 case is a factor in determining value, but is not controlling.

(ii) *Example.* The following example illustrates these provisions:

Example Corporation X owes an indebtedness with an adjusted issue price of $100,000. The indebtedness is secured by certain property owned by Corporation X. Corporation X exchanges the indebtedness for $10,000 of stock and new secured indebtedness with an issue price of $70,000. Under paragraph (d)(6)(i) of this section, the indebtedness is bifurcated into a secured indebtedness of $70,000 (the issue price of the new secured indebtedness received in exchange therefor) and an unsecured indebtedness of $30,000 (the remainder of the adjusted issue price of the indebtedness).

(e) *Effective date.* This section is effective with respect to any issuance of stock for indebtedness on or before December 31, 1994, or any issuance of stock for indebtedness in a title 11 or similar case (as defined in section 368(a)(3)(A) of the Internal Revenue Code) that was filed on or before December 31, 1993—

(1) Pursuant to a plan confirmed by the court in a title 11 case after May 17, 1994; or

(2) If there is no title 11 case, pursuant to an insolvency workout in which all issuances of stock for indebtedness occur after May 17, 1994.

[59 FR 12831, Mar. 18, 1994]

§1.108–2 Acquisition of indebtedness by a person related to the debtor.

(a) *General rules.* The acquisition of outstanding indebtedness by a person related to the debtor from a person who is not related to the debtor results in the realization by the debtor of income from discharge of indebtedness (to the extent required by section 61(a)(12) and section 108) in an amount determined under paragraph (f) of this section. Income realized pursuant to the preceding sentence is excludible from gross income to the extent provided in section 108(a). The rules of this paragraph apply if indebtedness is acquired directly by a person related to the debtor in a direct acquisition (as defined in paragraph (b) of this section) or if a holder of indebtedness becomes related to the debtor in an indirect acquisition (as defined in paragraph (c) of this section).

(b) *Direct acquisition.* An acquisition of outstanding indebtedness is a direct acquisition under this section if a person related to the debtor (or a person who becomes related to the debtor on the date the indebtedness is acquired) acquires the indebtedness from a person who is not related to the debtor. Notwithstanding the foregoing, the Commissioner may provide by Revenue

Procedure or other published guidance that certain acquisitions of indebtedness described in the preceding sentence are not direct acquisitions for purposes of this section.

(c) *Indirect acquisition*—(1) *In general.* An indirect acquisition is a transaction in which a holder of outstanding indebtedness becomes related to the debtor, if the holder acquired the indebtedness in anticipation of becoming related to the debtor.

(2) *Proof of anticipation of relationship.* In determining whether indebtedness was acquired by a holder in anticipation of becoming related to the debtor, all relevant facts and circumstances will be considered. Such facts and circumstances include, but are not limited to, the intent of the parties at the time of the acquisition, the nature of any contacts between the parties (or their respective affiliates) before the acquisition, the period of time for which the holder held the indebtedness, and the significance of the indebtedness in proportion to the total assets of the holder group (as defined in paragraph (c)(5) of this section). For example, if a holder acquired the indebtedness in the ordinary course of its portfolio investment activities and the holder's acquisition of the indebtedness preceded any discussions concerning the acquisition of the holder by the debtor (or by a person related to the debtor) or the acquisition of the debtor by the holder (or by a person related to the holder), as the case may be, these facts, taken together, would ordinarily establish that the holder did not acquire the indebtedness in anticipation of becoming related to the debtor. The absence of discussions between the debtor and the holder (or their respective affiliates), however, does not by itself establish that the holder did not acquire the indebtedness in anticipation of becoming related to the debtor (if, for example, the facts and circumstances show that the holder was considering a potential acquisition of or by the debtor, or the relationship is created within a relatively short period of time of the acquisition, or the indebtedness constitutes a disproportionate portion of the holder group's assets).

(3) *Indebtedness acquired within 6 months of becoming related.* Notwithstanding any other provision of this paragraph (c), a holder of indebtedness is treated as having acquired the indebtedness in anticipation of becoming related to the debtor if the holder acquired the indebtedness less than 6 months before the date the holder becomes related to the debtor.

(4) *Disclosure of potential indirect acquisition*—(i) *In general.* If a holder of outstanding indebtedness becomes related to the debtor under the circumstances described in paragraph (c)(4)(ii) or (iii) of this section, the debtor is required to attach the statement described in paragraph (c)(4)(iv) of this section to its tax return (or to a qualified amended return within the meaning of § 1.6664–2(c)(3)) for the taxable year in which the debtor becomes related to the holder, unless the debtor reports its income on the basis that the holder acquired the indebtedness in anticipation of becoming related to the debtor. Disclosure under this paragraph (c)(4) is in addition to, and is not in substitution for, any disclosure required to be made under section 6662, 6664 or 6694.

(ii) *Indebtedness represents more than 25 percent of holder group's assets*—(A) *In general.* Disclosure under this paragraph (c)(4) is required if, on the date the holder becomes related to the debtor, indebtedness of the debtor represents more than 25 percent of the fair market value of the total gross assets of the holder group (as defined in paragraph (c)(5) of this section).

(B) *Determination of total gross assets.* In determining the total gross assets of the holder group, total gross assets do not include any cash, cash item, marketable stock or security, short-term indebtedness, option, futures contract, notional principal contract, or similar item (other than indebtedness of the debtor), nor do total gross assets include any asset in which the holder has substantially reduced its risk of loss. In addition, total gross assets do not include any ownership interest in or indebtedness of a member of the holder group.

(iii) *Indebtedness acquired within 6 to 24 months of becoming related.* Disclosure under this paragraph (c)(4) is required if the holder acquired the indebtedness 6 months or more before the date the holder becomes related to the debtor, but less than 24 months before that date.

(iv) *Contents of statement.* A statement under this paragraph (c)(4) must include the following—

(A) A caption identifying the statement as disclosure under §1.108–2(c);

(B) An identification of the indebtedness with respect to which disclosure is made;

(C) The amount of such indebtedness and the amount of income from discharge of indebtedness is section 108(e)(4) were to apply;

(D) Whether paragraph (c)(4)(ii) or (iii) of this section applies to the transaction; and

(E) A statement describing the facts and circumstances supporting the debtor's position that the holder did not acquire the indebtedness in anticipation of becoming related to the debtor.

(v) *Failure to disclose.* In addition to any other penalties that may apply, if a debtor fails to provide a statement required by this paragraph (c)(4), the holder is presumed to have acquired the indebtedness in anticipation of becoming related to the debtor unless the facts and circumstances clearly establish that the holder did not acquire the indebtedness in anticipation of becoming related to the debtor.

(5) *Holder group.* For purposes of this paragraph (c), the holder group consists of the holder of the indebtedness and all persons who are both—

(i) Related to the holder before the holder becomes related to the debtor; and

(ii) Related to the debtor after the holder becomes related to the debtor.

(6) *Holding period*—(i) *Suspensions.* The running of the holding periods set forth in paragraphs (c)(3) and (c)(4)(iii) of this section is suspended during any period in which the holder or any person related to the holder is protected (directly or indirectly) against risk of loss by an option, a short sale, or any other device or transaction.

(ii) *Tacking.* For purposes of paragraphs (c)(3) and (c)(4)(iii) of this section, the period for which a holder held the debtor's indebtedness includes—

(A) The period for which the indebtedness was held by a corporation to whose attributes the holder succeeded pursuant to section 381; and

(B) The period (ending on the date on which the holder becomes related to the debtor) for which the indebtedness was held continuously by members of the holder group (as defined in paragraph (c)(5) of this section).

(d) *Definitions*—(1) *Acquisition date.* For purposes of this section, the acquisition date is the date on which a direct acquisition of indebtedness or an indirect acquisition of indebtedness occurs.

(2) *Relationship.* For purposes of this section, persons are considered related if they are related within the meaning of sections 267(b) or 707(b)(1). However—

(i) Sections 267(b) and 707(b)(1) are applied as if section 267(c)(4) provided that the family of an individual consists of the individual's spouse, the individual's children, grandchildren, and parents, and any spouse of the individual's children or grandchildren; and

(ii) Two entities that are treated as a single employer under subsection (b) or (c) of section 414 are treated as having a relationship to each other that is described in section 267(b).

(e) *Exceptions*—(1) *Indebtedness retired within one year.* This section does not apply to a direct or indirect acquisition of indebtedness with a stated maturity date on or before the date that is one year after the acquisition date, if the indebtedness is, in fact, retired on or before its stated maturity date.

(2) *Acquisitions by securities dealers.* (i) This section does not apply to a direct acquisition or an indirect acquisition of indebtedness by a dealer that acquires and disposes of such indebtedness in the ordinary course of its business of dealing in securities if—

(A) The dealer accounts for the indebtedness as a security held primarily for sale to customers in the ordinary course of business;

(B) The dealer disposes of the indebtedness (or it matures while held by the dealer) within a period consistent with the holding of the indebtedness for sale to customers in the ordinary course of business, taking into account the terms of the indebtedness and the conditions and practices prevailing in the markets for similar indebtedness during the period in which it is held; and

(C) The dealer does not sell or otherwise transfer the indebtedness to a person related to the debtor (other than in a sale to a dealer that in turn meets the requirements of this paragraph (e)(2)).

(ii) A dealer will continue to satisfy the conditions of this paragraph (e)(2) with respect to indebtedness that is exchanged for successor indebtedness in a transaction in which unrelated holders also exchange indebtedness of the same issue, provided that the conditions of this paragraph (e)(2) are met with respect to the successor indebtedness.

(iii) For purposes of this paragraph (e)(2), if the period consistent with the holding of indebtedness for sale to customers in the ordinary course of business is 30 days or less, the dealer is considered to dispose of indebtedness within that period if the aggregate principal amount of indebtedness of that issue sold by the dealer to customers in the ordinary course of business (or that mature and are paid while held by the dealer) in the calendar month following the month in which the indebtedness is acquired equals or exceeds the aggregate principal amount of indebtedness of that issue held in the dealer's inventory at the close of the month in which the indebtedness is acquired. If the period consistent with the holding of indebtedness for sale to customers in the ordinary course of business is greater than 30 days, the dealer is considered to dispose of the indebtedness within that period if the aggregate principal amount of indebtedness of that issue sold by the dealer to customers in the ordinary course of business (or that mature and are paid while held by the dealer) within that period equals or exceeds the aggregate principal amount of indebtedness of that issue held in inventory at the close of the day on which the indebtedness was acquired.

(f) *Amount of discharge of indebtedness income realized*—(1) *Holder acquired the indebtedness by purchase on or less than six months before the acquisition date.* Except as otherwise provided in this paragraph (f), the amount of discharge of indebtedness income realized under paragraph (a) of this section is measured by reference to the adjusted basis of the related holder (or of the holder that becomes related to the debtor) in the indebtedness on the acquisition date if the holder acquired the indebtedness by purchase on or less than six months before the acquisition date. For purposes of this paragraph (f), indebtedness is acquired ''by purchase'' if the indebtedness in the hands of the holder is not substituted basis property within the meaning of section 7701(a)(42). However, indebtedness is also considered acquired by purchase within six months before the acquisition date if the holder acquired the indebtedness as transferred basis property (within the meaning of section 7701(a)(43)) from a person who acquired the indebtedness by purchase on or less than six months before the acquisition date.

(2) *Holder did not acquire the indebtedness by purchase on or less than six* months before the acquisition date. Except as otherwise provided in this paragraph (f), the amount of discharge of indebtedness income realized under paragraph (a) of this section is measured by reference to the fair market value of the indebtedness on the acquisition date if the holder (or the transferor to the holder in a transferred basis transaction) did not acquire the indebtedness by purchase on or less than six months before the acquisition date.

(3) *Acquisitions of indebtedness in nonrecognition transactions.* [Reserved]

(4) *Avoidance transactions.* The amount of discharge of indebtedness income realized by the debtor under paragraph (a) of this section is measured by reference to the fair market value of the indebtedness on the acquisition date if the indebtedness is acquired in a direct or an indirect acquisition in which a principal purpose for the acquisition is the avoidance of federal income tax.

(g) *Correlative adjustments*—(1) *Deemed issuance.* For income tax purposes, if a debtor realizes income from discharge of its indebtedness in a direct or an indirect acquisition under this section (whether or not the income is excludible under section 108(a)), the debtor's indebtedness is treated as new indebtedness issued by the debtor to the related holder on the acquisition date (the deemed issuance). The new indebtedness is deemed issued with an issue price equal to the amount used under paragraph (f) of this section to compute the amount realized by the debtor under paragraph (a) of this section (*i.e.*, either the holder's adjusted basis or the fair market value of the indebtedness, as the case may be). Under section 1273(a)(1), the excess of the stated redemption price at maturity (as defined in section 1273(a)(2)) of the indebtedness over its issue price is original issue discount (OID) which, to the extent provided in sections 163 and 1272, is deductible by the debtor and includible in the gross income of the related holder. Notwithstanding the foregoing, the Commissioner may provide by Revenue Procedure or other published guidance that the indebtedness is not treated as newly issued indebtedness for purposes of designated provisions of the income tax laws.

(2) *Treatment of related holder.* The related holder does not recognize any gain or loss on the deemed issuance described in paragraph (g)(1) of this section. The related holder's adjusted basis in the indebtedness remains the same as it was immediately before the deemed issuance. The deemed issuance is treated as a purchase of the indebtedness by the related holder for purposes of section 1272(a)(7) (pertaining to reduction of original issue discount where a subsequent holder pays acquisition premium) and section 1276 (pertaining to acquisitions of debt at a market discount).

(3) *Loss deferral on disposition of indebtedness acquired in certain exchanges.* (i) Any loss otherwise allowable to a related holder on the disposition at any time of indebtedness acquired in a direct or indirect acquisition (whether or not any discharge of indebtedness income was realized under paragraph (a) of this section) is deferred until the date the debtor retires the indebtedness if—

(A) The related holder acquired the debtor's indebtedness in exchange for its own indebtedness; and

(B) The issue price of the related holder's indebtedness was not determined by reference to its fair market value (*e.g.*, the issue price was determined under section 1273(b)(4) or 1274(a) or any other provision of applicable law).

(ii) Any comparable tax benefit that would otherwise be available to the holder, debtor, or any person related to either, in any other transaction that directly or indirectly results in the disposition of the indebtedness is also deferred until the date the debtor retires the indebtedness.

(4) *Examples.* The following examples illustrate the application of this paragraph (g). In each example, all taxpayers are calendar-year taxpayers, no taxpayer is insolvent or under the jurisdiction of a court in a title 11 case and no indebtedness is qualified farm indebtedness described in section 108(g).

Example 1. (i) P, a domestic corporation, owns 70 percent of the single class of stock of S, a domestic corporation. S has outstanding indebtedness that has an issue price of $10,000,000 and provides for monthly interest payments of $80,000 payable at the end of each month and a payment at maturity of $10,000,000. The indebtedness has a stated maturity date of December 31, 1994. On January 1, 1992, P purchases S's indebtedness from I, an individual not related to S within the meaning of paragraph (d)(2) of this section, for cash in the amount of $9,000,000. S repays the indebtedness in full at maturity.

(ii) Under section 61(a)(12), section 108(e)(4), and paragraphs (a) and (f) of this section, S realizes $1,000,000 of income from discharge of indebtedness on January 1, 1992.

(iii) Under paragraph (g)(1) of this section, the indebtedness is treated as issued to P on January 1, 1992, with an issue price of $9,000,000. Under section 1273(a), the $1,000,000 excess of the stated redemption price at maturity of the indebtedness ($10,000,000) over its issue price ($9,000,000) is original issue discount, which is includible in gross income by P and deductible by S over the remaining term of the indebtedness under sections 163(e) and 1272(a).

(iv) Accordingly, S deducts and P includes in income original issue discount, in addition to stated interest, as follows: in 1992, $289,144.88; in 1993, $331,286.06; and in 1994, $379,569.06.

Example 2. The facts are the same as in *Example 1*, except that on January 1, 1992, P sells S's indebtedness to J, who is not related to S within the meaning of paragraph (d)(2) of this section, for $9,400,000 in cash. J holds S's indebtedness to maturity. On January 1, 1993, P's adjusted basis in S's indebtedness is

$9,289,144.88. Accordingly, P realizes gain in the amount of $110,855.12 upon the disposition. S and J continue to deduct and include the original issue discount on the indebtedness in accordance with *Example 1.* The amount of original issue discount includible by J is reduced by the $110,855.12 acquisition premium as provided in section 1272(a)(7).

Example 3. The facts are the same as in *Example 1,* except that on February 1, 1992 (one month after P purchased S's indebtedness), S retires the indebtedness for an amount of cash equal to the fair market value of the indebtedness. Assume that the fair market value of the indebtedness is $9,022,621.41, which in this case equals the issue price of indebtedness determined under paragraph (g)(1) of this section ($9,000,000) plus the accrued original issue discount through February 1 ($22,621.41). Section 1.61–12(c)(3) provides that if indebtedness is repurchased for a price that is exceeded by the issue price of the indebtedness plus the amount of discount already deducted, the excess is income from discharge of indebtedness. Therefore, S does not realize income from discharge of indebtedness. The result would be the same if P had contributed the indebtedness to the capital of S. Under section 108(e)(6), S would be treated as having satisfied the indebtedness with an amount of money equal to P's adjusted basis and, under section 1272(d)(2), P's adjusted basis is equal to $9,022,621.41.

Example 4. (i) P, a domestic corporation, owns 70 percent of the single class of stock of S, a domestic corporation. On January 1, 1986, P issued indebtedness that has an issue price of $5,000,000 and provides for no stated interest payments and a payment at maturity of $10,000,000. The indebtedness has a stated maturity date of December 31, 1995. On January 1, 1992, S purchases P's indebtedness from K, a partnership not related to P within the meaning of paragraph (d)(2) of this section, for cash in the amount of $6,000,000. The sum of the debt's issue price and previously deducted original issue discount is $7,578,582.83. P repays the indebtedness in full at maturity.

(ii) Under section 61(a)(12), section 108(e)(4), and paragraphs (a) and (f) of this section, P realizes $1,578,582.83 in income from discharge of indebtedness ($7,578,582.83 minus $6,000,000) on January 1, 1992.

(iii) Under paragraph (g)(1) of this section, the indebtedness is treated as issued to S on January 1, 1992, with an issue price of $6,000,000. Under section 1273(a), the $4,000,000 excess of the stated redemption price at maturity of the indebtedness ($10,000,000) over its issue price ($6,000,000) is orignial issue discount, which is includible in gross income by S and deductible by P over the remaining term of the indebtedness under sections 163(e) and 1272(a).

(iv) Accordingly, P deducts and S includes in income original issue discount as follows: in 1992, $817,316.20; in 1993, $928,650.49; in 1994, $1,055,150.67; and in 1995, $1,198,882.64.

(h) *Effective date.* This section applies to any transaction described in paragraph (a) and in either paragraph (b) or (c) of this section with an acquisition date on or after March 21, 1991. Although this section does not apply to direct or indirect acquisitions occurring before March 21, 1991, section 108(e)(4) is effective for any transaction after December 31, 1980, subject to the rules of section 7 of the Bankruptcy Tax Act of 1980 (Pub. L. 96–589, 94 Stat. 3389, 3411). Taxpayers may use any reasonable method of determining the amount of discharge of indebtedness income realized and the treatment of correlative adjustments under section 108(e)(4) for acquisitions of indebtedness before March 21, 1991, if such method is applied consistently by both the debtor and related holder.

[T.D. 8460, 57 FR 61808, Dec. 29, 1992]

§ 1.108–3 Intercompany losses and deductions.

(a) *General rule.* This section applies to certain losses and deductions from the sale, exchange, or other transfer of property between corporations that are members of a consolidated group or a controlled group (an intercompany transaction). See section 267(f) (controlled groups) and § 1.1502–13 (consolidated groups) for applicable definitions. For purposes of determining the attributes to which section 108(b) applies, a loss or deduction not yet taken into account under section 267(f) or § 1.1502–13 (an intercompany loss or deduction) is treated as basis described in section 108(b) that the transferor retains in property. To the extent a loss not yet taken into account is reduced under this section, it cannot subsequently be taken into account under section 267(f) or § 1.1502–13. For example, if S and B are corporations filing a consolidated return, and S sells land with a $100 basis to B for $90 and the $10 loss is deferred under section 267(f) and § 1.1502–13, the deferred loss is treated for purposes of section 108(b) as $10 of basis that S has in land (even though S has no remaining interest in the land sold to B) and is subject to reduction under section 108(b)(2)(E). Similar principles apply, with appropriate adjustments, if S and B are members of a controlled group and S's loss is deferred only under section 267(f).

(b) *Effective date.* This section applies with respect to discharges of indebtedness occurring on or after September 11, 1995.

[T.D. 8597, 60 FR 36680, July 18, 1995]

§1.108–4 Election to reduce basis of depreciable property under section 108(b)(5) of the Internal Revenue Code .

(a) *Description.* An election under section 108(b)(5) is available whenever a taxpayer excludes discharge of indebtedness income (COD income) from gross income under sections 108(a)(1)(A), (B), or (C) (concerning title 11 cases, insolvency, and qualified farm indebtedness, respectively). See sections 108(d)(2) and (3) for the definitions of *title 11 case* and *insolvent.* See section 108(g)(2) for the definition of *qualified farm indebtedness.*

(b) *Time and manner.* To make an election under section 108(b)(5), a taxpayer must enter the appropriate information on Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment),* and attach the form to the timely filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a). An election under this section may be revoked only with the consent of the Commissioner.

(c) *Effective date.* This section applies to elections concerning discharges of indebtedness occurring on or after October 22, 1998.

[T.D. 8787, 63 FR 56562, Oct. 22, 1998]

§1.108–5 Time and manner for making election under the Omnibus Budget Reconciliation Act of 1993.

(a) *Description.* Section 108(c)(3)(C), as added by section 13150 of the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103–66, 107 Stat. 446), allows certain noncorporate taxpayers to elect to treat certain indebtedness described in section 108(c)(3) that is discharged after December 31, 1992, as qualified real property business indebtedness. This discharged indebtedness is excluded from gross income to the extent allowed by section 108.

(b) *Time and manner for making election.* The election described in this section must be made on the timely-filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has discharge of indebtedness income that is excludible from gross income under section 108(a). The election is to be made on a completed Form 982, in accordance with that Form and its instructions.

(c) *Revocability of election.* The election described in this section is revocable with the consent of the Commissioner.

(d) *Effective date.* The rules set forth in this section are effective December 27, 1993.

[T.D. 8688, 61 FR 65322, Dec. 12, 1996. Redesignated by T.D. 8787, 63 FR 56563, Oct. 22, 1998]

§1.108–6 Limitations on the exclusion of income from the discharge of qualified real property business indebtedness.

(a) *Indebtedness in excess of value.* With respect to any qualified real property business indebtedness that is discharged, the amount excluded from gross income under section 108(a)(1)(D) (concerning discharges of qualified real property business indebtedness) shall not exceed the excess, if any, of the outstanding principal amount of that indebtedness immediately before the discharge over the net fair market value of the qualifying real property, as defined in §1.1017–1(c)(1), immediately before the discharge. For purposes of this section, *net fair market value* means the fair market value of the qualifying real property (notwithstanding section 7701(g)), reduced by the outstanding principal amount of any qualified real property business indebtedness (other than the discharged indebtedness) that is secured by such property immediately before and after the discharge. Also, for purposes of section 108(c)(2)(A) and this section, outstanding principal amount means the principal amount of indebtedness together with all additional amounts owed that, immediately before the discharge, are equivalent to principal, in that interest on such amounts would accrue and compound in the future, except that outstanding principal amount shall not include amounts that are subject to section 108(e)(2) and shall be adjusted to account for unamortized premium and discount consistent with section 108(e)(3).

(b) *Overall limitation.* The amount excluded from gross income under section 108(a)(1)(D) shall not exceed the aggregate adjusted bases of all depreciable real property held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of the discharge) reduced by the sum of any—

(1) Depreciation claimed for the taxable year the taxpayer excluded discharge of indebtedness from gross income under section 108(a)(1)(D); and

(2) Reductions to the adjusted bases of depreciable real property required under section 108(b) or section 108(g) for the same taxable year.

(c) *Effective date.* This section applies to discharges of qualified real property business indebtedness occurring on or after October 22, 1998.

[T.D. 8787, 63 FR 56563, Oct. 22, 1998]

§ 1.108(c)–1T [Reserved]

§ 1.109–1 Exclusion from gross income of lessor of real property of value of improvements erected by lessee.

(a) Income derived by a lessor of real property upon the termination, through forfeiture or otherwise, of the lease of such property and attributable to buildings erected or other improvements made by the lessee upon the leased property is excluded from gross income. However, where the facts disclose that such buildings or improvements represent in whole or in part a liquidation in kind of lease rentals, the exclusion from gross income shall not apply to the extent that such buildings or improvements represent such liquidation. The exclusion applies only with respect to the income realized by the lessor upon the termination of the lease and has no application to income, if any, in the form of rent, which may be derived by a lessor during the period of the lease and attributable to buildings erected or other improvements made by the lessee. It has no application to income which may be realized by the lessor upon the termination of the lease but not attributable to the value of such buildings or improvements. Neither does it apply to income derived by the lessor subsequent to the termination of the lease incident to the ownership of such buildings or improvements.

(b) The provisions of this section may be illustrated by the following example:

Example. The A Corporation leased in 1945 for a period of 50 years unimproved real property to the B Corporation under a lease providing that the B Corporation erect on the leased premises an office building costing $500,000, in addition to paying the A Corporation a lease rental of $10,000 per annum beginning on the date of completion of the improvements, the sum of $100,000 being placed in escrow for the payment of the rental. The building was completed on January 1, 1950. The lease provided that all improvements made by the lessee on the leased property would become the absolute property of the A Corporation on the termination of the lease by forfeiture or otherwise and that the lessor would become entitled on such termination to the remainder of the sum, if any, remaining in the escrow fund. The B Corporation forfeited its lease on January 1, 1955, when the improvements had a value of $100,000. Under the provisions of section 109, the $100,000 is excluded from gross income. The amount of $50,000 representing the remainder in the escrow fund is forfeited to the A Corporation and is included in the gross income of that taxpayer. As to the basis of the property in the hands of the A Corporation, see § 1.1019–1.

§ 1.111–1 Recovery of certain items previously deducted or credited.

(a) *General.* Section 111 provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the ‘‘recovery exclusion’’ with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127 of the Internal Revenue Code of 1939, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. The term ‘‘recovery exclusion’’ as used in this section means an amount equal to the portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in section 111), and of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under subtitle A (other than the accumulated earnings tax imposed by section 531 or the personal holding company tax imposed by section 541) of the Internal Revenue Code of 1954 or corresponding provisions of prior income tax laws (other than the World War II excess profits tax imposed under subchapter E, chapter 2 of the Internal Revenue Code of 1939).

(1) *Section 111 items.* The term ‘‘section 111 items’’ as used in this section means bad debts, prior taxes, delinquency amounts, and all other items subject to the rule of exclusion, for which a deduction or credit was allowed for a prior taxable year. If a bad debt was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts, it was not deducted, and it is therefore not considered a section 111 item. Bad debts, prior taxes, and delinquency amounts are defined in section 111(b) (1), (2), and (3), respectively. An example of a delinquency amount is interest on delinquent taxes. An example of the other items not expressly referred to in section 111 but nevertheless subject to the rule of exclusion is a loss sustained upon the sale of stock and later recovered, in whole or in part, through an action against the party from whom such stock had been purchased.

(2) *Definition of ‘‘recovery’’.* Recoveries result from the receipt of amounts in respect of the previously deducted or credited section 111 items, such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued. Care should be taken in the case of bad debts which were treated as only partially worthless in prior years to distinguish between the item described in section 111, that is, the part of such debt which was deducted, and the part not previously deducted, which is not a section 111 item and is considered the first part collected. The collection of the part not deducted is not considered a ‘‘recovery’’. Furthermore, the term ‘‘recovery’’ does not include the gain resulting from the receipt of an amount on account of a section 111 item which, together with previous such receipts, exceeds the deduction or credit previously allowed for such item. For instance, a $100 corporate bond purchased for $40 and later deducted as worthless is subsequently collected to the extent of $50. The $10 gain (excess of $50 collection over $40 cost) is not a recovery of a section 111 item. Such gain is in no case excluded from gross income under section 111, regardless of whether the $40 recovery is or is not excluded.

(3) *Treatment of debt deducted in more than one year by reason of partial worthlessness.* In the case of a bad debt deducted in part for two or more prior years, each such deduction of a part of the debt is considered a separate section 111 item. A recovery with respect to such debt is considered first a recovery of those items (or portions thereof), resulting from such debt, for which there are recovery exclusions. If there are recovery exclusions for two or more items resulting from the same bad debt, such items are considered recovered in the order of the taxable years for which they were deducted, beginning with the latest. The recovery exclusion for any such item is determined by considering the recovery exclusion with respect to the prior year for which such item was deducted as being first used to offset all other applicable recoveries in the year in which the bad debt is recovered.

(4) *Special provisions as to worthless bonds, etc., which are treated as capital losses.* Certain bad debts arising from the worthlessness of securities and certain nonbusiness bad debts are treated as losses from the sale or exchange of capital assets. See sections 165(g) and 166(d). The amounts of the deductions allowed for any year under section 1211 on account of such losses for such year are considered to be section 111 items. Any part of such losses which, under section 1211, is a deduction for a subsequent year through the capital loss carryover (any later receipt of an amount with respect to such deducted

loss is a recovery) is considered a section 111 item for the year in which such loss was sustained.

(b) *Computation of recovery exclusion*—(1) *Amount of recovery exclusion allowable for year of recovery.* For the year of any recovery, the section 111 items which were deducted or credited for one prior year are considered as a group and the recovery thereon is considered separately from recoveries of any items which were deducted or credited for other years. This recovery is excluded from gross income to the extent of the recovery exclusion with respect to this group of items as (i) determined for the original year for which such items were deducted or credited (see subparagraph (2) of this paragraph) and (ii) reduced by the excludable recoveries in intervening years on account of all section 111 items for such original year. A taxpayer claiming a recovery exclusion shall submit, at the time the exclusion is claimed, the computation of the recovery exclusion claimed for the original year for which the items were deducted or credited, and computations showing the amount recovered in intervening years on account of the section 111 items deducted or credited for the original year.

(2) *Determination of recovery exclusion for original year for which items were deducted or credited.* (i) The recovery exclusion for the taxable year for which section 111 items were deducted or credited (that is, the ‘‘original taxable year’’) is the portion of the aggregate amount of such deductions and credits which could be disallowed without causing an increase in any tax of the taxpayer imposed under subtitle A (other than the accumulated earnings tax imposed by section 531 or the personal holding company tax imposed by section 541) of the Internal Revenue Code of 1954 or corresponding provisions of prior income tax laws (other than the World War II excess profits tax imposed under subchapter E, chapter 2 of the Internal Revenue Code of 1939). For the purpose of such recovery exclusion, consideration must be given to the effect of net operating loss carryovers and carrybacks or capital loss carryovers.

(ii) This rule shall be applied by determining the recovery exclusion as the aggregate amount of the section 111 items for the original year for which such items were deducted or credited reduced by whichever of the following amounts is the greater:

(a) The difference between *(1)* the taxable income for such original year and *(2)* the taxable income computed without regard to the section 111 items for such original year.

(b) In the case of a taxpayer subject to any income tax in lieu of normal tax or surtax or both (except the alternative tax on capital gains imposed by section 1201, which is disregarded), the difference between *(1)* the income subject to such tax for such original year and *(2)* the income subject to such tax computed without regard to the section 111 items for such original year.

(Neither the amount determined under *(1)* nor the amount under *(2)* of *(a)* or *(b)* of this subdivision shall in any case be considered less than zero.) For this determination of the recovery exclusion, the aggregate of the section 111 items must be further decreased by the portion thereof which caused a reduction in tax in preceding or succeeding taxable years through any net operating loss carryovers or carrybacks or capital loss carryovers affected by such items. This decrease is the aggregate of the largest amount determined for each of such preceding and succeeding years under *(a)* and *(b)* of this subdivision, the computation of each carryover or carryback to the preceding or succeeding year being made under *(1)* of *(a)* and *(b)* of this subdivision with regard to the section 111 items for the original year and such computation being made under *(2)* of *(a)* and *(b)* of this subdivision without regard to such items. For the purpose of the preceding sentence, the computations under both *(1)* and *(2)* of *(a)* and *(b)* of this subdivision shall be made without regard to any section 111 items for such preceding or succeeding year and the carryovers and carrybacks to such year shall be determined without regard to any section 111 items for years subsequent to the original year.

(iii) The determination of the recovery exclusion for original taxable years subject to the provisions of the Internal Revenue Code of 1939 shall be made under 26 CFR (1939) 39.22(b)(12)–1(b)(2) (Regulations 118).

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

Example. A single individual with no dependents has for his 1954 taxable year the following income and deductions:

	With deduction of section 111 items	Without deduction of section 111 items
Gross income	$25,000	$25,000
Less deductions:		
Depreciation	20,000	20,000
Business bad debts and taxes	6,300	....
Personal exemption	600	600
	26,900	20,600
Taxable income or (loss)	(1,900)	4,400
Adjustment under section 172(d)(3)	600	....
Net operating loss	(1,300)	....

The full amount of the net operating loss of $1,300 is carried back and allowed as a deduction for 1952. The aggregate of the section 111 items for 1954 is $6,300 (bad debts and taxes). The recovery exclusion on account of section 111 items for 1954 is $600, determined by reducing the $6,300 aggregate of the section 111 items by $5,700, i.e., the sum of (1) the difference between the amount of the taxable income for 1954 computed without regard to the section 111 items ($4,400) and the amount of the taxable income for 1954 (not less than zero) computed by taking such items into account, and (2) the amount of the net operating loss ($1,300) which caused the reduction in tax for 1952 by reason of the carryback provisions. If in 1956 the taxpayer recovers $400 of the bad debts, all of the recovery is excluded from the income by reason of the recovery exclusion of $600 determined for the original year 1954. If in 1957 the taxpayer recovers an additional $300 of the bad debts, only $200 is excluded from gross income. That is, the recovery exclusion of $600 determined for the original year 1954 is reduced by the $400 recovered in 1956, leaving a balance of $200 which is used in 1957. The balance of the amount recovered in 1957, $100 ($300 less $200), is included in gross income for 1957.

(c) *Provisions as to taxes imposed by section 531 (relating to the accumulated earnings tax) and section 541 (relating to the tax on personal holding companies).* A recovery exclusion allowed for purposes of subtitle A (other than section 531 or section 541) of the Internal Revenue Code of 1954 shall also be allowed for the purpose of determining the accumulated earnings tax under section 531 or the personal holding company tax under section 541 regardless of whether or not the section 111 items on which such recovery exclusion is based resulted in a reduction of the tax under section 531 or section 541 of the Internal Revenue Code of 1954 (or corresponding provisions of prior income tax laws) for the prior taxable year. Furthermore, if there is recovery of a section 111 item which was not allowable as a deduction or credit for the prior taxable year for purposes of Subtitle A (not including section 531 or section 541) or corresponding provisions of prior income tax laws (other than Subchapter E, Chapter 2 of the Internal Revenue Code of 1939, relating to World War II excess profits tax), but was allowable for such prior taxable year in determining the tax under section 531 or section 541 (or corresponding provisions of prior income tax laws) then for the purpose of determining the tax under section 531 or section 541 a recovery exclusion shall be allowable with respect to such recovery if the section 111 item did not result in a reduction of the tax under section 531 or section 541 (or corresponding provisions of prior income tax laws).

§1.112–1 Combat zone compensation of members of the Armed Forces.

(a) *Combat zone compensation exclusion*—(1) *Amount excluded.* In addition to the exemptions and credits otherwise applicable, section 112 excludes from gross income the following compensation of members of the Armed Forces:

(i) *Enlisted personnel.* Compensation received for active service as a member below the grade of commissioned officer in the Armed Forces of the United States for any month during any part of which the member served in a combat zone or was hospitalized at any place as a result of wounds, disease, or injury incurred while serving in the combat zone.

(ii) *Commissioned officers.* Compensation not exceeding the monthly dollar limit received for active service as a commissioned officer in the Armed Forces of the United States for any month during any part of which the officer served in a combat zone or was hospitalized at any place as a result of wounds, disease, or injury incurred while serving in the combat zone. The monthly dollar limit is the monthly amount excludable from the officer's income under section 112(b) as amended. Beginning in 1966, the monthly dollar limit for periods of active service after 1965 became $500. As of September 10, 1993, the monthly dollar limit continues to be $500.

(2) *Time limits on exclusion during hospitalization.* Compensation received for service for any month of hospitalization that begins more than 2 years after the date specified by the President in an Executive Order as the date of the termination of combatant activities in the combat zone cannot be excluded under section 112. Furthermore, compensation received while hospitalized after January 1978 for wounds, disease, or injury incurred in the Vietnam combat zone designated by Executive Order 11216 cannot be excluded under section 112.

(3) *Special terms.* A commissioned warrant officer is not a *commissioned officer* under section 112(b) and is entitled to the exclusion allowed to enlisted personnel under section 112(a). *Compensation,* for the purpose of section 112, does not include pensions and retirement pay. *Armed Forces of the United States* is defined (and members of the Armed Forces are described) in section 7701(a)(15).

(4) *Military compensation only.* Only compensation paid by the Armed Forces of the United States to members of the Armed Forces can be excluded under section 112, except for compensation paid by an agency or instrumentality of the United States or by an international organization to a member of the Armed Forces whose military active duty status continues during the member's assignment to the agency or instrumentality or organization on official detail. Compensation paid by other employers (whether private enterprises or governmental entities) to members of the Armed Forces cannot be excluded under section 112 even if the payment is made to supplement the member's military compensation or is labeled by the employer as compensation for active service in the Armed Forces of the United States. Compensation paid to civilian employees of the federal government, including civilian employees of the Armed Forces, cannot be excluded under section 112, except as provided in section 112(d)(2) (which extends the exclusion to compensation of civilian employees of the federal government in missing status due to the Vietnam conflict).

(b) *Service in combat zone*—(1) *Active service.* The exclusion under section 112 applies only if active service is performed in a combat zone. A member of the Armed Forces is in active service if the member is actually serving in the Armed Forces of the United States. Periods during which a member of the Armed Forces is absent from duty on account of sickness, wounds, leave, internment by the enemy, or other lawful cause are periods of active service. A member of the Armed Forces in active service in a combat zone who becomes a prisoner of war or missing in action in the combat zone is deemed, for the purpose of section 112, to continue in active service in the combat zone for the period for which the member is treated as a prisoner of war or as missing in action for military pay purposes.

(2) *Combat zone status.* Except as provided in paragraphs (e) and (f) of this section, service is performed in a combat zone only if it is performed in an area which the President of the United States has designated by Executive Order, for the purpose of section 112, as an area in which Armed Forces of the United States are or have been engaged in combat, and only if it is performed on or after the date designated by the President by Executive Order as the date of the commencing of combatant activities in that zone and on or before the date designated by the President by Executive Order as the date of the termination of combatant activities in that zone.

(3) *Partial month service.* If a member of the Armed Forces serves in a combat zone for any part of a month, the member is entitled to the exclusion for that month to the same extent as if the member has served in that zone for the entire month. If a member of the Armed Forces is hospitalized for a part

of a month as a result of wounds, disease, or injury incurred while serving in that zone, the member is entitled to the exclusion for the entire month.

(4) *Payment time and place.* The time and place of payment are irrelevant in considering whether compensation is excludable under section 112; rather, the time and place of the entitlement to compensation determine whether the compensation is excludable under section 112. Thus, compensation can be excluded under section 112 whether or not it is received outside a combat zone, or while the recipient is hospitalized, or in a year different from that in which the service was rendered for which the compensation is paid, provided that the member's entitlement to the compensation fully accrued in a month during which the member served in the combat zone or was hospitalized as a result of wounds, disease, or injury incurred while serving in the combat zone. For this purpose, entitlement to compensation fully accrues upon the completion of all actions required of the member to receive the compensation. Compensation received by a member of the Armed Forces for services rendered while in active service can be excluded under section 112 even though payment is received subsequent to discharge or release from active service. Compensation credited to a deceased member's account for a period subsequent to the established date of the member's death and received by the member's estate can be excluded from the gross income of the estate under section 112 to the same extent that it would have been excluded from the gross income of the member had the member lived and received the compensation.

(5) *Examples of combat zone compensation.* The rules of this section are illustrated by the following examples:

Example 1. On January 5, outside of a combat zone, an enlisted member received basic pay for active duty services performed from the preceding December 1 through December 31. On December 4 (and no other date), the member performed services within a combat zone. The member may exclude from income the entire payment received on January 5, although the member served in the combat zone only one day during December, received the payment outside of the combat zone, and received the payment in a year other than the year in which the combat zone services were performed.

Example 2. From March through December, an enlisted member became entitled to 25 days of annual leave while serving in a combat zone. The member used all 25 days of leave in the following year. The member may exclude from income the compensation received for those 25 days, even if the member performs no services in the combat zone in the year the compensation is received.

Example 3. From March through December, a commissioned officer became entitled to 25 days of annual leave while serving in a combat zone. During that period the officer also received basic pay of $1,000 per month from which the officer excluded from income $500 per month (exhausting the monthly dollar limit under section 112 for that period). The officer used all 25 days of leave in the following year. The officer may not exclude from income any compensation received in the following year related to those 25 days of leave, since the officer had already excluded from income the maximum amount of combat zone compensation for the period in which the leave was earned.

Example 4. In November, while serving in a combat zone, an enlisted member competing for a cash award submitted an employee suggestion. After November, the member neither served in a combat zone nor was hospitalized for wounds incurred in the combat zone. In June of the following year, the member's suggestion was selected as the winner of the competition and the award was paid. The award can be excluded from income as combat zone compensation although granted and received outside of the combat zone, since the member completed the necessary action to win the award (submission of the suggestion) in a month during which the member served in the combat zone.

Example 5. In July, while serving in a combat zone, an enlisted member voluntarily reenlisted. After July, the member neither served in a combat zone nor was hospitalized for wounds incurred in the combat zone. In February of the following year, the member received a bonus as a result of the July reenlistment. The reenlistment bonus can be excluded from income as combat zone compensation although received outside of the combat zone, since the member completed the necessary action for entitlement to the reenlistment bonus in a month during which the member served in the combat zone.

Example 6. In July, while serving outside a combat zone, an enlisted member voluntarily reenlisted. In February of the following year, the member, while performing services in a combat zone, received a bonus as a result of the July reenlistment. The reenlistment bonus cannot be excluded from income as combat zone compensation although received while serving in the combat zone, since the member completed the necessary action for entitlement to the reenlistment bonus in a month during which the member had neither served in the combat zone nor was hospitalized for wounds incurred while serving in a combat zone.

(c) *Hospitalization*—(1) *Presumption of combat zone injury.* If an individual is hospitalized for wound, disease, or injury while serving in a combat zone, the wound, disease, or injury will be presumed to have been incurred while serving in a combat zone, unless the contrary clearly appears. In certain cases, however, a wound, disease, or injury may have been incurred while serving in a combat zone even though the individual was not hospitalized for it while so serving. In exceptional cases, a wound, disease, or injury will not have been incurred while serving in a combat zone even though the individual was hospitalized for it while so serving.

(2) *Length of hospitalization.* An individual is hospitalized only until the date the individual is discharged from the hospital.

(3) *Examples of combat zone injury.* The rules of this paragraph (c) are illustrated by the following examples:

Example 1. An individual is hospitalized for a disease in the combat zone where the individual has been serving for three weeks. The incubation period of the disease is two to four weeks. The disease is incurred while serving in the combat zone.

Example 2. The facts are the same as in *Example 1* except that the incubation period of the disease is one year. The disease is not incurred while serving in the combat zone.

Example 3. A member of the Air Force, stationed outside the combat zone, is shot while participating in aerial combat over the combat zone, but is not hospitalized until returning to the home base. The injury is incurred while serving in a combat zone.

Example 4. An individual is hospitalized for a disease three weeks after having departed from a combat zone. The incubation period of the disease is two to four weeks. The disease is incurred while serving in a combat zone.

(d) *Married members.* The exclusion under section 112 applies without regard to the marital status of the recipient of the compensation. If both spouses meet the requirements of the statute, then each spouse is entitled to the benefit of an exclusion. In the case of a husband and wife domiciled in a State recognized for Federal income tax purposes as a community property State, any exclusion from gross income under section 112 operates before apportionment of the gross income of the spouses under community property law. For example, a husband and wife are domiciled in a community property State and the member spouse is entitled, as a commissioned officer, to the benefit of the exclusion under section 112(b) of $500 for each month. The member receives $7,899 as compensation for active service for 3 months in a combat zone. Of that amount, $1,500 is excluded from gross income under section 112(b) and $6,399 is taken into account in determining the gross income of both spouses.

(e) *Service in area outside combat zone*—(1) *Combat zone treatment.* For purposes of section 112, a member of the Armed Forces who performs military service in an area outside the area designated by Executive Order as a combat zone is deemed to serve in that combat zone while the member's service is in direct support of military operations in that zone and qualifies the member for the special pay for duty subject to hostile fire or imminent danger authorized under section 310 of title 37 of the United States Code, as amended (37 U.S.C. 310) (hostile fire/imminent danger pay).

(2) *Examples of combat zone treatment.* The examples in this paragraph (e)(2) are based on the following circumstances: Certain areas, airspace, and adjacent waters are designated as a combat zone for purposes of section 112 as of May 1. Some members of the Armed Forces are stationed in the combat zone; others are stationed in two foreign countries outside the combat zone, named Nearby Country and Destination Country.

Example 1. B is a member of an Armed Forces ground unit stationed in the combat zone. On May 31, B's unit crosses into Nearby Country. B performs military service in Nearby Country in direct support of the military operations in the combat zone from June 1 through June 8 that qualifies B for hostile fire/imminent danger pay. B does not return to the combat zone during June. B is deemed to serve in the combat zone from June 1 through June 8. Accordingly, B is entitled to the exclusion under section 112 for

June. Of course, B is also entitled to the exclusion for any month (May, in this example) in which B actually served in the combat zone.

Example 2. B is a member of an Armed Forces ground unit stationed in the combat zone. On May 31, B's unit crosses into Nearby Country. On June 1, B is wounded while performing military service in Nearby Country in direct support of the military operations in the combat zone that qualifies B for hostile fire/imminent danger pay. On June 2, B is transferred for treatment to a hospital in the United States. B is hospitalized from June through October for those wounds. B is deemed to have incurred the wounds while serving in the combat zone on June 1. Accordingly, B is entitled to the exclusion under section 112 for June through October. Of course, B is also entitled to the exclusion for any month (May, in this example) in which B actually served in the combat zone.

Example 3. B is stationed in Nearby Country for the entire month of June as a member of a ground crew servicing combat aircraft operating in the combat zone. B's service in Nearby Country during June does not qualify B for hostile fire/imminent danger pay. Accordingly, B is not deemed to serve in the combat zone during June and is not entitled to the exclusion under section 112 for that month.

Example 4. B is assigned to an air unit stationed in Nearby Country for the entire month of June. In June, members of air units of the Armed Forces stationed in Nearby Country fly combat and supply missions into and over Destination Country in direct support of military operations in the combat zone. B flies combat missions over Destination Country from Nearby Country from June 1 through June 8. B's service qualifies B for hostile fire/imminent danger pay. Accordingly, B is deemed to serve in the combat zone during June and is entitled to the exclusion under section 112. The result would be the same if B were to fly supply missions into Destination Country from Nearby Country in direct support of operations in the combat zone qualifying B for hostile fire/imminent danger pay.

Example 5. Assigned to an air unit stationed in Nearby Country, B was killed in June when B's plane crashed on returning to the airbase in Nearby Country. B was performing military service in direct support of the military operations in the combat zone at the time of B's death. B's service also qualified B for hostile fire/imminent danger pay. B is deemed to have died while serving in the combat zone or to have died as a result of wounds, disease, or injury incurred while serving in the combat zone for purposes of section 692(a) and section 692(b) (providing relief from certain income taxes for members of the Armed Forces dying in a combat zone or as a result of wounds, disease, or injury incurred while serving in a combat zone) and section 2201 (providing relief from certain estate taxes for members of the Armed Forces dying in a combat zone or by reason of combat-zone-incurred wounds). The result would be the same if B's mission had been a supply mission instead of a combat mission.

Example 6. In June, B was killed as a result of an off-duty automobile accident while leaving the airbase in Nearby Country shortly after returning from a mission over Destination Country. At the time of B's death, B was not performing military duty qualifying B for hostile fire/imminent danger pay. B is not deemed to have died while serving in the combat zone or to have died as the result of wounds, disease, or injury incurred while serving in the combat zone. Accordingly, B does not qualify for the benefits of section 692(a), section 692(b), or section 2201.

Example 7. B performs military service in Nearby Country from June 1 through June 8 in direct support of the military operations in the combat zone. Nearby Country is designated as an area in which members of the Armed Forces qualify for hostile fire/imminent danger pay due to imminent danger, even though members in Nearby Country are not subject to hostile fire. B is deemed to serve in the combat zone from June 1 through June 8. Accordingly, B is entitled to the exclusion under section 112 for June.

(f) *Nonqualifying presence in combat zone*—(1) *Inapplicability of exclusion.* The following members of the Armed Forces are not deemed to serve in a combat zone within the meaning of section 112(a)(1) or section 112(b)(1) or to be hospitalized as a result of wounds, disease, or injury incurred while serving in a combat zone within the meaning of section 112(a)(2) or section 112(b)(2)—

(i) Members present in a combat zone while on leave from a duty station located outside a combat zone;

(ii) Members who pass over or through a combat zone during the course of a trip between two points both of which lie outside a combat zone; or

(iii) Members present in a combat zone solely for their own personal convenience.

(2) *Exceptions for temporary duty or special pay.* Paragraph (f)(1) of this section does not apply to members of the Armed Forces who—

(i) Are assigned on official temporary duty to a combat zone (including official temporary duty to the airspace of a combat zone); or

(ii) Qualify for hostile fire/imminent danger pay.

(3) *Examples of nonqualifying presence and its exceptions.* The examples in this paragraph (f)(3) are based on the following circumstances: Certain areas, airspace, and adjacent waters are designated as a combat zone for purposes of section 112 as of May 1. Some members of the Armed Forces are stationed in the combat zone; others are stationed in two foreign countries outside the combat zone, named Nearby Country and Destination Country.

Example 1. B is a member of the Armed Forces assigned to a unit stationed in Nearby Country. On June 1, B voluntarily visits a city within the combat zone while on leave. B is not deemed to serve in a combat zone since B is present in a combat zone while on leave from a duty station located outside a combat zone.

Example 2. B is a member of the Armed Forces assigned to a unit stationed in Nearby Country. During June, B takes authorized leave and elects to spend the leave period by visiting a city in the combat zone. While on leave in the combat zone, B is subject to hostile fire qualifying B for hostile fire/imminent danger pay. Although B is present in the combat zone while on leave from a duty station outside the combat zone, B qualifies for the exclusion under section 112 because B qualifies for hostile fire/imminent danger pay while in the combat zone.

Example 3. B is a member of the Armed Forces assigned to a ground unit stationed in the combat zone. During June, B takes authorized leave and elects to spend the leave period in the combat zone. B is not on leave from a duty station located outside a combat zone, nor is B present in a combat zone solely for B's own personal convenience. Accordingly, B's combat zone tax benefits continue while B is on leave in the combat zone.

Example 4. B is assigned as a navigator to an air unit stationed in Nearby Country. On June 4, during the course of a flight between B's home base in Nearby Country and another base in Destination Country, the aircraft on which B serves as a navigator flies over the combat zone. B is not on official temporary duty to the airspace of the combat zone and does not qualify for hostile fire/imminent danger pay as a result of the flight. Accordingly, B is not deemed to serve in a combat zone since B passes over the combat zone during the course of a trip between two points both of which lie outside the combat zone without either being on official temporary duty to the combat zone or qualifying for hostile fire/imminent danger pay.

Example 5. B is a member of the Armed Forces assigned to a unit stationed in Nearby Country. B enters the combat zone on a 3-day pass. B is not on official temporary duty and does not qualify for hostile fire/imminent danger pay while present in the combat zone. Accordingly, B is not deemed to serve in a combat zone since B is present in the combat zone solely for B's own personal convenience.

Example 6. B, stationed in Nearby Country, is a military courier assigned on official temporary duty to deliver military pouches in the combat zone and in Destination Country. On June 1, B arrives in the combat zone from Nearby Country, and on June 2, B departs for Destination Country. Although B passes through the combat zone during the course of a trip between two points outside the combat zone, B is nevertheless deemed to serve in a combat zone while in the combat zone because B is assigned to the combat zone on official temporary duty.

Example 7. B is a member of an Armed Forces ground unit stationed in Nearby Country. On June 1, B took authorized leave and elected to spend the leave period by visiting a city in the combat zone. On June 2, while on leave in the combat zone, B was wounded by hostile fire qualifying B for hostile fire/imminent danger pay. On June 3, B was transferred for treatment to a hospital in the United States. B is hospitalized from June through October for those wounds. Although B was present in the combat zone while on leave from a duty station outside the combat zone, B is deemed to have incurred the wounds while serving in the combat zone on June 2, because B qualified for hostile fire/imminent danger pay while in the combat zone. Accordingly, B is entitled to the exclusion under section 112 for June through October.

Example 8. The facts are the same as in *Example 7* except that B dies on September 1 as a result of the wounds incurred in the combat zone. B is deemed to have died as a result of wounds, disease, or injury incurred while serving in the combat zone for purposes of section 692(a) and section 692(b) (providing relief from certain income taxes for members of the Armed Forces dying in a combat zone or as a result of wounds, disease, or injury incurred while serving in a combat zone) and section 2201 (providing relief from certain estate taxes for members of the Armed Forces dying in a combat zone or by reason of combat-zone-incurred wounds).

[T.D. 8489, 58 FR 47640, Sept. 10, 1993]

§ 1.113–1 Mustering-out payments for members of the Armed Forces.

For the purposes of the exclusion from gross income under section 113 of mustering-out payments with respect to service in the Armed Forces, mustering-out payments are payments made to any recipients pursuant to the provisions of 38 U.S.C. 2105 (formerly section 5 of the Mustering-out Payment Act of 1944 and section 505 of the Veterans' Readjustment Assistance Act of 1952).

§1.117–1 Exclusion of amounts received as a scholarship or fellowship grant.

(a) *In general.* Any amount received by an individual as a scholarship at an educational institution or as a fellowship grant, including the value of contributed services and accommodations, shall be excluded from the gross income of the recipient, subject to the limitations set forth in section 117(b) and §1.117–2. The exclusion from gross income of an amount which is a scholarship or fellowship grant is controlled solely by section 117. Accordingly, to the extent that a scholarship or a fellowship grant exceeds the limitations of section 117(b) and §1.117–2, it is includible in the gross income of the recipient notwithstanding the provisions of section 102 relating to exclusion from gross income of gifts, or section 74(b) relating to exclusion from gross income of certain prizes and awards. For definitions, see §1.117–3.

(b) *Exclusion of amounts received to cover expenses.* (1) Subject to the limitations provided in subparagraph (2) of this paragraph, any amount received by an individual to cover expenses for travel (including meals and lodging while traveling and an allowance for travel of the individual's family), research, clerical help, or equipment is excludable from gross income provided that such expenses are incident to a scholarship or fellowship grant which is excludable from gross income under section 117(a)(1). If, however, only a portion of a scholarship or fellowship grant is excludable from gross income under section 117(a)(1) because of the part-time employment limitation contained in section 117(b)(1) or because of the expiration of the 36-month period described in section 117(b)(2)(B), only the amount received to cover expenses incident to such excludable portion is excludable from gross income. The requirement that these expenses be incident to the scholarship or the fellowship grant means that the expenses of travel, research, clerical help, or equipment must be incurred by the individual in order to effectuate the purpose for which the scholarship or the fellowship grant was awarded.

(2)(i) In the case of a scholarship or fellowship grant which is awarded after July 28, 1956, the exclusion provided under subparagraph (1) of this paragraph is not applicable unless the amount received by the individual is specifically designated to cover expenses for travel, research, clerical help, or equipment.

(ii) In the case of a scholarship or fellowship grant awarded before July 29, 1956, the exclusion provided under subparagraph (1) of this paragraph is not applicable unless the recipient establishes, by competent evidence, that the amount was received to cover expenses for travel, research, clerical help, or equipment, but such amount need not be specifically designated. The fact that the recipient actually incurred expenses for travel, research, clerical help, or equipment is not sufficient to establish that the amount was received to cover such expenses.

(iii) The exclusion provided under subparagraph (1) of this paragraph is applicable only to the extent that the amount received for travel, research, clerical help, or equipment is actually expended for such expenses by the recipient during the term of the scholarship or fellowship grant and within a reasonable time before and after such term.

(3) The portion of any amount received to cover the expenses described in subparagraph (1) of this paragraph which is not actually expended for such expenses within the exclusion period described in subparagraph (2) of this paragraph shall, if not returned to the grantor within this period, be included in the gross income of the recipient for the taxable year in which such exclusion period expires.

§1.117–2 Limitations.

(a) *Individuals who are candidates for degrees*—(1) *In general.* Under the limitations provided by section 117(b)(1) in the case of an individual who is a candidate for a degree at an educational institution, the exclusion from gross income shall not apply (except as otherwise provided in subparagraph (2) of this paragraph) to that portion of any amount received as payment for teaching, research, or other services in the nature of parttime employment required as a condition to receiving the scholarship or fellowship grant. Payments for such part-time employment shall be included in the gross income of the recipient in an amount determined by reference to the rate of compensation ordinarily paid for similar services performed by an individual who is not the recipient of a scholarship or a fellowship grant. A typical example of employment under this subparagraph is the case of an individual who is required, as a condition to receiving the scholarship or the fellowship grant, to perform part-time teaching services. A requirement that the individual shall furnish periodic reports to the grantor of the scholarship or the fellowship grant for the purpose of keeping the grantor informed as to the general progress of the individual shall not be deemed to constitute the performance of services in the nature of part-time employment.

(2) *Exception.* If teaching, research, or other services are required of all candidates (whether or not recipients of scholarships or fellowship grants) for a particular degree as a condition to receiving the degree, such teaching, research, or other services on the part of the recipient of a scholarship or fellowship grant who is a candidate for such degree shall not be regarded as part-time employment within the meaning of this paragraph. Thus, if all candidates for a particular education degree are required, as part of their regular course of study or curriculum, to perform part-time practice teaching services, such services are not to be regarded as part-time employment within the meaning of this paragraph.

(b) *Individuals who are not candidates for degrees*—(1) *Conditions for exclusion.* In the case of an individual who is not a candidate for a degree at an educational institution, the exclusion from gross income of an amount received as a scholarship or a fellowship grant shall apply (to the extent provided in subparagraph (2) of this paragraph) only if the grantor of the scholarship or fellowship grant is—

(i) An organization described in section 501(c)(3) which is exempt from tax under section 501(a),

(ii) The United States or an instrumentality or agency thereof, or a State, a territory, or a possession of the United States, or any political subdivision thereof, or the District of Columbia, or

(iii) For taxable years beginning after December 31, 1961, a foreign government, an international organization, or a binational or multinational educational and cultural foundation or commission created or continued pursuant to section 103 of the Mutual Educational and Cultural Exchange Act of 1961 (22 U.S.C. 2453).

(2) *Extent of exclusion.* (i) In the case of an individual who is not a candidate for a degree, the amount received as a scholarship or a fellowship grant which is excludable from gross income under section 117(a)(1) shall not exceed an amount equal to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during the taxable year. In determining the number of months during the period for which the recipient received amounts under a scholarship or fellowship grant, computation shall be made on the basis of whole calendar months. A whole calendar month means a period of time terminating with the day of the succeeding month numerically corresponding to the day of the month of its beginning, less one, except that if there be no corresponding day of the succeeding month the period terminates with the last day of the succeeding month. For purposes of this computation a fractional part of a calendar month consisting of a period of time including 15 days or more shall be considered to be a whole calendar month and a fractional part of a calendar month consisting of a period of time including 14 days or less shall be disregarded. For example, if an individual receives a fellowship grant on September 13 which is to expire on June 12 of the following year, the grant shall be considered to have extended for a period of 9 months. If in the preceding example the grant expired on

June 27, instead of June 12, the grant shall be considered to have extended for a period of 10 months.

(ii) No exclusion shall be allowed under section 117(a)(1) to an individual who is not a candidate for a degree after the recipient has, as an individual who is not a candidate for a degree, been entitled to an exclusion under that section for a period of 36 months. This limitation applies if the individual has received any amount which was either excluded or excludable from his gross income under section 117(a)(1) for any prior 36 months, whether or not consecutive. For example, if the individual received a fellowship grant of $7,200 for 3 years (which he elected to receive in 36 monthly installments of $200), his exclusion period would be exhausted even though he did not in any of the 36 months make use of the maximum exclusion. Accordingly, such individual would be entitled to no further exclusion from gross income with respect to any additional grants which he may receive as an individual who is not a candidate for a degree.

(iii) If an individual who is not a candidate for a degree receives amounts from more than one scholarship or fellowship grant during the taxable year, the total amounts received in the taxable year shall be aggregated for the purpose of computing the amount which may be excludable from gross income for such taxable year. If amounts are received from more than one scholarship or fellowship grant during the same month or months within the taxable year, such month or months shall be counted only once for the purpose of determining the number of months for which the individual received such amounts under the scholarships or fellowship grants during the taxable year. For example, if an individual receives a fellowship grant from one source for the months of January to June of the taxable year and also receives a fellowship grant from another source for the months of March through December of the same taxable year, he shall be considered to have received amounts for 12 months of the taxable year. See example (4) in subparagraph (3) of this paragraph for further illustration.

(3) *Examples.* The application of this paragraph may be further illustrated by the following examples, it being assumed that in each example the grantor is a grantor who is described in section 117(b)(2)(A) and subparagraph (1) of this paragraph:

Example (1). B, an individual who files his return on the calendar year basis, is awarded a post-doctorate fellowship grant in March 1955. The grant is to commence on September 1, 1955, and is to end on May 31, 1956, so that it will extend over a period of 9 months. The amount of the fellowship grant is $4,500 and B receives this amount in monthly installments of $500 on the first day of each month commencing September 1, 1955. During the taxable year 1955, B receives a total of $2,000 with respect to the 4-month period September through December, inclusive. He may exclude $1,200 from gross income in the taxable year 1955 ($300×4) and must include the remaining $800 in gross income for that year. For the year 1956, he will exclude $1,500 ($300×5) from gross income with respect to the $2,500 which he receives in that year and must include in gross income $1,000.

Example (2). Assume the same facts as in example (1) except that B receives the full amount of the grant ($4,500) on September 1, 1955. Since the amount received in the taxable year 1955 is for the full term of the fellowship grant (9 months), B may exclude $2,700 ($300×9) from gross income for the taxable year 1955. The remaining $1,800 must be included in gross income for that year.

Example (3). C, an individual who files his return on the calendar year basis, is awarded a post-doctorate fellowship grant in March 1955. The amount of the grant is $4,500 for a period commencing on September 1, 1955, and ending 24 months thereafter. C receives the full amount of the grant on September 1, 1955. C may exclude from gross income for the taxable year 1955, the full amount of the grant ($4,500) since this amount does not exceed an amount equal to $300 times the number of months (24) for which he received the amount of the grant during that taxable year.

Example (4). (i) F, an individual who files his return on the calendar year basis, is awarded a post-doctorate fellowship grant (Grant A) for two years commencing June 1, 1955, in the amount of $4,800. He elects to receive his grant in monthly installments of $200 commencing June 1, 1955. On March 1, 1956, F is awarded another post-doctorate fellowship grant (Grant B) for two years commencing September 1, 1956, in the amount of $7,200. He elects to receive this grant in monthly installments of $300 commencing September 1, 1956.

(ii) For the calendar year 1955, F receives $1,400 from Grant A which he is entitled to exclude from gross income since it does not exceed an amount equal to $300 times the number of months (7) for which he received amounts under the grant in the taxable year.

(iii) For the calendar year 1956, F receives $3,600 as the aggregate of amounts received under fellowship grants ($2,400 from Grant A and $1,200 from Grant B). F will be entitled to exclude the entire amount of $3,600 from gross income for the calendar year 1956 since such amount does not exceed an amount equal to $300 times the number of months (12) for which he received amounts under the grants in the taxable year.

(iv) For the calendar year 1957, F receives $4,600 as the aggregate of amounts received under fellowship grants ($1,000 from Grant A and $3,600 from Grant B). F will be entitled to exclude $3,600 ($300×12) from gross income for the calendar year 1957 and he will have to include $1,000 in gross income.

(v) For the calendar year 1958, F receives $2,400 from Grant B. F is entitled to exclude $1,500 ($300×5) from gross income for the calendar year 1958 and he will have to include $900 in gross income. While F receives amounts under fellowship Grant B for 8 months during the calendar year 1958, he is limited to an amount equal to $300 times 5 (months) because of the fact that he has already been entitled to exclude (and has in fact excluded) amounts received as a fellowship grant for a period of 31 months. Accordingly, he can only exclude amounts received under the fellowship grant for 5 months during the calendar year 1958, because of the 36-month limitation period. The fact that he was entitled to exclude only $1,400 ($200 a month for 7 months) instead of the maximum amount of $2,100 ($300×7) in 1955, is immaterial and the limitation period of 36 months is applicable.

(vi) The following chart illustrates the computation of the number of months for which F received amounts under the fellowship grants during the respective taxable years and the computation of the total amounts received under the fellowship grants during each taxable year:

Period for which received and source	Number of months	Amounts received
1955:		
June 1 to December 31	7	
Grant A		$1,400
Grant B		None
Aggregate	7	1,400
1956:		
January 1 to August 31	8	
Grant A		1,600
Grant B		None
September 1 to December 31	4	
Grant A		800
Grant B		1,200
Aggregate	12	3,600
1957:		
January 1 to May 31	5	
Grant A		1,000
Grant B		1,500
June 1 to December 31	7	
Grant A		None
Grant B		2,100
Aggregate	12	4,600
1958:		
January 1 to August 31	8	
Grant A		None
Grant B		2,400
Aggregate		2,400

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6782, 29 FR 18355, Dec. 24, 1964]

§ 1.117–3 Definitions.

(a) *Scholarship.* A scholarship generally means an amount paid or allowed to, or for the benefit of, a student, whether an undergraduate or a graduate, to aid such individual in pursuing his studies. The term includes the value of contributed services and accommodations (see paragraph (d) of this section) and the amount of tuition, matriculation, and other fees which are furnished or remitted to a student to aid him in pursuing his studies. The term also includes any amount received in the nature of a family allowance as a part of a scholarship. However, the term does not include any amount provided by an individual to aid a relative, friend, or other individual in pursuing his studies where the grantor is motivated by family or philanthropic considerations. If an educational institution maintains or participates in a plan whereby the tuition of a child of a faculty member of such institution is remitted by any other participating educational institution attended by such child, the amount of the tuition so remitted shall be considered to be an amount received as a scholarship.

(b) *Educational organization.* For definition of ‘‘educational organization’’ paragraphs (a) and (b) of section 117 adopt the definition of that term which is prescribed in section 151(e)(4). Accordingly, for purposes of section 117 the term ‘‘educational organization’’ means only an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly organized body of students in attendance at the place where its educational activities are carried on. See section 151(e)(4) and regulations thereunder.

(c) *Fellowship grant.* A fellowship grant generally means an amount paid or allowed to, or for the benefit of, an individual to aid him in the pursuit of study or research. The term includes the value of contributed services and accommodations (see paragraph (d) of this section) and the amount of tuition, matriculation, and other fees which are furnished or remitted to an individual to aid him in the pursuit of study or research. The term also includes any amount received in the nature of a family allowance as a part of a fellowship grant. However, the term does not include any amount provided by an individual to aid a relative, friend, or other individual in the pursuit of study or research where the grantor is motivated by family or philanthropic considerations.

(d) *Contributed services and accommodations.* The term ''contributed services and accommodations'' means such services and accommodations as room, board, laundry service, and similar services or accommodations which are received by an individual as a part of a scholarship or fellowship grant.

(e) *Candidate for a degree.* The term ''candidate for a degree'' means an individual, whether an undergraduate or a graduate, who is pursuing studies or conducting research to meet the requirements for an academic or professional degree conferred by colleges or universities. It is not essential that such study or research be pursued or conducted at an educational institution which confers such degrees if the purpose thereof is to meet the requirements for a degree of a college or university which does confer such degrees. A student who receives a scholarship for study at a secondary school or other educational institution is considered to be a ''candidate for a degree.''

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 8032, 50 FR 27232, July 2, 1985]

§1.117–4 Items not considered as scholarships or fellowship grants.

The following payments or allowances shall not be considered to be amounts received as a scholarship or a fellowship grant for the purpose of section 117:

(a) *Educational and training allowances to veterans.* Educational and training allowances to a veteran pursuant to section 400 of the Servicemen's Readjustment Act of 1944 (58 Stat. 287) or pursuant to 38 U.S.C. 1631 (formerly section 231 of the Veterans' Readjustment Assistance Act of 1952).

(b) *Allowances to members of the Armed Forces of the United States.* Tuition and subsistence allowances to members of the Armed Forces of the United States who are students at an educational institution operated by the United States or approved by the United States for their education and training, such as the United States Naval Academy and the United States Military Academy.

(c) *Amounts paid as compensation for services or primarily for the benefit of the grantor.* (1) Except as provided in paragraph (a) of §§1.117–2 and 1.117–5, any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research, if such amount represents either compensation for past, present, or future employment services or represents payment for services which are subject to the direction or supervision of the grantor.

(2) Any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research primarily for the benefit of the grantor.

However, amounts paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research are considered to be amounts received as a scholarship or fellowship grant for the purpose of section 117 if the primary purpose of the studies or research is to further the education and training of the recipient in his individual capacity and the amount provided by the grantor for such purpose does not represent compensation or payment for the services described in subparagraph (1) of this paragraph. Neither the fact that the recipient is required to furnish reports of his progress to the grantor, nor the fact that the results of his studies or research may be of some incidental benefits to the grantor shall, of itself, be considered to destroy the essential character of such amount as a scholarship or fellowship grant.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 8032, 50 FR 27232, July 2, 1985]

§ 1.117–5 Federal grants requiring future service as a Federal employee.

(a) *In general.* Under section 117(c), amounts received by an individual under a Federal program as a scholarship or grant for qualified tuition and expenses at an institution of higher education are excluded from the gross income of the recipient even though the recipient is required to perform future service as a Federal employee. See paragraph (c) of this section for the definitions of the terms ''qualified tuition and expenses'' and ''institution of higher education.''

(b) *Exception for uniformed services scholarship programs.* The requirements of this section do not apply to amounts received before 1985 by a member of a uniformed service who entered training before 1981 under the Armed Forces Health Professions Scholarship Program, National Public Health Service Corps Scholarship Training Program, or other substantially similar Federal programs requiring the recipient to work for a uniformed Federal service after completion of studies. These awards are governed by section 4 of Pub. L. 93–483 as amended by Pub. L. 95–171, Pub. L. 95–600 and Pub. L. 96–167. See section 101(3) of title 37, United States Code for the definition of the term ''uniformed service.''

(c) *Definitions*—(1) *Qualified tuition and related expenses.* For purposes of section 117(c) and this section, qualified tuition and related expenses are those amounts which under the terms of the Federal program are required to be used and in fact are used for payment of:

(i) Tuition and fees that are required for the recipient's enrollment or attendance at an institution of higher education; and

(ii) Those amounts used for payment of fees, books, supplies and equipment required for courses of instruction at such an institution.

Incidental expenses are not considered related expenses and thus are not excludable from gross income under section 117(c). Incidental expenses include room and board at an institution of higher education, expenses for travel (including expenses for meals and lodging incurred during travel and allowances for travel of the recipient's family), research, clerical help, equipment and other expenses which are not required for enrollment at the institution or in a course of instruction at such institution.

(2) *Institution of higher education.* To qualify as an institution of higher education under this section, the institution must be a public or other nonprofit institution in any state which—

(i) Admits as regular students only individuals who have a certificate of graduation from a high school or the recognized equivalent of such a certificate;

(ii) Is legally authorized within the state to provide a program of education beyond high school; and

(iii) Provides an education program for which it awards a bachelor's or higher degree or which is acceptable for full credit towards such a degree, or which trains and prepares students for gainful employment in a recognized health profession. For purposes of this section, recognized health professions are those health professions which are supervised or monitored by appropriate state or Federal agencies or governing professional associations and which require members to be currently licensed or certified in order to practice.

(3) *Service as a Federal employee*—(i) *In general.* Except as otherwise provided in paragraph (c)(3)(ii) of this section, service as a Federal employee refers to employment of the recipient by the Federal government to work directly for the Federal government. Thus, Federal grants or scholarships which do not require the recipient to work directly for the Federal government are not governed by the rules of this section.

(ii) *Service in a health manpower shortage area.* For purposes of this section an obligation under a grant for the recipient to serve in a health related field in a health manpower shortage area as designated by the Secretary of Health and Human Services according to the criteria of the Public Health Services Act (42 U.S.C. 254(e)) and the regulations promulgated thereunder (42 CFR 5.1–5.4) will be considered an obligation to serve as a Federal employee.

(d) *Records required for exclusion from gross income.* To exclude amounts received under Federal programs requiring future services as a Federal employee, the recipient must maintain records that establish that the amounts received under such programs were used for qualified tuition and related expenses as defined in paragraph (c)(1) of this section. Qualifying uses may be established by providing to the Service, upon request, copies of relevant bills, receipts, cancelled checks or other convenient documentation or records which clearly reflect the use of the money received under the grant. The recipient must also submit, upon request, documentation establishing receipt of the grant and setting out the terms and requirements of the particular grant.

(e) *Applicability of rules of §§117(a) and 117(b).* Except where a different rule has been expressly provided in this section, amounts received under Federal grants requiring future service as a Federal employee, and which meet the requirements for exclusion from gross income under this section, are subject to the rules, limitations and definitions specified in §§117 (a) and (b) of the Code and §§1.117–1 through 1.117–4.

(f) *Effective date.* Except as provided in paragraph (b) of this section, this section will apply to amounts received after December 31, 1980 under Federal programs which meet the requirements of this section.

[T.D. 8032, 50 FR 27232, July 2, 1985]

§1.118–1 Contributions to the capital of a corporation.

In the case of a corporation, section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. Section 118 also applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production. See section 362 for the basis of property acquired by a corporation through a contribution to its capital by its stockholders or by nonstockholders.

§1.119–1 Meals and lodging furnished for the convenience of the employer.

(a) *Meals*—(1) *In general.* The value of meals furnished to an employee by his employer shall be excluded from the employee's gross income if two tests are met: (i) The meals are furnished on the business premises of the employer, and (ii) the meals are furnished for the convenience of the employer. The question of whether meals are furnished for the convenience of the employer is one of fact to be determined by analysis of all the facts and circumstances in each case. If the tests described in subdivisions (i) and (ii) of this subparagraph are met, the exclusion shall apply irrespective of whether under an employment contract or a statute fixing the terms of employment such meals are furnished as compensation.

(2) *Meals furnished without a charge.* (i) Meals furnished by an employer without charge to the employee will be regarded as furnished for the convenience of the employer if such meals are furnished for a substantial noncompensatory business reason of the employer. If an employer furnishes meals as a

means of providing additional compensation to his employee (and not for a substantial noncompensatory business reason of the employer), the meals so furnished will not be regarded as furnished for the convenience of the employer. Conversely, if the employer furnishes meals to his employee for a substantial noncompensatory business reason, the meals so furnished will be regarded as furnished for the convenience of the employer, even though such meals are also furnished for a compensatory reason. In determining the reason of an employer for furnishing meals, the mere declaration that meals are furnished for a noncompensatory business reason is not sufficient to prove that meals are furnished for the convenience of the employer, but such determination will be based upon an examination of all the surrounding facts and circumstances. In subdivision (ii) of this subparagraph, there are set forth some of the substantial noncompensatory business reasons which occur frequently and which justify the conclusion that meals furnished for such a reason are furnished for the convenience of the employer. In subdivision (iii) of this subparagraph, there are set forth some of the business reasons which are considered to be compensatory and which, in the absence of a substantial noncompensatory business reason, justify the conclusion that meals furnished for such a reason are not furnished for the convenience of the employer. Generally, meals furnished before or after the working hours of the employee will not be regarded as furnished for the convenience of the employer, but see subdivision (ii) *(d)* and *(f)* of this subparagraph for some exceptions to this general rule. Meals furnished on nonworking days do not qualify for the exclusion under section 119. If the employee is required to occupy living quarters on the business premises of his employer as a condition of his employment (as defined in paragraph (b) of this section), the exclusion applies to the value of any meal furnished without charge to the employee on such premises.

(ii)*(a)* Meals will be regarded as furnished for a substantial noncompensatory business reason of the employer when the meals are furnished to the employee during his working hours to have the employee available for emergency call during his meal period. In order to demonstrate that meals are furnished to the employee to have the employee available for emergency call during the meal period, it must be shown that emergencies have actually occurred, or can reasonably be expected to occur, in the employer's business which have resulted, or will result, in the employer calling on the employee to perform his job during his meal period.

(b) Meals will be regarded as furnished for a substantial noncompensatory business reason of the employer when the meals are furnished to the employee during his working hours because the employer's business is such that the employee must be restricted to a short meal period, such as 30 or 45 minutes, and because the employee could not be expected to eat elsewhere in such a short meal period. For example, meals may qualify under this subdivision when the employer is engaged in a business in which the peak work load occurs during the normal lunch hours. However, meals cannot qualify under this subdivision *(b)* when the reason for restricting the time of the meal period is so that the employee can be let off earlier in the day.

(c) Meals will be regarded as furnished for a substantial noncompensatory business reason of the employer when the meals are furnished to the employee during his working hours because the employee could not otherwise secure proper meals within a reasonable meal period. For example, meals may qualify under this subdivision *(c)* when there are insufficient eating facilities in the vicinity of the employer's premises.

(d) A meal furnished to a restaurant employee or other food service employee for each meal period in which the employee works will be regarded as furnished for a substantial noncompensatory business reason of the employer, irrespective of whether the meal is furnished during, immediately before, or immediately after the working hours of the employee.

(e) If the employer furnishes meals to employees at a place of business and

the reason for furnishing the meals to each of substantially all of the employees who are furnished the meals is a substantial noncompensatory business reason of the employer, the meals furnished to each other employee will also be regarded as furnished for a substantial noncompensatory business reason of the employer.

(f) If an employer would have furnished a meal to an employee during his working hours for a substantial noncompensatory business reason, a meal furnished to such an employee immediately after his working hours because his duties prevented him from obtaining a meal during his working hours will be regarded as furnished for a substantial noncompensatory business reason.

(iii) Meals will be regarded as furnished for a compensatory business reason of the employer when the meals are furnished to the employee to promote the morale or goodwill of the employee, or to attract prospective employees.

(3) *Meals furnished with a charge.* (i) If an employer provides meals which an employee may or may not purchase, the meals will not be regarded as furnished for the convenience of the employer. Thus, meals for which a charge is made by the employer will not be regarded as furnished for the convenience of the employer if the employee has a choice of accepting the meals and paying for them or of not paying for them and providing his meals in another manner.

(ii) If an employer furnishes an employee meals for which the employee is charged an unvarying amount (for example, by subtraction from his stated compensation) irrespective of whether he accepts the meals, the amount of such flat charge made by the employer for such meals is not, as such, part of the compensation includible in the gross income of the employee; whether the value of the meals so furnished is excludable under section 119 is determined by applying the rules of subparagraph (2) of this paragraph. If meals furnished for an unvarying amount are not furnished for the convenience of the employer in accordance with the rules of subparagraph (2) of this paragraph, the employee shall include in gross income the value of the meals regardless of whether the value exceeds or is less than the amount charged for such meals. In the absence of evidence to the contrary, the value of the meals may be deemed to be equal to the amount charged for them.

(b) *Lodging.* The value of lodging furnished to an employee by the employer shall be excluded from the employee's gross income if three tests are met:

(1) The lodging is furnished on the business premises of the employer,

(2) The lodging is furnished for the convenience of the employer, and

(3) The employee is required to accept such lodging as a condition of his employment.

The requirement of subparagraph (3) of this paragraph that the employee is required to accept such lodging as a condition of his employment means that he be required to accept the lodging in order to enable him properly to perform the duties of his employment. Lodging will be regarded as furnished to enable the employee properly to perform the duties of his employment when, for example, the lodging is furnished because the employee is required to be available for duty at all times or because the employee could not perform the services required of him unless he is furnished such lodging. If the tests described in subparagraphs (1), (2), and (3) of this paragraph are met, the exclusion shall apply irrespective of whether a charge is made, or whether, under an employment contract or statute fixing the terms of employment, such lodging is furnished as compensation. If the employer furnishes the employee lodging for which the employee is charged an unvarying amount irrespective of whether he accepts the lodging, the amount of the charge made by the employer for such lodging is not, as such, part of the compensation includible in the gross income of the employee; whether the value of the lodging is excludable from gross income under section 119 is determined by applying the other rules of this paragraph. If the tests described in subparagraph (1), (2), and (3) of this paragraph are not met, the employee shall include in gross income the value of the lodging regardless of whether it exceeds or is less than the amount charged. In the absence of evidence to the contrary, the value of the lodging may be deemed to be equal to the amount charged.

(c) *Business premises of the employer*—(1) *In general.* For purposes of this section, the term ''business premises of the employer'' generally means the place of employment of the employee. For example, meals and lodging furnished in the employer's home to a domestic servant would constitute meals and lodging furnished on the business premises of the employer. Similarly, meals furnished to cowhands while herding their employer's cattle on leased land would be regarded as furnished on the business premises of the employer.

(2) *Certain camps.* For taxable years beginning after December 31, 1981, in the case of an individual who is furnished lodging by or on behalf of his employer in a camp (as defined in paragraph (d) of this section) in a foreign country (as defined in § 1.911–2(h)), the camp shall be considered to be part of the business premises of the employer.

(d) *Camp defined*—(1) *In general.* For the purposes of paragraph (c)(2) of this section, a camp is lodging that is all of the following:

(i) Provided by or on behalf of the employer for the convenience of the employer because the place at which the employee renders services is in a remote area where satisfactory housing is not available to the employee on the open market within a reasonable commuting distance of that place;

(ii) Located, as near as practicable, in the vicinity of the place at which the employee renders services; and

(iii) Furnished in a common area or enclave which is not available to the general public for lodging or accommodations and which normally accommodates ten or more employees.

(2) *Satisfactory housing.* For purposes of paragraph (d)(1)(i) of this section, facts and circumstances that may be relevant in determining whether housing available to the employee is satisfactory include, but are not limited to, the size and condition of living space and the availability and quality of utilities such as water, sewers or other waste disposal facilities, electricity, or heat. The general environment in which housing is located (*e.g.* climate, prevalence of insects, etc.) does not of itself make housing unsatisfactory. The general environment is relevant, however, if housing is inadequate to protect the occupants from environmental conditions. The individual employee's income level is not relevant in determining whether housing is satisfactory; it may, however, be relevant in determining whether satisfactory housing is available to the employee (see paragraph (d)(3)(i)(B) of this section).

(3) *Availability of satisfactory housing*—(i) *Facts and circumstances.* For purposes of paragraph (d)(1)(i) of this section, facts and circumstances to be considered in determining whether satisfactory housing is available to the employee on the open market include but are not limited to:

(A) The number of housing units available on the open market in relation to the number of housing units required for the employer's employees;

(B) The cost of housing available on the open market;

(C) The quality of housing available on the open market; and

(D) The presence of warfare or civil insurrection within the area where housing would be available which would subject U.S. citizens to unusual risk of personal harm or property loss.

(ii) *Presumptions.* Satisfactory housing will generally be considered to be unavailable to the employee on the open market if either of the following conditions is satisfied:

(A) The foreign government requires the employer to provide housing for its employees other than housing available on the open market; or

(B) An unrelated person awarding work to the employer requires that the employer's employees occupy housing specified by such unrelated person.

The condition of either paragraph (d)(3)(ii) (A) or (B) of this section is not satisfied if the requirement described therein and imposed either by a foreign government or unrelated person applies primarily to U.S. employers and not to a significant number of third country employers or applies primarily to employers of U.S. employees and not to a significant number of employers of third country employees.

(4) *Reasonable commuting distance.* For purposes of paragraph (d)(1)(i) of this section, in determining whether a commuting distance is reasonable, the accessibility of the place at which the employee renders services due to geographic factors, the quality of the roads, the customarily available transportation, and the usual travel time (at the time of day such travel would be required) to the place at which the employee renders services shall be taken into account.

(5) *Common area or enclave.* A cluster of housing units does not satisfy paragraph (d)(1)(iii) of this section if it is adjacent to or surrounded by substantially similar housing available to the general public. Two or more common areas or enclaves that house employees who work on the same project (for example, a highway project) are considered to be one common area or enclave in determining whether they normally accommodate ten or more employees.

(e) *Rules.* The exclusion provided by section 119 applies only to meals and lodging furnished in kind by or on behalf of an employer to his employee. If the employee has an option to receive additional compensation in lieu of meals or lodging in kind, the value of such meals and lodging is not excludable from gross income under section 119. However, the mere fact that an employee, at his option, may decline to accept meals tendered in kind will not of itself require inclusion of the value thereof in gross income. Cash allowances for meals or lodging received by an employee are includible in gross income to the extent that such allowances constitute compensation.

(f) *Examples.* The provisions of section 119 may be illustrated by the following examples:

Example (1). A waitress who works from 7 a.m. to 4 p.m. is furnished without charge two meals a work day. The employer encourages the waitress to have her breakfast on his business premises before starting work, but does not require her to have breakfast there. She is required, however, to have her lunch on such premises. Since the waitress is a food service employee and works during the normal breakfast and lunch periods, the waitress is permitted to exclude from her gross income both the value of the breakfast and the value of the lunch.

Example (2). The waitress in example (1) is allowed to have meals on the employer's premises without charge on her days off. The waitress is not permitted to exclude the value of such meals from her gross income.

Example (3). A bank teller who works from 9 a.m. to 5 p.m. is furnished his lunch without charge in a cafeteria which the bank maintains on its premises. The bank furnishes the teller such meals in order to limit his lunch period to 30 minutes since the bank's peak work load occurs during the normal lunch period. If the teller had to obtain his lunch elsewhere, it would take him considerably longer than 30 minutes for lunch, and the bank strictly enforces the 30-minute time limit. The bank teller may exclude from his gross income the value of such meals obtained in the bank cafeteria.

Example (4). Assume the same facts as in example (3), except that the bank charges the bank teller an unvarying rate per meal regardless of whether he eats in the cafeteria. The bank teller is not required to include in gross income such flat amount charged as part of his compensation, and he is entitled to exclude from his gross income the value of the meals he receives for such flat charge.

Example (5). A Civil Service employee of a State is employed at an institution and is required by his employer to be available for duty at all times. The employer furnishes the employee with meals and lodging at the institution without charge. Under the applicable State statute, his meals and lodging are regarded as part of the employee's compensation. The employee would nevertheless be entitled to exclude the value of such meals and lodging from his gross income.

Example (6). An employee of an institution is given the choice of residing at the institution free of charge, or of residing elsewhere and receiving a cash allowance in addition to his regular salary. If he elects to reside at the institution, the value to the employee of the lodging furnished by the employer will be includible in the employee's gross income because his residence at the institution is not required in order for him to perform properly the duties of his employment.

Example (7). A construction worker is employed at a construction project at a remote job site in Alaska. Due to the inaccessibility of facilities for the employees who are working at the job site to obtain food and lodging and the prevailing weather conditions, the employer is required to furnish meals and lodging to the employee at the camp site in order to carry on the construction project. The employee is required to pay $40 a week for the meals and lodging. The weekly charge of $40 is not, as such, part of the compensation includible in the gross income of the employee, and under paragraphs (a) and (b) of this section the value of the meals and lodging is excludable from his gross income.

Example (8). A manufacturing company provides a cafeteria on its premises at which its employees can purchase their lunch. There is no other eating facility located near the company's premises, but the employee can furnish his own meal by bringing his lunch. The amount of compensation which any employee is required to include in gross income is not reduced by the amount charged for the meals, and the meals are not considered to be furnished for the convenience of the employer.

Example (9). A hospital maintains a cafeteria on its premises where all of its 230 employees may obtain a meal during their working hours. No charge is made for these meals. The hospital furnishes such meals in order to have each of 210 of the employees available for any emergencies that may occur, and it is shown that each such employee is at times called upon to perform services during his meal period. Although the hospital does not require such employees to remain on the premises during meal periods, they rarely leave the hospital during their meal period. Since the hospital furnishes meals to each of substantially all of its employees in order to have each of them available for emergency call during his meal period, all of the hospital employees who obtain their meals in the hospital cafeteria may exclude from their gross income the value of such meals.

[T.D. 6745, 29 FR 9380, July 9, 1964, as amended by T.D. 8006, 50 FR 2964, Jan. 23, 1985]

§ 1.120–1 Statutory subsistence allowance received by police.

(a) Section 120 excludes from the gross income of an individual employed as a police official by a State, Territory, or possession of the United States, by any of their political subdivisions, or by the District of Columbia, any amount received as a statutory subsistence allowance to the extent that such allowance does not exceed $5 per day. For purposes of this section, the term ''statutory subsistence allowance'' means an amount which is designated as a subsistence allowance under the laws of a State, a Territory, or a possession of the United States, any political subdivision of any of the foregoing, or the District of Columbia and which is paid to an individual who is employed as a police official of such governmental unit. A subsistence allowance paid to a police official by any of the foregoing governmental units which is not so provided by statute may not be excluded from gross income under the provisions of section 120. The term ''police official'' includes an employee of any of the foregoing governmental units who has police duties, such as a sheriff, a detective, a policeman, or a State police trooper, however designated.

(b) The exclusion provided by section 120 is to be computed on a daily basis, that is, for each day for which the statutory allowance is paid. If the statute providing the allowance does not specify the daily amount of such allowance, the allowance shall be converted to a daily basis for the purpose of applying the limitation provided herein. For example, if a State statute provides for a weekly subsistence allowance, the daily amount is to be determined by dividing the weekly amount by the number of days for which the allowance is paid. Thus, if a State trooper receives a weekly statutory subsistence allowance of $40 would be $8, that is, $40 divided by 5 for 5 days of the week, the daily amount would be $8, that is, $40 divided by 5. However, for purposes of this section, only $5 per day may be excluded, or $25 on a weekly basis.

(c) Expenses in respect of which the allowance under section 120 is paid may not be deducted under any provision of the income tax laws except to the extent that (1) such expenses exceed the amount of the exclusion, and (2) the excess is otherwise allowable as a deduction. For example, if a State statute provides a subsistence allowance of $3 per day and the taxpayer, a state trooper, incurs expenditures of $4.50 for meals while away from home overnight on official police duties only $3 would be excludable under this section. Expenses relating to such exclusion ($3) may not be deducted under any provision of the income tax laws. However, the remaining $1.50 may be an allowable deduction under section 162 as traveling expenses while away from home in the performance of official duties. See § 1.162–2.

(d) In the case of taxable years ending after September 30, 1958, section 120 and this section do not apply to amounts received as a statutory subsistence allowance for any day after September 30, 1958.

§1.120–3 Notice of application for recognition of status of qualified group legal services plan.

(a) *In general.* In order for a plan to be a qualified group legal services plan for purposes of the exclusion from gross income provided by section 120(a), the plan must give notice to the Internal Revenue Service that it is applying for recognition of its status as a qualified plan. Paragraph (b) of this section describes how the notice is to be filed for the plan. Paragraph (c) of this section describes the action that the Internal Revenue Service will take in response to the notice submitted for the plan. Paragraph (d) of this section describes the period of plan qualification.

(b) *Filing of notice*—(1) *In general.* A notice of application for recognition of the status of a qualified group legal services plan must be filed with the key district director of internal revenue as described in §601.201(n). The notice must be filed on Form 1024, Application for Recognition of Exemption Under section 501(a) or for Determination Under section 120, with the accompanying Schedule L, and must contain the information required by the form and any accompanying instructions. The form may be filed by either the employer adopting the plan or the person administering the plan. No Form 1024 and Schedule L may be filed for a plan before an employer adopts the plan, or proposes to adopt the plan contingent only upon the recognition of the plan as a qualified plan.

(2) *Plans to which more than one employer contributes.* In general, for purposes of section 120 the adoption of a plan by an employer constitutes the adoption of a separate plan to which that employer alone contributes, notwithstanding that, in form, the employer purports to adopt a plan with respect to which the employer is one of two or more contributing employers. Accordingly, a separate Schedule L must be filed pursuant to the instructions accompanying Form 1024 for each employer adopting a plan.

(3) *Certain collectively bargained plans.* Notwithstanding subparagraph (2) of this paragraph, if a plan to which more than one employer contributes is a plan to which this subparagraph (3) applies, the plan is treated as a single plan for purposes of section 120. Accordingly, only one Form 1024 and Schedule L is required to be filed for the plan, regardless of the number of employers originally adopting the plan. In addition, once a Form 1024 and Schedule L is filed, no additional filing is required with respect to an employer who thereafter adopts the plan. In general, this subparagraph (3) applies to any plan that is maintained pursuant to a collective bargaining agreement between employee representatives and more than one employer who is required by the plan instrument or other agreement to contribute to the plan with respect to employees (or their spouses or dependents) participating in the plan. This subparagraph does not apply, however, if all employers required to contribute to the plan are corporations which are members of a controlled group of corporations within the meaning of section 1563(a), determined without regard to section 1563(e)(3)(C). If all employers required to contribute to the plan are corporations which are members of such a controlled group, the filing requirements described in subparagraph (2) of this paragraph apply, notwithstanding that the plan is maintained pursuant to a collective bargaining agreement.

(c) *Internal Revenue Service action on notice of application for recognition.* The Internal Revenue Service will issue to the person submitting Form 1024 and Schedule L a ruling or determination letter stating that the plan is or is not a qualified group legal services plan. For general procedural rules, see §601.201 (a) through (n), as that section relates to rulings and determination letters.

(d) *Period of plan qualification*—(1) *In general.* In the case of a favorable determination, the plan will be considered a qualified group legal services plan. If a Form 1024 and Schedule L required to be filed by or on behalf of an employer is filed before—

(i) The end of the first plan year (as determined under the plan),

(ii) The end of the plan year within which the employer adopts the plan, or

(iii) July 29, 1980,

the period of plan qualification with respect to the employer will begin on the date the plan is adopted by the employer (or, if later, January 1, 1977). If the form and schedule are not filed before the latest of the dates described in subdivisions (i), (ii) and (iii), the period of plan qualification with respect to the employer will begin on the date of filing. In any case in which either the Form 1024 or Schedule L filed by or on behalf of an employer is incomplete, the date of filing is the date on which the incomplete form or schedule is filed, if the necessary additional information is provided at the request of the Commissioner within the additional time period allowed by the Commissioner. If the additional information is not provided within the additional time period, allowed, the date of filing is the date on which the additional information is filed. If no separate Form 1024 and Schedule L are required to be filed by or on behalf of an employer (see paragraph (b)(3) of this section), the period of plan qualification with respect to the employer will begin on the date the plan is adopted by the employer (or, if later, January 1, 1977). In any case in which a plan is materially modified to conform to the requirements of section 120, either before or after a Form 1024 and Schedule L are filed, the period of plan qualification will not include any period before the effective date of the modification.

(2) *Plans in existence on June 4, 1976.* (i) Notwithstanding paragraph (d)(1) of this section, a written group legal services plan providing for employer contributions which was in existence on June 4, 1976, will be considered a qualified group legal services plan for the period January 1, 1977, through April 2, 1977. However, if the plan is maintained pursuant to one or more agreements which were in effect on October 4, 1976, and which the Secretary of Labor finds to be collective bargaining agreements, the period of deemed qualification will extend beyond April 2, 1977, and end on the date on which the last of the collective bargaining agreements relating to the plan terminates. Extensions of a bargaining agreement which are agreed to after October 4, 1976, are to be disregarded. The period of deemed qualification for a plan maintained pursuant to a collective bargaining agreement will not, however, extend beyond December 31, 1981.

(ii) A written group legal services plan will be considered to have been in existence on June 4, 1976, if on or before that date the plan was reduced to writing and adopted by one or more employers. No amounts need have been contributed under the plan as of June 4, 1976.

(iii) Notwithstanding that a plan is a qualified plan for the period of deemed qualification described in this paragraph (d)(2), the rules of paragraphs (c) and (d)(1) of this section still apply with respect to a Form 1024 and Schedule L filed for the plan. For example, if a Form 1024 and Schedule L filed by or on behalf of an employer are filed before the latest of the 3 dates described in paragraph (d)(1) of this section, in the case of a favorable determination the plan will be a qualified plan from the date the plan is adopted by the employer (or, if later, January 1, 1977), and any period of deemed qualification and the period of qualification based upon the favorable determination will overlap. However, in the case of a plan to which this paragraph (d)(2) applies, if a Form 1024 and Schedule L required to be filed by or on behalf of an employer is not filed before the latest of the 3 dates described in paragraph (d)(1) of this section, the following rules shall apply. In general, if Form 1024 and Schedule L are filed before the end of the plan year following the plan year with or within which the plan's period of deemed qualification expires, in the event of a favorable determination the plan will be a qualified plan with respect to the employer beginning on the earlier of the day following the date on which the period of deemed qualification expires or the date on which the Form 1024 and Schedule L are filed. The period of plan qualification with respect to an employer cannot, however, include any period before the employer adopts the plan. If the Form 1024 and Schedule L are not filed before the end of the plan year following the plan year with or within which the plan's period of deemed qualification expires, in the case of a favorable determination the plan will be a qualified plan with respect to an employer from the later of the date of filing or adoption of the plan by the employer. The rules described in paragraph (d)(1) of this section relating to incomplete filings and plan modifications apply with respect to a filing described in this paragraph (d)(2).

(e) *Effective date.* This section is effective for notices of application for recognition of the status of a qualified group legal services plan filed after May 29, 1980.

(Secs. 120(c)(4) and 7805 of the Internal Revenue Code of 1954, 90 Stat. 1926, 68A Stat. 917; (26 U.S.C. 120(c)(4), 7805))

[T.D. 7696, 45 FR 28320, Apr. 29, 1980]

§1.121–1 Gain from sale or exchange of residence of individual who has attained age 55.

(a) *General rule.* Section 121(a) provides that a taxpayer may, under certain circumstances, elect to exclude from gross income gain realized on the sale or exchange of property which was the taxpayer's principal residence. Subject to the other provisions of section 121 and the regulations thereunder, the election may be made only if—

(1) The taxpayer attained the age of 55 before the date of the sale or exchange of the taxpayer's principal residence, and

(2) Except as provided in paragraph (b) of this section, during the 5-year period ending on the date of the sale or exchange of the property the taxpayer owned and used the property as the taxpayer's principal residence for periods aggregating 3 years or more.

(b) *Transitional rule.* In the case of a sale or exchange of a residence before July 26, 1981, a taxpayer who has attained age 65 on the date of such sale or exchange may elect to have this section applied by substituting ''8-year period'' for ''5-year period'' and ''5 years'' for ''3 years'' in paragraph (a) of this section and where appropriate in §§1.121–4 and 1.121–5.

(c) *Ownership and use.* The requirements of ownership and use for periods aggregating 3 years or more may be satisfied by establishing ownership and use for 36 full months (or 60 full months if the transitional rule is elected) or for 1,095 days (365×3) (or 1,825 days if the transitional rule is elected). In establishing whether a taxpayer has satisfied the requirement of three years of use, short temporary absences such as for vacation or other seasonal absence (although accompanied with rental of the residence) are counted as periods of use.

(d) *Examples.* The provisions of paragraph (a) are illustrated by the following examples:

Example (1). Taxpayer A owned and used his house as his principal residence since 1966. On January 1, 1980, when he is over 55, A retires and moves to another state with his wife. A leases his house from then until September 30, 1981, when he sells it. A may make an election under section 121(a) with respect to any gain on such sale since he has owned and used the house as his principal residence for 3 years out of the 5 years preceding the sale.

Example (2). Taxpayer B purchased his house in 1971 when he was 65 and lived there with his wife. On July 1, 1977, he moved out and leased the house to a tenant. On September 15, 1979, he sold the house. Although he does not meet the use requirements of section 1.121–1(a), he may elect to use the transitional rule in section 1.121–1(b), since the sale was made before July 26, 1981. Because he owned and used the house as his principal residence for 5 out of the 8 years preceding the sale, under the transitional rule he may elect the section 121 exclusion.

Example (3). Taxpayer C lived with his son and daughter-in-law in a house owned by his son from 1973 through 1979. On January 1, 1980, he purchased this house and on July 31, 1982 , he sold it. Although B used the property as his principal residence for more than 3 years, he is not entitled to make an election under section 121(a) in respect of such sale since he did not own the residence for a period aggregating 3 years during the 5 year period ending on the date of the sale.

Example (4). Taxpayer D, a college professor, purchased and moved into a house on January 1, 1980. He used the house as his principal residence continuously to February 1, 1982, on which date he went abroad for a 1-year sabbatical leave. During a portion of the period of leave the property was unoccupied and it was leased during the balance of the period. On March 1, 1983, 1 month after returning from such leave, he sold the house. Since his leave is not considered to be a short temporary absence for purposes of section 121(a), the period of such leave may not be included in determining whether D used the house as his principal residence for periods aggregating 3 years during the 5 year period ending on the date of the sale. Thus, D is not entitled to make an election under section 121(a) since he did not use the residence for the requisite period.

Example (5). Assume the same facts as in example (1) except that during the three summers from 1977 through 1979, A left his residence for a 2-month vacation each year. Although, in the 5 year period preceding the date of sale, the total time spent away from his residence on such vacations (6 months) plus the time spent away from such residence from January 1, 1980, to September 30, 1981 (21 months) exceeds 2 years, he may make an election under section 121(a) since the 2-month vacations are counted as periods of use in determining whether A used the residence for the requisite period.

[T.D. 7614, 44 FR 24839, Apr. 27, 1979]

§ 1.121–2 Limitations.

(a) *Dollar limitation*—(1) *Amount excludable.* Under section 121(a), an individual may exclude from gross income up to $100,000 of gain from the sale of his or her principal residence ($50,000 in the case of a separate return by a married individual).

(2) *Example.* The provisions of this paragraph are illustrated by the following example:

Example. Assume that A sells his principal residence for $160,800, that the amount realized is $160,400 (selling price reduced by selling expenses, described in paragraph (b)(4)(i) of § 1.1034–1, of $400); and that A's gain realized from the sale is $107,900 (amount realized reduced by adjusted basis of $52,500). The portion of the gain which is taxable is $7,900 ($107,900) − ($100,000). Thus $100,000 is the portion of the gain excludable from gross income pursuant to an election under section 121(a).

(b) *Application to only one sale or exchange.* (1) Except as provided in paragraph (c), a taxpayer may not make an election to exclude from gross income gain from the sale or exchange or a principal residence if there is in effect at the time the taxpayer wishes to make such election—

(i) An election made by the taxpayer, under section 121(a), in respect of any other sale or exchange of a residence, or

(ii) An election made by the taxpayer's spouse (such marital status to be determined at the time of the sale or exchange by the taxpayer, see paragraph (f) of § 1.121–5) under the provisions of section 121(a) in respect of any other sale or exchange of a residence (without regard to whether at the time of such sale or exchange such spouse was married to the taxpayer).

If the taxpayer and his spouse, before their marriage each owned and used a separate residence and if (after their marriage) both residences are sold, whether or not in a single transaction, an election under section 121(a) may be made with respect to a sale of either residence (but not with respect to both residences) if, at the time of sale, the age, ownership, and use requirements are met.

(2) The provisions of this paragraph are illustrated by the following examples:

Example (1). While A and B are married, A sells his separately owned residence and makes an election under section 121(a) in respect of such sale. Pursuant to the requirement of section 121(c), B joins in such election. Subsequently, A and B are divorced and B married C. While B and C are married, C sells his residence. C is not entitled to make an election under section 121(a) since an election by B, his spouse, is in effect. It does not matter that B obtained no personal benefit from her election.

Example (2). The facts are the same as in example (1) except that after the sale of C's residence, A and B, pursuant to the provisions of paragraph (c) of § 1.121–4, revoke their election. B and C, subject to the other provisions of this section, may then make an election with respect to any gain realized on the sale of C's residence.

Example (3). The facts are the same as in example (1) except that C marries B after C sells his residence but before he makes an election under section 121(a) with respect to any gain realized on such sale. C, if there is not in effect an election made by him under section 121(a) with respect to a prior sale, may make an election with respect to his sale since B does not have to join with him in such election. (In the case of a sale of property jointly held by husband and wife, see paragraph (a) of § 1.121–5.)

(c) *Additional election if prior sale was made on or before July 26, 1978.* In the case of any sale or exchange after July 26, 1978, section 121 shall be applied by not taking into account any election made with respect to a sale or exchange on or before such date.

[T.D. 7614, 44 FR 24840, Apr. 27, 1979]

§ 1.121–3 Definitions.

(a) *Principal residence.* The term ''principal residence'' has the same meaning as in section 1034 (relating to sale or exchange of residence) and the regulations thereunder (see paragraph (c) (3) of §1.1034–1).

(b) *Sale or exchange.* A ''sale or exchange'' of a residence includes the destruction, theft, seizure, requisition, or condemnation of such residence.

(c) *Gain realized.* The term ''gain realized'' has the same meaning as in paragraph (b)(5) of §1.1034–1 (determined without regard to section 121(d) (7) and paragraph (g) of §1.121–5).

[T.D. 7614, 44 FR 24840, Apr. 27, 1979]

§1.121–4 Election.

(a) *General rule.* A taxpayer may make an election under section 121(a) in respect of a particular sale (or may revoke any such election) at any time before the expiration of the period for making a claim for credit or refund of Federal income tax for the taxable year in which the sale or exchange occurred. A taxpayer who is married at the time of the sale or exchange—

(1) May not make an election under section 121(a) unless his spouse (at the time of the sale or exchange) joins him in such election, and

(2) May not revoke an election previously made by him unless his spouse (at the time of the sale or exchange) joins him in the revocation.

If the taxpayer's spouse dies after the sale or exchange but before the expiration of the time for making an election under this section (and an election was not made by the husband and wife), the deceased spouse's personal representative (administrator or executor, etc.) must join with the taxpayer in making an election. For purposes of making an election under section 121(a), if no personal representative of the deceased spouse has been appointed at or before the time of making the election, then the surviving spouse shall be considered the personal representative of such deceased spouse. Any election previously made by the taxpayer may be revoked only if the personal representative of the taxpayer's deceased spouse joins in such revocation.

(b) *Manner of making election.* The election under section 121(a) shall be made in a statement signed by the taxpayer and (where required) by his spouse and attached to the taxpayer's income tax return, when filed, for the taxable year during which the sale or exchange of his residence occurs. (See Form 2119 and the accompanying instructions). The statement shall indicate that the taxpayer elects to exclude from his gross income for such year so much of the gain realized on such sale or exchange as may be excluded under section 121. The statement shall also show—

(1) The adjusted basis of the residence as of the date of disposition;

(2) The date of its acquisition;

(3) The date of its disposition;

(4) The names and social security numbers of the owners of the residence as of the date of sale, the form of such ownership, and the age and marital status (as determined under paragraph (f) of §1.121–5) of such owner or owners at the time of the sale;

(5) The duration of any absences (other than vacation or other seasonal absence) by such owner or owners during the 5 years (8 years under the transitional rule) preceding the sale; and

(6) Whether any such owner or owners have previously made an election under section 121(a), the date of such election, the taxable year with respect to which such election was made, the district director with whom such election was filed, and, if such election has been revoked, the date of such revocation.

(c) *Manner of revoking election.* The revocation of an election under section 121(a) shall be made by the taxpayer by filing a signed statement showing his name and social security number and indicating that the taxpayer revokes the election he made under section 121(a). The statement shall also show the taxable year of the taxpayer for which such election was made. The statement shall be signed by the taxpayer and (where required) by his spouse or their personal representatives and filed with either the Internal Revenue Service Center with which the election was filed, the Internal Revenue Service Center nearest the taxpayer at the time the statement is filed, or the taxpayer's local Internal Revenue office. In addition, if, at the time the statement is filed, the statutory period for assessment of a deficiency for the taxable year for which the election was made will expire within one year, then, the revocation is not effective unless the taxpayer also consents, in writing, that the statutory period for assessment of any deficiency (to the extent that such deficiency is attributable to the revocation of the election) shall not expire before the expiration of one year after the date the statement was filed with the district director. Such consent must be filed prior to the date of the expiration of the statutory period for assessment for the taxable year for which the election was made.

(Secs. 194 (94 Stat. 1989; 26 U.S.C. 194) and 7805 (68A Stat. 917, 26 U.S.C. 7805) of the Internal Revenue Code of 1954))

[T.D. 7614, 44 FR 24840, Apr. 27, 1979, as amended by T.D. 7927, 48 FR 55849, Dec. 16, 1983]

§ 1.121–5 Special rules.

(a) *Property held jointly by husband and wife.* (1) If—

(i) On the date of the sale or exchange of a residence, such residence is held by a husband and wife as joint tenants, tenants by the entirety, or community property,

(ii) A joint return under section 6013 is made by such husband and wife for the taxable year in which the residence is sold or exchanged, and

(iii) One spouse satisfies the age, ownership, and use requirements of section 121(a),

then both the husband and wife are treated as satisfying the age, ownership, and use requirements of section 121(a). Thus, if the above conditions exist and one spouse meets all the requirements of section 121(a), the other spouse will be treated as meeting all such requirements.

(2) The provisions of this paragraph are illustrated by the following example:

Example. On January 1, 1979, A and B while married, sell their jointly owned residence which they have owned and used as their prinicipal residence continuously since 1968. At the time of the sale, A is age 56 and B is age 54. If A and B file a joint return for the year of the sale, B will be considered to have satisfied the age, ownership and use requirements of section 121(a) since A has satisfied such requirements.

(b) *Property of deceased spouse.* (1) A taxpayer is treated as satisfying the ownership and use requirements of section 121(a)(2) with respect to property if—

(i) His spouse is deceased on the date of the sale or exchange of such property, and

(ii) Such deceased spouse, had, during the 5-year period ending on the date of the sale or exchange of the property, satisfied such ownership and use requirements with respect to such property.

This rule, however, has no application if the surviving spouse is married at the time of the sale or exchange of such property, or if an election made by the deceased spouse under section 121(a) is in effect with respect to any other sale or exchange.

(2) The provisions of this paragraph are illustrated by the following example:

Example. H and W become husband and wife on January 1, 1979. On and after such date they use as their principal residence property which H has owned and used as his principal residence since January 1, 1967. H dies on January 1, 1981, and W inherits the property and continues to use the property as her principal residence. W sells the property on August 31, 1981, at which time she is over 55 and not married. H, during the 5-year period ending on the date of the sale (September 1, 1976, through August 31, 1981), satisfied the 3-year use and ownership requirements of section 121(a)(2) with respect to such property. Accordingly, W may make an election under section 121(a).

(c) *Tenant-stockholder in cooperative housing corporation.* An individual who holds stock as a ‘‘tenant-stockholder’’ in a ‘‘cooperative housing corporation’’, as those terms are defined in section 216(b), may be eligible to make an election under section 121(a) in respect of the sale or exchange of such stock. In determining whether the taxpayer meets the requirements of section 121(a), the ownership requirements of such section are applied to the holding of such stock and the use requirements of such section are applied to the house or apartment which the individual was entitled to occupy because of such stock ownership.

(d) *Tacking of holding periods in the case of involuntary conversion.* If the basis of the property sold or exchanged is determined (in whole or in part) under subsection (b) of section 1033 (relating to basis of property acquired through involuntary conversion), then the holding and use by the taxpayer of the converted property shall be treated as holding and use by the taxpayer of the property sold or exchanged.

For the treatment of involuntary conversion as a ‘‘sale or exchange’’ see section 1.121–3(b).

(e) *Property used in part as principal residence.* (1) When a taxpayer can satisfy the ownership and use requirements of section 121(a)(2) only with respect to a portion of the property sold, then section 121 shall apply only with respect to so much of the gain from the sale or exchange of the property as is attributable to such portion. Thus, if the residence was used only partially for residential purposes, only that part of the gain allocable to the residential portion is not to be recognized under section 121(a).

(2) The provisions of this paragraph are illustrated by the following example:

Example. Taxpayer A, an attorney, uses a portion of the property constituting his principal residence as a law office for a period in excess of 2 years out of the 5 years preceding the sale of such residence. Accordingly, section 121 does not apply with respect to so much of the gain on the sale of the property as is allocable to the portion of the property used as a law office.

(f) *Determination of marital status.* Marital status is to be determined as of the date of the sale or exchange of the residence. An individual who on the date of the sale or exchange is legally separated from his spouse under a decree of divorce or of separate maintenance is not considered as married on such date.

(g) *Application of sections 1033 and 1034.* (1) In applying sections 1033 (relating to involuntary conversions) and 1034 (relating to sale or exchange of residence), the amount realized from the sale or exchange of property used as one’s principal residence is treated as being the amount determined without regard to section 121, reduced by the amount of gain excluded from gross income pursuant to an election made under section 121(a). Thus, the amount which must be invested in a new residence in order to fully satisfy the nonrecognition provisions of section 1033 or 1034 is reduced by the amount of gain not included in the taxpayer’s gross income because of an election made under section 121(a).

(2) The provisions of this paragraph are illustrated by the following examples:

Example (1). Taxpayer A sells his residence for $180,000, incurring $2,000 in fixing-up expenses described in section 1034(b)(2). He has a basis of $65,000 for the residence. Of his total gain of $115,000 ($180,000–$65,000), $100,000 is excluded from his gross income under this section.

He may still use the provisions of section 1034 to defer all or part of the remaining $15,000 of gain. To determine the adjusted sales price for purposes of section 1034, the amount realized (consideration received minus selling expenses, described in paragraph (b)(4)(i) of section 1.1034–1) is reduced by the sum of the fixing-up expenses (described in paragraph (b)(6) of section 1.1034–1) plus the amount excluded under section 121. Here, then, for purposes of section 1034, A’s adjusted sales price is $78,000 (($180,000—$2,000)—$100,000)). If his new residence costs at least $78,000, all $15,000 of the remaining gain will be deferred. However, if he purchases a new residence for $72,000, then $6,000 ($78,000—$72,000) of his gain is currently taxable.

Example (2). Taxpayer B’s residence has a basis of $65,000. She sells the residence for $115,000. If she makes an election under section 121(a), her gain of $50,000 is all excluded from gross income, and, accordingly, no portion of the realized gain remains to be deferred under section 1034.

(h) *Special rules applicable to certain reacquisitions of real property.* For special rules relating to a case where real property with respect to which an election under this section is in effect is reacquired by the seller in partial or full satisfaction of the indebtedness arising from the sale of such property and resold by him within 1 year after the date of such reacquisition, §1.1038–2.

[T.D. 7614, 44 FR 24841, Apr. 27, 1979]

§1.122–1 Applicable rules relating to certain reduced uniformed services retirement pay.

(a) *Rule applicable prior to January 1, 1966.* In the case of a member or former member of the uniformed services of the United States (as defined in 37 U.S.C. 101(3)) who has made an election under Subchapter I of Chapter 73 of Title 10 of the U.S. Code (also referred to in this section as the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431)) to receive a reduced amount of retired or retainer pay, gross income shall include the amount of any reduction made in his retired or retainer pay before January 1, 1966, by reason of such election, unless such reduction, or portion thereof, is otherwise excluded from gross income under Part III of Subchapter B of Chapter 1 of the Internal Revenue Code of 1954 or any other provision of law.

(b) *Rule applicable after December 31, 1965*—(1) In a case of a member or former member of the uniformed services of the United States (as defined in 37 U.S.C. 101(3)), gross income shall not include the amount of any reduction made in his or her retired or retainer pay after December 31, 1965, by reason of—

(i) An election made under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431), or

(ii) The provisions of Subchapter II of Chapter 73 of Title 10 of the U.S. Code (also referred to in this section as the Survivor Benefit Plan (10 U.S.C. 1447)).

(2)(i) In a case where a member or former member of the uniformed services has, pursuant to the election described in paragraph (a) of this section, received before January 1, 1966, a reduced amount of retired or retainer pay, he shall, after December 31, 1965, exclude from gross income under section 122(b) and this subdivision all amounts received as uniformed services retired or retainer pay until there has been so excluded an amount of retired or retainer pay equal to the "consideration for the contract" (as described in subdivision (iii) of this subparagraph).

(ii) Upon the death of a member or former member of the uniformed services, where the "consideration for the contract" (as described in subdivision (iii) of this subparagraph) has not been excluded in whole or in part from gross income under section 122(b) and subdivision (i) of this subparagraph, the survivor of such member who is receiving an annuity under Chapter 73 of Title 10 of the U.S. Code shall, after December 31, 1965, exclude from gross income under section 72(o) and this subdivision such annuity payments received after December 31, 1965, until there has been so excluded annuity payments equalling the portion of the "consideration for the contract" not previously excluded under subdivision (i) of this subparagraph.

(iii) The term "consideration for the contract" as used in this subparagraph means—

(a) The total amount of the reductions, if any, before January 1, 1966, in retired or retainer pay by reason of an election under Subchapter I of Chapter 73 of Title 10 of the United States Code, plus

(b) The total amount, if any, deposited by the serviceman at any time pursuant to the provisions of sections 1438 or 1452(d) of Title 10 of the United States Code, plus

(c) The total amount, if any, excludable from income under section 101(b)(2)(D) and paragraph (a)(2) of §1.101–2 with respect to a survivor annuity provided by such retired or retainer pay, minus

(d) The total amount, if any, excluded from income before January 1, 1966, pursuant to the provisions of section 72 (b) and (d) with respect to a survivor annuity provided by such retired or retainer pay.

(iv) In determining whether there has been a recovery of the "consideration for the contract" under subdivision (i) of this subparagraph, the exclusion of retired pay from income after December 31, 1965, under sections 104(a)(4) and 105(d) shall not be considered as recovery of all or part of the "consideration for the contract."

(c) *Special rules.* In any of the following situations, the computation of the excludable portion of disability retired pay received by the member or former member of the uniformed services shall be governed by the following rules:

(1) An exclusion under section 122(a) and paragraph (b)(1) of this section is applicable only in the taxable year in which a reduction in retired pay is made under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) or the Survivor Benefit Plan (10 U.S.C. 1447).

(2) Where the member or former member of the uniformed services is entitled to exclude the whole or a portion of his retired pay under the provisions of section 104(a)(4) or section 105(d) and under section 122(a) and paragraph (b)(1) of this section, the exclusion under section 122(a) and paragraph (b)(1) of this section shall be applied prior to the exclusions under sections 104(a)(4) and 105(d).

(3) Where the member or former member of the uniformed services waives a portion of his disability retired pay, or such retired pay reduced under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431),or the Survivor Benefit Plan (10 U.S.C. 1447) in favor of a nontaxable pension or compensation receivable under laws administered by the Veterans Administration (38 U.S.C. 3105), the waived amount of such disability retired pay, or reduced amount thereof, shall first be subtracted from any amounts which are excludable under the provisions of sections 104(a)(4) or 105(d) so as to reduce the amounts otherwise excludable under those sections.

(4) Where the member or former member of the uniformed services receives (before any forfeiture) disability retired pay (whether or not reduced under the Retired Serviceman's Family Protection Plan) or the Survivor Benefit Plan which is partially excludable under section 104(a)(4), and also forfeits a portion of such disability retired pay under the Dual Compensation Act of 1964 (5 U.S.C. 5531 or any former corresponding provision of law), the amount of the forfeiture under such Act shall be applied against disability retired pay (before any forfeiture) in the same proportion that the excludable portion of such pay under section 104(a)(4) bears to the total amount of such pay after subtraction of any reduction under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) or the Survivor Benefit Plan (10 U.S.C. 1447).

(5) The exclusion provided by section 122(b) and paragraph (b)(2)(i) of this section shall be available with respect to repayments made upon removal from the temporary disability retired list even though such repayments were previously excluded from gross income under section 104(a)(4) or 105(d).

However, the exclusion permitted by the prior sentence will apply only to the extent the repaid amount has not been previously excluded under section 122(b) and paragraph (b)(2)(i) of this section.

(d) *Examples with respect to the Retired Serviceman's Family Protection Plan.* The rules discussed in this section relating to the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) may be illustrated by the following examples:

Example (1). A, a member of the uniformed services, retires on January 1, 1963, and receives nondisability retired pay computed to be 60 percent of his active duty pay of $10,000 per year, or $6,000 per year, based upon 24 years of service. He elects, under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431), to provide his survivor with an annuity equal to one-fourth of his reduced retired pay. His retired pay of $6,000 is reduced by $600, to $5,400, in order to provide a survivor annuity of $1,350 per year or $112.50 per month. For 1963, 1964, and 1965, A must include in gross income the unreduced amount of retired pay, or $6,000. For 1966 and subsequent years, he may exclude under section 122(a) and paragraph (b)(1) of this section the $600 total annual reductions to provide the survivor annuity, and may, for 1966, further exclude from gross income under section 122(b) and paragraph (b)(2)(i) of this section the $1,800 ''consideration for the contract'' *i.e.,* the total reductions which were made in 1963, 1964, and 1965, to provide the survivor annuity. Accordingly, A will include $3,600 of retired pay in gross income for 1966 ($6,000 minus the sum of $600 and $1,800).

Example (2). Assume the facts in Example (1) except that A retires on disability resulting from active service and his disability is rated at 40 percent. The entire amount of disability retirement pay, prior to and including 1966, is excludable from gross income under sections 104(a)(4) and 105(d), and in 1966, section 122(a). Assume further that A attains retirement age on December 31, 1966, dies on January 1, 1967, and his widow then begins receiving a survivor annuity under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431). A's widow may exclude from gross income in 1967 and 1968 under section 72(o) and paragraph (b)(2)(ii) of this section, the $1,800 of ''consideration for the contract'' *i.e.,* the reductions in 1963, 1964, and 1965 to provide the survivor annuity. Thus, A's widow will exclude all of the survivor annuity she receives in 1967 ($1,350) and $450 of the $1,350 annuity received in 1968. In addition, if A had not attained retirement age at the time of his death, his widow would, under section 101 and paragraph (a)(2) of § 1.101–2, exclude up to $5,000 subject to the limitations of paragraph (b)(2)(ii) of this section.

Example (3). Assume, in the previous example, that A dies on January 1, 1965, and his widow then begins receiving a survivor annuity. Assume further that A's widow is entitled to exclude under section 72(b) $1,000 of the $1,350 she received in 1965. Under section 72(o) and paragraph (b)(2)(ii) of this section, A's widow for 1966 will exclude the $200 remaining consideration for the contract ($1,200 − $1,000) and will include $1,150 of the survivor annuity in gross income.

Example (4). B, a member of the uniformed services, retires on January 1, 1966, after 32 years of active military service, and receives disability retirement pay under section 1401 of title 10, limited to 75 percent of his active duty pay of $15,000 per year, or $11,250. His disability rating is 30 percent. B has not reached retirement age (as defined in § 1.79–2(b)(3)). He elects under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) to provide his survivor with an annuity equal to one-half of his reduced retired pay and, for that purpose, his retired pay of $11,250 is reduced by $1,250 to provide an annuity of $5,000 per year. B also elects to waive retired pay in the amount of $1,000 in order to receive disability compensation in like amount under laws administered by the Veterans Administration. In addition, B is required to forfeit $4,088 of his retired pay under the Dual Compensation Act of 1964 (5 U.S.C. 5532) ($11,250 − $1,000 = $10,250 less one-half of excess thereof over $2,074) and by reason of his Federal employment is not entitled to an exclusion of his retired pay under section 105(d). B's taxable retired pay for 1966 is $3,002, computed as follows:

Gross retired pay	$11,250
Less: Section 122(a) exclusion	(1,250)
Reduced retired pay	10,000
Less: Retired pay waived to receive V.A. compensation	(1,000)
Adjusted retired pay—	9,000
Less:	
(i) Excludable retired pay computed under section 104(a)(4) as limited by 10 U.S.C. 1403	$4,500
(ii) Less: Retired pay, not to exceed (i), waived to receive V.A. compensation	(1,000)
(iii) Net disability exclusion	(3,500)
Taxable retired pay before adjustment for Dual Compensation forfeiture	5,500
Less:	
Adjustment for Dual Compensation forfeiture of $4,088	
5500÷9000×$4,088=$2,498 (rounded)	(2,498)
Net taxable retired pay	3,002

Example (5). C, a member of the uniformed services retires on January 1, 1966, and receives disability retirement pay of $11,250 per year, which is reduced by $1,250 to provide a survivor annuity, and $1,000 of which is waived in order to receive disability compensation in like amount under laws administered by the Veterans Administration. C has not reached retirement age for purposes of section 105(d) and is not employed by the Federal Government. C's taxable disability retirement pay for 1966 is $300 computed as follows:

Adjusted retired pay	$9,000	
Less:		
(i) Excludable retired pay under section (a)(4) as limited by 10 U.S.C. 1403	$4,500	
(ii) Excludable retired pay under section 105(d)	5,200	
(iii) Total	9,700	
(iv) Less: Retired pay, not to exceed (iii), waived to receive V.A. compensation "sick pay" exclusion	(1,000)	
(v) Net disability and "sick pay" exclusion		(8,700)
Net taxable retired pay	800	

Example (6). D, a member of the uniformed services, retires for physical disability resulting from active service on January 1, 1966, after 35 years of service and with a disability rated at 20 percent. His active duty pay is $4,000 per year and he attained retirement age prior to retirement. He had an election in effect under the Retired Serviceman's Family Protection Plan to provide his survivor with an annuity and his retired pay is reduced therefor by $500 per year. He waives $1,300 of his retired pay in order to receive compensation from the Veterans Administration in like amount. His taxable retired pay for 1966 is $1,200 computed as follows:

Gross retired pay (75%×$4,000)	$3,000	
Less: Section 122(a) exclusion	(500)	
Reduced retired pay	2,500	
Less: V.A. waiver	(1,300)	
Adjusted retired pay	1,200	
Less:		
(i) Section 104(a)(4) exclusion	$800	
(ii) Less: Retired pay, not to exceed (i), waived to receive V.A. compensation	(800)	
(iii) Net disability exclusion	0	
Net taxable retired pay		1,200

(e) *Principles applicable to the Survivor Benefit Plan.* The principles illustrated by the examples set forth in paragraph (d) of this section apply to an annuity under the Survivor Benefit Plan (10 U.S.C. 1447).

[T.D. 7043, 35 FR 8478, June 2, 1970, as amended by T.D. 7562, 43 FR 38819, Aug. 31, 1978]

§1.123–1 Exclusion of insurance proceeds for reimbursement of certain living expenses.

(a) *In general.* (1) Gross income does not include insurance proceeds received by an individual on or after January 1, 1969, pursuant to the terms of an insurance contract for indemnification of the temporary increase in living expenses resulting from the loss of use or occupancy of his principal residence, or a part thereof, due to damage or destruction by fire, storm, or other casualty. The term ‘‘other casualty’’ has the same meaning assigned to such term under section 165(c)(3). The exclusion also applies in the case of an individual who is denied access to his principal residence by governmental authorities because of the occurrence (or threat of occurrence) of such a casualty. The amount excludable under this section is subject to the limitation set forth in paragraph (b) of this section.

(2) This exclusion applies to amounts received as reimbursement or compensation for the reasonable and necessary increase in living expenses incurred by the insured and members of his household to maintain their customary standard of living during the loss period.

(3) This exclusion does not apply to an insurance recovery for the loss of rental income. Nor does the exclusion apply to any insurance recovery which compensates for the loss of, or damage to, real or personal property. See section 165(c)(3) relating to casualty losses; section 1231 relating to gain on an involuntary conversion of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977); and section 1033 relating to recognition of gain on an involuntary conversion. In the case of property used by an insured partially as a principal residence and partially for other purposes, the exclusion does not apply to the amount of insurance proceeds which compensates for the portion of increased expenses attributable to the nonresidential use of temporary replacement property during the loss period. In the case of denial of access to a principal residence by governmental authority, the exclusion provided by this section does not apply to an insurance recovery received by an individual as reimbursement for living expenses incurred by reason of a governmental condemnation or order not related to a casualty or the threat of a casualty.

(4)(i) Subject to the limitation set forth in paragraph (b), the amount excludable is the amount which is identified by the insurer as being paid exclusively for increased living expenses resulting from the loss of use or occupancy of the principal residence and pursuant to the terms of the insurance contract.

(ii) When a lump-sum insurance settlement includes, but does not specifically identify, compensation for property damage, loss of rental income, and increased living expenses, the amount of such settlement allocable to living expenses shall, in the case of uncontested claims, be that portion of the settlement which bears the same ratio to the total recovery as the amount of claimed increased living expense bears to the total amount of claimed losses and expenses, to the extent not in excess of the coverage limitations specified in the contract for such losses and expenses.

(iii) In the case of a lump-sum settlement involving contested claims, the insured shall establish the amount reasonably allocable to increased living expenses, consistent with the terms of the contract and other facts of the particular case.

(iv) In no event may the amount of a lump-sum settlement which is allocable to increased living expenses exceed the coverage limitation specified in the contract for increased living expenses. Where, however, a coverage limitation is applicable to the total amount payable for increased living expenses and, for example, loss of rental income, the amount of an unitemized settlement which is allocable to increased living expenses may not exceed the portion of the applicable coverage limitation which bears the same ratio to such limitation as the amount of increased living expenses bears to the sum of the amount of such increased living expenses and the amount, if any, of lost rental income.

(5) The portion of any insurance recovery for increased living expenses which exceeds the limitation set forth in paragraph (b) shall be included in gross income under section 61 of the Code.

(b) *Limitation*—(1) *Amount excludable.* The amount excludable under this section is limited to amounts received which are not in excess of the amount by which (i) total actual living expenses incurred by the insured and members of his household which result from the loss of use or occupancy of their residence exceed (ii) the total normal living expenses which would have been incurred during the loss period but are not incurred as a result of the loss of use or occupancy of the principal residence. Generally, the excludable amount represents such excess expenses actually incurred by reason of a casualty, or threat thereof, for renting suitable housing and for extraordinary expenses for transportation, food, utilities, and miscellaneous services during the period of repair or replacement of the damaged principal residence or denial of access by governmental authority.

(2) *Actual living expenses.* For purposes of this section, actual living expenses are the reasonable and necessary expenses incurred as a result of the loss of use or occupancy of the principal residence to maintain the insured and members of his household in accordance with their customary standard of living. Actual living expenses must be of such a nature as to qualify as a reimbursable expense under the terms of the applicable insurance contract without regard to monetary limitations upon coverage. Generally, actual living expenses include the cost during the loss period of temporary housing, utilities furnished at the place of temporary housing, meals obtained at restaurants which customarily would have been prepared in the residence, transportation, and other miscellaneous services. To the extent that the loss of use or occupancy of the principal residence results merely in an increase in the amount expended for items of living expenses normally incurred, such as food and transportation, only the increase in such costs shall be considered as actual living expenses in computing the limitation.

(3) *Normal living expenses not incurred.* Normal living expenses consist of the same categories of expenses comprising actual living expenses which would have been incurred but are not incurred as a result of the casualty or threat thereof. If the loss of use of the residence results in a decrease in the amount normally expended for a living expense item during the loss period, the item of normal living expense is considered not to have been incurred to the extent of the decrease for purposes of computing the limitation.

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

Example (1). On March 1, 1970, A's principal residence, a dwelling owned by A no part of which was rented to others or used for nonresidential purposes, was extensively damaged by fire. The damaged residence was under repair during the entire month of March making it necessary for A and his spouse to obtain temporary lodging and to take their meals at a restaurant. A and his spouse incur expenses of $200 for lodging at a motel, $180 for meals which customarily would have been prepared in his residence, and $25 for commercial laundry service which customarily would have been done by A's wife. A makes (directly or through mortgage insurance), or remains liable for, the required March payment of $190 on the mortgage note on his residence. The mortgage payment results from a contractual obligation having no causal relationship to the occurrence of the casualty and is not considered as an actual living expense resulting from the loss of use of the residence. A's customary commuting expense of $40 for bus fares to and from work is decreased by $20 for the month because of the motel's closer proximity to his place of employment. Other transportation expenses remain stable. Since there has been a decrease in the amount of A's customary bus fares, normal transportation expenses are considered not to have been incurred to the extent of the decrease. Finally, A does not incur customary expenses of $150 for food obtained for home preparation, $75 for utilities expenses, and $10 for laundry cleansers. The limitation upon the excludable amount of an insurance recovery for excess living expenses is $150, computed as follows:

LIVING EXPENSES

	Actual resulting from casualty	Normal not incurred	Increase (decrease)
Housing	$200.00	....	$200.00
Utilities	....	$75.00	(75.00)
Meals	180.00	150.00	30.00
Transportation	....	20.00	(20.00)
Laundry	25.00	10.00	150.00
Total	405.00	255.00	15.00

Example (2). Assume the same facts as in example (1) except that the damaged residence is not owned by A but is rented to him for $100 per month and that the risk of loss is upon the lessor. Since A would not have incurred the normal rental of $100 for March, the excludable amount is limited to $50 ($150 as in previous example less $100 normal rent not incurred).

(c) *Principal residence.* Whether or not property is used by the insured taxpayer and members of his household as their principal residence depends upon all the facts and circumstances in each case. For purposes of this section, a principal residence may be a dwelling or an apartment leased to the insured as well as a dwelling or apartment owned by the insured.

[T.D. 7118, 36 FR 10729, June 2, 1971, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§1.125–2T Question and answer relating to the benefits that may be offered under a cafeteria plan (temporary).

Q–1: What benefits may be offered to participants under a cafeteria plan?

A–1: (a) Generally, for cafeteria plan years beginning on or after January 1, 1985, a cafeteria plan is a written plan under which participants may choose among two or more benefits consisting of cash and certain other permissible benefits. In general, benefits that are excludable from the gross income of an employee under a specific section of the Internal Revenue Code may be offered under a cafeteria plan. However, scholarships and fellowships under section 117, vanpooling under section 124, educational assistance under section 127 and certain fringe benefits under section 132 may not be offered under a cafeteria plan. In addition, meals and lodging under section 119, because they are furnished for the convenience of the employer and thus are not elective in lieu of other benefits or compensation provided by the employer, may not be offered under a cafeteria plan. Thus, a cafeteria plan may offer coverage under a group-term life insurance plan of up to $50,000 (section 79), coverage under an accident or health plan (sections 105 and 106), coverage under a qualified group legal services plan (section 120), coverage under a dependent care assistance program (section 129), and participation in a qualified cash or deferred arrangement that is part of a profit-sharing or stock bonus plan (section 401(k)). In addition, a cafeteria plan may offer group-term life insurance coverage which is includable in gross income only because it is in excess of $50,000 or is on the lives of the participant's spouse and/or children. In addition, a cafeteria plan may offer participants the opportunity to purchase, with after-tax employee contributions, coverage under a group-term life insurance plan (section 79), coverage under an accident or health plan (section 105(e)), coverage under a qualified group legal services plan (section 120), or coverage under a dependent care assistance program (section 129). Finally, a cafeteria plan may offer paid vacation days if the plan precludes any participant from using, or receiving cash for, in a subsequent plan year, any of such paid vacation days remaining unused as of the end of the plan year. For purposes of the preceding sentence, elective vacation days provided under a cafeteria plan are not considered to be used until all nonelective paid vacation days have been used.

(b) Note that benefits that may be offered under a cafeteria plan may or may not be taxable depending upon whether such benefits qualify for an exclusion from gross income. However, a cafeteria plan may not offer a benefit that is taxable because such benefit fails to satisfy any applicable eligibility, coverage, or nondiscrimination requirement. Similarly, a plan may not offer a benefit for purchase with after-tax employee contributions if such benefit would fail to satisfy any eligibility, coverage, or nondiscrimination requirement that would apply if such benefit were designed to be provided on a nontaxable basis with employer contributions. Also, note that section 125(d)(2) provides that a cafeteria plan may not offer a benefit that defers the receipt of compensation (other than the opportunity to make elective contributions under a qualified cash or deferred arrangement) and may not operate in a manner that enables participants to defer the receipt of compensation.

[T.D. 8073, 51 FR 4318, Feb. 4, 1986]

§ 1.125–4T Permitted election changes (temporary).

(a) *Election changes.* A cafeteria plan may permit an employee to revoke an election during a period of coverage and to make a new election only as provided in paragraphs (b) through (i) of this section. See paragraph (j) of this section for special provisions relating to qualified cash or deferred arrangements.

(b) *Special enrollment rights.* A cafeteria plan may permit an employee to revoke an election for accident or health coverage during a period of coverage and make a new election that corresponds with the special enrollment rights provided in section 9801(f), whether or not the change in election is permitted under paragraph (c) of this section.

(c) *Changes in status for accident or health coverage and group-term life.* (1) *In general.* A cafeteria plan may permit an employee to revoke an election for accident or health coverage or group-term life insurance coverage during a period of coverage and make a new election for the remaining portion of the period if, under the facts and circumstances—

(i) A change in status occurs; and

(ii) The election change satisfies the consistency requirement in paragraph (c)(3) of this section (consistency rule for accident or health coverage) or (c)(4) of this section (consistency rule for group-term life insurance coverage).

(2) *Change in status events.* The following events are changes in status for purposes of this paragraph (c):

(i) *Legal marital status.* Events that change an employee's legal marital status, including marriage, death of spouse, divorce, legal separation, or annulment;

(ii) *Number of dependents.* Events that change an employee's number of dependents (as defined in section 152), including birth, adoption, placement for adoption (as defined in regulations under section 9801), or death of a dependent;

(iii) *Employment status.* A termination or commencement of employment by the employee, spouse, or dependent;

(iv) *Work schedule.* A reduction or increase in hours of employment by the employee, spouse, or dependent, including a switch between part-time and full-time, a strike or lockout, or commencement or return from an unpaid leave of absence;

(v) *Dependent satisfies or ceases to satisfy the requirements for unmarried dependents.* An event that causes an employee's dependent to satisfy or cease to satisfy the requirements for coverage due to attainment of age, student status, or any similar circumstance as provided in the accident or health plan under which the employee receives coverage; and

(vi) *Residence or Worksite.* A change in the place of residence or work of the employee, spouse, or dependent.

(3) *Consistency rule for accident or health coverage.* (i) *General rule.* (A) An employee's revocation of a cafeteria plan election during a period of coverage and new election for the remaining portion of the period (referred to below as an ''election change'') is consistent with a change in status if, and only if—

(*1*) The change in status results in the employee, spouse, or dependent gaining or losing eligibility for accident or health coverage under either the cafeteria plan or an accident or health plan of the spouse's or dependent's employer; and

(*2*) The election change corresponds with that gain or loss of coverage.

(B) A change in status results in an employee, spouse, or dependent gaining (or losing) eligibility for coverage under a plan only if the individual becomes eligible (or ineligible) to participate in the plan. A cafeteria plan may treat an individual as gaining (or losing) eligibility for coverage if the individual becomes eligible (or ineligible) for a particular benefit package option under a plan (e.g., a change in status results in an individual becoming eligible for a managed care option or an indemnity option). If, as a result of a change in status, the individual gains eligibility for elective coverage under a plan of the spouse's or dependent's employer, the consistency rule of this paragraph (c)(3)(i) is satisfied only if the individual elects the coverage under the spouse's or dependent's employer. See the *Examples* in paragraph (k) of this section for illustrations of the consistency rule.

(ii) *Exception for COBRA.* Notwithstanding paragraph (c)(3)(i) of this section, if the employee, spouse, or dependent becomes eligible for continuation coverage under the employer's group health plan as provided in section 4980B or any similar State law, the employee may elect to increase payments under the employer's cafeteria plan in order to pay for the continuation coverage.

(4) *Consistency rule for group-term life insurance coverage.* Except as provided in this paragraph (c)(4), the provisions of paragraph (c)(3)(i) of this section apply to group-term life insurance coverage. In the case of marriage, birth, adoption, or placement for adoption, a cafeteria plan can allow an election change to increase (but not to reduce) the amount of the employee's life insurance coverage. In the case of divorce, legal separation, annulment, or death of a spouse or dependent, a cafeteria plan may allow an election change to reduce (but not to increase) the amount of the employee's life insurance coverage.

(d) *Judgment, decree, or order.* This paragraph (d) applies to a judgment, decree, or order (''order'') resulting from a divorce, legal separation, annulment, or change in legal custody (including a qualified medical child support order defined in section 609 of the Employee Retirement Income Security Act of 1974) that requires accident or health coverage for an employee's child. Notwithstanding the provisions of paragraph (c) of this section, a cafeteria plan may—

(1) Change the employee's election to provide coverage for the child if the order requires coverage under the employee's plan; or

(2) Permit the employee to make an election change to cancel coverage for the child if the order requires the former spouse to provide coverage.

(e) *Entitlement to Medicare or Medicaid.* If an employee, spouse, or dependent who is enrolled in an accident or health plan of the employer becomes entitled to coverage (i.e., enrolled) under Part A or Part B of Title XVIII of the Social Security Act (Medicare) or Title XIX of the Social Security Act (Medicaid), other than coverage consisting solely of benefits under section 1928 of the Social Security Act (the program for distribution of pediatric vaccines), a cafeteria plan may permit the employee to make an election change to cancel coverage of that employee, spouse or dependent under the accident or health plan.

(f) *Changes in status for other qualified benefits.* [Reserved].

(g) *Significant coverage or cost changes.* [Reserved].

(1) *Employer's plan.* [Reserved].

(2) *Plan of spouse's or dependent's employer.* [Reserved].

(h) *Cessation of required contributions.* [Reserved].

(i) *Special requirements concerning the Family and Medical Leave Act.* [Reserved].

(j) *Elective contributions under a qualified cash or deferred arrangement.* The provisions of this section do not apply with respect to elective contributions under a qualified cash or deferred arrangement (within the meaning of section 401(k)) or employee contributions subject to section 401(m). Thus, a cafeteria plan may permit an employee to modify or revoke elections in accordance with sections 401(k) and 401(m) and the regulations thereunder.

(k) *Examples.* The following examples illustrate the rules of this section. In each case involving an accident or health plan, assume that the plan is subject to section 9801(f) (providing for special enrollment rights under certain group health plans).

Example 1. (i) Employer M provides health coverage for its employees under which employees may elect either employee-only coverage or family coverage. M also maintains a calendar year cafeteria plan under which qualified benefits, including health coverage, are funded through salary reduction. M's employee, A, elects employee-only health coverage before the beginning of the calendar year. During the year, A adopts a child, C. Within 30 days thereafter, A wants to revoke A's election for employee-only health coverage and obtain family health coverage, as of the date of C's adoption. A satisfies the conditions for special enrollment of an employee with a new dependent under section 9801(f)(2), so that A may enroll in family coverage under M's accident or health plan in order to provide coverage for C, effective as of the date of C's adoption.

(ii) In this *Example 1*, M's cafeteria plan may permit A to change the employee's salary reduction election to family coverage for salary not yet currently available. The increased salary reduction could reflect the cost of family coverage from the date of adoption. (The adoption of C is also a change in status, and the election of family coverage is consistent with that change in status. Thus, under the change in status provisions of paragraph (c) of this section, M's cafeteria plan could permit A to elect family coverage prospectively in order to cover C for the remaining portion of the coverage period.)

Example 2. (i) The employer plans and permissible coverage are the same as in *Example 1*. Before the beginning of the calendar year, Employee A elects employee-only health coverage under M's cafeteria plan. A marries B during the plan year. B's employer, N, offers health coverage to N's employees, and, prior to the marriage, B had elected employee-only coverage. A wants to revoke the election for employee-only coverage, and is considering electing family health coverage under M's plan or obtaining family health coverage under N's plan.

(ii) In this *Example 2*, A's marriage to B is a change in status. Two possible election changes by A would be consistent with the change in status: to cover A and B by electing family health coverage under M's plan, or to cancel coverage under M's plan (with B electing family health coverage under N's plan in order to cover A and B). Thus, M's cafeteria plan may permit A to make either change in election. (M's cafeteria plan could also permit A to change A's salary reduction election to reflect the change to family coverage under M's group health plan in accordance with paragraph (b) of this section because the marriage would also create special enrollment rights under section 9801(f), pursuant to which an election of family coverage under M's plan would be required to be effective no later than the first day of the first calendar month beginning after the completed request for enrollment is received by the plan.)

Example 3. (i) Employee G, a single parent, elects family health coverage under a calendar year cafeteria plan maintained by Employer O. G and G's 21-year old child, H, are covered under O's health plan. During the year, H graduates from college. Under the terms of the health plan, dependents over the age of 19 must be full-time students to receive coverage. G wants to revoke G's election for family health coverage and obtain employee-only coverage under O's cafeteria plan.

(ii) In this *Example 3*, H's loss of eligibility for coverage under the terms of the health plan is a change in status. A revocation of G's election for family coverage and new election of employee-only coverage is consistent with the change in status. Thus, O's cafeteria plan may permit G to elect employee-only coverage.

Example 4. (i) Employee J is married to K and they have one child, S. A calendar year cafeteria plan maintained by Employer P allows employees to elect no health coverage, employee-only coverage, employee-plus-one-dependent coverage, or family coverage. Under the plan, before the beginning of the calendar year, J elects family health coverage for J, K, and S. J and K divorce during the year and, under the terms of P's accident or health plan, K loses eligibility for P's health coverage. S does not lose eligibility for health coverage under P's plan upon the divorce. J now wants to revoke J's election under the cafeteria plan and elect no coverage.

(ii) In this *Example 4*, the divorce is a change in status. A change in the cafeteria plan election to cancel health coverage for K is consistent with that change in status. However, the divorce does not affect J's or S's eligibility for health coverage. Therefore, an election change to cancel J's or S's health coverage is not consistent with the change in status. The cafeteria plan, however, may permit J to elect employee-plus-one-dependent health coverage.

Example 5. (i) The facts are the same as *Example 4*, except that, before the beginning of the year, Employee J elected employee-only health coverage (rather than family coverage). Pursuant to J's divorce agreement with K, P's health plan receives a qualified medical child support order (as defined in section 609 of the Employee Retirement Income Security Act) during the plan year. The order requires P's health plan to cover S.

(ii) In this *Example 5*, P's cafeteria plan may change J's election from employee-only health coverage to employee-plus-one-dependent coverage in order to cover S.

Example 6. (i) Before the beginning of the coverage period, Employee L elects to participate in a cafeteria plan maintained by

L's Employer, Q. However, in order to change the election during the coverage period so as to cancel coverage, and by prior understanding with Q, L terminates employment and resumes employment one week later.

(ii) In this *Example 6,* under the facts and circumstances, in which a principal purpose of the termination of employment was to alter the election and reinstatement of employment was understood at the time of termination, L does not have a change in status. However, L's termination of employment would constitute a change in status, permitting a cancellation of coverage during the period of unemployment, if L's original cafeteria plan election was reinstated upon resumption of employment (for example, because of a cafeteria plan provision requiring an employee who resumes employment within 30 days, without any other intervening event that would permit a change in election, to return to the election in effect prior to termination of employment).

Example 7. (i) Employer R maintains a calendar year cafeteria plan under which full-time employees may elect coverage under one of three benefit package options provided under an accident or health plan: an indemnity option or either of two HMO options for employees that work in the respective service areas of the two HMOs. Employee T, who works in the service area of HMO #1, elects the HMO #1 option. During the year, T is transferred to another work location which is outside the HMO #1 service area and inside the HMO #2 service area.

(ii) In this *Example 7,* the transfer is a change in status and, under the consistency rule, the cafeteria plan may permit T to make an election change to either the indemnity option or HMO #2, or to cancel accident or health coverage.

Example 8. (i) A calendar year cafeteria plan maintained by Employer S allows employees to elect coverage under an accident or health plan providing indemnity coverage and under a flexible spending arrangement (FSA). Prior to the beginning of the calendar year, Employee U elects employee-only indemnity coverage, and coverage under the FSA for up to $600 of reimbursements for the year to be funded by salary reduction contributions of $600 during the year. U's spouse, V, has employee-only coverage under an accident or health plan maintained by V's employer. During the year, V terminates employment and loses coverage under that plan. U now wants to elect family coverage under S's accident or health plan and increase U's FSA election.

(ii) In this *Example 8,* V's termination of employment is a change in status. The cafeteria plan may permit U to elect family coverage under S's accident or health plan, and to increase U's FSA coverage.

Example 9. (i) Employer T provides group-term life insurance coverage as described under section 79. Under T's plan, an employee may elect life insurance coverage in an amount up to the lesser of his or her salary or $50,000. T also maintains a calendar year cafeteria plan under which qualified benefits, including the group-term life insurance coverage, are funded through salary reduction. Before the beginning of the calendar year, Employee W elects $10,000 of life insurance coverage, with W's spouse, X, as the beneficiary. During the year, a child is placed for adoption with W and X. W wants to increase W's election for life insurance coverage to $50,000 (without changing the designation of X as the beneficiary).

(ii) In this *Example 9,* the placement of a child for adoption with W is a change in status. The increase in coverage is consistent with the change in status. Thus, W's cafeteria plan may permit W to increase W's life insurance coverage.

(l) *Effective date.* This section is effective for plan years beginning after December 31, 1998.

[T.D. 8738, 62 FR 60166, Nov. 7, 1997; 63 FR 8528, Feb. 19, 1998]

§1.127–1 Amounts received under a qualified educational assistance program.

(a) *Exclusion from gross income.* The gross income of an employee does not include—

(1) Amounts paid to, or on behalf of the employee under a qualified educational assistance program described in §1.127–2, or

(2) The value of education provided to the employee under such a program.

(b) *Disallowance of excluded amounts as credit or deduction.* Any amount excluded from the gross income of an employee under paragraph (a) of this section shall not be allowed as a credit or deduction to such employee under any other provision of this part.

(c) *Amounts received under a non-qualified program.* Any amount received under an educational assistance program that is not a ‘‘qualified program’’ described in §1.127–2 will not be excluded from gross income under paragraph (a) of this section. All or part of the amounts received under such a nonqualified program may, however, be excluded under section 117 or deducted under section 162 or section 212 (as the case may be), if the requirements of such section are satisfied.

(d) *Definitions.* For rules relating to the meaning of the terms ''employee'' and ''employer'', see paragraph (h) of § 1.127–2.

(e) *Effective date.* This section is effective for taxable years of the employee beginning after December 31, 1978, and before January 1, 1984.

[T.D. 7898, 48 FR 31017, July 6, 1983]

§ 1.127–2 Qualified educational assistance program.

(a) *In general.* A qualified educational assistance program is a plan established and maintained by an employer under which the employer provides educational assistance to employees. To be a qualified program, the requirements described in paragraphs (b) through (g) of this section must be satisfied. It is not required that a program be funded or that the employer apply to the Internal Revenue Service for a determination that the plan is a qualified program. However, under § 601.201 (relating to rulings and determination letters), an employer may request that the Service determine whether a plan is a qualified program.

(b) *Separate written plan.* The program must be a separate written plan of the employer. This requirement means that the terms of the program must be set forth in a separate document or documents providing only educational assistance within the meaning of paragraph (c) of this section. The requirement for a separate plan does not, however, preclude an educational assistance program from being part of a more comprehensive employer plan that provides a choice of nontaxable benefits to employees.

(c) *Educational assistance*—(1) *In general.* The benefits provided under the program must consist solely of educational assistance. The term ''educational assistance'' means—

(i) The employer's payment of expenses incurred by or on behalf of an employee for education, or

(ii) The employer's provision of education to an employee.

(2) *Alternative benefits.* Benefits will not be considered to consist solely of educational assistance if the program, in form or in actual operation, provides employees with a choice between educational assistance and other remuneration includible in the employee's gross income.

(3) *Certain benefits not considered educational assistance.* The term ''educational assistance'' does not include the employer's payment for, or provision of—

(i) Tools or supplies (other than textbooks) that the employee may retain after completing a course of instruction,

(ii) Meals, lodging, or transportation, or

(iii) Education involving sports, games, or hobbies, unless such education involves the business of the employer or is required as part of a degree program. The phrase ''sports, games, or hobbies'' does not include education that instructs employees how to maintain and improve health so long as such education does not involve the use of athletic facilities or equipment and is not recreational in nature.

(4) *Education defined.* As used in section 127, § 1.127–1, and this section, the term ''education'' includes any form of instruction or training that improves or develops the capabilities of an individual. Education paid for or provided under a qualified program may be furnished directly by the employer, either alone or in conjunction with other employers, or through a third party such as an educational institution. Education is not limited to courses that are job related or part of a degree program.

(d) *Exclusive benefit.* The program may benefit only the employees of the employer, including, at the employer's option, individuals who are employees within the meaning of paragraph (h)(1) of this section. A program that provides benefits to spouses or dependents of employees is not a qualified program within the meaning of this section.

(e) *Prohibited discrimination*—(1) *Eligibility for benefits.* The program must benefit the employer's employees generally. Among those benefited may be employees who are officers, shareholders, self-employed or highly compensated. A program is not for the benefit of employees generally, however, if the program discriminates in favor of employees described in the preceeding sentence (or in favor of their spouses and dependents who are themselves employees) in requirements relating to eligibility for benefits. Thus, although a program need not provide benefits for all employees, it must benefit those employees who qualify under a classification of employees that does not discriminate in favor of the employees with respect to whom discrimination is prohibited. The classification of employees to be considered benefited will consist of that group of employees who are actually eligible for educational assistance under the program, taking into account the eligibility requirements set forth in the written plan, the eligibility requirements reflected in the types of educational assistance available under the program, and any other conditions that may affect the availability of benefits under the program. Thus, for example, if an employer's plan provides that all employees are eligible for educational assistance, yet limits that assistance to courses of study leading to postgraduate degrees in fields relating to the employer's business, then only those employees able to pursue such a course of study are considered actually eligible for educational assistance under the program. Whether any classification of employees discriminates in favor of employees with respect to whom discrimination is prohibited will generally be determined by applying the same standards as are applied under section 410(b)(1)(B) (relating to qualified pension, profit-sharing and stock bonus plans), without regard to section 401(a)(5). For purposes of making this determination, there shall be excluded from consideration employees not covered by the program who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if the Internal Revenue Service finds that educational assistance benefits were the subject of good faith bargaining between the employee representatives and the employer or employers. For purposes of determining whether such bargaining occurred, it is not material that the employees are not covered by another educational assistance program or that the employer's present program was not considered in the bargaining.

(2) *Factors not considered in determining the existence of prohibited discrimination.* A program shall not be considered discriminatory under this paragraph (e) merely because—

(i) Different types of educational assistance available under the program are utilized to a greater degree by employees with respect to whom discrimination is prohibited than by other employees, or

(ii) With respect to a course of study for which benefits are otherwise available, successful completion of the course, attaining a particular course grade, or satisfying a reasonable condition subsequent (such as remaining employed for one year after completing the course) are required or considered in determining the availability of benefits.

(f) *Benefit limitation*—(1) *In general.* Under section 127(b)(3), a program is a qualified program for a program year only if no more than 5% of the amounts paid or incurred by the employer for educational assistance benefits during the year are provided to the limitation class described in subparagraph (2). For purposes of this paragraph (f), the program year must be specified in the written plan as either the calendar year or the taxable year of the employer.

(2) *Limitation class.* The limitation class consists of—

(i) *Shareholders.* Individuals who, on any day of the program year, own more than 5% of the total number of shares of outstanding stock of the employer, or

(ii) *Owners.* In the case of an employer's trade or business which is not incorporated, individuals who, on any day of the program year, own more than 5% of the capital or profits interest in the employer, and

(iii) *Spouses or dependents.* Individuals who are spouses or dependents of shareholders or owners described in subdivision (i) or (ii). For purposes of determining stock ownership, the attribution rules described in paragraph (h)(4) of this section apply. The regulations prescribed under section 414(c) are applicable in determining an individual's interest in the capital or profits of an unincorporated trade or business.

(g) *Notification of employees.* A program is not a qualified program unless employees eligible to participate in the program are given reasonable notice of the terms and availability of the program.

(h) *Definitions.* For purposes of this section and § 1.127–1—

(1) *Employee.* The term ''employee'' includes—

(i) A retired, disabled or laid-off employee,

(ii) A present employee who is on leave, as, for example, in the Armed Forces of the United States, or

(iii) An individual who is self-employed within the meaning of section 401(c)(1).

(2) *Employer.* An individual who owns the entire interest in an unincorporated trade or business shall be treated as his or her own employer. A partnership is treated as the employer of each partner who is an employee within the meaning of section 401(c)(1).

(3) *Officer.* An officer is an individual who is an officer within the meaning of regulations prescribed under section 414(c).

(4) *Shareholder.* The term ''shareholder'' includes an individual who is a shareholder as determined by the attribution rules under section 1563 (d) and (e), without regard to section 1563(e)(3)(C).

(5) *Highly compensated.* The term ''highly compensated'' has the same meaning as it does for purposes of section 410(b)(1)(B).

(i) *Substantiation.* An employee receiving payments under a qualified educational assistance program must be prepared to provide substantiation to the employer such that it is reasonable to believe that payments or reimbursements made under the program constitute educational assistance within the meaning of paragraph (c) of this section.

[T.D. 7898, 48 FR 31017, July 6, 1983]

§ 1.132–0 Outline of regulations under section 132.

The following is an outline of regulations in this section relating to exclusions from gross income for certain fringe benefits:

§ 1.132–0 Outline of regulations under section 132.

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§ 1.132–3 Qualified employee discounts.
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§1.132–4 (c) Grandfather rule for telephone service provided to pre-divestiture retirees.
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(1) Government and non-government employees.
(2) Former employees.

[T.D. 8256, 54 FR 28600, July 6, 1989, as amended by T.D. 8457, 57 FR 62196, Dec. 30, 1992]

§ 1.132–1 Exclusion from gross income for certain fringe benefits.

(a) *In general.* Gross income does not include any fringe benefit which qualifies as a—

(1) No-additional-cost service,

(2) Qualified employee discount,

(3) Working condition fringe, or

(4) De minimis fringe.

Special rules apply with respect to certain on-premises gyms and other athletic facilities (§ 1.132–1(e)), demonstration use of employer-provided automobiles by full-time automobile salesmen (§ 1.132–5(o)), parking provided to an employee on or near the business premises of the employer (§ 1.132–5(p)), and on-premises eating facilities (§ 1.132–7).

(b) *Definition of employee*—(1) *No-additional-cost services and qualified employee discounts.* For purposes of section 132(a)(1) (relating to no-additonal-cost services) and section 132(a)(2) (relating to qualified employee discounts), the term ''employee'' (with respect to a line of business of an employer means—

(i) Any individual who is currently employed by the employer in the line of business,

(ii) Any individual who was formerly employed by the employer in the line of business and who separated from service with the employer in the line of business by reason of retirement or disability, and

(iii) Any widow or widower of an individual who died while employed by the employer in the line of business or who separated from service with the employer in the line of business by reason of retirement or disability.

For purposes of this paragraph (b)(1), any partner who performs services for a partnership is considered employed by the partnership. In addition, any use by the spouse or dependent child (as defined in paragraph (b)(5) of this section) of the employee will be treated as use by the employee. For purposes of section 132(a)(1) (relating to no-additional-cost services), any use of air transportation by a parent of an employee (determined without regard to section 132(f)(1)(B) and paragraph (b)(1)(iii) of this section) will be treated as use by the employee.

(2) *Working condition fringes.* For purposes of section 132(a)(3) (relating to working condition fringes), the term ''employee'' means—

(i) Any individual who is currently employed by the employer,

(ii) Any partner who performs services for the partnership,

(iii) Any director of the employer, and

(iv) Any independent contractor who performs services for the employer.

Notwithstanding anything in this paragraph (b)(2) to the contrary, an independent contractor who performs services for the employer cannot exclude the value of parking or the use of consumer goods provided pursuant to a product testing program under §1.132–5(n); in addition, any director of the employer cannot exclude the value of the use of consumer goods provided pursuant to a product testing program under §1.132–5(n).

(3) *On-premises athletic facilities.* For purposes of section 132(h)(5) (relating to on-premises athletic facilities), the term ''employee'' means—

(i) Any individual who is currently employed by the employer,

(ii) Any individual who was formerly employed by the employer and who separated from service with the employer by reason of retirement or disability, and

(iii) Any widow or widower of an individual who died while employed by the employer or who separated from service with the employer by reason of retirement or disability.

For purposes of this paragraph (b)(3), any partner who performs services for a partnership is considered employed by the partnership. In addition, any use by the spouse or dependent child (as defined in paragraph (b)(5) of this section) of the employee will be treated as use by the employee.

(4) *De minimis fringes.* For purposes of section 132(a)(4) (relating to de minimis fringes), the term ''employee'' means any recipient of a fringe benefit.

(5) *Dependent child.* The term ''dependent child'' means any son, stepson, daughter, or stepdaughter of the employee who is a dependent of the employee, or both of whose parents are deceased and who has not attained age 25. Any child to whom section 152(e) applies will be treated as the dependent of both parents.

(c) *Special rules for employers—Effect of section 414.* All employees treated as employed by a single employer under section 414 (b), (c), (m), or (o) will be treated as employed by a single employer for purposes of this section. Thus, employees of one corporation that is part of a controlled group of corporations may under certain circumstances be eligible to receive section 132 benefits from the other corporations that comprise the controlled group. However, the aggregation of employers described in this paragraph (c) does not change the other requirements for an exclusion, such as the line of business requirement. Thus, for example, if a controlled group of corporations consists of two corporations that operate in different lines of business, the corporations are not treated as operating in the same line of business even though the corporations are treated as one employer.

(d) *Customers not to include employees.* For purposes of section 132 and the regulations thereunder, the term ''customer'' means any customer who is not an employee. However, the preceding sentence does not apply to section 132(c)(2) (relating to the gross profit percentage for determining a qualified employee discount). Thus, an employer that provides employee discounts cannot exclude sales made to employees in determining the aggregate sales to customers.

(e) *Treatment of on-premises athletic facilities*—(1) *In general.* Gross income does not include the value of any on-premises athletic facility provided by an employer to its employees. For purposes of section 132(h)(5) and this paragraph (e), the term ''on-premises athletic facility'' means any gym or other athletic facility (such as a pool, tennis court, or golf course)—

(i) Which is located on the premises of the employer, (ii) Which is operated by the employer, and (iii) Substantially all of the use of which during the calendar year is by employees of the employer, their spouses, and their dependent children.

For purposes of paragraph (e) (1) (iii) of this section, the term ''dependent children'' has the same meaning as the plural of the term ''dependent child'' in paragraph (b)(5) of this section. The exclusion of this paragraph (e) does not apply to any athletic facility if access to the facility is made available to the general public through the sale of memberships, the rental of the facility, or a similar arrangement.

(2) *Premises of the employer.* The athletic facility need not be located on the employer's business premises. However, the athletic facility must be located on

premises of the employer. The exclusion provided in this paragraph (e) applies whether the premises are owned or leased by the employer; in addition, the exclusion is available even if the employer is not a named lessee on the lease so long as the employer pays reasonable rent. The exclusion provided in this paragraph (e) does not apply to any athletic facility that is a facility for residential use. Thus, for example, a resort with accompanying athletic facilities (such as tennis courts, pool, and gym) would not qualify for the exclusion provided in this paragraph (e). An athletic facility is considered to be located on the employer's premises if the facility is located on the premises of a voluntary employees' beneficiary association funded by the employer.

(3) *Application of rules to membership in an athletic facility.* The exclusion provided in this paragraph (e) does not apply to any membership in an athletic facility (including health clubs or country clubs) unless the facility is owned (or leased) and operated by the employer and substantially all the use of the facility is by employees of the employer, their spouses, and their dependent children. Therefore, membership in a health club or country club not meeting the rules provided in this paragraph (e) would not qualify for the exclusion.

(4) *Operation by the employer.* An employer is considered to operate the athletic facility if the employer operates the facility through its own employees, or if the employer contracts out to another to operate the athletic facility. For example, if an employer hires an independent contractor to operate the athletic facility for the employer's employees, the facility is considered to be operated by the employer. In addition, if an athletic facility is operated by more than one employer, it is considered to be operated by each employer. For purposes of paragraph (e) (1) (iii) of this section, substantially all of the use of a facility that is operated by more than one employer must be by employees of the various employers, their spouses, and their dependent children. Where the facility is operated by more than one employer, an employer that pays rent either directly to the owner of the premises or to a sublessor of the premises is eligible for the exclusion. If an athletic facility is operated by a voluntary employees' beneficiary association funded by an employer, the employer is considered to operate the facility.

(5) *Nonapplicability of nondiscrimination rules.* The nondiscrimination rules of section 132 and § 1.132–8 do not apply to on-premises athletic facilities.

(f) *Nonapplicability of section 132 in certain cases*—(1) Tax treatment provided for in another section. If the tax treatment or a particular fringe benefit is expressly provided for in another section of Chapter 1 of the Internal Revenue Code of 1986, section 132 and the applicable regulations (except for section 132 (e) and the regulations thereunder) do not apply to such fringe benefit. For example, because section 129 provides an exclusion from gross income for amounts paid or incurred by an employer for dependent care assistance for an employee, the exclusions under section 132 and this section do not apply to the provision by an employer to an employee of dependent care assistance. Similarly, because section 117 (d) applies to tuition reductions, the exclusions under section 132 do not apply to free or discounted tuition provided to an employee by an organization operated by the employer, whether the tuition is for study at or below the graduate level. Of course, if the amounts paid by the employer are for education relating to the employee's trade or business of being an employee of the employer so that, if the employee paid for the education, the amount paid could be deducted under section 162, the costs of the education may be eligible for exclusion as a working condition fringe.

(2) *Limited statutory exclusions.* If another section of Chapter 1 of the Internal Revenue Code of 1986 provides an exclusion from gross income based on the cost of the benefit provided to the employee and such exclusion is a limited amount, section 132 and the regulations thereunder may apply to the extent the cost of the benefit exceeds the statutory exclusion.

(g) *Effective date.* Sections 1.132–0, 1.132–1, 1.132–2, 1.132–3, 1.132–4, 1.132–5, 1.132–6, 1.132–7 and 1.132–8 are effective as of January 1, 1989, except that

§§1.132–1(b)(1) with respect to the use of air transportation by a parent of an employee and 1.132–4(d) are effective as of January 1, 1985. Furthermore, in §1.132–5, the eleventh sentence of paragraph (m)(1), *Examples 6* and *7* in paragraph (m)(8), and paragraphs (m)(2)(i), (m)(2)(v), (m)(3)(iv), (m)(6), (m)(7), and (r) are effective December 30, 1992; however, taxpayers may treat the rules as applicable to benefits provided on or after January 1, 1989. For the applicable rules relating to employer-provided transportation for security concerns prior to December 30, 1992, see §1.132–5(m) (as contained in 26 CFR part 1 (§§1.61 to 1.169) revised April 1, 1992). See §§1.132–1T, 1.132–2T, 1.132–3T, 1.132–4T, 1.132–5T, 1.132–6T, 1.132–7T and 1.132–8T for rules in effect for benefits received from January 1, 1985, to December 31, 1988.

[T.D. 8256, 54 FR 28601, July 6, 1989, as amended by T.D. 8457, 57 FR 62196, Dec. 30, 1992; 58 FR 7296, Feb. 5, 1993]

§1.132–1T Exclusion from gross income of certain fringe benefits—1985 through 1988 (temporary).

(a) *In general.* Gross income does not include any fringe benefit which qualifies as a—

(1) No-additional-cost service,

(2) Qualified employee discount,

(3) Working condition fringe, or

(4) De minimis fringe.

Special rules apply with respect to certain on-premises gyms and other athletic facilities (§1.132–1T(e)), demonstration use of employer-provided automobiles by full-time automobile salesmen (§1.132–1T(n)), parking provided to an employee on or near the business premises of the employer (§1.132–5T(o)), and on-premises eating facilities (§1.132–7T).

(b) *Definition of employee*—(1) *No-additional-cost services and qualified employee discounts.* For purposes of section 132(a)(1) (relating to no-additional-cost services) and section 132(a)(2) (relating to qualified employee discounts), the term ‘‘employee’’ (with respect to a line of business of an employer) means—

(i) Any individual who is currently employed by the employer in the line of business,

(ii) Any individual who was formerly employed by the employer in the line of business and who separated from service with the employer in the line of business by reason of retirement or disability, and

(iii) Any widow or widower of an individual who died while employed by the employer in the line of business or who separated from service with the employer in the line of business by reason of retirement or disability.

For purposes of this paragraph (b)(1), any partner who performs services for a partnership is considered employed by the partnership. In addition, any use by the spouse or dependent child (as defined in this paragraph (b)) of the employee will be treated as use by the employee.

(2) *Working condition fringes.* For purposes of section 132(a)(2) (relating to working condition fringes), the term ‘‘employee’’ means—

(i) Any individual who is currently employed by the employer,

(ii) Any partner who performs services for the partnership,

(iii) Any director of the employer, and

(iv) Any independent contractor who performs services for the employer.

Notwithstanding anything in this paragraph (b)(2) to the contrary, any independent contractor who performs services for the employer cannot exclude the value of parking or the use of consumer goods provided pursuant to a product testing program under §1.132–5T (n); in addition, any director of the employer cannot exclude the value of the use of consumer goods provided pursuant to a product testing program under §1.132–5T (n).

(3) *De minimis fringe.* For purpose of section 132(a)(4) (relating to de minimis fringes), the term ‘‘employee’’ means any recipient of a fringe benefit.

(4) *Dependent child.* For purposes of this paragraph (b), the term ‘‘dependent child’’ means any son, stepson, daughter or stepdaughter of the employee who is a dependent of the employee, or both of whose parents are deceased. Any child to whom section 152(e) applies will be treated as the dependent of both parents.

(c) *Special rules for employers—Effect of section 414.* All employees treated as employed by a single employer under section 414(b), (c) or (m) will be treated as employed by a single employer for purposes of this section. Thus, employees of one corporation that is part of a controlled group of corporations may under certain circumstances be eligible to receive section 132 benefits from the other corporations that comprise the controlled group. However, the aggregation of employers described in this paragraph (c) does not change the other requirements for an exclusion, such as the line of business requirement. Thus, for example, if a controlled group of corporations consists of two corporations that operate in different lines of business, the corporations are not treated as operating in the same line of business even though the corporations are treated as one employer.

(d) *Customers not to include employees.* For purposes of section 132 and the regulations thereunder, the term ''customer'' means customers who are not employees. However, the preceding sentence does not apply to section 132(c)(2) (relating to the gross profit percentage for determining a qualified employee discount). Thus, an employer that provides employee discounts cannot exclude sales made to employees in determining the aggregate sales to customers.

(e) *Treatment of on-premises athletic facilities*—(1) *In general.* Gross income does not include the value of any on-premises athletic facility provided by the employer to its employees. For purposes of section 132 and this paragraph (e), the term ''on-premises athletic facility'' means any gym or other athletic facility (such as a pool, tennis court, or golf course)—

(i) Which is located on the premises of the employer,

(ii) Which is operated by the employer, and

(iii) Where substantially all of the use of which is, during the calendar year, by employees of the employer, their spouses, and their dependent children.

For purposes of this paragraph (e)(1)(iii), the term ''dependent children'' has the same meaning as the plural of the term ''dependent child'' in paragraph (b)(4) of this section. The exclusion of this paragraph (e) does not apply to any athletic facility if access to the facility is made available to the general public through the sale of memberships, the rental of the facility, etc.

(2) *Premises of the employer.* The athletic facility need not be located on the employer's business premises. However, the athletic facility must be located on premises of the employer. The exclusion provided in this paragraph (e) applies whether the premises are owned or leased by the employer; in addition, the exclusion is available even if the employer is not a named lesse on the lease so long as the employer pays reasonable rent. The exclusion provided in this paragraph (e) does not apply to any athletic facility that is a facility for residential use. Thus, for example, a resort with accompanying athletic facilities (such as tennis courts, pool, and gym) would not qualify for the exclusion provided in this paragraph (e).

(3) *Application of rules to membership in an athletic facility.* The exclusion provided in this paragraph (e) does not apply to any membership in an athletic facility (including health clubs or country clubs) unless the facility is owned (or leased) and operated by the employer and substantially all the use of the facility is by employees of the employer, their spouses, and their dependent children. Therefore, membership in health club or country club not meeting the rules provided in this paragraph (e) would not quality for the exclusion.

(4) *Operation by the employer.* An employer is considered to operate the athletic facility if the employer itself operates the facility through its own employees, or if the employer contracts out to another to operate the athletic facility. For example, if an employer hires an independent contractor to operate the athletic facility for the employer's employees, the facility is considered to be operated by the employer. In addition, if an athletic facility is operated by more than one employer, it is considered to be operated by each employer. For purposes of paragraph (e)(1)(iii) of this section, substantially all the use of a facility operated by more than one employer must be by employees of all of the employers,

their spouses, and their dependent children. Where the facility is operated by more than one employer, an employer that either pays rent directly to the owner of the premises or pays rent to a named lessor of the premises is eligible for the exclusion.

(5) *Nonapplicability of nondiscrimination rules.* The nondiscrimination rules of section 132 and §1.132–8T do not apply to on-premises athletic facilities.

(f) *Nonapplicability of section 132.* If the tax treatment of a particular fringe benefit is expressely provided for in another section of Chapter 1, section 132 and the applicable regulations (except for section 132 (e) and the regulations thereunder) do not apply to such fringe benefits. For example, since section 129 provides an exclusion from gross income for amounts paid or incurred by the employer for dependent care assistance for an employee, the exclusions under section 132 and this section do not apply to the provision by an employer to an employee of dependent care assistance.

[T.D. 8063, 50 FR 52297, Dec. 23, 1985, as amended by T.D. 8256, 54 FR 28600, July 6, 1989]

§1.132–2 No-additional-cost services.

(a) *In general*—(1) *Definition.* Gross income does not include the value of a no-additional-cost service. A ‘‘no-additional-cost service’’ is any service provided by an employer to an employee for the employee's personal use if—

(i) The service is offered for sale by the employer to its customers in the ordinary course of the line of business of the employer in which the employee performs substantial services, and

(ii) The employer incurs no substantial additional cost in providing the service to the employee (including foregone revenue and excluding any amount paid by or on behalf of the employee for the service).

For rules relating to the line of business limitation, see §1.132–4. For purposes of this section, a service will not be considered to be offered for sale by the employer to its customers if that service is primarily provided to employees and not to the employer's customers.

(2) *Excess capacity services.* Services that are eligible for treatment as no-additional-cost services include excess capacity services such as hotel accommodations; transportation by aircraft, train, bus, subway, or cruise line; and telephone services. Services that are not eligible for treatment as no-additional-cost services are non-excess capacity services such as the facilitation by a stock brokerage firm of the purchase of stock. Employees who receive non-excess capacity services may, however, be eligible for a qualified employee discount of up to 20 percent of the value of the service provided. See §1.132–3.

(3) *Cash rebates.* The exclusion for a no-additional-cost service applies whether the service is provided at no charge or at a reduced price. The exclusion also applies if the benefit is provided through a partial or total cash rebate of an amount paid for the service.

(4) *Applicability of nondiscrimination rules.* The exclusion for a no-additional-cost service applies to highly compensated employees only if the service is available on substantially the same terms to each member of a group of employees that is defined under a reasonable classification set up by the employer that does not discriminate in favor of highly compensated employees. See §1.132–8.

(5) *No substantial additional cost*—(i) *In general.* The exclusion for a no-additional-cost service applies only if the employer does not incur substantial additional cost in providing the service to the employee. For purposes of the preceding sentence, the term ‘‘cost’’ includes revenue that is forgone because the service is provided to an employee rather than a nonemployee. (For purposes of determining whether any revenue is forgone, it is assumed that the employee would not have purchased the service unless it were available to the employee at the actual price charged to the employee.) Whether an employer incurs substantial additional cost must be determined without regard to any amount paid by the employee for the service. Thus, any reimbursement by the employee for the cost of providing the service does not affect the determination of whether the employer incurs substantial additional cost.

(ii) *Labor intensive services.* An employer must include the cost of labor incurred in providing services to employees when determining whether the employer has incurred substantial additional cost. An employer incurs substantial additional cost, whether nonlabor costs are incurred, if a substantial amount of time is spent by the employer or its employees in providing the service to employees. This would be the result whether the time spent by the employer or its employees in providing the services would have been ''idle,'' or if the services were provided outside normal business hours. An employer generally incurs no substantial additional cost, however, if the services provided to the employee are merely incidental to the primary service being provided by the employer. For example, the in-flight services of a flight attendant and the cost of in-flight meals provided to airline employees traveling on a space-available basis are merely incidental to the primary service being provided (i.e., air transportation). Similarly, maid service provided to hotel employees renting hotel rooms on a space-available basis is merely incidental to the primary service being provided (i.e., hotel accommodations).

(6) *Payments for telephone service.* Payment made by an entity subject to the modified final judgment (as defined in section 559(c)(5) of the Tax Reform Act of 1984) of all or part of the cost of local telephone service provided to an employee by a person other than an entity subject to the modified final judgment shall be treated as telephone service provided to the employee by the entity making the payment for purposes of this section. The preceding sentence also applies to a rebate of the amount paid by the employee for the service and a payment to the person providing the service. This paragraph (a)(6) applies only to services and employees described in §1.132–4 (c). For a special line of business rule relating to such services and employees, see §1.132–4 (c).

(b) *Reciprocal agreements.* For purposes of the exclusion from gross income for a no-additional-cost service, an exclusion is available to an employee of one employer for a no-additional-cost service provided by an unrelated employer only if all of the following requirements are satisfied—

(1) The service provided to such employee by the unrelated employer is the same type of service generally provided to nonemployee customers by both the line of business in which the employee works and the line of business in which the service is provided to such employee (so that the employee would be permitted to exclude from gross income the value of the service if such service were provided directly by the employee's employer);

(2) Both employers are parties to a written reciprocal agreement under which a group of employees of each employer, all of whom perform substantial services in the same line of business, may receive no-additional-cost services from the other employer; and

(3) Neither employer incurs any substantial additional cost (including forgone revenue) in providing such service to the employees of the other employer, or pursuant to such agreement. If one employer receives a substantial payment from the other employer with respect to the reciprocal agreement, the paying employer will be considered to have incurred a substantial additional cost pursuant to the agreement, and consequently services performed under the reciprocal agreement will not qualify for exclusion as no-additional-cost services.

(c) *Example.* The rules of this section are illustrated by the following example:

Example. Assume that a commercial airline permits its employees to take personal flights on the airline at no charge and receive reserved seating. Because the employer forgoes potential revenue by permitting the employees to reserve seats, employees receiving such free flights are not eligible for the no-additional-cost exclusion.

[T.D. 8256, 54 FR 28602, July 6, 1989]

§1.132–2T No-additional-cost service—1985 through 1988 (temporary).

(a) *In general*—(1) *Definition.* Gross income does not include the value of a no-additional-cost service. The term ''no-additional-cost service'' means any service provided by an employer to an employee for the employee's personal use if—

(i) The service is offered for sale to customers in the ordinary course of the line of business of the employer in which the employee performs substantial services, and

(ii) The employer incurs no substantial additional cost in providing the service to the employee (including forgone revenue and excluding any amount paid by or on behalf of the employee for the service).

For rules relating to the line of business limitation, see § 1.132–4T.

(2) *Examples.* Services that are eligible for treatment as no-additional-cost services are excess capacity services such as hotel accommodations; transportation by aircraft, train, bus, subway, or cruise line; and telephone services. Services that are not eligible for treatment as no-additonal-cost services are non-excess capacity services such as the facilitation by a stock brokerage firm of the purchase of stock. Employees who receive non-excess capacity services may, however, be eligible for a qualified employee discount of up to 20 percent of the value of the service provided. See § 1.132-3T.

(3) *Cash rebates.* The exclusion for a no-additional-cost service applies whether the service is provided at no charge or at a reduced price. The exclusion also applies if the benefit is provided through a partial or total cash rebate of an amount paid for the service.

(4) *Applicability of nondiscrimination rules.* The exclusion for a no-additional-cost service applies to officers, owners, and highly compensated employees only if the service is available on substantially the same terms to each member of a group of employees that is defined under a reasonable classification set up by the employer that does not discriminate in favor of officers, owners, or highly compensated employees. See § 1.132-8T.

(5) *No substantial additional cost*—(i) *In general.* The exclusion for a non-additional-cost service applies only if the employer does not incur substantial additional cost in providing the service to the employee. For purposes of the preceding sentence, the term ''cost'' includes revenue that is forgone because the service is provided to an employee rather than a nonemployee. (For purposes of determining whether any revenue is forgone, it is assumed that the employee would not have purchased the service unless it were available to the employee at the actual price charged to the employee.) Whether an employer incurs substantial additional cost must be determined without regard to any amount paid by the employee for the service. Thus, any reimbursement by the employee for the cost of providing the service does not affect the determination of whether the employer incurs substantial additional cost.

(ii) *Labor intensive services.* An employer must include the cost of labor incurred in providing services to employees when determining whether the employer has incurred substantial additional cost. An employer has incurred substantial additional cost. An employer incurs substantial additional cost, whether or not non-labor costs are incurred, if a substantial amount of time is spent by the employer or its employees in providing the service to employees. This would be the result whether or not the time spent by the employer or its employees in providing the services would have been ''idle'', or if the services were provided outside normal business hours. An employer generally incurs no substantial additional cost, however, if the employee services provided are merely incidental to the primary service being provided by the employer. For example, the in-flight services of a flight attendant provided to airline employees traveling on a space-available basis are merely incidental to the primary service being provided (i.e., air transportation). In addition, the cost of in-flight meals provided to airline employees is not considered substantial in relation to the air transportation being provided.

(b) *Reciprocal agreements.* For purposes of the exclusion for a no-additional-cost service, any service provided by an employer to an employee of another employer shall be treated as provided by the employer of such employee if all of the following requirements are satisfied:

(1) The service is provided pursuant to a written reciprocal agreement between the employers under which a group of employees of each employer,

all of whom perform substantial services in the same line of business, may receive no-additional-cost services from the other employer;

(2) The service provided pursuant to the agreement to the employees of both employers is the same type of service provided by the employers to customers both in the line of business in which the employees perform substantial services and the line of business in which the service is provided to customers; and

(3) Neither employer incurs substantial additional cost (including forgone revenue) in providing the service to the employees of the other employer or pursuant to the agreement.

If one employer receives a substantial payment from the other employer with respect to the reciprocal agreement, the paying employer will be considered to have incurred a substantial additional cost pursuant to the agreement.

[T.D. 8063, 50 FR 52298, Dec. 23, 1985, as amended by T.D. 8256, 54 FR 28600, July 6, 1989]

§ 1.132–3 Qualified employee discounts.

(a) *In general*—(1) *Definition.* Gross income does not include the value of a qualified employee discount. A ''qualified employee discount'' is any employee discount with respect to qualified property or services provided by an employer to an employee for use by the employee to the extent the discount does not exceed—

(i) The gross profit percentage multiplied by the price at which the property is offered to customers in the ordinary course of the employer's line of business, for discounts on property, or

(ii) Twenty percent of the price at which the service is offered to customers, for discounts on services.

(2) *Qualified property or services*—(i) *In general.* The term ''qualified property or services'' means any property or services that are offered for sale to customers in the ordinary course of the line of business of the employer in which the employee performs substantial services. For rules relating to the line of business limitation, see § 1.132–4.

(ii) *Exception for certain property.* The term ''qualified property'' does not include real property and it does not include personal property (whether tangible or intangible) of a kind commonly held for investment. Thus, an employee may not exclude from gross income the amount of an employee discount provided on the purchase of securities, commodities, or currency, or of either residential or commercial real estate, whether or not the particular purchase is made for investment purposes.

(iii) *Property and services not offered in ordinary course of business.* The term ''qualified property or services'' does not include any property or services of a kind that is not offered for sale to customers in the ordinary course of the line of business of the employer. For example, employee discounts provided on property or services that are offered for sale primarily to employees and their families (such as merchandise sold at an employee store or through an employer-provided catalog service) may not be excluded from gross income. For rules relating to employer-operated eating facilities, see § 1.132–7, and for rules relating to employer-operated on-premises athletic facilities, see § 1.132–1(e).

(3) *No reciprocal agreement exception.* The exclusion for a qualified employee discount does not apply to property or services provided by another employer pursuant to a written reciprocal agreement that exists between employers to provide discounts on property and services to employees of the other employer.

(4) *Property or services provided without charge, at a reduced price, or by rebates.* The exclusion for a qualified employee discount applies whether the property or service is provided at no charge (in which case only part of the discount may be excludable as a qualified employee discount) or at a reduced price. The exclusion also applies if the benefit is provided through a partial or total cash rebate of an amount paid for the property or service.

(5) *Property or services provided directly by the employer or indirectly through a third party.* A qualified employee discount may be provided either directly by the employer or indirectly through a third party. For example, an employee of an appliance manufacturer

may receive a qualified employee discount on the manufacturer's appliances purchased at a retail store that offers such appliances for sale to customers. The employee may exclude the amount of the qualified employee discount whether the employee is provided the appliance at no charge or purchases it at a reduced price, or whether the employee receives a partial or total cash rebate from either the employer-manufacturer or the retailer. If an employee receives additional rights associated with the property that are not provided by the employee's employer to customers in the ordinary course of the line of business in which the employee performs substantial services (such as the right to return or exchange the property or special warranty rights), the employee may only receive a qualified employee discount with respect to the property and not the additional rights. Receipt of such additional rights may occur, for example, when an employee of a manufacturer purchases property manufactured by the employee's employer at a retail outlet.

(6) *Applicability of nondiscrimination rules.* The exclusion for a qualified employee discount applies to highly compensated employees only if the discount is available on substantially the same terms to each member of a group of employees that is defined under a reasonable classification set up by the employer that does not discriminate in favor of highly compensated employees. See §1.132–8.

(b) *Employee discount*—(1) *Definition.* The term ''employee discount'' means the excess of—

(i) The price at which the property or service is being offered by the employer for sale to customers, over

(ii) The price at which the property or service is provided by the employer to an employee for use by the employee. A transfer of property by an employee without consideration is treated as use by the employee for purposes of this section. Thus, for example, if an employee receives a discount on property offered for sale by his employer to customers and the employee makes a gift of the property to his parent, the property will be considered to be provided for use by the employee; thus, the discount will be eligible for exclusion as a qualified employee discount.

(2) *Price to customers*—(i) *Determined at time of sale.* In determining the amount of an employee discount, the price at which the property or service is being offered to customers at the time of the employee's purchase is controlling. For example, assume that an employer offers a product to customers for $20 during the first six months of a calendar year, but at the time the employee purchases the product at a discount, the price at which the product is being offered to customers is $25. In this case, the price from which the employee discount is measured is $25. Assume instead that, at the time the employee purchases the product at a discount, the price at which the product is being offered to customers is $15 and the price charged the employee is $12. The employee discount is measured from $15, the price at which the product is offered for sale to customers at the time of the employee purchase. Thus, the employee discount is $15 − $12, or $3.

(ii) *Quantity discount not reflected.* The price at which a property or service is being offered to customers cannot reflect any quantity discount unless the employee actually purchases the requisite quantity of the property or service.

(iii) *Price to employer's customers controls.* In determining the amount of an employee discount, the price at which a property or service is offered to customers of the employee's employer is controlling. Thus, the price at which the property is sold to the wholesale customers of a manufacturer will generally be lower than the price at which the same property is sold to the customers of a retailer. However, see paragraph (a)(5) of this section regarding the effect of a wholesaler providing to its employees additional rights not provided to customers of the wholesaler in the ordinary course of its business.

(iv) *Discounts to discrete customer or consumer groups.* Subject to paragraph (2)(ii) of this section, if an employer offers for sale property or services at one or more discounted prices to discrete customer or consumer groups, and sales at all such discounted prices comprise at least 35 percent of the employer's gross sales for a representative period, then in determining the amount of an employee discount, the price at which such property or service is being offered to customers for purposes of this section is a discounted price. The applicable discounted price is the current undiscounted price, reduced by the percentage discount at which the greatest percentage of the employer's discounted gross sales are made for such representative period. If sales at different percentage discounts equal the same percentage of the employer's gross sales, the price at which the property or service is being provided to customers may be reduced by the average of the discounts offered to each of the two groups. For purposes of this section, a representative period is the taxable year of the employer immediately preceding the taxable year in which the property or service is provided to the employee at a discount. If more than one employer would be aggregated under section 414 (b), (c), (m), or (o), and not all of the employers have the same taxable year, the employers required to be aggregated must designate the 12-month period to be used in determining gross sales for a representative period. The 12-month period designated, however, must be used on a consistent basis.

(v) *Examples.* The rules provided in this paragraph (b)(2) are illustrated by the following examples:

Example (1). Assume that a wholesale employer offers property for sale to two discrete customer groups at differing prices. Assume further that during the prior taxable year of the employer, 70 percent of the employer's gross sales are made at a 15 percent discount and 30 percent at no discount. For purposes of this paragraph (b)(2), the current undiscounted price at which the property or service is being offered by the employer for sale to customers may be reduced by the 15 percent discount.

Example (2). Assume that a retail employer offers a 20 percent discount to members of the American Bar Association, a 15 percent discount to members of the American Medical Association, and a ten percent discount to employees of the Federal Government. Assume further that during the prior taxable year of the employer, sales to American Bar Association members equal 15 percent of the employer's gross sales, sales to American Medical Association members equal 20 percent of the employer's gross sales, and sales to Federal Government employees equal 25 percent of the employer's gross sales. For purposes of this paragraph (b)(2), the current undiscounted price at which the property or service is being offered by the employer for sale to customers may be reduced by the ten percent Federal Government discount.

(3) *Damaged, distressed, or returned goods.* If an employee pays at least fair market value for damaged, distressed, or returned property, such employee will not have income attributable to such purchase.

(c) *Gross profit percentage*—(1) *In general*—(i) *General rule.* An exclusion from gross income for an employee discount on qualified property is limited to the price at which the property is being offered to customers in the ordinary course of the employer's line of business, multiplied by the employer's gross profit percentage. The term ''gross profit percentage'' means the excess of the aggregate sales price of the property sold by the employer to customers (including employees) over the employer's aggregate cost of the property, then divided by the aggregate sales price.

(ii) *Calculation of gross profit percentage.* The gross profit percentage must be calculated separately for each line of business based on the aggregate sales price and aggregate cost of property in that line of business for a representative period. For purposes of this section, a representative period is the taxable year of the employer immediately preceding the taxable year in which the discount is available. For example, if the aggregate amount of sales of property in an employer's line of business for the prior taxable year was $800,000, and the aggregate cost of the property for the year was $600,000, the gross profit percentage would be 25 percent ($800,000 minus $600,000, then divided by $800,000). If two or more employers are required to aggregate under section 414 (b), (c), (m), or (o) (aggregated employer), and if all of the aggregated employers do not share the same taxable year, then the aggregated employers must designate the 12-month period to be used in determining the gross profit percentage. The 12-month period designated, however, must be used on a consistent basis. If an employee performs substantial services in more than one line of business, the gross profit percentage of the line of business in which the property is sold determines the amount of the excludable employee discount.

(iii) *Special rule for employers in their first year of existence.* An employer in its first year of existence may estimate the gross profit percentage of a line of business based on its mark-up from cost. Alternatively, an employer in its first year of existence may determine the gross profit percentage by reference to an appropriate industry average.

(iv) *Redetermination of gross profit percentage.* If substantial changes in an employer's business indicate at any time that it is inappropriate for the prior year's gross profit percentage to be used for the current year, the employer must, within a reasonable period, redetermine the gross profit percentage for the remaining portion of the current year as if such portion of the year were the first year of the employer's existence.

(2) *Line of business.* In general, an employer must determine the gross profit percentage on the basis of all property offered to customers (including employees) in each separate line of business. An employer may instead select a classification of property that is narrower than the applicable line of business. However, the classification must be reasonable. For example, if an employer computes gross profit percentage according to the department in which products are sold, such classification is reasonable. Similarly, it is reasonable to compute gross profit percentage on the basis of the type of merchandise sold (such as high mark-up and low mark-up classifications). It is not reasonable, however, for an employer to classify certain low mark-up products preferred by certain employees (such as highly compensated employees) with high mark-up products or to classify certain high mark-up products preferred by other employees with low mark-up products.

(3) *Generally accepted accounting principles.* In general, the aggregate sales price of property must be determined in accordance with generally accepted accounting principles. An employer must compute the aggregate cost of property in the same manner in which it is computed for the employer's Federal income tax liability; thus, for example, section 263A and the regulations thereunder apply in determining the cost of property.

(d) *Treatment of leased sections of department stores*—(1) *In general*—(i) *General rule.* For purposes of determining whether employees of a leased section of a department store may receive qualified employee discounts at the department store and whether employees of the department store may receive qualified employee discounts at the leased section of the department store, the leased section is treated as part of the line of business of the person operating the department store, and employees of the leased section are treated as employees of the person operating the department store as well as employees of their employer. The term ''leased section of a department store'' means a section of a department store where substantially all of the gross receipts of the leased section are from over-the-counter sales of property made under a lease, license, or similar arrangement where it appears to the general public that individuals making such sales are employed by the department store. A leased section of a department store which, in connection with the offering of beautician services, customarily makes sales of beauty aids in the ordinary course of business is deemed to derive substantially all of its gross receipts from over-the-counter sales of property.

(ii) *Calculation of gross profit percentage.* For purposes of paragraph (d) of this section, when calculating the gross profit percentage of property and services sold at a department store, sales of property and services sold at the department store, as well as sales of property and services sold at the leased section, are considered. The rule provided in the preceding sentence does not apply, however, if it is more reasonable to calculate the gross profit percentage for the department store and leased section separately, or if it would be inappropriate to combine them (such as where either the department store or the leased section but not both provides employee discounts).

(2) *Employees of the leased section*—(i) *Definition.* For purposes of this paragraph (d), ''employees of the leased section'' means all employees who perform substantial services at the leased section of the department store regardless of whether the employees engage in over-the-counter sales of property or services. The term ''employee'' has the same meaning as in section 132(f) and § 1.132–1(b)(1).

(ii) *Discounts offered to either department store employees or employees of the leased section.* If the requrements of this paragraph (d) are satisfied, employees of the leased section may receive qualified employee discounts at the department store whether or not employees of the department store are offered discounts at the leased section. Similarly, employees of the department store may receive a qualified employee discount at the leased section whether or not employees of the leased section are offered discounts at the department store.

(e) *Excess discounts.* Unless excludable under a provision of the Internal Revenue Code of 1986 other than section 132(a)(2), an employee discount provided on property is excludable to the extent of the gross profit percentage multiplied by the price at which the property is being offered for sale to customers. If an employee discount exceeds the gross profit percentage, the excess discount is includible in the employee's income. For example, if the discount on employer-purchased property is 30 percent and the employer's gross profit percentage for the period in the relevant line of business is 25 percent, then 5 percent of the price at which the property is being offered for sale to customers is includible in the empoyee's income. With respect to services, an employee discount of up to 20 percent may be excludable. If an employee discount exceeds 20 percent, the excess discount is includible in the employee's income. For example, assume that a commercial airline provides a pass to each of its employees permitting the employees to obtain a free round-trip coach ticket with a confirmed seat to any destination the airline services. Neither the exclusion of section 132(a)(1) (relating to no-additional-cost services) nor any other statutory exclusion applies to a flight taken primarily for personal purposes by an employee under this program. However, an employee discount of up to 20 percent may be excluded as a qualified employee discount. Thus, if the price charged to customers for the flight taken is $300 (under restrictions comparable to those actually placed on travel associated with the employee airline ticket), $60 is excludible from gross income as a qualified employee discount and $240 is includible in gross income.

[T.D. 8256, 54 FR 28603, July 6, 1989]

§ 1.132–3T Qualified employee discount—1985 through 1988 (temporary).

(a) *In general*—(1) *Definition.* Gross income does not include the value of a qualified employee discount. The term ''qualified employee discount'' means any employee discount with respect to qualified property or services provided by an employer to an employee for the employee's personal use to the extent the discount does not exceed—

(i) The gross profit percentage of the price at which the property is offered to customers, for discounts on property, or

(ii) 20 percent of the price at which the services are offered to customers, for discounts on services.

(2) *Qualified property or services*—(i) *In general.* The term ''qualified property or services'' means any property or services that are offered for sale to customers in the ordinary course of the line of business of the employer in which the employee performs substantial services. For rules relating to the line of business limitation, see § 1.132–4T.

(ii) *Exception for certain property.* The term ''qualified property'' does not include real property and it does not include personal property (whether tangible or intangible) of a kind commonly held for investment. Thus, an employee may not exclude from gross income the amount of an employee discount provided on the purchase of either residential or commercial real estate, securities, commodities, or currency, whether or not the particular purchase is made for investment purposes.

(iii) *Property and services not offered in ordinary course of business.* The term ''qualified property or services'' does not include any property or services of a kind that is not offered for sale to customers in the ordinary course of the line of business of the employer. For example, employee discounts provided on property or services that are offered for sale only to employees and their families (such as merchandise sold at an employee store or through an employer-provided catalog service) may not be excluded from gross income.

(3) *No reciprocal agreement exception.* The exclusion for a qualified employee discount does not apply to property or services provided by another employer pursuant to a written reciprocal agreement that exists between employers to provide discounts on property and services to employees of the other employer.

(4) *Cash or third-party rebates*—(i) *Property or services provided without charge or at a reduced price.* The exclusion for a qualified employee discount applies whether the property or service is provided at no charge (in which case only part of the discount may be excludable as a qualified employee discount) or at a reduced price. The exclusion also applies if the benefit is provided through a partial or total cash rebate of an amount paid for the property or service.

(ii) *Property or services provided directly by the employer or indirectly through a third party.* A qualified employee discount may be provided either directly by the employer or indirectly through a third party. For example, an employee of an appliance manufacturer may receive a qualified employee discount on the manufacturer's appliances purchased at a retail store that offers such appliances for sale to customers. The employee may exclude the amount of the qualified employee discount whether the employee is provided the appliance at no charge or purchases it at a reduced price, or whether the employee receives a partial or total cash rebate from either the employer-manufacturer or the retailer. If an employee receives additional rights associated with the property that are not provided by the employee's employer to customers in the ordinary course of the line of business in which the employee performs substantial services (such as the right to return or exchange the property or special warranty rights), the employee may only receive a qualified employee discount with respect to the property and not the additional rights. Receipt of such additional rights may occur, for example, when an employee of a manufacturer purchases property manufactured by the employee's employer at a retail outlet.

(5) *Applicability of nondiscrimination rules.* The exclusion for a qualified employee discount applies to officers, owners, and highly compensated employees only if the discount is available on substantially the same terms to each member of a group of employees that is defined under a reasonable classification set up by the employer that does not discriminate in favor of officers, owners, or highly compensated employees. See § 1.132–8T.

(b) *Employee discount*—(1) *Definition.* The term ''employee discount'' means the excess of—

(i) The price at which the property or service is being offered by the employer for sale to customers, over

(ii) The price at which the property or service is provided by the employer to an employee for use by the employee.

A transfer of property by an employee without consideration is considered use by the employee for purposes of this section. Thus, for example, if an employee receives a discount on property offered for sale by his employer to customers and the employee makes a gift of the property to his parent, the property will be considered to be provided for use by the employee, thus enabling the discount to be eligible for exclusion as a qualified employee discount.

(2) *Price to customers*—(i) *Determined at time of sale.* In determining the amount of an employee discount, the price at which the property or service is being offered to customers at the time of the employee's purchase is controlling. For example, assume that an employer offers a product to customers for $20 during the first six months of a calendar year, but at the time the employee purchases the product at a discount, the price at which the product is being offered to customers is $25. In

this case, the price from which the employee discount is measured is $25.

(ii) *Quantity discount not reflected.* The price referred to in paragraph (b)(2)(i) of this section cannot reflect any quantity discount unless the employee actually purchases the requisite quantity of the property or service.

(iii) *Customers of employee's employer controls.* In determining the amount of an employee discount, the price at which the property or service is offered to customers of the employee's employer is controlling. Thus, the price at which property is sold to the wholesale customers of a manufacturer will generally be lower than the price at which the same property is sold to the customers of a retailer. However, see paragraph (a)(4)(ii) of this section regarding the effect of a wholesaler providing to its employees additional rights not provided to customers of the wholesaler in the ordinary course of its business.

(iv) *Discounts to discrete customer or consumer groups.* In determining the amount of an employee discount, if an employer offers for sale property or services at one or more discounted prices to discrete customer or consumer groups, and sales at all such discounted prices comprise at least 35 percent of the employer's gross sales for a representative period, then the price at which property or service is being offered to customers is a discounted price. The applicable discounted price is the current undiscounted price, reduced by the percentage discount at which the greatest percentage of the employer's gross sales are made for such representative period. If sales at different percentage discounts equal the same percentage of the employer's gross sales, the price at which the property or service is being provided to customers may be reduced by the average of the two group discounts. For purposes of this section, a representative period is the taxable year of the employer immediately preceding the taxable year in which the property or service is provided to the employee at a discount. If more than one employer would be aggregated under section 414 (b), (c), or (m), and all of the employers do not have the same taxable year, the employers required to be aggregated must designate the 12-month period to be used in determining gross sales for a representative period.

(v) *Examples.* The rules provided in this paragraph (b)(2) are illustrated by the following examples:

Example (1). Assume that a wholesale employer offers property for sale to two discrete customer groups at differing prices. Assume further that during the prior taxable year of the employer, 70 percent of the employer's gross sales are made at a 15-percent discount and 30 percent at no discount. The current undiscounted price at which the property or service is being offered by the employer for sale to customers may be reduced by the 15-percent discount.

Example (2). Assume that a retail employer offers a 20 percent discount to members of the American Bar Association, a 15 percent discount to members of the American Medical Association, and a ten percent discount to employees of the Federal Government. Assume further that during the prior taxable year of the employer, sales to American Bar Association members equal 15 percent of the employer's gross sales, sales to American Medical Association members equal 20 percent of the employer's gross sales, and sales to Federal Government employees equal 25 percent of the employer's gross sales. The current undiscounted price at which the property or service is being offered by the employer for sale to customers may be reduced by the ten percent Federal Government discount.

(3) *Damaged, distressed, or returned goods.* If an employee pays at least fair market value for damaged, distressed, or returned property, such employee will not have income attributable to such purchase.

(c) *Gross profit percentage*—(1) *In general*—(i) *General rule.* An exclusion from gross income for an employee discount on qualified property is limited to the price at which the property is being offered to customers in the ordinary course of the employer's line of business, multiplied by the employer's gross profit percentage. The term ''gross profit percentage'' means the excess of the aggregate sales price of the property sold by the employer to customers (including employees) over the employer's aggregate cost of the property, then divided by the aggregate sales price.

(ii) *Calculation of gross profit percentage.* The gross profit percentage must be calculated separately for each line of business based on the aggregate sales price and aggregate cost of property in that line of business for a representative period. For purposes of this section, a representative period is the taxable year of the employer immediately preceding the taxable year in which the discount is available. For example, if the aggregate sales of property in an employer's line of business for the prior taxable year were $800,000, and the aggregate cost of the property for the year were $600,000, the gross profit percentage would be 25 percent ($800,000 minus $600,000, then divided by $800,000). If more than one employer would be aggregated under section 414 (b), (c), or (m), and all of the employers do not have the same taxable year, the employers required to be aggregated must designate the 12-month period to be used in determining the gross profit percentage. If an employee performs substantial services in more than one line of business, the gross profit percentage of the line of business in which the property is sold determines the amount of the excludable employee discount.

(iii) *Special rule for employers in their first year of existence.* An employer in its first year of existence may estimate the gross profit percentage of a line of business based on its mark-up from the cost. Alternatively, an employer in its first year of existence may determine the gross profit percentage by reference to an appropriate industry average.

(iv) *Redetermination of gross profit percentage.* If substantial changes in an employer's business indicate at any time that it is inappropriate for the prior years' gross profit percentage to be used for the current year, the employer must, within a reasonable period, redetermine the gross profit percentage for the remaining portion of the current year as if such portion of the year were the first year of the employer's existence.

(2) *Line of business.* In general, an employer must determine the gross profit percentage on the basis of all property offered to customers (including employees) in each separate line of business. An employer may instead select a classification of property that is narrower than the applicable line of business. However, such classification must be reasonable. For example, if an employer computes gross profit percentage according to the department in which products are sold, such classification is reasonable. Similarly, it is reasonable to compute gross profit percentage on the basis of the type of merchandise sold (such as high mark-up and low mark-up classifications). It is not reasonable, however, for an employer to classify certain low mark-up products preferred by certain employees (such as officers, owners, and highly compensated employees) with high mark-up products or to classify certain high mark-up products preferred by other employees with low mark-up products.

(3) *Generally accepted accounting principles.* In general, the aggregate sales price of property must be determined in accordance with generally accepted accounting principles. An employer must compute the aggregate cost of property in the same manner in which it is computed for the employer's Federal income tax liability, pursuant to the inventory rules in section 471 and the regulations thereunder.

(d) *Treatment of leased sections of department stores*—(1) *In general*—(i) *General rule.* For purposes of determining whether employees of a leased section of a department store may receive qualified employees discounts at the department store and whether employees of the department store may receive qualified employee discounts at the leased section of the department store, the leased section is treated as part of the line of business of the person operating the department store, and employees of the leased section are treated as employees of the person operating the department store as well as employees of their employer. The term ''leased section of a department store'' means a section of a department store where substantially all of the gross receipts of the leased section are over-the-counter sales of property made under a lease, license, or similar arrangement where it appears to the general public that individuals making such sales are employed by the department store. An example of a leased section of a department store is a cosmetics firm that leases floor space from a department store.

(ii) *Calculation of gross profit percentage.* When calculating the gross profit percentage of property and services sold at the department store under paragraph (c) of this section, sales of property and services sold at the department store, as well as sales of property and services sold at the leased section, are considered. The rule provided in the preceding sentence does not apply, however, if it is reasonable to calculate the gross profit percentage for the department store and leased section separately, or if it would be inappropriate to combine them (such as where either the department store or the leased section, but not both, provides employee discounts).

(2) *Employees of the leased section*—(i) *Definition.* For purposes of this paragraph (d), ''employees of the leased section'' means all employees who perform substantial services at the leased section regardless of whether the employees engage in over-the-counter sales of property or services. The term ''employee'' has the same meaning as in section 133(f).

(ii) *Discounts offered to either department store employees or employees of the leased section.* If the requirements of this paragraph (d) are satisfied, employees of the leased section may receive qualified employee discounts at the department store regardless of whether employees of the department store are offered discounts at the leased section. Similarly, regardless of whether employees of the leased section are offered discounts at the department store, employees of the department store may receive qualified employee discounts at the leased section.

(e) *Excess discounts.* Unless excludable under a statutory provision other than section 132(a)(2), an employee discount provided on property is excludable to the extent of the gross profit percentage multiplied by the price at which the property is being offered for sale to customers. If an employee discount exceeds the gross profit percentage, the excess discount is includible in the employee's income. For example, if the discount on property is 30 percent and the employer's gross profit percentage for the period in the relevant line of business is 25 percent, then 5 percent of the price at which the property is being offered for sale to customers is includible in the emloyee's income. With respect to services, an employee discount of up to 20 percent may be excludable. If an employee discount exceeds 20 percent, the excess discount is includible in the employee's income.

[T.D. 8063, 50 FR 52299, Dec. 23, 1985, as amended by T.D. 8256, 54 FR 28600, July 6, 1989]

§ 1.132–4 Line of business limitation.

(a) *In general*—(1) *Applicability*—(i) *General rule.* A no-additional-cost service or a qualified employee discount provided to an employee is only available with respect to property or services that are offered for sale to customers in the ordinary course of the same line of business in which the employee receiving the property or service performs substantial services. Thus, an employee who does not perform substantial services in a particular line of business of the employer may not exclude from income under section 132 (a)(1) or (a)(2) the value of services or employee discounts received on property or services in that line of business. For rules that relax the line of business requirement, see paragraphs (b) through (g) of this section.

(ii) *Property and services sold to employees rather than customers.* Because the property or services must be offered for sale to customers in the ordinary course of the same line of business in which the employee performs substantial services, the line of business limitation is not satisfied if the employer's products or services are sold primarily to employees of the employer, rather than to customers. Thus, for example, an employer in the banking line of business is not considered in the variety store line of business if the employer establishes an employee store that offers variety store items for sale to the employer's employees. See § 1.132–7 for rules relating to employer-operated eating facilities, and see § 1.132–1(e) for rules relating to employer-operated on-premises athletic facilities.

(iii) *Performance of substantial services in more than one line of business.* An employee who performs services in more than one of the employer's lines of business may only exclude no-additional-cost services and qualified employee discounts in the lines of business in which the employee performs substantial services.

(iv) *Performance of services that directly benefit more than one line of business*—(A) *In general.* An employee who performs substantial services that directly benefit more than one line of business of an employer is treated as performing substantial services in all such line of business. For example, an employee who maintains accounting records for an employer's three lines of business may receive qualified employee discounts in all three lines of business. Similarly, if an employee of a minor line of business of an employer that is significantly interrelated with a major line of business of the employer performs substantial services that directly benefit both the major and the minor lines of business, the employee is treated as performing substantial services for both the major and the minor lines of business.

(B) *Examples.* The rules provided in this paragraph (a)(1)(iv) are illustrated by the following examples:

Example (1). Assume that employees of units of an employer provide repair or financing services, or sell by catalog, with respect to retail merchandise sold by the employer. Such employees may be considered to perform substantial services for the retail merchandise line of business under paragraph (a)(1)(iv)(A) of this section.

Example (2). Assume that an employer operates a hospital and a laundry service. Assume further that some of the gross receipts of the laundry service line of business are from laundry services sold to customers other than the hospital employer. Only the employees of the laundry service who perform substantial services which directly benefit the hospital line of business (through the provision of laundry services to the hospital) will be treated as performing substantial services for the hospital line of business. Other employees of the laundry service line of business will not be treated as employees of the hospital line of business.

Example (3). Assume the same facts as in example (2), except that the employer also operates a chain of dry cleaning stores. Employees who perform substantial services which directly benefit the dry cleaning stores but who do not perform substantial services that directly benefit the hospital line of business will not be treated as performing substantial services for the hospital line of business.

(2) *Definition*—(i) *In general.* An employer's line of business is determined by reference to the Enterprise Standard Industrial Classification Manual (ESIC Manual) prepared by the Statistical Policy Division of the U.S. Office of Management and Budget. An employer is considered to have more than one line of business if the employer offers for sale to customers property or services in more than one two-digit code classification referred to in the ESIC Manual.

(ii) *Examples.* Examples of two-digit classifications are general retail merchandise stores; hotels and other lodging places; auto repair, services, and garages; and food stores.

(3) *Aggregation of two-digit classifications.* If, pursuant to paragraph (a)(2) of this section, an employer has more than one line of business, such lines of business will be treated as a single line of business where and to the extent that one or more of the following aggregation rules apply:

(i) If it is uncommon in the industry of the employer for any of the separate lines of business of the employer to be operated without the others, the separate lines of business are treated as one line of business.

(ii) If it is common for a substantial number of employees (other than those employees who work at the headquarters or main office of the employer) to perform substantial services for more than one line of business of the employer, so that determination of which employees perform substantial services for which line or lines of business would be difficult, then the separate lines of business of the employer in which such employees perform substantial services are treated as one line of business. For example, assume that an employer operates a delicatessen with an attached service counter at which food is sold for consumption on the premises. Assume further that most but not all employees work both at the delicatessen and at the service counter. Under the aggregation rule of this paragraph (a)(3)(ii), the delicatessen and the service counter are treated as one line of business.

(iii) If the retail operations of an employer that are located on the same premises are in separate lines of business but would be considered to be within one line of business under paragraph (a)(2) of this section if the merchandise offered for sale in such lines of business were offered for sale at a department store, then the operations are treated as one line of business. For example, assume that on the same premises an employer sells both women's apparel and jewelry. Because, if sold together at a department store, the operations would be part of the same line of business, the operations are treated as one line of business.

(b) *Grandfather rule for certain retail stores*—(1) *In general.* The line of business limitation may be relaxed under the special grandfather rule of this paragraph (b). Under this special grandfather rule, if—

(i) On October 5, 1983, at least 85 percent of the employees of one member of an affiliated group (as defined in section 1504 without regard to subsections (b)(2) and (b)(4) thereof) (''first member'') were entitled to receive employee discounts at retail department stores operated by another member of the affiliated group (''second member''), and

(ii) More than 50 percent of the previous year's sales of the affiliated group are attributable to the operation of retail department stores, then, for purposes of the exclusion from gross income of a qualified employee discount, the first member is treated as engaged in the same line of business as the second member (the opeator of the retail department stores). Therefore, employees of the first member of the affiliated group may exclude from income qualified employee discounts received at the retail department stores operated by the second member. However, employees of the second member of the affiliated group may not under this paragraph (b)(1) exclude any discounts received on property or services offered for sale to customers by the first member of the affiliated group.

(2) *Taxable year of affiliated group.* If not all of the members of an affiliated group have the same taxable year, the affiliated group must designate the 12-month period to be used in determining the ''previous year's sales'' (as referred to in the grandfather rule of this paragraph (b)). The 12-month period designated, however, must be used on a consistent basis.

(3) *Definition of ''sales.''* For purposes of this paragraph (b), the term ''sales'' means the gross receipts of an affiliated group, based upon the accounting methods used by its members.

(4) *Retired and disabled employees.* For purposes of this paragraph (b), an employee includes any individual who was, or whose spouse was, formerly employed by the first member of an affiliated group and who separated from service with the member by reason of retirement or disability if the second member of the group provided employee discounts to that individual on October 5, 1983.

(5) *Increase of employee discount.* If, after October 5, 1983, the employee discount described in this paragraph (b) is increased, the grandfather rule of this paragraph (b) does not apply to the amount of the increase. For example, if on January 1, 1989, the employee discount is increased from 10 percent to 15 percent, the grandfather rule will not apply to the additional 5 percent discount.

(c) *Grandfather rule for telephone service provided to predivestiture retirees.* All entities subject to the modified final judgment (as defined in section 559(c)(5) of the Tax Reform Act of 1984) shall be treated as a single employer engaged in the same line of business for purposes of determining whether telephone service provided to certain employees is a no-additional-cost service. The preceding sentence applies only in the case of an employee who by reason of retirement or disability separated before January 1, 1984, from the service of an entity subject to the modified final judgment. This paragraph (c) only applies to services provided to such employees as of January 1, 1984. For a special no-additional-cost service rule relating to such employees and such services, see § 1.132–2(a)(6).

(d) *Special rule for certain affiliates of commercial airlines*—(1) *General rule.* If a qualified affiliate is a member of an airline affiliated group and employees of the qualified affiliate who are directly engaged in providing airline-related services are entitled to no-additional-cost service with respect to air transportation provided by such other member, then, for purposes of applying §1.132–2 (relating to no-additional-cost services with respect to such air transportation), such qualified affiliate shall be treated as engaged in the same line of business as such other member.

(2) *''Airline affiliated group'' defined.* An ''airline affiliated group'' is an affiliated group (as defined in section 1504 (a)) one of whose members operates a commercial airline that provides air transportation to customers on a per-seat basis.

(3) *''Qualified affiliate'' defined.* A ''qualified affiliate'' is any corporation that is predominantly engaged in providing airline-related services. The term ''airline-related services'' means any of the following services provided in connection with air transportation:

(i) Catering,

(ii) Baggage handling,

(iii) Ticketing and reservations,

(iv) Flight planning and weather analysis, and

(v) Restaurants and gift shops located at an airport.

(e) *Grandfather rule for affiliated groups operating airlines.* The line of business limitation may be relaxed under the special grandfather rule of this paragraph (e). Under this special grandfather rule, if, as of September 12, 1984—

(1) An individual—

(i) Was an employee (within the meaning of §1.132–1 (b)) of one member of an affiliated group (as defined in section 1504(a)) (''first corporation''), and

(ii) Was eligible for no-additional-cost services in the form of air transportation provided by another member of such affiliated group (''second corporation''),

(2) At least 50 percent of the individuals performing services for the first corporation were, or had been employees of, or had previously performed services for, the second corporation, and

(3) The primary business of the affiliated group was air transportation of passengers, then, for purposes of applying sections 132(a) (1) and (2), with respect to no-additional-cost services and qualified employee discounts provided after December 31, 1984, for that individual by the second corporation, the first corporation is treated as engaged in the same air transporation line of business as the second corporation. For purposes of the preceding sentence, an employee of the second corporation who is performing services for the first corporation is also treated as an employee of the first corporation.

(f) *Special rule for qualified air transportation organizations.* A qualified air transportation organization is treated as engaged in the line of business of providing air transportation with respect to any individual who performs services for the organization if those services are peformed primarily for persons engaged in providing air transportation, and are of a kind which (if performed on September 12, 1984) would qualify the individual for no-additional-cost services in the form of air transportation. The term ''qualified air transportation organization'' means any organization—

(1) If such organization (or a predecessor) was in existence on September 12, 1984,

(2) If such organization is—

(i) A tax-exempt organization under section(c)(6) whose membership is limited to entities engaged in the transportation by air of individuals or property for compensation or hire, or

(ii) Is a corporation all the stock of which is owned entirely by entities described in paragraph (f)(2)(i) of this section, and

(3) If such organization is operated in furtherance of the activities of its members or owners.

(g) *Relaxation of line of business requirement.* The line of business requirement may be relaxed under an elective grandfather rule provided in section 4977. For rules relating to the section 4977 election, see §54.4977–1T.

(h) *Line of business requirement does not expand benefits eligible for exclusion.* The line of business requirement limits the benefits eligible for the no-additional-cost service and qualified employee discount exclusions to property or services provided by an employer to its customers in the ordinary course of the line of business of the employer in which the employee performs substantial services. The requirement is intended to ensure that employers do not offer, on a tax-free or reduced basis, property or services to employees that are not offered to the employer's customers, even if the property or services offered to the customers and the employees are within the same line of business (as defined in this section).

[T.D. 8256, 54 FR 28606, July 6, 1989]

§ 1.132–4T Line of business limitation—1985 through 1988 (temporary).

(a) *In general*—(1) *Applicability*—(i) *General rule.* A no-additional-cost service or qualified employee discount provided to an employee must be for property or services that are offered for sale to customers in the ordinary course of the same line of business in which the employee receiving the property or service performs substantial services. Thus, an employee who does not perform substantial services in a particular line of business of the employer may not exclude the value of services or employee discounts received on property or services in that line of business.

(ii) *Property and services sold to employees rather than customers.* Since the property or services must be offered for sale to customers in the ordinary course of the same line of business in which the employee performs substantial services, the line of business limitation is not satisfied if the employer's products or services are sold to employees of the employer, rather than to customers. Thus, for example, an employer in the banking line of business is not considered in the variety store line of business if the employer establishes an employee store that offers variety store items for sale to the employer's employees.

(iii) *Performance of substantial services in more than one line of business.* An employee who performs services in more than one of the employer's lines of business may only exclude no-additional-cost services and qualified employee discounts in the lines of business in which the employee performs substantial services.

(iv) *Performance of services that directly benefit more than one line of business*—(A) *In general.* An employee who performs substantial services that directly benefit more than one line of business of an employer is treated as performing substantial services in all such lines of business. For example, an employee who maintains accounting records for an employer's three lines of business may receive qualified employee discounts in all three lines of business.

(B) *Significantly interrelated minor line of business.* The employees of a minor line of business of an employer that is significantly interrelated with a major line of business of the employer who perform substantial services that directly benefit both the major and the minor lines of business are treated as employees of both the major and the minor lines of business. Employees of the minor line of business who do not perform substantial services which directly benefit the major line of business are not treated as employees of the major line of business. A minor line of business is significantly interrelated with a major line of business when, for example, the activity of the minor line of business is directly related to but is a minor part of the major line of business (such as laundry services provided at a hospital).

(C) *Examples.* The rules provided in this paragraph are illustrated in the following examples:

Example (1). Assume that employees of units of an employer provide repair or financing services, or sell by catalog, with respect to retail merchandise sold by the employer. Such employees may be considered as employees of the retail merchandise line of business under this paragraph (a)(1)(iv).

Example (2). Assume that an employer operates a hospital and a laundry service. Assume further that some of the gross receipts of the laundry service line of business are from laundry services sold to customers other than the hospital employer. Only the employees of the laundry service who perform substantial services which directly benefit the hospital line of business (through the provision of laundry services to the hospital) will be treated as employees of the hospital line of business. Other employees of the laundry service line of business will not be treated as employees of the hospital line of business.

Example (3). Assume the same facts as in example (2), except that the minor line of business also operates a chain of dry cleaning stores. Employees who perform substantial services which directly benefit the dry cleaning stores but who do not perform substantial services that directly benefit the hospital line of business will not be treated as employees of the hospital line of business.

(2) *Definition*—(i) *In general.* An employer's line of business is determined by reference to the Enterprise Standard Industrial Classification Manual (ESIC Manual) prepared by the Statistical Policy Division of the U.S. Office of Management and Budget. An employer is considered to have more than one line of business if the employer offers for sale to customers property or services in more than one two-digit code classification referred to in the ESIC Manual.

(ii) *Examples.* Examples of two-digit classifications are general retail merchandise stores; hotels and other lodging places; auto repair, services, and garages; and food stores.

(3) *Aggregation of two-digit classifications.* If, pursuant to paragraph (a)(2) of this section, an employer has more than one line of business, such lines of business will be treated as a single line of business where and to the extent that one or more of the following aggregation rules apply:

(i) If it is uncommon in the industry of the employer for any of the separate lines of business of the employer to be operated without the others, the separate lines of business are treated as one line of business.

(ii) If it is common for a substantial number of employees (other than those employees who work at the headquarters or main office of the employer) to perform substantial services for more than one line of business of the employer, so that determination of which employees perform substantial services for which line of business would be difficult, then the separate lines of business of the employer in which such employees perform substantial services are treated as one line of business. For example, assume that an employer operates a delicatessen with an attached service counter at which food is sold for consumption on the premises. Assume further that most but not all employees work both at the delicatessen and at the service counter. The delicatessen and the service counter are treated as one line of business.

(iii) If the retail operations of an employer that are located on the same premises are in separate lines of business but would be considered to be within one line of business under paragraph (a)(2) of this section if the merchandise offered for sale in such lines of business were offered for sale at a department store, then the operations are treated as one line of business. For example, assume that on the same premises an employer sells both women's apparel and jewelry. Since, if sold together at a department store, the operations would be part of the same line of business, the operations are treated as one line of business.

(b) *Grandfather rule for certain retail stores*—(1) *In general.* The line of business limitation may be relaxed under a special grandfather rule. If—

(i) On October 5, 1983, 85 percent of the employees of one member of an affiliated group (as defined in section 1504 without regard to subsections (b)(2) and (b)(4) thereof) were entitled to employee discounts at retail department stores operated by another member of the affiliated group, and

(ii) More than 50 percent of the current year's sales of the affiliated group are attributable to the operation of retail department stores,

then for purposes of the exclusion from gross income of a qualified employee discount, the first member is treated as engaged in the same line of business as the second member (the operator of the retail department stores). Therefore, employees of the first member of the affiliated group may exclude qualified employee discounts received at the retail department stores operated by the second member. However, employees of the second member of the affiliated group may not exclude any discounts received on property or services offered for sale to customers by the first member of the affiliated group.

(2) *Taxable year of affiliated group.* If all of the members do not have the same taxable year, the affiliated group must designate the 12-month period to be used in determining the ‘‘current year's sales'' (as referred to in this paragraph (b)). The 12-month period

designated, however, must be used consistently.

(3) *Definition of ''sales''.* For purposes of this paragraph (b), the term ''sales'' means the gross receipts of the affiliated group, based upon the accounting methods used by its members.

(4) *Retired and disabled employees.* For purposes of this paragraph (b), an employee includes any individual who was, or whose spouse was, formerly employed by the first member of the affiliated group and who separated from service with the member by reason of retirement or disability if the second member of the group provided employee discounts to such individuals on October 5, 1983.

(5) *Increase of employee discount.* If, after October 5, 1983, the employee discount described in this paragraph (b) is increased, the grandfather rule of this paragraph (b) does not apply to the amount of the increase. For example, if on January 1, 1985, the employee discount is increased from 10 percent to 15 percent, the grandfather rule will not apply to the additional five percent discount.

(c) *Relaxation of line of business requirement.* The line of business requirement may be relaxed under an elective grandfather rule provided in section 4977. For rules relating to the section 4977 election, see § 54.4977–1.

[T.D. 8063, 50 FR 52301, Dec. 23, 1985, as amended by T.D. 8256, 54 FR 28600, July 6, 1989]

§ 1.132–5 Working condition fringes.

(a) *In general*—(1) *Definition.* Gross income does not include the value of a working condition fringe. A ''working condition fringe'' is any property or service provided to an employee of an employer to the extent that, if the employee paid for the property or service, the amount paid would be allowable as a deduction under section 162 or 167.

(i) A service or property offered by an employer in connection with a flexible spending account is not excludable from gross income as a working condition fringe. For purposes of the preceding sentence, a flexible spending account is an agreement (whether or not written) entered into between an employer and an employee that makes available to the employee over a time period a certain level of unspecified non-cash benefits with a pre-determined cash value.

(ii) If, under section 274 or any other section, certain substantiation requirements must be met in order for a deduction under section 162 or 167 to be allowable, then those substantiation requirements apply when determining whether a property or service is excludable as a working condition fringe.

(iii) An amount that would be deductible by the employee under a section other than section 162 or 167, such as section 212, is not a working condition fringe.

(iv) A physical examination program provided by the employer is not excludable as a working condition fringe even if the value of such program might be deductible to the employee under section 213. The previous sentence applies without regard to whether the employer makes the program mandatory to some or all employees.

(v) A cash payment made by an employer to an employee will not qualify as a working condition fringe unless the employer requires the employee to—

(A) Use the payment for expenses in connection with a specific or pre-arranged activity or undertaking for which a deduction is allowable under section 162 or 167,

(B) Verify that the payment is actually used for such expenses, and

(C) Return to the employer any part of the payment not so used.

(vi) The limitation of section 67(a) (relating to the two-percent floor on miscellaneous itemized deductions) is not considered when determining the amount of a working condition fringe. For example, assume that an employer provides a $1,000 cash advance to Employee A and that the conditions of paragraph (a)(1)(v) of this section are not satisfied. Even to the extent A uses the allowance for expenses for which a deduction is allowable under section 162 and 167, because such cash payment is not a working condition fringe, section 67(a) applies. The $1,000 payment is includible in A's gross income and subject to income and employment tax withholding. If, however, the conditions of paragraph (a)(1)(v) of this section are satisfied with respect to the payment, then the amount of A's working condition fringe is determined without regard to section 67(a). The $1,000 payment is excludible from A's gross income and not subject to income and employment tax reporting and withholding.

(2) *Trade or business of the employee*—(i) *General.* If the hypothetical payment for a property or service would be allowable as a deduction with respect to a trade or business of an employee other than the employee's trade or business of being an employee of the employer, it cannot be taken into account for purposes of determining the amount, if any, of the working condition fringe.

(ii) *Examples.* The rule of paragraph (a)(2)(i) of this section may be illustrated by the following examples:

Example (1). Assume that, unrelated to company X's trade or business and unrelated to employee A's trade or business of being an employee of company X, A is a member of the board of directors of company Y. Assume further that company X provides A with air transportation to a company Y board of director's meeting. A may not exclude from gross income the value of the air transportation to the meeting as a working condition fringe. A may, however, deduct such amount under section 162 if the section 162 requirements are satisfied. The result would be the same whether the air transportation was provided in the form of a flight on a commercial airline or a seat on a company X airplane.

Example (2). Assume the same facts as in example (1) except that A serves on the board of directors of company Z and company Z regularly purchases a significant amount of goods and services from company X. Because of the relationship between Company Z and A's employer, A's membership on Company Z's board of directors is related to A's trade or business of being an employee of Company X. Thus, A may exclude from gross income the value of air transportation to board meetings as a working condition fringe.

Example (3). Assume the same facts as in example (1) except that A serves on the board of directors of a charitable organization. Assume further that the service by A on the charity's board is substantially related to company X's trade or business. In this case, A may exclude from gross income the value of air transportation to board meetings as a working condition fringe.

Example (4). Assume the same facts as in example (3) except that company X also provides A with the use of a company X conference room which A uses for monthly meetings relating to the charitable organization. Also assume that A uses company X's copy machine and word processor each month in connection with functions of the charitable organization. Because of the substantial business benefit that company X derives from A's service on the board of the charity, A may exclude as a working condition fringe the value of the use of company X property in connection with the charitable organization.

(b) *Vehicle allocation rules*—(1) *In general*—(i) *General rule.* In general, with respect to an employer-provided vehicle, the amount excludable as a working condition fringe is the amount that would be allowable as a deduction under section 162 or 167 if the employee paid for the availability of the vehicle. For example, assume that the value of the availability of an employer-provided vehicle for a full year is $2,000, without regard to any working condition fringe (i.e., assuming all personal use). Assume Further that the employee drives the vehicle 6,000 miles for his employer's business and 2,000 miles for reasons other than the employer's business. In this situation, the value of the working condition fringe is $2,000 multiplied by a fraction, the numerator of which is the business-use mileage (6,000 miles) and the denominator of which is the total mileage (8,000 miles). Thus, the value of the working condition fringe is $1,500. The total amount includible in the employee's gross income on account of the availability of the vehicle is $500 ($2,000 − $1,500). For purposes of this section, the term ''vehicle'' has the meaning given the term in §1.61–21(e)(2). Generally, when determining the amount of an employee's working condition fringe, miles accumulated on the vehicle by all employees of the employer during the period in which the vehicle is available to the employee are considered. For example, assume that during the year in which the vehicle is available to the employee in the above example, other employees accumulate 2,000 additional miles on the vehicle (while the employee is not in the automobile). In this case, the value of the working condition fringe is $2,000 multiplied by a fraction, the numerator of which is the business-use mileage by the employee (including all mileage (business and personal) accumulated by other employees) (8,000 miles) and the denominator of which is the total mileage (including all mileage accumulated by other employees) (10,000 miles). Thus, the value of the working condition fringe is $1,600; the total amount includible in the employee's gross income on account of the availability of the vehicle is $400 ($2,000 − $1,600). If, however, substantially all of the use of the automobile by other employees in the employer's business is limited to a certain period, such as the last three months of the year, the miles driven by the other employees during that period would not be considered when determining the employee's working condition fringe exclusion. Similarly, miles driven by other employees are not considered if the pattern of use of the employer-provided automobiles is designed to reduce Federal taxes. For example, assume that an employer provides employees A and B each with the availability of an employer-provided automobile and that A uses the automobile assigned to him 80 percent for the employer's business and that B uses the automobile assigned to him 30 percent for the employer's business. If A and B alternate the use of their assigned automobiles each week in such a way as to achieve a reduction in federal taxes, then the employer may count only miles placed on the automobile by the employee to whom the automobile is assigned when determining each employee's working condition fringe.

(ii) *Use by an individual other than the employee.* For purposes of this section, if the availability of a vehicle to an individual would be taxed to an employee, use of the vehicle by the individual is included in references to use by the employee.

(iii) *Provision of an expensive vehicle for personal use.* If an employer provides an employee with a vehicle that an employee may use in part for personal purposes, there is no working condition fringe exclusion with respect to the personal miles driven by the employee; if the employee paid for the availability of the vehicle, he would not be entitled to deduct under section 162 or 167 any part of the payment attributable to personal miles. The amount of the inclusion is not affected by the fact that the employee would have chosen the availability of a less expensive vehicle. Moreover, the result is the same even though the decision to provide an expensive rather than an inexpensive vehicle is made by the employer for bona fide noncompensatory business reasons.

(iv) *Total value inclusion.* In lieu of excluding the value of a working condition fringe with respect of an automobile, an employer using the automobile lease valuation rule of § 1.61–21(d) may include in an employee's gross income the entire Annual Lease Value of the automobile. Any deduction allowable to the employee under section 162 or 167 with respect to the automobile may be taken on the employee's income tax return. The total inclusion rule of this paragraph (b)(1)(iv) is not available if the employer is valuing the use or availability of a vehicle under general valuation principles or a special valuation rule other than the automobile lease valuation rule. See §§ 1.162–25 and 1.162–25T for rules relating to the employee's deduction.

(v) *Shared usage.* In calculating the working condition fringe benefit exclusion with respect to a vehicle provided for use by more than one employee, an employer shall compute the working condition fringe in a manner consistent with the allocation of the value of the vehicle under section 1.61–21(c)(2)(ii)(B).

(2) *Use of different employer-provided vehicles.* The working condition fringe exclusion must be applied on a vehicle-by-vehicle basis. For example, assume that automobile Y is available to employee D for 3 days in January and for 5 days in March, and automobile Z is available to D for a week in July. Assume further that the Daily Lease Value, as defined in § 1.61–21(d)(4)(ii), of each automobile is $50. For the eight days of availability of Y in January and March, D uses Y 90 percent for business (by mileage). During July, D uses Z 60 percent for business (by mileage). The value of the working condition fringe is determined separately for each automobile. Therefore, the working condition fringe for Y is $360 ($400×.90) leaving an income inclusion

of $40. The working condition fringe for Z is $210 ($350×.60), leaving an income inclusion of $140. If the value of the availability of an automobile is determined under the Annual Lease Value rule for one period and Daily Lease Value rule for a second period (see § 1.61–21(d)), the working condition fringe exclusion must be calculated separately for the two periods.

(3) *Provision of a vehicle and chauffeur services*—(i) *General rule.* In general, with respect to the value of chauffeur services provided by an employer, the amount excludable as a working condition fringe is the amount that would be allowable as a deduction under section 162 and 167 if the employee paid for the chauffeur services. The working condition fringe with respect to a chauffeur is determined separately from the working condition fringe with respect to the vehicle. An employee may exclude from gross income the excess of the value of the chauffeur services over the value of the chauffeur services for personal purposes (such as commuting) as determined under § 1.61–21(b)(5). See § 1.61–21(b)(5) for additional rules and examples concerning the valuation of chauffeur services. See § 1.132–5(m)(5) for rules relating to an exclusion from gross income for the value of bodyguard/chauffeur services. When determining whether miles placed on the vehicle are for the employer's business, miles placed on the vehicle by a chauffeur between the chauffeur's residence and the place at which the chauffeur picks up (or drops off) the employee are with respect to the employee (but not the chauffeur) considered to be miles placed on the vehicle for the employer's business and thus eligible for the working condition fringe exclusion. Thus, because miles placed on the vehicle by a chauffeur between the chauffeur's residence and the place at which the chauffeur picks up (or drops off) the employee are not considered business miles with respect to the chauffeur, the value of the availability of the vehicle for commuting is includible in the gross income of the chauffeur. For general and special rules concerning the valuation of the use of employer-provided vehicles, see paragraphs (b) through (f) of § 1.61–21.

(ii) *Examples.* The rules of paragraph (b)(3)(i) of this section are illustrated by the following examples:

Example (1). Assume that an employer makes available to an employee an automobile and a chauffeur. Assume further that the value of the chauffeur services determined in accordance with § 1.61–21 is $30,000 and that the chauffeur spends 30 percent of each workday driving the employee for personal purposes. There may be excluded from the employee's income 70 percent of $30,000, or $21,000, leaving an income inclusion with respect to the chauffeur services of $9,000.

Example (2). Assume that the value of the availability of an employer-provided vehicle for a year is $4,850 and that the value of employer-provided chauffeur services with respect to the vehicle for the year is $20,000. Assume further that 40 percent of the miles placed on the vehicle are for the employer's business and that 60 percent are for other purposes. In addition, assume that the chauffeur spends 25 percent of each workday driving the employee for personal purposes (i.e., 2 hours). The value of the chauffeur services includible in the employee's income is 25 percent of $20,000, or $5,000. The excess of $20,000 over $5,000 or $15,000 is excluded from the employee's income as a working condition fringe. The amount excludable as a working condition fringe with respect to the vehicle is 40 percent of $4,850, or $1,940 and the amount includible is $4,850 − $1,940, or $2,910.

(c) *Applicability of substantiation requirements of sections 162 and 274 (d)*—(1) *In general.* The value of property or services provided to an employee may not be excluded from the employee's gross income as a working condition fringe, by either the employer or the employee, unless the applicable substantiation requirements of either section 274(d) or section 162 (whichever is applicable) and the regulations thereunder are satisfied. The substantiation requirements of section 274(d) apply to an employee even if the requirements of section 274 do not apply to the employee's employer for deduction purposes (such as when the employer is a tax-exempt organization or a governmental unit).

(2) *Section 274(d) requirements.* The substantiation requirements of section 274(d) are satisfied by ‘‘adequate records or sufficient evidence corroborating the [employee's] own statement''. Therefore, such records or evidence provided by the employee, and

relied upon by the employer to the extent permitted by the regulations promulgated under section 274(d), will be sufficient to substantiate a working condition fringe exclusion.

(d) *Safe harbor substantiation rules*—(1) *In general.* Section 1.274–6T provides that the substantiation requirements of section 274(d) and the regulations thereunder may be satisfied, in certain circumstances, by using one or more of the safe harbor rules prescribed in § 1.274–6T. If the employer uses one of the safe harbor rules prescribed in § 1.274–6T during a period with respect to a vehicle (as defined in § 1.61–21(e)(2)), that rule must be used by the employer to substantiate a working condition fringe exclusion with respect to that vehicle during the period. An employer that is exempt from Federal income tax may still use one of the safe harbor rules (if the requirements of that section are otherwise met during a period) to substantiate a working condition fringe exclusion with respect to a vehicle during the period. If the employer uses one of the methods prescribed in § 1.274–6T during a period with respect to an employer-provided vehicle, that method may be used by an employee to substantiate a working condition fringe exclusion with respect to the same vehicle during the period, as long as the employee includes in gross income the amount allocated to the employee pursuant to § 1.274–6T and this section. (See § 1.61–21(c)(2) for other rules concerning when an employee must include in income the amount determined by the employer.) If, however, the employer uses the safe harbor rule prescribed in § 1.274–6T(a)(2) or (3) and the employee without the employer's knowledge uses the vehicle for purposes other than de minimis personal use (in the case of the rule prescribed in § 1.274–6T(a)(2)), or for purposes other than de minimis personal use and commuting (in the case of the rule prescribed in § 1.274–6T(a)(3)), then the employees must include an additional amount in income for the unauthorized use of the vehicle.

(2) *Period for use of safe harbor rules.* The rules prescribed in this paragraph (d) assume that the safe harbor rules prescribed in § 1.274–6T are used for a one-year period. Accordingly, references to the value of the availability of a vehicle, amounts excluded as a working condition fringe, etc., are based on a one-year period. If the safe harbor rules prescribed in § 1.274–6T are used for a period of less than a year, the amounts referred to in the previous sentence must be adjusted accordingly. For purposes of this section, the term ‘‘personal use’’ has the same meaning as prescribed in § 1.274–6T (e)(5).

(e) *Safe harbor substantiation rule for vehicles not used for personal purposes.* For a vehicle described in § 1.274–6T(a)(2) (relating to certain vehicles not used for personal purposes), the working condition fringe exclusion is equal to the value of the availability of the vehicle if the employer uses the method prescribed in § 1.274–6T(a)(2).

(f) *Safe harbor substantiation rule for vehicles not available to employees for personal use other than commuting.* For a vehicle described in § 1.274–6T(a)(3) (relating to certain vehicles not used for personal purposes other than commuting), the working condition fringe exclusion is equal to the value of the availability of the vehicle for purposes other than commuting if the employer uses the method prescribed in § 1.274–6T(a)(3). This rule applies only if the special rule for valuing commuting use, as prescribed in § 1.61–21(f), is used and the amount determined under the special rule is either included in the employee's income or reimbursed by the employee.

(g) *Safe harbor substantiation rule for vehicles used in connection with the business of farming that are available to employees for personal use*—(1) *In general.* For a vehicle described in § 1.274–6T(b) (relating to certain vehicles used in connection with the business of farming), the working condition fringe exclusion is calculated by multiplying the value of the availability of the vehicle by 75 percent.

(2) *Vehicles available to more than one individual.* If the vehicle is available to more than one individual, the employer must allocate the gross income inclusion attributable to the vehicle (25 percent of the value of the availability of the vehicle) among the employees (and other individuals whose use would not be attributed to an employee) to whom

the vehicle was available. This allocation must be done in a reasonable manner to reflect the personal use of the vehicle by the individuals. An amount that would be allocated to a sole proprietor reduces the amounts that may be allocated to employees but is otherwise to be disregarded for purposes of this paragraph (g). For purposes of this paragraph (g), the value of the availability of a vehicle may be calculated as if the vehicle were available to only one employee continuously and without regard to any working condition fringe exclusion.

(3) *Examples.* The following examples illustrate a reasonable allocation of gross income with respect to an employer-provided vehicle between two employees:

Example (1). Assume that two farm employees share the use of a vehicle that for a calendar year is regularly used directly in connection with the business of farming and qualifies for use of the rule in §1.274–6T(b). Employee A uses the vehicle in the morning directly in connection with the business of farming and employee B uses the vehicle in the afternoon directly in connection with the business of farming. Assume further that employee B takes the vehicle home in the evenings and on weekends. The employer should allocate all the income attributable to the availability of the vehicle to employee B.

Example (2). Assume that for a calendar year, farm employees C and D share the use of a vehicle that is regularly used directly in connection with the business of farming and qualifies for use of the rule in §1.2.4–6T(b). Assume further that the employees alternate taking the vehicle home in the evening and alternate the availability of the vehicle for personal purposes on weekends. The employer should allocate the income attributable to the availability of the vehicle for personal use (25 percent of the value of the availability of the vehicle) equally between the two employees.

Example (3). Assume the same facts as in example (2) except that C is the sole proprietor of the farm. Based on these facts, C should allocate the same amount of income to D as was allocated to D in example (2). No other income attributable to the availability of the vehicle for personal use should be allocated.

(h) *Qualified nonpersonal use vehicles.* (1) *In general.* Except as provided in paragraph (h)(2) of this section, 100 percent of the value of the use of a qualified nonpersonal use vehicle (as described in §1.274–5T(k)) is excluded from gross income as a working condition fringe, provided that, in the case of a vehicle described in paragraph (k) (3) through (8) of that section, the use of the vehicle conforms to the requirements of that paragraph.

(2) *Shared usage of qualified nonpersonal use vehicles.* In general, a working condition fringe under paragraph (h) of this section is available to the driver and all passengers of a qualified nonpersonal use vehicle. However, a working condition fringe under this paragraph (h) is available only with respect to the driver and not with respect to any passengers of a qualified nonpersonal use vehicle described in §1.274–5T(k)(2)(ii) (L) or (P). In this case, the passengers must comply with provisions of this section (excluding this paragraph (h)) to determine the applicability of the working condition fringe exclusion. For example, if an employer provides a passenger bus with a capacity of 25 passengers to its employees for purposes of transporting employees to and/or from work, the driver of the bus may exclude from gross income as a working condition fringe 100 percent of the value of the use of the vehicle. The value of the commuting use of the employer-provided bus by the employee-passengers is includible in their gross incomes. See §1.61–21(f) for a special rule to value the commuting-only use of employer-provided vehicles.

(i) [Reserved]

(j) *Application of section 280F.* In determining the amount, if any, of an employee's working condition fringe, section 280F and the regulations thereunder do not apply. For example, assume that an employee has available for a calendar year an employer-provided automobile with a fair market value of $28,000. Assume further that the special rule provided in §1.61–21(d) is used yielding an Annual Lease Value, as defined in §1.61–21(d), of $7,750, and that all of the employee's use of the automobile is for the employer's business. The employee would be entitled to exclude as a working condition fringe the entire Annual Lease Value, despite the fact that if the employee paid for the availability of the automobile, an income inclusion would be required under § 1.280F–6(d)(1). This paragraph (j) does not affect the applicability of section 280F to the employer with respect to such employer-provided automobile, nor does it affect the applicability of section 274 to either the employer or the employee. For rules concerning substantiation of an employee's working condition fringe, see paragraph (c) of this section.

(k) *Aircraft allocation rule.* In general, with respect to a flight on an employer-provided aircraft, the amount excludable as a working condition fringe is the amount that would be allowable as a deduction under section 162 or 167 if the employee paid for the flight on the aircraft. For example, if employee P and P's spouse fly on P's employer's airplane primarily for business reasons of P's employer so that P could deduct the expenses relating to the trip to the extent of P's payments, the value of the flights is excludable from gross income as a working condition fringe. However, if P's children accompany P on the trip primarily for personal reasons, the value of the flights by P's children are includible in P's gross income. See § 1.61–21 (g) for special rules for valuing personal flights on employer-provided aircraft.

(l) [Reserved]

(m) *Employer-provided transportation for security concerns*—(1) *In general.* The amount of a working condition fringe exclusion with respect to employer-provided transportation is the amount that would be allowable as a deduction under section 162 or 167 if the employee paid for the transportation. Generally, if an employee pays for transportation taken for primarily personal purposes, the employee may not deduct any part of the amount paid. Thus, the employee may not generally exclude the value of employer-provided transportation as a working condition fringe if such transportation is primarily personal. If, however, for bona fide business-oriented security concerns, the employee purchases transportation that provides him or her with additional security, the employee may generally deduct the excess of the amount actually paid for the transportation over the amount the employee would have paid for the same mode of transportation absent the bona fide business-oriented security concerns. This is the case whether or not the employee would have taken the same mode of transportation absent the bona fide business-oriented security concerns. With respect to a vehicle, the phrase ‘‘the same mode of transportation’’ means use of the same vehicle without the additional security aspects, such as bulletproof glass. With respect to air transportation, the phrase ‘‘the same mode of transportation’’ means comparable air transportation. These same rules apply to the determination of an employee's working condition fringe exclusion. For example, if an employer provides an employee with a vehicle for commuting and, because of bona fide business-oriented security concerns, the vehicle is specially designed for security, then the employee may exclude from gross income the value of the special security design as a working condition fringe. The employee may not exclude the value of the commuting from income as a working condition fringe because commuting is a nondeductible personal expense. However, if an independent security study meeting the requirements of paragraph (m)(2)(v) of this section has been performed with respect to a government employee, the government employee may exclude the value of the personal use (other than commuting) of the employer-provided vehicle that the security study determines to be reasonable and necessary for local transportation. Similarly, if an employee travels on a personal trip in an employer-provided aircraft for bona fide business-oriented security concerns, the employee may exclude the excess, if any, of the value of the flight over the amount the employee would have paid for the same mode of transportation, but for the bona fide business-oriented security concerns. Because personal travel is a nondeductible expense, the employee may not exclude the total value of the trip as a working condition fringe.

(2) *Demonstration of bona fide business-oriented security concerns*—(i) *In general.* For purposes of this paragraph (m), a bona fide business-oriented security concern exists only if the facts and circumstances establish a specific basis for concern regarding the safety of the employee. A generalized concern for an

employee's safety is not a bona fide business-oriented security concern. Once a bona fide business-oriented security concern is determined to exist with respect to a particular employee, the employer must periodically evaluate the situation for purposes of determining whether the bona fide business-oriented security concern still exists. Example of factors indicating a specific basis for concern regarding the safety of an employee are—

(A) A threat of death or kidnapping of, or serious bodily harm to, the employee or a similarly situated employee because of either employee's status as an employee of the employer; or

(B) A recent history of violent terrorist activity (such as bombings) in the geographic area in which the transportation is provided, unless that activity is focused on a group of individuals which does not include the employee (or a similarly situated employee of an employer), or occurs to a significant degree only in a location within the geographic area where the employee does not travel.

(ii) *Establishment of overall security program.* Notwithstanding anything in paragraph (m)(2)(i) of this section to the contrary, no bona fide business-oriented security concern will be deemed to exist unless the employee's employer establishes to the satisfaction of the Commissioner that an overall security program has been provided with respect to the employee involved. An overall security program is deemed to exist if the requirements of paragraph (m)(2)(iv) of this section are satisfied (relating to an independent security study).

(iii) *Overall security program*—(A) *Defined.* An overall security program is one in which security is provided to protect the employee on a 24-hour basis. The employee must be protected while at the employee's residence, while commuting to and from the employee's workplace, and while at the employee's workplace. In addition, the employee must be protected while traveling both at home and away from home, whether for business or personal purposes. An overall security program must include the provision of a bodyguard/chauffeur who is trained in evasive driving techniques; an automobile specially equipped for security; guards, metal detectors, alarms, or similar methods of controlling access to the employee's workplace and residence; and, in appropriate cases, flights on the employer's aircraft for business and personal reasons.

(B) *Application.* There is no overall security program when, for example, security is provided at the employee's workplace but not at the employee's residence. In addition, the fact that an employer requires an employee to travel on the employer's aircraft, or in an employer-provided vehicle that contains special security features, does not alone constitute an overall security program. The preceding sentence applies regardless of the existence of a corporate or other resolution requiring the employee to travel in the employer's aircraft or vehicle for personal as well as business reasons.

(iv) *Effect of an independent security study.* An overall security program with respect to an employee is deemed to exist if the conditions of this paragraph (m)(2)(iv) are satisfied:

(A) A security study is performed with respect to the employer and the employee (or a similarly situated employee of the employer) by an independent security consultant;

(B) The security study is based on an objective assessment of all facts and circumstances;

(C) The recommendation of the security study is that an overall security program (as defined in paragraph (m)(2)(iii) of this section) is not necessary and the recommendation is reasonable under the circumstances; and

(D) The employer applies the specific security recommendations contained in the security study to the employee on a consistent basis.

The value of transportation-related security provided pursuant to a security study that meets the requirements of this paragraph (m)(2)(iv) may be excluded from income if the security study conclusions are reasonable and, but for the bona fide business-oriented security concerns, the employee would not have had such security. No exclusion from income applies to security provided by the employer that is not recommended in the security study.

Security study conclusions may be reasonable even if, for example, it is recommended that security be limited to certain geographic areas, as in the case in which air travel security is provided only in certain foreign countries.

(v) *Independent security study with respect to government employees.* For purposes of establishing the existence of an overall security program under paragraph (m)(2)(ii) of this section with respect to a particular government employee, a security study conducted by the government employer (including an agency or instrumentality thereof) will be treated as a security study pursuant to paragraph (m)(2)(iv) of this section if, in lieu of the conditions of paragraphs (m)(2)(iv)(A) through (D) of this section, the following conditions are satisfied:

(A) The security study is conducted by a person expressly designated by the government employer as having the responsibility and independent authority to determine both the need for employer-provided security and the appropriate protective services in response to that determination;

(B) The security study is conducted in accordance with written internal procedures that require an independent and objective assessment of the facts and circumstances, such as the nature of the threat to the employee, the appropriate security response to that threat, an estimate of the length of time protective services will be necessary, and the extent to which employer-provided transportation may be necessary during the period of protection;

(C) With respect to employer-provided transportation, the security study evaluates the extent to which personal use, including commuting, by the employee and the employee's spouse and dependents may be necessary during the period of protection and makes a recommendation as to what would be considered reasonable personal use during that period; and

(D) The employer applies the specific security recommendations contained in the study to the employee on a consistent basis.

(3) *Application of security rules to spouses and dependents.* (i) *In general.* If a bona fide business-oriented security concern exists with respect to an employee (because, for example, threats are made on the life of an employee), the bona fide business-oriented security concern is deemed to exist with respect to the employee's spouse and dependents to the extent provided in this paragraph (m)(3).

(ii) *Certain transportation.* If a working condition fringe exclusion is available under this paragraph (m) for transportation in a vehicle or aircraft provided for a bona fide business-oriented security concern with respect to an employee, the requirements of this paragraph (m) are deemed to be satisfied with respect to transportation in the same vehicle or aircraft provided at the same time to the employee's spouse and dependent children.

(iii) *Other.* Except as provided in paragraph (m)(3)(ii) of this section, a bona fide business oriented security concern is deemed to exist for the spouse and dependent children of the employer only if the requirements of paragraph (m)(2) (iii) or (iv) of this section are applied independently to such spouse and dependent children.

(iv) *Spouses and dependents of government employees.* The security rules of this paragraph (m)(3) apply to the spouse and dependents of a government employee. However, the value of local vehicle transportation provided to the government employee's spouse and dependents for personal purposes, other than commuting, during the period that a bona fide business-oriented security concern exists with respect to the government employee will not be included in the government employee's gross income if the personal use is determined to be reasonable and necessary by the security study described in paragraph (m)(2)(v) of this section.

(4) *Working condition safe harbor for travel on employer-provided aircraft.* Under the safe harbor rule of this paragraph (m)(4), if, for a bona fide business-oriented security concern, the employer requires that an employee travel on an employer-provided aircraft for a personal trip, the employer and the employee may exclude from the employee's gross income, as a working condition fringe, the excess value of the aircraft trip over the safe harbor airfare without having to show what

method of transportation the employee would have flown but for the bona fide business-oriented security concern. For purposes of the safe harbor rule of this paragraph (m)(4), the value of the safe harbor airfare is determined under the non-commercial flight valuation rule of §1.61–21(g) (regardless of whether the employer or employee elects to use such valuation rule) by multiplying an aircraft multiple of 200-percent by the applicable cents-per-mile rates and the number of miles in the flight and then adding the applicable terminal charge. The value of the safe harbor airfare determined under this paragraph (m)(4) must be included in the employee's income (to the extent not reimbursed by the employee) regardless of whether the employee or the employer uses the special valuation rule of §1.61–21(g). The excess of the value of the aircraft trip over this amount may be excluded from gross income as a working condition fringe. If, for a bona fide business-oriented security concern, the employer requires that an employee's spouse and dependents travel on an employer-provided aircraft for a personal trip, the special rule of this paragraph (m)(4) is available to exclude the excess value of the aircraft trips over the safe harbor airfares.

(5) *Bodyguard/chauffeur provided for a bona fide business-oriented security concern.* If an employer provides an employee with vehicle transportation and a bodyguard/chauffeur for a bona fide business-oriented security concern, and but for the bona fide business-oriented security concern the employee would not have had a bodyguard or a chauffeur, then the entire value of the services of the bodyguard/chauffeur is excludable from gross income as a working condition fringe. For purposes of this section, a bodyguard/chauffeur must be trained in evasive driving techniques. An individual who performs services as a driver for an employee is not a bodyguard/chauffeur if the individual is not trained in evasive driving techniques. Thus, no part of the value of the services of such an individual is excludable from gross income under this paragraph (m)(5). (See paragraph (b)(3) of this section for rules relating to the determination of the working condition fringe exclusion for chauffeur services.)

(6) *Special valuation rule for government employees.* If transportation is provided to a government employee for commuting during the period that a bona fide business-oriented security concern under §1.132–5(m) exists, the commuting use may be valued by reference to the values set forth in §1.61–21(e)(1)(i) or (f)(3) (vehicle cents-per-mile or commuting valuation of $1.50 per one-way commute, respectively) without regard to the additional requirements contained in §1.61–21 (e) or (f) and is deemed to have met the requirements of §1.61–21(c).

(7) *Government employer and employee defined.* For purposes of this paragraph (m), ''government employer'' includes any Federal, State, or local government unit, and any agency or instrumentality thereof. A ''government employee'' is any individual who is employed by the government employer.

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

Example (1). Assume that in response to several death threats on the life of A, the president of X a multinational company, X establishes an overall security program for A, including an alarm system at A's home and guards at A's workplace, the use of a vehicle that is specially equipped with alarms, bulletproof glass, and armor plating, and a bodyguard/chauffeur. Assume further that A is driven for both personal and business reasons in the vehicle. Also, assume that but for the bona fide business-oriented security concerns, no part of the overall security program would have been provided to A. With respect to the transportation provided for security reasons, A may exclude as a working condition fringe the value of the special security features of the vehicle and the value attributable to the bodyguard/chauffeur. Thus, if the value of the specially equipped vehicle is $40,000, and the value of the vehicle without the security features is $25,000, A may determine A's inclusion in income attributable to the vehicle as if the vehicle were worth $25,000. A must include in income the value of the availability of the vehicle for personal use.

Example (2). Assume that B is the chief executive officer of Y, a multinational corporation. Assume further that there have been kidnapping attempts and other terrorist activities in the foreign countries in which B performs services and that at least some of such activities have been directed against B or similarly situated employees. ln response to these activities, Y provides B with an overall security program, including an alarm system at B's home and bodyguards at B's workplace, a bodyguard/chauffeur, and a vehicle specially designed for security during B's overseas travels. In addition, assume that Y requires B to travel in Y's airplane for business and personal trips taken to, from, and within these foreign countries. Also, assume that but for bona fide business-oriented security concerns, no part of the overall security program would have been provided to B. B may exclude as a working condition fringe the value of the special security features of the automobile and the value attributable to the bodyguards and the bodyguard/chauffeur. B may also exclude the excess, if any, of the value of the flights over the amount A would have paid for the same mode of transportation but for the security concerns. As an alternative to the preceding sentence, B may use the working condition safe harbor described in paragraph (m)(4) of this section and exclude as a working condition fringe the excess, if any, of the value of personal flights in the Y airplane over the safe harbor airfare determined under the method described in paragraph (m)(4) of this section. If this alternative is used, B must include in income the value of the availability of the vehicle for personal use and the value of the safe harbor.

Example (3). Assume the same facts as in example (2) except that Y also requires B to travel in Y's airplane within the United States, and provides B with a chauffeur-driven limousine for business and personal travel in the United States. Assume further that Y also requires B's spouse and dependents to travel in Y's airplane for personal flights in the United States. If no bona fide business-oriented security concern exists with respect to travel in the United States, B may not exclude from income any portion of the value of the availability of the chauffeur or limousine for personal use in the United States. Thus, B must include in income the value of the availability of the vehicle and chauffeur for personal use. In addition, B may not exclude any portion of the value attributable to personal flights by B or B's spouse and dependents on Y's airplane. Thus, B must include in income the value attributable to the personal use of Y's airplane. See § 1.61–21 for rules relating to the valuation of an employer-provided vehicle and chauffeur, and personal flights on employer-provided airplanes.

Example (4). Assume that company Z retains an independent security consultant to perform a security study with respect to its chief executive officer. Assume further that, based on an objective assessment of the facts and circumstances, the security consultant reasonably recommends that 24-hour protection is not necessary but that the employee be provided security at his workplace and for ground transportation, but not for air transportation. If company Z follows the recommendations on a consistent basis, an overall security program will be deemed to exist with respect to the workplace and ground transportation security only.

Example (5). Assume the same facts as in example (4) except that company Z only provides the employee security while commuting to and from work, but not for any other ground transportation. Because the recommendations of the independent security study are not applied on a consistent basis, an overall security program will not be deemed to exist. Thus, the value of commuting to and from work is not excludable from income. However, the value of a bodyguard with professional security training who does not provide chauffeur or other personal services to the employee or any member of the employee's family may be excludable as a working condition fringe if such expense would be otherwise allowable as a deduction by the employee under section 162 or 167.

Example (6). J is a United States District Judge. At the beginning of a 3-month criminal trial in J's court, a member of J's family receives death threats. M, the division (within government agency W) responsible for evaluating threats and providing protective services to the Federal judiciary, directs its threat analysis unit to conduct a security study with respect to J and J's family. The study is conducted pursuant to internal written procedures that require an independent and objective assessment of any threats to members of the Federal judiciary and their families, a statement of the requisite security response, if any, to a particular threat (including the form of transportation to be furnished to the employee as part of the security program), and a description of the circumstances under which local transportation for the employee and the employee's spouse and dependents may be necessary for personal reasons during the time protective services are provided. M's study concludes that a bona fide business-oriented security concern exists with respect to J and J's family and determines that 24-hour protection of J and J's family is not necessary, but that protection is necessary during the course of the criminal trial whenever J or J's family is away from home. Consistent with that recommendation, J is transported every day in a government vehicle for both personal and business reasons and is accompanied by two bodyguard/chauffeurs who have been trained in evasive driving techniques. In addition, J's spouse is driven to and from work and J's children are driven to and from school and occasional school activities. Shortly after the trial is concluded, M's threat analysis unit determines that J and J's family no longer need special protection because the danger posed by the threat no longer exists and, accordingly, vehicle transportation is no longer provided. Because the security study conducted by M complies with the conditions of §1.132–5(m)(2)(v), M has satisfied the requirement for an independent security study and an overall security program with respect to J is deemed to exist. Thus, with respect to the transportation provided for security concerns, J may exclude as a working condition fringe the value of any special security features of the government vehicle and the value attributable to the two bodyguard/chauffeurs. See *Example (1)* of this paragraph (m)(8). The value of vehicle transportation provided to J and J's family for personal reasons, other than commuting, may also be excluded during the period of protection, because its provision was consistent with the recommendation of the security study.

Example (7). Assume the same facts as in *Example (6)* and that J's one-way commute between home and work is 10 miles. Under paragraph (m)(6) of this section, the Federal Government may value transportation provided to J for commuting purposes pursuant to the value set forth in either the vehicle cents-per-mile rule of §1.61–21(e) or the commuting valuation rule of §1.61–21(f). Because the commuting valuation rule yields the least amount of taxable income to J under the circumstances, W values the transportation provided to J for commuting at $1.50 per one-way commute, even though J is a control employee within the meaning of §1.61–21(f)(6).

(n) *Product testing*—(1) *In general.* The fair market value of the use of consumer goods, which are manufactured for sale to nonemployees, for product testing and evaluation by an employee of the manufacturer outside the employer's workplace, is excludible from gross income as a working condition fringe if—

(i) Consumer testing and evaluation of the product is an ordinary and necessary business expense of the employer;

(ii) Business reasons necessitate that the testing and evaluation of the product be performed off the employer's business premises by employees (i.e., the testing and evaluation cannot be carried out adequately in the employer's office or in laboratory testing facilities);

(iii) The product is furnished to the employee for purposes of testing and evaluation;

(iv) The product is made available to the employee for no longer than necessary to test and evaluate its performance and (to the extent not exhausted) must be returned to the employer at completion of the testing and evaluation period;

(v) The employer imposes limits on the employee's use of the product that significantly reduce the value of any personal benefit to the employee; and

(vi) The employee must submit detailed reports to the employer on the testing and evaluation. The length of the testing and evaluation period must be reasonable in relation to the product being tested.

(2) *Employer-imposed limits.* The requirement of paragraph (n)(1)(v) of this section is satisfied if—

(i) The employer places limits on the employee's ability to select among different models or varieties of the consumer product that is furnished for testing and evaluation purposes; and

(ii) The employer generally prohibits use of the product by persons other than the employee and, in appropriate cases, requires the employee, to purchase or lease at the employee's own expense the same type of product as that being tested (so that personal use by the employee's family will be limited). In addition, any charge by the employer for the personal use by an employee of a product being tested shall be taken into account in determining whether the requirement of paragraph (n)(1)(v) of this section is satisfied.

(3) *Discriminating classifications.* If an employer furnishes products under a testing and evaluation program only, or presumably, to certain classes of employees (such as highly compensated employees, as defined in §1.132–8(g)), this fact may be relevant when determining whether the products are furnished for testing and evaluation purposes or for compensation purposes, unless the employer can show a business reason for the classification of employees to whom the products are furnished (e.g., that automobiles are furnished for testing and evaluation by an automobile manufacturer to its design engineers and supervisory mechanics).

(4) *Factors that negate the existence of a product testing program.* If an employer fails to tabulate and examine

the results of the detailed reports submitted by employees within a reasonable period of time after expiration of the testing period, the program will not be considered a product testing program for purposes of the exclusion of this paragraph (n). Existence of one or more of the following factors may also establish that the program is not a bona fide product testing program for purposes of the exclusion of this paragraph (n):

(i) The program is in essence a leasing program under which employees lease the consumer goods from the employer for a fee;

(ii) The nature of the product and other considerations are insufficient to justify the testing program; or

(iii) The expense of the program outweighs the benefits to be gained from testing and evaluation.

(5) *Failure to meet the requirements of this paragraph (n).* The fair market value of the use of property for product testing and evaluation by an employee outside the employee's workplace, under a product testing program that does not meet all of the requirements of this paragraph (n), is not excludable from gross income as a working condition fringe under this paragraph (n).

(6) *Example.* The rules of this paragraph (n) may be illustrated by the following example:

Example. Assume that an employer that manufactures automobiles establishes a product testing program under which 50 of its 5,000 employees test and evaluate the automobiles for 30 days. Assume further that the 50 employees represent a fair cross-section of all of the employees of the employer, such employees submit detailed reports to the employer on the testing and evaluation, the employer tabulates and examines the test results within a reasonable time, and the use of the automobiles is restricted to the employees. If the employer imposes the limits described in paragraph (n)(2) of this section, the employees may exclude the value of the use of the automobile during the testing and evaluation period.

(o) *Qualified automobile demonstration use*—(1) *In general.* The value of qualified automobile demonstration use is excludable from gross income as a working condition fringe. ''Qualified automobile demonstration use'' is any use of a demonstration automobile by a full-time automobile salesman in the sales area in which the automobile dealer's sales office is located if—

(i) Such use is provided primarily to facilitate the salesman's performance of services for the employer; and

(ii) There are substantial restrictions on the personal use of the automobile by the salesman.

(2) *Full-time automobile salesman*—(i) *Defined.* The term ''full-time automobile salesman'' means any individual who—

(A) Is employed by an automobile dealer;

(B) Customarily spends at least half of a normal business day performing the functions of a floor salesperson or sales manager;

(C) Directly engages in substantial promotion and negotiation of sales to customers;

(D) Customarily works a number of hours considered full-time in the industry (but at a rate not less than 1,000 hours per year); and

(E) Derives at least 25 percent of his or her gross income from the automobi1e dealership directly as a result of the activities described in paragraphs (o)(2)(i) (B) and (C) of this section.

For purposes of paragraph (o)(2)(i) (E) of this section, income is not considered to be derived directly as a result of activities described in paragraphs (o)(2)(i) (B) and (C) of this section to the extent that the income is attributable to an individual's ownership interest in the dealership. An individual will not be considered to engage in direct sales activities if the individual's sales-related activities are substantially limited to review of sales price offers from customers. An individual, such as the general manager of an automobi1e dealership, who receives a sales commission on the sale of an automobile is not a full-time automobile salesman unless the requirements of this paragraph (o)(2)(i) are met. The exclusion provided in this paragraph (o) is available to an individual who meets the definition of this paragraph (o)(2)(i) whether the individual performs services in addition to those described in this paragraph (o)(2)(i). For example, an individual who is an owner of the automobile dealership but who otherwise meets the requirements of this paragraph (o)(2)(i) may exclude from gross income the value of qualified automobile demonstration use. However, the exclusion of this paragraph (o) is not available to owners of large automobile dealerships who do not customarily engage in significant sales activities.

(ii) *Use by an individual other than a full-time automobile salesman.* Personal use of a demonstration automobile by an individual other than a full-time automobile salesman is not treated as a working condition fringe. Therefore, any personal use, including commuting use, of a demonstration automobile by a part-time salesman, automobile mechanic, or other individual who is not a full-time automobile salesman is not ‘‘qualified automobile demonstration use’’ and thus not excludable from gross income. This is the case whether or not the personal use is within the sales area (as defined in paragraph (o)(5) of this section).

(3) *Demonstration automobile.* The exclusion provided in this paragraph (o) applies only to qualified use of a demonstration automobile. A demonstration automobile is an automobile that is—

(i) Currently in the inventory of the automobile dealership; and

(ii) Available for test drives by customers during the normal business hours of the employee.

(4) *Substantial restrictions on personal use.* Substantial restrictions on the personal use of a demonstration automobile exist when all of the following conditions are satisfied:

(i) Use by individuals other than the full-time automobile salesmen (e.g., the salesman's family) is prohibited;

(ii) Use for personal vacation trips is prohibited;

(iii) The storage of personal possessions in the automobile is prohibited; and

(iv) The total use by mileage of the automobile by the salesman outside the salesman's normal working hours is limited.

(5) *Sales area—(i) In general.* Qualified automobile demonstration use consists of use in the sales area in which the automobile dealer's sales office is located. The sales area is the geographic area surrounding the automobile dealer's sales office from which the office regularly derives customers.

(ii) *Sales area safe harbor.* With respect to a particular full-time salesman, the automobile dealer's sales area may be treated as the area within a radius of the larger of—

(A) 75 miles or

(B) The one-way commuting distance (in miles) of the particular salesman from the dealer's sales office.

(6) *Applicability of substantiation requirements of sections 162 and 274(d).* Notwithstanding anything in this section to the contrary, the value of the use of a demonstration automobile may not be excluded from gross income as a working condition fringe, by either the employer or the employee, unless, with respect to the restrictions of paragraph (o)(4) of this section, the substantiation requirements of section 274(d) and the regulations thereunder are satisfied. See §1.132–5(c) for general and safe harbor rules relating to the applicability of the substantiation requirements of section 274(d).

(7) *Special valuation rules.* See §1.61–21(d)(6)(ii) for special rules that may be used to value the availability of demonstration automobiles.

(p) *Parking*—(1) *In general.* The value of parking provided to an employee on or near the business premises of the employer is excludable from gross income as a working condition fringe under the special rule of this paragraph (p). If the rules of this paragraph (p) are satisfied, the value of parking is excludable from gross income whether the amount paid by the employee for parking would be deductible under section 162. The working condition fringe exclusion applies whether the employer owns or rents the parking facility or parking space.

(2) *Reimbursement of parking expenses.* A reimbursement to the employee of the ordinary and necessary expenses of renting a parking space on or near the business premises of the employer is excludable from gross income as a working condition fringe, if, but for the parking expense, the employee would not have been entitled to receive and retain such amount from the employer. If, however an employee is entitled to retain a general transportation allowance or a similar benefit whether or

not the employee has parking expenses, no portion of that allowance is excludable from gross income under this paragraph (p) even if it is used for parking expenses.

(3) *Parking on residential property.* With respect to an employee, this paragraph (p) does not apply to any parking facility or space located on property owned or leased by the employee for residential purposes.

(q) *Nonapplicability of nondiscrimination rules.* Except to the extent provided in paragraph (n)(3) of this section (relating to discriminating classifications of a product testing program), the nondiscrimination rules of section 132 (h)(1) and § 1.132–8 do not apply in determining the amount, if any, of a working condition fringe.

(r) *Volunteers*—(1) *In general.* Solely for purposes of section 132(d) and paragraph (a)(1) of this section, a bona fide volunteer (including a director or officer) who performs services for an organization exempt from tax under section 501(a), or for a government employer (as defined in paragraph (m)(7) of this section), is deemed to have a profit motive under section 162.

(2) *Limit on application of this paragraph.* This paragraph (r) shall not be used to support treatment of the bona fide volunteer as having a profit motive for purposes of any provision of the Internal Revenue Code of 1986 (Code) other than section 132(d). Nothing in this paragraph (r) shall be interpreted as determining the employment status of a bona fide volunteer for purposes of any section of the Code other than section 132(d).

(3) *Definitions*—(i) *Bona fide volunteer.* For purposes of this paragraph (r), an individual is considered a ‘‘bona fide volunteer’’ if the individual does not have a profit motive for purposes of section 162. For example, an individual is considered a ‘‘bona fide volunteer’’ if the total value of the benefits provided with respect to the volunteer services is substantially less than the total value of the volunteer services the individual provides to an exempt organization or government employer.

(ii) *Liability insurance coverage for a bona fide volunteer.* For purposes of this paragraph (r), the receipt of liability insurance coverage by a volunteer, or an exempt organization or government employer’s undertaking to indemnify the volunteer for liability, does not by itself confer a profit motive on the volunteer, provided the insurance coverage or indemnification relates to acts performed by the volunteer in the discharge of duties, or the performance of services, on behalf of the exempt organization or government employer.

(4) *Example.* The following example illustrates the provisions of paragraph (r) of this section.

Example. A is a manager and full-time employee of P, a tax-exempt organization described in section 501(c)(3). B is a member of P’s board of directors. Other than $25 to defray expenses for attending board meetings, B receives no compensation for serving as a director and does not have a profit motive. Therefore, B is a bona fide volunteer by application of paragraph (r)(3)(i) of this section and is deemed to have a profit motive under paragraph (r)(1) of this section for purposes of section 132(d). In order to provide liability insurance coverage, P purchases a policy that covers actions arising from A’s and B’s activities performed as part of their duties to P. The value of the policy and payments made to or on behalf of A under the policy are excludable for A’s gross income as a working condition fringe, because A has a profit motive under section 162 and would be able to deduct payments for liability insurance coverage had he paid for it himself. The receipt of liability insurance coverage by B does not confer a profit motive on B by application of paragraph (r)(3)(ii) of this section. Thus, the value of the policy and payments made to or on behalf of B under the policy are excludable from B’s income as a working condition fringe. For the year in which the liability insurance coverage is provided to A and B, P may exclude the value of the benefit on the Form W–2 it issues to A or on any Form 1099 it might otherwise issue to B.

(s) *Application of section 274(a)(3)*—(1) *In general.* If an employer’s deduction under section 162(a) for dues paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose is disallowed by section 274(a)(3), the amount, if any, of an employee’s working condition fringe benefit relating to an employer-provided membership in the club is determined without regard to the application of section 274(a) to the employee. To be excludible as a working condition fringe benefit, however, the amount must otherwise qualify for deduction by the employee under section 162(a). If an employer treats the amount paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose as compensation under section 274(e)(2), then the expense is deductible by the employer as compensation and no amount may be excluded from the employee's gross income as a working condition fringe benefit. See §1.274–2(f)(2)(iii)(A).

(2) *Treatment of tax-exempt employers.* In the case of an employer exempt from taxation under subtitle A of the Internal Revenue Code, any reference in this paragraph (s) to a deduction disallowed by section 274(a)(3) shall be treated as a reference to the amount which would be disallowed as a deduction by section 274(a)(3) to the employer if the employer were not exempt from taxation under subtitle A of the Internal Revenue Code.

(3) *Examples.* The following examples illustrate this paragraph (s):

Example 1. Assume that Company *X* provides Employee *B* with a country club membership for which it paid $20,000. B substantiates, within the meaning of paragraph (c) of this section, that the club was used 40 percent for business purposes. The business use of the club (40 percent) may be considered a working condition fringe benefit, notwithstanding that the employer's deduction for the dues allocable to the business use is disallowed by section 274(a)(3), if *X* does not treat the club membership as compensation under section 274(e)(2). Thus, *B* may exclude from gross income $8,000 (40 percent of the club dues, which reflects *B*'s business use). *X* must report $12,000 as wages subject to withholding and payment of employment taxes (60 percent of the value of the club dues, which reflects *B*'s personal use). *B* must include $12,000 in gross income. *X* may deduct as compensation the amount it paid for the club dues which reflects *B*'s personal use provided the amount satisfies the other requirements for a salary or compensation deduction under section 162.

Example 2. Assume the same facts as *Example 1* except that Company *X* treats the $20,000 as compensation to *B* under section 274(e)(2). No portion of the $20,000 will be considered a working condition fringe benefit because the section 274(a)(3) disallowance will apply to *B*. Therefore, *B* must include $20,000 in gross income.

(t) *Application of section 274(m)(3)*—(1) *In general.* If an employer's deduction under section 162(a) for amounts paid or incurred for the travel expenses of a spouse, dependent, or other individual accompanying an employee is disallowed by section 274(m)(3), the amount, if any, of the employee's working condition fringe benefit relating to the employer-provided travel is determined without regard to the application of section 274(m)(3). To be excludible as a working condition fringe benefit, however, the amount must otherwise qualify for deduction by the employee under section 162(a). The amount will qualify for deduction and for exclusion as a working condition fringe benefit if it can be adequately shown that the spouse's, dependent's, or other accompanying individual's presence on the employee's business trip has a bona fide business purpose and if the employee substantiates the travel within the meaning of paragraph (c) of this section. If the travel does not qualify as a working condition fringe benefit, the employee must include in gross income as a fringe benefit the value of the employer's payment of travel expenses with respect to a spouse, dependent, or other individual accompanying the employee on business travel. See §§1.61–21(a)(4) and 1.162–2(c). If an employer treats as compensation under section 274(e)(2) the amount paid or incurred for the travel expenses of a spouse, dependent, or other individual accompanying an employee, then the expense is deductible by the employer as compensation and no amount may be excluded from the employee's gross income as a working condition fringe benefit. See §1.274–2(f)(2)(iii)(A).

(2) *Treatment of tax-exempt employers.* In the case of an employer exempt from taxation under subtitle A of the Internal Revenue Code, any reference in this paragraph (t) to a deduction disallowed by section 274(m)(3) shall be treated as a reference to the amount which would be disallowed as a deduction by section 274(m)(3) to the employer if the employer were not exempt from taxation

under subtitle A of the Internal Revenue Code.

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§ 1.132–5T Working condition fringe—1985 through 1988 (temporary).

(a) *In general*—(1) *Definition.* Gross income does not include the value of a working condition fringe. The term ''working condition fringe'' means any property or service provided to an employee of an employer to the extent that, if the employee paid for the property or service, the amount paid would be allowable as a deduction under section 162 or 167. If, under section 274 or any other section, certain substantiation requirements must be met in order for a deduction under section 162 or 167 to be allowable, those substantiation requirements apply to the determination of a working condition fringe. An amount that would be deductible by the employee under, for example, section 212 is not a working condition fringe.

(2) *Trade or business of the employee.* If the hypothetical payment for the property or service would be allowable as a deduction with respect to a trade or business of the employee other than the employee's trade or business of being an employee of the employer, it cannot be taken into account for purposes of determining the amount, if any, of the working condition fringe. For example, assume that, unrelated to company X's trade or business and unrelated to company X's employee's trade or business of being an employee of company X, the employee is a member of the board of directors of company Y. Assume further that company X provides the employee with air transportation to a company Y board of director's meeting. The employee may not exclude the value of the air transportation to the meeting as a working condition fringe. The employee may, however, deduct such amount under section 162 if the section 162 requirements are satisfied. The result would be the same whether the air transportation was provided in the form of a flight on a commercial airline or a seat on a company X airplane.

(b) *Vehicle allocation rules*—(1) *In general*—(i) *General rule.* In general, with respect to an employer-provided vehicle, the amount excludable as a working condition fringe is the amount that would be allowable as a deduction under section 162 or 167 if the employee paid for the availability of the vehicle. For example, assume that the value of the availability of an employer-provided vehicle for a full year is $2,000, without regard to any working condition fringe (i.e., assuming all personal use). Assume further that the employee drives the vehicle 6,000 miles for his employer's business and 2,000 miles for reasons other than the employer's business. In this situation, the value of the working condition fringe is $2,000 multiplied by a fraction, the numerator of which is the business-use mileage (6,000 miles) and the denominator of which is the total mileage (8,000 miles). Thus, the value of the working condition fringe is $1,500. The total amount includable in the employee's gross income on account of the availability of the vehicle is $500. For purposes of this section, the term ''vehicle'' has the same meaning given the term in § 1.61–2T(e)(*2*). Generally, when determining the amount of an employee's working condition fringe, miles accumulated on the vehicle by all employees of the employer during the period in which the vehicle is available to the employee must be considered. For example, assume that an employee of the employer is provided the availability of an automobile for one year. Assume further that during the year, the automobile is regularly used in the employer's business by other employees. All miles accumulated on the automobile by all employees of the employer during the year must be considered. If, however, substantially all the use of the automobile by other employees in the employer's business is permitted during a certain period, such as the last three months of the year, the miles driven by the other employees during that period would not be considered when determining the employee's working condition fringe exclusion.

(ii) *Use by an individual other than the employee.* For purposes of this section, if the availability of a vehicle to an individual would be taxed to an employee, use of the vehicle by the individual is included in references to use by the employee.

(iii) *Provision of an expensive vehicle for personal use.* Assume an employer provides an employee with an expensive vehicle that an employee may use in part for personal purposes. Even though the decision to provide an expensive rather than an inexpensive vehicle is made by the employer for bona fide noncompensatory business reasons, there is no working condition fringe exclusion with respect to the personal miles driven by the employee. If the employee paid for the availability of the vehicle, he would not be entitled to deduct any part of the payment attributable to personal miles.

(2) *Use of different employer-provided automobiles.* The working condition fringe exclusion must be applied on an automobile by automobile basis. For example, assume that automobile Y is available to employee D for 3 days in January and for 5 days in March, and automobile Z is available to D for a week in July. Assume further that the Daily Lease Value, as defined in § 1.61–2T, of each automobile is $50. For the eight days of availability of Y in January and March, D uses Y 90 percent for business (by mileage). During July, D uses Z 60 percent for business (by mileage). The value of the working condition fringe is determined separately for each automobile. Therefore, the working condition fringe for Y is $360 ($400 x .90) leaving an income inclusion of $40. The working condition fringe for Z is $210 ($350 x .60) leaving an income inclusion of $140. If the value of the availability of an automobile is determined under the Annual Lease Value rule for one period and Daily Lease Value rule for a second period (see § 1.61–2T), the working condition fringe exclusion must be calculated separately for the two periods.

(c) *Applicability of sections 162 and 274(d)*—(1) *In general.* The value of property or services provided to an employee may not be excluded from the employee's gross income as a working condition fringe, by either the employer or the employee, unless the applicable substantiation requirements of either section 274(d) or section 162 (whichever is applicable) and the regulations thereunder are statisfied. With respect to listed property, the substantiation requirements of section 274(d) and the regulations thereunder do not apply to the determination of an employee's working condition fringe exclusion prior to the date that those requirements apply to the first taxable year of the employer beginning after December 31, 1985. For example, if an employer's first taxable year beginning after December 31, 1985, begins on July 1, 1986, with respect to listed property, the substantiation requirements of section 274(d) apply as of that date. The substantiation requirements of section 274(d) apply to an employee even if the requirements of section 274 do not apply to the employee's employer for deduction purposes (such as when the employer is a tax-exempt organization or a governmental unit); in these cases, the requirements of section 274(d) apply to the employee as of January 1, 1986.

(2) *Section 274(d) requirements.* The substantiation requirements of section 274(d) are satisfied by ‘‘adequate records or sufficient evidence corroborating the [employee's] own statement''. Therefore, such records or evidence provided by the employee, and relied upon by the employer to the extent permitted by the regulations promulgated under section 274(d), will be sufficient to substantiate a working condition fringe exclusion.

(d) *Safe harbor rules*—(1) *In general.* Section 1.274–6T provides that the substantiation requirements of section 274(d) and the regulations thereunder may be satisfied, in certain circumstances, by using one or more of the safe harbor rules prescribed in § 1.274–6T. If the employer uses one of the safe harbor rules prescribed in § 1.274–6T during a period with respect to a vehicle (as defined in § 1.61–2T), that rule must be used by the employer to substantiate a working condition fringe exclusion with respect to that vehicle during the period. An employer that is exempt from Federal income tax may still use one of the safe harbor rules (if the requirements of that section are otherwise met during a period) to substantiate a working condition fringe exclusion with respect to a vehicle during the period. If the employer uses one of the methods prescribed in § 1.274–6T during a period with respect to an employer-provided vehicle, that method may be used by an employee to substantiate a working condition fringe exclusion with respect to the same vehicle during the period, as long as the employee includes in gross income the amount allocated to the employee pursuant to § 1.274–6T and this section. (See § 1.61–2T(c)(2)(i) for other rules concerning when an employee must include in income the amount determined by the employer.) If, however, the employer uses the safe harbor rule prescribed in § 1.274–6T(a) (2) or (3) and the employee without the employer's knowledge uses the vehicle for purposes other than de minimis personal use (in the case of the rule prescribed in § 1.274–6T(a)(2)), or for purposes other than de minimis personal use and commuting (in the case of the rule prescribed in § 1.274–6T(a)(3)), then the employee must include additional income for the unauthorized use of the vehicle.

(2) *Period for use of safe harbor rules.* The rules prescribed in this paragraph (d) assume that the safe harbor rules prescribed in § 1.274–6T are used for a one-year period. Accordingly, references to the value of the availability of a vehicle, amounts excluded as a working condition fringe, etc., are based on a one-year period. If the safe harbor rules prescribed in § 1.274–6T are used for a period of less than a year, the amounts referenced in the previous sentence must be adjusted accordingly. For purposes of this section, the term ''personal use'' has the same meaning as prescribed in § 1.274–6T(e)(5).

(e) *Vehicles not available to employees for personal use.* For a vehicle described in § 1.274–6T(a)(2) (relating to certain vehicles not used for personal purposes), the working condition fringe exclusion is equal to the value of the availability of the vehicle if the employer uses the method prescribed in § 1.274–6T(a)(2).

(f) *Vehicles not available to employees for personal use other than commuting.* For a vehicle described in § 1.274–6T(a)(3) (relating to certain vehicles not used for personal purposes other than commuting), the working condition fringe exclusion is equal to the value of the availability of the vehicle for purposes other than commuting if the employer uses the method prescribed in § 1.274–6T(a)(3). This rule applies only if the special rule for valuing commuting use, as prescribed in § 1.61–2T, is used and the amount determined under the special rule is either included in the employee's income or reimbursed by the employee.

(g) *Vehicles used in connection with the business of farming that are available to employees for personal use*—(1) *In general.* For a vehicle described in § 1.274–6T(b) (relating to certain vehicles used in connection with the business of farming), the working condition fringe exclusion is calculated by multiplying the value of the availability of the vehicle by 75 percent.

(2) *Vehicles available to more than one individual.* If the vehicle is available to more than one individual, the employer must allocate the gross income attributable to the vehicle (25 percent of the value of the availability of the vehicle) among the employees (and other individuals whose use would not be attributed to an employee) to whom the vehicle was available. This allocation must be done in a reasonable manner to reflect the personal use of the vehicle by the individuals. An amount that would be allocated to a sole proprietor reduces the amounts that may be allocated to employees but are otherwise to be disregarded for purposes of this paragraph (g). For purposes of this paragraph (g), the value of the availability of a vehicle may be calculated as if the vehicle were available to only one employee continuously and without regard to any working condition fringe exclusion.

(3) *Examples.* The following examples illustrate a reasonable allocation of gross income with respect to an employer-provided vehicle between two employees:

Example (1). Assume that two farm employees share the use of a vehicle which for a calendar year is regularly used directly in connection with the business of farming and qualifies for use of the rule in § 1.274–6T (b). Employee A uses the vehicle in the morning directly in connection with the business of farming and employee B uses the vehicle in the afternoon directly in connection with the business of farming. Assume further that employee B takes the vehicle home in the evenings and on weekends. The employer should allocate all the income attributable to the availability of the vehicle to employee B.

Example (2). Assume that for a calendar year, farm employees C and D share the use of a vehicle that is regularly used directly in connection with the business of farming and qualifies for use of the rule in § 1.274–6T (b). Assume further that the employees alternate taking the vehicle home in the evening and alternate the availability of the vehicle for personal purposes on weekends. The employer should allocate the income attributable to the availability of the vehicle for personal use (25 percent of the value of the availability of the vehicle) equally between the two employees.

Example (3). Assume the same facts as in example (2) except that C is the sole proprietor of the farm. Based on these facts, C should allocate the same amount of income to D as was allocated to D in example (2). No other income attributable to the availability of the vehicle for personal use should be allocated.

(h) *Qualified non-personal use vehicles.* Effective January 1, 1985, 100 percent of the value of the use of a qualified non-personal use vehicle (as described in § 1.274–5T (k)) is excluded from gross income as a working condition fringe, provided that, in the case of a vehicle described in paragraph (k) (3) through (7) of that section, the use of the vehicles conforms to the requirements of that paragraph.

(i) [Reserved]

(j) *Application of section 280F.* In determining the amount, if any, of an employee's working condition fringe, section 280F and the regulations thereunder do not apply. For example, assume that an employee has available for a calendar year an employer-provided automobile with a fair market value of $28,000. Assume further that the special rule provided in § 1.61–2T is used and that the Annual Lease Value, as defined in § 1.61–2T, is $7,750, and that all of the employee's use of the automobile is in the employer's business. The employee would be entitled to exclude the entire Annual Lease Value as a working condition fringe, despite the fact that if the employee paid for the availability of the automobile, an income inclusion would be required under § 1.280F–5T(d)(1). This paragraph (j) does not affect the applicability of section 280F to the employer with respect to such employer-provided automobile, nor does it affect the applicability of section 274. For rules concerning substantiation of an employee's working condition fringe, see paragraph (c) of this section.

(k) *Aircraft allocation rule.* In general, with respect to a flight on an employer-provided aircraft, the amount excludable as a working condition fringe is the amount that would be allowable as a deduction under section 162 or 167 if the employee paid for the flight on the aircraft. For example, if employee P flies on P's employer's airplane primarily for business reasons of P's employer, the value of P's flight is excludable as a working condition fringe. However, if P's spouse and children accompany P on such airplane trip primarily for personal reasons, the value of the flights by P's spouse and children are includable in P's gross income. See § 1.61–2T(g) for special rules for valuing personal flights.

(l) [Reserved]

(m) *Employer-provided transportation for security concerns*—(1) *In general.* The amount of a working condition fringe exclusion with respect to employer-provided transportation is the amount that would be allowable as a deduction under section 162 or 167 if the employee paid for the transportation. Generally, if an employee pays for transportation taken for primarily personal purposes, the employee may not deduct any part of the amount paid. Thus, the employee may not generally exclude the value of employer-provided transportation as a working condition fringe if such transportation is primarily personal. If, however, for bona fide business-oriented security concerns, the employee purchases transportation that provides him or her with additional security, the employee may generally deduct the excess of the amount paid for the transportation over the lesser amount the employee would have paid for the same mode of transportation absent the bona fide business-oriented security concerns. With respect to a vehicle, the phrase ‘‘the same mode of transportation’’ means use of the same vehicle without the additional security aspects, such as bulletproof glass. With respect to air transportation, the phrase ‘‘the same mode of transportation'' means comparable air transportation. These same rules apply to the determination of an employee's working condition fringe exclusion. For example, if an employer provides an employee with an automobile for commuting and, for bona fide business-oriented security concerns, the automobile is specially designed for security, then the employee may exclude the value of the special security design as a working condition fringe if the employee's automobile would not have had such security design but for the bona fide business-oriented security concerns. The employee may not exclude the value of the commuting from income as a working condition fringe because commuting is a nondeductible personal expense. Similarly, if an employee travels on a personal trip in an employer-provided aircraft for bona fide business-oriented security concerns, the employee may exclude the excess, if any, of the value of the flight over the amount the employee would have paid for comparable air transportation, but for the bona fide business-oriented security concerns. Because personal travel is a nondeductible expense, the employee may not exclude the total value of the trip as a working condition fringe.

(2) *Demonstration of bona fide business-oriented security concerns*—(i) *In general.* For purposes of this paragraph (m), the existence of a bona fide business-oriented security concern for the furnishing of a specific form of transportation to an employee is determined on the basis of all the facts and circumstances within the following guidelines:

(A) *Services performed outside the United States.* With respect to an employee performing services for an employer in a geographic area other than the United States, a factor indicating a bona fide business-oriented security concern is a recent history of violent terrorist activity in such geographic area (such as bombings or abductions for ransom), unless such activity is focused on a group of individuals which does not include the employee or a similarly situated employee or on a section of the geographic area which does not incude the employee.

(B) *Services performed in the United States.* With respect to an employee performing services for an employer in the United States, a factor indicating a bona fide business-oriented security concern is threats on the life of the employee or on the life of a similarly situated employee because of the employee's status as an employee of the employer.

(ii) *Establishment of overall security program.* Notwithstanding anything in paragraph (m)(2)(i) of this section to the contrary, *no* bona fide business-oriented security concern will be deemed to exist unless the employee's employer establishes an overall security program with respect to the employee involved.

(iii) *Overall security program*—(A) *Definition.* An overall security program is one in which security is provided to protect the employee on a 24-hour basis. The employee must be protected while at the employee's residence, while commuting to and from the employee's workplace, and while at the employee's workplace. In addition, the employee must be protected while traveling, whether for business or personal purposes. An overall security program would include the provision of a bodyguard/driver who is trained in evasive driving techniques; and automobile specially equipped for security; guards, metal detectors, alarms, or similar methods of controling access to the employee's workplace and residence; and, in appropriate cases, flights on the employer's aircraft for business and personal reasons.

(B) *Application.* There is no overall security program when, for example, security is provided at the employee's workplace but not at the employee's residence. In addition, the fact that an employer requires an employee to travel on the employer's aircraft, or in an employer-provided vehicle that contains special security features, does not alone constitute an overall security program. The preceding sentence applies regardless of the existence of a corporate or other resolution requiring the employee to travel in the employer's airplane or vehicle for personal as well as business reasons. Similarly, the existence of an independent security study particular to the employer and its employees, or to the employee involved, does not alone constitute an overall security program.

(iv) *Effect of an independent security study.* An overall security program with respect to an employee is deemed to exist even though security is not provided to an employee on a 24-hour basis if the conditions of this paragraph (m)(2)(iv) are satisfied:

(A) A security study is performed with respect to the employer and the employee (or a similarly situated employee) by an independent security consultant;

(B) The security study is based on an objective assessment of all the facts and circumstances;

(C) The recommendation of the security study is that an overall security program (as defined in paragraph (m)(2)(iii) of this section) is not necessary and such recommendation is reasonable under the circumstances; and

(D) The employer applies the specific security recommendations contained in the security study to the employee on a consistent basis.

The value of the security provided pursuant to a security study that meets the requirements of this paragraph (m)(2)(iv) may be excluded from income, if the security study conclusions are reasonable and, but for the bona fide business-oriented security concerns, the employee would not have had such security. No exclusion from income applies to security provided by the employer that is not recommended in the security study. Security study conclusions may be reasonable even if, for example, it is recommended that security be limited to certain geographic areas, as in the case where air travel security is provided only in certain foreign countries.

(v) *Application of security rules to spouses and dependents.* The availability of a working condition fringe exclusion based on the existence of a bona fide business-oriented security concern with respect to the spouse and dependents of an employee is determined separately for such spouse and dependents under the rules established in this paragraph (m).

(vi) *Working condition safe harbor.* Under the special rule of this paragraph (m)(2)(vi), if, for a bona fide business-oriented security concern, the employer requires that the employee travel on an employer-provided aircraft for a personal trip, the employer and the employee may exclude, as a working condition fringe, the excess value of the trip over comparable first-class airfare without having to show that but for the bona fide business-oriented security concerns, the employee would have flown first-class on a commercial aircraft. If the special valuation rule provided in § 1.61–2T is used, the excess over the amount determined by multiplying an aircraft multiple of 200-percent by the base aircraft valuation formula may be excluded as a working condition fringe.

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

Example (1). Assume that in response to several death threats on the life of A, the president of a multinational company (company X), company X establishes an overall security program for A, including an alarm system at A’s home and guards at A’s workplace, the use of a vehicle that is specially equipped with alarms, bulletproof glass, and armor plating and a bodyguard/driver who is trained in evasive driving techniques. Assume further that A is driven for both personal and business reasons in the vehicle. Also, assume that but for the bona fide business-oriented security concerns, no part of the overall suecurity program would been provided to A. With respect to the transportation provided for security reasons, A may exclude as a working condition fringe the value of the special security features of the vehicle and the value attributable to the bodyguard/driver. Thus, if the value of the specially equipped vehicle is $40,000, and the value of the vehicle without the security features is $25,000, A may determine A’s income attributable to the vehicle as if the vehicle were worth $25,000. A must include in income the value of the availability of the vehicle for personal use.

Example (2). Assume that B is the chief executive officer of a multinational corporation (company Y). Assume further that there have been kidnapping attempts and other terrorist activities in the foreign countries in which B performs services and that at least some of such activities have been directed against B or similarly situated employees. In response to these activities, company Y provides B with an overall security program, including an alarm system at B’s home and bodyguards at B’s workplace, a bodyguard/driver who is trained in evasive driving techniques, and a vehicle specially designed for security during B's overseas travels. In addition, assume that company Y requires B to travel in company Y's airplane for business and personal trips taken to, from, and within these foreign countries. Also, assume that but for bona fide business-oriented security concerns, no part of the overall sucurity program would have been provided to B. B may exclude as a working condition fringe the value of the special security features of the automobile and the value attributable to the bodyguards and the bodyguard/driver. B may also exclude as a working condition fringe the excess, if any, of the value of personal flights in the company Y airplane over first-class airfare (as determined under the special valuation rule provided in §1.61–2T if the safe harbor described in paragraph (m)(2)(vi) of this section is used). B must include in income the value of the availability of the vehicle for personal use and the lesser of the value of first-class airfare or the value of the flight determined under §1.61–2T for each personal flight taken by B in company Y's airplane.

Example (3). Assume the same facts as in example (2) except that company Y also requires B to travel in company Y's airplane within the United States, and provides B with a chauffeur-driven limousine for business and personal travel in the United States. Assume further that company Y also requires B's spouse and dependents to travel in company Y's airplane for personal flights in the United States. If no bona fide business-oriented security concern exists with respect to travel in the United States, B may not exclude any portion of the value of the availability of the driver or limousine for personal use in the United States. Thus, B must include in income the value of the availability of the vehicle and driver for personal use. In addition, B may not exclude any portion of the value attributable to personal flights by B or B's spouse and dependents on company Y's airplane. Thus, B must include in income the value attributable to the personal use of company Y's airplane. See §1.61–2T for rules relating to the valuation of personal flights on employer-provided airplanes.

Example (4). Assume that company Z retains an independent security consultant to perform a security study with respect to its chief executive officer. Assume further that, based on an objective assessment of the facts and circumstances, the security consultant reasonably recommends that the employee be provided security at his workplace and for ground transportation, but not for air transportation. If company Z follows the recommendations on a consistent basis, an overall security program will be deemed to exist with respect to the workplace and ground transportation security only.

Example (5). Assume the same facts as in example (4) except that company Z only provides the employee security while commuting to and from work, but not for any other ground transportation. Since the recommendations of the independent security study are not applied on a consistent basis, an overall security program will not be deemed to exist.

(n) *Product testing*—(1) *In general.* The fair market value of the use of consumer goods, which are manufactured for sale to nonemployees, for product testing and evaluation by an employee outside the employer's workplace is excludable as a working condition fringe if—

(i) Consumer testing and evaluation of the product is an ordinary and necessary business expense of the employer,

(ii) Business reasons necessitate that the testing and evaluation of the product be performed off the employer's business premises by employees (i.e., the testing and evaluation cannot be carried out adequately in the employer's office or in laboratory testing facilities),

(iii) The product is furnished to the employee for purposes of testing and evaluation,

(iv) The product is made available to the employee for no longer than necessary to test and evaluate its performance and must be returned to the employer at completion of the testing and evaluation period,

(v) The employer imposes limitations of the employee's use of the product which significantly reduce the value of any personal benefit to the employee, and

(vi) The employee must submit detailed reports to the employer on the testing and evaluation.

The length of the testing and evaluation period must be reasonable in relation to the product being tested.

(2) *Employer-imposed limitations.* The requirement of paragraph (n)(1)(v) of this section is satisfied if—

(i) The employer places limitations on the employee's ability to select among different models or varieties of the consumer product that is furnished for testing and evaluation purposes,

(ii) The employer's policy provides for the employee, in appropriate cases, to purchase or lease at his or her own expense the same type of product as that being tested (so that personal use by the employee's family will be limited), and

(iii) The employer generally prohibits use of the product by members of the employee's family.

(3) *Discriminating classifications.* If an employer furnishes products under a testing and evaluation program only to officers, owners, or highly compensated employees, this fact may be considered in a determination of whether the products are furnished for testing and evaluation purposes or for compensation purposes, unless the employer can show a business reason for the classification of employees to whom the products are furnished (e.g., that automobiles are furnished for testing and evaluation by an automobile manufacturer to its design engineers and supervisory mechanics).

(4) *Factors that negate the existence of a product testing program.* If an employer fails to tabulate and examine the results of the detailed reports within a reasonable period of time after expiration of the testing period, the program will not be considered a product testing program. Existence of one or more of the following factors may also establish that the program is not a bona fide product testing program:

(i) The program is in essence a leasing program under which employees lease the consumer goods from the employer for a fee;

(ii) The nature of the product and other considerations are insufficient to justify the testing program; or

(iii) The expense of the program outweighs the benefits to be gained from testing and evaluation.

(5) *Failure to meet the requirements of this paragraph (n).* The fair market value of the use of property for product testing and evaluation by an employee outside the employee's workplace, under a product testing program that does not meet all of the requirements of this paragraph (n), is not excludable as a working condition fringe.

(6) *Example.* Assume that an employer that manufactures automobiles establishes a product testing program under which 50 of its 5,000 employees test and evaluate the automobiles for 30 days. Assume further that the 50 employees represent a fair cross section of all of the employees of the employer, such employees submit detailed reports to the employer on the testing and evaluation, the employer tabulates and examines the test results within a reasonable time, and the use of the automobiles is restricted to the employees. If the rules of paragraph (n)(2) of this section are also met, the employees may exclude the value of the use of the automobile during the testing and evaluation period.

(o) *Qualified automobile demonstration use*—(1) *In general.* The value of qualified automobile demonstration use is excludable from gross income as a working condition fringe. The term ''qualified automobile demonstration use'' means any use of a demonstration automobile by a full-time automobile salesman in the sales area in which the automobile dealer's sales office is located if—

(i) Such use is provided primarily to facilitate the salesman's performance of services for the employer, and

(ii) There are substantial restrictions on the personal use of the automobile by the salesman.

(2) *Full-time automobile salesman*—(i) *Definition.* The term ''full-time automobile salesman'' means any individual who—

(A) Is employed by an automobile dealer,

(B) Customarily spends substantially all of a normal business day on the sales floor selling automobiles to customers of the automobile dealership,

(C) Customarily works a number of hours considered full-time in the industry (but at a rate not less than 1,000 hours per year), and

(D) Derives at least 85 percent of his or her gross income from the automobile dealership directly as a result of such automobile sales activities.

An individual, such as the general manager of an automobile dealership, who receives a sales commission on the sale of an automobile is not a full-time automobile salesman unless the requirements of this paragraph (o)(2)(i) are met. The exclusion provided in this paragraph (o) is available to an individual who meets the definition of this paragraph (o)(2)(i) regardless of whether the individual performs services in addition to those described in this paragraph (o)(2)(i). For example, an individual who is an owner of the automobile dealership but who otherwise meets the requirements of this paragraph (o)(2)(i) may exclude from gross income the value of qualified automobile demonstration use.

(ii) *Use by an individual other than a full-time automobile salesman.* Personal use of a demonstration automobile by an individual other than a full-time automobile salesman is not treated as a working condition fringe. Therefore, any personal use, including commuting use, of a demonstration automobile by a part-time salesman, automobile mechanic, manager, or other individual is not ''qualified automobile demonstration use'' and thus not excludable from gross income.

(3) *Demonstration Automobile.* The exclusion provided in this paragraph (o) applies only to qualified use of a demonstration automobile. A demonstration automobile is an automobile that is—

(i) Currently in the inventory of the automobile dealership, and

(ii) Available for test drives by customers during the normal business hours of the employee.

(4) *Substantial restrictions on personal use.* Substantial restrictions on the personal use of demonstration automobiles exist when all of the following conditions are satisfied:

(i) Use by individuals other than the full-time automobile salesmen (e.g., the salesman's family) is prohibited,

(ii) Use for personal vacation trips is prohibited,

(iii) The storage of personal possessions in the automobile is prohibited, and

(iv) The total use by mileage of the automobile by the salesman outside the salesman's normal working hours is limited.

(5) *Sales area*—(i) *In general.* Qualified automobile demonstration use must be use in the sales area in which the automobile dealer's sales office is located. The sales area is the geographic area surrounding the automobile dealer's sales office from which the office regularly derives customers.

(ii) *Sales area safe harbor.* With respect to a particular full-time salesman, the automobile dealer's sales area may be treated as the larger of the area within a 75 mile radius of the dealer's sales office, or the on-way commuting distance (in miles) of the particular salesman.

(p) *Parking*—(1) *In general.* The value of parking provided to an employee on or near the business premises of the employer is excludable from gross income as a working condition fringe. The working condition fringe exclusion applies whether the employer owns or rents the parking facility or parking space.

(2) *Reimbursement of parking expenses.* Any reimbursement to the employee of the ordinary and necessary expenses of renting a parking space on or near the business premises of the employer is excludable as a working condition fringe. The preceding sentence does not apply, however, to cash payments that are not actually used for renting a parking space. Thus, that part of a general transportation allowance that is not used for parking is not excludable as a working condition fringe under this paragraph (p).

(3) *Parking on residential property.* With respect to an employee, this paragraph (p) does not apply to any parking facility or space located on property owned or leased for residential purposes by the employee.

(q) *Nonapplicability of nondiscrimination rules.* Except to the extent provided in paragraph (n)(3) of this section, the nondiscrimination rules of section 132(h)(1) and § 1.132–8T do not apply in determining the amount, if any, of a working condition fringe.

[T.D. 8063, 50 FR 52303, Dec. 23, 1985, as amended by T.D. 8256, 54 FR 28600, July 6, 1989]

§ 1.132–6 De minimis fringes.

(a) *In general.* Gross income does not include the value of a de minimis fringe provided to an employee. The term ''de minimis fringe'' means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable.

(b) *Frequency*—(1) *Employee-measured frequency.* Generally, the frequency with which similar fringes are provided by the employer to the employer's employees is determined by reference to the frequency with which the employer provides the fringes to each individual employee. For example, if an employer provides a free meal in kind to one employee on a daily basis, but not to any other employee, the value of the meals is not de minimis with respect to that one employee even though with respect to the employer's entire workforce the meals are provided ''infrequently.''

(2) *Employer-measured frequency.* Notwithstanding the rule of paragraph (b)(1) of this section, except for purposes of applying the special rules of paragraph (d)(2) of this section, where it would be administratively difficult to determine frequency with respect to individual employees, the frequency with which similar fringes are provided by the employer to the employer's employees is determined by reference to the frequency with which the employer provides the fringes to the workforce as a whole. Therefore, under this rule, the frequency with which any individual employee receives such a fringe benefit is not relevant and in some circumstances, the de minimis fringe exclusion may apply with respect to a benefit even though a particular employee receives the benefit frequently. For example, if an employer exercises sufficient control and imposes significant restrictions on the personal use of a company copying machine so that at least 85 percent of the use of the machine is for business purposes, any personal use of the copying machine by particular employees is considered to be a de minimis fringe.

(c) *Administrability.* Unless excluded by a provision of chapter 1 of the Internal Revenue Code of 1986 other than section 132(a)(4), the value of any fringe benefit that would not be unreasonable or administratively impracticable to account for is includible in the employee's gross income. Thus, except as provided in paragraph (d)(2) of this section, the provision of any cash fringe benefit is never excludable under section 132(a) as a de minimis fringe benefit. Similarly except as otherwise provided in paragraph (d) of this section, a cash equivalent fringe benefit (such as a fringe benefit provided to an employee through the use of a gift certificate or charge or credit card) is generally not excludable under section 132(a) even if the same property or service acquired (if provided in kind) would be excludable as a de minimis fringe benefit. For example, the provision of cash to an employee for a theatre ticket that would itself be excludable as a de minimis fringe (see paragraph (e)(1) of this section) is not excludable as a de minimis fringe.

(d) *Special rules*—(1) *Transit passes.* A public transit pass provided at a discount to defray an employee's commuting costs may be excluded from the employee's gross income as a de minimis fringe if such discount does not exceed $21 in any month. The exclusion provided in this paragraph (d)(1) also applies to the provision of tokens or fare cards that enable an individual to travel on the public transit system if the value of such tokens and fare cards in any month does not exceed by more than $21 the amount the employee paid for the tokens and fare cards for such month. Similarly, the exclusion of this paragraph (d)(1) applies to the provision of a voucher or similar instrument that is exchangeable solely for tokens, fare cards, or other instruments that enable the employee to use the public transit system if the value of such vouchers and other instruments in any month does not exceed $21. The exclusion of this paragraph (d)(1) also applies to reimbursements made by an employer to an employee after December 31, 1988, to cover the cost of commuting on a public transit system, provided the employee does not receive more than $21 in such reimbursements for commuting costs in any given month. The reimbursement must be made under a bona fide reimbursement arrangement. A reimbursement arrangement will be treated as bona fide if the employer establishes appropriate procedures for verifying on a periodic basis that the employee's use of public transportation for commuting is consistent with the value of the benefit provided by the employer for that purpose. The amount of in-kind public transit commuting benefits and reimbursements provided during any month that are excludible under this paragraph (d)(1) is limited to $21. For months ending before July 1, 1991, the amount is $15 per month. The exclusion provided in this paragraph (d)(1) does not apply to the provision of any benefit to defray public transit expenses incurred for personal travel other than commuting.

(2) *Occasional meal money or local transportation fare*—(i) *General rule.* Meals, meal money or local transportation fare provided to an employee is excluded as a de minimis fringe benefit if the benefit provided is reasonable and is provided in a manner that satisfies the following three conditions:

(A) *Occasional basis.* The meals, meal money or local transportation fare is provided to the employee on an occasional basis. Whether meal money or local transportation fare is provided to an employee on an occasional basis will depend upon the frequency i.e. the availability of the benefit and regularity with which the benefit is provided by the employer to the employee. Thus, meals, meal money, or local transportation fare or a combination of such benefits provided to an employee on a regular or routine basis is not provided on an occasional basis.

(B) *Overtime.* The meals, meal money or local transportation fare is provided to an employee because overtime work necessitates an extension of the employee's normal work schedule. This condition does not fail to be satisifed merely because the circumstances giving rise to the need for overtime work are reasonably foreseeable.

(C) *Meal money.* ln the case of a meal or meal money, the meal or meal money is provided to enable the employee to work overtime. Thus, for example, meals provided on the employer's premises that are consumed during the period that the employee works overtime or meal money provided for meals consumed during such period satisfy this condition.

In no event shall meal money or local transportation fare calculated on the basis of the number of hours worked (e.g., $1.00 per hour for each hour over eight hours) be considered a de minimis fringe benefit.

(ii) *Applicability of other exclusions for certain meals and for transportation provided for security concerns.* The value of meals furnished to an employee, an employee's spouse, or any of the employee's dependents by or on behalf of the employee's employer for the convenience of the employer is excluded from the employee's gross income if the meals are furnished on the business premises of the employer (see section 119). (For purposes of the exclusion under section 119, the definitions of an employee under §1.132–1(b) do not apply.) If, for a bona fide business-oriented security concern, an employer provides an employee vehicle transportation that is specially designed for security (for example, the vehicle is equipped with bulletproof glass and armor plating), and the conditions of §1.132–5(m) are satisfied, the value of the special security design is excludable from gross income as a working condition fringe if the employee would not have had such special security design but for the bona fide business-oriented security concern.

(iii) *Special rule for employer-provided transportation provided in certain circumstances.* (A) *Partial exclusion of value.* If an employer provides transportation (such as taxi fare to an employee for use in commuting to and/or from work because or unusual circumstances and because, based on the facts and circumstances, it is unsafe for the employee to use other available means of transportation, the excess of the value of each one-way trip over $1.50 per one-way commute is excluded from gross income. The rule of this paragraph (d)(2)(iii) is not available to a control employee as defined in §1.61–21(f) (5) and (6).

(B) *''Unusual circumstances''.* Unusual circumstances are determined with respect to the employee receiving the transportation and are based on all facts and circumstances. An example of unusual circumstances would be when an employee is asked to work outside of his normal work hours (such as being called to the workplace at 1:00 am when the employee normally works from 8:00 am to 4:00 pm). Another example of unusual circumstances is a temporary change in the employee's work schedule (such as working from 12 midnight to 8:00 am rather than from 8:00 am to 4:00 pm for a two-week period).

(C) *''Unsafe conditions''.* Factors indicating whether it is unsafe for an employee to use other available means of transportation are the history of crime in the geographic area surrounding the employee's workplace or residence and the time of day during which the employee must commute.

(3) *Use of special rules or examples to establish a general rule.* The special rules provided in this paragraph (d) or examples provided in paragraph (e) of this section may not be used to establish any general rule permitting exclusion as a de minimis fringe. For example, the fact that $252 (i.e., $21 per month for 12 months) worth of public transit passes can be excluded from gross income as a de minimis fringe in 1992 does not mean that any fringe benefit with a value equal to or less than $252 may be excluded as a de minimis fringe. As another example, the fact that the commuting use of an employer-provided vehicle more than one day a month is an example of a benefit not excludable as a de minimis fringe (see paragraph (e)(2) of this section) does not mean that the commuting use of a vehicle up to 12 times per year is excludable from gross income as a de minimis fringe.

(4) *Benefits exceeding value and frequency limits.* If a benefit provided to an employee is not de minimis because either the value or frequency exceeds a limit provided in this paragraph (d), no amount of the benefit is considered to be a de minimis fringe. For example, if, in 1992, an employer provides a $50 monthly public transit pass, the entire $50 must be included in income, not just the excess value over $21.

(e) *Examples*—(1) *Benefits excludable from income.* Examples of de minimis fringe benefits are occasional typing of personal letters by a company secretary; occasional personal use of an employer's copying machine, provided that the employer exercises sufficient control and imposes significant restrictions on the personal use of the machine so that at least 85 percent of the use of the machine is for business purposes; occasional cocktail parties, group meals, or picnics for employees and their guests; traditional birthday or holiday gifts of property (not cash) with a low fair market value; occasional theater or sporting event tickets; coffee, doughnuts, and soft drinks; local telephone calls; and flowers, fruit, books, or similar property provided to employees under special circumstances (e.g., on account of illness, outstanding performance, or family crisis).

(2) *Benefits not excludable as de minimis fringes.* Examples of fringe benefits that are not excludable from gross income as de minimis fringes are: season tickets to sporting or theatrical events; the commuting use of an employer-provided automobile or other vehicle more than one day a month; membership in a private country club or athletic facility, regardless of the frequency with which the employee uses the facility; employer-provided group-term life insurance on the life of the spouse or child of an employee; and use of employer-owned or leased facilities (such as an apartment, hunting lodge, boat, etc.) for a weekend. Some amount of the value of certain of these fringe benefits may be excluded from income under other statutory provisions, such as the exclusion for working condition fringes. See §1.132–5.

(f) *Nonapplicability of nondiscrimination rules.* Except to the extent provided in §1.132–7, the nondiscrimination rules of section 132(h)(1) and §1.132–8 do not apply in determining the amount, if any, of a de minimis fringe. Thus, a fringe benefit may be excludable as a de minimis fringe even if the benefit is provided exclusively to highly compensated employees of the employer.

[T.D. 8256, 54 FR 28615, July 6, 1989, as amended by T.D. 8389, 57 FR 1871, Jan 16, 1992; 57 FR 5982, Feb. 19, 1992]

§1.132–6T De minimis fringe—1985 through 1988 (temporary).

(a) *In general.* Gross income does not include the value of a de minimis fringe provided to an employee. The term ''de minimis fringe'' means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable.

(b) *Frequency.* Generally, the frequency with which similar fringes are provided by the employer to the employer's employees is determined by reference to the frequency with which the employer provides the fringe to each individual employee. For example, if an employer provides a free meal to one employee on a daily basis, but not to any other employee, the value of the meals is not de minimis with respect to that one employee even though with respect to the employer's entire workforce the meals are provided ''infrequently.'' However, where it would be administratively difficult to determine frequency with respect to individual employees, the frequency with which similar fringes are provided by the employer to the employer's employees is determined by reference to the frequency with which the employer provides the fringes to the employees and not the frequency with which individual employees receive them. In these cases, if an employer occasionally provides a fringe benefit of de minimis value to the employer's employees, the de minimis fringe exclusion may apply even though a particular employee receives the benefit frequently. For example, if an employer exercises sufficient control and imposes significant restrictions on the personal use of a company copying machine so that at least 85 percent of the use of the machine is for business purposes, any personal use the copying machine by particular employees is considered to be a de minimis fringe.

(c) *Administrability.* Unless excluded by a statutory provision other than section 132(a)(4), the value of any fringe benefit that would not be unreasonable or administratively impracticable to account for must be included in the employee's gross income. Thus, except as otherwise provided in this section, the provision of any cash fringe benefit (or any fringe benefit provided to an employee through the use of a charge or credit card) is not excludable as a de minimis fringe. For example, the provision of cash to an employee for personal entertainment is not excludable as a de minimis fringe.

(d) *Special rules*—(1) *Transit passes.* A transit pass provided to an employee at a discount not exceeding $15 per month may be excluded as a de minimis fringe. The exclusion provided in this paragraph (d) also applies to the provision of $15 in tokens or fare cards that enable an individual to travel on the transit system. The exclusion provided in this paragraph (d) does not apply to any provision of cash or other benefit to defray transit expenses incurred for personal travel.

(2) *Occasional meal money or local transportation fare.* Occasional meal money or local transportation fare provided to an employee because overtime work necessitates an extension of the employee's normal workday is excluded as a de minimis fringe.

(3) *Use of special rules to establish a general rule.* The special rules provided in this paragraph (d) may not be used to establish any general rule. For example, the fact that $180 ($15 per month for 12 months) worth of transit passes can be excluded in a year does not mean that any fringe benefit with a value equal to or less than $180 may be excluded as a de minimis fringe.

(4) *Benefits exceeding value and frequency limitations.* If the benefit provided to an employee is not de minimis because either the value or frequency exceeds a limit provided in this paragraph (d), no amount of the benefit is considered to be de minimis. For example, if an employer provides a $20 monthly transit pass, the entire $20 must be included in income, not just the excess value over $15.

(e) *Nonapplicability of nondiscrimination rules.* Except to the extent provided in § 1.132–7T, the nondiscrimination rules of section 132(h)(1) and § 1.132–8T do not apply. Thus, for example, a fringe benefit may be a de minimis fringe even if the benefit is provided exclusively to officers of the employer.

(f) *Examples*—(1) *Benefits excludable from income.* Examples of de minimis fringe benefits are occasional typing of personal letters by a company secretary; occasional personal use of an employer's copying machine, provided that the employer exercises sufficient control and imposes significant restrictions on the personal use of the machine so that at least 85 percent of the use of the machine is for business purposes; occasional cocktail parties or picnics for employees and their guests; traditional holiday gifts of property (not cash) with a low fair market value; occasional theatre or sporting event tickets; and coffee and doughnuts.

(2) *Benefits not excludable as de minimis fringes.* Examples of fringe benefits that are not excludable from income as de minimis fringes are: season tickets to sporting or theatrical events; the commuting use of an employer-provided automobile or other vehicle more than once a month; membership in a private country club or athletic facility, regardless of the frequency with which the employee uses the facility; and use of employer-owned or leased facilities (such as an apartment, hunting lodge, boat, etc.) for a weekend. Some amount of the value of these fringe benefits may be excluded under other statutory provisions, such as the exclusion for working condition fringes. See §1.132–5T.

[T.D. 8063, 50 FR 52308, Dec. 23, 1985, as amended by T.D. 8256, 54 FR 28600, July 6, 1989]

§1.132–7 Employer-operated eating facilities.

(a) *In general*—(1) *Condition for exclusion*—(i) *General rule.* The value of meals provided to employees at an employer-operated eating facility for employees is excludable from gross income as a de minimis fringe only if on an annual basis, the revenue from the facility equals or exceeds the direct operating costs of the facility.

(ii) *Additional condition for highly compensated employees.* With respect to any highly compensated employee, an exclusion is available under this section only if the condition set out in paragraph (a)(1)(i) of this section is satisfied and access to the facility is available on substantially the same terms to each member of a group of employees that is defined under a reasonable classification set up by the employer that does not discriminate in favor of highly compensated employees. See §1.132–8. For purposes of this paragraph (a)(1)(ii), each dining room or cafeteria in which meals are served is treated as a separate eating facility, whether each such dining room or cafeteria has its own kitchen or other food-preparation area.

(2) *Employer-operated eating facility for employees.* An employer-operated eating facility for employees is a facility that meets all of the following conditions—

(i) The facility is owned or leased by the employer,

(ii) The facility is operated by the employer,

(iii) The facility is located on or near the business premises of the employer, and

(iv) The meals furnished at the facility are provided during, or immediately before or after, the employee's workday.

For purposes of this section, the term ''meals'' means food, beverages, and related services provided at the facility. If an employer can reasonably determine the number of meals that are excludable from income by the recipient employees under section 119, the employer may, in determining whether the requirement of paragraph (a)(1)(i) of this section is satisfied, disregard all costs and revenues attributable to such meals provided to such employees. lf an employer can reasonably determine the number of meals received by volunteers who receive food and beverages at a hospital, free or at a discount, the employer may, in determining whether the requirement of paragraph (a)(1)(i) of this section is satisfied, disregard all costs and revenues attributable to such meals provided to such volunteers. If an employer charges nonemployees a greater amount than employees, in determining whether the requirement of paragraph (a)(1)(i) of this section is satisfied, the employer must disregard all costs and revenues attributable to such meals provided to such nonemployees.

(3) *Operation by the employer.* If an employer contracts with another to operate an eating facility for its employees, the facility is considered to be operated by the employer for purposes of this section. If an eating facility is operated by more than one employer, it is considered to be operated by each employer.

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

Example (1). Assume that a not-for-profit hospital system maintains cafeterias for the use of its employees and volunteers. Only the employees are charged for food service at the cafeteria and the policy of the hospital is to charge the employees only for the costs of food, beverage and labor directly attributable to the meal. Most of the cafeterias within the system furnish more free meals to volunteers than they serve paid meals to employees. For purposes of this paragraph, as long as the employer can accurately determine the number of meals received free or at a discount by volunteers, the employer may disregard all the costs and revenues attributable to such meals provided to volunteers. Therefore, for purposes of this paragraph, the costs of the hospital system for furnishing meals to employees who pay for them are the costs to be compared to determine if the revenues from the facility equal or exceed direct operating costs of the facility's service to employees.

(b) *Direct operating costs*—(1) *In general.* For purposes of this section, the direct operating costs of an eating facility are—

(i) The cost of food and beverages, and

(ii) The cost of labor for personnel whose services relating to the facility are performed primarily on the premises of the eating facility. Direct operating costs do not include the labor cost attributable to personnel whose services relating to the facility are not performed primarily on the premises of the eating facility. Thus, for example, the labor costs attributable to cooks, waiters, and waitresses are included in direct operating costs, but the labor cost attributable to a manager of an eating facility whose services relating to the facility are not primarily performed on the premises of the eating facility is not included in direct operating costs. If an employee performs services relating to the facility both on and off the premises of the eating facility, only the portion of the total labor cost of the employee relating to the facility that bears the same proportion to such total labor cost as time spent on the premises bears to total time spent performing services relating to the facility is included in direct operating costs. For example, assume that 60 percent of the services of a cook in the above example are not related to the eating facility. Only 40 percent of the total labor cost of the cook is includible in direct operating costs. For purposes of this section, labor costs include all compensation required to be reported on a Form W–2 for income tax purposes and related employment taxes paid by the employer. In determining the direct operating costs of an eating facility, the employer may include as part of the facility, vending machines that are provided by the employer and located on the same premises as the other eating facilities operated by the employer.

(2) *Multiple dining rooms or cafeterias.* The direct operating costs test may be applied separately for each dining room or cafeteria. Alternatively, the direct operating costs test may be applied with respect to all the eating facilities operated by the employer.

(3) *Payment to operator of facility.* If an employer contracts with another to operate an eating facility for its employees, the direct operating costs of the facility consist both of direct operating costs, if any, incurred by the employer and the amount paid to the operator of the facility to the extent that such amount is attributable to what would be direct operating costs if the employer operated the facility directly.

(c) *Valuation of non-excluded meals provided at an employer-operated eating facility for employees.* If the exclusion for meals provided at an employer-operated eating facility for employees is not available, the recipient of meals provided at such facility must include in income the amount by which the fair market value of the meals provided exceeds the sum of—

(1) The amount, if any, paid for the meals, and

(2) The amount, if any, specifically excluded by another section of chapter 1 of this subtitle.

For special valuation rules relating to such meals, see § 1.61–21(j).

[T.D. 8256, 54 FR 28617, July 6, 1989]

§ 1.132–7T Treatment of employer-operated eating facilities—1985 through 1988 (temporary).

(a) *In general*—(1) *General rule.* The value of meals provided to employees at an employer-operated eating facility for employees is excludable from gross income as a de minimis fringe only if—

(i) On an annual basis, the revenue from the facility equals or exceeds the direct operating costs of the facility, and

(ii) With respect to any officer, owner or highly compensated employee, access to the facility is available on substantially the same terms to each member of a group of employees that is defined under a reasonable classification set up by the employer that does not discriminate in favor of officers, owners, and highly compensated employees. See §1.132–8T.

(2) *Employer-operated eating facility for employees.* An employer-operated eating facility for employees is a facility that meets all of the following conditions—

(i) The facility is owned or leased by the employer,

(ii) The facility is operated by the employer,

(iii) The facility is located on or near the business premises of the employer,

(iv) Substantially all of the use of the facility is by employees of the employer operating the facility, and

(v) The meals furnished at the facility are provided during, or immediately before or after, the employee's workday.

For purposes of this section, the term ''meals'' means food, beverages, and related services provided at the facility. If an employer can determine the number of employees who receive meals that are excludable from income under section 119, the employer may, in determining whether the requirement of paragraph (a)(1)(i) of this section is satisfied, disregard all costs and revenues attributable to such meals provided to such employees. For purposes of this section, each dining room or cafeteria in which meals are served is treated as a separate eating facility, regardless of whether each such dining room or cafeteria has its own kitchen or other food-preparation area.

(3) *Operation by the employer.* If an employer contracts with another to operate an eating facility for its employees, the facility is considered to be operated by the employer for purposes of this section. If an eating facility is operated by more than one employer, it is considered to be operated by each employer.

(b) *Direct operating costs.* The direct operating costs test must be applied separately for each dining room or cafeteria. For purpose of this section, the direct operating costs of an eating facilities are: (1) The cost of food and beverages and (2) the cost of labor for personnel whose services relating to the facility are performed primarily on the premises of the eating facility. Direct operating costs do not include the cost of labor for personnel whose services relating to the facility are not performed primarily on the premises of the eating facility. Thus, for example, the labor cost for cooks, waiters, and waitresses is included in direct operating costs, but the labor cost for a manager of an eating facility whose services relating to the facility are not primarily performed on the premises of the eating facility is not included in direct operating costs. If an employee perfoms services both on and off the premises of the eating facility, only the applicable percentage of the total labor cost of the employee that bears the same proportion as time spent on the premises bears to total time is included in direct operating costs. For example, assume that 60 percent of the services of the cooks in the above example are not related to the eating facility. Only 40 percent of the total labor cost of the cooks is includible in direct operating costs. For purposes of this section, labor costs include all compensation required to be reported on a Form W–2 for income tax purposes and related employment taxes paid by the employer.

(c) *Valuation of non-excluded meals provided at an employer-operated eating facility for employees.* If the exclusion for meals provided at an employer-operated eating facility for employees is not available, the recipient of meals provided at such facility must include in income the amount by which the fair market value of the meals provided exceeds the sume of: (1) The amount, if any, paid for the meals, and (2) the amount, if any, specifically excluded by another section of the Code. For special valuation rules relating to such meals see §1.61–2T (j).

[T.D. 8063, 50 FR 52308, Dec. 23, 1985, as amended by T.D. 8256, 54 FR 28600, July 6, 1989]

§ 1.132–8 Fringe benefit nondiscrimination rules.

(a) *Application of nondiscrimination rules*—(1) *General rule.* A highly compensated employee who receives a no-additional cost service, a qualified employee discount or a meal provided at an employer-operated eating facility for employees shall not be permitted to exclude such benefit from his or her income unless the benefit is available on substantially the same terms to:

(i) All employees of the employer; or

(ii) A group of employees of the employer which is defined under a reasonable classification set up by the employer that does not discriminate in favor of highly compensated employees. See paragraph (f) of this section for the definition of a highly compensated employee.

(2) *Consequences of discrimination*—(i) *In general.* If an employer maintains more than one fringe benefit program, i.e., either different fringe benefits being provided to the same group of employees, or different classifications of employees or the same fringe benefit being provided to two or more classifications of employees, the nondiscrimination requirements of section 132 will generally be applied separately to each such program. Thus, a determination that one fringe benefit program discriminates in favor of highly compensated employees generally will not cause other fringe benefit programs covering the same highly compensated employees to be treated as discriminatory. If the fringe benefits provided to a highly compensated individual do not satisfy the nondiscrimination rules provided in this section, such individual shall be unable to exclude from gross income any portion of the benefit. For example, if an employer offers a 20 percent discount (which otherwise satisfies the requirements for a qualified employee discount) to all non-highly compensated employees and a 35 percent discount to all highly compensated employees, the entire value of the 35 percent discount (not just the excess over 20 percent) is includible in the gross income and wages of the highly compensated employees who make purchases at a discount.

(ii) *Exception*—(A) *Related fringe benefit programs.* If one of a group of fringe benefit programs discriminates in favor of highly compensated employees, no related fringe benefit provided to such highly compensated employees under any other fringe benefit program may be excluded from the gross income of such highly compensated employees. For example, assume a department store provides a 20 percent merchandise discount to all employees under one fringe benefit program. Assume further that under a second fringe benefit program, the department store provides an additional 15 percent merchandise discount to a group of employees defined under a classification which discriminates in favor of highly compensated employees. Because the second fringe benefit program is discriminatory, the 15 percent merchandise discount provided to the highly compensated employees is not a qualified employee discount. In addition, because the 20 percent merchandise discount provided under the first fringe benefit program is related to the fringe benefit provided under the second fringe benefit program, the 20 percent merchandise discount provided the highly compensated employees is not a qualified employee discount. Thus, the entire 35 percent merchandise discount provided to the highly compensated employees is includible in such employees' gross incomes.

(B) *Employer operated eating facilities for employees.* For purposes of paragraph (a)(2)(ii)(A) of this section, meals at different employer-operated eating facilities for employees are not related fringe benefits, so that a highly compensated employee may exclude from gross income the value of a meal at a nondiscriminatory facility even though any meals provided to him or her at a discriminatory facility cannot be excluded.

(3) *Scope of the nondiscrimination rules provided in this section.* The nondiscrimination rules provided in this section apply only to fringe benefits provided pursuant to section 132 (a)(1), (a)(2), and (e)(2). These rules have no application to any other employee benefit that may be subject to nondiscrimination requirements under any other section of the Code.

(b) *Aggregation of employees*—(1) *Section 132(a) (1) and (2).* For purposes of determining whether the exclusions for no-additional-cost services and qualified employee discounts are available to highly compensated employees, the nondiscrimination rules of this section are applied by aggregating the employees of all related employers (as defined in §1.132–1(c)), except that employees in different lines of business (as defined in §1.132–4) are not to be aggregated. Thus, in general, for purposes of this section, the term ''employees of the employer'' refers to all employees of the employer and any other entity that is a member of a group described in sections 414 (b), (c), (m), or (o) and that performs services within the same line of business as the employer which provides the particular fringe benefit. Employees in different lines of business will be aggregated, however, if the line of business limitation has been relaxed pursuant to paragraphs (b) through (g) of §1.132–4.

(2) *Section 132 (e) (2).* For purposes of determining whether the exclusions for meals provided at employer-operated eating facilities are available to highly compensated, the nondiscrimination rules of this section are applied by aggregating the employees of all related employers (as defined in section §1.132–1(c)) who regularly work at or near the premises on which the eating facility is located, except that employees in different lines of business (as defined in §1.132–4) are not to be aggregated. The nondiscrimination rules of this section are applied separately to each eating facility. Each dining room or cafeteria in which meals are served is treated as a separate eating facility, regardless of whether each such dining room or cafeteria has its own kitchen or other food-preparation area.

(3) *Classes of employees who may be excluded.* For purposes of applying the nondiscrimination rules of this section to a particular fringe benefit program, there may be excluded from consideration employees who may be excluded from consideration under section 89(h), as enacted by the Tax Reform Act of 1986, Pub. L. 99–514, 100 Stat. 2085 (1986) and amended by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100–647, 102 Stat. 3342 (1988).

(c) *Availability on substantially the same terms*—(1) *General rule.* The determination of whether a benefit is available on substantially the same terms shall be made upon the basis of the facts and circumstances of each situation. In general, however, if any one of the terms or conditions governing the availability of a particular benefit to one or more employees varies from any one of the terms or conditions governing the availability of a benefit made available to one or more other employees, such benefit shall not be considered to be available on substantially the same terms except to the extent otherwise provided in paragraph (c)(2) of this section. For example, if a department store provides a 20 percent qualified employee discount to all of its employees on all merchandise, the substantially the same terms requirement will be satisfied. Similarly, if the discount provided to all employees is 30 percent on certain merchandise (such as apparel), and 20 percent on all other merchandise, the substantially the same terms requirement will be satisfied. However, if a department store provides a 20 percent qualified employee discount to all employees, but as to the employees in certain departments, the discount is available upon hire, and as to the remaining departments, the discount is only available when an employee has completed a specified term of services, the 20 percent discount is not available on substantially the same terms to all of the employees of the employer. Similarly, if a greater discount is given to employees with more seniority, full-time work status, or a particular job description, such benefit (i.e., the discount) would not be available to all employees eligible for the discount on substantially the same terms, except to the extent otherwise provided in paragraph (c)(2) of this section. These examples also apply to no-additional-cost-services. Thus, if an employer charges non-highly compensated employees for a no-additional-cost service and does not charge highly compensated employees (or charges highly compensated employees a lesser amount), the substantially the same terms requirement will not be satisfied.

(2) *Certain terms relating to priority.* Certain fringe benefits made available

to employees are available only in limited quantities that may be insufficient to meet employee demand. This situation may occur either because of employer policy (such as where an employer determines that only a certain number of units of a specific product will be made available to employees each year) or because of the nature of the fringe benefit (such as where an employer provides a no-additional-cost transportation service that is limited to the number of seats available just before departure). Under these circumstances, an employer may find it necessary to establish some method of allocating the limited fringe benefits among the employees eligible to receive the fringe benefits. The employer may establish the priorities described below.

(i) *Priority on a first come, first served, or similar basis.* A benefit shall not fail to be treated as available to a group of employees on substantially the same terms merely because the employer allocates the benefit among such employees on a ''first come, first served'' or lottery basis, provided that the same notice of the terms of availability is given to all employees in the group and the terms under which the benefit is provided to employees within the group are otherwise the same with respect to all employees. For purposes of the preceding sentence, a program that gives priority to employees who are the first to submit written requests for the benefit will constitute priority on a ''first come, first served'' basis. Similarly, if the employer regularly engages in the practice of allocating benefits on a priority basis to employees demonstrating a critical need, such benefit shall not fail to be treated as available on substantially the same terms to all of the employees with respect to whom such priority status is available as long as the determination is based upon uniform and objective criteria which have been communicated to all employees in the group of eligible employees. An example of a critical need would be priority transportation given to an employee in the event of a medical emergency involving the employee (or a member of the employee's immediate family) or a recent death in the employee's immediate family. Frustrated vacation plans or forfeited deposits would not be treated as giving rise to particularly critical needs.

(ii) *Priority on the basis of seniority.* Solely for purposes of § 1.132–8, a benefit shall not fail to be treated as available to a group of employees of the employer on substantially the same terms merely because the employer allocates the benefit among such employees on a seniority basis provided that:

(A) The same notice of the terms of availability is given to all employees in the group; and

(B) The average value of the benefit provided for each nonhighly compensated employee is at least 75% of that provided for each highly compensated employee. For purposes of this test, the average value of the benefit provided for each nonhighly compensated (highly compensated) employee is determined by taking the sum of the fair market values of such benefit provided to all the nonhighly compensated (highly compensated) employees, determined in accordance with § 1.61–21, and then dividing that sum by the total number of nonhighly compensated (highly compensated) employees of the employer. For purposes of determining the average value of the benefit provided for each employee, all employee's of the employer are counted, including those who are not eligible to receive the benefit from the employer.

(d) *Testing for discrimination*—(1) *Classification test.* In the event that a benefit described in section 132 (a)(1), (a)(2) or (e)(2) is not available on substantially the same terms to all of the employees of the employer, no exclusion shall be available to a highly compensated employee for such benefit unless the program under which the benefit is provided satisfies the nondiscrimination standards set forth in this section. The nondiscrimination standard of this section will be satisfied only if the benefit is available on substantially the same terms to a group of employees of the employer which is defined under a reasonable classification established by the employer that does not discriminate in favor of highly compensated employees. The determination of whether a particular classification is discriminatory will generally depend upon the facts and circumstances involved, based upon principles similar to those applied for purposes of section 410(b)(2)(A)(i) or, for years commencing prior to January 1, 1988, section 410(b)(1)(B). Thus, in general, except as otherwise provided in this section, if a benefit is available on substantially the same terms to a group of employees which, when compared with all of the other employees of the employer, constitutes a nondiscriminatory classification under section 410(b)(2)(A)(i) (or, if applicable, section 410(b)(1)(B)), it shall be deemed to be nondiscriminatory.

(2) *Classifications that are per se discriminatory.* A classification that, on its face, makes fringe benefits available principally to highly compensated employees is per se discriminatory. In addition, a classification that is based on either an amount or rate of compensation is per se discriminatory if it favors those with the higher amount or rate of compensation. On the other hand, a classification that is based on factors such as seniority, full-time vs. part-time employment, or job description is not per se discriminatory but may be discriminatory as applied to the workforce of a particular employer.

(3) *Former employees.* When determining whether a classification is discriminatory, former employees shall be tested separately from other employees of the employer. Therefore, a classification is not discriminatory solely because the employer does not make fringe benefits available to any former employee. Whether a classification of former employees discriminates in favor of highly compensated employees will depend upon the particular facts and circumstances.

(4) *Restructuring of benefits.* For purposes of testing whether a particular group of employees would constitute a discriminatory classification for purposes of this section, an employer may restructure its fringe benefit program as described in this paragraph. If a fringe benefit is provided to more than one group of employees, and one or more such groups would constitute a discriminatory classification if considered by itself, then for purposes of this section, the employer may restructure its fringe benefit program so that all or some of the members of such group may be aggregated with another group, provided that each member of the restructured group will have available to him or her the same benefit upon the same terms and conditions. For example, assume that all highly compensated employees of an employer have fewer than five years of service and all nonhighly compensated employees have over five years of service. If the employer provided a five percent discount to employees with under five years of service and a ten percent discount to employees with over five years of service, the discount program available to the highly compensated employees would not satisfy the nondiscriminatory classification test; however, as a result of the rule described in this paragraph (d)(4), the employer could structure the program to consist of a five percent discount for all employees and a five percent additional discount for nonhighly compensated employees.

(5) *Employer-operated eating facilities for employees*—(i) *General rule.* If access to an employer-operated eating facility for employees is available to a classification of employees that discriminates in favor of highly compensated employees, then the classification will not be treated as discriminating in favor of highly compensated employees unless the facility is used by one or more executive group employees more than a de minimis amount.

(ii) *Executive group employee.* For purposes of this paragraph (d)(5), an employee is an ‘‘executive group employee’’ if the definition of paragraph (f)(1) of this section is satisfied. For purposes of identifying such employees, the phrase ‘‘top one percent of the employees’’ is substituted for the phrase ‘‘top ten percent of the employees’’ in section 414(q)(4) (relating to the definition of ‘‘top-paid group’’).

(e) *Cash bonuses or rebates.* A cash bonus or rebate provided to an employee by an employer that is determined with reference to the value of employer-provided property or services purchased by the employee, is treated as an equivalent employee discount. For example, assume a department store provides a 20 percent merchandise discount to all employees under a fringe benefit program. In addition, assume that the department store provides cash bonuses to a group of employees defined under a classification which discriminates in favor of highly compensated employees. Assume further that such cash bonuses equal 15 percent of the value of merchandise purchased by each employee. This arrangement is substantively identical to the example described in paragraph (e)(2)(i) of this section concerning related fringe benefit programs. Thus, both the 20 percent merchandise discount and the 15 percent cash bonus provided to the highly compensated employees are includible in such employees' gross incomes.

(f) *Highly compensated employee*—(1) *Government and nongovernment employees.* A highly compensated employee of any employer is any employee who, during the year or the preceding year—

(i) Was a 5-percent owner,

(ii) Received compensation from the employer in excess of $75,000,

(iii) Received compensation from the employer in excess of $50,000 and was in the top-paid group of employees for such year, or

(iv) Was at any time an officer and received compensation greater than 150 percent of the amount in effect under section 415(c)(1)(A) for such year.

For purposes of determining whether an employee is a highly compensated employee, the rules of sections 414 (q), (s), and (t) apply.

(2) *Former employees.* A former employee shall be treated as a highly compensated employee if—

(i) The employee was a highly compensated employee when the employee separated from service, or

(ii) The employee was a highly compensated employee at any time after attaining age 55.

[T.D. 8256, 54 FR 28618, July 6, 1989]

§ 1.132–8T Nondiscrimination rules—1985 through 1988 (temporary).

(a) *Application of nondiscrimination rules*—(1) *General rule.* To qualify under section 132 for the exclusions for non-additional-cost services, qualified employee discounts, or meals provided at employer-operated eating facilities for employees, the fringe benefit must be available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer that does not discriminate in favor of officers, owners, or highly compensated employees (the ''prohibited group employees'').

(2) *Consequences of discrimination.* If the availability of or the provision of the fringe benefit does not satisfy the nondiscrimination rules provided in this section, the exclusion applies only to those employees (if any) who receive the benefit and who are not prohibited group employees. For example, if an employer offers a 20 percent discount (which otherwise satisfies the requirements for a qualified employee discount) to all nonprohibited group employees and a 35 percent discount to all prohibited group employees, the entire value of the 35 percent discount (not just the excess over 20 percent) is includible in the gross income and wages of the prohibited group employees who make purchases at a discount.

(3) *Scope of the nondiscrimination rules provided in this section.* The nondiscrimination rules provided in this section apply only to fringe benefits provided pursuant to section 132 (a)(1), (a)(2), and (e)(2). These rules have no application to any other employee benefit that may be subject to nondiscrimination requirements under any other section of the Code.

(b) *Coverage requirement*—(1) *Section 132 (a)(1) and (2).* For purposes of the exclusions for no-additional-cost services and qualified employee discounts, the nondiscrimination rules of this section are applied by aggregating the employees of all related employers (as defined in § 1.132–1T (c)), but without aggregating employees in different lines of business (as defined in § 1.132–4T). Employees in different lines of business will be aggregated, however, if the line of business limitation has been relaxed pursuant to either section 1.132–4T (b) or (c). Except as provided in paragraph (e) of this section, the nondiscrimination rules of this section are generally applied separately to each fringe benefit program of an employer.

(2) *Section 132(e)(2).* For purposes of the exclusion for meals provided at employer-operated eating facilities for employees, the nondiscrimination rules of this section are applied by aggregating the employees of all related employers, without regard to different lines of business, who regularly work at or near the premises on which the eating facility is located. The nondiscrimination rules of this section are applied separately to each eating facility. Each dining room or cafeteria in which meals are served is treated as a separate eating facility, regardless of whether each such dining room or cafeteria has its own kitchen or other food-preparation area.

(3) *Classes of employees who may be excluded.* Except as otherwise provided in this section, for purposes of applying the nondiscrimination rules of this section to a particular fringe benefit program, there may be excluded from consideration the following classes of employees provided that, with respect to each class (other than the class described in paragraph (b)(3)(iii) of this section), all employees in the class are excluded from participating in the particular fringe benefit program—

(i) All part-time or seasonal employees who are (or who are reasonably expected to be) credited with less than 1,000 hours (or such lesser number required for the program) of service during a calendar year;

(ii) All employees who are included in a unit of employees covered by an agreement with the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that the particular fringe benefit program was the subject of good faith bargaining between such employee representatives and such employer or employers (and if, after March 31, 1984, the additional condition of section 7701(a)(46) is satisfied);

(iii) All employees who are nonresident aliens and who receive no earned income (within the meaning of section 911(d)(2)) from the employer which constitutes income from services within the United States (within the meaning of section 861(a)(3));

(iv) All employees who have not completed at least one year (or such lesser period required for the program) of service with the employer;

(v) All employees who have separated from the service of the employer in a year prior to the current year (regardless of the reason for the separation);

(vi) All employees who have separated from the service of the employer in a year prior to the current year except for retired and/or disabled employees (either with or without a time limit based on a set number of years since separation from the service of the employer); and

(vii) All employees of a leased section of a department store.

(c) *Classification requirement*—(1) *General rule.* The determination of whether a particular classification established by an employer discriminates in favor of the prohibited group will depend on the facts and circumstances involved, based on principles similar to those applied in the qualified plan area (see section 410(b)(1)(B) and the regulations thereunder). In general, except as otherwise provided in this section, a classification that would be determined to be nondiscriminatory pursuant to the application of the nondiscrimination standards that are applied in the qualified plan area shall be deemed to be nondiscriminatory for purposes of section 132.

(2) *Classifications that are per se discriminatory.* A classification that, on its face, makes fringe benefits available only to prohibited group employees is per se discriminatory, and no exclusion from gross income is available to any prohibited group employee under section 132. In addition, a classification that is based on either an amount or rate of compensation is per se discriminatory if it favors those with the higher amount or rate of compensation. On the other hand, a classification that is based on factors such as seniority, full-time vs. part-time employment, or job description is not per se discriminatory but may be discriminatory as applied to the workforce of a particular employer.

(3) *Former employees.* When determining whether a classification is discriminatory, former employees shall not be considered together with other

employees of the employer. Therefore, a classification is not discriminatory if the employer does not make the fringe benefits available to any former employee. Whether a classification of former employees discriminates in favor of prohibited group employees will depend on the facts and circumstances. The rules of this section shall apply separately to the former employee classification.

(4) *Employer-operated eating facilities for employees*—(i) *General rule.* If access to an employer-operated eating facility for employees is available to a classification of employees that discriminates in favor of highly compensated employees, the classification will not be treated as discriminating in favor of the prohibited group employees unless the facility is used, more than a de minimis amount, by any executive group employee.

(ii) *Executive group employees.* For purposes of this paragraph (c)(4), the term ''executive group employees'' has the same meaning as the term ''prohibited group employees'' (as defined in paragraph (g) of this section), except that for purposes of identifying highly compensated employees—

(A) The exception provided in paragraph (g)(1)(i)(A) of this section does not apply, and

(B) The phrase ''highest-paid one percent of all employees of an employer'' is substituted for the phrase ''highest-paid ten percent of all employees of an employer'' in paragraph (g)(1)(ii)(A) of this section.

(d) *Substantially-the-same-terms requirement*—(1) *General rule.* Fringe benefits available to a particular classification of employees must be available to each employee in the classification on substantially the same terms. The determination of whether this requirement is met shall depend on the facts and circumstances involved. For example, if a department store provides a 20 percent qualified employee discount to its employees on all merchandise, the substantially-the-same-terms requirement will be satisfied. Similarly, if the discount provided to all employees is 30 percent on certain merchandise (such as apparel), and 20 percent on all other merchandise, the substantially-the-same-terms requirement will be satisfied. However, if the discount provided is 20 percent on all merchandise for hourly employees and 30 percent on all merchandise for salaried employees, the substantially-the-same-terms requirement will not be satisfied. In addition, if the percentage discount varies depending on either an employee's amount or rate of compensation, or volume of purchases, the substantially-the-same-terms requirement will not be satisfied. In order to determine whether such a discount program satisfies the nondiscrimination requirements of section 132, each group of employees that does receive fringe benefits on substantially the same terms must be treated as a separate classification. However, subject to the rules of paragraph (e)(2) of this section, an employer may divide a fringe benefit program into two programs for purposes of aggregating groups of employees. See Example (1) of paragraph (d)(3) of this section.

(2) *Terms relating to priority.* Certain fringe benefits made available to employees are available only in limited quantities that may be insufficient to meet employee demand. This may occur either because of employer policy (such as where an employer determines that only a certain number of units of a specific product will be made available to employees each year) or because of the nature of the fringe benefit (such as where an employer provides a no-additional-cost transportation service that is limited to the number of seats available just before departure). Under these circumstances, an employer may find it necessary to establish some method of allocating the limited fringe benefits among the employees eligible to receive the fringe benefits. An allocation among employees on a ''first-come, first-served'' basis will not violate the substantially-the-same-terms requirement provided that such an allocation is not discriminatory in practice. In addition, an allocation among employees on a lottery basis will not violate the substantially-the-same-terms requirement provided that such an allocation is nondiscriminatory in practice. For example, assume that an employer has a limited number of a particular benefit to offer to its employees. Assume further that

the employees interested in receiving the benefit submit their names to the employer who then selects a number of names, at random, equal to the number of fringe benefits available. This lottery system would not violate the substantially-the-same-terms requirement. An allocation among employees on other than a ‘‘first-come, first-served’’, lottery, or similar basis will violate the substantially-the-same-terms requirement. Therefore, an allocation based on seniority, full-time vs. part-time employment, or job description will violate the substantially-the-same-terms requirement. In order to determine whether such a fringe benefit program satisfies the nondiscrimination requirements of section 132, each group of employees that does receive fringe benefits on substantially the same terms must be treated as a separate classification. For purposes of this rule, the last two sentences of paragraph (d)(1) of this section apply.

(3) *Examples.* The followings examples illustrate the provisions of this paragraph (d):

Example 1. Assume that with respect to a benefit available in limited quantities an employer provides priority to employees based on seniority. Assume further that all non-prohibited group employees have ten years of seniority and all prohibited group employees have nine years seniority. If each of these groups were tested separately, the benefits offered to prohibited group employees would be discriminatory under this section. In this case, the employer could divide the fringe benefit program provided to non-prohibited group employees into two parts: one relating to nine years of seniority and one relating to an additional year of seniority. As restructured in this manner, all employees receive the benefit relating to nine years seniority and only non-prohibited group employees receive the benefit relating to an additional year of seniority. Both groups (all employees and all non-prohibited group employees) are nondiscriminatory groups.

Example 2. Assume that prices charged to prohibited group employees at an employer-operated eating facility for employees are lower than prices charged to non-prohibited group employees. The substantially-the-same requirement is not satisfied.

(4) *Disproportionate use of eating facility.* If access to an employer-operated eating facility for employees is technically available on substantially-the-same-terms (to (i) all employees who regularly work at or near the premises on which the eating facility is located (the employee group), or (ii) a nondiscriminatory classification of the employee group, but in practice a highly disproportionate number of the prohibited group employees in the employee group, compared to the non-prohibited group employees in the employee group, use the facility, the substantially-the-same-terms requirement will not be satisfied unless no member of the executive group eats there more than a de minimis amount.

(e) *Aggregation of separate fringe benefit programs*—(1) *General rule.* If an employer maintains more than one fringe benefit program, i.e., two or more classifications of employees providing either identical or different fringe benefits, the nondiscrimination requirements of section 132 will generally be applied separately to each such program. Thus, a determination that one fringe benefit program discriminates in favor of prohibited group employees generally will not cause other fringe benefit programs covering the same prohibited group employees to be treated as discriminatory.

(2) *Exception*—(i) *Related fringe benefit programs.* If one of a group of fringe benefit programs discriminates in favor of prohibited group employees, no related fringe benefit provided to such prohibited group employees under any other fringe benefit program may be excluded from the gross income of such prohibited group employees. For example, assume a department store provides a 20 percent merchandise discount to all employees under one fringe benefit program. Assume further that under a second fringe benefit program, the department store provides an additional 15 percent merchandise discount to a group of employees defined under a classification which discriminates in favor of the prohibited group. Because the second fringe benefit program is discriminatory, the 15 percent merchandise discount provided to the prohibited group employees is not a qualified employee discount. In addition, because the 20 percent merchandise discount provided under the first fringe benefit program is related to the fringe benefit provided under the second

fringe benefit program, the 20 percent merchandise discount provided the prohibited group employees is not a qualified employee discount. Thus, the entire 35 percent merchandise discount provided to the prohibited group employees is includible in such employees' gross incomes.

(ii) *Employer-operated eating facilities for employees.* For purposes of paragraph (e)(2)(i) of this section, meals at different employer-operated eating facilities for employees are not related fringe benefits, so that a prohibited group employee may exclude the value of a meal at a nondiscriminatory facility even though any meals provided to him or her at the discriminatory facility cannot be excluded.

(f) *Cash bonuses or rebates.* A cash bonus or rebate provided to an employee by an employer that is determined pursuant to the value of employer-provided property or services purchased by the employee, is treated as an equivalent employee discount. For example, assume a department store provides a 20 percent merchandise discount to all employees under a fringe benefit program. In addition, assume that the department store provides cash bonuses to a group of employees defined under a classification which discriminates in favor of the prohibited group. Assume further that such cash bonuses equal 15 percent of the value of merchandise purchased by each employee. This arrangement is substantively identical to the example described in paragraph (e)(2) of this section. Thus, both the 20 percent merchandise discount and the 15 percent cash bonus provided to the prohibited group employees are includible in such employees' gross incomes.

(g) *Prohibited group employees*—(1) *Highly compensated*—(i) *General rule.* Except as otherwise provided in this paragraph (g)(1)(i), any employee of an employer who has (or is reasonably expected to have) compensation during a calendar year equal to or greater than the employer's base compensation amount is highly compensated. There are two exceptions to this rule:

(A) Any employee who has (or is reasonably expected to have) compensation during a calendar year equal to or greater than $50,000 is highly compensated, regardless of whether such compensation is in excess of the base compensation amount, and

(B) Any employee who is reasonably expected to have compensation during a calendar year equal to or less than $20,000 is not highly compensated, unless no employee of the employer is reasonably expected to have compensation equal to or greater than $35,000.

The determination of whether an employee is a highly compensated employee will be determined based on the entire employee workforce of all employers aggregated pursuant to the rules of section 414 (b), (c), or (m) without regard to the regular workplace of the employees.

(ii) *Base compensation amount*—(A) *General rule.* The term ''base compensation amount'' is defined as that amount corresponding to the lowest annual compensation amount received by the highest-paid ten percent of all employees of an employer (the number of employees in the top ten percent will be increased to the next highest integer if necessary), determined on the basis of the preceding calendar year. For purposes of this paragraph (g)(1)(ii), the term ''employer'' includes all entities that would be aggregated pursuant to the rules of section 414 (b), (c), or (m).

(B) *Employees that are excluded.* For purposes of determining the base compensation amount with respect to a fringe benefit program, employees described in paragraph (b)(3) of this section are excluded whether or not they are covered under the fringe benefit program, except that: (*1*) Employees described in paragraph (b)(3)(ii) of this section are taken into account with respect to the program even if they are excluded under paragraph (b)(3), and (*2*) employees described in paragraph (b)(3) (i) and (iv) of this section are taken into account with respect to the program unless they are excluded under paragraph (b)(3).

(C) *Exception to preceding calendar year rule.* In the case of an employer's first year of operation, or where an employer's business has changed significantly from the prior calendar year (e.g., due to an acquisition or merger), the employer must make a good faith attempt to either determine or adjust the base compensation amount for the current year based on reasonable estimates of current year compensation.

(iii) *Compensation.* The term ''compensation'' is defined as the amount reportable on a Form W–2 as income. Amounts that would be excluded from income but for section 132(h)(1) are not included in compensation for purposes of this paragraph (g)(1). Compensation includes amounts received from all entities which would be treated as a single employer under section 414 (b), (c), or (m) and is not restricted to amounts received with respect to any one line of business.

(iv) *Employee.* Generally, for purposes of determining whether an employee is highly compensated under this paragraph (g)(1), the term ''employee'' does not include any individual who does not perform services for the employer as an employee during the calendar year. For example, if an employer has active employees, retired or disabled employees, and widows or widowers who are ''employees'' under section 132(f)(1)(B), the general rule (described in paragraph (g)(1)(i) of this section) applies only to the active employees.

(2) *Owner*—(i) *General rule.* For purposes of this section, the term ''owner'' means any employee who owns a one percent or greater interest in either the employer or in any entity that would be aggregated with the employer pursuant to the rules of section 414 (b), (c), or (m). In addition, such an employee shall be treated as an owner of all entities that would be aggregated with the employer pursuant to the rules of section 414 (b), (c), or (m).

(ii) *Determining ownership.* Ownership in a corporation shall be determined pursuant to the rules of section 318(a). For purposes of determining ownership in an entity other than a corporation, the rules of section 318(a) shall apply in a manner similar to the way in which they apply for purposes of determining ownership in a corporation. For noncorporate interests, capital or profits interest must be substituted for stock.

(3) *Officer*—(i) *Non-government.* For purposes of this section, an officer of a non-government employer is any employee who is appointed, confirmed, or elected by the Board or shareholders of the employer. An employee who is an officer of an employer shall be treated as an officer of all entities treated as a single employer pursuant to section 414 (b), (c), or (m). The number of officers is not to exceed one-percent of the total number of employees of all entities treated as a single employer pursuant to section 414 (b), (c), or (m) (increased to the next highest integer, if necessary). If the number of officers exceeds one-percent of all employees, then the limitation is to be applied to employees in descending order of compensation (as defined in paragraph (g)(1)(iii) of this section). Thus, if an employer with 1,000 employees has 11 board-appointed officers, the employee with the least compensation of those officers would not be an officer under this paragraph (g)(3)(i). In determining the total number of employees with respect to a fringe benefit program, employees described in paragraph (b)(3) of this section are excluded whether or not they are covered under the fringe benefit program, except that (A) employees described in paragraph (b)(3)(ii) of this section are taken into account with respect to the program even if they are excluded under paragraph (b)(3), and (B) employees described in paragraph (b)(3) (i) and (iv) of this section are taken into account with respect to the program unless they are excluded under paragraph (b)(3).

(ii) *Government.* For purposes of this section, an officer of a government employer is any—

(A) Elected official,

(B) Federal employee appointed by the President and confirmed by the Senate. However, in the case of any commissioned officer of the United States Armed Forces, an officer is any employee with the rank of brigadier general or rear admiral (lower half) or above, and

(C) State or local executive officer comparable to individuals described in paragraphs (g)(3)(ii) (A) and (B) of this section.

For purposes of this paragraph (g)(3)(ii), the term ''government'' includes any Federal, state, or local governmental unit, and any agency or instrumentality thereof.

(4) *Former employees.* [Reserved]

[T.D. 8063, 50 FR 52309, Dec. 23, 1985, as amended by T.D. 8256, 54 FR 28600, July 6, 1989]

§ 1.133–1T Questions and answers relating to interest on certain loans used to acquire employer securities (temporary).

Q–1: What does section 133 provide?

A–1: In general, section 133 provides that certain commercial lenders may exclude from gross income fifty percent of the interest received with respect to securities acquisition loans. A securities acquisition loan is any loan to an employee stock ownership plan (ESOP) (as defined in section 4975(e)(7)) that qualifies as an exempt loan under §§ 54.4975–7 and –11 to the extent that the proceeds are used to acquire employer securities (within the meaning of section 409(l)) for the ESOP. A loan made to a corporation sponsoring an ESOP (or to a person related to such corporation under section 133(b)(2)) may also qualify as a securities acquisition loan to the extent and for the period that the proceeds are (a) loaned to the corporation's ESOP under a loan that qualifies as an exempt loan under §§ 54.4975–7 and –11 and that has substantially similar terms as the loan from the commercial lender to the sponsoring corporation, and (b) used to acquire employer securities for the ESOP. The terms of the loan between the commercial lender and the sponsoring corporation (or a related corporation) and the loan between such corporation and the ESOP shall be treated as substantially similar only if the timing and rate at which employer securities would be released from encumbrance if the loan from the commercial lender were the exempt loan under the applicable rule of § 54.4975–7(b)(8) are substantially similar to the timing and rate at which employer securities will actually be released from encumbrance in accordance with such rule. For this purpose, if the loan from the commercial lender to the sponsoring corporation states a variable rate of interest and the loan between the corporation and the ESOP states a fixed rate of interest, whether the terms of the loans are substantially similar shall be determined at the time the obligations are initially issued by taking into account the adjustment interval on the variable rate loan and the maturity of the fixed rate loan. For example, if the rate on the loan from the commercial lender to the sponsoring corporation adjusts each six months and the loan from the corporation to the ESOP has a ten year term, the initial interest rate on the variable rate loan could be compared to the rate on the fixed rate loan by comparing the yields on 6 month and ten year Treasury obligations. Similarly, if the rates on the two loans are based on different compounding assumptions, whether the terms of the loans are substantially similar shall be determined by taking into account the different compounding assumptions. A securities acquisition loan may be evidenced by any note, bond, debenture, or certificate. Also, section 133(b)(2) provides that certain loans between related persons are not securities acquisition loans. In addition, a loan from a commercial lender to an ESOP or sponsoring corporation to purchase employer securities will not be treated as a securities acquisition loan to the extent that such loan is used, either directly or indirectly, to purchase employer securities from any other qualified plan, including any other ESOP, maintained by the employer or any other corporation which is a member of the same controlled group (as defined in section 409(l)(4)).

Q–2: What lenders are eligible to receive the fifty percent interest exclusion?

A–2: Under section 133(a), a bank (within the meaning of section 581), an insurance company to which subchapter L applies, or a corporation (other than a subchapter S corporation) actively engaged in the business of lending money may exclude from gross income fifty percent of the interest received with respect to a securities acquisition loan (as defined in Q&A–1 of § 1.133–1T). For purposes of section 133(a)(3), a corporation is actively engaged in the business of lending money if it lends money to the public on a regular and continuing basis (other than in connection with the purchase by the public of goods and services from the lender or a related party). A corporation is not actively engaged in the business of lending money if a predominant share of the original value of the loans it makes to unrelated parties (other than in connection with the purchase by the public of goods and services from the lender or a related party) are securities acquisition loans.

Q–3: May loans which qualify for the fifty percent interest exclusion under section 133 be syndicated to other lending institutions?

A–3: Securities acquisition loans under section 133 may be syndicated to other lending institutions provided that such lending institutions are described in section 133(a) (1), (2) or (3) and the loan was originated by a qualified holder. Subsequent holders of the debt instrument may qualify for the partial interest exclusion of section 133 if such holders satisfy the requirements of section 133 and such loan does not fail to be a securities acquisition loan under section 133(b)(2).

Q–4: When is section 133 effective?

A–4: Section 133 applies to securities acquisition loans made after July 18, 1984, and used to acquire employer securities after July 18, 1984. The provision does not apply to loans made after July 18, 1984, to the extent that such loans are renegotiations, directly or indirectly, of loans outstanding on such date. A loan extended to an ESOP or sponsoring corporation after July 18, 1984, will be treated as a renegotiation of an outstanding loan if the loan proceeds are used to refinance acquisitions of employer securities made prior to July 19, 1984. For example, if an ESOP borrowed money prior to July 19, 1984, to purchase employer securities and after July 18, 1984, borrows other funds from the same or a different commercial lender to repay the first loan, the second loan will be treated as a renegotiation of an outstanding loan to the extent of the repaid amount. Similarly, if, after July 18, 1984, an ESOP sells employer securities, uses the proceeds to retire a pre-July 19, 1984, loan and obtains a second loan to acquire replacement employer securities, the second loan will be treated as a renegotiation of an outstanding loan.

[T.D. 8073, 51 FR 4319, Feb. 4, 1986]

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[T.D. 8712, 62 FR 2283, Jan. 16, 1997, as amended by T.D. 8757, 63 FR 3259, Jan. 22, 1998]

TAX EXEMPTION REQUIREMENTS FOR STATE AND LOCAL BONDS

§1.141–1 Definitions and rules of general application.

(a) *In general.* For purposes of §§1.141–0 through 1.141–16, the following definitions and rules apply: the definitions in this section, the definitions in §1.150–1, the definition of placed in service under §1.150–2(c), the definition of grant under §1.148–6(d)(4)(iii), the definition of reasonably required reserve or replacement fund in §1.148–2(f), and the following definitions under §1.148–1: bond year, commingled fund, fixed yield issue, higher yielding investments, investment, investment proceeds, issue price, issuer, nonpurpose investment, purpose investment, qualified guarantee, qualified hedge, reasonable expectations or reasonableness, rebate amount, replacement proceeds, sale proceeds, variable yield issue, and yield.

(b) *Certain general definitions.*

Common areas means portions of a facility that are equally available to all users of a facility on the same basis for uses that are incidental to the primary use of the facility. For example, hallways and elevators generally are treated as common areas if they are used by the different lessees of a facility in connection with the primary use of that facility.

Consistently applied means applied uniformly to account for proceeds and other amounts.

Deliberate action is defined in § 1.141–2(d)(3).

Discrete portion means a portion of a facility that consists of any separate and discrete portion of a facility to which use is limited, other than common areas. A floor of a building and a portion of a building separated by walls, partitions, or other physical barriers are examples of a discrete portion.

Disposition is defined in § 1.141–12(c)(1).

Disposition proceeds is defined in § 1.141–12(c)(1).

Essential governmental function is defined in § 1.141–5(d)(4)(ii).

Financed means constructed, reconstructed, or acquired with proceeds of an issue.

Governmental bond means a bond issued as part of an issue no portion of which consists of private activity bonds.

Governmental person means a state or local governmental unit as defined in § 1.103–1 or any instrumentality thereof. It does not include the United States or any agency or instrumentality thereof.

Hazardous waste remediation bonds is defined in § 1.141–4(f)(1).

Measurement period is defined in § 1.141–3(g)(2).

Nongovernmental person means a person other than a governmental person.

Output facility means electric and gas generation, transmission, distribution, and related facilities, and water collection, storage, and distribution facilities.

Private business tests means the private business use test and the private security or payment test of section 141(b).

Proceeds means the sale proceeds of an issue (other than those sale proceeds used to retire bonds of the issue that are not deposited in a reasonably required reserve or replacement fund). Proceeds also include any investment proceeds from investments that accrue during the project period (net of rebate amounts attributable to the project period). Disposition proceeds of an issue are treated as proceeds to the extent provided in § 1.141–12. The Commissioner may treat any replaced amounts as proceeds.

Project period means the period beginning on the issue date and ending on the date that the project is placed in service. In the case of a multipurpose issue, the issuer may elect to treat the project period for the entire issue as ending on either the expiration of the temporary period described in § 1.148–2(e)(2) or the end of the fifth bond year after the issue date.

Public utility property means public utility property as defined in section 168(i)(10).

Qualified bond means a qualified bond as defined in section 141(e).

Renewal option means a provision under which either party has a legally enforceable right to renew the contract. Thus, for example, a provision under which a contract is automatically renewed for 1-year periods absent cancellation by either party is not a renewal option (even if it is expected to be renewed).

Replaced amounts means replacement proceeds other than amounts that are treated as replacement proceeds solely because they are sinking funds or pledged funds.

Weighted average maturity is determined under section 147(b).

Weighted average reasonably expected economic life is determined under section 147(b). The reasonably expected economic life of property may be determined by reference to the class life of the property under section 168.

(c) *Elections.* Elections must be made in writing on or before the issue date and retained as part of the bond documents, and, once made, may not be revoked without the permission of the Commissioner.

(d) *Related parties.* Except as otherwise provided, all related parties are treated as one person and any reference to ''person'' includes any related party.

[T.D. 8712, 62 FR 2284, Jan. 16, 1997]

§1.141–2 Private activity bond tests.

(a) *Overview.* Interest on a private activity bond is not excludable from gross income under section 103(a) unless the bond is a qualified bond. The purpose of the private activity bond tests of section 141 is to limit the volume of tax-exempt bonds that finance the activities of nongovernmental persons, without regard to whether a financing actually transfers benefits of tax-exempt financing to a nongovernmental person. The private activity bond tests serve to identify arrangements that have the potential to transfer the benefits of tax-exempt financing, as well as arrangements that actually transfer these benefits. The regulations under section 141 may not be applied in a manner that is inconsistent with these purposes.

(b) *Scope.* Sections 1.141–0 through 1.141–16 apply generally for purposes of the private activity bond limitations under section 141.

(c) *General definition of private activity bond.* Under section 141, bonds are private activity bonds if they meet either the private business use test and private security or payment test of section 141(b) or the private loan financing test of section 141(c). The private business use and private security or payment tests are described in §§1.141–3 and 1.141–4. The private loan financing test is described in §1.141–5.

(d) *Reasonable expectations and deliberate actions*—(1) *In general.* An issue is an issue of private activity bonds if the issuer reasonably expects, as of the issue date, that the issue will meet either the private business tests or the private loan financing test. An issue is also an issue of private activity bonds if the issuer takes a deliberate action, subsequent to the issue date, that causes the conditions of either the private business tests or the private loan financing test to be met.

(2) *Reasonable expectations test*—(i) *In general.* In general, the reasonable expectations test must take into account reasonable expectations about events and actions over the entire stated term of an issue.

(ii) *Special rule for issues with mandatory redemption provisions.* An action that is reasonably expected, as of the issue date, to occur after the issue date and to cause either the private business tests or the private loan financing test to be met may be disregarded for purposes of those tests if—

(A) The issuer reasonably expects, as of the issue date, that the financed property will be used for a governmental purpose for a substantial period before the action;

(B) The issuer is required to redeem all nonqualifying bonds (regardless of the amount of disposition proceeds actually received) within 6 months of the date of the action;

(C) The issuer does not enter into any arrangement with a nongovernmental person, as of the issue date, with respect to that specific action; and

(D) The mandatory redemption of bonds meets all of the conditions for remedial action under §1.141–12(a).

(3) *Deliberate action defined*—(i) *In general.* Except as otherwise provided in this paragraph (d)(3), a deliberate action is any action taken by the issuer that is within its control. An intent to violate the requirements of section 141 is not necessary for an action to be deliberate.

(ii) *Safe harbor exceptions.* An action is not treated as a deliberate action if—

(A) It would be treated as an involuntary or compulsory conversion under section 1033; or

(B) It is taken in response to a regulatory directive made by the federal government. See §1.141–7T(f)(5).

(4) *Special rule for dispositions of personal property in the ordinary course of an established governmental program*—(i) *In general.* Dispositions of personal property in the ordinary course of an established governmental program are not treated as deliberate actions if—

(A) The weighted average maturity of the bonds financing that personal property is not greater than 120 percent of the reasonably expected actual use of that property for governmental purposes;

(B) The issuer reasonably expects on the issue date that the fair market value of that property on the date of disposition will be not greater than 25 percent of its cost; and

(C) The property is no longer suitable for its governmental purposes on the date of disposition.

(ii) *Reasonable expectations test.* The reasonable expectation that a disposition described in paragraph (d)(4)(i) of this section may occur in the ordinary course while the bonds are outstanding will not cause the issue to meet the private activity bond tests if the issuer is required to deposit amounts received from the disposition in a commingled fund with substantial tax or other governmental revenues and the issuer reasonably expects to spend the amounts on governmental programs within 6 months from the date of commingling.

(iii) *Separate issue treatment.* An issuer may treat the bonds properly allocable to the personal property eligible for this exception as a separate issue under § 1.150–1(c)(3).

(5) *Special rule for general obligation bond programs that finance a large number of separate purposes.* The determination of whether bonds of an issue are private activity bonds may be based solely on the issuer's reasonable expectations as of the issue date if all of the requirements of paragraphs (d)(5)(i) through (vii) of this section are met.

(i) The issue is an issue of general obligation bonds of a general purpose governmental unit that finances at least 25 separate purposes (as defined in § 1.150–1(c)(3)) and does not predominantly finance fewer than 4 separate purposes.

(ii) The issuer has adopted a fund method of accounting for its general governmental purposes that makes tracing the bond proceeds to specific expenditures unreasonably burdensome.

(iii) The issuer reasonably expects on the issue date to allocate all of the net proceeds of the issue to capital expenditures within 6 months of the issue date and adopts reasonable procedures to verify that net proceeds are in fact so expended. A program to randomly spot check that 10 percent of the net proceeds were so expended generally is a reasonable verification procedure for this purpose.

(iv) The issuer reasonably expects on the issue date to expend all of the net proceeds of the issue before expending proceeds of a subsequent issue of similar general obligation bonds.

(v) The issuer reasonably expects on the issue date that it will not make any loans to nongovernmental persons with the proceeds of the issue.

(vi) The issuer reasonably expects on the issue date that the capital expenditures that it could make during the 6-month period beginning on the issue date with the net proceeds of the issue that would not meet the private business tests are not less than 125 percent of the capital expenditures to be financed with the net proceeds of the issue.

(vii) The issuer reasonably expects on the issue date that the weighted average maturity of the issue is not greater than 120 percent of the weighted average reasonably expected economic life of the capital expenditures financed with the issue. To determine reasonably expected economic life for this purpose an issuer may use reasonable estimates based on the type of expenditures made from a fund.

(e) *When a deliberate action occurs.* A deliberate action occurs on the date the issuer enters into a binding contract with a nongovernmental person for use of the financed property that is not subject to any material contingencies.

(f) *Certain remedial actions.* See § 1.141–12 for certain remedial actions that prevent a deliberate action with respect to property financed by an issue from causing that issue to meet the private business use test or the private loan financing test.

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

Example 1. Involuntary action. City B issues bonds to finance the purchase of land. On the issue date, B reasonably expects that it will be the sole user of the land for the entire term of the bonds. Subsequently, the federal government acquires the land in a condemnation action. B sets aside the condemnation proceeds to pay debt service on the bonds but does not redeem them on their first call date. The bonds are not private activity bonds because B has not taken a deliberate action after the issue date. See, however, §1.141–14(b), *Example 2.*

Example 2. Reasonable expectations test—involuntary action. The facts are the same as in *Example 1,* except that, on the issue date, B reasonably expects that the federal government will acquire the land in a condemnation action during the term of the bonds. On the issue date, the present value of the amount that B reasonably expects to receive from the federal government is greater than 10 percent of the present value of the debt service on the bonds. The terms of the bonds do not require that the bonds be redeemed within 6 months of the acquisition by the federal government. The bonds are private activity bonds because the issuer expects as of the issue date that the private business tests will be met.

Example 3. Reasonable expectations test—mandatory redemption. City C issues bonds to rehabilitate an existing hospital that it currently owns. On the issue date of the bonds, C reasonably expects that the hospital will be used for a governmental purpose for a substantial period. On the issue date, C also plans to construct a new hospital, but the placed in service date of that new hospital is uncertain. C reasonably expects that, when the new hospital is placed in service, it will sell or lease the rehabilitated hospital to a private hospital corporation. The bond documents require that the bonds must be redeemed within 6 months of the sale or lease of the rehabilitated hospital (regardless of the amount actually received from the sale). The bonds meet the reasonable expectations requirement of the private activity bond tests if the mandatory redemption of bonds meets all of the conditions for a remedial action under §1.141–12(a).

Example 4. Dispositions in the ordinary course of an established governmental program. City D issues bonds with a weighted average maturity of 6 years for the acquisition of police cars. D reasonably expects on the issue date that the police cars will be used solely by its police department, except that, in the ordinary course of its police operations, D sells its police cars to a taxicab corporation after 5 years of use because they are no longer suitable for police use. Further, D reasonably expects that the value of the police cars when they are no longer suitable for police use will be no more than 25 percent of cost. D subsequently sells 20 percent of the police cars after only 3 years of actual use. At that time, D deposits the proceeds from the sale of the police cars in a commingled fund with substantial tax revenues and reasonably expects to spend the proceeds on governmental programs within 6 months of the date of deposit. D does not trace the actual use of these commingled amounts. The sale of the police cars does not cause the private activity bond tests to be met because the requirements of paragraph (d)(4) of this section are met.

[T.D. 8712, 62 FR 2284, Jan. 16, 1997, as amended by T.D. 8757, 63 FR 3260, Jan. 22, 1998]

§1.141–3 Definition of private business use.

(a) *General rule*—(1) *In general.* The private business use test relates to the use of the proceeds of an issue. The 10 percent private business use test of section 141(b)(1) is met if more than 10 percent of the proceeds of an issue is used in a trade or business of a nongovernmental person. For this purpose, the use of financed property is treated as the direct use of proceeds. Any activity carried on by a person other than a natural person is treated as a trade or business. Unless the context or a provision clearly requires otherwise, this section also applies to the private business use test under sections 141(b)(3) (unrelated or disproportionate use), 141(b)(4) ($15 million limitation for certain output facilities), and 141(b)(5) (the coordination with the volume cap where the nonqualified amount exceeds $15 million).

(2) *Indirect use.* In determining whether an issue meets the private business use test, it is necessary to look to both the indirect and direct uses of proceeds. For example, a facility is treated as being used for a private business use if it is leased to a nongovernmental person and subleased to a governmental person or if it is leased to a governmental person and then subleased to a nongovernmental person, provided that in each case the nongovernmental person's use is in a trade or business. Similarly, the issuer's use of the proceeds to engage in a series of financing transactions for property to be used by nongovernmental persons in their trades or businesses may cause the private business use test to be met. In addition, proceeds are treated as used in the trade or business of a nongovernmental person if a nongovernmental person, as a result of a single transaction or a series of related transactions, uses property acquired with the proceeds of an issue.

(3) *Aggregation of private business use.* The use of proceeds by all nongovernmental persons is aggregated to determine whether the private business use test is met.

(b) *Types of private business use arrangements*—(1) *In general.* Both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user of proceeds and financed property as a result of ownership; actual or beneficial use of property pursuant to a lease, or a management or incentive payment contract; or certain other arrangements such as a take or pay or other output-type contract.

(2) *Ownership.* Except as provided in paragraph (d)(1) or (d)(2) of this section, ownership by a nongovernmental person of financed property is private business use of that property. For this purpose, ownership refers to ownership for federal income tax purposes.

(3) *Leases.* Except as provided in paragraph (d) of this section, the lease of financed property to a nongovernmental person is private business use of that property. For this purpose, any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease. In determining whether a management contract is properly characterized as a lease, it is necessary to consider all of the facts and circumstances, including the following factors—

(i) The degree of control over the property that is exercised by a nongovernmental person; and

(ii) Whether a nongovernmental person bears risk of loss of the financed property.

(4) *Management contracts*—(i) *Facts and circumstances test.* Except as provided in paragraph (d) of this section, a management contract (within the meaning of paragraph (b)(4)(ii) of this section) with respect to financed property may result in private business use of that property, based on all of the facts and circumstances. A management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.

(ii) *Management contract defined.* For purposes of this section, a management contract is a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. For example, a contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract.

(iii) *Arrangements generally not treated as management contracts.* The arrangements described in paragraphs (b)(4)(iii)(A) through (D) of this section generally are not treated as management contracts that give rise to private business use.

(A) Contracts for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing, or similar services).

(B) The mere granting of admitting privileges by a hospital to a doctor, even if those privileges are conditioned on the provision of de minimis services, if those privileges are available to all qualified physicians in the area, consistent with the size and nature of its facilities.

(C) A contract to provide for the operation of a facility or system of facilities that consists predominantly of public utility property, if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider.

(D) A contract to provide for services, if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.

(iv) *Management contracts that are properly treated as other types of private business use.* A management contract with respect to financed property results in private business use of that property if the service provider is treated as the lessee or owner of financed property for federal income tax purposes, unless an exception under paragraph (d) of this section applies to the arrangement.

(5) *Output contracts.* See §1.141–7 for special rules for contracts for the purchase of output of output facilities.

(6) *Research agreements*—(i) *Facts and circumstances test.* Except as provided in paragraph (d) of this section, an agreement by a nongovernmental person to sponsor research performed by a governmental person may result in private business use of the property used for the research, based on all of the facts and circumstances.

(ii) *Research agreements that are properly treated as other types of private business use.* A research agreement with respect to financed property results in private business use of that property if the sponsor is treated as the lessee or owner of financed property for federal income tax purposes, unless an exception under paragraph (d) of this section applies to the arrangement.

(7) *Other actual or beneficial use*—(i) *In general.* Any other arrangement that conveys special legal entitlements for beneficial use of bond proceeds or of financed property that are comparable to special legal entitlements described in paragraphs (b)(2), (3), (4), (5), or (6) of this section results in private business use. For example, an arrangement that conveys priority rights to the use or capacity of a facility generally results in private business use.

(ii) *Special rule for facilities not used by the general public.* In the case of financed property that is not available for use by the general public (within the meaning of paragraph (c) of this section), private business use may be established solely on the basis of a special economic benefit to one or more nongovernmental persons, even if those nongovernmental persons have no special legal entitlements to use of the property. In determining whether special economic benefit gives rise to private business use it is necessary to consider all of the facts and circumstances, including one or more of the following factors—

(A) Whether the financed property is functionally related or physically proximate to property used in the trade or business of a nongovernmental person;

(B) Whether only a small number of nongovernmental persons receive the special economic benefit; and

(C) Whether the cost of the financed property is treated as depreciable by any nongovernmental person.

(c) *Exception for general public use*—(1) *In general.* Use as a member of the general public (general public use) is not private business use. Use of financed property by nongovernmental persons in their trades or businesses is treated as general public use only if the property is intended to be available and in fact is reasonably available for use on the same basis by natural persons not engaged in a trade or business.

(2) *Use on the same basis.* In general, use under an arrangement that conveys priority rights or other preferential benefits is not use on the same basis as the general public. Arrangements providing for use that is available to the general public at no charge or on the basis of rates that are generally applicable and uniformly applied do not convey priority rights or other preferential benefits. For this purpose, rates may be treated as generally applicable and uniformly applied even if—

(i) Different rates apply to different classes of users, such as volume purchasers, if the differences in rates are customary and reasonable; or

(ii) A specially negotiated rate arrangement is entered into, but only if the user is prohibited by federal law from paying the generally applicable rates, and the rates established are as comparable as reasonably possible to the generally applicable rates.

(3) *Long-term arrangements not treated as general public use.* An arrangement is not treated as general public use if the term of the use under the arrangement, including all renewal options, is greater than 180 days. For this purpose, a right of first refusal to renew use under the arrangement is not treated as a renewal option if—

(i) The compensation for the use under the arrangement is redetermined at generally applicable, fair market value rates that are in effect at the time of renewal; and

(ii) The use of the financed property under the same or similar arrangements is predominantly by natural persons who are not engaged in a trade or business.

(4) *Relation to other use.* Use of financed property by the general public does not prevent the proceeds from being used for a private business use because of other use under this section.

(d) *Other exceptions*—(1) *Agents.* Use of proceeds by nongovernmental persons solely in their capacity as agents of a governmental person is not private business use. For example, use by a nongovernmental person that issues obligations on behalf of a governmental person is not private business use to the extent the nongovernmental person's use of proceeds is in its capacity as an agent of the governmental person.

(2) *Use incidental to financing arrangements.* Use by a nongovernmental person that is solely incidental to a financing arrangement is not private business use. A use is solely incidental to a financing arrangement only if the nongovernmental person has no substantial rights to use bond proceeds or financed property other than as an agent of the bondholders. For example, a nongovernmental person that acts solely as an owner of title in a sale and leaseback financing transaction with a city generally is not a private business user of the property leased to the city, provided that the nongovernmental person has assigned all of its rights to use the leased facility to the trustee for the bondholders upon default by the city. Similarly, bond trustees, servicers, and guarantors are generally not treated as private business users.

(3) *Exceptions for arrangements other than arrangements resulting in ownership of financed property by a nongovernmental person*—(i) *Arrangements not available for use on the same basis by natural persons not engaged in a trade or business.* Use by a nongovernmental person pursuant to an arrangement, other than an arrangement resulting in ownership of financed property by a nongovernmental person, is not private business use if—

(A) The term of the use under the arrangement, including all renewal options, is not longer than 90 days;

(B) The arrangement would be treated as general public use, except that it is not available for use on the same basis by natural persons not engaged in a trade or business because generally applicable and uniformly applied rates are not reasonably available to natural persons not engaged in a trade or business; and

(C) The property is not financed for a principal purpose of providing that property for use by that nongovernmental person.

(ii) *Negotiated arm's-length arrangements.* Use by a nongovernmental person pursuant to an arrangement, other than an arrangement resulting in ownership of financed property by a nongovernmental person, is not private business use if—

(A) The term of the use under the arrangement, including all renewal options, is not longer than 30 days;

(B) The arrangement is a negotiated arm's-length arrangement, and compensation under the arrangement is at fair market value; and

(C) The property is not financed for a principal purpose of providing that property for use by that nongovernmental person.

(4) *Temporary use by developers.* Use during an initial development period by a developer of an improvement that carries out an essential governmental function is not private business use if the issuer and the developer reasonably expect on the issue date to proceed with all reasonable speed to develop the improvement and property benefited by that improvement and to transfer the improvement to a governmental person, and if the improvement is in fact transferred to a governmental person promptly after the property benefited by the improvement is developed.

(5) *Incidental use*—(i) *General rule.* Incidental uses of a financed facility are disregarded, to the extent that those uses do not exceed 2.5 percent of the proceeds of the issue used to finance the facility. A use of a facility by a

nongovernmental person is incidental if—

(A) Except for vending machines, pay telephones, kiosks, and similar uses, the use does not involve the transfer to the nongovernmental person of possession and control of space that is separated from other areas of the facility by walls, partitions, or other physical barriers, such as a night gate affixed to a structural component of a building (a nonpossessory use);

(B) The nonpossessory use is not functionally related to any other use of the facility by the same person (other than a different nonpossessory use); and

(C) All nonpossessory uses of the facility do not, in the aggregate, involve the use of more than 2.5 percent of the facility.

(ii) *Illustrations.* Incidental uses may include pay telephones, vending machines, advertising displays, and use for television cameras, but incidental uses may not include output purchases.

(6) *Qualified improvements.* Proceeds that provide a governmentally owned improvement to a governmentally owned building (including its structural components and land functionally related and subordinate to the building) are not used for a private business use if—

(i) The building was placed in service more than 1 year before the construction or acquisition of the improvement is begun;

(ii) The improvement is not an enlargement of the building or an improvement of interior space occupied exclusively for any private business use;

(iii) No portion of the improved building or any payments in respect of the improved building are taken into account under section 141(b)(2)(A) (the private security test); and

(iv) No more than 15 percent of the improved building is used for a private business use.

(e) *Special rule for tax assessment bonds.* In the case of a tax assessment bond that satisfies the requirements of §1.141–5(d), the loan (or deemed loan) of the proceeds to the borrower paying the assessment is disregarded in determining whether the private business use test is met. However, the use of the loan proceeds is not disregarded in determining whether the private business use test is met.

(f) *Examples.* The following examples illustrate the application of paragraphs (a) through (e) of this section. In each example, assume that the arrangements described are the only arrangements with nongovernmental persons for use of the financed property.

Example 1. Nongovernmental ownership. State A issues 20-year bonds to purchase land and equip and construct a factory. A then enters into an arrangement with Corporation X to sell the factory to X on an installment basis while the bonds are outstanding. The issue meets the private business use test because a nongovernmental person owns the financed facility. See also §1.141–2 (relating to the private activity bond tests), and §1.141–5 (relating to the private loan financing test).

Example 2. Lease to a nongovernmental person. (i) The facts are the same as in *Example 1,* except that A enters into an arrangement with X to lease the factory to X for 3 years rather than to sell it to X. The lease payments will be made annually and will be based on the tax-exempt interest rate on the bonds. The issue meets the private business use test because a nongovernmental person leases the financed facility. See also §1.141–14 (relating to anti-abuse rules).

(ii) The facts are the same as in *Example 2(i),* except that the annual payments made by X will equal fair rental value of the facility and exceed the amount necessary to pay debt service on the bonds for the 3 years of the lease. The issue meets the private business use test because a nongovernmental person leases the financed facility and the test does not require that the benefits of tax-exempt financing be passed through to the nongovernmental person.

Example 3. Management contract in substance a lease. City L issues 30-year bonds to finance the construction of a city hospital. L enters into a 15-year contract with M, a nongovernmental person that operates a health maintenance organization relating to the treatment of M's members at L's hospital. The contract provides for reasonable fixed compensation to M for services rendered with no compensation based, in whole or in part, on a share of net profits from the operation of the hospital. However, the contract also provides that 30 percent of the capacity of the hospital will be exclusively available to M's members and M will bear the risk of loss of that portion of the capacity of the hospital so that, under all of the facts and circumstances, the contract is properly characterized as a lease for federal income tax purposes. The issue meets the private business use test because a nongovernmental person leases the financed facility.

Example 4. Ownership of title in substance a leasehold interest. Nonprofit Corporation R issues bonds on behalf of City P to finance the construction of a hospital. R will own legal title to the hospital. In addition, R will operate the hospital, but R is not treated as an agent of P in its capacity as operator of the hospital. P has certain rights to the hospital that establish that it is properly treated as the owner of the property for federal income tax purposes. P does not have rights, however, to directly control operation of the hospital while R owns legal title to it and operates it. The issue meets the private business use test because the arrangement provides a nongovernmental person an interest in the financed facility that is comparable to a leasehold interest. See paragraphs (a)(2) and (b)(7)(i) of this section.

Example 5. Rights to control use of property treated as private business use—parking lot. Corporation C and City D enter into a plan to finance the construction of a parking lot adjacent to C's factory. Pursuant to the plan, C conveys the site for the parking lot to D for a nominal amount, subject to a covenant running with the land that the property be used only for a parking lot. In addition, D agrees that C will have the right to approve rates charged by D for use of the parking lot. D issues bonds to finance construction of the parking lot on the site. The parking lot will be available for use by the general public on the basis of rates that are generally applicable and uniformly applied. The issue meets the private business use test because a nongovernmental person has special legal entitlements for beneficial use of the financed facility that are comparable to an ownership interest. See paragraph (b)(7)(i) of this section.

Example 6. Other actual or beneficial use—hydroelectric enhancements. J, a political subdivision, owns and operates a hydroelectric generation plant and related facilities. Pursuant to a take or pay contract, J sells 15 percent of the output of the plant to Corporation K, an investor-owned utility. K is treated as a private business user of the plant. Under the license issued to J for operation of the plant, J is required by federal regulations to construct and operate various facilities for the preservation of fish and for public recreation. J issues its obligations to finance the fish preservation and public recreation facilities. K has no special legal entitlements for beneficial use of the financed facilities. The fish preservation facilities are functionally related to the operation of the plant. The recreation facilities are available to natural persons on a short-term basis according to generally applicable and uniformly applied rates. Under paragraph (c) of this section, the recreation facilities are treated as used by the general public. Under paragraph (b)(7) of this section, K's use is not treated as private business use of the recreation facilities because K has no special legal entitlements for beneficial use of the recreation facilities. The fish preservation facilities are not of a type reasonably available for use on the same basis by natural persons not engaged in a trade or business. Under all of the facts and circumstances (including the functional relationship of the fish preservation facilities to property used in K's trade or business) under paragraph (b)(7)(ii) of this section, K derives a special economic benefit from the fish preservation facilities. Therefore, K's private business use may be established solely on the basis of that special economic benefit, and K's use of the fish preservation facilities is treated as private business use.

Example 7. Other actual or beneficial use—pollution control facilities. City B issues obligations to finance construction of a specialized pollution control facility on land that it owns adjacent to a factory owned by Corporation N. B will own and operate the pollution control facility, and N will have no special legal entitlements to use the facility. B, however, reasonably expects that N will be the only user of the facility. The facility will not be reasonably available for use on the same basis by natural persons not engaged in a trade or business. Under paragraph (b)(7)(ii) of this section, because under all of the facts and circumstances the facility is functionally related and is physically proximate to property used in N's trade or business, N derives a special economic benefit from the facility. Therefore, N's private business use may be established solely on the basis of that special economic benefit, and N's use is treated as private business use of the facility. See paragraph (b)(7)(ii) of this section.

Example 8. General public use—airport runway. (i) City I issues bonds and uses all of the proceeds to finance construction of a runway at a new city-owned airport. The runway will be available for take-off and landing by any operator of an aircraft desiring to use the airport, including general aviation operators who are natural persons not engaged in a trade or business. It is reasonably expected that most of the actual use of the runway will be by private air carriers (both charter airlines and commercial airlines) in connection with their use of the airport terminals leased by those carriers. These leases for the use of terminal space provide no priority rights or other preferential benefits to the air carriers for use of the runway. Moreover, under the leases the lease payments are determined without taking into account the revenues generated by runway landing fees (that is, the lease payments are not determined on a ''residual'' basis). Although the lessee air carriers receive a special economic benefit from the use of the runway, this economic benefit is not sufficient to cause the air carriers to be private business users, because the runway is available for general public use. The issue does not meet the private business use test. See paragraphs (b)(7)(ii) and (c) of this section.

(ii) The facts are the same as in *Example 8(i),* except that the runway will be available for use only by private air carriers. The use by these private air carriers is not for general public use, because the runway is not reasonably available for use on the same basis by natural persons not engaged in a trade or business. Depending on all of the facts and circumstances, including whether there are only a small number of lessee private air carriers, the issue may meet the private business use test solely because the private air carriers receive a special economic benefit from the runway. See paragraph (b)(7)(ii) of this section.

(iii) The facts are the same as in *Example 8(i),* except that the lease payments under the leases with the private air carriers are determined on a residual basis by taking into account the net revenues generated by runway landing fees. These leases cause the private business use test to be met with respect to the runway because they are arrangements that convey special legal entitlements to the financed facility to nongovernmental persons. See paragraph (b)(7)(i) of this section.

Example 9. General public use—airport parking garage. City S issues bonds and uses all of the proceeds to finance construction of a city-owned parking garage at the city-owned airport. S reasonably expects that more than 10 percent of the actual use of the parking garage will be by employees of private air carriers (both charter airlines and commercial airlines) in connection with their use of the airport terminals leased by those carriers. The air carriers' use of the parking garage, however, will be on the same basis as passengers and other members of the general public using the airport. The leases for the use of the terminal space provide no priority rights to the air carriers for use of the parking garage, and the lease payments are determined without taking into account the revenues generated by the parking garage. Although the lessee air carriers receive a special economic benefit from the use of the parking garage, this economic benefit is not sufficient to cause the air carriers to be private business users, because the parking garage is available for general public use. The issue does not meet the private business use test. See paragraphs (b)(7)(ii) and (c) of this section.

Example 10. Long-term arrangements not treated as general public use—insurance fund. Authority T deposits all of the proceeds of its bonds in its insurance fund and invests all of those proceeds in tax-exempt bonds. The insurance fund provides insurance to a large number of businesses and natural persons not engaged in a trade or business. Each participant receives insurance for a term of 1 year. The use by the participants, other than participants that are natural persons not engaged in a trade or business, is treated as private business use of the proceeds of the bonds because the participants have special legal entitlements to the use of bond proceeds, even though the contractual rights are not necessarily properly characterized as ownership, leasehold, or similar interests listed in paragraph (b) of this section. Use of the bond proceeds is not treated as general public use because the term of the insurance is greater than 180 days. See paragraphs (b)(7)(i) and (c)(3) of this section.

Example 11. General public use—port road. Highway Authority W uses all of the proceeds of its bonds to construct a 25-mile road to connect an industrial port owned by Corporation Y with existing roads owned and operated by W. Other than the port, the nearest residential or commercial development to the new road is 12 miles away. There is no reasonable expectation that development will occur in the area surrounding the new road. W and Y enter into no arrangement (either by contract or ordinance) that conveys special legal entitlements to Y for the use of the road. Use of the road will be available without restriction to all users, including natural persons who are not engaged in a trade or business. The issue does not meet the private business use test because the road is treated as used only by the general public.

Example 12. General public use of governmentally owned hotel. State Q issues bonds to purchase land and construct a hotel for use by the general public (that is, tourists, visitors, and business travelers). The bond documents provide that Q will own and operate the project for the term of the bonds. Q will not enter into a lease or license with any user for use of rooms for a period longer than 180 days (although users may actually use rooms for consecutive periods in excess of 180 days). Use of the hotel by hotel guests who are travelling in connection with trades or businesses of nongovernmental persons is not a private business use of the hotel by these persons because the hotel is intended to be available and in fact is reasonably available for use on the same basis by natural persons not engaged in a trade or business. See paragraph (c)(1) of this section.

Example 13. General public use with rights of first refusal. Authority V uses all of the proceeds of its bonds to construct a parking garage. At least 90 percent of the spaces in the garage will be available to the general public on a monthly first-come, first-served basis. V reasonably expects that the spaces will be predominantly leased to natural persons not engaged in a trade or business who have priority rights to renew their spaces at then current fair market value rates. More than 10 percent of the spaces will be leased to nongovernmental persons acting in a trade or business. These leases are not treated as arrangements with a term of use greater than 180 days. The rights to renew are not treated as renewal options because the compensation for the spaces is redetermined at generally applicable, fair market value rates that will be in effect at the time of renewal and the use of the spaces under similar arrangements is predominantly by natural persons who are not engaged in a trade or business. The issue does not meet the private business use test because at least 90 percent of the use of the parking garage is general public use. See paragraph (c)(3) of this section.

Example 14. General public use with a specially negotiated rate agreement with agency of United States. G, a sewage collection and treatment district, operates facilities that were financed with its bonds. F, an agency of the United States, has a base located within G. Approximately 20 percent of G's facilities are used to treat sewage produced by F under a specially negotiated rate agreement. Under the specially negotiated rate agreement, G uses its best efforts to charge F as closely as possible the same amount for its use of G's services as its other customers pay for the same amount of services, although those other customers pay for services based on standard district charges and tax levies. F is prohibited by federal law from paying for the services based on those standard district charges and tax levies. The use of G's facilities by F is on the same basis as the general public. See paragraph (c)(2)(ii) of this section.

Example 15. Arrangements not available for use by natural persons not engaged in a trade or business—federal use of prisons. Authority E uses all of the proceeds of its bonds to construct a prison. E contracts with federal agency F to house federal prisoners on a space-available, first-come, first-served basis, pursuant to which F will be charged approximately the same amount for each prisoner as other persons that enter into similar transfer agreements. It is reasonably expected that other persons will enter into similar agreements. The term of the use under the contract is not longer than 90 days, and F has no right to renew, although E reasonably expects to renew the contract indefinitely. The prison is not financed for a principal purpose of providing the prison for use by F. It is reasonably expected that during the term of the bonds, more than 10 percent of the prisoners at the prison will be federal prisoners. F's use of the facility is not general public use because this type of use (leasing space for prisoners) is not available for use on the same basis by natural persons not engaged in a trade or business. The issue does not meet the private business use test, however, because the leases satisfy the exception of paragraph (d)(3)(i) of this section.

Example 16. Negotiated arm's-length arrangements—auditorium reserved in advance. (i) City Z issues obligations to finance the construction of a municipal auditorium that it will own and operate. The use of the auditorium will be open to anyone who wishes to use it for a short period of time on a rate-scale basis. Z reasonably expects that the auditorium will be used by schools, church groups, sororities, and numerous commercial organizations. Corporation H, a nongovernmental person, enters into an arm's-length arrangement with Z to use the auditorium for 1 week for each year for a 10-year period (a total of 70 days), pursuant to which H will be charged a specific price reflecting fair market value. On the date the contract is entered into, Z has not established generally applicable rates for future years. Even though the auditorium is not financed for a principal purpose of providing use of the auditorium to H, H is not treated as using the auditorium as a member of the general public because its use is not on the same basis as the general public. Because the term of H's use of the auditorium is longer than 30 days, the arrangement does not meet the exception under paragraph (d)(3)(ii) of this section.

(ii) The facts are the same as in *Example 16(i)*, except that H will enter into an arm's-length arrangement with Z to use the auditorium for 1 week for each year for a 4-year period (a total of 28 days), pursuant to which H will be charged a specific price reflecting fair market value. H is not treated as a private business user of the auditorium because its contract satisfies the exception of paragraph (d)(3)(ii) of this section for negotiated arm's-length arrangements.

(g) *Measurement of private business use*—(1) *In general.* In general, the private business use of proceeds is allocated to property under §1.141–6. The amount of private business use of that property is determined according to the average percentage of private business use of that property during the measurement period.

(2) *Measurement period*—(i) *General rule.* Except as provided in this paragraph (g)(2), the measurement period of property financed by an issue begins on the later of the issue date of that issue or the date the property is placed in service and ends on the earlier of the last date of the reasonably expected economic life of the property or the

latest maturity date of any bond of the issue financing the property (determined without regard to any optional redemption dates). In general, the period of reasonably expected economic life of the property for this purpose is based on reasonable expectations as of the issue date.

(ii) *Special rule for refundings of short-term obligations.* For an issue of short-term obligations that the issuer reasonably expects to refund with a long-term financing (such as bond anticipation notes), the measurement period is based on the latest maturity date of any bond of the last refunding issue with respect to the financed property (determined without regard to any optional redemption dates).

(iii) *Special rule for reasonably expected mandatory redemptions.* If an issuer reasonably expects on the issue date that an action will occur during the term of the bonds to cause either the private business tests or the private loan financing test to be met and is required to redeem bonds to meet the reasonable expectations test of §1.141–2(d)(2), the measurement period ends on the reasonably expected redemption date.

(iv) *Special rule for ownership by a nongovernmental person.* The amount of private business use resulting from ownership by a nongovernmental person is the greatest percentage of private business use in any 1-year period.

(v) *Anti-abuse rule.* If an issuer establishes the term of an issue for a period that is longer than is reasonably necessary for the governmental purposes of the issue for a principal purpose of increasing the permitted amount of private business use, the Commissioner may determine the amount of private business use according to the greatest percentage of private business use in any 1-year period.

(3) *Determining average percentage of private business use.* The average percentage of private business use is the average of the percentages of private business use during the 1-year periods within the measurement period. Appropriate adjustments must be made for beginning and ending periods of less than 1 year.

(4) *Determining the average amount of private business use for a 1-year period*—(i) *In general.* The percentage of private business use of property for any 1-year period is the average private business use during that year. This average is determined by comparing the amount of private business use during the year to the total amount of private business use and use that is not private business use (government use) during that year. Paragraphs (g)(4) (ii) through (v) of this section apply to determine the average amount of private business use for a 1-year period.

(ii) *Uses at different times.* For a facility in which actual government use and private business use occur at different times (for example, different days), the average amount of private business use generally is based on the amount of time that the facility is used for private business use as a percentage of the total time for all actual use. In determining the total amount of actual use, periods during which the facility is not in use are disregarded.

(iii) *Simultaneous use.* In general, for a facility in which government use and private business use occur simultaneously, the entire facility is treated as having private business use. For example, a governmentally owned facility that is leased or managed by a nongovernmental person in a manner that results in private business use is treated as entirely used for a private business use. If, however, there is also private business use and actual government use on the same basis, the average amount of private business use may be determined on a reasonable basis that properly reflects the proportionate benefit to be derived by the various users of the facility (for example, reasonably expected fair market value of use). For example, the average amount of private business use of a garage with unassigned spaces that is used for government use and private business use is generally based on the number of spaces used for private business use as a percentage of the total number of spaces.

(iv) *Discrete portion.* For purposes of this paragraph (g), measurement of the use of proceeds allocated to a discrete portion of a facility is determined by treating that discrete portion as a separate facility.

(v) *Relationship to fair market value.* For purposes of paragraphs (g)(4) (ii) through (iv) of this section, if private business use is reasonably expected as of the issue date to have a significantly greater fair market value than government use, the average amount of private business use must be determined according to the relative reasonably expected fair market values of use rather than another measure, such as average time of use. This determination of relative fair market value may be made as of the date the property is acquired or placed in service if making this determination as of the issue date is not reasonably possible (for example, if the financed property is not identified on the issue date). In general, the relative reasonably expected fair market value for a period must be determined by taking into account the amount of reasonably expected payments for private business use for the period in a manner that properly reflects the proportionate benefit to be derived from the private business use.

(5) *Common areas.* The amount of private business use of common areas within a facility is based on a reasonable method that properly reflects the proportionate benefit to be derived by the users of the facility. For example, in general, a method that is based on the average amount of private business use of the remainder of the entire facility reflects proportionate benefit.

(6) *Allocation of neutral costs.* Proceeds that are used to pay costs of issuance, invested in a reserve or replacement fund, or paid as fees for a qualified guarantee or a qualified hedge must be allocated ratably among the other purposes for which the proceeds are used.

(7) *Commencement of measurement of private business use.* Generally, private business use commences on the first date on which there is a right to actual use by the nongovernmental person. However, if an issuer enters into an arrangement for private business use a substantial period before the right to actual private business use commences and the arrangement transfers ownership or is an arrangement for other long-term use (such as a lease for a significant portion of the remaining economic life of financed property), private business use commences on the date the arrangement is entered into, even if the right to actual use commences after the measurement period. For this purpose, 10 percent of the measurement period is generally treated as a substantial period.

(8) *Examples.* The following examples illustrate the application of this paragraph (g):

Example 1. Research facility. University U, a state owned and operated university, owns and operates a research facility. U proposes to finance general improvements to the facility with the proceeds of an issue of bonds. U enters into sponsored research agreements with nongovernmental persons that result in private business use because the sponsors will own title to any patents resulting from the research. The governmental research conducted by U and the research U conducts for the sponsors take place simultaneously in all laboratories within the research facility. All laboratory equipment is available continuously for use by workers who perform both types of research. Because it is not possible to predict which research projects will be successful, it is not reasonably practicable to estimate the relative revenues expected to result from the governmental and nongovernmental research. U contributed 90 percent of the cost of the facility and the nongovernmental persons contributed 10 percent of the cost. Under this section, the nongovernmental persons are using the facility for a private business use on the same basis as the government use of the facility. The portions of the costs contributed by the various users of the facility provide a reasonable basis that properly reflects the proportionate benefit to be derived by the users of the facility. The nongovernmental persons are treated as using 10 percent of the proceeds of the issue.

Example 2. Stadium. (i) City L issues bonds and uses all of the proceeds to construct a stadium. L enters into a long-term contract with a professional sports team T under which T will use the stadium 20 times during each year. These uses will occur on nights and weekends. L reasonably expects that the stadium will be used more than 180 other times each year, none of which will give rise to private business use. This expectation is based on a feasibility study and historical use of the old stadium that is being replaced by the new stadium. There is no significant difference in the value of T's uses when compared to the other uses of the stadium, taking into account the payments that T is reasonably expected to make for its use. Assuming no other private business use, the issue does not meet the private business use test because not more than 10 percent of the use of the facility is for a private business use.

(ii) The facts are the same as in *Example 2(i),* except that L reasonably expects that the stadium will be used not more than 60 other times each year, none of which will give rise to private business use. The issue meets the private business use test because 25 percent of the proceeds are used for a private business use.

Example 3. Airport terminal areas treated as common areas. City N issues bonds to finance the construction of an airport terminal. Eighty percent of the leasable space of the terminal will be leased to private air carriers. The remaining 20 percent of the leasable space will be used for the term of the bonds by N for its administrative purposes. The common areas of the terminal, including waiting areas, lobbies, and hallways are treated as 80 percent used by the air carriers for purposes of the private business use test.

[T.D. 8712, 62 FR 2286, Jan. 16, 1997]

§1.141–4 Private security or payment test.

(a) *General rule*—(1) *Private security or payment.* The private security or payment test relates to the nature of the security for, and the source of, the payment of debt service on an issue. The private payment portion of the test takes into account the payment of the debt service on the issue that is directly or indirectly to be derived from payments (whether or not to the issuer or any related party) in respect of property, or borrowed money, used or to be used for a private business use. The private security portion of the test takes into account the payment of the debt service on the issue that is directly or indirectly secured by any interest in property used or to be used for a private business use or payments in respect of property used or to be used for a private business use. For additional rules for output facilities, see §1.141–7.

(2) *Aggregation of private payments and security.* For purposes of the private security or payment test, payments taken into account as private payments and payments or property taken into account as private security are aggregated. However, the same payments are not taken into account as both private security and private payments.

(3) *Underlying arrangement.* The security for, and payment of debt service on, an issue is determined from both the terms of the bond documents and on the basis of any underlying arrangement. An underlying arrangement may result from separate agreements between the parties or may be determined on the basis of all of the facts and circumstances surrounding the issuance of the bonds. For example, if the payment of debt service on an issue is secured by both a pledge of the full faith and credit of a state or local governmental unit and any interest in property used or to be used in a private business use, the issue meets the private security or payment test.

(b) *Measurement of private payments and security*—(1) *Scope.* This paragraph (b) contains rules that apply to both private security and private payments.

(2) *Present value measurement*—(i) *Use of present value.* In determining whether an issue meets the private security or payment test, the present value of the payments or property taken into account is compared to the present value of the debt service to be paid over the term of the issue.

(ii) *Debt service*—(A) *Debt service paid from proceeds.* Debt service does not include any amount paid or to be paid from sale proceeds or investment proceeds. For example, debt service does not include payments of capitalized interest funded with proceeds.

(B) *Adjustments to debt service.* Debt service is adjusted to take into account payments and receipts that adjust the yield on an issue for purposes of section 148(f). For example, debt service includes fees paid for qualified guarantees under §1.148–4(f) and is adjusted to take into account payments and receipts on qualified hedges under §1.148–4(h).

(iii) *Computation of present value*—(A) *In general.* Present values are determined by using the yield on the issue as the discount rate and by discounting all amounts to the issue date. See, however, §1.141–13 for special rules for refunding bonds.

(B) *Fixed yield issues.* For a fixed yield issue, yield is determined on the issue date and is not adjusted to take into account subsequent events.

(C) *Variable yield issues.* The yield on a variable yield issue is determined over the term of the issue. To determine the reasonably expected yield as of any date, the issuer may assume that the future interest rate on a variable yield bond will be the then-current interest rate on the bonds determined under the formula prescribed in the bond documents. A deliberate action requires a recomputation of the yield on the variable yield issue to determine the present value of payments under that arrangement. In that case, the issuer must use the yield determined as of the date of the deliberate action for purposes of determining the present value of payments under the arrangement causing the deliberate action. See paragraph (g) of this section, *Example 3.*

(iv) *Application to private security.* For purposes of determining the present value of debt service that is secured by property, the property is valued at fair market value as of the first date on which the property secures bonds of the issue.

(c) *Private payments*—(1) *In general.* This paragraph (c) contains rules that apply to private payments.

(2) *Payments taken into account*—(i) *Payments for use*—(A) *In general.* Both direct and indirect payments made by any nongovernmental person that is treated as using proceeds of the issue are taken into account as private payments to the extent allocable to the proceeds used by that person. Payments are taken into account as private payments only to the extent that they are made for the period of time that proceeds are used for a private business use. Payments for a use of proceeds include payments (whether or not to the issuer) in respect of property financed (directly or indirectly) with those proceeds, even if not made by a private business user. Payments are not made in respect of financed property if those payments are directly allocable to other property being directly used by the person making the payment and those payments represent fair market value compensation for that other use. See paragraph (g) of this section, *Example 4* and *Example 5.* See also paragraph (c)(3) of this section for rules relating to allocation of payments to the source or sources of funding of property.

(B) *Payments not to exceed use.* Payments with respect to proceeds that are used for a private business use are not taken into account to the extent that the present value of those payments exceeds the present value of debt service on those proceeds. Payments need not be directly derived from a private business user, however, to be taken into account. Thus, if 7 percent of the proceeds of an issue is used by a person over the measurement period, payments with respect to the property financed with those proceeds are taken into account as private payments only to the extent that the present value of those payments does not exceed the present value of 7 percent of the debt service on the issue.

(C) *Payments for operating expenses.* Payments by a person for a use of proceeds do not include the portion of any payment that is properly allocable to the payment of ordinary and necessary expenses (as defined under section 162) directly attributable to the operation and maintenance of the financed property used by that person. For this purpose, general overhead and administrative expenses are not directly attributable to those operations and maintenance. For example, if an issuer receives $5,000 rent during the year for use of space in a financed facility and during the year pays $500 for ordinary and necessary expenses properly allocable to the operation and maintenance of that space and $400 for general overhead and general administrative expenses properly allocable to that space, $500 of the $5,000 received would not be considered a payment for the use of the proceeds allocable to that space (regardless of the manner in which that $500 is actually used).

(ii) *Refinanced debt service.* Payments of debt service on an issue to be made from proceeds of a refunding issue are taken into account as private payments in the same proportion that the present value of the payments taken into account as private payments for the refunding issue bears to the present value of the debt service to be paid on the refunding issue. For example, if all the debt service on a note is paid with proceeds of a refunding issue, the note meets the private security or payment test if (and to the same extent that) the refunding issue meets the private security or payment test. This paragraph (c)(2)(ii) does not apply to payments that arise from deliberate actions that occur more than 3 years after the retirement of the prior issue that are not reasonably expected on the issue date of the refunding issue. For purposes of this paragraph (c)(2)(ii), whether an issue is a refunding issue is determined without regard to §1.150–1(d)(2)(i) (relating to certain payments of interest).

(3) *Allocation of payments*—(i) *In general.* Private payments for the use of property are allocated to the source or different sources of funding of property. The allocation to the source or different sources of funding is based on all of the facts and circumstances, including whether an allocation is consistent with the purposes of section 141. In general, a private payment for the use of property is allocated to a source of funding based upon the nexus between the payment and both the financed property and the source of funding. For this purpose, different sources of funding may include different tax-exempt issues, taxable issues, and amounts that are not derived from a borrowing, such as revenues of an issuer (equity).

(ii) *Payments for use of discrete property.* Payments for the use of a discrete facility (or a discrete portion of a facility) are allocated to the source or different sources of funding of that discrete property.

(iii) *Allocations among two or more sources of funding.* In general, except as provided in paragraphs (c)(3)(iv) and (v) of this section, if a payment is made for the use of property financed with two or more sources of funding (for example, equity and a tax-exempt issue), that payment must be allocated to those sources of funding in a manner that reasonably corresponds to the relative amounts of those sources of funding that are expended on that property. If an issuer has not retained records of amounts expended on the property (for example, records of costs of a building that was built 30 years before the allocation), an issuer may use reasonable estimates of those expenditures. For this purpose, costs of issuance and other similar neutral costs are allocated ratably among expenditures in the same manner as in §1.141–3(g)(6). A payment for the use of property may be allocated to two or more issues that finance property according to the relative amounts of debt service (both paid and accrued) on the issues during the annual period for which the payment is made, if that allocation reasonably reflects the economic substance of the arrangement. In general, allocations of payments according to relative debt service reasonably reflect the economic substance of the arrangement if the maturity of the bonds reasonably corresponds to the reasonably expected economic life of the property and debt service payments on the bonds are approximately level from year to year.

(iv) *Payments made under an arrangement entered into in connection with issuance of bonds.* A private payment for the use of property made under an arrangement that is entered into in connection with the issuance of the issue that finances that property generally is allocated to that issue. Whether an arrangement is entered into in connection with the issuance of an issue is determined on the basis of all of the facts and circumstances. An arrangement is ordinarily treated as entered into in connection with the issuance of an issue if—

(A) The issuer enters into the arrangement during the 3-year period beginning 18 months before the issue date; and

(B) The amount of payments reflects all or a portion of debt service on the issue.

(v) *Allocations to equity.* A private payment for the use of property may be allocated to equity before payments are allocated to an issue only if—

(A) Not later than 60 days after the date of the expenditure of those amounts, the issuer adopts an official intent (in a manner comparable to §1.150–2(e)) indicating that the issuer reasonably expects to be repaid for the expenditure from a specific arrangement; and

(B) The private payment is made not later than 18 months after the later of the date the expenditure is made or the date the project is placed in service.

(d) *Private security*—(1) *In general.* This paragraph (d) contains rules that relate to private security.

(2) *Security taken into account.* The property that is the security for, or the source of, the payment of debt service on an issue need not be property financed with proceeds. For example, unimproved land or investment securities used, directly or indirectly, in a private business use that secures an issue provides private security. Private security (other than financed property and private payments) for an issue is taken into account under section 141(b), however, only to the extent it is provided, directly or indirectly, by a user of proceeds of the issue.

(3) *Pledge of unexpended proceeds.* Proceeds qualifying for an initial temporary period under §1.148–2(e)(2) or (3) or deposited in a reasonably required reserve or replacement fund (as defined in §1.148–2(f)(2)(i)) are not taken into account under this paragraph (d) before the date on which those amounts are either expended or loaned by the issuer to an unrelated party.

(4) *Secured by any interest in property or payments.* Property used or to be used for a private business use and payments in respect of that property are treated as private security if any interest in that property or payments secures the payment of debt service on the bonds. For this purpose, the phrase any interest in is to be interpreted broadly and includes, for example, any right, claim, title, or legal share in property or payments.

(5) *Payments in respect of property.* The payments taken into account as private security are payments in respect of property used or to be used for a private business use. Except as otherwise provided in this paragraph (d)(5) and paragraph (d)(6) of this section, the rules in paragraphs (c)(2)(i)(A) and (B) and (c)(2)(ii) of this section apply to determine the amount of payments treated as payments in respect of property used or to be used for a private business use. Thus, payments made by members of the general public for use of a facility used for a private business use (for example, a facility that is the subject of a management contract that results in private business use) are taken into account as private security to the extent that they are made for the period of time that property is used by a private business user.

(6) *Allocation of security among issues.* In general, property or payments from the disposition of that property that are taken into account as private security are allocated to each issue secured by the property or payments on a reasonable basis that takes into account bondholders' rights to the payments or property upon default.

(e) *Generally applicable taxes*—(1) *General rule.* For purposes of the private security or payment test, generally applicable taxes are not taken into account (that is, are not payments from a nongovernmental person and are not payments in respect of property used for a private business use).

(2) *Definition of generally applicable taxes.* A generally applicable tax is an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenue to be used for governmental purposes. A generally applicable tax must have a uniform tax rate that is applied to all persons of the same classification in the appropriate jurisdiction and a generally applicable manner of determination and collection.

(3) *Special charges.* A payment for a special privilege granted or service rendered is not a generally applicable tax. Special assessments paid by property owners benefiting from financed improvements are not generally applicable taxes. For example, a tax or a payment in lieu of tax that is limited to the property or persons benefited by an improvement is not a generally applicable tax.

(4) *Manner of determination and collection*—(i) *In general.* A tax does not have a generally applicable manner of determination and collection to the extent that one or more taxpayers make any impermissible agreements relating to payment of those taxes. An impermissible agreement relating to the payment of a tax is taken into account whether or not it is reasonably expected to result in any payments that would not otherwise have been made. For example, if an issuer uses proceeds

to make a grant to a taxpayer to improve property, agreements that impose reasonable conditions on the use of the grant do not cause a tax on that property to fail to be a generally applicable tax. If an agreement by a taxpayer causes the tax imposed on that taxpayer not to be treated as a generally applicable tax, the entire tax paid by that taxpayer is treated as a special charge, unless the agreement is limited to a specific portion of the tax.

(ii) *Impermissible agreements.* The following are examples of agreements that cause a tax to fail to have a generally applicable manner of determination and collection: an agreement to be personally liable on a tax that does not generally impose personal liability, to provide additional credit support such as a third party guarantee, or to pay unanticipated shortfalls; an agreement regarding the minimum market value of property subject to property tax; and an agreement not to challenge or seek deferral of the tax.

(iii) *Permissible agreements.* The following are examples of agreements that do not cause a tax to fail to have a generally applicable manner of determination and collection: an agreement to use a grant for specified purposes (whether or not that agreement is secured); a representation regarding the expected value of the property following the improvement; an agreement to insure the property and, if damaged, to restore the property; a right of a grantor to rescind the grant if property taxes are not paid; and an agreement to reduce or limit the amount of taxes collected to further a bona fide governmental purpose. For example, an agreement to abate taxes to encourage a property owner to rehabilitate property in a distressed area is a permissible agreement.

(5) *Payments in lieu of taxes.* A tax equivalency payment and any other payment in lieu of a tax is treated as a generally applicable tax if—

(i) The payment is commensurate with and not greater than the amounts imposed by a statute for a tax of general application; and

(ii) The payment is designated for a public purpose and is not a special charge (as described in paragraph (e)(3) of this section). For example, a payment in lieu of taxes made in consideration for the use of property financed with tax-exempt bonds is treated as a special charge.

(f) *Certain waste remediation bonds*—(1) *Scope.* This paragraph (f) applies to bonds issued to finance hazardous waste clean-up activities on privately owned land (hazardous waste remediation bonds).

(2) *Persons that are not private users.* Payments from nongovernmental persons who are not (other than coincidentally) either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on that site are not taken into account as private security. This paragraph (f)(2) applies to payments that secure (directly or indirectly) the payment of principal of, or interest on, the bonds under the terms of the bonds. This paragraph (f)(2) applies only if the payments are made pursuant to either a generally applicable state or local taxing statute or a state or local statute that regulates or restrains activities on an industry-wide basis of persons who are engaged in generating or handling hazardous waste, or in refining, producing, or transporting petroleum, provided that those payments do not represent, in substance, payment for the use of proceeds. For this purpose, a state or local statute that imposes payments that have substantially the same character as those described in Chapter 38 of the Code are treated as generally applicable taxes.

(3) *Persons that are private users.* If payments from nongovernmental persons who are either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on that site do not secure (directly or indirectly) the payment of principal of, or interest on, the bonds under the terms of the bonds, the payments are not taken into account as private payments. This paragraph (f)(3) applies only if at the time the bonds are issued the payments from those nongovernmental persons are not material to the security for the bonds. For this purpose, payments are not material to the security for the bonds if—

(i) The payments are not required for the payment of debt service on the bonds;

(ii) The amount and timing of the payments are not structured or designed to reflect the payment of debt service on the bonds;

(iii) The receipt or the amount of the payment is uncertain (for example, as of the issue date, no final judgment has been entered into against the nongovernmental person);

(iv) The payments from those nongovernmental persons, when and if received, are used either to redeem bonds of the issuer or to pay for costs of any hazardous waste remediation project; and

(v) In the case when a judgment (but not a final judgment) has been entered by the issue date against a nongovernmental person, there are, as of the issue date, costs of hazardous waste remediation other than those financed with the bonds that may be financed with the payments.

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

Example 1. Aggregation of payments. State B issues bonds with proceeds of $10 million. B uses $9.7 million of the proceeds to construct a 10-story office building. B uses the remaining $300,000 of proceeds to make a loan to Corporation Y. In addition, Corporation X leases 1 floor of the building for the term of the bonds. Under all of the facts and circumstances, it is reasonable to allocate 10 percent of the proceeds to that 1 floor. As a percentage of the present value of the debt service on the bonds, the present value of Y's loan repayments is 3 percent and the present value of X's lease payments is 8 percent. The bonds meet the private security or payment test because the private payments taken into account are more than 10 percent of the present value of the debt service on the bonds.

Example 2. Indirect private payments. J, a political subdivision of a state, will issue several series of bonds from time to time and will use the proceeds to rehabilitate urban areas. Under all of the facts and circumstances, the private business use test will be met with respect to each issue that will be used for the rehabilitation and construction of buildings that will be leased or sold to nongovernmental persons for use in their trades or businesses. Nongovernmental persons will make payments for these sales and leases. There is no limitation either on the number of issues or the aggregate amount of bonds that may be outstanding. No group of bondholders has any legal claim prior to any other bondholders or creditors with respect to specific revenues of J, and there is no arrangement whereby revenues from a particular project are paid into a trust or constructive trust, or sinking fund, or are otherwise segregated or restricted for the benefit of any group of bondholders. There is, however, an unconditional obligation by J to pay the principal of, and the interest on, each issue. Although not directly pledged under the terms of the bond documents, the leases and sales are underlying arrangements. The payments relating to these leases and sales are taken into account as private payments to determine whether each issue of bonds meets the private security or payment test.

Example 3. Computation of payment in variable yield issues. (i) City M issues general obligation bonds with proceeds of $10 million to finance a 5-story office building. The bonds bear interest at a variable rate that is recomputed monthly according to an index that reflects current market yields. The yield that the interest index would produce on the issue date is 6 percent. M leases 1 floor of the office building to Corporation T, a nongovernmental person, for the term of the bonds. Under all of the facts and circumstances, T is treated as using more than 10 percent of the proceeds. Using the 6 percent yield as the discount rate, M reasonably expects on the issue date that the present value of lease payments to be made by T will be 8 percent of the present value of the total debt service on the bonds. After the issue date of the bonds, interest rates decline significantly, so that the yield on the bonds over their entire term is 4 percent. Using this actual 4 percent yield as the discount rate, the present value of lease payments made by T is 12 percent of the present value of the actual total debt service on the bonds. The bonds are not private activity bonds because M reasonably expected on the issue date that the bonds would not meet the private security or payment test and because M did not take any subsequent deliberate action to meet the private security or payment test.

(ii) The facts are the same as *Example 3(i),* except that 5 years after the issue date M leases a second floor to Corporation S, a nongovernmental person, under a long-term lease. Because M has taken a deliberate action, the present value of the lease payments must be computed. On the date this lease is entered into, M reasonably expects that the yield on the bonds over their entire term will be 5.5 percent, based on actual interest rates to date and the then-current rate on the variable yield bonds. M uses this 5.5 percent yield as the discount rate. Using this 5.5 percent yield as the discount rate, as a percentage of the present value of the debt service on the bonds, the present value of the lease payments made by S is 3 percent. The bonds are private activity bonds because the present value of the aggregate private payments is greater than 10 percent of the present value of debt service.

Example 4. Payments not in respect of financed property. In order to further public safety, City Y issues tax assessment bonds the proceeds of which are used to move existing electric utility lines underground. Although the utility lines are owned by a nongovernmental utility company, that company is under no obligation to move the lines. The debt service on the bonds will be paid using assessments levied by City Y on the customers of the utility. Although the utility lines are privately owned and the utility customers make payments to the utility company for the use of those lines, the assessments are payments in respect of the cost of relocating the utility line. Thus, the assessment payments are not made in respect of property used for a private business use. Any direct or indirect payments to Y by the utility company for the undergrounding are, however, taken into account as private payments.

Example 5. Payments from users of proceeds that are not private business users taken into account. City P issues general obligation bonds to finance the renovation of a hospital that it owns. The hospital is operated for P by D, a nongovernmental person, under a management contract that results in private business use under §1.141–3. P will use the revenues from the hospital (after the required payments to D and the payment of operation and maintenance expenses) to pay the debt service on the bonds. The bonds meet the private security or payment test because the revenues from the hospital are payments in respect of property used for a private business use.

Example 6. Limitation of amount of payments to amount of private business use not determined annually. City Q issues bonds with a term of 15 years and uses the proceeds to construct an office building. The debt service on the bonds is level throughout the 15-year term. Q enters into a 5-year lease with Corporation R under which R is treated as a user of 11 percent of the proceeds. R will make lease payments equal to 20 percent of the annual debt service on the bonds for each year of the lease. The present value of R's lease payments is equal to 12 percent of the present value of the debt service over the entire 15-year term of the bonds. If, however, the lease payments taken into account as private payments were limited to 11 percent of debt service paid in each year of the lease, the present value of these payments would be only 8 percent of the debt service on the bonds over the entire term of the bonds. The bonds meet the private security or payment test, because R's lease payments are taken into account as private payments in an amount not to exceed 11 percent of the debt service of the bonds.

Example 7. Allocation of payments to funds not derived from a borrowing. City Z purchases property for $1,250,000 using $1,000,000 of proceeds of its tax increment bonds and $250,000 of other revenues that are in its redevelopment fund. Within 60 days of the date of purchase, Z declared its intent to sell the property pursuant to a redevelopment plan and to use that amount to reimburse its redevelopment fund. The bonds are secured only by the incremental property taxes attributable to the increase in value of the property from the planned redevelopment of the property. Within 18 months after the issue date, Z sells the financed property to Developer M for $250,000, which Z uses to reimburse the redevelopment fund. The property that M uses is financed both with the proceeds of the bonds and Z's redevelopment fund. The payments by M are properly allocable to the costs of property financed with the amounts in Z's redevelopment fund. See paragraphs (c)(3) (i) and (v) of this section.

Example 8. Allocation of payments to different sources of funding—improvements. In 1997, City L issues bonds with proceeds of $8 million to finance the acquisition of a building. In 2002, L spends $2 million of its general revenues to improve the heating system and roof of the building. At that time, L enters into a 10-year lease with Corporation M for the building providing for annual payments of $1 million to L. The lease payments are at fair market value, and the lease payments do not otherwise have a significant nexus to either the issue or to the expenditure of general revenues. Eighty percent of each lease payment is allocated to the issue and is taken into account under the private payment test because each lease payment is properly allocated to the sources of funding in a manner that reasonably corresponds to the relative amounts of the sources of funding that are expended on the building.

Example 9. Security not provided by users of proceeds not taken into account. County W issues certificates of participation in a lease of a building that W owns and covenants to appropriate annual payments for the lease. A portion of each payment is specified as interest. More than 10 percent of the building is used for private business use. None of the proceeds of the obligations are used with respect to the building. W uses the proceeds of the obligations to make a grant to Corporation Y for the construction of a factory that Y will own. Y makes no payments to W, directly or indirectly, for its use of proceeds, and Y has no relationship to the users of the leased building. If W defaults under the lease, the trustee for the holders of the certificates of participation has a limited right of repossession under which the trustee may not foreclose but may lease the property to a new tenant at fair market value. The obligations are secured by an interest in property used for a private business use. However, because the property is not provided by a private business user and is not financed property, the obligations do not meet the private security or payment test.

Example 10. Allocation of payments among issues. University L, a political subdivision, issued three separate series of revenue bonds during 1989, 1991, and 1993 under the same bond resolution. L used the proceeds to construct facilities exclusively for its own use. Bonds issued under the resolution are equally and ratably secured and payable solely from the income derived by L from rates, fees, and charges imposed by L for the use of the facilities. The bonds issued in 1989, 1991, and 1993 are not private activity bonds. In 1997, L issues another series of bonds under the resolution to finance additional facilities. L leases 20 percent of the new facilities for the term of the 1997 bonds to nongovernmental persons who will use the facilities in their trades or businesses. The present value of the lease payments from the nongovernmental users will equal 15 percent of the present value of the debt service on the 1997 bonds. L will commingle all of the revenues from all its bond-financed facilities in its revenue fund. The present value of the portion of the lease payments from nongovernmental lessees of the new facilities allocable to the 1997 bonds under paragraph (d) of this section is less than 10 percent of the present value of the debt service on the 1997 bonds because the bond documents provide that the bonds are equally and ratably secured. Accordingly, the 1997 bonds do not meet the private security test. The 1997 bonds meet the private payment test, however, because the private lease payments for the new facility are properly allocated to those bonds (that is, because none of the proceeds of the prior issues were used for the new facilities). See paragraph (c) of this section.

Example 11. Generally applicable tax. (i) Authority N issues bonds to finance the construction of a stadium. Under a long-term lease, Corporation X, a professional sports team, will use more than 10 percent of the stadium. X will not, however, make any payments for this private business use. The security for the bonds will be a ticket tax imposed on each person purchasing a ticket for an event at the stadium. The portion of the ticket tax attributable to tickets purchased by persons attending X's events will, on a present value basis, exceed 10 percent of the present value of the debt service on N's bonds. The bonds meet the private security or payment test. The ticket tax is not a generally applicable tax and, to the extent that the tax receipts relate to X's events, the taxes are payments in respect of property used for a private business use.

(ii) The facts are the same as *Example 11(i)*, except that the ticket tax is imposed by N on tickets purchased for events at a number of large entertainment facilities within the N's jurisdiction (for example, other stadiums, arenas, and concert halls), some of which were not financed with tax-exempt bonds. The ticket tax is a generally applicable tax and therefore the revenues from this tax are not payments in respect of property used for a private business use. The receipt of the ticket tax does not cause the bonds to meet the private security or payment test.

[T.D. 8712, 62 FR 2291, Jan. 16, 1997]

§ 1.141–5 Private loan financing test.

(a) *In general.* Bonds of an issue are private activity bonds if more than the lesser of 5 percent or $5 million of the proceeds of the issue is to be used (directly or indirectly) to make or finance loans to persons other than governmental persons. Section 1.141–2(d) applies in determining whether the private loan financing test is met. In determining whether the proceeds of an issue are used to make or finance loans, indirect, as well as direct, use of the proceeds is taken into account.

(b) *Measurement of test.* In determining whether the private loan financing test is met, the amount actually loaned to a nongovernmental person is not discounted to reflect the present value of the loan repayments.

(c) *Definition of private loan*—(1) *In general.* Any transaction that is generally characterized as a loan for federal income tax purposes is a loan for purposes of this section. In addition, a loan may arise from the direct lending of bond proceeds or may arise from transactions in which indirect benefits that are the economic equivalent of a loan are conveyed. Thus, the determination of whether a loan is made depends on the substance of a transaction rather than its form. For example, a lease or other contractual arrangement (for example, a management contract or an output contract) may in substance constitute a loan if the arrangement transfers tax ownership of the facility to a nongovernmental person. Similarly, an output contract or a management contract with respect to a financed facility generally is not treated as a loan of proceeds unless the agreement in substance shifts significant burdens and benefits of ownership to the nongovernmental purchaser or manager of the facility.

(2) *Application only to purpose investments*—(i) *In general.* A loan may be either a purpose investment or a nonpurpose investment. A loan that is a nonpurpose investment does not cause the private loan financing test to be met. For example, proceeds invested in loans, such as obligations of the United States, during a temporary period, as part of a reasonably required reserve or replacement fund, as part of a refunding escrow, or as part of a minor portion (as each of those terms are defined in §1.148–1 or §1.148–2) are generally not treated as loans under the private loan financing test.

(ii) *Certain prepayments treated as loans.* Except as otherwise provided, a prepayment for property or services is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller. A prepayment is not treated as a loan for purposes of the private loan financing test if—

(A) The prepayment is made for a substantial business purpose other than providing a benefit of tax-exempt financing to the seller and the issuer has no commercially reasonable alternative to the prepayment; or

(B) Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing.

(3) *Grants*—(i) *In general.* A grant of proceeds is not a loan. Whether a transaction may be treated as a grant or a loan depends on all of the facts and circumstances.

(ii) *Tax increment financing*—(A) *In general.* Generally, a grant using proceeds of an issue that is secured by generally applicable taxes attributable to the improvements to be made with the grant is not treated as a loan, unless the grantee makes any impermissible agreements relating to the payment that results in the taxes imposed on that taxpayer not to be treated as generally applicable taxes under §1.141–4(e).

(B) *Amount of loan.* If a grant is treated as a loan under this paragraph (c)(3), the entire grant is treated as a loan unless the impermissible agreement is limited to a specific portion of the tax. For this purpose, an arrangement with each unrelated grantee is treated as a separate grant.

(4) *Hazardous waste remediation bonds.* In the case of an issue of hazardous waste remediation bonds, payments from nongovernmental persons that are either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on that site do not establish that the transaction is a loan for purposes of this section. This paragraph (c)(4) applies only if those payments do not secure the payment of principal of, or interest on, the bonds (directly or indirectly), under the terms of the bonds and those payments are not taken into account under the private payment test pursuant to §1.141–4(f)(3).

(d) *Tax assessment loan exception*—(1) *General rule.* For purposes of this section, a tax assessment loan that satisfies the requirements of this paragraph (d) is not a loan for purposes of the private loan financing test.

(2) *Tax assessment loan defined.* A tax assessment loan is a loan that arises when a governmental person permits or requires property owners to finance any governmental tax or assessment of general application for an essential governmental function that satisfies each of the requirements of paragraphs (d) (3) through (5) of this section.

(3) *Mandatory tax or other assessment.* The tax or assessment must be an enforced contribution that is imposed and collected for the purpose of raising revenue to be used for a specific purpose (that is, to defray the capital cost of an improvement). Taxes and assessments do not include fees for services. The tax or assessment must be imposed pursuant to a state law of general application that can be applied equally to natural persons not acting in a trade or business and persons acting in a trade or business. For this purpose, taxes and assessments that are imposed subject to protest procedures are treated as enforced contributions.

(4) *Specific essential governmental function*—(i) *In general.* A mandatory tax or assessment that gives rise to a tax assessment loan must be imposed for one

or more specific, essential governmental functions.

(ii) *Essential governmental functions.* For purposes of paragraph (d) of this section, improvements to utilities and systems that are owned by a governmental person and that are available for use by the general public (such as sidewalks, streets and street-lights; electric, telephone, and cable television systems; sewage treatment and disposal systems; and municipal water facilities) serve essential governmental functions. For other types of facilities, the extent to which the service provided by the facility is customarily performed (and financed with governmental bonds) by governments with general taxing powers is a primary factor in determining whether the facility serves an essential governmental function. For example, parks that are owned by a governmental person and that are available for use by the general public serve an essential governmental function. Except as otherwise provided in this paragraph (d)(4)(ii), commercial or industrial facilities and improvements to property owned by a nongovernmental person do not serve an essential governmental function. Permitting installment payments of property taxes or other taxes is not an essential governmental function.

(5) *Equal basis requirement*—(i) *In general.* Owners of both business and nonbusiness property benefiting from the financed improvements must be eligible, or required, to make deferred payments of the tax or assessment giving rise to a tax assessment loan on an equal basis (the equal basis requirement). A tax or assessment does not satisfy the equal basis requirement if the terms for payment of the tax or assessment are not the same for all taxed or assessed persons. For example, the equal basis requirement is not met if certain property owners are permitted to pay the tax or assessment over a period of years while others must pay the entire tax or assessment immediately or if only certain property owners are required to prepay the tax or assessment when the property is sold.

(ii) *General rule for guarantees.* A guarantee of debt service on bonds, or of taxes or assessments, by a person that is treated as a borrower of bond proceeds violates the equal basis requirement if it is reasonable to expect on the date the guarantee is entered into that payments will be made under the guarantee.

(6) *Coordination with private business tests.* See §§ 1.141–3 and 1.141–4 for rules for determining whether tax assessment loans cause the bonds financing those loans to be private activity bonds under the private business use and the private security or payment tests.

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

Example 1. Turnkey contract not treated as a loan. State agency Z and federal agency H will each contribute to rehabilitate a project owned by Z. H can only provide its funds through a contribution to Z to be used to acquire the rehabilitated project on a turnkey basis from an approved developer. Under H's turnkey program, the developer must own the project while it is rehabilitated. Z issues its notes to provide funds for construction. A portion of the notes will be retired using the H contribution, and the balance of the notes will be retired through the issuance by Z of long-term bonds. Z lends the proceeds of its notes to Developer B as construction financing and transfers title to B for a nominal amount. The conveyance is made on condition that B rehabilitate the property and reconvey it upon completion, with Z retaining the right to force reconveyance if these conditions are not satisfied. B must name Z as an additional insured on all insurance. Upon completion, B must transfer title to the project back to Z at a set price, which price reflects B's costs and profit, not fair market value. Further, this price is adjusted downward to reflect any cost-underruns. For purposes of section 141(c), this transaction does not involve a private loan.

Example 2. Essential government function requirement not met. City D creates a special taxing district consisting of property owned by nongovernmental persons that requires environmental clean-up. D imposes a special tax on each parcel within the district in an amount that is related to the expected environmental clean-up costs of that parcel. The payment of the tax over a 20-year period is treated as a loan by the property owners for purposes of the private loan financing test. The special district issues bonds, acting on behalf of D, that are payable from the special tax levied within the district, and uses the proceeds to pay for the costs of environmental clean-up on the property within the district. The bonds meet the private loan financing test because more than 5 percent of the proceeds of the issue are loaned to nongovernmental persons. The issue does not meet the tax assessment loan exception because the improvements to property owned by a nongovernmental person are not an essential governmental function under section 141(c)(2). The issue also meets the private business tests of section 141(b).

[T.D. 8712, 62 FR 2296, Jan. 16, 1997]

§ 1.141–6 Allocation and accounting rules.

(a) *Allocation of proceeds to expenditures.* For purposes of §§ 1.141–1 through 1.141–15, the provisions of § 1.148–6(d) apply for purposes of allocating proceeds to expenditures. Thus, allocations generally may be made using any reasonable, consistently applied accounting method, and allocations under section 141 and section 148 must be consistent with each other.

(b) *Allocation of proceeds to property.* [Reserved]

(c) *Special rules for mixed use facilities.* [Reserved]

(d) *Allocation of proceeds to common areas.* [Reserved]

(e) *Allocation of proceeds to bonds.* [Reserved]

(f) *Treatment of partnerships.* [Reserved]

(g) *Examples.* [Reserved]

[T.D. 8712, 62 FR 2297, Jan. 16, 1997]

§ 1.141–7T Special rules for output facilities (temporary).

(a) *Overview.* This section provides special rules to determine whether arrangements for purchases of output from an output facility cause an issue of bonds to meet the private business tests. For this purpose, unless otherwise stated, water facilities are treated as output facilities. Section 1.141–3 generally applies to determine whether other types of arrangements for use of an output facility cause an issue to meet the private business tests.

(b) *Definitions.* For purposes of this section and § 1.141–8T, the following definitions and rules apply:

(1) *Available output.* The available output of a facility financed by an issue is determined by multiplying the number of units produced or to be produced by the facility in one year by the number of years in the measurement period of that facility for that issue.

(i) *Generating facilities.* The number of units produced or to be produced by a generating facility in one year is determined by reference to its nameplate capacity or the equivalent (or where there is no nameplate capacity or the equivalent, its maximum capacity), which is not reduced for reserves or other unutilized capacity.

(ii) *Transmission and other output facilities*—(A) *In general.* For transmission, cogeneration, and other output facilities, available output must be measured in a reasonable manner to reflect capacity.

(B) *Electric transmission facilities.* Measurement of the available output of all or a portion of electric transmission facilities may be determined in a manner consistent with the reporting rules and requirements for transmission networks promulgated by the Federal Energy Regulatory Commission (FERC). For example, for a transmission network, the use of aggregate load and load share ratios in a manner consistent with the requirements of the FERC may be reasonable. In addition, depending on the facts and circumstances, measurement of the available output of transmission facilities using thermal capacity or transfer capacity may be reasonable.

(iii) *Special rule for facilities acquired or constructed primarily for use by private business users.* If an issuer reasonably expects on the issue date that persons that are treated as private business users will purchase more than 30 percent of the actual output of the facility financed with the issue, the Commissioner may determine the number of units produced or to be produced by the facility in one year on a reasonable basis other than by reference to nameplate capacity, such as the average expected annual output of the facility. For example, the Commissioner may treat the reasonably expected annual output of a financed peaking electric generating unit as the available output of that unit if the issuer reasonably expects, on the issue date of bonds that finance the unit, that an investor-owned utility will purchase 30 percent of the actual output of the facility under a take or pay contract, even if the amount of output purchased is less than 10 percent of the available output determined by reference to nameplate capacity. The reasonably expected annual output of the generating facility must be consistent with the capacity reported for prudent reliability purposes.

(iv) *Special rule for facilities with a limited source of supply.* If a limited source of supply constrains the output of an output facility, the number of units produced or to be produced by the facility must be determined by reasonably taking into account those constraints. For example, the available output of a hydroelectric unit must be determined by reference to the reasonably expected annual flow of water through the unit.

(2) *Measurement period.* The measurement period of an output facility financed by an issue is determined under § 1.141–3(g).

(3) *Sale at wholesale.* For purposes of this section, a sale at wholesale means a sale of output to any person for resale.

(4) *Stranded costs.* For purposes of this section, *stranded costs* means stranded costs as defined in 18 CFR 35.26 and costs that an issuer incurred to provide service to a wholesale or retail customer that subsequently becomes, in whole or in part, an unbundled transmission customer and that an issuer is authorized to recover by the FERC or a state regulatory authority.

(5) *Take contract and take or pay contract.* A *take contract* is an output contract under which a purchaser agrees to pay for the output under the contract if the output facility is capable of providing the output. A take or pay contract is an output contract under which a purchaser agrees to pay for the output under the contract, whether or not the output facility is capable of providing the output.

(6) *Transmission facilities. Transmission facilities* are facilities for the transmission or distribution of output. Transmission facilities include facilities necessary to provide ancillary services required to be offered as part of open access transmission tariffs under rules promulgated by the FERC under sections 205 and 206 of the Federal Power Act (16 U.S.C. 824d and 824e). Thus, if a facility also serves another function (for example, a facility that provides for operating reserves for transmission and also provides generation) an allocable portion of the facility is treated as a transmission facility.

(7) *Nonqualified amount.* The nonqualified amount with respect to an issue is determined under section 141(b)(8).

(c) *Output contracts*—(1) *General rule.* The purchase by a nongovernmental person of the available output of an output facility (output contract) financed with the proceeds of an issue is taken into account under the private business tests if the purchase has the effect of transferring substantial benefits of owning the facility and substantial burdens of paying the debt service on bonds used (directly or indirectly) to finance the facility (the benefits and burdens test). See paragraph (c)(5) of this section for other output contract arrangements that are taken into account under the private business tests. See also § 1.141–8T for rules for when an issue that finances an output facility (other than a water facility) meets the private business tests because the nonqualified amount of the issue exceeds $15 million.

(2) *Benefits and burdens test*—(i) *Benefits of ownership.* An output contract transfers substantial benefits of owning a facility if the contract gives the purchaser (directly or indirectly) rights to capacity of the facility on a basis that is preferential to the rights of the general public.

(ii) *Burdens of paying debt service.* An output contract transfers substantial burdens of paying debt service on an issue to the extent that the issuer reasonably expects that it is substantially certain that payments will be made under the terms of the contract (disregarding default, insolvency, or other similar circumstances). For example, an output contract is treated as transferring burdens of paying debt service on an issue if payments must be made upon contract termination.

(iii) *Payments pursuant to pledged contract.* Payments made or to be made under the terms of an output contract that is pledged as security for an issue are taken into account under the private business tests even if the issuer reasonably expects that it is not substantially certain that payments will be made under the contract (disregarding default, insolvency, or other similar circumstances). For this purpose, an output contract is pledged as security only if the bond documents provide that the pledged contract cannot be substantially amended without the consent of bondholders or a trustee for the bondholders.

(3) *Take contract or take or pay contract*—(i) *In general.* The benefits and burdens test is met if a nongovernmental person agrees pursuant to a take contract or a take or pay contract to purchase the available output of a facility. See paragraphs (d) and (e) of this section for rules regarding measuring the use of, and payments on debt service for, an output facility for determining whether the private business tests are met.

(ii) *Transmission contracts.* In the case of a transmission facility, an agreement to provide firm or priority transmission services is generally treated as a take contract or a take or pay contract. The extent to which transmission services are interruptible is an important factor indicating that a contract for transmission services is not treated as a take contract or a take or pay contract.

(4) *Requirements contracts*—(i) *In general.* A requirements contract under which a nongovernmental person agrees to purchase all or part of its output requirements is taken into account under the private business tests only to the extent that, based on all the facts and circumstances, the contract meets the benefits and burdens test. See §1.141–15T(f)(3) for special effective dates for the application of this paragraph (c)(4) to issues financing facilities subject to requirements contracts.

(ii) *Significant factors.* Significant factors that tend to establish that the benefits and burdens test is met under the rule set forth in paragraph (c)(4)(i) of this section include—

(A) The purchaser's customer base has significant indicators of stability, such as large size, diverse composition, and a substantial residential component;

(B) The contract covers historical requirements of the purchaser, rather than only projected requirements that are in addition to historical requirements; and

(C) The purchaser agrees not to construct or acquire other power resources to meet the requirements covered by the contract.

(iii) *Special rule for retail requirements contracts.* In general, a requirements contract that is not a sale at wholesale does not meet the benefits and burdens test because the obligation to make payments on the contract is contingent on the output requirements of a single user. Such a requirements contract in general meets the benefits and burdens test, however, to the extent that it contains contractual terms that obligate the purchaser to make payments that are not contingent on the output requirements of the purchaser (such as significant termination payments) or that obligate the purchaser to have output requirements. For example, a requirements contract with an industrial purchaser meets the benefits and burdens test if the purchaser enters into additional contractual obligations with the issuer or another governmental unit not to cease operations.

(5) *Contract with specific performance rights.* An output contract that provides the purchaser with specific rights to control the output of a facility or with other specific performance rights to the use of output of a facility is generally taken into account under the private business tests, even if the benefits and burdens test is not met. Payments made and to be made under such a contract are generally taken into account under the private payment test, even if the issuer does not reasonably expect that it is substantially certain that payments will be made under the contract (disregarding default, insolvency, or other similar circumstances). A customer's normal entitlement to receive utility service (for example, an entitlement to reasonable protection against blackouts in times of high demand through rotating the effects of blackouts) is not treated as a specific performance right for this purpose.

(d) *Measurement of private business use.* If an output contract results in private business use under this section, the amount of private business use generally is the capacity that must be reserved for the nongovernmental person under prudent reliability standards. For example, in the case of a take contract for a peaking electric generating unit, under which a nongovernmental person has priority rights to use capacity at any time for the entire term of the bonds, but under which the total energy purchases are limited in any one year to 10 percent of annual available output (determined by reference to nameplate capacity), the amount of private business use is the amount of capacity that must be reserved for that nongovernmental person under prudent reliability standards, which may be as much as 100 percent.

(e) *Measurement of private security or payment.* The measurement of payments made or to be made by nongovernmental persons under output contracts as a percent of the debt service of an issue is determined under the rules provided in § 1.141–4.

(f) *Exceptions for certain contracts*—(1) *Small purchases of output.* An output contract is not taken into account under the private business tests if the purchaser is not required under the contract to make a payment that is substantially certain to be made under paragraph (c)(2)(ii) of this section in any year greater than 0.5 percent of the average annual debt service on an issue that finances the output facility.

(2) *Swapping and pooling arrangements.* An agreement that provides for swapping or pooling of output by one or more governmental persons and one or more nongovernmental persons does not result in private business use of the output facility owned by the governmental person to the extent that—

(i) The swapped output is reasonably expected to be approximately equal in value (determined over periods of one year or less); and

(ii) The purpose of the agreement is to enable each of the parties to satisfy different peak load demands, to accommodate temporary outages, to diversify supply, or to enhance reliability in accordance with prudent reliability standards.

(3) *Short-term output contracts.* The exceptions for short-term arrangements provided in § 1.141–3 (c) and (d)(3) apply to output contracts. For example, a spot sale for use for a period of 90 days on the basis of rates that are generally applicable and uniformly applied generally does not result in private business use, and a spot sale for use for a period of 30 days on the basis of rates that are specially negotiated generally does not result in private business use.

(4) *Special 3-year exception for sales of output attributable to excess generating capacity resulting from participation in open access.* The purchase of output of an output facility (not including a water facility) by a nongovernmental person is not treated as private business use if all of the following requirements are met:

(i) The term of the contract is not longer than 3 years, including all renewal options.

(ii) The issuer does not make expenditures to increase the generating capacity of its system during the term of the contract that are, or will be, financed with proceeds of tax-exempt bonds.

(iii) The governmental owner offers non-discriminatory, open access transmission tariffs for use of its transmission system pursuant to rules promulgated by the FERC under sections 205 and 206 of the Federal Power Act (16 U.S.C. 824d and 824e) (or comparable provisions of state law pursuant to a plan approved by the FERC).

(iv) All of the output sold under the contract is attributable to excess capacity resulting from the offer of the non-discriminatory, open access transmission tariffs referred to in paragraph (f)(5)(ii) of this section.

(v) The contract mitigates stranded costs of the governmental owner that are attributable to the offer of the non-discriminatory, open access transmission tariffs referred to in paragraph (f)(5)(ii) of this section.

(vi) Any stranded costs recovered by the governmental owner (including amounts recovered under the contract) with respect to the output facility under rules promulgated by the FERC under the Federal Power Act (or comparable provisions of state law) are applied as promptly as is reasonably practical to redeem tax-exempt bonds that financed that facility in a manner consistent with § 1.141–12.

(5) *Special exceptions for transmission facilities*—(i) *Mandated wheeling.* Entering into a contract for the use of transmission facilities financed by an issue is not treated as a deliberate action under §1.141–2(d) if—

(A) The contract is entered into in response to (or in anticipation of) an order by the United States under sections 211 and 212 of the Federal Power Act (16 U.S.C. 824j and 824k) (or a State regulatory authority under comparable provisions of state law pursuant to a plan approved by the FERC); and

(B) The terms of the contract are bona fide and arm's length, and the consideration paid is consistent with the provisions of section 212(a) of the Federal Power Act.

(ii) *Actions taken to implement non-discriminatory, open access.* An action is not treated as a deliberate action under §1.141–2(d) if it is taken to implement the offering of non-discriminatory, open access tariffs for the use of transmission facilities financed by an issue in a manner consistent with rules promulgated by the FERC under sections 205 and 206 of the Federal Power Act (16 U.S.C. 824d and 824e) (or by a state regulatory authority under comparable provisions of state law pursuant to a plan approved by the FERC). This paragraph (f)(5)(ii) does not apply, however, to the sale, exchange, or other disposition of transmission facilities to a nongovernmental person.

(iii) *Application to reasonable expectations test to certain current refunding bonds.* An action taken or to be taken with respect to transmission facilities refinanced by an issue is not taken into account under the reasonable expectations test of §1.141–2(d) if—

(A) The action is described in paragraph (f)(5) (i) or (ii) of this section;

(B) The bonds of the issue are current refunding bonds that, directly or indirectly, refund bonds issued before July 9, 1996; and

(C) The weighted average maturity of the refunding bonds is not greater than the remaining weighted average maturity of those prior bonds.

(6) *Certain conduit parties disregarded.* A nongovernmental person acting solely as a conduit for the exchange of output among governmentally owned and operated utilities is disregarded in determining whether the private business tests are met with respect to financed facilities owned by a governmental person. Use of property by a power marketer in the trade or business of purchasing and reselling power, however, is taken into account under the private business tests.

(g) *Allocations of output facilities and systems*—(1) *Facts and circumstances analysis.* Whether output sold under an output contract is allocated to a particular facility (for example, a generating unit), to the entire system of the seller of that output (net of any uses of that system output allocated to a particular facility), or to a portion of a facility is based on all the facts and circumstances. Significant factors to be considered in determining the allocation of an output contract to financed property are the following:

(i) The extent to which it is physically possible to deliver output to or from a particular facility or system.

(ii) The terms of a contract relating to the delivery of output (such as delivery limitations and options or obligations to deliver power from additional sources).

(iii) Whether a contract is entered into as part of a common plan of financing for a facility.

(iv) The method of pricing output under the contract, such as the use of market rates rather than rates designed to pay debt service of tax-exempt bonds used to finance a particular facility.

(2) *Illustrations.* The following illustrate the factors set forth in paragraph (g)(1) of this section:

(i) *Physical possibility.* Output from a generating unit that is fed directly into a low voltage distribution system of the owner of that unit and that cannot physically leave that distribution system generally must be allocated to those receiving electricity through that distribution system. Output may be allocated without regard to physical limitations, however, if exchange or similar agreements provide output to a purchaser where, but for the exchange agreements, it would not be possible for the seller to provide output to that purchaser.

(ii) *Contract terms relating to performance.* A contract to provide a specified amount of electricity from a system, but only when at least that amount of electricity is being generated by a particular unit, is allocated to that unit. For example, a contract to buy 20 MW of system power with a right to take up to 40 percent of the actual output of a specific 50 MW facility whenever total system output is insufficient to meet all of the seller's obligations generally is allocated to the specific facility rather than to the system.

(iii) *Common plan of financing.* A contract entered into as part of a common plan of financing for a facility generally is allocated to the facility if debt service for the issue of bonds is reasonably expected to be paid, directly or indirectly, from payments substantially certain to be made under the contract (disregarding default, insolvency, or other similar circumstances).

(iv) *Pricing method.* Pricing based on the capital and generating costs of a particular turbine tends to indicate that output under the contract is properly allocated to that turbine.

(3) *Transmission contracts.* Whether use under an output contract for transmission is allocated to a particular facility or to a transmission network is based on all the facts and circumstances, in a manner similar to paragraphs (g) (1) and (2) of this section. In general, the method used to determine payments under a contract is a more significant contract term for this purpose than nominal contract path. In general, if reasonable and consistently applied, the determination of use of transmission facilities under an output contract may be based on a method used by third parties, such as reliability councils.

(4) *Allocation of payments.* Payments for output provided by an output facility financed with two or more sources of funding are generally allocated under the rules in § 1.141–4(c).

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

Example 1. Joint ownership. Z, an investor-owned electric utility, and City H agree to construct an electric generating facility of a size sufficient to take advantage of the economies of scale. H will issue $50 million of its 25-year bonds, and Z will use $100 million of its funds for construction of a facility they will jointly own as tenants in common. Each of the participants will share in the ownership, output, and operating expenses of the facility in proportion to its contribution to the cost of the facility, that is, one-third by H and two-thirds by Z. H's bonds will be secured by H's ownership interest in the facility and by revenues to be derived from its share of the annual output of the facility. H will need only 50 percent of its share of the annual output of the facility during the first 20 years of operations. It agrees to sell 10 percent of its share of the annual output to Z for a period of 20 years pursuant to a contract under which Z agrees to take that power if available. The facility will begin operation, and Z will begin to receive power, 4 years after the H bonds are issued. The measurement period for the property financed by the issue is 21 years. H also will sell the remaining 40 percent of its share of the annual output to numerous other private utilities under contracts of 90 days or less entered into under a prevailing rate schedule, including demand charges. No contracts will be executed obligating any person other than Z to purchase any specified amount of the power for any specified period of time. No person (other than Z) will make payments substantially certain to be made (disregarding default, insolvency, or other similar circumstances) under paragraph (c)(2) of this section that will result in a transfer of substantial burdens of paying debt service on bonds used directly or indirectly to provide H's share of the facilities. The bonds are not private activity bonds, because H's one-third interest in the facility is not treated as used by the other owners of the facility. Although 10 percent of H's share of the annual output of the facility will be used in the trade or business of Z, a non-governmental person, under the rule in paragraph (c) of this section, that portion constitutes not more than 10 percent of the available output of H's ownership interest in the facility.

Example 2. Requirements contract treated as take contract. (i) City J issues 20-year bonds to acquire an electric generating facility having a reasonably expected economic life substantially greater than 20 years and a nameplate capacity of 100 MW. The available output of the facility under paragraphs (b)(1) of this section is approximately 17,520,000 MWh. On the issue date, J enters into a contract with T, an investor-owned utility, to provide T with all of its power requirements for a period of 10 years, commencing on the issue date. J reasonably expects that T will actually purchase an average of 20 MW over the 10-year period. Based on all of the facts and circumstances, including the size, diversity, and composition of T's customer base, J reasonably expects that it is substantially certain (disregarding default, insolvency, or other similar circumstances) that T will actually purchase only an average of 16 MW over the 10-year period. The contract is a requirements contract that must be taken into account under the private business tests pursuant to paragraph (c)(4) of this section because it provides T with substantial benefits of ownership (rights to capacity) and obligates T with substantial burdens of making payments that the issuer reasonably expects are substantially certain.

(ii) J is required to reserve for T's use 40 MW of capacity in accordance with prudent reliability standards. Under paragraph (d) of this section, the amount of private business use under this contract, therefore, is approximately 20 percent (40 MW × 24 hours × 365 days × 10 years, or 3,504,000 MWh) of the available output. Accordingly, the issue meets the private business use test. J reasonably expects that the amount to be paid for an average of 16 MW of power (less the operation and maintenance costs directly attributable to generating that 16 MW of power), will be more than 10 percent of debt service on the issue on a present-value basis. The payment for 16 MW of power is an amount that J reasonably expects is substantially certain to be made under paragraph (c)(2) of this section. Accordingly, the issue meets the private security or payment test because J reasonably expects that it is substantially certain that payment of more than 10 percent of the debt service will be indirectly derived from payments by T. The bonds are private activity bonds under paragraph (c) of this section. Further, if 20 percent of the sale proceeds of the issue is greater than $15 million and the issue meets the private security or payment test with respect to the $15 million output limitation, the bonds are also private activity bonds under section 141(b)(4). See §1.141–8T.

Example 3. Allocation of existing contracts to new facilities. Power Authority K, a political subdivision created by the legislature in State X to own and operate certain power generating facilities, sells all of the power from its existing facilities to four private utility systems under contracts executed in 1999, under which the four systems are required to take or pay for specified portions of the total power output until the year 2029. Existing facilities supply all of the present needs of the four utility systems, but their future power requirements are expected to increase substantially beyond the capacity of K's current generating system. K issues 20-year bonds in 2004 to construct a large generating facility. As part of the financing plan for the bonds, a fifth private utility system contracts with K to take or pay for 15 percent of the available output of the new facility. The balance of the output of the new facility will be available for sale as required, but initially it is not anticipated that there will be any need for that power. The revenues from the contract with the fifth private utility system will be sufficient to pay less than 10 percent of the debt service on the bonds (determined on a present value basis). The balance, which will exceed 10 percent of the debt service on the bonds, will be paid from revenues derived from the contracts with the four systems initially from sale of power produced by the old facilities. The output contracts with all the private utilities are allocated to K's entire generating system. See paragraphs (g)(1) and (2) of this section. Thus, the bonds meet the private business use test because more than 10 percent of the proceeds will be used in the trade or business of a nongovernmental person. In addition, the bonds meet the private payment or security test because payment of more than 10 percent of the debt service, pursuant to underlying arrangements, will be derived from payments in respect of property used for a private business use.

Example 4. Allocation to displaced resource. Municipal utility MU, a political sub- division, purchases all of the electricity required to meet the needs of its customers (1,000 MW) from B, an investor-owned utility that operates its own electric generating facilities, under a 50-year take or pay contract. MU does not anticipate that it will require additional electric resources, and any new resources would produce electricity at a higher cost to MU than its cost under its contract with B. Nevertheless, B encourages MU to construct a new generating plant sufficient to meet MU's requirements. MU issues obligations to construct facilities that will produce 1,000 MW of electricity. MU, B, and I, another investor-owned utility, enter into an agreement under which MU assigns to I its rights under MU's take or pay contract with B. Under this arrangement, I will pay MU, and MU will continue to pay B, for the 1,000 MW. I's payments to MU will at least equal the amounts required to pay debt service on MU's bonds. In addition, under paragraph (g)(1)(iii) of this section, the contract among MU, B, and I is entered into as part of a common plan of financing of the MU facilities. Under all the facts and circumstances, MU's assignment to I of its rights under the original take or pay contract is allocable to MU's new facilities under paragraph (g) of this section. Because I is a nongovernmental person, MU's bonds are private activity bonds.

Example 5. Transmission facilities transferred to independent system operator. (i) In 1998, the public utilities commission of State C adopts a plan for restructuring its electric power industry. The plan fosters competition by providing both wholesale and retail customers with non-discriminatory access to transmission facilities within the State. The plan provides that investor-owned utilities will transfer operating control over all of their transmission assets to an independent system operator (ISO), which is a nongovernmental person that will operate those combined assets as a single, state-wide system. Municipally-owned utilities are eligible for, but are not required to participate in, the open access system implemented by the ISO. The functions of the ISO include control of transmission access and pricing, scheduling transmission, control area operations, and settlements and billing. In addition, under certain circumstances the ISO may order the transmission owners to construct additional transmission facilities. The restructuring plan is approved by the FERC pursuant to sections 205 and 206 of the Federal Power Act.

(ii) In 1994 City D had issued bonds to finance improvements to its transmission system. In 1998, D transfers operating control of its transmission system to the ISO pursuant to the restructuring plan. At the same time, D chooses to apply the private activity bond regulations of §§ 1.141–0 through 1.141–15 to the 1994 bonds. The operation of the financed facilities by the ISO does not meet the exception for management contracts that do not give rise to private business use under § 1.141–3(b)(4)(iii)(C) because it is not a contract solely for the operation of a facility under that exception. Under the special exception in paragraph (f)(5) of this section, however, the transfer of control is not treated as a deliberate action. Accordingly, the transfer of control does not cause the 1994 bonds to meet the private activity bond tests.

Example 6. Current refunding. The facts are the same as in *Example 5* of this paragraph (h), and in addition D issues bonds in 1999 to currently refund the 1994 bonds. The weighted average maturity of the 1999 bonds is not greater than the remaining weighted average maturity of the 1994 bonds. D chooses to apply the private activity bond regulations of §§ 1.141–0 through 1.141-15 to the refunding bonds. In general, reasonable expectations must be separately tested on the date that refunding bonds are issued under § 1.141–2(d). Under the special exception in paragraph (f)(5) of this section, however, the transfer of the financed facilities to the ISO need not be taken into account in applying the reasonable expectations test to the refunding bonds.

[T.D. 8757, 63 FR 3260, Jan. 22, 1998]

§ 1.141–8T $15 million limitation for output facilities (temporary).

(a) *In general*—(1) *General rule.* Section 141(b)(4) provides a special private activity bond limitation (the $15 million output limitation) for issues 5 percent or more of the proceeds of which are to be used to finance output facilities (other than a facility for the furnishing of water). Under this rule, a bond is a private activity bond under the private business tests of section 141(b) (1) and (2) if the nonqualified amount with respect to output facilities financed by the proceeds of the issue exceeds $15 million. The $15 million output limitation applies in addition to the private business tests of section 141(b) (1) and (2). Under section 141(b)(4) and paragraph (a)(2) of this section, the $15 million output limitation is reduced in certain cases. Specifically, an issue meets the test in section 141(b)(4) if both of the following tests are met:

(i) More than $15 million of the proceeds of the issue to be used with respect to an output facility are to be used for a private business use. Investment proceeds are disregarded for this purpose if they are not allocated disproportionately to the private business use portion of the issue.

(ii) The payment of the principal of, or the interest on, more than $15 million of the sales proceeds of the portion of the issue used with respect to an output facility is (under the terms of the issue or any underlying arrangement) directly or indirectly—

(A) Secured by any interest in an output facility used or to be used for a private business use (or payments in respect of such an output facility); or

(B) To be derived from payments (whether or not to the issuer) in respect of an output facility used or to be used for a private business use.

(2) *Reduction in $15 million output limitation for outstanding issues*—(i) *General rule.* In determining whether an issue more than 5 percent of the proceeds of which are to be used with respect to an output facility consists of private activity bonds under the $15 million output limitation, the $15 million limitation on private business use and private security or payments is applied by taking into account the aggregate nonqualified amounts of any outstanding bonds of other issues 5 percent or more of the proceeds of which are or will be used with respect to that output facility or any other output facility that is part of the same project.

(ii) *Bonds taken into account.* For purposes of this paragraph (a)(2), in applying the $15 million output limitation to an issue (the later issue), a tax-exempt bond of another issue (the earlier issue) is taken into account if—

(A) That bond is outstanding on the issue date of the later issue;

(B) That bond will not be redeemed within 90 days of the issue date of the later issue in connection with the refunding of that bond by the later issue; and

(C) More than 5 percent of the sale proceeds of the earlier issue financed an output facility that is part of the same project as the output facility that is financed by more than 5 percent of the sale proceeds of the later issue.

(3) *Benefits and burdens test applicable*—(i) *In general.* In applying the $15 million output limitation, the benefits and burdens test of § 1.141–7T applies, except that ''$15 million'' is substituted for ''10 percent'', or ''5 percent'' as appropriate.

(ii) *Earlier issues for the project.* If bonds of an earlier issue are outstanding and must be taken into account under paragraph (a)(2) of this section, the nonqualified amount for that earlier issue is multiplied by a fraction, the numerator of which is the adjusted issue price of the earlier issue as of the issue date of the later issue, and the denominator of which is the issue price of the earlier issue. Pre-issuance accrued interest as defined in § 1.148–1(b) is disregarded for this purpose.

(b) *Definition of project*—(1) *General rule.* For purposes of paragraph (a)(2) of this section, *project* has the meaning provided in this paragraph. Facilities that are functionally related and subordinate to a project are treated as part of that same project. Facilities having different purposes or serving different customer bases are not ordinarily part of the same project. For example, the following are generally not part of the same project—

(i) Generation and transmission facilities;

(ii) Separate facilities designed to serve wholesale customers and retail customers; and

(iii) A peaking unit and a baseload unit.

(2) *Separate ownership.* Except as otherwise provided in this paragraph (b)(2), facilities that are not owned by the same person are not part of the same project. If different governmental persons act in concert to finance a project, however (for example as participants in a joint powers authority), their interests are aggregated with respect to that project to determine whether the $15 million output limitation is met. In the case of undivided ownership interests in a single output facility, property that is not owned by different persons is treated as separate projects only if the separate interests are financed—

(i) With bonds of different issuers; and

(ii) Without a principal purpose of avoiding the limitation in this section.

(3) *Generating property*—(i) *Property on same site.* In the case of generation and related facilities, *project* means property located at the same site.

(ii) *Special rule for generating units.* Separate generating units are not part of the same project, if one unit is reasonably expected, on the date of each issue that finances the project, to be placed in service more than 3 years before the other. Common facilities or property that will be functionally related to more than one generating unit must be allocated on a reasonable basis. If a generating unit already is constructed or is under construction (the first unit) and bonds are to be issued to finance an additional generating unit (the second unit), all costs for any common facilities paid or incurred before the earlier of the issue date of bonds to finance the second unit or the commencement of construction of the second unit are allocated to the first unit. At the time that bonds are issued to finance the second unit (or, if earlier, upon commencement of construction of that unit), any remaining costs of the common facilities may be allocated among the first and second units so that in the aggregate the allocation is reasonable.

(4) *Transmission.* In the case of transmission facilities, *project* means functionally related or contiguous property and property for ancillary services,

such as property required to be included in open access transmission tariffs under rules of the FERC. Separate transmission facilities are not part of the same project if one facility is reasonably expected, on the issue date of each issue that finances the project, to be placed in service more than 2 years before the other.

(5) *Subsequent improvements*—(i) *In general.* An improvement to generating or transmission facilities that is not part of the original design of those facilities (the original project) is not part of the same project as the original project if the construction, reconstruction, or acquisition of that improvement commences more than 3 years after the original project was placed in service and the bonds issued to finance that improvement are issued more than 3 years after the original project was placed in service.

(ii) *Special rule for transmission facilities.* An improvement to transmission facilities that is not part of the original design of that property is not part of the same project as the original project if the issuer did not reasonably expect the need to make that improvement when it commenced construction of the original project and the construction, reconstruction, or acquisition of that improvement is mandated by the federal government or a state regulatory authority to accommodate requests for wheeling.

(6) *Replacement property.* For purposes of this section, property that replaces existing property of an output facility is treated as part of the same project as the replaced property unless—

(i) The need to replace the property was not reasonably expected on the issue date or the need to replace the property occurred more than 3 years before the issuer reasonably expected (determined on the issue date of the bonds financing the property) that it would need to replace the property; and

(ii) The bonds that finance (and refinance) the replaced property have a weighted average maturity that is not greater than 120 percent of the reasonably expected economic life of the replaced property.

(c) *Example.* The application of the provisions of this section is illustrated by the following example:

Example. (i) Power Authority K, a political subdivision, intends to issue a single issue of tax-exempt bonds at par with a stated principal amount and sales proceeds of $500 million to finance the acquisition of an electric generating facility. No portion of the facility will be used for a private business use, except that L, an investor-owned utility, will purchase 10 percent of the output of the facility under a take contract and will pay 10 percent of the debt service on the bonds. The nonqualified amount with respect to the bonds is $50 million.

(ii) The maximum amount of tax-exempt bonds that may be issued for the acquisition of an interest in the facility in paragraph (i) of this *Example* is $465 million (that is, $450 million for the 90 percent of the facility that is governmentally owned and used plus a nonqualified amount of $15 million).

[T.D. 8757, 63 FR 3264, Jan. 22, 1998]

§ 1.141–9 Unrelated or disproportionate use test.

(a) *General rules*—(1) *Description of test.* Under section 141(b)(3) (the unrelated or disproportionate use test), an issue meets the private business tests if the amount of private business use and private security or payments attributable to unrelated or disproportionate private business use exceeds 5 percent of the proceeds of the issue. For this purpose, the private business use test is applied by taking into account only use that is not related to any government use of proceeds of the issue (unrelated use) and use that is related but disproportionate to any government use of those proceeds (disproportionate use).

(2) *Application of unrelated or disproportionate use test*—(i) *Order of application.* The unrelated or disproportionate use test is applied by first determining whether a private business use is related to a government use. Next, private business use that relates to a government use is examined to determine whether it is disproportionate to that government use.

(ii) *Aggregation of unrelated and disproportionate use.* All the unrelated use and disproportionate use financed with the proceeds of an issue are aggregated to determine compliance with the unrelated or disproportionate use test. The amount of permissible unrelated and disproportionate private business use is not reduced by the amount of private business use financed with the proceeds of an issue that is neither unrelated use nor disproportionate use.

(iii) *Deliberate actions.* A deliberate action that occurs after the issue date does not result in unrelated or disproportionate use if the issue meets the conditions of § 1.141–12(a).

(b) *Unrelated use*—(1) *In general.* Whether a private business use is related to a government use financed with the proceeds of an issue is determined on a case-by-case basis, emphasizing the operational relationship between the government use and the private business use. In general, a facility that is used for a related private business use must be located within, or adjacent to, the governmentally used facility.

(2) *Use for the same purpose as government use.* Use of a facility by a nongovernmental person for the same purpose as use by a governmental person is not treated as unrelated use if the government use is not insignificant. Similarly, a use of a facility in the same manner both for private business use that is related use and private business use that is unrelated use does not result in unrelated use if the related use is not insignificant. For example, a privately owned pharmacy in a governmentally owned hospital does not ordinarily result in unrelated use solely because the pharmacy also serves individuals not using the hospital. In addition, use of parking spaces in a garage by a nongovernmental person is not treated as unrelated use if more than an insignificant portion of the parking spaces are used for a government use (or a private business use that is related to a government use), even though the use by the nongovernmental person is not directly related to that other use.

(c) *Disproportionate use*—(1) *Definition of disproportionate use.* A private business use is disproportionate to a related government use only to the extent that the amount of proceeds used for that private business use exceeds the amount of proceeds used for the related government use. For example, a private use of $100 of proceeds that is related to a government use of $70 of proceeds results in $30 of disproportionate use.

(2) *Aggregation of related uses.* If two or more private business uses of the proceeds of an issue relate to a single government use of those proceeds, those private business uses are aggregated to apply the disproportionate use test.

(3) *Allocation rule.* If a private business use relates to more than a single use of the proceeds of the issue (for example, two or more government uses of the proceeds of the issue or a government use and a private use), the amount of any disproportionate use may be determined by—

(i) Reasonably allocating the proceeds used for the private business use among the related uses;

(ii) Aggregating government uses that are directly related to each other; or

(iii) Allocating the private business use to the government use to which it is primarily related.

(d) *Maximum use taken into account.* The determination of the amount of unrelated use or disproportionate use of a facility is based on the maximum amount of reasonably expected government use of a facility during the measurement period. Thus, no unrelated use or disproportionate use arises solely because a facility initially has excess capacity that is to be used by a nongovernmental person if the facility will be completely used by the issuer during the term of the issue for more than an insignificant period.

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

Example 1. School and remote cafeteria. County X issues bonds with proceeds of $20 million and uses $18.1 million of the proceeds for construction of a new school building and $1.9 million of the proceeds for construction of a privately operated cafeteria in its administrative office building, which is located at a remote site. The bonds are secured, in part, by the cafeteria. The $1.9 million of proceeds is unrelated to the government use (that is, school construction) financed with the bonds and exceeds 5 percent of $20 million. Thus, the issue meets the private business tests.

Example 2. Public safety building and courthouse. City Y issues bonds with proceeds of $50 million for construction of a new public safety building ($32 million) and for improvements to an existing courthouse ($15 million). Y uses $3 million of the bond proceeds for renovations to an existing privately operated cafeteria located in the courthouse. The bonds are secured, in part, by the cafeteria. Y's use of the $3 million for the privately operated cafeteria does not meet the unrelated or disproportionate use test because these expenditures are neither unrelated use nor disproportionate use.

Example 3. Unrelated garage. City Y issues bonds with proceeds of $50 million for construction of a new public safety building ($30.5 million) and for improvements to an existing courthouse ($15 million). Y uses $3 million of the bond proceeds for renovations to an existing privately operated cafeteria located in the courthouse. The bonds are secured, in part, by the cafeteria. Y also uses $1.5 million of the proceeds to construct a privately operated parking garage adjacent to a private office building. The private business use of the parking garage is unrelated to any government use of proceeds of the issue. Since the proceeds used for unrelated uses and disproportionate uses do not exceed 5 percent of the proceeds, the unrelated or disproportionate use test is not met.

Example 4. Disproportionate use of garage. County Z issues bonds with proceeds of $20 million for construction of a hospital with no private business use ($17 million); renovation of an office building with no private business use ($1 million); and construction of a garage that is entirely used for a private business use ($2 million). The use of the garage is related to the use of the office building but not to the use of the hospital. The private business use of the garage results in $1 million of disproportionate use because the proceeds used for the garage ($2 million) exceed the proceeds used for the related government use ($1 million). The bonds are not private activity bonds, however, because the disproportionate use does not exceed 5 percent of the proceeds of the issue.

Example 5. Bonds for multiple projects. (i) County W issues bonds with proceeds of $80 million for the following purposes: (1) $72 million to construct a County-owned and operated waste incinerator; (2) $1 million for a County-owned and operated facility for the temporary storage of hazardous waste prior to final disposal; (3) $1 million to construct a privately owned recycling facility located at a remote site; and (4) $6 million to build a garage adjacent to the County-owned incinerator that will be leased to Company T to store and repair trucks that it owns and uses to haul County W refuse. Company T uses 75 percent of its trucks to haul materials to the incinerator and the remaining 25 percent of its trucks to haul materials to the temporary storage facility.

(ii) The $1 million of proceeds used for the recycling facility is used for an unrelated use. The garage is related use. In addition, 75 percent of the use of the $6 million of proceeds used for the garage is allocable to the government use of proceeds at the incinerator. The remaining 25 percent of the proceeds used for the garage ($1.5 million) relates to the government use of proceeds at the temporary storage facility. Thus, this portion of the proceeds used for the garage exceeds the proceeds used for the temporary storage facility by $0.5 million and this excess is disproportionate use (but not unrelated use). Thus, the aggregate amount of unrelated use and disproportionate use financed with the proceeds of the issue is $1.5 million. Alternatively, under paragraph (c)(3)(iii) of this section, the entire garage may be treated as related to the government use of the incinerator and, under that allocation, the garage is not disproportionate use. In either event, section 141(b)(3) limits the aggregate unrelated use and disproportionate use to $4 million. Therefore, the bonds are not private activity bonds under this section.

[T.D. 8712, 62 FR 2297, Jan. 16, 1997]

§ 1.141–10 Coordination with volume cap. [Reserved]

§ 1.141–11 Acquisition of nongovernmental output property. [Reserved]

§ 1.141–12 Remedial actions.

(a) *Conditions to taking remedial action.* An action that causes an issue to meet the private business tests or the private loan financing test is not treated as a deliberate action if the issuer takes a remedial action described in paragraph (d), (e), or (f) of this section with respect to the nonqualified bonds and if all of the requirements in paragraphs (a) (1) through (5) of this section are met.

(1) *Reasonable expectations test met.* The issuer reasonably expected on the issue date that the issue would meet neither the private business tests nor the private loan financing test for the entire term of the bonds. For this purpose, if the issuer reasonably expected on the issue date to take a deliberate action prior to the final maturity date of the issue that would cause either the private business tests or the private loan financing test to be met, the term of the bonds for this purpose may be determined by taking into account a redemption provision if the provisions of § 1.141–2(d)(2)(ii) (A) through (C) are met.

(2) *Maturity not unreasonably long.* The term of the issue must not be longer than is reasonably necessary for

the governmental purposes of the issue (within the meaning of §1.148–1(c)(4)). Thus, this requirement is met if the weighted average maturity of the bonds of the issue is not greater than 120 percent of the average reasonably expected economic life of the property financed with the proceeds of the issue as of the issue date.

(3) *Fair market value consideration.* Except as provided in paragraph (f) of this section, the terms of any arrangement that results in satisfaction of either the private business tests or the private loan financing test are bona fide and arm's-length, and the new user pays fair market value for the use of the financed property. Thus, for example, fair market value may be determined in a manner that takes into account restrictions on the use of the financed property that serve a bona fide governmental purpose.

(4) *Disposition proceeds treated as gross proceeds for arbitrage purposes.* The issuer must treat any disposition proceeds as gross proceeds for purposes of section 148. For purposes of eligibility for temporary periods under section 148(c) and exemptions from the requirement of section 148(f) the issuer may treat the date of receipt of the disposition proceeds as the issue date of the bonds and disregard the receipt of disposition proceeds for exemptions based on expenditure of proceeds under §1.148–7 that were met before the receipt of the disposition proceeds.

(5) *Proceeds expended on a governmental purpose.* Except for a remedial action under paragraph (d) of this section, the proceeds of the issue that are affected by the deliberate action must have been expended on a governmental purpose before the date of the deliberate action.

(b) *Effect of a remedial action*—(1) *In general.* The effect of a remedial action is to cure use of proceeds that causes the private business use test or the private loan financing test to be met. A remedial action does not affect application of the private security or payment test.

(2) *Effect on bonds that have been advance refunded.* If proceeds of an issue were used to advance refund another bond, a remedial action taken with respect to the refunding bond proportionately reduces the amount of proceeds of the advance refunded bond that is taken into account under the private business use test or the private loan financing test.

(c) *Disposition proceeds*—(1) *Definition. Disposition proceeds* are any amounts (including property, such as an agreement to provide services) derived from the sale, exchange, or other disposition (disposition) of property (other than investments) financed with the proceeds of an issue.

(2) *Allocating disposition proceeds to an issue.* In general, if the requirements of paragraph (a) of this section are met, after the date of the disposition, the proceeds of the issue allocable to the transferred property are treated as financing the disposition proceeds rather than the transferred property. If a disposition is made pursuant to an installment sale, the proceeds of the issue continue to be allocated to the transferred property. If an issue does not meet the requirements for remedial action in paragraph (a) of this section or the issuer does not take an appropriate remedial action, the proceeds of the issue are allocable to either the transferred property or the disposition proceeds, whichever allocation produces the greater amount of private business use and private security or payments.

(3) *Allocating disposition proceeds to different sources of funding.* If property has been financed by different sources of funding, for purposes of this section, the disposition proceeds from that property are first allocated to the outstanding bonds that financed that property in proportion to the principal amounts of those outstanding bonds. In no event may disposition proceeds be allocated to bonds that are no longer outstanding or to a source of funding not derived from a borrowing (such as revenues of the issuer) if the disposition proceeds are not greater than the total principal amounts of the outstanding bonds that are allocable to that property. For purposes of this paragraph (c)(3), principal amount has the same meaning as in §1.148–9(b)(2) and outstanding bonds do not include advance refunded bonds.

(d) *Redemption or defeasance of nonqualified bonds*—(1) *In general.* The requirements of this paragraph (d) are met if all of the nonqualified bonds of the issue are redeemed. Proceeds of tax-exempt bonds must not be used for this purpose, unless the tax-exempt bonds are qualified bonds, taking into account the purchaser's use of the facility. If the bonds are not redeemed within 90 days of the date of the deliberate action, a defeasance escrow must be established for those bonds within 90 days of the deliberate action.

(2) *Special rule for dispositions for cash.* If the consideration for the disposition of financed property is exclusively cash, the requirements of this paragraph (d) are met if the disposition proceeds are used to redeem a pro rata portion of the nonqualified bonds at the earliest call date after the deliberate action. If the bonds are not redeemed within 90 days of the date of the deliberate action, the disposition proceeds must be used to establish a defeasance escrow for those bonds within 90 days of the deliberate action.

(3) *Notice of defeasance.* The issuer must provide written notice to the Commissioner of the establishment of the defeasance escrow within 90 days of the date the defeasance escrow is established.

(4) *Special limitation.* The establishment of a defeasance escrow does not satisfy the requirements of this paragraph (d) if the period between the issue date and the first call date of the bonds is more than 10 1/2 years.

(5) *Defeasance escrow defined.* A defeasance escrow is an irrevocable escrow established to redeem bonds on their earliest call date in an amount that, together with investment earnings, is sufficient to pay all the principal of, and interest and call premium on, bonds from the date the escrow is established to the earliest call date. The escrow may not be invested in higher yielding investments or in any investment under which the obligor is a user of the proceeds of the bonds.

(e) *Alternative use of disposition proceeds*—(1) *In general.* The requirements of this paragraph (e) are met if—

(i) The deliberate action is a disposition for which the consideration is exclusively cash;

(ii) The issuer reasonably expects to expend the disposition proceeds within two years of the date of the deliberate action;

(iii) The disposition proceeds are treated as proceeds for purposes of section 141 and are used in a manner that does not cause the issue to meet either the private business tests or the private loan financing test, and the issuer does not take any action subsequent to the date of the deliberate action to cause either of these tests to be met; and

(iv) If the issuer does not use all of the disposition proceeds for an alternative use described in paragraph (e)(1)(iii) of this section, the issuer uses those remaining disposition proceeds for a remedial action that meets paragraph (d) of this section.

(2) *Special rule for use by 501(c)(3) organizations.* If the disposition proceeds are to be used by a 501(c)(3) organization, the nonqualified bonds must in addition be treated as reissued for purposes of sections 141, 145, 147, 149, and 150 and, under this treatment, satisfy all of the applicable requirements for qualified 501(c)(3) bonds. Thus, beginning on the date of the deliberate action, nonqualified bonds that satisfy these requirements must be treated as qualified 501(c)(3) bonds for all purposes, including sections 145(b) and 150(b).

(f) *Alternative use of facility.* The requirements of this paragraph (f) are met if—

(1) The facility with respect to which the deliberate action occurs is used in an alternative manner (for example, used for a qualifying purpose by a nongovernmental person or used by a 501(c)(3) organization rather than a governmental person);

(2) The nonqualified bonds are treated as reissued, as of the date of the deliberate action, for purposes of sections 55 through 59 and 141, 142, 144, 145, 146, 147, 149 and 150, and under this treatment, the nonqualified bonds satisfy all the applicable requirements for qualified bonds throughout the remaining term of the nonqualified bonds;

(3) The deliberate action does not involve a disposition to a purchaser that finances the acquisition with proceeds of another issue of tax-exempt bonds; and

(4) Any disposition proceeds other than those arising from an agreement to provide services (including disposition proceeds from an installment sale) resulting from the deliberate action are used to pay the debt service on the bonds on the next available payment date or, within 90 days of receipt, are deposited into an escrow that is restricted to the yield on the bonds to pay the debt service on the bonds on the next available payment date.

(g) *Rules for deemed reissuance.* For purposes of determining whether bonds that are treated as reissued under paragraphs (e) and (f) of this section are qualified bonds—

(1) The provisions of the Code and regulations thereunder in effect as of the date of the deliberate action apply; and

(2) For purposes of paragraph (f) of this section, section 147(d) (relating to the acquisition of existing property) does not apply.

(h) *Authority of Commissioner to provide for additional remedial actions.* The Commissioner may, by publication in the FEDERAL REGISTER or the Internal Revenue Bulletin, provide additional remedial actions, including making a remedial payment to the United States, under which a subsequent action will not be treated as a deliberate action for purposes of §1.141–2.

(i) *Effect of remedial action on continuing compliance.* Solely for purposes of determining whether deliberate actions that are taken after a remedial action cause an issue to meet the private business tests or the private loan financing test—

(1) If a remedial action is taken under paragraph (d), (e), or (f) of this section, the private business use or private loans resulting from the deliberate action are not taken into account for purposes of determining whether the bonds are private activity bonds; and

(2) After a remedial action is taken, the amount of disposition proceeds is treated as equal to the proceeds of the issue that had been allocable to the transferred property immediately prior to the disposition. See paragraph (k) of this section, *Example 5.*

(j) *Nonqualified bonds*—(1) *Amount of nonqualified bonds.* The percentage of outstanding bonds that are nonqualified bonds equals the highest percentage of private business use in any 1-year period commencing with the deliberate action.

(2) *Allocation of nonqualified bonds.* Allocations to nonqualified bonds must be made on a pro rata basis, except that, for purposes of paragraph (d) of this section (relating to redemption or defeasance), an issuer may treat bonds with longer maturities (determined on a bond-by-bond basis) as the nonqualified bonds.

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

Example 1. Disposition proceeds less than outstanding bonds used to retire bonds. On June 1, 1997, City C issues 30-year bonds with an issue price of $10 million to finance the construction of a hospital building. The bonds have a weighted average maturity that does not exceed 120 percent of the reasonably expected economic life of the building. On the issue date, C reasonably expects that it will be the only user of the building for the entire term of the bonds. Six years after the issue date, C sells the building to Corporation P for $5 million. The sale price is the fair market value of the building, as verified by an independent appraiser. C uses all of the $5 million disposition proceeds to immediately retire a pro rata portion of the bonds. The sale does not cause the bonds to be private activity bonds because C has taken a remedial action described in paragraph (d) of this section so that P is not treated as a private business user of bond proceeds.

Example 2. Lease to nongovernmental person. The facts are the same as in *Example 1,* except that instead of selling the building, C, 6 years after the issue date, leases the building to P for 7 years and uses other funds to redeem all of the $10 million outstanding bonds within 90 days of the deliberate act. The bonds are not treated as private activity bonds because C has taken the remedial action described in paragraph (d) of this section.

Example 3. Sale for less than fair market value. The facts are the same as in *Example 1,* except that the fair market value of the building at the time of the sale to P is $6 million. Because the transfer was for less than fair market value, the bonds are ineligible for the remedial actions under this section. The bonds are private activity bonds because P is treated as a user of all of the proceeds and P makes a payment ($6 million) for this use that is greater than 10 percent of the debt service on the bonds, on a present value basis.

Example 4. Fair market value determined taking into account governmental restrictions. The facts are the same as in *Example 1,* except that the building was used by C only for hospital purposes and C determines to sell the building subject to a restriction that it be used only for hospital purposes. After conducting a public bidding procedure as required by state law, the best price that C is able to obtain for the building subject to this restriction is $4.5 million from P. C uses all of the $4.5 million disposition proceeds to immediately retire a pro rata portion of the bonds. The sale does not cause the bonds to be private activity bonds because C has taken a remedial action described in paragraph (d) of this section so that P is not treated as a private business user of bond proceeds.

Example 5. Alternative use of disposition proceeds. The facts are the same as in *Example 1,* except that C reasonably expects on the date of the deliberate action to use the $5 million disposition proceeds for another governmental purpose (construction of governmentally owned roads) within two years of receipt, rather than using the $5 million to redeem outstanding bonds. C treats these disposition proceeds as gross proceeds for purposes of section 148. The bonds are not private activity bonds because C has taken a remedial action described in paragraph (e) of this section. After the date of the deliberate action, the proceeds of all of the outstanding bonds are treated as used for the construction of the roads, even though only $5 million of disposition proceeds was actually used for the roads.

Example 6. Alternative use of financed property. The facts are the same as in *Example 1,* except that C determines to lease the hospital building to Q, an organization described in section 501(c)(3), for a term of 10 years rather than to sell the building to P. In order to induce Q to provide hospital services, C agrees to lease payments that are less than fair market value. Before entering into the lease, an applicable elected representative of C approves the lease after a noticed public hearing. As of the date of the deliberate action, the issue meets all the requirements for qualified 501(c)(3) bonds, treating the bonds as reissued on that date. For example, the issue meets the two percent restriction on use of proceeds of finance issuance costs of section 147(g) because the issue pays no costs of issuance from disposition proceeds in connection with the deemed reissuance. C and Q treat the bonds as qualified 501(c)(3) bonds for all purposes commencing with the date of the deliberate action. The bonds are treated as qualified 501(c)(3) bonds commencing with the date of the deliberate action.

Example 7. Deliberate action before proceeds are expended on a governmental purpose. County J issues bonds with proceeds of $10 million that can be used only to finance a correctional facility. On the issue date of the bonds, J reasonably expects that it will be the sole user of the bonds for the useful life of the facility. The bonds have a weighted average maturity that does not exceed 120 percent of the reasonably expected economic life of the facility. After the issue date of the bonds, but before the facility is placed in service, J enters into a contract with the federal government pursuant to which the federal government will make a fair market value, lump sum payment equal to 25 percent of the cost of the facility. In exchange for this payment, J provides the federal government with priority rights to use of 25 percent of the facility. J uses the payment received from the federal government to defease the nonqualified bonds. The agreement does not cause the bonds to be private activity bonds because J has taken a remedial action described in paragraph (d) of this section. See paragraph (a)(5) of this section.

Example 8. Compliance after remedial action. In 1997, City G issues bonds with proceeds of $10 million to finance a courthouse. The bonds have a weighted average maturity that does not exceed 120 percent of the reasonably expected economic life of the courthouse. G uses $1 million of the proceeds for a private business use and more than 10 percent of the debt service on the issue is secured by private security or payments. G later sells one-half of the courthouse property to a nongovernmental person for cash. G immediately redeems 60 percent of the outstanding bonds. This percentage of outstanding bonds is based on the highest private business use of the courthouse in any 1-year period commencing with the deliberate action. For purposes of subsequently applying section 141 to the issue, G may continue to use all of the proceeds of the outstanding bonds in the same manner (that is, for both the courthouse and the existing private business use) without causing the issue to meet the private business use test. The issue, however, continues to meet the private security or payment test. The result would be the same if D, instead of redeeming the bonds, established a defeasance escrow for those bonds, provided that the requirement of paragraph (d)(4) of this section was met.

[T.D. 8712, 62 FR 2298, Jan. 16, 1997]

§ 1.141–13 Refunding issues. [Reserved]

§ 1.141–14 Anti-abuse rules.

(a) *Authority of Commissioner to reflect substance of transactions.* If an issuer enters into a transaction or series of transactions with respect to one or more issues with a principal purpose of transferring to nongovernmental persons (other than as members of the general public) significant benefits of tax-exempt financing in a manner that is inconsistent with the purposes of section 141, the Commissioner may take any action to reflect the substance of the transaction or series of transactions, including—

(1) Treating separate issues as a single issue for purposes of the private activity bond tests;

(2) Reallocating proceeds to expenditures, property, use, or bonds;

(3) Reallocating payments to use or proceeds;

(4) Measuring private business use on a basis that reasonably reflects the economic benefit in a manner different than as provided in §1.141–3(g); and

(5) Measuring private payments or security on a basis that reasonably reflects the economic substance in a manner different than as provided in §1.141–4.

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

Example 1. Reallocating proceeds to indirect use. City C issues bonds with proceeds of $20 million for the stated purpose of financing improvements to roads that it owns. As a part of the same plan of financing, however, C also agrees to make a loan of $7 million to Corporation M from its general revenues that it otherwise would have used for the road improvements. The interest rate of the loan corresponds to the interest rate on a portion of the issue. A principal purpose of the financing arrangement is to transfer to M significant benefits of the tax-exempt financing. Although C actually allocates all of the proceeds of the bonds to the road improvements, the Commissioner may reallocate a portion of the proceeds of the bonds to the loan to M because a principal purpose of the financing arrangement is to transfer to M significant benefits of tax-exempt financing in a manner that is inconsistent with the purposes of section 141. The bonds are private activity bonds because the issue meets the private loan financing test. The bonds also meet the private business tests. See also §§1.141–3(a)(2), 1.141–4(a)(1), and 1.141–5(a), under which indirect use of proceeds and payments are taken into account.

Example 2. Taking into account use of amounts derived from proceeds that would be otherwise disregarded. County B issues bonds with proceeds of $10 million to finance the purchase of land. On the issue date, B reasonably expects that it will be the sole user of the land. Subsequently, the federal government acquires the land for $3 million in a condemnation action. B uses this amount to make a loan to Corporation M. In addition, the interest rate on the loan reflects the tax-exempt interest rate on the bonds and thus is substantially less than a current market rate. A principal purpose of the arrangement is to transfer to M significant benefits of the tax-exempt financing. Although the condemnation action is not a deliberate action, the Commissioner may treat the condemnation proceeds as proceeds of the issue because a principal purpose of the arrangement is to transfer to M significant benefits of tax-exempt financing in a manner inconsistent with the purposes of section 141. The bonds are private activity bonds.

Example 3. Measuring private business use on an alternative basis. City F issues bonds with a 30-year term to finance the acquisition of an industrial building having a remaining reasonably expected useful economic life of more than 30 years. On the issue date, F leases the building to Corporation G for 3 years. F reasonably expects that it will be the sole user of the building for the remaining term of the bonds. Because of the local market conditions, it is reasonably expected that the fair rental value of the industrial building will be significantly greater during the early years of the term of the bonds than in the later years. The annual rental payments are significantly less than fair market value, reflecting the interest rate on the bonds. The present value of these rental payments (net of operation and maintenance expenses) as of the issue date, however, is approximately 25 percent of the present value of debt service on the issue. Under §1.141–3, the issue does not meet the private business tests, because only 10 percent of the proceeds are used in a trade or business by a nongovernmental person. A principal purpose of the issue is to transfer to G significant benefits of tax-exempt financing in a manner inconsistent with the purposes of section 141. The method of measuring private business use over the reasonably expected useful economic life of financed property is for the administrative convenience of issuers of state and local bonds. In cases where this method is used in a manner inconsistent with the purposes of section 141, the Commissioner may measure private business use on another basis that reasonably reflects economic benefit, such as in this case on an annual basis. If the Commissioner measures private business use on an annual basis, the bonds are private activity bonds because the private payment test is met and more than 10 percent of the proceeds are used in a trade or business by a nongovernmental person.

Example 4. Treating separate issues as a single issue. City D enters into a development agreement with Corporation T to induce T to locate its headquarters within D's city limits. Pursuant to the development agreement, in 1997 D will issue $20 million of its general obligation bonds (the 1997 bonds) to purchase land that it will grant to T. The development agreement also provides that, in 1998, D will issue $20 million of its tax increment bonds (the 1998 bonds), secured solely by the increase in property taxes in a special taxing district. Substantially all of the property within the special taxing district is owned by T or D. T will separately enter into an agreement to guarantee the payment of tax increment to D in an amount sufficient to retire the 1998 bonds. The proceeds of the 1998 bonds will be used to finance improvements owned and operated by D that will not give rise to private business use. Treated separately, the 1997 issue meets the private business use test, but not the private security or payment test; the 1998 issue meets the private security or payment test, but not the private business use test. A principal purpose of the financing plan, including the two issues, is to transfer significant benefits of tax-exempt financing to T for its headquarters. Thus, the 1997 issue and the 1998 issue may be treated by the Commissioner as a single issue for purposes of applying the private activity bond tests. Accordingly, the bonds of both the 1997 issue and the 1998 issue may be treated as private activity bonds.

Example 5. Reallocating proceeds. City E acquires an electric generating facility with a useful economic life of more than 40 years and enters into a 30-year take or pay contract to sell 30 percent of the available output to investor-owned utility M. E plans to use the remaining 70 percent of available output for its own governmental purposes. To finance the entire cost of the facility, E issues $30 million of its series A taxable bonds at taxable interest rates and $70 million series B bonds, which purport to be tax-exempt bonds, at tax-exempt interest rates. E allocates all of M's private business use to the proceeds of the series A bonds and all of its own government use to the proceeds of the series B bonds. The series A bonds have a weighted average maturity of 15 years, while the series B bonds have a weighted average maturity of 26 years. M's payments under the take or pay contract are expressly determined by reference to 30 percent of M's total costs (that is, the sum of the debt service required to be paid on both the series A and the series B bonds and all other operating costs). The allocation of all of M's private business use to the series A bonds does not reflect economic substance because the series of transactions transfers to M significant benefits of the tax-exempt interest rates paid on the series B bonds. A principal purpose of the financing arrangement is to transfer to M significant benefits of the tax-exempt financing. Accordingly, the Commissioner may allocate M's private business use on a pro rata basis to both the series B bonds as well as the series A bonds, in which case the series B bonds are private activity bonds.

Example 6. Allocations respected. The facts are the same as in *Example 5,* except that the debt service component of M's payments under the take or pay contract is based exclusively on the amounts necessary to pay the debt service on the taxable series A bonds. E's allocation of all of M's private business use to the series A bonds is respected because the series of transactions does not actually transfer benefits of tax-exempt interest rates to M. Accordingly, the series B bonds are not private activity bonds. The result would be the same if M's payments under the take or pay contract were based exclusively on fair market value pricing, rather than the tax-exempt interest rates on E's bonds. The result also would be the same if the series A bonds and the series B bonds had substantially equivalent weighted average maturities and E and M had entered into a customary contract providing for payments based on a ratable share of total debt service. E would not be treated by the Commissioner in any of these cases as entering into the contract with a principal purpose of transferring the benefits of tax-exempt financing to M in a manner inconsistent with the purposes of section 141.

[T.D. 8712, 62 FR 2301, Jan. 16, 1997]

§ 1.141–15 Effective dates.

(a) *Scope.* The effective dates of this section apply for purposes of §§ 1.141–1 through 1.141–6(a), 1.141–9 through 1.141–14, 1.145–1 through 1.145–2, 1.150–1(a)(3) and the definition of bond documents contained in § 1.150–1(b).

(b) *Effective dates.* Except as otherwise provided in this section, §§ 1.141–1 through 1.141–6(a), 1.141–9 through 1.141–14, 1.145–1 through 1.145–2, 1.150–1(a)(3) and the definition of bond documents contained in § 1.150–1(b) apply to bonds issued on or after May 16, 1997, that are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602).

(c) *Refunding bonds.* Sections 1.141–1 through 1.141–6(a), 1.141–9 through 1.141–14, 1.145–1 through 1.145–2, 1.150–1(a)(3) and the definition of bond documents contained in § 1.150–1(b) do not apply to any bonds issued on or after May 16, 1997, to refund a bond to which those sections do not apply unless—

(1) The weighted average maturity of the refunding bonds is longer than—

(i) The weighted average maturity of the refunded bonds; or

(ii) In the case of a short-term obligation that the issuer reasonably expects to refund with a long-term financing (such as a bond anticipation note), 120 percent of the weighted average reasonably expected economic life of the facilities financed; or

(2) A principal purpose for the issuance of the refunding bonds is to make one or more new conduit loans.

(d) *Permissive application of regulations.* Except as provided in paragraph (e) of this section, §§1.141–1 through 1.141–6(a), 1.141–9 through 1.141–14, 1.145–1 through 1.145–2, 1.150–1(a)(3) and the definition of bond documents contained in §1.150–1(b) may be applied in whole, but not in part, to actions taken before February 23, 1998 with respect to—

(1) Bonds that are outstanding on May 16, 1997, and subject to section 141; or

(2) Refunding bonds issued on or after May 16, 1997.

(e) *Permissive retroactive application of certain sections.* The following sections may each be applied to any bonds issued before May 16, 1997—

(1) Section 1.141–3(b)(4);

(2) Section 1.141–3(b)(6); and

(3) Section 1.141–12.

[T.D. 8757, 63 FR 3265, Jan. 22, 1998]

§1.141–15T Effective dates (temporary).

(a) through (e) [Reserved]. For guidance see §1.141–15.

(f) *Effective dates for certain regulations relating to output facilities*—(1) *General rule.* Except as otherwise provided in this section, §§1.141–7T and 1.141–8T apply to bonds issued on or after February 23, 1998 that are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602).

(2) *Transition rule for requirements contracts.* Section 1.141–7T(c)(4) applies to output contracts entered into on or after February 23, 1998. An output contract is treated as entered into on or after that date if its term is extended, the parties to the contract change, or other material terms are amended on or after that date.

(g) *Refunding bonds in general.* Except as otherwise provided in paragraph (h) or (i) of this section, §§1.141–7T and 1.141–8T do not apply to bonds issued on or after February 23, 1998, to refund a bond to which the §§1.141–7T and 1.141–8T do not apply unless—

(1) The weighted average maturity of the refunding bonds is longer than—

(i) The weighted average maturity of the refunded bonds; or

(ii) In the case of short-term financings (such as a bond anticipation note), 120 percent of the weighted average reasonably expected economic life of the facilities financed; or

(2) A principal purpose of the issuance of the refunding bonds is to make one or more new conduit loans.

(h) *Permissive retroactive application.* Except as provided in §1.141–15 (d) or (e) or paragraph (i) of this section, §§1.141–1 through 1.141–6, 1.141–7T through 1.141–8T, 1.141–9 through 1.141–14, 1.145–1 through 1.145–2, 1.150–1(a)(3) and the definition of bond documents contained in §1.150–1(b) may be applied in whole, but not in part to—

(1) Bonds that are outstanding on May 16, 1997, and subject to section 141; or

(2) Refunding bonds issued on or after May 16, 1997.

(i) *Permissive retroactive application of certain regulations pertaining to output contracts.* Section 1.141–7T(f) (4) and (5) may be applied to any bonds issued before February 23, 1998.

[T.D. 8757, 63 FR 3266, Jan. 22, 1998]

§1.141–16 Effective dates for qualified private activity bond provisions.

(a) *Scope.* The effective dates of this section apply for purposes of §§1.142–0 through 1.142–2, 1.144–0 through 1.144–2, 1.147–0 through 1.147–2, and 1.150–4.

(b) *Effective dates.* Except as otherwise provided in this section, the regulations designated in paragraph (a) of this section apply to bonds issued on or after May 16, 1997 (the effective date).

(c) *Permissive application.* The regulations designated in paragraph (a) of this section may be applied in whole, but not in part, to bonds outstanding on the effective date.

[T.D. 8712, 62 FR 2302, Jan. 16, 1997]

§1.142–0 Table of contents.

This section lists the captioned paragraphs contained in §§1.142–1 through 1.142–3.

§1.142–1 Exempt facility bonds.

(a) Overview.

(b) Scope.

(c) Effective dates.

§1.142–2 Remedial actions.

(a) General rule.

(b) Reasonable expectations requirement.

(c) Redemption or defeasance.

(1) In general.

(2) Notice of defeasance.

(3) Special limitation.

(4) Special rule for dispositions of personal property.

(5) Definitions.

(d) When a failure to properly use proceeds occurs.

(1) Proceeds not spent.

(2) Proceeds spent.

(e) Nonqualified bonds.

§ 1.142–3 Refunding issues.

[Reserved]

[T.D. 8712, 62 FR 2302, Jan. 16, 1997]

§ 1.142–1 Exempt facility bonds.

(a) *Overview*. Interest on a private activity bond is not excludable from gross income under section 103(a) unless the bond is a qualified bond. Under section 141(e)(1)(A), an exempt facility bond issued under section 142 may be a qualified bond.

Under section 142(a), an exempt facility bond is any bond issued as a part of an issue using 95 percent or more of the proceeds for certain exempt facilities.

(b) *Scope*. Sections 1.142–0 through 1.142–3 apply for purposes of the rules for exempt facility bonds under section 142, except that, with respect to net proceeds that have been spent, § 1.142–2 does not apply to bonds issued under section 142(d) (relating to bonds issued to provide qualified residential rental projects) and section 142(f) (2) and (4) (relating to bonds issued to provide local furnishing of electric energy or gas).

(c) *Effective dates*. For effective dates of §§ 1.142–0 through 1.142–2, see § 1.141–16.

[T.D. 8712, 62 FR 2302, Jan. 16, 1997]

§ 1.142–2 Remedial actions.

(a) *General rule*. If less than 95 percent of the net proceeds of an exempt facility bond are actually used to provide an exempt facility, and for no other purpose, the issue will be treated as meeting the use of proceeds requirement of section 142(a) if the issue meets the condition of paragraph (b) of this section and the issuer takes the remedial action described in paragraph (c) of this section.

(b) *Reasonable expectations requirement*. The issuer must have reasonably expected on the issue date that 95 percent of the net proceeds of the issue would be used to provide an exempt facility and for no other purpose for the entire term of the bonds (disregarding any redemption provisions). To meet this condition the amount of the issue must have been based on reasonable estimates about the cost of the facility.

(c) *Redemption or defeasance*—(1) *In general*. The requirements of this paragraph (c) are met if all of the nonqualified bonds of the issue are redeemed on the earliest call date after the date on which the failure to properly use the proceeds occurs under paragraph (d) of this section. Proceeds of tax-exempt bonds (other than those described in paragraph (d)(1) of this section) must not be used for this purpose. If the bonds are not redeemed within 90 days of the date on which the failure to properly use proceeds occurs, a defeasance escrow must be established for those bonds within 90 days of that date.

(2) *Notice of defeasance*. The issuer must provide written notice to the Commissioner of the establishment of the defeasance escrow within 90 days of the date the escrow is established.

(3) *Special limitation*. The establishment of a defeasance escrow does not satisfy the requirements of this paragraph (c) if the period between the issue date and the first call date is more than 10½ years.

(4) *Special rule for dispositions of personal property*. For dispositions of personal property exclusively for cash, the requirements of this paragraph (c) are met if the issuer expends the disposition proceeds within 6 months of the date of the disposition to acquire replacement property for the same qualifying purpose of the issue under section 142.

(5) *Definitions*. For purposes of paragraph (c)(4) of this section, *disposition proceeds* means disposition proceeds as defined in § 1.141–12(c).

(d) *When a failure to properly use proceeds occurs*—(1) *Proceeds not spent*. For net proceeds that are not spent, a failure to properly use proceeds occurs on the earlier of the date on which the issuer reasonably determines that the financed facility will not be completed or the date on which the financed facility is placed in service.

(2) *Proceeds spent.* For net proceeds that are spent, a failure to properly use proceeds occurs on the date on which an action is taken that causes the bonds not to be used for the qualifying purpose for which the bonds were issued.

(e) *Nonqualified bonds.* For purposes of this section, the nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the failure to properly use the proceeds occurs, at least 95 percent of the net proceeds of the remaining bonds would be used to provide an exempt facility. If no proceeds have been spent to provide an exempt facility, all of the outstanding bonds are nonqualified bonds. The nonqualified bonds must be determined on a pro rata allocation basis, except that an issuer may treat bonds with longer maturities (determined on a bond-by-bond basis) as the nonqualified bonds.

[T.D. 8712, 62 FR 2302, Jan. 16, 1997]

§1.142–3 Refunding Issues. [Reserved]

§1.142–4 Use of proceeds to provide a facility.

(a) *In general.* [Reserved]

(b) *Reimbursement allocations.* If an expenditure for a facility is paid before the issue date of the bonds to provide that facility, the facility is described in section 142(a) only if the expenditure meets the requirements of §1.150–2 (relating to reimbursement allocations). For purposes of this paragraph (b), if the proceeds of an issue are used to pay principal of or interest on an obligation other than a State or local bond (for example, temporary construction financing of the conduit borrower), that issue is not a refunding issue, and, thus, §1.150–2(g) does not apply.

(c) *Limitation on use of facilities by substantial users*—(1) *In general.* If the original use of a facility begins before the issue date of the bonds to provide the facility, the facility is not described in section 142(a) if any person that was a substantial user of the facility at any time during the 5-year period before the issue date or any related person to that user receives (directly or indirectly) 5 percent or more of the proceeds of the issue for the user's interest in the facility and is a substantial user of the facility at any time during the 5-year period after the issue date, unless—

(i) An official intent for the facility is adopted under §1.150–2 within 60 days after the date on which acquisition, construction, or reconstruction of that facility commenced; and

(ii) For an acquisition, no person that is a substantial user or related person after the acquisition date was also a substantial user more than 60 days before the date on which the official intent was adopted.

(2) *Definitions.* For purposes of paragraph (c)(1) of this section, *substantial user* has the meaning used in section 147(a)(1), *related person* has the meaning used in section 144(a)(3), and a user that is a governmental unit within the meaning of §1.103–1 is disregarded.

(d) *Effective date*—(1) *In general.* This section applies to bonds sold on or after July 8, 1997. See §1.103–8(a)(5) for rules applicable to bonds sold before that date.

(2) *Elective retroactive application.* An issuer may apply this section to any bond sold before July 8, 1997.

[T.D. 8718, 62 FR 25506, May 9, 1997]

§1.142(a)(5)–1 Exempt facility bonds: Sewage facilities.

(a) *In general.* Under section 103(a), a private activity bond is a tax-exempt bond only if it is a qualified bond. A qualified bond includes an exempt facility bond, defined as any bond issued as part of an issue 95 percent or more of the net proceeds of which are used to provide a facility specified in section 142. One type of facility specified in section 142(a) is a sewage facility. This section defines the term *sewage facility* for purposes of section 142(a).

(b) *Definitions*—(1) *Sewage facility defined.* A sewage facility is property—

(i) Except as provided in paragraphs (b)(2) and (d) of this section, used for the secondary treatment of wastewater; however, for property treating wastewater reasonably expected to have an average daily raw wasteload concentration of biochemical oxygen demand (BOD) that exceeds 350 milligrams per liter as oxygen (measured at the time the influent enters the facility) (the *BOD limit*), this paragraph (b)(1)(i) applies only to the extent the treatment is for wastewater having an average daily raw wasteload concentration of BOD that does not exceed the BOD limit;

(ii) Used for the preliminary and/or primary treatment of wastewater but only to the extent used in connection with secondary treatment (without regard to the BOD limit described in paragraph (b)(1)(i) of this section);

(iii) Used for the advanced or tertiary treatment of wastewater but only to the extent used in connection with and after secondary treatment;

(iv) Used for the collection, storage, use, processing, or final disposal of—

(A) Wastewater, which property is necessary for such preliminary, primary, secondary, advanced, or tertiary treatment; or

(B) Sewage sludge removed during such preliminary, primary, secondary, advanced, or tertiary treatment (without regard to the BOD limit described in paragraph (b)(1)(i) of this section);

(v) Used for the treatment, collection, storage, use, processing, or final disposal of septage (without regard to the BOD limit described in paragraph (b)(1)(i) of this section); and

(vi) Functionally related and subordinate to property described in this paragraph (b)(1), such as sewage disinfection property.

(2) *Special rules and exceptions*—(i) *Exception to BOD limit.* A facility treating wastewater with an average daily raw wasteload concentration of BOD exceeding the BOD limit will not fail to qualify as a sewage facility described in paragraph (b)(1) of this section to the extent that the failure to satisfy the BOD limit results from the implementation of a federal, state, or local water conservation program (for example, a program designed to promote water use efficiency that results in BOD concentrations beyond the BOD limit).

(ii) *Anti-abuse rule for BOD limit.* A facility does not satisfy the BOD limit if there is any intentional manipulation of the BOD level to circumvent the BOD limit (for example, increasing the volume of water in the wastewater before the influent enters the facility with the intention of reducing the BOD level).

(iii) *Authority of Commissioner.* In appropriate cases upon application to the Commissioner, the Commissioner may determine that facilities employing technologically advanced or innovative treatment processes qualify as sewage facilities if it is demonstrated that these facilities perform functions that are consistent with the definition of sewage facilities described in paragraph (b)(1) of this section.

(3) *Other applicable definitions*—(i) *Advanced or tertiary treatment* means the treatment of wastewater after secondary treatment. Advanced or tertiary treatment ranges from biological treatment extensions to physical-chemical separation techniques such as denitrification, ammonia stripping, carbon adsorption, and chemical precipitation.

(ii) *Nonconventional pollutants* are any pollutants that are not listed in 40 CFR 401.15, 401.16, or appendix A to part 423.

(iii) *Preliminary treatment* means treatment that removes large extraneous matter from incoming wastewater and renders the incoming wastewater more amenable to subsequent treatment and handling.

(iv) *Pretreatment* means a process that preconditions wastewater to neutralize or remove toxic, priority, or nonconventional pollutants that could adversely affect sewers or inhibit a preliminary, primary, secondary, advanced, or tertiary treatment operation.

(v) *Primary treatment* means treatment that removes material that floats or will settle, usually by screens or settling tanks.

(vi) *Priority pollutants* are those pollutants listed in appendix A to 40 CFR part 423.

(vii) *Secondary treatment* means the stage in sewage treatment in which a bacterial process (or an equivalent process) consumes the organic parts of wastes, usually by trickling filters or an activated sludge process.

(viii) *Sewage sludge* is defined in 40 CFR 122.2 and includes septage.

(ix) *Toxic pollutants* are those pollutants listed in 40 CFR 401.15.

(c) *Other property not included in the definition of a sewage facility.* Property other than property described in paragraph (b)(1) of this section is not a sewage facility. Thus, for example, property is not a sewage facility, or functionally related and subordinate property, if the property is used for pretreatment of wastewater (whether or not this treatment is necessary to perform preliminary, primary, secondary, advanced, or tertiary treatment), or the related collection, storage, use, processing, or final disposal of the wastewater. In addition, property used to treat, process, or use wastewater subsequent to the time the wastewater can be discharged into navigable waters, as defined in 33 U.S.C. 1362, is not a sewage facility.

(d) *Allocation of costs.* In the case of property that has both a use described in paragraph (b)(1) of this section (a sewage treatment function) and a use other than sewage treatment, only the portion of the cost of the property allocable to the sewage treatment function is taken into account as an expenditure to provide sewage facilities. The portion of the cost of property allocable to the sewage treatment function is determined by allocating the cost of that property between the property's sewage treatment function and any other uses by any method which, based on all the facts and circumstances, reasonably reflects a separation of costs for each use of the property.

(e) *Effective date*—(1) *In general.* This section applies to issues of bonds issued after February 21, 1995.

(2) *Refundings.* In the case of a refunding bond issued to refund a bond to which this section does not apply, the issuer need not apply this section to that refunding bond. This paragraph (e)(2) applies only if the weighted average maturity of the refunding bonds, as described in section 147(b), is not greater than the remaining weighted average maturity of the refunded bonds.

[T.D. 8576, 59 FR 66163, Dec. 23, 1994]

§ 1.142(f)(4)–1T Manner of making election to terminate tax-exempt bond financing (temporary).

(a) *Overview.* Section 142(f)(4) permits a person engaged in the local furnishing of electric energy or gas (a local furnisher) that uses facilities financed with exempt facility bonds under section 142(a)(8) and that expands its service area in a manner inconsistent with the requirements of sections 142(a)(8) and 142(f) to make an election to ensure that those bonds will continue to be treated as exempt facility bonds. The election must meet the requirements of paragraphs (b) and (c) of this section.

(b) *Time for making election*—(1) *In general.* An election under section 142(f)(4)(B) must be filed with the Internal Revenue Service on or before 90 days after the later of—

(i) The date of the service area expansion that causes bonds to cease to meet the requirements of sections 142(a)(8) and 142(f); or

(ii) February 23, 1998.

(2) *Date of service area expansion.* For the purposes of this section, the date of the service area expansion is the first date on which the local furnisher is authorized to collect revenue for the provision of service in the expanded area.

(c) *Manner of making election.* An election under section 142(f)(4)(B) must be captioned ‘‘ELECTION TO TERMINATE TAX-EXEMPT BOND FINANCING’’, must be signed under penalties of perjury by a person who has authority to sign on behalf of the local furnisher, and must contain the following information—

(1) The name of the local furnisher;

(2) The tax identification number of the local furnisher;

(3) The complete address of the local furnisher;

(4) The date of the service area expansion;

(5) Identification of each bond issue subject to the election, including the complete name of each issue, the tax identification number of each issuer, the issue date of each issue, the issue price of each issue, the adjusted issue price of each issue as of the date of the election, the earliest date on which the bonds of each issue may be redeemed, and the principal amount of bonds of each issue to be redeemed on the earliest redemption date;

(6) A statement that the local furnisher making the election agrees to the conditions stated in section 142(f)(4)(B); and

(7) A statement that each issuer of the bonds subject to the election has received written notice of the election.

(d) *Effect on section 150(b).* Except as provided in paragraph (e) of this section, if a local furnisher files an election within the period specified in paragraph (b) of this section, section 150(b) does not apply to bonds identified in the election during and after that period.

(e) *Effect of failure to meet agreements.* If a local furnisher fails to meet any of the conditions stated in an election pursuant to paragraph (c)(6) of this section, the election is invalid.

(f) *Corresponding provisions of the Internal Revenue Code of 1954.* Section 103(b)(4)(E) of the Internal Revenue Code of 1954 set forth corresponding requirements for the exclusion from gross income of the interest on bonds issued for facilities for the local furnishing of electric energy or gas. For the purposes of this section any reference to sections 142(a)(8) and (f) of the Internal Revenue Code of 1986 includes a reference to the corresponding portion of section 103(b)(4)(E) of the Internal Revenue Code of 1954.

(g) *Effective dates.* Section 1.142(f)(4)–1 applies to elections made on or after February 23, 1998.

[T.D. 8757, 63 FR 3266, Jan. 22, 1998]

§1.144–0 Table of contents.

This section lists the captioned paragraphs contained in §§1.144–1 and 1.144–2.

§1.144–1 Qualified small issue bonds, qualified student loan bonds, and qualified redevelopment bonds.

(a) Overview.

(b) Scope.

(c) Effective dates.

§1.144–2 Remedial actions.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997]

§1.144–1 Qualified small issue bonds, qualified student loan bonds, and qualified redevelopment bonds.

(a) *Overview*. Interest on a private activity bond is not excludable from gross income under section 103(a) unless the bond is a qualified bond. Under section 141(e)(1)(D), a qualified small issue bond issued under section 144(a) may be a qualified bond. Under section 144(a), any qualified small issue bond is any bond issued as a part of an issue 95 percent or more of the proceeds of which are to be used to provide certain manufacturing facilities or certain depreciable farm property and which meets other requirements. Under section 141(e)(1)(F) a qualified redevelopment bond issued under section 144(c) is a qualified bond. Under section 144(c), a qualified redevelopment bond is any bond issued as a part of an issue 95 percent or more of the net proceeds of which are to be used for one or more redevelopment purposes and which meets certain other requirements.

(b) *Scope.* Sections 1.144–0 through 1.144–2 apply for purposes of the rules for small issue bonds under section 144(a) and qualified redevelopment bonds under section 144(c), except that §1.144–2 does not apply to the requirements for qualified small issue bonds under section 144(a)(4) (relating to the limitation on capital expenditures) or under section 144(a)(10) (relating to the aggregate limit of tax-exempt bonds per taxpayer).

(c) *Effective dates.* For effective dates of §§1.144–0 through 1.144–2, see §1.141–16.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997]

§1.144–2 Remedial actions.

The remedial action rules of §1.142–2 apply to qualified small issue bonds issued under section 144(a) and to qualified redevelopment bonds issued under section 144(c), for this purpose treating those bonds as exempt facility bonds and the qualifying purposes for those bonds as exempt facilities.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997]

§1.145–0 Table of contents.

This section lists the captioned paragraphs contained in §§1.145–1 and 1.145–2.

§1.145–1 Qualified 501(c)(3) bonds.

(a) Overview.

(b) Scope.

(c) Effective dates.

§1.145–2 Application of private activity bond regulations.

(a) In general.

(b) Modification of private business tests.

(c) Exceptions.

(1) Certain provisions relating to governmental programs.

(2) Costs of issuance.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997]

§1.145–1 Qualified 501(c)(3) bonds.

(a) *Overview.* Interest on a private activity bond is not excludable from gross income under section 103(a) unless the bond is a qualified bond. Under section 141(e)(1)(G), a qualified 501(c)(3) bond issued under section 145 is a qualified bond. Under section 145, a qualified 501(c)(3) bond is any bond issued as a part of an issue that satisfies the requirements of sections 145(a) through (d).

(b) *Scope.* Sections 1.145–0 through 1.145–2 apply for purposes of section 145(a).

(c) *Effective dates.* For effective dates of §§1.145–0 through 1.145–2, see §1.141–15.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997]

§1.145–2 Application of private activity bond regulations.

(a) *In general.* Except as provided in this section, §§1.141–0 through 1.141–15 apply to section 145(a). For example, under this section, §1.141–1, and §1.141–2, an issue ceases to be an issue of qualified 501(c)(3) bonds if the issuer or a conduit borrower 501(c)(3) organization takes a deliberate action, subsequent to the issue date, that causes the issue to fail to comply with the requirements of sections 141(e) and 145 (such as an action that results in revocation of exempt status of the 501(c)(3) organization).

(b) *Modification of private business tests.* In applying §§1.141–0 through 1.141–15 to section 145(a)—

(1) References to governmental persons include 501(c)(3) organizations with respect to their activities that do not constitute unrelated trades or businesses under section 513(a);

(2) References to ‘‘10 percent’’ and ‘‘proceeds’’ in the context of the private business use test and the private security or payment test mean ‘‘5 percent’’ and ‘‘net proceeds’’; and

(3) References to the private business use test in §§1.141–2 and 1.141–12 include the ownership test of section 145(a)(1).

(c) *Exceptions*—(1) *Certain provisions relating to governmental programs.* The following provisions do not apply to section 145: §1.141–2(d)(4) (relating to the special rule for dispositions of personal property in the ordinary course of an established governmental program) and §1.141–2(d)(5) (relating to the special rule for general obligation bond programs that finance a large number of separate purposes).

(2) *Costs of issuance.* Section 1.141–3(g)(6) does not apply to section 145(a)(2) to the extent that it provides that costs of issuance are allocated ratably among the other purposes for which the proceeds are used. For purposes of section 145(a)(2), costs of issuance are treated as private business use.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997]

§1.147–0 Table of contents.

This section lists the captioned paragraphs contained in §§1.147–1 and 1.147–2.

§1.147–1 Other requirements applicable to certain private activity bonds.

(a) Overview.

(b) Scope.

(c) Effective dates.

§1.147–2 Remedial actions.

[T.D. 8712, 62 FR 2304, Jan. 16, 1997]

§1.147–1 Other requirements applicable to certain private activity bonds.

(a) *Overview.* Interest on a private activity bond is not excludable from gross income under section 103(a) unless the bond is a qualified bond. Under section 147, certain requirements must be met for a private activity bond to qualify as a qualified bond.

(b) *Scope.* Sections 1.147–0 through 1.147–2 apply for purposes of the rules in section 147 for qualified private activity bonds that permit use of proceeds to acquire land for environmental purposes (section 147(c)(3)), permit use of proceeds for certain rehabilitations (section 147(d) (2) and (3)), prohibit use of proceeds to finance skyboxes, airplanes, gambling establishments and similar facilities (section 147(e)), and require public approval (section 147(f)), but not for the rules limiting use of proceeds to acquire land or existing property under sections 147(c) (1) and (2), and (d)(1).

(c) *Effective dates.* For effective dates of §§ 1.147–0 through 1.147–2, see § 1.141–16.

[T.D. 8712, 62 FR 2304, Jan. 16, 1997]

§ 1.147–2 Remedial actions.

The remedial action rules of § 1.142–2 apply to the rules in section 147 for qualified private activity bonds that permit use of proceeds to acquire land for environmental purposes (section 147(c)(3)), permit use of proceeds for certain rehabilitations (section 147(d) (2) and (3)), prohibit use of proceeds to finance skyboxes, airplanes, gambling establishments and similar facilities (section 147(e)), and require public approval (section 147(f)), for this purpose treating those private activity bonds subject to the rules under section 147 as exempt facility bonds and the qualifying purposes for those bonds as exempt facilities.

[T.D. 8712, 62 FR 2304, Jan. 16, 1997]

§ 1.147(b)–1 Bond maturity limitation-treatment of working capital.

Section 147(b) does not apply to proceeds of a private activity bond issue used to finance working capital expenditures.

[T.D. 8476, 58 FR 33515, June 18, 1993]

§ 1.148–0 Scope and table of contents.

(a) *Overview.* Under section 103(a), interest on certain obligations issued by States and local governments is excludable from the gross income of the owners. Section 148 was enacted to minimize the arbitrage benefits from investing gross proceeds of tax-exempt bonds in higher yielding investments and to remove the arbitrage incentives to issue more bonds, to issue bonds earlier, or to leave bonds outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes for which the bonds were issued. To accomplish these purposes, section 148 restricts the direct and indirect investment of bond proceeds in higher yielding investments and requires that certain earnings on higher yielding investments be rebated to the United States. Violation of these provisions causes the bonds in the issue to become *arbitrage bonds,* the interest on which is not excludable from the gross income of the owners under section 103(a). The regulations in §§ 1.148–1 through 1.148–11 apply in a manner consistent with these purposes.

(b) *Scope.* Sections 1.148–1 through 1.148–11 apply generally for purposes of the arbitrage restrictions on State and local bonds under section 148.

(c) *Table of contents.* This paragraph (c) lists the table of contents for §§ 1.148–1, 1.148–2, 1.148–3, 1.148–4, 1.148–5, 1.148–6, 1.148–7, 1.148–8, 1.148–9, 1.148–10 and 1.148–11.

§ 1.148–1 Definitions and elections.

(a) In general.
(b) Certain definitions.
(c) Definition of replacement proceeds.
(1) In general.
(2) Sinking fund.
(3) Pledged fund.
(4) Other replacement proceeds.
(d) Elections.
(e) Investment-type property.

§ 1.148–2 General arbitrage yield restriction rules.

(a) In general.
(b) Reasonable expectations.
(1) In general.
(2) Certification of expectations.
(c) Intentional acts.
(d) Materially higher yielding investments.
(1) In general.
(2) Definitions of materially higher yield.
(3) Mortgage loans.
(e) Temporary periods.
(1) In general.
(2) General 3-year temporary period for capital projects and qualified mortgage loans.
(3) Temporary period for restricted working capital expenditures.
(4) Temporary period for pooled financings.
(5) Temporary period for replacement proceeds.
(6) Temporary period for investment proceeds.
(7) Other amounts.
(f) Reserve or replacement funds.
(1) General 10 percent limitation on funding with sale proceeds.
(2) Exception from yield restriction for reasonably required reserve or replacement funds.
(3) Certain parity reserve funds.
(g) Minor portion.
(h) Certain waivers permitted.

§ 1.148–3 General arbitrage rebate rules.

(a) In general.
(b) Definition of rebate amount.
(c) Computation of future value of a payment or receipt.
(d) Payments and receipts.
(1) Definition of payments.
(2) Definition of receipts.
(3) Special rules for commingled funds.

(e) Computation dates.
(1) In general.
(2) Final computation date.
(f) Amount of required rebate installment payment.
(1) Amount of interim rebate payments.
(2) Amount of final rebate payment.
(3) Future value of rebate payments.
(g) Time and manner of payment.
(h) Penalty in lieu of loss of tax exemption.
(1) In general.
(2) Interest on underpayments.
(3) Waivers of the penalty.
(4) Application to alternative penalty under §1.148–7.
(i) Recovery of overpayment of rebate.
(1) In general.
(2) Limitations on recovery.
(j) Examples.
(k) Bona fide debt service fund exception.
§1.148–4 Yield on an issue of bonds.
(a) In general.
(b) Computing yield on a fixed yield issue.
(1) In general.
(2) Yield on certain fixed yield bonds subject to mandatory or contingent early redemption.
(3) Yield on certain fixed yield bonds subject to optional early redemption.
(4) Yield recomputed upon transfer of certain rights associated with the bond.
(5) Special aggregation rule treating certain bonds as a single fixed yield bond.
(6) Examples.
(c) Computing yield on a variable yield issue.
(1) In general.
(2) Payments on bonds included in yield for a computation period.
(3) Example.
(d) Conversion from variable yield issue to fixed yield issue.
(e) Value of bonds.
(1) Plain par bonds.
(2) Other bonds.
(f) Qualified guarantees.
(1) In general.
(2) Interest savings.
(3) Guarantee in substance.
(4) Reasonable charge.
(5) Guarantee of purpose investments.
(6) Allocation of qualified guarantee payments.
(7) Refund or reduction of guarantee payments.
(g) Yield on certain mortgage revenue and student loan bonds.
(h) Qualified hedging transactions.
(1) In general.
(2) Qualified hedge defined.
(3) Accounting for qualified hedges.
(4) Certain variable yield bonds treated as fixed yield bonds.
(5) Contracts entered into before issue date of hedged bond.
(6) Authority of the Commissioner.
§1.148–5 Yield and valuation of investments.
(a) In general.
(b) Yield on an investment.
(1) In general.
(2) Yield on a separate class of investments.
(3) Investments to be held beyond issue's maturity or beyond temporary period.
(4) Consistent redemption assumptions on purpose investments.
(5) Student loan special allowance payments included in yield.
(c) Yield reduction payments to the United States.
(1) In general.
(2) Manner of payment.
(3) Applicability of special yield reduction rule.
(d) Value of investments.
(1) In general.
(2) Mandatory valuation of yield restricted investments at present value.
(3) Mandatory valuation of certain investments at fair market value.
(4) Special transition rule for transferred proceeds.
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§1.148–1 Definitions and elections.

(a) *In general.* The definitions in this section and the definitions under section 150 apply for purposes of section 148 and §§1.148–1 through 1.148–11.

(b) *Certain definitions.* The following definitions apply:

Accounting method means both the overall method used to account for gross proceeds of an issue (e.g., the cash method or a modified accrual method) and the method used to account for or allocate any particular item within that overall accounting method (e.g., accounting for investments, expenditures, allocations to and from different sources, and particular items of the foregoing).

Annuity contract means annuity contract as defined in section 72.

Available amount means available amount as defined in §1.148–6(d)(3)(iii).

Bona fide debt service fund means a fund, which may include proceeds of an issue, that—

(1) Is used primarily to achieve a proper matching of revenues with principal and interest payments within each bond year; and

(2) Is depleted at least once each bond year, except for a reasonable carryover amount not to exceed the greater of:

(i) the earnings on the fund for the immediately preceding bond year; or

(ii) one-twelfth of the principal and interest payments on the issue for the immediately preceding bond year.

Bond year means, in reference to an issue, each 1-year period that ends on the day selected by the issuer. The first and last bond years may be short periods. If no day is selected by the issuer before the earlier of the final maturity date of the issue or the date that is 5 years after the issue date, bond years end on each anniversary of the issue date and on the final maturity date.

Capital project or capital projects means all capital expenditures, plus related working capital expenditures to which the de minimis rule under §1.148–6(d)(3)(ii)(A) applies, that carry out the governmental purposes of an issue. For example, a capital project may include capital expenditures for one or more buildings, plus related start-up operating costs.

Commingled fund means any fund or account containing both gross proceeds of an issue and amounts in excess of $25,000 that are not gross proceeds of that issue if the amounts in the fund or account are invested and accounted for collectively, without regard to the source of funds deposited in the fund or account. An open-end regulated investment company under section 851, however, is not a commingled fund.

Computation date means each date on which the rebate amount for an issue is computed under § 1.148–3(e).

Computation period means the period between computation dates. The first computation period begins on the issue date and ends on the first computation date. Each succeeding computation period begins on the date immediately following the computation date and ends on the next computation date.

Consistently applied means applied uniformly within a fiscal period and between fiscal periods to account for gross proceeds of an issue and any amounts that are in a commingled fund.

De minimis amount means—

(1) In reference to original issue discount (as defined in section 1273(a)(1)) or premium on an obligation—

(i) An amount that does not exceed 2 percent multiplied by the stated redemption price at maturity; plus

(ii) Any original issue premium that is attributable exclusively to reasonable underwriters' compensation; and

(2) In reference to market discount (as defined in section 1278(a)(2)(A)) or premium on an obligation, an amount that does not exceed 2 percent multiplied by the stated redemption price at maturity.

Economic accrual method (also known as the *constant interest method* or *actuarial method*) means the method of computing yield that is based on the compounding of interest at the end of each compounding period.

Fair market value means fair market value as defined in § 1.148–5(d)(6).

Fixed rate investment means any investment whose yield is fixed and determinable on the issue date.

Fixed yield bond means any bond whose yield is fixed and determinable on the issue date using the assumptions and rules provided in § 1.148–4(b).

Fixed yield issue means any issue if each bond that is part of the issue is a fixed yield bond.

Gross proceeds means any proceeds and replacement proceeds of an issue.

Guaranteed investment contract includes any nonpurpose investment that has specifically negotiated withdrawal or reinvestment provisions and a specifically negotiated interest rate, and also includes any agreement to supply investments on two or more future dates (e.g., a forward supply contract).

Higher yielding investments means higher yielding investments as defined in section 148(b)(1).

Investment means any investment property as defined in sections 148(b)(2) and 148(b)(3), and any other tax-exempt bond.

Investment proceeds means any amounts actually or constructively received from investing proceeds of an issue.

Investment-type property is defined in paragraph (e) of this section.

Issue price means, except as otherwise provided, issue price as defined in sections 1273 and 1274. Generally, the issue price of bonds that are publicly offered is the first price at which a substantial amount of the bonds is sold to the public. Ten percent is a substantial amount. The public does not include bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers. The issue price does not change if part of the issue is later sold at a different price. The issue price of bonds that are not substantially identical is determined separately. The issue price of bonds for which a bona fide public offering is made is determined as of the sale date based on reasonable expectations regarding the initial public offering price. If a bond is issued for property, the applicable Federal tax-exempt rate is used in lieu of the Federal rate in determining the issue price under section 1274. The issue price of bonds may not exceed their fair market value as of the sale date.

Issuer generally means the entity that actually issues the issue, and, unless the context or a provision clearly requires otherwise, each conduit borrower of the issue. For example, rules imposed on issuers to account for gross proceeds of an issue apply to a conduit borrower to account for any gross proceeds received under a purpose investment. Provisions regarding elections, filings, liability for the rebate amount, and certifications of reasonable expectations apply only to the actual issuer.

Multipurpose issue means an issue the proceeds of which are used for two or more separate purposes determined in accordance with §1.148–9(h).

Net sale proceeds means sale proceeds, less the portion of those sale proceeds invested in a reasonably required reserve or replacement fund under section 148(d) and as part of a minor portion under section 148(e).

Nonpurpose investment means any investment property, as defined in section 148(b), that is not a purpose investment.

Payment means a payment as defined in §1.148–3(d) for purposes of computing the rebate amount, and a payment as defined in §1.148–5(b) for purposes of computing the yield on an investment.

Plain par bond means a qualified tender bond or a bond—

(1) Issued with not more than a de minimis amount of original issue discount or premium;

(2) Issued for a price that does not include accrued interest other than preissuance accrued interest;

(3) That bears interest from the issue date at a single, stated, fixed rate or that is a variable rate debt instrument under section 1275, in each case with interest unconditionally payable at least annually; and

(4) That has a lowest stated redemption price that is not less than its outstanding stated principal amount.

Plain par investment means an investment that is an obligation—

(1) Issued with not more than a de minimis amount of original issue discount or premium, or, if acquired on a date other than the issue date, acquired with not more than a de minimis amount of market discount or premium;

(2) Issued for a price that does not include accrued interest other than preissuance accrued interest;

(3) That bears interest from the issue date at a single, stated, fixed rate or that is a variable rate debt instrument under section 1275, in each case with interest unconditionally payable at least annually; and

(4) That has a lowest stated redemption price that is not less than its outstanding stated principal amount.

Pre-issuance accrued interest means amounts representing interest that accrued on an obligation for a period not greater than one year before its issue date but only if those amounts are paid within one year after the issue date.

Proceeds means any sale proceeds, investment proceeds, and transferred proceeds of an issue. Proceeds do not include, however, amounts actually or constructively received with respect to a purpose investment that are properly allocable to the immaterially higher yield under §1.148–2(d) or section 143(g) or to qualified administrative costs recoverable under §1.148–5(e).

Program investment means a purpose investment that is part of a governmental program in which—

(1) The program involves the origination or acquisition of purpose investments;

(2) At least 95 percent (90 percent for qualified student loans under section 144(b)(1)(A)) of the cost of the purpose investments acquired under the program represents one or more loans to a substantial number of persons representing the general public, States or political subdivisions, 501(c)(3) organizations, persons who provide housing and related facilities, or any combination of the foregoing;

(3) At least 95 percent of the receipts from the purpose investments are used to pay principal, interest, or redemption prices on issues that financed the program, to pay or reimburse administrative costs of those issues or of the program, to pay or reimburse anticipated future losses directly related to the program, to finance additional purpose investments for the same general purposes of the program, or to redeem and retire governmental obligations at the next earliest possible date of redemption;

(4) The program documents prohibit any obligor on a purpose investment financed by the program or any related party to that obligor from purchasing bonds of an issue that finance the program in an amount related to the amount of the purpose investment acquired from that obligor; and

(5) The issuer has not waived the right to treat the investment as a program investment.

Purpose investment means an investment that is acquired to carry out the governmental purpose of an issue.

Qualified administrative costs means qualified administrative costs as defined in § 1.148–5(e).

Qualified guarantee means a qualified guarantee as defined in § 1.148–4(f).

Qualified hedge means a qualified hedge as defined in § 1.148–4(h)(2).

Reasonable expectations or reasonableness. An issuer's expectations or actions are reasonable only if a prudent person in the same circumstances as the issuer would have those same expectations or take those same actions, based on all the objective facts and circumstances. Factors relevant to a determination of reasonableness include the issuer's history of conduct concerning stated expectations made in connection with the issuance of obligations, the level of inquiry by the issuer into factual matters, and the existence of covenants, enforceable by bondholders, that require implementation of specific expectations. For a conduit financing issue, factors relevant to a determination of reasonableness include the reasonable expectations of the conduit borrower, but only if, under the circumstances, it is reasonable and prudent for the issuer to rely on those expectations.

Rebate amount means 100 percent of the amount owed to the United States under section 148(f)(2), as further described in § 1.148–3.

Receipt means a receipt as defined in § 1.148–3(d) for purposes of computing the rebate amount, and a receipt as defined in § 1.148–5(b) for purposes of computing yield on an investment.

Refunding escrow means one or more funds established as part of a single transaction or a series of related transactions, containing proceeds of a refunding issue and any other amounts to provide for payment of principal or interest on one or more prior issues. For this purpose, funds are generally not so established solely because of—

(1) The deposit of proceeds of an issue and replacement proceeds of the prior issue in an escrow more than 6 months apart, or

(2) The deposit of proceeds of completely separate issues in an escrow.

Replacement proceeds is defined in paragraph (c) of this section.

Restricted working capital expenditures means working capital expenditures that are subject to the proceeds-spent-last rule in § 1.148–6(d)(3)(i) and are ineligible for any exception to that rule.

Sale proceeds means any amounts actually or constructively received from the sale of the issue, including amounts used to pay underwriters' discount or compensation and accrued interest other than pre-issuance accrued interest. Sale proceeds also include, but are not limited to, amounts derived from the sale of a right that is associated with a bond, and that is described in § 1.148–4(b)(4). See also § 1.148–4(h)(5) treating amounts received upon the termination of certain hedges as sale proceeds.

Stated redemption price means the redemption price of an obligation under the terms of that obligation, including any call premium.

Transferred proceeds means transferred proceeds as defined in § 1.148–9 (or the applicable corresponding provision of prior law).

Unconditionally payable means payable under terms in which—

(1) Late payment or nonpayment results in a significant penalty to the borrower or reasonable remedies to the lender, and

(2) It is reasonably certain on the issue date that the payment will actually be made.

Value means value determined under § 1.148–4(e) for a bond, and value determined under § 1.148–5(d) for an investment.

Variable yield bond means any bond that is not a fixed yield bond.

Variable yield issue means any issue that is not a fixed yield issue.

Yield means yield computed under § 1.148–4 for an issue, and yield computed under § 1.148–5 for an investment.

Yield restricted means required to be invested at a yield that is not materially higher than the yield on the issue under section 148(a) and § 1.148–2.

(c) *Definition of replacement proceeds*—(1) *In general.* Amounts are replacement proceeds of an issue if the amounts have a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not used or to be used for that governmental purpose. For this purpose, governmental purposes include the expected use of amounts for the payment of debt service on a particular date. The mere availability or preliminary earmarking of amounts for a governmental purpose, however, does not in itself establish a sufficient nexus to cause those amounts to be replacement proceeds. Replacement proceeds include, but are not limited to, sinking funds, pledged funds, and other replacement proceeds described in paragraph (c)(4) of this section, to the extent that those funds or amounts are held by or derived from a substantial beneficiary of the issue. A substantial beneficiary of an issue includes the issuer and any related party to the issuer, and, if the issuer is not a state, the state in which the issuer is located. A person is not a substantial beneficiary of an issue solely because it is a guarantor under a qualified guarantee.

(2) *Sinking fund. Sinking fund* includes a debt service fund, redemption fund, reserve fund, replacement fund, or any similar fund, to the extent reasonably expected to be used directly or indirectly to pay principal or interest on the issue.

(3) *Pledged fund*—(i) *In general.* A *pledged fund* is any amount that is directly or indirectly pledged to pay principal or interest on the issue. A pledge need not be cast in any particular form but, in substance, must provide reasonable assurance that the amount will be available to pay principal or interest on the issue, even if the issuer encounters financial difficulties. A pledge to a guarantor of an issue is an indirect pledge to secure payment of principal or interest on the issue. A pledge of more than 50 percent of the outstanding stock of a corporation that is a conduit borrower of the issue is not treated as a pledge for this purpose, unless the corporation is formed or availed of to avoid the creation of replacement proceeds.

(ii) *Negative pledges.* An amount is treated as pledged to pay principal or interest on an issue if it is held under an agreement to maintain the amount at a particular level for the direct or indirect benefit of the bondholders or a guarantor of the bonds. An amount is not treated as pledged under this paragraph (c)(3)(ii), however, if—

(A) The issuer or a substantial beneficiary may grant rights in the amount that are superior to the rights of the bondholders or the guarantor; or

(B) The amount does not exceed reasonable needs for which it is maintained, the required level is tested no more frequently than every 6 months, and the amount may be spent without any substantial restriction other than a requirement to replenish the amount by the next testing date.

(4) *Other replacement proceeds*—(i) *Bonds outstanding longer than necessary*—(A) *In general.* Replacement proceeds arise to the extent that the issuer reasonably expects as of the issue date that—

(*1*) The term of an issue will be longer than is reasonably necessary for the governmental purposes of the issue, and

(*2*) There will be available amounts during the period that the issue remains outstanding longer than necessary. Whether an issue is outstanding longer than necessary is determined under §1.148–10. Replacement proceeds are created under this paragraph (c)(4)(i)(A) at the beginning of each fiscal year during which an issue remains outstanding longer than necessary in an amount equal to available amounts of the issuer as of that date.

(B) *Safe harbor against creation of replacement proceeds.* As a safe harbor, replacement proceeds do not arise under paragraph (c)(4)(i)(A) of this section—

(*1*) For the portion of an issue that is to be used to finance restricted working capital expenditures, if that portion is not outstanding longer than 2 years;

(*2*) For the portion of an issue (including a refunding issue) that is to be used to finance or refinance capital projects, if that portion has a weighted average maturity that does not exceed 120 percent of the average reasonably expected economic life of the financed capital projects, determined in the same manner as under section 147(b); or

(*3*) For the portion of an issue that is a refunding issue, if that portion has a weighted average maturity that does not exceed the remaining weighted average maturity of the prior issue, and the issue of which the prior issue is a part satisfies paragraph (c)(4)(i)(B) (*1*) or (*2*) of this section.

(ii) *Bonds financing a working capital reserve*—(A) *In general.* Except as otherwise provided in paragraph (c)(4)(ii)(B) of this section, replacement proceeds arise to the extent a working capital reserve is, directly or indirectly, financed with the proceeds of the issue (regardless of the expenditure of proceeds of the issue). Thus, for example, if an issuer that does not maintain a working capital reserve borrows to fund a working capital reserve, the issuer will have replacement proceeds. To determine the amount of a working capital reserve maintained, an issuer may use the average amount maintained as a working capital reserve during annual periods of at least 1 year, the last of which ends within 1 year before the issue date. For example, the amount of a working capital reserve may be computed using the average of the beginning or ending monthly balances of the amount maintained as a reserve (net of unexpended gross proceeds) during the 1 year period preceding the issue date.

(B) *Exception to creation of replacement proceeds.* Replacement proceeds do not arise under paragraph (c)(4)(ii)(A) of this section with respect to an issue—

(*1*) All of the net proceeds of which are spent within 6 months of the issue date under section 148(f)(4)(B)(iii)(I); or

(*2*) That is not subject to the rebate requirement under the exception provided by section 148(f)(4)(D).

(d) *Elections.* Except as otherwise provided, any required elections must be made in writing, and, once made, may not be revoked without the permission of the Commissioner.

(e) *Investment-type property*—(1) *In general.* Investment-type property includes any property, other than property described in section 148(b)(2) (A), (B), (C), or (E), that is held principally as a passive vehicle for the production of income. For this purpose, production of income includes any benefit based on the time value of money, including the benefit from making a prepayment.

(2) *Non-customary prepayments.* Except as otherwise provided in this paragraph (e), a prepayment for property or services gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. A prepayment does not give rise to investment-type property if—

(i) The prepayment is made for a substantial business purpose other than investment return and the issuer has no commercially reasonable alternative to the prepayment; or

(ii) Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing.

(3) *Certain hedges.* Investment-type property also includes the investment element of a contract that is a hedge (within the meaning of §1.148–4(h)(2)(i)(A)) and that contains a significant investment element because a payment by the issuer relates to a conditional or unconditional obligation by the hedge provider to make a payment on a later date. See §1.148–4(h)(2)(ii) relating to hedges with a significant investment element.

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§1.148–2 General arbitrage yield restriction rules.

(a) *In general.* Under section 148(a), the direct or indirect investment of the gross proceeds of an issue in higher yielding investments causes the bonds of the issue to be arbitrage bonds. The investment of proceeds in higher yielding investments, however, during a temporary period described in paragraph (e) of this section, as part of a reasonably required reserve or replacement fund described in paragraph (f) of this section, or as part of a minor portion described in paragraph (g) of this section does not cause the bonds of the issue to be arbitrage bonds. Bonds are not arbitrage bonds under this section as a result of an inadvertent, insubstantial error.

(b) *Reasonable expectations*—(1) *In general.* Except as provided in paragraph (c) of this section, the determination of whether an issue consists of arbitrage bonds under section 148(a) is based on the issuer's reasonable expectations as of the issue date regarding the amount and use of the gross proceeds of the issue.

(2) *Certification of expectations*—(i) *In general.* An officer of the issuer responsible for issuing the bonds must, in good faith, certify the issuer's expectations as of the issue date. The certification must state the facts and estimates that form the basis for the issuer's expectations. The certification is evidence of the issuer's expectations, but does not establish any conclusions of law or any presumptions regarding either the issuer's actual expectations or their reasonableness.

(ii) *Exceptions to certification requirement.* An issuer is not required to make a certification for an issue under paragraph (b)(2)(i) of this section if—

(A) The issuer reasonably expects as of the issue date that there will be no unspent gross proceeds after the issue date, other than gross proceeds in a bona fide debt service fund (e.g., equipment lease financings in which the issuer purchases equipment in exchange for an installment payment note); or

(B) The issue price of the issue does not exceed $1,000,000.

(c) *Intentional acts.* The taking of any deliberate, intentional action by the issuer or person acting on its behalf after the issue date in order to earn arbitrage causes the bonds of the issue to be arbitrage bonds if that action, had it been expected on the issue date, would have caused the bonds to be arbitrage bonds. An intent to violate the requirements of section 148 is not necessary for an action to be intentional.

(d) *Materially higher yielding investments*—(1) *In general.* The yield on investments is materially higher than the yield on the issue to which the investments are allocated if the yield on the investments over the term of the issue exceeds the yield on the issue by an amount in excess of the applicable definition of *materially higher* set forth in paragraph (d)(2) of this section. If yield restricted investments in the same class are subject to different definitions of *materially higher,* the applicable definition of *materially higher* that produces the lowest permitted yield applies to all the investments in the class. The yield on the issue is determined under §1.148–4. The yield on investments is determined under §1.148–5.

(2) *Definitions of materially higher yield*—(i) *General rule for purpose and nonpurpose investments.* For investments that are not otherwise described in this paragraph (d)(2), materially higher means one-eighth of 1 percentage point.

(ii) *Refunding escrows and replacement proceeds.* For investments in a refunding escrow or for investments allocable to replacement proceeds, materially higher means one-thousandth of 1 percentage point.

(iii) *Program investments.* For program investments that are not described in paragraph (d)(2)(iv) of this section, materially higher means 1 and one-half percentage points.

(iv) *Student loans.* For qualified student loans that are program investments, materially higher means 2 percentage points.

(v) *Tax-exempt investments.* For investments that are tax-exempt bonds and are not investment property under section 148(b)(3), no yield limitation applies.

(3) *Mortgage loans.* Qualified mortgage loans that satisfy the requirements of section 143(g) are treated as meeting the requirements of this paragraph (d).

(e) *Temporary periods*—(1) *In general.* During the temporary periods set forth in this paragraph (e), the proceeds and replacement proceeds of an issue may be invested in higher yielding investments without causing bonds in the issue to be arbitrage bonds. This paragraph (e) does not apply to refunding issues (see §1.148–9).

(2) *General 3-year temporary period for capital projects and qualified mortgage loans*—(i) *In general.* The net sale proceeds and investment proceeds of an issue reasonably expected to be allocated to expenditures for capital projects qualify for a temporary period of 3 years beginning on the issue date (the *3-year temporary period).* The 3-year temporary period also applies to the

proceeds of qualified mortgage bonds and qualified veterans' mortgage bonds by substituting *qualified mortgage loans* in each place that *capital projects* appears in this paragraph (e)(2). The 3-year temporary period applies only if the issuer reasonably expects to satisfy the expenditure test, the time test, and the due diligence test. These rules apply separately to each conduit loan financed by an issue (other than qualified mortgage loans), with the expenditure and time tests measured from the issue date of the issue.

(A) *Expenditure test.* The expenditure test is met if at least 85 percent of the net sale proceeds of the issue are allocated to expenditures on the capital projects by the end of the 3-year temporary period.

(B) *Time test.* The time test is met if the issuer incurs within 6 months of the issue date a substantial binding obligation to a third party to expend at least 5 percent of the net sale proceeds of the issue on the capital projects. An obligation is not binding if it is subject to contingencies within the issuer's or a related party's control.

(C) *Due diligence test.* The due diligence test is met if completion of the capital projects and the allocation of the net sale proceeds of the issue to expenditures proceed with due diligence.

(ii) *5-year temporary period.* In the case of proceeds expected to be allocated to a capital project involving a substantial amount of construction expenditures (as defined in § 1.148–7), a 5-year temporary period applies in lieu of the 3-year temporary period if the issuer satisfies the requirements of paragraph (e)(2)(i) of this section applied by substituting ''5 years'' in each place that ''3 years'' appears, and both the issuer and a licensed architect or engineer certify that the longer period is necessary to complete the capital project.

(3) *Temporary period for restricted working capital expenditures*—(i) *General rule.* The proceeds of an issue that are reasonably expected to be allocated to restricted working capital expenditures within 13 months after the issue date qualify for a temporary period of 13 months beginning on the issue date. Paragraph (e)(2) of this section contains additional temporary period rules for certain working capital expenditures that are treated as part of a capital project.

(ii) *Longer temporary period for certain tax anticipation issues.* If an issuer reasonably expects to use tax revenues arising from tax levies for a single fiscal year to redeem or retire an issue, and the issue matures by the earlier of 2 years after the issue date or 60 days after the last date for payment of those taxes without interest or penalty, the temporary period under paragraph (e)(3)(i) of this section is extended until the maturity date of the issue.

(4) *Temporary period for pooled financings*—(i) *In general.* Proceeds of a pooled financing issue reasonably expected to be used to finance purpose investments qualify for a temporary period of 6 months while held by the issuer before being loaned to a conduit borrower. Any otherwise available temporary period for proceeds held by a conduit borrower, however, is reduced by the period of time during which those proceeds were held by the issuer before being loaned. For example, if the proceeds of a pooled financing issue loaned to a conduit borrower would qualify for a 3-year temporary period, and the proceeds are held by the issuer for 5 months before being loaned to the conduit borrower, the proceeds qualify for only an additional 31-month temporary period after being loaned to the conduit borrower. Except as provided in paragraph (e)(4)(iv) of this section, this paragraph (e)(4) does not apply to any qualified mortgage bond or qualified veterans' mortgage bond under section 143.

(ii) *Loan repayments*—(A) *Amount held by the issuer.* The temporary period under this paragraph (e)(4) for proceeds from the sale or repayment of any loan that are reasonably expected to be used to make or finance new loans is 3 months.

(B) *Amounts re-loaned to conduit borrowers.* Any temporary period for proceeds held by a conduit borrower under a new loan from amounts described in paragraph (e)(4)(ii)(A) of this section is determined by treating the date the new loan is made as the issue date and by reducing the temporary period by the period the amounts were held by the issuer following the last repayment.

(iii) *Construction issues.* If all or a portion of a pooled financing issue qualifies as a construction issue under §1.148–7(b)(6), paragraph (e)(4)(i) of this section is applied by substituting ''2 years'' for ''6 months.''

(iv) *Amounts re-loaned for qualified mortgage loans.* The temporary period under this paragraph (e)(4) for proceeds from the sale, prepayment, or repayment of any qualified mortgage loan that are reasonably expected to be used to make or finance new qualified mortgage loans is 3 years.

(5) *Temporary period for replacement proceeds*—(i) *In general.* Except as otherwise provided, replacement proceeds qualify for a temporary period of 30 days beginning on the date that the amounts are first treated as replacement proceeds.

(ii) *Temporary period for bona fide debt service funds.* Amounts in a bona fide debt service fund for an issue qualify for a temporary period of 13 months. If only a portion of a fund qualifies as a bona fide debt service fund, only that portion qualifies for this temporary period.

(6) *Temporary period for investment proceeds.* Except as otherwise provided in this paragraph (e), investment proceeds qualify for a temporary period of 1 year beginning on the date of receipt.

(7) *Other amounts.* Gross proceeds not otherwise eligible for a temporary period described in this paragraph (e) qualify for a temporary period of 30 days beginning on the date of receipt.

(f) *Reserve or replacement funds*—(1) *General 10 percent limitation on funding with sale proceeds.* An issue consists of arbitrage bonds if sale proceeds of the issue in excess of 10 percent of the stated principal amount of the issue are used to finance any reserve or replacement fund, without regard to whether those sale proceeds are invested in higher yielding investments. If an issue has more than a de minimis amount of original issue discount or premium, the issue price (net of pre-issuance accrued interest) is used to measure the 10-percent limitation in lieu of stated principal amount. This rule does not limit the use of amounts other than sale proceeds of an issue to fund a reserve or replacement fund.

(2) *Exception from yield restriction for reasonably required reserve or replacement funds*—(i) *In general.* The investment of amounts that are part of a reasonably required reserve or replacement fund in higher yielding investments will not cause an issue to consist of arbitrage bonds. A reasonably required reserve or replacement fund may consist of all or a portion of one or more funds, however labelled, derived from one or more sources. Amounts in a reserve or replacement fund in excess of the amount that is reasonably required are not part of a reasonably required reserve or replacement fund.

(ii) *Size limitation.* The amount of gross proceeds of an issue that qualifies as a reasonably required reserve or replacement fund may not exceed an amount equal to the least of 10 percent of the stated principal amount of the issue, the maximum annual principal and interest requirements on the issue, or 125 percent of the average annual principal and interest requirements on the issue. If an issue has more than a de minimis amount of original issue discount or premium, the issue price of the issue (net of pre-issuance accrued interest) is used to measure the 10 percent limitation in lieu of its stated principal amount. For a reserve or replacement fund that secures more than one issue (e.g. a parity reserve fund), the size limitation may be measured on an aggregate basis.

(iii) *Valuation of investments.* Investments in a reasonably required reserve or replacement fund may be valued in any reasonable, consistently applied manner that is permitted under §1.148–5.

(iv) *150 percent debt service limitation on investment in nonpurpose investments for certain private activity bonds.* Section 148(d)(3) contains additional limits on the amount of gross proceeds of an issue of private activity bonds, other than qualified 501(c)(3) bonds, that may be invested in higher yielding nonpurpose investments without causing the bonds to be arbitrage bonds. For purposes of these rules, *initial temporary period* means the temporary periods under paragraphs (e)(2), (e)(3), and (e)(4) of this section and under §1.148–9(d)(2)(i), (ii), and (iii).

(3) *Certain parity reserve funds.* The limitation contained in paragraph (f)(1) of this section does not apply to an issue if the master legal document authorizing the issuance of the bonds (e.g., a master indenture) was adopted before August 16, 1986, and that document—

(i) Requires a reserve or replacement fund in excess of 10 percent of the sale proceeds, but not more than maximum annual principal and interest requirements;

(ii) Is not amended after August 31, 1986 (other than to permit the issuance of additional bonds as contemplated in the master legal document); and

(iii) Provides that bonds having a parity of security may not be issued by or on behalf of the issuer for the purposes provided under the document without satisfying the reserve fund requirements of the indenture.

(g) *Minor portion.* Under section 148(e), a bond of an issue is not an arbitrage bond solely because of the investment in higher yielding investments of gross proceeds of the issue in an amount not exceeding the lesser of—

(1) 5 percent of the sale proceeds of the issue; or

(2) $100,000.

(h) *Certain waivers permitted.* On or before the issue date, an issuer may elect to waive the right to invest in higher yielding investments during any temporary period under paragraph (e) of this section or as part of a reasonably required reserve or replacement fund under paragraph (f) of this section. At any time, an issuer may waive the right to invest in higher yielding investments as part of a minor portion under paragraph (g) of this section.

[T.D. 8476, 58 FR 33520, June 18, 1993; 58 FR 44452, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24042, May 10, 1994; T.D. 8718, 62 FR 25507, May 9, 1997]

§1.148–3 General arbitrage rebate rules.

(a) *In general.* Section 148(f) requires that certain earnings on nonpurpose investments allocable to the gross proceeds of an issue be paid to the United States to prevent the bonds in the issue from being arbitrage bonds. The arbitrage that must be rebated is based on the difference between the amount actually earned on nonpurpose investments and the amount that would have been earned if those investments had a yield equal to the yield on the issue.

(b) *Definition of rebate amount.* As of any date, the rebate amount for an issue is the excess of the future value, as of that date, of all receipts on nonpurpose investments over the future value, as of that date, of all payments on nonpurpose investments.

(c) *Computation of future value of a payment or receipt.* The future value of a payment or receipt at the end of any period is determined using the economic accrual method and equals the value of that payment or receipt when it is paid or received (or treated as paid or received), plus interest assumed to be earned and compounded over the period at a rate equal to the yield on the issue, using the same compounding interval and financial conventions used to compute that yield.

(d) *Payments and receipts*— (1) *Definition of payments.* For purposes of this section, payments are—

(i) Amounts actually or constructively paid to acquire a nonpurpose investment (or treated as paid to a commingled fund);

(ii) For a nonpurpose investment that is first allocated to an issue on a date after it is actually acquired (e.g., an investment that becomes allocable to transferred proceeds or to replacement proceeds) or that becomes subject to the rebate requirement on a date after it is actually acquired (e.g., an investment allocated to a reasonably required reserve or replacement fund for a construction issue at the end of the 2-year spending period), the value of that investment on that date;

(iii) For a nonpurpose investment that was allocated to an issue at the end of the preceding computation period, the value of that investment at the beginning of the computation period;

(iv) On the last day of each bond year during which there are amounts allocated to gross proceeds of an issue that are subject to the rebate requirement, and on the final maturity date, a computation credit of $1,000; and

(v) Yield reduction payments on nonpurpose investments made pursuant to §1.148–5(c).

(2) *Definition of receipts.* For purposes of this section, receipts are—

(i) Amounts actually or constructively received from a nonpurpose investment (including amounts treated as received from a commingled fund), such as earnings and return of principal;

(ii) For a nonpurpose investment that ceases to be allocated to an issue before its disposition or redemption date (e.g., an investment that becomes allocable to transferred proceeds of another issue or that ceases to be allocable to the issue pursuant to the universal cap under §1.148–6) or that ceases to be subject to the rebate requirement on a date earlier than its disposition or redemption date (e.g., an investment allocated to a fund initially subject to the rebate requirement but that subsequently qualifies as a bona fide debt service fund), the value of that nonpurpose investment on that date; and

(iii) For a nonpurpose investment that is held at the end of a computation period, the value of that investment at the end of that period.

(3) *Special rules for commingled funds.* Section 1.148–6(e) provides special rules to limit certain of the required determinations of payments and receipts for investments of a commingled fund.

(e) *Computation dates*—(1) *In general.* For a fixed yield issue, an issuer may treat any date as a computation date. For a variable yield issue, an issuer:

(i) May treat the last day of any bond year ending on or before the latest date on which the first rebate amount is required to be paid under paragraph (f) of this section (the *first required payment date*) as a computation date but may not change that treatment after the first payment date; and

(ii) After the first required payment date, must consistently treat either the end of each bond year or the end of each fifth bond year as computation dates and may not change these computation dates after the first required payment date.

(2) *Final computation date.* The date that an issue is discharged is the final computation date. For an issue retired within 3 years of the issue date, however, the final computation date need not occur before the end of 8 months after the issue date or during the period in which the issuer reasonably expects that any of the spending exceptions under §1.148–7 will apply to the issue.

(f) *Amount of required rebate installment payment*—(1) *Amount of interim rebate payments.* The first rebate installment payment must be made for a computation date that is not later than 5 years after the issue date. Subsequent rebate installment payments must be made for a computation date that is not later than 5 years after the previous computation date for which an installment payment was made. A rebate installment payment must be in an amount that, when added to the future value, as of the computation date, of previous rebate payments made for the issue, equals at least 90 percent of the rebate amount as of that date.

(2) *Amount of final rebate payment.* For the final computation date, a final rebate payment must be paid in an amount that, when added to the future value of previous rebate payments made for the issue, equals 100 percent of the rebate amount as of that date.

(3) *Future value of rebate payments.* The future value of a rebate payment is determined under paragraph (c) of this section. This value is computed by taking into account recoveries of overpayments.

(g) *Time and manner of payment.* Each rebate payment must be paid no later than 60 days after the computation date to which the payment relates. Any rebate payment paid within this 60-day period may be treated as paid on the computation date to which it relates. A rebate payment is paid when it is filed with the Internal Revenue Service at the place or places designated by the Commissioner. A payment must be accompanied by the form provided by the Commissioner for this purpose.

(h) *Penalty in lieu of loss of tax exemption*—(1) *In general.* The failure to pay the correct rebate amount when required will cause the bonds of the issue to be arbitrage bonds, unless the Commissioner determines that the failure was not caused by willful neglect and the issuer promptly pays a penalty to the United States. If no bond of the issue is a private activity bond (other than a qualified 501(c)(3) bond), the penalty equals 50 percent of the rebate amount not paid when required to be paid, plus interest on that amount. Otherwise, the penalty equals 100 percent of the rebate amount not paid when required to be paid, plus interest on that amount.

(2) *Interest on underpayments.* Interest accrues at the underpayment rate under section 6621, beginning on the date the correct rebate amount is due and ending on the date 10 days before it is paid.

(3) *Waivers of the penalty.* The penalty is automatically waived if the rebate amount that the issuer failed to pay plus interest is paid within 180 days after discovery of the failure, unless, the Commissioner determines that the failure was due to willful neglect, or the issue is under examination by the Commissioner at any time during the period beginning on the date the failure first occurred and ending on the date 90 days after the receipt of the rebate amount. Generally, extensions of this 180-day period and waivers of the penalty in other cases will be granted by the Commissioner only in unusual circumstances. For purposes of this paragraph (h)(3), willful neglect does not include a failure that is attributable solely to the permissible retroactive selection of a short first bond year if the rebate amount that the issuer failed to pay is paid within 60 days of the selection of that bond year.

(4) *Application to alternative penalty under §1.148–7.* Paragraphs (h) (1), (2), and (3) of this section apply to failures to pay penalty payments under § 1.148–7 (*alternative penalty amounts)* by substituting *alternative penalty amounts* for *rebate amount* and *the last day of each spending period* for *computation date.*

(i) *Recovery of overpayment of rebate*—(1) *In general.* An issuer may recover an overpayment for an issue of tax-exempt bonds by establishing to the satisfaction of the Commissioner that the overpayment occurred. An overpayment is the excess of the amount paid to the United States for an issue under section 148 over the sum of the rebate amount for the issue as of the most recent computation date and all amounts that are otherwise required to be paid under section 148 as of the date the recovery is requested.

(2) *Limitations on recovery.* (i) An overpayment may be recovered only to the extent that a recovery on the date that it is first requested would not result in an additional rebate amount if that date were treated as a computation date.

(ii) Except for overpayments of penalty in lieu of rebate under section 148(f)(4)(C)(vii) and § 1.148–7(k), an overpayment of less than $5,000 may not be recovered before the final computation date.

(j) *Examples.* The provisions of this section may be illustrated by the following examples.

Example 1. Calculation and payment of rebate for a fixed yield issue. (i) *Facts.* On January 1, 1994, City *A* issues a fixed yield issue and invests all the sale proceeds of the issue ($49 million). There are no other gross proceeds. The issue has a yield of 7.0000 percent per year compounded semiannually (computed on a 30 day month/360 day year basis). City *A* receives amounts from the investment and immediately expends them for the governmental purpose of the issue as follows:

Date	Amount
2/1/94	$3,000,000
5/1/94	5,000,000
1/1/95	5,000,000
9/1/95	20,000,000
3/1/96	22,000,000

(ii) *First computation date.* (A) City *A* chooses January 1, 1999, as its first computation date. This date is the latest date that may be used to compute the first required rebate installment payment. The rebate amount as of this date is computed by determining the future value of the receipts and the payments for the investment. The compounding interval is each 6-month (or shorter) period and the 30 day month/360 day year basis is used because these conventions were used to compute yield on the issue. The future value of these amounts, plus the computation credit, as of January 1, 1999, is:

Date	Receipts (payments)	FV (7.0000 percent)
1/1/94	($49,000,000)	($69,119,339)
2/1/94	3,000,000	4,207,602
5/1/94	5,000,000	6,893,079
1/1/95	5,000,000	6,584,045
1/1/95	(1,000)	(1,317)
9/1/95	20,000,000	25,155,464
1/1/96	(1,000)	1,229)
3/1/96	22,000,000	26,735,275
1/1/97	(1,000)	(1,148)

Date	Receipts (payments)	FV (7.0000 percent)
Rebate amount (1/01/99)	....	452,432

(B) City *A* pays 90 percent of the rebate amount ($407,189) to the United States within 60 days of January 1, 1999.

(iii) *Second computation date.* (A) On the next required computation date, January 1, 2004, the future value of the payments and receipts is:

Date	Receipts (payments)	FV (7.0000 percent)
1/1/99	$452,432	$638,200
Rebate amount (1/01/04)	....	638,200

(B) As of this computation date, the future value of the payment treated as made on January 1, 1999, is $574,380, which equals at least 90 percent of the rebate amount as of this computation date ($638,200 × 0.9), and thus no additional rebate payment is due as of this date.

(iv) *Final computation date.* (A) On January 1, 2009, City *A* redeems all the bonds, and thus this date is the final computation date. The future value of the receipts and payments as of this date is:

Date	Receipts (payments)	FV (7.0000 percent)
1/1/04	$638,200	$900,244
1/1/09	(1,000)	(1,000)
Rebate amount (1/01/09)	....	899,244

(B) As of this computation date, the future value of the payment made on January 1, 1999, is $810,220 and thus an additional rebate payment of $89,024 is due. This payment reflects the future value of the 10 percent unpaid portion, and thus would not be owed had the issuer paid the full rebate amount as of any prior computation date.

Example 2. Calculation and payment of rebate for a variable yield issue. (i) *Facts.* On July 1, 1994, City *B* issues a variable yield issue and invests all of the sale proceeds of the issue ($30 million). There are no other gross proceeds. As of July 1, 1999, there are nonpurpose investments allocated to the issue. Prior to July 1, 1999, City *B* receives amounts from nonpurpose investments and immediately expends them for the governmental purpose of the issue as follows:

Date	Amount
8/1/1994	$5,000,000
7/1/1995	8,000,000
12/1/1995	17,000,000
7/1/1999	650,000

(ii) *First computation date.* (A) City *B* treats the last day of the fifth bond year (July 1, 1999) as a computation date. The yield on the variable yield issue during the first computation period (the period beginning on the issue date and ending on the first computation date) is 6.0000 percent per year compounded semiannually. The value of the nonpurpose investments allocated to the issue as of July 1, 1999, is $3 million. The rebate amount as of July 1, 1999, is computed by determining the future value of the receipts and the payments for the nonpurpose investments. The compounding interval is each 6-month (or shorter) period and the 30 day month/360 day year basis is used because these conventions were used to compute yield on the issue. The future value of these amounts and of the computation date credits as of July 1, 1999, is:

Date	Receipts (payments)	FV (6.0000 percent)
7/1/1994	($30,000,000)	($40,317,491)
8/1/1994	5,000,000	6,686,560
7/1/1995	(1,000)	(1,267)
7/1/1995	8,000,000	10,134,161
12/1/1995	17,000,000	21,011,112
7/1/1996	(1,000)	(1,194)
7/1/1997	(1,000)	(1,126)
7/1/1998	(1,000)	(1,061)
7/1/1999	3,000,000	3,000,000
7/1/1999	650,000	650,000
7/1/1999	(1,000)	(1,000)
Rebate amount (7/01/1999)		1,158,694

(B) City *B* pays 90 percent of the rebate amount ($1,042,824.60) to the United States within 60 days of July 1, 1999.

(iii) *Next computation date.* (A) On July 1, 2004, City *B* redeems all of the bonds. Thus, the next computation date is July 1, 2004. On July 30, 1999, City *B* chose to compute rebate for periods following the first computation period by treating the end of each fifth bond year as a computation date. The yield during the second computation period is 5.0000 percent per year compounded semiannually. The computation of the rebate amount as of this date reflects the value of the nonpurpose investments allocated to the issue at the end of the prior computation period. On July 1, 2004, City *B* sells those nonpurpose investments for $3,925,000 and expends that amount for the governmental purpose of the issue.

(B) As of July 1, 2004, the future value of the rebate amount computed as of July 1, 1999, and of all other payments and receipts is:

Date	Receipts (payments)	FV (5.0000 percent)
7/1/1999	$1,158,694	$1,483,226
7/1/1999	(3,000,000)	(3,840,254)
7/1/2000	(1,000)	(1,218)
7/1/2001	(1,000)	(1,160)
7/1/2002	(1,000)	(1,104)
7/1/2003	(1,000)	(1,051)

Date	Receipts (payments)	FV (5.0000 percent)
7/1/2004	(2,000)	(2,000)
7/1/2004	3,925,000	3,925,000
		1,561,439

(C) As of this computation date, the future value of the payment made on July 1, 1999, is $1,334,904 and thus an additional rebate payment of $226,535 is due.

(D) If the yield during the second computation period were, instead, 7.0000 percent, the rebate amount computed as of July 1, 1999, would be $1,320,891. The future value of the payment made on July 1, 1999, would be $1,471,007, and, therefore, City B would have overpaid the rebate amount by $150,116.

(k) *Bona fide debt service fund exception.* Under section 148(f)(4)(A), the rebate requirement does not apply to amounts in certain bona fide debt service funds. An issue with an average annual debt service that is not in excess of $2,500,000 may be treated as satisfying the $100,000 limitation in section 148(f)(4)(A)(ii).

[T.D. 8476, 58 FR 33522, June 18, 1993; 58 FR 44452, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24042, May 10, 1994; T.D. 8476, 59 FR 24350, May 11, 1994; T.D. 8718, 62 FR 25507, May 9, 1997]

§ 1.148–4 Yield on an issue of bonds.

(a) *In general.* The yield on an issue of bonds is used to apply investment yield restrictions under section 148(a) and to compute rebate liability under section 148(f). Yield is computed under the economic accrual method using any consistently applied compounding interval of not more than one year. A short first compounding interval and a short last compounding interval may be used. Yield is expressed as an annual percentage rate that is calculated to at least four decimal places (e.g., 5.2525 percent). Other reasonable, standard financial conventions, such as the 30 days per month/360 days per year convention, may be used in computing yield but must be consistently applied. The yield on an issue that would be a purpose investment (absent section 148(b)(3)(A)) is equal to the yield on the conduit financing issue that financed that purpose investment. The Commissioner may permit issuers of qualified mortgage bonds or qualified student loan bonds to use a single yield for two or more issues.

(b) *Computing yield on a fixed yield issue*—(1) *In general*—(i) *Yield on an issue.* The yield on a fixed yield issue is the discount rate that, when used in computing the present value as of the issue date of all unconditionally payable payments of principal, interest, and fees for qualified guarantees on the issue and amounts reasonably expected to be paid as fees for qualified guarantees on the issue, produces an amount equal to the present value, using the same discount rate, of the aggregate issue price of bonds of the issue as of the issue date. Further, payments include certain amounts properly allocable to a qualified hedge. Yield on a fixed yield issue is computed as of the issue date and is not affected by subsequent unexpected events, except to the extent provided in paragraphs (b)(4) and (h)(3) of this section.

(ii) *Yield on a bond.* Yield on a fixed yield bond is computed in the same manner as yield on a fixed yield issue.

(2) *Yield on certain fixed yield bonds subject to mandatory or contingent early redemption*—(i) *In general.* The yield on a fixed yield issue that includes a bond subject to mandatory early redemption or expected contingent redemption is computed by treating that bond as redeemed on its reasonably expected early redemption date for an amount equal to its value on that date. Reasonable expectations are determined on the issue date. A bond is subject to mandatory early redemption if it is unconditionally payable in full before its final maturity date. A bond is subject to a contingent redemption if it must be, or is reasonably expected to be, redeemed prior to final maturity upon the occurrence of a contingency. A contingent redemption is taken into account only if the contingency is reasonably expected to occur, in which case the date of occurrence of the contingency must be reasonably estimated. For example, if bonds are reasonably expected to be redeemed early using excess revenues from general or special property taxes or benefit assessments or similar amounts, the reasonably expected redemption schedule is used to determine yield. For purposes of this paragraph (b)(2)(i), excess

proceeds calls for issues for which the requirements of §1.148–2(e) (2) or (3) are satisfied, calamity calls, and refundings do not cause a bond to be subject to early redemption. The value of a bond is determined under paragraph (e) of this section.

(ii) *Substantially identical bonds subject to mandatory early redemption.* If substantially identical bonds of an issue are subject to specified mandatory redemptions prior to final maturity (e.g., a mandatory sinking fund redemption requirement), yield on that issue is computed by treating those bonds as redeemed in accordance with the redemption schedule for an amount equal to their value. Generally, bonds are substantially identical if the stated interest rate, maturity, and payment dates are the same. In computing the yield on an issue containing bonds described in this paragraph (b)(2)(ii), each of those bonds must be treated as redeemed at its present value, unless the stated redemption price at maturity of the bond does not exceed the issue price of the bond by more than one-fourth of one percent multiplied by the product of the stated redemption price at maturity and the number of years to the weighted average maturity date of the substantially identical bonds, in which case each of those bonds must be treated as redeemed at its outstanding stated principal amount, plus accrued, unpaid interest. Weighted average maturity is determined by taking into account the mandatory redemption schedule.

(3) *Yield on certain fixed yield bonds subject to optional early redemption*—(i) *In general.* If a fixed yield bond is subject to optional early redemption and is described in paragraph (b)(3)(ii) of this section, the yield on the issue containing the bond is computed by treating the bond as redeemed at its stated redemption price on the optional redemption date that would produce the lowest yield on the issue.

(ii) *Fixed yield bonds subject to special yield calculation rule.* A fixed yield bond is described in this paragraph (b)(3)(ii) only if it—

(A) Is subject to optional redemption within five years of the issue date, but only if the yield on the issue computed by assuming all bonds in the issue subject to redemption within 5 years of the issue date are redeemed at maturity is more than one-eighth of one percentage point higher than the yield on that issue computed by assuming all bonds subject to optional redemption within 5 years of the issue date are redeemed at the earliest date for their redemption;

(B) Is issued at an issue price that exceeds the stated redemption price at maturity by more than one-fourth of one percent multiplied by the product of the stated redemption price at maturity and the number of complete years to the first optional redemption date for the bond; or

(C) Bears interest at increasing interest rates (i.e., a *stepped coupon bond*).

(4) *Yield recomputed upon transfer of certain rights associated with the bond.* For purposes of §1.148–3, as of the date of any transfer, waiver, modification, or similar transaction (collectively, a *transfer*) of any right that is part of the terms of a bond or is otherwise associated with a bond (e.g., a redemption right), in a transaction that is separate and apart from the original sale of the bond, the issue is treated as if it were retired and a new issue issued on the date of the transfer (*reissued*). The redemption price of the retired issue and the issue price of the new issue equal the aggregate values of all the bonds of the issue on the date of the transfer. In computing yield on the new issue, any amounts received by the issuer as consideration for the transfer are taken into account.

(5) *Special aggregation rule treating certain bonds as a single fixed yield bond.* Two variable yield bonds of an issue are treated in the aggregate as a single fixed yield bond if—

(i) Aggregate treatment would result in the single bond being a fixed yield bond; and

(ii) The terms of the bonds do not contain any features that could distort the aggregate fixed yield from what the yield would be if a single fixed yield bond were issued. For example, if an issue contains a bond bearing interest at a floating rate and a related bond bearing interest at a rate equal to a fixed rate minus that floating rate, those two bonds are treated as a single fixed yield bond only if neither bond may be redeemed unless the other bond is also redeemed at the same time.

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

Example 1. No early call—(i) *Facts.* On January 1, 1994, City *A* issues an issue consisting of four identical fixed yield bonds. The stated final maturity date of each bond is January 1, 2004, and no bond is subject to redemption before this date. Interest is payable on January 1 of each year at a rate of 6.0000 percent per year on the outstanding principal amount. The total stated principal amount of the bonds is $20 million. The issue price of the bonds $20,060,000.

(ii) *Computation.* The yield on the issue is computed by treating the bonds as retired at the stated maturity under the general rule of § 1.148–4(b)(1). The bonds are treated as redeemed for their stated redemption prices. The yield on the issue is 5.8731 percent per year compounded semiannually, computed as follows:

Date	Payments	PV (5.8731 percent)
1/1/1995	$1,200,000	$1,132,510
1/1/1996	1,200,000	1,068,816
1/1/1997	1,200,000	1,008,704
1/1/1998	1,200,000	951,973
1/1/1999	1,200,000	898,433
1/1/2000	1,200,000	847,903
1/1/2001	1,200,000	800,216
1/1/2002	1,200,000	755,210
1/1/2003	1,200,000	712,736
1/1/2004	21,200,000	11,883,498
		20,060,000

Example 2. Mandatory calls. (i) *Facts.* The facts are the same as in *Example 1.* In this case, however, the bonds are subject to mandatory sinking fund redemption on January 1 of each year, beginning January 1, 2001. On each sinking fund redemption date, one of the bonds is chosen by lottery and is required to be redeemed at par plus accrued interest.

(ii) *Computation.* Because the bonds are subject to specified redemptions, yield on the issue is computed by treating the bonds as redeemed in accordance with the redemption schedule under § 1.148–4(b)(2)(ii). Because the bonds are not sold at a discount, the bonds are treated as retired at their stated redemption prices. The yield on the issue is 5.8678 percent per year compounded semiannually, computed as follows:

Date	Payments	PV (5.8678 percent)
1/1/1995	$1,200,000	$1,132,569
1/1/1996	1,200,000	1,068,926
1/1/1997	1,200,000	1,008,860
1/1/1998	1,200,000	952,169
1/1/1999	1,200,000	898,664
1/1/2000	1,200,000	848,166
1/1/2001	6,200,000	4,135,942
1/1/2002	5,900,000	3,714,650
1/1/2003	5,600,000	3,327,647
1/1/2004	5,300,000	2,972,407
		$20,060,000

Example 3. Optional early call. (i) *Facts.* On January 1, 1994, City *C* issues an issue consisting of three bonds. Each bond has a stated principal amount of $10 million dollars and is issued for par. Bond *X* bears interest at 5 percent per year and matures on January 1, 1999. Bond*Y* bears interest at 6 percent per year and matures on January 1, 2002. Bond *Z* bears interest at 7 percent per year and matures on January 1, 2004. Bonds *Y* and *Z* are callable by the issuer at par plus accrued interest after December 31, 1998.

(ii) *Computation.* (A) The yield on the issue computed as if each bond is outstanding to its maturity is 6.0834 percent per year compounded semiannually, computed as follows:

Date	Payments	PV (6.0834 percent)
1/1/1995	$1,800,000	$1,695,299
1/1/1996	1,800,000	1,596,689
1/1/1997	1,800,000	1,503,814
1/1/1998	1,800,000	1,416,342
1/1/1999	11,800,000	8,744,830
1/1/2000	1,300,000	907,374
1/1/2001	1,300,000	854,595
1/1/2002	11,300,000	6,996,316
1/1/2003	700,000	408,190
1/1/2004	10,700,000	5,876,551
		30,000,000

(B) The yield on the issue computed as if all bonds are called at the earliest date for redemption is 5.9126 percent per year compounded semiannually, computed as follows:

Date	Payments	PV (5.9126 percent)
1/1/1995	$1,800,000	$1,698,113
1/1/1996	1,800,000	1,601,994
1/1/1997	1,800,000	1,511,315
1/1/1998	1,800,000	1,425,769
1/1/1999	31,800,000	23,762,809
		30,000,000

(C) Because the yield on the issue computed by assuming all bonds in the issue subject to redemption within 5 years of the issue date are redeemed at maturity is more than one-eighth of one percentage point higher than the yield on the issue computed by assuming all bonds subject to optional redemption within 5 years of the issue date are redeemed at the earliest date for their redemption, each bond is treated as redeemed on the date that would produce the lowest yield for the issue. The lowest yield on the issue would result from a redemption of all the bonds on January 1, 1999. Thus, the yield on the issue is 5.9126 percent per year compounded semiannually.

(c) *Computing yield on a variable yield issue*—(1) *In general.* The yield on a variable yield issue is computed separately for each computation period. The yield for each computation period is the discount rate that, when used in computing the present value as of the first day of the computation period of all the payments of principal and interest and fees for qualified guarantees that are attributable to the computation period, produces an amount equal to the present value, using the same discount rate, of the aggregate issue price (or deemed issue price, as determined in paragraph (c)(2)(iv) of this section) of the bonds of the issue as of the first day of the computation period. The yield on a variable yield bond is computed in the same manner as the yield on a variable yield issue. Except as provided in paragraph (c)(2) of this section, yield on any fixed yield bond in a variable yield issue is computed in the same manner as the yield on a fixed yield issue as provided in paragraph (b) of this section.

(2) *Payments on bonds included in yield for a computation period*—(i) *Payments in general.* The payments on a bond that are attributable to a computation period include any amounts actually paid during the period for principal on the bond. Payments also include any amounts paid during the current period both for interest accruing on the bond during the current period and for interest accruing during the prior period that was included in the deemed issue price of the bond as accrued unpaid interest at the start of the current period under this paragraph (c)(2). Further, payments include any amounts properly allocable to fees for a qualified guarantee of the bond for the period and to any amounts properly allocable to a qualified hedge for the period.

(ii) *Payments at actual redemption.* If a bond is actually redeemed during a computation period, an amount equal to the greater of its value on the redemption date or the actual redemption price is a payment on the actual redemption date.

(iii) *Payments for bonds outstanding at end of computation period.* If a bond is outstanding at the end of a computation period, a payment equal to the bond's value is taken into account on the last day of that period.

(iv) *Issue price for bonds outstanding at beginning of next computation period.* A bond outstanding at the end of a computation period is treated as if it were immediately reissued on the next day for a deemed issue price equal to the value from the day before as determined under paragraph (c)(2)(iii) of this section.

(3) *Example.* The provisions of this paragraph (c) may be illustrated by the following example.

Example. On January 1, 1994, City *A* issues an issue of identical plain par bonds in an aggregate principal amount of $1,000,000. The bonds pay interest at a variable rate on each June 1 throughout the term of the issue. The entire principal amount of the bonds plus accrued, unpaid interest is payable on the final maturity date of January 1, 2000. No bond year is selected. On June 1, 1994, 1995, 1996, 1997, and 1998, interest in the amounts of $30,000, $55,000, $57,000, $56,000, and $45,000 is paid on the bonds. From June 1, 1998, to January 1, 1999, $30,000 of interest accrues on the bonds. From January 1, 1999, to June 1, 1999, another $35,000 of interest accrues. On June 1, 1999, the issuer actually pays $65,000 of interest. On January 1, 2000, $1,000,000 of principal and $38,000 of accrued interest are paid. The payments for the computation period starting on the issue date and ending on January 1, 1999, include all annual interest payments paid from the issue date to June 1, 1998. Because the issue is outstanding on January 1, 1999, it is treated as redeemed on that date for amount equal to its value ($1,000,000 plus accrued, unpaid interest of $30,000 under paragraph (e)(1) of this section). Thus, $1,030,000 is treated as paid on January 1, 1999. The issue is then treated as reissued on January 1, 1999, for $1,030,000. The payments for the next computation period starting on January 1, 1999, and ending on January 1, 2000, include the interest actually paid on the bonds during that period ($65,000 on June 1, 1999, plus $38,000 paid on January 1, 2000). Because the issue was actually redeemed on January 1, 2000, an amount equal to its stated redemption price is also treated as paid on January 1, 2000.

(d) *Conversion from variable yield issue to fixed yield issue.* For purposes of determining yield under this section, as of the first day on which a variable yield issue would qualify as a fixed yield issue if it were newly issued on that date (a *conversion date*), that issue is treated as if it were reissued as a fixed yield issue on the conversion date. The redemption price of the variable yield issue and the issue price of the fixed yield issue equal the aggregate values of all the bonds on the conversion date. Thus, for example, for plain par bonds (e.g., tender bonds), the deemed issue price would be the outstanding principal amount, plus accrued unpaid interest. If the conversion date occurs on a date other than a computation date, the issuer may continue to treat the issue as a variable yield issue until the next computation date, at which time it must be treated as converted to a fixed yield issue.

(e) *Value of bonds*—(1) *Plain par bonds.* Except as otherwise provided, the value of a plain par bond is its outstanding stated principal amount, plus accrued unpaid interest. The value of a plain par bond that is actually redeemed or treated as redeemed is its stated redemption price on the redemption date, plus accrued, unpaid interest.

(2) *Other bonds.* The value of a bond other than a plain par bond on a date is its present value on that date. The present value of a bond is computed under the economic accrual method taking into account all the unconditionally payable payments of principal, interest, and fees for a qualified guarantee to be paid on or after that date and using the yield on the bond as the discount rate, except that for purposes of § 1.148–6(b)(2) (relating to the universal cap), these values may be determined by consistently using the yield on the issue of which the bonds are a part. To determine yield on fixed yield bonds, see paragraph (b)(1) of this section. The rules contained in paragraphs (b)(2) and (b)(3) of this section apply for this purpose. In the case of bonds described in paragraph (b)(2)(ii) of this section, the present value of those bonds on any date is computed using the yield to the final maturity date of those bonds as the discount rate. In determining the present value of a variable yield bond under this paragraph (e)(2), the initial interest rate on the bond established by the interest index or other interest rate setting mechanism is used to determine the interest payments on that bond.

(f) *Qualified guarantees*—(1) *In general.* Fees properly allocable to payments for a qualified guarantee for an issue (as determined under paragraph (f)(6) of this section) are treated as additional interest on that issue under section 148. A guarantee is a qualified guarantee if it satisfies each of the requirements of paragraphs (f)(2) through (f)(4) of this section.

(2) *Interest savings.* As of the date the guarantee is obtained, the issuer must reasonably expect that the present value of the fees for the guarantee will be less than the present value of the expected interest savings on the issue as a result of the guarantee. For this purpose, present value is computed using the yield on the issue, determined with regard to guarantee payments, as the discount rate.

(3) *Guarantee in substance.* The arrangement must create a guarantee in substance. The arrangement must impose a secondary liability that unconditionally shifts substantially all of the credit risk for all or part of the payments, such as payments for principal and interest, redemption prices, or tender prices, on the guaranteed bonds. Reasonable procedural or administrative requirements of the guarantee do not cause the guarantee to be conditional. In the case of a guarantee against failure to remarket a qualified tender bond, commercially reasonable limitations based on credit risk, such as limitations on payment in the event of default by the primary obligor or the bankruptcy of a long-term credit guarantor, do not cause the guarantee to be conditional. The guarantee may be in any form. The guarantor may not be a co-obligor. Thus, the guarantor must not expect to make any payments other than under a direct-pay letter of credit or similar arrangement for which the guarantor will be reimbursed immediately. The guarantor and any related parties together must not use more than 10 percent of the proceeds of the portion of the issue allocable to the guaranteed bonds.

(4) *Reasonable charge*—(i) *In general.* Fees for a guarantee must not exceed a reasonable, arm's-length charge for the transfer of credit risk. In complying with this requirement, the issuer may

not rely on the representations of the guarantor.

(ii) *Fees for services other than transfer of credit risk must be separately stated.* A fee for a guarantee must not include any payment for any direct or indirect services other than the transfer of credit risk, unless the compensation for those other services is separately stated, reasonable, and excluded from the guarantee fee. Fees for the transfer of credit risk include fees for the guarantor's overhead and other costs relating to the transfer of credit risk. For example, a fee includes payment for services other than transfer of credit risk if—

(A) It includes payment for the cost of underwriting or remarketing bonds or for the cost of insurance for casualty to bond-financed property;

(B) It is refundable upon redemption of the guaranteed bond before the final maturity date and the amount of the refund would exceed the portion of the fee that had not been earned; or

(C) The requirements of §1.148–2(e)(2) (relating to temporary periods for capital projects) are not satisfied, and the guarantor is not reasonably assured that the bonds will be repaid if the project to be financed is not completed.

(5) *Guarantee of purpose investments.* Except for guarantees of qualified mortgage loans and qualified student loans, a guarantee of payments on a purpose investment is a qualified guarantee of the issue if all payments on the purpose investment reasonably coincide with payments on the related bonds and the payments on the purpose investment are unconditionally payable no more than 6 months before the corresponding interest payment and 12 months before the corresponding principal payments on the bonds. This paragraph (f)(5) only applies if, in addition to satisfying the other requirements of this paragraph (f), the guarantee is, in substance, a guarantee of the bonds allocable to that purpose investment and to no other bonds except for bonds that are equally and ratably secured by purpose investments of the same conduit borrower.

(6) *Allocation of qualified guarantee payments*—(i) *In general.* Payments for a qualified guarantee must be allocated to bonds and to computation periods in a manner that properly reflects the proportionate credit risk for which the guarantor is compensated. Proportionate credit risk for bonds that are not substantially identical may be determined using any reasonable, consistently applied method. For example, this risk may be based on the ratio of the total principal and interest paid and to be paid on a guaranteed bond to the total principal and interest paid and to be paid on all bonds of the guaranteed issue. An allocation method generally is not reasonable, for example, if a substantial portion of the fee is allocated to the construction portion of the issue and a correspondingly insubstantial portion is allocated to the later years covered by the guarantee. Reasonable letter of credit *set up* fees may be allocated ratably during the initial term of the letter of credit. Upon an early redemption of a variable yield bond, fees otherwise allocable to the period after the redemption are allocated to remaining outstanding bonds of the issue or, if none remain outstanding, to the period before the redemption.

(ii) *Safe harbor for allocation of qualified guarantee fees for variable yield issues.* An allocation of non-level payments for a qualified guarantee for variable yield bonds is treated as meeting the requirements of paragraph (f)(6)(i) of this section if, for each bond year for which the guarantee is in effect, an equal amount (or for any short bond year, a proportionate amount of the equal amount) is treated as paid as of the beginning of that bond year. The present value of the annual amounts must equal the fee for the guarantee allocated to that bond, with present value computed as of the first day the guarantee is in effect by using as the discount rate the yield on the variable yield bonds covered by the guarantee, determined without regard to any fee allocated under this paragraph (f)(6)(ii).

(7) *Refund or reduction of guarantee payments.* If as a result of an investment of proceeds of a refunding issue in a refunding escrow, there will be a reduction in, or refund of, payments for a guarantee (*savings*), the savings must be treated as a reduction in the payments on the refunding issue.

(g) *Yield on certain mortgage revenue and student loan bonds.* For purposes of section 148 and this section, section 143(g)(2)(C)(ii) applies to the computation of yield on an issue of qualified mortgage bonds or qualified veterans' mortgage bonds. For purposes of applying section 148 and section 143(g) with respect to purpose investments allocable to a variable yield issue of qualified mortgage bonds, qualified veterans' mortgage bonds, or qualified student loan bonds that is reasonably expected as of the issue date to convert to a fixed yield issue, the yield may be computed over the term of the issue, and, if the yield is so computed, paragraph (d) of this section does not apply to the issue. As of any date, the yield over the term of the issue is based on—

(1) With respect to any bond of the issue that has not converted to a fixed and determinable yield on or before that date, the actual amounts paid or received to that date and the amounts that are reasonably expected (as of that date) to be paid or received with respect to that bond over the remaining term of the issue (taking into account prepayment assumptions under section 143(g)(2)(B)(iv), if applicable); and

(2) With respect to any bond of the issue that has converted to a fixed and determinable yield on or before that date, the actual amounts paid or received before that bond converted, if any, and the amount that was reasonably expected (on the date that bond converted) to be paid or received with respect to that bond over the remaining term of the issue (taking into account prepayment assumptions under section 143(g)(2)(B)(iv), if applicable).

(h) *Qualified hedging transactions*—(1) *In general.* Payments made or received by an issuer under a qualified hedge (as defined in paragraph (h)(2) of this section) relating to bonds of an issue are taken into account (as provided in paragraph (h)(3) of this section) to determine the yield on the issue. Except as provided in paragraphs (h)(4) and (h)(5)(ii)(E) of this section, the bonds to which a qualified hedge relates are treated as variable yield bonds from the issue date of the bonds. This paragraph (h) applies solely for purposes of sections 143(g), 148, and 149(d).

(2) *Qualified hedge defined.* Except as provided in paragraph (h)(5) of this section, the term *qualified hedge* means a contract that satisfies each of the following requirements:

(i) *Hedge*—(A) *In general.* The contract is entered into primarily to modify the issuer's risk of interest rate changes with respect to a bond (a hedge). For example, the contract may be an interest rate swap, an interest rate cap, a futures contract, a forward contract, or an option.

(B) *Special rule for fixed rate issues.* If the contract modifies the issuer's risk of interest rate changes with respect to a bond that is part of an issue that, absent the contract, would be a fixed rate issue, the contract must be entered into—

(*1*) No later than 15 days after the issue date (or the deemed issue date under paragraph (d) of this section) of the issue; or

(*2*) No later than the expiration of a qualified hedge with respect to bonds of that issue that satisfies paragraph (h)(2)(i)(B)(*1*) of this section; or

(*3*) No later than the expiration of a qualified hedge with respect to bonds of that issue that satisfies either paragraph (h)(2)(i)(B)(*2*) of this section or this paragraph (h)(2)(i)(B)(*3*).

(C) *Contracts with certain acquisition payments.* If a hedge provider makes a single payment to the issuer (e.g., a payment for an off-market swap) in connection with the acquisition of a contract, the issuer may treat a portion of that contract as a hedge provided—

(*1*) The hedge provider's payment to the issuer and the issuer's payments under the contract in excess of those that it would make if the contract bore rates equal to the on-market rates for the contract (determined as of the date the parties enter into the contract) are separately identified in a certification of the hedge provider; and

(*2*) The payments described in paragraph (h)(2)(i)(C)(*1*) of this section are not treated as payments on the hedge.

(ii) *No significant investment element*—(A) *In general.* The contract does not contain a significant investment element. Except as provided in paragraph (h)(2)(ii)(B) of this section, a contract contains a significant investment element if a significant portion of any payment by one party relates to a conditional or unconditional obligation by the other party to make a payment on a different date. Examples of contracts that contain a significant investment element are a debt instrument held by the issuer; an interest rate swap requiring any payments other than periodic payments, within the meaning of §1.446–3 (periodic payments) (e.g., a payment for an off-market swap or prepayment of part or all of one leg of a swap); and an interest rate cap requiring the issuer's premium for the cap to be paid in a single, up-front payment.

(B) *Special level payment rule for interest rate caps.* An interest rate cap does not contain a significant investment element if—

(*1*) All payments to the issuer by the hedge provider are periodic payments;

(*2*) The issuer makes payments for the cap at the same time as periodic payments by the hedge provider must be made if the specified index (within the meaning of §1.446–3) of the cap is above the strike price of the cap; and

(*3*) Each payment by the issuer bears the same ratio to the notional principal amount (within the meaning of §1.446–3) that is used to compute the hedge provider's payment, if any, on that date.

(iii) *Parties.* The contract is entered into between the issuer or the political subdivision on behalf of which the issuer issues the bonds (collectively referred to in this paragraph (h) as the *issuer*) and a provider that is not a related party (the *hedge provider*).

(iv) *Hedged bonds.* The contract covers, in whole or in part, all of one or more groups of substantially identical bonds in the issue (i.e., all of the bonds having the same interest rate, maturity, and terms). Thus, for example, a qualified hedge may include a hedge of all or a pro rata portion of each interest payment on the variable rate bonds in an issue for the first 5 years following their issuance. For purposes of this paragraph (h), unless the context clearly requires otherwise, *hedged bonds* means the specific bonds or portions thereof covered by a hedge.

(v) *Interest based contract.* The contract is primarily interest based. A contract is not primarily interest based unless—

(A) The hedged bond, without regard to the contract, is either a fixed rate bond, a variable rate debt instrument within the meaning of §1.1275–5 provided the rate is not based on an objective rate other than a qualified inverse floating rate or a qualified inflation rate, a tax-exempt obligation described in §1.1275–4(d)(2), or an inflation-indexed debt instrument within the meaning of §1.1275–7T; and

(B) As a result of treating all payments on (and receipts from) the contract as additional payments on (and receipts from) the hedged bond, the resulting bond would be substantially similar to either a fixed rate bond, a variable rate debt instrument within the meaning of §1.1275–5 provided the rate is not based on an objective rate other than a qualified inverse floating rate or a qualified inflation rate, a tax-exempt obligation described in §1.1275–4(d)(2), or an inflation-indexed debt instrument within the meaning of §1.1275–7T. For this purpose, differences that would not prevent the resulting bond from being substantially similar to another type of bond include a difference between the index used to compute payments on the hedged bond and the index used to compute payments on the hedge where one index is substantially the same, but not identical to, the other; the difference resulting from the payment of a fixed premium for a cap (e.g., payments for a cap that are made in other than level installments); and the difference resulting from the allocation of a termination payment where the termination was not expected as of the date the contract was entered into.

(vi) *Payments closely correspond.* The payments received by the issuer from the hedge provider under the contract correspond closely in time to either the specific payments being hedged on the hedged bonds or specific payments required to be made pursuant to the bond documents, regardless of the hedge, to a sinking fund, debt service fund, or similar fund maintained for the issue of which the hedged bond is a part.

(vii) *Source of payments.* Payments to the hedge provider are reasonably expected to be made from the same source of funds that, absent the hedge, would be reasonably expected to be used to pay principal and interest on the hedged bonds.

(viii) *Identification.* The contract must be identified by the actual issuer on its books and records maintained for the hedged bonds not later than 3 days after the date on which the issuer and the hedge provider enter into the contract. The identification must specify the hedge provider, the terms of the contract, and the hedged bonds. The identification must contain sufficient detail to establish that the requirements of this paragraph (h)(2) and, if applicable, paragraph (h)(4) of this section are satisfied. In addition, the existence of the hedge must be noted on the first form relating to the issue of which the hedged bonds are a part that is filed with the Internal Revenue Service on or after the date on which the contract is identified pursuant to this paragraph (h)(2)(viii).

(3) *Accounting for qualified hedges*—(i) *In general.* Except as otherwise provided in paragraph (h)(4) of this section, payments made or received by the issuer under a qualified hedge are treated as payments made or received, as appropriate, on the hedged bonds that are taken into account in determining the yield on those bonds. These payments are reasonably allocated to the hedged bonds in the period to which the payments relate, as determined under paragraph (h)(3)(iii) of this section. Payments made or received by the issuer include payments deemed made or received when a contract is terminated or deemed terminated under this paragraph (h)(3). Payments reasonably allocable to the modification of risk of interest rate changes and to the hedge provider's overhead under this paragraph (h) are included as payments made or received under a qualified hedge.

(ii) *Exclusions from hedge.* If any payment for services or other items under the contract is not expressly treated by paragraph (h)(3)(i) of this section as a payment under the qualified hedge, the payment is not a payment with respect to a qualified hedge.

(iii) *Timing and allocation of payments.* Except as provided in paragraphs (h)(3)(iv) and (h)(5) of this section, payments made or received by the issuer under a qualified hedge are taken into account in the same period in which those amounts would be treated as income or deductions under § 1.446–4 (without regard to § 1.446–4(a)(2)(iv)) and are adjusted as necessary to reflect the end of a computation period and the start of a new computation period.

(iv) *Termination payments*—(A) *Termination defined.* A termination of a qualified hedge includes any sale or other disposition of the hedge by the issuer or the acquisition by the issuer of an offsetting hedge. A deemed termination occurs when the hedged bonds are redeemed or when a hedge ceases to be a qualified hedge of the hedged bonds. In the case of an assignment by a hedge provider of its remaining rights and obligations under the hedge to a third party or a modification of the hedging contract, the assignment or modification is treated as a termination with respect to the issuer only if it results in a deemed exchange of the hedge and a realization event under section 1001 to the issuer.

(B) *General rule.* A payment made or received by an issuer to terminate a qualified hedge, including loss or gain realized or deemed realized, is treated as a payment made or received on the hedged bonds, as appropriate. The payment is reasonably allocated to the remaining periods originally covered by the terminated hedge in a manner that reflects the economic substance of the hedge.

(C) *Special rule for terminations when bonds are redeemed.* Except as otherwise provided in this paragraph (h)(3)(iv)(C) and in paragraph (h)(3)(iv)(D) of this section, when a qualified hedge is deemed terminated because the hedged bonds are redeemed, the fair market value of the qualified hedge on the redemption date is treated as a termination payment made or received on that date. When hedged bonds are redeemed, any payment received by the issuer on termination of a hedge, including a termination payment or a deemed termination payment, reduces, but not below zero, the interest payments made by the issuer on the hedged bonds in the computation period ending on the termination date. The remainder of the payment, if any, is reasonably allocated over the bond years in the immediately preceding computation period or periods to the extent necessary to eliminate the excess.

(D) *Special rules for refundings.* To the extent that the hedged bonds are redeemed using the proceeds of a refunding issue, the termination payment is accounted for under paragraph (h)(3)(iv)(B) of this section by treating it as a payment on the refunding issue, rather than the hedged bonds. In addition, to the extent that the refunding issue is redeemed during the period to which the termination payment has been allocated to that issue, paragraph (h)(3)(iv)(C) of this section applies to the termination payment by treating it as a payment on the redeemed refunding issue.

(E) *Safe harbor for allocation of certain termination payments.* A payment to terminate a qualified hedge does not result in that hedge failing to satisfy the applicable provisions of paragraph (h)(3)(iv)(B) of this section if the payment is allocated in accordance with this paragraph (h)(3)(iv)(E). For an issue that is a variable yield issue after termination of a qualified hedge, an amount must be allocated to each date on which the hedge provider's payment, if any, would have been made had the hedge not been terminated. The amounts allocated to each date must bear the same ratio to the notional principal amount (within the meaning of §1.446–3) that would have been used to compute the hedge provider's payment, if any, on that date, and the sum of the present values of those amounts must equal the present value of the termination payment. Present value is computed as of the day the qualified hedge is terminated, using the yield on the hedged bonds, determined without regard to the termination payment. The yield used for this purpose is computed for the period beginning on the first date the qualified hedge is in effect and ending on the date the qualified hedge is terminated. On the other hand, for an issue that is a fixed yield issue after termination of a qualified hedge, the termination payment is taken into account as a single payment on the date it is paid.

(4) *Certain variable yield bonds treated as fixed yield bonds*—(i) *In general.* Except as otherwise provided in this paragraph (h)(4), if the issuer of variable yield bonds enters into a qualified hedge, the hedged bonds are treated as fixed yield bonds paying a fixed interest rate if:

(A) *Maturity.* The term of the hedge is equal to the entire period during which the hedged bonds bear interest at variable interest rates, and the issuer does not reasonably expect that the hedge will be terminated before the end of that period.

(B) *Payments closely correspond.* Payments to be received under the hedge correspond closely in time to the hedged portion of payments on the hedged bonds. Hedge payments received within 15 days of the related payments on the hedged bonds generally so correspond.

(C) *Aggregate payments fixed.* Taking into account all payments made and received under the hedge and all payments on the hedged bonds (i.e., after netting all payments), the issuer's aggregate payments are fixed and determinable as of a date not later than 15 days after the issue date of the hedged bonds. Payments on bonds are treated as fixed for purposes of this paragraph (h)(4)(i)(C) if payments on the bonds are based, in whole or in part, on one interest rate, payments on the hedge are based, in whole or in part, on a second interest rate that is substantially the same as, but not identical to, the first interest rate and payments on the bonds would be fixed if the two rates were identical. Rates are treated as substantially the same if they are reasonably expected to be substantially the same throughout the term of the hedge. For example, an objective 30-day tax-exempt variable rate index or other objective index may be substantially the same as an issuer's individual 30-day interest rate.

(ii) *Accounting.* Except as otherwise provided in this paragraph (h)(4)(ii), in determining yield on the hedged bonds, all the issuer's payments on the hedged bonds and all payments made and received on a hedge described in paragraph (h)(4)(i) of this section are taken into account. If payments on the bonds and payments on the hedge are based, in whole or in part, on variable interest rates that are substantially the same within the meaning of paragraph (h)(4)(i)(C) of this section (but not identical), yield on the issue is determined by treating the variable interest rates as identical. For example, if variable rate bonds bearing interest at a weekly rate equal to the rate necessary to remarket the bonds at par are hedged with an interest rate swap under which the issuer receives payments based on a short-term floating rate index that is substantially the same as, but not identical to, the weekly rate on the bonds, the interest payments on the bonds are treated as equal to the payments received by the issuer under the swap for purposes of computing the yield on the bonds.

(iii) *Effect of termination*—(A) *In general.* Except as otherwise provided in this paragraph (h)(4)(iii) and paragraph (h)(5) of this section, the issue of which the hedged bonds are a part is treated as if it were reissued as of the termination date of the qualified hedge covered by paragraph (h)(4)(i) of this section in determining yield on the hedged bonds for purposes of § 1.148–3. The redemption price of the retired issue and the issue price of the new issue equal the aggregate values of all the bonds of the issue on the termination date. In computing the yield on the new issue for this purpose, any termination payment is accounted for under paragraph (h)(3)(iv) of this section, applied by treating the termination payment as made or received on the new issue under this paragraph (h)(4)(iii).

(B) *Effect of early termination.* Except as otherwise provided in this paragraph (h)(4)(iii), the general rules of paragraph (h)(4)(i) of this section do not apply in determining the yield on the hedged bonds for purposes of § 1.148–3 if the hedge is terminated or deemed terminated within 5 years after the issue date of the issue of which the hedged bonds are a part. Thus, the hedged bonds are treated as variable yield bonds for purposes of § 1.148–3 from the issue date.

(C) *Certain terminations disregarded.* This paragraph (h)(4)(iii) does not apply to a termination if, based on the facts and circumstances (e.g., taking into account both the termination and any qualified hedge that immediately replaces the terminated hedge), there is no change in the yield.

(5) *Contracts entered into before issue date of hedged bond*—(i) *In general.* A contract does not fail to be a hedge under paragraph (h)(2)(i) of this section solely because it is entered into before the issue date of the hedged bond. However, that contract must be one to which either paragraph (h)(5)(ii) or (h)(5)(iii) of this section applies.

(ii) *Contracts expected to be closed substantially contemporaneously with the issue date of hedged bond*—(A) *Application.* This paragraph (h)(5)(ii) applies to a contract if, on the date the contract is identified, the issuer reasonably expects to terminate or otherwise close (terminate) the contract substantially contemporaneously with the issue date of the hedged bond.

(B) *Contract terminated.* If a contract to which this paragraph (h)(5)(ii) applies is terminated substantially contemporaneously with the issue date of the hedged bond, the amount paid or received, or deemed to be paid or received, by the issuer in connection with the issuance of the hedged bond to terminate the contract is treated as an adjustment to the issue price of the hedged bond and as an adjustment to the sale proceeds of the hedged bond for purposes of section 148. Amounts paid or received, or deemed to be paid or received, before the issue date of the hedged bond are treated as paid or received on the issue date in an amount equal to the future value of the payment or receipt on that date. For this purpose, future value is computed using yield on the hedged bond without taking into account amounts paid or received (or deemed paid or received) on the contract.

(C) *Contract not terminated.* If a contract to which this paragraph (h)(5)(ii) applies is not terminated substantially contemporaneously with the issue date of the hedged bond, the contract is deemed terminated for its fair market value as of the issue date of the hedged bond. Once a contract has been deemed terminated pursuant to this paragraph (h)(5)(ii)(C), payments on and receipts from the contract are no longer taken into account under this paragraph (h) for purposes of determining yield on the hedged bond.

(D) *Relation to other requirements of a qualified hedge.* Payments made in connection with the issuance of a bond to terminate a contract to which this paragraph (h)(5)(ii) applies do not prevent the contract from satisfying the requirements of paragraph (h)(2)(vi) of this section.

(E) *Fixed yield treatment.* A bond that is hedged with a contract to which this paragraph (h)(5)(ii) applies does not fail to be a fixed yield bond if, taking into account payments on the contract and the payments to be made on the bond, the bond satisfies the definition of fixed yield bond. See also paragraph (h)(4) of this section.

(iii) *Contracts expected not to be closed substantially contemporaneously with the issue date of hedged bond*—(A) *Application.* This paragraph (h)(5)(iii) applies to a contract if, on the date the contract is identified, the issuer does not reasonably expect to terminate the contract substantially contemporaneously with the issue date of the hedge bond.

(B) *Contract terminated.* If a contract to which this paragraph (h)(5)(iii) applies is terminated in connection with the issuance of the hedged bond, the amount paid or received, or deemed to be paid or received, by the issuer to terminate the contract is treated as an adjustment to the issue price of the hedged bond and as an adjustment to the sale proceeds of the hedged bond for purposes of section 148.

(C) *Contract not terminated.* If a contract to which this paragraph (h)(5)(iii) applies is not terminated substantially contemporaneously with the issue date of the hedged bond, no payments with respect to the hedge made by the issuer before the issue date of the hedged bond are taken into account under this section.

(iv) *Identification.* The identification required under paragraph (h)(2)(viii) of this section must specify the reasonably expected governmental purpose, issue price, maturity, and issue date of the hedged bond, the manner in which interest is reasonably expected to be computed, and whether paragraph (h)(5)(ii) or (h)(5)(iii) of this section applies to the contract. If an issuer identifies a contract under this paragraph (h)(5)(iv) that would be a qualified hedge with respect to the anticipated bond, but does not issue the anticipated bond on the identified issue date, the contract is taken into account as a qualified hedge of any bond of the issuer that is issued for the identified governmental purpose within a reasonable interval around the identified issue date of the anticipated bond.

(6) *Authority of the Commissioner.* The Commissioner, by publication of a revenue ruling or revenue procedure (see §601.601(d)(2) of this chapter), may specify contracts that, although they do not meet the requirements of paragraph (h)(2) of this section, are qualified hedges or, although they do not meet the requirements of paragraph (h)(4) of this section, cause the hedged bonds to be treated as fixed yield bonds.

[T.D. 8476, 58 FR 33524, June 18, 1993; 58 FR 44452, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24042, May 10, 1994; T.D. 8718, 62 FR 25507, May 9, 1997]

§1.148–5 Yield and valuation of investments.

(a) *In general.* This section provides rules for computing the yield and value of investments allocated to an issue for various purposes under section 148.

(b) *Yield on an investment*—(1) *In general.* Except as otherwise provided, the yield on an investment allocated to an issue is computed under the economic accrual method, using the same compounding interval and financial conventions used to compute the yield on the issue. The yield on an investment allocated to an issue is the discount rate that, when used in computing the present value as of the date the investment is first allocated to the issue of all unconditionally payable receipts from the investment, produces an amount equal to the present value of all unconditionally payable payments for the investment. For this purpose, *payments* means amounts to be actually or constructively paid to acquire the investment, and *receipts* means amounts to be actually or constructively received from the investment, such as earnings and return of principal. The yield on a variable rate investment is determined in a manner comparable to the determination of the yield on a variable rate issue. For an issue of qualified mortgage bonds, qualified veterans' mortgage bonds, or qualified student loan bonds on which interest is paid semiannually, all regular monthly loan payments to be received during a semiannual debt service period may be treated as received at the end of that period. In addition, for any conduit financing issue, payments made by the conduit borrower are not treated as paid until the conduit borrower ceases to receive the benefit of earnings on those amounts.

(2) *Yield on a separate class of investments*—(i) *In general.* For purposes of the yield restriction rules of section 148(a) and § 1.148–2, yield is computed separately for each class of investments. For this purpose, in determining the yield on a separate class of investments, the yield on each individual investment within the class is blended with the yield on other individual investments within the class, whether or not held concurrently, by treating those investments as a single investment. The yields on investments that are not within the same class are not blended.

(ii) *Separate classes of investments.* Each of the following is a separate class of investments—

(A) Each category of yield restricted purpose investment and program investment that is subject to a different definition of *materially higher* under § 1.148–2(d)(2);

(B) Yield-restricted nonpurpose investments; and

(C) All other nonpurpose investments;

(iii) *Permissive application of single investment rules to certain yield restricted investments for all purposes of section 148.* For all purposes of section 148, if an issuer reasonably expects as of the issue date to establish and maintain a sinking fund solely to reduce the yield on the investments in a refunding escrow, then the issuer may treat all of the yield restricted nonpurpose investments in the refunding escrow and that sinking fund as a single investment having a single yield, determined under this paragraph (b)(2). Thus, an issuer may not treat the nonpurpose investments in a reasonably required reserve fund and a refunding escrow as a single investment having a single yield under this paragraph (b)(2)(iii).

(iv) *Mandatory application of single investment rules for refunding escrows for all purposes of section 148.* For all purposes of section 148, in computing the yield on yield restricted investments allocable to proceeds (i.e., sale proceeds, investment proceeds, and transferred proceeds) of a refunding issue that are held in one or more refunding escrows, the individual investments are treated as a single investment having a single yield, whether or not held concurrently. For example, this single investment includes both the individual investments allocable to sale and investment proceeds of a refunding issue that are held in one refunding escrow for a prior issue and the investments allocable to transferred proceeds of that refunding issue that are held in another refunding escrow.

(3) *Investments to be held beyond issue's maturity or beyond temporary period.* In computing the yield on investments allocable to an issue that are to be held beyond the reasonably expected redemption date of the issue, those investments are treated as sold for an amount equal to their value on that date. In computing the yield on investments that are held beyond an applicable temporary period under § 1.148–2, for purposes of § 1.148–2 those investments may be treated as purchased for an amount equal to their fair market value as of the end of the temporary period.

(4) *Consistent redemption assumptions on purpose investments.* The yield on purpose investments allocable to an issue is computed using the same redemption assumptions used to compute the yield on the issue. Yield on purpose investments allocable to an issue of qualified mortgage bonds and qualified veterans' mortgage bonds must be determined in a manner that is consistent with, and using the assumptions required by, section 143(g)(2)(B).

(5) *Student loan special allowance payments included in yield.* Except as provided in § 1.148–11(e), the yield on qualified student loans is computed by including as receipts any special allowance payments made by the Secretary

of Education pursuant to section 438 of the Higher Education Act of 1965.

(c) *Yield reduction payments to the United States*—(1) *In general.* In determining the yield on an investment to which this paragraph (c) applies, any amount paid to the United States in accordance with this paragraph (c), including a rebate amount, is treated as a payment for that investment that reduces the yield on that investment.

(2) *Manner of payment*—(i) *In general.* Except as otherwise provided in paragraph (c)(2)(ii) of this section, an amount is paid under this paragraph (c) if it is paid to the United States at the same time and in the same manner as rebate amounts are required to be paid or at such other time or in such manner as the Commissioner may prescribe. For example, yield reduction payments must be made on or before the date of required rebate installment payments as described in §§1.148–3(f), (g), and (h). The provisions of §1.148–3(i) apply to payments made under this paragraph (c).

(ii) *Special rule for purpose investments.* For purpose investments allocable to an issue—

(A) No amounts are required to be paid to satisfy this paragraph (c) until the earlier of the end of the tenth bond year after the issue date of the issue or 60 days after the date on which the issue is no longer outstanding; and

(B) For payments made prior to the date on which the issue is retired, the issuer need not pay more than 75 percent of the amount otherwise required to be paid as of the date to which the payment relates.

(3) *Applicability of special yield reduction rule*—(i) *Covered investments.* This paragraph (c) applies to—

(A) Nonpurpose investments allocable to proceeds of an issue that qualified for one of the temporary periods available for capital projects, restricted working capital expenditures, pooled financings, or investment proceeds under §1.148–2(e)(2), (e)(3), (e)(4), or (e)(6), respectively;

(B) Investments allocable to a variable yield issue during any computation period in which at least 5 percent of the value of the issue is represented by variable yield bonds, unless the issue is an issue of hedge bonds (as defined in section 149(g)(3)(A));

(C) Nonpurpose investments allocable to transferred proceeds of—

(*1*) A current refunding issue to the extent necessary to reduce the yield on those investments to satisfy yield restrictions under section 148(a); or

(*2*) An advance refunding issue to the extent that investment of the refunding escrows allocable to the proceeds, other than transferred proceeds, of the refunding issue in zero-yielding nonpurpose investments is insufficient to satisfy yield restrictions under section 148(a);

(D) Purpose investments allocable to qualified student loans under a program described in section 144(b)(1)(A);

(E) Nonpurpose investments allocable to gross proceeds of an issue in a reasonably required reserve or replacement fund or in a fund that, except for its failure to satisfy the size limitation in §1.148–2(f)(2)(ii), would qualify as a reasonably required reserve or replacement fund, but only to the extent that—

(*1*) The value of the nonpurpose investments in the fund is not greater than 15 percent of the stated principal amount of the issue, as computed under §1.148–2(f)(2)(ii), or

(*2*) The amounts in the fund (other than investment earnings) are not reasonably expected to be used to pay debt service on the issue other than in connection with reductions in the amount required to be in that fund (e.g. a reserve fund for a revolving fund loan program);

(F) Nonpurpose investments allocated to replacement proceeds of a refunded issue as a result of the application of the universal cap to amounts in a refunding escrow (see §1.148–11(c)(1)(ii)); and

(G) Investments described in §1.148–11(f).

(ii) *Exception to yield reduction payments rule for advance refunding issues.* Paragraph (c)(1) of this section does not apply to investments allocable to gross proceeds of an advance refunding issue, other than—

(A) Transferred proceeds to which paragraph (c)(3)(i)(C) of this section applies;

(B) Replacement proceeds to which paragraph (c)(3)(i)(F) of this section applies; and

(C) Transferred proceeds to which paragraph (c)(3)(i)(E) of this section applies, but only to the extent necessary to satisfy yield restriction under section 148(a) on those proceeds treating all investments allocable to those proceeds as a separate class.

(d) *Value of investments*—(1) *In general.* Except as otherwise provided, the value of an investment (including a payment or receipt on the investment) on a date must be determined using one of the following valuation methods consistently for all purposes of section 148 to that investment on that date:

(i) *Plain par investment—outstanding principal amount.* A plain par investment may be valued at its outstanding stated principal amount, plus any accrued unpaid interest on that date.

(ii) *Fixed rate investment—present value.* A fixed rate investment may be valued at its present value on that date.

(iii) *Any investment—fair market value.* An investment may be valued at its fair market value on that date.

(2) *Mandatory valuation of yield restricted investments at present value.* Any yield restricted investment must be valued at present value. For example, a purpose investment or an investment allocable to gross proceeds in a refunding escrow after the expiration of the initial temporary period must be valued at present value. See, however, paragraph (b)(3) of this section.

(3) *Mandatory valuation of certain investments at fair market value*—(i) *In general.* Except as provided in paragraphs (d)(2), (d)(3)(ii), and (d)(4) of this section, an investment must be valued at fair market value on the date that it is first allocated to an issue or first ceases to be allocated to an issue as a consequence of a deemed acquisition or deemed disposition. For example, if an issuer deposits existing investments into a sinking fund for an issue, those investments must be valued at fair market value as of the date first deposited into the fund.

(ii) *Exception to fair market value requirement for transferred proceeds allocations, universal cap allocations, and commingled funds.* Paragraph (d)(3)(i) of this section does not apply if the investment is allocated from one issue to another issue as a result of the transferred proceeds allocation rule under § 1.148–9(b) or the universal cap rule under § 1.148–6(b)(2), provided that both issues consist exclusively of tax-exempt bonds. In addition, paragraph (d)(3)(i) of this section does not apply to investments in a commingled fund (other than a bona fide debt service fund) unless it is an investment being initially deposited in or withdrawn from a commingled fund described in § 1.148–6(e)(5)(iii).

(4) *Special transition rule for transferred proceeds.* The value of a nonpurpose investment that is allocated to transferred proceeds of a refunding issue on a transfer date may not exceed the value of that investment on the transfer date used for purposes of applying the arbitrage restrictions to the refunded issue.

(5) *Definition of present value of an investment.* Except as otherwise provided, present value of an investment is computed under the economic accrual method, using the same compounding interval and financial conventions used to compute the yield on the issue. The present value of an investment on a date is equal to the present value of all unconditionally payable receipts to be received from and payments to be paid for the investment after that date, using the yield on the investment as the discount rate.

(6) *Definition of fair market value*—(i) *In general.* The fair market value of an investment is the price at which a willing buyer would purchase the investment from a willing seller in a bona fide, arm's-length transaction. Fair market value generally is determined on the date on which a contract to purchase or sell the nonpurpose investment becomes binding (i.e., the trade date rather than the settlement date). Except as otherwise provided in this paragraph (d)(6), an investment that is not of a type traded on an established securities market, within the meaning of section 1273, is rebuttably presumed to be acquired or disposed of for a price that is not equal to its fair market value. The fair market value of a United States Treasury obligation that

is purchased directly from the United States Treasury is its purchase price.

(ii) *Safe harbor for establishing fair market value for certificates of deposit.* This paragraph (d)(6)(ii) applies to a certificate of deposit that has a fixed interest rate, a fixed payment schedule, and a substantial penalty for early withdrawal. The purchase price of such a certificate of deposit is treated as its fair market value on the purchase date if the yield on the certificate of deposit is not less than—

(A) The yield on reasonably comparable direct obligations of the United States; and

(B) The highest yield that is published or posted by the provider to be currently available from the provider on reasonably comparable certificates of deposit offered to the public.

(iii) *Safe harbor for establishing fair market value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow.* The purchase price of a guaranteed investment contract and the purchase price of an investment purchased for a yield restricted defeasance escrow will be treated as the fair market value of the investment on the purchase date if all of the following requirements are satisfied:

(A) The issuer makes a bona fide solicitation for the purchase of the investment. A bona fide solicitation is a solicitation that satisfies all of the following requirements:

(*1*) The bid specifications are in writing and are timely forwarded to potential providers.

(*2*) The bid specifications include all material terms of the bid. A term is material if it may directly or indirectly affect the yield or the cost of the investment.

(*3*) The bid specifications include a statement notifying potential providers that submission of a bid is a representation that the potential provider did not consult with any other potential provider about its bid, that the bid was determined without regard to any other formal or informal agreement that the potential provider has with the issuer or any other person (whether or not in connection with the bond issue), and that the bid is not being submitted solely as a courtesy to the issuer or any other person for purposes of satisfying the requirements of paragraph (d)(6)(iii)(B)(*1*) or (*2*) of this section.

(*4*) The terms of the bid specifications are commercially reasonable. A term is commercially reasonable if there is a legitimate business purpose for the term other than to increase the purchase price or reduce the yield of the investment. For example, for solicitations of investments for a yield restricted defeasance escrow, the hold firm period must be no longer than the issuer reasonably requires.

(*5*) For purchases of guaranteed investment contracts only, the terms of the solicitation take into account the issuer's reasonably expected deposit and drawdown schedule for the amounts to be invested.

(*6*) All potential providers have an equal opportunity to bid. For example, no potential provider is given the opportunity to review other bids (i.e., a last look) before providing a bid.

(*7*) At least three reasonably competitive providers are solicited for bids. A reasonably competitive provider is a provider that has an established industry reputation as a competitive provider of the type of investments being purchased.

(B) The bids received by the issuer meet all of the following requirements:

(*1*) The issuer receives at least three bids from providers that the issuer solicited under a bona fide solicitation meeting the requirements of paragraph (d)(6)(iii)(A) of this section and that do not have a material financial interest in the issue. A lead underwriter in a negotiated underwriting transaction is deemed to have a material financial interest in the issue until 15 days after the issue date of the issue. In addition, any entity acting as a financial advisor with respect to the purchase of the investment at the time the bid specifications are forwarded to potential providers has a material financial interest in the issue. A provider that is a related party to a provider that has a material financial interest in the issue is deemed to have a material financial interest in the issue.

(*2*) At least one of the three bids described in paragraph (d)(6)(iii)(B)(*1*) of this section is from a reasonably competitive provider, within the meaning of paragraph (d)(6)(iii)(A)(*7*) of this section.

(*3*) If the issuer uses an agent to conduct the bidding process, the agent did not bid to provide the investment.

(C) The winning bid meets the following requirements:

(*1*) *Guaranteed investment contracts.* If the investment is a guaranteed investment contract, the winning bid is the highest yielding bona fide bid (determined net of any broker's fees).

(*2*) *Other investments.* If the investment is not a guaranteed investment contract, the following requirements are met:

(*i*) The winning bid is the lowest cost bona fide bid (including any broker's fees). The lowest cost bid is either the lowest cost bid for the portfolio or, if the issuer compares the bids on an investment-by-investment basis, the aggregate cost of a portfolio comprised of the lowest cost bid for each investment. Any payment received by the issuer from a provider at the time a guaranteed investment contract is purchased (e.g., an escrow float contract) for a yield restricted defeasance escrow under a bidding procedure meeting the requirements of this paragraph (d)(6)(iii) is taken into account in determining the lowest cost bid.

(*ii*) The lowest cost bona fide bid (including any broker's fees) is not greater than the cost of the most efficient portfolio comprised exclusively of State and Local Government Series Securities from the United States Department of the Treasury, Bureau of Public Debt. The cost of the most efficient portfolio of State and Local Government Series Securities is to be determined at the time that bids are required to be submitted pursuant to the terms of the bid specifications.

(*iii*) If State and Local Government Series Securities from the United States Department of the Treasury, Bureau of Public Debt are not available for purchase on the day that bids are required to be submitted pursuant to terms of the bid specifications because sales of those securities have been suspended, the cost comparison of paragraph (d)(6)(iii) (C)(*2*)(*ii*) of this section is not required.

(D) The provider of the investments or the obligor on the guaranteed investment contract certifies the administrative costs that it pays (or expects to pay, if any) to third parties in connection with supplying the investment.

(E) The issuer retains the following records with the bond documents until three years after the last outstanding bond is redeemed:

(*1*) For purchases of guaranteed investment contracts, a copy of the contract, and for purchases of investments other than guaranteed investment contracts, the purchase agreement or confirmation.

(*2*) The receipt or other record of the amount actually paid by the issuer for the investments, including a record of any administrative costs paid by the issuer, and the certification under paragraph (d)(6)(iii)(D) of this section.

(*3*) For each bid that is submitted, the name of the person and entity submitting the bid, the time and date of the bid, and the bid results.

(*4*) The bid solicitation form and, if the terms of the purchase agreement or the guaranteed investment contract deviated from the bid solicitation form or a submitted bid is modified, a brief statement explaining the deviation and stating the purpose for the deviation. For example, if the issuer purchases a portfolio of investments for a yield restricted defeasance escrow and, in order to satisfy the yield restriction requirements of section 148, an investment in the winning bid is replaced with an investment with a lower yield, the issuer must retain a record of the substitution and how the price of the substitute investment was determined. If the issuer replaces an investment in the winning bid portfolio with another investment, the purchase price of the new investment is not covered by the safe harbor unless the investment is bid under a bidding procedure meeting the requirements of this paragraph (d)(6)(iii).

(*5*) For purchases of investments other than guaranteed investment contracts, the cost of the most efficient portfolio of State and Local Government Series Securities, determined at the time that the bids were required to be submitted pursuant to the terms of the bid specifications.

(e) *Administrative costs of investments*—(1) *In general.* Except as otherwise provided in this paragraph (e), an allocation of gross proceeds of an issue to a payment or a receipt on an investment is not adjusted to take into account any costs or expenses paid, directly or indirectly, to purchase, carry, sell, or retire the investment (administrative costs). Thus, these administrative costs generally do not increase the payments for, or reduce the receipts from, investments.

(2) *Qualified administrative costs on nonpurpose investments*—(i) *In general.* In determining payments and receipts on nonpurpose investments, qualified administrative costs are taken into account. Thus, qualified administrative costs increase the payments for, or decrease the receipts from, the investments. Qualified administrative costs are reasonable, direct administrative costs, other than carrying costs, such as separately stated brokerage or selling commissions, but not legal and accounting fees, recordkeeping, custody, and similar costs. General overhead costs and similar indirect costs of the issuer such as employee salaries and office expenses and costs associated with computing the rebate amount under section 148(f) are not qualified administrative costs. In general, administrative costs are not reasonable unless they are comparable to administrative costs that would be charged for the same investment or a reasonably comparable investment if acquired with a source of funds other than gross proceeds of tax-exempt bonds.

(ii) *Special rule for administrative costs of nonpurpose investments in certain regulated investment companies and commingled funds.* Qualified administrative costs include all reasonable administrative costs, without regard to the limitation on indirect costs under paragraph (e)(2)(i) of this section, incurred by:

(A) *Regulated investment companies.* A publicly offered regulated investment company (as defined in section 67(c)(2)(B)); and

(B) *External commingled funds.* A widely held commingled fund in which no investor in the fund owns more than 10 percent of the beneficial interest in the fund. For purposes of this paragraph (e)(2)(ii)(B), a fund is treated as widely held only if, during the immediately preceding fixed, semiannual period chosen by the fund (e.g., semiannual periods ending June 30 and December 31), the fund had a daily average of more than 15 investors that were not related parties, and the daily average amount each investor had invested in the fund was not less than the lesser of $500,000 and 1 percent of the daily average of the total amount invested in the fund. For purposes of this paragraph (e)(2)(ii)(B), an investor will be treated as owning not more than 10 percent of the beneficial interest in the fund if, on the date of each deposit by the investor into the fund, the total amount the investor and any related parties have on deposit in the fund is not more than 10 percent of the total amount that all investors have on deposit in the fund. For purposes of the preceding sentence, the total amount that all investors have on deposit in the fund is equal to the sum of all deposits made by the investor and any related parties on the date of those deposits and the closing balance in the fund on the day before those deposits. If any investor in the fund owns more than 10 percent of the beneficial interest in the fund, the fund does not qualify under this paragraph (e)(2)(ii)(B) until that investor makes sufficient withdrawals from the fund to reduce its beneficial interest in the fund to 10 percent or less.

(iii) *Special rule for guaranteed investment contracts.* For a guaranteed investment contract, a broker's commission or similar fee paid on behalf of either an issuer or the provider is treated as an administrative cost and, except in the case of an issue that satisfies section 148(f)(4)(D)(i), is a qualified administrative cost to the extent that the present value of the commission, as of the date the contract is allocated to the issue, does not exceed the lesser of a reasonable amount within the meaning of paragraph (e)(2)(i) of this section or the present value of annual payments equal to .05 percent of the weighted average amount reasonably expected to be invested each year of the term of the contract. For this purpose, present value is computed using the taxable discount rate used by the parties to compute the commission or, if not readily ascertainable, the yield to the issuer on the investment contract or other reasonable taxable discount rate.

(iv) *Special rule for investments purchased for a yield restricted defeasance escrow.* For investments purchased for a yield restricted defeasance escrow, a fee paid to a bidding agent is a qualified administrative cost only if the following requirements are satisfied:

(A) The fee is comparable to a fee that would be charged for a reasonably comparable investment if acquired with a source of funds other than gross proceeds of tax-exempt bonds, and it is reasonable. The fee is deemed to be comparable to a fee that would be charged for a comparable investment acquired with a source of funds other than gross proceeds of tax-exempt bonds, and to be reasonable if the fee does not exceed the lesser of $10,000 or .1% of the initial principal amount of investments deposited in the yield restricted defeasance escrow.

(B) For transactions in which a guaranteed investment contract and other investments are purchased for a yield restricted defeasance escrow in a single investment (e.g., an issuer bids United States Treasury obligations and an escrow float contract collectively), a broker's fee described in paragraph (e)(2)(iv)(A) of this section will apply to the initial principal amount of the investment deposited in the yield restricted defeasance escrow, and a broker's fee described in paragraph (e)(2)(iii) of this section will apply only to the guaranteed investment contract portion of the investment.

(3) *Qualified administrative costs on purpose investments*—(i) *In general.* In determining payments and receipts on purpose investments, qualified administrative costs described in this paragraph (e)(3) paid by the conduit borrower are taken into account. Thus, these costs increase the payments for, or decrease the receipts from, the purpose investments. This rule applies even if those payments merely reimburse the issuer. Although the actual payments by the conduit borrower may be made at any time, for this purpose, a pro rata portion of each payment made by a conduit borrower is treated as a reimbursement of reasonable administrative costs, if the present value of those payments does not exceed the present value of the reasonable administrative costs paid by the issuer, using the yield on the issue as the discount rate.

(ii) *Definition of qualified administrative costs of purpose investments*—(A) *In general.* Except as otherwise provided in this paragraph (e)(3)(ii), qualified administrative costs of a purpose investment means—

(*1*) Costs or expenses paid, directly or indirectly, to purchase, carry, sell, or retire the investment; and

(*2*) Costs of issuing, carrying, or repaying the issue, and any underwriters' discount.

(B) *Limitation on program investments.* For a program investment, qualified administrative costs include only those costs described in paragraph (e)(3)(ii)(A)(*2*) of this section.

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§ 1.148–6 General allocation and accounting rules.

(a) *In general*—(1) *Reasonable accounting methods required.* An issuer may use any reasonable, consistently applied accounting method to account for gross proceeds, investments, and expenditures of an issue.

(2) *Bona fide deviations from accounting method.* An accounting method does not fail to be reasonable and consistently applied solely because a different accounting method is used for a bona fide governmental purpose to consistently account for a particular item. Bona fide governmental purposes may include special State law restrictions imposed on specific funds or actions to avoid grant forfeitures.

(3) *Absence of allocation and accounting methods.* If an issuer fails to maintain books and records sufficient to establish the accounting method for an issue and the allocation of the proceeds of that issue, the rules of this section are applied using the specific tracing method. This paragraph (a)(3) applies to bonds issued on or after May 16, 1997.

(b) *Allocation of gross proceeds to an issue*—(1) *One-issue rule and general ordering rules.* Except as otherwise provided, amounts are allocable to only one issue at a time as gross proceeds, and if amounts simultaneously are proceeds of one issue and replacement proceeds of another issue, those amounts are allocable to the issue of which they are proceeds. Amounts cease to be allocated to an issue as proceeds only when those amounts are allocated to an expenditure for a governmental purpose, are allocated to transferred proceeds of another issue, or cease to be allocated to that issue at retirement of the issue or under the universal cap of paragraph (b)(2) of this section. Amounts cease to be allocated to an issue as replacement proceeds only when those amounts are allocated to an expenditure for a governmental purpose, are no longer used in a manner that causes those amounts to be replacement proceeds of that issue, or cease to be allocated to that issue because of the retirement of the issue or the application of the universal cap under paragraph (b)(2) of this section. Amounts that cease to be allocated to an issue as gross proceeds are eligible for allocation to another issue. Under §1.148–10(a), however, the rules in this paragraph (b)(1) do not apply in certain cases involving abusive arbitrage devices.

(2) *Universal cap on value of nonpurpose investments allocated to an issue*—(i) *Application*. The rules in this paragraph (b)(2) provide an overall limitation on the amount of gross proceeds allocable to an issue. Although the universal cap generally may be applied at any time in the manner described in this paragraph (b)(2), it need not be applied on any otherwise required date of application if its application on that date would not result in a reduction or reallocation of gross proceeds of an issue. For this purpose, if an issuer reasonably expects as of the issue date that the universal cap will not reduce the amount of gross proceeds allocable to the issue during the term of the issue, the universal cap need not be applied on any date on which an issue actually has all of the following characteristics—

(A) No replacement proceeds are allocable to the issue, other than replacement proceeds in a bona fide debt service fund or a reasonably required reserve or replacement fund;

(B) The net sale proceeds of the issue—

(*1*) Qualified for one of the temporary periods available for capital projects, restricted working capital expenditures, or pooled financings under §1.148–2 (e)(2), (e)(3), or (e)(4), and those net sales proceeds were in fact allocated to expenditures prior to the expiration of the longest applicable temporary period; or

(*2*) were deposited in a refunding escrow and expended as originally expected;

(C) The issue does not refund a prior issue that, on any transfer date, has unspent proceeds allocable to it;

(D) None of the bonds are retired prior to the date on which those bonds are treated as retired in computing the yield on the issue; and

(E) No proceeds of the issue are invested in qualified student loans or qualified mortgage loans.

(ii) *General rule.* Except as otherwise provided below, amounts that would otherwise be gross proceeds allocable to an issue are allocated (and remain allocated) to the issue only to the extent that the value of the nonpurpose investments allocable to those gross proceeds does not exceed the value of all outstanding bonds of the issue. For this purpose, gross proceeds allocable to cash, tax-exempt bonds that would be nonpurpose investments (absent section 148(b)(3)(A)), qualified student loans, and qualified mortgage loans are treated as nonpurpose investments. The values of bonds and investments are determined under §1.148–4(e) and §1.148–5(d), respectively. The value of all outstanding bonds of the issue is referred to as the *universal cap.* Thus, for example, the universal cap for an issue of plain par bonds is equal to the outstanding stated principal amount of those bonds plus accrued interest.

(iii) *Determination and application of the universal cap.* Except as otherwise provided, beginning with the first bond year that commences after the second anniversary of the issue date, the amount of the universal cap and the value of the nonpurpose investments must be determined as of the first day of each bond year. For refunding and refunded issues, the cap and values must be determined as of each date that, but for this paragraph (b)(2), proceeds of the refunded issue would become transferred proceeds of the refunding issue, and need not otherwise be determined in the bond year in which that date occurs. All values are determined as of the close of business on each determination date, after giving effect to all payments on bonds and payments for and receipts on investments on that date.

(iv) *General ordering rule for allocations of amounts in excess of the universal cap*—(A) *In general.* If the value of all nonpurpose investments allocated to the gross proceeds of an issue exceeds the universal cap for that issue on a date as of which the cap is determined under paragraph (b)(2)(iii) of this section, nonpurpose investments allocable to gross proceeds necessary to eliminate that excess cease to be allocated to the issue, in the following order of priority—

(*1*) First, nonpurpose investments allocable to replacement proceeds;

(*2*) Second, nonpurpose investments allocable to transferred proceeds; and

(*3*) Third, nonpurpose investments allocable to sale proceeds and investment proceeds.

(B) *Re-allocation of certain amounts.* Except as provided in § 1.148–9(b)(3), amounts that cease to be allocated to an issue as a result of the application of the universal cap may only be allocated to another issue as replacement proceeds.

(C) *Allocations of portions of investments.* Portions of investments to which this paragraph (b)(2)(iv) applies are allocated under either the ratable method or the representative method in the same manner as allocations of portions of investments to transferred proceeds under § 1.148–9(c).

(v) *Nonpurpose investments in a bona fide debt service fund not counted.* For purposes of this paragraph (b)(2), nonpurpose investments allocated to gross proceeds in a bona fide debt service fund for an issue are not taken into account in determining the value of the nonpurpose investments, and those nonpurpose investments remain allocated to the issue.

(c) *Fair market value limit on allocations to nonpurpose investments.* Upon a purchase or sale of a nonpurpose investment, gross proceeds of an issue are not allocated to a payment for that nonpurpose investment in an amount greater than, or to a receipt from that nonpurpose investment in an amount less than, the fair market value of the nonpurpose investment as of the purchase or sale date. For purposes of this paragraph (c) only, the fair market value of a nonpurpose investment is adjusted to take into account qualified administrative costs allocable to the investment.

(d) *Allocation of gross proceeds to expenditures*—(1) *Expenditures in general*—(i) *General rule.* Reasonable accounting methods for allocating funds from different sources to expenditures for the same governmental purpose include any of the following methods if consistently applied: a specific tracing method; a gross proceeds spent first method; a first-in, first-out method; or a ratable allocation method.

(ii) *General limitation.* An allocation of gross proceeds of an issue to an expenditure must involve a current outlay of cash for a governmental purpose of the issue. A *current outlay of cash* means an outlay reasonably expected to occur not later than 5 banking days after the date as of which the allocation of gross proceeds to the expenditure is made.

(iii) *Timing.* An issuer must account for the allocation of proceeds to expenditures not later than 18 months after the later of the date the expenditure is paid or the date the project, if any, that is financed by the issue is placed in service. This allocation must be made in any event by the date 60 days after the fifth anniversary of the issue date or the date 60 days after the retirement of the issue, if earlier. This paragraph (d)(1)(iii) applies to bonds issued on or after May 16, 1997.

(2) *Treatment of gross proceeds invested in purpose investments*—(i) *In general.* Gross proceeds of an issue invested in a purpose investment are allocated to an expenditure on the date on which the conduit borrower under the purpose investment allocates the gross proceeds to an expenditure in accordance with this paragraph (d).

(ii) *Exception for qualified mortgage loans and qualified student loans.* If gross proceeds of an issue are allocated to a purpose investment that is a qualified mortgage loan or a qualified student loan, those gross proceeds are allocated to an expenditure for the governmental purpose of the issue on the date on which the issuer allocates gross proceeds to that purpose investment.

(iii) *Continuing allocation of gross proceeds to purpose investments.* Regardless of whether gross proceeds of a conduit financing issue invested in a purpose investment have been allocated to an expenditure under paragraph (d)(2) (i) or (ii) of this section, with respect to the actual issuer those gross proceeds continue to be allocated to the purpose investment until the sale, discharge, or other disposition of the purpose investment.

(3) *Expenditures for working capital purposes*—(i) *In general.* Except as otherwise provided in this paragraph (d)(3) or paragraph (d)(4) of this section, proceeds of an issue may only be allocated to working capital expenditures as of any date to the extent that those working capital expenditures exceed available amounts (as defined in paragraph (d)(3)(iii) of this section) as of that date (i.e., a ‘‘proceeds-spent-last’’ method). For this purpose, proceeds include replacement proceeds described in §1.148–1(c)(4).

(ii) *Exceptions*—(A) *General de minimis exception.* Paragraph (d)(3)(i) of this section does not apply to expenditures to pay—

(*1*) Any issuance costs of the issue or any qualified administrative costs within the meaning of §§1.148–5(e)(2) (i) or (ii), or §1.148–5(e)(3)(ii)(A);

(*2*) Fees for qualified guarantees of the issue or payments for a qualified hedge for the issue;

(*3*) Interest on the issue for a period commencing on the issue date and ending on the date that is the later of three years from the issue date or one year after the date on which the project is placed in service;

(*4*) Amounts paid to the United States under §§1.148–3, 1.148–5(c), or 1.148–7 for the issue;

(*5*) Costs, other than those described in paragraphs (d)(3)(ii)(A) (*1*) through (*4*) of this section, that do not exceed 5 percent of the sale proceeds of an issue and that are directly related to capital expenditures financed by the issue (e.g., initial operating expenses for a new capital project);

(*6*) Principal or interest on an issue paid from unexpected excess sale or investment proceeds; and

(*7*) Principal or interest on an issue paid from investment earnings on a reserve or replacement fund that are deposited in a bona fide debt service fund.

(B) *Exception for extraordinary items.* Paragraph (d)(3)(i) of this section does not apply to expenditures for extraordinary, nonrecurring items that are not customarily payable from current revenues, such as casualty losses or extraordinary legal judgments in amounts in excess of reasonable insurance coverage. If, however, an issuer or a related party maintains a reserve for such items (e.g., a self-insurance fund) or has set aside other available amounts for such expenses, gross proceeds within that reserve must be allocated to expenditures only after all other available amounts in that reserve are expended.

(C) *Exception for payment of principal and interest on prior issues.* Paragraph (d)(3)(i) of this section does not apply to expenditures for payment of principal, interest, or redemption prices on a prior issue and, for a crossover refunding issue, interest on that issue.

(D) *No exceptions if replacement proceeds created.* The exceptions provided in this paragraph (d)(3)(ii) do not apply if the allocation merely substitutes gross proceeds for other amounts that would have been used to make those expenditures in a manner that gives rise to replacement proceeds. For example, if a purported reimbursement allocation of proceeds of a reimbursement bond does not result in an expenditure under §1.150–2, those proceeds may not be allocated to pay interest on an issue that, absent this allocation, would have been paid from the issuer’s current revenues.

(iii) *Definition of available amount*—(A) *In general.* For purposes of this paragraph (d)(3), *available amount* means any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue. Except as otherwise provided, *available amount* excludes proceeds of the issue but includes cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party if those amounts may be used by the issuer for working capital expenditures of the type being financed by an issue without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed.

(B) *Reasonable working capital reserve treated as unavailable.* A reasonable working capital reserve is treated as unavailable. Any working capital reserve is reasonable if it does not exceed 5 percent of the actual working capital expenditures of the issuer in the fiscal year before the year in which the determination of available amounts is made. For this purpose only, in determining the working capital expenditures of an issuer for a prior fiscal year, any expenditures (whether capital or working capital expenditures) that are paid out of current revenues may be treated as working capital expenditures.

(C) *Qualified endowment funds treated as unavailable.* For a 501(c)(3) organization, a qualified endowment fund is treated as unavailable. A fund is a qualified endowment fund if—

(*1*) The fund is derived from gifts or bequests, or the income thereon, that were neither made nor reasonably expected to be used to pay working capital expenditures;

(*2*) Pursuant to reasonable, established practices of the organization, the governing body of the 501(c)(3) organization designates and consistently operates the fund as a permanent endowment fund or quasi-endowment fund restricted as to use; and

(*3*) There is an independent verification that the fund is reasonably necessary as part of the organization's permanent capital.

(D) *Application to statutory safe harbor for tax and revenue anticipation bonds.* For purposes of section 148(f)(4)(B)(iii)(II), *available amount* has the same meaning as in paragraph (d)(3)(iii) of this section, except that the otherwise-permitted reasonable working capital reserve is treated as part of the available amount.

(4) *Expenditures for grants*—(i) *In general.* Gross proceeds of an issue that are used to make a grant are allocated to an expenditure on the date on which the grant is made.

(ii) *Characterization of repayments of grants.* If any amount of a grant financed by gross proceeds of an issue is repaid to the grantor, the repaid amount is treated as unspent proceeds of the issue as of the repayment date unless expended within 60 days of repayment.

(iii) *Definition of grant. Grant* means a transfer for a governmental purpose of money or property to a transferee that is not a related party to or an agent of the transferor. The transfer must not impose any obligation or condition to directly or indirectly repay any amount to the transferor. Obligations or conditions intended solely to assure expenditure of the transferred moneys in accordance with the governmental purpose of the transfer do not prevent a transfer from being a grant.

(5) *Expenditures for reimbursement purposes.* In allocating gross proceeds of issues of reimbursement bonds (as defined in § 1.150–2)) to certain expenditures, § 1.150–2 applies. In allocating gross proceeds to an expenditure to reimburse a previously paid working capital expenditure, paragraph (d)(3) of this section applies. Thus, if the expenditure is described in paragraph (d)(3)(ii) of this section or there are no available amounts on the date a working capital expenditure is made and there are no other available amounts on the date of the reimbursement of that expenditure, gross proceeds are allocated to the working capital expenditure as of the date of the reimbursement.

(6) *Expenditures of certain commingled investment proceeds of governmental issues.* This paragraph (d)(6) applies to any issue of governmental bonds, any issue of private activity bonds issued to finance a facility that is required by section 142 to be owned by a governmental unit, and any portion of an issue that is not treated as consisting of private activity bonds under section 141(b)(9). Investment proceeds of the issue (other than investment proceeds held in a refunding escrow) are treated

as allocated to expenditures for a governmental purpose when the amounts are deposited in a commingled fund with substantial tax or other revenues from governmental operations of the issuer and the amounts are reasonably expected to be spent for governmental purposes within 6 months from the date of the commingling. In establishing these reasonable expectations, an issuer may use any reasonable accounting assumption and is not bound by the *proceeds-spent-last* assumption generally required for working capital expenditures under paragraph (d)(3) of this section.

(7) *Payments to related parties.* Any payment of gross proceeds of the issue to a related party of the payor is not an expenditure of those gross proceeds.

(e) *Special rules for commingled funds*—(1) *In general.* An accounting method for gross proceeds of an issue in a commingled fund, other than a bona fide debt service fund, is reasonable only if it satisfies the requirements of paragraphs (e)(2) through (6) of this section in addition to the other requirements of this section.

(2) *Investments held by a commingled fund*—(i) *Required ratable allocations.* Not less frequently than as of the close of each fiscal period, all payments and receipts (including deemed payments and receipts) on investments held by a commingled fund must be allocated (but not necessarily distributed) among the different investors in the fund. This allocation must be based on a consistently applied, reasonable ratable allocation method.

(ii) *Safe harbors for ratable allocation methods.* Reasonable ratable allocation methods include, without limitation, methods that allocate these items in proportion to either—

(A) The average daily balances of the amounts in the commingled fund from different investors during a fiscal period (as described in paragraph (e)(4) of this section); or

(B) The average of the beginning and ending balances of the amounts in the commingled fund from different investors for a fiscal period that does not exceed one month.

(iii) *Definition of investor.* For purposes of this paragraph (e), the term *investor* means each different source of funds invested in a commingled fund. For example, if a city invests gross proceeds of an issue and tax revenues in a commingled fund, it is treated as two different investors.

(3) *Certain expenditures involving a commingled fund.* If a ratable allocation method is used under paragraph (d) of this section to allocate expenditures from the commingled fund, the same ratable allocation method must be used to allocate payments and receipts on investments in the commingled fund under paragraph (e)(2) of this section.

(4) *Fiscal periods.* The fiscal year of a commingled fund is the calendar year unless the fund adopts another fiscal year. A commingled fund may use any consistent fiscal period that does not exceed three months (e.g., a daily, weekly, monthly, or quarterly fiscal period).

(5) *Unrealized gains and losses on investments of a commingled fund*—(i) *Mark-to-market requirement for internal commingled funds with longer-term investment portfolios.* Except as otherwise provided in this paragraph (e), in the case of a commingled fund in which the issuer and any related party own more than 25 percent of the beneficial interests in the fund (an *internal commingled fund*), the fund must treat all its investments as if sold at fair market value either on the last day of the fiscal year or the last day of each fiscal period. The net gains or losses from these deemed sales of investments must be allocated to all investors of the commingled fund during the period since the last allocation.

(ii) *Exception for internal commingled funds with shorter-term investment portfolios.* If the remaining weighted average maturity of all investments held by a commingled fund during a particular fiscal year does not exceed 18 months, and the investments held by the commingled fund during that fiscal year consist exclusively of obligations, the mark-to-market requirement of paragraph (e)(5)(i) of this section does not apply.

(iii) *Exception for commingled reserve funds and sinking funds.* The mark-to-market requirement of paragraph (e)(5)(i) of this section does not apply to a commingled fund that operates exclusively as a reserve fund, sinking fund, or replacement fund for two or more issues of the same issuer.

(6) *Allocations of commingled funds serving as common reserve funds or sinking funds*—(i) *Permitted ratable allocation methods.* If a commingled fund serves as a common reserve fund, replacement fund, or sinking fund for two or more issues (a *commingled reserve*), after making reasonable adjustments to account for proceeds allocated under paragraph (b)(1) or (b)(2) of this section, investments held by that commingled fund must be allocated ratably among the issues served by the commingled fund in accordance with one of the following methods—

(A) The relative values of the bonds of those issues under § 1.148–4(e);

(B) The relative amounts of the remaining maximum annual debt service requirements on the outstanding principal amounts of those issues; or

(C) The relative original stated principal amounts of the outstanding issues.

(ii) *Frequency of allocations.* An issuer must make any allocations required by this paragraph (e)(6) as of a date at least every 3 years and as of each date that an issue first becomes secured by the commingled reserve. If relative original principal amounts are used to allocate, allocations must also be made on the retirement of any issue secured by the commingled reserve.

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§ 1.148–7 Spending exceptions to the rebate requirement.

(a) *Scope of section*—(1) *In general.* This section provides guidance on the spending exceptions to the arbitrage rebate requirement of section 148(f)(2). These exceptions are the 6-month exception in section 148(f)(4)(B) (the *6-month exception*), the 18-month exception under paragraph (d) of this section (the *18-month exception*), and the 2-year construction exception under section 148(f)(4)(C) (the *2-year exception*) (collectively, the *spending exceptions*).

(2) *Relationship of spending exceptions.* Each of the spending exceptions is an independent exception to arbitrage rebate. For example, a construction issue may qualify for the 6-month exception or the 18-month exception even though the issuer makes one or more elections under the 2-year exception with respect to the issue.

(3) *Spending exceptions not mandatory.* Use of the spending exceptions is not mandatory. An issuer may apply the arbitrage rebate requirement to an issue that otherwise satisfies a spending exception. If an issuer elects to pay penalty in lieu of rebate under the 2-year exception, however, the issuer must apply those penalty provisions.

(b) *Rules applicable for all spending exceptions.* The provisions of this paragraph (b) apply for purposes of applying each of the spending exceptions.

(1) *Special transferred proceeds rules*—(i) *Application to prior issues.* For purposes of applying the spending exceptions to a prior issue only, proceeds of the prior issue that become transferred proceeds of the refunding issue continue to be treated as unspent proceeds of the prior issue. If the prior issue satisfies one of the spending exceptions, the proceeds of the prior issue that are excepted from rebate under that spending exception are not subject to rebate either as proceeds of the prior issue or as transferred proceeds of the refunding issue.

(ii) *Application to refunding issues*—(A) *In general.* The only spending exception applicable to refunding issues is the 6-month exception. For purposes of applying the 6-month exception to a refunding issue only, proceeds of the prior issue that become transferred proceeds of the refunding issue generally are not treated as proceeds of the refunding issue and need not be spent for the refunding issue to satisfy that spending exception. Even if the refunding issue qualifies for that spending exception, those transferred proceeds are subject to rebate as proceeds of the refunding issue unless an exception to rebate applied to those proceeds as proceeds of the prior issue.

(B) *Exception.* For purposes of applying the 6-month exception to refunding issues, those transferred proceeds of the refunding issue excluded from the gross proceeds of the prior issue under the special definition of gross proceeds in paragraph (c)(3) of this section, and those that transferred from a prior taxable issue, are generally treated as gross proceeds of the refunding issue. Thus, for the refunding issue to qualify for the 6-month exception, those proceeds must be spent within 6 months of the issue date of the refunding issue, unless those amounts continue to be used in a manner that does not cause those amounts to be gross proceeds under paragraph (c)(3) of this section.

(2) *Application of multipurpose issue rules.* Except as otherwise provided, if any portion of an issue is treated as a separate issue allocable to refunding purposes under §1.148–9(h) (relating to multipurpose issues), for purposes of this section, that portion is treated as a separate issue.

(3) *Expenditures for governmental purposes of the issue.* For purposes of this section, expenditures for the governmental purpose of an issue include payments for interest, but not principal, on the issue, and for principal or interest on another issue of obligations. The preceding sentence does not apply for purposes of the 18-month and 2-year exceptions if those payments cause the issue to be a refunding issue.

(4) *De minimis rule.* Any failure to satisfy the final spending requirement of the 18-month exception or the 2-year exception is disregarded if the issuer exercises due diligence to complete the project financed and the amount of the failure does not exceed the lesser of 3 percent of the issue price of the issue or $250,000.

(5) *Special definition of reasonably required reserve or replacement fund.* For purposes of this section only, a reasonably required reserve or replacement fund also includes any fund to the extent described in §1.148–5(c)(3)(i)(E) or (G).

(6) *Pooled financing issue*—(i) *In general.* Except as otherwise provided in this paragraph (b)(6), the spending exceptions apply to a pooled financing issue as a whole, rather than to each loan separately.

(ii) *Election to apply spending exceptions separately to each loan*—(A) *In general.* At the election (made on or before the issue date) of the issuer of a pooled financing issue, the spending exceptions are applied separately to each conduit loan, and the applicable spending requirements for a loan begin on the earlier of the date the loan is made, or the first day following the 1-year period beginning on the issue date of the pooled financing issue. If this election is made, the rebate requirement applies to, and none of the spending exceptions are available for, gross proceeds of the pooled financing bonds before the date on which the spending requirements for those proceeds begin.

(B) *Application of spending exceptions.* If the issuer makes the election under this paragraph (b)(6)(ii), the rebate requirement is satisfied for proceeds used to finance a particular conduit loan to the extent that the loan satisfies a spending exception or the small issuer exception under §1.148–8, regardless of whether any other conduit loans allocable to the issue satisfy such an exception. A pooled financing issue is an issue of arbitrage bonds, however, unless the entire issue satisfies the requirements of section 148. An issuer may pay rebate for some conduit loans and 1½ percent penalty for other conduit loans from the same pooled financing issue. The 1½ percent penalty is computed separately for each conduit loan.

(C) *Elections under 2-year exception.* If the issuer makes the election under this paragraph (b)(6)(ii), the issuer may make all elections under the 2-year exception separately for each loan. Elections regarding a loan that otherwise must be made by the issuer on or before the issue date instead may be made on or before the date the loan is made (but not later than 1 year after the issue date).

(D) *Example.* The operation of this paragraph (b)(6) is illustrated by the following example:

Example. Pooled financing issue. On January 1, 1994, Authority *J* issues bonds. As of the issue date, *J* reasonably expects to use the proceeds of the issue to make loans to City *K*, County *L*, and City *M*. *J* does not reasonably expect to use more than 75 percent of the available construction proceeds of the issue for construction expenditures. On or before the issue date, *J* elects to apply the spending exceptions separately for each loan, with spending requirements beginning on the earlier of the date the loan is made or the first day following the 1-year period beginning on the issue date. On February 1, 1994, *J* loans a portion of the proceeds to *K*, and *K* reasonably expects that 45 percent of those amounts will be used for construction expenditures. On the date this loan is made, *J* elects under paragraph (j) of this section to treat 60 percent of the amount loaned to *K* as a separate construction issue, and also elects the 1½ percent penalty under paragraph (k) of this section for the separate construction issue. On March 1, 1994, *J* loans a portion of the proceeds to *L*, and *L* reasonably expects that more than 75 percent of those amounts will be used for construction expenditures. On March 1, 1995, *J* loans the remainder of the proceeds to *M*, and none of those amounts will be used for construction expenditures. *J* must satisfy the rebate requirement for all gross proceeds before those amounts are loaned. For the loan to *K*, the spending periods begin on February 1, 1994, and the 1½ percent penalty must be paid for any failure to meet a spending requirement for the portion of the loan to *K* that is treated as a separate construction issue. Rebate must be paid on the remaining portion of the loan to *K*, unless that portion qualifies for the 6-month exception. For the loan to *L*, the spending periods begin on March 1, 1994, and the rebate requirement must be satisfied unless the 6-month, 18-month, or the 2-year exception is satisfied with respect to those amounts. For the loan to *M*, the spending periods begin on January 2, 1995, and the rebate requirement must be satisfied for those amounts unless the 6-month or 18-month exception is satisfied.

(c) *6-month exception*— (1) *General rule.* An issue is treated as meeting the rebate requirement if—

(i) The gross proceeds (as modified by paragraph (c)(3) of this section) of the issue are allocated to expenditures for the governmental purposes of the issue within the 6-month period beginning on the issue date (the *6-month spending period*); and

(ii) The rebate requirement is met for amounts not required to be spent within the 6-month spending period (excluding earnings on a bona fide debt service fund).

(2) *Additional period for certain bonds.* The 6-month spending period is extended for an additional 6 months in certain circumstances specified under section 148(f)(4)(B)(ii).

(3) *Amounts not included in gross proceeds.* For purposes of paragraph (c)(1)(i) of this section only, gross proceeds has the meaning used in § 1.148–1, except it does not include amounts—

(i) In a bona fide debt service fund;

(ii) In a reasonably required reserve or replacement fund (see § 1.148–7(b)(5));

(iii) That, as of the issue date, are not reasonably expected to be gross proceeds but that become gross proceeds after the end of the 6-month spending period;

(iv) Representing sale or investment proceeds derived from payments under any purpose investment of the issue; and

(v) Representing repayments of grants (as defined in § 1.148–6(d)(4)) financed by the issue.

(4) *Series of refundings.* If a principal purpose of a series of refunding issues is to exploit the difference between taxable and tax-exempt interest rates by investing proceeds during the temporary periods provided in § 1.148–9(d), the 6-month spending period for all issues in the series begins on the issue date of the first issue in the series.

(d) *18-month exception*—(1) *General rule.* An issue is treated as meeting the rebate requirement if all of the following requirements are satisfied—

(i) *18-month expenditure schedule met.* The gross proceeds (as defined in paragraph (d)(3) of this section) are allocated to expenditures for a governmental purpose of the issue in accordance with the following schedule (the *18-month expenditure schedule*) measured from the issue date—

(A) At least 15 percent within 6 months (the *first spending period*);

(B) At least 60 percent within 12 months (the *second spending period*); and

(C) 100 percent within 18 months (the *third spending period*).

(ii) *Rebate requirement met for amounts not required to be spent.* The rebate requirement is met for all amounts not required to be spent in accordance with the 18-month expenditure schedule (other than earnings on a bona fide debt service fund).

(iii) *Issue qualifies for initial temporary period.* All of the gross proceeds (as defined in paragraph (d)(3)(i) of this section) of the issue qualify for the initial temporary period under § 1.148–2(e)(2).

(2) *Extension for reasonable retainage.* An issue does not fail to satisfy the spending requirement for the third spending period as a result of a reasonable retainage if the reasonable retainage is allocated to expenditures within 30 months of the issue date.

Reasonable retainage has the meaning under paragraph (h) of this section, as modified to refer to net sale proceeds on the date 18 months after the issue date.

(3) *Gross proceeds*—(i) *Definition of gross proceeds.* For purposes of paragraph (d)(1) of this section only, *gross proceeds* means gross proceeds as defined in paragraph (c)(3) of this section, as modified to refer to ''18 months'' in paragraph (c)(3)(iii) of this section in lieu of ''6 months.''

(ii) *Estimated earnings.* For purposes of determining compliance with the first two spending periods under paragraph (d)(1)(i) of this section, the amount of investment proceeds included in gross proceeds of the issue is determined based on the issuer's reasonable expectations on the issue date.

(4) *Application to multipurpose issues.* This paragraph (d) does not apply to an issue any portion of which is treated as meeting the rebate requirement under paragraph (e) of this section (relating to the 2-year exception).

(e) *2-year exception*—(1) *General rule.* A construction issue is treated as meeting the rebate requirement for available construction proceeds if those proceeds are allocated to expenditures for governmental purposes of the issue in accordance with the following schedule (the *2-year expenditure schedule*), measured from the issue date—

(i) At least 10 percent within 6 months (the *first spending period*);

(ii) At least 45 percent within 1 year (the *second spending period*);

(iii) At least 75 percent within 18 months (the *third spending period*); and

(iv) 100 percent within 2 years (the *fourth spending period*).

(2) *Extension for reasonable retainage.* An issue does not fail to satisfy the spending requirement for the fourth spending period as a result of unspent amounts for reasonable retainage (as defined in paragraph (h) of this section) if those amounts are allocated to expenditures within 3 years of the issue date.

(3) *Definitions.* For purposes of the 2-year exception, the following definitions apply:

(i) *Real property* means land and improvements to land, such as buildings or other inherently permanent structures, including interests in real property. For example, real property includes wiring in a building, plumbing systems, central heating or air-conditioning systems, pipes or ducts, elevators, escalators installed in a building, paved parking areas, roads, wharves and docks, bridges, and sewage lines.

(ii) *Tangible personal property* means any tangible property other than real property, including interests in tangible personal property. For example, tangible personal property includes machinery that is not a structural component of a building, subway cars, fire trucks, automobiles, office equipment, testing equipment, and furnishings.

(iii) *Substantially completed.* Construction may be treated as substantially completed when the issuer abandons construction or when at least 90 percent of the total costs of the construction reasonably expected, as of that date, to be financed with the available construction proceeds have been allocated to expenditures.

(f) *Construction issue*—(1) *Definition. Construction issue* means any issue that is not a refunding issue if—

(i) The issuer reasonably expects, as of the issue date, that at least 75 percent of the available construction proceeds of the issue will be allocated to construction expenditures (as defined in paragraph (g) of this section) for property owned by a governmental unit or a 501(c)(3) organization; and

(ii) Any private activity bonds that are part of the issue are qualified 501(c)(3) bonds or private activity bonds issued to finance property to be owned by a governmental unit or a 501(c)(3) organization.

(2) *Use of actual facts.* For the provisions of paragraphs (e) through (m) of this section that apply based on the issuer's reasonable expectations, an issuer may elect on or before the issue date to apply all of those provisions based on actual facts, except that this election does not apply for purposes of determining whether an issue is a construction issue under paragraph (f)(1) of this section if the 1½ percent penalty election is made under paragraph (k) of this section.

(3) *Ownership requirement*—(i) *In general.* A governmental unit or 501(c)(3) organization is treated as the owner of property if it would be treated as the owner for Federal income tax purposes. For obligations issued on behalf of a State or local governmental unit, the entity that actually issues the bonds is treated as a governmental unit.

(ii) *Safe harbor for leases and management contracts.* Property leased by a governmental unit or a 501(c)(3) organization is treated as owned by the governmental unit or 501(c)(3) organization if the lessee complies with the requirements of section 142(b)(1)(B). For a bond described in section 142(a)(6), the requirements of section 142(b)(1)(B) apply as modified by section 146(h)(2).

(g) *Construction expenditures*—(1) *Definition.* Except as otherwise provided, *construction expenditures* means capital expenditures (as defined in § 1.150–1) that are allocable to the cost of real property or constructed personal property (as defined in paragraph (g)(3) of this section). Except as provided in paragraph (g)(2) of this section, construction expenditures do not include expenditures for acquisitions of interests in land or other existing real property.

(2) *Certain acquisitions under turnkey contracts treated as construction expenditures.* Expenditures are not for the acquisition of an interest in existing real property other than land if the contract between the seller and the issuer requires the seller to build or install the property (e.g., a *turnkey contract*), but only to the extent that the property has not been built or installed at the time the parties enter into the contract.

(3) *Constructed personal property. Constructed personal property* means tangible personal property (or, if acquired pursuant to a single acquisition contract, properties) or specially developed computer software if—

(i) A substantial portion of the property or properties is completed more than 6 months after the earlier of the date construction or rehabilitation commenced and the date the issuer entered into an acquisition contract;

(ii) Based on the reasonable expectations of the issuer, if any, or representations of the person constructing the property, with the exercise of due diligence, completion of construction or rehabilitation (and delivery to the issuer) could not have occurred within that 6-month period; and

(iii) If the issuer itself builds or rehabilitates the property, not more than 75 percent of the capitalizable cost is attributable to property acquired by the issuer (e.g., components, raw materials, and other supplies).

(4) *Specially developed computer software. Specially developed computer software* means any programs or routines used to cause a computer to perform a desired task or set of tasks, and the documentation required to describe and maintain those programs, provided that the software is specially developed and is functionally related and subordinate to real property or other constructed personal property.

(5) *Examples.* The operation of this paragraph (g) is illustrated by the following examples:

Example 1. Purchase of construction materials. City A issues bonds to finance a new office building. *A* uses proceeds of the bonds to purchase materials to be used in constructing the building, such as bricks, pipes, wires, lighting, carpeting, heating equipment, and similar materials. Expenditures by *A* for the construction materials are construction expenditures because those expenditures will be capitalizable to the cost of the building upon completion, even though they are not initially capitalizable to the cost of existing real property. This result would be the same if *A* hires a third-party to perform the construction, unless the office building is partially constructed at the time that *A* contracts to purchase the building.

Example 2. Turnkey contract. City *B* issues bonds to finance a new office building. *B* enters into a turnkey contract with developer *D* under which *D* agrees to provide *B* with a completed building on a specified completion date on land currently owned by *D*. Under the agreement, *D* holds title to the land and building and assumes any risk of loss until the completion date, at which time title to the land and the building will be transferred to *B*. No construction has been performed by the date that *B* and *D* enter into the agreement. All payments by *B* to *D* for construction of the building are construction expenditures because all the payments are properly capitalized to the cost of the building, but payments by *B* to *D* allocable to the acquisition of the land are not construction expenditures.

Example 3. Right-of-way. P, a public agency, issues bonds to finance the acquisition of a right-of-way and the construction of sewage lines through numerous parcels of land. The right-of-way is acquired primarily through *P'* s exercise of its powers of eminent domain. As of the issue date, *P* reasonably expects that it will take approximately 2 years to acquire the entire right-of-way because of the time normally required for condemnation proceedings. No expenditures for the acquisition of the right-of-way are construction expenditures because they are costs incurred to acquire an interest in existing real property.

Example 4. Subway cars. City *C* issues bonds to finance new subway cars. *C* reasonably expects that it will take more than 6 months for the subway cars to be constructed to *C*'s specifications. The subway cars are constructed personal property. Alternatively, if the builder of the subway cars informs *C* that it will only take 3 months to build the subway cars to *C*'s specifications, no payments for the subway cars are construction expenditures.

Example 5. Fractional interest in property. U, a public agency, issues bonds to finance an undivided fractional interest in a newly constructed power-generating facility. *U* contributes its ratable share of the cost of building the new facility to the project manager for the facility. *U*'s contributions are construction expenditures in the same proportion that the total expenditures for the facility qualify as construction expenditures.

Example 6. Park land. City *D* issues bonds to finance the purchase of unimproved land and the cost of subsequent improvements to the land, such as grading and landscaping, necessary to transform it into a park. The costs of the improvements are properly capitalizable to the cost of the land, and therefore, are construction expenditures, but expenditures for the acquisition of the land are not.

(h) *Reasonable retainage definition. Reasonable retainage* means an amount, not to exceed 5 percent of available construction proceeds as of the end of the fourth spending period, that is retained for reasonable business purposes relating to the property financed with the proceeds of the issue. For example, a reasonable retainage may include a retention to ensure or promote compliance with a construction contract in circumstances in which the retained amount is not yet payable, or in which the issuer reasonably determines that a dispute exists regarding completion or payment.

(i) *Available construction proceeds*—(1) *Definition in general. Available construction proceeds* has the meaning used in section 148(f)(4)(C)(vi). For purposes of this definition, earnings include earnings on any tax-exempt bond. Pre-issuance accrued interest and earnings thereon may be disregarded. Amounts that are not gross proceeds as a result of the application of the universal cap under §1.148–6(b)(2) are not available construction proceeds.

(2) *Earnings on a reasonably required reserve or replacement fund.* Earnings on any reasonably required reserve or replacement fund are available construction proceeds only to the extent that those earnings accrue before the earlier of the date construction is substantially completed or the date that is 2 years after the issue date. An issuer may elect on or before the issue date to exclude from available construction proceeds the earnings on such a fund. If the election is made, the rebate requirement applies to the excluded amounts from the issue date.

(3) *Reasonable expectations test for future earnings.* For purposes of determining compliance with the spending requirements as of the end of each of the first three spending periods, available construction proceeds include the amount of future earnings that the issuer reasonably expected as of the issue date.

(4) *Issuance costs.* Available construction proceeds do not include gross proceeds used to pay issuance costs financed by an issue, but do include earnings on such proceeds. Thus, an expenditure of gross proceeds of an issue for issuance costs does not count toward meeting the spending requirements. The expenditure of earnings on gross proceeds used to pay issuance costs does count toward meeting those requirements. If the spending requirements are met and the proceeds used to pay issuance costs are expended by the end of the fourth spending period, those proceeds and the earnings thereon are treated as having satisfied the rebate requirement.

(5) *One and one-half percent penalty in lieu of arbitrage rebate.* For purposes of the spending requirements of paragraph (e) of this section, available construction proceeds as of the end of any spending period are reduced by the amount of penalty in lieu of arbitrage rebate (under paragraph (k) of this section) that the issuer has paid from

available construction proceeds before the last day of the spending period.

(6) *Payments on purpose investments and repayments of grants.* Available construction proceeds do not include—

(i) Sale or investment proceeds derived from payments under any purpose investment of the issue; or

(ii) Repayments of grants (as defined in § 1.148–6(d)(4)) financed by the issue.

(7) *Examples.* The operation of this paragraph (i) is illustrated by the following examples:

Example 1. Treatment of investment earnings. City *F* issues bonds having an issue price of $10,000,000. *F* deposits all of the proceeds of the issue into a construction fund to be used for expenditures other than costs of issuance. *F* estimates on the issue date that, based on reasonably expected expenditures and rates of investment, earnings on the construction fund will be $800,000. As of the issue date and the end of each of the first three spending periods, the amount of available construction proceeds is $10,800,000. To qualify as a construction issue, *F* must reasonably expect on the issue date that at least $8,100,000 (75 percent of $10,800,000) will be used for construction expenditures. In order to meet the 10 percent spending requirement at the end of the first spending period, *F* must spend at least $1,080,000. As of the end of the fourth spending period, *F* has received $1,100,000 in earnings. In order to meet the spending requirement at the end of the fourth spending period, however, *F* must spend all of the $11,100,000 of actual available construction proceeds (except for reasonable retainage not exceeding $555,000).

Example 2. Treatment of investment earnings without a reserve fund. City *G* issues bonds having an issue price of $11,200,000. *G* does not elect to exclude earnings on the reserve fund from available construction proceeds. *G* uses $200,000 of proceeds to pay issuance costs and deposits $1,000,000 of proceeds into a reasonably required reserve fund. *G* deposits the remaining $10,000,000 of proceeds into a construction fund to be used for construction expenditures. On the issue date, *G* reasonably expects that, based on the reasonably expected date of substantial completion and rates of investment, total earnings on the construction fund will be $800,000, and total earnings on the reserve fund to the date of substantial completion will be $150,000. *G* reasonably expects that substantial completion will occur during the fourth spending period. As of the issue date, the amount of available construction proceeds is $10,950,000 ($10,000,000 originally deposited into the construction fund plus $800,000 expected earnings on the construction fund and $150,000 expected earnings on the reserve fund). To qualify as a construction issue, *G* must reasonably expect on the issue date that at least $8,212,500 will be used for construction expenditures.

Example 3. Election to exclude earnings on a reserve fund. The facts are the same as *Example 2,* except that *G* elects on the issue date to exclude earnings on the reserve fund from available construction proceeds. The amount of available construction proceeds as of the issue date is $10,800,000.

(j) *Election to treat portion of issue used for construction as separate issue*—(1) *In general.* For purposes of paragraph (e) of this section, if any proceeds of an issue are to be used for construction expenditures, the issuer may elect on or before the issue date to treat the portion of the issue that is not a refunding issue as two, and only two, separate issues, if—

(i) One of the separate issues is a construction issue as defined in paragraph (f) of this section;

(ii) The issuer reasonably expects, as of the issue date, that this construction issue will finance all of the construction expenditures to be financed by the issue; and

(iii) The issuer makes an election to apportion the issue under this paragraph (j)(1) in which it identifies the amount of the issue price of the issue allocable to the construction issue.

(2) *Example.* The operation of this paragraph (j) is illustrated by the following example.

Example. City *D* issues bonds having an issue price of $19,000,000. On the issue date, *D* reasonably expects to use $10,800,000 of bond proceeds (including investment earnings) for construction expenditures for the project being financed. *D* deposits $10,000,000 in a construction fund to be used for construction expenditures and $9,000,000 in an acquisition fund to be used for acquisition of equipment not qualifying as construction expenditures. *D* estimates on the issue date, based on reasonably expected expenditures and rates of investment, that total earnings on the construction fund will be $800,000 and total earnings on the acquisition fund will be $200,000. Because the total construction expenditures to be financed by the issue are expected to be $10,800,000, the maximum available construction proceeds for a construction issue is $14,400,000 ($10,800,000 divided by 0.75). To determine the maximum amount of the issue price allocable to a construction issue, the estimated investment earnings allocable to the construction issue are subtracted. The entire $800,000 of earnings on the construction fund are allocable to the construction issue. Only a portion of the $200,000 of earnings on the acquisition fund, however, are allocable to the construction issue. The total amount of the available construction proceeds that is expected to be used for acquisition is $3,600,000 ($14,400,000−$10,800,000). The portion of earnings on the acquisition fund that is allocable to the construction issue is $78,261 ($200,000×$3,600,000/$9,200,000). Accordingly, *D* may elect on or before the issue date to treat up to $13,521,739 of the issue price as a construction issue ($14,400,000−$800,000−$78,261). *D*'s election must specify the amount of the issue price treated as a construction issue. The balance of the issue price is treated as a separate nonconstruction issue that is subject to the rebate requirement unless it meets another exception to arbitrage rebate. Because the financing of a construction issue is a separate governmental purpose under §1.148–9(h), the election causes the issue to be a multipurpose issue under that section.

(k) *One and one-half percent penalty in lieu of arbitrage rebate*—(1) *In general.* Under section 148(f)(4)(C)(vii), an issuer of a construction issue may elect on or before the issue date to pay a penalty (the *1½ percent penalty*) to the United States in lieu of the obligation to pay the rebate amount on available construction proceeds upon failure to satisfy the spending requirements of paragraph (e) of this section. The 1½ percent penalty is calculated separately for each spending period, including each semiannual period after the end of the fourth spending period, and is equal to 1.5 percent times the underexpended proceeds as of the end of the spending period. For each spending period, underexpended proceeds equal the amount of available construction proceeds required to be spent by the end of the spending period, less the amount actually allocated to expenditures for the governmental purposes of the issue by that date. The 1½ percent penalty must be paid to the United States no later than 90 days after the end of the spending period to which it relates. The 1½ percent penalty continues to apply at the end of each spending period and each semiannual period thereafter until the earliest of the following—

(i) The termination of the penalty under paragraph (l) of this section;

(ii) The expenditure of all of the available construction proceeds; or

(iii) The last stated final maturity date of bonds that are part of the issue and any bonds that refund those bonds.

(2) *Application to reasonable retainage.* If an issue meets the exception for reasonable retainage except that all retainage is not spent within 3 years of the issue date, the issuer must pay the 1½ percent penalty to the United States for any reasonable retainage that was not so spent as of the close of the 3-year period and each later spending period.

(3) *Coordination with rebate requirement.* The rebate requirement is treated as met with respect to available construction proceeds for a period if the 1½ percent penalty is paid in accordance with this section.

(l) *Termination of 1½ percent penalty*—(1) *Termination after initial temporary period.* The issuer may terminate the 1½ percent penalty after the initial temporary period (a *section 148(f)(4)(C)(viii) penalty termination*) if—

(i) Not later than 90 days after the earlier of the end of the initial temporary period or the date construction is substantially completed, the issuer elects to terminate the 1½ percent penalty; provided that solely for this purpose, the initial temporary period may be extended by the issuer to a date ending 5 years after the issue date;

(ii) Within 90 days after the end of the initial temporary period, the issuer pays a penalty equal to 3 percent of the unexpended available construction proceeds determined as of the end of the initial temporary period, multiplied by the number of years (including fractions of years computed to 2 decimal places) in the initial temporary period;

(iii) For the period beginning as of the close of the initial temporary period, the unexpended available construction proceeds are not invested in higher yielding investments; and

(iv) On the earliest date on which the bonds may be called or otherwise redeemed, with or without a call premium, the unexpended available construction proceeds as of that date (not including any amount earned after the date on which notice of the redemption was required to be given) must be used to redeem the bonds. Amounts used to pay any call premium are treated as used to redeem bonds. This redemption requirement may be met by purchases of bonds by the issuer on the open market at prices not exceeding fair market value. A portion of the annual principal payment due on serial bonds of a construction issue may be paid from the unexpended amount, but only in an amount no greater than the amount that bears the same ratio to the annual principal due that the total unexpended amount bears to the issue price of the construction issue.

(2) *Termination before end of initial temporary period.* If the construction to be financed by the construction issue is substantially completed before the end of the initial temporary period, the issuer may elect to terminate the 1½ percent penalty before the end of the initial temporary period (a *section 148(f)(4)(C)(ix) penalty termination*) if—

(i) Before the close of the initial temporary period and not later than 90 days after the date the construction is substantially completed, the issuer elects to terminate the 1½ percent penalty;

(ii) The election identifies the amount of available construction proceeds that will not be spent for the governmental purposes of the issue; and

(iii) The issuer has met all of the conditions for a section 148(f)(4)(C)(viii) penalty termination, applied as if the initial temporary period ended as of the date the required election for a section 148(f)(4)(C)(ix) penalty termination is made. That penalty termination election satisfies the required election for a section 148(f)(4)(C)(viii) termination.

(3) *Application to reasonable retainage.* Solely for purposes of determining whether the conditions for terminating the 1½ percent penalty are met, reasonable retainage may be treated as spent for a governmental purpose of the construction issue. Reasonable retainage that is so treated continues to be subject to the 1½ percent penalty.

(4) *Example.* The operation of this paragraph (l) is illustrated by the following example.

Example. City *I* issues a construction issue having a 20-year maturity and qualifying for a 3-year initial temporary period. The bonds are first subject to optional redemption 10 years after the issue date at a premium of 3 percent. *I* elects, on or before the issue date, to pay the 1½ percent penalty in lieu of arbitrage rebate. At the end of the 3-year temporary period, the project is not substantially completed, and $1,500,000 of available construction proceeds of the issue are unspent. At that time, *I* reasonably expects to need $500,000 to complete the project. *I* may terminate the 1½ percent penalty in lieu of arbitrage rebate with respect to the excess $1,500,000 by electing to terminate within 90 days of the end of the initial temporary period; paying a penalty to the United States of $135,000 (3 percent of $1,500,000 multiplied by 3 years); restricting the yield on the investment of unspent available construction proceeds for 7 years until the first call date, although any portion of these proceeds may still be spent on the project prior to that call date; and using the available construction proceeds that, as of the first call date, have not been allocated to expenditures for the governmental purposes of the issue to redeem bonds on that call date. If *I* fails to make the termination election, *I* is required to pay the 1½ percent penalty on unspent available construction proceeds every 6 months until the latest maturity date of bonds of the issue (or any bonds of another issue that refund such bonds).

(m) *Payment of penalties.* Each penalty payment under this section must be paid in the manner provided in § 1.148–3(g). See § 1.148–3(h) for rules on failures to pay penalties under this section.

[T.D. 8476, 58 FR 33535, June 18, 1993; 58 FR 44452, Aug. 23, 1993]

§ 1.148–8 Small issuer exception to rebate requirement.

(a) *Scope.* Under section 148(f)(4)(D), bonds issued to finance governmental activities of certain small issuers are treated as meeting the arbitrage rebate requirement of section 148(f)(2) (the ‘‘small issuer exception’’). This section provides guidance on the small issuer exception.

(b) *General taxing powers.* The small issuer exception generally applies only to bonds issued by governmental units with general taxing powers. A governmental unit has general taxing powers if it has the power to impose taxes (or to cause another entity to impose taxes) of general applicability which, when collected, may be used for the general purposes of the issuer. The taxing power may be limited to a specific type of tax, provided that the applicability of the tax is not limited to a small number of persons. The governmental unit's exercise of its taxing power may be subject to procedural limitations, such as voter approval requirements, but may not be contingent on approval by another governmental unit. See, also, section 148(f)(4)(D)(iv).

(c) *Size limitation*—(1) *In general.* An issue (other than a refunding issue) qualifies for the small issuer exception only if the issuer reasonably expects, as of the issue date, that the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by it during that calendar year will not exceed $5,000,000; or the aggregate face amount of all tax-exempt bonds of the issuer (other than private activity bonds) actually issued during that calendar year does not exceed $5,000,000. For this purpose, if an issue has more than a de minimis amount of original issue discount or premium, *aggregate face amount* means the aggregate issue price of that issue (determined without regard to pre-issuance accrued interest).

(2) *Aggregation rules.* The following aggregation rules apply for purposes of applying the $5,000,000 size limitation under paragraph (c)(1) of this section.

(i) *On-behalf-of issuers.* An issuer and all entities (other than political subdivisions) that issue bonds on behalf of that issuer are treated as one issuer.

(ii) *Subordinate entities*—(A) *In general.* Except as otherwise provided in paragraph (d) of this section and section 148(f)(4)(D)(iv), all bonds issued by a subordinate entity are also treated as issued by each entity to which it is subordinate. An issuer is subordinate to another governmental entity if it is directly or indirectly controlled by the other entity within the meaning of §1.150–1(e).

(B) *Exception for allocations of size limitation.* If an entity properly makes an allocation of a portion of its $5,000,000 size limitation to a subordinate entity (including an on behalf of issuer) under section 148(f)(4)(D)(iv), the portion of bonds issued by the subordinate entity under the allocation is treated as issued only by the allocating entity and not by any other entity to which the issuing entity is subordinate. These allocations are irrevocable and must bear a reasonable relationship to the benefits received by the allocating unit from issues issued by the subordinate entity. The benefits to be considered include the manner in which—

(*1*) Proceeds are to be distributed;

(*2*) The debt service is to be paid;

(*3*) The facility financed is to be owned;

(*4*) The use or output of the facility is to be shared; and

(*5*) Costs of operation and maintenance are to be shared.

(iii) *Avoidance of size limitation.* An entity formed or availed of to avoid the purposes of the $5,000,000 size limitation and all entities that would benefit from the avoidance are treated as one issuer. Situations in which an entity is formed or availed of to avoid the purposes of the $5,000,000 size limitation include those in which the issuer—

(A) Issues bonds which, but for the $5,000,000 size limitation, would have been issued by another entity; and

(B) Does not receive a substantial benefit from the project financed by the bonds.

(3) *Certain refunding bonds not taken into account.* In applying the $5,000,000 size limitation, there is not taken into account the portion of an issue that is a current refunding issue to the extent that the stated principal amount of the refunding bond does not exceed the portion of the outstanding stated principal amount of the refunded bond paid with proceeds of the refunding bond. For this purpose, *principal amount* means, in reference to a plain par bond, its stated principal amount plus accrued unpaid interest, and in reference to any other bond, its present value.

(d) *Pooled financings*—(1) *Treatment of pool issuer.* To the extent that an issuer of a pooled financing is not an ultimate borrower in the financing and the conduit borrowers are governmental units with general taxing powers and not subordinate to the issuer, the pooled financing is not counted towards the $5,000,000 size limitation of the issuer for purposes of applying the small issuer exception to its other issues. The issuer of the pooled financing issue is, however, subject to the rebate requirement for any unloaned gross proceeds.

(2) *Treatment of conduit borrowers.* A loan to a conduit borrower in a pooled

financing qualifies for the small issuer exception, regardless of the size of either the pooled financing or of any loan to other conduit borrowers, only if—

(i) The bonds of the pooled financing are not private activity bonds;

(ii) None of the loans to conduit borrowers are private activity bonds; and

(iii) The loan to the conduit borrower meets all the requirements of the small issuer exception.

(e) *Refunding issues*—(1) *In general.* Sections 148(f)(4)(D) (v) and (vi) provide restrictions on application of the small issuer exception to refunding issues.

(2) *Multipurpose issues.* The multipurpose issue allocation rules of § 1.148–9(h) apply for purposes of determining whether refunding bonds meet the requirements of section 148(f)(4)(D)(v).

[T.D. 8476, 58 FR 33540, June 18, 1993]

§ 1.148–9 Arbitrage rules for refunding issues.

(a) *Scope of application.* This section contains special arbitrage rules for refunding issues. These rules apply for all purposes of section 148 and govern allocations of proceeds, bonds, and investments to determine transferred proceeds, temporary periods, reasonably required reserve or replacement funds, minor portions, and separate issue treatment of certain multipurpose issues.

(b) *Transferred proceeds allocation rule*—(1) *In general.* When proceeds of the refunding issue discharge any of the outstanding principal amount of the prior issue, proceeds of the prior issue become transferred proceeds of the refunding issue and cease to be proceeds of the prior issue. The amount of proceeds of the prior issue that becomes transferred proceeds of the refunding issue is an amount equal to the proceeds of the prior issue on the date of that discharge multiplied by a fraction—

(i) The numerator of which is the principal amount of the prior issue discharged with proceeds of the refunding issue on the date of that discharge; and

(ii) The denominator of which is the total outstanding principal amount of the prior issue on the date immediately before the date of that discharge.

(2) *Special definition of principal amount.* For purposes of this section, *principal amount* means, in reference to a plain par bond, its stated principal amount, and in reference to any other bond, its present value.

(3) *Relation of transferred proceeds rule to universal cap rule*—(i) *In general.* Paragraphs (b)(1) and (c) of this section apply to allocate transferred proceeds and corresponding investments to a refunding issue on any date required by those paragraphs before the application of the universal cap rule of § 1.148–6(b)(2) to reallocate any of those amounts. To the extent nonpurpose investments allocable to proceeds of a refunding issue exceed the universal cap for the issue on the date that amounts become transferred proceeds of the refunding issue, those transferred proceeds and corresponding investments are reallocated back to the issue from which they transferred on that same date to the extent of the unused universal cap on that prior issue.

(ii) *Example.* The following example illustrates the application of this paragraph of (b)(3):

Example. On January 1, 1995, $100,000 of nonpurpose investments allocable to proceeds of issue *A* become transferred proceeds of issue *B* under § 1.148–9, but the unused portion of issue *B'* s universal cap is $75,000 as of that date. On January 1, 1995, issue *A* has unused universal cap in excess of $25,000. Thus, $25,000 of nonpurpose investments representing the transferred proceeds are immediately reallocated back to issue *A* on January 1, 1995, and are proceeds of issue *A*. On the next transfer date under § 1.148–9, the $25,000 receives no priority in determining transferred proceeds as of that date but is treated the same as all other proceeds of issue *A* subject to transfer.

(4) *Limitation on multi-generational transfers.* This paragraph (b)(4) contains limitations on the manner in which proceeds of a first generation issue that is refunded by a refunding issue (a *second generation issue*) become transferred proceeds of a refunding issue (a *third generation issue*) that refunds the second generation issue. Proceeds of the first generation issue that become transferred proceeds of the third generation issue are treated as having a yield equal to the yield on the refunding escrow allocated to the second generation issue (i.e., as determined under

§1.148–5(b)(2)(iv)). The determination of the transferred proceeds of the third generation issue does not affect compliance with the requirements of section 148, including the determination of the amount of arbitrage rebate with respect to or the yield on the refunding escrow, of the second generation issue.

(c) *Special allocation rules for refunding issues*—(1) *Allocations of investments*—(i) *In general.* Except as otherwise provided in this paragraph (c), investments purchased with sale proceeds or investment proceeds of a refunding issue must be allocated to those proceeds, and investments not purchased with those proceeds may not be allocated to those proceeds (i.e., a *specific tracing method*).

(ii) *Allocations to transferred proceeds.* When proceeds of a prior issue become transferred proceeds of a refunding issue, investments (and the related payments and receipts) of proceeds of the prior issue that are held in a refunding escrow for another issue are allocated to the transferred proceeds under the ratable allocation method described in paragraph (c)(1)(iii) of this section. Investments of proceeds of the prior issue that are not held in a refunding escrow for another issue are allocated to the transferred proceeds by application of the allocation methods described in paragraph (c)(1) (iii) or (iv) of this section, consistently applied to all investments on a transfer date.

(iii) *Ratable allocation method.* Under the ratable allocation method, a ratable portion of each nonpurpose and purpose investment of proceeds of the prior issue is allocated to transferred proceeds of the refunding issue.

(iv) *Representative allocation method*—(A) *In general.* Under the representative allocation method, representative portions of the portfolio of nonpurpose investments and the portfolio of purpose investments of proceeds of the prior issue are allocated to transferred proceeds of the refunding issue. Unlike the ratable allocation method, this representative allocation method permits an allocation of particular whole investments. Whether a portion is representative is based on all the facts and circumstances, including, without limitation, whether the current yields, maturities, and current unrealized gains or losses on the particular allocated investments are reasonably comparable to those of the unallocated investments in the aggregate. In addition, if a portion of nonpurpose investments is otherwise representative, it is within the issuer's discretion to allocate the portion from whichever source of funds it deems appropriate, such as a reserve fund or a construction fund for a prior issue.

(B) *Mark-to-market safe harbor for representative allocation method.* In addition to other representative allocations, a specific allocation of a particular nonpurpose investment to transferred proceeds (e.g., of lower yielding investments) is treated as satisfying the representative allocation method if that investment is valued at fair market value on the transfer date in determining the payments and receipts on that date, but only if the portion of the nonpurpose investments that transfers is based on the relative fair market value of all nonpurpose investments.

(2) *Allocations of mixed escrows to expenditures for principal, interest, and redemption prices on a prior issue*—(i) *In general.* Except for amounts required or permitted to be accounted for under paragraph (c)(2)(ii) of this section, proceeds of a refunding issue and other amounts that are not proceeds of a refunding issue that are deposited in a refunding escrow (a *mixed escrow*) must be accounted for under this paragraph (c)(2)(i). Those proceeds and other amounts must be allocated to expenditures for principal, interest, or stated redemption prices on the prior issue so that the expenditures of those proceeds do not occur faster than ratably with expenditures of the other amounts in the mixed escrow. During the period that the prior issue has unspent proceeds, however, these allocations must be ratable (with reasonable adjustments for rounding) both between sources for expenditures (i.e., proceeds and other amounts) and between uses (i.e., principal, interest, and stated redemption prices on the prior issue).

(ii) *Exceptions*—(A) *Mandatory allocation of certain non-proceeds to earliest expenditures.* If amounts other than proceeds of the refunding issue are deposited in a mixed escrow, but before the issue date of the refunding issue those amounts had been held in a bona fide debt service fund or a fund to carry out the governmental purpose of the prior issue (e.g., a construction fund), those amounts must be allocated to the earliest maturing investments in the mixed escrow.

(B) *Permissive allocation of non-proceeds to earliest expenditures.* Excluding amounts covered by paragraph (c)(2)(ii)(A) of this section and subject to any required earlier expenditure of those amounts, any amounts in a mixed escrow that are not proceeds of a refunding issue may be allocated to the earliest maturing investments in the mixed escrow, provided that those investments mature and the proceeds thereof are expended before the date of any expenditure from the mixed escrow to pay any principal of the prior issue.

(d) *Temporary periods in refundings*—(1) *In general.* Proceeds of a refunding issue may be invested in higher yielding investments under section 148(c) only during the temporary periods described in paragraph (d)(2) of this section.

(2) *Types of temporary periods in refundings.* The available temporary periods for proceeds of a refunding issue are as follows:

(i) *General temporary period for refunding issues.* Except as otherwise provided in this paragraph (d)(2), the temporary period for proceeds (other than transferred proceeds) of a refunding issue is the period ending 30 days after the issue date of the refunding issue.

(ii) *Temporary periods for current refunding issues*—(A) *In general.* Except as otherwise provided in paragraph (d)(2)(ii)(B) of this section, the temporary period for proceeds (other than transferred proceeds) of a current refunding issue is 90 days.

(B) *Temporary period for short-term current refunding issues.* The temporary period for proceeds (other than transferred proceeds) of a current refunding issue that has an original term to maturity of 270 days or less may not exceed 30 days. The aggregate temporary periods for proceeds (other than transferred proceeds) of all current refunding issues described in the preceding sentence that are part of the same series of refundings is 90 days. An issue is part of a series of refundings if it finances or refinances the same expenditures for a particular governmental purpose as another issue.

(iii) *Temporary periods for transferred proceeds*—(A) *In general.* Except as otherwise provided in paragraph (d)(2)(iii)(B) of this section, each available temporary period for transferred proceeds of a refunding issue begins on the date those amounts become transferred proceeds of the refunding issue and ends on the date that, without regard to the discharge of the prior issue, the available temporary period for those proceeds would have ended had those proceeds remained proceeds of the prior issue.

(B) *Termination of initial temporary period for prior issue in an advance refunding.* The initial temporary period under § 1.148–2(e) (2) and (3) for the proceeds of a prior issue that is refunded by an advance refunding issue (including transferred proceeds) terminates on the issue date of the advance refunding issue.

(iv) *Certain short-term gross proceeds.* Except for proceeds of a refunding issue held in a refunding escrow, proceeds otherwise reasonably expected to be used to pay principal or interest on the prior issue, replacement proceeds not held in a bona fide debt service fund, and transferred proceeds, the temporary period for gross proceeds of a refunding issue is the 13-month period beginning on the date of receipt.

(e) *Reasonably required reserve or replacement funds in refundings.* In addition to the requirements of § 1.148–2(f), beginning on the issue date of a refunding issue, a reserve or replacement fund for a refunding issue or a prior issue is a reasonably required reserve or replacement fund under section 148(d) that may be invested in higher yielding investments only if the aggregate amount invested in higher yielding investments under this paragraph (e) for both the refunding issue and the prior issue does not exceed the size limitations under § 1.148–2 (f)(2) and (f)(3), measured by reference to the refunding issue only (regardless of whether proceeds of the prior issue have become transferred proceeds of the refunding issue).

(f) *Minor portions in refundings.* Beginning on the issue date of the refunding issue, gross proceeds not in excess of a minor portion of the refunding issue qualify for investment in higher yielding investments under section 148(e), and gross proceeds not in excess of a minor portion of the prior issue qualify for investment in higher yielding investments under either section 148(e) or section 149(d)(3)(A)(v), whichever is applicable. *Minor portion* is defined in §1.148–2(g).

(g) *Certain waivers permitted.* On or before the issue date, an issuer may waive the right to invest in higher yielding investments during any temporary period or as part of a reasonably required reserve or replacement fund. At any time, an issuer may waive the right to invest in higher yielding investments as part of a minor portion.

(h) *Multipurpose issue allocations*—(1) *Application of multipurpose issue allocation rules.* The portion of the bonds of a multipurpose issue reasonably allocated to any separate purpose under this paragraph (h) is treated as a separate issue for all purposes of section 148 except the following—

(i) *Arbitrage yield.* Except to the extent that the proceeds of an issue are allocable to two or more conduit loans that are tax-exempt bonds, determining the yield on a multipurpose issue and the yield on investments for purposes of the arbitrage yield restrictions of section 148 and the arbitrage rebate requirement of section 148(f);

(ii) *Rebate amount.* Except as provided in paragraph (h)(1)(i) of this section, determining the rebate amount for a multipurpose issue, including subsidiary matters with respect to that determination, such as the computation date credit under §1.148–3(d)(1), the due date for payments, and the $100,000 bona fide debt service fund exception under section 148(f)(4)(A)(ii);

(iii) *Minor portion.* Determining the *minor portion* of an issue under section 148(e);

(iv) *Reasonably required reserve or replacement fund.* Determining the portion of an issue eligible for investment in higher yielding investments as part of a reasonably required reserve or replacement fund under section 148(d); and

(v) *Effective date.* Applying the provisions of §1.148–11(b) (relating to elective retroactive application of §§1.148–1 through 1.148–10 to certain issues).

(2) *Rules on allocations of multipurpose issues*—(i) *In general.* This paragraph (h) applies to allocations of multipurpose issues, including allocations involving the refunding purposes of the issue. Except as otherwise provided in this paragraph (h), proceeds, investments, and bonds of a multipurpose issue may be allocated among the various separate purposes of the issue using any reasonable, consistently applied allocation method. An allocation is not reasonable if it achieves more favorable results under section 148 or 149(d) than could be achieved with actual separate issues. An allocation under this paragraph (h) may be made at any time, but once made may not be changed.

(ii) *Allocations involving certain common costs.* A ratable allocation of common costs (as described in paragraph (h)(3)(ii) of this section) among the separate purposes of the multipurpose issue is generally reasonable. If another allocation method more accurately reflects the extent to which any separate purpose of a multipurpose issue enjoys the economic benefit or bears the economic burden of certain common costs, that allocation method may be used.

(3) *Separate purposes of a multipurpose issue*—(i) *In general.* Separate purposes of a multipurpose issue include refunding a separate prior issue, financing a separate purpose investment, financing a construction issue (as defined in §1.148–7(f)), and any clearly discrete governmental purpose reasonably expected to be financed by that issue. In general, all integrated or functionally related capital projects that qualify for the same initial temporary period under §1.148–2(e)(2) are treated as having a single governmental purpose. The separate purposes of a refunding issue include the separate purposes of the prior issue, if any. Separate purposes may be treated as a single purpose if the proceeds used to finance those purposes are eligible for the same initial temporary period under section 148(c). For example, the use of proceeds of a multipurpose issue to finance separate

qualified mortgage loans may be treated as a single purpose.

(ii) *Financing common costs.* Common costs of a multipurpose issue are not separate purposes. Common costs include issuance costs, accrued interest, capitalized interest on the issue, a reserve or replacement fund, qualified guarantee fees, and similar costs properly allocable to the separate purposes of the issue.

(iii) *Example.* The following example illustrates the application of this paragraph (h)(3).

Example. On January 1, 1994, Housing Authority of State *A* issues a $10 million issue (the *1994 issue*) at an interest rate of 10 percent to finance qualified mortgage loans for owner-occupied residences under section 143. During 1994, *A* originates $5 million in qualified mortgage loans at an interest rate of 10 percent. In 1995, the market interest rates for housing loans falls to 8 percent and *A* is unable to originate further loans from the 1994 issue. On January 1, 1996, *A* issues a $5 million issue (the *1996 issue*) at an interest rate of 8 percent to refund partially the 1994 issue. Under paragraph (h) of this section, *A* treats the portion of the 1994 issue used to originate $5 million in loans as a separate issue comprised of that group of purpose investments. *A* allocates those purpose investments representing those loans to that separate unrefunded portion of the issue. In addition, *A* treats the unoriginated portion of the 1994 issue as a separate issue and allocates the nonpurpose investments representing the unoriginated proceeds of the 1994 issue to the refunded portion of the issue. Thus, when proceeds of the 1996 issue are used to pay principal on the refunded portion of the 1994 issue that is treated as a separate issue under paragraph (h) of this section, only the portion of the 1994 issue representing unoriginated loan funds invested in nonpurpose investments transfer to become transferred proceeds of the 1996 issue.

(4) *Allocations of bonds of a multipurpose issue*—(i) *Reasonable allocation of bonds to portions of issue.* After reasonable adjustment of the issue price of a multipurpose issue to account for common costs, the portion of the bonds of a multipurpose issue allocated to a separate purpose must have an issue price that bears the same ratio to the aggregate issue price of the multipurpose issue as the portion of the sale proceeds of the multipurpose issue used for that separate purpose bears to the aggregate sale proceeds of the multipurpose issue. For a refunding issue used to refund two or more prior issues, the portion of the sales proceeds allocated to the refunding of a separate prior issue is based on the present value of the refunded debt service on that prior issue, using the yield on investments in the refunding escrow allocable to the entire refunding issue as the discount rate.

(ii) *Safe harbor for pro rata allocation method for bonds.* The use of the relative amount of sales proceeds used for each separate purpose to ratably allocate each bond or a ratable number of substantially identical whole bonds is a reasonable method for allocating bonds of a multipurpose issue.

(iii) *Safe harbor for allocations of bonds used to finance separate purpose investments.* An allocation of a portion of the bonds of a multipurpose issue to a particular purpose investment is generally reasonable if that purpose investment has principal and interest payments that reasonably coincide in time and amount to principal and interest payments on the bonds allocated to that purpose investment.

(iv) *Rounding of bond allocations to next whole bond denomination permitted.* An allocation that rounds each resulting fractional bond up or down to the next integral multiple of a permitted denomination of bonds of that issue not in excess of $100,000 does not prevent the allocation from satisfying this paragraph (h)(4).

(v) *Restrictions on allocations of bonds to refunding purposes.* For each portion of a multipurpose issue that is used to refund a separate prior issue, a method of allocating bonds of that issue is reasonable under this paragraph (h) only if, in addition to the requirements of paragraphs (h)(1) and (h)(2) of this section, the portion of the bonds allocated to the refunding of that prior issue—

(A) Results from a pro rata allocation under paragraph (h)(4)(ii) of this section;

(B) Reflects aggregate principal and interest payable in each bond year that is less than, equal to, or proportionate to, the aggregate principal and interest payable on the prior issue in each bond year;

(C) Results from an allocation of all the bonds of the entire multipurpose issue in proportion to the remaining weighted average economic life of the capital projects financed or refinanced by the issue, determined in the same manner as under section 147(b); or

(D) Results from another reasonable allocation method, but only to the extent that the application of the allocation methods provided in this paragraph (h)(4)(v) is not permitted under state law restrictions applicable to the bonds, reasonable terms of bonds issued before, or subject to a master indenture that became effective prior to, July 1, 1993, or other similar restrictions or circumstances. This paragraph (h)(4)(v)(D) shall be strictly construed and is available only if it does not result in a greater burden on the market for tax-exempt bonds than would occur using one of the other allocation methods provided in this paragraph (h)(4)(v). (See also §1.148–11(c)(2).)

(vi) *Exception for refundings of interim notes.* Paragraph (h)(4)(v) of this section need not be applied to refunding bonds issued to provide permanent financing for one or more projects if the prior issue had a term of less than 3 years and was sold in anticipation of permanent financing, but only if the aggregate term of all prior issues sold in anticipation of permanent financing was less than 3 years.

(5) *Limitation on multi-generation allocations.* This paragraph (h) does not apply to allocations of a multipurpose refunded issue unless that refunded issue is refunded directly by an issue to which this paragraph (h) applies. For example, if a 1994 issue refunds a 1984 multipurpose issue, which in turn refunded a 1980 multipurpose issue, this paragraph (h) applies to allocations of the 1984 issue for purposes of allocating the refunding purposes of the 1994 issue, but does not permit allocations of the 1980 issue.

(i) *Operating rules for separation of prior issue into refunded and unrefunded portions*—(1) *In general.* For purposes of paragraph (h)(3)(i) of this section, the separate purposes of a prior issue include the refunded and unrefunded portions of the prior issue. Thus, the refunded and unrefunded portions are treated as separate issues under paragraph (h)(1) of this section. Those separate issues must satisfy the requirements of paragraphs (h) and (i) of this section. The refunded portion of the bonds of a prior issue is based on a fraction the numerator of which is the principal amount of the prior issue to be paid with proceeds of the refunding issue and the denominator of which is the outstanding principal amount of the bonds of the prior issue, each determined as of the issue date of the refunding issue. (See also paragraph (b)(2) of this section.)

(2) *Allocations of proceeds and investments in a partial refunding.* As of the issue date of a partial refunding issue under this paragraph (i), unspent proceeds of the prior issue are allocated ratably between the refunded and unrefunded portions of the prior issue and the investments allocable to those unspent proceeds are allocated in the manner required for the allocation of investments to transferred proceeds under paragraph (c)(1)(ii) of this section.

(3) *References to prior issue.* If the refunded and unrefunded portions of a prior issue are treated as separate issues under this paragraph (i), then, except to the extent that the context clearly requires otherwise (e.g., references to the aggregate prior issue in the mixed escrow rule in paragraph (c)(2) of this section), all references in this section to a prior issue refer only to the refunded portion of that prior issue.

[T.D. 8476, 58 FR 33541, June 18, 1993; 58 FR 44453, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24045, May 10, 1994; T.D. 8718, 62 FR 25512, May 9, 1997]

§1.148–10 Anti-abuse rules and authority of Commissioner.

(a) *Abusive arbitrage device*—(1) *In general.* Bonds of an issue are arbitrage bonds under section 148 if an abusive arbitrage device under paragraph (a)(2) of this section is used in connection with the issue. This paragraph (a) is to be applied and interpreted broadly to carry out the purposes of section 148, as further described in §1.148–0. Except as otherwise provided in paragraph (c) of this section, any action that is expressly permitted by section 148 or §§1.148–1 through 1.148–11 is not an abusive arbitrage device (e.g., investment in higher yielding investments during a permitted temporary period under section 148(c)).

(2) *Abusive arbitrage device defined.* Any action is an abusive arbitrage device if the action has the effect of—

(i) Enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage; and

(ii) Overburdening the tax-exempt bond market.

(3) *Exploitation of tax-exempt interest rates.* An action may exploit tax-exempt interest rates under paragraph (a)(2) of this section as a result of an investment of any portion of the gross proceeds of an issue over any period of time, notwithstanding that, in the aggregate, the gross proceeds of the issue are not invested in higher yielding investments over the term of the issue.

(4) *Overburdening the tax-exempt market.* An action overburdens the tax-exempt bond market under paragraph (a)(2)(ii) of this section if it results in issuing more bonds, issuing bonds earlier, or allowing bonds to remain outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes of the bonds, based on all the facts and circumstances. Whether an action is reasonably necessary to accomplish the governmental purposes of the bonds depends on whether the primary purpose of the transaction is a bona fide governmental purpose (e.g., an issue of refunding bonds to achieve a debt service restructuring that would be issued independent of any arbitrage benefit). An important factor bearing on this determination is whether the action would reasonably be taken to accomplish the governmental purpose of the issue if the interest on the issue were not excludable from gross income under section 103(a) (assuming that the hypothetical taxable interest rate would be the same as the actual tax-exempt interest rate). Factors evidencing an overissuance include the issuance of an issue the proceeds of which are reasonably expected to exceed by more than a minor portion the amount necessary to accomplish the governmental purposes of the issue, or an issue the proceeds of which are, in fact, substantially in excess of the amount of sale proceeds allocated to expenditures for the governmental purposes of the issue. One factor evidencing an early issuance is the issuance of bonds that do not qualify for a temporary period under § 1.148–2(e)(2), (e)(3), or (e)(4). One factor evidencing that bonds may remain outstanding longer than necessary is a term that exceeds the safe harbors against the creation of replacement proceeds under § 1.148–1(c)(4)(i)(B). These factors may be outweighed by other factors, however, such as bona fide cost underruns or long-term financial distress.

(b) *Consequences of overburdening the tax-exempt bond market*—(1) *In general.* An issue that overburdens the tax-exempt bond market (within the meaning of paragraph (a)(4) of this section) is subject to the following special limitations—

(i) *Special yield restriction.* Investments are subject to the definition of *materially higher* yield under § 1.148–2(d) that is equal to one-thousandth of 1 percent. In addition, each investment is treated as a separate class of investments under § 1.148–5(b)(2)(ii), the yield on which may not be blended with that of other investments.

(ii) *Certain regulatory provisions inapplicable.* The provisions of § 1.148–5(c) (relating to yield reduction payments) and § 1.148–5(e) (2) and (3) (relating to recovery of qualified administrative costs) do not apply.

(iii) *Restrictive expenditure rule.* Proceeds are not allocated to expenditures unless the proceeds-spent-last rule under § 1.148–6(d)(3)(i) is satisfied, applied by treating those proceeds as proceeds to be used for restricted working capital expenditures. For this purpose, available amount includes a reasonable working capital reserve as defined in § 1.148–6(d)(3)(iii)(B).

(2) *Application.* The provisions of this paragraph (b) only apply to the portion of an issue that, as a result of actions taken (or actions not taken) after the issue date, overburdens the market for tax-exempt bonds, except that for an issue that is reasonably expected as of the issue date to overburden the market, those provisions apply to all of the gross proceeds of the issue.

(c) *Anti-abuse rules on excess gross proceeds of advance refunding issues*—(1) *In general.* Except as otherwise provided in this paragraph (c), an abusive arbitrage device is used and bonds of an advance refunding issue are arbitrage bonds if the issue has excess gross proceeds.

(2) *Definition of excess gross proceeds.* Excess gross proceeds means all gross proceeds of an advance refunding issue that exceed an amount equal to 1 percent of sale proceeds of the issue, other than gross proceeds allocable to—

(i) Payment of principal, interest, or call premium on the prior issue;

(ii) Payment of pre-issuance accrued interest on the refunding issue, and interest on the refunding issue that accrues for a period up to the completion date of any capital project for which the prior issue was issued, plus one year;

(iii) A reasonably required reserve or replacement fund for the refunding issue or investment proceeds of such a fund;

(iv) Payment of costs of issuance of the refunding issue;

(v) Payment of administrative costs allocable to repaying the prior issue, carrying and repaying the refunding issue, or investments of the refunding issue;

(vi) Transferred proceeds that will be used or maintained for the governmental purpose of the prior issue;

(vii) Interest on purpose investments;

(viii) Replacement proceeds in a sinking fund for the refunding issue;

(ix) Qualified guarantee fees for the refunding issue or the prior issue; and

(x) Fees for a qualified hedge for the refunding issue.

(3) *Special treatment of transferred proceeds.* For purposes of this paragraph (c), all unspent proceeds of the prior issue as of the issue date of the refunding issue are treated as transferred proceeds of the advance refunding issue.

(4) *Special rule for crossover refundings.* An advance refunding issue is not an issue of arbitrage bonds under this paragraph (c) if all excess gross proceeds of the refunding issue are used to pay interest that accrues on the refunding issue before the prior issue is discharged, and no gross proceeds of any refunding issue are used to pay interest on the prior issue or to replace funds used directly or indirectly to pay such interest (other than transferred proceeds used to pay interest on the prior issue that accrues for a period up to the completion date of the project for which the prior issue was issued, plus one year, or proceeds used to pay principal that is attributable to accrued original issue discount).

(5) *Special rule for gross refundings.* This paragraph (c)(5) applies if an advance refunding issue (the *series B issue*) is used together with one or more other advance refunding issues (the *series A issues*) in a gross refunding of a prior issue, but only if the use of a gross refunding method is required under bond documents that were effective prior to November 6, 1992. These advance refunding issues are not arbitrage bonds under this paragraph (c) if—

(i) All excess gross proceeds of the series B issue and each series A issue are investment proceeds used to pay principal and interest on the series B issue;

(ii) At least 99 percent of all principal and interest on the series B issue is paid with proceeds of the series B and series A issues or with the earnings on other amounts in the refunding escrow for the prior issue;

(iii) The series B issue is discharged not later than the prior issue; and

(iv) As of any date, the amount of gross proceeds of the series B issue allocated to expenditures does not exceed the aggregate amount of expenditures before that date for principal and interest on the series B issue, and administrative costs of carrying and repaying the series B issue, or of investments of the series B issue.

(d) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. Mortgage sale. In 1982, City issued its revenue issue (the *1982 issue*) and lent the proceeds to Developer to finance a low-income housing project under former section 103(b)(4)(A) of the 1954 Code. In 1994, Developer encounters financial difficulties and negotiates with City to refund the 1982 issue. City issues $10 million in principal amount of its 8 percent bonds (the *1994 issue*). City lends the proceeds of the 1994 issue to Developer. To evidence Developer's obligation to repay that loan, Developer, as obligor, issues a note to City (the *City note*). Bank agrees to provide Developer with a direct-pay letter of credit pursuant to which Bank will make all payments to the trustee for the 1994 issue necessary to meet Developer's obligations under the City note. Developer pays Bank a fee for the issuance of the letter of credit and issues a note to Bank (the *Bank note*). The Bank note is secured by a mortgage on the housing project and is guaranteed by FHA. The Bank note and the 1994 issue have different prepayment terms. The City does not reasonably expect to treat prepayments of the Bank note as gross proceeds of the 1994 issue. At the same time or pursuant to a series of related transactions, Bank sells the Bank note to Investor for $9.5 million. Bank invests these monies together with its other funds. In substance, the transaction is a loan by City to Bank, under which Bank enters into a series of transactions that, in effect, result in Bank retaining $9.5 million in amounts treated as proceeds of the 1994 issue. Those amounts are invested in materially higher yielding investments that provide funds sufficient to equal or exceed the Bank's liability under the letter of credit. Alternatively, the letter of credit is investment property in a sinking fund for the 1994 issue provided by Developer, a substantial beneficiary of the financing. Because, in substance, Developer acquires the $10 million principal amount letter of credit for a fair market value purchase price of $9.5 million, the letter of credit is a materially higher yielding investment. Neither result would change if Developer's obligation under the Bank note is contingent on Bank performing its obligation under the letter of credit. Each characterization causes the bonds to be arbitrage bonds.

Example 2. Bonds outstanding longer than necessary for yield-blending device. (i) *Longer bond maturity to create sinking fund.* In 1994, Authority issues an advance refunding issue (the *refunding issue*) to refund a 1982 prior issue (the *prior issue*). Under current market conditions, Authority will have to invest the refunding escrow at a yield significantly below the yield on the refunding issue. Authority issues its refunding issue with a longer weighted average maturity than otherwise necessary primarily for the purpose of creating a sinking fund for the refunding issue that will be invested in a guaranteed investment contract. The weighted average maturity of the refunding issue is less than 120 percent of the remaining average economic life of the facilities financed with the proceeds of the prior issue. The guaranteed investment contract has a yield that is higher than the yield on the refunding issue. The yield on the refunding escrow blended with the yield on the guaranteed investment contract does not exceed the yield on the issue. The refunding issue uses an abusive arbitrage device and the bonds of the issue are arbitrage bonds under section 148(a).

(ii) *Refunding of noncallable bonds.* The facts are the same as in paragraph (i) of this *Example 2* except that instead of structuring the refunding issue to enable it to take advantage of sinking fund investments, Authority will also refund other long-term, non-callable bonds in the same refunding issue. There are no savings attributable to the refunding of the non-callable bonds (e.g., a *low-to-high* refunding). The Authority invests the portion of the proceeds of the refunding issue allocable to the refunding of the non-callable bonds in the refunding escrow at a yield that is higher than the yield on the refunding issue, based on the relatively long escrow period for this portion of the refunding. The Authority invests the other portion of the proceeds of the refunding issue in the refunding escrow at a yield lower than the yield on the refunding issue. The blended yield on all the investments in the refunding escrow for the prior issues does not exceed the yield on the refunding issue. The portion of the refunding issue used to refund the noncallable bonds, however, was not otherwise necessary and was issued primarily to exploit the difference between taxable and tax-exempt rates for that long portion of the refunding escrow to minimize the effect of lower yielding investments in the other portion of the escrow. The refunding issue uses an abusive arbitrage device and the bonds of the issue are arbitrage bonds.

(iii) *Governmental purpose.* In paragraphs (i) and (ii) of this *Example 2,* the existence of a governmental purpose for the described financing structures would not change the conclusions unless Authority clearly established that the primary purpose for the use of the particular structure was a bona fide governmental purpose. The fact that each financing structure had the effect of eliminating significant amounts of negative arbitrage is strong evidence of a primary purpose that is not a bona fide governmental purpose. Moreover, in paragraph (i) of this *Example 2,* the structure of the refunding issue coupled with the acquisition of the guaranteed investment contract to lock in the investment yield associated with the structure is strong evidence of a primary purpose that is not a bona fide governmental purpose.

Example 3. Window refunding. (i) Authority issues its 1994 refunding issue to refund a portion of the principal and interest on its outstanding 1985 issue. The 1994 refunding issue is structured using zero-coupon bonds that pay no interest or principal for the 5-year period following the issue date. The proceeds of the 1994 refunding issue are deposited in a refunding escrow to be used to pay only the interest requirements of the refunded portion of the 1985 issue. Authority enters into a guaranteed investment contract with a financial institution, *G,* under which *G* agrees to provide a guaranteed yield on revenues invested by Authority during the 5-year period following the issue date. The guaranteed investment contract has a yield that is no higher than the yield on the refunding issue. The revenues to be invested under this guaranteed investment contract consist of the amounts that Authority otherwise would have used to pay principal and interest on the 1994 refunding issue. The guaranteed investment contract is structured to generate receipts at times and in amounts sufficient to pay the principal and redemption requirements of the refunded portion of the 1985 issue. A principal purpose of these transactions is to avoid transferred proceeds. Authority will continue to invest the unspent proceeds of the 1985 issue that are on deposit in a refunding escrow for its 1982 issue at a yield equal to the yield on the 1985 issue and will not otherwise treat those unspent proceeds as transferred proceeds of the 1994 refunding issue. The 1994 refunding issue is an issue of arbitrage bonds since those bonds involve a transaction or series of transactions that overburdens the market by leaving bonds outstanding longer than is necessary to obtain a material financial advantage based on arbitrage. Specifically, Authority has structured the 1994 refunding issue to make available for the refunding of the 1985 issue replacement proceeds rather than proceeds so that the unspent proceeds of the 1985 issue will not become transferred proceeds of the 1994 refunding issue.

(ii) The result would be the same in each of the following circumstances:

(A) The facts are the same as in paragraph (i) of this *Example 3* except that Authority does not enter into the guaranteed investment contract but instead, as of the issue date of the 1994 refunding issue, reasonably expects that the released revenues will be available for investment until used to pay principal and interest on the 1985 issue.

(B) The facts are the same as in paragraph (i) of this *Example 3* except that there are no unspent proceeds of the 1985 issue and Authority invests the released revenues at a yield materially higher than the yield on the 1994 issue.

(C) The facts are the same as in paragraph (i) of this *Example 3* except that Authority uses the proceeds of the 1994 issue for capital projects instead of to refund a portion of the 1985 issue.

Example 4. Sale of conduit loan. On January 1, 1994, Authority issues a conduit financing issue (the *1994 conduit financing issue*) and uses the proceeds to purchase from City, an unrelated party, a tax-exempt bond of City (the *City note*). The proceeds of the 1994 conduit financing issue are to be used to advance refund a prior conduit financing issue that was issued in 1988 and used to make a loan to City. The 1994 conduit financing issue and the City note each have a yield of 8 percent on January 1, 1994. On June 30, 1996, interest rates have decreased and Authority sells the City note to D, a person unrelated to either City or Authority. Based on the sale price of the City note and treating June 30, 1996 as the issue date of the City note, the City note has a 6 percent yield. Authority deposits the proceeds of the sale of the City note into an escrow to redeem the bonds of the 1994 conduit financing issue on January 1, 2001. The escrow is invested in nonpurpose investments having a yield of 8 percent. For purposes of section 149(d), City and Authority are related parties and, therefore, the issue date of the City note is treated as being June 30, 1996. Thus, the City note is an advance refunding of Authority's 1994 conduit financing issue. Interest on the City note is not exempt from Federal income tax from the date it is sold to D under section 149(d), because, by investing the escrow investments at a yield of 8 percent instead of a yield not materially higher than 6 percent, the sale of the City note employs a device to obtain a material financial advantage, based on arbitrage, apart from the savings attributable to lower interest rates. In addition, the City note is not a tax-exempt bond because the note is the second advance refunding of the original bond under section 149(d)(3). The City note also employs an abusive arbitrage device and is an arbitrage bond under section 148.

Example 5. Re-refunding. (i) On January 1, 1984, City issues a tax-exempt issue (the *1984 issue*) to finance the cost of constructing a prison. The 1984 issue has a 7 percent yield and a 30-year maturity. The 1984 issue is callable at any time on or after January 1, 1994. On January 1, 1990, City issues a refunding issue (the *1990 issue*) to advance refund the 1984 issue. The 1990 issue has an 8 percent yield and a 30-year maturity. The 1990 issue is callable at any time on or after January 1, 2000. The proceeds of the 1990 issue are invested at an 8 percent yield in a refunding escrow for the 1984 issue (the *original 1984 escrow*) in a manner sufficient to pay debt service on the 1984 issue until maturity (i.e., an escrow to maturity). On January 1, 1994, City issues a refunding issue (the *1994 issue*). The 1994 issue has a 6 percent yield and a 30-year maturity. City does not invest the proceeds of the 1994 issue in a refunding escrow for the 1990 issue in a manner sufficient to pay a portion of the debt service until, and redeem a portion of that issue on, January 1, 2000. Instead, City invests those proceeds at a 6 percent yield in a new refunding escrow for a portion of the 1984 issue (the *new 1984 escrow*) in a manner sufficient to pay debt service on a portion of the 1984 issue until maturity. City also liquidates the investments allocable to the proceeds of the 1990 issue held in the original 1984 escrow and reinvests those proceeds in an escrow to pay a portion of the debt service on the 1990 issue itself until, and redeem a portion of that issue on, January 1, 2000 (the *1990 escrow*). The 1994 bonds are arbitrage bonds and employ an abusive device under section 149(d)(4). Although, in form, the proceeds of the 1994 issue are used to pay principal on the 1984 issue, this accounting for the use of the proceeds of the 1994 issue is an unreasonable, inconsistent accounting method under § 1.148–6(a). Moreover, since the proceeds of the 1990 issue were set aside in an escrow to be used to retire the 1984 issue, the use of proceeds of the 1994 issue for that same purpose involves a replacement of funds invested in higher yielding investments under section 148(a)(2). Thus, using a reasonable, consistent accounting method and giving effect to the substance of the transaction, the proceeds of the 1994 issue are treated as used to refund the 1990 issue and are allocable to the 1990 escrow. The proceeds of the 1990 issue are treated as used to refund the 1984 issue and are allocable to the investments in the new 1984 escrow. The proceeds of the 1990 issue allocable to the nonpurpose investments in the new 1984 escrow become transferred proceeds of the 1994 issue as principal is paid on the 1990 issue from amounts on deposit in the 1990 escrow. As a result, the yield on nonpurpose investments allocable to the 1994 issue is materially higher than the yield on the 1994 issue, causing the bonds of the 1994 issue to be arbitrage bonds. In addition, the transaction employs a device under section 149(d)(4) to obtain a material financial advantage based on arbitrage, other than savings attributable to lower interest rates.

(ii) The following changes in the facts do not affect the conclusion that the 1994 issue consists of arbitrage bonds—

(1) The 1990 issue is a taxable issue;

(2) The original 1984 escrow is used to pay the 1994 issue (rather than the 1990 issue); or

(3) The 1994 issue is used to retire the 1984 issue within 90 days of January 1, 1994.

(e) *Authority of the Commissioner to clearly reflect the economic substance of a transaction.* If an issuer enters into a transaction for a principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of section 148, the Commissioner may exercise the Commissioner's discretion to depart from the rules of § 1.148–1 through § 1.148–11 as necessary to clearly reflect the economic substance of the transaction. For this purpose, the Commissioner may recompute yield on an issue or on investments, reallocate payments and receipts on investments, recompute the rebate amount on an issue, treat a hedge as either a qualified hedge or not a qualified hedge, or otherwise adjust any item whatsoever bearing upon the investments and expenditures of gross proceeds of an issue. For example, if the amount paid for a hedge is specifically based on the amount of arbitrage earned or expected to be earned on the hedged bonds, a principal purpose of entering into the contract is to obtain a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of section 148.

(f) *Authority of the Commissioner to require an earlier date for payment of rebate.* If the Commissioner determines that an issue is likely to fail to meet the requirements of § 1.148–3 and that a failure to serve a notice of demand for payment on the issuer will jeopardize the assessment or collection of tax on interest paid or to be paid on the issue, the date that the Commissioner serves notice on the issuer is treated as a required computation date for payment of rebate for that issue.

(g) *Authority of the Commissioner to waive regulatory limitations.* Notwithstanding any specific provision in §§ 1.148–1 through 1.148–11, the Commissioner may prescribe extensions of temporary periods, larger reasonably required reserve or replacement funds, or consequences of failures or remedial action under section 148 in lieu of or in addition to other consequences of those failures, or take other action, if the Commissioner finds that good faith or other similar circumstances so warrant, consistent with the purposes of section 148.

[T.D. 8476, 58 FR 33544, June 18, 1993; 58 FR 44453, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24046, May 10, 1994; T.D. 8476, 59 FR 24351, May 11, 1994; T.D. 8718, 62 FR 25512, May 9, 1997]

§ 1.148–11 Effective dates.

(a) *In general.* Except as otherwise provided in this section, §§ 1.148–1 through 1.148–11 apply to bonds sold on or after July 8, 1997.

(b) *Elective retroactive application in whole*—(1) *In general.* Except as otherwise provided in this section, and subject to the applicable effective dates for the corresponding statutory provisions, an issuer may apply the provisions of §§ 1.148–1 through 1.148–11 in whole, but not in part, to any issue that is outstanding on July 8, 1997, and is subject to section 148(f) or to sections 103(c)(6) or 103A(i) of the Internal Revenue Code of 1954, in lieu of otherwise applicable regulations under those sections.

(2) *No elective retroactive application for 18-month spending exception.* The provisions of §1.148–7(d) (relating to the 18-month spending exception) may not be applied to any issue issued on or before June 30, 1993.

(3) *No elective retroactive application for hedges of fixed rate issues.* The provisions of §1.148–4(h)(2)(i)(B) (relating to hedges of fixed rate issues) may not be applied to any bond sold on or before July 8, 1997.

(c) *Elective retroactive application of certain provisions and special rules*—(1) *Retroactive application of overpayment recovery provisions.* An issuer may apply the provisions of §1.148–3(i) to any issue that is subject to section 148(f) or to sections 103(c)(6) or 103A(i) of the Internal Revenue Code of 1954.

(2) *Certain allocations of multipurpose issues.* An allocation of bonds to a refunding purpose under §1.148–9(h) may be adjusted as necessary to reflect allocations made between May 18, 1992, and August 15, 1993, if the allocations satisfied the corresponding prior provision of §1.148–11(j)(4) under applicable prior regulations.

(3) *Special limitation.* The provisions of §1.148–9 apply to issues issued before August 15, 1993, only if the issuer in good faith estimates the present value savings, if any, associated with the effect of the application of that section on refunding escrows, using any reasonable accounting method, and applies those savings, if any, to redeem outstanding tax-exempt bonds of the applicable issue at the earliest possible date on which those bonds may be redeemed or otherwise retired. These savings are not reduced to take into account any administrative costs associated with applying these provisions retroactively.

(d) *Transition rule excepting certain state guarantee funds from the definition of replacement proceeds*—(1) *Certain perpetual trust funds.* A guarantee by a fund created and controlled by a State and established pursuant to its constitution does not cause the amounts in the fund to be pledged funds treated as replacement proceeds if—

(i) Substantially all of the corpus of the fund consists of nonfinancial assets, revenues derived from these assets, gifts, and bequests;

(ii) The corpus of the guarantee fund may be invaded only to support specifically designated essential governmental functions (*designated functions*) carried on by political subdivisions with general taxing powers;

(iii) Substantially all of the available income of the fund is required to be applied annually to support designated functions;

(iv) The issue guaranteed consists of general obligations that are not private activity bonds substantially all of the proceeds of which are to be used for designated functions;

(v) The fund satisfied each of the requirements of paragraphs (d)(1)(i) through (d)(1)(iii) of this section on August 16, 1986; and

(vi) The guarantee is not attributable to a deposit to the fund made after May 14, 1989, unless—

(A) The deposit is attributable to the sale or other disposition of fund assets; or

(B) Prior to the deposit, the outstanding amount of the bonds guaranteed by the fund did not exceed 250 percent of the lower of the cost or fair market value of the fund.

(2) *Permanent University Fund.* Replacement proceeds do not include amounts allocable to investments of the fund described in section 648 of Public Law 98–369.

(e) *Transition rule regarding special allowance payments.* Section 1.148–5(b)(5) applies to any bond issued after January 5, 1990, except a bond issued exclusively to refund a bond issued before January 6, 1990, if the amount of the refunding bond does not exceed 101 percent of the amount of the refunded bond, and the maturity date of the refunding bond is not later than the date that is 17 years after the date on which the refunded bond was issued (or, in the case of a series of refundings, the date on which the original bond was issued), but only if §1.148–2(d)(2)(iv) is applied by substituting *1 and one-half percentage points* for *2 percentage points.*

(f) *Transition rule regarding applicability of yield reduction rule.* Section 1.148–5(c) applies to nonpurpose investments allocable to replacement proceeds of an issue that are held in a reserve or replacement fund to the extent that—

(1) Amounts must be paid into the fund under a constitutional provision, statute, or ordinance adopted before May 3, 1978;

(2) Under that provision, amounts paid into the fund (and investment earnings thereon) can be used only to pay debt service on the issues; and

(3) The size of the payments made into the fund is independent of the size of the outstanding issues or the debt service thereon.

(g) *Provisions applicable to certain bonds sold before effective date.* Except for bonds to which paragraph (b)(1) of this section applies—

(1) Section 1.148–11A provides rules applicable to bonds sold after June 6, 1994, and before July 8, 1997; and

(2) Sections 1.148–1 through 1.148–11 as in effect on July 1, 1993 (see 26 CFR part 1 as revised April 1, 1994), and §1.148–11A(i) (relating to elective retroactive application of certain provisions) provide rules applicable to certain issues issued before June 7, 1994.

[T.D. 8476, 58 FR 33547, June 18, 1993; 58 FR 44453, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24046, May 10, 1994; T.D. 8718, 62 FR 25512, May 9, 1997]

§1.149(b)–1 Federally guaranteed bonds.

(a) *General rule.* Under section 149(b) and this section, nothing in section 103(a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any bond issued as part of an issue that is federally guaranteed.

(b) *Exceptions.* Pursuant to section 149(b)(3)(B), section 149(b)(1) and paragraph (a) of this section do not apply to—

(1) Investments in obligations issued pursuant to §21B(d)(3) of the Federal Home Loan Bank Act, as amended by §511 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, or any successor provision; or

(2) Any investments that are held in a refunding escrow (as defined in §1.148–1).

(c) *Effective date.* This section applies to investments made after June 30, 1993.

[T.D. 8476, 58 FR 33548, June 18, 1993]

§1.149(d)–1 Limitations on advance refundings.

(a) *General rule.* Under section 149(d) and this section, nothing in section 103(a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any bond issued as part of an issue described in paragraphs (2), (3), or (4) of section 149(d).

(b) *Advance refunding issues that employ abusive devices*—(1) *In general.* An advance refunding issue employs an abusive device and is described in section 149(d)(4) if the issue violates any of the anti-abuse rules under §1.148–10.

(2) *Failure to pay required rebate.* An advance refunding issue is described in section 149(d)(4) if the issue fails to meet the requirements of §1.148–3. This paragraph (b)(2) applies to any advance refunding issue issued after August 31, 1986.

(3) *Mixed escrows invested in tax-exempt bonds.* An advance refunding issue is described in section 149(d)(4) if—

(i) Any of the proceeds of the issue are invested in a refunding escrow in which a portion of the proceeds are invested in tax-exempt bonds and a portion of the proceeds are invested in nonpurpose investments;

(ii) The yield on the tax-exempt bonds in the refunding escrow exceeds the yield on the issue;

(iii) The yield on all the investments (including investment property and tax-exempt bonds) in the refunding escrow exceeds the yield on the issue; and

(iv) The weighted average maturity of the tax-exempt bonds in the refunding escrow is more than 25 percent greater or less than the weighted average maturity of the nonpurpose investments in the refunding escrow, and the weighted average maturity of nonpurpose investments in the refunding escrow is greater than 60 days.

(4) *Tax-exempt conduit loans.* For purposes of applying section 149(d) to a

conduit financing issue that finances any conduit loan that is a tax-exempt bond, the actual issuer of a conduit financing issue and the conduit borrower of that conduit financing issue are treated as related parties. Thus, the issue date of the conduit loan does not occur prior to the date on which the actual issuer of the conduit financing issue sells, exchanges, or otherwise disposes of that conduit loan, and the use of the proceeds of the disposition to pay debt service on the conduit financing issue causes the conduit loan to be a refunding issue. See §1.148–10(d), *Example 4.*

(c) *Unrefunded debt service remains eligible for future advance refunding.* For purposes of section 149(d)(3)(A)(i), any principal or interest on a prior issue that has not been paid or provided for by any advance refunding issue is treated as not having been advance refunded.

(d) *Application of arbitrage regulations*—(1) *Application of multipurpose issue rules.* For purposes of sections 149(d)(2) and (3)(A)(i), (ii), and (iii), the provisions of the multipurpose issue rule in §1.148–9(h) apply, except that the limitation in §1.148–9(h)(5) is disregarded.

(2) *General mixed escrow rules.* For purposes of section 149(d), the provisions of §1.148–9(c) (relating to mixed escrows) apply, except that those provisions do not apply for purposes of section 149(d)(2) and (d)(3)(A) (i) and (ii) to amounts that were not gross proceeds of the prior issue before the issue date of the refunding issue.

(3) *Temporary periods and minor portions.* Section 1.148–9(d) and (f) contains rules applicable to temporary periods and minor portions for advance refunding issues.

(4) *Definitions.* Section 1.148–1 applies for purposes of section 149(d).

(e) *Taxable refundings*—(1) *In general.* Except as provided in paragraph (e)(2) of this section, for purposes of section 149(d)(3)(A)(i), an advance refunding issue the interest on which is not excludable from gross income under section 103(a) (i.e., a taxable advance refunding issue) is not taken into account. In addition, for this purpose, an advance refunding of a taxable issue is not taken into account unless the taxable issue is a conduit loan of a tax-exempt conduit financing issue.

(2) *Use to avoid section 149(d)(3)(A)(i).* A taxable issue is taken into account under section 149(d)(3)(A)(i) if it is issued to avoid the limitations of that section. For example, in the case of a refunding of a tax-exempt issue with a taxable advance refunding issue that is, in turn, currently refunded with a tax-exempt issue, the taxable advance refunding issue is taken into account under section 149(d)(3)(A)(i) if the two tax-exempt issues are outstanding concurrently for more than 90 days.

(f) *Redemption at first call date*—(1) *General rule.* Under sections 149(d)(3)(A) (ii) and (iii) (the *first call requirement*), bonds refunded by an advance refunding must be redeemed on their first call date if the savings test under section 149(d)(3)(B)(i) (the *savings test*) is satisfied. The savings test is satisfied if the issuer may realize present value debt service savings (determined without regard to administrative expenses) in connection with the issue of which the refunding bond is a part.

(2) *First call date. First call date* means the earliest date on which a bond may be redeemed (or, if issued before 1986, on the earliest date on which that bond may be redeemed at a redemption price not in excess of 103 percent of par). If, however, the savings test is not met with respect to the date described in the preceding sentence (i.e., there are no present value savings if the refunded bonds are retired on that date), the first call date is the first date thereafter on which the bonds can be redeemed and on which the savings test is met.

(3) *Application of savings test to multipurpose issues.* Except as otherwise provided in this paragraph (f)(3), the multipurpose issue rules in §1.148–9(h) apply for purposes of the savings test. If any separate issue in a multipurpose issue increases the aggregate present value debt service savings on the entire multipurpose issue or reduces the present value debt service losses on that entire multipurpose issue, that separate issue satisfies the savings test.

(g) *Effective date*—(1) *In general.* Except as provided in paragraph (g)(2) of this section, this section applies to bonds issued after June 30, 1993, to which §§ 1.148–1 through 1.148–11 apply, including conduit loans that are treated as issued after June 30, 1993, under paragraph (b)(4) of this section. In addition, this section applies to any issue to which the election described in § 1.148–11(b)(1) is made.

(2) *Special effective date for paragraph (b)(3).* Paragraph (b)(3) of this section applies to any advance refunding issue issued after May 28, 1991.

(3) *Special effective date for paragraph (f)(3).* Paragraph (f)(3) of this section applies to bonds sold on or after July 8, 1997, and to any issue to which the election described in § 1.148–11(b)(1) is made. See § 1.148–11A(i) for rules relating to certain bonds sold before July 8, 1997.

[T.D. 8476, 58 FR 33548, June 18, 1993; 58 FR 44453, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24046, May 10, 1994; T.D. 8718, 62 FR 25513, May 9, 1997]

§ 1.149(e)–1 Information reporting requirements for tax-exempt bonds.

(a) *General rule.* Interest on a bond is included in gross income unless certain information with respect to the issue of which the bond is a part is reported to the Internal Revenue Service in accordance with the requirements of this section. This section applies to any bond if the issue of which the bond is a part is issued after December 31, 1986 (including any bond issued to refund a bond issued on or before December 31, 1986).

(b) *Requirements for private activity bonds*—(1) *In general.* If the issue of which the bond is a part is an issue of private activity bonds, the issuer must comply with the following requirements—

(i) Not later than the 15th day of the second calendar month after the close of the calendar quarter in which the issue is issued, the issuer must file with the Internal Revenue Service a completed information reporting form prescribed for this purpose;

(ii) If any bond that is part of the issue is taken into account under section 146 (relating to volume cap on private activity bonds), the state certification requirement of paragraph (b)(2) of this section must be satisfied; and

(iii) If any bond that is part of the issue is a qualified mortgage bond or qualified veterans' mortgage bond (within the meaning of section 143 (a) or (b) or section 103A(c) (1) or (3) as in effect on the day before enactment of the Tax Reform Act of 1986), the issuer must submit the annual report containing information on the borrowers of the original proceeds of the issue as required under § 1.103A–2 (k)(2)(ii) and (k)(3) through (k)(6).

(2) *State certification with respect to volume cap*—(i) *In general.* If an issue is subject to the volume cap under section 146, a state official designated by state law (if there is no such official, then the governor or the governor's delegate) must certify that the issue meets the requirements of section 146, and a copy of this certification must be attached to the information reporting form filed with respect to the issue. In the case of any constitutional home rule city (as defined in section 146(d)(3)(C)), the preceding sentence is applied by substituting ''city'' for ''state'' and ''chief executive officer'' for ''governor.''

(ii) *Certification.* The certifying official need not perform an independent investigation in order to certify that the issue meets the requirements of section 146. For example, if the certifying official receives an affidavit that was executed by an officer of the issuer who is responsible for issuing the bonds and that sets forth, in brief and summary terms, the facts necessary to determine that the issue meets the requirements of section 146 and if the certifying official has compared the information in that affidavit to other readily available information with respect to that issuer (*e.g.,* previous affidavits and certifications for other private activity bonds issued by that issuer), the certifying official may rely on the affidavit.

(c) *Requirements for governmental bonds*—(1) *Issue price of $100,000 or more.* If the issue of which the bond is a part has an issue price of $100,000 or more and is not an issue of private activity bonds, then, not later than the 15th day of the second calendar month after the close of the calendar quarter in which the issue is issued, the issuer must file with the Internal Revenue Service a completed information reporting form prescribed for this purpose.

(2) *Issue price of less than $100,000*—(i) *In general.* If the issue of which the bond is a part has an issue price of less than $100,000 and is not an issue of private activity bonds, the issuer must file with the Internal Revenue Service one of the following information reporting forms within the prescribed period—

(A) *Separate return.* Not later than the 15th day of the second calendar month after the close of the calendar quarter in which the issue is issued, a completed information reporting form prescribed for this purpose with respect to that issue; or

(B) *Consolidated return.* Not later than February 15 of the calendar year following the calendar year in which the issue is issued, a completed information form prescribed for this purpose with respect to all issues to which this paragraph (c)(2) applies that were issued by the issuer during the calendar year and for which information was not reported on a separate information return pursuant to paragraph (c)(2)(i)(A) of this section.

(ii) *Bond issues issued before January 1, 1992.* Paragraph (c)(2)(i)(A) of this section does not apply if the issue of which the bond is a part is issued before January 1, 1992.

(iii) *Extended filing date for first and second calendar quarters of 1992.* If the issue of which the bond is a part is issued during the first or second calendar quarter of 1992, the prescribed period for filing an information reporting form with respect to that issue pursuant to paragraph (c)(2)(i)(A) of this section is extended until November 16, 1992.

(d) *Filing of forms and special rules*—(1) *Completed form.* For purposes of this section—

(i) *Good faith effort.* An information reporting form is treated as completed if the issuer (or a person acting on behalf of the issuer) has made a good faith effort to complete the form (taking into account the instructions to the form).

(ii) *Information.* In general, information reporting forms filed pursuant to this section must be completed on the basis of available information and reasonable expectations as of the date the issue is issued. Forms that are filed on a consolidated basis pursuant to paragraph (c)(2)(i)(B) of this section, however, may be completed on the basis of information readily available to the issuer at the close of the calendar year to which the form relates, supplemented by estimates made in good faith.

(iii) *Certain information not required.* An issuer need not report to the Internal Revenue Service any information specified in the first sentence of section 149(e)(2) that is not required to be reported to the Internal Revenue Service pursuant to the information reporting forms prescribed under that section and the instructions to those forms.

(2) *Manner of filing*—(i) *Place for filing.* The information reporting form must be filed with the Internal Revenue Service at the address specified on the form or in the instructions to the form.

(ii) *Extension of time.* The Commissioner may grant an extension of time to file any form or attachment required under this section if the Commissioner determines that the failure to file in a timely manner was not due to willful neglect. The Commissioner may make this determination with respect to an issue or to a class of issues.

(e) *Definitions.* For purposes of this section only—(1) *Private activity bond.* The term ‘‘private activity bond’’ has the meaning given that term in section 141(a) of the Internal Revenue Code, except that the term does not include any bond described in section 1312(c) of the Tax Reform Act of 1986 to which section 1312 or 1313 of the Tax Reform Act of 1986 applies.

(2) *Issue*—(i) *In general.* Except as otherwise provided in this paragraph (e)(2), bonds are treated as part of the same issue only if the bonds are issued—

(A) By the same issuer;

(B) On the same date; and

(C) Pursuant to a single transaction or to a series of related transactions.

(ii) *Draw-down loans, commercial paper, etc.* (A) Bonds issued during the same calendar year may be treated as part of the same tissue if the bonds are issued—

(*1*) Pursuant to a loan agreement under which amounts are to be advanced periodically (''draw-down loan''); or

(*2*) With a term not exceeding 270 days.

(B) In addition, the bonds must be equally and ratably secured under a single indenture or loan agreement and issued pursuant to a common financing arrangement (*e.g.*, pursuant to the same official statement that is periodically updated to reflect changing factual circumstances). In the case of bonds issued pursuant to a draw-down loan that meets the requirements of the preceding sentence, bonds issued during different calendar years may be treated as part of the same issue if all the amounts to be advanced pursuant to the draw-down loan are reasonably expected to be advanced within three years of the date of issue of the first bond.

(iii) *Leases and installment sales.* Bonds other than private activity bonds may be treated as part of the same issue if—

(A) The bonds are issued pursuant to a single agreement that is in the form of a lease or installment sales agreement; and

(B) All of the property covered by that agreement is reasonably expected to be delivered within three years of the date of issue of the first bond.

(iv) *Qualified 501(c)(3) bonds.* If an issuer elects under section 141(b)(9) to treat a portion of an issue as a qualified 501(c)(3) bond, that portion is treated as a separate issue.

(3) *Date of issue*—(i) *Bond.* The date of issue of a bond is determined under §1.150–1.

(ii) *Issue.* The date of issue of an issue of bonds is the date of issue of the first bond that is part of the issue. See paragraphs (e)(2) (ii) and (iii) of this section for rules relating to draw-down loans, commercial paper, *etc.*, and leases and installment sales.

(iii) *Bonds to which prior law applied.* Notwithstanding the provisions of this paragraph (e)(3), an issue for which an information report was required to be filed under section 103(l) or section 103A(j)(3) is treated as issued prior to January 1, 1987.

(4) *Issue price.* The term ''issue price'' has the same meaning given the term under §1.148–1(b).

[T.D. 8425, 57 FR 36002, Aug. 12, 1992, as amended by T.D. 8425, 59 FR 24351, May 11, 1994]

§1.149(g)–1 Hedge bonds.

(a) *Certain definitions.* Except as otherwise provided, the definitions set forth in §1.148–1 apply for purposes of section 149(g) and this section. In addition, the following terms have the following meanings:

Reasonable expectations means reasonable expectations (as defined in §1.148–1), as modified to take into account the provisions of section 149(f)(2)(B).

Spendable proceeds means net sale proceeds (as defined in §1.148–1).

(b) *Applicability of arbitrage allocation and accounting rules.* Section 1.148–6 applies for purposes of section 149(g), except that an expenditure that results in the creation of replacement proceeds (other than amounts in a bona fide debt service fund or a reasonably required reserve or replacement fund) is not an expenditure for purposes of section 149(g).

(c) *Refundings*—(1) *Investment in tax-exempt bonds.* A bond issued to refund a bond that is a tax-exempt bond by virtue of the rule in section 149(g)(3)(B) is not a tax-exempt bond unless the gross proceeds of that refunding bond (other than proceeds in a refunding escrow for the refunded bond) satisfy the requirements of section 149(g)(3)(B).

(2) *Anti-abuse rule.* A refunding bond is treated as a hedge bond unless there is a significant governmental purpose for the issuance of that bond (e.g., an advance refunding bond issued to realize debt service savings or to relieve the issuer of significantly burdensome document provisions, but not to otherwise hedge against future increases in interest rates).

(d) *Effective date.* This section applies to bonds issued after June 30, 1993 to which §§1.148–1 through 1.148–11 apply. In addition, this section applies to any issue to which the election described in §1.148–11(b)(1) is made.

[T.D. 8476, 58 FR 33549, June 18, 1993]

§1.150–1 Definitions.

(a) *Scope and effective date*—(1) *In general.* Except as otherwise provided, the definitions in this section apply for all purposes of sections 103 and 141 through 150.

(2) *Effective date*—(i) *In general.* Except as otherwise provided in this paragraph (a)(2), this section applies to issues issued after June 30, 1993 to which §§1.148–1 through 1.148–11 apply. In addition, this section (other than paragraph (c)(3) of this section) applies to any issue to which the election described in §1.148–11(b)(1) is made.

(ii) *Special effective date for paragraphs (c)(1), (c)(4)(iii), and (c)(6).* Paragraphs (c)(1), (c)(4)(iii), and (c)(6) of this section apply to bonds sold on or after July 8, 1997 and to any issue to which the election described in §1.148–11(b)(1) is made. See §1.148–11A(i) for rules relating to certain bonds sold before July 8, 1997.

(3) *Exception to general effective date.* See §1.141–15 for the effective date of the definition of bond documents contained in paragraph (b) of this section.

(b) *Certain general definitions.* The following definitions apply:

Bond means any obligation of a State or political subdivision thereof under section 103(c)(1).

Bond documents means the bond indenture or resolution, transcript of proceedings, and any related documents.

Capital expenditure means any cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election or with the application of the definition of placed in service under §1.150–2(c)) under general Federal income tax principles. For example, costs incurred to acquire, construct, or improve land, buildings, and equipment generally are capital expenditures. Whether an expenditure is a capital expenditure is determined at the time the expenditure is paid with respect to the property. Future changes in law do not affect whether an expenditure is a capital expenditure.

Conduit borrower means the obligor on a purpose investment (as defined in §1.148–1). For example, if an issuer invests proceeds in a purpose investment in the form of a loan, lease, installment sale obligation, or similar obligation to another entity and the obligor uses the proceeds to carry out the governmental purpose of the issue, the obligor is a conduit borrower.

Conduit financing issue means an issue the proceeds of which are used or are reasonably expected to be used to finance at least one purpose investment representing at least one conduit loan to one conduit borrower.

Conduit loan means a purpose investment (as defined in §1.148–1).

Governmental bond means any bond of an issue of tax-exempt bonds in which none of the bonds are private activity bonds.

Issuance costs means costs to the extent incurred in connection with, and allocable to, the issuance of an issue within the meaning of section 147(g). For example, issuance costs include the following costs but only to the extent incurred in connection with, and allocable to, the borrowing: underwriters' spread; counsel fees; financial advisory fees; rating agency fees; trustee fees; paying agent fees; bond registrar, certification, and authentication fees; accounting fees; printing costs for bonds and offering documents; public approval process costs; engineering and feasibility study costs; guarantee fees, other than for qualified guarantees (as defined in §1.148–4(f)); and similar costs.

Issue date means, in reference to an issue, the first date on which the issuer receives the purchase price in exchange for delivery of the evidence of indebtedness representing any bond included in the issue. Issue date means, in reference to a bond, the date on which the issuer receives the purchase price in exchange for that bond. In no event is the issue date earlier than the first day on which interest begins to accrue on the bond or bonds for Federal income tax purposes.

Obligation means any valid evidence of indebtedness under general Federal income tax principles.

Pooled financing issue means an issue the proceeds of which are to be used to finance purpose investments representing conduit loans to two or more conduit borrowers, unless those conduit loans are to be used to finance a single capital project.

Private activity bond means a private activity bond (as defined in section 141).

Qualified mortgage loan means a mortgage loan with respect to an owner-occupied residence acquired with the proceeds of an obligation described in section 143(a)(1) or 143(b) (or applicable prior law).

Qualified student loan means a student loan acquired with the proceeds of an obligation described in section 144(b)(1).

Related party means, in reference to a governmental unit or a 501(c)(3) organization, any member of the same controlled group, and, in reference to any person that is not a governmental unit or 501(c)(3) organization, a related person (as defined in section 144(a)(3)).

Taxable bond means any obligation the interest on which is not excludable from gross income under section 103.

Tax-exempt bond means any bond the interest on which is excludable from gross income under section 103(a). For purposes of section 148, tax-exempt bond includes:

(1) An interest in a regulated investment company to the extent that at least 95 percent of the income to the holder of the interest is interest that is excludable from gross income under section 103; and

(2) A certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR part 344.

Working capital expenditure means any cost that is not a capital expenditure. Generally, current operating expenses are working capital expenditures.

(c) *Definition of issue*—(1) *In general.* Except as otherwise provided in this paragraph (c), the term *issue* means two or more bonds that meet all of the following requirements:

(i) *Sold at substantially the same time.* The bonds are sold at substantially the same time. Bonds are treated as sold at substantially the same time if they are sold less than 15 days apart.

(ii) *Sold pursuant to the same plan of financing.* The bonds are sold pursuant to the same plan of financing. Factors material to the plan of financing include the purposes for the bonds and the structure of the financing. For example, generally—

(A) Bonds to finance a single facility or related facilities are part of the same plan of financing;

(B) Short-term bonds to finance working capital expenditures and long-term bonds to finance capital projects are not part of the same plan of financing; and

(C) Certificates of participation in a lease and general obligation bonds secured by tax revenues are not part of the same plan of financing.

(iii) *Payable from same source of funds.* The bonds are reasonably expected to be paid from substantially the same source of funds, determined without regard to guarantees from parties unrelated to the obligor.

(2) *Exception for taxable bonds.* Taxable bonds and tax-exempt bonds are not part of the same issue under this paragraph (c). The issuance of tax-exempt bonds in a transaction (or series of related transactions) that includes taxable bonds, however, may constitute an abusive arbitrage device under § 1.148–10(a) or a device to avoid other limitations in sections 103 and 141 through 150 (for example, structures involving *windows* or unreasonable allocations of bonds).

(3) *Exception for certain bonds financing separate purposes*—(i) *In general.* Bonds may be treated as part of separate issues if the requirements of this paragraph (c)(3) are satisfied. Each of these separate issues must finance a separate purpose (e.g., refunding a separate prior issue, financing a separate purpose investment, financing integrated or functionally related capital projects, and financing any clearly discrete governmental purpose). Each of these separate issues independently must be a tax-exempt bond (e.g., a governmental bond or a qualified mortgage bond). The aggregate proceeds, investments, and bonds in such a transaction must be allocated between each of the separate issues using a reasonable, consistently applied allocation method. If any separate issue consists of refunding bonds, the allocation rules in § 1.148–9(h) must be satisfied. An allocation is not reasonable if it achieves more favorable results under sections 103 and 141 to 150 than could be

achieved with actual separate issues. All allocations under this paragraph (c)(3) must be made in writing on or before the issue date.

(ii) *Exceptions.* This paragraph (c)(3) does not apply for purposes of sections 141(b)(5), 141(c)(1), 141(d)(1), 144(a), 148, 149(d), and 149(g).

(4) *Special rules for certain financings*—(i) *Draw-down loans.* Bonds issued pursuant to a draw-down loan are treated as part of a single issue. The issue date of that issue is the first date on which the aggregate draws under the loan exceed the lesser of $50,000 or 5 percent of the issue price.

(ii) *Commercial paper*—(A) *In general.* Short-term bonds having a maturity of 270 days or less (*commercial paper*) issued pursuant to the same commercial paper program may be treated as part of a single issue, the issue date of which is the first date the aggregate amount of commercial paper issued under the program exceeds the lesser of $50,000 or 5 percent of the aggregate issue price of the commercial paper in the program. A commercial paper program is a program to issue commercial paper to finance or refinance the same governmental purpose pursuant to a single master legal document. Commercial paper is not part of the same commercial paper program unless issued during an 18-month period, beginning on the deemed issue date. In addition, commercial paper issued after the end of this 18-month period may be treated as part of the program to the extent issued to refund commercial paper that is part of the program, but only to the extent that—

(*1*) There is no increase in the principal amount outstanding; and

(*2*) The program does not have a term in excess of—

(*i*) 30 years; or

(*ii*) The period reasonably necessary for the governmental purposes of the program.

(B) *Safe harbor.* The requirement of paragraph (c)(4)(ii)(A)(*2*) of this section is treated as satisfied if the weighted average maturity of the issue does not exceed 120 percent of the weighted average expected economic life of the property financed by the issue.

(iii) *Certain general obligation bonds.* Except as otherwise provided in paragraph (c)(2) of this section, bonds that are secured by a pledge of the issuer's full faith and credit (or a substantially similar pledge) and sold and issued on the same dates pursuant to a single offering document may be treated as part of the same issue if the issuer so elects on or before the issue date.

(5) *Anti-abuse rule.* In order to prevent the avoidance of sections 103 and 141 through 150 and the general purposes thereof, the Commissioner may treat bonds as part of the same issue or as part of separate issues to clearly reflect the economic substance of a transaction.

(6) *Sale date.* The sale date of a bond is the first day on which there is a binding contract in writing for the sale or exchange of the bond.

(d) *Definition of refunding issue and related definitions*—(1) *General definition of refunding issue. Refunding issue* means an issue of obligations the proceeds of which are used to pay principal, interest, or redemption price on another issue (a *prior issue,* as more particularly defined in paragraph (d)(5) of this section), including the issuance costs, accrued interest, capitalized interest on the refunding issue, a reserve or replacement fund, or similar costs, if any, properly allocable to that refunding issue.

(2) *Exceptions and special rules.* For purposes of paragraph (d)(1) of this section, the following exceptions and special rules apply—

(i) *Payment of certain interest.* An issue is not a refunding issue if the only principal and interest that is paid with proceeds of the issue (determined without regard to the multipurpose issue rules of §1.148–9(h)) is interest on another issue that—

(A) Accrues on the other issue during a one-year period including the issue date of the issue that finances the interest;

(B) Is a capital expenditure; or

(C) Is a working capital expenditure to which the de minimis rule of §1.148–6(d)(3)(ii)(A) applies.

(ii) *Certain issues with different obligors*—(A) *In general.* An issue is not a refunding issue to the extent that the obligor (as defined in paragraph (d)(2)(ii)(B) of this section) of one issue is neither the obligor of the other issue nor a related party with respect to the obligor of the other issue.

(B) *Definition of obligor.* The *obligor* of an issue means the actual issuer of the issue, except that the obligor of the portion of an issue properly allocable to an investment in a purpose investment means the conduit borrower under that purpose investment. The obligor of an issue used to finance qualified mortgage loans, qualified student loans, or similar program investments (as defined in § 1.148–1) does not include the ultimate recipient of the loan (e.g., the homeowner, the student).

(iii) *Certain special rules for purpose investments.* For purposes of this paragraph (d), the following special rules apply:

(A) *Refunding of a conduit financing issue by a conduit loan refunding issue.* Except as provided in paragraph (d)(2)(iii)(B) of this section, the use of the proceeds of an issue that is used to refund an obligation that is a purpose investment (a *conduit refunding issue*) by the actual issuer of the conduit financing issue determines whether the conduit refunding issue is a refunding of the conduit financing issue (in addition to a refunding of the obligation that is the purpose investment).

(B) *Recycling of certain payments under purpose investments.* A conduit refunding issue is not a refunding of a conduit financing issue to the extent that the actual issuer of the conduit financing issue reasonably expects as of the date of receipt of the proceeds of the conduit refunding issue to use those amounts within 6 months (or, if greater, during the applicable temporary period for those amounts under section 148(c) or under applicable prior law) to acquire a new purpose investment. Any new purpose investment is treated as made from the proceeds of the conduit financing issue.

(C) *Application to tax-exempt loans.* For purposes of this paragraph (d), obligations that would be purpose investments (absent section 148(b)(3)(A)) are treated as purpose investments.

(iv) *Substance of transaction controls.* In the absence of other applicable controlling rules under this paragraph (d), the determination of whether an issue is a refunding issue is based on the substance of the transaction in light of all the facts and circumstances.

(v) *Certain integrated transactions in connection with asset acquisition not treated as refunding issues.* If, within six months before or after a person assumes (including taking subject to) obligations of an unrelated party in connection with an asset acquisition (other than a transaction to which section 381(a) applies if the person assuming the obligation is the acquiring corporation within the meaning of section 381(a)), the assumed issue is refinanced, the refinancing issue is not treated as a refunding issue.

(3) *Current refunding issue. Current refunding issue* means:

(i) Except as provided in paragraph (d)(3)(ii) of this section, a refunding issue that is issued not more than 90 days before the last expenditure of any proceeds of the refunding issue for the payment of principal or interest on the prior issue; and

(ii) In the case of a refunding issue issued before 1986—

(A) A refunding issue that is issued not more than 180 days before the last expenditure of any proceeds of the refunding issue for the payment of principal or interest on the prior issue; or

(B) A refunding issue if the prior issue had a term of less than 3 years and was sold in anticipation of permanent financing, but only if the aggregate term of all prior issues sold in anticipation of permanent financing was less than 3 years.

(4) *Advance refunding issue. Advance refunding issue* means a refunding issue that is not a current refunding issue.

(5) *Prior issue. Prior issue* means an issue of obligations all or a portion of the principal, interest, or call premium on which is paid or provided for with proceeds of a refunding issue. A prior issue may be issued before, at the same time as, or after a refunding issue. If the refunded and unrefunded portions of a prior issue are treated as separate issues under § 1.148–9(i), for the purposes for which that section applies, except to the extent that the context clearly requires otherwise, references to a prior issue refer only to the refunded portion of that prior issue.

(e) *Controlled group* means a group of entities controlled directly or indirectly by the same entity or group of entities within the meaning of this paragraph (e).

(1) *Direct control.* The determination of direct control is made on the basis of all the relevant facts and circumstances. One entity or group of entities (the *controlling entity*) generally controls another entity or group of entities (the *controlled entity*) for purposes of this paragraph if the controlling entity possesses either of the following rights or powers and the rights or powers are discretionary and non-ministerial—

(i) The right or power both to approve and to remove without cause a controlling portion of the governing body of the controlled entity; or

(ii) The right or power to require the use of funds or assets of the controlled entity for any purpose of the controlling entity.

(2) *Indirect control.* If a controlling entity controls a controlled entity under the test in paragraph (e)(1) of this section, then the controlling entity also controls all entities controlled, directly or indirectly, by the controlled entity or entities.

(3) *Exception for general purpose governmental entities.* An entity is not a controlled entity under this paragraph (e) if the entity possesses substantial taxing, eminent domain, and police powers. For example, a city possessing substantial amounts of each of these sovereign powers is not a controlled entity of the state.

[T.D. 8476, 58 FR 33549, June 18, 1993; 58 FR 44453, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24046, May 10, 1994; T.D. 8712, 62 FR 2304, Jan. 16, 1997; T.D. 8718, 62 FR 25513, May 9, 1997]

§1.150–2 Proceeds of bonds used for reimbursement.

(a) *Table of contents.* This table of contents contains a listing of the headings contained in §1.150–2.

(a) Table of contents.
(b) Scope.
(c) Definitions.
(d) General operating rules for reimbursement expenditures.
  (1) Official intent.
  (2) Reimbursement period.
  (3) Nature of expenditure.
(e) Official intent rules.
  (1) Form of official intent.
  (2) Project description in official intent.
  (3) Reasonableness of official intent.
(f) Exceptions to general operating rules.
  (1) De minimis exception.
  (2) Preliminary expenditures exception.
(g) Special rules on refundings.
  (1) In general—once financed, not reimbursed.
  (2) Certain proceeds of prior issue used for reimbursement treated as unspent.
(h) Anti-abuse rules.
  (1) General rule.
  (2) One-year step transaction rule.
(i) Authority of the Commissioner to prescribe rules.
(j) Effective date.
  (1) In general.
  (2) Transitional rules.

(b) *Scope.* This section applies to reimbursement bonds (as defined in paragraph (c) of this section) for all purposes of sections 103 and 141 to 150.

(c) *Definitions.* The following definitions apply:

Issuer means—

(1) For any private activity bond (excluding a qualified 501(c)(3) bond, qualified student loan bond, qualified mortgage bond, or qualified veterans' mortgage bond), the entity that actually issues the reimbursement bond; and

(2) For any bond not described in paragraph (1) of this definition, either the entity that actually issues the reimbursement bond or, to the extent that the reimbursement bond proceeds are to be loaned to a conduit borrower, that conduit borrower.

Official intent means an issuer's declaration of intent to reimburse an original expenditure with proceeds of an obligation.

Original expenditure means an expenditure for a governmental purpose that is originally paid from a source other than a reimbursement bond.

Placed in service means, with respect to a facility, the date on which, based on all the facts and circumstances—

(1) The facility has reached a degree of completion which would permit its operation at substantially its design level; and

(2) The facility is, in fact, in operation at such level.

Reimbursement allocation means an allocation in writing that evidences an issuer's use of proceeds of a reimbursement bond to reimburse an original expenditure. An allocation made within 30 days after the issue date of a reimbursement bond may be treated as made on the issue date.

Reimbursement bond means the portion of an issue allocated to reimburse an original expenditure that was paid before the issue date.

(d) *General operating rules for reimbursement expenditures.* Except as otherwise provided, a reimbursement allocation is treated as an expenditure of proceeds of a reimbursement bond for the governmental purpose of the original expenditure on the date of the reimbursement allocation only if:

(1) *Official intent.* Not later than 60 days after payment of the original expenditure, the issuer adopts an official intent for the original expenditure that satisfies paragraph (e) of this section.

(2) *Reimbursement period*—(i) *In general.* The reimbursement allocation is made not later than 18 months after the later of—

(A) The date the original expenditure is paid; or

(B) The date the project is placed in service or abandoned, but in no event more than 3 years after the original expenditure is paid.

(ii) *Special rule for small issuers.* In applying paragraph (d)(2)(i) of this section to an issue that satisfies section 148(f)(4)(D)(i) (I) through (IV), the ''18 month'' limitation is changed to ''3 years'' and the ''3-year'' maximum reimbursement period is disregarded.

(iii) *Special rule for long-term construction projects.* In applying paragraph (d)(2)(i) to a construction project for which both the issuer and a licensed architect or engineer certify that at least 5 years is necessary to complete construction of the project, the maximum reimbursement period is changed from ''3 years'' to ''5 years.''

(3) *Nature of expenditure.* The original expenditure is a capital expenditure, a cost of issuance for a bond, an expenditure described in § 1.148–6(d)(3)(ii)(B) (relating to certain extraordinary working capital items), a grant (as defined in § 1.148–6(d)(4)), a qualified student loan, a qualified mortgage loan, or a qualified veterans' mortgage loan.

(e) *Official intent rules.* An official intent satisfies this paragraph (e) if:

(1) *Form of official intent.* The official intent is made in any reasonable form, including issuer resolution, action by an appropriate representative of the issuer (e.g., a person authorized or designated to declare official intent on behalf of the issuer), or specific legislative authorization for the issuance of obligations for a particular project.

(2) *Project description in official intent*—(i) *In general.* The official intent generally describes the project for which the original expenditure is paid and states the maximum principal amount of obligations expected to be issued for the project. A project includes any property, project, or program (e.g., *highway capital improvement program, hospital equipment acquisition,* or *school building renovation*).

(ii) *Fund accounting.* A project description is sufficient if it identifies, by name and functional purpose, the fund or account from which the original expenditure is paid (e.g., *parks and recreation fund—recreational facility capital improvement program*).

(iii) *Reasonable deviations in project description.* Deviations between a project described in an official intent and the actual project financed with reimbursement bonds do not invalidate the official intent to the extent that the actual project is reasonably related in function to the described project. For example, *hospital equipment* is a reasonable deviation from *hospital building improvements.* In contrast, a *city office building rehabilitation* is not a reasonable deviation from *highway improvements.*

(3) *Reasonableness of official intent.* On the date of the declaration, the issuer must have a reasonable expectation (as defined in § 1.148–1(b)) that it will reimburse the original expenditure with proceeds of an obligation. Official intents declared as a matter of course or in amounts substantially in excess of the amounts expected to be necessary for the project (e.g., *blanket declarations*) are not reasonable. Similarly, a pattern of failure to reimburse actual original expenditures covered by official intents (other than in extraordinary circumstances) is evidence of unreasonableness. An official intent

declared pursuant to a specific legislative authorization is rebuttably presumed to satisfy this paragraph (e)(3).

(f) *Exceptions to general operating rules*—(1) *De minimis exception.* Paragraphs (d)(1) and (d)(2) of this section do not apply to costs of issuance of any bond or to an amount not in excess of the lesser of $100,000 or 5 percent of the proceeds of the issue.

(2) *Preliminary expenditures exception.* Paragraphs (d)(1) and (d)(2) of this section do not apply to any preliminary expenditures, up to an amount not in excess of 20 percent of the aggregate issue price of the issue or issues that finance or are reasonably expected by the issuer to finance the project for which the preliminary expenditures were incurred. Preliminary expenditures include architectural, engineering, surveying, soil testing, reimbursement bond issuance, and similar costs that are incurred prior to commencement of acquisition, construction, or rehabilitation of a project, other than land acquisition, site preparation, and similar costs incident to commencement of construction.

(g) *Special rules on refundings*—(1) *In general—once financed, not reimbursed.* Except as provided in paragraph (g)(2) of this section, paragraph (d) of this section does not apply to an allocation to pay principal or interest on an obligation or to reimburse an original expenditure paid by another obligation. Instead, such an allocation is analyzed under rules on refunding issues. See §1.148–9.

(2) *Certain proceeds of prior issue used for reimbursement treated as unspent.* In the case of a refunding issue (or series of refunding issues), proceeds of a prior issue purportedly used to reimburse original expenditures are treated as unspent proceeds of the prior issue unless the purported reimbursement was a valid expenditure under applicable law on reimbursement expenditures on the issue date of the prior issue.

(h) *Anti-abuse rules*—(1) *General rule.* A reimbursement allocation is not an expenditure of proceeds of an issue under this section if the allocation employs an abusive arbitrage device under §1.148–10 to avoid the arbitrage restrictions or to avoid the restrictions under sections 142 through 147.

(2) *One-year step transaction rule*—(i) *Creation of replacement proceeds.* A purported reimbursement allocation is invalid and thus is not an expenditure of proceeds of an issue if, within 1 year after the allocation, funds corresponding to the proceeds of a reimbursement bond for which a reimbursement allocation was made are used in a manner that results in the creation of replacement proceeds (as defined in §1.148–1) of that issue or another issue. The preceding sentence does not apply to amounts deposited in a bona fide debt service fund (as defined in §1.148–1).

(ii) *Example.* The provisions of paragraph (h)(2)(i) of this section are illustrated by the following example.

Example. On January 1, 1994, County *A* issues an issue of 7 percent tax-exempt bonds (the *1994 issue*) and makes a purported reimbursement allocation to reimburse an original expenditure for specified capital improvements. *A* immediately deposits funds corresponding to the proceeds subject to the reimbursement allocation in an escrow fund to provide for payment of principal and interest on its outstanding 1991 issue of 9 percent tax-exempt bonds (the *prior issue*). The use of amounts corresponding to the proceeds of the reimbursement bonds to create a sinking fund for another issue within 1 year after the purported reimbursement allocation invalidates the reimbursement allocation. The proceeds retain their character as unspent proceeds of the 7 percent issue upon deposit in the escrow fund. Accordingly, the proceeds are subject to the 7 percent yield restriction of the 1994 issue instead of the 9 percent yield restriction of the prior issue.

(i) *Authority of the Commissioner to prescribe rules.* The Commissioner may by revenue ruling or revenue procedure (see §601.601(d)(2)(ii)(*b*) of this chapter) prescribe rules for the expenditure of proceeds of reimbursement bonds in circumstances that do not otherwise satisfy this section.

(j) *Effective date*—(1) *In general.* The provisions of this section apply to all allocations of proceeds of reimbursement bonds issued after June 30, 1993.

(2) *Transitional rules*—(i) *Official intent.* An official intent is treated as satisfying the official intent requirement of paragraph (d)(1) of this section if it—

(A) Satisfied the applicable provisions of §1.103–8(a)(5) as in effect prior to July 1, 1993, (as contained in 26 CFR part 1 revised as of April 1, 1993) and was made prior to that date, or

(B) Satisfied the applicable provisions of § 1.103–18 as in effect between January 27, 1992, and June 30, 1993, (as contained in 26 CFR part 1 revised as of April 1, 1993) and was made during that period.

(ii) *Certain expenditures of private activity bonds.* For any expenditure that was originally paid prior to August 15, 1993, and that would have qualified for expenditure by reimbursement from the proceeds of a private activity bond under T.D. 7199, section 1.103–8(a)(5), 1972–2 C.B. 45 (see § 601.601(d)(2)(ii)(*b*)) of this chapter, the requirements of that section may be applied in lieu of this section.

[T.D. 8476, 58 FR 33551, June 18, 1993; 58 FR 44453, Aug. 23, 1993]

§ 1.150–4 Change in use of facilities financed with tax-exempt private activity bonds.

(a) *Scope.* This section applies for purposes of the rules for change of use of facilities financed with private activity bonds under sections 150(b)(3) (relating to qualified 501(c)(3) bonds), 150(b)(4) (relating to certain exempt facility bonds and small issue bonds), 150(b)(5) (relating to facilities required to be owned by governmental units or 501(c)(3) organizations), and 150(c).

(b) *Effect of remedial actions*—(1) *In general.* Except as provided in this section, the change of use provisions of sections 150(b) (3) through (5), and 150(c) apply even if the issuer takes a remedial action described in §§ 1.142–2, 1.144–2, or 1.145–2.

(2) *Exceptions*—(i) *Redemption.* If nonqualified bonds are redeemed within 90 days of a deliberate action under § 1.145–2(a) or within 90 days of the date on which a failure to properly use proceeds occurs under § 1.142–2 or § 1.144–2, sections 150(b) (3) through (5) do not apply during the period between that date and the date on which the nonqualified bonds are redeemed.

(ii) *Alternative qualifying use of facility.* If a bond-financed facility is used for an alternative qualifying use under §§ 1.145–2 and 1.141–12(f), sections 150(b) (3) and (5) do not apply because of the alternative use.

(iii) *Alternative use of disposition proceeds.* If disposition proceeds are used for a qualifying purpose under §§ 1.145–2 and 1.141–12(e), 1.142–2(c)(4), or 1.144–2, sections 150(b) (3) through (5) do not apply because of the deliberate action that gave rise to the disposition proceeds after the date on which all of the disposition proceeds have been expended on the qualifying purpose. If all of the disposition proceeds are so expended within 90 days of the date of the deliberate action, however, sections 150(b) (3) through (5) do not apply because of the deliberate action.

(c) *Allocation rules*—(1) *In general.* If a change in use of a portion of the property financed with an issue of qualified private activity bonds causes section 150 (b)(3), (b)(4), or (b)(5) to apply to an issue, the bonds of the issue allocable to that portion under section 150(c)(3) are the same as the nonqualified bonds determined for purposes of §§ 1.142–1, 1.144–1, and 1.145–1, except that bonds allocable to all common areas are also allocated to that portion.

(2) *Special rule when remedial action is taken.* If an issuer takes a remedial action with respect to an issue of private activity bonds under §§ 1.142–2, 1.144–2, or 1.145–2, the bonds of the issue allocable to a portion of property are the same as the nonqualified bonds determined for purposes of those sections.

(d) *Effective dates.* For effective dates of this section, see § 1.141–16.

[T.D. 8712, 62 FR 2304, Jan. 16, 1997]

§ 1.150–5T Filing notices and elections (temporary).

(a) *In general.* Notices and elections under the following sections must be filed with the Chief, Employee Plans and Exempt Organizations' of the appropriate key district office—

(1) Section 1.141–12(d)(3); and

(2) Section 1.142(f)(4)–1T.

(b) *Effective dates.* This section applies to notices and elections filed on or after February 23, 1998.

[T.D. 8757, 63 FR 3266, Jan. 22, 1998]

Regulations Applicable to Certain Bonds Sold Prior to July 8, 1997

Editorial Note: IRS redesignated the following sections to appear below the undesignated center heading ‘‘Regulations Applicable to Certain Bonds Sold Prior to July 8, 1997’’ and preceding the undesignated center heading ‘‘Deductions for Personal Exemptions.’’ See 62 FR 25507 and 25513, May 9, 1997 for the specific sections involved in the redesignation.

§1.148–1A Definitions and elections.

(a) [Reserved]. For guidance see §1.148–1.

(b) *Certain definitions.*

Investment-type property. See §1.148–1(b). Investment-type property also includes a contract that would be a hedge (within the meaning of §1.148–4(h)) except that it contains a significant investment element.

(c) through (c)(4)(i) [Reserved]. For guidance see §1.148–1.

(c)(4)(ii) *Bonds financing a working capital reserve*—(A) *In general.* Except as otherwise provided in §1.148–1(c)(4)(ii)(B), replacement proceeds arise to the extent a working capital reserve is, directly or indirectly, financed with the proceeds of the issue (regardless of the expenditure of proceeds of the issue). Thus, for example, if an issuer that does not maintain a working capital reserve borrows to fund such a reserve, the issuer will have replacement proceeds. To determine the amount of a working capital reserve maintained, an issuer may use the average amount maintained as a working capital reserve during annual periods of at least one year, the last of which ends within a year before the issue date. For example, the amount of a working capital reserve may be computed using the average of the beginning or ending monthly balances of the amount maintained as a reserve (net of unexpended gross proceeds) during the one year period preceding the issue date.

[T.D. 8538, 59 FR 24041, May 10, 1994. Redesignated by T.D. 8718, 62 FR 25507, May 9, 1997]

§1.148–2A General arbitrage yield restriction rules.

(a) through (b)(2)(i) [Reserved]. For guidance see §1.148–2.

(b)(2)(ii) *Exceptions to certification requirement.* An issuer is not required to make a certification for an issue under §1.148–2(b)(2)(i) if—

(A) The issuer reasonably expects as of the issue date that there will be no unspent gross proceeds after the issue date, other than gross proceeds in a bona fide debt service fund (e.g., *equipment lease* financings in which the issuer purchases equipment in exchange for an installment payment note); or

(B) The issue price of the issue does not exceed $1,000,000.

[T.D. 8538, 59 FR 24042, May 10, 1994. Redesignated by T.D. 8718, 62 FR 25507, May 9, 1997]

§1.148–3A General arbitrage rebate rules.

(a) through (h)(2) [Reserved]. For guidance see §1.148–3.

(h)(3) *Waivers of the penalty.* For purposes of §1.148–3(h)(3), willful neglect does not include a failure that is attributable solely to the permissible retroactive selection of a short first bond year if the rebate amount that the issuer failed to pay is paid within 60 days of the selection of that bond year.

[T.D. 8538, 59 FR 24042, May 10, 1994. Redesignated by T.D. 8718, 62 FR 25507, May 9, 1997]

§1.148–4A Yield on an issue of bonds.

(a) through (b)(4) [Reserved]. For guidance see §1.148–4.

(b)(5) *Special aggregation rule treating certain bonds as a single fixed yield bond.* Two variable yield bonds of an issue are treated in the aggregate as a single fixed yield bond if—

(i) Aggregate treatment would result in the single bond being a fixed yield bond; and

(ii) The terms of the bonds do not contain any features that could distort the aggregate fixed yield from what the yield would be if a single fixed yield bond were issued. For example, if an issue contains a bond bearing interest at a floating rate and a related bond bearing interest at a rate equal to a fixed rate minus that floating rate, those two bonds are treated as a single fixed yield bond only if neither bond may be redeemed unless the other bond is also redeemed at the same time.

(c) through (f) [Reserved]. For guidance see § 1.148–4.

(g) *Yield on certain mortgage revenue and student loan bonds.* For purposes of section 148 and § 1.148–4, section 143(g)(2)(C)(ii) applies to the computation of yield on an issue of qualified mortgage bonds or qualified veterans' mortgage bonds. For purposes of applying sections 148 and 143(g) to a variable yield issue of qualified mortgage bonds, qualified veterans' mortgage bonds, or qualified student loan bonds, the yield on that issue is computed over the term of the issue, and § 1.148–4(d) does not apply to the issue. As of any date before the final maturity date, the yield over the term of the issue is based on the actual amounts paid or received to that date and the amounts that are reasonably expected (as of that date) to be paid or received over the remaining term of the issue.

(h) *Qualified hedging transactions*—(1) *In general.* Payments made or received by an issuer under a qualified hedge (as defined in § 1.148–4(h)(2)) relating to bonds of an issue are taken into account (as provided in paragraph (h)(3) of this section) to determine the yield on the issue. Except as provided in paragraphs (h)(4) and (h)(5)(ii)(C) of this section, the bonds to which a qualified hedge relates are treated as variable yield bonds. These hedging rules apply solely for purposes of sections 143(g), 148, and 149(d).

(2) (i) through (vi) [Reserved]. For guidance see § 1.148–4(h)(2).

(2)(vii) *Timing and duration.* For a contract to be a qualified hedge under § 1.148–4(h)(2), payments must not begin to accrue under the contract on a date earlier than the issue date of the hedged bonds and must not accrue longer than the hedged interest payments on the hedged bonds.

(viii) [Reserved]. For guidance see § 1.148–4(h).

(ix) *Identification.* For a contract to be a qualified hedge under § 1.148–4(h)(2), the contract must be identified by the actual issuer on its books and records maintained for the hedged bonds not later than three days after the date on which the parties enter into the contract. The identification must specify the hedge provider, the terms of the contract, and the hedged bonds. The identification must contain sufficient detail to establish that the requirements of § 1.148–4(h)(2), and if applicable, paragraph (h)(4) of this section are satisfied. The existence of the hedge must be noted on all forms filed with the Internal Revenue Service for the issue on or after the date on which the hedge is entered into.

(3) *Accounting for qualified hedges*—(i) *In general.* Except as otherwise provided in paragraph (h)(4) of this section, payments made or received by the issuer under a qualified hedge are treated as payments made or received, as appropriate, on the hedged bonds that are taken into account in determining the yield on those bonds. These payments are reasonably allocated to the hedged bonds in the period to which the payments relate, as determined under paragraph (h)(3)(iii) of this section. Payments made or received by the issuer include payments deemed made or received when a contract is terminated or deemed terminated under this paragraph (h)(3). Payments reasonably allocable to the reduction of risk of interest rate changes and to the hedge provider's overhead under this paragraph (h) are included as payments made or received under a qualified hedge.

(ii) *Exclusions from hedge.* Payments for services or other items under the contract that are not expressly treated as payments under the qualified hedge under paragraph (h)(3)(i) of this section are not payments with respect to a qualified hedge.

(iii) *Timing and allocation of payments.* The period to which a payment made by the issuer relates is determined under general Federal income tax principles, including, without limitation, § 1.446–3, and adjusted as necessary to reflect the end of a computation period and the start of a new computation period. Except as provided in paragraphs (h)(3)(iv) and (h)(5)(ii) of this section, a payment received by the issuer is taken into account in the period that the interest payment that the payment hedges is required to be made.

(iv) *Termination payments*—(A) *Termination defined.* A termination of a qualified hedge includes any sale or other disposition of the hedge by the issuer, or the acquisition by the issuer of an offsetting hedge. A deemed termination occurs when the hedged bonds are redeemed and when a hedge ceases to be a qualified hedge of the hedged bonds. In the case of an assignment by a hedge provider of its remaining rights and obligations on the hedge to a third party or a modification of the hedging contract, the assignment or modification is treated as a termination with respect to the issuer only if it results in a deemed exchange of the hedge and a realization event under section 1001.

(B) *General rule.* A payment made or received by an issuer to terminate a qualified hedge, including loss or gain realized or deemed realized, is treated as a payment made or received on the hedged bonds, as appropriate. The payment is reasonably allocated to the remaining periods originally covered by the terminated hedge in a manner that reflects the economic substance of the hedge.

(C) *Special rule for terminations when bonds are redeemed.* Except as otherwise provided in this paragraph (h)(3)(iv)(C) and in paragraph (h)(3)(iv)(D) of this section, when a qualified hedge is deemed terminated because the hedged bonds are redeemed, the fair market value of the contract on the redemption date is treated as a termination payment made or received on that date. When hedged bonds are redeemed, any payment received by the issuer on termination of a hedge, including a termination payment or a deemed termination payment, reduces, but not below zero, the interest payments made by the issuer on the hedged bonds in the computation period ending on the termination date. The remainder of the payment, if any, is reasonably allocated over the bond years in the immediately preceding computation period or periods to the extent necessary to eliminate the excess.

(D) *Special rules for refundings.* To the extent that the hedged bonds are redeemed using the proceeds of a refunding issue, the termination payment is accounted for under paragraph (h)(3)(iv)(B) of this section by treating it as a payment on the refunding issue, rather than the hedged bonds. In addition, to the extent that the refunding issue, rather than the hedged bonds, has been redeemed, paragraph (h)(3)(iv)(C) of this section applies to the termination payment by treating it as a payment on the redeemed refunding issue.

(E) *Safe harbor for certain non-level payments.* A non-level payment to terminate a hedge does not result in that hedge failing to satisfy the applicable provisions of paragraph (h)(3)(iv)(B) of this section if the payment is allocated to each bond year for which the hedge would have been in effect in accordance with this paragraph (h)(3)(iv)(E). For a variable yield issue, an equal amount (or for any short bond year, a proportionate amount of the equal amount) must be allocated to each bond year such that the sum of the present values of the annual amounts equals the present value of the non-level payment. Present value is computed as of the day the hedge is terminated, using the yield on the hedged bonds, determined without regard to the non-level payment. The yield used for this purpose is computed for the period beginning on the first date the hedge is in effect and ending on the date the hedge is terminated. On the other hand, for a fixed yield issue, the non-level payment is taken into account as a single payment on the date it is paid.

(4) *Certain variable yield bonds treated as fixed yield bonds*—(i) *In general.* Except as otherwise provided in this paragraph (h)(4), if the issuer of variable yield bonds enters into a qualified hedge, the hedged bonds are treated as fixed yield bonds paying a fixed interest rate if:

(A) *Start date.* The date on which payments begin to accrue on the hedge is not later than 15 days after the issue date of the hedged bonds.

(B) *Maturity.* The term of the hedge is equal to the entire period during which the hedged bonds bear interest at variable interest rates.

(C) *Payments closely correspond.* Payments to be received under the hedge correspond closely in time to the hedged portion of the payments on the hedged bonds. Hedge payments received within 15 days of the related payments on the hedged bonds generally so correspond.

(D) *Aggregate payments fixed.* Taking into account all payments made and received under the hedge and all payments on the hedged bonds (i.e., after netting all payments), the issuer's aggregate payments are fixed and determinable as of a date not later than 15 days after the issue date of the hedged bonds. Payments on bonds are treated as fixed for purposes of this paragraph (h)(4)(i)(D) if payments on the bonds are based, in whole or in part, on one interest rate, payments on the hedge are based, in whole or in part, on a second interest rate that is substantially the same as, but not identical to, the first interest rate and payments on the bonds would be fixed if the two rates were identical. Rates are treated as substantially the same if they are reasonably expected to be substantially the same throughout the term of the hedge. For example, an objective 30-day tax-exempt variable rate index or other objective index (e.g., J.J. Kenny Index, PSA Municipal swap index, a percentage of LIBOR) may be substantially the same as an issuer's individual 30-day interest rate.

(ii) *Accounting.* Except as otherwise provided in this paragraph (h)(4)(ii), in determining yield on the hedged bonds, all the issuer's actual interest payments on the hedged bonds and all payments made and received on a hedge described in paragraph (h)(4)(i) of this section are taken into account. If payments on the bonds and payments on the hedge are based, in whole or in part, on variable interest rates that are substantially the same within the meaning of paragraph (h)(4)(i)(D) of this section (but not identical), yield on the issue is determined by treating the variable interest rates as identical. For example, if variable rate bonds bearing interest at a weekly rate equal to the rate necessary to remarket the bonds at par are hedged with an interest rate swap under which the issuer receives payments based on a short-term floating rate index that is substantially the same as, but not identical to, the weekly rate on the bonds, the interest payments on the bonds are treated as equal to the payments received by the issuer under the swap for purposes of computing the yield on the bonds.

(iii) *Effect of termination*—(A) *In general.* Except as otherwise provided in this paragraph (h)(4)(iii) and paragraph (h)(5) of this section, the issue of which the hedged bonds are a part is treated as if it were reissued as of the termination date of the qualified hedge covered by paragraph (h)(4)(i) of this section in determining yield on the hedged bonds for purposes of § 1.148–3. The redemption price of the retired issue and the issue price of the new issue equal the aggregate values of all the bonds of the issue on the termination date. In computing the yield on the new issue for this purpose, any termination payment is accounted for under paragraph (h)(3)(iv) of this section, applied by treating the termination payment as made or received on the new issue under this paragraph (h)(4)(iii).

(B) *Effect of early termination.* Except as otherwise provided in this paragraph (h)(4)(iii), the general rules of paragraph (h)(4)(i) of this section do not apply in determining the yield on the hedged bonds for purposes of § 1.148–3 if the hedge is terminated or deemed terminated within 5 years after the issue date of the issue of which the hedged bonds are a part. Thus, the hedged bonds are treated as variable yield bonds for purposes of § 1.148–3 from the issue date.

(C) *Certain terminations disregarded.* This paragraph (h)(4)(iii) does not apply to a termination if, based on the facts and circumstances (e.g., taking into account both the termination and any qualified hedge that immediately replaces the terminated hedge), there is no change in the yield. In addition, this paragraph (h)(4)(iii) does not apply to a termination caused by the bankruptcy or insolvency of the hedge provider if the Commissioner determines that the termination occurred without any action by the issuer (other than to protect its rights under the hedge).

(5) *Special rules for certain hedges*—(i) *Certain acquisition payments.* A payment to the issuer by the hedge provider (e.g., an up-front payment for an off-market swap) in connection with the acquisition of a hedge that, but for that payment, would be a qualified hedge, does not cause the hedge to fail to be a qualified hedge provided the payment to the issuer and the issuer's payments under the hedge in excess of those that it would make if the hedge

bore rates equal to the on-market rates for the hedge are separately identified in a certification of the hedge provider and not taken into account in determining the yield on the issue of which the hedged bonds are a part. The on-market rates are determined as of the date the parties enter into the contract.

(ii) *Anticipatory hedges*—(A) *In general.* A contract does not fail to be a hedge under §1.148–4(h)(2)(i)(A) solely because it is entered into with respect to an anticipated issuance of tax-exempt bonds. The identification required under §1.148–4T(h)(2)(ix) must specify the reasonably expected governmental purpose, principal amount, and issue date of the hedged bonds, and the manner in which interest is reasonably expected to be computed.

(B) *Special rules.* Payments made in connection with the issuance of a bond to terminate or otherwise close (*terminate*) an anticipatory hedge of that bond do not prevent the hedge from satisfying the requirements of §1.148–4(h)(2)(vi) and paragraph (h)(2)(vii) of this section. Amounts received or deemed to be received by the issuer in connection with the issuance of the hedged bonds to terminate an anticipatory hedge are treated as proceeds of the hedged bonds.

(C) *Fixed yield treatment.* A bond that is hedged with an anticipatory hedge is a fixed yield bond if, taking into account payments on the hedge that are made or fixed on or before the issue date of the bond and the payments to be made on the bond, the bond satisfies the definition of fixed yield bond. See also paragraph (h)(4) of this section.

(6) *Authority of the Commissioner*—(i) *In general.* A contract is not a qualified hedge if the Commissioner determines, based on all the facts and circumstances, that treating the contract as a qualified hedge would provide a material potential for arbitrage, or a principal purpose for entering into the contract is that arbitrage potential. For example, a contract that requires a substantial nonperiodic payment may constitute, in whole or part, an embedded loan, investment-type property, or other investment.

(ii) *Other qualified hedges.* The Commissioner, by publication of a revenue ruling or revenue procedure, may specify contracts that do not otherwise meet the requirements of §1.148–4(h)(2) as qualified hedges and contracts that do not otherwise meet the requirements of paragraph (h)(4) of this section as causing the hedged bonds to be treated as fixed yield bonds.

(iii) *Recomputation of yield.* If an issuer enters into a hedge that is not properly identified, fails to properly associate an anticipatory hedge with the hedged bonds, or otherwise fails to meet the requirements of this section, the Commissioner may recompute the yield on the issue taking the hedge into account if the failure to take the hedge into account distorts that yield or otherwise fails to clearly reflect the economic substance of the transaction.

[T.D. 8538, 59 FR 24042, May 10, 1994. Redesignated by T.D. 8718, 62 FR 25507, May 9, 1997]

§1.148–5A Yield and valuation of investments.

(a) through (b)(2)(ii) [Reserved]. For guidance see §1.148–5.

(b)(2)(iii) *Permissive application of single investment rules to certain yield restricted investments for all purposes of section 148.* For all purposes of section 148, an issuer may treat all of the yield restricted nonpurpose investments in a refunding escrow and a sinking fund that is reasonably expected as of the issue date to be maintained to reduce the yield on the investments in the refunding escrow as a single investment having a single yield, determined under §1.148(b)(2).

(b) (2)(iv) through (c)(1) [Reserved]. For guidance see §1.148–5.

(c)(2) *Manner of payment*—(i) *In general.* Except as otherwise provided in §1.148–5(c)(2)(ii), an amount is paid under §1.148–5(c) if it is paid to the United States at the same time and in the same manner as rebate amounts are required to be paid or at such other time or in such manner as the Commissioner may prescribe. For example, yield reduction payments must be made on or before the date of required rebate installment payments as described in §1.148–3(f). The date a payment is required to be paid is determined without regard to §1.148–3(h). An amount that is paid untimely is not taken into account under this paragraph (c) unless the Commissioner determines that the failure to pay timely is not due to willful neglect. The provisions of §1.148–3(i) apply to payments made under §1.148–5(c).

(c)(2)(ii) through (c)(3)(i) [Reserved] For guidance see §1.148–5.

(c)(3)(ii) *Exception to yield reduction payments rule for advance refunding issues.* Section 1.148–5(c)(1) does not apply to investments allocable to gross proceeds of an advance refunding issue, other than—

(A) Transferred proceeds to which §1.148–5(c)(3)(i)(C) applies;

(B) Replacement proceeds to which §1.148–5(c)(3)(i)(F) applies; and

(C) Transferred proceeds to which §1.148–5(c)(3)(i)(E) applies, but only to the extent necessary to satisfy yield restriction under section 148(a) on those proceeds treating all investments allocable to those proceeds as a separate class.

(d)(1) through (d)(3)(i) [Reserved]. For guidance see §1.148–5.

(d)(3)(ii) *Exception to fair market value requirement for transferred proceeds allocations, universal cap allocations, and commingled funds.* Section 1.148–5(d)(3)(i) does not apply if the investment is allocated from one issue to another issue as a result of the transferred proceeds allocation rule under §1.148–9(b) or the universal cap rule under §1.148–6(b)(2), provided that both issues consist exclusively of tax-exempt bonds. In addition, §1.148–5(d)(3)(i) does not apply to investments in a commingled fund (other than a bona fide debt service fund) unless it is an investment being initially deposited in or withdrawn from a commingled fund described in §1.148–6(e)(5)(iii).

(e)(1) through (e)(2)(ii)(A) [Reserved]. For guidance see §1.148–5.

(e)(2)(ii)(B) *External commingled funds.* For any semiannual period, a commingled fund satisfies the 10 percent requirement of §1.148–5(e)(2)(ii)(B) if—

(*1*) Based on average amounts on deposit, this requirement was satisfied for the prior semiannual period; and

(*2*) The fund does not accept deposits that would cause it to fail to meet this requirement.

(iii) *Special rule for guaranteed investment contracts.* For a guaranteed investment contract, a broker's commission or similar fee paid on behalf of either an issuer or the provider is treated as an administrative cost and, except in the case of an issue that satisfies section 148(f)(4)(D)(i), is not a qualified administrative cost to the extent that the present value of the commission, as of the date the contract is allocated to the issue, exceeds the present value of annual payments equal to .05 percent of the weighted average amount reasonably expected to be invested each year of the term of the contract. For this purpose, present value is computed using the taxable discount rate used by the parties to compute the commission or, if not readily ascertainable, a reasonable taxable discount rate.

[T.D. 8538, 59 FR 24045, May 10, 1994. Redesignated by T.D. 8718, 62 FR 25507, May 9, 1997]

§1.148–6A General allocation and accounting rules.

(a) through (d)(3)(iii)(B) [Reserved]. For guidance see §1.148–6.

(d)(3)(iii)(C) *Qualified endowment funds treated as unavailable.* For a 501(c)(3) organization, a qualified endowment fund is treated as unavailable. A fund is a qualified endowment fund if—

(*1*) The fund is derived from gifts or bequests, or the income thereon, that were neither made nor reasonably expected to be used to pay working capital expenditures;

(*2*) Pursuant to reasonable, established practices of the organization, the governing body of the 501(c)(3) organization designates and consistently operates the fund as a permanent endowment fund or quasi-endowment fund restricted as to use; and

(*3*) There is an independent verification (e.g., from an independent certified public accountant) that the fund is reasonably necessary as part of the organization's permanent capital.

[T. D. 8538, 59 FR 24045, May 10, 1994. Redesignated by T.D. 8718, 62 FR 25507, May 9, 1997]

§1.148–9A Arbitrage rules for refunding issues.

(a) through (c)(2)(ii)(A) [Reserved]. For guidance see §1.148–9.

(c)(2)(ii)(B) *Permissive allocation of non-proceeds to earliest expenditures.* Excluding amounts covered by §1.148–

9(c)(2)(ii)(A) and subject to any required earlier expenditure of those amounts, any amounts in a mixed escrow that are not proceeds of a refunding issue may be allocated to the earliest maturing investments in the mixed escrow, provided that those investments mature and the proceeds thereof are expended before the date of any expenditure from the mixed escrow to pay any principal of the prior issue.

(d) through (h)(4)(v) [Reserved]. For guidance see §1.148–9.

(h)(4)(vi) *Exception for refundings of interim notes.* Section 1.148–9(h)(4)(v) need not be applied to refunding bonds issued to provide permanent financing for one or more projects if the prior issue had a term of less than 3 years and was sold in anticipation of permanent financing, but only if the aggregate term of all prior issues sold in anticipation of permanent financing was less than 3 years.

[T.D. 8538, 59 FR 24045, May 10, 1994. Redesignated by T.D. 8718, 62 FR 25507, May 9, 1997]

§1.148–10A Anti-abuse rules and authority of Commissioner.

(a) through (b)(1) [Reserved]. For guidance see §1.148–10.

(b)(2) *Application.* The provisions of §1.148–10(b) only apply to the portion of an issue that, as a result of actions taken (or actions not taken) after the issue date, overburdens the market for tax-exempt bonds, except that for an issue that is reasonably expected as of the issue date to overburden the market, those provisions apply to all of the gross proceeds of the issue.

(c) through (c)(2)(viii) [Reserved]. For guidance see §1.148–10.

(c)(2)(ix) For purposes of §1.148–10(c)(2), excess gross proceeds do not include gross proceeds allocable to fees for a qualified hedge for the refunding issue.

[T.D. 8538, 59 FR 24046, May 10, 1994. Redesignated by T.D. 8718, 62 FR 25507, May 9, 1997]

§1.148–11A Effective dates.

(a) through (c)(3) [Reserved]. For guidance see §1.148–11.

(c)(4) *Retroactive application of overpayment recovery provisions.* An issuer may apply the provisions of §1.148–3(i) to any issue that is subject to section 148(f) or to sections 103(c)(6) or 103A(i) of the Internal Revenue Code of 1954.

(d) through (h) [Reserved]. For guidance see §1.148–11.

(i) *Transition rules for certain amendments*—(1) *In general.* Section 1.103–8(a)(5), §§1.148–1, 1.148–2, 1.148–3, 1.148–4, .148–5, 1.148–6, 1.148–7, 1.148–8, 1.148–9, 1.148–10, 1.148–11, 1.149(d)–1, and 1.150–1 as in effect on June 7, 1994 (see 26 CFR part 1 as revised April 1, 1997), and §§1.148–1A through 1.148–11A, 1.149(d)–1A, and 1.150–1A apply, in whole, but not in part—

(i) To bonds sold after June 6, 1994, and before July 8, 1997;

(ii) To bonds issued before July 1, 1993, that are outstanding on June 7, 1994, if the first time the issuer applies §§1.148–1 through 1.148–11 as in effect on June 7, 1994 (see 26 CFR part 1 as revised April 1, 1997), to the bonds under §1.148–11 (b) or (c) is after June 6, 1994, and before July 8, 1997;

(iii) At the option of the issuer, to bonds to which §§1.148–1 through 1.148–11, as in effect on July 1, 1993 (see 26 CFR part 1 as revised April 1, 1994), apply, if the bonds are outstanding on June 7, 1994, and the issuer applies §1.103–8(a)(5), §§1.148–1, 1.148–2, 1.148–3, 1.148–4, 1.148–5, 1.148–6, 1.148–7, 1.148–8, 1.148–9, 1.148–10, 1.148–11, 1.149(d)–1, and 1.150–1 as in effect on June 7, 1994 (see 26 CFR part 1 as revised April 1, 1997), and §§1.148–1A through 1.148–11A, 1.149(d)–1A, and 1.150–1A to the bonds before July 8, 1997.

(2) *Special rule.* For purposes of paragraph (i)(1) of this section, any reference to a particular paragraph of §§1.148–1T, 1.148–2T, 1.148–3T, 1.148–4T, 1.148–5T, 1.148–6T, 1.148–9T, 1.148–10T, 1.148–11T, 1.149(d)–1T, or 1.150–1T shall be applied as a reference to the corresponding paragraph of §§1.148–1A, 1.148–2A, 1.148–3A, 1.148–4A, 1.148–5A, 1.148–6A, 1.148–9A, 1.148–10A, 1.148–11A, 1.149(d)–1A, or 1.150–1A, respectively.

(3) *Identification of certain hedges.* For any hedge entered into after June 18, 1993, and on or before June 6, 1994, that would be a qualified hedge within the meaning of §1.148–4(h)(2), as in effect on June 7, 1994 (see 26 CFR part 1 as revised April 1, 1997), except that the hedge does not meet the requirements of §1.148–4A(h)(2)(ix) because the issuer failed to identify the hedge not later

than 3 days after which the issuer and the provider entered into the contract, the requirements of § 1.148–4A(h)(2)(ix) are treated as met if the contract is identified by the actual issuer on its books and records maintained for the hedged bonds not later than July 8, 1997.

[T.D. 8538, 59 FR 24046, May 10, 1994. Redesignated and amended by T.D. 8718, 62 FR 25507, 25513, May 9, 1997]

§ 1.149(d)–1A Limitations on advance refundings.

(a) through (f)(2) [Reserved]. For guidance see § 1.149(d)–1.

(f)(3) *Application of savings test to multipurpose issues.* Except as otherwise provided in this paragraph (f)(3), the multipurpose issue rules in § 1.148–9(h) apply for purposes of the savings test. If any separate issue in a multipurpose issue increases the aggregate present value debt service savings on the entire multipurpose issue or reduces the present value debt service losses on that entire multipurpose issue, that separate issue satisfies the savings test.

[T.D. 8538, 59 FR 24046, May 10, 1994. Redesignated by T.D. 8718, 62 FR 25513, May 9, 1997]

§ 1.150–1A Definitions.

(a) through (b) [Reserved]. For guidance see § 1.150–1.

(c) *Definition of issue*—(1) *In general.* Except as otherwise provided, the provisions of this paragraph (c) apply for all purposes of sections 103 and 141 through 150. Except as otherwise provided in this paragraph (c), two or more bonds are treated as part of the same issue if all of the following factors are present:

(i) *Sold at substantially the same time.* The bonds are sold at substantially the same time. Bonds are treated as sold at substantially the same time if they are sold less than 15 days apart. For this purpose only, a variable yield bond is treated as sold on its issue date.

(ii) *Sold pursuant to the same plan of financing.* The bonds are sold pursuant to the same plan of financing. Factors material to the plan of financing include the purposes for the bonds and the structure of the financing. For example, generally—

(A) Bonds to finance a single facility or related facilities are part of the same plan of financing;

(B) Short-term bonds to finance working capital expenditures and long-term bonds to finance capital projects are not part of the same plan of financing; and

(C) Certificates of participation in a lease and general obligation bonds secured by tax revenues are not part of the same plan of financing.

(iii) *Payable from same source of funds.* The bonds are reasonably expected to be paid from substantially the same source of funds, determined without regard to guarantees from parties unrelated to the obligor.

(2) through (4)(ii) [Reserved]. For guidance see § 1.150–1 (c)(3) through (c)(4)(ii).

(c)(4)(iii) *Certain general obligation bonds.* Bonds are part of the same issue if secured by a pledge of the issuer's full faith and credit (or a substantially similar pledge) and sold and issued on the same dates pursuant to a single offering document.

(5) [Reserved]. For guidance see § 1.150–1(c)(5).

(6) *Sale date.* The sale date of a bond is the first day on which there is a binding contract in writing for the sale or exchange of the bond.

[T.D. 8538, 59 FR 24046, May 10, 1994. Redesignated by T.D. 8718, 62 FR 25513, May 9, 1997]

DEDUCTIONS FOR PERSONAL EXEMPTIONS

§ 1.151–1 Deductions for personal exemptions.

(a) *In general.* (1) In computing taxable income, an individual is allowed a deduction for the exemptions specified in section 151. Such exemptions are: (i) The exemptions for an individual taxpayer and spouse (the so-called personal exemptions); (ii) the additional exemptions for a taxpayer attaining the age of 65 years and spouse attaining the age of 65 years (the so-called old-age exemptions); (iii) the additional exemptions for a blind taxpayer and a blind spouse; and (iv) the exemptions for dependents of the taxpayer.

(2) A nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year and subject to tax under section 1 or 1201(b)

is allowed as deductions the exemptions specified in section 151, even though as to the United States such individual is a nonresident alien. See section 876 and the regulations thereunder, relating to alien residents of Puerto Rico.

(b) *Exemptions for individual taxpayer and spouse (so-called personal exemptions).* Section 151(b) allows an exemption for the taxpayer and an additional exemption for the spouse of the taxpayer if a joint return is not made by the taxpayer and his spouse, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer. Thus, a husband is not entitled to an exemption for his wife on his separate return for the taxable year beginning in a calendar year during which she has any gross income (though insufficient to require her to file a return). Since, in the case of a joint return, there are two taxpayers (although under section 6013 there is only one income for the two taxpayers on such return, i.e., their aggregate income), two exemptions are allowed on such return, one for each taxpayer spouse. If in any case a joint return is made by the taxpayer and his spouse, no other person is allowed an exemption for such spouse even though such other person would have been entitled to claim an exemption for such spouse as a dependent if such joint return had not been made.

(c) *Exemptions for taxpayer attaining the age of 65 and spouse attaining the age of 65 (so-called old-age exemptions).* (1) Section 151(c) provides an additional exemption for the taxpayer if he has attained the age of 65 before the close of his taxable year. An additional exemption is also allowed to the taxpayer for his spouse if a joint return is not made by the taxpayer and his spouse and if the spouse has attained the age of 65 before the close of the taxable year of the taxpayer and, for the calendar year in which the taxable year of the taxpayer begins, the spouse has no gross income and is not the dependent of another taxpayer. If a husband and wife make a joint return, an old-age exemption will be allowed as to each taxpayer spouse who has attained the age of 65 before the close of the taxable year for which the joint return is made. The exemptions under section 151(c) are in addition to the exemptions for the taxpayer and spouse under section 151(b).

(2) In determining the age of an individual for the purposes of the exemption for old age, the last day of the taxable year of the taxpayer is the controlling date. Thus, in the event of a separate return by a husband, no additional exemption for old age may be claimed for his spouse unless such spouse has attained the age of 65 on or before the close of the taxable year of the husband. In no event shall the additional exemption for old age be allowed with respect to a spouse who dies before attaining the age of 65 even though such spouse would have attained the age of 65 before the close of the taxable year of the taxpayer. For the purposes of the old-age exemption, an individual attains the age of 65 on the first moment of the day preceding his sixty-fifth birthday. Accordingly, an individual whose sixty-fifth birthday falls on January 1 in a given year attains the age of 65 on the last day of the calendar year immediately preceding.

(d) *Exemptions for the blind.* (1) Section 151(d) provides an additional exemption for the taxpayer if he is blind at the close of his taxable year. An additional exemption is also allowed to the taxpayer for his spouse if the spouse is blind and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer. The determination of whether the spouse is blind shall be made as of the close of the taxable year of the taxpayer, unless the spouse dies during such taxable year, in which case such determination shall be made as of the time of such death.

(2) The exemptions for the blind are in addition to the exemptions for the taxpayer and spouse under section 151(b) and are also in addition to the exemptions under section 151(c) for taxpayers and spouses attaining the age of 65 years. Thus, a single individual who has attained the age of 65 before the close of his taxable year and who is blind at the close of his taxable year is entitled, in addition to the so-called

personal exemption, to two further exemptions, one by reason of his age and the other by reason of his blindness. If a husband and wife make a joint return, an exemption for the blind will be allowed as to each taxpayer spouse who is blind at the close of the taxable year for which the joint return is made.

(3) A taxpayer claiming an exemption allowed by section 151(d) for a blind taxpayer and a blind spouse shall, if the individual for whom the exemption is claimed is not totally blind as of the last day of the taxable year of the taxpayer (or, in the case of a spouse who dies during such taxable year, as of the time of such death), attach to his return a certificate from a physician skilled in the diseases of the eye or a registered optometrist stating that as of the applicable status determination date in the opinion of such physician or optometrist (i) the central visual acuity of the individual for whom the exemption is claimed did not exceed 20/200 in the better eye with correcting lenses or (ii) such individual's visual acuity was accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees. If such individual is totally blind as of the status determination date there shall be attached to the return a statement by the person or persons making the return setting forth such fact.

(4) Notwithstanding subparagraph (3) of this paragraph, this subparagraph may be applied where the individual for whom an exemption under section 151(d) is claimed is not totally blind, and in the certified opinion of an examining physician skilled in the diseases of the eye there is no reasonable probability that the individual's visual acuity will ever improve beyond the minimum standards described in subparagraph (3) of this paragraph. In this event, if the examination occurs during a taxable year for which the exemption is claimed, and the examining physician certifies that, in his opinion, the condition is irreversible, and a copy of this certification is filed with the return for that taxable year, then a statement described in subparagraph (3) of this paragraph need not be attached to such individual's return for subsequent taxable years so long as the condition remains irreversible. The taxpayer shall retain a copy of the certified opinion in his records, and a statement referring to such opinion shall be attached to future returns claiming the section 151(d) exemption.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7114, 36 FR 9018, May 18, 1971; T.D. 7230, 37 FR 28288, Dec. 22, 1972]

§ 1.151–2 Additional exemptions for dependents.

(a) Section 151(e) allows to a taxpayer an exemption for each dependent (as defined in section 152) whose gross income (as defined in section 61) for the calendar year in which the taxable year of the taxpayer begins is less than the amount provided in section 151(e)(1)(A) applicable to the taxable year of the taxpayer, or who is a child of the taxpayer and who—

(1) The taxable year of the taxpayer begins, or

(2) Is a student, as defined in paragraph (b) of § 1.151–3.

No exemption shall be allowed under section 151(e) for any dependent who has made a joint return with his spouse under section 6013 for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins. The amount provided in section 151(e)(1)(A) is $750 in the case of a taxable year beginning after December 31, 1972; $700 in the case of a taxable year beginning after December 31, 1971, and before January 1, 1973; $650 in the case of a taxable year beginning after December 31, 1970, and before January 1, 1972; $625 in the case of a taxable year beginning after December 31, 1969, and before January 1, 1971; and $600 in the case of a taxable year beginning before January 1, 1970. For special rules in the case of a taxpayer whose taxable year is a fiscal year ending after December 31, 1969, and beginning before January 1, 1973, see section 21(d) and the regulations thereunder.

(b) The only exemption allowed for a dependent of the taxpayer is that provided by section 151(e). The exemptions provided by section 151(c) (old-age exemptions) and section 151(d) (exemptions for the blind) are allowed only for the taxpayer or his spouse. For example, where a taxpayer provides the entire support for his father who meets all the requirements of a dependent, he is entitled to only one exemption for his father (section 151(e)), even though his father is over the age of 65.

[T.D. 7114, 36 FR 9019, May 18, 1971]

§1.151–3 Definitions.

(a) *Child.* For purposes of sections 151(e), 152, and the regulations thereunder, the term ''child'' means a son, stepson, daughter, stepdaughter, adopted son, adopted daughter, or for taxable years beginning after December 31, 1958, a child who is a member of an individual's household if the child was placed with the individual by an authorized placement agency for legal adoption pursuant to a formal application filed by the individual with the agency (see paragraph (c)(2) of §1.152–2), or, for taxable years beginning after December 31, 1969, a foster child (if such foster child satisfies the requirements set forth in paragraph (b) of §1.152–1 with respect to the taxpayer) of the taxpayer.

(b) *Student.* For purposes of section 151(e) and section 152(d), and the regulations thereunder, the term ''student'' means an individual who during each of 5 calendar months during the calendar year in which the taxable year of the taxpayer begins is a full-time student at an educational institution or is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational institution or of a State or political subdivision of a State. An example of ''institutional on-farm training'' is that authorized by 38 U.S.C. 1652 (formerly section 252 of the Veterans' Readjustment Assistance Act of 1952), as described in section 252 of such act. A full-time student is one who is enrolled for some part of 5 calendar months for the number of hours or courses which is considered to be full-time attendance. The 5 calendar months need not be consecutive. School attendance exclusively at night does not constitute full-time attendance. However, full-time attendance at an educational institution may include some attendance at night in connection with a full-time course of study.

(c) *Educational institution.* For purposes of sections 151(e) and 152, and the regulations thereunder, the term ''educational institution'' means a school maintaining a regular faculty and established curriculum, and having an organized body of students in attendance. It includes primary and secondary schools, colleges, universities, normal schools, technical schools, mechanical schools, and similar institutions, but does not include noneducational institutions, on-the-job training, correspondence schools, night schools, and so forth.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7051, 35 FR 11020, July 9, 1970]

§1.151–4 Amount of deduction for each exemption under section 151.

The amount allowed as a deduction for each exemption under section 151 is (a) $750 in the case of a taxable year beginning after December 31, 1972; (b) $700 in the case of a taxable year beginning after December 31, 1971, and before January 1, 1973; (c) $650 in the case of a taxable year beginning after December 31, 1970, and before January 1, 1972; (d) $625 in the case of a taxable year beginning after December 31, 1969, and before January 1, 1971; and (e) $600 in the case of a taxable year beginning before January 1, 1970. For special rules in the case of a fiscal year ending after December 31, 1969, and beginning before January 1, 1973, see section 21(d) and the regulations thereunder.

[T.D. 7114, 36 FR 9019, May 18, 1971]

§1.152–1 General definition of a dependent.

(a)(1) For purposes of the income taxes imposed on individuals by chapter 1 of the Code, the term ''dependent'' means any individual described in paragraphs (1) through (10) of section 152(a) over half of whose support, for the calendar year in which the taxable year of the taxpayer begins, was received from the taxpayer.

(2)(i) For purposes of determining whether or not an individual received, for a given calendar year, over half of his support from the taxpayer, there shall be taken into account the amount of support received from the taxpayer as compared to the entire amount of support which the individual received from all sources, including support which the individual himself supplied. The term ''support'' includes food, shelter, clothing, medical and dental care, education, and the like. Generally, the amount of an item of support will be the amount of expense incurred by the one furnishing such item. If the item of support furnished an individual is in the form of property or lodging, it will be necessary to measure the amount of such item of support in terms of its fair market value.

(ii) In computing the amount which is contributed for the support of an individual, there must be included any amount which is contributed by such individual for his own support, including income which is ordinarily excludable from gross income, such as benefits received under the Social Security Act (42 U.S.C. ch. 7). For example, a father receives $800 social security benefits, $400 interest, and $1,000 from his son during 1955, all of which sums represent his sole support during that year. The fact that the social security benefits of $800 are not includible in the father's gross income does not prevent such amount from entering into the computation of the total amount contributed for the father's support. Consequently, since the son's contribution of $1,000 was less than one-half of the father's support ($2,200) he may not claim his father as a dependent.

(iii)*(a)* For purposes of determining the amount of support furnished for a child (or children) by a taxpayer for a given calendar year, an arrearage payment made in a year subsequent to a calendar year for which there is an unpaid liability shall not be treated as paid either during that calendar year or in the year of payment, but no amount shall be treated as an arrearage payment to the extent that there is an unpaid liability (determined without regard to such payment) with respect to the support of a child for the taxable year of payment; and

(b) Similarly, payments made prior to any calendar year (whether or not made in the form of a lump sum payment in settlement of the parent's liability for support) shall not be treated as made during such calendar year, but payments made during any calendar year from amounts set aside in trust by a parent in a prior year, shall be treated as made during the calendar year in which paid.

(b) Section 152(a)(9) applies to any individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to section 153, of the taxpayer) who lives with the taxpayer and is a member of the taxpayer's household during the entire taxable year of the taxpayer. An individual is not a member of the taxpayer's household if at any time during the taxable year of the taxpayer the relationship between such individual and the taxpayer is in violation of local law. It is not necessary under section 152(a)(9) that the dependent be related to the taxpayer. For example, foster children may qualify as dependents. It is necessary, however, that the taxpayer both maintain and occupy the household. The taxpayer and dependent will be considered as occupying the household for such entire taxable year notwithstanding temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which the dependent is absent for less than six months in the taxable year of the taxpayer, shall be considered temporary absence due to special circumstances. The fact that the dependent dies during the year shall not deprive the taxpayer of the deduction if the dependent lived in the household for the entire part of the year preceding his death. Likewise, the period during the taxable year preceding the birth of an individual shall not prevent such individual from qualifying as a dependent under section 152(a)(9). Moreover, a child who actually becomes a member of the taxpayer's household during the taxable year shall not be prevented from being considered a member of such household for the entire taxable year, if the child is required to remain in a hospital for a period following its birth, and if such child would otherwise have been a member of the taxpayer's household during such period.

(c) In the case of a child of the taxpayer who is under 19 or who is a student, the taxpayer may claim the dependency exemption for such child provided he has furnished more than one-half of the support of such child for the calendar year in which the taxable year of the taxpayer begins, even though the income of the child for such calendar year may be equal to or in excess of the amount determined pursuant to §1.151–2 applicable to such calendar year. In such a case, there may be two exemptions claimed for the child: One on the parent's (or stepparent's) return, and one on the child's return. In determining whether the taxpayer does in fact furnish more than one-half of the support of an individual who is a child, as defined in paragraph (a) of §1.151–3, of the taxpayer and who is a student, as defined in paragraph (b) of §1.151–3, a special rule regarding scholarships applies. Amounts received as scholarships, as defined in paragraph (a) of §1.117–3, for study at an educational institution shall not be considered in determining whether the taxpayer furnishes more than one-half the support of such individual. For example, A has a child who receives a $1,000 scholarship to the X college for 1 year. A contributes $500, which constitutes the balance of the child's support for that year. A may claim the child as a dependent, as the $1,000 scholarship is not counted in determining the support of the child. For purposes of this paragraph, amounts received for tuition payments and allowances by a veteran under the provisions of the Servicemen's Readjustment Act of 1944 (58 Stat. 284) or the Veterans' Readjustment Assistance Act of 1952 (38 U.S.C. ch. 38) are not amounts received as scholarships. See also §1.117–4. For definition of the terms ''child'', ''student'', and ''educational institution'', as used in this paragraph, see §1.151–3.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6603, 28 FR 7094, July 11, 1963; T.D. 7099, 36 FR 5337, Mar. 20, 1971; T.D. 7114, 36 FR 9019, May 18, 1971]

§1.152–2 Rules relating to general definition of dependent.

(a)(1) Except as provided in subparagraph (2) of this paragraph, to qualify as a dependent an individual must be a citizen or resident of the United States or be a resident of the Canal Zone, the Republic of Panama, Canada, or Mexico, or, for taxable years beginning after December 31, 1971, a national of the United States, at some time during the calendar year in which the taxable year of the taxpayer begins. A resident of the Republic of the Philippines who was born to or legally adopted by the taxpayer in the Philippine Islands before January 1, 1956, at a time when the taxpayer was a member of the Armed Forces of the United States, may also be claimed as a dependent if such resident otherwise qualifies as a dependent. For definition of ''Armed Forces of the United States,'' see section 7701(a)(15).

(2)(i) For any taxable year beginning after December 31, 1957, a taxpayer who is a citizen, or, for any taxable year beginning after December 31, 1971, a national, of the United States is permitted under section 152(b)(3)(B) to treat as a dependent his legally adopted child who lives with him, as a member of his household, for the entire taxable year and who, but for the citizenship, nationality, or residence requirements of section 152(b)(3) and subparagraph (1) of this paragraph, would qualify as a dependent of the taxpayer for such taxable year.

(ii) Under section 152(b)(3)(B) and this subparagraph, it is necessary that the taxpayer both maintain and occupy the household. The taxpayer and his legally adopted child will be considered as occupying the household for the entire taxable year of the taxpayer notwithstanding temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which the legally adopted child is absent for less than six months in the taxable year of the taxpayer shall be considered temporary absence due to special circumstances. The fact that a legally adopted child dies during the year shall not deprive the taxpayer of the deduction if the child lived in the household for the entire part of the year preceding his death. The period during the taxable year preceding the birth of a child shall not prevent such child from qualifying as a dependent under this subparagraph. Moreover, a legally adopted child who actually becomes a member of the taxpayer's household during the taxable year shall not be prevented from being considered a member of such household for the entire taxable year, if the child is required to remain in a hospital for a period following its birth and if such child would otherwise have been a member of the taxpayer's household during such period.

(iii) For purposes of section 152(b)(3)(B) and this subparagraph, any child whose legal adoption by the taxpayer (a citizen or national of the United States) becomes final at any time before the end of the taxable year of the taxpayer shall not be disqualified as a dependent of such taxpayer by reason of his citizenship, nationality, or residence, provided the child lived with the taxpayer and was a member of the taxpayer's household for the entire taxable year in which the legal adoption became final. For example, A, a citizen of the United States who makes his income tax returns on the basis of the calendar year, is employed in Brazil by an agency of the United States Government. In October 1958 he takes into his household C, a resident of Brazil who is not a citizen of the United States, for the purpose of initiating adoption proceedings. C lives with A and is a member of his household for the remainder of 1958 and for the entire calendar year 1959. On July 1, 1959, the adoption proceedings were completed and C became the legally adopted child of A. If C otherwise qualifies as a dependent, he may be claimed as a dependent by A for 1959.

(b) A payment to a wife which is includible in her gross income under section 71 or section 682 shall not be considered a payment by her husband for the support of any dependent.

(c)(1) For purposes of determining the existence of any of the relationships specified in section 152 (a) or (b)(1), a legally adopted child of an individual shall be treated as a child of such individual by blood.

(2) For any taxable year beginning after December 31, 1958, a child who is a member of an individual's household also shall be treated as a child of such individual by blood if the child was placed with the individual by an authorized placement agency for legal adoption pursuant to a formal application filed by the individual with the agency. For purposes of this subparagraph an authorized placement agency is any agency which is authorized by a State, the District of Columbia, a possession of the United States, a foreign country, or a political subdivision of any of the foregoing to place children for adoption. A taxpayer who claims as a dependent a child placed with him for adoption shall attach to his income tax return a statement setting forth the name of the child for whom the dependency deduction is claimed, the name and address of the authorized placement agency, and the date the formal application was filed with the agency.

(3) The application of this paragraph may be illustrated by the following example:

Example. On March 1, 1959, D, a resident of the United States, made formal application to an authorized child placement agency for the placement of E, a resident of the United States, with him for legal adoption. On June 1, 1959, E was placed with D for legal adoption. During the year 1959 E received over one-half of his support from D. D may claim E as a dependent for 1959. Since E was a resident of the United States, his qualification as a dependent is in no way based on the provisions of section 152(b)(3)(B). Therefore, it is immaterial that E was not a member of D's household during the entire taxable year.

(4) For purposes of determining the existence of any of the relationships specified in section 152 (a) or (b)(1), a foster child of an individual (if such foster child satisfies the requirements set forth in paragraph (b) of § 1.152–1 with respect to such individual) shall, for taxable years beginning after December 31, 1969, be treated as a child of such individual by blood. For purposes of this subparagraph, a foster child is a child who is in the care of a person or persons (other than the parents or adopted parents of the child) who care for the child as their own child. Status as a foster child is not dependent upon or affected by the circumstances under which the child became a member of the household.

(d) In the case of a joint return it is not necessary that the prescribed relationship exist between the person claimed as a dependent and the spouse who furnishes the support; it is sufficient if the prescribed relationship exists with respect to either spouse. Thus, a husband and wife making a joint return may claim as a dependent a daughter of the wife's brother (wife's niece) even though the husband is the one who furnishes the chief support. The relationship of affinity once existing will not terminate by divorce or the death of a spouse. For example, a widower may continue to claim his deceased wife's father (his father-in-law) as a dependent provided he meets the other requirements of section 151.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6603, 28 FR 7094, July 11, 1963; T.D. 7051, 35 FR 11020, July 9, 1970; T.D. 7291, 38 FR 33396, Dec. 4, 1973]

§1.152–3 Multiple support agreements.

(a) Section 152(c) provides that a taxpayer shall be treated as having contributed over half of the support of an individual for the calendar year (in cases where two or more taxpayers contributed to the support of such individual) if—

(1) No one person contributed over half of the individual's support,

(2) Each member of the group which collectively contributed more than half of the support of the individual would have been entitled to claim the individual as a dependent but for the fact that he did not contribute more than one-half of such support.

(3) The member of the group claiming the individual as a dependent contributed more than 10 percent of the individual's support, and

(4) Each other person in the group who contributed more than 10 percent of such support files a written declaration that he will not claim the individual as a dependent for any taxable year beginning in such calendar year.

(b) Application of the rule contained in paragraph (a) of this section may be illustrated by the following examples:

Example (1). Brothers A, B, C, and D contributed the entire support of their mother in 1956 in the following percentages: A, 30 percent; B, 20 percent; C, 29 percent; and D, 21 percent. Any one of the brothers, except for the fact that he did not contribute more than half of her support, would have been entitled to claim his mother as a dependent. Consequently, any one of the brothers could claim a deduction for the exemption of the mother provided a written declaration (as provided in paragraph (c) of this section) from each of the other brothers is attached to his income tax return. Even though A and D together contributed more than one-half the support of the mother, A, if he wished to claim his mother as a dependent, would be required to attach written declarations from B, C, and D to his income tax return, since each of those three contributed more than 10 percent of the support and, but for the support requirement, would have been entitled to claim his mother as a dependent.

Example (2). E, an individual who resides with his son, received $1,500 during the calendar year 1956, which constituted his entire support for that year. The source of the $1,500 was as follows:

Source	Amount received	Percentage of total
Social Security	$375	25
N, an unrelated neighbor	165	11
B, a brother	210	14
D, a daughter	150	10
S, a son	600	40
Total received by E	1,500	100

B, D, and S are persons each of whom, but for the fact that he did not contribute more than half of the $1,500, could claim E as a dependent for a taxable year beginning in 1956. The three together contributed $960, or 64 percent of the $1,500, and, thus, each is a member of the group to be considered for the purpose of section 152(c). B and S are the only members of such group who can meet all the requirements of section 152(c) and either one could claim E as a dependent for his taxable year beginning in 1956 provided he attached to his income tax return a written declaration (as provided in paragraph (c) of this section) signed by the other, and furnished the other information required by the return with respect to all the contributions to E. Inasmuch as D did not contribute more than 10 percent of E's support, she is not entitled to claim E as a dependent for a taxable year beginning in 1956 nor is she required to file a written declaration with respect to her contributions to E. N contributed over 10 percent of the support of E in 1956 but, since he is an unrelated neighbor, he does not qualify as a member of the group for the purpose of the multiple support agreement under section 152(c).

(c) The member of a group of contributors who claim an individual as a dependent under the multiple support agreement provisions of section 152(c) must attach to his income tax return for the year of the deduction a written declaration from each of the other persons who contributed more than 10 percent of the support of such individual and who, but for the failure to contribute more than half of the support of the individual, would have been entitled to claim the individual as a dependent. The written declaration required by this paragraph may be made on Form 2120. Any declaration made other than on Form 2120 shall conform to the substance of Form 2120. The taxpayer claiming the individual as a dependent should be prepared to furnish other information, when required, which will substantiate his right to claim such individual as a dependent. Such information may include a statement showing the names of all contributors (whether or not members of the group described in section 152(c)) and the amount contributed by each to the support of the claimed dependent.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6603, 28 FR 7094, July 11, 1963]

§ 1.152–4 Support test in case of child of divorced or separated parents.

(a) *Applicability.* For taxable years beginning after December 31, 1966, the provisions of section 152(e) and this section relate to a determination of which of separated parents (that is, parents who are divorced or legally separated under a decree of divorce or separate maintenance, or separated under a written separation agreement) is to be treated for purposes of section 152(a) and § 1.152–1 as having provided more than half of the support of a child, as defined in section 151(e)(3) and § 1.151–3(a). For section 152(e) and this section to apply either parent or both parents combined must provide more than one-half of the child's total support, within the meaning of § 1.152–1(a)(2)(i) during the calendar year in which the taxable year of the parent who is claiming the child as a dependent begins; and such child must be in the custody of one or both of his parents for more than one-half of the calendar year. Thus, section 152(e) and this section do not apply if a person other than the parents provides one-half or more for the support of such child during the calendar year or has custody of the child for one-half or more of the calendar year. In addition, section 152(e) and this section do not apply in any case where over half of the support of the child is treated as having been received from a taxpayer pursuant to a multiple support agreement under the provisions of section 152(c) and § 1.152–3. Nor does section 152(e) and this section apply to a period for which a joint return signed by both parents is filed.

(b) *Custody.* ''Custody,'' for purposes of this section, will be determined by the terms of the most recent decree of divorce or separate maintenance, or subsequent custody decree, or, if none, a written separation agreement. In the event of so-called ''split'' custody, or if neither a decree or agreement establishes who has custody, or if the validity or continuing effect of such decree or agreement is uncertain by reason of proceedings pending on the last day of the calendar year, ''custody'' will be deemed to be with the parent who, as between both parents, has the physical custody of the child for the greater portion of the calendar year.

(c) *General rule.* For purposes of section 152(a) and § 1.152–1, a child shall be treated as receiving over half of his support during the calendar year from the parent (hereinafter referred to as the ''custodial parent'') having custody within the meaning of paragraph (b) of this section for a greater portion of the calendar year unless the exceptions of paragraph (d) of this section apply. If the parents of such a child are divorced or separated for only a portion of a calendar year after having had joint custody of the child for the prior portion of the year, the parent who has custody for the greater portion of the remainder of the year after divorce or separation shall be treated as having custody for a greater portion of the calendar year. Except as provided in section 152(e)(2)(A) and paragraph (d)(2) of this section (relating to decree or agreement) parents who are unable to enter into a multiple support agreement under section 152(c) cannot enter into an agreement as to which parent is entitled to claim a child as a dependent. Therefore, in general, the custodial parent shall be allowed as a deduction the exemption for the dependent child, if the requirements of section 151(e) are met.

(d) *Exceptions*—(1) *In general.* Notwithstanding paragraph (c) of this section, a child shall be treated as receiving over half of his support during the calendar year from the parent who is not the custodial parent (hereinafter referred to as the ‘‘noncustodial parent’’) if the conditions of subparagraph (2) or (3) of this paragraph are met.

(2) *Decree or agreement.* A noncustodial parent who provides at least $600 for the support of a child during the calendar year shall be treated as having provided more than half the support of the child if the decree of divorce or of separate maintenance, or a written agreement between the parents applicable to the taxable year of the noncustodial parent beginning in such calendar year, provides that the noncustodial parent shall be entitled to any deduction allowable under section 151 as an exemption for the dependent child. In order for this subparagraph to apply, the noncustodial parent must provide at least $600 for the support of each child he claims as a dependent. For taxable years beginning after December 31, 1970, in the case of a written agreement or portion of a written agreement between the parents which allocates the deduction to the noncustodial parent, the noncustodial parent must attach to his return (or amended return) a copy of such agreement or such portion of such agreement which is applicable to the calendar year in which the taxable year of the noncustodial parent begins.

(3) *Actual support.* A noncustodial parent who provides $1,200 or more support for the child (or, for taxable years beginning before October 5, 1976, if there is more than one child for which he claims an exemption, $1,200 or more for the combined support for all of such children) shall be treated as having provided more than half the support for the child (or children) notwithstanding any provision to the contrary contained in a decree of divorce or separation or in a written agreement, unless the custodial parent clearly established that the custodial parent provided, in fact, more for the support of the child during the calendar year than the noncustodial parent. Under section 152(e)(2)(B) and this subparagraph, if the noncustodial parent established that the noncustodial parent has provided $1,200 or more for support of the child, then the custodial parent has the burden of establishing by a clear preponderance of the evidence that the custodial parent has provided more for the support of the child than has been established by the noncustodial parent in order to be treated as having provided over half of the support of the child. See paragraph (e) of this section with regard to notification and submission of itemized statements.

(4) *Amount of support.* For purposes of this paragraph, amounts expended for the support of a child shall be treated as received from the noncustodial parent to the extent that the noncustodial parent provided amounts for the support of the child, whether or not such amounts provided by the noncustodial parent are actually expended for child support. Therefore, for example, if only the parents have provided support for the child during a calendar year, only the excess of the total amount expended for the support of the child over the amount so provided by the noncustodial parent shall be treated as provided by the custodial parent for the support of the child.

(e) *Itemized statement*—(1) *Exchange.* (i) If a parent intends to claim for a taxable year a child as a dependent or a parent is uncertain whether he is entitled to claim a child and desires either to determine whether the second parent intends to or has claimed the same child as a dependent, or if the first parent desires to receive an itemized statement as provided in subparagraph (3) of this paragraph from the second parent, the first parent is entitled to receive such information from the second parent in writing upon request provided he both notifies the second parent of his intention (or possible intention) to so claim the child and sends the second parent a copy of such an itemized statement upon which the first parent’s claim is based. A failure to make such a request shall not affect the right of the first parent to claim the child as a dependent. However, if the first parent makes such a request, and the second parent does not respond within a reasonable time, and it is determined that the first parent is not entitled to claim the child as a dependent, the inability of the first parent to obtain information will be taken into account in determining whether the addition to tax under section 6653, relating to failure to pay tax, is applicable.

(ii) Upon receipt of such a request accompanied by an itemized statement, if the second parent intends to claim (with respect to the calendar year in which such taxable year of the first parent begins) or has claimed the same child as a dependent, the second parent shall so inform the first parent, and if so requested shall send him a copy of the itemized statement upon which the second parent's claim is based. A notification under this subparagraph that the parent is claiming or is not claiming the child as a dependent shall not affect the rights of the parent making such notification and does not constitute a waiver.

(2) *Attachment to return.* For taxable years beginning after December 31, 1970, if a parent intends to claim a child as a dependent and, prior to the filing of his return or the time prescribed by law for filing the return (determined without regard to any extension thereof), whichever is later, such parent makes or receives a request under the procedures provided under paragraph (e)(1) of this section, then unless he is reasonably certain that the other parent will not claim the child as a dependent, such parent must attach to his return (or if the return is already filed, to a corrected or amended return) a copy of the itemized statement upon which such parent's claim is based, as provided in subparagraph (3) of this paragraph, together with a copy of the other parent's itemized statement, if available, at the time the return is filed. Failure to attach an itemized statement to the extent required by this subparagraph will be taken into account in determining whether the addition to tax under section 6653, relating to failure to pay tax, is applicable in the event it is determined that the parent is not entitled to claim the child as a dependent.

(3) *Contents.* The itemized statement referred to in subparagraphs (1) and (2) of this paragraph shall include—

(i) The name of the child (or children) being claimed as a dependent as well as the name of both parents and, if known, the address and social security number of both parents;

(ii) If known, the number of months the dependent child (or children) lived during the calendar year in the home of each parent or person other than the parents;

(iii) If known, income for the taxable year of each dependent child;

(iv) If known, the total amount of support furnished the child (or children) (including amounts furnished by persons other than the parents);

(v) A list of amounts expended during the calendar year for the child (or children) made by the parent making the statement and itemized to show the amounts expended for medical and dental care, food, shelter, clothing, education, recreation, and transportation;

(vi) Amounts actually paid by the parent making the statement during the calendar year for the support of the child (or children) pursuant to a decree of divorce or separate maintenance, or a written separation agreement; and

(vii) Other amounts paid or expended by the parent making the statement during the calendar year, for the support of the child (or children).

(4) *Requirement by officer.* Notwithstanding subparagraph (1), (2), or (3) of this paragraph, an internal revenue officer may require the submission of an itemized statement from either parent and may make it available to the other parent. Such itemized statement shall contain the information requested by the internal revenue officer and shall be filed within such reasonable time as may be designated by him. If the required statement is not furnished pursuant to the instructions of the internal revenue officer, the claim of support of the parent failing to comply with such requirement may be disallowed by the Internal Revenue Service.

(f) *Illustration of principles.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). A, a child of B and C, who were divorced June 1, 1970, received $1,000 for support during the calendar year 1970, of which $400 was provided by B and $300 was provided by C. No multiple support agreement was entered into. Prior to the divorce B and C jointly had custody of A, and for the remainder of 1970, B had custody of A for the months of October through December, while C had custody of A for the months of June through September. Since C had custody for 4 of the 7 months following the divorce, C is the custodial parent for 1970 and is treated as having provided over half of the support for A during 1970.

Example (2). Assume the same facts as in example (1) and that for the calendar year 1971, of $1,000 support expended for A during 1971, $400 was provided by B and $300 was provided by C. Furthermore, assume that in addition to having custody of A for the months of October through December 1971, B had custody for the first 5 months of 1971. Since B had custody of A for a total of 8 months in 1971, B is the custodial parent for 1971 and is treated as having provided over half of the support for A during 1971.

Example (3). D received all of his support, $1,000, during the calendar year 1970, from his parents E and F, who are separated under a written separation agreement. F had custody of D for the entire year of 1970, but under the agreement E was to provide $600 for the support of D during 1970, and E is entitled to any deduction allowable under section 151 for the years 1970 and 1971. E, in fact, provides only $550 for the support of D during 1970, but makes up the arrearage of $50 early in 1971. Nevertheless, F is treated as having provided over half of the support for D during 1970.

Example (4). Assume the same facts as in example (3) and that F had custody of D for the entire year 1971, and of $2,350 expended for the support of D during 1971, E provided $650 while F provided $1,700. Since under the written separation agreement E is entitled to any deduction allowable under section 151 for D for the year 1971 and E provided at least $600 for the support of D, E is treated as having provided over half of the support of D, for 1971.

Example (5). G and H are legally separated under a decree of separate maintenance. G has custody of I, the child of G and H, for the entire year, and G and H enter into a written agreement that G is entitled to any deduction allowable under section 151 for I for the calendar year 1970. However, during 1970, of the $2,000 provided for the support of I, H provided $1,300 while G provided only $700. H has provided more than $1,200 for the support of I, and G cannot establish that G provided more for the support of I, than did H. Therefore, notwithstanding the agreement, since H does not have custody of I, H is treated as having provided over half of the support for I for 1970.

Example (6). J and K, the children of L and M, who are divorced, received a total of $3,400 for the support of both during the calendar year 1970 from their parents. L, who has custody of J and K for the entire year 1970, provided $1,800 for the support of both, while M, the noncustodial parent, provided $1,600 for such support. Under the decree of divorce, M is entitled to any deduction allowable under section 151 for such children. Since M has provided at least $600 for the support of each child, M is treated as having provided over half the support for J and K for 1970. Furthermore, as J and K are determined under section 152(e) and §1.152–4 to be dependents of M for purposes of section 151(e), they are also considered to be dependents of M with respect to other provisions of the Code that are dependent upon such a determination for their operation. (For example, section 213.)

Example (7). N, O, and P are the children of divorced parents Q and R, both calendar year taxpayers. During calendar year 1976, the children received over half their support from Q and R. Q, who has custody of the three children for the entire year 1976, provided $800 for the support of each of the three children. R, the noncustodial parent, provided $2,700 during 1976 for the combined support of the three children under the terms of the decree of divorce. So, for calendar year 1976, although R, the noncustodial parent, did not provide support in the amount $1,200 per child under paragraph (d)(3) of this section, R, the noncustodial parent, is treated as having provided more than half the support of each child during 1976, since R provided more than $1,200 for the combined support of all the children and Q did not provide more for the support of either N, O, or P ($800 per child) during 1976 than R provided during 1976 ($900 per child).

Example (8). Assume the same facts that occurred in 1976 in example 7 also occurred in 1977. For 1977 R does not satisfy the $1,200 support test under paragraph (d)(3) of this section because he has not provided $1,200 support for each individual child N, O, or P for calendar year 1977. Therefore, R, the noncustodial parent, is not treated as having provided more than half the support of the children for calendar year 1977.

Example (9). A, B, and C, the children of divorced parents M and N, both calendar year taxpayers, receive all of their support, $5,900, from their parents during the calendar year 1979. M has custody of A, B, and C and provides $2,700 for their collective support during 1979. Pursuant to the terms of the decree of divorce N provided $1,200 for the support of A, $1,000 for the support of B, and $1,000 for the support of C. Since N has provided $1,200 or more for the support of A, and M has provided $900 ($2,700÷3) for the support of A during 1979, N is treated as having provided more than half the support for A during 1979.

However, since N has not provided $1,200 or more for the support of either B or C, N, the noncustodial parent, is not treated as having provided more than half the support of B or C during 1979.

[T.D. 7099, 36 FR 5337, Mar. 20, 1971, as amended by T.D. 7145, 36 FR 20039, Oct. 15, 1971; T.D. 7639, 44 FR 48674, Aug. 20, 1979]

§ 1.152–4T Dependency exemption in the case of a child of divorced parents, etc. (temporary).

(a) *In general.*

Q–1 Which parent may claim the dependency exemption in the case of a child of divorced or separated parents?

A–1 Provided the parents together would have been entitled to the dependency exemption had they been married and filing a joint return, the parent having custody of a child for the greater portion of the year (the custodial parent) will generally be entitled to the dependency exemption. This rule applies to parents not living together during the last 6 months of the calendar year, as well as those divorced or separated under a separation agreement.

Q–2 Are there any exceptions to the general rule in A–1?

A–2 Yes, there are three exceptions. The general rule does not apply (i) if a multiple support agreement is in effect (see section 152(c)), (ii) if a decree or agreement executed prior to January 1, 1985 provides that the custodial parent has agreed to release his or her claim to the dependency exemption to the noncustodial parent and the noncustodial parent provides at least $600 of support to the child (see section 152(e)(4)), or (iii) if the custodial parent relinquishes the exemption in the manner described in A–3.

Q–3 How may the exemption for a dependent child be claimed by a noncustodial parent?

A–3 A noncustodial parent may claim the exemption for a dependent child only if the noncustodial parent attaches to his/her income tax return for the year of the exemption a written declaration from the custodial parent stating that he/she will not claim the child as a dependent for the taxable year begining in such calendar year. The written declaration may be made on a form to be provided by the Service for this purpose. Once the Service has released the form, any declaration made other than on the official form shall conform to the substance of such form.

Q–4 For what period may a custodial parent release to the noncustodial parent a claim to the exemption for a dependent child?

A–4 The exemption may be released for a single year, for a number of specified years (for example, alternate years), or for all future years, as specified in the declaration. If the exemption is released for more than one year, the original release must be attached to the return of the noncustodial spouse and a copy of such release must be attached to his/her return for each succeeding taxable year for which he/she claims the dependency exemption.

Q–5 May only the custodial parent claim a deduction under section 213(d) for medical expenses paid by the parent or an income exclusion under section 105(b) for medical expenses paid by an employer for a dependent child?

A–5 No. Under the new rules, if a child receives over half of his support during the calendar year from his parents who are divorced or legally separated under a decree of divorce or separate maintenance, or who are separated under a written separation agreement, that child will be treated as a dependent of both parents for purposes of sections 105(b) and 213(d). Thus, a parent can deduct medical expenses paid by that parent for a child even though a dependency exemption for the child is claimed by the other parent. The special rule of sections 105(b) and 213(d) does not apply where over half of the support of a child is treated as having been received from a person under the provisions of section 152(c) (relating to multiple support agreements).

Q–6 When does section 152(e), as amended by the Tax Reform Act of 1984, become effective?

A–6 Section 152(e), as amended, is effective with respect to dependency exemptions for taxable years beginning after December 31, 1984.

(Secs. 1041(d)(4) (98 Stat. 798, 26 U.S.C. 1041(d)(4)), 152(e)(2)(A) (98 Stat. 802, 26 U.S.C. 152(e)(2)(A)), 215(c) (98 Stat. 800, 26 U.S.C. 215(c)) and 7805 (68A Stat. 917, 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 7973, 49 FR 34459, Aug. 31, 1984]

§1.153–1 Determination of marital status.

For the purpose of determining the right of an individual to claim an exemption for his spouse under section 151(b), the determination of whether such individual is married shall be made as of the close of his taxable year, unless his spouse dies during such year, in which case the determination shall be made as of the time of such death. An individual legally separated from his spouse under a decree of divorce or separate maintenance shall not be considered as married. The provisions of this section may be illustrated by the following examples:

Example (1). A, who files his returns on the basis of a calendar year, married B on December 31, 1956. B, who had never previously married, had no gross income for the calendar year 1956 nor was she the dependent of another taxpayer for such year. A may claim an exemption for B for 1956.

Example (2). C and his wife, D, were married in 1940. They remained married until July 1956 at which time D was granted a decree of divorce. C, who files his income tax returns on a calendar year basis, cannot claim an exemption for D on his 1956 return as C and D were not married on the last day of C's taxable year. Had D died instead of being divorced, C could have claimed an exemption for D for 1956 as their marital status would have been determined as of the date of D's death.

§1.154 Statutory provisions; cross references.

SEC. 154. *Cross references.* (1) For definitions of ''husband'' and ''wife'', as used in section 152(b)(4), see section 7701(a)(17).

(2) For deductions of estates and trusts, in lieu of the exemptions under section 151, see section 642(b).

(3) For exemptions of nonresident aliens, see section 873(b)(3).

(4) For exemptions of citizens deriving income mainly from sources within possessions of the United States, see section 931(e).

[Sec. 154 as amended by sec. 103(c)(2), Foreign Investors Tax Act 1966 (80 Stat. 1551)]

[TD 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 7332, 39 FR 44216, Dec. 23, 1974]

ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

§1.161–1 Allowance of deductions.

Section 161 provides for the allowance as deductions, in computing taxable income under section 63(a), of the items specified in Part VI (section 161 and following), Subchapter B, Chapter 1 of the Code, subject to the exceptions provided in Part IX (section 261 and following), of such Subchapter B, relating to items not deductible. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code of 1954 cannot again be deducted under any other provision thereof. See also section 7852(c), relating to the taking into account, both in computing a tax under Subtitle A of the Internal Revenue Code of 1954 and a tax under Chapter 1 or 2 of the Internal Revenue Code of 1939, of the same item of deduction.

§1.162–1 Business expenses.

(a) *In general.* Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. See paragraph (a) of §1.161–3. Among the items included in business expenses are management expenses, commissions (but see section 263 and the regulations thereunder), labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see § 1.162–2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. No such item shall be included in business expenses, however, to the extent that it is used by the taxpayer in computing the cost of property included in its inventory or used in determining the gain or loss basis of its plant, equipment, or other property. See section 1054 and the regulations thereunder. A deduction for an expense paid or incurred after December 30, 1969, which would otherwise be allowable under section 162 shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy. See section 162(c), (f), and (g) and the regulations thereunder. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is deductible, even though such expenses exceed the gross income derived during the taxable year from such business. In the case of any sports program to which section 114 (relating to sports programs conducted for the American National Red Cross) applies, expenses described in section 114(a)(2) shall be allowable as deductions under section 162(a) only to the extent that such expenses exceed the amount excluded from gross income under section 114(a).

(b) *Cross references.* (1) For charitable contributions by individuals and corporations not deductible under section 162, see § 1.162–15.

(2) For items not deductible, see sections 261–276, inclusive, and the regulations thereunder.

(3) For research and experimental expenditures, see section 174 and regulations thereunder.

(4) For soil and water conservation expenditures, see section 175 and regulations thereunder.

(5) For expenditures attributable to grant or loan by United States for encouragement of exploration for, or development or mining of, critical and strategic minerals or metals, see section 621 and regulations thereunder.

(6) For treatment of certain rental payments with respect to public utility property, see section 167(1) and § 1.167(1)–3.

(7) For limitations on the deductibility of miscellaneous itemized deductions, see section 67 and §§ 1.67–1T through 1.67–4T.

(8) For the timing of deductions with respect to notional principal contracts. see § 1.446–3.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6690, 28 FR 12253, Nov. 19, 1963; T.D. 6996, 34 FR 835, Jan. 18, 1969; T.D. 7315, 39 FR 20203, June 7, 1974, as amended by T.D. 7345, 40 FR 7437, Feb. 20, 1975; T.D. 8189, 53 FR 9881, Mar. 28, 1988; T.D. 8491, 58 FR 53128, Oct. 14, 1993]

§ 1.162–2 Traveling expenses.

(a) Traveling expenses include travel fares, meals and lodging, and expenses incident to travel such as expenses for sample rooms, telephone and telegraph, public stenographers, etc. Only such traveling expenses as are reasonable and necessary in the conduct of the taxpayer's business and directly attributable to it may be deducted. If the trip is undertaken for other than business purposes, the travel fares and expenses incident to travel are personal expenses and the meals and lodging are living expenses. If the trip is solely on business, the reasonable and necessary traveling expenses, including travel fares, meals and lodging, and expenses incident to travel, are business expenses. For the allowance of traveling expenses as deductions in determining adjusted gross income, see section 62(2)(B) and the regulations thereunder.

(b)(1) If a taxpayer travels to a destination and while at such destination engages in both business and personal activities, traveling expenses to and from such destination are deductible only if the trip is related primarily to the taxpayer's trade or business. If the trip is primarily personal in nature, the traveling expenses to and from the destination are not deductible even though the taxpayer engages in business activities while at such destination. However, expenses while at the destination which are properly allocable to the taxpayer's trade or business are deductible even though the traveling expenses to and from the destination are not deductible.

(2) Whether a trip is related primarily to the taxpayer's trade or business or is primarily personal in nature depends on the facts and circumstances in each case. The amount of time during the period of the trip which is spent on personal activity compared to the amount of time spent on activities directly relating to the taxpayer's trade or business is an important factor in determining whether the trip is primarily personal. If, for example, a taxpayer spends one week while at a destination on activities which are directly related to his trade or business and subsequently spends an additional five weeks for vacation or other personal activities, the trip will be considered primarily personal in nature in the absence of a clear showing to the contrary.

(c) Where a taxpayer's wife accompanies him on a business trip, expenses attributable to her travel are not deductible unless it can be adequately shown that the wife's presence on the trip has a bona fide business purpose. The wife's performance of some incidental service does not cause her expenses to qualify as deductible business expenses. The same rules apply to any other members of the taxpayer's family who accompany him on such a trip.

(d) Expenses paid or incurred by a taxpayer in attending a convention or other meeting may constitute an ordinary and necessary business expense under section 162 depending upon the facts and circumstances of each case. No distinction will be made between self-employed persons and employees. The fact that an employee uses vacation or leave time or that his attendance at the convention is voluntary will not necessarily prohibit the allowance of the deduction. The allowance of deductions for such expenses will depend upon whether there is a sufficient relationship between the taxpayer's trade of business and his attendance at the convention or other meeting so that he is benefiting or advancing the interests of his trade or business by such attendance. If the convention is for political, social or other purposes unrelated to the taxpayer's trade or business, the expenses are not deductible.

(e) Commuters' fares are not considered as business expenses and are not deductible.

(f) For rules with respect to the reporting and substantiation of traveling and other business expenses of employees for taxable years beginning after December 31, 1957, see §1.162–17.

§1.162–3 Cost of materials.

Taxpayers carrying materials and supplies on hand should include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operation during the taxable year for which the return is made, provided that the costs of such materials and supplies have not been deducted in determining the net income or loss or taxable income for any previous year. If a taxpayer carries incidental materials or supplies on hand for which no record of consumption is kept or of which physical inventories at the beginning and end of the year are not taken, it will be permissible for the taxpayer to include in his expenses and to deduct from gross income the total cost of such supplies and materials as were purchased during the taxable year for which the return is made, provided the taxable income is clearly reflected by this method.

§1.162–4 Repairs.

The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with section 167 or charged against the depreciation reserve if such an account is kept.

§ 1.162–5 Expenses for education.

(a) *General rule.* Expenditures made by an individual for education (including research undertaken as part of his educational program) which are not expenditures of a type described in paragraph (b) (2) or (3) of this section are deductible as ordinary and necessary business expenses (even though the education may lead to a degree) if the education—

(1) Maintains or improves skills required by the individual in his employment or other trade or business, or

(2) Meets the express requirements of the individual's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation.

(b) *Nondeductible educational expenditures*—(1) *In general.* Educational expenditures described in subparagraphs (2) and (3) of this paragraph are personal expenditures or constitute an inseparable aggregate of personal and capital expenditures and, therefore, are not deductible as ordinary and necessary business expenses even though the education may maintain or improve skills required by the individual in his employment or other trade or business or may meet the express requirements of the individual's employer or of applicable law or regulations.

(2) *Minimum educational requirements.* (i) The first category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures made by an individual for education which is required of him in order to meet the minimum educational requirements for qualification in his employment or other trade or business. The minimum education necessary to qualify for a position or other trade or business must be determined from a consideration of such factors as the requirements of the employer, the applicable law and regulations, and the standards of the profession, trade, or business involved. The fact that an individual is already performing service in an employment status does not establish that he has met the minimum educational requirements for qualification in that employment. Once an individual has met the minimum educational requirements for qualification in his employment or other trade or business (as in effect when he enters the employment or trade or business), he shall be treated as continuing to meet those requirements even though they are changed.

(ii) The minimum educational requirements for qualification of a particular individual in a position in an educational institution is the minimum level of education (in terms of aggregate college hours or degree) which under the applicable laws or regulations, in effect at the time this individual is first employed in such position, is normally required of an individual initially being employed in such a position. If there are no normal requirements as to the minimum level of education required for a position in an educational institution, then an individual in such a position shall be considered to have met the minimum educational requirements for qualification in that position when he becomes a member of the faculty of the educational institution. The determination of whether an individual is a member of the faculty of an educational institution must be made on the basis of the particular practices of the institution. However, an individual will ordinarily be considered to be a member of the faculty of an institution if *(a)* he has tenure or his years of service are being counted toward obtaining tenure; *(b)* the institution is making contributions to a retirement plan (other than Social Security or a similar program) in respect of his employment; or *(c)* he has a vote in faculty affairs.

(iii) The application of this subparagraph may be illustrated by the following examples:

000000Example (1). General facts:State X requires a bachelor's degree for beginning secondary school teachers which must include 30 credit hours of professional educational courses. In addition, in order to retain his position, a secondary school teacher must complete a fifth year of preparation within 10 years after beginning his employment. If an employing school official certifies to the

State Department of Education that applicants having a bachelor's degree and the required courses in professional education cannot be found, he may hire individuals as secondary school teachers if they have completed a minimum of 90 semester hours of college work. However, to be retained in his position, such an individual must obtain his bachelor's degree and complete the required professional educational courses within 3 years after his employment commences. Under these facts, a bachelor's degree, without regard to whether it includes 30 credit hours of professional educational courses, is considered to be the minimum educational requirement for qualification as a secondary school teacher in State X. This is the case notwithstanding the number of teachers who are actually hired without such a degree. The following are examples of the application of these facts in particular situations:

Situation 1. A, at the time he is employed as a secondary school teacher in State X, has a bachelor's degree including 30 credit hours of professional educational courses. After his employment, A completes a fifth college year of education and, as a result, is issued a standard certificate. The fifth college year of education undertaken by A is not education required to meet the minimum educational requirements for qualification as a secondary school teacher. Accordingly, the expenditures for such education are deductible unless the expenditures are for education which is part of a program of study being pursued by A which will lead to qualifying him in a new trade or business.

Situation 2. Because of a shortage of applicants meeting the stated requirements, B, who has a bachelor's degree, is employed as a secondary school teacher in State X even though he has only 20 credit hours of professional educational courses. After his employment, B takes an additional 10 credit hours of professional educational courses. Since these courses do not constitute education required to meet the minimum educational requirements for qualification as a secondary school teacher which is a bachelor's degree and will not lead to qualifying B in a new trade or business, the expenditures for such courses are deductible.

Situation 3. Because of a shortage of applicants meeting the stated requirements, C is employed as a secondary school teacher in State X although he has only 90 semester hours of college work toward his bachelor's degree. After his employment, C undertakes courses leading to a bachelor's degree. These courses (including any courses in professional education) constitute education required to meet the minimum educational requirements for qualification as a secondary school teacher. Accordingly, the expenditures for such education are not deductible.

Situation 4. Subsequent to the employment of A, B, and C, but before they have completed a fifth college year of education, State X changes its requirements affecting secondary school teachers to provide that beginning teachers must have completed 5 college years of preparation. In the cases of A, B, and C, a fifth college year of education is not considered to be education undertaken to meet the minimum educational requirements for qualifications as a secondary school teacher. Accordingly, expenditures for a fifth year of college will be deductible unless the expenditures are for education which is part of a program being pursued by A, B, or C which will lead to qualifying him in a new trade or business.

Example (2). D, who holds a bachelor's degree, obtains temporary employment as an instructor at University Y and undertakes graduate courses as a candidate for a graduate degree. D may become a faculty member only if he obtains a graduate degree and may continue to hold a position as instructor only so long as he shows satisfactory progress towards obtaining this graduate degree. The graduate courses taken by D constitute education required to meet the minimum educational requirements for qualification in D's trade or business and, thus, the expenditures for such courses are not deductible.

Example (3). E, who has completed 2 years of a normal 3-year law school course leading to a bachelor of laws degree (LL.B.), is hired by a law firm to do legal research and perform other functions on a full-time basis. As a condition to continued employment, E is required to obtain an LL.B. and pass the State bar examination. E completes his law school education by attending night law school, and he takes a bar review course in order to prepare for the State bar examination. The law courses and bar review course constitute education required to meet the minimum educational requirements for qualification in E's trade or business and, thus, the expenditures for such courses are not deductible.

(3) *Qualification for new trade or business.* (i) The second category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures made by an individual for education which is part of a program of study being pursued by him which will lead to qualifying him in a new trade or business. In the case of an employee, a change of duties does not constitute a new trade or business if the new duties involve the same general type of work as is involved in the individual's present employment. For this purpose, all teaching and related duties shall be considered to involve

the same general type of work. The following are examples of changes in duties which do not constitute new trades or businesses:

(a) Elementary to secondary school classroom teacher.

(b) Classroom teacher in one subject (such as mathematics) to classroom teacher in another subject (such as science).

(c) Classroom teacher to guidance counselor.

(d) Classroom teacher to principal.

(ii) The application of this subparagraph to individuals other than teachers may be illustrated by the following examples:

Example (1). A, a self-employed individual practicing a profession other than law, for example, engineering, accounting, etc., attends law school at night and after completing his law school studies receives a bachelor of laws degree. The expenditures made by A in attending law school are nondeductible because this course of study qualifies him for a new trade or business.

Example (2). Assume the same facts as in example (1) except that A has the status of an employee rather than a self-employed individual, and that his employer requires him to obtain a bachelor of laws degree. A intends to continue practicing his nonlegal profession as an employee of such employer. Nevertheless, the expenditures made by A in attending law school are not deductible since this course of study qualifies him for a new trade or business.

Example (3). B, a general practitioner of medicine, takes a 2-week course reviewing new developments in several specialized fields of medicine. B's expenses for the course are deductible because the course maintains or improves skills required by him in his trade or business and does not qualify him for a new trade or business.

Example (4). C, while engaged in the private practice of psychiatry, undertakes a program of study and training at an accredited psychoanalytic institute which will lead to qualifying him to practice psychoanalysis. C's expenditures for such study and training are deductible because the study and training maintains or improves skills required by him in his trade or business and does not qualify him for a new trade or business.

(c) *Deductible educational expenditures*—(1) *Maintaining or improving skills.* The deduction under the category of expenditures for education which maintains or improves skills required by the individual in his employment or other trade or business includes refresher courses or courses dealing with current developments as well as academic or vocational courses provided the expenditures for the courses are not within either category of nondeductible expenditures described in paragraph (b) (2) or (3) of this section.

(2) *Meeting requirements of employer.* An individual is considered to have undertaken education in order to meet the express requirements of his employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the taxpayer of his established employment relationship, status, or rate of compensation only if such requirements are imposed for a bona fide business purpose of the individual's employer. Only the minimum education necessary to the retention by the individual of his established employment relationship, status, or rate of compensation may be considered as undertaken to meet the express requirements of the taxpayer's employer. However, education in excess of such minimum education may qualify as education undertaken in order to maintain or improve the skills required by the taxpayer in his employment or other trade or business (see subparagraph (1) of this paragraph). In no event, however, is a deduction allowable for expenditures for education which, even though for education required by the employer or applicable law or regulations, are within one of the categories of nondeductible expenditures described in paragraph (b) (2) and (3) of this section.

(d) *Travel as a form of education.* Subject to the provisions of paragraph (b) and (e) of this section, expenditures for travel (including travel while on sabbatical leave) as a form of education are deductible only to the extent such expenditures are attributable to a period of travel that is directly related to the duties of the individual in his employment or other trade or business. For this purpose, a period of travel shall be considered directly related to the duties of an individual in his employment or other trade or business only if the major portion of the activities during such period is of a nature which directly maintains or improves skills required by the individual in such employment or other trade or business. The approval of a travel program by an employer or the fact that travel is accepted by an employer in the fulfillment of its requirements for retention of rate of compensation, status or employment, is not determinative that the required relationship exists between the travel involved and the duties of the individual in his particular position.

(e) *Travel away from home.* (1) If an individual travels away from home primarily to obtain education the expenses of which are deductible under this section, his expenditures for travel, meals, and lodging while away from home are deductible. However, if as an incident of such trip the individual engages in some personal activity such as sightseeing, social visiting, or entertaining, or other recreation, the portion of the expenses attributable to such personal activity constitutes nondeductible personal or living expenses and is not allowable as a deduction. If the individual's travel away from home is primarily personal, the individual's expenditures for travel, meals and lodging (other than meals and lodging during the time spent in participating in deductible education pursuits) are not deductible. Whether a particular trip is primarily person or primarily to obtain education the expenses of which are deductible under this section depends upon all the facts and circumstances of each case. An important factor to be taken into consideration in making the determination is the relative amount of time devoted to personal activity as compared with the time devoted to educational pursuits. The rules set forth in this paragraph are subject to the provisions of section 162(a)(2), relating to deductibility of certain traveling expenses, and section 274 (c) and (d), relating to allocation of certain foreign travel expenses and substantiation required, respectively, and the regulations thereunder.

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

Example (1). A, a self-employed tax practitioner, decides to take a 1-week course in new developments in taxation, which is offered in City X, 500 miles away from his home. His primary purpose in going to X is to take the course, but he also takes a side trip to City Y (50 miles from X) for 1 day, takes a sightseeing trip while in X, and entertains some personal friends. A's transportation expenses to City X and return to his home are deductible but his transportation expenses to City Y are not deductible. A's expenses for meals and lodging while away from home will be allocated between his educational pursuits and his personal activities. Those expenses which are entirely personal, such as sightseeing and entertaining friends, are not deductible to any extent.

Example (2). The facts are the same as in example (1) except that A's primary purpose in going to City X is to take a vacation. This purpose is indicated by several factors, one of which is the fact that he spends only 1 week attending the tax course and devotes 5 weeks entirely to personal activities. None of A's transportation expenses are deductible and his expenses for meals and lodging while away from home are not deductible to the extent attributable to personal activities. His expenses for meals and lodging allocable to the week attending the tax course are, however, deductible.

Example (3). B, a high school mathematics teacher in New York City, in the summertime travels to a university in California in order to take a mathematics course the expense of which is deductible under this section. B pursues only one-fourth of a full course of study and the remainder of her time is devoted to personal activities the expense of which is not deductible. Absent a showing by B of a substantial nonpersonal reason for taking the course in the university in California, the trip is considered taken primarily for personal reasons and the cost of traveling from New York City to California and return would not be deductible. However, one-fourth of the cost of B's meals and lodging while attending the university in California may be considered properly allocable to deductible educational pursuits and, therefore, is deductible.

[T.D. 6918, 32 FR 6679, May 2, 1967]

§1.162–6 Professional expenses.

A professional man may claim as deductions the cost of supplies used by him in the practice of his profession, expenses paid or accrued in the operation and repair of an automobile used in making professional calls, dues to professional societies and subscriptions to professional journals, the rent paid or accrued for office rooms, the cost of the fuel, light, water, telephone, etc., used in such offices, and the hire of office assistance. Amounts currently paid or accrued for books, furniture, and professional instruments and equipment, the useful life of which is short, may be deducted.

§1.162–7 Compensation for personal services.

(a) There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

(b) The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

(4) For disallowance of deduction in the case of certain transfers of stock pursuant to employees stock options, see section 421 and the regulations thereunder.

§1.162–8 Treatment of excessive compensation.

The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend. If such payments constitute payment for property, they should be treated by the payor as a capital expenditure and by the recipient as part of the purchase price. In the absence of evidence to justify other treatment, excessive payments for salaries or other compensation for personal services will be included in gross income of the recipient.

§1.162–9 Bonuses to employees.

Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or which are in excess of reasonable compensation for services, are not deductible from gross income.

§1.162–10 Certain employee benefits.

(a) *In general.* Amounts paid or accrued by a taxpayer on account of injuries received by employees and lump sum amounts paid or accrued as compensation for injuries, are proper deductions as ordinary and necessary expenses. Such deductions are limited to the amount not compensated for by insurance or otherwise. Amounts paid or accrued within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan, are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business. However, except as provided in paragraph (b) of this section, such amounts shall not be deductible under section 162(a) if, under any circumstances, they may be used to provide benefits under a stock bonus, pension, annuity, profit-sharing, or other deferred compensation plan of the type referred to in section 404(a). In such an event, the extent to which these amounts are deductible from gross income shall be governed by the provisions of section 404 and the regulations issued thereunder.

(b) *Certain negotiated plans.* (1) Subject to the limitations set forth in subparagraphs (2) and (3) of this paragraph, contributions paid by an employer under a plan under which such contributions are held in a welfare trust for the purpose of paying (either from principal or income or both) for the benefit of employees, their families, and dependents, at least medical or hospital care, and pensions on retirement or death of employees, are deductible when paid as business expenses under section 162(a).

(2) For the purpose of subparagraph (1) of this paragraph, the word ‘‘plan’’ means any plan established prior to January 1, 1954, as a result of an agreement between employee representatives and the Government of the United States, during a period of Government operation, under seizure powers, of a major part of the productive facilities of the industry in which the employer claiming the deduction is engaged. The phrase ‘‘plan established prior to January 1, 1954, as a result of an agreement’’ is intended primarily to cover a trust established under the terms of such an agreement. It also includes a trust established under a plan of an employer, or group of employers, who, by reason of producing the same commodity, are in competition with the employers whose facilities were seized and who would therefore be expected to establish such a trust as a reasonable measure to maintain a sound position in the labor market producing the commodity. For example, if a trust was established under such an agreement in the bituminous coal industry, a similar trust established in the anthracite coal industry within a reasonable time, but before January 1, 1954, would qualify under subparagraph (1) of this paragraph.

(3) If any trust described in subparagraph (2) of this paragraph becomes qualified for exemption from tax under the provisions of section 501(a), the deductibility of contributions by an employer to such trust on or after any date of such qualification shall no longer be governed by the provisions of section 162, even though the trust may later lose its exemption from tax under section 501(a).

(c) *Other plans providing deferred compensation.* For rules relating to the deduction of amounts paid to or under a stock bonus, pension, annuity, or profit-sharing plan or amounts paid or accrued under any other plan deferring the receipt of compensation, see section 404 and the regulations thereunder.

§ 1.162–10T Questions and answers relating to the deduction of employee benefits under the Tax Reform Act of 1984; certain limits on amounts deductible (temporary).

Q–1: How does the amendment of section 404(b) by the Tax Reform Act of 1984 affect the deduction of employee benefits under section 162 of the Internal Revenue Code?

A–1: As amended by the Tax Reform Act of 1984, section 404(b) clarifies that section 404(a) and (d) (in the case of employees and nonemployees, respectively) shall govern the deduction of contributions paid or compensation paid or incurred under a plan, or method or arrangement, deferring the receipt of compensation or providing for deferred benefits. Section 404(a) and (d) requires that such a contribution or compensation be paid or incurred for purposes of section 162 or 212 and satisfy the requirements for deductibility under either of these sections. However, notwithstanding the above, section 404 does not apply to contributions paid or accrued with respect to a ‘‘welfare benefit fund’’ (as defined in section 419(e)) after July 18, 1984, in taxable years of employers (and payors) ending after that date.

Also, section 463 shall govern the deduction of vacation pay by a taxpayer that has elected the application of such section. Section 404(b), as amended, generally applies to contributions paid and compensation paid or incurred after July 18, 1984, in taxable years of employers (and payors) ending after that date. See Q&A–3 of § 1.404(b)–1T. For rules relating to the deduction of contributions attributable to the provision of deferred benefits, see section 404 (a), (b) and (d) and § 1.404(a)–1T, § 1.404(b)–1T and § 1.404(d)–1T. For rules relating to the deduction of contributions paid or accrued with respect to a welfare benefit fund, see section 419, § 1.419–1T and § 1.419A–2T. For rules relating to the deduction of vacation pay for which an election is made under section 463, see § 301.9100–16T of this chapter and § 1.463–1T.

Q–2: How does the enactment of section 419 by the Tax Reform Act of 1984 affect the deduction of employee benefits under section 162?

A–2: As enacted by the Tax Reform Act of 1984, section 419 shall govern the deduction of contributions paid or accrued by an employer (or a person receiving services under section 419(g)) with respect to a ‘‘welfare benefit fund’’ (within the meaning of section 419(e)) after December 31, 1985, in taxable years of the employer (or person receiving the services) ending after that date. Section 419(a) requires that such a contribution be paid or accrued for purposes of section 162 or 212 and satisfy the requirements for deductibility under either of those sections. Generally, subject to a binding contract exception (as described in section 511(e)(5) of the Tax Reform Act of 1984), section 419 shall also govern the deduction of the contribution of a facility (or other contribution used to acquire or improve a facility) to a welfare benefit fund after June 22, 1984. See Q&A–11 of § 1.419–1T. In the case of a welfare benefit fund maintained pursuant to a collective bargaining agreement, section 419 applies to the extent provided under the special effective date rule described in Q&A–2 of § 1.419–1T and the special rules of § 1.419A–2T. For rules relating to the deduction of contributions paid or accrued with respect to a welfare benefit fund, see section 419 and § 1.419–1T.

[T.D. 8073, 51 FR 4319, Feb. 4, 1986, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

§ 1.162–11 Rentals.

(a) *Acquisition of a leasehold.* If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. For disallowance of deduction for income taxes paid by a lessee corporation pursuant to a lease arrangement with the lessor corporation, see section 110 and the regulations thereunder. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in amortizing the costs incurred after July 28, 1958 of acquiring a lease.

(b) *Improvements by lessee on lessor's property.* (1) The cost to a lessee of erecting buildings or making permanent improvements on property of which he is the lessee is a capital investment, and is not deductible as a business expense. If the estimated useful life in the hands of the taxpayer of the building erected or of the improvements made, determined without regard to the terms of the lease, is longer than the remaining period of the lease, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining in the term of the lease, and such deduction shall be in lieu of a deduction for depreciation. If, on the other hand, the useful life of such buildings or improvements in the hands of the taxpayer is equal to or shorter than the remaining period of the lease, this deduction shall be computed under the provisions of section 167 (relating to depreciation).

(2) If the lessee began improvements on leased property before July 28, 1958, or if the lessee was on such date and at all times thereafter under a binding legal obligation to make such improvements, the matter of spreading the cost of erecting buildings or making permanent improvements over the term of the original lease, together with the renewal period or periods depends upon the facts in the particular case, including the presence or absence of an obligation of renewal and the relationship between the parties. As a general rule, unless the lease has been renewed or the facts show with reasonable certainty that the lease will be renewed, the cost or other basis of the lease, or the cost of improvements shall be spread only over the number of years the lease has to run without taking into account any right of renewal. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). A subsidiary corporation leases land from its parent at a fair rental for a 25-year period. The subsidiary erects on the land valuable factory buildings having an estimated useful life of 50 years. These facts show with reasonable certainty that the lease will be renewed, even though the lease contains no option of renewal. Therefore, the cost of the buildings shall be depreciated over the estimated useful life of the buildings in accordance with section 167 and the regulations thereunder.

Example (2). A retail merchandising corporation leases land at a fair rental from an unrelated lessor for the longest period that the lessor is willing to lease the land (30 years). The lessee erects on the land a department store having an estimated useful life of 40 years. These facts do not show with reasonable certainty that the lease will be renewed. Therefore, the cost of the building shall be spread over the remaining term of the lease. An annual deduction may be made of an amount equal to the cost of the building divided by the number of years remaining in the term of the lease, and such deduction shall be in lieu of a deduction for depreciation.

(3) See section 178 and the regulations thereunder for rules governing the effect to be given renewal options where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make.

[T.D. 6520, 25 FR 13692, Dec. 24, 1960]

§1.162–12 Expenses of farmers.

(a) *Farms engaged in for profit.* A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be deducted. The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. For rules regarding the capitalization of expenses of producing property in the trade or business of farming, see section 263A and the regulations thereunder. For taxable years beginning after July 12, 1972, where a farmer is engaged in producing crops and the process of gathering and disposal of such crops is not completed within the taxable year in which such crops were planted, expenses deducted may, with the consent of the Commissioner (see section 446 and the regulations thereunder), be determined upon the crop method, and such deductions must be taken in the taxable year in which the gross income from the crop has been realized. For taxable years beginning on or before July 12, 1972, where a farmer is engaged in producing crops which take more than a year from the time of planting to the process of gathering and disposal, expenses deducted may, with the consent of the Commissioner (see section 446 and the regulations thereunder), be determined upon the crop method, and such deductions must be taken in the taxable year in which the gross income from the crop has been realized. If a farmer does not compute income upon the crop method, the cost of seeds and young plants which are purchased for further development and cultivation prior to sale in later years may be deducted as an expense for the year of purchase, provided the farmer follows a consistent practice of deducting such costs as an expense from year to year. The preceding sentence does not apply to the cost of seeds and young plants connected with the planting of timber (see section 611 and the regulations thereunder). For rules regarding the capitalization of expenses of producing property in the trade or business of farming, see section 263A and § 1.263A–4T. The cost of farm machinery, equipment, and farm buildings represents a capital investment and is not an allowable deduction as an item of expense. Amounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached may, at the election of the taxpayer, be regarded as investments of capital. For the treatment of soil and water conservation expenditures as expenses which are not chargeable to capital account, see section 175 and the regulations thereunder. For taxable years beginning after December 31, 1959, in the case of expenditures paid or incurred by farmers for fertilizer, lime, etc., see section 180 and the regulations thereunder. Amounts expended in purchasing work, breeding, dairy, or sporting animals are regarded as investments of capital, and shall be depreciated unless such animals are included in an inventory in accordance with § 1.61–4. The purchase price of an automobile, even when wholly used in carrying on farming operations, is not deductible, but is regarded as an investment of capital. The cost of gasoline, repairs, and upkeep of an automobile if used wholly in the business of farming is deductible as an expense; if used partly for business purposes and partly for the pleasure or convenience of the taxpayer or his family, such cost may be apportioned according to the extent of the use for purposes of business and pleasure or convenience, and only the proportion of such cost justly attributable to business purposes is deductible as a necessary expense.

(b) *Farms not engaged in for profit; taxable years beginning before January 1, 1970*—(1) *In general.* If a farm is operated for recreation or pleasure and not on a commercial basis, and if the expenses incurred in connection with the farm are in excess of the receipts therefrom, the entire receipts from the sale of farm products may be ignored in rendering a return of income, and the expenses incurred, being regarded as personal expenses, will not constitute allowable deductions.

(2) *Effective date.* The provisions of this paragraph shall apply with respect to taxable years beginning before January 1, 1970.

(3) *Cross reference.* For provisions relating to activities not engaged in for profit, applicable to taxable years beginning after December 31, 1969, see section 183 and the regulations thereunder.

[T.D. 7198, 37 FR 13679, July 13, 1972, as amended by T.D. 8729, 62 FR 44546, Aug. 22, 1997]

§ 1.162–13 Depositors' guaranty fund.

Banking corporations which pursuant to the laws of the State in which they are doing business are required to set apart, keep, and maintain in their banks the amount levied and assessed against them by the State authorities as a ''Depositors' guaranty fund,'' may deduct from their gross income the amount so set apart each year to this fund provided that such fund, when set aside and carried to the credit of the State banking board or duly authorized State officer, ceases to be an asset of the bank and may be withdrawn in whole or in part upon demand by such board or State officer to meet the needs of these officers in reimbursing depositors in insolvent banks, and provided further that no portion of the amount thus set aside and credited is returnable under the laws of the State to the assets of the banking corporation. If, however, such amount is simply set up on the books of the bank as a reserve to meet a contingent liability and remains an asset of the bank, it will not be deductible except as it is actually paid out as required by law and upon demand of the proper State officers.

§1.162–14 Expenditures for advertising or promotion of good will.

A corporation which has, for the purpose of computing its excess profits tax credit under Subchapter E, Chapter 2, or Subchapter D, Chapter 1 of the Internal Revenue Code of 1939, elected under section 733 or section 451 (applicable to the excess profits tax imposed by Subchapter E of Chapter 2, and Subchapter D of Chapter 1, respectively) to charge to capital account for taxable years in its base period expenditures for advertising or the promotion of good will which may be regarded as capital investments, may not deduct similar expenditures for the taxable year. See section 263(b). Such a taxpayer has the burden of proving that expenditures for advertising or the promotion of good will which it seeks to deduct in the taxable year may not be regarded as capital investments under the provisions of the regulations prescribed under section 733 or section 451 of the Internal Revenue Code of 1939. See 26 CFR, 1938 ed., 35.733–2 (Regulations 112) and 26 CFR (1939) 40.451–2 (Regulations 130). For the disallowance of deductions for the cost of advertising in programs of certain conventions of political parties, or in publications part of the proceeds of which directly or indirectly inures (or is intended to inure) to or for the use of a political party or political candidate, see §1.276–1.

[T.D. 6996, 34 FR 835, Jan. 18, 1969]

§1.162–15 Contributions, dues, etc.

(a) *Contributions to organizations described in section 170*—(1) *In general.* No deduction is allowable under section 162(a) for a contribution or gift by an individual or a corporation if any part thereof is deductible under section 170. For example, if a taxpayer makes a contribution of $5,000 and only $4,000 of this amount is deductible under section 170(a) (whether because of the percentage limitation under either section 170(b) (1) or (2), the requirement as to time of payment, or both) no deduction is allowable under section 162(a) for the remaining $1,000.

(2) *Scope of limitations.* The limitations provided in section 162(b) and this paragraph apply only to payments which are in fact contributions or gifts to organizations described in section 170. For example, payments by a transit company to a local hospital (which is a charitable organization within the meaning of section 170) in consideration of a binding obligation on the part of the hospital to provide hospital services and facilities for the company's employees are not contributions or gifts within the meaning of section 170 and may be deductible under section 162(a) if the requirements of section 162(a) are otherwise satisfied.

(b) *Other contributions.* Donations to organizations other than those described in section 170 which bear a direct relationship to the taxpayer's business and are made with a reasonable expectation of a financial return commensurate with the amount of the donation may constitute allowable deductions as business expenses, provided the donation is not made for a purpose for which a deduction is not allowable by reason of the provisions of paragraph (b)(1)(i) or (c) of §1.162–20. For example, a transit company may donate a sum of money to an organization (of a class not referred to in section 170) intending to hold a convention in the city in which it operates, with a reasonable expectation that the holding of such convention will augment its income through a greater number of people using its transportation facilities.

(c) *Dues.* Dues and other payments to an organization, such as a labor union or a trade association, which otherwise meet the requirements of the regulations under section 162, are deductible in full. For limitations on the deductibility of dues and other payments, see paragraph (b) and (c) of § 1.162–20.

(d) *Cross reference.* For provisions dealing with expenditures for institutional or ''good will'' advertising, see § 1.162–20.

[T.D. 6819, 30 FR 5580, Apr. 20, 1965]

§ 1.162–16 Cross reference.

For special rules relating to expenses in connection with subdividing real property for sale, see section 1237 and the regulations thereunder.

§ 1.162–17 Reporting and substantiation of certain business expenses of employees.

(a) *Introductory.* The purpose of the regulations in this section is to provide rules for the reporting of information on income tax returns by taxpayers who pay or incur ordinary and necessary business expenses in connection with the performance of services as an employee and to furnish guidance as to the type of records which will be useful in compiling such information and in its substantiation, if required. The rules prescribed in this section do not apply to expenses paid or incurred for incidentals, such as office supplies for the employer or local transportation in connection with an errand. Employees incurring such incidental expenses are not required to provide substantiation for such amounts. The term ''ordinary and necessary business expenses'' means only those expenses which are ordinary and necessary in the conduct of the taxpayer's business and are directly attributable to such business. The term does not include nondeductible personal, living or family expenses.

(b) *Expenses for which the employee is required to account to his employer*—(1) *Reimbursements equal to expenses.* The employee need not report on his tax return (either itemized or in total amount) expenses for travel, transportation, entertainment, and similar purposes paid or incurred by him solely for the benefit of his employer for which he is required to account and does account to his employer and which are charged directly or indirectly to the employer (for example, through credit cards) or for which the employee is paid through advances, reimbursements, or otherwise, provided the total amount of such advances, reimbursements, and charges is equal to such expenses. In such a case the taxpayer need only state in his return that the total of amounts charged directly or indirectly to his employer through credit cards or otherwise and received from the employer as advances or reimbursements did not exceed the ordinary and necessary business expenses paid or incurred by the employee.

(2) *Reimbursements in excess of expenses.* In case the total of amounts charged directly or indirectly to the employer and received from the employer as advances, reimbursements, or otherwise, exceeds the ordinary and necessary business expenses paid or incurred by the employee and the employee is required to and does account to his employer for such expenses, the taxpayer must include such excess in income and state on his return that he has done so.

(3) *Expenses in excess of reimbursements.* If the employee's ordinary and necessary business expenses exceed the total of the amounts charged directly or indirectly to the employer and received from the employer as advances, reimbursements, or otherwise, and the employee is required to and does account to his employer for such expenses, the taxpayer may make the statement in his return required by subparagraph (1) of this paragraph unless he wishes to claim a deduction for such excess. If, however, he wishes to secure a deduction for such excess, he must submit a statement showing the following information as part of his tax return:

(i) The total of any charges paid or borne by the employer and of any other amounts received from the employer for payment of expenses whether by means of advances, reimbursements or otherwise; and

(ii) The nature of his occupation, the number of days away from home on business, and the total amount of ordinary and necessary business expenses paid or incurred by him (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses.

(4) To ''account'' to his employer as used in this section means to submit an expense account or other required written statement to the employer showing the business nature and the amount of all the employee's expenses (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses. For this purpose, the Commissioner in his discretion may approve reasonable business practices under which mileage, per diem in lieu of subsistence, and similar allowances providing for ordinary and necessary business expenses in accordance with a fixed scale may be regarded as equivalent to an accounting to the employer.

(c) *Expenses for which the employee is not required to account to his employer.* If the employee is not required to account to his employer for his ordinary and necessary business expenses, e.g., travel, transportation, entertainment, and similar items, or, though required, fails to account for such expenses, he must submit, as a part of his tax return, a statement showing the following information:

(1) The total of all amounts received as advances or reimbursements from his employer in connection with the ordinary and necessary business expenses of the employee, including amounts charged directly or indirectly to the employer through credit cards or otherwise; and

(2) The nature of his occupation, the number of days away from home on business, and the total amount of ordinary and necessary business expenses paid or incurred by him (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses.

(d) *Substantiation of items of expense.* (1) Although the Commissioner may require any taxpayer to substantiate such information concerning expense accounts as may appear to be pertinent in determining tax liability, taxpayers ordinarily will not be called upon to substantiate expense account information except those in the following categories:

(i) A taxpayer who is not required to account to his employer, or who does not account;

(ii) A taxpayer whose expenses exceed the total of amounts charged to his employer and amounts received through advances, reimbursements or otherwise and who claims a deduction on his return for such excess;

(iii) A taxpayer who is related to his employer within the meaning of section 267(b); and

(iv) Other taxpayers in cases where it is determined that the accounting procedures used by the employer for the reporting and substantiation of expenses by employees are not adequate.

(2) The Code contemplates that taxpayers keep such records as will be sufficient to enable the Commissioner to correctly determine income tax liability. Accordingly, it is to the advantage of taxpayers who may be called upon to substantiate expense account information to maintain as adequate and detailed records of travel, transportation, entertainment, and similar business expenses as practical since the burden of proof is upon the taxpayer to show that such expenses were not only paid or incurred but also that they constitute ordinary and necessary business expenses. One method for substantiating expenses incurred by an employee in connection with his employment is through the preparation of a daily diary or record of expenditures, maintained in sufficient detail to enable him to readily identify the amount and nature of any expenditure, and the preservation of supporting documents, especially in connection with large or exceptional expenditures. Nevertheless, it is recognized that by reason of the nature of certain expenses or the circumstances under which they are incurred, it is often difficult for an employee to maintain detailed records or to preserve supporting documents

for all his expenses. Detailed records of small expenditures incurred in traveling or for transportation, as for example, tips, will not be required.

(3) Where records are incomplete or documentary proof is unavailable, it may be possible to establish the amount of the expenditures by approximations based upon reliable secondary sources of information and collateral evidence. For example, in connection with an item of traveling expense a taxpayer might establish that he was in a travel status a certain number of days but that it was impracticable for him to establish the details of all his various items of travel expense. In such a case rail fares or plane fares can usually be ascertained with exactness and automobile costs approximated on the basis of mileage covered. A reasonable approximation of meals and lodging might be based upon receipted hotel bills or upon average daily rates for such accommodations and meals prevailing in the particular community for comparable accommodations. Since detailed records of incidental items are not required, deductions for these items may be based upon a reasonable approximation. In cases where a taxpayer is called upon to substantiate expense account information, the burden is on the taxpayer to establish that the amounts claimed as a deduction are reasonably accurate and constitute ordinary and necessary business expenses paid or incurred by him in connection with his trade or business. In connection with the determination of factual matters of this type, due consideration will be given to the reasonableness of the stated expenditures for the claimed purposes in relation to the taxpayer's circumstances (such as his income and the nature of his occupation), to the reliability and accuracy of records in connection with other items more readily lending themselves to detailed recordkeeping, and to all of the facts and circumstances in the particular case.

(e) *Applicability.* (1) Except as provided in subparagraph (2) of this paragraph, the provisions of the regulations in this section are supplemental to existing regulations relating to information required to be submitted with income tax returns, and shall be applicable with respect to taxable years beginning after December 31, 1957, notwithstanding any existing regulation to the contrary.

(2) With respect to taxable years ending after December 31, 1962, but only in respect of periods after such date, the provisions of the regulations in this section are superseded by the regulations under section 274(d) to the extent inconsistent therewith. See § 1.274–5.

(3) For taxable years beginning on or after January 1, 1989, the provisions of this section are superseded by the regulations under section 62(c) to the extent this section is inconsistent with those regulations. See § 1.62–2.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6630, 27 FR 12935, Dec. 29, 1962; T.D. 8276, 54 FR 51026, Dec. 12, 1989; T.D. 8324, 55 FR 51695, Dec. 17, 1990]

§ 1.162–18 Illegal bribes and kickbacks.

(a) *Illegal payments to government officials or employees*—(1) *In general.* No deduction shall be allowed under section 162(a) for any amount paid or incurred, directly or indirectly, to an official or employee of any government, or of any agency or other instrumentality of any government, if—

(i) In the case of a payment made to an official or employee of a government other than a foreign government described in subparagraph (3) (ii) or (iii) of this paragraph, the payment constitutes an illegal bribe or kickback, or

(ii) In the case of a payment made to an official or employee of a foreign government described in subparagraph (3) (ii) or (iii) of this paragraph, the making of the payment would be unlawful under the laws of the United States (if such laws were applicable to the payment and to the official or employee at the time the expenses were paid or incurred).

No deduction shall be allowed for an accrued expense if the eventual payment thereof would fall within the prohibition of this section. The place where the expenses are paid or incurred is immaterial. For purposes of subdivision (ii) of this subparagraph, lawfulness, or unlawfulness of the payment under the laws of the foreign country is immaterial.

(2) *Indirect payment.* For purposes of this paragraph, an indirect payment to an individual shall include any payment which inures to his benefit or promotes his interests, regardless of the medium in which the payment is made and regardless of the identity of the immediate recipient or payor. Thus, for example, payment made to an agent, relative, or independent contractor of an official or employee, or even directly into the general treasury of a foreign country of which the beneficiary is an official or employee, may be treated as an indirect payment to the official or employee, if in fact such payment inures or will inure to his benefit or promotes or will promote his financial or other interests. A payment made by an agent or independent contractor of the taxpayer which benefits the taxpayer shall be treated as an indirect payment by the taxpayer to the official or employee.

(3) *Official or employee of a government.* Any individual officially connected with—

(i) The Government of the United States, a State, a territory or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico,

(ii) The government of a foreign country, or

(iii) A political subdivision of, or a corporation or other entity serving as an agency or instrumentality of, any of the above,

in whatever capacity, whether on a permanent or temporary basis, and whether or not serving for compensation, shall be included within the term ‘‘official or employee of a government’’, regardless of the place of residence or post of duty of such individual. An independent contractor would not ordinarily be considered to be an official or employee. For purposes of section 162(c) and this paragraph, the term ‘‘foreign country’’ shall include any foreign nation, whether or not such nation has been accorded diplomatic recognition by the United States. Individuals who purport to act on behalf of or as the government of a foreign nation, or an agency or instrumentality thereof, shall be treated under this section as officials or employees of a foreign government, whether or not such individuals in fact control such foreign nation, agency, or instrumentality, and whether or not such individuals are accorded diplomatic recognition. Accordingly, a group in rebellion against an established government shall be treated as officials or employees of a foreign government, as shall officials or employees of the government against which the group is in rebellion.

(4) *Laws of the United States.* The term ‘‘laws of the United States’’, to which reference is made in paragraph (a)(1)(ii) of this section, shall be deemed to include only Federal statutes, including State laws which are assimilated into Federal law by Federal statute, and legislative and interpretative regulations thereunder. The term shall also be limited to statutes which prohibit some act or acts, for the violation of which there is a civil or criminal penalty.

(5) *Burden of proof.* In any proceeding involving the issue of whether, for purposes of section 162(c)(1), a payment made to a government official or employee constitutes an illegal bribe or kickback (or would be unlawful under the laws of the United States) the burden of proof in respect of such issue shall be upon the Commissioner to the same extent as he bears the burden of proof in civil fraud cases under section 7454 (i.e., he must prove the illegality of the payment by clear and convincing evidence).

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

Example. X Corp. is in the business of selling hospital equipment in State Y. During 1970, X Corp. employed A who at the time was employed full time by State Y as Superintendent of Hospitals. The purpose of A’s employment by X Corp. was to procure for it an improper advantage over other concerns in the making of sales to hospitals in respect of which A, as Superintendent, had authority. X Corp. paid A $5,000 during 1970. The making of this payment was illegal under the laws of State Y. Under section 162(c)(1), X Corp. is precluded from deducting as a trade or business expense the $5,000 paid to A.

(b) *Other illegal payments*—(1) *In general.* No deduction shall be allowed under section 162(a) for any payment (other than a payment described in paragraph (a) of this section) made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under the laws of the United States (as defined in paragraph (a)(4) of this section), or under any State law (but only if such State law is generally enforced), which subjects the payor to a criminal penalty or the loss (including a suspension) of license or privilege to engage in a trade or business (whether or not such penalty or loss is actually imposed upon the taxpayer). For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer. This paragraph applies only to payments made after December 30, 1969.

(2) *State law.* For purposes of this paragraph, State law means a statute of a State or the District of Columbia.

(3) *Generally enforced.* For purposes of this paragraph, a State law shall be considered to be generally enforced unless it is never enforced or the only persons normally charged with violations thereof in the State (or the District of Columbia) enacting the law are infamous or those whose violations are extraordinarily flagrant. For example, a criminal statute of a State shall be considered to be generally enforced unless violations of the statute which are brought to the attention of appropriate enforcement authorities do not result in any enforcement action in the absence of unusual circumstances.

(4) *Burden of proof.* In any proceeding involving the issue of whether, for purposes of section 162(c)(2), a payment constitutes an illegal bribe, illegal kickback, or other illegal payment the burden of proof in respect of such issue shall be upon the Commissioner to the same extent as he bears the burden of proof in civil fraud cases under section 7454 (i.e., he must prove the illegality of the payment by clear and convincing evidence).

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

Example. X Corp., a calendar-year taxpayer, is engaged in the ship repair business in State Y. During 1970, repairs on foreign ships accounted for a substantial part of its total business. It was X Corp.'s practice to kick back approximately 10 percent of the repair bill to the captain and chief engineer of all foreign-owned vessels, which kickbacks are illegal under a law of State Y (which is generally enforced) and potentially subject X Corp. to fines. During 1970, X Corp. paid $50,000 in such kickbacks. On X Corp.'s return for 1970, a deduction under section 162 was taken for the $50,000. The deduction of the $50,000 of illegal kickbacks during 1970 is disallowed under section 162(c)(2), whether or not X Corp. is prosecuted with respect to the kickbacks.

(c) *Kickbacks, rebates, and bribes under medicare and medicaid.* No deduction shall be allowed under section 162(a) for any kickback, rebate, or bribe (whether or not illegal) made on or after December 10, 1971, by any provider of services, supplier, physician, or other person who furnishes items or services for which payment is or may be made under the Social Security Act, as amended, or in whole or in part out of Federal funds under a State plan approved under such Act, if such kickback, rebate, or bribe is made in connection with the furnishing of such items or services or the making or receipt of such payments. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer.

[T.D. 7345, 40 FR 7437, Feb. 20, 1975; 40 FR 8948, Mar. 4, 1975]

§ 1.162–19 Capital contributions to Federal National Mortgage Association.

(a) *In general.* The initial holder of stock of the Federal National Mortgage Association (FNMA) which is issued pursuant to section 303(c) of the Federal National Mortgage Association Charter Act (12 U.S.C., section 1718) in a taxable year beginning after December 31, 1959, shall treat the excess, if any, of the issuance price (the amount of capital contributions evidenced by a share of stock) over the fair market value of the stock as of the issue date of such stock as an ordinary and necessary business expense paid or incurred during the year in which occurs the date of issuance of the stock. To the extent that a sale to FNMA of mortgage paper gives rise to the issuance of a share of FNMA stock during a taxable year beginning after December 31, 1959, such sale is to be treated in a manner consistent with the purpose for, and the legislative intent underlying the enactment of, the provisions of section 8, Act of September 14, 1960 (Pub. L. 86–779, 74 Stat. 1003). Thus, for the purpose of determining an initial holder's gain or loss from the sale to FNMA of mortgage paper, with respect to which a share of FNMA stock is issued in a taxable year beginning after December 31, 1959 (irrespective of when the sale is made), the amount realized by the initial holder from the sale of the mortgage paper is the amount of the ''FNMA purchase price''. The ''FNMA purchase price'' is the gross amount of the consideration agreed upon between FNMA and the initial holder for the purchase of the mortgage paper, without regard to any deduction therefrom as, for example, a deduction representing a capital contribution or a purchase or marketing fee. The date of issuance of the stock is the date which appears on the stock certificates of the initial holder as the date of issue. The initial holder is the original purchaser who is issued stock of the Federal National Mortgage Association pursuant to section 303(c) of the Act, and who appears on the books of FNMA as the initial holder. In determining the period for which the initial holder has held such stock, such period shall begin with the date of issuance.

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

Example (1). A, a banking institution which reports its income on a calendar year basis, sold mortgage paper with an outstanding principal balance of $12,500 to FNMA on October 17, 1960. The FNMA purchase price was $11,500. A's basis for the mortgage paper was $10,500. In accordance with the terms of the contract, FNMA deducted $375 ($250 representing capital contribution and $125 representing purchase and marketing fee) from the amount of the purchase price. FNMA credited A's account with the amount of the capital contribution. A stock certificate evidencing two shares of FNMA common stock of $100 par value was mailed to A and FNMA deducted $200 from A's account, leaving a net balance of $50 in such account. The stock certificate, bearing an issue date of November 1, 1960, was received by A on November 7, 1960. The fair market value of a share of FNMA stock on October 17, 1960, was $65, on November 1, 1960, was $67, and on November 7, 1960, was $68. A may deduct $66 the difference between the issuance price ($200) and the fair market value ($134) of the two shares of stock on the date of issuance (November 1, 1960), as a business expense for the taxable year 1960. The basis of each share of stock issued as of November 1, 1960 will be $67. See section 1054 and §1.1054–1. A's gain from the sale of the mortgage paper is $875 computed as follows:

Amount realized in FNMA purchase price		$11,500
A's basis in mortgage paper	$10,500	
Purchase and marketing fee	125	
		10,625
Gain on sale		875

Example (2). Assume the same facts as in Example (1), and, in addition, that A sold to FNMA on December 15, 1960, additional mortgage paper having an outstanding principal balance of $12,500. FNMA deducted from the FNMA purchase price $250 representing capital contribution and credited A's account with this amount. A then had a total credit of $300 to his account consisting of the $50 balance from the transaction described in Example (1) and $250 from the December 15th transaction. A stock certificate evidencing three shares of FNMA common stock of $100 par value was mailed to A and FNMA deducted $300 from A's account. The stock certificate, bearing an issue date of January 1, 1961, was received by A on January 9, 1961. The fair market value of a share of FNMA stock on January 1, 1961, was $69. A may deduct $93, the difference between the issuance price ($300) and the fair market value ($207) of the three shares of stock on the date of issuance (January 1, 1961), as a business expense for the taxable year 1961. The gain or loss on the sale of mortgage paper on December 15, 1960, is reportable for the taxable year 1960.

[T.D. 6690, 28 FR 12253, Nov. 19, 1963]

§1.162–20 Expenditures attributable to lobbying, political campaigns, attempts to influence legislation, etc., and certain advertising.

(a) *In general*—(1) *Scope of section.* This section contains rules governing the deductibility or nondeductibility of expenditures for lobbying purposes, for the promotion or defeat of legislation, for political campaign purposes (including the support of or opposition to any candidate for public office) or for carrying on propaganda (including advertising) related to any of the foregoing purposes. For rules applicable to such expenditures in respect of taxable years beginning before January 1, 1963, and for taxable years beginning after December 31, 1962, see paragraphs (b) and (c), respectively, of this section. This section also deals with expenditures for institutional or ‘‘good will'' advertising.

(2) *Institutional or ‘‘good will'' advertising.* Expenditures for institutional or ‘‘good will'' advertising which keeps the taxpayer's name before the public are generally deductible as ordinary and necessary business expenses provided the expenditures are related to the patronage the taxpayer might reasonably expect in the future. For example, a deduction will ordinarily be allowed for the cost of advertising which keeps the taxpayer's name before the public in connection with encouraging contributions to such organizations as the Red Cross, the purchase of United States Savings Bonds, or participation in similar causes. In like fashion, expenditures for advertising which presents views on economic, financial, social, or other subjects of a general nature, but which does not involve any of the activities specified in paragraph (b) or (c) of this section for which a deduction is not allowable, are deductible if they otherwise meet the requirements of the regulations under section 162.

(b) *Taxable years beginning before January 1, 1963*—(1) *In general.* (i) For taxable years beginning before January 1, 1963, expenditures for lobbying purposes, for the promotion or defeat of legislation, for political campaign purposes (including the support of or opposition to any candidate for public office), or for carrying on propaganda (including advertising) related to any of the foregoing purposes are not deductible from gross income. For example, the cost of advertising to promote or defeat legislation or to influence the public with respect to the desirability or undesirability of proposed legislation is not deductible as a business expense, even though the legislation may directly affect the taxpayer's business.

(ii) If a substantial part of the activities of an organization, such as a labor union or a trade association, consists of one or more of the activities specified in the first sentence of this subparagraph, deduction will be allowed only for such portion of the dues or other payments to the organization as the taxpayer can clearly establish is attributable to activities other than those so specified. The determination of whether such specified activities constitute a substantial part of an organization's activities shall be based on all the facts and circumstances. In no event shall special assessments or similar payments (including an increase in dues) made to any organization for any of such specified purposes be deductible. For other provisions relating to the deductibility of dues and other payments to an organization, such as a labor union or a trade association, see paragraph (c) of § 1.162–15.

(2) *Expenditures for promotion or defeat of legislation.* For purposes of this paragraph, expenditures for the promotion or the defeat of legislation include, but shall not be limited to, expenditures for the purpose of attempting to—

(i) Influence members of a legislative body directly, or indirectly by urging or encouraging the public to contact such members for the purpose of proposing, supporting, or opposing legislation, or

(ii) Influence the public to approve or reject a measure in a referendum, initiative, vote on a constitutional amendment, or similar procedure.

(c) *Taxable years beginning after December 31, 1962*—(1) *In general.* For taxable years beginning after December 31, 1962, certain types of expenses incurred with respect to legislative matters are deductible under section 162(a) if they otherwise meet the requirements of the regulations under section 162. These deductible expenses are described in subparagraph (2) of this paragraph. All other expenditures for lobbying purposes, for the promotion or defeat of legislation (see paragraph (b)(2) of this section), for political campaign purposes (including the support of or opposition to any candidate for public office), or for carrying on propaganda (including advertising) relating to any of the foregoing purposes are not deductible from gross income for such taxable years. For the disallowance of deductions for bad debts and worthless securities of a political party, see § 1.271–1. For the disallowance of deductions for certain indirect political contributions, such as the cost of certain advertising and the cost of admission to certain dinners, programs, and inaugural events, see §1.276–1.

(2) *Appearances, etc., with respect to legislation*—(i) *General rule.* Pursuant to the provisions of section 162(e), expenses incurred with respect to legislative matters which may be deductible are those ordinary and necessary expenses (including, but not limited to, traveling expenses described in section 162(a)(2) and the cost of preparing testimony) paid or incurred by the taxpayer during a taxable year beginning after December 31, 1962, in carrying on any trade or business which are in direct connection with—

(a) Appearances before, submission of statements to, or sending communications to, the committees, or individual members of Congress or of any legislative body of a State, a possession of the United States, or a political subdivision of any of the foregoing with respect to legislation or proposed legislation of direct interest to the taxpayer, or

(b) Communication of information between the taxpayer and an organization of which he is a member with respect to legislation or proposed legislation of direct interest to the taxpayer and to such organization.

For provisions relating to dues paid or incurred with respect to an organization of which the taxpayer is a member, see subparagraph (3) of this paragraph.

(ii) *Legislation or proposed legislation of direct interest to the taxpayer—(a) Legislation or proposed legislation.* The term ‘‘legislation or proposed legislation’’ includes bills and resolutions introduced by a member of Congress or other legislative body referred to in subdivision (i)*(a)* of this subparagraph for consideration by such body as well as oral or written proposals for legislative action submitted to the legislative body or to a committee or member of such body.

(b) Direct interest—(1) In general. (i) Legislation or proposed legislation is of direct interest to a taxpayer if the legislation or proposed legislation is of such a nature that it will, or may reasonably be expected to, affect the trade or business of the taxpayer. It is immaterial whether the effect, or expected effect, on the trade or business will be beneficial or detrimental to the trade or business or whether it will be immediate. If legislation or proposed legislation has such a relationship to a trade or business that the expenses of any appearance or communication in connection with the legislation meets the ordinary and necessary test of section 162(a), then such legislation ordinarily meets the direct interest test of section 162(e). However, if the nature of the legislation or proposed legislation is such that the likelihood of its having an effect on the trade or business of the taxpayer is remote or speculative, the legislation or proposed legislation is not of direct interest to the taxpayer. Legislation or proposed legislation which will not affect the trade or business of the taxpayer is not of direct interest to the taxpayer even though such legislation will affect the personal, living, or family activities or expenses of the taxpayer. Legislation or proposed legislation is not of direct interest to a taxpayer merely because it may affect business in general; however, if the legislation or proposed legislation will, or may reasonably be expected to, affect the taxpayer’s trade or business it will be of direct interest to the taxpayer even though it also will affect the trade or business of other taxpayers or business in general. To meet the direct interest test, it is not necessary that all provisions of the legislation or proposed legislation have an effect, or expected effect, on the taxpayer’s trade or business. The test will be met if one of the provisions of the legislation has the specified effect. Legislation or proposed legislation will be considered to be of direct interest to a membership organization if it is of direct interest to the organization, as such, or if it is of direct interest to one or more of its members.

(ii) Legislation which would increase or decrease the taxes applicable to the trade or business, increase or decrease the operating costs or earnings of the trade or business, or increase or decrease the administrative burdens connected with the trade or business meets the direct interest test. Legislation which would increase the social

security benefits or liberalize the right to such benefits meets the direct interest test because such changes in the social security benefits may reasonably be expected to affect the retirement benefits which the employer will be asked to provide his employees or to increase his taxes. Legislation which would impose a retailer's sales tax is of direct interest to a retailer because, although the tax may be passed on to his customers, collection of the tax will impose additional burdens on the retailer, and because the increased cost of his products to the consumer may reduce the demand for them. Legislation which would provide an income tax credit or exclusion for shareholders is of direct interest to a corporation, because those tax benefits may increase the sources of capital available to the corporation. Legislation which would favorably or adversely affect the business of a competitor so as to affect the taxpayer's competitive position is of direct interest to the taxpayer. Legislation which would improve the school system of a community is of direct interest to a membership organization comprised of employers in the community because the improved school system is likely to make the community more attractive to prospective employees of such employers. On the other hand, proposed legislation relating to Presidential succession in the event of the death of the President has only a remote and speculative effect on any trade or business and therefore does not meet the direct interest test. Similarly, if a corporation is represented before a congressional committee to oppose an appropriation bill merely because of a desire to bring increased Government economy with the hope that such economy will eventually cause a reduction in the Federal income tax, the legislation does not meet the direct interest test because any effect it may have upon the corporation's trade or business is highly speculative.

(2) Appearances, etc., by expert witnesses. (i) An appearance or communication (of a type described in paragraph (c)(2)(i)*(a)* of this section) by an individual in connection with legislation or proposed legislation shall be considered to be with respect to legislation of direct interest to such individual if the legislation is in a field in which he specializes as an employee, if the appearance or communication is not on behalf of his employer, and if it is customary for individuals in his type of employment to publicly express their views in respect of matters in their field of competence. Expenses incurred by such an individual in connection with such an appearance of communication, including traveling expenses properly allocable thereto, represent ordinary and necessary business expenses and are, therefore, deductible under section 162. For example, if a university professor who teaches in the field of money and banking appears, on his own behalf, before a legislative committee to testify on proposed legislation regarding the banking system, his expenses incurred in connection with such appearance are deductible under section 162 since university professors customarily take an active part in the development of the law in their field of competence and publicly communicate the results of their work.

(ii) An appearance or communication (of a type described in paragraph (c)(2)(i)*(a)* of this section) by an employee or self-employed individual in connection with legislation or proposed legislation shall be considered to be with respect to legislation of direct interest to such person if the legislation is in the field in which he specializes in his business (or as an employee) and if the appearance or communication is made pursuant to an invitation extended to him individually for the purpose of receiving his expert testimony. Expenses incurred by an employee or self-employed individual in connection with such an appearance or communication, including traveling expenses properly allocable thereto, represent ordinary and necessary business expenses and are, therefore, deductible under section 162. For example, if a self-employed individual is personally invited by a congressional committee to testify on proposed legislation in the

field in which he specializes in his business, his expenses incurred in connection with such appearance are deductible under section 162. If a self-employed individual makes an appearance, on his own behalf, before a legislative committee without having been extended an invitation his expenses will be deductible to the extent otherwise provided in this paragraph.

(3) Nominations, etc. A taxpayer does not have a direct interest in matters such as nominations, appointments, or the operation of the legislative body.

(iii) *Allowable expenses.* To be deductible under section 162(a), expenditures which meet the tests of deductibility under the provisions of this paragraph must also qualify as ordinary and necessary business expenses under section 162(a) and, in addition, be in direct connection with the carrying on of the activities specified in subdivision (i)*(a)* or (i)*(b)* of this subparagraph. For example, a taxpayer appearing before a committee of the Congress to present testimony concerning legislation or proposed legislation in which he has a direct interest may deduct the ordinary and necessary expenses directly connected with his appearance, such as traveling expenses described in section 162(a)(2), and the cost of preparing testimony.

(3) *Deductibility of dues and other payments to an organization.* If a substantial part of the activities of an organization, such as a labor union or a trade association, consists of one or more of the activities to which this paragraph relates (legislative matters, political campaigns, etc.), exclusive of any activity constituting an appearance or communication with respect to legislation or proposed legislation of direct interest to the organization (see subparagraph (c)(2)(ii)*(b)(1)*), a deduction will be allowed only for such portion of the dues or other payments to the organization as the taxpayer can clearly establish is attributable to activities to which this paragraph does not relate and to any activity constituting an appearance or communication with respect to legislation or proposed legislation of direct interest to the organization. The determination of whether a substantial part of an organization's activities consists of one or more of the activities to which this paragraph relates (exclusive of appearances or communications with respect to legislation or proposed legislation of direct interest to the organization) shall be based on all the facts and circumstances. In no event shall a deduction be allowed for that portion of a special assessment or similar payment (including an increase in dues) made to any organization for any activity to which this paragraph relates if the activity does not constitute an appearance or communication with respect to legislation or proposed legislation of direct interest to the organization. If an organization pays or incurs expenses allocable to legislative activities which meet the tests of subdivisions (i) and (ii) of subparagraph (2) of this paragraph (appearances or communications with respect to legislation or proposed legislation of direct interest to the organization), on behalf of its members, the dues paid by a taxpayer are deductible to the extent used for such activities. Dues paid by a taxpayer will be considered to be used for such an activity, and thus deductible, although the legislation or proposed legislation involved is not of direct interest to the taxpayer, if, pursuant to the provisions of subparagraph (2)(ii)*(b)(1)* of this paragraph, the legislation or proposed legislation is of direct interest to the organization, as such, or is of direct interest to one or more members of the organization. For other provisions relating to the deductibility of dues and other payments to an organization, such as a labor union or a trade association, see paragraph (c) of §1.162–15.

(4) *Limitations.* No deduction shall be allowed under section 162(a) for any amount paid or incurred (whether by way of contribution, gift, or otherwise) in connection with any attempt to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums. For example, no deduction shall be allowed for any expenses incurred in connection with ''grassroot'' campaigns or any other attempts to urge or encourage the public to contact members of a legislative body for the purpose of proposing, supporting, or opposing legislation.

(5) *Expenses paid or incurred after December 31, 1993, in connection with influencing legislation other than certain local legislation.* The provisions of paragraphs (c)(1) through (3) of this section are superseded for expenses paid or incurred after December 31, 1993, in connection with influencing legislation (other than certain local legislation) to the extent inconsistent with section 162(e)(1)(A) (as limited by section 162(e)(2)) and §§ 1.162–20(d) and 1.162–29.

(d) *Dues allocable to expenditures after 1993.* No deduction is allowed under section 162(a) for the portion of dues or other similar amounts paid by the taxpayer to an organization exempt from tax (other than an organization described in section 501(c)(3)) which the organization notifies the taxpayer under section 6033(e)(1)(A)(ii) is allocable to expenditures to which section 162(e)(1) applies. The first sentence of this paragraph (d) applies to dues or other similar amounts whether or not paid on or before December 31, 1993. Section 1.162–20(c)(3) is superseded to the extent inconsistent with this paragraph (d).

[T.D. 6819, 30 FR 5581, Apr. 20, 1965, as amended by T.D. 6996, 34 FR 835, Jan. 18, 1969; T.D. 8602, 60 FR 37573, July 21, 1995]

§ 1.162–21 Fines and penalties.

(a) *In general.* No deduction shall be allowed under section 162(a) for any fine or similar penalty paid to—

(1) The government of the United States, a State, a territory or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico;

(2) The government of a foreign country; or

(3) A political subdivision of, or corporation or other entity serving as an agency or instrumentality of, any of the above.

(b) *Definition.* (1) For purposes of this section a fine or similar penalty includes an amount—

(i) Paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding;

(ii) Paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Internal Revenue Code of 1954;

(iii) Paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or

(iv) Forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty.

(2) The amount of a fine or penalty does not include legal fees and related expenses paid or incurred in the defense of a prosecution or civil action arising from a violation of the law imposing the fine or civil penalty, nor court costs assessed against the taxpayer, or stenographic and printing charges. Compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.

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

Example (1). M Corp. was indicted under section 1 of the Sherman Anti-Trust Act (15 U.S.C. 1) for fixing and maintaining prices of certain electrical products. M Corp. was convicted and was fined $50,000. The United States sued M Corp. under section 4A of the Clayton Act (15 U.S.C. 15a) for $100,000, the amount of the actual damages resulting from the price fixing of which M Corp. was convicted. Pursuant to a final judgment entered in the civil action. M Corp. paid the United States $100,000 in damages. Section 162(f) precludes M Corp. from deducting the fine of $50,000 as a trade or business expense. Section 162(f) does not preclude it from deducting the $100,000 paid to the United States as actual damages.

Example (2). N Corp. was found to have violated 33 U.S.C. 1321(b)(3) when a vessel it operated discharged oil in harmful quantities into the navigable waters of the United States. A civil penalty under 33 U.S.C. 1321(b)(6) of $5,000 was assessed against N Corp. with respect to the discharge. N Corp. paid $5,000 to the Coast Guard in payment of the civil penalty. Section 162(f) precludes N Corp. from deducting the $5,000 penalty.

Example (3). O Corp., a manufacturer of motor vehicles, was found to have violated 42 U.S.C. 1857f–2(a)(1) by selling a new motor vehicle which was not covered by the required certificate of conformity. Pursuant to 42 U.S.C. 1857f–4, O Corp. was required to pay, and did pay, a civil penalty of $10,000. In addition, pursuant to 42 U.S.C. 1857f–5a(c)(1), O Corp. was required to expend, and did expend, $500 in order to remedy the nonconformity of that motor vehicle. Section 162(f) precludes O Corp. from deducting the $10,000 penalty as a trade or business expense, but does not preclude it from deducting the $500 which it expended to remedy the nonconformity.

Example (4). P Corp. was the operator of a coal mine in which occurred a violation of a mandatory safety standard prescribed by the Federal Coal Mine Health and Safety Act of 1969 (30 U.S.C. 801 et seq.). Pursuant to 30 U.S.C. 819(a), a civil penalty of $10,000 was assessed against P Corp., and P Corp. paid the penalty. Section 162(f) precludes P Corp. from deducting the $10,000 penalty.

Example (5). Q Corp., a common carrier engaged in interstate commerce by railroad, hauled a railroad car which was not equipped with efficient hand brakes, in violation of 45 U.S.C. 11. Q Corp. was found to be liable for a penalty of $250 pursuant to 45 U.S.C. 13. Q Corp. paid that penalty. Section 162(f) precludes Q Corp. from deducting the $250 penalty.

Example (6). R Corp. owned and operated on the highways of State X a truck weighing in excess of the amount permitted under the law of State X. R Corp. was found to have violated the law and was assessed a fine of $85 which it paid to State X. Section 162(f) precludes R Corp. from deducting the amount so paid.

Example (7). S Corp. was found to have violated a law of State Y which prohibited the emission into the air of particulate matter in excess of a limit set forth in a regulation promulgated under that law. The Environmental Quality Hearing Board of State Y assessed a fine of $500 against S Corp. The fine was payable to State Y, and S Corp. paid it. Section 162(f) precludes S Corp. from deducting the $500 fine.

Example (8). T Corp. was found by a magistrate of City Z to be operating in such city an apartment building which did not conform to a provision of the city housing code requiring operable fire escapes on apartment buildings of that type. Upon the basis of the magistrate's finding, T Corp. was required to pay, and did pay, a fine of $200 to City Z. Section 162(f) precludes T Corp. from deducting the $200 fine.

[T.D. 7345, 40 FR 7437, Feb. 20, 1975; 40 FR 8948, Mar. 4, 1975, as amended by T.D. 7366, 40 FR 29290, July 11, 1975]

§ 1.162–22 Treble damage payments under the antitrust laws.

(a) *In general.* In the case of a taxpayer who after December 31, 1969, either is convicted in a criminal action of a violation of the Federal antitrust laws or enters a plea of guilty or *nolo contendere* to an indictment or information charging such a violation, and whose conviction or plea does not occur in a new trial following an appeal of a conviction on or before such date, no deduction shall be allowed under section 162(a) for two-thirds of any amount paid or incurred after December 31, 1969, with respect to—

(1) Any judgment for damages entered against the taxpayer under section 4 of the Clayton Act (15 U.S.C. 15), as amended, on account of such violation or any related violation of the Federal antitrust laws, provided such related violation occurred prior to the date of the final judgment of such conviction, or

(2) Settlement of any action brought under such section 4 on account of such violation or related violation.

For the purposes of this section, where a civil judgment has been entered or a settlement made with respect to a violation of the antitrust laws and a criminal proceeding is based upon the same violation, the criminal proceeding need not have been brought prior to the civil judgment or settlement. If, in his return for any taxable year, a taxpayer claims a deduction for an amount paid or incurred with respect to a judgment or settlement described in the first sentence of this paragraph and is subsequently convicted of a violation of the antitrust laws which makes a portion of such amount unallowable, then the taxpayer shall file an amended return for such taxable year on which the amount of the deduction is appropriately reduced. Attorney's fees, court costs, and other amounts paid or incurred in connection with a controversy under such section 4 which meet the requirements of section 162 are deductible under that section. For purposes of subparagraph (2) of this paragraph, the amount paid or incurred in settlement shall not include amounts attributable to the plaintiff's costs of suit and attorney's fees, to the extent that such costs or fees have actually been paid.

(b) *Conviction.* For purposes of paragraph (a) of this section, a taxpayer is convicted of a violation of the antitrust laws if a judgment of conviction (whether or not a final judgment) with respect to such violation has been entered against him, provided a subsequent final judgment of acquittal has not been entered or criminal prosecution with respect to such violation terminated without a final judgment of conviction. During the pendency of an appeal or other action directly contesting a judgment of conviction, the taxpayer should file a protective claim for credit or refund to avoid being barred by the period of limitations on credit or refund under section 6511.

(c) *Related violation.* For purposes of this section, a violation of the Federal antitrust laws is related to a subsequent violation if (1) with respect to the subsequent violation the United States obtains both a judgment in a criminal proceeding and an injunction against the taxpayer, and (2) the taxpayer's actions which constituted the prior violation would have contravened such injunction if such injunction were applicable at the time of the prior violation.

(d) *Settlement following a dismissal of an action or amendment of the complaint.* For purposes of paragraph (a)(2) of this section, an amount may be considered as paid in settlement of an action even though the action is dismissed or otherwise disposed of prior to such settlement or the complaint is amended to eliminate the claim with respect to the violation or related violation.

(e) *Antitrust laws.* The term ''antitrust laws'' as used in section 162(g) and this section shall include the Federal acts enumerated in paragraph (1) of section 1 of the Clayton Act (15 U.S.C. 12), as amended.

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

Example (1). In 1970, the United States instituted a criminal prosecution against X Co., Y Co., A, the president of X Co., and B, the president of Y Co., under section 1 of the Sherman Anti-Trust Act, 15 U.S.C. 1. In the indictment, the defendants were charged with conspiring to fix and maintain prices of electrical transformers from 1965 to 1970. All defendants entered pleas of nolo contendere to these charges. These pleas were accepted and judgments of conviction entered. In a companion civil suit, the United States obtained an injunction prohibiting the defendants from conspiring to fix and maintain prices in the electrical transformer market. Thereafter, Z Co. sued X Co. and Y Co. for $300,000 in treble damages under section 4 of the Clayton Act. Z Co.'s complaint alleged that the criminal conspiracy between X Co. and Y Co. forced Z Co. to pay excessive prices for electrical transformers. X Co. and Y Co. each paid Z Co. $85,000 in full settlement of Z Co.'s action. Of each $85,000 paid, $10,000 was attributable to court costs and attorney's fees actually paid by Z Co. Under section 162(g), X Co. and Y Co. are each precluded from deducting as a trade or business expense more than $35,000 of the $85,000 paid to Z Co. in settlement—

$10,000+[($85,000−$10,000)÷3]

Example (2). Assume the same facts as in example (1) except that Z Co.'s claim for treble damages was based on a conspiracy to fix and maintain prices in the sale of electrical transformers during 1963. Although the criminal prosecution of the defendants did not involve 1963 (a year barred by the applicable criminal statute of limitations when the prosecution was instituted), Z Co.'s pleadings alleged that the civil statute of limitations had been tolled by the defendants' fraudulent concealment of their conspiracy. Since the United States has obtained both a judgment in a criminal proceeding and an injunction against the defendants in connection with their activities from 1965 to 1970, and the alleged actions of the defendants in 1963 would have contravened such injunction if it were applicable in 1963, the alleged violation in 1963 is related to the violation from 1965 to 1970. Accordingly, the tax consequences to X Co. and Y Co. of the payments of $85,000 in settlement of Z Co.'s claim against X Co. and Y Co. are the same as in example (1).

Example (3). Assume the same facts as in example (1) except that Z Co.'s claim for treble damages was based on a conspiracy to fix and maintain prices with respect to electrical insulators for high-tension power poles. Since the civil action was not based on the same violation of the Federal antitrust laws as the criminal action, or on a related violation (a violation which would have contravened the injunction if it were applicable), X Co. and Y Co. are not precluded by section 162(g) from deducting as a trade or business expense the entire $85,000 paid by each in settlement of the civil action.

[T.D. 7217, 37 FR 23916, Nov. 10, 1972]

§ 1.162–25 Deductions with respect to noncash fringe benefits.

(a) [Reserved]

(b) *Employee.* If an employer provides the use of a vehicle (as defined in § 1.61–21(e)(2)) to an employee as a noncash fringe benefit and includes the entire value of the benefit in the employee's gross income without taking into account any exclusion for a working condition fringe allowable under section 132 and the regulations thereunder, the employee may deduct that value multiplied by the percentage of the total use of the vehicle that is in connection with the employer's trade or business (business value). For taxable years beginning before January 1, 1990, the employee may deduct the business value from gross income in determining adjusted gross income. For taxable years beginning on or after January 1, 1990, the employee may deduct the business value only as a miscellaneous itemized deduction in determining taxable income, subject to the 2-percent floor provided in section 67. If the employer determines the value of the noncash fringe benefit under a special accounting rule that allows the employer to treat the value of benefits provided during the last two months of the calendar year or any shorter period as paid during the subsequent calendar year, then the employee must determine the deduction allowable under this paragraph (b) without regard to any use of the benefit during those last two months or any shorter period. The employee may not use a cents-per-mile valuation method to determine the deduction allowable under this paragraph (b).

[T.D. 8451, 57 FR 57669, Dec. 7, 1992; 57 FR 60568, Dec. 21, 1992]

§1.162–25T Deductions with respect to noncash fringe benefits (temporary).

(a) *Employer.* If an employer includes the value of a noncash fringe benefit in an employee's gross income, the employer may not deduct this amount as compensation for services, but rather may deduct only the costs incurred by the employer in providing the benefit to the employee. The employer may be allowed a cost recovery deduction under section 168 or a deduction under section 179 for an expense not chargeable to capital account, or, if the noncash fringe benefit is property leased by the employer, a deduction for the ordinary and necessary business expense of leasing the property.

(b) [Reserved]

(c) *Examples.* The following examples illustrate the provisions of this section.

Example (1). On January 1, 1986, X Company owns and provides the use of an automobile with a fair market value of $20,000 to E, an employee, for the entire calendar year. Both X and E compute taxable income on the basis of the calendar year. Seventy percent of the use of the automobile by E is in connection with X's trade or business. If X uses the special rule provided in §1.61–2T for valuing the availability of the automobile and takes into account the amount excludable as a working condition fringe, X would include $1,680 ($5,600, the Annual Lease Value, less 70 percent of $5,600) in E's gross income for 1986. X may not deduct the amount included in E's income as compensation for services. X may, however, determine a cost recovery deduction under section 168, subject to the limitations under section 280F, for taxable year 1986.

Example (2). The facts are the same as in example (1), except that X includes $5,600 in E's gross income, the value of the noncash fringe benefit without taking into account the amount excludable as a working condition fringe. X may not deduct that amount as compensation for services, but may determine a cost recovery deduction under section 168, subject to the limitations under section 280F. For purposes of determining adjusted gross income, E may deduct $3,920 ($5,600 multiplied by the percent of business use).

[T.D. 8061, 50 FR 46013, Nov. 6, 1985, as amended by T.D. 8063, 50 FR 52312, Dec. 23, 1985; T.D. 8276, 54 FR 51026, Dec. 12, 1989; T.D. 8451, 57 FR 57669, Dec. 7, 1992]

§1.162–27 Certain employee remuneration in excess of $1,000,000.

(a) *Scope.* This section provides rules for the application of the $1 million deduction limit under section 162(m) of the Internal Revenue Code. Paragraph (b) of this section provides the general rule limiting deductions under section 162(m). Paragraph (c) of this section provides definitions of generally applicable terms. Paragraph (d) of this section provides an exception from the deduction limit for compensation payable on a commission basis. Paragraph (e) of this section provides an exception for qualified performance-based compensation. Paragraphs (f) and (g) of this section provide special rules for corporations that become publicly held corporations and payments that are subject to section 280G, respectively. Paragraph (h) of this section provides transition rules, including the rules for contracts that are grandfathered and not subject to section 162(m). Paragraph (j) of this section contains the effective date provisions. For rules concerning the deductibility of compensation for services that are not covered by section 162(m) and this section, see section 162(a)(1) and § 1.162–7. This section is not determinative as to whether compensation meets the requirements of section 162(a)(1).

(b) *Limitation on deduction.* Section 162(m) precludes a deduction under chapter 1 of the Internal Revenue Code by any publicly held corporation for compensation paid to any covered employee to the extent that the compensation for the taxable year exceeds $1,000,000.

(c) *Definitions*—(1) *Publicly held corporation*—(i) *General rule.* A *publicly held corporation* means any corporation issuing any class of common equity securities required to be registered under section 12 of the Exchange Act. A corporation is not considered publicly held if the registration of its equity securities is voluntary. For purposes of this section, whether a corporation is publicly held is determined based solely on whether, as of the last day of its taxable year, the corporation is subject to the reporting obligations of section 12 of the Exchange Act.

(ii) *Affiliated groups.* A publicly held corporation includes an affiliated group of corporations, as defined in section 1504 (determined without regard to section 1504(b)). For purposes of this section, however, an affiliated group of corporations does not include any subsidiary that is itself a publicly held corporation. Such a publicly held subsidiary, and its subsidiaries (if any), are separately subject to this section. If a covered employee is paid compensation in a taxable year by more than one member of an affiliated group, compensation paid by each member of the affiliated group is aggregated with compensation paid to the covered employee by all other members of the group. Any amount disallowed as a deduction by this section must be prorated among the payor corporations in proportion to the amount of compensation paid to the covered employee by each such corporation in the taxable year.

(2) *Covered employee*—(i) *General rule.* A *covered employee* means any individual who, on the last day of the taxable year, is—

(A) The chief executive officer of the corporation or is acting in such capacity; or

(B) Among the four highest compensated officers (other than the chief executive officer).

(ii) *Application of rules of the Securities and Exchange Commission.* Whether an individual is the chief executive officer described in paragraph (c)(2)(i)(A) of this section or an officer described in paragraph (c)(2)(i)(B) of this section is determined pursuant to the executive compensation disclosure rules under the Exchange Act.

(3) *Compensation*—(i) *In general.* For purposes of the deduction limitation described in paragraph (b) of this section, *compensation* means the aggregate amount allowable as a deduction under chapter 1 of the Internal Revenue Code for the taxable year (determined without regard to section 162(m)) for remuneration for services performed by a covered employee, whether or not the services were performed during the taxable year.

(ii) *Exceptions. Compensation* does not include—

(A) Remuneration covered in section 3121(a)(5)(A) through section 3121(a)(5)(D) (concerning remuneration that is not treated as *wages* for purposes of the Federal Insurance Contributions Act); and

(B) Remuneration consisting of any benefit provided to or on behalf of an employee if, at the time the benefit is provided, it is reasonable to believe that the employee will be able to exclude it from gross income. In addition, compensation does not include salary reduction contributions described in section 3121(v)(1).

(4) *Compensation Committee.* The *compensation committee* means the committee of directors (including any subcommittee of directors) of the publicly held corporation that has the authority to establish and administer performance goals described in paragraph (e)(2) of this section, and to certify that performance goals are attained, as described in paragraph (e)(5) of this section. A committee of directors is

not treated as failing to have the authority to establish performance goals merely because the goals are ratified by the board of directors of the publicly held corporation or, if applicable, any other committee of the board of directors. See paragraph (e)(3) of this section for rules concerning the composition of the compensation committee.

(5) *Exchange Act.* The *Exchange Act* means the Securities Exchange Act of 1934.

(6) *Examples.* This paragraph (c) may be illustrated by the following examples:

Example 1. Corporation X is a publicly held corporation with a July 1 to June 30 fiscal year. For Corporation X's taxable year ending on June 30, 1995, Corporation X pays compensation of $2,000,000 to A, an employee. However, A's compensation is not required to be reported to shareholders under the executive compensation disclosure rules of the Exchange Act because A is neither the chief executive officer nor one of the four highest compensated officers employed on the last day of the taxable year. A's compensation is not subject to the deduction limitation of paragraph (b) of this section.

Example 2. C, a covered employee, performs services and receives compensation from Corporations X, Y, and Z, members of an affiliated group of corporations. Corporation X, the parent corporation, is a publicly held corporation. The total compensation paid to C from all affiliated group members is $3,000,000 for the taxable year, of which Corporation X pays $1,500,000; Corporation Y pays $900,000; and Corporation Z pays $600,000. Because the compensation paid by all affiliated group members is aggregated for purposes of section 162(m), $2,000,000 of the aggregate compensation paid is nondeductible. Corporations X, Y, and Z each are treated as paying a ratable portion of the nondeductible compensation. Thus, two thirds of each corporation's payment will be nondeductible. Corporation X has a nondeductible compensation expense of $1,000,000 ($1,500,000×$2,000,000/$3,000,000). Corporation Y has a nondeductible compensation expense of $600,000 ($900,000×$2,000,000/$3,000,000). Corporation Z has a nondeductible compensation expense of $400,000 ($600,000×$2,000,000/$3,000,000).

Example 3. Corporation W, a calendar year taxpayer, has total assets equal to or exceeding $5 million and a class of equity security held of record by 500 or more persons on December 31, 1994. However, under the Exchange Act, Corporation W is not required to file a registration statement with respect to that security until April 30, 1995. Thus, Corporation W is not a publicly held corporation on December 31, 1994, but is a publicly held corporation on December 31, 1995.

Example 4. The facts are the same as in *Example 3,* except that on December 15, 1996, Corporation W files with the Securities and Exchange Commission to disclose that Corporation W is no longer required to be registered under section 12 of the Exchange Act and to terminate its registration of securities under that provision. Because Corporation W is no longer subject to Exchange Act reporting obligations as of December 31, 1996, Corporation W is not a publicly held corporation for taxable year 1996, even though the registration of Corporation W's securities does not terminate until 90 days after Corporation W files with the Securities and Exchange Commission.

(d) *Exception for compensation paid on a commission basis.* The deduction limit in paragraph (b) of this section shall not apply to any compensation paid on a commission basis. For this purpose, compensation is paid on a commission basis if the facts and circumstances show that it is paid solely on account of income generated directly by the individual performance of the individual to whom the compensation is paid. Compensation does not fail to be attributable directly to the individual merely because support services, such as secretarial or research services, are utilized in generating the income. However, if compensation is paid on account of broader performance standards, such as income produced by a business unit of the corporation, the compensation does not qualify for the exception provided under this paragraph (d).

(e) *Exception for qualified performance-based compensation*—

(1) *In general.* The deduction limit in paragraph (b) of this section does not apply to qualified performance-based compensation. Qualified performance-based compensation is compensation that meets all of the requirements of paragraphs (e)(2) through (e)(5) of this section.

(2) *Performance goal requirement*—(i) *Preestablished goal.* Qualified performance-based compensation must be paid solely on account of the attainment of one or more preestablished, objective performance goals. A performance goal is considered preestablished if it is established in writing by the compensation committee not later than 90 days after the commencement of the period

of service to which the performance goal relates, provided that the outcome is substantially uncertain at the time the compensation committee actually establishes the goal. However, in no event will a performance goal be considered to be preestablished if it is established after 25 percent of the period of service (as scheduled in good faith at the time the goal is established) has elapsed. A performance goal is objective if a third party having knowledge of the relevant facts could determine whether the goal is met. Performance goals can be based on one or more business criteria that apply to the individual, a business unit, or the corporation as a whole. Such business criteria could include, for example, stock price, market share, sales, earnings per share, return on equity, or costs. A performance goal need not, however, be based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses (measured, in each case, by reference to a specific business criterion). A performance goal does not include the mere continued employment of the covered employee. Thus, a vesting provision based solely on continued employment would not constitute a performance goal. See paragraph (e)(2)(vi) of this section for rules on compensation that is based on an increase in the price of stock.

(ii) *Objective compensation formula.* A preestablished performance goal must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained. A formula or standard is objective if a third party having knowledge of the relevant performance results could calculate the amount to be paid to the employee. In addition, a formula or standard must specify the individual employees or class of employees to which it applies.

(iii) *Discretion.*

(A) The terms of an objective formula or standard must preclude discretion to increase the amount of compensation payable that would otherwise be due upon attainment of the goal. A performance goal is not discretionary for purposes of this paragraph (e)(2)(iii) merely because the compensation committee reduces or eliminates the compensation or other economic benefit that was due upon attainment of the goal. However, the exercise of negative discretion with respect to one employee is not permitted to result in an increase in the amount payable to another employee. Thus, for example, in the case of a bonus pool, if the amount payable to each employee is stated in terms of a percentage of the pool, the sum of these individual percentages of the pool is not permitted to exceed 100 percent. If the terms of an objective formula or standard fail to preclude discretion to increase the amount of compensation merely because the amount of compensation to be paid upon attainment of the performance goal is based, in whole or in part, on a percentage of salary or base pay and the dollar amount of the salary or base pay is not fixed at the time the performance goal is established, then the objective formula or standard will not be considered discretionary for purposes of this paragraph (e)(2)(iii) if the maximum dollar amount to be paid is fixed at that time.

(B) If compensation is payable upon or after the attainment of a performance goal, and a change is made to accelerate the payment of compensation to an earlier date after the attainment of the goal, the change will be treated as an increase in the amount of compensation, unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If compensation is payable upon or after the attainment of a performance goal, and a change is made to defer the payment of compensation to a later date, any amount paid in excess of the amount that was originally owed to the employee will not be treated as an increase in the amount of compensation if the additional amount is based either on a reasonable rate of interest or on one or more predetermined actual investments (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of a specific investment (including any decrease as well as any increase in the value of an investment). If compensation is payable in the form of property, a change in the timing of the transfer of that property after the attainment of the goal will not be treated as an increase in the amount of compensation for purposes of this paragraph (e)(2)(iii). Thus, for example, if the terms of a stock grant provide for stock to be transferred after the attainment of a performance goal and the transfer of the stock also is subject to a vesting schedule, a change in the vesting schedule that either accelerates or defers the transfer of stock will not be treated as an increase in the amount of compensation payable under the performance goal.

(C) Compensation attributable to a stock option, stock appreciation right, or other stock-based compensation does not fail to satisfy the requirements of this paragraph (e)(2) to the extent that a change in the grant or award is made to reflect a change in corporate capitalization, such as a stock split or dividend, or a corporate transaction, such as any merger of a corporation into another corporation, any consolidation of two or more corporations into another corporation, any separation of a corporation (including a spinoff or other distribution of stock or property by a corporation), any reorganization of a corporation (whether or not such reorganization comes within the definition of such term in section 368), or any partial or complete liquidation by a corporation.

(iv) *Grant-by-grant determination*. The determination of whether compensation satisfies the requirements of this paragraph (e)(2) generally shall be made on a grant-by-grant basis. Thus, for example, whether compensation attributable to a stock option grant satisfies the requirements of this paragraph (e)(2) generally is determined on the basis of the particular grant made and without regard to the terms of any other option grant, or other grant of compensation, to the same or another employee. As a further example, except as provided in paragraph (e)(2)(vi), whether a grant of restricted stock or other stock-based compensation satisfies the requirements of this paragraph (e)(2) is determined without regard to whether dividends, dividend equivalents, or other similar distributions with respect to stock, on such stock-based compensation are payable prior to the attainment of the performance goal. Dividends, dividend equivalents, or other similar distributions with respect to stock that are treated as separate grants under this paragraph (e)(2)(iv) are not performance-based compensation unless they separately satisfy the requirements of this paragraph (e)(2).

(v) *Compensation contingent upon attainment of performance goal.* Compensation does not satisfy the requirements of this paragraph (e)(2) if the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained. Thus, if the payment of compensation under a grant or award is only nominally or partially contingent on attaining a performance goal, none of the compensation payable under the grant or award will be considered performance-based. For example, if an employee is entitled to a bonus under either of two arrangements, where payment under a nonperformance-based arrangement is contingent upon the failure to attain the performance goals under an otherwise performance-based arrangement, then neither arrangement provides for compensation that satisfies the requirements of this paragraph (e)(2). Compensation does not fail to be qualified performance-based compensation merely because the plan allows the compensation to be payable upon death, disability, or change of ownership or control, although compensation actually paid on account of those events prior to the attainment of the performance goal would not satisfy the requirements of this paragraph (e)(2). As an exception to the general rule set forth in the first sentence of paragraph (e)(2)(iv) of this section, the facts-and-circumstances determination referred to in the first sentence of this paragraph (e)(2)(v) is made taking into account all plans, arrangements, and agreements that provide for compensation to the employee.

(vi) *Application of requirements to stock options and stock appreciation rights*—(A) *In general.* Compensation attributable to a stock option or a stock appreciation right is deemed to satisfy the requirements of this paragraph (e)(2) if the grant or award is made by the compensation committee; the plan under which the option or right is granted states the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee; and, under the terms of the option or right, the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award. Conversely, if the amount of compensation the employee will receive under the grant or award is not based solely on an increase in the value of the stock after the date of grant or award (e.g., in the case of restricted stock, or an option that is granted with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant or award is qualified performance-based compensation because it does not satisfy the requirement of this paragraph (e)(2)(vi)(A). Whether a stock option grant is based solely on an increase in the value of the stock after the date of grant is determined without regard to any dividend equivalent that may be payable, provided that payment of the dividend equivalent is not made contingent on the exercise of the option. The rule that the compensation attributable to a stock option or stock appreciation right must be based solely on an increase in the value of the stock after the date of grant or award does not apply if the grant or award is made on account of, or if the vesting or exercisability of the grant or award is contingent on, the attainment of a performance goal that satisfies the requirements of this paragraph (e)(2).

(B) *Cancellation and repricing.* Compensation attributable to a stock option or stock appreciation right does not satisfy the requirements of this paragraph (e)(2) to the extent that the number of options granted exceeds the maximum number of shares for which options may be granted to the employee as specified in the plan. If an option is canceled, the canceled option continues to be counted against the maximum number of shares for which options may be granted to the employee under the plan. If, after grant, the exercise price of an option is reduced, the transaction is treated as a cancellation of the option and a grant of a new option. In such case, both the option that is deemed to be canceled and the option that is deemed to be granted reduce the maximum number of shares for which options may be granted to the employee under the plan. This paragraph (e)(2)(vi)(B) also applies in the case of a stock appreciation right where, after the award is made, the base amount on which stock appreciation is calculated is reduced to reflect a reduction in the fair market value of stock.

(vii) *Examples.* This paragraph (e)(2) may be illustrated by the following examples:

Example 1. No later than 90 days after the start of a fiscal year, but while the outcome is substantially uncertain, Corporation S establishes a bonus plan under which A, the chief executive officer, will receive a cash bonus of $500,000, if year-end corporate sales are increased by at least 5 percent. The compensation committee retains the right, if the performance goal is met, to reduce the bonus payment to A if, in its judgment, other subjective factors warrant a reduction. The bonus will meet the requirements of this paragraph (e)(2).

Example 2. The facts are the same as in *Example 1,* except that the bonus is based on a percentage of Corporation S's total sales for the fiscal year. Because Corporation S is virtually certain to have some sales for the fiscal year, the outcome of the performance goal is not substantially uncertain, and therefore the bonus does not meet the requirements of this paragraph (e)(2).

Example 3. The facts are the same as in *Example 1,* except that the bonus is based on a percentage of Corporation S's total profits for the fiscal year. Although some sales are virtually certain for virtually all public companies, it is substantially uncertain whether a company will have profits for a specified future period even if the company has a history of profitability. Therefore, the bonus will meet the requirements of this paragraph (e)(2).

Example 4. B is the general counsel of Corporation R, which is engaged in patent litigation with Corporation S. Representatives of Corporation S have informally indicated to Corporation R a willingness to settle the litigation for $50,000,000. Subsequently, the compensation committee of Corporation R agrees to pay B a bonus if B obtains a formal settlement for at least $50,000,000. The bonus to B does not meet the requirement of this paragraph (e)(2) because the performance goal was not established at a time when the outcome was substantially uncertain.

Example 5. Corporation S, a public utility, adopts a bonus plan for selected salaried employees that will pay a bonus at the end of a 3-year period of $750,000 each if, at the end of the 3 years, the price of S stock has increased by 10 percent. The plan also provides that the 10-percent goal will automatically adjust upward or downward by the percentage change in a published utilities index. Thus, for example, if the published utilities index shows a net increase of 5 percent over a 3-year period, then the salaried employees would receive a bonus only if Corporation S stock has increased by 15 percent. Conversely, if the published utilities index shows a net decrease of 5 percent over a 3-year period, then the salaried employees would receive a bonus if Corporation S stock has increased by 5 percent. Because these automatic adjustments in the performance goal are preestablished, the bonus meets the requirement of this paragraph (e)(2), notwithstanding the potential changes in the performance goal.

Example 6. The facts are the same as in *Example 5,* except that the bonus plan provides that, at the end of the 3-year period, a bonus of $750,000 will be paid to each salaried employee if either the price of Corporation S stock has increased by 10 percent or the earnings per share on Corporation S stock have increased by 5 percent. If both the earnings-per-share goal and the stock-price goal are preestablished, the compensation committee's discretion to choose to pay a bonus under either of the two goals does not cause any bonus paid under the plan to fail to meet the requirement of this paragraph (e)(2) because each goal independently meets the requirements of this paragraph (e)(2). The choice to pay under either of the two goals is tantamount to the discretion to choose not to pay under one of the goals, as provided in paragraph (e)(2)(iii) of this section.

Example 7. Corporation U establishes a bonus plan under which a specified class of employees will participate in a bonus pool if certain preestablished performance goals are attained. The amount of the bonus pool is determined under an objective formula. Under the terms of the bonus plan, the compensation committee retains the discretion to determine the fraction of the bonus pool that each employee may receive. The bonus plan does not satisfy the requirements of this paragraph (e)(2). Although the aggregate amount of the bonus plan is determined under an objective formula, a third party could not determine the amount that any individual could receive under the plan.

Example 8. The facts are the same as in *Example 7,* except that the bonus plan provides that a specified share of the bonus pool is payable to each employee, and the total of these shares does not exceed 100% of the pool. The bonus plan satisfies the requirements of this paragraph (e)(2). In addition, the bonus plan will satisfy the requirements of this paragraph (e)(2) even if the compensation committee retains the discretion to reduce the compensation payable to any individual employee, provided that a reduction in the amount of one employee's bonus does not result in an increase in the amount of any other employee's bonus.

Example 9. Corporation V establishes a stock option plan for salaried employees. The terms of the stock option plan specify that no salaried employee shall receive options for more than 100,000 shares over any 3-year period. The compensation committee grants options for 50,000 shares to each of several salaried employees. The exercise price of each option is equal to or greater than the fair market value at the time of each grant. Compensation attributable to the exercise of the options satisfies the requirements of this paragraph (e)(2). If, however, the terms of the options provide that the exercise price is less than fair market value at the date of grant, no compensation attributable to the exercise of those options satisfies the requirements of this paragraph (e)(2) unless issuance or exercise of the options was contingent upon the attainment of a preestablished performance goal that satisfies this paragraph (e)(2).

Example 10. The facts are the same as in *Example 9,* except that, within the same 3-year grant period, the fair market value of Corporation V stock is significantly less than the exercise price of the options. The compensation committee reprices those options to that lower current fair market value of Corporation V stock. The repricing of the options for 50,000 shares held by each salaried employee is treated as the grant of new options for an additional 50,000 shares to each employee. Thus, each of the salaried employees is treated as having received grants for 100,000 shares. Consequently, if any additional options are granted to those employees during the 3-year period, compensation attributable to the exercise of those additional options would not satisfy the requirements of this paragraph (e)(2). The results would be the same if the compensation committee canceled the outstanding options and issued new options to the same employees that were exercisable at the fair market value of Corporation V stock on the date of reissue.

Example 11. Corporation W maintains a plan under which each participating employee may receive incentive stock options, nonqualified stock options, stock appreciation rights, or grants of restricted Corporation W stock. The plan specifies that each participating employee may receive options, stock appreciation rights, restricted stock, or any combination of each, for no more than 20,000 shares over the life of the plan. The plan provides that stock options may be granted with an exercise price of less than, equal to, or greater than fair market value on the date of grant. Options granted with an exercise price equal to, or greater than, fair market value on the date of grant do not fail to meet the requirements of this paragraph (e)(2) merely because the compensation committee has the discretion to determine the types of awards (i.e., options, rights, or restricted stock) to be granted to each employee or the discretion to issue options or make other compensation awards under the plan that would not meet the requirements of this paragraph (e)(2). Whether an option granted under the plan satisfies the requirements of this paragraph (e)(2) is determined on the basis of the specific terms of the option and without regard to other options or awards under the plan.

Example 12. Corporation X maintains a plan under which stock appreciation rights may be awarded to key employees. The plan permits the compensation committee to make awards under which the amount of compensation payable to the employee is equal to the increase in the stock price plus a percentage ‘‘gross up’’ intended to offset the tax liability of the employee. In addition, the plan permits the compensation committee to make awards under which the amount of compensation payable to the employee is equal to the increase in the stock price, based on the highest price, which is defined as the highest price paid for Corporation X stock (or offered in a tender offer or other arms-length offer) during the 90 days preceding exercise. Compensation attributable to awards under the plan satisfies the requirements of paragraph (e)(2)(vi) of this section, provided that the terms of the plan specify the maximum number of shares for which awards may be made.

Example 13. Corporation W adopts a plan under which a bonus will be paid to the CEO only if there is a 10% increase in earnings per share during the performance period. The plan provides that earnings per share will be calculated without regard to any change in accounting standards that may be required by the Financial Accounting Standards Board after the goal is established. After the goal is established, such a change in accounting standards occurs. Corporation W's reported earnings, for purposes of determining earnings per share under the plan, are adjusted pursuant to this plan provision to factor out this change in standards. This adjustment will not be considered an exercise of impermissible discretion because it is made pursuant to the plan provision.

Example 14. Corporation X adopts a performance-based incentive pay plan with a four-year performance period. Bonuses under the plan are scheduled to be paid in the first year after the end of the performance period (year 5). However, in the second year of the performance period, the compensation committee determines that any bonuses payable in year 5 will instead, for bona fide business reasons, be paid in year 10. The compensation committee also determines that any compensation that would have been payable in year 5 will be adjusted to reflect the delay in payment. The adjustment will be based on the greater of the future rate of return of a specified mutual fund that invests in blue chip stocks or of a specified venture capital investment over the five-year deferral period. Each of these investments, considered by itself, is a predetermined actual investment because it is based on the future rate of return of an actual investment. However, the adjustment in this case is not based on predetermined actual investments within the meaning of paragraph (e)(2)(iii)(B) of this section because the amount payable by Corporation X in year 10 will be based on the greater of the two investment returns and, thus, will not be based on the actual rate of return on either specific investment.

Example 15. The facts are the same as in *Example 14,* except that the increase will be based on Moody's Average Corporate Bond Yield over the five-year deferral period. Because this index reflects a reasonable rate of interest, the increase in the compensation payable that is based on the index's rate of return is not considered an impermissible increase in the amount of compensation payable under the formula.

Example 16. The facts are the same as in *Example 14,* except that the increase will be based on the rate of return for the Standard & Poor's 500 Index. This index does not measure interest rates and thus does not represent a reasonable rate of interest. In addition, this index does not represent an actual investment. Therefore, any additional compensation payable based on the rate of return of this index will result in an impermissible increase in the amount payable under the formula. If, in contrast, the increase were based on the rate of return of an existing mutual fund that is invested in a manner that seeks to approximate the Standard & Poor's 500 Index, the increase would be based on a predetermined actual investment within the meaning of paragraph (e)(2)(iii)(B) of this section and thus would not result in an impermissible increase in the amount payable under the formula.

(3) *Outside directors*—(i) *General rule.* The performance goal under which compensation is paid must be established by a compensation committee comprised solely of two or more outside directors. A director is an outside director if the director—

(A) Is not a current employee of the publicly held corporation;

(B) Is not a former employee of the publicly held corporation who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year;

(C) Has not been an officer of the publicly held corporation; and

(D) Does not receive remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as a director. For this purpose, remuneration includes any payment in exchange for goods or services.

(ii) *Remuneration received.* For purposes of this paragraph (e)(3), remuneration is received, directly or indirectly, by a director in each of the following circumstances:

(A) If remuneration is paid, directly or indirectly, to the director personally or to an entity in which the director has a beneficial ownership interest of greater than 50 percent. For this purpose, remuneration is considered paid when actually paid (and throughout the remainder of that taxable year of the corporation) and, if earlier, throughout the period when a contract or agreement to pay remuneration is outstanding.

(B) If remuneration, other than de minimis remuneration, was paid by the publicly held corporation in its preceding taxable year to an entity in which the director has a beneficial ownership interest of at least 5 percent but not more than 50 percent. For this purpose, remuneration is considered paid when actually paid or, if earlier, when the publicly held corporation becomes liable to pay it.

(C) If remuneration, other than de minimis remuneration, was paid by the publicly held corporation in its preceding taxable year to an entity by which the director is employed or self-employed other than as a director. For this purpose, remuneration is considered paid when actually paid or, if earlier, when the publicly held corporation becomes liable to pay it.

(iii) *De minimis remuneration*—(A) *In general.* For purposes of paragraphs (e)(3)(ii)(B) and (C) of this section, remuneration that was paid by the publicly held corporation in its preceding taxable year to an entity is de minimis if payments to the entity did not exceed 5 percent of the gross revenue of the entity for its taxable year ending with or within that preceding taxable year of the publicly held corporation.

(B) *Remuneration for personal services and substantial owners.* Notwithstanding paragraph (e)(3)(iii)(A) of this section, remuneration in excess of $60,000 is not de minimis if the remuneration is paid to an entity described in paragraph (e)(3)(ii)(B) of this section, or is paid for personal services to an entity described in paragraph (e)(3)(ii)(C) of this section.

(iv) *Remuneration for personal services.* For purposes of paragraph (e)(3)(iii)(B) of this section, remuneration from a publicly held corporation is for personal services if—

(A) The remuneration is paid to an entity for personal or professional services, consisting of legal, accounting, investment banking, and management consulting services (and other similar services that may be specified by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin), performed for the publicly held corporation, and the remuneration is not for services that are incidental to the purchase of goods or to the purchase of services that are not personal services; and

(B) The director performs significant services (whether or not as an employee) for the corporation, division, or similar organization (within the entity) that actually provides the services described in paragraph (e)(3)(iv)(A) of this section to the publicly held corporation, or more than 50 percent of the entity's gross revenues (for the entity's preceding taxable year) are derived from that corporation, subsidiary, or similar organization.

(v) *Entity defined.* For purposes of this paragraph (e)(3), entity means an organization that is a sole proprietorship, trust, estate, partnership, or corporation. The term also includes an affiliated group of corporations as defined in section 1504 (determined without regard to section 1504(b)) and a group of organizations that would be an affiliated group but for the fact that one or more of the organizations are not incorporated. However, the aggregation rules referred to in the preceding sentence do not apply for purposes of determining whether a director has a beneficial ownership interest of at least 5 percent or greater than 50 percent.

(vi) *Employees and former officers.* Whether a director is an employee or a former officer is determined on the basis of the facts at the time that the individual is serving as a director on the compensation committee. Thus, a director is not precluded from being an outside director solely because the director is a former officer of a corporation that previously was an affiliated corporation of the publicly held corporation. For example, a director of a parent corporation of an affiliated group is not precluded from being an outside director solely because that director is a former officer of an affiliated subsidiary that was spun off or liquidated. However, an outside director would no longer be an outside director if a corporation in which the director was previously an officer became an affiliated corporation of the publicly held corporation.

(vii) *Officer.* Solely for purposes of this paragraph (e)(3), *officer* means an administrative executive who is or was in regular and continued service. The term implies continuity of service and excludes those employed for a special and single transaction. An individual who merely has (or had) the title of officer but not the authority of an officer is not considered an officer. The determination of whether an individual is or was an officer is based on all of the facts and circumstances in the particular case, including without limitation the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties.

(viii) *Members of affiliated groups.* For purposes of this paragraph (e)(3), the outside directors of the publicly held member of an affiliated group are treated as the outside directors of all members of the affiliated group.

(ix) *Examples.* This paragraph (e)(3) may be illustrated by the following examples:

Example 1. Corporations X and Y are members of an affiliated group of corporations as defined in section 1504, until July 1, 1994, when Y is sold to another group. Prior to the sale, A served as an officer of Corporation Y. After July 1, 1994, A is not treated as a former officer of Corporation X by reason of having been an officer of Y.

Example 2. Corporation Z, a calendar-year taxpayer, uses the services of a law firm by which B is employed, but in which B has a less-than-5-percent ownership interest. The law firm reports income on a July 1 to June 30 basis. Corporation Z appoints B to serve on its compensation committee for calendar year 1998 after determining that, in calendar year 1997, it did not become liable to the law firm for remuneration exceeding the lesser of $60,000 or five percent of the law firm's gross revenue (calculated for the year ending June 30, 1997). On October 1, 1998, Corporation Z becomes liable to pay remuneration of $50,000 to the law firm on June 30, 1999. For the year ending June 30, 1998, the law firm's gross revenue was less than $1 million. Thus, in calendar year 1999, B is not an outside director. However, B may satisfy the requirements for an outside director in calendar year 2000, if, in calendar year 1999, Corporation Z does not become liable to the law firm for additional remuneration. This is because the remuneration actually paid on June 30, 1999 was considered paid on October 1, 1998 under paragraph (e)(3)(ii)(C) of this section.

Example 3. Corporation Z, a publicly held corporation, purchases goods from Corporation A. D, an executive and less- than-5-percent owner of Corporation A, sits on the board of directors of Corporation Z and on its compensation committee. For 1997, Corporation Z obtains representations to the effect that D is not eligible for any commission for D's sales to Corporation Z and that, for purposes of determining D's compensation for 1997, Corporation A's sales to Corporation Z are not otherwise treated differently than sales to other customers of Corporation A (including its affiliates, if any) or are irrelevant. In addition, Corporation Z has no reason to believe that these representations are inaccurate or that it is otherwise paying remuneration indirectly to D personally. Thus, in 1997, no remuneration is considered paid by Corporation Z indirectly to D personally under paragraph (e)(3)(ii)(A) of this section.

Example 4. (i) Corporation W, a publicly held corporation, purchases goods from Corporation T. C, an executive and less- than-5-percent owner of Corporation T, sits on the board of directors of Corporation W and on its compensation committee. Corporation T develops a new product and agrees on January 1, 1998 to pay C a bonus of $500,000 if Corporation W contracts to purchase the product. Even if Corporation W purchases the new product, sales to Corporation W will represent less than 5 percent of Corporation T's gross revenues. In 1999, Corporation W contracts to purchase the new product and, in 2000, C receives the $500,000 bonus from Corporation T. In 1998, 1999, and 2000, Corporation W does not obtain any representations relating to indirect remuneration to C personally (such as the representations described in *Example 3*).

(ii) Thus, in 1998, 1999, and 2000, remuneration is considered paid by Corporation W indirectly to C personally under paragraph (e)(3)(ii)(A) of this section. Accordingly, in 1998, 1999, and 2000, C is not an outside director of Corporation W. The result would have been the same if Corporation W had obtained appropriate representations but nevertheless had reason to believe that it was paying remuneration indirectly to C personally.

Example 5. Corporation R, a publicly held corporation, purchases utility service from Corporation Q, a public utility. The chief executive officer, and less-than-5-percent owner, of Corporation Q is a director of Corporation R. Corporation R pays Corporation Q more than $60,000 per year for the utility service, but less than 5 percent of Corporation Q's gross revenues. Because utility services are not personal services, the fees paid are not subject to the $60,000 de minimis rule for remuneration for personal services within the meaning of paragraph (e)(3)(iii)(B) of this section. Thus, the chief executive officer qualifies as an outside director of Corporation R, unless disqualified on some other basis.

Example 6. Corporation A, a publicly held corporation, purchases management consulting services from Division S of Conglomerate P. The chief financial officer of Division S is a director of Corporation A. Corporation A pays more than $60,000 per year for the management consulting services, but less than 5 percent of Conglomerate P's gross revenues. Because management consulting services are personal services within the meaning of paragraph (e)(3)(iv)(A) of this section, and the chief financial officer performs significant services for Division S, the fees paid are subject to the $60,000 de minimis rule as remuneration for personal services. Thus, the chief financial officer does not qualify as an outside director of Corporation A.

Example 7. The facts are the same as in *Example 6,* except that the chief executive officer, and less-than-5-percent owner, of the parent company of Conglomerate P is a director of Corporation A and does not perform significant services for Division S. If the gross revenues of Division S do not constitute more than 50 percent of the gross revenues of Conglomerate P for P's preceding taxable year, the chief executive officer will qualify as an outside director of Corporation A, unless disqualified on some other basis.

(4) *Shareholder approval requirement*—(i) *General rule.* The material terms of the performance goal under which the compensation is to be paid must be disclosed to and subsequently approved by the shareholders of the publicly held corporation before the compensation is paid. The requirements of this paragraph (e)(4) are not satisfied if the compensation would be paid regardless of whether the material terms are approved by shareholders. The material terms include the employees eligible to receive compensation; a description of the business criteria on which the performance goal is based; and either the maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation to be paid to the employee if the performance goal is attained (except that, in the case of a formula based, in whole or in part, on a percentage of salary or base pay, the maximum dollar amount of compensation that could be paid to the employee must be disclosed).

(ii) *Eligible employees.* Disclosure of the employees eligible to receive compensation need not be so specific as to identify the particular individuals by name. A general description of the class of eligible employees by title or class is sufficient, such as the chief executive officer and vice presidents, or all salaried employees, all executive officers, or all key employees.

(iii) *Description of business criteria*—(A) *In general.* Disclosure of the business criteria on which the performance goal is based need not include the specific targets that must be satisfied under the performance goal. For example, if a bonus plan provides that a bonus will be paid if earnings per share increase by 10 percent, the 10-percent figure is a target that need not be disclosed to shareholders. However, in that case, disclosure must be made that the bonus plan is based on an earnings-per-share business criterion. In the case of a plan under which employees may be granted stock options or stock appreciation rights, no specific description of the business criteria is required if the grants or awards are based on a stock price that is no less than current fair market value.

(B) *Disclosure of confidential information.* The requirements of this paragraph (e)(4) may be satisfied even though information that otherwise would be a material term of a performance goal is not disclosed to shareholders, provided that the compensation committee determines that the information is confidential commercial or business information, the disclosure of which would have an adverse effect on the publicly held corporation. Whether disclosure would adversely affect the corporation is determined on the basis of the facts and circumstances. If the compensation committee makes such a determination, the disclosure to shareholders must state the compensation committee's belief that the information is confidential commercial or business information, the disclosure of which would adversely affect the company. In addition, the ability not to disclose confidential information does not eliminate the requirement that disclosure be made of the maximum amount of compensation that is payable to an individual under a performance goal. Confidential information does not include the identity of an executive or the class of executives to which a performance goal applies or the amount of compensation that is payable if the goal is satisfied.

(iv) *Description of compensation.* Disclosure as to the compensation payable under a performance goal must be specific enough so that shareholders can determine the maximum amount of compensation that could be paid to any employee during a specified period. If the terms of the performance goal do not provide for a maximum dollar amount, the disclosure must include the formula under which the compensation would be calculated. Thus, for example, if compensation attributable to the exercise of stock options is equal to the difference in the exercise price and the current value of the stock, disclosure would be required of the maximum number of shares for which grants may be made to any employee and the exercise price of those options (e.g., fair market value on date of grant). In that case, shareholders could calculate the maximum amount of compensation that would be attributable to the exercise of options on the basis of their assumptions as to the future stock price.

(v) *Disclosure requirements of the Securities and Exchange Commission.* To the extent not otherwise specifically provided in this paragraph (e)(4), whether the material terms of a performance goal are adequately disclosed to shareholders is determined under the same standards as apply under the Exchange Act.

(vi) *Frequency of disclosure.* Once the material terms of a performance goal are disclosed to and approved by shareholders, no additional disclosure or approval is required unless the compensation committee changes the material terms of the performance goal. If, however, the compensation committee has authority to change the targets under a performance goal after shareholder approval of the goal, material terms of the performance goal must be disclosed to and reapproved by shareholders no later than the first shareholder meeting that occurs in the fifth year following the year in which shareholders previously approved the performance goal.

(vii) *Shareholder vote.* For purposes of this paragraph (e)(4), the material terms of a performance goal are approved by shareholders if, in a separate vote, a majority of the votes cast on the issue (including abstentions to the extent abstentions are counted as voting under applicable state law) are cast in favor of approval.

(viii) *Members of affiliated group.* For purposes of this paragraph (e)(4), the shareholders of the publicly held member of the affiliated group are treated as the shareholders of all members of the affiliated group.

(ix) *Examples.* This paragraph (e)(4) may be illustrated by the following examples:

Example 1. Corporation X adopts a plan that will pay a specified class of its executives an annual cash bonus based on the overall increase in corporate sales during the year. Under the terms of the plan, the cash bonus of each executive equals $100,000 multiplied by the number of percentage points by which sales increase in the current year when compared to the prior year. Corporation X discloses to its shareholders prior to the vote both the class of executives eligible to receive awards and the annual formula of

$100,000 multiplied by the percentage increase in sales. This disclosure meets the requirements of this paragraph (e)(4). Because the compensation committee does not have the authority to establish a different target under the plan, Corporation X need not redisclose to its shareholders and obtain their reapproval of the material terms of the plan until those material terms are changed.

Example 2. The facts are the same as in *Example 1* except that Corporation X discloses only that bonuses will be paid on the basis of the annual increase in sales. This disclosure does not meet the requirements of this paragraph (e)(4) because it does not include the formula for calculating the compensation or a maximum amount of compensation to be paid if the performance goal is satisfied.

Example 3. Corporation Y adopts an incentive compensation plan in 1995 that will pay a specified class of its executives a bonus every 3 years based on the following 3 factors: increases in earnings per share, reduction in costs for specified divisions, and increases in sales by specified divisions. The bonus is payable in cash or in Corporation Y stock, at the option of the executive. Under the terms of the plan, prior to the beginning of each 3-year period, the compensation committee determines the specific targets under each of the three factors (i.e., the amount of the increase in earnings per share, the reduction in costs, and the amount of sales) that must be met in order for the executives to receive a bonus. Under the terms of the plan, the compensation committee retains the discretion to determine whether a bonus will be paid under any one of the goals. The terms of the plan also specify that no executive may receive a bonus in excess of $1,500,000 for any 3-year period. To satisfy the requirements of this paragraph (e)(4), Corporation Y obtains shareholder approval of the plan at its 1995 annual shareholder meeting. In the proxy statement issued to shareholders, Corporation Y need not disclose to shareholders the specific targets that are set by the compensation committee. However, Corporation Y must disclose that bonuses are paid on the basis of earnings per share, reductions in costs, and increases in sales of specified divisions. Corporation Y also must disclose the maximum amount of compensation that any executive may receive under the plan is $1,500,000 per 3-year period. Unless changes in the material terms of the plan are made earlier, Corporation Y need not disclose the material terms of the plan to the shareholders and obtain their reapproval until the first shareholders' meeting held in 2000.

Example 4. The same facts as in *Example 3,* except that prior to the beginning of the second 3-year period, the compensation committee determines that different targets will be set under the plan for that period with regard to all three of the performance criteria (i.e., earnings per share, reductions in costs, and increases in sales). In addition, the compensation committee raises the maximum dollar amount that can be paid under the plan for a 3-year period to $2,000,000. The increase in the maximum dollar amount of compensation under the plan is a changed material term. Thus, to satisfy the requirements of this paragraph (e)(4), Corporation Y must disclose to and obtain approval by the shareholders of the plan as amended.

Example 5. In 1998, Corporation Z establishes a plan under which a specified group of executives will receive a cash bonus not to exceed $750,000 each if a new product that has been in development is completed and ready for sale to customers by January 1, 2000. Although the completion of the new product is a material term of the performance goal under this paragraph (e)(4), the compensation committee determines that the disclosure to shareholders of the performance goal would adversely affect Corporation Z because its competitors would be made aware of the existence and timing of its new product. In this case, the requirements of this paragraph (e)(4) are satisfied if all other material terms, including the maximum amount of compensation, are disclosed and the disclosure affirmatively states that the terms of the performance goal are not being disclosed because the compensation committee has determined that those terms include confidential information, the disclosure of which would adversely affect Corporation Z.

(5) *Compensation committee certification.* The compensation committee must certify in writing prior to payment of the compensation that the performance goals and any other material terms were in fact satisfied. For this purpose, approved minutes of the compensation committee meeting in which the certification is made are treated as a written certification. Certification by the compensation committee is not required for compensation that is attributable solely to the increase in the value of the stock of the publicly held corporation.

(f) *Companies that become publicly held, spinoffs, and similar transactions*—(1) *In general.* In the case of a corporation that was not a publicly held corporation and then becomes a publicly held corporation, the deduction limit of paragraph (b) of this section does not apply to any remuneration paid pursuant to a compensation plan or agreement that existed during the period in which the corporation was not publicly held. However, in the case of such a corporation that becomes publicly held in connection with an initial public offering, this relief applies only to the extent that the prospectus accompanying the initial public offering disclosed information concerning those plans or agreements that satisfied all applicable securities laws then in effect. In accordance with paragraph (c)(1)(ii) of this section, a corporation that is a member of an affiliated group that includes a publicly held corporation is considered publicly held and, therefore, cannot rely on this paragraph (f)(1).

(2) *Reliance period.* Paragraph (f)(1) of this section may be relied upon until the earliest of—

(i) The expiration of the plan or agreement;

(ii) The material modification of the plan or agreement, within the meaning of paragraph (h)(1)(iii) of this section;

(iii) The issuance of all employer stock and other compensation that has been allocated under the plan; or

(iv) The first meeting of shareholders at which directors are to be elected that occurs after the close of the third calendar year following the calendar year in which the initial public offering occurs or, in the case of a privately held corporation that becomes publicly held without an initial public offering, the first calendar year following the calendar year in which the corporation becomes publicly held.

(3) *Stock-based compensation.* Paragraph (f)(1) of this section will apply to any compensation received pursuant to the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property, granted under a plan or agreement described in paragraph (f)(1) of this section if the grant occurs on or before the earliest of the events specified in paragraph (f)(2) of this section.

(4) *Subsidiaries that become separate publicly held corporations*—(i) *In general.* If a subsidiary that is a member of the affiliated group described in paragraph (c)(1)(ii) of this section becomes a separate publicly held corporation (whether by spinoff or otherwise), any remuneration paid to covered employees of the new publicly held corporation will satisfy the exception for performance-based compensation described in paragraph (e) of this section if the conditions in either paragraph (f)(4)(ii) or (f)(4)(iii) of this section are satisfied.

(ii) *Prior establishment and approval.* Remuneration satisfies the requirements of this paragraph (f)(4)(ii) if the remuneration satisfies the requirements for performance-based compensation set forth in paragraphs (e)(2), (e)(3), and (e)(4) of this section (by application of paragraphs (e)(3)(viii) and (e)(4)(viii) of this section) before the corporation becomes a separate publicly held corporation, and the certification required by paragraph (e)(5) of this section is made by the compensation committee of the new publicly held corporation (but if the performance goals are attained before the corporation becomes a separate publicly held corporation, the certification may be made by the compensation committee referred to in paragraph (e)(3)(viii) of this section before it becomes a separate publicly held corporation). Thus, this paragraph (f)(4)(ii) requires that the outside directors and shareholders (within the meaning of paragraphs (e)(3)(viii) and (e)(4)(viii) of this section) of the corporation before it becomes a separate publicly held corporation establish and approve, respectively, the performance-based compensation for the covered employees of the new publicly held corporation in accordance with paragraphs (e)(3) and (e)(4) of this section.

(iii) *Transition period.* Remuneration satisfies the requirements of this paragraph (f)(4)(iii) if the remuneration satisfies all of the requirements of paragraphs (e)(2), (e)(3), and (e)(5) of this section. The outside directors (within the meaning of paragraph (e)(3)(viii) of this section) of the corporation before it becomes a separate publicly held corporation, or the outside directors of the new publicly held corporation, may establish and administer the performance goals for the covered employees of the new publicly held corporation for purposes of satisfying the requirements of paragraphs (e)(2) and (e)(3) of this section. The certification required by paragraph (e)(5) of this section must be made by the compensation committee of the new publicly held corporation. However, a taxpayer may rely on this paragraph (f)(4)(iii) to satisfy the requirements of paragraph (e) of this section only for compensation paid, or stock options, stock appreciation rights, or restricted property granted, prior to the first regularly scheduled meeting of the shareholders of the new publicly held corporation that occurs more than 12 months after the date the corporation becomes a separate publicly held corporation. Compensation paid, or stock options, stock appreciation rights, or restricted property granted, on or after the date of that meeting of shareholders must satisfy all requirements of paragraph (e) of this section, including the shareholder approval requirement of paragraph (e)(4) of this section, in order to satisfy the requirements for performance-based compensation.

(5) *Example.* The following example illustrates the application of paragraph (f)(4)(ii) of this section:

Example. Corporation P, which is publicly held, decides to spin off Corporation S, a wholly owned subsidiary of Corporation P. After the spinoff, Corporation S will be a separate publicly held corporation. Before the spinoff, the compensation committee of Corporation P, pursuant to paragraph (e)(3)(viii) of this section, establishes a bonus plan for the executives of Corporation S that provides for bonuses payable after the spinoff and that satisfies the requirements of paragraph (e)(2) of this section. If, pursuant to paragraph (e)(4)(viii) of this section, the shareholders of Corporation P approve the plan prior to the spinoff, that approval will satisfy the requirements of paragraph (e)(4) of this section with respect to compensation paid pursuant to the bonus plan after the spinoff. However, the compensation committee of Corporation S will be required to certify that the goals are satisfied prior to the payment of the bonuses in order for the bonuses to be considered performance-based compensation.

(g) *Coordination with disallowed excess parachute payments.* The $1,000,000 limitation in paragraph (b) of this section is reduced (but not below zero) by the amount (if any) that would have been included in the compensation of the covered employee for the taxable year but for being disallowed by reason of section 280G. For example, assume that during a taxable year a corporation pays $1,500,000 to a covered employee and no portion satisfies the exception in paragraph (d) of this section for commissions or paragraph (e) of this section for qualified performance-based compensation. Of the $1,500,000, $600,000 is an excess parachute payment, as defined in section 280G(b)(1) and is disallowed by reason of that section. Because the excess parachute payment reduces the limitation of paragraph (b) of this section, the corporation can deduct $400,000, and $500,000 of the otherwise deductible amount is nondeductible by reason of section 162(m).

(h) *Transition rules*—(1) *Compensation payable under a written binding contract which was in effect on February 17, 1993*—(i) *General rule.* The deduction limit of paragraph (b) of this section does not apply to any compensation payable under a written binding contract that was in effect on February 17, 1993. The preceding sentence does not apply unless, under applicable state law, the corporation is obligated to pay the compensation if the employee performs services. However, the deduction limit of paragraph (b) of this section does apply to a contract that is renewed after February 17, 1993. A written binding contract that is terminable or cancelable by the corporation after February 17, 1993, without the employee's consent is treated as a new contract as of the date that any such termination or cancellation, if made, would be effective. Thus, for example, if the terms of a contract provide that it will be automatically renewed as of a certain date unless either the corporation or the employee gives notice of termination of the contract at least 30 days before that date, the contract is treated as a new contract as of the date that termination would be effective if that notice were given. Similarly, for example, if the terms of a contract provide that the contract will be terminated or canceled as of a certain date unless either the corporation or the employee elects to renew within 30 days of that date, the contract is treated as renewed by the corporation as of that date. Alternatively, if the corporation will remain legally obligated by the terms of a contract beyond a certain date at the sole discretion of the employee, the contract will not be treated as a new contract as of that date if the employee exercises the discretion to keep the corporation bound to the contract. A contract is not treated as terminable or cancelable if it can be terminated or canceled only by terminating the employment relationship of the employee.

(ii) *Compensation payable under a plan or arrangement.* If a compensation plan or arrangement meets the requirements of paragraph (h)(1)(i) of this section, the compensation paid to an employee pursuant to the plan or arrangement will not be subject to the deduction limit of paragraph (b) of this section even though the employee was not eligible to participate in the plan as of February 17, 1993. However, the preceding sentence does not apply unless the employee was employed on February 17, 1993, by the corporation that maintained the plan or arrangement, or the employee had the right to participate in the plan or arrangement under a written binding contract as of that date.

(iii) *Material modifications.*

(A) Paragraph (h)(1)(i) of this section will not apply to any written binding contract that is materially modified. A material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. If a binding written contract is materially modified, it is treated as a new contract entered into as of the date of the material modification. Thus, amounts received by an employee under the contract prior to a material modification are not affected, but amounts received subsequent to the material modification are not treated as paid under a binding, written contract described in paragraph (h)(1)(i) of this section.

(B) A modification of the contract that accelerates the payment of compensation will be treated as a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If the contract is modified to defer the payment of compensation, any compensation paid in excess of the amount that was originally payable to the employee under the contract will not be treated as a material modification if the additional amount is based on either a reasonable rate of interest or one or more predetermined actual investments (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of the specific investment (including any decrease as well as any increase in the value of the investment).

(C) The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a binding, written contract where the facts and circumstances show that the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid under the written binding contract. However, a material modification of a written binding contract does not include a supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that written binding contract. In addition, a supplemental payment of compensation that satisfies the requirements of qualified performance-based compensation in paragraph (e) of this section will not be treated as a material modification.

(iv) Examples. The following examples illustrate the exception of this paragraph (h)(1):

Example 1. Corporation X executed a 3-year compensation arrangement with C on February 15, 1993, that constitutes a written binding contract under applicable state law. The terms of the arrangement provide for automatic extension after the 3-year term for additional 1-year periods, unless the corporation exercises its option to terminate the arrangement within 30 days of the end of the 3-year term or, thereafter, within 30 days before each anniversary date. Termination of the compensation arrangement does not require the termination of C’s employment relationship with Corporation X. Unless terminated, the arrangement is treated as renewed on February 15, 1996, and the deduction limit of paragraph (b) of this section applies to payments under the arrangement after that date.

Example 2. Corporation Y executed a 5-year employment agreement with B on January 1, 1992, providing for a salary of $900,000 per year. Assume that this agreement constitutes a written binding contract under applicable state law. In 1992 and 1993, B receives the salary of $900,000 per year. In 1994, Corporation Y increases B’s salary with a payment of $20,000. The $20,000 supplemental payment does not constitute a material modification of the written binding contract because the $20,000 payment is less than or equal to a reasonable cost-of-living increase from 1993. However, the $20,000 supplemental payment is subject to the limitation in paragraph (b) of this section. On January 1, 1995, Corporation Y increases B's salary to $1,200,000. The $280,000 supplemental payment is a material modification of the written binding contract because the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid under the written binding contract and it is greater than a reasonable, annual cost-of-living increase. Because the written binding contract is materially modified as of January 1, 1995, all compensation paid to B in 1995 and thereafter is subject to the deduction limitation of section 162(m).

Example 3. Assume the same facts as in *Example 2,* except that instead of an increase in salary, B receives a restricted stock grant subject to B's continued employment for the balance of the contract. The restricted stock grant is not a material modification of the binding written contract because any additional compensation paid to B under the grant is not paid on the basis of substantially the same elements and conditions as B's salary because it is based both on the stock price and B's continued service. However, compensation attributable to the restricted stock grant is subject to the deduction limitation of section 162(m).

(2) *Special transition rule for outside directors.* A director who is a disinterested director is treated as satisfying the requirements of an outside director under paragraph (e)(3) of this section until the first meeting of shareholders at which directors are to be elected that occurs on or after January 1, 1996. For purposes of this paragraph (h)(2) and paragraph (h)(3) of this section, a director is a disinterested director if the director is disinterested within the meaning of Rule 16b–3(c)(2)(i), 17 CFR 240.16b–3(c)(2)(i), under the Exchange Act (including the provisions of Rule 16b–3(d)(3), as in effect on April 30, 1991).

(3) *Special transition rule for previously-approved plans—(i) In general.* Any compensation paid under a plan or agreement approved by shareholders before December 20, 1993, is treated as satisfying the requirements of paragraphs (e)(3) and (e)(4) of this section, provided that the directors administering the plan or agreement are disinterested directors and the plan was approved by shareholders in a manner consistent with Rule 16b–3(b), 17 CFR 240.16b–3(b), under the Exchange Act or Rule 16b–3(a), 17 CFR 240.16b–3(a) (as contained in 17 CFR part 240 revised April 1, 1990). In addition, for purposes of satisfying the requirements of paragraph (e)(2)(vi) of this section, a plan or agreement is treated as stating a maximum number of shares with respect to which an option or right may be granted to any employee if the plan or agreement that was approved by the shareholders provided for an aggregate limit, consistent with Rule 16b–3(b), 17 CFR 250.16b–3(b), on the shares of employer stock with respect to which awards may be made under the plan or agreement.

(ii) *Reliance period.* The transition rule provided in this paragraph (h)(3) shall continue and may be relied upon until the earliest of—

(A) The expiration or material modification of the plan or agreement;

(B) The issuance of all employer stock and other compensation that has been allocated under the plan; or

(C) The first meeting of shareholders at which directors are to be elected that occurs after December 31, 1996.

(iii) *Stock-based compensation.* This paragraph (h)(3) will apply to any compensation received pursuant to the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property, granted under a plan or agreement described in paragraph (h)(3)(i) of this section if the grant occurs on or before the earliest of the events specified in paragraph (h)(3)(ii) of this section.

(iv) *Example.* The following example illustrates the application of this paragraph (h)(3):

Example. Corporation Z adopted a stock option plan in 1991. Pursuant to Rule 16b–3 under the Exchange Act, the stock option plan has been administered by disinterested directors and was approved by Corporation Z shareholders. Under the terms of the plan, shareholder approval is not required again until 2001. In addition, the terms of the stock option plan include an aggregate limit on the number of shares available under the plan. Option grants under the Corporation Z plan are made with an exercise price equal to or greater than the fair market value of Corporation Z stock. Compensation attributable to the exercise of options that are granted under the plan before the earliest of the dates specified in paragraph (h)(3)(ii) of this section will be treated as satisfying the requirements of paragraph (e) of this section for qualified performance-based compensation, regardless of when the options are exercised.

(i) (*Reserved*)

(j) *Effective date*—(1) *In general.* Section 162(m) and this section apply to compensation that is otherwise deductible by the corporation in a taxable year beginning on or after January 1, 1994.

(2) *Delayed effective date for certain provisions*—(i) *Date on which remuneration is considered paid.* Notwithstanding paragraph (j)(1) of this section, the rules in the second sentence of each of paragraphs (e)(3)(ii)(A), (e)(3)(ii)(B), and (e)(3)(ii)(C) of this section for determining the date or dates on which remuneration is considered paid to a director are effective for taxable years beginning on or after January 1, 1995. Prior to those taxable years, taxpayers must follow the rules in paragraphs (e)(3)(ii)(A), (e)(3)(ii)(B), and (e)(3)(ii)(C) of this section or another reasonable, good faith interpretation of section 162(m) with respect to the date or dates on which remuneration is considered paid to a director.

(ii) *Separate treatment of publicly held subsidiaries.* Notwithstanding paragraph (j)(1) of this section, the rule in paragraph (c)(1)(ii) of this section that treats publicly held subsidiaries as separately subject to section 162(m) is effective as of the first regularly scheduled meeting of the shareholders of the publicly held subsidiary that occurs more than 12 months after December 2, 1994. The rule for stock-based compensation set forth in paragraph (f)(3) of this section will apply for this purpose, except that the grant must occur before the shareholder meeting specified in this paragraph (j)(2)(ii). Taxpayers may choose to rely on the rule referred to in the first sentence of this paragraph (j)(2)(ii) for the period prior to the effective date of the rule.

(iii) *Subsidiaries that become separate publicly held corporations.* Notwithstanding paragraph (j)(1) of this section, if a subsidiary of a publicly held corporation becomes a separate publicly held corporation as described in paragraph (f)(4)(i) of this section, then, for the duration of the reliance period described in paragraph (f)(2) of this section, the rules of paragraph (f)(1) of this section are treated as applying (and the rules of paragraph (f)(4) of this section do not apply) to remuneration paid to covered employees of that new publicly held corporation pursuant to a plan or agreement that existed prior to December 2, 1994, provided that the treatment of that remuneration as performance-based is in accordance with a reasonable, good faith interpretation of section 162(m). However, if remuneration is paid to covered employees of that new publicly held corporation pursuant to a plan or agreement that existed prior to December 2, 1994, but that remuneration is not performance-based under a reasonable, good faith interpretation of section 162(m), the rules of paragraph (f)(1) of this section will be treated as applying only until the first regularly scheduled meeting of shareholders that occurs more than 12 months after December 2, 1994. The rules of paragraph (f)(4) of this section will apply as of that first regularly scheduled meeting. The rule for stock-based compensation set forth in paragraph (f)(3) of this section will apply for purposes of this paragraph (j)(2)(iii), except that the grant must occur before the shareholder meeting specified in the preceding sentence if the remuneration is not performance-based under a reasonable, good faith interpretation of section 162(m). Taxpayers may choose to rely on the rules of paragraph (f)(4) of this section for the period prior to the applicable effective date referred to in the first or second sentence of this paragraph (j)(2)(iii).

(iv) *Bonus pools.* Notwithstanding paragraph (j)(1) of this section, the rules in paragraph (e)(2)(iii)(A) that limit the sum of individual percentages of a bonus pool to 100 percent will not apply to remuneration paid before January 1, 2001, based on performance in any performance period that began prior to December 20, 1995.

(v) *Compensation based on a percentage of salary or base pay.* Notwithstanding paragraph (j)(1) of this section, the requirement in paragraph (e)(4)(i) of this section that, in the case of certain formulas based on a percentage of salary or base pay, a corporation disclose to shareholders the maximum dollar amount of compensation that could be paid to the employee, will apply only to plans approved by shareholders after April 30, 1995.

[T.D. 8650, 60 FR 65537, Dec. 20, 1995, as amended by T.D. 8650, 61 FR 4350, Feb. 6, 1996]

§1.162–28 Allocation of costs to lobbying activities.

(a) *Introduction*—(1) *In general.* Section 162(e)(1) denies a deduction for certain amounts paid or incurred in connection with activities described in section 162(e)(1) (A) and (D) (*lobbying activities*). To determine the nondeductible amount, a taxpayer must allocate costs to lobbying activities. This section describes costs that must be allocated to lobbying activities and prescribes rules permitting a taxpayer to use a reasonable method to allocate those costs. This section does not apply to taxpayers subject to section 162(e)(5)(A). In addition, this section does not apply for purposes of sections 4911 and 4945 and the regulations thereunder.

(2) *Recordkeeping.* For recordkeeping requirements, see section 6001 and the regulations thereunder.

(b) *Reasonable method of allocating costs*—(1) *In general.* A taxpayer must use a reasonable method to allocate the costs described in paragraph (c) of this section to lobbying activities. A method is not reasonable unless it is applied consistently and is consistent with the special rules in paragraph (g) of this section. Except as provided in paragraph (b)(2) of this section, reasonable methods of allocating costs to lobbying activities include (but are not limited to)—

(i) The ratio method described in paragraph (d) of this section;

(ii) The gross-up method described in paragraph (e) of this section; and

(iii) A method that applies the principles of section 263A and the regulations thereunder (see paragraph (f) of this section).

(2) *Taxpayers not permitted to use certain methods.* A taxpayer (other than one subject to section 6033(e)) that does not pay or incur reasonable labor costs for persons engaged in lobbying activities may not use the gross-up method. For example, a partnership or sole proprietorship in which the lobbying activities are performed by the owners who do not receive a salary or guaranteed payment for services does not pay or incur reasonable labor costs for persons engaged in those activities and may not use the gross-up method.

(c) *Costs allocable to lobbying activities*—(1) *In general.* Costs properly allocable to lobbying activities include labor costs and general and administrative costs.

(2) *Labor costs.* For each taxable year, labor costs include costs attributable to full-time, part-time, and contract employees. Labor costs include all elements of compensation, such as basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay, payroll taxes, pension costs, employee benefits, and payments to a supplemental unemployment benefit plan.

(3) *General and administrative costs.* For each taxable year, general and administrative costs include depreciation, rent, utilities, insurance, maintenance costs, security costs, and other administrative department costs (for example, payroll, personnel, and accounting).

(d) *Ratio method*—(1) *In general.* Under the ratio method described in this paragraph (d), a taxpayer allocates to lobbying activities the sum of its third-party costs (as defined in paragraph (d)(5) of this section) allocable to lobbying activities and the costs determined by using the following formula:

$$\frac{\text{Lobbying labor hours}}{\text{Total labor hours}} \times \begin{matrix}\text{Total costs}\\ \text{of operations.}\end{matrix}$$

(2) *Lobbying labor hours.* Lobbying labor hours are the hours that a taxpayer's personnel spend on lobbying activities during the taxable year. A taxpayer may use any reasonable method to determine the number of labor hours spent on lobbying activities and may use the de minimis rule of paragraph (g)(1) of this section. A taxpayer may treat as zero the lobbying labor hours of personnel engaged in secretarial, clerical, support, and other administrative activities (as opposed to activities involving significant judgment with respect to lobbying activities). Thus, for example, the hours spent on lobbying

activities by para-professionals and analysts may not be treated as zero.

(3) *Total labor hours.* Total labor hours means the total number of hours that a taxpayer's personnel spend on a taxpayer's trade or business during the taxable year. A taxpayer may make reasonable assumptions concerning total hours spent by personnel on the taxpayer's trade or business. For example, it may be reasonable, based on all the facts and circumstances, to assume that all full-time personnel spend 1,800 hours per year on a taxpayer's trade or business. If, under paragraph (d)(2) of this section, a taxpayer treats as zero the lobbying labor hours of personnel engaged in secretarial, clerical, support, and other administrative activities, the taxpayer must also treat as zero the total labor hours of all personnel engaged in those activities.

(4) *Total costs of operations.* A taxpayer's total costs of operations means the total costs of the taxpayer's trade or business for a taxable year, excluding third-party costs (as defined in paragraph (d)(5) of this section).

(5) *Third-party costs.* Third-party costs are amounts paid or incurred in whole or in part for lobbying activities conducted by third parties (such as amounts paid to taxpayers subject to section 162(e)(5)(A) or dues or other similar amounts that are not deductible in whole or in part under section 162(e)(3)) and amounts paid or incurred for travel (including meals and lodging while away from home) and entertainment relating in whole or in part to lobbying activities.

(6) *Example.* The provisions of this paragraph (d) are illustrated by the following example.

Example. (i) In 1996, three full-time employees, A, B, and C, of Taxpayer W engage in both lobbying activities and nonlobbying activities. A spends 300 hours, B spends 1,700 hours, and C spends 1,000 hours on lobbying activities, for a total of 3,000 hours spent on lobbying activities for W. W reasonably assumes that each of its three employees spends 2,000 hours a year on W's business.

(ii) W's total costs of operations are $300,000. W has no third-party costs.

(iii) Under the ratio method, X allocates $150,000 to its lobbying activities for 1996, as follows:

$$\frac{\text{Lobbying labor hours}}{\text{Total labor hours}} \times \begin{matrix}\text{Total costs}\\ \text{of operations}\end{matrix} + \begin{matrix}\text{Allocable third -}\\ \text{party costs}\end{matrix} = \begin{matrix}\text{Costs allocable to}\\ \text{lobbying activities}\end{matrix}$$

$$\left[\frac{300+1{,}700+1{,}000}{6{,}000} \times \$300{,}000\right] + [0] = \$150{,}000.$$

(e) *Gross-up method*—(1) *In general.* Under the gross-up method described in this paragraph (e)(1), the taxpayer allocates to lobbying activities the sum of its third-party costs (as defined in paragraph (d)(5) of this section) allocable to lobbying activities and 175 percent of its basic lobbying labor costs (as defined in paragraph (e)(3) of this section) of all personnel.

(2) *Alternative gross-up method.* Under the alternative gross-up method described in this paragraph (e)(2), the taxpayer allocates to lobbying activities the sum of its third-party costs (as defined in paragraph (d)(5) of this section) allocable to lobbying activities and 225 percent of its basic lobbying labor costs (as defined in paragraph (e)(3)), excluding the costs of personnel who engage in secretarial, clerical, support, and other administrative activities (as opposed to activities involving significant judgment with respect to lobbying activities).

(3) *Basic lobbying labor costs.* For purposes of this paragraph (e), basic lobbying labor costs are the basic costs of lobbying labor hours (as defined in paragraph (d)(2) of this section) determined for the appropriate personnel. For purposes of this paragraph (e), basic costs of lobbying labor hours are wages or other similar costs of labor, including, for example, guaranteed payments for services. Basic costs do

not include pension, profit-sharing, employee benefits, and supplemental unemployment benefit plan costs, or other similar costs.

(4) *Example.* The provisions of this paragraph (e) are illustrated by the following example.

Example. (i) In 1996, three employees, A, B, and C, of Taxpayer X engage in both lobbying activities and nonlobbying activities. A spends 300 hours, B spends 1,700 hours, and C spends 1,000 hours on lobbying activities.

(ii) X has no third-party costs.

(iii) For purposes of the gross-up method, X determines that its basic labor costs are $20 per hour for A, $30 per hour for B, and $25 per hour for C. Thus, its basic lobbying labor costs are ($20×300)+($30×1,700)+($25×1,000), or ($6,000+$51,000+$25,000), for total basic lobbying labor costs for 1996 of $82,000.

(iv) Under the gross-up method, X allocates $143,500 to its lobbying activities for 1996, as follows:

$$175\% \times \begin{array}{l}\text{Basic lobbying labor}\\ \text{costs of all personnel}\end{array} + \begin{array}{l}\text{Allocable third-}\\ \text{party costs}\end{array} = \begin{array}{l}\text{Costs allocable to}\\ \text{lobbying activities}\end{array}$$

$$[175\% \times \$82{,}000] \quad + [0] \quad = \$143{,}500.$$

(f) *Section 263A cost allocation methods*—(1) *In general.* A taxpayer may allocate its costs to lobbying activities under the principles set forth in section 263A and the regulations thereunder, except to the extent inconsistent with paragraph (g) of this section. For this purpose, lobbying activities are considered a service department or function. Therefore, a taxpayer may allocate costs to lobbying activities by applying the methods provided in §§1.263A–1 through 1.263A–3. See §1.263A–1(e)(4), which describes service costs generally; §1.263A–1(f), which sets forth cost allocation methods available under section 263A; and §1.263A–1(g)(4), which provides methods of allocating service costs.

(2) *Example.* The provisions of this paragraph (f) are illustrated by the following example.

Example. (i) Three full-time employees, A, B, and C, work in the Washington office of Taxpayer Y, a manufacturing concern. They each engage in lobbying activities and nonlobbying activities. In 1996, A spends 75 hours, B spends 1,750 hours, and C spends 2,000 hours on lobbying activities. A's hours are not spent on direct contact lobbying as defined in paragraph (g)(2) of this section. All three work 2,000 hours during 1996. The Washington office also employs one secretary, D, who works exclusively for A, B, and C.

(ii) In addition, three departments in the corporate headquarters in Chicago benefit the Washington office: Public affairs, human resources, and insurance.

(iii) Y is subject to section 263A and uses the step-allocation method to allocate its service costs. Prior to the amendments to section 162(e), the Washington office was treated as an overall management function for purposes of section 263A. As such, its costs were fully deductible and no further allocations were made under Y's step allocation. Following the amendments to section 162(e), Y adopts its 263A step-allocation methodology to allocate costs to lobbying activities. Y adds a lobbying department to its step-allocation program, which results in an allocation of costs to the lobbying department from both the Washington office and the Chicago office.

(iv) Y develops a labor ratio to allocate its Washington office costs between the newly defined lobbying department and the overall management department. To determine the hours allocable to lobbying activities, Y uses the de minimis rule of paragraph (g)(1) of this section. Under this rule, A's hours spent on lobbying activities are treated as zero because less than 5 percent of A's time is spent on lobbying (75/2,000=3.75%). In addition, because D works exclusively for personnel engaged in lobbying activities, D's hours are not used to develop the allocation ratio. Y assumes that D's allocation of time follows the average time of all the personnel engaged in lobbying activities. Thus, Y's labor ratio is determined as follows:

Employee	Departments		
	Lobbying hours	Overall management hours	Total hours
A	0	2,000	2,000
B	1,750	250	2,000
C	2,000	0	2,000
Totals	3,750	2,250	6,000

$$\begin{matrix}\text{Lobbying}\\ \text{Department}\\ \text{Ratio}\end{matrix} = \frac{3{,}750}{6{,}000} = 62.5\%$$

$$\begin{matrix}\text{Overall}\\ \text{Management}\\ \text{Department}\\ \text{Ratio}\end{matrix} = \frac{2{,}250}{6{,}000} = 37.5\%$$

(v) In 1996, the Washington office has the following costs:

Account	Amount
Professional Salaries and Benefits	$660,000
Clerical Salaries and Benefits	50,000
Rent Expense	100,000
Depreciation on Furniture and Equip	40,000
Utilities	15,000
Outside Payroll Service	5,000
Miscellaneous	10,000
Third-Party Lobbying (Law Firm)	90,000
Total Washington Costs	$970,000

(vi) In addition, $233,800 of costs from the public affairs department, $30,000 of costs from the insurance department, and $5,000 of costs from the human resources department are allocable to the Washington office from departments in Chicago. Therefore, the Washington office costs are allocated to the Lobbying and Overall Management departments as follows:

Total Washington department costs from above	$970,000
Plus Costs Allocated From Other Departments	268,800
Less third-party costs directly allocable to lobbying	(90,000)
Total Washington office costs	1,148,800

	Lobbying department	Overall management department
Department Allocation Ratios	62.5%	37.5%
× Washington Office Costs	$1,148,800	$1,148,800
= Costs Allocated To Departments	$718,000	$430,800

(vii) Y's step-allocation for its Lobbying Department is determined as follows:

Y's step-allocation	Lobbying department
Washington costs allocated to lobbying department	$718,000
Plus third-party costs	90,000
Total costs of lobbying activities	808,000

(g) *Special rules.* The following rules apply to any reasonable method of allocating costs to lobbying activities.

(1) *De minimis rule for labor hours.* Subject to the exception provided in paragraph (g)(2) of this section, a taxpayer may treat time spent by an individual on lobbying activities as zero if less than five percent of the person's time is spent on lobbying activities. Reasonable methods must be used to determine if less than five percent of a person's time is spent on lobbying activities.

(2) *Direct contact lobbying labor hours.* Notwithstanding paragraph (g)(1) of this section, a taxpayer must treat all hours spent by a person on direct contact lobbying (as well as the hours that person spends in connection with direct contact lobbying, including time spent traveling that is allocable to the direct contact lobbying) as labor hours allocable to lobbying activities. An activity is direct contact lobbying if it is a meeting, telephone conversation, letter, or other similar means of communication with a legislator (other than a local legislator) or covered executive branch official (as defined in section 162(e)(6)) and otherwise qualifies as a lobbying activity. A person who engages in research, preparation, and

other background activities related to direct contact lobbying but who does not make direct contact with a legislator or covered executive branch official is not engaged in direct contact lobbying.

(3) *Taxpayer defined.* For purposes of this section, a taxpayer includes a tax-exempt organization subject to section 6033(e).

(h) *Effective date.* This section is effective for amounts paid or incurred on or after July 21, 1995. Taxpayers must adopt a reasonable interpretation of sections 162(e)(1)(A) and (D) for amounts paid or incurred before this date.

[T.D. 8602, 60 FR 37573, July 21, 1995]

§1.162–29 Influencing legislation.

(a) *Scope.* This section provides rules for determining whether an activity is influencing legislation for purposes of section 162(e)(1)(A). This section does not apply for purposes of sections 4911 and 4945 and the regulations thereunder.

(b) *Definitions.* For purposes of this section—

(1) *Influencing legislation.* Influencing legislation means—

(i) Any attempt to influence any legislation through a lobbying communication; and

(ii) All activities, such as research, preparation, planning, and coordination, including deciding whether to make a lobbying communication, engaged in for a purpose of making or supporting a lobbying communication, even if not yet made. See paragraph (c) of this section for rules for determining the purposes for engaging in an activity.

(2) *Attempt to influence legislation.* An attempt to influence any legislation through a lobbying communication is making the lobbying communication.

(3) *Lobbying communication.* A lobbying communication is any communication (other than any communication compelled by subpoena, or otherwise compelled by Federal or State law) with any member or employee of a legislative body or any other government official or employee who may participate in the formulation of the legislation that—

(i) Refers to specific legislation and reflects a view on that legislation; or

(ii) Clarifies, amplifies, modifies, or provides support for views reflected in a prior lobbying communication.

(4) *Legislation.* Legislation includes any action with respect to Acts, bills, resolutions, or other similar items by a legislative body. Legislation includes a proposed treaty required to be submitted by the President to the Senate for its advice and consent from the time the President's representative begins to negotiate its position with the prospective parties to the proposed treaty.

(5) *Specific legislation.* Specific legislation includes a specific legislative proposal that has not been introduced in a legislative body.

(6) *Legislative bodies.* Legislative bodies are Congress, state legislatures, and other similar governing bodies, excluding local councils (and similar governing bodies), and executive, judicial, or administrative bodies. For this purpose, administrative bodies include school boards, housing authorities, sewer and water districts, zoning boards, and other similar Federal, State, or local special purpose bodies, whether elective or appointive.

(7) *Examples.* The provisions of this paragraph (b) are illustrated by the following examples.

Example 1. Taxpayer P's employee, A, is assigned to approach members of Congress to gain their support for a pending bill. A drafts and P prints a position letter on the bill. P distributes the letter to members of Congress. Additionally, A personally contacts several members of Congress or their staffs to seek support for P's position on the bill. The letter and the personal contacts are lobbying communications. Therefore, P is influencing legislation.

Example 2. Taxpayer R is invited to provide testimony at a congressional oversight hearing concerning the implementation of The Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Specifically, the hearing concerns a proposed regulation increasing the threshold value of commercial and residential real estate transactions for which an appraisal by a state licensed or certified appraiser is required. In its testimony, R states that it is in favor of the proposed regulation. Because R does not refer to any specific legislation or reflect a view on any such legislation, R has not made a lobbying communication. Therefore, R is not influencing legislation.

Example 3. State X enacts a statute that requires the licensing of all day-care providers. Agency B in State X is charged with writing rules to implement the statute. After the enactment of the statute, Taxpayer S sends a letter to Agency B providing detailed proposed rules that S recommends Agency B adopt to implement the statute on licensing of day-care providers. Because the letter to Agency B neither refers to nor reflects a view on any specific legislation, it is not a lobbying communication. Therefore, S is not influencing legislation.

Example 4. Taxpayer T proposes to a State Park Authority that it purchase a particular tract of land for a new park. Even if T's proposal would necessarily require the State Park Authority eventually to seek appropriations to acquire the land and develop the new park, T has not made a lobbying communication because there has been no reference to, nor any view reflected on, any specific legislation. Therefore, T's proposal is not influencing legislation.

Example 5. (i) Taxpayer U prepares a paper that asserts that lack of new capital is hurting State X's economy. The paper indicates that State X residents either should invest more in local businesses or increase their savings so that funds will be available to others interested in making investments. U forwards a summary of the unpublished paper to legislators in State X with a cover letter that states in part:

You must take action to improve the availability of new capital in the state.

(ii) Because neither the summary nor the cover letter refers to any specific legislative proposal and no other facts or circumstances indicate that they refer to an existing legislative proposal, forwarding the summary to legislators in State X is not a lobbying communication. Therefore, U is not influencing legislation.

(iii) Q, a member of the legislature of State X, calls U to request a copy of the unpublished paper from which the summary was prepared. U forwards the paper with a cover letter that simply refers to the enclosed materials. Because U's letter to Q and the unpublished paper do not refer to any specific legislation or reflect a view on any such legislation, the letter is not a lobbying communication. Therefore, U is not influencing legislation.

Example 6. (i) Taxpayer V prepares a paper that asserts that lack of new capital is hurting the national economy. The paper indicates that lowering the capital gains rate would increase the availability of capital and increase tax receipts from the capital gains tax. V forwards the paper to its representatives in Congress with a cover letter that says, in part:

I urge you to support a reduction in the capital gains tax rate.

(ii) V's communication is a lobbying communication because it refers to and reflects a view on a specific legislative proposal (i.e., lowering the capital gains rate). Therefore, V is influencing legislation.

Example 7. Taxpayer W, based in State A, notes in a letter to a legislator of State A that State X has passed a bill that accomplishes a stated purpose and then says that State A should pass such a bill. No such bill has been introduced into the State A legislature. The communication is a lobbying communication because it refers to and reflects a view on a specific legislative proposal. Therefore, W is influencing legislation.

Example 8. (i) Taxpayer Y represents citrus fruit growers. Y writes a letter to a United States senator discussing how pesticide O has benefited citrus fruit growers and disputing problems linked to its use. The letter discusses a bill pending in Congress and states in part:

This bill would prohibit the use of pesticide O. If citrus growers are unable to use this pesticide, their crop yields will be severely reduced, leading to higher prices for consumers and lower profits, even bankruptcy, for growers.

(ii) Y's views on the bill are reflected in this statement. Thus, the communication is a lobbying communication, and Y is influencing legislation.

Example 9. (i) B, the president of Taxpayer Z, an insurance company, meets with Q, who chairs the X state legislature's committee with jurisdiction over laws regulating insurance companies, to discuss the possibility of legislation to address current problems with surplus-line companies. B recommends that legislation be introduced that would create minimum capital and surplus requirements for surplus-line companies and create clearer guidelines concerning the risks that surplus-line companies can insure. B's discussion with Q is a lobbying communication because B refers to and reflects a view on a specific legislative proposal. Therefore, Z is influencing legislation.

(ii) Q is not convinced that the market for surplus-line companies is substantial enough to warrant such legislation and requests that B provide information on the amount and types of risks covered by surplus-line companies. After the meeting, B has employees of Z prepare estimates of the percentage of property and casualty insurance risks handled by surplus-line companies. B sends the estimates with a cover letter that simply refers to the enclosed materials. Although B's follow-up letter to Q does not refer to specific legislation or reflect a view on such legislation, B's letter supports the views reflected in the earlier communication. Therefore, the letter is a lobbying communication and Z is influencing legislation.

(c) *Purpose for engaging in an activity*—(1) *In general.* The purposes for engaging in an activity are determined based on all the facts and circumstances. Facts and circumstances include, but are not limited to—

(i) Whether the activity and the lobbying communication are proximate in time;

(ii) Whether the activity and the lobbying communication relate to similar subject matter;

(iii) Whether the activity is performed at the request of, under the direction of, or on behalf of a person making the lobbying communication;

(iv) Whether the results of the activity are also used for a nonlobbying purpose; and

(v) Whether, at the time the taxpayer engages in the activity, there is specific legislation to which the activity relates.

(2) *Multiple purposes.* If a taxpayer engages in an activity both for the purpose of making or supporting a lobbying communication and for some nonlobbying purpose, the taxpayer must treat the activity as engaged in partially for a lobbying purpose and partially for a nonlobbying purpose. This division of the activity must result in a reasonable allocation of costs to influencing legislation. See §1.162–28 (allocation rules for certain expenditures to which section 162(e)(1) applies). A taxpayer's treatment of these multiple-purpose activities will, in general, not result in a reasonable allocation if it allocates to influencing legislation—

(i) Only the incremental amount of costs that would not have been incurred but for the lobbying purpose; or

(ii) An amount based solely on the number of purposes for engaging in that activity without regard to the relative importance of those purposes.

(3) *Activities treated as having no purpose to influence legislation.* A taxpayer that engages in any of the following activities is treated as having done so without a purpose of making or supporting a lobbying communication—

(i) Before evidencing a purpose to influence any specific legislation referred to in paragraph (c)(3)(i)(A) or (B) of this section (or similar legislation)—

(A) Determining the existence or procedural status of specific legislation, or the time, place, and subject of any hearing to be held by a legislative body with respect to specific legislation; or

(B) Preparing routine, brief summaries of the provisions of specific legislation;

(ii) Performing an activity for purposes of complying with the requirements of any law (for example, satisfying state or federal securities law filing requirements);

(iii) Reading any publications available to the general public or viewing or listening to other mass media communications; and

(iv) Merely attending a widely attended speech.

(4) *Examples.* The provisions of this paragraph (c) are illustrated by the following examples.

Example 1. (i) *Facts.* In 1997, Agency F issues proposed regulations relating to the business of Taxpayer W. There is no specific legislation during 1997 that is similar to the regulatory proposal. W undertakes a study of the impact of the proposed regulations on its business. W incorporates the results of that study in comments sent to Agency F in 1997. In 1998, legislation is introduced in Congress that is similar to the regulatory proposal. Also in 1998, W writes a letter to Senator P stating that it opposes the proposed legislation. W encloses with the letter a copy of the comments it sent to Agency F.

(ii) *Analysis.* W's letter to Senator P refers to and reflects a view on specific legislation and therefore is a lobbying communication. Although W's study of the impact of the proposed regulations is proximate in time and similar in subject matter to its lobbying communication, W performed the study and incorporated the results in comments sent to Agency F when no legislation with a similar subject matter was pending (a nonlobbying use). On these facts, W engaged in the study solely for a nonlobbying purpose.

Example 2. (i) *Facts.* The governor of State Q proposes a budget that includes a proposed sales tax on electricity. Using its records of electricity consumption, Taxpayer Y estimates the additional costs that the budget proposal would impose upon its business. In the same year, Y writes to members of the state legislature and explains that it opposes the proposed sales tax. In its letter, Y includes its estimate of the costs that the sales tax would impose on its business. Y does not demonstrate any other use of its estimates.

(ii) *Analysis.* The letter is a lobbying communication (because it refers to and reflects a view on specific legislation, the governor's proposed budget). Y's estimate of additional costs under the proposal supports the lobbying communication, is proximate in time and similar in subject matter to a specific legislative proposal then in existence, and is not used for a nonlobbying purpose. Based on these facts, Y estimated its additional costs under the budget proposal solely to support the lobbying communication.

Example 3. (i) *Facts.* A senator in the State Q legislature announces her intention to introduce legislation to require health insurers to cover a particular medical procedure in all policies sold in the state. Taxpayer Y has different policies for two groups of employees, one of which covers the procedure and one of which does not. After the bill is introduced, Y's legislative affairs staff asks Y's human resources staff to estimate the additional cost to cover the procedure for both groups of employees. Y's human resources staff prepares a study estimating Y's increased costs and forwards it to the legislative affairs staff. Y's legislative staff then writes to members of the state legislature and explains that it opposes the proposed change in insurance coverage based on the study. Y's legislative affairs staff thereafter forwards the study, prepared for its use in opposing the statutory proposal, to its labor relations staff for use in negotiations with employees scheduled to begin later in the year.

(ii) *Analysis.* The letter to legislators is a lobbying communication (because it refers to and reflects a view on specific legislation). The activity of estimating Y's additional costs under the proposed legislation relates to the same subject as the lobbying communication, occurs close in time to the lobbying communication, is conducted at the request of a person making a lobbying communication, and relates to specific legislation then in existence. Although Y used the study in its labor negotiations, mere use for that purpose does not establish that Y estimated its additional costs under the proposed legislation in part for a nonlobbying purpose. Thus, based on all the facts and circumstances, Y estimated the additional costs it would incur under the proposal solely to make or support the lobbying communication.

Example 4. (i) *Facts.* After several years of developmental work under various contracts, in 1996, Taxpayer A contracts with the Department of Defense (DOD) to produce a prototype of a new generation military aircraft. A is aware that DOD will be able to fund the contract only if Congress appropriates an amount for that purpose in the upcoming appropriations process. In 1997, A conducts simulation tests of the aircraft and revises the specifications of the aircraft's expected performance capabilities, as required under the contract. A submits the results of the tests and the revised specifications to DOD. In 1998, Congress considers legislation to appropriate funds for the contract. In that connection, A summarizes the results of the simulation tests and of the aircraft's expected performance capabilities, and submits the summary to interested members of Congress with a cover letter that encourages them to support appropriations of funds for the contract.

(ii) *Analysis.* The letter is a lobbying communication (because it refers to specific legislation (i.e., appropriations) and requests passage). The described activities in 1996, 1997, and 1998 relate to the same subject as the lobbying communication. The summary was prepared specifically for, and close in time to, that communication. Based on these facts, the summary was prepared solely for a lobbying purpose. In contrast, A conducted the tests and revised the specifications to comply with its production contract with DOD. A conducted the tests and revised the specifications solely for a nonlobbying purpose.

Example 5. (i) *Facts.* C, president of Taxpayer W, travels to the state capital to attend a two-day conference on new manufacturing processes. C plans to spend a third day in the capital meeting with state legislators to explain why W opposes a pending bill unrelated to the subject of the conference. At the meetings with the legislators, C makes lobbying communications by referring to and reflecting a view on the pending bill.

(ii) *Analysis.* C's traveling expenses (transportation and meals and lodging) are partially for the purpose of making or supporting the lobbying communications and partially for a nonlobbying purpose. As a result, under paragraph (c)(2) of this section, W must reasonably allocate C's traveling expenses between these two purposes. Allocating to influencing legislation only C's incremental transportation expenses (i.e., the taxi fare to meet with the state legislators) does not result in a reasonable allocation of traveling expenses.

Example 6. (i) *Facts.* On February 1, 1997, a bill is introduced in Congress that would affect Company E. Employees in E's legislative affairs department, as is customary, prepare a brief summary of the bill and periodically confirm the procedural status of the bill through conversations with employees and members of Congress. On March 31, 1997, the head of E's legislative affairs department meets with E's President to request that B, a chemist, temporarily help the legislative affairs department analyze the bill. The President agrees, and suggests that B also be assigned to draft a position letter in opposition to the bill. Employees of the legislative affairs department continue to confirm periodically the procedural status of the bill. On October 31, 1997, B's position letter in opposition to the bill is delivered to members of Congress.

(ii) *Analysis.* B's letter is a lobbying communication because it refers to and reflects a view on specific legislation. Under paragraph (c)(3)(i) of this section, the assignment of B to assist the legislative affairs department in analyzing the bill and in drafting a position letter in opposition to the bill evidences a purpose to influence legislation. Neither the activity of periodically confirming the procedural status of the bill nor the activity of preparing the routine, brief summary of the bill before March 31 constitutes influencing legislation. In contrast, periodically confirming the procedural status of the bill on or after March 31 relates to the same subject as, and is close in time to, the lobbying communication and is used for no nonlobbying purpose. Consequently, after March 31, E determined the procedural status of the bill for the purpose of supporting the lobbying communication by B.

(d) *Lobbying communication made by another.* If a taxpayer engages in activities for a purpose of supporting a lobbying communication to be made by another person (or by a group of persons), the taxpayer's activities are treated under paragraph (b) of this section as influencing legislation. For example, if a taxpayer or an employee of the taxpayer (as a volunteer or otherwise) engages in an activity to assist a trade association in preparing its lobbying communication, the taxpayer's activities are influencing legislation even if the lobbying communication is made by the trade association and not the taxpayer. If, however, the taxpayer's employee, acting outside the employee's scope of employment, volunteers to engage in those activities, then the taxpayer is not influencing legislation.

(e) *No lobbying communication.* Paragraph (e) of this section applies if a taxpayer engages in an activity for a purpose of making or supporting a lobbying communication, but no lobbying communication that the activity supports has yet been made.

(1) *Before the filing date.* Under this paragraph (e)(1), if on the filing date of the return for any taxable year the taxpayer no longer expects, under any reasonably foreseeable circumstances, that a lobbying communication will be made that is supported by the activity, then the taxpayer will be treated as if it did not engage in the activity for a purpose of making or supporting a lobbying communication. Thus, the taxpayer need not treat any amount allocated to that activity for that year under §1.162–28 as an amount to which section 162(e)(1)(A) applies. The filing date for purposes of paragraph (e) of this section is the earlier of the time the taxpayer files its timely return for the year or the due date of the timely return.

(2) *After the filing date*—(i) *In general.* If, at any time after the filing date, the taxpayer no longer expects, under any reasonably foreseeable circumstances, that a lobbying communication will be made that is supported by the activity, then any amount previously allocated under §1.162–28 to the activity and disallowed under section 162(e)(1)(A) is treated as an amount that is not subject to section 162(e)(1)(A) and that is paid or incurred only at the time the taxpayer no longer expects that a lobbying communication will be made.

(ii) *Special rule for certain tax-exempt organizations.* For a tax-exempt organization subject to section 6033(e), the amounts described in paragraph (e)(2)(i) of this section are treated as reducing (but not below zero) its expenditures to which section 162(e)(1) applies beginning with that year and continuing for subsequent years to the extent not treated in prior years as reducing those expenditures.

(f) *Anti-avoidance rule.* If a taxpayer, alone or with others, structures its activities with a principal purpose of achieving results that are unreasonable in light of the purposes of section 162(e)(1)(A) and section 6033(e), the Commissioner can recast the taxpayer's activities for federal tax purposes as appropriate to achieve tax results that are consistent with the intent of section 162(e)(1)(A), section 6033(e) (if applicable), and this section, and the pertinent facts and circumstances.

(g) *Taxpayer defined.* For purposes of this section, a taxpayer includes a tax-exempt organization subject to section 6033(e).

(h) *Effective date.* This section is effective for amounts paid or incurred on or after July 21, 1995. Taxpayers must adopt a reasonable interpretation of section 162(e)(1)(A) for amounts paid or incurred before this date.

[T.D. 8602, 60 FR 37575, July 21, 1995]

§ 1.163–1 Interest deduction in general.

(a) Except as otherwise provided in sections 264 to 267, inclusive, interest paid or accrued within the taxable year on indebtedness shall be allowed as a deduction in computing taxable income. For rules relating to interest on certain deferred payments, see section 483 and the regulations thereunder.

(b) Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. Pursuant to the provisions of section 163(c), any annual or periodic rental payment made by a taxpayer on or after January 1, 1962, under a redeemable ground rent, as defined in section 1055(c) and paragraph (b) of § 1.1055–1, is required to be treated as interest on an indebtedness secured by a mortgage and, accordingly, may be deducted by the taxpayer as interest on his indebtedness. Section 163(c) has no application in respect of any annual or periodic rental payment made prior to January 1, 1962, or pursuant to an arrangement which does not constitute a ‘‘redeemable ground rent’’ as defined in section 1055(c) and paragraph (b) of § 1.1055–1. Accordingly, annual or periodic payments of Pennsylvania ground rents made before, on, or after January 1, 1962, are deductible as interest if the ground rent is redeemable. An annual or periodic rental payment under a Maryland redeemable ground rent made prior to January 1, 1962, is deductible in accordance with the rules and regulations applicable at the time such payment was made. Any annual or periodic rental payment under a Maryland redeemable ground rent made by the taxpayer on or after January 1, 1962, is, pursuant to the provisions of section 163(c), treated as interest on an indebtedness secured by a mortgage and, accordingly, is deductible by the taxpayer as interest on his indebtedness. In any case where the ground rent is irredeemable, any annual or periodic ground rent payment shall be treated as rent and shall be deductible only to the extent that the payment constitutes a proper business expense. Amounts paid in redemption of a ground rent shall not be treated as interest. For treatment of redeemable ground rents and real property held subject to liabilities under redeemable ground rents, see section 1055 and the regulations thereunder.

(c) Interest calculated for costkeeping or other purposes on account of capital or surplus invested in the business which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing taxable income. (See, however, section 583.) In the case of banks and loan or trust companies, interest paid within the year on deposits, such as interest paid on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank or loan or trust company, may be deducted from gross income.

(d) To the extent of assistance payments made in respect of an indebtedness of the taxpayer during the taxable year by the Department of Housing and Urban Development under section 235 of the National Housing Act (12 U.S.C. 1715z), as amended, no deduction shall be allowed under section 163 and this section for interest paid or accrued with respect to such indebtedness. However, such payments shall not affect the amount of any deduction under any section of the Code other than section 163. The provisions of this paragraph shall apply to taxable years beginning after December 31, 1974.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6821, 30 FR 6216, May 4, 1965; T.D. 6873, 31 FR 941, Jan. 25, 1966; T.D. 7408, 41 FR 9547, Mar. 5, 1976]

§ 1.163–2 Installment purchases where interest charge is not separately stated.

(a) *In general.* (1) Whenever there is a contract with a seller for the purchase of personal property providing for payment of part or all of the purchase price in installments and there is a separately stated carrying charge (including a finance charge, service charge, and the like) but the actual interest charge cannot be ascertained, a portion of the payments made during the taxable year under the contract shall be treated as interest and is deductible under section 163 and this section. Section 163(b) contains a formula, described in paragraph (b) of this section, in accordance with which the amount of interest deductible in the taxable year must be computed. This formula is designed to operate automatically in the case of any installment purchase, without regard to whether payments under the contract are made when due or are in default. For applicable limitations when an obligation to pay is terminated, see paragraph (c) of this section.

(2) Whenever there is a contract with an educational institution for the purchase of educational services providing for payment of part or all of the purchase price in installments and there is a separately stated carrying charge (including a finance charge, service charge, and the like) but the actual interest charge cannot be ascertained, a portion of the payments made during the taxable year under the contract shall be treated as interest and is deductible under section 163 and this section. See paragraphs (b) and (c) of this section for the applicable computation and limitations rules. For purposes of section 163(b) and this section, the term ‘‘educational services’’ means any service (including lodging) which is purchased from an educational institution (as defined in section 151(e)(4) and paragraph (c) of §1.151–3) and which is provided for a student of such institution.

(3) Section 163(b) and this section do not apply to a contract for the loan of money, even if the loan is to be repaid in installments and even if the borrowed amount is used to purchase personal property or educational services. In cases to which the preceding sentence applies, the portion of the installment payment which constitutes interest (as distinguished from payments of principal and charges such as payments for credit life insurance) is deductible under section 163(a) and §1.163–1.

(b) *Computation.* The portion of any such payments to be treated as interest shall be equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of this computation, the average unpaid balance under the contract is the sum of the unpaid balance outstanding on the first day of each month beginning during the taxable year, divided by 12.

(c) *Limitations.* The amount treated as interest under section 163(b) and this section for any taxable year shall not exceed the amount of the payments made under the contract during the taxable year nor the aggregate carrying charges properly attributable to each contract for such taxable year. In computing the amount to be treated as interest if the obligation to pay is terminated as, for example, in the case of a repossession of the property, the unpaid balance on the first day of the month during which the obligation is terminated shall be zero.

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

Example (1). On January 20, 1955, A purchased a television set for $400, including a stated carrying charge of $25. The down payment was $50, and the balance was paid in 14 monthly installments of $25 each, on the 20th day of each month commencing with February. Assuming that A is a cash method, calendar year taxpayer and that no other installment purchases were made, the amount to be treated as interest in 1955 is $12.38, computed as follows:

YEAR 1955

First day of	Unpaid balance outstanding
January	0
February	$350
March	325
April	300
May	275
June	250
July	225
August	200
September	175
October	150
November	125
December	100
	2,475

Sum of unpaid balances $2,475÷12= $206.25; 6 percent thereof=$12.38.

Example (2). On November 20, 1955, B purchased a furniture set for $1,250, including a stated carrying charge of $48. The down payment was $50 and the balance was payable in

12 monthly installments of $100 each, on the first day of each month commencing with December 1955. Assume that B is a cash method, calendar year taxpayer and that no other installment purchases were made. Assume further that B made the first payment when due, but made only one other payment on June 1, 1956. The amount to be treated as interest in 1955 is $4, and the amount to be treated as interest in 1956 is $33, computed as follows:

YEAR 1955

First day of	Unpaid balance outstanding
December	$1,200

Sum of unpaid balances $1,200÷12=$100; 6 percent thereof=$6.

Carrying charges attributable to 1955=$4.

YEAR 1956

First day of	Unpaid balance outstanding
January	$1,100
February	1,000
March	900
April	800
May	700
June	600
July	500
August	400
September	300
October	200
November	100
	6,600

Sum of unpaid balances $6,600÷12=$550; 6 percent thereof=$33.

Carrying charges attributable to 1956=$44 ($4×11).

Example (3). Assume the same facts as in example (2), except that the furniture was repossessed and B's obligation to pay terminated as of July 15, 1956. The amount to be treated as interest in 1955 is $4, computed as in example (2) above. The amount to be treated as interest in 1956 is $25.50, computed as follows:

YEAR 1956

First day of	Unpaid balance outstanding
January	$1,100
February	1,000
March	900
April	800
May	700
June	600
July–November	0
	5,100

Sum of unpaid balances $5,100÷12=$425. 6 percent thereof=$25.50.

Carrying charges attributable to 1956= $44 ($4×11).

Example (4). (i) On September 15, 1968, C registered at X University for the 1968–69 academic year. C entered into an agreement with the X University for the purchase during such academic year of educational services (including lodging and tuition) for a total fee of $1,000, including a separately stated carrying charge of $50. Under the terms of the agreement, an initial payment of $200 was to be made by C on September 15, 1968, and the balance was to be paid in 8 monthly installments of $100 each, on the 15th day of each month commencing with October 1968. C made all of the required 1968 payments. Assuming that C is a cash method, calendar year taxpayer and that no other installment purchases of services or property were made, the amount to be treated as interest in 1968 is $10.50, computed as follows:

YEAR 1968

First day of	Unpaid balance outstanding
January–September	0
October	$800
November	700
December	600
Total	2,100

The sum of unpaid balances ($2,100) divided by 12 is $175; 6 percent thereof is $10.50. The carrying charges attributable to 1968 are $18.75 (i.e., the total carrying charges ($50), divided by the total number of payments (8), multiplied by the number of payments made in 1968 (3)). Since the amount to be treated as interest in 1968 ($10.50) does not exceed the carrying charges attributable to 1968 ($18.75), the limitation set forth in paragraph (c) of this section is not applicable.

(ii) The result in this example would be the same even if the X University assigned the agreement to a bank or other financial institution and C made his payments directly to the bank or other financial institution.

Example (5). On September 15, 1968, D registered at Y University for the 1968–69 academic year. The tuition for such year was $1,500. In order to pay his tuition, D borrowed $1,500 from the M Corporation, a lending institution, and remitted that sum to the Y University. The loan agreement between M Corporation and D provided that D was to repay the loan, plus a service charge, in 10 equal monthly installments, on the first day of each month commencing with October 1968. The service charge consisted of interest and the cost of credit life insurance on D's life. Since section 163(b) and this section do not apply to a contract for the loan of money, D is not entitled to compute his interest deduction with respect to his loan from M Corporation under such sections. D may deduct that portion of each installment payment which constitutes interest (as distinguished from payments of principal and the charge for credit life insurance) under section 163(a) and §1.163–1, provided that the amount of such interest can be ascertained.

(e) *Effective date.* Except in the case of payments made under a contract for educational services, the rule provided in section 163(b) and this section applies to payments made during taxable years beginning after December 31, 1953, and ending after August 16, 1954, regardless of when the contract of sale was made. In the case of payments made under a contract for educational services, the rule provided in section 163(b) and this section applies to payments made during taxable years beginning after December 31, 1963, regardless of when the contract for educational services was made.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6991, 34 FR 742, Jan. 17, 1969]

§1.163–3 Deduction for discount on bond issued on or before May 27, 1969.

(a) *Discount upon issuance.* (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity (or, in the case of a callable bond, at the earlier call date) over the issue price of the bond (as defined in paragraph (b)(2) of §1.1232–3).

(2) In the case of a bond issued by a corporation after December 31, 1954, as part of an investment unit consisting of an obligation and an option, the issue price of the bond is determined by allocating the amount received for the investment unit to the individual elements of the unit in the manner set forth in subdivision (ii)*(a)* of §1.1232–3(b)(2). Discount with respect to bonds issued by a corporation as part of investment units consisting of obligations and options after December 31, 1954, and before Dec. 24, 1968—

(i) Increased by any amount treated as bond premium which has been included in gross income with respect to such bonds prior to Dec. 24, 1968, or

(ii) Decreased by any amount which has been deducted by the issuer as discount attributable to such bonds prior to Dec. 24, 1968, and

(iii) Decreased by any amount which has been deducted by the issuer prior to Dec. 24, 1968 upon the exercise or sale by investors of options issued in investment units with such bonds,

should be amortized, starting with the first taxable year ending on or after Dec. 24, 1968 over the remaining life of such bonds.

(b) *Examples.* The rules in paragraph (a) of this section are illustrated by the following examples:

Example (1). M Corporation, on January 1, 1960, the beginning of its taxable year issued for $95,000, 3 percent bonds, maturing 10 years from the date of issue, with a stated redemption price at maturity of $100,000. M Corporation should treat $5,000 ($100,000–$95,000) as the total amount to be amortized over the life of the bonds.

Example (2). Assume the same facts as example (1), except that the bonds are convertible into common stock of M Corporation. Since the issue price of the bonds includes any amount attributable to the conversion privilege, the result is the same as in example (1).

Example (3). Assume the same facts as example (1), except that the bonds are issued as part of an investment unit consisting of an obligation and an option. Assume further that the issue price of the bonds as determined under the rules of allocation set forth in subdivision (ii)*(a)* of §1.1232–3(b)(2) is $94,000. Accordingly, M Corporation should treat $6,000 ($100,000–$94,000) as the total amount to be amortized over the life of the bonds.

Example (4). Assume in example (3), that prior to Dec. 24, 1968, M Corporation had only treated $5,000 as the bond discount to be amortized and deducted only $4,000 of this amount. Starting with the first taxable year ending on or after Dec. 24, 1968, M Corporation should amortize $2,000 ($6,000 discount, less $4,000 previously deducted) over the remaining life of the bonds.

Example (5). N Corporation, on January 1, 1956, for a consideration of $102,000, issued 20-year bonds in the face amount of $100,000, together with options to purchase stock of N Corporation. The issue price of the bonds as determined under the rules of allocation set forth in subdivision (ii)*(a)* of § 1.1232–3(b)(2) is $99,000. Until Dec. 24, 1968, N Corporation has treated as bond premium, $2,000, representing the excess of the consideration received for the bond-option investment units over the maturity value of the bonds, and has accordingly prorated and included in income $1,200 of such amount. Starting with the first taxable year beginning on or after Dec. 24, 1968, N Corporation may amortize as a deduction over the remaining life of the bonds the amount of $2,200 ($1,000 discount, plus $1,200 previously included in income).

Example (6). O Corporation, on January 1, 1956, for a consideration of $100,000, issued 20-year bonds with a $100,000 face value, together with options to purchase stock of O Corporation, which could be exercised at any time up to 5 years from the date of issue. The issue price of the bonds as determined under the rules of allocation set forth in subdivision (ii)*(a)* of § 1.1232–3(b)(2) is $98,000. O Corporation, upon the exercise of the options prior to Dec. 24, 1968, had deducted from income their fair market value at the time of exercise, which is assumed for purposes of this example to have been $3,000. Even though the bonds are considered to have been issued at a discount under paragraph (a)(1) of this section, O Corporation would have no deduction over the remaining life of the bonds, inasmuch as O Corporation, in computing the amount of such deduction, is required under paragraph (a)(2)(iii) of this section to reduce the amount which would otherwise be treated as bond discount, $2,000 ($100,000–$98,000), by the amount deducted from income upon the exercise of the options, in this case, $3,000.

(c) *Deduction upon repurchase.* (1) Except as provided in subparagraphs (2) and (3) of this paragraph, if bonds are issued by a corporation and are subsequently repurchased by the corporation at a price in excess of the issue price plus any amount of discount deducted prior to repurchase, or (in the case of bonds issued subsequent to Feb. 28, 1913) minus any amount of premium returned as income prior to repurchase, the excess of the purchase price over the issue price adjusted for amortized premium or discount is a deductible expense for the taxable year.

(2) In the case of a convertible bond (except a bond which the corporation, before Sept. 5, 1968, has obligated itself to repurchase at a specified price), the deduction allowable under subparagraph (1) of this paragraph may not exceed an amount equal to 1 year's interest at the rate specified in the bond, except to the extent that the corporation can demonstrate to the satisfaction of the Commissioner or his delegate that an amount in excess of 1 year's interest does not include any amount attributable to the conversion feature.

(3) No deduction shall be allowed under subparagraph (1) of this paragraph to the extent a deduction is disallowed under subparagraph (2) of this paragraph or to the extent a deduction is disallowed by section 249 (relating to limitation on deduction of bond premium on repurchase of convertible obligation) and the regulations thereunder. See paragraph (f) of § 1.249–1 for effective date limitation on section 249.

(d) *Definition.* For purposes of this section, a debenture, note, certificate other evidence of indebtedness, issued by a corporation and bearing interest shall be given the same treatment as a bond.

(e) *Effective date.* The provisions of this section shall not apply in respect of a bond issued after May 27, 1969, unless issued pursuant to a written commitment which was binding on that date and at all times thereafter.

[T.D. 6984, 33 FR 19175, Dec. 24, 1968, as amended at 36 FR 24996, Dec. 28, 1971; T.D. 7259, 38 FR 4253, Feb. 12, 1973]

§ 1.163–4 Deduction for original issue discount on certain obligations issued after May 27, 1969.

(a) *In general.* (1) If an obligation is issued by a corporation with original issue discount, the amount of such discount is deductible as interest and shall be prorated or amortized over the life of the obligation. For purposes of this section the term ''obligation'' shall have the same meaning as in § 1.1232–1 (without regard to whether the obligation is a capital asset in the hands of the holder) and the term ''original issue discount'' shall have the same meaning as in section 1232(b)(1) (without regard to the one-fourth of 1 percent limitation in the second sentence thereof). Thus, in general, the amount of original issue discount equals the excess of the amount payable at maturity over the issue price of the bond (as defined in paragraph (b)(2) of §1.1232–3), regardless of whether that amount is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of complete years to maturity. For the rule as to whether there is original issue discount in the case of an obligation issued in an exchange for property other than money, and the amount thereof, see paragraph (b)(2)(iii) of §1.1232–3. In any case in which original issue discount is carried over from one corporation to another corporation under section 381(c)(9) or from an obligation exchanged to an obligation received in any exchange under paragraph (b)(1)(iv) of §1.1232–3, such discount shall be carried over for purposes of this section. The amount of original issue discount carried over in an exchange of obligations under the preceding sentence shall be prorated or amortized over the life of the obligation issued in such exchange. For computation of issue price and the amount of original issue discount in the case of serial obligations, see paragraph (b)(2)(iv) of §1.1232–3.

(2) In the case of an obligation issued by a corporation as part of an investment unit (as defined in paragraph (b)(2)(ii)*(a)* of §1.1232–3) consisting of an obligation and other property, the issue price of the obligation is determined by allocating the amount received for the investment unit to the individual elements of the unit in the manner set forth in paragraph (b)(2)(ii) of §1.1232–3.

(3) *Recovery or retention of amounts previously deducted.* In any taxable year in which an amount of original issue discount which was deducted as interest under this section is retained or recovered by the taxpayer, such as, for example, by reason of a fine, penalty, forfeiture, or other withdrawal fee, such amount shall be includible in the gross income of such taxpayer for such taxable year.

(b) *Examples.* The rules in paragraph (a) of this section are illustrated by the following examples:

Example (1). N Corporation, which uses the calendar year as its taxable year, on January 1, 1970, issued for $99,000, 9 percent bonds maturing 10 years from the date of issue, with a stated redemption price at maturity of $100,000. The original issue discount on each bond (as determined under section 1232(b)(1) without regard to the one-fourth-of-1-percent limitation in the second sentence thereof) is $1,000, i.e., redemption price, $100,000, minus issue price, $99,000. N shall treat $1,000 as the total amount to be amortized over the life of the bonds.

Example (2). Assume the same facts as example (1), except that the bonds are convertible into common stock of N Corporation. Since the issue price of the bonds includes any amount attributable to the conversion privilege, the result is the same as in example (1).

Example (3). Assume the same facts as example (1), except that the bonds are issued as part of an investment unit consisting of an obligation and an option. Assume further that the issue price of the bonds as determined under the rules of allocation set forth in paragraph (b)(2)(ii) of §1.1232–3 is $94,000. The original issue discount on the bond (as determined under section 1232(b)(1) without regard to the one-fourth-of-1-percent limitation in the second sentence thereof) is $6,000, i.e., redemption price, $100,000, minus issue price, $94,000. N shall treat $6,000 as the total amount to be amortized over the life of the bonds.

Example (4). On January 1, 1971, a commercial bank which uses the calendar year as its taxable year, issued a certificate of deposit for $10,000. The certificate of deposit is not redeemable until December 31, 1975, except in an emergency as defined in, and subject to the qualifications provided by Regulations Q of the Board of Governors of the Federal Reserve. See 12 CFR §217.4(d). The stated redemption price at maturity is $13,382.26. The certificate is an obligation to which section 1232(a)(3)(A) applies (see paragraph (d) of §1.1232–1), and the original issue discount with respect to the certificate (as determined under section 1232(b)(1) without regard to the one-fourth-of-1-percent limitation in the second sentence thereof) is $3,382.26 (i.e., redemption price, $13,382.26, minus issued price, $10,000). Y shall treat $3,382.26 as the total amount to be amortized over the life of the certificate.

(c) *Deduction upon repurchase.* (1) Except as provided in subparagraph (2) of this paragraph, if bonds are issued by a corporation and are subsequently repurchased by the corporation at a price in excess of the issue price plus any amount of original issue discount deducted prior to repurchase, or minus any amount of premium returned as income prior to repurchase, the excess of the repurchase price over the issue price adjusted for amortized premium or deducted discount is deductible as interest for the taxable year.

(2) The provisions of subparagraph (1) of this paragraph shall not apply to the extent a deduction is disallowed by section 249 (relating to limitation on deduction of bond premium or repurchase of convertible obligation) and the regulations thereunder.

(d) *Effective date.* The provisions of this section shall apply in respect of obligations issued after May 27, 1969, other than—

(1) Obligations issued pursuant to a written commitment which was binding on May 27, 1969, and at all times thereafter, and

(2) Deposits made before January 1, 1971, in the case of certificates of deposit, time deposits, bonus plans, and other deposit arrangements with banks, domestic building and loan associations, and similar financial institutions.

[36 FR 24996, Dec. 28, 1971, as amended by T.D. 7213, 37 FR 21991, Oct. 18, 1972; T.D. 7259, 38 FR 4253, Feb. 12, 1973]

§ 1.163–5 Denial of interest deduction on certain obligations issued after December 31, 1982, unless issued in registered form.

(a)–(b) [Reserved]

(c) *Obligations issued to foreign persons after September 21, 1984*—(1) *In general.* A determination of whether an obligation satisfies each of the requirements of this paragraph shall be made on an obligation-by-obligation basis. An obligation issued directly (or through affiliated entities) in bearer form by, or guaranteed by, a United States Government-owned agency or a United States Government-sponsored enterprise, such as the Federal National Mortgage Association, the Federal Home Loan Banks, the Federal Loan Mortgage Corporation, the Farm Credit Administration, and the Student Loan Marketing Association, may not satisfy this paragraph (c). An obligation issued after September 21, 1984 is described in this paragraph if—

(i) There are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with its original issuance) only to a person who is not a United States person or who is a United States person that is a financial institution (as defined in § 1.165–12(c)(1)(v)) purchasing for its own account or for the account of a customer and that agrees to comply with the requirements of section 165(j)(3) (A), (B), or (C) and the regulations thereunder, and

(ii) In the case of an obligation which is not in registered form—

(A) Interest on such obligation is payable only outside the United States and its possessions, and

(B) Unless the obligation is described in subparagraph (2)(i)(C) of this paragraph or is a temporary global security, the following statement in English either appears on the face of the obligation and on any interest coupons which may be detached therefrom or, if the obligation is evidenced by a book entry, appears in the book or record in which the book entry is made: ‘‘Any United States person who holds this obligation will be subject to limitations under the United States income tax laws, including the limitations provided in sections 165(j) and 1287(a) of the Internal Revenue Code.’’ For purposes of this paragraph, the term ‘‘temporary global security’’ means a security which is held for the benefit of the purchasers of the obligations of the issuer and interests in which are exchangeable for securities in definitive registered or bearer form prior to its stated maturity.

(2) *Rules for the application of this paragraph*—(i) *Arrangements reasonably designed to ensure sale to non-United States persons.* An obligation will be considered to satisfy paragraph (c)(1)(i) of this section if the conditions of paragraph (c)(2)(i) (A), (B), (C), or (D) of this section are met in connection with the original issuance of the obligation. An exchange of one obligation for another is considered an original issuance if and only if the exchange constitutes a disposition of property for purposes of section 1001 of the Code. However, an exchange of one obligation for another will not be considered a new issuance if the obligation received is identical in all respects to the obligation surrendered in exchange therefor, except that

the obligor of the obligation received need not be the same obligor as the obligor of the obligation surrendered. Obligations that meet the conditions of paragraph (c)(2)(i) (A), (B), (C) or (D) of this section may be issued in a single public offering. The preceding sentence does not apply to certificates of deposit issued under the conditions of paragraph (c)(2)(i)(C) of this section by a United States person or by a controlled foreign corporation within the meaning of section 957(a) that is engaged in the active conduct of a banking business within the meaning of section 954(c)(3)(B) as in effect prior to the Tax Reform Act of 1986, and the regulations thereunder. A temporary global security need not satisfy the conditions of paragraph (c)(2)(i) (A), (B) or (C) of this section, but must satisfy the applicable requirements of paragraph (c)(2)(i)(D) of this section.

(A) In connection with the original issuance of an obligation, the obligation is offered for sale or resale only outside of the United States and its possessions, is delivered only outside the United States and its possessions and is not registered under the Securities Act of 1933 because it is intended for distribution to persons who are not United States persons. An obligation will not be considered to be required to be registered under the Securities Act of 1933 if the issuer, in reliance on the written opinion of counsel received prior to the issuance thereof, determines in good faith that the obligation need not be registered under the Securities Act of 1933 for the reason that it is intended for distribution to persons who are not United States persons. Solely for purposes of this subdivision (i)(A), the term ''United States person'' has the same meaning as it has for purposes of determining whether an obligation is intended for distribution to persons under the Securities Act of 1933. Except as provided in paragraph (c)(3) of this section, this paragraph (c)(2)(i)(A) applies only to obligations issued on or before September 7, 1990.

(B) The obligation is registered under the Securities Act of 1933, is exempt from registration by reason of section 3 or section 4 of such Act, or does not qualify as a security under the Securities Act of 1933; all of the conditions set forth in paragraph (c)(2)(i)(B) (*1*), (*2*), (*3*), (*4*), and (*5*) of this section are met with respect to such obligations; and, except as provided in paragraph (c)(3) of this section, the obligation is issued on or before September 7, 1990.

(*1*) In connection with the original issuance of an obligation in bearer form, the obligation is offered for sale or resale only outside the United States and its possessions.

(*2*) The issuer does not, and each underwriter and each member of the selling group, if any, covenants that it will not, in connection with the original issuance of the obligation, offer to sell or resell the obligation in bearer form to any person inside the United States or to a United States person unless such United States person is a financial institution as defined in §1.165–12(c)(v) purchasing for its own account or for the account of a customer, which financial institution, as a condition of the purchase, agrees to provide on delivery of the obligation (or on issuance, if the obligation is not in definitive form) the certificate required under paragraph (c)(2)(i)(B)(4).

(*3*) In connection with its sale or resale during the original issuance of the obligation in bearer form, each underwriter and each member of the selling group, if any, or the issuer, if there is no underwriter or selling group, sends a confirmation to the purchaser of the bearer obligation stating that the purchaser represents that it is not a United States person or, if it is a United States person, it is a financial institution as defined in §1.165–12(c)(v) purchasing for its own account or for the account of a customer and that the financial institution will comply with the requirements of section 165(j)(3) (A), (B), or (C) and the regulations thereunder. The confirmation must also state that, if the purchaser is a dealer, it will send similar confirmations to whomever purchases from it.

(*4*) In connection with the original issuance of the obligation in bearer form it is delivered in definitive form (or issued, if the obligation is not in definitive form) to the person entitled to physical delivery thereof only outside the United States and its possessions and only upon presentation of a certificate signed by such person to the issuer, underwriter, or member of the selling group, which certificate states that the obligation is not being acquired by or on behalf of a United States person, or for offer to resell or for resale to a United States person or any person inside the United States, or, if a beneficial interest in the obligation is being acquired by a United States person, that such person is a financial institution as defined in §1.165.12(c)(1)(v) or is acquiring through a financial institution and that the obligation is held by a financial institution that has agreed to comply with the requirements of section 165(j)(3) (A), (B), or (C) and the regulations thereunder and that is not purchasing for offer to resell or for resale inside the United States. When a certificate is provided by a clearing organization, it must be based on statements provided to it by its member organizations. A clearing organization is an entity which is in the business of holding obligations for member organizations and transferring obligations among such members by credit or debit to the account of a member without the necessity of physical delivery of the obligation. For purposes of paragraph (c)(2)(i)(B), the term ''delivery'' does not include the delivery of an obligation to an underwriter or member of the selling group, if any.

(*5*) The issuer, underwriter, or member of the selling group does not have actual knowledge that the certificate described in paragraph (c)(2)(i)(B)(*4*) of this section is false. The issuer, underwriter, or member of the selling group shall be deemed to have actual knowledge that the certificate described in paragraph (c)(2)(i)(B)(*4*) of this section is false if the issuer, underwriter, or member of the selling group has a United States address for the beneficial owner (other than a financial institution as defined in §1.165–12(c)(v) that represents that it will comply with the requirements of section 165(j)(3) (A), (B), or (C) and the regulations thereunder) and does not have documentary evidence as described in§1.6049–5(c)(1) that the beneficial owner is not a United States person.

(C) The obligation is issued only outside the United States and its possessions by an issuer that does not significantly engage in interstate commerce with respect to the issuance of such obligation either directly or through its agent, an underwriter, or a member of the selling group. In the case of an issuer that is a United States person, such issuer may only satisfy the test set forth in this paragraph (c)(2)(i)(C) if—

(*1*) It is engaged through a branch in the active conduct of a banking business, within the meaning of section 954(c)(3)(B) as in effect before the Tax Reform Act of 1986, and the regulations thereunder, outside the United States;

(*2*) The obligation is issued outside of the United States by the branch in connection with that trade or business;

(*3*) The obligation that is so issued is sold directly to the public and is not issued as a part of a larger issuance made by means of a public offering; and

(*4*) The issuer either maintains documentary evidence as described in subdivision (iii) of A–5 of §35a.9999–4T that the purchaser is not a United States person (provided that the issuer has no actual knowledge that the documentary evidence is false) or on delivery of the obligation the issuer receives a statement signed by the person entitled to physical delivery thereof and stating either that the obligation is not being acquired by or on behalf of a United States person or that, if a beneficial interest in the obligation is being acquired by a United States person, such person is a financial institution as defined in §1.165–12(c)(v) or is acquiring through a financial institution and the obligation is held by a financial institution that has agreed to comply with the requirements of 165(j)(3) (A), (B) or (C) and the regulations thereunder and that it is not purchasing for offer to resell or for resale inside the United States (provided that the issuer has no actual knowledge that the statement is false).

In addition, an issuer that is a controlled foreign corporation within the meaning of section 957 (a) that is engaged in the active conduct of a banking business outside the United States within the meaning of section 954(c)(3)(B) as in effect before the Tax Reform Act of 1986, and the regulations thereunder, can only satisfy the provisions of this paragraph (c)(2)(i)(C), if it meets the requirements of this paragraph (c)(2)(i)(C)(2), (3) and (4).

(D) The obligation is issued after September 7, 1990, and all of the conditions set forth in this paragraph (c)(2)(i)(D) are met with respect to such obligation.

(*1*) *Offers and sales*—(*i*) *Issuer.* The issuer does not offer or sell the obligation during the restricted period to a person who is within the United States or its possessions or to a United States person.

(*ii*) *Distributors.* (*A*) The distributor of the obligation does not offer or sell the obligation during the restricted period to a person who is within the United States or its possessions or to a United States person.

(*B*) The distributor of the obligation will be deemed to satisfy the requirements of paragraph (c)(2)(i)(D)(*1*)(*ii*)(*A*) of this section if the distributor of the obligation convenants that it will not offer or sell the obligation during the restricted period to a person who is within the United States or its possessions or to a United States person; and the distributor of the obligation has in effect, in connection with the offer and sale of the obligation during the restricted period, procedures reasonably designed to ensure that its employees or agents who are directly engaged in selling the obligation are aware that the obligation cannot be offered or sold during the restricted period to a person who is within the United States or its possessions or is a United States person.

(*iii*) *Certain rules.* For purposes of paragraph (c)(2)(i)(D)(*1*) (*i*) and (*ii*) of this section:

(*A*) An offer or sale will be considered to be made to a person who is within the United States or its possessions if the offeror or seller of the obligation has an address within the United States or its possessions for the offeree or buyer of the obligation with respect to the offer or sale.

(*B*) An offer or sale of an obligation will not be treated as made to a person within the United States or its possessions or to a United States person if the person to whom the offer or sale is made is: An exempt distributor, as defined in paragraph (c)(2)(i)(D)(*5*) of this section; An international organization as defined in section 7701(a)(18) and the regulations thereunder, or a foreign central bank as defined in section 895 and the regulations thereunder; or The foreign branch of a United States financial institution as described in paragraph (c)(2)(i)(D)(*6*)(*i*) of this section.

Paragraph (c)(2)(i)(D)(*1*)(*iii*)(*B*) regarding an exempt distributor will only apply to an offer to the United States office of an exempt distributor, and paragraph (c)(2)(i)(D)(*1*)(*iii*)(*B*) regarding an international organization or foreign central bank will only apply to an offer to an international organization or foreign central bank, if such offer is made directly and specifically to the United States office, organization or bank.

(*C*) A sale of an obligation will not be treated as made to a person within the United States or its possessions or to a United States person if the person to whom the sale is made is a person described in paragraph (c)(2)(i)(D)(*6*)(*ii*) of this section.

(*2*) *Delivery.* In connection with the sale of the obligation during the restricted period, neither the issuer nor any distributor delivers the obligation in definitive form within the United States or it possessions.

(*3*) *Certification*—(*i*) *In general.* On the earlier of the date of the first actual payment of interest by the issuer on the obligation or the date of delivery by the issuer of the obligation in definitive form, a certificate is provided to the issuer of the obligation stating that on such date:

(*A*) The obligation is owned by a person that is not a United States person:

(*B*) The obligation is owned by a United States person described in paragraph (c)(2)(i)(D)(*6*) of this section; or

(*C*) The obligation is owned by a financial institution for purposes of resale during the restricted period, and such financial institution certifies in addition that it has not acquired the obligation for purposes of resale directly or indirectly to a United States person or to a person within the United States or its possessions.

A certificate described in paragraph (c)(2)(i)(D)(*3*)(*i*) (*A*) or (*B*) of this section may not be given with respect to an obligation that is owned by a financial institution for purposes of resale during the restricted period. For purposes of paragraph (c)(2)(i)(D) (*2*) and (*3*) of this section, a temporary global security (as defined in § 1.163–5 (c)(1)(ii)(B)) is not considered to be an obligation in definitive form. If the issuer does not make the obligation available for delivery in definitive form within a reasonable period of time after the end of the restricted period, then the obligation shall be treated as not satisfying the requirements of this paragraph (c)(2)(i)(D)(*3*). The certificate must be signed (or sent, as provided in paragraph (c)(2)(i)(D)(*3*)(*ii*) of this section) either by the owner of the obligation or by a financial institution or clearing organization through which the owner holds the obligation, directly or indirectly. For purposes of this paragraph (c)(2)(i)(D)(*3*), the term ''financial institution'' means a financial institution described in § 1.165–12(c)(i)(v). When a certificate is provided by a clearing organization, the certificate must be based on statements provided to it by its member organizations. The requirement of this paragraph (c)(1)(D)(*3*) shall be deemed not to be satisfied with respect to an obligation if the issuer knows or has reason to know that the certificate with respect to such obligation is false. The certificate must be retained by the issuer (and statements by member organizations must be retained by the clearing organization, in the case of certificates based on such statements) for a period of four calendar years following the year in which the certificate is received.

(*ii*) *Electronic certification.* The certificate required by paragraph (c)(2)(i)(D)(*3*)(*i*) of this section (including a statement provided to a clearing organization by a member organization) may be provided electronically, but only if the person receiving such electronic certificate maintains adequate records, for the retention period described in paragraph (c)(2)(i)(D)(*3*)(*i*) of this section, establishing that such certificate was received in respect of the subject obligation, and only if there is a written agreement entered into prior to the time of certification (including the written membership rules of a clearing organization) to which the sender and recipient are subject, providing that the electronic certificate shall have the effect of a signed certificate described in paragraph (c)(2)(i)(D)(*3*)(*i*) of this section.

(*iii*) *Exception for certain obligations.* This paragraph (c)(2)(i)(D)(*3*) shall not apply, and no certificate shall be required, in the case of an obligation that is sold during the restricted period and that satisfies all of the following requirements:

(*A*) The interest and principal with respect to the obligation are denominated only in the currency of a single foreign country.

(*B*) The interest and principal with respect to the obligation are payable only within that foreign country (according to rules similar to those set forth in § 1.163–5(c)(2)(v)).

(*C*) The obligation is offered and sold in accordance with practices and documentation customary in that foreign country.

(*D*) The distributor covenants to use reasonable efforts to sell the obligation within that foreign country.

(*E*) The obligation is not listed, or the subject of an application for listing, on an exchange located outside that foreign country.

(*F*) The Commissioner has designated that foreign country as a foreign country in which certification under paragraph (c)(2)(i)(D)(*3*)(*i*) of this section is not permissible.

(*G*) The issuance of the obligation is subject to guidelines or restrictions imposed by governmental, banking or securities authorities in that foreign country.

(*H*) More than 80 percent by value of the obligations included in the offering of which the obligation is a part are offered and sold to non-distributors by distributors maintaining an office located in that foreign country. Foreign currency denominated obligations that are convertible into U.S. dollar denominated obligations or that by their terms are linked to the U.S. dollar in a way which effectively converts the obligations to U.S. dollar denominated obligations do not satisfy the requirements of this paragraph (c)(2)(i)(D)(*3*)(*iii*). A foreign currency denominated obligation will not be treated as linked, by its terms, to the

U.S. dollar solely because the obligation is the subject of a swap transaction.

(*4*) *Distributor.* For purposes of this paragraph (c)(2)(i)(D), the term ‘‘distributor’’ means:

(*i*) A person that offers or sells the obligation during the restricted period pursuant to a written contract with the issuer;

(*ii*) Any person that offers or sells the obligation during the restricted period pursuant to a written contract with a person described in paragraph (c)(2)(i)(D) (*4*) (*i*); and

(*iii*) Any affiliate that acquires the obligation from another member of its affiliated group for the purpose of offering or selling the obligation during the restricted period, but only if the transferor member of the group is the issuer or a person described in paragraph (c)(2)(i)(D) (*4*)(*i*) or (*ii*) of this section. The terms ‘‘affiliate’’ and ‘‘affiliated group’’ have the same meanings as in section 1504(a) of the Code, but without regard to the exceptions contained in section 1504(b) and substituting ‘‘50 percent’’ for ‘‘80 percent’’ each time it appears.

For purposes of this paragraph (c)(2)(i)(D)(*4*), a written contract does not include a confirmation or other notice of the transaction.

(*5*) *Exempt distributor.* For purposes of this paragraph (c)(2)(i)(D), the term ‘‘exempt distributor’’ means a distributor that convenants in its contract with the issuer or with a distributor described in paragraph (c)(2)(i)(D)(*4*)(*i*) that it is buying the obligation for the purpose of resale in connection with the original issuance of the obligation, and that if it retains the obligation for its own account, it will only do so in accordance with the requirements of paragraph (c)(2)(i)(D)(*6*) of this section. In the latter case, the convenant will constitute the certificate required under paragraph (c)(2)(i)(D)(*6*). The provisions of paragraph (c)(2)(i)(D)(*7*) governing the restricted period for unsold allotments or subscriptions shall apply to any obligation retained for investment by an exempt distributor.

(*6*) *Certain United States persons.* A person is described in this paragraph (c)(2)(i)(D)(*6*) if the requirements of this paragraph are satisfied and the person is:

(*i*) The foreign branch of a United States financial institution purchasing for its own account or for resale, or

(*ii*) A United States person who acquired the obligation through the foreign branch of a United States financial institution and who, for purposes of the certification required in paragraph (c)(2)(i)(D)(*3*) of this section, holds the obligation through such financial institution on the date of certification.

For purposes of paragraph (c)(2)(i)(D)(*6*)(*ii*) of this section, a United States person will be considered to acquire and hold an obligation through the foreign branch of a United States financial institution if the United States person has an account with the United States office of a financial institution, and the transaction is executed by a foreign office of that financial institution, or by the foreign office of another financial institution acting on behalf of that financial institution. This paragraph (c)(2)(i)(D)(*6*) will apply, however, only if the United States financial institution (or the United States office of a foreign financial institution) holding the obligation provides a certificate to the issuer or distributor selling the obligation within a reasonable time stating that it agrees to comply with the requirements of section 165(j)(3)(A), (B), or (C) and the regulations thereunder. For purposes of this paragraph (c)(2)(i)(D)(*6*), the term ‘‘financial institution’’ means a financial institution as defined in §1.165–12(c)(1)(v). As an alternative to the certification required above, a financial institution may provide a blanket certificate to the issuer or distributor selling the obligation stating that the financial institution will comply with the requirements of section 165(j)(3)(A), (B) or (C) and the regulations thereunder. A blanket certificate must be received by the issuer or the distributor in the year of the issuance of the obligation or in either of the preceding two calendar years, and must be retained by the issuer or distributor for at least four years after the end of the last calendar year to which it relates.

(*7*) *Restricted period.* For purposes of this paragraph (c)(2)(i)(D), the restricted period with respect to an obligation begins on the earlier of the closing date (or the date on which the issuer receives the loan proceeds, if there is no closing with respect to the obligation), or the first date on which the obligation is offered to persons other than a distributor. The restricted period with respect to an obligation ends on the expiration of the forty day period beginning on the closing date (or the date on which the issuer receives the loan proceeds, if there is no closing with respect to the obligation). Notwithstanding the preceding sentence, any offer or sale of the obligation by the issuer or a distributor shall be deemed to be during the restricted period if the issuer or distributor holds the obligation as part of an unsold allotment or subscription.

(*8*) *Clearing organization.* For purposes of this paragraph (c)(2)(i)(D), a ''clearing organization'' is an entity which is in the business of holding obligations for member organizations and transferring obligations among such members by credit or debit to the account of a member without the necessity of physical delivery of the obligation.

(ii) *Special rules.* An obligation shall not be considered to be described in paragraph (c)(2)(i)(C) of this section if it is—

(A) Guaranteed by a United States shareholder of the issuer;

(B) Convertible into a debt or equity interest in a United States shareholder of the issuer; or

(C) Substantially identical to an obligation issued by a United States shareholder of the issuer.

For purposes of this paragraph (c)(2)(ii), the term ''United States shareholder'' is defined as it is defined in section 951 (b) and the regulations thereunder. For purposes of this paragraph (c)(2)(ii)(C), obligations are substantially identical if the face amount, interest rate, term of the issue, due dates for payments, and maturity date of each is substantially identical to the other.

(iii) *Interstate commerce.* For purposes of this paragraph, the term ''interstate commerce'' means trade or commerce in obligations or any transportation or communication relating thereto between any foreign country and the United States or its possessions.

(A) An issuer will not be considered to engage significantly in interstate commerce with respect to the issuance of an obligation if the only activities with respect to which the issuer uses the means or instrumentalities of interstate commerce are activities of a preparatory or auxiliary character that do not involve communication between a prospective purchaser and an issuer, its agent, an underwriter, or member of the selling group if either is inside the United States or its possessions. Activities of a preparatory or auxiliary character include, but are not limited to, the following activities:

(*1*) Establishment or participation in establishment of policies concerning the issuance of obligations and the allocation of funding by a United States shareholder with respect to obligations issued by a foreign corporation or by a United States office with respect to obligations issued by a foreign branch;

(*2*) Negotiation between the issuer and underwriters as to the terms and pricing of an issue;

(*3*) Transfer of funds to an office of an issuer in the United States or its possessions by a foreign branch or to a United States shareholder by a foreign corporation;

(*4*) Consultation by an issuer with accountants and lawyers or other financial advisors in the United States or its possessions regarding the issuance of an obligation;

(*5*) Document drafting and printing; and

(*6*) Provision of payment or delivery instructions to members of the selling group by an issuer's office or agent that is located in the United States or its possessions.

(B) Activities that will not be considered to be of a preparatory or auxiliary character include, but are not limited to, any of the following activities:

(*1*) Negotiation or communication between a prospective purchaser and an issuer, its agent, an underwriter, or a member of the selling group concerning the sale of an obligation if either is inside the United States or its possessions;

(*2*) Involvement of an issuer's office, its agent, an underwriter, or a member of the selling group in the United States or its possessions in the offer or sale of a particular obligation, either directly with the prospective purchaser, or through the issuer in a foreign country;

(*3*) Delivery of an obligation in the United States or its possessions; or

(*4*) Advertising or otherwise promoting an obligation in the United States or its possessions.

(C) The following examples illustrate the application of this subdivision (iii) of §1.163–5(c)(2).

Example (1). Foreign corporation A, a corporation organized in and doing business in foreign country Z, and not a controlled foreign corporation within the meaning of section 957(a) that is engaged in the conduct of a banking business within the meaning of section 954(c)(3)(B) as in effect before the Tax Reform Act of 1986, issues its debentures outside the United States. The debentures are not guaranteed by a United States shareholder of A, nor are they convertible into a debt or equity interest of a United States shareholder of A, nor are they substantially identical to an obligation issued by a United States shareholder of A. A consults its accountants and lawyers in the United States for certain securities and tax advice regarding the debt offering. The underwriting and selling group in respect to A's offering is composed entirely of foreign securities firms, some of which are foreign subsidiaries of United States securities firms. A U.S. affiliate of the foreign underwriter communicates payment and delivery instructions to the selling group. All offering circulars for the offering are mailed and delivered outside the United States and its possessions. All debentures are delivered and paid for outside the United States and its possessions. No office located in the United States or in a United States possession is involved in the sale of debentures. Interest on the debentures is payable only outside the United States and its possessions. A is not significantly engaged in interstate commerce with respect to the offering.

Example (2). B, a United States bank, does business in foreign country X through a branch located in X. The branch is a staffed and operating unit engaged in the active conduct of a banking business consisting of one or more of the activities set forth in §1.954–2(d)(2)(ii). As part of its ongoing business, the branch in X issues negotiable certificates of deposit with a maturity in excess of one year to customers upon request. The certificates of deposit are not guaranteed by a United States shareholder of B, nor are they convertible into a debt or equity interest of a United States shareholder of B, nor are they substantially identical to an obligation issued by a United States shareholder of B. Policies regarding the issuance of negotiable certificates of deposit and funding allocations for foreign branches are set in the United States at B's main office. Branch personnel decide whether to issue a negotiable certificate of deposit based on the guidelines established by the United States offices of B, but without communicating with the United States offices of B with respect to the issuance of a particular obligation. Negotiable certificates of deposits are delivered and paid for outside the United States and its possessions. Interest on the negotiable certificates of deposit is payable only outside the United States and its possessions. B maintains documentary evidence described in §1.163–5(c)(2)(i)(C)(*4*). After the issuance of negotiable certificates of deposit by the foreign branch of B, the foreign branch sends the funds to a United States branch of B for use in domestic operations. B is not significantly engaged in interstate commerce with respect to the issuance of such obligation.

Example (3). The facts in Example (2) apply except that the foreign branch of B consulted, by telephone, the main office in the United States to request approval of the issuance of the certificate of deposit at a particular rate of interest. The main office granted permission to issue the negotiable certificate of deposit to the customer by a telex sent from the main office of B to the branch in X. B is significantly engaged in interstate commerce with respect to the issuance of the obligation as a result of involvement of B's United States office in the issuance of the obligation.

Example (4). The facts in Example (2) apply with the additional fact that a customer contacted the foreign branch of B through a telex originating in the United States or its possessions. Subsequent to the telex, the foreign branch issued the negotiable certificate of deposit and recorded it on the books. B is significantly engaged in interstate commerce with respect to the issuance of the obligation as a result of its communication by telex with a customer in the United States.

(iv) *Possessions.* For purposes of this section, the term ''possessions'' includes Puerto Rico, the U.S. Virgin Islands, Guam, American Samoa, Wake Island, and Northern Mariana Islands.

(v) *Interest payable outside of the United States.* Interest will be considered payable only outside the United States and its possessions if payment of such interest can be made only upon presentation of a coupon, or upon making of any other demand for payment, outside of the United States and its possessions to the issuer or a paying agent. The fact that payment is made by a draft drawn on a United States bank account or by a wire or other electronic transfer from a United States account does not affect this result. Interest payments will be considered to be made within the United States if the payments are made by a transfer of funds into an account maintained by the payee in the United States or mailed to an address in the United States, if—

(A) The interest is paid on an obligation issued by either a United States person, a controlled foreign corporation as defined in section 957 (a), or a foreign corporation if 50 percent or more of the gross income of the foreign corporation from all sources of the 3-year period ending with the close of its taxable year preceding the original issuance of the obligation (or for such part of the period that the foreign corporation has been in existence) was effectively connected with the conduct of a trade or business within the United States; and

(B) The interest is paid to a person other than—

(*1*) A person who may satisfy the requirements of section 165 (j)(3) (A), (B), or (C) and the regulations thereunder; and

(*2*) A financial institution as a step in the clearance of funds and such interest is promptly credited to an account maintained outside the United States for such financial institution or for persons for which the financial institution has collected such interest.

Interest is considered to be paid within the United States and its possessions if a coupon is presented, or a demand for payment is otherwise made, to the issuer or a paying agent (whether a United States or foreign person) in the United States and its possessions even if the funds paid are credited to an account maintained by the payee outside the United States and its possessions. Interest will be considered payable only outside the United States and its possessions notwithstanding that such interest may become payable at the office of the issuer or its United States paying agent under the following conditions: the issuer has appointed paying agents located outside the United States and its possessions with the reasonable expectation that such paying agents will be able to pay the interest in United States dollars, and the full amount of such payment at the offices of all such paying agents is illegal or effectively precluded because of the imposition of exchange controls or other similar restrictions on the full payment or receipt of interest in United States dollars. A lawsuit brought in the United States or its possessions for payment of the obligation or interest thereon as a result of a default shall not be considered to be a demand for payment. For purposes of this subdivision (v), interest includes original issue discount as defined in section 1273(a). Therefore, an amount equal to the original issue discount as defined in section 1273(a) is payable only outside the United States and its possessions. The amount of market discount as defined in section 1278(a) does not affect the amount of interest to be considered payable only outside the United States and its possessions.

(vi) *Rules relating to obligations issued after December 31, 1982 and on or before September 21, 1984.* Whether an obligation originally issued after December 31, 1982 and on or before September 21, 1984, or an obligation originally issued after September 21, 1984 pursuant to the exercise of a warrant or the conversion of a convertible obligation, which warrant or obligation (including conversion privilege) was issued after December 31, 1982 and on or before September 21, 1984, is described in section 163(f)(2)(B) shall be determined under the rules provided in § 5f.163–1(c) as in effect prior to its removal. Notwithstanding the preceding sentence, an issuer will be considered to satisfy the requirements of section 163(f)(2)(B) with respect to an obligation issued after December 31, 1982 and on or before September 21, 1984 or after September 21, 1984 pursuant to the exercise of a warrant or the conversion of a convertible obligation, which warrant or obligation (including conversion privilege) was issued after December 31, 1982 and on or before September 21, 1984, if the issuer substantially complied with the proposed regulations provided in § 1.163–5(c), which were published in the FEDERAL REGISTER on September 2, 1983 (48 FR 39953) and superseded by temporary regulations published in the FEDERAL REGISTER on August 22, 1984 (49 FR 33228).

(3) *Effective date*—(i) *In general.* These regulations apply generally to obligations issued after January 20, 1987. A taxpayer may choose to apply the rules of §1.163–5(c) with respect to an obligation issued after December 31, 1982 and on or before January 20, 1987. If this choice is made, the rules of §1.163–5(c) will apply in lieu of §1.163–5T(c) except that the legend requirement under §1.163–5(c)(l)(ii)(B) does not apply with respect to a bearer obligation evidenced exclusively by a book entry and that the certification requirement under §1.163–5T(c)(2)(B)(*4*) applies in lieu of the certification under §1.163–5(c)(2)(i)(B)(4).

(ii) *Special rules.* If an obligation is originally issued after September 7, 1990 pursuant to the exercise of a warrant or the conversion of a convertible obligation, which warrant or obligation (including conversion privilege) was issued on or before May 10, 1990, then the issuer may choose to apply either the rules of §1.163–5(c)(2)(i)(A) or §1.163–5(c)(2)(i)(B), or the rules of §1.163–5(c)(2)(i)(D). The issuer of an obligation may choose to apply either the rules of §1.163–5(c)(2)(i) (A) or (B), or the rules of §1.163–5(c)(2)(i)(D), to an obligation that is originally issued after May 10, 1990, and on or before September 7, 1990. However, any issuer choosing to apply the rules of §1.163–5(c)(2)(i)(A) must apply the definition of United States person used for such purposes on December 31, 1989, and must obtain any certificates that would have been required under applicable law on December 31, 1989.

[T.D. 8110, 51 FR 45456, Dec. 19, 1986, as amended by T.D. 8203, 53 FR 17926, May 19, 1988; T.D. 8300, 55 FR 19624, May 10, 1990; T.D. 8734, 62 FR 53416, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53416, Oct. 14, 1997, in §1.163–5, paragraph (c)(2)(i)(B)(*5*) was amended by removing the words ‘‘subdivision (iii) of A–5 of §35a.9999–4T’’ and inserting ‘‘§1.6049–5(c)(1)’’ in its place, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of the amendments to §1.163–5 was delayed until Jan. 1, 2000.

§1.163–5T Denial of interest deduction on certain obligations issued after December 31, 1982, unless issued in registered form (temporary).

(a)—(c) [Reserved]

(d) *Pass-through certificates.* (1) A pass-through or participation certificate evidencing an interest in a pool of mortgage loans which under subpart E of subchapter J of the Code is treated as a trust of which the grantor is the owner (or similar evidence of interest in a similar pooled fund or pooled trust treated as a grantor trust) (‘‘pass-through certificate’’) is considered to be a ‘‘registration-required obligation’’ under section 163(f)(2)(A) and §1.163–5(c) if the pass-through certificate is described in section 163(f)(2)(A) and §1.163–5(c) without regard to whether any obligation held by the fund or trust to which the pass-through certificate relates is described in section 163(f)(2)(A) and §1.163–5(c). A pass-through certificate is considered to be described in section 163(f)(2)(B) and §1.163–5(c) if the pass-through certificate is described in section 163(f)(2)(B) and §1.163–5(c) without regard to whether any obligation held by the fund or trust to which the pass-through certificate relates is described in section 163(f)(2)(B) and §1.163–5(c).

(2) An obligation held by a fund or trust in which ownership interests are represented by pass-through certificates is considered to be in registered form under section 149(a) and the regulations thereunder or to be described in section 163(f)(2) (A) or (B), if the obligation held by the fund or trust is in registered form under section 149(a) and the regulations thereunder or is described in section 163(f)(2) (A) or (B), respectively, without regard to whether the pass-through certificates are so considered.

(3) For purposes of section 4701, a pass-through certificate is considered to be issued solely by the recipient of the proceeds from the issuance of the pass-through certificate (hereinafter the ‘‘sponsor’’). The sponsor is therefore liable for any excise tax under section 4701 that may be imposed with reference to the principal amount of the pass-through certificate.

(4) In order to implement the purpose of section 163, § 1.163–5(c) and this section, the Commissioner may characterize a certificate or other evidence of interest in a fund or trust which under subpart E of subchapter J of the Code is treated as a trust of which the grantor is the owner and any obligation held by such fund or trust in accordance with the substance of the arrangement they represent and may impose the penalties provided under sections 163(f)(1) and 4701 in the appropriate amounts and on the appropriate persons. This provision may be applied, for example, where a corporation issues obligations purportedly in registered form, contributes them to a grantor trust as its only assets, and arranges for the sale to investors of bearer certificates of interest in the trust which do not meet the requirements of section 163(f)(2)(B). If this provision is applied, the obligations held by the fund or trust will not be considered to be issued in registered form or to meet the requirements of section 163(f)(2)(B). The corporation will not be allowed a deduction for the payment of interest on the obligations held by the trust, and the excise tax under section 4701, calculated with reference to the principal amount of the obligations held by the trust will be imposed on the corporation may be collected from the corporation and its agents. This paragraph (d)(4) will not be applied so as to alter the tax consequences of transactions as to which rulings have been issued by the Internal Revenue Service prior to September 19, 1985.

(5) The rules set forth in this paragraph (d) apply solely for purposes of sections 4701, 163(f)(2)(A), 163(f)(2)(B), § 1.163–5(c), and any other section that refers to this section for the definition of the term ''registration-required obligation'' (such as the regulations under sections 871(h) and 881(c)). The treatment of obligations described in this paragraph (d) for purposes of section 163(f)(2) (A) and (B) does not affect the determination of whether bearer obligations that are issued or guaranteed by the United States Government, a United States Government-owned agency, a United States Government sponsored enterprise (within the meaning of § 1.163–5(c)(1)) or that are backed (as described in the Treasury Department News Release R–2835 of September 10, 1984 and Treasury Department News Release R–2847 of September 14, 1984) by obligations issued by the United States Government, a United States Government-owned agency, or a United States Government sponsored enterprise comply with the requirements of section 163(f)(2)(B) and the regulations thereunder.

(6) The provisions of paragraphs (d) (1) through (5) may be illustrated by the following example:

Commercial Bank K forms a pool of 1000 residential mortgage loans, each made to a different individual homeowner, by assigning them to Commercial Bank L, an unrelated entity serving as trustee of the pool. Commercial Bank L immediately sells in a public offering certificates of interest in the trust of a maturity of 10 years in registered form. Commercial Bank L transfers the cash proceeds of the offering to Commercial Bank K. The certificates of interest in the trust are of a type offered to the public and are not described in section 163(f)(2)(B). Pursuant to paragraph (d)(1), the certificates of interest in the pool are registration-required obligations without regard to the fact that the obligations held by the trust are not registration-required obligations.

(e) *Regular interests in REMICS.* (1) A regular interest in a REMIC, as defined in sections 860D and 860G and the regulations thereunder, is considered to be a ''registration-required obligation'' under section 163(f)(2)(A) and § 1.163–5(c) if the regular interest is described in section 163(f)(2)(A) and § 1.163–5(c), without regard to whether any obligation held by the REMIC to which the regular interest relates is described in section 163(f)(2)(A) and § 1.163–5(c). A regular interest in a REMIC is considered to be described in section 163(f)(2)(B) and § 1.163–5(c), if the regular interest is described in section 163(f)(2)(B) and § 1.163(c), without regard to whether any obligation held by the REMIC to which the regular interest relates is described in section 163(f)(2)(B) and § 1.163–5(c).

(2) An obligation held by a REMIC is considered to be described in section 163(f)(2) (A) or (B) if such obligation is described in section 163(f)(2) (A) or (B), respectively, without regard to whether the regular interests in the REMIC are so considered.

(3) For purposes of section 4701, a regular interest is considered to be issued solely by the recipient of the proceeds from the issuance of the regular interest (hereinafter the ''sponsor''). The sponsor is therefore liable for any excise tax under section 4701 that may be imposed with reference to the principal amount of the regular interest.

(4) In order to implement the purpose of section 163, §1.163–5(c), and this section, the Commissioner may characterize a regular interest in a REMIC and any obligation held by such REMIC in accordance with the substance of the arrangement they represent and may impose the penalties provided under sections 163(f)(1) and 4701 in the appropriate amounts and on the appropriate persons. This provision may be applied, for example, where a corporation issues an obligation that is purportedly in registered form and that will qualify as a ''qualified mortgage'' within the meaning of section 860G(a)(3) in the hands of a REMIC, contributes the obligation to a REMIC as its only asset, and arranges for the sale to investors of regular interests in the REMIC in bearer form that do not meet the requirements of section 163(f)(2)(B). If this provision is applied, the obligation held by the REMIC will not be considered to be issued in registered form or to meet the requirements of section 163(f)(2)(B). The corporation will not be allowed a deduction for the payment of interest on the obligation held by the REMIC, and the excise tax under section 4701, calculated with reference to the principal amount of the obligation held by the REMIC, will be imposed on the corporation and may be collected from the corporation and its agents.

[T.D. 8202, 53 FR 17928, May 19, 1988, as amended by T.D. 8300, 55 FR 19626, May 10, 1990]

§1.163–6T Reduction of deduction where section 25 credit taken (temporary).

(a) *In general.* The amount of the deduction under section 163 for interest paid or accrued during any taxable year on a certified indebtedness amount with respect to a mortgage credit certificate which has been issued under section 25 shall be reduced by the amount of the credit allowable with respect to such interest under section 25 (determined without regard to section 26).

(b) *Cross reference.* See §§1.25–1T through 1.25–8T with respect to rules relating to mortgage credit certificates.

[T.D. 8023, 50 FR 19355, May 8, 1985]

§1.163–7 Deduction for OID on certain debt instruments.

(a) *General rule.* Except as otherwise provided in paragraph (b) of this section, an issuer (including a transferee) determines the amount of OID that is deductible each year under section 163(e)(1) by using the constant yield method described in §1.1272–1(b). This determination, however, is made without regard to section 1272(a)(7) (relating to acquisition premium) and §1.1273–1(d) (relating to de minimis OID). An issuer is permitted a deduction under section 163(e)(1) only to the extent the issuer is primarily liable on the debt instrument. For certain limitations on the deductibility of OID, see sections 163(e) and 1275(b)(2). To determine the amount of interest (OID) that is deductible each year on a debt instrument that provides for contingent payments, see §1.1275–4.

(b) *Special rules for de minimis OID*—(1) *Stated interest.* If a debt instrument has a de minimis amount of OID (within the meaning of §1.1273–1(d)), the issuer treats all stated interest on the debt instrument as qualified stated interest. See §§1.446–2(b) and 1.461–1 for the treatment of qualified stated interest.

(2) *Deduction of de minimis OID on other than a constant yield basis.* In lieu of deducting de minimis OID under the general rule of paragraph (a) of this section, an issuer of a debt instrument with a de minimis amount of OID (other than a de minimis amount treated as qualified stated interest under paragraph (b)(1) of this section) may choose to deduct the OID at maturity, on a straight-line basis over the term of the debt instrument, or in proportion to stated interest payments. The issuer makes this choice by reporting the de minimis OID in a manner consistent with the method chosen on the issuer's timely filed Federal income tax return for the taxable year in which the debt instrument is issued.

(c) *Deduction upon repurchase.* Except to the extent disallowed by any other section of the Internal Revenue Code (e.g., section 249) or this paragraph (c), if a debt instrument is repurchased by the issuer for a price in excess of its adjusted issue price (as defined in § 1.1275–1(b)), the excess (repurchase premium) is deductible as interest for the taxable year in which the repurchase occurs. If the issuer repurchases a debt instrument in a debt-for-debt exchange, the repurchase price is the issue price of the newly issued debt instrument (reduced by any unstated interest within the meaning of section 483). However, if the issue price of the newly issued debt instrument is determined under either section 1273(b)(4) or section 1274, any repurchase premium is not deductible in the year of the repurchase, but is amortized over the term of the newly issued debt instrument in the same manner as if it were OID.

(d) *Choice of accrual periods to determine whether a debt instrument is an applicable high yield discount obligation (AHYDO).* Section 163(e)(5) affects an issuer's OID deductions for certain high yield debt instruments that have significant OID. For purposes of section 163(i)(2), which defines significant OID, the issuer's choice of accrual periods to determine OID accruals is used to determine whether a debt instrument has significant OID. See § 1.1275–2(e) for rules relating to the issuer's obligation to disclose certain information to holders.

(e) *Effective date.* This section applies to debt instruments issued on or after April 4, 1994. Taxpayers, however, may rely on this section for debt instruments issued after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4804, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30138, June 14, 1996]

§ 1.163–8T Allocation of interest expense among expenditures (temporary).

(a) *In general*—(1) *Application.* This section prescribes rules for allocating interest expense for purposes of applying sections 469 (the ''passive loss limitation'') and 163 (d) and (h) (the ''nonbusiness interest limitations'').

(2) *Cross-references.* This paragraph provides an overview of the manner in which interest expense is allocated for the purposes of applying the passive loss limitation and nonbusiness interest limitations and the manner in which interest expense allocated under this section is treated. See paragraph (b) of this section for definitions of certain terms, paragraph (c) for the rules for allocating debt and interest expense among expenditures, paragraphs (d) and (e) for the treatment of debt repayments and refinancings, paragraph (j) for the rules for reallocating debt upon the occurrence of certain events, paragraph (m) for the coordination of the rules in this section with other limitations on the deductibility of interest expense, and paragraph (n) of this section for effective date and transitional rules.

(3) *Manner of allocation.* In general, interest expense on a debt is allocated in the same manner as the debt to which such interest expense relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. This section prescribes rules for tracing debt proceeds to specific expenditures.

(4) *Treatment of interest expenses*—(i) *General rule.* Except as otherwise provided in paragraph (m) of this section (relating to limitations on interest expense other than the passive loss and nonbusiness interest limitations), interest expense allocated under the rules of this section is treated in the following manner:

(A) Interest expense allocated to a trade or business expenditure (as defined in paragraph (b)(7) of this section) is taken into account under section 163 (h)(2)(A);

(B) Interest expense allocated to a passive activity expenditure (as defined in paragraph (b)(4) of this section) or a former passive activity expenditure (as defined in paragraph (b)(2) of this section) is taken into account for purposes of section 469 in determining the income or loss from the activity to which such expenditure relates;

(C) Interest expense allocated to an investment expenditure (as defined in paragraph (b)(3) of this section) is treated for purposes of section 163(d) as investment interest;

(D) Interest expense allocated to a personal expenditure (as defined in paragraph (b)(5) of this section) is treated for purposes of section 163(h) as personal interest; and

(E) Interest expense allocated to a portfolio expenditure (as defined in paragraph (b)(6) of this section) is treated for purposes of section 469(e)(2)(B)(ii) as interest expense described in section 469(e)(1)(A)(i)(III).

(ii) *Examples.* The following examples illustrate the application of this paragraph (a)(4):

Example (1). Taxpayer A, an individual, incurs interest expense allocated under the rules of this section to the following expenditures:

$6,000	Passive activity expenditure.
$4,000	Personal expenditure.

The $6,000 interest expense allocated to the passive activity expenditure is taken into account for purposes of section 469 in computing A's income or loss from the activity to which such interest relates. Pursuant to section 163(h), A may not deduct the $4,000 interest expense allocated to the personal expenditure (except to the extent such interest is qualified residence interest, within the meaning of section 163(h)(3)).

Example (2). (i) Corporation M, a closely held C corporation (within the meaning of section 469 (j)(1)) has $10,000 of interest expense for a taxable year. Under the rules of this section, M's interest expense is allocated to the following expenditures:

$2,000	Passive activity expenditure.
$3,000	Portfolio expenditure.
$5,000	Other expenditures.

(ii) Under section 163(d)(3)(D) and this paragraph (a)(4), the $2,000 interest expense allocated to the passive activity expenditure is taken into account in computing M's passive activity loss for the taxable year, but, pursuant to section 469(e)(1) and this paragraph (a)(4), the interest expense allocated to the portfolio expenditure and the other expenditures is not taken into account for such purposes.

(iii) Since M is a closely held C corporation, its passive activity loss is allowable under section 469(e)(2)(A) as a deduction from net active income. Under section 469(e)(2)(B) and this paragraph (a)(4), the $5,000 interest expense allocated to other expenditures is taken into account in computing M's net active income, but the interest expense allocated to the passive activity expenditure and the portfolio expenditure is not taken into account for such purposes.

(iv) Since M is a corporation, the $3,000 interest expense allocated to the portfolio expenditure is allowable without regard to section 163(d). If M were an individual, however, the interest expense allocated to the portfolio expenditure would be treated as investment interest for purposes of applying the limitation of section 163(d).

(b) *Definitions.* For purposes of this section—

(1) ''Former passive activity'' means an activity described in section 469(f)(3), but only if an unused deduction or credit (within the meaning of section 469(f)(1) (A) or (B)) is allocable to the activity under section 469(b) for the taxable year.

(2) ''Former passive activity expenditure'' means an expenditure that is taken into account under section 469 in computing the income or loss from a former passive activity of the taxpayer or an expenditure (including an expenditure properly chargeable to capital account) that would be so taken into account if such expenditure were otherwise deductible.

(3) ''Investment expenditure'' means an expenditure (other than a passive activity expenditure) properly chargeable to capital account with respect to property held for investment (within the meaning of section 163(d)(5)(A)) or an expenditure in connection with the holding of such property.

(4) ''Passive activity expenditure'' means an expenditure that is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer or an expenditure (including an expenditure properly chargeable to capital account) that would be so taken into account if such expenditure were otherwise deductible. For purposes of this section, the term ''passive activity expenditure'' does not include any expenditure with respect to any low-income housing project in any taxable year in which any benefit is allowed with respect to such project under section 502 of the Tax Reform Act of 1986.

(5) ''Personal expenditure'' means an expenditure that is not a trade or business expenditure, a passive activity expenditure, or an investment expenditure.

(6) ''Portfolio expenditure'' means an investment expenditure properly chargeable to capital account with respect to property producing income of a type described in section 469(e)(1)(A) or an investment expenditure for an expense clearly and directly allocable to such income.

(7) ‘‘Trade or business expenditure’’ means an expenditure (other than a passive activity expenditure or an investment expenditure) in connection with the conduct of any trade or business other than the trade or business of performing services as an employee.

(c) *Allocation of debt and interest expense*—(1) *Allocation in accordance with use of proceeds.* Debt is allocated to expenditures in accordance with the use of the debt proceeds and, except as provided in paragraph (m) of this section, interest expense accruing on a debt during any period is allocated to expenditures in the same manner as the debt is allocated from time to time during such period. Except as provided in paragraph (m) of this section, debt proceeds and related interest expense are allocated solely by reference to the use of such proceeds, and the allocation is not affected by the use of an interest in any property to secure the repayment of such debt or interest. The following example illustrates the principles of this paragraph (c)(1):

Example. Taxpayer A, an individual, pledges corporate stock held for investment as security for a loan and uses the debt proceeds to purchase an automobile for personal use. Interest expense accruing on the debt is allocated to the personal expenditure to purchase the automobile even though the debt is secured by investment property.

(2) *Allocation period*—(i) *Allocation of debt.* Debt is allocated to an expenditure for the period beginning on the date the proceeds of the debt are used or treated as used under the rules of this section to make the expenditure and ending on the earlier of—

(A) The date the debt is repaid; or

(B) The date the debt is reallocated in accordance with the rules in paragraphs (c)(4) and (j) of this section.

(ii) *Allocation of interest expense*—(A) *In general.* Except as otherwise provided in paragraph (m) of this section, interest expense accruing on a debt for any period is allocated in the same manner as the debt is allocated from time to time, regardless of when the interest is paid.

(B) *Effect of compounding.* Accrued interest is treated as a debt until it is paid and any interest accruing on unpaid interest is allocated in the same manner as the unpaid interest is allocated. For the taxable year in which a debt is reallocated under the rules in paragraphs (c)(4) and (j) of this section, however, compound interest accruing on such debt (other than compound interest accruing on interest that accrued before the beginning of the year) may be allocated between the original expenditure and the new expenditure on a straight-line basis (i.e., by allocating an equal amount of such interest expense to each day during the taxable year). In addition, a taxpayer may treat a year as consisting of 12 30-day months for purposes of allocating interest on a straight-line basis.

(C) *Accrual of interest expense.* For purposes of this paragraph (c)(2)(ii), the amount of interest expense that accrues during any period is determined by taking into account relevant provisions of the loan agreement and any applicable law such as sections 163(e), 483, and 1271 through 1275.

(iii) *Examples.* The following examples illustrate the principles of this paragraph (c)(2):

Example (1). (i) On January 1, taxpayer B, a calendar year taxpayer, borrows $1,000 at an interest rate of 11 percent, compounded semiannually. B immediately uses the debt proceeds to purchase an investment security. On July 1, B sells the investment security for $1,000 and uses the sales proceeds to make a passive activity expenditure. On December 31, B pays accrued interest on the $1,000 debt for the entire year.

(ii) Under this paragraph (c)(2) and paragraph (j) of this section, the $1,000 debt is allocated to the investment expenditure for the period from January 1 through June 30, and to the passive activity expenditure from July 1 through December 31. Interest expense accruing on the $1,000 debt is allocated in accordance with the allocation of the debt from time to time during the year even though the debt was allocated to the passive activity expenditure on the date the interest was paid. Thus, the $55 interest expense for the period from January 1 through June 30 is allocated to the investment expenditure. In addition, during the period from July 1 through December 31, the interest expense allocated to the investment expenditure is a debt, the proceeds of which are treated as used to make an investment expenditure. Accordingly, an additional $3 of interest expense for the period from July 1 through December 31 ($55×.055) is allocated to the investment expenditure. The remaining $55 of interest expense for the period from July 1 through December 31 ($1,000×.055) is allocated to the passive activity expenditure.

(iii) Alternatively, under the rule in paragraph (c)(2)(ii)(B) of this section, B may allocate the interest expense on a straight-line basis and may also treat the year as consisting of 12 30-day months for this purpose. In that case, $56.50 of interest expense (180/360×$113) would be allocated to the investment expenditure and the remaining $56.50 of interest expense would be allocated to the passive activity expenditure.

Example (2). On January 1, 1988, taxpayer C borrows $10,000 at an interest rate of 11 percent, compounded annually. All interest and principal on the debt is payable in a lump sum on December 31, 1992. C immediately uses the debt proceeds to make a passive activity expenditure. C materially participates in the activity in 1990, 1991, and 1992. Therefore, under paragraphs (c)(2) (i) and (j) of this section, the debt is allocated to a passive activity expenditure from January 1, 1988, through December 31, 1989, and to a former passive activity expenditure from January 1, 1990, through December 31, 1992. In accordance with the loan agreement (and consistent with § 1.1272–1(d)(1) of the proposed regulations, 51 FR 12022, April 8, 1986), interest expense accruing during any period is determined on the basis of annual compounding. Accordingly, the interest expense on the debt is allocated as follows:

Year	Amount		Expenditure
1988	$10,000 × .11	$1,100	Passive activity.
1989	11,100 × .11	1,221	Passive activity.
1990	12,321 × .11 = 1,355	....	
	1,355 × 2,321/12,321	255	Passive activity.
	1,355 × 10,000/12,321	1,100	Former passive activity.
		1,355	
1991	13,676 × .11 = 1,504	....	
	1,504 × 2,576/13,676	283	Passive activity.
	1,504 × 11,100/13,676	1,221	Former passive activity.
		1,504	
1992	15,180 × .11 = 1,670	....	
	1,670 × 2,859/15,180	315	Passive activity.
	1,670 × 12,321/15,180	1,355	Former passive activity.
		1,670	

(3) *Allocation of debt; proceeds not disbursed to borrower*—(i) *Third-party financing.* If a lender disburses debt proceeds to a person other than the borrower in consideration for the sale or use of property, for services, or for any other purpose, the debt is treated for purposes of this section as if the borrower used an amount of the debt proceeds equal to such disbursement to make an expenditure for such property, services, or other purpose.

(ii) *Debt assumptions not involving cash disbursements.* If a taxpayer incurs or assumes a debt in consideration for the sale or use of property, for services, or for any other purpose, or takes property subject to a debt, and no debt proceeds are disbursed to the taxpayer, the debt is treated for purposes of this section as if the taxpayer used an amount of the debt proceeds equal to the balance of the debt outstanding at such time to make an expenditure for such property, services, or other purpose.

(4) *Allocation of debt; proceeds deposited in borrower's account*—(i) *Treatment of deposit.* For purposes of this section, a deposit of debt proceeds in an account is treated as an investment expenditure, and amounts held in an account (whether or not interest bearing) are treated as property held for investment. Debt allocated to an account under this paragraph (c)(4)(i) must be reallocated as required by paragraph (j) of this section whenever debt proceeds held in the account are used for another expenditure. This paragraph (c)(4) provides rules for determining when debt proceeds are expended from the account. The following example illustrates the principles of this paragraph (c)(4)(i):

Example. Taxpayer C, a calendar year taxpayer, borrows $100,000 on January 1 and immediately uses the proceeds to open a noninterest-bearing checking account. No other amounts are deposited in the account during the year, and no portion of the principal amount of the debt is repaid during the year. On April 1, C uses $20,000 of the debt proceeds held in the account for a passive activity expenditure. On September 1, C uses an additional $40,000 of the debt proceeds held in the account for a personal expenditure. Under this paragraph (c)(4)(i), from January 1 through March 31 the entire $100,000 debt is allocated to an investment expenditure for the account. From April 1 through August 31, $20,000 of the debt is allocated to the passive activity expenditure, and $80,000 of the debt is allocated to the investment expenditure for the account. From September 1 through December 31, $40,000 of the debt is allocated to the personal expenditure, $20,000 is allocated to the passive activity expenditure, and $40,000 is allocated to an investment expenditure for the account.

(ii) *Expenditures from account; general ordering rule.* Except as provided in paragraph (c)(4)(iii) (B) or (C) of this section, debt proceeds deposited in an account are treated as expended before—

(A) Any unborrowed amounts held in the account at the time such debt proceeds are deposited; and

(B) Any amounts (borrowed or unborrowed) that are deposited in the account after such debt proceeds are deposited.

The following example illustrates the application of this paragraph (c)(4)(ii):

Example. On January 10, taxpayer E opens a checking account, depositing $500 of proceeds of Debt A and $1,000 of unborrowed funds. The following chart summarizes the transactions which occur during the year with respect to the account:

Date	Transaction
Jan. 10	$500 proceeds of Debt A and $1,000 unborowed funds deposited.
Jan. 11	$500 proceeds of Debt B deposited.
Feb. 17	$800 personal expenditure.
Feb. 26	$700 passive activity expenditure.
June 21	$1,000 proceeds of Debt C deposited.
Nov. 24	$800 investment expenditure.
Dec. 20	$600 personal expenditure.

The $800 personal expenditure is treated as made from the $500 proceeds of Debt A and $300 of the proceeds of Debt B. The $700 passive activity expenditure is treated as made from the remaining $200 proceeds of Debt B and $500 of unborrowed funds. The $800 investment expenditure is treated as made entirely from the proceeds of Debt C. The $600 personal expenditure is treated as made from the remaining $200 proceeds of Debt C and $400 of unborrowed funds. Under paragraph (c)(4)(i) of this section, debt is allocated to an investment expenditure for periods during which debt proceeds are held in the account.

(iii) *Expenditures from account; supplemental ordering rules*—(A) *Checking or similar accounts.* Except as otherwise provided in this paragraph (c)(4)(iii), an expenditure from a checking or similar account is treated as made at the time the check is written on the account, provided the check is delivered or mailed to the payee within a reasonable period after the writing of the check. For this purpose, the taxpayer may treat checks written on the same day as written in any order. In the absence of evidence to the contrary, a check is presumed to be written on the date appearing on the check and to be delivered or mailed to the payee within a reasonable period thereafter. Evidence to the contrary may include the fact that a check does not clear within a reasonable period after the date appearing on the check.

(B) *Expenditures within 15 days after deposit of borrowed funds.* The taxpayer may treat any expenditure made from an account within 15 days after debt proceeds are deposited in such account as made from such proceeds to the extent thereof even if under paragraph (c)(4)(ii) of this section the debt proceeds would be treated as used to make one or more other expenditures. Any such expenditures and the debt proceeds from which such expenditures are treated as made are disregarded in applying paragraph (c)(4)(ii) of this section. The following examples illustrate the application of this paragraph (c)(4)(iii)(B):

Example (1). Taxpayer D incurs a $1,000 debt on June 5 and immediately deposits the proceeds in an account (''Account A''). On June 17, D transfers $2,000 from Account A to another account (''Account B''). On June 30, D writes a $1,500 check on Account B for a passive activity expenditure. In addition, numerous deposits of borrowed and unborrowed amounts and expenditures occur with respect to both accounts throughout the month of June. Notwithstanding these other transactions, D may treat $1,000 of the deposit to Account B on June 17 as an expenditure from the debt proceeds deposited in Account A on June 5. In addition, D may similarly treat $1,000 of the passive activity expenditure on June 30 as made from debt proceeds treated as deposited in Account B on June 17.

Example (2). The facts are the same as in the example in paragraph (c)(4)(ii) of this section, except that the proceeds of Debt B are deposited on February 11 rather than on

January 11. Since the $700 passive activity expenditure occurs within 15 days after the proceeds of Debt B are deposited in the account, E may treat such expenditure as being made from the proceeds of Debt B to the extent thereof. If E treats the passive activity expenditure in this manner, the expenditures from the account are treated as follows: The $800 personal expenditure is treated as made from the $500 proceeds of Debt A and $300 of unborrrowed funds. The $700 passive activity expenditure is treated as made from the $500 proceeds of Debt B and $200 of unborrowed funds. The remaining expenditures are treated as in the example in paragraph (c)(4)(ii) of this section.

(C) *Interest on segregated account.* In the case of an account consisting solely of the proceeds of a debt and interest earned on such account, the taxpayer may treat any expenditure from such account as made first from amounts constituting interest (rather than debt proceeds) to the extent of the balance of such interest in the account at the time of the expenditure, determined by applying the rules in this paragraph (c)(4). To the extent any expenditure is treated as made from interest under this paragraph (c)(4)(iii)(C), the expenditure is disregarded in applying paragraph (c)(4)(ii) of this section.

(iv) *Optional method for determining date of reallocation.* Solely for the purpose of determining the date on which debt allocated to an account under paragraph (c)(4)(i) of this section is reallocated, the taxpayer may treat all expenditures made during any calendar month from debt proceeds in the account as occurring on the later of the first day of such month or the date on which such debt proceeds are deposited in the account. This paragraph (c)(4)(iv) applies only if all expenditures from an account during the same calendar month are similarly treated. The following example illustrates the application of this paragraph (c)(4)(iv):

Example. On January 10, taxpayer G opens a checking account, depositing $500 of proceeds of Debt A and $1,000 of unborrowed funds. The following chart summarizes the transactions which occur during the year with respect to the account (note that these facts are the same as the facts of the example in paragraph (c)(4)(ii) of this section):

Date	Transaction
Jan. 10	$500 proceeds of Debt A and $1,000 unborrowed funds deposited.
Jan. 11	$500 proceeds of Debt B deposited.
Feb. 17	$800 personal expenditure.
Feb. 26	$700 passive activity expenditure.
June 21	$1,000 proceeds of Debt C deposited.
Nov. 24	$800 investment expenditure.
Dec. 20	$600 personal expenditure.

Assume that G chooses to apply the optional rule of this paragraph (c)(4)(iv) to all expenditures. For purposes of determining the date on which debt is allocated to the $800 personal expenditure made on February 17, the $500 treated as made from the proceeds of Debt A and the $300 treated as made from the proceeds of Debt B are treated as expenditures occurring on February 1. Accordingly, Debt A is allocated to an investment expenditure for the account from January 10 through January 31 and to the personal expenditure from February 1 through December 31, and $300 of Debt B is allocated to an investment expenditure for the account from January 11 through January 31 and to the personal expenditure from February 1 through December 31. The remaining $200 of Debt B is allocated to an investment expenditure for the account from January 11 through January 31 and to the passive activity expenditure from February 1 through December 31. The $800 of Debt C used to make the investment expenditure on November 24 is allocated to an investment expenditure for the account from June 21 through October 31 and to an investment expenditure from November 1 through December 31. The remaining $200 of Debt C is allocated to an investment expenditure for the account from June 21 through November 30 and to a personal expenditure from December 1 through December 31.

(v) *Simultaneous deposits*—(A) *In general.* If the proceeds of two or more debts are deposited in an account simultaneously, such proceeds are treated for purposes of this paragraph (c)(4) as deposited in the order in which the debts were incurred.

(B) *Order in which debts incurred.* If two or more debts are incurred simultaneously or are treated under applicable law as incurred simultaneously, the debts are treated for purposes of this paragraph (c)(4)(v) as incurred in any order the taxpayer selects.

(C) *Borrowings on which interest accrues at different rates.* If interest does not accrue at the same fixed or variable rate on the entire amount of a borrowing, each portion of the borrowing on which interest accrues at a different fixed or variable rate is treated as a separate debt for purposes of this paragraph (c)(4)(v).

(vi) *Multiple accounts.* The rules in this paragraph (c)(4) apply separately to each account of a taxpayer.

(5) *Allocation of debt; proceeds received in cash*—(i) *Expenditure within 15 days of receiving debt proceeds.* If a taxpayer receives the proceeds of a debt in cash, the taxpayer may treat any cash expenditure made within 15 days after receiving the cash as made from such debt proceeds to the extent thereof and may treat such expenditure as made on the date the taxpayer received the cash. The following example illustrates the rule in this paragraph (c)(5)(i):

Example. Taxpayer F incurs a $1,000 debt on August 4 and receives the debt proceeds in cash. F deposits $1,500 cash in an account on August 15 and on August 27 writes a check on the account for a passive activity expenditure. In addition, F engages in numerous other cash transactions throughout the month of August, and numerous deposits of borrowed and unborrowed amounts and expenditures occur with respect to the account during the same period. Notwithstanding these other transactions, F may treat $1,000 of the deposit on August 15 as an expenditure made from the debt proceeds on August 4. In addition, under the rule in paragraph (c)(4)(v)(B) of this section, F may treat the passive activity expenditure on August 27 as made from the $1,000 debt proceeds treated as deposited in the account.

(ii) *Other expenditures.* Except as provided in paragraphs (c)(5) (i) and (iii) of this section, any debt proceeds a taxpayer (other than a corporation) receives in cash are treated as used to make personal expenditures. For purposes of this paragraph (c)(5), debt proceeds are received in cash if, for example, a withdrawal of cash from an account is treated under the rules of this section as an expenditure of debt proceeds.

(iii) *Special rules for certain taxpayers.* [Reserved]

(6) *Special rules*—(i) *Qualified residence debt.* [Reserved]

(ii) *Debt used to pay interest.* To the extent proceeds of a debt are used to pay interest, such debt is allocated in the same manner as the debt on which such interest accrued is allocated from time to time. The following example illustrates the application of this paragraph (c)(6)(ii):

Example. On January 1, taxpayer H incurs a debt of $1,000, bearing interest at an annual rate of 10 percent, compounded annually, payable at the end of each year (''Debt A''). H immediately opens a checking account, in which H deposits the proceeds of Debt A. No other amounts are deposited in the account during the year. On April 1, H writes a check for a personal expenditure in the amount of $1,000. On December 31, H borrows $100 (''Debt B'') and immediately uses the proceeds of Debt B to pay the accrued interest of $100 on Debt A. From January 1 through March 31, Debt A is allocated, under the rule in paragraph (c)(4)(i) of this section, to the investment expenditure for the account. From April 1 through December 31, Debt A is allocated to the personal expenditure. Under the rule in paragraph (c)(2)(ii) of this section, $25 of the interest on Debt A for the year is allocated to the investment expenditure, and $75 of the interest on Debt A for the year is allocated to the personal expenditure. Accordingly, for the purpose of allocating the interest on Debt B for all periods until Debt B is repaid, $25 of Debt B is allocated to the investment expenditure, and $75 of Debt B is allocated to the personal expenditure.

(iii) *Debt used to pay borrowing costs*—(A) *Borrowing costs with respect to different debt.* To the extent the proceeds of a debt (the ''ancillary debt'') are used to pay borrowing costs (other than interest) with respect to another debt (the ''primary debt''), the ancillary debt is allocated in the same manner as the primary debt is allocated from time to time. To the extent the primary debt is repaid, the ancillary debt will continue to be allocated in the same manner as the primary debt was allocated immediately before its repayment. The following example illustrates the rule in this paragraph (c)(6)(iii)(A):

Example. Taxpayer I incurs debts of $60,000 (''Debt A'') and $10,000 (''Debt B''). I immediately uses $30,000 of the proceeds of Debt A to make a trade or business expenditure, $20,000 to make a passive activity expenditure, and $10,000 to make an investment expenditure. I immediately use $3,000 of the proceeds of Debt B to pay borrowing costs (other than interest) with respect to Debt A (such as loan origination, loan commitment, abstract, and recording fees) and deposits the remaining $7,000 in an account. Under the rule in this paragraph (c)(6)(iii)(A), the $3,000 of Debt B used to pay expenses of incurring Debt A is allocated $1,500 to the trade or business expenditure ($3,000 × $30,000/$60,000), $1,000 to the passive activity expenditure ($3,000 × $20,000/$60,000), and $500 ($3,000 × $10,000/$60,000) to the investment expenditure. The manner in which the $3,000 of Debt B used to pay expenses of incurring Debt A is allocated may change if the allocation of Debt A changes, but such allocation will be unaffected by any repayment of Debt A. The remaining $7,000 of Debt B is allocated to an investment expenditure for the account until such time, if any, as this amount is used for a different expenditure.

(B) *Borrowing costs with respect to same debt.* To the extent the proceeds of a debt are used to pay borrowing costs (other than interest) with respect to such debt, such debt is allocated in the same manner as the remaining debt is allocated from time to time. The remaining debt for this purpose is the portion of the debt that is not used to pay borrowing costs (other than interst) with respect to such debt. Any repayment of the debt is treated as a repayment of the debt allocated under this paragraph (c)(6)(iii)(B) and the remaining debt is the same proportion as such amount bear to each other. The following example illustrates the application of this paragraph (c)(6)(iii)(B):

Example. (i) Taxpayer J borrows $85,000. The lender disburses $80,000 of this amount to J, retaining $5,000 for borrowing costs (other than interest) with respect to the loan. J immediately uses $40,000 of the debt proceeds to make a personal expenditure, $20,000 to make a passive activity expenditure, and $20,000 to make an investment expenditure. Under the rule in this paragraph (c)(6)(iii)(B), the $5,000 used to pay borrowing costs is allocated $2,500 ($5,000 × $40,000/$80,000) to the personal expenditure, $1,250 ($5,000 × $20,000/$80,000) to the investment expenditure. The manner in which this $5,000 is allocated may change if the allocation of the remaining $80,000 of debt is changed.

(ii) Assume that J repays $50,000 of the debt. The repayment is treated as a repayment of $2,941 ($50,000 x $5,000/$85,000) of the debt used to pay borrowing costs and a repayment of $47,059 ($50,000 x $80,000/$85,000) of the remaining debt. Under paragraph (d) of this section, J is treated as repaying the $42,500 of debt allocated to the personal expenditure ($2,500 of debt used to pay borrowing costs and $40,000 of remaining debt). In addition, assuming that under paragraph (d)(2) J chooses to treat the allocation to the passive activity expenditure as having occurred before the allocation to the investment expenditure, J is treated as repaying $7,500 of debt allocated to the passive activity expenditure ($441 of debt used to pay borrowing costs and $7,059 of remaining debt).

(iv) *Allocation of debt before actual receipt of debt proceeds.* If interest properly accrues on a debt during any period before the debt proceeds are actually received or used to make an expenditure, the debt is allocated to an investment expenditure for such period.

(7) *Antiabuse rules.* [Reserved]

(d) *Debt repayments*—(1) *General ordering rule.* If, at the time any portion of a debt is repaid, such debt is allocated to more than one expenditure, the debt is treated for purposes of this section as repaid in the following order:

(i) Amounts allocated to personal expenditures;

(ii) Amounts allocated to investment expenditures and passive activity expenditures (other than passive activity expenditures described in paragraph (d)(1)(iii) of this section);

(iii) Amounts allocated to passive activity expenditures in connection with a rental real estate activity with respect to which the taxpayer actively participates (within the meaning of section 469(i));

(iv) Amounts allocated to former passive activity expenditures; and

(v) Amounts allocated to trade or business expenditures and to expenditures described in the last sentence of paragraph (b)(4) of this section.

(2) *Supplemental ordering rules for expenditures in same class.* Amounts allocated to two or more expenditures that are described in the subdivision of paragraph (d)(1) of this section (e.g., amounts allocated to different personal expenditures) are treated as repaid in the order in which the amounts were allocated (or reallocated) to such expenditures. For purposes of this paragraph (d)(2), the taxpayer may treat allocations and reallocations that occur on the same day as occurring in any order (without regard to the order in which expenditures are treated as made under paragraph (c)(4)(iii)(A) of this section).

(3) *Continuous borrowings.* In the case of borrowings pursuant to a line of credit or similar account or arrangement that allows a taxpayer to borrow funds periodically under a single loan agreement—

(i) All borrowings on which interest accrues at the same fixed or variable rate are treated as a single debt; and

(ii) Borrowings or portions of borrowings on which interest accrues at different fixed or variable rates are treated as different debts, and such debts are treated as repaid for purposes of this paragraph (d) in the order in which such borrowings are treated as repaid under the loan agreement.

(4) *Examples.* The following examples illustrate the application of this paragraph (d):

Example (1). Taxpayer B borrows $100,000 (''Debt A'') on July 12, immediately deposits the proceeds in an account, and uses the debt proceeds to make the following expenditures on the following dates:

August 31—$40,000 passive activity expenditure #1.

October 5—$20,000 passive activity expenditure #2.

December 24—$40,000 personal expenditure.

On January 19 of the following year, B repays $90,000 of Debt A (leaving $10,000 of Debt A outstanding). The $40,000 of Debt A allocated to the personal expenditure, the $40,000 allocated to passive activity expenditure #1, and $10,000 of the $20,000 allocated to passive activity expenditure #2 are treated as repaid.

Example (2). (i) Taxpayer A obtains a line of credit. Interest on any borrowing on the line of credit accrues at the lender's ''prime lending rate'' on the date of the borrowing plus two percentage points. The loan documents provide that borrowings on the line of credit are treated as repaid in the order the borrowings were made. A borrows $30,000 (''Borrowing #1'') on the line of credit and immediately uses $20,000 of the debt proceeds to make a personal expenditure (''personal expenditure #1'') and $10,000 to make a trade or business expenditure (''trade or business expenditure #1''). A subsequently borrows another $20,000 (''Borrowing #2'') on the line of credit and immediately uses $15,000 of the debt proceeds to make a personal expenditure (''personal expenditure #2'') and $5,000 to make a trade or business expenditure (''trade or business expenditure #2''). A then repays $40,000 of the borrowings.

(ii) If the prime lending rate plus two percentage points was the same on both the date of Borrowing #1 and the date of Borrowing #2, the borrowings are treated for purposes of this paragraph (d) as a single debt, and A is treated as having repaid $35,000 of debt allocated to personal expenditure #1 and personal expenditure #2, and $5,000 of debt allocated to trade or business expenditure #1.

(iii) If the prime lending rate plus two percentage points was different on the date of Borrowing #1 and Borrowing #2, the borrowings are treated as two debts, and, in accordance with the loan agreement, the $40,000 repaid amount is treated as a repayment of Borrowing #1 and $10,000 of Borrowing #2. Accordingly, A is treated as having repaid $20,000 of debt allocated to personal expenditure #1, $10,000 of debt allocated to trade or business expenditure #1, and $10,000 of debt allocated to personal expenditure #2.

(e) *Debt refinancings*—(1) *In general.* To the extent proceeds of any debt (the ''replacement debt'') are used to repay any portion of a debt, the replacement debt is allocated to the expenditures to which the repaid debt was allocated. The amount of replacement debt allocated to any such expenditure is equal to the amount of debt allocated to such expenditure that was repaid with proceeds of the replacement debt. To the extent proceeds of the replacement debt are used for expenditures other than repayment of a debt, the replacement debt is allocated to expenditures in accordance with the rules of this section.

(2) *Example.* The following example illustrates the application of this paragraph (e):

Example. Taxpayer C borrows $100,000 (''Debt A'') on July 12, immediately deposits the debt proceeds in an account, and uses the proceeds to make the following expenditures on the following dates (note that the facts of this example are the same as the facts of example (1) in paragraph (d)(4) of this section):

August 31—$40,000 passive activity expenditure #1.

October 5—$20,000 passive activity expenditure #2.

December 24—$40,000 personal expenditure #1.

On January 19 of the following year, C borrows $120,000 (''Debt B'') and uses $90,000 of the proceeds of repay $90,000 of Debt A (leaving $10,000 of Debt A outstanding). In addition, C uses $30,000 of the proceeds of Debt B to make a personal expenditure (''personal expenditure #2''). Debt B is allocated $40,000 to personal expenditure #1, $40,000 to passive activity expenditure #1, $10,000 to passive activity expenditure #2, and $30,000 to personal expenditure #2. Under paragraph (d)(1) of this section, Debt B will be treated as repaid in the following order: (1) amounts allocated to personal expenditure #1, (2) amounts allocated to personal expenditure #2, (3) amounts allocated to passive activity expenditure #1, and (4) amounts allocated to passive activity expenditure #2.

(f) *Debt allocated to distributions by passthrough entities.* [Reserved]

(g) *Repayment of passthrough entity debt.* [Reserved]

(h) *Debt allocated to expenditures for interests in passthrough entities.* [Reserved]

(i) *Allocation of debt to loans between passthrough entities and interest holders.* [Reserved]

(j) *Reallocation of debt*—(1) *Debt allocated to capital expenditures*—(i) *Time of reallocation.* Except as provided in paragraph (j)(2) of this section, debt allocated to an expenditure properly chargeable to capital account with respect to an asset (the ‘‘first expenditure’’) is reallocated to another expenditure on the earlier of—

(A) The date on which proceeds from a disposition of such asset are used for another expenditure; or

(B) The date on which the character of the first expenditure changes (e.g., from a passive activity expenditure to an expenditure that is not a passive activity expenditure) by reason of a change in the use of the asset with respect to which the first expenditure was capitalized.

(ii) *Limitation on amount reallocated.* The amount of debt reallocated under paragraph (j)(1)(i)(A) of this section may not exceed the proceeds from the disposition of the asset. The amount of debt reallocated under paragraph (j)(1)(i)(B) of this section may not exceed the fair market value of the asset on the date of the change in use. In applying this paragraph (j)(1)(ii) with respect to a debt in any case in which two or more debts are allocable to expenditures properly chargeable to capital account with respect to the same asset, only a ratable portion (determined with respect to any such debt by dividing the amount of such debt by the aggregate amount of all such debts) of the fair market value or proceeds from the disposition of such asset shall be taken into account.

(iii) *Treatment of loans made by the taxpayer.* Except as provided in paragraph (j)(1)(iv) of this section, an expenditure to make a loan is treated as an expenditure properly chargeable to capital account with respect to an asset, and for purposes of paragraph (j)(1)(i)(A) of this section any repayment of the loan is treated as a disposition of the asset. Paragraph (j)(3) of this section applies to any repayment of a loan in installments.

(iv) *Treatment of accounts.* Debt allocated to an account under paragraph (c)(4)(i) of this section is treated as allocated to an expenditure properly chargeable to capital account with respect to an asset, and any expenditure from the account is treated as a disposition of the asset. See paragraph (c)(4) of this section for rules under which debt proceeds allocated to an account are treated as used for another expenditure.

(2) *Disposition proceeds in excess of debt.* If the proceeds from the disposition of an asset exceed the amount of debt reallocated by reason of such disposition, or two or more debts are reallocated by reason of the disposition of an asset, the proceeds of the disposition are treated as an account to which the rules in paragraph (c)(4) of this section apply.

(3) *Special rule for deferred payment sales.* If any portion of the proceeds of a disposition of an asset are received subsequent to the disposition—

(i) The portion of the proceeds to be received subsequent to the disposition is treated for periods prior to the receipt as used to make an investment expenditure; and

(ii) Debt reallocated by reason of the disposition is allocated to such investment expenditure to the extent such debt exceeds the proceeds of the disposition previously received (other than proceeds used to repay such debt).

(4) *Examples.* The following examples illustrate the application of this paragraph (j):

Example (1). On January 1, 1988, taxpayer D sells an asset for $25,000. Immediately before the sale, the amount of debt allocated to expenditures properly chargeable to capital account with respect to the asset was $15,000. The proceeds of the disposition are treated as an account consisting of $15,000 of debt proceeds and $10,000 of unborrowed funds to which paragraph (c)(4) of this section applies. Thus, if D immediately makes a $10,000 personal expenditure from the proceeds and within 15 days deposits the remaining proceeds in an account, D may, pursuant to paragraph (c)(4)(iii)(B) of this section, treat the entire $15,000 deposited in the account as proceeds of a debt.

Example (2). The facts are the same as in example (1) except that, instead of receiving all $25,000 of the sale proceeds on January 1, 1988, D receives 5,000 on that date, $10,000 on January 1, 1989, and $10,000 on January 1, 1990. D does not use any portion of the sale proceeds to repay the debt. Between January 1, 1988, and December 31, 1988, D is treated under paragraph (j)(3) of this section as making an investment expenditure of $20,000 to which $10,000 of debt is allocated. In addition, the remaining $5,000 of debt is reallocated on January 1, 1988, in accordance with D's use of the sales proceeds received on that date. Between January 1, 1989, and December 31, 1989, D is treated as making an investment expenditure of $10,000 to which no debt is allocated. In addition, as of January 1, 1989, $10,000 of debt is reallocated in accordance with D's use of the sales proceeds received on that date.

Example 3. The facts are the same as in example (2), except that D immediately uses the $5,000 sale proceeds received on January 1, 1988, to repay $5,000 of the $15,000 debt. Between January 1, 1988, and December 31, 1988, D is treated as making an investment expenditure of $20,000 to which the remaining balance ($10,000) of the debt is reallocated. The results in 1989 are as described in example (2).

(k) *Modification of rules in the case of interest expense allocated to foreign source income.* [Reserved]

(l) [Reserved]

(m) *Coordination with other provisions*—(1) *Effect of other limitations*—(i) *In general.* All debt is allocated among expenditures pursuant to the rules in this section, without regard to any limitations on the deductibility of interest expense on such debt. The applicability of the passive loss and nonbusiness interest limitations to interest on such debt, however, may be affected by other limitations on the deductibility of interest expense.

(ii) *Disallowance provisions.* (Interest expense that is not allowable as a deduction by reason of a disallowance provision (within the meaning of paragraph (m)(7)(ii) of this section) is not taken into account for any taxable year for purposes of applying the passive loss and nonbusiness interest limitations.

(iii) *Deferral provisions.* Interest expense that is not allowable as a deduction for the taxable year in which paid or accrued by reason of a deferral provision (within the meaning of paragraph (m)(7)(iii) of this section) is allocated in the same manner as the debt giving rise to the interest expense is allocated for such taxable year. Such interest expense is taken into account for purposes of applying the passive loss and nonbusiness interest limitations for the taxable year in which such interest expense is allowable under such deferral provision.

(iv) *Capitalization provisions.* Interest expense that is capitalized pursuant to a capitalization provision (within the meaning of paragraph (m)(7)(i) of this section) is not taken into account as interest for any taxable year for purposes of applying the passive loss and nonbusiness interest limitations.

(2) *Effect on other limitations*—(i) *General rule.* Except as provided in paragraph (m)(2)(ii) of this section, any limitation on the deductibility of an item (other than the passive loss and nonbusiness interest limitations) applies without regard to the manner in which debt is allocated under this section. Thus, for example, interest expense treated under section 265(a)(2) as interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax is not deductible regardless of the expenditure to which the underlying debt is allocated under this section.

(ii) *Exception.* Capitalization provisions (within the meaning of paragraph (m)(7)(i) of this section) do not apply to interest expense allocated to any personal expenditure under the rules of this section.

(3) *Qualified residence interest.* Qualified residence interest (within the meaning of section 163(h)(3)) is allowable as a deduction without regard to the manner in which such interest expense is allocated under the rules of this section. In addition, qualified residence interest is not taken into account in determining the income or loss from any activity for purposes of section 469 or in determining the amount of investment interest for purposes of section 163(d). The following example illustrates the rule in this paragraph (m)(3):

Example. Taxpayer E, an individual, incurs a $20,000 debt secured by a residence and immediately uses the proceeds to purchase an automobile exclusively for E's personal use. Under the rules in this section, the debt and interest expense on the debt are allocated to a personal expenditure. If, however, the interest on the debt is qualified residence interest within the meaning of section 163(h)(3), the interest is not treated as personal interest for purposes of section 163(h).

(4) *Interest described in section 163(h)(2)(E).* Interest described in section 163(h)(2)(E) is allowable as a deduction without regard to the rules of this section.

(5) *Interest on deemed distributee debt.* [Reserved]

(6) *Examples.* The following examples illustrate the relationship between the passive loss and nonbusiness interest limitations and other limitations on the deductibility of interest expense:

Example (1). Debt is allocated pursuant to the rules in this section to an investment expenditure for the purchase of taxable investment securities. Pursuant to section 265(a)(2), the debt is treated as indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax, and, accordingly, interest on the debt is disallowed. If section 265(a)(2) subsequently ceases to apply (because, for example, the taxpayer ceases to hold any tax-exempt obligations), and the debt at such time continues to be allocated to an investment expenditure, interest on the debt that accrues after such time is subject to section 163(d).

Example (2). An accrual method taxpayer incurs a debt payable to a cash method lender who is related to the taxpayer within the meaning of section 267(b). During the period in which interest on the debt is not deductible by reason of section 267(a)(2), the debt is allocated to a passive activity expenditure. Thus, interest that accrues on the debt for such period is also allocated to the passive activity expenditure. When such interest expense becomes deductible under section 267(a)(2), it will be allocated to the passive activity expenditure, regardless of how the debt is allocated at such time.

Example (3). A taxpayer incurs debt that is allocated under the rules of this section to an investment expenditure. Under section 263A(f), however, interest expense on such debt is capitalized during the production period (within the meaning of section 263A(f)(4)(B)) of property used in a passive activity of the taxpayer. The capitalized interest expense is not allocated to the investment expenditure, and depreciation deductions attributable to the capitalized interest expense are subject to the passive loss limitation as long as the property is used in a passive activity. However, interest expense on the debt for periods after the production period is allocated to the investment expenditure as long as the debt remains allocated to the investment expenditure.

(7) *Other limitations on interest expense*—(i) *Capitalization provisions.* A capitalization provision is any provision that requires or allows interest expense to be capitalized. Capitalization provisions include sections 263(g), 263A(f), and 266.

(ii) *Disallowance provisions.* A disallowance provision is any provision (other than the passive loss and nonbusiness interest limitations) that disallows a deduction for interest expense for all taxable years and is not a capitalization provision. Disallowance provisions include sections 163(f)(2), 264(a)(2), 264(a)(4), 265(a)(2), 265(b)(2), 279(a), 291(e)(1)(B)(ii), 805(b)(1), and 834(c)(5).

(iii) *Deferral provisions.* A deferral provision is any provision (other than the passive loss and nonbusiness interest limitations) that disallows a deduction for interest expense for any taxable year and is not a capitalization or disallowance provision. Deferral provisions include sections 267(a)(2), 465, 1277, and 1282.

(n) *Effective date*—(1) *In general.* This section applies to interest expense paid or accrued in taxable years beginning after December 31, 1986.

(2) *Transitional rule for certain expenditures.* For purposes of determining whether debt is allocated to expenditures made on or before August 3, 1987, paragraphs (c)(4)(iii)(B) and (c)(5)(i) of this section are applied by substituting ''90 days'' for ''15 days.''

(3) *Transitional rule for certain debt*—(i) *General rule.* Except as provided in paragraph (n)(3)(ii) of this section, any debt outstanding on December 31, 1986, that is properly attributable to a business or rental activity is treated for purposes of this section as debt allocated to expenditures properly chargeable to capital account with respect to the assets held for use or for sale to customers in such business or rental activity. Debt is properly attributable to a business or rental activity for purposes of this section (regardless of whether such debt otherwise would be

allocable under this section to expenditures in connection with such activity) if the taxpayer has properly and consistently deducted interest expense (including interest subject to limitation under section 163(d) as in effect prior to the Tax Reform Act of 1986) on such debt on Schedule C, E, or F of Form 1040 in computing income or loss from such business or rental activity for taxable years beginning before January 1, 1987. For purposes of this paragraph (n)(3), amended returns filed after July 2, 1987 are disregarded in determining whether a taxpayer has consistently deducted interest expense on Schedule C, E, or F of Form 1040 in computing income or loss from a business or rental activity.

(ii) *Exceptions*—(A) *Debt financed distributions by passthrough entities.* [Reserved]

(B) *Election out.* This paragraph (n)(3) does not apply with respect to debt of a taxpayer who elects under paragraph (n)(3) (viii) of this section to allocate debt outstanding on December 31, 1986, in accordance with the provisions of this section other than this paragraph (n)(3) (i.e., in accordance with the use of the debt proceeds).

(iii) *Business or rental activity.* For purposes of this paragraph (n)(3), a business or rental activity is any trade or business or rental activity of the taxpayer. For this purpose—

(A) A trade or business includes a business or profession the income and deductions of which (or, in the case of a partner or S corporation shareholder, the taxpayer's share thereof) are properly reported on Schedule C, E, or F of Form 1040; and

(B) A rental activity includes an activity of renting property the income and deductions of which (or, in the case of a partner or S corporation shareholder, the taxpayer's share thereof) are properly reported on Schedule E of Form 1040.

(iv) *Example.* The following example illustrates the circumstances in which debt is properly attributable to a business or rental activity:

Example. Taxpayer H incurred a debt in 1979 and properly deducted the interest expense on the debt on Schedule C of Form 1040 for each year from 1979 through 1986. Under this paragraph (n) (3), the debt is properly attributable to the business the results of which are reported on Schedule C.

(v) *Allocation requirement*—(A) *In general.* Debt outstanding on December 31, 1986, that is properly attributable (within the meaning of paragraph (n)(3)(i) of this section) to a business or rental activity must be allocated in a reasonable and consistent manner among the assets held for use or for sale to customers in such activity on the last day of the taxable year that includes December 31, 1986. The taxpayer shall specify the manner in which such debt is allocated by filing a statement in accordance with paragraph (n)(3)(vii) of this section. If the taxpayer does not file such a statement or fails to allocate such debt in a reasonable and consistent manner, the Commissioner shall allocate the debt.

(B) *Reasonable and consistent manner—examples of improper allocation.* For purposes of this paragraph (n)(3)(v), debt is not treated as allocated in a reasonable and consistent manner if—

(*1*) The amount of debt allocated to goodwill exceeds the basis of the goodwill; or

(*2*) The amount of debt allocated to an asset exceeds the fair market value of the asset, and the amount of debt allocated to any other asset is less than the fair market value (lesser of basis or fair market value in the case of goodwill) of such other asset.

(vi) *Coordination with other provisions.* The effect of any events occurring after the last day of the taxable year that includes December 31, 1986, shall be determined under the rules of this section, applied by treating the debt allocated to an asset under paragraph (n)(3)(v) of this section as if proceeds of such debt were used to make an expenditure properly chargeable to capital account with respect to such asset on the last day of the taxable year that includes December 31, 1986. Thus, debt that is allocated to an asset in accordance with this paragraph (n)(3) must be reallocated in accordance with paragraph (j) of this section upon the occurrence with respect to such asset of any event described in such paragraph (j). Similarly, such debt is treated as repaid in the order prescribed in paragraph (d) of this section. In addition, a replacement debt (within the meaning of paragraph (e) of this section) is allocated to an expenditure properly chargeable to capital account with respect to an asset to the extent the proceeds of such debt are used to repay the portion of a debt allocated to such asset under this paragraph (n)(3).

(vii) *Form for allocation of debt.* A taxpayer shall allocate debt for purposes of this paragraph (n)(3) by attaching to the taxpayer's return for the first taxable year beginning after December 31, 1986, a statement that is prominently identified as a transitional allocation statement under §1.163–8T(n)(3) and includes the following information:

(A) A description of the business or rental activity to which the debt is properly attributable;

(B) The amount of debt allocated;

(C) The assets among which the debt is allocated;

(D) The manner in which the debt is allocated;

(E) The amount of debt allocated to each asset; and

(F) Such other information as the Commissioner may require.

(viii) *Form for election out.* A taxpayer shall elect to allocate debt outstanding on December 31, 1986, in accordance with the provisions of this section other than this paragraph (n)(3) by attaching to the taxpayer's return (or amended return) for the first taxable year beginning after December 31, 1986, a statement to that effect, prominently identified as as election out under §1.163–8T(n)(3).

(ix) *Special rule for partnerships and S corporations.* For purposes of paragraph (n)(3)(ii)(B), (v), (vii) and (viii) of this section (relating to the allocation of debt and election out), a partnership or S corporation shall be treated as the taxpayer with respect to the debt of the partnership or S corporation.

(x) *Irrevocability.* An allocation or election filed in accordance with paragraph (n)(3) (vii) or (viii) of this section may not be revoked or modified except with the consent of the Commissioner.

[T.D. 8145, 52 FR 24999, July 2, 1987, as amended by T.D. 8145, 62 FR 40270, July 28, 1997]

§1.163–9T Personal interest (temporary).

(a) *In general.* No deduction under any provision of Chapter 1 of the Internal Revenue Code shall be allowed for personal interest paid or accrued during the taxable year by a taxpayer other than a corporation.

(b) *Personal interest*—(1) *Definition.* For purposes of this section, personal interest is any interest expense other than—

(i) Interest paid or accrued on indebtedness properly allocable (within the meaning of §1.163–8T) to the conduct of trade or business (other than the trade or business of performing services as an employee),

(ii) Any investment interest (within the meaning of section 163(d)(3)),

(iii) Any interest that is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer,

(iv) Any qualified residence interest (within the meaning of section 163(h)(3) and §1.163–10T), and

(v) Any interest payable under section 6601 with respect to the unpaid portion of the tax imposed by section 2001 for the period during which an extension of time for payment of such tax is in effect under section 6163, 6166, or 6166A (as in effect before its repeal by the Economic Recovery Tax Act of 1981).

(2) *Interest relating to taxes*—(i) *In general.* Except as provided in paragraph (b)(2)(iii) of this section, personal interest includes interest—

(A) Paid on underpayments of individual Federal, State or local income taxes and on indebtedness used to pay such taxes (within the meaning of §1.168–8T), regardless of the source of the income generating the tax liability;

(B) Paid under section 453(e)(4)(B) (interest on deferred tax resulting from certain installment sales) and section 1291(c) (interest on deferred tax attributable to passive foreign investment companies); or

(C) Paid by a trust, S corporation, or other pass-through entity on underpayments of State or local income taxes and on indebtedness used to pay such taxes.

(ii) *Example.*

A, an individual, owns stock of an S corporation. On its return for 1987, the corporation underreports its taxable income. Consequently, A underreports A's share of that income on A's tax return. In 1989, A pays the resulting deficiency plus interest to the Internal Revenue Service. The interest paid by A in 1989 on the tax deficiency is personal interest, notwithstanding the fact that the additional tax liability may have arisen out of income from a trade or business. The result would be the same if A's business had been operated as a sole proprietorship.

(iii) *Certain other taxes.* Personal interest does not include interest—

(A) Paid with respect to sales, excise and similar taxes that are incurred in connection with a trade or business or an investment activity;

(B) Paid by an S corporation with respect to an underpayment of income tax from a year in which the S corporation was a C corporation or with respect to an underpayment of the taxes imposed by sections 1374 or 1375, or similar provision of State law; or

(C) Paid by a transferee under section 6901 (tax liability resulting from transferred assets), or a similar provision of State law, with respect to a C corporation's underpayment of income tax.

(3) *Cross references.* See § 1.163–8T for rules for determining the allocation of interest expense to various activities. See § 1.163–10T for rules concerning qualified residence interest.

(c) *Effective date*—(1) *In general.* The provisions of this section are effective for taxable years beginning after December 31, 1986. In the case of any taxable year beginning in calendar years 1987 through 1990, the amount of personal interest that is nondeductible under this section is limited to the applicable percentage of such amount.

(2) *Applicable percentages.* The applicable percentage for taxable years beginning in 1987 through 1990 are as follows:

1987:	35 percent
1988:	60 percent
1989:	80 percent
1990:	90 percent

[T.D. 8168, 52 FR 48409, Dec. 22, 1987]

§ 1.163–10T Qualified residence interest (temporary).

(a) *Table of contents.* This paragraph (a) lists the major paragraphs that appear in this § 1.163–10T.

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(b) *Treatment of qualified residence interest.* Except as provided below, qualified residence interest is deductible under section 163(a). Qualified residence interest is not subject to limitation or otherwise taken into account under section 163(d) (limitation on investment interest), section 163(h)(1) (disallowance of deduction for personal interest), section 263A (capitalization and inclusion in inventory costs of certain expenses) or section 469 (limitations on losses from passive activities). Qualified residence interest is subject to the limitation imposed by section 263(g) (certain interest in the case of straddles), section 264(a) (2) and (4) (interest paid in connection with certain insurance), section 265(a)(2) (interest relating to tax-exempt income), section 266 (carrying charges), section 267(a)(2) (interest with respect to transactions between related taxpayers) section 465 (deductions limited to amount at risk), section 1277 (deferral of interest deduction allocable to accrued market discount), and section 1282 (deferral of interest deduction allocable to accrued discount).

(c) *Determination of qualified residence interest when secured debt does not exceed adjusted purchase price*—(1) *In general.* If the sum of the average balances for the taxable year of all secured debts on a qualified residence does not exceed the adjusted purchase price (determined as of the end of the taxable year) of the qualified residence, all of the interest paid or accrued during the taxable year with respect to the secured debts is qualified residence interest. If the sum of the average balances for the taxable year of all secured debts exceeds the adjusted purchase price of the qualified residences (determined as of the end of the taxable year), the taxpayer must use either the simplified method (see paragraph (d) of this section) or the exact method (see paragraph (e) of this section) to determine the amount of interest that is qualified residence interest.

(2) *Examples.*

Example (1). T purchases a qualified residence in 1987 for $65,000. T pays $6,500 in cash and finances the remainder of the purchase with a mortgage of $58,500. In 1988, the average balance of the mortgage is $58,000. Because the average balance of the mortgage is less than the adjusted purchase price of the residence ($65,000), all of the interest paid or accrued during 1988 on the mortgage is qualified residence interest.

Example (2). The facts are the same as in example (1), except that T incurs a second mortgage on January 1, 1988, with an initial principal balance of $2,000. The average balance of the second mortgage in 1988 is $1,900. Because the sum of the average balance of the first and second mortgages ($59,900) is less than the adjusted purchase price of the residence ($65,000), all of the interest paid or accrued during 1988 on both the first and second mortgages is qualified residence interest.

Example (3). P borrows $50,000 on January 1, 1988 and secures the debt by a qualified residence. P pays the interest on the debt monthly, but makes no principal payments in 1988. There are no other debts secured by the residence during 1988. On December 31, 1988, the adjusted purchase price of the residence is $40,000. The average balance of the debt in 1988 is $50,000. Because the average balance of the debt exceeds the adjusted purchase price ($10,000), some of the interest on the debt is not qualified residence interest. The portion of the total interest that is qualified residence interest must be determined in accordance with the rules of paragraph (d) or paragraph (e) of this section.

(d) *Determination of qualified residence interest when secured debt exceeds adjusted purchase price—Simplified method*—(1) *In general.* Under the simplified method, the amount of qualified residence interest for the taxable year is equal to the total interest paid or accrued during the taxable year with respect to all secured debts multiplied by a fraction (not in excess of one), the numerator of which is the adjusted purchase price (determined as of the end of the taxable year) of the qualified residence and the denominator of which is the sum of the average balances of all secured debts.

(2) *Treatment of interest paid or accrued on secured debt that is not qualified residence interest.* Under the simplified method, the excess of the total interest paid or accrued during the taxable year with respect to all secured debts over the amount of qualified residence interest is personal interest.

(3) *Example.*

Example. R's principal residence has an adjusted purchase price on December 31, 1988, of $105,000. R has two debts secured by the residence, with the following average balances and interest payments:

Debt	Date secured	Average balance	Interest
Debt 1	June 1983	$80,000	$8,000
Debt 2	May 1987	40,000	4,800
Total	....	120,000	12,800

The amount of qualified residence interest is determined under the simplified method by multiplying the total interest ($12,800) by a fraction (expressed as a decimal amount) equal to the adjusted purchase price ($105,000) of the residence divided by the combined average balances ($120,000). For 1988, this fraction is equal to 0.875 ($105,000/$120,000). Therefore, $11,200 ($12,800×0.875) of the total interest is qualified residence interest. The remaining $1,600 in interest ($12,800–$11,200) is personal interest, even if (under the rules of § 1.163–8T) such remaining interest would be allocated to some other category of interest.

(e) *Determination of qualified residence interest when secured debt exceeds adjusted purchase price—Exact method*—(1) *In general.* Under the exact method, the amount of qualified residence interest for the taxable year is determined on a debt-by-debt basis by computing the applicable debt limit for each secured debt and comparing each such applicable debt limit to the average balance of the corresponding debt. If, for the taxable year, the average balance of a secured debt does not exceed the applicable debt limit for that debt, all of the interest paid or accrued during the taxable year with respect to the debt is qualified residence interest. If the average balance of the secured debt exceeds the applicable debt limit for that debt, the amount of qualified residence interest with respect to the debt is determined by multiplying the interest paid or accrued with respect to the debt by a fraction, the numerator of which is the applicable debt limit for that debt and the denominator of which is the average balance of the debt.

(2) *Determination of applicable debt limit.* For each secured debt, the applicable debt limit for the taxable year is equal to

(i) The lesser of—

(A) The fair market value of the qualified residence as of the date the debt is first secured, and

(B) The adjusted purchase price of the qualified residence as of the end of the taxable year,

(ii) Reduced by the average balance of each debt previously secured by the qualified residence.

For purposes of paragraph (e)(2)(ii) of this section, the average balance of a debt shall be treated as not exceeding the applicable debt limit of such debt. See paragraph (n)(1)(i) of this section for the rule that increases the adjusted purchase price in paragraph (e)(2)(i)(B) of this section by the amount of any qualified indebtedness (certain medical and educational debt). See paragraph (f) of this section for special rules relating to the determination of the fair market value of the qualified residence.

(3) *Example.*

(i) R's principal residence has an adjusted purchase price on December 31, 1988, of $105,000. R has two debts secured by the residence. The average balances and interest payments on each debt during 1988 and fair market value of the residence on the date each debt was secured are as follows:

Debt	Date secured	Fair market value	Average balance	Interest
Debt 1	June 1983	$100,000	$80,000	$8,000
Debt 2	May 1987	140,000	40,000	4,800
Total	....	....	120,000	12,800

(ii) The amount of qualified residence interest for 1988 under the exact method is determined as follows. Because there are no debts previously secured by the residence, the applicable debt limit for Debt 1 is $100,000 (the lesser of the adjusted purchase price as of the end of the taxable year and the fair market value of the residence at the time the debt was secured). Because the average balance of Debt 1 ($80,000) does not exceed its applicable debt limit ($100,000), all of the interest paid on the debt during 1988 ($8,000) is qualified residence interest.

(iii) The applicable debt limit for Debt 2 is $25,000 ($105,000 (the lesser of $140,000 fair market value and $105,000 adjusted purchase price) reduced by $80,000 (the average balance of Debt 1)). Because the average balance of Debt 2 ($40,000) exceeds its applicable debt limit, the amount of qualified residence interest on Debt 2 is determined by multiplying the amount of interest paid on the debt during the year ($4,800) by a fraction equal to its applicable debt limit divided by its average balance ($25,000/$40,000=0.625). Accordingly, $3,000 ($4,800 x 0.625) of the interest paid in 1988 on Debt 2 is qualified residence interest. The character of the remaining $1,800 of interest paid on Debt 2 is determined under the rules of paragraph (e)(4) of this section.

(4) *Treatment of interest paid or accrued with respect to secured debt that is not qualified residence interest*—(i) *In general.* Under the exact method, the excess of the interest paid or accrued during the taxable year with respect to a secured debt over the amount of qualified residence interest with respect to the debt is allocated under the rules of §1.163–8T.

(ii) *Example.*

T borrows $20,000 and the entire proceeds of the debt are disbursed by the lender to T's broker to purchase securities held for investment. T secures the debt with T's principal residence. In 1990, T pays $2,000 of interest on the debt. Assume that under the rules of paragraph (e) of this section, $1,500 of the interest is qualified residence interest. The remaining $500 in interest expense would be allocated under the rules of § 1.163–8T. Section 1.163–8T generally allocates debt (and the associated interest expense) by tracing disbursements of the debt proceeds to specific expenditures. Accordingly, the $500 interest expense on the debt that is not qualified residence interest is investment interest subject to section 163(d).

(iii) *Special rule if debt is allocated to more than one expenditure.* If—

(A) The average balance of a secured debt exceeds the applicable debt limit for that debt, and

(B) Under the rules of § 1.163–8T, interest paid or accrued with respect to such debt is allocated to more than one expenditure,

the interest expense that is not qualified residence interest may be allocated among such expenditures, to the extent of such expenditures, in any manner selected by the taxpayer.

(iv) *Example.*

(*i*) C borrows $60,000 secured by a qualified residence. C uses (within the meaning of § 1.163–8T) $20,000 of the proceeds in C's trade or business, $20,000 to purchase stock held for investment and $20,000 for personal purposes. In 1990, C pays $6,000 in interest on the debt and, under the rules of § 1.163–8T, $2,000 in interest is allocable to trade or business expenses, $2,000 to investment expenses and $2,000 to personal expenses. Assume that under paragraph (e) of this section, $2,500 of the interest is qualified residence interest and $3,500 of the interest is not qualified residence interest.

(*ii*) Under paragraph (e)(4)(iii) of this section, C may allocate up to $2,000 of the interest that is not qualified residence interest to any of the three categories of expenditures up to a total of $3,500 for all three categories. Therefore, for example, C may allocate $2,000 of such interest to C's trade or business and $1,500 of such interest to the purchase of stock.

(f) *Special rules*—(1) *Special rules for personal property*—(i) *In general.* If a qualified residence is personal property under State law (*e.g.*, a boat or motorized vehicle)—

(A) For purposes of paragraphs (c)(1) and (d)(1) of this section, if the fair market value of the residence as of the date that any secured debt (outstanding during the taxable year) is first secured by the residence is less than the adjusted purchase price as of the end of the taxable year, the lowest such fair market value shall be substituted for the adjusted purchase price.

(B) For purposes of paragraphs (e)(2)(i)(A) and (f)(1)(i)(A) of this section, the fair market value of the residence as of the date the debt is first secured by the residence shall not exceed the fair market value as of any date on which the taxpayer borrows any additional amount with respect to the debt.

(ii) *Example.*

D owns a recreational vehicle that is a qualified residence under paragraph (p)(4) of this section. The adjusted purchase price and fair market value of the recreational vehicle is $20,000 in 1989. In 1989, D establishes a line of credit secured by the recreational vehicle. As of June 1, 1992, the fair market value of the vehicle has decreased to $10,000. On that day, D borrows an additional amount on the debt by using the line of credit. Although under paragraphs (e)(2)(i) and (f)(1)(i)(A) of this section, fair market value is determined at the time the debt is first secured, under paragraph (f)(1)(i)(B) of this section, the fair market value is the lesser of that amount or the fair market value on the most recent date that D borrows any additional amount with respect to the line of credit. Therefore, the fair market value with respect to the debt is $10,000.

(2) *Special rule for real property*—(i) *In general.* For purposes of paragraph (e)(2)(i)(A) of this section, the fair market value of a qualified residence that is real property under State law is presumed irrebuttably to be not less than the adjusted purchase price of the residence as of the last day of the taxable year.

(ii) *Example.*

(*i*) C purchases a residence on August 11, 1987, for $50,000, incurring a first mortgage. The residence is real property under State law. During 1987, C makes $10,000 in home improvements. Accordingly, the adjusted purchase price of the residence as of December 31, 1988, is $60,000. C incurs a second mortgage on May 19, 1988, as of which time the fair market value of the residence is $55,000.

(*ii*) For purposes of determining the applicable debt limit for each debt, the fair market value of the residence is generally determined as of the time the debt is first secured. Accordingly, the fair market value would be $50,000 and $55,000 with respect to the first and second mortgage, respectively. Under the special rule of paragraph (f)(2)(i) of this section, however, the fair market value with respect to both debts in 1988 is $60,000, the adjusted purchase price on December 31, 1988.

(g) *Selection of method.* For any taxable year, a taxpayer may use the simplified method (described in paragraph (d) of this section) or the exact method (described in paragraph (e) of this section) by completing the appropriate portion of Form 8598. A taxpayer with two qualified residences may use the simplified method for one residence and the exact method for the other residence.

(h) *Average balance*—(1) *Average balance defined.* For purposes of this section, the term ‘‘average balance’’ means the amount determined under this paragraph (h). A taxpayer is not required to use the same method to determine the average balance of all secured debts during a taxable year or of any particular secured debt from one year to the next.

(2) *Average balance reported by lender.* If a lender that is subject to section 6050H (returns relating to mortgage interest received in trade or business from individuals) reports the average balance of a secured debt on Form 1098, the taxpayer may use the average balance so reported.

(3) *Average balance computed on a daily basis*—(i) *In general.* The average balance may be determined by—

(A) Adding the outstanding balance of a debt on each day during the taxable year that the debt is secured by a qualified residence, and

(B) Dividing the sum by the number of days during the taxable year that the residence is a qualified residence.

(ii) *Example.*

Taxpayer A incurs a debt of $10,000 on September 1, 1989, securing the debt with A’s principal residence. The residence is A’s principal residence during the entire taxable year. A pays current interest on the debt monthly, but makes no principal payments. The debt is, therefore, outstanding for 122 days with a balance each day of $10,000. The residence is a qualified residence for 365 days. The average balance of the debt for 1989 is $3,342 (122 x $10,000/365).

(4) *Average balance computed using the interest rate*—(i) *In general.* If all accrued interest on a secured debt is paid at least monthly, the average balance of the secured debt may be determined by dividing the interest paid or accrued during the taxable year while the debt is secured by a qualified residence by the annual interest rate on the debt. If the interest rate on a debt varies during the taxable year, the lowest annual interest rate that applies to the debt during the taxable year must be used for purposes of this paragraph (h)(4). If the residence securing the debt is a qualified residence for less than the entire taxable year, the average balance of any secured debt may be determined by dividing the average balance determined under the preceding sentence by the percentage of the taxable year that the debt is secured by a qualified residence.

(ii) *Points and prepaid interest.* For purposes of paragraph (h)(4)(i) of this section, the amount of interest paid during the taxable year does not include any amount paid as points and includes prepaid interest only in the year accrued.

(iii) *Examples.*

Example (1). B has a line of credit secured by a qualified residence for the entire taxable year. The interest rate on the debt is 10 percent throughout the taxable year. The principal balance on the debt changes throughout the year. B pays the accrued interest on the debt monthly. B pays $2,500 in interest on the debt during the taxable year. The average balance of the debt ($25,000) may be computed by dividing the total interest paid by the interest rate ($25,000 = $2,500/0.10).

Example (2). Assume the same facts as in example 1, except that the residence is a qualified residence, and the debt is outstanding, for only one-half of the taxable year and B pays only $1,250 in interest on the debt during the taxable year. The average balance of the debt may be computed by first dividing the total interest paid by the interest rate ($12,500 = $1,250/0.10). Second, because the residence is not a qualified residence for the entire taxable year, the average balance must be determined by dividing this amount ($12,500) by the portion of the year that the residence is qualified (0.50). The average balance is therefore $25,000 ($12,500/0.50).

(5) *Average balance computed using average of beginning and ending balances*—(i) *In general.* If—

(A) A debt requires level payments at fixed equal intervals (*e.g.,* monthly, quarterly) no less often than semi-annually during the taxable year,

(B) The taxpayer prepays no more than one month's principal on the debt during the taxable year, and

(C) No new amounts are borrowed on the debt during the taxable year,

the average balance of the debt may be determined by adding the principal balance as of the first day of the taxable year that the debt is secured by the qualified residence and the principal balance as of the last day of the taxable year that the debt is secured by the qualified residence and dividing the sum by 2. If the debt is secured by a qualified residence for less than the entire period during the taxable year that the residence is a qualified residence, the average balance may be determined by multiplying the average balance determined under the preceding sentence by a fraction, the numerator of which is the number of days during the taxable year that the debt is secured by the qualified residence and the denominator of which is the number of days during the taxable year that the residence is a qualified residence. For purposes of this paragraph (h)(5)(i), the determination of whether payments are level shall disregard the fact that the amount of the payments may be adjusted from time to time to take into account changes in the applicable interest rate.

(ii) *Example.*

C borrows $10,000 in 1988, securing the debt with a second mortgage on a principal residence. The terms of the loan require C to make equal monthly payments of principal and interest so as to amortize the entire loan balance over 20 years. The balance of the debt is $9,652 on January 1, 1990, and is $9,450 on December 31, 1990. The average balance of the debt during 1990 may be computed as follows:

Balance on first day of the year: $9,652
Balance on last day of the year: $9,450

$$\text{Average balance: } \frac{\$9{,}652 + \$9{,}450}{2} = \$9{,}551$$

(6) *Highest principal balance.* The average balance of a debt may be determined by taking the highest principal balance of the debt during the taxable year.

(7) *Other methods provided by the Commissioner.* The average balance may be determined using any other method provided by the Commissioner by form, publication, revenue ruling, or revenue procedure. Such methods may include methods similar to (but with restrictions different from) those provided in paragraph (h) of this section.

(8) *Anti-abuse rule.* If, as a result of the determination of the average balance of a debt using any of the methods specified in paragraphs (h) (4), (5), or (6) of this section, there is a significant overstatement of the amount of qualified residence interest and a principal purpose of the pattern of payments and borrowing on the debt is to cause the amount of such qualified residence interest to be overstated, the district director may redetermine the average balance using the method specified under paragraph (h)(3) of this section.

(i) [Reserved]

(j) *Determination of interest paid or accrued during the taxable year*—(1) *In general.* For purposes of determining the amount of qualified residence interest with respect to a secured debt, the amount of interest paid or accrued during the taxable year includes only interest paid or accrued while the debt is secured by a qualified residence.

(2) *Special rules for cash-basis taxpayers*—(i) *Points deductible in year paid under section 461(g)(2).* If points described in section 461(g)(2) (certain points paid in respect of debt incurred in connection with the purchase or improvement of a principal residence) are paid with respect to a debt, the amount of such points is qualified residence interest.

(ii) *Points and other prepaid interest described in section 461(g)(1).* The amount of points or other prepaid interest charged to capital account under section 461(g)(1) (prepaid interest) that is qualified residence interest shall be determined under the rules of paragraphs (c) through (e) of this section in the same manner as any other interest paid with respect to the debt in the taxable year to which such payments are allocable under section 461(g)(1).

(3) *Examples.*

Example (1). T designates a vacation home as a qualified residence as of October 1, 1987. The home is encumbered by a mortgage during the entire taxable year. For purposes of determining the amount of qualified residence interest for 1987, T may take into account the interest paid or accrued on the secured debt from October 1, 1987, through December 31, 1987.

Example (2). R purchases a principal residence on June 17, 1987. As part of the purchase price, R obtains a conventional 30-year mortgage, secured by the residence. At closing, R pays 2½ points on the mortgage and interest on the mortgage for the period June 17, 1987 through June 30, 1987. The points are actually paid by R and are not merely withheld from the loan proceeds. R incurs no additional secured debt during 1987. Assuming that the points satisfy the requirements of section 461(g) (2), the entire amount of points and the interest paid at closing are qualified residence interest.

Example (3). (*i*) On July 1, 1987, W borrows $120,000 to purchase a residence to use as a vacation home. W secures the debt with the residence. W pays 2 points, or $2,400. The debt has a term of 10 years and requires monthly payments of principal and interest. W is permitted to amortize the points at the rate of $20 per month over 120 months. W elects to treat the residence as a second residence. W has no other debt secured by the residence. The average balance of the debt in each taxable year is less than the adjusted purchase price of the residence. W sells the residence on June 30, 1990, and pays off the remaining balance of the debt.

(*ii*) W is entitled to treat the following amounts of the points as interest paid on a debt secured by a qualified residence—

1987	$120=$20×6 months;
1988	$240=$20×12 months;
1989	$120=$20×6 months.
Total	$480

All of the interest paid on the debt, including the allocable points, is qualified residence interest. Upon repaying the debt, the remaining $1,920 ($2,400−$480) in unamortized points is treated as interest paid in 1990 and, because the average balance of the secured debt in 1990 is less than the adjusted purchase price, is also qualified residence interest.

(k) *Determination of adjusted purchase price and fair market value*—(1) *Adjusted purchase price*—(i) *In general.* For purposes of this section, the adjusted purchase price of a qualified residence is equal to the taxpayer's basis in the residence as initially determined under section 1012 or other applicable sections of the Internal Revenue Code, increased by the cost of any improvements to the residence that have been added to the taxpayer's basis in the residence under section 1016(a)(1). Any other adjustments to basis, including those required under section 1033(b) (involuntary conversions), and 1034(e) (rollover of gain or sale of principal residence) are disregarded in determining the taxpayer's adjusted purchase price. If, for example, a taxpayer's second residence is rented for a portion of the year and its basis is reduced by depreciation allowed in connection with the rental use of the property, the amount of the taxpayer's adjusted purchase price in the residence is not reduced. See paragraph (m) of this section for a rule that treats the sum of the grandfathered amounts of all secured debts as the adjusted purchase price of the residence.

(ii) *Adjusted purchase price of a qualified residence acquired incident to divorce.* [Reserved]

(iii) *Examples.*

Example (1). X purchases a residence for $120,000. X's basis, as determined under section 1012, is the cost of the property, or $120,000. Accordingly, the adjusted purchase price of the residence is initially $120,000.

Example (2). Y owns a principal residence that has a basis of $30,000. Y sells the residence for $100,000 and purchases a new principal residence for $120,000. Under section 1034, Y does not recognize gain on the sale of the former residence. Under section 1034(e), Y's basis in the new residence is reduced by the amount of gain not recognized. Therefore, under section 1034(e), Y's basis in the new residence is $50,000 ($120,000−$70,000). For purposes of section 163(h), however, the adjusted purchase price of the residence is not adjusted under section 1034(e). Therefore, the adjusted purchase price of the residence is initially $120,000.

Example (3). Z acquires a residence by gift. The donor's basis in the residence was $30,000. Z's basis in the residence, determined under section 1015, is $30,000. Accordingly, the adjusted purchase price of the residence is initially $30,000.

(2) *Fair market value*—(i) *In general.* For purposes of this section, the fair market value of a qualified residence on any date is the fair market value of the taxpayer's interest in the residence on such date. In addition, the fair market value determined under this paragraph (k)(2)(i) shall be determined by taking into account the cost of improvements to the residence reasonably expected to be made with the proceeds of the debt.

(ii) *Example.* In 1988, the adjusted purchase price of P's second residence is $65,000 and the fair market value of the residence is $70,000. At that time, P incurs an additional debt of $10,000, the proceeds of which P reasonably expects to use to add two bedrooms to the residence. Because the fair market value is determined by taking into account the cost of improvements to the residence that are reasonably expected to be made with the proceeds of the debt, the fair market value of the residence with respect to the debt incurred in 1988 is $80,000 ($70,000+$10,000).

(3) *Allocation of adjusted purchase price and fair market value.* If a property includes both a qualified residence and other property, the adjusted purchase price and the fair market value of such property must be allocated between the qualified residence and the other property. See paragraph (p)(4) of this section for rules governing such an allocation.

(l) [Reserved]

(m) *Grandfathered amount*—(1) *Substitution for adjusted purchase price.* If, for the taxable year, the sum of the grandfathered amounts, if any, of all secured debts exceeds the adjusted purchase price of the qualified residence, such sum may be treated as the adjusted purchase price of the residence under paragraphs (c), (d) and (e) of this section.

(2) *Determination of grandfathered amount*—(i) *In general.* For any taxable year, the grandfathered amount of any secured debt that was incurred on or before August 16, 1986, and was secured by the residence continuously from August 16, 1986, through the end of the taxable year, is the average balance of the debt for the taxable year. A secured debt that was not incurred and secured on or before August 16, 1986, has no grandfathered amount.

(ii) *Special rule for lines of credit and certain other debt.* If, with respect to a debt described in paragraph (m)(2)(i) of this section, a taxpayer has borrowed any additional amounts after August 16, 1986, the grandfathered amount of such debt is equal to the lesser of—

(A) The average balance of the debt for the taxable year, or

(B) The principal balance of the debt as of August 16, 1986, reduced (but not below zero) by all principal payments after August 16, 1986, and before the first day of the current taxable year.

For purposes of this paragraph (m)(2)(ii), a taxpayer shall not be considered to have borrowed any additional amount with respect to a debt merely because accrued interest is added to the principal balance of the debt, so long as such accrued interest is paid by the taxpayer no less often than quarterly.

(iii) *Fair market value limitation.* The grandfathered amount of any debt for any taxable year may not exceed the fair market value of the residence on August 16, 1986, reduced by the principal balance on that day of all previously secured debt.

(iv) *Examples.*

Example (1). As of August 16, 1986, T has one debt secured by T's principal residence. The debt is a conventional self-amortizing mortgage and, on August 16, 1986, it has an outstanding principal balance of $75,000. In 1987, the average balance of the mortgage is $73,000. The adjusted purchase price of the residence as of the end of 1987 is $50,000. Because the mortgage was incurred and secured on or before August 16, 1986 and T has not borrowed any additional amounts with respect to the mortgage, the grandfathered amount is the average balance, $73,000. Because the grandfathered amount exceeds the adjusted purchase price ($50,000), T may treat the grandfathered amount as the adjusted purchase price in determining the amount of qualified residence interest.

Example (2). (*i*) The facts are the same as in example (1), except that in May 1986, T also obtains a home equity line of credit that, on August 16, 1986, has a principal balance of $40,000. In November 1986, T borrows an additional $10,000 on the home equity line, increasing the balance to $50,000. In December 1986, T repays $5,000 of principal on the home equity line. The average balance of the home equity line in 1987 is $45,000.

(*ii*) Because T has borrowed additional amounts on the line of credit after August 16, 1986, the grandfathered amount for that debt must be determined under the rules of paragraph (m)(2)(ii) of this section. Accordingly, the grandfathered amount for the line of credit is equal to the lesser of $45,000, the average balance of the debt in 1987, and $35,000, the principal balance on August 16, 1986, reduced by all principal payments between August 17, 1986, and December 31, 1986 ($40,000–$5,000). The sum of the grandfathered amounts with respect to the residence is $108,000 ($73,000+$35,000). Because the sum of the grandfathered amounts exceeds the adjusted purchase price ($50,000), T may treat the sum as the adjusted purchase price in determining the qualified residence interest for 1987.

(3) *Refinancing of grandfathered debt*—(i) *In general.* A debt incurred and secured on or before August 16, 1986, is refinanced if some or all of the outstanding balance of such a debt (the ‘‘original debt’’) is repaid out of the proceeds of a second debt secured by the same qualified residence (the ‘‘replacement debt’’). In the case of a refinancing, the replacement debt is treated as a debt incurred and secured on or before August 16, 1986, and the grandfathered amount of such debt is the amount (but not less than zero) determined pursuant to paragraph (m)(3)(ii) of this section.

(ii) *Determination of grandfathered amount*—(A) *Exact refinancing.* If—

(*1*) The entire proceeds of a replacement debt are used to refinance one or more original debts, and

(*2*) The taxpayer has not borrowed any additional amounts after August 16, 1986, with respect to the original debt or debts,

the grandfathered amount of the replacement debt is the average balance of the replacement debt. For purposes of the preceding sentence, the fact that proceeds of a replacement debt are used to pay costs of obtaining the replacement debt (including points or other closing costs) shall be disregarded in determining whether the entire proceeds of the replacement debt have been used to refinance one or more original debts.

(B) *Refinancing other than exact refinancings*—(*1*) *Year of refinancing.* In the taxable year in which an original debt is refinanced, the grandfathered amount of the original and replacement debts is equal to the lesser of—

(*i*) The sum of the average balances of the original debt and the replacement debt, and

(*ii*) The principal balance of the original debt as of August 16, 1986, reduced by all principal payments on the original debt after August 16, 1986, and before the first day of the current taxable year.

(*2*) *In subsequent years.* In any taxable year after the taxable year in which an original debt is refinanced, the grandfathered amount of the replacement debt is equal to the least of—

(*i*) The average balance of the replacement debt for the taxable year,

(*ii*) The amount of the replacement debt used to repay the principal balance of the original debt, reduced by all principal payments on the replacement debt after the date of the refinancing and before the first day of the current taxable year, or

(*iii*) The principal balance of the original debt on August 16, 1986, reduced by all principal payments on the original debt after August 16, 1986, and before the date of the refinancing, and further reduced by all principal payments on the replacement debt after the date of the refinancing and before the first day of the current taxable year.

(C) *Example.*

(*i*) *Facts.* On August 16, 1986, T has a single debt secured by a principal residence with a balance of $150,000. On July 1, 1988, T refinances the debt, which still has a principal balance of $150,000, with a new secured debt. The principal balance of the replacement debt throughout 1988 and 1989 is $150,000. The adjusted purchase price of the residence is $100,000 throughout 1987, 1988 and 1989. The average balance of the original debt was $150,000 in 1987 and $75,000 in 1988. The average balance of the replacement debt is $75,000 in 1988 and $150,000 in 1989.

(*ii*) *Grandfathered amount in 1987.* The original debt was incurred and secured on or before August 16, 1986 and T has not borrowed any additional amounts with respect to the debt. Therefore, its grandfathered amount in 1987 is its average balance ($150,000). This amount is treated as the adjusted purchase price for 1987 and all of the interest paid on the debt is qualified residence interest.

(*iii*) *Grandfathered amount in 1988.* Because the replacement debt was used to refinance a debt incurred and secured on or before August 16, 1986, the replacement debt is treated as a grandfathered debt. Because all of the proceeds of the replacement debt were used in the refinancing and because no amounts have been borrowed after August 16, 1986, on the original debt, the grandfathered amount for the original debt is its average balance ($75,000) and the grandfathered amount for the replacement debt is its average balance ($75,000). Since the sum of the grandfathered amounts ($150,000) exceeds the adjusted purchase price of the residence, the sum of the grandfathered amounts may be substituted for the adjusted purchase price for 1988 and all of the interest paid on the debt is qualified residence interest.

(*iv*) *Grandfathered amount in 1989.* The grandfathered amount for the placement debt is its average balance ($150,000). This amount is treated as the adjusted purchase price for 1989 and all of the interest paid on the mortgage is qualified residence interest.

(4) *Limitation on term of grandfathered debt*—(i) *In general.* An original debt or replacement debt shall not have any grandfathered amount in any taxable year that begins after the date, as determined on August 16, 1986, that the original debt was required to be repaid in full (the ''maturity date''). If a replacement debt is used to refinance more than one original debt, the maturity date is determined by reference to the original debt that, as of August 16, 1986, had the latest maturity date.

(ii) *Special rule for nonamortizing debt.* If an original debt was actually incurred and secured on or before August 16, 1986, and if as of such date the terms of such debt did not require the amortization of its principal over its original term, the maturity date of the replacement debt is the earlier of the maturity date of the replacement debt or the date 30 years after the date the original debt is first refinanced.

(iii) *Example.*

C incurs a debt on May 10, 1986, the final payment of which is due May 1, 2006. C incurs a second debt on August 11, 1990, with a term of 20 years and uses the proceeds of the second debt to refinance the first debt. Because, under paragraph (m)(4)(i) of this section, a replacement debt will not have any grandfathered amount in any taxable year that begins after the maturity date of the original debt (May 1, 2006), the second debt has no grandfathered amount in any taxable year after 2006.

(n) *Qualified indebtedness (secured debt used for medical and educational purposes)*—(1) *In general*—(i) *Treatment of qualified indebtedness.* The amount of any qualified indebtedness resulting from a secured debt may be added to the adjusted purchase price under paragraph (e)(2)(i)(B) of this section to determine the applicable debt limit for that secured debt and any other debt subsequently secured by the qualified residence.

(ii) *Determination of amount of qualified indebtedness.* If, as of the end of the taxable year (or the last day in the taxable year that the debt is secured), at least 90 percent of the proceeds of a secured debt are used (within the meaning of paragraph (n)(2) of this section) to pay for qualified medical and educational expenses (within the meaning of paragraphs (n)(3) and (n)(4) of this section), the amount of qualified indebtedness resulting from that debt for the taxable year is equal to the average balance of such debt for the taxable year.

(iii) *Determination of amount of qualified indebtedness for mixed-use debt.* If, as of the end of the taxable year (or the last day in the taxable year that the debt is secured), more than ten percent of the proceeds of a secured debt are used to pay for expenses other than qualified medical and educational expenses, the amount of qualified indebtedness resulting from that debt for the taxable year shall equal the lesser of—

(A) The average balance of the debt, or

(B) The amount of the proceeds of the debt used to pay for qualified medical and educational expenses through the end of the taxable year, reduced by any principal payments on the debt before the first day of the current taxable year.

(iv) *Example.*

(*i*) C incurs a $10,000 debt on April 20, 1987, which is secured on that date by C's principal residence. C immediately uses (within the meaning of paragraph (n)(2) of this section) $4,000 of the proceeds of the debt to pay for a qualified medical expense. C makes no principal payments on the debt during 1987. During 1988 and 1989, C makes principal payments of $1,000 per year. The average balance of the debt during 1988 is $9,500 and the average balance during 1989 is $8,500.

(*ii*) Under paragraph (n)(1)(iii) of this section, C determines the amount of qualified indebtedness for 1988 as follows:

Average balance		$9,500
Amount of debt used to pay for qualified medical expenses	$4,000	
Less payments of principal before 1988	$0	
Net qualified expenses		$4,000

The amount of qualified indebtedness for 1988 is, therefore, $4,000 (lesser of $9,500 average balance or $4,000 net qualified expenses). This amount may be added to the adjusted purchase price of C's principal residence under paragraph (e)(2)(i)(B) of this section for purposes of computing the applicable debt limit for this debt and any other debt subsequently secured by the principal residence.

(*iii*) C determines the amount of qualified indebtedness for 1989 as follows:

Average balance		$8,500
Amount of debt used to pay for qualified medical expenses	$4,000	
Less payments of principal before 1988	$1,000	
Net qualified expenses		$3,000

The amount of qualified indebtedness for 1989 is, therefore, $3,000 (lesser of $8,500 average balance or $3,000 net qualified expenses).

(v) *Prevention of double counting in year of refinancing*—(A) *In general.* A debt used to pay for qualified medical or educational expenses is refinanced if some or all of the outstanding balance of the debt (the ''original debt'') is repaid out of the proceeds of a second debt (the ''replacement debt''). If, in the year of a refinancing, the combined qualified indebtedness of the original debt and the replacement debt exceeds the combined qualified expenses of such debts, the amount of qualified indebtedness for each such debt shall be determined by multiplying the amount of qualified indebtedness for each such debt by a fraction, the numerator of which is the combined qualified expenses and the denominator of which is the combined qualified indebtedness.

(B) *Definitions.* For purposes of paragraph (n)(1)(v)(A) of this section—

(*1*) The term ''combined qualified indebtedness'' means the sum of the qualified indebtedness (determined without regard to paragraph (n)(1)(v) of this section) for the original debt and the replacement debt.

(*2*) The term ''combined qualified expenses'' means the amount of the proceeds of the original debt used to pay for qualified medical and educational expenses through the end of the current taxable year, reduced by any principal payments on the debt before the first day of the current taxable year, and increased by the amount, if any, of the proceeds of the replacement debt used to pay such expenses through the end of the current taxable year other than as part of the refinancing.

(C) *Example.*

(*i*) On August 11, 1987, C incurs a $8,000 debt secured by a principal residence. C uses (within the meaning of paragraph (n)(2)(i) of this section) $5,000 of the proceeds of the debt to pay for qualified educational expenses. C makes no principal payments on the debt. On July 1, 1988, C incurs a new debt in the amount of $8,000 secured by C's principal residence and uses all of the proceeds of the new debt to repay the original debt. Under paragraph (n)(2)(ii) of this section $5,000 of the new debt is treated as being used to pay for qualified educational expenses. C makes no principal payments (other than the refinancing) during 1987 or 1988 on either debt and pays all accrued interest monthly. The average balance of each debt in 1988 is $4,000.

(*ii*) Under paragraph (n)(1)(iii) of this section, the amount of qualified indebtedness for 1988 with respect to the original debt is $4,000 (the lesser of its average balance ($4,000) and the amount of the debt used to pay for qualified medical and educational expenses ($5,000)). Similarly, the amount of qualified indebtedness for 1988 with respect to the replacement debt is also $4,000. Both debts, however, are subject in 1988 to the limitation in paragraph (n)(1)(v)(A) of this section. The combined qualified indebtedness, determined without regard to the limitation, is $8,000 ($4,000 of qualified indebtedness from each debt). The combined qualified expenses are $5,000 ($5,000 from the original debt and $0 from the replacement debt). The amount of qualified indebtedness from each debt must, therefore, be reduced by a fraction, the numerator of which is $5,000 (the combined qualified expenses) and the denominator of which is $8,000 (the combined qualified indebtedness). After application of the limitation, the amount of qualified indebtedness for the original debt is $2,500 ($4,000 x ⅝). Similarly, the amount of qualified indebtedness for the replacement debt is $2,500. Note that the total qualified indebtedness for both the original and the replacement debt is $5,000 ($2,500 + $2,500). Therefore, C is entitled to the same amount of qualified indebtedness as C would have been entitled to if C had not refinanced the debt.

(vi) *Special rule for principal payments in excess of qualified expenses.* For purposes of paragraph (n)(1)(iii)(B), (n)(1)(v)(B)(*2*) and (n)(2)(ii) of this section, a principal payment is taken into account only to the extent that the payment, when added to all prior payments, does not exceed the amount used on or before the date of the payment to pay for qualified medical and educational expenses.

(2) *Debt used to pay for qualified medical or educational expenses*—(i) *In general.* For purposes of this section, the proceeds of a debt are used to pay for qualified medical or educational expenses to the extent that—

(A) The taxpayer pays qualified medical or educational expenses within 90 days before or after the date that amounts are actually borrowed with respect to the debt, the proceeds of the debt are not directly allocable to another expense under § 1.163–8T(c)(3) (allocation of debt; proceeds not disbursed to borrower) and the proceeds of any other debt are not allocable to the medical or educational expenses under § 1.163–8T(c)(3), or

(B) The proceeds of the debt are otherwise allocated to such expenditures under § 1.163–8T.

(ii) *Special rule for refinancings.* For purposes of this section, the proceeds of a debt are used to pay for qualified medical and educational expenses to the extent that the proceeds of the debt are allocated under § 1.163–8T to the repayment of another debt (the ''original debt''), but only to the extent of the amount of the original debt used to pay for qualified medical and educational expenses, reduced by any principal payments on such debt up to the time of the refinancing.

(iii) *Other special rules.* The following special rules apply for purposes of this section.

(A) Proceeds of a debt are used to pay for qualified medical or educational expenses as of the later of the taxable year in which such proceeds are borrowed or the taxable year in which such expenses are paid.

(B) The amount of debt which may be treated as being used to pay for qualified medical or educational expenses may not exceed the amount of such expenses.

(C) Proceeds of a debt may not be treated as being used to pay for qualified medical or educational expenses to the extent that:

(*1*) The proceeds have been repaid as of the time the expense is paid;

(*2*) The proceeds are actually borrowed before August 17, 1986; or

(*3*) The medical or educational expenses are paid before August 17, 1986.

(iv) *Examples—*

Example (1). A pays a $5,000 qualified educational expense from a checking account that A maintains at Bank 1 on November 9, 1987. On January 1, 1988, A incurs a $20,000 debt that is secured by A's residence and places the proceeds of the debt in a savings account that A also maintains at Bank 1. A pays another $5,000 qualified educations expense on March 15 from a checking account that A maintains at Bank 2. Under paragraph (n)(2) of this section, the debt proceeds are used to pay for both educational expenses, regardless of other deposits to, or expenditures from, the accounts, because both expenditures are made within 90 days before or after the debt was incurred.

Example (2). B pays a $5,000 qualified educational expense from a checking account on November 1, 1987. On November 30, 1987, B incurs a debt secured by B's residence, and the lender disburses the debt proceeds directly to a person who sells B a new car. Although the educational expense is paid within 90 days of the date the debt is incurred, the proceeds of the debt are not used to pay for the educational expense because the proceeds are directly allocable to the purchase of the new car under § 1.163–8T(c)(3).

Example (3). On November 1, 1987, C borrows $5,000 from C's college. The proceeds of this debt are not disbursed to C, but rather are used to pay tuition fees for C's attendance at the college. On November 30, 1987, C incurs a second debt and secures the debt by C's residence. Although the $5,000 educational expense is paid within 90 days before the second debt is incurred, the proceeds of the second debt are not used to pay for the educational expense, because the proceeds of the first debt are directly allocable to the educational expense under § 1.163–8T(c)(3).

Example (4). On January 1, 1988, D incurs a $20,000 debt secured by a qualified residence. D places the proceeds of the debt in a separate account (*i.e.,* the proceeds of the debt are the only deposit in the account). D makes payments of $5,000 each for qualified educational expenses on September 1, 1988, September 1, 1989, September 1, 1990, and September 1, 1991. Because the debt proceeds are allocated to educational expenses as of the date the expenses are paid, under the rules of § 1.163–8T(c)(4), the following amounts of the debt proceeds are used to pay for qualified educational expenses as of the end of each year:

1988:	$5,000
1989:	$10,000
1990:	$15,000
1991:	$20,000

Example (5). During 1987 E incurs a $10,000 debt secured by a principal residence. E uses (within the meaning of paragraph (n)(2)(i) of this section) all of the proceeds of the debt to pay for qualified educational expenses. On August 20, 1988, at which time the balance of the debt is $9,500, E incurs a new debt in the amount of $9,500 secured by E's principal residence and uses all of the proceeds of the new debt to repay the original debt. Under paragraph (n)(2)(ii) of this section, all of the proceeds of the new debt are used to pay for qualified educational expenses.

(3) *Qualified medical expenses.* Qualified medical expenses are amounts that

are paid for medical care (within the meaning of section 213(d)(1) (A) and (B)) for the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer (within the meaning of section 152), and that are not compensated for by insurance or otherwise.

(4) *Qualified educational expenses.* Qualified educational expenses are amounts that are paid for tuition, fees, books, supplies and equipment required for enrollment, attendance or courses of instruction at an educational organization described in section 170(b)(1)(A)(ii) and for any reasonable living expenses while away from home while in attendance at such an institution, for the taxpayer, the taxpayer's spouse or a dependent of the taxpayer (within the meaning of section 152) and that are not reimbursed by scholarship or otherwise.

(o) *Secured debt*—(1) *In general.* For purposes of this section, the term ''secured debt'' means a debt that is on the security of any instrument (such as a mortgage, deed of trust, or land contract)—

(i) That makes the interest of the debtor in the qualified residence specific security for the payment of the debt,

(ii) Under which, in the event of default, the residence could be subjected to the satisfaction of the debt with the same priority as a mortgage or deed of trust in the jurisdiction in which the property is situated, and

(iii) That is recorded, where permitted, or is otherwise perfected in accordance with applicable State law.

A debt will not be considered to be secured by a qualified residence if it is secured solely by virtue of a lien upon the general assets of the taxpayer or by a security interest, such as a mechanic's lien or judgment lien, that attaches to the property without the consent of the debtor.

(2) *Special rule for debt in certain States.* Debt will not fail to be treated as secured solely because, under an applicable State or local homestead law or other debtor protection law in effect on August 16, 1986, the security interest is ineffective or the enforceability of the security interest is restricted.

(3) *Times at which debt is treated as secured.* For purposes of this section, a debt is treated as secured as of the date on which each of the requirements of paragraph (o)(1) of this section are satisfied, regardless of when amounts are actually borrowed with respect to the debt. For purposes of this paragraph (o)(3), if the instrument is recorded within a commercially reasonable time after the security interest is granted, the instrument will be treated as recorded on the date that the security interest was granted.

(4) *Partially secured debt*—(i) *In general.* If the security interest is limited to a prescribed maximum amount or portion of the residence, and the average balance of the debt exceeds such amount or the value of such portion, such excess shall not be treated as secured debt for purposes of this section.

(ii) *Example.*

T borrows $80,000 on January 1, 1991. T secures the debt with a principal residence. The security in the residence for the debt, however, is limited to $20,000. T pays $8,000 in interest on the debt in 1991 and the average balance of the debt in that year is $80,000. Because the average balance of the debt exceeds the maximum amount of the security interest, such excess is not treated as secured debt. Therefore, for purposes of applying the limitation on qualified residence interest, the average balance of the secured debt is $20,000 (the maximum amount of the security interest) and the interest paid or accrued on the secured debt is $2,000 (the total interest paid on the debt multiplied by the ratio of the average balance of the secured debt ($20,000) and the average balance of the total debt ($80,000)).

(5) *Election to treat debt as not secured by a qualified residence*—(i) *In general.* For purposes of this section, a taxpayer may elect to treat any debt that is secured by a qualified residence as not secured by the qualified residence. An election made under this paragraph shall be effective for the taxable year for which the election is made and for all subsequent taxable years unless revoked with the consent of the Commissioner.

(ii) *Example.*

T owns a principal residence with a fair market value of $75,000 and an adjusted purchase price of $40,000. In 1988, debt A, the proceeds of which were used to purchase the residence, has an average balance of $15,000. The proceeds of debt B, which is secured by a second mortgage on the property, are allocable to T's trade or business under §1.163–8T and has an average balance of $25,000. In 1988, T incurs debt C, which is also secured by T's principal residence and which has an average balance in 1988 of $5,000. In the absence of an election to treat debt B as unsecured, the applicable debt limit for debt C in 1988 under paragraph (e) of this section would be zero dollars ($40,000 − $15,000 − $25,000) and none of the interest paid on debt C would be qualified residence interest. If, however, T makes or has previously made an election pursuant to paragraph (o)(5)(i) of this section to treat debt B as not secured by the residence, the applicable debt limit for debt C would be $25,000 ($40,000 − $15,000), and all of the interest paid on debt C during the taxable year would be qualified residence interest. Since the proceeds of debt B are allocable to T's trade or business under § 1.163–8T, interest on debt B may be deductible under other sections of the Internal Revenue Code.

(iii) *Allocation of debt secured by two qualified residences.* [Reserved]

(p) *Definition of qualified residence*—(1) *In general.* The term ''qualified residence'' means the taxpayer's principal residence (as defined in paragraph (p)(2) of this section), or the taxpayer's second residence (as defined in paragraph (p)(3) of this section).

(2) *Principal residence.* The term ''principal residence'' means the taxpayer's principal residence within the meaning of section 1034. For purposes of this section, a taxpayer cannot have more than one principal residence at any one time.

(3) *Second residence*—(i) *In general.* The term ''second residence'' means—

(A) A residence within the meaning of paragraph (p)(3)(ii) of this section,

(B) That the taxpayer uses as a residence within the meaning of paragraph (p)(3)(iii) of this section, and

(C) That the taxpayer elects to treat as a second residence pursuant to paragraph (p)(3)(iv) of this section.

A taxpayer cannot have more than one second residence at any time.

(ii) *Definition of residence.* Whether property is a residence shall be determined based on all the facts and circumstances, including the good faith of the taxpayer. A residence generally includes a house, condominium, mobile home, boat, or house trailer, that contains sleeping space and toilet and cooking facilities. A residence does not include personal property, such as furniture or a television, that, in accordance with the applicable local law, is not a fixture.

(iii) *Use as a residence.* If a residence is rented at any time during the taxable year, it is considered to be used as a residence only if the taxpayer uses it during the taxable year as a residence within the meaning of section 280A(d). If a residence is not rented at any time during the taxable year, it shall be considered to be used as a residence. For purposes of the preceding sentence, a residence will be deemed to be rented during any period that the taxpayer holds the residence out for rental or resale or repairs or renovates the residence with the intention of holding it out for rental or resale.

(iv) *Election of second residence.* A taxpayer may elect a different residence (other than the taxpayer's principal residence) to be the taxpayer's second residence for each taxable year. A taxpayer may not elect different residences as second residences at different times of the same taxable year except as provided below—

(A) If the taxpayer acquires a new residence during the taxable year, the taxpayer may elect the new residence as a taxpayer's second residence as of the date acquired;

(B) If property that was the taxpayer's principal residence during the taxable year ceases to qualify as the taxpayer's principal residence, the taxpayer may elect that property as the taxpayer's second residence as of the date that the property ceases to be the taxpayer's principal residence; or

(C) If property that was the taxpayer's second residence is sold during the taxable year or becomes the taxpayer's principal residence, the taxpayer may elect a new second residence as of such day.

(4) *Allocations between residence and other property*—(i) *In general.* For purposes of this section, the adjusted purchase price and fair market value of property must be allocated between the portion of the property that is a qualified residence and the portion that is not a qualified residence. Neither the average balance of the secured debt nor the interest paid or accrued on secured debt is so allocated. Property that is not used for residential purposes does

not qualify as a residence. For example, if a portion of the property is used as an office in the taxpayer's trade or business, that portion of the property does not qualify as a residence.

(ii) *Special rule for rental of residence.* If a taxpayer rents a portion of his or her principal or second residence to another person (a ''tenant''), such portion may be treated as used by the taxpayer for residential purposes if, but only if—

(A) Such rented portion is used by the tenant primarily for residential purposes,

(B) The rented portion is not a self-contained residential unit containing separate sleeping space and toilet and cooking facilities, and

(C) The total number of tenants renting (directly or by sublease) the same or different portions of the residence at any time during the taxable year does not exceed two. For this purpose, if two persons (and the dependents, as defined by section 152, of either of them) share the same sleeping quarters, they shall be treated as a single tenant.

(iii) *Examples.*

Example (1). D, a dentist, uses a room in D's principal residence as an office which qualifies under section 280A(c)(1)(B) as a portion of the dwelling unit used exclusively on a regular basis as a place of business for meeting with patients in the normal course of D's trade or business. D's adjusted purchase price of the property is $65,000; $10,000 of which is allocable under paragraph (o)(4)(i) of this section to the room used as an office. For purposes of this section, D's residence does not include the room used as an office. The adjusted purchase price of the residence is, accordingly, $55,000. Similarly, the fair market value of D's residence must be allocated between the office and the remainder of the property.

Example (2). J rents out the basement of property that is otherwise used as J's principal residence. The basement is a self-contained residential unit, with sleeping space and toilet and cooking facilities. The adjusted purchase price of the property is $100,000; $15,000 of which is allocable under paragraph (o)(4)(i) of this section to the basement. For purposes of this section, J's residence does not include the basement and the adjusted purchase price of the residence is $85,000. Similarly, the fair market value of the residence must be allocated between the basement unit and the remainder of the property.

(5) *Residence under construction*—(i) *In general.* A taxpayer may treat a residence under construction as a qualified residence for a period of up to 24 months, but only if the residence becomes a qualified residence, without regard to this paragraph (p)(5)(i), as of the time that the residence is ready for occupancy.

(ii) *Example.*

X owns a residential lot suitable for the construction of a vacation home. On April 20, 1987, X obtains a mortgage secured by the lot and any property to be constructed on the lot. On August 9, 1987, X begins construction of a residence on the lot. The residence is ready for occupancy on November 9, 1989. The residence is used as a residence within the meaning of paragraph (p)(3)(iii) of this section during 1989 and X elects to treat the residence as his second residence for the period November 9, 1989, through December 31, 1989. Since the residence under construction is a qualified residence as of the first day that the residence is ready for occupancy (November 9, 1987), X may treat the residence as his second residence under paragraph (p)(5)(i) of this section for up to 24 months of the period during which the residence is under construction, commencing on or after the date that construction is begun (August 9, 1987). If X treats the residence under construction as X's second residence beginning on August 9, 1987, the residence under construction would cease to qualify as a qualified residence under paragraph (p)(5)(i) on August 8, 1989. The residence's status as a qualified residence for future periods would be determined without regard to paragraph (p)(5)(i) of this section.

(6) *Special rule for time-sharing arrangements.* Property that is otherwise a qualified residence will not fail to qualify as such solely because the taxpayer's interest in or right to use the property is restricted by an arrangement whereby two or more persons with interests in the property agree to exercise control over the property for different periods during the taxable year. For purposes of determining the use of a residence under paragraph (p)(3)(iii) of this section, a taxpayer will not be considered to have used or rented a residence during any period that the taxpayer does not have the right to use the property or to receive any benefits from the rental of the property.

(q) *Special rules for tenant-stockholders in cooperative housing corporations*—(1) *In general.* For purposes of this section, a residence includes stock in a cooperative housing corporation owned by a tenant-stockholder if the house or apartment which the tenant-stockholder is entitled to occupy by virtue of owning such stock is a residence within the meaning of paragraph (p)(3)(ii) of this section.

(2) *Special rule where stock may not be used to secure debt.* For purposes of this section, if stock described in paragraph (q)(1) of this section may not be used to secure debt because of restrictions under local or State law or because of restrictions in the cooperative agreement (other than restrictions the principal purpose of which is to permit the tenant-stockholder to treat unsecured debt as secured debt under this paragraph (q)(2)), debt may be treated as secured by such stock to the extent that the proceeds of the debt are allocated to the purchase of the stock under the rules of § 1.163–8T. For purposes of this paragraph (q)(2), proceeds of debt incurred prior to January 1, 1987, may be treated as allocated to the purchase of such stock to the extent that the tenant-stockholder has properly and consistently deducted interest expense on such debt as home mortgage interest attributable to such stock on Schedule A of Form 1040 in determining his taxable income for taxable years beginning before January 1, 1987. For purposes of this paragraph (q)(2), amended returns filed after December 22, 1987, are disregarded.

(3) *Treatment of interest expense of the cooperative described in section 216(a)(2).* For purposes of section 163(h) and § 1.163–9T (disallowance of deduction for personal interest) and section 163(d) (limitation on investment interest), any amount allowable as a deduction to a tenant-stockholder under section 216(a)(2) shall be treated as interest paid or accrued by the tenant-stockholder. If a tenant-stockholder's stock in a cooperative housing corporation is a qualified residence of the tenant-shareholder, any amount allowable as a deduction to the tenant-stockholder under section 216(a)(2) is qualified residence interest.

(4) *Special rule to prevent tax avoidance.* If the amount treated as qualified residence interest under this section exceeds the amount which would be so treated if the tenant-stockholder were treated as directly owning his proportionate share of the assets and liabilities of the cooperative and one of the principal purposes of the cooperative arrangement is to permit the tenant-stockholder to increase the amount of qualified residence interest, the district director may determine that such excess is not qualified residence interest.

(5) *Other definitions.* For purposes of this section, the terms ''tenant-stockholder,'' ''cooperative housing corporation'' and ''proportionate share'' shall have the meaning given by section 216 and the regulations thereunder.

(r) *Effective date.* The provisions of this section are effective for taxable years beginning after December 31, 1986.

[T.D. 8168, 52 FR 48410, Dec. 22, 1987]

§ 1.163–12 Deduction of original issue discount on instrument held by related foreign person.

(a) *General rules*—(1) *Deferral of deduction.* Except as provided in paragraph (b) of this section, section 163(e)(3) requires a taxpayer to use the cash method of accounting with respect to the deduction of original issue discount owed to a related foreign person. A deduction for an otherwise deductible portion of original issue discount with respect to a debt instrument will not be allowable as a deduction to the issuer until paid if, at the close of the issuer's taxable year in which such amount would otherwise be deductible, the person holding the debt instrument is a related foreign person. For purposes of this section, a related foreign person is any person that is not a United States person within the meaning of section 7701(a)(30), and that is related (within the meaning of section 267(b)) to the issuer at the close of the taxable year in which the amount incurred by the taxpayer would otherwise be deductible. Section 267(f) defines ''controlled group'' for purposes of section 267(b) without regard to the limitations of section 1563(b). An amount is treated as paid for purposes of this section if the amount is considered paid for purposes of section 1441 or section 1442 (including an amount taken into account pursuant to section 871(a)(1)(C), section 881(a)(3), or section 884(f)). The rules of this paragraph (a) apply even if the original issue discount is not subject to United States tax, or is subject to a reduced rate of tax, pursuant to a provision of the Internal Revenue Code or a treaty obligation of the United States. For purposes of this section, original issue discount is an amount described in section 1273, whether from sources inside or outside the United States.

(2) *Change in method of accounting.* A taxpayer that uses a method of accounting other than that required by the rules of this section must change its method of accounting to conform its method to the rules of this section. The taxpayer's change in method must be made pursuant to the rules of section 446(e), the regulations thereunder, and any applicable administrative procedures prescribed by the Commissioner. Because the rules of this section prescribe a method of accounting, these rules apply in the determination of a taxpayer's earnings and profits pursuant to §1.312–6(a).

(b) *Exceptions and special rules*—(1) *Effectively connected income.* The provisions of section 267(a)(2) and the regulations thereunder, and not the provisions of paragraph (a) of this section, apply to an amount of original issue discount that is income of the related foreign person that is effectively connected with the conduct of a United States trade or business of such related foreign person. An amount described in this paragraph (b)(1) thus is allowable as a deduction as of the day on which the amount is includible in the gross income of the related foreign person as effectively connected income under sections 872(a)(2) or 882(b) (or, if later, as of the day on which the deduction would be so allowable but for section 267(a)(2)). However, this paragraph (b)(1) does not apply if the related foreign person is exempt from United States income tax on the amount owed, or is subject to a reduced rate of tax, pursuant to a treaty obligation of the United States (such as under an article relating to the taxation of business profits).

(2) *Certain obligations issued by natural persons.* This section does not apply to any debt instrument described in section 163(e)(4) (relating to obligations issued by natural persons before March 2, 1984, and to loans between natural persons).

(3) *Amounts owed to a foreign personal holding company, controlled foreign corporation, or passive foreign investment company*—(i) *Foreign personal holding companies.* If an amount to which paragraph (a) of this section otherwise applies is owed to a related foreign person that is a foreign personal holding company within the meaning of section 552, then the amount is allowable as a deduction as of the day on which the amount is includible in the income of the foreign personal holding company. The day on which the amount is includible in income is determined with reference to the method of accounting under which the foreign personal holding company computes its taxable income and earnings and profits for purposes of sections 551 through 558. See section 551(c) and the regulations thereunder for the reporting requirements of the foreign personal holding company provisions (sections 551 through 558).

(ii) *Controlled foreign corporations.* If an amount to which paragraph (a) of this section otherwise applies is owed to a related foreign person that is a controlled foreign corporation within the meaning of section 957, then the amount is allowable as a deduction as of the day on which the amount is includible in the income of the controlled foreign corporation. The day on which the amount is includible in income is determined with reference to the method of accounting under which the controlled foreign corporation computes its taxable income and earnings and profits for purposes of sections 951 through 964. See section 6038 and the regulations thereunder for the reporting requirements of the controlled foreign corporation provisions (sections 951 through 964).

(iii) *Passive foreign investment companies.* If an amount to which paragraph (a) of this section otherwise applies is owed to a related foreign person that is a passive foreign investment company within the meaning of section 1296, then the amount is allowable as a deduction as of the day on which amount is includible in the income of the passive foreign investment company. The day on which the amount is includible in income is determined with reference to the method of accounting under which the earnings and profits of the passive foreign investment company are computed for purposes of sections 1291 through 1297. See sections 1291 through 1297 and the regulations thereunder for the reporting requirements of the passive foreign investment company provisions. This exception shall apply, however, only if the person that owes the amount at issue has made and has in effect an election pursuant to section 1295 with respect to the passive foreign investment company to which the amount at issue is owed.

(c) *Application of section 267.* Except as limited in paragraph (b)(1) of this section, the provisions of section 267 and the regulations thereunder shall apply to any amount of original issue discount to which the provisions of this section do not apply.

(d) *Effective date.* The rules of this section are effective with respect to all original issue discount on debt instruments issued after June 9, 1984.

[T.D. 8465, 58 FR 236, Jan. 5, 1993; 58 FR 8098, Feb. 11, 1993]

§ 1.163–13 Treatment of bond issuance premium.

(a) *General rule.* If a debt instrument is issued with bond issuance premium, this section limits the amount of the issuer's interest deduction otherwise allowable under section 163(a). In general, the issuer determines its interest deduction by offsetting the interest allocable to an accrual period with the bond issuance premium allocable to that period. Bond issuance premium is allocable to an accrual period based on a constant yield. The use of a constant yield to amortize bond issuance premium is intended to generally conform the treatment of debt instruments having bond issuance premium with those having original issue discount. Unless otherwise provided, the terms used in this section have the same meaning as those terms in section 163(e), sections 1271 through 1275, and the corresponding regulations. Moreover, unless otherwise provided, the provisions of this section apply in a manner consistent with those of section 163(e), sections 1271 through 1275, and the corresponding regulations. In addition, the anti-abuse rule in § 1.1275–2(g) applies for purposes of this section. For rules dealing with the treatment of bond premium by a holder, see §§ 1.171–1 through 1.171–5.

(b) *Exceptions.* This section does not apply to—

(1) A debt instrument described in section 1272(a)(6)(C) (regular interests in a REMIC, qualified mortgages held by a REMIC, and certain other debt instruments, or pools of debt instruments, with payments subject to acceleration); or

(2) A debt instrument to which § 1.1275–4 applies (relating to certain debt instruments that provide for contingent payments).

(c) *Bond issuance premium.* Bond issuance premium is the excess, if any, of the issue price of a debt instrument over its stated redemption price at maturity. For purposes of this section, the issue price of a convertible bond (as defined in § 1.171–1(e)(1)(iii)(C)) does not include an amount equal to the value of the conversion option (as determined under § 1.171–1(e)(1)(iii)(A)).

(d) *Offsetting qualified stated interest with bond issuance premium*—(1) *In general.* An issuer amortizes bond issuance premium by offsetting the qualified stated interest allocable to an accrual period with the bond issuance premium allocable to the accrual period. This offset occurs when the issuer takes the qualified stated interest into account under its regular method of accounting.

(2) *Qualified stated interest allocable to an accrual period.* See § 1.446–2(b) to determine the accrual period to which qualified stated interest is allocable and to determine the accrual of qualified stated interest within an accrual period.

(3) *Bond issuance premium allocable to an accrual period.* The bond issuance premium allocable to an accrual period is determined under this paragraph (d)(3). Within an accrual period, the bond issuance premium allocable to the period accrues ratably.

(i) *Step one: Determine the debt instrument's yield to maturity.* The yield to maturity of a debt instrument is determined under the rules of § 1.1272–1(b)(1)(i).

(ii) *Step two: Determine the accrual periods.* The accrual periods are determined under the rules of §1.1272–1(b)(1)(ii).

(iii) *Step three: Determine the bond issuance premium allocable to the accrual period.* The bond issuance premium allocable to an accrual period is the excess of the qualified stated interest allocable to the accrual period over the product of the adjusted issue price at the beginning of the accrual period and the yield. In performing this calculation, the yield must be stated appropriately taking into account the length of the particular accrual period. Principles similar to those in §1.1272–1(b)(4) apply in determining the bond issuance premium allocable to an accrual period.

(4) *Bond issuance premium in excess of qualified stated interest*—(i) *Ordinary income.* If the bond issuance premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the excess is treated as ordinary income by the issuer for the accrual period. However, the amount treated as ordinary income is limited to the amount by which the issuer's total interest deductions on the debt instrument in prior accrual periods exceed the total amount treated by the issuer as ordinary income on the debt instrument in prior accrual periods.

(ii) *Carryforward.* If the bond issuance premium allocable to an accrual period exceeds the sum of the qualified stated interest allocable to the accrual period and the amount treated as ordinary income for the accrual period under paragraph (d)(4)(i) of this section, the excess is carried forward to the next accrual period and is treated as bond issuance premium allocable to that period. If a carryforward exists on the date the debt instrument is retired, the carryforward is treated as ordinary income on that date.

(e) *Special rules*—(1) *Variable rate debt instruments.* An issuer determines bond issuance premium on a variable rate debt instrument by reference to the stated redemption price at maturity of the equivalent fixed rate debt instrument constructed for the variable rate debt instrument. The issuer also allocates any bond issuance premium among the accrual periods by reference to the equivalent fixed rate debt instrument. The issuer constructs the equivalent fixed rate debt instrument, as of the issue date, by using the principles of §1.1275–5(e).

(2) *Inflation-indexed debt instruments.* An issuer determines bond issuance premium on an inflation-indexed debt instrument by assuming that there will be no inflation or deflation over the term of the instrument. The issuer also allocates any bond issuance premium among the accrual periods by assuming that there will be no inflation or deflation over the term of the instrument. The bond issuance premium allocable to an accrual period offsets qualified stated interest allocable to the period. Notwithstanding paragraph (d)(4) of this section, if the bond issuance premium allocable to an accrual period exceeds the qualified stated interest allocable to the period, the excess is treated as a deflation adjustment under §1.1275–7T(f)(1)(ii). See §1.1275–7T for other rules relating to inflation-indexed debt instruments.

(3) *Certain debt instruments subject to contingencies*—(i) *In general.* Except as provided in paragraph (e)(3)(ii) of this section, the rules of §1.1272–1(c) apply to determine a debt instrument's payment schedule for purposes of this section. For example, an issuer uses the payment schedule determined under §1.1272–1(c) to determine the amount, if any, of bond issuance premium on the debt instrument, the yield and maturity of the debt instrument, and the allocation of bond issuance premium to an accrual period.

(ii) *Mandatory sinking fund provision.* Notwithstanding paragraph (e)(3)(i) of this section, if a debt instrument is subject to a mandatory sinking fund provision described in §1.1272–1(c)(3), the issuer must determine the payment schedule by assuming that a pro rata portion of the debt instrument will be called under the sinking fund provision.

(4) *Remote and incidental contingencies.* For purposes of determining the amount of bond issuance premium and allocating bond issuance premium among accrual periods, if a bond provides for a contingency that is remote or incidental (within the meaning of

§1.1275–2(h)), the issuer takes the contingency into account under the rules for remote and incidental contingencies in §1.1275–2(h).

(f) *Example.* The following example illustrates the rules of this section:

Example—(i) Facts. On February 1, 1999, X issues for $110,000 a debt instrument maturing on February 1, 2006, with a stated principal amount of $100,000, payable at maturity. The debt instrument provides for unconditional payments of interest of $10,000, payable on February 1 of each year. X uses the calendar year as its taxable year, X uses the cash receipts and disbursements method of accounting, and X decides to use annual accrual periods ending on February 1 of each year. X's calculations assume a 30-day month and 360-day year.

(ii) *Amount of bond issuance premium.* The issue price of the debt instrument is $110,000. Because the interest payments on the debt instrument are qualified stated interest, the stated redemption price at maturity of the debt instrument is $100,000. Therefore, the amount of bond issuance premium is $10,000 ($110,000 − $100,000).

(iii) *Bond issuance premium allocable to the first accrual period.* Based on the payment schedule and the issue price of the debt instrument, the yield of the debt instrument is 8.07 percent, compounded annually. (Although, for purposes of simplicity, the yield as stated is rounded to two decimal places, the computations do not reflect this rounding convention.) The bond issuance premium allocable to the accrual period ending on February 1, 2000, is the excess of the qualified stated interest allocable to the period ($10,000) over the product of the adjusted issue price at the beginning of the period ($110,000) and the yield (8.07 percent, compounded annually). Therefore, the bond issuance premium allocable to the accrual period is $1,118.17 ($10,000 − $8,881.83).

(iv) *Premium used to offset interest.* Although X makes an interest payment of $10,000 on February 1, 2000, X only deducts interest of $8,881.83, the qualified stated interest allocable to the period ($10,000) offset with the bond issuance premium allocable to the period ($1,118.17).

(g) *Effective date.* This section applies to debt instruments issued on or after March 2, 1998.

(h) *Accounting method changes*—(1) *Consent to change.* An issuer required to change its method of accounting for bond issuance premium to comply with this section must secure the consent of the Commissioner in accordance with the requirements of §1.446–1(e). Paragraph (h)(2) of this section provides the Commissioner's automatic consent for certain changes.

(2) *Automatic consent.* The Commissioner grants consent for an issuer to change its method of accounting for bond issuance premium on debt instruments issued on or after March 2, 1998. Because this change is made on a cutoff basis, no items of income or deduction are omitted or duplicated and, therefore, no adjustment under section 481 is allowed. The consent granted by this paragraph (h)(2) applies provided—

(i) The change is made to comply with this section;

(ii) The change is made for the first taxable year for which the issuer must account for a debt instrument under this section; and

(iii) The issuer attaches to its federal income tax return for the taxable year containing the change a statement that it has changed its method of accounting under this section.

[T.D. 8746, 62 FR 68176, Dec. 31, 1997]

§1.163(d)–1 Time and manner for making election under the Omnibus Budget Reconciliation Act of 1993.

(a) *Description.* Section 163(d)(4)(B)(iii), as added by section 13206(d) of the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103–66, 107 Stat. 467), allows an electing taxpayer to take all or a portion of certain net capital gains, attributable to dispositions of property held for investment, into account as investment income. As a consequence, the capital gains affected by this election are not eligible for the maximum capital gain rate of 28 percent. The election may be made for net capital gains recognized by noncorporate taxpayers during any taxable year beginning after December 31, 1992.

(b) *Time and manner for making the election.* The election under section 163(d)(4)(B)(iii) must be made on or before the due date (including extensions) of the income tax return for the taxable year in which the net capital gain is recognized. The election is to be made on Form 4952, Investment Interest Expense Deduction, in accordance with the Form and its instructions.

(c) *Revocability of election.* The election described in this section is revocable with the consent of the Commissioner.

(d) *Effective date.* The rules set forth in this section are effective December 12, 1996.

[T.D. 8688, 61 FR 65322, Dec. 12, 1996]

§1.164–1 Deduction for taxes.

(a) *In general.* Only the following taxes shall be allowed as a deduction under this section for the taxable year within which paid or accrued, according to the method of accounting used in computing taxable income:

(1) State and local, and foreign, real property taxes.

(2) State and local personal property taxes.

(3) State and local, and foreign, income, war profits, and excess profits taxes.

(4) State and local general sales taxes.

(5) State and local taxes on the sale of gasoline, diesel fuel, and other motor fuels.

In addition, there shall be allowed as a deduction under this section State and local and foreign taxes not described in subparagraphs (1) through (5) of this paragraph which are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income). For example, dealers or investors in securities and dealers or investors in real estate may deduct State stock transfer and real estate transfer taxes, respectively, under section 164, to the extent they are expenses incurred in carrying on a trade or business or an activity for the production of income. In general, taxes are deductible only by the person upon whom they are imposed. However, see §1.164–5 in the case of certain taxes paid by the consumer. Also, in the case of a qualified State individual income tax (as defined in section 6362 and the regulations thereunder) which is determined by reference to a percentage of the Federal income tax (pursuant to section 6362 (c)), an accrual method taxpayer shall use the cash receipts and disbursements method to compute the amount of his deduction therefor. Thus, the deduction under section 164 is in the amount actually paid with respect to the qualified tax, rather than the amount accrued with respect thereto, during the taxable year even though the taxpayer uses the accrual method of accounting for other purposes. In addition, see paragraph (f)(1) of §301.6361–1 of this chapter (Regulations on Procedure and Administration) with respect to rules relating to allocation and reallocation of amounts collected on account of the Federal income tax and qualified taxes.

(b) *Taxable years beginning before January 1, 1964.* For taxable years beginning before January 1, 1964, except as otherwise provided in §§1.164–2 through 1.164–8, inclusive, taxes imposed by the United States, any State, territory, possession of the United States, or a political subdivision of any of the foregoing, or by any foreign country, are deductible from gross income for the taxable year in which paid or accrued, according to the method of accounting used in computing taxable income. For this purpose, postage is not a tax and automobile license or registration fees are ordinarily taxes.

(c) *Cross references.* For the definition of the term ‘‘real property taxes’’, see paragraph (d) of §1.164–3. For the definition of the term ‘‘foreign taxes’’, see paragraph (d) of §1.164–3. For the definition of the term ‘‘general sales taxes’’, see paragraph (f) of §1.164–3. For the treatment of gasoline, diesel fuel, and other motor fuel taxes, see §1.164–5. For apportionment of taxes on real property between seller and purchaser, see section 164(d) and §1.164–6. For the general rule for taxable year of deduction, see section 461. For provisions disallowing any deduction for the tax paid at the source on interest from tax-free covenant bonds, see section 1451(f).

[T.D. 6780, 29 FR 18145, Dec. 22, 1964, as amended by T.D. 7577, 43 FR 59357, Dec. 20, 1978]

§ 1.164–2 Deduction denied in case of certain taxes.

This section and § 1.275 describe certain taxes for which no deduction is allowed. In the case of taxable years beginning before January 1, 1964, the denial is provided for by section 164(b) (prior to being amended by section 207 of the Revenue Act of 1964 (78 Stat. 40)). In the case of taxable years beginning after December 31, 1963, the denial is governed by sections 164 and 275. No deduction is allowed for the following taxes:

(a) *Federal income taxes.* Federal income taxes, including the taxes imposed by section 3101, relating to the tax on employees under the Federal Insurance Contributions Act (chapter 21 of the Code); sections 3201 and 3211, relating to the taxes on railroad employees and railroad employee representatives; section 3402, relating to the tax withheld at source on wages; and by corresponding provisions of prior internal revenue laws.

(b) *Federal war profits and excess profits taxes.* Federal war profits and excess profits taxes including those imposed by Title II of the Revenue Act of 1917 (39 Stat. 1000), Title III of the Revenue Act of 1918 (40 Stat. 1088), Title III of the Revenue Act of 1921 (42 Stat. 271), section 216 of the National Industrial Recovery Act (48 Stat. 208), section 702 of the Revenue Act of 1934 (48 Stat. 770), Subchapter D, Chapter 1 of the Internal Revenue Code of 1939, and Subchapter E, Chapter 2 of the Internal Revenue Code of 1939.

(c) *Estate and gift taxes.* Estate, inheritance, legacy, succession, and gift taxes.

(d) *Foreign income, war profits, and excess profits taxes.* Income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, if the taxpayer chooses to take to any extent the benefits of section 901, relating to the credit for taxes of foreign countries and possessions of the United States.

(e) *Real property taxes.* Taxes on real property, to the extent that section 164(d) and § 1.164–6 require such taxes to be treated as imposed on another taxpayer.

(f) *Federal duties and excise taxes.* Federal import or tariff duties, business, license, privilege, excise, and stamp taxes (not described in paragraphs (a), (b), (c), or (h) of this section, or § 1.164–4) paid or accrued within the taxable year. The fact that any such tax is not deductible as a tax under section 164 does not prevent (1) its deduction under section 162 or section 212, provided it represents an ordinary and necessary expense paid or incurred during the taxable year by a corporation or an individual in the conduct of any trade or business or, in the case of an individual for the production or collection of income, for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection, or refund of any tax, or (2) its being taken into account during the taxable year by a corporation or an individual as a part of the cost of acquiring or producing property in the trade or business or, in the case of an individual, as a part of the cost of property held for the production of income with respect to which it relates.

(g) *Taxes for local benefits.* Except as provided in § 1.164–4, taxes assessed against local benefits of a kind tending to increase the value of the property assessed.

(h) *Excise tax on real estate investment trusts.* The excise tax imposed on certain real estate investment trusts by section 4981.

[T.D. 6780, 29 FR 18145, Dec 22, 1964, as amended by T.D. 7767, 46 FR 11263, Feb. 6, 1981]

§ 1.164–3 Definitions and special rules.

For purposes of section 164 and § 1.164–1 to § 1.164–8, inclusive—

(a) *State or local taxes.* A State or local tax includes only a tax imposed by a State, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia.

(b) *Real property taxes.* The term ‘‘real property taxes’’ means taxes imposed on interests in real property and levied for the general public welfare, but it does not include taxes assessed against local benefits. See § 1.164–4.

(c) *Personal property taxes.* The term ‘‘personal property tax’’ means an ad valorem tax which is imposed on an annual basis in respect of personal property. To qualify as a personal property tax, a tax must meet the following three tests:

(1) The tax must be ad valorem—that is, substantially in proportion to the value of the personal property. A tax which is based on criteria other than value does not qualify as ad valorem. For example, a motor vehicle tax based on weight, model year, and horsepower, or any of these characteristics is not an ad valorem tax. However, a tax which is partly based on value and partly based on other criteria may qualify in part. For example, in the case of a motor vehicle tax of 1 percent of value plus 40 cents per hundredweight, the part of the tax equal to 1 percent of value qualifies as an ad valorem tax and the balance does not qualify.

(2) The tax must be imposed on an annual basis, even if collected more frequently or less frequently.

(3) The tax must be imposed in respect of personal property. A tax may be considered to be imposed in respect of personal property even if in form it is imposed on the exercise of a privilege. Thus, for taxable years beginning after December 31, 1963, State and local taxes on the registration or licensing of highway motor vehicles are not deductible as personal property taxes unless and to the extent that the tests prescribed in this subparagraph are met. For example, an annual ad valorem tax qualifies as a personal property tax although it is denominated a registration fee imposed for the privilege of registering motor vehicles or of using them on the highways.

(d) *Foreign taxes.* The term ‘‘foreign tax’’ includes only a tax imposed by the authority of a foreign country. A tax-imposed by a political subdivision of a foreign country is considered to be imposed by the authority of that foreign country.

(e) *Sales tax.* (1) The term ‘‘sales tax’’ means a tax imposed upon persons engaged in selling tangible personal property, or upon the consumers of such property, including persons selling gasoline or other motor vehicle fuels at wholesale or retail, which is a stated sum per unit of property sold or which is measured by the gross sales price or the gross receipts from the sale. The term also includes a tax imposed upon persons engaged in furnishing services which is measured by the gross receipts for furnishing such services.

(2) In general, the term ‘‘consumer’’ means the ultimate user or purchaser; it does not include a purchaser such as a retailer, who acquires the property for resale.

(f) *General sales tax.* A ‘‘general sales tax’’ is a sales tax which is imposed at one rate in respect of the sale at retail of a broad range of classes of items. No foreign sales tax is deductible under section 164(a) and paragraph (a)(4) of §1.164–1. To qualify as a general sales tax, a tax must meet the following two tests:

(1) The tax must be a tax in respect of sales at retail. This may include a tax imposed on persons engaged in selling property at retail or furnishing services at retail, for example, if the tax is measured by gross sales price or by gross receipts from sales or services. Rentals qualify as sales at retail if so treated under applicable State sales tax laws.

(2) The tax must be general—that is, it must be imposed at one rate in respect of the retail sales of a broad range of classes of items. A sales tax is considered to be general although imposed on sales of various classes of items at more than one rate provided that one rate applies to the retail sales of a broad range of classes of items. The term ‘‘items’’ includes both commodities and services.

(g) *Special rules relating to general sales taxes.* (1) A sales tax which is general is usually imposed at one rate in respect of the retail sales of all tangible personal property (with exceptions and additions). However, a sales tax which is selective—that is, a tax which applies at one rate with respect to retail sales of specified classes of items also qualifies as general if the specified classes represent a broad range of classes of items. A selective sales tax which does not apply at one rate to the retail sales of a broad range of classes of items is not general. For example, a tax which applies only to sales of alcoholic beverages, tobacco, admissions, luxury items, and a few other items is not general. Similarly, a tax imposed solely on services is not general. However, a selective sales tax may be deemed to be part of the general sales tax and hence may be deductible, even if imposed by a separate title, etc., of the State or local law, if imposed at the same rate as the general rate of tax (as defined in subparagraph (4) of this paragraph) which qualifies a tax in the taxing jurisdiction as a general sales tax. For example, if a State has a 5 percent general sales tax and a separate selective sales tax of 5 percent on transient accommodations, the tax on transient accommodations is deductible.

(2) A tax is imposed at one rate only if it is imposed at that rate on generally the same base for all items subject to tax. For example, a sales tax imposed at a 3 percent rate on 100 percent of the sales price of some classes of items and at a 3 percent rate on 50 percent of the sales price of other classes of items would not be imposed at one rate with respect to all such classes. However, a tax is considered to be imposed at one rate although it allows dollar exemptions, if the exemptions are designed to exclude all sales under a certain dollar amount. For example, a tax may be imposed at one rate although it applies to all sales of tangible personal property but applies only to sales amounting to more than 10 cents.

(3) The fact that a sales tax exempts food, clothing, medical supplies, and motor vehicles, or any of them, shall not be taken into account in determining whether the tax applies to a broad range of classes of items. The fact that a sales tax applies to food, clothing, medical supplies, and motor vehicles, or any of them, at a rate which is lower than the general rate of tax (as defined in subparagraph (4) of this paragraph) is not taken into account in determining whether the tax is imposed at one rate on the retail sales of a broad range of classes of items. For purposes of this section, the term ‘‘food’’ means food for human consumption off the premises where sold, and the term ‘‘medical supplies’’ includes drugs, medicines, and medical devices.

(4) Except in the case of a lower rate of tax applicable in respect of food, clothing, medical supplies, and motor vehicles, or any of them, no deduction is allowed for a general sales tax in respect of any item if the tax is imposed on such item at a rate other than the general rate of tax. The general rate of tax is the one rate which qualifies a tax in a taxing jurisdiction as a general sales tax because the tax is imposed at such one rate on a broad range of classes of items. There can be only one general rate of tax in any one taxing jurisdiction. However, a general sales tax imposed at a lower rate or rates on food, clothing, motor vehicles, and medical supplies, or any of them, may nonetheless be deductible with respect to such items. For example, a sales tax which is imposed at 1 percent with respect to food, imposed at 3 percent with respect to a broad range of classes of tangible personal property, and imposed at 4 percent with respect to transient accommodations would qualify as a general sales tax. Taxes paid at the 1 percent and the 3 percent rates are deductible, but tax paid at the 4 percent rate is not deductible. The fact that a sales tax provides for the adjustment of the general rate of tax to reflect the sales tax rate in another taxing jurisdiction shall not be taken into account in determining whether the tax is imposed at one rate on the retail sales of a broad range of classes of items. Moreover, a general sales tax imposed at a lower rate with respect to an item in order to reflect the tax rate in another jurisdiction is also deductible at such lower rate. For example, State E imposes a general sales tax whose general rate is 3 percent. The State E sales tax law provides that in areas bordering on States with general sales taxes, selective sales taxes, or special excise taxes, the rate applied in the adjoining State will be used if such rate is under 3 percent. State F imposes a 2 percent sales tax. The 2 percent sales tax paid by residents of State E in areas bordering on State F is deductible.

(h) *Compensating use taxes.* A compensating use tax in respect of any item is treated as a general sales tax. The term ‘‘compensating use tax’’ means, in respect of any item, a tax which is imposed on the use, storage, or consumption of such item and which is complementary to a general sales tax which is deductible with respect to sales of similar items.

(i) *Special rules relating to compensating use taxes.* (1) In general, a use tax on an item is complementary to a general sales tax on similar items if the use tax is imposed on an item which was not subject to such general sales tax but which would have been subject to such general sales tax if the sale of the item had taken place within the jurisdiction imposing the use tax. For example, a tax imposed by State A on the use of a motor vehicle purchased in State B is complementary to the general sales tax of State A on similar items, if the latter tax applies to motor vehicles sold in State A.

(2) Since a compensating use tax is treated as a general sales tax, it is subject to the rule of subparagraph (C) of section 164(b)(2) and paragraph (g)(4) of this section that no deduction is allowed for a general sales tax imposed in respect of an item at a rate other than the general rate of tax (except in the case of lower rates on the sale of food, clothing, medical supplies, and motor vehicles). The fact that a compensating use tax in respect of any item provides for an adjustment in the rate of the compensating use tax or the amount of such tax to be paid on account of a sales tax on such item imposed by another taxing jurisdiction is not taken into account in determining whether the compensating use tax is imposed in respect of the item at a rate other than the general rate of tax. For example, a compensating use tax imposed by State C on the use of an item purchased in State D is considered to be imposed at the general rate of tax even though the tax imposed by State C allows a credit for any sales tax paid on such item in State D, or the rate of such compensating use tax is adjusted to reflect the rate of sales tax imposed by State D.

[T.D. 6780, 29 FR 18146, Dec. 22, 1964]

§1.164–4 Taxes for local benefits.

(a) So-called taxes for local benefits referred to in paragraph (g) of §1.164–2, more properly assessments, paid for local benefits such as street, sidewalk, and other like improvements, imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied are not deductible as taxes. A tax is considered assessed against local benefits when the property subject to the tax is limited to property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The real property taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction. Assessments under the statutes of California relating to irrigation, and of Iowa relating to drainage, and under certain statutes of Tennessee relating to levees, are limited to property benefited, and if the assessments are so limited, the amounts paid thereunder are not deductible as taxes. For treatment of assessments for local benefits as adjustments to the basis of property, see section 1016(a)(1) and the regulations thereunder.

(b)(1) Insofar as assessments against local benefits are made for the purpose of maintenance or repair or for the purpose of meeting interest charges with respect to such benefits, they are deductible. In such cases, the burden is on the taxpayer to show the allocation of the amounts assessed to the different purposes. If the allocation cannot be made, none of the amount so paid is deductible.

(2) Taxes levied by a special taxing district which was in existence on December 31, 1963, for the purpose of retiring indebtedness existing on such date, are deductible, to the extent levied for such purpose, if (i) the district covers the whole of at least one county, (ii) if at least 1,000 persons are subject to the taxes levied by the district, and (iii) if the district levies its assessments annually at a uniform rate on the same assessed value of real property, including improvements, as is used for purposes of the real property tax generally.

[T.D. 6780, 29 FR 18147, Dec. 22, 1964]

§1.164–5 Certain retail sales taxes and gasoline taxes.

For taxable years beginning before January 1, 1964, any amount representing a State or local sales tax paid by a consumer of services or tangible personal property is deductible by such consumer as a tax, provided it is separately stated and not paid in connection with his trade or business. For taxable years beginning after December 31, 1963, only the amount of any separately stated State and local general sales tax (as defined in paragraph (g) of § 1.164–3) and tax on the sale of gasoline, diesel fuel or other motor fuel paid by the consumer (other than in connection with his trade or business) is deductible by the consumer as tax. The fact that, under the law imposing it, the incidence of such State or local tax does not fall on the consumer is immaterial. The requirement that the amount of tax must be separately stated will be deemed complied with where it clearly appears that at the time of sale to the consumer, the tax was added to the sales price and collected or charged as a separate item. It is not necessary, for the purpose of this section, that the consumer be furnished with a sales slip, bill, invoice, or other statement on which the tax is separately stated. For example, where the law imposing the State or local tax for which the taxpayer seeks a deduction contains a prohibition against the seller absorbing the tax, or a provision requiring a posted notice stating that the tax will be added to the quoted price, or a requirement that the tax be separately shown in advertisements or separately stated on all bills and invoices, it is presumed that the amount of the State or local tax was separately stated at the time paid by the consumer; except that such presumption shall have no application to a tax on the sale of gasoline, diesel fuel or other motor fuel imposed upon a wholesaler unless such provisions of law apply with respect to both the sale at wholesale and the sale at retail.

[T.D. 6780, 29 FR 18147, Dec. 22, 1964]

§ 1.164–6 Apportionment of taxes on real property between seller and purchaser.

(a) *Scope.* Except as provided otherwise in section 164(f) and § 1.164–8, when real property is sold, section 164(d)(1) governs the deduction by the seller and the purchaser of current real property taxes. Section 164(d)(1) performs two functions: (1) It provides a method by which a portion of the taxes for the real property tax year in which the property is sold may be deducted by the seller and a portion by the purchaser; and (2) it limits the deduction of the seller and the purchaser to the portion of the taxes corresponding to the part of the real property tax year during which each was the owner of the property. These functions are accomplished by treating a portion of the taxes for the real property tax year in which the property is sold as imposed on the seller and a portion as imposed on the purchaser. To the extent that the taxes are treated as imposed on the seller and the purchaser, each shall be allowed a deduction, under section 164(a), in the taxable year such tax is paid or accrued, or treated as paid or accrued under section 164(d)(2) (A) or (D) and this section. No deduction is allowed for taxes on real property to the extent that they are imposed on another taxpayer, or are treated as imposed on another taxpayer under section 164(d). For the election to accrue real property taxes ratably see section 461(c) and the regulations thereunder.

(b) *Application of rule of apportionment.* (1)(i) For purposes of the deduction provided by section 164(a), if real property is sold during any real property tax year, the portion of the real property tax properly allocable to that part of the real property tax year which ends on the day before the date of the sale shall be treated as a tax imposed on the seller, and the portion of such tax properly allocable to that part of such real property tax year which begins on the date of the sale shall be treated as a tax imposed on the purchased. For definition of ‘‘real property tax year’’ see paragraph (c) of this section. This rule shall apply whether or not the seller and the purchaser apportion such tax. The rule of apportionment contained in section 164(d)(1) applies even though the same real property is sold more than once during the real property tax year. (See paragraph (d)(5) of this section for rule requiring inclusion in gross income of excess deductions.)

(ii) Where the real property tax becomes a personal liability or a lien before the beginning of the real property tax year to which it relates and the real property is sold subsequent to the time the tax becomes a personal liability or a lien but prior to the beginning of the related real property tax year—

(a) The seller may not deduct any amount for real property taxes for the related real property tax year, and

(b) To the extent that he holds the property for such real property tax year, the purchaser may deduct the amount of such taxes for the taxable year they are paid (or amounts representing such taxes are paid to the seller, mortgagee, trustee or other person having an interest in the property as security) or accrued by him according to his method of accounting.

(iii) Similarly, where the real property tax becomes a personal liability or a lien after the end of the real property tax year to which it relates and the real property is sold prior to the time the tax becomes a personal liability or a lien but after the end of the related real property tax year—

(a) The purchaser may not deduct any amount for real property taxes for the related real property tax year, and

(b) To the extent that he holds the property for such real property tax year, the seller may deduct the amount of such taxes for the taxable year they are paid (or amounts representing such taxes are paid to the purchaser, mortgagee, trustee, or other person having an interest in the property as security) or accrued by him according to his method of accounting.

(iv) Where the real property is sold (or purchased) during the related real property tax year the real property taxes for such year are apportioned between the parties to such sale and may be deducted by such parties in accordance with the provisions of paragraph (d) of this section.

(2) Section 164(d) does not apply to delinquent real property taxes for any real property tax year prior to the real property tax year in which the property is sold.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example (1). The real property tax year in County R is April 1 to March 31. A, the owner on April 1, 1954, of real property located in County R sells the real property to B on June 30, 1954. B owns the real property from June 30, 1954, through March 31, 1955. The real property tax for the real property tax year April 1, 1954–March 31, 1955 is $365. For purposes of section 164(a), $90 (90/365×$365, April 1, 1954–June 29, 1954) of the real property tax is treated as imposed on A, the seller, and $275 (275/365× $365, June 30, 1954–March 31, 1955) of such real property tax is treated as imposed on B, the purchaser.

Example (2). In County S the real property tax year is the calendar year. The real property tax becomes a lien on June 1 and is payable on July 1 of the current real property tax year, but there is no personal liability for such tax. On April 30, 1955, C, the owner of real property in County S on January 1, 1955, sells the real property to D. On July 1, 1955, D pays the 1955 real property tax. On August 31, 1955, D sells the same real property to E. C, D, and E use the cash receipts and disbursements method of accounting. Under the provisions of section 164(d)(1), 119/365 (January 1–April 29, 1955) of the real property tax payable on July 1, 1955, for the 1955 real property tax year is treated as imposed on C, and, under the provisions of section 164(d)(2)(A), such portion is treated as having been paid by him on the date of sale. Under the provisions of section 164(d)(1), 123/365 (April 30–August 30, 1955) of the real property tax paid July 1, 1955, for the 1955 real property tax year is treated as imposed on D and may be deducted by him. Under the provisions of section 164(d)(1), 123/365 (August 31–December 31, 1955) of the real property tax due and paid on July 1, 1955, for the 1955 real property tax year is treated as imposed on E and, under the provisions of section 164(d)(2)(A) such portion is treated as having been paid by him on the date of sale.

Example (3). In State X the real property tax year is the calendar year. The real property tax becomes a lien on November 1 of the preceding calendar year. On November 15, 1955, F sells real property in State X to G. G owns the real property through December 31, 1956. Under section 164(d)(1), the real property tax (which became a lien on November 1, 1954) for the 1955 real property tax year is apportioned between F and G. No part of the real property tax for the 1956 real property tax year may be deducted by F. The entire real property tax for the 1956 real property tax year may be deducted by G when paid or accrued, depending upon the method of accounting used by him. See subparagraph (6) of paragraph (d) and section 461(c) and the regulations thereunder.

(c) *Real property tax year.* As used in section 164(d), the term ‘‘real property tax year’’ refers to the period which, under the law imposing the tax, is regarded as the period to which the tax imposed relates. Where the State and one or more local governmental units each imposes a tax on real property, the real property tax year for each tax must be determined for purposes of applying the rule of apportionment of section 164(d)(1) to each tax. The time when the tax rate is determined, the time when the assessment is made, the time when the tax becomes a lien, or the time when the tax becomes due or delinquent does not necessarily determine the real property tax year. The real property tax year may or may not correspond to the fiscal year of the governmental unit imposing the tax. In each case the State or local law determines what constitutes the real property tax year. Although the seller and the purchaser may or may not make an allocation of real property taxes, the meaning of ''real property tax year'' in section 164(d) and the application of section 164(d) do not depend upon what real property taxes were allocated nor the method of allocation used by the parties.

(d) *Special rules*—(1) *Seller using cash receipts and disbursements method of accounting.* Under the provisions of section 164(d), if the seller by reason of his method of accounting may not deduct any amount for taxes unless paid, and—

(i) The purchaser (under the law imposing the real property tax) is liable for the real property tax for the real property tax year, or

(ii) The seller (under the law imposing the real property tax) is liable for the real property tax for the real property tax year and the tax is not payable until after the date of sale,

then the portion of the tax treated under section 164(d)(1) as imposed upon the seller (whether or not actually paid by him in the taxable year in which the sale occurs) shall be considered as having been paid by him in such taxable year. Such portion may be deducted by him for the taxable year in which the sale occurs, or, if at a later time, for the taxable year (which would be proper under the taxpayer's method of accounting) in which the tax is actually paid, or an amount representing such tax is paid to the purchaser, mortgagee, trustee, or other person having an interest in the property as security.

(2) *Purchasers using the cash receipts and disbursements method of accounting.* Under the provisions of section 164(d), if the purchaser by reason of his method of accounting may not deduct any amount for taxes unless paid and the seller (under the law imposing the real property tax) is liable for the real property tax for the real property tax year, the portion of the tax treated under section 164(d)(1) as imposed upon the purchaser (whether or not actually paid by him in the taxable year in which the sale occurs) shall be considered as having been paid by him in such taxable year. Such portion may be deducted by him for the taxable year in which the sale occurs, or, if at a later time, for the taxable year (which would be proper under the taxpayer's method of accounting) in which the tax is actually paid, or an amount representing such tax is paid to the seller, mortgagee, trustee, or other person having an interest in the property as security.

(3) *Persons considered liable for tax.* Where the tax is not a liability of any person, the person who holds the property at the time the tax becomes a lien on the property shall be considered liable for the tax. As to a particular sale, in determining:

(i) Whether the other party to the sale is liable for the tax or,

(ii) The person who holds the property at the time the tax becomes a lien on the property (where the tax is not a liability of any person),

prior or subsequent sales of the property during the real property tax year shall be disregarded.

(4) *Examples.* The provisions of subparagraphs (1), (2), and (3) of this paragraph may be illustrated as follows:

Example (1). In County X the real property tax year is the calendar year. The real property tax is a personal liability of the owner of the real property on June 30 of the current real property tax year, but is not payable until February 28 of the following real property tax year. A, the owner of real property in County X on January 1, 1955, uses the cash receipts and disbursements method of accounting. On May 30, 1955, A sells the real property to B, who also uses the cash receipts and disbursements method of accounting. B retains ownership of the real property for the balance of the 1955 calendar year. Under the provisions of section 164(d)(1), 149/365 (January 1–May 29, 1955) of the real property tax payable on February 28, 1956, for the 1955 real property tax year is treated as imposed on A, the seller, and under the provisions of section 164(d)(2)(A) such portion is treated as having been paid by him on the date of sale and may be deducted by him for his taxable year in which the sale occurs (whether or not such portion is actually paid by him in that year) or for his taxable year in which the tax is actually paid or an amount representing such tax is paid. Under the provisions of section 164(d)(1), 216/365 (May 30–December 31, 1955) of the real property tax payable on February 28, 1956, for the 1955 real property tax year is treated as imposed on B, the purchaser, and may be deducted by him for his taxable year in which the tax is actually paid, or an amount representing such tax is paid.

Example (2). In County Y, the real property tax year is the calendar year. The real property tax becomes a lien on January 1, 1955, and is payable on April 30, 1955. There is no personal liability for the real property tax imposed by County Y. On April 30, 1955, C, the owner of real property in County Y on January 1, 1955, pays the real property tax for the 1955 real property tax year. On May 1, 1955, C sells the real property to D. On September 1, 1955, D sells the real property to E. C, D, and E use the cash receipts and disbursements method of accounting. Under the provisions of section 164(d)(1), 120/365 (January 1–April 30, 1955) of the real property tax is treated as imposed upon C and may be deducted by him for his taxable year in which the tax is actually paid. Under section 164(d)(1), 123/365 (May 1– August 31, 1955) of the real property tax is treated as imposed upon D and, under the provisions of section 164(d)(2)(A), is treated as having been paid by him on May 1, 1955, and may be deducted by D for his taxable year in which the sale from C to him occurs (whether or not such portion is actually paid by him in that year), or for his taxable year in which an amount representing such tax is paid. Since, according to paragraph (d)(3) of this section, the prior sale by C to D is disregarded, under the provisions of section 164(d)(1), 122/365 (September 1–December 31, 1955) of the real property tax is treated as imposed on E and, under the provisions of section 164(d)(2)(A), is treated as having been paid by him on September 1, 1955, and may be deducted by E for his taxable year in which the sale from D to him occurs (whether or not such portion is actually paid by him in that year), or for his taxable year in which an amount representing such tax is paid.

Example (3). In County X the real property tax year is the calendar year and the real property taxes are assessed and become a lien on June 30 of the current real property tax year, but are not payable until September 1 of that year. There is no personal liability for the real property tax imposed by County X. A, the owner on January 1, 1955, of real property in County X, uses the cash receipts and disbursements method of accounting. On July 15, 1955, A sells the real property to B. Under the provisions of section 164(d)(1), 195/365 (January 1–July 14, 1955) of the real property tax payable on September 1, 1955, for the 1955 real property tax year is treated as imposed on A, and may be deducted by him for his taxable year in which the sale occurs (whether or not such portion is actually paid by him in that year) or for his taxable year in which the tax is actually paid or an amount representing such tax is paid. Under the provisions of section 164(d)(1), 170/365 (July 15–December 31, 1955) of the real property tax is treated as imposed on B and may be deducted by him for his taxable year in which the sale occurs (whether or not such portion is actually paid by him in that year), or for his taxable year in which the tax is actually paid or an amount representing such tax is paid.

(5) *Treatment of excess deduction.* If, for a taxable year prior to the taxable year of sale of real property, a taxpayer has deducted an amount for real property tax in excess of the portion of such real property tax treated as imposed on him under the provisions of section 164(d), the excess of the amount deducted over the portion treated as imposed on him shall be included in his gross income for the taxable year of the sale, subject to the provisions of section 111, relating to the recovery of bad debts, prior taxes, and delinquency amounts. The provisions of this subparagraph may be illustrated as follows:

Example (1). In Borough Y the real property tax is due and payable on November 30 for the succeeding calendar year, which is also the real property tax year. On November 30, 1954, taxpayer A, who reports his income on a calendar year under the cash receipts and disbursements method of accounting, pays the real property tax on real property owned by him in Borough Y for the 1955 real property tax year. On June 30, 1955, A sells the real property. Under the provisions of section 164(d), only 180/365 (January 1–June 29, 1955) of the real property tax for the 1955 real property tax year is treated as imposed on A, and the excess of the amount of real property tax for 1955 deducted by A, on his 1954 income tax return, over the 180/365 portion of such tax treated as imposed on him under section 164(d), must be included in gross income in A's 1955 income tax return, subject to the provisions of section 111.

Example (2). In County Z the real property tax year is the calendar year. The real property tax becomes a personal liability of the owner of real property on January 1 of the current real property tax year, and is payable on July 1 of the current real property tax year. On May 1, 1955, A, the owner of real property in County Z on January 1, 1955, sells the real property to B. On November 1, 1955, B sells the same real property to C. B uses the cash receipts and disbursements method of accounting and reports his income on the basis of a fiscal year ending July 31. B, on July 1, 1955, pays the entire real property tax for the real property tax year ending December 31, 1955. Under the provisions of section 164(d), only 184/365 (May 1–October 31, 1955) of the real property tax for the 1955 real property tax year is treated as imposed on B, and the excess of the amount of real property tax for 1955 deducted by B on his income tax return for the fiscal year ending July 31, 1955, over the 184/365 portion of such tax treated as imposed on him under section 164(d), must be included in gross income in B's income tax return for his fiscal year ending July 31, 1956, subject to the provisions of section 111.

(6) *Persons using an accrual method of accounting.* Where real property is sold and the seller or the purchaser computes his taxable income (for the taxable year during which the sale occurs) on an accrual method of accounting then, if the seller or the purchaser has not made the election provided in section 461(c) (relating to the accrual of real property taxes), the portion of any real property tax which is treated as imposed on him and which may not be deducted by him for any taxable year by reason of his method of accounting shall be treated as having accrued on the date of sale. The provisions of this subparagraph may be illustrated as follows:

Example. In County X the real property tax becomes a lien on property and is assessed on November 30 for the current calendar year, which is also the real property tax year. There is no personal liability for the real property tax imposed by County X. A owns, on January 1, 1955, real property in County X. A uses an accrual method of accounting and has not made any election under section 461(c) to accrue ratably real property taxes. A sells real property on June 30, 1955. By reason of A's method of accounting, he could not deduct any part of the real property tax for 1955 on the real property since he sold the real property prior to November 30, 1955, the accrual date. Under section 164(d)(1), 180/365 (January 1–June 29, 1955) of the real property tax for the 1955 real property tax year is treated as imposed on A, and under section 164(d)(2)(D) that portion is treated as having accrued on June 30, 1955, and may be deducted by A for his taxable year in which such date falls. B, the purchaser from A, who uses an accrual method of accounting, has likewise not made an election under section 461(c) to accrue real property taxes ratably. Under section 164(d)(1), 185/365 of the real property taxes may be accrued by B on November 30, 1955, and deducted for his taxable year in which such date falls.

(7) *Cross references.* For determination of amount realized on a sale of real property, see section 1001(b) and the regulations thereunder. For determination of basis of real property acquired by purchase, see section 1012 and the regulations thereunder.

(8) *Effective dates.* Section 164(d) applies to taxable years ending after December 31, 1953, but only in the case of sales made after December 31, 1953. However, section 164(d) does not apply to any real property tax to the extent that such tax was allowable as a deduction under the Internal Revenue Code of 1939 to the seller for any taxable year which ended before January 1, 1954.

§ 1.164–7 Taxes of shareholder paid by corporation.

Banks and other corporations paying taxes assessed against their shareholders on account of their ownership of the shares of stock issued by such corporations without reimbursement from such shareholders may deduct the amount of taxes so paid. In such cases no deduction shall be allowed to the shareholders for such taxes. The amount so paid should not be included in the gross income of the shareholder.

§ 1.164–8 Payments for municipal services in atomic energy communities.

(a) *General.* For taxable years beginning after December 31, 1957, amounts paid or accrued by any owner of real property within any community (as defined in section 21b of the Atomic Energy Community Act of 1955 (42 U.S.C. 2304)) to compensate the Atomic Energy Commission for municipal-type services (or any agent or contractor authorized by the Atomic Energy Commission to charge for such services) shall be treated as State real property taxes paid or accrued for purposes of section 164. Such amounts shall be deductible as taxes to the extent provided in section 164, §§ 1.164–1 through 1.164–7, and this section. See paragraph (b) of this section for definition of the term

''Atomic Energy Commission''; paragraph (c) of this section for the definition of the term ''municipal-type services''; and paragraph (d) of this section for the definition of the term ''owner''.

(b) *Atomic Energy Commission.* For purposes of paragraph (a) of this section, the term ''Atomic Energy Commission'' shall mean—

(1) The Atomic Energy Commission, and

(2) Any other agency of the United States Government to which the duties and responsibilities of providing municipal-type services are delegated under the authority of section 101 of the Atomic Energy Community Act of 1955 (42 U.S.C. 2313).

(c) *Municipal-type services.* For purposes of paragraph (a) of this section, the term ''municipal-type services'' includes services usually rendered by a municipality and usually paid for by taxes. Examples of municipal-type services are police protection, fire protection, public recreational facilities, public libraries, public schools, public health, public welfare, and the maintenance of roads and streets. The term shall include sewage and refuse disposal which are maintained out of revenues derived from a general charge for municipal-type services; however, the term shall not include sewage and refuse disposal if a separate charge for such services is made. Charges assessed against local benefits of a kind tending to increase the value of the property assessed are not charges for municipal-type services. See section 164(c)(1) and §1.164–4.

(d) *Owner.* For purposes of paragraph (a) of this section, the term ''owner'' includes a person who holds the real property under a leasehold of 40 or more years from the Atomic Energy Commission (or any agency of the United States Government to which the duties and responsibilities of leasing real property are delegated under section 101 of the Atomic Energy Community Act of 1955), and a person who has entered into a contract to purchase under section 61 of the Atomic Energy Community Act of 1955 (42 U.S.C. 2361). An assignee (either immediate or more remote) of a lessee referred to in the preceding sentence will also qualify as an owner for purposes of paragraph (a) of this section.

(e) *Nonapplication of section 164(d).* Section 164(d) and §1.164–6, relating to apportionment of taxes on real property between seller and purchaser, do not apply to a sale by the United States or any of its agencies of real property to which section 164(f) and this section apply. Thus, amounts paid or accrued which qualify under paragraph (a) of this section will continue to be deductible as taxes to the extent provided in this section, even in the taxable year in which the owner actually purchases the real property from the United States or any of its agencies. However, the provisions of section 164(d) and §1.164–6 shall apply to a sale of real property to which section 164(f) and this section apply, if the seller is other than the United States or any of its agencies.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6789, 29 FR 18147, Dec. 22, 1964]

§1.165–1 Losses.

(a) *Allowance of deduction.* Section 165(a) provides that, in computing taxable income under section 63, any loss actually sustained during the taxable year and not made good by insurance or some other form of compensation shall be allowed as a deduction subject to any provision of the internal revenue laws which prohibits or limits the amount of the deduction. This deduction for losses sustained shall be taken in accordance with section 165 and the regulations thereunder. For the disallowance of deductions for worthless securities issued by a political party, see §1.271–1.

(b) *Nature of loss allowable.* To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and §1.165–11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

(c) *Amount deductible.* (1) The amount of loss allowable as a deduction under section 165(a) shall not exceed the amount prescribed by § 1.1011–1 as the adjusted basis for determining the loss from the sale or other disposition of the property involved. In the case of each such deduction claimed, therefore, the basis of the property must be properly adjusted as prescribed by § 1.1011–1 for such items as expenditures, receipts, or losses, properly chargeable to capital account, and for such items as depreciation, obsolescence, amortization, and depletion, in order to determine the amount of loss allowable as a deduction. To determine the allowable loss in the case of property acquired before March 1, 1913, see also paragraph (b) of § 1.1053–1.

(2) The amount of loss recognized upon the sale or exchange of property shall be determined for purposes of section 165(a) in accordance with § 1.1002–1.

(3) A loss from the sale or exchange of a capital asset shall be allowed as a deduction under section 165(a) but only to the extent allowed in section 1211 (relating to limitation on capital losses) and section 1212 (relating to capital loss carrybacks and carryovers), and in the regulations under those sections.

(4) In determining the amount of loss actually sustained for purposes of section 165(a), proper adjustment shall be made for any salvage value and for any insurance or other compensation received.

(d) *Year of deduction.* (1) A loss shall be allowed as a deduction under section 165(a) only for the taxable year in which the loss is sustained. For this purpose, a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. For provisions relating to situations where a loss attributable to a disaster will be treated as sustained in the taxable year immediately preceding the taxable year in which the disaster actually occurred, see section 165(h) and § 1.165–11.

(2)(i) If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim. When a taxpayer claims that the taxable year in which a loss is sustained is fixed by his abandonment of the claim for reimbursement, he must be able to produce objective evidence of his having abandoned the claim, such as the execution of a release.

(ii) If in the year of the casualty or other event a portion of the loss is not covered by a claim for reimbursement with respect to which there is a reasonable prospect of recovery, then such portion of the loss is sustained during the taxable year in which the casualty or other event occurs. For example, if property having an adjusted basis of $10,000 is completely destroyed by fire in 1961, and if the taxpayer's only claim for reimbursement consists of an insurance claim for $8,000 which is settled in 1962, the taxpayer sustains a loss of $2,000 in 1961. However, if the taxpayer's automobile is completely destroyed in 1961 as a result of the negligence of another person and there exists a reasonable prospect of recovery on a claim for the full value of the automobile against such person, the taxpayer does not sustain any loss until the taxable year in which the claim is adjudicated or otherwise settled. If the automobile had an adjusted basis of $5,000 and the taxpayer secures a judgment of $4,000 in 1962, $1,000 is deductible for the taxable year 1962. If in 1963 it becomes reasonably certain that only $3,500 can ever be collected on such judgment, $500 is deductible for the taxable year 1963.

(iii) If the taxpayer deducted a loss in accordance with the provisions of this paragraph and in a subsequent taxable year receives reimbursement for such loss, he does not recompute the tax for the taxable year in which the deduction was taken but includes the amount of such reimbursement in his gross income for the taxable year in which received, subject to the provisions of section 111, relating to recovery of amounts previously deducted.

(3) Any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers the loss (see §1.165–8, relating to theft losses). However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received.

(4) The rules of this paragraph are applicable with respect to a casualty or other event which may result in a loss and which occurs after January 16, 1960. If the casualty or other event occurs on or before such date, a taxpayer may treat any loss resulting therefrom in accordance with the rules then applicable, or, if he so desires, in accordance with the provisions of this paragraph; but no provision of this paragraph shall be construed to permit a deduction of the same loss or any part thereof in more than one taxable year or to extend the period of limitations within which a claim for credit or refund may be filed under section 6511.

(e) *Limitation on losses of individuals.* In the case of an individual, the deduction for losses granted by section 165(a) shall, subject to the provisions of section 165(c) and paragraph (a) of this section, be limited to:

(1) Losses incurred in a trade or business;

(2) Losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) Losses of property not connected with a trade or business and not incurred in any transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft, and if the loss involved has not been allowed for estate tax purposes in the estate tax return. For additional provisions pertaining to the allowance of casualty and theft losses, see §§1.165–7 and 1.165–8, respectively.

For special rules relating to an election by a taxpayer to deduct disaster losses in the taxable year immediately preceding the taxable year in which the disaster occurred, see section 165(h) and §1.165–11.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6735, 29 FR 6493, May 19, 1964; T.D. 6996, 34 FR 835, Jan. 18, 1969; T.D. 7301, 39 FR 963, Jan. 4, 1974; T.D. 7522, 42 FR 63411, Dec. 16, 1977]

§1.165–2 Obsolescence of nondepreciable property.

(a) *Allowance of deduction.* A loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained. For this purpose, the taxable year in which the loss is sustained is not necessarily the taxable year in which the overt act of abandonment, or the loss of title to the property, occurs.

(b) *Exceptions.* This section does not apply to losses sustained upon the sale or exchange of property, losses sustained upon the obsolescence or worthlessness of depreciable property, casualty losses, or losses reflected in inventories required to be taken under section 471. The limitations contained in sections 1211 and 1212 upon losses from the sale or exchange of capital assets do not apply to losses allowable under this section.

(c) *Cross references.* For the allowance under section 165(a) of losses arising from the permanent withdrawal of depreciable property from use in the trade or business or in the production of income, see §1.167(a)–8. For provisions respecting the obsolescence of depreciable property, see §1.167(a)–9. For the allowance of casualty losses, see §1.165–7.

§ 1.165–3 Demolition of buildings.

(a) *Intent to demolish formed at time of purchase.* (1) Except as provided in subparagraph (2) of this paragraph, the following rule shall apply when, in the course of a trade or business or in a transaction entered into for profit, real property is purchased with the intention of demolishing either immediately or subsequently the buildings situated thereon: No deduction shall be allowed under section 165(a) on account of the demolition of the old buildings even though any demolition originally planned is subsequently deferred or abandoned. The entire basis of the property so purchased shall, notwithstanding the provisions of § 1.167(a)–5, be allocated to the land only. Such basis shall be increased by the net cost of demolition or decreased by the net proceeds from demolition.

(2)(i) If the property is purchased with the intention of demolishing the buildings and the buildings are used in a trade or business or held for the production of income before their demolition, a portion of the basis of the property may be allocated to such buildings and depreciated over the period during which they are so used or held. The fact that the taxpayer intends to demolish the buildings shall be taken into account in making the apportionment of basis between the land and buildings under § 1.167(a)–5. In any event, the portion of the purchase price which may be allocated to the buildings shall not exceed the present value of the right to receive rentals from the buildings over the period of their intended use. The present value of such right shall be determined at the time that the buildings are first used in the trade or business or first held for the production of income. If the taxpayer does not rent the buildings, but uses them in his own trade or business or in the production of his income, the present value of such right shall be determined by reference to the rentals which could be realized during such period of intended use. The fact that the taxpayer intends to rent or use the buildings for a limited period before their demolition shall also be taken into account in computing the useful life in accordance with paragraph (b) of § 1.167(a)–1.

(ii) Any portion of the purchase price which is allocated to the buildings in accordance with this subparagraph shall not be included in the basis of the land computed under subparagraph (1) of this paragraph, and any portion of the basis of the buildings which has not been recovered through depreciation or otherwise at the time of the demolition of the buildings is allowable as a deduction under section 165.

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

Example. In January 1958, A purchased land and a building for $60,000 with the intention of demolishing the building. In the following April, A concludes that he will be unable to commence the construction of a proposed new building for a period of more than 3 years. Accordingly, on June 1, 1958, he leased the building for a period of 3 years at an annual rental of $1,200. A intends to demolish the building upon expiration of the lease. A may allocate a portion of the $60,000 basis of the property to the building to be depreciated over the 3-year period. That portion is equal to the present value of the right to receive $3,600 (3 times $1,200). Assuming that the present value of that right determined as of June 1, 1958, is $2,850, A may allocate that amount to the building and, if A files his return on the basis of a taxable year ending May 31, 1959, A may take a depreciation deduction with respect to such building of $950 for such taxable year. The basis of the land to A as determined under subparagraph (1) of this paragraph is reduced by $2,850. If on June 1, 1960, A ceases to rent the building and demolishes it, the balance of the undepreciated portion allocated to the buildings, $950, may be deducted from gross income under section 165.

(3) The basis of any building acquired in replacement of the old buildings shall not include any part of the basis of the property originally purchased even though such part was, at the time of purchase, allocated to the buildings to be demolished for purposes of determining allowable depreciation for the period before demolition.

(b) *Intent to demolish formed subsequent to the time of acquisition.* (1) Except as provided in subparagraph (2) of this paragraph, the loss incurred in a trade or business or in a transaction entered into for profit and arising from a demolition of old buildings shall be allowed as a deduction under section

165(a) if the demolition occurs as a result of a plan formed subsequent to the acquisition of the buildings demolished. The amount of the loss shall be the adjusted basis of the buildings demolished increased by the net cost of demolition or decreased by the net proceeds from demolition. See paragraph (c) of §1.165–1 relating to amount deductible under section 165. The basis of any building acquired in replacement of the old buildings shall not include any part of the basis of the property demolished.

(2) If a lessor or lessee of real property demolishes the buildings situated thereon pursuant to a lease or an agreement which resulted in a lease, under which either the lessor was required or the lessee was required or permitted to demolish such buildings, no deduction shall be allowed to the lessor under section 165(a) on account of the demolition of the old buildings. However, the adjusted basis of the demolished buildings, increased by the net cost of demolition or decreased by the net proceeds from demolition, shall be considered as a part of the cost of the lease to be amortized over the remaining term thereof.

(c) *Evidence of intention.* (1) Whether real property has been purchased with the intention of demolishing the buildings thereon or whether the demolition of the buildings occurs as a result of a plan formed subsequent to their acquisition is a question of fact, and the answer depends upon an examination of all the surrounding facts and circumstances. The answer to the question does not depend solely upon the statements of the taxpayer at the time he acquired the property or demolished the buildings, but such statements, if made, are relevant and will be considered. Certain other relevant facts and circumstances that exist in some cases and the inferences that might reasonably be drawn from them are described in subparagraphs (2) and (3) of this paragraph. The question as to the taxpayer's intention is not answered by any inference that is drawn from any one fact or circumstance but can be answered only by a consideration of all relevant facts and circumstances and the reasonable inferences to be drawn therefrom.

(2) An intention at the time of acquisition to demolish may be suggested by:

(i) A short delay between the date of acquisition and the date of demolition;

(ii) Evidence of prohibitive remodeling costs determined at the time of acquisition;

(iii) Existence of municipal regulations at the time of acquisition which would prohibit the continued use of the buildings for profit purposes;

(iv) Unsuitability of the buildings for the taxpayer's trade or business at the time of acquisition; or

(v) Inability at the time of acquisition to realize a reasonable income from the buildings.

(3) The fact that the demolition occurred pursuant to a plan formed subsequent to the acquisition of the property may be suggested by:

(i) Substantial improvement of the buildings immediately after their acquisition;

(ii) Prolonged use of the buildings for business purposes after their acquisition;

(iii) Suitability of the buildings for investment purposes at the time of acquisition;

(iv) Substantial change in economic or business conditions after the date of acquisition;

(v) Loss of useful value occurring after the date of acquisition;

(vi) Substantial damage to the buildings occurring after their acquisition;

(vii) Discovery of latent structural defects in the buildings after their acquisition;

(viii) Decline in the taxpayer's business after the date of acquisition;

(ix) Condemnation of the property by municipal authorities after the date of acquisition; or

(x) Inability after acquisition to obtain building material necessary for the improvement of the property.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 74474, 41 FR 55710, Dec. 22, 1976]

§1.165–4 Decline in value of stock.

(a) *Deduction disallowed.* No deduction shall be allowed under section 165(a) solely on account of a decline in the value of stock owned by the taxpayer when the decline is due to a fluctuation in the market price of the stock or to other similar cause. A mere shrinkage in the value of stock owned by the taxpayer, even though extensive, does not give rise to a deduction under section 165(a) if the stock has any recognizable value on the date claimed as the date of loss. No loss for a decline in the value of stock owned by the taxpayer shall be allowed as a deduction under section 165(a) except insofar as the loss is recognized under § 1.1002–1 upon the sale or exchange of the stock and except as otherwise provided in § 1.165–5 with respect to stock which becomes worthless during the taxable year.

(b) *Stock owned by banks.* (1) In the regulation of banks and certain other corporations, Federal and State authorities may require that stock owned by such organizations be charged off as worthless or written down to a nominal value. If, in any such case, this requirement is premised upon the worthlessness of the stock, the charging off or writing down will be considered prima facie evidence of worthlessness for purposes of section 165(a); but, if the charging off or writing down is due to a fluctuation in the market price of the stock or if no reasonable attempt to determine the worthlessness of the stock has been made, then no deduction shall be allowed under section 165(a) for the amount so charged off or written down.

(2) This paragraph shall not be construed, however, to permit a deduction under section 165(a) unless the stock owned by the bank or other corporation actually becomes worthless in the taxable year. Such a taxpayer owning stock which becomes worthless during the taxable year is not precluded from deducting the loss under section 165(a) merely because, in obedience to the specific orders or general policy of such supervisory authorities, the value of the stock is written down to a nominal amount instead of being charged off completely.

(c) *Application to inventories.* This section does not apply to a decline in the value of corporate stock reflected in inventories required to be taken by a dealer in securities under section 471. See § 1.471–5.

(d) *Definition.* As used in this section, the term ''stock'' means a share of stock in a corporation or a right to subscribe for, or to receive, a share of stock in a corporation.

§ 1.165–5 Worthless securities.

(a) *Definition of security.* As used in section 165(g) and this section, the term ''security'' means:

(1) A share of stock in a corporation;

(2) A right to subscribe for, or to receive, a share of stock in a corporation; or

(3) A bond, debenture, note, or certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money, which has been issued with interest coupons or in registered form by a domestic or foreign corporation or by any government or political subdivision thereof.

(b) *Ordinary loss.* If any security which is not a capital asset becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss.

(c) *Capital loss.* If any security which is a capital asset becomes wholly worthless at any time during the taxable year, the loss resulting therefrom may be deducted under section 165(a) but only as though it were a loss from a sale or exchange, on the last day of the taxable year, of a capital asset. See section 165(g)(1). The amount so allowed as a deduction shall be subject to the limitations upon capital losses described in paragraph (c)(3) of § 1.165–1.

(d) *Loss on worthless securities of an affiliated corporation*—(1) *Deductible as an ordinary loss.* If a taxpayer which is a domestic corporation owns any security of a domestic or foreign corporation which is affiliated with the taxpayer within the meaning of subparagraph (2) of this paragraph and such security becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss in accordance with paragraph (b) of this section. The fact that the security is in fact a capital asset of the taxpayer is immaterial for this purpose, since section 165(g)(3) provides that such security shall be treated as though it were not a capital asset for the purposes of section 165(g)(1). A debt which becomes wholly worthless during the taxable year shall be as an ordinary loss in accordance with the provisions of this subparagraph, to the extent that such debt is a security within the meaning of paragraph (a)(3) of this section.

(2) *Affiliated corporation defined.* For purposes of this paragraph, a corporation shall be treated as affiliated with the taxpayer owning the security if—

(i)*(a)* In the case of a taxable year beginning on or after January 1, 1970, the taxpayer owns directly—

(1) Stock possessing at least 80 percent of the voting power of all classes of such corporation's stock, and

(2) At least 80 percent of each class of such corporation's nonvoting stock excluding for purposes of this subdivision (i)*(a)* nonvoting stock which is limited and preferred as to dividends (see section 1504(a)), or

(b) In the case of a taxable year beginning before January 1, 1970, the taxpayer owns directly at least 95 percent of each class of the stock of such corporation;

(ii) None of the stock of such corporation was acquired by the taxpayer solely for the purpose of converting a capital loss sustained by reason of the worthlessness of any such stock into an ordinary loss under section 165(g)(3), and

(iii) More than 90 percent of the aggregate of the gross receipts of such corporation for all the taxable years during which it has been in existence has been from sources other than royalties, rents (except rents derived from rental of properties to employees of such corporation in the ordinary course of its operating business), dividends, interest (except interest received on the deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities. For this purpose, the term ''gross receipts'' means total receipts determined without any deduction for cost of goods sold, and gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains from such sales or exchanges.

(e) *Bonds issued by an insolvent corporation.* A bond of an insolvent corporation secured only by a mortgage from which nothing is realized for the bondholders on foreclosure shall be regarded as having become worthless not later than the year of the foreclosure sale, and no deduction in respect of the loss shall be allowed under section 165(a) in computing a bondholder's taxable income for a subsequent year. See also paragraph (d) of §1.165–1.

(f) *Decline in market value.* A taxpayer possessing a security to which this section relates shall not be allowed any deduction under section 165(a) on account of mere market fluctuation in the value of such security. See also §1.165–4.

(g) *Application to inventories.* This section does not apply to any loss upon the worthlessness of any security reflected in inventories required to be taken by a dealer in securities under section 471. See §1.471–5.

(h) *Special rules for banks.* For special rules applicable under this section to worthless securities of a bank, including securities issued by an affiliated bank, see §1.582–1.

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

Example (1). (i) X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 100 percent of each class of the stock of Y Corporation; and, in addition, 19 percent of the common stock (the only class of stock) of Z Corporation, which it acquired in 1948. Y Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 81 percent of the common stock of Z Corporation, which it acquired in 1946. It is established that the stock of Z Corporation, which has from its inception derived all of its gross receipts from manufacturing operations, became worthless during 1971.

(ii) Since the stock of Z Corporation which is owned by X Corporation is a capital asset and since X Corporation does not directly own at least 80 percent of the stock of Z Corporation, any loss sustained by X Corporation upon the worthlessness of such stock shall be deducted under section 165(g)(1) and paragraph (c) of this section as a loss from a sale or exchange on December 31, 1971, of a capital asset. The loss so sustained by X Corporation shall be considered a long-term capital loss under the provisions of section 1222(4), since the stock was held by that corporation for more than 6 months.

(iii) Since Z Corporation is considered to be affiliated with Y Corporation under the provisions of paragraph (d)(2) of this section, any loss sustained by Y Corporation upon the worthlessness of the stock of Z Corporation shall be deducted in 1971 under section 165(g)(3) and paragraph (d)(1) of this section as an ordinary loss.

Example (2). (i) On January 1, 1971, X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 60 percent of each class of the stock of Y Corporation, a foreign corporation, which it acquired in 1950. Y Corporation has, from the date of its incorporation, derived all of its gross receipts from manufacturing operations. It is established that the stock of Y Corporation became worthless on June 30, 1971. On August 1, 1971, X Corporation acquires the balance of the stock of Y Corporation for the purpose of obtaining the benefit of section 165(g)(3) with respect to the loss it has sustained on the worthlessness of the stock of Y Corporation.

(ii) Since the stock of Y Corporation which is owned by X Corporation is a capital asset and since Y Corporation is not to be treated as affiliated with X Corporation under the provisions of paragraph (d)(2) of this section, notwithstanding the fact that, at the close of 1971, X Corporation owns 100 percent of each class of stock of Y Corporation, any loss sustained by X Corporation upon the worthlessness of such stock shall be deducted under the provisions of section 165(g)(1) and paragraph (c) of this section as a loss from a sale or exchange on December 31, 1971, of a capital asset.

Example (3). (i) X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 80 percent of each class of the stock of Y Corporation, which from its inception has derived all of its gross receipts from manufacturing operations. As one of its capital assets, X Corporation owns $100,000 in registered bonds issued by Y Corporation payable at maturity on December 31, 1974. It is established that these bonds became worthless during 1971.

(ii) Since Y Corporation is considered to be affiliated with X Corporation under the provisions of paragraph (d)(2) of this section, any loss sustained by X Corporation upon the worthlessness of these bonds may be deducted in 1971 under section 165(g)(3) and paragraph (d)(1) of this section as an ordinary loss. The loss may not be deducted under section 166 as a bad debt. See section 166(e).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7224, 37 FR 25928, Dec. 6, 1972]

§ 1.165–6 Farming losses.

(a) *Allowance of losses.* (1) Except as otherwise provided in this section, any loss incurred in the operation of a farm as a trade or business shall be allowed as a deduction under section 165(a) or as a net operating loss deduction in accordance with the provisions of section 172. See § 1.172–1.

(2) If the taxpayer owns and operates a farm for profit in addition to being engaged in another trade or business, but sustains a loss from the operation of the farming business, then the amount of loss sustained in the operation of the farm may be deducted from gross income, if any, from all other sources.

(3) Loss incurred in the operation of a farm for recreation or pleasure shall not be allowed as a deduction from gross income. See § 1.162–12.

(b) *Loss from shrinkage.* If, in the course of the business of farming, farm products are held for a favorable market, no deduction shall be allowed under section 165(a) in respect of such products merely because of shrinkage in weight, decline in value, or deterioration in storage.

(c) *Loss of prospective crop.* The total loss by frost, storm, flood, or fire of a prospective crop being grown in the business of farming shall not be allowed as a deduction under section 165(a).

(d) *Loss of livestock*—(1) *Raised stock.* A taxpayer engaged in the business of raising and selling livestock, such as cattle, sheep, or horses, may not deduct as a loss under section 165(a) the value of animals that perish from among those which were raised on the farm.

(2) *Purchased stock.* The loss sustained upon the death by disease, exposure, or injury of any livestock purchased and used in the trade or business of farming shall be allowed as a deduction under section 165(a). See, also, paragraph (e) of this section.

(e) *Loss due to compliance with orders of governmental authority.* The loss sustained upon the destruction by order of the United States, a State, or any other governmental authority, of any livestock, or other property, purchased and used in the trade or business of farming shall be allowed as a deduction under section 165(a).

(f) *Amount deductible*—(1) *Expenses of operation.* The cost of any feed, pasture, or care which is allowed under section 162 as an expense of operating a farm for profit shall not be included as a part of the cost of livestock for purposes of determining the amount of loss deductible under section 165(a) and this section. For the deduction of farming expenses, see §1.162–12.

(2) *Losses reflected in inventories.* If inventories are taken into account in determining the income from the trade or business of farming, no deduction shall be allowed under this section for losses sustained during the taxable year upon livestock or other products, whether purchased for resale or produced on the farm, to the extent such losses are reflected in the inventory on hand at the close of the taxable year. Nothing in this section shall be construed to disallow the deduction of any loss reflected in the inventories of the taxpayer. For provisions relating to inventories of farmers, see section 471 and the regulations thereunder.

(3) *Other limitations.* For other provisions relating to the amount deductible under this section, see paragraph (c) of §1.165–1, relating to the amount deductible under section 165(a); §1.165–7, relating to casualty losses; and §1.1231–1, relating to gains and losses from the sale or exchange of certain property used in the trade or business.

(g) *Other provisions applicable to farmers.* For other provisions relating to farmers, see §1.61–4, relating to gross income of farmers; paragraph (b) of §1.167(a)–6, relating to depreciation in the case of farmers; and §1.175–1, relating to soil and water conservation expenditures.

§1.165–7 Casualty losses.

(a) *In general*—(1) *Allowance of deduction.* Except as otherwise provided in paragraphs (b)(4) and (c) of this section, any loss arising from fire, storm, shipwreck, or other casualty is allowable as a deduction under section 165(a) for the taxable year in which the loss is sustained. However, see §1.165–6, relating to farming losses, and §1.165–11, relating to an election by a taxpayer to deduct disaster losses in the taxable year immediately preceding the taxable year in which the disaster occurred. The manner of determining the amount of a casualty loss allowable as a deduction in computing taxable income under section 63 is the same whether the loss has been incurred in a trade or business or in any transaction entered into for profit, or whether it has been a loss of property not connected with a trade or business and not incurred in any transaction entered into for profit. The amount of a casualty loss shall be determined in accordance with paragraph (b) of this section. For other rules relating to the treatment of deductible casualty losses, see §1.1231–1, relating to the involuntary conversion of property.

(2) *Method of valuation.* (i) In determining the amount of loss deductible under this section, the fair market value of the property immediately before and immediately after the casualty shall generally be ascertained by competent appraisal. This appraisal must recognize the effects of any general market decline affecting undamaged as well as damaged property which may occur simultaneously with the casualty, in order that any deduction under this section shall be limited to the actual loss resulting from damage to the property.

(ii) The cost of repairs to the property damaged is acceptable as evidence of the loss of value if the taxpayer shows that *(a)* the repairs are necessary to restore the property to its condition immediately before the casualty, *(b)* the amount spent for such repairs is not excessive, *(c)* the repairs do not care for more than the damage suffered, and (*d*) the value of the property after the repairs does not as a result of the repairs exceed the value of the property immediately before the casualty.

(3) *Damage to automobiles.* An automobile owned by the taxpayer, whether used for business purposes or maintained for recreation or pleasure, may be the subject of a casualty loss, including those losses specifically referred to in subparagraph (1) of this paragraph. In addition, a casualty loss occurs when an automobile owned by the taxpayer is damaged and when:

(i) The damage results from the faulty driving of the taxpayer or other person operating the automobile but is not due to the willful act or willful negligence of the taxpayer or of one acting in his behalf or

(ii) The damage results from the faulty driving of the operator of the vehicle with which the automobile of the taxpayer collides.

(4) *Application to inventories.* This section does not apply to a casualty loss reflected in the inventories of the taxpayer. For provisions relating to inventories, see section 471 and the regulations thereunder.

(5) *Property converted from personal use.* In the case of property which originally was not used in the trade or business or for income-producing purposes and which is thereafter converted to either of such uses, the fair market value of the property on the date of conversion, if less than the adjusted basis of the property at such time, shall be used, after making proper adjustments in respect of basis, as the basis for determining the amount of loss under paragraph (b)(1) of this section. See paragraph (b) of § 1.165–9, and § 1.167(g)–1.

(6) *Theft losses.* A loss which arises from theft is not considered a casualty loss for purposes of this section. See § 1.165–8, relating to theft losses.

(b) *Amount deductible*—(1) *General rule.* In the case of any casualty loss whether or not incurred in a trade or business or in any transaction entered into for profit, the amount of loss to be taken into account for purposes of section 165(a) shall be the lesser of either—

(i) The amount which is equal to the fair market value of the property immediately before the casualty reduced by the fair market value of the property immediately after the casualty; or

(ii) The amount of the adjusted basis prescribed in § 1.1011–1 for determining the loss from the sale or other disposition of the property involved.

However, if property used in a trade or business or held for the production of income is totally destroyed by casualty, and if the fair market value of such property immediately before the casualty is less than the adjusted basis of such property, the amount of the adjusted basis of such property shall be treated as the amount of the loss for purposes of section 165(a).

(2) *Aggregation of property for computing loss.* (i) A loss incurred in a trade or business or in any transaction entered into for profit shall be determined under subparagraph (1) of this paragraph by reference to the single, identifiable property damaged or destroyed. Thus, for example, in determining the fair market value of the property before and after the casualty in a case where damage by casualty has occurred to a building and ornamental or fruit trees used in a trade or business, the decrease in value shall be measured by taking the building and trees into account separately, and not together as an integral part of the realty, and separate losses shall be determined for such building and trees.

(ii) In determining a casualty loss involving real property and improvements thereon not used in a trade or business or in any transaction entered into for profit, the improvements (such as buildings and ornamental trees and shrubbery) to the property damaged or destroyed shall be considered an integral part of the property, for purposes of subparagraph (1) of this paragraph, and no separate basis need be apportioned to such improvements.

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

Example (1). In 1956 B purchases for $3,600 an automobile which he uses for nonbusiness purposes. In 1959 the automobile is damaged in an accidental collision with another automobile. The fair market value of B's automobile is $2,000 immediately before the collision and $1,500 immediately after the collision. B receives insurance proceeds of $300 to cover the loss. The amount of the deduction allowable under section 165(a) for the taxable year 1959 is $200, computed as follows:

Value of automobile immediately before casualty	$2,000
Less: Value of automobile immediately after casualty	1,500
Value of property actually destroyed	500
Loss to be taken into account for purposes of section 165(a): Lesser amount of property actually destroyed ($500) or adjusted basis of property ($3,600)	500
Less: Insurance received	300
Deduction allowable	200

Example (2). In 1958 A purchases land containing an office building for the lump sum of $90,000. The purchase price is allocated between the land ($18,000) and the building ($72,000) for purposes of determiningbasis. After the purchase A planted trees and ornamental shrubs on the grounds surrounding the building. In 1961 the land, building, trees, and shrubs are damaged by hurricane. At the time of the casualty the adjusted basis of the land is $18,000 and the adjusted basis of the building is $66,000. At that time the trees and shrubs have an adjusted basis of $1,200. The fair market value of the land and building immediately before the casualty is $18,000 and $70,000, respectively, and immediately after the casualty is $18,000 and $52,000, respectively. The fair market value of the trees and shrubs immediately before the casualty is $2,000 and immediately after the casualty is $400. In 1961 insurance of $5,000 is received to cover the loss to the building. A has no other gains or losses in 1961 subject to section 1231 and §1.1231–1. The amount of the deduction allowable under section 165(a) with respect to the building for the taxable year 1961 is $13,000, computed as follows:

Value of property immediately before casualty	$70,000
Less: Value of property immediately after casualty	52,000
Value of property actually destroyed	18,000
Less: Insurance received	5,000
Loss to be taken into account for purposes of section 165(a): Lesser amount of property actually destroyed ($18,000) or adjusted basis of property ($66,000)	18,000
Less: Insurance received	5,000
Deduction allowable	13,000

The amount of the deduction allowable under section 165(a) with respect to the trees and shrubs for the taxable year 1961 is $1,200, computed as follows:

Value of property immediately before casualty	$2,000
Less: Value of property immediately after casualty	$400
Value of property actually destroyed	1,600
Loss to be taken into account for purposes of section 165(a): Lesser amount of property actually destroyed ($1,600) or adjusted basis of property ($1,200)	1,200

Example (3). Assume the same facts as in example (2) except that A purchases land containing a house instead of an office building. The house is used as his private residence. Since the property is used for personal purposes, no allocation of the purchase price is necessary for the land and house. Likewise, no individual determination of the fair market values of the land, house, trees, and shrubs is necessary. The amount of the deduction allowable under section 165(a) with respect to the land, house, trees, and shrubs for the taxable year 1961 is $14,600, computed as follows:

Value of property immediately before casualty	$90,000
Less: Value of property immediately after casualty	70,400
Value of property actually destroyed	19,600
Loss to be taken into account for purposes of section 165(a): Lesser amount of property actually destroyed ($19,600) or adjusted basis of property ($91,200)	19,600
Less: Insurance received	5,000
Deduction allowable	14,600

(4) *Limitation on certain losses sustained by individuals after December 31, 1963.* (i) Pursuant to section 165(c)(3), the deduction allowable under section 165(a) in respect of a loss sustained—

(a) After December 31, 1963, in a taxable year ending after such date,

(b) In respect of property not used in a trade or business or for income producing purposes, and

(c) From a single casualty

shall be limited to that portion of the loss which is in excess of $100. The nondeductibility of the first $100 of loss applies to a loss sustained after December 31, 1963, without regard to when the casualty occurred. Thus, if property not used in a trade or business or for income producing purposes is damaged or destroyed by a casualty which occurred prior to January 1, 1964, and loss resulting therefrom is sustained after December 31, 1963, the $100 limitation applies.

(ii) The $100 limitation applies separately in respect of each casualty and applies to the entire loss sustained from each casualty. Thus, if as a result of a particular casualty occurring in 1964, a taxpayer sustains in 1964 a loss of $40 and in 1965 a loss of $250, no deduction is allowable for the loss sustained in 1964 and the loss sustained in 1965 must be reduced by $60 ($100−$40). The determination of whether damage to, or destruction of, property resulted from a single casualty or from two or more separate casualties will be made upon the basis of the particular facts of each case. However, events which are closely related in origin generally give rise to a single casualty. For example, if a storm damages a taxpayer's residence and his automobile parked in his driveway, any loss sustained results from a single casualty. Similarly, if a hurricane causes high waves, all wind and flood damage to a taxpayer's property caused by the hurricane and the waves results from a single casualty.

(iii) Except as otherwise provided in this subdivision, the $100 limitation applies separately to each individual taxpayer who sustains a loss even though the property damaged or destroyed is owned by two or more individuals.

Thus, if a house occupied by two sisters and jointly owned by them is damaged or destroyed, the $100 limitation applies separately to each sister in respect of any loss sustained by her. However, for purposes of applying the $100 limitation, a husband and wife who file a joint return for the first taxable year in which the loss is allowable as a deduction are treated as one individual taxpayer. Accordingly, if property jointly owned by a husband and wife, or property separately owned by the husband or by the wife, is damaged or destroyed by a single casualty in 1964, and a loss is sustained in that year by either or both the husband or wife, only one $100 limitation applies if a joint return is filed for 1964. If, however, the husband and wife file separate returns for 1964, the $100 limitation applies separately in respect of any loss sustained by the husband and in respect of any loss sustained by the wife. Where losses from a single casualty are sustained in two or more separate tax years, the husband and wife shall, for purposes of applying the $100 limitation to such losses, be treated as one individual for all such years if they file a joint return for the first year in which a loss is sustained from the casualty; they shall be treated as separate individuals for all such years if they file separate returns for the first such year. If a joint return is filed in the first loss year but separate returns are filed in a subsequent year, any unused portion of the $100 limitation shall be allocated equally between the husband and wife in the latter year.

(iv) If a loss is sustained in respect of property used partially for business and partially for nonbusiness purposes, the $100 limitation applies only to that portion of the loss properly attributable to the nonbusiness use. For example, if a taxpayer sustains a $1,000 loss in respect of an automobile which he uses 60 percent for business and 40 percent for nonbusiness, the loss is allocated 60 percent to business use and 40 percent to nonbusiness use. The $100 limitation applies to the portion of the loss allocable to the nonbusiness loss.

(c) *Loss sustained by an estate.* A casualty loss of property not connected with a trade or business and not incurred in any transaction entered into for profit which is sustained during the settlement of an estate shall be allowed as a deduction under sections 165(a) and 641(b) in computing the taxable income of the estate if the loss has not been allowed under section 2054 in computing the taxable estate of the decedent and if the statement has been filed in accordance with § 1.642(g)–1. See section 165(c)(3).

(d) *Loss treated as though attributable to a trade or business.* For the rule treating a casualty loss not connected with a trade or business as though it were a deduction attributable to a trade or business for purposes of computing a net operating loss, see paragraph (a)(3)(iii) of § 1.172–3.

(e) *Effective date.* The rules of this section are applicable to any taxable year beginning after January 16, 1960. If, for any taxable year beginning on or before such date, a taxpayer computed the amount of any casualty loss in accordance with the rules then applicable, such taxpayer is not required to change the amount of the casualty loss allowable for any such prior taxable year. On the other hand, the taxpayer may, if he so desires, amend his income tax return for such year to compute the amount of a casualty loss in accordance with the provisions of this section, but no provision in this section shall be construed as extending the period of limitations within which a claim for credit or refund may be filed under section 6511.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3652, Mar. 24, 1964; T.D. 6786, 29 FR 18501, Dec. 29, 1964; T.D. 7522, 42 FR 63411, Dec. 16, 1977]

§ 1.165–8 Theft losses.

(a) *Allowance of deduction.* (1) Except as otherwise provided in paragraphs (b) and (c) of this section, any loss arising from theft is allowable as a deduction under section 165(a) for the taxable year in which the loss is sustained. See section 165(c)(3).

(2) A loss arising from theft shall be treated under section 165(a) as sustained during the taxable year in which the taxpayer discovers the loss. See section 165(e). Thus, a theft loss is not deductible under section 165(a) for the taxable year in which the theft actually occurs unless that is also the year

in which the taxpayer discovers the loss. However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, see paragraph (d) of §1.165–1.

(3) The same theft loss shall not be taken into account both in computing a tax under chapter 1, relating to the income tax, or chapter 2, relating to additional income taxes, of the Internal Revenue Code of 1939 and in computing the income tax under the Internal Revenue Code of 1954. See section 7852(c), relating to items not to be twice deducted from income.

(b) *Loss sustained by an estate.* A theft loss of property not connected with a trade or business and not incurred in any transaction entered into for profit which is discovered during the settlement of an estate, even though the theft actually occurred during a taxable year of the decedent, shall be allowed as a deduction under sections 165(a) and 641(b) in computing the taxable income of the estate if the loss has not been allowed under section 2054 in computing the taxable estate of the decedent and if the statement has been filed in accordance with §1.642(g)–1. See section 165(c)(3). For purposes of determining the year of deduction, see paragraph (a)(2) of this section.

(c) *Amount deductible.* The amount deductible under this section in respect of a theft loss shall be determined consistently with the manner prescribed in §1.165–7 for determining the amount of casualty loss allowable as a deduction under section 165(a). In applying the provisions of paragraph (b) of §1.165–7 for this purpose, the fair market value of the property immediately after the theft shall be considered to be zero. In the case of a loss sustained after December 31, 1963, in a taxable year ending after such date, in respect of property not used in a trade or business or for income producing purposes, the amount deductible shall be limited to that portion of the loss which is in excess of $100. For rules applicable in applying the $100 limitation, see paragraph (b)(4) of §1.165–7. For other rules relating to the treatment of deductible theft losses, see §1.1231–1, relating to the involuntary conversion of property.

(d) *Definition.* For purposes of this section the term ‘‘theft’’ shall be deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery.

(e) *Application to inventories.* This section does not apply to a theft loss reflected in the inventories of the taxpayer. For provisions relating to inventories, see section 471 and the regulations thereunder.

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

Example. In 1955 B, who makes her return on the basis of the calendar year, purchases for personal use a diamond brooch costing $4,000. On November 30, 1961, at which time it has a fair market value of $3,500, the brooch is stolen; but B does not discover the loss until January 1962. The brooch was fully insured against theft. A controversy develops with the insurance company over its liability in respect of the loss. However, in 1962, B has a reasonable prospect of recovery of the fair market value of the brooch from the insurance company. The controversy is settled in March 1963, at which time B receives $2,000 in insurance proceeds to cover the loss from theft. No deduction for the loss is allowable for 1961 or 1962; but the amount of the deduction allowable under section 165(a) for the taxable year 1963 is $1,500, computed as follows:

Value of property immediately before theft	$3,500
Less: Value of property immediately after the theft	0
Balance	3,500
Loss to be taken into account for purposes of section 165(a): ($3,500 but not to exceed adjusted basis of $4,000 at time of theft)	$3,500
Less: Insurance received in 1963	2,000
Deduction allowable for 1963	1,500

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6786, 29 FR 18502, Dec. 29, 1964]

§1.165–9 Sale of residential property.

(a) *Losses not allowed.* A loss sustained on the sale of residential property purchased or constructed by the taxpayer for use as his personal residence and so used by him up to the time of the sale is not deductible under section 165(a).

(b) *Property converted from personal use.* (1) If property purchased or constructed by the taxpayer for use as his personal residence is, prior to its sale, rented or otherwise appropriated to income-producing purposes and is used for such purposes up to the time of its sale, a loss sustained on the sale of the property shall be allowed as a deduction under section 165(a).

(2) The loss allowed under this paragraph upon the sale of the property shall be the excess of the adjusted basis prescribed in § 1.1011–1 for determining loss over the amount realized from the sale. For this purpose, the adjusted basis for determining loss shall be the lesser of either of the following amounts, adjusted as prescribed in § 1.1011–1 for the period subsequent to the conversion of the property to income-producing purposes:

(i) The fair market value of the property at the time of conversion, or

(ii) The adjusted basis for loss, at the time of conversion, determined under § 1.1011–1 but without reference to the fair market value.

(3) For rules relating to casualty losses of property converted from personal use, see paragraph (a)(5) of § 1.165–7. To determine the basis for depreciation in the case of such property, see § 1.167(g)–1. For limitations on the loss from the sale of a capital asset, see paragraph (c)(3) of § 1.165–1.

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

Example (1). Residential property is purchased by the taxpayer in 1943 for use as his personal residence at a cost of $25,000, of which $15,000 is allocable to the building. The taxpayer uses the property as his personal residence until January 1, 1952, at which time its fair market value is $22,000, of which $12,000 is allocable to the building. The taxpayer rents the property from January 1, 1952, until January 1, 1955, at which time it is sold for $16,000. On January 1, 1952, the building has an estimated useful life of 20 years. It is assumed that the building has no estimated salvage value and that there are no adjustments in respect of basis other than depreciation, which is computed on the straight-line method. The loss to be taken into account for purposes of section 165(a) for the taxable year 1955 is $4,200, computed as follows:

Basis of property at time of conversion for purposes of this section (that is, the lesser of $25,000 cost or $22,000 fair market value)	$22,000
Less: Depreciation allowable from January 1, 1952, to January 1, 1955 (3 years at 5 percent based on $12,000, the value of the building at time of conversion, as prescribed by § 1.167(g)–1)	1,800
Adjusted basis prescribed in § 1.1011–1 for determining loss on sale of the property	20,200
Less: Amount realized on sale	16,000
Loss to be taken into account for purposes of section 165(a)	4,200

In this example the value of the building at the time of conversion is used as the basis for computing depreciation. See example (2) of this paragraph wherein the adjusted basis of the building is required to be used for such purpose.

Example (2). Residential property is purchased by the taxpayer in 1940 for use as his personal residence at a cost of $23,000, of which $10,000 is allocable to the building. The taxpayer uses the property as his personal residence until January 1, 1953, at which time its fair market value is $20,000, of which $12,000 is allocable to the building. The taxpayer rents the property from January 1, 1953, until January 1, 1957, at which time it is sold for $17,000. On January 1, 1953, the building has an estimated useful life of 20 years. It is assumed that the building has no estimated salvage value and that there are no adjustments in respect of basis other than depreciation, which is computed on the straight-line method. The loss to be taken into account for purposes of section 165(a) for the taxable year 1957 is $1,000, computed as follows:

Basis of property at time of conversion for purposes of this section (that is, the lesser of $23,000 cost or $20,000 fair market value)	$20,000
Less: Depreciation allowable from January 1, 1953, to January 1, 1957 (4 years at 5 percent based on $10,000, the cost of the building, as prescribed by § 1.167(g)–1	2,000
Adjusted basis prescribed in § 1.1011–1 for determining loss on sale of the property	$18,000
Less: Amount realized on sale	17,000
Loss to be taken into account for purposes of section 165(a)	1,000

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3652, Mar. 24, 1964]

§ 1.165–10 Wagering losses.

Losses sustained during the taxable year on wagering transactions shall be allowed as a deduction but only to the extent of the gains during the taxable year from such transactions. In the case of a husband and wife making a joint return for the taxable year, the combined losses of the spouses from wagering transactions shall be allowed to the extent of the combined gains of the spouses from wagering transactions.

§1.165–11 Election in respect of losses attributable to a disaster.

(a) *In general.* Section 165(h) provides that a taxpayer who has sustained a disaster loss which is allowable as a deduction under section 165(a) may, under certain circumstances, elect to deduct such loss for the taxable year immediately preceding the taxable year in which the disaster actually occurred.

(b) *Loss subject to election.* The election provided by section 165(h) and paragraph (a) of this section applies only to a loss:

(1) Arising from a disaster resulting in a determination referred to in subparagraph (2) of this paragraph and occurring—

(i) After December 31, 1971, or

(ii) After December 31, 1961, and before January 1, 1972, and during the period following the close of a particular taxable year of the taxpayer and on or before the due date for filing the income tax return for that taxable year (determined without regard to any extension of time granted the taxpayer for filing such return);

(2) Occurring in an area subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief Act of 1974; and

(3) Constituting a loss otherwise allowable as a deduction for the year in which the loss occurred under section 165(a) and the provisions of §§1.165–1 through 1.165–10 which are applicable to such losses.

(c) *Amount of loss to which election applies.* The amount of the loss to which section 165(h) and this section apply shall be the amount of the loss sustained during the period specified in paragraph (b)(1) of this section computed in accordance with the provisions of section 165 and those provisions of §§1.165–1 through 1.165–10 which are applicable to such losses. However, for purposes of making such computation, the period specified in paragraph (b)(1) of this section shall be deemed to be a taxable year.

(d) *Scope and effect of election.* An election made pursuant to section 165(h) and this section in respect of a loss arising from a particular disaster shall apply to the entire loss sustained by the taxpayer from such disaster during the period specified in paragraph (b)(1) of this section in the area specified in paragraph (b)(2) of this section. If such an election is made, the disaster to which the election relates will be deemed to have occurred in the taxable year immediately preceding the taxable year in which the disaster actually occurred, and the loss to which the election applies will be deemed to have been sustained in such preceding taxable year.

(e) *Time and manner of making election.* An election to claim a deduction with respect to a disaster loss described in paragraph (b) of this section for the taxable year immediately preceding the taxable year in which the disaster actually occurred must be made by filing a return, an amended return, or a claim for refund clearly showing that the election provided by section 165(h) has been made. In general, the return or claim should specify the date or dates of the disaster which gave rise to the loss, and the city, town, county, and State in which the property which was damaged or destroyed was located at the time of the disaster. An election in respect of a loss arising from a particular disaster occurring after December 31, 1971, must be made on or before the later of (1) the due date for filing the income tax return (determined without regard to any extension of time granted the taxpayer for filing such return) for the taxable year in which the disaster actually occurred, or (2) the due date of filing the income tax return (determined with regard to any extension of time granted the taxpayer for filing such return) for the taxable year immediately preceding the taxableyear in which the disaster actually occurred. Such election shall be irrevocable after the later of (1) 90 days after the date on which the election was made, or (2) March 6, 1973. No revocation of such election shall be effective unless the amount of any credit or refund which resulted from such election is paid to the Internal Revenue Service within the revocation period described in the preceding sentence. However, in the case of a revocation made before receipt by the taxpayer of a refund claimed pursuant to such election, the revocation shall be effective if the refund is repaid within 30 calendar days after such receipt. An election in respect of a loss arising from a particular disaster occurring after December 31, 1961, and before January 1, 1972, must be made on or before the later of (1) the 15th day of the third month following the month in which falls the date prescribed for the filing of the income tax return (determined without regard to any extension of time granted the taxpayer for filing such return) for the taxable year immediately preceding the taxable year in which the disaster actually occurred, or (2) the due date for filing the income tax return (determined with regard to any extension of time granted the taxpayer for filing such return) for the taxable year immediately preceding the taxable year in which the disaster actually occurred. Such election shall be irrevocable after the date by which it must be made.

[T.D. 6735, 29 FR 6493, May 19, 1964, as amended by T.D. 7224, 37 FR 25928, Dec. 6, 1972; T.D. 7522, 42 FR 63411, Dec. 16, 1977]

§ 1.165–12 Denial of deduction for losses on registration-required obligations not in registered form.

(a) *In general.* Except as provided in paragraph (c) of this section, nothing in section 165(a) and the regulations thereunder, or in any other provision of law, shall be construed to provide a deduction for any loss sustained on any registration-required obligation held after December 31, 1982, unless the obligation is in registered form or the issuance of the obligation was subject to tax under section 4701. The term ‘‘registration-required obligation’’ has the meaning given to that term in section 163(f)(2), except that clause (iv) of subparagraph (A) thereof shall not apply. Therefore, although an obligation that is not in registered form is described in § 1.163–5(c)(1), the holder of such an obligation shall not be allowed a deduction for any loss sustained on such obligation unless paragraph (c) of this section applies. The term ‘‘holder’’ means the person that would be denied a loss deduction under section 165(j)(1) or denied capital gain treatment under section 1287(a). For purposes of this section, the term *United States* means the United States and its possessions within the meaning of § 1.163–5(c)(2)(iv).

(b) *Registered form*—(1) *Obligations issued after September 21, 1984.* With respect to any obligation originally issued after September 21, 1984, the term ‘‘registered form’’ has the meaning given that term in section 103(j)(3) and the regulations thereunder. Therefore, an obligation that would otherwise be in registered form is not considered to be in registered form if it can be transferred at that time or at any time until its maturity by any means not described in § 5f.103–1(c). An obligation that, as of a particular time, is not considered to be in registered form because it can be transferred by any means not described in § 5f.103–1(c) is considered to be in registered form at all times during the period beginning with a later time and ending with the maturity of the obligation in which the obligation can be transferred only by a means described in § 5f.103–1(c).

(2) *Obligations issued after December 31, 1982 and on or before September 21, 1984.* With respect to any obligation originally issued after December 31, 1982 and on or before September 21, 1984 or an obligation originally issued after September 21, 1984 pursuant to the exercise of a warrant or the conversion of a convertible obligation, which warrant or obligation (including conversion privilege) was issued after December 31, 1982 and on or before September 21, 1984, that obligation will be considered in registered form if it satisfied § 5f.163–1 or the proposed regulations provided in § 1.163–5(c) and published in the FEDERAL REGISTER on September 2, 1983 (48 FR 39953).

(c) *Registration-required obligations not in registered form which are not subject to section 165(j)(1).* Notwithstanding the fact that an obligation is a registration-required obligation that is not in registered form, the holder will not be subject to section 165(j)(1) if the holder meets the conditions of any one of the following subparagraphs (1), (2), (3), or (4) of this paragraph (c).

(1) *Persons permitted to hold in connection with the conduct of a trade or business.* (i) The holder is an underwriter, broker, dealer, bank, or other financial institution (defined in paragraph (c)(1)(iv)) that holds such obligation in connection with its trade or business conducted outside the United States; or the holder is a broker-dealer (registered under Federal or State law or exempted from registration by the provisions of such law because it is a bank) that holds such obligation for sale to customers in the ordinary course of its trade or business.

(ii) The holder must offer to sell, sell and deliver the obligation in bearer form only outside of the United States except that a holder that is a registered broker-dealer as described in paragraph (c)(1)(i) of this section may offer to sell and sell the obligation in bearer form inside the United States to a financial institution as defined in paragraph (c)(1)(iv) of this section for its own account or for the account of another financial institution or of an exempt organization as defined in section 501(c)(3).

(iii) The holder may deliver an obligation in bearer form that is offered or sold inside the United States only if the holder delivers it to a financial institution that is purchasing for its own account, or for the account of another financial institution or of an exempt organization, and the financial institution or organization that purchases the obligation for its own account or for whose account the obligation is purchased represents that it will comply with the requirements of section 165(j)(3) (A), (B), or (C). Absent actual knowledge that the representation is false, the holder may rely on a written statement provided by the financial institution or exempt organization, including a statement that is delivered in electronic form. The holder may deliver a registration-required obligation in bearer form that is offered and sold outside the United States to a person other than a financial institution only if the holder has evidence in its records that such person is not a U.S. citizen or resident and does not have actual knowledge that such evidence is false. Such evidence may include a written statement by that person, including a statement that is delivered electronically. For purposes of this paragraph (c), the term *deliver* includes a transfer of an obligation evidenced by a book entry including a book entry notation by a clearing organization evidencing transfer of the obligation from one member of the organization to another member. For purposes of this paragraph (c), the term *deliver* does not include a transfer of an obligation to the issuer or its agent for cancellation or extinguishment. The record-retention provisions in §1.1441–1(e)(4)(iii) shall apply to any statement that a holder receives pursuant to this paragraph (c)(1)(iii).

(iv) For purposes of paragraph (c) of this section, the term ‘‘financial institution’’ means a person which itself is, or more than 50 percent of the total combined voting power of all classes of whose stock entitled to vote is owned by a person which is—

(A) Engaged in the conduct of a banking, financing, or similar business within the meaning of section 954(c)(3)(B) as in effect before the Tax Reform Act of 1986, and the regulations thereunder;

(B) Engaged in business as a broker or dealer in securities;

(C) An insurance company;

(D) A person that provides pensions or other similar benefits to retired employees;

(E) Primarily engaged in the business of rendering investment advice;

(F) A regulated investment company or other mutual fund; or

(G) A finance corporation a substantial part of the business of which consists of making loans (including the acquisition of obligations under a lease which is entered into primarily as a financing transaction), acquiring accounts receivable, notes or installment obligations arising out of the sale of tangible personal property or the performing of services, or servicing debt obligations.

(2) *Persons permitted to hold obligations for their own investment account.* The holder is a financial institution holding the obligation for its own investment account that satisfies the conditions

set forth in subdivisions (i), (ii), (iii), and (iv) of his paragraph (c) (2).

(i) The holder reports on its Federal income tax return for the taxable year any interest payments received (including original issue discount includable in gross income for such taxable year) with respect to such obligation and gain or loss on the sale or other disposition of such obligation;

(ii) The holder indicates on its Federal income tax return that income, gain or loss described in paragraph (c)(2)(i) is attributable to registration-required obligations held in bearer form for its own account;

(iii) The holder of a bearer obligation that resells the obligation inside the United States resells the obligation only to another financial institution for its own account or for the account of another financial institution or exempt organization; and

(iv) The holder delivers such obligation in bearer form to any other person in accordance with paragraph (c)(1) (ii) and (iii) of this section.

(3) *Persons permitted to hold through financial institutions.* The holder is any person that purchases and holds a registration-required obligation in bearer form through a financial institution with which the holder maintains a customer, custodial or nominee relationship and such institution agrees to satisfy, and does in fact satisfy, the conditions set forth in subdivisions (i), (ii), (iii), (iv) and (v) of this paragraph (c)(3).

(i) The financial institution makes a return of information to the Internal Revenue Service with respect to any interest payments received. The financial institution must report original issue discount includable in the holder's gross income for the taxable year on any obligation so held, but only if the obligation appears in an Internal Revenue Service publication of obligations issued at an original issue discount and only in an amount determined in accordance with information contained in that publication. An information return for any interest payment shall be made on a Form 1099 for the calendar year. It shall indicate the aggregate amount of the payment received, the name, address and taxpayer identification number of the holder, and such other information as is required by the form. No return of information is required under this subdivision if the financial institution reports payments under section 6041 or 6049.

(ii) The financial institution makes a return of information on Form 1099B with respect to any disposition by the holder of such obligation. The return shall show the name, address, and taxpayer identification number of the holder of the obligation, Committee on Uniform Security Information Procedures (CUSIP), gross proceeds, sale date, and such other information as may be required by the form. No return of information is required under this subdivision if such financial institution reports with respect to the disposition under section 6045.

(iii) In the case of a bearer obligation offered for resale or resold in the United States, the financial institution may resell the obligation only to another financial institution for its own account or for the account of an exempt organization.

(iv) The financial institution covenants with the holder that the financial institution will deliver the obligation in bearer form in accordance with the requirements set forth in paragraph (c)(1) (ii) and (iii).

(v) The financial institution delivers the obligation in bearer form in accordance with paragraph (c)(1) (ii) and (iv) as if the financial institution delivering the obligation were the holder referred to in such paragraph.

(4) *Conversion of obligations into registered form.* The holder is not a person described in paragraph (c) (1), (2), or (3) of this section, and within thirty days of the date when the seller or other transferor is reasonably able to make the bearer obligation available to the holder, the holder surrenders the obligation to a transfer agent or the issuer for conversion of the obligation into registered form. If such obligation is not registered within such 30 day period, the holder shall be subject to sections 165(j) and 1287(a).

(d) *Effective date.* These regulations apply generally to obligations issued after January 20, 1987. However, a taxpayer may choose to apply the rules of § 1.165–12 with respect to an obligation issued after December 31, 1982 and on or before January 20, 1987, which obligation is held after January 20, 1987.

[T.D. 8110, 51 FR 45459, Dec. 19, 1986, as amended by T.D. 8734, 62 FR 53416, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53416, Oct. 14, 1997, §1.163–5 was amended: By adding a sentence at the end of paragraph (a); by removing the language ''(c)(1)(v)'' and adding ''(c)(1)(iv)'' in its place in paragraph (c)(1)(i); by removing paragraph (c)(1)(iii) and redesignating paragraphs (c)(1)(iv) and (c)(1)(v) as paragraphs (c)(1) (iii) and (iv); by revising paragraphs (c)(1)(ii) and newly redesignated paragraph (c)(1)(iii); and by removing the language ''(c)(1) (ii) and (iv)'' and inserting ''(c)(1) (ii) and (iii)'' in its place in paragraphs (c)(2)(iv) and (c)(3)(iv), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of the amendments to §1.165–12 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.165–12 Denial of deduction for losses on registration-required obligations not in registered form.

* * * * *

(c) * * *

(1) * * *

(ii) The holder must offer to sell, sell and deliver the obligation in bearer form only outside of the United States except that a holder that is a registered broker-dealer as described in paragraph (c)(1)(i) may offer to sell and sell the obligation in bearer form inside the United States to a financial institution as defined in paragraph (c)(1)(v) for its own account or for the account of another financial institution or exempt organization as defined in section 501(c)(3) if the transaction consists of the purchases of a block of obligations the total denominations of which are at least $1,000,000.

(iii) If a financial institution purchases an obligation in bearer form that is offered or sold inside the United States, it must agree as a condition of the purchase to provide on delivery the statement described in paragraph (c)(1)(iv).

(iv) The holder may deliver an obligation in bearer form that is offered or sold inside the United States only if the holder delivers it to a financial institution that states that it is a financial institution as defined in §1.165–12(c)(1)(v) that is purchasing for its own account or for the account of another financial institution or exempt organization, that will comply with the requirements of section 165(j)(3)(A), (B), or (C) and the regulations thereunder and the holder has no actual knowledge that the statement is false. The statement must contain the name and address of the person entitled to delivery and must be signed by such person under penalties of perjury. The holder may deliver an obligation in bearer form that is offered and sold outside the United States to a financial institution if it delivers to such person a confirmation stating that any United States taxpayer who holds this obligation in bearer form and who is not exempt under section 165(j)(3) (A), (B), or (C) and the regulations thereunder will, for purposes of the United States income tax, be denied a deduction for any loss incurred with respect to the obligation and will be denied capital gain treatment with respect to the obligation. The holder may deliver a registration-required obligation in bearer form that is offered and sold outside the United States to a person other than a financial institution only if the holder has documentary evidence as described in subdivision (iii) of A–5 of §35a.9999–4T that the person is not a United States person. For purposes of this paragraph (c), the word ''deliver'' includes the transfer of an obligation evidenced by a book entry including a book entry notation by a clearing organization evidencing transfer of the obligation from one member of the organization to another member. For purposes of this paragraph (c), the word ''deliver'' does not include a transfer of an obligation to the issuer or its agent for cancellation or extinguishment. If a holder that is a member of a clearing organization (defined in §1.163–5(c)(2)(i)(B)(*4*)) delivers an obligation to another member of the same or another clearing organization by transfer of the obligation between the clearing organization accounts of such members, the selling member shall receive the statement from the purchasing member (in the case of obligations offered or sold inside the United States) or send the confirmation to the purchasing member (in the case of obligations offered and sold outside the United States).

* * * * *

§1.165–13T Questions and answers relating to the treatment of losses on certain straddle transactions entered into before the effective date of the Economic Recovery Tax Act of 1981, under section 108 of the Tax Reform Act of 1984 (temporary).

The following questions and answers concern the treatment of losses on certain straddle transactions entered into before the effective date of the Economic Recovery Tax Act of 1981, under the Tax Reform Act of 1984 (98 Stat. 494).

Q–1 What is the scope of section 108 of the Tax Reform Act of 1984 (Act)?

A–1 Section 108 of the Act provides that in the case of any disposition of one or more positions, which were entered into before 1982 and form part of a straddle, and to which the provisions of Title V of The Economic Recovery Act of 1981 (ERTA) do not apply, any loss from such disposition shall be allowed for the taxable year of the disposition if such position is part of a transaction entered into for profit. For purposes of section 108 of the Act, the term ''straddle'' has the meaning given to such term by section 1092(c) of the Internal Revenue Code of 1954 as in effect on the day after the date of enactment of ERTA; including a straddle all the positions of which are regulated futures contracts (as defined in Q&A–6 of this section). Straddles in certain listed stock options were not covered by ERTA and are not affected by this provision.

Q–2 What transactions are considered entered into for profit?

A–2 A transaction is considered entered into for profit if the transaction is entered into for profit within the meaning of section 165(c)(2) of the Code. In this respect, section 108 of the Act restates existing law applicable to stradddle transactions. All the circumstances surrounding the transaction, including the magnitude and timing for entry into, and disposition of, the positions comprising the transaction are relevant in making the determination whether a transaction is considered entered into for profit. Moreover, in order for section 108 of the Act to apply, the transaction must have sufficient substance to be recognized for Federal income tax purposes. Thus, for example, since a ''sham'' transaction would not be recognized for tax purposes, section 108 of the Act would not apply to such a transaction.

Q–3 If a loss is disallowed in a taxable year (year 1) because the transaction was not entered into for profit, is the entire gain from the straddle occurring in a later taxable year taxed?

A–3 No. Under section 108(c) of the Act the taxpayer is allowed to offset the gain in the subsequent taxable year by the amount of loss (including expenses) disallowed in year 1.

Q–4 In what manner does the for-profit test of Q&A–2 apply to losses from straddle transactions sustained by commodities dealers and persons regularly engaged in investing in regulated futures contracts?

A–4 In general, for a loss to be allowable with respect to positions that form part of a straddle, the for-profit test of Q&A–2 must be satisfied. However, certain positions (see Q&A–6) held by a commodities dealer or person regularly engaged in investing in regulated futures contracts are rebuttably presumed to be part of a transaction entered into for profit. Thus, the for profit test is applied to commodities dealers and persons regularly engaged in investing in regulated futures contracts in light of the factors relating to the applicability and rebuttal of the profit presumption, including, for example, the nature and extent of the taxpayer's trading activities.

Q–5 Under what circumstances is the presumption considered rebutted?

A–5 All the facts and circumstances of each case are to be considered in determining if the presumption is rebutted. The following factors are significant in making this determination: (1) The level of transaction costs; (2) the extent to which the transaction results from trading patterns different from the taxpayer's regular patterns; and (3) the extent of straddle transactions having tax results disproportionate to economic consequences. Factors other than the ones described above may be taken into account in making the determination. Moreover, a determination is not to be made solely on the basis of the number of factors indicating that the presumption is rebutted.

Q–6 Does a commodities dealer or person regularly engaged in investing in regulated futures contracts qualify for the profit presumption for all transactions?

A–6 No. The presumption is only applicable to regulated futures contract transactions in property that is the subject of the person's regular trading activity. For example, a commodities dealer who regularly trades only in agricultural futures will not qualify for the presumption for a silver futures straddle transaction. For purposes of this section, the term ''regulated futures contracts'' has the meaning given to such term by section 1256(b) of the Code as in effect before the enactment of the Tax Reform Act of 1984.

Q–7 Who qualifies as a commodities dealer or as a person regularly engaged in investing in regulated futures contracts for purposes of the profit presumption?

A–7 For purposes of this section, the term ''commodities dealer'' has the meaning given to such term by section 1402(i)(2)(B) of the Code. Section 1402(i)(2)(B) defines a commodities dealer as a person who is actively engaged in trading section 1256 contracts (which includes regulated futures contracts as defined in Q&A–6) and is registered with a domestic board of trade which is designated as a contract market by the Commodity Futures Trading Commission. To determine if a person is regularly engaged in investing in regulated futures contracts all the facts and circumstances should be considered including, but not limited to, the following factors: (1) Regularity of trading at all times throughout the year; (2) the level of transaction costs; (3) substantial volume and economic consequences of trading at all times throughout the year; (4) percentage of time dedicated to commodity trading activities as compared to other activities; and (5) the person's knowledge of the regulated futures contract market.

Q–8 If a commodities dealer or a person regularly engaged in investing in regulated futures contracts participates in a syndicate, as defined in section 1256(e)(3)(B) of the Code, does the rebuttable presumption of ''entered into for profit'' apply to the transactions entered into through the syndicate?

A–8 No. A participant in a syndicate does not qualify for the rebuttable presumption of ''entered into for profit'' with respect to transactions entered into by or for the syndicate. A syndicate is defined in section 1256(e)(3)(B) of the Code as any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs (within the meaning of section 464(e)(2)).

Q–9 Will the Service continue to make the closed and completed transaction argument set forth in Rev. Rul. 77–185, 1977–1 C.B. 48, with respect to transactions covered by section 108 of the Act?

A–9 No. The closed and completed transaction argument will not be made regarding transactions subject to section 108 of the Act. In general, losses in such transactions will be allowed for the taxable year of disposition if the transaction is not viewed as a sham and satisfies the ''entered into for profit'' test described in Q&A–2. Nevertheless, for certain positions covered by section 108 of the Act, various Code sections may apply without regard to whether such position constitutes a straddle to disallow or limit the loss otherwise allowable in the year of the disposition. For example, dispositions of certain positions held by a partnership which resulted in a loss to a partner may be limited or disallowed under section 465 of 704(d).

[T.D. 7968, 49 FR 33445, Aug. 23, 1984]

§1.166–1 Bad debts.

(a) *Allowance of deduction.* Section 166 provides that, in computing taxable income under section 63, a deduction shall be allowed in respect of bad debts owed to the taxpayer. For this purpose, bad debts shall, subject to the provisions of section 166 and the regulations thereunder, be taken into account either as—

(1) A deduction in respect of debts which become worthless in whole or in part; or as

(2) A deduction for a reasonable addition to a reserve for bad debts.

(b) *Manner of selecting method.* (1) A taxpayer filing a return of income for the first taxable year for which he is entitled to a bad debt deduction may select either of the two methods prescribed by paragraph (a) of this section for treating bad debts, but such selection is subject to the approval of the district director upon examination of the return. If the method so selected is approved, it shall be used in returns for all subsequent taxable years unless the Commissioner grants permission to use the other method. A statement of facts substantiating any deduction claimed under section 166 on account of bad debts shall accompany each return of income.

(2) Taxpayers who have properly selected one of the two methods for treating bad debts under provisions of prior law corresponding to section 166 shall continue to use that method for all subsequent taxable years unless the Commissioner grants permission to use the other method.

(3)(i) For taxable years beginning after December 31, 1959, application for permission to change the method of treating bad debts shall be made in accordance with section 446(e) and paragraph (e)(3) of § 1.446–1.

(ii) For taxable years beginning before January 1, 1960, application for permission to change the method of treating bad debts shall be made at least 30 days before the close of the taxable year for which the change is effective.

(4) Nothwithstanding paragraphs (b) (1), (2), and (3) of this section, a dealer in property currently employing the accrual method of accounting and currently maintaining a reserve for bad debts under section 166(c) (which may have included guaranteed debt obligations described in section 166(f)(1)(A)) may establish a reserve for section 166(f)(1)(A) guaranteed debt obligations for a taxable year ending after October 21, 1965 under section 166(f) and § 1.166–10 by filing on or before April 17, 1986 an amended return indicating that such a reserve has been established. The establishment of such a reserve will not be considered a change in method of accounting for purposes of section 446(e). However, an election by a taxpayer to establish a reserve for bad debts under section 166(c) shall be treated as a change in method of accounting. See also § 1.166–4, relating to reserve for bad debts, and § 1.166–10, relating to reserve for guaranteed debt obligations.

(c) *Bona fide debt required.* Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A debt arising out of the receivables of an accrual method taxpayer is deemed to be an enforceable obligation for purposes of the preceding sentence to the extent that the income such debt represents have been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year. For example, a debt arising out of gambling receivables that are unenforceable under state or local law, which an accrual method taxpayer includes in income under section 61, is an enforceable obligation for purposes of this pargarph. A gift or contribution to capital shall not be considered a debt for purposes of section 166. The fact that a bad debt its not due at the time of deduction shall not of itself prevent is allowance under section 166. For the disallowance of deductions for bad debts owed by a political party, see § 1.271–1.

(d) *Amount deductible*—(1) *General rule.* Except in the case of a deduction for a reasonable addition to a reserve for bad debts, the basis for determining the amount of deduction under section 166 in respect of a bad debt shall be the same as the adjusted basis prescribed by § 1.1011–1 for determining the loss from the sale or other disposition of property. To determine the allowable deduction in the case of obligations acquired before March 1, 1913, see also paragraph (b) of § 1.1053–1.

(2) *Specific cases.* Subject to any provision of section 166 and the regulations thereunder which provides to the contrary, the following amounts are deductible as bad debts:

(i) *Notes or accounts receivable. (a)* If, in computing taxable income, a taxpayer values his notes or accounts receivable at their fair market value when received, the amount deductible as a bad debt under section 166 in respect of such receivables shall be limited to such fair market value even though it is less than their face value.

(b) A purchaser of accounts receivable which become worthless during the taxable year shall be entitled under section 166 to a deduction which is based upon the price he paid for such receivables but not upon their face value.

(ii) *Bankruptcy claim.* Only the difference between the amount received in distribution of the assets of a bankrupt and the amount of the claim may be deducted under section 166 as a bad debt.

(iii) *Claim against decedent's estate.* The excess of the amount of the claim over the amount received by a creditor of a decedent in distribution of the assets of the decedent's estate may be considered a worthless debt under section 166.

(e) *Prior inclusion in income required.* Worthless debts arising from unpaid wages, salaries, fees, rents, and similar items of taxable income shall not be allowed as a deduction under section 166 unless the income such items represent has been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year.

(f) *Recovery of bad debts.* Any amount attributable to the recovery during the taxable year of a bad debt, or of a part of a bad debt, which was allowed as a deduction from gross income in a prior taxable year shall be included in gross income for the taxable year of recovery, except to the extent that the recovery is excluded from gross income under the provisions of §1.111–1, relating to the recovery of certain items previously deducted or credited. This paragraph shall not apply, however, to a bad debt which was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts.

(g) *Worthless securities.* (1) Section 166 and the regulations thereunder do not apply to a debt which is evidenced by a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. See section 166(e). For provisions allowing the deduction of a loss resulting from the worthlessness of such a debt, see §1.165–5.

(2) The provisions of subparagraph (1) of this paragraph do not apply to any loss sustained by a bank and resulting from the worthlessness of a security described in section 165(g)(2)(C). See paragraph (a) of §1.582–1.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6996, 34 FR 835, Jan. 18, 1969; T.D. 7902, 48 FR 33260, July 21, 1983; T.D. 8071, 51 FR 2479, Jan. 17, 1986]

§1.166–2 Evidence of worthlessness.

(a) *General rule.* In determining whether a debt is worthless in whole or in part the district director will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor.

(b) *Legal action not required.* Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for purposes of the deduction under section 166.

(c) *Bankruptcy*—(1) *General rule.* Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt.

(2) *Year of deduction.* In bankruptcy cases a debt may become worthless before settlement in some instances; and in others, only when a settlement in bankruptcy has been reached. In either case, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, thereby confirming the conclusion that the debt is worthless, shall not authorize the shifting of the deduction under section 166 to such later year.

(d) *Banks and other regulated corporations*—(1) *Worthlessness presumed in year of charge-off.* If a bank or other corporation which is subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards, charges off a debt in whole or in part, either—

(i) In obedience to the specific orders of such authorities, or

(ii) In accordance with established policies of such authorities, and, upon their first audit of the bank or other corporation subsequent to the charge-off, such authorities confirm in writing that the charge-off would have been subject to such specific orders if the audit had been made on the date of the charge-off,

then the debt shall, to the extent charged off during the taxable year, be conclusively presumed to have become worthless, or worthless only in part, as the case may be, during such taxable year. But no such debt shall be so conclusively presumed to be worthless, or worthless only in part, as the case may be, if the amount so charged off is not claimed as a deduction by the taxpayer at the time of filing the return for the taxable year in which the charge-off takes place.

(2) *Evidence of worthlessness in later taxable year.* If such a bank or other corporation does not claim a deduction for such a totally or partially worthless debt in its return for the taxable year in which the charge-off takes place, but claims the deduction for a later taxable year, then the charge-off in the prior taxable year shall be deemed to have been involuntary and the deduction under section 166 shall be allowed for the taxable year for which claimed, provided that the taxpayer produces sufficient evidence to show that—

(i) The debt became wholly worthless in the later taxable year, or became recoverable only in part subsequent to the taxable year of the involuntary charge-off, as the case may be; and,

(ii) To the extent that the deduction claimed in the later taxable year for a debt partially worthless was not involuntarily charged off in prior taxable years, it was charged off in the later taxable year.

(3) *Conformity election*—(i) *Eligibility for election.* In lieu of applying paragraphs (d)(1) and (2) of this section, a bank (as defined in paragraph (d)(4)(i) of this section) that is subject to supervision by Federal authorities, or by state authorities maintaining substantially equivalent standards, may elect under this paragraph (d)(3) to use a method of accounting that establishes a conclusive presumption of worthlessness for debts, provided that the bank meets the express determination requirement of paragraph (d)(3)(iii)(D) of this section for the taxable year of the election.

(ii) *Conclusive presumption*—(A) *In general.* If a bank satisfies the express determination requirement of paragraph (d)(3)(iii)(D) of this section and elects to use the method of accounting under this paragraph (d)(3)—

(*1*) Debts charged off, in whole or in part, for regulatory purposes during a taxable year are conclusively presumed to have become worthless, or worthless only in part, as the case may be, during that year, but only if the charge-off results from a specific order of the bank's supervisory authority or corresponds to the bank's classification of the debt, in whole or in part, as a loss asset, as described in paragraph (d)(3)(ii)(C) of this section; and

(*2*) A bad debt deduction for a debt that is subject to regulatory loss classification standards is allowed for a taxable year only to the extent that the debt is conclusively presumed to have become worthless under paragraph (d)(3)(ii)(A)(*1*) of this section during that year.

(B) *Charge-off should have been made in earlier year.* The conclusive presumption that a debt is worthless in the year that it is charged off for regulatory purposes applies even if the bank's supervisory authority determines in a subsequent year that the charge-off should have been made in an earlier year. A pattern of charge-offs in the wrong year, however, may result in revocation of the bank's election by the Commissioner pursuant to paragraph (d)(3)(iv)(D) of this section.

(C) *Loss asset defined.* A debt is classified as a loss asset by a bank if the bank assigns the debt to a class that corresponds to a loss asset classification under the standards set forth in the ‘‘Uniform Agreement on the Classification of Assets and Securities Held by Banks'' (See Attachment to Comptroller of the Currency Banking Circular No. 127, Rev. 4–26–91, Comptroller of the Currency, Communications Department, Washington, DC 20219) or similar guidance issued by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve, or the Farm Credit Administration; or for institutions under the supervision of the Office of Thrift Supervision, 12 CFR 563.160(b)(3).

(iii) *Election*—(A) *In general.* An election under this paragraph (d)(3) is to be made on bank-by-bank basis and constitutes either the adoption of or a change in method of accounting, depending on the particular bank's facts. A change in method of accounting that results from the making of an election under this paragraph (d)(3) has the effects described in paragraph (d)(3)(iii)(B) of this section.

(B) *Effect of change in method of accounting.* A change in method of accounting resulting from an election under this paragraph (d)(3) does not require or permit an adjustment under section 481(a). Under this cut-off approach—

(*1*) There is no change in the §1.1011–1 adjusted basis of the bank's existing debts (as determined under the bank's former method of accounting for bad debts) as a result of the change in method of accounting;

(*2*) With respect to debts that are subject to regulatory loss classification standards and are held by the bank at the beginning of the year of change (to the extent that they have not been charged off for regulatory purposes), and with respect to debts subject to regulatory loss classification standards that are originated or acquired subsequent to the beginning of the year of change, bad debt deductions in the year of change and thereafter are determined under the method of accounting for bad debts prescribed by this paragraph (d)(3);

(*3*) With respect to debts that are not subject to regulatory loss classification standards or that have been totally charged off prior to the year of change, bad debt deductions are determined under the general rules of section 166; and

(*4*) If there was any partial charge-off of a debt in a prechange year, any portion of which was not claimed as a deduction, the deduction reflecting that partial charge-off must be taken in the first year in which there is any further charge-off of the debt for regulatory purposes.

(C) *Procedures*—(*1*) *In general.* A new bank adopts the method of accounting under this paragraph (d)(3) for any taxable year ending on or after December 31, 1991 (and for all subsequent taxable years) when it adopts its overall method of accounting for bad debts, by attaching a statement to this effect to its income tax return for that year. Any other bank makes an election for any taxable year ending on or after December 31, 1991 (and for all subsequent taxable years) by filing a completed Form 3115 (Application for Change in Accounting Method) in accordance with the rules of paragraph (d)(3)(iii)(C)(*2*) or (*3*) of this section. The statement or Form 3115 must include the name, address, and taxpayer identification number of the electing bank and contain a declaration that the express determination requirement of paragraph (d)(3)(iii)(D) of this section is satisfied for the taxable year of the election. When a Form 3115 is used, the declaration must be made in the space provided on the form for ''Other changes in method of accounting.'' The words ''ELECTION UNDER §1.166–2(d)(3)'' must be typed or legibly printed at the top of the statement or page 1 of the Form 3115.

(*2*) *First election.* The first time a bank makes this election, the statement or Form 3115 must be attached to the bank's timely filed return (taking into account extensions of time to file) for the first taxable year covered by the election. The consent of the Commissioner to make a change in method of accounting under this paragraph (d)(3) is granted, pursuant to section 446(e), to any bank that makes the election in accordance with this paragraph (d)(3)(iii)(C), provided the bank has not made a prior election under this paragraph (d)(3).

(*3*) *Subsequent elections.* The advance consent of the Commissioner is required to make any election under this paragraph (d)(3) after a previous election has been revoked pursuant to paragraph (d)(3)(iv) of this section. This consent must be requested under the procedures, terms, and conditions prescribed under the authority of section 446(e) and §1.446–1(e) for requesting a change in method of accounting.

(D) *Express determination requirement.* In connection with its most recent examination involving the bank's loan review process, the bank's supervisory authority must have made an express determination (in accordance with any applicable administrative procedure prescribed hereunder) that the bank maintains and applies loan loss classification standards that are consistent with the regulatory standards of that supervisory authority. For purposes of this paragraph (d)(3)(iii)(D), the supervisory authority of a bank is the *appropriate Federal banking agency* for the bank, as that term is defined in 12 U.S.C. 1813(q), or, in the case of an institution in the Farm Credit System, the Farm Credit Administration.

(E) *Transition period election.* For taxable years ending before completion of the first examination of the bank by its supervisory authority (as defined in paragraph (d)(3)(iii)(D) of this section) that is after October 1, 1992, and that involves the bank's loan review process, the statement or Form 3115 filed by the bank must include a declaration that the bank maintains and applies loan loss classification standards that are consistent with the regulatory standards of that supervisory authority. A bank that makes this declaration is deemed to satisfy the express determination requirement of paragraph (d)(3)(iii)(D) of this section for those years, even though an express determination has not yet been made.

(iv) *Revocation of Election*—(A) *In general.* Revocation of an election under this paragraph (d)(3) constitutes a change in method of accounting that has the effects described in paragraph (d)(3)(iv)(B) of this section. If an election under this paragraph (d)(3) has been revoked, a bank may make a subsequent election only under the provisions of paragraph (d)(3)(iii)(C)(*3*) of this section.

(B) *Effect of change in method of accounting.* A change in method of accounting resulting from revocation of an election under this paragraph (d)(3) does not require or permit an adjustment under section 481(a). Under this cut-off approach—

(*1*) There is no change in the § 1.1011–1 adjusted basis of the bank's existing debts (as determined under this paragraph (d)(3) method or any other former method of accounting used by the bank with respect to its bad debts) as a result of the change in method of accounting; and

(*2*) Bad debt deductions in the year of change and thereafter with respect to all debts held by the bank, whether in existence at the beginning of the year of change or subsequently originated or acquired, are determined under the new method of accounting.

(C) *Automatic revocation*—(*1*) *In general*— A bank's election under this paragraph (d)(3) is revoked automatically if, in connection with any examination involving the bank's loan review process by the bank's supervisory authority as defined in paragraph (d)(3)(iii)(D) of this section, the bank does not obtain the express determination required by that paragraph.

(*2*) *Year of revocation.* If a bank makes the conformity election under the transition rules of paragraph (d)(3)(iii)(E) of this section and does not obtain the express determination in connection with the first examination involving the bank's loan review process that is after October 1, 1992, the election is revoked as of the beginning of the taxable year of the election or, if later, the earliest taxable year for which tax may be assessed. In other cases in which a bank does not obtain an express determination in connection with an examination of its loan review process, the election is revoked as of the beginning of the taxable year that includes the date as of which the supervisory authority conducts the examination even if the examination is completed in the following taxable year.

(*3*) *Consent granted.* Under the Commissioner's authority in section 446(e) and § 1.446–1(e), the bank is directed to and is granted consent to change from this paragraph (3)(1) method as of the year of revocation (year of change) prescribed by paragraph (d)(3)(iv)(C)(*2*) of this section.

(*4*) *Requirements.* A bank changing its method of accounting under the automatic revocation rules of this paragraph (d)(3)(iv)(C) must attach a completed Form 3115 to its income tax return for the year of revocation prescribed by paragraph (d)(3)(iv)(C)(*2*) of this section. The words ''REVOCATION OF § 1.166–2(d)(3) ELECTION'' must be typed or legibly printed at the top of page 1 of the Form 3115. If the year of revocation is a year for which the bank has already filed its income tax return, the bank must file an amended return for that year reflecting its change in method of accounting and must attach the completed Form 3115 to that amended return. The bank also must file amended returns reflecting the new method of accounting for all subsequent taxable years for which returns have been filed and tax may be assessed.

(D) *Revocation by Commissioner.* An election under this paragraph (d)(3) may be revoked by the Commissioner as of the beginning of any taxable year for which a bank fails to follow the method of accounting prescribed by this paragraph. In addition, the Commissioner may revoke an election as of the beginning of any taxable year for which the Commissioner determines that a bank has taken charge-offs and deductions that, under all facts and circumstances existing at the time, were substantially in excess of those warranted by the exercise of reasonable business judgment in applying the regulatory standards of the bank's supervisory authority as defined in paragraph (d)(3)(III)(D) of this section.

(E) *Voluntary revocation.* A bank may apply for revocation of its election made under this paragraph (d)(3) by timely filing a completed Form 3115 for the appropriate year and obtaining the consent of the Commissioner in accordance with section 446(e) and §1.446–1(e) (including any applicable administrative procedures prescribed thereunder). The words ''REVOCATION OF §1.166–2(d)(3) ELECTION'' must be typed or legibly printed at the top of page 1 of the Form 3115. If any bank has had its election automatically revoked pursuant to paragraph (d)(3)(iv)(C) of this section and has not changed its method of accounting in accordance with the requirements of that paragraph, the Commissioner will require that any voluntary change in method of accounting under this paragraph (d)(3)(iv)(E) be implemented retroactively pursuant to the same amended return terms and conditions as are prescribed by paragraph (d)(3)(iv)(C) of this section.

(4) *Definitions.* For purposes of this paragraph (d)—

(i) *Bank.* The term *bank* has the meaning assigned to it by section 581. The term *bank* also includes any corporation that would be a bank within the meaning of section 581 except for the fact that it is a foreign corporation, but this paragraph (d) applies only with respect to loans the interest on which is effectively connected with the conduct of a banking business within the United States. In addition, the term *bank* includes a Farm Credit System institution that is subject to supervision by the Farm Credit Administration.

(ii) *Charge-off.* For banks regulated by the Office of Thrift Supervision, the term *charge-off* includes the establishment of specific allowances for loan losses in the amount of 100 percent of the portion of the debt classified as loss.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7254, 38 FR 2418, Jan. 26, 1973; T.D. 8396, 57 FR 6294, Feb. 24, 1992; T.D. 8441, 57 FR 45569, Oct. 2, 1992; T.D. 8492, 58 FR 53658, Oct. 18, 1993]

§1.166–3 Partial or total worthlessness.

(a) *Partial worthlessness*—(1) *Applicable to specific debts only.* A deduction under section 166(a)(2) on account of partially worthless debts shall be allowed with respect to specific debts only.

(2) *Charge-off required.* (i) If, from all the surrounding and attending circumstances, the district director is satisfied that a debt is partially worthless, the amount which has become worthless shall be allowed as a deduction under section 166(a)(2) but only to the extent charged off during the taxable year.

(ii) If a taxpayer claims a deduction for a part of a debt for the taxable year within which that part of the debt is charged off and the deduction is disallowed for that taxable year, then, in a case where the debt becomes partially worthless after the close of that taxable year, a deduction under section 166(a)(2) shall be allowed for a subsequent taxable year but not in excess of the amount charged off in the prior taxable year plus any amount charged off in the subsequent taxable year. In such instance, the charge-off in the prior taxable year shall, if consistently maintained as such, be sufficient to that extent to meet the charge-off requirement of section 166(a)(2) with respect to the subsequent taxable year.

(iii) Before a taxpayer may deduct a debt in part, he must be able to demonstrate to the satisfaction of the district director the amount thereof which is worthless and the part thereof which has been charged off.

(3) *Significantly modified debt*—(i) *Deemed charge-off.* If a significant modification of a debt instrument (within the meaning of §1.1001–3) during a taxable year results in the recognition of gain by a taxpayer under §1.1001–1(a), and if the requirements of paragraph (a)(3)(ii) of this section are met, there is a deemed charge-off of the debt during that taxable year in the amount specified in paragraph (a)(3)(iii) of this section.

(ii) *Requirements for deemed charge-off.* A debt is deemed to have been charged off only if—

(A) The taxpayer (or, in the case of a debt that constitutes transferred basis property within the meaning of section 7701(a)(43), a transferor taxpayer) has claimed a deduction for partial worthlessness of the debt in any prior taxable year; and

(B) Each prior charge-off and deduction for partial worthlessness satisfied the requirements of paragraphs (a) (1) and (2) of this section.

(iii) *Amount of deemed charge-off.* The amount of the deemed charge-off, if any, is the amount by which the tax basis of the debt exceeds the greater of the fair market value of the debt or the amount of the debt recorded on the taxpayer's books and records reduced as appropriate for a specific allowance for loan losses. The amount of the deemed charge-off, however, may not exceed the amount of recognized gain described in paragraph (a)(3)(i) of this section.

(iv) *Effective date.* This paragraph (a)(3) applies to significant modifications of debt instruments occurring on or after September 23, 1996.

(b) *Total worthlessness.* If a debt becomes wholly worthless during the taxable year, the amount thereof which has not been allowed as a deduction from gross income for any prior taxable year shall be allowed as a deduction for the current taxable year.

[T.D. 6500, 25 FR 11402, Nov. 29, 1960, as amended by T.D. 8763, 63 FR 4396, Jan. 29, 1998]

§1.166–4 Reserve for bad debts.

(a) *Allowance of deduction.* A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of §1.166–1, adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items. This paragraph applies both to bad debts owed to the taxpayer and to bad debts arising out of section 166(f)(1)(A) guaranteed debt obligations. If a reserve is maintained for bad debts arising out of section 166(f)(1)(A) guaranteed debt obligations, then a separate reserve must also be maintained for all other debt obligations of the taxpayer in the same trade or business, if any. A taxpayer may not maintain a reserve for bad debts arising out of section 166(f)(1)(A) guaranteed debt obligations if with respect to direct debt obligations in the same trade or business the taxpayer takes deductions when the debts become worthless in whole or in part rather than maintaining a reserve for such obligations. See §1.166–10 for rules concerning section 166(f)(1)(A) guaranteed debt obligations.

(b) *Reasonableness of addition to reserve*—(1) *Relevant factors.* What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

(2) *Correction of errors in prior estimates.* In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated

at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year.

(c) *Statement required.* A taxpayer using the reserve method shall file with his return a statement showing—

(1) The volume of his charge sales or other business transactions for the taxable year and the percentage of the reserve to such amount;

(2) The total amount of notes and accounts receivable at the beginning and close of the taxable year;

(3) The amount of the debts which have become wholly or partially worthless and have been charged against the reserve account; and

(4) The computation of the addition to the reserve for bad debts.

(d) *Special rules applicable to financial institutions.* (1) For special rules for the addition to the bad debt reserves of certain banks, see §§1.585–1 through 1.585–3.

(2) For special rules for the addition to the bad debt reserves of small business investment companies and business development corporations, see §§1.586–1 and 1.586–2.

(3) For special rules for the addition to the bad debts reserves of certain mutual savings banks, domestic building and loan associations, and cooperative banks, see §§1.593–1 through 1.593–11.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6728, 29 FR 5855, May 5, 1964; T.D. 7444, 41 FR 53481, Dec. 7, 1976; T.D. 8071, 51 FR 2479, Jan. 17, 1986]

§1.166–5 Nonbusiness debts.

(a) *Allowance of deduction as capital loss.* (1) The loss resulting from any nonbusiness debt's becoming partially or wholly worthless within the taxable year shall not be allowed as a deduction under either section 166(a) or section 166(c) in determining the taxable income of a taxpayer other than a corporation. See section 166(d)(1)(A).

(2) If, in the case of a taxpayer other than a corporation, a nonbusiness debt becomes wholly worthless within the taxable year, the loss resulting therefrom shall be treated as a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). Such a loss is subject to the limitations provided in section 1211, relating to the limitation on capital losses, and section 1212, relating to the capital loss carryover, and in the regulations under those sections. A loss on a nonbusiness debt shall be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a nonbusiness debt which is recoverable in part during the taxable year.

(b) *Nonbusiness debt defined.* For purposes of section 166 and this section, a nonbusiness debt is any debt other than—

(1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or

(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. For purposes of section 166 and this section, a nonbusiness debt does not include a debt described in section 165(g)(2)(C).

See § 1.165–5, relating to losses on worthless securities.

(c) *Guaranty of obligations.* For provisions treating a loss sustained by a guarantor of obligations as a loss resulting from the worthlessness of a debt, see §§ 1.166–8 and 1.166–9.

(d) *Examples.* The application of this section may be illustrated by the following examples involving a case where A, an individual who is engaged in the grocery business and who makes his return on the basis of the calendar year, extends credit to B in 1955 on an open account:

Example (1). In 1956 A sells the business but retains the claim against B. The claim becomes worthless in A's hands in 1957. A's loss is not controlled by the nonbusiness debt provisions, since the original consideration has been advanced by A in his trade or business.

Example (2). In 1956 A sells the business to C but sells the claim against B to the taxpayer, D. The claim becomes worthless in D's hands in 1957. During 1956 and 1957, D is not engaged in any trade or business. D's loss is controlled by the nonbusiness debt provisions even though the original consideration has been advanced by A in his trade or business, since the debt has not been created or acquired in connection with a trade or business of D and since in 1957 D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such claim is a proximate result.

Example (3). In 1956 A dies, leaving the business, including the accounts receivable, to his son, C, the taxpayer. The claim against B becomes worthless in C's hands in 1957. C's loss is not controlled by the nonbusiness debt provisions. While C does not advance any consideration for the claim, or create or acquire it in connection with his trade or business, the loss is sustained as a proximate incident to the conduct of the trade or business in which he is engaged at the time the debt becomes worthless.

Example (4). In 1956 A dies, leaving the business to his son, C, but leaving the claim against B to his son, D, the taxpayer. The claim against B becomes worthless in D's hands in 1957. During 1956 and 1957, D is not engaged in any trade or business. D's loss is controlled by the nonbusiness debt provisions even though the original consideration has been advanced by A in his trade or business, since the debt has not been created or acquired in connection with a trade or business of D and since in 1957 D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such claim is a proximate result.

Example (5). In 1956 A dies; and, while his executor, C, is carrying on the business, the claim against B becomes worthless in 1957. The loss sustained by A's estate is not controlled by the nonbusiness debt provisions. While C does not advance any consideration for the claim on behalf of the estate, or create or acquire it in connection with a trade or business in which the estate is engaged, the loss is sustained as a proximate incident to the conduct of the trade or business in which the estate is engaged at the time the debt becomes worthless.

Example (6). In 1956, A, in liquidating the business, attempts to collect the claim against B but finds that it has become worthless. A's loss is not controlled by the nonbusiness debt provisions, since the original consideration has been advanced by A in his trade or business and since a loss incurred in liquidating a trade or business is a proximate incident to the conduct thereof.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7657, 44 FR 68464, Nov. 29, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.166–6 Sale of mortgaged or pledged property.

(a) *Deficiency deductible as bad debt*—(1) *Principal amount.* If mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the portion of the indebtedness remaining unsatisfied after the sale is wholly or partially uncollectible, the mortgagee or pledgee may deduct such amount under section 166(a) (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it becomes wholly worthless or is charged off as partially worthless. See § 1.166–3.

(2) *Accrued interest.* Accrued interest may be included as part of the deduction allowable under this paragraph, but only if it has previously been returned as income.

(b) *Realization of gain or loss*—(1) *Determination of amount.* If, in the case of a sale described in paragraph (a) of this section, the creditor buys in the mortgaged or pledged property, loss or gain is also realized, measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by the creditor) and the fair market value of the property.

(2) *Fair market value defined.* The fair market value of the property for this purpose shall, in the absence of clear and convincing proof to the contrary, be presumed to be the amount for which it is bid in by the taxpayer.

(c) *Basis of property purchased.* If the creditor subsequently sells the property so acquired, the basis for determining gain or loss upon the subsequent sale is the fair market value of the property at the date of its acquisition by the creditor.

(d) *Special rules applicable to certain banking organizations.* For special rules relating to the treatment of mortgaged or pledged property by certain mutual savings banks, domestic building and loan associations, and cooperative banks, see section 595 and the regulations thereunder.

(e) *Special rules applicable to certain reacquisitions of real property.* Notwithstanding this section, special rules apply for taxable years beginning after September 2, 1964 (and for certain taxable years beginning after December 31, 1957), to the gain or loss on certain reacquisitions of real property, to indebtedness remaining unsatisfied as a result of such reacquisitions, and to the basis of the reacquired real property. See §§1.1038–1 through 1.1038–3.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6814, 30 FR 4472, Apr. 7, 1965, T.D. 6916, 32 FR 5923, Apr. 13, 1967]

§1.166–7 Worthless bonds issued by an individual.

(a) *Allowance of deduction.* A bond or other similar obligation issued by an individual, if it becomes worthless in whole or in part, is subject to the bad debt provisions of section 166. The loss from the worthlessness of any such bond or obligation is deductible in accordance with section 166(a), unless such bond or obligation is a nonbusiness debt as defined in section 166(d)(2). If the bond or obligation is a nonbusiness debt, it is subject to section 166(d) and §1.166–5.

(b) *Decline in market value.* A taxpayer possessing debts evidenced by bonds or other similar obligations issued by an individual shall not be allowed any deduction under section 166 on account of mere market fluctuation in the value of such obligations.

(c) *Worthless bonds issued by corporation.* For provisions allowing the deduction under section 165(a) of the loss sustained upon the worthlessness of any bond or similar obligation issued by a corporation or a government, see §1.165–5.

(d) *Application to inventories.* This section does not apply to any loss upon the worthlessness of any bond or similar obligation reflected in inventories required to be taken by a dealer in securities under section 471. See §1.471–5.

§1.166–8 Losses of guarantors, endorsers, and indemnitors incurred on agreements made before January 1, 1976.

(a) *Noncorporate obligations*—(1) *Deductible as bad debt.* A payment during the taxable year by a taxpayer other than a corporation in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of an obligation issued by a person other than a corporation shall, for purposes of section 166 and the regulations thereunder, be treated as a debt's becoming worthless within the taxable year, if—

(i) The proceeds of the obligation so issued have been used in the trade or business of the borrower, and

(ii) The borrower's obligation to the person to whom the taxpayer's payment is made is worthless at the time of payment except for the existence of the guaranty, endorsement, or indemnity, whether or not such obligation has in fact become worthless within the taxable year in which payment is made.

(2) *Nonbusiness debt rule not applicable.* If a payment is treated as a loss in accordance with the provisions of subparagraph (1) of this paragraph, section 166(d), relating to the special rule for losses sustained on the worthlessness of a nonbusiness debt, shall not apply. Accordingly, in each instance the loss shall be deducted under section 166(a)(1) as a wholly worthless debt even though there has been a discharge of only a part of the taxpayer's obligation. Thus, if the taxpayer makes a payment during the taxable year in discharge of only part of his obligation as a guarantor, endorser, or

indemnitor, he may treat such payment under section 166(a)(1) as a debt's becoming wholly worthless within the taxable year, provided that he can establish that such part of the borrower's obligation to the person to whom the taxpayer's payment is made is worthless at the time of payment and the conditions of subparagraph (1) of this paragraph have otherwise been satisfied.

(3) *Other applicable provisions.* Other provisions of the internal revenue laws relating to bad debts, such as section 111, relating to the recovery of bad debts, shall be deemed to apply to any payment which, under the provisions of this paragraph, is treated as a bad debt. If the requirements of section 166(f) are not met, any loss sustained by a guarantor, endorser, or indemnitor upon the worthlessness of the debtor's obligation shall be treated under the provisions of law applicable thereto. See, for example, paragraph (b) of this section.

(b) *Corporate obligations.* The loss sustained during the taxable year by a taxpayer other than a corporation in discharge of all of his obligation as a guarantor of an obligation issued by a corporation shall be treated, in accordance with section 166(d) and the regulations thereunder, as a loss sustained on the worthlessness of a nonbusiness debt if the debt created in the guarantor's favor as a result of the payment does not come within the exceptions prescribed by section 166(d)(2) (A) or (B). See paragraph (a)(2) of § 1.166–5.

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

Example (1). During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of B, an individual, to the X Bank, the proceeds of the obligation being used in B's business. B defaults on his obligation in 1956. A makes payment to the X Bank during 1957 in discharge of his entire obligation as a guarantor, the obligation of B to the X Bank being wholly worthless. For his taxable year 1957, A is entitled to a deduction under section 166(a)(1) as a result of his payment during that year.

Example (2). During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of B, an individual, to the X Bank, the proceeds of the obligation being used in B's business. In 1956, B pays a part of his obligation to the X Bank but defaults on the remaining part. In 1957, A makes payment to the X Bank, in discharge of part of his obligation as a guarantor, of the remaining unpaid part of B's obligation to the bank, such part of B's obligation then being worthless. For his taxable year 1957, A is entitled to a deduction under section 166(a) (1) as a result of his payment of the remaining unpaid part of B's obligation.

Example (3). During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of B, an individual, to the X Bank, the proceeds of the obligation being used for B's personal use. B defaults on his obligation in 1956. A makes payment to the X Bank during 1957 in discharge of his entire obligation as a guarantor, the obligation of B to X Bank being wholly worthless. A may not apply the benefit of section 166(f) to his loss, since the proceeds of B's obligation have not been used in B's trade or business.

Example (4). During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of Y Corporation to the X Bank, the proceeds of the obligation being used in Y Corporation's business. Y Corporation defaults on its obligation in 1956. A makes payment to the X Bank during 1957 in discharge of his entire obligation as a guarantor, the obligation of Y Corporation to the X Bank being wholly worthless. At no time during 1955 or 1957 is A engaged in a trade or business. For his taxable year 1957, A is entitled to deduct a capital loss in accordance with the provisions of section 166(d) and paragraph (a) (2) of § 1.166–5. He may not apply the benefit of section 166(f) to his loss, since his payment is in discharge of an obligation issued by a corporation.

(d) *Effective date.* This section applies only to losses, regardless of the taxable year in which incurred, on agreements made before January 1, 1976.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7657, 44 FR 68464, Nov. 29, 1979]

§ 1.166–9 Losses of guarantors, endorsers, and indemnitors incurred, on agreements made after December 31, 1975, in taxable years beginning after such date.

(a) *Payment treated as worthless business debt.* This paragraph applies to taxpayers who, after December 31, 1975, enter into an agreement in the course of their trade or business to act as (or in a manner essentially equivalent to) a guarantor, endorser, or indemnitor of (or other secondary obligor upon) a debt obligation. Subject to the provisions of paragraphs (c), (d), and (e) of this section, a payment of principal or interest made during a taxable year beginning after December 31, 1975, by the taxpayer in discharge of part or all of the taxpayer's obligation as a guarantor, endorser, or idemnitor is treated as a business debt becoming worthless in the taxable year in which the payment is made or in the taxable year described in paragraph (e)(2) of this section. Neither section 163 (relating to interest) nor section 165 (relating to losses) shall apply with respect to such a payment.

(b) *Payment treated as worthless nonbusiness debt.* This paragraph applies to taxpayers (other than corporations) who, after December 31, 1975, enter into a transaction for profit, but not in the course of their trade or business, to act as (or in a manner essentially equivalent to) a guarantor, endorser, or indemnitor of (or other secondary obligor upon) a debt obligation. Subject to the provisions of paragraphs (c), (d), and (e) of this section, a payment of principal or interest made during a taxable year beginning after December 31, 1975, by the taxpayer in discharge of part or all of the taxpayer's obligation as a guarantor, endorser, or indemnitor is treated as a worthless nonbusiness debt in the taxable year in which the payment is made or in the taxable year described in paragraph (e)(2) of this section. Neither section 163 nor section 165 shall apply with respect to such a payment.

(c) *Obligations issued by corporations.* No treatment as a worthless debt is allowed with respect to a payment made by the taxpayer in discharge of part or all of the taxpayer's obligation as a guarantor, endorser, or indemnitor of an obligation issued by a corporation if, on the basis of the facts and circumstances at the time the obligation was entered into, the payment constitutes a contribution to capital by a shareholder. The rule of this paragraph (c) applies to payments whenever made (see paragraph (f) of this section).

(d) *Certain payments treated as worthless debts.* A payment in discharge of part or all of taxpayer's agreement to act as guarantor, endorser, or indemnitor of an obligation is to be treated as a worthless debt only if—

(1) The agreement was entered into in the course of the taxpayer's trade or business or a transaction for profit;

(2) There was an enforceable legal duty upon the taxpayer to make the payment (except that legal action need not have been brought against the taxpayer); and

(3) The agreement was entered into before the obligation became worthless (or partially worthless in the case of an agreement entered into in the course of the taxpayer's trade or business). See §§1.166–2 and 1.166–3 for rules on worthless and partially worthless debts. For purposes of this paragraph (d)(3), an agreement is considered as entered into before the obligation became worthless (or partially worthless) if there was a reasonable expectation on the part of the taxpayer at the time the agreement was entered into that the taxpayer would not be called upon to pay the debt (subject to such agreement) without full reimbursement from the issuer of the obligation.

(e) *Special rules*—(1) *Reasonable consideration required.* Treatment as a worthless debt of a payment made by a taxpayer in discharge of part or all of the taxpayer's agreement to act as a guarantor, endorser, or indemnitor of an obligation is allowed only if the taxpayer demonstrates that reasonable consideration was received for entering into the agreement. For purposes of this paragraph (e)(1), reasonable consideration is not limited to direct consideration in the form of cash or property. Thus, where a taxpayer can demonstrate that the agreement was given without direct consideration in the form of cash or property but in accordance with normal business practice or for a good faith business purpose, worthless debt treatment is allowed with respect to a payment in discharge of part or all of the agreement if the conditions of this section are met. However, consideration received from a taxpayer's spouse or any individual listed in section 152(a) must be direct consideration in the form of cash or property.

(2) *Right of subrogation.* With respect to a payment made by a taxpayer in

discharge of part or all of the taxpayer's agreement to act as a guarantor, endorser, or indemnitor where the agreement provides for a right of subrogation or other similar right against the issuer, treatment as a worthless debt is not allowed until the taxable year in which the right of subrogation or other similar right becomes totally worthless (or partially worthless in the case of an agreement which arose in the course of the taxpayer's trade or business).

(3) *Other applicable provisions.* Unless inconsistent with this section, other Internal Revenue laws concerning worthless debts, such as section 111 relating to the recovery of bad debts, apply to any payment which, under the provisions of this section, is treated as giving rise to a worthless debt.

(4) *Taxpayer defined.* For purposes of this section, except as otherwise provided, the term ''taxpayer'' means any taxpayer and includes individuals, corporations, partnerships, trusts and estates.

(f) *Effective date.* This section applies to losses incurred on agreements made after December 31, 1975, in taxable years beginning after such date. However, paragraph (c) of this section also applies to payments, regardless of the taxable year in which made, under agreements made before January 1, 1976.

[T.D. 7657, 44 FR 68465, Nov. 29, 1979, as amended by T.D. 7920, 48 FR 50712, Nov. 3, 1983]

§ 1.166–10 Reserve for guaranteed debt obligations.

(a) *Definitions.* The following provisions apply for purposes of this section and section 166(f):

(1) *Dealer in property.* A dealer in property is a person who regularly sells property in the ordinary course of the person's trade or business.

(2) *Guaranteed debt obligation.* A guaranteed debt obligation is a legal duty of one person as a guarantor, endorser or indemnitor of a second person to pay a third person. It does not include duties based solely on moral or good public relations considerations that are not legally binding. A guaranteed debt obligation typically arises where a seller receives in payment for property or services the debt obligation of a purchaser and sells that obligation to a third party with recourse. However, a guaranteed debt obligation also may arise out of a sale in respect of which there is no direct debtor-creditor relationship between the debtor purchaser and the seller. For example, it arises where a purchaser borrows money from a third party to make payment to the seller and the seller guarantees the payment of the purchaser's debt. Generally, debt obligations which are sold without recourse do not result in any obligation of the seller as a guarantor, endorser, or indemnitor. However, there are certain without-recourse transactions which may give rise to a seller's liability as a guarantor or indemnitor. For example, such a liability may arise where a holder of a debt obligation holds money or other property of a seller which the holder may apply, without seeking permission of the seller, against any uncollectible debt obligations transferred to the holder by the seller without recourse, or where the seller is under a legal obligation to reacquire the real or tangible personal property from the holder of the debt obligation who repossessed property in satisfaction of the debt obligations.

(3) *Real or tangible personal property.* Real or tangible personal property generally does not include other forms of property, such as securities. However, if the sale of other property is related to the sale of actual real or tangible personal property, the other property will be considered to be real or tangible personal property. In order for the sale of other property to be related, it must be—

(i) Incidental to the sale of the actual real or tangible personal property; and

(ii) Made under an agreement, entered into at the same time as the sale of actual real or tangible personal property, between the dealer in that property and the customer with respect to that property.

The other property may be charged for as a part of, or in addition to, the sales price of the actual real or tangible personal property. If the value of the other property is not greater than 20 percent of the total sales price, including the value of all related services other than financing services, the sale of the other property is related to the sale of actual real or tangible personal property.

(4) *Related services.* In the case of a sale of both property and services a determination must be made as to whether the services are related to the property. Related services include only those services which are—

(i) Incidental to the sale of the real or tangible personal property; and

(ii) To be performed under an agreement, entered into at the same time as the sale of the property, between the dealer in property and the customer with respect to the property.

Delivery, financing installation. maintenance, repair, or instructional services generally qualify as related services. The services may be charged for as a part of, or in addition to, the sales price of the property. Where the value of all services other than financing services is not greater than 20 percent of the total of the sales price of the property, including the value of all the services other than financing services, all of the services are considered to be incidental to the sale of the property. Where the value of the services is greater than 20 percent, the determination as to whether a service is a related service in a particular case is to be made on the basis of all relevant facts and circumstances.

(5) *Examples.* The following examples apply to paragraph (a)(4) of this section:

Example (1). A. a dealer in television sets sells a television set to B, his customer. If at the time of the sale A, for a separate charge which is added to the sales price of the set and which is not greater than 20 percent of the total sales price, provides a 3-year service contract on only that television set, the service contract is a related service agreement. However, if A does not sell the service contract to B contemporaneously with the sale of the television set, as would be the case if the service agreement were entered into after the sale of the set were completed, or if the service contract includes services for a television set in addition to the one then sold by A to B, the service contract is not an agreement for a related service.

Example (2). C, an automobile dealer, at the time of the sale by C of an automobile to D, agrees to made available to D driving instructions furnished by the M driving school, the cost of which is included in the sale price of the automobile and is not greater than 20 percent of the total sales price. C also agrees to pay M for the driving instructions furnished to D. Since C's agreement with D to make available driving instructions is incidental to the sale of the automobile, is made contemporaneously with the sale, and is charged for as part of the sales price of the automobile, it is an agreement for a related service. In contrast, however, because M's agreement with C is not an agreement between the dealer in property and the customer, M's agreement with C to provide driving instructions to C's customers is not an agreement for a related service.

(b) *Incorporation of section 166(c) rules.* A reserve for section 166(f)(1)(A) guaranteed debt obligations must be established and maintained under the rules applicable to the reserve for bad debts under section 166(c) (with the exception of the statement requirement under §1.166–4 (c)). For example, the rules in §1.166–4(b), relating to what constitutes a reasonable addition to a reserve for bad debts and to correction of errors in prior estimates, apply to a reserve for section 166(f)(1)(A) guaranteed debt obligations as well.

(c) *Special requirements.* Any reserve for section 166(f)(1)(A) guaranteed debt obligations must be established and maintained separately from any reserve for other debt obligations. In addition, a taxpayer who charges off direct debts when they become worthless in whole or in part rather than maintaining a reserve for such obligations may not maintain a reserve for section 166(f)(1)(A) guaranteed debt obligations in the same trade or business.

(d) *Requirement of statement.* A taxpayer who uses the reserve method of treating section 166(f)(1)(A) guaranteed debt obligations must attach to his return for each taxable year, returns for which are filed after April 17, 1986, and for each trade or business for which the reserve is maintained a statement showing—

(1) The total amount of these obligations at the beginning of the taxable year;

(2) The total amount of these obligations incurred during the taxable year;

(3) The amount of the initial balance of the suspense account, if any, established with respect to these obligations;

(4) The balance of the suspense account, if any, at the beginning of the taxable year,

(5) The adjustment, if any, to that account;

(6) The adjusted balance, if any, at the close of the taxable year;

(7) The reconciliation of the beginning and closing balances of the reserve for these obligations and the computation of the addition to the reserve; and

(8) The taxable year for which the reserve for these obligations was established.

(e) *Computation of opening balance*—(1) *In general.* The opening balance of a reserve for section 166(f)(1)(A) guaranteed debt obligations established for the first taxable year for which a taxpayer maintains such a reserve shall be determined as if the taxpayer had maintained such a reserve for the taxable years preceding that taxable year. The amount of the opening balance may be determined under the following formula:

$$OB = CG \times \frac{SNL}{SG}$$

where—

OB=the opening balance at the beginning of the first taxable year

CG=the amount of these obligations at the close of the last preceding taxable year

SG=the sum of the amounts of these obligations at the close of the five preceding taxable years

SNL=the sum of the amounts of net losses arising from these obligations for the five preceding taxable years

(2) *Example.* The following example applies to paragraph (e)(1) of this section.

Example. For 1977, A, a dealer in automobiles who uses the calendar year as the taxable year, adopts in accordance with this section the reserve method of treating section 166(f)(1)(A) guaranteed debt obligations. A's first year in business as an automobile dealer is 1973. For 1972, 1973, 1974, 1975, and 1976, A's records disclose the following information with respect to these obligations:

Year	Obligations outstanding at close of year	Gross losses from these obligations	Recoveries from these obligations	Net losses from these obligations
1972	$0	$0	$0	$0
1973	780,000	9,700	1,000	8,700
1974	795,000	8,900	1,050	7,850
1975	850,000	8,850	850	8,000
1976	820,000	8,300	1,400	7,900
Total ...	3,245,000	36,750	4,300	32,450

The opening balance for 1977 of A's reserve for these obligations is $8,200, determined as follows:

$$\$8{,}200 = \$820{,}000 \times \frac{\$32{,}450}{\$3{,}245{,}000}$$

(3) *More appropriate balance.* A taxpayer may select a balance other than the one produced under paragraph (e)(1) of this section if it is more appropriate, based upon the taxpayer's actual experience, and in the event the taxpayer's return is examined, if the balance is approved by the district director.

(4) *No losses in the five preceding taxable years.* If a taxpayer is in the taxpayer's first taxable year of a particular trade or business, or if the taxpayer has no losses arising from section 166(f)(1)(A) guaranteed debt obligations in a particular trade or business for any other reason in the five preceding taxable years, then the taxpayer's opening balance is zero for that particular trade or business.

(5) *Where reserve method was used before October 22, 1965.* If for a taxable year ending before October 22, 1965, the taxpayer maintained a reserve for bad debts under section 166(c) which included guaranteed debt obligations described in section 166(f)(1)(A), and if the taxpayer is allowed a deduction referred to in paragraph (g)(2) of this section on account of those obligations, the amount of the opening balance of the reserve for section 166(f)(1)(A) guaranteed debt obligations for the taxpayer's first taxable year ending after October 21, 1965, shall be an amount equal to that portion of the section 166(c) reserve at the close of the last taxable year which is attributable to those debt obligations. The amount of the balance of the section 166(c) reserve for the taxable year shall be reduced by the amount of the opening balance of the reserve for those guaranteed debt obligations.

(f) *Suspense account*—(1) *Zero opening balance cases.* No suspense account shall be maintained if the opening balance of the reserve for section 166(f)(1)(A) guaranteed debt obligations under section 166(f)(3) is zero

(2) *Example.* The following example applies to section 166(f)(4)(B), relating to adjustments to the suspense account:

Example. In 1977, A, an individual who operates an appliance store and uses the calendar year as the taxable year, adopts the reserve method of treating section 166(f)(1)(A) guaranteed debt obligations. The initial balance of A's suspense account is $8,200. At the close of 1977, 1978, 1979, and 1980, the balance of A's reserve for these obligations is $8,400, $8,250, $8,150, and $8,175, respectively, after making the addition to the reserve for each year. The adjustments under section 166(f)(4)(B) to the suspense account at the close of each of the years involved are as follows:

(1) Taxable year	1977	1978	1979	1980
(2) Closing reserve account balance	$8,400	$8,250	$8,150	$8,175
(3) Opening suspense account balance	8,200	8,200	8,200	8,150
(4) Line (2) less line (3)	200	50	(50	25
(5) Adjustment to suspense account balance	0	0	(50	25
(6) Closing suspense account balance (line 3 plus line 5)	8,200	8,200	8,150	8,175

(g) *Effective date*—(1) *In general.* This section is generally effective for taxable years ending after October 21, 1965.

(2) *Transitional rule.* Section 2(b) of the Act of November 2, 1966 (Pub. L. 89–722, 80 Stat. 1151) allows additions to section 166(c) bad debt reserves in earlier taxable years on account of section 166(f)(1)(A) guaranteed debt obligations to be deducted for those earlier taxable years. Paragraphs (c), (d), (e), and (f) of this section do not apply in determining whether a deduction is allowed under section 2(b) of the Act. See Rev. Rul. 68–313 (1968–1C.B. 75) for rules relating to that deduction.

[T.D. 8071, 51 FR 2479, Jan. 17, 1986; 51 FR 9787, Mar. 21, 1986]

§ 1.167(a)–1 Depreciation in general.

(a) *Reasonable allowance.* Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(g) and § 1.167(g)–1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. However, see section 167(f) and § 1.167(f)–1 for rules which permit a reduction in the amount of salvage value to be taken into account for certain personal property acquired after October 16, 1962. See also paragraph (c) of this section for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value. See section 179 and § 1.179–1 for a further description of the term ''reasonable allowance.''

(b) *Useful life.* For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)–1. If a taxpayer claims an investment credit with respect to an asset for a taxable year preceding the taxable year in which the asset is considered as placed in service under § 1.167(a)–10(b) or § 1.167(a)–11(e), the useful life of the asset under this paragraph shall be the same useful life assigned to the asset under § 1.46–3(e).

(c) *Salvage.* (1) Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section, salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value.Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, paragraph (a) of § 1.167(b)–2 for the treatment of salvage under the declining balance method, and § 1.179–1 for the treatment of salvage in computing the additional first-year depreciation allowance. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value, see §§ 1.167(b)–1, 1.167(b)–2, and 1.167(b)–3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

(2) For taxable years beginning after December 31, 1961, and ending after October 16, 1962, see section 167(f) and § 1.167(f)–1 for rules applicable to the reduction of salvage value taken into account for certain personal property acquired after October 16, 1962.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3653, Mar. 24, 1964; T.D. 7203, 37 FR 17133, Aug. 25, 1972]

§ 1.167(a)–2 Tangible property.

The depreciation allowance in the case of tangible property applies only to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. The allowance does not apply to inventories or stock in trade, or to land apart from the improvements or physical development added to it. The allowance does not apply to natural resources which are subject to the allowance for depletion provided in section 611. No deduction for depreciation shall be allowed on automobiles or other vehicles used solely for pleasure, on a building used by the taxpayer solely as his residence, or on furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business, may be depreciated.

§1.167(a)–3 Intangibles.

If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill. For rules with respect to organizational expenditures, see section 248 and the regulations thereunder. For rules with respect to trademark and trade name expenditures, see section 177 and the regulations thereunder.

§1.167(a)–4 Leased property.

Capital expenditures made by a lessee for the erection of buildings or the construction of other permanent improvements on leased property are recoverable through allowances for depreciation or amortization. If the useful life of such improvements in the hands of the taxpayer is equal to or shorter than the remaining period of the lease, the allowances shall take the form of depreciation under section 167. See §§1.167(b)–0, 1.167(b)–1, 1.167(b)–2, 1.167(b)–3, and 1.167(b)–4 for methods of computing such depreciation allowances. If, on the other hand, the estimated useful life of such property in the hands of the taxpayer, determined without regard to the terms of the lease, would be longer than the remaining period of such lease, the allowances shall take the form of annual deductions from gross income in an amount equal to the unrecovered cost of such capital expenditures divided by the number of years remaining of the term of the lease. Such deductions shall be in lieu of allowances for depreciation. See section 162 and the regulations thereunder. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in determining whether the useful life of the improvement exceeds the remaining term of the lease where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make. Capital expenditures made by a lessor for the erection of buildings or other improvements shall, if subject to depreciation allowances, be recovered by him over the estimated life of the improvements without regard to the period of the lease.

[T.D. 6520, 25 FR 13692, Dec. 24, 1960]

§1.167(a)–5 Apportionment of basis.

In the case of the acquisition on or after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump sum, as for example,buildings and land, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time. In the case of property which is subject to both the allowance for depreciation and amortization, depreciation is allowable only with respect to the portion of the depreciable property which is not subject to the allowance for amortization and may be taken concurrently with the allowance for amortization. After the close of the amortization period or after amortization deductions have been discontinued with respect to any such property, the unrecovered cost or other basis of the depreciable portion of such property will be subject to depreciation. For adjustments to basis, see section 1016 and other applicable provisions of law. For the adjustment to the basis of a structure in the case of a donation of a qualified conservation contribution under section 170(h), see §1.170A–14(h)(3)(iii).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 8069, 51 FR 1498, Jan. 14, 1986]

§ 1.167(a)–5T Application of section 1060 to section 167 (temporary).

In the case of an acquisition of a combination of depreciable and nondepreciable property for a lump sum in an applicable asset acquisition to which section 1060 applies, the basis for depreciation of the depreciable property cannot exceed the amount of consideration allocated to that property under section 1060 and § 1.1060–1T.

[T.D. 8215, 53 FR 27043, July 18, 1988]

§ 1.167(a)–6 Depreciation in special cases.

(a) *Depreciation of patents or copyrights.* The cost or other basis of a patent or copyright shall be depreciated over its remaining useful life. Its cost to the patentee includes the various Government fees, cost of drawings, models, attorneys' fees, and similar expenditures. For rules applicable to research and experimental expenditures, see sections 174 and 1016 and the regulations thereunder. If a patent or copyright becomes valueless in any year before its expiration the unrecovered cost or other basis may be deducted in that year.

(b) *Depreciation in case of farmers.* A reasonable allowance for depreciation may be claimed on farm buildings (except a dwelling occupied by the owner), farm machinery, and other physical property but not including land. Livestock acquired for work, breeding, or dairy purposes may be depreciated unless included in an inventory used to determine profits in accordance with section 61 and the regulations thereunder. Such depreciation should be determined with reference to the cost or other basis, salvage value, and the estimated useful life of the livestock. See also section 162 and the regulations thereunder relating to trade or business expenses, section 165 and the regulations thereunder relating to losses of farmers, and section 175 and the regulations thereunder relating to soil or water conservation expenditures.

§ 1.167(a)–7 Accounting for depreciable property.

(a) Depreciable property may be accounted for by treating each individual item as an account, or by combining two or more assets in a single account. Assets may be grouped in an account in a variety of ways. For example, assets similar in kind with approximately the same useful lives may be grouped together. Such an account is commonly known as a group account. Another appropriate grouping might consist of assets segregated according to use without regard to useful life, for example, machinery and equipment, furniture and fixtures, or transportation equipment. Such an account is commonly known as a classified account. A broader grouping, where assets are included in the same account regardless of their character or useful lives, is commonly referred to as a composite account. For example, all the assets used in a business may be included in a single account. Group, classified, or composite accounts may be further broken down on the basis of location, dates of acquisition, cost, character, use, etc.

(b) When group, classified, or composite accounts are used with average useful lives and a normal retirement occurs, the full cost or other basis of the asset retired, unadjusted for depreciation or salvage, shall be removed from the asset account and shall be charged to the depreciation reserve. Amounts representing salvage ordinarily are credited to the depreciation reserve. Where an asset is disposed of for reasons other than normal retirement, the full cost or other basis of the asset shall be removed from the asset account, and the depreciation reserve shall be charged with the depreciation applicable to the retired asset. For rules with respect to losses on normal retirements, see § 1.167 (a)–8.

(c) A taxpayer may establish as many accounts for depreciable property as he desires. Depreciation allowances shall be computed separately for each account. Such depreciation preferably should be recorded in a depreciation reserve account; however, in appropriate cases it may be recorded directly in the asset account. Where depreciation reserves are maintained, a separate reserve account shall be maintained for each asset account. The regular books of account or permanent auxiliary records shall show for each account the basis of the property, including adjustments necessary to conform to the requirements of section 1016 and other provisions of law relating to adjustments to basis, and the depreciation allowances for tax purposes. In the event that reserves for book purposes do not correspond with reserves maintained for tax purposes, permanent auxiliary records shall be maintained with the regular books of accounts reconciling the differences in depreciation for tax and book purposes because of different methods of depreciation, bases, rates, salvage, or other factors. Depreciation schedules filed with the income tax return shall show the accumulated reserves computed in accordance with the allowances for income tax purposes.

(d) In classified or composite accounts, the average useful life and rate shall be redetermined whenever additions, retirements, or replacements substantially alter the relative proportion of types of assets in the accounts. See example (2) in paragraph (b) of §1.167(b)–1 for method of determining the depreciation rate for a classified or composite account.

§1.167(a)–8 Retirements.

(a) *Gains and losses on retirements.* For the purposes of this section the term ‘‘retirement’’ means the permanent withdrawal of depreciable property from use in the trade or business or in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. In addition, the asset may be withdrawn from such productive use without disposition as, for example, by being placed in a supplies or scrap account. The tax consequences of a retirement depend upon the form of the transaction, the reason therefor, the timing of the retirement, the estimated useful life used in computing depreciation, and whether the asset is accounted for in a separate or multiple asset account. Upon the retirement of assets, the rules in this section apply in determining whether gain or loss will be recognized, the amount of such gain or loss, and the basis for determining gain or loss:

(1) Where an asset is retired by sale at arm’s length, recognition of gain or loss will be subject to the provisions of sections 1002, 1231, and other applicable provisions of law.

(2) Where an asset is retired by exchange, the recognition of gain or loss will be subject to the provisions of sections 1002, 1031, 1231, and other applicable provisions of law.

(3) Where an asset is permanently retired from use in the trade or business or in the production of income but is not disposed of by the taxpayer or physically abandoned (as, for example, when the asset is transferred to a supplies or scrap account), gain will not be recognized. In such a case loss will be recognized measured by the excess of the adjusted basis of the asset at the time of retirement over the estimated salvage value or over the fair market value at the time of such retirement if greater, but only if—

(i) The retirement is an abnormal retirement, or

(ii) The retirement is a normal retirement from a single asset account (but see paragraph (d) of this section for special rule for item accounts), or

(iii) The retirement is a normal retirement from a multiple asset account in which the depreciation rate was based on the maximum expected life of the longest lived asset contained in the account.

(4) Where an asset is retired by actual physical abandonment (as, for example, in the case of a building condemned as unfit for further occupancy or other use), loss will be recognized measured by the amount of the adjusted basis of the asset abandoned at the time of such abandonment. In order to qualify for the recognition of loss from physical abandonment, the intent of the taxpayer must be irrevocably to discard the asset so that it will neither be used again by him nor retrieved by him for sale, exchange, or other disposition.

Experience with assets which have attained an exceptional or unusual age shall, with respect to similar assets, be disregarded in determining the maximum expected useful life of the longest lived asset in a multiple asset account. For example, if a manufacturer establishes a proper multiple asset account for 50 assets which are expected to have an average life of 30 years but which will remain useful to him for varying periods between 20 and 40 years, the maximum expected useful life will be 40 years, even though an occasional asset of this kind may last 60 years.

(b) *Definition of normal and abnormal retirements.* For the purpose of this section the determination of whether a retirement is normal or abnormal shall be made in the light of all the facts and circumstances. In general, a retirement shall be considered a normal retirement unless the taxpayer can show that the withdrawal of the asset was due to a cause not contemplated in setting the applicable depreciation rate. For example, a retirement is considered normal if made within the range of years taken into consideration in fixing the depreciation rate and if the asset has reached a condition at which, in the normal course of events, the taxpayer customarily retires similar assets from use in his business. On the other hand, a retirement may be abnormal if the asset is withdrawn at an earlier time or under other circumstances, as, for example, when the asset has been damaged by casualty or has lost its usefulness suddenly as the result of extraordinary obsolescence.

(c) *Basis of assets retired.* The basis of an asset at the time of retirement for computing gain or loss shall be its adjusted basis for determining gain or loss upon a sale or other disposition as determined in accordance with the provisions of section 1011 and the following rules:

(1) In the case of a normal retirement of an asset from a multiple asset account where the depreciation rate is based on average expected useful life, the term ‘‘adjusted basis’’ means the salvage value estimated in determining the depreciation deduction in accordance with the provisions in paragraph (c) of §1.167(a)–1.

(2) In the case of a normal retirement of an asset from a multiple asset account on which the depreciation rate was based on the maximum expected life of the longest lived asset in the account, the adjustment for depreciation allowed or allowable shall be made at the rate which would have been proper if the asset had been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) using a rate based upon the maximum expected useful life of that asset, and

(3) In the case of an abnormal retirement from a multiple asset account the adjustment for depreciation allowed or allowable shall be made at the rate which would have been proper had the asset been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) and using a rate based upon either the average expected useful life or the maximum expected useful life of the asset, depending upon the method of determining the rate of depreciation used in connection with the multiple asset account.

(d) *Special rule for item accounts.* (1) As indicated in paragraph (a)(3)(ii) and (iii) of this section, a loss is recognized upon the normal retirement of an asset from a single asset account but a loss on the normal retirement of an asset in a multiple asset account is not allowable where the depreciation rate is based upon the average useful life of the assets in the account. Where a taxpayer with more than one depreciable asset chooses to set up a separate account for each such asset and the depreciation rate is based on the average useful life of such assets (so that he uses the same life for each account), the question arises whether his depreciation deductions in substance are the equivalent of those which would result from the use of multiple asset accounts and, therefore, he should be subject to the rules governing losses on retirements of assets from multiple asset accounts. Where a taxpayer has only a few depreciable assets which he chooses to account for in single asset accounts, particularly where such assets cover a relatively narrow range of lives, it cannot be said in the usual case that the allowance of losses on retirements from such accounts clearly will distort income. This results from the fact that where a taxpayer has only a few depreciable assets it is usually not possible clearly to determine that thedepreciation rate is based upon the average useful life of such assets. Accordingly, it cannot be said that the taxpayer is in effect clearly operating with a multiple asset account using an average life rate so that losses should not be allowed on normal retirements. Therefore, losses normally will be allowed upon retirement of assets from single asset accounts where the taxpayer has only a few depreciable assets. On the other hand, when a taxpayer who has only a few depreciable assets chooses to account for them in single asset accounts, using for each account a depreciation rate based on the average useful life of such assets, and the assets cover a wide range of lives, the likelihood that income will be distorted is greater than where the group of assets covers a relatively narrow range of lives. In those cases where the allowance of losses would distort income, the rules with respect to the allowance of losses on normal retirement shall be applied to such assets in the same manner as though the assets had been accounted for in multiple asset accounts using a rate based upon average expected useful life.

(2) Where a taxpayer has a large number of depreciable assets and depreciation is based on the average useful life of such assets, then, whether such assets are similar or dissimilar and regardless of whether they are accounted for in individual asset accounts or multiple asset accounts the allowance of losses on the normal retirement of such assets would distort income. Such distortion would result from the fact that the use of average useful life (and, accordingly, average rate) assumes that while some assets normally will be retired before the expiration of the average life, others normally will be retired after expiration of the average life. Accordingly, if instead of accounting for a large number of similar or dissimilar depreciable assets in multiple asset accounts, the taxpayer chooses to account separately for such assets, using a rate based upon the average life of such assets, the rules with respect to the allowances of losses on normal retirements will be applied to such assets in the same manner as though the assets were accounted for in multiple asset accounts using a rate based upon average expected useful life.

(3) Where a taxpayer who does not have a large number of depreciable assets (and who therefore is not subject to subparagraph (2) of this paragraph) chooses to set up a separate account for each such asset, and has sought to compute an average life for such assets on which to base his depreciation deductions (so that he uses the same life for each account), the allowance of losses on normal retirements from such accounts may in some situations substantially distort income. Such distortion would result from the fact that the use of average useful life (and, accordingly, average rate) assumes that while some assets normally will be retired before expiration of the average life, others normally will be retired after expiration of the average life. Accordingly, where a taxpayer chooses to account separately for such assets instead of accounting for them in multiple asset accounts, and the result is to substantially distort his income, the rules with respect to the allowance of losses on normal retirements shall be applied to such assets in the same manner as though the assets had been accounted for in multiple asset accounts using a rate based upon average expected useful life.

(4) Whenever a taxpayer is treated under this paragraph as though his assets were accounted for in a multiple asset account using an average life rate, and, therefore, he is denied a loss on retirements, the unrecovered cost less salvage of each asset which was accounted for separately may be amortized in accordance with the regulation stated in paragraph (e)(1)(ii) of this section.

(e) *Accounting treatment of asset retirements.* (1) In the case of a normal retirement where under the foregoing rules no loss is recognized and where the asset is retired without disposition or abandonment, (i) if the asset was contained in a multiple asset account, the full cost of such asset, reduced by estimated salvage, shall be charged to the depreciation reserve, or (ii) if the asset was accounted for separately, the unrecovered cost or other basis, less salvage, of the asset may be amortized through annual deductions from gross income in amounts equal to the unrecovered cost or other basis of such asset, divided by the average expected useful life (not the remaining useful life) applicable to the asset at the time of retirement. For example, if an asset is retired after six years of use and at the time of retirement depreciation was being claimed on the basis of an average expected useful life of ten years, the unrecovered cost or other basis less salvage would be amortized through equal annual deductions over a period of ten years from the time of retirement.

(2) Where multiple asset accounts are used and acquisitions and retirements are numerous, if a taxpayer, in order to avoid unnecessarily detailed accounting for individual retirements, consistently follows the practice of charging the reserve with the full cost or other basis of assets retired and of crediting it with all receipts from salvage, the practice may be continued so long as, in the opinion of the Commissioner, it clearly reflects income. Conversely, where the taxpayer customarily follows a practice of reporting all receipts from salvage as ordinary taxable income such practice may be continued so long as, in the opinion of the Commissioner, it clearly reflects income.

(f) *Cross reference.* For special rules in connection with the retirement of the last assets of a given year's acquisitions under the declining balance method, see example (2) in paragraph (b) of § 1.167 (b)–2.

§ 1.167(a)–9 Obsolescence.

The depreciation allowance includes an allowance for normal obsolescence which should be taken into account to the extent that the expected useful life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its physical condition. Obsolescence is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences, supersession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and other like changes, and legislative or regulatory action. In any case in which the taxpayer shows that the estimated useful life previously used should be shortened by reason of obsolescence greater than had been assumed in computing such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete. For rules governing the allowance of a loss when the usefulness of depreciable property is suddenly terminated, see § 1.167(a)–8. If the estimated useful life and the depreciation rates have been the subject of a previous agreement, see section 167(d) and § 1.167(d)–1.

§ 1.167(a)–10 When depreciation deduction is allowable.

(a) A taxpayer should deduct the proper depreciation allowance each year and may not increase his depreciation allowances in later years by reason of his failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line method if no allowance has ever been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section 167(b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. However, in the case of a multiple asset account, the amount of depreciation may be determined by using what is commonly described as an ‘‘averaging convention’’, that is, by using an assumed timing of additions and retirements. For example, it might be assumed that all additions and retirements to the asset account occur uniformly throughout the taxable year, in which case depreciation is computed on the average of the beginning and ending balances of the asset account for the taxable year. See example (3) under paragraph (b) of §1.167(b)–1. Among still other averaging conventions which may be used is the one under which it is assumed that all additions and retirements during the first half of a given year were made on the first day of that year and that all additions and retirements during the second half of the year were made on the first day of the following year. Thus, a full year’s depreciation would be taken on additions in the first half of the year and no depreciation would be taken on additions in the second half. Moreover, under this convention, no depreciation would be taken on retirements in the first half of the year and a full year’s depreciation would be taken on the retirements in the second half. An averaging convention, if used, must be consistently followed as to the account or accounts for which it is adopted, and must be applied to both additions and retirements. In any year in which an averaging convention substantially distorts the depreciation allowance for the taxable year, it may not be used.

§1.167(a)–11 Depreciation based on class lives and asset depreciation ranges for property placed in service after December 31, 1970.

(a) *In general*—(1) *Summary*. This section provides an asset depreciation range and class life system for determining the reasonable allowance for depreciation of designated classes of assets placed in service after December 31, 1970. The system is designed to minimize disputes between taxpayers and the Internal Revenue Service as to the useful life of property, and as to salvage value, repairs, and other matters. The system is optional with the taxpayer. The taxpayer has an annual election. Generally, an election for a taxable year must apply to all additions of eligible property during the taxable year of election, but does not apply to additions of eligible property in any other taxable year. The taxpayer’s election, made with the return for the taxable year, may not be revoked or modified for any property included in the election. Generally, the taxpayer must establish vintage accounts for all eligible property included in the election, must determine the allowance for depreciation of such property in the taxable year of election, and in subsequent taxable years, on the basis of the asset depreciation period selected and must apply the first-year convention specified in the election to determine the allowance for depreciation of such property. This section also contains special provisions for the treatment of salvage value, retirements, and the costs of the repair, maintenance, rehabilitation or improvement of property. In general, a taxpayer may not apply any provision of this section unless he makes an election and thereby consents to, and agrees to apply, all the provisions of this section. A taxpayer who elects to apply this section does, however, have certain options as to the application of specified provisions of this section. A taxpayer may elect to apply this section for a taxable year only if for such taxable year he complies with the requirements of paragraph (f)(4) of this section.

(2) *Definitions.* For the meaning of certain terms used in this section, see paragraphs (b)(2) (‘‘eligible property’’), (b)(3) (‘‘vintage account’’ and ‘‘vintage’’), (b)(4) (‘‘asset depreciation range’’, ‘‘asset guideline class’’, ‘‘asset guideline period’’, and ‘‘asset depreciation period’’), (b)(5)(iii)*(c)* (‘‘used property’’), (b)(6)(i) (‘‘public utility property’’), (c)(1)(iv) (‘‘original use’’), (c)(1)(v) (‘‘unadjusted basis’’ and ‘‘adjusted basis’’), (c)(2)(ii) (‘‘modified half-year convention’’), (c)(2)(iii) (‘‘half-year convention’’), (d)(1)(i) (‘‘gross salvage value’’), (d)(1)(ii) (‘‘salvage value’’), (d)(2)(iii)(‘‘repair allowance’’, ‘‘repair allowance percentage’’, and ‘‘repair allowance property’’), (d)(2)(vi) (‘‘excluded addition’’), (d)(2)(vii) (‘‘property improvement’’), (d)(3)(ii)

(''ordinary retirement'' and ''extraordinary retirement''), (d)(3)(vi) (''special basis vintage account''), and (e)(1) (''first placed in service'') of this section.

(b) *Reasonable allowance using asset depreciation ranges*—(1) *In general.* The allowance for depreciation of eligible property (as defined in subparagraph (2) of this paragraph) to which the taxpayer elects to apply this section shall be determined as provided in paragraph (c) of this section and shall constitute the reasonable allowance for depreciation of such property under section 167(a).

(2) *Definition of eligible property.* For purposes of this section, the term ''eligible property'' means tangible property which is subject to the allowance for depreciation provided by section 167(a) but only if—

(i) An asset guideline class and asset guideline period are in effect for such property for the taxable year of election (see subparagraph (4) of this paragraph);

(ii) The property is first placed in service (as described in paragraph (e) (1) of this section) by the taxpayer after December 31, 1970 (but see subparagraph (7) of this paragraph for special rule where there is a mere change in the form of conducting a trade or business); and

(iii) The property is either—

(a) Section 1245 property as defined in section 1245(a) (3), or

(b) Section 1250 property as defined in section 1250(c).

See, however, subparagraph (6) of this paragraph for special rule for certain public utility property as defined in section 167(l)(3)(A). Property which meets the requirements of this subparagraph is eligible property even if depreciation with respect to such property, determined in accordance with this section, is allocated to or otherwise required to be reflected in the cost of a capitalized item. The term ''eligible property'' includes any property which meets the requirements of this subparagraph, whether such property is new property, ''used property'' (as described in subparagraph (5)(iii)*(c)* of this paragraph), a ''property improvement'' (as described in paragraph (d)(2)(vii) of this section), or an ''excluded addition'' (as described in paragraph (d)(2)(vi) of this section). For the treatment of expenditures for the repair, maintenance, rehabilitation or improvement of certain property, see paragraph (d) (2) of this section.

(3) *Requirement of vintage accounts*—(i) *In general.* For purposes of this section, a ''vintage account'' is a closed-end depreciation account containing eligible property to which the taxpayer elects to apply this section, first placed in service by the taxpayer during the taxable year of election. The ''vintage'' of an account refers to the taxable year during which the eligible property in the account is first placed in service by the taxpayer. Such an account will consist of an asset, or a group of assets, within a single asset guideline class established pursuant to subparagraph (4) of this paragraph and may contain only eligible property. Each item of eligible property to which the taxpayer elects to apply this section, first placed in service by the taxpayer during the taxable year of election (determined without regard to a convention described in paragraph (c)(2) of this section) shall be placed in a vintage account of the taxable year of election. For rule regarding ''special basis vintage accounts'' for certain property improvements, see paragraph (d)(2)(viii) and (3)(vi) of this section. Any number of vintage accounts of a taxable year may be established. More than one account of the same vintage may be established for different assets of the same asset guideline class. See paragraph (d)(3)(xi) of this section for special rule for treatment of certain multiple asset and item accounts.

(ii) *Special rule.* Section 1245 property may not be placed in a vintage account with section 1250 property. Property the original use of which does not commence with the taxpayer may not be placed in a vintage account with property the original use of which commences with the taxpayer. Property described in section 167(f)(2) may not be placed in a vintage account with property not described in section 167(f)(2). Property described in section 179(d)(1) for which the taxpayer elects the allowance for the first taxable year in accordance with section 179(c) may not be placed in a vintage account with property not described in section 179(d)(1) or for which the taxpayer does not elect such allowance for the first taxable year. For special rule for property acquired in a transaction to which section 381(a) applies, see paragraph (e)(3)(i) of this section. For additional rules with respect to accounting for eligible property, see paragraph (e) of this section.

(4) *Asset depreciation ranges and periods*—(i) *Selection of asset depreciation period.* The taxpayers books and records must specify for each vintage account of the taxable year of election—

(a) In the case of vintage account for property in an asset guideline class for which no asset depreciation range is in effect for the taxable year, the asset depreciation period (which shall be equal to the asset guideline period for the assets in such account), or

(b) In the case of a vintage account for property in an asset guideline class for which an asset depreciation range is in effect for the taxable year, the asset depreciation period selected by the taxpayer from the asset depreciation range for the assets in such account.

Unless otherwise expressly provided in the establishment thereof, for purposes of this section, the term ‘‘asset guideline class’’ means a category of assets (including ‘‘subsidiary assets’’) for which a separate asset guideline period is in effect for the taxable year as provided in subdivision (ii) of this subparagraph. The ‘‘asset depreciation range’’ is a period of years which extends from 80 percent of the asset guideline period to 120 percent of such period, determined in each case by rounding any fractional part of a year to the nearer of the nearest whole or half year. Except as provided in paragraph (e)(3)(iv) of this section, in the case of an asset guideline class for which an asset depreciation range is in effect, any period within the asset depreciation range for the assets in avintage account which is a whole number of years or a whole number of years plus a half year, may be selected. The term ‘‘asset depreciation period’’ means the period selected from the asset depreciation range, or if no asset depreciation range is in effect for the class, the asset guideline period. The ‘‘asset guideline period’’ is established in accordance with subdivision (ii) of this subparagraph and is the class life under section 167(m). See Revenue Procedure 72–10 for special rules for section 1250 property and property predominately used outside the United States. In general, an asset guideline period, but no asset depreciation range, is in effect for such property.

(ii) *Establishment of asset guideline classes and periods.* The asset guideline classes and the asset guideline periods, and the asset depreciation ranges determined from such periods, in effect for taxable years ending before the effective date of the first supplemental asset guideline classes, asset guideline periods, and asset depreciation ranges, established pursuant to this section are set forth in Revenue Procedure 72–10. Asset guideline classes and periods, and asset depreciation ranges, will from time to time be established, supplemented, and revised with express reference to this section, and will be published in the Internal Revenue Bulletin. The asset guideline classes, the asset guideline periods, and the asset depreciation ranges determined from such periods in effect as of the last day of a taxable year of election shall apply to all vintage accountsof such taxable year, except that neither the asset guideline period nor the lower limit of the asset depreciation range for any such account shall be longer than the asset guideline period or the lower limit of the asset depreciation range, as the case may be, for such account in effect as of the first day of the taxable year (or as of such later time in such year as an asset guideline class first established during such year becomes effective). Generally, the reasonable allowance for depreciation of property for any taxable year in a vintage account shall not be changed to reflect any supplement or revision of the asset guideline classes or periods, and asset depreciation ranges, for the taxable year in which the account is established, which occurs after the end of such taxable year. However, if expressly provided in such a supplement or revision, the taxpayer may, at his option in the manner specified therein, apply the revised or supplemented asset guideline classes or periods and asset depreciation ranges to such property for such taxable year and succeeding taxable years.

(iii) *Applicable guideline classes and periods in special situations. (a)* An electric or gas utility which would in accordance with Revenue Procedure 64–21 be entitled to use a composite guideline class basis for applying Revenue Procedure 62–21 may, solely with respect to property for which an asset depreciation range is in effect for the taxable year, elect to apply this section on the basis of a composite asset guideline class and asset guideline period determined by applying the provisions ofRevenue Procedure 64–21 to such property. The asset depreciation range for such a composite asset guideline class shall be determined by reference to the composite asset guideline period at the beginning of the first taxable year to which the taxpayer elects to apply this section and shall not be changed until such time as major variations in the asset mix or the asset guideline classes or periods justify some other composite asset guideline period. Except as provided in paragraph (d)(2)(iii) of this section with respect to buildings and other structures, for the purposes of this section, all property in the composite asset guideline class shall be treated as included in a single asset guideline class. If the taxpayer elects to apply this subdivision, the election shall be made on the tax return filed for the first taxable year for which the taxpayer elects to apply this section. An election to apply this subdivision for any taxable year shall apply to all succeeding taxable years to which the taxpayer elects to apply this section, except to the extent the election to apply this subdivision is with the consent of the Commissioner terminated with respect to a succeeding taxable year and all taxable years thereafter.

(b) For purposes of this section, property shall be included in the asset guideline class for the activity in which the property is primarily used. See paragraph (e)(3)(iii) of this section for rule for leased property. Property shall be classified according to primary use even though the activity in which such property is primarily used is insubstantial in relation to all the taxpayer's activities. No change in the classification of property shall be made because of a change in primary use after the end of the taxable year in which property is first placed in service, including a change in use which results in section 1250 property becoming section 1245 property.

(c) An incorrect classification or characterization by the taxpayer of property for the purposes of this section (such as under *(b)* of this subdivision or under subparagraph (2) or (3)(ii) of this paragraph) shall not cause or permit a revocation of the election to apply this section for the taxable year in which such property was first placed in service. The classification or characterization of such property shall be corrected. All adjustments necessary to the correction shall be made, including adjustments of unadjusted basis, adjusted basis, salvage value, the reserve for depreciation of all vintage accounts affected, and the amount of depreciation allowable for all taxable years for which the period for assessment of tax prescribed in section 6501 has not expired. If because of incorrect classification or characterization property included in an election to apply this section was not placed in a vintage account and no asset depreciation period was selected for the property or the property was placed in a vintage account but an asset depreciation period was selected from an incorrect asset depreciation range, the taxpayer shall place the property in a vintage account and select an asset depreciation period for the account from the correct asset depreciation range.

(d) Generally, except as provided in subparagraph (5)(v)*(a)* of this paragraph, a taxpayer may not compute depreciation for eligible property first placed in service during the taxable year under a method of depreciation not described in section 167(b) (1), (2), or (3). (If the taxpayer computes depreciation with respect to such property under section 167(k), or amortizes such property, the property must be excluded from the election to apply this section.) (See subparagraph (5)(v) *(b)* of this paragraph.) However, if the taxpayer establishes to the satisfaction of

the Commissioner that a method of depreciation not described in section 167(b) (1), (2), (3), or (k) was adopted for property in the asset guideline class on the basis of a good faith mistake as to the proper asset guideline class for the property, then, unless the requirements of subparagraph (5)(v) *(a)* of this paragraph are met, the taxpayer must terminate (as of the beginning of the taxable year) such method of depreciation with respect to all eligible property in the asset guideline class which was first placed in service during the taxable year. In such event, the taxpayer's election to apply this section shall include eligible property in the asset guideline class without regard to subparagraph (5)(v)*(a)* of this paragraph. The provisions of *(c)* of this subdivision shall apply to the correction in the classification of the property.

(e) If the provisions of section 167(j) apply to require a change in the method of depreciation with respect to an item of section 1250 property in a multiple asset vintage account, the asset shall be removed from the account and placed in a separate item vintage account. The unadjusted basis of the asset shall be removed from the unadjusted basis of the vintage account as of the first day of the taxable year in which the change in method of depreciation is required and the depreciation reserve established for the account shall be reduced by the depreciation allowable for the property computed in the manner prescribed in paragraph (c)(1)(v)*(b)* of this section for determination of the adjusted basis of property. See paragraph (d)(3)(vii)*(e)* of this section for treatment of salvage value when property is removed from a vintage account.

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

Example (1). Corporation X purchases a bulldozer for the use in its construction business. The bulldozer is first placed in service in 1972. Since the bulldozer is tangible property for which an asset guideline class and period have been established, the bulldozer is eligible property. The bulldozer is in asset guideline class 15.1 of Revenue Procedure 72–10, and the asset depreciation range is 4–6 years.

Example (2). In 1972, corporation Y first places in service a factory building. Since the factory building is tangible property for which an asset guideline class and period have been established, it is eligible property. The factory building is in asset guideline class 65.11 of Revenue Procedure 72–10. Since no asset depreciation range is in effect for the asset guideline class, the asset depreciation period is the asset guideline period of 45 years. (See subparagraph (5)(vi) of this paragraph for election to exclude certain section 1250 property during transition period.)

Example (3). In January of 1971, corporation Y, a calendar year taxpayer, pays or incurs $2,000 for the rehabilitation and improvement of machine A which was first placed in service in 1969. On January 1, 1971, corporation Y first placed in service machines B and C, each with an unadjusted basis of $10,000. Machines B and C are eligible property. Machine A would be eligible property but for the fact it was first placed in service prior to January 1, 1971 (that is, machine A is eligible property determined without regard to subparagraph (2)(ii) of this paragraph). Corporation Y elects to apply this section for the taxable year, and adopts the modified half-year convention described in paragraph (c)(2)(ii) of this section, but does not elect to apply the asset guideline class repair allowance described in paragraph (d)(2)(iii) of this section. Machines A, B, and C are in asset guideline class 24.4 under Revenue Procedure 72–10 for which the asset depreciation range is 8 to 12 years. The $2,000 expended on machine A substantially increases its capacity and is a capital expenditure under sections 162 and 263. The $2,000 is a property improvement (as defined in paragraph (d)(2)(vii)*(b)* of this section) which is eligible property. However, corporation Y by mistake treats the property improvement of $2,000 as a deductible repair. Also by mistake, corporation Y includes machine B in asset guideline class 24.3 under Revenue Procedure 72–10 for which the asset depreciation range is 5 to 7 years. Corporation Y establishes vintage accounts for 1971, and computes depreciation for 1971 and 1972 as follows:

	Dec. 31, 1972, reserve for depreciation	Dec. 31, 1972, adjusted basis
Vintage account for machine B, with an asset depreciation period of 5 years and an unadjusted basis of $10,000 for which corporation Y adopts the straight line method	$4,000	$6,000
Vintage account for machine C, with an asset depreciation period of 8 years and an unadjusted basis of $10,000 for which corporation Y adopts the straight line method	2,500	7,500

After audit in 1973 of corporation Y's taxable years 1971 and 1972, it is determined that the $2,000 paid in 1971 for the rehabilitation and improvement of machine A is a capital expenditure and that machine B is in asset guideline class 24.4. The incorrect classification is corrected. Corporation Y places machine B and the property improvement in a vintage account of 1971 and on its tax return filed for 1973 selects an asset depreciation period of 8 years for that account. Giving effect to the correction in classification of the property in accordance with subdivision (iii) *(c)* of this subparagraph, at the end of 1972 the unadjusted basis, reserve for depreciation, and adjusted basis of the vintage account for machine B and the property improvement with respect to machine A are $12,000, $3,000, and $9,000, respectively. Corporation Y's deduction of the $2,000 property improvement in 1971 as a repair expense under section 162 is disallowed. For 1971 and 1972 depreciation deductions are disallowed in the amount of $500 each year (that is, $750 excess annual depreciation on machine B minus $250 annual depreciation on the property improvement).

Example (4). (a) In 1971, Corporation X, a calendar year taxpayer, first places in service machines A through M, all of which are eligible property. All the machines except machine A are in asset guideline class 24.3 under Revenue Procedure 72–10. Machine A is in asset guideline class 24.4 under Revenue Procedure 72–10. Machine B has an unadjusted basis equal to 80 percent of the total unadjusted basis of machines B through M. By good faith mistake as to proper classification, corporation X includes both machine A and machine B in asset guideline class 24.4. Corporation X consistently uses the machine hour method of depreciation on all property in asset guideline class 24.4, and for 1971 computes depreciation for machines A and B under that method. Corporation X elects to apply this section for 1971 on the assumption that the election includes machines C through M which are in asset guideline class 24.3. In 1973, upon audit of corporation X's taxable years 1971 and 1972, it is determined that machine B is included in asset guideline class 24.3 and that since for 1971 corporation X computed depreciation on machine B under the machine hour method, in accordance with subparagraph (5)(v) *(a)* of this paragraph, all property in asset guideline class 24.3 (machines B through M) is excluded from corporation X's election to apply this section for 1971. Although corporation X has consistently used the machine hour method for asset guideline class 24.4, corporation X has not in the past used the machine hour method for machines of the type and function of machines C through M which are in asset guideline class 24.3. Both machine A and machine B are used in connection with the manufacture of wood products. There is reasonable basisfor corporation X having assumed that machine B is in asset guideline class 24.4 along with machine A to which it is similar. Corporation X establishes to the satisfaction of the Commissioner that it used the machine hour method for machine B on the basis of a good faith mistake as to the proper classification of the machine. Corporation X may, at its option (see subparagraph (5)(v) of this paragraph), terminate the machine hour method of depreciation for machine B as of the beginning of 1971, and in that event corporation X's election to apply this section for 1971 will apply to machines B through M without regard to subparagraph (5)(v)*(a)* of this paragraph. The adjustments provided in subdivision (iii)*(c)* of this subparagraph will be made as a result of the correction in classification of property. If corporation X does not terminate the machine hour method with respect to machine B, machines B through M must be excluded from the election to apply this section (see subparagraph (5)(v) of this paragraph).

(b) The facts are the same as in *(a)* of this example except that machine B has an unadjusted basis equal to only 65 percent of the total unadjusted basis of machines B through M.

In this case, corporation X must either terminate the machine hour method of depreciation with respect to asset B (since the provisions of subparagraph (5)(v) of this paragraph do not permit the exclusion of the property from the election to apply this section) or otherwise comply with the provisions of subparagraph (5)(v) of this paragraph. (See paragraph (c)(1)(iv) for limitation on methods which may be adopted for property included in the election to apply this section.)

(5) *Requirements of election*—(i) *In general.* Except as otherwise provided in paragraph (d)(2) of this section dealing with expenditures for the repair, maintenance, rehabilitation or improvement of certain property, no provision of this section shall apply to any property other than eligible property to which the taxpayer elects in accordance with this section, to apply this section. For the time and manner of election, and certain conditions to an election, see paragraph (f) of this section. Except as otherwise provided in subparagraph (4)(iii) of this paragraph, subdivision (v) of this subparagraph and in subparagraph (6)(iii) of this paragraph, a taxpayer's election to apply this section may not be revoked or modified after the last day prescribed for filing the election. Thus, for

example, after such day, a taxpayer may not cease to apply this section to property included in the election, establish different vintage accounts for the taxable year of election, select a different period from the asset depreciation range for any such account, or adopt a different first-year convention for any such account.

(ii) *Property required to be included in election.* Except as otherwise provided in subdivision (iii) of this subparagraph dealing with certain ''used property'', in subdivision (iv) of this subparagraph dealing with ''section 38 property'', in subdivision (v) of this subparagraph dealing with property subject to special depreciation or amortization, in subdivision (vi) of this subparagraph dealing with certain section 1250 property, in subdivision (vii) of this subparagraph dealing with certain subsidiary assets, and in paragraph (e)(3) (i) and (iv) of this section dealing with transactions to which section 381(a) applies, if the taxpayer elects to apply this section to any eligible property first placed in service by the taxpayer during the taxable year of election, the election shall apply to all such eligible property, whether placed in service in a trade or business or held for production of income.

(iii) *Special 10 percent used property rule. (a)* If *(1)* the unadjusted basis of eligible used section 1245 property (as defined in *(c)* of this subdivision) first placed in service by the taxpayer during the taxable year of election, for which no specific used property asset guideline class (as defined in *(c)* of this subdivision) is in effect for the taxable year, exceeds *(2)* 10 percent of the unadjusted basis of all eligible section 1245 property first placed in service during the taxable year of election, the taxpayer may exclude all (but not less than all) the property described in *(a)(1)* of this subdivision from the election to apply this section.

(b) If *(1)* the unadjusted basis of eligible used section 1250 property first placed in service by the taxpayer during the taxable year of election, for which no specific used property asset guideline class is in effect for the taxable year, exceeds *(2)* 10 percent of the unadjusted basis of all eligible section 1250 property first placed in service during the taxable year of election, the taxpayer may exclude all (but not less than all) the property described in *(b)(1)* of this subdivision from the election to apply this section.

(c) For the purposes of this section, the term ''used property'' means property the original use of which does not commence with the taxpayer. Solely for the purpose of determining whether the 10 percent rule of this subdivision is satisfied, *(1)* eligible used property first placed in service during the taxable year and excluded from the election to apply this section pursuant to subdivision (v)*(a)* of this subparagraph and (*2*) eligible property acquired during the taxable year in a transaction to which section 381(a) applies, shall all be treated as used property regardless of whether such property would be treated as new property under section 167(c) and the regulations thereunder. The term ''specific used property asset guideline class'' means a class established in accordance with subparagraph (4) of this paragraph solely for used property primarily used in connection with the activity to which the class relates.

(iv) *Property subject to investment tax credit.* The taxpayer may exclude from an election to apply this section all, or less than all, units of eligible property first placed in service during the taxable year which is—

(a) ''Section 38 property'' as defined in section 48(a) which meets the requirements of section 49 and which is not property described in section 50, or

(b) Property to which section 47(a)(5)(B) applies which would be section 38 property but for section 49 and which is placed in service to replace section 38 property (other than property described in section 50) disposed of prior to August 15, 1971.

(v) *Property subject to special method of depreciation or authorization. (a)* In the case of eligible property first placed in service in a taxable year of election (and not otherwise properly excluded from an election to apply this section) the taxpayer may not compute depreciation for any of such property in the asset guideline class under a method not described in section 167(b) (1), (2), (3), or (k) unless he *(1)* computes depreciation under a method or methods not so described for eligible property first placed in service in the taxable year in the asset guideline class with an unadjusted basis at least equal to 75 percent of the unadjusted basis of all eligible property first placed in service in the taxable year in the asset guideline class and *(2)* agrees to continue to depreciate such property under such method or methods until the consent of the Commissioner is obtained to a change in method. The consent of the Commissioner must be obtained by filing Form 3115 with the Commissioner of Internal Revenue, Washington, D.C. 20224, within the first 180 days of the taxable year for which the change is desired. If for the taxable year of election the taxpayer computes depreciation under any method not described in section 167(b) (1), (2), (3), or (k) for any eligible property (other than property otherwise properly excluded from an election to apply this section) first placed in service during the taxable year, an election to apply this section for the taxable year shall not include such property or any other eligible property in the same asset guideline class as such property. With respect to a taxable year beginning before January 1, 1973, if the taxpayer has adopted a method of depreciation which is not permitted under this subdivision, the taxpayer may under this section adopt a method of depreciation permitted under this subdivision or otherwise comply with the provisions of this subdivision.

(b) An election to apply this section shall not include eligible property for which, for the taxable year of election, the taxpayer computes depreciation under section 167(k), or computes amortization under section 169, 184, 185, 187, 188, or paragraph (b) of § 1.162–11. If the taxpayer has elected to apply this section to eligible property described in section 167(k), 169, 184, 185, or 187 and the taxpayer thereafter computes depreciation or amortization for such property for any taxable year in accordance with section 167(k), 169, 184, 185, or 187, then the election to apply this section to such property shall terminate as of the beginning of the taxable year for which depreciation or amortization is computed under such section. Application of this section to the property for any period prior to the termination date will not be affected by the termination. The unadjusted basis of the property shall be removed as of the termination date from the unadjusted basis of the vintage account. The depreciation reserve established for the account shall be reduced by the depreciation allowable for the property, computed in the manner prescribed in paragraph (c)(1)(v)*(b)* of this section for determination of the adjusted basis of the property. See paragraph (d)(3)(vii)*(e)* of this section for treatment of salvage value when property is removed from a vintage account.

(vi) *Certain section 1250 property. (a)* The taxpayer may exclude from an election to apply this section all, or less than all, items of eligible section 1250 property first placed in service during the taxable year of election provided that—

(1) The item is first placed in service before the earlier of the effective date of the first supplemental asset guideline class including such property established in accordance with subparagraph (4)(ii) of this paragraph, or January 1, 1974, and

(2) The taxpayer establishes that a useful life shorter than the asset guideline period in effect on January 1, 1971, for such item of property is justified for such taxable year.

A useful life shorter than the asset guideline period in effect on January 1, 1971, will be considered justified only if such life is justified in accordance with the provisions of Revenue Procedure 62–21 (including all modifications, amendments or supplements thereto as of January 1, 1971), determined without application of the minimal adjustment rule in section 4, part II, of Revenue Procedure 65–13. If an item of section 1250 property is excluded from an election to apply this section pursuant to this subdivision, any elevator or escalator which is a part of such item shall also be excluded from the election.

(b) If the taxpayer excludes an item of section 1250 property from an election to apply this section in accordance with this subdivision, the useful life justified under Revenue Procedure 62–21 in accordance with this subdivision for the taxable year of exclusion will be

treated as justified for such item of section 1250 property for the taxable year of the exclusion and all subsequent taxable years.

(vii) *Subsidiary assets.* The taxpayer may exclude from an election to apply this section all (but not less than all) subsidiary assets first placed in service during the taxable year of election in an asset guideline class, provided that—

(a) The unadjusted basis of eligible subsidiary assets first placed in service during the taxable year in the class is as much as 3 percent of the unadjusted basis of all eligible property first placed in service during the taxable year in the class, and

(b) Such subsidiary assets are first placed in service by the taxpayer before the earlier of *(1)* the effective date of the first supplemental asset guideline class including such subsidiary assets established in accordance with subparagraph (4)(ii) of this paragraph, or *(2)* January 1, 1974.

For purposes of this subdivision the term ‘‘subsidiary assets’’ includes jigs, dies, molds, returnable containers, glassware, silverware, textile mill cam assemblies, and other equipment included in group 1, class 5, of Revenue Procedure 62–21. which is usually and property accounted for separately from other property and under a method of depreciation not expressed in terms of years.

(6) *Special rule for certain public utility property*—(i) *Requirement of normalization in certain cases.* Under section 167(1), in the case of public utility property (as defined in section 167(1)(3)(A)), if the taxpayer—

(a) Is entitled to use a method of depreciation other than a ‘‘subsection (1) method’’ of depreciation (as defined in section 167(1)(3)(F)) only if it uses the ‘‘normalization method of accounting’’ (as defined in section 167(1)(3)(G)) with respect to such property, or

(b) Is entitled for the taxable year to use only a ‘‘subsection (1) method’’ of depreciation, such property shall be eligible property (as defined in subparagraph (2) of this paragraph) only if the taxpayer normalizes the tax deferral resulting from the election to apply this section.

(ii) *Normalization.* The taxpayer will be considered to normalize the tax deferral resulting from the election to apply this section only if it computes its tax expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using a period for depreciation no less than the lesser of—

(a) 100 percent of the asset guideline period in effect in accordance with subparagraph (4)(ii) of this paragraph for the first taxable year to which this section applies, or

(b) The period for computing its depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account, and makes adjustments to a reserve to reflect the deferral of taxes resulting from the election to apply this section. A determination whether the taxpayer is considered to normalize (within the meaning of the preceding sentence) the tax deferral resulting from the election to apply this section shall be made in a manner consistent with the principles for determining whether a taxpayer is using the ‘‘normalization method of accounting’’ (within the meaning of section 167(1)(3)(G)). [Removed] See §1.167(1)–1(h).

(iii) *Failure to normalize.* If a taxpayer, which has elected to apply this section to any eligible public utility property and is required under subdivision (i) of this subparagraph to normalize the tax deferral resulting from the election to apply this section to such property, fails to normalize such tax deferral, the election to apply this section to such property shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize such tax deferral. Application of this section to such property for any period prior to the termination date will not be affected by the termination. The unadjusted basis of the property shall be removed as of the termination date from the unadjusted basis of the vintage account. The depreciation reserve established for the account shall be reduced by the depreciation allowable for the property, computed in the manner prescribed in paragraph (c)(1)(v)*(b)* of this section for determination of the adjusted basis of the property. See paragraph (d)(3)(vii)*(e)* of this section for treatment of salvage value when property is removed from a vintage account.

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

Example (1). Corporation A is a gas pipeline company, subject to the jurisdiction of the Federal Power Commission, which is entitled under section 167(1) to use a method of depreciation other than a ''subsection (1) method'' of depreciation (as defined in section 167(1)(3) (F)) only if it uses the ''normalization method of accounting'' (as defined in section 167(1)(3)(G)). Corporation A elects to apply this section for 1972 with respect to all eligible property. In 1972, corporation A places in service eligible property with an unadjusted basis of $2 million. One hundred percent of the asset guideline period for such property is 22 years and the asset depreciation range is from 17.5 years to 26.5 years. The taxpayer uses the double declining balance method of depreciation, selects an asset depreciation period of 17.5 years and applies the half-year convention (described in paragraph (c)(2)(iii) of this section). The depreciation allowable under this section with respect to such property in 1972 is $114,285. The taxpayer will be considered to normalize the tax deferral resulting from the election to apply this section and to use the ''normalization method of accounting'' (within the meaning of section 167(1)(3)(G)) if it computes its tax expense for purposes of determining its cost of service for rate making purposes and for reflecting operating results in its regulated books of account using a ''subsection (1) method'' of depreciation, such as the straight line method, determined by using a depreciation period of 22 years (that is, 100 percent of the asset guideline period). A depreciation allowance computed in this manner is $45,454. The difference in the amount determined under this section ($114,285) and the amount used in computing its tax expense for purposes of estimating its cost of service for rate making purposes and for reflecting operating results in its regulated books of account ($45,454) is $68,831. Assuming a tax rate of 48 percent, the deferral of taxes resulting from an election to apply this section and using a different method of depreciationfor tax purposes from that used for establishing its cost of service for rate making purposes and for reflecting operating results in its regulated books of account is 48 percent of $68,831, or $33,039, which amount should be added to a reserve to reflect the deferral of taxes resulting from the election to apply this section and from the use of a different method of depreciation in computing the allowance for depreciation under section 167 from that used in computing its depreciation expense for purposes of establishing its cost of service for rate making purposes and for reflecting operating results in its regulated books of account.

Example (2). Corporation B, a telephone company subject to the jurisdiction of the Federal Communications Commission used a ''flow-through method of accounting'' (as defined in section 167(1)(3)(H)) for its ''July 1969 accounting period'' (as defined in section 167(1)(3)(I)) with respect to all of its pre-1970 public utility property and did not make an election under section 167(1)(4)(A). Thus, corporation B is entitled under section 167(1) to use a method of depreciation other than a ''subsection (1) method'' with respect to certain property without using the ''normalization method of accounting.'' In 1972, corporation B makes an election to apply this section with respect to all eligible property. Corporation B is not required to normalize the tax deferral resulting from the election to apply this section in the case of property for which it is not required to use the ''normalization method of accounting'' under section 167(1).

Example (3). Assume the same facts as in example (2) except that corporation B made a timely election under section 167(1)(4)(A) that section 167(1)(2)(C) not apply with respect to property which increases the productive or operational capacity of the taxpayer. Corporation B must normalize the tax deferral resulting from the election to apply this section with respect to such property.

(7) *Mere change in form of conducting a trade or business.* Property which was first placed in service by the transferor before January 1, 1971, shall not be eligible property if such property is first placed in service by the transferee after December 31, 1970, by reason of a mere change in the form of conducting a trade or business in which such property is used. A mere change in the form of conducting a trade or business in which such property is used will be considered to have occurred if—

(i) The transferor (or in a case where the transferor is a partnership, estate, trust, or corporation, the partners, beneficiaries, or shareholders) of such property retains a substantial interest in such trade or business, or

(ii) The basis of such property in the hands of the transferee is determined in whole or in part by reference to the basis of such property in the hands of the transferor.

For purposes of this subparagraph, a transferor (or in a case where the transferor is a partnership, estate, trust, or corporation, the partners, beneficiaries, or shareholders) shall be considered as having retained a substantial interest in the trade or business only if, after the change in form, his (or their) interest in such trade or business is substantial in relation to the total interest of all persons in such trade or business. This subparagraph shall apply to property first placed in service prior to January 1, 1971, held for the production of income (within the meaning of section 167(a)(2)) as well as to property used in a trade or business. The principles of this subdivision may be illustrated by the following examples:

Example (1). Corporation X and corporation Y are includible corporations in an affiliated group as defined in section 1504(a). In 1971 corporation X sells property to corporation Y for cash. The property would meet the requirements of subparagraph (2) of this paragraph for eligible property except that it was first placed in service by corporation X in 1970. After the transfer, the property is first placed in service by corporation Y in 1971. The property is not eligible property because of the mere change in the form of conducting a trade or business.

Example (2). In 1971, in a transaction to which section 351 applies, taxpayer B transfers to corporation W property which would meet the requirements of subparagraph (2) of this paragraph for eligible property except that the property was first placed in service by B in 1969. Corporation W first places the property in service in 1971. The property is not eligible property because of the mere change in the form of conducting a trade or business.

(c) *Manner of determining allowance*—(1) *In general*—(i) *Computation of allowance. (a)* The allowance for depreciation of property in a vintage account shall be determined in the manner specified in this paragraph by using the method of depreciation adopted by the taxpayer for the account and a rate based upon the asset depreciation period for the account. (For limitations on methods of depreciation permitted with respect to property, see section 167 (c) and (j) and subdivision (iv) of this subparagraph.) In applying the method of depreciation adopted by the taxpayer, the annual allowance for depreciation of a vintage account shall be determined without adjustment for the salvage value of the property in such account except that no account may be depreciated below the reasonable salvage value of the account. (For rules regarding estimation and treatment of salvage value, see paragraph (d)(1) and (3) (vii) and (viii) of this section.) Regardless of the method of depreciation adopted by the taxpayer, the depreciation allowable for a taxable year with respect to a vintage account may not exceed the amount by which (as of the beginning of the taxable year) the unadjusted basis of the account exceeds *(1)* the reserve for depreciation established for the account plus *(2)* the salvage value of the account. The unadjusted basis of a vintage account is defined in subdivision (v) of this subparagraph. The adjustments to the depreciation reserve are described in subdivision (ii) of this subparagraph.

(b) The annual allowance for depreciation of a vintage account using the straight line method of depreciation shall be determined by dividing the unadjusted basis of the vintage account (without reduction for salvage value) by the number of years in the asset depreciation period selected for the account. See subdivision (iii)*(b)* of this subparagraph for the manner of computing the depreciation allowance following a change from the declining balance method or the sum of the years-digits method to the straight line method.

(c) In the case of the sum of the years-digits method, the annual allowance for depreciation of a vintage account shall be computed by multiplying the unadjusted basis of the vintage account (without reduction for salvage value) by a fraction, the numerator of which changes each year to a number which corresponds to the years remaining in the asset depreciation period for the account (including the year for which the allowance is being computed) and the denominator of which is the sum of all the year's digits corresponding to the asset depreciation period for the account. See subdivision (iii)*(c)* of this subparagraph for the manner of computing the depreciation allowance following a change from the declining balance method to the sum of the years-digits method.

(d) The annual allowance for depreciation of a vintage account using a declining balance method is determined

by applying a uniform rate to the excess of the unadjusted basis of the vintage account over the depreciation reserve established for that account. The rate under the declining balance method may not exceed twice the straight line rate based upon the asset depreciation period for the vintage account.

(e) The allowance for depreciation under this paragraph shall constitute the amount of depreciation allowable under section 167. See section 179 for additional first-year allowance for certain property.

(ii) *Establishment of depreciation reserve.* The taxpayer must establish a depreciation reserve for each vintage account. The amount of the reserve for a guideline class must be stated on each income tax return on which depreciation with respect to such class is determined under this section. The depreciation reserve for a vintage account consists of the accumulated depreciation allowable under this section with respect to the vintage account, increased by the adjustments for ordinary retirements prescribed by paragraph (d)(3)(iii) of this section, by the adjustments for reduction of the salvage value of a vintage account prescribed by paragraph (d)(3)(vii)*(d)* of this section, and by the adjustments for transfers to supplies or scrap prescribed by paragraph (d)(3)(viii)*(b)* of this section, and decreased by the adjustments for extraordinary retirements and certain special retirements as prescribed by paragraph (d)(3) (iv) and (v) of this section, by the adjustments for the amount of the reserve in excess of the unadjusted basis of a vintage account prescribed by paragraph (d)(3)(ix)*(a)* of this section, and by the adjustments for property removed from a vintage account prescribed by paragraphs (b)(4)(iii)*(e),* (5)(v)*(b)* and (6)(iii) of this section. The adjustments to the depreciation reserve for ordinary retirements during the taxable year shall be made as of the beginning of the taxable year. The adjustments to the depreciation reserve for extraordinary retirements shall be made as of the date the retirement is treated as having occurred in accordance with the first-year convention (described in subparagraph (2) of this paragraph) adopted by the taxpayer for the vintage account. The adjustment to the depreciation reserve for reduction of salvage value and for transfers to supplies or scrap shall, in the case of an ordinary retirement, be made as of the beginning of the taxable year, and in the case of an extraordinary retirement the adjustment for reduction of salvage value shall be made as of the date the retirement is treated as having occurred in accordance with the first-year convention (described in subparagraph (2) of this paragraph) adopted by the taxpayer for the vintage account. The adjustment to the depreciation reserve for property removed from a vintage account in accordance with paragraph (b)(4)(iii)*(e),* (5)(v)*(b)* and (6)(iii) of this section shall be made as of the beginning of the taxable year. The depreciation reserve of a vintage account may not be decreased below zero.

(iii) *Consent to change in method of depreciation. (a)* During the asset depreciation period for a vintage account, the taxpayer is permitted to change under this section from a declining balance method of depreciation to the sum of the years-digits method of depreciation and from a declining balance method of depreciation or the sum of the years-digits method of depreciation to the straight line method of depreciation with respect to such account. Except as provided in section 167(j)(2)(1), and paragraph (e)(3)(i) of this section, no other changes in the method of depreciation adopted for a vintage account will be permitted. The provisions of § 1.167(e)–1 shall not apply to any change in depreciation method permitted under this section. The change in method applies to all property in the vintage account and must be adhered to for the entire taxable year of the change.

(b) When a change is made to the straight line method of depreciation, the annual allowance for depreciation of the vintage account shall be determined by dividing the adjusted basis of the vintage account (without reduction for salvage value) by the number of years remaining (at the time as of which the change is made) in the asset depreciation period selected for the account. However, the depreciation allowable for any taxable year following a change to the straight line method

may not exceed an amount determined by dividing the unadjusted basis of the vintage account (without reduction for salvage value) by the number of years in the asset depreciation period selected for the account.

(c) When a change is made from the declining balance method of depreciation to the sum of the years-digits method of depreciation, the annual allowance for depreciation of a vintage account shall be determined by multiplying the adjusted basis of the account (without reduction for salvage value) at the time as of which the change is made by a fraction, the numerator of which changes each year to a number which corresponds to the number of years remaining in the asset depreciation period selected for the account (including the year for which the allowance is being computed), and the denominator of which is the sum of all the year's digits corresponding to the number of years remaining in the asset depreciation period at the time as of which the change is made.

(d) The number of years remaining in the asset depreciation period selected for an account is equal to the asset depreciation period less the number of years of depreciation previously allowed. For this purpose, regardless of the first year convention adopted by the taxpayer, it will be assumed that depreciation was allowed for one-half of a year in the first year.

(e) The taxpayer shall furnish a statement setting forth the vintage accounts for which the change is made with the income tax return filed for the taxable year of the change.

(f) The principles of this subdivision may be illustrated by the following examples:

Example (1). A, a calendar year taxpayer, places new section 1245 property in service in a trade or business as follows:

Asset	Placed in service	Unadjusted basis	Estimated salvage
X	Mar. 15, 1971	$400	$20
Y	June 13, 1971	500	50
Z	July 30, 1971	100	0

The property is eligible property and is properly included in a single vintage account. The asset depreciation range for such property is 5 to 7 years and the taxpayer selects an asset depreciation period of 5½ years and adopts the 200-percent declining balance method of depreciation. The taxpayer adopts the half-year convention described in subparagraph (2)(iii) of this paragraph. After 3 years, A changes from the 200-percent declining balance method to the straight line method of depreciation. Depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	$1,000	0.18182	$181.82	$181.82	$818.18
1972	1,000	.36363	297.52	479.34	520.66
1973	1,000	.36363	189.33	668.67	331.33
1974	1,000	[1].33333	110.44	779.11	220.89
1975	1,000	.33333	110.44	889.56	110.44
1976	1,000	.33333	[2]40.44	930.00	70.00

[1] Rate applied to adjusted basis of the account (without reduction by salvage) at the time as of which the change is made to the straight line method.

[2] The allowable depreciation is limited by estimated salvage.

Example (2). The facts are the same as in example (1) except that A elects to use the modified half-year convention described in subparagraph (2)(ii) of this paragraph. The depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	$1,000	[1]0.36363	$327.27	$327.27	$672.73
1972	1,000	.36363	244.63	571.90	428.10
1973	1,000	.36363	155.67	727.57	272.43
1974	1,000	.33333	90.81	818.38	181.62
1975	1,000	.33333	90.81	909.19	90.81
1976	1,000	.33333	[2]20.81	930.00	70.00

[1] Rate applied to $900, the amount of assets placed in service during the first half of the taxable year.

[2] The allowable depreciation is limited by estimated salvage.

Example (3). The facts are the same as in example (1) except that A adopted the sum of the years-digits method of depreciation and does not change to the straight line method of depreciation. The depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	$1,000	[1] 2.75/18	$152.78	$152.78	$847.22
1972	1,000	5/18	277.78	430.56	569.44
1973	1,000	4/18	222.22	652.78	347.22
1974	1,000	3/18	166.67	819.45	180.55
1975	1,000	2/18	[2] 110.55	930.00	70.00
1976	1,000	1/18	0.00	930.00	70.00
1977	1,000	0.25/18	0.00	930.00	70.00

[1] Rate is equal to one-half of 5.5/18. The denominator is equal to 5.5+4.5+3.5+2.5+1.5+0.5.
[2] The allowable depreciation is limited by estimated salvage.

Example (4). The facts are the same as in example (3) except that A elects to use the modified half-year convention described in subparagraph (2) (ii) of this paragraph. The depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	$1,000	[1] 5.5/18	$275.00	$275.00	$725.00
1972	1,000	5/18	277.78	552.78	447.22
1973	1,000	4/18	222.22	775.00	225.00
1974	1,000	3/18	[2] 155.00	930.00	70.00
1975	1,000	2/18	0.00	930.00	70.00
1976	1,000	1/18	0.00	930.00	70.00
1977	1,000	0.25/18	0.00	930.00	70.00

[1] Rate applied to $900, the amount of assets placed in service during the first half of the taxable year.
[2] The allowable depreciation is limited by estimated salvage.

Example (5). The facts are the same as in example (2) except that after 2 years A changes from the 200-percent declining balance method to the sum of the years-digits method of depreciation. The depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	$1,000	0.36363	$327.27	$327.27	$672.73
1972	1,000	.36363	244.63	571.90	428.10
1973	1,000	4/10	171.24	743.14	256.86
1974	1,000	3/10	128.43	871.57	128.43
1975	1,000	2/10	[1] 58.43	930.00	70.00
1976	1,000	1/10	0.00	930.00	70.00

[1] The allowable depreciation is limited by estimated salvage.

(iv) *Limitation on methods. (a)* The same method of depreciation must be adopted for all property in a single vintage account. Generally, the method of depreciation which may be adopted is subject to the limitations contained in section 167(c), (j) and (l).

(b) Except as otherwise provided in section 167(j) with respect to certain eligible section 1250 property—

(1) In the case of a vintage account for which the taxpayer has selected an asset depreciation period of 3 years or more and which only contains property the original use of which commences with the taxpayer, any method of depreciation described in section 167(b) (1), (2), or (3) may be adopted, but if the vintage account contains property the original use of which does not commence with the taxpayer, or if the asset depreciation period for the account is less than 3 years, a method of depreciation described in section 167(b) (2) or (3) may not be adopted for the account, and

(2) The declining balance method using a rate not in excess of 150 percent of the straight line rate based upon the asset depreciation period for the vintage account may be adopted for the account even if the original use of the

property does not commence with the taxpayer provided the asset depreciation period for the account is at least 3 years.

(c) The term ‘‘original use’’ means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. (See §1.167(c)–1).

(v) *Unadjusted and adjusted basis. (a)* For purposes of this section, the unadjusted basis of an asset (including an ‘‘excluded addition’’ and a ‘‘property improvement’’ as described, respectively, in paragraph (d)(2) (vi) and (vii) of this section) is its cost or other basis without any adjustment for depreciation or amortization (other than depreciation under section 179) but with other adjustments required under section 1016 or other applicable provisions of law. The unadjusted basis of a vintage account is the total of the unadjusted bases of all the assets in the account. The unadjusted basis of a ‘‘special basis vintage account’’ as described in paragraph (d)(3)(vi) of this section is the amount of the property improvement determined in paragraph (d)(2)(vii)*(a)* of this section.

(b) The adjusted basis of a vintage account is the amount by which the unadjusted basis of the account exceeds the reserve for depreciation for the account. The adjusted basis of an asset in a vintage account is the amount by which the unadjusted basis of the asset exceeds the amount of depreciation allowable for the asset under this section computed by using the method of depreciation and the rate applicable to the account. For purposes of this subdivision, the depreciation allowable for an asset shall include, to the extent identifiable, the amount of proceeds previously added to the depreciation reserve in accordance with paragraph (d)(3)(iii) of this section upon the retirement of any portion of such asset. (See paragraph (d)(3)(vi) of this section for election under certain circumstances to allocate adjusted basis of an amount of property improvement determined under paragraph (d)(2)(vii)*(a)* of this section.)

(2) *Conventions applied to additions and retirements*—(i) *In general.* The allowance for depreciation of a vintage account (whether an item account or a multiple asset account) shall be determined by applying one of the conventions described in subdivisions (ii) and (iii) of this subparagraph. (For the manner of applying a convention in the case of taxable years beginning before and ending after December 31, 1970, see subparagraph (3) of this paragraph.) The same convention must be adopted for all vintage accounts of a taxable year, but the same convention need not be adopted for the vintage accounts of another taxable year. An election to apply this section must specify the convention adopted. (See paragraph (f) of this section for information required in making the election.) The convention adopted by the taxpayer is a method of accounting for purposes of section 446, but the consent of the Commissioner will be deemed granted to make an annual adoption of either of the conventions described in subdivisions (ii) and (iii) of this subparagraph.

(ii) *Modified half-year convention.* The depreciation allowance for a vintage account for which the taxpayer adopts the ‘‘modified half-year convention’’ shall be determined by treating: *(a)* All property in such account which is placed in service during the first half of the taxable year as placed in service on the first day of the taxable year; and *(b)* all property in such account which is placed in service during the second half of the taxable year as placed in service on the first day of the succeeding taxable year. The depreciation allowance for a vintage account for a taxable year in which there is an extraordinary retirement (as defined in paragraph (d) (3) (ii) of this section) of property first placed in service during the first half of the taxable year is determined by treating all such retirements from such account during the first half of the taxable year as occurring on the first day of the taxable year and all such retirements from such account during the second half of the taxable year as occurring on the first day of the second half of the taxable year. The depreciation allowance for a vintage account for a taxable year in which there is an extraordinary retirement (as defined in paragraph (d)(3)(ii) of this section) of property first placed in service during the second half of the taxable year is determined by treating all such retirements from such account during the first half of the taxable year as occurring on the first day of the second half of the taxable year and all such retirements in the second half of the taxable year as occurring on the first day of the succeeding taxable year.

(iii) *Half-year convention.* The depreciation allowance for a vintage account for which the taxpayer adopts the ''half-year convention'' shall be determined by treating all property in the account as placed in service on the first day of the second half of the taxable year and by treating all extraordinary retirements (as defined in paragraph (d)(3)(ii) of this section) from the account as occurring on the first day of the second half of the taxable year.

(iv) *Rules of application.* (*a*) The first-year convention adopted for a vintage account must be consistently applied to all additions to and all extraordinary retirements from such account. See paragraph (d)(3) (ii) and (iii) of this section for definition and treatment of ordinary retirements.

(*b*) If the actual number of months in a taxable year is other than 12 full calendar months, depreciation is allowed only for such actual number of months and the term ''taxable year'', for purposes of this subparagraph, shall mean only such number of months. In such event, the first half of such taxable year shall be deemed to expire at the close of the last day of a calendar month which is the closest such last day to the middle of such taxable year and the second half of such taxable year shall be deemed to begin the day after the expiration of the first half of such taxable year. If a taxable year consists of a period which includes only 1 calendar month, the first half of the taxable year shall be deemed to expire on the first day which is nearest to the midpoint of the month, and the second half of the taxable year shall begin the day after the expiration of the first half of the month.

(*c*) For purposes of this subparagraph, for property placed in service after November 14, 1979, other than depreciable property described in paragraph (c)(2)(iv)(*e*) of this section, the taxable year of the person placing such property in service does not include any month before the month in which the person begins engaging in a trade or business or holding depreciable property for the production of income.

(*d*) For purposes of paragraph (c)(2)(iv)(*c*) of this section—

(*1*) For property placed in service after February 21, 1981, an employee is not considered engaged in a trade or business by virtue of employment.

(*2*) If a person engages in a small amount of trade or business activity after February 21, 1981, for the purpose of obtaining a disproportionately large depreciation deduction for assets for the taxable year in which they are placed in service, and placing those assets in service represents a substantial increase in the person's level of business activity, then for purposes of depreciating those assets the person will not be treated as beginning a trade or business until the increased amount of business activity begins. For property held for the production of income, the principle of the preceding sentence applies.

(*3*) A person may elect to apply the rules of § 1.167(a)–11 (c)(2)(iv)(*d*) as set forth in T.D. 7763 (''(*d*) rules in T.D. 7763''). This election shall be made by reflecting it under paragraph (f)(4) of this section in the books and records. If necessary, amended returns shall be filed.

(*4*) If an averaging convention was adopted in reliance on or in anticipation of the (*d*) rules in T.D. 7763, that convention may be changed without regard to paragraph (f)(3) of this section. Similarly, if an election is made under paragraph (c)(2)(iv)(*d*)(*3*) of this section to apply to the (*d*) rules in T.D. 7763, the averaging convention adopted for the taxable years for which the election is made may be changed. The change shall be made by filing a timely amended return for the taxable year for which the convention was adopted. Notwithstanding the three preceding sentences, if an averaging convention was adopted in reliance on or in anticipation of the (*d*) rules in T.D. 7763, and if an election is made to apply those rules, the averaging convention adopted cannot be changed except as provided in paragraph (f) of this section.

(*e*) The rules in paragraph (c)(2)(iv)(*c*) of this section do not apply to depreciable property placed in service after November 14, 1979, and the rules in paragraph (c)(2)(iv)(*d*) of this section do not apply to depreciable property placed in service after February 21, 1981, with respect to which substantial expenditures were paid or incurred prior to November 15, 1979. For purposes of the preceding sentence, expenditures will not be considered substantial unless they exceed the lesser of 30 percent of the final cost of the property or $10 million. Expenditures that are not includible in the basis of the depreciable property will be considered expenditures with respect to property if they are directly related to a specific project involving such property. For purposes of determining whether expenditures were paid or incurred prior to November 15, 1979, expenditures made by a person (transferor) other than the person placing the property in service (transferee) will be taken into account only if the basis of the property in the hands of the transferee is determined in whole or in part by reference to the basis in the hands of the transferor. The principle of the preceding sentence also applies if there are multiple transfers.

(v) *Mass assets.* In the case of mass assets, if extraordinary retirements of such assets in a guideline class during the first half of the taxable year are allocated to a particular vintage year for which the taxpayer applied the modified half-year convention, then that portion of the mass assets so allocated which bears the same ratio to the total number of mass assets so allocated as the mass assets in the same vintage and assets guideline class placed in service during the first half of that vintage year bear to the total mass assets in the same vintage and asset guideline class shall be treated as retired on the first day of the taxable year. The remaining mass assets which are subject to extraordinary retirement during the first half of the taxable year and which are allocated to that vintage year and assets guideline class shall be treated as retired on the first days of the second half of the taxable year. If extraordinary retirements of mass assets in a guideline class occur in the second half of the taxable year and are allocated to a particular vintage year for which the taxpayer applied the modified half-year convention, then that portion of the mass assets so allocated which bears the same ratio to the total number ofmass assets so allocated as the mass assets in the same vintage and asset guideline class first placed in service during the first half of that vintage year bear to the total mass assets in the same vintage and asset guideline class shall be treated as retired on the first day of the second half of the taxable year. The remaining mass assets which are subject to extraordinary retirements during the second half of the taxable year and which are allocated to that same vintage and asset guideline class shall be treated as retired on the first day of the succeeding taxable year. If the taxpayer has applied the half-year convention for the vintage year to which the extraordinary retirements are allocated, the mass assets shall be treated as retired on the first day of the second half of the taxable year.

(3) *Taxable years beginning before and ending after December 31, 1970.* In the case of a taxable year which begins before January 1, 1971, and ends after December 31, 1970, property first placed in service after December 31, 1970, but treated as first placed in service before January 1, 1971, by application of a convention described in subparagraph (2) of this paragraph shall be treated as provided in this subparagraph. The depreciation allowed (or allowable) for the taxable year shall consist of the depreciation allowed (or allowable) for the period before January 1, 1971, determined without regard to this section plus the amount allowable for the period after December 31, 1970, determined under this section. However, neither the modified half-year convention described in subparagraph (2)(ii) of this paragraph, nor the half-year convention described in subparagraph (2)(iii) of this paragraph may for any such taxable year be applied with respect to property placed in service after December 31, 1970, to allow depreciation for any period prior to January 1, 1971, unless such convention is consistent with the convention applied by the taxpayer

with respect to property placed in service in such taxable year prior to January 1, 1971.

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

Example (1). Taxpayer A, a calendar year taxpayer, places new property in service in a trade or business as follows:

Asset	Placed in service	Unadjusted basis
W	Apr. 1, 1971	$5,000
X	June 30, 1971	8,000
Y	July 15, 1971	12,000

Taxpayer A adopts the modified half-year convention described in subparagraph (2) (ii) of this paragraph. Assets W, X, and Y are placed in a multiple asset account for which the asset depreciation range is 8 to 12 years. A selects 8 years, the minimum asset depreciation period with respect to such assets, and adopts the declining balance method of depreciation using a rate twice the straight line rate (computed without reduction for salvage). The annual rate under this method using a period of 8 years is 25 percent. The depreciation allowance for assets W and X for 1971 is $3,250, a full year's depreciation under the modified half-year convention (that is, basis of $13,000 (unreduced by salvage) multiplied by 25 percent). The depreciation allowance for asset Y for 1971 is zero under the modified half-year convention.

Example (2). The facts are the same as in example (1), except that the taxpayer adopts the half-year convention described in subparagraph (2) (iii) of this paragraph. The depreciation allowance with respect to asset Y is $1,500 (that is the basis of $12,000 multiplied by 25 percent, then multiplied by ½). Assets W and X are also entitled to a depreciation allowance for only a half year. Thus, the depreciation allowance for assets W and X for 1971 is $1,625 (that is, ½ of the $3,250 allowance computed in example (1)).

Example (3). Asset Z is placed in service by a calendar year taxpayer on December 1, 1971. The taxpayer places asset Z in an item account and adopts the sum of the years-digits method and the half year convention described in subparagraph (2) (iii) of this paragraph. The asset depreciation range for such asset is 4 to 6 years and the taxpayer selects an asset depreciation period of 5 years. The depreciation allowance for asset Z in 1971 is $10,000 (that is, basis of $60,000 (unreduced by salvage) multiplied by $\frac{5}{15}$, the appropriate fraction using the sum of the years-digits method then multiplied by ½, since only one half year's depreciation is allowable under the convention).

Example (4). A is a calendar year taxpayer. All taxpayer A's assets are placed in service in the first half of 1971. If the taxpayer selects the modified half-year convention described in subparagraph (2) (ii) of this paragraph, a full year's depreciation is allowable for all assets.

Example (5). (i) The taxpayer during his taxable year which begins April 1, 1970, and ends March 31, 1971, places new property in service in a trade or business as follows:

Asset	Placed in service	Unadjusted basis
A	Apr. 30, 1970	$10,000
B	Dec. 15, 1970	10,000
C	Jan. 1, 1971	10,000

The taxpayer adopted a convention under § 1.167(a)–10(b) with respect to assets placed in service prior to January 1, 1971, which treats assets placed in service during the first half of the year as placed in service on the first day of such year and assets placed in service in the second half of the year as placed in service on the first day of the following year. If the taxpayer selects the half-year convention described in subparagraph (2) (iii) of this paragraph, one year's depreciation is allowable on asset A determined without regard to this section. No depreciation is allowable for asset B. No depreciation is allowable for asset C for the period prior to January 1, 1971. One-fourth year's depreciation is allowable on asset C determined under this section.

(ii) The facts are the same as in (i) of this example except that the taxpayer adopts the modified half-year convention described in subparagraph (2) (ii) of this paragraph for 1971. No depreciation is allowable for assets B and C which were placed in service in the second half of the taxable year.

Example (6). The taxpayer during his taxable year which begins August 1, 1970, and ends July 31, 1971, places new property in service in a trade or business as follows:

Asset	Placed in service
A	Aug. 1, 1970.
B	Jan. 15, 1971.
C	June 30, 1971.

The taxpayer adopted a convention under § 1.167(a)–10(b) with respect to assets placed in service prior to January 1, 1971, which treats all assets as placed in service at the mid-point of the taxable year. If the taxpayer selects the half-year convention described in subparagraph (2) (iii) of this paragraph, one-half year's depreciation is allowable for asset A determined without regard to this section. One-half year's depreciation is allowable for assets B and C determined under this section.

Example (7). X, a calendar year corporation, is incorporated on July 1, 1978, and begins engaging in a trade or business in September 1979. X purchases asset A and places it in service on November 20, 1979. Substantial expenditures were not paid or incurred by X with respect to asset A prior to November 15, 1979. For purposes of applying the conventions under this section to determine depreciation for asset A, the 1979 taxable year is treated as consisting of 4 months. The first half of the taxable year ends on October 31, 1979, and the second half begins on November 1, 1979. X adopts the half-year convention. Asset A is treated as placed in service on November 1, 1979.

Example (8). On January 20, 1982, A, B, and C enter an agreement to form partnership P for the purpose of purchasing and leasing a ship to a third party, Z. P uses the calendar year as its taxable year. On December 15, 1982, P acquires the ship and leases it to Z. For purposes of applying the conventions, P begins its leasing business in December 1982, and its taxable year begins on December 1, 1982. Assuming that P elects to apply this section and adopts the modified half-year convention, P depreciates the ship placed in service in 1982 for the 1-month period beginning December 1, 1982, and ending December 31, 1982.

Example (9). A and B form partnership P on December 15, 1981, to conduct a business of leasing small aircraft. P uses the calendar year as its taxable year. On January 15, 1982, P acquires and places in service a $25,000 aircraft. P begins engaging in business with only one aircraft for the purpose of obtaining a disproportionately large depreciation deduction for aircraft that P plans to acquire at the end of the year. On December 10, 1982, P acquires and places in service 4 aircraft, the total purchase price of which is $250,000. For purposes of applying the conventions to the aircraft acquired in December, P begins its leasing business in December 1982, and P's taxable year begins December 1, 1982, and ends December 31, 1982. Assuming that P elects to apply this section and adopts the modified half-year convention, P depreciates the aircraft placed in service in December 1982, for the 1-month period beginning December 1, 1982, and ending December 31, 1982. P depreciates the aircraft placed in service in January 1982, for the 12-month period beginning January 1, 1982, and ending December 31, 1982.

(d) *Special rules for salvage, repairs and retirements*—(1) *Salvage value*—(i) *Definition of gross salvage value.* ''Gross salvage'' value is the amount which is estimated will be realized upon a sale or other disposition of the property in the vintage account when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service, without reduction for the cost of removal, dismantling, demolition or similar operations. If a taxpayer customarily sells or otherwise disposes of property at a time when such property is still in good operating condition, the gross salvage value of such property is the amount expected to be realized upon such sale or disposition, and under certain circumstances, as where such property is customarily sold at a time when it is still relatively new, the gross salvage value may constitute a relatively large proportion of the unadjusted basis of such property.

(ii) *Definition of salvage value.* ''Salvage value'' means gross salvage value less the amount, if any, by which the gross salvage value is reduced by application of section 167(f). Generally, as provided in section 167(f), a taxpayer may reduce the amount of gross salvage value of a vintage account by an amount which does not exceed 10 percent of the unadjusted basis of the personal property (as defined in section 167(f)(2)) in the account. See paragraph (b)(3)(ii) of this section for requirement of separate vintage accounts for personal property described in section 167(f)(2).

(iii) *Estimation of salvage value.* The salvage value of each vintage account of the taxable year shall be estimated by the taxpayer at the time the election to apply this section is made, upon the basis of all the facts and circumstances existing at the close of the taxable year in which the account is established. The taxpayer shall specify the amount, if any, by which gross salvage value taken into account is reduced by application of section 167(f). See paragraph (f)(2) of this section for requirement that the election specify the estimated salvage value for each vintage account of the taxable year of election. The salvage value estimated by the taxpayer will not be redetermined merely as a result of fluctuations in price levels or as a result of other facts and circumstances occurring after the close of the taxable year of election. Salvage value for a vintage account need not be established or increased as a result of a property improvement as described in subparagraph (2) (vii) of this paragraph. The taxpayer shall maintain records reasonably sufficient to determine facts and circumstances taken into account in estimating salvage value.

(iv) *Salvage as limitation on depreciation*. In no case may a vintage account be depreciated below a reasonable salvage value after taking into account any reduction in gross salvage value permitted by section 167(f).

(v) *Limitation on adjustment of reasonable salvage value.* The salvage value established by the taxpayer for a vintage account will not be redetermined if it is reasonable. Since the determination of salvage value is a matter of estimation, minimal adjustments will not be made. The salvage value established by the taxpayer will be deemed to be reasonable unless there is sufficient basis in the facts and circumstances existing at the close of the taxable year in which the account is established for a determination of an amount of salvage value for the account which exceeds the salvage value established by the taxpayer for the account by an amount greater than 10 percent of the unadjusted basis of the account at the close of the taxable year in which the account is established. If the salvage value established by the taxpayer for the account is not within the 10 percent range, or if the taxpayer follows the practice of understating his estimates of gross salvage value to take advantage of this subdivision, and if there is a determination of an amount of salvage value for the account which exceeds the salvage value established by the taxpayer for the account, an adjustment will be made by increasing the salvage value established by the taxpayer for the account by an amount equal to the difference between the salvage value as determined and the salvage value established by the taxpayer for the account. For the purposes of this subdivision, a determination of salvage value shall include all determinations at all levels of audit and appellate proceedings, and as well as all final determinations within the meaning of section 1313(a) (1). This subdivision shall apply to each such determination. (See example (3) of subdivision (vi) of this subparagraph.)

(vi) *Examples.* The principles of this subparagraph may be illustrated by the following examples in which it is assumed that the taxpayer has not followed a practice of understating his estimates of gross salvage value:

Example (1). Taxpayer B elects to apply this section to assets Y and Z, which are placed in a multiple asset vintage account of 1971 for which the taxpayer selects an asset depreciation period of 8 years. The unadjusted basis of asset Y is $50,000 and the unadjusted basis of asset Z is $30,000. B estimates a gross salvage value of $55,000. The property qualifies under section 167(f) (2) and B reduces the amount of salvage taken into account by $8,000 (that is, 10 percent of $80,000 under section 167(f)). Thus, B establishes a salvage value of $47,000 for the account. Assume that there is not sufficient basis for determining a salvage value for the account greater than $52,000 (that is, $60,000 minus the $8,000 reduction under section 167(f)). Since the salvage value of $47,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage value for the account will not be redetermined.

Example (2). The facts are the same as in example (1) except that B estimates a gross salvage value of $50,000 and establishes a salvage value of $42,000 for the account (that is, $50,000 minus the $8,000 reduction under section 167(f)). There is sufficient basis for determining an amount of salvage value greater than $50,000 (that is, $58,000 minus the $8,000 reduction under section 167(f)). The salvage value of $42,000 established by B for the account can be redetermined without regard to the limitation in subdivision (v) of this subparagraph, since it is not within the 10 percent range. Upon audit of B's tax return for a taxable year for which the redetermination would affect the amount of depreciation allowable for the account, salvage value is determined to be $52,000 after taking into account the reduction under section 167(f). Salvage value for the account will be adjusted to $52,000.

Example (3). The facts are the same as in example (1) except that upon audit of B's tax return for a taxable year the examining officer determines the salvage value to be $58,000 (that is, $66,000 minus the $8,000 reduction under section 167(f)), and proposes to adjust salvage value for the vintage account to $58,000 which will result in disallowing an amount of depreciation for the taxable year. B does not agree with the finding of the examining officer. After receipt of a ''30-day letter'', B waives a district conference and initiates proceedings before the Appellate Division. In consideration of the case by the Appellate Division it is concluded that there is not sufficient basis for determining an amount of salvage value for the account in excess of $55,000 (that is $63,000 minus the $8,000 reduction under section 167(f)). Since the salvage of $47,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage value for the account will not be redetermined.

Example (4). Taxpayer C elects to apply this section to factory building X which is placed in an item vintage account of 1971. The unadjusted basis of factory building X is $90,000. C estimates a gross salvage value for the account of $10,000. The property does not qualify under section 167(f)(2). C establishes a salvage value of $10,000 for the account. Assume that there is not sufficient basis for determining a salvage value for the account greater than $18,000. Since the salvage value of $10,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage value for the account will not be redetermined.

(2) *Treatment of repairs*—(i) *In general. (a)* Sections 162, 212, and 263 provide general rules for the treatment of certain expenditures for the repair, maintenance, rehabilitation or improvement of property. In general, under those sections, expenditures which substantially prolong the life of an asset, or are made to increase its value or adapt it to a different use are capital expenditures. If an expenditure is treated as a capital expenditure under section 162, 212, or 263, it is subject to the allowance for depreciation. On the other hand, in general, expenditures which do not substantially prolong the life of an asset or materially increase its value or adapt it for a substantially different use may be deducted as an expense in the taxable year in which paid or incurred. Expenditures, or a series of expenditures, may have characteristics both of deductible expenses and capital expenditures. Other expenditures may have the characteristics of capital expenditures, as in the case of an ‘‘excluded addition’’ (as defined in subdivision (vi) of this subparagraph). This subparagraph provides a simplified procedure for determining whether expenditures with respect to certain property are to be treated as deductible expenses or capital expenditures.

(b) [Reserved]

(ii) *Election of repair allowance.* In the case of an asset guideline class which consists of ‘‘repair allowance property’’ as defined in subdivision (iii) of this subparagraph, subject to the provisions of subdivision (v) of this subparagraph, the taxpayer may elect to apply the asset guideline class repair allowance described in subdivision (iii) of this subparagraph for any taxable year ending after December 31, 1970, for which the taxpayer elects to apply this section.

(iii) *Repair allowance for an asset guideline class.* For a taxable year for which the taxpayer elects to apply this section, the ‘‘repair allowance’’ for an asset guideline class which consists of ‘‘repair allowance property’’ is an amount equal to—

(a) The average of *(1)* the unadjusted basis of all ‘‘repair allowance property’’ in the asset guideline class at the beginning of the taxable year, less in the case of such property in a vintage account the unadjusted basis of all such property retired in an ordinary retirement (as described in subparagraph (3)(ii) of this paragraph) in prior taxable years, and *(2)* the unadjusted basis of all ‘‘repair allowance property’’ in the asset guideline class at the end of the taxable year, less in the case of such property in a vintage account the unadjusted basis of all such property retired in an ordinary retirement (including ordinary retirements during the taxable year), multiplied by—

(b) The repair allowance percentage in effect for the asset guideline class for the taxable year.

In applying the assets guideline class repair allowance to buildings which are section 1250 property, for the purpose of this subparagraph each building shall be treated as in a separate asset guideline class. If two or more buildings are in the same asset guideline class determined without regard to the preceding sentence and are operated as an integrated unit (as evidenced by their actual operation, management, financing and accounting), they shall be treated as a single building for this purpose. The ‘‘repair allowance percentages’’ in effect for taxable years ending before the effective date of the first supplemental repair allowance percentages established pursuant to this section are set forth in Revenue Procedure 72–10. Repair allowance percentages will from time to time be established,supplemented and revised with express reference to this section. These repair allowance percentages will be published in the Internal Revenue Bulletin. The repair allowance percentages in effect on the last day of the taxable year shall apply for the taxable year, except that the repair allowance percentage for a particular taxable year shall not be less than the repair allowance percentage in effect on the first day of such taxable year (or as of such later time in such year as a repair allowance percentage first established during such year becomes effective). Generally, the repair allowance percentages for a taxable year shall not be changed to reflect any supplement or revision of the repair allowance percentages after the end of such taxable year. However, if expressly provided in such a supplement or revision of the repair allowance percentages, the taxpayer may, at his option in the manner specified therein, apply the revised or supplemented repair allowance percentages for such taxable year and succeeding taxable years. For the purposes of this section, ''repair allowance property'' means eligible property determined without regard to paragraph (b)(2)(ii) of this section (that is, without regard to whether such property was first placed in service by the taxpayer before or after December 31, 1970) in an asset guideline class for which a repair allowance percentage is in effect for the taxable year. The determination whether property is repair allowance property shall be made without regard to whether such property is excluded, under paragraph (b)(5) of this section, from an election to apply this section.Property in an asset guideline class for which the taxpayer elects to apply the asset guideline class repair allowance described in this subdivision, which results from expenditures in the taxable year of election for the repair, maintenance, rehabilitation, or improvement of property in an asset guideline class shall not be ''repair allowance property'' for such taxable year but shall be for each succeeding taxable year provided such property is a property improvement as described in subdivision (vii) (*a*) of this subparagraph and is in an asset guideline class for which a repair allowance percentage is in effect for such succeeding taxable year.

(iv) *Application of asset guideline class repair allowance.* In accordance with the principles of sections 162, 212, and 263, if the taxpayer pays or incurs any expenditures during the taxable year for the repair, maintenance, rehabilitation or improvement of eligible property (determined without regard to paragraph (b)(2)(ii) of this section), the taxpayer must either—

(a) If such property is repair allowance property and if the taxpayer elects to apply the repair allowance for the asset guideline class, treat an amount of all such expenditures in such taxable year with respect to all such property in the asset guideline class which does not exceed in total the repair allowance for that asset guideline class as deductible repairs, and treat the excess of all such expenditures with respect to all such property in the asset guideline class in the manner described for a property improvement in subdivision (viii) of this subparagraph, or

(b) If such property is not repair allowance property or if the taxpayer does not elect to apply the repair allowance for the asset guideline class, treat each of such expenditures in such taxable year with respect to all such property in the asset guideline class as either a capital expenditure or as a deductible repair in accordance with the principles of sections 162, 212, and 263 (without regard to *(a)* of this subdivision), and treat the expenditures which are required to be capitalized under sections 162, 212, and 263 (without regard to *(a)* of this subdivision) in the manner described for a property improvement in subdivision (viii) of this subparagraph.

For the purposes of *(a)* of this subdivision, expenditures for the repair, maintenance, rehabilitation or improvement of property do not include expenditures for an excluded addition or for which a deduction is allowed under section 167(k). (See subdivision (viii) of this subparagraph for treatment of an excluded addition.) The taxpayer shall elect each taxable year whether to apply the repair allowance and treat expenditures under *(a)* of this subdivision, or to treat expenditures under *(b)* of this subdivision. The treatment of expenditures under this subdivision for a taxable year for all asset guideline classes shall be specified in the books and records of the taxpayer for the taxable year. The taxpayer may treat expenditures under *(a)* of this subdivision with respect to property in one asset guideline class and treat expenditures under *(b)* of this subdivision with respect to property in some other asset guideline class. In addition, the taxpayer may treat expenditures with respect to property in an asset guideline class under (*a*) of this subdivision in one taxable year, and treat expenditures with respect to property in that asset guideline class under *(b)* of this subdivision in another taxable year.

(v) *Special rules for repair allowance. (a)* The asset guideline class repair allowance described in subdivision (iii) of this subparagraph shall apply only to expenditures for the repair, maintenance, rehabilitation or improvement of repair allowance property (as described in subdivision (iii) of this subparagraph). The taxpayer may apply the asset guideline class repair allowance for the taxable year only if he maintains books and records reasonably sufficient to determine:

(1) The amount of expenditures paid or incurred during the taxable year for the repair, maintenance, rehabilitation or improvement of repair allowance property in the asset guideline class, and

(2) The expenditures (and the amount thereof) with respect to such property which are for excluded additions (such as whether the expenditure is for an additional identifiable unit of property, or substantially increases the productivity or capacity of an existing identifiable unit of property or adapts it for a substantially different use).

In general, such books and records shall be sufficient to identify the amount and nature of expenditures with respect to specific items of repair allowance property or groups of similar properties in the same asset guideline class. However, in the case of such expenditures with respect to property, part of which is in one asset guideline class and part in another, or part of which is repair allowance property and part of which is not, and in comparable circumstances involving property in the same asset guideline class, to the extent books and records are not maintained identifying such expenditures with specific items of property or groups of similar properties and it is not practicable to do so, the total amount of such expenditures which is not specifically identified may be allocated by any reasonable method consistently applied. In any case, the cost of repair, maintenance, rehabilitation or improvement of property performed by production personnel may be allocated by any reasonable method consistently applied and if performed incidental to production and not substantial in amount, no allocation to repair, maintenance, rehabilitation or improvement need be made. The types of expenditures for which specific identification would ordinarily be madeinclude: Substantial expenditures such as for major parts or major structural materials for which a work order is or would customarily be written; expenditures for work performed by an outside contractor; or expenditures under a specific down time program. Types of expenditures for which specific identification would ordinarily be impractical include: General maintenance costs of machinery, equipment, and plant in the case of a taxpayer having assets in more than one class (or different types of assets in the same class) which are located together and generally maintained by the same work crew; small supplies which are used with respect to various classes or types of property; labor costs of personnel who work on property in different classes, or different types of property in the same class, if the work is performed on a routine, as needed, basis and the only identification of the property repaired is by the personnel. Factors which will be taken into account in determining the reasonableness of the taxpayer's allocation of expenditures include prior experience of the taxpayer; relative bases of the assets in the guideline class; types of assets involved; and relationship to specifically identified expenditures.

(b) If for the taxable year the taxpayer elects to deduct under section 263(e) expenditures with respect to repair allowance property consisting of railroad rolling stock (other than a locomotive) in a particular asset guideline class, the taxpayer may not, for such taxable year, use the asset guideline class repair allowance described in subdivision (iii) of this subparagraph

for any property in such asset guideline class.

(c)(1) If the taxpayer repairs, rehabilitates or improves property for sale or resale to customers, the asset guideline class repair allowance described in subdivision (iii) of this subparagraph shall not apply to expenditures for the repair, maintenance, rehabilitation or improvement of such property, or *(2)* if a taxpayer follows the practice of acquiring for his own use property (in need of repair, rehabilitation or improvement to be suitable for the use intended by the taxpayer) and of making expenditures to repair, rehabilitate or improve such property in order to take advantage of this subparagraph, the asset guideline class repair allowance described in subdivision (iii) of this subparagraph shall not apply to such expenditures. In either event, such property shall not be ''repair allowance property'' as described in subdivision (iii) of this subparagraph.

(vi) *Definition of excluded addition.* The term ''excluded addition'' means—

(a) An expenditure which substantially increases the productivity of an existing identifiable unit of property over its productivity when first acquired by the taxpayer;

(b) An expenditure which substantially increases the capacity of an existing identifiable unit of property over its capacity when first acquired by the taxpayer;

(c) An expenditure which modifies an existing identifiable unit of property for a substantially different use;

(d) An expenditure for an identifiable unit of property if *(1)* such expenditure is for an additional identifiable unit of property or *(2)* such expenditure (other than an expenditure described in *(e)* of this subdivision) is for replacement of an identifiable unit of property which was retired;

(e) An expenditure for replacement of a part in or a component or portion of an existing identifiable unit of property (whether or not such part, component or portion is also an identifiable unit of property) if such part, component or portion is for replacement of a part, component or portion which was retired in a retirement upon which gain or loss is recognized (or would be recognized but for a special nonrecognition provision of the Code or § 1.1502–13).

(f) In the case of a building or other structure (in addition to *(b), (c), (d),* and *(e)* of this subdivision which also apply to such property), an expenditure for additional cubic or linear space; and

(g) In the case of those units of property of pipelines, electric utilities, telephone companies, and telegraph companies consisting of lines, cables and poles (in addition to *(a)* through *(e)* of this subdivision which also apply to such property), an expenditure for replacement of a material portion of the unit of property.

Except as provided in *(d)* and *(e)* of this subdivision, notwithstanding any other provision of this subdivision, the term ''excluded addition'' does not include any expenditure in connection with the repair, maintenance, rehabilitation or improvement of an identifiable unit of property which does not exceed $100. For this purpose all related expenditures with respect to the unit of property shall be treated as a single expenditure. For the purposes of *(a),* and *(b)* of this subdivision, an increase in productivity or capacity is substantial only if the increase is more than 25 percent. An expenditure which merely extends the productive life of an identifiable unit of property is not an increase in productivity within the meaning of *(a)* of this subdivision. Under *(g)* of this subdivision a replacement is material only if the portion replaced exceeds 5 percent of the unit of property with respect to which the replacement is made. For the purposes of this subdivision, a unit of property generally consists of each operating unit (that is, each separate machine or piece of equipment) which performs a discrete function and which the taxpayer customarily acquires for original installation and retires as a unit. The taxpayer's accounting classification of units of property willgenerally be accepted for purposes of this subdivision provided the classifications are reasonably consistent with the preceding sentence and are consistently applied. In the case of a building the unit of property generally consists of the building as well as its structural components;

except that each building service system (such as an elevator, an escalator, the electrical system, or the heating and cooling system) is an identifiable unit for the purpose of *(a), (b), (c),* and *(d)* of this subdivision. However, both in the case of machinery and equipment and in the case of a building, for the purpose of applying *(d)(1)* of this subdivision a unit of property may consist of a part in or a component or portion of a larger unit of property. In the case of property described in *(g)* of this subdivision (such as a pipeline), a unit of property generally consists of each segment which performs a discrete function either as to capacity, service, transmission or distribution between identifiable points. Thus, for example, under this subdivision in the case of a vintage account of five automobiles each automobile is an identifiable unit of property (which is not merely a part in or a component or portion of larger unit of property within the meaning of *(e)* of this subdivision). Accordingly, the replacement of one of the automobiles (which is retired) with another automobile is an excluded addition under *(d)(2)* of this subdivision. Also the purchase of a sixth automobile is an expenditure for an additional identifiable unit of property and is an excluded addition under *(d)(1)* of this subdivision. An automobile air conditioner is also an identifiable unit of property for the purposes of *(d)(1)* of this subdivision, but not for the purposes of *(d)(2)* of this subdivision. Accordingly, the addition of an air conditioner to an automobile is an excluded addition under *(d)(1)* of this subdivision, but the replacement of an existing air conditioner in an automobile is not an excluded addition under *(d)(2)* of this subdivision (since it is merely the replacement of a part in an existing identifiable unit of property). The replacement of the air conditioner may, however, be an excluded addition under *(e)* of this subdivision, if the air conditioner replaced was retired in a retirement upon which gain or loss was recognized. The principles of this subdivision may be further illustrated by the following examples in which it is assumed (unless otherwise stated) that *(e)* of this subdivision does not apply:

Example (1). For the taxable year, B pays or incurs only the following expenditures: *(1)* $5,000 for general maintenance of repair allowance property (as described in subdivision (iii) of this subparagraph) such as inspection, oiling, machine adjustments, cleaning, and painting; *(2)* $175 for replacement of bearings and gears in an existing lathe; *(3)* $125 for replacement of an electric starter (of the same capacity) and certain electrical wiring in an automatic drill press; *(4)* $300 for modification of a metal fabricating machine (including replacement of certain parts) which substantially increases its capacity; *(5)* $175 for repair of the same metal fabricating machine which does not substantially increase its capacity; *(6)* $800 for the replacement of an existing lathe with a new lathe; and *(7)* $65 for the repair of a drill press. Expenditures *(1)* through *(3)* are expenditures for the repair, maintenance, rehabilitation or improvement of property to which B can elect to apply the asset guideline class repair allowance described in subdivision (iii) of this subparagraph. Expenditure *(4)* is an excluded addition under *(b)* of this subdivision. Expenditure *(5)* is not an excluded addition. Expenditure *(6)* is an excluded addition under *(d)(2)* of this subdivision. Without regard to *(a), (b),* and *(c)* of this subdivision, expenditure (7) is not an excluded addition since the expenditure does not exceed $100.

Example (2). Corporation M operates a steel plant which produces rails, blooms, billets, special bar sections, reinforcing bars, and large diameter line pipe. During the taxable year, corporation M: *(1)* relines an openhearth furnace; *(2)* places in service 20 new ingot molds; *(3)* replaces one reversing roll in the blooming mill; *(4)* overhauls the rail and billet mill with no increase in capacity; *(5)* replaces a roll stand in the 20-inch bar mill; and *(6)* overhauls the 11-inch bar mill and reducing stands increasing billet speed from 1,800 feet per minute to 2,300 feet per minute. Assume that each expenditure exceeds $100. Expenditure *(1)* is not an excluded addition. Expenditure *(2)* is an excluded addition under *(d)(1)* of this subdivision. Expenditure *(3)* is not an excluded addition since the expenditure for the reversing roll merely replaces a part in an existing identifiable unit of property. Expenditure *(4)* is not an excluded addition. Expenditure *(5)* is an excluded addition under *(d)(2)* of this subdivision since the roll stand is not merely a part of an existing identifiable unit of property. Expenditure *(6)* is an excluded addition under *(a)* of this subdivision since it increases the billet speed by more than 25 percent.

Example (3). For the taxable year, corporation X pays or incurs the following expenditures: *(1)* $1,000 for two new temporary partition walls in the company's offices; *(2)* $1,400 for repainting the exterior of a terminal building; *(3)* $300 for repair of the roof of a warehouse; *(4)* $150 for replacement of two window frames and panes in the warehouse; and *(5)* $100 for plumbing repair. Expenditure *(1)* is an excluded addition under *(d)(1)* of this subdivision. None of the other expenditures are excluded additions.

Example (4). For the taxable year, corporation Y pays or incurs the following expenditures: *(1)* $10,000 for expansion of a loading dock from 600 square feet to 750 square feet; *(2)* $600 for replacement of two roof girders in a factory building; and *(3)* $9,500 for replacement of columns and girders supporting the floor of a second story loft storage area within the factory building in order to permit storage of supplies with a gross weight 50 percent greater than the previous capacity of the loft. Expenditure *(1)* is an excluded addition under *(f)* of this subdivision. Expenditure *(2)* is not an excluded addition. Expenditure *(3)* is an excluded addition under *(b)* of this subdivision.

Example (5). Corporation A has an office building with an unadjusted basis of $10 million. The building has 10 elevators, five of which are manually operated and five of which are automatic. During 1971, corporation A:

(1) Replaces the five manually operated elevators with highspeed automatic elevators at a cost of $400,000;

(2) Replaces the cable in one of the existing automatic elevators at a cost of $1,700. The replacements of the elevators are excluded additions under *(d)(2)* of this subdivision. The replacement of the cable is not an excluded addition.

Example (6). Taxpayer W, a cement manufacturer, engages in the following modification and maintenance activities during the taxable year: *(1)* Replaces eccentric-bearing, spindle, and wearing surface in a gyratory crusher; *(2)* places in service a new apron feeder and hammer mill; *(3)* replaces four buckets on a chain bucket elevator; *(4)* relines refractory surface in the burning zone of a rotary kiln; *(5)* installs additional new dust collectors; and *(6)* Replaces two 16-inch × 90-foot belts on his conveyer system. Assume that there is no increase in productivity or capacity and that each expenditure exceeds $100. Expenditure *(1)* is not an excluded addition. Expenditure *(2)* an excluded addition under *(d)(1)* of this subdivision. Expenditures *(3)* and *(4)* are not excluded additions. Expenditures *(5)* is an excluded addition under *(d)(1)* of this subdivision. Expenditure *(6)* is not an excluded addition.

Example (7). Corporation X, a gas pipeline company, has, in addition to others, the following units of property: *(1)* A gathering pipeline for a field consisting of 25 gas wells; *(2)* the main transmission line between compressor stations (that is, in the case of a 500-mile main transmission line with a compressor station every 100 miles, each one hundred miles section between compressor stations is a separate unit of property); *(3)* a lateral transmission line from the main transmission line to a city border station; *(4)* a medium pressure distribution line to the northern portion of the city; and *(5)* a low pressure distribution line serving a group of approximately 200 residential customers off the medium pressure distribution line. In 1971, corporation X pays or incurs the following expenditures in connection with the repair, maintenance, rehabilitation or improvement of repair allowance property: *(1)* replaces a meter on a gas well; *(2)* in connection with the repair and rehabilitation of a unit of property consisting of a 2-mile gathering pipeline, replaces a 3,000-foot section of the gathering line; *(3)* in connection with the repair of leaks in a unit of property consisting of a 100-mile gas transmission line (that is, the 100 miles between compressor stations), replaces a 2,000-foot section of pipeline at one point; and *(4)* at another point replaces a 7-mile section of the same 100-mile gas transmission line. Assumethat none of these expenditures substantially increases capacity and that each expenditure exceeds $100. Expenditure *(1)* is an excluded addition under *(d)* of this subdivision. Expenditure *(2)* is an excluded addition under *(g)* of this subdivision since the portion replaced is more than 5 percent of the unit of property. Expenditure *(3)* is not an excluded addition. Expenditure *(4)* is an excluded addition under *(g)* of this subdivision.

Example (8). Taxpayer Y, an electric utility company, has in addition to others, the following units of property: *(1)* A high voltage transmission circuit from the switching station (at the generating station) to the transmission station; *(2)* a series of 100 poles (fully dressed) supporting the circuit in *(1); (3)* a high voltage circuit from the transmission station to the distribution substation; *(4)* a high voltage distribution circuit (either radial or looped) from the distribution substation; *(5)* a transformer on a distribution pole; *(6)* a circuit breaker on a distribution pole; and *(7)* all 220 (and lower) volt circuit (including customer service connections) off the distribution circuit in *(4).* In 1971, taxpayer Y pays or incurs the following expenditures for the repair, maintenance, rehabilitation or improvement of repair allowance property: *(1)* Replaces 25 adjacent poles in a unit of property consisting ofthe 300 poles supporting a radial distribution circuit from a distribution substation; *(2)* replaces a transformer on one of the poles in *(1); (3)* replaces a cross-arm on one of the poles in *(1); (4)* replaces a 200-foot section of a 2-mile radial distribution circuit serving 100 residential customers; and *(5)* replaces a 2,000-foot section on a 10-mile high voltage circuit from a transmission station to a distribution substation which was destroyed by a casualty which taxpayer Y treated as an extraordinary retirement under paragraph (d)(3)(ii) of this section. Expenditure *(1)* is an excluded addition under *(g)* of this subdivision. Expenditure *(2)* is an excluded addition under *(d)(2)* of this subdivision. Expenditures *(3)* and *(4)* are not excluded additions. Expenditure *(5)* is an excluded addition under *(e)* of this subdivision.

Example (9). Corporation Z, a telephone company, has in addition to others, the following units of property: *(1)* A buried feeder cable 3 miles in length off a local switching station; *(2)* a buried subfeeder cable 1 mile in length off the feeder cable in *(1); (3)* all the distribution cable (and customer service drops) off the subfeeder cable in *(2); (4)* the 300 poles (fully dressed) supporting the distribution cable in *(3);* (5) a 10-mile local trunk cable which interconnects two local tandem switching stations; *(6)* a toll connecting trunk cable from a local tandem switching station to a long distance tandem switching station; *(7)* a toll trunk cable 50 miles in length from the access point at one city to the access point at another city. In 1971, corporation Z pays or incurs the following expenditures in connection with the repair, maintenance, rehabilitation or improvement of repair allowance property: *(1)* replaces 100 feet of distribution cable in a unit of property consisting of 8 miles of local distribution cable (plus customer service drops); *(2)* replaces an amplifier in the distribution system; and *(3)* replaces 10 miles of a unit of property consisting of a toll trunk cable 50 miles in length. Expenditure *(1)* is not an excluded addition. Expenditure *(2)* is an excluded addition under *(d)(2)* of this subdivision. Expenditure *(3)* is an excluded addition under *(g)* of this subdivision.

(vii) *Definition of property improvement.* The term ‘‘property improvement’’ means—

(a) If the taxpayer treats expenditures for the asset guideline class under subdivision (iv) (*a*) of this subparagraph, the amount of all expenditures paid or incurred during the taxable year for the repair, maintenance, rehabilitation or improvement of repair allowance property in the asset guideline class, which exceeds the asset guideline class repair allowance for the taxable year; and

(b) If the taxpayer treats expenditures for the asset guideline class under subdivision (iv) (*b*) of this subparagraph, the amount of each expenditure paid or incurred during the taxable year for the repair, maintenance, rehabilitation or improvement of property which is treated under sections 162, 212, and 263 as a capital expenditure.

The term ‘‘property improvement’’ does not include any expenditure for an excluded addition.

(viii) *Treatment of property improvements and excluded additions.* If for the taxable year there is a property improvement as described in subdivision (vii) of this subparagraph or an excluded addition as described in subdivision (vi) of this subparagraph, the following rules shall apply—

(a) The total amount of any property improvement for the asset guideline class determined under subdivision (vii)*(a)* of this subparagraph shall be capitalized in a single ‘‘special basis vintage account’’ of the taxable year in accordance with the taxpayer’s election to apply this section for the taxable year (applied without regard to paragraph (b)(5)(v)*(a)* of this section). See subparagraph (3)(vi) of this paragraph for definition and treatment of a ‘‘special basis vintage account’’.

(b) Each property improvement determined under subdivision (vii)*(b)* of this subparagraph, if it is eligible property, shall be capitalized in a vintage account of the taxable year in accordance with the taxpayer’s election to apply this section for the taxable year (applied without regard to paragraph (b)(5)(v)*(a)* of this section).

(c) Each excluded addition, if it is eligible property, shall be capitalized in a vintage account of the taxable year in accordance with the taxpayer’s election to apply this section for the taxable year.

For rule as to date on which a property improvement or an excluded addition is first placed in service, see paragraph (e)(1) (iii) and (iv) of this section.

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

Example (1). For the taxable year 1972, B elects to apply this section. B has repair allowance property (as described in subdivision (iii) of this subparagraph) in asset guideline class 20.2 under Revenue Procedure 72–10 with an average unadjusted basis determined as provided in subdivision (iii) *(a)* of this subparagraph of $100,000 and repair allowance property in asset guideline class 24.4 with an average unadjusted basis of $300,000. The repair allowance percentage for asset guideline class 20.2 is 4.5 percent and for asset guideline class 24.4 is 6.5 percent. The two asset guideline class repair allowances for 1972 are

$4,500 and $19,500, respectively, determined as follows:

Asset Guideline Class 20.2	
$100,000 average unadjusted basis multiplied by 4.5 percent	$4,500
Asset Guideline Class 24.4	
$300,000 average unadjusted basis multiplied by 6.5 percent	$19,500

Example (2). The facts are the same as in example (1). During the taxable year 1972, B pays or incurs the following expenditures for the repair, maintenance, rehabilitation or improvement of repair allowance property in asset guideline class 20.2

General maintenance (including primarily labor costs)	$3,000
Replacement of parts in several machines (including labor costs of $1,650)	4,000
	7,000

In addition, in connection with the rehabilitation and improvement of two other machines B pays or incurs $6,000 (including labor costs of $2,000) which is treated as an excluded addition because the capacity of the machines was substantially increased. For 1972, B elects to apply this section and to apply the asset guideline class repair allowance to asset guideline class 20.2. Since the asset guideline class repair allowance is $4,500, B can deduct $4,500 in accordance with subdivision (iv) *(a)* of this subparagraph. B must capitalize $2,500 in a special basis vintage account in accordance with subdivisions (vii) *(a)* and (viii) *(a)* of this subparagraph. Since the excluded addition is a capital item and is eligible property, B must also capitalize $6,000 in a vintage account in accordance with subdivision (viii) *(c)* of this subparagraph. B selects from the asset depreciation range an asset depreciation period of 17 years for the special basis vintage account. B includes the excluded addition in a vintage account of 1972 for which he also selects an asset depreciation period of 17 years.

(3) *Treatment of retirements*—(i) *In general.* The rules of this subparagraph specify the treatment of all retirements from vintage accounts. The rules of § 1.167(a)–8 shall not apply to any retirement from a vintage account. An asset in a vintage account is retired when such asset is permanently withdrawn from use in a trade or business or in the production of income by the taxpayer. A retirement may occur as a result of a sale or exchange, by other act of the taxpayer amounting to a permanent disposition of an asset, or by physical abandonment of an asset. A retirement may also occur by transfer of an asset to supplies or scrap.

(ii) *Definitions of ordinary and extraordinary retirements.* The term ‘‘ordinary retirement’’ means any retirement of section 1245 property from a vintage account which is not treated as an ‘‘extraordinary retirement’’ under this subparagraph. The retirement of an asset from a vintage account in a taxable year is an ‘‘extraordinary retirement’’ if—

(a) The asset is section 1250 property;

(b) The asset is section 1245 property which is retired as the direct result of fire, storm, shipwreck, or other casualty and the taxpayer, at his option consistently applied (taking into account type, frequency, and the size of such casualties) treats such retirements as extraordinary; or

(c)(1) The asset is section 1245 property which is retired (other than by transfer to supplies or scrap) in a taxable year as the direct result of a cessation, termination, curtailment, or disposition of a business, manufacturing, or other income producing process, operation, facility or unit, and (2) the unadjusted basis (determined without regard to subdivision (vi) of this subparagraph) of all such assets so retired in such taxable year from such account as a direct result of the event described in *(c)(1)* of this subdivision exceeds 20 percent of the unadjusted basis of such account immediately prior to such event.

For the purposes of *(c)* of this subdivision, all accounts (other than a special basis vintage account as described in subdivision (vi) of this subparagraph) containing section 1245 property of the same vintage in the same asset guideline class, and from which a retirement as a direct result of such event occurs within the taxable year, shall be treated as a single vintage account. See subdivision (xi) of this subparagraph for special rule for item accounts. The principles of this subdivision may be illustrated by the following examples:

Example (1). Taxpayer A is a processor and distributor of dairy products. Part of taxpayer A’s operation is a bottle washing facility consisting of machines X, Y, and Z, each of which is in an item vintage account of 1971. Each item vintage account has an unadjusted basis of $1,000. Taxpayer A also has a 1971 multiple asset vintage account consisting of machines E, S, and C. Machines E and S, used in processing butter, each has an unadjusted basis of $10,000. Machine C used in capping bottles has an unadjusted basis of $1,000. In 1975, taxpayer A changes to the use of paper milk cartons and disposes of all bottle washing machines (X, Y, and Z) as well as machine C which was used in capping bottles. The sales of machine C, X, Y, and Z are the direct result of the termination of a manufacturing process. However, since the total unadjusted basis of the eligible section 1245 property retired as a direct result of such event is only $4,000 (which is less than 20 percent of the total unadjusted basis of machines E, S, C, X, Y, and Z, $24,000) the sales are ordinary retirements. All the assets are in the same asset guideline class and are of the same vintage. Accordingly, machines E, S, C, X, Y, and Z are for this purpose treated as being in a single vintage account.

Example (2). The facts are the same as in example (1) except that in 1976, taxpayer A sells six of his 12 milk delivery trucks as a direct result of eliminating home deliveries to customers in the suburbs. Deliveries within the city require only six trucks. Each of the trucks has an unadjusted basis of $3,000. Six of the taxpayer's delivery trucks are in a multiple asset vintage account of 1974 and six are in a multiple asset vintage account of 1972. Neither account contains any other property. Four trucks are retired from the 1972 vintage account and two trucks are retired from the 1974 vintage account. The sales result from the curtailment of taxpayer A's home delivery operation. The unadjusted basis of the four trucks retired from the 1972 vintage exceeds 20 percent of the total unadjusted basis of the affected account. The same is true for the two trucks retired from the 1974 vintage account. The sales of the trucks are extraordinary retirements.

(*d*) The asset is section 1245 property which is retired after December 30, 1980 by a charitable contribution for which a deduction is allowable under section 170.

(iii) *Treatment of ordinary retirements.* No loss shall be recognized upon an ordinary retirement. Gain shall be recognized only to the extent specified in this subparagraph. All proceeds from ordinary retirements shall be added to the depreciation reserve of the vintage account from which the retirement occurs. See subdivision (vi) of this subparagraph for optional allocation of basis in the case of a special basis vintage account. See subdivision (ix) of this subparagraph for recognition of gain when the depreciation reserve exceeds the unadjusted basis of the vintage account. The amount of salvage value for a vintage account shall be reduced (but not below zero) as of the beginning of the taxable year by the excess of *(a)* the depreciation reserve for the account, after adjustment for depreciation allowable for such taxable year and all other adjustments prescribed by this section (other than the adjustment prescribed by subdivision (ix) of this subparagraph), over *(b)* the unadjusted basis of the account less the amount of salvage value for the account before such reduction. Thus, in the case of a vintage account with an unadjusted basis of $1,000 and a salvage value of $100, to the extent that proceeds from ordinary retirements increase the depreciation reserve above $900, the salvage value is reduced. If the proceeds increase the depreciation reserve for the account to $1,000, the salvage value is reduced to zero. The unadjusted basis of the asset retired in an ordinary retirement is not removed from the account and the depreciation reserve for the account is not reduced by the depreciation allowable for the retired asset. The previously unrecovered basis of the retired asset will be recovered through the allowance for depreciationwith respect to the vintage account. See subdivision (v)*(a)* of this subparagraph for treatment of retirements on which gain or loss is not recognized in whole or in part. See subdivision (v)*(b)* of this subparagraph for treatment of retirements by disposition to a member of an affiliated group as defined in section 1504(a). See subdivision (v)(*c*) of this subparagraph for treatment of transfers between members of an affiliated group of corporations or other related parties as extraordinary retirements.

(iv) *Treatment of extraordinary retirements. (a)* Unless the transaction is governed by a special nonrecognition section of the Code such as 1031 or 337 or is one to which subdivision (v)*(b)* of this subparagraph applies, gain or loss shall be recognized upon an extraordinary retirement in the taxable year in which such retirement occurs subject to section 1231, section 165, and all other applicable provisions of law such as sections 1245 and 1250. If the asset which is retired in an extraordinary retirement is the only or last asset in the account, the account shall terminate and no longer be an account to which this section applies. In all other cases, the unadjusted basis of the retired asset shall be removed from the unadjusted basis of the vintage account, and the depreciation reserve established for the account shall be reduced by the depreciation allowable for the retired asset computed in the manner prescribed in paragraph (c) (1)(v)*(b)* of this section for determination of the adjusted basis of the asset. See subdivision (ix) of this subparagraph for recognition of gain in the case of an account containing section 1245 property when the depreciation reserve exceeds the unadjusted basis of the vintage account. See subdivision (iii) of this subparagraph for reduction of salvage value for such an account when the depreciation reserve exceeds the unadjusted basis of the account minus salvage value. See subdivision (v)*(b)* of this subparagraph for treatment of retirements by disposition to a member of an affiliated group as defined in section 1504(a).

(b) The principles of this subdivision may be illustrated by the following examples:

Example (1). Corporation X has a multiple asset vintage account of 1971 consisting of assets K, R, A, and P all of which are section 1245 property. The unadjusted basis of the account is $40,000. The unadjusted basis of asset A is $10,000. When the reserve for depreciation for the account is $20,000, asset A is sold in an extraordinary retirement for $8,000 in cash. The $10,000 unadjusted basis of asset A is removed from the account and the $5,000 depreciation allowable for asset A is removed from the reserve for depreciation. Gain in the amount of $3,000 (to which section 1245 applies) is recognized upon the sale of asset A.

Example (2). Corporation X has an item vintage account of 1972 consisting of residential apartment unit A. Unit A is section 1250 property. It is residential rental property and meets the requirements of section 167(j)(2). Corporation X adopts the declining balance method of depreciation using a rate twice the straight line rate. The asset depreciation period is 40 years. Unit A has an unadjusted basis of $200,000. On June 30, 1974, when the reserve for depreciation for the account is $19,500, unit A is sold for $220,000. Since unit A is section 1250 property, the sale is an extraordinary retirement in accordance with subdivision (ii)*(a)* of this subparagraph (without regard to subdivision (ii) *(b)* or *(c)* of this subparagraph). The adjusted basis of unit A is $180,500. Gain in the amount of $39,500 is recognized. The ‘‘additional depreciation’’ (as defined in section 1250(b)) for unit A is $9,500. Accordingly, $9,500 is in accordance with section 1250 treated as gain from the sale or exchange of an asset which is neither a capital asset nor property described in section 1231. The $30,000 balance of the gain from the sale of unit A may be gain to which section 1231 applies.

(v) *Special rule for certain retirements. (a)* In the case of an ordinary retirement on which gain or loss is in whole or in part not recognized because of a special nonrecognition section of the Code, such as 1031 or 337, no part of the proceeds from such retirement shall be added to the depreciation reserve of the vintage account in accordance with subdivision (iii) of this subparagraph. Instead, such retirement shall for all purposes of this section be treated as an extraordinary retirement.

(b) The provisions of § 1.1502–13 shall apply to a retirement. In the case of an ordinary retirement to which the provisions of § 1.1502–13 apply, no part of the proceeds from such retirement shall be added to the depreciation reserve of the vintage account in accordance with subdivision (iii) of this subparagraph. Instead, such retirement shall for all purposes of this section be treated as an extraordinary retirement.

(c) In a case in which property is transferred, in a transaction which would without regard to this subdivision be treated as an ordinary retirement, during the taxable year in which first placed in service to a person who bears a relationship described in section 179(d)(2) (A) or (B), such transfer shall for all purposes of this section be treated as an extraordinary retirement.

(d)(1) If, in the case of mass assets, it is impracticable for the taxpayer to maintain records from which he can establish the vintage of such assets as retirements occur, and if he adopts other reasonable recordkeeping practices, then the vintage of mass asset retirements may be determined by use of an appropriate mortality dispersion table. Such a mortality dispersion table may be based upon an acceptable sampling of the taxpayer’s actual experience or

other acceptable statistical or engineering techniques. Alternatively, the taxpayer may use a standard mortality dispersion table prescribed by the Commissioner for this purpose. If the taxpayer uses such standard mortality dispersion table for any taxable year of election, it must be used for all subsequent taxable years of election unless the taxpayer obtains the consent of the Commissioner to change to another dispersion table or to actual identification of retirements. For information requirements regarding mass assets, see paragraph (f)(5) of this section.

(2) For purposes of this section, the term ''mass assets'' has the same meaning as when used in paragraph (e)(4) of §1.47–1.

(e) The principles of this subdivision may be illustrated by the following examples:

Example (1). Corporation X has a vintage account of 1971 consisting of machines A, B, and C, each with an unadjusted basis of $1,000. The unadjusted basis of the account is $3,000 and at the end of 1977 the reserve for depreciation is $2,100. On January 1, 1978, machine A is transferred to corporation Y solely for stock in the amount of $1,400 in a transaction to which section 351 applies. Since the adjusted basis of machine A is $300, a gain of $1,100 is realized, but no gain is recognized under section 351. Even though machine A was transferred in an ordinary retirement in accordance with *(a)* of this subdivision the rules for an extraordinary retirement are applied. The proceeds are not added to the reserve for depreciation for the account. Machine A is removed from the account, the unadjusted basis of the account is reduced by $1,000, and the reserve for depreciation for the account is reduced by $700.

Example (2). The facts are the same as in example (1) except that the consideration received for machine A is stock of corporation Y in the amount of $1,200 and cash in the amount of $200. The result is the same as in example (1) except that gain is recognized in the amount of $200 all of which is gain to which section 1245 applies.

Example (3). The facts are the same as in example (1) except that machine A is sold for $1,400 cash in an ordinary retirement and corporation X and corporation Y are includible corporations in an affiliated group as defined in section 1504(a) which files a consolidated return for 1978. Accordingly, *(b)* of this subdivision applies. The retirement is treated as an extraordinary retirement. Machine A is removed from the account, the unadjusted basis of the account is reduced by $1,000, and the reserve for depreciation for the account is reduced by $700. The gain of $1,100 is deferred gain to which §1.1502–13 applies.

(vi) *Treatment of special basis vintage accounts.* A ''special basis vintage account'' is a vintage account for an amount of property improvement determined under subparagraph (2) (vii)*(a)* of this paragraph. In general, reference in this section to a ''vintage account'' shall include a special basis vintage account. The unadjusted basis of a special basis vintage account shall be recovered through the allowance for depreciation in accordance with this section over the asset depreciation period for the account. Except as provided in this subdivision, the unadjusted basis, adjusted basis and reserve for depreciation of such account shall not be allocated to any specific asset in the asset guideline class, and the provisions of this subparagraph shall not apply tosuch account. However, in the event of a sale, exchange or other disposition of ''repair allowance property'' (as described in subparagraph (2)(iii) of this paragraph) in an extraordinary retirement as described in subdivision (ii) of this subparagraph (or if the asset is not in a vintage account, in an abnormal retirement as described in §1.167(a)–8), the taxpayer may, if consistently applied to all such retirements in the taxable year and adequately identified in the taxpayer's books and records, elect to allocate the adjusted basis (as of the end of the taxable year) of all special basis vintage accounts for the asset guideline class to each such retired asset in the proportion that the adjusted basis of the retired asset (as of the beginning of the taxable year) bears to the adjusted basis of all repair allowance property in the asset guideline class at the beginning of the taxable year. The election to allocate basis in accordance with this subdivision shall be made on the tax return filed for the taxable year. The principles of this subdivision may be illustrated by the following example:

Example. In addition to other property, the taxpayer has machines A, B, and C all in the same asset guideline class and each with an adjusted basis on January 1, 1977, of $10,000. The adjusted basis on January 1, 1977, of all repair allowance property (as described in subparagraph (2)(iii) of this paragraph) in the asset guideline class is $90,000. The machines are sold in an extraordinary retirement in 1977. The taxpayer is entitled to and does elect to allocate basis in accordance with this subdivision. There is also a 1972 special basis vintage account for the asset guideline class, as follows:

	Unadjusted basis	Reserve for depreciation	Dec. 31, 1977, adjusted basis
1972 special basis vintage account, for which the taxpayer selected an asset depreciation period of 10 years, adopted the straight line method, and used the half-year convention	$2,000	$1,100	$900

By application of this subdivision, the adjusted basis of machines A, B, and C is increased to $10,100 each (that is, $10,000÷$90,000×$900=$100). The unadjusted basis, reserve for depreciation and adjusted basis of the special basis vintage account are reduced, respectively, by one-third (that is, $300÷$900=⅓) in order to reflect the allocation of basis from the special basis vintage account.

(vii) *Reduction in the salvage value of a vintage account. (a)* A taxpayer may apply this section without reducing the salvage value for a vintage account in accordance with this subdivision or in accordance with subdivision (viii) of this subparagraph (relating to transfers to supplies or scrap). See subdivision (iii) of this subparagraph for reduction of salvage value in certain circumstances in the amount of proceeds from ordinary retirements.

(b) However, the taxpayer may, at his option, follow the consistent practice of reducing, as retirements occur, the salvage value for a vintage account by the amount of salvage value attributable to the retired asset, or the taxpayer may consistently follow the practice of so reducing the salvage value for a vintage account as extraordinary retirements occur while not reducing the salvage value for the account as ordinary retirements occur. If the taxpayer does not reduce the salvage value for a vintage account as ordinary retirements occur, the taxpayer may be entitled to a deduction in the taxable year in which the last asset is retired from the account in accordance with subdivision (ix) (*b*) of this subparagraph.

(c) For purposes of this subdivision, the portion of the salvage value for a vintage account attributable to a retired asset may be determined by multiplying the salvage value for the account by a fraction, the numerator of which is the unadjusted basis of the retired asset and the denominator of which is the unadjusted basis of the account, or any other method consistently applied which reasonably reflects that portion of the salvage value for the account originally attributable to the retired asset.

(d) In the case of ordinary retirements the taxpayer may—

(1) In the case of retirements (other than by transfer to supplies or scrap) follow the consistent practice of reducing the salvage value for the account by the amount of salvage value attributable to the retired asset and not adding the same amount to the depreciation reserve for the account, and

(2) In the case of retirements by transfer to supplies or scrap, follow the consistent practice of reducing the salvage value for the account by the amount of salvage value attributable to the retired asset and not adding the same amount to the depreciation reserve for the account (in which case the basis in the supplies or scrap account of the retired asset will be zero) or follow the consistent practice of reducing the salvage value for the account by the amount of salvage value attributable to the retired asset and adding the same amount to the depreciation reserve for the account (up to an amount which does not increase the depreciation reserve to an amount in excess of the unadjusted basis of the account) in which case the basis in the supplies or scrap account of the retired asset will be the amount added to the depreciation reserve for the account.

Thus, for example, in the case of an ordinary retirement by transfer of an asset to supplies or scrap, the basis of the asset in the supplies or scrap account would either be zero or the amount added to the depreciation reserve of the vintage account from which the retirement occurred. When the depreciation reserve for the account equals the unadjusted basis of the account no further adjustment to salvage value for the account will be made. See subdivision (viii) of this subparagraph for special optional rule for reduction of salvage value in the case of an ordinary retirement by transfer of an asset to supplies or scrap.

(e) In the event of a removal of property from a vintage account in accordance with paragraph (b)(4)(iii)*(e),* (5)(v)*(b)* or (6)(iii) of this section the salvage value for the account may be reduced by the amount of salvage value attributable to the asset removed determined as provided in *(c)* of this subdivision.

(viii) *Special optional adjustments for transfers to supplies or scrap.* If the taxpayer does not follow the consistent practice of reducing, as ordinary retirements occur, the salvage value for a vintage account in accordance with subdivision (vii) of this subparagraph, the taxpayer may (in lieu of the method described in subdivision (vii) *(c)* and *(d)* of this subparagraph) follow the consistent practice of reducing salvage value as ordinary retirements occur by transfer of assets to supplies or scrap and of determining the basis (in the supplies or scrap account) as assets retired in an ordinary retirement by transfer to supplies or scrap, in the following manner—

(a) The taxpayer may determine the value of the asset (not to exceed its unadjusted basis) by any reasonable method consistently applied (such as average cost, conditioned cost, or fair market value) if such method is adequately identified in the taxpayer's books and records.

(b) The value attributable to the asset determined in accordance with *(a)* of this subdivision shall be subtracted from the salvage value for the account (to the extent thereof) and the greater of *(1)* the amount subtracted from the salvage value for the vintage account and *(2)* the value of the asset determined in accordance with *(a)* of this subdivision, shall be added to the reserve for depreciation of this vintage account.

(c) The amount added to the reserve for depreciation of the vintage account in accordance with *(b)* of this subdivision shall be treated as the basis of the retired asset in the supplies or scrap account.

If the taxpayer makes the adjustments in accordance with this subdivision, the reserve for depreciation of the vintage account may exceed the unadjusted basis of the account, and in that event gain will be recognized in accordance with subdivision (ix) of this subparagraph.

(ix) *Recognition of gain or loss in certain situations. (a)* In the case of a vintage account for section 1245 property, if at the end of any taxable year after adjustment for depreciation allowable for such taxable year and all other adjustments prescribed by this section, the depreciation reserve established for such account exceeds the unadjusted basis of the account, the entire amount of such excess shall be recognized as gain in such taxable year. Such gain—

(1) Shall constitute gain to which section 1245 applies to the extent that it does not exceed the total amount of depreciation allowances in the depreciation reserve at the end of such taxable year, reduced by gain recognized pursuant to this subdivision with respect to the account previously treated as gain to which section 1245 applies, and

(2) May constitute gain to which section 1231 applies to the extent that it exceeds such total amount as so reduced.

In such event, the depreciation reserve shall be reduced by the amount of gain recognized, so that after such reduction the amount of the depreciation reserve is equal to the unadjusted basis of the account.

(b) In the case of an account for section 1245 property, if at the time the last asset in the vintage account is retired the unadjusted basis of the account exceeds the depreciation reserve for the account (after all adjustments prescribed by this section), the entire amount of such excess shall be recognized in such taxable year as a loss under section 165 or as a deduction for depreciation under section 167. If the retirement of such asset occurs by sale or exchange on which gain or loss is recognized, the amount of such excess may constitute a loss subject to section 1231. Upon retirement of the last asset in a vintage account, the account

shall terminate and no longer be an account to which this section applies. See subdivision (xi) of this subparagraph for treatment of certain multiple asset and item accounts.

(c) The principles of this subdivision may be illustrated by the following example:

Example. The taxpayer has a vintage account for section 1245 property with an unadjusted basis of $1,000 and a depreciation reserve of $700 (of which $600 represents depreciation allowances and $100 represents the proceeds of ordinary retirements from the account). If $500 is realized during the taxable year from ordinary retirements of assets from the account, the reserve is increased to $1,200, gain is recognized to the extent of $200 (the amount by which the depreciation reserve before further adjustment exceeds $1,000) and the depreciation reserve is then decreased to $1,000. The $200 of gain constitutes gain to which section 1245 applies. If the amount realized from ordinary retirements during the year had been $1,100 instead of $500, the gain of $800 would have consisted of $600 of gain to which section 1245 applies and $200 of gain to which section 1231 may apply.

(x) *Dismantling cost.* The cost of dismantling, demolishing, or removing an asset in the process of a retirement from the vintage account shall be treated as an expense deductible in the year paid or incurred, and such cost shall not be subtracted from the depreciation reserve for the account.

(xi) *Special rule for treatment of multiple asset and item accounts.* For the purposes of subdivision (ix)*(b)* of this subparagraph, all accounts (other than a special basis vintage account as described in subdivision (vi) of this subparagraph) of the same vintage in the same asset guideline class for which the taxpayer has selected the same asset depreciation period and adopted the same method of depreciation, and which contain only section 1245 property permitted by paragraph (b)(3)(ii) of this section to be included in the same vintage account, shall be treated as a single multiple asset vintage account.

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

Example (1). (a)Taxpayer A has a multiple asset vintage account for selection 1245 property with an unadjusted basis of $1,000. All the assets were first placed in service by A on January 15, 1971. This account contains all of A's assets in a single asset guideline class. A elects to apply this section for 1971 and adopts the modified half-year convention. A estimates a salvage value for the account of $100 and this estimate is determined to be reasonable. (See subparagraph (1)(v) of this paragraph for limitation on adjustment of reasonable salvage value.) A adopts the straight line method of depreciation with respect to the account and selects a 10-year asset depreciation period. A does not follow a practice of reducing the salvage value for the account in the amount of salvage value attributable to each retired asset in accordance with subparagraph (3)(vii) of this paragraph. The depreciation allowance for each of the first 4 years is $100, that is 1⁄10 multiplied by the unadjusted basis of $1,000, with reduction for salvage.

(b) In the fifth year of the asset depreciation period, three assets are sold in an ordinary retirement for $300. Under paragraph (c)(1)(ii) of this section and subparagraph (3)(iii) of this paragraph, the proceeds of the retirement are added to the depreciation reserve as of the beginning of the fifth year. Accordingly, the reserve as of the beginning of the fifth year is $700, that is, $400 of depreciation as of the beginning of the year plus $300 proceeds from ordinary retirements. The depreciation allowance for the fifth year is $100, that is 1⁄10 multiplied by the unadjusted basis of $1,000, without reduction for salvage. Accordingly, the depreciation reserve at the end of the fifth year is $800.

(c) In the sixth year, asset X is sold in an extraordinary retirement for $30 and gain or loss is recognized. Under the first-year convention used by the taxpayer, the unadjusted basis of X, $300, is removed from the unadjusted basis of the vintage account as of the beginning of the sixth year and the depreciation reserve as of the beginning of such year is reduced to $650 by removing the depreciation applicable to asset X, $150 (see subparagraph (3)(iv) of this paragraph). Since the depreciation reserve ($650) exceeds the unadjusted basis of the account ($700) minus salvage value ($100) by $50, under subparagraph (3)(iii) of this paragraph, salvage value is reduced by $50. No depreciation is allowable for the sixth year.

(d) In the seventh year, an asset is sold in an ordinary retirement for $110. This would increase the reserve as of the beginning of the seventh year to $760 and under subparagraph (3)(iii) of this paragraph the salvage value is reduced to zero. Under subparagraph (3)(ix)*(a)* of this paragraph the depreciation reserve is then decreased to $700 (the unadjusted basis of the account) and $60 is reported as gain, without regard to the adjusted basis of the asset. No depreciation is allowable for the seventh year since the depreciation reserve ($700) equals the unadjusted basis of the account ($700).

(e)(1) In the eighth year, A elects to apply this section and to treat expenditures during the year for repair, maintenance, rehabilitation or improvement under subparagraph (2)(iii) and (iv)(*a*) of this paragraph (the ‘‘guideline class repair allowance’’). This results in the treatment of $300 as a property improvement for the asset guideline class. (See subparagraph (2)(vii) of this paragraph for definition of a property improvement.) The property improvement is capitalized in a special basis vintage account of the eighth taxable year (see subparagraph (2)(viii)*(a)* of this paragraph). A selects an asset depreciation period of 10 years and adopts the straight line method for the special basis vintage account. A adopts the modified half-year convention for the eighth year.

(2) In the eighth year, A sells asset Y in an ordinary retirement for $175. Under paragraph (c)(1)(ii) of this section and subparagraph (3)(iii) of this paragraph, $175 is added to the depreciation reserve for the account as of the beginning of the taxable year. Since the depreciation reserve for the account ($875) exceeds the unadjusted basis of the account ($700) by $175, that amount of gain is recognized under subparagraph (3)(ix) of this paragraph. Upon recognition of gain in the amount of $175, the depreciation reserve for the account is reduced to $700.

(3) No depreciation is allowable in the eighth year for the vintage account since the depreciation reserve ($700) equals the unadjusted basis of the account ($700). The depreciation allowable in the eighth year for the special basis vintage account is $15, that is, unadjusted basis of $300, multiplied by 1⁄10, the asset depreciation period selected for the special basis vintage account, but limited to $15 under the modified half-year convention. (See paragraph (e)(1)(iv) of this section for treatment of $150 of the property improvement as first placed in service in the first half of the taxable year and $150 of the property improvement as first placed in service in the last half of the taxable year.)

Example (2). Taxpayer B has a 1971 multiple asset vintage account for section 1245 property with an unadjusted basis of $100,000. B selects from the asset depreciation range an asset depreciation period of 10 years and adopts the straight line method of depreciation and the modified half-year convention. B establishes a salvage value for the account of $10,000. All the assets in the account are first placed in service on January 15, 1971. B follows the practice of reducing salvage value for the account as ordinary retirements occur in accordance with subparagraph (3)(vii) of this paragraph, but does not follow the optional practice of determining the basis of assets transferred to supplies or scrap in accordance with subparagraph (3)(vii) of this paragraph. No retirements occur during the first five years. The depreciation reserve at the beginning of the sixth year is $50,000. In the sixth year an asset with an unadjusted basis of $20,000 is transferred to supplies in an ordinary retirement. By application of subparagraph (3)(vii) *(c)* and *(d)(2)* of this paragraph B determines the reduction in salvage value for the account attributable to such asset to be

$$\$2{,}000 \text{ (that is, } \$20{,}000 \div \$100{,}000 \times \$10{,}000 = \$2{,}000).$$

B reduces the salvage value for the account by $2,000 and adds 2,000 to the depreciation reserve for the account. The basis of the retired asset in the supplies account is $2,000. The depreciation allowable for the account for the sixth year is $10,000. The depreciation reserve for the account at the beginning of the seventh year is $62,000. At the mid-point of the seventh year all the remaining assets in the account are sold in an ordinary retirement for $20,000, which is added to the depreciation reserve as of the beginning of the seventh year, thus increasing the reserve to $82,000. The $5,000 depreciation allowable for the account for the seventh year (one-half of a full-year’s depreciation of $10,000) increases the depreciation reserve to $87,000. Under subparagraph (3)(ix)*(b)* of this paragraph, a loss of $13,000 subject to section 1231 is realized in the seventh year (that is, the excess of the unadjusted basis of $100,000 over the depreciation reserve of $87,000). No depreciation is allowable for the account after the mid-point of the seventh year since all the assets are retired and the account has terminated.

(e) *Accounting for eligible property*— (1) *Definition of first placed in service*—(i) *In general.* The term ‘‘first placed in service’’ refers to the time the property is first placed in service by the taxpayer, not to the first time the property is placed in service. Property is first placed in service when first placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity. In general, the provisions of paragraph (d)(1)(ii) and (d)(2) of § 1.46–3 shall apply for the purpose of determining the date on which property is placed in service, but see subdivision (ii) of this subparagraph for special rule for certain replacement parts. In the case of a building which is intended to house machinery and equipment and which is constructed, reconstructed, or erected by or for the taxpayer and for the taxpayer’s use, the building will ordinarily be placed in service on the date such construction, reconstruction, or erection is substantially complete and the building is in a condition or state of readiness and availability. Thus, for example, in the case of a factory building, such readiness and availability shall be determined without regard to whether the machinery or equipment which the building houses, or is intended to house, has been placed in service. However, in an appropriate case, as for example where the building is essentially an item of machinery or equipment, or the use ofthe building is so closely related to the use of the machinery or equipment that it clearly can be expected to be replaced or retired when the property it initially houses is replaced or retired, the determination of readiness or availability of the building shall be made by taking into account the readiness and availability of such machinery or equipment. The date on which depreciation begins under a convention used by the taxpayer or under a particular method of depreciation, such as the unit of production method or the retirement method, shall not determine the date on which the property is first placed in service. See paragraph (c)(2) of this section for application of a first-year convention to determine the allowance for depreciation of property in a vintage account.

(ii) *Certain replacement parts.* Property (such as replacement parts) the cost or other basis of which is deducted as a repair expense in accordance with the asset guideline repair allowance described in paragraph (d)(2)(iii) of this section shall not be treated as placed in service.

(iii) *Property improvements and excluded additions. (a)* Except as provided in *(b)* of this subdivision, a property improvement determined under paragraph (d)(2)(vii)*(b)* of this section, and an excluded addition (other than an excluded addition referred to in the succeeding sentence) is first placed in service when its cost is paid or incurred. The general rule in subdivision (i) of this subparagraph applies to an excluded addition described in paragraph (d) (2)(vi) *(d), (e), (f),* or *(g)* of this section.

(b) If a property improvement or an excluded addition to which the first sentence of *(a)* of this subdivision applies is paid or incurred in part in one taxable year and in part in the succeeding taxable year (or in part in the first half of a taxable year and in part in the last half of the taxable year) the taxpayer may at his option consistently treat such property improvements and excluded additions under the general rule in subdivision (i) of this subparagraph.

(iv) *Certain property improvements.* In the case of an amount of property improvement determined under paragraph (d)(2)(vii)*(a)* of this section, one-half of such amount is first placed in service in the first half of the taxable year in which the cost is paid or incurred and one-half is first placed in service in the last half of such taxable year.

(v) *Special rules for clearing accounts.* In the case of public utilities which consistently account for certain property through ‘‘clearing accounts,’’ the date on which such property is first placed in service shall be determined in accordance with rules to be prescribed by the Commissioner.

(2) *Special rules for transferred property.* If eligible property is first placed in service by the taxpayer during a taxable year of election, and the property is disposed of before the end of the taxable year, the election for such taxable year shall include such property unless such property is excluded in accordance with paragraph (b)(5) (iii), (iv, (v), (vi), or (vii) of this section.

(3) *Special rules in the case of certain transfers*—(i) *Transaction to which section 381(a) applies. (a)* In general the acquiring corporation in a transaction to which section 381(a) applies is for the purposes of this section treated as if it were the distributor or transferor corporation.

(b) If the distributor or transferor corporation (including any distributor or transferor corporation of any distributor or transferor corporation) has made an election to apply this section to eligible property transferred in a transaction to which section 381(a) applies, the acquiring corporation must segregate such eligible property (to which the distributor or transferor corporation elected to apply this section) into vintage accounts as nearly coextensive as possible with the vintage accounts created by the distributor or

transferor corporation identified by reference to the year the property was first placed in service by the distributor or transferor corporation. The asset depreciation period for the vintage account in the hands of the distributor or transferor corporation must be used by the acquiring corporation. The method of depreciation adopted by the distributor or transferor corporation, shall be used by the acquiring corporation unless such corporation obtains the consent of the Commissioner to use another method of depreciation in accordance with paragraph (e) of §1.446–1 or changes the method of depreciation under paragraph (c)(1)(iii) of this section.

(c) The acquiring corporation may apply this section to the property so acquired only if the distributor or transferor corporation elected to apply this section to such property.

(d) See paragraph (b)(7) of this section for special rule for certain property where there is a mere change in the form of conducting a trade or business.

(ii) *Partnerships, trusts, estates, donees, and corporations.* Except as provided in subdivision (i) of this subparagraph with respect to transactions to which section 381(a) applies and subdivision (iv) of this subparagraph with respect to certain transfers between members of an affiliated group of corporations or other related parties, if eligible property is placed in service by an individual, trust, estate, partnership or corporation, the election to apply this section shall be made by the individual, trust, estate, partnership or corporation placing such property in service. For example, if a partnership places in service property contributed to the partnership by a partner, the partnership may elect to apply this section to such property. If the partnership does not make the election, this section will not apply to such property. See paragraph (b)(7) of this section for special rule for certain property where there is mere change in the form of conducting a trade or business.

(iii) *Leased property.* The asset depreciation range and the asset depreciation period for eligible property subject to a lease shall be determined without regard to the period for which such property is leased, including any extensions or renewals of such period. See paragraph (b)(5)(v) of this section for exclusion of property amortized under paragraph (b) of §1.162–11 from an election to apply this section. In the case of a lessor of property, unless there is an asset guideline class in effect for lessors of such property, the asset guideline class for such property shall be determined as if the property were owned by the lessee. However, in the case of an asset guideline class based upon the type of property (such as trucks or railroad cars) as distinguished from the activity in which used, the property shall be classified without regard to the activity of the lessee. Notwithstanding the preceding sentence, if a lease with respect to property, which would be includible in an asset guideline class based upon the type of property under the preceding sentence (such as trucks or railroad cars), is entered into after March 12, 1971, and before April 23, 1973, or a written contract to execute such a lease is entered into during such periodand such contract is binding on April 23, 1973, and at all times thereafter, and if the rent or rate of return is based on a classification of such property as if it were owned by the lessee, then such property shall be classified as if it were owned by the lessee. However, the preceding sentence shall not apply if pursuant to the terms or conditions of the lease or binding contract the rent or rate of return may be adjusted to take account of a change in the period for depreciation with respect to the property resulting from inclusion of the property in an asset guideline class based upon the type of property rather than in an asset guideline class based upon the activity of the lessee. Similarly, where the terms of such a lease or contract provide that the obligation of the taxpayer to enter into the lease is subject to a condition that the property be included in an asset guideline class based upon the activity of the lessee, the contract or lease will not be considered as binding upon the taxpayer, for purposes of this subdivision. See paragraph (b)(4)(iii)*(b)* of this section for general rule for classification of property according to primary use.

(iv) *Treatment of certain transfers between members of affiliated groups or other related persons.* If section 38 property in an asset guideline class (determined without regard to whether the taxpayer elects to apply this section) is transferred by the taxpayer to a person who bears a relationship described in section 179(d)(2) (A) or (B), such property is in the same asset guideline class in the hands of transferee, and the transfer is neither described in section 381(a) nor treated as a disposition or cessation within the meaning of section 47, then the asset guideline period for such property selected by the taxpayer under this section shall not be shorter than the period used for computing the qualified investment with respect to the property under section 46(c). In a case in which the asset depreciation range for the asset guideline class which includes such property does not include the period for depreciation used by the transferor in computing the qualified investment with respect to such property, the transferee will not be permitted to include such property in an election under this section. However, in such a case, the transferor of the property may recompute the qualified investment for the year the property was placed in service using a period for depreciation which falls within the asset depreciation range.

(f) *Election with respect to eligible property*—(1) *Time and manner of election*—(i) *In general.* An election to apply this section to eligible property shall be made with the income tax return filed for the taxable year in which the property is first placed in service (see paragraph (e)(1) of this section) by the taxpayer. In the case of an affiliated group of corporations (as defined in section 1504(a)) which makes a consolidated return with respect to income tax in accordance with section 1502 and the regulations thereunder, each corporation which joins in the making of such return may elect to apply this section for a taxable year. An election to compute the allowance for depreciation under this section is a method of accounting but the consent of the Commissioner will be deemed granted to make an annual election. For election by a partnership see section 703 (b) and paragraph (e)(3)(ii) of this section. If the taxpayer does not file a timely return (taking into account extensions of the time for filing) for the taxable year in which the property is first placed in service, the election shall be filed at the time the taxpayer files his first return for that year. The election may be made with an amended return filed within the time prescribed by law (including extensions) for filing the original return for the taxable year of election. If an election is not made within the time and in the manner prescribed in this paragraph, no election may be made for such taxable year (by the filing of an amended return or in any other manner) with respect to any eligible property placed in service in the taxable year.

(ii) *Other elections under this section.* All other elections under this section may be made only within the time and in the manner prescribed by subdivision (i) of this subparagraph with respect to an election to apply this section.

(iii) *Effective date.* See paragraph (f)(6) of this section for the effective date of this paragraph.

(2) *Information required.* A taxpayer who elects to apply this section must specify in the election:

(i) That the taxpayer makes such election and consents to and agrees to apply, all the provisions of this section;

(ii) The asset guideline class for each vintage account of the taxable year;

(iii) The first-year convention adopted by the taxpayer for the taxable year of election;

(iv) Whether the special 10 percent used property rule described in paragraph (b)(5)(iii) of this section has been applied to exclude used property from the election;

(v) Whether the taxpayer elects to apply the asset guideline class repair allowance described in paragraph (d)(2)(iii) of this section;

(vi) Whether the taxpayer elects for the taxable year to allocate the adjusted basis of a special basis vintage account in accordance with paragraph (d)(3)(vi) of this section;

(vii) Whether any eligible property for which the taxpayer was not required or permitted to make an election was excluded because of the special rules of paragraph (b)(5)(v) or (6), or paragraph (e)(3)(i) or (iv) of this section;

(viii) Whether any ‘‘section 38 property’’ was excluded under paragraph (b)(5)(iv) of this section from the election to apply this section;

(ix) If the taxpayer is an electric or gas utility, whether the taxpayer elects to apply this section on the basis of a composite asset guideline class in accordance with paragraph (b)(4)(iii)(*a*) of this section; and

(x) Such other information as may reasonably be required.

The information required under this subparagraph may be provided in accordance with rules prescribed by the Commissioner for reasonable grouping of assets or accounts. Form 4832 is provided for making an election and for submission of the information required. An election may be made and the information submitted only in accordance with Form 4832. An election to apply this section will not be rendered invalid under this subparagraph so long as there is substantial compliance, in good faith, with the requirements of this subparagraph.

(3) *Irrevocable election.* An election to apply this section to eligible property for any taxable year may not be revoked or changed after the time for filing the election prescribed under subparagraph (1) of this paragraph has expired. No other election under this section may be revoked or changed after such time unless expressly provided for under this section. (See paragraph (b)(5)(v)*(b)* of this section for special rule.)

(4) *Special conditions to election to apply this section*—(i) *Maintenance of books and records.* The taxpayer may not elect to apply this section for a taxable year unless the taxpayer maintains the books and records required under this section. In addition to any other information required under this section, the taxpayer's books and records must specify—

(*a*) The asset depreciation period selected by the taxpayer for each vintage account;

(*b*) If the taxpayer applies the modified half-year convention, the total cost or other basis of all eligible property first placed in service in the first half of the taxable year and the total cost or other basis of all eligible property first placed in service in the last half of the taxable year;

(*c*) The unadjusted basis and salvage value for each vintage account, and the amount, if any, by which gross salvage value was decreased under section 167 (f);

(*d*) Each asset guideline class for which the taxpayer elects to apply the asset guideline class repair allowance described in paragraph (d)(2)(iii) of this section;

(*e*) The amount of property improvement, determined under paragraph (d)(2)(vii)(*a*) of this section, for each asset guideline class for which the taxpayer elects to apply the asset guideline class repair allowance;

(*f*) A reasonable description of property excluded from an election to apply this section and the basis for the exclusion;

(*g*) The total unadjusted basis of all assets retired during the taxable year from each asset guideline class, and the proceeds realized during the taxable year from such retirements; and

(*h*) The vintage (that is, the taxable year in which established) of the assets retired during the year from each asset guideline class.

For purposes of paragraph (f)(4)(i) (*g*) and (*h*) of this section, all accounts of the same vintage and asset guideline class may be treated as a single account. The taxpayer must specify the information required under paragraph (f)(4)(i) (*g*) and (*h*) without regard to the retirement of an asset by transfer to a supplies account for reuse.

(ii) *Response to survey.* Taxpayers who elect to apply this section must respond to infrequent data surveys conducted by the Treasury Department. These periodic surveys, which will be conducted on the basis of scientifically sound sampling methods, are designed to obtain data (including industry asset acquisitions and retirements) used to keep the asset guideline classes and periods up to date.

(iii) *Effect of noncompliance.* An election to apply this section will not be rendered invalid under this subparagraph so long as there is substantial compliance, in good faith, with the requirements of this subparagraph.

(5) *Mass assets.* In the case of mass assets, if the taxpayer assigns retirements to vintage accounts in the manner provided in paragraph (d)(3)(v)*(c)* of this section, the following information must be supplied with form 4832:

(i) Whether the taxpayer used the standard mortality dispersion curve or a curve based upon his own experience, and

(ii) Such other reasonable information as may be required by the Commissioner.

(6) *Effective date.* The rules in this paragraph apply to elections for taxable years ending on or after December 31, 1978. In the case of an election for a taxable year ending before December 31, 1978, the rules in paragraph (f) of this section, in effect before the amendments made by T.D. 7593 approved January 11, 1979, shall apply. See 26 CFR § 1.167(a)–11(f) (1977) for paragraph (f) of this section as it appeared before the amendments made by T.D. 7593.

(g) *Relationship to other provisions*—(1) *Useful life*—(i) *In general.* Except as provided in subdivision (ii) of this subparagraph, an election to apply this section to eligible property constitutes an agreement under section 167(d) and this section to treat the asset depreciation period for each vintage account as the useful life of the property in such account for all purposes of the Code, including sections 46, 47, 48, 57, 163(d), 167(c), 167(f)(2), 179, 312(m), 514(a), and 4940(c). For example, since section 167(c) requires a useful life of at least 3 years and the asset depreciation period selected is treated as the useful life for purposes of section 167(c), the taxpayer may adopt a method of depreciation described in section 167(b) (2) or (3) for an account only if the asset depreciation period selected for the account is at least 3 years.

(ii) *Special rules. (a)* For the purposes of paragraph (d) of this section, the anticipated period of use (estimated at the close of the taxable year in which the asset is first placed in service) on the basis of which salvage value is estimated, shall be determined without regard to the asset depreciation period for the property.

(b) For the purposes of sections 162 and 263 and the regulations thereunder, whether an expenditure prolongs the life of an asset shall be determined on the basis of the anticipated period of use of the asset (estimated at the close of the taxable year in which the asset is first placed in service) without regard to the asset depreciation period for such asset.

(c) The determination whether a transaction with respect to qualified property constitutes a sale or a lease of such property shall be made without regard to the asset depreciation period for the property.

(d) The principles of this subdivision may be illustrated by the following example:

Example. Corporation X has assets in asset guideline class 32.3 which are used in the manufacture of stone and clay products. The asset depreciation range for assets in asset guideline class 32.3 is from 12 to 18 years. Assume that corporation X selects 14 years as the asset depreciation period for all assets in asset guideline class 32.3. Under paragraph (d)(1)(i) of this section, corporation X must estimate salvage value on the basis of the anticipated period of use of the property (determined as of the close of the taxable year in which the property is first placed in service). The anticipated period of use must also be used for purposes of sections 162 and 263 in determining whether an expenditure materially prolongs the useful life of an asset. The anticipated period of use of an asset is determined without regard to the asset depreciation period of 14 years. Corporation X has, among other assets in the asset guideline class, machines A, B, and C. Corporation X estimates the anticipated period of use of machines A, B, and C as 8 years, 14 years, and 22 years, respectively. These estimates are reasonable and will be used for estimating salvage value and for purposes of sections 162 and 263.

(2) *Section 167(d) agreements.* If the taxpayer has, prior to January 1, 1971, entered into a section 167(d) agreement which applies to any eligible property, the taxpayer will be permitted to withdraw the eligible property from the agreement provided that an election is made to apply this section to such property. The statement of intent to withdraw eligible property from such an agreement must be made in an election filed for the taxable year in which the property is first placed in service. The withdrawal, in accordance with this subparagraph, of any eligible property from a section 167(d) agreement

shall not affect any other property covered by such an agreement.

(3) *Relationship to the straight line method*—(i) *In general.* For purposes of determining the amount of depreciation which would be allowable under the straight line method of depreciation, such amount shall be computed with respect to any property in a vintage account using the straight line method in the manner described in paragraph (c)(1)(i) of this section and a rate based upon the period for the vintage account selected from the asset depreciation range. Thus, for example, section 57(a)(3) requires a taxpayer to compute an amount using the straight line method of depreciation if the taxpayer uses an accelerated method of depreciation. For purposes of section 57(a)(3), the amount for property in a vintage account shall be computed using the asset depreciation period for the vintage account selected from the asset depreciation range. In the case of property to which the taxpayer does not elect to apply this section, such amount computed by using the straight line method shall be determined under §1.167(b)–1 without regard to this section.

(ii) *Examples.* The principles of this subparagraph may be illustrated by the following example:

Example. (a) Corporation X places a new asset in service to which it elects to apply this section. The cost of the asset is $200,000 and the estimated salvage value is zero. The taxpayer selects 9 years from the applicable asset depreciation range of 8 to 12 years. Corporation X adopts the double declining balance method of depreciation and thus the rate of depreciation is 22.2 percent (twice the applicable straight line rate). The depreciation allowance in the first year would be $44,400, that is, 22.2 percent of $200,000.

(b) Assume that the provisions of section 57(a)(3) apply to the property. The amount of the tax preference would be $22,200, that is, the excess of the depreciation allowed under this section ($44,400) over the depreciation which would have been allowable if the taxpayer had used the period selected from the asset depreciation range and the straight line rate ($22,200).

(Secs. 167(m), 85 Stat. 508 (26 U.S.C. 167(m) and 7805, 68A Stat. 917, (26 U.S.C. 7805))

[T.D. 7272, 38 FR 9967, Apr. 23, 1973]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.167(a)–11, see the List of CFR Sections Affected in the Finding Aids section of this volume.

§1.167(a)–12 Depreciation based on class lives for property first placed in service before January 1, 1971.

(a) *In general*—(1) *Summary.* This section provides an elective class life system for determining the reasonable allowance for depreciation of certain classes of assets for taxable years ending after December 31, 1970. The system applies only to assets placed in service before January 1, 1971. Depreciation for such assets during periods prior to January 1, 1971, may have been determined in accordance with Revenue Procedure 62–21. Accordingly, rules are provided which permit taxpayers to apply the system in taxable years ending after December 31, 1970, to such assets without the necessity of changing or regrouping their depreciation accounts other than as previously required by Revenue Procedure 62–21. The system is designed to minimize disputes between taxpayers and the Internal Revenue Service as to the useful life of assets, salvage value, and repairs. See §1.167(a)–11 for a similar system for property placed in service after December 31, 1970. See paragraph (d)(2) of §1.167(a)–11 for treatment of expenditures for the repair, maintenance, rehabilitation or improvement of certain property. The system provided by this section is optional with the taxpayer. An election under this section applies only to qualified property in an asset guideline class for which an election is made and only for the taxable year of election. The taxpayer's election is made with the income tax return for the taxable year. This section also revokes the reserve ratio test for taxable years ending after December 31, 1970, and provides transitional rules for taxpayers who after January 11, 1971, adopt Revenue Procedure 62–21 for a taxable year ending prior to January 1, 1971.

(2) *Revocation of reserve ratio test and other matters.* Except as otherwise expressly provided in this section and in paragraph (b)(5)(vi) of §1.167(a)–11, the provisions of Revenue Procedure 62–21 shall not apply to any property for any taxable year ending after December 31, 1970, whether or not the taxpayer elects to apply this section to any

property. See paragraph (f) of this section for rules for the adoption of Revenue Procedure 62–21 for taxable years ending prior to January 1, 1971.

(3) *Definition of qualified property.* The term ''qualified property'' means tangible property which is subject to the allowance for depreciation provided by section 167(a), but only if—

(i) An asset guideline class and asset guideline period are in effect for such property for the taxable year, and

(ii) The property is first placed in service by the taxpayer before January 1, 1971,

(iii) The property is placed in service before January 1, 1971, but first placed in service by the taxpayer after December 31, 1970, and is not includible in an election under §1.167(a)–11 by reason of §1.167(a)–11(b)(7) (property acquired as a result of a mere change in form) or §1.167(a)–11(e)(3)(i) (certain property acquired in a transaction to which section 381(a) applies), or

(iv) The property is acquired and first placed in service by the taxpayer after December 31, 1970, pursuant to a binding written contract entered into prior to January 1, 1971, and is excluded in accordance with paragraph (b)(5)(iv) of §1.167(a)–11 from an election to apply §1.167(a)–11.

The provisions of paragraph (e)(1) of §1.167(a)–11 apply in determining whether property is first placed in service before January 1, 1971. See subparagraph (4)(ii) of this paragraph for special rules for the exclusion of property from the definition of qualified property.

(4) *Requirements of election*—(i) *In general.* An election to apply this section to qualified property must be made within the time and in the manner specified in paragraph (e) of this section. The election must specify that the taxpayer consents to and agrees to apply all the provisions of this section. The election may be made separately for each asset guideline class. Thus, a taxpayer may for the taxable year elect to apply this section to one, more than one, or all asset guideline classes in which he has qualified property. An election to apply this section for a taxable year must include all qualified property in the asset guideline class for which the election is made.

(ii) *Special rules for exclusion of property from application of this section. (a)* If for the taxable year of election, the taxpayer computes depreciation under section 167(k) or computes amortization under sections 169, 185, 187, 188, or paragraph (b) of §1.162–11 with respect to property, such property is not qualified property for such taxable year. If for the taxable year of election, the taxpayer computes depreciation under any method of depreciation (other than a method described in the preceding sentence) not permitted by subparagraph (5)(v) of this paragraph for any property in an asset guideline class (other than subsidiary assets excluded from an election under *(b)* of this subdivision), no property in such asset guideline class is qualified property for such taxable year.

(b) The taxpayer may exclude from an election to apply this section all (but not less than all) subsidiary assets. Subsidiary assets so excluded are not qualified property for such taxable year. For purposes of this subdivision the term ''subsidiary assets'' includes jigs, dies, molds, returnable containers, glassware, silverware, textile mill cam assemblies, and other equipment includable in Group One, Class 5, of Revenue Procedure 62–21 which is usually and properly accounted for separately from other property and under a method of depreciation not expressed in terms of years.

(iii) *Special rule for certain public utility property. (a)* In the case of public utility property described in section 167(1)(3)(A)(iii) for which no guideline life was prescribed in Revenue Procedure 62–21 (or for which reference was made in Revenue Procedure 62–21 to lives or rates established by governmental regulatory agencies) of a taxpayer which—

(1) Is entitled to use a method of depreciation other than a ''subsection (1) method'' of depreciation (as defined in section 167(1)(3)(F)) only if it uses the ''normalization method of accounting'' (as defined in section 167(1)(3)(G)) with respect to such property, or

(2) Is entitled for the taxable year to use only a ''subsection (1) method'' of depreciation,

such property shall be qualified property (as defined in subparagraph (3) of this paragraph) only if the taxpayer normalizes the tax deferral resulting from the election to apply this section.

(b) The taxpayer will be considered to normalize the tax deferral resulting from the election to apply this section only if it computes its tax expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using a period for depreciation no less than the period used for computing its depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account for the taxable year, and the taxpayer makes adjustments to a reserve to reflect the deferralof taxes resulting from the use of a period for depreciation under section 167 in accordance with an election to apply this section different from the period used for computing its depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account for the taxable year. A determination whether the taxpayer is considered to normalize under this subdivision the tax deferral resulting from the election to apply this section shall be made in a manner consistent with the principles for determining whether a taxpayer is using the ''normalization method of accounting'' (within the meaning of section 167(1)(3)(G)). See §1.167(l)–1(h).

(c) If a taxpayer, which has elected to apply this section to any qualified public utility property and is required under *(a)* of this subdivision to normalize the tax deferral resulting from the election to apply this section to such property, fails to normalize such tax deferral, the election to apply this section to such property shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize such tax deferral. Application of this section to such property for any period prior to the termination date will not be affected by this termination.

(5) *Determination of reasonable allowance for depreciation*—(i) *In general.* The allowance for depreciation of qualified property to which the taxpayer elects to apply this section shall be determined in accordance with this section. The annual allowance for depreciation is determined by using the method of depreciation adopted by the taxpayer and a rate based upon a life permitted by this section. In the case of the straight-line method of depreciation, the rate of depreciation shall be based upon the class life (or individual life if the taxpayer assigns individual depreciable lives in accordance with subdivision (iii) of this subparagraph) used by the taxpayer with respect to the assets in the asset guideline class. Such rate will be applied to the unadjusted basis of the asset guideline class (individual assets or depreciation accounts if the taxpayer assigns individual depreciable lives). In the case of the sum of the years-digits method of depreciation, the rate of depreciation will be determined based upon the remaining life of the class (or individual remaining lives if the taxpayer assigns such lives in accordance with subdivision (iii) of this subparagraph) and is applied to the adjusted basis of the class (or individual accounts or assets) as of the beginning of the taxable year of election. The remaining life of a depreciation account is determined by dividing the unrecovered cost or other basis of the account, as computed by straight-line depreciation, by the gross cost or unadjusted basis of the account, and multiplying the result by the class life used with respect to the account. In the case of the declining balance method of depreciation, the rate of depreciation for the asset guideline class shall be based upon the class life (or individual life if the taxpayer assigns such lives in accordance with subdivision (iii) of this subparagraph). Such rate is applied to the adjusted basis of the class (or individual accounts or assets) as of the beginning of the taxable year of election.

(ii) *Reasonable allowance by reference to class lives.* The amount of depreciation for all qualified property in an asset guideline class to which the taxpayer elects to apply this section will constitute the reasonable allowance provided by section 167(a) and the depreciation for the asset guideline class will not be adjusted if—

(a) The taxpayer's qualified property is accounted for in one or more depreciation accounts which conform to the

asset guideline class, and the depreciation for each such account is determined by using a rate based upon a life not less than the class life, or

(b) The taxpayer's qualified property is accounted for in one or more depreciation accounts (whether or not conforming to the asset guideline class) for which depreciation is determined at a rate based upon the taxpayer's estimate of the lives of the assets (instead of the class life) and the total amount of depreciation so determined for the asset guideline class for the taxable year of election is not more than would be permitted under *(a)* of this subdivision for such year using the method of depreciation adopted by the taxpayer for the property.

See subdivision (vii) of this subparagraph for determination of reasonable allowance if depreciation exceeds the amount permitted by this subdivision. See paragraph (b) of this section for rules regarding the determination of ''class life''. For rules for regrouping depreciation accounts to conform to the asset guideline class, see subdivision (iv) of this subparagraph.

(iii) *Consistency when individual lives are used.* If the taxpayer assigns individual depreciable lives to assets in accordance with subdivision (ii)*(b)* of this subparagraph, even though the total amount of depreciation for the asset guideline class will not be adjusted, the lives assigned to the various assets in the asset guideline class must be reasonably in proportion to their relative expected periods of use in the taxpayer's business. Thus, although the taxpayer who uses individual asset lives normally has latitude in thereby allocating the depreciation for the asset guideline class among the assets, if the lives are grossly disproportionate (as where a short life is assigned to one asset and a long life to another even though the expected periods of use are the same), the taxpayer's allocation of depreciation to particular assets or depreciation accounts may be adjusted. For example, the taxpayer's allocation may be adjusted for purposes of determining adjusted basis under section 1016(a) or in allocating depreciation to the 50-percent limitation on percentage depletion provided by section 613(a). See paragraph (d) of this section for rules regarding the use of individual asset lives for purposes of classifying retirements as normal or abnormal.

(iv) *Regrouping depreciation accounts.* Without the consent of the Commissioner, the taxpayer may for any taxable year for which he elects to apply this section to an asset guideline class, regroup his accounts for that and all succeeding taxable years to conform to the asset guideline class. Other changes in accounting, including a change from item accounts to multiple-asset accounting, may be made with the consent of the Commissioner. No depreciation accounts for which the straight line or sum of the years-digits method of depreciation is adopted may be combined under this section which would not be permitted to be combined under part III of Revenue Procedure 65–13, as in effect on January 1, 1971. Accordingly, whether or not the taxpayer adopted the guideline system of Revenue Procedure 62–21 for a taxable year to which part III of Revenue Procedure 65–13 is applicable, the depreciation allowance for any taxable year of election under this section may not exceed that amount which would have been allowed for such year if the taxpayer had used item accounts or year of acquisition accounts. Thus, for example, if a calendar year taxpayer acquired a $90 asset on the first day of each year from 1966 through 1970, placed such assets in a single multiple asset account, adopted the sum of the years-digits method of depreciation and used a 5-year depreciable life for such assets, and in 1971 uses the 5-year class life determined under paragraph (b) of this section, the depreciation allowance for such assets in 1971 under this section may not exceed $60, that is, the amount which would be allowed if the taxpayer had used year of acquisition accounts for the assets for the years 1966 through 1970.

For purposes of this subparagraph, a taxpayer's depreciation accounts conform to the asset guideline class if each depreciation account includes only assets of the same asset guideline class.

(v) *Method of depreciation.* The same method of depreciation must be applied to all property in a single depreciation account. The method of depreciation is subject to the limitations of section 167 (c), (j), and (l). Except as otherwise provided in this subdivision, the taxpayer must apply a method of depreciation described in section 167(b) (1), (2), or (3) for qualified property to which the taxpayer elects to apply this section. A method of depreciation permitted under section 167(b)(4) may be used under this section if the method was used by the taxpayer with respect to the property for his last taxable year ending before January 1, 1971, the method is expressed in terms of years, the taxpayer establishes to the satisfaction of the Commissioner that the method is both a reasonable and consistent method, and if the taxpayer applies paragraph (b)(2) of this section (relating to class lives in special situations) to determine a classlife, that the method of determining such class life is consistent with the principles of Revenue Procedure 62–21 as applied to such a method. If the taxpayer has applied a method of depreciation with respect to the property which is not described in section 167(b) (1), (2), (3), or (4) (as permitted under the preceding sentence), he must change under this section to a method of depreciation described in section 167(b) (1), (2), or (3) for the first taxable year for which an election is made under this section. Other changes in depreciation method may be made with the consent of the Commissioner (see sec. 446 and the regulations thereunder). (See also sec. 167(e).)

(vi) *Salvage value.* In applying the method of depreciation adopted by the taxpayer, the annual allowance for depreciation is determined without adjustment for the salvage value of the property, except that no depreciation account may be depreciated below a reasonable salvage value for the account. See paragraph (c) of this section for definition and treatment of salvage value.

(vii) *Reasonable allowance when depreciation exceeds amount based on class life.* In the event that the total amount of depreciation claimed by the taxpayer on his income tax return, in a claim for refund, or otherwise, for an asset guideline class with respect to which an election is made under this section for the taxable year, exceeds the maximum amount permitted under subdivision (ii)(*a*) of this subparagraph—

(a) If the excess is established to the satisfaction of the Commissioner to be the result of a good faith mistake by the taxpayer in determining the maximum amount permitted under subdivision (ii) (*a*) of this subparagraph, the taxpayer's election to apply this section will be treated as valid and only such excess will be disallowed, and

(b) In all other cases, the taxpayer's election to apply this section to the asset guideline class for the taxable year is invalid and the reasonable allowance for depreciation will be determined without regard to this section. (See §1.167(a)–1 (b) for rules regarding the estimated useful life of property.)

(b) *Determination of class lives*—(1) *Class lives in general.* The class life determined under this paragraph (without regard to any range or variance permitted with respect to class lives under §1.167(a)–11) will be applied for purposes of determining whether the allowance for depreciation for qualified property included in an election under this section is subject to adjustment. The taxpayer is not required to use the class life determined under this paragraph for purposes of determining the allowance for depreciation. Except as provided in subparagraph (2) of this paragraph, the class life of qualified property to which the taxpayer elects to apply this section is the shorter of—

(i) The asset guideline period for the asset guideline class as set forth in Revenue Procedure 72–10 as in effect on March 1, 1972 (applied without regard to any special provision therein with respect to property predominantly used outside the United States), or

(ii) The asset guideline period for the asset guideline class as set forth in any supplement or revision of Revenue Procedure 72–10, but only if and to the extent by express reference in such supplement or revision made applicable for the purpose of changing the asset guideline period or classification of qualified property to which this section applies.

See paragraph (e)(3)(iii) of this section for requirement that the election for the taxable year specify the class life for each asset guideline class. Generally, the applicable asset guideline class and asset guideline period for qualified property to which the taxpayer has elected to apply this section will not be changed for the taxable year of election to reflect any supplement or revision thereof after the taxable year. However, if expressly provided in such a supplement or revision, the taxpayer may, at his option in the manner specified therein, apply the revised or supplemented asset guideline classes or periods to such property for such taxable year and succeeding taxable years. The principles of this subparagraph may be illustrated by the following example:

Example. (i) Corporation X, a calendar year taxpayer, has assets in asset guideline class 20.4 of Revenue Procedure 72–10 which were placed in service by corporation X in 1967, 1968, and 1970. Corporation X also has assets in asset guideline class 22.1 of Revenue Procedure 72–10 which were placed in service at various times prior to 1971. Corporation X has no other qualified property. Corporation X elects to apply this section for 1971 to both classes. Assume that the class lives are determined under this subparagraph and not under subparagraph (2) of this paragraph.

(ii) The class lives for asset guideline classes 20.4 and 22.1 are their respective asset guideline periods of 12 years and 9 years in Revenue Procedure 72–10.

(iii) Accordingly, in the election for the taxable year, in accordance with paragraph (e)(3)(iii) of this section, corporation X specifies a class life of 12 years for asset guideline class 20.4 and a class life of 9 years for asset guideline class 22.1

(2) *Class lives in special situations.* Notwithstanding subparagraph (1) of this paragraph, for the purposes of this section the class life for the asset guideline class determined under this subparagraph shall be used if such class life is shorter than the class life determined under subparagraph (1) of this paragraph. If property described in paragraph (a)(2)(iii) of this section in an asset guideline class is acquired by the taxpayer in a transaction to which section 381(a) applies, for purposes of this subparagraph such property shall be segregated from other property in the class and treated as in a separate asset guideline class, and the class life for that asset guideline class under this subparagraph shall be the shortest class life the transferor was entitled to use under this section for such property on the date of such transfer. In all other cases, the class life for the asset guideline class for purposes of this subparagraph shall be the shortest class life (within the meaning of sec. 4, part II, of Revenue Procedure 62–21) which can be justified by application of secs. 3.02(a), 3.03(a), or 3.05, part II, of Revenue Procedure 62–21 (other than the portion of such sec. 3.05 dealing with justification of a class life by reference to facts and circumstances) for the taxpayer's last taxable year ending prior to January 1, 1971.

A class life justified by application of section 3.03(a), Part II, of Revenue Procedure 62–21 shall not be shorter than can be justified under the Adjustment Table for Class Lives in Part III of such Revenue Procedure. For purposes of this subparagraph and paragraph (f)(1)(iii) of this section, the reserve ratio test is met only if the taxpayer's reserve ratio does not exceed the upper limit of the appropriate reserve ratio range or in the alternative during the transitional period there provided does not exceed the appropriate ''transitional upper limit'' in section 3, Part II, of Revenue Procedure 65–13. References to Revenue Procedure 62–21 include all morifications, amendments, and supplements thereto as of January 1, 1971. The guideline form of the reserve ratio test, as described in Revenue Procedure 65–13, may be applied for purposes of this subparagraph in a manner consistent with the rules contained in section 7, Part II, of Revenue Procedure 65–13 and sections 3.02, 3.03, and 3.05, Part II, of Revenue Procedure 62–21. The principles of this subparagraph may be illustrated by the following examples:

Example (1). Corporation X, a calendar year taxpayer, has all its assets in asset guideline class 20.4 of Revenue Procedure 72–10 which were placed in service by corporation X prior to 1971. Corporation X elects to apply this section for 1971. For taxable years 1967 through 1969, corporation X had used a class life (within the meaning of section 4, Part II, of Revenue Procedure 62–21) for asset guideline class 20.4 of 12 years. The asset guideline period in Revenue Procedure 72–10 in effect for 1971 is also 12 years. Assume that for 1969 corporation X's reserve ratio was below the appropriate reserve ratio lower limit. However, corporation X could not justify a class life shorter than the asset guideline period of 12 years for 1970 since corporation X had not used the 12-year class life for a period at least equal to one-half of 12 years. (See section 3.03(a), Part II, of Revenue Procedure 62–21.) Accordingly, the class life for asset guideline class 20.4 in 1971 is the asset guideline period of 12 years in accordance with subparagraph (1) of this paragraph.

Example (2). The facts are the same as in example (1) except that corporation X had used a class life of 10 years for guideline class 20.4 since 1967. Corporation X had not used the class life of 10 years for a period at least equal to one-half of 10 years. However, in 1968 corporation X's 10-year class life was accepted on audit by the Internal Revenue Service and corporation X met the reserve ratio test in 1970 for guideline class 20.4 using a test life of 10 years. (See section 3.05, Part II, of Revenue Procedure 62–21.) Accordingly, the class life of 10 years is justified for 1970 and the class life for 1971 is 10 years in accordance with this subparagraph. If the taxpayer's class life had not been audited and accepted for 1968, and in the absence of other circumstances, the taxpayer could not justify a class life shorter than the asset guideline period of 12 years since it had not used the 10-year class life for a period at least equal to one-half of 10 years. (See section 3.02, Part II, of Revenue Procedure 62–21.)

Example (3). Corporation Y, a calendar year taxpayer, has all its assets in asset guideline class 13.3 of Revenue Procedure 72–10 which were placed in service from 1960 through 1970. Corporation Y elects to apply this section for 1971. The asset guideline period in Revenue Procedure 72–10 in effect for 1971 is 16 years. Since 1963 corporation Y had used a class life of 16 years for asset guideline 13.3. At the end of 1969 corporation Y's reserve ratio for guideline class 13.3 was 36 percent. With a growth rate of 8 percent and a test life of 16 years the appropriate reserve ratio lower limit was 37 percent. Corporation Y's reserve ratio of 36 percent was below the lower limit of the appropriate reserve ratio range. Corporation Y had used the 16-year class life for at least eight years. A class life of 13.5 years for 1970 was justified by application of section 3.03(a), Part II, of Revenue Procedure 62–21 and the Adjustment Table for Class Lives in Part III, of Revenue Procedure 62–21. The class life for 1971 is 13.5 years in accordance with this subparagraph.

(3) *Classification of property*—(i) *In general.* Property to which this section applies shall be included in the asset guideline class for the activity in which the property is primarily used in the taxable year of election. See paragraph (d)(5) of this section for rule regarding the classification of leased property.

(ii) *Insubstantial activity.* The provisions of Revenue Produce 62–21 with respect to classification of assets used in an activity which is insubstantial may be applied under this section.

(iii) *Special rule for certain public utilities.* An electric or gas utility which in accordance with Revenue Procedure 64–21 used a composite guideline class basis for applying Revenue Procedure 62–21 for its last taxable year prior to January 1, 1971, may apply Revenue Procedure 72–10 and this section on the basis of such composite asset guideline class determined as provided in Revenue Procedure 64–21. For the purposes of this section all property in the composite guideline class shall be treated as included in a single asset guideline class.

(c) *Salvage value*—(1) *In general*— (i) *Definition of gross salvage value.* ''Gross salvage'' value is the amount (determined at or as of the time of acquisition but without regard to the application of Revenue Procedure 62–21) which is estimated will be realized upon a sale or other disposition of qualified property when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service, without reduction for the cost of removal, dismantling, demolition, or similar operations. ''Net salvage'' is gross salvage reduced by the cost of removal, dismantling, demolition, or similar operations. If a taxpayer customarily sells or otherwise disposes of property at a time when such property is still in good operating condition, the gross salvage value of such property is the amount expected to be realized upon such sale or disposition, and under certain circumstances, as where such property is customarily sold at a time when it is still relatively new, the gross salvage value may constitute a relatively large proportion of the unadjusted basis of such property.

(ii) *Definition of salvage value.* ''Salvage value'' for purposes of this section means gross or net salvage value less the amount, if any, by which reduced by application of section 167(f). Generally, as provided in section 167(f), a taxpayer may reduce the gross or net salvage value for an account by an amount which does not exceed 10 percent of the unadjusted basis of the personal property (as defined in section 167(f)(2)) in the account.

(2) *Estimation of salvage value*—(i) *In general.* For the first taxable year for which he elects to apply this section, the taxpayer must (in accordance with paragraph (e)(3)(iv)*(c)* of this section) establish salvage value for all qualified property to which the election applies. The taxpayer may (in accordance with subparagraph (1) of this paragraph) determine either gross or net salvage, but an election under this section does not constitute permission to change the manner of estimating salvage. Permission to change the manner of estimating salvage must be obtained by filing form 3115 with the Commissioner of Internal Revenue, Washington, D.C. 20224, within the time otherwise permitted for thetaxable year or before September 6, 1973. Salvage value in succeeding taxable years of election will be determined by adjustments of such initial salvage value for the account, as retirements occur. This salvage value established by the taxpayer for the first taxable year of election will not be redetermined merely as a result of fluctuations in price levels or as a result of other circumstances occurring after the close of such taxable year. See paragraph (e)(3)(iv) of this section for requirements that the taxpayer specify in his election the aggregate amount of salvage value for an asset guideline class and that the taxpayer maintain records reasonably sufficient to identify the salvage value established for each depreciation account in the class.

(ii) *Salvage as limitation on depreciation.* In no case may an account be depreciated under this section below a reasonable salvage value, after taking into account any reduction in gross or net salvage value permitted by section 167(f). For example, if the salvage value of an account for 1971 is $75, the unadjusted basis of the account is $500, and the depreciation reserve is $425, no depreciation is allowable for 1971.

(iii) *Special rule for first taxable year.* If for a taxable year ending prior to January 1, 1971, the taxpayer had adopted Revenue Procedure 62–21 prior to January 12, 1971 (see paragraph (f)(2) of this section), no adjustment in the amount of depreciation allowable for any taxable year ending prior to January 1, 1971, shall be made solely by reason of establishing salvage value under this paragraph for any taxable year ending after December 31, 1970. The principles of this subdivision may be illustrated by the following example:

Example. Taxpayer A had adopted Revenue Procedure 62–21 prior to January 12, 1971, for taxable years prior to 1971. Taxpayer A had not taken into account any salvage value for account No. 1 which is one of four depreciation accounts A has in the class. The reserve ratio test has been met for all years prior to 1971 and in accordance with Revenue Procedure 62–21 no adjustments in depreciable lives or salvage values were made. At the end of A's taxable year 1970, the unadjusted basis of account No. 1 was $10,000 and the reserve for depreciation was $9,800. Pursuant to this paragraph, A establishes a salvage value of $400 for account No. 1 (determined at or as of the time of acquisition). This salvage value is determined to be correct. No depreciation is allowable for account No. 1 in 1971. No depreciation is disallowed for any taxable year prior to 1971, solely by reason of establishing salvage value under this paragraph.

(3) *Limitation on adjustment of reasonable salvage value.* The salvage value established by the taxpayer for a depreciation account will not be redetermined if it is reasonable. Since the determination of salvage value is a matter of estimation, minimal adjustments will not be made. The salvage value established by the taxpayer will be deemed to be reasonable unless there is sufficient basis for a determination of an amount of salvage value for the account which exceeds the salvage value established by the taxpayer for the account by an amount greater than 10 percent of the unadjusted basis of the account at the close of such taxable year. If the salvage value established by the taxpayer for the account is not within the 10-percent range or if the taxpayer follows the practice of understating his estimates of salvage to take advantage of this subdivision, and if there is a determination of an amount of salvage value for the account for the taxable year which exceeds the salvage value established by the taxpayer for the account for such taxable year, an adjustment will be made by increasing the salvage value

established by the taxpayer for the account by an amount equal to the difference between the salvage value as determined and the salvage value established by the taxpayer for the account. For the purposes of this subdivision, a determination of salvage value shall include all determinations at all levels of audit and appellate proceedings, and as well as all final determinations within the meaning of section 1313(a)(1). This subparagraph shall apply to each such determination.

(4) *Examples.* The principles of this paragraph may be illustrated by the following examples in which it is assumed that the taxpayer has established salvage value in accordance with this paragraph and has not followed a practice of understating his estimates of salvage value:

Example (1). Taxpayer B elects to apply this section for 1971. Assets Y and Z are the only assets in a multiple asset account of 1967, the year in which the assets were acquired. The unadjusted basis of asset Y is $50,000 and the unadjusted basis of asset Z is $30,000. B estimated a gross salvage value of $55,000 at the time of acquisition. The property qualified under section 167(f)(2) and B reduced the amount of salvage taken into account by $8,000 (that is, 10 percent of $80,000, under sec. 167(f)). Thus, in accordance with this paragraph and paragraph (e)(3)(iv)*(c)* of this section, B establishes a salvage value of $47,000 for the account for 1971. Assume that there is not sufficient basis for determining a salvage value for the account greater $52,000 (that is $60,000 minus the $8,000 reduction under sec. 167(f)). Since the salvage value of $47,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage for the account will not be redetermined.

Example (2). The facts are the same as in example (1) except that B estimated a gross salvage value of $50,000 and establishes a salvage value of $42,000 for the account (that is, $50,000 minus the $8,000 reduction under section 167(f)). There is sufficient basis for determining an amount of salvage value greater than $50,000 (that is, $58,000 minus the $8,000 reduction under section 167(f)). The salvage value of $42,000 established by B for the account can be redetermined without regard to the limitation in subparagraph (3) of this paragraph, since it is not within the 10 percent range. Upon audit of B's tax return for 1971 (a year in which the redetermination would affect the amount of depreciation allowable for the account), salvage value is determined to be $52,000 after taking into account the reduction under section 167(f). Salvage value for the account will be adjusted to $52,000.

Example (3). The facts are the same as in example (1) except that upon audit of B's tax return for 1971 the examining officer determines the salvage value to be $58,000 (that is, $66,000 minus the $8,000 reduction under section 167(f)), and proposes to adjust salvage value for the account to $58,000 which will result in disallowing an amount of depreciation for the taxable year. B does not agree with the finding of the examining officer. After receipt of a ''30-day letter,'' B waives a district conference and initiates proceedings before the Appellate Division. In consideration of the case by the Appellate Division it is concluded that there is not sufficient basis for determining an amount of salvage value for the account in excess of $55,000 (that is, $63,000 minus the $8,000 reduction under section 167(f)). Since the salvage value of $47,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage value for the account will not be redetermined.

Example (4). For 1971, taxpayer C elects to apply this section to factory building X which is in an item account of 1965, the year in which the building was acquired. The unadjusted basis of factory building X is $90,000. C estimated a gross salvage value for the account of $10,000. The property did not qualify under section 167(f)(2). Thus, C establishes a salvage value of $10,000 for the account for 1971. Assume that there is not sufficient basis for determining a salvage value for the account greater than $14,000. Since the salvage value of $10,000 established by C for the account is within the 10-percent range, it is reasonable. Salvage value for the account will not be redetermined.

(d) *Accounting for qualified property*—(1) *In general.* Qualified property for which the taxpayer elects to apply this section may be accounted for in any number of item or multiple asset accounts.

(2) *Retirements of qualified property*—(i) *In general.* The provisions of this subparagraph and §1.167(a)–8 apply to retirements of qualified property to which the taxpayer elects to apply this section for the taxable year. See subdivision (iii) of this subparagraph for special rule for normal retirements.

(ii) *Adjusted basis of assets retired.* In the case of a taxpayer who depreciates qualified property in a multiple-asset account conforming to the asset guideline class at a rate based on the class life in accordance with paragraph (a)(5)(ii)*(a)* of this section, §1.167(a)–8(c) (relating to basis of assets retired) shall be applied by assuming that the class life is the average expected useful life of the assets in the account. See §1.167(a)–8, generally, for the basis of assets retired.

(iii) *Definition of normal retirements.* Notwithstanding §1.167(a)– 8(b), the determination whether a retirement of qualified property is normal or abnormal shall be made in light of all the facts and circumstances, primarily with reference to the expected period of use of the asset in the taxpayer's business without regard to paragraph (a)(5)(ii) of this section. A retirement is not abnormal unless the taxpayer can show that the withdrawal of the asset was not due to a cause which would customarily be contemplated (in light of the taxpayer's practice and experience) in setting a depreciation rate for the assets without regard to paragraph (a)(5)(ii) of this section. Thus, for example, a retirement is normal if made within the range of years which would customarily be taken into account in setting such depreciation rate and if the asset has reached a condition at which, in the normal course of events, the taxpayer customarily retires similar assets from use in his business. A retirement may be abnormal if the asset is withdrawn at an earlier time or under other circumstances, as, for example, when the asset has been damaged by casualty or has lost its usefulness suddenly as the result of extraordinary obsolescence.

(3) *Special rules*—(i) *In general.* The provisions of this subparagraph shall apply to qualified property in a taxable year for which an election to apply this section is made.

(ii) *Repairs.* For the purpose of sections 162 and 263 and the regulations thereunder, whether an expenditure prolongs the life of an asset shall be determined by reference to the expected period of use of the asset in the taxpayer's business without regard to paragraph (a)(5)(ii) of this section.

(iii) *Sale and lease.* For the purpose of comparison with the term of a lease of such property, the remaining life of qualified property shall be determined by reference to the expected period of use of the asset in the taxpayer's business without regard to paragraph (a)(5)(ii) of this section.

(4) *Expected period of use.* For the purposes of subparagraphs (2) and (3) of this paragraph, the determination of the expected period of use of an asset shall be made in light of all the facts and circumstances. The expected period of use of a particular asset will not necessarily coincide with the class life used for depreciation (or with the individual asset life for depreciation under the alternative method in paragraph (a)(5)(ii) (*b*) of this section for applying the class life). Thus, for example, if the question is whether an asset has been leased for a period less than, equal to or greater than its remaining life, the determination shall be based on the remaining expected period of use of the individual asset without regard to the fact that the asset is depreciated at a rate based on the class life in accordance with paragraph (a)(5)(ii)*(a)* of this section.

(5) *Leased property.* In the case of a lessor of qualified property, unless there is an asset guideline class in effect for such lessors, the asset guideline class for such property shall be determined by reference to the activity in which such property is primarily used by the lessee. See paragraph (b)(3) of this section for general rule for classification of qualified property according to primary use. However, in the case of an asset guideline class based upon the type of property (such as trucks or railroad cars), as distinguished from the activity in which used, the property shall be classified without regard to the activity of the lessee.

(e) *Election under this section*—(1) *Consent to change in method of accounting.* An election to apply this section for a taxable year ending after December 31, 1970, is a method of accounting but the consent of the Commissioner will be deemed granted to make an annual election.

(2) *Election for taxable years ending after December 31, 1976.* For taxable years ending after December 31, 1976, the election to apply this section for a taxable year shall be made by attaching to the income tax return a statement that an election under this section is being made. If the taxpayer does not file a timely return (taking into account extensions of time for filing)

for the taxable year, the election shall be made at the time the taxpayer files his first return for the taxable year. The election may be made with an amended return only if such amended return is filed no later than the time prescribed by law (including extensions thereof) for filing the return for the taxable year. A taxpayer who makes an election under this subparagraph must maintain books and records reflecting the information described in paragraph (e)(3) (ii) and (iii) of this section.

(3) *Election for taxable years ending on or before December 31, 1976.* (i) For taxable years ending on or before December 31, 1976, the election to apply this section for a taxable year may be made by filing Form 5006 with the income tax return for the taxable year. If the taxpayer does not file a timely return (taking into account extensions of time for filing) for the taxable year, the election shall be filed at the time the taxpayer files his first return for the taxable year. The election may be made with an amended return only if such amended return is filed no later than the later of (*a*) the time prescribed by law (including extensions thereof) for filing the return for the taxable year, or (*b*) November 5, 1973.

(ii) The election to apply this section for a taxable year ending on or before December 31, 1976, will be deemed to be made if the tax return (filed within the periods referred to in paragraph (e)(3)(i) of this section) contains information sufficient to establish the following:

(*a*) Each asset guideline class for which the election is intended to apply;

(*b*) The class life for each such asset guideline class and whether the class life is determined under paragraph (b)(1) or (2) of this section;

(*c*) For each asset guideline class, as of the end of the taxable year of election, (*1*) the total unadjusted basis of all qualified property, (*2*) the aggregate of the reserves for depreciation of all accounts in the asset guideline class, and (*3*) the aggregate of the salvage value established for all accounts in the asset guideline class; and

(*d*) Whether the taxpayer is an electric or gas utility using a composite asset guideline class basis in accordance with paragraph (b)(3)(iii) of this section.

If an election is deemed to be made under this subdivision (ii), the taxpayer will be deemed to have consented to apply all the provisions of this section.

(iii) A taxpayer to whom the election applies shall maintain books and records for each asset guideline class reasonably sufficient to identify the unadjusted basis, reserve for depreciation and salvage value established for each depreciation account in such asset guidelines class.

(f) *Depreciation for taxable years ending before January 1, 1971*—(1) *Adoption of Revenue Procedure 62–21*—(i) *In general.* Except as provided in subdivision (ii) of this subparagraph, a taxpayer may elect to be examined under the provisions of Revenue Procedure 62–21 for a taxable year ending before January 1, 1971, only in accordance with the rules of this paragraph. The election must specify:

(a) That the taxpayer makes such election and consents to, and agrees to apply, all the provisions of this paragraph;

(b) Each guideline class and taxable year for which the taxpayer elects to be examined under Revenue Procedure 62–21;

(c) The class life claimed for each such guideline class;

(d) The class life and the total amount of the depreciation for the guideline class claimed on the last income tax return for such taxable year filed prior to January 12, 1971 (or in case no income tax return was filed prior to January 12, 1971, on the first income tax return filed for such taxable year);

(e) The class life claimed and the total amount of depreciation for the guideline class under the election to apply Revenue Procedure 62–21, in accordance with this paragraph, for the taxable year; and

(f) If the class life or total amount of depreciation for the guideline class is different in *(d)* and *(e)* of this subdivision, a reasonable description of the computation of the class life in *(e)* of this subdivision, the amount of difference in tax liability resulting therefrom, and the amount of any refund or

reduction in any deficiency in tax. The election shall be made in an amended tax return or claim for refund (or by a supplement to the tax return or claim) for the taxable year, and if the class life or total amount of depreciation for the guideline class is different in accordance with *(f)* of this subdivision, such difference shall be reflected in the amended tax return or claim for refund. Forms may be provided for making the election and submission of the information. In the case of an election made after issuance of such forms and more than 30 days after publication of notice thereof in the Internal Revenue Bulletin, the election may be made and the information submitted only in accordance with such forms. An election will not otherwise be invalid under this paragraph so long as there is substantial compliance, in good faith, with the requirements of this paragraph.

(ii) *Special rule.* The provisions of this subparagraph shall not apply to a guideline class in any taxable year for which the taxpayer has prior to January 12, 1971, adopted Revenue Procedure 62–21 for such class. See subparagraph (2) of this paragraph for determination of adoption of Revenue Procedure 62–21 prior to January 12, 1971.

(iii) *Justification of class life claimed and limitations on refunds.* If the taxpayer elects for a taxable year to be examined under the provisions of Revenue Procedure 62–21 in accordance with subdivision (i) of this subparagraph, any of the provisions of Revenue Procedure 62–21 may be applied to justify a class life claimed on the income tax return filed for such year or to offset an increase in tax liability for such year. Unless it meets the reserve ratio test, no class life will be accepted on audit which (after all other adjustments in tax liability for such year)results in a reduction (or further reduction) in the amount of tax liability shown on the income tax return (specified in subdivision (i)(*d*) of this subparagraph) for such taxable year, or results in an amount of loss carryback or carryover to any taxable year, but if it is justified under Revenue Procedure 62–21 and meets the reserve ratio test, a class life will be accepted on audit without regard to the foregoing limitations and, for example, may produce a refund or credit against tax. For example, if a class life of 9 years is otherwise justified under Revenue Procedure 62–21 for 1969, but the taxpayer does not meet the reserve ratio test for 1969 using a test life of 9 years, a class life of 9 years (or any class life justified under Revenue Procedure 62–21) will be accepted on audit under Revenue Procedure 62–21 pursuant to an election in accordance with this paragraph provided it does not result in the reduction or further reduction in tax liability or in an amount of loss carryback or carryover as described in the preceding sentence. On the other hand, for example, if a class life of 10 years is justified under Revenue Procedure 62–21 for 1969 and the taxpayer meets the reserve ratio test for 1969 using a test life of 10 years, a class life of 10 years will be accepted on audit under Revenue Procedure 62–21 pursuant to an election in accordance with this paragraph even though it results in a reduction or further reduction in tax liability or in an amount of loss carryback or carryover as described above and produces a refund of tax. For purposes of this section, the term ‘‘audit’’ includes examination of claims for refund or credit against tax.

(iv) *Definitions.* For purposes of this paragraph, the determination whether the reserve ratio test is met shall be made in accordance with that portion of paragraph (b)(2) of this section which is by express reference therein made applicable to this paragraph. In addition, the guideline form of the reserve ratio test, as described in Revenue Procedure 65–13, may be applied. For purposes of this paragraph, references to Revenue Procedure 62–21 include all modifications, amendments, and supplements thereto as of January 11, 1971. The terms ‘‘class life’’ and ‘‘guideline class’’ have the same meaning as in Revenue Procedure 62–21.

(2) *Determination whether Revenue Procedure 62–21 adopted prior to January 12, 1971*—(i) *In general.* For the purposes of this paragraph, a taxpayer will be treated as having adopted prior to January 12, 1971, Revenue Procedure 62–21 for a guideline class for a taxable year ending before January 1, 1971, only if—

(a) For the guideline class and taxable year, the taxpayer adopted Revenue Procedure 62–21 by expressly so indicating on the income tax return filed for such taxable year prior to January 12, 1971;

(b) For the guideline class and taxable year, the taxpayer adopted Revenue Procedure 62–21 prior to January 12, 1971, by expressly so indicating in a proceeding before the Internal Revenue Service (such as upon examination of the income tax return for such taxable year) and there is reasonable evidence to that effect; or

(c) There is other reasonable evidence that prior to January 12, 1971, the taxpayer adopted Revenue Procedure 62–21 for the guideline class and taxable year.

If not treated under *(b)* or *(c)* of this subdivision as having done so for the last taxable year ending before January 1, 1971, and if the taxpayer files his first income tax return for such taxable year after January 11, 1971, the taxpayer will be treated as having adopted Revenue Procedure 62–21 prior to January 12, 1971, for a guideline class for such taxable year if he expressly so indicated on that return, or is treated under this subparagraph as having adopted Revenue Procedure 62–21 prior to January 12, 1971, for that guideline class for the immediately preceding taxable year.

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

Example (1). Taxpayer A, an individual who uses the calendar year as his taxable year, has property in Group Three, Class 16(a), of Revenue Procedure 62–21. On A's income tax return for 1968, filed prior to January 12, 1971, he adopted Revenue Procedure 62–21 for the guideline class by so indicating under ''Summary of Depreciation'' in the appropriate schedule of Form 1040 for 1968. Under subdivision (i) *(a)* of this subparagraph, A is treated as having adopted Revenue Procedure 62–21 for the guideline class for 1968 prior to January 12, 1971.

Example (2). Taxpayer B, an individual who uses the calendar year as his taxable year, has property in Group Two, Class 5, of Revenue Procedure 62–21. B filed timely income tax returns for 1966 through 1968 but did not adopt Revenue Procedures 62–21 on any of such returns. In 1969 upon audit of B's taxable years 1966 through 1968, B exercised his option to be examined under the provisions of Revenue Procedure 62–21. The Revenue Agent's report shows that B was examined under Revenue Procedure 62–21 for taxable years 1966 through 1968. B will be treated under subdivision (ii)(*b*) of this subparagraph as having adopted Revenue Procedure 62–21 for such years prior to January 12, 1971.

Example (3). The facts are the same as in example (2) except that B did not upon examination by the Revenue Agent in 1969 exercise his option to be examined under Revenue Procedure 62–21. B has six accounts in the guideline class, Nos. 1 through 6. The Revenue Agent proposed to lengthen the depreciable lives on accounts Nos. 2 and 3 from 8 years to 12 years. In proceedings before the Appellate Division in 1970, B exercised his option to be examined under the provisions of Revenue Procedure 62–21. This is shown by correspondence between B and the Appellate Conferee as well as by other documents in the case before the Appellate Division. The case was settled on that basis before the Appellate Division without adjustment of the depreciable lives for B's accounts Nos. 2 and 3. B will be treated under subdivision (ii) *(b)* of this subparagraph as having adopted Revenue Procedure 62–21 for taxable years 1966 through 1968 prior to January 12, 1971.

Example (4). Corporation X uses the calendar year as its taxable year and has assets in Group Two, Class 5, of Revenue Procedure 62–21. Beginning in 1964, corporation X used the guideline life of 10 years as the depreciable life for all assets in the guideline class. In 1967, corporation X's taxable years 1964 through 1966 were examined and corporation X exercised its option to be examined under the provisions of Revenue Procedure 62–21. Corporation X did not adopt Revenue Procedure 62–21 on any of its income tax returns, for the years 1964 through 1970. Corporation X has not been examined since 1967, but has continued to use the guideline life of 10 years for all property in the guideline class including additions since 1966. Corporation X will be treated under subdivision (ii) *(c)* and *(d)* of this subparagraph as having adopted Revenue Procedure 62–21 prior to January 12, 1971, for taxable years 1964 through 1970.

Example (5). Corporation Y uses the calendar year as its taxable year and has asset in Group Two, Class 5, of Revenue Procedure 62–21. Since 1964, corporation Y has used various depreciable lives, based on the facts and circumstances, for different accounts in the guideline class. Corporation Y was examined in 1968 for taxable years 1965 through 1967. Corporation Y was also examined in 1970 for taxable years 1968 and 1969. Corporation Y did not exercise its option to be examined under the provisions of Revenue Procedure 62–21. Corporation Y has not adopted Revenue Procedure 62–21 on any income tax return. For taxable years 1964 through 1970, corporation Y's class life (within the meaning of section 4, Part II, of Revenue Procedure 62–21) was between 12 and 14 years. In August of 1971, corporation Y filed amended income tax returns for 1968 and 1969, and an income tax return for 1970, using a depreciable life of 10 years (equal to the guideline life) for all assets in the guideline class. Corporation Y will not be treated as having adopted Revenue Procedure 62–21 prior to January 12, 1971.

Example (6). Corporation Z uses the calendar year as its taxable year and has assets in group 2, class 5, of Revenue Procedure 62–21. Corporation Z adopted Revenue Procedure 62–21 for this guideline class by expressly so indicating on its tax return for 1966, which was filed before January 12, 1971. Corporation Z computed its allowable depreciation for 1966 as if it adopted Revenue Procedure 62–21 for this guideline class for its taxable years 1962 through 1965, although it had earlier filed its tax returns for those years without regard to Revenue Procedure 62–21. The depreciation thus claimed in 1966 was less than what would have been allowable if corporation Z first adopted Revenue Procedure 62–21 in 1966. This was the result of certain accounts becoming fully depreciated through use of Revenue Procedure 62–21 in computing depreciation for 1962 through 1965. In addition, in deferred tax accounting procedures employed before January 12, 1971, for financial reporting purposes, corporation Z calculated its tax deferrals on the basis that it had adopted Revenue Procedure 62–21 for the years 1962 through 1965. Corporation Z will be treated under subdivision (i) (*c*) of this subparagraph as having adopted Revenue Procedure 62–21 for taxable years 1962 through 1965 prior to January 12, 1971.

(Sec. 167(m), 85 Stat. 508 (26 U.S.C. 167))

[T.D. 7278, 38 FR 14923, June 7, 1973, as amended by T.D. 7315, 39 FR 20195, June 7, 1974; T.D. 7517, 42 FR 58934, Nov. 14, 1977]

§ 1.167(a)–13T Certain elections for intangible property (temporary).

For rules applying the elections under section 13261(g) (2) and (3) of the Omnibus Budget Reconciliation Act of 1993 to intangible property described in section 167(f), see § 1.197–1T.

[59 FR 11922, Mar. 15, 1994]

§ 1.167(b)–0 Methods of computing depreciation.

(a) *In general.* Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Generally, depreciation deductions so claimed will be changed only where there is a clear and convincing basis for a change.

(b) *Certain methods.* Methods previously found adequate to produce a reasonable allowance under the Internal Revenue Code of 1939 or prior revenue laws will, if used consistently by the taxpayer, continue to be acceptable under section 167(a). Examples of such methods which continue to be acceptable are the straight line method, the declining balance method with the rate limited to 150 percent of the applicable straight line rate, and under appropriate circumstances, the unit of production method. The methods described in section 167(b) and §§ 1.167(b)–1, 1.167(b)–2, 1.167(b)–3, and 1.167(b)–4 shall be deemed to produce a reasonable allowance for depreciation except as limited under section 167(c) and § 1.167(c)–1. See also § 1.167(e)–1 for rules relating to change in method of computing depreciation.

(c) *Application of methods.* In the case of item accounts, any method which results in a reasonable allowance for depreciation may be selected for each item of property, but such method must thereafter be applied consistently to that particular item. In the case of group, classified, or composite accounts, any method may be selected for each account. Such method must be applied to that particular account consistently thereafter but need not necessarily be applied to acquisitions of similar property in the same or subsequent years, provided such acquisitions are set up in separate accounts. See, however, § 1.167(e)–1 and section 446 and the regulations thereunder, for rules relating to changes in the method of computing depreciation, and § 1.167(c)–1 for restriction on the use of certain methods. See also §1.167(a)–7 for definition of account.

§1.167(b)–1 Straight line method.

(a) *In general.* Under the straight line method the cost or other basis of the property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the property. The allowance for depreciation for the taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. For convenience, the allowance so determined may be reduced to a percentage or fraction. The straight line method may be used in determining a reasonable allowance for depreciation for any property which is subject to depreciation under section 167 and it shall be used in all cases where the taxpayer has not adopted a different acceptable method with respect to such property.

(b) *Illustrations.* The straight line method is illustrated by the following examples:

Example (1). Under the straight line method items may be depreciated separately:

Year and item	Cost or other basis less salaries	Useful life (years)	Depreciation allowable		
			1954	1955	1956
1954:					
Asset A	$1,600	4	[1] $200	$400	$400
Asset B	12,000	40	[1] 150	300	300

[1] In this example it is assumed that the assets were placed in service on July 1, 1954.

Example (2). In group, classified, or composite accounting, a number of assets with the same or different useful lives may be combined into one account, and a single rate of depreciation, i.e., the group, classified, or composite rate used for the entire account. In the case of group accounts, i.e., accounts containing assets which are similar in kind and which have approximately the same estimated useful lives, the group rate is determined from the average of the useful lives of the assets. In the case of classified or composite accounts, the classified or composite rate is generally computed by determining the amount of one year's depreciation for each item or each group of similar items, and by dividing the total depreciation thus obtained by the total cost or other basis of the assets. The average rate so obtained is to be used as long as subsequent additions, retirements, or replacements do not substantially alter the relative proportions of different types of assets in the account. An example of the computation of a classified or composite rate follows:

Cost or other basis	Estimated useful life (years)	Annual depreciation
$10,000	5	$2,000
10,000	15	667
20,000		2,667

Average rate is 13.33 percent ($2,667÷$20,000) unadjusted for salvage. Assuming the estimated salvage value is 10 percent of the cost or other basis, the rate adjusted for salvage will be 13.33 percent minus 10 percent of 13.33 percent (13.33% − 1.33%), or 12 percent.

Example (3). The use of the straight line method for group, classified, or composite accounts is illustrated by the following example: A taxpayer filing his returns on a calendar year basis maintains an asset account for which a group rate of 20 percent has been determined, before adjustment for salvage. Estimated salvage is determined to be 6⅔ percent, resulting in an adjusted rate of 18.67 percent. During the years illustrated, the initial investment, additions, retirements, and salvage recoveries, which were determined not to change the composition of the group sufficiently to require a change in rate, were assumed to have been made as follows:

1954—Initial investment of $12,000.

1957—Retirement $2,000, salvage realized $200.

1958—Retirement $2,000, salvage realized $200.

1959—Retirement $4,000, salvage realized $400.

1959—Additions $10,000.

1960—Retirement $2,000, no salvage realized.

1961—Retirement $2,000, no salvage realized.

DEPRECIABLE ASSET ACCOUNT AND DEPRECIATION COMPUTATION ON AVERAGE BALANCES

Year	Asset balance Jan. 1	Current additions	Current retirements	Asset balance Dec. 31	Average balance	Rate (percent)	Allowable depreciation
1954	....	$12,000	....	$12,000	$6,000	18.67	$1,120
1955	$12,000	....	....	12,000	12,000	18.67	2,240

DEPRECIABLE ASSET ACCOUNT AND DEPRECIATION COMPUTATION ON AVERAGE BALANCES—Continued

Year	Asset balance Jan. 1	Current additions	Current retirements	Asset balance Dec. 31	Average balance	Rate (percent)	Allowable depreciation
1956	12,000			12,000	12,000	18.67	2,240
1957	12,000		$2,000	10,000	11,000	18.67	2,054
1958	10,000		2,000	8,000	9,000	18.67	1,680
1959	8,000	10,000	4,000	14,000	11,000	18.67	2,054
1960	14,000		2,000	12,000	13,000	18.67	2,427
1961	12,000		2,000	10,000	11,000	18.67	2,054

CORRESPONDING DEPRECIATION RESERVE ACCOUNT

Year	Depreciation reserve Jan. 1	Depreciation allowable	Current retirements	Salvage realized	Depreciation reserve Dec. 31
1954		$1,120			$1,120
1955	$1,120	2,240			3,360
1956	3,360	2,240			5,600
1957	5,600	2,054	$2,000	$200	5,854
1958	5,854	1,680	2,000	200	5,734
1959	5,734	2,054	4,000	400	4,188
1960	4,188	2,427	2,000		4,615
1961	4,615	2,054	2,000		4,669

§ 1.167(b)–2 Declining balance method.

(a) *Application of method.* Under the declining balance method a uniform rate is applied each year to the unrecovered cost or other basis of the property. The unrecovered cost or other basis is the basis provided by section 167(g), adjusted for depreciation previously allowed or allowable, and for all other adjustments provided by section 1016 and other applicable provisions of law. The declining balance rate may be determined without resort to formula. Such rate determined under section 167(b)(2) shall not exceed twice the appropriate straight line rate computed without adjustment for salvage. While salvage is not taken into account in determining the annual allowances under this method, in no event shall an asset (or an account) be depreciated below a reasonable salvage value. However, see section 167(f) and § 1.167(f)–1 for rules which permit a reduction in the amount of salvage value to be taken into account for certain personal property acquired after October 16, 1962. Also, see section 167(c) and § 1.167(c)–1 for restrictions on the use of the declining balance method.

(b) *Illustrations.* The declining balance method is illustrated by the following examples:

Example (1). A new asset having an estimated useful life of 20 years was purchased on January 1, 1954, for $1,000. The normal straight line rate (without adjustment for salvage) is 5 percent, and the declining balance rate at twice the normal straight line rate is 10 percent. The annual depreciation allowances for 1954, 1955, and 1956 are as follows:

Year	Basis	Declining balance rate (percent)	Depreciation allowance
1954	$1,000	10	$100
1955	900	10	90
1956	810	10	81

Example (2). A taxpayer filing his returns on a calendar year basis maintains a group account to which a 5 year life and a 40 percent declining balance rate are applicable. Original investment, additions, retirements, and salvage recoveries are the same as those set forth in example (3) of paragraph (b) of § 1.167(b)–1. Although salvage value is not taken into consideration in computing a declining balance rate, it must be recognized and accounted for when assets are retired.

DEPRECIABLE ASSET ACCOUNT AND DEPRECIATION COMPUTATION USING AVERAGE ASSET AND RESERVE BALANCES

Year	Asset balance Jan. 1	Current additions	Current retirements	Asset balance Dec. 31	Average	Average reserve before depreciation	Net depreciable balance	Rate (pct.)	Allowable depreciation
1954	....	$12,000	....	$12,000	$6,000	....	$6,000	40	$2,400
1955	$12,000	....	....	12,000	12,000	$2,400	9,600	40	3,840
1956	12,000	....	....	12,000	12,000	6,240	5,760	40	2,304
1957	12,000	....	$2,000	10,000	11,000	7,644	3,356	40	1,342
1958	10,000	....	2,000	8,000	9,000	7,186	1,814	40	726
1959	8,000	10,000	4,000	14,000	11,000	5,212	5,788	40	2,315
1960	14,000	....	2,000	12,000	13,000	4,727	8,273	40	3,309
1961	12,000	....	2,000	10,000	11,000	6,036	4,964	40	1,986

DEPRECIATION RESERVE

Year	Reserve Jan. 1	Current retirements	Salvage realized	Reserve Dec. 31, before depreciation	Average reserve before depreciation	Allowable depreciation	Reserve Dec. 31, after depreciation
1954	....	....	....	....	....	$2,400	$2,400
1955	$2,400	....	....	$2,400	$2,400	3,840	6,240
1956	6,240	....	....	6,240	6,240	2,304	8,544
1957	8,544	$2,000	$200	6,744	7,644	1,342	8,086
1958	8,086	2,000	200	6,286	7,186	726	7,012
1959	7,012	4,000	400	3,412	5,212	2,315	5,727
1960	5,727	2,000	....	3,727	4,727	3,309	7,036
1961	7,036	2,000	....	5,036	6,036	1,986	7,022

Where separate depreciation accounts are maintained by year of acquisition and there is an unrecovered balance at the time of the last retirement, such unrecovered balance may be deducted as part of the depreciation allowance for the year of such retirement. Thus, if the taxpayer had kept separate depreciation accounts by year of acquisition and all the retirements shown in the example above were from 1954 acquisitions, depreciation would be computed on the 1954 and 1959 acquisitions as follows:

1954 ACQUISITIONS

Year	Asset balance Jan. 1	Acquisitions	Current retirements	Asset balance Dec. 31	Average balance	Avg. reserve before depreciation	Net depreciable balance	Rate (percent)	Allowable depreciation
1954	....	$12,000	....	$12,000	$6,000	....	$6,000	40	$2,400
1955	$12,000	....	....	12,000	12,000	$2,400	9,600	40	3,840
1956	12,000	....	....	12,000	12,000	6,240	5,760	40	2,304
1957	12,000	....	$2,000	10,000	11,000	7,644	3,356	40	1,342
1958	10,000	....	2,000	8,000	9,000	7,186	1,814	40	726
1959	8,000	....	4,000	4,000	6,000	5,212	788	40	315
1960	4,000	....	2,000	2,000	3,000	2,727	273	40	109
1961	2,000	....	2,000	....	1,000	836	164	....	[1] 164

[1] Balance allowable as depreciation in the year of retirement of the last survivor of the 1954 acquisitions.

DEPRECIATION RESERVE FOR 1954 ACQUISITIONS

Year	Reserve Jan. 1	Current retirements	Salvage realized	Reserve Dec. 31, before depreciation	Average reserve before depreciation	Allowable depreciation	Reserve Dec. 31, after depreciation
1954	....	....	....	....	....	$2,400	$2,400
1955	$2,400	....	....	$2,400	$2,400	3,840	6,240
1956	6,240	....	....	6,240	6,240	2,304	8,544
1957	8,544	$2,000	$200	6,744	7,644	1,342	8,086
1958	8,086	2,000	200	6,286	7,186	726	7,012

DEPRECIATION RESERVE FOR 1954 ACQUISITIONS—Continued

Year	Reserve Jan. 1	Current retirements	Salvage realized	Reserve Dec. 31, before depreciation	Average reserve before depreciation	Allowable depreciation	Reserve Dec. 31, after depreciation
1959	7,012	4,000	400	3,412	5,212	315	3,727
1960	3,727	2,000	....	1,727	2,727	109	1,836
1961	1,836	2,000	....	(164)	836	164	....

1959 ACQUISITIONS

Year	Asset balance Jan. 1	Acquisition	Asset balance Dec. 31	Avg. balance	Reserve Dec. 31, before depreciation	Net depreciable balance	Rate percent	Allowable depreciation	Reserve Dec. 31, after depreciation
1959	....	$10,000	$10,000	$5,000	None	$5,000	40	$2,000	$2,000
1960	$10,000	....	10,000	10,000	$2,000	8,000	40	3,200	5,200
1961	10,000	....	10,000	10,000	5,200	4,800	40	1,920	7,120

In the above example, the allowable depreciation on the 1954 acquisitions totals $11,200. This amount when increased by salvage realized in the amount of $800, equals the entire cost or other basis of the 1954 acquisitions ($12,000).

(c) *Change in estimated useful life.* In the declining balance method when a change is justified in the useful life estimated for an account, subsequent computations shall be made as though the revised useful life had been originally estimated. For example, assume that an account has an estimated useful life of ten years and that a declining balance rate of 20 percent is applicable. If, at the end of the sixth year, it is determined that the remaining useful life of the account is six years, computations shall be made as though the estimated useful life was originally determined as twelve years. Accordingly, the applicable depreciation rate will be 16⅔ percent. This rate is thereafter applied to the unrecovered cost or other basis.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3653, Mar. 24, 1964]

§ 1.167(b)–3 Sum of the years-digits method.

(a) *Applied to a single asset*—(1) *General rule.* Under the sum of the years-digits method annual allowances for depreciation are computed by applying changing fractions to the cost or other basis of the property reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the asset (including the year for which the allowance is being computed), and the denominator which remains constant is the sum of all the years digits corresponding to the estimated useful life of the asset. See section 167(c) and § 1.167(c)–1 for restrictions on the use of the sum of the years-digits method.

(i) *Illustrations.* Computation of depreciation allowances on a single asset under the sum of the years-digits method is illustrated by the following examples:

Example (1). A new asset having an estimated useful life of five years was acquired on January 1, 1954, for $1,750. The estimated salvage is $250. For a taxpayer filing his returns on a calendar year basis, the annual depreciation allowances are as follows:

Year	Cost or other basis less salvage	Fraction[1]	Allowable depreciation	Depreciation reserve
1954	$1,500	5/15	$500	$500
1955	1,500	4/15	400	900
1956	1,500	3/15	300	1,200
1957	1,500	2/15	200	1,400
1958	1,500	1/15	100	1,500
Unrecovered value (salvage)	....	....	....	$250

[1] The denominator of the fraction is the sum of the digits representing the years of useful life, i.e., 5, 4, 3, 2, and 1, or 15.

Example (2). Assume in connection with an asset acquired in 1954 that three-fourths of a year's depreciation is allowable in that year. The following illustrates a reasonable method of allocating depreciation:

	Depreciation for 12 months	Allowable depreciation		
		1954	1955	1956
1st year	$500	(¾) $375	(¼) $125	
2d year	400		(¾) 300	(¼) $100
3d year	300			(¾) 225
Total		375	425	325

(ii) *Change in useful life.* Where in the case of a single asset, a change is justified in the useful life, subsequent computations shall be made as though the remaining useful life at the beginning of the taxable year of change were the useful life of a new asset acquired at such time and with a basis equal to the unrecovered cost or other basis of the asset at that time. For example, assume that a new asset with an estimated useful life of ten years is purchased in 1954. At the time of making out his return for 1959, the taxpayer finds that the asset has a remaining useful life of seven years from January 1, 1959. Depreciation for 1959 should then be computed as though 1959 were the first year of the life of an asset estimated to have a useful life of seven years, and the allowance for 1959 would be 7⁄28 of the unrecovered cost or other basis of the asset after adjustment for salvage.

(2) *Remaining life*—(i) *Application.* Under the sum of the years-digits method, annual allowances for depreciation may also be computed by applying changing fractions to the unrecovered cost or other basis of the asset reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the asset (including the year for which the allowance is being computed), and the denominator changes each year to a number which represents the sum of the digits corresponding to the years of estimated remaining useful life of the asset. For decimal equivalents of such fractions, see Table I of subdivision (ii) of this subparagraph. For example, a new asset with an estimated useful life of 10 years is purchased January 1, 1954, for $6,000. Assuming a salvage value of $500, the depreciation allowance for 1954 is $1,000 ($5,500×0.1818, the applicable rate from Table I). For 1955, the unrecovered balance is $4,500, and the remaining life is 9 years. The depreciation allowance for 1955 would then be $900 ($4,500×0.2000, the applicable rate from Table I).

(ii) *Table I.* This table shows decimal equivalents of sum of the years-digits fractions corresponding to remaining lives from 1 to 100 years.

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE

Remaining life (years)	Decimal equivalent
100.0	0.0198
99.9	.0198
99.8	.0198
99.7	.0199
99.6	.0199
99.5	.0199
99.4	.0199
99.3	.0199
99.2	.0200
99.1	.0200
99.0	.0200
98.9	.0200
98.8	.0200
98.7	.0201
98.6	.0201
98.5	.0201
98.4	.0201
98.3	.0201
98.2	.0202
98.1	.0202
98.0	.0202
97.9	.0202
97.8	.0202
97.7	.0203
97.6	.0203
97.5	.0203
97.4	.0203
97.3	.0203
97.2	.0204
97.1	.0204
97.0	.0204
96.9	.0204
96.8	.0204
96.7	.0205
96.6	.0205
96.5	.0205
96.4	.0205
96.3	.0206
96.2	.0206
96.1	.0206
96.0	.0206
95.9	.0206
95.8	.0207
95.7	.0207
95.6	.0207
95.5	.0207
95.4	.0207
95.3	.0208
95.2	.0208
95.1	.0208
95.0	.0208
94.9	.0209
94.8	.0209

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
94.7	.0209
94.6	.0209
94.5	.0209
94.4	.0210
94.3	.0210
94.2	.0210
94.1	.0210
94.0	.0211
93.9	.0211
93.8	.0211
93.7	.0211
93.6	.0211
93.5	.0212
93.4	.0212
93.3	.0212
93.2	.0212
93.1	.0213
93.0	.0213
92.9	.0213
92.8	.0213
92.7	.0213
92.6	.0214
92.5	.0214
92.4	.0214
92.3	.0214
92.2	.0215
92.1	.0215
92.0	.0215
91.9	.0215
91.8	.0216
91.7	.0216
91.6	.0216
91.5	.0216
91.4	.0216
91.3	.0217
91.2	.0217
91.1	.0217
91.0	.0217
90.9	.0218
90.8	.0218
90.7	.0218
90.6	.0218
90.5	.0219
90.4	.0219
90.3	.0219
90.2	.0219
90.1	.0220
90.0	.0220
89.9	.0220
89.8	.0220
89.7	.0221
89.6	.0221
89.5	.0221
89.4	.0221
89.3	.0221
89.2	.0222
89.1	.0222
89.0	.0222
88.9	.0222
88.8	.0223
88.7	.0223
88.6	.0223
88.5	.0223
88.4	.0224
88.3	.0224
88.2	.0224
88.1	.0224
88.0	.0225
87.9	.0225
87.8	.0225
87.7	.0225
87.6	.0226
87.5	.0226
87.4	.0226
87.3	.0226
87.2	.0227
87.1	.0227
87.0	.0227
86.9	.0228
86.8	.0228
86.7	.0228
86.6	.0228
86.5	.0229
86.4	.0229
86.3	.0229
86.2	.0229
86.1	.0230
86.0	.0230
85.9	.0230
85.8	.0230
85.7	.0231
85.6	.0231
85.5	.0231
85.4	.0231
85.3	.0232
85.2	.0232
85.1	.0232
85.0	.0233
84.9	.0233
84.8	.0233
84.7	.0233
84.6	.0234
84.5	.0234
84.4	.0234
84.3	.0234
84.2	.0235
84.1	.0235
84.0	.0235
83.9	.0236
83.8	.0236
83.7	.0236
83.6	.0236
83.5	.0237
83.4	.0237
83.3	.0237
83.2	.0238
83.1	.0238
83.0	.0238
82.9	.0238
82.8	.0239
82.7	.0239
82.6	.0239
82.5	.0240
82.4	.0240
82.3	.0240
82.2	.0240
82.1	.0241
82.0	.0241
81.9	.0241
81.8	.0242
81.7	.0242
81.6	.0242
81.5	.0242
81.4	.0243
81.3	.0243
81.2	.0243

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
81.1	.0244
81.0	.0244
80.9	.0244
80.8	.0244
80.7	.0245
80.6	.0245
80.5	.0245
80.4	.0246
80.3	.0246
80.2	.0246
80.1	.0247
80.0	.0247
79.9	.0247
79.8	.0248
79.7	.0248
79.6	.0248
79.5	.0248
79.4	.0249
79.3	.0249
79.2	.0249
79.1	.0250
79.0	.0250
78.9	.0250
78.8	.0251
78.7	.0251
78.6	.0251
78.5	.0252
78.4	.0252
78.3	.0252
78.2	.0253
78.1	.0253
78.0	.0253
77.9	.0253
77.8	.0254
77.7	.0254
77.6	.0254
77.5	.0255
77.4	.0255
77.3	.0255
77.2	.0256
77.1	.0256
77.0	.0256
76.9	.0257
76.8	.0257
76.7	.0257
76.6	.0258
76.5	.0258
76.4	.0258
76.3	.0259
76.2	.0259
76.1	.0259
76.0	.0260
75.9	.0260
75.8	.0260
75.7	.0261
75.6	.0261
75.5	.0261
75.4	.0262
75.3	.0262
75.2	.0262
75.1	.0263
75.0	.0263
74.9	.0264
74.8	.0264
74.7	.0264
74.6	.0265
74.5	.0265
74.4	.0265
74.3	.0266
74.2	.0266
74.1	.0266
74.0	.0267
73.9	.0267
73.8	.0267
73.7	.0268
73.6	.0268
73.5	.0268
73.4	.0269
73.3	.0269
73.2	.0270
73.1	.0270
73.0	.0270
72.9	.0271
72.8	.0271
72.7	.0271
72.6	.0272
72.5	.0272
72.4	.0272
72.3	.0273
72.2	.0273
72.1	.0274
72.0	.0274
71.9	.0274
71.8	.0275
71.7	.0275
71.6	.0275
71.5	.0276
71.4	.0276
71.3	.0277
71.2	.0277
71.1	.0277
71.0	.0278
70.9	.0278
70.8	.0279
70.7	.0279
70.6	.0279
70.5	.0280
70.4	.0280
70.3	.0280
70.2	.0281
70.1	.0281
70.0	.0282
69.9	.0282
69.8	.0282
69.7	.0283
69.6	.0283
69.5	.0284
69.4	.0284
69.3	.0284
69.2	.0285
69.1	.0285
69.0	.0286
68.9	.0286
68.8	.0287
68.7	.0287
68.6	.0287
68.5	.0288
68.4	.0288
68.3	.0289
68.2	.0289
68.1	.0289
68.0	.0290
67.9	.0290
67.8	.0291
67.7	.0291
67.6	.0292

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
67.5	.0292
67.4	.0292
67.3	.0293
67.2	.0293
67.1	.0294
67.0	.0294
66.9	.0295
66.8	.0295
66.7	.0295
66.6	.0296
66.5	.0296
66.4	.0297
66.3	.0297
66.2	.0298
66.1	.0298
66.0	.0299
65.9	.0299
65.8	.0299
65.7	.0300
65.6	.0300
65.5	.0301
65.4	.0301
65.3	.0302
65.2	.0302
65.1	.0303
65.0	.0303
64.9	.0303
64.8	.0304
64.7	.0304
64.6	.0305
64.5	.0305
64.4	.0306
64.3	.0306
64.2	.0307
64.1	.0307
64.0	.0308
63.9	.0308
63.8	.0309
63.7	.0309
63.6	.0310
63.5	.0310
63.4	.0311
63.3	.0311
63.2	.0312
63.1	.0312
63.0	.0313
62.9	.0313
62.8	.0313
62.7	.0314
62.6	.0314
62.5	.0315
62.4	.0315
62.3	.0316
62.2	.0316
62.1	.0317
62.0	.0317
61.9	.0318
61.8	.0318
61.7	.0319
61.6	.0319
61.5	.0320
61.4	.0320
61.3	.0321
61.2	.0322
61.1	.0322
61.0	.0323
60.9	.0323
60.8	.0324
60.7	.0324
60.6	.0325
60.5	.0325
60.4	.0326
60.3	.0326
60.2	.0327
60.1	.0327
60.0	.0328
59.9	.0328
59.8	.0329
59.7	.0329
59.6	.0330
59.5	.0331
59.4	.0331
59.3	.0332
59.2	.0332
59.1	.0333
59.0	.0333
58.9	.0334
58.8	.0334
58.7	.0335
58.6	.0336
58.5	.0336
58.4	.0337
58.3	.0337
58.2	.0338
58.1	.0338
58.0	.0339
57.9	.0340
57.8	.0340
57.7	.0341
57.6	.0341
57.5	.0342
57.4	.0342
57.3	.0343
57.2	.0344
57.1	.0344
57.0	.0345
56.9	.0345
56.8	.0346
56.7	.0347
56.6	.0347
56.5	.0348
56.4	.0348
56.3	.0349
56.2	.0350
56.1	.0350
56.0	.0351
55.9	.0351
55.8	.0352
55.7	.0353
55.6	.0353
55.5	.0354
55.4	.0355
55.3	.0355
55.2	.0356
55.1	.0356
55.0	.0357
54.9	.0358
54.8	.0358
54.7	.0359
54.6	.0360
54.5	.0360
54.4	.0361
54.3	.0362
54.2	.0362
54.1	.0363
54.0	.0364

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
53.9	.0364
53.8	.0365
53.7	.0366
53.6	.0366
53.5	.0367
53.4	.0368
53.3	.0368
53.2	.0369
53.1	.0370
53.0	.0370
52.9	.0371
52.8	.0372
52.7	.0372
52.6	.0373
52.5	.0374
52.4	.0374
52.3	.0375
52.2	.0376
52.1	.0377
52.0	.0377
51.9	.0378
51.8	.0379
51.7	.0379
51.6	.0380
51.5	.0381
51.4	.0382
51.3	.0382
51.2	.0383
51.1	.0384
51.0	.0385
50.9	.0385
50.8	.0386
50.7	.0387
50.6	.0388
50.5	.0388
50.4	.0389
50.3	.0390
50.2	.0391
50.1	.0391
50.0	.0392
49.9	.0393
49.8	.0394
49.7	.0394
49.6	.0395
49.5	.0396
49.4	.0397
49.3	.0398
49.2	.0398
49.1	.0399
49.0	.0400
48.9	.0401
48.8	.0402
48.7	.0402
48.6	.0403
48.5	.0404
48.4	.0405
48.3	.0406
48.2	.0406
48.1	.0407
48.0	.0408
47.9	.0409
47.8	.0410
47.7	.0411
47.6	.0411
47.5	.0412
47.4	.0413
47.3	.0414
47.2	.0415

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
47.1	.0416
47.0	.0417
46.9	.0418
46.8	.0418
46.7	.0419
46.6	.0420
46.5	.0421
46.4	.0422
46.3	.0423
46.2	.0424
46.1	.0425
46.0	.0426
45.9	.0426
45.8	.0427
45.7	.0428
45.6	.0429
45.5	.0430
45.4	.0431
45.3	.0432
45.2	.0433
45.1	.0434
45.0	.0435
44.9	.0436
44.8	.0437
44.7	.0438
44.6	.0439
44.5	.0440
44.4	.0440
44.3	.0441
44.2	.0442
44.1	.0443
44.0	.0444
43.9	.0445
43.8	.0446
43.7	.0447
43.6	.0448
43.5	.0449
43.4	.0450
43.3	.0451
43.2	.0452
43.1	.0453
43.0	.0455
42.9	.0456
42.8	.0457
42.7	.0458
42.6	.0459
42.5	.0460
42.4	.0461
42.3	.0462
42.2	.0463
42.1	.0464
42.0	.0465
41.9	.0466
41.8	.0467
41.7	.0468
41.6	.0469
41.5	.0471
41.4	.0472
41.3	.0473
41.2	.0474
41.1	.0475
41.0	.0476
40.9	.0477
40.8	.0478
40.7	.0480
40.6	.0481
40.5	.0482
40.4	.0483

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
40.3	.0484
40.2	.0485
40.1	.0487
40.0	.0488
39.9	.0489
39.8	.0490
39.7	.0491
39.6	.0493
39.5	.0494
39.4	.0495
39.3	.0496
39.2	.0497
39.1	.0499
39.0	.0500
38.9	.0501
38.8	.0502
38.7	.0504
38.6	.0505
38.5	.0506
38.4	.0508
38.3	.0509
38.2	.0510
38.1	.0511
38.0	.0513
37.9	.0514
37.8	.0515
37.7	.0517
37.6	.0518
37.5	.0519
37.4	.0521
37.3	.0522
37.2	.0524
37.1	.0525
37.0	.0526
36.9	.0528
36.8	.0529
36.7	.0530
36.6	.0532
36.5	.0533
36.4	.0525
36.3	.0536
36.2	.0538
36.1	.0539
36.0	.0541
35.9	.0542
35.8	.0543
35.7	.0545
35.6	.0546
35.5	.0548
35.4	.0549
35.3	.0551
35.2	.0552
35.1	.0554
35.0	.0556
34.9	.0557
34.8	.0559
34.7	.0560
34.6	.0562
34.5	.0563
34.4	.0565
34.3	.0566
34.2	.0566
34.1	.0570
34.0	.0571
33.9	.0573
33.8	.0575
33.7	.0576
33.6	.0578
33.5	.0580
33.4	.0581
33.3	.0583
33.2	.0585
33.1	.0586
33.0	.0588
32.9	.0590
32.8	.0592
32.7	.0593
32.6	.0595
32.5	.0597
32.4	.0599
32.3	.0600
32.2	.0602
32.1	.0604
32.0	.0606
31.9	.0608
31.8	.0610
31.7	.0611
31.6	.0613
31.5	.0615
31.4	.0617
31.3	.0619
31.2	.0621
31.1	.0623
31.0	.0625
30.9	.0627
30.8	.0629
30.7	.0631
30.6	.0633
30.5	.0635
30.4	.0637
30.3	.0639
30.2	.0641
30.1	.0643
30.0	.0645
29.9	.0647
29.8	.0649
29.7	.0651
29.6	.0653
29.5	.0656
29.4	.0658
29.3	.0660
29.2	.0662
29.1	.0664
29.0	.0667
28.9	.0669
28.8	.0671
28.7	.0673
28.6	.0675
28.5	.0678
28.4	.0680
28.3	.0682
28.2	.0685
28.1	.0687
28.0	.0690
27.9	.0692
27.8	.0694
27.7	.0697
27.6	.0699
27.5	.0702
27.4	.0704
27.3	.0707
27.2	.0709
27.1	.0712
27.0	.0714
26.9	.0717
26.8	.0719

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
26.7	.0722
26.6	.0724
26.5	.0727
26.4	.0730
26.3	.0732
26.2	.0735
26.1	.0738
26.0	.0741
25.9	.0743
25.8	.0746
25.7	.0749
25.6	.0752
25.5	.0754
25.4	.0757
25.3	.0760
25.2	.0763
25.1	.0766
25.0	.0769
24.9	.0772
24.8	.0775
24.7	.0778
24.6	.0781
24.5	.0784
24.4	.0787
24.3	.0790
24.2	.0793
24.1	.0797
24.0	.0800
23.9	.0803
23.8	.0806
23.7	.0809
23.6	.0813
23.5	.0816
23.4	.0819
23.3	.0823
23.2	.0826
23.1	.0830
23.0	.0833
22.9	.0837
22.8	.0840
22.7	.0844
22.6	.0847
22.5	.0851
22.4	.0854
22.3	.0858
22.2	.0862
22.1	.0866
22.0	.0870
21.9	.0873
21.8	.0877
21.7	.0881
21.6	.0885
21.5	.0888
21.4	.0892
21.3	.0896
21.2	.0901
21.1	.0905
21.0	.0909
20.9	.0913
20.8	.0917
20.7	.0921
20.6	.0925
20.5	.0930
20.4	.0934
20.3	.0939
20.2	.0943
20.1	.0948
20.0	.0952

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
19.9	.0957
19.8	.0961
19.7	.0966
19.6	.0970
19.5	.0975
19.4	.0980
19.3	.0985
19.2	.0990
19.1	.0995
19.0	.1000
18.9	.1005
18.8	.1010
18.7	.1015
18.6	.1020
18.5	.1025
18.4	.1030
18.3	.1036
18.2	.1041
18.1	.1047
18.0	.1053
17.9	.1058
17.8	.1063
17.7	.1069
17.6	.1074
17.5	.1080
17.4	.1086
17.3	.1092
17.2	.1098
17.1	.1105
17.0	.1111
16.9	.1117
16.8	.1123
16.7	.1129
16.6	.1135
16.5	.1142
16.4	.1148
16.3	.1155
16.2	.1162
16.1	.1169
16.0	.1176
15.9	.1183
15.8	.1190
15.7	.1197
15.6	.1204
15.5	.1211
15.4	.1218
15.3	.1226
15.2	.1234
15.1	.1242
15.0	.1250
14.9	.1257
14.8	.1265
14.7	.1273
14.6	.1281
14.5	.1289
14.4	.1297
14.3	.1306
14.2	.1315
14.1	.1324
14.0	.1333
13.9	.1342
13.8	.1350
13.7	.1359
13.6	.1368
13.5	.1378
13.4	.1387
13.3	.1397
13.2	.1407

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
13.1	.1418
13.0	.1429
12.9	.1438
12.8	.1448
12.7	.1458
12.6	.1469
12.5	.1479
12.4	.1490
12.3	.1502
12.2	.1514
12.1	.1526
12.0	.1538
11.9	.1549
11.8	.1561
11.7	.1573
11.6	.1585
11.5	.1597
11.4	.1610
11.3	.1624
11.2	.1637
11.1	.1652
11.0	.1667
10.9	.1680
10.8	.1693
10.7	.1707
10.6	.1721
10.5	.1736
10.4	.1751
10.3	.1767
10.2	.1783
10.1	.1800
10.0	.1818
9.9	.1833
9.8	.1849
9.7	.1865
9.6	.1882
9.5	.1900
9.4	.1918
9.3	.1938
9.2	.1957
9.1	.1978
9.0	.2000
8.9	.2018
8.8	.2037
8.7	.2057
8.6	.2077
8.5	.2099
8.4	.2121
8.3	.2145
8.2	.2169
8.1	.2195
8.0	.2222
7.9	.2244
7.8	.2267
7.7	.2292
7.6	.2317
7.5	.2344
7.4	.2372
7.3	.2401
7.2	.2432
7.1	.2465
7.0	.2500
6.9	.2527
6.8	.2556
6.7	.2587
6.6	.2619
6.5	.2653
6.4	.2689
6.3	.2727
6.2	.2768
6.1	.2811
6.0	.2857
5.9	.2892
5.8	.2929
5.7	.2969
5.6	.3011
5.5	.3056
5.4	.3103
5.3	.3155
5.2	.3210
5.1	.3269
5.0	.3333
4.9	.3379
4.8	.3429
4.7	.3481
4.6	.3538
4.5	.3600
4.4	.3667
4.3	.3739
4.2	.3818
4.1	.3905
4.0	.4000
3.9	.4063
3.8	.4130
3.7	.4205
3.6	.4286
3.5	.4375
3.4	.4474
3.3	.4583
3.2	.4706
3.1	.4844
3.0	.5000
2.9	.5088
2.8	.5185
2.7	.5294
2.6	.5417
2.5	.5556
2.4	.5714
2.3	.5897
2.2	.6111
2.1	.6364
2.0	.6667
1.9	.6786
1.8	.6923
1.7	.7083
1.6	.7273
1.5	.7500
1.4	.7778
1.3	.8125
1.2	.8571
1.1	.9167
1.0	1.0000

NOTE: For determination of decimal equivalents of remaining lives falling between those shown in the above table, the taxpayer may use the next longest life shown in the table, interpolate from the table, or use the following formula from which the table was derived.

$D=2R/(W+2F)(W+1)$

where:

D=Decimal equivalent.

R=Remaining life.

W=Whole number of years in remaining life.
F=Fractional part of a year in remaining life.

If the taxpayer desires to carry his calculations of decimal equivalents to a greater number of decimal places than is provided in the table, he may use the formula. The procedure adopted must be consistently followed thereafter.

(b) *Applied to group, classified, or composite accounts*—(1) *General rule.* The sum of the years-digits method may be applied to group, classified, or composite accounts in accordance with the plan described in subparagraph (2) of this paragraph or in accordance with other plans as explained in subparagraph (3) of this paragraph.

(2) *Remaining life plan.* The remaining life plan as applied to a single asset is described in paragraph (a)(2) of this section. This plan may also be applied to group, classified, or composite accounts. Under this plan the allowance for depreciation is computed by applying changing fractions to the unrecovered cost or other basis of the account reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the account (including the year for which the allowance is being computed), and the denominator changes each year to a number which represents the sum of the years digits corresponding to the years of estimated remaining useful life of the account. Decimal equivalents of such fractions can be obtained by use of Table I under paragraph (a)(2)(ii) of this section. The proper application of this methodrequires that the estimated remaining useful life of the account be determined each year. This determination, of course, may be made each year by analysis, i.e., by determining the remaining lives for each of the components in the account, and averaging them. The estimated remaining life of any account, however, may also be determined arithmetically. For example, it may be computed by dividing the unrecovered cost or other basis of the account, as computed by straight line depreciation, by the gross cost or other basis of the account, and multiplying the result by the average life of the assets in the account. Salvage value is not a factor for the purpose of determining remaining life. Thus, if a group account with an average life of ten years had at January 1, 1958, a gross asset balance of $12,600 and a depreciation reserve computed on the straight line method of $9,450, the remaining life of the account at January 1, 1958, would be computed as follows:

$12,600−$9,450÷$12,600×10 years equals 2.50 years.

Example. The use of the sum of the years-digits method with group, classified, or composite accounts under the remaining life plan is illustrated by the following example:

A calendar year taxpayer maintains a group account to which a five-year life is applicable. Original investment, additions, retirements, and salvage recoveries are the same as those set forth in example (3) of paragraph (b) of §1.167(b)–1.

DEPRECIATION COMPUTATIONS ON A GROUP ACCOUNT UNDER REMAINING LIFE PLAN

	1	2	3	4	5	6	7	8	9	10	11	12	13	14
Year	Asset balance Jan. 1	Current additions	Current retirements	Average asset balance	Straight line amount	Straight line reserve	Remaining life	Asset balance reduced by salvage	Current additions reduced by salvage	Salvage realized	Sum of the years digits depreciation			
											Accumulated reserve Jan. 1	Unrecovered Jan. 1	Rate based on Col. (7) from Table 1	Allowable depreciation
					Col. (4)÷ life	Col. (5) − Col. (3) accumulated Jan. 1	[Col. (1) − Col. (6)÷ Col. (1)]× average service life	Col. (1)× (100% − 6.67%)	Col (2)× (100% − 6.67%)		Prior reserve+ Col. (14)+ Col. (10) − Col. (3)	Col. (8) − Col. (11)		Col. (12)× Col. (13)+ ½ Col. (9)×F[2]
1954	....	$12,000	....	$6,000	[1]$1,200	....	5.00	....	$11,200	....	....	....	0.3333	$1,866
1955	$12,000	....	....	12,000	2,400	$1,200	4.50	$11,200	....	....	$1,866	$9,334	.3600	3,360
1956	12,000	....	....	12,000	2,400	3,600	3.50	11,200	....	....	5,226	5,974	.4375	2,614
1957	12,000	....	$2,000	11,000	2,200	6,000	2.50	11,200	....	$200	7,840	3,360	.5556	1,867
1958	10,000	....	2,000	9,000	1,800	6,200	1.90	9,333	....	200	7,907	1,426	.6786	968
1959	8,000	10,000	4,000	11,000	2,200	6,000	1.25	7,466	9,333	400	7,075	391	.8125	1,874
1960	14,000	....	2,000	13,000	2,600	4,200	3.50	13,066	....	....	5,349	7,717	.4375	3,376
1961	12,000	....	2,000	11,000	2,200	4,800	3.00	11,200	....	....	6,725	4,475	.5000	2,238
1962	....	....	....	....	....	5,000	....	....	....	....	6,963	....	....	....

[1] ½ year's amount.

[2] F=Rate based on average service life (0.3333 in this example).

(3) *Other plans for application of the sum of the years-digits method.* Taxpayers who wish to use the sum of the years-digits method in computing depreciation for group, classified, or composite accounts in accordance with a sum of the years digits plan other than the remaining life plan described herein may do so only with the consent of the Commissioner. Request for permission to use plans other than that described shall be addressed to the Commissioner of Internal Revenue, Washington, D.C. 20224.

§1.167(b)–4 Other methods.

(a) Under section 167(b)(4) a taxpayer may use any consistent method of computing depreciation, such as the sinking fund method, provided depreciation allowances computed in accordance with such method do not result in accumulated allowances at the end of any taxable year greater than the total of the accumulated allowances which could have resulted from the use of the declining balance method described in section 167(b)(2). This limitation applies only during the first two-thirds of the useful life of the property. For example, an asset costing $1,000 having a useful life of six years may be depreciated under the declining balance method in accordance with §1.167(b)–2, at a rate of 33⅓ percent. During the first four years or ⅔ of its useful life, maximum depreciation allowances under the declining balance method would be as follows:

	Current depreciation	Accumulated depreciation	Balance
Cost of asset			$1,000
First year	$333	$333	667
Second year	222	555	445
Third year	148	703	297
Fourth year	99	802	198

An annual allowance computed by any other method under section 167(b)(4) could not exceed $333 for the first year, and at the end of the second year the total allowances for the two years could not exceed $555. Likewise, the total allowances for the three years could not exceed $703 and for the four years could not exceed $802. This limitation would not apply in the fifth and sixth years. See section 167(c) and §1.167(c)–1 for restriction on the use of certain methods.

(b) It shall be the responsibility of the taxpayer to establish to the satisfaction of the Commissioner that a method of depreciation under section 167(b)(4) is both a reasonable and consistent method and that it does not produce depreciation allowances in excess of the amount permitted under the limitations provided in such section.

§1.167(c)–1 Limitations on methods of computing depreciation under section 167(b) (2), (3), and (4).

(a) *In general.* (1) Section 167(c) provides limitations on the use of the declining balance method described in section 167(b)(2), the sum of the years-digits method described in section 167(b)(3), and certain other methods authorized by section 167(b)(4). These methods are applicable only to tangible property having a useful life of three years or more. If construction, reconstruction, or erection by the taxpayer began before January 1, 1954, and was completed after December 31, 1953, these methods apply only to that portion of the basis of the property which is properly attributable to such construction, reconstruction, or erection after December 31, 1953. Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications. The portion of the basis of such property attributable to construction, reconstruction, or erection after December 31, 1953, consists of all costs of the property allocable to the period after December 31, 1953, including the cost or other basis of materials entering into such work. It is not necessary that such materials be acquired after December 31, 1953, or that they be new in use. If construction or erection by the taxpayer began after December 31, 1953, the entire cost or other basis of such construction or erection qualifies for these methods of depreciation. In the case of reconstruction of property, these methods do not apply to any part of the adjusted basis of such property on December 31, 1953. For purposes of this section, construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(2) If the property was not constructed, reconstructed, or erected by the taxpayer, these methods apply only if it was acquired after December 31, 1953, and if the original use of the property commences with the taxpayer and commences after December 31, 1953. For the purpose of the preceding sentence, property shall be deemed to be acquired when reduced to physical possession, or control. The term ''original use'' means the first use to whichthe property is put, whether or not such use corresponds to the use of such property by the taxpayer. For example, a reconditioned or rebuilt machine acquired after December 31, 1953, will not be treated as being put to original use by the taxpayer even though it is put to a different use, nor will a horse acquired for breeding purposes be treated as being put to original use by the taxpayer if prior to the purchase the horse was used for racing purposes. See §§ 1.167(b)–2, 1.167 (b)–3, and 1.167(b)–4 for application of the various methods.

(3) Assets having an estimated average useful life of less than three years shall not be included in a group, classified, or composite account to which the methods described in §§ 1.167 (b)–2, 1.167(b)–3, and 1.167(b)–4 are applicable. However, an incidental retirement of an asset from such an account prior to the expiration of a useful life of three years will not prevent the application of these methods to such an account.

(4) See section 381(c)(6) and the regulations thereunder for rules covering the use of depreciation methods by acquiring corporations in the case of certain corporate acquisitions.

(5) See §§ 1.1502–12(g) and 1.1502–13 for provisions dealing with depreciation of property received by a member of an affiliated group from another member of the group during a consolidated return period.

(6) Except in the cases described in subparagraphs (4) and (5) of this paragraph, the methods of depreciation described in §§ 1.167(b)–2, 1.167(b–(3), and 1.167(b)–4 are not applicable to property in the hands of a distributee, vendee, transferee, donee, or grantee unless the original use of the property begins with such person and the conditions required by section 167(c) and this section are otherwise met. For example, these methods of depreciation may not be used by a corporation with respect to property which it acquires from an individual or partnership in exchange for its stock. Similarly, if an individual or partnership receives property in a distribution upon dissolution of a corporation, these methods of depreciation may not be used with respect to property so acquired by such individual or partnership. As a further example, these methods of depreciation may not be used by a partnership with respect to contributed property, nor by a partner with respect to partnership property distributed to him. Moreover, where a partnership is entitled to use these depreciation methods, and the optional adjustment to basis of partnership property provided by section 743 is applicable, (i) in the case of an increase in the adjusted basis of the partnership property under such section, the transferee partner with respect to whom such adjustment is applicable shall not be entitled to use such methods with respect to such increase, and (ii) in the case of a decrease in the adjusted basis of the partnership property under such section, the transferee partner with respect to whom such adjustment is applicable shall include in his income an amount equal to the portion of the depreciation deducted by the partnership which is attributable to such decrease.

(b) *Illustrations.* (1) The application of these methods to property constructed, reconstructed, or erected by the taxpayer after December 31, 1953, may be illustrated by the following examples:

Example (1). If a building with a total cost of $100,000 is completed after December 31, 1953, and the portion attributable to construction after December 31, 1953, is determined by engineering estimates or by cost accounting records to be $30,000, the methods referred to in paragraph (a)(1) of this section are applicable only to the $30,000 portion of the total.

Example (2). In 1954, a taxpayer has an old machine with an unrecovered cost of $1,000. If he contracts to have it reconditioned, or reconditions it himself, at a cost of an additional $5,000, only the $5,000 may be depreciated under the methods referred to in paragraph (a)(1) of this section, whether or not the materials used for reconditioning are new in use.

Example (3). A taxpayer who acquired a building in 1940 makes major maintenance or repair expenditures in 1954 of a type which must be capitalized. For these expenditures the taxpayer may use a method of depreciation different from that used on the building (for example, the methods referred to in paragraph (a)(1) of this section) only if he accounts for such expenditures separately from the account which contained the original building. In such case, the unadjusted basis on any parts replaced shall be removed from the asset account and shall be charged to the appropriate depreciation reserve account. In the alternative he may capitalize such expenditures by charging them to the depreciation reserve account for the building.

(2) The application of these methods to property which was not constructed, reconstructed, or erected by the taxpayer but which was acquired after December 31, 1953, may be illustrated by the following examples:

Example (1). A taxpayer contracted in 1953 to purchase a new machine which he acquired in 1954 and put into first use in that year. He may use the methods referred to in paragraph (a)(1) of this section, in recovering the cost of the new machine.

Example (2). A taxpayer instead of reconditioning his old machine buys a ‘‘factory reconditioned’’ machine in 1954 to replace it. He cannot apply the methods referred to in paragraph (a)(1) of this section, to any part of the cost of the reconditioned machine since he is not the first user of the machine.

Example (3). In 1954, a taxpayer buys a house for $20,000 which had been used as a personal residence and thus had not been subject to depreciation allowances. He makes a capital addition of $5,000 and rents the property to another. The taxpayer may use the methods referred to in paragraph (a)(1) of this section, only with respect to the $5,000 cost of the addition.

(c) *Election to use methods.* Subject to the limitations set forth in paragraph (a) of this section, the methods of computing the allowance for depreciation specified in section 167(b) (2), (3), and (4) may be adopted without permission and no formal election is required. In order for a taxpayer to elect to use these methods for any property described in paragraph (a) of this section, he need only compute depreciation thereon under any of these methods for any taxable year ending after December 31, 1953, in which the property may first be depreciated by him. The election with respect to any property shall not be binding with respect to acquisitions of similar property in the same year or subsequent year which are set up in separate accounts. If a taxpayer has filed his return for a taxable year ending after December 31, 1953, for which the return is required to be filed on or before September 15, 1956, an election to compute the depreciation allowance under any of the methods specified in section 167 (b) or a change in such an election may be made in an amended return or claim for refund filed on or before September 15, 1956.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 8560, 59 FR 41674, Aug. 15, 1994; T.D. 8597, 60 FR 36679, July 18, 1995]

§1.167(d)–1 Agreement as to useful life and rates of depreciation.

After August 16, 1954, a taxpayer may, for taxable years ending after December 31, 1953, enter into an agreement with respect to the estimated useful life, method and rate of depreciation and treatment of salvage of any property which is subject to the allowance for depreciation. An application for such agreement may be made to the district director for the internal revenue district in which the taxpayer's return is required to be filed. Such application shall be filed in quadruplicate and shall contain in such detail as may be practical the following information:

(a) The character and location of the property.

(b) The original cost or other basis and date of acquisition.

(c) Proper adjustments to the basis including depreciation accumulated to the first taxable year to be covered by the agreement.

(d) Estimated useful life and estimated salvage value.

(e) Method and rate of depreciation.

(f) Any other facts and circumstances pertinent to making a reasonable estimate of the useful life of the property and its salvage value.

The agreement must be in writing and must be signed by the taxpayer and by the district director. The agreement must be signed in quadruplicate, and two of the signed copies will be returned to the taxpayer. The agreement shall set forth its effective date, the estimated remaining useful life, the estimated salvage value, and rate and method of depreciation of the property and the facts and circumstances taken into consideration in adoption of the agreement, and shall relate only to depreciation allowances for such property on and after the effective date of the agreement. Such an agreement shall be binding on both parties until such time as facts and circumstances which were not taken into account in making the agreement are shown to exist. The party wishing to modify or change the agreement shall have the responsibility of establishing the existence of such facts and circumstances. Any change in the useful life or rate specified in such agreement shall be effective only prospectively, that is, it shall be effective beginning with the taxable year in which notice of the intention to change, including facts and circumstances warranting the adjustment of useful life and rate, is sent by the party proposing the change to the other party and is sent by registered mail, if such notice is mailed before September 3, 1958, or is sent by certified mail or registered mail, if such notice is mailed after September 2, 1958. A copy of the agreement (and any modification thereof) shall be filed with the taxpayer's return for the first taxable year which is affected by the agreement (or any modification thereof). A signed copy should be retained with the permanent records of the taxpayer. For rules relating to changes in method of depreciation, see § 1.167(e)–1 and section 446 and the regulations thereunder.

§ 1.167(e)–1 Change in method.

(a) *In general.* Any change in the method of computing the depreciation allowances with respect to a particular account (other than a change in method permitted or required by reason of the operation of section 167(j)(2) and § 1.167(j)–3(c)) is a change in method of accounting, and such a change will be permitted only with the consent of the Commissioner, except that certain changes to the straight line method of depreciation will be permitted without consent as provided in section 167(e) (1), (2), and (3). Except as provided in paragraphs (c) and (d) of this section, a change in method of computing depreciation will be permitted only with respect to all the assets contained in a particular account as defined in § 1.167(a)–7. Any change in the percentage of the current straight line rate under the declining balance method, as for example, from 200 percent of the straight line rate to any other percent of the straight line rate, or any change in the interest factor used in connection with a compound interest or sinking fund method, will constitute a change in method of depreciation. Any request for a change in method of depreciation shall bemade in accordance with section 446 and the regulations thereunder and shall state the character and location of the property, method of depreciation being used and the method proposed, the date of acquisition, the cost or other basis and adjustments thereto, amount recovered through depreciation and other allowances, the estimated salvage value, the estimated remaining life of the property, and such other information as may be required. For rules covering the use of depreciation methods by acquiring corporations in the case of certain corporate acquisitions, see section 381(c)(6) and the regulations thereunder.

(b) *Declining balance to straight line.* In the case of an account to which the method described in section 167(b)(2) is applicable, a taxpayer may change without the consent of the Commissioner from the declining balance method of depreciation to the straight line method at any time during the useful life of the property under the following conditions. Such a change may not be made if a provision prohibiting such a change is contained in an agreement under section 167(d). When the change is made, the unrecovered cost or other basis (less a reasonable estimate for salvage) shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at the time. With respect to any account, this change will be permitted only if applied to all the assets in the account as defined in § 1.167(a)–7. If the method of depreciation described in section 167(b)(2) (the decliningbalance method of depreciation using a rate not exceeding 200 percent of the straight line rate) is an acceptable method of depreciation with respect to a particular account, the taxpayer may elect under this paragraph to change to the straight line method of depreciation even if with respect to that particular account the declining balance method is permitted under a provision other than section 167(b)(2). Thus, for example, in the case of section 1250 property to which section 167(j)(1) is applicable, section 167(b) does not apply, but the declining balance method of depreciation using 150 percent of the straight line rate is an acceptable method of depreciation under section 167(j)(1)(B). Accordingly, the taxpayer may elect under this paragraph to change to the straight line method of depreciation with respect to such property. Similarly, if the taxpayer acquired used property before July 25, 1969, and adopted the 150 percent declining balance method of depreciation permitted with respect to such property under §1.167(b)–0(b), the taxpayer may elect under this paragraph to change to the straight line method of depreciation with respect to such property. The taxpayer shall furnish a statement with respect to the property which is the subject of the change showing the date of acquisition, cost or other basis, amounts recovered through depreciation and other allowances, the estimated salvage value, the character of the property, the remaining useful life of the property, and such other information as may be required. The statement shall be attached to the taxpayer's return for the taxable year in which the change is made. A change to the straight line method must be adhered to for the entire taxable year of the change and for all subsequent taxable years unless, with the consent of the Commissioner, a change to another method is permitted.

(c) *Change with respect to section 1245 property.* (1) In respect of his first taxable year beginning after December 31, 1962, a taxpayer may elect, without the consent of the Commissioner, to change the method of depreciation of section 1245 property (as defined in section 1245(a)(3)) from any declining balance method or sum of the years-digits method to the straight line method. With respect to any account (as defined in §1.167(a)–7), this change may be made notwithstanding any provision to the contrary in an agreement under section 167(d), but such change shall constitute (as of the first day of such taxable year) a termination of such agreement as to all property in such account. With respect to any account, this change will be permitted only if applied to all the section 1245 property in the account. The election shall be made by a statement on, or attached to, the return for such taxable year filed on or before the last day prescribed by law, including any extensions thereof, for filing such return.

(2) When an election under this paragraph is made in respect of section 1245 property in an account, the unrecovered cost or other basis (less a reasonable estimate for salvage) of all the section 1245 property in the account shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time. If there is other property in such account, the other property shall be placed in a separate account and depreciated by using the same method as was used before the change permitted by this paragraph, but the estimated useful life of such property shall be redetermined in accordance with §1.167(b)–2, or 1.167(b)–3, whichever is applicable. The taxpayer shall maintain records which permit specific identification of the section 1245 property in the account with respect to which the election is made, and any other property in such account. The records shall also show for all the property in the account the date of acquisition, cost or other basis, amounts recovered through depreciation and other allowances, the estimated salvage value, the character of the property, and the remaining useful life of the property. A change to the straight line method under this paragraph must be adhered to for the entire taxable year of the change and for all subsequent taxable years unless, with the consent of the Commissioner, a change to another method is permitted.

(d) *Change with respect to section 1250 property.* (1) In respect of his first taxable year beginning after July 24, 1969, a taxpayer may elect, without the consent of the Commissioner, to change the method of depreciation of section 1250 property (as defined in section 1250(c)) from any declining balance method or sum of the years-digits method to the straight line method. With respect to any account (as defined in § 1.167(a)–7) this change may be made notwithstanding any provision to the contrary in an agreement under section 167(d), but such change will constitute (as of the first day of such taxable year) a termination of such agreement as to all property in such account. With respect to any account, this change will be permitted only if applied to all the section 1250 property in the account. The election shall be made by a statement on, or attached to, the return for such taxable year filed on or before the last day prescribed by law, including extensions thereof, for filing such return.

(2) When an election under this paragraph is made in respect of section 1250 property in an account, the unrecovered cost or other basis (less a reasonable estimate for salvage) of all the section 1250 property in the account shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time. If there is other property in such account, the other property shall be placed in a separate account and depreciated by using the same method as was used before the change permitted by this paragraph, but the estimated useful life of such property shall be redetermined in accordance with § 1.167(b)–2 or § 1.167(b)–3, whichever is applicable. The taxpayer shall maintain records which permit specific identification of the section 1250 property in the account with respect to which the election is made and any other property in such account. The records shall also show for all the property in the account the date of the acquisition, cost or other basis, amounts recovered through depreciation and other allowances, the estimated salvage value, the character of the property, and the estimated remaining useful life of the property. A change to the straight line method under this paragraph must be adhered to for the entire taxable year of the change and for all subsequent taxable years unless, with the consent of the Commissioner, a change to another method is permitted.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8573, July 7, 1965; T.D. 7166, 37 FR 5245, Mar. 11, 1972]

§ 1.167(f)–1 Reduction of salvage value taken into account for certain personal property.

(a) *In general.* For taxable years beginning after December 31, 1961, and ending after October 16, 1962, a taxpayer may reduce the amount taken into account as salvage value in computing the allowance for depreciation under section 167(a) with respect to ‘‘personal property’’ as defined in section 167(f)(2) and paragraph (b) of this section. The reduction may be made in an amount which does not exceed 10 percent of the basis of the property for determining depreciation, as of the time as of which salvage value is required to be determined (or when salvage value is redetermined), taking into account all adjustments under section 1016 other than (1) the adjustment under section 1016(a)(2) for depreciation allowed or allowable to the taxpayer, and (2) the adjustment under section1016(a)(19) for a credit earned by the taxpayer under section 38, to the extent such adjustment is reflected in the basis for depreciation. See paragraph (c) of § 1.167(a)–1 for the definition of salvage value, the time for making the determination, the redetermination of salvage value, and the general rules with respect to the treatment of salvage value. See also section 167(g) and § 1.167(g)–1 for basis for depreciation. A reduction of the amount taken into account as salvage value with respect to any property shall not be binding with respect to other property. In no event shall an asset (or an account) be depreciated below a reasonable salvage value after taking into account the reduction in salvage value permitted by section 167(f) and this section.

(b) *Definitions and special rules.* The following definitions and special rules apply for purposes of section 167(f) and this section.

(1) *Personal property.* The term ‘‘personal property’’ shall include only depreciable—

(i) Tangible personal property (as defined in section 48 and the regulations thereunder) and

(ii) Intangible personal property

which has an estimated useful life (determined at the time of acquisition) of 3 years or more and which is acquired after October 16, 1962. Such term shall not include livestock. The term ‘‘livestock’’ includes horses, cattle, hogs, sheep, goats, and mink and other furbearing animals, irrespective of the use to which they are put or the purpose for which they are held. The original use of the property need not commence with the taxpayer so long as he acquired it after October 16, 1962; thus, the property may be new or used. For purposes of determining the estimated useful life, the provisions of paragraph (b) of §1.167(a)–1 shall be applied. For rules determining when property is acquired, see subparagraph (2) of this paragraph. For purposes of determining the types of intangible personal property which are subject to the allowance for depreciation, see §1.167(a)–3.

(2) *Acquired.* In determining whether property is acquired after October 16, 1962, property shall be deemed to be acquired when reduced to physical possession, or control. Property which has not been used in the taxpayer’s trade or business or held for the production of income and which is thereafter converted by the taxpayer to such use shall be deemed to be acquired on the date of such conversion. In addition, property shall be deemed to be acquired if constructed, reconstructed, or erected by the taxpayer. If construction, reconstruction, or erection by the taxpayer began before October 17, 1962, and was completed after October 16, 1962, section 167(f) and this section apply only to that portion of the basis of the property which is properly attributable to such construction, reconstruction, or erection afterOctober 16, 1962. Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications. The portion of the basis of such property attributable to construction, reconstruction, or erection after October 16, 1962, consists of all costs of the property allocable to the period after October 16, 1962, including the cost or other basis of materials entering into such work. It is not necessary that such materials be acquired after October 16, 1962, or that they be new in use. If construction or erection by the taxpayer began after October 16, 1962, the entire cost or other basis of such construction or erection qualifies for the reduction provided for by section 167(f) and this section. In the case of reconstruction of property, section 167(f) and this section do not apply to any part of the adjusted basis of such property on October 16, 1962. For purposes of this section, construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(c) *Illustrations.* The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). Taxpayer A purchases a new asset for use in his business on January 1, 1963, for $10,000. The asset qualifies for the investment credit under section 38 and for the additional first-year depreciation allowance under section 179. A is entitled to an investment credit of $700 (7%×$10,000) and elects to take an additional first-year depreciation allowance of $2,000 (20%×$10,000). The basis for depreciation (determined in accordance with the provisions of section 167(g) and §1.167(g)–1) is computed as follows:

Purchase price		$10,000
Less: Adjustment required for taxable years beginning before Jan. 1, 1964, under section 1016(a)(19), for the investment credit	$700	
Adjustment required under section 1016(a)(2) for the additional first-year depreciation allowance	2,000	
	2,700	
Basis for depreciation for the taxable year 1963		7,300

However, the basis of the property for determining depreciation as of the time as of which salvage value is required to be determined is $10,000, the purchase price of the property. A files his income tax returns on a calendar year basis and uses the straight line method of depreciation. A estimates that he will use the asset in his business for 10 years after which it will have a salvage value of $500, which is less than $1,000 (10%×$10,000, the basis of the property for determining depreciation as of the time as of which salvage value is required to be determined). For the taxable year 1963 A may deduct $730 as the depreciation allowance. As of January 1, 1964, the basis of the asset is increased by $700 in accordance with paragraph (d) of § 1.48–7. In computing his total depreciation allowance on the asset, A may reduce the amount taken into account as salvage value to zero and may claim depreciation deductions (including the additional first-year depreciation allowance) totaling $10,000. See paragraph (d) of § 1.48–7 for the computation of depreciation for taxable years beginning after December 31, 1963, where there is an increase in basis of property subject to the investment credit.

Example (2). Assume the same facts as in example (1) except that A in a subsequent taxable year redetermines the estimate of the useful life of the asset and at the same time also redetermines the estimate of salvage value. Assume also that at such time the only reductions reflected in the basis are for depreciation allowed or allowable. Accordingly, the reduction under section 167(f) and this section will be computed with regard to the purchase price and not the unrecovered basis for depreciation at the time of the redetermination.

Example (3). Assume the same facts as in example (1) except that A estimates that the asset will have a salvage value of $1,200 at the end of its useful life. In computing his depreciation for the asset, A may reduce the amount to be taken into account as salvage value to $200 ($1,200−$1,000). Accordingly, A may claim depreciation deductions (including the additional first-year depreciation allowance) totaling $9,800, i.e., the purchase price of the property ($10,000) less the amount taken into account as salvage value ($200).

Example (4). Assume the same facts as in example (1) except that the taxpayer had taken into account salvage value of only $200 but that the estimated salvage value had actually been $700. The amount of salvage value taken into account by the taxpayer is permissible since the reduction of salvage value by $500 ($700−$200) would be within the limit provided for in section 167 (f), i.e., $1,000 (10%×$10,000).

Example (5). On January 1, 1963, taxpayer B, a taxicab operator, traded his old taxicab plus cash for a new one, which had an estimated useful life of three years, in a transaction qualifying as a nontaxable exchange. The old taxicab had an adjusted basis of $2,500. B was allowed $3,000 for his old taxicab and paid $1,000 in cash. The basis of the new taxicab for determining depreciation (as determined under section 167(g) and § 1.167(g)–1) is the adjusted basis of the old taxicab at the time of trade-in ($2,500) plus the additional cash paid out ($1,000), or $3,500. In computing his depreciation allowance on the new taxicab, B may reduce the amount taken into account as salvage value by $350 (10% of $3,500).

Example (6). Taxpayer C purchases a new asset for use in his business on January 1, 1963, for $10,000. At the time of purchase, the asset has an estimated useful life of 10 years and an estimated salvage value of $1,500. C elects to compute his depreciation allowance for the asset by the declining balance method of depreciation, using a rate of 20% which is twice the normal straight line rate of 10% (without adjustment for salvage value). C files his income tax returns on a calendar year basis. In computing his depreciation allowance for the year 1966, C changes his method of determining the depreciation allowance for the asset from the declining balance method to the straight line method (in which salvage value is accounted for in determining the annual depreciation allowances) in accordance with the provisions of section 167(e) and paragraph (b) of § 1.167(e)–1. He also wishes to reduce the amount of salvage value taken into account in accordance with the provisions of section 167(f) and this section. At the close of the year 1966, the only reductions reflected in the basis of the asset are for depreciation allowances. Thus, C may reduce the amount of salvage value taken into account by $1,000 (10%×$10,000, the basis of the asset when it was acquired), and, therefore, will account for salvage value of only $500 in computing his depreciation allowance for the asset in 1966 and subsequent years.

Example (7). Taxpayer D purchases a station wagon for his personal use on January 1, 1962, for $4,500. On January 1, 1963, D converts the use of the station wagon to his business, and at that time it has an estimated useful life of 4 years, an estimated salvage value of $500, and a basis of $3,000 (as determined under section 167 (g) and § 1.167 (g)–1). Thus, for purposes of section 167 (f) and this section, D is deemed to have acquired the station wagon on January 1, 1963. D elects the straight line method of depreciation in computing the depreciation allowance for the station wagon and also wishes to reduce the amount of salvage value taken into account in accordance with the provisions of section 167(f) and this section. Accordingly, D may reduce the amount of salvage value taken into account by $300 (10% of $3,000). D files his income tax returns on a calendar year basis. His depreciation allowance for the year 1963 would be computed as follows:

Basis for depreciation		$3,000
Less:		
Salvage value	$500	

Reduction permitted by section 167(f)	300	
		200
Amount to be depreciated over the useful life		2,800

D’s depreciation allowance on the station wagon for the year 1963 would be $700 ($2,800 divided by 4, the remaining useful life).

[T.D. 6712, 29 FR 3654, Mar. 24, 1964, as amended by T.D. 6838, 30 FR 9064, July 20, 1965]

§1.167(g)–1 Basis for depreciation.

The basis upon which the allowance for depreciation is to be computed with respect to any property shall be the adjusted basis provided in section 1011 for the purpose of determining gain on the sale or other disposition of such property. In the case of property which has not been used in the trade or business or held for the production of income and which is thereafter converted to such use, the fair market value on the date of such conversion, if less than the adjusted basis of the property at that time, is the basis for computing depreciation.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960. Redesignated, T.D. 6712, 29 FR 3653, Mar. 24, 1964]

§1.167(h)–1 Life tenants and beneficiaries of trusts and estates.

(a) *Life tenants.* In the case of property held by one person for life with remainder to another person, the deduction for depreciation shall be computed as if the life tenant were the absolute owner of the property so that he will be entitled to the deduction during his life, and thereafter the deduction, if any, shall be allowed to the remainderman.

(b) *Trusts.* If property is held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depreciation reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each. For example:

(1) If under the trust instrument or local law the income of a trust computed without regard to depreciation is to be distributed to a named beneficiary, the beneficiary is entitled to the deduction to the exclusion of the trustee.

(2) If under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depreciation in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction). The same result would follow if the trustee sets aside income for a depreciation reserve pursuant to discretionary authority to do so in the governing instrument.

No effect shall be given to any allocation of the depreciation deduction which gives any beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument except as otherwise provided in this paragraph when the trust instrument or local law requires or permits the trustee to maintain a reserve for depreciation.

(c) *Estates.* In the case of an estate the allowable deduction shall be apportioned between the estate and the heirs legatees, and devisees on the basis of income of the estate which is allocable to each.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960. Redesignated, T.D. 6712, 29 FR 3653, Mar. 24, 1964]

§1.167(i)–1 Depreciation of improvements in the case of mines, etc.

Property used in the trade or business or held for the production of income which is subject to the allowance for depreciation provided in section 611 shall be treated for all purposes of the Code as if it were property subject to the allowance for depreciation under section 167. The preceding sentence shall not limit the allowance for depreciation otherwise allowable under section 611.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960. Redesignated, T.D. 6712, 29 FR 3653, Mar. 24, 1964]

§ 1.167(l)–1 Limitations on reasonable allowance in case of property of certain public utilities.

(a) *In general*—(1) *Scope.* Section 167(l) in general provides limitations on the use of certain methods of computing a reasonable allowance for depreciation under section 167(a) with respect to ‘‘public utility property’’ (see paragraph (b) of this section) for all taxable years for which a Federal income tax return was not filed before August 1, 1969. The limitations are set forth in paragraph (c) of this section for ‘‘pre-1970 public utility property’’ and in paragraph (d) of this section for ‘‘post-1969 public utility property.’’ Under section 167(l), a taxpayer may always use a straight line method (or other ‘‘subsection (l) method’’ as defined in paragraph (f) of this section). In general, the use of a method of depreciation other than a subsection (l) method is not prohibited by section 167(l) for any taxpayer if the taxpayer uses a ‘‘normalization method of regulated accounting’’ (described in paragraph (h) of this section). In certain cases, the use of a method of depreciation other than a subsection (l) method is not prohibited by section 167(l) if the taxpayer used a ‘‘flow-through method of regulated accounting’’ described in paragraph (i) of this section) for its ‘‘July 1969 regulated accounting period’’ (described in paragraph (g) of this section) whether or not the taxpayer uses either a normalization or a flow-through method of regulated accounting after its July 1969 regulated accounting period. However, in no event may a method of depreciation other than a subsection (l) method be used in the case of pre-1970 public utility property unless such method of depreciation is the ‘‘applicable 1968 method’’ (within the meaning of paragraph (e) of this section). The normalization requirements of section 167(l) with respect to public utilityproperty defined in section 167(l)(3)(A) pertain only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. Regulations under section 167(l) do not pertain to other book-tax timing differences with respect to State income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items. The rules provided in paragraph (h)(6) of this section are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that may be excluded from the rate base or included in no-cost capital in determining such cost of services. The formula provided in paragraph (h)(6)(ii) of this section is to be used in conjunction with the method of accounting for the reserve for deferred taxes (otherwise proper under paragraph (h)(2) of this section) in accordance with the accounting requirements prescribed or approved, if applicable, by the regulatory body having jurisdiction over the taxpayer’s regulated books of account. The formula provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer. The formula serves to limit the amount of such disallowance.

(2) *Methods of depreciation.* For purposes of section 167(l), in the case of a declining balance method each different uniform rate applied to the unrecovered cost or other basis of the property is a different method of depreciation. For purposes of section 167(l), a change in a uniform rate of depreciation due to a change in the useful life of the property or a change in the taxpayer’s unrecovered cost or other basis for the property is not a change in the method of depreciation. The use of

‘‘guideline lives’’ or ‘‘class lives’’ for Federal income tax purposes and different lives on the taxpayer’s regulated books of account is not treated for purposes of section 167(l) as a different method of depreciation. Further, the use of an unrecovered cost or other basis or salvage value for Federal income tax purposes different from the basis or salvage value used on the taxpayer’s regulated books of account is not treated as a different method of depreciation.

(3) *Application of certain other provisions to public utility property.* For rules with respect to application of the investment credit to public utility property, see section 46(e). For rules with respect to the application of the class life asset depreciation range system, including the treatment of the use of ‘‘class lives’’ for Federal income tax purposes and different lives on the taxpayer’s regulated books of account, see §1.167(a)–11 and §1.167(a)–12.

(4) *Effect on agreements under section 167(d).* If the taxpayer has entered into an agreement under section 167(d) as to any public utility property and such agreement requires the use of a method of depreciation prohibited by section 167(l), such agreement shall terminate as to such property. The termination, in accordance with this subparagraph, shall not affect any other property (whether or not public utility property) covered by the agreement.

(5) *Effect of change in method of depreciation.* If, because the method of depreciation used by the taxpayer with respect to public utility property is prohibited by section 167(l), the taxpayer changes to a method of depreciation not prohibited by section 167(l), then when the change is made the unrecovered cost or other basis shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time.

(b) *Public utility property*—(1) *In general.* Under section 167(l)(3)(A), property is ‘‘public utility property’’ during any period in which it is used predominantly in a ‘‘section 167(l) public utility activity’’. The term ‘‘section 167(l) public utility activity’’ means the trade or business of the furnishing or sale of—

(i) Electrical energy, water, or sewage disposal services,

(ii) Gas or steam through a local distribution system,

(iii) Telephone services,

(iv) Other communication services (whether or not telephone services) if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), or

(v) Transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, are regulated, i.e., have been established or approved by a regulatory body described in section 167(l)(3)(A). The term ‘‘regulatory body described in section 167(l)(3)(A)’’ means a State (including the District of Columbia) or political subdivision thereof, any agency or instrumentality of the United States, or a public service or public utility commission or other body of any State or political subdivision thereof similar to such a commission. The term ‘‘established or approved’’ includes the filing of a schedule of rates with a regulatory body which has the power to approve such rates, even though such body has taken no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer involved.

(2) *Classification of property.* If property is not used solely in a section 167(l) public utility activity, such property shall be public utility property if its predominant use is in a section 167(l) public utility activity. The predominant use of property for any period shall be determined by reference to the proper accounts to which expenditures for such property are chargeable under the system of regulated accounts required to be used for the period for which the determination is made and in accordance with the principles of §1.46–3(g)(4) (relating to credit for investment in certain depreciable property). Thus, for example, for purposes of determining whether property is used predominantly in the trade or business of the furnishing or sale of transportation of gas by pipeline, or furnishing or sale of gas through a local distribution system, or both, the rules prescribed in §1.46–3(g)(4) apply,

except that accounts 365 through 371, inclusive (Transmission Plant), shall be added to the accounts enumerated in subdivision (i) of such paragraph (g)(4).

(c) *Pre-1970 public utility property*—(1) *Definition.* (i) Under section 167(l)(3)(B), the term ''pre-1970 public utility property'' means property which was public utility property at any time before January 1, 1970. If a taxpayer acquires pre-1970 public utility property, such property shall be pre-1970 public utility property in the hands of the taxpayer even though such property may have been acquired by the taxpayer in an arm's-length cash sale at fair market value or in a tax-free exchange. Thus, for example, if corporation X which is a member of the same controlled group of corporations (within the meaning of section 1563(a)) as corporation Y sells pre-1970 public utility property to Y, such property is pre-1970 public utility property in the hands of Y. The result would be the same if X and Y were not members of the same controlled group of corporations.

(ii) If the basis of public utility property acquired by the taxpayer in a transaction is determined in whole or in part by reference to the basis of any of the taxpayer's pre-1970 public utility property by reason of the application of any provision of the code, and if immediately after the transaction the adjusted basis of the property acquired is less than 200 percent of the adjusted basis of such pre-1970 public utility property immediately before the transaction, the property acquired is pre-1970 public utility property.

(2) *Methods of depreciation not prohibited.* Under section 167(l)(1), in the case of pre-1970 public utility property, the term ''reasonable allowance'' as used in section 167(a) means, for a taxable year for which a Federal income tax return was not filed before August 1, 1969, and in which such property is public utility property, an allowance (allowable without regard to section 167(l)) computed under—

(i) A subsection (l) method, or

(ii) The applicable 1968 method (other than a subsection (l) method) used by the taxpayer for such property, but only if—

(a) The taxpayer uses in respect of such taxable year a normalization method of regulated accounting for such property,

(b) The taxpayer used a flow-through method of regulated accounting for such property for its July 1969 regulated accounting period, or

(c) The taxpayer's first regulated accounting period with respect to such property is after the taxpayer's July 1969 regulated accounting period and the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period for public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service. See paragraph (e)(5) of this section for determination of same (or similar) kind.

(3) *Flow-through method of regulated accounting in certain cases.* See paragraph (e)(6) of this section for treatment of certain taxpayers with pending applications for change in method of accounting as being deemed to have used a flow-through method of regulated accounting for the July 1969 regulated accounting period.

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

Example (1). Corporation X, a calendar-year taxpayer subject to the jurisdiction of a regulatory body described in section 167(l)(3)(A), used the straight line method of depreciation (a subsection (l) method) for all of its public utility property for which depreciation was allowable on its Federal income tax return for 1967 (the latest taxable year for which X, prior to August 1, 1969, filed a return). Assume that under paragraph (e) of this section, X's applicable 1968 method is a subsection (l) method with respect to all of its public utility property. Thus, with respect to its pre-1970 public utility property, X may only use a straight line method (or any other subsection (l) method) of depreciation for all taxable years after 1967.

Example (2). Corporation Y, a calendar-year taxpayer subject to the jurisdiction of the Federal Power Commission, is engaged exclusively in the transportation of gas by pipeline. On its Federal income tax return for 1967 (the latest taxable year for which Y, prior to August 1, 1969, filed a return), Y used the declining balance method of depreciation using a rate of 150 percent of the straightline rate for all of its nonsection 1250 public utility property with respect to which depreciation was allowable. Assume that with respect to all of such property, Y's applicable 1968 method under paragraph (e) of this section is such 150 percent declining balance method. Assume that Y used a normalization method of regulated accounting for all relevant regulated accounting periods. If Y continues to use a normalization method of regulated accounting, Y may compute itsreasonable allowance for purposes of section 167(a) using such 150 percent declining balance method for its nonsection 1250 pre-1970 public utility property for all taxable years beginning with 1968, provided the use of such method is allowable without regard to section 167(l). Y may also use a subsection (l) method for any of such pre-1970 public utility property for all taxable years beginning after 1967. However, because each different uniform rate applied to the basis of the property is a different method of depreciation, Y may not use a declining balance method of depreciation using a rate of twice the straight line rate for any of such pre-1970 public utility property for any taxable year beginning after 1967.

Example (3). Assume the same facts as in example (2) except that with respect to all of its nonsection 1250 pre-1970 public utility property accounted for in its July 1969 regulated accounting period Y used a flow-through method of regulated accounting for such period. Assume further that such property is the property on the basis of which the applicable 1968 method is established for pre-1970 public utility property of the same kind, but having a first regulated accounting period after the taxpayer's July 1969 regulated accounting period. Beginning with 1968, with respect to such property Y may compute its reasonable allowance for purposes of section 167(a) using the declining balance method of depreciation and a rate of 150 percent of the straight line rate, whether it uses a normalization or flow-through method of regulated accounting after its July 1969 regulated accounting period, provided the use of such method is allowable without regard to section 167(l).

(d) *Post-1969 public utility property*—(1) *In general.* Under section 167(l)(3)(C), the term ''post-1969 public utility property'' means any public utility property which is not pre-1970 public utility property.

(2) *Methods of depreciation not prohibited.* Under section 167(l)(2), in the case of post-1969 public utility property, the term ''reasonable allowance'' as used in section 167(a) means, for a taxable year, an allowance (allowable without regard to section 167(l)) computed under—

(i) A subsection (l) method,

(ii) A method of depreciation otherwise allowable under section 167 if, with respect to the property, the taxpayer uses in respect of such taxable year a normalization method of regulated accounting, or

(iii) The taxpayer's applicable 1968 method (other than a subsection (l) method) with respect to the property in question, if the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period for the property of the same (or similar) kind most recently placed in service, provided that the property in question is not property to which an election under section 167(l)(4)(A) applies. See §1.167(l)(2) for rules with respect to an election under section 167(l)(4)(A). See paragraph (e)(5) of this section for definition of same (or similar) kind.

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

Example (1). Corporation X is engaged exclusively in the trade or business of the transportation of gas by pipeline and is subject to the jurisdiction of the Federal Power Commission. With respect to all its public utility property, X's applicable 1968 method (as determined under paragraph (e) of this section) is the straight line method of depreciation. X may determine its reasonable allowance for depreciation under section 167(a) with respect to its post-1969 public utility property under a straight line method (or other subsection (l) method) or, if X uses a normalization method of regulated accounting, any other method of depreciation, provided that the use of such other method is allowable under section 167 without regard to section 167(l).

Example (2). Assume the same facts as in example (1) except that with respect to all of X's post-1969 public utility property the applicable 1968 method (as determined under paragraph (e) of this section) is the declining balance method using a rate of 150 percent of the straight line rate. Assume further that all of X's pre-1970 public utility property was accounted for in its July 1969 regulated accounting period, and that X used a flow-through method of regulated accounting for such period. X may determine its reasonable allowance for depreciation under section 167 with respect to its post-1969 public utility property by using the straight line method of depreciation (or any other subsection (l) method), by using any method otherwise allowable under section 167 (such as a declining balance method) if X uses a normalization method of regulated accounting, or, by using the declining balance method using a rate of 150 percent of the straight line rate, whether or not X uses a normalization or a flow-through method of regulated accounting.

(e) *Applicable 1968 method*—(1) *In general.* Under section 167(l)(3)(D), except as provided in subparagraphs (3) and (4) of this paragraph, the term ''applicable 1968 method'' means with respect to any public utility property—

(i) The method of depreciation properly used by the taxpayer in its Federal income tax return with respect to such property for the latest taxable year for which a return was filed before August 1, 1969,

(ii) If subdivision (i) of this subparagraph does not apply, the method of depreciation properly used by the taxpayer in its Federal income tax return for the latest taxable year for which a return was filed before August 1, 1969, with respect to public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service before the end of such latest taxable year, or

(iii) If neither subdivision (i) nor (ii) of this subparagraph applies, a subsection (l) method.

If, on or after August 1, 1969, the taxpayer files an amended return for the taxable year referred to in subdivisions (i) and (ii) of this subparagraph, such amended return shall not be taken into consideration in determining the applicable 1968 method. The term ''applicable 1968 method'' if such new method results to any public utility property, for the year of change and subsequent years, a method of depreciation otherwise allowable under section 167 to which the taxpayer changes from an applicable 1968 method if such new method results in a lesser allowance for depreciation for such property under section 167 in the year of change and the taxpayer secures the Commissioner's consent to the change in accordance with the procedures of section 446(e) and § 1.446–1.

(2) *Placed in service.* For purposes of this section, property is placed in service on the date on which the period for depreciation begins under section 167. See, for example, § 1.167(a)–10(b) and § 1.167(a)–11(c)(2). If under an averaging convention property which is placed in service (as defined in § 1.46–3(d)(ii)) by the taxpayer on different dates is treated as placed in service on the same date, then for purposes of section 167(l) the property shall be treated as having been placed in service on the date the period for depreciation with respect to such property would begin under section 167 absent such averaging convention. Thus, for example, if, except for the fact that the averaging convention used assumes that all additions and retirements made during the first half of the year were made on the first day of the year, the period of depreciation for two items of public utility property would begin on January 10 and March 15, respectively, then for purposes of determining the property of the same (or similar) kind most recently placed in service, such items of property shall be treated as placed in service on January 10 and March 15, respectively.

(3) *Certain section 1250 property.* If a taxpayer is required under section 167(j) to use a method of depreciation other than its applicable 1968 method with respect to any section 1250 property, the term ''applicable 1968 method'' means the method of depreciation allowable under section 167(j) which is the most nearly comparable method to the applicable 1968 method determined under subparagraph (1) of this paragraph. For example, if the applicable 1968 method on new section 1250 property is the declining balance method using 200 percent of the straight line rate, the most nearly comparable method allowable for new section 1250 property under section 167(j) would be the declining balance method using 150 percent of the straight line rate. If the applicable 1968 method determined under subparagraph (1) of this paragraph is the sum of the years-digits method, the term ''most nearly comparable method'' refers to any method of depreciation allowable under section 167(j).

(4) *Applicable 1968 method in certain cases.* (i)*(a)* Under section 167(l)(3)(E), if the taxpayer evidenced within the time

and manner specified in *(b)* of this subdivision (i) the intent to use a method of depreciation under section 167 (other than its applicable 1968 method as determined under subparagraph (1) or (3) of this paragraph or a subsection (l) method) with respect to any public utility property, such method of depreciation shall be deemed to be the taxpayer's applicable 1968 method with respect to such public utility property and public utility property of the same (or most similar) kind subsequently placed in service.

(b) Under this subdivision (i), the intent to use a method of depreciation under section 167 is evidenced—

(1) By a timely application for permission for a change in method of accounting filed by the taxpayer before August 1, 1969, or

(2) By the use of such method of depreciation in the computation by the taxpayer of its tax expense for purposes of reflecting operating results in its regulated books of account for its July 1969 regulated accounting period, as established in the manner prescribed in paragraph (g)(1) (i), (ii), or (iii) of this section.

(ii)*(a)* If public utility property is acquired in a transaction in which its basis in the hands of the transferee is determined in whole or in part by reference to its basis in the hands of the transferor by reason of the application of any provision of the Code, or in a transfer (including any purchase for cash or in exchange) from a related person, then in the hands of the transferee the applicable 1968 method with respect to such property shall be determined by reference to the treatment in respect of such property in the hands of the transferor.

(b) For purposes of this subdivision (ii), the term ''related person'' means a person who is related to another person if either immediately before or after the transfer—

(1) The relationship between such persons would result in a disallowance of losses under section 267 (relating to disallowance of losses, etc., between related taxpayers) or section 707(b) (relating to losses disallowed, etc., between partners and controlled partnerships) and the regulations thereunder, or

(2) Such persons are members of the same controlled group of corporations, as defined in section 1563(a) (relating to definition of controlled group of corporations), except that ''more than 50 percent'' shall be substituted for ''at least 80 percent'' each place it appears in section 1563(a) and the regulations thereunder.

(5) *Same or similar.* The classification of property as being of the same (or similar) kind shall be made by reference to the function of the public utility to which the primary use of the property relates. Property which performs the identical function in the identical manner shall be treated as property of the same kind. The determination that property is of a similar kind shall be made by reference to the proper account to which expenditures for the property are chargeable under the system of regulated accounts required to be used by the taxpayer for the period in which the property in question was acquired. Property, the expenditure for which is chargeable to the same account, is property of the most similar kind. Property, the expenditure for which is chargeable to an account for property which serves the same general function, is property of a similar kind. Thus, for example, if corporation X, a natural gas company, subject to the jurisdiction of the Federal Power Commission, had property properly chargeable to account 366 (relating to transmission plant structures and improvements) acquired an additional structure properly chargeable to account 366, under the uniform system of accounts prescribed for natural gas companies (class A and class B) by the Federal Power Commission, effective September 1, 1968, the addition would constitute property of the same kind if it performed the identical function in the identical manner. If, however, the addition did not perform the identical function in the identical manner, it would be property of the most similar kind.

(6) *Regulated method of accounting in certain cases.* Under section 167(l)(4)(B), if with respect to any pre-1970 public utility property the taxpayer filed a timely application for change in method of accounting referred to in subparagraph (4)(i)*(b)(1)* of this paragraph and

with respect to property of the same (or similar) kind most recently placed in service the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period, then for purposes of section 167(l)(1)(B) and paragraph (c) of this section the taxpayer shall be deemed to have used a flow-through method of regulated accounting with respect to such pre-1970 public utility property.

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

Example (1). Corporation X is a calendar-year taxpayer. On its Federal income tax return for 1967 (the latest taxable year for which X, prior to August 1, 1969, filed a return) X used a straight line method of depreciation with respect to certain public utility property placed in service before 1965 and used the declining balance method of depreciation using 200 percent of the straight line rate (double declining balance) with respect to the same kind of public utility property placed in service after 1964. In 1968 and 1970, X placed in service additional public utility property of the same kind. The applicable 1968 method with respect to the above described public utility property is shown in the following chart:

Property held in 1970	Placed in service	Method on 1967 return	Applicable 1968 method
Group 1	Before 1965	Straight line	Straight line.
Group 2	After 1964 and before 1968.	Double declining balance.	Double declining balance.
Group 3	After 1967 and before 1969.	....	Do.
Group 4	After 1968	....	Do.

Example (2). Corporation Y is a calendar-year taxpayer engaged exclusively in the trade or business of the furnishing of electrical energy. In 1954, Y placed in service hydroelectric generators and for all purposes Y has taken straight line depreciation with respect to such generators. In 1960, Y placed in service fossil fuel generators and for all purposes since 1960 has used the declining balance method of depreciation using a rate of 150 percent of the straight line rate (computed without reduction for salvage) with respect to such generators. After 1960 and before 1970 Y did not place in service any generators. In 1970, Y placed in service additional hydroelectric generators. The applicable 1968 method with respect to the hydroelectric generators placed in service in 1970 would be the straight line method because it was the method used by Y on its return for the latest taxable year for which Y filed a return before August 1, 1969, with respect to property of the same kind (i.e., hydroelectric generators) most recently placed in service.

Example (3). Assume the same facts as in example (2), except that the generators placed in service in 1970 were nuclear generators. The applicable 1968 method with respect to such generators is the declining balance method using a rate of 150 percent of the straight line rate because, with respect to property of the most similar kind (fossil fuel generators) most recently placed in service, Y used such declining balance method on its return for the latest taxable year for which it filed a return before August 1, 1969.

(f) *Subsection (l) method.* Under section 167(l)(3)(F), the term ‘‘subsection (l) method’’ means a reasonable and consistently applied ratable method of computing depreciation which is allowable under section 167(a), such as, for example, the straight line method or a unit of production method or machine-hour method. The term ‘‘subsection (l) method’’ does not include any declining balance method (regardless of the uniform rate applied), sum of the years-digits method, or method of depreciation which is allowable solely by reason of section 167(b)(4) or (j)(1)(C).

(g) *July 1969 regulated accounting period*—(1) *In general.* Under section 167(l)(3)(I), the term ‘‘July 1969 regulated accounting period’’ means the taxpayer’s latest accounting period ending before August 1, 1969, for which the taxpayer regularly computed, before January 1, 1970, its tax expense for purposes of reflecting operating results in its regulated books of account. The computation by the taxpayer of such tax expense may be established by reference to the following:

(i) The most recent periodic report of a period ending before August 1, 1969, required by a regulatory body described in section 167(l)(3)(A) having jurisdiction over the taxpayer’s regulated books of account which was filed with such body before January 1, 1970 (whether or not such body has jurisdiction over rates).

(ii) If subdivision (i) of this subparagraph does not apply, the taxpayer’s most recent report to its shareholders for a period ending before August 1, 1969, but only if such report was distributed to the shareholders before January 1, 1970, and if the taxpayer’s stocks or securities are traded in an established securities market during such period. For purposes of this subdivision, the term ''established securities market'' has the meaning assigned to such term in §1.453–3(d)(4).

(iii) If subdivisions (i) and (ii) of this subparagraph do not apply, entries made to the satisfaction of the district director before January 1, 1970, in its regulated books of account for its most recent accounting period ending before August 1, 1969.

(2) *July 1969 method of regulated accounting in certain acquisitions.* If public utility property is acquired in a transaction in which its basis in the hands of the transferee is determined in whole or in part by reference to its basis in the hands of the transferor by reason of the application of any provision of the Code, or in a transfer (including any purchase for cash or in exchange) from a related person, then in the hands of the transferee the method of regulated accounting for such property's July 1969 regulated accounting period shall be determined by reference to the treatment in respect of such property in the hands of the transferor. See paragraph (e)(4)(ii) of this section for definition of ''related person''.

(3) *Determination date.* For purposes of section 167(l), any reference to a method of depreciation under section 167(a), or a method of regulated accounting, taken into account by the taxpayer in computing its tax expense for its July 1969 regulated accounting period shall be a reference to such tax expense as shown on the periodic report or report to shareholders to which subparagraph (1) (i) or (ii) of this paragraph applies or the entries made on the taxpayer's regulated books of account to which subparagraph (1)(iii) of this paragraph applies. Thus, for example, assume that regulatory body A having jurisdiction over public utility property with respect to X's regulated books of account requires X to reflect its tax expense in such books using the same method of depreciation which regulatory body B uses for determining X's cost of service for ratemaking purposes. If in 1971, in the course of approving a rate change for X, B retroactively determines X's cost of service for ratemaking purposes for X's July 1969 regulated accounting period using a method of depreciation different from the method reflected in X's regulated books of account as of January 1, 1970, the method of depreciation used by X for its July 1969 regulated accounting period would be determined without reference to the method retroactively used by B in 1971.

(h) *Normalization method of accounting*—(1) *In general.* (i) Under section 167(l), a taxpayer uses a normalization method of regulated accounting with respect to public utility property—

(a) If the same method of depreciation (whether or not a subsection (l) method) is used to compute both its tax expense and its depreciation expense for purposes of establishing cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(b) If to compute its allowance for depreciation under section 167 it uses a method of depreciation other than the method it used for purposes described in *(a)* of this subdivision, the taxpayer makes adjustments consistent with subparagraph (2) of this paragraph to a reserve to reflect the total amount of the deferral of Federal income tax liability resulting from the use with respect to all of its public utility property of such different methods of depreciation.

(ii) In the case of a taxpayer described in section 167(l) (1) (B) or (2) (C), the reference in subdivision (i) of this subparagraph shall be a reference only to such taxpayer's ''qualified public utility property''. See §1.167(l)–2(b) for definition of ''qualified public utility property''.

(iii) Except as provided in this subparagraph, the amount of Federal income tax liability deferred as a result of the use of different method of depreciation under subdivision (i) of this subparagraph is the excess (computed without regard to credits) of the amount the tax liability would have been had a subsection (l) method been used over the amount of the actual tax liability. Such amount shall be taken into account for the taxable year in which such different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (l) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover (as determined under section 172) to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (l) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

(2) *Adjustments to reserve.* (i) The taxpayer must credit the amount of deferred Federal income tax determined under subparagraph (1)(i) of this paragraph for any taxable year to a reserve for deferred taxes, a depreciation reserve, or other reserve account. The taxpayer need not establish a separate reserve account for such amount but the amount of deferred tax determined under subparagraph (1) (i) of this paragraph must be accounted for in such a manner so as to be readily identifiable. With respect to any account, the aggregate amount allocable to deferred tax under section 167(l) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation under subparagraph (1)(i) of this paragraph. An additional exception is that the aggregate amount allocable to deferred tax under section 167(l) may be properly adjusted to reflect asset retirements or the expiration of the period for depreciation used in determining the allowance for depreciation under section 167(a).

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

Example (1). Corporation X is exclusively engaged in the transportation of gas by pipeline subject to the jurisdiction of the Federal Power Commission. With respect to its post-1969 public utility property, X is entitled under section 167(l)(2)(B) to use a method of depreciation other than a subsection (l) method if it uses a normalization method of regulated accounting. With respect to such property, X has not made any election under § 1.167(a)–11 (relating to depreciation based on class lives and asset depreciation ranges). In 1972, X places in service public utility property with an unadjusted basis of $2 million, and an estimated useful life of 20 years. X uses the declining balance method of depreciation with a rate twice the straight line rate. If X uses a normalization method of regulated accounting, the amount of depreciation allowable under section 167(a) with respect to such property for 1972 computed under the double declining balance method would be $200,000. X computes its tax expense and depreciation expense for purposes of determining its cost of service for rate-making purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation (asubsection (l) method). A depreciation allowance computed in this manner is $100,000. The excess of the depreciation allowance determined under the double declining balance method ($200,000) over the depreciation expense computed using the straight line method ($100,000) is $100,000. Thus, assuming a tax rate of 48 percent, X used a normalization method of regulated accounting for 1972 with respect to property placed in service that year if for 1972 it added to a reserve $48,000 as taxes deferred as a result of the use by X of a method of depreciation for Federal income tax purposes different from that used for establishing its cost of service for rate-making purposes and for reflecting operating results in its regulated books of account.

Example (2). Assume the same facts as in example (1), except that X elects to apply § 1.167(a)–11 with respect to all eligible property placed in service in 1972. Assume further that all property X placed in service in 1972 is eligible property. One hudnred percent of the asset guideline period for such property is 22 years and the asset depreciation range is from 17.5 years to 26.5 years. X uses the double declining balance method of depreciation, selects an asset depreciation period of 17.5 years, and applies the half-year convention (described in § 1.167(a)–11(c)(2)(iii)). In 1972, the depreciation allowable under section 167(a) with respect to property placed in service in 1972 is $114,285 (determined without regard to the normalization requirements in § 1.167(a)–11(b)(6) and in section 167(l)). X computes its tax expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation (a subsection (l) method), an estimated useful life of 22 years (that is, 100 percent of the asset guideline period), and the half-year convention. A depreciation allowance computed in this manner is $45,454. Assuming a tax rate of 48 percent, the amount that X must add to a reserve for 1972 with respect to property placed in service that year in order to qualify as using a normalization method of regulated accounting under section 167(l) (3) (G) is $27,429 and the amount in order to satisfy the normalization requirements of § 1.167(a)–11(b)(6) is $5,610. X determined such amounts as follows:

(1) Depreciation allowance on tax return (determined without regard to section 167(l) and §1.167(a)–11(b) (6))	$114,285
(2) Line (1), recomputed using a straight line method	57,142
(3) Difference in depreciation allowance attributable to different methods (line (1) minus line (2))	$57,143
(4) Amount to add to reserve under this paragraph (48 percent of line (3))	27,429
(5) Amount in line (2)	$57,142
(6) Line (5), recomputed by using an estimated useful life of 22 years and the half-year convention	45,454
(7) Difference in depreciation allowance attributable to difference in depreciation periods	$11,688
(8) Amount to add to reserve under §1.167(a)–11(b) (6) (ii) (48 percent of line (7))	5,610

If, for its depreciation expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, X had used a period in excess of the asset guideline period of 22 years, the total amount in lines (4) and (8) in this example would not be changed.

Example (3). Corporation Y, a calendar-year taxpayer which is engaged in furnishing electrical energy, made the election provided by section 167(l) (4) (a) with respect to its ‘‘qualified public utility property’’ (as defined in §1.167(l)–2(b)). In 1971, Y placed in service qualified public utility property which had an adjusted basis of $2 million, estimated useful life of 20 years, and no salvage value. With respect to property of the same kind most recently placed in service, Y used a flow-through method of regulated accounting for its July 1969 regulated accounting period and the applicable 1968 method is the declining balance method of depreciation using 200 percent of the straight line rate. The amount of depreciation allowable under the double declining balance method with respect to the qualified public utility property would be $200,000. Y computes its tax expense and depreciation expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation. A depreciation allowance with respect to the qualified public utility property determined in this manner is $100,000. The excess of the depreciation allowance determined under the double declining balance method ($200,000) over the depreciation expense computed using the straight line method ($100,000) is $100,000. Thus, assuming a tax rate of 48 percent, Y used a normalization method of regulated accounting for 1971 if for 1971 it added to a reserve $48,000 as tax deferred as a result of the use by Y of a method of depreciation for Federal income tax purposes with respect to its qualified public utility property which method was different from that used for establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account for such property.

Example (4). Corporation Z, exclusively engaged in a public utility activity did not use a flow-through method of regulated accounting for its July 1969 regulated accounting period. In 1971, a regulatory body having jurisdiction over all of Z's property issued an order applicable to all years beginning with 1968 which provided, in effect, that Z use an accelerated method of depreciation for purposes of section 167 and for determining its tax expenses for purposes of reflecting operating results in its regulated books of account. The order further provided that Z normalize 50 percent of the tax deferral resulting from the use of the accelerated method of depreciation and that Z flow-through 50 percent of the tax deferral resulting therefrom. Under section 167(l), the method of accounting provided in the order would not be a normalization method of regulated accounting because Z would not be permitted to normalize 100 percent of the tax deferral resulting from the use of an accelerated method of depreciation. Thus, with respect to its public utility property for purposes of section 167, Z may only use a subsection (l) method of depreciation.

Example (5). Assume the same facts as in example (4) except that the order of the regulatory body provided, in effect, that Z normalize 100 percent of the tax deferral with respect to 50 percent of its public utility property and flow-through the tax savings with respect to the other 50 percent of its property. Because the effect of such an order would allow Z to flow-through a portion of the tax savings resulting from the use of an accelerated method of depreciation, Z would not be using a normalization method of regulated accounting with respect to any of its properties. Thus, with respect to its public utility property for purposes of section 167, Z may only use a subsection (l) method of depreciation.

(3) *Establishing compliance with normalization requirements in respect of operating books of account.* The taxpayer may establish compliance with the requirement in subparagraph (l)(i) of this paragraph in respect of reflecting operating results, and adjustments to a reserve, in its operating books of account by reference to the following:

(i) The most recent periodic report for a period beginning before the end of the taxable year, required by a regulatory body described in section 167(l)(3)(A) having jurisdiction over the taxpayer's regulated operating books of account which was filed with such body before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for such taxable year (whether or not such body has jurisdiction over rates).

(ii) If subdivision (i) of this subparagraph does not apply, the taxpayer's most recent report to its shareholders for the taxable year but only if *(a)* such report was distributed to the shareholders before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for the taxable year and *(b)* the taxpayer's stocks or securities are traded in an established securities market during such taxable year. For purposes of this subdivision, the term ''established securities market'' has the meaning assigned to such term in § 1.453–3(d)(4).

(iii) If neither subdivision (i) nor (ii) of this subparagraph applies, entries made to the satisfaction of the district director before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for the taxable year in its regulated books of account for its most recent period beginning before the end of such taxable year.

(4) *Establishing compliance with normalization requirements in computing cost of service for ratemaking purposes.* (i) In the case of a taxpayer which used a flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter, with respect to all or a portion of its pre-1970 public utility property, if a regulatory body having jurisdiction to establish the rates of such taxpayer as to such property (or a court which has jurisdiction over such body) issues an order of general application (or an order of specific application to the taxpayer) which states that such regulatory body (or court) will permit a class of taxpayers of which such taxpayer is a member (or such taxpayer) to use the normalization method of regulated accounting to establish cost of service for ratemaking purposes with respect to all or a portion of its public utility property, the taxpayer will be presumed to be using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to the public utility property to which such order applies. In the event that such order is in any way conditional, the preceding sentence shall not apply until all of the conditions contained in such order which are applicable to the taxpayer have been fulfilled. The taxpayer shall establish to the satisfaction of the Commissioner or his delegate that such conditions have been fulfilled.

(ii) In the case of a taxpayer which did not use the flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter (including a taxpayer which used a subsection (l) method of depreciation to compute its allowance for depreciation under section 167(a) and to compute its tax expense for purposes of reflecting operating results in its regulated books of account), with respect to any of its public utility property, it will be presumed that such taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to its post-1969 public utility property. The presumption described in the preceding sentence shall not apply in any case where there is *(a)* an expression of intent (regardless of the manner in which such expression of intent is indicated) by the regulatory body (or bodies), having jurisdiction to establish the rates of such taxpayer, which indicates that the policy of such regulatory body is in any way inconsistent with the use of the normalization method of regulated accounting by such taxpayer or by a class of taxpayers of which such taxpayer is a member, or *(b)* a decision by a court having jurisdiction over such regulatory body which decision is in any way inconsistent with the use of the normalization method of regulated accounting by such taxpayer or a class of taxpayers of which such taxpayer is a member. The presumption shall be applicable on January 1, 1970, and shall, unless rebutted, be effective until an inconsistent expression of intent is indicated by such regulatory body or by such court. An example of such an inconsistent expression of intent is the case of a regulatory body which has, after the July 1969 regulated accounting period and before January 1, 1970, directed public utilities subject to its ratemaking jurisdiction to use a flow-through method of regulated accounting, or has issued an order of general application which states that such agency will direct a class of public utilities of which the taxpayer is a member to use a flow-through method of regulated accounting. The presumption described in this subdivision may be rebutted by evidence that the flow-through method of regulated accounting is being used by the taxpayer with respect to such property.

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

Example (1). Corporation X is a calendar-year taxpayer and its ‘‘applicable 1968 method’’ is a straight line method of depreciation. Effective January 1, 1970, X began collecting rates which were based on a sum of the years-digits method of depreciation and a normalization method of regulated accounting which rates had been approved by a regulatory body having jurisdiction over X. On October 1, 1971, a court of proper jurisdiction annulled the rate order prospectively, which annulment was not appealed, on the basis that the regulatory body had abused its discretion by determining the rates on the basis of a normalization method of regulated accounting. As there was no inconsistent expression of intent during 1970 or prior to the due date of X’s return for 1970, X’s use of the sum of the years-digits method of depreciation for purposes of section 167 on such return was proper. For 1971, the presumption is in effect through September 30. During 1971, X may use the sum of the years-digits method of depreciation for purposes of section 167 from January 1 through September 30, 1971. After September 30, 1971, and for taxable years after 1971, X must use a straight line method of depreciation until the inconsistent court decision is no longer in effect.

Example (2). Assume the same facts as in example (1), except that pursuant to the order of annulment, X was required to refund the portion of the rates attributable to the use of the normalization method of regulated accounting. As there was no inconsistent expression of intent during 1970 or prior to the due date of X’s return for 1970, X has the benefit of the presumption with respect to its use of the sum of the years-digits method of depreciation for purposes of section 167, but because of the retroactive nature of the rate order X must file an amended return for 1970 using a straight line method of depreciation. As the inconsistent decision by the court was handed down prior to the due date of X’s Federal income tax return for 1971, for 1971 and thereafter the presumption of subdivision (ii) of this subparagraph does not apply. X must file its Federal income tax returns for such years using a straight line method of depreciation.

Example (3). Assume the same facts as in example (2), except that the annulment order was stayed pending appeal of the decision to a court of proper appellate jurisdiction, X has the benefit of the presumption as described in example (2) for the year 1970, but for 1971 and thereafter the presumption of subdivision (ii) of this subparagraph does not apply. Further, X must file an amended return for 1970 using a straight line method of depreciation and for 1971 and thereafter X must file its returns using a straight line method of depreciation unless X and the district director have consented in writing to extend the time for assessment of tax for 1970 and thereafter with respect to the issue of normalization method of regulated accounting for as long as may be necessary to allow for resolution of the appeal with respect to the annulment of the rate order.

(5) *Change in method of regulated accounting.* The taxpayer shall notify the district director of a change in its method of regulated accounting, an order by a regulatory body or court that such method be changed, or an interim or final rate determination by a regulatory body which determination is inconsistent with the method of regulated accounting used by the taxpayer immediately prior to the effective date of such rate determination. Such notification shall be made within 90 days of the date that the change in method, the order, or the determination is effective. In the case of a change in the method of regulated accounting, the taxpayer shall recompute its tax liability for any affected taxable year and such recomputation shall be made in the form of an amended return where necessary unless the taxpayer and the district director have consented in writing to extend the time for assessment of tax with respect to the issue of normalization method of regulated accounting.

(6) *Exclusion of normalization reserve from rate base.* (i) Notwithstanding the provisions of subparagraph (1) of this paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes,

the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking.

(ii) For the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i) of this subparagraph, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for the period is the amount of the reserve (determined under subparagraph (2) of this paragraph) at the end of the historical period. If solely a future period is used for such determination, the amount of the reserve account for the period is the amount of the reserve at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during such period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period. The pro rata portion of any increase to be credited or decrease to be charged during a future period (or the future portion of a part-historical and part-future period) shall be determined by multiplying any such increase or decrease by a fraction, the numerator of which is the number of days remaining in the period at the time such increase or decrease is to be accrued, and the denominator of which is the total number of days in the period (or future portion).

(iii) The provisions of subdivision (i) of this subparagraph shall not apply in the case of a final determination of a rate case entered on or before May 31, 1973. For this purpose, a determination is final if all rights to request a review, a rehearing, or a redetermination by the regulatory body which makes such determination have been exhausted or have lapsed. The provisions of subdivision (ii) of this subparagraph shall not apply in the case of a rate case filed prior to June 7, 1974 for which a rate order is entered by a regulatory body having jurisdiction to establish the rates of the taxpayer prior to September 5, 1974, whether or not such order is final, appealable, or subject to further review or reconsideration.

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

Example (1). Corporation X is exclusively engaged in the transportation of gas by pipeline subject to the jurisdiction of the Z Power Commission. With respect to its post-1969 public utility property, X is entitled under section 167(l)(2)(B) to use a method of depreciation other than a subsection (l) method if it uses a normalization method of regulated accounting. With respect to X the Z Power Commission for purposes of establishing cost of service uses a recent consecutive 12-month period ending not more than 4 months prior to the date of filing a rate case adjusted for certain known changes occurring within a 9-month period subsequent to the base period. X's rate case is filed on January 1, 1975. The year 1974 is the recorded test period for X's rate case and is the period used in determining X's tax expense in computing cost of service. The rates are contemplated to be in effect for the years 1975, 1976, and 1977. The adjustments for known changes relate only to wages and salaries. X's rate base at the end of 1974 is$145,000,000. The amount of the reserve for deferred taxes under section 167(l) at the end of 1974 is $1,300,000, and the reserve is projected to be $4,400,000 at the end of 1975, $6,500,000 at the end of 1976, and $9,800,000 at the end of 1977. X does not use a normalization method of regulated accounting if the Z Power Commission excludes more than $1,300,000 from the rate base to which X's rate of return is applied. Similarly, X does not use a normalization method of regulated accounting if, instead of the above, the Z Power Commission, in determining X's rate of return which is applied to the rate base, assigns to no-cost capital an amount that represents the reserve account for deferred tax that is greater than $1,300,000.

Example (2). Assume the same facts as in example (1) except that the adjustments for known changes in cost of service made by the Z Power Commission include an additional depreciation expense that reflects the installation of new equipment put into service on January 1, 1975. Assume further that the reserve for deferred taxes under section 167(1) at the end of 1974 is $1,300,000 and that the monthly net increases for the first 9 months of 1975 are projected to be:

January 1–31	$310,000
February 1–28	300,000
March 1–31	300,000
April 1–30	280,000
May 1–31	270,000
June 1–30	260,000
July 1–31	260,000
August 1–31	250,000
September 1–30	240,000
	$2,470,000

For its regulated books of account X accrues such increases as of the last day of the month but as a matter of convenience credits increases or charges decreases to the reserve account on the 15th day of the month following the whole month for which such increase or decrease is accrued. The maximum amount that may be excluded from the rate base is $2,470,879 (the amount in the reserve at the end of the historical portion of the period ($1,300,000) and a pro rata portion of the amount of any projected increase for the future portion of the period to be credited to the reserve ($1,170,879)). Such pro rata portion is computed (without regard to the date such increase will actually be posted to the account) as follows:

$310,000×243/273=	$275,934
300,000×215/273=	236,264
300,000×184/273=	202,198
280,000×154/273=	157,949
270,000×123/273=	121,648
260,000×93/273=	88,571
260,000×62/273=	59,048
250,000×31/273=	28,388
240,000×1/273=	879
	$1,170,879

Example (3). Assume the same facts as in example (1) except that for purposes of establishing cost of service the Z Power Commission uses a future test year (1975). The rates are contemplated to be in effect for 1975, 1976, and 1977. Assume further that plant additions, depreciation expense, and taxes are projected to the end of 1975 and that the reserve for deferred taxes under section 167(l) is $1,300,000 for 1974 and is projected to be $4,400,000 at the end of 1975. Assume also that the Z Power Commission applies the rate of return to X's 1974 rate base of $145,000,000. X and the Z Power Commission through negotiation arrive at the level of approved rates. X uses a normalization method of regulated accounting only if the settlement agreement, the rate order, or record of the proceedings of the Z Power Commission indicates that the Z Power Commission did not exclude an amount representing the reserve for deferred taxes from X's rate base ($145,000,000) greater than $1,300,000 plus a pro rata portion of the projected increases and decreases that are to be credited or charged to the reserve account for 1975. Assume that for 1975 quarterly net increases are projected to be:

1st quarter	$910,000
2nd quarter	810,000
3rd quarter	750,000
4th quarter	630,000
Total	$3,100,000

For its regulated books of account X will accrue such increases as of the last day of the quarter but as a matter of convenience will credit increases or charge decreases to the reserve account on the 15th day of the month following the last month of the quarter for which such increase or decrease will be accrued. The maximum amount that may be excluded from the rate base is $2,591,480 (the amount of the reserve at the beginning of the period ($1,300,000) plus a pro rata portion ($1,291,480) of the $3,100,000 projected increase to be credited to the reserve during the period). Such portion is computed (without regard to the date such increase will actually be posted to the account) as follows:

$910,000×276/365=	$688,110
810,000×185/365=	410,548
750,000×93/365=	191,096
630,000×1/365=	1,726
	$1,291,480

(i) *Flow-through method of regulated accounting.* Under section 167(l)(3)(H), a taxpayer uses a flow-through method of regulated accounting with respect to public utility property if it uses the same method of depreciation (other than a subsection (l) method) to compute its allowance for depreciation under section 167 and to compute its tax expense for purposes of reflecting operating results in its regulated books of account unless such method is the same method used by the taxpayer to determine its depreciation expense for purposes of reflecting operating results in its regulated books of account. Except as provided in the preceding sentence, the method of depreciation used by a taxpayer with respect to public utility property for purposes of determining cost of service for ratemaking purposes or rate base for ratemaking purposes shall not be considered in determining whether the taxpayer used a flow-through method of regulated accounting. A taxpayer may establish use of a flow-through method of regulated accounting in the same manner that compliance with normalization requirements in respect of operating books of account may be established under paragraph (h)(4) of this section.

[T.D. 7315, 39 FR 20195, June 7, 1974]

§ 1.167(l)–2 Public utility property; election as to post-1969 property representing growth in capacity.

(a) *In general.* Section 167(l)(2) prescribes the methods of depreciation which may be used by a taxpayer with respect to its post-1969 public utility property. Under section 167(l)(2) (A) and (B) the taxpayer may use a subsection (l) method of depreciation (as defined in section 167(l)(3)(F)) or any other method of depreciation which is otherwise allowable under section 167 if, in conjunction with the use of such other method, such taxpayer uses the normalization method of accounting (as defined in section 167(l)(3)(G)). Paragraph (2)(C) of section 167(l) permits a taxpayer which used the flow-through method of accounting for its July 1969 accounting period (as these terms are defined in section 167(l)(3) (H) and (I), respectively) to use its applicable 1968 method of depreciation with respect to certain property. Section 167(l)(3)(D) describes the term ‘‘applicable 1968 method’’. Accordingly, a regulatory agency is not precluded by section 167(l) from requiring such a taxpayer subject to its jurisdiction to continue to use the flow-through method of accounting unless the taxpayer makes the election pursuant to section 167(l)(4)(A) and this section. Whether or not the election is made, if such a regulatory agency permits the taxpayer to change from the flow-through method of accounting, subsection (l)(2) (A) or (B) would apply and such taxpayer could, subject to the provisions of section 167(e) and the regulations thereunder (relating to change in method), use a subsection (l) method of depreciation or, if the taxpayer uses the normalization method of accounting, any other method of depreciation otherwise allowable under section 167.

(1) *Election.* Under subparagraph (A) of section 167(l)(4), if the taxpayer so elects, the provisions of paragraph (2)(C) of section 167(l) shall not apply to its qualified public utility property (as such term is described in paragraph (b) of this section). In such case the taxpayer making the election shall use a method of depreciation prescribed by section 167(l)(2) (A) or (B) with respect to such property.

(2) *Property to which election shall apply.* (i) Except as provided in subdivision (ii) of this subparagraph the election provided by section 167(l)(4)(A) shall apply to all of the qualified public utility property of the taxpayer.

(ii) In the event that the taxpayer wishes the election provided by section 167(l)(4)(A) to apply to only a portion of its qualified public utility property, it must clearly identify the property to be subject to the election in the statement of election described in paragraph (e) of this section. Where all property which performs a certain function is included within the election, the election shall apply to all future acquisitions of qualified public utility property which perform the same function. Where only certain property within a functional group of property is included within the election, the election shall apply only to property which is of the same kind as the included property.

(iii) The provisions of subdivision (ii) of this subparagraph may be illustrated by the following examples:

Example (1). Corporation *A,* an electric utility company, wishes to have the election provided by section 167(l)(4)(A) apply only with respect to its production plant. A statement that the election shall apply only with respect to production plant will be sufficient to include within the election all of the taxpayer’s qualified production plant of any kind. All public utility property of the taxpayer other than production plant will not be subject to the election.

Example (2). Corporation *B,* an electric utility company, wishes to have the election provided by section 167(l)(4)(A) apply only with respect to nuclear production plant. A statement which clearly indicates that only nuclear production plant will be included in the election will be sufficient to exclude from the election all public utility property other than nuclear production plant.

(b) *Qualified public utility property*—(1) *Definition.* For purposes of this section the term ‘‘qualified public utility property’’ means post-1969 public utility property to which section 167(l)(2)(C) applies, or would apply if the election described in section 167(l)(4)(A) had not been made, to the extent that such property constitutes property which increases the productive or operational capacity of the taxpayer with respect to the goods or services described in section 167(l)(3)(A) and does not represent the replacement of existing capacity. In the event that particular assets which are post-1969 public utility property both replace existing public utility property and increase the productive or operational capacity of the taxpayer, only that portion of each such asset which is properly allocable, pursuant to the provisions of subparagraph (3)(v) of this paragraph or paragraph (c)(2) of this section (as the case may be), to increasing the productive or operational capacity of the taxpayer shall be qualified public utility property.

(2) *Limitation on use of formula method.* A taxpayer which makes the election with respect to all of its post-1969 public utility property may determine the amount of its qualified public utility property by using the formula method described in paragraph (c) of this section or, where the taxpayer so chooses, it may use any other method based on engineering data which is satisfactory to the Commissioner. A taxpayer which chooses to include only a portion of its post-1969 public utility property in the election described in paragraph (a)(1) of this section shall, in a manner satisfactory to the Commissioner and consistent with the provisions of subparagraph (3) of this paragraph, use a method based on engineering data. If a taxpayer uses the formula method described in paragraph (c) of this section, it must continue to use such method with respect to additions made in subsequent taxable years. The taxpayer may change from an engineering method to the formula method described in paragraph (c) of this section by filing a statement described in paragraph (h) of this section if it could have used such formula method for the prior taxable year.

(3) *Measuring capacity under an engineering method in the case of a general election.* (i) The provisions of this subparagraph apply in the case of an election made with respect to all of the post-1969 public utility property of the taxpayer.

(ii) A taxpayer which uses a method based on engineering data to determine the portion of its additions for a taxable year which constitutes qualified public utility property shall make such determination with reference to its ‘‘adjusted capacity’’ as of the first day of the taxable year during which such additions are placed in service. For purposes of this subparagraph, the term ‘‘adjusted capacity’’ means the taxpayer's capacity as of January 1, 1970, adjusted upward in the manner described in subdivision (iii) of this subparagraph for each taxable year ending after December 31, 1969, and before the first day of the taxable year during which the additions described in the preceding sentence are placed in service.

(iii) The adjustment described in this subdivision for each taxable year shall be equal to the number of units of capacity by which additions for the taxable year of public utility property with respect to which the election had been made exceed the number of units of capacity of retirements for such taxable year of public utility property with respect to which the flow-through method of accounting was being used at the time of their retirement. If for any taxable year the computation in the preceding sentence results in a negative amount, such negative amount shall be taken into account as a reduction in the amount of the adjustment (computed without regard to this sentence) in succeeding taxable years.

(iv) The provisions of this subparagraph may be illustrated by the following table which assumes that the taxpayer's adjusted capacity as of January 1, 1970, was 5,000 units:

1	2	3	4	5	6	7
Year	Additions	Flow-through retirements	Net additions	Adjusted capacity[1]	Actual capacity	Units of qualified additions[1][2]
1970	1000	700	300	5000	5300	300
1971	300	500	(200)	5300	5100	....
1972	500	200	300	5300	5400	100

1	2	3	4	5	6	7
Year	Additions	Flow-through retirements	Net additions	Adjusted capacity [1]	Actual capacity	Units of qualified additions [1] [2]
1973	400	800	(400)	5400	5000	
1974	600	400	200	5400	5200	
1975	800	300	500	5400	5700	300

[1] Capacity as of Jan. 1, 1970, plus amounts in column 7 for years prior to the year for which determination is being made.
[2] Column 6 minus column 5.

(v) The qualified portion of the basis for depreciation (as defined in section 167(g)) of each asset or group of assets (if group or composite accounting is used by the taxpayer) subject to the election shall be determined using the following ratio:

Qualified portion of basis of asset ÷ Total basis of asset = Units of qualified additions computed in column 7 on chart ÷ Units of capacity of additions computed in column 2 on chart.

(c) *Formula method of determining amount of property subject to election*—(1) *In general.* The following formula method may be used to determine the amount of qualified public utility property:

Step 1. Find the total cost (within the meaning of section 1012) to the taxpayer of additions during the taxable year of all post-1969 public utility property with respect to which section 167(l)(2)(C) would apply if the election had not been made.

Step 2. Aggregate the cost (within the meaning of section 1012) to the taxpayer of all retirements during the taxable year of public utility property with respect to which the flow-through method of accounting was being used at the time of their retirement.

Step 3. Subtract the figure reached in step 2 from the figure reached in step 1.

In the event that the figure reached in step 2 exceeds the figure reached in step 1 such excess shall be carried forward to the next taxable year and shall be aggregated with the cost (within the meaning of section 1012) to the taxpayer of all retirements referred to in step 2 for such next taxable year.

(2) *Allocation of bases.* The amount of qualified public utility property as determined in accordance with the formula method described in subparagraph (1) of this paragraph shall be allocated to the basis for depreciation (as defined in section 167(g)) of each asset or group of assets (if group or composite accounting is used by the taxpayer) subject to the election using the following ratio:

Amount of qualified additions computed in step 3 ÷ Amount of total additions computed in step 1 = Qualified portion of basis of asset ÷ Total basis of asset.

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

Example (1). Corporation *A*, a telephone company subject to the jurisdiction of the Federal Communications Commission, elected, pursuant to the provisions of section 167(l)(4)(A) and this section, with respect to all of its qualified post-1969 public utility property to have the provisions of paragraph (2) (C) of section 167(l) not apply. In 1971 the Corporation added new underground cable with a cost (within the meaning of section 1012) to it of $4 million to its underground cable account. In the same year it retired public utility property with a cost (within the meaning of section 1012) to Corporation *A* of $1.5 million. The flow-through method of accounting was being used with respect to all of the retired property at the time of retirement. Using the formula method described in paragraph (c) of this section, the amount of qualified underground cable would be determined as follows:

	Million
Step 1. Aggregate cost of flow-through additions	$4.0
Step 2. Cost of all flow-through retirements	1.5
Step 3. Figure reached in step 1 less figure reached in step 2	2.5

The amount of qualified public utility property to which section 167(l)(2)(C) will not apply is $2.5 million. Pursuant to the provisions of paragraph (c)(2) of this section, the amount of qualified public utility property would be allocated to the basis for depreciation (as defined in section 167(g)) of an asset with a total basis for depreciation of $2 million as follows:

$2.5 million (figure in step 3)/$4 million (figure in step 1) = Qualified portion of basis of asset/$2 million Qualified portion of basis of asset = $1.25 million.

Example (2). In 1972 Corporation *A* (the corporation described in example (1)) added underground cable with a cost (within the meaning of section 1012) to it of $1 million. In the same year the cost (within the meaning of section 1012) to the corporation of retirements of public utility property with respect to which the flow-through method of accounting was being used was $3 million. There were no other additions or retirements. The amount of qualified public utility property would be determined as follows:

	Million
Step 1. Aggregate cost of flow-through additions	$1.0
Step 2. Cost of all flow-through retirements	3.0
Step 3. Figure reached in step 1 less figure reached in step 2	(2.0)

Since retirements of flow-through public utility property for the year 1972 exceeded additions made during such year, the excess retirements, $2.0 million, must be carried forward to be aggregated with retirements for 1973.

Example (3). Corporation *B,* a gas pipeline company subject to the jurisdiction of the Federal Power Commission, made the election provided by section 167(l)(4)(A) and this section with respect to all of its post-1969 public utility property. Corporation *B* chose to use an engineering data method of determining which property was subject to the election provided by this section. In 1970, the corporation replaced a portion of its pipeline with respect to which the flow-through method of accounting was being used at the time of its retirement which had a peak capacity on January 1, 1970, of 100,000 thousand cubic feet (M c.f.) per day at a pressure of 14.73 pounds per square inch absolute (p.s.i.a.) with pipe with a capacity of 125,000 M c.f. per day at 14.73 p.s.i.a. Assuming that there were no other additions or retirements, using an engineering data method one-fifth of the new pipeline would be property subject to the election of this section effective for its taxable year beginning on January 1, 1971.

Example (4). In 1970 Corporation *C* (with the same characteristics as the corporation described in example (3)) extended its pipeline 5 miles further than it extended on January 1, 1970. Assuming that there were no other additions or retirements, the entire extension would be property subject to the election provided by this section effective for its taxable year beginning on January 1, 1971.

Example (5). As a result of a change of service areas between two corporations, in 1970 Corporation *D* (with the same characteristics as the corporation described in example (3)) retired a pipeline running north and south and replaced it with a pipeline of equal length and capacity running east and west. No part of the pipeline running east and west is property subject to the election.

(e) *Manner of making election.* The election described in paragraph (a) of this section shall be made by filing, in duplicate, with the Commissioner of Internal Revenue, Washington, D.C. 20224, Attention, T:I:E, a statement of such election.

(f) *Content of statement.* The statement described in paragraph (e) of this section shall indicate that an election is being made under section 167(l) of the Internal Revenue Code of 1954, and it shall contain the following information:

(1) The name, address, and taxpayer identification number of the taxpayer,

(2) Whether the taxpayer will use the formula method of determining the amount of its qualified public utility property described in paragraph (c) of this section, or an engineering method, and

(3) Where the taxpayer wishes to include only a portion of its public utility property in the election pursuant to the provisions of paragraph (a)(2) of this section, a description sufficient to clearly identify the property to be included.

(g) *Time for making election.* The election permitted by this section shall be made by filing the statement described in paragraph (e) of this section not later than Monday, June 29, 1970.

(h) *Change of method of determining amount of qualified property.* Where a taxpayer which has elected pursuant to the provisions of section 167(l)(4)(A) wishes to change, pursuant to the provisions of paragraph (b)(2) of this section, from an engineering data method of determining which of its property is qualified public utility property to the formula method described in paragraph (c) of this section, it may do so by filing a statement to that effect at the time that it files its income tax return, with the district director or director of the regional service center, with whom the taxpayer's income tax return is required to be filed.

(i) *Revocability of election.* An election made under section 167(l) shall be irrevocable.

(j) *Effective date.* The election prescribed by section 167(l)(4)(A) and this section shall be effective for taxable years beginning after December 31, 1970.

[T.D. 7045, 35 FR 8933, June 10, 1970. Redesignated by T.D. 7315, 39 FR 20195, June 7, 1974]

§ 1.167(l)–3 Multiple regulation, asset acquisitions, reorganizations, etc.

(a) *Property not entirely subject to jurisdiction of one regulatory body*—(1) *In general.* If a taxpayer which uses a method of depreciation other than a subsection (l) method of depreciation is required by a regulatory body having jurisdiction over less than all of its property to use, or not to use, a method of regulated accounting (i.e., normalization or flow-through), such taxpayer shall be considered as using, or not using, such method of regulated accounting only with respect to property subject to the jurisdiction of such regulatory body. In the case of property which is contained in a multiple asset account, the provisions of § 1.167(a)–7(c) and § 1.167 (a)–11(c)(1)(iv) apply to prohibit depreciating a single account by two or more different methods.

(2) *Jurisdiction of regulatory body.* For purposes of this paragraph, a regulatory body is considered to have jurisdiction over property of a taxpayer if expenses with respect to the property are included in cost of service as determined by the regulatory body for ratemaking purposes or for reflecting operating results in its regulated books of account. For example, if regulatory body A, having jurisdiction over 60 percent of an item of X corporation's public utility property, required X to use the flow-through method of regulated accounting in circumstances which would bar X from using a method of depreciation under section 167(a) other than a subsection (l) method, and if regulatory body B, having jurisdiction over the remaining 40 percent of such item of property does not so require X to use the flow-through method of regulated accounting (or if the remaining 40 percent is not subjectto the jurisdiction of any regulatory body), then with respect to 60 percent of the adjusted basis of the property X is prohibited from using a method of depreciation for purposes of section 167(a) other than a subsection (1) method. If in such example, A, having jurisdiction over 60 percent of X's public utility property, had jurisdiction over 100 percent of a particular generator, then with respect to the generator X would be prohibited from using a method of depreciation other than a subsection (l) method.

(3) *Public utility property subject to more than one regulatory body.* If a regulatory body having jurisdiction over public utility property with respect to the taxpayer's regulated books of account requires the taxpayer to reflect its tax expense in such books in the manner used by the regulatory body having jurisdiction over the public utility property for purposes of determining the taxpayer's cost of service for ratemaking purposes, the rules of subparagraphs (1) and (2) of this paragraph shall apply.

(b) *Leasing transactions*—(1) *Leased property.* Public utility property as defined in paragraph (b) of § 1.167(l)–1 includes property which is leased by a taxpayer where the leasing of such property is part of the lessor's section 167(l) public utility activity. Thus, such leased property qualifies as public utility property even though the predominant use of such property by the lessee is in other than a section 167(l) public utility activity. Further, leased property qualifies as public utility property under section 167(l) even though the leasing is not part of the lessor's public utility activity if the predominant use of such property by the lessee or any sublessee is in a section 167(l) public utility activity. However, the limitations of section 167(l) apply to a taxpayer only if such taxpayer is subject to the jurisdiction of a regulatory body described in a section 167(l)(3)(A). For example, if a financial institution purchases property which it then leases to a lessee which uses such property predominantly in a section 167(l) public utility activity, the property qualifies as public utility property. However, because the financial institution's rates for leasing the property are not subject to the jurisdiction of a regulatory body described in section 167(l)(3)(A), the provisions of section 167(l) do not apply to the depreciation deductions taken with respect to the property by the financial institution. For possible application of section 167(l) to the lessee, see subparagraph (2) of this paragraph.

(2) *Certain rental payments.* Under section 167(l)(5), if a taxpayer leases property which is public utility property and the regulatory body having jurisdiction over such property for purposes of determining the taxpayer's operating results in its regulated books of account or for ratemaking purposes allows only an amount of such lessee's expenses with respect to the lease which is less than the amount which the taxpayer deducts for purposes of its Federal income tax liability, then a portion of the difference between such amounts shall not be allowed as a deduction by the taxpayer for purposes of its Federal income tax liability in such manner and time as the Commissioner or his delegate may determine consistent with the principles of §1.167(l)–1 and this section applicable as to when a method of depreciation other than a subsection (1) method may be used for purposes of section 167(a).

(c) *Certain partnership arrangements.* Under section 167(l)(5), if property held by a partnership is not public utility property in the hands of the partnership but would be public utility property if an election was made under section 761 to be excluded from partnership treatment, then section 167(l) shall be applied by treating the partners as directly owning the property in proportion to their partnership interests.

(d) *Cross reference.* See §1.167(l)–1(c)(1) for treatment of certain property as ''pre-1970 public utility property'' and §1.167(l)–1(e)(4)(ii) for applicable 1968 method in the case of property acquired in certain transactions.

[T.D. 7315, 39 FR 20202, June 7, 1974]

§1.167(l)–4 Public utility property; election to use asset depreciation range system.

(a) *Application of section 167(l) to certain property subject to asset depreciation range system.* If the taxpayer elects to compute depreciation under the asset depreciation range system described in §1.167(a)–11 with respect to certain public utility property placed in service after December 31, 1970, see §1.167(a)–11(b) (6).

(Sec. 167 of the Internal Revenue Code of 1954 (26 U.S.C. 167) and sec. 7805 of the Internal Revenue Code of 1954 (26 U.S.C. 7805))

[T.D. 7128, 36 FR 11939, June 23, 1971. Redesignated by T.D. 7315, 39 FR 20203, June 7, 1974]

§1.167(m)–1 Class lives.

(a) For rules regarding the election to use the class life system authorized by section 167(m), see the provisions of §1.167(a)–11.

(Sec. 167(m), 85 Stat. 508 (26 U.S.C. 167))

[T.D. 7272, 38 FR 9986, Apr. 23, 1973]

§1.168–5 Special rules.

(a) *Retirement-replacement-betterment (RRB) property*—(1) *RRB replacement property placed in service before January 1, 1985.* (i) Except as provided in paragraph (a)(1)(ii) of this section, the recovery deduction for the taxable year for retirement-replacement-betterment (RRB) replacement property (as defined in paragraph (a)(3) of this section) placed in service before January 1, 1985, shall be (in lieu of the amount determined under section 168(b)) an amount determined by applying to the unadjusted basis (as defined in section 168(d)(1) and the regulations thereunder) of such property the applicable percentage determined in accordance with the following table:

If the recovery year is:	And the year the property is placed in service is:			
	1981	1982	1983	1984
	The applicable percentage is:			
1	100	50	33	25
2	....	50	45	38
3	....	....	22	25
4	....	....	....	12

(ii) The provisions of paragraph (a)(1)(i) of this section do not apply to any taxpayer who did not use the RRB method of depreciation under section 167 as of December 31, 1980. In such case, RRB replacement property placed in service by the taxpayer after December 31, 1980, shall be treated as other 5-year recovery property under section 168.

(2) *RRB replacement property placed in service after December 31, 1984.* RRB replacement property placed in service after December 31, 1984, is treated as other 5-year recovery property under section 168.

(3) *RRB replacement property defined.* RRB replacement property, for purposes of section 168, means replacement track material (including rail, ties, other track material, and ballast) installed by a railroad (including a railroad switching or terminal company) if—

(i) The replacement is made pursuant to a scheduled program for replacement.

(ii) The replacement is made pursuant to observations by maintenance-of-way personnel of specific track material needing replacement.

(iii) The replacement is made pursuant to the detection by a rail-test car of specific track material needing replacement, or

(iv) The replacement is made as a result of a casualty.

Replacements made as a result of a casualty shall be RRB replacement property only to the extent that, in the case of each casualty, the replacement cost with respect to the replacement track material exceeds $50,000.

(4) *Recovery of adjusted basis of RRB property as of December 31, 1980.* The taxpayer shall recover the adjusted basis of RRB property (as defined in section 168(g)(6)) as of December 31, 1980, over a period of not less than 5 years and not more than 50 years, using a rate of recovery consistent with any method described in section 167(b), including the method described in section 167(b)(2), switching to the method described in section 167(b)(3) at a time to maximize the deduction. For purposes of determining the recovery allowance under this subparagraph, salvage value shall be disregarded and, in the case of a taxpayer that depreciated RRB property placed in service before January 1, 1981, using the RRB method consistently for all periods after February 28, 1913, the adjusted basis of RRB property is the adjusted basis for purposes of determining the deduction for retirements under the RRB method, with no adjustment for depreciation sustained prior to March 1, 1913.

(5) *RRB property (which is not RRB replacement property) placed in service after December 31, 1980.* Property placed in service by the taxpayer after December 31, 1980, which is not RRB replacement property and which, under the taxpayer's method of depreciation as of December 31, 1980, would have been depreciated by the taxpayer under the RRB method, is treated as other property under section 168.

(b)–(f) [Reserved]

[T.D. 8116, 51 FR 46619, Dec. 24, 1986]

§ 1.168(d)–0 Table of contents for the applicable convention rules.

This section lists the major paragraphs in § 1.168(d)–1.

§ 1.168(d)–1 Applicable conventions—Half-year and mid-quarter conventions.

(a) In general.
(b) Additional rules for determining whether the mid-quarter convention applies and for applying the applicable convention.
(1) Property described in section 168(f).
(2) Listed property.
(3) Property placed in service and disposed of in the same taxable year.
(4) Aggregate basis of property.
(5) Special rules for affiliated groups.
(6) Special rule for partnerships and S corporations.
(7) Certain nonrecognition transactions.
(c) Disposition of property subject to the half-year or mid-quarter convention.
(1) In general.
(2) Example.
(d) Effective date.

[T.D. 8444, 57 FR 48981, Oct. 29, 1992]

§ 1.168(d)–1 Applicable convention—Half-year and mid-quarter conventions.

(a) *In general.* Under section 168(d), the half-year convention applies to depreciable property (other than certain real property described in section 168(d)(2)) placed in service during a taxable year, unless the mid-quarter convention applies to the property. Under section 168(d)(3)(A), the mid-quarter convention applies to depreciable property (other than certain real property described in section 168(d)(2)) placed in service during a taxable year if the aggregate basis of property placed in service during the last three months of the taxable year exceeds 40 percent of the aggregate basis of property placed in service during the taxable year (''the

40-percent test''). Thus, if the depreciable property is placed in service during a taxable year that consists of three months or less, the mid-quarter convention applies to the property. Under section 168(d)(3)(b)(i), the depreciable basis of nonresidential real property, residential rental property, and any railroad grading or tunnel bore is disregarded in applying the 40-percent test. For rules regarding property that is placed in service and disposed of in the same taxable year, see paragraph (b)(3) of this section. For the definition of ''aggregate basis of property,'' see paragraph (b)(4) if this section.

(b) *Additional rules for determining whether the mid-quarter convention applies and for applying the applicable convention*—(1) *Property described in section 168(f).* In determining whether the 40-percent test is testified for a taxable year, the depreciable basis of property described in section 168(f) (property to which section 168 does not apply) is not taken into account.

(2) *Listed property.* The depreciable basis of listed property (as defined in section 280F(d)(4) and the regulations thereunder) placed in service during a taxable year is taken into account (unless otherwise excluded) in applying the 40-percent test.

(3) *Property placed in service and disposed of in the same taxable year*—(i) Under section 168(d)(3)(B)(ii), the depreciable basis of property placed in service and disposed of in the same taxable year is not taken into account in determining whether the 40-percent test is satisfied. However, the depreciable basis of property placed in service, disposed of, subsequently reacquired, and again placed in service in the same taxable year must be taken into account in applying the 40-percent test, but the basis of the property is only taken into account on the later of the dates that the property is placed in service during the taxable year.

(ii) The applicable convention, as determined under this section, applies to all depreciable property (except nonresidential real property, residential rental property, and any railroad grading or tunnel bore) placed in service during the taxable year, excluding property placed in service and disposed of in the same taxable year. No depreciation deduction is allowed for property placed in service and disposed of during the same taxable year.

(iii) The provisions of this paragraph (b)(3) are illustrated by the following examples.

Example 1. During 1990, A, a calendar-year taxpayer, purchases a light general purpose truck costing $8,000, an office desk costing $500, a safe costing $1,000, and a computer costing $3,000. The truck is placed in service in January, the desk and safe in August, and the computer in November. These are the only items placed in service during 1990. In September, A sells the truck and the desk. Thus, the truck and the desk were placed in service and disposed of in the same taxable year. Therefore, the depreciable basis of the truck and the desk are not taken into account in determining whether the mid-quarter convention applies to depreciable property placed in service during 1990. Because the computer was placed in service during the last three months of the taxable year and its basis ($3,000) exceeds 40 percent of the aggregate basis of depreciable property placed in service during the taxable year (safe and computer with an aggregate basis of $4,000), the mid-quarter convention applies to the safe and the computer. No depreciation is allowed with respect to the truck and desk because they were placed in service and disposed of in the same taxable year.

EXAMPLE 2. The facts are the same as in EXAMPLE 1, except that, in December, A reacquires the truck for $7,000. Thus, the truck is considered placed in service in December and its basis is included in determining whether the mid-quarter convention applies. The mid-quarter convention is applicable, because the computer ($3,000) and the truck ($7,000) are placed in service during the last three months of the taxable year and their aggregate basis ($10,000) exceeds 40 percent of the aggregate basis of property placed in service during the taxable year (safe, computer, and truck with an aggregate basis of $11,000).

(4) *Aggregate basis of property.* For purposes of the 40-percent test, the term ''aggregate basis of property'' means the sum of the depreciable bases of all items of depreciable property that are taken into account in applying the 40-percent test. ''Depreciable basis'' means the basis of depreciable property for purposes of determining gain under sections 1011 through 1024. The depreciable basis for the taxable year the property is placed in service reflects the reduction in basis for—

(i) Any portion of the basis the taxpayer properly elects to treat as an expense under section 179;

(ii) Any adjustment to basis under section 48(q); and

(iii) The percentage of the taxpayer's use of the property for the taxable year other than in the taxpayer's trade or business (or for the production of income), but is determined before any reduction for depreciation under section 167(a) for that taxable year.

(5) *Special rules for affiliated groups*—(i) In the case of a consolidated group (as defined in § 1.1502–1(h)), all members of the group that are included on the consolidated return are treated as one taxpayer for purposes of applying the 40-percent test. Thus, the depreciable bases of all property placed in service by members of a consolidated group during a consolidated return year are taken into account (unless otherwise excluded) in applying the 40-percent test to determine whether the mid-quarter convention applies to property placed in service by the members during the consolidated return year. The 40-percent test is applied separately to the depreciable bases of property placed in service by any member of an affiliated group that is not included in a consolidated return of the taxable year in which the property is placed in service.

(ii) In the case of a corporation formed by a member or members of a consolidated group and that is itself a member of the consolidated group (''newly-formed subsidiary''), the depreciable bases of property placed in service by the newly-formed subsidiary in the consolidated return year in which it is formed is included with the depreciable bases of property placed in service during the consolidated return year by the other members of the consolidated group in applying the 40-percent test. If depreciable property is placed in service by a newly-formed subsidiary during the consolidated return year in which it was formed, the newly-formed subsidiary is considered as being in existence for the entire consolidated return year for purposes of applying the applicable convention to determine when the recovery period begins.

(iii) The provisions of paragraph (b)(5)(ii) of this section are illustrated by the following example.

Example. Assume a member of a consolidated group that files its return on a calendar-year basis forms a subsidiary on August 1. The subsidiary places depreciable property in service on August 5. If the mid-quarter convention applies to property placed in service by the members of the consolidated group (including the newly-formed subsidiary), the property placed in service by the subsidiary on August 5 is deemed placed in service on the mid-point of the third quarter of the consolidated return year (*i.e.*, August 15). If the mid-quarter convention does not apply, the property is deemed placed in service on the mid-point of the consolidated return year (*i.e.*, July 1).

(iv) In the case of a corporation that joins or leaves a consolidated group, the depreciable bases of property placed in service by the corporation joining or leaving the group during the portion of the consolidated return year that the corporation is a member of the consolidated group is included with the depreciable bases of property placed in service during the consolidated return year by the other members in applying the 40-percent test. The depreciable bases of property placed in service by the joining or leaving member in the taxable year before it joins or after it leaves the consolidated group is not taken into account by the consolidated group in applying the 40-percent test for the consolidated return year. If a corporation leaves a consolidated group and joins another consolidated group, each consolidated group takes into account, in applying the 40-percent test, the depreciable bases of property placed in service by the corporation while a member of the group.

(v) The provisions of paragraph (b)(5)(iv) of this section are illustrated by the following example.

Example. Assume Corporations A and B file a consolidated return on a calendar-year basis. Corporation C, also a calendar-year taxpayer, enters the consolidated group on July 1 and is included on the consolidated return for that taxable year. The depreciable bases of property placed in service by C during the period of July 1 to December 31 is included with the depreciable bases of property placed in service by A and B during the entire consolidated return year in applying the 40-percent test. The depreciable bases of property placed in service by C from January 1 to June 30 is not taken into account by the consolidated group in applying the 40-percent test. If C was a member of another consolidated group during the period from January 1 to June 30, that consolidated group would include the depreciable bases of property placed in service by C during that period.

(vi) A corporation that joins or leaves a consolidated group during a consolidated year is considered as being a member of the consolidated group for the entire consolidated return year for purposes of applying the applicable convention to determine when the recovery period begins for depreciable property placed in service by the corporation during the portion of the consolidated return year that the corporation is a member of the group.

(vii) If depreciable property is placed in service by a corporation in the taxable year ending immediately before it joins a consolidated group or beginning immediately after it leaves a consolidated group, the applicable convention is applied to the property under either the full taxable year rules or the short taxable year rules, as applicable.

(viii) The provisions of paragraphs (d)(5)(vi) and (vii) of this section are illustrated by the following example.

Example. Assume that on July 1, C, a calendar-return corporation, joins a consolidated group that files a return on a calendar-year basis. The short taxable year rules apply to C for the period of January 1 to June 30. However, in applying the applicable convention to determine when the recovery period begins for depreciable property placed in service for the period of July 1 to December 31, C is considered as being a member of the consolidated group for the entire consolidated return year. Thus, if the half-year convention applies to depreciable property placed in service by the consolidated group (taking into account the depreciable bases of property placed in service by C after June 30), the property is deemed placed in service on the mid-point of the consolidated return year (*i.e.,* July 1, if the group did not have a short taxable year).

(ix) In the case of a transfer of depreciable property between members of a consolidated group, the following special rules apply for purposes of applying the 40-percent test. Property that is placed in service by one member of a consolidated group and transferred to another member of the same group is considered as placed in service on the date that it is placed in service by the transferor member, and the date it is placed in service by the transferee member is disregarded. In the case of multiple transfers of property between members of a consolidated group, the property is considered as placed in service on the date that the first member places the property in service, and the dates it is placed in service by other members are disregarded. The depreciable basis of the transferred property that is taken into account in applying the 40-percent test is the depreciable basis of the property in the hands of the transferor member (as determined under paragraph (b)(4) of this section), or, in the case of multiple transfers of property between members, the depreciable basis in the hands of the first member that placed the property in service.

(x) The provisions of paragraph (b)(5)(ix) of this section are illustrated by the following example.

Example. Assume the ABC consolidated group files its return on a calendar-year basis. A, a member of the consolidated group, purchases depreciable property costing $50,000 and places the property in service on January 5, 1991. On December 1, 1991, the property is transferred for $75,000 to B, another member of the consolidated group. In applying the 40-percent test to the members of the consolidated group for 1991, the property is considered as placed in service on January 5, the date that A placed the property in service, and the depreciable basis of the property that is taken into account is $50,000.

(6) *Special rule for partnerships and S corporations.* In the case of property placed in service by a partnership or an S corporation, the 40-percent test is generally applied at the partnership or corporate level. However, if a partnership or an S corporation is formed or availed of for the principal purpose of either avoiding the application of the mid-quarter convention or having the mid-quarter convention apply where it otherwise would not, the 40-percent test is applied at the partner, shareholder, or other appropriate level.

(7) *Certain nonrecognition transaction*—(i) Except as provided in paragraph (b)(6) of this section, if depreciable property is transferred in a transaction described in section

168(i)(7)(B)(i) (other than in a transaction between members of a consolidated group) in the same taxable year that the property is placed in service by the transferor, the 40-percent test is applied by treating the transferred property as placed in service by the transferee on the date of transfer. Thus, if the aggregate basis of property (including the transferred property) placed in service by the transferee during the last three months of its taxable year exceeds 40 percent of the aggregate basis of property (including the transferred property) placed in service by the transferee during the taxable year, the mid-quarter convention applies to the transferee's depreciable property, including the transferred property. The depreciable basis of the transferred property is not taken into account by the transferor in applying the 40-percent test for the taxable year that the transferor placed the property in service.

(ii) In applying the applicable convention to determine when the recovery period for the transferred property begins, the date on which the transferor placed the property in service must be used. Thus, for example, if the mid-quarter convention applies, the recovery period for the transferred property begins on the mid-point of the quarter of the taxable year that the transferor placed the property in service. If the transferor placed the transferred property in service in a short taxable year, then for purposes of applying the applicable convention and allocating the depreciation deduction between the transferor and the transferee, the transferor is treated as having a full 12-month taxable year commencing on the first day of the short taxable year. The depreciation deduction for the transferor's taxable year in which the property was placed in service is allocated between the transferor and the transferee based on the number of months in the transferor's taxable year that each partyheld the property in service. For purposes of allocating the depreciation deduction, the transferor takes into account the month in which the property was placed in service but does not take into account the month in which the property was transferred. The transferee is allocated the remaining portion of the depreciation deduction for the transferor's taxable year in which the property was transferred. For the remainder of the transferee's current taxable year (if the transferee has a different taxable year than the transferor) and for subsequent taxable years, the depreciation deduction for the transferee is calculated by allocating to the transferee's taxable year the depreciation attributable to each recovery year, or portion thereof, that falls within the transferee's taxable year.

(iii) If the applicable convention for the transferred property has not been determined by the time the transferor files its income tax return for the year of transfer because the transferee's taxable year has not ended, the transferor may use either the mid-quarter or the half-year convention in determining the depreciation deduction for the property. However, the transferor must specify on the depreciation form filed for the taxable year that the applicable convention has not been determined for the property. If the transferee determines that a different convention applies to the transferred property, the transferor should redetermine the depreciation deduction on the property, and, within the period of limitation, should file an amended income tax return for the taxable year and pay any additional tax due plus interest.

(iv) The provisions of the paragraph (b)(7) are illustrated by the following example.

Example. (i) During 1991, C, a calendar-year taxpayer, purchases satellite equipment costing $100,000, and computer equipment costing $15,000. The satellite equipment is placed in service in January, and the computer equipment in February. On October 1, C transfers the computer equipment to Z Partnership in a transaction described in section 721. During 1991, Z, a calendar-year partnership, purchases 30 office desks for a total of $15,000. The desks are placed in service in June. These are the only items of depreciable property placed in service by C and Z during 1991.

(ii) In applying the 40-percent test, because C transferred the computer equipment in a transaction described in section 168(i)(7)(B)(i) in the same taxable year that C placed it in service, the computer equipment is treated as placed in service by the transferee, Z, on the date of transfer, October 1. The 40-percent test is satisfied with respect to Z, because the computer equipment is placed in service during the last three months of Z's taxable year and its basis ($15,000) exceeds 40 percent of the aggregate basis of property placed in service by Z during the taxable year (desks and computer equipment with an aggregate basis of $30,000).

(iii) In applying the mid-quarter convention to determine when the computer equipment is deemed to be placed in service, the date on which C placed the property in service is used. Accordingly, because C placed the computer equipment in service during the first quarter of its taxable year, the computer equipment is deemed placed in service on February 15, 1991, the mid-point of the first quarter of C's taxable year. The depreciation deduction allowable for C's 1991 taxable year, $5,250 ($15,000×40 percent×10.5/12), is allocated between C and Z based on the number of months in C's taxable year that C and Z held the property in service. Thus, because the property was in service for 11 months during C's 1991 taxable year and C held it for 8 of those 11 months, C is allocated $3,818 (8/11×$5,250). Z is allocated $1,432, the remaining 3/11 of the $5,250 depreciation deduction for C's 1991 taxable year. For 1992, Z's depreciation deduction for the computer equipment is $3,900, the sum of the remaining 1.5 months of depreciation deduction for the first recovery year and 10.5 months of depreciation deduction for the second recovery year (($15,000×40 percent×1.5/12)+($9,000×40 [percent×10.5/12)).

(c) *Disposition of property subject to the half-year or mid-quarter convention*—(1) *In general.* If depreciable property is subject to the half-year (or mid-quarter) convention in the taxable year in which it is placed in service, it also is subject to the half-year (or mid-quarter) convention in the taxable year in which it is disposed of.

(2) *Example.* The provisions of paragraph (c)(1) of this section are illustrated by the following example.

Example. In October 1991, B, a calendar-year taxpayer, purchases and places in service a light general purpose truck costing $10,000. B does not elect to expense any part of the cost of the truck, and this is the only item of depreciable property placed in service by B during 1991. The 40-percent test is satisfied and the mid-quarter convention applies, because the truck is placed in service during the last three months of the taxable year and no other assets are placed in service in that year. In April 1993 (prior to the end of the truck's recovery period), B sells the truck. The mid-quarter convention applies in determining the depreciation deduction for the truck in 1993, the year of disposition.

(d) *Effective date.* This section applies to depreciable property placed in service in taxable years ending after January 30, 1991. For depreciable property placed in service after December 31, 1986, in taxable years ending on or before January 30, 1991, a taxpayer may use a method other than the method provided in this section in applying the 40-percent test and the applicable convention, provided the method is reasonable and is consistently applied to the taxpayer's property.

[T.D. 8444, 57 FR 48981, Oct. 29, 1992]

§ 1.168(f)(8)–1T Safe-harbor lease information returns concerning qualified mass commuting vehicles (temporary).

In general. Form 6793, Safe Harbor Lease Information Return, is obsolete for safe harbor lease agreements executed after June 30, 1985. The parties to a safe harbor lease agreement under section 168(f)(8) executed after June 30, 1985 must file with their timely filed (including extensions) Federal income tax returns for the taxable year during which the lease term begins a statement containing the following information:

(a) The name, address, and taxpayer identification number of the lessor and the lessee;

(b) A description of the property with respect to which safe-harbor lease treatment is claimed;

(c) The date on which the lessee places the property in service, the date on which the lease begins, and the term of the lease;

(d) The recovery property class of the leased property under section 168(c)(2) (for example, 5-year);

(e) The terms of the payments between the parties to the lease transaction;

(f) The unadjusted basis of the property as defined in section 168(d)(1) and its adjusted basis as determined under § 5c.168(f)(8)–6(b)(3); and

(g) If the lessor is a partnership or grantor trust, the name, address, and taxpayer identification number of the partners or beneficiaries and the service center at which the income tax return of each partner or beneficiary is filed.

The lessor's failure to file the above-described statement shall void such agreement as a safe-harbor lease under section 168(f)(8) as of the date of the execution of the lease agreement. For rules regarding extensions of time for filing elections, see § 1.9100–1.

[T.D. 8033, 50 FR 27224, July 2, 1985]

§ 1.168(h)–1 Like-kind exchanges involving tax-exempt use property.

(a) *Scope.* (1) This section applies with respect to a direct or indirect transfer of property among related persons, including transfers made through a qualified intermediary (as defined in § 1.1031(k)–1(g)(4)) or other unrelated person, (a transfer) if—

(i) Section 1031 applies to any party to the transfer or to any related transaction; and

(ii) A principal purpose of the transfer or any related transaction is to avoid or limit the application of the alternative depreciation system (within the meaning of section 168(g)).

(2) For purposes of this section, a person is related to another person if they bear a relationship specified in section 267(b) or section 707(b)(1).

(b) *Allowable depreciation deduction for property subject to this section*—(1) *In general.* Property (tainted property) transferred directly or indirectly to a taxpayer by a related person (related party) as part of, or in connection with, a transaction in which the related party receives tax-exempt use property (related tax-exempt use property) will, if the tainted property is subject to an allowance for depreciation, be treated in the same manner as the related tax-exempt use property for purposes of determining the allowable depreciation deduction under section 167(a). Under this paragraph (b), the tainted property is depreciated by the taxpayer over the remaining recovery period of, and using the same depreciation method and convention as that of, the related tax-exempt use property.

(2) *Limitations*—(i) *Taxpayer's basis in related tax-exempt use property.* The rules of this paragraph (b) apply only with respect to so much of the taxpayer's basis in the tainted property as does not exceed the taxpayer's adjusted basis in the related tax-exempt use property prior to the transfer. Any excess of the taxpayer's basis in the tainted property over its adjusted basis in the related tax-exempt use property prior to the transfer is treated as property to which this section does not apply. This paragraph (b)(2)(i) does not apply if the related tax-exempt use property is not acquired from the taxpayer (e.g., if the taxpayer acquires the tainted property for cash but section 1031 nevertheless applies to the related party because the transfer involves a qualified intermediary).

(ii) *Application of section 168(i)(7).* This section does not apply to so much of the taxpayer's basis in the tainted property as is subject to section 168(i)(7).

(c) *Related tax-exempt use property.* (1) For purposes of paragraph (b) of this section, related tax-exempt use property includes—

(i) Property that is tax-exempt use property (as defined in section 168(h)) at the time of the transfer; and

(ii) Property that does not become tax-exempt use property until after the transfer if, at the time of the transfer, it was intended that the property become tax-exempt use property.

(2) For purposes of determining the remaining recovery period of the related tax-exempt use property in the circumstances described in paragraph (c)(1)(ii) of this section, the related tax-exempt use property will be treated as having, prior to the transfer, a lease term equal to the term of any lease that causes such property to become tax-exempt use property.

(d) *Examples.* The following examples illustrate the application of this section. The examples do not address common law doctrines or other authorities that may apply to recharacterize or alter the effects of the transactions described therein. Unless otherwise indicated, parties to the transactions are not related to one another.

Example 1. (i) X owns all of the stock of two subsidiaries, B and Z. X, B and Z do not file a consolidated federal income tax return. On May 5, 1995, B purchases an aircraft (*FA*) for $1 million and leases it to a foreign airline whose income is not subject to United States taxation and which is a tax-exempt entity as defined in section 168(h)(2). On the same date, Z owns an aircraft (*DA*) with a fair market value of $1 million, which has been, and continues to be, leased to an airline that is a United States taxpayer. Z's adjusted basis in DA is $0. The next day, at a time when each aircraft is still worth $1 million, B transfers FA to Z (subject to the lease to the foreign airline) in exchange for DA (subject to the lease to the airline that is a United States taxpayer). Z realizes gain of $1 million on the exchange, but that gain is not recognized pursuant to section 1031(a) because the exchange is of like-kind properties. Assume that a principal purpose of the transfer of DA to B or of FA to Z is to avoid the application of the alternative depreciation system. Following the exchange, Z has a $0 basis in FA pursuant to section 1031(d). B has a $1 million basis in DA.

(ii) B has acquired property from Z, a related person; Z's gain is not recognized pursuant to section 1031(a); Z has received tax-exempt use property as part of the transaction; and a principal purpose of the transfer of DA to B or of FA to Z is to avoid the application of the alternative depreciation system. Accordingly, the transaction is within the scope of this section. Pursuant to paragraph (b) of this section, B must recover its $1 million basis in DA over the remaining recovery period of, and using the same depreciation method and convention as that of, FA, the related tax-exempt use property.

(iii) If FA did not become tax-exempt use property until after the exchange, it would still be related tax-exempt use property and paragraph (b) of this section would apply if, at the time of the exchange, it was intended that FA become tax-exempt use property.

Example 2. (i) X owns all of the stock of two subsidiaries, B and Z. X, B and Z do not file a consolidated federal income tax return. B and Z each own identical aircraft. B's aircraft (*FA*) is leased to a tax-exempt entity as defined in section 168(h)(2) and has a fair market value of $1 million and an adjusted basis of $500,000. Z's aircraft (*DA*) is leased to a United States taxpayer and has a fair market value of $1 million and an adjusted basis of $10,000. On May 1, 1995, B and Z exchange aircraft, subject to their respective leases. B realizes gain of $500,000 and Z realizes gain of $990,000, but neither person recognizes gain because of the operation of section 1031(a). Moreover, assume that a principal purpose of the transfer of DA to B or of FA to Z is to avoid the application of the alternative depreciation system.

(ii) As in *Example 1,* B has acquired property from Z, a related person; Z's gain is not recognized pursuant to section 1031(a); Z has received tax-exempt use property as part of the transaction; and a principal purpose of the transfer of DA to B or of FA to Z is to avoid the application of the alternative depreciation system. Thus, the transaction is within the scope of this section even though B has held tax-exempt use property for a period of time and, during that time, has used the alternative depreciation system with respect to such property. Pursuant to paragraph (b) of this section, B, which has a substituted basis determined pursuant to section 1031(d) of $500,000 in DA, must depreciate the aircraft over the remaining recovery period of FA, using the same depreciation method and convention. Z holds tax-exempt use property with a basis of $10,000, which must be depreciated under the alternative depreciation system.

(iii) Assume the same facts as in paragraph (i) of this *Example 2,* except that B and Z are members of an affiliated group that files a consolidated federal income tax return. Of B's $500,000 basis in DA, $10,000 is subject to section 168(i)(7) and therefore not subject to this section. The remaining $490,000 of basis is subject to this section. But see §1.1502–80(f) making section 1031 inapplicable to intercompany transactions occurring in consolidated return years beginning on or after July 12, 1995.

(e) *Effective date.* This section applies to transfers made on or after April 20, 1995.

[T.D. 8667, 61 FR 18676, Apr. 29, 1996]

§1.168(i)–0 Table of contents for the general asset account rules.

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[T.D. 8566, 59 FR 51371, Oct. 11, 1994]

§ 1.168(i)–1 General asset accounts.

(a) *Scope.* This section provides rules for general asset accounts under section 168(i)(4). The provisions of this section apply only to assets for which an election has been made under paragraph (k) of this section.

(b) *Definitions.* For purposes of this section, the following definitions apply:

(1) *Unadjusted depreciable basis* is the basis of an asset for purposes of section 1011 without regard to any adjustments described in sections 1016(a)(2) and (3).

(2) *Unadjusted depreciable basis of the general asset account* is the sum of the unadjusted depreciable bases of all assets included in the general asset account.

(3) *Adjusted depreciable basis of the general asset account* is the unadjusted depreciable basis of the general asset account less the adjustments to basis described in sections 1016(a)(2) and (3).

(4) *Expensed cost* is the amount of any allowable credit or deduction treated as a deduction allowable for depreciation or amortization for purposes of section 1245 (for example, a credit allowable under section 30 or a deduction allowable under section 179, 179A, or 190).

(c) *Establishment of general asset accounts*—(1) *Assets eligible for general asset accounts*—(i) *General rules.* Assets that are subject to either the general depreciation system of section 168(a) or the alternative depreciation system of section 168(g) may be accounted for in one or more general asset accounts. An asset may be included in a general asset account only to the extent of the asset's unadjusted depreciable basis (for example, if, in 1995, a taxpayer places in service an asset that costs $20,000 and elects under section 179 to expense $17,500 of that asset's cost, the unadjusted depreciable basis of the asset is $2,500 and, therefore, only $2,500 of the asset's cost may be included in a general asset account). However, an asset is not to be included in a general asset account if the asset is used both in a trade or business (or for the production of income) and in a personal activity at any time during the taxable year in which the asset is first placed in service by the taxpayer.

(ii) *Special rules for assets generating foreign source income*—(A) Assets that generate foreign source income, both United States and foreign source income, or combined gross income of a FSC (as defined in section 922), DISC (as defined in section 992(a)), or possessions corporation (as defined in section 936) and its related supplier, may be included in a general asset account if the requirements of paragraph (c)(2)(i) of this section are satisfied. If, however, the inclusion of these assets in a general asset account results in a substantial distortion of income, the Commissioner may disregard the general asset account election and make any reallocations of income or expense necessary to clearly reflect income.

(B) A general asset account shall be treated as a single asset for purposes of applying the rules in § 1.861- 9T(g)(3) (relating to allocation and apportionment of interest expense under the asset method). A general asset account that generates income in more than one grouping of income (statutory and residual) is a multiple category asset (as defined in §1.861–9T(g)(3)(ii)), and the income yield from the general asset account must be determined by applying the rules for multiple category assets as if the general asset account were a single asset.

(2) *Grouping assets in general asset accounts*—(i) *General rules.* If a taxpayer makes the election under paragraph (k) of this section, assets that are subject to the election are grouped into one or more general asset accounts. Assets that are eligible to be grouped into a single general asset account may be divided into more than one general asset account. Each general asset account must include only assets that—

(A) Have the same asset class (for further guidance, see Rev. Proc. 87–56, 1987–2 C.B. 674, and §601.601(d)(2)(ii)(*b*) of this chapter);

(B) Have the same applicable depreciation method;

(C) Have the same applicable recovery period;

(D) Have the same applicable convention; and

(E) Are placed in service by the taxpayer in the same taxable year.

(ii) *Special rules.* In addition to the general rules in paragraph (c)(2)(i) of this section, the following rules apply when establishing general asset accounts—

(A) Assets without an asset class, but with the same characteristics described in paragraphs (c)(2)(i)(B), (C), (D), and (E) of this section, may be grouped into a general asset account;

(B) Assets subject to the mid-quarter convention may only be grouped into a general asset account with assets that are placed in service in the same quarter of the taxable year;

(C) Assets subject to the mid-month convention may only be grouped into a general asset account with assets that are placed in service in the same month of the taxable year; and

(D) Passenger automobiles for which the depreciation allowance is limited under section 280F(a) must be grouped into a separate general asset account.

(d) *Determination of depreciation allowance*—(1) *In general.* Depreciation allowances are determined for each general asset account by using the applicable depreciation method, recovery period, and convention for the assets in the account. The depreciation allowances are recorded in a depreciation reserve account for each general asset account. The allowance for depreciation under this section constitutes the amount of depreciation allowable under section 167(a).

(2) *Special rule for passenger automobiles.* For purposes of applying section 280F(a), the depreciation allowance for a general asset account established for passenger automobiles is limited for each taxable year to the amount prescribed in section 280F(a) multiplied by the excess of the number of automobiles originally included in the account over the number of automobiles disposed of during the taxable year or in any prior taxable year in a transaction described in paragraph (e)(3)(iii) (disposition of an asset in a qualifying disposition), (e)(3)(iv) (transactions subject to section 168(i)(7)), (e)(3)(v) (anti-abuse rule), (g) (assets subject to recapture), or (h)(1) (conversion to personal use) of this section.

(e) *Disposition of an asset from a general asset account*—(1) *Scope.* This paragraph (e) provides rules applicable to dispositions of assets included in a general asset account. For purposes of this paragraph (e), an asset in a general asset account is disposed of when ownership of the asset is transferred or when the asset is permanently withdrawn from use either in the taxpayer's trade or business or in the production of income. A disposition includes the sale, exchange, retirement, physical abandonment, or destruction of an asset. A disposition also occurs when an asset is transferred to a supplies, scrap, or similar account. A disposition does not include, however, the retirement of a structural component of real property.

(2) *General rules for a disposition*—(i) *No immediate recovery of basis.* Immediately before a disposition of any asset in a general asset account, the asset is treated as having an adjusted basis of zero for purposes of section 1011. Therefore, no loss is realized upon

the disposition of an asset from the general asset account. Similarly, where an asset is disposed of by transfer to a supplies, scrap, or similar account, the basis of the asset in the supplies, scrap, or similar account will be zero.

(ii) *Treatment of amount realized.* Any amount realized on a disposition is recognized as ordinary income (notwithstanding any other provision of subtitle A of the Internal Revenue Code (Code)) to the extent the sum of the unadjusted depreciable basis of the general asset account and any expensed cost (as defined in paragraph (b)(4) of this section) for assets in the account exceeds any amounts previously recognized as ordinary income upon the disposition of other assets in the account. The recognition and character of any excess amount realized are determined under other applicable provisions of the Code (other than sections 1245 and 1250 or provisions of the Code that treat gain on a disposition as subject to section 1245 or 1250).

(iii) *Effect of disposition on a general asset account.* The unadjusted depreciable basis and the depreciation reserve of the general asset account are not affected as a result of a disposition of an asset from the general asset account.

(iv) *Coordination with nonrecognition provisions.* For purposes of determining the basis of an asset acquired in a transaction described in paragraph (e)(3)(iii)(B)(*4*) of this section (relating to certain nonrecognition provisions), the amount of ordinary income recognized under this paragraph (e)(2) is treated as the amount of gain recognized on the disposition.

(v) *Examples.* The following examples illustrate the application of this paragraph (e)(2).

Example 1. (i) *R,* a calendar-year corporation, maintains one general asset account for ten machines. The machines cost a total of $10,000 and were placed in service in June 1995. Of the ten machines, one machine costs $8,200 and nine machines cost a total of $1,800. Assume this general asset account has a depreciation method of 200 percent declining balance, a recovery period of 5 years, and a half-year convention. *R* does not make a section 179 election for any of the machines. As of January 1, 1996, the depreciation reserve of the account is $2,000 [(($10,000 − $0) × 40%)/2].

(ii) On February 8, 1996, *R* sells the machine that cost $8,200 to an unrelated party for $9,000. Under paragraph (e)(2)(i) of this section, this machine has an adjusted basis of zero.

(iii) On its 1996 tax return, *R* recognizes the amount realized of $9,000 as ordinary income because such amount does not exceed the unadjusted depreciable basis of the general asset account ($10,000), plus any expensed cost for assets in the account ($0), less amounts previously recognized as ordinary income ($0). Moreover, the unadjusted depreciable basis and depreciation reserve of the account are not affected by the disposition of the machine. Thus, the depreciation allowance for the account in 1996 is $3,200 (($10,000 − $2,000)×40%).

Example 2. (i) The facts are the same as in *Example 1.* In addition, on June 4, 1997, *R* sells seven machines to an unrelated party for a total of $1,100. In accordance with paragraph (e)(2)(i) of this section, these machines have an adjusted basis of zero.

(ii) On its 1997 tax return, *R* recognizes $1,000 as ordinary income (the unadjusted depreciable basis of $10,000, plus the expensed cost of $0, less the amount of $9,000 previously recognized as ordinary income). The recognition and character of the excess amount realized of $100 ($1,100 − $1,000) are determined under applicable provisions of the Code other than section 1245 (such as section 1231). Moreover, the unadjusted depreciable basis and depreciation reserve of the account are not affected by the disposition of the machines. Thus, the depreciation allowance for the account in 1997 is $1,920 (($10,000 − $5,200)×40%).

(3) *Special rules*—(i) *In general.* This paragraph (e)(3) provides the rules for terminating general asset account treatment upon certain dispositions. While the rules under paragraphs (e)(3)(ii) and (iii) of this section are optional rules, the rules under paragraphs (e)(3)(iv) and (v) of this section are mandatory rules. A taxpayer applies paragraph (e)(3)(ii) or (iii) of this section by reporting the gain, loss, or other deduction on the taxpayer's timely filed (including extensions) income tax return for the taxable year in which the disposition occurs. For purposes of applying paragraph (e)(3)(iii) through (v) of this section, see paragraph (i) of this section for identifying the unadjusted depreciable basis of a disposed asset.

(ii) *Disposition of all assets remaining in a general asset account*—(A) *Optional termination of a general asset account.*

Upon the disposition of all of the assets, or the last asset, in a general asset account, a taxpayer may apply this paragraph (e)(3)(ii) to recover the adjusted depreciable basis of the general asset account (rather than having paragraph (e)(2) of this section apply). Under this paragraph (e)(3)(ii), the general asset account terminates and the amount of gain or loss for the general asset account is determined under section 1001(a) by taking into account the adjusted depreciable basis of the general asset account at the time of the disposition. The recognition and character of the gain or loss are determined under other applicable provisions of the Code, except that the amount of gain subject to section 1245 (or section 1250) is limited to the excess of the depreciation allowed or allowable for the general asset account, including any expensed cost (or the excess of the additional depreciation allowed or allowable for the general asset account), over any amounts previously recognized as ordinary income under paragraph (e)(2) of this section.

(B) *Example.* The following example illustrates the application of this paragraph (e)(3)(ii).

Example. (i) *T*, a calendar-year corporation, maintains a general asset account for 1,000 calculators. The calculators cost a total of $60,000 and were placed in service in 1995. Assume this general asset account has a depreciation method of 200 percent declining balance, a recovery period of 5 years, and a half-year convention. *T* does not make a section 179 election for any of the calculators. In 1996, *T* sells 200 of the calculators to an unrelated party for a total of $10,000 and recognizes the $10,000 as ordinary income in accordance with paragraph (e)(2) of this section.

(ii) On March 26, 1997, *T* sells the remaining calculators in the general asset account to an unrelated party for $35,000. *T* chooses to apply paragraph (e)(3)(ii) of this section. As a result, the account terminates and gain or loss is determined for the account.

(iii) On the date of disposition, the adjusted depreciable basis of the account is $23,040 (unadjusted depreciable basis of $60,000 less the depreciation allowed or allowable of $36,960). Thus, in 1997, *T* recognizes gain of $11,960 (amount realized of $35,000 less the adjusted depreciable basis of $23,040). The gain of $11,960 is subject to section 1245 to the extent of the depreciation allowed or allowable for the account (plus the expensed cost for assets in the account) less the amounts previously recognized as ordinary income ($36,960 + $0 − $10,000 = $26,960). As a result, the entire gain of $11,960 is subject to section 1245.

(iii) *Disposition of an asset in a qualifying disposition*—(A) *Optional determination of the amount of gain, loss, or other deduction.* In the case of a qualifying disposition of an asset (described in paragraph (e)(3)(iii)(B) of this section), a taxpayer may apply this paragraph (e)(3)(iii) (rather than having paragraph (e)(2) of this section apply). Under this paragraph (e)(3)(iii), general asset account treatment for the asset terminates as of the first day of the taxable year in which the qualifying disposition occurs, and the amount of gain, loss, or other deduction for the asset is determined by taking into account the asset's adjusted basis. The adjusted basis of the asset at the time of the disposition equals the unadjusted depreciable basis of the asset less the depreciation allowed or allowable for the asset, computed by using the depreciation method, recovery period, and convention applicable to the general asset account in which the asset was included. The recognition and character of the gain, loss, or other deduction are determined under other applicable provisions of the Code, except that the amount of gain subject to section 1245 (or section 1250) is limited to the lesser of—

(*1*) The depreciation allowed or allowable for the asset, including any expensed cost (or the additional depreciation allowed or allowable for the asset); or

(*2*) The excess of—

(*i*) The original unadjusted depreciable basis of the general asset account plus, in the case of section 1245 property originally included in the general asset account, any expensed cost; over

(*ii*) The cumulative amounts of gain previously recognized as ordinary income under either paragraph (e)(2) of this section or section 1245 (or section 1250).

(B) *Qualifying dispositions.* A qualifying disposition is a disposition that does not involve all the assets, or the last asset, remaining in a general asset account and that is—

(*1*) A direct result of a fire, storm, shipwreck, or other casualty, or from theft;

(*2*) A charitable contribution for which a deduction is allowable under section 170;

(*3*) A direct result of a cessation, termination, or disposition of a business, manufacturing or other income producing process, operation, facility, plant, or other unit (other than by transfer to a supplies, scrap, or similar account); or

(*4*) A transaction, other than a transaction described in paragraph (e)(3)(iv) of this section (pertaining to transactions subject to section 168(i)(7)), to which a nonrecognition section of the Code applies (determined without regard to this section), such as section 1031 or 1033.

(C) *Effect of a qualifying disposition on a general asset account.* If the taxpayer applies this paragraph (e)(3)(iii) to a qualifying disposition of an asset, then—

(*1*) The asset is removed from the general asset account as of the first day of the taxable year in which the qualifying disposition occurs;

(*2*) The unadjusted depreciable basis of the general asset account is reduced by the unadjusted depreciable basis of the asset as of the first day of the taxable year in which the disposition occurs;

(*3*) The depreciation reserve of the general asset account is reduced by the depreciation allowed or allowable for the asset as of the end of the taxable year immediately preceding the year of disposition, computed by using the depreciation method, recovery period, and convention applicable to the general asset account in which the asset was included; and

(*4*) For purposes of determining the amount of gain realized on subsequent dispositions that is subject to ordinary income treatment under paragraph (e)(2)(ii) of this section, the amount of any expensed cost with respect to the asset is disregarded.

(D) *Example.* The provisions of this paragraph (e)(3)(iii) are illustrated by the following example.

Example. (i) *Z*, a calendar-year corporation, maintains one general asset account for 12 machines. Each machine costs $15,000 and was placed in service in 1995. Of the 12 machines, nine machines that cost a total of $135,000 are used in *Z's* Kentucky plant, and three machines that cost a total of $45,000 are used in *Z's* Ohio plant. Assume this general asset account has a depreciation method of 200 percent declining balance, a recovery period of 5 years, and a half-year convention. *Z* does not make a section 179 election for any of the machines. As of January 1, 1997, the depreciation reserve for the account is $93,600.

(ii) On May 27, 1997, *Z* sells its entire manufacturing plant in Ohio to an unrelated party. The sales proceeds allocated to each of the three machines at the Ohio plant is $5,000. Because this transaction is a qualifying disposition under paragraph (e)(3)(iii)(B)(*3*) of this section, *Z* chooses to apply paragraph (e)(3)(iii) of this section.

(iii) For *Z*'s 1997 return, the depreciation allowance for the account is computed as follows. As of December 31, 1996, the depreciation allowed or allowable for the three machines at the Ohio plant is $23,400. Thus, as of January 1, 1997, the unadjusted depreciable basis of the account is reduced from $180,000 to $135,000 ($180,000 less the unadjusted depreciable basis of $45,000 for the three machines), and the depreciation reserve of the account is decreased from $93,600 to $70,200 ($93,600 less the depreciation allowed or allowable of $23,400 for the three machines as of December 31, 1996). Consequently, the depreciation allowance for the account in 1997 is $25,920 (($135,000 − $70,200) × 40%).

(iv) For *Z*'s 1997 return, gain or loss for each of the three machines at the Ohio plant is determined as follows. The depreciation allowed or allowable in 1997 for each machine is $1,440 [(($15,000 − $7,800) × 40%) / 2]. Thus, the adjusted basis of each machine under section 1011 is $5,760 (the adjusted depreciable basis of $7,200 removed from the account less the depreciation allowed or allowable of $1,440 in 1997). As a result, the loss recognized in 1997 for each machine is $760 ($5,000 − $5,760), which is subject to section 1231.

(iv) *Transactions subject to section 168(i)(7).* If an asset in a general asset account is transferred in a transaction described in section 168(i)(7)(B) (pertaining to treatment of transferees in certain nonrecognition transactions), the transferor must remove the transferred asset from the general asset account as of the first day of the taxable year in which the transaction occurs. In addition, the adjustments to the general asset account described in paragraph (e)(3)(iii)(C)(*2*) through (*4*) of this section must be made. The transferee is bound by the transferor's election under paragraph (k) of this section with respect to so much of the asset's basis in the hands of the transferee as does not exceed the asset's adjusted basis in the hands of the transferor. If all of the assets, or the last asset, in a general asset account are transferred, the transferee's basis in the assets or asset transferred is equal to the adjusted depreciable basis of the general asset account as of the beginning of the transferor's taxable year in which the transaction occurs, decreased by the amount of depreciation allocable to the transferor for the year of the transfer.

(v) *Anti-abuse rule*—(A) *In general.* If an asset in a general asset account is disposed of by a taxpayer in a transaction described in paragraph (e)(3)(v)(B) of this section, general asset account treatment for the asset terminates as of the first day of the taxable year in which the disposition occurs. Consequently, the taxpayer must determine the amount of gain, loss, or other deduction attributable to the disposition in the manner described in paragraph (e)(3)(iii)(A) of this section (notwithstanding that paragraph (e)(3)(iii)(A) of this section is an optional rule) and must make the adjustments to the general asset account described in paragraph (e)(3)(iii)(C)(*1*) through (*4*) of this section.

(B) *Abusive transactions.* A transaction is described in this paragraph (e)(3)(v)(B) if the transaction is not described in paragraph (e)(3)(iv) of this section and the transaction is entered into, or made, with a principal purpose of achieving a tax benefit or result that would not be available absent an election under this section. Examples of these types of transactions include—

(*1*) A transaction entered into with a principal purpose of shifting income or deductions among taxpayers in a manner that would not be possible absent an election under this section in order to take advantage of differing effective tax rates among the taxpayers; or

(*2*) An election made under this section with a principal purpose of disposing of an asset from a general asset account in order to utilize an expiring net operating loss or credit. The fact that a taxpayer with a net operating loss carryover or a credit carryover transfers an asset to a related person or transfers an asset pursuant to an arrangement where the asset continues to be used (or is available for use) by the taxpayer pursuant to a lease (or otherwise) indicates, absent strong evidence to the contrary, that the transaction is described in this paragraph (e)(3)(v)(B).

(f) *Assets generating foreign source income*—(1) *In general.* This paragraph (f) provides the rules for determining the source of any income, gain, or loss recognized, and the appropriate section 904(d) separate limitation category or categories for any foreign source income, gain, or loss recognized, on a disposition (within the meaning of paragraph (e)(1) of this section) of an asset in a general asset account that consists of assets generating both United States and foreign source income. These rules apply only to a disposition to which paragraph (e)(2) (general disposition rules), (e)(3)(ii) (disposition of all assets remaining in a general asset account), (e)(3)(iii) (disposition of an asset in a qualifying disposition), or (e)(3)(v) (anti-abuse rule) of this section applies.

(2) *Source of ordinary income, gain, or loss*—(i) *Source determined by allocation and apportionment of depreciation allowed.* The amount of any ordinary income, gain, or loss that is recognized on the disposition of an asset in a general asset account must be apportioned between United States and foreign sources based on the allocation and apportionment of the—

(A) Depreciation allowed for the general asset account as of the end of the taxable year in which the disposition occurs if paragraph (e)(2) of this section applies to the disposition;

(B) Depreciation allowed for the general asset account as of the time of the disposition if the taxpayer applies paragraph (e)(3)(ii) of this section to the disposition of all of the assets, or the last asset, in the general asset account; or

(C) Depreciation allowed for the disposed asset for only the taxable year in which the disposition occurs if the taxpayer applies paragraph (e)(3)(iii) to the disposition of the asset in a qualifying disposition or if the asset is disposed in a transaction described in paragraph (e)(3)(v) (anti-abuse rule) of this section.

(ii) *Formula for determining foreign source income, gain, or loss.* The amount of ordinary income, gain, or loss recognized on the disposition that shall be treated as foreign source income, gain, or loss must be determined under the formula in this paragraph (f)(2)(ii). For purposes of this formula, the allowed depreciation deductions are determined for the applicable time period provided in paragraph (f)(2)(i) of this section. The formula is:

$$\begin{array}{c}\text{Foreign Source Income,}\\ \text{Gain, or Loss}\\ \text{from the Disposition}\\ \text{of an Asset}\end{array} = \begin{array}{c}\text{Total Ordinary Income,}\\ \text{Gain, or Loss}\\ \text{from Disposition}\\ \text{of an Asset}\end{array} \times \begin{array}{c}\text{Allowed Depreciation Deductions}\\ \text{Allocated and Apportioned to}\\ \text{Foreign Source Income/Total}\\ \text{Allowed Depreciation Deductions}\\ \text{for the General Asset Account}\\ \text{or for the Disposed Asset}\\ \text{(as applicable)}\end{array}$$

(3) *Section 904(d) separate categories.* If the assets in the general asset account generate foreign source income in more than one separate category under section 904(d)(1) or another section of the Code (for example, income treated as foreign source income under section 904(g)(10)), or under a United States income tax treaty that requires the foreign tax credit limitation to be determined separately for specified types of income, the amount of ‘‘foreign source income, gain, or loss from the disposition of an asset’’ (as determined under the formula in paragraph (f)(2)(ii) of this section) must be allocated and apportioned to the applicable separate category or categories under the formula in this paragraph (f)(3). For purposes of this formula, the allowed depreciation deductions are determined for the applicable time period provided in paragraph (f)(2)(i) of this section. The formula is:

$$\begin{array}{c}\text{Foreign Source Income,}\\ \text{Gain, or Loss}\\ \text{In a Separate}\\ \text{Category}\end{array} = \begin{array}{c}\text{Foreign Source Income,}\\ \text{Gain, or Loss}\\ \text{from the Disposition}\\ \text{of an Asset}\end{array} \times \begin{array}{c}\text{Allowed Depreciation Deductions}\\ \text{Allocated and Apportioned to a}\\ \text{Separate Category/Total}\\ \text{Allowed Depreciation Deductions}\\ \text{and Apportioned to}\\ \text{Foreign Source Income}\end{array}$$

(g) *Assets subject to recapture.* If the basis of an asset in a general asset account is increased as a result of the recapture of any allowable credit or deduction (for example, the basis adjustment for the recapture amount under section 30(d)(2), 50(c)(2), 179(d)(10), or 179A(e)(4)), general asset account treatment for the asset terminates as of the first day of the taxable year in which the recapture event occurs. Consequently, the taxpayer must remove the asset from the general asset account as of that day and must make the adjustments to the general asset account described in paragraph (e)(3)(iii)(C)(*2*) through (*4*) of this section.

(h) *Changes in use*—(1) *Conversion to personal use.* An asset in a general asset account becomes ineligible for general asset account treatment if a taxpayer uses the asset in a personal activity during a taxable year. Upon a conversion to personal use, the taxpayer must remove the asset from the general asset account as of the first day of the taxable year in which the change in use occurs and must make the adjustments to the general asset account described in paragraph (e)(3)(iii)(C)(*2*) through (*4*) of this section.

(2) *Other changes in use.* [Reserved].

(i) *Identification of disposed or converted asset.* A taxpayer may use any reasonable method that is consistently applied to the taxpayer's general asset accounts for purposes of determining the unadjusted depreciable basis of a disposed or converted asset in a transaction described in paragraph (e)(3)(iii) (disposition of an asset in a qualifying disposition), (e)(3)(iv) (transactions subject to section 168(i)(7)), (e)(3)(v) (anti-abuse rule), (g) (assets subject to recapture), or (h)(1) (conversion to personal use) of this section.

(j) *Effect of adjustments on prior dispositions.* The adjustments to a general asset account under paragraph (e)(3)(iii), (e)(3)(iv), (e)(3)(v), (g), or (h)(1) of this section have no effect on the recognition and character of prior dispositions subject to paragraph (e)(2) of this section.

(k) *Election*—(1) *Irrevocable election.* If a taxpayer makes an election under this paragraph (k), the taxpayer consents to, and agrees to apply, all of the provisions of this section to the assets included in a general asset account. Except as provided in paragraph (c)(1)(ii)(A), (e)(3), (g), or (h)(1) of this section, an election made under this section is irrevocable and will be binding on the taxpayer for computing taxable income for the taxable year for which the election is made and for all subsequent taxable years. An election under this paragraph (k) is made separately by each person owning an asset to which this section applies (for example, by each member of a consolidated group, at the partnership level (and not by the partner separately), or at the S corporation level (and not by the shareholder separately)).

(2) *Time for making election.* The election to apply this section shall be made on the taxpayer's timely filed (including extensions) income tax return for the taxable year in which the assets included in the general asset account are placed in service by the taxpayer.

(3) *Manner of making election.* In the year of election, a taxpayer makes the election under this section by typing or legibly printing at the top of the Form 4562, ''GENERAL ASSET ACCOUNT ELECTION MADE UNDER SECTION 168(i)(4),'' or in the manner provided for on Form 4562 and its instructions. The taxpayer shall maintain records (for example, ''General Asset Account #1 - all 1995 additions in asset class 00.11 for Salt Lake City, Utah facility'') that identify the assets included in each general asset account, that establish the unadjusted depreciable basis and depreciation reserve of the general asset account, and that reflect the amount realized during the taxable year upon dispositions from each general asset account. (But see section 179(c) and §1.179–5 for the recordkeeping requirements for section 179 property.) The taxpayer's recordkeeping practices should be consistently applied to the general asset accounts. If Form 4562 is revised or renumbered, any reference in this section to that form shall be treated as a reference to the revised or renumbered form.

(l) *Effective date.* This section applies to depreciable assets placed in service in taxable years ending on or after October 11, 1994. For depreciable assets placed in service after December 31, 1986, in taxable years ending before October 11, 1994, the Internal Revenue Service will allow any reasonable method that is consistently applied to the taxpayer's general asset accounts.

[T.D. 8566, 59 FR 51371, Oct. 11, 1994; 59 FR 64849, Dec. 16, 1994]

§1.168(i)–2 Lease term.

(a) *In general.* For purposes of section 168, a lease term is determined under all the facts and circumstances. Paragraph (b) of this section and §1.168(j)–1T, Q&A 17, describe certain circumstances that will result in a period of time not included in the stated duration of an original lease (additional period) nevertheless being included in the lease term. These rules do not prevent the inclusion of an additional period in the lease term in other circumstances.

(b) *Lessee retains financial obligation*—(1) *In general.* An additional period of time during which a lessee may not continue to be the lessee will nevertheless be included in the lease term if the lessee (or a related person)—

(i) Has agreed that one or both of them will or could be obligated to make a payment of rent or a payment in the nature of rent with respect to such period; or

(ii) Has assumed or retained any risk of loss with respect to the property for such period (including, for example, by holding a note secured by the property).

(2) *Payments in the nature of rent.* For purposes of paragraph (b)(1)(i) of this section, a payment in the nature of rent includes a payment intended to substitute for rent or to fund or supplement the rental payments of another. For example, a payment in the nature of rent includes a payment of any kind (whether denominated as supplemental rent, as liquidated damages, or otherwise) that is required to be made in the event that—

(i) The leased property is not leased for the additional period;

(ii) The leased property is leased for the additional period under terms that do not satisfy specified terms and conditions;

(iii) There is a failure to make a payment of rent with respect to such additional period; or

(iv) Circumstances similar to those described in paragraph (b)(2) (i), (ii), or (iii) of this section occur.

(3) *De minimis rule.* For the purposes of this paragraph (b), obligations to make de minimis payments will be disregarded.

(c) *Multiple leases or subleases.* If property is subject to more than one lease (including any sublease) entered into as part of a single transaction (or a series of related transactions), the lease term includes all periods described in one or more of such leases. For example, if one taxable corporation leases property to another taxable corporation for a 20-year term and, as part of the same transaction, the lessee subleases the property to a tax-exempt entity for a 10-year term, then the lease term of the property for purposes of section 168 is 20 years. During the period of tax-exempt use, the property must be depreciated under the alternative depreciation system using the straight line method over the greater of its class life or 25 years (125 percent of the 20-year lease term).

(d) *Related person.* For purposes of paragraph (b) of this section, a person is related to the lessee if such person is described in section 168(h)(4).

(e) *Changes in status.* Section 168(i)(5) (changes in status) applies if an additional period is included in a lease term under this section and the leased property ceases to be tax-exempt use property for such additional period.

(f) *Example.* The following example illustrates the principles of this section. The example does not address common law doctrines or other authorities that may apply to cause an additional period to be included in the lease term or to recharacterize a lease as a conditional sale or otherwise for federal income tax purposes. Unless otherwise indicated, parties to the transactions are not related to one another.

Example Financial obligation with respect to an additional period—(i) *Facts.* X, a taxable corporation, and Y, a foreign airline whose income is not subject to United States taxation, enter into a lease agreement under which X agrees to lease an aircraft to Y for a period of 10 years. The lease agreement provides that, at the end of the lease period, Y is obligated to find a subsequent lessee (replacement lessee) to enter into a subsequent lease (replacement lease) of the aircraft from X for an additional 10-year period. The provisions of the lease agreement require that any replacement lessee be unrelated to Y and that it not be a tax-exempt entity as defined in section 168(h)(2). The provisions of the lease agreement also set forth the basic terms and conditions of the replacement lease, including its duration and the required rental payments. In the event Y fails to secure a replacement lease, the lease agreement requires Y to make a payment to X in an amount determined under the lease agreement.

(ii) *Application of this section.* The lease agreement between X and Y obligates Y to make a payment in the event the aircraft is not leased for the period commencing after the initial 10-year lease period and ending on the date the replacement lease is scheduled to end. Accordingly, pursuant to paragraph (b) of this section, the term of the lease between X and Y includes such additional period, and the lease term is 20 years for purposes of section 168.

(iii) *Facts modified.* Assume the same facts as in paragraph (i) of this *Example,* except that Y is required to guarantee the payment of rentals under the 10-year replacement lease and to make a payment to X equal to the present value of any excess of the replacement lease rental payments specified in the lease agreement between X and Y, over the rental payments actually agreed to be paid by the replacement lessee. Pursuant to paragraph (b) of this section, the term of the lease between X and Y includes the additional period, and the lease term is 20 years for purposes of section 168.

(iv) *Changes in status.* If, upon the conclusion of the stated duration of the lease between X and Y, the aircraft either is returned to X or leased to a replacement lessee that is not a tax-exempt entity as defined in section 168(h)(2), the subsequent method of depreciation will be determined pursuant to section 168(i)(5).

(g) *Effective date*—(1) *In general.* Except as provided in paragraph (g)(2) of this section, this section applies to leases entered into on or after April 20, 1995.

(2) *Special rules.* Paragraphs (b)(1)(ii) and (c) of this section apply to leases entered into after April 26, 1996.

[T.D. 8667, 61 FR 18677, Apr. 29, 1996]

§ 1.168(j)–1T Questions and answers concerning tax-exempt entity leasing rules (temporary).

The following questions and answers concern tax-exempt entity leasing under section 168(j) of the Internal Revenue Code of 1954, as enacted by section 31 of the Tax Reform Act of 1984 (''TRA'') (Pub. L. 98–369):

CONSEQUENCES OF TAX-EXEMPT USE STATUS

Q–1. If recovery property is subject to the tax-exempt entity leasing provisions of section 168(j), how must the taxpayer compute the property's recovery deductions?

A–1. The taxpayer must compute the property's recovery deductions in accordance with section 168(j) (1) and (2); that is, the taxpayer must use the straight line method and the specified recovery period. For property other than 18-year real property, the applicable recovery percentages for the specified recovery period are to be determined with reference to the tables contained in Prop. Treas. Reg. § 1.168–2(g)(3)(iv)(A). For 18-year real property for which a 40-year recovery period is required, the applicable recovery percentages are to be determined under the following table:

40-YEAR STRAIGHT LINE METHOD (ASSUMING MID-MONTH CONVENTION)

If the recovery year is—	And the month in the first recovery year the property is placed in service is—											
	1	2	3	4	5	6	7	8	9	10	11	12
	The applicable recovery percentage is—											
1	2.4	2.2	2.0	1.8	1.6	1.4	1.1	0.9	0.7	0.5	0.3	0.1
2	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
3	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
4	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
6	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
7	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
8	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
9	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
10	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
11	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
12	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
13	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
14	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
15	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
16	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
17	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
18	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
19	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
20	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
21	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
22	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
23	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
24	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
25	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
26	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
27	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5

40-YEAR STRAIGHT LINE METHOD (ASSUMING MID-MONTH CONVENTION)—Continued

If the recovery year is—	And the month in the first recovery year the property is placed in service is—											
	1	2	3	4	5	6	7	8	9	10	11	12
28	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
29	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
30	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
31	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
32	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
33	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
34	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
35	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
36	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
37	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
38	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
39	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
40	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
41	0.1	0.3	0.5	0.7	0.9	1.1	1.4	1.6	1.8	2.0	2.2	2.4

Q–2. If recovery property that was placed in service after December 31, 1980 by a taxable entity subsequently becomes tax-exempt use property, how are such property's cost recovery deductions under section 168 affected?

A–2. A change to tax-exempt use property, as defined in section 168(j)(3), will cause the cost recovery deductions under the accelerated cost recovery system (ACRS) to be recomputed. The allowable recovery deduction for the taxable year in which the change occurs (and for subsequent taxable years) must be determined as if the property had originally been tax-exempt use property. Proper adjustment must be made under the principles of Prop. Treas. Reg. § 1.168–2(j)(3)(i)(B) to account for the difference between the deductions allowable with respect to the property prior to the year of change and those which would have been allowable had the taxpayer used the recovery period and method for tax-exempt use property under section 168(j) (1) and (2). However, no adjustment is made pursuant to the provisions of this A–2 if section 168(j)(2)(C) applies, that is, if the taxpayer had selected a longer recovery period in the year the property was placed in service than the recovery period prescribed for such property under section 168(j)(1).

Example (1). On July 1, 1983, X, a calendar year taxpayer, places in service 5-year recovery property with an unadjusted basis of $100. For 1983, X's allowable deduction is $15 (*i.e.*, .15 × $100). In 1984, the property becomes tax-exempt use property. Under section 168(j), assume the prescribed recovery period is 12 years. For 1984 (and subsequent taxable years), X's allowable deduction is determined as if the property had been tax-exempt use property since 1983, that is, the year it was placed in service. Thus, taxable year 1984 is the property's second recovery year of its 12-year recovery period. Additionally, X must account for the excess allowable recovery deduction of $11 (*i.e.*, the difference between the recovery allowance for 1983 ($15) and the allowance for that year had the property been tax-exempt use property ($4)) in accordance with the principles of Prop. Treas. Reg. § 1.168–2(j)(3)(i)(B). Thus, the recovery allowances in 1984 and 1985 are $7.97, determined as follows:

Unadjusted basis multiplied by the applicable recovery percentage for second recovery year ($100×.09	$9.00
Excess allowable recovery deduction multiplied by the applicable recovery percentage for second recovery year divided by the sum of the remaining unused applicable percentages for tax-exempt use property existing as of the taxable year of change (1984) (($11×.09)/.96)	−1.03
Difference—allowable deduction for 1984	$7.97
Unadjusted basis multiplied by the applicable recovery percentage for third recovery year ($100×.09)	$9.00
Excess allowable recovery deduction multiplied by the applicable recovery percentage for third recovery year divided by the sum of the remaining unused applicable percentages for tax-exempt use property existing as of the taxable year of change (1984) (($11×.09)/.96)	−1.03

Difference—allowable deduction for 1985 .... $7.97

Additionally, X must make a similar adjustment for the taxable years 1986 through 1995, that is, his fourth through thirteenth recovery years.

Example (2). Assume the same facts as in *Example (1)* except that in 1983, X elected under section 168 (b) (3) with respect to the 5-year property to use the optional recovery percentages over a 25-year recovery period. Based on these facts, the provisions of this A–2 do not apply.

DEFINITION OF TAX-EXEMPT USE PROPERTY

Mixed Leases of Real and Personal Property

Q–3. How is a mixed lease of real property and personal property (*e.g.,* a building with furniture) to be treated for purposes of applying the rules of section 168(j)(3) defining which property constitutes tax-exempt use property?

A–3. The general rule is that 18-year real property and property other than 18-year real property are tested separately to determine whether each constitutes tax-exempt use property. However, if a lease of section 1245 class property is incidental to a lease of 18-year real property, and the 18-year real property is not tax-exempt use property, then the section 1245 class property also does not constitute tax-exempt use property. A lease of section 1245 class property will be considered incidental if the adjusted basis of all section 1245 class property leased in the same transaction is 1 percent or less of the adjusted basis of all 18-year real property leased in such transaction.

Buildings Which Are Partially Tax-Exempt Use Property

Q–4. If part of a building is leased to a tax-exempt entity in a disqualified lease and part of the building is leased other than to a tax-exempt entity in a disqualified lease, to what extent do the tax-exempt entity leasing rules apply to such building?

A–4. The taxpaper must determine the amount of the building's unadjusted basis that is properly allocable to the portion of the building that is tax-exempt use property; the section 168(j) rules apply to the allocated amount. Solely for purposes of determining what percentage of the building's basis is subject to the tax-exempt entity leasing rules, no part of the basis is allocated to common areas.

Example. A constructs a 3-story building in 1984 at a cost of $900,000. Each floor consists of 30,000 square feet. The only common area (10,000 square feet) in the building is on the first floor. A leases the first floor (other than the common areas) to a firm that is not a tax-exempt entity. A leases the top two floors to a tax-exempt entity in a 25-year lease. The top two floors constitute tax-exempt use property. Assume that square footage is the appropriate method for allocating basis in this case. Thus, A must allocate $675,000 of the $900,000 basis to the tax-exempt use portion, determined as follows:

$$\frac{\begin{array}{c}\text{square footage of building which is tax-exempt}\\ \text{use property (excluding common areas)}\end{array}}{\begin{array}{c}\text{total square footage in the building}\\ \text{(excluding common areas)}\end{array}} = \frac{60{,}000 \text{ sq. feet}}{80{,}000 \text{ sq. feet}} = 3/4$$

$$3/4 \times \$900{,}000 = \$675{,}000$$

A must compute his recovery deductions on this portion of the basis ($675,000) in accordance with the rules of section 168(j) (1) and (2).

Requirement of a Lease

Q–5. Can the use of property by a party other than a tax-exempt entity result in the property being treated as tax-exempt use property within the meaning of section 168(j)(3)?

A–5. Yes, if based on all the facts and circumstances it is more appropriate to characterize the transaction as a lease to a tax-exempt entity. A transaction can be characterized as a lease to a tax-exempt entity under section 168(j)(6)(A), which provides that ''the term 'lease' includes any grant of a right to use property''; or under the service contract rules of section 7701(e). See Q&A #18 for rules regarding service contracts.

Example. A trust is executed on January 1, 1984, to create a pooled income fund (P) that meets the requirements of section 642(c)(5). A university (U) that is tax-exempt under section 501(c)(3) is the remainderman of the pooled income fund. P's purpose is to construct and operate an athletic center on land adjacent to U's campus. Construction of the athletic center, which has a 50-year useful life, was completed and the center was placed in service on February 1, 1985. The athletic center is managed for a fee by M, an unrelated taxable organization which operates athletic facilities open to the public. Office space at the facility is occupied rent-free by both the U athletic department and M. Scheduling of activities at the center is handled jointly by members of U's athletic department and M. General operating expenses of the athletic center are paid by P. Although the athletic center is open to the public for a membership fee, the majority of members are U's students who pay membership fees as part of their tuition. These fees are remitted by U to P. This arrangement is in substance a grant to U of a right to use the facility, and therefore a lease to U under section 168(j)(6)(A). U, as remainderman, will have obtained title to the entire building when the last pooled income fund donor dies. This arrangement is a disqualified lease because either (1) U has the equivalent of a fixed price purchase option under section 168(j)(3)(B)(ii)(II) (if U receives title as remainderman before the end of the useful life of the building), or (2) the lease has a term in excess of 20 years under section 168(j)(3)(B)(ii)(III) (if U does not receive title as remainderman until 20 years have elapsed), or both. Therefore, the allowable recovery deductions (without regard to salvage value) must be computed in accordance with section 168(j) (1) and (2). In addition, because this arrangement is treated as a lease under section 168(j), the facility is used by U for purposes of section 48(a)(4), and thus no investment tax credit is permitted with respect to any portion of the facility. This arrangement also may be treated as a lease to U for all purposes of chapter 1 of the Internal Revenue Code under section 7701 (e).

''More Than 35 Percent of the Property'' Test

Q–6. How is the percentage of 18-year real property leased to a tax-exempt entity in a disqualified lease to be determined for purposes of the ''more than 35 percent of the property'' test of section 168(j)(3)(B)(iii)?

A–6. The phrase ''more than 35 percent of the property'' means more than 35 percent of the net rentable floor space of the property. The net rentable floor space in a building does not include the common areas of the building, regardless of the terms of the lease. For purposes of the ''more than 35 percent of the property'' rule, two or more buildings will be treated as separate properties unless they are part of the same project, in which case they will be treated as one property. Two or more buildings will be treated as part of the same project if the buildings are constructed, under a common plan, within a reasonable time of each other on the same site and will be used in an integrated manner.

Q–7. Are disqualified leases to different tax-exempt entities (regardless of whether they are related) aggregated in determining whether 18-year real property is tax-exempt use property?

A–7. Yes.

Example. A tax-exempt entity participates in industrial development bond financing for the acquisition of a new building by a taxable entity. The tax-exempt entity leases 60 percent of the net rentable floor space in the building for 5 years. Sixty percent of the building is tax-exempt use property. If the same tax-exempt entity leased only 19 percent of the net rentable floor space in the building for 5 years, no portion of the building would be tax-exempt use property because not more than 35 percent of the property is leased to a tax-exempt entity pursuant to a disqualified lease. If such tax-exempt entity leased only 19 percent of the net rentable floor space in the building for 5 years and another tax-exempt entity leased 20 percent of the net rentable floor space in the building for a term in excess of 20 years (or a related entity leased 20 percent of the building for 5 years), 39 percent of the building would be tax-exempt use property. See A–4 regarding the determination of the amount of the building's unadjusted basis that is properly allocable to the portion of the building that is tax-exempt use property.

''Predominantly Used'' Test

Q–8. What does the term ''predominantly used'' mean for purposes of the section 168(j)(3)(D) exception to the tax-exempt use property rules?

A–8. ''Predominantly used'' means that for more than 50 percent of the time used, as determined for each taxable year, the real or personal property is used in an unrelated trade or business the income of which is subject to tax under section 511 (determined without regard to the debt-financed income rules of section 514). If only a portion of property is predominantly used in an unrelated trade or business, the remainder may nevertheless be tax-exempt use property.

Q–9. How is the ‘‘predominantly used’’ test of section 168(j)(3)(D) to be applied to a building?

A–9. The ‘‘predominantly used’’ test is to be applied to a building in the following manner:

(i) Identify the discrete portions (excluding common areas) of the building which are leased to a tax-exempt entity in a disqualified lease under section 168(j)(3)(B)(ii). A discrete portion of a building is an area physically separated from other areas. An area is physically separated from other areas if separated by permanent walls or by partitions serving as room dividers if such partitions remain in place throughout the taxable year. A discrete portion can be the entire building, floors, wings, offices, rooms, or a combination thereof. For example, a building whose entire internal space consists of a single large room used as a gymnasium has only one discrete portion. On the other hand, if the building has 3 stories with 10 offices on each floor, each of the 30 offices is a discrete portion.

(ii) Determine whether each discrete portion is predominantly used in an unrelated trade or business subject to tax under section 511. See A–8 for the rules regarding how to make this determination.

(iii) Once the discrete portions of the building that constitute tax-exempt use property have been identified, an appropriate allocation of basis must be made to such discrete portions. See A–4 for rules regarding how to make such allocation.

(iv) The application of these rules is illustrated by the following example:

Example. A building, constructed in 1985, is leased in its entirety to a tax-exempt entity (E) pursuant to a 25-year lease. The building has 25,000 square feet of net rentable floor space and consists of an auditorium (15,000 square feet), a retail shop (10,000 square feet), plus common area of 5,000 square feet. E uses the auditorium 80 percent of the time in its exempt activity and 20 percent of the time in an unrelated trade or business subject to tax under section 511. The retail shop is used 90 percent of the time in an unrelated trade or business subject to tax under section 511 and 10 percent of the time in an exempt activity. Thus, the auditorium is tax-exempt use property; the retail shop is not. An appropriate allocation of basis to the auditorium must be made. See A–4.

DEFINITION OF TAX-EXEMPT ENTITY

Q–10. What elections must be made in order to avoid the ‘‘5-year lookback’’ rule of section 168(j)(4)(E)(i)?

A–10. Only organizations which were exempt from tax under section 501(a) as organizations described in section 501(c)(12) (and which are no longer tax-exempt) may avoid the 5-year lookback rule of section 168(j)(4)(E)(i). In order to avoid the 5-year lookback rule with respect to any property, two elections are required. First, the organization must elect not to be exempt from tax under section 501(a) during the tax-exempt use period (as defined in section 168(j)(4)(E)(ii)(II)) with respect to the property. Second, the organization must elect to be taxed on the exempt arbitrage profits as provided in section 31(g)(16) of the Tax Reform Act of 1984. See Temp. Treas. Reg. §301.9100–6T(a) for the time and manner of making these elections. These elections, once made, are irrevocable.

Q–11. Does the term ‘‘tax-exempt entity’’ include tax-exempt plans of deferred compensation and similar arrangements?

A–11. Yes. For purposes of section 168 (j), the term ‘‘tax-exempt entity’’ includes trusts or other entities that are tax-qualified under section 401 (a), individual retirement accounts, simplified employee pensions, and other tax-exempt arrangements described in subchapter D of chapter 1 of the Internal Revenue Code.

SPECIAL RULES FOR HIGH TECHNOLOGY EQUIPMENT

Q–12. What effect do the tax-exempt entity leasing provisions have on ‘‘qualified technological equipment’’?

A–12. ‘‘Qualified technological equipment’’ which is leased to a tax-exempt entity for a term of 5 years or less shall not constitute tax-exempt use property. If ‘‘qualified technological equipment’’ which is leased to a tax-exempt entity for a term of more than 5 years constitutes tax-exempt use property (as defined in section 168(j)(3)) and is not used predominantly outside the United States, the rules of section 168(j) (1) and (2) apply except that the recovery period to be used for such equipment shall be 5 years regardless of the length of the lease term. For purposes of section 168(j)(5), ‘‘qualified technological equipment’’ means (1) any computer or peripheral equipment, (2) any high technology telephone station equipment installed on the customer’s premises, and (3) any high technology medical equipment. For definitions of these terms, see A–13 through A–16.

Q–13. What is a ‘‘computer’’ as that term is used in section 168(j)(5)(C)(i)(I)?

A–13. Computers are electronically activated devices that are programmable by the user and that are capable of accepting information, applying prescribed processes to it, and supplying the results of those processes with or without human intervention. Computers consist of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities. A computer does not include any equipment which is an integral part of property that is not a user-programmable device, any video games or other devices used by the user primarily for amusement or entertainment purposes, or any typewriters, calculators, adding or accounting machines, copiers, duplicating equipment, or similar equipment. A computer does not include any equipment that is not tangible personal property.

Q–14. What is ‘‘peripheral equipment’’ as that term is used in section 168(j)(5)(C)(i)(I)?

A–14. Peripheral equipment means tangible personal property such as auxiliary machines, whether on-line or off-line, that are designed to be placed under the control of the central processing unit of the computer. Some examples of peripheral equipment are: card readers, card punches, magnetic tape feeds, high speed printers, optical character readers, tape cassettes, mass storage units, paper tape equipment, keypunches, data entry devices, teleprinters, terminals, tape drives, disc drives, disc files, disc packs, visual image projector tubes, card sorters, plotters, and collators. Peripheral equipment does not include equipment not included in Asset Depreciation Range (ADR) 00.12 listed in section 3 of Rev. Proc. 83–35, 1983–1 C.B. 745, 746. Peripheral equipment also does not include any equipment that is an integral part of property that is not a user-programmable device, any video games or other devices used by the user primarily for amusement or entertainment purposes, or any typewriters, calculators, adding or accounting machines, copiers, duplicating equipment, or similar equipment.

Q–15. What does ‘‘high technology telephone station equipment’’ mean as that term is used in section 168(j)(5)(C)(i)(II)?

A–15. High technology telephone station equipment includes only tangible personal property described in asset depreciation range (ADR) class 48.13 listed in section 3 of Rev. Proc. 83–35, 1983–1 C.B. 745, 758 that has a high technology content and which, because of such high technology content, can reasonably be expected to become obsolete before the expiration of its physical useful life. For example, telephone booths and telephones which include only a standard dialing feature are not high technology equipment. However, telephones with features such as an abbreviated dialing short program, an automatic callback, or conference call feature may qualify as high technology equipment. High technology telephone station equipment may include terminal equipment including such extra features but not terminal equipment used in conjunction with features offered through central office capacity. There are no current plans to utilize the regulatory authority provided in section 168(j)(5)(C)(iv).

Q–16. What is ‘‘high technology medical equipment’’ as that term is used in section 168 (j)(5)(C)(i)(III)?

A–16. High technology medical equipment is any electronic, electromechanical, or computer-based high technology equipment which is tangible personal property used in the screening, monitoring, observation, diagnosis, or treatment of human patients in a laboratory, medical, or hospital environment. High technology medical equipment includes only equipment that has a high technology content and which, because of such high technology content, can reasonably be expected to become obsolete before the expiration of its physical useful life. High technology medical equipment may include computer axial tomography (C.A.T.) scanners, nuclear magnetic resonance equipment, clinical chemistry analyzers, drug monitors, diagnostic ultrasound scanners, nuclear cameras, radiographic and fluoroscopic systems, Holter monitors, and bedside monitors. Incidental use of any such equipment for othe purposes, such as research, will not prevent it from qualifying as high technology medical equipment. There are no current plans to utilize the regulatory authority provided in section 168(j)(5)(C)(iv).

LEASE TERM

Q–17. What is included in determining the length of a lease term?

A–17. (i) The lease term starts when the property is first made available to the lessee under the lease. The lease term includes not only the stated duration, but also any additional period of time which is within the ''realistic contemplation of the parties at the time the property is first put into service. *Hokanson* v. *Commissioner,* 730 F.2d 1245, 1248 (9th Cir. 1984). A subsequent period of time is included in the term of the original lease if the circumstances indicate that the parties, upon entering into the original lease, had informally agreed that there would be an extension of the original lease.

(ii) With respect to personal property, the lease term includes all periods for which the tax-exempt lessee or a related party (as defined under section 168(j)(7)) has a legally enforceable option to renew the lease, or the lessor has a legally enforceable option to compel its renewal by the tax-exempt entity or a related party. This is true regardless of the renewal terms of the lease agreement or whether the lease is in fact renewed.

(iii) With respect to real property, the lease term includes all periods for which the tax-exempt lessee or a related party (as defined under section 168(j)(7)) has a legally enforceable option to renew the lease, or the lessor has a legally enforceable option to compel its renewal by the tax-exempt entity or a related party, unless the option to renew is at fair market value, determined at the time of renewal. The *Hokanson* facts and circumstances test (see (i) above) may cause the term of a fair market value renewal option to be treated as part of the original lease term.

(iv) Successive leases that are part of the same transaction or a series of related transactions concerning the same or substantially similar property shall be treated as one lease. This rule applies if at substantially the same time or as part of one arrangement the parties enter into multiple leases covering the same or substantially similar property, each having a different term. If so, then the original lease term will be treated as running through the term of the lease that has the last expiration date of the multiple leases. The multiple lease rule will not apply merely because the parties enter into a new lease at fair market rental value at the end of the original lease term.

(v) The application of the above rules is illustrated by the following examples:

Example (1). On December 30, 1984, X, a taxable corporation, and Y, a tax-exempt entity, enter into a requirements contract for a period of 3 years. The requirements contract sets the terms and conditions under which X and Y will do business on those occasions when X actually leases items of personal property to Y. The requirements contract imposes no obligation on either party to actually enter into a lease agreement. Pursuant to this requirements contract, on January 1, 1985, X and Y enter into three separate leases. Under the leases, Y obtained the use of three identical items of personal property, each for a term of six months beginning on January 1, 1985. On March 1, 1985, Y entered into a fourth lease for the use of a fourth item of personal property substantially similar to the other three items for a term of 20 months beginning on that date. The mere fact that all 4 leases were entered into pursuant to the same requirements contract and involved the same or substantially similar property does not require aggregation of the terms of such leases under section 168(j)(6)(B).

Example (2). Assume the same facts as in *example* (1) except that, instead of the 4 leases entered into in example (1), on January 1, 1985, pursuant to the requirements contract, X and Y enter into a lease for an item of personal property for one year. On January 10, 1986, after the end of the one-year lease term, X and Y enter into a second lease with respect to the same or substantially similar equipment. Assuming that the requirements contract itself is not a lease and assuming that the parties did not have any informal or implicit understanding (other than the general expectation of doing some business in the future) to enter into the second lease when the first lease was entered into, these two leases are not aggregated. The mere fact that the parties entered into two leases under the requirements contract does not result in the application of the section 168(j)(6)(B) rules for successive leases.

Example (3). The facts are the same as in *example* (2) except that the parties did have an understanding, informal or otherwise, at the time of the first lease that they would enter into a second lease of the same personal property. The terms of the leases are aggregated.

Example (4). The facts are the same as in *example* (2) except that, instead of the leases entered into in example (2), on January 1, 1985, X and Y enter into two separate leases, each for a term of one year. One lease is for the period beginning on January 1, 1985 and ending on December 31, 1985. The other lease is for the period beginning on January 1, 1986 and ending on December 31, 1986. Both leases involve the same or substantially similar personal property. Under the successive lease rule, the terms of both leases are aggregated for purposes of determining the term of either lease under section 168(j)(6)(B). This result occurs because the two leases were entered into as part of the same transaction, and they relate to the same or substantially similar personal property.

SERVICE CONTRACT ISSUES

Q–18. How is the treatment of service contracts affected by the service contract rules set forth in section 7701(e)?

A–18. If a contract which purports to be a service contract is treated as a lease under section 7701(e), such contract is to be treated as a lease for all purposes of Chapter 1 of the Internal Revenue Code (including, for example, section 168(j) and section 48(a) (4) and (5)).

Q–19. Does a contract to provide heating, maintenance, etc. services in low-income housing come within the low-income housing exception in section 7701(e)(5) to the service contract rules set forth in section 7701(e)?

A–19. No. Although certain low-income housing operated by or for an organization described in paragraphs (3) or (4) of section 501(c) is not subject to the service contract rules in section 7701(e), a contract, for instance, to provide heating services to low-income housing units, such as by installing and operating a furnace, does not constitute ‘‘low-income housing’’ within the meaning of section 7701(e)(5). Thus, the rules of section 7701(e) apply to such contracts in determining whether they are properly treated as leases.

PARTNERSHIP ISSUES

Q–20. Do the provisions applicable to property leased to partnerships, set forth in section 168(j)(8), and the provisions applicable to property owned by partnerships, set forth in section 168(j)(9), apply to pass-through entities other than partnerships?

A–20. Yes. Rules similar to those provided in paragraphs (8), (9)(A), (9)(B), and (9)(C) of section 168(j) and those provided in Q & A’s 21–26 apply to pass-through entities other than partnerships.

Q–21. What rules apply to property owned by a partnership in which one or more partners is a tax-exempt entity?

A–21. If property is owned by a partnership having both taxable and tax-exempt entities as partners, and any allocation to a tax-exempt entity partner is not a ‘‘qualified allocation’’ under section 168(j)(9)(B), then such entity’s proportionate share of the property is to be treated as tax-exempt use property for all purposes. However, the property will not be tax-exempt use property if it is predominantly used by the partnership in an activity which, with respect to the tax-exempt entity, is an unrelated trade or business. An activity is an unrelated trade or business with respect to a tax-exempt entity if such entity’s distributive share of the partnership’s gross income from the activity is includible in computing its unrelated business taxable income under section 512(c) (determined without regard to the debt-financed income rules of section 514). A tax-exempt entity partner's proportionate share of property of a partnership equals such partner's share of that item of the partnership's income or gain (excluding income or gain allocated under section 704(c)) in which the tax-exempt entity has the highest share. If the tax-exempt entity partner's share of any item of income or gain (excluding income or gain allocated under section 704(c)) may vary during the period it is a partner, the previous sentence shall be applied with reference to the highest share of any such item that it may receive at any time during such period. The application of these rules is illustrated by the following example:

Example. A partnership (P) operates a factory, which consists of a building and various items of machinery. P has one tax-exempt entity (E) as a partner, and E's proportionate share is 10 percent (*i.e.*, 10 percent is the largest share of any item of income or gain that E may receive during the time E is a partner). Unless P's allocations to E are qualified under section 168(j)(9)(B), 10 percent of each item of partnership property (including the building) is tax-exempt use property, notwithstanding the 35 percent threshold test of section 168(j)(3)(B)(iii) that is otherwise applicable to 18-year real property. However, the property will not be tax-exempt use property if it is predominantly used by the partnership in an activity which, with respect to E, is an unrelated trade or business (determined without regard to the debt-financed income rules of section 514).

Q–22. What consititutes a "qualified allocation" under section 168(j)(9)(B)?

A–22. (i) A "qualified allocation" means any allocation to a tax-exempt entity which is consistent with such entity's being allocated the same share (*i.e.*, the identical percentage) of each and every item of partnership income, gain, loss, deduction, credit, and basis during the entire period such entity is a partner. Except as provided in A–23, an allocation is not qualified if it does not have substantial economic effect under section 704(b). However, for purposes of the two preceding sentences, items allocated under section 704(c) (relating to contributed property) are not taken into account. An allocation is not a "qualified allocation" under section 168(j)(9)(B) if the partnership agreement provides for, or the partners have otherwise formally or informally agreed to, any change (regardless of whether such change is contingent upon the happening of one or more events) in the tax-exempt entity's distributive share of income, gain, loss, deduction, credit, or basis at any time during the entire period the tax-exempt entity is a partner.

(ii) A change in a tax-exempt entity's distributive share of income, gain, loss, deduction, credit, or basis which occurs as a result of a sale or redemption of a partnership interest (or portion thereof) or a contribution of cash or property to the partnership shall be disregarded in determining whether the partnership allocations are qualified, provided that such transaction is based on fair market value at the time of the transaction and that the allocations are qualified after the change. For this purpose, the consideration determined by the parties dealing at arm's length and with adverse interests normally will be deemed to satisfy the fair market value requirement. In addition, a change in a tax-exempt entity's distributive share which occurs as a result of a partner's default (other than a prearranged default) under the terms of the partnership agreement will be disregarded, provided that the allocations are qualified after the change, and that the change does not have the effect of avoiding the restrictions of section 168(j)(9). Any of the above-described transactions between existing partners (and parties related to them) will be closely scrutinized.

Example (1). A, a taxable entity, and B, a tax-exempt entity, form a partnership in 1985. A contributes $800,000 to the partnership; B contributes $200,000. The partnership agreement allocates 95 percent of each item of income, gain, loss, deduction, credit, and basis to A; B's share of each of these items is 5 percent. Liquidation proceeds are, throughout the term of the partnership, to be distributed in accordance with the partner's capital account balances, and any partner with a deficit in his capital account following the distribution of liquidation proceeds is required to restore the amount of such deficit to the partnership. Assuming that these allocations have substantial economic effect within the meaning of section 704(b)(2), they are qualified because B's distributive share of each item of income, gain, loss, deduction, credit, and basis will remain the same during the entire period that B is a partner. The fact that the liquidation proceeds may be distributed in a ratio other than 95 percent/5 percent does not cause the allocations not to be qualified.

Example (2). A, B, and E are members of a partnership formed on July 1, 1984. On that date the partnership places in service a building and section 1245 class property. A and B are taxable entities; E is a tax-exempt entity. The partnership agreement provides that during the first 5 years of the partnership, A and B are each allocated 40 percent of each item of income, gain, loss, deduction, credit, and basis; E is allocated 20 percent. Thereafter, A, B, and E are each allocated 33⅓ percent of each item of income, gain, loss, deduction, credit, and basis. Assume that these allocations meet the substantial economic effect test of section 704(b)(2) and E's distributive share of the partnership's income is not unrelated trade or business income subject to tax under section 511. The allocations to E are not qualified allocations under section 168(j)(9)(B) because E's distributive share of partnership items does not remain the same during the entire period that E is a partner in the partnership. Thus, 33⅓ percent of the building and 33⅓ percent of the section 1245 class property are tax-exempt use property from the time each is placed in service by the partnership and are thus subject to the cost recovery rules of section 168(j) (1) and (2). In addition, no investment tax credit is allowed for 33⅓ percent of the section 1245 class property because of section 48(a)(4).

Q–23. In determining whether allocations constitute qualified allocations, what rules are applied to test allocations that are not governed by the substantial economic effect rules?

A–23. A–22 provides the general rules to be used in determining whether an allocation is a qualified allocation, including the rule that the allocation must have substantial economic effect. However, certain allocations are not governed by the substantial economic effect rules (*e.g.*, an allocation of basis of an oil and gas property is generally governed by section 613A(c)(7)(D), rather than section 704(b)), and other allocations cannot satisfy the substantial economic effect rules (*e.g.*, allocations of credits, allocations of deduction and loss attributable to nonrecourse debt, and allocations of percentage depletion in excess of basis). Since allocations in either of these categories cannot be tested under the substantial economic effect test, these allocations, in order to be qualified, must comply with the relevant Code or regulation section that governs the particular allocation (*e.g.*, in the case of an allocation of basis of an oil and gas property, section 613A(c)(7)(D)).

Q–24. Will the Internal Revenue Service issue letter rulings on the issue of whether an allocation is a ‘‘qualified allocation’’ for purposes of section 168(j)(9)?

A–24. The Internal Revenue Service will accept requests for rulings on the question of whether an allocation is a ‘‘qualified allocation’’ for purposes of section 168(j)(9). Such requests should be submitted in accordance with the appropriate revenue procedure. One requirement of a qualified allocation is that such allocation must have substantial economic effect under section 704(b)(2). Currently, the Service will not rule on the question of whether an allocation has substantial economic effect under section 704(b)(2). Therefore, unless and until this policy is changed, a ruling request regarding a qualified allocation must contain a representation that the subject allocation has substantial economic effect (or complies with A–23, if applicable).

Q–25. Do priority cash distributions which constitute guaranteed payments under section 707(c) disqualify an otherwise qualified allocation?

A–25. Priority cash distributions to partners which constitute guaranteed payments will not disqualify an otherwise qualified allocation if the priority cash distributions are reasonable in amount (*e.g.*, equal to the Federal short-term rate described in section 1274(d)) and are made in equal priorities to all partners in proportion to their capital in the partnership. Other guaranteed payments will be closely scrutinized and, in appropriate cases, will disqualify an otherwise qualified allocation.

Example. A and B form Partnership AB to operate a manufacturing business. A is a tax-exempt entity; B is a taxable person. A contributes $500,000 to the partnership; B contributes $100,000. The partnership agreement provides that A and B are each entitled to cash distributions each year, in equal priority, in an amount equal to 8 percent of their capital contribution. Assume that these payments are reasonable in amount and constitute guaranteed payments under section 707(c). Without taking into consideration the guaranteed payments, all allocations constitute qualified allocations under section 168(j)(9)(B) and A–22. These guaranteed payments will not disqualify such allocations.

Q–26. Can property be treated as tax-exempt use property under both the general rule of section 168(j)(3) and the partnership provisions of section 168(j)(9)?

A–26. Yes. For example, a tax-exempt entity may be a partner in a partnership that owns a building 60 percent of which is tax-exempt use property because it is leased to an unrelated tax-exempt entity under a 25-year lease. The status of the remaining 40 percent depends on whether or not allocations under the partnership agreement are qualified under section 168(j)(9). If the allocations are not qualified under section 168(j)(9), the tax-exempt entity's proportionate share (as determined under section 168(j)(9)(C)) of the remaining 40 percent will be tax-exempt use property. For example, if the tax-exempt entity's proportionate share is 30 percent, then 12 percent of the remaining 40 percent (*i.e.*, .30 times .40) is tax-exempt use property and a total of 72 percent of the property (60 percent +12 percent) is tax-exempt use property.

EFFECTIVE DATE QUESTIONS

Q–27. Does an amendment to a lease (or sublease) to a tax-exempt entity of property which, pursuant to the effective date provisions of section 31(g) of TRA, is not subject to section 168(j) cause such property to be subject to the provisions of section 168(j)?

A–27. An amendment to such a lease (or sublease) does not cause such property to be subject to the provisions of section 168(j) unless the amendment increases the term of the lease (or sublease). However, if the amendment increases the amount of property subject to the lease, the additional property must be tested independently under the effective date provisions of section 31(g) of TRA. See A–31 for special rules regarding improvements to property.

Example. On May 1, 1983, X, a taxable entity, and E, a tax-exempt entity, enter into a lease whereby X will lease to E the top 4 floors of a ten-story building for a lease term of 25 years. In 1985, the lease is amended to provide that E will lease an additional floor for the balance of the lease term. At that time the annual rent due under the lease is increased. Pursuant to the provisions of section 31(g)(2)(A) of TRA, section 168(j) does not apply to the lease to E of the top 4 floors of the building. Assuming that no other provision of section 31(g) of TRA provides otherwise, the floor added to the lease in 1985 is subject to the provisions of section 168(j).

Q–28. If property which is not subject to section 168(j) by virtue of the effective date provisions of section 31(g) of TRA is sold, subject to the lease to the tax-exempt entity, what are the consequences?

A–28. Property to which section 168(j) does not apply by virtue of the effective date provisions set forth in section 31(g) (2), (3), and (4) of TRA will not become subject to section 168(j) merely by reason of a transfer of the property subject to the lease by the lessor (or a transfer of the contract to acquire, construct, reconstruct, or rehabilitate the property), so long as the lessee (or party obligated to lease) does not change. For purposes of the preceding sentence, the term ‘‘transfer’’ includes the sale-leaseback by a taxable lessor of its interest in the property, subject to the underlying lease to the tax-exempt entity. However, if property is transferred to a partnership or other pass-through entity after the effective date of section 168(j)(9) (see section 31(g) of TRA), such property is subject to the provisions of section 168(j)(9).

Q–29. Can property which was leased to a tax-exempt entity after May 23, 1983 and acquired by a partnership before October 22, 1983 be tax-exempt use property?

A–29. Yes. Because the property was leased to a tax-exempt entity after May 23, 1983, it may be tax-exempt use property under section 168(j)(3) and section 31(g)(1) of TRA. However, if the partnership included a tax-exempt entity as a partner, section 168(j)(9) would be inapplicable under section 31(g)(3)(B) of TRA because the partnership acquired the property before October 22, 1983.

Q–30. What is a binding contract for purposes of the transitional rules in section 31(g) of TRA?

A–30. (i) A contract is binding only if it is enforceable under State law against the taxpayer or a predecessor and does not limit damages to a specified amount, as for example, by a liquidated damages provision. A contract that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages for this purpose. In determining whether a contract limits damages, the fact that there may be little or no damages because the contract price does not significantly differ from fair market value will not be taken into account. For example, if a taxpayer entered into an irrevocable contract to purchase an asset for $100 and the contract contained no provision for liquidated damages, the contract is considered binding notwithstanding the fact that the property had a fair market value of $99 and under local law the seller would only recover the difference in the event the purchaser failed to perform. If the contract provided for a refund of the purchase price in lieu of any damages allowable by law in the event of breach or cancellation, the contract is not considered binding.

(ii) A contract is binding even if subject to a condition, so long as the condition is not within the control of either party or a predecessor in interest. A contract will not be treated as ceasing to be binding merely because the parties make insubstantial changes in its terms or because any term is to be determined by a standard beyond the control of either party. A contract which imposes significant obligations on the taxpayer (or a predecessor) will be treated as binding notwithstanding the fact that insubstantial terms remain to be negotiated by the parties to the contract.

(iii) A binding contract to acquire a component part of a larger piece of property will not be treated as a binding contract to acquire the larger piece of property. For example, if a tax-exempt entity entered into a binding contract on May 1, 1983 to acquire a new aircraft engine, there would be a binding contract to acquire only the engine, not the entire aircraft.

Q–31. If an improvement is made to a property that is ‘‘grandfathered’’ (*i.e.*, property that is not subject to section 168(j) because of the effective date provisions of section 31(g) of TRA), to what extent will such improvement be grandfathered?

A–31. Section 31(g)(20)(B) provides that a ‘‘substantial improvement’’ to property is treated as a separate property for purposes of the effective date provisions of section 31(g) of TRA. As a result, a ‘‘substantial improvement’’ will not be grandfathered unless such ‘‘substantial improvement’’ is grandfathered under a provision other than section 31(g)(20)(B). A property that is grandfathered will not become subject to section 168(j) merely because an improvement is made to such property, regardless of whether the improvement is a ‘‘substantial improvement’’. If an improvement other than a ‘‘substantial improvement’’ is made to property (other than land) that is grandfathered, that improvement also will be grandfathered. The determination of whether new construction constitutes an improvement to property or the creation of a new separate property will be based on all facts and circumstances. Furthermore, any improvement to land will be treated as a separate property.

Example. On January 3, 1983, T, a taxable entity, entered into a lease of a parking lot to E, a tax-exempt entity. On January 1, 1985, T begins construction of a building for use by E on the site of the parking lot. The building is completed and placed in service in November 1985. The building is treated as a separate property, and is thus subject to the provisions of section 168(j), unless the building is grandfathered under a provision other than section 31(g)(20)(B) of TRA.

Q–32. What is ‘‘significant official governmental action’’ for purposes of the section 31(g)(4) transitional rule of TRA?

A–32. (i) ‘‘Significant official governmental action’’ involves three separate requirements. First, the action must be an official action. Second, the action must be specific action with respect to a particular project. Third, the action must be taken by a governmental entity having authority to commit the tax-exempt entity to the project, to provide funds for it, or to approve the project under State or local law.

(ii) The first requirement of official action means that the governing body must adopt a resolution or ordinance, or take similar official action, on or before November 1, 1983. The action qualifies only if it conforms with Federal, State, and local law (as applicable) and is a proper exercise of the powers of the governing body. Moreover, the action must not have been withdrawn. There must be satisfactory written evidence of the action that was in existence on or before November 1, 1983. Satisfactory written evidence includes a formal resolution or ordinance, minutes of meetings, and binding contracts with third parties pursuant to which third parties are to render services in furtherance of the project.

(iii) The second requirement of specific action is directed at the substance of the action taken. The action must be a specific action with respect to a particular project in which the governing body indicates an intent to have the project (or the design work for it) proceed. This requires that a specific project have been formulated and that the significant official action be a step toward consummation of the project. If the action does not relate to a specific project or merely directs that a proposal or recommendation be formulated, it will not qualify. The following set of actions with respect to a particular project constitute specific action: the hiring of bond counsel or bond underwriters necessary to assist inthe issuance and sale of bonds to finance a particular project or the adoption of an inducement resolution relating to bonds to be issued for such a project; applying for an Urban Development Action Grant on behalf of the project described in the application, receiving such a grant concerning the project, or the recommendation of a city planning authority to proceed with a project; the enactment of a State law authorizing the sale, lease, or construction of the property; the appropriation of funds for the property or authorization of a feasibility study or a development services contract with respect to it; the approval of financing arrangements by a regulatory agency; the enactment of a State law designed to provide funding for a project; the certification of a building as a historic structure by a State agency and the Department of the Interior; or the endorsement of the application for a certification of need with respect to a medical facility by a regulatory agency other than the agency empowered to issue such a certificate.

(iv) The third requirement for significant official governmental action is that the action must be taken by a Federal, State, or local governing body having authority to commit the tax-exempt entity to the project, to provide funds for it, or to approve the project under applicable law.

If the chief executive or another representative of a governing body has such authority, action by such representative would satisfy the requirement of this (iv). A governing body may have the authority to commit the tax-exempt entity to a project notwithstanding the fact that the project cannot be consummated without other governmental action being taken. For example, a city council will be treated as having authority to commit a city to do a sale-leaseback of its city hall notwithstanding the fact that State law needs to be amended to permit such a transaction. Similarly, if a local project cannot be completed without Federal approval, either legislative or administrative, the obtaining of such approval satisfies the requirements of this (iv).

(v) Routine governmental action at a local level will not qualify as significant official governmental action. Routine governmental action includes the granting of building permits or zoning changes and the issuance of environmental impact statements.

(vi) In order to qualify under the transitional rule of TRA section 31(g)(4), a sale and leaseback pursuant to a binding contract entered into before January 1, 1985 must be part of the project as to which there was significant official governmental action. Except as provided in the following sentence, where there has been significant official governmental action on or before November 1, 1983 with respect to the construction, reconstruction or rehabilitation of a property, the sale and leaseback of such property pursuant to a binding contract entered into before January 1, 1985 will be treated as part of the project which was the subject of the significant official governmental action. However, if the construction, reconstruction or rehabilitation was substantially completed prior to January 1, 1983, the sale and leaseback of such property will be treated as a separate project, unless the sale and leaseback was contemplated at the time of the significant official governmental action. Nevertheless, where the sale and leaseback is treated as a separate project, section 31(g)(4) may apply if there was significant official governmental action on or before November 1, 1983, with respect to such sale and leaseback. The application of this provision is illustrated by the following example:

Example. In the summer of 1927, the Board of Aldermen of City C passed a resolution authorizing the design and contruction of a new city hall and appropriated the funds necessary for such project. Construction was completed in 1928. At the time of the significant official governmental action, City C had no plan to enter into a sale-leaseback arrangement with respect to the facility. On December 15, 1984, City C entered into a binding sale-leaseback arrangement concerning the city hall. This transaction will not qualify for exclusion from section 168(j) under the section 31(g)(4) of TRA since construction of the facility in question was substantially completed before January 1, 1983. If, however, there had been significant official governmental action on or before November 1, 1983 with respect to the sale-leaseback project, then the transitional rule of section 31(g)(4) of TRA would apply.

[T.D. 8033, 50 FR 27224, July 2, 1985, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

§ 1.168A–1 Amortization of emergency facilities; general rule.

(a) A person (including an estate or trust (see section 642(f) and § 1.642(f)–1) and a partnership (see section 703 and § 1.703–1)) is entitled, by election, to a deduction with respect to the amortization of the adjusted basis (for determining gain) of an emergency facility, such amortization to be based on a period of 60 months. As to the adjusted basis of an emergency facility, see § 1.168A–5. The taxpayer may elect to begin the 60-month amortization period with (1) the month following the month in which such facility was completed or acquired, or (2) the taxable year succeeding that in which such facility was completed or acquired (see § 1.168A–2). The date on which, or the month within which, an emergency facility is completed or acquired is to be determined upon the facts in the particular case. Ordinarily, the taxpayer is in possession of all the facts and, therefore, in a position to ascertain such date. A statement of the date ascertained by the taxpayer, together with a statement of the pertinent facts relied upon, should be filed with the taxpayer's election to take amortization deductions with respect to such facility.

(b) Generally, an amortization deduction will not be allowed with respect to an emergency facility for any taxable year unless such facility has been certified before the date of filing of the taxpayer's income tax return for such taxable year. However, this limitation does not apply in the case of a certificate made after August 22, 1957, for an emergency facility to provide primary processing for uranium ore or uranium concentrate under a program of the Atomic Energy Commission for the development of any sources of uranium ore or uranium concentrate, if application for such certificate was filed either (1) before September 2, 1958, and before the expiration of six months after the beginning of construction, reconstruction, erection, or installation or the date of acquisition of the facility, or (2) after September 1, 1958, and on or before December 2, 1958.

(c) In general, with respect to each month of the 60-month period which falls within the taxable year, the amortization deduction is an amount equal to the adjusted basis of the facility at the end of each month divided by the number of months (including the particular month for which the deduction is computed) remaining in the 60-month period. The adjusted basis at the end of any month shall be computed without regard to the amortization deduction for such month. The total amortization deduction with respect to an emergency facility for a particular taxable year is the sum of the amortization deductions allowable for each month of the 60-month period which falls within such taxable year. The amortization deduction taken for any month is in lieu of the deduction for depreciation which would otherwise be allowable under section 167. See, however, § 1.168A–6, relating to depreciation with respect to any portion of the emergency facility not subject to amortization.

(d) This section may be illustrated by the following examples:

Example (1). On July 1, 1954, the X Corporation, which makes its income tax returns on the calendar year basis, begins the construction of an emergency facility which is completed on September 30, 1954, at a cost of $240,000. The certificate covers the entire construction. The X Corporation elects to take amortization deductions with respect to the facility and to begin the 60-month amortization period with October, the month following its completion. The adjusted basis of the facility at the end of October is $240,000. The allowable amortization deduction with respect to such facility for the taxable year 1954 is $12,000, computed as follows:

Monthly amortization deductions:	
October: $240,000 divided by 60	$4,000
November: $236,000 ($240,000 minus $4,000) divided by 59	4,000
December: $232,000 ($236,000 minus $4,000) divided by 58	4,000
Total amortization deduction for 1954	12,000

Example (2). The Y Corporation, which makes its income tax returns on the basis of a fiscal year ending November 30, purchases an emergency facility (No. 1) on July 29, 1955. On June 15, 1955, it begins the construction of an emergency facility (No. 2) which is completed on August 2, 1955. The entire acquisition and construction of such facilities are covered by the certificate. The Y Corporation elects to take amortization deductions with respect to both facilities and to begin the 60-month amortization period in each case with the month following the month of acquisition or completion. At the end of the first month of the amortization period the adjusted basis of facility No. 1 is $300,000 and the adjusted basis of facility No. 2 is $54,000. In September 1955, facility No. 1 is damaged by fire, as a result of which its adjusted basis is properly reduced by $25,370. The allowable amortization deduction with respect to such facilities for the taxable year ending November 30, 1955, is $21,410, computed as follows:

Facility No. 1

Monthly amortization deductions:	
August: $300,000 divided by 60	$5,000
September: $269,630 ($300,000 minus $5,000 and $25,370) divided by 59	4,570
October: $265,060 ($269,630 minus $4,570) divided by 58	4,570
November: $260,490 ($265,060 minus $4,570) divided by 57	4,570
Amortization deduction for 1955	18,710

Facility No. 2

Monthly amortization deductions:	
September: $54,000 divided by 60	$900
October: $53,100 divided by 59	900
November: $52,200 divided by 58	900
Amortization deduction for 1955	2,700
Total amortization deduction for 1955	21,410

Example (3). On June 15, 1954, the Z Corporation, which makes its income tax returns on the calendar year basis, completes the construction of an emergency facility at a cost of $110,000. In its income tax return for 1954, filed on March 15, 1955, the Z Corporation elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with July 1954, the month following its completion. No certificate with respect to such facility is made until April 10, 1955, and therefore no amortization deduction with respect to such facility is allowable for any month in the taxable year 1954. The Z Corporation is entitled, however, to take a deduction for depreciation of such facility for the taxable year 1954, such deduction being assumed, for the purposes of this example, to be $2,000. Accordingly, the adjusted basis of such facility at the end of January 1955 (without regard to the amortization deduction for such month) is $108,000 ($110,000 minus $2,000). For the taxable year 1955, the Z Corporation is, with respect to such facility, entitled to an amortization deduction of $24,000, computed as follows:

Monthly amortization deductions:	
January: $108,000 divided by 54	$2,000
February: $106,000 ($108,000 minus $2,000) divided by 53	2,000
March: $104,000 ($106,000 minus $2,000) divided by 52	2,000
For the remaining nine months (similarly computed)	18,000
Total amortization deduction for 1955	24,000

Since the Z Corporation elected in its return for 1954 to take amortization deductions with respect to such facility and to begin the 60-month amortization period with July 1954, it must compute its amortization deductions for the 12 months in the taxable year 1955 on the basis of the remaining months of the established 60-month amortization period, as indicated in the above computation.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960. Redesignated and amended by T.D. 8116, 51 FR 46618, Dec. 24, 1986]

§ 1.168A–2 Election of amortization.

(a) *General rule.* An election by the taxpayer to take amortization deductions with respect to an emergency facility and to begin the 60-month amortization period either with the month following the month in which such facility was completed or acquired, or with the taxable year succeeding the taxable year in which such facility was completed or acquired, shall be made by a statement to that effect in its return for the taxable year in which falls the first month of the 60-month amortization period so elected. However, if the facility is described in section 168(e)(2)(C) and an application for a certificate is filed within the period prescribed by section 9(c) of the Technical Amendments Act of 1958 (72 Stat. 1609) and paragraph (b) of § 1.168A–1, the election may be made by a statement in an amended income tax return for the taxable year in which falls the first month of the 60-month amortization period so elected. The statement and amended return in such case must be filed not later than 90 days after the date the certificate is made or not later than April 4, 1960, whichever is later. Amended income tax returns or claims for credit or refund should also be filed for other taxable years which are within such amortization period and which precede the taxable year in which the election is made. Nothing in this paragraph should be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(b) *Election not made, in prescribed manner.* If the statement of election is not made by the taxpayer as prescribed in paragraph (a) of this section, it may, in the discretion of the Commissioner and for good cause shown, be made in such manner and form and within such time as may be approved by the Commissioner.

(c) *Other requirements and considerations.* No method of making such election other than those prescribed in this section and corresponding sections of prior regulations is permitted. Any statement of election should contain a description clearly identifying each emergency facility for which an amortization deduction is claimed. A taxpayer which does not elect, in the manner prescribed in this section or corresponding sections of prior regulations, to take amortization deductions with respect to an emergency facility shall not be entitled to such deductions.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960. Redesignated and amended by T.D. 8116, 51 FR 46618, Dec. 24, 1986]

§ 1.168A–3 Election to discontinue amortization.

(a) If a taxpayer has elected to take amortization deductions with respect to an emergency facility, it may, after such election and prior to the expiration of the 60-month amortization period, discontinue the amortization deductions for the remainder of the 60-month period. An election to discontinue the amortization deductions shall be made by a notice in writing filed with the district director for the internal revenue district in which the return of the taxpayer is required to be filed, specifying the month as of the beginning of which the taxpayer elects to discontinue such deductions. Such notice shall be filed before the beginning of the month specified therein, and shall contain a description clearly identifying the emergency facility with respect to which the taxpayer elects to discontinue the amortization deductions. If the taxpayer so elects to discontinue the amortization deductions, it shall not be entitled to any further amortization deductions with respect to such facility.

(b) A taxpayer which thus elects to discontinue amortization deductions with respect to an emergency facility is entitled, if such facility is depreciable property under section 167 and the regulations thereunder, to a deduction for depreciation with respect to such facility. The deduction for depreciation shall begin with the first month as to which the amortization deduction is not applicable, and shall be computed on the adjusted basis of the property as of the beginning of such month (see section 1011 and the regulations thereunder).

(c) This section may be illustrated by the following example:

Example. On July 1, 1954, the X Corporation, which makes its income tax returns on the calendar year basis, purchases an emergency facility, consisting of land with a building thereon, at a cost of $306,000 of which $60,000 is allocable to the land and $246,000 to the building. The certificate covers the entire acquisition. The corporation elects to take amortization deductions with respect to the facility and to begin the 60-month amortization period with the taxable year 1955. Depreciation of the building in the amount of $6,000 is deducted and allowed for the taxable year 1954. On March 25, 1956, the corporation files notice with the district director of its election to discontinue the amortization deductions beginning with the month of April 1956. The adjusted basis of the facility on January 31, 1955, is $300,000, or the cost of the facility ($306,000) less the depreciation allowed for 1954 ($6,000). The amortization deductions for the taxable year 1955 and the months of January, February, and March 1956, amount to $75,000, or $5,000 per month for 15 months. Since, at the beginning of the amortization period (January 1, 1955), the adjusted basis of the land ($60,000) is one-fifth of the adjusted basis of the entire facility ($300,000) and since there are no adjustments to basis other than on account of amortization during the period, the adjusted basis of the land should be reduced by $15,000, or one-fifth of the entire amortization deduction, and the adjusted basis of the building should be reduced by $60,000, or four-fifths of the entire amortization deduction. Accordingly, the adjusted basis of the facility as of April 1, 1956, is $225,000, of which $180,000 is allocable to the building for the purpose of depreciation deductions under section 167, and $45,000 is allocable to the land.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960. Redesignated by T.D. 8116, 51 FR 46619, Dec. 24, 1986]

§1.168A–4 Definitions.

As used in the regulations under section 168, the term—

(a) ‘‘Certifying authority’’ means the certifying authority designated by the President by Executive order.

(b) ‘‘Emergency facility’’ means any facility, land, building, machinery, or equipment, or any part thereof, the acquisition of which occurred after December 31, 1949, or the construction, reconstruction, erection, or installation of which was completed after such date, and with respect to which a certificate under section 168(e) has been made. In the case of an application for a certificate under section 168(e) which is filed after March 23, 1951, only the part of any such facility which is constructed, reconstructed, erected, or installed by any person not earlier than six months prior to the filing of such application, and which is certified in accordance with section 168(e), shall be deemed to be an emergency facility, notwithstanding that the other part of such facility was constructed, reconstructed, erected, or installed earlier than six months prior to the filing of such application. However, if the facility is one described in section 168(e)(2)(C) and the application was filed after September 1, 1958, and on or before December 2, 1958, the preceding sentence shall not apply. The term ‘‘emergency facility,’’ as so defined, may include, among other things, improvements of land, such as the construction of roads, bridges, and airstrips, and the dredging of channels.

(c) ‘‘Emergency period’’ means the period beginning on January 1, 1950, and ending on the date on which the President proclaims that the utilization of a substantial portion of the certified emergency facilities is no longer required in the interest of national defense.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960. Redesignated by T.D. 8116, 51 FR 46619, Dec. 24, 1986]

§1.168A–5 Adjusted basis of emergency facility.

(a) *In general.* (1) The adjusted basis of an emergency facility for the purpose of computing the amortization deduction may differ from what would otherwise constitute the adjusted basis of such emergency facility in that it shall be the adjusted basis for determining gain (see Part II (section 1011 and following), Subchapter 0, Chapter 1 of the Code) and in that it may be only a portion of what would otherwise constitute the adjusted basis. It will be only a portion of such other adjusted basis if only a portion of the basis (unadjusted) is attributable to certified construction, reconstruction, erection, installation, or acquisition taking place after December 31, 1949. Also, it will be only a portion of what would otherwise constitute the adjusted basis of the emergency facility if only a portion of the basis (unadjusted) is certified as attributable to defense purposes or, in the case of a certification after August 22, 1957, if only a portion of the basis (unadjusted) is certified as attributable to the national defense program. It is therefore necessary first to determine the unadjusted basis of the emergency facility from which the adjusted basis for amortization purposes is derived.

(2) The unadjusted basis for amortization purposes is the same as the unadjusted basis otherwise determined only when the entire construction, reconstruction, erection, installation, or acquisition takes place after December 31, 1949, and is certified in its entirety by the certifying authority.

(3) In cases in which only a portion of the construction, reconstruction, erection, installation, or acquisition takes place after December 31, 1949, and that portion is certified in its entirety by the certifying authority, the unadjusted basis for the purpose of amortization is so much of the entire unadjusted basis as is attributable to the certified construction, reconstruction, erection, installation, or acquisition which takes place after December 31, 1949. For example, the X Corporation begins the construction of a facility on November 15, 1949, and such facility is completed on April 1, 1952, at a cost of $5,000,000, of which $4,600,000 is attributable to construction after December 31, 1949. The entire construction after December 31, 1949, is certified by the certifying authority. The unadjusted basis of the emergency facility for amortization purposes is therefore $4,600,000. For depreciation of the remaining portion ($400,000) of the cost see § 1.168A–6.

(4) If the certifying authority certifies only a portion of the construction, reconstruction, erection, installation, or acquisition of property which takes place after December 31, 1949, the unadjusted basis for amortization purposes is limited to such portion so certified. Assuming the same facts as in the example in subparagraph (3) of this paragraph, except that only 50 percent of the construction, reconstruction, erection, installation, or acquisition after December 31, 1949, is certified, the unadjusted basis for amortization purposes is 50 percent of $4,600,000, or $2,300,000.

(5) The adjusted basis of an emergency facility for amortization purposes is the unadjusted basis for amortization purposes less the adjustments properly applicable thereto. Such adjustments are those specified in sections 1016 and 1017, except that no adjustments are to be taken into account which increase the adjusted basis. (See paragraph (b) of this section.) If the taxpayer constructs, reconstructs, erects, installs, or acquires an emergency facility pursuant to a cost reimbursement contract with an obligation for reimbursement by the United States of all or a part of the cost of such facility, the unadjusted basis of such facility for amortization purposes shall not include that part of the cost for which the taxpayer is entitled to reimbursement, and the amount received as reimbursement shall be treated as a capital receipt. However, amounts received by a taxpayer which represent in fact compensation by reason of termination of a government contract or payment for articles under such a contract, though denominated reimbursements for all or a part of the cost of an emergency facility, are not to be treated as capital receipts but are to be taken into account in computing income, and are therefore not to be applied in reduction of the basis of such facility.

(6) The following examples will illustrate the computation of the adjusted basis of an emergency facility for amortization purposes:

Example (1). The X Corporation completes an emergency facility on July 1, 1954, the entire unadjusted basis of which is $500,000, and the unadjusted basis of which for the purpose of amortization is $300,000. The X Corporation elects to begin amortization as of January 1, 1955. The only adjustment to basis for the period July 1, 1954, to January 31, 1955, other than depreciation or amortization for January 1955, is $5,000 for depreciation for the last six months of 1954. The adjusted basis for the purpose of amortization is therefore $300,000 less $3,000 (300,000/500,000×$5,000), or $297,000.

Example (2). On July 31, 1956, the Y Corporation has an emergency facility (a building) which was completed on July 1, 1952, the entire basis of which is $500,000 and the unadjusted basis of which for the purpose of amortization is $300,000. The corporation elected to begin amortization as of January 1, 1953, at which time it was entitled to $5,000 depreciation for the last six months of 1952. On July 1, 1956, the facility was damaged by fire, as the result of which its adjusted basis is properly reduced by $200,000. The adjusted basis of the emergency facility as of July 1956 for the purpose of amortization and depreciation, and the adjusted basis for other purposes, are $23,849.18, $49,250.82, and $73,100.00, respectively, computed as follows:

	For amortization	For depreciation	For other purposes
Unadjusted basis	$300,000.00	$200,000.00	$500,000
Less depreciation to Jan. 1, 1953	3,000.00	2,000.00	5,000
Adjusted basis January 1953	297,000.00	198,000.00	495,000
Less amortization for 42 months	207,900.00	....	207,900
Less depreciation for 42 months	....	14,000.00	14,000
Adjusted basis at time of fire	89,100.00	184,000.00	273,100
Less fire loss (apportioned as explained below)	65,250.82	134,749.18	200,000
Adjusted basis after fire loss	23,849.18	49,250.82	73,100

The $200,000 fire loss is applied against the adjusted basis for the purpose of amortization and the adjusted basis for the purpose of depreciation in the proportion that each such adjusted basis at the time of the fire bears to their sum, i.e., 89,100/273,100×$200,000 or $65,250.82, against the amortization basis, and 184,000/273,100×$200,000, or $134,749.18 against the depreciation basis.

(b) *Capital additions.* (1) If, after the completion or acquisition of an emergency facility which has been certified by the certifying authority, further expenditures are made for construction, reconstruction, erection, installation, or acquisition attributable to such facility but not covered by such certification, such expenditures shall not be added to the adjusted basis of the emergency facility for amortization purposes under such certification. If such further expenditures are separately certified in accordance with the provisions of section 168(e) (1) or (2) and this section, they are treated as certified expenditures in connection with a new and separate emergency facility and, if proper election is made, will be taken into account in computing the adjusted basis of such new and separate emergency facility for the purpose of amortization.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. On March 1, 1954, the certifying authority certifies as an emergency facility a heating plant proposed to be constructed by the Z Corporation. Such facility is completed on July 1, 1954. The Z Corporation, on August 1, 1954, begins the installation in the plant of an additional boiler, which is not included in the certification for the plant but is certified as a new and separate emergency facility. For amortization purposes, the adjusted basis of the heating plant is determined without including the cost of the additional boiler. Such cost is taken into account in computing the adjusted basis of the new and separate emergency facility (the boiler), as to which the taxpayer has a separate election for amortization purposes and a separate amortization period.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960. Redesignated and amended by T.D. 8116, 51 FR 46619, Dec. 24, 1986]

§1.168A–6 Depreciation of portion of emergency facility not subject to amortization.

(a) The rule that an amortization deduction with respect to an emergency facility is in lieu of any deduction for depreciation which would otherwise be allowable under section 167 is subject to the exception provided in section 168(f). Under this exception, if the property constituting such facility is depreciable property under section 167 and the regulations thereunder and if the adjusted basis of such facility as computed under section 1011 for purposes other than the amortization deductions is in excess of the adjusted basis computed for the purpose of the amortization deductions, then the excess shall be charged off over the useful life of the facility and recovered through depreciation deductions. Thus, if the construction of an emergency facility is begun on or before December 31, 1949, and completed after such date, no amortization deductions are allowable with respect to the amount attributable to such construction on or before such date (see §1.168A–5). However, if the property constituting such facility is depreciable property under section 167 and the regulations thereunder, then the depreciation deduction provided by such section and regulations is allowable with respect to the amount attributable to such construction on or before December 31, 1949.

(b) Similarly, if only a portion of the construction, reconstruction, erection, installation, or acquisition after December 31, 1949, of an emergency facility has been certified by the certifying authority, and if such facility is depreciable property under section 167 and the regulations thereunder, then the depreciation deduction provided by such section and regulations is allowable with respect to the portion which has not been so certified.

(c) For illustration of the treatment of a depreciable portion of an emergency facility, see example (2) in paragraph (a)(6) of §1.168A–5.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960. Redesignated and amended by T.D. 8116, 51 FR 46619, Dec. 24, 1986]

§1.168A–7 Payment by United States of unamortized cost of facility.

(a) Section 168(g) contemplates that certain payments may be made by the United States to a taxpayer as compensation for the unamortized cost of an emergency facility. If any such payment is properly includible in gross income and has been certified, as provided in section 168(g), as having been paid under the circumstances described therein, a taxpayer which is recovering the adjusted basis of an emergency facility through amortization rather than depreciation may elect to take an amount equal to such payment as an amortization deduction with respect to such facility for the month in which such payment is so includible. Such amortization deduction shall be in lieu of the amortization deduction otherwise allowable with respect to such facility for such month, but it shall not in any case exceed the adjusted basis of such facility (see §1.168A–5) as of the end of such month (computed without regard to any amortization deduction for such month). The election referred to in this paragraph shall be made in the return for the taxable year in which the amount of such payment is includible in gross income.

(b) If a taxpayer is recovering the adjusted basis of an emergency facility through depreciation rather than amortization, the depreciation deduction allowable under section 167 for the month in which the amount of any such payment is includible in gross income shall, at the taxpayer's election, be increased by such amount; but the total deduction with respect to the certified portion of such facility shall not in any case exceed the adjusted basis of such facility (computed as provided in section 168(e) and §1.168A–5 for amortization purposes) as of the end of such month (computed without regard to any amount allowable for such month under section 167 or 168(g)(2)). The election referred to in this paragraph shall be made in the return for the taxable year in which the amount of such payment is includible in gross income.

(c) This section may be illustrated by the following examples:

Example (1). On January 31, 1954, the X Corporation purchases an emergency facility at a cost of $600,000. The certificate covers the entire acquisition. The X Corporation elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with February 1954, the month following the month of acquisition. On July 15, 1955, as a result of the cancellation of certain contracts with the X Corporation, the United States makes a payment of $300,000 to the corporation as compensation for the unamortized cost of such facility. The $300,000 payment is includible in the X Corporation's gross income for July 1955. The adjusted basis of such facility for amortization purposes as of the end of July 1955, computed without regard to any amortization deduction for such month, is $430,000. Accordingly, the corporation is entitled to take an amortization deduction of $300,000 for such month, in lieu of the $10,000 amortization deduction which is otherwise allowable.

Example (2). On November 30, 1954, the Y Corporation purchases an emergency facility, consisting of land with a building thereon, at a cost of $500,000, of which $200,000 is allocable to the land and $300,000 to the building. The certificate covers the entire acquisition. The Y Corporation does not elect to take amortization deductions with respect to such facility, but is entitled to a depreciation deduction with respect to the building at the rate of 3 percent per annum, or $750 per month. On August 12, 1956, as a result of cancellation of certain contracts, the United States makes a payment of $400,000 to the corporation as compensation for the unrecovered cost of such facility. The $400,000 is includible in the Y Corporation's gross income for August 1956. The adjusted basis of the facility as of the end of August 1956, computed without regard to depreciation for such month, is $485,000, of which amount $200,000 is allocable to the land and $285,000 to the building. Accordingly, the corporation is entitled to increase the $750 depreciation deduction for August 1956 by the full amount of the $400,000 payment.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960. Redesignated and amended by T.D. 8116, 51 FR 46619, Dec. 24, 1986]

§1.169–1 Amortization of pollution control facilities.

(a) *Allowance of deduction*—(1) *In general.* Under section 169(a), every person, at his election, shall be entitled to a deduction with respect to the amortization of the amortizable basis (as defined in §1.169–3) of any certified pollution control facility (as defined in §1.169–2), based on a period of 60 months. Under section 169(b) and paragraph (a) of §1.169–4, the taxpayer may further elect to begin such 60-month period either with the month following the month in which the facility is completed or acquired or with the first month of the taxable year succeeding the taxable year in which such facility is completed or acquired. Under section 169(c), a taxpayer who has elected under section 169(b) to take the amortization deduction provided by section 169(a) may, at any time after making such election and prior to the expiration of the 60-month amortization period, elect to discontinue the amortization deduction for the remainder of the 60-month period in the manner prescribed in paragraph (b)(1) of §1.169–4. In addition, if on or before May 18, 1971, an election under section 169(a) has been made, consent is hereby given to revoke such election without the consent of the Commissioner in the manner prescribed in (b)(2) of §1.169–4.

(2) *Amount of deduction.* With respect to each month of such 60-month period which falls within the taxable year, the amortization deduction shall be an amount equal to the amortizable basis of the certified pollution control facility at the end of such month divided by the number of months (including the month for which the deduction is computed) remaining in such 60-month period. The amortizable basis at the end of any month shall be computed without regard to the amortization deduction for such month. The total amortization deduction with respect to a certified pollution control facility for a taxable year is the sum of the amortization deductions allowable for each month of the 60-month period which falls within such taxable year. If a certified pollution control facility is sold or exchanged or otherwise disposed of during 1 month, the amortization deduction (if any) allowable to the original holder in respect of such month shall be that portion of the amount to which such person would be entitled for a full month which the number of days in such month during which the facility was held by such person bears to the total number of days in such month.

(3) *Effect on other deductions.* (i) The amortization deduction provided by section 169 with respect to any month shall be in lieu of the depreciation deduction which would otherwise be allowable under section 167 or a deduction in lieu of depreciation which would otherwise be allowable under paragraph (b) of §1.162–11 for such month.

(ii) If the adjusted basis of such facility as computed under section 1011 for purposes other than the amortization deduction provided by section 169 is in excess of the amortizable basis, as computed under §1.169–3, such excess shall be recovered through depreciation deductions under the rules of section 167. See section 169(g).

(iii) See section 179 and paragraph (e)(1)(ii) of §1.179–1 and paragraph (b)(2) of §1.169–3 for additional first-year depreciation in respect of a certified pollution control facility.

(4) [Reserved]

(5) *Special rules.* (i) In the case of a certified pollution control facility held by one person for life with the remainder to another person, the amortization deduction under section 169(a) shall be computed as if the life tenant were the absolute owner of the property and shall be allowable to the life tenant during his life.

(ii) If the assets of a corporation which has elected to take the amortization deduction under section 169(a) are acquired by another corporation in a transaction to which section 381 (relating to carryovers in certain corporate acquisitions) applies, the acquiring corporation is to be treated as if it were the distributor or transferor corporation for purposes of this section.

(iii) For the right of estates and trusts to amortize pollution control facilities see section 642(f) and §1.642 (f)–1. For the allowance of the amortization deduction in the case of pollution control facilities of partnerships, see section 703 and §1.703–1.

(6) *Depreciation subsequent to discontinuance or in the case of revocation of amortization.* A taxpayer which elects in the manner prescribed under paragraph (b) (1) of §1.169–4 to discontinue amortization deductions or under paragraph (b) (2) of §1.169–4 to revoke an election under section 169(a) with respect to a certified pollution control facility is entitled, if such facility is of a character subject to the allowance for depreciation provided in section 167, to a deduction for depreciation (to the extent allowable) with respect to such facility. In the case of an election to discontinue an amortization deduction, the deduction for depreciation shall begin with the first month as to which such amortization deduction is not applicable and shall be computed on the adjusted basis of the property as of the beginning of such month (see section 1011 and the regulations thereunder). Suchdepreciation deduction shall be based upon the remaining portion of the period authorized under section 167 for the facility as determined, as of the first day of the first month as of which the amortization deduction is not applicable. If the taxpayer so elects to discontinue the amortization deduction under section 169(a), such taxpayer shall not be entitled to any further amortization deduction under this section and section 169(a) with respect to such pollution control facility. In the case of a revocation of an election under section 169(a), the deduction for depreciation shall begin as of the time such depreciation deduction would have been taken but for the election under section 169(a). See paragraph (b)(2) of §1.169–4 for rules as to filing amended returns for years for which amortization deductions have been taken.

(7) *Definitions.* Except as otherwise provided in §1.169–2, all terms used in section 169 and the regulations thereunder shall have the meaning provided by this section and §§1.169–2 through 1.169–4.

(b) *Examples.* This section may be illustrated by the following examples:

Example (1). On September 30, 1970, the X Corporation, which uses the calendar year as its taxable year, completes the installation of a facility all of which qualifies as a certified pollution control facility within the meaning of paragraph (a) of §1.169–2. The cost of the facility is $120,000 and the period referred to in paragraph (a)(6) of §1.169–2 is 10 years in accordance with the rules set forth in paragraph (a) of §1.169–4, on its income tax return filed for 1970, X elects to take amortization deductions under section 169(a) with respect to the facility and to begin the 60-month amortization period with October 1970, the month following the month in which it was completed. The amortizable basis at the end of October 1970 (determined without regard to the amortization deduction under section 169(a) for that month) is $120,000. The allowable amortization deduction with respect to such facility for the taxable year 1970 is $6,000, computed as follows:

Monthly amortization deductions:	
October: $120,000 divided by 60	$2,000
November: $118,000 (that is, $120,000 minus $2,000) divided by 59	2,000
December: $116,000 (that is, $118,000 minus $2,000) divided by 58	2,000
Total amortization deduction for 1970	6,000

Example (2). Assume the same facts as in example (1). Assume further that on May 20, 1972, X properly files notice of its election to discontinue the amortization deductions with the month of June 1972. The adjusted basis of the facility as of June 1, 1972, is $80,000, computed as follows:

Yearly amortization deductions:	
1970 (as computed in example (1))	$6,000
1971 (computed in accordance with example (1))	24,000
1972 (for the first 5 months of 1972 computed in accordance with example (1))	10,000
Total amortization deductions for 20 months	40,000
Adjusted basis as beginning of amortization period	120,000
Less: Amortization deductions	40,000
Adjusted basis as of June 1, 1972	80,000

Beginning as of June 1, 1972, the deduction for depreciation under section 167 is allowable with respect to the property on its adjusted basis of $80,000.

[T.D. 7116, 36 FR 9012, May 18, 1971; 36 FR 9770, May 28, 1971, as amended by T.D. 7203, 37 FR 17133, Aug. 25, 1972]

§1.169–2 Definitions.

(a) *Certified pollution control facility*—(1) *In general.* Under section 169 (d), the term ''certified pollution control facility'' means a facility which—

(i) The Federal certifying authority certifies, in accordance with the rules prescribed in paragraph (c) of this section, is a ''treatment facility'' described in subparagraph (2) of this paragraph, and

(ii) Is ''a new identifiable facility'' (as defined in paragraph (b) of this section).

For profitmaking abatement works limitation, see paragraph (d) of this section.

(2) *Treatment facility.* For purposes of subparagraph (1)(i) of this paragraph, a ''treatment facility'' is a facility which (i) is used to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, or storing of pollutants, contaminants, wastes, or heat and (ii) is used in connection with a plant or other property in operation before January 1, 1969. Determinations under subdivision (i) of this subparagraph shall be made solely by the Federal certifying authority. See subparagraph (3) of this paragraph. For meaning of the phrases ''plant or other property'' and ''in operation before January 1, 1969,'' see subparagraphs (4) and (5), respectively, of this paragraph.

(3) *Facilities performing multiple functions or used in connection with several plants, etc.* (i) If a facility is designed to perform or does perform a function in addition to abating or controlling water or atmospheric pollution or contamination by removing, altering, disposing or storing pollutants, contaminants, wastes, or heat, such facility shall be a treatment facility only with respect to that part of the cost thereof which is certified by the Federal certifying authority as attributable to abating of controlling water or atmospheric pollution or contamination. For example, if a machine which performs a function in addition to abating water pollution is installed at a cost of $100,000 in, and is used only in connection with, a plant which was in operation before January 1, 1969, and if the Federal certifying authority certifies that $30,000 of the cost of such machine is allocable to its function of abating water pollution, such $30,000 will be deemed to be the adjusted basis for purposes of determining gain for purposes of paragraph (a) of §1.169–3.

(ii) If a facility is used in connection with more than one plant or other property, and at least one such plant or other property was not in operation before January 1, 1969, such facility shall be a treatment facility only to the extent of that part of the cost thereof certified by the Federal certifying authority as attributable to abating or controlling water or atmospheric pollution in connection with plants or other property in operation before January 1, 1969. For example, if a machine is constructed after December 31, 1968, at a cost of $100,000 and is used in connection with a number of plants only some of which were in operation before January 1, 1969, and if the Federal certifying authority certifies that $20,000 of the cost of such machine is allocable to its function of abating or controlling water pollution in connection with the plants or other property in operation before January 1, 1969, such $20,000 will be deemed to be the adjusted basis for purposes of determining gain for purposes of paragraph (a) of §1.169–3. In a case in which the Federal certifying authority certifies the percentage of a facility which is used in connection with plants or other property in operation before January 1, 1969, the adjusted basis for the purposes of determining gain for purposes of paragraph (a) of §1.169–3 of the portion of the facility so used shall be the adjusted basis for determining gain of the entire facility multiplied by such percentage.

(4) *Plant or other property.* As used in subparagraph (2) of this paragraph, the phrase ''plant or other property'' means any tangible property whether or not such property is used in the trade or business or held for the production of income. Such term includes,

for example, a papermill, a motor vehicle, or a furnace in an apartment house.

(5) *In operation before January 1, 1969.* (i) For purposes of subparagraph (2) of this paragraph and section 169 (d), a plant or other property will be considered to be in operation before January 1, 1969, if prior to that date such plant or other property was actually performing the function for which it was constructed or acquired. For example, a papermill which is completed in July 1968, but which is not actually used to produce paper until 1969 would not be considered to be in operation before January 1, 1969. The fact that such plant or other property was only operating at partial capacity prior to January 1, 1969, or was being used as a standby facility prior to such date, shall not prevent its being considered to be in operation before such date.

(ii)*(a)* A piece of machinery which replaces one which was in operation prior to January 1, 1969, and which was a part of the manufacturing operation carried on by the plant but which does not substantially increase the capacity of the plant will be considered to be in operation prior to January 1, 1969. However, an additional machine that is added to a plant which was in operation before January 1, 1969, and which represents a substantial increase in the plant's capacity will not be considered to have been in operation before such date. There shall be deemed to be a substantial increase in the capacity of a plant or other property as of the time its capacity exceeds by more than 20 percent its capacity on December 31, 1968.

(b) In addition, if the total replacements of equipment in any single taxable year beginning after December 31, 1968, represents the replacement of a substantial portion of a manufacturing plant which had been in operation before such date, such replacement shall be considered to result in a new plant which was not in operation before such date. Thus, if a substantial portion of a plant which was in existence before January 1, 1969, is subsequently destroyed by fire and such substantial portion is replaced in a taxable year beginning after that date, such replacement property shall not be considered to have been in operation before January 1, 1969. The replacement of a substantial portion of a plant or other property shall be deemed to have occurred if, during a single taxable year, the taxpayer replaces manufacturing or production facilities or equipment which comprises such plant or other property and which has an adjusted basis (determined without regard to the adjustments provided in section 1016(a) (2) and (3)) in excess of 20 percent of the adjusted basis (so determined) of such plant or other property determined as of the first day of such taxable year.

(6) *Useful life.* For purposes of section 169 and the regulations thereunder, the terms ''useful life'' and ''actual useful life'' shall mean the shortest period authorized under section 167 and the regulations thereunder if an election were not made under section 169.

(b) *New identifiable facility*—(1) *In general.* For purposes of paragraph (a)(1)(ii) of this section, the term ''new identifiable facility'' includes only tangible property (not including a building and its structural components referred to in subparagraph (2) (i) of this paragraph, other than a building and its structural components which under subparagraph (2) (ii) of this paragraph is exclusively a treatment facility) which—

(i) Is of a character subject to the allowance for depreciation provided in section 167,

(ii)*(a)* Is property the construction, reconstruction, or erection (as defined in subparagraph (2) (iii) of this paragraph) of which is completed by the taxpayer after December 31, 1968, or

(b) Is property acquired by the taxpayer after December 31, 1968, if the original use of the property commences with the taxpayer and commences after such date (see subparagraph (2) (iii) of this paragraph), and

(iii) Is placed in service (as defined in subparagraph (2) (v) of this paragraph) prior to January 1, 1975.

(2) *Meaning of terms.* (i) For purposes of subparagraph (1) of this paragraph, the terms ''building'' and ''structural component'' shall be construed in a manner consistent with the principles set forth in paragraph (e) of § 1.48–1.

Thus, for example, the following rules are applicable:

(a) The term ‘‘building’’ generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. Such term includes any such structure constructed by, or for, a lessee even if such structure must be removed, or ownership of such structure reverts to the lessor, at the termination of the lease. Such term does not include (*1*) a structure which is essentially an item of machinery or equipment, or (*2*) an enclosure which is so closely combined with the machinery or equipment which it supports, houses, or serves that it must be replaced, retired, or abandoned contemporaneously with such machinery or equipment, and which is depreciated over the life of such machinery or equipment. Thus, the term ‘‘building’’ does not include such structures as oil and gas storage tanks, grain storage bins, silos, fractioning towers, blast furnaces, coke ovens, brick kilns, and coal tipples.

(b) The term ‘‘structural components’’ includes, for example, chimneys, and other components relating to the operating or maintenance of a building. However, the term ‘‘structural components’’ does not include machinery or a device which serves no function other than the abatement or control of water or atmospheric pollution.

(ii) For purposes of subparagraph (1) of this paragraph, a building and its structural components will be considered to be exclusively a treatment facility if its only function is the abatement or control of air or water pollution. However, the incidental recovery of profits from wastes or otherwise shall not be deemed to be a function other than the abatement or control of air or water pollution. A building and its structural components which serve no function other than the treatment of wastes will be considered to be exclusively a treatment facility even if it contains areas for employees to operate the treatment facility, rest rooms for such workers, and an office for the management of such treatment facility. However, for example, if a portion of a building is used for the treatment of sewage and another portion of the building is used for the manufacture of machinery, the building is not exclusively a treatment facility. The Federal certifying authority will not certify as to what is a building and its structural components within the meaning of subdivision (i) of this subparagraph.

(iii) For purposes of subparagraph (1)(ii) *(a)* and *(b)* of this paragraph (relating to construction, reconstruction, or erection after December 31, 1968, and original use after December 31, 1968) and paragraph (b)(1) of § 1.169–3 (relating to definition of amortizable basis), the principles set forth in paragraph (a) (1) and (2) of § 1.167(c)–1 and in paragraphs (b) and (c) of § 1.48–2 shall be applied. Thus, for example, the following rules are applicable:

(a) Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications.

(b) The portion of the basis of property attributable to construction, reconstruction, or erection after December 31, 1968, consists of all costs of construction, reconstruction, or erection allocable to the period after December 31, 1968, including the cost or other basis of materials entering into such work (but not including, in the case of reconstruction of property, the adjusted basis of the property as of the time such reconstruction is commenced).

(c) It is not necessary that materials entering into construction, reconstruction or erection be acquired after December 31, 1968, or that they be new in use.

(d) If construction or erection by the taxpayer began after December 31, 1968, the entire cost or other basis of such construction or erection may be taken into account for purposes of determining the amortizable basis under section 169.

(e) Construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(f) Property shall be deemed to be acquired when reduced to physical possession or control.

(g) The term ''original use'' means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. For example, a reconditioned or rebuilt machine acquired by the taxpayer after December 31, 1968, for pollution control purposes will not be treated as being put to original use by the taxpayer regardless of whether it was used for purposes other than pollution control by its previous owner. Whether property is reconditioned or rebuilt property is a question of fact. Property will not be treated as reconditioned or rebuilt merely because it contains some used parts.

(iv) For purposes of subparagraph (1)(iii) of this paragraph (relating to property placed in service prior to January 1, 1975), the principles set forth in paragraph (d) of § 1.46–3 are applicable. Thus, property shall be considered placed in service in the earlier of the following taxable years:

(a) The taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins or would have begun; or

(b) The taxable year in which the property is placed in a condition or state of readiness and availability for the abatement or control of water or atmospheric pollution.

Thus, if property meets the conditions of *(b)* of this subdivision in a taxable year, it shall be considered placed in service in such year notwithstanding that the period for depreciation with respect to such property begins or would have begun in a succeeding taxable year because, for example, under the taxpayer's depreciation practice such property is or would have been accounted for in a multiple asset account and depreciation is or would have been computed under an ''averaging convention'' (§ 1.167(a)–10), or depreciation with respect to suchproperty would have been computed under the completed contract method, the unit of production method, or the retirement method. In the case of property acquired by a taxpayer for use in his trade or business (or in the production of income), property shall be considered in a condition or state of readiness and availability for the abatement or control of water or atmospheric pollution if, for example, equipment is acquired for the abatement or control of water or atmospheric pollution and is operational but is undergoing testing to eliminate any defects. However, materials and parts acquired to be used in the construction of an item of equipment shall not be considered in a condition or state of readiness and availability for the abatement or control of water or atmospheric pollution.

(c) *Certification*—(1) *In general.* For purposes of paragraph (a)(1) of this section, a facility is certified in accordance with the rules prescribed in this paragraph if—

(i) The State certifying authority (as defined in subparagraph (2) of this paragraph) having jurisdiction with respect to such facility has certified to the Federal certifying authority (as defined in subparagraph (3) of this paragraph) that the facility was constructed, reconstructed, erected, or acquired in conformity with the State program or requirements for the abatement or control of water or atmospheric pollution or contamination applicable at the time of such certification, and

(ii) The Federal certifying authority has certified such facility to the Secretary or his delegate as *(a)* being in compliance with the applicable regulations of Federal agencies (such as, for example, the Atomic Energy Commission's regulations pertaining to radiological discharge (10 CFR Part 20)) and *(b)* being in furtherance of the general policy of the United States for cooperation with the States in the prevention and abatement of water pollution under the Federal Water Pollution Control Act, as amended (33 U.S.C. 1151–1175) or in the prevention and abatement of atmospheric pollution and contamination under the Clean Air Act, as amended (42 U.S.C. 1857 et seq.).

(2) *State certifying authority.* The term ''state certifying authority'' means—

(i) In the case of water pollution, the State water pollution control agency as defined in section 23(a) of the Federal Water Pollution Control Act, as amended (33 U.S.C. 1173(a)),

(ii) In the case of air pollution, the air pollution control agency designated pursuant to section 302(b)(1) of the Clean Air Act, as amended (42 U.S.C. 1857h(b)), and

(iii) Any interstate agency authorized to act in place of a certifying authority of a State. See section 23(a) of the Federal Water Pollution Control Act, as amended (33 U.S.C. 1173(b)) and section 302(c) of the Clean Air Act, as amended (42 U.S.C. 1857h(c)).

(3) *Federal certifying authority.* The term ‘‘Federal certifying authority’’ means the Administrator of the Environmental Protection Agency (see Reorganization Plan No. 3 of 1970, 35 FR 15623).

(d) *Profitmaking abatement works, etc.*—(1) *In general.* Section 169(e) provides that the Federal certifying authority shall not certify any property to the extent it appears that by reason of estimated profits to be derived through the recovery of wastes or otherwise in the operation of such property its costs will be recovered over the period referred to in paragraph (a) (6) of this section for such property. The Federal certifying authority need not certify the amount of estimated profits to be derived from such recovery of wastes or otherwise with respect to such facility. Such estimated profits shall be determined pursuant to subparagraph (2) of this paragraph. However, the Federal certifying authority shall certify—

(i) Whether, in connection with any treatment facility so certified, there is potential cost recovery through the recovery of wastes or otherwise, and

(ii) A specific description of the wastes which will be recovered, or the nature of such cost recovery if otherwise than through the recovery of wastes.

For effect on computation of amortizable basis, see paragraph (c) of §1.169–3.

(2) *Estimated profits.* For purpose of this paragraph, the term ‘‘estimated profits’’ means the estimated gross receipts from the sale of recovered wastes reduced by the sum of the (i) estimated average annual maintenance and operating expenses, including utilities and labor, allocable to that portion of the facility which is certified as a treatment facility pursuant to paragraph (a)(1)(i) of this section which produces the recovered waste from which the gross receipts are derived, and (ii) estimated selling expenses. However, in determining expenses to be subtracted neither depreciation nor amortization of the facility is to be taken into account. Estimated profits shall not include any estimated savings to the taxpayer by reason of the taxpayer’s reuse or recycling of wastes or other items recovered in connection with the operation of the plant or other property served by the treatment facility.

(3) *Special rules.* The estimates of cost recovery required by subparagraph (2) of this paragraph shall be based on the period referred to in paragraph (a)(6) of this section. Such estimates shall be made at the time the election provided for by section 169 is made and shall also be set out in the application for certification made to the Federal certifying authority. There shall be no redetermination of estimated profits due to unanticipated fluctuations in the market price for wastes or other items, to an unanticipated increase or decrease in the costs of extracting them from the gas or liquid released, or to other unanticipated factors or events occurring after certification.

[T.D. 7116, 36 FR 9013, May 18, 1971; 36 FR 9770, May 28, 1971]

§1.169–3 Amortizable basis.

(a) *In general.* The amortizable basis of a certified pollution control facility for the purpose of computing the amortization deduction under section 169 is the adjusted basis of such facility for purposes of determining gain (see Part II (section 1011 and following) Subchapter O, Chapter 1 of the Code), as modified by paragraphs (b), (c), and (d) of this section. For the adjusted basis for purposes of determining gain (computed without regard to such modifications) of a facility which performs a function in addition to pollution control, or which is used in connection with more than one plant or other property, or both, see paragraph (a)(3) of §1.169–2. For rules as to additions and improvements to such a facility, see paragraph (f) of this section.

(b) *Limitation to post-1968 construction, reconstruction, or erection.* (1) If the construction, reconstruction, or erection was begun before January 1, 1969, there shall be included in the amortizable basis only so much of the adjusted basis of such facility for purposes of determining gain (referred to in paragraph (a) of this section) as is properly attributable under the rules set forth in paragraph (b)(2)(iii) of § 1.169–2 to construction, reconstruction, or erection after December 31, 1968. See section 169 (d)(4). For example, assume a certified pollution control facility for which the shortest period authorized under section 167 is 10 years has a cost of $500,000, of which $450,000 is attributable to construction after December 31, 1968. Further, assume such facility does not perform a function in addition to pollution control and is used only in connection with a plant in operation before January 1, 1969. The facility would have an amortizable basis of $450,000 (computed without regard to paragraphs (c) and (d) of this section). For depreciation of the remaining portion ($50,000) of the cost, see section 169(g) and paragraph (a)(3)(ii) of § 1.169–1. For the definition of the term ''certified pollution control facility'' see paragraph (a) of § 1.169–2.

(2) If the taxpayer elects to begin the 60-month amortization period with the first month of the taxable year succeeding the taxable year in which such facility is completed or acquired and a depreciation deduction is allowable under section 167 (including an additional first-year depreciation allowance under section 179) with respect to the facility for the taxable year in which it is completed or acquired, the amount determined under subparagraph (1) of this paragraph shall be reduced by an amount equal to (i) the amount of such allowable depreciation multiplied by (ii) a fraction the numerator of which is the amount determined under subparagraph (1) of this paragraph, and the denominator of which is its total cost. The additional first-year allowance for depreciation under section 179 will be allowable only for the year in which the facility is completed or acquired and only if the taxpayer elects to begin the amortization deduction under section 169 with the taxable year succeeding the taxable year in which such facility is completed or acquired. See paragraph (e)(1)(ii) of § 1.179–1.

(c) *Modification for profitmaking abatement works, etc.* If it appears that by reason of estimated profits to be derived through the recovery of wastes or otherwise (as determined by applying the rules prescribed in paragraph (d) of § 1.169–2) a portion or all of the total costs of the certified pollution control facility will be recovered over the period referred to in paragraph (a)(b) of § 1.169–2, its amortizable basis (computed without regard to this paragraph and paragraph (d) of this section) shall be reduced by an amount equal to (1) its amortizable basis (so computed) multiplied by (2) a fraction the numerator of which is such estimated profits and the denominator of which is its adjusted basis for purposes of determining gain. See section 169(e).

(d) *Cases in which the period referred to in paragraph (a)(6) of § 1.169–2 exceeds 15 years.* If as to a certified pollution control facility the period referred to in paragraph (a)(6) of § 1.169–2 exceeds 15 years (determined as of the first day of the first month for which a deduction is allowable under the election made under the section 169(b) and paragraph (a) of § 1.169–4), the amortizable basis of such facility shall be an amount equal to (1) its amortizable basis (computed without regard to this paragraph) multiplied by (2) a fraction the numerator of which is 15 years and the denominator of which is the number of years of such period. See section 169(f) (2)(A).

(e) *Examples.* This section may be illustrated by the following example:

Example (1). The X Corporation, which uses the calendar year as its taxable year, began the installation of a facility on November 1, 1968, and completed the installation on June 30, 1970, at a cost of $400,000. All of the facility qualifies as a certified pollution control facility within the meaning of paragraph (a) of § 1.169–2. $40,000 of such cost is attributable to construction prior to January 1, 1969. The X Corporation elects to take amortization deductions under section 169(a) with respect to the facility and to begin the 60-month amortization period with January 1, 1971. The corporation takes a depreciation deduction under sections 167 and 179 of $10,000 (the amount allowable, of which $2,000 is for additional first year depreciation under section 179) for the last 6 months of 1970. It is estimated that over the period referred to in paragraph (a) (6) of §1.169–2 (20 years) as to such facility, $80,000 in profits will be realized from the sale of wastes recovered in its operation. The amortizable basis of the facility for purposes of computing the amortization deduction as of January 1, 1971, is $210,600, computed as follows:

(1) Portion of $400,000 cost attributable to post-1968 construction, reconstruction, or erection ...		$360,000
(2) Reduction for portion of depreciation deduction taken for the taxable year in which the facility was completed:		
(a) $10,000 depreciation deduction taken for last 6 months of 1970 including $2,000 for additional first year depreciation under section 179	$10,000	
(b) Multiplied by the amount in line (1) and divided by the total cost of the facility ($360,000/ $400,000)	0.9	$9,000
(3) Subtotal		$351,000
(4) Modification for profitmaking abatement works: Multiply line (3) by estimated profits through waste recovery ($80,000) and divide by the adjusted basis for determining gain of the facility ($400,000).		
(5) Reduction		$70,200
(6) Subtotal		$280,800
(7) Modification for period referred to in paragraph (a)(6) of §1.169–2 exceeding 15 years: Multiply by 15 years and divide by such period (determined in accordance with paragraph (d) of this section) (20 years)		0.75
(8) Amortizable basis		$210,600

Example (2). Assume the same facts as in example (1) except that the facility is used in connection with a number of separate plants some of which were in operation before January 1, 1969, that the Federal certifying authority certifies that 80 percent of the capacity of the facility is allocable to the plants which were in operation before such date, and that all of the waste recovery is allocable to the portion of the facility used in connection with the plants in operation before January 1, 1969. The amortizable basis of such facility, for purposes of computing the amortization deduction as of January 1, 1971, is $157,950 computed as follows:

(1) Adjusted basis for purposes of determining gain: Multiply percent certified as allocable to plants in operation before January 1, 1969 (80 percent) by cost of entire facility ($400,000)		$320,000
(2) Portion of adjusted basis for determining gain attributable to post-1968 construction, reconstruction, or rection: Multiply line (1) by portion of total cost of facility attributable to post-1968 construction, reconstruction, or erection ($360,000) and divide by the total cost of the facility ($400,000)		$288,000
(3) Reduction for portion of depreciation deduction taken for the taxable year in which the facility was completed:		
(a) $10,000 depreciation deduction taken for last 6 months of 1970 including $2,000 for additional first year depreciation under section 170	$10,000	
(b) Multiplied by the amount in line (2) and divided by the total cost of the facility ($288,000/$400,000)	0.72	$7,200
(4) Subtotal		$280,800
(5) Modification for profitmaking abatement works; Multiply line (4) by estimated profits through waste recovery ($80,000) and divide by the amount in line (1) ($320,000).		
(6) Reduction		$70,200
(7) Subtotal		$210,600
(8) Modification for period referred to in paragraph (a)(6) of §1.169–2 exceeding 15 years: Multiply by 15 years and divide by such period (determined in accordance with paragraph (d) of this section) (20 years)		0.75
(9) Amortizable basis		$157,950

(f) *Additions or improvements.* (1) If after the completion or acquisition of a certified pollution control facility further expenditures are made for additional construction, reconstruction, or improvements, the cost of such additions or improvements made prior to the beginning of the amortization period shall increase the amortizable basis of such facility, but the cost of additions or improvements made after the amortization period has begun, shall not increase the amortizable basis. See section 169(f)(2)(B).

(2) If expenditures for such additional construction, reconstruction, or improvements result in a facility which is new and is separately certified as a certified pollution control facility as defined in section 169(d)(1) and paragraph (a) of §1.169–2, and, if proper election is made, such expenditures shall be taken into account in computing under paragraph (a) of this section the amortizable basis of such new and separately certified pollution control facility.

[T.D. 7116, 36 FR 9015, May 18, 1971; 36 FR 9770, May 28, 1971]

§1.169–4 Time and manner of making elections.

(a) *Election of amortization*—(1) *In general.* Under section 169(b), an election by the taxpayer to take an amortization deduction with respect to a certified pollution control facility and to begin the 60-month amortization period (either with the month following the month in which the facility is completed or acquired, or with the first month of the taxable year succeeding the taxable year in which such facility is completed or acquired) shall be made by a statement to that effect attached to its return for the taxable year in which falls the first month of the 60-month amortization period so elected. Such statement shall include the following information (if not otherwise included in the documents referred to in subdivision (ix) of this subparagraph):

(i) A description clearly identifying each certified pollution control facility for which an amortization deduction is claimed;

(ii) The date on which such facility was completed or acquired (see paragraph (b)(2)(iii) of §1.169–2);

(iii) The period referred to in paragraph (a)(6) of §1.169–2 for the facility as of the date the property is placed in service;

(iv) The date as of which the amortization period is to begin;

(v) The date the plant or other property to which the facility is connected began operating (see paragraph (a)(5) of §1.169–2);

(vi) The total costs and expenditures paid or incurred in the acquisition, construction, and installation of such facility;

(vii) A description of any wastes which the facility will recover during the course of its operation, and a reasonable estimate of the profits which will be realized by the sale of such wastes whether pollutants or otherwise, over the period referred to in paragraph (a)(6) of §1.169–2 as to the facility. Such estimate shall include a schedule setting forth a detailed computation illustrating how the estimate was arrived at including every element prescribed in the definition of estimated profits in paragraph (d)(2) of §1.169–2;

(viii) A computation showing the amortizable basis (as defined in §1.169–3) of the facility as of the first month for which the amortization deduction provided for by section 169(a) is elected; and

(ix)*(a)* A statement that the facility has been certified by the Federal certifying authority, together with a copy of such certification, and a copy of the application for certification which was filed with and approved by the Federal certifying authority or *(b)*, if the facility has not been certified by the Federal certifying authority, a statement that application has been made to the proper State certifying authority (see paragraph (c)(2) of §1.169–2) together with a copy of such application and (except in the case of an election to which subparagraph (4) of this paragraph applies) a copy of the application filed or to be filed with the Federal certifying authority.

If subdivision (ix)*(b)* of this subparagraph applies, within 90 days after receipt by the taxpayer, the certification from the Federal certifying authority shall be filed by the taxpayer with the district director, or with the director of the internal revenue service center, with whom the return referred to in this subparagraph was filed.

(2) *Special rule.* If the return for the taxable year in which falls the first month of the 60-month amortization period to be elected is filed before November 16, 1971, without making the election for such year, then on or before December 31, 1971 (or if there is no State certifying authority in existence on November 16, 1971, on or before the 90th day after such authority is established), the election may be made by a statement attached to an amended income tax return for the taxable year in which falls the first month of the 60-month amortization period so elected. Amended income tax returns or claims for credit or refund must also be filed at this time for other taxable years which are within the amortization period and which are subsequent to the taxable year for which the election is made. Nothing in this paragraph should be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(3) *Other requirements and considerations.* No method of making the election provided for in section 169(a) other than that prescribed in this section shall be permitted on or after May 18, 1971. A taxpayer which does not elect in the manner prescribed in this section to take amortization deductions

with respect to a certified pollution control facility shall not be entitled to such deductions. In the case of a taxpayer which elects prior to May 18, 1971, the statement required by subparagraph (1) of this paragraph shall be attached to its income tax return for either its taxable year in which December 31, 1971, occurs or its taxable year preceding such year.

(4) *Elections filed before February 29, 1972.* If a statement of election required by subparagraph (1) of this paragraph is attached to a return (including an amended return referred to in subparagraph (2) of this paragraph) filed before February 29, 1972, such statement of election need not include a copy of the Federal application to be filed with the Federal certifying authority but a copy of such application must be filed no later than February 29, 1972, by the taxpayer with the district director, or with the director of the internal revenue service center, with whom the return or amended return referred to in this subparagraph was filed.

(b) *Election to discontinue or revoke amortization*—(1) *Election to discontinue.* An election to discontinue the amortization deduction provided by section 169(c) and paragraph (a)(1) of §1.169–1 shall be made by a statement in writing filed with the district director, or with the director of the internal revenue service center, with whom the return of the taxpayer is required to be filed for its taxable year in which falls the first month for which the election terminates. Such statement shall specify the month as of the beginning of which the taxpayer elects to discontinue such deductions. Unless the election to discontinue amortization is one to which subparagraph (2) of this paragraph applies, such statement shall be filed before the beginning of the month specified therein. In addition, such statement shall contain a description clearly identifying the certified pollution control facility with respect to which the taxpayer elects to discontinue the amortization deduction, and, if a certification has previously been issued, a copy of the certification by the Federal certifying authority. If at the time of such election a certification has not been issued (or if one has been issued it has not been filed as provided in paragraph (a)(1) of this section), the taxpayer shall file, with respect to any taxable year or years for which a deduction under section 169 has been taken, a copy of such certification within 90 days after receipt thereof. For purposes of this paragraph, notification to the Secretary or his delegate from the Federal certifying authority that the facility no longer meets the requirements under which certification was originally granted by the State or Federal certifying authority shall have the same effect as a notice from the taxpayer electing to terminate amortization as of the month following the month such facility ceased functioning in accordance with such requirements.

(2) *Revocation of elections made prior to May 18, 1971.* If on or before May 18, 1971, an election under section 169(a) has been made, such election may be revoked (see paragraph (a)(1) of §1.169–1) by filing on or before August 16, 1971, a statement of revocation of an election under section 169(a) in accordance with the requirements in subparagraph (1) of this paragraph for filing a notice to discontinue an election. If such election to revoke is for a period which falls within one or more taxable years for which an income tax return has been filed, amended income tax returns shall be filed for any such taxable years in which deductions were taken under section 169 on or before August 16, 1971.

[T.D. 7116, 36 FR 9016, May 18, 1971, as amended by T.D. 7135, 36 FR 14183, July 31, 1971; 36 FR 24995, Dec. 28, 1971]

SUBCHAPTER A—INCOME TAX (Continued)

PART 1—INCOME TAXES

Normal Taxes and Surtaxes (Continued)

COMPUTATION OF TAXABLE INCOME (Continued)

ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS (CONTINUED)

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Section 1.280F–1T also issued under 26 U.S.C. 280F.

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PART 1—INCOME TAXES

Normal Taxes and Surtaxes (Continued)

COMPUTATION OF TAXABLE INCOME (Continued)

ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS (CONTINUED)

§ 1.170–0 Effective dates.

Except as otherwise provided in this section, the provisions of section 170 and §§ 1.170–1 through 1.170–3 are applicable to contributions paid in taxable years beginning before January 1, 1970, and all references therein to sections of the Code are to sections of the Internal Revenue Code of 1954 prior to the amendments made by section 201(a) of the Tax Reform Act of 1969 (83 Stat. 549). Except as otherwise provided therein, §§ 1.170A through 1.170A–11 are applicable to contributions paid in taxable years beginning after December 31, 1969. In a case where a provision in §§1.170A through 1.170A–11 is applicable to a contribution paid in a taxable year beginning before January 1, 1970, such provision shall apply to the contribution and §§1.170–1 through 1.170–3 shall not apply to the contribution.

[T.D. 7207, 37 FR 20767, Oct. 5, 1972]

§1.170–1 Charitable, etc., contributions and gifts; allowance of deduction (before amendment by Tax Reform Act of 1969).

(a) *In general*—(1) *General rule.* Any charitable contribution (as defined in section 170(c)) actually paid during the taxable year is allowable as a deduction in computing taxable income, regardless of the method of accounting employed or when pledged. In addition, contributions by corporations may under certain circumstances be deductible even though not paid during the taxable year (see §1.170–3), and subject to the provisions of section 170(b)(5) and paragraph (g) of §1.170–2, certain excess charitable contributions made by individuals in taxable years beginning after December 31, 1963, shall be treated as paid in certain succeeding taxable years. The deduction is subject to the limitations of section 170(b) (see §§1.170–2 and 1.170–3) and is subject to verification by the district director. For rules relating to the determination of, and the deduction for, amounts paid to maintain certain students as members of the taxpayer's household and treated under section 170(d) as paid for the use of an organization described in section 170(c) (2), (3), or (4), see paragraph (f) of §1.170–2. For a special rule relating to the computation of the amount of the deduction with respect to a contribution of section 1245 or section 1250 property, see section 170(e).

(2) *Information required in support of deductions for taxable years beginning before January 1, 1964.* In connection with claims for deductions for charitable contributions paid in taxable years beginning before January 1, 1964, taxpayers shall state in their income tax returns the name and address of each organization to which a contribution was made and the amount and approximate date of the actual payment of each contribution. Any deduction for charitable contribution must be substantiated, when required by the district director, by a statement from the organization to which the contribution was made indicating whether the organization is a domestic organization, the name and address of the contributor, the amount of the contribution, and the date of its actual payment, and by such other information as the district director may deem necessary.

(3) *Information required in support of deductions for taxable years beginning after December 31, 1963*—(i) *In general.* In connection with claims for deductions for charitable contributions paid in taxable years beginning after December 31, 1963, taxpayers shall state in their income tax returns the name of each organization to which a contribution was made and the amount and date of the actual payment of each contribution. If a contribution is made in property other than money, the taxpayer shall state the kind of property contributed (for example, used clothing, paintings, securities) and shall state the method utilized in determining the fair market value of the property at the time the contribution was made. In any case in which a taxpayer makes numerous cash contributions to an organization during the taxable year, the taxpayer may state the total cash payments made to such organization during the taxable year in lieu of listing each cash contribution and the date of payment.

(ii) *Contribution by individual of property other than money.* If an individual taxpayer makes a charitable contribution of an item of property other than money and claims a deduction in excess of $200 in respect of his contribution of such item, he shall attach to his income tax return a statement setting forth the following information with respect to such item:

(*a*) The name and address of the organization to which the contribution was made.

(*b*) The date of the actual contribution.

(*c*) A description of the property in sufficient detail to identify the particular property contributed including, in the case of tangible property, the physical condition of the property at the time of contribution. In the case of securities, the name of the issuer, the type of security, and whether or not such security is regularly traded on a stock exchange or in an over-the-counter market.

(*d*) The manner (for example, by purchase, gift, bequest, inheritance, exchange, etc.) and the approximate date of acquisition of the property by the taxpayer. If the property was created, produced, or manufactured by the taxpayer, the approximate date the property was substantially completed.

(*e*) The fair market value of the property at the time the contribution was made, showing the method utilized in determining the fair market value. (If the valuation was determined by appraisal, a copy of the signed report of the appraiser should be submitted.)

(*f*) In the case of property (not including securities) held by the taxpayer for a period less than five years immediately preceding the date on which the contribution was made, the cost or other basis, adjusted as provided by section 1016. If available, the cost or other basis, adjusted as provided by section 1016, of property (not including securities) held for a period of five years or more prior to the time of contribution should be submitted.

(*g*) In the case of section 1245 or section 1250 property, the reduction by reason of section 170(e) in the amount of the charitable contribution taken into account under section 170.

(*h*) The terms of any agreement or understanding entered into by or on behalf of the taxpayer relating to the use, sale, or disposition of the property contributed. For example, there must be attached to the income tax return of an individual taxpayer the terms of any agreement or understanding which restricts the donee's right to dispose of the donated property (either temporarily or permanently) or which reserves to, or confers upon, anyone other than the donee organization (or an organization participating with such organization in cooperative fund raising) any right to the income from such property, to the possession of the property (including the right to vote securities), to acquire such property by purchase or otherwise, or to designate who shall have such income, possession, or right to acquire. Notwithstanding the above, it will not be necessary to set forth the terms of any agreement or understanding which merely earmarks contributed property for a particular charitable use, such as the use of donated furniture in the reading room of the donee organization's library.

(*i*) The total amount claimed as a deduction for the taxable year due to the contribution of the property. If less than the entire interest in the property is contributed during the taxable year, the amount claimed as a deduction in any prior year or years for contributions of other interests in such property, the name and address of each organization to which any such contribution was made, the place where the property (if tangible property) is located or kept and the name of the person having actual possession of the property, if other than the organization to which the property giving rise to the deduction was contributed.

(iii) *Statement from donee organization.* Any deduction for a charitable contribution must be substantiated, when required by the district director, by a statement from the organization to which the contribution was made indicating whether the organization is a domestic organization, the name and address of the contributor, the amount of the contribution, the date of actual receipt of the contribution, and such other information as the district director may deem necessary. If the contribution includes an item of property (other than money or securities which are regularly traded on a stock exchange or in an over-the-counter market) which the donee deems to have a fair market value in excess of $200 at the time of receipt, such statement shall also indicate for each such item its location if retained by the organization, the amount received by the organization on any sale of the property and the date of sale, or in case of other disposition of the property, the method of disposition.

(b) *Time of making contribution.* Ordinarly a contribution is made at the time delivery is effected. In the case of a check, the unconditional delivery (or mailing) of a check which subsequently clears in due course will constitute an effective contribution on the date of delivery (or mailing). If a taxpayer unconditionally delivers (or mails) a properly endorsed stock certificate to a charitable donee or the donee's agent, the gift is completed on the date of delivery (or mailing, provided that such certificate is received in the ordinary course of the mails). If the donor delivers the certificate to his bank or broker as the donor's agent, or to the issuing corporation or its agent, for transfer into the name of the donee, the gift is completed on the date the stock is transferred on the books of the corporation. For rules relating to a contribution consisting of a future interest in tangible personal property, see paragraph (d)(2) of this section.

(c) *Contribution in property*—(1) *General rules.* If a contribution is made in property other than money, the amount of the deduction is determined by the fair market value of the property at the time of the contribution. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. If the contribution is made in property of a type which the taxpayer sells in the course of his business, the fair market value is the price which the taxpayer would have received if he had sold the contributed property in the lowest usual market in which he customarily sells, at the time and place of the contribution (and in the case of a contribution of goods in quantity, in the quantity contributed). The usual market of a manufacturer or other producer consists of the wholesalers or other distributors to or through whom he customarily sells, unless he sells only at retail in which event it is his retail customers. If a donor makes a charitable contribution of, for example, stock in trade at a time when he could not reasonably have been expected to realize its usual selling price, the value of the gift is not the usual selling price but is the amount for which the quantity of merchandise contributed would have been sold by the donor at the time of the contribution. Costs and expenses incurred in the year of contribution in producing or acquiring the contributed property are not deductible and are not a part of the cost of goods sold. Similarly, to the extent that costs and expenses incurred in a prior taxable year in producing or acquiring the contributed property are reflected in the cost of goods sold in the year of contribution, cost of goods sold must be reduced by such costs and expenses. Transfers of property to an organization described in section 170(c) which bear a direct relationship to the taxpayer's business and which are made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute allowable deductions as trade or business expenses rather than as charitable contributions. See section 162 and the regulations thereunder.

(2) *Reduction for certain interest.* (i) With respect to charitable contributions made after December 31, 1957, section 170(b)(4) requires that the amount of the charitable deduction be reduced for certain interest to the extent necessary to avoid the reduction of the same amount both as an interest deduction under section 163 and as a deduction for charitable contributions under section 170. The reduction is to be determined in accordance with subdivisions (ii) and (iii) of this subparagraph.

(ii) With respect to charitable contributions made after December 31, 1957, in determining the amount to be taken into account as a charitable contribution for purposes of section 170, the amount determined without regard to section 170(b)(4) or this subparagraph shall be reduced by the amount of interest which has been paid (or is to be paid) by the taxpayer, which is attributable to any liability connected with the contribution, and which is attributable to any period of time after the making of the contribution. The deduction otherwise allowable for charitable contributions under section 170 is required to be reduced pursuant to section 170(b)(4) only if, in connection with a charitable contribution, a liability is assumed by the recipient of the contribution or by any other person, or if the charitable contribution is of property which is subject to a liability. Thus, if the contribution is made in property and the transfer is conditioned upon the assumption of a liability by the donee or by some other person, any interest paid (or to be paid) by the taxpayer, attributable to the liability, and with respect to a period after the making of the contribution, will serve to reduce the amount that may be taken into account as a charitable contribution for purposes of section 170. The adjustment referred to in this subdivision must also be made where the contributed property is subject to a liability and the value of the property reflects the payment by the donor of interest with respect to a period of time after the making of the contribution.

(iii) If, in connection with the charitable contribution, after December 31, 1957, of a bond, a liability is assumed by the recipient or by any other person, or if the bond is subject to a liability, then, in determining the amount to be taken into account as a charitable contribution under section 170, the amount determined without regard to section 170(b)(4) or this subparagraph shall, without regard to whether any reduction may be required by subdivision (ii) of this subparagraph, also be reduced for interest which has been paid (or is to be paid) by the taxpayer on indebtedness incurred or continued to purchase or carry such bond, and which is attributable to any period before the making of the contribution. However, the reduction referred to in this subdivision shall be made only to the extent that such reduction does not exceed the interest (including bond discount and other interest equivalent) receivable on the bond, and attributable to any period before the making of the contribution which is not, by reason of the taxpayer's method of accounting, includible in the taxpayer's gross income for any taxable year. For purposes of section 170(b)(4) and this subdivision the term *bond* means any bond, debenture, note, or certificate or other evidence of indebtedness.

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

Example 1. A, an individual using the cash receipts and disbursements method of accounting, on January 1, 1960, contributed to a charitable organization real estate having a fair market value of $10,000. In connection with the contribution the charitable organization assumed an indebtedness of $8,000 which A had incurred. A has prepaid two years' interest on that indebtedness (for 1960 and 1961) amounting to $960, and has taken an interest deduction of $960 for such amount. The amount of the gift, determined without regard to this subparagraph, is $2,960 ($10,000 less $8,000, the outstanding indebtedness, plus $960, the amount of prepaid interest). In determining the amount of the deduction for charitable contributions, the value of the gift ($2,960) must be reduced by $960 to eliminate from the computation of such deduction that portion thereof for which A has been allowed an interest deduction.

Example 2. On January 1, 1960, B, an individual using the cash receipts and disbursements method of accounting, purchased for $9,600 a 5 1/2 percent $10,000, 20-year M Corporation bond, the interest on which was payable semiannually on June 30 and December 31. The M Corporation had issued the bond on January 1, 1950, at a discount of $720 from the principal amount. On December 1, 1960, B donated the bond to a charitable organization, and, in connection with the contribution, the charitable organization assumed an indebtedness of $7,000 which B had incurred to purchase and carry the bond. During the calendar year 1960 B paid accrued interest of $330 on the indebtedness for the period from January 1 to December 1, 1960, and has taken an interest deduction of $330 for such amount. No portion of the bond discount of $36 a year ($720 divided by 20 years) has been included in B's income, and of the $550 of annual interest receivable on the bond, he included in income only the June 30 payment of $275. The market value of the bond on the date of the contribution was $9,902. Such value reflects a proportionate part of the original bond discount ($9,280 plus $393, or $9,673) and of interest receivable of $229 which had accrued from July 1 to December 1, 1960. The amount of the charitable contribution determined without regard to this subparagraph is $2,902 ($9,902, the value of the property on the date of gift, less $7,000, the amount of the liability assumed by the charitable organization). In determining the amount of the allowable deduction for charitable contributions, the value of the gift ($2,902) must be reduced to eliminate from the deduction that portion thereof for which B has been allowed an interest deduction. Although the amount of such interest deduction was $330, the reduction required by this subparagraph is limited to $262, since the reduction is not in excess of the amount of interest income on the bond ($229 of accrued interest plus $33, the amount of bond discount attributable to the eleven-month period B held the bond).

(3) *Reduction for depreciable property.* (i) With respect to a charitable contribution of section 1245 property (as defined in section 1245(a)(3)), or section 1250 property (as defined in section 1250(c)), section 170(e) requires that the amount of the charitable contribution taken into account under section 170 shall be reduced by the amount which would have been treated (but was not actually treated) as gain to which section 1245(a)(1) or 1250(a) (relating to gain from dispositions of depreciable property) applies if the property contributed had been sold at its fair market value (determined at the time of such contribution).

(ii) Section 170(e) applies to charitable contributions of section 1245 property in taxable years beginning after December 31, 1962, except that in respect of section 1245 property which is an elevator or escalator section 170(e) applies to charitable contributions after December 31, 1963. Section 170(e) applies to charitable contributions of section 1250 property after December 31, 1963.

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

Example. Jones contributes to a charitable organization section 1245 property which has an adjusted basis of $10,000, a recomputed basis (as defined in section 1245 (a)(2)) of $14,000, and a fair market value of $17,000. If Jones had instead sold the property at its fair market value, he would have recognized gain under section 1245(a)(1) of $4,000. See paragraph (b) of §1.1245–1. Under section 170(e), the amount of the charitable contribution taken into account under section 170 is reduced by $4,000. Accordingly, the amount of the charitable contribution is $13,000 ($17,000 minus $4,000).

(d) *Transfers of income and future interests*—(1) *In general.* A deduction may be allowed for a contribution of an interest in the income from property or an interest in the remainder (but see subparagraph (2) of this paragraph for rules relating to transfers, after December 31, 1963, of future interests in tangible personal property). The income or remainder interest shall be valued according to the tables referred to in paragraph (d) of §1.170–2. For rules with respect to certain transfers to a trust, see paragraph (d) of §1.170–2.

(2) *Future interests in tangible personal property.* (i) Except as otherwise provided in subdivision (iii) of this subparagraph, a contribution consisting of a transfer, after December 31, 1963, in a taxable year ending after such date, of a future interest in tangible personal property shall be treated as made only when:

(*a*) All intervening interests in, and rights to the actual possession or enjoyment of, the property have expired, or

(*b*) Are held by persons other than the taxpayer or those standing in a relationship to the taxpayer described in section 267(b) and the regulations thereunder (relating to losses, expenses, and interest with respect to transactions between related taxpayers).

Section 170(f) and this subparagraph have no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during three months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. Section 170(f) and this subparagraph have no application in respect of a transfer of a future interest in intangible personal property or in real property. However, a fixture which is intended to be severed from real property shall be treated as tangible personal property. For example, a contribution of a future interest in a chandelier which is attached to a building is considered a contribution which consists of a future interest in tangible personal property if the transferor intends that it be detached from the building at or prior to the time when the charitable organization's right to possession or enjoyment of the chandelier is to commence. For purposes of section 170(f) and this subparagraph, the term *future interest* has generally the same meaning as it has when used in section 2503, relating to taxable gifts, see §25.2503–3 of Part 25 of this chapter (Gift Tax Regulations), and such term includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession or enjoyment at some future date or time. The term *future interest* includes situations in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc. (whether written or oral) with the charitable organization which has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. On December 31, 1964, A, an individual who reports his income on the calendar year basis, conveys by deed of gift to a museum title to a painting, but reserves to himself the right to the use, possession, and enjoyment of the painting during his lifetime. At the time of the gift the value of the painting is $90,000. Since the contribution consists of a future interest in tangible personal property in which the donor has retained an intervening interest, no contribution is considered as having been made in 1964.

Example 2. Assume the same facts as in *Example (1)* except that on December 31, 1965, A relinquishes all of his right to the use, possession, and enjoyment of the painting and delivers the painting to the museum. Assuming that the value of the painting has increased to $95,000, A is treated as having made a charitable contribution of $95,000 in 1965.

Example 3. Assume the same facts as *Example (1)* except A dies without relinquishing his right to the use, possession, and enjoyment of the painting. Since A did not relinquish his right to the use, possession, and enjoyment of the property during his life, A is treated as not having made a charitable contribution of the painting for income tax purposes.

Example 4. Assume the same facts as in *Example (1)* except A, on December 31, 1965, transfers his interest in the painting to his son, B. Since the relationship between A and B is one described in section 267(b), no contribution of the remainder interest in the painting is considered as having been made in 1965.

Example 5. Assume the same facts as in *Example (4).* Also assume that on December 31, 1966, B conveys the interest measured by A's life to the museum. B has made a charitable contribution of the present interest in the painting conveyed to the museum (i.e., the life interest measured by A's life expectancy in 1966 valued according to paragraph (f), Table 1, of §20.2031–7 of Part 20 of this chapter (Estate Tax Regulations)). In addition, since all intervening interests in, and rights to the actual possession or enjoyment of the property, have expired, a charitable contribution of the remainder interest is treated as having been made by A in 1966. Such remainder interest shall also be valued according to paragraph (f), Table 1, of §20.2031–7 of Part 20 of this chapter (Estate Tax Regulations)).

(iii) Section 209(f)(3) of the Revenue Act of 1964 (78 Stat. 47) provides an exception to the rule set forth in section 170(f). Pursuant to the exception, section 170(f) and subdivision (i) of this subparagraph shall not apply in the case of a transfer of a future interest in tangible personal property made after December 31, 1963, and before July 1, 1964, where:

(a) The sole intervening interest or right is a nontransferable life interest reserved by the donor, or

(b) In the case of a joint gift by husband and wife, the sole intervening interest or right is a nontransferable life interest reserved by the donors which expires not later than the death of whichever of such donors dies later.

For purposes of the preceding sentence, the right to make a transfer of the reserved life interest to the donee of the future interest shall not be treated as making a life interest transferable.

(e) *Transfers subject to a condition or a power.* If as of the date of a gift a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an interest passes to or is vested in charity on the date of the gift and the interest would be defeated by the performance of some act or the happening of some event, the occurrence of which appeared to have been highly improbable on the date of the gift, the deduction is allowable. The deduction is not allowed in the case of a transfer in trust conveying a present interest in income if by reason of all the conditions and circumstances surrounding the transfer it appears that the charity may not receive the beneficial enjoyment of the interest.

For example, assume that assets placed in trust consist of stock in a corporation the fiscal policies of which are controlled by the donor and his family, that the trustees and remaindermen are likewise members of the donor's family, and that the governing instrument contains no adequate guarantee of the requisite income to the charitable organization. Under such circumstances, no deduction will be allowed. Similarly, if the trustees were not members of the donor's family but had no power to sell or otherwise dispose of closely held stock, or otherwise insure the requisite enjoyment of income to the charitable organization, no deduction would be allowed.

(f) *Exceptions.* (1) This section does not apply to contributions by estates and trusts (see section 642(c)). For disallowance of certain charitable deductions otherwise allowable under section 170, see sections 503(e) and 681(b)(5) (relating to organizations engaged in prohibited transactions). For disallowance of deductions for contributions to or for the use of communist controlled organizations, see section 11(a) of the Internal Security Act of 1950, as amended (50 U.S.C. 790). For denial of deduction for charitable contributions as trade or business expenses and rules with respect to treatment of payments to organizations other than those described in section 170(c), see section 162 and the regulations thereunder.

(2) No deduction shall be allowed under section 170 for amounts paid to an organization:

(i) A substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, or

(ii) Which participates in or intervenes in any political campaign on behalf of any candidate for public office.

For purposes of determining whether an organization is attempting to influence legislation or is engaging in political activities, see section 501(c)(3) and the regulations thereunder. Moreover, no deduction shall be allowed under section 170 for expenditures for lobbying purposes, promotion or defeat of legislation, etc. See also the regulations under section 162.

(3) No deduction for charitable contributions is allowed in computing the taxable income of a common trust fund or of a partnership. See sections 584(d) and 703(a)(2)(D). However, a partner's distributive share of charitable contributions actually paid by a partnership during its taxable year may be allowed as a deduction in the partner's separate return for his taxable year with or within which the taxable year of the partnership ends, to the extent that the aggregate of his share of the partnership contributions and his own contributions does not exceed the limitations in section 170 (b). In the case of a nonresident alien individual, or a citizen of the United States entitled to the benefits of section 931, see sections 873(c), 876, and 931.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6605, 27 FR 8094, Aug. 15, 1962; T.D. 6785, 29 FR 18499, Dec. 29, 1964; T.D. 6832, 30 FR 8574, July 7, 1965; T.D. 6900, 31 FR 14633, Nov. 17, 1966; T.D. 7084, 36 FR 266, Jan. 8, 1971; T.D. 7207, 37 FR 20768, Oct. 4, 1972]

§1.170–2 Charitable deductions by individuals; limitations (before amendment by Tax Reform Act of 1969).

(a) *In general.* (1) A deduction is allowable to an individual under section 170 only for charitable contributions actually paid during the taxable year, regardless of when pledged and regardless of the method of accounting employed by the taxpayer in keeping his books and records. A contribution to an organization described in section 170(c) is deductible even though some portion of the funds of the organization may be used in foreign countries for charitable or educational purposes. The deduction by an individual for charitable contributions under section 170 is limited generally to 20 percent of the taxpayer's adjusted gross income (computed without regard to any net operating loss carryback to the taxable year under section 172). If a husband and wife make a joint return, the deduction for contributions is the aggregate of the contributions made by the spouses, and the limitation in section 170(b) is based on the aggregate adjusted gross income of the spouses. The 20-percent limitation applies to amounts contributed during the taxable year ‘‘to or for the use of’’ those recipients described in section 170(c), including amounts treated under section 170(d) as paid for the use of an organization described in section 170(c) (2), (3), or (4). See paragraph (f) of this section. The limitation is computed without regard to contributions qualifying for the additional 10-percent deduction. For examples of the application of the 10- and 20-percent limitation, see paragraph (b)(5) of this section. For special rules reducing amount of certain charitable deductions, see paragraph (c)(2) of § 1.170–1.

(2) No deduction is allowable for contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization contributions to which are deductible may constitute a deductible contribution. For example, the cost of a uniform without general utility which is required to be worn in performing donated services is deductible. Similarly, out-of-pocket transportation expenses necessarily incurred in rendering donated services are deductible. Reasonable expenditures for meals and lodging necessarily incurred while away from home in the course of rendering donated services also are deductible. For the purposes of this section, the phrase *while away from home* has the same meaning as that phrase is used for purposes of section 162.

(3)(i) In the case of an annuity or portion thereof purchased from an organization described in section 170(c), there shall be allowed as a deduction the excess of the amount paid over the value at the time of purchase of the annuity or portion purchased.

(ii) The value of the annuity or portion is the value of the annuity determined in accordance with section 101(b) and the regulations thereunder.

(b) *Additional 10-percent deduction*—(1) *In general.* In addition to the deduction which may be allowed for contributions subject to the general 20-percent limitation, an individual may deduct charitable contributions made during the taxable year to the organizations specified in section 170(b)(1)(A) to the extent that such contributions in the aggregate do not exceed 10 percent of his adjusted gross income (computed without regard to any net operating loss carryback to the taxable year under section 172). The additional 10-percent deduction may be allowed with respect to contributions to:

(i) A church or a convention or association of churches,

(ii) An educational organization referred to in section 503(b)(2) and defined in subparagraph (3)(i) of this paragraph,

(iii) A hospital referred to in section 503(b)(5) and defined in subparagraph (4)(i) of this paragraph,

(iv) Subject to certain conditions and limitations set forth in subparagraph (4)(ii) of this paragraph, and for taxable years beginning after December 31, 1955, a medical research organization referred to in section 503(b)(5),

(v) Subject to certain limitations and conditions set forth in subparagraph (3)(ii) of this paragraph, and for taxable years beginning after December 31, 1960, an organization referred to in section 503(b)(3) which is organized and operated for the benefit of certain State and municipal colleges and universities,

(vi) For taxable years beginning after December 31, 1963, a governmental unit referred to in section 170(c)(1), and

(vii) Subject to certain limitations and conditions set forth in subparagraph (5) of this paragraph, and for taxable years beginning after December 31, 1963, an organization referred to in section 170(c)(2).

To qualify for the additional 10-percent deduction the contributions must be made ‘‘to’’, and not merely ‘‘for the use of’’, one of the specified organizations. A contribution to an organization referred to in section 170(c)(2) (other than an organization specified in subdivisions (i) through (vi) of this subparagraph) which, for taxable years beginning after December 31, 1963, is not ‘‘publicly supported’’ under the rules of subparagraph (5) of this paragraph will not qualify for the additional 10-percent deduction even though such organization makes the contribution available to an organization which is specified in section 170(b)(1)(A). The computation of this additional deduction is not necessary unless the total contributions paid during the taxable year are in excess of the general 20-percent limitation. Where the total contributions exceed the 20-percent limitation, the taxpayer should first ascertain the amount of charitable contributions subject to the 10-percent limitation, and any excess over the 10-percent limitation should then be added to all other contributions and limited by the 20-percent limitation. For provisions relating to a carryover of certain charitable contributions made by individuals, see paragraph (g) of this section.

(2) *Church.* For definition of *church,* see the regulations under section 511.

(3) *Educational organization and organizations for the benefit of certain State and municipal colleges and universities*—(i) *Educational organization.* An *educational organization* within the meaning of section 170(b)(1)(A) is one whose primary function is the presentation of formal instruction and which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term, therefore, includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities. It includes Federal, State, and other public-supported schools which otherwise come within the definition. It does not include organizations engaged in both educational and noneducational activities unless the latter are merely incidental to and growing out of the educational activities. A recognized university which incidentally operates a museum or sponsors concerts is an educational organization. However, the operation of a school by a museum does not necessarily qualify the museum as an educational organization. A gift to an educational institution through an alumni association or a class organization, which acts simply as a fund-raising or collection agency through which gifts may be made currently to the institution, is a gift to the educational organization if the entire gift inures to its benefit, but not if any part of it inures to the general or operating fund of the agency. Similarly, a gift to one or more educational institutions through an association of educational institutions will be considered a gift to the institutions if it inures entirely to their benefit.

(ii) *Organizations for the benefit of certain State and municipal colleges and universities. (a)* For taxable years beginning after December 31, 1960, gifts made to an organization referred to in section 503(b)(3) organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of certain colleges and universities, may be taken into account in computing the additional 10-percent limitation. The phrase *expenditures to or for the benefit of certain colleges and universities* includes expenditures made for any one or more of the normally accepted functions of colleges and universities, for example, for the acquisition and maintenance of real property comprising part of the campus area, the erection of or participation in the erection of college or university buildings, scholarships, libraries, student loans, and the acquisition and maintenance of equipment and furnishings used for or in conjunction with normally accepted functions of colleges and universities.

(b) The recipient organization must be one which normally receives a substantial portion of its support from the United States or any State or political subdivision thereof or from direct or indirect contributions from the general public, or from a combination of two or more of such sources. An example of an indirect contribution from the public would be the receipt by the organization of its share of the proceeds of an annual collection campaign of a community chest, community fund, or united fund.

(c) The college or university (including land grant colleges and universities) to be benefited must be an educational organization referred to in section 170(b)(1)(A)(ii) and subdivision (i) of this subparagraph; and must be an agency or instrumentality of a State or political subdivision thereof, or must be owned or operated by a State or political subdivision thereof or by an agency or instrumentality of one or more States or political subdivisions.

(4) *Hospital and medical research organization*—(i) *Hospital.* The term *hospital,* as used in section 170(b)(1)(A), means an organization the principal purposes or functions of which are the providing of hospital or medical care. The term includes Federal and State hospitals

otherwise coming within the definition but does not include medical education organizations, or medical research organizations. See, however, subdivision (ii) of this subparagraph, relating to contributions to certain medical research organizations for taxable years beginning after December 31, 1955. A rehabilitation institution or an outpatient clinic may qualify as a hospital if its principal purposes or functions are the providing of hospital or medical care. The term *hospital* does not include convalescent homes or homes for children or the aged, nor does the term include institutions whose principal purposes or functions are to train handicapped individuals to pursue some vocation.

(ii) *Certain medical research organizations. (a)* For taxable years beginning after December 31, 1955, certain charitable contributions made to certain medical research organizations may be taken into account in computing the additional 10-percent limitation. To be so taken into account the charitable contribution must be made to a medical research organization that is directly engaged in the continuous active conduct of medical research in conjunction with a hospital (as defined in subdivision (i) of this subparagraph), and, during the calendar year in which the contribution is made, the organization must be committed to spend the contribution for such active conduct of medical research before January 1 of the fifth calendar year beginning after the date the contribution is made.

(b) As used in section 170(b)(1)(A) and this subparagraph, the term *medical research organization* means an organization the principal purpose or function of which is to engage in medical research. Medical research may be defined as the conduct of investigations, experiments, and studies to discover, develop, or verify knowledge relating to the causes, diagnosis, treatment, prevention, or control of physical or mental diseases and impairments of man. To qualify as a medical research organization, the organization must have the appropriate equipment and professional personnel necessary to carry out its principal function.

(c) The organization must, at the time of the contribution, be directly engaged in the continuous active conduct of medical research in conjunction with a hospital described in subdivision (i) of this subparagraph. The organization need not be formally affiliated with a hospital to be considered engaged in the active conduct of medical research in conjunction with a hospital, but it must be physically connected, or closely associated, with a hospital. In any case, there must be a joint effort on the part of the research organization and the hospital pursuant to an understanding that the two organizations shall maintain continuing close cooperation in the active conduct of medical research. For example, the necessary joint effort will normally be found to exist if the activities of the medical research organization are carried on in space located within or adjacent to a hospital provided that the organization is permitted to utilize the facilities (including equipment, case studies, etc.) of the hospital on a continuing basis in the active conduct of medical research. A medical research organization which is closely associated, in the manner described above, with a particular hospital or particular hospitals, may be considered to be pursuing research in conjunction with a hospital if the necessary joint effort is supported by substantial evidence of the close cooperation of the members of the research organization and the staff of the particular hospital or hospitals. The active participation in medical research by the staff of the particular hospital or hospitals will be considered as evidence of the requisite joint effort. If the organization's primary purpose is to disburse funds to other organizations for the conduct of research by them, or, if the organization's primary purpose is to extend research grants or scholarships to others, it is not directly engaged in the active conduct of medical research, and contributions to such an organization may not be taken into account for purposes of the additional 10-percent limitation.

(d) A charitable contribution to a medical research organization may be taken into account in computing the additional 10-percent limitation only if the organization is committed to spend such contribution for medical research

in conjunction with a hospital on or before the first day of the fifth calendar year which begins after the date the contribution is made. The organization's commitment that the contribution will be spent within the prescribed time only for the prescribed purposes must be legally enforceable. A promise in writing to the donor in consideration of his making a contribution that such contribution will be so spent within the prescribed time will constitute a commitment. The expenditure of contributions received for plant, facilities, or equipment, used solely for medical research purposes shall ordinarily be considered to be an expenditure for medical research for purposes of section 170(b) and this section. If a contribution is made in other than money, it shall be considered spent for medical research if the funds from the proceeds of a disposition thereof are spent by the organization within the five-year period for medical research; or, if such property is of such a kind that it is used on a continuing basis directly in connection with such research, it shall be considered spent for medical research in the year in which it is first so used.

(5) *Corporation, trust, or community chest, fund, or foundation*—(i) *In general.* *(a)* For taxable years beginning after December 31, 1963, gifts made to a corporation, trust, or community chest, fund, or foundation, referred to in section 170(c)(2) (other than an organization specified in subparagraph (1) (i) through (vi) of this paragraph), may be taken into account in computing the additional 10-percent limitation, provided the organization is a ''publicly supported'' organization. For purposes of this subparagraph, an organization is ''publicly supported'' if it normally receives a substantial part of its support from a governmental unit referred to in section 170(c)(1) or from direct or indirect contributions from the general public.

(b) An important factor in determining whether an organization normally receives a substantial part of its support from ''direct or indirect contributions from the general public'' is the extent to which the organization derives its support from or through voluntary contributions made by persons representing the general public. Except in unusual situations (particularly in the case of newly created organizations), an organization is not ''publicly supported'' if it receives contributions only from the members of a single family or from a few individuals.

(ii) *Special rules and meaning of terms.* *(a)* For purposes of this subparagraph, the term *support*, except as otherwise provided in *(b)* of this subdivision (ii), means all forms of support including (but not limited to) contributions received by the organization, investment income (such as, interest, rents, royalties, and dividends), and net income from unrelated business activities whether or not such activities are carried on regularly as a trade or business.

(b) The term *support* does not include:

(1) Any amounts received from the exercise or performance by an organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a). In general, such amounts include amounts received from any activity the conduct of which is substantially related to the furtherance of such purpose or function (other than through the production of income).

(2) Any gain upon the sale or exchange of property which would be considered under any section of the Code as gain from the sale or exchange of a capital asset.

(3) Contributions of services for which a deduction is not allowable.

(c) The term *support from a governmental unit* includes:

(1) Any amounts received from a governmental unit including donations or contributions and amounts received in connection with a contract entered into with a governmental unit for the performance of services or in connection with a government research grant, provided such amounts are not excluded from the term *support* under *(b)* of this subdivision (ii). For purposes of *(b)(1)* of this subdivision (ii), an amount paid by a governmental unit to an organization is not received from the exercise or performance of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a) if the purpose of the payment is to enable the organization to provide a service to, or

maintain a facility for, the direct benefit of the public, as, for example, the maintenance of library facilities which are open to the public.

(2) Tax revenues levied for the benefit of the organization and either paid to or expended on behalf of the organization.

(3) The value of services or facilities (exclusive of services or facilities generally furnished, without charge, to the public) furnished by a governmental unit to the organization without charge, as, for example, where a city pays the salaries of personnel used to guard a museum, art gallery, etc., or provides, rent free, the use of a building. However, the term does not include the value of any exemption from Federal, State, or local tax or any similar benefit.

(d) The term *indirect contributions from the general public* includes contributions received by the organization from organizations which normally receive a substantial part of their support from direct contributions from the general public.

(iii) *Determination of whether organization is ''publicly supported''—(a) In general.* No single test which would be appropriate in every case may be prescribed for determining whether a corporation, trust, or community chest, fund, or foundation, referred to in section 170(c)(2), is ''publicly supported''. For example, since the statutory test is whether the organization normally receives a substantial part of its support from the prescribed sources, a test which would be appropriate in the case of an organization which has been in operation for a number of years would not necessarily be appropriate in the case of a newly established organization. The determination of whether an organization is ''publicly supported'' depends on the facts and circumstances in each case. Thus, although a ''mechanical test'' is set forth in *(b)* of this subdivision (iii), such test is not an exclusive test. Accordingly, an organization which does not qualify as a ''publicly supported'' organization by application of the ''mechanical test'' may qualify as a ''publicly supported'' organization on the basis of the facts and circumstances in its case. For provisions relating to the facts and circumstances test, see *(c)* of this subdivision (iii).

(b) Mechanical test. An organization will be considered to be a ''publicly supported'' organization for its current taxable year and the taxable year immediately succeeding its current year, if, for the four taxable years immediately preceding the current taxable year, the total amount of the support which the organization receives from governmental units, from donations made directly or indirectly by the general public, or from a combination of these sources equals 33⅓ percent or more of the total support of the organization for such four taxable years. The rule in the preceding sentence does not apply if there are substantial changes in the organization's character, purposes, or methods of operation in the current year, and does not apply in respect of the immediately succeeding taxable year if such changes occur in such year. In determining whether the 33⅓-percent-of-support test is met, contributions by an individual, trust, or corporation shall be taken into account only to the extent that the total amount of the contributions by any such individual, trust, or corporation during the four-taxable-year period does not exceed 1 percent of the organization's total support for such four taxable years. In applying the 1-percent limitation, all contributions made by a donor and by any person or persons standing in a relationship to the donor which is described in section 267(b) and the regulations thereunder shall be treated as made by one person. The 1-percent limitation shall not apply to support from governmental units referred to in section 170(c)(1) or to contributions from ''publicly supported'' organizations. A national organization which carries out its purposes through local chapters with which it has an identity of aims and purposes may, for purposes of determining whether the organization and the local chapters meet the mechanical test, make the computation on an aggregate basis.

Example. For the years 1964 through 1967, X, an organization referred to in section 170(c)(2), received support (as defined in subdivision (ii) of this subparagraph) of $600,000 from the following sources:

Investment income	$300,000

City Y (a governmental unit referred to in section 170(c)(1))	40,000
United Fund (an organization referred to in section 170(c)(2) which is "publicly supported")	40,000
Contributions	220,000
Total support	600,000

For the years 1964 through 1967, X received in excess of 33⅓ percent of its support from a governmental unit referred to in section 170(c)(1) and from direct and indirect contributions from the general public computed as follows:

33⅓ percent of total support	$200,000
Support from a governmental unit referred to in section 170(c)(1)	40,000
Indirect contributions from the general public (United Fund)	40,000
Contributions by various donors (no one donor having made contributions which total in excess of $6,000—1 percent of total support)	50,000
12 contributions (each in excess of $6,000—1 percent of total support) 12×$6,000	72,000
	202,000

Since the amount of X's support from governmental units referred to in section 170 (c)(1) and from direct and indirect contributions from the general public in the years 1964 through 1967 is in excess of 33⅓ percent of X's total support for such four taxable years, X is considered a ''publicly supported'' organization with respect to contributions made to it during 1968 and 1969 without regard to whether X receives 33⅓ percent of its support during 1968 or 1969 from such sources (assuming that there are no substantial changes in X's character, purposes, or methods of operation).

(c) Facts and circumstances test. (1) A corporation, trust, or community chest, fund or foundation referred to in section 170(c)(2) which does not qualify as a ''publicly supported'' organization under the mechanical test described in (b) of this subdivision (iii) (including an organization which has not been in existence for a sufficient length of time to make such test applicable) may be a ''publicly supported'' organization on the basis of the facts and circumstances in its case.

(2) The facts and circumstances which are relevant and the weight to be accorded such facts and circumstances may differ in certain cases depending, for example, on the nature of the organization and the period of time it has been in existence. However, under no circumstances will an organization which normally receives substantially all of its contributions (directly or indirectly) from the members of a single family or from a few individuals qualify as a ''publicly supported'' organization.

(3) For purposes of the facts and circumstances test the most important consideration is the organization's source of support. An organization will be considered a ''publicly supported'' organization if it is constituted so as to attract substantial support from contributions, directly or indirectly, from a representative number of persons in the community or area in which it operates. In determining what is a ''representative number of persons,'' consideration must be given to the type of organization and whether or not the organization limits its activities to a special field which can be expected to appeal to a limited number of persons. An organization is so constituted if, for example, it establishes that it does in fact receive substantial support from contributions from a representative number of persons; that pursuant to its organizational structure and method of operation it makes bona fide solicitations for broad based public support, or, in the case of a newly created organization, that its organizational structure and method of operation are such as to require bona fide solicitations for broad based public support; that it receives substantial support from a community chest or similar public federated fund raising organization, such as a United Fund or United Appeal; or that it has a substantial number of members (in relation to the community it serves, the nature of its activities, and its total support) who pay annual membership dues.

(4) Although primary consideration will be given to the source of an organization's support, other relevant factors may be taken into account in determining whether or not the organization is of a public nature, such as:

(i) Whether the organization has a governing body (whether designated in the organization's bylaws, certificate of incorporation, deed of trust, etc., as a Board of Directors, Board of Trustees, etc.) which is comprised of public officials, of individuals chosen by public officials acting in their capacity as such, or of citizens broadly representative of the interests and views of the public. This characteristic does not

exist if the membership of an organization's governing body is such as to indicate that it represents the personal or private interests of a limited number of donors to the organization (or persons standing in a relationship to such donors which is described in section 267(b) and the regulations thereunder), rather than the interests of the community or the general public.

(ii) Whether the organization annually or more frequently makes available to the public financial reports or, in the case of a newly created organization, is constituted so as to require such reporting. For this purpose an information or other return made pursuant to a requirement of a governmental unit shall not be considered a financial report. An organization shall be considered as making financial reports of its operations available to the public if it publishes a financial report in a newspaper which is widely circulated in the community in which the organization operates or if it makes a bona fide dissemination of a brochure containing a financial report.

(iii) If the organization is of a type which generally holds open to the public its buildings (as in the case of a museum) or performances conducted by it (as in the case of a symphonic orchestra), whether the organization actually follows such practice, or, in the case of a newly created organization, is so organized as to require that its facilities be open to the public.

(5) The application of this subdivision *(c)* may be illustrated by the following examples:

Example 1. M, a community trust, is an organization referred to in section 170(c)(2). In 1950, M was organized in the X Community by several leading trusts and financial institutions with the purpose of serving permanently the educational and charitable needs of the X Community by providing a means by which the public may establish funds or make gifts of various amounts to established funds which are administered as an aggregate fund with provision for distribution of income and, in certain cases, principal for educational or charitable purposes by a single impartial committee. The M Organization, by distribution of pamphlets to the public through participating trustee banks, actively solicits members of the X Community and other concerned parties to establish funds within the trust or to contribute to established funds within the trust. Under the declaration of trust, a contributor to a fund may suggest or request (but not require) that his contribution be used in respect of his preferred charitable, educational, or other benevolent purpose, and distributions of the income from the fund, and in certain cases the principal, will be made by the Distribution Committee with regard to such request unless changing conditions make such purpose unnecessary, undesirable, impractical, or impossible in which case income and (where the contributor has so specified) principal will be distributed by the Distribution Committee in order to promote the public welfare more effectively. Where a contributor has not expressed a desire as to a charitable, educational, or other benevolent purpose, the Distribution Committee will distribute the entire annual income from the fund to such a purpose agreed upon by such committee. The Distribution Committee is composed of representatives of the community chosen one each by the X Bar Association, the X Medical Society, the mayor of X Community, the judge of the highest X Court, and the president of the X College, and two representatives chosen by the participating trustee banks. There are a number of separate funds within the trust administered by several participating banks. M has consistently distributed or used its entire annual income for projects with purposes described in section 170(c)(2)(B) from which members of the public may benefit or to other organizations described in section 170(b)(1)(A) which so distribute or use such income. Through its participating trustee banks, M annually makes available to the public a brochure containing a financial statement of its operations including a list of all receipts and disbursements. Under the facts and circumstances, M is a ''publicly supported'' organization.

Example 2. Assume the same facts as in *Example (1)* except that M has been in existence for only one year and only two contributors have established funds within the trust. The Distribution Committee has been chosen and is required by the governing declaration of trust to make annual distribution of the entire income of the trust to projects with purposes described in section 170(c)(2)(B) from which members of the public may benefit or to other organizations described in section 170(b)(1)(A) which so distribute or use such income. The declaration of trust and other governing instruments require (1) that the M Community Trust actively solicit contributions from members of the X Community through dissemination of literature and other public appeals, and (2) that it make available to the members of the X Community, annual financial reports of its operations. Under the facts and circumstances, M is a ''publicly supported'' organization.

Example 3. N, an art museum, is an organization referred to in section 170(c)(2). In 1930, N was founded in Y City by the members of a single family to collect, preserve, interpret, and display to the public important works of art. N is governed by a self-perpetuating Board of Trustees limited by the governing instruments to a maximum membership of 20 individuals. The original board consisted almost entirely of members of the founding family. Since 1945, members of the founding family or persons standing in a relationship to the members of such family described in section 267(b) have annually constituted less than one-fifth of the Board of Trustees. The remaining board members are citizens of Y City from a variety of professions and occupations who represent the interests and views of the people of Y City in the activities carried on by the organization rather than the personal or private interests of the founding family. N solicits contributions from the general public and for each of its four most recent taxable years has received total contributions in small sums (less than $100) in excess of $10,000. For N's four most recent taxable years, investment income from several large endowment funds has constituted 75 percent of its total support. N normally expends a substantial part of its annual income for purposes described in section 170(c)(2)(B). N has, for the entire period of its existence, been open to the public and more than 300,000 people (from the Y City and elsewhere) have visited the museum in each of its four most recent taxable years. N annually publishes a financial report of its operation in the Y City newspaper. Under the facts and circumstances, N museum is a ''publicly supported'' organization.

Example 4. In 1960, the O Philharmonic Orchestra was organized in Z City through the combined efforts of a local music society and a local women's club to present to the public a wide variety of musical programs intended to foster music appreciation in the community. O is an organization referred to in section 170(c)(2). The orchestra is composed of professional musicians who are paid by the association. Twelve performances, open to the public, are scheduled each year. The admission charge for each of these performances is $3. In addition, several performances are staged annually without charge. In each of its four most recent taxable years, O has received separate contributions of $10,000 from A, B, C, and D (not members of a single family) and support of $5,000 from the Z Community Chest, a public federated fund raising organization operating in Z City. O is governed by a Board of Directors comprised of five individuals. A faculty member of a local college, the president of a local music society, the head of a local banking institution, a prominent doctor, and a member of the governing body of the local Chamber of Commerce currently serve on the Board and represent the interests and views of the community in the activities carried on by O. O annually files a financial report with Z City which makes such report available for public inspection. Under the facts and circumstances, O is a ''publicly supported'' organization.

Example 5. P is a newly created organization of a type referred to in section 170 (c)(2). P's charter requires that its governing body be selected by public officials and by public organizations representing the community in which it operates. Pursuant to P's charter, a continuing fund raising campaign which will encompass the entire community has been planned. P's charter requires that its entire annual income be distributed to or used for projects with purposes described in section 170(c)(2)(B) and that it make available to the public annual financial reports of its operations. By reason of the express provisions of P's charter relating to its organizational structure and prescribed methods of operation, P is a ''publicly supported'' organization.

(6) *Examples.* The application of the special 10-percent limitation and the general 20-percent limitation on contributions by individuals may be illustrated by the following examples:

Example 1. A, an individual, reports his income on the calendar year basis and for the year 1957 has an adjusted gross income of $10,000. During 1957 he made the following charitable contributions:

1. Contributions qualifying for the additional 10-percent deduction under section 170(b)(1)(A)	$2,400	
2. Other charitable contributions	700	
3. Total contributions paid	3,100	

		Deductible contributions
4. Contributions qualifying for the additional 10-percent deduction under section 170(b)(1)(A)	2,400	
5. Special limitation under section 170(b)(1)(A): 10 percent of adjusted gross income	1,000	
6. Deductible amount: line 4 or line 5, whichever is the lesser		$1,000
7. Excess of line 4 over line 5	1,400	
8. Add: Other charitable contributions	700	

		Deductible contributions
9. Contributions subject to the general 20-percent limitation under section 170(b)(1)(B)	2,100	
10. Limitation under section 170(b)(1)(B): 20 percent of the adjusted gross income	2,000	
11. Deductible amount: line 9 or line 10, whichever is the lesser		2,000
12. Contributions not deductible	100	
13. Total deduction for contributions		3,000

Example 2. B, an individual, reports his income on the calendar year basis and for the year 1957 has an adjusted gross income of $10,000. During 1957 he made the following charitable contributions:

1. Contributions qualifying for the additional 10-percent deduction under section 170(b)(1)(A)	$700	
2. Other charitable contributions	2,400	
3. Total contributions paid	3,100	
4. Contributions qualifying for the additional 10-percent deduction under section 170(b)(1)(A)	700	
5. Limitation described in section 170(b)(1)(A): 10 percent of the adjusted gross income	1,000	
6. Deductible amount: line 4 or line 5, whichever is the lesser		$700
7. Excess of line 4 over line 5	0	
8. Add: Other charitable contributions	2,400	
9. Contributions subject to the general 20-percent limitation under section 170(b)(1)(B)	2,400	
10. Limitation under section 170(b)(1)(B): 20 percent of the adjusted gross income	2,000	
11. Deductible amount: line 9 or line 10, whichever is the lesser		2,000
12. Contributions not deductible	400	
13. Total deduction for contributions		2,700

(c) *Unlimited deduction for individuals*—(1) *In general.* (i) The deduction for charitable contributions made by an individual is not subject to the 10- and 20-percent limitations of section 170(b) if in the taxable year and each of 8 of the 10 preceding taxable years the sum of his charitable contributions paid during the year, plus his payments during the year on account of Federal income taxes, is more than 90 percent of his taxable income for the year (or net income, in years governed by the Internal Revenue Code of 1939). In determining the applicability of the 10- and 20-percent limitations of section 170(b) for taxable years beginning after December 31, 1957, there may be substituted, in lieu of the amount of income tax paid during any year, the amount of income tax paid in respect of such year, provided that any amount so included for the year in respect of which payment was made shall not be included for any other year. For the purpose of the first sentence of this paragraph, taxable income under the 1954 Code is determined without regard to the deductions for charitable contributions under section 170, for personal exemptions under section 151, or for a net operating loss carryback under section 172. On the other hand, for this purpose net income under the 1939 Code is computed without the benefit only of the deduction for charitable contributions. See section 120 of the Internal Revenue Code of 1939. The term *income tax* as used in section 170(b)(1)(C) means only Federal income taxes, and does not include the taxes imposed on self-employment income, on employees under the Federal Insurance Contributions Act, and on railroad employees and their representatives under the Railroad Retirement Tax Act by Chapters 2, 21, and 22, respectively, or corresponding provisions of the Internal Revenue Code of 1939. For purposes of section 170(b)(1)(C) and this paragraph, the amount of income tax paid during a taxable year shall be determined (except as provided in subdivision (ii) of this subparagraph) by including all payments made by the taxpayer during such taxable year on account of his Federal income taxes (whether for the taxable year or for preceding taxable years). Such payments would include any amount paid during the taxable year as estimated tax (exclusive of any portion of such amount for taxable years beginning after December 31, 1966, which is attributable to the self-employment tax imposed by chapter (2) for that year, payment of the final installment of estimated tax (exclusive of any portion of such installment, for taxable years beginning after December 31, 1966, which is attributable to the self-employment tax imposed by chapter 2) for the preceding taxable year, final payment for the preceding taxable year, and any payment of a deficiency for an earlier taxable year, to the extent that such payments do not exceed the tax for the taxable year for which payment is made. Any payment of income tax with respect to which the taxpayer receives a refund or credit shall be reduced by the amount of such refund or credit. Any such refund or credit shall be applied against the most recent payments for the taxable year in respect of which the refund or credit arose.

(ii) For any taxable year beginning after December 31, 1957, the applicability of the 10- and 20-percent limitations of section 170(b) may be determined either with reference to the income tax paid during the year or any prior year, or with reference to the income tax paid in respect of any such year or prior years. The 90-percent test of section 170(b)(1)(C) may be applied for the taxable year, or for any one or more of the preceding 10 taxable years, by taking into account the income taxes paid in respect of that year or years, and for the balance of the 10 years by taking into account the income tax payments made during those years. Thus, a taxable year which qualifies under either of the two permissible methods shall be considered as a qualifying year irrespective of whether the taxable year begins before or after December 31, 1957. However, a particular income tax payment may only be taken into account once, either with respect to the year of liability or for the year of payment.

(2) *Joint returns*—(i) *Joint return for current taxable year.* If a husband and wife make a joint return for any taxable year, their deduction for charitable contributions is not subject to the 10- and 20-percent limitations of section 170(b), if, under the rules of subparagraph (1) of this paragraph, in the taxable year and in each of 8 of the 10 preceding taxable years (regardless of whether separate or joint returns were filed), the aggregate charitable contributions of both spouses paid during the year, plus their aggregate payments during the year on account of Federal income taxes (or, if the taxable year begins after December 31, 1957, the aggregate tax paid in respect of such taxable year or any preceding taxable year) exceed 90 percent of their aggregate taxable incomes for the year.

(ii) *Separate return by spouse or by unremarried widow or widower.* If a spouse, or the unremarried widow or widower of a deceased spouse, makes a separate return for any taxable year, his deduction for charitable contributions is not subject to the 10- and 20-percent limitations of section 170(b), if, under the rules of subparagraph (1) of this paragraph, in the taxable year and each of 8 of the 10 preceding taxable years:

(a) For which the taxpayer filed a joint return with his spouse, either their aggregate charitable contributions and payments of Federal income taxes made during the taxable year (or if the taxable year begins after December 31, 1957, made in respect of such taxable year or any preceding taxable year) exceed 90 percent of their aggregate taxable income for that year, or the taxpayer's separate charitable contributions and payments of Federal income taxes allocable to his separate income and made during the taxable year (or if the taxable year begins after December 31, 1957, made in respect of such taxable year or any preceding taxable year) exceed 90 percent of his separate taxable income for that year, and *(b)* For which the taxpayer did not file a joint return with his spouse, the aggregate of his charitable contributions and payments of Federal income taxes made during the taxable year (or, if the taxable year begins after December 31, 1957, the payments of income taxes

made in respect of such taxable year or any preceding taxable year) exceeds 90 percent of his taxable income for that year.

For the purpose of the preceding sentence, the word *spouse* does not include a spouse from whom the taxpayer has been divorced.

(iii) *Joint return with former spouse for prior taxable year.* A divorced or remarried taxpayer who filed a joint return for a prior taxable year with a former spouse shall, for purposes of applying this paragraph, be treated in the same manner as if he had filed a separate return for such prior taxable year, and as if his Federal income tax liability and taxable income for such prior taxable year were his allocable portions of the joint tax liability and combined taxable income, respectively, for such year.

(iv) *Allocation.* Whenever it is necessary to allocate the joint tax liability or the combined taxable income, or both, for a taxable year for which a joint return was filed, a computation shall be made for the taxpayer and for his spouse or former spouse showing for each of them the Federal income taxes and taxable income which would be determined if separate returns had been filed by them for such taxable year. The joint tax liability and conbined taxable income for such taxable year shall then be allocated proportionately to the income taxes and taxable income, respectively, so computed. Whenever it is necessary to determine the separate payments made by a taxpayer in respect of a joint tax liability, the amount paid by him during the taxable year as estimated tax (exclusive of any portion of such amount for taxable years beginning after December 31, 1966, which is attributable to the self-employment tax imposed by Chapter 2) for that year shall be included to the extent it does not exceed his allocable portion of the joint tax under Chapter 1 (exclusive of tax under section 56) for the taxable year, and any amount paid by him for a prior year (whether as the final installment of estimated tax—exclusive of any portion of such installment, for taxable years beginning after December 31, 1966, which is attributable to the self-employment tax imposed by Chapter 2—for the preceding taxable year, or a final payment for the preceding year, or the payment of a deficiency for an earlier year) shall be included to the extent such amount, when added to amounts previously paid by him for such prior year, does not exceed his allocable portion of the joint tax liability for the prior year.

(d) *Denial of deduction in case of certain transfers in trust*—(1) *Reversionary interest in grantor.* No charitable deduction will be allowed for the value of any interest in property transferred to a trust after March 9, 1954, if the grantor at the time of the transfer has a reversionary interest in the corpus or income and the value of such reversionary interest exceeds 5 percent of the total value on which the charitable deduction would, but for section 170(b)(1)(D), be determined. For purposes of this paragraph, the term *reversionary interest* means a possibility that after the possession or enjoyment of property or its income has been obtained by a charitable donee, the property or its income may revest in the grantor or his estate, or may be subject to a power exercisable by the grantor or a nonadverse party (within the meaning of section 672 (b)), or both, to revest in, or return to or for the benefit of, the grantor or his estate the property or income therefrom. An interest of the grantor which, in any event, will terminate before the ripening of the assured charitable gift for which a deduction is claimed is not considered a reversionary interest for purposes of this section. For example, assume that a taxpayer conveyed property to a trust under the terms of which the income is payable to the taxpayer's wife for her life, and, if she predeceases him, to him for his life, and after the death of both the property is to be transferred to a charitable organization.

(2) *Valuation of interests.* The present value of the remainder interest in the property, taking into account the value of the life estates reserved to the taxpayer and his wife, may be allowed as a charitable deduction. Where the corpus of the trust is to return to the grantor after a number of years certain, the value of the reversionary interest at the time of the transfer may

be computed by the use of tables showing the present value at 3 1/2 percent a year, compuounded annually, of $1 payable at the end of a number of years certain. See paragraph (f), Table II, of §20.2031–7 of this chapter (Estate Tax Regulations). Where the value of a reversionary interest is dependent upon the continuation or termination of the life of one or more persons, it must be determined on the basis of Table 38 of United States Life Tables and Actuarial Tables 1939–1941, published by the United States Department of Commerce, Bureau of the Census, and interest at the rate of 3 1/2 percent a year, compounded annually. See paragraph (f), Table I, of §20.2031–7 of this chapter (Estate Tax Regulations) for valuations based on one life, and ''Actuarial Values for Estate and Gift Tax'' (Internal Revenue Service Publication No. 11, Rev. 5–59) for values based on more than one life. In an actual case (not merely hypothetical), the grantor or his legal representative may, upon request, obtain the information necessary to determine such a value from the district director with whom the grantor files his return. The request must be accompanied by a statement showing the date of birth of each person the duration of whose life may affect the value of the reversionary interest and by copies of the instruments relevant to the transfer.

(e) *Fiscal years and short taxable years ending after March 9, 1954, subject to the Internal Revenue Code of 1939.* Pursuant to section 7851(a)(1)(C) of the Internal Revenue Code of 1954, the regulations prescribed in paragraph (d) of this section, to the extent that they relate to transfers in trust occurring after March 9, 1954, shall apply to all taxable years ending after March 9, 1954, even though those years may be subject to the Internal Revenue Code of 1939.

(f) *Amounts paid to maintain certain students as members of the taxpayer's household*—(1) *In General.* (i) For taxable years beginning after December 31, 1959, the term *charitable contribution* includes amounts paid by the taxpayer during the taxable year to maintain certain students as members of his household which, under the provisions of section 170(d) and this paragraph, are treated as amounts paid for the use of an organization described in section 170(c) (2), (3), or (4), and such amounts, to the extent they do not exceed the limitations under section 170(d)(2) and paragraph (f)(2) of this section, are deductible contributions under section 170. In order for such amounts to be so treated, the student must be an individual who is neither a dependent (as defined in section 152) of the taxpayer nor related to the taxpayer in a manner described in any of the paragraphs (1) through (8) of section 152(a), and such individual must be a member of the taxpayer's household pursuant to a written agreement between the taxpayer and an organization described in section 170(c) (2), (3), or (4) to implement a program of the organization to provide educational opportunities for pupils or students placed in private homes by such organization. Furthermore, such amounts must be paid to maintain such individual during the period in the taxable year he is a member of the taxpayer's household and is a full-time pupil or student in the twelfth or any lower grade at an educational institution (as defined in section 151(e)(4)) located in the United States. Amounts paid outside of the period (but within the taxable year) for expenses necessary for the maintenance of the student during the period will qualify for the charitable deduction if the other limitation requirements of the section are met.

(ii) For purposes of paragraph (i) of this section, amounts treated as charitable contributions include only those amounts actually paid by the taxpayer during the taxable year which are directly attributable to the maintenance of the student while he is a member of the taxpayer's household and is attending school on a full-time basis. This would include amounts paid to ensure the well-being of the individual and to carry out the purpose for which the individual was placed in the taxpayer's home. For example, a deduction would be allowed for amounts paid for books, tuition, food, clothing, transportation, medical and dental care, and recreation for the individual. Amounts treated as charitable contributions under this paragraph do not include amounts which the taxpayer would have expended had the student not been in the household. They would not include, for example, amounts paid in connection with the taxpayer's home for taxes, insurance, interest on a mortgage, repairs, etc. Moreover, such amounts do not include any depreciation sustained by the taxpayer in maintaining such student or students in his household, nor do they include the value of any services rendered on behalf of such student or students by the taxpayer or any member of the taxpayer's household.

(iii) For purposes of section 170(d) and this paragraph, an individual will be considered to be a full-time pupil or student at an educational institution only if he is enrolled for a course of study (prescribed for a full-time student) at such institution and is attending classes on a full-time basis. Nevertheless, such individual may be absent from school due to special circumstances and still be considered to be in full-time attendance. Periods during the regular school term when the school is closed for holidays, such as Christmas and Easter, and for periods between semesters are treated as periods during which the pupil or student is in full-time attendance at the school. Also, absences during the regular school term due to illness of such individual shall not prevent him from being considered as a full-time pupil or student. Similarly, absences from the taxpayer's household due to special circumstances will not disqualify the student as a member of the household. Summer vacations between regular school terms are not considered periods of school attendance.

(iv) As in the case of other charitable deductions, any deduction claimed for amounts described in section 170(d) and this paragraph which are treated as charitable contributions under section 170(c) is subject to verification by the district director. When claiming a deduction for such amounts, the taxpayer should submit a copy of his agreement with the organization sponsoring the individual placed in the taxpayer's household together with a summary of the various items for which amounts were paid to maintain such individual, and a statement as to the date the individual became a member of the household and the period of his attendance at school and the name and location of such school. Substantiation of amounts claimed must be supported by adequate records of the amounts actually paid. Due to the nature of certain items, such as food, a record of amounts spent for all members of the household, with an equal portion thereof allocated to each member, will be acceptable.

(2) *Limitations.* Section 170(d) and this paragraph shall apply to amounts paid during the taxable year only to the extent that the amounts paid in maintaining each pupil or student do not exceed $50 multiplied by the number of full calendar months in the taxable year that the pupil or student is maintained in accordance with the provisions of this paragraph. For purposes of such limitation, if 15 or more days of a calendar month fall within the period to which the maintenance of such pupil or student relates, such month is considered as a full calendar month. To the extent that such amounts qualify as charitable contributions under section 170(c), the aggregate of such amounts plus other contributions made during the taxable year is deductible under section 170, subject to the 20-percent limitation provided in section 170(b)(1)(B). Also, see § 1.170–2(a)(1).

(3) *Compensation or reimbursement.* Amounts paid during the taxable year to maintain a pupil or student as a member of the taxpayer's household, as provided in paragraph (f)(1) of this section, shall not be taken into account under section 170(d) of this paragraph, if the taxpayer receives any money or other property as compensation or reimbursement for any portion of such amounts. The taxpayer will not be denied the benefits of section 170(d) if he prepays an extraordinary or nonrecurring expense, such as a hospital bill or vacation trip, at the request of the individual's parents or the sponsoring organization and is reimbursed for such prepayment. The value of services performed by the pupil or student in attending to ordinary chores of the household will not generally be considered to constitute compensation or reimbursement. However, if the pupil or student is taken into the taxpayer's household to replace a former employee of the taxpayer or gratuitously

to perform substantial services for the taxpayer, the facts and circumstances may warrant a conclusion that the taxpayer received reimbursement for maintaining the pupil or student.

(4) *No other amount allowed as deduction.* Except to the extent that amounts described in section 170(d) and this paragraph are treated as charitable contributions under section 170(c) and, therefore, deductible under section 170(a), no deduction is allowed for any amount paid to maintain an individual, as a member of the taxpayer's household, in accordance with the provisions of section 170(d) and this paragraph.

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

Example 1. The X organization is an organization described in section 170(c)(2) and is engaged in a program under which a number of European children are placed in the homes of United States residents in order to further the children's high school education. In accordance with the provisions of subparagraph (1) of this paragraph, the taxpayer, A, who reports his income on the calendar year basis, agreed with X to take two of the children, and they were placed in the taxpayer's home on January 2, 1960, where they remained until January 21, 1961, during which time they were fully maintained by the taxpayer. The children enrolled at the local high school for the full course of study prescribed for tenth grade students and attended the school on a full-time basis for the spring semester starting January 18, 1960, and ending June 3, 1960, and for the fall semester starting September 1, 1960, and ending January 13, 1961. The total cost of food paid by A in 1960 for himself, his wife, and the two children amounted to $1,920, or $40 per month for each member of the household. Since the children were actually full-time students for only 8 1/2 months during 1960, the amount paid for food for each child during that period amounted to $340. Other amounts paid during the 8 1/2 month period for each child for laundry, lights, water, recreation, and school supplies amounted to $160. Thus, the amounts treated under section 170(d) and this paragraph as paid for the use of X would, with respect to each child, total $500 ($340+$160), or a total for both children of $1,000, subject to the limitations of subparagraph (2) of this paragraph. Since, for purposes of such limitations, the children were full-time students for only 8 full calendar months during 1960 (less than 15 days in January 1960), the taxpayer may treat only $800 as a charitable contribution made in 1960, that is, $50 multiplied by the 8 full calendar months, or $400 paid for the maintenance of each child. Neither the excess payments nor amounts paid to maintain the children during the period before school opened and for the period in summer between regular school terms is taken into account by reason of section 170(d). Also, because the children were full-time students for less than 15 days in January 1961 (although maintained in the taxpayer's household for 21 days), amounts paid to maintain the children during 1961 would not qualify as a charitable contribution.

Example 2. A religious organization described in section 170(c)(2) has a program for providing educational opportunities for children it places in private homes. In order to implement the program, the taxpayer, H, who resides with his wife, son, and daughter of high school age in a town in the United States, signs an agreement with the organization to maintain a girl sponsored by the organization as a member of his household while the child attends the local high school for the regular 1960–61 school year. The child is a full-time student at the school during the school year starting September 6, 1960, and ending June 6, 1961, and is a member of the taxpayer's household during that period. Although the taxpayer pays $200 during the school period falling in 1960, and $240 during the school period falling in 1961, to maintain the child, he cannot claim either amount as a charitable contribution because the child's parents, from time to time during the school year, send butter, eggs, meat, and vegetables to H to help defray the expenses of maintaining the child. This is considered property received as reimbursement under subparagraph (3) of this paragraph. Had her parents not contributed the food, the fact that the child, in addition to the normal chores she shared with the taxpayer's daughter, such as cleaning their own rooms and helping with the shopping and cooking, was responsible for the family laundry and for the heavy cleaning of the entire house while the taxpayer's daughter had no comparable responsibilities would also preclude a claim for a charitable deduction. These substantial gratuitous services are considered property received as reimbursement under subparagraph (3) of this paragraph.

Example 3. A taxpayer resides with his wife in a city in the eastern United States. He agrees, in writing, with a fraternal society described in section 170(c)(4) to accept a child selected by the society for maintenance by him as a member of his household during 1961 in order that the child may attend the local grammar school as a part of the society's program to provide elementary education for certain children selected by it. The taxpayer maintains the child, who has as his principal place of abode the home of the taxpayer, and is a member of the taxpayer's household, during the entire year

1961. The child is a full-time student at the local grammar school for 9 full calendar months during the year. Under the agreement, the society pays the taxpayer $30 per month to help maintain the child. Since the $30 per month is considered as compensation or reimbursement to the taxpayer for some portion of the maintenance paid on behalf of the child, no amounts paid with respect to such maintenance can be treated as amounts paid in accordance with section 170(d). In the absence of the $30 per month payments, if the child qualifies as a dependent of the taxpayer under section 152(a)(9), that fact would also prevent the maintenance payments from being treated as charitable contributions paid for the use of the fraternal society.

(g) *Charitable contributions carryover of individuals*—(1) *Computation of excess charitable contributions made in contribution year.* Subject to certain conditions and limitations, the excess of:

(i) The amount of the charitable contributions made by an individual in a taxable year beginning after December 31, 1963 (hereinafter in this paragraph referred to as the ‘‘contribution year’’), to organizations specified in section 170(b)(1)(A) (see paragraph (b) of this section), over

(ii) Thirty percent of his adjusted gross income (computed without regard to any net operating loss carryback to such year under section 172) for such contribution year, shall be treated as a charitable contribution paid by him to an organization specified in section 170(b)(1)(A) and paragraph (b) of this section, relating to the additional 10-percent deduction, in each of the 5 taxable years immediately succeeding the contribution year in order of time. (For provisions requiring a reduction of such excess, see subparagraph (5) of this paragraph.) The provisions of this subparagraph apply even though the taxpayer elects under section 144 to take the standard deduction in the contribution year instead of itemizing the deductions (other than those specified in sections 62 and 151) allowable in computing taxable income for the contribution year. No excess charitable contribution carryover shall be allowed with respect to contributions ‘‘for the use of’’ rather than ‘‘to’’ organizations described in section 170(b)(1)(A) and paragraph (b) of this section or with respect to contributions made ‘‘to’’ or ‘‘for the use of’’ organizations which are not described in such sections. The provisions of section 170(b)(5) and this paragraph are not applicable in the case of estates or trusts, see section 642(c), relating to deductions for amounts paid or permanently set aside for a charitable purpose, and the regulations thereunder. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Assume that H and W (husband and wife) have adjusted gross income for 1964 of $50,000 and for 1965 of $40,000 and file a joint return for each year. Assume further that in 1964 they contribute $16,500 to a church and $1,000 to X (an organization not referred to in section 170(b)(1)(A)) and in 1965 contribute $11,000 to the church and $400 to X. They may claim a charitable contribution deduction of $15,000 in 1964, and the excess of $16,500 (contribution to the church) over $15,000 (30 percent of adjusted gross income) or $1,500 constitutes a charitable contribution carryover which shall be treated as a charitable contribution paid by them to an organization referred to in section 170(b)(1)(A) in each of the 5 succeeding taxable years in order of time. No carryover is allowed with respect to the $1,000 contribution made to X in 1964. Since 30 percent of their adjusted gross income for 1965 ($12,000) exceeds the charitable contributions of $11,000 made by them in 1965 to organizations referred to in section 170(b)(1)(A) (computed without regard to section 170(b)(5) and this paragraph) the portion of the 1964 carryover equal to such excess of $1,000 ($12,000 minus $11,000) is treated, pursuant to the provisions of subparagraph (2) of this paragraph, as paid to a section 170(b)(1)(A) organization in 1965; the remaining $500 constitutes an unused charitable contribution carryover. No carryover is allowed with respect to the $400 contribution made to X in 1965.

Example 2. Assume the same facts as in *Example (1)* except that H and W have adjusted gross income for 1965 of $42,000. Since 30 percent of their adjusted gross income for 1965 ($12,600) exceeds by $1,600 the charitable contribution of $11,000 made by them in 1965 to organizations referred to in section 170(b)(1)(A) (computed without regard to section 170(b)(5) and this paragraph), the full amount of the 1964 carryover of $1,500 is treated, pursuant to the provisions of subparagraph (2) of this paragraph, as paid to a section 170(b)(1)(A) organization in 1965. They may also claim a charitable contribution of $100 ($12,600 −$12,500 ($11,000+$1,500)) with respect to the gift to X in 1965. No carryover is allowed with respect to the $300 ($400−$100) of the contribution to X which is not deductible in 1965.

(2) *Determination of amount treated as paid in taxable years succeeding contribution year.* Notwithstanding the provisions of subparagraph (1) of this paragraph, the amount of the excess computed in accordance with the provisions of subparagraphs (1) and (5) of this paragraph which is to be treated as paid in any one of the 5 taxable years immediately succeeding the contribution year to an organization specified in section 170(b)(1)(A) shall not exceed the lesser of the amount computed under subdivision (i) or (ii) of this subparagraph:

(i) The amount by which *(a)* 30 percent of the taxpayer's adjusted gross income for such succeeding taxable year (computed without regard to any net operating loss carryback to such succeeding taxable year under section 172) exceeds *(b)* the sum of *(1)* the charitable contributions actually made (computed without regard to the provisions of section 170(b)(5) and this paragraph) by the taxpayer in such succeeding taxable year to organizations referred to in section 170(b)(1)(A), and (2) the charitable contributions made to organizations referred to in section 170(b)(1)(A) in taxable years (excluding any taxable year beginning before January 1, 1964) preceding the contribution year which, pursuant to the provisions of section 170(b)(5) and this paragraph, are treated as having been paid to an organization referred to in section 170(b)(1)(A) in such succeeding year.

(ii) In the case of the first taxable year succeeding the contribution year, the amount of the excess charitable contribution in the contribution year, computed under subparagraphs (1) and (5) of this paragraph. In the case of the second, third, fourth, and fifth succeeding taxable years, the portion of the excess charitable contribution in the contribution year (computed under subparagraphs (1) and (5) of this paragraph) which has not been treated as paid to a section 170(b)(1)(A) organization in a year intervening between the contribution year and such succeeding taxable year.

If a taxpayer, in any one of the four taxable years succeeding a contribution year, elects under section 144 to take the standard deduction in the amount provided for in section 141 instead of itemizing the deductions (other than those specified in sections 62 and 151) allowable in computing taxable income, there shall be treated as paid (but not allowable as a deduction) in the standard deduction year the amount determined under subdivision (i) or (ii) of this subparagraph, whichever is the lesser. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Assume that B has adjusted gross income for 1966 of $20,000 and for 1967 of $30,000. Assume further that in 1966 B contributed $8,000 to a church and in 1967 he contributes $7,500 to the church. B may claim a charitable contribution deduction of $6,000 in 1966, and the excess of $8,000 (contribution to the church) over $6,000 (30 percent of B's adjusted gross income) or $2,000 constitutes a charitable contribution carryover which shall be treated as a charitable contribution paid by B to an organization referred to in section 170(b)(1)(A) in the 5 taxable years succeeding 1966 in order of time. (B made no excess contributions in 1964 or 1965 which should be treated as paid in years succeeding 1964 or 1965.) B may claim a charitable contribution deduction of $9,000 in 1967. Such $9,000 consists of the $7,500 contribution to the church in 1967 and $1,500 carried over from 1966 and treated as a charitable contribution paid to a section 170(b)(1)(A) organization in 1967. The $1,500 contribution treated as paid in 1967 is computed as follows:

1966 excess contributions		$2,000
30 percent of B's adjusted gross income for 1967		9,000
Less:		
Contributions actually made in 1967 to section 170(b)(1)(A) organizations	$7,500	
Contributions made to section 170(b)(1)(A) organizations in taxable years prior to 1966 treated as having been paid in 1967	0	7,500
		1,500

Amount of 1966 excess treated as paid in 1967—the lesser of $2,000 (1966 excess contributions) or $1,500 (30 percent of adjusted gross income for 1967 ($9,000) over the section 170(b)(1)(A) contributions actually made in 1967 ($7,500) and the section 170(b)(1)(A) contributions made in years prior to 1966 treated as having been paid in 1967 (0))	1,500

If the excess contributions made by B in 1966 had been $1,000 instead of $2,000, then, for purposes of this example, the amount of the 1966 excess treated as paid in 1967 would be $1,000 rather than $1,500.

Example 2. Assume the same facts as in *Example (1)*, and, in addition, that B has adjusted gross income for 1968 of $10,000 and for 1969 of $20,000. Assume further with respect to 1968 that B elects under section 144 to take the standard deduction in computing taxable income and that his actual contributions to organizations specified in section 170(b)(1)(A) are $300. Assume further with respect to 1969, that B itemizes his deductions which include a $5,000 contribution to a church. B's deductions for 1968 are not increased by reason of the $500 available as a charitable contribution carryover from 1966 (excess contributions made in 1966 ($2,000) less the amount of such excess treated as paid in 1967 ($1,500)) since B elected to take the standard deduction in 1968. However, for purposes of determining the amount of the excess charitable contributions made in 1966 which is available as a carryover to 1969, B is required to treat such $500 as a charitable contribution paid in 1968—the lesser of $500 or $2,700 (30 percent of adjusted gross income ($3,000) over contributions actually made in 1968 to section 170(b)(1)(A) organizations ($300)). Therefore, even though the $5,000 contribution made by B in 1969 to a church does not amount to 30 percent of B's adjusted gross income for 1969 (30 percent of $20,000=$6,000), B may claim a charitable contribution deduction of only the $5,000 actually paid in 1969 since the entire excess charitable contribution made in 1966 ($2,000) has been treated as paid in 1967 ($1,500) and 1968 ($500).

Example 3. Assume the following factual situation for C who itemizes his deductions in computing taxable income for each of the years set forth in the example:

	1964	1965	1966	1967	1968
Adjusted gross income	$10,000	$7,000	$15,000	$10,000	$9,000
Contributions to section 170(b)(1)(A) organizations (no other contributions)	4,000	3,000	5,000	1,000	1,500
Allowable charitable contributions deductions computed without regard to carryover of contributions	3,000	2,100	4,500	1,000	1,500
Excess contributions for taxable year to be treated as paid in 5 succeeding taxable years	1,000	900	500	0	0

Since C's contributions in 1967 and 1968 to section 170(b)(1)(A) organizations are less than 30 percent of his adjusted gross income for such years, the excess contributions for 1964, 1965, and 1966 are treated as having been paid to section 170(b)(1)(A) organizations in 1967 and 1968 as follows:

1967

Contribution year	*Total excess*	*Less: Amount treated as paid in year prior to 1967*	*Available charitable contribution carryovers*
1964	$1,000	0	$1,000
1965	900	0	900
1966	500	0	500
			2,400
30 percent of B's adjusted gross income for 1967			3,000
Less: Charitable contributions made in 1967 to section 170(b)(1)(A) organizations			1,000
			2,000
Amount of excess contributions treated as paid in 1967—the lesser of $2,400 (available carryovers to 1967) or $2,000 (excess of 30 percent of adjusted gross income ($3,000) over contributions actually made in 1967 to section 170(b)(1)(A) organizations ($1,000))			2,000

1968

Contribution year	*Total excess*	*Less: Amount treated as paid in year prior to 1968*	*Available charitable contribution carryovers*
1964	$1,000	$1,000	0
1965	900	900	0
1966	500	100	$400
1967	0	0	0
			400
30 percent of B's adjusted gross income for 1968			2,700
Less: Charitable contributions made in 1968 to section 170(b)(1)(A) organizations			1,500
			1,200
Amount of excess contributions treated as paid in 1968—the lesser of $400 (available carryovers to 1968) or $1,200 (30 percent of adjusted gross income $2,700) over contributions actually made in 1968 to section 170(b)(1)(A) organizations ($1,500)			400

(3) *Effect of net operating loss carryback to contribution year.* The amount of the excess contribution for a contribution year (computed as provided in subparagraphs (1) and (5) of this paragraph) shall not be increased because a net operating loss carryback is available as a deduction in the contribution year. In addition, in determining (under the provisions of section 172(b)(2)) the amount of the net operating loss for any year subsequent to the contribution year which is a carryback or carryover to taxable years succeeding the contribution year, the amount of contributions made to organizations referred to in section 170(b)(1)(A) shall be limited to the amount of such contributions which did not exceed 30 percent of the donor's adjusted gross income (computed without regard to any net operating loss carryback or any of the modifications referred to in section 172(d)) for the contribution year.

(4) *Effect of net operating loss carryback to taxable years succeeding the contribution year.* The amount of the charitable contribution from a preceding taxable year which is treated as paid (as provided in subparagraph (2) of this paragraph) in a current taxable year (hereinafter referred to in this subparagraph as the "deduction year") shall not be reduced because a net operating loss carryback is available as a deduction in the deduction year. In addition, in determining (under the provisions of section 172(b)(2)) the amount of the net operating loss for any year subsequent to the deduction year which is a carryback or carryover to taxable years succeeding the deduction year, the amount of contributions made to organizations referred to in section 170(b)(1)(A) in the deduction year shall be limited to the amount of such contributions which were actually made in such year and those which were treated as paid in such year which did not exceed 30 percent of the donor's adjusted gross income (computed without regard to any net operating loss carryback or any of the modifications referred to in section 172(d)) for the deduction year.

(5) *Reduction of excess contributions.* An individual having a net operating loss carryover from a prior taxable year which is available as a deduction in a contribution year must apply the special rule of section 170(b)(5)(B) and this subparagraph in computing the excess described in subparagraph (1) of this paragraph for such contribution year. In determining the amount of excess charitable contributions that shall be treated as paid in each of the 5 taxable years succeeding the contribution year, the excess charitable contributions described in such subparagraph (1) must be reduced by the amount by which such excess reduces taxable income (for purposes of determining the portion of a net operating loss which shall be carried to taxable years succeeding the contribution year under the second sentence of section 172(b)(2)) and increases the net operating loss which is carried to a succeeding taxable year. In reducing taxable income under the second sentence of section 172(b)(2), an individual who has made charitable contributions in the contribution year to both organizations specified in section 170(b)(1)(A) (see paragraph (b) of this section) and to organizations not so specified must first deduct contributions made to the section 170(b)(1)(A) organizations from his adjusted gross income computed without regard to his net operating loss deduction before any of the contributions made to organizations not specified in section 170(b)(1)(A) may be deducted

from such adjusted gross income. Thus, if the excess of the contributions made in the contribution year to organizations specified in section 170(b)(1)(A) over the amount deductible in such contribution year is utilized to reduce taxable income (under the provisions of section 172 (b)(2)) for such year, thereby serving to increase the amount of the net operating loss carryover to a succeeding year or years, no part of the excess charitable contributions made in such contribution year shall be treated as paid in any of the 5 immediately succeeding taxable years. If only a portion of the excess charitable contributions is so used, the excess charitable contributions will be reduced only to that extent. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. B, an individual, reports his income on the calendar year basis and for the year 1964 has adjusted gross income (computed without regard to any net operating loss deduction) of $50,000. During 1964 he made charitable contributions in the amount of $20,000 all of which were to organizations specified in section 170(b)(1)(A). B has a net operating loss carryover from 1963 of $50,000. In the absence of the net operating loss deduction B would have been allowed a deduction for charitable contributions of $15,000. After the application of the net operating loss deduction, B is allowed no deduction for charitable contributions, and there is (before applying the special rule of section 170(b)(5)(B) and this subparagraph) a tentative excess charitable contribution of $20,000. For purposes of determining the net operating loss which remains to be carried over to 1965, B computes his taxable income for his prior taxable year, 1964, under section 172(b)(2) by deducting the $15,000 charitable contribution. After the $50,000 net operating loss carryover is applied against the $35,000 of taxable income for 1964 (computed in accordance with section 172(b)(2), assuming no deductions other than the charitable contribution deduction are applicable in making such computation), there remains a $15,000 net operating loss carryover to 1965. Since the application of the net operating loss carryover of $50,000 from 1963 reduces the 1964 adjusted gross income (for purposes of determining 1964 tax liability) to zero, no part of the $20,000 of charitable contributions in that year is deductible under section 170(b)(1). However, in determining the amount of the excess charitable contributions which shall be treated as paid in taxable years 1965, 1966, 1967, 1968, 1969, the $20,000 must be reduced by the portion thereof ($15,000) which was used to reduce taxable income for 1964 (as computed for purposes of the second sentence of section 172(b)(2)) and which thereby served to increase the net operating loss carryover to 1965 from zero to $15,000.

Example 2. Assume the same facts as in *Example (1)*, except that B's total contributions of $20,000 made during 1964 consisted of $15,000 to organizations specified in section 170(b)(1)(A) and $5,000 to organizations not so specified. Under these facts there is a tentative excess charitable contribution of $15,000, rather than $20,000 as in *Example (1)*. For purposes of determining the net operating loss which remains to be carried over to 1965, B computes his taxable income for his prior taxable year, 1964, under section 172(b)(2) by deducting the $15,000 of charitable contributions made to organizations specified in section 170(b)(1)(A). Since the excess charitable contribution of $15,000 determined in accordance with subparagraph (1) of this paragraph was used to reduce taxable income for 1964 (as computed for purposes of the second sentence of section 172(b)(2)) and thereby served to increase the net operating loss carryover to 1965 from zero to $15,000, no part of such excess charitable contributions made in the contribution year shall be treated as paid in any of the five immediately succeeding taxable years. No carryover is allowed with respect to the $5,000 of charitable contributions made in 1964 to organizations not specified in section 170(b)(1)(A).

(6) *Change in type of return filed*—(i) *From joint return to separate returns.* If a husband and wife—

(a) Make a joint return for a contribution year and compute an excess charitable contribution for such year in accordance with the provisions of subparagraphs (1) and (5) of this paragraph, and

(b) Make separate returns for one or more of the 5 taxable years immediately succeeding such contribution year, any excess charitable contribution for the contribution year which is unused at the beginning of the first such taxable year for which separate returns are filed shall be allocated between the husband and wife. For purposes of the allocation, a computation shall be made of the amount of any excess charitable contribution which each spouse would have computed in accordance with subparagraphs (1) and (5) of this paragraph if separate returns (rather than a joint return) had been filed for the contribution year. The

portion of the total unused excess charitable contribution for the contribution year allocated to each spouse shall be an amount which bears the same ratio to such unused excess charitable contribution as such spouse's excess contribution (based on the separate return computation) bears to the total excess contributions of both spouses (based on the separate return computation). To the extent that a portion of the amount allocated to either spouse in accordance with the foregoing provisions of this subdivision is not treated in accordance with the provisions of subparagraph (2) of this paragraph as a charitable contribution paid to an organization specified in section 170(b)(1)(A) in the taxable year in which a separate return or separate returns are filed, each spouse shall for purposes of subparagraph (2) of this paragraph treat his respective unused portion as the available charitable contributions carryover to the next succeeding taxable year in which the joint excess charitable contribution may be treated as paid in accordance with subparagraph (1) of this paragraph. If such husband and wife make a joint return in one of the five taxable years immediately succeeding the contribution year with respect to which a joint excess charitable contribution is computed and following the first succeeding year in which such husband and wife filed a separate return or separate returns, the amounts allocated to each spouse in accordance with this subdivision for such first year reduced by the portion of such amounts treated as paid to an organization specified in section 170(b)(1)(A) in such first year and in any taxable year intervening between such first year and the succeeding taxable year in which the joint return is filed shall be aggregated for purposes of determining the amount of the available charitable contributions carryover to such succeeding taxable year. The provisions of this subdivision (i) may be illustrated by the following example:

Example. H and W file joint returns for 1964, 1965, and 1966, and in 1967 they file separate returns. In each such year H and W itemize their deductions in computing taxable income. Assume the following factual situation with respect to H and W for 1964:

1964

	H	*W*	*Joint return*
Adjusted gross income	$50,000	$40,000	$90,000
Contributions to section 170(b)(1)(A) organization (no other contributions)	27,000	20,000	47,000
Allowable charitable contribution deductions	15,000	12,000	27,000
Excess contributions for taxable year to be treated as paid in 5 succeeding taxable years	12,000	8,000	20,000

The joint excess charitable contribution of $20,000 is to be treated as having been paid to a section 170(b)(1)(A) organization in the five succeeding taxable years. Assume that in 1965, the portion of such excess treated as paid by H and W is $3,000 and that in 1966, the portion of such excess treated as paid is $7,000. Thus, the unused portion of the excess charitable contribution made in the contribution year is $10,000 ($20,000 less $3,000 (amount treated as paid in 1965) and $7,000 (amount treated as paid in 1966)). Since H and W file separate returns in 1967, $6,000 of such $10,000 is allocable to H and $4,000 is allocable to W. Such allocation is computed as follows:

$12,000 (excess charitable contributions made by H (based on separate return computation) in 1964)/$20,000 (total excess charitable contributions made by H and W (based on separate return computation) in 1964)×$10,000=$6,000

$8,000 (excess charitable contributions made by W (based on separate return computation) in 1964)/$20,000 (total excess charitable contributions made by H and W (based on separate return computation) in 1964)×$10,000=$4,000

In 1967 H has adjusted gross income of $70,000 and he contributes $14,000 to an organization specified in section 170(b)(1)(A). In 1967 W has adjusted gross income of $50,000, and she contributes $10,000 to an organization specified in section 170(b)(1)(A). H may claim a charitable contribution deduction of $20,000 in 1967, and W may claim a charitable contribution deduction of $14,000 in 1967. H's $20,000 deduction consists of the $14,000 contribution to the section 170(b)(1)(A) organization in 1967 and $6,000 carried over from 1964 and treated as a charitable contribution paid to a section 170(b)(1)(A) organization in 1967. W's $14,000 deduction consists of the $10,000 contribution made to a section 170(b)(1)(A) organization in 1967 and $4,000 carried over from 1964 and treated as a charitable contribution paid to a section 170(b)(1)(A) organization in 1967. The $6,000 contribution treated as paid in 1967 by H, and the $4,000 contribution treated as paid in 1967 by W are computed as follows:

	H	W
Available charitable contribution carryover (see computations above)	$6,000	$4,000
30-percent of adjusted gross income	21,000	15,000
Contributions made in 1967 to section 170(b)(1)(A) organization (no other contributions)	14,000	10,000
Amount of allowable deduction unused	7,000	5,000
Amount of excess contributions treated as paid in 1967—the lesser of $6,000 (available carryover of H to 1967) or $7,000 (excess of 30 percent of adjusted gross income ($21,000) over contributions actually made in 1967 to section 170(b)(1)(A) organizations ($14,000))	6,000	
The lesser of $4,000 (available carryover of W to 1967) or $5,000 (excess of 30 percent of adjusted gross income ($15,000) over contributions actually made in 1967 to section 170(b)(1)(A) organizations ($10,000))		4,000

(ii) *From separate returns to joint return and remarried taxpayers.* If in the case of a husband and wife:

(a) Either or both of the spouses make a separate return for a contribution year and compute an excess charitable contribution for such year in accordance with the provisions of subparagraphs (1) and (5) of this paragraph, and

(b) Such husband and wife make a joint return for one or more of the taxable years immediately succeeding such contribution year, the excess charitable contribution of the husband and wife for the contribution year which is unused at the beginning of the first taxable year for which a joint return is filed shall be aggregated for purposes of determining the portion of such unused charitable contribution which shall be treated in accordance with subparagraph (2) of this paragraph as a charitable contribution paid to an organization specified in section 170(b)(1)(A). The provisions of this subdivision are also applicable in the case of two single individuals who are subsequently married and file a joint return. A remarried taxpayer who filed a joint return with a former spouse in a contribution year with respect to which an excess charitable contribution was computed and who in any one of the five taxable years immediately succeeding such contribution year files a joint return with his (or her) present spouse shall treat the unused portion of such excess charitable contribution allocated to him (or her) in accordance with subdivision (i) of this subparagraph in the same manner as the unused portion of an excess charitable contribution computed in a contribution year in which he filed a separate return for purposes of determining the amount which in accordance with subparagraph (2) of this paragraph shall be treated as paid to an organization specified in section 170(b)(1)(A) in such succeeding year.

(iii) *Unused excess charitable contribution of deceased spouse.* In case of the death of one spouse, any unused portion of an excess charitable contribution which is allocable (in accordance with subdivision (i) of this subparagraph) to such spouse shall not be treated as paid in the taxable year in which such death occurs or in any subsequent taxable year except on a separate return made for the deceased spouse by a fiduciary for the taxable year which ends with the date of death or on a joint return for the taxable year in which such death occurs. The application of this subdivision may be illustrated by the following example:

Example. Assume the same facts as in the example in subdivision (i) of this subparagraph except that H dies in 1966 and W files a separate return for 1967. W made a joint return for herself and H for 1966. In that example, the unused excess charitable contribution as of January 1, 1967, was $10,000, $6,000 of which was allocable to H and $4,000 to W. No portion of the $6,000 allocable to H may be treated as paid by W or any other person in 1967 or any subsequent year.

(7) *Information required in support of a deduction of an amount treated as paid.* If, in a taxable year, a deduction is claimed in respect of an excess charitable contribution which, in accordance with the provisions of subparagraph (2) of this paragraph, is treated (in whole or in part) as paid in such taxable year, the taxpayer shall attach to his return a statement showing:

(i) The year (or years) in which the excess charitable contributions were made (the contribution year or years),

(ii) The excess charitable contributions made in each contribution year,

(iii) The portion of such excess (or each such excess) treated as paid in accordance with subparagraph (2) of this paragraph in any taxable year intervening between the contribution year and the taxable year for which the return is made, and

(iv) Such other information as the return or the instructions relating thereto may require.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6605, 27 FR 8096, Aug. 15, 1962; T.D. 6639, 28 FR 1762, Feb. 26, 1963; T.D. 6732, 29 FR 6280, May 13, 1964; T.D. 6900, 31 FR 14634, Nov. 17, 1966; T.D. 7207, 37 FR 20768, Oct. 4, 1972; T.D. 7427, 41 FR 34026, Aug. 12, 1976]

§1.170–3 Contributions or gifts by corporations (before amendment by Tax Reform Act of 1969).

(a) *In general.* The deduction by a corporation in any taxable year for charitable contributions, as defined in section 170(c), is limited to 5 percent of its taxable income for the year computed without regard to:

(1) The deduction for charitable contributions,

(2) The special deductions for corporations allowed under part VIII (except section 248), subchapter B, chapter 1 of the Code,

(3) Any net operating loss carryback to the taxable year under section 172,

(4) The special deduction for Western Hemisphere trade corporations under section 922, and

(5) Any capital loss carryback to the taxable year under section 1212(a)(1).

A contribution by a corporation to a trust, chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals is deductible only if the contribution is to be used in the United States or its possessions for those purposes. See section 170(c)(2). For the purposes of section 170, amounts excluded from the gross income of a corporation under section 114 (relating to sports programs conducted for the American National Red Cross) are not to be considered contributions or gifts. For reduction or disallowance of certain charitable, etc., deductions, see paragraphs (c)(2), (e), and (f) of §1.170–1.

(b) *Election by corporations on an accrual method.* A corporation reporting its taxable income on an accrual method may elect to have a charitable contribution (as defined in section 170 (c)) considered as paid during the taxable year, if payment is actually made on or before the fifteenth day of the third month following the close of the year and if, during the year, the board of directors authorized the contribution. The election must be made at the time the return for the taxable year is filed, by reporting the contribution on the return. There shall be attached to the return when filed a written declaration that the resolution authorizing the contribution was adopted by the board of directors during the taxable year, and the declaration shall be verified by a statement signed by an officer authorized to sign the return that it is made under the penalties of perjury. There shall also be attached to the return when filed a copy of the resolution of the board of directors authorizing the contribution.

(c) *Charitable contributions carryover of corporations*—(1) *Contributions made in taxable years beginning before January 1, 1962.* Subject to the rules set forth in subparagraph (3) of this paragraph, any contributions made by a corporation in a taxable year (hereinafter in this paragraph referred to as the contribution year) subject to the Code beginning before January 1, 1962, in excess of the amount deductible in such contribution year under the 5-percent limitation of section 170(b)(2) are deductible in each of the two succeeding taxable years in order of time, but only to the extent of the lesser of the following amounts:

(i) The excess of the maximum amount deductible for the succeeding year under the 5-percent limitation of section 170(b)(2) over the contributions made in that year; and

(ii) In the case of the first taxable year succeeding the contribution year, the amount of the excess contributions; and, in the case of the second taxable year succeeding the contribution year, the portion of the excess contributions not deductible in the first succeeding taxable year.

The application of the rules in this subparagraph may be illustrated by the following example:

Example. A corporation which reports its income on the calendar year basis makes a charitable contribution of $10,000 in June 1961, anticipating taxable income for 1961 of $200,000. Its actual taxable income (without regard to any deduction for charitable contributions) for 1961 is only $50,000 and the charitable deduction for that year is limited to $2,500 (5 percent of $50,000). The excess charitable contribution not deductible in 1961 ($7,500) represents a carryover potentially available as a deduction in the two succeeding taxable years. The corporation has taxable income (without regard to any deduction for charitable contributions) of $150,000 in 1962 and makes a charitable contribution of $2,500 in that year. For 1962, the corporation may deduct as a charitable contribution the amount of $7,500 (5 percent of $150,000). This amount consists first of the $2,500 contribution made in 1962, and $5,000 of the $7,500 carried over from 1961. The remaining $2,500 carried over from 1961 and not allowable as a deduction in 1962 because of the 5-percent limitation may be carried over to 1963. The corporation has taxable income (without regard to any deduction for charitable contributions) of $100,000 in 1963 and makes a charitable contribution of $3,000. For 1963, the corporation may deduct under section 170 the amount of $5,000 (5 percent of $100,000). This amount consists first of the $3,000 contributed in 1963, and $2,000 of the $2,500 carried over from 1961 to 1963. The remaining $500 of the carryover from 1961 is not allowable as a deduction in any year because of the 2-year limitation with respect to excess contributions made in taxable years beginning before January 1, 1962.

(2) *Contributions made in taxable years beginning after December 31, 1961.* Subject to the rules set forth in subparagraph (3) of this paragraph, any contributions made by a corporation in a taxable year (hereinafter in this paragraph referred to as the contribution year) beginning after December 31, 1961, in excess of the amount deductible in such contribution year under the 5-percent limitation of section 170(b)(2) are deductible in each of the five succeeding taxable years in order of time, but only to the extent of the lesser of the following amounts:

(i) The excess of the maximum amount deductible for such succeeding taxable year under the 5-percent limitation of section 170(b)(2) over the sum of the contributions made in that year plus the aggregate of the excess contributions which were made in taxable years before the contribution year and which are deductible under this paragraph in such succeeding taxable year; or

(ii) In the case of the first taxable year succeeding the contribution year, the amount of the excess contributions, and in the case of the second, third, fourth, or fifth taxable years succeeding the contribution year, the portion of the excess contributions not deductible under this subparagraph for any taxable year intervening between the contribution year and such succeeding taxable year.

The application of the rules of this subparagraph may be illustrated by the following example:

Example. A corporation which reports its income on the calendar year basis makes a charitable contribution of $20,000 in June 1964, anticipating taxable income for 1964 of $400,000. Its actual taxable income (without regard to any deduction for charitable contributions) for 1964 is only $100,000 and the charitable deduction for that year is limited to $5,000 (5 percent of $100,000). The excess charitable contribution not deductible in 1964 ($15,000) represents a carryover potentially available as a deduction in the five succeeding taxable years. The corporation has taxable income (without regard to any deduction for charitable contributions) of $150,000 in 1965 and makes a charitable contribution of $5,000 in that year. For 1965 the corporation may deduct as a charitable contribution the amount of $7,500 (5 percent of $150,000). This amount consists first of the $5,000 contribution made in 1965, and $2,500 carried over from 1964. The remaining $12,500 carried over from 1964 and not allowable as a deduction for 1965 because of the 5-percent limitation may be carried over to 1966. The corporation has taxable income (without regard to any deduction for charitable contributions) of $200,000 in 1966 and makes a charitable contribution of $5,000. For 1966, the corporation may deduct the amount of $10,000 (5 percent of $200,000). This amount consists first of the $5,000 contributed in 1966, and $5,000 of the $12,500 carried over from 1964 to 1966. The remaining $7,500 of the carryover from 1964 is available for purposes of computing the charitable contributions carryover from 1964 to 1967, 1968, and 1969.

(3) *Reduction of excess contributions.* A corporation having a net operating loss carryover (or carryovers) must apply the special rule of section 170(b)(3) and this subparagraph before computing under subparagraph (1) or (2) of this

paragraph the charitable contributions carryover for any taxable year subject to the Internal Revenue Code of 1954. In determining the amount of charitable contributions that may be deducted in accordance with the rules set forth in subparagraph (1) or (2) of this paragraph in taxable years succeeding the contribution year, the excess of contributions made by a corporation in the contribution year over the amount deductible in such year must be reduced by the amount by which such excess reduces taxable income (for purposes of determining the net operating loss carryover under the second sentence of section 172(b)(2) and increases a net operating loss carryover to a succeeding taxable year. Thus, if the excess of the contributions made in a taxable year over the amount deductible in the taxable year is utilized to reduce taxable income (under the provisions of section 172(b)(2)) for such year, thereby serving to increase the amount of the net operating loss carryover to a succeeding year or years, no charitable contributions carryover will be allowed. If only a portion of the excess charitable contributions is so used, the charitable contributions carryover. will be reduced only to that extent. The application of the rules of this subparagraph may be illustrated by the following example:

Example. A corporation which reports its income on the calendar year basis makes a charitable contribution of $10,000 during the taxable year 1960. Its taxable income for 1960 is $80,000 (computed without regard to any net operating loss deduction and computed in accordance with section 170(b)(2) without regard to any deduction for charitable contributions). The corporation has a net operating loss carryover from 1959 of $80,000. In the absence of the net operating loss deduction the corporation would have been allowed a deduction for charitable contributions of $4,000 (5 percent of $80,000). After the application of the net operating loss deduction the corporation is allowed no deduction for charitable contributions, and there is a tentative charitable contribution carryover of $10,000. For purposes of determining the net operating loss carryover to 1961 the corporation computes its taxable income for its prior taxable year 1960 under section 172(b)(2) by deducting the $4,000 charitable contribution. Thus, after the $80,000 net operating loss carryover is applied against the $76,000 of taxable income for 1960 (computed in accordance with section 172(b)(2)), there remains a $4,000 net operating loss carryover to 1961. Since the application of the net operating loss carryover of $80,000 from 1959 reduces the taxable income for 1960 to zero, no part of the $10,000 of charitable contributions in that year is deductible under section 170(b)(2). However, in determining the amount of the allowable charitable contributions carryover to the taxable years 1961 and 1962, the $10,000 must be reduced by the portion thereof ($4,000) which was used to reduce taxable income for 1960 (as computed for purposes of the second sentence of section 172(b)(2)) and which thereby served to increase the net operating loss carryover to 1961 from zero to $4,000.

(4) *Year contribution is made.* For purposes of this paragraph, contributions made by a corporation in a contribution year include contributions which, in accordance with the provisions of section 170(a)(2) and paragraph (b) of this section, are considered as paid during such contribution year.

(5) *Effect of net operating loss carryback to contribution year.* The amount of the excess contribution for a contribution year (computed as provided in this paragraph) shall not be increased because a net operating loss carryback is available as a deduction in the contribution year. In addition, in determining (under the provisions of section 172(b)(2)) the amount of the net operating loss for any year subsequent to the contribution year which is a carryback or carryover to taxable years succeeding the contribution year, the amount of contributions shall be limited to the maximum amount deductible under the 5-percent limitation of section 170(b)(2) (computed without regard to any net operating loss carryback or any of the modifications referred to in section 172(d)) for the contribution year.

(6) *Effect of net operating loss carryback to taxable years succeeding the contribution year.* The amount of the charitable contribution from a preceding taxable year which is deductible (as provided in this paragraph) in a current taxable year (hereinafter referred to in this subparagraph as the ‘‘deduction year’’) shall not be reduced because a net operating loss carryback is available as a deduction in the deduction year. In addition, in determining (under the provisions of section 172(b)(2)) the amount of the net operating loss for any year subsequent to

the deduction year which is a carryback or a carryover to taxable years succeeding the deduction year, the amount of contributions shall be limited to the maximum amount deductible under the 5-percent limitation of section 170(b)(2) (computed without regard to any net operating loss carryback or any of the modifications referred to in section 172(d)) for the deduction year.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6605, 27 FR 8096, Aug. 15, 1962; T.D. 6900, 31 FR 14640, Nov. 17, 1966; T.D. 7207, 37 FR 20768, Oct. 4, 1972]

§1.170A–1 Charitable, etc., contributions and gifts; allowance of deduction.

(a) *Allowance of deduction.* Any charitable contribution, as defined in section 170(c), actually paid during the taxable year is allowable as a deduction in computing taxable income irrespective of the method of accounting employed or of the date on which the contribution is pledged. However, charitable contributions by corporations may under certain circumstances be deductible even though not paid during the taxable year as provided in section 170(a)(2) and §1.170A–11. For rules relating to recordkeeping and return requirements in support of deductions for charitable contributions (whether by an itemizing or nonitemizing taxpayer) see §1.170A–13. The deduction is subject to the limitations of section 170(b) and §1.170A–8 or §1.170A–11. Subject to the provisions of section 170(d) and §§1.170A–10 and 1.170A–11, certain excess charitable contributions made by individuals and corporations shall be treated as paid in certain succeeding taxable years. For provisions relating to direct charitable deductions under section 63 by nonitemizers, see section 63 (b)(1)(C) and (i) and section 170(i). For rules relating to the detemination of, and the deduction for, amounts paid to maintain certain students as members of the taxpayer's household and treated under section 170(g) as paid for the use of an organization described in section 170(c) (2), (3), or (4), see §1.170A–2. For the reduction of any charitable contributions for interest on certain indebtedness, see section 170(f)(5) and §1.170A–3. For a special rule relating to the computation of the amount of the deduction with respect to a charitable contribution of certain ordinary income or capital gain property, see section 170(e) and §§1.170A–4 and 1.170A–4A. For rules for postponing the time for deduction of a charitable contribution of a future interest in tangible personal property, see section 170(a)(3) and §1.170A–5. For rules with respect to transfers in trust and of partial interests in property, see section 170(e), section 170(f) (2) and (3), §§1.170A–4, 1.170A–6, and 1.170A–7. For definition of the term *section 170(b)(1)(A) organization,* see §1.170A–9. For valuation of a remainder interest in real property, see section 170(f)(4) and the regulations thereunder. The deduction for charitable contributions is subject to verification by the district director.

(b) *Time of making contribution.* Ordinarily, a contribution is made at the time delivery is effected. The unconditional delivery or mailing of a check which subsequently clears in due course will constitute an effective contribution on the date of delivery or mailing. If a taxpayer unconditionally delivers or mails a properly endorsed stock certificate to a charitable donee or the donee's agent, the gift is completed on the date of delivery or, if such certificate is received in the ordinary course of the mails, on the date of mailing. If the donor delivers the stock certificate to his bank or broker as the donor's agent, or to the issuing corporation or its agent, for transfer into the name of the donee, the gift is completed on the date the stock is transferred on the books of the corporation. For rules relating to the date of payment of a contribution consisting of a future interest in tangible personal property, see section 170(a)(3) and §1.170A–5.

(c) *Value of a contribution in property.* (1) If a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution reduced as provided in section 170(e)(1) and paragraph (a) of §1.170A–4, or section 170(e)(3) and paragraph (c) of §1.170A–4A.

(2) The fair market value is the price at which the property would change

hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. If the contribution is made in property of a type which the taxpayer sells in the course of his business, the fair market value is the price which the taxpayer would have received if he had sold the contributed property in the usual market in which he customarily sells, at the time and place of the contribution and, in the case of a contribution of goods in quantity, in the quantity contributed. The usual market of a manufacturer or other producer consists of the wholesalers or other distributors to or through whom he customarily sells, but if he sells only at retail the usual market consists of his retail customers.

(3) If a donor makes a charitable contribution of property, such as stock in trade, at a time when he could not reasonably have been expected to realize its usual selling price, the value of the gift is not the usual selling price but is the amount for which the quantity of property contributed would have been sold by the donor at the time of the contribution.

(4) Any costs and expenses pertaining to the contributed property which were incurred in taxable years preceding the year of contribution and are properly reflected in the opening inventory for the year of contribution must be removed from inventory and are not a part of the cost of goods sold for purposes of determining gross income for the year of contribution. Any costs and expenses pertaining to the contributed property which are incurred in the year of contribution and would, under the method of accounting used, be properly reflected in the cost of goods sold for such year are to be treated as part of the costs of goods sold for such year. If costs and expenses incurred in producing or acquiring the contributed property are, under the method of accounting used, properly deducted under section 162 or other section of the Code, such costs and expenses will be allowed as deductions for the taxable year in which they are paid or incurred whether or not such year is the year of the contribution. Any such costs and expenses which are treated as part of the cost of goods sold for the year of contribution, and any such costs and expenses which are properly deducted under section 162 or other section of the Code, are not to be treated under any section of the Code as resulting in any basis for the contributed property. Thus, for example, the contributed property has no basis for purposes of determining under section 170(e)(1)(A) and paragraph (a) of §1.170A–4 the amount of gain which would have been recognized if such property had been sold by the donor at its fair market value at the time of its contribution. The amount of any charitable contribution for the taxable year is not to be reduced by the amount of any costs or expenses pertaining to the contributed property which was properly deducted under section 162 or other section of the Code for any taxable year preceding the year of the contribution. This subparagraph applies only to property which was held by the taxpayer for sale in the course of a trade or business. The application of this subparagraph may be illustrated by the following examples:

Example 1. In 1970, A, an individual using the calendar year as the taxable year and the accrual method of accounting, contributed to a church property from inventory having a fair market value of $600. The closing inventory at the end of 1969 properly included $400 of costs attributable to the acquisition of such property, and in 1969 A properly deducted under section 162 $50 of administrative and other expenses attributable to such property. Under section 170(e)(1)(A) and paragraph (a) of §1.170A–4, the amount of the charitable contribution allowed for 1970 is $400 ($600 − [$600 − $400]). Pursuant to this subparagraph, the cost of goods sold to be used in determining gross income for 1970 may not include the $400 which was included in opening inventory for that year.

Example 2. The facts are the same as in *Example (1)* except that the contributed property was acquired in 1970 at a cost of $400. The $400 cost of the property is included in determining the cost of goods sold for 1970, and $50 is allowed as a deduction for that year under section 162. A is not allowed any deduction under section 170 for the contributed property, since under section 170(e)(1)(A) and paragraph (a) of §1.170A–4 the amount of the charitable contribution is reduced to zero ($600 − [$600 − $0]).

Example 3. In 1970, B, an individual using the calendar year as the taxable year and the accrual method of accounting, contributed to a church property from inventory having a fair market value of $600. Under § 1.471–3(c), the closing inventory at the end of 1969 properly included $450 costs attributable to the production of such property, including $50 of administrative and other indirect expenses which, under his method of accounting, was properly added to inventory rather than deducted as a business expense. Under section 170(e)(1)(A) and paragraph (a) of § 1.170A–4, the amount of the charitable contribution allowed for 1970 is $450 ($600 − [$600 − $450]). Pursuant to this subparagraph, the cost of goods sold to be used in determining gross income for 1970 may not include the $450 which was included in opening inventory for that year.

Example 4. The facts are the same as in *Example (3)* except that the contributed property was produced in 1970 at a cost of $450, including $50 of administrative and other indirect expenses. The $450 cost of the property is included in determining the cost of goods sold for 1970. B is not allowed any deduction under section 170 for the contributed property, since under section 170(e)(1)(A) and paragraph (a) of § 1.170A–4 the amount of the charitable contribution is reduced to zero ($600 − [$600 − $0]).

Example 5. In 1970, C, a farmer using the cash method of accounting and the calendar year as the taxable year, contributed to a church a quantity of grain which he had raised having a fair market value of $600. In 1969, C paid expenses of $450 in raising the property which he properly deducted for such year under section 162. Under section 170(e)(1)(A) and paragraph (a) of § 1.170A–4, the amount of the charitable contribution in 1970 is reduced to zero ($600 − [$600 − $0]). Accordingly, C is not allowed any deduction under section 170 for the contributed property.

Example 6. The facts are the same as in *Example (5)* except that the $450 expenses incurred in raising the contributed property were paid in 1970. The result is the same as in *Example (5)*, except the amount of $450 is deductible under section 162 for 1970.

(5) Transfers of property to an organization described in section 170(c) which bear a direct relationship to the taxpayer’s trade or business and which are made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute allowable deductions as trade or business expenses rather than as charitable contributions. See section 162 and the regulations thereunder.

(d) *Purchase of an annuity.* (1) In the case of an annuity or portion thereof purchased from an organization described in section 170(c), there shall be allowed as a deduction the excess of the amount paid over the value at the time of purchase of the annuity or portion purchased.

(2) The value of the annuity or portion is the value of the annuity determined in accordance with paragraph (e)(1)(iii) *(b)(2)* of § 1.101–2.

(3) For determining gain on any such transaction constituting a bargain sale, see section 1011(b) and § 1.1011–2.

(e) *Transfers subject to a condition or power.* If as of the date of a gift a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an interest in property passes to, or is vested in, charity on the date of the gift and the interest would be defeated by the subsequent performance of some act or the happening of some event, the possibility of occurrence of which appears on the date of the gift to be so remote as to be negligible, the deduction is allowable. For example, A transfers land to a city government for as long as the land is used by the city for a public park. If on the date of the gift the city does plan to use the land for a park and the possibility that the city will not use the land for a public park is so remote as to be negligible, A is entitled to a deduction under section 170 for his charitable contribution.

(f) *Special rules applicable to certain contributions.* (1) See section 14 of the Wild and Scenic Rivers Act (Pub. L. 90–542, 82 Stat. 918) for provisions relating to the claim and allowance of the value of certain easements as a charitable contribution under section 170.

(2) For treatment of gifts accepted by the Secretary of State or the Secretary of Commerce, for the purpose of organizing and holding an international conference to negotiate a Patent Corporation Treaty, as gifts to or for the use of the United States, see section 3 of joint resolution of December 24, 1969 (Pub. L. 91–160, 83 Stat. 443).

(3) For treatment of gifts accepted by the Secretary of the Department of Housing and Urban Development, for the purpose of aiding or facilitating the

work of the Department, as gifts to or for the use of the United States, see section 7(k) of the Department of Housing and Urban Development Act (42 U.S.C. 3535), as added by section 905 of Pub. L. 91–609 (84 Stat. 1809).

(g) *Contributions of services.* No deduction is allowable under section 170 for a contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization contributions to which are deductible may constitute a deductible contribution. For example, the cost of a uniform without general utility which is required to be worn in performing donated services is deductible. Similarly, out-of-pocket transportation expenses necessarily incurred in performing donated services are deductible. Reasonable expenditures for meals and lodging necessarily incurred while away from home in the course of performing donated services also are deductible. For the purposes of this paragraph, the phrase *while away from home* has the same meaning as that phrase is used for purposes of section 162 and the regulations thereunder.

(h) *Payment in exchange for consideration*—(1) *Burden on taxpayer to show that all or part of payment is a charitable contribution or gift.* No part of a payment that a taxpayer makes to or for the use of an organization described in section 170(c) that is in consideration for (as defined in §1.170A–13(f)(6)) goods or services (as defined in §1.170A–13(f)(5)) is a contribution or gift within the meaning of section 170(c) unless the taxpayer—

(i) Intends to make a payment in an amount that exceeds the fair market value of the goods or services; and

(ii) Makes a payment in an amount that exceeds the fair market value of the goods or services.

(2) *Limitation on amount deductible*—(i) *In general.* The charitable contribution deduction under section 170(a) for a payment a taxpayer makes partly in consideration for goods or services may not exceed the excess of—

(A) The amount of any cash paid and the fair market value of any property (other than cash) transferred by the taxpayer to an organization described in section 170(c); over

(B) The fair market value of the goods or services the organization provides in return.

(ii) *Special rules.* For special limits on the deduction for charitable contributions of ordinary income and capital gain property, see section 170(e) and §§1.170A–4 and 1.170A–4A.

(3) *Certain goods or services disregarded.* For purposes of section 170(a) and paragraphs (h)(1) and (h)(2) of this section, goods or services described in §1.170A–13(f)(8)(i) or §1.170A–13(f)(9)(i) are disregarded.

(4) *Donee estimates of the value of goods or services may be treated as fair market value*—(i) *In general.* For purposes of section 170(a), a taxpayer may rely on either a contemporaneous written acknowledgment provided under section 170(f)(8) and §1.170A–13(f) or a written disclosure statement provided under section 6115 for the fair market value of any goods or services provided to the taxpayer by the donee organization.

(ii) *Exception.* A taxpayer may not treat an estimate of the value of goods or services as their fair market value if the taxpayer knows, or has reason to know, that such treatment is unreasonable. For example, if a taxpayer knows, or has reason to know, that there is an error in an estimate provided by an organization described in section 170(c) pertaining to goods or services that have a readily ascertainable value, it is unreasonable for the taxpayer to treat the estimate as the fair market value of the goods or services. Similarly, if a taxpayer is a dealer in the type of goods or services provided in consideration for the taxpayer's payment and knows, or has reason to know, that the estimate is in error, it is unreasonable for the taxpayer to treat the estimate as the fair market value of the goods or services.

(5) *Examples.* The following examples illustrate the rules of this paragraph (h).

Example 1. Certain goods or services disregarded. Taxpayer makes a $50 payment to Charity *B*, an organization described in section 170(c), in exchange for a family membership. The family membership entitles Taxpayer and members of Taxpayer's family to certain benefits. These benefits include free admission to weekly poetry readings, discounts on merchandise sold by *B* in its gift shop or by mail order, and invitations to special events for members only, such as lectures or informal receptions. When *B* first offers its membership package for the year, *B* reasonably projects that each special event for members will have a cost to *B,* excluding any allocable overhead, of $5 or less per person attending the event. Because the family membership benefits are disregarded pursuant to § 1.170A–13(f)(8)(i), Taxpayer may treat the $50 payment as a contribution or gift within the meaning of section 170(c), regardless of Taxpayer's intent and whether or not the payment exceeds the fair market value of the goods or services. Furthermore, any charitable contribution deduction available to Taxpayer may be calculated without regard to the membership benefits.

Example 2. Treatment of good faith estimate at auction as the fair market value. Taxpayer attends an auction held by Charity *C,* an organization described in section 170(c). Prior to the auction, *C* publishes a catalog that meets the requirements for a written disclosure statement under section 6115(a) (including *C*'s good faith estimate of the value of items that will be available for bidding). A representative of *C* gives a copy of the catalog to each individual (including Taxpayer) who attends the auction. Taxpayer notes that in the catalog *C*'s estimate of the value of a vase is $100. Taxpayer has no reason to doubt the accuracy of this estimate. Taxpayer successfully bids and pays $500 for the vase. Because Taxpayer knew, prior to making her payment, that the estimate in the catalog was less than the amount of her payment, Taxpayer satisfies the requirement of paragraph (h)(1)(i) of this section. Because Taxpayer makes a payment in an amount that exceeds that estimate, Taxpayer satisfies the requirements of paragraph (h)(1)(ii) of this section. Taxpayer may treat *C*'s estimate of the value of the vase as its fair market value in determining the amount of her charitable contribution deduction.

Example 3. Good faith estimate not in error. Taxpayer makes a $200 payment to Charity *D,* an organization described in section 170(c). In return for Taxpayer's payment, *D* gives Taxpayer a book that Taxpayer could buy at retail prices typically ranging from $18 to $25. *D* provides Taxpayer with a good faith estimate, in a written disclosure statement under section 6115(a), of $20 for the value of the book. Because the estimate is within the range of typical retail prices for the book, the estimate contained in the written disclosure statement is not in error. Although Taxpayer knows that the book is sold for as much as $25, Taxpayer may treat the estimate of $20 as the fair market value of the book in determining the amount of his charitable contribution deduction.

(i) [Reserved]

(j) *Exceptions and other rules.* (1) The provisions of section 170 do not apply to contributions by an estate; nor do they apply to a trust unless the trust is a private foundation which, pursuant to section 642(c)(6) and § 1.642(c)–4, is allowed a deduction under section 170 subject to the provisions applicable to individuals.

(2) No deduction shall be allowed under section 170 for a charitable contribution to or for the use of an organization or trust described in section 508(d) or 4948(c)(4), subject to the conditions specified in such sections and the regulations thereunder.

(3) For disallowance of deductions for contributions to or for the use of communist controlled organizations, see section 11(a) of the Internal Security Act of 1950, as amended (50 U.S.C. 790).

(4) For denial of deductions for charitable contributions as trade or business expenses and rules with respect to treatment of payments to organizations other than those described in section 170(c), see section 162 and the regulations thereunder.

(5) No deduction shall be allowed under section 170 for amounts paid to an organization:

(i) Which is disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, or

(ii) Which participates in, or intervenes in (including the publishing or distribution of statements), any political campaign on behalf of or in opposition to any candidate for public office.

For purposes of determining whether an organization is attempting to influence legislation or is engaging in political activities, see sections 501(c)(3), 501(h), 4911 and the regulations thereunder.

(6) No deduction shall be allowed under section 170 for expenditures for lobbying purposes, the promotion or defeat of legislation, etc. See also the regulations under sections 162 and 4945.

(7) No deduction for charitable contributions is allowed in computing the taxable income of a common trust fund or of a partnership. See sections 584(d)(3) and 703(a)(2)(D). However, a partner's distributive share of charitable contributions actually paid by a partnership during its taxable year

may be allowed as a deduction in the partner's separate return for his taxable year with or within which the taxable year of the partnership ends, to the extent that the aggregate of his share of the partnership contributions and his own contributions does not exceed the limitations in section 170(b).

(8) For charitable contributions paid by a nonresident alien individual or a foreign corporation, see §1.170A–4(b)(5) and sections 873, 876, 877, and 882(c), and the regulations thereunder.

(9) For charitable contributions paid by a citizen of the United States or a domestic corporation entitled to the benefits of section 931 (relating to income from sources within possessions of the United States), see section 931(d) and the regulations thereunder.

(10) For carryover of excess charitable contributions in certain corporate acquisitions, see section 381(c)(19) and the regulations thereunder.

(11) No deduction shall be allowed under section 170 for out-of-pocket expenditures on behalf of an eligible organization (within the meaning of §1.501(h)–2(b)(1)) if the expenditure is made in connection with influencing legislation (within the meaning of section 501(c)(3) or §56.4911–2), or in connection with the payment of the organization's tax liability under section 4911. For the treatment of similar expenditures on behalf of other organizations see paragraph (h)(6) of this section.

(k) *Effective date.* In general this section applies to contributions made in taxable years beginning after December 31, 1969. Paragraph (j)(11) of this section, however, applies only to out-of-pocket expenditures made in taxable years beginning after December 31, 1976. In addition, paragraph (h) of this section applies only to payments made on or after December 16, 1996. However, taxpayers may rely on the rules of paragraph (h) of this section for payments made on or after January 1, 1994.

(68A Stat. 58, 26 U.S.C. 170(a)(1); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7207, 37 FR 20771, Oct. 4, 1972, as amended by T.D. 7340, 40 FR 1238, Jan. 7, 1975; T.D. 7807, 47 FR 4510, Feb. 1, 1982; T.D. 8002, 49 FR 50666, Dec. 31, 1984; T.D. 8308, 55 FR 35587, Aug. 31, 1990; T.D. 8690, 61 FR 65951, Dec. 16, 1996]

§1.170A–2 Amounts paid to maintain certain students as members of the taxpayer's household.

(a) *In general.* (1) The term *charitable contributions* includes amounts paid by the taxpayer during the taxable year to maintain certain students as members of his household which, under the provisions of section 170(h) and this section, are treated as amounts paid for the use of an organization described in section 170(c) (2), (3), or (4), and such amounts, to the extent they do not exceed the limitations under section 170(h)(2) and paragraph (b) of this section, are contributions deductible under section 170. In order for such amounts to be so treated, the student must be an individual who is neither a dependent (as defined in section 152) of the taxpayer nor related to the taxpayer in a manner described in any of the paragraphs (1) through (8) of section 152(a), and such individual must be a member of the taxpayer's household pursuant to a written agreement between the taxpayer and an organization described in section 170(c) (2), (3), or (4) to implement a program of the organization to provide educational opportunities for pupils or students placed in private homes by such organization. Furthermore, such amounts must be paid to maintain such individual during the period in the taxable year he is a member of the taxpayer's household and is a full-time pupil or student in the 12th or any lower grade at an educational institution, as defined in section 151(e)(4) and §1.151–3, located in the United States. Amounts paid outside of such period, but within the taxable year, for expenses necessary for the maintenance of the student during the period will qualify for the charitable contributions deduction if the other limitation requirements of the section are met.

(2) For purposes of subparagraph (1) of this paragraph, amounts treated as charitable contributions include only those amounts actually paid by the taxpayer during the taxable year which are directly attributable to the maintenance of the student while he is a member of the taxpayer's household and is attending an educational institution on a full-time basis. This would include amounts paid to insure the well-being of the individual and to carry out the purpose for which the individual was placed in the taxpayer's home. For example, a deduction under section 170 would be allowed for amounts paid for books, tuition, food, clothing, transportation, medical and dental care, and recreation for the individual. Amounts treated as charitable contributions under this section do not include amounts which the taxpayer would have expended had the student not been in the household. They would not include, for example, amounts paid in connection with the taxpayer's home for taxes, insurance, interest on a mortgage, repairs, etc. Moreover, such amounts do not include any depreciation sustained by the taxpayer in maintaining such student or students in his household, nor do they include the value of any services rendered on behalf of such student or students by the taxpayer or any member of the taxpayer's household.

(3) For purposes of section 170(h) and this section, an individual will be considered to be a full-time pupil or student at an educational institution only if he is enrolled for a course of study prescribed for a full-time student at such institution and is attending classes on a full-time basis. Nevertheless, such individual may be absent from school due to special circumstances and still be considered to be in full-time attendance. Periods during the regular school term when the school is closed for holidays, such as Christmas and Easter, and for periods between semesters are treated as periods during which the pupil or student is in full-time attendance at the school. Also, absences during the regular school term due to illness of such individual shall not prevent him from being considered as a full-time pupil or student. Similarly, absences from the taxpayer's household due to special circumstances will not disqualify the student as a member of the household. Summer vacations between regular school terms are not considered periods of school attendance.

(4) When claiming a deduction for amounts described in section 170(h) and this section, the taxpayer must submit with his return a copy of his agreement with the organization sponsoring the individual placed in the taxpayer's household, together with a summary of the various items for which amounts were paid to maintain such individual, and a statement as to the date the individual became a member of the household and the period of his full-time attendance at school and the name and location of such school. Substantiation of amounts claimed must be supported by adequate records of the amounts actually paid. Due to the nature of certain items, such as food, a record of amount spent for all members of the household, with an equal portion thereof allocated to each member, will be acceptable.

(b) *Limitations.* Section 170(h) and this section shall apply to amounts paid during the taxable year only to the extent that the amounts paid in maintaining each pupil or student do not exceed $50 multiplied by the number of full calendar months in the taxable year that the pupil or student is maintained in accordance with the provisions of this section. For purposes of such limitation if 15 or more days of a calendar month fall within the period to which the maintenance of such pupil or student relates, such month is considered as a full calendar month. To the extent that such amounts qualify as charitable contributions under section 170(c), the aggregate of such amounts plus other contributions made during the taxable year for the use of an organization described in section 170(c) is deductible under section 170 subject to the limitation provided in section 170(b)(1)(B) and paragraph (c) of § 1.170A–8.

(c) *Compensation or reimbursement.* Amounts paid during the taxable year to maintain a pupil or student as a member of the taxpayer's household as provided in paragraph (a) of this section, shall not be taken into account under section 170(h) and this section, if the taxpayer receives any money or other property as compensation or reimbursement for any portion of such amounts. The taxpayer will not be denied the benefits of section 170(h) if he prepays an extraordinary or nonrecurring expense such as a hospital bill or vacation trip, at the request of the individual's parents or the sponsoring organization and is reimbursed for such prepayment. The value of services performed by the pupil or student in attending to ordinary chores of the household will generally not be considered to constitute compensation or reimbursement. However, if the pupil or student is taken into the taxpayer's household to replace a former employee of the taxpayer or gratuitously to perform substantial services for the taxpayer, the facts and circumstances may warrant a conclusion that the taxpayer received reimbursement for maintaining the pupil or student.

(d) *No other amount allowed as deduction.* Except to the extent that amounts described in section 170(h) and this section are treated as charitable contributions under section 170(c) and, therefore, deductible under section 170(a), no deduction is allowed for any amount paid to maintain an individual, as a member of the taxpayer's household, in accordance with the provisions of section 170(h) and this section.

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

Example 1. The X organization is an organization described in section 170(c)(2) and is engaged in a program under which a number of European children are placed in the homes of U.S. residents in order to further the children's high school education. In accordance with paragraph (a) of this section, the taxpayer, A, who reports his income on the calendar year basis, agreed with X to take two of the children, and they were placed in the taxpayer's home on January 2, 1970, where they remained until January 21, 1971, during which time they were fully maintained by the taxpayer. The children enrolled at the local high school for the full course of study prescribed for 10th grade students and attended the school on a full-time basis for the spring semester starting January 18, 1970, and ending June 3, 1970, and for the fall semester starting September 1, 1970, and ending January 13, 1971. The total cost of food paid by A in 1970 for himself, his wife, and the two children amounted to $1,920, or $40 per month for each member of the household. Since the children were actually full-time students for only 8 1/2 months during 1970, the amount paid for food for each child during that period amounted to $340. Other amounts paid during the 8 1/2 -month period for each child for laundry, lights, water, recreation, and school supplies amounted to $160. Thus, the amounts treated under section 170(h) and this section as paid for the use of X would, with respect to each child, total $500 ($340+$160), or a total for both children of $1,000, subject to the limitations of paragraph (b) of this section. Since, for purposes of such limitations, the children were full-time students for only 8 full calendar months during 1970 (less than 15 days in January 1970), the taxpayer may treat only $800 as a charitable contribution made in 1970, that is, $50 multiplied by the 8 full calendar months, or $400 paid for the maintenance of each child. Neither the excess payments nor amounts paid to maintain the children during the period before school opened and for the period in summer between regular school terms is taken into account by reason of section 170(h). Also, because the children were full-time students for less than 15 days in January 1971 (although maintained in the taxpayer's household for 21 days), amounts paid to maintain the children during 1971 would not qualify as a charitable contribution.

Example 2. A religious organization described in section 170(c)(2) has a program for providing educational opportunities for children it places in private homes. In order to implement the program, the taxpayer, H, who resides with his wife, son, and daughter of high school age in a town in the United States, signs an agreement with the organization to maintain a girl sponsored by the organization as a member of his household while the child attends the local high school for the regular 1970–71 school year. The child is a full-time student at the school during the school year starting September 6, 1970, and ending June 6, 1971, and is a member of the taxpayer's household during that period. Although the taxpayer pays $200 during the school period falling in 1970, and $240 during the school period falling in 1971, to maintain the child, he cannot claim either amount as a charitable contribution because the child's parents, from time to time during the school year, send butter, eggs, meat, and vegetables to H to help defray the expenses of maintaining the child. This is considered property received as reimbursement under paragraph (c) of this section. Had her parents not contributed the food, the fact that the child, in addition to the normal chores she shared with the taxpayer's daughter, such as cleaning their own rooms and helping with the shopping and cooking, was responsible for the family laundry and for the heavy cleaning of the entire house while the taxpayer's daughter had no comparable responsibilities would also preclude a claim for a charitable contributions deduction. These substantial gratuitous services are considered property received as reimbursement under paragraph (c) of this section.

Example 3. A taxpayer resides with his wife in a city in the eastern United States. He agrees, in writing, with a fraternal society described in section 170(c)(4) to accept a child selected by the society for maintenance by him as a member of his household during 1971 in order that the child may attend the local grammar school as a part of the society's program to provide elementary education for certain children selected by it. The taxpayer maintains the child, who has as his principal place of abode the home of the taxpayer, and is a member of the taxpayer's household, during the entire year 1971. The child is a full-time student at the local grammar school for 9 full calendar months during the year. Under the agreement, the society pays the taxpayer $30 per month to help maintain the child. Since the $30 per month is considered as compensation or reimbursement to the taxpayer for some portion of the maintenance paid on behalf of the child, no amounts paid with respect to such maintenance can be treated as amounts paid in accordance with section 170(h). In the absence of the $30 per month payments, if the child qualifies as a dependent of the taxpayer under section 152(a)(9), that fact would also prevent the maintenance payments from being treated as charitable contributions paid for the use of the fraternal society.

(f) *Effective date.* This section applies only to contributions paid in taxable years beginning after December 31, 1969.

[T.D. 7207, 37 FR 20774, Oct. 4, 1972]

§ 1.170A–3 Reduction of charitable contribution for interest on certain indebtedness.

(a) *In general.* Section 170(f)(5) requires that the amount of a charitable contribution be reduced for certain interest to the extent necessary to avoid the deduction of the same amount both as an interest deduction under section 163 and as a deduction for charitable contributions under section 170. The reduction is to be determined in accordance with paragraphs (b) and (c) of this section.

(b) *Interest attributable to postcontribution period.* In determining the amount to be taken into account as a charitable contribution for purposes of section 170, the amount determined without regard to section 170(f)(5) or this section shall be reduced by the amount of interest which has been paid, or is to be paid, by the taxpayer, which is attributable to any liability connected with the contribution, and which is attributable to any period of time after the making of the contribution. The deduction otherwise allowable for charitable contributions under section 170 is required to be reduced pursuant to section 170(f)(5) and this section only if, in connection with a charitable contribution, a liability is assumed by the recipient of the contribution or by any other person or if the charitable contribution is of property which is subject to a liability. Thus, if a charitable contribution is made in property and the transfer is conditioned upon the assumption of a liability by the donee or by some other person, the contribution must be reduced by the amount of any interest which has been paid, or will be paid, by the taxpayer, which is attributable to the liability, and which is attributable to any period after the making of the contribution. The adjustment referred to in this paragraph must also be made where the contributed property is subject to a liability and the value of the property reflects the payment by the donor of interest with respect to a period of time after the making of the contribution.

(c) *Interest attributable to precontribution period.* If, in connection with the charitable contribution of a bond, a liability is assumed by the recipient or by any other person, or if the bond is subject to a liability, then, in determining the amount to be taken into account as a charitable contribution under section 170, the amount determined without regard to section 170(f)(5) and this section shall, without regard to whether any reduction may be required by paragraph (b) of this section, also be reduced for interest which has been paid, or is to be paid, by the taxpayer on indebtedness incurred or continued to purchase or carry such bond, and which is attributable to any period before the making of the contribution. However, the reduction referred to in this paragraph shall be made only to the extent that such reduction does not exceed the interest (including bond discount and other interest equivalent) receivable on the bond, and attributable to any period before the making of the contribution which is not, by reason of the taxpayer's method of accounting, includible in the taxpayer's gross income for any taxable year. For purposes of section 170(f)(5) and this section the term *bond* means any bond, debenture, note, or certificate or other evidence of indebtedness.

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

Example 1. On January 1, 1970, A, a cash basis taxpayer using the calendar year as the taxable year, contributed to a charitable organization real estate having a fair market value and adjusted basis of $10,000. In connection with the contribution the charitable organization assumed an indebtedness of $8,000 which A had incurred. On December 31, 1969, A prepaid one year's interest on that indebtedness for 1970, amounting to $960, and took an interest deduction of $960 for such amount. The amount of the gift, determined without regard to this section, is $2,960 ($10,000 less $8,000, the outstanding indebtedness, plus $960, the amount of prepaid interest). In determining the amount of the deduction for the charitable contribution, the value of the gift ($2,960) must be reduced by $960 to eliminate from the computation of such deduction that portion thereof for which A has been allowed an interest deduction.

Example 2. (a) On January 1, 1970, B, an individual using the cash receipts and disbursements method of accounting, purchased for $9,950 a 5 1/2 percent $10,000, 20-year M Corporation bond, the interest on which was payable semiannually on June 30 and December 31. The M Corporation had issued the bond on January 1, 1960, at a discount of $720 from the principal amount. On December 1, 1970, B donated the bond to a charitable organization, and, in connection with the contribution, the charitable organization assumed an indebtedness of $7,000 which B had incurred to purchase and carry the bond.

(b) During the calendar year 1970 B paid accrued interest of $330 on the indebtedness for the period from January 1, 1970, to December 1, 1970, and has taken an interest deduction of $330 for such amount. No portion of the bond discount of $36 a year ($720 divided by 20 years) has been included in B's income, and of the $550 of annual interest receivable on the bond, he included in income only the June 30, 1970, payment of $275.

(c) The market value of the bond on December 1, 1970, was $9,902. Such value includes $229 of interest receivable which had accrued from July 1 to December 1, 1970.

(d) The amount of the charitable contribution determined without regard to this section is $2,902 ($9,902, the value of the property on the date of gift, less $7,000, the amount of the liability assumed by the charitable organization). In determining the amount of the allowable deduction for charitable contributions, the value of the gift ($2,902) must be reduced to eliminate from the deduction that portion thereof for which B has been allowed an interest deduction. Although the amount of such interest deduction was $330, the reduction required by this section is limited to $262, since the reduction is not in excess of the amount of interest income on the bond ($229 of accrued interest plus $33, the amount of bond discount attributable to the 11-month period B held the bond).

(e) *Effective date.* This section applies only to contributions paid in taxable years beginning after December 31, 1969.

[T.D. 7207, 37 FR 20775, Oct. 4, 1972]

§1.170A–4 Reduction in amount of charitable contributions of certain appreciated property.

(a) *Amount of reduction.* Section 170(e)(1) requires that the amount of the charitable contribution which would be taken into account under section 170(a) without regard to section 170(e) shall be reduced before applying the percentage limitations under section 170(b):

(1) In the case of a contribution by an individual or by a corporation of ordinary income property, as defined in paragraph (b)(1) of this section, by the amount of gain (hereinafter in this section referred to as ordinary income) which would have been recognized as gain which is not long-term capital gain if the property had been sold by the donor at its fair market value at the time of its contribution to the charitable organization,

(2) In the case of a contribution by an individual of section 170(e) capital gain property, as defined in paragraph (b)(2) of this section, by 50 percent of the

amount of gain (hereinafter in this section referred to as long-term capital gain) which would have been recognized as long-term capital gain if the property had been sold by the donor at its fair market value at the time of its contribution to the charitable organization, and

(3) In the case of a contribution by a corporation of section 170(e) capital gain property, as defined in paragraph (b)(2) of this section, by 62 1/2 percent of the amount of gain (hereinafter in this section referred to as long-term capital gain) which would have been recognized as long-term capital gain if the property had been sold by the donor at its fair market value at the time of its contribution to the charitable organization.

Section 170(e)(1) and this paragraph do not apply to reduce the amount of the charitable contribution where, by reason of the transfer of the contributed property, ordinary income or capital gain is recognized by the donor in the same taxable year in which the contribution is made. Thus, where income or gain is recognized under section 453(d) upon the transfer of an installment obligation to a charitable organization, or under section 454(b) upon the transfer of an obligation issued at a discount to such an organization, or upon the assignment of income to such an organization, section 170(e)(1) and this paragraph do not apply if recognition of the income or gain occurs in the same taxable year in which the contribution is made. Section 170(e)(1) and this paragraph apply to a charitable contribution of an interest in ordinary income property or section 170(e) capital gain property which is described in paragraph (b) of § 1.170A–6, or paragraph (b) of § 1.170A–7. For purposes of applying section 170(e)(1) and this paragraph it is immaterial whether the charitable contribution is made ''to'' the charitable organization or whether it is made ''for the use of'' the charitable organization. See § 1.170A–8(a)(2).

(b) *Definitions and other rules.* For purposes of this section:

(1) *Ordinary income property.* The term *ordinary income property* means property any portion of the gain on which would not have been long term capital gain if the property had been sold by the donor at its fair market value at the time of its contribution to the charitable organization. Such term includes, for example, property held by the donor primarily for sale to customers in the ordinary course of his trade or business, a work of art created by the donor, a manuscript prepared by the donor, letters and memorandums prepared by or for the donor, a capital asset held by the donor for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), and stock described in section 306(a), 341(a), or 1248(a) to the extent that, after applying such section, gain on its disposition would not have been long-term capital gain. The term does not include an income interest in respect of which a deduction is allowed under section 170(f)(2)(B) and paragraph (c) of § 1.170A–6.

(2) *Section 170(e) capital gain property.* The term *section 170(e) capital gain property* means property any portion of the gain on which would have been treated as long-term capital gain if the property had been sold by the donor at its fair market value at the time of its contribution to the charitable organization and which:

(i) Is contributed to or for the use of a private foundation, as defined in section 509(a) and the regulations thereunder, other than a private foundation described in section 170(b)(1)(E),

(ii) Constitutes tangible personal property contributed to or for the use of a charitable organization, other than a private foundation to which subdivision (i) of this subparagraph applies, which is put to an unrelated use by the charitable organization within the meaning of subparagraph (3) of this paragraph, or

(iii) Constitutes property not described in subdivision (i) or (ii) of this subparagraph which is 30-percent capital gain property to which an election under paragraph (d)(2) of § 1.170A–8 applies.

For purposes of this subparagraph a fixture which is intended to be severed from real property shall be treated as tangible personal property.

(3) *Unrelated use*—(i) *In general.* The term *unrelated use* means a use which is unrelated to the purpose or function

constituting the basis of the charitable organization's exemption under section 501 or, in the case of a contribution of property to a governmental unit, the use of such property by such unit for other than exclusively public purposes. For example, if a painting contributed to an educational institution is used by that organization for educational purposes by being placed in its library for display and study by art students, the use is not an unrelated use; but if the painting is sold and the proceeds used by the organization for educational purposes, the use of the property is an unrelated use. If furnishings contributed to a charitable organization are used by it in its offices and buildings in the course of carrying out its functions, the use of the property is not an unrelated use. If a set or collection of items of tangible personal property is contributed to a charitable organization or governmental unit, the use of the set or collection is not an unrelated use if the donee sells or otherwise disposes of only an insubstantial portion of the set or collection. The use by a trust of tangible personal property contributed to it for the benefit of a charitable organization is an unrelated use if the use by the trust is one which would have been unrelated if made by the charitable organization.

(ii) *Proof of use.* For purposes of applying subparagraph (2)(ii) of this paragraph, a taxpayer who makes a charitable contribution of tangible personal property to or for the use of a charitable organization or governmental unit may treat such property as not being put to an unrelated use by the donee if:

(a) He establishes that the property is not in fact put to an unrelated use by the donee, or

(b) At the time of the contribution or at the time the contribution is treated as made, it is reasonable to anticipate that the property will not be put to an unrelated use by the donee. In the case of a contribution of tangible personal property to or for the use of a museum, if the object donated is of a general type normally retained by such museum or other museums for museum purposes, it will be reasonable for the donor to anticipate, unless he has actual knowledge to the contrary, that the object will not be put to an unrelated use by the donee, whether or not the object is later sold or exchanged by the donee.

(4) *Property used in trade or business.* For purposes of applying subparagraphs (1) and (2) of this paragraph, property which is used in the trade or business, as defined in section 1231(b), shall be treated as a capital asset, except that any gain in respect of such property which would have been recognized if the property had been sold by the donor at its fair market value at the time of its contribution to the charitable organization shall be treated as ordinary income to the extent that such gain would have constituted ordinary income by reason of the application of section 617 (d)(1), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a).

(5) *Nonresident alien individuals and foreign corporations.* The reduction in the case of a nonresident alien individual or a foreign corporation shall be determined by taking into account the gain which would have been recognized and subject to tax under chapter 1 of the Code if the property had been sold or disposed of within the United States by the donor at its fair market value at the time of its contribution to the charitable organization. However, the amount of such gain which would have been subject to tax under section 871(a) or 881 (relating to gain not effectively connected with the conduct of a trade or business within the United States) if there had been a sale or other disposition within the United States shall be treated as long-term capital gain. Thus, a charitable contribution by a nonresident alien individual or a foreign corporation of property the sale or other disposition of which within the United States would have resulted in gain subject to tax under section 871(a) or 881 will be reduced only as provided in section 170(e)(1)(B) and paragraph (a)(2) or (3) of this section, but only if the property contributed is described in subdivision (i), (ii), or (iii) of subparagraph (2) of this paragraph. A charitable contribution by a nonresident alien individual or a foreign corporation of property the sale or other disposition of which within the United States would have resulted in gain subject to tax under section 871(a) or 881

will in no case be reduced under section 170(e)(1)(A) and paragraph (a)(1) of this section.

(c) *Allocation of basis and gain*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph:

(i) If a taxpayer makes a charitable contribution of less than his entire interest in appreciated property, whether or not the transfer is made in trust, as, for example, in the case of a transfer of appreciated property to a pooled income fund described in section 642(c)(5) and § 1.642(c)–5, and is allowed a deduction under section 170 for a portion of the fair market value of such property, then for purposes of applying the reduction rules of section 170(e)(1) and this section to the contributed portion of the property the taxpayer's adjusted basis in such property at the time of the contribution shall be allocated under section 170(e)(2) between the contributed portion of the property and the noncontributed portion.

(ii) The adjusted basis of the contributed portion of the property shall be that portion of the adjusted basis of the entire property which bears the same ratio to the total adjusted basis as the fair market value of the contributed portion of the property bears to the fair market value of the entire property.

(iii) The ordinary income and the long-term capital gain which shall be taken into account in applying section 170(e)(1) and paragraph (a) of this section to the contributed portion of the property shall be the amount of gain which would have been recognized as ordinary income and long-term capital gain if such contributed portion had been sold by the donor at its fair market value at the time of its contribution to the charitable organization.

(2) *Bargain sale.* (i) Section 1011(b) and § 1.1011–2 apply to bargain sales of property to charitable organizations. For purposes of applying the reduction rules of section 170(e)(1) and this section to the contributed portion of the property in the case of a bargain sale, there shall be allocated under section 1011(b) to the contributed portion of the property that portion of the adjusted basis of the entire property that bears the same ratio to the total adjusted basis as the fair market value of the contributed portion of the property bears to the fair market value of the entire property. For purposes of applying section 170(e)(1) and paragraph (a) of this section to the contributed portion of the property in such a case, there shall be allocated to the contributed portion the amount of gain that is not recognized on the bargain sale but that would have been recognized if such contributed portion had been sold by the donor at its fair market value at the time of its contribution to the charitable organization.

(ii) The term *bargain sale,* as used in this subparagraph, means a transfer of property which is in part a sale or exchange of the property and in part a charitable contribution, as defined in section 170(c), of the property.

(3) *Ratio of ordinary income and capital gain.* For purposes of applying subparagraphs (1)(iii) and (2)(i) of this paragraph, the amount of ordinary income (or long-term capital gain) which would have been recognized if the contributed portion of the property had been sold by the donor at its fair market value at the time of its contribution shall be that amount which bears the same ratio to the ordinary income (or long-term capital gain) which would have been recognized if the entire property had been sold by the donor at its fair market value at the time of its contribution as (i) the fair market value of the contributed portion at such time bears to (ii) the fair market value of the entire property at such time. In the case of a bargain sale, the fair market value of the contributed portion for purposes of subdivision (i) is the amount determined by subtracting from the fair market value of the entire property the amount realized on the sale.

(4) *Donee's basis of property acquired.* The adjusted basis of the contributed portion of the property, as determined under subparagraph (1) or (2) of this paragraph, shall be used by the donee in applying to the contributed portion such provisions as section 514(a)(1), relating to adjusted basis of debt-financed property; section 1015(a), relating to basis of property acquired by gift; section 4940(c)(4), relating to capital gains and losses in determination of net investment income; and section

4942(f)(2)(B), relating to net short-term capital gain in determination of tax on failure to distribute income. The fair market value of the contributed portion of the property at the time of the contribution shall not be used by the donee as the basis of such contributed portion.

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

Example 1. (a) On July 1, 1970, C, an individual, makes the following charitable contributions, all of which are made to a church except in the case of the stock (as indicated):

Property	Fair market value	Adjusted basis	Recognized gain sold
Ordinary income property	$50,000	$35,000	$15,000
Property which, if sold, would produce long-term capital gain:			
(1) Stock held more than 6 months contributed to—.			
(i) A church	25,000	21,000	4,000
(ii) A private foundation not described in section 170(b)(1)(E)	15,000	10,000	5,000
(2) Tangible personal property held more than 6 months (put to unrelated use by church)	12,000	6,000	6,000
Total	102,000	72,000	30,000

(b) After making the reductions required by paragraph (a) of this section, the amount of charitable contributions allowed (before application of section 170(b) limitations) is as follows:

Property	Fair market value	Reduction	Contribution allowed
Ordinary income property	$50,000	$15,000	$35,000
Property which, if sold, would produce long-term capital gain:			
(1) Stock contributed to:.			
(i) The church	25,000	....	25,000
(ii) The private foundation	15,000	2,500	12,500
(2) Tangible personal property	12,000	3,000	9,000
Total	102,000	20,500	81,500

(c) If C were a corporation, rather than an individual, the amount of charitable contributions allowed (before application of section 170(b) limitation) would be as follows:

Property	Fair market value	Reduction	Contribution allowed
Ordinary income property	$50,000	$15,000	$35,000
Property which, if sold, would produce long-term capital gain:			
(1) Stock contributed to:.			
(i) The church	25,000	....	25,000
(ii) The private foundation	15,000	3,125	11,875
(2) Tangible personal property	12,000	3,750	8,250
Total	102,000	21,875	80,125

Example 2. On March 1, 1970, D, an individual, contributes to a church intangible property to which section 1245 applies which has a fair market value of $60,000 and an adjusted basis of $10,000. At the time of the contribution D has used the property in his business for more than 6 months. If the property had been sold by D at its fair market value at the time of its contribution, it is assumed that under section 1245 $20,000 of the gain of $50,000 would have been treated as ordinary income and $30,000 would have been long-term capital gain. Under paragraph (a)(1) of this section, D's contribution of $60,000 is reduced by $20,000.

Example 3. The facts are the same as in *Example (2)* except that the property is contributed to a private foundation not described in section 170(b)(1)(E). Under paragraph (a) (1) and (2) of this section, D's contribution is reduced by $35,000 (100 percent of the ordinary income of $20,000 and 50 percent of the long-term capital gain of $30,000).

Example 4. (a) In 1971, E, an individual calendar-year taxpayer, contributes to a church stock held for more than 6 months which has a fair market value of $90,000 and an adjusted basis of $10,000. In 1972, E also contributes to a church stock held for more than 6 months which has a fair market value of $20,000 and an adjusted basis of $10,000. E's contribution base for 1971 is $200,000; and for 1972, is $150,000. E makes no other charitable contributions for these 2 taxable years.

(b) For 1971 the amount of the contribution which may be taken into account under section 170(a) is limited by section 170(b)(1)(D)(i) to $60,000 ($200,000×30%), and A is allowed a deduction for $60,000. Under section 170(b)(1)(D)(ii), E has a $30,000 carryover to 1972 of 30-percent capital gain property, as defined in paragraph (d)(3) of §1.170A–8. For 1972 the amount of the charitable contributions deduction is $45,000 (total contributions of $50,000 [$30,000+$20,000] but not to exceed 30% of $150,000).

(c) Assuming, however, that in 1972 E elects under section 170(b)(1)(D)(iii) and paragraph (d)(2) of §1.170A–8 to have section 170(e)(1)(B) apply to his contributions and carryovers of 30-percent capital gain property, he must apply section 170(d)(1) as if section 170(e)(1)(B) had applied to the contribution for 1971. If section 170 (e)(1)(B) had applied in 1971 to his contributions of 30-percent capital gain property, E's contribution would have been reduced from $90,000 to $50,000, the reduction of $40,000 being 50 percent of the gain of $80,000 ($90,000 − $10,000) which would have been recognized as long-term capital gain if the property had been sold by E at its fair market value at the time of its contribution to the church. Accordingly, by taking the election into account, E has no carryover of 30-percent capital gain property to 1972 since the charitable contributions deduction of $60,000 allowed for 1971 in respect of that property exceeds the reduced contribution of $50,000 for 1971 which may be taken into account by reason of the election. The charitable contributions deduction of $60,000 allowed for 1971 is not reduced by reason of the election.

(d) Since by reason of the election E is allowed under paragraph (a)(2) of this section a charitable contributions deduction for 1972 of $15,000 ($20,000 − [($20,000 − $10,000)×50%]) and since the $30,000 carryover from 1971 is eliminated, it would not be to E's advantage to make the election under section 170(b)(1)(D)(iii) in 1972.

Example 5. In 1970, F, an individual calendar-year taxpayer, sells to a church for $4,000 ordinary income property with a fair market value of $10,000 and an adjusted basis of $4,000. F's contribution base for 1970 is $20,000, and F makes no other charitable contributions in 1970. Thus, F makes a charitable contribution to the church of $6,000 ($10,000 − $4,000 amount realized), which is 60% of the value of the property. The amount realized on the bargain sale is 40% ($4,000/$10,000) of the value of the property. In applying section 1011(b) to the bargain sale, adjusted basis in the amount of $1,600 ($4,000 adjusted basis × 40%) is allocated under § 1.1011–2(b) to the noncontributed portion of the property, and F recognizes $2,400 ($4,000 amount realized less $1,600 adjusted basis) of ordinary income. Under paragraphs (a)(1) and (c)(2)(i) of this section, F's contribution of $6,000 is reduced by $3,600 ($6,000 − [$4,000 adjusted basis × 60%]) (*i.e.*, the amount of ordinary income that would have been recognized on the contributed portion had the property been sold). The reduced contribution of $2,400 consists of the portion ($4,000 × 60%) of the adjusted basis not allocated to the noncontributed portion of the property. That is, the reduced contribution consists of the portion of the adjusted basis allocated to the contributed portion. Under sections 1012 and 1015(a) the basis of the property to the church is $6,400 ($4,000 + $2,400).

Example 6. In 1970, G, an individual calendar-year taxpayer, sells to a church for $6,000 ordinary income property with a fair market value of $10,000 and an adjusted basis of $4,000. G's contribution base for 1970 is $20,000, and G makes no other charitable contributions in 1970. Thus, G makes a charitable contribution to the church of $4,000 ($10,000 − $6,000 amount realized), which is 40% of the value of the property. The amount realized on the bargain sale is 60% ($6,000/$10,000) of the value of the property. In applying section 1011(b) to the bargain sale, adjusted basis in the amount of $2,400 ($4,000 adjusted basis × 60%) is allocated under § 1.1011–2(b) to the noncontributed portion of the property, and G recognizes $3,600 ($6,000 amount realized less $2,400 adjusted basis) of ordinary income. Under paragraphs (a)(1) and (c)(2)(i) of this section, G's contribution of $4,000 is reduced by $2,400 ($4,000 − [$4,000 adjusted basis × 40%]) (*i.e.*, the amount of ordinary income that would have been recognized on the contributed portion had the property been sold). The reduced contribution of $1,600 consist of the portion ($4,000×40%) of the adjusted basis not allocated to the noncontributed portion of the property. That is, the reduced contribution consists of the portion of the adjusted basis allocated to the contributed portion. Under sections 1012 and 1015(a) the basis of the property to the church is $7,600 ($6,000+$1,600).

Example 7. In 1970, H, an individual calendar-year taxpayer, sells to a church for $2,000 stock held for not more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. H's contribution base for 1970 is $20,000, and H makes no other charitable contributions in 1970. Thus, H makes a charitable contribution to the church of $8,000 ($10,000 − $2,000 amount realized), which is 80% of the value of the property. The amount realized on the bargain sale is 20% ($2,000/$10,000) of the value of the property. In applying section 1011(b) to the bargain sale, adjusted basis in the amount of $800 ($4,000 adjusted basis × 20%) is allocated under § 1.1011–2(b) to the noncontributed portion of the property, and H recognizes $1,200 ($2,000 amount realized less $800 adjusted basis) of ordinary income. Under paragraphs (a)(1) and (c)(2)(i) of this section, H's contribution of $8,000 is reduced by $4,800 ($8,000 − [$4,000 adjusted basis×80%]) (*i.e.*, the amount of ordinary income that would have been recognized on the contributed portion had the property been sold). The reduced contribution of $3,200 consists of the portion ($4,000×80%) of the adjusted basis not allocated to the noncontributed portion of the property. That is, the reduced contribution consists of the portion of the adjusted basis allocated to the contributed portion. Under sections 1012 and 1015(a) the basis of the property to the church is $5,200 ($2,000+$3,200).

Example 8. In 1970, F, an individual calendar-year taxpayer, sells for $4,000 to a private foundation not described in section 170(b)(1)(E) property to which section 1245 applies which has a fair market value of $10,000 and an adjusted basis of $4,000. F's contribution base for 1970 is $20,000, and F makes no other charitable contributions in 1970. At the time of the bargain sale, F has used the property in his business for more than 6 months. Thus F makes a charitable contribution of $6,000 ($10,000 − $4,000 amount realized), which is 60% of the value of the property. The amount realized on the bargain sale is 40% ($4,000/$10,000) of the value of the property. If the property had been sold by F at its fair market value at the time of its contribution, it is assumed that under section 1245 $4,000 of the gain of $6,000 ($10,000 − $4,000 adjusted basis) would have been treated as ordinary income and $2,000 would have been long-term capital gain. In applying section 1011(b) to the bargain sale, adjusted basis in the amount of $1,600 ($4,000 adjusted basis × 40%) is allocated under §1.1011–2(b) to the noncontributed portion of the property, and F's recognized gain of $2,400 ($4,000 amount realized less $1,600 adjusted basis) consists of $1,600 ($4,000×40%) of ordinary income and $800 ($2,000×40%) of long-term capital gain. Under paragraphs (a) and (c)(2)(i) of this section, F's contribution of $6,000 is reduced by $3,000 (the sum of $2,400 ($4,000×60%) of ordinary income and $600 ([$2,000×60%] × 50%) of long-term capital gain) (*i.e.,* the amount of gain that would have been recognized on the contributed portion had the property been sold). The reduced contribution of $3,000 consists of $2,400 ($4,000×60%) of adjusted basis and $600 ([$2,000×60%] × 50%) of long-term capital gain not used as a reduction under paragraph (a)(2) of this section. Under sections 1012 and 1015(a) the basis of the property to the private foundation is $6,400 ($4,000+$2,400).

Example 9. On January 1, 1970, A, an individual, transfers to a charitable remainder annuity trust described in section 664 (d)(1) stock which he has held for more than 6 months and which has a fair market value of $250,000 and an adjusted basis of $50,000, an irrevocable remainder interest in the property being contributed to a private foundation not described in section 170(b)(1)(E). The trusts provides that an annuity of $12,500 a year is payable to A at the end of each year for 20 years. By reference to §20.2031–7A(c) of this chapter (Estate Tax Regulations) the figure in column (2) opposite 20 years is 11.4699. Therefore, under §1.664–2 the fair market value of the gift of the remainder interest to charity is $106,626.25 ($250,000 − [$12,500×11.4699]). Under paragraph (c)(1)(ii) of this section, the adjusted basis allocated to the contributed portion of the property is $21,325.25 ($50,000×$106,626.25/$250,000). Under paragraphs (a)(2) and (c)(1) of this section, A's contribution is reduced by $42,650.50 (50 percent × [$106,626.25 − $21,325.25]) to $63,975.75 ($106,626.25 − $42,650.50). If, however, the irrevocable remainder interest in the property had been contributed to a section 170(b)(1)(A) organization, A's contribution of $106,626.25 would not be reduced under paragraph (a) of this section.

Example 10. (a) On July 1, 1970, B, a calendar-year individual taxpayer, sells to a church for $75,000 intangible property to which section 1245 applies which has a fair market value of $250,000 and an adjusted basis of $75,000. Thus, B makes a charitable contribution to the church of $175,000 ($250,000 − $75,000 amount realized), which is 70% ($175,000/$250,000) of the value of the property, the amount realized on the bargain sale is 30% ($75,000/$250,000) of the value of the property. At the time of the bargain sale, B has used the property in his business for more than 6 months. B's contribution base for 1970 is $500,000, and B makes no other charitable contributions in 1970. If the property had been sold by B at its fair market value at the time of its contribution, it is assumed that under section 1245 $105,000 of the gain of $175,000 ($250,000 − $75,000 adjusted basis) would have been treated as ordinary income and $70,000 would have been long-term capital gain. In applying section 1011(b) to the bargain sale, adjusted basis in the amount of $22,500 ($75,000 adjusted basis × 30%) is allocated under §1.1011–2(b) to the noncontributed portion of the property and B's recognized gain of $52,500 ($75,000 amount realized less $22,500 adjusted basis) consists of $31,500 ($105,000×30%) of ordinary income and $21,000 ($70,000×30%) of long term capital gain.

(b) Under paragraphs (a)(1) and (c)(2)(i) of this section B's contribution of $175,000 is reduced by $73,500 ($105,000×70%) (*i.e.,* the amount of ordinary income that would have been recognized on the contributed portion had the property been sold). The reduced contribution of $101,500 consists of $52,500 [$75,000×70%] of adjusted basis allocated to the contributed portion of the property and $49,000 [$70,000×70%] of long-term capital gain allocated to the contributed portion. Under sections 1012 and 1015(a) the basis of the property to the church is $127,500 ($75,000+$52,500).

(e) *Effective date.* This section applies only to contributions paid after December 31, 1969, except that, in the case of a charitable contribution of a letter, memorandum, or property similar to a letter or memorandum, it applies to contributions paid after July 25, 1969.

[T.D. 7207, 37 FR 20776, Oct. 4, 1972; 37 FR 22982, Oct. 27, 1972, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 7807, 47 FR 4510, Feb. 1, 1982; T.D. 8176, 53 FR 5569, Feb. 25, 1988; T.D. 8540, 59 FR 30102, June 10, 1994]

§ 1.170A–4A Special rule for the deduction of certain charitable contributions of inventory and other property.

(a) *Introduction.* Section 170(e)(3) provides a special rule for the deduction of certain qualified contributions of inventory and certain other property. To be treated as a ''qualified contribution'', a contribution must meet the restrictions and requirements of section 170(e)(3)(A) and paragraph (b) of this section. Paragraph (b)(1) of this section describes the corporations whose contributions may be subject to this section, the exempt organizations to which these contributions may be made, and the kinds of property which may be contributed. Under paragraph (b)(2) of this section, the use of the property must be related to the purpose or function constituting the ground for the exemption of the organization to which the contribution is made. Also, the property must be used for the care of the ill, needy, or infants. Under paragraph (b)(3) of this section, the recipient organization may not, except as there provided, require or receive in exchange money, property, or services for the transfer or use of property contributed under section 170(e)(3). Under paragraph (b)(4) of this section, the recipient organization must provide the contributing taxpayer with a written statement representing that the organization intends to comply with the restrictions set forth in paragraph (b) (2) and (3) of this section on the use and transfer of the property. Under paragraph (b)(5) of this section, the contributed property must conform to any applicable provisions of the Federal Food, Drug, and Cosmetic Act (as amended), and the regulations thereunder, at the date of contribution and for the immediately preceding 180 days. Paragraph (c) of this section provides the rules for determining the amount of reduction of the charitable contribution under section 170(e)(3). In general, the amount of the reduction is equal to one-half of the amount of gain (other than gain described in paragraph (d) of this section) which would not have been long-term capital gain if the property had been sold by the donor-taxpayer at fair market value at the date of contribution. If, after this reduction, the amount of the deduction would be more than twice the basis of the contributed property, the amount of the deduction is accordingly further reduced under paragraph (c)(1) of this section. The basis of contributed property which is inventory is determined under paragraph (c)(2) of this section, and the donor's cost of goods sold for the year of contribution must be adjusted under paragraph (c)(3) of this section. Under paragraph (d) of this section, a deduction is not allowed for any amount which, if the property had been sold by the donor-taxpayer, would have been gain to which the recapture provisions of section 617, 1245, 1250, 1251, or 1252 would have applied. For purposes of section 170(e)(3) the rules of § 1.170A–4 apply where not inconsistent with the rules of this section.

(b) *Qualified contributions*—(1) *In general.* A contribution of property qualifies under section 170(e)(3) of this section only if it is a charitable contribution:

(i) By a corporation, other than a corporation which is an electing small business corporation within the meaning of section 1371(b);

(ii) To an organization described in section 501(c)(3) and exempt under section 501(a), other than a private foundation, as defined in section 509(a), which is not an operating foundation, as defined in section 4942(j)(e);

(iii) Of property described in section 1221 (1) or (2);

(iv) Which contribution meets the restrictions and requirements of paragraph (b) (2) through (5) of this section.

(2) *Restrictions on use of contributed property.* In order for the contribution to qualify under this section, the contributed property is subject to the following restrictions in use. If the transferred property is used or transferred by the donee organization (or by any subsequent transferee that furnished to the donee organization the written statement described in paragraph

(b)(4)(ii) of this section) in a manner inconsistent with the requirements of subdivision (i) or (ii) of this paragraph (b)(2) or the requirements of paragraph (b)(3) of this section, the donor's deduction is reduced to the amount allowable under section 170 of the regulations thereunder, determined without regard to section 170(e)(3) of this section. If, however, the donor establishes that, at the time of the contribution, the donor reasonably anticipated that the property would be used in a manner consistent with those requirements, then the donor's deduction is not reduced.

(i) *Requirement of use for exempt purpose.* The use of the property must be related to the purpose or function constituting the ground for exemption under section 501(c)(3) of the organization to which the contribution is made. The property may not be used in connection with any activity which gives rise to unrelated trade or business income, as defined in sections 512 and 513 and the regulations thereunder.

(ii) *Requirement of use for care of the ill, needy, or infants*—(A) *In general.* The property must be used for the care of the ill, needy, or infants, as defined in this subdivision (ii). The property itself must ultimately either be transferred to (or for the use of) the ill, needy, or infants for their care or be retained for their care. No other person may use the contributed property except as incidental to primary use in the care of the ill, needy, or infants. The organization may satisfy the requirement of this subdivision by transferring the property to a relative, custodian, parent or guardian of the ill or needy individual or infant, or to any other individual if it makes a reasonable effort to ascertain that the property will ultimately be used primarily for the care of the ill or needy individual, or infant, and not for the primary benefit of any other person. The recipient organization may transfer the property to another exempt organization within the jurisdiction of the United States which meets the description contained in paragraph (b)(1)(ii) of this section, or to an organization not within the jurisdiction of the United States that, but for the fact that it is not within the jurisdiction of the United States, would be described in paragraph (b)(1)(ii) of this section. If an organization transfers the property to another organization, the transferring organization must obtain a written statement from the transferee organization as set forth in paragraph (b)(4) of this section. If the property is ultimately transferred to, or used for the benefit of, ill or needy persons, or infants, not within the jurisdiction of the United States, the organization which so transfers the property outside the jurisdiction of the United States must necessarily be a corporation. See section 170(c)(2) and §1.170A–11(a). For purposes of this subdivision, if the donee-organization charges for its transfer of contributed property (other than a fee allowed by paragraph (b)(3)(ii) of this section), the requirement of this subdivision is not met. See paragraph (b)(3) of this section.

(B) *Definition of the ill.* An ill person is a person who requires medical care within the meaning of §1.213–1(e). Examples of ill persons include a person suffering from physical injury, a person with a significant impairment of a bodily organ, a person with an existing handicap, whether from birth or later injury, a person suffering from malnutrition, a person with a disease, sickness, or infection which significantly impairs physical health, a person partially or totally incapable of self-care (including incapacity due to old age). A person suffering from mental illness is included if the person is hospitalized or institutionalized for the mental disorder, or, although the person is nonhospitalized or noninstitutionalized, if the person's mental illness constitutes a significant health impairment.

(C) *Definition of care of the ill.* Care of the ill means alleviation or cure of an existing illness and includes care of the physical, mental, or emotional needs of the ill.

(D) *Definition of the needy.* A needy person is a person who lacks the necessities of life, involving physical, mental, or emotional well-being, as a result of poverty or temporary distress. Examples of needy persons include a person who is financially impoverished as a result of low income and lack of financial resources, a person who temporarily lacks food or shelter (and the means to provide for it), a person who is the victim of a natural disaster (such as fire or flood), a person who is the victim of a civil disaster (such as a civil disturbance), a person who is temporarily not self-sufficient as a result of a sudden and severe personal or family crisis (such as a person who is the victim of a crime of violence or who has been physically abused), a person who is a refugee or immigrant and who is experiencing language, cultural, or financial difficulties, a minor child who is not self-sufficient and who is not cared for by a parent or guardian, and a person who is not self-sufficient as a result of previous institutionalization (such as a former prisoner or a former patient in a mental institution).

(E) *Definition of care of the needy.* Care of the needy means alleviation or satisfaction of an existing need. Since a person may be needy in some respects and not needy in other respects, care of the needy must relate to the particular need which causes the person to be needy. For example, a person whose temporary need arises from a natural disaster may need temporary shelter and food but not recreational facilities.

(F) *Definition of infant.* An infant is a minor child (as determined under the laws of the jurisdiction in which the child resides).

(G) *Definition of care of an infant.* Care of an infant means performance of parental functions and provision for the physical, mental, and emotional needs of the infant.

(3) *Restrictions on Transfer of contributed property*—(i) *In general.* Except as otherwise provided in subdivision (ii) of this paragraph (b)(3), a contribution will not qualify under this section, if the donee-organization or any transferee of the donee-organization requires or receives any money, property, or services for the transfer or use of property contributed under section 170(e)(3). For example, if an organization provides temporary shelter for a fee, and also provides free meals to ill or needy individuals, or infants using food contributed under this section the contribution of food is subject to this section (if the other requirements of this section are met). However, the fee charged by the organization for the shelter may not be increased merely because meals are served to the ill or needy individuals or infants.

(ii) *Exception.* A contribution may qualify under this section if the donee-organization charges a fee to another organization in connection with its transfer of the donated property, if:

(A) The fee is small or nominal in relation to the value of the transferred property and is not determined by this value; and

(B) The fee is designed to reimburse the donee-organization for its administrative, warehousing, or other similar costs.

For example, if a charitable organization (such as a food bank) accepts surplus food to distribute to other charities which give the food to needy persons, a small fee may be charged to cover administrative, warehousing, and other similar costs. This fee may be charged on the basis of the total number of pounds of food distributed to the transferee charity but not on the basis of the value of the food distributed. The provisions of this subdivision (ii) do not apply to a transfer of donated property directly from an organization to ill or needy individuals, or infants.

(4) *Requirement of a written statement*—(i) *Furnished to taxpayer.* In the case of any contribution made on or after March 3, 1982, the donee-organization must furnish to the taxpayer a written statement which:

(A) Describes the contributed property, stating the date of its receipt;

(B) Represents that the property will be used in compliance with section 170(e)(3) and paragraphs (b) (2) and (3) of this section;

(C) Represents that the donee-organization meets the requirements of paragraph (b)(1)(ii) of this section; and

(D) Represents that adequate books and records will be maintained, and made available to the Internal Revenue Service upon request.

The written statement must be furnished within a reasonable period after the contribution, but not later than the date (including extensions) by which the donor is required to file a United States corporate income tax return for the year in which the contribution was made. The books and records described in (D) of this subdivision (i) need not trace the receipt and disposition of specific items of donated property if they disclose compliance with the requirements by reference to aggregate quantities of donated property. The books and records are adequate if they reflect total amounts received and distributed (or used), and outline the procedure used for determining that the ultimate recipient of the property is an ill or needy individual, or infant. However, the books and records need not reflect the names of the ultimate individual recipients or the property distributed to (or used by) each one.

(ii) *Furnished to transferring organization.* If an organization that received a contribution under this section transfers the contributed property to another organization on or after March 3, 1982, the transferee organization must furnish to the transferring organization a written statement which contains the information required in paragraph (b)(4)(i) (A), (B) and (D) of this section. The statement must also represent that the transferee organization meets the requirements of paragraph (b)(1)(ii) of this section (or, in the case of a transferee organization which is a foreign organization not within the jurisdiction of the United States, that, but for such fact, the organization would meet the requirements of paragraph (b)(1)(ii) of this section). The written statement must be furnished within a reasonable period after the transfer.

(5) *Requirement of compliance with the Federal Food, Drug, and Cosmetic Act*—(i) *In general.* With respect to property contributed under this section which is subject to the Federal Food, Drug, and Cosmetic Act (as amended), and regulations thereunder, the contributed property must comply with the applicable provisions of that Act and regulations thereunder at the date of the contribution and for the immediately preceding 180 days. In the case of specific items of contributed property not in existence for the entire period of 180 days immediately preceding the date of contribution, the requirement of this paragraph (b)(5) is considered met if the contributed property complied with that Act and the regulations thereunder during the period of its existence and at the date of contribution and if, for the 180 day period prior to contribution other property (if any) held by the taxpayer at any time during that period, which property was fungible with the contributed property, complied with that Act and the regulations thereunder during the period held by the taxpayer.

(ii) *Example.* The rule of this paragraph (b)(5) may be illustrated by the following example.

Example. Corporation X a grocery store, contributes 12 crates of navel oranges. The oranges were picked and placed in the grocery store's stock two weeks prior to the date of contribution. The contribution satisfies the requirements of this paragraph (b)(5) if X complied with the Act and regulations thereunder for 180 days prior to the date of contribution with respect to all navel oranges in stock during that period.

(c) *Amount of reduction*—(1) *In general.* Section 170(e)(3)(B) requires that the amount of the charitable contribution subject to this section which would be taken into account under section 170(a), without regard to section 170(e), must be reduced before applying the percentage limitations under section 170(b). The amount of the first reduction is equal to one-half of the amount of gain which would not have been long-term capital gain if the property had been sold by the donor-taxpayer at its fair market value on the date of its contribution, excluding, however, any amount described in paragraph (d) of this section. If the amount of the charitable contribution which remains after this reduction exceeds twice the basis of the contributed property, then the amount of the charitable contribution is reduced a second time to an amount which is equal to twice the amount of the basis of the property.

(2) *Basis of contributed property which is inventory.* For the purposes of this section, notwithstanding the rules of §1.170A–1(c)(4), the basis of contributed property which is inventory must be determined under the donor's method of accounting for inventory for purposes of United States income tax. The donor must use as the basis of the contributed item the inventoriable carrying cost assigned to any similar item not included in closing inventory. For example, under the LIFO dollar value

method of accounting for inventory, where there has been an invasion of a prior year's layer, the donor may choose to treat the item contributed as having a basis of the unit's cost with reference to the layer(s) of prior year(s) cost or with reference to the current year cost.

(3) *Adjustment to cost of goods sold.* Notwithstanding the rules of § 1.170A–1(c)(4), the donor of the property which is inventory contributed under this section must make a corresponding adjustment to cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the contributed item or the amount of basis determined under paragraph (c)(2) of this section.

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

Example 1. During 1978 corporation X, a calendar year taxpayer, makes a qualified contribution of women's coats which were section 1221(1) property. The fair market value of the property at the date of contribution is $1,000, and the basis of the property is $200. The amount of the charitable contribution which would be taken into account under section 170(a) is the fair market value ($1,000). The amount of gain which would not have been long-term capital gain if the property had been sold is $800 ($1,000 − $200). The amount of the contribution is reduced by one-half the amount which would not have been capital gain if the property had been sold ($800/2=–$400).

After this reduction, the amount of the contribution which may be taken into account is $600 ($1,000 − $400). A second reduction is made in the amount of the charitable contribution because this amount (as first reduced to $600) is more than $400 which is an amount equal to twice the basis of the property. The amount of the further reduction is $200 [$600 − (2×$200)], and the amount of the contribution as finally reduced is $400 [$1,00 − ($400+$200)]. X would also have to decrease its cost of goods sold for the year of contribution by $200.

Example 2. Assume the same facts as set forth in *Example (1)* except that the basis of the property is $600. The amount of the first reduction is $200 (($1,000 − $600)/2).

As reduced, the amount of the contribution which may be taken into account is $800 ($1,000 − $200). There is no second reduction because $800 is less than $1,200 which is twice the basis of the property. However, X would have to decrease its cost of goods sold for the year of contribution by $600.

(d) *Recapture excluded.* A deduction is not allowed under section 170(e)(3) or this section for any amount which, if the property had been sold by the donor-taxpayer on the date of its contribution for an amount equal to its fair market value, would have been treated as ordinary income under section 617, 1245, 1250, 1251, or 1252. Thus, before making either reduction required by section 170(e)(3)(B) and paragraph (c) of this section, the fair market value of the contributed property must be reduced by the amount of gain that would have been recognized (if the property had been sold) as ordinary income under section 617, 1245, 1250, 1251, or 1252.

(e) *Effective date.* This section applies to qualified contributions made after October 4, 1976.

[T.D. 7807, 47 FR 4510, Feb. 1, 1982, as amended by T.D. 7962, 49 FR 27317, July 3, 1984]

§ 1.170A–5 Future interests in tangible personal property.

(a) *In general.* (1) A contribution consisting of a transfer of a future interest in tangible personal property shall be treated as made only when all intervening interests in, and rights to the actual possession or enjoyment of, the property:

(i) Have expired, or

(ii) Are held by persons other than the taxpayer or those standing in a relationship to the taxpayer described in section 267(b) and the regulations thereunder, relating to losses, expenses, and interest with respect to transactions between related taxpayers.

(2) Section 170(a)(3) and this section have no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during 3 months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than 1 year.

(3) Section 170(a)(3) and this section have no application in respect of a

transfer of a future interest in intangible personal property or in real property. However, a fixture which is intended to be severed from real property shall be treated as tangible personal property. For example, a contribution of a future interest in a chandelier which is attached to a building is considered a contribution which consists of a future interest in tangible personal property if the transferor intends that it be detached from the building at or prior to the time when the charitable organization's right to possession or enjoyment of the chandelier is to commence.

(4) For purposes of section 170(a)(3) and this section, the term *future interest* has generally the same meaning as it has when used in section 2503 and §25.2503–3 of this chapter (Gift Tax Regulations); it includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time. The term *future interest* includes situations in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization which has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property.

(5) In the case of a charitable contribution of a future interest to which section 170(a)(3) and this section apply the other provisions of section 170 and the regulations thereunder are inapplicable to the contribution until such time as the contribution is treated as made under section 170(a)(3).

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

Example 1. On December 31, 1970, A, an individual who reports his income on the calendar year basis, conveys by deed of gift to a museum title to a painting, but reserves to himself the right to the use, possession, and enjoyment of the painting during his lifetime. It is assumed that there was no intention to avoid the application of section 170(f)(3)(A) by the conveyance. At the time of the gift the value of the painting is $90,000. Since the contribution consists of a future interest in tangible personal property in which the donor has retained an intervening interest, no contribution is considered to have been made in 1970.

Example 2. Assume the same facts as in *Example (1)* except that on December 31, 1971, A relinquishes all of his right to the use, possession, and enjoyment of the painting and delivers the painting to the museum. Assuming that the value of the painting has increased to $95,000, A is treated as having made a charitable contribution of $95,000 in 1971 for which a deduction is allowable without regard to section 170(f)(3)(A).

Example 3. Assume the same facts as in *Example (1)* except A dies without relinquishing his right to the use, possession, and enjoyment of the painting. Since A did not relinquish his right to the use, possession, and enjoyment of the property during his life, A is treated as not having made a charitable contribution of the painting for income tax purposes.

Example 4. Assume the same facts as in *Example (1)* except A, on December 31, 1971, transfers his interest in the painting to his son, B, who reports his income on the calendar year basis. Since the relationship between A and B is one described in section 267(b), no contribution of the remainder interest in the painting is considered to have been made in 1971.

Example 5. Assume the same facts as in *Example (4).* Also assume that on December 31, 1972, B conveys to the museum the interest measured by A's life. B has made a charitable contribution of the present interest in the painting conveyed to the museum. In addition, since all intervening interests in, and rights to the actual possession or enjoyment of the property, have expired, a charitable contribution of the remainder interest is treated as having been made by A in 1972 for which a deduction is allowable without regard to section 170(f)(3)(A). Such remainder interest is valued according to §20.2031–7A(c) of this chapter (estate tax regulations), determined by subtracting the value of B's interest measured by A's life expectancy in 1972, and B receives a deduction in 1972 for the life interest measured by A's life expectancy and valued according to Table A(1) in such section.

Example 6. On December 31, 1970, C, an individual who reports his income on the calendar year basis, transfers a valuable painting to a pooled income fund described in section 642(c)(5), which is maintained by a university. C retains for himself for life an income interest in the painting, the remainder interest in the painting being contributed to the university. Since the contribution consists of a future interest in tangible personal property in which the donor has retained an intervening interest, no charitable contribution is considered to have been made in 1970.

Example 7. On January 15, 1972, D, an individual who reports his income on the calendar year basis, transfers a capital asset held for more than 6 months consisting of a valuable painting to a pooled income fund described in section 642(c)(5), which is maintained by a university, and creates an income interest in such painting for E for life. E is an individual not standing in a relationship to D described in section 267(b). The remainder interest in the property is contributed by D to the university. The trustee of the pooled income fund puts the painting to an unrelated use within the meaning of paragraph (b)(3) of § 1.170A–4. Accordingly, D is allowed a deduction under section 170 in 1972 for the present value of the remainder interest in the painting, after reducing such amount under section 170 (e)(1)(B)(i) and paragraph (a)(2) of § 1.170A–4. This reduction in the amount of the contribution is required since under paragraph (b)(3) of that section the use by the pooled income fund of the painting is a use which would have been an unrelated use if it had been made by the university.

(c) *Effective date.* This section applies only to contributions paid in taxable years beginning after December 31, 1969.

[T.D. 7207, 37 FR 20779, Oct. 4, 1972, as amended by T.D. 8540, 59 FR 30102, June 10, 1994]

§ 1.170A–6 Charitable contributions in trust.

(a) *In general.* (1) No deduction is allowed under section 170 for the fair market value of a charitable contribution of any interest in property which is less than the donor's entire interest in the property and which is transferred in trust unless the transfer meets the requirements of paragraph (b) or (c) of this section. If the donor's entire interest in the property is transferred in trust and is contributed to a charitable organization described in section 170(c), a deduction is allowed under section 170. Thus, if on July 1, 1972, property is transferred in trust with the requirement that the income of the trust be paid for a term of 20 years to a church and thereafter the remainder be paid to an educational organization described in section 170(b)(1)(A), a deduction is allowed for the value of such property. See section 170(f)(2) and (3)(B), and paragraph (b)(1) of § 1.170A–7.

(2) A deduction is allowed without regard to this section for a contribution of a partial interest in property if such interest is the taxpayer's entire interest in the property, such as an income interest or a remainder interest. If, however, the property in which such partial interest exists was divided in order to create such interest and thus avoid section 170(f)(2), the deduction will not be allowed. Thus, for example, assume that a taxpayer desires to contribute to a charitable organization the reversionary interest in certain stocks and bonds which he owns. If the taxpayer transfers such property in trust with the requirement that the income of the trust be paid to his son for life and that the reversionary interest be paid to himself and immediately after creating the trust contributes the reversionary interest to a charitable organization, no deduction will be allowed under section 170 for the contribution of the taxpayer's entire interest consisting of the reversionary interest in the trust.

(b) *Charitable contribution of a remainder interest in trust*—(1) *In general.* No deduction is allowed under section 170 for the fair market value of a charitable contribution of a remainder interest in property which is less than the donor's entire interest in the property and which the donor transfers in trust unless the trust is:

(i) A pooled income fund described in section 642(c)(5) and § 1.642(c)–5,

(ii) A charitable remainder annuity trust described in section 664(d)(1) and § 1.664–2, or

(iii) A charitable remainder unitrust described in section 664(d)(2) and § 1.664–3.

(2) *Value of a remainder interest.* The fair market value of a remainder interest in a pooled income fund shall be computed under § 1.642(c)–6. The fair market value of a remainder interest in a charitable remainder annuity trust shall be computed under § 1.664–2. The fair market value of a remainder interest in a charitable remainder unitrust shall be computed under § 1.664–4. However, in some cases a reduction in the amount of a charitable contribution of the remainder interest may be required. See section 170(e) and § 1.170A–4.

(c) *Charitable contribution of an income interest in trust*—(1) *In general.* No deduction is allowed under section 170 for the fair market value of a charitable contribution of an income interest in property which is less than the donor's entire interest in the property and which the donor transfers in trust unless the income interest is either a guaranteed annuity interest or a unitrust interest, as defined in paragraph (c)(2) of this section, and the grantor is treated as the owner of such interest for purposes of applying section 671, relating to grantors and others treated as substantial owners. See section 4947(a)(2) for the application to such income interests in trust of the provisions relating to private foundations and section 508(e) for rules relating to provisions required in the governing instruments.

(2) *Definitions.* For purposes of this paragraph:

(i) *Guaranteed annuity interest.* (A) An income interest is a ''guaranteed annuity interest'', only if it is an irrevocable right pursuant to the governing instrument of the trust to receive a guaranteed annuity. A guaranteed annuity is an arrangement under which a determinable amount is paid periodically, but not less often than annually, for a specified term or for the life or lives of an individual or individuals, each of whom must be living at the date of transfer and can be ascertained at such date. For example, the annuity may be paid for the life of A plus a term of years. An amount is determinable if the exact amount which must be paid under the conditions specified in the governing instrument of the trust can be ascertained as of the date of transfer. For example, the amount to be paid may be a stated sum for a term, or for the life of an individual, at the expiration of which it may be changed by a specified amount, but it may not be redetermined by reference to a fluctuating index such as the cost of living index. In further illustration, the amount to be paid may be expressed in terms of a fraction or percentage of the cost of living index on the date of transfer.

(B) An income interest is a guaranteed annuity interest only if it is a guaranteed annuity interest in every respect. For example, if the income interest is the right to receive from a trust each year a payment equal to the lesser of a sum certain or a fixed percentage of the net fair market value of the trust assets, determined annually, such interest is not a guaranteed annuity interest.

(C) Where a charitable interest is in the form of a guaranteed annuity interest, the governing instrument of the trust may provide that income of the trust which is in excess of the amount required to pay the guaranteed annuity interest shall be paid to or for the use of a charitable organization. Nevertheless, the amount of the deduction under section 170(f)(2)(B) shall be limited to the fair market value of the guaranteed annuity interest as determined under paragraph (c)(3) of this section. For a rule relating to treatment by the grantor of any contribution made by the trust in excess of the amount required to pay the guaranteed annuity interest, see paragraph (d)(2)(ii) of this section.

(D) If the present value on the date of transfer of all the income interests for a charitable purpose exceeds 60 percent of the aggregate fair market value of all amounts in the trust (after the payment of liabilities), the income interest will not be considered a guaranteed annuity interest unless the governing instrument of the trust prohibits both the acquisition and the retention of assets which would give rise to a tax under section 4944 if the trustee had acquired such assets. The requirement in this subdivision (D) for a prohibition in the governing instrument against the retention of assets which would give rise to a tax under section 4944 if the trustee had acquired the assets shall not apply to a transfer in trust made on or before May 21, 1972.

(E) An income interest consisting of an annuity transferred in trust after May 21, 1972, will not be considered a guaranteed annuity interest if any amount other than an amount in payment of a guaranteed annuity interest may be paid by the trust for a private purpose before the expiration of all the income interests for a charitable purpose, unless such amount for a private purpose is paid from a group of assets which, pursuant to the governing instrument of the trust, are devoted exclusively to private purposes and to which section 4947(a)(2) is inapplicable by reason of section 4947(a)(2)(B). The exception in the immediately preceding sentence with respect to any guaranteed annuity for a private purpose shall apply only if the obligation to pay the annuity for a charitable purpose begins as of the date of creation of the trust and the obligation to pay the guaranteed annuity for a private purpose does not precede in point of time the obligation to pay the annuity for a charitable purpose and only if the governing instrument of the trust does not provide for any preference or priority in respect of any payment of the guaranteed annuity for a private purpose as opposed to any payment of any annuity for a charitable purpose. For purposes of this subdivision (E), an amount is not paid for a private purpose if it is paid for an adequate and full consideration in money or money's worth. See § 53.4947–1 (c) of this chapter (Foundation Excise Tax Regulations) for rules relating to the inapplicability of section 4947(a)(2) to segregated amounts in a split-interest trust.

Example. In 1975, E transfers $75,000 in trust with the requirement that an annuity of $5,000 a year, payable annually at the end of each year, be paid to B, an individual, for a period of 5 years and thereafter an annuity of $5,000 a year, payable annually at the end of each year, be paid to M Charity for a period of 5 years. The remainder is to be paid to C, an individual. No deduction is allowed under subparagraph (1) of this paragraph with respect to the charitable annuity because it is not a ''guaranteed annuity interest'' within the meaning of this subdivision.

(F) For rules relating to certain governing instrument requirements and to the imposition of certain excise taxes where the guaranteed annuity interest is in trust and for rules governing payment of private income interests by a split-interest trust, see section 4947(a)(2) and (b)(3)(A), and the regulations thereunder.

(ii) *Unitrust interest.* (A) An income interest is a ''unitrust interest'' only if it is an irrevocable right pursuant to the governing instrument of the trust to receive payment, not less often than annually of a fixed percentage of the net fair market value of the trust assets, determined annually. In computing the net fair market value of the trust assets, all assets and liabilities shall be taken into account without regard to whether particular items are taken into account in determining the income of the trust. The net fair market value of the trust assets may be determined on any one date during the year or by taking the average of valuations made on more than one date during the year, provided that the same valuation date or dates and valuation methods are used each year. Where the governing instrument of the trust does not specify the valuation date or dates, the trustee shall select such date or dates and shall indicate his selection on the first return on Form 1041 which the trust is required to file. Payments under a unitrust interest may be paid for a specified term or for the life or lives of an individual or individuals, each of whom must be living at the date of transfer and can be ascertained at such date. For example, the unitrust interest may be paid for the life of A plus a term of years.

(B) An income interest is a unitrust interest only if it is a unitrust interest in every respect. For example, if the income interest is the right to receive from a trust each year a payment equal to the lesser of a sum certain or a fixed percentage of the net fair market value of the trust assets, determined annually, such interest is not a unitrust interest.

(C) Where a charitable interest is in the form of a unitrust interest, the governing instrument of the trust may provide that income of the trust which is in excess of the amount required to pay the unitrust interest shall be paid to or for the use of a charitable organization. Nevertheless, the amount of the deduction under section 170(f)(2)(B) shall be limited to the fair market value of the unitrust interest as determined under paragraph (c)(3) of this section. For a rule relating to treatment by the grantor of any contribution made by the trust in excess of the amount required to pay the unitrust interest, see paragraph (d)(2)(ii) of this section.

(D) An income interest in the form of a unitrust interest will not be considered a unitrust interest if any amount other than an amount in payment of a unitrust interest may be paid by the trust for a private purpose before the expiration of all the income interests for a charitable purpose, unless such amount for a private purpose is paid from a group of assets which, pursuant to the governing instrument of the trust, are devoted exclusively to private purposes and to which section 4947(a)(2) is inapplicable by reason of section 4947 (a)(2)(B). The exception in the immediately preceding sentence with respect to any unitrust interest for a private purpose shall apply only if the obligation to pay the unitrust interest for a charitable purpose begins as of the date of creation of the trust and the obligation to pay the unitrust interest for a private purpose does not precede in point of time the obligation to pay the unitrust interest for a charitable purpose and only if the governing instrument of the trust does not provide for any preference or priority in respect of any payment of the unitrust interest for a private purpose as opposed to any payments of any unitrust interest for a charitable purpose. For purposes of this subdivision (D), an amount is not paid for a private purpose if it is paid for an adequate and full consideration in money or money's worth. See §53.4947–1(c) of this chapter (Foundation Excise Tax Regulations) for rules relating to the inapplicability of section 4947(a)(2) to segregated amounts in a split-interest trust.

(E) For rules relating to certain governing instrument requirements and to the imposition of certain excise taxes where the unitrust interest is in trust and for rules governing payment of private income interests by a split-interest trust, see section 4947(a)(2) and (b)(3)(A), and the regulations thereunder.

(3) *Valuation of income interest.* (i) The deduction allowed by section 170(f)(2)(B) for a charitable contribution of a guaranteed annuity interest is limited to the fair market value of such interest on the date of contribution, as computed under §20.2031–7 or, for certain prior periods, 20.2031–7A of this chapter (Estate Tax Regulations).

(ii) The deduction allowed under section 170(f)(2)(B) for a charitable contribution of a unitrust interest is limited to the fair market value of the unitrust interest on the date of contribution. The fair market value of the unitrust interest shall be determined by subtracting the present value of all interests in the transferred property other than the unitrust interest from the fair market value of the transferred property.

(iii) If by reason of all the conditions and circumstances surrounding a transfer of an income interest in property in trust it appears that the charity may not receive the beneficial enjoyment of the interest, a deduction will be allowed under paragraph (c)(1) of this section only for the minimum amount it is evident the charity will receive. The application of this subdivision may be illustrated by the following examples:

Example 1. In 1972, B transfers $20,000 in trust with the requirement that M Church be paid a guaranteed annuity interest (as defined in subparagraph (2)(i) of this paragraph) of $4,000, payable annually at the end of each year for 9 years, and that the residue revert to himself. Since the fair market value of an annuity of $4,000 a year for a period of 9 years, as determined under §20.2031–7A(c) of this chapter, is $27,206.80 ($4,000 × 6.8017), it appears that M will not receive the beneficial enjoyment of the income interest. Accordingly, even though B is treated as the owner of the trust under section 673, he is allowed a deduction under subparagraph (1) of this paragraph for only $20,000, which is the minimum amount it is evident M will receive.

Example 2. In 1975, C transfers $40,000 in trust with the requirement that D, an individual, and X Charity be paid simultaneously guaranteed annuity interests (as defined in subparagraph (2)(i) of this paragraph) of $5,000 a year each, payable annually at the end of each year, for a period of 5 years and that the remainder be paid to C's children. The fair market value of two annuities of $5,000 each a year for a period of 5 years is $42,124 ([$5,000 × 4.2124] × 2), as determined under §20.2031–7A(c) of this chapter. The trust instrument provides that in the event the trust fund is insufficient to pay both annuities in a given year, the trust fund will be evenly divided between the charitable and private annuitants. The deduction under subparagraph (1) of this paragraph with respect to the charitable annuity will be limited to $20,000, which is the minimum amount it is evident X will receive.

Example 3. In 1975, D transfers $65,000 in trust with the requirement that a guaranteed annuity interest (as defined in subparagraph (2)(i) of this paragraph) of $5,000 a year, payable annually at the end of each year, be paid to Y Charity for a period of 10 years and that a guaranteed annuity interest (as defined in subparagraph (2)(i) of this paragraph) of $5,000 a year, payable annually at the end of each year, be paid to W, his wife, aged 62, for 10 years or until her prior death. The annuities are to be paid simultaneously, and the remainder is to be paid to D's children. The fair market value of the private annuity is $33,877 ($5,000 × 6.7754), as determined pursuant to § 20.2031–7A(c) of this chapter and by the use of factors involving one life and a term of years as published in Publication 723A (12–70). The fair market value of the charitable annuity is $36,800.50 ($5,000 × 7.3601), as determined under § 20.2031–7A(c) of this chapter. It is not evident from the governing instrument of the trust or from local law that the trustee would be required to apportion the trust fund between the wife and charity in the event the fund were insufficient to pay both annuities in a given year. Accordingly, the deduction under subparagraph (1) of this paragraph with respect to the charitable annuity will be limited to $31,123 ($65,000 less $33,877 [the value of the private annuity]), which is the minimum amount it is evident Y will receive.

(iv) See paragraph (b)(1) of § 1.170A–4 for rule that the term *ordinary income property* for purposes of section 170(e) does not include an income interest in respect of which a deduction is allowed under section 170(f)(2)(B) and this paragraph.

(4) *Recapture upon termination of treatment as owner.* If for any reason the donor of an income interest in property ceases at any time before the termination of such interest to be treated as the owner of such interest for purposes of applying section 671, as for example, where he dies before the termination of such interest, he shall for purposes of this chapter be considered as having received, on the date he ceases to be so treated, an amount of income equal to (i) the amount of any deduction he was allowed under section 170 for the contribution of such interest reduced by (ii) the discounted value of all amounts which were required to be, and actually were, paid with respect to such interest under the terms of trust to the charitable organization before the time at which he ceases to be treated as the owner of the interest. The discounted value of the amounts described in subdivision (ii) of this subparagraph shall be computed by treating each such amount as a contribution of a remainder interest after a term of years and valuing such amount as of the date of contribution of the income interest by the donor, such value to be determined under § 20.2031–7 of this chapter consistently with the manner in which the fair market value of the income interest was determined pursuant to subparagraph (3)(i) of this paragraph. The application of this subparagraph will not be construed to disallow a deduction to the trust for amounts paid by the trust to the charitable organization after the time at which the donor ceased to be treated as the owner of the trust.

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

Example 1. On January 1, 1970, A contributes to a church in trust a 9-year irrevocable income interest in property. Both A and the trust report income on a calendar year basis. The fair market value of the property placed in trust is $10,000. The trust instrument provides that the church will receive an annuity of $500, payable annually at the end of each year for 9 years. The income interest is a guaranteed annuity interest as defined in subparagraph (2)(i) of this paragraph; upon termination of such interest the residue of the trust is to revert to A. By reference to § 20.2031–7A(c) of this chapter, it is found that the figure in column (2) opposite 9 years is 6.8017. The present value of the annuity is therefore $3,400.85 ($500 × 6.8017). The present value of the income interest and A's charitable contribution for 1970 is $3,400.85.

Example 2. (a) On January 1, 1970, B contributes to a church in trust a 9-year irrevocable income interest in property. Both B and the trust report income on a calendar year basis. The fair market value of the property placed in trust is $10,000. The trust instrument provides that the trust will pay to the church at the end of each year for 9 years 5 percent of the fair market value of all property in the trust at the beginning of the year. The income interest is a unitrust interest as defined in subparagraph (2)(ii) of this paragraph; upon termination of such interest the residue of the trust is to revert to B.

(b) By reference to Table F in § 1.664–4 (b)(5), the adjusted payout rate is 4.717 percent (5 percent × 0.943396). The present value of the reversion is $6,473.75, computed by reference to Table D in § 1.664–4A(c), as follows:

Factor at 4.6 percent for 9 years	0.654539

Factor at 4.8 percent for 9 years	.642292
Difference	.012247
Interpolation adjustment:	

4.717%−4.6%/0.2%=×/0.012247
×=0.007164

Factor at 4.6 percent for 9 years	.654539
Less: Interpolation adjustment	.007164
Interpolated factor	.647375
Present value of reversion ($10,000×0.647375)	$6,473.75

(c) The present value of the income interest and B's charitable contribution for 1970 is $3,526.25 ($10,000−$6,473.75).

Example 3. (a) On January 1, 1970, C contributes to a church in trust a 9-year irrevocable income interest in property. Both C and the trust report income on a calendar year basis. The fair market value of the property placed in trust is $10,000. The trust instrument provides that the church will receive an annuity of $500, payable annually at the end of each year for 9 years. The income interest is a guaranteed annuity interest as defined in subparagraph (2)(i) of this paragraph; upon termination of such interest the residue of the trust is to revert to C. C's charitable contribution for 1970 is $3,400.85, determined as provided in *Example (1)*. The trust earns income of $600 in 1970, $400 in 1971, and $500 in 1972, all of which is taxable to C under section 671. The church is paid $500 at the end of 1970, 1971, and 1972, respectively. On December 31, 1972, C dies and ceases to be treated as the owner of the income interest under section 673.

(b) Pursuant to subparagraph (4) of this paragraph, the discounted value as of January 1, 1970, of the amounts paid to the church by the trust is $1,336.51, determined by reference to column (4) of §20.2031–7A(c) of this chapter, as follows:

Annuity	Amount paid	Years from Jan. 1, 1970, to payment date	Discount factor	Discount value as of Jan. 1, 1970
Payment date				
Dec. 31, 1970	$500	1	0.943396	$471.70
Dec. 31, 1971	500	2	.889996	445.00
Dec. 31, 1972	500	3	.839619	419.81
Total discounted value	....	....	....	1,336.51

(c) Pursuant to subparagraph (4) of this paragraph, there must be included in C's gross income for 1972 the amount of $2,064.34 ($3,400.85 less $1,336.51).

(d) For deduction by the trust for amounts paid to the church after December 31, 1972, see section 642(c)(1) and the regulations thereunder.

(d) *Denial of deduction for certain contributions by a trust.* (1) If by reason of section 170(f)(2)(B) and paragraph (c) of this section a charitable contributions deduction is allowed under section 170 for the fair market value of an income interest transferred in trust, neither the grantor of the income interest, the trust, nor any other person shall be allowed a deduction under section 170 or any other section for the amount of any charitable contribution made by the trust with respect to, or in fulfillment of, such income interest.

(2) Section 170(f)(2)(C) and subparagraph (1) of this paragraph shall not be construed, however, to:

(i) Disallow a deduction to the trust, pursuant to section 642(c)(1) and the regulations thereunder, for amounts paid by the trust after the grantor ceases to be treated as the owner of the income interest for purposes of applying section 671 and which are not taken into account in determining the amount of recapture under paragraph (c)(4) of this section, or

(ii) Disallow a deduction to the grantor under section 671 and §1.671–2(c) for a charitable contribution made by the trust in excess of the contribution required to be made by the trust under the terms of the trust instrument with respect to, or in fulfillment of, the income interest.

(3) Although a deduction for the fair market value of an income interest in property which is less than the donor's entire interest in the property and which the donor transfers in trust is disallowed under section 170 because such interest is not a guaranteed annuity interest, or a unitrust interest, as defined in paragraph (c)(2) of this section, the donor may be entitled to a deduction under section 671 and §1.671–2(c) for any charitable contributions made by the trust if he is treated as the owner of such interest for purposes of applying section 671.

(e) *Effective date.* This section applies only to transfers in trust made after July 31, 1969.

(83 Stat. 544, 26 U.S.C. 170(f)(4); 83 Stat. 560, 26 U.S.C. 642(c)(5); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7207, 37 FR 20780, Oct. 5, 1972; 37 FR 22982, Oct. 27, 1972, as amended by T.D. 7340, 40 FR 1238, Jan. 7, 1975; T.D. 7955, 49 FR 19975, May 11, 1984; T.D. 8540, 59 FR 30102, June 10, 1994]

§ 1.170A–7 Contributions not in trust of partial interests in property.

(a) *In general.* (1) In the case of a charitable contribution, not made by a transfer in trust, of any interest in property which consists of less than the donor's entire interest in such property, no deduction is allowed under section 170 for the value of such interest unless the interest is an interest described in paragraph (b) of this section. See section 170(f)(3)(A). For purposes of this section, a contribution of the right to use property which the donor owns, for example, a rent-free lease, shall be treated as a contribution of less than the taxpayer's entire interest in such property.

(2)(i) A deduction is allowed without regard to this section for a contribution of a partial interest in property if such interest is the taxpayer's entire interest in the property, such as an income interest or a remainder interest. Thus, if securities are given to A for life, with the remainder over to B, and B makes a charitable contribution of his remainder interest to an organization described in section 170(c), a deduction is allowed under section 170 for the present value of B's remainder interest in the securities. If, however, the property in which such partial interest exists was divided in order to create such interest and thus avoid section 170(f)(3)(A), the deduction will not be allowed. Thus, for example, assume that a taxpayer desires to contribute to a charitable organization an income interest in property held by him, which is not of a type described in paragraph (b)(2) of this section. If the taxpayer transfers the remainder interest in such property to his son and immediately thereafter contributes the income interest to a charitable organization, no deduction shall be allowed under section 170 for the contribution of the taxpayer's entire interest consisting of the retained income interest. In further illustration, assume that a taxpayer desires to contribute to a charitable organization the reversionary interest in certain stocks and bonds held by him, which is not of a type described in paragraph (b)(2) of this section. If the taxpayer grants a life estate in such property to his son and immediately thereafter contributes the reversionary interest to a charitable organization, no deduction will be allowed under section 170 for the contribution of the taxpayer's entire interest consisting of the reversionary interest.

(ii) A deduction is allowed without regard to this section for a contribution of a partial interest in property if such contribution constitutes part of a charitable contribution not in trust in which all interests of the taxpayer in the property are given to a charitable organization described in section 170(c). Thus, if on March 1, 1971, an income interest in property is given not in trust to a church and the remainder interest in the property is given not in trust to an educational organization described in section 170(b)(1)(A), a deduction is allowed for the value of such property.

(3) A deduction shall not be disallowed under section 170(f)(3)(A) and this section merely because the interest which passes to, or is vested in, the charity may be defeated by the performance of some act or the happening of some event, if on the date of the gift it appears that the possibility that such act or event will occur is so remote as to be negligible. See paragraph (e) of § 1.170A–1.

(b) *Contributions of certain partial interests in property for which a deduction is allowed.* A deduction is allowed under section 170 for a contribution not in trust of a partial interest which is less than the donor's entire interest in property and which qualifies under one of the following subparagraphs:

(1) *Undivided portion of donor's entire interest.* (i) A deduction is allowed under section 170 for the value of a charitable contribution not in trust of an undivided portion of a donor's entire interest in property. An undivided portion of a donor's entire interest in

property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property and in other property into which such property is converted. For example, assuming that in 1967 B has been given a life estate in an office building for the life of A and that B has no other interest in the office building, B will be allowed a deduction under section 170 for his contribution in 1972 to charity of a one-half interest in such life estate in a transfer which is not made in trust. Such contribution by B will be considered a contribution of an undivided portion of the donor's entire interest in property. In further illustration, assuming that in 1968 C has been given the remainder interest in a trust created under the will of his father and C has no other interest in the trust, C will be allowed a deduction under section 170 for his contribution in 1972 to charity of a 20-percent interest in such remainder interest in a transfer which is not made in trust. Such contribution by C will be considered a contribution of an undivided portion of the donor's entire interest in property. If a taxpayer owns 100 acres of land and makes a contribution of 50 acres to a charitable organization, the charitable contribution is allowed as a deduction under section 170. A deduction is allowed under section 170 for a contribution of property to a charitable organization whereby such organization is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property. However, for purposes of this subparagraph a charitable contribution in perpetuity of an interest in property not in trust where the donor transfers some specific rights and retains other substantial rights will not be considered a contribution of an undivided portion of the donor's entire interest in property to which section 170(f)(3)(A) does not apply. Thus, for example, a deduction is not allowable for the value of an immediate and perpetual gift not in trust of an interest in original historic motion picture films to a charitable organization where the donor retains the exclusive right to make reproductions of such films and to exploit such reproductions commercially.

(ii) With respect to contributions made on or before December 17, 1980, for purposes of this subparagraph a charitable contribution of an open space easement in gross in perpetuity shall be considered a contribution of an undivided portion of the donor's entire interest in property to which section 170(f)(3)(A) does not apply. For this purpose an easement in gross is a mere personal interest in, or right to use, the land of another; it is not supported by a dominant estate but is attached to, and vested in, the person to whom it is granted. Thus, for example, a deduction is allowed under section 170 for the value of a restrictive easement gratuitously conveyed to the United States in perpetuity whereby the donor agrees to certain restrictions on the use of his property, such as, restrictions on the type and height of buildings that may be erected, the removal of trees, the erection of utility lines, the dumping of trash, and the use of signs. For the deductibility of a qualified conservation contribution, see §1.170A–14.

(2) *Partial interests in property which would be deductible in trust.* A deduction is allowed under section 170 for the value of a charitable contribution not in trust of a partial interest in property which is less than the donor's entire interest in the property and which would be deductible under section 170(f)(2) and §1.170A–6 if such interest had been transferred in trust.

(3) *Contribution of a remainder interest in a personal residence.* A deduction is allowed under section 170 for the value of a charitable contribution not in trust of an irrevocable remainder interest in a personal residence which is not the donor's entire interest in such property. Thus, for example, if a taxpayer contributes not in trust to an organization described in section 170(c) a remainder interest in a personal residence and retains an estate in such property for life or for a term of years, a deduction is allowed under section 170 for the value of such remainder interest not transferred in trust. For purposes of section 170(f)(3)(B)(i) and this

subparagraph, the term *personal residence* means any property used by the taxpayer as his personal residence even though it is not used as his principal residence. For example, the taxpayer's vacation home may be a personal residence for purposes of this subparagraph. The term *personal residence* also includes stock owned by a taxpayer as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b) (1) and (2)) if the dwelling which the taxpayer is entitled to occupy as such stockholder is used by him as his personal residence.

(4) *Contribution of a remainder interest in a farm.* A deduction is allowed under section 170 for the value of a charitable contribution not in trust of an irrevocable remainder interest in a farm which is not the donor's entire interest in such property. Thus, for example, if a taxpayer contributes not in trust to an organization described in section 170(c) a remainder interest in a farm and retains an estate in such farm for life or for a term of years, a deduction is allowed under section 170 for the value of such remainder interest not transferred in trust. For purposes of section 170(f)(3)(B)(i) and this subparagraph, the term *farm* means any land used by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock. The term *livestock* includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry. A farm includes the improvements thereon.

(5) *Qualified conservation contribution.* A deduction is allowed under section 170 for the value of a qualified conservation contribution. For the definition of a qualified conservation contribution, see § 1.170A–14.

(c) *Valuation of a partial interest in property.* Except as provided in § 1.170A–14, the amount of the deduction under section 170 in the case of a charitable contribution of a partial interest in property to which paragraph (b) of this section applies is the fair market value of the partial interest at the time of the contribution. See § 1.170A–1(c). The fair market value of such partial interest must be determined in accordance with § 20.2031–7, of this chapter (Estate Tax Regulations), except that, in the case of a charitable contribution of a remainder interest in real property which is not transferred in trust, the fair market value of such interest must be determined in accordance with section 170(f)(4) and § 1.170A–12. In the case of a charitable contribution of a remainder interest in the form of a remainder interest in a pooled income fund, a charitable remainder annuity trust, or a charitable remainder unitrust, the fair market value of the remainder interest must be determined as provided in paragraph (b)(2) of § 1.170A–6. However, in some cases a reduction in the amount of a charitable contribution of the remainder interest may be required. See section 170(e) and paragraph (a) of § 1.170A–4.

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

Example 1. A, an individual owning a 10-story office building, donates the rent-free use of the top floor of the building for the year 1971 to a charitable organization. Since A's contribution consists of a partial interest to which section 170(f)(3)(A) applies, he is not entitled to a charitable contributions deduction for the contribution of such partial interest.

Example 2. In 1971, B contributes to a charitable organization an undivided one-half interest in 100 acres of land, whereby as tenants in common they share in the economic benefits from the property. The present value of the contributed property is $50,000. Since B's contribution consists of an undivided portion of his entire interest in the property to which section 170(f)(3)(B) applies, he is allowed a deduction in 1971 for his charitable contribution of $50,000.

Example 3. In 1971, D loans $10,000 in cash to a charitable organization and does not require the organization to pay any interest for the use of the money. Since D's contribution consists of a partial interest to which section 170(f)(3)(A) applies, he is not entitled to a charitable contributions deduction for the contribution of such partial interest.

(e) *Effective date.* This section applies only to contributions made after July 31, 1969. The deduction allowable under § 1.170A–7(b)(1)(ii) shall be available only for contributions made on or before December 17, 1980. Except as otherwise provided in § 1.170A–14(g)(4)(ii), the deduction allowable under § 1.170A–

7(b)(5) shall be available for contributions made on or after December 18, 1980.

(83 Stat. 544, 26 U.S.C. 170(f)(4); 83 Stat. 560, 26 U.S.C. 642(c)(5); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7207, 37 FR 20782, Oct. 4, 1972; 37 FR 22982, Oct. 27, 1972; as amended by T.D. 7955, 49 FR 19975, May 11, 1984; T.D. 8069, 51 FR 1498, Jan. 14, 1986; T.D. 8540, 59 FR 30102, June 10, 1994]

§1.170A–8 Limitations on charitable deductions by individuals.

(a) *Percentage limitations*—(1) *In general.* An individual's charitable contributions deduction is subject to 20-, 30-, and 50-percent limitations unless the individual qualifies for the unlimited charitable contributions deduction under section 170(b)(1)(C). For a discussion of these limitations and examples of their application, see paragraphs (b) through (f) of this section. If a husband and wife make a joint return, the deduction for contributions is the aggregate of the contributions made by the spouses, and the limitations in section 170(b) and this section are based on the aggregate contribution base of the spouses. A charitable contribution by an individual to or for the use of an organization described in section 170(c) may be deductible even though all, or some portion, of the funds of the organization may be used in foreign countries for charitable or educational purposes.

(2) *''To'' or ''for the use of'' defined.* For purposes of section 170, a contribution of an income interest in property, whether or not such contributed interest is transferred in trust, for which a deduction is allowed under section 170(f)(2)(B) or (3)(A) shall be considered as made ''for the use of'' rather than ''to'' the charitable organization. A contribution of a remainder interest in property, whether or not such contributed interest is transferred in trust, for which a deduction is allowed under section 170(f)(2)(A) or (3)(A), shall be considered as made ''to'' the charitable organization except that, if such interest is transferred in trust and, pursuant to the terms of the trust instrument, the interest contributed is, upon termination of the predecessor estate, to be held in trust for the benefit of such organization, the contribution shall be considered as made ''for the use of'' such organization. Thus, for example, assume that A transfers property to a charitable remainder annuity trust described in section 664(d)(1) which is required to pay to B for life an annuity equal to 5 percent of the initial fair market value of the property transferred in trust. The trust instrument provides that after B's death the remainder interest in the trust is to be transferred to M Church or, in the event M Church is not an organization described in section 170(c) when the amount is to be irrevocably transferred to such church, to an organization which is described in section 170(c) at that time. The contribution by A of the remainder interest shall be considered as made ''to'' M Church. However, if in the trust instrument A had directed that after B's death the remainder interest is to be held in trust for the benefit of M Church, the contribution shall be considered as made ''for the use of'' M Church. This subparagraph does not apply to the contribution of a partial interest in property, or of an undivided portion of such partial interest, if such partial interest is the donor's entire interest in the property and such entire interest was not created to avoid section 170(f)(2) or (3)(A). See paragraph (a)(2) of §1.170A–6 and paragraphs (a)(2)(i) and (b)(1) of §1.170A–7.

(b) *50-percent limitation.* An individual may deduct charitable contributions made during a taxable year to any one or more section 170(b)(1)(A) organizations, as defined in §1.170A–9, to the extent that such contributions in the aggregate do not exceed 50 percent of his contribution base, as defined in section 170(b)(1)(F) and paragraph (e) of this section, for the taxable year. However, see paragraph (d) of this section for a limitation on the amount of charitable contributions of 30-percent capital gain property. To qualify for the 50-percent limitation the contributions must be made ''to,'' and not merely ''for the use of,'' one of the specified organizations. A contribution to an organization referred to in section 170(c)(2), other than a section 170(b)(1)(A) organization, will not qualify for the 50-percent limitation even though such organization makes the contribution available to an organization which is a section 170 (b)(1)(A) organization. For provisions relating to the carryover of contributions in excess of 50-percent of an individual's contribution base see section 170(d)(1) and paragraph (b) of § 1.170A–10.

(c) *20-percent limitation.* (1) An individual may deduct charitable contributions made during a taxable year:

(i) To any one or more charitable organizations described in section 170(c) other than section 170(b)(1)(A) organizations, as defined in § 1.170A–9, and,

(ii) For the use of any charitable organization described in section 170(c), to the extent that such contributions in the aggregate do not exceed the lesser of the limitations under subparagraph (2) of this paragraph.

(2) For purposes of subparagraph (1) of this paragraph the limitations are:

(i) 20 percent of the individual's contribution base, as defined in paragraph (e) of this section, for the taxable year, or

(ii) The excess of 50 percent of the individual's contribution base, as so defined, for the taxable year over the total amount of the charitable contributions allowed under section 170(b)(1)(A) and paragraph (b) of this section, determined by first reducing the amount of such contributions under section 170(e)(1) and paragraph (a) of § 1.170A–4 but without applying the 30-percent limitation under section 170(b)(1)(D)(i) and paragraph (d)(1) of this section.

However, see paragraph (d) of this section for a limitation on the amount of charitable contributions of 30-percent capital gain property. If an election under section 170(b)(1)(D)(iii) and paragraph (d)(2) of this section applies to any contributions of 30-percent capital gain property made during the taxable year or carried over to the taxable year, the amount allowed for the taxable year under paragraph (b) of this section with respect to such contributions for purposes of applying subdivision (ii) of this subparagraph shall be the reduced amount of such contributions determined by applying paragraph (d)(2) of this section.

(d) *30-percent limitation*—(1) *In general.* An individual may deduct charitable contributions of 30-percent capital gain property, as defined in subparagraph (3) of this paragraph, made during a taxable year to or for the use of any charitable organization described in section 170(c) to the extent that such contributions in the aggregate do not exceed 30-percent of his contribution base, as defined in paragraph (e) of this section, subject, however, to the 50- and 20-percent limitations prescribed by paragraphs (b) and (c) of this section. For purposes of applying the 50-percent and 20-percent limitations described in paragraphs (b) and (c) of this section, charitable contributions of 30-percent capital gain property paid during the taxable year, and limited as provided by this subparagraph, shall be taken into account after all other charitable contributions paid during the taxable year. For provisions relating to the carryover of certain contributions of 30-percent capital gain property in excess of 30-percent of an individual's contribution base, see section 170(b)(1)(D)(ii) and paragraph (c) of § 1.170A–10.

(2) *Election by an individual to have section 170(e)(1)(B) apply to contributions*—(i) *In general.* (A) An individual may elect under section 170(b)(1)(D)(iii) for any taxable year to have the reduction rule of section 170(e)(1)(B) and paragraph (a) of § 1.170A–4 apply to all his charitable contributions of 30-percent capital gain property made during such taxable year or carried over to such taxable year from a taxable year beginning after December 31, 1969. If such election is made such contributions shall be treated as contributions of section 170(e) capital gain property in accordance with paragraph (b)(2)(iii) of § 1.170A–4. The election may be made with respect to contributions of 30-percent capital gain property carried over to the taxable year even though the individual has not made any contribution of 30-percent capital gain property in such year. If such an election is made, section 170(b)(1)(D) (i) and (ii) and subparagraph (1) of this paragraph shall not apply to such contributions made during such year. However, such contributions must be reduced as required under section 170(e)(1)(B) and paragraph (a) of § 1.170A–4.

(B) If there are carryovers to such taxable year of charitable contributions of 30-percent capital gain property made in preceding taxable years beginning after December 31, 1969, the amount of such contributions in each such preceding year shall be reduced as if section 170(e)(1)(B) had applied to them in the preceding year and shall be carried over to the taxable year and succeeding taxable years under section 170(d)(1) and paragraph (b) of §1.170A–10 as contributions of property other than 30-percent capital gain property. For purposes of applying the immediately preceding sentence, the percentage limitations under section 170(b) for the preceding taxable year and for any taxable years intervening between such year and the year of the election shall not be redetermined and the amount of any deduction allowed for such years under section 170 in respect of the charitable contributions of 30-percent capital gain property in the preceding taxable year shall not be redetermined. However, the amount of the deduction so allowed under section 170 in the preceding taxable year must be subtracted from the reduced amount of the charitable contributions made in such year in order to determine the excess amount which is carried over from such year under section 170(d)(1). If the amount of the deduction so allowed in the preceding taxable year equals or exceeds the reduced amount of the charitable contributions, there shall be no carryover from such year to the year of the election.

(C) An election under this subparagraph may be made for each taxable year in which charitable contributions of 30-percent capital gain property are made or to which they are carried over under section 170(b)(1)(D)(ii). If there are also carryovers under section 170(d)(1) to the year of the election by reason of an election made under this subparagraph for a previous taxable year, such carryovers under section 170(d)(1) shall not be redetermined by reason of the subsequent election.

(ii) *Husband and wife making joint return.* If a husband and wife make a joint return of income for a contribution year and one of the spouses elects under this subparagraph in a later year when he files a separate return, or if a spouse dies after a contribution year for which a joint return is made, any excess contribution of 30-percent capital gain property which is carried over to the election year from the contribution year shall be allocated between the husband and wife as provided in paragraph (d)(4) (i) and (iii) of §1.170A–10. If a husband and wife file separate returns in a contribution year, any election under this subparagraph in a later year when a joint return is filed shall be applicable to any excess contributions of 30-percent capital gain property of either taxpayer carried over from the contribution year to the election year. The immediately preceding sentence shall also apply where two single individuals are subsequently married and file a joint return. A remarried individual who filed a joint return with his former spouse for a contribution year and thereafter files a joint return with his present spouse shall treat the carryover to the election year as provided in paragraph (d)(4)(ii) of §1.170A–10.

(iii) *Manner of making election.* The election under subdivision (i) of this subparagraph shall be made by attaching to the income tax return for the election year a statement indicating that the election under section 170(b)(1)(D)(iii) and this subparagraph is being made. If there is a carryover to the taxable year of any charitable contributions of 30-percent capital gain property from a previous taxable year or years, the statement shall show a recomputation, in accordance with this subparagraph and §1.170A–4, of such carryover, setting forth sufficient information with respect to the previous taxable year or any intervening year to show the basis of the recomputation. The statement shall indicate the district director, or the director of the internal revenue service center, with whom the return for the previous taxable year or years was filed, the name or names in which such return or returns were filed, and whether each such return was a joint or separate return.

(3) *30-percent capital gain property defined.* If there is a charitable contribution of a capital asset which, if it were sold by the donor at its fair market value at the time of its contribution, would result in the recognition of gain

all, or any portion, of which would be long-term capital gain and if the amount of such contribution is not required to be reduced under section 170(e)(1)(B) and § 1.170A–4(a)(2), such capital asset shall be treated as ''30-percent capital gain property'' for purposes of section 170 and the regulations thereunder. For such purposes any property which is property used in the trade or business, as defined in section 1231(b), shall be treated as a capital asset. However, see paragraph (b)(4) of § 1.170A–4. For the treatment of such property as section 170(e) capital gain property, see paragraph (b)(2)(iii) of § 1.170A–4.

(e) *Contribution base defined.* For purposes of section 170 the term *contribution base* means adjusted gross income under section 62, computed without regard to any net operating loss carryback to the taxable year under section 172. See section 170(b)(1)(F).

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

Example 1. B, an individual, reports his income on the calendar-year basis and for 1970 has a contribution base of $100,000. During 1970 he makes charitable contributions of $70,000 in cash, of which $40,000 is given to section 170(b)(1)(A) organizations and $30,000 is given to other organizations described in section 170(c). Accordingly, B is allowed a charitable contributions deduction of $50,000 (50% of $100,000), which consists of the $40,000 contributed to section 170(b)(1)(A) organizations and $10,000 of the $30,000 contributed to the other organizations. Under paragraph (c) of this section, only $10,000 of the $30,000 contributed to the other organizations is allowed as a deduction since such contribution of $30,000 is allowed to the extent of the lesser of $20,000 (20% of $100,000) or $10,000 ([50% of $100,000]−$40,000 (contributions allowed under section 170(b)(1)(A) and paragraph (b) of this section)). Under section 170 (b)(1)(D)(ii) and (d)(1) and § 1.170A–10, B is not allowed a carryover to 1971 or to any other taxable year for any of the $20,000 ($30,000−$10,000) not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

Example 2. C, an individual, reports his income on the calendar-year basis and for 1970 has a contribution base of $100,000. During 1970 he makes charitable contributions of $40,000 in 30-percent capital gain property to section 170(b)(1)(A) organizations and of $30,000 in cash to other organizations described in section 170(c). The 20-percent limitation in section 170(b)(1)(B) and paragraph (c) of this section is applied before the 30-percent limitation in section 170(b)(1)(D)(i) and paragraph (d) of this section; accordingly section 170(b)(1)(B)(ii) limits the deduction for the $30,000 cash contribution to $10,000 ([50% of $100,000]− $40,000). The amount of the contribution of 30-percent capital gain property is limited by section 170(b)(1)(D)(i) and paragraph (d) of this section to $30,000 (30% of $100,000). Accordingly, C's charitable contributions deduction for 1970 is limited to $40,000 ($10,000+$30,000). Under section 170 (b)(1)(D)(ii) and paragraph (c) of § 1.170A–10, C is allowed a carryover to 1971 of $10,000 ($40,000−$30,000) in respect of his contributions of 30-percent capital gain property. C is not allowed a carryover to 1971 or to any other taxable year for any of the $20,000 cash ($30,000−$10,000) not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

Example 3. (a) D, an individual, reports his income on the calendar-year basis and for 1970 has a contribution base of $100,000. During 1970 he makes charitable contributions of $70,000 in cash, of which $40,000 is given to section 170(b)(1)(A) organizations and $30,000 is given to other organizations described in section 170(c). During 1971 D makes charitable contributions to a section 170(b)(1)(A) organization of $12,000, consisting of cash of $1,000 and $11,000 in 30-percent capital gain property. His contribution base for 1971 is $10,000.

(b) For 1970, D is allowed a charitable contributions deduction of $50,000 (50% of $100,000), which consists of the $40,000 contributed to section 170(b)(1)(A) organizations and $10,000 of the $30,000 contributed to the other organizations. Under paragraph (c) of this section, only $10,000 of the $30,000 contributed to the other organizations is allowed as a deduction since such contribution of $30,000 is allowed to the extent of the lesser of $20,000 (20% of $100,000) or $10,000 ([50% of $100,000]−$40,000 (contributions allowed under section 170(b)(1)(A) and paragraph (b) of this section)). D is not allowed a carryover to 1971 or to any other taxable year for any of the $20,000 ($30,000−$10,000) not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

(c) For 1971, D is allowed a charitable contributions deduction of $4,000, consisting of $1,000 cash and $3,000 of the 30-percent capital gain property (30% of $10,000). Under section 170(b)(1)(D)(ii) and paragraph (c) of § 1.170A–10, D is allowed a carryover to 1972 of $8,000 ($11,000−$3,000) in respect of his contribution of 30-percent capital gain property in 1971.

Example 4. (a) E, an individual, reports his income on the calendar-year basis and for 1970 has a contribution base of $100,000. During 1970 he makes charitable contributions of $70,000 in cash, of which $40,000 is given to section 170(b)(1)(A) organizations and $30,000 is given to other organizations described in section 170(c). During 1971 E makes charitable contributions to a section 170(b)(1)(A) organization of $14,000 consisting of cash of $3,000 and $11,000 in 30-percent capital gain property. His contribution base for 1971 is $10,000.

(b) For 1970, E is allowed a charitable contributions deduction of $50,000 (50% of $100,000), which consists of the $40,000 contributed to section 170(b)(1)(A) organizations and $10,000 of the $30,000 contributed to the other organizations. Under paragraph (c) of this section, only $10,000 of the $30,000 contributed to the other organizations is allowed as a deduction since such contribution of $30,000 is allowed to the extent of the lesser of $20,000 (20% of $100,000) or ($10,000 ([50% of $100,000]−$40,000 (contributions allowed under section 170(b)(1)(A) and paragraph (b) of this section)). E is not allowed a carryover to 1971 or to any other taxable year for any of the $20,000 ($30,000−$10,000) not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

(c) For 1971, E is allowed a charitable contributions deduction of $5,000 (50% of $10,000), consisting of $3,000 cash and $2,000 of the $3,000 (30% of $10,000) 30-percent capital gain property which is taken into account. This result is reached because, as provided in section 170(b)(1)(D)(i) and paragraph (d)(1) of this section, cash contributions are taken into account before charitable contributions of 30-percent capital gain property. Under section 170(b)(1)(D)(ii) and (d)(1) and paragraphs (b) and (c) of §1.170A–10, E is allowed a carryover of $9,000 ([$11,000−$3,000] plus [$6,000 −$5,000]) to 1972 in respect of his contribution of 30-percent capital gain property in 1971.

Example 5. In 1970, C, a calendar-year individual taxpayer, contributes to section 170(b)(1)(A) organizations the amount of $8,000, consisting of $3,000 in cash and $5,000 in 30-percent capital gain property. In 1970, C also makes charitable contributions of $8,500 in 30 percent capital gain property to other organizations described in section 170(c). C's contribution base for 1970 is $20,000. The 20-percent limitation in section 170(b)(1)(B) and paragraph (c) of this section is applied before the 30-percent limitation in section 170(b)(1)(D)(i) and paragraph (d) of this section; accordingly, section 170(b)(1)(B)(ii) limits the deduction for the $8,500 of contributions to the other organizations described in section 170(c) to $2,000 ([50% of $20,000]−[$3,000+$5,000]). However, the total amount of contributions of 30-percent capital gain property which is allowed as a deduction for 1970 is limited by section 170(b)(1)(D)(i) and paragraph (d) of this section to $6,000 (30% of $20,000), consisting of the $5,000 contribution to the section 170(b)(1)(A) organizations and $1,000 of the contributions to the other organizations described in section 170(c). Accordingly C is allowed a charitable contributions deduction for 1970 of $9,000, which consists of $3,000 cash and $6,000 of the $13,500 of 30-percent capital gain property. C is not allowed to carryover to 1971 or any other year the remaining $7,500 because his contributions of 30-percent capital gain property for 1970 to section 170(b)(1)(A) organizations amount only to $5,000 and do not exceed $6,000 (30% of $20,000). Thus, the requirement of section 170(b)(1)(D)(ii) is not satisfied.

Example 6. During 1971, D, a calendar-year individual taxpayer, makes a charitable contribution to a church of $8,000, consisting of $5,000 in cash and $3,000 in 30-percent capital gain property. For such year, D's contribution base is $10,000. Accordingly, D is allowed a charitable contributions deduction for 1971 of $5,000 (50% of $10,000) of cash. Under section 170(d)(1) and paragraph (b) of §1.170A–10, D is allowed a carryover to 1972 of his $3,000 contribution of 30-percent capital gain property, even though such amount does not exceed 30 percent of his contribution base for 1971.

Example 7. In 1970, E, a calendar-year individual taxpayer, makes a charitable contribution to a section 170(b)(1)(A) organization in the amount of $10,000, consisting of $8,000 in 30-percent capital gain property and of $2,000 (after reduction under section 170(e)) in other property. E's contribution base of 1970 is $20,000. Accordingly, E is allowed a charitable contributions deduction for 1970 of $8,000, consisting of the $2,000 of property the amount of which was reduced under section 170(e) and $6,000 (30% of $20,000) of the 30-percent capital gain property. Under section 170(b)(1)(D)(ii) and paragraph (c) of §1.170A–10, E is allowed to carryover to 1971 $2,000 ($8,000−$6,000) of his contribution of 30-percent capital gain property.

Example 8. (a) In 1972, F, calendar-year individual taxpayer, makes a charitable contribution to a church of $4,000, consisting of $1,000 in cash and $3,000 in 30-percent capital gain property. In addition, F makes a charitable contribution in 1972 of $2,000 in cash to an organization described in section 170(c)(4). F also has a carryover from 1971 under section 170(d)(1) of $5,000 (none of which consists of contributions of 30-percent capital gain property) and a carryover from 1971 under section 170(b)(1)(D)(ii) of $6,000 of contributions of 30-percent capital gain property. F's contribution base for 1972 is $11,000.

Accordingly, F is allowed a charitable contributions deduction for 1972 of $5,500 (50% of $11,000), which consists of $1,000 cash contributed in 1972 to the church, $3,000 of 30-percent capital gain property contributed in 1972 to the church, and $1,500 (carryover of $5,000 but not to exceed [$5,500−($1,000 +$3,000)]) of the carryover from 1971 under section 170(d)(1).

(b) No deduction is allowed for 1972 for the contribution in that year of $2,000 cash to the section 170(c)(4) organization since section 170(b)(1)(B)(ii) and paragraph (c) of this section limit the deduction for such contribution to $0([50% of $11,000]−[$1,000 +$1,500+$3,000]). Moreover, F is not allowed a carryover to 1973 or to any other year for any of such $2,000 cash contributed to the section 170(c)(4) organization.

(c) Under section 170(d)(1) and paragraph (b) of § 1.170A–10, F is allowed a carryover to 1973 from 1971 of $3,500 ($5,000−$1,500) of contributions of other than 30-percent capital gain property. Under section 170(b)(1)(D)(ii) and paragraph (c) of § 1.170A–10, F is allowed a carryover to 1973 from 1971 of $6,000 ($6,000−$0 of such carryover treated as paid in 1972) of contributions of 30-percent capital gain property. The portion of such $6,000 carryover from 1971 which is treated as paid in 1972 is $0 ([50% of $11,000]−[$4,000 contributions to the church in 1972 plus $1,500 of section 170(d)(1) carryover treated as paid in 1972]).

Example 9. (a) In 1970, A, a calendar-year individual taxpayer, makes a charitable contribution to a church of 30-percent capital gain property having a fair market value of $60,000 and an adjusted basis of $10,000. A's contribution base for 1970 is $50,000, and he makes no other charitable contributions in that year. A does not elect for 1970 under paragraph (d)(2) of this section to have section 170(e)(1)(B) apply to such contribution. Accordingly, under section 170(b)(1)(D)(i) and paragraph (d) of this section, A is allowed a charitable contributions deduction for 1970 of $15,000 (30% of $50,000). Under section 170(b)(1)(D)(ii) and paragraph (c) of § 1.170A–10, A is allowed a carryover to 1971 of $45,000 ($60,000−$15,000) for his contribution of 30-percent capital gain property.

(b) In 1971, A makes a charitable contribution to a church of 30-percent capital gain property having a fair market value of $11,000 and an adjusted basis of $10,000. A's contribution base for 1971 is $60,000, and he makes no other charitable contributions in that year. A elects for 1971 under paragraph (d)(2) of this section to have section 170(e)(1)(B) and § 1.170A–4 apply to his contribution of $11,000 in that year and to his carryover of $45,000 from 1970. Accordingly, he is required to recompute his carryover from 1970 as if section 170(e)(1)(B) had applied to his contribution of 30-percent capital gain property in that year.

(c) If section 170(e)(1)(B) had applied in 1970 to his contribution of 30-percent capital gain property, A's contribution would have been reduced from $60,000 to $35,000, the reduction of $25,000 being 50 percent of the gain of $50,000 ($60,000−$10,000) which would have been recognized as long-term capital gain if the property had been sold by A at its fair market value at the time of the contribution in 1970. Accordingly, by taking the election under paragraph (d)(2) of this section into account, A has a recomputed carryover to 1971 of $20,000 ($35,000− $15,000) of his contribution of 30-percent capital gain property in 1970. However, A's charitable contributions deduction of $15,000 allowed for 1970 is not recomputed by reason of the election.

(d) Pursuant to the election for 1971, the contribution of 30-percent capital gain property for 1971 is reduced from $11,000 to $10,500, the reduction of $500 being 50 percent of the gain of $1,000 ($11,000−$10,000) which would have been recognized as long-term capital gain if the property had been sold by A at its fair market value at the time of its contribution in 1971.

(e) Accordingly, A is allowed a charitable contributions deduction for 1971 of $30,000 (total contributions of $30,500 [$20,000+ $10,500] but not to exceed 50% of $60,000).

(f) Under section 170(d)(1) and paragraph (b) of § 1.170A–10, A is allowed a carryover of $500 ($30,500−$30,000) to 1972 and the 3 succeeding taxable years. The $500 carryover, which by reason of the election is no longer treated as a contribution of 30-percent capital gain property, is treated as carried over under paragraph (b) of § 1.170A–10 from 1970 since in 1971 current year contributions are deducted before contributions which are carried over from preceding taxable years.

Example 10. The facts are the same as in *Example (9)* except that A also makes a charitable contribution in 1971 of $2,000 cash to a private foundation not described in section 170(b)(1)(E) and that A's contribution base for that year is $62,000, instead of $60,000. Accordingly, A is allowed a charitable contributions deduction for 1971 of $31,000, determined in the following manner Under section 170(b)(1)(A) and paragraph (b) of this section, A is allowed a charitable contributions deduction for 1971 of $30,500, consisting of $10,500 of property contributed to the church in 1971 and of $20,000 (carryover of $20,000 but not to exceed [($62,000×50%)−$10,500]) of contributions of property carried over to 1971 under section 170(d)(1) and paragraph (b) of § 1.170A–10. Under section 170(b)(1)(B) and paragraph (c) of this section, A is allowed a charitable contributions deduction for 1971 of $500 ([50% of $62,000]−[$10,500+ $20,000]) of cash contributed to the private foundation in that year. A is not allowed a carryover to 1972 or to any other taxable year for any of the $1,500 ($2,000−$500) cash not deductible in 1971 under section 170(b)(1)(B) and paragraph (c) of this section.

Example 11. The facts are the same as in *Example (9)* except that A's contribution base for 1970 is $120,000. Thus, before making the election under paragraph (d)(2) of this section for 1971, A is allowed a charitable contributions deduction for 1970 of $36,000 (30% of $120,000) and is allowed a carryover to 1971 of $24,000 ($60,000−$36,000). By making the election for 1971, A is required to recompute the carryover from 1970, which is reduced from $24,000 to zero, since the charitable contributions deduction of $36,000 allowed for 1970 exceeds the reduced $35,000 contribution for 1970 which iay be taken into account by reason of the election for 1971. Accordingly, A is allowed a deduction for 1971 of $10,500 and is allowed no carryover to 1972, since the reduced contribution for 1971 ($10,500) does not exceed the limitation of $30,000 (50% of $60,000) for 1971 which applies under section 170(d)(1) and paragraph (b) of §1.170A–10. A's charitable contributions deduction of $36,000 allowed for 1970 is not recomputed by reason of the election. Thus, it is not to A's advantage to make the election under paragraph (d)(2) of this section.

Example 12. (a) B, an individual, reports his income on the calendar-year basis and for 1970 has a contribution base of $100,000. During 1970 he makes charitable contributions of $70,000, consisting of $50,000 in 30-percent capital gain property contributed to a church and $20,000 in cash contributed to a private foundation not described in section 170(b)(1)(E). For 1971, B's contribution base is $40,000, and in that year he makes a charitable contribution of $5,000 in cash to such private foundation. During the years involved B makes no other charitable contributions.

(b) The amount of the contribution of 30-percent capital gain property which may be taken into account for 1970 is limited by section 170(b)(1)(D)(i) and paragraph (d) of this section to $30,000 (30% of $100,000). Accordingly, under section 170(b)(1)(A) and paragraph (b) of this section B is allowed a deduction for 1970 of $30,000 of 30-percent capital gain property (contribution of $30,000 but not to exceed $50,000 [50% of $100,000]). No deduction is allowed for 1970 for the contribution in that year of $20,000 of cash to the private foundation since section 170(b)(1)(B)(ii) and paragraph (c) of this section limit the deduction for such contribution to $0 ([50% of $100,000]− $50,000, the amount of the contribution of 30-percent capital gain property).

(c) Under section 170(b)(1)(D)(ii) and paragraph (c) of §1.170A–10, B is allowed a carryover to 1971 of $20,000 ($50,000−[30% of $100,000]) of his contribution in 1970 of 30-percent capital gain property. B is not allowed a carryover to 1971 or to any other taxable year for any of the $20,000 cash contribution in 1970 which is not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

(d) The amount of the contribution of 30-percent capital gain property which may be taken into account for 1971 is limited by section 170(b)(1)(D)(i) and paragraph (d) of this section to $12,000 (30% of $40,000).

Accordingly, under section 170(b)(1)(A) and paragraph (b) of this section B is allowed a deduction for 1971 of $12,000 of 30-percent capital gain property (contribution of $12,000 but not to exceed $20,000 [50% of $40,000]). No deduction is allowed for 1971 for the contribution in that year of $5,000 of cash to the private foundation, since section 170(b)(1)(B)(ii) and paragraph (c) of this section limit the deduction for such contribution to $0 ([50% of $40,000] −$20,000 carryover of 30-percent capital gain property from 1970).

(e) Under section 170(b)(1)(D)(ii) and paragraph (c) of §1.170A–10, B is allowed a carryover to 1972 of $8,000 ($20,000−[30% of $40,000]) of his contribution in 1970 of 30-percent capital gain property. B is not allowed a carryover to 1972 or to any other taxable year for any of the $5,000 cash contribution for 1971 which is not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

Example 13. D, an individual, reports his income on the calendar-year basis and for 1970 has a contribution base of $100,000. On March 1, 1970, he contributes to a church intangible property to which section 1245 applies which has a fair market value of $60,000 and an adjusted basis of $10,000. At the time of the contribution D has used the property in his business for more than 6 months. If the property had been sold by D at its fair market value at the time of its contribution, it is assumed that under section 1245 $20,000 of the gain of $50,000 would have been treated as ordinary income and $30,000 would have been long-term capital gain. Since the property contributed is ordinary income property within the meaning of paragraph (b)(1) of §1.170A–4, D's contribution of $60,000 is reduced under paragraph (a)(1) of such section to $40,000 ($60,000−$20,000 ordinary income). However, since the property contributed is also 30-percent capital gain property within the meaning of paragraph (d)(3) of this section, D's deduction for 1970 is limited by section 170(b)(1)(D)(i) and paragraph (d) of this section to $30,000 (30% of $100,000). Under section 170(b)(1)(D)(ii) and paragraph (c) of §1.170A–10, D is allowed to carry over to 1971 $10,000 ($40,000−$30,000) of his contribution of 30-percent capital gain property.

Example 14. C, an individual, reports his income on the calendar-year basis and for 1970 has a contribution base of $50,000. During 1970 he makes charitable contributions to a church of $57,000, consisting of $2,000 cash and of 30-percent capital gain property with a fair market value of $55,000 and an adjusted basis of $15,000. In addition, C contributes $3,000 cash in 1970 to a private foundation not described in section 170(b)(1)(E). For 1970, C elects under paragraph (d)(2) of this section to have section 170(e)(1)(B) and §1.170A–4(a) apply to his contribution of property to the church. Accordingly, for 1970 C's contribution of property to the church is reduced from $55,000 to $35,000, the reduction of $20,000 being 50 percent of the gain of $40,000 ($55,000 −$15,000) which would have been recognized as long-term capital gain if the property had been sold by C at its fair market value at the time of its contribution to the church. Under section 170(b)(1)(A) and paragraph (b) of this section, C is allowed a charitable contributions deduction for 1970 of $25,000 ([$2,000+$35,000] but not to exceed [$50,000×50%]). Under section 170(d)(1) and paragraph (b) of § 1.170A–10, C is allowed a carryover from 1970 to 1971 of $12,000 ($37,000−$25,000). No deduction is allowed for 1970 for the contribution in that year of $3,000 cash to the private foundation since section 170(b)(1)(B) and paragraph (c) of this section limit the deduction for such contribution to the smaller of $10,000 ($50,000×20%) or $0 ([$50,000×50%]−$25,000). C is not allowed a carryover from 1970 for any of the $3,000 cash contribution in that year which is not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

Example 15. (a) D, an individual, reports his income on the calendar-year basis and for 1970 has a contribution base of $100,000. During 1970 he makes a charitable contribution to a church of 30-percent capital gain property with a fair market value of $40,000 and an adjusted basis of $21,000. In addition, he contributes $23,000 cash in 1970 to a private foundation not described in section 170(b)(1)(E). For 1970, D elects under paragraph (d)(2) of this section to have section 170(e)(1)(B) and § 1.170A–4(a) apply to his contribution of property to the church. Accordingly, for 1970 D's contribution of property to the church is reduced from $40,000 to $30,500, the reduction of $9,500 being 50 percent of the gain of $19,000 ($40,000−$21,000) which would have been recognized as long-term capital gain if the property had been sold by D at its fair market value at the time of its contribution to the church. Under section 170(b)(1)(A) and paragraph (b) of this section, D is allowed a charitable contributions deduction for 1970 of $30,500 for the property contributed to the church. In addition, under section 170(b)(1)(B) and paragraph (c) of this section D is allowed a deduction of $19,500 for the cash contributed to the private foundation, since such contribution of $23,000 is allowed to the extent of the lesser of $20,000 (20% of $100,000) or $19,500 ([$100,000×50%]−$30,500). D is not allowed a carryover to 1971 or to any other taxable year for any of the $3,500 ($23,000−$19,500) of cash not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

(b) If D had not made the election under paragraph (d)(2) of this section for 1970, his deduction for 1970 under section 170(a) for the $40,000 contribution of property to the church would have been limited by section 170(b)(1)(D)(i) and paragraph (d) of this section to $30,000 (30% of $100,000), and under section 170(b)(1)(D)(ii) and paragraph (c) of § 1.170A–10 he would have been allowed a carryover to 1971 of $10,000 ($40,000−$30,000) for his contribution of such property. In addition, he would have been allowed under section 170(b)(1)(B)(ii) and paragraph (c) of this section for 1970 a charitable contributions deduction of $10,000 ([$100,000×50%]−$40,000) for the cash contributed to the private foundation. In such case, D would not have been allowed a carryover to 1971 or to any other taxable year for any of the $13,000 ($23,000−$10,000) of cash not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

(g) *Effective date.* This section applies only to contributions paid in taxable years beginning after December 31, 1969.

[T.D. 7207, 37 FR 20783, Oct. 4, 1972; 37 FR 22982, Oct. 27, 1972]

§ 1.170A–9 Definition of section 170(b)(1)(A) organization.

The term *section 170(b)(1)(A) organization* as used in the regulations under section 170 means any organization described in paragraphs (a) through (i) of this section, effective with respect to taxable years beginning after December 31, 1969, except as otherwise provided. Section 1.170–2(b) shall continue to be applicable with respect to taxable years beginning prior to January 1, 1970. The term *one or more organizations described in section 170(b)(1)(A) (other than in clauses (vii) and (viii))* as used in sections 507 and 509 of the Code and the regulations thereunder means one or more organizations described in paragraphs (a) through (e) of this section, except as modified by the regulations under part II of subchapter F of chapter I or under chapter 42.

(a) *Church or a convention or association of churches.* An organization is described in section 170(b)(1)(A)(i) if it is a church or a convention or association of churches.

(b) *Educational organization and organizations for the benefit of certain State and municipal colleges and universities*—(1) *Educational organization.* An educational organization is described in section 170(b)(1)(A)(ii) if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities.

It includes Federal, State, and other public-supported schools which otherwise come within the definition. It does not include organizations engaged in both educational and noneducational activities unless the latter are merely incidental to the educational activities. A recognized university which incidentally operates a museum or sponsors concerts is an educational organization within the meaning of section 170(b)(1)(A)(ii). However, the operation of a school by a museum does not necessarily qualify the museum as an educational organization within the meaning of this subparagraph.

(2) *Organizations for the benefit of certain State and municipal colleges and universities.* (i) An organization is described in section 170(b)(1)(A)(iv) if it meets the support requirements of subdivision (ii) of this subparagraph and is organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a college or university which is an organization described in subdivision (iii) of this subparagraph. The phrase ‘‘expenditures to or for the benefit of a college or university’’ includes expenditures made for any one or more of the normal functions of colleges and universities such as the acquisition and maintenance of real property comprising part of the campus area; the erection of, or participation in the erection of, college or university buildings; the acquisition and maintenance of equipment and furnishings used for, or in conjunction with, normal functions of colleges and universities; or expenditures for scholarships, libraries and student loans.

(ii) To qualify under section 170(b)(1)(A)(iv), the organization receiving the contribution must normally receive a substantial part of its support from the United States or any State or political subdivision thereof or from direct or indirect contributions from the general public, or from a combination of two or more of such sources. For such purposes, the term ‘‘support’’ does not include income received in the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a). An example of an indirect contribution from the public is the receipt by the organization of its share of the proceeds of an annual collection campaign of a community chest, community fund, or united fund. In determining the amount of support received by such organization with respect to a contribution of property which is subject to reduction under section 170(e), the fair market value of the property shall be taken into account.

(iii) The college or university (including a land grant college or university) to be benefited must be an educational organization referred to in section 170(b)(1)(A)(ii) and subparagraph (1) of this paragraph which is an agency or instrumentality of a State or political subdivision thereof, or which is owned or operated by a State or political subdivision thereof or by an agency or instrumentality of one or more States or political subdivisions.

(c) *Hospitals and medical research organizations*—(1) *Hospitals.* An organization (other than one described in subparagraph (2) of this paragraph) is described in section 170(b)(1)(a)(iii) if:

(i) It is a hospital, and

(ii) Its principal purpose or function is the providing of medical or hospital care or medical education or medical research.

The term *hospital* includes (A) Federal hospitals and (B) State, county, and municipal hospitals which are instrumentalities of governmental units referred to in section 170(c)(1) and otherwise come within the definition. A rehabilitation institution, outpatient clinic, or community mental health or drug treatment center may qualify as a ‘‘hospital’’ within the meaning of subdivision (i) of this subparagraph if its principal purpose or function is the providing of hospital or medical care. For purposes of this subdivision, the term ‘‘medical care’’ shall include the treatment of any physical or mental disability or condition, whether on an inpatient or outpatient basis, provided the cost of such treatment is deductible under section 213 by the person treated. An organization, all the accommodations of which qualify as being part of a ‘‘skilled nursing facility’’ within the meaning of 42 U.S.C. 1395x(j), may qualify as a ‘‘hospital’’ within the meaning of subdivision (i) of this subparagraph if its principal purpose or function is the providing of hospital or medical care. For taxable years ending after June 28, 1968, the term ''hospital'' also includes cooperative hospital service organizations which meet the requirements of section 501(e) and §1.501(e)–1. The term ''hospital'' does not, however, include convalescent homes or homes for children or the aged, nor does the term include institutions whose principal purpose or function is to train handicapped individuals to pursue some vocation. An organization whose principal purpose or function is the providing of medical education or medical research will not be considered a ''hospital'' within the meaning of subdivision (i) of this subparagraph, unless it is also actively engaged in providing medical or hospital care to patients on its premises or in its facilities, on an inpatient or outpatient basis, as an integral part of its medical education or medical research functions. See, however, subparagraph (2) of this paragraph with respect to certain medical research organizations.

(2) *Certain medical research organizations*—(i) *Introduction.* A medical research organization is described in section 170(b)(1)(A)(iii) if the principal purpose or functions of such organization are medical research and if it is directly engaged in the continuous active conduct of medical research in conjunction with a hospital. In addition, for purposes of the 50 percent limitation of section 170(b)(1)(A) with respect to a contribution, during the calendar year in which the contribution is made such organization must be committed to spend such contribution for such research before January 1 of the fifth calendar year which begins after the date such contribution is made. An organization need not receive contributions deductible under section 170 to qualify as a medical research organization and such organization need not be committed to spend amounts to which the limitation of section 170(b)(1)(A) does not apply within the 5-year period referred to in this subdivision. However, the requirement of continuous active conduct of medical research indicates that the type of organization contemplated in this subparagraph is one which is primarily engaged directly in the continuous active conduct of medical research, as compared to an inactive medical research organization or an organization primarily engaged in funding the programs of other medical research organizations. As in the case of a hospital, since an organization is ordinarily not described in section 170(b)(1)(A)(iii) as a hospital unless it functions primarily as a hospital, similarly a medical research organization is not so described unless it is primarily engaged directly in the continuous active conduct of medical research in conjunction with a hospital. Accordingly, the rules of this subparagraph shall only apply with respect to such medical research organizations.

(ii) *General rule.* An organization (other than a hospital described in subparagraph (1) of this paragraph) is described in section 170(b)(1)(A)(iii) only if within the meaning of this subparagraph:

(A) The principal purpose or functions of such organization are to engage primarily in the conduct of medical research, and

(B) It is primarily engaged directly in the continuous active conduct of medical research in conjunction with a hospital which is *(1)* described in section 501(c)(3), *(2)* a federal hospital, or *(3)* an instrumentality of a governmental unit referred to in section 170(c)(1).

However, in order for a contribution to such organization to qualify for purposes of the 50 percent limitation of section 170(b)(1)(A), during the calendar year in which such contribution is made or treated as made, such organization must be committed (within the meaning of subdivision (viii) of this subparagraph) to spend such contribution for such active conduct of medical research before January 1 of the fifth calendar year beginning after the date such contribution is made. For the meaning of the term ''medical research'' see subdivision (iii) of this subparagraph. For the meaning of the term ''principal purpose or functions'' see subdivision (iv) of this subparagraph. For the meaning of the term ''primarily engaged directly in the continuous active conduct of medical research'' see subdivision (v) of this subparagraph. For the meaning of the term ‘‘medical research in conjunction with a hospital’’ see subdivision (vii) of this subparagraph.

(iii) *Definition of medical research.* Medical research means the conduct of investigations, experiments, and studies to discover, develop, or verify knowledge relating to the causes, diagnosis, treatment, prevention, or control of physical or mental diseases and impairments of man. To qualify as a medical research organization, the organization must have or must have continuously available for its regular use the appropriate equipment and professional personnel necessary to carry out its principal function. Medical research encompasses the associated disciplines spanning the biological, social and behavioral sciences. Such disciplines include chemistry, (biochemistry, physical chemistry, bioorganic chemistry, etc.), behavioral sciences (psychiatry, physiological psychology, neurophysiology, neurology, neurobiology, and social psychology, etc.), biomedical engineering (applied biophysics, medical physics, and medical electronics, *e.g.,* developing pacemakers and other medically related electrical equipment), virology, immunology, biophysics, cell biology, molecular biology, pharmacology, toxicology, genetics, pathology, physiology, microbiology, parasitology, endocrinology, bacteriology, and epidemiology.

(iv) *Principal purpose or functions.* An organization must be organized for the principal purpose of engaging primarily in the conduct of medical research in order to be an organization meeting the requirements of this subparagraph. An organization will normally be considered to be so organized if it is expressly organized for the purpose of conducting medical research and is actually engaged primarily in the conduct of medical research. Other facts and circumstances, however, may indicate that an organization does not meet the principal purpose requirement of this subdivision even where its governing instrument so expressly provides. An organization that otherwise meets all of the requirements of this subparagraph (including this subdivision) to qualify as a medical research organization will not fail to so qualify solely because its governing instrument does not specifically state that its principal purpose is to conduct medical research.

(v) *Primarily engaged directly in the continuous active conduct of medical research.* (A) In order for an organization to be primarily engaged directly in the continuous active conduct of medical research, the organization must either devote a substantial part of its assets to, or expend a significant percentage of its endowment for, such purposes, or both. Whether an organization devotes a substantial part of its assets to, or makes significant expenditures for, such continuous active conduct depends upon the facts and circumstances existing in each specific case. An organization will be treated as devoting a substantial part of its assets to, or expending a significant percentage of its endowment for, such purposes if it meets the appropriate test contained in paragraph (c)(2)(v)*(b)* of this section. If an organization fails to satisfy both of such tests, in evaluating the facts and circumstances, the factor given most weight is the margin by which the organization failed to meet such tests. Some of the other facts and circumstances to be considered in making such a determination are:

(*1*) If the organization fails to satisfy the tests because it failed to properly value its assets or endowment, then upon determination of the improper valuation it devotes additional assets to, or makes additional expenditures for, such purposes, so that it satisfies such tests on an aggregate basis for the prior year in addition to such tests for the current year.

(*2*) The organization acquires new assets or has a significant increase in the value of its securities after it had developed a budget in a prior year based on the assets then owned and the then current values.

(*3*) The organization fails to make expenditures in any given year because of the interrelated aspects of its budget and long-term planning requirements, for example, where an organization prematurely terminates an unsuccessful program and because of long-term planning requirements it will not be able to establish a fully operational replacement program immediately.

(*4*) The organization has as its objective to spend less than a significant percentage in a particular year but make up the difference in the subsequent few years, or to budget a greater percentage earlier year and a lower percentage in in a later year.

(B) For purposes of this section, an organization which devotes more than one half of its assets to the continuous active conduct of medical research will be considered to be devoting a substantial part of its assets to such conduct within the meaning of paragraph (c)(2)(v)*(a)* of this section. An organization which expends funds equaling 3.5 percent or more of the fair market value of its endowment for the continuous active conduct of medical research will be considered to have expended a significant percentage of its endowment for such purposes within the meaning of paragraph (c)(2)(v)*(a)* of this section.

(C) Engaging directly in the continuous active conduct of medical research does not include the disbursing of funds to other organizations for the conduct of research by them or the extending of grants or scholarships to others. Therefore, if an organization's primary purpose is to disburse funds to other organizations for the conduct of research by them or to extend grants or scholarships to others, it is not primarily engaged directly in the continuous active conduct of medical research.

(vi) *Special rules.* The following rules shall apply in determining whether a substantial part of an organization's assets are devoted to, or its endowment is expended for, the continuous active conduct of medical research activities:

(A) An organization may satisfy the tests of paragraph (c)(2)(v)*(b)* of this section by meeting such tests either for a computation period consisting of the immediately preceding taxable year, or for the computation period consisting of the immediately preceding four taxable years. In addition, for taxable years beginning in 1970, 1971, 1972, 1973, and 1974, if an organization meets such tests for the computation period consisting of the first four taxable years beginning after December 31, 1969, an organization will be treated as meeting such tests, not only for the taxable year beginning in 1974, but also for the preceding four taxable years. Thus, for example, if a calendar year organization failed to satisfy such tests for a computation period consisting of 1969, 1970, 1971, or 1972, but on the basis of a computation period consisting of the years 1970 through 1973, it expended funds equaling 3.5 percent or more of the fair market value of its endowment for the continuous active conduct of medical research, such organization will be considered to have expended a significant percentage of its endowment for such purposes for the taxable years 1970 through 1974. In applying such tests for a four-year computation period, although the organization's expenditures for the entire four-year period shall be aggregated, the fair market value of its endowment for each year shall be summed, even though, in the case of an asset held throughout the four-year period, the fair market value of such an asset will be counted four times. Similarly, the fair market value of an organization's assets for each year of a four-year computation period shall be summed.

(B) Any property substantially all the use of which is ‘‘substantially related’’ (within the meaning of section 514(b)(1)(A)) to the exercise or performance of the organization's medical research activities will not be treated as part of its endowment.

(C) The valuation of assets must be made with commonly accepted methods of valuation. A method of valuation made in accordance with the principles stated in the regulations under section 2031 constitutes an acceptable method of valuation. Assets may be valued as of any day in the organization's taxable year to which such valuation applies, provided the organization follows a consistent practice of valuing such asset as of such date in all taxable years. For purposes of paragraph (c)(2)(v) of this section, an asset held by the organization for part of a taxable year shall be taken into account by multiplying the fair market value of such asset by a fraction, the numerator of which is the number of days in such taxable year that the foundation held such asset and the denominator of which is the number of days in such taxable year.

(vii) *Medical research in conjunction with a hospital.* The organization need not be formally affiliated with a hospital to be considered primarily engaged directly in the continuous active conduct of medical research in conjunction with a hospital, but in any event there must be a joint effort on the part of the research organization and the hospital pursuant to an understanding that the two organizations will maintain continuing close cooperation in the active conduct of medical research. For example, the necessary joint effort will normally be found to exist if the activities of the medical research organization are carried on in space located within or adjacent to a hospital, the organization is permitted to utilize the facilities (including equipment, case studies, etc.) of the hospital on a continuing basis directly in the active conduct of medical research, and there is substantial evidence of the close cooperation of the members of the staff of the research organization and members of the staff of the particular hospital or hospitals. The active participation in medical research by members of the staff of the particular hospital or hospitals will be considered to be evidence of such close cooperation. Because medical research may involve substantial investigation, experimentation and study not immediately connected with hospital or medical care, the requisite joint effort will also normally be found to exist if there is an established relationship between the research organization and the hospital which provides that the cooperation of appropriate personnel and the use of facilities of the particular hospital or hospitals will be required whenever it would aid such research.

(viii) *Commitment to spend contributions.* The organization's commitment that the contribution will be spent within the prescribed time only for the prescribed purposes must be legally enforceable. A promise in writing to the donor in consideration of his making a contribution that such contribution will be so spent within the prescribed time will constitute a commitment. The expenditure of contributions received for plant, facilities, or equipment, used solely for medical research purposes (within the meaning of subdivision (ii) of this subparagraph), shall ordinarily be considered to be an expenditure for medical research. If a contribution is made in other than money, it shall be considered spent for medical research if the funds from the proceeds of a disposition thereof are spent by the organization within the five-year period for medical research; or, if such property is of such a kind that it is used on a continuing basis directly in connection with such research, it shall be considered spent for medical research in the year in which it is first so used. A medical research organization will be presumed to have made the commitment required under this subdivision with respect to any contribution if its governing instrument or by-laws require that every contribution be spent for medical research before January 1 of the fifth year which begins after the date such contribution is made.

(ix) *Organizational period for new organizations.* A newly created organization, for its ''organizational'' period, shall be considered to be primarily engaged directly in the continuous active conduct of medical research in conjunction with a hospital within the meaning of subdivisions (v) and (vii) of this subparagraph if during such period the organization establishes to the satisfaction of the Commissioner that it reasonably can be expected to be so engaged by the end of such period. The information to be submitted shall include detailed plans showing the proposed initial medical research program, architectural drawings for the erection of buildings and facilities to be used for medical research in accordance with such plans, plans to assemble a professional staff and detailed projections showing the timetable for the expected accomplishment of the foregoing. The ''organizational'' period shall be that period which is appropriate to implement the proposed plans, giving effect to the proposed amounts involved and the magnitude and complexity of the projected medical research program, but in no event in excess of three years following organization.

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

Example 1. N, an organization referred to in section 170(c)(2), was created to promote human knowledge within the field of medical research and medical education. All of N's assets were contributed to it by A and consist of a diversified portfolio of stocks and bonds. N's endowment earns 3.5 percent annually, which N expends in the conduct of various medical research programs in conjunction with Y hospital. N is located adjacent to Y hospital, makes substantial use of Y's facilities and there is close cooperation between the staffs of N and Y. N is directly engaged in the continuous active conduct of medical research in conjunction with a hospital, meets the principal purpose test described in subdivision (iv) of this subparagraph, and is therefore an organization described in section 170(b)(1)(A)(iii).

Example 2. O, an organization referred to in section 170(c)(2), was created to promote human knowledge within the field of medical research and medical education. All of O's assets consist of a diversified portfolio of stocks and bonds. O's endowment earns 3.5 percent annually, which O expends in the conduct of various medical research programs in conjunction with certain hospitals. However, in 1974, O receives a substantial bequest of additional stocks and bonds. O's budget for 1974 does not take into account the bequest and as a result O expends only 3.1 percent of its endowment in 1974. However, O establishes that it will expend at least 3.5 percent of its endowment for the active conduct of medical research for taxable years 1975 through 1978. O is therefore directly engaged in the continuous active conduct of medical research in conjunction with a hospital for taxable year 1975. Since O also meets the principal purpose test described in subdivision (iv) of this subparagraph, it is therefore an organization described in section 170(b)(1)(A)(iii) for taxable year 1975.

Example 3. M, an organization referred to in section 170(c)(2), was created to promote human knowledge within the field of medical research and medical education. M's activities consist of the conduct of medical research programs in conjunction with various hospitals. Under such programs, researchers employed by M engage in research at laboratories set aside for M within the various hospitals. Substantially all of M's assets consists of 100 percent of the stock of X corporation, which has a fair market value of approximately 100 million dollars. X pays M approximately 3.3 million dollars in dividends annually, which M expends in the conduct of its medical research programs. Since M expends only 3.3 percent of its endowment, which does not constitute a significant percentage, in the active conduct of medical research, M is not an organization described in section 170(b)(1)(A)(iii) because M is not engaged in the continuous active conduct of medical research.

(xi) *Special rule for organizations with existing ruling.* This subdivision shall apply to an organization that prior to January 1, 1970, had received a ruling or determination letter which has not been expressly revoked holding the organization to be a medical research organization described in section 170(b)(1)(A)(iii) and with respect to which the facts and circumstances on which the ruling was based have not substantially changed. An organization to which this subdivision applies shall be treated as an organization described in section 170(b)(1)(A)(iii) for a period not ending prior to 90 days after February 13, 1976 (or where appropriate, for taxable years beginning before such 90th day). In addition, with respect to a grantor or contributor under sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522, the status of an organization to which this subdivision applies will not be affected until notice of change of status under section 170(b)(1)(A)(iii) is made to the public (such as by publication in the Internal Revenue Bulletin). The preceding sentence shall not apply if the grantor or contributor had previously acquired knowledge that the Internal Revenue Service had given notice to such organization that it would be deleted from classification as a section 170(b)(1)(A)(iii) organization.

(d) *Governmental unit.* A governmental unit is described in section 170(b)(1)(A)(v) if it is referred to in section 170(c)(1).

(e) *Definition of section 170(b)(1)(A)(vi) organization*—(1) *In general.* An organization is described in section 170 (b)(1)(A)(vi) if it is:

(i) A corporation, trust, or community chest, fund, or foundation, referred to in section 170(c)(2) (other than an organization specifically described in paragraphs (a) through (d) of this section), and

(ii) A ''publicly supported'' organization.

For purposes of this paragraph, an organization is *publicly supported* if it normally receives a substantial part of its support from a governmental unit referred to in section 170(c)(1) or from direct or indirect contributions from the general public. An organization will be treated as being ‘‘public supported’’ if it meets the requirements of either subparagraph (2) or subparagraph (3) of this paragraph. Types of organizations which, subject to the provisions of this paragraph, generally qualify under section 170(b)(1)(A)(vi) as ‘‘publicly supported’’ are publicly or governmentally supported museums of history, art, or science, libraries, community centers to promote the arts, organizations providing facilities for the support of an opera, symphony orchestra, ballet, or repertory drama or for some other direct service to the general public, and organizations such as the American Red Cross or the United Givers Fund.

(2) *Determination whether an organization is ‘‘publicly supported’’; 33⅓ percent-of-support test.* An organization will be treated as a ‘‘publicly supported’’ organization if the total amount of support which the organization ‘‘normally’’ (as defined in subparagraph (4) of this paragraph) receives from governmental units referred to in section 170(c)(1), from contributions made directly or indirectly by the general public, or from a combination of these sources, equals at least 33 1/3 percent of the total support ‘‘normally’’ received by the organization. See subparagraphs (6), (7), and (8) of this paragraph for the definition of ‘‘support.’’ The application of this test is illustrated by *Example 1* of subparagraph (9) of this paragraph.

(3) *Determination whether an organization is ‘‘publicly supported’’; facts and circumstances test for organizations failing to meet 33 1/3 percent-of-support test.* Even if an organization fails to meet the 33 1/3 percent-of-support test described in subparagraph (2) of this paragraph, it will be treated as a ‘‘publicly supported’’ organization if it normally receives a substantial part of its support from governmental units, from direct or indirect contributions from the general public, or from a combination of these sources, and meets the other requirements of this subparagraph. In order to satisfy this subparagraph, an organization must meet the requirements of subdivisions (i) and (ii) of this subparagraph in order to establish, under all the facts and circumstances, that it normally receives a substantial part of its support from governmental units or from direct or indirect contributions from the general public, and it must be in the nature of a ‘‘publicly supported’’ organization, taking into account the factors described in subdivisions (iii) through (vii) of this subparagraph. The requirements and factors referred to in the preceding sentence with respect to a ‘‘publicly supported’’ organization (other than one described in subparagraph (2) of this paragraph) are:

(i) *Ten percent-of-support limitation.* The percentage of support ‘‘normally’’ (as defined in subparagraph (4) of this paragraph) received by an organization from governmental units, from contributions made directly or indirectly by the general public, or from a combination of these sources, must be ‘‘substantial.’’ For purposes of this subparagraph, an organization will not be treated as ‘‘normally’’ receiving a ‘‘substantial’’ amount of governmental or public support unless the total amount of governmental and public support ‘‘normally’’ received equals at least 10 percent of the total support ‘‘normally’’ received by such organization. See subparagraphs (6), (7), and (8) of this paragraph for the definition of ‘‘support.’’

(ii) *Attraction of public support.* An organization must be so organized and operated as to attract new and additional public or governmental support on a continuous basis. An organization will be considered to meet this requirement if it maintains a continuous and bona fide program for solicitation of funds from the general public, community, or membership group involved, or if it carries on activities designed to attract support from governmental units or other organizations described in section 170 (b)(1)(A)(i) through (vi). In determining whether an organization maintains a continuous and bona fide program for solicitation of funds from the general public or community, consideration will be given to whether the scope of its fundraising activities is reasonable in light of its charitable activities. Consideration will also be given to the fact that an organization may, in its early years of existence, limit the scope of its solicitation to persons deemed most likely to provide seed money in an amount sufficient to enable it to commence its charitable activities and expand its solicitation program.

In addition to the requirements set forth in subdivisions (i) and (ii) of this subparagraph which must be satisfied, all pertinent facts and circumstances, including the following factors, will be taken into consideration in determining whether an organization is ''publicly supported'' within the meaning of subparagraph (1) of this paragraph. However, an organization is not generally required to satisfy all of the factors in subdivisions (iii) through (vii) of this subparagraph. The factors relevant to each case and the weight accorded to any one of them may differ depending upon the nature and purpose of the organization and the length of time it has been in existence.

(iii) *Percentage of financial support.* The percentage of support received by an organization from public or governmental sources will be taken into consideration in determining whether an organization is ''publicly supported.'' The higher the percentage of support above the 10 percent requirement of subdivision (i) of this subparagraph from public or governmental sources, the lesser will be the burden of establishing the publicly supported nature of the organization through other factors described in this subparagraph, while the lower the percentage, the greater will be the burden. If the percentage of the organization's support from public or governmental sources is low because it receives a high percentage of its total support from investment income on its endowment funds, such fact will be treated as evidence of compliance with this subdivision if such endowment funds were originally contributed by a governmental unit or by the general public. However, if such endowment funds were originally contributed by a few individuals or members of their families, such fact will increase the burden on the organization of establishing compliance with the other factors described in this subparagraph.

(iv) *Sources of support.* The fact that an organization meets the requirement of subdivision (i) of this subparagraph through support from governmental units or directly or indirectly from a representative number of persons, rather than receiving almost all of its support from the members of a single family, will be taken into consideration in determining whether an organization is ''publicly supported.'' In determining what is a ''representative number of persons,'' consideration will be given to the type of organization involved, the length of time it has been in existence, and whether it limits its activities to a particular community or region or to a special field which can be expected to appeal to a limited number of persons.

(v) *Representative governing body.* The fact that an organization has a governing body which represents the broad interests of the public, rather than the personal or private interests of a limited number of donors (or persons standing in a relationship to such donors which is described in section 4946(a)(1)(C) through (G)) will be taken into account in determining whether an organization is ''publicly supported.'' An organization will be treated as meeting this requirement if it has a governing body (whether designated in the organization's governing instrument or bylaws as a Board of Directors, Board of Trustees, etc.) which is comprised of public officials acting in their capacities as such; of individuals selected by public officials acting in their capacities as such; of persons having special knowledge or expertise in the particular field or discipline in which the organization is operating; of community leaders, such as elected or appointed officials, clergymen, educators, civic leaders, or other such persons representing a broad cross-section of the views and interests of the community; or, in the case of a membership organization, of individuals elected pursuant to the organization's governing instrument or bylaws by a broadly based membership.

(vi) *Availability of public facilities or services; public participation in programs or policies.* (A) The fact that an organization is of the type which generally provides facilities or services directly for the benefit of the general public on a continuing basis (such as a museum or library which holds open its building and facilities to the public, a symphony orchestra which gives public performances, a conservation organization which provides educational services to the public through the distribution of educational materials, or an old age home which provides domiciliary or nursing services for members of the general public) will be considered evidence that such organization is ‘‘publicly supported.’’

(B) The fact that an organization is an educational or research institution which regularly publishes scholarly studies that are widely used by colleges and universities or by members of the general public will also be considered evidence that such organization is ‘‘publicly supported.’’

(C) Similarly, the following factors will also be considered evidence that an organization is ‘‘publicly supported:’’

(*1*) The participation in, or sponsorship of, the programs of the organization by members of the public having special knowledge or expertise, public officials, or civic or community leaders;

(*2*) The maintenance of a definitive program by an organization to accomplish its charitable work in the community, such as slum clearance or developing employment opportunities; and

(*3*) The receipt of a significant part of its funds from a public charity or governmental agency to which it is in some way held accountable as a condition of the grant, contract, or contribution.

(vii) *Additional factors pertinent to membership organizations.* The following are additional factors to be considered in determining whether a membership organization is ‘‘publicly supported’’:

(A) Whether the solicitation for dues-paying members is designed to enroll a substantial number of persons in the community or area, or in a particular profession or field of special interest (taking into account the size of the area and the nature of the organization’s activities);

(B) Whether membership dues for individual (rather than institutional) members have been fixed at rates designed to make membership available to a broad cross section of the interested public, rather than to restrict membership to a limited number of persons; and

(C) Whether the activities of the organization will be likely to appeal to persons having some broad common interest or purpose, such as educational activities in the case of alumni associations, musical activities in the case of symphony societies, or civic affairs in the case of parent-teacher associations.

See *Examples (2) through (5)* contained in subparagraph (9) of this paragraph for illustrations of this subparagraph.

(4) *Definition of ‘‘normally’’; general rule*—(i) *Normally; one-third support test.* For purposes of subparagraph (2) of this paragraph, an organization will be considered as ‘‘normally’’ meeting the 33 1/3 percent-of-support test for its current taxable year and the taxable year immediately succeeding its current year, if, for the 4 taxable years immediately preceding the current taxable year, the organization meets the 33 1/3 percent-of-support test described in subparagraph (2) of this paragraph on an aggregate basis.

(ii) *Normally; facts and circumstances test.* For purposes of subparagraph (3) of this paragraph, an organization will be considered as ‘‘normally’’ meeting the requirements of subparagraph (3) of this paragraph for its current taxable year and the taxable year immediately succeeding its current year, if, for the 4 taxable years immediately preceding the current taxable year, the organization meets the requirements of subparagraph (3) (i) and (ii) of this paragraph on an aggregate basis and satisfies a sufficient combination of the factors set forth in subparagraph (3) (iii) through (vii) of this paragraph. In the case of subparagraph (3) (iii) and (iv) of this paragraph, facts pertinent to years preceding 4 taxable years immediately preceding the current taxable year may also be taken into consideration. The combination of factors set forth in subparagraph (3) (iii) through (vii) of this paragraph which an organization ‘‘normally’’ must meet does not have to be the same for each 4-year period so long as there exists a sufficient combination of factors to show compliance with subparagraph (3) of this paragraph.

(iii) *Special rule.* The fact that an organization has ''normally'' met the requirements of subparagraph (2) of this paragraph for a current taxable year, but is unable ''normally'' to meet such requirements for a succeeding taxable year, will not in itself prevent such organization from meeting the requirements of subparagraph (3) of this paragraph for such succeeding taxable year.

(iv) *Illustration.* The application of subdivisions (i), (ii), and (iii) of this subparagraph may be illustrated by the following example:

Example X, an organization described in section 170(c)(2), meets the 33 1/3 percent-of-support test described in subparagraph (2) of this paragraph in taxable year 1975 on the basis of support received during taxable years 1971, 1972, 1973, and 1974. It therefore ''normally'' meets the requirements of subparagraph (2) of this paragraph for 1975 and 1976, the taxable year immediately succeeding 1975 (the current taxable year). For the taxable year 1976, X is unable to meet the 33 1/3 percent-of-support test described in subparagraph (2) of this paragraph on the basis of support received during taxable years 1972, 1973, 1974, and 1975. If X can meet the requirements of subparagraph (3) of this paragraph on the basis of taxable years 1972, 1973, 1974, and 1975, X will meet the requirements of subparagraph (3) of this paragraph for 1977 (the taxable year immediately succeeding 1976, the current taxable year) under subdivision (ii) of this subparagraph. However, if on the basis of both the taxable years 1972 through 1975 and 1973 through 1976, X, fails to meet the requirements of both subparagraphs (2) and (3) of this paragraph, X will not be described in section 170(b)(1)(A)(vi) for 1977. However, X will not be disqualified as a section 170(b)(1)(A)(vi) organization for taxable year 1976, because it ''normally'' met the requirements of subparagraph (2) of this paragraph on the basis of the taxable years 1971 through 1974, unless the provisions of subdivision (v) of this subparagraph become applicable.

(v) *Exception for material changes in sources of support*—(A) *In general.* If for the current taxable year there are substantial and material changes in an organization's sources of support other than changes arising from unusual grants excluded under subparagraph (6)(ii) of this paragraph, then in applying subparagraph (2) or (3) of this paragraph, neither the 4-year computation period applicable to such year as an immediately succeeding taxable year or as a current taxable year shall apply, and in lieu of such computation periods there shall be applied a computation period consisting of the taxable year of substantial and material changes and the 4 taxable years immediately preceding such year. Thus, for example, if there are substantial and material changes in an organization's sources of support for taxable year 1976, then even though such organization meets the requirements of subparagraph (2) or (3) of this paragraph based on a computation period of taxable years 1971–74 or 1972–75, such an organization will not meet the requirements of section 170(b)(1)(A)(vi) unless it meets the requirements of subparagraph (2) or (3) of this paragraph for a computation period consisting of the taxable years 1972–76. See *Example 3* in § 1.509(a)–3(c)(6) for an illustration of a similar rule. An example of a substantial and material change is the receipt of an unusually large contribution or bequest which does not qualify as an unusual grant under subparagraph (6)(ii) of this paragraph. See subparagraph (6)(iv)*(b)* of this paragraph as to the procedure for obtaining a ruling whether an unusually large grant may be excluded as an unusual grant.

(B) *Status of grantors and contributors.* If as a result of *(a)* of this subdivision, an organization is not able to meet the requirements of either the 33 1/3 percent-of-support test described in subparagraph (2) of this paragraph, or the facts and circumstances test described in subparagraph (3) of this paragraph for its current taxable year, its status (with respect to a grantor or contributor under sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522) will not be affected until notice of change of status under section 170(b)(1)(A)(vi) is made to the public (such as by publication in the Internal Revenue Bulletin). The preceding sentence shall not apply, however, if the grantor or contributor was responsible for, or was aware of, the substantial and material change referred to in *(a)* of this subdivision, or acquired knowledge that the Internal Revenue Service had given notice to such organization that it would be deleted from classification as a section 170(b)(1)(A)(vi) organization.

(C) *Reliance by grantors and contributors.* A grantor or contributor, other than one of the organization's founders, creators, or foundation managers (within the meaning of section 4946(b)) will not be considered to be responsible for, or aware of, the substantial and material change referred to in *(a)* of this subdivision, if such grantor or contributor has made such grant or contribution in reliance upon a written statement by the grantee organization that such grant or contribution will not result in the loss of such organization's classification as a publicly supported organization as described in section 170(b)(1)(A)(vi). Such statement must be signed by a responsible officer of the grantee organization and must set forth sufficient information, including a summary of the pertinent financial data for the 4 preceding years, to assure a reasonably prudent man that his grant or contribution will not result in the loss of the grantee organization's classification as a publicly supported organization as described in section 170(b)(1)(A)(vi). If a reasonable doubt exists as to the effect of such grant or contribution, or if the grantor or contributor is one of the organizations' founders, creators, or foundation managers, the procedure set forth in subparagraph (6)(iv)*(b)* of this paragraph may be followed by the grantee organization for the protection of the grantor or contributor.

(vi) *Special rule for new organizations.* If an organization has been in existence for at least 1 taxable year consisting of at least 8 months, but for fewer than 5 taxable years, the number of years for which the organization has been in existence immediately preceding each current taxable year being tested will be substituted for the 4-year period described in subdivision (i) or (ii) of this subparagraph to determine whether the organization ''normally'' meets the requirements of subparagraph (2) or (3) of this paragraph. However, if subdivision (v)*(a)* of this subparagraph applies, then the period consisting of the number of years for which the organization has been in existence (up to and including the current year) will be substituted for the 4-year period described in subdivision (i) or (ii) of this subparagraph. An organization which has been in existence for at least 1 taxable year, consisting of 8 or more months, may be issued a ruling or determination letter if it ''normally'' meets the requirements of subparagraph (2) or (3) of this paragraph for the number of years described in this subdivision. Such an organization may apply for a ruling or determination letter under the provisions of this subparagraph, rather than under the provisions of subparagraph (5) of this paragraph. The issuance of a ruling or determination letter will be discretionary with the Commissioner. See subparagraph (5)(v) of this paragraph as to the initial determination of the status of a newly created organization. This subdivision shall not apply to those organizations receiving an extended advance ruling under subparagraph (5)(iv) of this paragraph.

(vii) *Special rule for organizations with existing ruling.* This subdivision shall apply to an organization that prior to January 1, 1970, had received a ruling or determination letter which has not been expressly revoked holding the organization to be a publicly supported organization described in section 170(b)(1)(A)(vi) and with respect to which the facts and circumstances on which the ruling was based have notssubstantially changed. An organization to which this subdivision applies shall be treated as an organization described in section 170(b)(1)(A)(vi) for a period not ending prior to 90 days after December 29, 1972. In addition, with respect to a grantor or contributor under sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522, the status of an organization to which this subdivision applies will not be affected until notice of change of status under section 170(b)(1)(A)(vi) is made to the public (such as by publication in the Internal Revenue Bulletin). The preceding sentence shall not apply if the grantor or contributor had previously acquired knowledge that the Internal Revenue Service had given notice to such organization that it would be deleted from classification as a section 170(b)(1)(A)(vi) organization.

(viii) *Termination of status.* For the transitional rules applicable to an organization that is unable to meet the requirements of this paragraph for its first taxable year beginning after December 31, 1969 (as extended by § 1.507–2(j)) and wishes to terminate its private foundation status, see § 1.507–2(c) (2) and (3).

(ix) *Status of ruling.* The provisions of this subparagraph do not require an organization to file a new application with the Internal Revenue Service every 2 years in order to maintain or reaffirm its status as a ''publicly supported'' organization described in section 170(b)(1)(A)(vi).

(5) *Advance rulings to newly created organizations*—(i) *In general.* A ruling or determination letter that an organization is described in section 170 (b)(1)(A)(vi) will not be issued to a newly created organization prior to the close of its first taxable year consisting of at least 8 months. However, such organization may request a ruling or determination letter that it will be treated as a section 170(b)(1)(A)(vi) organization for its first 2 taxable years (or its first 3 taxable years, if its first taxable year consists of less than 8 months). For purposes of this section, such 2- or 3-year period, whichever is applicable, shall be referred to as the advance ruling period. Such an advance ruling or determination letter may be issued if the organization can reasonably be expected to meet the requirements of subparagraph (2) or (3) of this paragraph during the advance ruling period. The issuance of a ruling or determination letter will be discretionary with the Commissioner.

(ii) *Basic consideration.* In determining whether an organization can reasonably be expected (within the meaning of subdivision (i) of this subparagraph) to meet the requirements of subparagraph (2) or (3) of this paragraph for its advance ruling period or extended advance ruling period as provided in subdivision (iv) of this subparagraph, if applicable, the basic consideration is whether its organizational structure, proposed programs or activities, and intended method of operation are such as to attract the type of broadly based support from the general public, public charities, and governmental units which is necessary to meet such tests. The information to be considered for this purpose shall consist of all pertinent facts and circumstances relating to the requirements set forth in subparagraph (3) of this paragraph.

(iii) *Status of newly created organizations*—(A) *Advance ruling.* This subdivision shall apply to a newly created organization which has received an advance ruling or determination letter under subdivision (i) of this subparagraph, or an extended advance ruling or determination letter under subdivision (iv) of this subparagraph, that it will be treated as a section 170(b)(1)(A)(vi) organization for its advance or extended advance ruling period. So long as such an organization's ruling or determination letter has not been terminated by the Commissioner before the expiration of the advance or extended advance ruling period, then whether or not such organization has satisfied the requirements of subparagraph (2) or (3) of this paragraph during such advance or extended advance ruling period, such an organization will be treated as an organization described in section 170(b)(1)(A)(vi) in accordance with (*b*) and (*c*) of this subdivision, both for purposes of the organization and any grantor or contributor to such organization.

(B) *Reliance period.* Except as provided in (*a*) and (*c*) of this subdivision, an organization described in *(a)* of this subdivision will be treated as an organization described in section 170(b)(1)(A)(vi) for all purposes other than sections 507(d) and 4940 for the period beginning with its inception and ending 90 days after its advance or extended advance ruling period. Such period will be extended until a final determination is made of such an organization's status only if the organization submits, within the 90-day period, information needed to determine whether it meets the requirements of subparagraph (2) or (3) of this paragraph for its advance or extended advance ruling period (even if such organization fails to meet the requirements of such subparagraph (2) or (3)). However, since this subparagraph does not apply to the tax imposed by section 4940, if it is subsequently determined that the organization was a private foundation from its inception, then the tax imposed by section 4940 shall be due without regard to the advance or extended advance ruling or determination letter. Consequently, if any amount of tax under section 4940 in such a case is not paid on or before the last date prescribed for payment, the organization is liable for interest in accordance with section 6601. However, since any failure to pay such tax during the period referred to in this subparagraph is due to reasonable cause, the penalty under section 6651 with respect to the tax imposed by section 4940 shall not apply.

(C) *Grantors or contributors.* If a ruling or determination letter is terminated by the Commissioner prior to the expiration of the period described in (b) of this subdivision, for purposes of sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522, the status of grants or contributions with respect to grantors or contributors to such organizations will not be affected until notice of change of status of such organization is made to the public (such as by publication of the Internal Revenue Bulletin). The preceding sentence shall not apply however, if the grantor or contributor was responsible for, or aware of, the act or failure to act that resulted in the organization's loss of classification under section 170(b)(1)(A)(vi) or acquired knowledge that the Internal Revenue Service had given notice to such organization that it would be deleted from such classification. Prior to the making of any grant or contribution which allegedly will not result in the grantee's loss of classification under section 170(b)(1)(A)(vi), a potential grantee organization may request a ruling whether such grant or contribution may be made without such loss of classification. A request for such ruling may be filed by the grantee organization with the district director. The issuance of such ruling will be at the sole discretion of the Commissioner. The organization must submit all information necessary to make a determination on the factors referred to in subparagraph (6)(iii) of this paragraph. If a favorable ruling is issued, such ruling may be relied upon by the grantor or contributor of the particular contribution in question for purposes of sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522 and by the grantee organization for purposes of subparagraph (6)(ii) of this paragraph.

(iv) *Extension of advance ruling period.* (A) The advance ruling period described in subdivision (i) of this subparagraph shall be extended for a period of 3 taxable years after the close of the unextended advance ruling period if the organization so requests, but only if such organization's request accompanies its request for an advance ruling and is filed with a consent under section 6501(c)(4) to the effect that the period of limitation upon assessment under section 4940 for any taxable year within the extended advance ruling period shall not expire prior to 1 year after the date of the expiration of the time prescribed by law for the assessment of a deficiency for the last taxable year within the extended advance ruling period. An organization's extended advance ruling period is 5 taxable years if its first taxable year consists of at least 8 months, or is 6 years if its first taxable year is less than 8 months.

(B) *Notwithstanding* (*a*) of this subdivision, an organization which has received or applied for an advance ruling prior to January 29, 1973, may file its request for the 3-year extension within 90 days from such date, but only if it files the consents required in this section.

(C) See subdivision (v) of this subparagraph for the effect upon the initial determination of status of an organization which receives a ruling for an extended advance ruling period.

(v) *Initial determination of status.* (A) The initial determination of status of a newly created organization is the first determination (other than by issuance of an advance ruling or determination letter under subdivision (i) of this subparagraph or an extended advance ruling or determination letter under subdivision (iv) of this subparagraph) that the organization will be considered as ''normally'' meeting the requirements of subparagraph (2) or (3) of this paragraph for a period beginning with its first taxable year.

(B) In the case of a new organization whose first taxable year is at least 8 months, except as provided for in subdivision (v)(*d*) of this subparagraph, the initial determination of status shall be based on a computation period of either the first taxable year or the first and second taxable years.

(C) In the case of a new organization whose first taxable year is less than 8 taxable months, except as provided for in subdivision (v)(*d*) of this subparagraph, the initial determination of status shall be based on a computation period of either the first and second taxable years or the first, second, and third taxable years.

(D) In the case of an organization which has received a ruling or determination letter for an extended advance ruling period under subdivision (iv) of this subparagraph, the initial determination of status shall be based on a computation period of all of the taxable years in the extended advance ruling period. However, where the ruling or determination letter for an extended advance ruling period under subdivision (iv) of this subparagraph is terminated by the Commissioner prior to the expiration of the relevant period described in subdivision (iii)(*b*) of this subparagraph, the initial determination of status shall be based on a computation period of the period provided in (*b*) or (*c*) of this subdivision or, if greater, the number of years to which the advance ruling applies.

(E) An initial determination that an organization will be considered as ''normally'' meeting the requirements of subparagraph (2) or (3) of this paragraph shall be effective for each taxable year in the computation period plus (except as provided by subparagraph (4)(v)(*a*) of this paragraph, relating to material changes in sources of support) the 2 taxable years immediately succeeding the computation period. Therefore, in the case of an organization referred to in (*b*) of this subdivision to which subparagraph (4)(v)(*a*) of this paragraph does not apply, with respect to its first, second, and third taxable years, such an organization shall be described in section 170(b)(1)(A)(vi) if it meets the requirements of subparagraph (2) or (3) of this paragraph for either its first taxable year or for its first and second taxable years on an aggregate basis. In addition, if it meets the requirements of subparagraph (2) or (3) of this paragraph for its first and second taxable years, it shall be described in section 170(b)(1)(A)(vi) for its fourth taxable year. Once an organization is considered as ''normally'' meeting the requirements of subparagraph (2) or (3) of this paragraph for a period specified under this subdivision, subparagraph (4) (i), (ii), (v), or (vi) of this paragraph shall apply.

(F) The provisions of this subdivision may be illustrated by the following examples:

Example 1. X, a calendar year organization described in section 501(c)(3), is created in February 1972. The support received from the public in 1972 by X will satisfy the one-third support test described in subparagraph (4)(i) of this paragraph over its first taxable year, 1972. X may therefore get an initial determination that it meets the requirements of subparagraph (2) of this paragraph for its first taxable year beginning in February 1972 and ending on December 31, 1972. This determination will be effective for taxable years 1972, 1973, and 1974.

Example 2. Assume the same facts as in *Example (1)* except that X also receives a substantial contribution from one individual in 1972 which is not excluded from the denominator of the one-third support fraction described in subparagraph (4)(i) of this paragraph by reason of the unusual grant provision of subparagraph (6)(ii) of this paragraph. Because of this substantial contribution, X fails to satisfy the one-third support test over its first taxable year, 1972. X also fails to satisfy the ''facts and circumstances'' test described in subparagraph (4)(ii) of this paragraph for its first taxable year, 1972. However, the support received from the public over X's first and second taxable years in the aggregate will satisfy the one-third support test. X may therefore get an initial determination that it meets the requirements of subparagraph (2) of this paragraph for its first and second taxable years in the aggregate beginning in February 1972 and ending on December 31, 1973. This determination will be effective for taxable years 1972, 1973, 1974, and 1975.

Example 3. Y, a calendar year organization described in section 501(c)(3), is created in July 1972. Y requests and receives an extended advance ruling period of 5 full taxable years plus its initial short taxable year of 6 months under subparagraph (5)(iv) of this paragraph. The extended advance ruling period begins in July 1972 and ends on December 31, 1977. The support received from the public over Y's first through sixth taxable years in the aggregate will satisfy the one-third support test described in subparagraph (4)(i) of this paragraph. Therefore, Y in 1978 may get an initial determination that it meets the requirements of subparagraph (2) of this paragraph in the aggregate over all the taxable years in its extended advance ruling period beginning in July 1972 and ending on December 31, 1977. This determination will be effective for taxable years 1972 through 1979.

Example 4. Assume the same facts as in *Example (3)* except that the ruling for the extended advance ruling period is terminated prospectively at the end of 1975, so that Y may not rely upon such ruling for 1976 or any succeeding year. The support received from the public over Y's first through fourth taxable years (1972 through 1975) will not satisfy either the one-third support test described in subparagraph (4)(i) of this paragraph, or the ''facts and circumstances'' test described in subparagraph (4)(ii) of this paragraph. Because the ruling was terminated the computation period for Y's initial determination of status is the period 1972 through 1975. Since Y has not met the requirements of either subparagraph (2) or (3) of this paragraph for such computation period, Y is not described in section 170(b)(1)(A)(vi) for purposes of its initial determination of status. If Y is not described in section 170(b)(1)(A) (i) through (v) or section 509(a) (2), (3), or (4), then Y is a private foundation. As of 1976, Y shall be treated as a private foundation for all purposes (except as provided in subdivision (iii)(*c*) of this subparagraph with respect to grantors and contributors), and as of July 1972 for purposes of the tax imposed by section 4940 and for purposes of section 507(d) (relating to aggregate tax benefit).

(vi) *Failure to obtain advance ruling.* (A) Unless a newly created organization has obtained an advance ruling or determination letter under subdivision (i) of this subparagraph, or an extended advance ruling or determination letter under subdivision (iv) of this subparagraph, that it will be treated as a section 170(b)(1)(A)(vi) organization for its advance or extended advance ruling period, it cannot rely upon the possibility it will meet the requirements of subparagraph (2) or (3) of this paragraph for a taxable year which begins before the close of either applicable computation period provided for in subdivision (v) *(b)* or *(c)* of this subparagraph. Therefore, such an organization, in order to avoid the risk of subsequently being determined to be a private foundation because of failure to qualify under section 170(b)(1)(A)(vi) and therefore under section 509(a)(1), may comply with the rules applicable to private foundations and may pay, for example, the tax imposed by section 4940. In that event, if the organization subsequently meets the requirements of subparagraph (2) or (3) of this paragraph for either applicable computation period, it shall be treated as a section 170(b)(1)(A)(vi) organization from its inception and, therefore, any tax imposed under chapter 42 shall be refunded and section 509(b) shall not apply.

(B) If a newly created organization fails to obtain an advance ruling or determination letter under subdivision (i) of this subparagraph, or an extended advance ruling or determination letter under subdivision (iv) of this subparagraph, and fails to meet the requirements of subparagraph (2) or (3) of this paragraph for the first applicable computation period provided for in subdivision (v) *(b)* or *(c)* of this subparagraph, see section 6651 for penalty for failure to file return and pay tax.

(6) *Definition of support; meaning of general public*—(i) *In general.* In determining whether the 33 1/3 percent-of-support test described in subparagraph (2) of this paragraph or the 10 percent-of-support limitation described in subparagraph (3)(i) of this paragraph is ''normally'' met, contributions by an individual, trust; or corporation shall be taken into account as ''support'' from direct or indirect contributions from the general public only to the extent that the total amount of the contributions by any such individual, trust, or corporation during the period described in subparagraph (4) (i), (ii), (v), or (vi) or (5)(v) of this paragraph does not exceed 2 percent of the organization's total support for such period, except as provided in subdivision (ii) of this subparagraph. Therefore, any contribution by one individual will be included in full in the denominator of the fraction determining the 33 1/3 percent-of-support or the 10 percent-of-support limitation, but will only be includible in the numerator of such fraction to the extent that such amount does not exceed 2 percent of the denominator. In applying the 2 percent limitation, all contributions made by a donor and by any person or persons standing in a relationship to the donor which is described in section 4946(a)(1) (C) through (G) and the regulations thereunder shall be treated as made by one person. The 2 percent limitation shall not

apply to support received from governmental units referred to in section 170(c)(1) or to contributions from organizations described in section 170(b)(1)(A)(vi), except as provided in subdivision (v) of this subparagraph. For purposes of subparagraphs (2), (3)(i) and (7)(ii)*(b)* of this paragraph, the term ''indirect contributions from the general public'' includes contributions received by the organization from organizations (such as section 170(b)(1)(A)(vi) organizations) which normally receive a substantial part of their support from direct contributions from the general public, except as provided in subdivision (v) of this subparagraph. See the examples in subparagraph (9) of this paragraph for the application of this subdivision.

(ii) *Exclusion of unusual grants.* For purposes of applying the 2 percent limitation described in subdivision (i) of this subparagraph to determine whether the 33 1/3 percent-of-support test in subparagraph (2) of this paragraph or the 10 percent-of-support limitation in subparagraph (3)(i) of this paragraph is satisfied, one or more contributions may be excluded from both the numerator and the denominator of the applicable percent-of-support fraction if such contributions meet the requirements of subdivision (iii) of this subparagraph. The exclusion provided by this subdivision is generally intended to apply to substantial contributions or bequests from disinterested parties which contributions or bequests:

(A) Are attracted by reason of the publicly supported nature of the organization;

(B) Are unusual or unexpected with respect to the amount thereof; and

(C) Would, by reason of their size, adversely affect the status of the organization as normally being publicly supported for the applicable period described in subparagraph (4) or (5) of this paragraph.

In the case of a grant (as defined in § 1.509(a)–3(g)) which meets the requirements of this subdivision, if the terms of the granting instrument (whether executed before or after 1969) require that the funds be paid to the recipient organization over a period of years, the amount received by the organization each year pursuant to the terms of such grant may be excluded for such year. However, no item of gross investment income may be excluded under this subparagraph. The provisions of this subparagraph shall apply to exclude unusual grants made during any of the applicable periods described in subparagraph (4), (5), or (6) of this paragraph. See subdivision (iv) of this subparagraph as to reliance by a grantee organization upon an unusual grant ruling under this subparagraph.

(iii) *Determining factors.* In determining whether a particular contribution may be excluded under subdivision (ii) of this subparagraph all pertinent facts and circumstances will be taken into consideration. No single factor will necessarily be determinative. For some of the factors similar to the factors to be considered, see § 1.509(a)–3(c)(4).

(iv) *Grantors and contributors.* (A) As to the status of grants and contributions which result in substantial and material changes in the organization (as described in subparagraph (4)(v)*(a)* of this paragraph) and which fail to meet the requirements for exclusion under subdivision (ii) of this subparagraph, see the rules prescribed in subparagraph (4)(v) *(b)* and *(c)* of this paragraph.

(B) Prior to the making of any grant or contribution which will allegedly meet the requirements for exclusion under subdivision (ii) of this subparagraph, a potential grantee organization may request a ruling whether such grant or contribution may be so excluded. Requests for such ruling may be filed by the grantee organization with the district director. The issuance of such ruling will be at the sole discretion of the Commissioner. The organization must submit all information necessary to make a determination on the factors referred to in subdivision (iii) of this subparagraph. If a favorable ruling is issued, such ruling may be relied upon by the grantor or contributor of the particular contribution in question for purposes of sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522 and by the grantee organization for purposes of subdivision (ii) of this subparagraph.

(v) *Grants from public charities.* Pursuant to subdivision (i) of this subparagraph, contributions received from a governmental unit or from a section 170(b)(1)(A)(vi) organization are not subject to the 2 percent limitation described in that subdivision unless such contributions represent amounts which have been expressly or impliedly earmarked by a donor to such governmental unit or section 170(b)(1)(A)(vi) organization as being for, or for the benefit of, the particular organization claiming section 170 (b)(1)(A)(vi) status. See §1.509(a)–3 (j)(3) for examples illustrating the rules of this subdivision.

(7) *Definition of support; special rules and meaning of terms*—(i) *Definition of support.* For purposes of this paragraph, the term *support* shall be as defined in section 509(d) (without regard to section 509(d)(2)). The term ''support'' does not include:

(A) Any amounts received from the exercise or performance by an organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a). In general, such amounts include amounts received from any activity the conduct of which is substantially related to the furtherance of such purpose or function (other than through the production of income), or

(B) Contributions of services for which a deduction is not allowable.

For purposes of the 33 1/3 percent-of-support test in subparagraph (2) of this paragraph and the 10 percent-of-support limitation in subparagraph (3)(i) of this paragraph, all amounts received which are described in *(a)* or *(b)* of this division are to be excluded from both the numerator and the denominator of the fractions determining compliance with such tests, except as provided in subdivision (ii) of this subparagraph.

(ii) *Organizations dependent primarily on gross receipts from related activities.* Notwithstanding the provisions of subdivision (i) of this subparagraph, an organization will not be treated as satisfying the 33 1/3 percent-of-support test in subparagraph (2) of this paragraph or the 10 percent-of-support limitation in subparagraph (3)(i) of this paragraph if it receives:

(A) Almost all of its support (as defined in section 509(d)) from gross receipts from related activities; and

(B) An insignificant amount of its support from governmental units (without regard to amounts referred to in subdivision (i)*(a)* of this subparagraph) and contributions made directly or indirectly by the general public.

For example X, an organization described in section 501(c)(3), is controlled by A, its president. X received $500,000 during the 4 taxable years immediately preceding its current taxable year under a contract with the Department of Transportation, pursuant to which X has engaged in research to improve a particular vehicle used primarily by the Federal Government. During this same period, the only other support received by X consisted of $5,000 in small contributions primarily from X's employees and business associates. The $500,000 amount constitutes support under section 509(d)(2) and 509(d)(2)*(a)* of this subdivision. Under these circumstances, X meets the conditions of *(a)* and *(b)* of this subdivision and will not be treated as meeting the requirements of either subparagraph (2) or subparagraph (3) of this paragraph. As to the rules applicable to organizations which fail to qualify under section 170(b)(1)(A)(vi) because of the provisions of this subdivision, see section 509(a)(2) and the regulations thereunder. For the distinction between gross receipts (as referred to in section 509(d)(2)) and gross investment income (as referred to in section 509(d)(4)), see §1.509(a)–3(m).

(iii) *Membership fees.* For purposes of this subparagraph, the term ''support'' shall include ''membership fees'' within the meaning of §1.509(a)–3(h) (that is, if the basic purpose for making a payment is to provide support for the organization rather than to purchase admissions, merchandise, services, or the use of facilities).

(8) *Support from a governmental unit.* (i) For purposes of subparagraphs (2) and (3)(i) of this paragraph, the term ''support from a governmental unit'' includes any amounts received from a governmental unit, including donations or contributions and amounts received in connection with a contract entered into with a governmental unit

for the performance of services or in connection with a Government research grant. However, such amounts will not constitute ‘‘support from a governmental unit’’ for such purposes if they constitute amounts received from the exercise or performance of the organization’s exempt functions as provided in subparagraph (7)(i)*(a)* of this paragraph.

(ii) For purposes of subdivision (i) of this subparagraph, any amount paid by a governmental unit to an organization is not to be treated as received from the exercise or performance of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a) (within the meaning of subparagraph (7)(i)*(a)* of this paragraph) if the purpose of the payment is primarily to enable the organization to provide a service to, or maintain a facility for, the direct benefit of the public (regardless of whether part of the expense of providing such service or facility is paid for by the public), rather than to serve the direct and immediate needs of the payor. For example:

(A) Amounts paid for the maintenance of library facilities which are open to the public.

(B) Amounts paid under Government programs to nursing homes or homes for the aged in order to provide health care or domiciliary services to residents of such facilities, and

(C) Amounts paid to child placement or child guidance organizations under Government programs for services rendered to children in the community, are considered payments the purpose of which is primarily to enable the recipient organization to provide a service or maintain a facility for the direct benefit of the public, rather than to serve the direct and immediate needs of the payor. Furthermore, any amount received from a governmental unit under circumstances such that the amount would be treated as a ‘‘grant’’ within the meaning of § 1.509(a)–3(g) will generally constitute ‘‘support from a governmental unit’’ described in this subdivision, rather than an amount described in subparagraph (7)(i)*(a)* of this paragraph.

(9) *Examples.* The application of subparagraphs (1) through (8) of this paragraph may be illustrated by the following examples:

Example 1. (a) M is an organization referred to in section 170(c)(2). For the years 1970 through 1973 (the applicable period with respect to the taxable year 1974 under subparagraph (4) of this paragraph), M received support (as defined in subparagraphs (6) through (8) of this paragraph) of $600,000 from the following sources:

Investment income	$300,000
City Y (a governmental unit referred to in section 170(c)(1))	40,000
United Fund (an organization referred to in section 170(b)(1)(A)(vi)	40,000
Contributions	220,000
Total support	600,000

(b) With respect to the taxable year 1974, M ‘‘normally’’ received in excess of 33 1/3 percent of its support from a governmental unit referred to in section 170(c)(1) and from direct and indirect contributions from the general public (as defined in subparagraph (6) of this paragraph) computed as follows:

33⅓ percent of total support	$200,000
Support from a governmental unit referred to in section 170(c)(1)	40,000
Indirect contributions from the general public (United Fund)	40,000
Contributions by various donors (no one having made contributions which total in excess of $12,000—2 percent of total support)	50,000
Six contributions (each in excess of $12,000—2 percent total support) 6×$12,000	72,000
	202,000

(c) Since the amount of X’s support from governmental units referred to in section 170(c)(1) and from direct and indirect contributions from the general public with respect to the taxable year 1974 ‘‘normally’’ exceeds 33 1/3 percent of M’s total support for the applicable period (1970–73), X meets the 33 1/3 percent-of-support test under subparagraph (2) of this paragraph and is therefore treated as satisfying the requirements for classification as a ‘‘publicly supported’’ organization under subparagraph (2) of this paragraph for the taxable years 1974 and 1975 (there being no substantial and material changes in the organization’s character, purposes, methods of operation, or sources of support in these years).

Example 2. N is an organization referred to in section 170(c)(2). It was created to maintain public gardens containing botanical specimens and displaying statuary and other art objects. The facilities, works of art, and a large endowment were all contributed by a single contributor. The members of the governing body of the organization are unrelated to its creator. The gardens are open to the public without charge and attract a substantial number of visitors each year. For the 4 taxable years immediately preceding the current taxable year, 95 percent of the organization's total support was received from investment income from its original endowment. N also maintains a membership society which is supported by members of the general public who wish to contribute to the upkeep of the gardens by paying a small annual membership fee. Over the 4-year period in question, these fees from the general public constituted the remaining 5 percent of the organization's total support for such period. Under these circumstances, N does not meet the 33 1/3 percent-of-support test under subparagraph (2) of this paragraph for its current taxable year. Furthermore, since only 5 percent of its total support is, with respect to the current taxable year, normally received from the general public, N does not satisfy the 10 percent-of-support limitation described in subparagraph (3)(i) of this paragraph and cannot therefore be classified as ‘‘publicly supported'' under subparagraph (3) of this paragraph. For its current taxable year, N therefore, is not an organization described in section 170(b)(1)(A)(vi). Since N has failed to satisfy the 10 percent-of-support limitation under subparagraph (3)(i) of this paragraph, none of the other requirements or factors set forth in subparagraph (3) (iii) through (vii) of this paragraph can be considered in determining whether N qualifies as a ‘‘publicly supported'' organization.

Example 3. (a) O, an art museum, is an organization referred to in section 170(c)(2). In 1930, O was founded in Y City by the members of a single family to collect, preserve, interpret, and display to the public important works of art. O is governed by a Board of Trustees which originally consisted almost entirely of members of the founding family. However, since 1945, members of the founding family or persons standing in a relationship to the members of such family described in section 4946(a)(1)(C) through (G) have annually constituted less than one-fifth of the Board of Trustees. The remaining board members are citizens of Y City from a variety of professions and occupations who represent the interests and views of the people of Y City in the activities carried on by the organization rather than the personal or private interests of the founding family. O solicits contributions from the general public and for each of its 4 most recent taxable years has received total contributions (in small sums of less than $100, none of which exceeds 2 percent of O's total support for such period) in excess of $10,000. These contributions from the general public (as defined in subparagraph (6) of this paragraph) represent 25 percent of the organization's total support for such 4-year period. For this same period, investment income from several large endowment funds has constituted 75 percent of its total support. O expends substantially all of its annual income for its exempt purposes and thus depends upon the funds it annually solicits from the public as well as its investment income in order to carry out its activities on a normal and continuing basis and to acquire new works of art. O has, for the entire period of its existence, been open to the public and more than 300,000 people (from Y City and elsewhere) have visited the museum in each of its four most recent taxable years.

(b) Under these circumstances, O does not meet the 33 1/3 percent-of-support test under subparagraph (2) of this paragraph for its current year since it has received only 25 percent of its total support for the applicable 4-year period from the general public. However, under the facts set forth above, O has met the 10 percent-of-support limitation under subparagraph (3)(i), as well as the requirements of subparagraph (3)(ii), of this paragraph. Under all of the facts set forth in this example, O is considered as meeting the requirements of subparagraph (3) of this paragraph on the basis of satisfying subparagraph (3) (i) and (ii) of this paragraph and the factors set forth in subparagraph (3) (iii), (iv), (v), and (vi) of this paragraph, and is therefore classified as a ‘‘publicly supported organization'' under subparagraph (1) of this paragraph for its current taxable year and the immediately succeeding taxable year (there being no substantial and material changes in the organization's character, purposes, methods of operation, or sources of support in these years).

Example 4. (a) In 1960, the P Philharmonic Orchestra was organized in Z City through the combined efforts of a local music society and a local women's club to present to the public a wide variety of musical programs intended to foster music appreciation in the community. P is an organization referred to in section 170(c)(2). The orchestra is composed of professional musicians who are paid by the association. Twelve performances open to the public are scheduled each year. A small admission charge is made for each of these performances. In addition, several performances are staged annually without charge. During its 4 most recent taxable years, P has received separate contributions of $200,000 each from A and B (not members of a single family) and support of $120,000 from the Z Community Chest, a public federated fundraising organization operating in Z City. P depends on these funds in order to carry out its activities and will continue to depend on contributions of this type to be made in the future. P has also begun a fundraising campaign in an attempt to expand its activities for the coming years. P is governed by a Board of Directors comprised of five individuals. A faculty member of a local college, the president of a local music society, the head of a local banking institution, a prominent doctor, and a member of the governing body of the local chamber of commerce currently serve on the Board and represent the interests and views of the community in the activities carried on by P.

(b) With respect to P's current taxable year, P's sources of support are computed on the basis of the 4 immediately preceding years, as follows:

Contributions	$520,000
Receipts from performances	100,000
Total support	620,000
Less:	
Receipts from performances (excluded under subparagraph (7)(i)(*a*) of this paragraph)	100,000
Total support for purposes of subparagraphs (2) and (3)(i) of this paragraph	520,000

(c) For purposes of subparagraphs (2) and (3)(i) of this paragraph, P's support is computed as follows:

Z Community Chest (indirect support from the general public)	$120,000
Two contributions (each in excess of $10,400—2 percent of total support) 2×$10,400	20,800
Total	140,800

(d) P's support from the general public, directly and indirectly, does not meet the 33 1/3 percent-of-support test under subparagraph (2) of this paragraph ($140,800/$520,000=27 percent of total support). However, since P receives 27 percent of its total support from the general public, it meets the 10 percent-of-support limitation under subparagraph (3)(i) of this paragraph. P also meets the requirements of subparagraph (3)(ii) of this paragraph. As a result of satisfying these requirements and the factors set forth in subparagraph (3) (iii), (iv), (v), and (vi) of this paragraph, P is considered as meeting the requirements of subparagraph (3) of this paragraph and is therefore considered to be a ''publicly supported'' organization under subparagraph (1) of this paragraph.

(e) If, instead of the above facts, P were a newly created organization, P could obtain a ruling pursuant to subparagraph (5) of this paragraph by reason of its purposes, organizational structure and proposed method of operation. Even if P had initially been founded by the contributions of a few individuals, such fact would not, in and of itself, disqualify P from receiving a ruling under subparagraph (5) of this paragraph.

Example 5. (a) Q is an organization referred to in section 170(c)(2). It is a philanthropic organization founded in 1965 by A for the purpose of making annual contributions to worthy charities. A created Q as a charitable trust by the transfer of $500,000 worth of appreciated securities to Q.

Pursuant to the trust agreement, A and two other members of his family are the sole trustees and are vested with the right to appoint successor trustees. In each of its four most recent taxable years, Q received $15,000 in investment income from its original endowment. Each year Q makes a solicitation for funds by operating a charity ball at A's residence. Guests are invited and requested to make contributions of $100 per couple. During the 4-year period involved, $15,000 was received from the proceeds of these events. A and his family have also made contributions to Q of $25,000 over the course of the organization's 4 most recent taxable years. Q makes disbursements each year of substantially all of its net income to the public charities chosen by the trustees.

(b) With respect to Q's current taxable year, Q's sources of support are computed on the basis of the 4 immediately preceding years as follows:

Investment income	$60,000
Contributions	40,000
Total support	100,000

(c) For purposes of subparagraphs (2) and (3)(i) of this paragraph, Q's support is computed as follows:

Contributions from the general public	$15,000
One contribution (in excess of $2,000—2 percent of total support) 1×$2,000	2,000
Total	17,000

(d) Q's support from the general public does not meet the 33 1/3 percent-of-support test under subparagraph (2) of this paragraph ($17,000/$100,000=17 percent of total support). Thus, Q's classification as a ''publicly supported'' organization depends on whether it meets the requirements of subparagraph (3) of this paragraph. Even though it satisfies the 10 percent-of-support limitation under subparagraph (3)(i) of this paragraph, its method of solicitation makes it questionable whether Q satisfies the requirements of subparagraph (3)(ii) of this paragraph. Because of its method of operating, Q also has a greater burden of establishing its publicly supported nature under subparagraph (3)(iii) of this paragraph. Based upon the foregoing and upon Q's failure to receive favorable consideration under the factors set forth in subparagraph (3) (iv), (v), and (vi) of this paragraph, Q does not satisfy the requirements of subparagraph (3) of this paragraph as a ''publicly supported'' organization.

(e) If, instead of the above facts, Q were a newly created organization, Q would not be able to receive a ruling pursuant to subparagraph (5) of this paragraph. Its purposes, organizational structure, and method of operation would be insufficient to establish that Q could reasonably be expected to meet the requirements of subparagraph (2) or (3) of this paragraph for its first 2 or its first 5 taxable years.

(10) *Community trusts; introduction.* Community trusts have often been established to attract large contributions

of a capital or endowment nature for the benefit of a particular community or area, and often such contributions have come initially from a small number of donors. While the community trust generally has a governing body comprised of representatives of the particular community or area, its contributions are often received and maintained in the form of separate trusts or funds, which are subject to varying degrees of control by the governing body. To qualify as a ‘‘publicly supported’’ organization, a community trust must meet the 33 1/3 percent-of-support test of paragraph (e)(2) of this section, or, if it cannot meet that test, be organized and operated so as to attract new and additional public or governmental support on a continuous basis sufficient to meet the facts and circumstances test of paragraph (e)(3) of this section. Such facts and circumstances test includes a requirement of attraction of public support in paragraph (e)(3)(ii) of this section which, as applied to community trusts will generally satisfied, if they seek gifts and bequests from a wide range of potential donors in the community or area served, through banks or trust companies, through attorneys or other professional persons, or in other appropriate ways which call attention to the community trust as a potential recipient of gifts and berquests made for the benefit of the community or area served. A community trust is not required to engage in periodic, community-wide, fund-raising campaigns directed toward attracting a large number of small contributions in a manner similiar to campaigns conducted by a community chest or united fund. Paragraph (e) (12) and (13) of this section provide a transitional ruling period for certain community trusts in existence before November 11, 1976 that had irregular public support, so that they can meet the requirements of paragraph (e) (2) or (3) of this section based on the 4-year computation period described in paragraph (e)(4) of this section. Paragraph (e)(11) of this section provides rules for determining the extent to which separate trusts or funds may be treated as component parts of a community trust, fund or foundation (herein collectively referred to as a ‘‘community trust’’, and sometimes referred to as an ‘‘organization’’) for purposes of meeting the requirements of this paragraph for classification as a ‘‘publicly supported’’ organization. Paragraph (e)(14) of this section contains rules for trusts or funds which are prevented from qualifying as component parts of a community trust by paragraph (e)(11) of this section.

(11) *Community trusts; requirements for treatment as a single entity*—(i) *General rule.* For purposes of sections 170, 501, 507, 508, 509, and Chapter 42, any organization that meets the requirements contained in paragraph (e)(11) (iii) through (iv) of this section will be treated as a single entity, rather than as an aggregation of separate funds, and except as otherwise provided, all funds associated with such organization (whether a trust, not-for-profit corporation, unincorporated association, or a combination thereof) which meet the requirements of paragraph (e)(11)(ii) of this section will be treated as component parts of such organization.

(ii) *Component part of a community trust.* In order to be treated as a component part of a community trust referred to in paragraph (e)(11) of this section (rather than as a separate trust or not-for-profit corporation or association) a trust or fund:

(A) Must be created by a gift, bequest, legacy, devise, or other transfer to a community trust which is treated as a single entity under paragraph (e)(11) of this section; and

(B) May not be directly or indirectly subjected by the transferor to any material restriction or condition (within the meaning of §1.507–2(a)(8) with respect to the transferred assets.

For purposes of paragraph (e)(11)(ii)(B) of this section, if the transferor is not a private foundation, the provisions of §1.507–2(a)(8) shall be applied to the trust or fund as if the transferor were a private foundation established and funded by the person establishing the trust or fund and such foundation transferred all its assets to the trust or fund. Any transfer made to a fund or trust which is treated as a component part of a community trust under paragraph (e)(11)(ii) of this section will be treated as a transfer made ‘‘to’’ a ‘‘publicly supported’’ community trust for purposes of section 170(b)(1)(A) and 507(b)(1)(A) if such community trust meets the requirements of section 170(b)(10(A)(vi) as a ''publicly supported'' organization at the time of the transfer, except as provided in § 1.170A–9(e)(4)(v)(*b*) or § 1.508–1(b) (4) and (6) (relating, generally, to reliance by grantors and contributors). See, also, paragraph (e)(14) (ii) and (iii) of this section for special provisions relating to split-interest trusts and certain private foundations described in section 170(b)(1)(E)(iii).

(iii) *Name.* The organization must be commonly known as a community trust, fund, foundation or other similar name conveying the concept of a capital or endoment fund to support charitable activities (within the meaning of section 170(c)(1) or (2)(B)) in the community or area it serves.

(iv) *Common instrument.* All funds of the organization must be subject to a common governing instrument or a master trust or agency agreement (herein referred to as the ''governing instrument''), which may be embodied in a single document or several documents containing common language. Language in an instrument of transfer to the community trust making a fund subject to the community trust's governing instrument or master trust or agency agreement will satisfy the requirements of paragraph (e)(11)(iv) of this section. In addition, if a community trust adopts a new governing instrument (or creates a corporation) to put into effect new provisions (applying to future transfers to the community trust), the adoption of such new governing instrument (or creation of a corporation with a governing instrument) which contains common language with the existing governing instrument shall not preclude the community trust from meeting the requirements of such paragraph (e)(11)(iv).

(v) *Common governing body.* (A) The organization must have a common governing body or distribution committee (herein referred to as the ''governing body'') which either directs or, in the case of a fund designated for specified beneficiaries, monitors the distribution of all of the funds exclusively for charitable purposes (within the meaning of section 170(c) (1) or (2)(B)). For purposes of this (v) a fund is designated for specified beneficiaries only if no person is left with the discretion to direct the distribution of the fund.

(B) *Powers of modification and removal.* Except as provided in paragraph (e)(11)(v)(C) of this section, the governing body must have the power in the governing instrument, the instrument of transfer, the resolutions or bylaws of the governing body, a written agreement, or otherwise—

(1) To modify any restriction or condition on the distribution of funds for any specified charitable purposes or to specified charitable purposes or to specified organizations if in the sole judgment of the governing body (without the necessity of the approval of any participating trustee, custodian, or agent), such restriction or condition becomes, in effect, unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served;

(2) To replace any participating trustee, custodian, or agent for breach of fiduciary duty under State law; and

(3) To replace any participating trustee, custodian, or agent for failure to produce a reasonable (as determined by the governing body) return of net income (within the meaning of paragraph (e)(11)(v)(F) of this section) over a reasonable period of time (as determined by the governing body).

The fact that the exercise of any such power in paragraph (e)(11)(v)(B) *(1), (2)* or *(3)* of this section is reviewable by an appropriate State authority will not preclude the community trust from meeting the requirements of paragraph (e)(11)(v)(B) of this section.

(C) *Transitional rule. (1)* Notwithstanding paragraph (e)(11)(v)(B) of this section, if a community trust meets the requirements of paragraph (e)(11)(v)(C)*(2)* of this section, then in the case of any instrument of transfer which is executed before July 19, 1977 and is not revoked or amended thereafter (with respect to any dispositive provision affecting the transfer to the community trust), and in the case of any instrument of transfer which is irrevocable on January 19, 1982, the governing body must have the power to cause proceedings to be instituted (by request to the appropriate State authority):

(i) To modify any restriction or condition on the distribution of funds for any specified charitable purposes or to specified organizations if in the judgment of the governing body such restriction or condition becomes, in effect, unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served; and *(ii)* To remove any participating trustee, custodian, or agent for breach of fiduciary duty under State law.

The necessity for the governing body to obtain the approval of a participating trustee to exercise such a power shall be treated as not preventing the governing body from having such power, unless (and until) such approval has been (or is) requested by the governing body and has been (or is) denied.

(*2*) Paragraph (e)(11)(v)(C)(*1*) of this section shall not apply unless the community trust meets the requirements of paragraph (e)(11)(v)(B) of this section, with respect to funds other than those under instruments of transfer described in the first sentence of such paragraph (e)(11)(v)(C)(*1*), by January 19, 1978, or such later date as the Commissioner may provide for such community trust, and unless the community trust does not, once it so complies, thereafter solicit for funds that will not qualify under the requirements of such paragraph (e)(11)(v)(B).

(D) *Inconsistent State law. (1)* For purposes of paragraph (e)(11)(v)(B) *(1), (2),* or *(3)* or (C)(*1*) *(i)* or (*ii*) or (E) of this section, if a power described in such a provision is inconsistent with State law even if such power were expressly granted to the governing body by the governing instrument and were accepted without limitation under an instrument of transfer, then the community trust will be treated as meeting the requirements of such a provision if it meets such requirements to the fullest extent possible consistent with State law (if such power is or had been so expressly granted).

(2) For example, if, under the conditions of paragraph (e)(11)(v)(D)(*1*) of this section, the power to modify is inconsistent with State law, but the power to institute proceedings to modify if so expressly granted, would be consistent with State law, the community trust will be treated as meeting such requirements to the fullest extent possible if the governing body has the power (in the governing instrument or otherwise) to institute proceedings to modify a condition or restriction. On the other hand, if in such a case the community trust has only the power to cause proceedings to be instituted to modify a condition or restriction, it will not be treated as meeting such requirements to the fullest extent possible.

(3) In addition, if, for example, under the conditions of paragraph (e)(11)(v)(D)(*1)* of this section, the power to modify and the power to institute proceedings to modify a condition or restriction is inconsistent with State law, but the power to cause such proceedings to be instituted would be consistent with State law, if it were expressly granted in the governing instrument and if the approval of the State Attorney General were obtained, then the community trust will be treated as meeting such requirements to the fullest extent possible if it has the power (in the governing instrument or otherwise) to cause such proceedings to be instituted, even if such proceedings can be instituted only with the approval of the State Attorney General.

(E) *Exercise of powers.* The governing body shall (by resolution or otherwise) commit itself to exercise the powers described in paragraph (e)(11)(v) (B), (C) and (D) of this section in the best interests of the community trust. The governing body will be considered not to be so committed where it has grounds to exercise such a power and fails to exercise it by taking appropriate action. Such appropriate action may include, for example, consulting with the appropriate State authority prior to taking action to replace a participating trustee.

(F) *Reasonable return.* In addition to the requirements of paragraph (e)(11)(v) (B), (C), (D) or (E) of this section, the governing body shall (by resolution or otherwise) commit itself to obtain information and take other appropriate steps with the view to seeing that each participating trustee, custodian, or agent, with respect to each restricted (within the meaning of paragraph (e)(13)(x) of this section) trust or fund that is, and with respect to the aggregate of the unrestricted trusts or funds that are, a component part of the community trust, administers such trust or fund in accordance with the terms of its governing instrument and accepted standards of fiduciary conduct to produce a reasonable return of net income (or appreciation where not inconsistent with the community trust's need for current income), with due regard to safety of principal, in furtherance of the exempt purposes of the community trust (except for assets held for the active conduct of the community trust's exempt activities). In the case of a low return of net income (and, where appropriate, appreciation), the Internal Revenue Service will examine carefully whether the governing body has, in fact, committed itself to take the appropriate steps.

(vi) *Common reports.* The organization must prepare periodic financial reports treating all of the funds which are held by the community trust, either directly or in component parts, as funds of the organization.

(vii) *Transitional rule.* If the governing instrument of a community trust (or an instrument of transfer) is inconsistent with the requirements of paragraph (e)(11) (iv) or (v) of this section but with respect to gifts or bequests acquired before January 1, 1982, the community trust changes its governing instrument (or instrument of transfer) by the later of November 11, 1977, or one year after the gift or bequest is acquired, in order to conform such instruments to such provisions, then such an instrument shall be treated as consistent with paragraph (e)(11) (iv) or (v) of this section for taxable years beginning after December 31, 1969. In addition, if prior to the later of such dates, the organization has instituted court proceedings in order to conform such an instrument, then it may apply (prior to the later of such dates) for an extension of the period to conform such instrument to such provisions. Such application shall be made to the Commissioner of Internal Revenue, Attention: E:EO, Washington, DC 20224. The Commissioner, at the Commissioner's discretion, may grant such an extension, if in the Commissioner's opinion such a change will conform the instrument to such provisions and will be made within a reasonable time.

(12) *Community trusts qualifying for 5-year transitional ruling period*—(i) *In general.* Paragraph (e) (12) and (13) of this section contain transitional rules for certain community trusts in existence before November 11, 1976 which are unable to meet the requirements of paragraph (e) (2) or (3) of this section based upon a 4-year computation period under paragraph (e)(4) of this section. A community trust that satisfies the requirements of paragraph (e)(12)(ii) of this section will be eligible for a transitional ruling or determination letter that it will be treated as a section 170(b)(1)(A)(vi) organization for a 5-year transitional ruling period (referred to in this section as ''transitional ruling or determination letter''). These transitional rules apply to:

(A) A community trust which has been in existence less than 9 taxable years before November 11, 1976; and

(B) Other community trusts that for each taxable year beginning after December 31, 1969, and before January 1, 1978, qualify as ''publicly supported'' under paragraph (e) (2) or (3) of this section based upon a computation period of either:

(1) 10 taxable years, or

(2) The number of taxable years (but not more than 20 nor less than 10) preceding such taxable year that the organization was in existence.

For special rules in applying the requirements of paragraph (e) (2) or (3) of this section based upon such computation periods, see paragraph (e)(12)(v) of this section. For purposes of paragraph (e)(12) of this section the initial taxable year of the 5-year transitional ruling period (hereinafter referred to as the ''transitional ruling period'') shall be the organization's taxable year beginning in 1977, and (unless terminated earlier) the last year of the transitional ruling period is the organization's taxable year which begins in 1981.

(ii) *Transitional 5-year ruling.* (A) If a community trust meets the requirements of paragraph (e) (11), (12) and (13) of this section and can reasonably be expected to meet the requirements of paragraph (e) (2) or (3) of this section:

(1) For each of its taxable years (if such a year begins after its tenth taxable year) beginning in 1978, 1979, 1980 and 1981 based upon a 10-year computation period, and

(2) For its taxable year beginning in 1982 based upon a 4-year computation period under paragraph (e)(4) of this section;

it may, at the discretion of the Commissioner, receive a transitional ruling or determination letter for the transitional ruling period.

(B)*(1)* However, if for the taxable year beginning in 1977, a community trust can meet the requirements of paragraph (e)(12)(i)(B) of this section only by using the computation period of its existence described in paragraph (e)(12)(i)(B)*(2)* of this section, then the community trust may meet the requirements of paragraph (e)(12)(ii)(A)*(1)* of this section if it is reasonably expected to meet the requirements of paragraph (e) (2) or (3) of this section for each of its taxable years beginning in 1978, 1979, 1980 and 1981 based upon a computation period consisting of the number of taxable years (but not more than 20 nor less than 10) preceding such taxable year that the organization was in existence.

(2) In the case of a community trust that will not have been in existence more than ten taxable years as of its taxable year beginning in 1981, a transitional ruling or determination letter for the transitional ruling period will not be granted unless the community trust can reasonably be expected to meet the requirements of paragraph (e) (2) or (3) of this section for its taxable year beginning in 1982 based upon a 4-year computation period under paragraph (e)(4) of this section and also a computation period consisting of the taxable years the organization has been in existence (other than the organization's taxable year beginning in 1982).

(C) A community trust that is eligible for a transitional ruling or determination letter must apply with the district director for such ruling or determination letter within one year after November 11, 1976. A transitional ruling or determination letter will be granted only if the requesting organization files with its request for such ruling or determination letter a consent letter under section 6501(c)(4) to the effect that the period of limitation upon assessment under section 4940 for all taxable years beginning before January 1, 1982 during the transitional ruling period shall not expire prior to 1 year after the date of the expiration of the time prescribed by law for the assessment of a deficiency for its taxable year beginning in 1981. The provisions of paragraph (e)(5)(iii) of this section (relating to reliance upon ruling) shall apply with respect to a community trust which receives a transitional ruling or determination letter and with respect to its grantors and contributors, expect that the transitional ruling period described in paragraph (e)(12)(ii) of this section shall be substituted for the advance ruling period described in paragraph (e)(5) (i) or (iv) of this section.

(D) A community trust does not have to meet the requirements of paragraph (e)(13) of this section for taxable years beginning prior to the date of its application for a transitional ruling or determination letter or for any taxable year beginning after the expiration or termination of its transitional ruling or determination letter. In applying paragraph (e)(13) of this section to organizations applying for a transitional ruling or determination letter, paragraph (e)(13) (x) and (xii) of this section (relating to unrestricted gifts and excess holdings, respectively) shall be applied without regard to assets acquired prior to November 11, 1976. In addition, if within 1 year from acquiring any asset, the community trust removes any restriction inconsistent with paragraph (e)(13) of this section, such asset shall be treated as if it were not subject to such restriction as of the time it was acquired. Since under paragraph (e)(12)(ii)(D) of this section, a community trust does not have to meet the requirements of paragraph (e)(13) of this section for taxable years beginning prior to the date of its application for the transitional ruling or determination letter, then if the community trust makes such application in its taxable year beginning 1977 and it terminates such ruling or determination letter in such year as well, such a community trust does not have to meet such requirements for any taxable year.

(E) After the transitional ruling or determination letter of an organization has expired or been terminated under paragraph (e)(12)(iii) of this section, the organization must qualify as a ''publicly supported'' organization pursuant to the rules set forth in paragraph (e) (1) through (11) of this section. Thus, since the transitional ruling period of a community trust expires with its taxable year beginning in 1981, for its taxable year beginning in 1982 and thereafter, the community trust must meet the requirements of paragraph (e) (2) or (3) of this section based upon the 4-year computation period under paragraph (e)(4) of this section.

(iii) *Termination of transitional ruling.* (A) The transitional ruling or determination letter issued under this paragraph is subject to termination under paragraph (e)(12)(iii) (B) or (D) of this section without a request from the organization. In addition, such a ruling or determination letter is subject to termination under paragraph (e)(12)(iii)(E) of this section at the request of the organization. A transitional ruling or determination letter is subject to termination for any taxable year beginning after December 31, 1976, and before January 1, 1982, under paragraph (e)(12)(iii) (B), (D) or (E) of this section.

(B) The transitional ruling or determination letter issued under this paragraph shall be terminated for any taxable year (if such a year begins after its tenth taxable year) beginning in 1978, 1979, 1980 or 1981 for which a community trust receiving such a ruling or determination letter fails to meet the requirements of paragraph (e) (2) or (3) of this section for a 10-year computation period, except as provided in paragraph (e)(12)(iii)(C) of this section.

(C) In applying paragraph (e)(12)(iii)(B) of this section to a community trust described in paragraph (e)(12)(ii)(B)*(1)* of this section, a computation period consisting of the number of taxable years (but not more than 20 nor less than 10) preceding such taxable year that the organization has been in existence shall be substituted for the 10-year computation period until the first taxable year beginning in 1978, 1979, 1980 or 1981 that the community trust can meet the requirements of paragraph (e) (2) or (3) of this section based upon a 10-year computation period.

(D) The Commissioner may, at the discretion of the Commissioner, terminate the transitional ruling or determation letter of any community trust for any taxable year beginning prior to January 1, 1982, for which the organization fails to meet the requirements of paragraph (e) (11), (12) or (13) of this section as provided in paragraph (e)(12)(ii) of this section.

(E) A community trust may request an immediate termination of the community trust's transitional ruling or determination letter in order that, for the current taxable year, it may be determined if such community trust meets the requirements of paragraph (e) (2) or (3) of this section based upon a 4-year computation period under paragraph (e)(4) of this section. Such a request shall be granted and the transitional ruling or determination letter terminated only if the community trust meets such requirements, and in the case of an organization that has been in existence less than 11 taxable years at the time of such request, the organization also meets the requirements of paragraph (e) (2) or (3) of this section for the computation period consisting of the taxable years that the organization has been in existence.

(iv) *Initial determination of status.* (A) The initial determination of status of a community trust is the first determination (other than by issuance of an advance ruling or determination letter under paragraph (e)(5) or a transitional ruling or determination letter under paragraph (e)(12)(ii) of this section) that the community trust will be considered as ''normally'' meeting the requirements of paragraph (e) (2) or (3) of this section for a period beginning with its first taxable year.

(B)*(1)* In the case of a community trust described in paragraph (e)(12)(i)(B) of this section, the initial determination of status shall be made for the community trust's taxable year beginning in 1977 if such community trust has met the requirements of paragraph (e) (2) or (3) of this section for its taxable year beginning in 1977, based upon a 10-year computation period.

(2) In the case of any other community trust described in paragraph (e)(12)(i)(B) of this section (but not described in paragraph (e)(12)(iv) (B)*(1)* of this section), the initial determination of status shall be made for its first taxable year beginning after December 31, 1976 and before January 1, 1982, for which it meets the requirements of paragraph (e) (2) or (3) of this section based upon a 10-year computation period (if the community trust has received a transitional ruling or determination letter that has not been terminated before such taxable year).

(C) In the case of a community trust described in paragraph (e)(12)(i)(A) of this section (relating to an organization in existence less than 9 taxable years) that reaches its 11th taxable year before its taxable year beginning in 1982, its initial determination of status a 10-year computation period (if it has received a transitional ruling or determination letter that has not been terminated before such taxable year).

(D) If a community trust has not received an initial determination of status shall be for its 11th taxable year based upon prior to the expiration or termination of its transitional ruling period, the initial determination of status shall be made:

(1) In the case of an expiration, for the taxable year beginning in 1982, or

(2) In the case of a termination, for the last taxable year of the terminated transitional period.

Based upon a 4-year computation period under paragraph (e)(4) of this section. In the case of an organization that has been in existence less than 11 taxable years at such time, the initial determination of status shall also be based upon a computation period consisting of the taxable years it has been in existence. For example, if the initial determination of status (for an organization that has been in existence for at least 11 taxable years) is made for its taxable year beginning in 1982, then, except as provided in paragraph (e)(4)(v) of this section (relating to exception for material changes of support), such determination shall be based upon a 4-year computation period ending with the taxable year beginning in 1980 or 1981 (treating the taxable year beginning in 1982, as the subsequent year or current year, respectively).

On the other hand, if, for example, the transitional ruling or determination letter is terminated in the taxable year beginning in 1980, then, except as provided in such paragraph (e)(4)(v), the initial determination of status shall be made for the taxable year beginning in 1980 based upon the 4-year computation period ending with the taxable year beginning in 1978 or 1979.

(v) *Special rules*—(A) Consequences of organization failing to meet requirements at end of transitional period. If upon the expiration (or termination) of the transitional period an organization with a transitional ruling or determination letter fails to meet the requirements of paragraph (e) (2) or (3) of this section based upon the 4-year computation period of paragraph (e)(4) of this section, it shall not be treated as an organization described in section 170(b)(1)(A)(vi) for its taxable year beginning in 1982 (or for the last taxable year of its terminated transitional period, as the case may be). If, by reason of failing to qualify as an organization described in section 170(b)(1)(A)(vi), such organization becomes a private foundation, then the organization will be a private foundation for its taxable year beginning in 1982 (or the last taxable year of its terminated transitional period, as the case may be) and all subsequent taxable years, unless and until it terminates its status under section 507. In addition, such an organization is a private foundation for all taxable years beginning prior to its taxable year beginning in 1982 (or for the last taxable year of the terminated transition period, as the case may be), except:

(1) That if the organization had received an initial determination of status that it met the requirements of paragraph (e) (2) or (3) of this section, then the organization will be treated as ''publicly supported'' for the taxable

years to which the initial determination of status is effective, as well as for all taxable years beginning after the last of such years and before January 1, 1982, for which the organization consecutively meets the requirements of paragraph (e) (2) or (3) of this section based upon a 10-year computation period,

(2) That in the case of an organization that has reached its tenth taxable year of existence before January 1, 1970, if the organization has not received an initial determination of status prior to its taxable year beginning in 1982, then the organization will be treated as ''publicly supported'' for each taxable year beginning before January 1, 1977, that the organization, beginning with the taxable year beginning in 1970, consecutively met the requirements of paragraph (e) (2) or (3) of this section based upon a 10-year computation period, or

(3) That in the case of an organization whose 11th taxable year of its existence began after December 31, 1970 and before January 1, 1977, if the organization has not received an initial determination of status prior to its taxable year beginning in 1982, but the organization for its 11th taxable year of existence met the requirements of paragraph (e) (2) or (3) of this section based upon a 10-year computation period, then the organization will be treated as ''publicly supported'' for the first 12 taxable years of its existence. In addition, such an organization will be so treated for its 13th taxable year and each subsequent taxable year (if such a year begins before January 1, 1977) that the organization, beginning with its 12th taxable year, consecutively met the requirements of paragraph (e) (2) or (3) of this section based upon a 10-year computation period.

(4) To the extent provided in paragraph (e)(4)(vii) of this section (relating to special rule for organization with existing rulings), § 1.508–1(b) (relating to notice that an organization is not a private foundation) or § 1.509(a)–7 (relating to reliance by grantors and contributors to section 509(a) (1), (2), and (3) organizations).

(B) *Computation period.* In applying the requirements of paragraph (e) (2) or (3) of this section to a 10-year or other computation period under paragraph (e) (12) or (13) of this section, such 10-year or other computation period shall be substituted for the 4-year computation period of paragraph (e)(4) of this section. Thus, for example, an organization will (except as provided in paragraph (e)(4)(v) of this section relating to exemption for material changes in sources of support) meet the ''publicly supported'' test of this paragraph for the taxable year beginning in 1977 based upon a 10-year computation period, if it met the requirements of paragraph (e) (2) or (3) of this section for a computation period consisting of either the taxable years beginning in the years 1966 through 1975 or the years 1967 through 1976, since under paragraph (e)(4) of this section, meeting the requirements for a computation period is effective for the current taxable year and the immediately succeeding taxable year. However, in substituting a 10-year or other computation period for the 4-year computation period of paragraph (e)(4) of this section, the rules of such paragraph (e) (4) and (6) apply, including the 2-percent limitation under paragraph (e)(6)(i) of this section and the exclusion for unusual grants under paragraph (e)(6)(ii) of this section. In applying such provisions, the fact that the computation period is other than a 4-year computation period shall be taken into account, so that, for example, the 2-percent limitation shall be applied, in the case of a 10-year computation period, with reference to 2 percent of the organization's total support for the 10-year computation period rather than a 4-year computation period.

In addition, in substituting a 10-year or other computation period for purposes of paragraph (e)(3) of this section, all of the facts and circumstances referred to in such paragraph (e)(3) shall be considered with respect to such period, viewing such period as a whole. See, also, paragraph (e)(10) of this section with respect to the organization being organized and operated to attract public support.

(C) *First taxable year of less than 8 months.* In the case of an organization whose first taxable year consisted of less than 8 months, in order to coordinate the rules of paragraph (e)(12) of this section with the rules of paragraph (e)(5) of this section, in applying the rules of paragraph (e)(12) of this section, such an organization shall be treated as organized at the beginning of its succeeding taxable year, so that such succeeding taxable year shall be treated as its first taxable year of existence. However, the support received for the period preceding such succeeding taxable year shall be taken into account with the support received in such succeeding taxable year.

(13) *Community trusts; requirements for 5-year transitional ruling period*—(i) *In general.* In order for a community trust to be eligible for a transitional ruling or determination letter for the transitional ruling period under paragraph (e)(12) of this section, it must establish that it is organized, and will be operated, in such manner that it can reasonably be expected to meet the requirements of paragraph (e)(13) of this section, and can reasonably be expected to meet the requirements of paragraph (e) (2) or (3) of this section, for each taxable year during and immediately following the transitional ruling period, as provided in paragraph (e)(12)(ii) of this section. In determining whether an organization can reasonably be expected to meet the requirements of paragraph (e) (2) or (3) of this section for each such taxable year, the basic consideration is whether its organizational structure, proposed programs or activities, and intended method of operation are such as to attract the type of broadly based support from the general public, public charities, and governmental units which is necessary to meet such tests. The information to be considered for this purpose shall consist of all pertinent facts and circumstances relating to the requirements set forth in paragraph (e)(3) of this section. For purposes of meeting the requirements of paragraph (e)(13) of this section, a community trust may, prior to its application for a transitional ruling or determination letter under paragraph (e)(12)(i)(C) of this section, adopt a resolution stating that, as a matter of policy, it will attempt to meet the conditions set forth in paragraph (e)(13) of this section during the transitional ruling period. A community trust will not be treated as failing to satisfy the requirements of paragraph (e)(13) of this section merely because the governing body, or any of its trustees, agents, or custodians, fails to meet one or more of the requirements contained in paragraph (e)(13) (ii) through (xiii) of this section by reason of isolated and nonrepetitive acts. However, any continuing pattern on the part of the governing body, or its trustees, agents or custodians, indicating a continued and repetitive failure to comply with a policy of meeting such requirements will result in termination of the transitional ruling or determination letter under paragraph (e)(12)(iii)(D) of this section.

(ii) *Area.* The community trust is organized and operated exclusively to carry out charitable purposes (within the meeting of section 170(c) (1) or (2)(B)) primarily within a broad geographical area which it serves, such as a municipality, county, metropolitan area, State or region.

(iii) *General composition of governing body.* The governing body must represent the board interests of the public rather than the personal or private interests of a limited number of donors. An organization will be treated as meeting this requirement if it has a governing body comprised of public officials acting in their capacities as such; individuals selected by public officials acting in their capacities as such; persons having special knowledge or expertise in a particular field or discipline in which the community trust operates; community leaders, such as elected or appointed officials, clergymen, educators, civic leaders; or other such persons representing a broad cross-section of the views and interests of the area served.

(iv) *Rules for governing body.* With respect to terms of office beginning after the date of the application of the community trust for a transitional ruling or determination letter:

(A) Its governing body is comprised of members who may serve a period of not more than ten consecutive years;

(B) Upon completion of a period of service (beginning before or after such date) no person may serve within a period consisting of the lesser of 5 years or the number of consecutive years the member has immediately completed serving;

(C) Persons who would be described in section 4946(a)(1) (A) or (C) through (G) if the community trust were a private foundation do not constitute more than one-third of its governing body; and

(D) Representatives of banks or trust companies which serve as trustees, investment managers, custodians, or agents, plus persons described in paragraph (e)(13)(iv)(C) of this section, do not constitute a majority of the governing body.

No term of office beginning on or before the date of such application may continue for more than 10 years from such date.

(v) *Fiduciary responsibility.* Fiduciary responsibility with respect to the funds of the community trust is imposed, either by the master trust or agency agreement or by State law, on either its governing body or its trustee banks or trust companies or both.

(vi) *Ultimate control of assets.* Neither its governing body, nor any of its trustees, investment managers, custodians or agents may be subjected by any donor to the community trust to any material condition or restriction within the meaning of §1.507–2(a)(8) which would prevent it from exercising ultimate control over its assets.

(vii) *Administration.* Administration and investment of all gifts and bequests are accomplished through:

(A) A governing body which directly holds, administers or invests such gifts and bequests exclusively for charitable purposes;

(B) Banks or trust companies (acting or appointed as trustees), investment managers, custodians or agents of the community trust or one or more components thereof; or

(C) A combination of such persons.

(viii) *Annual distributions.* It makes annual distributions for purposes described in section 170(c) (1) or (2)(B), including administrative expenses and amounts paid to acquire an asset used (or held for use) directly in carrying out one or more of such purposes, in an amount not less than its adjusted net income (as defined in section 4942(f)). For purposes of paragraph (e)(13)(viii) of this section, the term ‘‘distributions’’ shall include amounts set aside for a specific project, but only if prior to making the set-aside the organization has, pursuant to a request for a ruling, established to the satisfaction of the Commissioner that:

(A) The amount will be paid for the specific project within 5 years; and

(B) The project is one which can be better accomplished by such set-aside than by immediate distribution of funds.

All annual distributions required to be made pursuant to paragraph (e)(13)(viii) of this section, except for set-asides, must be made no later than the close of the organization’s first taxable year after the taxable year for which the adjusted net income is computed. Thus, in the case of a calendar year community trust which has received a transitional ruling or determination letter upon an application made in 1977, it must make distributions under paragraph (e)(13)(vii) of this section for 1978, 1979, 1980 and 1981 based upon its adjusted net income for 1977, 1978, 1979 and 1980, respectively, unless its transitional ruling or determination letter is terminated. If such a community trust’s transitional ruling or determination letter is terminated in 1979, it must make distributions under paragraph (e)(13)(viii) of this section only for 1978 based upon its adjusted net income for 1977. On the other hand, if such ruling or letter is terminated in 1977 or 1978, no distribution under paragraph (e)(13)(viii) of this section need be made.

(ix) *Net income.* The community trust’s funds must, on an aggregate basis, be invested to produce an annual adjusted net income (as defined in section 4942(f)) of not less than two-thirds of what would be its minimum investment return (within the meaning of section 4942(e)) if such organization were a private foundation.

(x) *Unrestricted gifts.* At least one-half of the total income which the community trust derives from the investment of gifts and bequests received must be unrestricted (within the meaning of this (x)) with respect to its availability for distribution by the governing body. For purposes of this (x), any income which has been designated by the donor of the gift or bequest to which such income is attributable as being available only for the use or benefit of a broad charitable purpose, such as the encouragement of higher education or the promotion of better health care in the community, will be treated as unrestricted. However, any income which has been designated for the use or benefit of a named charitable organization or agency or for the use or benefit of a particular class of charitable organizations or agencies, the members of which are readily ascertainable and are less than five in number, will be treated as restricted.

(xi) *Self-dealing.* The community trust may not engage in any act with any person (other than a foundation manager acting only in such capacity) which would constitute self-dealing within the meaning of section 4941 if such community trust were a private foundation.

(xii) *Excess holdings.* The community trust must dispose of any holdings which would constitute excess business holdings (within the meaning of section 4943—applied on a component-by-component basis as if each component were a private foundation, except that components will be combined for purposes of this paragraph if such components would have been described in section 4946(a)(1)(H)(ii)).

(xiii) *Expenditure responsibility.* The community trust must exercise expenditure responsibility (within the meaning of section 4945(h)) through either its governing body, trustees, investment managers, custodians, or agents with respect to any grant which would otherwise constitute a taxable expenditure under section 4945(d)(4) if the community trust were a private foundation, except that it need not make the reports required of private foundations by section 4945(h)(3).

(14) *Community trusts; treatment of trusts and not-for-profit corporations and associations not included as components.* (i) For purposes of sections 170, 501, 507, 508, 509 and Chapter 42, any trust or not-for-profit corporation or association which is alleged to be a component part of a community trust, but which fails to meet the requirements of paragraph (e)(11)(ii) of this section, shall not be treated as a component part of a community trust and, if a trust, shall be treated as a separate trust and be subject to the provisions of section 501 or section 4947(a) (1) or (2), as the case may be. If such organization is a not-for-profit corporation or association, it will be treated as a separate entity, and, if it is described in section 501(c)(3), it will be treated as a private foundation unless it is described in section 509(a) (1), (2), (3), or (4). Any transfer made in connection with the creation of such separate trust or not-for-profit organization, or to such entity, will not be treated as being made ‘‘to’’ the community trust or one of its components for purposes of sections 170(b)(1)(A) and 507(b)(1)(A) even though a deduction with respect to such transfer is allowable under §1,170–1(e), §20.2055–2(b), or §25.2522(a)–2(b), unless such treatment is permitted under §1.170A–9(e)(4)(v)*(b)* or §1.508–1(b)(4). In the case of a fund which is ultimately treated as not being a component part of a community trust pursuant to paragraph (e)(14) of this section, if the Forms 990 filed annually by the community trust included financial information with respect to such fund and treated such fund in the same manner as other component parts thereof, such returns filed by the community trust prior to the taxable year in which the Commissioner notifies such fund that it will not be treated as a component part will be treated as its separate return for purpose of Subchapter A of Chapter 61 of Subtitle F, and the first such return filed by the community trust will be treated as the notification required of the separate entity for purposes of section 508(a).

(ii) If a transfer is made in trust to a community trust to make income or other payments for a period of a life or lives in being or a term of years to any individual or for any noncharitable purpose, followed by payments to or for the use of the community trust (such as in the case of a charitable remainder annuity trust or a charitable remainder unitrust described in section 664 or a pooled income fund described in section 642(c)(5)), such trust will be treated as a component part of the community trust upon the termination of all intervening noncharitable interests and rights to the actual possession or enjoyment of the property if such trust satisfies the requirements of paragraph (e)(11) of this section at such time. Until such time, the trust will be treated as a separate trust. If a transfer is made in trust to a community trust to make income or other payments to or for the use of the community trust, followed by payments to any individual or for any noncharitable purpose, such trust will be treated as a separate trust rather than as a component part of the community trust. See section 4947(a)(2) and the regulations thereunder for the treatment of such split-interest trusts. The provisions of this (ii) only provide rules for determining when a charitable remainder trust or pooled income fund may be treated as a component part of a community trust and are not intended to preclude a community trust from maintaining a charitable remainder trust or pooled income fund. Thus, for purposes of grantors and contributors, a pooled income fund of a ‘‘publicly supported’’ community trust shall be treated no differently than a pooled income fund of any other ‘‘publicly supported’’ organization.

(iii) An organization described in section 170(b)(1)(E)(iii) will not ordinarily satisfy the requirements of paragraph (e)(11)(ii) of this section because of the unqualified right of the donor to designate the recipients of the income and principal of the trust. Such organization will therefore ordinarily be treated as other than a component part of a community trust under paragraph (e)(14)(i) of this section. However, see section 170(b)(1)(E)(iii) and the regulations thereunder with respect to the treatment of contributions to such organizations.

(f) *Private operating foundation.* An organization is described in section 170(b)(1) (A)(vii) and (E)(i) if it is a private ‘‘operating foundation’’ as defined in section 4942(j)(3) and the regulations thereunder.

(g) *Private nonoperating foundation distributing amount equal to all contributions received*—(1) *In general.* (i) An organization is described in section 170(b)(1) (A)(vii) and (E)(ii) if it is a private foundation which, not later than the 15th day of the third month after the close of its taxable year in which any contributions are received, distributes an amount equal in value to 100 percent of all contributions received in such year. Such distributions must be qualifying distributions (as defined in section 4942(g) without regard to paragraph (3) thereof) which are treated, after the application of section 4942(g)(3), as distributions out of corpus in accordance with section 4942(h). Qualifying distributions, as defined in section 4942(g) without regard to paragraph (3) thereof, cannot be made to (i) an organization controlled directly or indirectly by the foundation or by one or more disqualified persons (as defined in section 4946) with respect to the foundation or (ii) a private foundation which is not an operating foundation (as defined in section 4942(j)(3)). The phrase ‘‘after the application of section 4942(g)(3)’’ means that every contribution described in section 4942(g)(3) received by a private foundation described in this subparagraph in a particular taxable year must be distributed (within the meaning of section 4942(g)(3)(A)) by such foundation not later than the 15th day of the third month after the close of such taxable year in order for any other distribution by such foundation to be counted toward the 100-percent requirement described in this subparagraph.

(ii) In order for an organization to meet the distribution requirements of subdivision (i) of this subparagraph, it must, not later than the 15th day of the third month after the close of its taxable year in which any contributions are received, distribute (within the meaning of subdivision (i) of this subparagraph) an amount equal in value to 100 percent of all contributions received in such year and have no remaining undistributed income for such year.

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

Example 1. X is a private foundation on a calendar year basis. As of January 1, 1971, X had no undistributed income for 1970. X’s distributable amount for 1971 was $600,000. In July 1971, A, an individual, contributed $500,000 (fair market value determined at the time of the contribution) of appreciated property to X (which, if sold, would give rise to long-term capital gain). X did not receive any other contribution in either 1970 or 1971. During 1971, X made qualifying distributions of $700,000 which were treated as made out of the undistributed income for 1971 and $100,000 out of corpus. X will meet the requirements of section 170(b)(1)(E)(ii) for 1971 if it makes additional qualifying distributions of $400,000 out of corpus by March 15, 1972.

Example 2. Assume the facts as stated in *Example 1,* except that as of January 1, 1971, X had $100,000 of undistributed income for 1970. Under these circumstances, the $700,000 distributed by X in 1971 would be treated as made out of the undistributed income for 1970 and 1971. X would therefore have to make additional qualifying distributions of $500,000 out of corpus between January 1, 1972, and March 15, 1972, in order to meet the requirements of section 170(b)(1)(E)(ii) for 1971.

(2) *Special rules.* In applying subparagraph (1) of this paragraph:

(i) For purposes of section 170(b)(1)(A)(vii), an organization described in section 170(b)(1)(E)(ii) must distribute all contributions received in any year, whether of cash or property. However, solely for purposes of section 170(e)(1)(B)(ii), an organization described in section 170(b)(1)(E)(ii) is required to distribute all contributions of property only received in any year. Contributions for purposes of this paragraph do not include bequests, legacies, devises, or transfers within the meaning of section 2055 or 2106(a)(2) with respect to which a deduction was not allowed under section 170.

(ii) Any distributions made by a private foundation pursuant to subparagraph (1) of this paragraph with respect to a particular taxable year shall be treated as made first out of contributions of property and then out of contributions of cash received by such foundation in such year.

(iii) A private foundation is not required to trace specific contributions of property, or amounts into which such contributions are converted, to specific distributions.

(iv) For purposes of satisfying the requirements of section 170(b)(1)(D)(ii), except as provided to the contrary in this subdivision (iv), the fair market value of contributed property, determined on the date of contribution, is required to be used for purposes of determining whether an amount equal in value to 100 percent of the contribution received has been distributed. However, reasonable selling expenses, if any, incurred by the foundation in the sale of the contributed property may be deducted from the fair market value of the contributed property on the date of contribution, and distribution of the balance of the fair market value will satisfy the 100 percent distribution requirement. If a private foundation receives a contribution of property and, within 30 days thereafter, either sells the property or makes an in kind distribution of the property to a public charity, then at the choice of the private foundation the gross amount received on the sale (less reasonable selling expenses incurred) or the fair market value of the contributed property at the date of its distribution to the public charity, and not the fair market value of the contributed property on the sale of contribution (less reasonable selling expenses, if any), is considered to be the amount of the fair market value of the contributed property for purposes of the requirements of section 170(b)(1)(D)(ii).

(v) A private foundation may satisfy the requirements of subparagraph (1) of this paragraph for a particular taxable year by electing (pursuant to section 4942(h)(2) and the regulations thereunder) to treat a portion or all of one or more distributions, made not later than the 15th day of the third month after the close of such year, as made out of corpus.

(3) *Transitional rules*—(i) *Taxable years beginning before January 1, 1970, and ending after December 31, 1969.* In order for an organization to meet the distribution requirements of subparagraph (1)(i) of this paragraph for a taxable year which begins before January 1, 1970, and ends after December 31, 1969, it must, not later than the 15th day of the third month after the close of such taxable year, distribute (within the meaning of subparagraph (1)(i) of this paragraph) an amount equal in value to 100 percent of all contributions (other than contributions described in section 4942(g)(3)) which were received between January 1, 1970, and the last day of such taxable year. Because the organization is not subject to the provisions of section 4942 for such year, the organization need not satisfy subparagraph (1)(ii) of this paragraph or the phrase ‘‘after the application of section 4942(g)(3)’’ for such year.

(ii) *Extension of period.* For purposes of section 170(b)(1)(A)(vii) and 170(e)(1)(B)(ii), in the case of a taxable year ending in either 1970, 1971 or 1972, the period referred to in section 170(b)(1)(E)(ii) for making distributions shall not expire before April 2, 1973.

(4) *Adequate records required.* A taxpayer claiming a deduction under section 170 for a charitable contribution to a foundation described in subparagraph (1) of this paragraph must obtain adequate records or other sufficient evidence from such foundation showing that the foundation made the required qualifying distributions within the time prescribed. Such records or other evidence must be attached to the taxpayer's return for the taxable year for which the charitable contribution deduction is claimed. If necessary, an amended income tax return or claim for refund may be filed in accordance with § 301.6402–2 and § 301.6402–3 of this chapter (procedure and administration regulations).

(h) *Private foundation maintaining a common fund*—(1) *Designation by substantial contributors.* An organization is described in section 170(b)(1) (A)(vii) and (E)(iii) if it is a private foundation all of the contributions to which are pooled in a common fund and which would be described in section 509(a)(3) but for the right of any donor who is a substantial contributor or his spouse to designate annually the recipients, from among public charities, of the income attributable to the donor's contribution to the fund and to direct (by deed or by will) the payment, to public charities, of the corpus in the common fund attributable to the donor's contribution. For purposes of this paragraph, the private foundation is to be treated as meeting the requirements of section 509(a)(3) (A) and (B) even though donors to the foundation, or their spouses, retain the right to, and in fact do, designate public charities to receive income or corpus from the fund.

(2) *Distribution requirements.* To qualify under subparagraph (1) of this paragraph, the private foundation described therein must be required by its governing instrument to distribute, and it must in fact distribute (including administrative expenses):

(i) All of the adjusted net income (as defined in section 4942(f)) of the common fund to one or more public charities not later than the 15th day of the third month after the close of the taxable year in which such income is realized by the fund, and

(ii) All the corpus attributable to any donor's contribution to the fund to one or more public charities not later than 1 year after the donor's death or after the death of the donor's surviving spouse if such surviving spouse has the right to designate the recipients of such corpus.

(3) *Failure to designate.* A private foundation will not fail to qualify under this paragraph merely because a substantial contributor or his spouse fails to exercise his right to designate the recipients of income or corpus of the fund, provided that the income and corpus attributable to his contribution are distributed as required by subparagraph (2) of this paragraph.

(4) *Definitions.* For purposes of this paragraph:

(i) The term *substantial contributor* is as defined in section 507(d)(2) and the regulations thereunder.

(ii) The term *public charity* means an organization described in section 170(b)(1)(A) (i) through (vi). If an organization is described in section 170(b)(1)(A) (i) through (vi), and is also described in section 170(b)(1)(A)(viii), it shall be treated as a public charity for purposes of this paragraph.

(iii) The term *income attributable to* means the income earned by the fund which is properly allocable to the contributed amount by any reasonable and consistently applied method. See, for example, § 1.642(c)–5(c).

(iv) The term *corpus attributable to* means the portion of the corpus of the fund attributable to the contributed amount. Such portion may be determined by any reasonable and consistently applied method.

(v) The term *donor* means any individual who makes a contribution (whether of cash or property) to the private foundation, whether or not such individual is a substantial contributor.

(i) *Section 509(a) (2) or (3) organization.* An organization is described in section

170(b)(1)(A)(viii) if it is described in section 509(a) (2) or (3) and the regulations thereunder.

[T.D. 7242, 38 FR 12, Jan. 3, 1973; 38 FR 3598, Feb. 8, 1973, as amended by T.D. 7406, 41 FR 7096, Feb. 17, 1976; T.D. 7440, 41 FR 50650, Nov. 17, 1976; T.D. 7456, 42 FR 4436, Jan. 25, 1977; T.D. 7679, 45 FR 13452, Feb. 29, 1980; T.D. 8100, 51 FR 31614, Sept. 4, 1986]

§1.170A–10 Charitable contributions carryovers of individuals.

(a) *In general.* (1) Section 170(d)(1), relating to carryover of charitable contributions in excess of 50 percent of contribution base, and section 170(b)(1)(D)(ii), relating to carryover of charitable contributions in excess of 30 percent of contribution base, provide for excess charitable contributions carryovers by individuals of charitable contributions to section 170(b)(1)(A) organizations described in §1.170A–9. These carryovers shall be determined as provided in paragraphs (b) and (c) of this section. No excess charitable contributions carryover shall be allowed with respect to contributions ‘‘for the use of,’’ rather than ‘‘to,’’ section 170(b)(1)(A) organizations or with respect to contributions ‘‘to’’ or ‘‘for the use of’’ organizations which are not section 170(b)(1)(A) organizations. See §1.170A–8(a)(2) for definitions of ‘‘to’’ or ‘‘for the use of’’ a charitable organization.

(2) The carryover provisions apply with respect to contributions made during a taxable year in excess of the applicable percentage limitation even though the taxpayer elects under section 144 to take the standard deduction in that year instead of itemizing the deduction allowable in computing taxable income for that year.

(3) For provisions requiring a reduction of the excess charitable contribution computed under paragraph (b)(1) or (c)(1) of this section when there is a net operating loss carryover to the taxable year, see paragraph (d)(1) of this section.

(4) The provisions of section 170 (b)(1)(D)(ii) and (d)(1) and this section do not apply to contributions by an estate; nor do they apply to a trust unless the trust is a private foundation which, pursuant to §1.642(c)–4, is allowed a deduction under section 170 subject to the provisions applicable to individuals.

(b) *50-percent charitable contributions carryover of individuals*—(1) *Computation of excess of charitable contributions made in a contribution year.* Under section 170(d)(1), subject to certain conditions and limitations, the excess of:

(i) The amount of the charitable contributions made by an individual in a taxable year (hereinafter) in this paragraph referred to as the ‘‘contribution year’’) to section 170(b)(1)(A) organizations described in §1.170A–9, over

(ii) 50 percent of his contribution base, as defined in section 170(b)(1)(F), for such contribution year, shall be treated as a charitable contribution paid by him to a section 170(b)(1)(A) organization in each of the 5 taxable years immediately succeeding the contribution year in order of time. However, such excess to the extent it consists of contributions of 30-percent capital gain property, as defined in §1.170A–8(d)(3), shall be subject to the rules of section 170(b)(1)(D)(ii) and paragraph (c) of this section in the years to which it is carried over. A charitable contribution made in a taxable year beginning before January 1, 1970, to a section 170(b)(1)(A) organization and carried over to a taxable year beginning after December 31, 1969, under section 170(b)(5) (before its amendment by the Tax Reform Act of 1969) shall be treated in such taxable year beginning after December 31, 1969, as a charitable contribution of cash subject to the limitations of this paragraph, whether or not such carryover consists of contributions of 30-percent capital gain property or of ordinary income property described in §1.170A–4(b)(1). For purposes of applying this paragraph and paragraph (c) of this section, such a carryover from a taxable year beginning before January 1, 1970, which is so treated as paid to a section 170(b)(1)(A) organization in a taxable year beginning after December 31, 1969, shall be treated as paid to such an organization under section 170(d)(1) and this section. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Assume that H and W (husband and wife) have a contribution base for 1970 of $50,000 and for 1971 of $40,000 and file a joint return for each year. Assume further that in 1970 they make a charitable contribution in cash of $26,500 to a church and $1,000 to X (not a section 170(b)(1)(A) organization) and in 1971 they make a charitable contribution in cash of $19,000 to a church and $600 to X. They may claim a charitable contributions deduction of $25,000 in 1970, and the excess of $26,500 (contribution to the church) over $25,000 (50 percent of contribution base), or $1,500, constitutes a charitable contributions carryover which shall be treated as a charitable contribution paid by them to a section 170(b)(1)(A) organization in each of the 5 succeeding taxable years in order of time. No carryover is allowed with respect to the $1,000 contribution made to X in 1970. Since 50 percent of their contribution base for 1971 ($20,000) exceeds the charitable contributions of $19,000 made by them in 1971 to section 170(b)(1)(A) organizations (computed without regard to section 170 (b)(1)(D)(ii) and (d)(1) and this section), the portion of the 1970 carryover equal to such excess of $1,000 ($20,000 minus $19,000) is treated, pursuant to the provisions of subparagraph (2) of this paragraph, as paid to a section 170(b)(1)(A) organization in 1971; the remaining $500 constitutes an unused charitable contributions carryover. No deduction for 1971, and no carryover, are allowed with respect to the $600 contribution made to X in 1971.

Example 2. Assume the same facts as in *Example (1)* except that H and W have a contribution base for 1971 of $42,000. Since 50 percent of their contribution base for 1971 ($21,000) exceeds by $2,000 the charitable contribution of $19,000 made by them in 1971 to the section 170(b)(1)(A) organization (computed without regard to section 170 (b)(1)(D)(ii) and (d)(1) and this section), the full amount of the 1970 carryover of $1,500 is treated, pursuant to the provisions of subparagraph (2) of this paragraph, as paid to a section 170(b)(1)(A) organization in 1971. They may also claim a charitable contribution of $500 ($21,000 −$20,500[$19,000+$1,500]) with respect to the gift to X in 1971. No carryover is allowed with respect to the $100 ($600−$500) of the contribution to X which is not deductible in 1971.

(2) *Determination of amount treated as paid in taxable years succeeding contribution year.* In applying the provisions of subparagraph (1) of this paragraph, the amount of the excess computed in accordance with the provisions of such subparagraph and paragraph (d)(1) of this section which is to be treated as paid in any one of the 5 taxable years immediately succeeding the contribution year to a section 170(b)(1)(A) organization shall not exceed the lesser of the amounts computed under subdivisions (i) to (iii), inclusive, of this subparagraph:

(i) The amount by which 50 percent of the taxpayer's contribution base for such succeeding taxable year exceeds the sum of:

(a) The charitable contributions actually made (computed without regard to the provisions of section 170 (b)(1)(D)(ii) and (d)(1) and this section) by the taxpayer in such succeeding taxable year to section 170(b)(1)(A) organizations, and

(b) The charitable contributions, other than contributions of 30-percent capital gain property, made to section 170(b)(1)(A) organizations in taxable years preceding the contribution year which, pursuant to the provisions of section 170(d)(1) and this section, are treated as having been paid to a section 170(b)(1)(A) organization in such succeeding year.

(ii) In the case of the first taxable year succeeding the contribution year, the amount of the excess charitable contribution in the contribution year, computed under subparagraph (1) of this paragraph and paragraph (d)(1) of this section.

(iii) In the case of the second, third, fourth, and fifth taxable years succeeding the contribution year, the portion of the excess charitable contribution in the contribution year, computed under subparagraph (1) of this paragraph and paragraph (d)(1) of this section, which has not been treated as paid to a section 170(b)(1)(A) organization in a year intervening between the contribution year and such succeeding taxable year.

For purposes of applying subdivision (i)*(a)* of this subparagraph, the amount of charitable contributions of 30-percent capital gain property actually made in a taxable year succeeding the contribution year shall be determined by first applying the 30-percent limitation of section 170(b)(1)(D)(i) and paragraph (d) of § 1.170A–8. If a taxpayer, in any one of the 4 taxable years succeeding a contribution year, elects under section 144 to take the standard deduction instead of itemizing the deductions allowable in computing taxable income, there shall be treated as paid (but not allowable as a deduction) in such standard deduction year the lesser of the amounts determined under subdivisions (i) to (iii), inclusive, of this subparagraph. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Assume that B has a contribution base for 1970 of $20,000 and for 1971 of $30,000. Assume further that in 1970 B contributed $12,000 in cash to a church and in 1971 he contributed $13,500 in cash to the church. B may claim a charitable contributions deduction of $10,000 in 1970, and the excess of $12,000 (contribution to the church) over $10,000 (50 percent of B's contribution base), or $2,000, constitutes a charitable contributions carryover which shall be treated as a charitable contribution paid by B to a section 170(b)(1)(A) organization in the 5 taxable years succeeding 1970 in order of time. B may claim a charitable contributions deduction of $15,000 in 1971. Such $15,000 consists of the $13,500 contribution to the church in 1971 and $1,500 carried over from 1970 and treated as a charitable contribution paid to a section 170(b)(1)(A) organization in 1971. The $1,500 contribution treated as paid in 1971 is computed as follows:

1970 excess contributions		$2,000
50 percent of B's contribution base for 1971		15,000
Less:		
Contributions actually made in 1971 to section 170(b)(1)(A) organizations	$13,500	
Contributions made to section 170(b)(1)(A) organizations in taxable years prior to 1970 treated as having been paid in 1971	0	13,500
Balance		1,500
Amount of 1970 excess treated as paid in 1971—the lesser of $2,000 (1970 excess contributions) or $1,500 (excess of 50 percent of contribution base for 1971 ($15,000) over the sum of the section 170(b)(1)(A) contributions actually made in 1971 ($13,500) and the section 170(b)(1)(A) contributions made in years prior to 1970 treated as having been paid in 1971 ($0))		1,500

If the excess contributions made by B in 1970 had been $1,000 instead of $2,000, then, for purposes of this example, the amount of the 1970 excess treated as paid in 1971 would be $1,000 rather than $1,500.

Example 2. Assume the same facts as in *Example (1)*, and, in addition, that B has a contribution base for 1972 of $10,000 and for 1973 of $20,000. Assume further with respect to 1972 that B elects under section 144 to take the standard deduction in computing taxable income and that his actual contributions to section 170(b)(1)(A) organizations in that year are $300 in cash. Assume further with respect to 1973 that R itemizes his deductions, which include a $5,000 cash contribution to a church. B's deductions for 1972 are not increased by reason of the $500 available as a charitable contributions carryover from 1970 (excess contributions made in 1970 ($2,000) less the amount of such excess treated as paid in 1971 ($1,500)), since B elected to take the standard deduction in 1972. However, for purposes of determining the amount of the excess charitable contributions made in 1970 which is available as a carryover to 1973, B is required to treat such $500 as a charitable contribution paid in 1972—the lesser of $500 or $4,700 (50 percent of contribution base ($5,000) over contributions actually made in 1972 to section 170(b)(1)(A) organizations ($300)). Therefore, even though the $5,000 contribution made by B in 1973 to a church does not amount to 50 percent of B's contribution base for 1973 (50 percent of $20,000), B may claim a charitable contributions deduction of only the $5,000 actually paid in 1973 since the entire excess charitable contribution made in 1970 ($2,000) has been treated as paid in 1971 ($1,500) and 1972 ($500).

Example 3. Assume the following factual situation for C who itemizes his deductions in computing taxable income for each of the years set forth in the example:

	1970	1971	1972	1973	1974
Contribution base	$10,000	$7,000	$15,000	$10,000	$9,000
Contributions of cash to section 170(b)(1)(A) organizations (no other contributions)	6,000	4,400	8,000	3,000	1,500
Allowable charitable contributions deductions computed without regard to carryover of contributions	5,000	3,500	7,500	3,000	1,500
Excess contributions for taxable year to be treated as paid in 5 succeeding taxable years	1,000	900	500	0	0

Since C's contributions in 1973 and 1974 to section 170(b)(1)(A) organizations are less than 50 percent of his contribution base for such years, the excess contributions for 1970, 1971, and 1972 are treated as having been paid to section 170(b)(1)(A) organizations in 1973 and 1974 as follows:

1973

Contribution year	Total excess	Less: Amount treated as paid in year prior to 1973	Available charitable contributions carryovers
1970	$1,000	0	$1,000
1971	900	0	900
1972	500	0	500
Total			2,400
50 percent of B's contribution base for 1973			$5,000
Less: Charitable contributions made in 1973 to section 170(b)(1)(A) organizations			3,000
			2,000
Amount of excess contributions treated as paid in 1973—lesser of $2,400 (available carryovers to 1973) or $2,000 (excess of 50 percent of contribution base ($5,000) over contributions actually made in 1973 to section 170(b)(1)(A) organizations ($3,000))			2,000

1974

Contribution year	Total excess	Less: Amount treated as paid in year prior to 1974	Available charitable contributions carryovers
1970	$1,000	$1,000	
1971	900	900	
1972	500	100	$40
1973	0	0	
Total			400
50 percent of B's contribution base for 1974			$4,500
Less: Charitable contributions made in 1974 to section 170(b)(1)(A) organizations			1,500
			3,000
Amount of excess contributions treated as paid in 1974—the lesser of $400 (available carryovers to 1974) or $3,000 (excess of 50 percent of contribution base ($4,500) over contributions actually made in 1974 to section 170(b)(1)(A) organizations ($1,500))			400

(c) *30-percent charitable contributions carryover of individuals*—(1) *Computation of excess of charitable contributions made in a contribution year.* Under section 170(b)(1)(D)(ii), subject to certain conditions and limitations, the excess of:

(i) The amount of the charitable contributions of 30-percent capital gain property, as defined in § 1.170A–8(d)(3), made by an individual in a taxable year (hereinafter in this paragraph referred to as the ''contribution year'') to section 170(b)(1)(A) organizations described in § 1.170A–9, over

(ii) 30 percent of his contribution base for such contribution year, shall, subject to section 170(b)(1)(A) and paragraph (b) of § 1.170A–8, be treated as a charitable contribution of 30-percent capital gain property paid by him to a section 170(b)(1)(A) organization in each of the 5 taxable years immediately succeeding the contribution year in order of time. In addition, any charitable contribution of 30-percent capital gain property which is carried over to such years under section 170(d)(1) and paragraph (b) of this section shall also be treated as though it were a carryover of 30-percent capital gain property under section 170(b)(1)(D)(ii) and this paragraph. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Assume that H and W (husband and wife) have a contribution base for 1970 of $50,000 and for 1971 of $40,000 and file a joint return for each year. Assume further that in 1970 they contribute $20,000 cash and $13,000 of 30-percent capital gain property to a church, and that in 1971 they contribute $5,000 cash and $10,000 of 30-percent capital gain property to a church. They may claim a charitable contributions deduction of $25,000 in 1970 and the excess of $33,000 (contributed to the church) over $25,000 (50 percent of contribution base), or $8,000, constitutes a charitable contributions carryover which shall be treated as a charitable contribution of 30-percent capital gain property paid by them to a section 170(b)(1)(A) organization in each of the 5 succeeding taxable years in order of time. Since 30 percent of their contribution base for 1971 ($12,000) exceeds the charitable contributions of 30-percent capital gain property ($10,000) made by them in 1971 to section 170(b)(1)(A) organizations (computed without regard to section 170 (b)(1)(D)(ii) and (d)(1) and this section), the portion of the 1970 carryover equal to such excess of $2,000 ($12,000—$10,000) is treated, pursuant to the provisions of subparagraph (2) of this paragraph, as paid to a section 170(b)(1)(A) organization in 1971; the remaining $6,000 constitutes an unused charitable contributions carryover in respect of 30-percent capital gain property from 1970.

Example 2. Assume the same facts as in *Example (1)* except the $33,000 of charitable contributions in 1970 are all 30-percent capital gain property. Since their charitable contributions in 1970 exceed 30 percent of their contribution base ($15,000) by $18,000 ($33,000—$15,000), they may claim a charitable contributions deduction of $15,000 in 1970, and the excess of $33,000 over $15,000, or $18,000, constitutes a charitable contributions carryover which shall be treated as a charitable contribution of 30-percent capital gain property paid by them to a section 170(b)(1)(A) organization in each of the 5 succeeding taxable years in order of time. Since they are allowed to treat only $2,000 of their 1970 contribution as paid in 1971, they have a remaining unused charitable contributions carryover of $16,000 in respect of 30-percent capital gain property from 1970.

(2) *Determination of amount treated as paid in taxable years succeeding contribution year.* In applying the provisions of subparagraph (1) of this paragraph, the amount of the excess computed in accordance with the provisions of such subparagraph and paragraph (d)(1) of this section which is to be treated as paid in any one of the 5 taxable years immediately succeeding the contribution year to a section 170(b)(1)(A) organization shall not exceed the least of the amounts computed under subdivisions (i) to (iv), inclusive, of this subparagraph:

(i) The amount by which 30 percent of the taxpayer's contribution base for such succeeding taxable year exceeds the sum of:

(a) The charitable contributions of 30-percent capital gain property actually made (computed without regard to the provisions of section 170 (b)(1)(D)(ii) and (d)(1) and this section) by the taxpayer in such succeeding taxable year to section 170(b)(1)(A) organizations, and

(b) The charitable contributions of 30-percent capital gain property made to section 170(b)(1)(A) organizations in taxable years preceding the contribution year, which, pursuant to the provisions of section 170 (b)(1)(D)(ii) and (d)(1) and this section, are treated as having been paid to a section 170(b)(1)(A) organization in such succeeding year.

(ii) The amount by which 50 percent of the taxpayer's contribution base for such succeeding taxable year exceeds the sum of:

(a) The charitable contributions actually made (computed without regard to the provisions of section 170 (b)(1)(D)(ii) and (d)(1) and this section) by the taxpayer in such succeeding taxable year to section 170(b)(1)(A) organizations,

(b) The charitable contributions of 30-percent capital gain property made to section 170(b)(1)(A) organizations in taxable years preceding the contribution year which, pursuant to the provisions of section 170 (b)(1)(D)(ii) and (d)(1) and this section, are treated as having been paid to a section 170(b)(1)(A) organization in such succeeding year, and

(c) The charitable contributions, other than contributions of 30-percent capital gain property, made to section 170(b)(1)(A) organizations which, pursuant to the provisions of section 170(d)(1) and paragraph (b) of this section, are treated as having been paid to a section 170(b)(1)(A) organization in such succeeding year.

(iii) In the case of the first taxable year succeeding the contribution year, the amount of the excess charitable contribution of 30-percent capital gain property in the contribution year, computed under subparagraph (1) of this paragraph and paragraph (d)(1) of this section.

(iv) In the case of the second, third, fourth, and fifth succeeding taxable years succeeding the contribution year, the portion of the excess charitable contribution of 30-percent capital gain property in the contribution year (computed under subparagraph (1) of this paragraph and paragraph (d)(1) of this section) which has not been treated as paid to a section 170(b)(1)(A) organization in a year intervening between the contribution year and such succeeding taxable year.

For purposes of applying subdivisions (i) and (ii) of this subparagraph, the amount of charitable contributions of 30-percent capital gain property actually made in a taxable year succeeding the contribution year shall be determined by first applying the 30-percent limitation of section 170(b)(1)(D)(i) and paragraph (d) of §1.170A–8. If a taxpayer, in any one of the four taxable years succeeding a contribution year, elects under section 144 to take the standard deduction instead of itemizing the deductions allowable in computing taxable income, there shall be treated as paid (but not allowable as a deduction) in the standard deduction year the least of the amounts determined under subdivisions (i) to (iv), inclusive, of this subparagraph. The provisions of this subparagraph may be illustrated by the following example:

Example. Assume the following factual situation for C who itemizes his deductions in computing taxable income for each of the years set forth in the example:

	1970	1971	1972	1973	1974
Contribution base	$10,000	$15,000	$20,000	$15,000	$33,000
Contributions of cash to section 170(b)(1)(A) organizations	2,000	8,500	0	14,000	700
Contributions of 30-percent capital gain property to section 170(b)(1)(A) organizations	5,000	0	7,800	0	6,400
Allowable charitable contributions deductions (computed without regard to carryover of contributions) subject to limitations of:					
50 percent	2,000	7,500	0	7,500	700
30 percent	3,000	0	6,000	0	6,400
Total	5,000	7,500	6,000	7,500	7,100
Excess of contributions for taxable year to be treated as paid in 5 succeeding taxable years:					
Carryover of contributions of property other than 30-percent capital gain property	0	1,000	0	6,500	
Carryover of contributions of 30-percent capital gain property.	2,000	0	1,800	0	

C's excess contributions for 1970, 1971, 1972, and 1973 which are treated as having been paid to section 170(b)(1)(A) organizations in 1972, 1973, and 1974 are indicated below. The portion of the excess charitable contribution for 1972 of 30-percent capital gain property which is not treated as paid in 1974 ($1,800–$900) is available as a carryover to 1975.

1971

Contribution	Total excess		Less: Amount treated as paid in years prior to 1971	Available charitable contributions carryovers	
	50%	30%		50%	30%
1970	0	$2,000	0	0	$2,000
50 percent of C's contribution base for 1971				$7,500	
30 percent of C's contribution base for 1971					4,500
Less: Charitable contributions actually made in 1971 to section 170(b)(1)(A) organizations ($8,500, but not to exceed 50% of contribution base)				7,500	0
Excess				0	4,500
The amount of excess contributions for 1970 of 30-percent capital gain property which is treated as paid in 1971 is the least of:					
(i) Available carryover from 1970 to 1971 of contributions of 30-percent capital gain property				2,000	
(ii) Excess of 50 percent of contribution base for 1971 ($7,500) over sum of contributions actually made in 1971 to section 170(b)(1)(A) organizations ($7,500)				0	
(iii) Excess of 30 percent of contribution base for 1971 ($4,500) over contributions of 30 percent capital gain property actually made in 1971 to section 170(b)(1)(A) organizations ($0)				4,500	
Amount treated as paid					0

1972

Contribution year	Total excess		Less: Amount treated as paid in years prior to 1972	Available charitable contributions carryovers	
	50%	30%		50%	30%
1970	0	$2,000	0	0	$2,000
1971	$1,000	0	0	$1,000	0
				1,000	2,000
50 percent of C's contribution base for 1972				10,000	
30 percent of C's contribution base for 1972					6,000
Less: Charitable contributions actually made in 1972 to section 170(b)(1)(A) organizations ($7,800, but not to exceed 30% of contribution base)				0	6,000
Excess				10,000	0

1972

Contribution year	Total excess		Less: Amount treated as paid in years prior to 1972	Available charitable contributions carryovers	
	50%	30%		50%	30%
(1) The amount of excess contributions for 1971 of property other than 30-percent capital gain property which is treated as paid in 1972 is the lesser of:					
(i) Available carryover from 1971 to 1972 of contributions of property other than 30-percent capital gain property				1,000	
(ii) Excess of 50 percent of contribution base for 1972 ($10,000) over contributions actually made in 1972 to section 170(b)(1)(A) organizations ($6,000)				4,000	
Amount treated as paid					1,000
(2) The amount of excess contributions for 1970 of 30-percent capital gain property which is treated as paid in 1972 is the least of:					
(i) Available carryover from 1970 to 1972 of contributions of 30-percent capital gain property				2,000	
(ii) Excess of 50 percent of contribution base for 1972 ($10,000) over sum of contributions actually made in 1972 to section 170(b)(1)(A) organizations ($6,000) and excess contributions for 1971 treated under item (1) above as paid in 1972 ($1,000)				3,000	
(iii) Excess of 30 percent of contribution base for 1972 ($6,000) over contributions of 30-percent capital gain property actually made in 1972 to section 170(b)(1)(A) organizations ($6,000)				0	
Amount treated as paid					0

1973

Contribution year	Total excess		Less: Amount treated as paid in years prior to 1973	Available charitable contributions carryovers	
	50%	30%		50%	30%
1970	0	$2,000	0	0	$2,000
1971	$1,000	0	$1,000	0	0
1972	0	1,800	0	0	1,800
				0	3,800
50 percent of C's contribution base for 1973				$7,500	
30 percent of C's contribution base for 1973					4,500
Less: Charitable contributions actually made in 1973 to section 170(b)(1)(A) organizations ($14,000, but not to exceed 50% of contribution base)				7,500	0
Excess				0	4,500
(1) The amount of excess contributions for 1970 of 30-percent capital gain property which is treated as paid in 1973 is the least of:					
(i) Available carryover from 1970 to 1973 of contributions of 30-percent capital gain property				2,000	
(ii) Excess of 50 percent of contribution base for 1973 ($7,500) over contributions actually made in 1973 to section 170(b)(1)(A) organizations ($7,500)				0	
(iii) Excess of 30 percent of contribution base for 1973 ($4,500) over contributions of 30-percent capital gain property actually made in 1973 to section 170(b)(1)(A) organizations ($0)				4,500	
Amount treated as paid				0	
(2) The amount of excess contributions for 1972 of 30-percent capital gain property which is treated as paid in 1973 is the least of:					
(i) Available carryover from 1972 to 1973 of contributions of 30-percent capital gain property				1,800	
(ii) Excess of 50 percent of contribution base for 1973 ($7,500) over contributions actually made in 1973 to section 170(b)(1)(A) organizations ($7,500)				0	
(iii) Excess of 30 percent of contribution base for 1973 ($4,500) over sum of contributions of 30-percent capital gain property actually made in 1973 to section 170(b)(1)(A) organizations ($0) and excess contributions for 1970 treated under item (1) above as paid in 1973 ($0)				4,500	
Amount treated as paid				0	

1974

Contribution year	Total excess		Less: Amount treated as paid in years prior to 1974	Available charitable contributions carryovers	
	50%	30%		50%	30%
1970	0	$2,000	0	0	$2,000
1971	$1,000	0	$1,000	0	0
1972	0	1,800	0	0	1,800
1973	6,500	0	0	$6,500	0
				6,500	3,800

50 percent of C's contribution base for 1974	16,500	....
30 percent of C's contribution base for 1974	....	9,900
Less: Charitable contributions actually made in 1974 to section 170(b)(1)(A) organizations	700	6,400
Excess	15,800	3,500
(1) The amount of excess contributions for 1973 of property other than 30-percent capital gain property which is treated as paid in 1974 is the lesser of:		
(i) Available carryover from 1973 to 1974 of contributions of property other than 30-percent capital gain property	6,500	....
(ii) Excess of 50 percent of contribution base for 1974 ($16,500) over contributions actually made in 1974 to section 170(b)(1)(A) organizations ($7,100)	9,400	....
Amount treated as paid	....	6,500
(2) The amount of excess contributions for 1970 of 30-percent capital gain property which is treated as paid in 1974 is the least of:		
(i) Available carryover from 1970 to 1974 of contributions of 30-percent capital gain property	$2,000	....
(ii) Excess of 50 percent of contribution base for 1974 ($16,500) over sum of contributions actually made in 1974 to section 170(b)(1)(A) organizations ($7,100) and excess contributions for 1973 of property other than 30-percent capital gain property treated under item (1) above as paid in 1974 ($6,500)	2,900	....
(iii) Excess of 30 percent of contribution base for 1974 ($9,900) over contributions of 30-percent capital gain property actually made in 1974 to section 170(b)(1)(A) organizations ($6,400)	3,500	....
Amount treated as paid	....	$2,000
(3) The amount of excess contributions for 1972 of 30-percent capital gain property which is treated as paid in 1974 is the least of:		
(i) Available carryover from 1972 to 1974 of contributions of 30-percent capital gain property	1,800	....
(ii) Excess of 50 percent of contribution base for 1974 ($16,500) over sum of contributions actually made in 1974 to section 170(b)(1)(A) organizations ($7,100) and excess contributions for 1973 and 1970 treated under items (1) and (2) above as paid in 1974 ($8,500)	900	....
(iii) Excess of 30 percent of contribution base for 1974 ($9,900) over sum of contributions of 30-percent capital gain property actually made in 1974 to section 170(b)(1)(A) organizations ($6,400) and excess contributions for 1970 of 30-percent capital gain property treated under item (2) above as paid in 1974 ($2,000)	1,500	....
Amount treated as paid	....	900

(d) *Adjustments*—(1) *Effect of net operating loss carryovers on carryover of excess contributions.* An individual having a net operating loss carryover from a prior taxable year which is available as a deduction in a contribution year must apply the special rule of section 170(d)(1)(B) and this subparagraph in computing the excess described in paragraph (b)(1) or (c)(1) of this section for such contribution year. In determining the amount of excess charitable contributions that shall be treated as paid in each of the 5 taxable years succeeding the contribution year, the excess charitable contributions described in paragraph (b)(1) or (c)(1) of this section must be reduced by the amount by which such excess reduces taxable income (for purposes of determining the portion of a net operating loss which shall be carried to taxable years succeeding the contribution year under the second sentence of section 172(b)(2)) and increases the net operating loss which is carried to a succeeding taxable year. In reducing taxable income under the second sentence of section 172(b)(2), an individual who has made charitable contributions in the contribution year to both section 170(b)(1)(A) organizations, as defined in §1.170A–9, and to organizations which are not section 170(b)(1)(A) organizations must first deduct contributions made to the section 170(b)(1)(A) organizations from his adjusted gross income computed without regard to his net operating loss deduction before any of the contributions made to organizations which are not section 170(b)(1)(A) organizations may be deducted from such adjusted gross income. Thus, if the excess of the contributions made in the contribution year to section 170(b)(1)(A) organizations over the amount deductible in such contribution year is utilized to reduce taxable income (under the provisions of section 172(b)(2)) for such year, thereby serving to increase the amount of the net operating loss carryover to a succeeding year or years, no part of the excess charitable contributions made in such contribution year shall be treated as paid in any of the 5 immediately succeeding taxable years. If only a portion of the excess charitable contributions is so used, the excess charitable contributions shall be reduced only to that extent. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. B, an individual, reports his income on the calendar year basis and for the year 1970 has adjusted gross income (computed without regard to any net operating loss deduction) of $50,000. During 1970 he made charitable contributions of cash in the amount of $30,000 all of which were to section 170(b)(1)(A) organizations. B has a net operating loss carryover from 1969 of $50,000. In the absence of the net operating loss deduction B would have been allowed a deduction for charitable contributions of $25,000. After the application of the net operating loss deduction, B is allowed no deduction for charitable contributions, and there is (before applying the special rule of section 170(d)(1)(B) and this subparagraph) a tentative excess charitable contribution of $30,000. For purposes of determining the net operating loss which remains to be carried over to 1971, B computes his taxable income for 1970 under section 172(b)(2) by deducting the $25,000 charitable contribution. After the $50,000 net operating loss carryover is applied against the $25,000 of taxable income for 1970 (computed in accordance with section 172(b)(2), assuming no deductions other than the charitable contributions deduction are applicable in making such computation), there remains a $25,000 net operating loss carryover to 1971. Since the application of the net operating loss carryover of $50,000 from 1969 reduces the 1970 adjusted gross income (for purposes of determining 1970 tax liability) to zero, no part of the $25,000 of charitable contributions in that year is deductible under section 170(b)(1). However, in determining the amount of the excess charitable contributions which shall be treated as paid in taxable years 1971, 1972, 1973, 1974, and 1975, the $30,000 must be reduced to $5,000 by the portion of the excess charitable contributions ($25,000) which was used to reduce taxable income for 1970 (as computed for purposes of the second sentence of section 172(b)(2)) and which thereby served to increase the net operating loss carryover to 1971 from zero to $25,000.

Example 2. Assume the same facts as in *Example (1),* except that B's total charitable contributions of $30,000 in cash made during 1970 consisted of $25,000 to section 170(b)(1)(A) organizations and $5,000 to organizations other than section 170(b)(1)(A) organizations. Under these facts there is a tentative excess charitable contribution of $25,000, rather than $30,000 as in *Example (1).* For purposes of determining the net operating loss which remains to be carried over to 1971, B computes his taxable income for 1970 under section 172(b)(2) by deducting the $25,000 of charitable contributions made to section 170(b)(1)(A) organizations. Since the excess charitable contribution of $25,000 determined in accordance with paragraph (b)(1) of this section was used to reduce taxable income for 1970 (as computed for purposes of the second sentence of section 172(b)(2)) and thereby served to increase the net operating loss carryover to 1971 from zero to $25,000, no part of such excess charitable contributions made in the contribution year shall be treated as paid in any of the five immediately succeeding taxable years. No carryover is allowed with respect to the $5,000 of charitable contributions made in 1970 to organizations other than section 170(b)(1)(A) organizations.

Example 3. Assume the same facts as in *Example (1),* except that B's total contributions of $30,000 made during 1970 were of 30-percent capital gain property. Under these facts there is a tentative excess charitable contribution of $30,000. For purposes of determining the net operating loss which remains to be carried over to 1971, B computes his taxable income for 1970 under section 172(b)(2)(B) by deducting the $15,000 (30% of $50,000) contribution of 30-percent capital gain property which would have been deductible in 1970 absent the net operating loss deduction. Since $15,000 of the excess charitable contribution of $30,000 determined in accordance with paragraph (c)(1) of this section was used to reduce taxable income for 1970 (as computed for purposes of the second sentence of section 172(b)(2)) and thereby served to increase the net operating loss carryover to 1971 from zero to $15,000, only $15,000 ($30,000—$15,000) of such excess shall be treated as paid in taxable years 1971, 1972, 1973, 1974, and 1975.

(2) *Effect of net operating loss carryback to contribution year.* The amount of the excess contribution for a contribution year computed as provided in paragraph (b)(1) or (c)(1) of this section and subparagraph (1) of this paragraph shall not be increased because a net operating loss carryback is available as a deduction in the contribution year. Thus, for example, assuming that in 1970 there is an excess contribution of $50,000 (determined as provided in paragraph (b)(1) of this section) which is to be carried to the 5 succeeding taxable years and that in 1973 the taxpayer has a net operating loss which may be carried back to 1970, the excess contribution of $50,000 for 1970 is not increased by reason of the fact that the adjusted gross income for 1970 (on which such excess contribution was based) is subsequently decreased by the carryback of the net operating loss from 1973. In addition, in determining under the provisions of section 172(b)(2) the amount of the net operating loss for any year subsequent to the contribution year which is a carryback or carryover to taxable years succeeding the contribution year, the amount of contributions made to section 170(b)(1)(A) organizations shall be limited to the amount of such contributions which did not exceed 50 percent or, in the case of 30-percent capital gain property, 30 percent of the donor's contribution base, computed without regard to any of the modifications referred to in section 172(d), for the contribution year. Thus, for example, assume that the taxpayer has a net operating loss in 1973 which is carried back to 1970 and in turn to 1971 and that he has made charitable contributions in 1970 to section 170(b)(1)(A) organizations. In determining the maximum amount of such charitable contributions which may be deducted in 1970 for purposes of determining the taxable income for 1970 which is deducted under section 172(b)(2) from the 1973 loss in order to ascertain the amount of such loss which is carried back to 1971, the 50-percent limitation of section 170(b)(1)(A) is based upon the adjusted gross income for 1970 computed without taking into account the net operating loss carryback from 1973 and without making any of the modifications specified in section 172(d).

(3) *Effect of net operating loss carryback to taxable years succeeding the contribution year.* The amount of the charitable contribution from a preceding taxable year which is treated as paid, as provided in paragraph (b)(2) or (c)(2) of this section, in a current taxable year (hereinafter referred to in this subparagraph as the ‘‘deduction year’’) shall not be reduced because a net operating loss carryback is available as a deduction in the deduction year. In addition, in determining under the provisions of section 172(b)(2) the amount of the net operating loss for any taxable year subsequent to the deduction year which is a carryback or carryover to taxable years succeeding the deduction year, the amount of contributions made to section 170(b)(1)(A) organizations in the deduction year shall be limited to the amount of such contributions, which were actually made in such year and those which were treated as paid in such year, which did not exceed 50 percent or, in the case of 30-percent capital gain property, 30 percent of the donor's contribution base, computed without regard to any of the modifications referred to in section 172(d), for the deduction year.

(4) *Husband and wife filing joint returns*—(i) *Change from joint return to separate returns.* If a husband and wife:

(a) Make a joint return for a contribution year and compute an excess charitable contribution for such year in accordance with the provisions of paragraph (b)(1) or (c)(1) of this section and subparagraph (1) of this paragraph, and

(b) Make separate returns for one or more of the 5 taxable years immediately succeeding such contribution year, any excess charitable contribution for the contribution year which is unused at the beginning of the first such taxable year for which separate returns are filed shall be allocated between the husband and wife. For purposes of the allocation, a computation

shall be made of the amount of any excess charitable contribution which each spouse would have computed in accordance with paragraph (b)(1) or (c)(1) of this section and subparagraph (1) of this paragraph if separate returns (rather than a joint return) had been filed for the contribution year. The portion of the total unused excess charitable contribution for the contribution year allocated to each spouse shall be an amount which bears the same ratio to such unused excess charitable contribution as such spouse's excess contribution, based on the separate return computation, bears to the total excess contributions of both spouses, based on the separate return computation. To the extent that a portion of the amount allocated to either spouse in accordance with the foregoing provisions of this subdivision is not treated in accordance with the provisions of paragraph (b)(2) or (c)(2) of this section as a charitable contribution paid to a section 170(b)(1)(A) organization in the taxable year in which a separate return or separate returns are filed, each spouse shall for purposes of paragraph (b)(2) or (c)(2) of this section treat his respective unused portion as the available charitable contributions carryover to the next succeeding taxable year in which the joint excess charitable contribution may be treated as paid in accordance with paragraph (b)(1) or (c)(1) of this section. If such husband and wife make a joint return in one of the 5 taxable years immediately succeeding the contribution year with respect to which a joint excess charitable contribution is computed and following such first taxable year for which such husband and wife filed a separate return, the amounts allocated to each spouse in accordance with this subdivision for such first year reduced by the portion of such amounts treated as paid to a section 170(b)(1)(A) organization in such first year and in any taxable year intervening between such first year and the succeeding taxable year in which the joint return is filed shall be aggregated for purposes of determining the amount of the available charitable contributions carryover to such succeeding taxable year. The provisions of this subdivision may be illustrated by the following example:

Example. (a) H and W file joint returns for 1970, 1971, and 1972, and in 1973 they file separate returns. In each such year H and W itemize their deductions in computing taxable income. Assume the following factual situation with respect to H and W for 1970:

1970

	H	W	Joint return
Contribution base	$50,000	$40,000	$90,000
Contributions of cash to section 170(b)(1)(A) organizations (no other contributions)	37,000	28,000	65,000
Allowable charitable contributions deductions	25,000	20,000	45,000
Excess contributions for taxable year to be treated as paid in 5 succeeding taxable years	12,000	8,000	20,000

(b) The joint excess charitable contribution of $20,000 is to be treated as having been paid to a section 170(b)(1)(A) organization in the 5 succeeding taxable years. Assume that in 1971 the portion of such excess treated as paid by H and W is $3,000, and that in 1972 the portion of such excess treated as paid is $7,000. Thus, the unused portion of the excess charitable contribution made in the contribution year is $10,000 ($20,000 less $3,000 [amount treated as paid in 1971] and $7,000 [amount treated as paid in 1972]). Since H and W file separate returns in 1973, $6,000 of such $10,000 is allocable to H, and $4,000 is allocable to W. Such allocation is computed as follows:

$12,000 (excess charitable contributions made by H (based on separate return computation) in 1970)/$20,000 (total excess charitable contributions made by H and W (based on separate return computation) in 1970)×$10,000=$6,000

$8,000 (excess charitable contributions made by W (based on separate return computation) in 1970)/$20,000 (total excess charitable contributions made by H and W (based on separate return computation) in 1970)×$10,000=$4,000

(c) In 1973 H has a contribution base of $70,000, and he contributes $14,000 in cash to a section 170(b)(1)(A) organization. In 1973 W has a contribution base of $50,000, and she contributes $10,000 in cash to a section 170(b)(1)(A) organization. Accordingly, H may claim a charitable contributions deduction of $20,000 in 1973, and W may claim a charitable contributions deduction of $14,000 in 1973. H's $20,000 deduction consists of the $14,000 contribution made to the section 170(b)(1)(A) organization in 1973 and the $6,000 carried over from 1970 and treated as a charitable contribution paid by him to a section 170(b)(1)(A) organization in 1973. W's

$14,000 deduction consists of the $10,000 contribution made to a section 170(b)(1)(A) organization in 1973 and the $4,000 carried over from 1970 and treated as a charitable contribution paid by her to a section 170(b)(1)(A) organization in 1973.

(d) The $6,000 contribution treated as paid in 1973 by H, and the $4,000 contribution treated as paid in 1973 by W, are computed as follows:

	H	W
Available charitable contribution carryover (see computations in (b))	$6,000	$4,000
50 percent of contribution base	35,000	25,000
Contributions of cash made in 1973 to section 170(b)(1)(A) organizations (no other contributions)	14,000	10,000
	21,000	15,000
Amount of excess contributions treated as paid in 1973: The lesser of $6,000 (available carryover of H to 1973) or $21,000 (excess of 50 percent of contribution base ($35,000) over contributions actually made in 1973 to section 170(b)(1)(A) organizations ($14,000))	$6,000	
The lesser of $4,000 (available carryover of W to 1973) or $15,000 (excess of 50 percent of contribution base ($25,000) over contributions actually made in 1973 to section 170(b)(1)(A) organizations ($10,000))	....	$4,000

(e) It is assumed that H and W made no contributions of 30-percent capital gain property during these years. If they had made such contributions, there would have been similar adjustments based on 30 percent of the contribution base.

(ii) *Change from separate returns to joint return.* If in the case of a husband and wife:

(a) Either or both of the spouses make a separate return for a contribution year and compute an excess charitable contribution for such year in accordance with the provisions of paragraph (b)(1) or (c)(1) of this section and subparagraph (1) of this paragraph, and

(b) Such husband and wife make a joint return for one or more of the taxable years succeeding such contribution year, the excess charitable contribution of the husband and wife for the contribution year which is unused at the beginning of the first taxable year for which a joint return is filed shall be aggregated for purposes of determining the portion of such unused charitable contribution which shall be treated in accordance with paragraph (b)(2) or (c)(2) of this section as a charitable contribution paid to a section 170(b)(1)(A) organization. The provisions of this subdivision also apply in the case of two single individuals who are subsequently married and file a joint return. A remarried taxpayer who filed a joint return with a former spouse in a contribution year with respect to which an excess charitable contribution was computed and who in any one of the 5 taxable years succeeding such contribution year files a joint return with his or her present spouse shall treat the unused portion of such excess charitable contribution allocated to him or her in accordance with subdivision (i) of this subparagraph in the same manner as the unused portion of an excess charitable contribution computed in a contribution year in which he filed a separate return, for purposes of determining the amount which in accordance with paragraph (b)(2) or (c)(2) of this section shall be treated as paid to an organization specified in section 170(b)(1)(A) in such succeeding year.

(iii) *Unused excess charitable contribution of deceased spouse.* In case of the death of one spouse, any unused portion of an excess charitable contribution which is allocable in accordance with subdivision (i) of this subparagraph to such spouse shall not be treated as paid in the taxable year in which such death occurs or in any subsequent taxable year except on a separate return made for the deceased spouse by a fiduciary for the taxable year which ends with the date of death or on a joint return for the taxable year in which such death occurs. The application of this subdivision may be illustrated by the following example:

Example. Assume the same facts as in the example in subdivision (i) of this subparagraph except that H dies in 1972 and W files a separate return for 1973. W made a joint return for herself and H for 1972. In the example, the unused excess charitable contribution as of January 1, 1973, was $10,000, $6,000 of which was allocable to H and $4,000 to W. No portion of the $6,000 allocable to H may be treated as paid by W or any other person in 1973 or any subsequent year.

(e) *Information required in support of a deduction of an amount carried over and treated as paid.* If, in a taxable year, a deduction is claimed in respect of an excess charitable contribution which, in accordance with the provisions of paragraph (b)(2) or (c)(2) of this section, is treated (in whole or in part) as paid in such taxable year, the taxpayer shall attach to his return a statement showing:

(1) The contribution year (or years) in which the excess charitable contributions were made,

(2) The excess charitable contributions made in each contribution year, and the amount of such excess charitable contributions consisting of 30-percent capital gain property,

(3) The portion of such excess, or of each such excess, treated as paid in accordance with paragraph (b)(2) or (c)(2) of this section in any taxable year intervening between the contribution year and the taxable year for which the return is made, and the portion of such excess which consists of 30-percent capital gain property.

(4) Whether or not an election under section 170(b)(1)(D)(iii) has been made which affects any of such excess contributions of 30-percent capital gain property, and

(5) Such other information as the return or the instructions relating thereto may require.

(f) *Effective date.* This section applies only to contributions paid in taxable years beginning after December 31, 1969. For purposes of applying section 170(d)(1) with respect to contributions paid in a taxable year beginning before January 1, 1970, subsection (b)(1)(D), subsection (e), and paragraphs (1), (2), (3), and (4) of subsection (f) of section 170 shall not apply. See section 201(g)(1)(D) of the Tax Reform Act of 1969 (83 Stat. 564).

[T.D. 7207, 37 FR 20787, Oct. 4, 1972; 37 FR 22982, Oct. 27, 1972, as amended by T.D. 7340, 40 FR 1240, Jan. 7, 1975]

§1.170A–11 Limitation on, and carryover of, contributions by corporations.

(a) *In general.* The deduction by a corporation in any taxable year for charitable contributions, as defined in section 170(c), is limited to 5 percent of its taxable income for the year, computed without regard to:

(1) The deduction under section 170 for charitable contributions,

(2) The special deductions for corporations allowed under Part VIII (except section 248), Subchapter B, Chapter 1 of the Code,

(3) Any net operating loss carryback to the taxable year under section 172, and

(4) Any capital loss carryback to the taxable year under section 1212(a)(1).

A charitable contribution by a corporation to a trust, chest, fund, or foundation described in section 170(c)(2) is deductible under section 170 only if the contribution is to be used in the United States or its possessions exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals. For the purposes of section 170, amounts excluded from the gross income of a corporation under section 114, relating to sports programs conducted for the American National Red Cross, are not to be considered contributions or gifts.

(b) *Election by corporations on an accrual method.* (1) A corporation reporting its taxable income on an accrual method may elect to have a charitable contribution treated as paid during the taxable year, if payment is actually made on or before the 15th day of the third month following the close of such year and if, during such year, its board of directors authorizes the charitable contribution. If by reason of such an election a charitable contribution (other than a contribution of a letter, memorandum, or property similar to a letter or memorandum) paid in a taxable year beginning after December 31, 1969, is treated as paid during a taxable year beginning before January 1, 1970, the provisions of §1.170A–4 shall not be applied to reduce the amount of such contribution. However, see section 170(e) before its amendment by the Tax Reform Act of 1969.

(2) The election must be made at the time the return for the taxable year is filed, by reporting the contribution on the return. There shall be attached to the return when filed a written declaration that the resolution authorizing the contribution was adopted by the board of directors during the taxable year, and the declaration shall be

verified by a statement signed by an officer authorized to sign the return that it is made under the penalties of perjury. There shall also be attached to the return when filed a copy of the resolution of the board of directors authorizing the contribution.

(c) *Charitable contributions carryover of corporations*—(1) *In general.* Subject to the reduction provided in subparagraph (2) of this paragraph, any charitable contributions made by a corporation in a taxable year (hereinafter in this paragraph referred to as the ''contribution year'') in excess of the amount deductible in such contribution year under the 5-percent limitation of section 170(b)(2) are deductible in each of the five succeeding taxable years in order of time, but only to the extent of the lesser of the following amounts:

(i) The excess of the maximum amount deductible for such succeeding taxable year under the 5-percent limitation of section 170(b)(2) over the sum of the charitable contributions made in that year plus the aggregate of the excess contributions which were made in taxable years before the contribution year and which are deductible under this paragraph in such succeeding taxable year; or

(ii) In the case of the first taxable year succeeding the contribution year, the amount of the excess charitable contributions, and in the case of the second, third, fourth, and fifth taxable years succeeding the contribution year, the portion of the excess charitable contributions not deductible under this subparagraph for any taxable year intervening between the contribution year and such succeeding taxable year.

This paragraph applies to excess charitable contributions by a corporation, whether or not such contributions are made to, or for the use of, the donee organization and whether or not such organization is a section 170(b)(1)(A) organization, as defined in § 1.170A–9. For purposes of applying this paragraph, a charitable contribution made in a taxable year beginning before January 1, 1970, which is carried over to taxable year beginning after December 31, 1969, under section 170(b)(2) (before its amendment by the Tax Reform Act of 1969) and is deductible in such taxable year beginning after December 31, 1969, shall be treated as deductible under section 170(d)(1) and this paragraph. The application of this subparagraph may be illustrated by the following example:

Example. A corporation which reports its income on the calendar year basis makes a charitable contribution of $20,000 in 1970. Its taxable income (determined without regard to any deduction for charitable contributions) for 1970 is $100,000. Accordingly, the charitable contributions deduction for that year is limited to $5,000 (5 percent of $100,000). The excess charitable contribution not deductible in 1970 ($15,000) is a carryover to 1971. The corporation has taxable income (determined without regard to any deduction for charitable contributions) of $150,000 in 1971 and makes a charitable contribution of $5,000 in that year. For 1971 the corporation may deduct as a charitable contribution the amount of $7,500 (5 percent of $150,000). This amount consists of the $5,000 contribution made in 1971 and of the $2,500 carried over from 1970. The remaining $12,500 carried over from 1970 and not allowable as a deduction for 1971 because of the 5-percent limitation may be carried over to 1972. The corporation has taxable income (determined without regard to any deduction for charitable contributions) of $200,000 in 1972 and makes a charitable contribution of $5,000 in that year. For 1972 the corporation may deduct the amount of $10,000 (5 percent of $200,000). This amount consists of the $5,000 contributed in 1972, and $5,000 of the $12,500 carried over from 1970 to 1972. The remaining $7,500 of the carryover from 1970 is available for purposes of computing the charitable contributions carryover from 1970 to 1973, 1974, and 1975.

(2) *Effect of net operating loss carryovers on carryover of excess contributions.* A corporation having a net operating loss carryover from any taxable year must apply the special rule of section 170(d)(2)(B) and this subparagraph before computing under subparagraph (1) of this paragraph the excess charitable contributions carryover from any taxable year. In determining the amount of excess charitable contributions that may be deducted in accordance with subparagraph (1) of this paragraph in taxable years succeeding the contribution year, the excess of the charitable contributions made by a corporation in the contributions year over the amount deductible in such year must be reduced by the amount by which such excess reduces taxable income for purposes of determining the

net operating loss carryover under the second sentence of section 172(b)(2)) and increases a net operating loss carryover to a succeeding taxable year. Thus, if the excess of the contributions made in a taxable year over the amount deductible in the taxable year is utilized to reduce taxable income (under the provisions of section 172(b)(2)) for such year, thereby serving to increase the amount of the net operating loss carryover to a succeeding taxable year or years, no charitable contributions carryover will be allowed. If only a portion of the excess charitable contributions is so used, the charitable contributions carryover will be reduced only to that extent. The application of this subparagraph may be illustrated by the following example:

Example. A corporation, which reports its income on the calendar year basis, makes a charitable contribution of $10,000 during 1971. Its taxable income for 1971 is $80,000 (computed without regard to any net operating loss deduction and computed in accordance with section 170(b)(2) without regard to any deduction for charitable contributions). The corporation has a net operating loss carryover from 1970 of $80,000. In the absence of the net operating loss deduction the corporation would have been allowed a deduction for charitable contributions of $4,000 (5 percent of $80,000). After the application of the net operating loss deduction the corporation is allowed no deduction for charitable contributions, and there is a tentative charitable contribution carryover from 1971 of $10,000. For purposes of determining the net operating loss carryover to 1972 the corporation computes its taxable income for 1971 under section 172(b)(2) by deducting the $4,000 charitable contribution. Thus, after the $80,000 net operating loss carryover is applied against the $76,000 of taxable income for 1971 (computed in accordance with section 172(b)(2)), there remains a $4,000 net operating loss carryover to 1972. Since the application of the net operating loss carryover of $80,000 from 1970 reduces the taxable income for 1971 to zero, no part of the $10,000 of charitable contributions in that year is deductible under section 170(b)(2). However, in determining the amount of the allowable charitable contributions carryover from 1971 to 1972, 1973, 1974, 1975, and 1976, the $10,000 must be reduced by the portion thereof ($4,000) which was used to reduce taxable income for 1971 (as computed for purposes of the second sentence of section 172(b)(2)) and which thereby served to increase the net operating loss carryover from 1970 to 1972 from zero to $4,000.

(3) *Effect of net operating loss carryback to contribution year.* The amount of the excess contribution for a contribution year computed as provided in subparagraph (1) of this paragraph shall not be increased because a net operating loss carryback is available as a deduction in the contribution year. In addition, in determining under the provisions of section 172(b)(2) the amount of the net operating loss for any year subsequent to the contribution year which is a carryback or carryover to taxable years succeeding the contribution year, the amount of any charitable contributions shall be limited to the amount of such contributions which did not exceed 5 percent of the donor's taxable income, computed as provided in paragraph (a) of this section and without regard to any of the modifications referred to in section 172(d), for the contribution year. For illustrations see paragraph (d)(2) of §1.170A–10.

(4) *Effect of net operating loss carryback to taxable year succeeding the contribution year.* The amount of the charitable contribution from a preceding taxable year which is deductible (as provided in this paragraph) in a current taxable year (hereinafter referred to in this subparagraph as the ''deduction year'') shall not be reduced because a net operating loss carryback is available as a deduction in the deduction year. In addition, in determining under the provisions of section 172(b)(2) the amount of the net operating loss for any taxable year subsequent to the deduction year which is a carryback or a carryover to taxable years succeeding the deduction year, the amount of contributions made in the deduction year shall be limited to the amount of such contributions, which were actually made in such year and those which were deductible in such year under section 170(d)(2), which did not exceed 5 percent of the donor's taxable income, computed as provided in paragraph (a) of this section and without regard to any of the modifications referred to in section 172(d), for the deduction year.

(5) *Year contribution is made.* For purposes of this paragraph, contributions made by a corporation in a contribution year include contributions which,

in accordance with the provisions of section 170(a)(2) and paragraph (b) of this section, are considered as paid during such contribution year.

(d) *Effective date.* This section applies only to contributions paid in taxable years beginning after December 31, 1969. For purposes of applying section 170(d)(2) with respect to contributions paid, or treated under section 170(a)(2) as paid, in a taxable year beginning before January 1, 1970, subsection (e), and paragraphs (1), (2), (3), and (4) of subsection (f) of section 170 shall not apply. See section 201(g)(1)(D) of the Tax Reform Act of 1969 (83 Stat. 564).

[T.D. 7207, 37 FR 20793, Oct. 4, 1972, as amended by T.D. 7807, 47 FR 4512, Feb. 1, 1982]

§ 1.170A–12 Valuation of a remainder interest in real property for contributions made after July 31, 1969.

(a) *In general.* (1) Section 170(f)(4) provides that, in determining the value of a remainder interest in real property for purposes of section 170, depreciation and depletion of such property shall be taken into account. Depreciation shall be computed by the straight line method and depletion shall be computed by the cost depletion method. Section 170(f)(4) and this section apply only in the case of a contribution, not made in trust, of a remainder interest in real property made after July 31, 1969, for which a deduction is otherwise allowable under section 170.

(2) In the case of the contribution of a remainder interest in real property consisting of a combination of both depreciable and nondepreciable property, or of both depletable and nondepletable property, and allocation of the fair market value of the property at the time of the contribution shall be made between the depreciable and nondepreciable property, or the depletable and nondepletable property, and depreciation or depletion shall be taken into account only with respect to the depreciable or depletable property. The expected value at the end of its ‘‘estimated useful life’’ (as defined in paragraph (d) of this section) of that part of the remainder interest consisting of depreciable property shall be considered to be nondepreciable property for purposes of the required allocation. In the case of the contribution of a remainder interest in stock in a cooperative housing corporation (as defined in section 216(b)(1)), an allocation of the fair market value of the stock at the time of the contribution shall be made to reflect the respective values of the depreciable and nondepreciable property underlying such stock, and depreciation on the depreciable part shall be taken into account for purposes of valuing the remainder interest in such stock.

(3) If the remainder interest that has been contributed follows only one life, the value of the remainder interest shall be computed under the rules contained in paragraph (b) of this section. If the remainder interest that has been contributed follows a term for years, the value of the remainder interest shall be computed under the rules contained in paragraph (c) of this section. If the remainder interest that has been contributed is dependent upon the continuation or the termination of more than one life or upon a term certain concurrent with one or more lives, the provisions of paragraph (e) of this section shall apply. In every case where it is provided in this section that the rules contained in § 25.2512–5 (or, for certain prior periods, § 25.2512–5A) of this chapter (Gift Tax Regulations) apply, such rules shall apply notwithstanding the general effective date for such rules contained in paragraph (a) of such section. Except as provided in § 1.7520–3(b) of this chapter, for transfers of remainder interests after April 30, 1989, the present value of the remainder interest is determined under § 25.2512–5 of this chapter by use of the interest rate component on the date the interest is transferred unless an election is made under section 7520 and § 1.7520–2 of this chapter to compute the present value of the interest transferred by use of the interest rate component for either of the 2 months preceding the month in which the interest is transferred. In some cases, a reduction in the amount of a charitable contribution of a remainder interest, after the computation of its value under section 170(f)(4) and this section, may be required. See section 170(e) and § 1.170A–4.

(b) *Valuation of a remainder interest following only one life*—(1) *General rule.* The value of a remainder interest in real property following only one life is determined under the rules provided in § 20.2031–7 (or for certain prior periods, § 20.2031–7A) of this chapter (Estate Tax Regulations), using the interest rate and life contingencies prescribed for the date of the gift. See, however, § 1.7520–3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). However, if any part of the real property is subject to exhaustion, wear and tear, or obsolescence, the special factor determined under paragraph (b)(2) of this section shall be used in valuing the remainder interest in that part. Further, if any part of the property is subject to depletion of its natural resources, such depletion is taken into account in determining the value of the remainder interest.

(2) *Computation of depreciation factor.* If the valuation of the remainder interest in depreciable property is dependent upon the continuation of one life, a special factor must be used. The factor determined under this paragraph (b)(2) is carried to the fifth decimal place. The special factor is to be computed on the basis of the interest rate and life contingencies prescribed in § 20.2031–7 (or for certain prior periods, § 20.2031–7A) of this chapter (Estate Tax Regulations) and on the assumption that the property depreciates on a straight-line basis over its estimated useful life. For transfers for which the valuation date is after April 30, 1989, special factors for determining the present value of a remainder interest following one life and an example describing the computation are contained in Internal Revenue Service Publication 1459, ‘‘Actuarial Values, Gamma Volume,’’ (8–89). This publication is no longer available for purchase from the Superintendent of Documents. However, it may be obtained by requesting a copy from: CC:DOM:CORP:T:R (IRS Publication 1459), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. See, however, § 1.7520–3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). Otherwise, in the case of the valuation of a remainder interest following one life, the special factor may be obtained through use of the following formula:

$$\left(1+\frac{i}{2}\right)\sum_{t=0}^{n-1} V^{(t+1)}\left[\left(1-\frac{l_{x+t+1}}{l_x}\right)-\left(1-\frac{l_{x+t}}{l_x}\right)\right]\left(1-\frac{1}{2n}-\frac{t}{n}\right)$$

Where:

n=the estimated number of years of useful life,

i=the applicable interest rate under section 7520 of the Internal Revenue Code,

v=1 divided by the sum of 1 plus the applicable interest rate under section 7520 of the Internal Revenue Code,

x=the age of the life tenant, and

lx=number of persons living at age x as set forth in Table 80CNSMT of § 20.2031–7 (or, for prior periods, in § 20.2031–7A) of this chapter.

(3) The following example illustrates the provisions of this paragraph (b):

Example. In June 1992, A, who is 62, donates to Y University a remainder interest in a personal residence, consisting of a house and land, subject to a reserved life estate in A. At the time of the gift, the land has a value of $30,000 and the house has a value of $100,000 with an estimated useful life of 45 years, at the end of which the value of the house is expected to be $20,000. The portion of the property considered to be depreciable is $80,000 (the value of the house ($100,000) less its expected value at the end of 45 years ($20,000)). The portion of the property considered to be nondepreciable is $50,000 (the value of the land at the time of the gift ($20,000) plus the expected value of the house at the end of 45 years ($20,000)). The interest rate prescribed under section 7520 for June 1992 is 8.4 percent. Based on an interest rate of 8.4 percent, the remainder factor for $1.00 prescribed in § 20.2031–7 of this chapter for a person age 62 is 0.29567. The value of the nondepreciable remainder interest is $14,783.50 (0.29567 times $50,000). The value of the depreciable remainder interest is $17,387.20 (0.21734, computed under the formula described in paragraph (b)(2) of this section, times $80,000). Therefore, the value of the remainder interest is $32,170.70.

(c) *Valuation of a remainder interest following a term for years.* The value of a remainder interest in real property following a term for years shall be determined under the rules provided in §25.2512–5 (or, for certain prior periods, §25.2512–5A) of this chapter (Gift Tax Regulations) using Table B provided in paragraph (f) of such sections. However, if any part of the real property is subject to exhaustion, wear and tear, or obsolescence, in valuing the remainder interest in that part the value of such part is adjusted by subtracting from the value of such part the amount determined by multiplying such value by a fraction, the numerator of which is the number of years in the term or, if less, the estimated useful life of the property, and the denominator of which is the estimated useful life of the property. The resultant figure is the value of the property to be used in §25.2512–5 (or, for certain prior periods, §25.2512–5A) of this chapter (Gift Tax Regulations). Further, if any part of the property is subject to depletion of its natural resources, such depletion shall be taken into account in determining the value of the remainder interest. The provisions of this paragraph as it relates to depreciation are illustrated by the following example:

Example. In 1972, B donates to Z University a remainder interest in his personal residence, consisting of a house and land, subject to a 20 year term interest provided for his sister. At such time the house has a value of $60,000, and an expected useful life of 45 years, at the end of which time it is expected to have a value of $10,000, and the land has a value of $8,000. The value of the portion of the property considered to be depreciable is $50,000 (the value of the house ($60,000) less its expected value at the end of 45 years ($10,000)), and this is multiplied by the fraction 20/45. The product, $22,222.22, is subtracted from $68,000, the value of the entire property, and the balance, $45,777.78, is multiplied by the factor .311805 (see §25.2512–5A(c)). The result, $14,273.74, is the value of the remainder interest in the property.

(d) *Definition of estimated useful life.* For the purposes of this section, the determination of the estimated useful life of depreciable property shall take account of the expected use of such property during the period of the life estate or term for years. The term ‘‘estimated useful life’’ means the estimated period (beginning with the date of the contribution) over which such property may reasonably be expected to be useful for such expected use. This period shall be determined by reference to the experience based on any prior use of the property for such purposes if such prior experience is adequate. If such prior experience is inadequate or if the property has not been previously used for such purposes, the estimated useful life shall be determined by reference to the general experience of persons normally holding similar property for such expected use, taking into account present conditions and probable future developments. The estimated useful life of such depreciable property is not limited to the period of the life estate or term for years preceding the remainder interest. In determining the expected use and the estimated useful life of the property, consideration is to be given to the provisions of the governing instrument creating the life estate or term for years or applicable local law, if any, relating to use, preservation, and maintenance of the property during the life estate or term for years. In arriving at the estimated useful life of the property, estimates, if available, of engineers or other persons skilled in estimating the useful life of similar property may be taken into account. At the option of the taxpayer, the estimated useful life of property contributed after December 31, 1970, for purposes of this section, shall be an asset depreciation period selected by the taxpayer that is within the permissible asset depreciation range for the relevant asset guideline class established pursuant to §1.167(a)–11(b) (4)(ii). For purposes of the preceding sentence, such period, range, and class shall be those which are in effect at the time that the contribution of the remainder interest was made. At the option of the taxpayer, in the case of property contributed before January 1, 1971, the estimated useful life, for purposes of this section, shall be the guideline life provided in Revenue Procedure 62–21 for the relevant asset guideline class.

(e) *Valuation of a remainder interest following more than one life or a term certain concurrent with one or more lives.*

(1)(i) If the valuation of the remainder interest in the real property is dependent upon the continuation or the termination of more than one life or upon a term certain concurrent with one or more lives, a special factor must be used.

(ii) The special factor is to be computed on the basis of—

(A) Interest at the rate prescribed under § 25.2512–5 (or, for certain prior periods, § 25.2512–5A) of this chapter, compounded annually;

(B) Life contingencies determined from the values that are set forth in the mortality table in § 20.2031–7 (or, for certain prior periods, § 20.2031–7A) of this chapter; and

(C) If depreciation is involved, the assumption that the property depreciates on a straight-line basis over its estimated useful life.

(iii) If any part of the property is subject to depletion of its natural resources, such depletion must be taken into account in determining the value of the remainder interest.

(2) In the case of the valuation of a remainder interest following two lives, the special factor may be obtained through use of the following formula:

$$\left(1+\frac{i}{2}\right)\sum_{t=0}^{n-1} V^{(t+1)}\left[\left(1-\frac{l_{x+t+1}}{l_x}\right)\left(1-\frac{l_{y+t+1}}{l_y}\right)-\left(1-\frac{l_{x+t}}{l_x}\right)\left(1-\frac{l_{y+t}}{l_y}\right)\right]\left(1-\frac{1}{2n}-\frac{t}{n}\right)$$

Where:

n=the estimated number of years of useful life,

i=the applicable interest rate under section 7520 of the Internal Revenue Code,

v=1 divided by the sum of 1 plus the applicable interest rate under section 7520 of the Internal Revenue Code,

x and y=the ages of the life tenants, and

lx and ly=the number of persons living at ages x and y as set forth in Table 80CNSMT in § 20.2031–7 (or, for prior periods, in § 20.2031–7A) of this chapter.

(3) Notwithstanding that the taxpayer may be able to compute the special factor in certain cases under paragraph (2), if a special factor is required in the case of an actual contribution, the Commissioner will furnish the factor to the donor upon request. The request must be accompanied by a statement of the sex and date of birth of each person the duration of whose life may affect the value of the remainder interest, copies of the relevant instruments, and, if depreciation is involved, a statement of the estimated useful life of the depreciable property. However, since remainder interests in that part of any property which is depletable cannot be valued on a purely actuarial basis, special factors will not be furnished with respect to such part. Requests should be forwarded to the Commissioner of Internal Revenue, Attention: E:A:G, Washington, DC 20224.

[T.D. 7370, 40 FR 34337, Aug. 15, 1975, as amended by T.D. 7955, 49 FR 19975, May 11, 1984; T.D. 8540, 59 FR 30102, 30104, June 10, 1994]

§ 1.170A–13 Recordkeeping and return requirements for deductions for charitable contributions.

(a) *Charitable contributions of money made in taxable years beginning after December 31, 1982*—(1) *In general.* If a taxpayer makes a charitable contribution of money in a taxable year beginning after December 31, 1982, the taxpayer shall maintain for each contribution one of the following:

(i) A cancelled check.

(ii) A receipt from the donee charitable organization showing the name of the donee, the date of the contribution, and the amount of the contribution. A letter or other communication from the donee charitable organization acknowledging receipt of a contribution and showing the date and amount of the contribution constitutes a receipt for purposes of this paragraph (a).

(iii) In the absence of a canceled check or receipt from the donee charitable organization, other reliable written records showing the name of the donee, the date of the contribution, and the amount of the contribution.

(2) *Special rules*—(i) *Reliability of records.* The reliability of the written records described in paragraph (a)(1)(iii) of this section is to be determined on the basis of all of the facts and circumstances of a particular case. In all events, however, the burden shall be on the taxpayer to establish reliability. Factors indicating that the written records are reliable include, but are not limited to:

(A) The contemporaneous nature of the writing evidencing the contribution.

(B) The regularity of the taxpayer's recordkeeping procedures. For example, a contemporaneous diary entry stating the amount and date of the donation and the name of the donee charitable organization made by a taxpayer who regularly makes such diary entries would generally be considered reliable.

(C) In the case of a contribution of a small amount, the existence of any written or other evidence from the donee charitable organization evidencing receipt of a donation that would not otherwise constitute a receipt under paragraph (a)(1)(ii) of this section (including an emblem, button, or other token traditionally associated with a charitable organization and regularly given by the organization to persons making cash donations).

(ii) *Information stated in income tax return.* The information required by paragraph (a)(1)(iii) of this section shall be stated in the taxpayer's income tax return if required by the return form or its instructions.

(3) *Taxpayer option to apply paragraph (d)(1) to pre-1985 contribution.* See paragraph (d)(1) of this section with regard to contributions of money made on or before December 31, 1984.

(b) *Charitable contributions of property other than money made in taxable years beginning after December 31, 1982*—(1) *In general.* Except in the case of certain charitable contributions of property made after December 31, 1984, to which paragraph (c) of this section applies, any taxpayer who makes a charitable contribution of property other than money in a taxable year beginning after December 31, 1982, shall maintain for each contribution a receipt from the donee showing the following information:

(i) The name of the donee.

(ii) The date and location of the contribution.

(iii) A description of the property in detail reasonably sufficient under the circumstances. Although the fair market value of the property is one of the circumstances to be taken into account in determining the amount of detail to be included on the receipt, such value need not be stated on the receipt.

A letter or other written communication from the donee acknowledging receipt of the contribution, showing the date of the contribution, and containing the required description of the property contributed constitutes a receipt for purposes of this paragraph. A receipt is not required if the contribution is made in circumstances where it is impractical to obtain a receipt (*e.g.*, by depositing property at a charity's unattended drop site). In such cases, however, the taxpayer shall maintain reliable written records with respect to each item of donated property that include the information required by paragraph (b)(2)(ii) of this section.

(2) *Special rules*—(i) *Reliability of records.* The rules described in paragraph (a)(2)(i) of this section also apply to this paragraph (b) for determining the reliability of the written records described in paragraph (b)(1) of this section

(ii) *Content of records.* The written records described in paragraph (b)(1) of this section shall include the following information and such information shall be stated in the taxpayers income tax return if required by the return form or its instructions:

(A) The name and address of the donee organization to which the contribution was made.

(B) The date and location of the contribution.

(C) A description of the property in detail reasonable under the circumstances (including the value of the property), and, in the case of securities, the name of the issuer, the type of security, and whether or not such security is regularly traded on a stock exchange or in an over-the-counter market.

(D) The fair market value of the property at the time the contribution was made, the method utilized in determining the fair market value, and, if the valuation was determined by appraisal, a copy of the signed report of the appraiser.

(E) In the case of property to which section 170(e) applies, the cost or other basis, adjusted as provided by section 1016, the reduction by reason of section 170(e)(1) in the amount of the charitable contribution otherwise taken into account, and the manner in which such reduction was determined. A taxpayer who elects under paragraph (d)(2) of §1.170A–8 to apply section 170(e)(1) to contributions and carryovers of 30 percent capital gain property shall maintain a written record indicating the years for which the election was made and showing the contributions in the current year and carryovers from preceding years to which it applies. For the definition of the term ''30-percent capital gain property,'' see paragraph (d)(3) of §1.170A–8.

(F) If less than the entire interest in the property is contributed during the taxable year, the total amount claimed as a deduction for the taxable year due to the contribution of the property, and the amount claimed as a deduction in any prior year or years for contributions of other interests in such property, the name and address of each organization to which any such contribution was made, the place where any such property which is tangible property is located or kept, and the name of any person, other than the organization to which the property giving rise to the deduction was contributed, having actual possession of the property.

(G) The terms of any agreement or understanding entered into by or on behalf of the taxpayer which relates to the use, sale, or other disposition of the property contributed, including for example, the terms of any agreement or understanding which:

(*1*) Restricts temporarily or permanently the donee's right to use or dispose of the donated property,

(*2*) Reserves to, or confers upon, anyone (other than the donee organization or an organization participating with the donee organization in cooperative fundraising) any right to the income from the donated property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire, or

(*3*) Earmarks donated property for a particular use.

(3) *Deductions in excess of $500 claimed for a charitable contribution of property other than money*—(i) *In general.* In addition to the information required under paragraph (b)(2)(ii) of this section, if a taxpayer makes a charitable contribution of property other than money in a taxable year beginning after December 31, 1982, and claims a deduction in excess of $500 in respect of the contribution of such item, the taxpayer shall maintain written records that include the following information with respect to such item of donated property, and shall state such information in his or her income tax return if required by the return form or its instructions:

(A) The manner of acquisition, as for example by purchase, gift bequest, inheritance, or exchange, and the approximate date of acquisition of the property by the taxpayer or, if the property was created, produced, or manufactured by or for the taxpayer, the approximate date the property was substantially completed.

(B) The cost or other basis, adjusted as provided by section 1016, of property, other than publicly traded securities, held by the taxpayer for a period of less than 12 months (6 months for property contributed in taxable years beginning after December 31, 1982, and on or before June 6, 1988, immediately preceding the date on which the contribution was made and, when the information is available, of property, other than publicly traded securities, held for a period of 12 months or more (6 months or more for property contributed in taxable years beginning after December 31, 1982, and on or before June 6, 1988, preceding the date on which the contribution was made.

(ii) *Information on acquisition date or cost basis not available.* If the return form or its instructions require the taxpayer to provide information on either the acquisition date of the property or the cost basis as described in paragraph (b)(3)(i) (A) and (B), respectively, of this section, and the taxpayer has reasonable cause for not being able to provide such information, the taxpayer shall attach an explanatory statement to the return. If a taxpayer has reasonable cause for not being able to provide such information, the taxpayer shall not be disallowed a charitable contribution deduction under section 170 for failure to comply with paragraph (b)(3)(i) (A) and (B) of the section.

(4) *Taxpayer option to apply paragraph (d) (1) and (2) to pre-1985 contributions.* See paragraph (d) (1) and (2) of this section with regard to contributions of property made on or before December 31, 1984.

(c) *Deductions in excess of $5,000 for certain charitable contributions of property made after December 31, 1984*—(1) *General Rule*—(i) *In general.* This paragraph applies to any charitable contribution made after December 31, 1984, by an individual, closely held corporation, personal service corporation, partnership, or S corporation of an item of property (other than money and publicly traded securities to which § 1.170A–13(c)(7)(xi)(B) does not apply if the amount claimed or reported as a deduction under section 170 with respect to such item exceeds $5,000. This paragraph also applies to charitable contributions by C corporations (as defined in section 1361(a)(2) of the Code) to the extent described in paragraph (c)(2)(ii) of this section. No deduction under section 170 shall be allowed with respect to a charitable contribution to which this paragraph applies unless the substantiation requirements described in paragraph (c)(2) of this section are met. For purposes of this paragraph (c), the amount claimed or reported as a deduction for an item of property is the aggregate amount claimed or reported as a deduction for a charitable contribution under section 170 for such items of property and all similar items of property (as defined in paragraph (c)(7)(iii) of this section) by the same donor for the same taxable year (whether or not donated to the same donee).

(ii) *Special rule for property to which section 170(e) (3) or (4) applies.* For purposes of this paragraph (c), in computing the amount claimed or reported as a deduction for donated property to which section 170(e) (3) or (4) applies (pertaining to certain contributions of inventory and scientific equipment) there shall be taken into account only the amount claimed or reported as a deduction in excess of the amount which would have been taken into account for tax purposes by the donor as costs of goods sold if the donor had sold the contributed property to the donee. For example, assume that a donor makes a contribution from inventory of clothing for the care of the needy to which section 170(e)(3) applies. The cost of the property to the donor was $5,000, and, pursuant to section 170(e)(3)(B), the donor claims a charitable contribution deduction of $8,000 with respect to the property. Therefore, $3,000 ($8,000–$5,000) is the amount taken into account for purposes of determining whether the $5,000 threshold of this paragraph (c)(1) is met.

(2) *Substantiation requirements*—(i) *In general.* Except as provided in paragraph (c)(2)(ii) of this section, a donor who claims or reports a deduction with respect to a charitable contribution to which this paragraph (c) applies must comply with the following three requirements:

(A) Obtain a qualified appraisal (as defined in paragraph (c) (3) of this section) for such property contributed. If the contributed property is a partial interest, the appraisal shall be of the partial interest.

(B) Attach a fully completed appraisal summary (as defined in paragraph (c) (4) of this section) to the tax return (or, in the case of a donor that is a partnership or S corporation, the information return) on which the deduction for the contribution is first claimed (or reported) by the donor.

(C) Maintain records containing the information required by paragraph (b) (2) (ii) of this section.

(ii) *Special rules for certain nonpublicly traded stock, certain publicly traded securities, and contributions by certain C corporations.* (A) In cases described in paragraph (c)(2)(ii)(B) of this section, a qualified appraisal is not required, and only a partially completed appraisal summary form (as described in paragraph (c)(4)(iv)(A) of this section) is required to be attached to the tax or information return specified in paragraph (c)(2)(i)(B) of this section. However, in all cases donors must maintain records containing the information required by paragraph (b)(2)(ii) of this section.

(B) This paragraph (c)(2)(ii) applies in each of the following cases:

(*1*) The contribution of nonpublicly traded stock, if the amount claimed or reported as a deduction for the charitable contribution of such stock is greater than $5,000 but does not exceed $10,000;

(*2*) The contribution of a security to which paragraph (c)(7)(xi)(B) of this section applies; and

(*3*) The contribution of an item of property or of similar items of property described in paragraph (c)(1) of this section made after June 6, 1988, by a C corporation (as defined in section 1361(a)(2) of the Code), other than a closely held corporation or a personal service corporation.

(3) *Qualified appraisal*—(i) *In general.* For purposes of this paragraph (c), the term ‘‘qualified appraisal’’ means an appraisal document that—

(A) Relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property nor later than the date specified in paragraph (c)(3)(iv)(B) of this section;

(B) Is prepared, signed, and dated by a qualified appraiser (within the meaning of paragraph (c)(5) of this section);

(C) Includes the information required by paragraph (c)(3)(ii) of this section; and

(D) Does not involve an appraisal fee prohibited by paragraph (c)(6) of this section.

(ii) *Information included in qualified appraisal.* A qualified appraisal shall include the following information:

(A) A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed;

(B) In the case of tangible property, the physical condition of the property;

(C) The date (or expected date) of contribution to the donee;

(D) The terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the donor or donee that relates to the use, sale, or other disposition of the property contributed, including, for example, the terms of any agreement or understanding that—

(*1*) Restricts temporarily or permanently a donee’s right to use or dispose of the donated property,

(*2*) Reserves to, or confers upon, anyone (other than a donee organization or an organization participating with a donee organization in cooperative fundraising) any right to the income from the contributed property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire, or

(*3*) Earmarks donated property for a particular use;

(E) The name, address, and (if a taxpayer identification number is otherwise required by section 6109 and the regulations thereunder) the identifying number of the qualified appraiser; and, if the qualified appraiser is acting in his or her capacity as a partner in a partnership, an employee of any person (whether an individual, corporation, or partnerships), or an independent contractor engaged by a person other than the donor, the name, address, and taxpayer identification number (if a number is otherwise required by section 6109 and the regulations thereunder) of the partnership or the person who employs or engages the qualified appraiser;

(F) The qualifications of the qualified appraiser who signs the appraisal, including the appraiser’s background, experience, education, and membership, if any, in professional appraisal associations;

(G) A statement that the appraisal was prepared for income tax purposes;

(H) The date (or dates) on which the property was appraised;

(I) The appraised fair market value (within the meaning of § 1.170A–1 (c)(2)) of the property on the date (or expected date) of contribution;

(J) The method of valuation used to determine the fair market value, such as the income approach, the market-data approach, and the replacement-cost-less-depreciation approach; and

(K) The specific basis for the valuation, such as specific comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.

(iii) *Effect of signature of the qualified appraiser.* Any appraiser who falsely or fraudulently overstates the value of the contributed property referred to in a qualified appraisal or appraisal summary (as defined in paragraphs (c) (3) and (4), respectively, of this section) that the appraiser has signed may be subject to a civil penalty under section 6701 for aiding and abetting an understatement of tax liability and, moreover, may have appraisals disregarded pursuant to 31 U.S.C. 330(c).

(iv) *Special rules*—(A) *Number of qualified appraisals.* For purposes of paragraph (c)(2)(i)(A) of this section, a separate qualified appraisal is required for each item of property that is not included in a group of similar items of property. See paragraph (c)(7)(iii) of this section for the definition of similar items of property. Only one qualified appraisal is required for a group of similar items of property contributed in the same taxable year of the donor, although a donor may obtain separate qualified appraisals for each item of property. A qualified appraisal prepared with respect to a group of similar items of property shall provide all the information required by paragraph (c)(3)(ii) of this section for each item of similar property, except that the appraiser may select any items whose aggregate value is appraised at $100 or less and provide a group description of such items.

(B) *Time of receipt of qualified appraisal.* The qualified appraisal must be received by the donor before the due date (including extensions) of the return on which a deduction is first claimed (or reported in the case of a donor that is a partnership or S corporation) under section 170 with respect to the donated property, or, in the case of a deduction first claimed (or reported) on an amended return, the date on which the return is filed.

(C) *Retention of qualified appraisal.* The donor must retain the qualified appraisal in the donor's records for so long as it may be relevant in the administration of any internal revenue law.

(D) *Appraisal disregarded pursuant to 31 U.S.C. 330(c).* If an appraisal is disregarded pursuant to 31 U.S.C. 330(c) it shall have no probative effect as to the value of the appraised property. Such appraisal will, however, otherwise constitute a ‘‘qualified appraisal’’ for purposes of this paragraph (c) if the appraisal summary includes the declaration described in paragraph (c)(4)(ii)(L)(*2*) and the taxpayer had no knowledge that such declaration was false as of the time described in paragraph (c)(4)(i)(B) of this section.

(4) *Appraisal summary*—(i) *In general.* For purposes of this paragraph (c), except as provided in paragraph (c)(4)(iv)(A) of this section, the term *appraisal summary* means a summary of a qualified appraisal that—

(A) Is made on the form prescribed by the Internal Revenue Service;

(B) Is signed and dated (as described in paragraph (c)(4)(iii) of this section) by the donee (or presented to the donee for signature in cases described in paragraph (c)(4)(iv)(C)(*2*) of this section);

(C) Is signed and dated by the qualified appraiser (within the meaning of paragraph (c)(5) of this section) who prepared the qualified appraisal (within the meaning of paragraph (c)(3) of this section); and

(D) Includes the information required by paragraph (c)(4)(ii) of this section.

(ii) *Information included in an appraisal summary.* An appraisal summary shall include the following information:

(A) The name and taxpayer identification number of the donor (social security number if the donor is an individual or employer identification number if the donor is a partnership or corporation);

(B) A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was contributed;

(C) In the case of tangible property, a brief summary of the overall physical condition of the property at the time of the contribution;

(D) The manner of acquisition (*e.g.*, purchase, exchange, gift, or bequest) and the date of acquisition of the property by the donor, or, if the property was created, produced, or manufactured by or for the donor, a statment to that effect and the approximate date the property was substantially completed;

(E) The cost or other basis of the property adjusted as provided by section 1016;

(F) The name, address, and taxpayer identification number of the donee;

(G) The date the donee received the property;

(H) For charitable contributions made after June 6, 1988, a statement explaining whether or not the charitable contribution was made by means of a bargain sale and the amount of any consideration received from the donee for the contribution;

(I) The name, address, and (if a taxpayer identification number is otherwise required by section 6109 and the regulations thereunder) the identifying number of the qualified appraiser who signs the appraisal summary and of other persons as required by paragraph (c)(3)(ii)(E) of this section;

(J) The appraised fair market value of the property on the date of contribution;

(K) The declaration by the appraiser described in paragraph (c)(5)(i) of this section;

(L) A declaration by the appraiser stating that—

(*1*) The fee charged for the appraisal is not of a type prohibited by paragraph (c)(6) of this section; and

(*2*) Appraisals prepared by the appraiser are not being disregarded pursuant to 31 U.S.C. 330(c) on the date the appraisal summary is signed by the appraiser; and

(M) Such other information as may be specified by the form.

(iii) *Signature of the original donee.* The person who signs the appraisal summary for the donee shall be an official authorized to sign the tax or information returns of the donee, or a person specifically authorized to sign appraisal summaries by an official authorized to sign the tax or information returns of such done. In the case of a donee that is a governmental unit, the person who signs the appraisal summary for such donee shall be the official authorized by such donee to sign appraisal summaries. The signature of the donee on the appraisal summary does not represent concurrence in the appraised value of the contributed property. Rather, it represents acknowledgment of receipt of the property described in the appraisal summary on the date specified in the appraisal summary and that the donee understands the information reporting requirements imposed by section 6050L and § 1.6050L–1. In general, § 1.6050L–1 requires the donee to file an information return with the Internal Revenue Service in the event the donee sells, exchanges, consumes, or otherwise disposes of the property (or any portion thereof) described in the appraisal summary within 2 years after the date of the donor's contribution of such property.

(iv) *Special rules*—(A) *Content of appraisal summary required in certain cases.* With respect to contributions of nonpublicly traded stock described in paragraph (c)(2)(ii)(B)(*1*) of this section, contributions of securities described in paragraph (c)(7)(xi)(B) of this section, and contributions by C corporations described in paragraph (c)(2)(ii)(B)(*3*) of this section, the term *appraisal summary* means a document that—

(*1*) Complies with the requirements of paragraph (c)(4)(i) (A) and (B) of this section,

(*2*) Includes the information required by paragraph (c)(4)(ii) (A) through (H) of this section,

(*3*) Includes the amount claimed or reported as a charitable contribution deduction, and

(*4*) In the case of securities described in paragraph (c)(7)(xi)(B) of this section, also includes the pertinent average trading price (as described in paragraph (c)(7)(xi)(B)(*2*)(iii) of this section).

(B) *Number of appraisal summaries.* A separate appraisal summary for each item of property described in paragraph (c)(1) of this section must be attached to the donor's return. If, during the donor's taxable year, the donor contributes similar items of property described in paragraph (c)(1) of this section to more than one donee, the donor shall attach to the donor's return a separate appraisal summary for each donee. See paragraph (c)(7)(iii) of this section for the definition of similar items of property. If, however, during the donor's taxable year, a donor contributes similar items of property described in paragraph (c)(1) of this section to the same donee, the donor may attach to the donor's return a single appraisal summary with respect to all similar items of property contributed to the same donee. Such an appraisal summary shall provide all the information required by paragraph (c)(4)(ii) of this section for each item of property, except that the appraiser may select any items whose aggregate value is appraised at $100 or less and provide a group description for such items.

(C) *Manner of acquisition, cost basis and donee's signature. (1)* If a taxpayer has reasonable cause for being unable to provide the information required by paragraph (c)(4)(ii) (D) and (E) of this section (relating to the manner of acquisition and basis of the contributed property), an appropriate explanation should be attached to the appraisal summary. The taxpayer's deduction will not be disallowed simply because of the inability (for reasonable cause) to provide these items of information.

(*2*) In rare and unusual circumstances in which it is impossible for the taxpayer to obtain the signature of the donee on the appraisal summary as required by paragraph (c)(4)(i)(B) of this section, the taxpayer's deduction will not be disallowed for that reason provided that the taxpayer attaches a statement to the appraisal summary explaining, in detail, why it was not possible to obtain the donee's signature. For example, if the donee ceases to exist as an entity subsequent to the date of the contribution and prior to the date when the appraisal summary must be signed, and the donor acted reasonably in not obtaining the donee's signature at the time of the contribution, relief under this paragraph (c)(4)(iv)(C)(*2*) would generally be appropriate.

(D) *Information excluded from certain appraisal summaries.* The information required by paragraph (c)(4)(i)(C), paragraph (c)(4)(ii) (D), (E), (H) through (M), and paragraph (c)(4)(iv)(A)(*3*), and the average trading price referred to in paragraph (c)(4)(iv)(A)(*4*) of this section do not have to be included on the appraisal summary at the time it is signed by the donee or a copy is provided to the donee pursuant to paragraph (c)(4)(iv)(E) of this section.

(E) *Statement to be furnished by donors to donees.* Every donor who presents an appraisal summary to a donee for signature after June 6, 1988, in order to comply with paragraph (c)(4)(i)(B) of this section shall furnish a copy of the appraisal summary to such donee.

(F) *Appraisal summary required to be provided to partners and S corporation shareholders.* If the donor is a partnership or S corporation, the donor shall provide a copy of the appraisal summary to every partner or shareholder, respectively, who receives an allocation of a charitable contribution deduction under section 170 with respect to the property described in the appraisal summary.

(G) *Partners and S corporation shareholders.* A partner of a partnership or shareholder of an S corporation who receives an allocation of a deduction under section 170 for a charitable contribution of property to which this paragraph (c) applies must attach a copy of the partnership's or S corporation's appraisal summary to the tax return on which the deduction for the contribution is first claimed. If such appraisal summary is not attached, the partner's or shareholder's deduction shall not be allowed except as provided for in paragraph (c)(4)(iv)(H) of this section.

(H) *Failure to attach appraisal summary.* In the event that a donor fails to attach to the donor's return an appraisal summary as required by paragraph (c)(2)(i)(B) of this section, the Internal Revenue Service may request that the donor submit the appraisal summary within 90 days of the request. If such a request is made and the donor complies with the request within the 90-day period, the deduction under section 170 shall not be disallowed for failure to attach the appraisal summary, provided that the donor's failure to attach the appraisal summary was a good faith omission and the requirements of paragraph (c) (3) and (4) of this section are met (including the completion of the qualified appraisal prior to the date specified in paragraph (c)(3)(iv)(B) of this section).

(5) *Qualified appraiser*—(i) *In general.* The term *qualified appraiser* means an individual (other than a person described in paragraph (c)(5)(iv) of this section) who includes on the appraisal summary (described in paragraph (c)(4) of this section), a declaration that—

(A) The individual either holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;

(B) Because of the appraiser's qualifications as described in the appraisal (pursuant to paragraph (c)(3)(ii)(F) of this section), the appraiser is qualified to make appraisals of the type of property being valued;

(C) The appraiser is not one of the persons described in paragraph (c)(5)(iv) of this section; and

(D) The appraiser understands that an intentionally false or fraudulent overstatement of the value of the property described in the qualified appraisal or appraisal summary may subject the appraiser to a civil penalty under section 6701 for aiding and abetting an understatement of tax liability, and, moreover, the appraiser may have appraisals disregarded pursuant to 31 U.S.C. 330(c) (see paragraph (c)(3)(iii) of this section).

(ii) *Exception.* An individual is not a qualified appraiser with respect to a particular donation, even if the declaration specified in paragraph (c)(5)(i) of this section is provided in the appraisal summary, if the donor had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property (*e.g.,* the donor and the appraiser make an agreement concerning the amount at which the property will be valued and the donor knows that such amount exceeds the fair market value of the property).

(iii) *Numbers of appraisers.* More than one appraiser may appraise the donated property. If more than one appraiser appraises the property, the donor does not have to use each appraiser's appraisal for purposes of substantiating the charitable contribution deduction pursuant to this paragraph (c). If the donor uses the appraisal of more than one appraiser, or if two or more appraisers contribute to a single appraisal, each appraiser shall comply with the requirements of this paragraph (c), including signing the qualified appraisal and appraisal summary as required by paragraphs (c)(3)(i)(B) and (c)(4)(i)(C) of this section, respectively.

(iv) *Qualified appraiser exclusions.* The following persons cannot be qualified appraisers with respect to particular property:

(A) The donor or the taxpayer who claims or reports a deductions under section 170 for the contribution of the property that is being appraised.

(B) A party to the transaction in which the donor acquired the property being appraised (*i.e.,* the person who sold, exchanged, or gave the property to the donor, or any person who acted as an agent for the transferor or for the donor with respect to such sale, exchange, or gift), unless the property is donated within 2 months of the date of acquisition and its appraised value does not exceed its acquisition price.

(C) The donee of the property.

(D) Any person employed by any of the foregoing persons (*e.g.,* if the donor acquired a painting from an art dealer, neither the art dealer nor persons employed by the dealer can be qualified appraisers with respect to that painting).

(E) Any person related to any of the foregoing persons under section 267(b), or, with respect to appraisals made after June 6, 1988, married to a person who is in a relationship described in section 267(b) with any of the foregoing persons.

(F) An appraiser who is regularly used by any person described in paragraph (c)(5)(iv) (A), (B), or (C) of this section and who does not perform a majority of his or her appraisals made during his or her taxable year for other persons.

(6) *Appraisal fees*—(i) *In general.* Except as otherwise provided in paragraph (c)(6)(ii) of this section, no part of the fee arrangement for a qualified appraisal can be based, in effect, on a percentage (or set of percentages) of the appraised value of the property. If a fee arrangement for an appraisal is based in whole or in part on the amount of the appraised value of the property, if any, that is allowed as a deduction under section 170, after Internal Revenue Service examination or otherwise, it shall be treated as a fee based on a percentage of the appraised value of the property. For example, an appraiser's fee that is subject to reduction by the same percentage as the appraised value may be reduced by the Internal Revenue Service would be treated as a fee that violates this paragraph (c)(6).

(ii) *Exception.* Paragraph (c)(6)(i) of this section does not apply to a fee paid to a generally recognized association that regulates appraisers provided all of the following requirements are met:

(A) The association is not organized for profit and no part of the net earnings of the association inures to the benefit of any private shareholder or individual (these terms have the same meaning as in section 501(c)),

(B) The appraiser does not receive any compensation from the association or any other persons for making the appraisal, and

(C) The fee arrangement is not based in whole or in part on the amount of the appraised value of the donated property, if any, that is allowed as a deduction under section 170 after Internal Revenue Service examination or otherwise.

(7) *Meaning of terms.* For purposes of this paragraph (c)—

(i) *Closely held corporation.* The term *closely held corporation* means any corporation (other than an S corporation) with respect to which the stock ownership requirement of paragraph (2) of section 542(a) of the Code is met.

(ii) *Personal service corporation.* The term *personal service corporation* means any corporation (other than an S corporation) which is a service organization (within the meaning of section 414(m)(3) of the Code).

(iii) *Similar items of property.* The phrase *similar items of property* means property of the same generic category or type, such as stamp collections (including philatelic supplies and books on stamp collecting), coin collections (including numismatic supplies and books on coin collecting), lithographs, paintings, photographs, books, nonpublicly traded stock, nonpublicly traded securities other than nonpublicly trade stock, land, buildings, clothing, jewelry, funiture, electronic equipment, household appliances, toys, everyday kitchenware, china, crystal, or silver. For example, if a donor claims on her return for the year deductions of $2,000 for books given by her to College A, $2,500 for books given by her to College B, and $900 for books given by her to College C, the $5,000 threshold of paragraph (c)(1) of this section is exceeded. Therefore, the donor must obtain a qualified appraisal for the books and attach to her return three appraisal summaries for the books donated to A, B, and C. For rules regarding the number of qualified appraisals and appraisal summaries required when similar items of property are contributed, see paragraphs (c)(3)(iv)(A) and (c)(4)(iv)(B), respectively, of this section.

(iv) *Donor.* The term *donor* means a person or entity (other than an organization described in section 170(c) to which the donated property was previously contributed) that makes a charitable contribution of property.

(v) *Donee.* The term *donee* means—

(A) Except as provided in paragraph (c)(7)(v) (B) and (C) of this section, an organization described in section 170(c) to which property is contributed,

(B) Except as provided in paragraph (c)(7)(v)(C) of this section, in the case of a charitable contribution of property placed in trust for the benefit of an organization described in section 170(c), the trust, or

(C) In the case of a charitable contribution of property placed in trust for the benefit of an organization described in section 170(c) made on or before June 6, 1988, the beneficiary that is an organization described in section 170(c), or if the trust has assumed the duties of a donee by signing the appraisal summary pursuant to paragraph (c)(4)(i)(B) of this section, the trust.

In general, the term, refers only to the original donee. However, with respect to paragraph (c)(3)(ii)(D), the last sentence of paragraph (c)(4)(iii), and paragraph (c)(5)(iv)(C) of this section, the term *donee* means the original donee and all successor donees in cases where the original donee transfers the contributed property to a successor donee after July 5, 1988.

(vi) *Original donee.* The term *original donee* means the donee to or for which property is initially donated by a donor.

(vii) *Successor donee.* The term *successor donee* means any donee of property other than its original donee (*i.e.*, a transferee of property for less than fair market value from an original donee or another successor donee).

(viii) *Fair market value.* For the meaning of the term *fair market value,* see section 1.170A–1(c)(2).

(ix) *Nonpublicly traded securities.* The term *nonpublicly traded securities* means securities (within the meaning of section 165(g)(2) of the Code) which are not publicly traded securities as defined in paragraph (c)(7)(xi) of this section.

(x) *Nonpublicly traded stock.* The term *nonpublicly traded stock* means any stock of a corporation (evidence by a stock certificate) which is not a publicly traded security. The term stock does not include a debenture or any other evidence of indebtedness.

(xi) *Publicly traded securities*—(A) *In general.* Except as provided in paragraph (c)(7)(xi)(C) of this section, the term *publicly traded securities* means securities (within the meaning of section 165(g)(2) of the Code) for which (as of the date of the contribution) market quotations are readily available on an established securities market. For purposes of this section, market quotations are readily available on an established securities market with respect to a security if:

(*1*) The security is listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations are published on a daily basis, including foreign securities listed on a recognized foreign, national, or regional exchange in which quotations are published on a daily basis;

(*2*) The security is regularly traded in the national or regional over-the-counter market, for which published quotations are available; or

(*3*) The security is a share of an open-end investment company (commonly known as a mutual fund) registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80a–1 to 80b–2), for which quotations are published on a daily basis in a newspaper of general circulation throughout the United States.

(If the market value of an issue of a security is reflected only on an interdealer quotation system, the issue shall not be considered to be publicly traded unless the special rule described in paragraph (c)(7)(xi)(B) of this section is satisfied.)

(B) *Special rule*—(*1*) *In General.* An issue of a security that does not satisfy the requirements of paragraph (c)(7)(xi)(A) (*1*), (*2*), or (*3*) of this section shall nonetheless be considered to have market quotations readily available on an established securities market for purposes of paragraph (c)(7)(xi)(A) of this section if all of the following five requirements are met:

(*i*) The issue is regularly traded during the computational period (as defined in paragraph (c)(7)(xi)(B)(*2*)(*iv*) of this section) in a market that is reflected by the existence of an interdealer quotation system for the issue,

(*ii*) The issuer or an agent of the issuer computes the average trading price (as defined in paragraph (c)(7)(xi)(B)(*2*)(*iii*) of this section) for the issue for the computational period,

(*iii*) The average trading price and total volume of the issue during the computational period are published in a newspaper of general circulation throughout the United States not later than the last day of the month following the end of the calendar quarter in which the computational period ends, (*iv*) The issuer or its agent keeps books and records that list for each transaction during the computational period involving each issue covered by this procedure the date of the settlement of the transaction, the name and address of the broker or dealer making the market in which the transaction occurred, and the trading price and volume, and

(*v*) The issuer or its agent permits the Internal Revenue Service to review the books and records described in paragraph (c)(7)(xi)(B)(*1*)(*iv*) of this section with respect to transactions during the computational period upon giving reasonable notice to the issuer or agent.

(*2*) *Definitions.* For purposes of this paragraph (c)(7)(xi)(B)—

(*i*) *Issue of a security.* The term *issue of a security* means a class of debt securities with the same obligor and identical terms except as to their relative denominations (amounts) or a class of stock having identical rights.

(*ii*) *Interdealer quotation system.* The term *interdealer quotation system* means any system of general circulation to brokers and dealers that regularly disseminates quotations of obligations by two or more identified brokers or dealers, who are not related to either the issuer of the security or to the issuer's agent, who compute the average trading price of the security. A quotation sheet prepared and distributed by a broker or dealer in the regular course of its business and containing only quotations of such broker or dealer is not an interdealer quotation system.

(*iii*) *Average trading price.* The term *average trading price* means the mean price of all transactions (weighted by volume), other than original issue or redemption transactions, conducted through a United States office of a broker or dealer who maintains a market in the issue of the security during the computational period. For this purpose, bid and asked quotations are not taken into account.

(*iv*) *Computational period.* For calendar quarters beginning on or after June 6, 1988, the term *computational period* means weekly during October through December (beginning with the first Monday in October and ending with the first Sunday following the last Monday in December) and monthly during January through September (beginning January 1). For calendar quarters beginning before June 6, 1988, the term *computational period* means weekly during October through December and monthly during January through September.

(C) *Exception.* Securities described in paragraph (c)(7)(xi) (A) or (B) of this section shall not be considered publicly traded securities if—

(*1*) The securities are subject to any restrictions that materially affect the value of the securities to the donor or prevent the securities from being freely traded, or

(*2*) If the amount claimed or reported as a deduction with respect to the contribution of the securities is different than the amount listed in the market quotations that are readily available on an established securities market pursuant to paragraph (c)(7)(xi) (A) or (B) of this section.

(D) *Market quotations and fair market value.* The fair market value of a publicly traded security, as defined in this paragraph (c)(7)(xi), is not necessarily equal to its market quotation, its average trading price (as defined in paragraph (c)(7)(xi)(B)(*2*)(*iii*) of this section), or its face value, if any. See section 1.170A–1(c)(2) for the definition of *fair market value.*

(d) *Charitable contributions; information required in support of deductions for taxable years beginning before January 1, 1983*—(1) *In general.* This paragraph (d)(1) shall apply to deductions for charitable contributions made in taxable years beginning before January 1, 1983. At the option of the taxpayer the requirements of this paragraph (d)(1) shall also apply to all charitable contributions made on or before December 31, 1984 (in lieu of the requirements of paragraphs (a) and (b) of this section). In connection with claims for deductions for charitable contributions, taxpayers shall state in their income tax returns the name of each organization to which a contribution was made and the amount and date of the actual payment of each contribution. If a contribution is made in property other than money, the taxpayer shall state the kind of property contributed, for example, used clothing, paintings, or securities, the method utilized in determining the fair market value of the property at the time the contribution was made, and whether or not the amount of the contribution was reduced under section 170(e). If a taxpayer makes more than one cash contribution to an organization during the taxable year, then in lieu of listing each cash contribution and the date of payment the taxpayer may state the total cash payments made to such organization during the taxable year. A taxpayer who elects under paragraph (d)(2) of §1.170A–8 to apply section 170(e)(1) to his contributions and carryovers of 30-percent capital gain property must file a statement with his return indicating that he has made the election and showing the contributions in the current year and carryovers from preceding years to which it applies. For the definition of the term *30-percent capital gain property*, see paragraph (d)(3) of §1.170A–8.

(2) *Contribution by individual of property other than money.* This paragraph (d)(2) shall apply to deductions for charitable contributions made in taxable years beginning before January 1, 1983. At the option of the taxpayer, the requirements of this paragraph (d)(2) shall also apply to contributions of property made on or before December 31, 1984 (in lieu of the requirements of paragraph (b) of this section). If an individual taxpayer makes a charitable contribution of an item of property other than money and claims a deduction in excess of $200 in respect of his contribution of such item, he shall attach to his income tax return the following information with respect to such item:

(i) The name and address of the organization to which the contribution was made.

(ii) The date of the actual contribution.

(iii) A description of the property in sufficient detail to identify the particular property contributed, including in the case of tangible property the physical condition of the property at the time of contribution, and, in the case of securities, the name of the issuer, the type of security, and whether or not such security is regularly traded on a stock exchange or in an over-the-counter market.

(iv) The manner of acquisition, as, for example, by purchase, gift, bequest, inheritance, or exchange, and the approximate date of acquisition of the property by the taxpayer or, if the property was created, produced, or manufactured by or for the taxpayer, the approximate date the property was substantially completed.

(v) The fair market value of the property at the time the contribution was made, the method utilized in determining the fair market value, and, if the valuation was determined by appraisal, a copy of the signed report of the appraiser.

(vi) The cost or other basis, adjusted as provided by section 1016, of property, other than securities, held by the taxpayer for a period of less than 5 years immediately preceding the date on which the contribution was made and, when the information is available, of property, other than securities, held for a period of 5 years or more preceding the date on which the contribution was made.

(vii) In the case of property to which section 170(e) applies, the cost or other basis, adjusted as provided by section 1016, the reduction by reason of section 170(e)(1) in the amount of the charitable contribution otherwise taken into account, and the manner in which such reduction was determined.

(viii) The terms of any agreement or understanding entered into by or on behalf of the taxpayer which relates to the use, sale, or disposition of the property contributed, as, for example, the terms of any agreement or understanding which:

(A) Restricts temporarily or permanently the donee's right to dispose of the donated property,

(B) Reserves to, or confers upon, anyone other than the donee organization or other than an organization participating with such organization in cooperative fundraising, any right to the income from such property, to the possession of the property, including the right to vote securities, to acquire such property by purchase or otherwise, or to designate the person to have such income, possession, or right to acquire, or

(C) Earmarks contributed property for a particular charitable use, such as the use of donated furniture in the reading room of the donee organization's library.

(ix) The total amount claimed as a deduction for the taxable year due to the contribution of the property and, if less than the entire interest in the property is contributed during the taxable year, the amount claimed as a deduction in any prior year or years for contributions of other interests in such property, the name and address of each organization to which any such contribution was made, the place where any such property which is tangible property is located or kept, and the name of any person, other than the organization to which the property giving rise to the deduction was contributed, having actual possession of the property.

(3) *Statement from donee organization*. Any deduction for a charitable contribution must be substantiated, when required by the district director, by a statement from the organization to which the contribution was made indicating whether the organization is a domestic organization, the name and address of the contributor, the amount of the contribution, the date of actual receipt of the contribution, and such other information as the district director may deem necessary. If the contribution includes an item of property, other than money or securities which are regularly traded on a stock exchange or in an over-the-counter market, which the donee deems to have a fair market value in excess of $500 ($200 in the case of a charitable contribution made in a taxable year beginning before January 1, 1983) at the time of receipt, such statement shall also indicate for each such item its location if it is retained by the organization, the amount received by the organization on any sale of the property and the date of sale or, in case of any other disposition of the property, the method of disposition. In the case of any contribution of tangible personal property, the statement shall indicate the use of the property by the organization and whether or not it is used for a purpose or function constituting the basis for the donee organization's exemption from income tax under section 501 or, in the case of a governmental unit, whether or not it is used for exclusively public purposes.

(e) [Reserved]

(f) *Substantiation of charitable contributions of $250 or more*—(1) *In general*. No deduction is allowed under section 170(a) for all or part of any contribution of $250 or more unless the taxpayer substantiates the contribution with a contemporaneous written acknowledgment from the donee organization. A taxpayer who makes more than one contribution of $250 or more to a donee organization in a taxable year may substantiate the contributions with one or more contemporaneous written acknowledgments. Section 170(f)(8) does not apply to a payment of $250 or more if the amount contributed (as determined under §1.170A–1(h)) is less than $250. Separate contributions of less than $250 are not subject to the requirements of section 170(f)(8), regardless of whether the sum of the contributions made by a taxpayer to a donee organization during a taxable year equals $250 or more.

(2) *Written acknowledgment*. Except as otherwise provided in paragraphs (f)(8) through (f)(11) and (f)(13) of this section, a written acknowledgment from a donee organization must provide the following information—

(i) The amount of any cash the taxpayer paid and a description (but not necessarily the value) of any property other than cash the taxpayer transferred to the donee organization;

(ii) A statement of whether or not the donee organization provides any goods or services in consideration, in whole or in part, for any of the cash or other property transferred to the donee organization;

(iii) If the donee organization provides any goods or services other than intangible religious benefits (as described in section 170(f)(8)), a description and good faith estimate of the value of those goods or services; and

(iv) If the donee organization provides any intangible religious benefits, a statement to that effect.

(3) *Contemporaneous*. A written acknowledgment is contemporaneous if it is obtained by the taxpayer on or before the earlier of—

(i) The date the taxpayer files the original return for the taxable year in which the contribution was made; or

(ii) The due date (including extensions) for filing the taxpayer's original return for that year.

(4) *Donee organization.* For purposes of this paragraph (f), a donee organization is an organization described in section 170(c).

(5) *Goods or services.* Goods or services means cash, property, services, benefits, and privileges.

(6) *In consideration for.* A donee organization provides goods or services in consideration for a taxpayer's payment if, at the time the taxpayer makes the payment to the donee organization, the taxpayer receives or expects to receive goods or services in exchange for that payment. Goods or services a donee organization provides in consideration for a payment by a taxpayer include goods or services provided in a year other than the year in which the taxpayer makes the payment to the donee organization.

(7) *Good faith estimate.* For purposes of this section, good faith estimate means a donee organization's estimate of the fair market value of any goods or services, without regard to the manner in which the organization in fact made that estimate. See §1.170A–1(h)(4) for rules regarding when a taxpayer may treat a donee organization's estimate of the value of goods or services as the fair market value.

(8) *Certain goods or services disregarded*—(i) *In general.* For purposes of section 170(f)(8), the following goods or services are disregarded—

(A) Goods or services that have insubstantial value under the guidelines provided in Revenue Procedures 90–12, 1990–1 C.B. 471, 92–49, 1992-1 C.B. 987, and any successor documents. (See §601.601(d)(2)(ii) of the Statement of Procedural Rules, 26 CFR part 601.); and

(B) Annual membership benefits offered to a taxpayer in exchange for a payment of $75 or less per year that consist of—

(*1*) Any rights or privileges, other than those described in section 170(l), that the taxpayer can exercise frequently during the membership period. Examples of such rights and privileges may include, but are not limited to, free or discounted admission to the organization's facilities or events, free or discounted parking, preferred access to goods or services, and discounts on the purchase of goods or services; and

(*2*) Admission to events during the membership period that are open only to members of a donee organization and for which the donee organization reasonably projects that the cost per person (excluding any allocable overhead) attending each such event is within the limits established for ''low cost articles'' under section 513(h)(2). The projected cost to the donee organization is determined at the time the organization first offers its membership package for the year (using section 3.07 of Revenue Procedure 90–12, or any successor documents, to determine the cost of any items or services that are donated).

(ii) *Examples.* The following examples illustrate the rules of this paragraph (f)(8).

Example 1. Membership benefits disregarded. Performing Arts Center *E* is an organization described in section 170(c). In return for a payment of $75, *E* offers a package of basic membership benefits that includes the right to purchase tickets to performances one week before they go on sale to the general public, free parking in *E*'s garage during evening and weekend performances, and a 10% discount on merchandise sold in *E*'s gift shop. In return for a payment of $150, *E* offers a package of preferred membership benefits that includes all of the benefits in the $75 package as well as a poster that is sold in *E*'s gift shop for $20. The basic membership and the preferred membership are each valid for twelve months, and there are approximately 50 performances of various productions at *E* during a twelve-month period. *E*'s gift shop is open for several hours each week and at performance times. *F*, a patron of the arts, is solicited by *E* to make a contribution. *E* offers *F* the preferred membership benefits in return for a payment of $150 or more. *F* makes a payment of $300 to *E*. *F* can satisfy the substantiation requirement of section 170(f)(8) by obtaining a contemporaneous written acknowledgment from *E* that includes a description of the poster and a good faith estimate of its fair market value ($20) and disregards the remaining membership benefits.

Example 2. Contemporaneous written acknowledgment need not mention rights or privileges that can be disregarded. The facts are the same as in Example 1, except that *F* made a payment of $300 and received only a basic membership. *F* can satisfy the section 170(f)(8) substantiation requirement with a contemporaneous written acknowledgment stating that no goods or services were provided.

Example 3. Rights or privileges that cannot be exercised frequently.

Community Theater Group *G* is an organization described in section 170(c). Every summer, *G* performs four different plays. Each play is performed two times. In return for a membership fee of $60, *G* offers its members free admission to any of its performances. Non-members may purchase tickets on a performance by performance basis for $15 a ticket. *H,* an individual who is a sponsor of the theater, is solicited by *G* to make a contribution. *G* tells *H* that the membership benefit will be provided in return for any payment of $60 or more. *H* chooses to make a payment of $350 to *G* and receives in return the membership benefit. *G'* s membership benefit of free admission is not described in paragraph (f)(8)(i)(B) of this section because it is not a privilege that can be exercised frequently (due to the limited number of performances offered by *G*). Therefore, to meet the requirements of section 170(f)(8), a contemporaneous written acknowledgment of *H*'s $350 payment must include a description of the free admission benefit and a good faith estimate of its value.

Example 4. Multiple memberships. In December of each year, *K*, an individual, gives each of her six grandchildren a junior membership in Dinosaur Museum, an organization described in section 170(c). Each junior membership costs $50, and *K* makes a single payment of $300 for all six memberships. A junior member is entitled to free admission to the museum and to weekly films, slide shows, and lectures about dinosaurs. In addition, each junior member receives a bimonthly, non-commercial quality newsletter with information about dinosaurs and upcoming events. *K*'s contemporaneous written acknowledgment from Dinosaur Museum may state that no goods or services were provided in exchange for *K*'s payment.

(9) *Goods or services provided to employees or partners of donors*—(i) *Certain goods or services disregarded.* For purposes of section 170(f)(8), goods or services provided by a donee organization to employees of a donor, or to partners of a partnership that is a donor, in return for a payment to the organization may be disregarded to the extent that the goods or services provided to each employee or partner are the same as those described in paragraph (f)(8)(i) of this section.

(ii) *No good faith estimate required for other goods or services.* If a taxpayer makes a contribution of $250 or more to a donee organization and, in return, the donee organization offers the taxpayer's employees or partners goods or services other than those described in paragraph (f)(9)(i) of this section, the contemporaneous written acknowledgment of the taxpayer's contribution is not required to include a good faith estimate of the value of such goods or services but must include a description of those goods or services.

(iii) *Example.* The following example illustrates the rules of this paragraph (f)(9).

Example. Museum *J* is an organization described in section 170(c). For a payment of $40, *J* offers a package of basic membership benefits that includes free admission and a 10% discount on merchandise sold in *J*'s gift shop. *J*'s other membership categories are for supporters who contribute $100 or more. Corporation *K* makes a payment of $50,000 to *J* and, in return, *J* offers *K*'s employees free admission for one year, a tee-shirt with *J*'s logo that costs *J* $4.50, and a gift shop discount of 25% for one year. The free admission for *K*'s employees is the same as the benefit made available to holders of the $40 membership and is otherwise described in paragraph (f)(8)(i)(B) of this section. The tee-shirt given to each of *K*'s employees is described in paragraph (f)(8)(i)(A) of this section. Therefore, the contemporaneous written acknowledgment of *K*'s payment is not required to include a description or good faith estimate of the value of the free admission or the tee-shirts. However, because the gift shop discount offered to *K*'s employees is different than that offered to those who purchase the $40 membership, the discount is not described in paragraph (f)(8)(i) of this section. Therefore, the contemporaneous written acknowledgment of *K*'s payment is required to include a description of the 25% discount offered to *K*'s employees.

(10) *Substantiation of out-of-pocket expenses.* A taxpayer who incurs unreimbursed expenditures incident to the rendition of services, within the meaning of §1.170A–1(g), is treated as having obtained a contemporaneous written acknowledgment of those expenditures if the taxpayer—

(i) Has adequate records under paragraph (a) of this section to substantiate the amount of the expenditures; and

(ii) Obtains by the date prescribed in paragraph (f)(3) of this section a statement prepared by the donee organization containing—

(A) A description of the services provided by the taxpayer;

(B) A statement of whether or not the donee organization provides any goods or services in consideration, in whole or in part, for the unreimbursed expenditures; and

(C) The information required by paragraphs (f)(2) (iii) and (iv) of this section.

(11) *Contributions made by payroll deduction*—(i) *Form of substantiation.* A contribution made by means of withholding from a taxpayer's wages and payment by the taxpayer's employer to a donee organization may be substantiated, for purposes of section 170(f)(8), by both—

(A) A pay stub, Form W–2, or other document furnished by the employer that sets forth the amount withheld by the employer for the purpose of payment to a donee organization; and

(B) A pledge card or other document prepared by or at the direction of the donee organization that includes a statement to the effect that the organization does not provide goods or services in whole or partial consideration for any contributions made to the organization by payroll deduction.

(ii) *Application of $250 threshold.* For the purpose of applying the $250 threshold provided in section 170(f)(8)(A) to contributions made by the means described in paragraph (f)(11)(i) of this section, the amount withheld from each payment of wages to a taxpayer is treated as a separate contribution.

(12) *Distributing organizations as donees.* An organization described in section 170(c), or an organization described in 5 CFR 950.105 (a Principal Combined Fund Organization for purposes of the Combined Federal Campaign) and acting in that capacity, that receives a payment made as a contribution is treated as a donee organization solely for purposes of section 170(f)(8), even if the organization (pursuant to the donor's instructions or otherwise) distributes the amount received to one or more organizations described in section 170(c). This paragraph (f)(12) does not apply, however, to a case in which the distributee organization provides goods or services as part of a transaction structured with a view to avoid taking the goods or services into account in determining the amount of the deduction to which the donor is entitled under section 170.

(13) *Transfers to certain trusts.* Section 170(f)(8) does not apply to a transfer of property to a trust described in section 170(f)(2)(B), a charitable remainder annuity trust (as defined in section 664(d)(1)), or a charitable remainder unitrust (as defined in section 664(d)(2) or (d)(3) or §1.664(3)(a)(1)(i)(*b*)). Section 170(f)(8) does apply, however, to a transfer to a pooled income fund (as defined in section 642(c)(5)); for such a transfer, the contemporaneous written acknowledgment must state that the contribution was transferred to the donee organization's pooled income fund and indicate whether any goods or services (in addition to an income interest in the fund) were provided in exchange for the transfer. The contemporaneous written acknowledgment is not required to include a good faith estimate of the income interest.

(14) *Substantiation of payments to a college or university for the right to purchase tickets to athletic events.* For purposes of paragraph (f)(2)(iii) of this section, the right to purchase tickets for seating at an athletic event in exchange for a payment described in section 170(l) is treated as having a value equal to twenty percent of such payment. For example, when a taxpayer makes a payment of $312.50 for the right to purchase tickets for seating at an athletic event, the right to purchase tickets is treated as having a value of $62.50. The remaining $250 is treated as a charitable contribution, which the taxpayer must substantiate in accordance with the requirements of this section.

(15) *Substantiation of charitable contributions made by a partnership or an S corporation.* If a partnership or an S corporation makes a charitable contribution of $250 or more, the partnership or S corporation will be treated as the taxpayer for purposes of section 170(f)(8). Therefore, the partnership or S corporation must substantiate the contribution with a contemporaneous written acknowledgment from the donee organization before reporting the contribution on its income tax return for the year in which the contribution

was made and must maintain the contemporaneous written acknowledgment in its records. A partner of a partnership or a shareholder of an S corporation is not required to obtain any additional substantiation for his or her share of the partnership's or S corporation's charitable contribution.

(16) *Purchase of an annuity.* If a taxpayer purchases an annuity from a charitable organization and claims a charitable contribution deduction of $250 or more for the excess of the amount paid over the value of the annuity, the contemporaneous written acknowledgment must state whether any goods or services in addition to the annuity were provided to the taxpayer. The contemporaneous written acknowledgment is not required to include a good faith estimate of the value of the annuity. See § 1.170A–1(d)(2) for guidance in determining the value of the annuity.

(17) *Substantiation of matched payments*—(i) *In general.* For purposes of section 170, if a taxpayer's payment to a donee organization is matched, in whole or in part, by another payor, and the taxpayer receives goods or services in consideration for its payment and some or all of the matching payment, those goods or services will be treated as provided in consideration for the taxpayer's payment and not in consideration for the matching payment.

(ii) *Example.* The following example illustrates the rules of this paragraph (f)(17).

Example Taxpayer makes a $400 payment to Charity *L*, a donee organization. Pursuant to a matching payment plan, Taxpayer's employer matches Taxpayer's $400 payment with an additional payment of $400. In consideration for the combined payments of $800, *L* gives Taxpayer an item that it estimates has a fair market value of $100. *L* does not give the employer any goods or services in consideration for its contribution. The contemporaneous written acknowledgment provided to the employer must include a statement that no goods or services were provided in consideration for the employer's $400 payment. The contemporaneous written acknowledgment provided to Taxpayer must include a statement of the amount of Taxpayer's payment, a description of the item received by Taxpayer, and a statement that *L*'s good faith estimate of the value of the item received by Taxpayer is $100.

(18) *Effective date.* This paragraph (f) applies to contributions made on or after December 16, 1996. However, taxpayers may rely on the rules of this paragraph (f) for contributions made on or after January 1, 1994.

[T.D. 8002, 49 FR 50664 and 50666, Dec. 31, 1984, as amended by T.D. 8003, 49 FR 50659, Dec. 31, 1984; T.D. 8199, 53 FR 16080, May 5, 1988; 53 FR 18372, May 23, 1988; T.D. 8623, 60 FR 53128, Oct. 12, 1995; T.D. 8690, 61 FR 65952, Dec. 16, 1996]

§ 1.170A–14 Qualified conservation contributions.

(a) *Qualified conservation contributions.* A deduction under section 170 is generally not allowed for a charitable contribution of any interest in property that consists of less than the donor's entire interest in the property other than certain transfers in trust (see § 1.170A–6 relating to charitable contributions in trust and § 1.170A–7 relating to contributions not in trust of partial interests in property). However, a deduction may be allowed under section 170(f)(3)(B)(iii) for the value of a qualified conservation contribution if the requirements of this section are met. A qualified conservation contribution is the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. To be eligible for a deduction under this section, the conservation purpose must be protected in perpetuity.

(b) *Qualified real property interest*—(1) *Entire interest of donor other than qualified mineral interest.* (i) The entire interest of the donor other than a qualified mineral interest is a qualified real property interest. A qualified mineral interest is the donor's interest in subsurface oil, gas, or other minerals and the right of access to such minerals.

(ii) A real property interest shall not be treated as an entire interest other than a qualified mineral interest by reason of section 170(h)(2)(A) and this paragraph (b)(1) if the property in which the donor's interest exists was divided prior to the contribution in order to enable the donor to retain control of more than a qualified mineral interest or to reduce the real property interest donated. See Treasury regulations § 1.170A–7(a)(2)(i). An entire interest in real property may consist of an undivided interest in the property. But see section 170(h)(5)(A) and the regulations thereunder (relating to the requirement that the conservation purpose which is the subject of the donation must be protected in perpetuity). Minor interests, such as rights-of-way, that will not interfere with the conservation purposes of the donation, may be transferred prior to the conservation contribution without affecting the treatment of a property interest as a qualified real property interest under this paragraph (b)(1).

(2) *Perpetual conservation restriction.* A ‘‘perpetual conservation restriction’’ is a qualified real property interest. A ‘‘perpetual conservation restriction’’ is a restriction granted in perpetuity on the use which may be made of real property—including, an easement or other interest in real property that under state law has attributes similar to an easement (e.g., a restrictive covenant or equitable servitude). For purposes of this section, the terms *easement, conservation restriction,* and *perpetual conservation restriction* have the same meaning. The definition of *perpetual conservation restriction* under this paragraph (b)(2) is not intended to preclude the deductibility of a donation of affirmative rights to use a land or water area under §1.170A–13(d)(2). Any rights reserved by the donor in the donation of a perpetual conservation restriction must conform to the requirements of this section. See *e.g.,* paragraph (d)(4)(ii), (d)(5)(i), (e)(3), and (g)(4) of this section.

(c) *Qualified organization*—(1) *Eligible donee.* To be considered an eligible donee under this section, an organization must be a qualified organization, have a commitment to protect the conservation purposes of the donation, and have the resources to enforce the restrictions. A conservation group organized or operated primarily or substantially for one of the conservation purposes specified in section 170(h)(4)(A) will be considered to have the commitment required by the preceding sentence. A qualified organization need not set aside funds to enforce the restrictions that are the subject of the contribution. For purposes of this section, the term *qualified organization* means:

(i) A governmental unit described in section 170(b)(1)(A)(v);

(ii) An organization described in section 170(b)(1)(A)(vi);

(iii) A charitable organization described in section 501(c)(3) that meets the public support test of section 509(a)(2);

(iv) A charitable organization described in section 501(c)(3) that meets the requirements of section 509(a)(3) and is controlled by an organization described in paragraphs (c)(1) (i), (ii), or (iii) of this section.

(2) *Transfers by donee.* A deduction shall be allowed for a contribution under this section only if in the instrument of conveyance the donor prohibits the donee from subsequently transferring the easement (or, in the case of a remainder interest or the reservation of a qualified mineral interest, the property), whether or not for consideration, unless the donee organization, as a condition of the subsequent transfer, requires that the conservation purposes which the contribution was originally intended to advance continue to be carried out. Moreover, subsequent transfers must be restricted to organizations qualifying, at the time of the subsequent transfer, as an eligible donee under paragraph (c)(1) of this section. When a later unexpected change in the conditions surrounding the property that is the subject of a donation under paragraph (b)(1), (2), or (3) of this section makes impossible or impractical the continued use of the property for conservation purposes, the requirement of this paragraph will be met if the property is sold or exchanged and any proceeds are used by the donee organization in a manner consistent with the conservation purposes of the original contribution. In the case of a donation under paragraph (b)(3) of this section to which the preceding sentence applies, see also paragraph (g)(5)(ii) of this section.

(d) *Conservation purposes*—(1) *In general.* For purposes of section 170(h) and this section, the term *conservation purposes* means—

(i) The preservation of land areas for outdoor recreation by, or the education of, the general public, within the meaning of paragraph (d)(2) of this section,

(ii) The protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem, within the meaning of paragraph (d)(3) of this section,

(iii) The preservation of certain open space (including farmland and forest land) within the meaning of paragraph (d)(4) of this section, or

(iv) The preservation of a historically important land area or a certified historic structure, within the meaning of paragraph (d)(5) of this section.

(2) *Recreation or education*—(i) *In general.* The donation of a qualified real property interest to preserve land areas for the outdoor recreation of the general public or for the education of the general public will meet the conservation purposes test of this section. Thus, conservation purposes would include, for example, the preservation of a water area for the use of the public for boating or fishing, or a nature or hiking trail for the use of the public.

(ii) *Access.* The preservation of land areas for recreation or education will not meet the test of this section unless the recreation or education is for the substantial and regular use of the general public.

(3) *Protection of environmental system*—(i) *In general.* The donation of a qualified real property interest to protect a significant relatively natural habitat in which a fish, wildlife, or plant community, or similar ecosystem normally lives will meet the conservation purposes test of this section. The fact that the habitat or environment has been altered to some extent by human activity will not result in a deduction being denied under this section if the fish, wildlife, or plants continue to exist there in a relatively natural state. For example, the preservation of a lake formed by a man-made dam or a salt pond formed by a man-made dike would meet the conservation purposes test if the lake or pond were a nature feeding area for a wildlife community that included rare, endangered, or threatened native species.

(ii) *Significant habitat or ecosystem.* Significant habitats and ecosystems include, but are not limited to, habitats for rare, endangered, or threatened species of animal, fish, or plants; natural areas that represent high quality examples of a terrestrial community or aquatic community, such as islands that are undeveloped or not intensely developed where the coastal ecosystem is relatively intact; and natural areas which are included in, or which contribute to, the ecological viability of a local, state, or national park, nature preserve, wildlife refuge, wilderness area, or other similar conservation area.

(iii) *Access.* Limitations on public access to property that is the subject of a donation under this paragraph (d)(3) shall not render the donation nondeductible. For example, a restriction on all public access to the habitat of a threatened native animal species protected by a donation under this paragraph (d)(3) would not cause the donation to be nondeductible.

(4) *Preservation of open space*—(i) *In general.* The donation of a qualified real property interest to preserve open space (including farmland and forest land) will meet the conservation purposes test of this section if such preservation is—

(A) Pursuant to a clearly delineated Federal, state, or local governmental conservation policy and will yield a significant public benefit, or

(B) For the scenic enjoyment of the general public and will yield a significant public benefit.

An open space easement donated on or after December 18, 1980, must meet the requirements of section 170(h) in order to be deductible.

(ii) *Scenic enjoyment*—(A) *Factors.* A contribution made for the preservation of open space may be for the scenic enjoyment of the general public. Preservation of land may be for the scenic enjoyment of the general public if development of the property would impair the scenic character of the local rural or urban landscape or would interfere with a scenic panorama that can be enjoyed from a park, nature preserve, road, waterbody, trail, or historic structure or land area, and such area or transportation way is open to, or utilized by, the public. ''Scenic enjoyment'' will be evaluated by considering all pertinent facts and circumstances germane to the contribution. Regional variations in topography, geology, biology, and cultural and economic conditions require flexibility in the application of this test, but do not lessen the burden on the taxpayer to demonstrate the scenic characteristics of a donation under this paragraph. The application of a particular objective factor to help define a view as *scenic* in one setting may in fact be entirely inappropriate in another setting. Among the factors to be considered are:

(*1*) The compatibility of the land use with other land in the vicinity;

(*2*) The degree of contrast and variety provided by the visual scene;

(*3*) The openness of the land (which would be a more significant factor in an urban or densely populated setting or in a heavily wooded area);

(*4*) Relief from urban closeness;

(*5*) The harmonious variety of shapes and textures;

(*6*) The degree to which the land use maintains the scale and character of the urban landscape to preserve open space, visual enjoyment, and sunlight for the surrounding area;

(*7*) The consistency of the proposed scenic view with a methodical state scenic identification program, such as a state landscape inventory; and

(*8*) The consistency of the proposed scenic view with a regional or local landscape inventory made pursuant to a sufficiently rigorous review process, especially if the donation is endorsed by an appropriate state or local governmental agency.

(B) *Access.* To satisfy the requirement of scenic enjoyment by the general public, visual (rather than physical) access to or across the property by the general public is sufficient. Under the terms of an open space easement on scenic property, the entire property need not be visible to the public for a donation to qualify under this section, although the public benefit from the donation may be insufficient to qualify for a deduction if only a small portion of the property is visible to the public.

(iii) *Governmental conservation policy*—(A) *In general.* The requirement that the preservation of open space be pursuant to a clearly delineated Federal, state, or local governmental policy is intended to protect the types of property identified by representatives of the general public as worthy of preservation or conservation. A general declaration of conservation goals by a single official or legislative body is not sufficient. However, a governmental conservation policy need not be a certification program that identifies particular lots or small parcels of individually owned property. This requirement will be met by donations that further a specific, identified conservation project, such as the preservation of land within a state or local landmark district that is locally recognized as being significant to that district; the preservation of a wild or scenic river, the preservation of farmland pursuant to a state program for flood prevention and control; or the protection of the scenic, ecological, or historic character of land that is contiguous to, or an integral part of, the surroundings of existing recreation or conservation sites. For example, the donation of a perpetual conservation restriction to a qualified organization pursuant to a formal resolution or certification by a local governmental agency established under state law specifically identifying the subject property as worthy of protection for conservation purposes will meet the requirement of this paragraph. A program need not be funded to satisfy this requirement, but the program must involve a significant commitment by the government with respect to the conservation project. For example, a governmental program according preferential tax assessment or preferential zoning for certain property deemed worthy of protection for conservation purposes would constitute a significant commitment by the government.

(B) *Effect of acceptance by governmental agency.* Acceptance of an easement by an agency of the Federal Government or by an agency of a state or local government (or by a commission, authority, or similar body duly constituted by the state or local government and acting on behalf of the state or local government) tends to establish the requisite clearly delineated governmental policy, although such acceptance, without more, is not sufficient. The more rigorous the review process by the governmental agency, the more the acceptance of the easement tends to establish the requisite clearly delineated governmental policy. For example, in a state where the legislature has established an Environmental Trust to accept gifts to the state which meet certain conservation purposes and to submit the gifts to a review that requires the approval of the state's highest officials, acceptance of a gift by the Trust tends to establish the requisite clearly delineated governmental policy. However, if the Trust merely accepts such gifts without a review process, the requisite clearly delineated governmental policy is not established.

(C) *Access.* A limitation on public access to property subject to a donation under this paragraph (d)(4)(iii) shall not render the deduction nondeductible unless the conservation purpose of the donation would be undermined or frustrated without public access. For example, a donation pursuant to a governmental policy to protect the scenic character of land near a river requires visual access to the same extent as would a donation under paragraph (d)(4)(ii) of this section.

(iv) *Significant public benefit*—(A) *Factors.* All contributions made for the preservation of open space must yield a significant public benefit. Public benefit will be evaluated by considering all pertinent facts and circumstances germane to the contribution. Factors germane to the evaluation of public benefit from one contribution may be irrelevant in determining public benefit from another contribution. No single factor will necessarily be determinative. Among the factors to be considered are:

(*1*) The uniqueness of the property to the area;

(*2*) The intensity of land development in the vicinity of the property (both existing development and foreseeable trends of development);

(*3*) The consistency of the proposed open space use with public programs (whether Federal, state or local) for conservation in the region, including programs for outdoor recreation, irrigation or water supply protection, water quality maintenance or enhancement, flood prevention and control, erosion control, shoreline protection, and protection of land areas included in, or related to, a government approved master plan or land management area;

(*4*) The consistency of the proposed open space use with existing private conservation programs in the area, as evidenced by other land, protected by easement or fee ownership by organizations referred to in § 1.170A–14(c)(1), in close proximity to the property;

(*5*) The likelihood that development of the property would lead to or contribute to degradation of the scenic, natural, or historic character of the area;

(*6*) The opportunity for the general public to use the property or to appreciate its scenic values;

(*7*) The importance of the property in preserving a local or regional landscape or resource that attracts tourism or commerce to the area;

(*8*) The likelihood that the donee will acquire equally desirable and valuable substitute property or property rights;

(*9*) The cost to the donee of enforcing the terms of the conservation restriction;

(*10*) The population density in the area of the property; and

(*11*) The consistency of the proposed open space use with a legislatively mandated program identifying particular parcels of land for future protection.

(B) *Illustrations.* The preservation of an ordinary tract of land would not in and of itself yield a significant public benefit, but the preservation of ordinary land areas in conjunction with other factors that demonstrate significant public benefit or the preservation of a unique land area for public employment would yield a significant public benefit. For example, the preservation of a vacant downtown lot would not by itself yield a significant public benefit, but the preservation of the downtown lot as a public garden would, absent countervailing factors, yield a significant public benefit. The following are other examples of contributions which would, absent countervailing factors, yield a significant public benefit: The preservation of farmland pursuant to a state program for flood prevention and control; the preservation of a unique natural land formation for the enjoyment of the general public; the preservation of woodland along a public highway pursuant to a government program to preserve the appearance of the area so as to maintain the scenic view from the highway; and the preservation of a stretch of undeveloped property located between a public highway and the ocean in order to maintain the scenic ocean view from the highway.

(v) *Limitation.* A deduction will not be allowed for the preservation of open space under section 170(h)(4)(A)(iii), if the terms of the easement permit a degree of intrusion or future development that would interfere with the essential scenic quality of the land or with the governmental conservation policy that is being furthered by the donation. See §1.170A–14(e)(2) for rules relating to inconsistent use.

(vi) *Relationship of requirements*—(A) *Clearly delineated governmental policy and significant public benefit.* Although the requirements of ‘‘clearly delineated governmental policy’’ and ‘‘significant public benefit’’ must be met independently, for purposes of this section the two requirements may also be related. The more specific the governmental policy with respect to the particular site to be protected, the more likely the governmental decision, by itself, will tend to establish the significant public benefit associated with the donation. For example, while a statute in State X permitting preferential assessment for farmland is, by definition, governmental policy, it is distinguishable from a state statute, accompanied by appropriations, naming the X River as a valuable resource and articulating the legislative policy that the X River and the relatively natural quality of its surrounding be protected. On these facts, an open space easement on farmland in State X would have to demonstrate additional factors to establish ‘‘significant public benefit.’’ The specificity of the legislative mandate to protect the X River, however, would by itself tend to establish the significant public benefit associated with an open space easement on land fronting the X River.

(B) *Scenic enjoyment and significant public benefit.* With respect to the relationship between the requirements of ‘‘scenic enjoyment’’ and ‘‘significant public benefit,’’ since the degrees of scenic enjoyment offered by a variety of open space easements are subjective and not as easily delineated as are increasingly specific levels of governmental policy, the significant public benefit of preserving a scenic view must be independently established in all cases.

(C) *Donations may satisfy more than one test.* In some cases, open space easements may be both for scenic enjoyment and pursuant to a clearly delineated governmental policy. For example, the preservation of a particular scenic view identified as part of a scenic landscape inventory by a rigorous governmental review process will meet the tests of both paragraphs (d)(4)(i)(A) and (d)(4)(i)(B) of this section.

(5) *Historic preservation*—(i) *In general.* The donation of a qualified real property interest to preserve an historically important land area or a certified historic structure will meet the conservation purposes test of this section. When restrictions to preserve a building or land area within a registered historic district permit future development on the site, a deduction will be allowed under this section only if the terms of the restrictions require that such development conform with appropriate local, state, or Federal standards for construction or rehabilitation within the district. See also, §1.170A–14(h)(3)(ii).

(ii) *Historically important land area.* The term *historically important land area* includes:

(A) An independently significant land area including any related historic resources (for example, an archaeological site or a Civil War battlefield with related monuments, bridges, cannons, or houses) that meets the National Register Criteria for Evaluation in 36 CFR 60.4 (Pub. L. 89–665, 80 Stat. 915);

(B) Any land area within a registered historic district including any buildings on the land area that can reasonably be considered as contributing to the significance of the district; and

(C) Any land area (including related historic resources) adjacent to a property listed individually in the National Register of Historic Places (but not within a registered historic district) in a case where the physical or environmental features of the land area contribute to the historic or cultural integrity of the property.

(iii) *Certified historic structure.* The term *certified historic structure,* for purposes of this section, means any building, structure or land area which is—

(A) Listed in the National Register, or

(B) Located in a registered historic district (as defined in section 48(g)(3)(B)) and is certified by the Secretary of the Interior (pursuant to 36 CFR 67.4) to the Secretary of the Treasury as being of historic significance to the district.

A *structure* for purposes of this section means any structure, whether or not it is depreciable. Accordingly easements on private residences may qualify under this section. In addition, a structure would be considered to be a certified historic structure if it were certified either at the time the transfer was made or at the due date (including extensions) for filing the donor's return for the taxable year in which the contribution was made.

(iv) *Access.* (A) In order for a conservation contribution described in section 170(h)(4)(A)(iv) and this paragraph (d)(5) to be deductible, some visual public access to the donated property is required. In the case of an historically important land area, the entire property need not be visible to the public for a donation to qualify under this section. However, the public benefit from the donation may be insufficient to qualify for a deduction if only a small portion of the property is so visible. Where the historic land area or certified historic structure which is the subject of the donation is not visible from a public way (*e.g.,* the structure is hidden from view by a wall or shrubbery, the structure is too far from the public way, or interior characteristics and features of the structure are the subject of the easement), the terms of the easement must be such that the general public is given the opportunity on a regular basis to view the characteristics and features of the property which are preserved by the easement to the extent consistent with the nature and condition of the property.

(B) Factors to be considered in determining the type and amount of public access required under paragraph (d)(5)(iv)(A) of this section include the historical significance of the donated property, the nature of the features that are the subject of the easement, the remoteness or accessibility of the site of the donated property, the possibility of physical hazards to the public visiting the property (for example, an unoccupied structure in a dilapidated condition), the extent to which public access would be an unreasonable intrusion on any privacy interests of individuals living on the property, the degree to which public access would impair the preservation interests which are the subject of the donation, and the availability of opportunities for the public to view the property by means other than visits to the site.

(C) The amount of access afforded the public by the donation of an easement shall be determined with reference to the amount of access permitted by the terms of the easement which are established by the donor, rather than the amount of access actually provided by the donee organization. However, if the donor is aware of any facts indicating that the amount of access that the donee organization will provide is significantly less than the amount of access permitted under the terms of the easement, then the amount of access afforded the public shall be determined with reference to this lesser amount.

(v) *Examples.* The provisions of paragraph (d)(5)(iv) of this section may be illustrated by the following examples:

Example 1. A and his family live in a house in a certified historic district in the State of X. The entire house, including its interior, has architectural features representing classic Victorian period architecture. A donates an exterior and interior easement on the property to a qualified organization but continues to live in the house with his family. A's house is surrounded by a high stone wall which obscures the public's view of it from the street. Pursuant to the terms of the easement, the house may be opened to the public from 10:00 a.m. to 4:00 p.m. on one Sunday in May and one Sunday in November each year for house and garden tours. These tours are to be under the supervision of the donee and open to members of the general public upon payment of a small fee. In addition, under the terms of the easement, the donee organization is given the right to photograph the interior and exterior of the house and distribute such photographs to magazines, newsletters, or other publicly available publications. The terms of the easement also permit persons affiliated with educational organizations, professional architectural associations, and historical societies to make an appointment through the donee organization to study the property. The donor is not aware of any facts indicating that the public access to be provided by the donee organization will be significantly less than that permitted by the terms of the easement. The 2 opportunities for public visits per year, when combined with the ability of the general public to view the architectural characteristics and features that are the subject of the easement through photographs, the opportunity for scholarly study of the property, and the fact that the house is used as an occupied residence, will enable the donation to satisfy the requirement of public access.

Example 2. B owns an unoccupied farmhouse built in the 1840's and located on a property that is adjacent to a Civil War battlefield. During the Civil War the farmhouse was used as quarters for Union troops. The battlefield is visited year round by the general public. The condition of the farmhouse is such that the safety of visitors will not be jeopardized and opening it to the public will not result in significant deterioration. The farmhouse is not visible from the battlefield or any public way. It is accessible only by way of a private road owned by B. B donates a conservation easement on the farmhouse to a qualified organization. The terms of the easement provide that the donee organization may open the property (via B's road) to the general public on four weekends each year from 8:30 a.m. to 4:00 p.m. The donation does not meet the public access requirement because the farmhouse is safe, unoccupied, and easily accessible to the general public who have come to the site to visit Civil War historic land areas (and related resources), but will only be open to the public on four weekends each year. However, the donation would meet the public access requirement if the terms of the easement permitted the donee organization to open the property to the public every other weekend during the year and the donor is not aware of any facts indicating that the donee organization will provide significantly less access than that permitted.

(e) *Exclusively for conservation purposes*—(1) *In general.* To meet the requirements of this section, a donation must be exclusively for conservation purposes. See paragraphs (c)(1) and (g)(1) through (g)(6)(ii) of this section. A deduction will not be denied under this section when incidental benefit inures to the donor merely as a result of conservation restrictions limiting the uses to which the donor's property may be put.

(2) *Inconsistent use.* Except as provided in paragraph (e)(4) of this section, a deduction will not be allowed if the contribution would accomplish one of the enumerated conservation purposes but would permit destruction of other significant conservation interests. For example, the preservation of farmland pursuant to a State program for flood prevention and control would not qualify under paragraph (d)(4) of this section if under the terms of the contribution a significant naturally occurring ecosystem could be injured or destroyed by the use of pesticides in the operation of the farm. However, this requirement is not intended to prohibit uses of the property, such as selective timber harvesting or selective farming if, under the circumstances, those uses do not impair significant conservation interests.

(3) *Inconsistent use permitted.* A use that is destructive of conservation interests will be permitted only if such use is necessary for the protection of the conservation interests that are the subject of the contribution. For example, a deduction for the donation of an easement to preserve an archaeological site that is listed on the National Register of Historic Places will not be disallowed if site excavation consistent with sound archaeological practices may impair a scenic view of which the land is a part. A donor may continue a pre-existing use of the property that does not conflict with the conservation purposes of the gift.

(f) *Examples.* The provisions of this section relating to conservation purposes may be illustrated by the following examples.

Example 1. State S contains many large tract forests that are desirable recreation and scenic areas for the general public. The forests' scenic values attract millions of people to the State. However, due to the increasing intensity of land development in State S, the continued existence of forestland parcels greater than 45 acres is threatened. J grants a perpetual easement on a 100-acre parcel of forestland that is part of one of the State's scenic areas to a qualifying organization. The easement imposes restrictions on the use of the parcel for the purpose of maintaining its scenic values. The restrictions include a requirement that the parcel be maintained forever as open space devoted exclusively to conservation purposes and wildlife protection, and that there be no commercial, industrial, residential, or other development use of such parcel. The law of State S recognizes a limited public right to enter private land, particularly for recreational pursuits, unless such land is posted or the landowner objects. The easement specifically restricts the landowner from posting the parcel, or from objecting, thereby maintaining public access to the parcel according to the custom of the State. J's parcel provides the opportunity for the public to enjoy the use of the property and appreciate its scenic values. Accordingly, J's donation qualifies for a deduction under this section.

Example 2. A qualified conservation organization owns Greenacre in fee as a nature preserve. Greenacre contains a high quality example of a tall grass prairie ecosystem. Farmacre, an operating farm, adjoins Greenacre and is a compatible buffer to the nature preserve. Conversion of Farmacre to a more intense use, such as a housing development, would adversely affect the continued use of Greenacre as a nature preserve because of human traffic generated by the development. The owner of Farmacre donates an easement preventing any future development on Farmacre to the qualified conservation organization for conservation purposes. Normal agricultural uses will be allowed on Farmacre. Accordingly, the donation qualifies for a deduction under this section.

Example 3. H owns Greenacre, a 900-acre parcel of woodland, rolling pasture, and orchards on the crest of a mountain. All of Greenacre is clearly visible from a nearby national park. Because of the strict enforcement of an applicable zoning plan, the highest and best use of Greenacre is as a subdivision of 40-acre tracts. H wishes to donate a scenic easement on Greenacre to a qualifying conservation organization, but H would like to reserve the right to subdivide Greenacre into 90-acre parcels with no more than one single-family home allowable on each parcel. Random building on the property, even as little as one home for each 90 acres, would destroy the scenic character of the view. Accordingly, no deduction would be allowable under this section.

Example 4. Assume the same facts as in *example (3),* except that not all of Greenacre is visible from the park and the deed of easement allows for limited cluster development of no more than five nine-acre clusters (with four houses on each cluster) located in areas generally not visible from the national park and subject to site and building plan approval by the donee organization in order to preserve the scenic view from the park. The donor and the donee have already identified sites where limited cluster development would not be visible from the park or would not impair the view. Owners of homes in the clusters will not have any rights with respect to the surrounding Greenacre property that are not also available to the general public. Accordingly, the donation qualifies for a deduction under this section.

Example 5. In order to protect State S's declining open space that is suited for agricultural use from increasing development pressure that has led to a marked decline in such open space, the Legislature of State S passed a statute authorizing the purchase of ''agricultural land development rights'' on open acreage. Agricultural land development rights allow the State to place agricultural preservation restrictions on land designated as worthy of protection in order to preserve open space and farm resources. Agricultural preservation restrictions prohibit or limit construction or placement of buildings except those used for agricultural purposes or dwellings used for family living by the farmer and his family and employees; removal of mineral substances in any manner that adversely affects the land's agricultural potential; or other uses detrimental to retention of the land for agricultural use. Money has been appropriated for this program and some landowners have in fact sold their ''agricultural land development rights'' to State S. K owns and operates a small dairy farm in State S located in an area designated by the Legislature as worthy of protection. K desires to preserve his farm for agricultural purposes in perpetuity. Rather than selling the development rights to State S, K grants to a qualified organization an agricultural preservation restriction on his property in the form of a conservation easement. K reserves to himself, his heirs and assigns the right to manage the farm consistent with sound agricultural and management practices. The preservation of K's land is pursuant to a clearly delineated governmental policy of preserving open space available for agricultural use, and will yield a significant public benefit by preserving open space against increasing development pressures.

(g) *Enforceable in perpetuity*—(1) *In general.* In the case of any donation under this section, any interest in the property retained by the donor (and the donor's successors in interest) must be subject to legally enforceable restrictions (for example, by recordation in the land records of the jurisdiction in which the property is located) that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation. In the case of a contribution of a remainder interest, the contribution will not qualify if the tenants, whether they are tenants for life or a term of years, can use the property in a manner that diminishes the conservation values which are intended to be protected by the contribution.

(2) *Protection of a conservation purpose in case of donation of property subject to a mortgage.* In the case of conservation contributions made after February 13, 1986, no deducion will be permitted under this section for an interest in property which is subject to a mortgage unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity. For conservation contributions made prior to February 14, 1986, the requirement of section 170 (h)(5)(A) is satisfied in the case of mortgaged property (with respect to which the mortgagee has not subordinated its rights) only if the donor can demonstrate that the conservation purpose is protected in perpetuity without subordination of the mortgagee's rights.

(3) *Remote future event.* A deduction shall not be disallowed under section 170(f)(3)(B)(iii) and this section merely because the interest which passes to, or is vested in, the donee organization may be defeated by the performance of some act or the happening of some event, if on the date of the gift it appears that the possibility that such act or event will occur is so remote as to be negligible. See paragraph (e) of §1.170A–1. For example, a state's statutory requirement that use restrictions must be rerecorded every 30 years to remain enforceable shall not, by itself, render an easement nonperpetual.

(4) *Retention of qualified mineral interest*—(i) *In general.* Except as otherwise provided in paragraph (g)(4)(ii) of this section, the requirements of this section are not met and no deduction shall be allowed in the case of a contribution of any interest when there is a retention by any person of a qualified mineral interest (as defined in paragraph (b)(1)(i) of this section) if at any time there may be extractions or removal of minerals by any surface mining method. Moreover, in the case of a qualified mineral interest gift, the requirement that the conservation purposes be protected in perpetuity is not satisfied if any method of mining that is inconsistent with the particular conservation purposes of a contribution is permitted at any time. See also §1.170A–14(e)(2). However, a deduction under this section will not be denied in the case of certain methods of mining that may have limited, localized impact on the real property but that are not irremediably destructive of significant conservation interests. For example, a deduction will not be denied in a case where production facilities are concealed or compatible with existing topography and landscape and when surface alteration is to be restored to its original state.

(ii) *Exception for qualified conservation contributions after July 1984.* (A) A contribution made after July 18, 1984, of a qualified real property interest described in section 170(h)(2)(A) shall not be disqualified under the first sentence of paragraph (g)(4)(i) of this section if the following requirements are satisfied.

(*1*) The ownership of the surface estate and mineral interest were separated before June 13, 1976, and remain so separated up to and including the time of the contribution.

(*2*) The present owner of the mineral interest is not a person whose relationship to the owner of the surface estate is described at the time of the contribution in section 267(b) or section 707(b), and

(*3*) The probability of extraction or removal of minerals by any surface mining method is so remote as to be negligible.

Whether the probability of extraction or removal of minerals by surface mining is so remote as to be negligible is a question of fact and is to be made on a case by case basis. Relevant factors to be considered in determining if the probability of extraction or removal of minerals by surface mining is so remote as to be negligible include: Geological, geophysical or economic data showing the absence of mineral reserves on the property, or the lack of commercial feasibility at the time of the contribution of surface mining the mineral interest.

(B) If the ownership of the surface estate and mineral interest first became separated after June 12, 1976, no deduction is permitted for a contribution under this section unless surface mining on the property is completely prohibited.

(iii) *Examples.* The provisions of paragraph (g)(4)(i) and (ii) of this section may be illustrated by the following examples:

Example 1. K owns 5,000 acres of bottomland hardwood property along a major watershed system in the southern part of the United States. Agencies within the Department of the Interior have determined that southern bottomland hardwoods are a rapidly diminishing resource and a critical ecosystem in the south because of the intense pressure to cut the trees and convert the land to agricultural use. These agencies have further determined (and have indicated in correspondence with K) that bottomland hardwoods provide a superb habitat for numerous species and play an important role in controlling floods and purifying rivers. K donates to a qualified organization his entire interest in this property other than his interest in the gas and oil deposits that have been identified under K's property. K covenants and can ensure that, although drilling for gas and oil on the property may have some temporary localized impact on the real property, the drilling will not interfere with the overall conservation purpose of the gift, which is to protect the unique bottomland hardwood ecosystem. Accordingly, the donation qualifies for a deduction under this section.

Example 2. Assume the same facts as in *Example (1)*, except that in 1979, K sells the mineral interest to A, an unrelated person, in an arm's-length transaction, subject to a recorded prohibition on the removal of any minerals by any surface mining method and a recorded prohibition against any mining technique that will harm the bottomland hardwood ecosystem. After the sale to A, K donates a qualified real property interest to a qualified organization to protect the bottomland hardwood ecosystem. Since at the time of the transfer, surface mining and any mining technique that will harm the bottomland hardwood ecosystem are completely prohibited, the donation qualifies for a deduction under this section.

(5) *Protection of conservation purpose where taxpayer reserves certain rights*—(i) *Documentation.* In the case of a donation made after February 13, 1986, of any qualified real property interest when the donor reserves rights the exercise of which may impair the conservation interests associated with the property, for a deduction to be allowable under this section the donor must make available to the donee, prior to the time the donation is made, documentation sufficient to establish the condition of the property at the time of the gift. Such documentation is designed to protect the conservation interests associated with the property, which although protected in perpetuity by the easement, could be adversely affected by the exercise of the reserved rights. Such documentation may include:

(A) The appropriate survey maps from the United States Geological Survey, showing the property line and other contiguous or nearby protected areas;

(B) A map of the area drawn to scale showing all existing man-made improvements or incursions (such as roads, buildings, fences, or gravel pits), vegetation and identification of flora and fauna (including, for example, rare species locations, animal breeding and roosting areas, and migration routes), land use history (including present uses and recent past disturbances), and distinct natural features (such as large trees and aquatic areas);

(C) An aerial photograph of the property at an appropriate scale taken as close as possible to the date the donation is made; and

(D) On-site photographs taken at appropriate locations on the property. If the terms of the donation contain restrictions with regard to a particular natural resource to be protected, such as water quality or air quality, the condition of the resource at or near the time of the gift must be established. The documentation, including the maps and photographs, must be accompanied by a statement signed by the donor and a representative of the donee clearly referencing the documentation and in substance saying ''This natural resources inventory is an accurate representation of [the protected property] at the time of the transfer.''.

(ii) *Donee's right to inspection and legal remedies.* In the case of any donation referred to in paragraph (g)(5)(i) of this section, the donor must agree to notify the donee, in writing, before exercising any reserved right, *e.g.* the right to extract certain minerals which may have an adverse impact on the conservation interests associated with the qualified real property interest. The terms of the donation must provide a right of the donee to enter the property at reasonable times for the purpose of inspecting the property to determine if there is compliance with the terms of the donation. Additionally, the terms of the donation must provide a right of the donee to enforce the conservation restrictions by appropriate legal proceedings, including but not limited to, the right to require the restoration of the property to its condition at the time of the donation.

(6) *Extinguishment.* (i) In general. If a subsequent unexpected change in the conditions surrounding the property that is the subject of a donation under this paragraph can make impossible or impractical the continued use of the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding and all of the donee's proceeds (determined under paragraph (g)(6)(ii) of this section) from a subsequent sale or exchange of the property are used by the donee organization in a manner consistent with the conservation purposes of the original contribution.

(ii) *Proceeds.* In case of a donation made after February 13, 1986, for a deduction to be allowed under this section, at the time of the gift the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift, bears to the value of the property as a whole at that time. See §1.170A–14(h)(3)(iii) relating to the allocation of basis. For purposes of this paragraph (g)(6)(ii), that proportionate value of the donee's property rights shall remain constant. Accordingly, when a change in conditions give rise to the extinguishment of a perpetual conservation restriction under paragraph (g)(6)(i) of this section, the donee organization, on a subsequent sale, exchange, or involuntary conversion of the subject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction.

(h) *Valuation*—(1) *Entire interest of donor other than qualified mineral interest.* The value of the contribution under section 170 in the case of a contribution of a taxpayer's entire interest in property other than a qualified mineral interest is the fair market value of the surface rights in the property contributed. The value of the contribution shall be computed without regard to the mineral rights. See paragraph (h)(4), *example (1),* of this section.

(2) *Remainder interest in real property.* In the case of a contribution of any remainder interest in real property, section 170(f)(4) provides that in determining the value of such interest for purposes of section 170, depreciation and depletion of such property shall be taken into account. See §1.170A–12. In the case of the contribution of a remainder interest for conservation purposes, the current fair market value of the property (against which the limitations of §1.170A–12 are applied) must take into account any pre-existing or contemporaneously recorded rights limiting, for conservation purposes, the use to which the subject property may be put.

(3) *Perpetual conservation restriction*—(i) *In general.* The value of the contribution under section 170 in the case of a charitable contribution of a perpetual conservation restriction is the fair market value of the perpetual conservation restriction at the time of the contribution. See §1.170A–7(c). If there is a substantial record of sales of easements comparable to the donated easement (such as purchases pursuant to a governmental program), the fair market value of the donated easement is based on the sales prices of such comparable easements. If no substantial record of market-place sales is available to use as a meaningful or valid comparison, as a general rule (but not necessarily in all cases) the fair market value of a perpetual conservation

restriction is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction. The amount of the deduction in the case of a charitable contribution of a perpetual conservation restriction covering a portion of the contiguous property owned by a donor and the donor's family (as defined in section 267(c)(4)) is the difference between the fair market value of the entire contiguous parcel of property before and after the granting of the restriction. If the granting of a perpetual conservation restriction after January 14, 1986, has the effect of increasing the value of any other property owned by the donor or a related person, the amount of the deduction for the conservation contribution shall be reduced by the amount of the increase in the value of the other property, whether or not such property is contiguous. If, as a result of the donation of a perpetual conservation restriction, the donor or a related person receives, or can reasonably expect to receive, financial or economic benefits that are greater than those that will inure to the general public from the transfer, no deduction is allowable under this section. However, if the donor or a related person receives, or can reasonably expect to receive, a financial or economic benefit that is substantial, but it is clearly shown that the benefit is less than the amount of the transfer, then a deduction under this section is allowable for the excess of the amount transferred over the amount of the financial or economic benefit received or reasonably expected to be received by the donor or the related person. For purposes of this paragraph (h)(3)((i), related person shall have the same meaning as in either section 267(b) or section 707(b). (See *Example (10)* of paragraph (h)(4) of this section.)

(ii) *Fair market value of property before and after restriction.* If before and after valuation is used, the fair market value of the property before contribution of the conservation restriction must take into account not only the current use of the property but also an objective assessment of how immediate or remote the likelihood is that the property, absent the restriction, would in fact be developed, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use. Further, there may be instances where the grant of a conservation restriction may have no material effect on the value of the property or may in fact serve to enhance, rather than reduce, the value of property. In such instances no deduction would be allowable. In the case of a conservation restriction that allows for any development, however limited, on the property to be protected, the fair maket value of the property after contribution of the restriction must take into account the effect of the development. In the case of a conservation easement such as an easement on a certified historic structure, the fair market value of the property after contribution of the restriction must take into account the amount of access permitted by the terms of the easement. Additionally, if before and after valuation is used, an appraisal of the property after contribution of the restriction must take into account the effect of restrictions that will result in a reduction of the potential fair market value represented by highest and best use but will, nevertheless, permit uses of the property that will increase its fair market value above that represented by the property's current use. The value of a perpetual conservation restriction shall not be reduced by reason of the existence of restrictions on transfer designed solely to ensure that the conservation restriction will be dedicated to conservation purposes. See § 1.170A–14 (c)(3).

(iii) *Allocation of basis.* In the case of the donation of a qualified real property interest for conservation purposes, the basis of the property retained by the donor must be adjusted by the elimination of that part of the total basis of the property that is properly allocable to the qualified real property interest granted. The amount of the basis that is allocable to the qualified real property interest shall bear the same ratio to the total basis of the property as the fair market value of the qualified real property interest bears to the fair market value of the property before the granting of the qualified real property interest. When a taxpayer donates to a qualifying conservation organization an easement on a structure with respect to which deductions are taken for depreciation, the reduction required by this paragraph (h)(3)(ii) in the basis of the property retained by the taxpayer must be allocated between the structure and the underlying land.

(4) *Examples.* The provisions of this section may be illustrated by the following examples. In examples illustrating the value or deductibility of donations, the applicable restrictions and limitations of §1.170A–4, with respect to reduction in amount of charitable contributions of certain appreciated property, and §1.170A–8, with respect to limitations on charitable deductions by individuals. must also be taken into account.

Example 1. A owns Goldacre, a property adjacent to a state park. A wants to donate Goldacre to the state to be used as part of the park, but A wants to reserve a qualified mineral interest in the property, to exploit currently and to devise at death. The fair market value of the surface rights in Goldacre is $200,000 and the fair market value of the mineral rights in $100.000. In order to ensure that the quality of the park will not be degraded, restrictions must be imposed on the right to extract the minerals that reduce the fair market value of the mineral rights to $80,000. Under this section, the value of the contribution is $200,000 (the value of the surface rights).

Example 2. In 1984 B, who is 62, donates a remainder interest in Greenacre to a qualifying organization for conservation purposes. Greenacre is a tract of 200 acres of undeveloped woodland that is valued at $200,000 at its highest and best use. Under §1.170A–12(b), the value of a remainder interest in real property following one life is determined under §25.2512–5 of this chapter (Gift Tax Regulations). (See §25.2512–5A of this chapter with respect to the valuation of annuities, interests for life or term of years, and remainder or reversionary interests transferred before December 1, 1983.) Accordingly, the value of the remainder interest, and thus the amount eligible for an income tax deduction under section 170(f), is $55,996 ($200,000×.27998).

Example 3. Assume the same facts as in *Example (2)*, except that Greenacre is B's 200-acre estate with a home built during the colonial period. Some of the acreage around the home is cleared; the balance of Greenacre, except for access roads, is wooded and undeveloped. See section 170(f)(3)(B)(i). However, B would like Greenacre to be maintained in its current state after his death, so he donates a remainder interest in Greenacre to a qualifying organization for conservation purposes pursunt to section 170 (f)(3)(B)(iii) and (h)(2)(B). At the time of the gift the land has a value of $200,000 and the house has a value of $100,000. The value of the remainder interest, and thus the amount eligible for an income tax deduction under section 170(f), is computed pursuant to §1.170A–12. See §1.170A–12(b)(3).

Example 4. Assume the same facts as in *Example (2)*, except that at age 62 instead of donating a remainder interest B donates an easement in Greenacre to a qualifying organization for conservation purposes. The fair market value of Greenacre after the donation is reduced to $110,000. Accordingly, the value of the easement, and thus the amount eligible for a deduction under section 170(f), is $90,000 ($200,000 less $110,000).

Example 5. Assume the same facts as in *Example (4)*, and assume that three years later, at age 65, B decides to donate a remainder interest in Greenacre to a qualifying organization for conservation purposes. Increasing real estate values in the area have raised the fair market value of Greenacre (subject to the easement) to $130,000. Accordingly, the value of the remainder interest, and thus the amount eligible for a deduction under section 170(f), is $41,639 ($130,000×.32030).

Example 6. Assume the same facts as in *Example (2)*, except that at the time of the donation of a remainder interest in Greenacre, B also donates an easement to a different qualifying organization for conservation purposes. Based on all the facts and circumstances, the value of the easement is determined to be $100,000. Therefore, the value of the property after the easement is $100,000 and the value of the remainder interest, and thus the amount eligible for deduction under section 170(f), is $27,998 ($100,000×.27998).

Example 7. C owns Greenacre, a 200-acre estate containing a house built during the colonial period. At its highest and best use, for home development, the fair market value of Greenacre is $300,000. C donates an easement (to maintain the house and Green acre in their current state) to a qualifying organization for conservation purposes. The fair market value of Greenacre after the donation is reduced to $125,000. Accordingly, the value of the easement and the amount eligible for a deduction under section 170(f) is $175.000 ($300,000 less $125,000).

Example 8. Assume the same facts as in *Example (7)* and assume that three years later, C decides to donate a remainder interest in Greenacre to a qualifying organization for conservation purposes. Increasing real estate values in the area have raised the fair market value of Greenacre to $180.000. Assume that because of the perpetual easement prohibiting any development of the land, the value of the house is $120,000 and the value of the land is $60,000. The value of the remainder interest, and thus the amount eligible for an income tax deduction under section 170(f), is computed pursuant to §1.170A–12. See §1.170A–12(b)(3).

Example 9. D owns property with a basis of $20,000 and a fair market value of $80,000. D donates to a qualifying organization an easement for conservation purposes that is determined under this section to have a fair market value of $60,000. The amount of basis allocable to the easement is $15,000 ($60,000/ $80,000=$15,000/$20,000). Accordingly, the basis of the property is reduced to $5,000 ($20,000 minus $15,000).

Example 10. E owns 10 one-acre lots that are currently woods and parkland. The fair market value of each of E's lots is $15,000 and the basis of each lot is $3,000. E grants to the county a perpetual easement for conservation purposes to use and maintain eight of the acres as a public park and to restrict any future development on those eight acres. As a result of the restrictions, the value of the eight acres is reduced to $1,000 an acre. However, by perpetually restricting development on this portion of the land, E has ensured that the two remaining acres will always be bordered by parkland, thus increasing their fair market value to $22,500 each. If the eight acres represented all of E's land, the fair market value of the easement would be $112,000, an amount equal to the fair market value of the land before the granting of the easement (8×$15,000=$120,000) minus the fair market value of the encumbered land after the granting of the easement (8×$1,000=$8,000). However, because the easement only covered a portion of the taxpayer's contiguous land, the amount of the deduction under section 170 is reduced to $97,000 ($150,000–$53,000), that is, the difference between the fair market value of the entire tract of land before ($150,000) and after ((8×$1,000)+(2× $22,500)) the granting of the easement.

Example 11. Assume the same facts as in *example (10).* Since the easement covers a portion of E's land, only the basis of that portion is adjusted. Therefore, the amount of basis allocable to the easement is $22,400 ((8×$3,000)×($112,000/$120,000)). Accordingly, the basis of the eight acres encumbered by the easement is reduced to $1,600 ($24,000–$22,400), or $200 for each acre. The basis of the two remaining acres is not affected by the donation.

Example 12. F owns and uses as professional offices a two-story building that lies within a registered historic district. F's building is an outstanding example of period architecture with a fair market value of $125,000. Restricted to its current use, which is the highest and best use of the property without making changes to the facade, the building and lot would have a fair market value of $100,000, of which $80,000 would be allocable to the building and $20,000 woud be allocable to the lot. F's basis in the property is $50,000, of which $40,000 is allocable to the building and $10,000 is allocable to the lot. F's neighborhood is a mix of residential and commercial uses, and it is possible that F (or another owner) could enlarge the building for more extensive commercial use, which is its highest and best use. However, this would require changes to the facade. F would like to donate to a qualifying preservation organization an easement restricting any changes to the facade and promising to maintain the facade in perpetuity. The donation would qualify for a deduction under this section. The fair market value of the easement is $25,000 (the fair market value of the property before the easement, $125,000, minus the fair market value of the property after the easement, $100,000). Pursuant to §1.170A–14(h)(3)(iii), the basis allocable to the easement is $10,000 and the basis of the underlying property (building and lot) is reduced to $40,000.

(i) *Substantiation requirement.* If a taxpayer makes a qualified conservation contribution and claims a deduction, the taxpayer must maintain written records of the fair market value of the underlying property before and after the donation and the conservation purpose furthered by the donation and such information shall be stated in the taxpayer's income tax return if required by the return or its instructions. See also §1.170A–13(c) (relating to substantiation requirements for deductions in excess of $5,000 for charitable contributions made after 1984), and section 6659 (relating to additions to tax in the case of valuation overstatements).

(j) *Effective date.* Except as otherwise provided in §1.170A–14(g)(4)(ii), this section applies only to contributions made on or after December 18, 1980.

[T.D. 8069, 51 FR 1499, Jan. 14, 1986; 51 FR 5322, Feb. 13, 1986; 51 FR 6219, Feb. 21, 1986, as amended by T.D. 8199, 53 FR 16085, May 5, 1988; T.D. 8540, 59 FR 30105, June 10, 1994]

§1.171–1 Bond premium.

(a) *Overview*—(1) *In general.* This section and §§1.171–2 through 1.171–5 provide rules for the determination and amortization of bond premium by a holder. In general, a holder amortizes bond premium by offsetting the interest allocable to an accrual period with the premium allocable to that period. Bond premium is allocable to an accrual period based on a constant yield. The use of a constant yield to amortize bond premium is intended to generally conform the treatment of bond premium to the treatment of original issue discount under sections 1271 through 1275. Unless otherwise provided, the terms used in this section and §§1.171–2 through 1.171–5 have the same meaning as those terms in sections 1271 through 1275 and the corresponding regulations. Moreover, unless otherwise provided, the provisions of this section and §§1.171–2 through 1.171–5 apply in a manner consistent with those of sections 1271 through 1275 and the corresponding regulations. In addition, the anti-abuse rule in §1.1275–2(g) applies for purposes of this section and §§1.171–2 through 1.171–5.

(2) *Cross-references.* For rules dealing with the adjustments to a holder's basis to reflect the amortization of bond premium, see §1.1016–5(b). For rules dealing with the treatment of bond issuance premium by an issuer, see §1.163–13.

(b) *Scope*—(1) *In general.* Except as provided in paragraph (b)(2) of this section and §1.171–5, this section and §§1.171–2 through 1.171–4 apply to any bond that, upon its acquisition by the holder, is held with bond premium. For purposes of this section and §§1.171–2 through 1.171–5, the term *bond* has the same meaning as the term *debt instrument* in §1.1275–1(d).

(2) *Exceptions.* This section and §§1.171–2 through 1.171–5 do not apply to—

(i) A bond described in section 1272(a)(6)(C) (regular interests in a REMIC, qualified mortgages held by a REMIC, and certain other debt instruments, or pools of debt instruments, with payments subject to acceleration);

(ii) A bond to which §1.1275–4 applies (relating to certain debt instruments that provide for contingent payments);

(iii) A bond held by a holder that has made a §1.1272–3 election with respect to the bond;

(iv) A bond that is stock in trade of the holder, a bond of a kind that would properly be included in the inventory of the holder if on hand at the close of the taxable year, or a bond held primarily for sale to customers in the ordinary course of the holder's trade or business; or

(v) A bond issued before September 28, 1985, unless the bond bears interest and was issued by a corporation or by a government or political subdivision thereof.

(c) *General rule*—(1) *Tax-exempt obligations.* A holder must amortize bond premium on a bond that is a tax-exempt obligation. See §1.171–2(c) *Example 4.*

(2) *Taxable bonds.* A holder may elect to amortize bond premium on a taxable bond. Except as provided in paragraph (c)(3) of this section, a taxable bond is any bond other than a tax-exempt obligation. See §1.171–4 for rules relating to the election to amortize bond premium on a taxable bond.

(3) *Bonds the interest on which is partially excludable.* For purposes of this section and §§1.171–2 through 1.171–5, a bond the interest on which is partially excludable from gross income is treated as two instruments, a tax-exempt obligation and a taxable bond. The holder's basis in the bond and each payment on the bond are allocated between the two instruments based on a reasonable method.

(d) *Determination of bond premium*—(1) *In general.* A holder acquires a bond at a premium if the holder's basis in the bond immediately after its acquisition by the holder exceeds the sum of all amounts payable on the bond after the acquisition date (other than payments of qualified stated interest). This excess is bond premium, which is amortizable under §1.171–2.

(2) *Additional rules for amounts payable on certain bonds.* Additional rules apply to determine the amounts payable on a variable rate debt instrument, an inflation-indexed debt instrument, a bond that provides for certain alternative payment schedules, and a bond that provides for remote or incidental contingencies. See §1.171–3.

(e) *Basis.* A holder determines its basis in a bond under this paragraph (e). This determination of basis applies only for purposes of this section and §§1.171–2 through 1.171–5. Because of the application of this paragraph (e), the holder's basis in the bond for purposes of these sections may differ from the holder's basis for determining gain or loss on the sale or exchange of the bond.

(1) *Determination of basis*—(i) *In general.* In general, the holder's basis in the bond is the holder's basis for determining loss on the sale or exchange of the bond.

(ii) *Bonds acquired in certain exchanges.* If the holder acquired the bond in exchange for other property (other than in a reorganization defined in section 368) and the holder's basis in the bond is determined in whole or in part by reference to the holder's basis in the other property, the holder's basis in the bond may not exceed its fair market value immediately after the exchange. See paragraph (f) *Example 1* of this section. If the bond is acquired in a reorganization, see section 171(b)(4)(B).

(iii) *Convertible bonds*—(A) *General rule.* If the bond is a convertible bond, the holder's basis in the bond is reduced by an amount equal to the value of the conversion option. The value of the conversion option may be determined under any reasonable method. For example, the holder may determine the value of the conversion option by comparing the market price of the convertible bond to the market prices of similar bonds that do not have conversion options. See paragraph (f) *Example 2* of this section.

(B) *Convertible bonds acquired in certain exchanges.* If the bond is a convertible bond acquired in a transaction described in paragraph (e)(1)(ii) of this section, the holder's basis in the bond may not exceed its fair market value immediately after the exchange reduced by the value of the conversion option.

(C) *Definition of convertible bond.* A convertible bond is a bond that provides the holder with an option to convert the bond into stock of the issuer, stock or debt of a related party (within the meaning of section 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of such stock or debt.

(2) *Basis in bonds held by certain transferees.* Notwithstanding paragraph (e)(1) of this section, if the bond is transferred basis property (as defined in section 7701(a)(43)) and the transferor had acquired the bond at a premium, the holder's basis in the bond is—

(i) The holder's basis for determining loss on the sale or exchange of the bond; reduced by

(ii) Any amounts that the transferor could not have amortized under this paragraph (e) or under § 1.171–4(c), except to the extent that the holder's basis already reflects a reduction attributable to such nonamortizable amounts.

(f) *Examples.* The following examples illustrate the rules of this section:

Example 1. Bond received in liquidation of a partnership interest—(i) *Facts.* PR is a partner in partnership PRS. PRS does not have any unrealized receivables or inventory items as defined in section 751. On January 1, 1998, PRS distributes to PR a taxable bond, issued by an unrelated corporation, in liquidation of PR's partnership interest. At that time, the fair market value of PR's partnership interest is $40,000 and the basis is $100,000. The fair market value of the bond is $40,000.

(ii) *Determination of basis.* Under section 732(b), PR's basis in the bond is equal to PR's basis in the partnership interest. Therefore, PR's basis for determining loss on the sale or exchange of the bond is $100,000. However, because the distribution is treated as an exchange for purposes of section 171(b)(4), PR's basis in the bond is $40,000 for purposes of this section and §§ 1.171–2 through 1.171–5. See paragraph (e)(1)(ii) of this section.

Example 2. Convertible bond—(i) *Facts.* On January 11, 1998, A purchases for $1,100 B corporation's bond maturing on January 1, 2001, with a stated principal amount of $1,000, payable at maturity. The bond provides for unconditional payments of interest of $30 on January 1 and July 1 of each year. In addition, the bond is convertible into 15 shares of B corporation stock at the option of the holder. On January 1, 1998, B corporation's nonconvertible, publicly-traded, three-year debt with a similar credit rating trades at a price that reflects a yield of 6.75 percent, compounded semiannually.

(ii) *Determination of basis.* A's basis for determining loss on the sale or exchange of the bond is $1,100. As of January 1, 1998, discounting the remaining payments on the bond at the yield at which B's similar nonconvertible bonds trade (6.75 percent, compounded semiannually) results in a present value of $980. Thus, the value of the conversion option is $120. Under paragraph (e)(1)(iii)(A) of this section, A's basis is $980 ($1,100 − $120) for purposes of this section and §§ 1.171–2 through 1.171–5. The sum of all amounts payable on the bond other than qualified stated interest is $1,000. Because

A's basis (as determined under paragraph (e)(1)(iii)(A) of this section) does not exceed $1,000, A does not acquire the bond at a premium.

[T.D. 8746, 62 FR 68177, Dec. 31, 1997]

§1.171–2 Amortization of bond premium.

(a) *Offsetting qualified stated interest with premium*—(1) *In general.* A holder amortizes bond premium by offsetting the qualified stated interest allocable to an accrual period with the bond premium allocable to the accrual period. This offset occurs when the holder takes the qualified stated interest into account under the holder's regular method of accounting.

(2) *Qualified stated interest allocable to an accrual period.* See §1.446–2(b) to determine the accrual period to which qualified stated interest is allocable and to determine the accrual of qualified stated interest within an accrual period.

(3) *Bond premium allocable to an accrual period.* The bond premium allocable to an accrual period is determined under this paragraph (a)(3). Within an accrual period, the bond premium allocable to the period accrues ratably.

(i) *Step one: Determine the holder's yield.* The holder's yield is the discount rate that, when used in computing the present value of all remaining payments to be made on the bond (including payments of qualified stated interest), produces an amount equal to the holder's basis in the bond as determined under §1.171–1(e). For this purpose, the remaining payments include only payments to be made after the date the holder acquires the bond. The yield is calculated as of the date the holder acquires the bond, must be constant over the term of the bond, and must be calculated to at least two decimal places when expressed as a percentage.

(ii) *Step two: Determine the accrual periods.* A holder determines the accrual periods for the bond under the rules of §1.1272–1(b)(1)(ii).

(iii) *Step three: Determine the bond premium allocable to the accrual period.* The bond premium allocable to an accrual period is the excess of the qualified stated interest allocable to the accrual period over the product of the holder's adjusted acquisition price (as defined in paragraph (b) of this section) at the beginning of the accrual period and the holder's yield. In performing this calculation, the yield must be stated appropriately taking into account the length of the particular accrual period. Principles similar to those in §1.1272–1(b)(4) apply in determining the bond premium allocable to an accrual period.

(4) *Bond premium in excess of qualified stated interest*—(i) *Taxable bonds*—(A) *Bond premium deduction.* In the case of a taxable bond, if the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the excess is treated by the holder as a bond premium deduction under section 171(a)(1) for the accrual period. However, the amount treated as a bond premium deduction is limited to the amount by which the holder's total interest inclusions on the bond in prior accrual periods exceed the total amount treated by the holder as a bond premium deduction on the bond in prior accrual periods. A deduction determined under this paragraph (a)(4)(i)(A) is not subject to section 67 (the 2-percent floor on miscellaneous itemized deductions). See *Example 1* of §1.171–3(e).

(B) *Carryforward.* If the bond premium allocable to an accrual period exceeds the sum of the qualified stated interest allocable to the accrual period and the amount treated as a deduction for the accrual period under paragraph (a)(4)(i)(A) of this section, the excess is carried forward to the next accrual period and is treated as bond premium allocable to that period.

(ii) *Tax-exempt obligations.* In the case of a tax-exempt obligation, if the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the excess is a nondeductible loss. If a regulated investment company (RIC) within the meaning of section 851 has excess bond premium for an accrual period that would be a nondeductible loss under the prior sentence, the RIC must use this excess bond premium to reduce its tax-exempt interest income on other tax-exempt obligations held during the accrual period.

(5) *Additional rules for certain bonds.* Additional rules apply to determine the amortization of bond premium on a variable rate debt instrument, an inflation-indexed debt instrument, a bond that provides for certain alternative payment schedules, and a bond that provides for remote or incidental contingencies. See § 1.171–3.

(b) *Adjusted acquisition price.* The adjusted acquisition price of a bond at the beginning of the first accrual period is the holder's basis as determined under § 1.171–1(e). Thereafter, the adjusted acquisition price is the holder's basis in the bond decreased by—

(1) The amount of bond premium previously allocable under paragraph (a)(3) of this section; and

(2) The amount of any payment previously made on the bond other than a payment of qualified stated interest.

(c) *Examples.* The following examples illustrate the rules of this section. Each example assumes the holder uses the calendar year as its taxable year and has elected to amortize bond premium, effective for all relevant taxable years. In addition, each example assumes a 30-day month and 360-day year. Although, for purposes of simplicity, the yield as stated is rounded to two decimal places, the computations do not reflect this rounding convention. The examples are as follows:

Example 1. Taxable bond—(i) *Facts.* On February 1, 1999, A purchases for $110,000 a taxable bond maturing on February 1, 2006, with a stated principal amount of $100,000, payable at maturity. The bond provides for unconditional payments of interest of $10,000, payable on February 1 of each year. A uses the cash receipts and disbursements method of accounting, and A decides to use annual accrual periods ending on February 1 of each year.

(ii) *Amount of bond premium.* The interest payments on the bond are qualified stated interest. Therefore, the sum of all amounts payable on the bond (other than the interest payments) is $100,000. Under § 1.171–1, the amount of bond premium is $10,000 ($110,000 − $100,000).

(iii) *Bond premium allocable to the first accrual period.* Based on the remaining payment schedule of the bond and A's basis in the bond, A's yield is 8.07 percent, compounded annually. The bond premium allocable to the accrual period ending on February 1, 2000, is the excess of the qualified stated interest allocable to the period ($10,000) over the product of the adjusted acquisition price at the beginning of the period ($110,000) and A's yield (8.07 percent, compounded annually). Therefore, the bond premium allocable to the accrual period is $1,118.17 ($10,000 − $8,881.83).

(iv) *Premium used to offset interest.* Although A receives an interest payment of $10,000 on February 1, 2000, A only includes in income $8,881.83, the qualified stated interest allocable to the period ($10,000) offset with bond premium allocable to the period ($1,118.17). Under § 1.1016–5(b), A's basis in the bond is reduced by $1,118.17 on February 1, 2000.

Example 2. Alternative accrual periods—(i) *Facts.* The facts are the same as in *Example 1* of this paragraph (c) except that A decides to use semiannual accrual periods ending on February 1 and August 1 of each year.

(ii) *Bond premium allocable to the first accrual period.* Based on the remaining payment schedule of the bond and A's basis in the bond, A's yield is 7.92 percent, compounded semiannually. The bond premium allocable to the accrual period ending on August 1, 1999, is the excess of the qualified stated interest allocable to the period ($5,000) over the product of the adjusted acquisition price at the beginning of the period ($110,000) and A's yield, stated appropriately taking into account the length of the accrual period (7.92 percent/2). Therefore, the bond premium allocable to the accrual period is $645.29 ($5,000 − $4,354.71). Although the accrual period ends on August 1, 1999, the qualified stated interest of $5,000 is not taken into income until February 1, 2000, the date it is received. Likewise, the bond premium of $645.29 is not taken into account until February 1, 2000. The adjusted acquisition price of the bond on August 1, 1999, is $109,354.71 (the adjusted acquisition price at the beginning of the period ($110,000) less the bond premium allocable to the period ($645.29)).

(iii) *Bond premium allocable to the second accrual period.* Because the interval between payments of qualified stated interest contains more than one accrual period, the adjusted acquisition price at the beginning of the second accrual period must be adjusted for the accrued but unpaid qualified stated interest. See paragraph (a)(3)(iii) of this section and § 1.1272–1(b)(4)(i)(B). Therefore, the adjusted acquisition price on August 1, 1999, is $114,354.71 ($109,354.71 + $5,000). The bond premium allocable to the accrual period ending on February 1, 2000, is the excess of the qualified stated interest allocable to the period ($5,000) over the product of the adjusted acquisition price at the beginning of the period ($114,354.71) and A's yield, stated appropriately taking into account the length of the accrual period (7.92 percent/2). Therefore, the bond premium allocable to the accrual period is $472.88 ($5,000 − $4,527.12).

(iv) *Premium used to offset interest.* Although A receives an interest payment of $10,000 on February 1, 2000, A only includes in income

$8,881.83, the qualified stated interest of $10,000 ($5,000 allocable to the accrual period ending on August 1, 1999, and $5,000 allocable to the accrual period ending on February 1, 2000) offset with bond premium of $1,118.17 ($645.29 allocable to the accrual period ending on August 1, 1999, and $472.88 allocable to the accrual period ending on February 1, 2000). As indicated in *Example 1* of this paragraph (c), this same amount would be taken into income at the same time had A used annual accrual periods.

Example 3. Holder uses accrual method of accounting—(i) *Facts.* The facts are the same as in *Example 1* of this paragraph (c) except that A uses an accrual method of accounting. Thus, for the accrual period ending on February 1, 2000, the qualified stated interest allocable to the period is $10,000, and the bond premium allocable to the period is $1,118.17. Because the accrual period extends beyond the end of A's taxable year, A must allocate these amounts between the two taxable years.

(ii) *Amounts allocable to the first taxable year.* The qualified stated interest allocable to the first taxable year is $9,166.67 ($10,000 × 11/12). The bond premium allocable to the first taxable year is $1,024.99 ($1,118.17 x 11/12).

(iii) *Premium used to offset interest.* For 1999, A includes in income $8,141.68, the qualified stated interest allocable to the period ($9,166.67) offset with bond premium allocable to the period ($1,024.99). Under §1.1016–5(b), A's basis in the bond is reduced by $1,024.99 in 1999.

(iv) *Amounts allocable to the next taxable year.* The remaining amounts of qualified stated interest and bond premium allocable to the accrual period ending on February 1, 2000, are taken into account for the taxable year ending on December 31, 2000.

Example 4. Tax-exempt obligation—(i) *Facts.* On January 15, 1999, C purchases for $120,000 a tax-exempt obligation maturing on January 15, 2006, with a stated principal amount of $100,000, payable at maturity. The obligation provides for unconditional payments of interest of $9,000, payable on January 15 of each year. C uses the cash receipts and disbursements method of accounting, and C decides to use annual accrual periods ending on January 15 of each year.

(ii) *Amount of bond premium.* The interest payments on the obligation are qualified stated interest. Therefore, the sum of all amounts payable on the obligation (other than the interest payments) is $100,000. Under §1.171–1, the amount of bond premium is $20,000 ($120,000—$100,000).

(iii) *Bond premium allocable to the first accrual period.* Based on the remaining payment schedule of the obligation and C's basis in the obligation, C's yield is 5.48 percent, compounded annually. The bond premium allocable to the accrual period ending on January 15, 2000, is the excess of the qualified stated interest allocable to the period ($9,000) over the product of the adjusted acquisition price at the beginning of the period ($120,000) and C's yield (5.48 percent, compounded annually). Therefore, the bond premium allocable to the accrual period is $2,420.55 ($9,000 − $6,579.45).

(iv) *Premium used to offset interest.* Although C receives an interest payment of $9,000 on January 15, 2000, C only receives tax-exempt interest income of $6,579.45, the qualified stated interest allocable to the period ($9,000) offset with bond premium allocable to the period ($2,420.55). Under §1.1016–5(b), C's basis in the obligation is reduced by $2,420.55 on January 15, 2000.

[T.D. 8746, 62 FR 68178, Dec. 31, 1997]

§1.171–3 Special rules for certain bonds.

(a) *Variable rate debt instruments.* A holder determines bond premium on a variable rate debt instrument by reference to the stated redemption price at maturity of the equivalent fixed rate debt instrument constructed for the variable rate debt instrument. The holder also allocates any bond premium among the accrual periods by reference to the equivalent fixed rate debt instrument. The holder constructs the equivalent fixed rate debt instrument, as of the date the holder acquires the variable rate debt instrument, by using the principles of §1.1275–5(e). See paragraph (e) *Example 1* of this section.

(b) *Inflation-indexed debt instruments.* A holder determines bond premium on an inflation-indexed debt instrument by assuming that there will be no inflation or deflation over the remaining term of the instrument. The holder also allocates any bond premium among the accrual periods by assuming that there will be no inflation or deflation over the remaining term of the instrument. The bond premium allocable to an accrual period offsets qualified stated interest allocable to the period. Notwithstanding §1.171–2(a)(4), if the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the period, the excess is treated as a deflation adjustment under §1.1275–7T(f)(1)(i). See §1.1275–7T for other rules relating to inflation-indexed debt instruments.

(c) *Yield and remaining payment schedule of certain bonds subject to contingencies*—(1) *Applicability.* This paragraph (c) provides rules that apply in determining the yield and remaining payment schedule of certain bonds that provide for an alternative payment schedule (or schedules) applicable upon the occurrence of a contingency (or contingencies). This paragraph (c) applies, however, only if the timing and amounts of the payments that comprise each payment schedule are known as of the date the holder acquires the bond (the acquisition date) and the bond is subject to paragraph (c)(2), (3), or (4) of this section. A bond does not provide for an alternative payment schedule merely because there is a possibility of impairment of a payment (or payments) by insolvency, default, or similar circumstances. See § 1.1275–4 for the treatment of a bond that provides for a contingency that is not described in this paragraph (c).

(2) *Remaining payment schedule that is significantly more likely than not to occur.* If, based on all the facts and circumstances as of the acquisition date, a single remaining payment schedule for a bond is significantly more likely than not to occur, this remaining payment schedule is used to determine and amortize bond premium under §§ 1.171–1 and 1.171–2.

(3) *Mandatory sinking fund provision.* Notwithstanding paragraph (c)(2) of this section, if a bond is subject to a mandatory sinking fund provision described in § 1.1272–1(c)(3), the provision is ignored for purposes of determining and amortizing bond premium under §§ 1.171–1 and 1.171–2.

(4) *Treatment of certain options*—(i) *Applicability.* Notwithstanding paragraphs (c)(2) and (3) of this section, the rules of this paragraph (c)(4) determine the remaining payment schedule of a bond that provides the holder or issuer with an unconditional option or options, exercisable on one or more dates during the remaining term of the bond, to alter the bond's remaining payment schedule.

(ii) *Operating rules.* A holder determines the remaining payment schedule of a bond by assuming that each option will (or will not) be exercised under the following rules:

(A) *Issuer options.* In general, the issuer is deemed to exercise or not exercise an option or combination of options in the manner that minimizes the holder's yield on the obligation. However, the issuer of a taxable bond is deemed to exercise or not exercise a call option or combination of call options in the manner that maximizes the holder's yield on the bond.

(B) *Holder options.* A holder is deemed to exercise or not exercise an option or combination of options in the manner that maximizes the holder's yield on the bond.

(C) *Multiple options.* If both the issuer and the holder have options, the rules of paragraphs (c)(4)(ii)(A) and (B) of this section are applied to the options in the order that they may be exercised. Thus, the deemed exercise of one option may eliminate other options that are later in time.

(5) *Subsequent adjustments*—(i) *In general.* Except as provided in paragraph (c)(5)(ii) of this section, if a contingency described in this paragraph (c) (including the exercise of an option described in paragraph (c)(4) of this section) actually occurs or does not occur, contrary to the assumption made pursuant to paragraph (c) of this section (a change in circumstances), then solely for purposes of section 171, the bond is treated as retired and reacquired by the holder on the date of the change in circumstances for an amount equal to the adjusted acquisition price of the bond as of that date. If, however, the change in circumstances results in a substantially contemporaneous pro-rata prepayment as defined in § 1.1275–2(f)(2), the pro-rata prepayment is treated as a payment in retirement of a portion of the bond. See paragraph (e) *Example 2* of this section.

(ii) *Bond premium deduction on the issuer's call of a taxable bond.* If a change in circumstances results from an issuer's call of a taxable bond or a partial call that is a pro-rata prepayment, the holder may deduct as bond premium an amount equal to the excess, if any, of the holder's adjusted acquisition price of the bond over the greater of—

(A) The amount received on redemption; and

(B) The amounts that would have been payable under the bond (other than payments of qualified stated interest) if no change in circumstances had occurred.

(d) *Remote and incidental contingencies*. For purposes of determining and amortizing bond premium, if a bond provides for a contingency that is remote or incidental (within the meaning of § 1.1275–2(h)), the holder takes the contingency into account under the rules for remote and incidental contingencies in § 1.1275–2(h).

(e) *Examples*. The following examples illustrate the rules of this section. Each example assumes the holder uses the calendar year as its taxable year and has elected to amortize bond premium, effective for all relevant taxable years. In addition, each example assumes a 30-day month and 360-day year. Although, for purposes of simplicity, the yield as stated is rounded to two decimal places, the computations do not reflect this rounding convention. The examples are as follows:

Example 1. Variable rate debt instrument—(i) *Facts*. On March 1, 1999, E purchases for $110,000 a taxable bond maturing on March 1, 2007, with a stated principal amount of $100,000, payable at maturity. The bond provides for unconditional payments of interest on March 1 of each year based on the percentage appreciation of a nationally-known commodity index. On March 1, 1999, it is reasonably expected that the bond will yield 12 percent, compounded annually. E uses the cash receipts and disbursements method of accounting, and E decides to use annual accrual periods ending on March 1 of each year. Assume that the bond is a variable rate debt instrument under § 1.1275–5.

(ii) *Amount of bond premium*. Because the bond is a variable rate debt instrument, E determines and amortizes its bond premium by reference to the equivalent fixed rate debt instrument constructed for the bond as of March 1, 1999. Because the bond provides for interest at a single objective rate that is reasonably expected to yield 12 percent, compounded annually, the equivalent fixed rate debt instrument for the bond is an eight-year bond with a principal amount of $100,000, payable at maturity. It provides for annual payments of interest of $12,000. E's basis in the equivalent fixed rate debt instrument is $110,000. The sum of all amounts payable on the equivalent fixed rate debt instrument (other than payments of qualified stated interest) is $100,000. Under § 1.171–1, the amount of bond premium is $10,000 ($110,000 − $100,000).

(iii) *Bond premium allocable to each accrual period*. E allocates bond premium to the remaining accrual periods by reference to the payment schedule on the equivalent fixed rate debt instrument. Based on the payment schedule of the equivalent fixed rate debt instrument and E's basis in the bond, E's yield is 10.12 percent, compounded annually. The bond premium allocable to the accrual period ending on March 1, 2000, is the excess of the qualified stated interest allocable to the period for the equivalent fixed rate debt instrument ($12,000) over the product of the adjusted acquisition price at the beginning of the period ($110,000) and E's yield (10.12 percent, compounded annually). Therefore, the bond premium allocable to the accrual period is $870.71 ($12,000 − $11,129.29). The bond premium allocable to all the accrual periods is listed in the following schedule:

Accrual period ending	Adjusted acquisition price at beginning of accrual period	Premium allocable to accrual period
3/1/00	$110,000.00	$870.71
3/1/01	109,129.29	958.81
3/1/02	108,170.48	1,055.82
3/1/03	107,114.66	1,162.64
3/1/04	105,952.02	1,280.27
3/1/05	104,671.75	1,409.80
3/1/06	103,261.95	1,552.44
3/1/07	101,709.51	1,709.51
		10,000.00

(iv) *Qualified stated interest for each accrual period*. Assume the bond actually pays the following amounts of qualified stated interest:

Accrual period ending	Qualified stated interest
3/1/00	$2,000.00
3/1/01	0.00
3/1/02	0.00
3/1/03	10,000.00
3/1/04	8,000.00
3/1/05	12,000.00
3/1/06	15,000.00
3/1/07	8,500.00

(v) *Premium used to offset interest*. E's interest income for each accrual period is determined by offsetting the qualified stated interest allocable to the period with the bond premium allocable to the period. For the accrual period ending on March 1, 2000, E includes in income $1,129.29, the qualified stated interest allocable to the period ($2,000) offset with the bond premium allocable to the period ($870.71). For the accrual period ending on March 1, 2001, the bond premium allocable to the accrual period ($958.81) exceeds the qualified stated interest allocable to the period ($0) and, therefore, E does not have interest income for this accrual period.

However, under § 1.171–2(a)(4)(i)(A), E may deduct as bond premium $958.81, the excess of the bond premium allocable to the accrual period ($958.81) over the qualified stated interest allocable to the accrual period ($0). For the accrual period ending on March 1, 2002, the bond premium allocable to the accrual period ($1,055.82) exceeds the qualified stated interest allocable to the accrual period ($0) and, therefore, E does not have interest income for the accrual period. Under § 1.171–2(a)(4)(i)(A), E's deduction for bond premium for the accrual period is limited to $170.48, the excess of E's total interest inclusions on the bond in prior accrual periods ($1,129.29) over the total amount treated by E as a bond premium deduction in prior accrual periods ($958.81). Under § 1.171–2(a)(4)(i)(B), E must carry forward the remaining $885.34 of bond premium allocable to the period ending March 1, 2002, and treat it as bond premium allocable to the period ending March 1, 2003. The amount E includes in income for each accrual period is shown in the following schedule:

Accrual period ending	Qualified stated interest	Premium allocable to accrual period	Interest income	Premium deduction	Premium carryforward
3/1/00	$2,000.00	$870.71	$1,129.29		
3/1/01	0.00	958.81	0.00	$958.81	
3/1/02	0.00	1,055.82	0.00	170.48	$885.34
3/1/03	10,000.00	1,162.64	7,951.93		
3/1/04	8,000.00	1,280.27	6,719.73		
3/1/05	12,000.00	1,409.80	10,590.20		
3/1/06	15,000.00	1,552.44	13,447.56		
3/1/07	8,500.00	1,709.51	6,790.49		
		10,000.00			

Example 2. Partial call that results in a pro-rata prepayment—(i) *Facts.* On April 1, 1999, M purchases for $110,000 N's taxable bond maturing on April 1, 2006, with a stated principal amount of $100,000, payable at maturity. The bond provides for unconditional payments of interest of $10,000, payable on April 1 of each year. N has the option to call all or part of the bond on April 1, 2001, at a 5 percent premium over the principal amount. M uses the cash receipts and disbursements method of accounting.

(ii) *Determination of yield and the remaining payment schedule.* M's yield determined without regard to the call option is 8.07 percent, compounded annually. M's yield determined by assuming N exercises its call option is 6.89 percent, compounded annually. Under paragraph (c)(4)(ii)(A) of this section, it is assumed N will not exercise the call option because exercising the option would minimize M's yield. Thus, for purposes of determining and amortizing bond premium, the bond is assumed to be a seven-year bond with a single principal payment at maturity of $100,000.

(iii) *Amount of bond premium.* The interest payments on the bond are qualified stated interest. Therefore, the sum of all amounts payable on the bond (other than the interest payments) is $100,000. Under § 1.171–1, the amount of bond premium is $10,000 ($110,000 − $100,000).

(iv) *Bond premium allocable to the first two accrual periods.* For the accrual period ending on April 1, 2000, M includes in income $8,881.83, the qualified stated interest allocable to the period ($10,000) offset with bond premium allocable to the period ($1,118.17). The adjusted acquisition price on April 1, 2000, is $108,881.83 ($110,000 − $1,118.17). For the accrual period ending on April 1, 2001, M includes in income $8,791.54, the qualified stated interest allocable to the period ($10,000) offset with bond premium allocable to the period ($1,208.46). The adjusted acquisition price on April 1, 2001, is $107,673.37 ($108,881.83 − $1,208.46).

(v) *Partial call.* Assume N calls one-half of M's bond for $52,500 on April 1, 2001. Because it was assumed the call would not be exercised, the call is a change in circumstances. However, the partial call is also a pro-rata prepayment within the meaning of § 1.1275–2(f)(2). As a result, the call is treated as a retirement of one-half of the bond. Under paragraph (c)(5)(ii) of this section, M may deduct $1,336.68, the excess of its adjusted acquisition price in the retired portion of the bond ($107,673.37/2, or $53,836.68) over the amount received on redemption ($52,500). M's adjusted basis in the portion of the bond that remains outstanding is $53,836.68 ($107,673.37 − $53,836.68).

[T.D. 8746, 62 FR 68180, Dec. 31, 1997]

§ 1.171–4 Election to amortize bond premium on taxable bonds.

(a) *Time and manner of making the election*—(1) *In general.* A holder makes the election to amortize bond premium by offsetting interest income with bond premium in the holder's timely filed federal income tax return for the first taxable year to which the holder desires the election to apply. The holder should attach to the return a statement that the holder is making the election under this section.

(2) *Coordination with OID election.* If a holder makes an election under §1.1272–3 for a bond with bond premium, the holder is deemed to have made the election under this section.

(b) *Scope of election.* The election under this section applies to all taxable bonds held during or after the taxable year for which the election is made.

(c) *Election to amortize made in a subsequent taxable year*—(1) *In general.* If a holder elects to amortize bond premium and holds a taxable bond acquired before the taxable year for which the election is made, the holder may not amortize amounts that would have been amortized in prior taxable years had an election been in effect for those prior years.

(2) *Example.* The following example illustrates the rule of this paragraph (c):

Example. (i) *Facts.* On May 1, 1999, C purchases for $130,000 a taxable bond maturing on May 1, 2006, with a stated principal amount of $100,000, payable at maturity. The bond provides for unconditional payments of interest of $15,000, payable on May 1 of each year. C uses the cash receipts and disbursements method of accounting and the calendar year as its taxable year. C has not previously elected to amortize bond premium, but does so for 2002.

(ii) *Amount to amortize.* C's basis for determining loss on the sale or exchange of the bond is $130,000. Thus, under §1.171–1, the amount of bond premium is $30,000. Under §1.171–2, if a bond premium election were in effect for the prior taxable years, C would have amortized $3,257.44 of bond premium on May 1, 2000, and $3,551.68 of bond premium on May 1, 2001, based on annual accrual periods ending on May 1. Thus, for 2002 and future years to which the election applies, C may amortize only $23,190.88 ($30,000 − $3,257.44 − $3,551.68).

(d) *Revocation of election.* The election under this section may not be revoked unless approved by the Commissioner. Because a revocation of the election is a change in accounting method, a taxpayer must follow the rules under §1.446–1(e)(3)(i) to request the Commissioner's consent to revoke the election. A revocation of the election applies to all taxable bonds held during or after the taxable year for which the revocation is effective. The holder may not amortize any remaining bond premium on bonds held at the beginning of the taxable year for which the revocation is effective. Therefore, no adjustment under section 481 is allowed upon the revocation of the election because no items of income or deduction are omitted or duplicated.

[T.D. 8746, 62 FR 68182, Dec. 31, 1997]

§1.171–5 Effective date and transition rules.

(a) *Effective date*—(1) *In general.* Sections 1.171–1 through 1.171–4 apply to bonds acquired on or after March 2, 1998. However, if a holder makes the election under §1.171–4 for the taxable year containing March 2, 1998, or any subsequent taxable year, §§1.171–1 through 1.171–4 apply to bonds held on or after the first day of the taxable year in which the election is made.

(2) *Transition rule for use of constant yield.* Notwithstanding paragraph (a)(1) of this section, §1.171–2(a)(3) (providing that the bond premium allocable to an accrual period is determined with reference to a constant yield) does not apply to a bond issued before September 28, 1985.

(b) *Coordination with existing election.* A holder is deemed to have made the election under §1.171–4 for the taxable year containing March 2, 1998, if the holder elected to amortize bond premium under section 171 and that election is effective on March 2, 1998. If the holder is deemed to have made the election under §1.171–4 for the taxable year containing March 2, 1998, §§1.171–1 through 1.171–4 apply to bonds acquired on or after the first day of that taxable year. See §1.171–4(d) for rules relating to a revocation of an election under section 171.

(c) *Accounting method changes*—(1) *Consent to change.* A holder required to change its method of accounting for bond premium to comply with §§1.171–1 through 1.171–3 must secure the consent of the Commissioner in accordance with the requirements of §1.446–1(e). Paragraph (c)(2) of this section provides the Commissioner's automatic consent for certain changes. A holder making the election under §1.171–4 does not need the Commissioner's consent to make the election.

(2) *Automatic consent.* The Commissioner grants consent for a holder to change its method of accounting for bond premium with respect to taxable bonds to which §§ 1.171–1 through 1.171–3 apply. Because this change is made on a cut-off basis, no items of income or deduction are omitted or duplicated and, therefore, no adjustment under section 481 is allowed. The consent granted by this paragraph (c)(2) applies provided—

(i) The holder elected to amortize bond premium under section 171 for a taxable year prior to the taxable year containing March 2, 1998, and that election has not been revoked;

(ii) The change is made for the first taxable year for which the holder must account for a bond under §§ 1.171–1 through 1.171–3; and

(iii) The holder attaches to its return for the taxable year containing the change a statement that it has changed its method of accounting under this section.

[T.D. 8746, 62 FR 68182, Dec. 31, 1997]

§ 1.172–1 Net operating loss deduction.

(a) *Allowance of deduction.* Section 172(a) allows as a deduction in computing taxable income for any taxable year subject to the Code the aggregate of the net operating loss carryovers and net operating loss carrybacks to such taxable year. This deduction is referred to as the net operating loss deduction. The net operating loss is the basis for the computation of the net operating loss carryovers and net operating loss carrybacks and ultimately for the net operating loss deduction itself. The net operating loss deduction shall not be disallowed for any taxable year merely because the taxpayer has no income from a trade or business for the taxable year.

(b) *Steps in computation of net operating loss deduction.* The three steps to be taken in the ascertainment of the net operating loss deduction for any taxable year subject to the Code are as follows:

(1) Compute the net operating loss for any preceding or succeeding taxable year from which a net operating loss may be carried over or carried back to such taxable year.

(2) Compute the net operating loss carryovers to such taxable year from such preceding taxable years and the net operating loss carrybacks to such taxable year from such succeeding taxable years.

(3) Add such net operating loss carryovers and carrybacks in order to determine the net operating loss deduction for such taxable year.

(c) *Statement with tax return.* Every taxpayer claiming a net operating loss deduction for any taxable year shall file with his return for such year a concise statement setting forth the amount of the net operating loss deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the net operating loss deduction.

(d) *Ascertainment of deduction dependent upon net operating loss carryback.* If the taxpayer is entitled in computing his net operating loss deduction to a carryback which he is not able to ascertain at the time his return is due, he shall compute the net operating loss deduction on his return without regard to such net operating loss carryback. When the taxpayer ascertains the net operating loss carryback, he may within the applicable period of limitations file a claim for credit or refund of the overpayment, if any, resulting from the failure to compute the net operating loss deduction for the taxable year with the inclusion of such carryback; or he may file an application under the provisions of section 6411 for a tentative carryback adjustment.

(e) *Law applicable to computations.* (1) In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year.

(2) The net operating loss for any taxable year shall be determined under the law applicable to that year without regard to the year to which it is to be carried and in which, in effect, it is to be deducted as part of the net operating loss deduction.

(3) The amount of the net operating loss deduction which shall be allowed for any taxable year shall be determined under the law applicable to that year.

(f) *Electing small business corporations.* In determining the amount of the net operating loss deduction of any corporation, there shall be disregarded the net operating loss of such corporation for any taxable year for which such corporation was an electing small business corporation under subchapter S (section 1371 and following), chapter 1 of the Code. In applying section 172(b)(1) and (2) to a net operating loss sustained in a taxable year in which the corporation was not an electing small business corporation, a taxable year in which the corporation was an electing small business corporation is counted as a taxable year to which such net operating loss is carried back or over. However, the taxable income for such year as determined under section 172(b)(2) is treated as if it were zero for purposes of computing the balance of the loss available to the corporation as a carryback or carryover to other taxable years in which the corporation is not an electing small business corporation. See section 1374 and the regulations thereunder for allowance of a deduction to shareholders for a net operating loss sustained by an electing small business corporation.

(g) *Husband and wife.* The net operating loss deduction of a husband and wife shall be determined in accordance with this section, but subject also to the provisions of §1.172–7.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 8107, 51 FR 43345, Dec. 2, 1986]

§1.172–2 Net operating loss in case of a corporation.

(a) *Modification of deductions.* A net operating loss is sustained by a corporation in any taxable year if and to the extent that, for such year, there is an excess of deductions allowed by chapter 1 of the Code over gross income computed thereunder. In determining the excess of deductions over gross income for such purpose—

(1) *Items not deductible.* No deduction shall be allowed under—

(i) Section 172 for the net operating loss deduction, and

(ii) Section 922 in respect of Western Hemisphere trade corporations;

(2) *Dividends received.* The 85-percent limitation provided by section 246(b) shall not apply to the deductions otherwise allowed under—

(i) Section 243(a) in respect of dividends received from domestic corporations.

(ii) Section 244 in respect of dividends received on preferred stock of public utilities, and

(iii) Section 245 in respect of dividends received from foreign corporations; and

(3) *Dividends paid.* The deduction granted by section 247 in respect of dividends paid on the preferred stock of public utilities shall be computed without regard to subsection (a)(1)(B) of Section 247.

(b) *Example.* The following example illustrates the application of paragraph (a):

Example For the calendar year 1981, the X corporation has a gross income of $400,000 and total deductions allowed by chapter 1 of the Code of $375,000 exclusive of any net operating loss deduction and exclusive of any deduction for dividends received or paid. Corporation X in 1981 received $100,000 of dividends entitled to the benefits of section 243(a). These dividends are included in Corporation X's $400,000 gross income. Corporation X has no other deductions to which section 172(d) applies. On the basis of these facts, Corporation X has a net operating loss for the year 1981 of $60,000, computed as follows:

Deductions for 1981	$375,000
Plus: Deduction for dividends received, computed without regard to the limitation provided in section 246(b) (85% of $100,000)	85,000
Total	460,000
Less: Gross income for 1981 (including $100,000 dividends)	400,000
Net operating loss for 1981	60,000

(c) *Qualified real estate investment trusts.* For taxable years ending after October 4, 1976, the net operating loss of a qualified real estate investment trust (as defined in §1.172–10(b)) is computed by taking into account the adjustments described in section 857(b)(2) (other than the deduction for dividends paid, as defined in section 561), as well as the modifications required by paragraph (a)(1) of this section. Thus, for example, the special deductions for dividends received, etc., provided in part VIII of subchapter B (other than section 248), as well as the net operating loss deduction under section 172, are not allowed in computing the net operating loss of a qualified real estate investment trust.

[T.D. 8107, 51 FR 43345, Dec. 2, 1986]

§ 1.172–3 Net operating loss in case of a taxpayer other than a corporation.

(a) *Modification of deductions.* A net operating loss is sustained by a taxpayer other than a corporation in any taxable year if and to the extent that, for such year there is an excess of deductions allowed by chapter 1 of the Internal Revenue Code over gross income computed thereunder. In determining the excess of deductions over gross income for such purpose:

(1) *Items not deductible.* No deduction shall be allowed under:

(i) Section 151 for the personal exemptions or under any other section which grants a deduction in lieu of the deductions allowed by section 151,

(ii) Section 172 for the net operating loss deduction, and

(iii) Section 1202 in respect of the net long-term capital gain.

(2) *Capital losses.* (i) The amount deductible on account of business capital losses shall not exceed the sum of the amount includible on account of business capital gains and that portion of nonbusiness capital gains which is computed in accordance with paragraph (c) of this section.

(ii) The amount deductible on account of nonbusiness capital losses shall not exceed the amount includible on account of nonbusiness capital gains.

(3) *Nonbusiness deductions*—(i) *Ordinary deductions.* Ordinary nonbusiness deductions shall be taken into account without regard to the amount of business deductions and shall be allowed in full to the extent, but not in excess, of that amount which is the sum of the ordinary nonbusiness gross income and the excess of nonbusiness capital gains over nonbusiness capital losses. See paragraph (c) of this section. For purposes of section 172, nonbusiness deductions and income are those deductions and that income which are not attributable to, or derived from, a taxpayer's trade or business. Wages and salary constitute income attributable to the taxpayer's trade or business for such purposes.

(ii) *Sale of business property.* Any gain or loss on the sale or other disposition of property which is used in the taxpayer's trade or business and which is of a character that is subject to the allowance for depreciation provided in section 167, or of real property used in the taxpayer's trade or business, shall be considered, for purposes of section 172(d)(4), as attributable to, or derived from, the taxpayer's trade or business. Such gains and losses are to be taken into account fully in computing a net operating loss without regard to the limitation on nonbusiness deductions. Thus, a farmer who sells at a loss land used in the business of farming may, in computing a net operating loss, include in full the deduction otherwise allowable with respect to such loss, without regard to the amount of his nonbusiness income and without regard to whether he is engaged in the trade or business of selling farms. Similarly, an individual who sells at a loss machinery which is used in his trade or business and which is of a character that is subject to the allowance for depreciation may, in computing the net operating loss, include in full the deduction otherwise allowable with respect to such loss.

(iii) *Casualty losses.* Any deduction allowable under section 165(c)(3) for losses of property not connected with a trade or business shall not be considered, for purposes of section 172(d)(4), to be a nonbusiness deduction but shall be treated as a deduction attributable to the taxpayer's trade or business.

(iv) *Self-employed retirement plans.* Any deduction allowed under section 404, relating to contributions of an employer to an employees' trust or annuity plan, or under section 405(c), relating to contributions to a bond purchase plan, to the extent attributable to contributions made on behalf of an individual while he is an employee within the meaning of section 401(c)(1), shall not be treated, for purposes of section

172(d)(4), as attributable to, or derived from, the taxpayer's trade or business, but shall be treated as a nonbusiness deduction.

(v) *Limitation.* The provisions of this subparagraph shall not be construed to permit the deduction of items disallowed by subparagraph (1) of this paragraph.

(b) *Treatment of capital loss carryovers.* Because of the distinction between business and nonbusiness capital gains and losses, a taxpayer who has a capital loss carryover from a preceding taxable year, includible by virtue of section 1212 among the capital losses for the taxable year in issue, is required to determine how much of such capital loss carryover is a business capital loss and how much is a nonbusiness capital loss. In order to make this determination, the taxpayer shall first ascertain what proportion of the net capital loss for such preceding taxable year was attributable to an excess of business capital losses over business capital gains for such year, and what proportion was attributable to an excess of nonbusiness capital losses over nonbusiness capital gains. The same proportion of the capital loss carryover from such preceding taxable year shall be treated as a business capital loss and a nonbusiness capital loss, respectively. In order to determine the composition (business—nonbusiness) of a net capital loss for a taxable year, for purposes of this paragraph, if such net capital loss is computed under paragraph (b) of §1.1212–1 and takes into account a capital loss carryover from a preceding taxable year, the composition (business—nonbusiness) of the net capital loss for such preceding taxable year must also be determined. For purposes of this paragraph, the term *capital loss carryover* means the sum of the short-term and long-term capital loss carryovers from such year. This paragraph may be illustrated by the following examples:

Example 1. (i) A, an individual, has $5,000 ordinary taxable income (computed without regard to the deductions for personal exemptions) for the calendar year 1954 and also has the following capital gains and losses for such year: Business capital gains of $2,000; business capital losses of $3,200; nonbusiness capital gains of $1,000; and nonbusiness capital losses of $1,200.

(ii) A's net capital loss for the taxable year 1954 is $400, computed as follows:

Capital losses	$4,400
Capital gains	3,000
Excess of capital losses over capital gains	1,400
Less: $1,000 of such ordinary taxable income	1,000
Net capital loss for 1954	400

(iii) A's capital losses for 1954 exceeded his capital gains for such year by $1,400. Since A's business capital losses for 1954 exceeded his business capital gains for such year by $1,200, 6/7ths ($1,200/$1,400) of A's net capital loss for 1954 is attributable to an excess of his business capital losses over his business capital gains for such year. Similarly, 1/7th of the net capital loss is attributable to the excess of nonbusiness capital losses over nonbusiness capital gains. Since the capital loss carryover for 1954 to 1955 is $400, 6/7ths of $400, or $342.86, shall be treated as a business capital loss in 1955; and 1/7th of $400, or $57.14, as a nonbusiness capital loss.

Example 2. (i) A, an individual who is computing a net operating loss for the calendar year 1966, has a capital loss carryover from 1965 of $8,000. In order to apply the provisions of this paragraph, A must determine what portion of the $8,000 carryover is attributable to the excess of business capital losses over business capital gains and what portion thereof is attributable to the excess of nonbusiness capital losses over nonbusiness capital gains. For 1965, A had $10,000 ordinary taxable income (computed without regard to the deductions for personal exemptions), and a short-term capital loss carryover of $6,000 from 1964. In order to determine the composition (business—nonbusiness) of the $8,000 carryover from 1965, A first determines that of the $6,000 carryover from 1964, $5,000 is a business capital loss and $1,000 is a nonbusiness capital loss. This must be done since, under paragraph (b) of §1.1212–1, the net capital loss for 1965 is computed by taking into account the capital loss carryover from 1964. A's capital gains and losses for 1965 are as follows:

	1965	Carried over from 1964
Business capital gains	$2,000	0
Business capital losses	3,000	$5,000
Nonbusiness capital gains	4,000	0
Nonbusiness capital losses	6,000	1,000

(ii) A's net capital loss for the taxable year 1965 is $8,000, computed as follows:

Capital losses (including carryovers)	$15,000
Capital gains	6,000
Excess of capital losses over capital gains	9,000
Less: $1,000 of such ordinary taxable income	1,000
Net capital loss for 1965	8,000

(iii) A's capital losses, including carryovers, for 1965 exceeded his capital gains for such year by $9,000. Since A's business capital losses for 1965 exceeded his business capital gains for such year by $6,000, 2/3rds ($6,000/$9,000) of A's net capital loss for 1965 is attributable to an excess of his business capital losses over his business capital gains for such year. Similarly, 1/3rd of the net capital loss is attributable to the excess of nonbusiness capital losses over nonbusiness capital gains. Since the total capital loss carryover from 1965 to 1966 is $8,000, 2/3rds of $8,000, or $5,333.33, shall be treated as a business capital loss in 1966; and 1/3rd of $8,000, or $2,666.67, as a nonbusiness capital loss.

(c) *Determination of portion of nonbusiness capital gains available for the deduction of business capital losses.* In the computation of a net operating loss a taxpayer other than a corporation must use his nonbusiness capital gains for the deduction of his nonbusiness capital losses. Any amount not necessary for this purpose shall then be used for the deduction of any excess of ordinary nonbusiness deductions over ordinary nonbusiness gross income. The remainder, computed by applying the excess ordinary nonbusiness deductions against the excess nonbusiness capital gains, shall be treated as nonbusiness capital gains and used for the purpose of determining the deductibility of business capital losses under paragraph (a)(2)(i) of this section. This principle may be illustrated by the following example:

Example. (1) A, an individual, has a total nonbusiness gross income of $20,500, computed as follows:

Ordinary gross income	$7,500
Capital gains	13,000
Total gross income	20,500

(2) A also has total nonbusiness deductions of $16,000, computed as follows:

Ordinary deductions	$9,000
Capital loss	7,000
Total deductions	16,000

(3) The portion of nonbusiness capital gains to be used for the purpose of determining the deductibility of business capital losses is $4,500, computed as follows:

Nonbusiness capital gains		$13,000
Less: Nonbusiness capital loss		7,000
Excess to be taken into account for purposes of paragraph (a)(3)(i) of this section		6,000
Ordinary nonbusiness deductions	$9,000	
Less: Ordinary nonbusiness gross income	7,500	
		1,500
Portion of nonbusiness capital gains to be used for purposes of paragraph (a)(2)(i) of this section		4,500

(d) *Joint net operating loss of husband and wife.* In the case of a husband and wife, the joint net operating loss for any taxable year for which a joint return is filed is to be computed on the basis of the combined income and deductions of both spouses, and the modifications prescribed in paragraph (a) of this section are to be computed as if the combined income and deductions of both spouses were the income and deductions of one individual.

(e) *Illustration of computation of net operating loss of a taxpayer other than a corporation*—(1) *Facts.* For the calendar year 1954 A, an individual, has gross income of $483,000 and allowable deductions of $540,000. The latter amount does not include the net operating loss deduction or any deduction on account of the sale or exchange of capital assets. Included in gross income are business capital gains of $50,000 and ordinary nonbusiness income of $10,000. Included among the deductions are ordinary nonbusiness deductions of $12,000 and a deduction of $600 for his personal exemption. A has a business capital loss of $60,000 in 1954. A has no other items of income or deductions to which section 172(d) applies.

(2) *Computation.* On the basis of these facts, A has a net operating loss for 1954 of $104,400, computed as follows:

Deductions for 1954 (as specified in first sentence of subparagraph (1))		$540,000
Plus: Amount of business capital loss ($60,000) to extent such amount does not exceed business capital gains ($50,000)		50,000
Total		590,000
Less: Excess of ordinary nonbusiness deductions over ordinary nonbusiness gross income ($12,000 minus $10,000)	$2,000	
Deduction for personal exemption	600	
		$2,600
Deductions for 1954 adjusted as required by section 172(d)		587,400
Gross income for 1954	483,000	
Net operating loss for 1954	104,400	

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6828, 30 FR 7805, June 17, 1965; T.D. 6862, 30 FR 14427, Nov. 18, 1965; T.D. 8107, 51 FR 43345, Dec. 2, 1986]

§1.172–4 Net operating loss carrybacks and net operating loss carryovers.

(a) *General provisions*—(1) *Years to which loss may be carried*—(i) *In general.* In order to compute the net operating loss deduction the taxpayer must first determine the part of any net operating losses for any preceding or succeeding taxable years which are carrybacks or carryovers to the taxable year in issue.

(ii) *General rule for carrybacks and carryovers.* Except as provided in section 172 (b)(1)(C), (D), (E), (F), (G), (H), (I), and (J), paragraphs (a)(1)(iii), (iv), (v), and (vi) of this section, and §1.172–10(a), a net operating loss shall be carried back to the 3 preceding taxable years and carried over to the 15 succeeding taxable years (5 succeeding taxable years for a loss sustained in a taxable year ending before January 1, 1976).

(iii) *Loss of a regulated transportation corporation.* Except as provided in subdivision (iv) of this subparagraph and §1.172–10(a), a net operating loss sustained by a taxpayer which is a regulated transportation corporation (as defined in section 172(g)(1)) in a taxable year ending before January 1, 1976, shall, subject to the provisions of section 172(g) and §1.172–8, be carried back to the taxable years specified in paragraph (a)(1)(ii) of this section and shall be carried over to the 7 succeeding taxable years.

(iv) *Loss attributable to foreign expropriation.* If the provisions of section 172(b)(3)(A) and §1.172–9 are satisfied, the portion of a net operating loss attributable to a foreign expropriation loss (as defined in section 172(h)) shall not be a net operating loss carryback to any taxable year preceding the taxable year of such loss and shall be a net operating loss carryover to each of the 10 taxable years following the taxable year of such loss.

(v) *Loss of a financial institution.* A net operating loss sustained in a taxable year beginning after December 31, 1975, by a taxpayer to which section 585, 586, or 593 applies shall be carried back (except as provided in §1.172–10(a)) to the 10 preceding taxable years and shall be carried over to the 5 succeeding taxable years.

(vi) *Loss of a Bank for Cooperatives.* A net operating loss sustained by a taxpayer which is a Bank for Cooperatives (organized and chartered pursuant to section 2 of the Farm Credit Act of 1933 (12 U.S.C. 1134)) shall be carried back (except as provided in §1.172–10(a)) to the 10 preceding taxable years and shall be carried over to the 5 succeeding taxable years.

(2) *Periods of less than 12 months.* A fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) is a preceding or a succeeding taxable year for the purpose of determining under section 172 the first, second, etc., preceding or succeeding taxable year.

(3) *Amount of loss to be carried.* The amount which is carried back or carried over to any taxable year is the net operating loss to the extent it was not absorbed in the computation of the taxable (or net) income for other taxable years, preceding such taxable year, to which it may be carried back or carried over. For the purpose of determining the taxable (or net) income for any such preceding taxable year, the various net operating loss carryovers and carrybacks to such taxable year are considered to be applied in reduction of the taxable (or net) income in the order of the taxable years from which such losses are carried over or carried back, beginning with the loss for the earliest taxable year.

(4) *Husband and wife.* The net operating loss carryovers and carrybacks of a husband and wife shall be determined in accordance with this section, but subject also to the provisions of §1.172–7.

(5) *Corporate acquisitions.* For the computation of the net operating loss carryovers in the case of certain acquisitions of the assets of a corporation by another corporation, see section 381 and the regulations thereunder.

(6) *Special limitations.* For special limitations on the net operating loss carryovers in certain cases of change in both the ownership and the trade or business of a corporation and in certain cases of corporate reorganization lacking specified continuity of ownership, see section 382 and the regulations thereunder.

(7) *Electing small business corporations.* For special rule applicable to corporations which were electing small business corporations under Subchapter S (section 1361 and following), chapter 1 of the Code, during one or more of the taxable years described in section 172 (b)(1), see paragraph (f) of § 1.172–1.

(b) *Portion of net operating loss which is a carryback or a carryover to the taxable year in issue.* (1) A net operating loss shall first be carried to the earliest of the several taxable years for which such loss is allowable as a carryback or a carryover, and shall then be carried to the next earliest of such several taxable years, etc. Except as provided in § 1.172–9, the entire net operating loss shall be carried back to such earliest year.

(2) The portion of the loss which shall be carried to any of such several taxable years subsequent to the earliest taxable year is the excess of such net operating loss over the sum of the taxable incomes (computed as provided in § 1.172–5) for all of such several taxable years preceding such subsequent taxable year.

(3) If a portion of the net operating loss for a taxable year is attributable to a foreign expropriation loss (as defined in section 172(h)) and if an election under paragraph (c) of §1.172–9 is made with respect to such portion of the net operating loss, then see § 1.172–9 for the separate treatment of such portion of the net operating loss.

(c) *Illustration.* The principles of this section are illustrated in § 1.172–6.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 8107, 51 FR 43345, Dec. 2, 1986]

§ 1.172–5 Taxable income which is subtracted from net operating loss to determine carryback or carryover.

(a) *Taxable year subject to the Internal Revenue Code of 1954.* The taxable income for any taxable year subject to the Internal Revenue Code of 1954 which is subtracted from the net operating loss for any other taxable year to determine the portion of such net operating loss which is a carryback or a carryover to a particular taxable year is computed with the modifications prescribed in this paragraph. These modifications shall be made independently of, and without reference to, the modifications required by §§ 1.172–2(a) and 1.172–3(a) for purposes of computing the net operating loss itself.

(1) *Modifications applicable to unincorporated taxpayers only.* In the case of a taxpayer other than a corporation, in computing taxable income and adjusted gross income:

(i) No deduction shall be allowed under section 151 for the personal exemptions (or under any other section which grants a deduction in lieu of the deductions allowed by section 151) and under section 1202 in respect of the net long-term capital gain.

(ii) The amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of capital assets.

(2) *Modifications applicable to all taxpayers.* In the case either of a corporation or of a taxpayer other than a corporation:

(i) *Net operating loss deduction.* The net operating loss deduction for such taxable year shall be computed by taking into account only such net operating losses otherwise allowable as carrybacks or carryovers to such taxable year as were sustained in taxable years preceding the taxable year in which the taxpayer sustained the net operating loss from which the taxable income is to be deducted. Thus, for such purposes, the net operating loss for the loss year or any taxable year thereafter shall not be taken into account.

Example. The taxpayer's income tax returns are made on the basis of the calendar year. In computing the net operating loss deduction for 1954, the taxpayer has a carryover from 1952 of $9,000, a carryover from 1953 of $6,000, a carryback from 1955 of $18,000, and a carryback from 1956 of $10,000, or an aggregate of $43,000 in carryovers and carrybacks. Thus, the net operating loss deduction for 1954, for purposes of determining the tax liability for 1954, is $43,000. However, in computing the taxable income for 1954 which is subtracted from the net operating loss for 1955 for the purpose of determining the portion of such loss which may be carried over to subsequent taxable years, the net operating loss deduction for 1954 is $15,000, that is, the aggregate of the $9,000 carryover from 1952 and the $6,000 carryover from 1953. In computing the net operating loss deduction for such purpose, the $18,000 carryback from 1955 and the $10,000 carryback from 1956 are disregarded. In computing the taxable income for 1954, however, which is subtracted from the net operating loss for 1956 for the purpose of determining the portion of such loss which may be carried over to subsequent taxable years, the net operating loss deduction for 1954 is $33,000, that is, the aggregate of the $9,000 carryover from 1952, the $6,000 carryover from 1953, and the $18,000 carryback from 1955. In computing the net operating loss deduction for such purpose, the $10,000 carryback from 1956 is disregarded.

(ii) *Recomputation of percentage limitations.* Unless otherwise specifically provided in this subchapter, any deduction which is limited in amount to a percentage of the taxpayer's taxable income or adjusted gross income shall be recomputed upon the basis of the taxable income or adjusted gross income, as the case may be, determined with the modifications prescribed in this paragraph. Thus, in the case of an individual the deduction for medical expenses would be recomputed after making all the modifications prescribed in this paragraph, whereas the deduction for charitable contributions would be determined without regard to any net operating loss carryback but with regard to any other modifications so prescribed. See, however, the regulations under paragraph (g) of § 1.170–2 (relating to charitable contributions carryover of individuals) and paragraph (c) of § 1.170–3 (relating to charitable contributions carryover of corporations) for special rules regarding charitable contributions in excess of the percentage limitations which may be treated as paid in succeeding taxable years.

Example 1. For the calendar year 1954 the taxpayer, an individual, files a return showing taxable income of $4,800, computed as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		9,000
Less: Deduction allowed by section 1202 in respect of net long-term capital gain		2,000
Adjusted gross income		7,000
Less:		
Deduction for personal exemption	$600	
Deduction for medical expense ($410 actually paid but allowable only to extent in excess of 3 percent of adjusted gross income)	200	
Deduction for charitable contributions ($2,000 actually paid but allowable only to extent not in excess of 20 percent of adjusted gross income)	$1,400	
		$2,200
Taxable income		4,800

In 1955 the taxpayer undertakes the operation of a trade or business and sustains therein a net operating loss of $3,000. Under section 172(b)(2), it is determined that the entire $3,000 is a carryback to 1954. In 1956 he sustains a net operating loss of $10,000 in the operation of the business. In determining the amount of the carryover of the 1956 loss to 1957, the taxable income for 1954 as computed under this paragraph is $3,970, determined as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		9,000
Less: Deduction for carryback of 1955 net operating loss		3,000
Adjusted gross income		6,000
Less:		
Deduction for medical expense ($410 actually paid but allowable only to extent in excess of 3 percent of adjusted gross income as modified under this paragraph)	$230	
Deduction for charitable contributions ($2,000 actually paid but allowable only to extent not in excess of 20 percent of adjusted gross income determined with all the modifications prescribed in this paragraph other than the net operating loss carryback)	1,800	
		2,030
Taxable income		3,970

Example 2. For the calendar year 1959 the taxpayer, an individual, files a return showing taxable income of $5,700, computed as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		9,000
Less: Deduction allowed by section 1202 in respect of net long-term capital gain		2,000
Adjusted gross income		7,000
Less:		
Deduction for personal exemption	$600	
Standard deduction allowed by section 141	$700	
		$1,300
Taxable income		5,700

In 1960 the taxpayer undertakes the operation of a trade or business and sustains therein a net operating loss of $4,700. In 1961 he sustains a net operating loss of $10,000 in the operation of the business. Under section 172(b)(2), it is determined that the entire amount of each loss, $4,700 and $10,000, is a carryback to 1959. In determining the amount of the carryover of the 1961 loss to 1962, the taxable income for 1959 as computed under this paragraph is $3,870, determined as follows:

Salary	$5,000
Net long-term capital gain	4,000
Total gross income	9,000
Less: Deduction for carryback of 1960 net operating loss	4,700
Adjusted gross income	4,300
Less: Standard deduction	430
Taxable income	3,870

(iii) *Minimum limitation.* The taxable income, as modified under this paragraph, shall in no case be considered less than zero.

(3) *Electing small business corporations.* For special rule applicable to corporations which were electing small business corporations under Subchapter S (section 1361 and following), Chapter 1 of the Code, during one or more of the taxable years described in section 172(b)(1), see paragraph (f) of § 1.172–1.

(4) *Qualified real estate investment trust.* Where a net operating loss is carried over to a qualified taxable year (as defined in § 1.172–10(b)) ending after October 4, 1976, the real estate investment trust taxable income (as defined in section 857(b)(2)) shall be used as the ‘‘taxable income’’ for that taxable year to determine, under section 172(b)(2), the balance of the net operating loss available as a carryover to a subsequent taxable year. The real estate investment trust taxable income, however, is computed by applying the rules applicable to corporations in paragraph (a)(2) of this section. Thus, in computing real estate investment trust taxable income for purposes of section 172(b)(2), the net operating loss deduction for the taxable year shall be computed in accordance with paragraph (a)(2)(i) of this section. The principles of this subparagraph may be illustrated by the following examples:

Example 1. Corporation X, a calendar year taxpayer, is formed on January 1, 1977. X incurs a net operating loss of $100,000 for its taxable year 1977, which under section 172(b)(2), is a carryover to 1978. For 1978 X is a qualified real estate investment trust (as defined in § 1.172–10(b)) and has real estate investment trust taxable income (determined without regard to the deduction for dividends paid or the net operating loss deduction) of $150,000, all of which consists of ordinary income. X pays dividends in 1978 totaling $120,000 that qualify for the deduction for dividends paid under section 857(b)(2)(B). The portion of the 1977 net operating loss available as a carryover to 1979 and subsequent years is $70,000 (i.e., the excess of the amount of the net operating loss ($100,000) over the amount of the real estate investment trust taxable income for 1978 ($30,000), determined by taking into account the deduction for dividends paid allowable under section 857(b)(2)(B) and without taking into account the net operating loss of 1977).

Example 2. (i) Assume the same facts as in *Example (1)*, except that the $150,000 of real estate investment trust taxable income (determined without the net operating loss deduction or the dividends paid deduction) consists of $80,000 of ordinary income and $70,000 of net capital gain. The amount of capital gain dividends which may be paid for 1978 is limited to $50,000, that is, the amount of the real estate investment trust taxable income for 1978, determined by taking into account the net operating loss deduction for the taxable year, but not the deduction for dividends paid ($150,000 minus $100,000). See § 1.857–6(e)(1)(ii).

(ii) X designated $50,000 of the $120,000 of dividends paid as capital gains dividends (as defined in section 857(b)(3)(C) and § 1.857–6(e)). Thus, $70,000 is an ordinary dividend. Since both ordinary dividends and capital gains dividends are taken into account in computing the deduction for dividends paid under section 857(b)(2)(B), the result will be the same as in *Example (1)*; that is, the portion of the 1977 net operating loss available as a carryover to 1979 and subsequent years is $70,000.

(b) [Reserved]

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6862, 30 FR 14428, Nov. 18, 1965; T.D. 6900, 31 FR 14641, Nov. 17, 1966; T.D. 7767, 46 FR 11263, Feb. 6, 1981; T.D. 8107, 51 FR 43346, Dec. 2, 1986]

§ 1.172–6 Illustration of net operating loss carrybacks and carryovers.

The application of § 1.172–4 may be illustrated by the following example:

(a) *Facts.* The books of the taxpayer, whose return is made on the basis of the calendar year, reveal the following facts:

Taxable year	*Taxable income*	*Net operating loss*
1954	$15,000	
1955	30,000	
1956		($75,000)
1957	20,000	
1958		(150,000)
1959	30,000	
1960	35,000	
1961	75,000	
1962	17,000	
1963	53,000	

The taxable income thus shown is computed without any net operating loss deduction. The assumption is also made that none of the other modifications prescribed in §1.172–5 apply. There are no net operating losses for 1950, 1951, 1952, 1953, 1964, 1965, or 1966.

(b) *Loss sustained in 1956.* The portions of the $75,000 net operating loss for 1956 which shall be used as carrybacks to 1954 and 1955 and as carryovers to 1957, 1958, 1959, 1960, and 1961 are computed as follows:

(1) *Carryback to 1954.* The carryback to this year is $75,000, that is, the amount of the net operating loss.

(2) *Carryback to 1955.* The carryback to this year is $60,000, computed as follows:

Net operating loss	$75,000
Less:	
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	15,000
Carryback	60,000

(3) *Carryover to 1957.* The carryover to this year is $30,000, computed as follows:

Net operating loss		$75,000
Less:		
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	$15,000	
Taxable income for 1955 (computed without the deduction of the carryback from 1956 or the carryback from 1958)	30,000	
		45,000
Carryover		30,000

(4) *Carryover to 1958.* The carryover to this year is $10,000, computed as follows:

Net operating loss		$75,000
Less:		
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	$15,000	
Taxable income for 1955 (computed without the deduction of the carryback from 1956 or the carryback from 1958)	30,000	
Taxable income for 1957 (computed without the deduction of the carryover from 1956 or the carryback from 1958)	20,000	
		65,000
Carryover		10,000

(5) *Carryover to 1959.* The carryover to this year is $10,000, computed as follows:

Net operating loss		$75,000
Less:		
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	$15,000	
Taxable income for 1955 (computed without the deduction of the carryback from 1956 or the carryback from 1958)	30,000	
Taxable income for 1957 (computed without the deduction of the carryover from 1956 or the carryback from 1958)	20,000	
Taxable income for 1958 (a year in which a net operating loss was sustained)	0	
		65,000
Carryover		10,000

(6) *Carryover to 1960.* The carryover to this year is $0, computed as follows:

Net operating loss		$75,000
Less:		
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	$15,000	
Taxable income for 1955 (computed without the deduction of the carryback from 1956 or the carryback from 1958)	30,000	
Taxable income for 1957 (computed without the deduction of the carryover from 1956 or the carryback from 1958)	20,000	
Taxable income for 1958 (a year in which a net operating loss was sustained)	0	
Taxable income for 1959 (computed without the deduction of the carryover from 1956 or the carryover from 1958)	30,000	
		95,000
Carryover		0

(7) *Carryover to 1961.* The carryover to this year is $0, computed as follows:

Net operating loss		$75,000
Less:		
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	$15,000	
Taxable income for 1955 (computed without the deduction of the carryback from 1956 or the carryback from 1958)	30,000	
Taxable income for 1957 (computed without the deduction of the carryover from 1956 or the carryback from 1958)	20,000	

Taxable income for 1958 (a year in which a net operating loss was sustained)	0	
Taxable income for 1959 (computed without the deduction of the carryover from 1956 or the carryover from 1958)	30,000	
Taxable income for 1960 (computed without the deduction of the carryover from 1956 or the carryover from 1958)	35,000	
		130,000
Carryover		0

(c) *Loss sustained in 1958.* The portions of the $150,000 net operating loss for 1958 which shall be used as carrybacks to 1955, 1956, and 1957 and as carryovers to 1959, 1960, 1961, 1962, and 1963 are computed as follows:

(1) *Carryback to 1955.* The carryback to this year is $150,000, that is, the amount of the net operating loss.

(2) *Carryback to 1956.* The carryback to this year is $150,000, computed as follows:

Net operating loss	$150,000
Less:	
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	0
Carryback	150,000

(3) *Carryback to 1957.* The carryback to this year is $150,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
		0
Carryback		150,000

(4) *Carryover to 1959.* The carryover to this year is $150,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $30,000 from 1956, the carryback from 1958 to 1957 not being taken into account)	0	
		0
Carryover		150,000

(5) *Carryover to 1960.* The carryover to this year is $130,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $30,000 from 1956, the carryback from 1958 to 1957 not being taken into account)	0	
Taxable income for 1959 (the $30,000 taxable income for such year reduced by the carryover to such year of $10,000 from 1956, the carryover from 1958 to 1959 not being taken into account)	$20,000	
		20,000
Carryover		130,000

(6) *Carryover to 1961.* The carryover to this year is $95,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $30,000 from 1956, the carryback from 1958 to 1957 not being taken into account)	0	
Taxable income for 1959 (the $30,000 taxable income for such year reduced by the carryover to such year of $10,000 from 1956, the carryover from 1958 to 1959 not being taken into account)	$20,000	

Taxable income for 1960 (the $35,000 taxable income for such year reduced by the carryover to such year of $0 from 1956, the carryover from 1958 to 1960 not being taken into account)	35,000	
		55,000
Carryover		95,000

(7) *Carryover to 1962.* The carryover to this year is $20,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $30,000 from 1956, the carryback from 1958 to 1957 not being taken into account)	0	
Taxable income for 1959 (the $30,000 taxable income for such year reduced by the carryover to such year of $10,000 from 1956, the carryover from 1958 to 1959 not being taken into account)	$20,000	
Taxable income for 1960 (the $35,000 taxable income for such year reduced by the carryover to such year of $0 from 1956, the carryover from 1958 to 1960 not being taken into account)	35,000	
Taxable income for 1961 (the $75,000 taxable income for such year reduced by the carryover to such year of $0 from 1956, the carryover from 1958 to 1961 not being taken into account)	75,000	
		130,000
Carryover		20,000

(8) *Carryover to 1963.* The carryover to this year is $3,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $30,000 from 1956, the carryback from 1958 to 1957 not being taken into account)	0	
Taxable income for 1959 (the $30,000 taxable income for such year reduced by the carryover to such year of $10,000 from 1956, the carryover from 1958 to 1959 not being taken into account)	$20,000	
Taxable income for 1960 (the $35,000 taxable income for such year reduced by the carryover to such year of $0 from 1956, the carryover from 1958 to 1960 not being taken into account)	35,000	
Taxable income for 1961 (the $75,000 taxable income for such year reduced by the carryover to such year of $0 from 1956, the carryover from 1958 to 1961 not being taken into account)	75,000	
Taxable income for 1962 (computed without the deduction of the carryover from 1958)	17,000	
		147,000
Carryover		3,000

(d) *Determination of net operating loss deduction for each year.* The carryovers and carrybacks computed under paragraphs (b) and (c) of this section are used as a basis for the computation of the net operating loss deduction in the following manner:

Taxable year	Carryover		Carryback		Net operating loss deduction
	From 1956	From 1958	From 1956	From 1958	
1954	$0	$0	$75,000	$0	$75,000
1955	0	0	60,000	150,000	210,000
1957	30,000	0	0	150,000	180,000
1959	10,000	150,000	0	0	160,000
1960	0	130,000	0	0	130,000
1961	0	95,000	0	0	95,000
1962	0	20,000	0	0	20,000
1963	0	3,000	0	0	3,000

§ 1.172–7 Joint return by husband and wife.

(a) *In general.* This section prescribes additional rules for computing the net operating loss carrybacks and carryovers of a husband and wife making a joint return for one or more of the taxable years involved in the computation of the net operating loss deduction.

(b) *From separate to joint return.* If a husband and wife, making a joint return for any taxable year, did not make a joint return for any of the taxable years involved in the computation of a net operating loss carryover or a net operating loss carryback to the taxable year for which the joint return is made, such separate net operating loss carryover or separate net operating loss carryback is a joint net operating loss carryover or joint net operating loss carryback to such taxable year.

(c) *Continuous use of joint return.* If a husband and wife making a joint return for a taxable year made a joint return for each of the taxable years involved in the computation of a net operating loss carryover or net operating loss carryback to such taxable year, the joint net operating loss carryover or joint net operating loss carryback to such taxable year is computed in the same manner as the net operating loss carryover or net operating loss carryback of an individual under § 1.172–4 but upon the basis of the joint net operating losses and the combined taxable income of both spouses.

(d) *From joint to separate return.* If a husband and wife making separate returns for a taxable year made a joint return for any, or all, of the taxable years involved in the computation of a net operating loss carryover or net operating loss carryback to such taxable year, the separate net operating loss carryover or separate net operating loss carryback of each spouse to the taxable year is computed in the manner set forth in § 1.172–4 but with the following modifications:

(1) *Net operating loss.* The net operating loss of each spouse for a taxable year for which a joint return was made shall be deemed to be that portion of the joint net operating loss (computed in accordance with paragraph (d) of § 1.172–3) which is attributable to the gross income and deductions of such spouse, gross income and deductions being taken into account to the same extent that they are taken into account in computing the joint net operating loss.

(2) *Taxable income to be subtracted*—(i) *Net operating loss of other spouse.* The taxable income of a particular spouse for any taxable year which is subtracted from the net operating loss of such spouse for another taxable year in order to determine the amount of such loss which may be carried back or carried over to still another taxable year is deemed to be, in a case in which such taxable income was reported in a joint return, the sum of the following:

(a) That portion of the combined taxable income of both spouses for such year for which the joint return was made which is attributable to the gross income and deductions of the particular spouse, gross income and deductions being taken into account to the same extent that they are taken into account in computing such combined taxable income, and

(b) That portion of such combined taxable income which is attributable to the other spouse; but, if such other spouse sustained a net operating loss in a taxable year beginning on the same date as the taxable year in which the particular spouse sustained the net operating loss from which the taxable income is subtracted, then such portion shall first be reduced by such net operating loss of such other spouse.

(ii) *Modifications.* For purposes of this subparagraph, the combined taxable income shall be computed as though the combined income and deductions of both spouses were those of one individual. The provisions of § 1.172–5 shall apply in computing the combined taxable income for such purposes except that the net operating loss deduction shall be determined without taking into account any separate net operating loss of either spouse, or any joint net operating loss of both spouses, which was sustained in a taxable year beginning on or after the date of the beginning of the taxable year in which the particular spouse sustained the net operating loss from which the taxable income is subtracted.

(e) *Recurrent use of joint return.* If a husband and wife making a joint return for any taxable year made a joint return for one or more, but not all, of the taxable years involved in the computation of a net operating loss carryover or net operating loss carryback to such taxable year, such net operating loss carryover or net operating loss carryback to the taxable year is computed in the manner set forth in paragraph (d) of this section. Such net operating loss carryover or net operating loss carryback is considered a joint net operating loss carryover or joint net operating loss carryback to such taxable year.

(f) *Joint carryovers and carrybacks.* The joint net operating loss carryovers and the joint net operating loss carrybacks to any taxable year for which a joint return is made are all the net operating loss carryovers and net operating loss carrybacks of both spouses to such taxable year. For example, a husband and wife file a joint return for the calendar year 1956, having a joint taxable income for such year. The wife filed a separate return for the calendar years 1954 and 1955, in which years she sustained net operating losses. The husband filed separate returns for his fiscal year ending June 30, 1955, and, having received permission to change his accounting period to a calendar year basis, for the 6-month period ending December 31, 1955. The husband sustained net operating losses in both such taxable years. Since the husband and wife did not file a joint return for any taxable year involved in the computation of the net operating loss carryovers to 1956 from 1954 and 1955, the joint net operating loss carryovers to 1956 are the separate net operating loss carryovers of the wife from the calendar years 1954 and 1955 and the separate net operating loss carryovers of the husband from the fiscal year ending June 30, 1955, and from the short taxable year ending December 31, 1955. If the husband and wife also file joint returns for the calendar years 1957, 1958, and 1959, having joint taxable income in 1957 and 1958 and a joint net operating loss in 1959, the joint net operating loss carrybacks to 1956, 1957, and 1958 from 1959 are computed on the basis of the joint net operating loss for 1959, since separate returns were not made for any taxable year involved in the computation of such carrybacks.

(g) *Illustration of principles.* In the following examples, which illustrate the application of this section, it is assumed that there are no items of adjustment under section 172(b)(2)(A) and that the taxable income or loss in each case is the taxable income or loss determined without any net operating loss deduction. The taxpayers in each example, H, a husband, and W, his wife, report their income on the calendar-year basis.

Example 1. H and W filed joint returns for 1954 and 1955. They sustained a joint net operating loss of $1,000 for 1954 and a joint net operating loss of $2,000 for 1955. For 1954 the deductions of H exceeded his gross income by $700, and the deductions of W exceeded her gross income by $300, the total of such amounts being $1,000. Therefore, $700 of the $1,000 joint net operating loss for 1954 is considered the net operating loss of H for 1954, and $300 of such joint net operating loss is considered the net operating loss of W for 1954. For 1955 the gross income of H exceeded his deductions, so that his separate taxable income would be $1,500, and the deductions of W exceeded her gross income by $3,500. Therefore, all of the $2,000 joint net operating loss for 1955 is considered the separate net operating loss of W for 1955.

Example 2. (i) H and W filed joint returns for 1954 and 1956, and separate returns for 1955 and 1957. For the years 1954, 1955, 1956, and 1957 they had taxable incomes and net operating losses as follows, losses being indicated in parentheses:

	1954	1955	1956	1957
H	($5,000)	($2,500)	$6,500	($4,000)
W	(3,000)	2,000	3,000	(1,500)
Total	(8,000)	....	9,500	....

(ii) The net operating loss carryover of H from 1957 to 1958 is $4,000, that is, his $4,000 net operating loss for 1957 which is not reduced by any part of the taxable income for 1956, since none of such taxable income is attributable to H and the portion attributable to W is entirely offset by her separate net operating loss for her taxable year 1957, which taxable year begins on the same date as H's taxable year 1957. H's $4,000 net operating loss for 1957 likewise is not reduced by reference to 1955 since H sustained a loss in 1955. The $0 taxable income for 1956 which reduces H's net operating loss for 1957 is computed as follows:

(iii) The combined taxable income of $9,500 for 1956 is reduced to $1,000 by the net operating loss deduction for such year of $8,500. This net operating loss deduction is computed without taking into account any net operating loss of either H or W sustained in a taxable year beginning on or after January 1, 1957, the date of the beginning of the taxable year in which H sustained the net operating loss from which the taxable income is subtracted. This $8,500 is composed of H's carryovers of $5,000 from 1954 and $2,500 from 1955, and of W's carryover of $1,000 from 1954 (the excess of W's $3,000 loss for 1954 over her $2,000 income for 1955). None of the $1,000 combined taxable income for 1956 (computed with the net operating loss deduction described above) is attributable to H since it is caused by W's income (computed after deducting her separate carryover) offsetting H's loss (computed by deducting from his income his separate carryovers). No part of the $1,000 combined taxable income for 1956 which is attributable to W is used to reduce H's net operating loss for 1957 since such taxable income attributable to W must first be reduced by W's $1,500 net operating loss for 1957, her taxable year beginning on the same date as the taxable year of H in which he sustained the net operating loss from which the taxable income is subtracted.

(iv) The net operating loss carryover of W from 1957 to 1958 is $500, her $1,500 loss reduced by the sum of her $0 taxable income for 1955 (computed by taking into account her $3,000 carryover from 1954) and her $1,000 taxable income for 1956, that is, the portion of the combined taxable income for 1956 which is attributable to her.

Example 3. (i) Assume the same facts as in *Example (2)* except that for 1957 the net operating loss of W is $200 instead of $1,500.

(ii) The net operating loss carryover of H from 1957 to 1958 is $3,200, that is, his $4,000 net operating loss for 1957 reduced by the sum of his $0 taxable income for 1955 (a year in which he sustained a loss) and his $800 taxable income for 1956. Such $800 is computed as follows:

(iii) The combined taxable income for 1956, computed with the net operating loss deduction in the manner described in *Example (2)*, remains $1,000, no part of which is attributable to H. To the $0 taxable income attributable to H for 1956 there is added $800, the excess of the $1,000 taxable income for such year attributable to W over her $200 net operating loss sustained in 1957, a taxable year beginning on the same date as the taxable year of H in which he sustained the $4,000 net operating loss from which the taxable income is subtracted.

(iv) W has no net operating loss carryover from 1957 to 1958 since her net operating loss of $200 for 1957 does not exceed the $1,000 taxable income for 1956 attributable to her.

Example 4. (i) Assume the same facts as in *Example (2)*, except that W changes her accounting period in 1957 to a fiscal year ending on January 31, and has neither income nor losses for the taxable year January 1, 1957, to January 31, 1957, or for the fiscal year February 1, 1957, to January 31, 1958, but has a net operating loss of $200 for the fiscal year February 1, 1958, to January 31, 1959.

(ii) The net operating loss carryover of H from 1957 to 1958 is $3,000, that is, his net operating loss of $4,000 for 1957 reduced by the sum of his $0 taxable income for 1955 (a year in which he sustained a loss) and his $1,000 taxable income for 1956. Such $1,000 is computed as follows:

(iii) The combined taxable income for 1956, computed with the net operating loss deduction in the manner described in *Example (2)*, remains $1,000, no part of which is attributable to H. To the $0 taxable income attributable to H for 1956 there is added the $1,000 taxable income attributable to W for such year. The taxable income attributable to W is not reduced by any amount since she does not have a net operating loss for her taxable year beginning on January 1, 1957, the date of the beginning of the taxable year of H in which he sustained the $4,000 net operating loss from which his taxable income is subtracted.

(iv) The net operating loss carryover of W from the fiscal year beginning February 1, 1958, to her next fiscal year is $200, that is, her net operating loss of $200 for the fiscal year beginning February 1, 1958, reduced by the sum of her $0 taxable income for 1956, her $0 taxable income for the taxable year January 1, 1957, to January 31, 1957 (a year in which she had neither income nor loss), and her $0 taxable income for the fiscal year February 1, 1957, to January 31, 1958 (also a year in which she had neither income nor loss). The $0 taxable income for 1956 is computed as follows:

(v) The combined taxable income of $9,500 for 1956 is reduced to $0 amount by the net operating loss deduction for such year of $12,500. This net operating loss deduction is computed by taking into account the net operating loss of H for 1957 since it was sustained in a taxable year beginning before February 1, 1958, the date of the beginning of the taxable year of W in which she sustained the $200 net operating loss from which her taxable income is subtracted. This $12,500 is composed of H's carryovers of $5,000 from 1954 and $2,500 from 1955 and of his carryback of $4,000 from 1957, plus W's carryover of $1,000 from 1954 (the excess of W's $3,000 loss for 1954 over her $2,000 income for 1955). Since there is no combined taxable income for 1956, there is no taxable income attributable to W for such year.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 8107, 51 FR 43346, Dec. 2, 1986]

§1.172–8 Net operating loss carryovers for regulated transportation corporations.

(a) *In general.* A net operating loss sustained in a taxable year ending before January 1, 1976, shall be a carryover to the 7 succeeding taxable years if the taxpayer is a regulated transportation corporation (as defined in paragraph (b) of this section) for the loss year and for the 6th and 7th succeeding taxable years. If, however, the taxpayer is a regulated transportation corporation for the loss year and for the 6th succeeding taxable year, but not for the 7th succeeding taxable year, then the loss shall be a carryover to the 6 succeeding taxable years. If the taxpayer is not a regulated transportation corporation for the 6th succeeding taxable year then this section shall not apply. A net operating loss sustained in a taxable year ending after December 31, 1975, shall be a carryover to the 15 succeeding taxable years.

(b) *Regulated transportation corporations.* A corporation is a *regulated transportation corporation* for a taxable year if it is included within one or more of the following categories:

(1) Eighty percent or more of the corporation's gross income (computed without regard to dividends and capital gains and losses) for such taxable year is income from transportation sources described in paragraph (c) of this section.

(2) The corporation is a railroad corporation, subject to Part I of the Interstate Commerce Act, which is either a lessor railroad corporation described in section 7701(a)(33)(G) or a common parent railroad corporation described in section 7701(a)(33)(H).

(3) The corporation is a member of a regulated transportation system for the taxable year. For purposes of this section, a member of a regulated transportation system for a taxable year means a member of an affiliated group of corporations making a consolidated return for such year, if 80 percent or more of the sum of the gross incomes of the members of the affiliated group for such year (computed without regard to dividends, capital gains and losses, or eliminations for intercompany transactions) is derived from transportation sources described in paragraph (c) of this section. For purposes of this subparagraph, income derived by a corporation described in subparagraph (2) of this paragraph from leases described in section 7701(a)(33)(G) shall be considered as income from transportation sources described in paragraph (c) of this section.

(c) *Transportation sources.* For purposes of this section, income from ‘‘transportation sources’’ means income received directly in consideration for transportation services, and income from the furnishing or sale of essential facilities, products, and other services which are directly necessary and incidental to the furnishing of transportation services. For purposes of the preceding sentence, the term *transportation services* means:

(1) Transportation by railroad as a common carrier subject to the jurisdiction of the Interstate Commerce Commission;

(2)(i) Transportation, which is not included in subparagraph (1) of this paragraph:

(a) On an intrastate, suburban, municipal, or interurban electric railroad,

(b) On an intrastate, municipal, or suburban trackless trolley system,

(c) On a municipal or suburban bus system, or

(d) By motor vehicle not otherwise included in this subparagraph, if the rates for the furnishing or sale of such transportation are established or approved by a regulatory body described in section 7701(a)(33)(A);

(ii) In the case of a corporation which establishes to the satisfaction of the district director that:

(a) Its revenue from regulated rates from transportation services described in subdivision (i) of this subparagraph and its revenue derived from unregulated rates are derived from its operation of a single interconnected and coordinated system or from the operation of more than one such system, and

(b) The unregulated rates have been and are substantially as favorable to

users and consumers as are the regulated rates, transportation, which is not included in subparagraph (1) of this paragraph, from which such revenue from unregulated rates is derived.

(3) Transportation by air as a common carrier subject to the jurisdiction of the Civil Aeronautics Board; and

(4) Transportation by water by common carrier subject to the jurisdiction of either the Interstate Commerce Commission under Part III of the Interstate Commerce Act (54 Stat. 929), or the Federal Maritime Board under the Intercoastal Shipping Act, 1933 (52 Stat. 965).

(d) *Corporate acquisitions.* This section shall apply to a carryover of a net operating loss sustained by a regulated transportation corporation (as defined in paragraph (b) of this section) to which an acquiring corporation succeeds under section 381(a) only if the acquiring corporation is a regulated transportation corporation (as defined in paragraph (b) of this section):

(1) For the sixth succeeding taxable year in the case of a carryover to the sixth succeeding taxable year, and

(2) For the sixth and seventh succeeding taxable years in the case of a carryover to the seventh succeeding taxable year.

[T.D. 6862, 30 FR 14430, Nov. 18, 1965, as amended by T.D. 8107, 51 FR 43346, Dec. 2, 1986]

§ 1.172–9 Election with respect to portion of net operating loss attributable to foreign expropriation loss.

(a) *In general.* If a taxpayer has a net operating loss for a taxable year ending after December 31, 1958, and if the foreign expropriation loss for such year (as defined in paragraph (b)(1) of this section) equals or exceeds 50 percent of the net operating loss for such year, then the taxpayer may elect (at the time and in the manner provided in paragraph (c) (1) or (2) of this section, whichever is applicable) to have the provisions of this section apply. If the taxpayer so elects, the portion of the net operating loss for such taxable year attributable (under paragraph (b)(2) of this section) to such foreign expropriation loss shall not be a net operating loss carryback to any taxable year preceding the taxable year of such loss and shall be a net operating loss carryover to each of the ten taxable years following the taxable year of such loss. In such case, the portion, if any, of the net operating loss not attributable to a foreign expropriation loss shall be carried back or carried over as provided in paragraph (a)(1)(ii) of § 1.172–4.

(b) *Determination of ''foreign expropriation loss''*—(1) *Definition of ''foreign expropriation loss''.* The term *foreign expropriation loss* means, for any taxable year, the sum of the losses allowable as deductions under section 165 (other than losses from, or which under section 165(g) or 1231(a) are treated or considered as losses from, sales or exchanges of capital assets and other than losses described in section 165(i)(1)) sustained by reason of the expropriation, intervention, seizure, or similar taking of property by the government or any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing. For purposes of the preceding sentence, a debt which becomes worthless in whole or in part, shall, to the extent of any deduction allowed under section 166(a), be treated as a loss allowable as a deduction under section 165.

(2) *Portion of the net operating loss attributable to a foreign expropriation loss.* (i) Except as provided in subdivision (ii) of this subparagraph, the portion of the net operating loss for any taxable year attributable to a foreign expropriation loss is the amount of the foreign expropriation loss for such taxable year (determined under subparagraph (1) of this paragraph).

(ii) The portion of the net operating loss for a taxable year attributable to a foreign expropriation loss shall not exceed the amount of the net operating loss, computed under section 172(c), for such year.

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

Example 1. M Corporation, a domestic calendar year corporation manufacturing cigars in the United States, owns, in country X, a tobacco plantation having an adjusted basis of $400,000 and farm equipment having an adjusted basis of $300,000. On January 15, 1961, country X expropriates the plantation and equipment without any allowance for compensation. For the taxable year 1961, M Corporation sustains a loss from the operation of its business (not including losses from the seizure of its plantation and equipment in country X) of $200,000, which loss would not have been sustained in the absence of the seizure. Accordingly, M has a net operating loss of $900,000 (the sum of $400,000, $300,000, and $200,000). For purposes of section 172(k)(1), M Corporation has a foreign expropriation loss for 1961 of $700,000 (the sum of $400,000 and $300,000, the losses directly sustained by reason of the seizure of its property by country X). Since the foreign expropriation loss for 1961, $700,000, equals or exceeds 50 percent of the net operating loss for such year, or $450,000 (i.e., 50 percent of $900,000), M Corporation may make the election under paragraph (c)(2) of this section with respect to $700,000, the portion of the net operating loss attributable to the foreign expropriation loss.

Example 2. Assume the same facts as in *Example (1)* except that for 1961, M Corporation has operating profits of $300,000 (not including losses from the seizure of its plantation and equipment in country X) so that its net operating loss (as defined in section 172(c)) is only $400,000. Under the provisions of section 172(k)(2) and paragraph (b)(2) of this section, the portion of the net operating loss for 1961 attributable to a foreign expropriation loss is limited to $400,000, the amount of the net operating loss.

(c) *Time and manner of making election*—(1) *Taxable years ending after December 31, 1963.* In the case of a taxpayer who has a foreign expropriation loss for a taxable year ending after December 31, 1963, the election referred to in paragraph (a) of this section shall be made by attaching to the taxpayer's income tax return (filed within the time prescribed by law, including extensions of time) for the taxable year of such foreign expropriation loss a statement containing the information required by subparagraph (3) of this paragraph. Such election shall be irrevocable after the due date (including extensions of time) of such return.

(2) *Information required.* The statement referred to in subparagraph (1) of this paragraph shall contain the following information:

(i) The name, address, and taxpayer account number of the taxpayer;

(ii) A statement that the taxpayer elects under section 172(b)(3)(A)(ii) or (iii), whichever is applicable, to have section 172(b)(1)(D) of the Code apply;

(iii) The amount of the net operating loss for the taxable year; and

(iv) The amount of the foreign expropriation loss for the taxable year, including a schedule showing the computation of such foreign expropriation loss.

(d) *Amount of foreign expropriation loss which is a carryover to the taxable year in issue*—(1) *General.* If a portion of a net operating loss for the taxable year is attributable to a foreign expropriation loss and if an election under paragraph (a) of this section has been made with respect to such portion of the net operating loss, then such portion shall be considered to be a separate net operating loss for such year, and, for the purpose of determining the amount of such separate loss which may be carried over to other taxable years, such portion shall be applied after the other portion (if any) of such net operating loss. Such separate loss shall be carried to the earliest of the several taxable years to which such separate loss is allowable as a carryover under the provisions of paragraph (a)(1)(iv) of §1.172–4, and the amount of such separate loss which shall be carried over to any taxable year subsequent to such earliest year is an amount (not exceeding such separate loss) equal to the excess of:

(i) The sum of *(a)* such separate loss and *(b)* the other portion (if any) of the net operating loss (i.e., that portion not attributable to a foreign expropriation loss) to the extent such other portion is a carryover to such earliest taxable year, over

(ii) The sum of the aggregate of the taxable incomes (computed as provided in §1.172–5) for all of such several taxable years preceding such subsequent taxable year.

(2) *Cross reference.* The portion of a net operating loss which is not attributable to a foreign expropriation loss shall be carried back or carried over, in accordance with the rules provided in paragraph (b)(1) of §1.172–4, as if such portion were the only net operating loss for such year.

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

Example 1. Corporation A, organized in 1960 and whose return is made on the basis of the calendar year, incurs for 1960 a net operating loss of $10,000, of which $7,500 is attributable to a foreign expropriation loss. With respect to such $7,500, A makes the election described in paragraph (a) of this section. In each of the years 1961, 1962, 1963, 1964, and 1965, A has taxable income in the amount of $600 (computed without any net operating loss deduction). The assumption is made that none of the other modifications prescribed in § 1.172–5 apply. The portion of the net operating loss attributable to the foreign expropriation loss which is a carryover to the year 1966 is $7,000, which is the sum of $7,500 (the portion of the net operating loss attributable to the foreign expropriation loss) and $2,500 (the other portion of the net operating loss available as a carryover to 1961), minus $3,000 (the aggregate of the taxable incomes for taxable years 1961 through 1965).

Example 2. Assume the same facts as in *Example (1)* except that taxable income for each of the years 1961 through 1965 is $400 (computed without any net operating loss deduction). The carryover to the year 1966 is $7,500, that is, the sum of $7,500 (the portion of the net operating loss attributable to the foreign expropriation loss) and $2,500 (the other portion of the net operating loss available as a carryover to 1961), minus $2,000 (the aggregate of the taxable incomes for taxable years 1961 through 1965), but limited to $7,500 (the portion of the net operating loss attributable to the foreign expropriation loss).

(e) *Taxable income which is subtracted from net operating loss to determine carryback or carryover.* In computing taxable income for a taxable year (hereinafter called a ‘‘prior taxable year’’) for the purpose of determining the portion of a net operating loss for another taxable year which shall be carried to each of the several taxable years subsequent to the earliest taxable year to which such loss may be carried, the net operating loss deduction for any such prior taxable year shall be determined without regard to that portion, if any, of a net operating loss for a taxable year attributable to a foreign expropriation loss, if such portion may not, under the provisions of section 172(b)(1)(D) and paragraph (a)(1)(iv) of § 1.172–4, be carried back to such prior taxable year. Thus, if the taxpayer has a foreign expropriation loss for 1962 and elects the 10-year carryover with respect to the portion of his net operating loss for 1962 attributable to the foreign expropriation loss, then in computing taxable income for the year 1960 for the purpose of determining the portion of a net operating loss for 1963 which is carried to years subsequent to 1960, the net operating loss deduction for 1960 is determined without regard to the portion of the net operating loss for 1962 attributable to the foreign expropriation loss, since under the provisions of section 172(b)(1)(D) and paragraph (a)(1)(iv) of § 1.172–4 such portion of the net operating loss for 1962 may not be carried back to 1960.

[T.D. 6862, 30 FR 14431, Nov. 18, 1965, as amended by T.D. 8107, 51 FR 43346, Dec. 2, 1986]

§ 1.172–10 Net operating losses of real estate investment trusts.

(a) *Taxable years to which a loss may be carried.* (1) A net operating loss sustained by a qualified real estate investment trust (as defined in paragraph (b)(1) of this section) in a qualified taxable year (as defined in paragraph (b)(2) of this section) ending after October 4, 1976, shall not be carried back to a preceding taxable year.

(2) A net operating loss sustained by a qualified real estate investment trust in a qualified taxable year ending before October 5, 1976, shall be carried back to the 3 preceding taxable years. However, see § 1.857–2(a)(5), which does not allow the net operating loss deduction in computing real estate investment trust taxable income for taxable years ending before October 5, 1976.

(3) A net operating loss sustained by a qualified real estate investment trust in a qualified taxable year ending after December 31, 1972, shall be carried over to the 15 succeeding taxable years. However, see § 1.857–2(a)(5).

(4) A net operating loss sustained by a qualified real estate investment trust in a qualified taxable year ending before January 1, 1973, shall be carried over to 8 succeeding taxable years. However, see § 1.857–2(a)(5).

(5) A net operating loss sustained in a taxable year for which the taxpayer is not a qualified real estate investment trust generally may be carried back to the 3 preceding taxable years; however, a net operating loss sustained in a taxable year ending after December 31, 1975, shall not be carried back to any qualified taxable year. However, see § 1.857–2(a)(5), with respect to a net

operating loss sustained in a taxable year ending before January 1, 1976.

(6) A net operating loss sustained in a taxable year ending after December 31, 1975, for which the taxpayer is not a qualified real estate investment trust generally may be carried over to the 15 succeeding taxable years.

(7)(i) A net operating loss sustained in a taxable year ending before January 1, 1986, for which the taxpayer is not a qualified real estate investment trust generally may be a net operating loss carryover to each of the 5 succeeding taxable years. However, where the loss was a net operating loss carryback to one or more qualified taxable years, the net operating loss, in accordance with paragraph (a)(7)(ii) of this section shall be—

(A) Carried over to the 15 succeeding taxable years if the loss could be a net operating loss carryover to a taxable year ending in 1981, or

(B) Carried over to the 5, 6, 7, or 8 succeeding taxable years if paragraph (a)(7)(i)(A) of this section does not apply.

(ii) For purposes of determining whether a net operating loss could be a carryover to a taxable year ending in 1981 under paragraph (a)(7)(i)(A) of this section or, where paragraph (a)(7)(i)(A) of this section does not apply, to determine the actual carryover period under paragraph (a)(7)(i)(B) of this section, the net operating loss shall have a carryover period of 5 years, and such period shall be increased (to a number not greater than 8) by the number of qualified taxable years to which such loss was a net operating loss carryback; however, where the taxpayer acted so as to cause itself to cease to be a qualified real estate investment trust and the principal purpose for such action was to secure the benefit of the allowance of a net operating loss carryover under section 172(b)(1)(B), the net operating loss carryover period shall be limited to 5 years. However, see §1.857–2(a)(5).

(8) A qualified taxable year is a taxable year preceding or following the taxable year of the net operating loss, for purposes of section 172(b)(1), even though the loss may not be carried to, or allowed as a deduction in, such qualified taxable year. Thus, a qualified taxable year ending before October 5, 1976 (for which no net operating loss deduction is allowable) is nevertheless a preceding or following taxable year for purposes of section 172(b)(1). Moreover, a qualified taxable year ending after October 4, 1976 (to which a net operating loss cannot be carried back because of section 172(b)(1)(E)) is nevertheless a preceding taxable year for purposes of section 172(b)(1). For purposes of determining, under section 172(b)(2), the balance of the loss available as a carryback or carryover to other taxable years, however, the net operating loss is not reduced on account of such qualified taxable year being a preceding or following taxable year.

(b) *Definitions.* For purposes of this section and §§1.172–2 and 1.172–5:

(1) The term *qualified real estate investment trust* means, with respect to any taxable year, a real estate investment trust within the meaning of part II of subchapter M which is taxable for such year under that part as a real estate investment trust, and

(2) The term *qualified taxable year* means a taxable year for which the taxpayer is a qualified real estate investment trust.

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

Example 1—(i) *Facts.* X was a qualified real estate investment trust for the taxable years ending on December 31, 1972, and December 31, 1973. X was not a qualified real estate investment trust for the taxable years ending on December 31, 1971, and December 31, 1974. X sustained a net operating loss for the taxable year ending on December 31, 1974.

(ii) *Applicable carryback and carryover periods.* The net operating loss must be carried back to the 3 preceding taxable years. Under §1.857–2 (a)(5) the net operating loss deduction shall not be allowed in computing real estate investment trust taxable income for the years ending December 31, 1972, and December 31, 1973. Where a net operating loss is sustained in a taxable year ending before January 1, 1976, for which the taxpayer is not a qualified real estate investment trust and the loss is a net operating loss carryback to one or more qualified taxable years, the carryover period is determined under §1.172–10 (a)(7); the carryover period is determined by first applying the rule provided in paragraph (a)(7)(ii) of this section to obtain the carryover period for purposes of determining whether the net operating loss could have been a net operating loss carryover to a taxable year ending in 1981. Under these facts, paragraph (a)(7)(ii) of this section provides for a 7-year carryover period (5 years increased by the 2 qualified taxable years to which the loss was a net operating loss carryback); therefore, since the carryover period provided for by paragraph (a)(7)(ii) of this section would allow the net operating loss to be a net operating loss carryover to a taxable year ending in 1981, under paragraph (a)(7)(ii)(A) of this section the applicable carryover period is 15 years (provided that X did not act so as to cause itself to cease to qualify as a real estate investment trust for the principal purpose of securing the benefit of a net operating loss carryover under section 172 (b)(1)(B)).

Example 2—(i) *Facts.* The facts are the same as in *example* (1) except that the taxable year ending December 31, 1973, was not a qualified taxable year for X.

(ii) *Applicable carryback and carryover periods.* The net operating loss must be carried back to the 3 preceding taxable years. Section 1.857–2 (a)(5) provides that the net operating loss deduction shall not be allowed in computing real estate investment trust taxable income for the year ending December 31, 1972. Under these facts the carryover period is determined under § 1.172–10 (a)(7). Paragraph (a)(7)(ii) of this section provides for a 6 year carryover period (5 years increased by the 1 qualified taxable year to which the loss was a net operating loss carryback); therefore, since a 6 year carryover period would not allow the net operating loss to be a net operating loss carryover to a taxable year ending in 1981, paragraph (a)(7)(i)(A) of this section does not apply. Where the rule stated in paragraph (a)(7)(i)(A) of this section does not apply, paragraph (a)(7)(i)(B) of this section provides that the applicable carryover period is the carryover period determined under paragraph (a)(7)(ii) of this section, which, in this case, is 6 years (provided that the principal purpose for X acting so as to cause itself to cease to qualify as a real estate investment trust was not to secure the benefit of the allowance of a net operating loss carryover under section 172 (b)(1)(B)).

(d) *Cross references.* See §§ 1.172–2(c) and 1.172–5(a)(5) for the computation of the net operating loss of a qualified real estate investment trust for a taxable year ending after October 4, 1976, and the amount of a net operating loss which is absorbed when carried over to a qualified taxable year ending after October 4, 1976. See § 1.857–2(a)(5), which provides that for a taxable year ending before October 5, 1976, the net operating loss deduction is not allowed in computing the real estate investment trust taxable income of a qualified real estate investment trust.

[T.D. 7767, 46 FR 11263, Feb. 6, 1981, as amended by T.D. 8107, 51 FR 43346, Dec. 2, 1986]

§ 1.172–13 Product liability losses.

(a) *Entitlement to 10-year carryback*—(1) *In general.* Unless an election is made pursuant to paragraph (c) of this section, in the case of a taxpayer which has a product liability loss (as defined in section 172(j) and paragraph (b)(1) of this section) for a taxable year beginning after September 30, 1979 (hereinafter ‘‘loss year’’), the product liability loss shall be a net operating loss carryback to each of the 10 taxable years preceding the loss year.

(2) *Years to which loss may be carried.* A product liability loss shall first be carried to the earliest of the taxable years to which such loss is allowable as a carryback and shall then be carried to the next earliest of such taxable years, etc.

(3) *Example.* The application of this paragraph may be illustrated as follows:

Example Taxpayer A incurs a net operating loss for taxable year 1980 of $80,000, of which $60,000 is a product liability loss. A’s taxable income for each of the 10 years immediately preceding taxable year 1980 was $5,000. The product liability loss of $60,000 is first carried back to the 10th through the 4th preceding taxable years ($5,000 per year), thus offsetting $35,000 of the loss. The remaining $25,000 of product liability loss is added to the remaining portion of the total net operating loss for taxable year 1980 which was not a product liability loss ($20,000), and the total is then carried back to the 3rd through 1st years preceding taxable year 1980, which offsets $15,000 of this loss. The remaining loss ($30,000) is carried forward pursuant to section 172(b)(1) and the regulations thereunder without regard to whether all or any portion thereof originated as a product liability loss.

(b) *Definitions*—(1) *Product liability loss.* The term *product liability loss* means, for any taxable year, the lesser of—

(i) The net operating loss for the current taxable year (not including the portion of such net operating loss attributable to foreign expropriation losses, as defined in § 1.172–11), or

(ii) The total of the amounts allowable as deductions under sections 162 and 165 directly attributable to—

(A) Product liability (as defined in paragraph (b)(2) of this section), and

(B) Expenses (including settlement payments) incurred in connection with the investigation or settlement of or opposition to claims against the taxpayer on account of alleged product liability.

Indirect corporate expense, or overhead, is not to be allocated to product liability claims so as to become a product liability loss.

(2) *Product liability.* (i) The term *product liability* means the liability of a taxpayer for damages resulting from physical injury or emotional harm to individuals, or damage to or loss of the use of property, on account of any defect in any product which is manufactured, leased, or sold by the taxpayer. The preceding sentence applies only to the extent that the injury, harm, or damage occurs after the taxpayer has completed or terminated operations with respect to the product, including, but not limited to the manufacture, installation, delivery, or testing of the product, and has relinquished possession of such product.

(ii) The term *product liability* does not include liabilities arising under warranty theories relating to repair or replacement of the property that are essentially contract liabilities. For example, the costs incurred by a taxpayer in repairing or replacing defective products under the terms of a warranty, express or implied, are not product liability losses. On the other hand, the taxpayer's liability for damage done to other property or for harm done to persons that is attributable to a defective product may be product liability losses regardless of whether the claim sounds in tort or contract. Further, liability incurred as a result of services performed by a taxpayer is not product liability. For purposes of the preceding sentence, where both a product and services are integral parts of a transaction, product liability does not arise until all operations with respect to the product are completed and the taxpayer has relinquished possession of it. On the other hand, any liability that arises after completion of the initial delivery, installation, servicing, testing, etc., is considered ‘‘product liability’’ even if such liability arises during the subsequent servicing of the product pursuant to a service agreement or otherwise.

(iii) Liability for injury, harm, or damage due to a defective product as described in this subparagraph shall be ‘‘product liability’’ notwithstanding that the liability is not considered product liability under the law of the State in which such liability arose.

(iv) Amounts paid for insurance against product liability risks are not paid on account of product liability.

(v) Notwithstanding subparagraph (iv), an amount is paid on account of product liability (even if such amount is paid to an insurance company) if the amount satisifies the provisions of paragraph (b)(2) (i) through (iii) of this section and the amount—

(A) Is paid on account of specific claims against the taxpayer (or on account of expenses incurred in connection with the investigation or settlement of or opposition to such claims), subsequent to the events giving rise to the claims and pursuant to a contract entered into before those events,

(B) Is not refundable, and

(C) Is not applicable to other claims, other expenses or to subsequent coverage.

(3) *Examples.* Paragraph (b)(2) of this section is illustrated by the following examples:

Example 1. X, a manufacturer of heating equipment, sells a boiler to A, a homeowner. Subsequent to the sale and installation of the boiler, the boiler explodes due to a defect causing physical injury to A. A sues X for damages for the injuries sustained in the explosion and is awarded $250,000, which X pays. The payment was made on account of product liability.

Example 2. Assume the same facts as in *Example (1)* and that A also sues under the contract with X to recover for the cost of the boiler and recovers $1,000, the boiler's replacement cost. The $1,000 payment is not a payment on account of product liability. Similarly, if X agrees to repair the destroyed boiler, any amount expended by X for such repair is not payment made on account of product liability.

Example 3. Y, a professional medical association, is sued by B, a patient, in an action based on the malpractice of one of its doctors. B recovers $25,000. Because the suit was based on the services of B, the payment is not made on account of product liability.

Example 4. R, a retailer of communications equipment, sells a telecommunication device to C. R also contracts with C to service the equipment for 3 years. While R is installing the equipment, the unit catches on fire due to faulty wiring within the unit and destroys C's office. Because R had not relinquished possession of this equipment when the fire started, any amount paid to C by R for the damage to C's property on account of the defective product is not payment on account of product liability.

Example 5. Assume the same facts as in *Example (4)* except that the fire and resulting property damages occurred after R had installed the equipment and relinquished possession of it. Any amount paid for the property damages sustained on account of the defective product is payment on account of product liability.

Example 6. Assume the same facts as in *Example (4)* except that the equipment catches on fire during the subsequent servicing of the unit. Because C is in possession of the unit during the servicing, any amount paid for the property damage sustained on account of the defective product would be payment on account of product liability.

Example 7. X, a manufacturer of computers, sells a computer to A. X also has its employees periodically service the computer for A from time to time after it is placed in service. After the initial delivery, installation, servicing, and testing of the computer is completed, the computer catches on fire while X's employee is servicing the equipment. This fire causes property damage to A's office and physical injury to A. Any amount paid for the property or physical damage sustained on account of the defective product is payment on account of product liability.

(c) *Election*—(1) *In general.* The 10-year carryback provision of this section applies, except as provided in this paragraph, to any taxpayer who, for a taxable year beginning after September 30, 1979, incurs a product liability loss. Any taxpayer entitled to a 10-year carryback under paragraph (a) of this section in any loss year may elect (at the time and in the manner provided in paragraph (c)(2) of this section) to have the carryback period with respect to the product liability loss determined without regard to the carryback rules provided by paragraph (a) of this section. If the taxpayer so elects, the product liability loss shall not be carried back to the 10th through the 4th taxable years preceding the loss year. In such case, the product liability loss shall be carried back or carried over as provided by section 172(b) (except subparagraph (1)(I) thereof) and the regulations thereunder.

(2) *Time and manner of making election.* An election by any taxpayer entitled to the 10-year carryback for the product liability loss to have the carryback with respect to such loss determined without regard to the 10-year carryback provision of paragraph (a) of this section must be made by attaching to the taxpayer's tax return (filed within the time prescribed by law, including extensions of time) for the taxable year in which such product liability loss is sustained, a statement containing the information required by paragraph (c)(3) of this section. Such election, once made for any taxable year, shall be irrevocable after the due date (including extensions of time) of the taxpayer's tax return for that taxable year.

(3) *Information required.* In the case of a statement filed after April 25, 1983, the statement referred to in paragraph (c)(2) of this section shall contain the following information:

(i) The name, address, and taxpayer identifying number of the taxpayer; and

(ii) A statement that the taxpayer elects under section 172(j)(3) not to have section 172(b)(1)(I) apply.

(4) *Relationship with section 172(b)(3)(C) election.* If a taxpayer sustains during the taxable year both a net operating loss not attributable to product liability and a product liability loss (as defined in section 172(j)(1) and paragraph (b)(1) of this section), an election pursuant to section 172(b)(3)(C) (relating to election to relinquish the entire carryback period) does not preclude the product liability loss from being carried back 10 years under section 172(b)(1)(I) and paragraph (a)(1) of this section.

[T.D. 8096, 51 FR 30482, Aug. 27, 1986]

§ 1.173–1 Circulation expenditures.

(a) *Allowance of deduction.* Section 173 provides for the deduction from gross income of all expenditures to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical, subject to the following limitations:

(1) No deduction shall be allowed for expenditures for the purchase of land

or depreciable property or for the acquisition of circulation through the purchase of any part of the business of another publisher of a newspaper, magazine, or other periodical;

(2) The deduction shall be allowed only to the publisher making the circulation expenditures; and

(3) The deduction shall be allowed only for the taxable year in which such expenditures are paid or incurred.

Subject to the provisions of paragraph (c) of this section, the deduction permitted under section 173 and this paragraph shall be allowed without regard to the method of accounting used by the taxpayer and notwithstanding the provisions of section 263 and the regulations thereunder, relating to capital expenditures.

(b) *Deferred expenditures.* Notwithstanding the provisions of paragraph (a)(3) of this section, expenditures paid or incurred in a taxable year subject to the Internal Revenue Code of 1939 which are deferrable pursuant to I.T. 3369 (C.B. 1940–1, 46), as modified by Rev. Rul. 57–87 (C.B. 1957–1, 507) may be deducted in the taxable year subject to the Internal Revenue Code of 1954 to which so deferred.

(c) *Election to capitalize.* (1) A taxpayer entitled to the deduction for circulation expenditures provided in section 173 and paragraph (a) of this section may, in lieu of taking such deduction, elect to capitalize the portion of such circulation expenditures which is properly chargeable to capital account. As a general rule, expenditures normally made from year to year in an effort to maintain circulation are not properly chargeable to capital account; conversely, expenditures made in an effort to establish or to increase circulation are properly chargeable to capital account. For example, if a newspaper normally employs five persons to obtain renewals of subscriptions by telephone, the expenditures in connection therewith would not be properly chargeable to capital account. However, if such newspaper, in a special effort to increase its circulation, hires for a limited period 20 additional employees to obtain new subscriptions by means of telephone calls to the general public, the expenditures in connection therewith would be properly chargeable to capital account. If an election is made by a taxpayer to treat any portion of his circulation expenditures as chargeable to capital account, the election must apply to all such expenditures which are properly so chargeable. In such case, no deduction shall be allowed under section 173 for any such expenditures. In particular cases, the extent to which any deductions attributable to the amortization of capital expenditures are allowed may be determined under sections 162, 263, and 461.

(2) A taxpayer may make the election referred to in subparagraph (1) of this paragraph by attaching a statement to his return for the first taxable year to which the election is applicable. Once an election is made, the taxpayer must continue in subsequent taxable years to charge to capital account all circulation expenditures properly so chargeable, unless the Commissioner, on application made to him in writing by the taxpayer, permits a revocation of such election for any subsequent taxable year or years. Permission to revoke such election may be granted subject to such conditions as the Commissioner deems necessary.

(3) Elections filed under section 23(bb) of the Internal Revenue Code of 1939 shall be given the same effect as if they were filed under section 173. (See section 7807(b)(2).)

§1.174–1 Research and experimental expenditures; in general.

Section 174 provides two methods for treating research or experimental expenditures paid or incurred by the taxpayer in connection with his trade or business. These expenditures may be treated as expenses not chargeable to capital account and deducted in the year in which they are paid or incurred (see §1.174–3), or they may be deferred and amortized (see §1.174–4). Research or experimental expenditures which are neither treated as expenses nor deferred and amortized under section 174 must be charged to capital account. The expenditures to which section 174 applies may relate either to a general research program or to a particular project. See §1.174–2 for the definition of research and experimental expenditures. The term *paid or incurred,* as used in section 174 and in §§1.174–1 to

1.174–4, inclusive, is to be construed according to the method of accounting used by the taxpayer in computing taxable income. See section 7701(a)(25).

§ 1.174–2 Definition of research and experimental expenditures.

(a) *In general.* (1) The term *research or experimental expenditures,* as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. The term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application. Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents.

(2) For purposes of this section, the term *product* includes any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license.

(3) The term *research or experimental expenditures* does not include expenditures for—

(i) The ordinary testing or inspection of materials or products for quality control (quality control testing);

(ii) Efficiency surveys;

(iii) Management studies;

(iv) Consumer surveys;

(v) Advertising or promotions;

(vi) The acquisition of another's patent, model, production or process; or

(vii) Research in connection with literary, historical, or similar projects.

(4) For purposes of paragraph (a)(3)(i) of this section, testing or inspection to determine whether particular units of materials or products conform to specified parameters is quality control testing. However, quality control testing does not include testing to determine if the design of the product is appropriate.

(5) See section 263A and the regulations thereunder for cost capitalization rules which apply to expenditures paid or incurred for research in connection with literary, historical, or similar projects involving the production of property, including the production of films, sound recordings, video tapes, books, or similar properties.

(6) Section 174 applies to a research or experimental expenditure only to the extent that the amount of the expenditure is reasonable under the circumstances. In general, the amount of an expenditure for research or experimental activities is reasonable if the amount would ordinarily be paid for like activities by like enterprises under like circumstances. Amounts supposedly paid for research that are not reasonable under the circumstances may be characterized as disguised dividends, gifts, loans, or similar payments. The reasonableness requirement of this paragraph (a)(6) does not apply to the reasonableness of the type or nature of the activities themselves.

(7) This paragraph (a) applies to taxable years beginning after October 3, 1994.

(8) The provisions of this section apply not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization (such as a research institute, foundation, engineering company, or similar contractor). However, any expenditures for research or experimentation carried on in the taxpayer's behalf by another person are not expenditures to which section 174

relates, to the extent that they represent expenditures for the acquisition or improvement of land or depreciable property, used in connection with the research or experimentation, to which the taxpayer acquires rights of ownership.

(9) The application of subparagraph (2) of this paragraph may be illustrated by the following examples:

Example 1. A engages B to undertake research and experimental work in order to create a particular product. B will be paid annually a fixed sum plus an amount equivalent to his actual expenditures. In 1957, A pays to B in respect of the project the sum of $150,000 of which $25,000 represents an addition to B's laboratory and the balance represents charges for research and experimentation on the project. It is agreed between the parties that A will absorb the entire cost of this addition to B's laboratory which will be retained by B. A may treat the entire $150,000 as expenditures under section 174.

Example 2. X Corporation, a manufacturer of explosives, contracts with the Y research organization to attempt through research and experimentation the creation of a new process for making certain explosives. Because of the danger involved in such an undertaking, Y is compelled to acquire an isolated tract of land on which to conduct the research and experimentation. It is agreed that upon completion of the project Y will transfer this tract, including any improvements thereon, to X. Section 174 does not apply to the amount paid to Y representing the costs of the tract of land and improvements.

(b) *Certain expenditures with respect to land and other property.* (1) Expenditures by the taxpayer for the acquisition or improvement of land, or for the acquisition or improvement of property which is subject to an allowance for depreciation under section 167 or depletion under section 611, are not deductible under section 174, irrespective of the fact that the property or improvements may be used by the taxpayer in connection with research or experimentation. However, allowances for depreciation or depletion of property are considered as research or experimental expenditures, for purposes of section 174, to the extent that the property to which the allowances relate is used in connection with research or experimentation. If any part of the cost of acquisition or improvement of depreciable property is attributable to research or experimentation (whether made by the taxpayer or another), see subparagraphs (2), (3), and (4) of this paragraph.

(2) Expenditures for research or experimentation which result, as an end product of the research or experimentation, in depreciable property to be used in the taxpayer's trade or business may, subject to the limitations of subparagraph (4) of this paragraph, be allowable as a current expense deduction under section 174(a). Such expenditures cannot be amortized under section 174(b) except to the extent provided in paragraph (a)(4) of §1.174–4.

(3) If expenditures for research or experimentation are incurred in connection with the construction or manufacture of depreciable property by another, they are deductible under section 174(a) only if made upon the taxpayer's order and at his risk. No deduction will be allowed (i) if the taxpayer purchases another's product under a performance guarantee (whether express, implied, or imposed by local law) unless the guarantee is limited, to engineering specifications or otherwise, in such a way that economic utility is not taken into account; or (ii) for any part of the purchase price of a product in regular production. For example, if a taxpayer orders a specially-built automatic milling machine under a guarantee that the machine will be capable of producing a given number of units per hour, no portion of the expenditure is deductible since none of it is made at the taxpayer's risk. Similarly, no deductible expense is incurred if a taxpayer enters into a contract for the construction of a new type of chemical processing plant under a turn-key contract guaranteeing a given annual production and a given consumption of raw material and fuel per unit. On the other hand, if the contract contained no guarantee of quality of production and of quantity of units in relation to consumption of raw material and fuel, and if real doubt existed as to the capabilities of the process, expenses for research or experimentation under the contract are at the taxpayer's risk and are deductible under section 174(a). However, see subparagraph (4) of this paragraph.

(4) The deductions referred to in subparagraphs (2) and (3) of this paragraph for expenditures in connection with the acquisition or production of depreciable property to be used in the taxpayer's trade or business are limited to amounts expended for research or experimentation. For the purpose of the preceding sentence, amounts expended for research or experimentation do not include the costs of the component materials of the depreciable property, the costs of labor or other elements involved in its construction and installation, or costs attributable to the acquisition or improvement of the property. For example, a taxpayer undertakes to develop a new machine for use in his business. He expends $30,000 on the project of which $10,000 represents the actual costs of material, labor, etc., to construct the machine, and $20,000 represents research costs which are not attributable to the machine itself. Under section 174(a) the taxpayer would be permitted to deduct the $20,000 as expenses not chargeable to capital account, but the $10,000 must be charged to the asset account (the machine).

(c) *Exploration expenditures.* The provisions of section 174 are not applicable to any expenditures paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore, oil, gas or other mineral. See sections 617 and 263.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 8562, 59 FR 50160, Oct. 3, 1994]

§ 1.174–3 Treatment as expenses.

(a) *In general.* Research or experimental expenditures paid or incurred by a taxpayer during the taxable year in connection with his trade or business are deductible as expenses, and are not chargeable to capital account, if the taxpayer adopts the method provided in section 174(a). See paragraph (b) of this section. If adopted, the method shall apply to all research and experimental expenditures paid or incurred in the taxable year of adoption and all subsequent taxable years, unless a different method is authorized by the Commissioner under section 174(a)(3) with respect to part or all of the expenditures. See paragraph (b)(3) of this section. Thus, if a change to the deferred expense method under section 174(b) is authorized by the Commissioner with respect to research or experimental expenditures attributable to a particular project or projects, the taxpayer, for the taxable year of the change and for subsequent taxable years, must apply the deferred expense method to all such expenditures paid or incurred during any of those taxable years in connection with the particular project or projects, even though all other research and experimental expenditures are required to be deducted as current expenses under this section. In no event will the taxpayer be permitted to adopt the method described in this section as to part of the expenditures relative to a particular project and adopt for the same taxable year a different method of treating the balance of the expenditures relating to the same project.

(b) *Adoption and change of method*—(1) *Adoption without consent.* The method described in this section may be adopted for any taxable year beginning after December 31, 1953, and ending after August 16, 1954. The consent of the Commissioner is not required if the taxpayer adopts the method for the first such taxable year in which he pays or incurs research or experimental expenditures. The taxpayer may do so by claiming in his income tax return for such year a deduction for his research or experimental expenditures. If the taxpayer fails to adopt the method for the first taxable year in which he incurs such expenditures, he cannot do so in subsequent taxable years unless he obtains the consent of the Commissioner under section 174(a)(2)(B) and subparagraph (2) of this paragraph. See, however, subparagraph (4) of this paragraph, relating to extensions of time.

(2) *Adoption with consent.* A taxpayer may, with the consent of the Commissioner, adopt at any time the method provided in section 174(a). The method adopted in this manner shall be applicable only to expenditures paid or incurred during the taxable year for which the request is made and in subsequent taxable years. A request to adopt this method shall be in writing and shall be addressed to the Commissioner

of Internal Revenue, Attention: T:R, Washington, DC, 20224. The request shall set forth the name and address of the taxpayer, the first taxable year for which the adoption of the method is requested, and a description of the project or projects with respect to which research or experimental expenditures are to be, or have already been, paid or incurred. The request shall be signed by the taxpayer (or his duly authorized representative) and shall be filed not later than the last day of the first taxable year for which the adoption of the method is requested. See, however, subparagraph (4) of this paragraph, relating to extensions of time.

(3) *Change of method.* An application for permission to change to a different method of treating research or experimental expenditures shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R, Washington, DC, 20224. The application shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the last day of the first taxable year for which the change in method is to apply. See, however, subparagraph (4) of this paragraph, relating to extensions of time. The application shall:

(i) State the first year to which the requested change is to be applicable;

(ii) State whether the change is to apply to all research or experimental expenditures paid or incurred by the taxpayer, or only to expenditures attributable to a particular project or projects;

(iii) Include such information as will identify the project or projects to which the change is applicable;

(iv) Indicate the number of months (not less than 60) selected for amortization of the expenditures, if any, which are to be treated as deferred expenses under section 174(b);

(v) State that, upon approval of the application, the taxpayer will make an accounting segregation on his books and records of the research or experimental expenditures to which the change in method is to apply; and

(vi) State the reasons for the change. If permission is granted to make the change, the taxpayer shall attach a copy of the letter granting permission to his income tax return for the first taxable year in which the different method is effective.

(4) *Special rules.* If the last day prescribed by law for filing a return for any taxable year (including extensions thereof) to which section 174(a) is applicable falls before January 2, 1958, consent is hereby given for the taxpayer to adopt the expense method or to change from the expense method to a different method. In the case of a change from the expense method to a different method, the taxpayer, on or before January 2, 1958, must submit to the district director for the internal revenue district in which the return was filed the information required by subparagraph (3) of this paragraph. For any taxable year for which the expense method or a different method is adopted pursuant to this subparagraph, an amended return reflecting such method shall be filed on or before January 2, 1958, if such return is necessary.

§1.174–4 Treatment as deferred expenses.

(a) *In general.* (1) If a taxpayer has not adopted the method provided in section 174(a) of treating research or experimental expenditures paid or incurred by him in connection with his trade or business as currently deductible expenses, he may, for any taxable year beginning after December 31, 1953, elect to treat such expenditures as deferred expenses under section 174(b), subject to the limitations of subparagraph (2) of this paragraph. If a taxpayer has adopted the method of treating such expenditures as expenses under section 174(a), he may not elect to defer and amortize any such expenditures unless permission to do so is granted under section 174(a)(3). See paragraph (b) of this section.

(2) The election to treat research or experimental expenditures as deferred expenses under section 174(b) applies only to those expenditures which are chargeable to capital account but which are not chargeable to property of a character subject to an allowance for depreciation or depletion under section

167 or 611, respectively. Thus, the election under section 174(b) applies only if the property resulting from the research or experimental expenditures has no determinable useful life. If the property resulting from the expenditures has a determinable useful life, section 174(b) is not applicable, and the capitalized expenditures must be amortized or depreciated over the determinable useful life. Amounts treated as deferred expenses are properly chargeable to capital account for purposes of section 1016(a)(1), relating to adjustments to basis of property. See section 1016(a)(14). See section 174(c) and paragraph (b)(1) of § 1.174–2 for treatment of expenditures for the acquisition or improvement of land or of depreciable or depletable property to be used in connection with the research or experimentation.

(3) Expenditures which are treated as deferred expenses under section 174(b) are allowable as a deduction ratably over a period of not less than 60 consecutive months beginning with the month in which the taxpayer first realizes benefits from the expenditures. The length of the period shall be selected by the taxpayer at the time he makes the election to defer the expenditures. If a taxpayer has two or more separate projects, he may select a different amortization period for each project. In the absence of a showing to the contrary, the taxpayer will be deemed to have begun to realize benefits from the deferred expenditures in the month in which the taxpayer first puts the process, formula, invention, or similar property to which the expenditures relate to an income-producing use. See section 1016(a)(14) for adjustments to basis of property for amounts allowed as deductions under section 174(b) and this section. See section 165 and the regulations thereunder for rules relating to the treatment of losses resulting from abandonment.

(4) If expenditures which the taxpayer has elected to defer and deduct ratably over a period of time in accordance with section 174(b) result in the development of depreciable property, deductions for the unrecovered expenditures, beginning with the time the asset becomes depreciable in character, shall be determined under section 167 (relating to depreciation) and the regulations thereunder. For example, for the taxable year 1954, A, who reports his income on the basis of a calendar year, elects to defer and deduct ratably over a period of 60 months research and experimental expenditures made in connection with a particular project. In 1956, the total of the deferred expenditures amounts to $60,000. At that time, A has developed a process which he seeks to patent. On July 1, 1956, A first realized benefits from the marketing of products resulting from this process. Therefore, the expenditures deferred are deductible ratably over the 60-month period beginning with July 1, 1956 (when A first realized benefits from the project). In his return for the year 1956. A deducted $6,000; in 1957, A deducted $12,000 ($1,000 per month). On July 1, 1958, a patent protecting his process is obtained by A. In his return for 1958, A is entitled to a deduction of $6,000, representing the amortizable portion of the deferred expenses attributable to the period prior to July 1, 1958. The balance of the unrecovered expenditures ($60,000 minus $24,000, or $36,000) is to be recovered as a depreciation deduction over the life of the patent commencing with July 1, 1958. Thus, one-half of the annual depreciation deduction based upon the useful life of the patent is also deductible for 1958 (from July 1 to December 31).

(5) The election shall be applicable to all research and experimental expenditures paid or incurred by the taxpayer or, if so limited by the taxpayer's election, to all such expenditures with respect to the particular project, subject to the limitations of subparagraph (2) of this paragraph. The election shall apply for the taxable year for which the election is made and for all subsequent taxable years, unless a change to a different treatment is authorized by the Commissioner under section 174(b)(2). See paragraph (b)(2) of this section. Likewise, the taxpayer shall adhere to the amortization period selected at the time of the election unless a different period of amortization with respect to a part or all of the expenditures is similarly authorized. However, no change in method will be permitted with respect to expenditures paid or incurred before the taxable

year to which the change is to apply. In no event will the taxpayer be permitted to treat part of the expenditures with respect to a particular project as deferred expenses under section 174(b) and to adopt a different method of treating the balance of the expenditures relating to the same project for the same taxable year. The election under this section shall not apply to any expenditures paid or incurred before the taxable year for which the taxpayer makes the election.

(b) *Election and change of method*—(1) *Election.* The election under section 174(b) shall be made not later than the time (including extensions) prescribed by law for filing the return for the taxable year for which the method is to be adopted. The election shall be made by attaching a statement to the taxpayer's return for the first taxable year to which the election is applicable. The statement shall be signed by the taxpayer (or his duly authorized representative), and shall:

(i) Set forth the name and address of the taxpayer;

(ii) Designate the first taxable year to which the election is to apply;

(iii) State whether the election is intended to apply to all expenditures within the permissible scope of the election, or only to a particular project or projects, and, if the latter, include such information as will identify the project or projects as to which the election is to apply;

(iv) Set forth the amount of all research or experimental expenditures paid or incurred during the taxable year for which the election is made;

(v) Indicate the number of months (not less than 60) selected for amortization of the deferred expenses for each project; and

(vi) State that the taxpayer will make an accounting segregation in his books and records of the expenditures to which the election relates.

(2) *Change to a different method or period.* Application for permission to change to a different method of treating research or experimental expenditures or to a different period of amortization for deferred expenses shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R, Washington, DC, 20224. The application shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the end of the first taxable year in which the different method or different amortization period is to be used (unless subparagraph (3) of this paragraph, relating to extensions of time, is applicable). The application shall set forth the following information with regard to the research or experimental expenditures which are being treated under section 174(b) as deferred expenses:

(i) Total amount of research or experimental expenditures attributable to each project;

(ii) Amortization period applicable to each project; and

(iii) Unamortized expenditures attributable to each project at the beginning of the taxable year in which the application is filed.

In addition, the application shall set forth the length of the new period or periods proposed, or the new method of treatment proposed, the reasons for the proposed change, and such information as will identify the project or projects to which the expenditures affected by the change relate. If permission is granted to make the change, the taxpayer shall attach a copy of the letter granting the permission to his income tax return for the first taxable year in which the different method or period is to be effective.

(3) *Special rules.* If the last day prescribed by law for filing a return for any taxable year for which the deferred method provided in section 174(b) has been adopted falls before January 2, 1958, consent is hereby given for the taxpayer to change from such method and adopt a different method of treating research or experimental expenditures, provided that on or before January 2, 1958, he submits to the district director for the district in which the return was filed the information required by subparagraph (2) of this paragraph, relating to a change to a different method or period. For any taxable year for which the different method is adopted pursuant to this subparagraph, an amended return reflecting such method shall be filed on or before January 2, 1958.

(c) *Example.* The application of this section is illustrated by the following example:

Example. N Corporation is engaged in the business of manufacturing chemical products. On January 1, 1955, work is begun on a special research project. N Corporation elects, pursuant to section 174(b), to defer the expenditures relating to the special project and to amortize the expenditures over a period of 72 months beginning with the month in which benefits from the expenditures are first realized. On January 1, 1955, N Corporation also purchased for $57,600 a building having a remaining useful life of 12 years as of the date of purchase and no salvage value at the end of the period. Fifty percent of the building's facilities are to be used in connection with the special research project. During 1955, N Corporation pays or incurs the following expenditures relating to the special research project:

Salaries	$15,000
Heat, light and power	700
Drawings	2,000
Models	6,500
Laboratory materials	8,000
Attorneys' fees	1,400
Depreciation on building attributable to project (50 percent of $4,800 allowable depreciation)	2,400
Total research and development expenditures	36,000

The above expenditures result in a process which is marketable but not patentable and which has no determinable useful life. N Corporation first realizes benefits from the process in January 1956. N Corporation is entitled to deduct the amount of $6,000 ($36,000×12 months÷72 months) as deferred expenses under section 174(b) in computing taxable income for 1956.

§ 1.175–1 Soil and water conservation expenditures; in general.

Under section 175, a farmer may deduct his soil or water conservation expenditures which do not give rise to a deduction for depreciation and which are not otherwise deductible. The amount of the deduction is limited annually to 25 percent of the taxpayer's gross income from farming. Any excess may be carried over and deducted in succeeding taxable years. As a general rule, once a farmer has adopted this method of treating soil and water conservation expenditures, he must deduct all such expenditures (subject to the 25-percent limitation) for the current and subsequent taxable years. If a farmer does not adopt this method, such expenditures increase the basis of the property to which they relate.

§ 1.175–2 Definition of soil and water conservation expenditures.

(a) *Expenditures treated as a deduction.* (1) The method described in section 175 applies to expenditures paid or incurred for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion of land used in farming, but only if such expenditures are made in the furtherance of the business of farming. More specifically, a farmer may deduct expenditures made for these purposes which are for (i) the treatment or moving of earth, (ii) the construction, control, and protection of diversion channels, drainage ditches, irrigation ditches, earthen dams, watercourses, outlets, and ponds, (iii) the eradication of brush, and (iv) the planting of windbreaks. Expenditures for the treatment or moving of earth include but are not limited to expenditures for leveling, conditioning, grading, terracing, contour furrowing, and restoration of soil fertility. For rules relating to the allocation of expenditures that benefit both land used in farming and other land of the taxpayer, see § 1.175–7.

(2) The following are examples of soil and water conservation: (i) Constructing terraces, or the like, to detain or control the flow of water, to check soil erosion on sloping land, to intercept runoff, and to divert excess water to protected outlets; (ii) constructing water detention or sediment retention dams to prevent or fill gullies, to retard or reduce run-off of water, or to collect stock water; and (iii) constructing earthen floodways, levies, or dikes, to prevent flood damage to farmland.

(b) *Expenditures not subject to section 175 treatment.* (1) The method described in section 175 applies only to expenditures for nondepreciable items. Accordingly, a taxpayer may not deduct expenditures for the purchase, construction, installation, or improvement of structures, appliances, or facilities subject to the allowance for depreciation. Thus, the method does not apply to depreciable nonearthen items such as those made of masonry or concrete (see section 167). For example, expenditures in respect of depreciable property include those for materials, supplies, wages, fuel, hauling, and dirt moving for making structures such as tanks, reservoirs, pipes, conduits, canals, dams, wells, or pumps composed of masonry, concrete, tile, metal, or wood. However, the method applies to expenditures for earthen items which are not subject to a depreciation allowance. For example, expenditures for earthen terraces and dams which are nondepreciable are deductible under section 175. For taxable years beginning after December 31, 1959, in the case of expenditures paid or incurred by farmers for fertilizer, lime, etc., for purposes other than soil or water conservation, see section 180 and the regulations thereunder.

(2) The method does not apply to expenses deductible apart from section 175. Adoption of the method is not necessary in order to deduct such expenses in full without limitation. Thus, the method does not apply to interest (deductible under section 163), nor to taxes (deductible under section 164). It does not apply to expenses for the repair of completed soil or water conservation structures, such as costs of annual removal of sediment from a drainage ditch. It does not apply to expenditures paid or incurred primarily to produce an agricultural crop even though they incidentally conserve soil. Thus, the cost of fertilizing (the effectiveness of which does not last beyond one year) used to produce hay is deductible without adoption of the method prescribed in section 175. For taxable years beginning after December 31, 1959, in the case of expenditures paid or incurred by farmers for fertilizer, lime, etc., for purposes other than soil or water conservation, see section 180 and the regulations thereunder. However, the method would apply to expenses incurred to produce vegetation primarily to conserve soil or water or to prevent erosion. Thus, for example, the method would apply to such expenditures as the cost of dirt moving, lime, fertilizer, seed and planting stock used in gulley stabilization, or in stabilizing severely eroded areas, in order to obtain a soil binding stand of vegetation on raw or infertile land.

(c) *Assessments.* The method applies also to that part of assessments levied by a soil or water conservation or drainage district to reimburse it for its expenditures which, if actually paid or incurred during the taxable year by the taxpayer directly, would be deductible under section 175. Depending upon the farmer's method of accounting, the time when the farmer pays or incurs the assessment, and not the time when the expenditures are paid or incurred by the district, controls the time the deduction must be taken. The provisions of this paragraph may be illustrated by the following example:

Example. In 1955 a soil and water conservation district levies an assessment of $700 upon a farmer on the cash method of accounting. The assessment is to reimburse the district for its expenditures in 1954. The farmer's share of such expenditures is as follows: $400 for digging drainage ditches for soil conservation and $300 for assets subject to the allowance for depreciation. If the farmer pays the assessment in 1955 and has adopted the method of treating expenditures for soil or water conservation as current expenses under section 175, he may deduct in 1955 the $400 attributable to the digging of drainage ditches as a soil conservation expenditure subject to the 25-percent limitation.

(74 Stat. 1001; 26 U.S.C. 180)

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6548, 26 FR 1487, Feb. 22, 1961; T.D. 7740, 45 FR 78634, Nov. 26, 1980]

§1.175–3 Definition of "the business of farming."

The method described in section 175 is available only to a taxpayer engaged in ''the business of farming''. A taxpayer is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant. For the purpose of section 175, a taxpayer who receives a rental (either in cash or in kind) which is based upon farm production is engaged in the business of farming. However, a taxpayer who receives a fixed rental (without reference to production) is engaged in the business of farming only if he participates to a material extent in the operation or management of the farm. A taxpayer engaged in forestry or the growing of timber is not thereby engaged in the business of farming. A person cultivating or operating a farm for recreation or pleasure rather than a profit is not engaged in the business of farming. For the purpose of this section, the term *farm* is used in its ordinary, accepted sense and includes stock, dairy, poultry, fish, fruit, and truck farms, and also plantations, ranches, ranges, and orchards. A fish farm is an area where fish are grown or raised, as opposed to merely caught or harvested; that is, an area where they are artificially fed, protected, cared for, etc. A taxpayer is engaged in ‘‘the business of farming’’ if he is a member of a partnership engaged in the business of farming. See paragraphs (a)(8)(i) and (c)(1)(iv) of § 1.702–1.

[T.D. 6649, 28 FR 3762, Apr. 18, 1963]

§ 1.175–4 Definition of "land used in farming."

(a) *Requirements.* For purposes of section 175, the term *land used in farming* means land which is used in the business of farming and which meets both of the following requirements:

(1) The land must be used for the production of crops, fruits, or other agricultural products, including fish, or for the sustenance of livestock. The term *livestock* includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry. Land used for the sustenance of livestock includes land used for grazing such livestock.

(2) The land must be or have been so used either by the taxpayer or his tenant at some time before or at the same time as, the taxpayer makes the expenditures for soil or water conservation or for the prevention of the erosion of land. The taxpayer will be considered to have used the land in farming before making such expenditure if he or his tenant has employed the land in a farming use in the past. If the expenditures are made by the taxpayer in respect of land newly acquired from one who immediately prior to the acquisition was using it in farming, the taxpayer will be considered to be using the land in farming at the time that such expenditures are made, if the use which is made by the taxpayer of the land from the time of its acquisition by him is substantially a continuation of its use in farming, whether for the same farming use as that of the taxpayer's predecessor or for one of the other uses specified in paragraph (a)(1) of this section.

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

Example 1. A purchases an operating farm from B in the autumn after B has harvested his crops. Prior to spring plowing and planting when the land is idle because of the season, A makes certain soil and water conservation expenditures on this farm. At the time such expenditures are made the land is considered to be used by A in farming, and A may deduct such expenditures under section 175, subject to the other requisite conditions of such section.

Example 2. C acquires uncultivated land, not previously used in farming, which he intends to develop for farming. Prior to putting this land into production it is necessary for C to clear brush, construct earthen terraces and ponds, and make other soil and water conservation expenditures. The land is not used in farming at the same time that such expenditures are made. Therefore, C may not deduct such expenditures under section 175.

Example 3. D acquires several tracts of land from persons who had used such land immediately prior to D's acquisition for grazing cattle. D intends to use the land for growing grapes. In order to make the land suitable for this use, D constructs earthen terraces, builds drainage ditches and irrigation ditches, extensively treats the soil, and makes other soil and water conservation expenditures. The land is considered to be used in farming by D at the time he makes such expenditures, even though it is being prepared for a different type of farming activity than that engaged in by D's predecessors. Therefore, D may deduct such expenditures under section 175, subject to the other requisite conditions of such section.

(c) *Cross reference.* For rules relating to the allocation of expenditures that benefit both land used in farming and other land of the taxpayer, see § 1.175–7.

[T.D. 7740, 45 FR 78634, Nov. 26, 1980]

§ 1.175–5 Percentage limitation and carryover.

(a) *The limitation*—(1) *General rule.* The amount of soil and water conservation expenditures which the taxpayer may deduct under section 175 in any one taxable year is limited to 25 percent of his ‘‘gross income from farming’’.

(2) *Definition of ''gross income from farming.''* For the purpose of section 175, the term *gross income from farming* means the gross income of the taxpayer, derived in ''the business of farming'' as defined in §1.175–3, from the production of crops, fruits, or other agricultural products, including fish, or from livestock (including livestock held for draft, breeding, or dairy purposes). It includes such income from land used in farming other than that upon which expenditures are made for soil or water conservation or for the prevention of erosion of land. It does not include gains from sales of assets such as farm machinery or gains from the disposition of land. A taxpayer shall compute his ''gross income from farming'' in accordance with his accounting method used in determining gross income. (See the regulations under section 61 relating to accounting methods used by farmers in determining gross income.) The provisions of this subparagraph may be illustrated by the following example:

Example. A, who uses the cash receipts and disbursements method of accounting, includes in his ''gross income from farming'' for purposes of determining the 25-percent limitation the following items:

Proceeds from sale of his 1955 yield of corn	$10,000
Gain from disposition of old breeding cows replaced by younger cows	500
Total gross income from farming	10,500

A must exclude from ''gross income from farming'' the following items which are included in his gross income:

Gain from sale of tractor	$100
Gain from sale of 40 acres of taxpayer's farm	8,000
Interest on loan to neighboring farmer	100

(3) *Deduction qualifies for net operating loss deduction.* Any amount allowed as a deduction under section 175, either for the year in which the expenditure is paid or incurred or for the year to which it is carried, is taken into account in computing a net operating loss for such taxable year. If a deduction for soil or water conservation expenditures has been taken into account in computing a net operating loss carryback or carryover, it shall not be considered a soil or water conservation expenditure for the year to which the loss is carried, and therefore, is not subject to the 25-percent limitation for that year. The provisions of this subparagraph may be illustrated by the following example:

Example. Assume that in 1956 A has gross income from farming of $4,000, soil and water conservation expenditures of $1,600 and deductible farm expenses of $3,500. Of the soil and water conservation expenditures $1,000 is deductible in 1956. The $600 in excess of 25 percent of A's gross income from farming is carried over into 1957. Assuming that A has no other income, his deductions of $4,500 ($1,000 plus $3,500) exceed his gross income of $4,000 by $500. This $500 will constitute a net operating loss which he must carry back two years and carry forward five years, until it has offset $500 of taxable income. No part of this $500 net operating loss carryback or carryover will be taken into account in determining the amount of soil and water conservation expenditures in the years to which it is carried.

(b) *Carryover of expenditures in excess of deduction.* The deduction for soil and water conservation expenditures in any one taxable year is limited to 25 percent of the taxpayer's gross income from farming. The taxpayer may carry over the excess of such expenditures over 25 percent of his gross income from farming into his next taxable year, and, if not deductible in that year, into the next year, and so on without limit as to time. In determining the deductible amount of such expenditures for any taxable year, the actual expenditures of that year shall be added to any such expenditures carried over from prior years, before applying the 25-percent limitation. Any such expenditures in excess of the deductible amount may be carried over during the taxpayer's entire existence. For this purpose in a farm partnership, since the 25-percent limitation is applied to each partner, not the partnership, the carryover may be carried forward during the life of the partner. The provisions of this paragraph may be illustrated by the following example:

Example. Assume the expenditures and income shown in the following table:

Year	Deductible soil and water conservation expenditures		Total	25 percent of gross income from farming	Excess to be carried forward
	Paid or incurred during taxable year	Carried forward from prior year			
1954	$900	None	$900	$800	$100
1955	1,000	$100	1,100	900	200
1956	None	200	200	1,000	None

The deduction for 1954 is limited to $800. The remainder, $100 ($900 minus $800), not being deductible for 1954, is a carryover to 1955. For 1955, accordingly, the total of the expenditures to be taken into account is $1,100 (the $100 carryover and the $1,000 actually paid in that year). The deduction for 1955 is limited to $900, and the remainder of the $1,100 total, or $200, is a carryover to 1956. The deduction for 1956 consists solely of this carryover of $200. Since the total expenditures, actual and carried-over, for 1956 are less than 25 percent of gross income from farming, there is no carryover into 1957.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6649, 28 FR 3762, Apr. 18, 1963]

§ 1.175–6 Adoption or change of method.

(a) *Adoption with consent.* A taxpayer may, without consent, adopt the method of treating expenditures for soil or water conservation as expenses for the first taxable year:

(1) Which begins after December 31, 1953, and ends after August 16, 1954, and

(2) For which soil or water conservation expenditures described in section 175(a) are paid or incurred.

Such adoption shall be made by claiming the deduction on his income tax return. For a taxable year ending prior to May 31, 1957, the adoption of the method described in section 175 shall be made by claiming the deduction on such return for that year, or by claiming the deduction on an amended return filed for that year on or before August 30, 1957.

(b) *Adoption with consent.* A taxpayer may adopt the method of treating soil and water conservation expenditures as provided by section 175 for any taxable year to which the section is applicable if consent is obtained from the district director for the internal revenue district in which the taxpayer's return is required to be filed.

(c) *Change of method.* A taxpayer who has adopted the method of treating expenditures for soil or water conservation, as provided by section 175, may change from this method and capitalize such expenditures made after the effective date of the change, if he obtains the consent of the district director for the internal revenue district in which his return is required to be filed.

(d) *Request for consent to adopt or change method.* Where the consent of the district director is required under paragraph (b) or (c) of this section, the request for his consent shall be in writing, signed by the taxpayer or his authorized representative, and shall be filed not later than the date prescribed by law for filing the income tax return for the first taxable year to which the adoption of, or change of, method is to apply, or not later than August 20, 1957, following their adoption, whichever is later. The request shall:

(1) Set forth the name and address of the taxpayer;

(2) Designate the first taxable year to which the method or change of method is to apply;

(3) State whether the method or change of method is intended to apply to all expenditures within the permissible scope of section 175, or only to a particular project or farm and, if the latter, include such information as will identify the project or farm as to which the method or change of method is to apply;

(4) Set forth the amount of all soil and water conservation expenditures paid or incurred during the first taxable year for which the method or change of method is to apply; and

(5) State that the taxpayer will make an accounting segregation in his books and records of the expenditures to which the election relates.

(e) *Scope of method.* Except with the consent of the district director as provided in paragraph (b) or (c) of this section, the taxpayer's method of treating soil and water conservation expenditures described in section 175 shall apply to all such expenditures for the taxable year of adoption and all subsequent taxable years. Although a taxpayer may have elected to deduct soil and water conservation expenditures, he may request an authorization to capitalize his soil and water conservation expenditures attributable to a special project or single farm. Similarly, a taxpayer who has not elected to deduct such expenditures may request an authorization to deduct his soil and water conservation expenditures attributable to a special project or single farm. The authorization with respect to the special project or single farm will not affect the method adopted with respect to the taxpayer's regularly incurred soil and water conservation expenditures. No adoption of, or change of, the method under section 175 will be permitted as to expenditures actually paid or incurred before the taxable year to which the method or change of method is to apply. Thus, if a taxpayer adopts such method for 1956, he cannot deduct any part of such expenditures which he capitalized, or should have capitalized, in 1955. Likewise, if a taxpayer who has adopted such method has an unused carryover of such expenditures in excess of the 25-percent limitation, and is granted consent to capitalize soil and water conservation expenditures beginning in 1956, he cannot capitalize any part of the unused carryover. The excess expenditures carried over continue to be deductible to the extent of 25 percent of the taxpayer's gross income from farming. No adjustment to the basis of land shall be made under section 1016 for expenditures to which the method under section 175 applies. For example, A has an unused carryover of soil and water conservation expenditures amounting to $5,000 as of December 31, 1956. On January 1, 1957, A sells his farm and goes out of the business of farming. The unused carryover of $5,000 cannot be added to the basis of the farm for purposes of determining gain or loss on its sale. In 1959, A purchases another farm and resumes the business of farming. In such year, A may deduct the amount of the unused carryover to the extent of 25 percent of his gross income from farming and may carry over any excess to subsequent years.

§1.175–7 Allocation of expenditures in certain circumstances.

(a) *General rule.* If at the time the taxpayer paid or incurred expenditures for the purpose of soil or water conservation, or for the prevention of erosion of land, it was reasonable to believe that such expenditures would directly and substantially benefit land of the taxpayer which does not qualify as ''land used in farming,'' as defined in §1.175–4, as well as land of the taxpayer which does so qualify, then, for purposes of section 175, only a part of the taxpayer's total expenditures is in respect of ''land used in farming.''

(b) *Method of allocation.* The part of expenditures allocable to ''land used in farming'' generally equals the amount which bears the same proportion to the total amount of such expenditures as the area of land of the taxpayer used in farming which it was reasonable to believe would be directly and substantially benefited as a result of the expenditures bears to the total area of land of the taxpayer which it was reasonable to believe would be so benefited. If it is established by clear and convincing evidence that, in the light of all the facts and circumstances, another method of allocation is more reasonable than the method provided in the preceding sentence, the taxpayer may allocate the expenditures under that other method. For purposes of this section, the term *land of the taxpayer* means land with respect to which the taxpayer has title, leasehold, or some other substantial interest.

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

Example 1. A owns a 200-acre tract of land, 80 acres of which qualify as ''land used in farming.'' A makes expenditures for the purpose of soil and water conservation which can reasonably be expected to directly and substantially benefit the entire 200-acre tract. In the absence of clear and convincing evidence that a different allocation is more reasonable, A may deduct 40 percent (80/200) of such expenditures under section 175. The same result would obtain if A had made the expenditures after newly acquiring the tract from a person who had used 80 of the 200 acres in farming immediately prior to A's acquisition.

Example 2. Assume the same facts as in *Example (1),* except that A's expenditures for the purpose of soil and water conservation can reasonably be expected to directly and substantially benefit only the 80 acres which qualify as land used in farming; any benefit to the other 120 acres would be minor and incidental. A may deduct all of such expenditures under section 175.

Example 3. Assume the same facts as in *Example (1),* except that A's expenditures for the purpose of soil and water conservation can reasonably be expected to directly and substantially benefit only the 120 acres which do not qualify as land used in farming. A may not deduct any of such expenditures under section 175. The same result would obtain even if A had leased the 200-acre tract to B in the expectation that B would farm the entire tract.

[T.D. 7740, 45 FR 78635, Nov. 26, 1980]

§ 1.177–1 Election to amortize trademark and trade name expenditures.

(a) *In general.* (1) Section 177 provides that a taxpayer may elect to treat any trademark or trade name expenditure (defined in section 177(b) and paragraph (b) of this section) paid or incurred during a taxable year beginning after December 31, 1955, as a deferred expense. Any expenditure so treated shall be allowed as a deduction ratably over the number of continuous months (not less than 60) selected by the taxpayer, beginning with the first month of the taxable year in which the expenditure is paid or incurred. The term *paid or incurred,* as used in section 177 and this section, is to be construed according to the method of accounting used by the taxpayer in computing taxable income. See section 7701(a)(25). An election under section 177 is irrevocable insofar as it applies to a particular trademark or trade name expenditure, but separate elections may be made with respect to other trademark or trade name expenditures. See subparagraph (3) of this paragraph. See also paragraph (c) of this section for time and manner of making election.

(2) The number of continuous months selected by the taxpayer may be equal to or greater, but not less than 60, but in any event the deduction must begin with the first month of the taxable year in which the expenditure is paid or incurred. The number of months selected by the taxpayer at the time he makes the election may not be subsequently changed but shall be adhered to in computing taxable income for the taxable year for which the election is made and all subsequent taxable years.

(3) Section 177 permits an election by the taxpayer for each separate trademark or trade name expenditure. Thus, a taxpayer who has several trademark or trade name expenditures in a taxable year may elect under section 177 with respect to some of such expenditures and not elect with respect to the other expenditures. Also, a taxpayer may choose different amortization periods for different trademark or trade name expenditures with respect to which he has made the election under section 177.

(4) All trademark and trade name expenditures are properly chargeable to capital account for purposes of section 1016(a)(1), relating to adjustments to basis of property, whether or not they are to be amortized under section 177. However, the trademark and trade name expenditures with respect to which the taxpayer has made an election under section 177 must be kept in a separate account in the taxpayer's books and records. See paragraph (c) of this section. See also section 1016(a)(16) and paragraph (m) of § 1.1016–5 for adjustments to basis of property for amounts allowed as deductions under section 177 and this section.

(b) *Trademark and trade name expenditures defined.* (1) The term *trademark and trade name expenditures,* as used in section 177 and this section, means any expenditure which:

(i) Is directly connected with the acquisition, protection, expansion, registration (Federal, State, or foreign), or defense of a trademark or trade name;

(ii) Is chargeable to capital account; and

(iii) Is not part of the consideration or purchase price paid for a trademark, trade name, or a business (including goodwill) already in existence.

An expenditure which fails to meet one or more of these tests is not a trademark or trade name expenditure for purposes of section 177 and this section.

Amounts paid in connection with the acquisition of an existing trademark or trade name may not be amortized under section 177 even though such amounts may be paid to protect or expand a previously owned trademark or trade name through purchase of a competitive trademark. Similarly, the provisions of section 177 and this section are not applicable to expenditures paid or incurred for an agreement to discontinue the use of a trademark or trade name (if the effect of the agreement is the purchase of a trademark or trade name) nor to expenditures paid or incurred in acquiring franchises or rights to the use of a trademark or trade name. Generally, section 177 will apply to expenditures such as legal fees and other costs in connection with the acquisition of a certificate of registration of a trademark from the United States or other government, artists' fees and similar expenses connected with the design of a distinctive mark for a product or service, litigation expenses connected with infringement proceedings, and costs in connection with the preparation and filing of an application for renewal of registration and continued use of a trademark.

(2) Expenditures for a trademark or trade name which has a determinable useful life and which would otherwise be depreciable under section 167 must be deferred and amortized under section 177 if an election under section 177 is made with respect to such expenditures.

(3) The following examples illustrate the application of section 177:

Example 1. X Corporation engages an artist to design a distinctive trademark for its product. At the same time it retains an attorney to prepare the papers necessary for registration of this trademark with the Federal Government. The fees of both the artist and the attorney may be amortized under section 177 over a period of not less than 60 continuous months.

Example 2. Y Corporation wishes to expand the market served by its product. It acquires a competing firm in a neighboring State. The contract of sale provides for a purchase price of $250,000 of which $225,000 shall constitute payment for physical assets and $25,000 for the trademark and goodwill. No part of the purchase price may be amortized under section 177.

Example 3. M Corporation brings suit against N Corporation for infringement of M's trademark. The costs of this litigation may be amortized under section 177.

(c) *Time and manner of making election.* (1) A taxpayer who elects to defer and amortize any trademark or trade name expenditure paid or incurred during a taxable year beginning after December 31, 1955, shall, within the time prescribed by law (including extensions thereof) for filing his income tax return for that year, attach to his income tax return a statement signifying his election under section 177 and setting forth the following:

(i) Name and address of the taxpayer, and the taxable year involved;

(ii) An identification of the character and amount of each expenditure to which the election applies and the number of continuous months (not less than 60) during which the expenditures are to be ratably deducted; and

(iii) A declaration by the taxpayer that he will make an accounting segregation on his books and records of the trademark and trade name expenditures for which the election has been made, sufficient to permit an identification of the character and amount of each such expenditure and the amortization period selected for each expenditure.

(2) The provisions of subparagraph (1) of this paragraph shall apply to income tax returns and statements required to be filed after May 4, 1960. Elections properly made in accordance with the provisions of Treasury Decision 6209, approved October 26, 1956 (21 FR 8319, C.B. 1956–2, 1370), continue in effect.

§1.178–1 Depreciation or amortization of improvements on leased property and cost of acquiring a lease.

(a) *In general.* Section 178 provides rules for determining the amount of the deduction allowable for any taxable year to a lessee for depreciation or amortization of improvements made on leased property and as amortization of the cost of acquiring a lease. For purposes of section 178 the term *depreciation* means the deduction allowable for exhaustion, wear and tear, or obsolescence under provisions of the Code such as section 167 or 611 and the regulations thereunder and the term *amortization* means the deduction allowable for amortization of buildings or other improvements made on leased property or for amortization of the cost of acquiring a lease under provisions of the Code such as section 162 or 212 and the regulations thereunder. The provisions of section 178 are applicable with respect to costs of acquiring a lease incurred, and improvements begun, after July 28, 1958, other than improvements which, on July 28, 1958, and at all times thereafter, the lessee was under a binding legal obligation to make.

(b) *Determination of amount of deduction.* (1) In determining the amount of the deduction allowable to a lessee (other than a lessee who is related to the lessor within the meaning of § 1.178–2) for any taxable year for depreciation or amortization of improvements made on leased property, or for amortization in respect of the cost of acquiring a lease, the term of the lease shall, except as provided in subparagraph (2) of this paragraph, be treated as including all periods for which the lease may be renewed, extended, or continued pursuant to an option or options exercisable by the lessee (whether or not specifically provided for in the lease) if:

(i) In the case of any building erected, or other improvements made, by the lessee on the leased property, the portion of the term of the lease (excluding all periods for which the lease may subsequently be renewed, extended, or continued pursuant to an option or options exercisable by the lessee) remaining upon the completion of such building or other improvements is less than 60 percent of the estimated useful life of such building or other improvements; or

(ii) In the case of any cost of acquiring the lease, less than 75 percent of such cost is attributable to the portion of the term of the lease (excluding all periods for which the lease may be renewed, extended, or continued pursuant to an option or options exercisable by the lessee) remaining on the date of its acquisition.

(2) The rules provided in subparagraph (1) of this paragraph shall not apply if the lessee establishes that, as of the close of the taxable year, it is more probable that the lease will not be renewed, extended, or continued than that the lease will be renewed, extended, or continued. In such case, the cost of improvements made on leased property or the cost of acquiring a lease shall be amortized over the remaining term of the lease without regard to any options exercisable by the lessee to renew, extend, or continue the lease. The probability test referred to in the first sentence of this subparagraph shall be applicable to each option period to which the lease may be renewed, extended, or continued. The establishment by a lessee as of the close of the taxable year that it is more probable that the lease will not be renewed, extended, or continued will ordinarily be effective as of the close of such taxable year and any subsequent taxable year, and the deduction for amortization will be based on the term of the lease without regard to any periods for which the lease may be renewed, extended, or continued pursuant to an option or options exercisable by the lessee. However, in appropriate cases, if the facts as of the close of any subsequent taxable year indicate that it is more probable that the lease will be renewed, extended, or continued, the deduction for amortization (or depreciation) shall, beginning with the first day of such subsequent taxable year, be determined by including in the remaining term of the lease all periods for which it is more probable that the lease will be renewed, extended, or continued.

(3) If at any time the remaining term of the lease determined in accordance with section 178 and this section is equal to or of longer duration than the then estimated useful life of the improvements made on the leased property by the lessee, the cost of such improvements shall be depreciated over the estimated useful life of such improvements under the provisions of section 167 and the regulations thereunder.

(4) For purposes of section 178(a)(1) and this section, the date on which the building erected or other improvements made are completed is the date on which the building or improvements are usable, whether or not used.

(5)(i) For purposes of section 178(a)(2) and this section, the portion of the cost of acquiring a lease which is attributable to the term of the lease remaining on the date of its acquisition without regard to options exercisable by the lessee to renew, extend, or continue the lease shall be determined on the basis of the facts and circumstances of each case. In some cases, it may be appropriate to determine such portion of the cost of acquiring a lease by applying the principles used to measure the present value of an annuity. Where that method is used, such portion shall be determined by multiplying the cost of the lease by a fraction, the numerator comprised of a factor representing the present value of an annually recurring savings of $1 per year for the period of the remaining term of the lease (without regard to options to renew, extend, or continue the lease) at an appropriate rate of interest (determined on the basis of all the facts and circumstances in each case), and the denominator comprised of a factor representing the present value of $1 per year for the period of the remaining term of the lease including the options to renew, extend, or continue the lease at an appropriate rate of interest.

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

Example. Lessee A acquires a lease with respect to unimproved property at a cost of $100,000 at which time there are 21 years remaining in the original term of the lease with two renewal options of 21 years each. The lease provides for a uniform annual rental for the remaining term of the lease and the renewal periods. It has been determined that this is an appropriate case for the application of the principles used to measure the present value of an annuity. Assume that in this case the appropriate rate of interest is 5 percent. By applying the tables (Inwood) used to measure the present value of an annuity of $1 per year, the factor representing the present value of $1 per annum for 21 years at 5% is ascertained to be 12.821, and the factor representing the present value of $1 per annum for 63 years at 5% is 19.075. The portion of the cost of the lease ($100,000) attributable to the remaining term of the original lease (21 years) is 67.21% or $67,210 determined as follows:

12.821/19.075 or 67.21%.

(6) The provisions of this paragraph may be illustrated by the following examples:

Example 1. Lessee A constructs a building on land leased from lessor B. The construction is commenced on August 1, 1958, and is completed and placed in service on December 31, 1958, at which time A has 15 years remaining on his lease with an option to renew for an additional 20 years. Lessee A computes his taxable income on a calendar year basis. Lessee A was not, on July 28, 1958, under a binding legal obligation to erect the building. The building has an estimated useful life of 30 years. A is not related to B. Since the portion of the term of the lease (without regard to any renewals) remaining upon completion of the building (15 years) is less than 60 percent of the estimated useful life of the building (60 percent of 30 years, or 18 years), the term of the lease shall be treated as including the remaining portion of the original lease period and the renewal period, or 35 years. Since the estimated useful life of the building (30 years) is less than 35 years, the cost of the building shall, in accord with paragraph (b)(3) of this section, be depreciated under the provisions of section 167, over its estimated useful life. If, however, lessee A establishes, as of the close of the taxable year 1958, it is more probable that the lease will not be renewed than that it will be renewed, then in such case the remaining term of the lease shall be treated as including only the 15-year period remaining in the original lease. Since this is less than the estimated useful life of the building, the remaining cost of the building would be amortized over such 15-year period under the provisions of section 162 and the regulations thereunder.

Example 2. Assume the same facts as in *Example (1)*, except that A has 21 years remaining on his lease with an option to renew for an additional 10 years. Section 178(a) and paragraph (b)(1) of this section do not apply since the term of the lease remaining on the date of completion of the building (21 years) is not less than 60 percent of the estimated useful life of the building (60 percent of 30 years, or 18 years).

Example 3. Assume the same facts as in *Example (1)*, except that A has no renewal option until July 1, 1961, when lessor B grants A an option to renew the lease for a 10-year period. Because there is no option to renew the lease, the term of the lease is, for the taxable years 1959 and 1960 and for the first six months of the taxable year 1961, determined without regard to section 178(a). However, as of July 1, 1961, the date the renewal option is granted, section 178(a) and paragraph (b)(1) of this section become applicable since the portion of the term of the lease remaining upon completion of the building (15 years) was less than 60 percent of the estimated useful life of the building (60 percent of 30 years, or 18 years). As of July 1, 1961, the term of the lease shall be treated as including the remaining portion of the original lease period (12 1/2 years) and the 10-year renewal period, or 22 1/2 years, unless lessee A can establish that, as of the close of 1961, it is more probable that the lease will not be renewed than that it will be.

Example 4. On January 1, 1959, lessee A pays $10,000 to acquire a lease for 20 years with two options exercisable by him to renew for periods of 5 years each. Of the total $10,000 cost to acquire the lease, $7,000 was paid for the original 20-year lease period and the balance of $3,000 was paid for the renewal options. Since the $7,000 cost of acquiring the initial lease is less than 75 percent of the $10,000 cost of the lease ($7,500), the term of the lease shall be treated as including the original lease period and the 2 renewal periods, or 30 years. However, if lessee A establishes that, as of the close of the taxable year 1959, it is more probable that the lease will not be renewed than that it will be renewed, the term of the lease shall be treated as including only the original lease period, or 20 years.

Example 5. Assume the same facts as in *Example (4)*, except that the portion of the total cost ($10,000) paid for the 20-year original lease period is $8,000. Since the $8,000 cost of acquiring the original lease is not less than 75 percent of the $10,000 cost of the lease ($7,500), section 178(a) and paragraph (b)(1) of this section do not apply.

(c) *Application of section 178(a) where lessee gives notice to lessor of intention to exercise option.* (1) If the lessee has given notice to the lessor of his intention to renew, extend, or continue a lease, the lessee shall, for purposes of applying the provisions of section 178(a) and paragraph (b)(1) of this section, take into account such renewal or extension in determining the portion of the term of the lease remaining upon the completion of the improvements or on the date of the acquisition of the lease.

(2) The application of the provisions of this paragraph may be illustrated by the following examples:

Example 1. Lessee A constructs a building on land leased from lessor B. The construction was commenced on September 1, 1958, and was completed and placed in service on December 31, 1958. Lessee A was not, on July 28, 1958, under a binding legal obligation to erect the building. A and B are not related. At the time the building was completed (December 31, 1958), lessee A had 3 years remaining on his lease with 2 options to renew for periods of 20 years each. The estimated useful life of the building is 50 years. Prior to completion of the building, lessee A gives notice to lessor B of his intention to exercise the first 20-year option. Therefore, the portion of the term of the lease remaining on January 1, 1959, shall be the 3 years remaining in the original lease period plus the 20-year renewal period, or 23 years. Since the term of the lease remaining upon completion of the building (23 years) is less than 60 percent of the estimated useful life of the building (60 percent of 50 years, or 30 years), the provisions of section 178(a) and paragraph (b)(1) of this section are applicable. Accordingly, the term of the lease shall be treated as including the aggregate of the remaining term of the original lease (23 years) and the second 20-year renewal period or 43 years, unless lessee A establishes that it is more probable that the lease will not be renewed, extended, or continued under the second 20-year option than that it will be so renewed, extended, or continued under such option. If this is established by lessee A, then the term of the lease shall be treated as including only the remaining portion of the original lease period and the first 20-year renewal period, or 23 years.

Example 2. Assume the same facts as in *Example (1)*, except that the estimated useful life of the building is 30 years. Since the term of the lease remaining upon completion of the building (23 years) is not less than 60 percent of the estimated life of the building (60 percent of 30 years, or 18 years), the provisions of section 178(a) and paragraph (b)(1) of this section do not apply.

Example 3. If in *Examples (1)* and *(2)*, the lessee failed to give notice of his intention to exercise the renewal option, the renewal period would not be taken into account in computing the percentage requirements under section 178(a) and paragraph (b)(1) of this section. Thus, unless lessee A establishes the required probability, the provisions of section 178(a) and paragraph (b)(1) of this section would apply in both examples since the term of the lease remaining upon completion of the building (3 years) is less than 60 percent of the estimated useful life of the building in either example (60 percent of 50 years, or 30 years; 60 percent of 30 years, or 18 years).

(d) *Application of section 178 where lessee is related to lessor.* (1)(i) If the lessee and lessor are related persons within the meaning of section 178(b)(2) and § 1.178–2 at any time during the taxable year, the lease shall be treated as including a period of not less duration than the remaining estimated useful life of improvements made by the lessee on leased property for purposes of determining the amount of deduction allowable to the lessee for such taxable year for depreciation or amortization in respect of any building erected or other improvements made on leased property. If the lessee and lessor cease to be related persons during any taxable year, then for the immediately following and subsequent taxable years during which they continue to be unrelated, the amount allowable to the lessee as a deduction shall be determined without reference to section 178(b) and in accordance with section 178(a) or section 178(c), whichever is applicable.

(ii) Although the related lessee and lessor rule of section 178(b) and §1.178–2 does not apply in determining the period over which the cost of acquiring a lease may be amortized, the relationship between a lessee and lessor will be a significant factor in applying section 178 (a) and (c) in cases in which the lease may be renewed, extended, or continued pursuant to an option or options exercisable by the lessee.

(2) The application of the provisions of this paragraph may be illustrated by the following examples:

Example 1. Lessee A constructs a building on land leased from lessor B. The construction was commenced on August 1, 1958, and was completed and put in service on December 31, 1958. Lessee A was not on July 28, 1958, under a binding legal obligation to erect the building. On the completion date of the building, lessee A had 20 years remaining in his original lease period with an option to renew for an additional 20 years. The building has an estimated useful life of 50 years. During the taxable years 1959 and 1960, A and B are related persons within the meaning of section 178(b)(2) and §1.178–2, but they are not related persons at any time during the taxable year 1961 or during any subsequent taxable year. Since A and B are related persons during the taxable years 1959 and 1960, the term of the lease shall, for each of those years, be treated as 50 years. Section 178(a) and paragraph (b)(1) of this section become applicable in the taxable year 1961 since A and B are not related persons at any time during that year and because the portion of the original lease period remaining at the time the building was completed (20 years) is less than 60 percent of the estimated useful life of the building (60 percent of 50 years, or 30 years). Thus, the term of the lease shall, beginning on January 1, 1961, be treated as including the remaining portion of the original lease period (18 years) and the renewal period (20 years), or 38 years, unless lessee A can establish that, as of the close of the taxable year 1961 or any subsequent taxable year, it is more probable that the lease will not be renewed than that it will be renewed.

Example 2. Assume the same facts as in *Example (1),* except that the estimated useful life of the building is 30 years. During the taxable years 1959 and 1960, the term of the lease shall be treated as 30 years. For the taxable year 1961, however, neither section 178(a) nor section 178(b) apply since the percentage requirement of section 178(a) and paragraph (b) of this section are not satisfied and A and B are not related persons within the meaning of section 178(b)(2) and §1.178–2.

[T.D. 6520, 25 FR 13689, Dec. 24, 1960]

§1.178–2 Related lessee and lessor.

(a) For purposes of section 178 and §1.178–1, a lessor and lessee shall be considered to be related persons if:

(1) The lessor and lessee are members of an affiliated group, as defined in section 1504 and the regulations thereunder; or

(2) The relationship between the lessor and lessee is one described in section 267(b), except that the phrase ‘‘80 percent or more’’ shall be substituted for the phrase ‘‘more than 50 percent’’ wherever such phrase appears in section 267(b).

(b) In the application of section 267(b) for purposes of section 178, the rules provided in section 267(c) shall apply, except that the family of an individual shall include only his spouse, ancestors, and lineal descendants. Thus, if the lessee is the brother or sister of the lessor, the lessee and lessor will not be considered to be related persons for purposes of section 178 and §1.178–1. If the lessor leases property to a corporation of which he owns 80 percent or more in value of the outstanding stock, the lessor and lessee shall be considered to be related persons. On the other hand, if the lessor leases property to a corporation of which he owns less than 80 percent in value of the outstanding stock and his brother owns the remaining stock, the lessor and lessee will not be considered to be related persons.

(c) If a relationship described in section 267(b) exists independently of family status, the brother-sister exception does not apply. For example, if the lessor leases property to the fiduciary of a trust of which he is the grantor, the lessor and lessee will be considered to be related persons for purposes of section 178. This result obtains whether or not the fiduciary is the brother or sister of the lessor since the disqualifying relationship exists because of the grantor-fiduciary status and not because of family status.

[T.D. 6520, 25 FR 13691, Dec. 24, 1960]

§ 1.178–3 Reasonable certainty test.

(a) In any case in which neither section 178 (a) nor (b) applies, the determination as to the amount of the deduction allowable to a lessee for any taxable year for depreciation or amortization in respect of any building erected, or other improvements made, on leased property, or in respect of any cost of acquiring a lease, shall be made with reference to the original term of the lease (excluding any period for which the lease may subsequently be renewed, extended, or continued pursuant to an option exercisable by the lessee) unless the lease has been renewed, extended, or continued, or the facts show with reasonable certainty that the lease will be renewed, extended, or continued. In a case in which the facts show with reasonable certainty that the lease will be renewed, extended, or continued, the term of the lease shall, beginning with the taxable year in which such reasonable certainty is shown, be treated as including the period or periods for which it is reasonably certain that the lease will be renewed, extended, or continued. If the lessee has given notice to the lessor of his intention to renew, extend, or continue a lease, the lease shall be considered as renewed, extended, or continued for the periods specified in the notice. See paragraph (c) of § 1.178–1.

(b) The reasonable certainty test is applicable to each option to which the lease is subject. Thus, in a case of two successive options, the facts in a particular taxable year may show with reasonable certainty that the lease will be renewed pursuant to an exercise of only the first option; and, beginning with such year, the term of the lease will be treated as including the first option, but not the second. If in a subsequent taxable year the facts show with reasonable certainty that the second option will also be exercised, the term of the lease shall, beginning with such subsequent taxable year, be treated as including both options. Although the related lessee and lessor rule of section 178(b) and paragraph (d) of § 1.178–1 does not apply in determining the period over which the cost of acquiring a lease may be amortized, the relationship between the lessee and lessor will be a significant factor in determining whether the ‘‘reasonable certainty’’ rule of section 178(c) and this section applies.

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

Example 1. Corporation A leases land from lessor B for a period of 30 years beginning with January 1, 1958. Corporation A and lessor B are not related persons. The lease provides that Corporation A will have two renewal options of 5 years each at the same annual rental as specified in the lease for the initial 30 years. Corporation A constructs a factory building on the leased land at a cost of $100,000. Corporation A was not, on July 28, 1958, under a binding legal obligation to erect the building. The construction was commenced on August 1, 1958, and was completed and placed in service on December 31, 1958. On January 1, 1959, Corporation A has 29 years remaining in the initial term of the lease. The estimated useful life of the building on January 1, 1959, is 40 years. The location of the leased property is particularly suitable for Corporation A’s business and the annual rental of the property is lower than A would have to pay for other suitable property. No factors are present which establish that these conditions will not continue to exist beyond the initial term of the lease. Since the period remaining in the initial term of the lease on January 1, 1959 (29 years) is not less than 60 percent of the estimated useful life of the building (60 percent of 40 years, or 24 years), the provisions of section 178(a) and paragraph (b)(1) of § 1.178–1 do not apply, and since Corporation A and lessor B are not related, section 178(b) and paragraph (d) of § 1.178–1 do not apply. However, since the facts show with reasonable certainty that Corporation A will renew the lease for the period of the two options (10 years), the cost of the building shall be amortized over the term of the lease, including the two renewal options, or 39 years.

Example 2. Assume the same facts as in *Example (1)*, except that a term of 30 years is the longest period that lessor B is willing to lease the unimproved property; that there was no agreement that Corporation A will have any renewal options; and that any other location would be as suitable for Corporation A’s business as the leased property. Since the facts do not show with reasonable certainty that the initial term of the lease will be renewed, extended, or continued, Corporation A shall amortize the cost of the building over the remaining term of the lease, or 29 years.

[T.D. 6520, 25 FR 13691, Dec. 24, 1960]

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(2) Dispositions and other transfers of a partner's interest in a partnership or a shareholder's interest in an S corporation.
(3) Examples.

§ 1.179–4 Definitions

(a) Section 179 property.
(b) Section 38 property.
(c) Purchase.
(d) Cost.
(e) Placed in service.
(f) Controlled group of corporations and component member of controlled group.

§ 1.179–5 Time and Manner of Making Election

(a) Election.
(b) Revocation.

§ 1.179–6 Effective Date

[T.D. 8455, 57 FR 61316, Dec. 24, 1992]

§ 1.179–1 Election to expense certain depreciable assets.

(a) *In general.* Section 179(a) allows a taxpayer to elect to expense the cost (as defined in § 1.179–4(d)), or a portion of the cost, of section 179 property (as defined in § 1.179–4(a)) for the taxable year in which the property is placed in service (as defined in § 1.179–4(e)). The election is not available for trusts, estates, and certain noncorporate lessors. See paragraph (i)(2) of this section for rules concerning noncorporate lessors. However, section 179(b) provides certain limitations on the amount that a taxpayer may elect to expense in any one taxable year. See §§ 1.179–2 and 1.179–3 for rules relating to the dollar and taxable income limitations and the carryover of disallowed deduction rules. For rules describing the time and manner of making an election under section 179, see § 1.179–5. For the effective date, see § 1.179–6.

(b) *Cost subject to expense.* The expense deduction under section 179 is allowed for the entire cost or a portion of the cost of one or more items of section 179 property. This expense deduction is subject to the limitations of section 179(b) and § 1.179–2. The taxpayer may select the properties that are subject to the election as well as the portion of each property's cost to expense.

(c) *Proration not required*—(1) *In general.* The expense deduction under section 179 is determined without any proration based on—

(i) The period of time the section 179 property has been in service during the taxable year; or

(ii) The length of the taxable year in which the property is placed in service.

(2) *Example.* The following example illustrates the provisions of paragraph (c)(1) of this section.

Example. On December 1, 1991, X, a calendar-year corporation, purchases and places in service section 179 property costing $20,000. For the taxable year ending December 31, 1991, X may elect to claim a section 179 expense deduction on the property (subject to the limitations imposed under section 179(b)) without proration of its cost for the number of days in 1991 during which the property was in service.

(d) *Partial business use*—(1) *In general.* If a taxpayer uses section 179 property for trade or business as well as other purposes, the portion of the cost of the property attributable to the trade or business use is eligible for expensing under section 179 provided that more than 50 percent of the property's use in the taxable year is for trade or business purposes. The limitations of section179(b) and § 1.179–2 are applied to the portion of the cost attributable to the trade or business use.

(2) *Example.* The following example illustrates the provisions of paragraph (d)(1) of this section.

Example. A purchases section 179 property costing $10,000 in 1991 for which 80 percent of its use will be in A's trade or business. The cost of the property adjusted to reflect the business use of the property is $8,000 (80 percent × $10,000). Thus, A may elect to expense up to $8,000 of the cost of the property (subject to the limitations imposed under section 179(b) and § 1.179–2).

(3) *Additional rules that may apply.* If a section 179 election is made for ''listed property'' within the meaning of section 280F(d)(4) and there is personal use of the property, section 280F(d)(1), which provides rules that coordinate section 179 with the section 280F limitation on the amount of depreciation, may apply. If section 179 property is no longer predominantly used in the taxpayer's trade or business, paragraphs (e) (1) through (4) of this section, relating to recapture of the section 179 deduction, may apply.

(e) *Change in use; recapture*—(1) *In general.* If a taxpayer's section 179 property is not used predominantly in a trade or business of the taxpayer at any time before the end of the property's recovery period, the taxpayer must recapture in the taxable year in which the section 179 property is not used predominantly in a trade or business any benefit derived from expensing such property. The benefit derived from expensing the property is equal to the excess of the amount expensed under this section over the total amount that would have been allowable for prior taxable years and the taxable year of recapture as a deduction under section 168 (had section 179 not been elected) for the portion of the cost of the property to which the expensing relates (regardless of whether such excess reduced the taxpayer's tax liability). For purposes of the preceding sentence (i) the ''amount expensed under this section'' shall not include any amount that was not allowed as a deduction to a taxpayer because the taxpayer's aggregate amount of allowable section 179 expenses exceeded the section 179(b) dollar limitation, and (ii) in the case of an individual who does not elect to itemize deductions under section 63(g) in the taxable year of recapture, the amount allowable as a deduction under section 168 in the taxable year of recapture shall be determined by treating property used in the production of income other than rents or royalties as being property used for personal purposes. The amount to be recaptured shall be treated as ordinary income for the taxable year in which the property is no longer used predominantly in a trade or business of the taxpayer. For taxable years following the year of recapture, the taxpayer's deductions under section 1688(a) shall be determined as if no section 179 election with respect to the property had been made. However, see section 280F(d)(1) relating to the coordination of section 179 with the limitation on the amount of depreciation for luxury automobiles and where certain property is used for personal purposes. If the recapture rules of both section 280F(b)(2) and this paragraph (e)(1) apply to an item of section 179 property, the amount of recapture for such property shall be determined only under the rules of section 280F(b)(2).

(2) *Predominant use.* Property will be treated as not used predominantly in a trade or business of the taxpayer if 50 percent or more of the use of such property during any taxable year within the recapture period is for a use other than in a trade or business of the taxpayer. If during any taxable year of the recapture period the taxpayer disposes of the property (other than in a disposition to which section 1245(a) applies) or ceases to use the property in a trade or business in a manner that had the taxpayer claimed a credit under section 38 for such property such disposition or cessation in use would cause recapture under section 47, the property will be treated as not used in a trade or business of the taxpayer. However, for purposes of applying the recapture rules of section 47 pursuant to the preceding sentence, converting the use of the property from use in trade or business to use in the production of income will be treated as a conversion to personal use.

(3) *Basis; application with section 1245.* The basis of property with respect to which there is recapture under paragraph (e)(1) of this section shall be increased immediately before the event resulting in such recapture by the amount recaptured. If section 1245(a) applies to a disposition of property, there is no recapture under paragraph (e)(1) of this section.

(4) *Carryover of disallowed deduction.* See §1.179–3 for rules on applying the recapture provisions of this paragraph (e) when a taxpayer has a carryover of disallowed deduction.

(5) *Example.* The following example illustrates the provisions of paragraphs (e)(1) through (e)(4) of this section.

Example. A, a calendar-year taxpayer, purchases and places in service on January 1, 1991, section 179 property costing $15,000. The property is 5-year property for section 168 purposes and is the only item of depreciable property placed in service by A during 1991. A properly elects to expense $10,000 of the cost and elects under section 168(b)(5) to depreciate the remaining cost under the straight-line method. On January 1, 1992, A converts the property from use in A's business to use for the production of income, and A uses the property in the latter capacity for the entire year. A elects to itemize deductions for 1992. Because the property was not predominantly used in A's trade or business in 1992, A must recapture any benefit derived from expensing the property under section 179. Had A not elected to expense the $10,000 in 1991, A would have been entitled to deduct, under section 168, 10 percent of the $10,000 in 1991, and 20 percent of the $10,000 in 1992. Therefore, A must include $7,000 in ordinary income for the 1992 taxable year, the excess of $10,000 (the section 179 expense amount) over $3,000 (30 percent of $10,000).

(f) *Basis*—(1) *In general.* A taxpayer who elects to expense under section 179 must reduce the depreciable basis of the section 179 property by the amount of the section 179 expense deduction.

(2) *Special rules for partnerships and S corporations.* Generally, the basis of a partnership or S corporation's section 179 property must be reduced to reflect the amount of section 179 expense elected by the partnership or S corporation. This reduction must be made in the basis of partnership or S corporation property even if the limitations of section 179(b) and § 1.179–2 prevent a partner in a partnership or a shareholder in an S corporation from deducting all or a portion of the amount of the section 179 expense allocated by the partnership or S corporation. See § 1.179–3 for rules on applying the basis provisions of this paragraph (f) when a person has a carryover of disallowed deduction.

(3) *Special rules with respect to trusts and estates which are partners or S corporation shareholders.* Since the section 179 election is not available for trusts or estates, a partner or S corporation shareholder that is a trust or estate may not deduct its allocable share of the section 179 expense elected by the partnership or S corporation. The partnership or S corporation's basis in section 179 property shall not be reduced to reflect any portion of the section 179 expense that is allocable to the trust or estate. Accordingly, the partnership or S corporation may claim a depreciation deduction under section 168 or a section 38 credit (if available) with respect to any depreciable basis resulting from the trust or estate's inability to claim its allocable portion of the section 179 expense.

(g) *Disallowance of the section 38 credit.* If a taxpayer elects to expense under section 179, no section 38 credit is allowable for the portion of the cost expensed. In addition, no section 38 credit shall be allowed under section 48(d) to a lessee of property for the portion of the cost of the property that the lessor expensed under section 179.

(h) *Partnerships and S corporations*—(1) *In general.* In the case of property purchased and placed in service by a partnership or an S corporation, the determination of whether the property is section 179 property is made at the partnership or S corporation level. The election to expense the cost of section 179 property is made by the partnership or the S corporation. See sections 703(b), 1363(c), 6221, 6231(a)(3), 6241, and 6245.

(2) *Example.* The following example illustrates the provisions of paragraph (h)(1) of this section.

Example. A owns certain residential rental property as an investment. A and others form ABC partnership whose function is to rent and manage such property. A and ABC partnership file their income tax returns on a calendar-year basis. In 1991, ABC partnership purchases and places in service office furniture costing $20,000 to be used in the active conduct of ABC's business. Although the office furniture is used with respect to an investment activity of A, the furniture is being used in the active conduct of ABC's trade or business. Therefore, because the determination of whether property is section 179 property is made at the partnership level, the office furniture is section 179 property and ABC may elect to expense a portion of its cost under section 179.

(i) *Leasing of section 179 property*—(1) *In general.* A lessor of section 179 property who is treated as the owner of the property for Federal tax purposes will be entitled to the section 179 expense deduction if the requirements of section 179 and the regulations thereunder are met. These requirements will not be met if the lessor merely holds the property for the production of income. For certain leases entered into prior to January 1, 1984, the safe harbor provisions of section 168(f)(8) apply in determining whether an agreement is treated as a lease for Federal tax purposes.

(2) *Noncorporate lessor.* In determining the class of taxpayers (other than an estate or trust) for which section 179 is applicable, section 179(d)(5) provides that if a taxpayer is a noncorporate lessor (*i.e.*, a person who is not a corporation and is a lessor), the taxpayer shall not be entitled to claim a section 179 expense for section 179 property purchased and leased by the taxpayer unless the taxpayer has satisfied all of the requirements of section 179(d)(5)(A) or (B).

(j) *Application of sections 263 and 263A.* Under section 263(a)(1)(G), expenditures for which a deduction is allowed under section 179 and this section are excluded from capitalization under section 263(a). Under this paragraph (j), amounts allowed as a deduction under section 179 and this section are excluded from the application of the uniform capitalization rules of section 263A.

(k) *Cross references.* See section 453(i) and the regulations thereunder with respect to installment sales of section 179 property. See section 1033(g)(3) and the regulations thereunder relating to condemnation of outdoor advertising displays. See section 1245(a) and the regulations thereunder with respect to recapture rules for section 179 property.

[T.D. 8121, 52 FR 410, Jan. 6, 1987, as amended by T.D. 8455, 57 FR 61316, Dec. 24, 1992]

§1.179–2 Limitations on amount subject to section 179 election.

(a) *In general.* Sections 179(b) (1) and (2) limit the aggregate cost of section 179 property that a taxpayer may elect to expense under section 179 for any one taxable year (dollar limitation). See paragraph (b) of this section. Section 179(b)(3)(A) limits the aggregate cost of section 179 property that a taxpayer may deduct in any taxable year (taxable income limitation). See paragraph (c) of this section. Any cost that is elected to be expensed but that is not currently deductible because of the taxable income limitation may be carried forward to the next taxable year (carryover of disallowed deduction). See §1.179–3 for rules relating to carryovers of disallowed deductions. See also sections 280F(a), (b), and (d)(1) relating to the coordination of section 179 with the limitations on the amount of depreciation for luxury automobiles and other listed property. The dollar and taxable income limitations apply to each taxpayer and not to each trade or business in which the taxpayer has an interest.

(b) *Dollar limitation*—(1) *In general.* The aggregate cost of section 179 property that a taxpayer may elect to expense under section 179 for any taxable year is $10,000 reduced (but not below zero) by the amount of any excess section 179 property (described in paragraph (b)(2) of this section) placed in service during the taxable year.

(2) *Excess section 179 property.* The amount of any excess section 179 property for a taxable year equals the excess (if any) of—

(i) The cost of section 179 property placed in service by the taxpayer in the taxable year; over

(ii) $200,000.

(3) *Application to partnerships*—(i) *In general.* The dollar limitation of this paragraph (b) applies to the partnership as well as to each partner. In applying the dollar limitation to a taxpayer that is a partner in one or more partnerships, the partner's share of section 179 expenses allocated to the partner from each partnership is aggregated with any nonpartnership section 179 expenses of the taxpayer for the taxable year. However, in determining the excess section 179 property placed in service by a partner in a taxable year, the cost of section 179 property placed in service by the partnership is not attributed to any partner.

(ii) *Example.* The following example illustrates the provisions of paragraph (b)(3)(i) of this section.

Example. During 1991, CD, a calendar-year partnership, purchases and places in service section 179 property costing $150,000 and elects under section 179(c) and §1.179–5 to expense $10,000 of the cost of that property. CD properly allocates to C, a calendar-year taxpayer and a partner in CD, $5,000 of section 179 expenses (C's distributive share of CD's section 179 expenses for 1991). In applying the dollar limitation to C for 1991, C must include the $5,000 of section 179 expenses allocated from CD. However, in determining the amount of any excess section 179 property C placed in service during 1991, C does not include any of the cost of section 179 property placed in service by CD, including the $5,000 of cost represented by the $5,000 of section 179 expenses allocated to C by the partnership.

(iii) *Partner's share of section 179 expenses.* Section 704 and the regulations thereunder govern the determination of a partner's share of a partnership's section 179 expenses for any taxable year. However, no allocation among partners of the section 179 expenses may be modified after the due date of the partnership return (without regard to extensions of time) for the taxable year for which the election under section 179 is made.

(iv) *Taxable year.* If the taxable years of a partner and the partnership do not coincide, then for purposes of section 179, the amount of the partnership's section 179 expenses attributable to a partner for a taxable year is determined under section 706 and the regulations thereunder (generally the partner's distributive share of partnership section 179 expenses for the partnership year that ends with or within the partner's taxable year).

(v) *Example.* The following example illustrates the provisions of paragraph (b)(3)(iv) of this section.

Example. AB partnership has a taxable year ending January 31. A, a partner of AB, has a taxable year ending December 31. AB purchases and places in service section 179 property on March 10, 1991, and elects to expense a portion of the cost of that property under section 179. Under section 706 and § 1.706–1(a)(1), A will be unable to claim A's distributive share of any of AB's section 179 expenses attributable to the property placed in service on March 10, 1991, until A's taxable year ending December 31, 1992.

(4) *S Corporations.* Rules similar to those contained in paragraph (b)(3) of this section apply in the case of S corporations (as defined in section 1361(a)) and their shareholders. Each shareholder's share of the section 179 expenses of an S corporation is determined under section 1366.

(5) *Joint returns*—(i) *In General.* A husband and wife who file a joint income tax return under section 6013(a) are treated as one taxpayer in determining the amount of the dollar limitation under paragraph (b)(1) of this section, regardless of which spouse purchased the property or placed it in service.

(ii) *Joint returns filed after separate returns.* In the case of a husband and wife who elect under section 6013(b) to file a joint income tax return for a taxable year after the time prescribed by law for filing the return for such taxable year has expired, the dollar limitation under paragraph (b)(1) of this section is the lesser of—

(A) The dollar limitation (as determined under paragraph (b)(5)(i) of this section); or

(B) The aggregate cost of section 179 property elected to be expensed by the husband and wife on their separate returns.

(iii) *Example.* The following example illustrates the provisions of paragraph (b)(5)(ii) of this section.

Example. During 1991, Mr. and Mrs. B, both calendar-year taxpayers, purchase and place in service section 179 property costing $100,000. On their separate returns for 1991, Mr. B elects to expense $3,000 of section 179 property as an expense and Mrs. B elects to expense $4,000. After the due date of the return they elect under section 6013(b) to file a joint income tax return for 1991. The dollar limitation for their joint income tax return is $7,000, the lesser of the dollar limitation ($10,000) or the aggregate cost elected to be expensed under section 179 on their separate returns ($3,000 elected by Mr. B plus $4,000 elected by Mrs. B, or $7,000).

(6) *Married individuals filing separately*—(i) *In general.* In the case of an individual who is married but files a separate income tax return for a taxable year, the dollar limitation of this paragraph (b) for such taxable year is the amount that would be determined under paragraph (b)(5)(i) of this section if the individual filed a joint income tax return under section 6013(a) multiplied by either the percentage elected by the individual under this paragraph (b)(6) or 50 percent. The election in the preceding sentence is made in accordance with the requirements of section 179(c) and § 1.179–5. However, the amount determined under paragraph (b)(5)(i) of this section must be multiplied by 50 percent if either the individual or the individual's spouse does not elect a percentage under this paragraph (b)(6) or the sum of the percentages elected by the individual and the individual's spouse does not equal 100 percent. For purposes of this paragraph (b)(6), marital status is determined under section 7703 and the regulations thereunder.

(ii) *Example.* The following example illustrates the provisions of paragraph (b)(6)(i) of this section.

Example. Mr. and Mrs. D, both calendar-year taxpayers, file separate income tax returns for 1991. During 1991, Mr. D places $195,000 of section 179 property in service and Mrs. D places $9,000 of section 179 property in service. Neither of them elects a percentage under paragraph (b)(6)(i) of this section. The 1991 dollar limitation for both Mr. D and Mrs. D is determined by multiplying by 50 percent the dollar limitation that would apply had they filed a joint income tax return. Had Mr. and Mrs. D filed a joint return for 1991, the dollar limitation would have been $6,000, $10,000 reduced by the excess section 179 property they placed in service during 1991 ($195,000 placed in service by Mr. D plus $9,000 placed in service by Mrs. D less $200,000, or $4,000). Thus, the 1991 dollar limitation for Mr. and Mrs. D is $3,000 each ($6,000 multiplied by 50 percent).

(7) *Component members of a controlled group*—(i) *In general.* Component members of a controlled group (as defined in §1.179–4(f)) on December 31 are treated as one taxpayer in applying the dollar limitation of sections 179(b) (1) and (2) and this paragraph (b). The expense deduction may be taken by any one component member or allocated (for the taxable year of each member that includes that December 31) among the several members in any manner. Any allocation of the expense deduction must be pursuant to an allocation by the common parent corporation if a consolidated return is filed for all component members of the group, or in accordance with an agreement entered into by the members of the group if separate returns are filed. If a consolidated return is filed by some component members of the group and separate returns are filed by other component members, the common parent of the group filing the consolidated return must enter into an agreement with those members that do not join in filing the consolidated return allocating the amount between the group filing the consolidated return and the other component members of the controlled group that do not join in filing the consolidated return. The amount of the expense allocated to any component member, however, may not exceed the cost of section 179 property actually purchased and placed in service by the member in the taxable year. If the component members have different taxable years, the term *taxable year* in sections 179(b) (1) and (2) means the taxable year of the member whose taxable year begins on the earliest date.

(ii) *Statement to be filed.* If a consolidated return is filed, the common parent corporation must file a separate statement attached to the income tax return on which the election is made to claim an expense deduction under section 179. See §1.179–5. If separate returns are filed by some or all component members of the group, each component member not included in a consolidated return must file a separate statement attached to the income tax return on which an election is made to claim a deduction under section 179. The statement must include the name, address, employer identification number, and the taxable year of each component member of the controlled group, a copy of the allocation agreement signed by persons duly authorized to act on behalf of the component members, and a description of the manner in which the deduction under section 179 has been divided among the component members.

(iii) *Revocation.* If a consolidated return is filed for all component members of the group, an allocation among such members of the expense deduction under section 179 may not be revoked after the due date of the return (including extensions of time) of the common parent corporation for the taxable year for which an election to take an expense deduction is made. If some or all of the component members of the controlled group file separate returns for taxable years including a particular December 31 for which an election to take the expense deduction is made, the allocation as to all members of the group may not be revoked after the due date of the return (including extensions of time) of the component member of the controlled group whose taxable year that includes such December 31 ends on the latest date.

(c) *Taxable income limitation*—(1) *In general.* The aggregate cost of section 179 property elected to be expensed under section 179 that may be deducted for any taxable year may not exceed the aggregate amount of taxable income of the taxpayer for such taxable year that is derived from the active conduct by the taxpayer of any trade or business during the taxable year. For purposes of section 179(b)(3) and this paragraph (c), the aggregate amount of taxable income derived from the active conduct by an individual, a partnership, or an S corporation of any trade or business is computed by aggregating the net income (or loss) from all of the trades or businesses actively conducted by the individual, partnership, or S corporation during the taxable year. Items of income that are derived from the active conduct of a trade or business include section 1231 gains (or losses) from the trade or business and interest from working capital of the trade or business. Taxable income derived from the active conduct of a trade or business is computed without regard to the deduction allowable under section 179, any section 164(f) deduction, any net operating loss carryback or carryforward, and deductions suspended under any section of the Code. See paragraph (c)(6) of this section for rules on determining whether a taxpayer is engaged in the active conduct of a trade or business for this purpose.

(2) *Application to partnerships and partners*—(i) *In general.* The taxable income limitation of this paragraph (c) applies to the partnership as well as to each partner. Thus, the partnership may not allocate to its partners as a section 179 expense deduction for any taxable year more than the partnership's taxable income limitation for that taxable year, and a partner may not deduct as a section 179 expense deduction for any taxable year more than the partner's taxable income limitation for that taxable year.

(ii) *Taxable year.* If the taxable year of a partner and the partnership do not coincide, then for purposes of section 179, the amount of the partnership's taxable income attributable to a partner for a taxable year is determined under section 706 and the regulations thereunder (generally the partner's distributive share of partnership taxable income for the partnership year that ends with or within the partner's taxable year).

(iii) *Example.* The following example illustrates the provisions of paragraph (c)(2)(ii) of this section.

Example AB partnership has a taxable year ending January 31. A, a partner of AB, has a taxable year ending December 31. For AB's taxable year ending January 31, 1992, AB has taxable income from the active conduct of its trade or business of $100,000, $90,000 of which was earned during 1991. Under section 706 and § 1.706–1(a)(1), A includes A's entire share of partnership taxable income in computing A's taxable income limitation for A's taxable year ending December 31, 1992.

(iv) *Taxable income of a partnership.* The taxable income (or loss) derived from the active conduct by a partnership of any trade or business is computed by aggregating the net income (or loss) from all of the trades or businesses actively conducted by the partnership during the taxable year. The net income (or loss) from a trade or business actively conducted by the partnership is determined by taking into account the aggregate amount of the partnership's items described in section 702(a) (other than credits, tax-exempt income, and guaranteed payments under section 707(c)) derived from that trade or business. For purposes of determining the aggregate amount of partnership items, deductions and losses are treated as negative income. Any limitation on the amount of a partnership item described in section 702(a) which may be taken into account for purposes of computing the taxable income of a partner shall be disregarded in computing the taxable income of the partnership.

(v) *Partner's share of partnership taxable income.* A taxpayer who is a partner in a partnership and is engaged in the active conduct of at least one of the partnership's trades or businesses includes as taxable income derived from the active conduct of a trade or business the amount of the taxpayer's allocable share of taxable income derived from the active conduct by the partnership of any trade or business (as determined under paragraph (c)(2)(iv) of this section).

(3) *S corporations and S corporation shareholders*—(i) *In general.* Rules similar to those contained in paragraphs (c)(2) (i) and (ii) of this section apply in the case of S corporations (as defined in section 1361(a)) and their shareholders. Each shareholder's share of the taxable income of an S corporation is determined under section 1366.

(ii) *Taxable income of an S corporation.* The taxable income (or loss) derived from the active conduct by an S corporation of any trade or business is computed by aggregating the net income (or loss) from all of the trades or businesses actively conducted by the S corporation during the taxable year. The net income (or loss) from a trade or business actively conducted by an S corporation is determined by taking into account the aggregate amount of the S corporation's items described in section 1366(a) (other than credits, tax-exempt income, and deductions for compensation paid to an S corporation's shareholder-employees) derived from that trade or business. For purposes of determining the aggregate amount of S corporation items, deductions and losses are treated as negative income. Any limitation on the amount of an S corporation item described in section 1366(a) which may be taken into account for purposes of computing the taxable income of a shareholder shall be disregarded in computing the taxable income of the S corporation.

(iii) *Shareholder's share of S corporation taxable income.* Rules similar to those contained in paragraph (c)(2)(v) and (c)(6)(ii) of this section apply to a taxpayer who is a shareholder in an S corporation and is engaged in the active conduct of the S corporation's trades or businesses.

(4) *Taxable income of a corporation other than an S corporation.* The aggregate amount of taxable income derived from the active conduct by a corporation other than an S corporation of any trade or business is the amount of the corporation's taxable income before deducting its net operating loss deduction and special deductions (as reported on the corporation's income tax return), adjusted to reflect those items of income or deduction included in that amount that were not derived by the corporation from a trade or business actively conducted by the corporation during the taxable year.

(5) *Ordering rule for certain circular problems*—(i) *In general.* A taxpayer who elects to expense the cost of section 179 property (the deduction of which is subject to the taxable income limitation) also may have to apply another Internal Revenue Code section that has a limitation based on the taxpayer's taxable income. Except as provided in paragraph (c)(1) of this section, this section provides rules for applying the taxable income limitation under section 179 in such a case. First, taxable income is computed for the other section of the Internal Revenue Code. In computing the taxable income of the taxpayer for the other section of the Internal Revenue Code, the taxpayer's section 179 deduction is computed by assuming that the taxpayer's taxable income is determined without regard to the deduction under the other Internal Revenue Code section. Next, after reducing taxable income by the amount of the section 179 deduction so computed, a hypothetical amount of deduction is determined for the other section of the Internal Revenue Code. The taxable income limitation of the taxpayer under section 179(b)(3) and this paragraph (c) then is computed by including that hypothetical amount in determining taxable income.

(ii) *Example.* The following example illustrates the ordering rule described in paragraph (c)(5)(i) of this section.

Example. X, a calendar-year corporation, elects to expense $10,000 of the cost of section 179 property purchased and placed in service during 1991. Assume X's dollar limitation is $10,000. X also gives a charitable contribution of $5,000 during the taxable year. X's taxable income for purposes of both sections 179 and 170(b)(2), but without regard to any deduction allowable under either section 179 or section 170, is $11,000. In determining X's taxable income limitation under section 179(b)(3) and this paragraph (c), X must first compute its section 170 deduction. However, section 170(b)(2) limits X's charitable contribution to 10 percent of its taxable income determined by taking into account its section 179 deduction. Paragraph (c)(5)(i) of this section provides that in determining X's section 179 deduction for 1991, X first computes a hypothetical section 170 deduction by assuming that its section 179 deduction is not affected by the section 170 deduction. Thus, in computing X's hypothetical section 170 deduction, X's taxable income limitation under section 179 is $11,000 and its section 179 deduction is $10,000. X's hypothetical section 170 deduction is $100 (10 percent of $1,000 ($11,000 less $10,000 section 179 deduction)). X's taxable income limitation for section 179 purposes is then computed by deducting the hypothetical charitable contribution of $100 for 1991. Thus, X's section 179 taxable income limitation is $10,900 ($11,000 less hypothetical $100 section 170 deduction), and its section 179 deduction for 1991 is $10,000. X's section 179 deduction so calculated applies for all purposes of the Code, including the computation of its actual section 170 deduction.

(6) *Active conduct by the taxpayer of a trade or business*—(i) *Trade or business.* For purposes of this section and §1.179–4(a), the term *trade or business* has the same meaning as in section 162 and the regulations thereunder. Thus, property held merely for the production of income or used in an activity not engaged in for profit (as described in section 183) does not qualify as section 179

property and taxable income derived from property held for the production of income or from an activity not engaged in for profit is not taken into account in determining the taxable income limitation.

(ii) *Active conduct.* For purposes of this section, the determination of whether a trade or business is actively conducted by the taxpayer is to be made from all the facts and circumstances and is to be applied in light of the purpose of the active conduct requirement of section 179(b)(3)(A). In the context of section 179, the purpose of the active conduct requirement is to prevent a passive investor in a trade or business from deducting section 179 expenses against taxable income derived from that trade or business. Consistent with this purpose, a taxpayer generally is considered to actively conduct a trade or business if the taxpayer meaningfully participates in the management or operations of the trade or business. Generally, a partner is considered to actively conduct a trade or business of the partnership if the partner meaningfully participates in the management or operations of the trade or business. A mere passive investor in a trade or business does not actively conduct the trade or business.

(iii) *Example.* The following example illustrates the provisions of paragraph (c)(6)(ii) of this section.

Example. A owns a salon as a sole proprietorship and employs B to operate it. A periodically meets with B to review developments relating to the business. A also approves the salon's annual budget that is prepared by B. B performs all the necessary operating functions, including hiring beauticians, acquiring the necessary beauty supplies, and writing the checks to pay all bills and the beauticians' salaries. In 1991, B purchased, as provided for in the salon's annual budget, equipment costing $9,500 for use in the active conduct of the salon. There were no other purchases of section 179 property during 1991. A's net income from the salon, before any section 179 deduction, totaled $8,000. A also is a partner in PRS, a calendar-year partnership, which owns a grocery store. C, a partner in PRS, runs the grocery store for the partnership, making all the management and operating decisions. PRS did not purchase any section 179 property during 1991. A's allocable share of partnership net income was $6,000. Based on the facts and circumstances, A meaningfully participates in the management of the salon. However, A does not meaningfully participate in the management or operations of the trade or business of PRS. Under section 179(b)(3)(A) and this paragraph (c), A's aggregate taxable income derived from the active conduct by A of any trade or business is $8,000, the net income from the salon.

(iv) *Employees.* For purposes of this section, employees are considered to be engaged in the active conduct of the trade or business of their employment. Thus, wages, salaries, tips, and other compensation (not reduced by unreimbursed employee business expenses) derived by a taxpayer as an employee are included in the aggregate amount of taxable income of the taxpayer under paragraph (c)(1) of this section.

(7) *Joint returns*—(i) *In general.* The taxable income limitation of this paragraph (c) is applied to a husband and wife who file a joint income tax return under section 6013(a) by aggregating the taxable income of each spouse (as determined under paragraph (c)(1) of this section).

(ii) *Joint returns filed after separate returns.* In the case of a husband and wife who elect under section 6013(b) to file a joint income tax return for a taxable year after the time prescribed by law for filing the return for such taxable year, the taxable income limitation of this paragraph (c) for the taxable year for which the joint return is filed is determined under paragraph (c)(7)(i) of this section.

(8) *Married individuals filing separately.* In the case of an individual who is married but files a separate tax return for a taxable year, the taxable income limitation for that individual is determined under paragraph (c)(1) of this section by treating the husband and wife as separate taxpayers.

(d) *Examples.* The following examples illustrate the provisions of paragraphs (b) and (c) of this section.

Example 1. (i) During 1991, PRS, a calendar-year partnership, purchases and places in service $50,000 of section 179 property. The taxable income of PRS derived from the active conduct of all its trades or businesses (as determined under paragraph (c)(1) of this section) is $8,000.

(ii) Under the dollar limitation of paragraph (b) of this section, PRS may elect to expense $10,000 of the cost of section 179 property purchased in 1991. Assume PRS elects under section 179(c) and §1.179–5 to expense $10,000 of the cost of section 179 property purchased in 1991.

(iii) Under the taxable income limitation of paragraph (c) of this section, PRS may allocate to its partners as a deduction only $8,000 of the cost of section 179 property in 1991. Under section 179(b)(3)(B) and §1.179–3(a), PRS may carry forward the remaining $2,000 it elected to expense, which would have been deductible under section 179(a) for 1991 absent the taxable income limitation.

Example 2. (i) The facts are the same as in *Example 1,* except that on December 31, 1991, PRS allocates to A, a calendar-year taxpayer and a partner in PRS, $7,000 of section 179 expenses and $2,000 of taxable income. A was engaged in the active conduct of a trade or business of PRS during 1991.

(ii) In addition to being a partner in PRS, A conducts a business as a sole proprietor. During 1991, A purchases and places in service $201,000 of section 179 property in connection with the sole proprietorship. A's 1991 taxable income derived from the active conduct of this business is $6,000.

(iii) Under the dollar limitation, A may elect to expense only $9,000 of the cost of section 179 property purchased in 1991, the $10,000 limit reduced by $1,000 (the amount by which the cost of section 179 property placed in service during 1991 ($201,000) exceeds $200,000). Under paragraph (b)(3)(i) of this section, the $7,000 of section 179 expenses allocated from PRS is subject to the $9,000 limit. Assume that A elects to expense $2,000 of the cost of section 179 property purchased by A's sole proprietorship in 1991. Thus, A has elected to expense under section 179 an amount equal to the dollar limitation for 1991 ($2,000 elected to be expensed by A's sole proprietorship plus $7,000, the amount of PRS's section 179 expenses allocated to A in 1991).

(iv) Under the taxable income limitation, A may only deduct $8,000 of the cost of section 179 property elected to be expensed in 1991, the aggregate taxable income derived from the active conduct of A's trades or businesses in 1991 ($2,000 from PRS and $6,000 from A's sole proprietorship). The entire $2,000 of taxable income allocated from PRS is included by A as taxable income derived from the active conduct by A of a trade or business because it was derived from the active conduct of a trade or business by PRS and A was engaged in the active conduct of a trade or business of PRS during 1991. Under section 179(b)(3)(B) and §1.179–3(a), A may carry forward the remaining $1,000 A elected to expense, which would have been deductible under section 179(a) for 1991 absent the taxable income limitation.

[T.D. 8455, 57 FR 61318, Dec. 24, 1992]

§1.179–3 Carryover of disallowed deduction.

(a) *In general.* Under section 179(b)(3)(B), a taxpayer may carry forward for an unlimited number of years the amount of any cost of section 179 property elected to be expensed in a taxable year but disallowed as a deduction in that taxable year because of the taxable income limitation of section 179(b)(3)(A) and §1.179–2(c) (‘‘carryover of disallowed deduction’’). This carryover of disallowed deduction may be deducted under section 179(a) and §1.179–1(a) in a future taxable year as provided in paragraph (b) of this section.

(b) *Deduction of carryover of disallowed deduction*—(1) *In general.* The amount allowable as a deduction under section 179(a) and §1.179–1(a) for any taxable year is increased by the lesser of—

(i) The aggregate amount disallowed under section 179(b)(3)(A) and §1.179–2(c) for all prior taxable years (to the extent not previously allowed as a deduction by reason of this section); or

(ii) The amount of any unused section 179 expense allowance for the taxable year (as described in paragraph (c) of this section).

(2) *Cross references.* See paragraph (f) of this section for rules that apply when a taxpayer disposes of or otherwise transfers section 179 property for which a carryover of disallowed deduction is outstanding. See paragraph (g) of this section for special rules that apply to partnerships and S corporations and paragraph (h) of this section for special rules that apply to partners and S corporation shareholders.

(c) *Unused section 179 expense allowance.* The amount of any unused section 179 expense allowance for a taxable year equals the excess (if any) of—

(1) The maximum cost of section 179 property that the taxpayer may deduct under section 179 and §1.179–1 for the taxable year after applying the limitations of section 179(b) and §1.179–2; over

(2) The amount of section 179 property that the taxpayer actually elected to expense under section 179 and §1.179–1(a) for the taxable year.

(d) *Example.* The following example illustrates the provisions of paragraphs (b) and (c) of this section.

Example. A, a calendar-year taxpayer, has a $3,000 carryover of disallowed deduction for an item of section 179 property purchased and placed in service in 1991. In 1992, A purchases and places in service an item of section 179 property costing $25,000. A's 1992 taxable income from the active conduct of all A's trades or businesses is $100,000. A elects, under section 179(c) and § 1.179–5, to expense $8,000 of the cost of the item of section 179 property purchased in 1992. Under paragraph (b) of this section, A may deduct $2,000 of A's carryover of disallowed deduction from 1991 (the lesser of A's total outstanding carryover of disallowed deductions ($3,000), or the amount of any unused section 179 expense allowance for 1992 ($10,000 limit less $8,000 elected to be expensed, or $2,000)). For 1993, A has a $1,000 carryover of disallowed deduction for the item of section 179 property purchased and placed in service in 1991.

(e) *Recordkeeping requirement and ordering rule.* The properties and the apportionment of cost that will be subject to a carryover of disallowed deduction are selected by the taxpayer in the year the properties are placed in service. This selection must be evidenced on the taxpayer's books and records and be applied consistently in subsequent years. If no selection is made, the total carryover of disallowed deduction is apportioned equally over the items of section 179 property elected to be expensed for the taxable year. For this purpose, the taxpayer treats any section 179 expense amount allocated from a partnership (or an S corporation) for a taxable year as one item of section 179 property. If the taxpayer is allowed to deduct a portion of the total carryover of disallowed deduction under paragraph (b) of this section, the taxpayer must deduct the cost of section 179 property carried forward from the earliest taxable year.

(f) *Dispositions and other transfers of section 179 property*—(1) *In general.* Upon a sale or other disposition of section 179 property, or a transfer of section 179 property in a transaction in which gain or loss is not recognized in whole or in part (including transfers at death), immediately before the transfer the adjusted basis of the section 179 property is increased by the amount of any outstanding carryover of disallowed deduction with respect to the property. This carryover of disallowed deduction is not available as a deduction to the transferor or the transferee of the section 179 property.

(2) *Recapture under section 179(d)(10).* Under § 1.179–1(e), if a taxpayer's section 179 property is subject to recapture under section 179(d)(10), the taxpayer must recapture the benefit derived from expensing the property. Upon recapture, any outstanding carryover of disallowed deduction with respect to the property is no longer available for expensing. In determining the amount subject to recapture under section 179(d)(10) and § 1.179–1(e), any outstanding carryover of disallowed deduction with respect to that property is not treated as an amount expensed under section 179.

(g) *Special rules for partnerships and S corporations*—(1) *In general.* Under section 179(d)(8) and § 1.179–2(c), the taxable income limitation applies at the partnership level as well as at the partner level. Therefore, a partnership may have a carryover of disallowed deduction with respect to the cost of its section 179 property. Similar rules apply to S corporations. This paragraph (g) provides special rules that apply when a partnership or an S corporation has a carryover of disallowed deduction.

(2) *Basis adjustment.* Under § 1.179–1(f)(2), the basis of a partnership's section 179 property must be reduced to reflect the amount of section 179 expense elected by the partnership. This reduction must be made for the taxable year for which the election is made even if the section 179 expense amount, or a portion thereof, must be carried forward by the partnership. Similar rules apply to S corporations.

(3) *Dispositions and other transfers of section 179 property by a partnership or an S corporation.* The provisions of paragraph (f) of this section apply in determining the treatment of any outstanding carryover of disallowed deduction with respect to section 179 property disposed of, or transferred in a nonrecognition transaction, by a partnership or an S corporation.

(4) *Example.* The following example illustrates the provisions of this paragraph (g).

Example. ABC, a calendar-year partnership, owns and operates a restaurant business. During 1992, ABC purchases and places in service two items of section 179 property—a cash register costing $4,000 and office furniture costing $6,000. ABC elects to expense under section 179(c) the full cost of the cash register and the office furniture. For 1992, ABC has $6,000 of taxable income derived from the active conduct of its restaurant business. Therefore, ABC may deduct only $6,000 of section 179 expenses and must carry forward the remaining $4,000 of section 179 expenses at the partnership level. ABC must reduce the adjusted basis of the section 179 property by the full amount elected to be expensed. However, ABC may not allocate to its partners any portion of the carryover of disallowed deduction until ABC is able to deduct it under paragraph (b) of this section.

(h) *Special rules for partners and S corporation shareholders*—(1) *In general.* Under section 179(d)(8) and §1.179–2(c), a partner may have a carryover of disallowed deduction with respect to the cost of section 179 property elected to be expensed by the partnership and allocated to the partner. A partner who is allocated section 179 expenses from a partnership must reduce the basis of his or her partnership interest by the full amount allocated regardless of whether the partner may deduct for the taxable year the allocated section 179 expenses or is required to carry forward all or a portion of the expenses. Similar rules apply to S corporation shareholders.

(2) *Dispositions and other transfers of a partner's interest in a partnership or a shareholder's interest in an S corporation.* A partner who disposes of a partnership interest, or transfers a partnership interest in a transaction in which gain or loss is not recognized in whole or in part (including transfers of a partnership interest at death), may have an outstanding carryover of disallowed deduction of section 179 expenses allocated from the partnership. In such a case, immediately before the transfer the partner's basis in the partnership interest is increased by the amount of the partner's outstanding carryover of disallowed deduction with respect to the partnership interest. This carryover of disallowed deduction is not available as a deduction to the transferor or transferee partner of the section 179 property. Similar rules apply to S corporation shareholders.

(3) *Examples.* The following examples illustrate the provisions of this paragraph (h).

Example 1. (i) G is a general partner in GD, a calendar-year partnership, and is engaged in the active conduct of GD's business. During 1991, GD purchases and places section 179 property in service and elects to expense a portion of the cost of the property under section 179. GD allocates $2,500 of section 179 expenses and $15,000 of taxable income (determined without regard to the section 179 deduction) to G. The income was derived from the active conduct by GD of a trade or business.

(ii) In addition to being a partner in GD, G conducts a business as a sole proprietor. During 1991, G purchases and places in service office equipment costing $25,000 and a computer costing $10,000 in connection with the sole proprietorship. G elects under section 179(c) and §1.179–5 to expense $7,500 of the cost of the office equipment. G has a taxable loss (determined without regard to the section 179 deduction) derived from the active conduct of this business of $12,500.

(iii) G has no other taxable income (or loss) derived from the active conduct of a trade or business during 1991. G's taxable income limitation for 1991 is $2,500 ($15,000 taxable income allocated from GD less $12,500 taxable loss from the sole proprietorship). Therefore, G may deduct during 1991 only $2,500 of the $10,000 of section 179 expenses. G notes on the appropriate books and records that G expenses the $2,500 of section 179 expenses allocated from GD and carries forward the $7,500 of section 179 expenses with respect to the office equipment purchased by G's sole proprietorship.

(iv) On January 1, 1992, G sells the office equipment G's sole proprietorship purchased and placed in service in 1991. Under paragraph (f) of this section, immediately before the sale G increases the adjusted basis of the office equipment by $7,500, the amount of the outstanding carryover of disallowed deduction with respect to the office equipment.

Example 2. (i) Assume the same facts as in *Example 1,* except that G notes on the appropriate books and records that G expenses $2,500 of section 179 expenses relating to G's sole proprietorship and carries forward the remaining $5,000 of section 179 expenses relating to G's sole proprietorship and $2,500 of section 179 expenses allocated from GD.

(ii) On January 1, 1992, G sells G's partnership interest to A. Under paragraph (h)(2) of this section, immediately before the sale G increases the adjusted basis of G's partnership interest by $2,500, the amount of the outstanding carryover of disallowed deduction with respect to the partnership interest.

[T.D. 8455, 57 FR 61321, Dec. 24, 1992]

§1.179–4 Definitions.

The following definitions apply for purposes of section 179 and §§1.179–1 through 1.179–6:

(a) *Section 179 property.* The term *section 179 property* means any tangible property described in section 179(d)(1) that is acquired by purchase for use in the active conduct of the taxpayer's trade or business (as described in § 1.179–2(c)(6)). For purposes of this paragraph (a), the term *trade or business* has the same meaning as in section 162 and the regulations thereunder.

(b) *Section 38 property.* The term *section 38 property* shall have the same meaning assigned to it in section 48(a) and the regulations thereunder.

(c) *Purchase.* (1)(i) Except as otherwise provided in paragraph (d)(2) of this section, the term *purchase* means any acquisition of the property, but only if all the requirements of paragraphs (c)(1) (ii), (iii), and (iv) of this section are satisfied.

(ii) Property is not acquired by purchase if it is acquired from a person whose relationship to the person acquiring it would result in the disallowance of losses under section 267 or 707(b). The property is considered not acquired by purchase only to the extent that losses would be disallowed under section 267 or 707(b). Thus, for example, if property is purchased by a husband and wife jointly from the husband's father, the property will be treated as not acquired by purchase only to the extent of the husband's interest in the property. However, in applying the rules of section 267 (b) and (c) for this purpose, section 267(c)(4) shall be treated as providing that the family of an individual will include only his spouse, ancestors, and lineal descendants. For example, a purchase of property from a corporation by a taxpayer who owns, directly or indirectly, more than 50 percent in value of the outstanding stock of such corporation does not qualify as a purchase under section 179(d)(2); nor does the purchase of property by a husband from his wife. However, the purchase of section 179 property by a taxpayer from his brother or sister does qualify as a purchase for purposes of section 179(d)(2).

(iii) The property is not acquired by purchase if acquired from a component member of a controlled group of corporations (as defined in paragraph (g) of this section) by another component member of the same group.

(iv) The property is not acquired by purchase if the basis of the property in the hands of the person acquiring it is determined in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, or is determined under section 1014(a), relating to property acquired from a decedent. For example, property acquired by gift or bequest does not qualify as property acquired by purchase for purposes of section 179(d)(2); nor does property received in a corporate distribution the basis of which is determined under section 301(d)(2)(B), property acquired by a corporation in a transaction to which section 351 applies, property acquired by a partnership through contribution (section 723), or property received in a partnership distribution which has a carryover basis under section 732(a)(1).

(2) Property deemed to have been acquired by a new target corporation as a result of a section 338 election (relating to certain stock purchases treated as asset acquisitions) will be considered acquired by purchase.

(d) *Cost.* The cost of section 179 property does not include so much of the basis of such property as is determined by reference to the basis of other property held at any time by the taxpayer. For example, X Corporation purchases a new drill press costing $10,000 in November 1984 which qualifies as section 179 property, and is granted a trade-in allowance of $2,000 on its old drill press. The old drill press had a basis of $1,200. Under the provisions of sections 1012 and 1031(d), the basis of the new drill press is $9,200 ($1,200 basis of oil drill press plus cash expended of $8,000). However, only $8,000 of the basis of the new drill press qualifies as cost for purposes of the section 179 expense deduction; the remaining $1,200 is not part of the cost because it is determined by reference to the basis of the old drill press.

(e) *Placed in service.* The term *placed in service* means the time that property is first placed by the taxpayer in a condition or state of readiness and availability for a specifically assigned function, whether for use in a trade or business, for the production of income, in a tax-exempt activity, or in a personal activity. See §1.46–3(d)(2) for examples regarding when property shall be considered in a condition or state of readiness and availability for a specifically assigned function.

(f) *Controlled group of corporations and component member of controlled group.* The terms *controlled group of corporations* and *component member* of a controlled group of corporations shall have the same meaning assigned to those terms in section 1563 (a) and (b), except that the phrase ''more than 50 percent'' shall be substituted for the phrase ''at least 80 percent'' each place it appears in section 1563(a)(1).

[T.D. 8121, 52 FR 413, Jan. 6, 1987. Redesignated by T.D. 8455, 57 FR 61321, 61323, Dec. 24, 1992]

§1.179–5 Time and manner of making election.

(a) *Election.* A separate election must be made for each taxable year in which a section 179 expense deduction is claimed with respect to section 179 property. The election under section 179 and §1.179–1 to claim a section 179 expense deduction for section 179 property shall be made on the taxpayer's first income tax return for the taxable year to which the election applies (whether or not the return is timely) or on an amended return filed within the time prescribed by law (including extensions) for filing the return for such taxable year. The election shall be made by showing as a separate item on the taxpayer's income tax return the following items:

(1) The total section 179 expense deduction claimed with respect to all section 179 property selected, and

(2) The portion of that deduction allocable to each specific item.

The person shall maintain records which permit specific identification of each piece of section 179 property and reflect how and from whom such property was acquired and when such property was placed in service. However, for this purpose a partner (or an S corporation shareholder) treats partnership (or S corporation) section 179 property for which section 179 expenses are allocated from a partnership (or an S corporation) as one item of section 179 property. The election to claim a section 179 expense deduction under this section, with respect to any property, is irrevocable and will be binding on the taxpayer with respect to such property for the taxable year for which the election is made and for all subsequent taxable years, unless the Commissioner consents to the revocation of the election. Similarly, the selection of section 179 property by the taxpayer to be subject to the expense deduction and apportionment scheme must be adhered to in computing the taxpayer's taxable income for the taxable year for which the election is made and for all subsequent taxable years, unless consent to change is given by the Commissioner.

(b) *Revocation.* Any election made under section 179, and any specification contained in such election, may not be revoked except with the consent of the Commissioner. Such consent will be granted only in extraordinary circumstances. Requests for consent must be filed with the Commissioner of Internal Revenue, Washington, DC 20224. The request must include the name, address, and taxpayer identification number of the taxpayer and must be signed by the taxpayer or his duly authorized representative. It must be accompanied by a statement showing the year and property involved, and must set forth in detail the reasons for the request.

[T.D. 8121, 52 FR 414, Jan. 6, 1987. Redesignated by T.D. 8455, 57 FR 61321, 61323, Dec. 24, 1992]

§1.179–6 Effective date.

The provisions of §§1.179–1 through 1.179–5 are effective for property placed in service in taxable years ending after January 25, 1993. However, a taxpayer may apply the provisions of §§1.179–1 through 1.179–5 to property placed in service after December 31, 1986, in taxable years ending on or before January 25, 1993. Otherwise, for property placed in service after December 31, 1986, in taxable years ending on or before January 25, 1993, the final regulations under section 179 as in effect for the year the property was placed in service apply, except to the extent modified by the changes made to section 179 by the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, and the Revenue Reconciliation Act of 1990. For that property, a taxpayer may apply any reasonable method that clearly reflects income in applying the changes to section 179, provided the taxpayer consistently applies the method to the property.

[T.D. 8455, 57 FR 61323, Dec. 24, 1992]

§ 1.179A–1 Recapture of deduction for qualified clean-fuel vehicle property and qualified clean-fuel vehicle refueling property.

(a) *In general.* If a recapture event occurs with respect to a taxpayer's qualified clean-fuel vehicle property or qualified clean-fuel vehicle refueling property, the taxpayer must include the recapture amount in taxable income for the taxable year in which the recapture event occurs.

(b) *Recapture event*—(1) *Qualified clean-fuel vehicle property*—(i) *In general.* A recapture event occurs if, within 3 full years from the date a vehicle of which qualified clean-fuel vehicle property is a part is placed in service, the property ceases to be qualified clean-fuel vehicle property. Property ceases to be qualified clean-fuel vehicle property if—

(A) The vehicle is modified by the taxpayer so that it may no longer be propelled by a clean-burning fuel;

(B) The vehicle is used by the taxpayer in a manner described in section 50(b);

(C) The vehicle otherwise ceases to qualify as property defined in section 179A(c); or

(D) The taxpayer receiving the deduction under section 179A sells or disposes of the vehicle and knows or has reason to know that the vehicle will be used in a manner described in paragraph (b)(1)(i) (A), (B), or (C) of this section.

(ii) *Exception for disposition.* Except as provided in paragraph (b)(1)(i)(D) of this section, a sale or other disposition (including a disposition by reason of an accident or other casualty) of qualified clean-fuel vehicle property is not a recapture event.

(2) *Qualified clean-fuel vehicle refueling property*—(i) *In general.* A recapture event occurs if, at any time before the end of its recovery period, the property ceases to be qualified clean-fuel vehicle refueling property. Property ceases to be qualified clean-fuel vehicle refueling property if—

(A) The property no longer qualifies as property described in section 179A(d);

(B) The property is no longer used predominantly in a trade or business (property will be treated as no longer used predominantly in a trade or business if 50 percent or more of the use of the property in a taxable year is for use other than in a trade or business);

(C) The property is used by the taxpayer in a manner described in section 50(b); or

(D) The taxpayer receiving the deduction under section 179A sells or disposes of the property and knows or has reason to know that the property will be used in a manner described in paragraph (b)(2)(i) (A), (B), or (C) of this section.

(ii) *Exception for disposition.* Except as provided in paragraph (b)(2)(i)(D) of this section, a sale or other disposition (including a disposition by reason of an accident or other casualty) of qualified clean-fuel vehicle refueling property is not a recapture event.

(c) *Recapture date*—(1) *Qualified clean-fuel vehicle property.* The recapture date is the actual date of the recapture event unless an event described in paragraph (b)(1)(i)(B) of this section occurs, in which case the recapture date is the first day of the recapture year.

(2) *Qualified clean-fuel vehicle refueling property.* The recapture date is the actual date of the recapture event unless the recapture occurs as a result of an event described in paragraph (b)(2)(i) (B) or (C) of this section, in which case the recapture date is the first day of the recapture year.

(d) *Recapture amount*—(1) *Qualified clean-fuel vehicle property.* The recapture amount is equal to the benefit of the section 179A deduction allowable multiplied by the recapture percentage. The recapture percentage is—

(i) 100, if the recapture date is within the first full year after the date the vehicle is placed in service;

(ii) 66⅔, if the recapture date is within the second full year after the date the vehicle is placed in service; or

(iii) 33⅓, if the recapture date is within the third full year after the date the vehicle is placed in service.

(2) *Qualified clean-fuel vehicle refueling property.* The recapture amount is equal to the benefit of the section 179A deduction allowable multiplied by the following fraction. The numerator of the fraction equals the total recovery period for the property minus the number of recovery years prior to, but not including, the recapture year. The denominator of the fraction equals the total recovery period.

(e) *Basis adjustment.* As of the first day of the taxable year in which the recapture event occurs, the basis of the vehicle of which qualified clean-fuel vehicle property is a part or the basis of qualified clean-fuel vehicle refueling property is increased by the recapture amount. For a vehicle or refueling property that is of a character that is subject to an allowance for depreciation, this increase in basis is recoverable over its remaining recovery period beginning as of the first day of the taxable year in which the recapture event occurs.

(f) *Application of section 1245 for sales and other dispositions.* For purposes of section 1245, the amount of the deduction allowable under section 179A(a) with respect to any property that is (or has been) of a character subject to an allowance for depreciation is treated as a deduction allowed for depreciation under section 167. Therefore, upon a sale or other disposition of depreciable qualified clean-fuel vehicle refueling property or a depreciable vehicle of which qualified clean-fuel vehicle property is a part, section 1245 will apply to any gain recognized to the extent the basis of the depreciable property or vehicle was reduced under section 179A(e)(6) net of any basis increase described in paragraph (e) of this section.

(g) *Examples.* The following examples illustrate the provisions of this section:

Example 1. A, a calendar-year taxpayer, purchases and places in service for personal use on January 1, 1995, a clean-fuel vehicle, a portion of which is qualified clean-fuel vehicle property, costing $25,000. The qualified clean-fuel vehicle property costs $11,000. On A's 1995 federal income tax return, A claims a section 179A deduction of $2,000. On January 2, 1996, A sells the vehicle to an unrelated third party who subsequently converts the vehicle into a gasoline-propelled vehicle on October 15, 1996. There is no recapture upon the sale of the vehicle by A provided A did not know or have reason to know that the purchaser intended to convert the vehicle to a gasoline-propelled vehicle.

Example 2. B, a calendar-year taxpayer, purchases and places in service for personal use on October 11, 1994, a clean-fuel vehicle costing $20,000, a portion of which is qualified clean-fuel vehicle property. The qualified clean-fuel vehicle property costs $10,000. On B's 1994 federal income tax return, B claims a deduction of $2,000, which reduces B's gross income by $2,000. The basis of the vehicle is reduced to $18,000 ($20,000 − $2,000). On January 31, 1996, B sells the vehicle to a tax-exempt entity. Because B knowingly sold the vehicle to a tax-exempt entity described in section 50(b) in the second full year from the date the vehicle was placed in service, B must recapture $1,333 ($2,000 × 66⅔ percent). This recapture amount increases B's gross income by $1,333 on B's 1996 federal income tax return and is added to the basis of the motor vehicle as of January 1, 1996, the beginning of the taxable year of recapture.

Example 3. X, a calendar-year taxpayer, purchases and places in service for its business use on January 1, 1994, qualified clean-fuel vehicle refueling property costing $400,000. Assume this property has a 5-year recovery period. On X's 1994 federal income tax return, X claims a deduction of $100,000, which reduces X's gross income by $100,000. The basis of the property is reduced to $300,000 ($400,000 − $100,000) prior to any adjustments for depreciation. In 1996, more than 50 percent of the use of the property is other than in X's trade or business.

Because the property is no longer used predominantly in X's business, X must recapture three-fifths of the section 179A deduction or $60,000 ($100,000×(5–2)/5 = $60,000) and include that amount in gross income on its 1996 federal income tax return. The recapture amount of $60,000 is added to the basis of the property as of January 1, 1996, the beginning of the taxable year of recapture, and to the extent the property remains depreciable, the adjusted basis is recoverable over the remaining recovery period.

Example 4. X, a calendar-year taxpayer, purchases and places in service for business use on January 1, 1994, qualified clean-fuel vehicle refueling property costing $350,000. Assume this property has a 5-year recovery period. On X's 1994 federal income tax return, X claims a deduction of $100,000, which reduces X's gross income by $100,000. The basis of the property is reduced to $250,000 ($350,000 − $100,000) prior to any adjustments for depreciation. In 1995, X converts the property to store and dispense gasoline. Because the property is no longer used as qualified clean-fuel vehicle refueling property in 1995, X must recapture four-fifths of the section 179A deduction or $80,000 ($100,000×(5–1)/5 = $80,000) and include that amount in gross income on its 1995 federal income tax return. The recapture amount of $80,000 is added to the basis of the property as of January 1, 1995, the beginning of the taxable year of recapture, and to the extent the property remains depreciable, the adjusted basis is recoverable over the remaining recovery period.

Example 5. The facts are the same as in *Example 4.* In 1996, X sells the refueling property for $351,000, recognizing a gain from this sale. Under paragraph (f) of this section, section 1245 will apply to any gain recognized on the sale of depreciable property to the extent the basis of the property was reduced by the section 179A deduction net of any basis increase from recapture of the section 179A deduction. Accordingly, the gain from the sale of the property is subject to section 1245 to the extent of the depreciation allowance for the property plus the deduction allowed under section 179A ($100,000), less the previous recapture amount ($80,000). Any remaining amount of gain may be subject to other applicable provisions of the Internal Revenue Code.

(h) *Effective date.* This section is effective on October 14, 1994. If the recapture date is before the effective date of this section, a taxpayer may use any reasonable method to recapture the benefit of any deduction allowable under section 179A(a) consistent with section 179A and its legislative history. For this purpose, the recapture date is defined in paragraph (c) of this section.

[T.D.8606, 60 FR 39651, Aug. 3, 1995]

§ 1.180–1 Expenditures by farmers for fertilizer, etc.

(a) *In general.* A taxpayer engaged in the business of farming may elect, for any taxable year beginning after December 31, 1959, to treat as deductible expenses those expenditures otherwise chargeable to capital account which are paid or incurred by him during the taxable year for the purchase or acquisition of fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming, and those expenditures otherwise chargeable to capital account paid or incurred for the application of such items and materials to such land. No election is required to be made for those expenditures which are not capital in nature. Section 180, § 1.180–2, and this section are not applicable to those expenses which are deductible under section 162 and the regulations thereunder or which are subject to the method described in section 175 and the regulations thereunder.

(b) *Land used in farming.* For purposes of section 180(a) and of paragraph (a) of this section, the term *land used in farming* means land used (before or simultaneously with the expenditures described in such section and such paragraph) by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock. See section 180(b). Expenditures for the initial preparation of land never previously used for farming purposes by the taxpayer or his tenant (although chargeable to capital account) are not subject to the election. The principles stated in §§ 1.175–3 and 1.175–4 are equally applicable under this section in determining whether the taxpayer is engaged in the business of farming and whether the land is used in farming.

(74 Stat. 1001, 26 U.S.C. 180)

[T.D. 6548, 26 FR 1486, Feb. 22, 1961]

§ 1.180–2 Time and manner of making election and revocation.

(a) *Election.* The claiming of a deduction on the taxpayer's return for an amount to which section 180 applies for amounts (otherwise chargeable to capital account) expended for fertilizer, lime, etc., shall constitute an election under section 180 and paragraph (a) of § 1.180–1. Such election shall be effective only for the taxable year for which the deduction is claimed.

(b) *Revocation.* Once the election is made for any taxable year such election may not be revoked without the consent of the district director for the district in which the taxpayer's return is required to be filed. Such requests for consent shall be in writing and signed by the taxpayer or his authorized representative and shall set forth:

(1) The name and address of the taxpayer;

(2) The taxable year to which the revocation of the election is to apply;

(3) The amount of expenditures paid or incurred during the taxable year, or portions thereof (where applicable), previously taken as a deduction on the

return in respect of which the revocation of the election is to be applicable; and

(4) The reasons for the request to revoke the election.

(74 Stat. 1001, 26 U.S.C. 180)

[T.D. 6548, 26 FR 1486, Feb. 22, 1961]

§1.182–1 Expenditures by farmers for clearing land; in general.

Under section 182, a taxpayer engaged in the business of farming may elect, in the manner provided in §1.182–6, to deduct certain expenditures paid or incurred by him in any taxable year beginning after December 31, 1962, in the clearing of land. The expenditures to which the election applies are all expenditures paid or incurred during the taxable year in clearing land for the purpose of making the ‘‘land suitable for use in farming’’ (as defined in §1.182–4) which are not otherwise deductible (exclusive of expenditures for or in connection with depreciable items referred to in paragraph (b)(1) of §1.182–3), but only if such expenditures are made in furtherance of the taxpayer’s business of farming. The term *expenditures* to which the election applies also includes a reasonable allowance for depreciation (not otherwise allowable) on equipment used in the clearing of land provided such equipment, if used in the carrying on of a trade or business, would be subject to the allowance for depreciation under section 167. (See paragraph (c) of §1.182–3.) (See section 175 and the regulations thereunder for deductibility of certain expenditures for treatment or moving of earth by a farmer where the land already qualifies as land used in farming as defined in §1.175–4.) The amount deductible for any taxable year is limited to the lesser of $5,000 or 25 percent of the taxable income derived from farming (as defined in paragraph (a)(2) of §1.182–5) during the taxable year. Expenditures paid or incurred in a taxable year in excess of the amount deductible under section 182 for such taxable year shall be treated as capital expenditures and shall constitute an adjustment to the basis of the land under section 1016(a).

[T.D. 6794, 30 FR 790, Jan. 26, 1965]

§1.182–2 Definition of “the business of farming.”

Under section 182, the election to deduct expenditures incurred in the clearing of land is applicable only to a taxpayer who is engaged in ‘‘the business of farming’’ during the taxable year. A taxpayer is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant. For purposes of section 182, a taxpayer who receives a rental (either in cash or in kind) which is based upon farm production is engaged in the business of farming. However, a taxpayer who receives a fixed rental (without reference to production) is engaged in the business of farming only if he participates to a material extent in the operation or management of the farm. A taxpayer engaged in forestry or the growing of timber is not thereby engaged in the business of farming. A person cultivating or operating a farm for recreation or pleasure rather than for profit is not engaged in the business of farming. For purposes of section 182 and this section, the term *farm* is used in its ordinary, accepted sense and includes stock, dairy, poultry, fish, fruit, and truck farms, and also plantations, ranches, ranges, and orchards. A fish farm is an area where fish are grown or raised, as opposed to merely caught or harvested; that is, an area where they are artificially fed, protected, cared for, etc. A taxpayer is engaged in ‘‘the business of farming’’ if he is a member of a partnership engaged in the business of farming. See §1.702–1.

[T.D. 6794, 30 FR 790, Jan. 26, 1965]

§1.182–3 Definition, exceptions, etc., relating to deductible expenditures.

(a) *Clearing of land.* (1) For purposes of section 182, the term *clearing of land* includes (but is not limited to):

(i) The removal of rocks, stones, trees, stumps, brush or other natural impediments to the use of the land in farming through blasting, cutting, burning, bulldozing, plowing, or in any other way;

(ii) The treatment or moving of earth, including the construction, repair or removal of nondepreciable earthen structures, such as dikes or levies, if the purpose of such treatment or moving of earth is to protect, level, contour, terrace, or condition the land so as to permit its use as farming land; and

(iii) The diversion of streams and watercourses, including the construction of nondepreciable drainage facilities, provided that the purpose is to remove or divert water from the land so as to make it available for use in farming.

(2) The following are examples of land clearing activities:

(i) The cutting of trees, the blasting of the resulting stumps, and the burning of the residual undergrowth;

(ii) The leveling of land so as to permit irrigation or planting;

(iii) The removal of salt or other minerals which might inhibit cultivation of the soil;

(iv) The draining and filling in of a swamp or marsh; and

(v) The diversion of a stream from one watercourse to another.

(b) *Expenditures not allowed as a deduction under section 182.* (1) Section 182 applies only to expenditures for nondepreciable items. Accordingly, a taxpayer may not deduct expenditures for the purchase, construction, installation, or improvement of structures, appliances, or facilities which are of a character which is subject to the allowance for depreciation under section 167 and the regulations thereunder. Expenditures in respect of such depreciable property include those for materials, supplies, wages, fuel, freight, and the moving of earth, paid or incurred with respect to tanks, reservoirs, pipes, conduits, canals, dams, wells, or pumps constructed of masonry, concrete, tile, metal, wood, or other nonearthen material.

(2) Expenditures which are deductible without regard to section 182 are not deductible under section 182. Thus, such expenditures are deductible without being subject to the limitations imposed by section 182(b) and § 1.182–5. For example, section 182 does not apply to the ordinary and necessary expenses incurred in the business of farming which are deductible under section 162 even though they might otherwise be considered to be clearing of land expenditures. Section 182 also does not apply to interest (deductible under section 163) nor to taxes (deductible under section 164). Similarly, section 182 does not apply to any expenditures (whether or not currently deductible) paid or incurred for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion of land used in farming, within the meaning of section 175 and the regulations thereunder, nor to expenditures deductible under section 180 and the regulations thereunder, relating to expenditures for fertilizer, etc.

(c) *Depreciation.* In addition to expenditures for the activities described in paragraph (a) of this section, there also shall be treated as an expenditure to which section 182 applies a reasonable allowance for depreciation not otherwise deductible on property of the taxpayer which is used in the clearing of land for the purpose of making such land suitable for use in farming, provided the property is property which, if used in a trade or business, would be subject to the allowance for depreciation under section 167. Depreciation allowable as a deduction under section 182 is limited to the portion of depreciation which is attributable to the use of the property in the clearing of land. The depreciation shall be computed in accordance with section 167 and the regulations thereunder. To the extent an amount representing a reasonable allowance for depreciation with respect to property used in clearing land is treated as an expenditure to which section 182 applies, such depreciation shall, for purposes of chapter 1 of the Code, be treated as an amount allowed under section 167 for depreciation. Thus, if a deduction is allowed for depreciation under section 182 in respect of property used in clearing land, proper adjustment to the basis of the property so used shall be made under section 1016(a).

[T.D. 6794, 30 FR 791, Jan. 26, 1965]

§ 1.182–4 Definition of "land suitable for use in farming", etc.

For purposes of section 182, the term *land suitable for use in farming* means land which, as a result of the land clearing activities described in paragraph (a) of § 1.182–3, could be used by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products, including fish, or for the sustenance of livestock. The term *livestock* includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry. Land used for the sustenance of livestock includes land used for grazing such livestock. Expenditures are considered to be for the purpose of making land suitable for use in farming by the taxpayer or his tenant only if made to prepare the land which is cleared for use by the taxpayer or his tenant in farming. Thus, if the taxpayer pays or incurs expenditures to clear land for the purpose of sale (whether or not for use in farming by the purchaser) or to be held by the taxpayer or his tenant other than for use in farming, section 182 does not apply to such expenditures. Whether the land is cleared for the purpose of making it suitable for use in farming by the taxpayer or his tenant, is a question of fact which must be resolved on the basis of all the relevant facts and circumstances. For purposes of section 182, it is not necessary that the land cleared actually be used in farming following the clearing activities. However, the fact that following the clearing operation, the land is used by the taxpayer or his tenant in the business of farming will, in most cases, constitute evidence that the purpose of the clearing was to make land suitable for use in farming by the taxpayer or his tenant. On the other hand, if the land cleared is sold or converted to nonfarming use soon after the taxpayer has completed his clearing activities, there will be a presumption that the expenditures were not made for the purpose of making the land suitable for use in farming by the taxpayer or his tenant. Other factors which will be considered in determining the taxpayer's purpose for clearing the land are, for example, the acreage, location, and character of the land cleared, the nature of the taxpayer's farming operation, and the use to which adjoining or nearby land is put.

[T.D. 6794, 30 FR 791, Jan. 26, 1965]

§1.182–5 Limitation.

(a) *Limitation*—(1) *General rule.* The amount of land clearing expenditures which the taxpayer may deduct under section 182 in any one taxable year is limited to the lesser of $5,000 or 25 percent of his ‘‘taxable income derived from farming’’. Expenditures in excess of the applicable limitation are to be charged to the capital account and constitute additions to the taxpayer's basis in the land.

(2) *Definition of ‘‘taxable income derived from farming’’.* For purposes of section 182, the term *taxable income derived from farming* means the gross income derived from the business of farming reduced by the deductions attributable to such gross income. Gross income derived from the business of farming is the gross income of the taxpayer derived from the production of crops, fruits, or other agricultural products, including fish, or from livestock (including livestock held for draft, breeding or dairy purposes). It does not include gains from sales of assets such as farm machinery or gains from the disposition of land. The deductions attributable to the business of farming are all the deductions allowed by Chapter 1 of the Code (other than the deduction allowed by section 182) for expenditures or charges (including depreciation and amortization) paid or incurred in connection with the production or raising of crops, fruits, or other agricultural products, including fish, or livestock. However, the deduction under section 1202 (relating to the capital gains deduction) attributable to gain on the sale or other disposition of assets (other than draft, breeding, or dairy stock), and the net operating loss deduction (computed under section 172) shall not be taken into account in computing ‘‘taxable income derived from farming.’’ Similarly, deductible losses on the sale, disposition, destruction, condemnation, or abandonment of assets (other than draft, breeding, or dairy stock) shall not be considered as deductions attributable to the business of farming. A taxpayer shall compute his gross income from farming in accordance with his accounting method used in determining gross income. (See

the regulations under section 61 relating to accounting methods used by farmers in determining gross income.)

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

Example 1. For the taxable year 1963, A, who uses the cash receipts and disbursements method of accounting, incurs expenditures to which section 182 applies in the amount of $2,000 and makes the election under section 182. A has the following items of income and deductions (without regard to section 182 expenditures).

Income:		
Proceeds from sale of his 1963 yield of corn	$10,000	
Proceeds from sales of milk	8,000	
Gain from disposition of old breeding cows	500	
Gain from sale of tractor	100	
Gain from sale of farmland	5,000	
Interest on loan to brother	100	
	23,700	
Deductions:		
Cost of labor	4,000	
Cost of feed	3,000	
Depreciation on farm equipment and buildings	2,500	
Cost of maintenance, fuel, etc	2,000	
Interest paid, mortgage on farm buildings	1,000	
Interest paid, personal loan	500	
Loss on destruction of barn	2,000	
Loss on sale of truck	300	
Section 1202 deduction—gain on sale of cows (500× 1/2)	250	
Section 1202 deduction—net gain on disposition of section 1231 property, other than cows [$2,800 ($5,100 − $2,300) × 1/2]	1,400	
		$16,950
Net income before section 182 deduction		6,750

For purposes of computing taxable income derived from farming under section 182, the following items of income and deductions are not taken into account:

Income:		
Gain from the sale of tractor	$100	
Gain from the sale of farmland	5,000	
Interest on loan to brother	100	
		$5,200
Deductions:		
Interest paid, personal loan	$500	
Loss on destruction of barn	2,000	
Loss on sale of truck	300	
Section 1202 deduction—Net gain from disposition of 1231 assets other than cows	1,400	
		$4,200

A's ''taxable income derived from farming'' for purposes of section 182 is $5,750; income of $18,500 ($23,700 − $5,200), less deductions of $12,750 ($16,950 − $4,200). A may deduct $1,437.50 (25% of $5,750) under section 182. The excess expenditures in the amount of $562.50 are to be charged to capital account and serve to increase the taxpayer's basis of the land.

Example 2. Assume the same facts as in *Example (1)* and in addition, assume that A is allowed a deduction for a net operating loss carryback from the taxable year 1966 in the amount of $3,000. The net operating loss deduction will not be taken into account in computing A's ''taxable income derived from farming'' for 1963 Accordingly, A will not be required to recompute such taxable income for purposes of applying the limitation on the deduction provided in section 182 and the deduction of $1,437.50 will not be reduced.

[T.D. 6794, 30 FR 791, Jan. 26, 1965]

§ 1.182–6 Election to deduct land clearing expenditures.

(a) *Manner of making election.* The election to deduct expenditures for land clearing provided by section 182(a) shall be made by means of a statement attached to the taxpayer's income tax return for the taxable year for which such election is to apply. The statement shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the time prescribed by law for filing the income tax return (including extensions thereof) for the taxable year for which the election is to apply. The statement shall also set forth the amount and description of the expenditures for land clearing claimed as a deduction under section 182, and shall include a computation of ''taxable income derived from farming'', if the amount of such income is not the same as the net income from farming shown on Schedule F of Form 1040, increased by the amount of the deduction claimed under section 182.

(b) *Scope of election.* An election under section 182(a) shall apply only to the taxable year for which made. However, once made, an election applies to all expenditures described in § 1.182–3 paid or incurred during the taxable year, and is binding for such taxable year unless the district director consents to a revocation of such election. Requests for consent to revoke an election under section 182 shall be made by means of a letter to the district director for the district in which the taxpayer is required to file his return, setting forth the taxpayer's name, address and identification number, the year for which it is desired to revoke the election, and the reasons therefor. However, consent will not be granted where the only reason therefor is a change in tax consequences.

[T.D. 6794, 30 FR 791, Jan. 26, 1965]

§1.183–1 Activities not engaged in for profit.

(a) *In general.* Section 183 provides rules relating to the allowance of deductions in the case of activities (whether active or passive in character) not engaged in for profit by individuals and electing small business corporations, creates a presumption that an activity is engaged in for profit if certain requirements are met, and permits the taxpayer to elect to postpone determination of whether such presumption applies until he has engaged in the activity for at least 5 taxable years, or, in certain cases, 7 taxable years. Whether an activity is engaged in for profit is determined under section 162 and section 212 (1) and (2) except insofar as section 183(d) creates a presumption that the activity is engaged in for profit. If deductions are not allowable under sections 162 and 212 (1) and (2), the deduction allowance rules of section 183(b) and this section apply. Pursuant to section 641(b), the taxable income of an estate or trust is computed in the same manner as in the case of an individual, with certain exceptions not here relevant. Accordingly, where an estate or trust engages in an activity or activities which are not for profit, the rules of section 183 and this section apply in computing the allowable deductions of such trust or estate. No inference is to be drawn from the provisions of section 183 and the regulations thereunder that any activity of a corporation (other than an electing small business corporation) is or is not a business or engaged in for profit. For rules relating to the deductions that may be taken into account by taxable membership organizations which are operated primarily to furnish services, facilities, or goods to members, see section 277 and the regulations thereunder. For the definition of an activity not engaged in for profit, see §1.183–2. For rules relating to the election contained in section 183(e), see §1.183–3.

(b) *Deductions allowable*—(1) *Manner and extent.* If an activity is not engaged in for profit, deductions are allowable under section 183(b) in the following order and only to the following extent:

(i) Amounts allowable as deductions during the taxable year under Chapter 1 of the Code without regard to whether the activity giving rise to such amounts was engaged in for profit are allowable to the full extent allowed by the relevant sections of the Code, determined after taking into account any limitations or exceptions with respect to the allowability of such amounts. For example, the allowability-of-interest expenses incurred with respect to activities not engaged in for profit is limited by the rules contained in section 163(d).

(ii) Amounts otherwise allowable as deductions during the taxable year under Chapter 1 of the Code, but only if such allowance does not result in an adjustment to the basis of property, determined as if the activity giving rise to such amounts was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivision (i) of this subparagraph.

(iii) Amounts otherwise allowable as deductions for the taxable year under Chapter 1 of the Code which result in (or if otherwise allowed would have resulted in) an adjustment to the basis of property, determined as if the activity giving rise to such deductions was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivisions (i) and (ii) of this subparagraph. Deductions falling within this subdivision include such items as depreciation, partial losses with respect to property, partially worthless debts, amortization, and amortizable bond premium.

(2) *Rule for deductions involving basis adjustments*—(i) *In general.* If deductions are allowed under subparagraph (1)(iii) of this paragraph, and such deductions are allowed with respect to more than one asset, the deduction allowed with respect to each asset shall be determined separately in accordance

with the computation set forth in subdivision (ii) of this subparagraph.

(ii) *Basis adjustment fraction.* The deduction allowed under subparagraph (1)(iii) of this paragraph is computed by multiplying the amount which would have been allowed, had the activity been engaged in for profit, as a deduction with respect to each particular asset which involves a basis adjustment, by the basis adjustment fraction:

(a) The numerator of which is the total of deductions allowable under subparagraph (1)(iii) of this paragraph, and

(b) The denominator of which is the total of deductions which involve basis adjustments which would have been allowed with respect to the activity had the activity been engaged in for profit.

The amount resulting from this computation is the deduction allowed under subparagraph (1)(iii) of this paragraph with respect to the particular asset. The basis of such asset is adjusted only to the extent of such deduction.

(3) *Examples.* The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. A, an individual, maintains a herd of dairy cattle, which is an ''activity not engaged in for profit'' within the meaning of section 183(c). A sold milk for $1,000 during the year. During the year A paid $300 State taxes on gasoline used to transport the cows, milk, etc., and paid $1,200 for feed for the cows. For the year A also had a casualty loss attributable to this activity of $500. A determines the amount of his allowable deductions under section 183 as follows:

(i) First, A computes his deductions allowable under subparagraph (1)(i) of this paragraph as follows:

State gasoline taxes specifically allowed under section 164(a)(5) without regard to whether the activity is engaged in for profit	$300
Casualty loss specifically allowed under section 165(c)(3) without regard to whether the activity is engaged in for profit ($500 less $100 limitation)	400
Deductions allowable under subparagraph (1)(i) of this paragraph	700

(ii) Second, A computes his deductions allowable under subparagraph (1)(ii) of this paragraph (deductions which would be allowed under chapter 1 of the Code if the activity were engaged in for profit and which do not involve basis adjustments) as follows:

Maximum amount of deductions allowable under subparagraph (1)(ii) of this paragraph:

Income from milk sales	$1,000
Gross income from activity	1,000
Less: deductions allowable under subparagraph (1)(i) of this paragraph	700
Maximum amount of deductions allowable under subparagraph (1)(ii) of this paragraph	300
Feed for cows	1,200
Deduction allowed under subparagraph (1)(ii) of this paragraph	300

$900 of the feed expense is not allowed as a deduction under section 183 because the total feed expense ($1,200) exceeds the maximum amount of deductions allowable under subparagraph (1)(ii) of this paragraph ($300). In view of these circumstances, it is not necessary to determine deductions allowable under subparagraph (1)(iii) of this paragraph which would be allowable under chapter 1 of the Code if the activity were engaged in for profit and which involve basis adjustment (the $100 of casualty loss not allowable under subparagraph (1)(i) of this paragraph because of the limitation in section 165(c)(3)) because none of such amount will be allowed as a deduction under section 183.

Example 2. Assume the same facts as in *Example (1),* except that A also had income from sales of hay grown on the farm of $1,200 and that depreciation of $750 with respect to a barn, and $650 with respect to a tractor would have been allowed with respect to the activity had it been engaged in for profit. A determines the amount of his allowable deductions under section 183 as follows:

(i) First, A computes his deductions allowable under subparagraph (1)(i) of this paragraph as follows:

State gasoline taxes specifically allowed under section 164(a)(5) without regard to whether the activity is engaged in for profit	$300
Casualty loss specifically allowed under section 165(c)(3) without regard to whether the activity is engaged in for profit ($500 less $100 limitation)	400
Deductions allowable under subparagraph (1)(i) of this paragraph	700

(ii) Second, A computes his deductions allowable under subparagraph (1)(ii) of this paragraph (deductions which would be allowable under chapter 1 of the Code if the activity were engaged in for profit and which do not involve basis adjustments) as follows:

Maximum amount of deductions allowable under subparagraph (1)(ii) of this paragraph:

Income from milk sales	$1,000
Income from hay sales	1,200
Gross income from activity	2,200
Less: deductions allowable under subparagraph (1)(i) of this paragraph	700
Maximum amount of deductions allowable under subparagraph (1)(ii) of this paragraph	1,500
Feed for cows	1,200

The entire $1,200 of expenses relating to feed for cows is allowable as a deduction under subparagraph (1)(ii) of this paragraph, since it does not exceed the maximum amount of deductions allowable under such subparagraph.

(iii) Last, A computes the deductions allowable under subparagraph (1)(iii) of this paragraph (deductions which would be allowable under chapter 1 of the Code if the activity were engaged in for profit and which involve basis adjustments) as follows:

Maximum amount of deductions allowable under subparagraph (1)(iii) of this paragraph:

Gross income from farming		$2,200
Less: Deductions allowed under subparagraph (1)(i) of this paragraph	$700	
Deductions allowed under subparagraph (1)(ii) of this paragraph	1,200	1,900
Maximum amount of deductions allowable under subparagraph (1)(iii) of this paragraph		300

(iv) Since the total of A's deductions under chapter 1 of the Code (determined as if the activity was engaged in for profit) which involve basis adjustments ($750 with respect to barn, $650 with respect to tractor, and $100 with respect to limitation on casualty loss) exceeds the maximum amount of the deductions allowable under subparagraph (1)(iii) of this paragraph ($300), A computes his allowable deductions with respect to such assets as follows:

A first computes his basis adjustment fraction under subparagraph (2)(ii) of this paragraph as follows:

The numerator of the fraction is the maximum of deductions allowable under subparagraph (1)(iii) of this paragraph which involve basis adjustments	$300
The denominator of the fraction is the total of deductions that involve basis adjustments which would have been allowed with respect to the activity had the activity been engaged in for profit	1,500

The basis adjustment fraction is then applied to the amount of each deduction which would have been allowable if the activity were engaged in for profit and which involves a basis adjustment as follows:

Depreciation allowed with respect to barn (300/1,500×$750)	$150
Depreciation allowed with respect to tractor (300/1,500×$650)	130
Deduction allowed with respect to limitation on casualty loss (300/1,500×$100)	20

The basis of the barn and of the tractor are adjusted only by the amount of depreciation actually allowed under section 183 with respect to each (as determined by the above computation). The basis of the asset with regard to which the casualty loss was suffered is adjusted only to the extent of the amount of the casualty loss actually allowed as a deduction under subparagraph (1) (i) and (iii) of this paragraph.

(4) *Rule for capital gains and losses*—(i) *In general.* For purposes of section 183 and the regulations thereunder, the gross income from any activity not engaged in for profit includes the total of all capital gains attributable to such activity determined without regard to the section 1202 deduction. Amounts attributable to an activity not engaged in for profit which would be allowable as a deduction under section 1202, without regard to section 183, shall be allowable as a deduction under section 183(b)(1) in accordance with the rules stated in this subparagraph.

(ii) *Cases where deduction not allowed under section 183.* No deduction is allowable under section 183(b)(1) with respect to capital gains attributable to an activity not engaged in for profit if:

(a) Without regard to section 183 and the regulations thereunder, there is no excess of net long-term capital gain over net short-term capital loss for the year, or

(b) There is no excess of net long-term capital gain attributable to the activity over net short-term capital loss attributable to the activity.

(iii) *Allocation of deduction.* If there is:

(a) An excess of net long-term capital gain over net short-term capital loss attributable to an activity not engaged in for profit, and

(b) Such an excess attributable to all activities, determined without regard to section 183 and the regulations thereunder, the deduction allowable under section 183(b)(1) attributable to capital gains with respect to each activity not engaged in for profit (with respect to which there is an excess of net long-term capital gain over net short-term capital loss for the year) shall be an amount equal to the deduction allowable under section 1202 for the taxable year (determined without regard to section 183) multiplied by a fraction the numerator of which is the excess of the net long-term capital gain attributable to the activity over the net short-term capital loss attributable to the activity and the denominator of which is an amount equal to the total excess of net long-term capital gain over net short-term capital loss for all activities with respect to which there is such excess. The amount

of the total section 1202 deduction allowable for the year shall be reduced by the amount determined to be allocable to activities not engaged in for profit and accordingly allowed as a deduction under section 183(b)(1).

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

Example. A, an individual who uses the cash receipts and disbursement method of accounting and the calendar year as the taxable year, has three activities not engaged in for profit. For his taxable year ending on December 31, 1973, A has a $200 net long-term capital gain from activity No. 1, a $100 net short-term capital loss from activity No. 2, and a $300 net long-term capital gain from activity No. 3. In addition, A has a $500 net long-term capital gain from another activity which he engages in for profit. A computes his deductions for capital gains for calendar year 1973 as follows:

Section 1202 deduction without regard to section 183 is determined as follows:

Net long-term capital gain from activity No. 1	$200
Net long-term capital gain from activity No. 3	300
Net long-term capital gain from activity engaged in for profit	500
Total net long-term capital gain from all activities	1,000
Less: Net short-term capital loss attributable to activity No. 2	100
Aggregate net long-term capital gain over net short-term capital loss from all activities	900
Section 1202 deduction determined without regard to section 183 (one-half of $900)	$450

Allocation of the total section 1202 deduction among A's various activities:

Portion allocable to activity No. 1 which is deductible under section 183(b)(1) (Excess net long-term capital gain attributable to activity No. 1 ($200) over total excess net long-term capital gain attributable to all of A's activities with respect to which there is such an excess ($1,000) times amount of section 1202 deduction ($450))	90
Portion allocable to activity No. 3 which is deductible under section 183(b)(1) (Excess net long-term capital gain attributable to activity No. 3 ($300) over total excess net long-term capital gain attributable to all of A's activities with respect to which there is such an excess ($1,000) times amount of section 1202 deduction ($450))	135
Portion allocable to all activities engaged in for profit (total section 1202 deduction ($450) less section 1202 deduction allowable to activities Nos. 1 and 3 ($225))	225
Total section 1202 deduction deductible under sections 1202 and 183(b)(1)	450

(c) *Presumption that activity is engaged in for profit*—(1) *In general.* If for:

(i) Any 2 of 7 consecutive taxable years, in the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, or

(ii) Any 2 of 5 consecutive taxable years, in the case of any other activity, the gross income derived from an activity exceeds the deductions attributable to such activity which would be allowed or allowable if the activity were engaged in for profit, such activity is presumed, unless the Commissioner establishes to the contrary, to be engaged in for profit. For purposes of this determination the deduction permitted by section 1202 shall not be taken into account. Such presumption applies with respect to the second profit year and all years subsequent to the second profit year within the 5- or 7-year period beginning with the first profit year. This presumption arises only if the activity is substantially the same activity for each of the relevant taxable years, including the taxable year in question. If the taxpayer does not meet the requirements of section 183(d) and this paragraph, no inference that the activity is not engaged in for profit shall arise by reason of the provisions of section 183. For purposes of this paragraph, a net operating loss deduction is not taken into account as a deduction. For purposes of this subparagraph a short taxable year constitutes a taxable year.

(2) *Examples.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples, in each of which it is assumed that the taxpayer has not elected, in accordance with section 183(e), to postpone determination of whether the presumption described in section 183(d) and this paragraph is applicable.

Example 1. For taxable years 1970–74, A, an individual who uses the cash receipts and disbursement method of accounting and the calendar year as the taxable year, is engaged in the activity of farming. In taxable years 1971, 1973, and 1974, A's deductible expenditures with respect to such activity exceed his gross income from the activity. In taxable years 1970 and 1972 A has income from the sale of farm produce of $30,000 for each year. In each of such years A had expenses for feed for his livestock of $10,000, depreciation of equipment of $10,000, and fertilizer cost of $5,000 which he elects to take as a deduction. A also has a net operating loss carryover to taxable year 1970 of $6,000. A is presumed, for taxable years 1972, 1973, and 1974, to have engaged in the activity of farming for profit, since for 2 years of a 5-consecutive-year period the gross income from the activity ($30,000 for each year) exceeded the deductions (computed without regard to the net operating loss) which are allowable in the case of the activity ($25,000 for each year).

Example 2. For the taxable years 1970 and 1971, B, an individual who uses the cash receipts and disbursement method of accounting and the calendar year as taxable year, engaged in raising pure-bred Charolais cattle for breeding purposes. The operation showed a loss during 1970. At the end of 1971, B sold a substantial portion of his herd and the cattle operation showed a profit for that year. For all subsequent relevant taxable years B continued to keep a few Charolais bulls at stud. In 1972, B started to raise Tennessee Walking Horses for breeding and show purposes, utilizing substantially the same pasture land, barns, and (with structural modifications) the same stalls. The Walking Horse operations showed a small profit in 1973 and losses in 1972 and 1974 through 1976.

(i) Assuming that under paragraph (d)(1) of this section the raising of cattle and raising of horses are determined to be separate activities, no presumption that the Walking Horse operation was carried on for profit arises under section 183(d) and this paragraph since this activity was not the same activity that generated the profit in 1971 and there are not, therefore, 2 profit years attributable to the horse activity.

(ii) Assuming the same facts as in (i) above, if there were no stud fees received in 1972 with respect to Charolais bulls, but for 1973 stud fees with respect to such bulls exceed deductions attributable to maintenance of the bulls in that year, the presumption will arise under section 183(d) and this paragraph with respect to the activity of raising and maintaining Charolais cattle for 1973 and for all subsequent years within the 5-year period beginning with taxable year 1971, since the activity of raising and maintaining Charolais cattle is the same activity in 1971 and in 1973, although carried on by B on a much reduced basis and in a different manner. Since it has been assumed that the horse and cattle operations are separate activities, no presumption will arise with respect to the Walking Horse operation because there are not 2 profit years attributable to such horse operation during the period in question.

(iii) Assuming, alternatively, that the raising of cattle and raising of horses would be considered a single activity under paragraph (d)(1) of this section, B would receive the benefit of the presumption beginning in 1973 with respect to both the cattle and horses since there were profits in 1971 and 1973. The presumption would be effective through 1977 (and longer if there is an excess of income over deductions in this activity in 1974, 1975, 1976, or 1977 which would extend the presumption) if, under section 183(d) and subparagraph (3) of this paragraph, it was determined that the activity consists in major part of the breeding, training, showing, or racing of horses. Otherwise, the presumption would be effective only through 1975 (assuming no excess of income over deductions in this activity in 1974 or 1975 which would extend the presumption).

(3) *Activity which consists in major part of the breeding, training, showing, or racing of horses.* For purposes of this paragraph an activity consists in major part of the breeding, training, showing, or racing of horses for the taxable year if the average of the portion of expenditures attributable to breeding, training, showing, and racing of horses for the 3 taxable years preceding the taxable year (or, in the case of an activity which has not been conducted by the taxpayer for 3 years, for so long as it has been carried on by him) was at least 50 percent of the total expenditures attributable to the activity for such prior taxable years.

(4) *Transitional rule.* In applying the presumption described in section 183(d) and this paragraph, only taxable years beginning after December 31, 1969, shall be taken into account. Accordingly, in the case of an activity referred to in subparagraph (1) (i) or (ii) of this paragraph, section 183(d) does not apply prior to the second profitable taxable year beginning after December 31, 1969, since taxable years prior to such date are not taken into account.

(5) *Cross reference.* For rules relating to section 183(e) which permits a taxpayer to elect to postpone determination of whether any activity shall be presumed to be “an activity engaged in for profit” by operation of the presumption described in section 183(d) and this paragraph until after the close of the fourth taxable year (sixth taxable year, in the case of activity which consists in major part of breeding, training, showing, or racing of horses) following the taxable year in which the taxpayer first engages in the activity, see §1.183–3.

(d) *Activity defined*—(1) *Ascertainment of activity.* In order to determine whether, and to what extent, section 183 and the regulations thereunder apply, the activity or activities of the taxpayer must be ascertained. For instance, where the taxpayer is engaged in several undertakings, each of these may be a separate activity, or several undertakings may constitute one activity. In ascertaining the activity or activities of the taxpayer, all the facts and circumstances of the case must be taken into account. Generally, the most significant facts and circumstances in making this determination are the degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting, and the similarity of various undertakings. Generally, the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities. The taxpayer's characterization will not be accepted, however, when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case. If the taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying section 183. Where land is purchased or held primarily with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value. Thus, the farming and holding of the land will be considered a single activity only if the income derived from farming exceeds the deductions attributable to the farming activity which are not directly attributable to the holding of the land (that is, deductions other than those directly attributable to the holding of the land such as interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land).

(2) *Rules for allocation of expenses.* If the taxpayer is engaged in more than one activity, an item of deduction or income may be allocated between two or more of these activities. Where property is used in several activities, and one or more of such activities is determined not to be engaged in for profit, deductions relating to such property must be allocated between the various activities on a reasonable and consistently applied basis.

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

Example. (i) A, an individual, owns a small house located near the beach in a resort community. Visitors come to the area for recreational purposes during only 3 months of the year. During the remaining 9 months of the year houses such as A's are not rented. Customarily, A arranges that the house will be leased for 2 months of 3-month recreational season to vacationers and reserves the house for his own vacation during the remaining month of the recreational season. In 1971, A leases the house for 2 months for $1,000 per month and actually uses the house for his own vacation during the other month of the recreational season. For 1971, the expenses attributable to the house are $1,200 interest, $600 real estate taxes, $600 maintenance, $300 utilities, and $1,200 which would have been allowed as depreciation had the activity been engaged in for profit. Under these facts and circumstances, A is engaged in a single activity, holding the beach house primarily for personal purposes, which is an ''activity not engaged in for profit'' within the meaning of section 183(c). See paragraph (b)(9) of § 1.183–2.

(ii) Since the $1,200 of interest and the $600 of real estate taxes are specifically allowable as deductions under sections 163 and 164(a) without regard to whether the beach house activity is engaged in for profit, no allocation of these expenses between the uses of the beach house is necessary. However, since section 262 specifically disallows personal, living, and family expenses as deductions, the maintenance and utilities expenses and the depreciation from the activity must be allocated between the rental use and the personal use of the beach house. Under the particular facts and circumstances, 2/3 (2 months of rental use over 3 months of total use) of each of these expenses are allocated to the rental use, and 1/3 (1 month of personal use over 3 months of total use) of each of these expenses are allocated to the personal use as follows:

	Rental use 2/3 —expenses allocable to section 183(b)(2)	Personal use 1/3 —expenses allocable to section 262
Maintenance expense $600	$400	$200
Utilities expense $300	200	100
Depreciation $1,200	800	400
Total	1,400	700

The $700 of expenses and depreciation allocated to the personal use of the beach house are disallowed as a deduction under section 262. In addition, the allowability of each of the expenses and the depreciation allocated to section 183(b)(2) is determined under paragraph (b)(1) (ii) and (iii) of this section. Thus, the maximum amount allowable as a deduction under section 183(b)(2) is $200 ($2,000 gross income from activity, less $1,800 deductions under section 183(b)(1)). Since the amounts described in section 183(b)(2) ($1,400) exceed the maximum amount allowable ($200), and since the amounts described in paragraph (b)(1)(ii) of this section ($600) exceed such maximum amount allowable ($200), none of the depreciation (an amount described in paragraph (b)(1)(iii) of this section) is allowable as a deduction.

(e) *Gross income from activity not engaged in for profit defined.* For purposes of section 183 and the regulations thereunder, gross income derived from an activity not engaged in for profit includes the total of all gains from the sale, exchange, or other disposition of property, and all other gross receipts derived from such activity. Such gross income shall include, for instance, capital gains, and rents received for the use of property which is held in connection with the activity. The taxpayer may determine gross income from any activity by subtracting the cost of goods sold from the gross receipts so long as he consistently does so and follows generally accepted methods of accounting in determining such gross income.

(f) *Rule for electing small business corporations.* Section 183 and this section shall be applied at the corporate level in determining the allowable deductions of an electing small business corporation.

[T.D. 7198, 37 FR 13680, July 13, 1972]

§1.183–2 Activity not engaged in for profit defined.

(a) *In general.* For purposes of section 183 and the regulations thereunder, the term *activity not engaged in for profit* means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212. Deductions are allowable under section 162 for expenses of carrying on activities which constitute a trade or business of the taxpayer and under section 212 for expenses incurred in connection with activities engaged in for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. Except as provided in section 183 and §1.183–1, no deductions are allowable for expenses incurred in connection with activities which are not engaged in for profit. Thus, for example, deductions are not allowable under section 162 or 212 for activities which are carried on primarily as a sport, hobby, or for recreation. The determination whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit. In determining whether such an objective exists, it may be sufficient that there is a small chance of making a large profit. Thus it may be found that an investor in a wildcat oil well who incurs very substantial expenditures is in the venture for profit even though the expectation of a profit might be considered unreasonable. In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent.

(b) *Relevant factors.* In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. No one factor is determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors which should normally be taken into account are the following:

(1) *Manner in which the taxpayer carries on the activity.* The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.

(2) *The expertise of the taxpayer or his advisors.* Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.

(3) *The time and effort expended by the taxpayer in carrying on the activity.* The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.

(4) *Expectation that assets used in activity may appreciate in value.* The term *profit* encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation. See, however, paragraph (d) of § 1.183–1 for definition of an activity in this connection.

(5) *The success of the taxpayer in carrying on other similar or dissimilar activities.* The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

(6) *The taxpayer's history of income or losses with respect to the activity.* A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of

course be strong evidence that the activity is engaged in for profit.

(7) *The amount of occasional profits, if any, which are earned.* The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

(8) *The financial status of the taxpayer.* The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.

(9) *Elements of personal pleasure or recreation.* The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.

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

Example 1. The taxpayer inherited a farm from her husband in an area which was becoming largely residential, and is now nearly all so. The farm had never made a profit before the taxpayer inherited it, and the farm has since had substantial losses in each year. The decedent from whom the taxpayer inherited the farm was a stockbroker, and he also left the taxpayer substantial stock holdings which yield large income from dividends. The taxpayer lives on an area of the farm which is set aside exclusively for living purposes. A farm manager is employed to operate the farm, but modern methods are not used in operating the farm. The taxpayer was born and raised on a farm, and expresses a strong preference for living on a farm. The taxpayer's activity of farming, based on all the facts and circumstances, could be found not to be engaged in for profit.

Example 2. The taxpayer is a wealthy individual who is greatly interested in philosophy. During the past 30 years he has written and published at his own expense several pamphlets, and he has engaged in extensive lecturing activity, advocating and disseminating his ideas. He has made a profit from these activities in only occasional years, and the profits in those years were small in relation to the amounts of the losses in all other years. The taxpayer has very sizable income from securities (dividends and capital gains) which constitutes the principal source of his livelihood. The activity of lecturing, publishing pamphlets, and disseminating his ideas is not an activity engaged in by the taxpayer for profit.

Example 3. The taxpayer, very successful in the business of retailing soft drinks, raises dogs and horses. He began raising a particular breed of dogs many years ago in the belief that the breed was in danger of declining, and he has raised and sold the dogs in each year since. The taxpayer recently began raising and racing thoroughbred horses. The losses from the taxpayer's dog and horse activities have increased in magnitude over the years, and he has not made a profit on these operations during any of the last 15 years. The taxpayer generally sells the dogs only to friends, does not advertise the dogs for sale, and shows the dogs only infrequently. The taxpayer races his horses only at the ‘‘prestige’’ tracks at which he combines his racing activities with social and recreational activities. The horse and dog operations are conducted at a large residential property on which the taxpayer also lives, which includes substantial living quarters and attractive recreational facilities for the taxpayer and his family. Since (i) the activity of raising dogs and horses and racing the horses is of a sporting and recreational nature, (ii) the taxpayer has substantial income from his business activities of retailing soft drinks, (iii) the horse and dog operations are not conducted in a businesslike manner, and (iv) such operations have a continuous record of losses, it could be determined that the horse and dog activities of the taxpayer are not engaged in for profit.

Example 4. The taxpayer inherited a farm of 65 acres from his parents when they died 6 years ago. The taxpayer moved to the farm from his house in a small nearby town, and he operates it in the same manner as his parents operated the farm before they died. The taxpayer is employed as a skilled machine operator in a nearby factory, for which he is paid approximately $8,500 per year. The farm has not been profitable for the past 15 years because of rising costs of operating farms in general, and because of the decline in the price of the produce of this farm in particular. The taxpayer consults the local agent of the State agricultural service from time to time, and the suggestions of the agent have generally been followed. The manner in which the farm is operated by the taxpayer is substantially similar to the manner in which farms of similar size, and which grow similar crops in the area, are operated. Many of these other farms do not make profits. The taxpayer does much of the required labor around the farm himself, such as fixing fences, planting crops, etc. The activity of farming could be found, based on all the facts and circumstances, to be engaged in by the taxpayer for profit.

Example 5. A, an independent oil and gas operator, frequently engages in the activity of searching for oil on undeveloped and unexplored land which is not near proven fields. He does so in a manner substantially similar to that of others who engage in the same activity. The chances, based on the experience of A and others who engaged in this activity, are strong that A will not find a commercially profitable oil deposit when he drills on land not established geologically to be proven oil bearing land. However, on the rare occasions that these activities do result in discovering a well, the operator generally realizes a very large return from such activity. Thus, there is a small chance that A will make a large profit from his soil exploration activity. Under these circumstances, A is engaged in the activity of oil drilling for profit.

Example 6. C, a chemist, is employed by a large chemical company and is engaged in a wide variety of basic research projects for his employer. Although he does no work for his employer with respect to the development of new plastics, he has always been interested in such development and has outfitted a workshop in his home at his own expense which he uses to experiment in the field. He has patented several developments at his own expense but as yet has realized no income from his inventions or from such patents. C conducts his research on a regular, systematic basis, incurs fees to secure consultation on his projects from time to time, and makes extensive efforts to ‘‘market’’ his developments. C has devoted substantial time and expense in an effort to develop a plastic sufficiently hard, durable, and malleable that it could be used in lieu of sheet steel in many major applications, such as automobile bodies. Although there may be only a small chance that C will invent new plastics, the return from any such development would be so large that it induces C to incur the costs of his experimental work. C is sufficiently qualified by his background that there is some reasonable basis for his experimental activities. C’s experimental work does not involve substantial personal or recreational aspects and is conducted in an effort to find practical applications for his work. Under these circumstances, C may be found to be engaged in the experimental activities for profit.

[T.D. 7198, 37 FR 13683, July 13, 1972]

§ 1.183–3 Election to postpone determination with respect to the presumption described in section 183(d). [Reserved]

§ 1.183–4 Taxable years affected.

The provisions of section 183 and the regulations thereunder shall apply only with respect to taxable years beginning after December 31, 1969. For provisions applicable to prior taxable years, see section 270 and § 1.270–1.

[T.D. 7198, 37 FR 13685, July 13, 1972]

§ 1.186–1 Recoveries of damages for antitrust violations, etc.

(a) *Allowance of deduction.* Under section 186, when a compensatory amount which is included in gross income is received or accrued during a taxable year for a compensable injury, a deduction is allowed in an amount equal to the lesser of (1) such compensatory amount, or (2) the unrecovered losses sustained as a result of such compensable injury.

(b) *Compensable injury*—(1) *In general.* For purposes of this section, the term *compensable injury* means any of the injuries described in subparagraph (2), (3), or (4) of this paragraph.

(2) *Patent infringement.* An injury sustained as a result of an infringement of a patent issued by the United States (whether or not issued to the taxpayer or another person or persons) constitutes a compensable injury. The term *patent issued by the United States* means any patent issued or granted by the United States under the authority of the Commissioner of Patents pursuant to 35 U.S.C. 153.

(3) *Breach of contract or of fiduciary duty or relationship.* An injury sustained as a result of a breach of contract (including an injury sustained by a third party beneficiary) or a breach of fiduciary duty or relationship constitutes a compensable injury.

(4) *Injury suffered under certain antitrust law violations.* An injury sustained in business, or to property, by reason of any conduct forbidden in the antitrust laws for which a civil action may be brought under section 4 of the Act of October 15, 1914 (15 U.S.C. 15), commonly known as the Clayton Act, constitutes a compensable injury.

(c) *Compensatory amount*—(1) *In general.* For purposes of this section, the term, *compensatory amount* means any amount received or accrued during the taxable year as damages as a result of an award in, or in settlement of, a civil action for recovery for a compensable injury, reduced by any amounts paid or incurred in the taxable year in securing such award or settlement. The term *compensatory amount* includes only amounts compensating for actual economic injury. Thus, additional amounts representing punitive, exemplary, or treble damages are not included within the term. Where, for example, a taxpayer recovers treble damages under section 4 of the Clayton Act, only one-third of the recovery representing economic injury constitutes a compensatory amount. In the absence of any indication to the contrary, amounts received in settlement of an action shall be deemed to be a recovery for an actual economic injury except to the extent such settlement amounts exceed actual damages claimed by the taxpayer in such action.

(2) *Interest on a compensatory amount.* Interest attributable to a compensatory amount shall not be included within the term *compensatory amount.*

(3) *Settlement of a civil action for damages*—(i) *Necessity for an action.* The term *compensatory amount* does not include an amount received or accrued in settlement of a claim for a compensable injury if the amount is received or accrued prior to institution of an action. An action shall be considered as instituted upon completion of service of process, in accordance with the laws and rules of the court in which the action has been commenced or to which the action has been removed, upon all defendants who pay or incur an obligation to pay a compensatory amount.

(ii) *Specifications of the parties.* If an action for a compensable injury is settled, the specifications of the parties will generally determine compensatory amounts unless such specifications are not reasonably supported by the facts and circumstances of the case. For example, the parties may provide that the sum of $1,000 represents actual damages sustained as the result of antitrust violations and that the total amount of the settlement after the trebling of damages is $3,000. In such case, only the sum of $1,000 would be a compensatory amount. In the absence of specifications of the parties, the complaint filed by the taxpayer may be considered in determining what portion of the amount of the settlement is a compensatory amount.

(4) *Amounts paid or incurred in securing the award or settlement.* For purposes of this section, the term *amounts paid or incurred in the taxable year in securing such award or settlement* shall include legal expenses such as attorney's fees, witness fees, accountant fees, and court costs. Expenses incurred in securing a recovery of both a compensatory amount and other amounts from the same action shall be allocated among such amounts in the ratio each of such amounts bears to the total recovery. For instance, where a taxpayer incurs attorney's fees and other expenses of $3,000 in recovering $10,000 as

a compensatory amount, $5,000 as a return of capital, and $25,000 as punitive damages from the same action, the taxpayer shall allocate $750 of the expenses to the compensatory amount (10,000/40,000×3,000), $375 to the return of capital (5,000/40,000×3,000), and $1,875 to the punitive damages (25,000/40,000× 3,000).

(d) *Unrecovered losses*—(1) *In general.* For purposes of this section, the term *unrecovered losses sustained as a result of such compensable injury* means the sum of the amounts of the net operating losses for each taxable year in whole or in part within the injury period, to the extent that such net operating losses are attributable to such compensable injury, reduced by (i) the sum of any amounts of such net operating losses which were allowed as a net operating loss carryback or carryover for any prior taxable year under the provisions of section 172, and (ii) the sum of any amounts allowed as deductions under section 186 (a) and this section for all prior taxable years with respect to the same compensable injury. Accordingly, a deduction is permitted under section 186(a) and this section with respect to net operating losses whether or not the period for carryover under section 172 has expired.

(2) *Injury period.* For purposes of this section, the term *injury period* means (i) with respect to an infringement of a patent, the period during which the infringement of the patent continued, (ii) with respect to a breach of contract or breach of fiduciary duty or relationship, the period during which amounts would have been received or accrued but for such breach of contract or breach of fiduciary duty or relationship, or (iii) with respect to injuries sustained by reason of a violation of section 4 of the Clayton Act, the period during which such injuries were sustained. The injury period will be determined on the basis of the facts and circumstances of the taxpayer's situation. The injury period may include a periods before and after the period covered by the civil action instituted.

(3) *Net operating losses attributable to compensable injuries.* A net operating loss for any taxable year shall be treated as attributable (whether actually attributable or not) to a compensable injury to the extent the compensable injury is sustained during the taxable year. For purposes of determining the extent of the compensable injury sustained during a taxable year, a judgment for a compensable injury apportioning the amount of the recovery (not reduced by any amounts paid or incurred in securing such recovery) to specific taxable years within the injury period will be conclusive. If a judgment for a compensable injury does not apportion the amount of the recovery to specific taxable years within the injury period, the amount of the recovery will be prorated among the years within the injury period in the proportion that the net operating loss sustained in each of such years bear to the total net operating losses sustained for all such years. If an action is settled, the specifications of the parties will generally determine the apportionment of the amount of the recovery unless such specifications are not reasonably supported by the facts and circumstances of the case. In the absence of specifications of the parties, the amount of the recovery will be prorated among the years within the injury period in the proportion that the net operating loss sustained in each of such years bears to the total net operating losses sustained for all such years.

(4) *Application of losses attributable to a compensable injury.* If only a portion of a net operating loss for any taxable year is attributable to a compensable injury, such portion shall (in applying section 172 for purposes of this section) be considered to be a separate net operating loss for such year to be applied after the other portion of such net operating loss. If, for example, in the year of the compensable injury the net operating loss was $1,000 and the amount of the compensable injury was $600, the amount of $400 not attributable to the compensable injury would be used first to offset profits in the carryover or carryback periods as prescribed by section 172. After the amount not attributable to the compensable injury is used to offset profits in other years, then the amount attributable to the compensable injury will be applied against profits in the carryover or carryback periods.

(e) *Effect on net operating loss carryovers*—(1) *In general.* Under section 186 (e) if for the taxable year in which a compensatory amount is received or accrued any portion of the net operating loss carryovers to such year is attributable to the compensable injury for which such amount is received or accrued, such portion of the net operating loss carryovers must be reduced by the excess, if any, of (i) the amount computed under section 186(e)(1) with respect to such compensatory amount, over (ii) the amount computed under section 186(e)(2) with respect to such compensable injury.

(2) *Amount computed under section 186(e)(1).* The amount computed under section 186(e)(1) is equal to the deduction allowed under section 186(a) with respect to the compensatory amount received or accrued for the taxable year.

(3) *Amount computed under section 186(e)(2).* The amount computed under section 186(e)(2) is equal to that portion of the unrecovered losses sustained as a result of the compensable injury with respect to which, as of the beginning of the taxable year, the period for carryover under section 172 has expired without benefit to the taxpayer, but only to the extent that such portion of the unrecovered losses did not reduce an amount computed under section 186(e)(1) for any prior taxable year.

(4) *Increase in income under section 172(b)(2).* If there is a reduction for any taxable year under subparagraph (1) of this paragraph in the portion of the net operating loss carryovers to such year attributable to a compensable injury, then, solely for purposes of determining the amount of such portion which may be carried to subsequent taxable years, the income of such taxable year, as computed under section 172(b)(2), shall be increased by the amount of the reduction computed under subparagraph (1) of this paragraph, for such year.

(f) *Illustration.* The provisions of section 186 and this section may be illustrated by the following example:

Example. (i) As of the beginning of his taxable year 1969, taxpayer A has a net operating loss carryover from his taxable year 1966 of $550 of which $250 is attributable to a compensable injury. In addition, he has a net operating loss attributable to the compensable injury of $150 with respect to which the period for carryover under section 172 has expired without benefit to the taxpayer. In 1969, he receives a $100 compensatory amount with respect to that injury and he has $75 in other income. Thus, A has gross income of $175 and he is entitled to a $100 deduction (the compensatory amount received) under section 186(a) and this section since this amount is less than the unrecovered losses sustained as a result of the compensable injury ($250+$150=$400). No portion of the net operating loss carryover to the current taxable year attributable to the compensable injury is reduced under section 186(e) since the amount determined under section 186(e)(1) ($100) does not exceed the amount determined under section 186(e)(2) ($150). Therefore, A applies a net operating loss carryover of $550 against his remaining income of $75 and retains a net operating loss carryover of $475 to following years of which amount $250 remains attributable to the compensable injury. In addition, he retains $50 of net operating losses attributable to the compensable injury with respect to which the period for carryover under section 172 has expired without benefit to the taxpayer.

(ii) In 1970, A receives a $200 compensatory amount with respect to the same compensable injury and has $75 of other income. Thus, A has gross income of $275 and he is entitled to a $200 deduction (the compensatory amount received) under section 186(a) and this section since this amount is less than the remaining unrecovered loss sustained as a result of the compensable injury ($250+$50=$300). The net operating loss carryover to the current taxable year of $250 attributable to the compensable injury is reduced under section 186(e) by $150, which is the excess of the amount determined under section 186(e)(1) ($200) over the amount determined under section 186(e)(2) ($50). Therefore, A applies net operating loss carryovers of $325 ($225 not attributable to the compensable injury, +$100 attributable to such injury) against his remaining income of $75. A retains net operating loss carryovers of $250 for following years, of which amount $100 is attributable to the compensable injury. A has used all of his net operating losses attributable to the compensable injury with respect to which the period for carryover under section 172 has expired without benefit to the taxpayer.

(iii) In 1971, A receives a $200 compensatory amount with respect to the same compensable injury and has $75 of other income. Thus, A has gross income of $275 and he is entitled to a $100 deduction (the amount of unrecovered losses) under section 186(a) and this section since this amount is less than the compensatory amount received ($200). The net operating loss carryover to the current taxable year of $100 attributable to the compensable injury is reduced under section 186(e) by $100, which is the excess of the amount determined under section 186(e)(1) ($100) over the amount determined under section 186(e)(2) ($0). Therefore, A applies net operating loss carryovers of $150 against his remaining income of $175 ($100 compensatory amount plus $75 other income) which leaves $25 taxable income. No net operating loss carryover remains for following years.

(g) *Effective date.* The provisions of this section are applicable as to compensatory amounts received or accrued in taxable years beginning after December 31, 1968, even though the compensable injury was sustained in taxable years beginning before such date.

[T.D. 7220, 37 FR 24744, Nov. 21, 1972]

§ 1.187–1 Amortization of certain coal mine safety equipment.

(a) *Allowance of deduction*—(1) *In general.* Under section 187(a), every person, at his election, shall be entitled to a deduction with respect to the amortization of the adjusted basis (for determining gain) of any certified coal mine safety equipment (as defined in § 1.187–2), based on a period of 60 months. Such 60-month period shall, at the election of the taxpayer, begin either with the month following the month in which such equipment was placed in service or with the succeeding taxable year. For rules as to making or discontinuing the election, see paragraphs (b) and (c) of this section. For the computation of the adjusted basis (for determining gain) of any certified coal mine safety equipment, see paragraph (b) of § 1.187–2.

(2) *Amount of deduction.* (i) Such amortization deduction shall be an amount, with respect to each month of such 60-month period which falls within the taxable year, equal to the adjusted basis for determining gain of the certified coal mine safety equipment at the end of such month divided by the number of months (including the month for which the deduction is computed) remaining in such 60-month period. Such adjusted basis at the end of any month shall be computed without regard to the amortization deduction for such month. The total amortization deduction with respect to any certified coal mine safety equipment for a particular taxable year is the sum of the amortization deductions allowable for each month of the 60-month period which falls within such taxable year.

(ii) If any certified coal mine safety equipment is sold or exchanged or otherwise disposed of during a particular month, then the amortization deduction (if any) allowable to the transferor in respect of that month shall be that portion of the amount to which such person would be entitled for a full month which the number of days in such month during which the equipment was held by such person bears to the total number of days in such month.

(3) *Effect on other deductions.* (i) The amortization deduction provided by section 187(a) with respect to any month shall be in lieu of the depreciation deduction which would otherwise be allowable with respect to such equipment under section 167 for such month.

(ii) If the adjusted basis of such coal mine safety equipment as computed under section 1011 for purposes other than the amortization deduction provided by section 187(a) is in excess of the adjusted basis, as computed under paragraph (b) of § 1.187–2, then such excess shall be recovered through depreciation deductions under the rules of section 167. See section 187(e), and paragraph (b)(2) of § 1.187–2.

(iii) See section 179 and paragraph (e)(1)(ii) of § 1.179–1 for additional first-year depreciation in respect of certified coal mine safety equipment.

(4) *Special rules.* (i) If the assets of a corporation which has elected to take the amortization deduction under section 187(a) are acquired by another corporation in a transaction to which section 381 (relating to carryovers in certain corporate acquisitions) applies, the acquiring corporation is to be treated as if it were the transferor or distributor corporation for purposes of this section.

(ii) For the right of estates and trusts to take the amortization deduction provided by section 187 see section 642(f) and § 1.642(f)-1.

(iii) For the allowance of the amortization deduction in the case of coal mine safety equipment of partnerships see section 703 and § 1.703–1.

(iv) In the case of certified coal mine safety equipment held by one person for life with the remainder to another person, the amortization deduction under section 187(a) shall be computed as if the life tenant were the absolute owner of the property and shall be allowable to the life tenant during his life.

(5) *Effective date.* The provisions of this paragraph shall apply to taxable years ending after December 31, 1969.

(6) *Meaning of terms.* Except as otherwise provided in §1.187–2, all terms used in section 187 and the regulations thereunder shall have the meaning provided by this section and §1.187–2.

(b) *Election of amortization*—(1) *In general.* Under section 187(b), an election by the taxpayer to make amortization deductions with respect to any certified coal mine safety equipment and to begin the 60-month amortization period shall be made by a statement to that effect attached to his return for the taxable year in which falls the first month of the 60-month amortization period so elected. Such statement shall include the following information:

(i) A description clearly identifying each piece of certified coal mine safety equipment for which an amortization deduction is claimed;

(ii) The date on which such equipment was ‘‘placed in service’’ (see paragraph (a)(2)(i) of §1.187–2);

(iii) The date on which the amortization period began;

(iv) The total costs paid or incurred in the acquisition and installation of such equipment;

(v) A computation showing the adjusted basis (as defined in paragraph (b) of §1.187–2) of the equipment as of the beginning of the amortization period;

(vi) In the case of electric face equipment which is newly acquired by the taxpayer, a statement that the equipment has been certified by the Secretary of the Interior or the Director of the Bureau of Mines as being permissible within the meaning of section 305(a)(2) of the Federal Coal Mine Health and Safety Act of 1969; and

(vii) In the case of property placed in service in connection with used electric face equipment (within the meaning of paragraph (a)(2)(ii) of §1.187–2), a statement that such property has resulted in the used electric face equipment becoming permissible and a copy of the notification that such property is permissible.

(2) *Late certification.* If, 90 days before the date on which the return described in this paragraph is due, a piece of coal mine safety equipment has not been certified as permissible by the Secretary of the Interior or the Director of the Bureau of Mines, then the election may be made by a statement in an amended income tax return for the taxable year in which falls the first month of the 60-month amortization period so elected. The statement and amended return in such case must be filed not later than 90 days after the date the equipment is certified as permissible by the Secretary of the Interior or the Director of the Bureau of Mines. Amended income tax returns or claims for credit or refund should also be filed at this time for other taxable years which are within the amortization period and which are subsequent to the taxable year for which the election is made. Nothing in this paragraph shall be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(3) *Other requirements and considerations.* No method of making the election provided for in section 187(a) other than that prescribed in this section shall be permitted on or after August 11, 1971. A taxpayer who does not elect in the manner prescribed in this section to take amortization deductions with respect to certified coal mine safety equipment shall not be entitled to such deductions. In the case of a taxpayer who has elected prior to August 11, 1971 the statement required by subparagraph (1) of this paragraph shall be attached to his income tax return for his taxable year in which August 11, 1971 occurs.

(c) *Election to discontinue or revoke amortization*—(1) *Election to discontinue.* (i) Under section 187(c), if a taxpayer has elected to take the amortization deduction provided by section 187(a) with respect to any certified coal mine safety equipment, he may, after such election and prior to the expiration of the 60-month amortization period, elect to discontinue the amortization deduction for the remainder of the 60-month period for such equipment.

(ii) An election to discontinue the amortization deduction shall be made by a statement in writing filed with the District Director or with the director of the Internal Revenue Service center with whom the return of the taxpayer is required to be filed for its taxable year in which falls the first month for which the election terminates. In addition, a copy of such statement shall be attached to the taxpayer's income tax return filed for such taxable year. Such statement shall specify the month as of the beginning of which the taxpayer elects to discontinue such deductions, and shall be filed before the beginning of the month specified therein. In addition, such notice shall contain a description clearly identifying the certified coal mine safety equipment with respect to which the taxpayer elects to discontinue the amortization deduction. If the taxpayer so elects to discontinue the amortization deduction, he shall not be entitled to any further amortization deductions under section 187 with respect to such equipment.

(2) *Revocation of elections made prior to August 11, 1971.* If before August 11, 1971 an election under section 187(a) has been made, consent is hereby given for the taxpayer to revoke such election without the consent of the Commissioner. Such election may be revoked by filing a notice of revocation on or before November 9, 1971. Such notice shall be in the form and shall be filed in the manner required by subparagraph (1)(ii) of this paragraph. If such revocation is for a period which falls within one or more taxable years for which an income tax return has been filed, an amended income tax return shall be filed for any taxable year in which a deduction was taken under section 187 on or before November 9, 1971.

(3) *Depreciation subsequent to discontinuance or in the case of revocation of amortization.* (i) A taxpayer who elects in the manner prescribed under subparagraph (1) of this section to discontinue amortization deductions under section 187(a) or under subparagraph (2) of this paragraph to revoke an election made prior to August 11, 1971 with respect to an item of certified coal mine safety equipment may be entitled to a deduction for depreciation with respect to such equipment. See section 167 and the regulations thereunder.

(ii) In the case of an election to discontinue an amortization deduction under section 187, the deduction for depreciation shall be computed beginning with the first month as to which such amortization deduction is not applicable, and shall be based upon the adjusted basis (see section 1011 and the regulations thereunder) of the property as of the beginning of such month. Such depreciation deduction shall be based upon the remaining portion of the period authorized under section 167 for the facility, as determined as of the first day of the first month as of which the amortization deduction is not applicable.

(iii) In the case of a revocation of an election under section 187 referred to in paragraph (c)(2) of this section the deduction for depreciation shall begin as of the time such depreciation deduction would have been taken but for the election under section 187. See subparagraph (2) of this section for rules as to filing amended returns for years for which amortization deductions have been taken.

(d) *Examples.* This section may be illustrated by the following examples:

Example 1. On September 30, 1970, the X Corporation, which uses the calendar year as its taxable year, places in service a piece of coal mine safety equipment required as a result of the Federal Coal Mine Health and Safety Act of 1969 which is certified as indicated in paragraph (a) of § 1.187–2. The cost of the equipment is $120,000. On its income tax return filed for 1970, the corporation elects to take the amortization deductions allowed by section 187(a) with respect to the equipment and to begin the 60-month amortization period with October 1970, the month following the month in which it was placed in service. The adjusted basis at the end of October 1970 (determined without regard to the amortization deduction allowed by section 187(a) for that month) is $120,000. The allowable amortization deduction with respect to such equipment for the taxable year 1970 is $6,000, computed as follows:

Monthly amortization deductions:	
October: $120,000 divided by 60	$2,000
November: $118,000 ($120,000 minus $2,000) divided by 59	2,000
December: $116,000 ($118,000 minus $2,000) divided by 58	2,000
Total amortization deduction for 1970	6,000

Example 2. Assume the same facts as in *Example (1).* Assume further that on May 20, 1972, X properly files notice of its election to discontinue the amortization deductions with the month of June 1972. The adjusted basis of the equipment as of June 1, 1972 (assuming no capital additions or improvements) is $80,000, computed as follows: Yearly amortization deductions computed in accordance with *Example (1):*

1970	$6,000
1971	24,000
1972 (for the first 5 months)	10,000
Total amortization deductions for 20 months	40,000
Adjusted basis at beginning of amortization period	120,000
Less: Amortization deductions	40,000
Adjusted basis as of June 1, 1972	80,000

Beginning as of June 1, 1972, the deduction for depreciation under section 167 is allowable with respect to the property on its adjusted basis of $80,000.

Example 3. Assume the same facts as in *Example (1),* except that on its income tax return filed in 1970, X does not elect to take amortization deductions allowed by section 187(a) but that on its income tax return filed for 1971 X elects to begin the amortization period as of January 1, 1971, the taxable year succeeding the taxable year the equipment was placed in service. Assume further that the only adjustment to basis for the period October 1, 1970, to January 1, 1971, is $3,000 for depreciation (the amount allowable, of which $2,000 is for additional first year depreciation under section 179) for the last 3 months of 1970. The adjusted basis (for determining gain) for purposes of section 187 as of that date is $120,000 less $3,000 or $117,000.

[T.D. 7137, 36 FR 14733, Aug. 11, 1971; 36 FR 16656, Aug. 25, 1971]

§1.187–2 Definitions.

(a) *Certified coal mine safety equipment*—(1) *In general*—(i) The term *certified coal mine safety equipment* means property which:

(a) Is electric face equipment (within the meaning of section 305 of the Federal Coal Mine Health and Safety Act of 1969) required in order to meet the requirements of section 305(a)(2) of such Act,

(b) The Secretary of the Interior or the Director of the Bureau of Mines certifies is permissible within the meaning of such section 305(a)(2), and

(c) Is placed in service (as defined in subparagraph (2)(i) of this paragraph) before January 1, 1975.

(ii) In addition, property placed in service in connection with any used electric face equipment which the Secretary of the Interior or the Director of the Bureau of Mines certifies makes such used electric face equipment permissible shall be treated as a separate item of certified coal mine safety equipment. See subparagraph (2)(ii) of this paragraph.

(2) *Meaning of terms.* (i) For purposes of subparagraph (1)(i)(c) of this paragraph, the term *placed in service* shall have the meaning assigned to such term in paragraph (d) of §1.46–3.

(ii) For purposes of subparagraph (1)(ii) of this paragraph, the term *property* includes those costs of converting existing nonpermissible electric face equipment to a permissible condition which are chargeable to capital account under the principles of §1.1016–2. Property is considered to be placed in service in connection with used electric face equipment (which was not permissible) if its use causes such electric face equipment to be certified as permissible.

(b) *Adjusted basis*—(1) *In general.* The basis upon which the deduction with respect to amortization allowed by section 187 is to be computed with respect to any item of certified coal mine safety equipment shall be the adjusted basis provided in section 1011 for the purpose of determining gain on the sale or other disposition of such property (see part II (section 1011 and following) subchapter O, chapter 1 of the Code) computed as of the first day of the amortization period. For an example showing the determination of the adjusted basis referred to in the preceding sentence in the case where the amortization period begins with the taxable year succeeding the taxable year in which the property is placed in service see *Example (3)* in paragraph (d) of §1.187–1.

(2) *Capital additions.* The adjusted basis of any certified coal mine safety equipment, with respect to which an election is made under section 187(b), shall not be increased, for purposes of section 187, for amounts chargeable to the capital account for additions or improvements after the amortization period has begun. However, nothing contained in this section or §1.187–1 shall

be deemed to disallow a deduction for depreciation for such capital additions. Thus, for example, if a taxpayer places a piece of certified coal mine safety equipment in service in 1971 and in 1972 makes improvements to it the expenditures for which are chargeable to the capital account, such improvements shall not increase the adjusted basis of the equipment for purposes of computing the amortization deduction allowed by section 187(a). However, the depreciation deduction provided by section 167 shall be allowed with respect to such improvements in accordance with the principles of section 167.

[T.D. 7137, 36 FR 14734, Aug. 11, 1971; 36 FR 19251, Oct. 1, 1971]

§ 1.188–1 Amortization of certain expenditures for qualified on-the-job training and child care facilities.

(a) *Allowance of deduction*—(1) *In general.* Under section 188, at the election of the taxpayer, any eligible expenditure (as defined in paragraph (d)(1) of this section) made by such taxpayer to acquire, construct, reconstruct, or rehabilitate section 188 property (as defined in paragraph (d)(2) of this section) shall be allowable as a deduction ratably over a period of 60 months. Such 60-month period shall begin with the month in which such property is placed in service. For rules for making the election, see paragraph (b) of this section. For rules relating to the termination of an election, see paragraph (c) of this section.

(2) *Amount of deduction*—(i) *In general.* For each eligible expenditure attributable to an item of section 188 property the amortization deduction shall be an amount, with respect to each month of the 60-month amortization period which falls within the taxable year, equal to the elgible expenditure divided by 60. The total amortization deduction with respect to each item of section 188 property for a particular taxable year is the sum of the amortization deductions allowable for each month of the 60-month period which falls within such taxable year. The total amortization deduction under section 188 for a particular taxable year is the sum of the amortization deductions allowable with respect to each item of section 188 property for that taxable year.

(ii) *Separate amortization period for each expenditure.* Each eligible expenditure attributable to an item of section 188 property to which an election relates shall be amortized over a 60-month period beginning with the month in which the item of section 188 property is placed in service. Thus, if a taxpayer makes an eligible expenditure for an addition to, or improvement of, section 188 property, such expenditure must be amortized over a separate 60-month period beginning with the month in which the section 188 property is placed in service.

(iii) *Separate items.* The determination of what constitutes a separate item of section 188 property is to be made on the basis of the facts and circumstances of each individual case. Additions or improvements to an existing item of section 188 property are treated as a separate item of section 188 property. In general, each item of personal property is a separate item of property and each building, or separate element or structural component thereof, is a separate item of property. For purposes of subdivisions (i) and (ii) of this subparagraph, two or more items of property may be treated as a single item of property if such items (A) are placed in service within the same month of the taxable year, (B) have same estimated useful life, and (C) are to be used in a functionally related manner in the operation of a qualified on-the-job training or child care facility or are integrally related facilities (described in paragraph (d) (3) or (4) of this section.

(iv) *Disposition of property or termination of election.* If an item of section 188 property is sold or exchanged or otherwise disposed of (or if the item of property ceases to be used as section 188 property by the taxpayer) during a particular month, then the amortization deduction (if any) allowable to the taxpayer in respect of that item for that month shall be an amount which bears the same ratio to the amount to which the taxpayer would be entitled for a full month as the number of days in such month during which the property was held by him (or used by him as section 188 property) bears to the total number of days in such month.

(3) *Effect on other deductions.* The amortization deduction provided by section 188(a) with respect to any month shall be in lieu of any depreciation deduction which would otherwise be allowable under sections 167 or 179 with respect to that portion of the adjusted basis of the property attributable to an adjustment under section 1016(a)(1) made on account of an eligible expenditure.

(4) *Depreciation with respect to property ceasing to be used as section 188 property.* A taxpayer is entitled to a deduction for the depreciation (to the extent allowable under section 167) of property with respect to which the election under section 188 is terminated under the provisions of paragraph (c) of this section. The deduction for depreciation shall begin with the date of such termination and shall be computed on the adjusted basis of the property as of such date. The depreciation deduction shall be based upon the estimated remaining useful life and salvage value authorized under section 167 for the property as of the termination date.

(5) *Investment credit not to be allowed.* Any property with respect to which an election has been made under section 188(a) shall not be treated as section 38 property within the meaning of section 48(a).

(6) *Special rules*—(i) *Life estates.* In the case of section 188 property held by one person for life with the remainder to another person, the amortization deduction under section 188(a) shall be computed as if the life tenant were the absolute owner of the property and shall be allowable to the life tenant during his life.

(ii) *Certain corporate acquistions.* If the assets of a corporation which has elected to take the amortization deduction under section 188(a) are acquired by another corporation in a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies, the acquiring corporation is to be treated as if it were the distributor or transferor corporation for purposes of this section.

(iii) *Estates and trusts.* For the allowance of the amortization deduction in the case of estates and trusts, see section 642(f) and §1.642(f)–(1).

(iv) *Partnerships.* For the allowance of the amortization deduction in the case of partnerships, see section 703 and §1.703–1.

(b) *Time and manner of making election*—(1) *In general.* Except as otherwise provided in subparagraph (2) of this paragraph, an election to amortize an eligible expenditure under section 188 shall be made by attaching, to the taxpayer's income tax return for the taxable period for which the deduction is first allowable to such taxpayer, a written statement containing:

(i) A description clearly identifying each item of property (or two or more items of property treated as a single item) forming a part of a qualified on-the-job training or child care facility to which the election relates. e.g., building, classroom equipment, etc.;

(ii) The date on which the eligible expenditure was made for such item of property (or the period during which eligible expenditures were made for two or more items of property treated as a single item of property);

(iii) The date on which such item of property was ''placed in service'' (see paragraph (d)(5) of this section);

(iv) The amount of the eligible expenditure of such item of property (or the total amount of expenditures for two or more items of property treated as a single item); and

(v) The annual amortization deduction claimed with respect to such item of property.

If the taxpayer does not file a timely return (taking into account extensions of the time for filing) for the taxable year for which the election is first to be made, the election shall be filed at the time the taxpayer files his first return for that year. The election may be made with an amended return only if such amended return is filed no later than the time prescribed by law (including extensions thereof) for filing the return for the taxable year of election.

(2) *Special rule.* With respect to any return filed before (90 days after the date on which final regulations are filed with the Office of the Federal

Register), the election to amortize an eligible expenditure for section 188 property shall be made by a statement on, or attached to, the income tax return (or an amended return) for the taxable year, indicating that an election is being made under section 188 and setting forth information to identify the election and the facility or facilities to which it applies. An election made under the provisions of this subparagraph, must be made not later than (i) the time, including extensions thereof, prescribed by law for filing the income tax return for the first taxable year for which the election is being made or (ii) before (90 days after the date on which final regulations under section 188 are filed with the Office of the Federal Register), whichever is later. Nothing in this subparagraph shall be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(3) *No other method of making election.* No method for making the election under section 188(a) other than the method prescribed in this paragraph shall be permitted. If an election to amortize section 188 property is not made within the time and in the manner prescribed in this paragraph, no election may be made (by the filing of an amended return or in any other manner) with respect to such section 188 property.

(4) *Effect of election.* An election once made may not be revoked by a taxpayer with respect to any item of section 188 property to which the election relates. The election of the amortization deducted for an item of section 188 property shall not affect the taxpayer's right to elect or not to elect the amortization deduction as to other items of section 188 property even though the items are part of the same facility. For rules relating to the termination of an election other than by revocation by the taxpayer, see paragraph (c) of this section.

(c) *Termination of election.* If the specific use of an item of section 188 property in connection with a qualified on-the-job training or child care facility is discontinued, the election made with respect to that item of property shall be terminated. The termination shall be effective with respect to such item of property as of the earliest date on which the taxpayer's specific use of the item is no longer in connection with the operation of a qualified on-the-job training or child care facility. If a facility ceases to meet the applicable requirements of paragraph (d)(3) of this section, relating to qualified on-the-job training facilities, or paragraph (d)(4) of this section, relating to qualified child care facilities, the election or elections made with respect to the items of section 188 property comprising such facility shall be terminated. The termination shall be effective with respect to such items of poperty as of the earliest date on which the facility is no longer qualified under the applicable rules. For rules relating to depreciation with respect to property ceasing to be used as section 188 property, see paragraph (a)(4) of this section.

(d) *Definitions and special requirements*—(1) *Eligible expenditure.* For purposes of this section, the term *eligible expenditure* means an expenditure:

(i) Chargeable to capital account;

(ii) Made after December 31, 1971, and before January 1, 1982, to acquire, construct, reconstruct, or rehabilitate section 188 property which is a qualified child care center facility (or, made after December 31, 1971, and before January 1, 1977, to acquire, construct, reconstruct, or rehabilitate section 188 property which is a qualified on-the-job training facility); and

(iii) For which, but only to the extent that, a grant or other reimbursement excludable from gross income is not, directly or indirectly, payable to, or for the benefit of, the taxpayer with respect to such expenditure under any job training or child care program established or funded by the United States, a State, or any instrumentality of the foregoing, or the District of Columbia.

For purposes of this subparagraph, an expenditure is considered to be made when actually paid by a taxpayer who computes his taxable income under the cash receipts and disbursements method or when the obligation therefore is incurred by a taxpayer who computes his taxable income under the accrual method. See subparagraph (5) of this paragraph for the determination of when section 188 property is placed in service for purposes of beginning the 60-month amortization period.

(2) *Section 188 property.* Section 188 property is tangible property which is:

(i) Of a character subject to depreciation;

(ii) Located within the United States; and

(iii) Specifically used as an integral part of a qualified on-the-job training facility (as defined in subparagraph (3) of this paragraph) or as an integral part of a qualified child care center facility (as defined in subparagraph (4) of this paragraph.)

(3) *Qualified on-the-job training facility.* A *qualified on-the-job training facility* is a facility specifically used by an employer as an on-the-job training facility in connection with an occupational training program for his employees or prospective employees provided that with respect to such program:

(i) All of the following requirements are met:

(A) There is offered at the training facility a systematic program comprised of work and training and related instruction;

(B) The occupation, together with a listing of its basic skills, and the estimated schedule of time for accomplishments of such skills, are clearly identified;

(C) The content of the training is adequate to qualify the employee, or prospective employee, for the occupation for which the individual is being trained;

(D) The skills are to be imparted by competent instructors;

(E) Upon completion of the training, placement is to be based primarily upon the skills learned through the training program;

(F) The period of training is not less than the time necessary to acquire minimum job skills nor longer than the usual period of training for the same occupation; and

(G) There is reasonable certainty that employment will be available with the employer in the occupation for which the training is provided; or

(ii) The employer has entered into an agreement with the United States, or a State agency, under the provisions of the Manpower Development and Training Act of 1962, as amended and supplemented (42 U.S.C. 2571 *et seq.*), the Economic Opportunity Act of 1964, as amended and supplemented (42 U.S.C. 2701 *et seq.*), section 432(b)(1) of the Social Security Act, as amended and supplemented (42 U.S.C. 632(b)(1)), the National Apprenticeship Act of 1937, as amended and supplemented (29 U.S.C. 50 *et seq.*), or other similar Federal statute.

A *facility* consists of a building or any portion of a building and its structural components in which training is conducted, and equipment or other personal property necessary to teach a trainee the basic skills required for satisfactory performance in the occupation for which the training is being given. A facility also includes a building or portion of a building which provides essential services for trainees during the course of the training program, such as a dormitory or dining hall. For purposes of this section, a facility is considered to be specifically used as an on-the-job training facility if such facility is actually used for such purposes and is not used in a significant manner for any purpose other than job training or the furnishing of essential services for trainees such as meals and lodging. For purposes of the preceding sentence if a facility is used 20 percent of the time for a purpose other than on-the-job training or providing trainees with essential services, it would not satisfy the significant use test. Thus, a production facility is not an on-the-job training facility for purposes of section 188 simply because new employees receive training on the machines they will be using as fully productive employees. A facility is considered to be used by an employer in connection with an occupational training program for his employees or prospective employees if at least 80 percent of the trainees participating in the program are employees or prospective employees. For purposes of this section, a prospective employee is a trainee with respect to whom it is reasonably expected that the trainee will be employed by the employer upon successful completion of the training program.

(4) *Qualified child care facility.* A *qualified child care facility* is a facility which is:

(i) Particulary suited to provide child care services and specifically used by an employer to provide such services primarily for his employees' children;

(ii) Operated as a licensed or approved facility under applicable local law, if any, relating to the day care of children; and

(iii) If directly or indirectly funded to any extent by the United States, established and operated in compliance with the requirements contained in Part 71 of Title 45 of the Code of Federal Regulations, relating to Federal Interagency Day Care Requirements. For purposes of this subparagraph, a *facility* consists of the buildings, or portions or structural components thereof, in which children receive such personal care protection, and supervision in the absence of their parents as may be required to meet their needs, and the equipment or other personal property necessary to render such services. Whether or not a facility, or any component property thereof, is particularly suited for the needs of the children being cared for depends upon the facts and circumstances of each individual case. Generally, a building and its structural component, or a room therein, and equipment are particulary suitable for furnishing child care service if they are designed or adapted for such use or satisfy requirements under local law for such use as a condition to granting a license for the operation of the facility. For example, such property includes special kitchen or toilet facilities connected to the building or room in which the services are rendered and equipment such as children's desks, chairs, and play or instructional equipment. Such property would not include general purpose rooms used for many purposes (for example, a room used as an employee recreation center during the evening) nor would it include a room or a part of a room which is simply screened off for use by children during the day. For purposes of this section, a facility is considered to be specifically used as a child care facility if such facility is actually used for such purpose and is not used in a significant manner for any purpose other than child care. For purposes of this subparagraph, a child care facility is used by an employer to provide child care services primarily for children of employees of the employer if, for any month, no more than 20 percent of the average daily enrolled or attending children for such month are other than children of such employees.

(5) *Placed in service.* For purposes of section 188 and this section, the term *placed in service* shall have the meaning assigned to such term in paragraph (d) of § 1.46–3.

(6) *Employees.* For purposes of section 188 and this section, the terms *employees* and *prospective employees* include employees and prospective employees of a member of a controlled group of corporations (within the meaning of section 1563) of which the taxpayer is a member.

(e) *Effective date.* The provisions of section 188 and this section apply to taxable years ending after December 31, 1971.

[T.D. 7599, 44 FR 14549, Mar. 13, 1979]

§ 1.190–1 Expenditures to remove architectural and transportation barriers to the handicapped and elderly.

(a) *In general.* Under section 190 of the Internal Revenue Code of 1954, a taxpayer may elect, in the manner provided in § 1.190–3 of this chapter, to deduct certain amounts paid or incurred by him in any taxable year beginning after December 31, 1976, and before January 1, 1980, for qualified architectural and transportation barrier removal expenses (as defined in § 1.190–2(b) of this chapter). In the case of a partnership, the election shall be made by the partnership. The election applies to expenditures paid or incurred during the taxable year which (but for the election) are chargeable to capital account.

(b) *Limitation.* The maximum deduction for a taxpayer (including an affiliated group of corporations filing a consolidated return) for any taxable year is $25,000. The $25,000 limitation applies to a partnership and to each partner. Expenditures paid or incurred in a taxable year in excess of the amount deductible under section 190 for such taxable year are capital expenditures and are adjustments to basis under section

1016(a). A partner must combine his distributive share of the partnership's deductible expenditures (after application of the $25,000 limitation at the partnership level) with that partner's distributive share of deductible expenditures from any other partnership plus that partner's own section 190 expenditures, if any (if he makes the election with respect to his own expenditures), and apply the partner's $25,000 limitation to the combined total to determine the aggregate amount deductible by that partner. In so doing, the partner may allocate the partner's $25,000 limitation among the partner's own section 190 expenditures and the partner's distributive share of partnership deductible expenditures in any manner. If such allocation results in all or a portion of the partner's distributive share of a partnership's deductible expenditures not being an allowable deduction by the partner, the partnership may capitalize such unallowable portion by an appropriate adjustment to the basis of the relevant partnership property under section 1016. For purposes of adjustments to the basis of properties held by a partnership, however, it shall be presumed that each partner's distributive share of partnership deductible expenditures (after application of the $25,000 limitation at the partnership level) was allowable in full to the partner. This presumption can be rebutted only by clear and convincing evidence that all or any portion of a partner's distributive share of the partnership section 190 deduction was not allowable as a deduction to the partner because it exceeded that partner's $25,000 limitation as allocated by him. For example, suppose for 1978 A's distributive share of the ABC partnership's deductible section 190 expenditures (after application of the $25,000 limitation at the partnership level) is $15,000. A also made section 190 expenditures of $20,000 in 1978 which he elects to deduct. A allocates $10,000 of his $25,000 limitation to his distributive share of the ABC expenditures and $15,000 to his own expenditures. A may capitalize the excess $5,000 of his own expenditures. In addition, if ABC obtains from A evidence which meets the requisite burden of proof, it may capitalize the $5,000 of A's distributive share which is not allowable as a deduction to A.

[T.D. 7634, 44 FR 43270, July 24, 1979]

§1.190–2 Definitions.

For purposes of section 190 and the regulations thereunder:

(a) *Architectural and transportation barrier removal expenses.* The term *architectural and transportation barrier removal expenses* means expenditures for the purpose of making any facility, or public transportation vehicle, owned or leased by the taxpayer for use in connection with his trade or business more accessible to, or usable by, handicapped individuals or elderly individuals. For purposes of this section:

(1) The term *facility* means all or any portion of buildings, structures, equipment, roads, walks, parking lots, or similar real or personal property.

(2) The term *public transportation vehicle* means a vehicle, such as a bus, a railroad car, or other conveyance, which provides to the public general or special transportation service (including such service rendered to the customers of a taxpayer who is not in the trade or business of rendering transportation services).

(3) The term *handicapped individual* means any individual who has:

(i) A physical or mental disability (including, but not limited to, blindness or deafness) which for such individual constitutes or results in a functional limitation to employment, or

(ii) A physical or mental impairment (including, but not limited to, a sight or hearing impairment) which substantially limits one or more of such individual's major life activities, such as performing manual tasks, walking, speaking, breathing, learning, or working.

(4) The term *elderly individual* means an individual age 65 or over.

(b) *Qualified architectual and transportation barrier removal expense*—(1) *In general.* The term *qualified architectural and transportation barrier removal expense* means an architectural or transportation barrier removal expense (as defined in paragraph (a) of this section) with respect to which the taxpayer establishes, to the satisfaction of the Commissioner or his delegate, that the resulting removal of any such barrier conforms a facility or public transportation vehicle to all the requirements set forth in one or more of paragraphs (b) (2) through (22) of this section or in one or more of the subdivisions of paragraph (b) (20) or (21). Such term includes only expenses specifically attributable to the removal of an existing architectural or transportation barrier. It does not include any part of any expense paid or incurred in connection with the construction or comprehensive renovation of a facility or public transportation vehicle or the normal replacement of depreciable property. Such term may include expenses of construction, as, for example, the construction of a ramp to remove the barrier posed for wheelchair users by steps. Major portions of the standards set forth in this paragraph were adapted from ''American National Standard Specifications for Making Buildings and Facilities Accessible to, and Usable by, the Physically Handicapped'' (1971), the copyright for which is held by the American National Standards Institute, 1430 Broadway, New York, New York 10018.

(2) *Grading.* The grading of ground, even contrary to existing topography, shall attain a level with a normal entrance to make a facility accessible to individuals with physical disabilities.

(3) *Walks.* (i) A public walk shall be at least 48 inches wide and shall have a gradient not greater than 5 percent. A walk of maximum or near maximum grade and of considerable length shall have level areas at regular intervals. A walk or driveway shall have a nonslip surface.

(ii) A walk shall be of a continuing common surface and shall not be interrupted by steps or abrupt changes in level.

(iii) Where a walk crosses a walk, a driveway, or a parking lot, they shall blend to a common level. However, the preceding sentence does not require the elimination of those curbs which are a safety feature for the handicapped, particularly the blind.

(iv) An inclined walk shall have a level platform at the top and at the bottom. If a door swings out onto the platform toward the walk, such platform shall be at least 5 feet deep and 5 feet wide. If a door does not swing onto the platform or toward the walk, such platform shall be at least 3 feet deep and 5 feet wide. A platform shall extend at least 1 foot beyond the strike jamb side of any doorway.

(4) *Parking lots.* (i) At least one parking space that is accessible and approximate to a facility shall be set aside and identified for use by the handicapped.

(ii) A parking space shall be open on one side to allow room for individuals in wheelchairs and individuals on braces or crutches to get in and out of an automobile onto a level surface which is suitable for wheeling and walking.

(iii) A parking space for the handicapped, when placed between two conventional diagonal or head-on parking spaces, shall be at least 12 feet wide.

(iv) A parking space shall be positioned so that individuals in wheelchairs and individuals on braces or crutches need not wheel or walk behind parked cars.

(5) *Ramps.* (i) A ramp shall not have a slope greater than 1 inch rise in 12 inches.

(ii) A ramp shall have at least one handrail that is 32 inches in height, measured from the surface of the ramp, that is smooth, and that extends 1 foot beyond the top and bottom of the ramp. However, the preceding sentence does not require a handrail extension which is itself a hazard.

(iii) A ramp shall have a nonslip surface.

(iv) A ramp shall have a level platform at the top and at the bottom. If a door swings out onto the platform or toward the ramp, such platform shall be at least 5 feet deep and 5 feet wide. If a door does not swing onto the platform or toward the ramp, such platform shall be at least 3 feet deep and 5 feet wide. A platform shall extend at least 1 foot beyond the strike jamb side of any doorway.

(v) A ramp shall have level platforms at not more than 30-foot intervals and at any turn.

(vi) A curb ramp shall be provided at an intersection. The curb ramp shall not be less than 4 feet wide; it shall not have a slope greater than 1 inch rise in 12 inches. The transition between the two surfaces shall be smooth. A curb ramp shall have a nonslip surface.

(6) *Entrances.* A building shall have at least one primary entrance which is usable by individuals in wheelchairs and which is on a level accessible to an elevator.

(7) *Doors and doorways.* (i) A door shall have a clear opening of no less than 32 inches and shall be operable by a single effort.

(ii) The floor on the inside and outside of a doorway shall be level for a distance of at least 5 feet from the door in the direction the door swings and shall extend at least 1 foot beyond the strike jamb side of the doorway.

(iii) There shall be no sharp inclines or abrupt changes in level at a doorway. The threshold shall be flush with the floor. The door closer shall be selected, placed, and set so as not to impair the use of the door by the handicapped.

(8) *Stairs.* (i) Stairsteps shall have round nosing of between 1 and 1½ inch radius.

(ii) Stairs shall have a handrail 32 inches high as measured from the tread at the face of the riser.

(iii) Stairs shall have at least one handrail that extends at least 18 inches beyond the top step and beyond the bottom step. The preceding sentence does not require a handrail extension which is itself a hazard.

(iv) Steps shall have risers which do not exceed 7 inches.

(9) *Floors.* (i) Floors shall have a nonslip surface.

(ii) Floors on a given story of a building shall be of a common level or shall be connected by a ramp in accordance with subparagraph (5) of this paragraph.

(10) *Toilet rooms.* (i) A toilet room shall have sufficient space to allow traffic of individuals in wheelchairs.

(ii) A toilet room shall have at least one toilet stall that:

(A) Is at least 36 inches wide;

(B) Is at least 56 inches deep;

(C) Has a door, if any, that is at least 32 inches wide and swings out;

(D) Has handrails on each side, 33 inches high and parallel to the floor, 1½ inches in outside diameter, 1½ inches clearance between rail and wall, and fastened securely at ends and center; and

(E) Has a water closet with a seat 19 to 20 inches from the finished floor.

(iii) A toilet room shall have, in addition to or in lieu of a toilet stall described in (ii), at least one toilet stall that:

(A) Is at least 66 inches wide;

(B) Is at least 60 inches deep;

(C) Has a door, if any, that is at least 32 inches wide and swings out;

(D) Has a handrail on one side, 33 inches high and parallel to the floor, 1½ inches in outside diameter, 1½ inches clearance between rail and wall, and fastened securely at ends and center; and

(E) Has a water closet with a seat 19 to 20 inches from the finished floor, centerline located 18 inches from the side wall on which the handrail is located.

(iv) A toilet room shall have lavatories with narrow aprons. Drain pipes and hot water pipes under a lavatory shall be covered or insulated.

(v) A mirror and a shelf above a lavatory shall be no higher than 40 inches above the floor, measured from the top of the shelf and the bottom of the mirror.

(vi) A toilet room for men shall have wall-mounted urinals with the opening of the basin 15 to 19 inches from the finished floor or shall have floor-mounted urinals that are level with the main floor of the toilet room.

(vii) Towel racks, towel dispensers, and other dispensers and disposal units shall be mounted no higher than 40 inches from the floor.

(11) *Water fountains.* (i) A water fountain and a cooler shall have upfront spouts and controls.

(ii) A water fountain and a cooler shall be hand-operated or hand-and-foot-operated.

(iii) A water fountain mounted on the side of a floor-mounted cooler shall not be more than 30 inches above the floor.

(iv) A wall-mounted, hand-operated water cooler shall be mounted with the basin 36 inches from the floor.

(v) A water fountain shall not be fully recessed and shall not be set into an alcove unless the alcove is at least 36 inches wide.

(12) *Public telephones.* (i) A public telephone shall be placed so that the dial and the headset can be reached by individuals in wheelchairs.

(ii) A public telephone shall be equipped for those with hearing disabilities and so identified with instructions for use.

(iii) Coin slots of public telephones shall be not more than 48 inches from the floor.

(13) *Elevators.* (i) An elevator shall be accessible to, and usable by the handicapped or the elderly on the levels they use to enter the building and all levels and areas normally used.

(ii) Cab size shall allow for the turning of a wheelchair. It shall measure at least 54 by 68 inches.

(iii) Door clear opening width shall be at least 32 inches.

(iv) All essential controls shall be within 48 to 54 inches from cab floor. Such controls shall be usable by the blind and shall be tactilely identifiable.

(14) *Controls.* Switches and controls for light, heat, ventilation, windows, draperies, fire alarms, and all similar controls of frequent or essential use, shall be placed within the reach of individuals in wheelchairs. Such switches and controls shall be no higher than 48 inches from the floor.

(15) *Identification.* (i) Raised letters or numbers shall be used to identify a room or an office. Such identification shall be placed on the wall to the right or left of the door at a height of 54 inches to 66 inches, measured from the finished floor.

(ii) A door that might prove dangerous if a blind person were to exit or enter by it (such as a door leading to a loading platform, boiler room, stage, or fire escape) shall be tactilely identifiable.

(16) *Warning signals.* (i) An audible warning signal shall be accompanied by a simultaneous visual signal for the benefit of those with hearing disabilities.

(ii) A visual warning signal shall be accompanied by a simultaneous audible signal for the benefit of the blind.

(17) *Hazards.* Hanging signs, ceiling lights, and similar objects and fixtures shall be placed at a minimum height of 7 feet, measured from the floor.

(18) *International accessibility symbol.* The international accessibility symbol (see illustration) shall be displayed on routes to and at wheelchair-accessible entrances to facilities and public transportation vehicles.

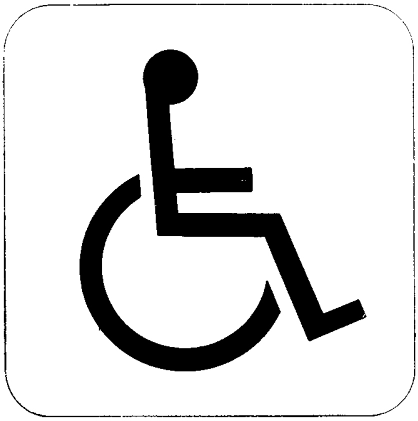

(19) *Additional standards for rail facilities.* (i) A rail facility shall contain a fare control area with at least one entrance with a clear opening at least 36 inches wide.

(ii) A boarding platform edge bordering a drop-off or other dangerous condition shall be marked with a warning device consisting of a strip of floor material differing in color and texture from the remaining floor surface. The gap between boarding platform and vehicle doorway shall be minimized.

(20) *Standards for buses.* (i) A bus shall have a level change mechanism (e.g., lift or ramp) to enter the bus and sufficient clearance to permit a wheelchair user to reach a secure location.

(ii) a bus shall have a wheelchair securement device. However, the preceding sentence does not require a wheelchair securement device which is itself a barrier or hazard.

(iii) The vertical distance from a curb or from street level to the first front door step shall not exceed 8 inches; the riser height for each front doorstep after the first step up from the curb or street level shall also not exceed 8 inches; and the tread depth of steps at front and rear doors shall be no less than 12 inches.

(iv) A bus shall contain clearly legible signs that indicate that seats in the front of the bus are priority seats for handicapped or elderly persons, and that encourage other passengers to make such seats available to handicapped and elderly persons who wish to use them.

(v) Handrails and stanchions shall be provided in the entranceway to the bus in a configuration that allows handicapped and elderly persons to grasp such assists from outside the bus while starting to board and to continue to use such assists throughout the boarding and fare collection processes. The configuration of the passenger assist system shall include a rail across the front of the interior of the bus located to allow passengers to lean against it while paying fares. Overhead handrails shall be continuous except for a gap at the rear doorway.

(vi) Floors and steps shall have nonslip surfaces. Step edges shall have a band of bright contrasting color running the full width of the step.

(vii) A stepwell immediately adjacent to the driver shall have, when the door is open, at least 2 foot-candles of illumination measured on the step tread. Other stepwells shall have, at all times, at least 2 foot-candles of illumination measured on the step tread.

(viii) The doorways of the bus shall have outside lighting that provides at least 1 foot-candle of illumination on the street surface for a distance of 3 feet from all points on the bottom step tread edge. Such lighting shall be located below window level and shall be shielded to protect the eyes of entering and exiting passengers.

(ix) The fare box shall be located as far forward as practicable and shall not obstruct traffic in the vestibule.

(21) *Standards for rapid and light rail vehicles.* (i) Passenger doorways on the vehicle sides shall have clear openings at least 32 inches wide.

(ii) Audible or visual warning signals shall be provided to alert handicapped and elderly persons of closing doors.

(iii) Handrails and stanchions shall be sufficient to permit safe boarding, onboard circulation, seating and standing assistance, and unboarding by handicapped and elderly persons. On a levelentry vehicle, handrails, stanchions, and seats shall be located so as to allow a wheelchair user to enter the vehicle and position the wheelchair in a location which does not obstruct the movement of other passengers. On a vehicle that requires the use of steps in the boarding process, handrails and stanchions shall be provided in the entranceway to the vehicle in a configuration that allows handicapped and elderly persons to grasp such assists from outside the vehicle while starting to board, and to continue using such assists throughout the boarding process.

(iv) Floors shall have nonslip surfaces. Step edges on a light rail vehicle shall have a band of bright contrasting color running the full width of the step.

(v) A stepwell immediately adjacent to the driver shall have, when the door is open, at least 2 foot-candles of illumination measured on the step tread. Other stepwells shall have, at all times, at least 2 foot-candles of illumination measured on the step tread.

(vi) Doorways on a light rail vehicle shall have outside lighting that provides at least 1 foot-candle of illumination on the street surface for a distance of 3 feet from all points on the bottom step tread edge. Such lighting shall be located below window level and shall be shielded to protect the eyes of entering and exiting passengers.

(22) *Other barrier removals.* The provisions of this subparagraph apply to any barrier which would not be removed by compliance with paragraphs (b)(2) through (21) of this section. The requirements of this subparagraph are:

(i) A substantial barrier to the access to or use of a facility or public transportation vehicle by handicapped or elderly individuals is removed;

(ii) The barrier which is removed had been a barrier for one or more major classes of such individuals (such as the blind, deaf, or wheelchair users); and

(iii) The removal of that barrier is accomplished without creating any new barrier that significantly impairs access to or use of the facility or vehicle by such class or classes.

[T.D. 7634, 44 FR 43270, July 24, 1979]

§ 1.190–3 Election to deduct architectural and transportation barrier removal expenses.

(a) *Manner of making election.* The election to deduct expenditures for removal of architectural and transportation barriers provided by section 190(a) shall be made by claiming the deduction as a separate item identified as such on the taxpayer's income tax return for the taxable year for which such election is to apply (or, in the case of a partnership, to the return of partnership income for such year). For the election to be valid, the return must be filed not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year for which the election is to apply.

(b) *Scope of election.* An election under section 190(a) shall apply to all expenditures described in § 1.190–2 (or in the case of a taxpayer whose architectural and transportation barrier removal expenses exceed $25,000 for the taxable year, to the $25,000 of such expenses with respect to which the deduction is claimed) paid or incurred during the taxable year for which made and shall be irrevocable after the date by which any such election must have been made.

(c) *Records to be kept.* In any case in which an election is made under section 190(a), the taxpayer shall have available, for the period prescribed by paragraph (e) of § 1.6001–1 of this chapter (Income Tax Regulations), records and documentation, including architectural plans and blueprints, contracts, and any building permits, of all the facts necessary to determine the amount of any deduction to which he is entitled by reason of the election, as well as the amount of any adjustment to basis made for expenditures in excess of the amount deductible under section 190.

[T.D. 7634, 44 FR 13273, July 24, 1979]

§ 1.193–1 Deduction for tertiary injectant expenses.

(a) *In general.* Subject to the limitations and restrictions of paragraphs (c) and (d) of this section, there shall be allowed as a deduction from gross income an amount equal to the qualified tertiary injectant expenses of the taxpayer. This deduction is allowed for the later of:

(1) The taxable year in which the injectant is injected, or

(2) The taxable year in which the expenses are paid or incurred.

(b) *Definitions*—(1) *Qualified tertiary injectant expenses.* Except as otherwise provided in this section, the term *qualified tertiary injectant expense* means any cost paid or incurred for any tertiary injectant which is used as part of a tertiary recovery method.

(2) *Tertiary recovery method. Tertiary recovery method* means:

(i) Any method which is described in subparagraphs (1) through (9) of section 212.78(c) of the June 1979 energy regulations (as defined by section 4996(b)(8)(C)),

(ii) Any method for which the taxpayer has obtained the approval of the Associate Chief Counsel (Technical), under section 4993(d)(1)(B) for purposes of Chapter 45 of the Internal Revenue Code,

(iii) Any method which is approved in the regulations under section 4993(d)(1)(B), or

(iv) Any other method to provide tertiary enhanced recovery for which the taxpayer obtains the approval of the

Associate Chief Counsel (Technical) for purposes of section 193.

(c) *Special rules for hydrocarbons*—(1) *In general.* If an injectant contains more than an insignificant amount of recoverable hydrocarbons, the amount deductible under section 193 and paragraph (a) of this section shall be limited to the cost of the injectant reduced by the lesser of:

(i) The fair market value of the hydrocarbon component in the form in which it is recovered, or

(ii) The cost to the taxpayer of the hydrocarbon component of the injectant. Price levels at the time of injection are to be used in determining the fair market value of the recoverable hydrocarbons.

(2) *Presumption of recoverability.* Except to the extent that the taxpayer can demonstrate otherwise, all hydrocarbons shall be presumed recoverable and shall be presumed to have the same value on recovery that they would have if separated from the other components of the injectant before injection. Estimates based on generally accepted engineering practices may provide evidence of limitations on the amount or value of recoverable hydrocarbons.

(3) *Significant amount.* For purposes of section 193 and this section, an injectant contains more than an insignificant amount of recoverable hydrocarbons if the fair market value of the recoverable hydrocarbon component of the injectant, in the form in which it is recovered, equals or exceeds 25 percent of the cost of the injectant.

(4) *Hydrocarbon defined.* For purposes of section 193 and this section, the term *hydrocarbon* means all forms of natural gas and crude oil (which includes oil recovered from sources such as oil shale and condensate).

(5) *Injectant defined.* For purposes of applying this paragraph (c), an injectant is the substance or mixture of substances injected at a particular time. Substances injected at different times are not treated as components of a single injectant even if the injections are part of a single tertiary recovery process.

(d) *Application with other deductions.* No deduction shall be allowed under section 193 and this section for any expenditure:

(1) With respect to which the taxpayer has made an election under section 263(c) or

(2) With respect to which a deduction is allowed or allowable under any other provision of chapter 1 of the Code.

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

Example 1. B, a calendar year taxpayer why uses the cash receipts and disbursements method of accounting, uses an approved tertiary recovery method for the enhanced recovery of crude oil from one of B's oil properties. During 1980, B pays $100x for a tertiary injectant which contains 1,000y units of hydrocarbon; if separated from the other components of the injectant before injection, the hydrocarbons would have a fair market value of $80x. B uses this injectant during the recovery effort during 1981. B has not made any election under section 263(c) with respect to the expenditures for the injectant, and no section of chapter 1 of the Code other than section 193 allows a deduction for the expenditure. B is unable to demonstrate that the value of the injected hydrocarbons recovered during production will be less than $80x. B's deduction under section 193 is limited to the excess of the cost for the injectant over the fair market value of the hydrocarbon component expected to be recovered ($100x—$80x=$20x). B may claim the deduction only for 1981, the year of the injection.

Example 2. Assume the same facts as in *Example (1)* except that through engineering studies B has shown that 700y units or 70 percent of the hydrocarbon injected is nonrecoverable. The recoverable hydrocarbons have a fair market value of $24x (30 percent of $80x). The recoverable hydrocarbon portion of the injectant is 24 percent of the cost of the injectant ($24x divided by $100x). The injectant does not contain a significant amount of recoverable hydrocarbons. B may claim a deduction for $100x, the entire cost of the injectant.

Example 3. Assume the same facts as in *Example (1)* except that through laboratory studies B has shown that because of chemical changes in the course of production the injected hydrocarbons that are recovered will have a fair market value of only $40x. B may claim a deduction for $60x, the excess of the cost of the injectant ($100x) over the fair market value of the recoverable hydrocarbons ($40x).

Example 4. B prepares an injectant from crude oil and certain non-hydrocarbon materials purchased by B. The total cost of the injectant to B is $100x, of which $24x is attributable to the crude oil. The fair market value of the crude oil used in the injectant is $27x. B is unable to demonstrate that the value of the crude oil from the injectant that will be recovered is less than $27x. The injectant contains more than an insignificant amount of recoverable hydrocarbons because the value of the recoverable crude oil ($27x) exceeds $25x (25 percent of $100x, the cost of the injectant). Because the cost to B of the hydrocarbon component of the injectant ($24x) is less than the fair market value of the hydrocarbon component in the form in which it is recovered ($27x), the cost rather than the value is taken into account in the adjustment required under paragraph (c)(1) of this section. B's deduction under section 193 is limited to the excess of the cost of the injectant over the cost of the hydrocarbon component ($100x—$24x=$76x).

(Secs. 193 and 7805, Internal Revenue Code of 1954, 94 Stat. 286, 26 U.S.C. 193; 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7980, 49 FR 39052, Oct. 3, 1984]

§ 1.194–1 Amortization of reforestation expenditures.

(a) *In general.* Section 194 allows a taxpayer to elect to amortize over an 84-month period, up to $10,000 of reforestation expenditures (as defined in § 1.194–3(c)) incurred by the taxpayer in a taxable year in connection with qualified timber property (as defined in § 1.194–3(a)). The election is not available to trusts. Only those reforestation expenditures which result in additions to capital accounts after December 31, 1979 are eligible for this special amortization.

(b) *Determination of amortization period.* The amortization period must begin on the first day of the first month of the last half of the taxable year during which the taxpayer incurs the reforestation expenditures. For example, the 84-month amortization period begins on July 1 of a taxable year for a calendar year taxpayer, regardless of whether the reforestation expenditures are incurred in January or December of that taxable year. Therefore, a taxpayer will be allowed to claim amortization deductions for only six months of each of the first and eighth taxable years of the period over which the reforestation expenditures will be amortized.

(c) *Recapture.* If a taxpayer disposes of qualified timber property within ten years of the year in which the amortizable basis was created and the taxpayer has claimed amortization deductions under section 194, part or all of any gain on the disposition may be recaptured as ordinary income. See section 1245.

[T.D. 7927, 48 FR 55849, Dec. 16, 1983]

§ 1.194–2 Amount of deduction allowable.

(a) *General rule.* The allowable monthly deduction with respect to reforestation expenditures made in a taxable year is determined by dividing the amount of reforestation expenditures made in such taxable year (after applying the limitations of paragraph (b) of this section) by 84. In order to determine the total allowable amortization deduction for a given month, a taxpayer should add the monthly amortization deductions computed under the preceding sentence for qualifying expenditures made by the taxpayer in the taxable year and the preceding seven taxable years.

(b) *Dollar limitation*—(1) *Maximum amount subject to election.* A taxpayer may elect to amortize up to $10,000 of qualifying reforestation expenditures each year under section 194. However, the maximum amortizable amount is $5,000 in the case of a married individual (as defined in section 143) filing a separate return. No carryover or carryback of expenditures in excess of $10,000 is permitted. The maximum annual amortization deduction for expenditures incurred in any taxable year is $1,428.57 ($10,000/7). The maximum deduction in the first and eighth taxable years of the amortization period is one-half that amount, or $714.29, because of the half-year convention provided in § 1.194–1(b). Total deductions for any one year under this section will reach $10,000 only if a taxpayer incurs and elects to amortize the maximum $10,000 of expenditures each year over an 8-year period.

(2) *Allocation of amortizable basis among taxpayer's timber properties.* The limit of $10,000 on amortizable reforestation expenditures applies to expenditures paid or incurred during a taxable year on all of the taxpayer's timber properties. A taxpayer who incurs more than $10,000 in qualifying expenditures in connection with more than one qualified timber property during a taxable year may select the properties for which section 194 amortization will be elected as well as the manner in which

the $10,000 limitation on amortizable basis is allocated among such properties. For example, A incurred $10,000 of qualifying reforestation expenditures on each of four properties in 1981. A may elect under section 194 to amortize $2,500 of the amount spent on each property, $5,000 of the amount spent on any two properties, the entire $10,000 spent on any one property, or A may allocate the $10,000 maximum amortizable basis among some or all of the properties in any other manner.

(3) *Basis*—(i) *In general.* Except as provided in paragraph (b)(3)(ii) of this section, the basis of a taxpayer's interest in qualified timber property for which an election is made under section 194 shall be adjusted to reflect the amount of the section 194 amortization deduction allowable to the taxpayer.

(ii) *Special rule for trusts.* Although a trust may be a partner of a partnership, income beneficiary of an estate, or (for taxable years beginning after December 31, 1982) shareholder of an S corporation, it may not deduct its allocable share of a section 194 amortization deduction allowable to such a partnership, estate, or S corporation. In addition, the basis of the interest held by the partnership, estate, or S corporation in the qualified timber property shall not be adjusted to reflect the portion of the section 194 amortization deduction that is allocable to the trust.

(4) *Allocation of amortizable basis among component members of a controlled group.* Component members of a controlled group (as defined in §1.194–3(d)) on a December 31 shall be treated as one taxpayer in applying the $10,000 limitation of paragraph (b)(1) of this section. The amortizable basis may be allocated to any one such member or allocated (for the taxable year of each such member which includes such December 31) among the several members in any manner, *Provided* That the amount of amortizable basis allocated to any member does not exceed the amount of amortizable basis actually acquired by the member in the taxable year. The allocation is to be made (i) by the common parent corporation if a consolidated return is filed for all component members of the group, or (ii) in accordance with an agreement entered into by the members of the group if separate returns are filed. If a consolidated return is filed by some component members of the group and separate returns are filed by other component members, then the common parent of the group filing the consolidated return shall enter into an agreement with those members who do not join in filing the consolidated return allocating the amount between the group filing the return and the other component members of the controlled group who do not join in filing the consolidated return. If a consolidated return is filed, the common parent corporation shall file a separate statement attached to the income tax return on which an election is made to amortize reforestation costs under section 194. See §1.194–4. If separate returns are filed by some or all component members of the group, each component member to which is allocated any part of the deduction under secton 194 shall file a separate statement attached to the income tax return in which an election is made to amortize reforestation expenditures. See §1.194–4. Such statement shall include the name, address, employer identification number, and the taxable year of each component member of the controlled group, a copy of the allocation agreement signed by persons duly authorized to act on behalf of those members who file separate returns, and a description of the manner in which the deduction under section 194 has been divided among them.

(5) *Partnerships*—(i) *Election to be made by partnership.* A partnership makes the election to amortize qualified reforestation expenditures of the partnership. See section 703(b).

(ii) *Dollar limitations applicable to partnerships.* The dollar limitations of section 194 apply to the partnership as well as to each partner. Thus, a partnership may not elect to amortize more than $10,000 of reforestation expenditures under section 194 in any taxable year.

(iii) *Partner's share of amortizable basis.* Section 704 and the regulations thereunder shall govern the determination of a partner's share of a partnership's amortizable reforestation expenditures for any taxable year.

(iv) *Dollar limitation applicable to partners.* A partner shall in no event be entitled in any taxable year to claim a deduction for amortization based on more than $10,000 ($5,000 in the case of a married taxpayer who files a separate return) of amortizable basis acquired in such taxable year regardless of the source of the amortizable basis. In the case of a partner who is a member of two or more partnerships that elect under section 194, the partner's aggregate share of partnership amortizable basis may not exceed $10,000 or $5,000, whichever is applicable. In the case of a member of a partnership that elects under section 194 who also has separately acquired qualified timber property, the aggregate of the member's partnership and non-partnership amortizable basis may not exceed $10,000 or $5,000 whichever is applicable.

(6) *S corporations.* For taxable years beginning after December 31, 1982, rules similar to those contained in paragraph (b)(5) (ii) and (iv) of this section shall apply in the case of S corporations (as defined in section 1361(a)) and their shareholders.

(7) *Estates.* Estates may elect to amortize in each taxable year up to a maximum of $10,000 of qualifying reforestation expenditures under section 194. Any amortizable basis acquired by an estate shall be apportioned between the estate and the income beneficiary on the basis of the income of the estate allocable to each. The amount of amortizable basis apportioned from an estate to a beneficiary shall be taken into account in determining the $10,000 (or $5,000) amount of amortizable basis allowable to such beneficiary under this section.

(c) *Life tenant and remainderman.* If property is held by one person for life with remainder to another person, the life tenant is entitled to the full benefit of any amortization allowable under section 194 on qualifying expenditures he or she makes. Any remainder interest in the property is ignored for this purpose.

[T.D. 7927, 48 FR 55849, Dec. 16, 1983]

§ 1.194–3 Definitions.

(a) *Qualified timber property.* The term *qualified timber property* means property located in the United States which will contain trees in significant commercial quantities. The property may be a woodlot or other site but must consist of at least one acre which is planted with tree seedlings in the manner normally used in forestation or reforestation. The property must be held by the taxpayer for the growing and cutting of timber which will either be sold for use in, or used by the taxpayer in, the commercial production of timber products. A taxpayer does not have to own the property in order to be eligible to elect to amortize costs attributable to it under section 194. Thus, a taxpayer may elect to amortize qualifying reforestation expenditures incurred by such taxpayer on leased qualified timber property. Qualified timber property does not include property on which the taxpayer has planted shelter belts (for which current deductions are allowed under section 175) or ornamental trees, such as Christmas trees.

(b) *Amortizable basis.* The term *amortizable basis* means that portion of the basis of qualified timber property which is attributable to reforestation expenditures.

(c) *Reforestation expenditures*—(1) *In general.* The term *reforestation expenditures* means direct costs incurred to plant or seed for forestation or reforestation purposes. Qualifying expenditures include amounts spent for site preparation, seed or seedlings, and labor and tool costs, including depreciation on equipment used in planting or seeding. Only those costs which must be capitalized and are included in the adjusted basis of the property qualify as reforestation expenditures. Costs which are currently deductible do not qualify.

(2) *Cost-sharing programs.* Any expenditures for which the taxpayer has been reimbursed under any governmental reforestation cost-sharing program do not qualify as reforestation expenditures unless the amounts reimbursed have been included in the gross income of the taxpayer.

(d) *Definitions of controlled group of corporations and component member of controlled group.* For purposes of section 194, the terms *controlled group of corporations* and *component member* of a controlled group of corporations shall have the same meaning assigned to those terms in section 1563 (a) and (b), except that the phrase ''more than 50 percent'' shall be substituted for the phrase ''at least 80 percent'' each place it appears in section 1563(a)(1).

[T.D. 7927, 48 FR 55850, Dec. 16, 1983]

§1.194–4 Time and manner of making election.

(a) *In general.* Except as provided in paragraph (b) of this section, an election to amortize reforestation expenditures under section 194 shall be made by entering the amortization deduction claimed at the appropriate place on the taxpayer's income tax return for the year in which the expenditures were incurred, and by attaching a statement to such return. The statement should state the amounts of the expenditures, describe the nature of the expenditures, and give the date on which each was incurred. The statement should also state the type of timber being grown and the purpose for which it is being grown. A separate statement must be included for each property for which reforestation expenditures are being amortized under section 194. The election may only be made on a timely return (taking into account extensions of the time for filing) for the taxable year in which the amortizable expenditures were made.

(b) *Special rule.* With respect to any return filed before March 15, 1984, on which a taxpayer was eligible to, but did not make an election under section 194, the election to amortize reforestation expenditures under section 194 may be made by a statement on, or attached to, the income tax return (or an amended return) for the taxable year, indicating that an election is being made under section 194 and setting forth the information required under paragraph (a) of this section. An election made under the provisions of this paragraph (b) must be made not later than,

(1) The time prescribed by law (including extensions thereof) for filing the income tax return for the year in which the reforestation expenditures were made, or

(2) March 15, 1984, whichever is later. Nothing in this paragraph shall be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(c) *Revocation.* An application for consent to revoke an election under section 194 shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall set forth the name and address of the taxpayer, state the taxable years for which the election was in effect, and state the reason for revoking the election. The application shall be signed by the taxpayer or a duly authorized representative of the taxpayer and shall be filed at least 90 days prior to the time prescribed by law (without regard to extensions thereof) for filing the income tax return for the first taxable year for which the election is to terminate. Ordinarily, the request for consent to revoke the election will not be granted if it appears from all the facts and circumstances that the only reason for the desired change is to obtain a tax advantage.

[T.D. 7927, 48 FR 55851, Dec. 16, 1983]

§1.195–1 Election to amortize start-up expenditures.

(a) *In general.* Under section 195(b), a taxpayer may elect to amortize start-up expenditures (as defined in section 195(c)(1)). A taxpayer who elects to amortize start-up expenditures must, at the time of the election, select an amortization period of not less than 60 months, beginning with the month in which the active trade or business begins. The election applies to all of the taxpayer's start-up expenditures with respect to the trade or business. The election to amortize start-up expenditures is irrevocable, and the amortization period selected by the taxpayer in making the election may not subsequently be changed.

(b) *Time and manner of making election.* The election to amortize start-up expenditures under section 195 shall be made by attaching a statement containing the information described in paragraph (c) of this section to the taxpayer's return. The statement must be filed no later than the date prescribed by law for filing the return (including any extensions of time) for the taxable year in which the active trade or business begins. The statement may be filed with a return for any taxable year prior to the year in which the taxpayer's active trade or business begins, but no later than the date prescribed in the preceding sentence. Accordingly, an election under section 195 filed for any taxable year prior to the year in which the taxpayer's active trade or business begins (and pursuant to which the taxpayer commenced amortizing start-up expenditures in that prior year) will become effective in the month of the year in which the taxpayer's active trade or business begins.

(c) *Information required.* The statement shall set forth a description of the trade or business to which it relates with sufficient detail so that expenses relating to the trade or business can be identified properly for the taxable year in which the statement is filed and for all future taxable years to which it relates. The statement also shall include the number of months (not less than 60) over which the expenditures are to be amortized, and to the extent known at the time the statement is filed, a description of each start-up expenditure incurred (whether or not paid) and the month in which the active trade or business began (or was acquired). A revised statement may be filed to include any start-up expenditures not included in the taxpayer's original election statement, but the revised statement may not include any expenditures for which the taxpayer had previously taken a position on a return inconsistent with their treatment as start-up expenditures. The revised statement may be filed with a return filed after the return that contained the election.

(d) *Effective date.* This section applies to elections filed on or after December 17, 1998.

[T.D. 8797, 63 FR 69555, Dec. 17, 1998]

§ 1.197–1T Certain elections for intangible property (temporary).

(a) *In general.* This section provides rules for making the two elections under section 13261 of the Omnibus Budget Reconciliation Act of 1993 (OBRA '93). Paragraph (c) of this section provides rules for making the section 13261(g)(2) election (the retroactive election) to apply the intangibles provisions of OBRA '93 to property acquired after July 25, 1991, and on or before August 10, 1993 (the date of enactment of OBRA '93). Paragraph (d) of this section provides rules for making the section 13261(g)(3) election (binding contract election) to apply prior law to property acquired pursuant to a written binding contract in effect on August 10, 1993, and at all times thereafter before the date of acquisition. The provisions of this section apply only to property for which an election is made under paragraph (c) or (d) of this section.

(b) *Definitions and special rules*—(1) *Intangibles provisions of OBRA '93.* The intangibles provisions of OBRA '93 are sections 167(f) and 197 of the Internal Revenue Code (Code) and all other pertinent provisions of section 13261 of OBRA '93 (e.g., the amendment of section 1253 in the case of a franchise, trademark, or trade name).

(2) *Transition period property.* The transition period property of a taxpayer is any property that was acquired by the taxpayer after July 25, 1991, and on or before August 10, 1993.

(3) *Eligible section 197 intangibles.* The eligible section 197 intangibles of a taxpayer are any section 197 intangibles that—

(i) Are transition period property; and

(ii) Qualify as amortizable section 197 intangibles (within the meaning of section 197(c)) if an election under section 13261(g)(2) of OBRA '93 applies.

(4) *Election date.* The election date is the date (determined after application of section 7502(a)) on which the taxpayer files the original or amended return to which the election statement described in paragraph (e) of this section is attached.

(5) *Election year.* The election year is the taxable year of the taxpayer that includes August 10, 1993.

(6) *Common control.* A taxpayer is under common control with the electing taxpayer if, at any time after August 2, 1993, and on or before the election date (as defined in paragraph (b)(4) of this section), the two taxpayers would be treated as a single taxpayer under section 41(f)(1) (A) or (B).

(7) *Applicable convention for sections 197 and 167(f) intangibles.* For purposes

of computing the depreciation or amortization deduction allowable with respect to transition period property described in section 167(f) (1) or (3) or with respect to eligible section 197 intangibles—

(i) Property acquired at any time during the month is treated as acquired as of the first day of the month and is eligible for depreciation or amortization during the month; and

(ii) Property is not eligible for depreciation or amortization in the month of disposition.

(8) *Application to adjustment to basis of partnership property under section 734(b) or 743(b).* Any increase in the basis of partnership property under section 734(b) (relating to the optional adjustment to basis of undistributed partnership property) or section 743(b) (relating to the optional adjustment to the basis of partnership property) will be taken into account under this section by a partner as if the increased portion of the basis were attributable to the partner's acquisition of the underlying partnership property on the date the distribution or transfer occurs. For example, if a section 754 election is in effect and, as a result of its acquisition of a partnership interest, a taxpayer obtains an increased basis in an intangible held through the partnership, the increased portion of the basis in the intangible will be treated as an intangible asset newly acquired by that taxpayer on the date of the transaction.

(9) *Former member.* A former member of a consolidated group is a corporation that was a member of the consolidated group at any time after July 25, 1991, and on or before August 2, 1993, but that is not under common control with the common parent of the group for purposes of paragraph (c)(1)(ii) of this section.

(c) *Retroactive election*—(1) *Effect of election*—(i) *On taxpayer.* Except as provided in paragraph (c)(1)(v) of this section, if a taxpayer makes the retroactive election, the intangibles provisions of OBRA '93 will apply to all the taxpayer's transition period property. Thus, for example, section 197 will apply to all the taxpayer's eligible section 197 intangibles.

(ii) *On taxpayers under common control.* If a taxpayer makes the retroactive election, the election applies to each taxpayer that is under common control with the electing taxpayer. If the retroactive election applies to a taxpayer under common control, the intangibles provisions of OBRA '93 apply to that taxpayer's transition period property in the same manner as if that taxpayer had itself made the retroactive election. However, a retroactive election that applies to a nonelecting taxpayer under common control is not treated as an election by that taxpayer for purposes of re-applying the rule of this paragraph (c)(1)(ii) to any other taxpayer.

(iii) *On former members of consolidated group.* A retroactive election by the common parent of a consolidated group applies to transition period property acquired by a former member while it was a member of the consolidated group and continues to apply to that property in each subsequent consolidated or separate return year of the former member.

(iv) *On transferred assets*—(A) *In general.* If property is transferred in a transaction described in paragraph (c)(1)(iv)(C) of this section and the intangibles provisions of OBRA '93 applied to such property in the hands of the transferor, the property remains subject to the intangibles provisions of OBRA '93 with respect to so much of its adjusted basis in the hands of the transferee as does not exceed its adjusted basis in the hands of the transferor. The transferee is not required to apply the intangibles provisions of OBRA '93 to any other transition period property that it owns, however, unless such provisions are otherwise applicable under the rules of this paragraph (c)(1).

(B) *Transferee election.* If property is transferred in a transaction described in paragraph (c)(1)(iv)(C)(*1*) of this section and the transferee makes the retroactive election, the transferor is not required to apply the intangibles provisions of OBRA '93 to any of its transition period property (including the property transferred to the transferee in the transaction described in paragraph (c)(1)(iv)(C)(*1*) of this section), unless such provisions are otherwise applicable under the rules of this paragraph (c)(1).

(C) *Transactions covered.* This paragraph (c)(1)(iv) applies to—

(*1*) Any transaction described in section 332, 351, 361, 721, 731, 1031, or 1033; and

(*2*) Any transaction between corporations that are members of the same consolidated group immediately after the transaction.

(D) *Exchanged basis property.* In the case of a transaction involving exchanged basis property (e.g., a transaction subject to section 1031 or 1033)—

(*1*) Paragraph (c)(1)(iv)(A) of this section shall not apply; and

(*2*) If the intangibles provisions of OBRA '93 applied to the property by reference to which the exchanged basis is determined (the predecessor property), the exchanged basis property becomes subject to the intangibles provisions of OBRA '93 with respect to so much of its basis as does not exceed the predecessor property's basis.

(E) *Acquisition date.* For purposes of paragraph (b)(2) of this section (definition of transition period property), property (other than exchanged basis property) acquired in a transaction described in paragraph (c)(1)(iv)(C)(*1*) of this section generally is treated as acquired when the transferor acquired (or was treated as acquiring) the property (or predecessor property). However, if the adjusted basis of the property in the hands of the transferee exceeds the adjusted basis of the property in the hands of the transferor, the property, with respect to that excess basis, is treated as acquired at the time of the transfer. The time at which exchanged basis property is considered acquired is determined by applying similar principles to the transferee's acquisition of predecessor property.

(v) *Special rule for property of former member of consolidated group*—(A) *Intangibles provisions inapplicable for certain periods.* If a former member of a consolidated group makes a retroactive election pursuant to paragraph (c)(1)(i) of this section or if an election applies to the former member under the common control rule of paragraph (c)(1)(ii) of this section, the intangibles provisions of OBRA '93 generally apply to all transition period property of the former member. The intangibles provisions of OBRA '93 do not apply, however, to the transition period property of a former member (including a former member that makes or is bound by a retroactive election) during the period beginning immediately after July 25, 1991, and ending immediately before the earlier of—

(*1*) The first day after July 25, 1991, that the former member was not a member of a consolidated group; or

(*2*) The first day after July 25, 1991, that the former member was a member of a consolidated group that is otherwise required to apply the intangibles provisions of OBRA '93 to its transition period property (e.g., because the common control election under paragraph (c)(1)(ii) of this section applies to the group).

(B) *Subsequent adjustments.* See paragraph (c)(5) of this section for adjustments when the intangibles provisions of OBRA '93 first apply to the transition period property of the former member after the property is acquired.

(2) *Making the election*—(i) *Partnerships, S corporations, estates, and trusts.* Except as provided in paragraph (c)(2)(ii) of this section, in the case of transition period property of a partnership, S corporation, estate, or trust, only the entity may make the retroactive election for purposes of paragraph (c)(1)(i) of this section.

(ii) *Partnerships for which a section 754 election is in effect.* In the case of increased basis that is treated as transition period property of a partner under paragraph (b)(8) of this section, only that partner may make the retroactive election for purposes of paragraph (c)(1)(i) of this section.

(iii) *Consolidated groups.* An election by the common parent of a consolidated group applies to members and former members as described in paragraphs (c)(1)(ii) and (iii) of this section. Further, for purposes of paragraph (c)(1)(ii) of this section, an election by the common parent is not treated as an election by any subsidiary member. A retroactive election cannot be made by a corporation that is a subsidiary member of a consolidated group on August 10, 1993, but an election can be made on behalf of the subsidiary member under paragraph (c)(1)(ii) of this section (e.g., by the common parent of the group). See paragraph (c)(1)(iii) of this section for rules concerning the effect of the common parent's election on transition period property of a former member.

(3) *Time and manner of election*—(i) *Time.* In general, the retroactive election must be made by the due date (including extensions of time) of the electing taxpayer's Federal income tax return for the election year. If, however, the taxpayer's original Federal income tax return for the election year is filed before April 14, 1994, the election may be made by amending that return no later than September 12, 1994.

(ii) *Manner.* The retroactive election is made by attaching the election statement described in paragraph (e) of this section to the taxpayer's original or amended income tax return for the election year. In addition, the taxpayer must—

(A) Amend any previously filed return when required to do so under paragraph (c)(4) of this section; and

(B) Satisfy the notification requirements of paragraph (c)(6) of this section.

(iii) *Effect of nonconforming elections.* An attempted election that does not satisfy the requirements of this paragraph (c)(3) (including an attempted election made on a return for a taxable year prior to the election year) is not valid.

(4) *Amended return requirements*—(i) *Requirements.* A taxpayer subject to this paragraph (c)(4) must amend all previously filed income tax returns as necessary to conform the taxpayer's treatment of transition period property to the treatment required under the intangibles provisions of OBRA '93. See paragraph (c)(5) of this section for certain adjustments that may be required on the amended returns required under this paragraph (c)(4) in the case of certain consolidated group member dispositions and tax-free transactions.

(ii) *Applicability.* This paragraph (c)(4) applies to a taxpayer if—

(A) The taxpayer makes the retroactive election; or

(B) Another person's retroactive election applies to the taxpayer or to any property acquired by the taxpayer.

(5) *Adjustment required with respect to certain consolidated group member dispositions and tax-free transactions*—(i) *Application.* This paragraph (c)(5) applies to transition period property if the intangibles provisions of OBRA '93 first apply to the property while it is held by the taxpayer but do not apply to the property for some period (the "interim period") after the property is acquired (or considered acquired) by the taxpayer. For example, this paragraph (c)(5) may apply to transition period property held by a former member of a consolidated group if a retroactive election is made by or on behalf of the former member but is not made by the consolidated group. See paragraph (c)(1)(v) of this section.

(ii) *Required adjustment to income.* If this paragraph (c)(5) applies, an adjustment must be taken into account in computing taxable income of the taxpayer for the taxable year in which the intangibles provisions of OBRA '93 first apply to the property. The amount of the adjustment is equal to the difference for the transition period property between—

(A) The sum of the depreciation, amortization, or other cost recovery deductions that the taxpayer (and its predecessors) would have been permitted if the intangibles provisions of OBRA '93 applied to the property during the interim period; and

(B) The sum of the depreciation, amortization, or other cost recovery deductions that the taxpayer (and its predecessors) claimed during that interim period.

(iii) *Required adjustment to basis.* The taxpayer also must make a corresponding adjustment to the basis of its transition period property to reflect any adjustment to taxable income with respect to the property under this paragraph (c)(5).

(6) *Notification requirements*—(i) *Notification of commonly controlled taxpayers.* A taxpayer that makes the retroactive election must provide written notification of the retroactive election (on or before the election date) to each taxpayer that is under common control with the electing taxpayer.

(ii) *Notification of certain former members, former consolidated groups, and transferees.* This paragraph (c)(6)(ii) applies to a common parent of a consolidated group that makes or is notified of a retroactive election that applies to transition period property of a former member, a corporation that makes or is notified of a retroactive election that affects any consolidated group of which the corporation is a former member, or a taxpayer that makes or is notified of a retroactive election that applies to transition period property the taxpayer transfers in a transaction described in paragraph (c)(1)(iv)(C) of this section. Such common parent, former member, or transferor must provide written notification of the retroactive election to any affected former member, consolidated group, or transferee. The written notification must be provided on or before the election date in the case of an election by the common parent, former member, or transferor, and within 30 days of the election date in the case of an election by a person other than the common parent, former member, or transferor.

(7) *Revocation.* Once made, the retroactive election may be revoked only with the consent of the Commissioner.

(8) *Examples.* The following examples illustrate the application of this paragraph (c).

Example 1. (i) X is a partnership with 5 equal partners, A through E. X acquires in 1989, as its sole asset, intangible asset M. X has a section 754 election in effect for all relevant years. F, an unrelated individual, purchases A's entire interest in the X partnership in January 1993 for $700. At the time of F's purchase, X's inside basis for M is $2,000, and its fair market value is $3,500.

(ii) Under section 743(b), X makes an adjustment to increase F's basis in asset M by $300, the difference between the allocated purchase price and M's inside basis ($700 − $400 = $300). Under paragraphs (b)(8) and (c)(2)(ii) of this section, if F makes the retroactive election, the section 743(b) basis increase of $300 in M is an amortizable section 197 intangible even though asset M is not an amortizable section 197 intangible in the hands of X. F's increase in the basis of asset M is amortizable over 15 years beginning with the month of F's acquisition of the partnership interest. With respect to the remaining $400 of basis, F is treated as stepping into A's shoes and continues A's amortization (if any) in asset M. F's retroactive election applies to all other intangibles acquired by F or a taxpayer under common control with F.

Example 2. A, a calendar year taxpayer, is under common control with B, a June 30 fiscal year taxpayer. A files its original election year Federal income tax return on March 15, 1994, and does not make either the retroactive election or the binding contract election. B files its election year tax return on September 15, 1994, and makes the retroactive election. B is required by paragraph (c)(6)(i) of this section to notify A of its election. Even though A had already filed its election year return, A is bound by B's retroactive election under the common control rules. Additionally, if A had made a binding contract election, it would have been negated by B's retroactive election. Because of B's retroactive election, A must comply with the requirements of this paragraph (c), and file amended returns for the election year and any affected prior years as necessary to conform the treatment of transition period property to the treatment required under the intangibles provisions of OBRA '93.

Example 3. (i) P and Y, calendar year taxpayers, are the common parents of unrelated calendar year consolidated groups. On August 15, 1991, S, a subsidiary member of the P group, acquires a section 197 intangible with an unadjusted basis of $180. Under prior law, no amortization or depreciation was allowed with respect to the acquired intangible. On November 1, 1992, a member of the Y group acquires the S stock in a taxable transaction. On the P group's 1993 consolidated return, P makes the retroactive election. The P group also files amended returns for its affected prior years. Y does not make the retroactive election for the Y group.

(ii) Under paragraph (c)(1)(iii) of this section, a retroactive election by the common parent of a consolidated group applies to all transition period property acquired by a former member while it was a member of the group. The section 197 intangible acquired by S is transition period property that S, a former member of the P group, acquired while a member of the P group. Thus, P's election applies to the acquired asset. P must notify S of the election pursuant to paragraph (c)(6)(ii) of this section.

(iii) S amortizes the unadjusted basis of its eligible section 197 intangible ($180) over the 15-year amortization period using the applicable convention beginning as of the first day of the month of acquisition (August 1, 1991). Thus, the P group amends its 1991 consolidated tax return to take into account $5 of amortization ($180/15 years × 5/12 year = $5) for S.

(iv) For 1992, S is entitled to $12 of amortization ($180/15). Assume that under § 1.1502–76, $10 of S's amortization for 1992 is allocated to the P group's consolidated return and $2 is allocated to the Y group's return. The P group amends its 1992 consolidated tax return to reflect the $10 deduction for S. The Y group must amend its 1992 return to reflect the $2 deduction for S.

Example 4. (i) The facts are the same as in *Example 3,* except that the retroactive election is made for the Y group, not for the P group.

(ii) The Y group amends its 1992 consolidated return to claim a section 197 deduction of $2 ($180/15 years × 2/12 year = $2) for S.

(iii) Under paragraph (c)(1)(ii) of this section, the retroactive election by Y applies to all transition period property acquired by S. However, under paragraph (c)(1)(v)(A) of this section, the intangibles provisions of OBRA '93 do not apply to S's transition period property during the period when it held such property as a member of P group. Instead, these provisions become applicable to S's transition period property beginning on November 1, 1992, when S becomes a member of Y group.

(iv) Because the P group did not make the retroactive election, there is an interim period during which the intangibles provisions of OBRA '93 do not apply to the asset acquired by S. Thus, under paragraph (c)(5) of this section, the Y group must take into account in computing taxable income in 1992 an adjustment equal to the difference between the section 197 deduction that would have been permitted if the intangibles provisions of OBRA '93 applied to the property for the interim period (i.e., the period for which S was included in the P group's 1991 and 1992 consolidated returns) and any amortization or depreciation deductions claimed by S for the transferred intangible for that period. The retroactive election does not affect the P group, and the P group is not required to amend its returns.

Example 5. The facts are the same as in *Example 3,* except that both P and Y make the retroactive election. P must notify S of its election pursuant to paragraph (c)(6)(ii) of this section. Further, both the P and Y groups must file amended returns for affected prior years. Because there is no period of time during which the intangibles provisions of OBRA '93 do not apply to the asset acquired by S, the Y group is permitted no adjustment under paragraph (c)(5) of this section for the asset.

(d) *Binding contract election*—(1) *General rule*—(i) *Effect of election.* If a taxpayer acquires property pursuant to a written binding contract in effect on August 10, 1993, and at all times thereafter before the acquisition (an eligible acquisition) and makes the binding contract election with respect to the contract, the law in effect prior to the enactment of OBRA '93 will apply to all property acquired pursuant to the contract. A separate binding contract election must be made with respect to each eligible acquisition to which the law in effect prior to the enactment of OBRA '93 is to apply.

(ii) *Taxpayers subject to retroactive election.* A taxpayer may not make the binding contract election if the taxpayer or a person under common control with the taxpayer makes the retroactive election under paragraph (c) of this section.

(iii) *Revocation.* A binding contract election, once made, may be revoked only with the consent of the Commissioner.

(2) *Time and manner of election*—(i) *Time.* In general, the binding contract election must be made by the due date (including extensions of time) of the electing taxpayer's Federal income tax return for the election year. If, however, the taxpayer's original Federal income tax return for the election year is filed before April 14, 1994, the election may be made by amending that return no later than September 12, 1994.

(ii) *Manner.* The binding contract election is made by attaching the election statement described in paragraph (e) of this section to the taxpayer's original or amended income tax return for the election year.

(iii) *Effect of nonconforming election.* An attempted election that does not satisfy the requirements of this paragraph (d)(2) is not valid.

(e) *Election statement*—(1) *Filing requirements.* For an election under paragraph (c) or (d) of this section to be valid, the electing taxpayer must:

(i) File (with its Federal income tax return for the election year and with any affected amended returns required under paragraph (c)(4) of this section) a written election statement, as an attachment to Form 4562 (Depreciation and Amortization), that satisfies the requirements of paragraph (e)(2) of this section; and

(ii) Forward a copy of the election statement to the Statistics Branch (QAM:S:6111), IRS Ogden Service Center, ATTN: Chief, Statistics Branch, P.O. Box 9941, Ogden, UT 84409.

(2) *Content of the election statement.* The written election statement must include the information in paragraphs (e)(2) (i) through (vi) and (ix) of this section in the case of a retroactive election, and the information in paragraphs (e)(2) (i) and (vii) through (ix) of

this section in the case of a binding contract election. The required information should be arranged and identified in accordance with the following order and numbering system—

(i) The name, address and taxpayer identification number (TIN) of the electing taxpayer (and the common parent if a consolidated return is filed).

(ii) A statement that the taxpayer is making the retroactive election.

(iii) Identification of the transition period property affected by the retroactive election, the name and TIN of the person from which the property was acquired, the manner and date of acquisition, the basis at which the property was acquired, and the amount of depreciation, amortization, or other cost recovery under section 167 or any other provision of the Code claimed with respect to the property.

(iv) Identification of each taxpayer under common control (as defined in paragraph (b)(6) of this section) with the electing taxpayer by name, TIN, and Internal Revenue Service Center where the taxpayer's income tax return is filed.

(v) If any persons are required to be notified of the retroactive election under paragraph (c)(6) of this section, identification of such persons and certification that written notification of the election has been provided to such persons.

(vi) A statement that the transition period property being amortized under section 197 is not subject to the anti-churning rules of section 197(f)(9).

(vii) A statement that the taxpayer is making the binding contract election.

(viii) Identification of the property affected by the binding contract election, the name and TIN of the person from which the property was acquired, the manner and date of acquisition, the basis at which the property was acquired, and whether any of the property is subject to depreciation under section 167 or to amortization or other cost recovery under any other provision of the Code.

(ix) The signature of the taxpayer or an individual authorized to sign the taxpayer's Federal income tax return.

(f) *Effective date.* These regulations are effective March 15, 1994.

[T.D. 8528, 59 FR 11920, Mar. 15, 1994]

ADDITIONAL ITEMIZED DEDUCTIONS FOR INDIVIDUALS

§ 1.211–1 Allowance of deductions.

In computing taxable income under section 63(a), the deductions provided by sections 212, 213, 214, 215, 216, and 217 shall be allowed subject to the exceptions provided in Part IX, Subchapter B, Chapter 1 of the Code (section 261 and following, relating to items not deductible).

[T.D. 6796, 30 FR 1037, Feb. 2, 1965]

§ 1.212–1 Nontrade or nonbusiness expenses.

(a) An expense may be deducted under section 212 only if:

(1) It has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income, or (iii) in connection with the determination, collection, or refund of any tax; and

(2) It is an ordinary and necessary expense for any of the purposes stated in subparagraph (1) of this paragraph.

(b) The term *income* for the purpose of section 212 includes not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter paid or incurred in connection with such bonds are deductible. Similarly, ordinary and necessary expenses paid or incurred in the management, conservation, or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto.

(c) In the case of taxable years beginning before January 1, 1970, expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case. For example, consideration will be given to the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer. For provisions relating to activities not engaged in for profit applicable to taxable years beginning after December 31, 1969, see section 183 and the regulations thereunder.

(d) Expenses, to be deductible under section 212, must be ‘‘ordinary and necessary’’. Thus, such expenses must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

(e) A deduction under section 212 is subject to the restrictions and limitations in part IX (section 261 and following), subchapter B, chapter 1 of the Code, relating to items not deductible. Thus, no deduction is allowable under section 212 for any amount allocable to the production or collection of one or more classes of income which are not includible in gross income, or for any amount allocable to the management, conservation, or maintenance of property held for the production of income which is not included in gross income. See section 265. Nor does section 212 allow the deduction of any expenses which are disallowed by any of the provisions of subtitle A of the Code, even though such expenses may be paid or incurred for one of the purposes specified in section 212.

(f) Among expenditures not allowable as deductions under section 212 are the following: Commuter’s expenses; expenses of taking special courses or training; expenses for improving personal appearance; the cost of rental of a safe-deposit box for storing jewelry and other personal effects; expenses such as those paid or incurred in seeking employment or in placing oneself in a position to begin rendering personal services for compensation, campaign expenses of a candidate for public office, bar examination fees and other expenses paid or incurred in securing admission to the bar, and corresponding fees and expenses paid or incurred by physicians, dentists, accountants, and other taxpayers for securing the right to practice their respective professions. See, however, section 162 and the regulations thereunder.

(g) Fees for services of investment counsel, custodial fees, clerical help, office rent, and similar expenses paid or incurred by a taxpayer in connection with investments held by him are deductible under section 212 only if (1) they are paid or incurred by the taxpayer for the production or collection of income or for the management, conservation, or maintenance of investments held by him for the production of income; and (2) they are ordinary and necessary under all the circumstances, having regard to the type of investment and to the relation of the taxpayer to such investment.

(h) Ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held for use as a residence by the taxpayer are not deductible. However, ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held by the taxpayer as rental property are deductible even though such property was formerly held by the taxpayer for use as a home.

(i) Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under section 212, notwithstanding that the estate or trust is not engaged in a trade or business, except to the extent that such expenses are allocable to the production or collection of tax-exempt income. But see section 642 (g) and the regulations thereunder for disallowance of such deductions to an estate where such items are allowed as a deduction under section 2053 or 2054 in computing the net estate subject to the estate tax.

(j) Reasonable amounts paid or incurred for the services of a guardian or committee for a ward or minor, and other expenses of guardians and committees which are ordinary and necessary, in connection with the production or collection of income inuring to the ward or minor, or in connection with the management, conservation, or maintenance of property, held for the production of income, belonging to the ward or minor, are deductible.

(k) Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenses paid or incurred in protecting or asserting one's right to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible.

(l) Expenses paid or incurred by an individual in connection with the determination, collection, or refund of any tax, whether the taxing authority be Federal, State, or municipal, and whether the tax be income, estate, gift, property, or any other tax, are deductible. Thus, expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of his tax liability or in contesting his tax liability are deductible.

(m) An expense (not otherwise deductible) paid or incurred by an individual in determining or contesting a liability asserted against him does not become deductible by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability.

(n) Capital expenditures are not allowable as nontrade or nonbusiness expenses. The deduction of an item otherwise allowable under section 212 will not be disallowed simply because the taxpayer was entitled under Subtitle A of the Code to treat such item as a capital expenditure, rather than to deduct it as an expense. For example, see section 266. Where, however, the item may properly be treated only as a capital expenditure or where it was properly so treated under an option granted in Subtitle A of the Code, no deduction is allowable under section 212; and this is true regardless of whether any basis adjustment is allowed under any other provision of the Code.

(o) The provisions of section 212 are not intended in any way to disallow expenses which would otherwise be allowable under section 162 and the regulations thereunder. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code of 1954 cannot again be deducted under any other provision thereof.

(p) *Frustration of public policy.* The deduction of a payment will be disallowed under section 212 if the payment is of a type for which a deduction would be disallowed under section 162(c), (f), or (g) and the regulations thereunder in the case of a business expense.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 12, 1960, as amended by T.D. 7198, 37 FR 13685, July 13, 1972; T.D. 7345, 40 FR 7439, Feb. 20, 1975]

§1.213–1 Medical, dental, etc., expenses.

(a) *Allowance of deduction.* (1) Section 213 permits a deduction of payments for certain medical expenses (including expenses for medicine and drugs). Except as provided in paragraph (d) of this section (relating to special rule for decedents) a deduction is allowable only to individuals and only with respect to medical expenses actually paid during the taxable year, regardless of when the incident or event which occasioned the expenses occurred and regardless of the method of accounting employed by the taxpayer in making his income tax return. Thus, if the medical expenses are incurred but not paid during the taxable year, no deduction for such expenses shall be allowed for such year.

(2) Except as provided in subparagraphs (4)(i) and (5)(i) of this paragraph, only such medical expenses (including the allowable expenses for medicine and drugs) are deductible as exceed 3 percent of the adjusted gross income for the taxable year. For taxable years beginning after December 31, 1966, the amounts paid during the taxable year for insurance that constitute expenses paid for medical care shall, for purposes of computing total medical expenses, be reduced by the amount determined under subparagraph (5)(i) of this paragraph. For the amounts paid during the taxable year for medicine and drugs which may be taken into account in computing total medical expenses, see paragraph (b) of this section. For the maximum deduction allowable under section 213 in the case of certain taxable years, see paragraph (c) of this section. As to what constitutes ‘‘adjusted gross income’’, see section 62 and the regulations thereunder.

(3)(i) For medical expenses paid (including expenses paid for medicine and drugs) to be deductible, they must be for medical care of the taxpayer, his spouse, or a dependent of the taxpayer and not be compensated for by insurance or otherwise. Expenses paid for the medical care of a dependent, as defined in section 152 and the regulations thereunder, are deductible under this section even though the dependent has gross income equal to or in excess of the amount determined pursuant to §1.151–2 applicable to the calendar year in which the taxable year of the taxpayer begins. Where such expenses are paid by two or more persons and the conditions of section 152(c) and the regulations thereunder are met, the medical expenses are deductible only by the person designated in the multiple support agreement filed by such persons and such deduction is limited to the amount of medical expenses paid by such person.

(ii) An amount excluded from gross income under section 105 (c) or (d) (relating to amounts received under accident and health plans) and the regulations thereunder shall not constitute compensation for expenses paid for medical care. Exclusion of such amounts from gross income will not affect the treatment of expenses paid for medical care.

(iii) The application of the rule allowing a deduction for medical expenses to the extent not compensated for by insurance or otherwise may be illustrated by the following example in which it is assumed that neither the taxpayer nor his wife has attained the age of 65:

Example. Taxpayer H, married to W and having one dependent child, had adjusted gross income for 1956 of $3,000. During 1956 he paid $300 for medical care, of which $100 was for treatment of his dependent child and $200 for an operation on W which was performed in September 1955. In 1956 he received a payment of $50 for health insurance to cover a portion of the cost of W's operation performed during 1955. The deduction allowable under section 213 for the calendar year 1956, provided the taxpayer itemizes his deductions and does not compute his tax under section 3 by use of the tax table, is $160, computed as follows:

Payments in 1956 for medical care	$300
Less: Amount of insurance received in 1956	50
Payments in 1956 for medical care not compensated for during 1956	250
Less: 3 percent of $3,000 (adjusted gross income)	90
Excess, allowable as a deduction for 1956	160

(4)(i) For taxable years beginning before January 1, 1967, where either the taxpayer or his spouse has attained the age of 65 before the close of the taxable year, the 3-percent limitation on the deduction for medical expenses does not apply with respect to expenses for medical care of the taxpayer or his spouse. Moreover, for taxable years beginning after December 31, 1959, and before January 1, 1967, the 3-percent limitation on the deduction for medical expenses does not apply to amounts paid for the medical care of a dependent (as defined in sec. 152) who is the mother or father of the taxpayer or his spouse and who has attained the age of 65 before the close of the taxpayer's taxable year. For taxable years beginning before January 1, 1964, and for taxable years beginning after December 31, 1966, all amounts paid by the taxpayer for medicine and drugs are subject to the 1-percent limitation provided by section 213(b). For taxable years beginning after December 31, 1963, and before January 1, 1967, the 1-percent limitation provided by section 213(b) does not apply, under certain circumstances, to amounts paid by the taxpayer for medicine and drugs for the taxpayer and his spouse or for a dependent (as defined in sec. 152) who is the mother or father of the taxpayer or of his spouse. (For additional provisions relating to the 1-percent limitation with respect to medicine and drugs, see paragraph (b) of this section.) For taxable years beginning before January 1, 1967, whether or not the 3-percent or 1-percent limitation applies, the total medical expenses deductible under section 213 are subject to the limitations described in section 213(c) and paragraph (c) of this section and, where applicable, to the limitations described in section 213(g) and § 1.213–2.

(ii) The age of a taxpayer shall be determined as of the last day of his taxable year. In the event of the taxpayer's death, his taxable year shall end as of the date of his death. The age of a taxpayer's spouse shall be determined as of the last day of the taxpayer's taxable year, except that, if the spouse dies within such taxable year, her age shall be determined as of the date of her death. Likewise, the age of the taxpayer's dependent who is the mother or father of the taxpayer or of his spouse shall be determined as of the last day of the taxpayer's taxable year but not later than the date of death of such dependent.

(iii) The application of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. Taxpayer A, who attained the age of 65 on February 22, 1956, makes his return on the basis of the calendar year. During the year 1956, A had adjusted gross income of $8,000, and paid the following medical bills: (*a*) $560 (7 percent of adjusted gross income) for the medical care of himself and his spouse, and (*b*) $160 (2 percent of adjusted gross income) for the medical care of his dependent son. No part of these payments was for medicine and drugs nor compensated for by insurance or otherwise. The allowable deduction under section 213 for 1956 is $560, the full amount of the medical expenses for the taxpayer and his spouse. No deduction is allowable for the amount of $160 paid for medical care of the dependent son since the amount of such payment (determined without regard to the payments for the care of the taxpayer and his spouse) does not exceed 3 percent of adjusted gross income.

Example 2. H and W, who have a dependent child, made a joint return for the calendar year 1956. H became 65 years of age on August 15, 1956. The adjusted gross income of H and W in 1956 was $40,000 and they paid in such year the following amounts for medical care: *(a)* $3,000 for the medical care of H; *(b)* $2,000 for the medical care of W; and *(c)* $3,000 for the medical care of the dependent child. No part of these payments was for medicine and drugs nor compensated for by insurance or otherwise. The allowable deduction under section 213 for medical expenses paid in 1956 is $6,800 computed as follows:

Payments for medical care of H and W in 1956		$5,000
Payments for medical care of the dependent in 1956	$3,000	
Less: 3 percent of $40,000 (adjusted gross income)	1,200	
		1,800
Allowable deduction for 1956		6,800

Example 3. D and his wife, E, made a joint income tax return for the calendar year 1962, and reported adjusted gross income of $30,000. On December 13, 1962, D attained the age of 65. During the year 1962, D's father, F,

who was 87 years of age, received over half of his support from, and was a dependent (as defined in section 152) of, D. However, D could not claim an exemption under section 151 for F because F had gross income from rents in 1962 of $800. D paid the following medical expenses in 1962, none of which were compensated for by insurance or otherwise: hospital and doctor bills for D and E, $6,500; hospital and doctor bills for F, $4,850; medicine and drugs for D and E, $225, and for F, $225. Since none of the medical expenses are subject to the 3-percent limitation, the amount of medical expenses to be taken into account (before computing the maximum deduction) is $11,500, computed as follows:

Hospital and doctor bills—for D and E		$6,500
Hospital and doctor bills—for F		4,850
Medicine and drugs—for D and E	$225	
Medicine and drugs—for F	$225	
Total medicine and drugs	450	
Less: 1 percent of adjusted gross income ($30,000)	300	
Allowable expenses for medicine and drugs		$150
Total medical expenses taken into account		11,500

Since an exemption cannot be claimed for F on the 1962 return of D and E, their deduction for medical expenses (assuming that section 213(g) does not apply) is limited to $10,000 for that year ($5,000 multiplied by the two exemptions allowed for D and E under section 151(b)). If these identical facts had occurred in a taxable year beginning before January 1, 1962, the medical expense deduction for D and E would, for such taxable year, be limited to $5,000 ($2,500 multiplied by the two exemptions allowed for D and E under section 151(b)). See paragraph (c) of this section.

Example 4. Assume the same facts as in *Example 3*, except that D furnished the entire support of his father's twin sister, G, who had no gross income during 1962 and for whom D was entitled to a dependency exemption. In addition, D paid $4,800 to doctors and hospitals during 1962 for the medical care of G. No part of the $4,800 was for medicine and drugs, and no amount was compensated for by insurance or otherwise. For purposes of the maximum limitation under section 213(c), the maximum deduction for medical expenses on the 1962 return of D and E is limited to $15,000 ($5,000 multiplied by 3, the number of exemptions allowed under section 151, exclusive of the exemptions for old age or blindness). If these identical facts had occurred in a taxable year beginning before January 1, 1962, the medical expense deduction for D and E would, for such taxable year, be limited to $7,500 ($2,500 multiplied by the three exemptions allowed under section 151, exclusive of the exemptions for old age or blindness). The medical expenses to be taken into account by D and E for 1962 and the maximum deductions allowable for such expenses are $15,400 and $15,000, respectively, computed as follows:

Medical expenses per *Example (3)*		$11,500
Add: Expenses paid for G	$4,800	
Less: 3 percent of adjusted gross income ($30,000)	900	
		3,900
Total medical expenses taken into account		15,400
Maximum deduction for 1962 ($5,000 multiplied by 3 exemptions)		15,000
Medical expenses not deductible		400

Example 5. Assume that the facts set forth in *Example 3* had occurred in respect of the calendar year 1964 rather than the calendar year 1962. Since both D and his father, F, had attained the age of 65 before the close of the taxable year, the 1-percent limitation does not apply to the amounts paid for medicine and drugs for D, E, and F. Accordingly, the total medical expenses taken into account by D and E for 1964 would be $11,800 (rather than $11,500 as in *Example 3*) computed as follows:

Hospital and doctor bills—for D and E	$6,500
Hospital and doctor bills—for F	4,350
Medicine and drugs—for D and E	225
Medicine and drugs—for F	225
Total medical expenses taken into account	11,800

(5)(i) For taxable years beginning after December 31, 1966, there may be deducted without regard to the 3-percent limitation the lesser of—(a) One-half of the amounts paid during the taxable year for insurance which constitute expenses for medical care for the taxpayer, his spouse, and dependents; or (b) $150.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. H and W made a joint return for the calendar year 1967. The adjusted gross income of H and W for 1967 was $10,000 and they paid in such year $370 for medical care of which amount $350 was paid for insurance which constitutes medical care for H and W. No part of the payment was for medicine and drugs or was compensated for by insurance or otherwise. The allowable deduction under section 213 for medical expenses paid in 1967 is $150, computed as follows:

(1) Lesser of $175 (one-half of amounts paid for insurance) or $150			$150
(2) Payments for medical care	$370		
(3) Less line 1	150		
(4) Medical expenses to be taken into account under 3-percent limitation (line 2 minus line 3)		$220	

(5) Less: 3 percent of $10,000 (adjusted gross income)	300	
(6) Excess allowable as a deduction for 1967 (excess of line 4 over line 5)		0
(7) Allowable medical expense deduction for 1967 (line 1 plus line 6)		$150

(b) *Limitation with respect to medicine and drugs*—(1) *Taxable years beginning before January 1, 1964.* (i) Amounts paid during taxable years beginning before January 1, 1964, for medicine and drugs are to be taken into account in computing the allowable deduction for medical expenses paid during the taxable year only to the extent that the aggregate of such amounts exceeds 1 percent of the adjusted gross income for the taxable year. Thus, if the aggregate of the amounts paid for medicine and drugs exceeds 1 percent of adjusted gross income, the excess is added to other medical expenses for the purpose of computing the medical expense deduction. The application of this subdivision may be illustrated by the following example:

Example. The taxpayer, a single individual with no dependents, had an adjusted gross income of $6,000 for the calendar year 1956. During 1956, he paid a doctor $300 for medical services, a hospital $100 for hospital care, and also spent $100 for medicine and drugs. These payments were not compensated for by insurance or otherwise. The deduction allowable under section 213 for the calendar year 1956 is $260, computed as follows:

Payments for medical care in 1956:

Doctor		$300
Hospital		100
Medicine and drugs	$100	
Less: 1 percent of $6,000 (adjusted gross income)	60	40
Total medical expenses taken into account		440
Less: 3 percent of $6,000 (adjusted gross income)		180
Allowable deduction for 1956		260

(ii) For taxable years beginning before January 1, 1964, the 1-percent limitation is applicable to all amounts paid by a taxpayer during the taxable year for medicine and drugs. Moreover, this limitation applies regardless of the fact that the amounts paid are for medicine and drugs for the taxpayer, his spouse, or dependent parent (the mother or father of the taxpayer or of his spouse) who has attained the age of 65 before the close of the taxable year. In a case where either a taxpayer or his spouse has attained the age of 65 and the taxpayer pays an amount in excess of 1 percent of adjusted gross income for medicine and drugs for himself, his spouse, and his dependents, it is necessary to apportion the 1 percent of adjusted gross income (the portion which is not taken into account as expenses paid for medical care) between the taxpayer and his spouse on the one hand and his dependents on the other. The part of the 1 percent allocable to the taxpayer and his spouse is an amount which bears the same ratio to 1 percent of his adjusted gross income which the amount paid for medicine and drugs for the taxpayer and his spouse bears to the total amount paid for medicine and drugs for the taxpayer, his spouse, and his dependents. The balance of the 1 percent shall be allocated to his dependents. The amount paid for medicine and drugs in excess of the allocated part of the 1 percent shall be taken into account as payments for medical care for the taxpayer and his spouse on the one hand and his dependents on the other, respectively. A similar apportionment must be made in the case of a dependent parent (65 years of age or over) of the taxpayer or his spouse. The application of this subdivision (ii) may be illustrated by the following example:

Example. H and W, who have a dependent child, made a joint return for the calendar year 1956. H became 65 years of age on September 15, 1956. The adjusted gross income of H and W for 1956 is $10,000. During the year, H and W paid the following amounts for medical care: (i) $1,000 for doctors and hospital expenses and $180 for medicine and drugs for themselves; and (ii) $500 for doctors and hospital expenses and $140 for medicine and drugs for the dependent child. These payments were not compensated for by insurance or otherwise. The deduction allowable under section 213(a)(2) for medical expenses paid in 1956 is $1,420, computed as follows:

H and W:			
Payments for doctors and hospital			$1,000.00
Payments for medicine and drugs		$180.00	
Less: Limitation for medicine and drugs (see computation below)		56.25	123.75
Medical expenses for H and W to be taken into account			1,123.75

Dependent:			
Payments for doctors and hospital		500.00	
Payments for medicine and drugs	$140.00		
Less: Limitation for medicine and drugs (see computation below)	43.75	96.25	
Total medical expenses		596.25	
Less: 3 percent of $10,000 (adjusted gross income)		300.00	
Medical expenses for the dependent to be taken into account			296.25
Allowable deductions for 1956			1,420.00
Payments for medicine and drugs:			
H and W			180.00
Dependent			140.00
Total payments			320.00
Less: 1 percent of $10,000 (adjusted gross income)			100.00
Payments to be taken into account			20.00
Allocation of 1-percent exclusion:			
H and W (180÷320×$100)			56.25
Dependent (140÷320×$100)			43.75
Total			100.00

(2) *Taxable years beginning after December 31, 1963.* (i) Except as otherwise provided in subdivision (ii) of this subparagraph, amounts paid during taxable years beginning after December 31, 1963, for medicine and drugs are to be taken into account in computing the allowable deduction for medical expenses paid during the taxable year only to the extent that the aggregate of such amounts exceeds 1 percent of the adjusted gross income for the taxable year. Thus, if the aggregate of the amounts paid for medicine and drugs which are subject to the 1-percent limitation exceeds 1 percent of adjusted gross income, the excess is added to other medical expenses for the purpose of computing the medical expense deduction.

(ii) The 1-percent limitation provided by section 213 does not apply to amounts paid by a taxpayer during a taxable year beginning after December 31, 1963, and before January 1, 1967, for medicine and drugs for the medical care of the taxpayer and his spouse if either has attained the age of 65 before the close of the taxable year. Moreover, for taxable years beginning after December 31, 1963, and before January 1, 1967, the 1-percent limitation with respect to medicine and drugs does not apply to amounts paid for the medical care of a dependent (as defined in sec. 152) who is the mother or father of the taxpayer or of his spouse and who has attained the age of 65 before the close of the taxpayer's taxable year. Amounts paid for medicine and drugs which are not subject to the limitation on medicine and drugs are added to other medical expenses of a taxpayer and his spouse or the dependent (as the case may be) for the purpose of computing the medical expense deduction.

(iii) The application of this subparagraph may be illustrated by the following examples:

Example 1. H and W, who have a dependent child, C, were both under 65 years of age at the close of the calendar year 1964 and made a joint return for that calendar year. During the year 1964, H's mother, M, attained the age of 65, and was a dependent (as defined in section 152) of H. The adjusted gross income of H and W in 1964 was $12,000. During 1964 H and W paid the following amounts for medical care: (i) $600 for doctors and hospital expenses and $120 for medicine and drugs for themselves; (ii) $350 for doctors and hospital expenses and $60 for medicine and drugs for C; and (iii) $400 for doctors and hospital expenses and $100 for medicine and drugs for M. These payments were not compensated for by insurance or otherwise. The deduction allowable under section 213(a) (1) for medical expenses paid in 1964 is $1,150, computed as follows:

H, W, and C:			
Payments for doctors and hospital		$950	
Payments for medicine and drugs	$180		
Less: 1 percent of $12,000 (adjusted gross income)	120	60	
Total medical expenses		1,010	
Less: 3 percent of $12,000 (adjusted gross income)		360	
Medical expenses of H, W, and C to be taken into account			$650

M:		
Payments for doctors and hospitals	400	
Payments for medicine and drugs	100	
Medical expenses of M to be taken into account		500
Allowable deduction for 1964		1,150

Example 2. H and W, who have a dependent child, C, made a joint return for the calendar year 1964, and reported adjusted gross income of $12,000. H became 65 years of age on January 23, 1964. F, the 87 year old father of W, was a dependent of H. During 1964, H and W paid the following amounts for medical care: (i) $400 for doctors and hospital expenses and $75 for medicine and drugs for H; (ii) $200 for doctors and hospital expenses and $100 for medicine and drugs for W; (iii) $200 for doctors and hospital expenses and $175 for medicine and drugs for C; and (iv) $700 for doctors and hospital expenses and $150 for medicine and drugs for F. These payments were not compensated for by insurance or otherwise. The deduction allowable under section 213(a) (2) for medical expenses paid in 1964 is $1,625, computed as follows:

H and W:			
Payments for doctors and hospital		$600	
Payments for medicine and drugs		175	
Medical expenses for H and W to be taken into account			$775
F:			
Payments for doctors and hospital		700	
Payments for medicine and drugs		150	
Medical expenses for F to be taken into account			850
C:			
Payments for doctors and hospital		200	
Payments for medicine and drugs	$175		
Less: 1 percent of $12,000 (adjusted gross income)	120	55	
Total medical expenses		255	
Less: 3 percent of $12,000 (adjusted gross income)		360	
Medical expenses for C to be taken into account			0
Allowable deduction for 1964.			1,625

Example 3. Assume the same facts as example (2) except that the calendar year of the return is 1967 and the amounts paid for medical care were paid during 1967. The deduction allowable under section 213(a) for medical expenses paid in 1967 is $1,520, computed as follows:

Payments for doctors and hospitals:				
H	$400			
W	200			
C	200			
F	700		$1,500	
Payments for medicine and drugs:				
H	75			
W	100			
C	175			
F	150			
		$500		
Less: 1 percent of $12,000 (adjusted gross income)		120	380	
Medical expenses to be taken into account				$1,880
Less: 3 percent of $12,000 (adjusted gross income)				360
Allowable medical expense deduction for 1967				1,520

(3) *Definition of medicine and drugs.* For definition of medicine and drugs, see paragraph (e) (2) of this section.

(c) *Maximum limitations.* (1) For taxable years beginning after December 31, 1966, there shall be no maximum limitation on the amount of the deduction allowable for payment of medical expenses.

(2) Except as provided in section 213(g) and § 1.213–2 (relating to maximum limitations with respect to certain aged and disabled individuals for taxable years beginning before January 1, 1967), for taxable years beginning after December 31, 1961, and before January 1, 1967, the maximum deduction allowable for medical expenses paid in any one taxable year is the lesser of:

(i) $5,000 multiplied by the number of exemptions allowed under section 151 (exclusive of exemptions allowed under section 151(c) for a taxpayer or spouse attaining the age of 65, or section 151(d) for a taxpayer who is blind or a spouse who is blind);

(ii) $10,000, if the taxpayer is single, not the head of a household (as defined in section 1(b) (2)) and not a surviving spouse (as defined in section 2(b)), or is married and files a separate return; or

(iii) $20,000 if the taxpayer is married and files a joint return with his spouse under section 6013, or is the head of a household (as defined in section 1(b) (2)), or a surviving spouse (as defined in section 2(b)).

(3) The application of subparagraph (2) of this paragraph may be illustrated by the following example:

Example. H and W made a joint return for the calendar year 1962 and were allowed five exemptions (exclusive of exemptions under sec. 151 (c) and (d)), one for each taxpayer and three for their dependents. The adjusted gross income of H and W in 1962 was $80,000. They paid during such year $26,000 for medical care, no part of which is compensated for by insurance or otherwise. The deduction allowable under section 213 for the calendar year 1962 is $20,000, computed as follows:

Payments for medical care in 1962	$26,000
Less: 3 percent of $80,000 (adjusted gross income)	2,400
Excess of medical expenses in 1962 over 3 percent of adjusted gross income	23,600
Allowable deduction for 1962 ($5,000 multiplied by five exemptions allowed under sec. 151 (b) and (e) but not in excess of $20,000)	20,000

(4) Except as provided in section 213(g) and §1.213–2 (relating to certain aged and disabled individuals), for taxable years beginning before January 1, 1962, the maximum deduction allowable for medical expenses paid in any 1 taxable year is the lesser of:

(i) $2,500 multiplied by the number of exemptions allowed under section 151 (exclusive of exemptions allowed under section 151(c) for a taxpayer or spouse attaining the age of 65, or section 151(d) for a taxpayer who is blind or a spouse who is blind);

(ii) $5,000, if the taxpayer is single, not the head of a household (as defined in section 1(b) (2)) and not a surviving spouse (as defined in section 2(b)) or is married and files a separate return; or

(iii) $10,000, if the taxpayer is married and files a joint return with his spouse under section 6013, or is head of a household (as defined in section 1(b) (2)), or a surviving spouse (as defined in section 2(b)).

(5) For the maximum deduction allowable for taxable years beginning before January 1, 1967, if the taxpayer or his spouse is age 65 or over and is disabled, see §1.213–2.

(d) *Special rule for decedents.* (1) For the purpose of section 213 (a), expenses for medical care of the taxpayer which are paid out of his estate during the 1-year period beginning with the day after the date of his death shall be treated as paid by the taxpayer at the time the medical services were rendered. However, no credit or refund of tax shall be allowed for any taxable year for which the statutory period for filing a claim has expired. See section 6511 and the regulations thereunder.

(2) The rule prescribed in subparagraph (1) of this paragraph shall not apply where the amount so paid is allowable under section 2053 as a deduction in computing the taxable estate of the decedent unless there is filed in duplicate (i) a statement that such amount has not been allowed as a deduction under section 2053 in computing the taxable estate of the decedent and (ii) a waiver of the right to have such amount allowed at any time as a deduction under section 2053. The statement and waiver shall be filed with or for association with the return, amended return, or claim for credit or refund for the decedent for any taxable year for which such an amount is claimed as a deduction.

(e) *Definitions*—(1) *General.* (i) The term *medical care* includes the diagnosis, cure, mitigation, treatment, or prevention of disease. Expenses paid for ‘‘medical care’’ shall include those paid for the purpose of affecting any structure or function of the body or for transportation primarily for and essential to medical care. See subparagraph (4) of this paragraph for provisions relating to medical insurance.

(ii) Amounts paid for operations or treatments affecting any portion of the body, including obstetrical expenses and expenses of therapy or X-ray treatments, are deemed to be for the purpose of affecting any structure or function of the body and are therefore paid for medical care. Amounts expended for illegal operations or treatments are not deductible. Deductions for expenditures for medical care allowable under section 213 will be confined strictly to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness. Thus, payments for the following are payments for medical care: hospital services, nursing services (including nurses' board where paid by the taxpayer), medical, laboratory, surgical, dental and other diagnostic and healing services, X-rays, medicine and drugs (as defined in subparagraph (2) of this paragraph, subject to the 1-percent limitation in paragraph (b) of this section), artificial teeth or limbs, and ambulance hire. However, an expenditure which is merely beneficial to the general health of an individual, such as an expenditure for a vacation, is not an expenditure for medical care.

(iii) Capital expenditures are generally not deductible for Federal income tax purposes. See section 263 and the regulations thereunder. However, an expenditure which otherwise qualifies as a medical expense under section 213 shall not be disqualified merely because it is a capital expenditure. For purposes of section 213 and this paragraph, a capital expenditure made by the taxpayer may qualify as a medical expense, if it has as its primary purpose the medical care (as defined in subdivisions (i) and (ii) of this subparagraph) of the taxpayer, his spouse, or his dependent. Thus, a capital expenditure which is related only to the sick person and is not related to permanent improvement or betterment of property, if it otherwise qualifies as an expenditure for medical care, shall be deductible; for example, an expenditure for eye glasses, a seeing eye dog, artificial teeth and limbs, a wheel chair, crutches, an inclinator or an air conditioner which is detachable from the property and purchased only for the use of a sick person, etc. Moreover, a capital expenditure for permanent improvement or betterment of property which would not ordinarily be for the purpose of medical care (within the meaning of this paragraph) may, nevertheless, qualify as a medical expense to the extent that the expenditure exceeds the increase in the value of the related property, if the particular expenditure is related directly to medical care. Such a situation could arise, for example, where a taxpayer is advised by a physician to install an elevator in his residence so that the taxpayer's wife who is afflicted with heart disease will not be required to climb stairs. If the cost of installing the elevator is $1,000 and the increase in the value of the residence is determined to be only $700, the difference of $300, which is the amount in excess of the value enhancement, is deductible as a medical expense. If, however, by reason of this expenditure, it is determined that the value of the residence has not been increased, the entire cost of installing the elevator would qualify as a medical expense. Expenditures made for the operation or maintenance of a capital asset are likewise deductible medical expenses if they have as their primary purpose the medical care (as defined in subdivisions (i) and (ii) of this subparagraph) of the taxpayer, his spouse, or his dependent. Normally, if a capital expenditure qualifies as a medical expense, expenditures for the operation or maintenance of the capital asset would also qualify provided that the medical reason for the capital expenditure still exists. The entire amount of such operation and maintenance expenditures qualifies, even if none or only a portion of the original cost of the capital asset itself qualified.

(iv) Expenses paid for transportation primarily for and essential to the rendition of the medical care are expenses paid for medical care. However, an amount allowable as a deduction for ‘‘transportation primarily for and essential to medical care’’ shall not include the cost of any meals and lodging while away from home receiving medical treatment. For example, if a doctor prescribes that a taxpayer go to a warm climate in order to alleviate a specific chronic ailment, the cost of meals and lodging while there would not be deductible. On the other hand, if the travel is undertaken merely for the general improvement of a taxpayer's health, neither the cost of transportation nor the cost of meals and lodging would be deductible. If a doctor prescribes an operation or other medical care, and the taxpayer chooses for purely personal considerations to travel to another locality (such as a resort area) for the operation or the other medical care, neither the cost of transportation nor the cost of meals and lodging (except where paid as part of a hospital bill) is deductible.

(v) The cost of in-patient hospital care (including the cost of meals and lodging therein) is an expenditure for medical care. The extent to which expenses for care in an institution other than a hospital shall constitute medical care is primarily a question of fact which depends upon the condition of the individual and the nature of the services he receives (rather than the nature of the institution). A private establishment which is regularly engaged in providing the types of care or services outlined in this subdivision shall be considered an institution for purposes of the rules provided herein. In general, the following rules will be applied:

(a) Where an individual is in an institution because his condition is such

that the availability of medical care (as defined in subdivisions (i) and (ii) of this subparagraph) in such institution is a principal reason for his presence there, and meals and lodging are furnished as a necessary incident to such care, the entire cost of medical care and meals and lodging at the institution, which are furnished while the individual requires continual medical care, shall constitute an expense for medical care. For example, medical care includes the entire cost of institutional care for a person who is mentally ill and unsafe when left alone. While ordinary education is not medical care, the cost of medical care includes the cost of attending a special school for a mentally or physically handicapped individual, if his condition is such that the resources of the institution for alleviating such mental or physical handicap are a principal reason for his presence there. In such a case, the cost of attending such a special school will include the cost of meals and lodging, if supplied, and the cost of ordinary education furnished which is incidental to the special services furnished by the school. Thus, the cost of medical care includes the cost of attending a special school designed to compensate for or overcome a physical handicap, in order to qualify the individual for future normal education or for normal living, such as a school for the teaching of braille or lip reading. Similarly, the cost of care and supervision, or of treatment and training, of a mentally retarded or physically handicapped individual at an institution is within the meaning of the term *medical care.*

(b) Where an individual is in an institution, and his condition is such that the availability of medical care in such institution is not a principal reason for his presence there, only that part of the cost of care in the institution as is attributable to medical care (as defined in subdivisions (i) and (ii) of this subparagraph) shall be considered as a cost of medical care; meals and lodging at the institution in such a case are not considered a cost of medical care for purposes of this section. For example, an individual is in a home for the aged for personal or family considerations and not because he requires medical or nursing attention. In such case, medical care consists only of that part of the cost for care in the home which is attributable to medical care or nursing attention furnished to him; his meals and lodging at the home are not considered a cost of medical care.

(c) It is immaterial for purposes of this subdivision whether the medical care is furnished in a Federal or State institution or in a private institution.

(vi) See section 262 and the regulations thereunder for disallowance of deduction for personal living, and family expenses not falling within the definition of medical care.

(2) *Medicine and drugs.* The term *medicine and drugs* shall include only items which are legally procured and which are generally accepted as falling within the category of medicine and drugs (whether or not requiring a prescription). Such term shall not include toiletries or similar preparations (such as toothpaste, shaving lotion, shaving cream, etc.) nor shall it include cosmetics (such as face creams, deodorants, hand lotions, etc., or any similar preparation used for ordinary cosmetic purposes) or sundry items. Amounts expended for items which, under this subparagraph, are excluded from the term *medicine and drugs* shall not constitute amounts expended for ‘‘medical care’’.

(3) *Status as spouse or dependent.* In the case of medical expenses for the care of a person who is the taxpayer’s spouse or dependent, the deduction under section 213 is allowable if the status of such person as ‘‘spouse’’ or ‘‘dependent’’ of the taxpayer exists either at the time the medical services were rendered or at the time the expenses were paid. In determining whether such status as ‘‘spouse’’ exists, a taxpayer who is legally separated from his spouse under a decree of separate maintenance is not considered as married. Thus, payments made in June 1956 by A, for medical services rendered in 1955 to B, his wife, may be deducted by A for 1956 even though, before the payments were made, B may have died or in 1956 secured a divorce. Payments made in July 1956 by C, for medical services rendered to D in 1955 may be deducted by C for 1956 even though C and D were not married until June 1956.

(4) *Medical insurance.* (i)*(a)* For taxable years beginning after December 31, 1966, expenditures for insurance shall constitute expenses paid for medical care only to the extent that such amounts are paid for insurance covering expenses of medical care referred to in subparagraph (1) of this paragraph. In the case of an insurance contract under which amounts are payable for other than medical care (as, for example, a policy providing an indemnity for loss of income or for loss of life, limb, or sight):

(1) No amount shall be treated as paid for insurance covering expenses of medical care referred to in subparagraph (1) of this paragraph unless the charge for such insurance is either separately stated in the contract or furnished to the policyholder by the insurer in a separate statement,

(2) The amount taken into account as the amount paid for such medical insurance shall not exceed such charge, and

(3) No amount shall be treated as paid for such medical insurance if the amount specified in the contract (or furnished to the policyholder by the insurer in a separate statement) as the charge for such insurance is unreasonably large in relation to the total charges under the contract.

For purposes of the preceding sentence, amounts will be considered payable for other than medical care under the contract if the contract provides for the waiver of premiums upon the occurrence of an event. In determining whether a separately stated charge for insurance covering expenses of medical care is unreasonably large in relation to the total premium, the relationship of the coverages under the contract together with all of the facts and circumstances shall be considered. In determining whether a contract constitutes an ‘‘insurance’’ contract it is irrelevant whether the benefits are payable in cash or in services. For example, amounts paid for hospitalization insurance, for membership in an association furnishing cooperative or so-called free-choice medical service, or for group hospitalization and clinical care are expenses paid for medical care. Premiums paid under Part B, Title XVIII of the Social Security Act (42 U.S.C. 1395j–1395w), relating to supplementary medical insurance benefits for the aged, are amounts paid for insurance covering expenses of medical care. Taxes imposed by any governmental unit do not, however, constitute amounts paid for such medical insurance.

(b) For taxable years beginning after December 31, 1966, subject to the rules of *(a)* of this subdivision, premiums paid during a taxable year by a taxpayer under the age of 65 for insurance covering expenses of medical care for the taxpayer, his spouse, or a dependent after the taxpayer attains the age of 65 are to be treated as expenses paid during the taxable year for insurance covering expenses of medical care if the premiums for such insurance are payable (on a level payment basis) under the contract:

(1) For a period of 10 years or more, or

(2) Until the year in which the taxpayer attains the age of 65 (but in no case for a period of less than 5 years).

For purposes of this subdivision (*b*), premiums will be considered payable on a level payment basis if the total premium under the contract is payable in equal annual or more frequent installments. Thus, a total premium of $10,000 payable over a period of 10 years at $1,000 a year shall be considered payable on a level payment basis.

(ii) For taxable years beginning before January 1, 1967, expenses paid for medical care shall include amounts paid for accident or health insurance. In determining whether a contract constitutes an ‘‘insurance’’ contract it is irrelevant whether the benefits are payable in cash or in services. For example, amounts paid for hospitalization insurance, for membership in an association furnishing cooperative or so-called free-choice medical service, or for group hospitalization and clinical care are expenses paid for medical care.

(f) *Exclusion of amounts allowed for care of certain dependents.* Amounts taken into account under section 44A in computing a credit for the care of certain dependents shall not be treated as expenses paid for medical care.

(g) *Reimbursement for expenses paid in prior years.* (1) Where reimbursement, from insurance or otherwise, for medical expenses is received in a taxable year subsequent to a year in which a deduction was claimed on account of such expenses, the reimbursement must be included in gross income in such subsequent year to the extent attributable to (and not in excess of) deductions allowed under section 213 for any prior taxable year. See section 104, relating to compensation for injuries or sickness, and section 105(b), relating to amounts expended for medical care, and the regulations thereunder, with regard to amounts in excess of or not attributable to deductions allowed.

(2) If no medical expense deduction was taken in an earlier year, for example, if the standard deduction under section 141 was taken for the earlier year, the reimbursement received in the taxable year for the medical expense of the earlier year is not includible in gross income.

(3) In order to allow the same aggregate medical expense deductions as if the reimbursement received in a subsequent year or years had been received in the year in which the payments for medical care were made, the following rules shall be followed:

(i) If the amount of the reimbursement is equal to or less than the amount which was deducted in a prior year, the entire amount of the reimbursement shall be considered attributable to the deduction taken in such prior year (and hence includible in gross income); or

(ii) If the amount of the reimbursement received in such subsequent year or years is greater than the amount which was deducted for the prior year, that portion of the reimbursement received which is equal in amount to the deduction taken in the prior year shall be considered as attributable to such deduction (and hence includible in gross income); but

(iii) If the deduction for the prior year would have been greater but for the limitations on the maximum amount of such deduction provided by section 213 (c), then the amount of the reimbursement attributable to such deduction (and hence includible in gross income) shall be the amount of the reimbursement received in a subsequent year or years reduced by the amount disallowed as a deduction because of the maximum limitation, but not in excess of the deduction allowed for the previous year.

(4) The application of subparagraphs (1), (2), and (3) of this paragraph may be illustrated by the following examples. Examples (1) and (2) reflect the maximum limitation on the medical expense deduction applicable to taxable years beginning after December 31, 1961. Examples (3) and (4) reflect the maximum limitation on the medical expense deduction applicable to taxable years beginning prior to January 1, 1962. For explanation of such maximum medical expense limitations, see paragraph (c) of this section.

Example 1. Taxpayer A, a single individual (not the head of a household and not a surviving spouse) with one dependent, is entitled to two exemptions under the provisions of section 151. He had an adjusted gross income of $35,000 for the calendar year 1962. During 1962 he paid $16,000 for medical care. A received no reimbursement for such medical expenses in 1962, but in 1963 he received $6,000 upon an insurance policy covering the medical expenses which he paid in 1962. A was allowed a deduction of $10,000 (the maximum) from his adjusted gross income for 1962. The amount which A must include in his gross income for 1963 is $1,050, and the amount to be excluded from gross income for 1963 is $4,950, computed as follows:

Payments for medical care in 1962 (not reimbursed in 1962)	$16,000
Less: 3 percent of $35,000 (adjusted gross income)	1,050
Excess of medical expenses not reimbursed in 1962 over 3 percent of adjusted gross income	10,000
Allowable deduction for 1962	10,000
Amount by which the medical deductions for 1962 would have been greater than $10,000 but for the limitations on the maximum amount provided by section 213	4,950
Reimbursement received in 1963	$6,000
Less: Amount by which the medical deduction for 1962 would have been greater than $10,000 but for the limitation on the maximum amount provided by section 213	4,950
Reimbursement received in 1963 reduced by the amount by which the medical deduction for 1962 would have been greater than $10,000 but for the limitations on the maximum amount provided by section 213	1,050
Amount attributed to medical deduction taken for 1962	1,050
Amount to be included in gross income for 1963	1,050
Amount to be excluded from gross income for 1963 ($6,000 less $1,050)	4,950

Example 2. Assuming that A, in example (1), received $15,000 in 1963 as reimbursement for the medical expenses which he paid in 1962, the amount which A must include in his gross income for 1963 is $10,000, and the amount to be excluded from gross income for 1963 is $5,000, computed as follows:

Reimbursement received in 1963	$15,000
Less: Amount by which the medical deduction for 1962 would have been greater than $10,000 but for the limitations on the maximum amount provided by section 213	4,950
Reimbursement received in 1963 reduced by the amount by which the medical deduction for 1962 would have been greater than $10,000 but for the limitations on the maximum amount provided by section 213	10,050
Deduction allowable for 1962	10,000
Amount of reimbursement received in 1963 to be included in gross income for 1963 as attributable to deduction allowable for 1962	10,000
Amount to be excluded from gross income for 1963 ($15,000 less $10,000)	5,000

Example 3. Taxpayer A, a single individual (not the head of a household and not a surviving spouse) with one dependent, is entitled to two exemptions under the provisions of section 151. He had an adjusted gross income of $35,000 for the calendar year 1956. During 1956 he paid $9,000 for medical care. A received no reimbursement for such medical expenses in 1956, but in 1957 he received $6,000 upon an insurance policy covering the medical expenses which he paid in 1956. A was allowed a deduction of $5,000 (the maximum) from his adjusted gross income for 1956. The amount which A must include in his gross income for 1957 is $3,050 and the amount to be excluded from gross income for 1957 is $2,950, computed as follows:

Payments for medical care in 1956 (not reimbursed in 1956)	$9,000
Less: 3 percent of $35,000 (adjusted gross income)	1,050
Excess of medical expenses not reimbursed in 1956 over 3 percent of adjusted gross income	7,950
Allowable deduction for 1956	5,000
Amount by which the medical deductions for 1956 would have been greater than $5,000 but for the limitations on the maximum amount provided by section 213	2,950
Reimbursement received in 1957	6,000
Less: Amount by which the medical deduction for 1956 would have been greater than $5,000 but for the limitations on the maximum amount provided by section 213	2,950
Reimbursement received in 1957 reduced by the amount by which the medical deduction for 1956 would have been greater than $5,000 but for the limitations on the maximum amount provided by section 213	8,050
Amount attributed to medical deduction taken for 1956	3,050
Amount to be included in gross income for 1957	3,050
Amount to be excluded from gross income for 1957 ($6,000 less $3,050)	2,950

Example 4. Assuming that A, in example (3), received $8,000 in 1957 as reimbursement for the medical expenses which he paid in 1956, the amount which A must include in his gross income for 1957 is $5,000 and the amount to be excluded from gross income for 1957 is $3,000 computed as follows:

Reimbursement received in 1957	$8,000
Less: Amount by which the medical deduction for 1956 would have been greater than $5,000 but for the limitations on the maximum amount provided by section 213	2,950
Reimbursement received in 1957 reduced by the amount by which the medical deduction for 1956 would have been greater than $5,000 but for the limitations on the maximum amount provided by section 213	5,050
Deduction allowable for 1956	5,000
Amount of reimbursement received in 1957 to be included in gross income for 1957 as attributable to deduction allowable for 1956	5,000
Amount to be excluded from gross income for 1957 ($8,000 less $5,000)	3,000

(h) *Substantiation of deductions.* In connection with claims for deductions under section 213, the taxpayer shall furnish the name and address of each person to whom payment for medical expenses was made and the amount and date of the payment thereof in each case. If payment was made in kind, such fact shall be so reflected. Claims for deductions must be substantiated, when requested by the district director, by a statement or itemized invoice from the individual or entity to which payment for medical expenses was made showing the nature of the service rendered, and to or for whom rendered; the nature of any other item of expense and for whom incurred and for what specific purpose, the amount paid therefor and the date of the payment thereof; and by such other information as the district director may deem necessary.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.213–1, see the List of CFR Sections Affected in the Finding Aids section of this volume.

§ 1.214–1 Expenses for the care of certain dependents incurred during taxable years beginning before January 1, 1972.

(a) *General rule.* (1) This section applies only for expenses incurred during taxable years beginning before January 1, 1972. For expenses incurring in taxable years beginning after December 31, 1971, see section 1.214A, and §§214A–1 through 1.214A–5.

(2) Section 214 allows, subject to certain limitations, a deduction from gross income of expenses paid for the care of certain dependents where the care is for the purpose of enabling the taxpayer to be gainfully employed. Such expenses are referred to in this section as ''child care'' expenses. The deduction is allowed only for expenses incurred while the taxpayer is gainfully employed or in active search of gainful employment. The employment which is the cause of the incurring of the expenses may, however, consist of service either within or without the home of the taxpayer. Self-employment constitutes employment for purposes of section 214.

(b) *Taxpayers who may qualify for the deduction.* The deduction provided in section 214 is allowed only to a taxpayer who is a woman, a widower, or, for taxable years beginning after December 31, 1963, a husband whose wife is incapacitated or institutionalized. For purposes of this paragraph, the following rules apply:

(1) *A widower.* The deduction is allowed for expenses paid by a taxpayer who is a widower at the time the expenses are incurred. The term *widower* includes (i) a man whose wife has died and who has not remarried, (ii) a man who is divorced from his wife and has not remarried, and (iii) a man who is legally separated from his wife under a decree of legal separation.

(2) *A married woman whose husband is capable of self-support.* If the expenses are paid by a woman (i) who is married at the time the expenses are incurred, (ii) whose husband at that time is not incapable of self-support because he is mentally defective or physically disabled, (iii) who is not divorced or legally separated at the end of the taxable year, and (iv) in the case of a woman who has been deserted by her husband and who does not meet all of the conditions set forth in subparagraph (4)(ii) of this paragraph, the deduction is allowed, but only if she files a joint income tax return with her husband for the taxable year in which the expenses are paid. Further, the amount otherwise deductible shall be reduced by the amount, if any, by which the combined adjusted gross income of the taxpayer and her spouse for the taxable year in which the expenses are paid exceeds $4,500 (for taxable years beginning before January 1, 1964) or $6,000 (for taxable years beginning after December 31, 1963). The amount otherwise deductible is the amount expended for child care or the maximum deduction allowable for any taxable year (see paragraph (c) of this section), whichever is the lesser. The determination of whether the taxpayer's husband is incapable of self-support because of a mental defect or physical disability shall be made without regard to his income from sources other than his own earnings. For purposes of this subparagraph, the term *earnings* means wages, salaries, commissions, professional fees, and other amounts received as compensation for personal services actually rendered. It does not include income such as pensions, annuities, sick pay, interest, dividends, or rents.

(3) *A married woman whose husband is incapable of self-support.* (i) The deduction is allowed without regard to the limitations described in subparagraph (2) of this paragraph for expenses paid by a married woman whose husband is incapable of self-support because he is mentally defective or physically disabled (as defined in subparagraph (2) of this paragraph) at the time the expenses are incurred.

(ii) A married woman claiming a deduction under this subparagraph shall submit with her income tax return in which the deduction is claimed information disclosing *(a)* the nature of her husband's disability, *(b)* the period of the disability, *(c)* the amount of her husband's earnings (if any) during the period he was incapable of self-support, and *(d)* such other information as is required by the return or instructions relating to the return. Where the husband is capable of self-support for part of a taxable year the child care expenses incurred for such part shall be treated under subparagraph (2) of this paragraph. See example (8) of paragraph (c)(3)(i) or example (8) of paragraph (c)(3)(ii) (whichever is applicable) of this section.

(4) *A single woman.* (i) The deduction is also allowed without regard to the limitation described in subparagraph (2) of this paragraph for expenses paid by a woman who *(a)* is unmarried at the time the expenses are incurred, or *(b)* is, at the close of the taxable year, legally separated from her husband under a decree of divorce or of separate maintenance.

(ii) For taxable years ending after April 2, 1963, the deduction is also allowed without regard to the limitation described in subparagraph (2) of this paragraph for expenses paid by a woman who *(a)* has been deserted by her husband, *(b)* at the time her return for the taxable year is filed, does not know the whereabouts of her husband, *(c)* has not known the whereabouts of her husband at any time during the taxable year, and *(d)* has applied to a court of competent jurisdiction for appropriate process to compel her husband to pay support or otherwise to comply with the law or a judicial order. In general, a wife shall be considered to be deserted by her husband during any period of time during which there is an actual, willful, and voluntary abandonment of the wife by her husband which abandonment is in violation of a legal obligation without legal justification or excuse. The determination as to whether a wife has been deserted by her husband is a question of fact which will not necessarily be governed by provisions of state law relating to desertion or abandonment. The determination as to whether a wife knew the whereabouts of her husband at any particular moment of time will be determined in the light of the particular facts of each case. A wife will be considered to have known the whereabouts of her husband if on a particular day she knew the address at which he was, on such day, residing or carrying on his trade or business, or if she knew the name and address of the person by whom he was employed on such day. A wife will not be considered to have known the whereabouts of her husband merely because she had information that he was residing or working in a particular city or state. To satisfy the requirement of (d) of this subdivision the wife must have initiated legal proceedings consistent with the applicable state law for the purpose of compelling her husband to pay support or, upon failure of the husband to comply with an order or decree of a court requiring the payment of support, must have initiated legal proceedings, consistent with the applicable state law, for the purpose of requiring compliance by the husband of the order or decree of the court. As used in this subdivision, the term *legal proceedings* includes criminal and quasi criminal proceedings as well as civil proceedings.

(5) *A husband whose wife is incapacitated or institutionalized*—(i) *In general.* Subject to certain limitations, the deduction is allowed for expenses paid in a taxable year beginning after December 31, 1963, by a husband if the expenses are incurred during a period in which his wife is incapacitated. However, the deduction is allowed only if the wife is incapacitated for a period of at least 90 consecutive days or a shorter period if the period of incapacitation is terminated by her death. The period of incapacitation need not occur entirely within one taxable year.

(ii) *Limitation on deduction.* Except as otherwise provided in this subdivision, the deduction is allowed only if the husband files a joint income tax return with his wife for the taxable year in which the expenses are paid. Further, the amount otherwise deductible shall be reduced by the amount, if any, by which the combined adjusted gross income of the husband and his spouse exceeds $6,000 for the taxable year in which the expenses are paid. The amount otherwise deductible is the amount expended for child care (and incurred during the period the wife was incapacitated) or the maximum deduction allowable for any taxable year beginning after December 31, 1963 (see paragraph (c) (2) of this section), whichever is the lesser. The limitations set forth in this subdivision do not apply to any expenses incurred in any period during which the taxpayer's wife is institutionalized if (*a*) the institutionaliza- tion is for a period of at least 90 consecutive days, or *(b)* the period of institutionalization (regardless of its length) is terminated by her death. The period of institutionalization referred to in subdivision *(a)* or *(b)* of this subdivision need not occur entirely within one taxable year.

(iii) *Incapacitated wife.* A wife is considered to be incapacitated during any period of time during which she is incapable of caring for herself because of a mental or physical defect. A wife is not considered to be incapacitated solely by reason of the fact that she has a mental or physical defect. A wife is incapacitated only if she is mentally or physically defective and as a result of the mental or physical defect is incapable of caring for herself. The fact that a wife, by reason of a mental or physical defect, is incapable of self-support, is unable to engage in any substantial gainful activity, or is unable to perform the normal household functions of a housewife or to care for her minor children, does not, of itself, establish that the wife is incapable of caring for herself. A wife who is mentally or physically defective to the extent that she cannot dress herself or cannot provide for her personal hygienical or nutritional needs will, ordinarily, be considered as incapable of caring for herself. Thus, a wife who because of an injury (whether temporary or permanent) is confined to a bed or to a wheel chair, even though otherwise enjoying good health, is incapable of caring for herself. In addition, a wife who is physically handicapped, or a wife who is mentally defective and has suicidal or other dangerous tendencies, and for such reason requires constant attention of another person is considered to be incapable of caring for herself. A wife is also considered to be incapacitated during any period of time (whether or not for 90 consecutive days) during which she is institutionalized.

(iv) *Institutionalized wife.* A wife is considered to be institutionalized only while she is, for purposes of receiving medical care or treatment, an inpatient, resident, or inmate of a public or private hospital, or other similar institution. A wife who resides at a hospital, sanitarium, or other similar institution other than for purposes of receiving medical care or treatment, as, for example, by reason of her employment, is not institutionalized. Generally, a wife is not considered institutionalized while residing at a health or beauty ranch or similar establishment even though some medical care or treatment is provided.

(v) *Information to be submitted with return.* A married man claiming a deduction under this subparagraph shall submit with his income tax return in which the deduction is claimed information disclosing, if his wife is institutionalized, the period of institutionalization and the name and address of the institution where the wife received medical care or treatment, or, if his wife is incapacitated (but not institutionalized), the nature and period of her incapacitation. There shall also be submitted such other information as is required by the return or instructions relating to the return. In addition, there should be submitted, wherever possible, a certificate of the attending physician indicating the nature and duration of the wife's mental or physical defect.

(vi) *Computation of 90-day period—(a) Incapacitation.* For the purpose of determining whether a wife is incapacitated for a period of at least 90 consecutive days, different periods of incapacitation which are separated by a period of time during which the wife is not incapacitated cannot be added together. Thus, if a wife is incapacitated during the months of March and April (61 days) and is incapacitated during the entire month of October (31 days), she is not incapacitated for a period of at least 90 consecutive days. Since a wife who is institutionalized is considered to be incapacitated, the period during which a wife is institutionalized is added to a consecutive period during which she is incapacitated (but not institutionalized) for the purpose of determining whether the wife is incapacitated for a period of at least 90 consecutive days. Thus, the 90-consecutive-day requirement is met where a wife remains at home unable to care for herself because of a mental or physical defect for 60 consecutive days and immediately thereafter enters an institution where she continuously remains for an additional 30 days receiving medical care or treatment, whether or not she is able to care for herself during such 30 days.

(b) Institutionalization. For the purpose of determining whether a wife is

institutionalized for a period of at least 90 consecutive days, different periods of institutionalization which are separated by a period of time during which the wife was not institutionalized cannot be added together. Thus, if a wife is institutionalized during the months of March and April (61 days), spends the months of May and June at home, and is institutionalized during the entire month of July (31 days), she is not institutionalized for a period of at least 90 consecutive days. However, if the wife is incapacitated during all of May and June, the entire period (March through July) constitutes a continuous period of incapacitation, see subdivision (*a*) of this subdivision. The running of a period of institutionalization is not discontinued because of, but rather such period includes, brief absences from the institution such as on weekends or holidays, and transfers from one institution to another.

(vii) *Rule where period of incapacitation does not occur in one taxable year.* The 90-consecutive-day period of incapacitation or of institutionalization need not occur entirely within one taxable year. If part of a period of at least 90 days of incapacitation, or part of a period of incapacitation of less than 90 days which is terminated by reason of the death of the wife, occurs in one taxable year and the remainder occurs in the succeeding taxable year, a deduction is allowed for the child care expenses incurred during the part of the period occurring in each such year, subject, however, to all other conditions and limitations. However, no deduction is allowed for expenses paid in any taxable year which begins before January 1, 1964 (see subdivision (i) of this subparagraph).

(6) *Determination of status.* If child care expenses are incurred in one taxable year and paid in another, the status of a taxpayer described in subparagraphs (1) to (5) of this paragraph, inclusive, shall be determined as of the time at which the expenses are incurred and not when such expenses are paid.

(c) *Computation of deduction*—(1) *In general.* The deduction for child care expenses is allowable only with respect to such expenses actually paid during the taxable year regardless of when the event which occasioned the expenses occurred and regardless of the method of accounting employed by the taxpayer in making his income tax return. If child care expenses are incurred but not paid during the taxable year, no deduction can be taken for such year. Thus, if an expenditure was incurred in December of a particular year, but not paid until January of the following calendar year, no deduction may be taken for the earlier calendar year.

(2) *Dollar limitation on amount of deduction*—(i) *Taxable years beginning before January 1, 1964.* For any taxable year beginning before January 1, 1964, the deduction for child care expenses may not exceed $600 regardless of the number of dependents for whose care the expenses are incurred.

(ii) *Taxable years beginning after December 31, 1963.* Except as otherwise provided in this subdivision, the deduction for child care expenses, for any taxable year beginning after December 31, 1963, may not exceed $600. If the taxpayer has two or more dependents at any time during the taxable year, the $600 limit is increased by the amount of child care expenses incurred by the taxpayer for the period or periods during which the taxpayer has two or more dependents. The $600 limit may not be increased to an amount in excess of $900. For a further limitation on the amount of the allowable deduction, see subparagraphs (2) and (5) of paragraph (b) of this section.

(3) *Examples.* The following examples illustrate the computation of the deduction allowed by section 214 in the case of a taxpayer making his return on the basis of the calendar year. In each example it is assumed that the expenses are of the type which would qualify for the deduction.

(i) The following examples apply to taxable years beginning before January 1, 1964:

Example 1. M was a widower during 1954, until September 1, when he remarried. He paid $50 each month in 1954 for child care expenses. He may take into account, for purposes of the deduction allowed by section 214, only the expenses paid during the taxable year which were incurred while he was unmarried. Since the expenses were $400 ($50 per month from January to August, inclusive), the amount of the deduction is $400. If M had paid $100 per month during 1954, the deduction would be limited to $600, although the expenses incurred while M was unmarried amount to $800.

Example 2. H and W were married during the entire year 1954. W, the wife, paid $900 for child care expenses incurred during the year. The combined adjusted gross income of H and W for 1954 was $5,000. The allowable deduction under section 214 is $100 ($600, the maximum deduction allowable, reduced by $500, the excess of adjusted gross income of $5,000 over $4,500). The deduction of $100 is allowable only if H and W made a joint return for 1954.

Example 3. The facts are the same as in example (2), except that the child care expenses paid during the year were $400. No deduction is allowable under section 214, since the amount of expenses paid, $400, is less than $500 (the excess of the adjusted gross income over $4,500).

Example 4. During 1954, W, a woman, paid $50 each month for child care expenses. She was unmarried until April 1, 1954, and was married for the remainder of the year. H, her husband, was capable of self-support, and the combined adjusted gross income of husband and wife was $4,700. H and W made a joint return for 1954. The total deduction allowable to W under section 214 is $400, computed as follows: $150 as expenses incurred while W was a single woman, and $250 as expenses incurred while W was married; the $250 is arrived at by taking the amount expended while H and W were married, $450, and reducing it by $200 (the excess of adjusted gross income, $4,700 over $4,500).

Example 5. The facts are the same as in example (4), except that the amounts paid are $75 per month ($225 being paid for expenses incurred while W was single and $675 while she was married). The total allowable deduction in this case is $600. $225 is deductible as expenses incurred while W was a single woman. $400 of the expenses incurred during the period of marriage is also deductible. However, the maximum deduction allowable to W is $600. The allowable amount for expenses incurred during the period of marriage is determined as follows: $675 (the amount expended during the period) is reduced to $600 (the maximum deduction allowable) and $600 is then reduced by $200 (the excess of adjusted gross income $4,700 over $4,500) to $400.

Example 6. H and W were married during 1954 prior to July 1, when they received a decree of divorce. She did not remarry during 1954. W paid $100 per month for child care expenses during 1954. The allowable deduction is $600. Since W is considered to have been a single woman during all of 1954, the limitations with respect to the deduction allowed to a married woman are not applicable, and only the $600 limitation applies.

Example 7. H and W married on July 1, 1954. At all times in 1954, until July 1, H was a widower and W was a widow. H and W each paid $750 for child care in 1954, prior to their marriage. Each is allowed a deduction for 1954 of $600, regardless of their adjusted gross income and of the amount of their child care expenditures while married, and whether or not a joint return was filed. However, no additional deduction would be allowed for child care expenses paid after their marriage.

Example 8. H and W were married at all times during the year 1954. As a result of an accident, H incurred injuries which rendered him incapable of self-support during 1954 until September 1. The adjusted gross income of H and W for 1954 was $4,700. W paid $60 each month in 1954 for child care expenses. The deduction allowable to W by section 214 is $520. This amount is composed of $480, representing the amounts paid during H's period of disability, and $40, representing the allowable deduction of expenses paid in the amount of $240 from September to December, inclusive ($240 is reduced by $200, the excess of the adjusted gross income ($4,700) over $4,500).

Example 9. H and W were married from January 1, 1954 to October 1, 1954, when H died. The combined adjusted gross income of the spouses was $4,800. W paid $50 per month for child care expenses throughout the entire year. The deduction allowed to W if she filed a separate return is $150, the amount paid while she was a widow. If a joint return is filed on behalf of the widow and her deceased husband, the deduction allowable is $300 which includes $150 deductible as a married woman (the amount expended during marriage, $450, being reduced by $300, the excess of $4,800 over $4,500).

(ii) The following examples apply to taxable years beginning after December 31, 1963:

Example 1. B was a widower during 1964, until August 1, when he remarried. He had two dependent children aged 7 and 10. He paid $90 each month in 1964 for child care expenses. His wife was not incapacitated or institutionalized at any time during 1964. He may take into account, for purposes of the deduction allowed by section 214, only those expenses paid during the taxable year which were incurred while he was unmarried. Therefore, the amount of the deduction allowable is $630 ($90 per month from January to July, inclusive). If B had only one dependent during the period he was unmarried, the amount of the deduction allowable would be limited to $600.

Example 2. H and W were married during the entire year 1964. They have one dependent child age 11. W, the wife, paid $800 for child care expenses incurred during the year. The combined adjusted gross income of H and W was $6,400. The allowable deduction under section 214 is $200, computed as follows: $600, the maximum deduction allowable for one dependent, is reduced by $400, the excess of adjusted gross income ($6,400) over $6,000. The deduction of $200 is allowable only if H and W made a joint return for 1964.

Example 3. The facts are the same as in example (2), except that the child care expenses paid during the year were $400. No deduction is allowable under section 214, since the amount of expenses paid, $400, does not exceed the excess of the adjusted gross income ($6,400) over $6,000.

Example 4. During 1964, W, a woman paid $60 each month for child care expenses for her dependent child age 11. She was a widow from January 1, through March 31, and was married for the remainder of the year. H, her husband, was capable of self-support, and the combined adjusted gross income of H and W for 1964 was $6,200. H and W made a joint return for 1964. The total deduction allowable to W under section 214 is $520, computed as follows: $180, as expenses incurred while W was a single woman, plus $340, as expenses incurred while W was married. The $340 is arrived at by reducing the amount expended while H and W were married, $540, by $200 (the excess of adjusted gross income ($6,200) over $6,000).

Example 5. The facts are the same as in example (4), except that the amounts paid for child care expenses are $75 per month ($225 being paid for expenses incurred while W was single and $675 while she was married). The total allowable deduction in this case is $600. $225 is deductible as expenses incurred while W was a single woman. $400 of the expenses incurred during the period of marriage is also deductible. However, the maximum deduction allowable to W is $600. The allowable amount for expenses incurred during the period of marriage is determined as follows: $675 (the amount expended during such period) is reduced to $600 (the maximum deduction allowable for one dependent) and $600 is then reduced by $200 (the excess of adjusted gross income ($6,200) over $6,000) to $400.

Example 6. H and W were married during 1964 prior to July 1, when they received a decree of divorce. W did not remarry during 1964. She had two dependent children age 6 and 8. W paid $100 per month for child care expenses during 1964. The allowable deduction is $900. Since W is considered to have been a single woman during all of 1964, the limitations with respect to the deduction allowed to a married woman are not applicable, and only the maximum dollar limitation applies ($900 for two dependents for the entire year). If W had only one dependent during the entire year, the allowable deduction would be limited to $600.

Example 7. H and W were married on July 1, 1964. At all times in 1964, until July 1, H was a widower and W was a widow. H and W each paid $600 for child care expenses in 1964, prior to their marriage. W had a dependent child age 6, and H had a dependent child age 8. Their combined adjusted gross income for 1964 was $6,400, and they made a joint return. From July 1, to the end of 1964, W paid $100 per month for child care expenses for both children. If a joint return is not made, H and W are each allowed a deduction of $600, regardless of their adjusted gross income, but no additional deduction would be allowed for child care expenses paid after their marriage. If a joint return is made, H is allowed a deduction of $600 for the expenses paid by him as a widower, and W is allowed a deduction of $800, computed as follows: $600 for expenses paid by her as a widow, and $200 for expenses incurred and paid by her after her marriage. The $200 is arrived at by reducing the amount expended by W from July 1, to the remainder of 1964 (when she had two dependents), $600, by $400, the excess of the adjusted gross income ($6,400) over $6,000. If after her marriage W had incurred and paid child care expenses in the amount of $1,000, W would be allowed a deduction of $900, computed as follows: $600 for expenses paid by her as a widow, and $300 for expenses incurred and paid by her after her marriage. The $300 is arrived at by reducing the $1,000 to $900 (the maximum deduction allowed for two dependents) and the $900 is reduced by $400 (the excess of adjusted gross income, $6,400 over $6,000); and the remainder, $500, is then reduced to $300, which represents the difference between the maximum dollar limitation for two dependents ($900) and the amount paid by W as a widow, $600.

Example 8. H and W were married at all times during 1964. As a result of an accident, H incurred injuries which rendered him incapable of self-support during 1964 until September 1. They had one dependent child age 10. The adjusted gross income of H and W for 1964 was $6,200. W paid $60 each month in 1964 for child care expenses. The deduction allowable to W under section 214 is $520. This amount is composed of $480, the amounts paid during H's period of disability and $40, the expenses paid from September to December, inclusive ($240) reduced by $200, the excess of the adjusted gross income ($6,200) over $6,000.

Example 9. H and W were married from January 1, 1964, until October 1, 1964, when H died. H and W had one child age 10. The combined adjusted gross income of H and W was $6,300. W paid $50 per month for child care expenses throughout the entire year. The deduction allowed to W if she filed a separate return is $150, the amount paid while she was a widow. If a joint return is filed on behalf of the widow and her deceased husband, the deduction allowable is $300, computed as follows: $150 for expenses incurred while W was a widow, and $150 for expenses incurred while W was married (the amount expended during marriage, $450, is reduced by $300, the excess of the adjusted gross income ($6,300) over $6,000).

Example 10. H and W were married at all times during 1964 and have two children. On March 1, 1964, the older child attained age 13 and during the remainder of the year was not a dependent as defined in section 214(d)(1). W incurred and paid $90 each month for child care expenses. H and W's adjusted gross income for 1964 was $6,100, and they made a joint return. The deduction allowable to W under section 214 is $680, computed as follows: $900 (the amount expended from March 1, to the end of 1964) is reduced to $600 (the maximum amount allowable for one dependent) to which is added $180 (the amount expended while H and W had two dependent children under age 13); a total of $780, which amount is reduced by $100 (the excess of the adjusted gross income ($6,100) over $6,000).

Example 11. H and W were married during the entire year 1964 and have two dependents. On March 1, 1964, W became incapacitated and remained unable to care for herself until April 1, 1964, at which time she was admitted to a hospital for medical treatment. W remained in the hospital continuously until June 1, 1964, at which time she returned home. On June 1, 1964, and for the remainder of 1964, W was capable of caring for herself. H incurred and paid $90 a month for child care expenses during 1964. H and W's adjusted gross income for 1964 was $6,100, and they made a joint return for 1964. For purposes of section 214, W is considered to be incapacitated from March 1, 1964 to May 31, 1964, inclusive (a period of at least 90 consecutive days). The allowable deduction is $170, computed as follows: $270, the amount incurred while W was incapacitated, is reduced by $100, the excess of adjusted gross income ($6,100) over $6,000).

Example 12. The facts are the same as in example (11), except that W was in the hospital until August 1, 1964. On August 1, 1964, and for the remainder of 1964, W was capable of caring for herself. The allowable deduction is $360 (the amount incurred while W was institutionalized). No deduction is allowed for the $90 of expenses incurred during March, 1964, because such amount is less than $100 (the excess of the adjusted gross income ($6,100) over $6,000).

(d) *Dependents*—(1) *In general.* The deduction provided by section 214 is allowed only for expenses paid for the care of an individual who (for the taxable year of the taxpayer in which the expenses are incurred) is a dependent of the taxpayer for whom an exemption is allowed under section 151(e)(1). Furthermore, the dependent must, at the time the expenses are incurred, be:

(i) For taxable years beginning before January 1, 1964, under the age of 12 years,

(ii) For taxable years beginning after December 31, 1963, under the age of 13 years, or

(iii) Mentally or physically unable to care for himself.

(2) *Special rules.* (i) It is not necessary that the dependent be permanently disabled in order for the amount expended for his care to be deductible. However, the mere fact that the disability, whether temporary or permanent, renders him incapable of self-support does not necessarily mean that he is incapable of self-care within the meaning of subparagraph (1)(iii) of this paragraph.

(ii) A dependent who has not attained the age of 13 years (for taxable years beginning before January 1, 1964, who has not attained the age of 12 years) is deemed mentally or physically unable to care for himself. Thus, the deduction for expenses paid for the care of a dependent under the age of 13 years (for taxable years beginning before January 1, 1964, under the age of 12 years) is allowable even though the dependent is not a child or stepchild of the taxpayer.

(iii) The rules provided in sections 151 and 152, with respect to the definition and qualification of an individual as a dependent, govern for the purpose of section 214. Thus, expenses for the care of a child or stepchild under the age of 13 years (for taxable years beginning before Jan. 1, 1964, under the age of 12 years) whom the taxpayer supports are deductible even though the child or stepchild has gross income equal to or in excess of the amount determined pursuant to §1.151–2 applicable to the calendar year in which the taxable year of the taxpayer begins. On the other hand, expenses for the care of an aged parent would not be deductible if the gross income condition of §1.151–2 is not met.

(iv) The term *dependent* does not include the spouse of a taxpayer.

(e) *Payments to a dependent.* No deduction is allowed under section 214 for expenses paid to an individual for whom the taxpayer is allowed, for the taxable year in which the expenses are paid, an exemption under section 151. Thus, if the taxpayer, a working widow, supports her mother and is entitled to claim her as a dependent, she may not deduct amounts paid to the mother for the care of the taxpayer's children.

(f) *What expenses are deductible*—(1) *In general.* In order for an expense to be deductible under section 214, it must meet three conditions: First, the expense must be for the care of a dependent; second, it must be for a dependent's care while the taxpayer is gainfully employed or in search of gainful employment; and third, the expense must be for the purpose of enabling the taxpayer to be gainfully employed. In determining whether an expense meets these conditions, all the facts and circumstances of the case must be taken into consideration.

(2) *Definition of care of a dependent.* (i) In general, the phrase *expenses for the care of a dependent* means amounts expended for the primary purpose of assuring the dependent's well being and protection. It does not include all benefits which may be bestowed upon him. Accordingly, amounts expended to provide food, clothing, or education, are not, in themselves, amounts expended for ''care'' so as to be deductible under section 214. However, where the manner of providing care is such that the expense which must be incurred includes payments for other benefits which are inseparably a part of the care, the full amount of the expense will be considered to be incurred for care. Thus, the full amount paid to a nursery school will be considered to be for the care of the child, even though the school also furnishes lunch, recreational activities, and other benefits.

(ii) The manner of providing the care need not be the least expensive method available to the taxpayer. For example, the taxpayer's mother may reside at the taxpayer's home and be available to afford the taxpayer's child adequate care. Regardless of this fact, the expense incurred for the child at a nursery school or day camp may be expense for the care of the child. See, however, subparagraph (4) of this paragraph with respect to the requirement that the expense must be for the purpose of enabling the taxpayer to be gainfully employed.

(iii) Where a portion of an expenditure is for the care of a dependent and a portion is for other unrelated purposes, a reasonable allocation shall be made and only the portion of the amount paid which is attributable to the care shall be considered an amount to which section 214 is applicable. This rule is applicable if, for example, a servant performs household duties and also cares for the children of the taxpayer. In this case, however, where one of the children is under 13 (for taxable years beginning before January 1, 1964, under 12), and the other (or others) is over such age, there need be no further allocation between the children under such age and those over such age.

(3) *Period of employment.* Since the deduction is allowed only for expenses for care for those periods during which the taxpayer is gainfully employed (or in active search of gainful employment), an allocation may be required when an expense covers periods of care in which no employment is involved. Thus, if a taxpayer pays $50 each month during the year for care of his child at a foster home, and the taxpayer is employed (or in search of employment) for only two months during the year, the deduction is limited to $100.

(4) *Purpose of expenditure.* Even if an expense is incurred for the care of a dependent, it is not deductible unless it is incurred for the purpose of permitting the taxpayer to be gainfully employed. Whether that is the true purpose of the expense depends upon the facts and circumstances of the particular case. Thus, the fact that the cost of providing care for a dependent is greater than the amounts anticipated to be received from the employment of the taxpayer may indicate that the purpose of the expenditure is other than to permit the taxpayer to be gainfully employed.

(5) *Examples.* The following examples illustrate the application of this paragraph:

Example 1. A widow has a child who is too young to attend public school. In order that she may be gainfully employed, the widow places the child in a nursery school while she is at work. The expenses paid to the nursery school are child care expenses to which the deduction under section 214 is applicable. Assuming the nursery school provides lunch for the child, no allocation is required between that part of the expense which might be considered to be for the lunch as distinguished from the expense of assuring the child's protection.

Example 2. The taxpayer, a single woman, in order to be gainfully employed employs a housekeeper who cares for the taxpayer's two children, aged 9 and 13 years, respectively, in addition to performing regular household duties of cleaning and cooking. If it is assumed that the compensation paid to the housekeeper is $1,200 during the year, and that $500 is allocated to the care of the children, a deduction of $500 is allowed under section 214. No allocation is required for purposes of determining which part of the $500 is for the care of the 9 year old child. If the expenses allocable to the care of the children were $700, the amount of the deduction would be $600, the maximum amount allowable for one dependent.

Example 3. The taxpayer, a single woman, has a dependent grandchild 10 years of age who has been attending public school. The taxpayer who has been working part time is offered a position involving full-time employment which she can accept only if arrangements are made for the care of the child from 8 a.m. to 5:30 p.m. Such arrangements are made at a private school to which she sends the child. The expenses paid to the school are for the care of the child without allocation between that part of the expense which represents tuition and that part which represents true care. The expense is considered to be incurred for the purpose of enabling the taxpayer to be gainfully employed.

Example 4. The taxpayer, a widow with a substantial income, has a child aged 11 who has been attending boarding school for several years. The taxpayer, who has been performing gratuitous services for a philanthropic organization, accepts a part-time job with the organization for which she is paid a small salary. From these facts it would appear that the expense of continuing the child in the boarding school is not for the purpose of enabling the taxpayer to be gainfully employed, whether or not the expense is considered to be incurred for the care of the child.

Example 5. The taxpayer, a widower, has a child who is physically incapable of caring for himself. In order to be gainfully employed the taxpayer sends the child to a school for children who are physically handicapped. The expense of the school, whether a day school or a boarding school, is a child care expense.

Example 6. The taxpayer, a single woman, lives with her mother who is an invalid incapable of caring for herself. In order to be gainfully employed the taxpayer hires a practical nurse whose sole duty consists of providing for the care of the mother while the taxpayer is at work. The expense paid to the nurse may be a ‘‘child care’’ expense.

(g) *Expenses qualifying under section 213.* (1) An expense which may constitute an amount otherwise deductible under section 213, relating to medical, etc., expenses, may also, as in example (6) of paragraph (f) of this section, constitute an expense for which a deduction is allowable under section 214. In such a case, that part of the amount for which a deduction is allowed under section 214 shall not be treated as an expense under section 213.

(2) On the other hand, where an amount is treated as a medical expense under section 213 for purposes of determining the amount deductible under that section, it shall not be allowed as a deduction under section 214.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example 1. W, a single woman, pays $720 during the taxable year for the care of her child who suffers from infantile paralysis. It is assumed that the expenses are of a nature which qualify as medical expenses under section 213. It is also assumed that these expenses are for the purpose of permitting W to be gainfully employed. W's adjusted gross income for the taxable year is $5,000. She is allowed a deduction of $600 for child care expenses under section 214. The balance of the expenses, or $120, she treats as medical expenses. However, this amount does not exceed 3 percent of her adjusted gross income and is thus not allowable as a deduction under section 213.

Example 2. It would not be proper in the case presented in (1) for W first to determine under section 213 her deductible medical expenses (which would be $570 ($720 less 3% × $5,000)), and then claim as a deduction under section 214 the $150 which is not deductible under section 213. The $150 would be disallowed under section 214 for the reason that it was treated as a medical expense in determining the amount deductible under section 213.

Example 3. W, a single woman under the age of 65 years, is also the head of a household. She pays $12,000 during the taxable year for child care expenses which also qualify as medical expenses under section 213. W's adjusted gross income for the taxable year is $18,000. She is allowed a deduction of $600 for child care expenses under section 214. The balance, or $11,400, is treated as medical expenses. The allowable deduction under section 213 for such expenses is the excess of 3 percent of W's adjusted gross income, or $10,860, but subject to the maximum limitation in section 213.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6740, 29 FR 7715, June 17, 1964; T.D. 6778, 29 FR 17900, Dec. 17, 1964; T.D. 7114, 36 FR 9020, May 18, 1971; T.D. 7411, 41 FR 15404, Apr. 13, 1976; T.D. 7643, 44 FR 50337, Aug. 28, 1979]

§ 1.214A–1 Certain expenses to enable individuals to be gainfully employed incurred during taxable years beginning after December 31, 1971, and before January 1, 1976.

(a) *In general.* (1) For expenses incurred during taxable years beginning after December 31, 1971, and before January 1, 1976, section 214 allows (subject to the requirements of this section and §§ 1.214A–2 through 1.214A–5) a deduction for employment-related expenses (as defined in paragraph (c) of this section) which are paid during the taxable year by an individual who maintains a household (within the meaning of paragraph (d) of this section) that includes as a member one or more qualifying individuals (as defined in paragraph (b) of this section). The deduction for expenses allowed under section 214 may be taken only as an itemized deduction and may not be taken into account in determining adjusted gross income under section 62. No deduction shall be allowed under section 214 in respect of any expenses incurred during a taxable year beginning after March 29, 1975, and before January 1, 1976, for which the taxpayer's adjusted gross income is $44,600 or more (or incurred during a taxable year beginning after December 31, 1971, and before March 30, 1975, for which the taxpayer's adjusted gross income is $27,600 or more). Expenses which are taken into account in determining the deduction under section 214:

(i) Must first be reduced by that amount by which a disabled dependent's (age 15 or over) adjusted gross income and nontaxable disability payments for the taxable year exceed $750 or by the total amount of a disabled spouse's nontaxable disability payments (see section 214(e)(5) and § 1.214A–3),

(ii) Are then disallowed to the extent that, for any calendar month, they exceed $400, determined after taking into account the $200 (or more) per calendar-month limitation on the amount of expenses incurred outside the household for the care of a dependent (or dependents) under the age of 15 (see section 214(c)(1) and (2) and § 1.214A–2 (a) and (b)), and

(iii) Finally, when the taxpayer's adjusted gross income for the taxable year exceeds the sum of $35,000 (or $18,000 in the case of a taxable year beginning after December 31, 1971, and before March 30, 1975), must be further reduced, on a monthly basis, by one-half of the amount by which the adjusted gross income for the calendar year exceeds such sum (see section 214(d) and § 1.214A–2(c)).

(2) The deduction for employment-related expenses is allowable only for such expenses as are actually paid during the taxable year regardless of when the event which occasions the expenses occurs and of the taxpayer's method of accounting. If such expenses are incurred but not paid during the taxable year, no deduction may be taken for such year. Thus, if such an expense is incurred in the last month of a taxable year but not paid until the following taxable year, a deduction for such expense shall not be allowed for the earlier taxable year. However, if the requirements for deductibility, other than payment, are satisfied in the last month of the taxable year, and the item is paid in the following taxable year, a deduction is allowed under section 214 for such following taxable year.

(3) The requirements of section 214, this section, and §§ 1.214A–2 through 1.214A–5 are to be applied to such expenses as of the time they are incurred regardless of when they are paid.

(4) For special rules relating to the deduction of employment-related expenses which may also qualify as medical expenses deductible under section 213, see § 1.214A–5(b).

(5) For substantiation of the deduction, see paragraph (e) of this section.

(b) *Qualifying individual*—(1) *In general.* A person is considered to be a qualifying individual if he is either (i) the taxpayer's dependent who is under the age of 15 and is an individual for whom the taxpayer is entitled to a deduction for a personal exemption under section 151(e); (ii) the taxpayer's dependent (not described in subdivision (i)) who is physically or mentally incapable of caring for himself; or (iii) the taxpayer's spouse who is physically or mentally incapable of caring for himself. The term *dependent*, as used in this subparagraph, includes any individual who is a dependent within the meaning of section 152. For the rules for determining which parent may claim a child as a dependent where the parents are divorced, legally separated, or separated under a written separation agreement, see section 152(e) and the regulations thereunder.

(2) *Qualification on a daily basis.* The status of a person as a qualifying individual will be determined on a daily basis. Thus, if a dependent or spouse of a taxpayer ceases to be a qualifying individual on September 16, the dependent or spouse will be treated as a qualifying individual through September 15 only.

(3) *Physical or mental incapacity.* An individual will be considered to be physically or mentally incapable of caring for himself if as a result of a physical or mental defect he is incapable of caring for his hygienical or nutritional needs, or requires full time attention of another person for his own safety or the safety of others. The fact that an individual, by reason of a physical or mental defect, is unable to engage in any substantial gainful activity, or is unable to perform the normal household functions of a homemaker or to care for minor children, will not of itself establish that the individual is physically or mentally incapable of caring for himself. An individual who is physically handicapped or is mentally defective, and for such reason requires constant attention of another person, is considered to be physically or mentally incapable of caring for himself.

(c) *Employment-related expenses*—(1) *Gainful employment*—(i) *In general.* Expenses are considered to be employment-related expenses only if they are incurred to enable the taxpayer to be gainfully employed and are paid for household services or for the care of one or more qualifying individuals. The expenses must be incurred while the taxpayer is gainfully employed or is in active search of gainful employment. The employment may consist of service either within or without the home of the taxpayer and may include self-employment. Unpaid volunteer work or work for a nominal salary does not constitute qualifying employment. An expense will not be considered to be employment-related merely because it is incurred while the taxpayer is gainfully employed. Whether the purpose of the expense is to enable the taxpayer to be gainfully employed depends upon the facts and circumstances of the particular case. Thus, the fact that the cost of providing care for a qualifying individual is greater than the amounts anticipated to be received from the employment of the taxpayer may indicate that the purpose of the expenditure is other than to permit the taxpayer to be gainfully employed. Any tax required to be paid by the taxpayer under section 3111 (relating to the Federal Insurance Contributions Act) in respect of any wages which otherwise constitute employment-related expenses shall be considered to be an employment-related expense.

(ii) *Determination of period of employment on a daily basis.* An allocation of expenses is required on a daily basis when such expenses cover any period during part of which the taxpayer is gainfully employed or is in active search of gainful employment and during the other part of which there is no employment or active search for gainful employment. Thus, for example, if a taxpayer incurs during each month of the taxable year $60 of expenses which would be employment-related if he were gainfully employed all year, and the taxpayer is gainfully employed, or in active search of gainful employment, for only 2 months and 10 days during such year, the amount of employment-related expenses is limited to $140. If a taxpayer is married, both he and his spouse must be gainfully employed on a substantially full-time basis (see §1.214A–4(b)). However, certain married individuals living apart are treated as not married for this purpose (see §1.214A–4(c)).

(2) *Household services.* Expenses will be considered to be paid for household services if they are paid for the performance in and about the taxpayer's home of ordinary and usual services necessary to the maintenance of the household. However, expenses will not be considered as paid for household services unless the expenses are attributable in part to the care of the qualifying individual. Thus, amounts paid for the services of a domestic maid or cook will be considered to be expenses paid for household services if a part of

those services is provided to the qualifying individual. Amounts paid for the services of an individual who is employed as a chauffeur, bartender, or gardener, however, will not be considered to be expenses paid for household services.

(3) *Care of qualifying individual*—(i) *In general.* The primary purpose of expenses for the care of a qualifying individual must be to assure that individual's well-being and protection. Not all benefits bestowed upon such an individual will be considered as provided for his care. Accordingly, amounts paid to provide food, clothing, or education are not expenses paid for the care of a qualifying individual. However, where the manner of providing care is such that the expense which is incurred includes expense for other benefits which are inseparably a part of the care, the full amount of the expense will be considered to be incurred for care. Thus, for example, the full amount paid to a nursery school in which a qualifying child is enrolled will be considered to be for the care of the child, even though the school also furnishes lunch, recreational activities, and other benefits. Educational expenses incurred for a child in the first or higher grade level are not expenses incurred for the care of one or more qualifying individuals. Expenses incurred for transportation of a qualifying individual described in paragraph (b)(1)(i) of this section between the taxpayer's household and a place outside the taxpayer's household where services for the care of such qualifying individual are provided will not be considered to be incurred for the care of such qualifying individual.

(ii) *Manner of providing care.* The manner of providing the care need not be the least expensive alternative available to the taxpayer. For example, the taxpayer's mother may reside at the taxpayer's home and be available to provide adequate care at no cost for the taxpayer's wife who is physically or mentally incapable of caring for herself. Nevertheless, the expenses incurred in providing a nurse for the wife may be an expense for the care of the wife. See, however, paragraph (c)(1)(i) of this section with respect to the requirement that the expense must be for the purpose of permitting the taxpayer to be gainfully employed.

(4) *Allocation of expenses.* Where a portion of an expense is for household services or for the care of a qualifying individual and a portion of such expense is for other unrelated purposes, a reasonable allocation must be made and only the portion of the expense paid which is attributable to such household services or care will be considered to be an employment-related expense. No such allocation is required to be made, however, if the portion of expense for the unrelated purpose is minimal or insignificant. Such an allocation must be made, for example, if a servant performs household duties, cares for the children of the taxpayer, and also performs social services for the taxpayer (for which a deduction is not allowable) and clerical services in the office of the taxpayer outside the home (for which a deduction may be allowable under section 162). Since a household service expense may be considered employment-related in its entirety even though it is only in part attributable to the care of a qualifying individual, no allocation is required between the part of the household service expense which is attributable to that care of a qualifying individual and that part which is not so attributable.

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

Example 1. The taxpayer lives with her mother who is physically incapable of caring for herself. In order to be gainfully employed the taxpayer hires a practical nurse whose sole duty consists of providing for the care of the mother in the home while the taxpayer is at work. All amounts spent for the services of the nurse are employment-related expenses.

Example 2. The taxpayer has a dependent child 10 years of age who has been attending public school. The taxpayer who has been working part time is offered a position involving full-time employment which she can accept only if the child is placed in a boarding school. The taxpayer accepts the position, and the child is sent to a boarding school. The expenses paid to the school must be allocated between that part of the expenses which represents care for the child and that part which represents tuition for education. The part of the expense representing care of the child is considered to be incurred for the purpose of permitting the taxpayer to be gainfully employed.

Example 3. The taxpayer, in order to be gainfully employed, employs a housekeeper who cares for the taxpayer's two children, aged 9 and 15 years, respectively, performs regular household services of cleaning and cooking, and chauffeurs the taxpayer to and from his place of employment. The chauffeuring service never requires more than 30 minutes out of the total period of employment each day. No allocation is required for purposes of determining the portion of the expense attributable to the chauffeuring (not a household service expense) since it is de minimis. Further, no allocation is required for the purpose of determining the portion of the expense attributable to the care of the 15 year old child (not a qualifying individual) since the household expense is in part attributable to the care of the 9 year old child, who is a qualifying individual. Accordingly, the entire expense of employing the housekeeper is an employment-related expense.

(d) *Maintenance of a household*—(1) *In general.* An individual is considered to have maintained a household for his taxable year (or lesser period) only if he (and his spouse if he is married) have furnished over one-half of the cost incurred for such taxable year (or lesser period) in maintaining the household. The household must actually constitute for the taxable year the principal place of abode of the taxpayer and the qualifying individual or individuals described in paragraph (b) of this section. It is not sufficient that the taxpayer maintain the household without being its occupant. A physical change in the location of the home will not, however, prevent the home from constituting the principal place of abode of the taxpayer and a qualifying individual. The fact that an individual is born or dies during the taxable year will not prevent a home from constituting his principal place of abode for such year. An individual will not be considered to have terminated a household as his principal place of abode merely by reason of temporary absences therefrom by reason of illness, education, business, vacation, military service, or a custody agreement.

(2) *Two or more families.* Solely for purposes of section 214 and this section, if two or more families occupy living quarters in common, each of such families will be treated as constituting a separate household, and the taxpayer who provides more than one-half of the costs of maintaining such a separate household will be treated as maintaining such household. Thus, for example, if two unrelated women each with children occupy living quarters in common and each woman pays more than one-half of her proportionate share of household costs incurred by both families, each woman will be treated as maintaining her separate household.

(3) *Costs of maintaining a household.* The cost of maintaining a household shall be the expenses incurred for the mutual benefit of the occupants thereof by reason of its operation as the principal place of abode of such occupants. The expenses of maintaining a household include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises. Such expenses do not include the cost of clothing, education, medical treatment, vacations, life insurance, or transportation or payments on mortgage principal or for the purchase, permanent improvement, betterment, or replacement of property. However, the cost of maintaining a household shall not include any amount which represents the value of services performed in the household by the taxpayer or by a qualifying individual described in paragraph (b) of this section. Expenses incurred in respect of which money or other property is received as compensation or reimbursement may not be included as a cost of maintaining a household.

(4) *Monthly proration of annual costs.* In determining the cost incurred for a period of less than a taxable year in maintaining a household, the cost incurred during the entire taxable year must be prorated on the basis of the number of calendar months within such lesser period. For this purpose a period of less than a calendar month will be treated as a calendar month. Thus, for example, if the cost of maintaining a household for a taxable year is $6,600, and the period in respect of which a determination is being made under section 214 is from June 20 to December 31, the taxpayer must furnish more than $1,925 ([$6,600×7/12]×50%) in maintaining the household from June 1 to December 31.

(e) *Substantiation.* A taxpayer claiming a deduction under paragraph (a) of this section for employment-related expenses must substantiate by adequate records or other sufficient evidence any deductions taken under this section. For example, if requested, the taxpayer must furnish information as to the nature and period of the physical or mental incapacitation of any dependent or spouse in respect of whom a deduction is claimed, including necessary information from the attending physician as to the nature of the physical or mental incapacity.

[T.D. 7411, 41 FR 5405, Apr. 13, 1976, as amended by T.D. 7643, 44 FR 50337, Aug. 28, 1979]

§ 1.214A–2 Limitations on deductible amounts.

(a) *Overall monthly limitation of $400.* The deduction under section 214(a) and § 1.214A–1(a) for employment-related expenses is not allowed in respect of any such expenses in excess of $400 incurred during any one calendar month. For purposes of the limitation of $400, a period of less than a calendar month will be treated as a calendar month. Any amount by which employment-related expenses incurred during any calendar month exceed $400 may not be carried to another calendar month and used in determining the employment-related expenses incurred in such other calendar month. Thus, for example, if a taxpayer incurs employment-related expenses of $500 during each of the first 6 months of the taxable year and only $200 of such expenses during each of the last 6 months, the amount of his deduction for the payment during such taxable year of such expenses shall be limited by this paragraph to $3,600, consisting of $2,400 ($400×6) incurred during the first 6 months of the taxable year and $1,200 ($200×6) incurred during the last 6 months of the taxable year. The limitation provided by this paragraph must be applied after making the reduction in the amount of employment-related expenses provided by paragraph (a) of § 1.214A–3 (relating to disability payments) and after the application of the limitation upon the amount deductible provided by paragraph (b) of this section.

(b) *Restriction to expenses incurred for services in the household*—(1) *In general.* Except as otherwise provided in paragraph (b)(2) of this section, deduction shall be allowed under § 1.214 A–1(a) only for employment-related expenses incurred for services performed in the household of the taxpayer. Thus, for example, if a taxpayer places his invalid father in a nursing home, he is not entitled to deduct his employment-related expenses incurred for his father's care provided by the nursing home. If, however, the taxpayer's father remains in the home used as the household, the taxpayer is allowed to deduct his employment-related expenses attributable to the employment in the household of a nurse to care for his father.

(2) *Exception for certain expenses incurred outside the household.* A deduction shall be allowed under § 1.214A–1(a) for employment-related expenses incurred for services performed outside the household of the taxpayer only if such expenses are incurred for the care of one or more dependents of the taxpayer who are under the age of 15 and who are persons for whom the taxpayer is entitled to a deduction for a personal exemption under section 151(e). The amount of such expenses incurred during a calendar month for services performed outside the household of the taxpayer which may be deducted is limited to:

(i) $200, in the case of one such dependent,

(ii) $300, in the case of two such dependents, or

(iii) $400, in the case of three or more such dependents.

For purposes of the limitation under this subparagraph, a period of less than a calendar month will be treated as a calendar month. Any amount which is taken into account after the application of such limitation is also subject to the monthly limitation of $400 provided by paragraph (a) of this section.

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

Example 1. If during a calendar month a taxpayer incurs employment-related expenses of $150 for services performed within his household and $300 for services performed outside the household for the care of his child, age 5, the taxpayer is entitled to deduct only $350 of such expenses. In such case the $300 for services performed outside the household is limited to $200 by subparagraph (2) of this paragraph.

Example 2. If the facts are the same as in example (1) except that during the month the taxpayer incurs employment-related expenses of $250 for services performed within his household, the taxpayer is entitled to deduct only $400 of the total expenses incurred. In such case the total expenses incurred during the month which may be taken into account ($450) are limited to $400 by paragraph (a) of this section.

(c) *Taxpayer's income limitation*—(1) *In general.* This paragraph applies only if the adjusted gross income of the taxpayer for the taxable year exceeds the amount of $35,000, in the case of a taxable year beginning after March 29, 1975, and before January 1, 1976 (or the amount of $18,000 in the case of a taxable year beginning after December 31, 1971, and before March 30, 1975). In either case, in determining the deduction allowable under §1.214A–1(a) for employment-related expenses, the amount of such expenses incurred during any calendar month of the taxable year must be reduced by an amount equal to the excess of the adjusted gross income of the taxpayer for the taxable year over the applicable income limitation ($35,000 or $18,000 as the case may be) divided by twice the number of calendar months in the taxable year. For purposes of applying the taxpayer's income limitation a period of less than a calendar month will be treated as a calendar month. The limitation provided by this paragraph must be applied after making the reduction in the amount of employment-related expenses provided by paragraph (a) of §1.214A–3 and after the application of the limitations upon the amount deductible provided by paragraph (a) of §1.214A–3 and after the application of the limitations upon the amount deductible provided by paragraphs (a) and (b) of this section. The application of this subparagraph may be illustrated by the following examples:

Example 1. A, a single individual who uses the fiscal year ending March 31 as the taxable year, incurs (and pays) during May 1975 employment-related expenses of $600. He has adjusted gross income of $41,000 for the fiscal year ending March 31, 1976. Under these circumstances the amount of employment-related expenses for the month of May 1975 which may be taken into account under paragraph (a) of §1.214A–1 is $150, determined as follows:

Employment-related expenses incurred during May ($600, but not to exceed $400 under par. (a) of this section)	$400
Less: Reduction under this subparagraph:	
Adjusted gross income for taxable year	41,000
Less: Taxpayer's income limitation applicable to taxable year beginning after March 29, 1975	35,000
Excess adjusted gross income over income limitation	6,000
Excess divided by twice the number of calendar months in taxable year ($6,000+[2×12])	250
Employment-related expenses to be taken into account	150

Example 2. Assume the same facts as in example (1) except that A incurs employment-related expenses of only $200 during May 1975. Under these circumstances no amount of employment-related expenses may be taken into account for the month of May under paragraph (a) of §1.214A–1 because the expenses of $200 for the month are fully offset by the reduction of $250 required under this subparagraph.

Example 3. B, a single individual who uses the calendar year as the taxable year, incurs and pays during June, 1975, employment-related expenses of $500. On August 31, 1975, B dies. His adjusted gross income for the taxable year ending August 31 is $22,800. Under such circumstances the amount of employment-related expenses for the month of June which may be taken into account under paragraph (a) of §1.214A–1 is $100, determined as follows:

Employment-related expenses incurred during June ($500, but not to exceed $400 under par. (a) of this sec.)	$400
Less: Reduction under this subparagraph:	
Adjusted gross income for taxable year	22,800
Less: Taxpayer's income limitation applicable to taxable year beginning before March 30, 1975	18,000
Excess adjusted gross income over income limitation	4,800
Excess divided by twice the number of calendar months in taxable year ($4,800+[2×8])	300
Employment-related expenses to be taken into account	100

(2) *Marital status.* For purposes of paragraph (c)(1) of this section, the adjusted gross income of the taxpayer for his taxable year shall include the adjusted gross income of his spouse for such year if he is married for the entire taxable year. If the taxpayer is married during only a part of his taxable year, his adjusted gross income for the taxable year shall include the adjusted gross income of his spouse for only

such period within the taxable year during which he is married. Thus, if the taxpayer and his wife use the calendar year as the taxable year and the taxpayer's wife dies on May 15 and he does not remarry before the close of his taxable year, the adjusted gross income of the wife for the period from January 1 to May 15 must be included in applying the income limitation for the taxable year under section 214(d) and paragraph (c)(1) of this section. If, however, in such case the taxpayer were to remarry on October 15 of his taxable year and file a single return jointly with the second wife, the adjusted gross income of the first wife for the period from January 1 to May 15 and the adjusted gross income of the second wife for the period from October 15 to December 31 must be included in applying the income limitation for the taxable year under paragraph (c)(1) of this section.

[T.D. 7411, 41 FR 15407, Apr. 13, 1976, as amended by T.D. 7643, 44 FR 50337, Aug. 28, 1979]

§ 1.214A–3 Reduction of expenses for certain disability payments and adjusted gross income.

(a) *Amount of reduction.* This section applies only if the taxpayer incurs employment-related expenses during a taxable year solely attributable to a qualifying individual who is either a dependent (other than a dependent described in § 1.214A–1(b)(1)(i)) of the taxpayer or a spouse of the taxpayer and who is physically or mentally incapable of caring for himself. The amount of such expenses, which may be taken into account under section 214 shall be reduced:

(1) In the case of such expenses attributable to a dependent who is physically or mentally incapable of caring for himself, by the excess, if any, over $750 of the sum of (i) such dependent's adjusted gross income for such taxable year and (ii) the disability payments (as defined in paragraph (b) of this section) he receives during such year, and

(2) In the case of such expenses attributable to a spouse who is physically or mentally incapable of caring for himself, by the disability payments (as defined in paragraph (b) of this section) such spouse receives during such taxable year.

The reduction so required must be made on the basis of a calendar month. Thus, the employment-related expenses attributable to a spouse which are incurred during any calendar month of the taxable year must be reduced by an amount equal to the disability payments received by the spouse during such taxable year divided by the number of calendar months therein during which such employment-related expenses are incurred. Further, the employment-related expenses attributable to a dependent which are incurred during any calendar month of the taxable year must be reduced by an amount equal to the excess described in paragraph (a)(1) of this section divided by the number of calendar months therein during which such employment-related expenses are incurred. For purposes of this reduction, a period of less than a calendar month will be treated as a calendar month. The reduction is not required to be made in respect of any employment-related expenses solely attributable to a dependent under the age of 15 for whom the taxpayer is entitled to a deduction for a personal exemption under section 151(e). The reduction required by this paragraph must be made before applying the limitations under section 214 (c) and (d) and § 1.214A–2 for the taxable year. The application of this paragraph may be illustrated by the following examples:

Example 1. A, a taxpayer who uses the calendar year as the taxable year, incurs $250 of employment-related expenses during each month of 1972 for services within his household. B, his wife, is physically incapable of caring for herself. During 1972, B receives total disability payments of $1,200, consisting of a lump-sum disability payment of $300 received in June and disability payments of $75 received each month. Under such circumstances, A may take into account $150 of his employment-related expenses for each month of 1972, determined as follows:

Employment-related expenses attributable to B incurred during each month	$250
Less: Disability payments received by B in 1972 divided by number of calendar months in 1972 during which employment-related expenses attributable to B are incurred ($1,200÷12)	100
Employment-related expenses to be taken into account	150

Example 2. B, a single individual who uses the calendar year as the taxable year, incurs

$200 of employment-related expenses during each month of 1972 for services within his household. C, his son aged 15, is physically incapable of caring for himself. During 1972, C receives total disability payments of $1,200, consisting of a lump-sum disability payment of $300 received in June and disability payments of $75 received each month. For 1972, C has adjusted gross income of $1,050. Under such circumstances, B may take into account $75 of his employment-related expenses for each month of 1972, determined as follows:

Employment-related expenses attributable to C incurred during each month	$200
Less: Reduction under this paragraph:	
C's adjusted gross income for 1972	1,050
Disability payments received by C in 1972	1,200
Total	2,250
Less: Income limitation	750
Excess under subparagraph (1) of this paragraph	1,500
Excess divided by number of calendar months in 1972 during which employment-related expenses attributable to C are incurred ($1,500÷12)	125
Employment-related expenses to be taken into account	75

Example 3. H, a taxpayer who uses the calendar year as the taxable year, incurs employment-related expenses attributable to W, his wife, during five months of 1972, including $350 for the month of July, for services within his household. W, who is physically incapable of caring for herself, receives during 1972 total disability payments of $625. Under such circumstances, H may take into account $225 of his employment-related expenses for July, determined as follows:

Employment-related expenses attributable to W incurred during July	$350
Less: Disability payments received by W in 1972 divided by number of calendar months in 1972 during which employment-related expenses attributable to W are incurred ($625÷5)	125
Employment-related expenses to be taken into account	225

Example 4. S, a single individual who uses the calendar year as the taxable year, incurs and pays during 1972 $450 of employment-related expenses attributable to P, his father, for each of the six months during which his father is incapacitated. During 1972, P receives adjusted gross income of $1,266, a gift of $300, and a disability payment of $55 for each month of disability. During 1972 S receives adjusted gross income of less than $18,000. Under such circumstances, S may deduct $1,854 for 1972 under section 214, determined as follows:

Employment-related expenses attributable to P incurred during each month of his incapacity	$450
Less: Reduction under this paragraph:	
P's adjusted gross income for 1972	1,266
Disability payments received by P in 1972	330
Total	1,596
Less: Income limitation	750
Excess under subparagraph (1) of this paragraph	846
Excess divided by number of calendar months in 1972 during which employment-related expenses attributable to P are incurred ($846÷6)	141
Employment-related expenses to be taken into account for each month of P's incapacity	309
Deduction for 1972 ($309×6)	1,854

(b) *Disability payment defined.* For purposes of paragraph (a) of this section, the term *disability payment* means any payment not includible in gross income which is made on account of the physical or mental incapacity of an individual. A disability payment may include social security payments, State or local payments, private disability insurance payments, or payments from a private person on account of a civil wrong, if attributable to the mental or physical disability of the individual. Gifts are not considered to be disability payments for purposes of this paragraph.

(c) *Expenses not solely attributable.* An employment-related expense which is not solely attributable to a qualifying individual to whom paragraph (a) (1) or (2) of this section applies shall not be reduced under this section. Thus, for example, if household expenses are incurred with respect to a qualifying individual to whom paragraph (a) (1) or (2) of this section applies and also with respect to a qualifying dependent under the age of 15, such expenses shall not be considered to be solely attributable to a qualifying individual to whom paragraph (a) (1) or (2) of this section applies, and such expenses shall not be reduced under this section. The application of this paragraph may be illustrated by the following examples:

Example 1. A taxpayer has a child, aged 6, and his spouse is physically incapable of caring for herself. During the taxable year he incurs employment-related expenses of $500 solely attributable to the care of the child, of $1,000 solely attributable to the care of his spouse, and of $1,500 for household services attributable to both the child and spouse. Of the taxpayer's total employment-related expenses of $3,000, only the $1,000 solely attributable to his spouse must be reduced as provided in paragraph (a) of this section.

Example 2. A taxpayer has a dependent, aged 15, and a spouse both of whom are physically incapable of caring for themselves. During the taxable year he incurs employment-related expenses of $500 solely attributable to the care of the dependent, of $1,000 solely attributable to the care of his spouse, and of $1,500 for household services equally attributable to both the dependent and spouse. The $1,500 of household expenses must be allocated one-half to the dependent and one-half to the spouse. Accordingly, employment-related expenses of $1,250 are attributable to the dependent, and employment-related expenses of $1,750 are attributable to the spouse. The expenses attributable to each must be reduced as provided in paragraph (a) of this section.

(d) *Ordering of reductions and limitations.* For purposes of determining the amount of employment-related expenses which may be taken into account under section 214, the employment-related expenses incurred by the taxpayer during any calendar month of the taxable year are first to be reduced by the amount of reduction determined under section 214(e)(5) and paragraph (a) (1) or (2) of this section in respect of disability payments and adjusted gross income, then by the outside-of-household limitation prescribed by section 214(c)(2)(B) and § 1.214A–2(b)(2), then by the overall monthly limitation of $400 prescribed by section 214(c)(1) and § 1.214A–2(a), and finally by the taxpayer's income limitation ($35,000 or $18,000, as the case may be) prescribed by section 214(d) and § 1.214A–2(c), in that order. The application of this subparagraph may be illustrated by the following examples:

Example 1. The taxpayer's wife is physically incapable of caring for herself. He incurs employment-related expenses of $1,000 during the calendar month for services within the household. Disability payments of the wife applicable to such month under paragraph (a)(2) of this section amount to $350. The taxpayer's excess adjusted gross income (over the taxpayer's income limitation) applicable to such month under § 1.214A–2(c)(1) amounts to $300. Under such circumstances, the amount of employment-related expenses for such month which may be taken into account for purposes of section 214 is $100, determined as follows:

Employment-related expenses	$1,000
Less: Reduction under paragraph (a)(2) of this section	350
Balance	650
Application of limitation under § 1.214A–2(a) (employment-related expenses of $650, but not to exceed $400)	400
Less: Reduction under § 1.214A–2(c)(1)	300
Employment-related expenses to be taken into account	100

Example 2. The taxpayer's child, aged 15, is physically incapable of caring for himself the taxpayer incurs employment-related expenses of $487 duing June for services within the household. The excess of the adjusted gross income and disability payments of the dependent child for the taxable year (over the $750 limitation) applicable to June under paragraph (a)(1) of this section amounts to $112. The taxpayer's excess adjusted gross income (over the taxpayer's income limitation) applicable to June under § 1.214A–2(c)(1) amounts to $125. Under such circumstances, the amount of employment-related expenses for June which may be taken into account for purposes of section 214 is $250, determined as follows:

Employment-related expenses	$487
Less: Reduction under paragraph (a)(1) of this section	112
Balance	375
Less: Reduction under § 1.214A–2(c)(1)	125
Employment-related expenses to be taken into account	250

[T.D. 7411, 41 FR 15408, Apr. 13, 1976]

§ 1.214A–4 Special rules applicable to married individuals.

(a) *Joint return requirement.* This section applies only if the taxpayer is married at the close of a taxable year in which employment-related expenses are paid. In such a case the deduction provided by section 214(a) and § 1.214A–1(a) for such expenses shall be allowed only if for such taxable year the taxpayer files a single return jointly with his spouse. If either spouse dies during the taxable year and a joint return may be made for such year under section 6013(a)(2) for the survivor and the deceased spouse, the deduction shall be allowed for such year only if a joint return is made. If, however, the surviving spouse remarries before the end of his taxable year in which his first spouse dies, a deduction is allowed under section 214(a) on the separate return which is made for the decedent spouse. For purposes of this section, certain married individuals living apart are treated as not married, as provided in paragraph (c) of this section.

(b) *Gainful employment requirement*—(1) *In general.* The employment-related expenses incurred during any month of any period within the taxable year of a taxpayer who is married for such period shall be taken into account under section 214(a) and §1.214A–1(a) only if both the taxpayer and his spouse are gainfully employed on a substantially full-time basis or are in active search of gainful employment on a substantially full-time basis, or if his spouse is physically or mentally incapable of caring for herself. For such purposes, an individual is considered to be gainfully employed on a substantially full-time basis if he is employed for three-quarters or more of the normal or customary work week (or the equivalent on the average during a month).

(2) *Determination of qualifying periods on a daily basis.* For purposes of this paragraph, the determination as to whether an individual is gainfully employed on a substantially full-time basis shall be made on a daily basis in accordance with the provisions of paragraph (c)(1)(ii) of §1.214A–1, and the determination as to whether a spouse is physically or mentally incapable of caring for himself shall be made on a daily basis in accordance with paragraph (b)(2) of such section. Thus, for example, if a taxpayer is gainfully employed throughout the taxable year on a substantially full-time basis but his spouse ceases on August 17 of such year to be employed on a substantially full-time basis and on November 16 of the same year becomes physically or mentally incapable of caring for herself, an allocation must be made to determine the period ending on August 17 during which both spouses are gainfully employed on a substantially full-time basis, and the incapacitated spouse is to be treated as a qualifying individual described in section 214(b)(1)(C) only for the period commencing with November 16. Employment-related expenses incurred from August 18 through November 15 may not be taken into account since only one spouse is gainfully employed on a substantially full-time basis during such period and the other spouse is not physically or mentally incapable of caring for herself during such period.

(c) *Certain married individuals living apart.* For purposes of section 214 an individual who for his taxable year would be treated as not married under section 143(a)(2), or would be treated as not married under section 143(b) if paragraph (1) of such section referred to any dependent of the taxpayer (and not simply to a son, stepson, daughter, or stepdaughter of such individual), shall be treated as not married for such taxable year. Thus, an individual who is married within the meaning of section 143(a) will be treated as not married for his entire taxable year for purposes of section 214, if:

(1) He files a separate return for such year,

(2) He maintains as his home a household which constitutes for more than one-half of such year the principal place of abode of one or more of his dependents with respect to whom he is entitled to a deduction under section 151 for such year,

(3) He furnishes over one-half of the cost of maintaining such household for such year, and

(4) His spouse is not a member of such household for any part of such year.

Thus, for example, an individual who is married during the taxable year and is living apart from his spouse, but is not legally separated under a decree of divorce or separate maintenance, may, if he is treated as not married by reason of this paragraph, determine the limitation upon the amount of his employment-related expenses without taking into account the adjusted gross income of his spouse under §1.214A–2(c)(2), without complying with the requirement under paragraph (a) of this section for filing a joint return with his spouse, and without complying with the requirement under paragraph (b) of this section that his spouse be gainfully employed. The principles of §1.143–1(b) shall apply in making determinations under this paragraph.

[T.D. 7411, 41 FR 15409, Apr. 13, 1976]

§ 1.214A–5 Other special rules relating to employment-related expenses.

(a) *Payments to related individuals.* No deduction will be allowed under section 214(a) and § 1.214A–1(a) for the amount of any employment-related expenses paid by the taxpayer to an individual who bears to the taxpayer any relationship described in section 152(a) (1) through (8). These relationships are those of a son or daughter or descendant thereof; a stepson or stepdaughter; a brother, sister, stepbrother, or stepsister; a father or mother or an ancestor of either; a stepfather or stepmother; a nephew or niece; an uncle or aunt; or a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law. In addition, no deduction will be allowed under section 214(a) for the amount of any employment-related expenses paid by the taxpayer to an individual who qualifies as a dependent of the taxpayer for the taxable year within the meaning of section 152(a)(9), which relates to an individual (other than the taxpayer's spouse) whose principal place of abode for the taxable year is the home of the taxpayer and who is a member of the taxpayer's household.

(b) *Expenses qualifying as medical expenses.* An expense which may constitute an amount otherwise deductible under section 213, relating to medical, etc., expenses, may also constitute an expense for which a deduction is allowable under section 214(a) and § 1.214A–1(a). In such a case, that part of the amount for which a deduction is allowed under section 214(a) will not be considered as an expense allowable as a deduction under section 213. On the other hand, where an amount is treated as a medical expense under section 213 for purposes of determining the amount deductible under that section, it may not be treated as an employment-related expense for purposes of section 214. The application of this paragraph may be illustrated by the following examples:

Example 1. A Taxpayer pays $520 of employment-related expenses in the taxable year for the care of his child during one month of such year when the child is physically incapable of caring for himself. These expenses are incurred for services performed in the taxpayer's household and are of a nature which qualify as medical expenses under section 213. The taxpayer's adjusted gross income for the taxable year is $5,000. Of the total expenses, the taxpayer may take $400 into account under section 214; the balance of the expenses, or $120, may be treated as medical expenses to which section 213 applies. However, this amount does not exceed 3 percent of the taxpayer's adjusted gross income for the taxable year and is thus not allowable as a deduction under section 213.

Example 2. Assume the same facts as in *Example (1).* In such case it is not proper for the taxpayer first to determine under section 213 his deductible medical expenses of $370 ($520—[$5,000×3%]) and then claim the $150 balance as employment-related expenses for purposes of section 214. This result is reached because the $150 balance has been treated as a medical expense in determining the amount deductible under section 213.

Example 3. A taxpayer incurs and pays $1,000 of employment-related expenses each month during the taxable year for the care of his child. These expenses are incurred for services performed in the taxpayer's household, and they also qualify as medical expenses under section 213. The taxpayer's adjusted gross income for the taxable year is $18,000. No reduction in the amount of the expenses is required under § 1.214A–3, and the taxpayer takes $4,800 ($400×12) of such expenses into account under section 214. The balance, or $7,200, he treats as medical expenses for purposes of section 213. The allowable deduction under section 213 for such expenses is limited to the excess of such balance of $7,200 over $540 (3 percent of the taxpayer's adjusted gross income of $18,000), or $6,600.

[T.D. 7411, 41 FR 15410, Apr. 13, 1976]

§ 1.215–1 Periodic alimony, etc., payments.

(a) A deduction is allowable under section 215 with respect to periodic payments in the nature of, or in lieu of, alimony or an allowance for support actually paid by the taxpayer during his taxable year and required to be included in the income of the payee wife or former wife, as the case may be, under section 71. As to the amounts required to be included in the income of such wife or former wife, see section 71 and the regulations thereunder. For definition of *husband* and *wife* see section 7701(a) (17).

(b) The deduction under section 215 is allowed only to the obligor spouse. It is not allowed to an estate, trust, corporation, or any other person who may pay the alimony obligation of such obligor spouse. The obligor spouse, however, is not allowed a deduction for any periodic payment includible under section 71 in the income of the wife or former wife, which payment is attributable to property transferred in discharge of his obligation and which, under section 71(d) or section 682, is not includible in his gross income.

(c) The following examples, in which both H and W file their income tax returns on the basis of a calendar year, illustrate cases in which a deduction is or is not allowed under section 215:

Example 1. Pursuant to the terms of a decree of divorce, H, in 1956, transferred securities valued at $100,000 in trust for the benefit of W, which fully discharged all his obligations to W. The periodic payments made by the trust to W are required to be included in W's income under section 71. Such payments are stated in section 71(d) not to be includible in H's income and, therefore, under section 215 are not deductible from his income.

Example 2. A decree of divorce obtained by W from H incorporated a previous agreement of H to establish a trust, the trustees of which were instructed to pay W $5,000 a year for the remainder of her life. The court retained jurisdiction to order H to provide further payments if necessary for the support of W. In 1956 the trustee paid to W $4,000 from the income of the trust and $1,000 from the corpus of the trust. Under the provisions of sections 71 and 682(b), W would include $5,000 in her income for 1956. H would not include any part of the $5,000 in his income nor take a deduction therefor. If H had paid the $1,000 to W pursuant to court order rather than allowing the trustees to pay it out of corpus, he would have been entitled to a deduction of $1,000 under the provisions of section 215.

(d) For other examples, see sections 71 and 682 and the regulations thereunder.

§1.215–1T Alimony, etc., payments (temporary).

Q–1 What information is required by the Internal Revenue Service when an alimony or separate maintenance payment is claimed as a deduction by a payor?

A–1 The payor spouse must include on his/her first filed return of tax (Form 1040) for the taxable year in which the payment is made the payee's social security number, which the payee is required to furnish to the payor. For penalties applicable to a payor spouse who fails to include such information on his/her return of tax or to a payee spouse who fails to furnish his/her social security number to the payor spouse, see section 6676.

(98 Stat. 798, 26 U.S.C. 1041(d)(4); 98 Stat. 802, 26 U.S.C. 152(e)(2)(A); 98 Stat. 800, 26 U.S.C. 215(c); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7973, 49 FR 34458, Aug. 31, 1984]

§1.216–1 Amounts representing taxes and interest paid to cooperative housing corporation.

(a) *General rule.* A tenant-stockholder of a cooperative housing corporation may deduct from his gross income amounts paid or accrued within his taxable year to a cooperative housing corporation representing his proportionate share of:

(1) The real estate taxes allowable as a deduction to the corporation under section 164 which are paid or incurred by the corporation before the close of the taxable year of the tenant-stockholder on the houses (or apartment building) and the land on which the houses (or apartment building) are situated, or

(2) The interest allowable as a deduction to the corporation under section 163 which is paid or incurred by the corporation before the close of the taxable year of the tenant-stockholder on its indebtedness contracted in the acquisition, construction, alteration, rehabilitation, or maintenance of the houses (or apartment building), or in the acquisition of the land on which the houses (or apartment building) are situated.

(b) *Limitation.* The deduction allowable under section 216 shall not exceed the amount of the tenant-stockholder's proportionate share of the taxes and interest described therein. If a tenant-stockholder pays or incurs only a part of his proportionate share of such taxes and interest to the corporation, only the amount so paid or incurred which represents taxes and interest is allowable as a deduction under section 216. If a tenant-stockholder pays an amount, or incurs an obligation for an amount, to the corporation on account of such taxes and interest and other items, such as maintenance, overhead expenses, and reduction of mortgage indebtedness, the amount representing such taxes and interest is an amount which bears the same ratio to the total amount of the tenant-stockholder's payment or liability, as the case may be, as the total amount of the tenant-stockholder's proportionate share of such taxes and interest bears to the total amount of the tenant-stockholder's proportionate share of the taxes, interest, and other items on account of which such payment is made or liability incurred. No deduction is allowable under section 216 for that part of amounts representing the taxes or interest described in that section which are deductible by a tenant-stockholder under any other provision of the Code.

(c) *Disallowance of deduction for certain payments to the corporation.* For taxable years beginning after December 31, 1986, no deduction shall be allowed to a stockholder during any taxable year for any amount paid or accrued to a cooperative housing corporation (in excess of the stockholder's proportionate share of the items described in paragraphs (a) (1) and (2) of this section) which is allocable to amounts that are paid or incurred at any time by the cooperative housing corporation and which is chargeable to the corporation's capital account. Examples of expenditures chargeable to the corporation's capital account include the cost of paving a community parking lot, the purchase of a new boiler or roof, and the payment of the principal of the corporation's building mortgage. The adjusted basis of the stockholder's stock in such corporation shall be increased by the amount of such disallowance. This paragraph may be illustrated by the following example:

Example The X corporation is a cooperative housing corporation within the meaning of section 216. In 1988 X uses $275,000 that it received from its shareholders in such year to purchase and place in service a new boiler. The $275,000 will be chargeable to the corporation's capital account. A owns 10% of the shares of X and uses in a trade or business the dwelling unit appurtenant to A's shares and was responsible for paying 10% of the cost of the boiler. A is thus responsible for $27,500 of the cost of the boiler, which amount A will not be able to deduct currently. A will, however, add the $27,500 to A's basis for A's shares in X.

(d) *Tenant-stockholder's proportionate share*—(1) *General rule.* The tenant-stockholder's proportionate share is that proportion which the stock of the cooperative housing corporation owned by the tenant-stockholder is of the total outstanding stock of the corporation, including any stock held by the corporation. For taxable years beginning after December 31, 1969, if the cooperative housing corporation had issued stock to a governmental unit, as defined in paragraph (g) of this section, then in determining the total outstanding stock of the corporation, the governmental unit shall be deemed to hold the number of shares that it would have held, with respect to the apartments or houses it is entitled to occupy, if it had been a tenant-stockholder. That is, the number of shares the governmental unit is deemed to hold is determined in the same manner as if stock had been issued to it as a tenant-stockholder. For example, if a cooperative housing corporation requires each tenant-stockholder to buy one share of stock for each one thousand dollars of value of the apartment he is entitled to occupy, a governmental unit shall be deemed to hold one share of stock for each one thousand dollars of value of the apartments it is entitled to occupy, regardless of the number of shares formally issued to it.

(2) *Special rule*—(i) *In general.* For taxable years beginning after December 31, 1986, if a cooperative housing corporation allocates to each tenant-stockholder a portion of the real estate taxes or interest (or both) that reasonably reflects the cost to the corporation of the taxes or interest attributable to each tenant-stockholder's dwelling unit (and the unit's share of the common areas), the cooperative housing corporation may elect to treat the amounts so allocated as the tenant-stockholders' proportionate shares.

(ii) *Time and manner of making election.* The election referred to in paragraph (d)(2)(i) of this section is effective only if, by January 31 of the year following the first calendar year that includes any period to which the election applies, the cooperative housing corporation furnishes to each person that is a tenant-stockholder during that period a written statement showing the amount of real estate taxes or interest (or both) allocated to the tenant-stockholder with respect to the tenant-stockholder's dwelling unit or units and share of common areas for that period. The election must be made by attaching a statement to the corporation's timely filed tax return (taking extensions into account) for the first taxable year for which the election is to be effective. The statement must contain the name, address, and taxpayer identification number of the cooperative housing corporation, identify the election as an election under section 216(b)(3)(B)(ii) of the Code, indicate whether the election is being made with respect to the allocation of real estate taxes or interest (or both), and include a description of the method of allocation being elected. The election applies for the taxable year and succeeding taxable years. It is revocable only with the consent of the Commissioner and will be binding on all tenant-stockholders.

(iii) *Reasonable allocation.* It is reasonable to allocate to each tenant-stockholder a portion of the real estate taxes or interest (or both) that bears the same ratio to the cooperative housing corporation's total interest or real estate taxes as the fair market value of each dwelling unit (including the unit's share of the common areas) bears to the fair market value of all the dwelling units with respect to which stock is outstanding (including stock held by the corporation) at the time of allocation. If real estate taxes are separately assessed on each dwelling unit by the relevant taxing authority, an allocation of real estates taxes to tenant-stockholders based on separate assessments is a reasonable allocation. If one or more of the tenant-stockholders prepays any portion of the principal of the indebtedness and gives rise to interest, an allocation of interest to those tenant-stockholders will be a reasonable allocation of interest if the allocation is reduced to reflect the reduction in the debt service attributable to the prepayment. In addition, similar kinds of allocations may also be reasonable, depending on the facts and circumstances.

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

Example 1. The X Corporation is a cooperative housing corporation within the meaning of section 216. In 1970, it acquires a building containing 40 category A apartments and 25 category B apartments, for $750,000. The value of each category A apartment is $12,500, and of each category B apartment is $10,000. X values each share of stock issued with respect to the category A apartments at $125, and sells 4,000 shares of its stock, along with the right to occupy the 40 category A apartments, to 40 tenant-stockholders for $500,000. X also sells 1,000 shares of nonvoting stock to G, a State housing authority qualifying as a governmental unit under paragraph (f) of this section, for $250,000. The purchase of this stock gives G the right to occupy all the category B apartments. G is deemed to hold the number of shares that it would have held if it had been a tenant-stockholder. G is therefore deemed to own 2,000 shares of stock of X. All stockholders are required to pay a specified part of the corporation's expenses. F, one of the tenant-stockholders, purchased 100 shares of the category A stock for $12,500 in order to obtain a right to occupy a category A apartment. Since there are 6,000 total shares deemed outstanding, F's proportionate share is 1/60 (100/6,000).

Example 2. The X Corporation is a cooperative housing corporation within the meaning of section 216. In 1960 it acquired a housing development containing 100 detached houses, each house having the same value. X issued one share of stock to each of 100 tenant-stockholders, each share carrying the right to occupy one of the houses. In 1971 X redeemed 40 of its 100 shares. It then sold to G, a municipal housing authority qualifying as a governmental unit under paragraph (f) of this section, 1,000 shares of preferred stock and the right to occupy the 40 houses with respect to which the stock had been redeemed. X sold the preferred stock to G for an amount equal to the cost of redeeming the 40 shares. G also agreed to pay 40 percent of X's expenses. For purposes of determining the total stock which X has outstanding, G is deemed to hold 40 shares of X.

Example 3. The X Corporation is a cooperative housing corporation within the meaning of section 216. In 1987, it acquires for $1,000,000 a building containing 10 category A apartments, 10 category B apartments, and 10 category C apartments. The value of each category A apartment is $20,000, of each category B apartment is $30,000 and of each category C apartment is $50,000. X issues 1 share of stock to each of the 30 tenant-stockholders, each share carrying the right to occupy one of the apartments. X allocates the real estate taxes and interest to the tenant-stockholders on the basis of the fair market value of their respective apartments. Since the total fair market value of all of the apartments is $1,000,000, the allocation of taxes and interest to each tenant-stockholder that has the right to occupy a category A apartment is 2/100 ($20,000/$1,000,000). Similarly, the allocation of taxes and interest to each tenant-stockholder who has a right to occupy a category B apartment is 3/100 ($30,000/$1,000,000) and of a category C apartment is 5/100 ($50,000/$1,000,000). X may elect in accordance with the rules described in paragraph (d)(2) of this section to treat the amounts so allocated as each tenant-stockholder's proportionate share of real estate taxes and interest.

Example 4. The Y Corporation is a cooperative housing corporation within the meaning of section 216. In 1987, it acquires a housing development containing 5 detached houses for $1,500,000, incurring an indebtedness of $1,000,000 for the purchase of the property. Each house is valued at $300,000, although the shares appurtenant to those houses have been sold to tenant-stockholders for $100,000. Y issues one share of stock to each of the five tenant-stockholders, each share carrying the right to occupy one of the houses. A, a tenant-stockholder, prepays all of the corporation's indebtedness allocable to A's house. The periodic charges payable to Y by A are reduced commensurately with the reduction in Y's debt service. Because no part of the indebtedness remains outstanding with respect to A's house, A's share of the interest expense is $0. The other four tenant-stockholders do not prepay their share of the indebtedness. Accordingly, 1/4 of the interest is allocated to each of the tenant-stockholders other than A. Y may elect in accordance with the rules described in paragraph (d)(2) of this section to treat the amounts so allocated as each tenant-stockholder's proportionate share of interest.

Example 5. The Z Corporation is a cooperative housing corporation within the meaning of section 216. In 1987, it acquires a building containing 10 apartments. One of the apartments is occupied by a senior citizen. Under local law, a senior citizen who owns and occupies a residential apartment is entitled to a $500 reduction in local property taxes assessed upon the apartment. As a result, Z corporation is eligible under local law for a reduction in local property taxes assessed upon the building. Z's real estate tax assessment for the year would have been $10,000, however, with the senior citizen reduction, the assessment is $9,500. The proprietary lease provides for a reduced maintenance fee to the senior citizen tenant-stockholder in accordance with the real estate tax reduction. Accordingly, each apartment owner is assessed $1,000 for local real estate taxes, except the senior citizen tenant-stockholder, who is assessed $500. Z may elect in accordance with the rules described in paragraph (d)(2) of this section to treat the amounts so allocated as each tenant-stockholder's proportionate share of taxes.

(e) *Cooperative housing corporation.* In order to qualify as a ‘‘cooperative housing corporation’’ under section 216, the requirements of subparagraphs (1) through (4) of this paragraph must be met.

(1) *One class of stock.* The corporation shall have one and only one class of stock outstanding. However, a special classification of preferred stock, in a nominal amount not exceeding $100, issued to a Federal housing agency or other governmental agency solely for the purpose of creating a security device on the mortgage indebtedness of the corporation, shall be disregarded for purposes of determining whether the corporation has one class of stock outstanding and such agency will not be considered a stockholder for purposes of section 216 and this section. Furthermore, for taxable years beginning after December 31, 1969, a special class of stock issued to a governmental unit, as defined in paragraph (g) of this section, shall also be disregarded for purposes of this paragraph in determining whether the corporation has one class of stock outstanding.

(2) *Right of occupancy.* Each stockholder of the corporation, whether or not the stockholder qualifies as a tenant-stockholder under section 216(b)(2) and paragraph (f) of this section, must be entitled to occupy for dwelling purposes an apartment in a building or a unit in a housing development owned or leased by such corporation. The stockholder is not required to occupy the premises. The right as against the corporation to occupy the premises is sufficient. Such right must be conferred on each stockholder solely by reasons of his or her ownership of stock in the corporation. That is, the stock must entitle the owner thereof either to occupy the premises or to a lease of the premises. The fact that the right to continue to occupy the premises is dependent upon the payment of charges to the corporation in the nature of rentals or assessments is immaterial.

For taxable years beginning after December 31, 1986, the fact that, by agreement with the cooperative housing corporation, a person or his nominee may not occupy the house or apartment without the prior approval of such corporation will not be taken into account for purposes of this paragraph in the following cases.

(i) In any case where a person acquires stock of the cooperative housing corporation by operation of law, by inheritance, or by foreclosure (or by instrument in lieu of foreclosure),

(ii) In any case where a person other than an individual acquires stock in the cooperative housing corporation, and

(iii) In any case where the person from whom the corporation has acquired the apartments or houses (or leaseholds therein) acquires any stock of the cooperative housing corporation from the corporation not later than one year after the date on which the apartments or houses (or leaseholds therein) are transferred to the corporation by such person. For purposes of the preceding sentence, paragraphs (e)(2) (i) and (ii) of this section will not apply to acquisitions of stock by foreclosure by the person from whom the corporation has acquired the apartments or houses (or leaseholds therein).

(3) *Distributions.* None of the stockholders of the corporation may be entitled, either conditionally or unconditionally, except upon a complete or partial liquidation of the corporation, to receive any distribution other than out of earnings and profits of the corporation.

(4) *Gross income.* Eighty percent or more of the gross income of the corporation for the taxable year of the corporation in which the taxes and interest are paid or incurred must be derived from the tenant-stockholders. For purposes of the 80-percent test, in taxable years beginning after December 31, 1969, gross income attributable to any house or apartment which a governmental unit is entitled to occupy, pursuant to a lease or stock ownership, shall be disregarded.

(f) *Tenant-stockholder.* The term *tenant-stockholder* means a person that is a stockholder in a cooperative housing corporation, as defined in section 216(b)(1) and paragraph (e) of this section, and whose stock is fully paid up in an amount at least equal to an amount shown to the satisfaction of the district director as bearing a reasonable relationship to the portion of the fair market value, as of the date of the original issuance of the stock, of the corporation's equity in the building and the land on which it is situated that is attributable to the apartment or housing unit which such person is entitled to occupy (within the meaning of paragraph (e)(2) of this section). Notwithstanding the preceding sentence, for taxable years beginning before January 1, 1987, tenant-stockholders include only individuals, certain lending institutions, and certain persons from whom the cooperative housing corporation has acquired the apartments or houses (or leaseholds thereon).

(g) *Governmental unit.* For purposes of section 216(b) and this section, the term *governmental unit* means the United States or any of its possessions, a State or any political subdivision thereof, or any agency or instrumentality of the foregoing empowered to acquire shares in a cooperative housing corporation for the purpose of providing housing facilities.

(h) *Examples.* The application of section 216(a) and (b) and this section may be illustrated by the following examples, which refer to apartments but which are equally applicable to housing units:

Example 1. The X Corporation is a cooperative housing corporation within the meaning of section 216. In 1970, at a total cost of $200,000, it purchased a site and constructed thereon a building with 15 apartments. The fair market value of the land and building was $200,000 at the time of completion of the building. The building contains five category A apartment units, each of equal value, and 10 category B apartment units. The total value of all of the category A apartment units is $100,000. The total value of all of the category B apartments is also $100,000. Upon completion of the building, the X Corporation mortgaged the land and building for $100,000, and sold its total authorized capital stock for $100,000. The stock attributable to the category A apartments was purchased by five individuals, each of whom paid $10,000 for 100 shares, or $100 a share. Each certificate for 100 shares of such stock provides that the holder thereof is entitled to a lease of a particular apartment in the building for a specified term of years. The stock attributable to the category B apartments was purchased by a governmental unit for $50,000. Since the shares sold to the tenant-stockholders are valued at $100 per share, the governmental unit is deemed to hold a total of 500 shares. The certificate of such stock provides that the governmental unit is entitled to a lease of all of the category B apartments. All leases provide that the lessee shall pay his proportionate part of the corporation's expenses. In 1970 the original owner of 100 shares of stock attributable to the category A apartments and to the lease to apartment No. 1 made a gift of the stock and lease to A, an individual. The taxable year of A and of the X Corporation is the calendar year. The corporation computes its taxable income on an accrual method, while A computes his taxable income on the cash receipts and disbursements method. In 1971, the X Corporation incurred expenses aggregating $13,800, including $4,000 for the real estate taxes on the land and building, and $5,000 for the interest on the mortgage. In 1972, A pays the X Corporation $1,380, representing his proportionate part of the expenses incurred by the corporation. The entire gross income of the X Corporation for 1971 was derived from the five tenant-stockholders and from the governmental unit. A is entitled under section 216 to a deduction of $900 in computing his taxable income for 1972. The deduction is computed as follows:

Shares of X Corporation owned by A		100
Shares of X Corporation owned by four other tenant-stockholders		400
Shares of X Corporation deemed owned by governmental unit		500
Total shares of X Corporation outstanding		1,000
A's proportionate share of the stock of X Corporation (100/1,000)		1/10
Expenses incurred by X Corporation:		
Real estate taxes	$4,000	
Interest	5,000	
Other	4,800	
Total		$13,800
Amount paid by A		1,380
A's proportionate share of real estate taxes and interest based on his stock ownership (1/10 of $9,000)		$900
A's proportionate share of total corporate expenses based on his stock ownership (1/10 of $13,800)		1,380
Amount of A's payment representing real estate taxes and interest (900/1,380 of $1,380)		$900
A's allowable deduction		$900

Since the stock which A acquired by gift was fully paid up by his donor in an amount equal to the portion of the fair market value, as of the date of the original issuance of the stock, of the corporation's equity in the land and building which is attributable to apartment No. 1, the requirement of section 216 in this regard is satisfied. The fair market value at the time of the gift of the corporation's equity attributable to the apartment is immaterial.

Example 2. The facts are the same as in *Example (1)* except that the building constructed by the X Corporation contained, in addition to the 15 apartments, business space on the ground floor, which the corporation rented at $2,400 for the calendar year 1971. The corporation deducted the $2,400 from its expenses in determining the amount of the expenses to be prorated among its tenant-stockholders. The amount paid by A to the corporation in 1972 is $1,140 instead of $1,380. More than 80 percent of the gross income of the corporation for 1971 was derived from tenant-stockholders. A is entitled under section 216 to a deduction of $743.48 in computing his taxable income for 1972. The deduction is computed as follows:

Expenses incurred by X Corporation	$13,800.00	
Less: Rent from business space	2,400.00	
Expenses to be prorated among tenant-stockholders		$11,400.00
Amount paid by A		1,140.00
A's proportionate share of real estate taxes and interest based on his stock ownership (1/10 of $9,000)		900.00
A's proportionate share of total corporate expenses based on his stock ownership (1/10 of $13,800)		1,380.00
Amount of A's payment representing real estate taxes and interest (900/1380 of $1,140)		743.48
A's allowable deduction		743.48

Since the portion of A's payment allocable to real estate taxes and interest is only $743.48, that amount instead of $900 is allowable as a deduction in computing A's taxable income for 1972.

Example 3. The facts are the same as in *Example (1)* except that the amount paid by A to the X Corporation in 1972 is $1,000 instead of $1,380. A is entitled under section 216 to a deduction of $652.17 in computing his taxable income for 1972. The deduction is computed as follows:

Amount paid by A	$1,000.00
A's proportionate share of real estate taxes and interest based on his stock ownership (1/10 of $9,000)	900.00
A's proportionate share of total corporate expenses based on his stock ownership (1/10 of $13,800)	1,380.00
Amount of A's payment representing real estate taxes and interest (900/1380 of $1,000)	652.17
A's allowable deduction	652.17

Since the portion of A's payment allocable to real estate taxes and interest is only $652.17, that amount instead of $900 is allowable as a deduction in computing A's taxable income for 1972.

Example 4. The facts are the same as in *Example (1)* except that X Corporation leases recreational facilities from Y Corporation for use by the tenant-stockholders of X. Under the terms of the lease, X is obligated to pay an annual rental of $5,000 plus all real estate taxes assessed against the facilities. In 1971 X paid, in addition to the $13,800 of expenses enumerated in *Example (1)*, $5,000 rent and $1,000 real estate taxes. In 1972 A pays the X Corporation $2,000, no part of which is refunded to him in 1972. A is entitled under section 216 to a deduction of $900 in computing his taxable income for 1972. The deduction is computed as follows:

Expenses to be prorated among tenant-stockholders	$19,800
Amount paid by A	2,000
A's proportionate share of real estate taxes and interest based on his stock ownership (1/10 of $9,000)	900
A's proportionate share of total corporate expenses based on his stock ownership (1/10 of $19,800)	1,980
Amount of A's payment representing real estate taxes and interest (900/1,980 of $1,980)	900
A's allowable deduction	900

The $1,000 of real estate taxes assessed against the recreational facilities constitutes additional rent and hence is not deductible by A as taxes under section 216. A's allowable deduction is limited to his proportionate share of real estate taxes and interest based on stock ownership and cannot be increased by the payment of an amount in excess of his proportionate share.

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§1.216–2 Treatment as property subject to depreciation.

(a) *General rule.* For taxable years beginning after December 31, 1961, stock in a cooperative housing corporation (as defined by section 216(b) (1) and paragraph (c) of §1.216–1) owned by a tenant-stockholder (as defined by section 216(b) (2) and paragraph (d) of §1.216–1) who uses the proprietary lease or right of tenancy, which was conferred on him solely by reason of his ownership of such stock, in a trade or business or for the production of income shall be treated as property subject to the allowance for depreciation under section 167(a) in the manner and to the extent prescribed in this section.

(b) *Determination of allowance for depreciation*—(1) *In general.* Subject to the special rules provided in subparagraphs (2) and (3) of this paragraph and the limitation provided in paragraph (c) of this section, the allowance for depreciation for the taxable year with respect to stock of a tenant-stockholder, subject to the extent provided in this section to an allowance for depreciation, shall be determined:

(i) By computing the amount of depreciation (amortization in the case of a leasehold) which would be allowable under one of the methods of depreciation prescribed in section 167(b) and the regulations thereunder (in paragraph (a) of §1.162–11 and §1.167(a)–4 in the case of a leasehold) in respect of the depreciable (amortizable) real property owned by the cooperative housing corporation in which such tenant-stockholder has a proprietary lease or right of tenancy,

(ii) By reducing the amount of depreciation (amortization) so computed in the same ratio as the rentable space in such property which is not subject to a proprietary lease or right of tenancy by reason of stock ownership but which is held for rental purposes bears to the total rentable space in such property, and

(iii) By computing such tenant-stockholder's proportionate share of such annual depreciation (amortization), so reduced.

As used in this section, the terms *depreciation* and *depreciable real property* include amortization and amortizable leasehold of real property. As used in this section, the tenant-stockholder's proportionate share is that proportion which stock of the cooperative housing corporation owned by the tenant-stockholder is of the total outstanding stock of the corporation, including any stock held by the corporation. In order to determine whether a tenant-stockholder may use one of the methods of depreciation prescribed in section 167(b) (2), (3), or (4) for purposes of subdivision (i) of this subparagraph, the limitations provided in section 167(c) on the use of such methods of depreciation shall be applied with respect to the depreciable real property owned by the cooperative housing corporation in which the tenant-stockholder has a proprietary lease or right of tenancy, rather than with respect to the stock in the cooperative housing corporation owned by the tenant-stockholder or with respect to the proprietary lease or right of tenancy conferred on the tenant-stockholder by reason of his ownership of such stock. The allowance for depreciation determined under this subparagraph shall be properly adjusted where only a portion of the property occupied under a proprietary lease or right of tenancy is used in a trade or business or for the production of income.

(2) *Stock acquired subsequent to first offering.* Except as provided in subparagraph (3), in the case of a tenant-stockholder who purchases stock other than as part of the first offering of stock by the corporation, the basis of the depreciable real property for purposes of the computation required by subparagraph (1)(i) of this paragraph shall be the amount obtained by:

(i) Multiplying the taxpayer's cost per share by the total number of outstanding shares of stock of the corporation, including any shares held by the corporation,

(ii) Adding thereto the mortgage indebtedness to which such depreciable real property is subject on the date of purchase of such stock, and

(iii) Subtracting from the sum so obtained the portion thereof not properly allocable as of the date such stock was purchased to the depreciable real property owned by the cooperative housing corporation in which such tenant-stockholder has a proprietary lease or right of tenancy.

In order to prevent an overstatement or understatement of the basis of the depreciable real property for purposes of the computation required by subparagraph (1)(i) of this paragraph, appropriate adjustment for purposes of the computations described in subdivisions (i) and (ii) of this subparagraph shall be made in respect of prepayments and delinquencies on account of the corporation's mortgage indebtedness. Thus, for purposes of subdivision (i) of this subparagraph, the taxpayer's cost per share shall be reduced by an amount determined by dividing the total mortgage indebtedness prepayments in respect of the shares purchased by the taxpayer by the number of such shares. For purposes of subdivision (ii) of this subparagraph, the mortgage indebtedness shall be increased by the sum of all prepayments applied in reduction of the mortgage indebtedness and shall be decreased by any amount due under the terms of the mortgage and unpaid.

(3) *Conversion subsequent to date of acquisition.* In the case of a tenant-stockholder whose proprietary lease or right of tenancy is converted, in whole or in part, to use in a trade or business or for the production of income on a date subsequent to the date on which he acquired the stock conferring on him such lease or right of tenancy, the basis of the depreciable real property for purposes of the computation required by subparagraph (1)(i) of this paragraph shall be the fair market value of such depreciable real property on the date of the conversion if the fair market value is less than the adjusted basis of such property in the hands of the cooperative housing corporation provided in section 1011 without taking into account any adjustment for depreciation required by section 1016(a)(2). Such fair market value shall be deemed to be equal to the adjusted basis of such property, taking into account adjustments required by section 1016(a)(2) computed as if the corporation had used the straight line method of depreciation, in the absence of evidence establishing that the fair market value so attributed to the property is unrealistic. In the case of a tenant-stockholder who purchases stock other than as part of the first offering of stock of the corporation, and at a later date converts his proprietary lease to use for business or production of income:

(i) The adjusted basis of the cooperative housing corporation's depreciable real property without taking into account any adjustment for depreciation shall be the amount determined in accordance with subdivisions (i), (ii), and (iii) of subparagraph (2) of this paragraph, and

(ii) The fair market value shall be deemed to be equal to such adjusted basis reduced by the amount of depreciation, computed under the straight line method, which would have been allowable in respect of depreciable real property having a cost or other basis equal to the amount representing such adjusted basis in the absence of evidence establishing that the fair market value so attributed to the property is unrealistic.

(c) *Limitation.* If the allowance for depreciation for the taxable year determined in accordance with the provisions of paragraph (b) of this section exceeds the adjusted basis (provided in section 1011) of the stock described in paragraph (a) of this section allocable to the tenant-stockholder's proprietary lease or right of tenancy used in a trade or business or for the production of income, such excess is not allowable as a deduction. For taxable years beginning after December 31, 1986, such excess, subject to the provisions of this paragraph (c), is allowable as a deduction for depreciation in the succeeding taxable year. To determine the portion of the adjusted basis of such stock which is allocable to such proprietary lease or right of tenancy, the adjusted basis is reduced by taking into account the same factors as are taken into account under paragraph (b)(1) of this section in determining the allowance for depreciation.

(d) *Examples.* The provisions of section 216(c) and this section may be illustrated by the following examples:

Example 1. The Y corporation, a cooperative housing corporation within the meaning of section 216, in 1961 purchased a site and constructed thereon a building with 10 apartments at a total cost of $250,000 ($200,000 being allocable to the building and $50,000 being allocable to the land). Such building was completed on January 1, 1962, and at that time had an estimated useful life of 50 years, with an estimated salvage value of $20,000. Each apartment is of equal value. Upon completion of the building, Y corporation mortgaged the land and building for $150,000 and sold its total authorized capital stock, consisting of 1000 shares of common stock, for $100,000. The stock was purchased by 10 individuals each of whom paid $10,000 for 100 shares. Each certificate for 100 shares provides that the holder thereof is entitled to a proprietary lease of a particular apartment in the building. Each lease provides that the lessee shall pay his proportionate share of the corporation's expenses including an amount on account of the curtailment of Y's mortgage indebtedness. B, a calendar year taxpayer, is the original owner of 100 shares of stock in Y corporation. On January 1, 1962, B subleases his apartment for a term of 5 years. B's stock in Y corporation is treated as property subject to the allowance for depreciation under section 167(a), and B, who uses the straight line method of depreciation for purposes of the computation prescribed by paragraph (b)(1)(i) of this section, computes the allowance for depreciation for the taxable year 1962 with respect to such stock as follows:

Y's basis in the building	$200,000
Less: Estimated salvage value	$20,000
Y's basis for depreciation	$180,000
Annual straight line depreciation on Y's building (1/50 of $180,000)	$3,600
Proportion of outstanding shares of stock of Y corporation (1,000) owned by B (100)	1/10
B's proportionate share of annual depreciation (1/10 of $3,600)	$360
Depreciation allowance for 1962 with respect to B's stock (if the limitation in paragraph (c) of this section is not applicable)	$360

Example 2. The facts are the same as in *Example (1)* except that the building constructed by Y corporation contained, in addition to the 10 apartments, space on the ground floor for 2 stores which were rented to persons who do not have a proprietary lease of such space by reason of stock ownership. Y corporation's building has a total area of 16,000 square feet, the 10 apartments in such building have an area of 10,000 square feet, and the 2 stores on the ground floor have an area of 2,000 square feet. Thus, the total rentable space in Y corporation's building is 12,000 square feet. B, who uses the straight line method of depreciation for purposes of the computation prescribed by paragraph (b)(1)(i) of this section, computes the allowance for depreciation for the taxable year 1962 with respect to his stock in Y corporation as follows:

Y's basis in the building	$200,000
Less: Estimated salvage value	20,000
Y's basis for depreciation	180,000
Annual straight line depreciation on Y's building (1/50 of $180,000)	3,600
Less: Amount representing rentable space not subject to proprietary lease but held for rental purposes over total rentable space 2,000÷12,000 (of $3,600)	600
Annual depreciation, as reduced	3,000
B's proportionate share of annual depreciation (1/10 of $3,000)	300
Depreciation allowance for 1962 with respect to B's stock (if the limitation in paragraph (c) of this section is not applicable)	300

Example 3. The facts are the same as in *Example (1)* except that B occupies his apartment from January 1, 1962, until December 31, 1966, and that on January 1, 1967, B sells his stock to C, an individual, for $15,000. C thereby obtains a proprietary lease from Y corporation with the same rights and obligations as B's lease provided. Y corporation's records disclose that its outstanding mortgage indebtedness is $135,000 on January 1,

1967. C, a physician, uses the entire apartment solely as an office. C's stock in Y corporation is treated as property subject to the allowance for depreciation under section 167(a), and C, who uses the straight line method of depreciation for purposes of the computation prescribed by paragraph (b)(1)(i) of this section, computes the allowance for depreciation for the taxable year 1967 with respect to such stock as follows:

Price paid for each share of stock in Y corporation purchased by C on 1–1–67 ($15,000÷100)	$150
Per share price paid by C multiplied by total shares of stock in Y corporation outstanding on 1–1–67 ($150×1,000)	150,000
Y's mortgage indebtedness outstanding on 1–1–67	135,000
	285,000
Less: Amount attributable to land (assumed to be 1/5 of $285,000)	57,000
	228,000
Less: Estimated salvage value	20,000
Basis of Y's building for purposes of computing C's depreciation	208,000
Annual straight line depreciation (1/45 of $208,000)	4,622.22
C's proportionate share of annual depreciation (1/10 of $4,622.22)	462.22
Depreciation allowance for 1967 with respect to C's stock (if the limitation in paragraph (c) of this section is not applicable)	462.22

[T.D. 6725, 29 FR 5665, Apr. 29, 1964, as amended by T.D. 8316, 55 FR 42006, Oct. 17, 1990]

§ 1.217–1 Deduction for moving expenses paid or incurred in taxable years beginning before January 1, 1970.

(a) *Allowance of deduction*—(1) *In general.* Section 217(a) allows a deduction from gross income for moving expenses paid or incurred by the taxpayer during the taxable year in connection with the commencement of work as an employee at a new principal place of work. Except as provided in section 217, no deduction is allowable for any expenses incurred by the taxpayer in connection with moving himself, the members of his family or household, or household goods and personal effects. The deduction allowable under this section is only for expenses incurred after December 31, 1963, in taxable years ending after such date and beginning before January 1, 1970, except in cases where a taxpayer makes an election under paragraph (g) of § 1.217–2 with respect to moving expenses paid or incurred before January 1, 1971, in connection with the commencement of work by such taxpayer as an employee at a new principal place of work of which such taxpayer has been notified by his employer on or before December 19, 1969. To qualify for the deduction the expenses must meet the definition of the term "moving expenses" provided in section 217(b); the taxpayer must meet the conditions set forth in section 217(c); and, if the taxpayer receives a reimbursement or other expense allowance for an item of expense, the deduction for the portion of the expense reimbursed is allowable only to the extent that such reimbursement or other expense allowance is included in his gross income as provided in section 217(e). The deduction is allowable only to a taxpayer who pays or incurs moving expenses in connection with his commencement of work as an employee and is not allowable to a taxpayer who pays or incurs such expenses in connection with his commencement of work as a self-employed individual. The term *employee* as used in this section has the same meaning as in § 31.3401(c)–1 of this chapter (Employment Tax Regulations). All references to section 217 in this section are to section 217 prior to the effective date of section 231 of the Tax Reform Act of 1969 (83 Stat. 577).

(2) *Commencement of work.* To be deductible, the moving expenses must be paid or incurred by the taxpayer in connection with the commencement of work by him at a new principal place of work (see paragraph (c)(3) of this section for a discussion of the term *principal place of work*). While it is not necessary that the taxpayer have a contract or commitment of employment prior to his moving to a new location, the deduction is not allowable unless employment actually does occur. The term *commencement* includes (i) the beginning of work by a taxpayer for the first time or after a substantial period of unemployment or part-time employment, (ii) the beginning of work by a taxpayer for a different employer, or (iii) the beginning of work by a taxpayer for the same employer at a new location. To qualify as being in connection with the commencement of work, the move for which moving expenses are incurred must bear a reasonable

proximity both in time and place to such commencement. In general, moving expenses incurred within one year of the date of the commencement of work are considered to be reasonably proximate to such commencement. Moving expenses incurred in relocating the taxpayer's residence to a location which is farther from his new principal place of work than was his former residence are not generally to be considered as incurred in connection with such commencement of work. For example, if A is transferred by his employer from place X to place Y and A's old residence while he worked at place X is 25 miles from Y, A will not generally be entitled to deduct moving expenses in moving to a new residence 40 miles from Y even though the minimum distance limitation contained in section 217(c)(1) is met. If, however, A is required, as a condition of his employment, to reside at a particular place, or if such residency will result in an actual decrease in his commuting time or expense, the expenses of the move may be considered as incurred in connection with his commencement of work at place Y.

(b) *Definition of moving expenses*—(1) *In general.* Section 217(b) defines the term *moving expenses* to mean only the reasonable expenses (i) of moving household goods and personal effects from the taxpayer's former residence to his new residence, and (ii) of traveling (including meals and lodging) from the taxpayer's former residence to his new place of residence. The test of deductibility thus is whether the expenses are reasonable and are incurred for the items set forth in (i) and (ii) above.

(2) *Reasonable expenses.* (i) The term *moving expenses* includes only those expenses which are reasonable under the circumstances of the particular move. Generally, expenses are reasonable only if they are paid or incurred for movement by the shortest and most direct route available from the taxpayer's former residence to his new residence by the conventional mode or modes of transportation actually used and in the shortest period of time commonly required to travel the distance involved by such mode. Expenses paid or incurred in excess of a reasonable amount are not deductible. Thus, if moving or travel arrangements are made to provide a circuitous route for scenic, stopover, or other similar reasons, the additional expenses resulting therefrom are not deductible since they do not meet the test of reasonableness.

(ii) The application of this subparagraph may be illustrated by the following example:

Example. A, an employee of the M Company works and maintains his principal residence in Boston, Massachusetts. Upon receiving orders from his employer that he is to be transferred to M's Los Angeles, California office, A motors to Los Angeles with his family with stopovers at various cities between Boston and Los Angeles to visit friends and relatives. In addition, A detours into Mexico for sight-seeing. Because of the stopovers and tour into Mexico, A's travel time and distance are increased over what they would have been had he proceeded directly to Los Angeles. To the extent that A's route of travel between Boston and Los Angeles is in a generally southwesterly direction it may be said that he is traveling by the shortest and most direct route available by motor vehicle. Since A's excursion into Mexico is away from the usual Boston-Los Angeles route, the portion of the expenses paid or incurred attributable to such excursion is not deductible. Likewise, that portion of the expenses attributable to A's delays en route not necessitated by reasons of rest or repair of his vehicle are not deductible.

(3) *Expenses of moving household goods and personal effects.* Expenses of moving household goods and personal effects include expenses of transporting such goods and effects owned by the taxpayer or a member of his household from the taxpayer's former residence to his new residence, and expenses of packing, crating and in-transit storage and insurance for such goods and effects. Expenses paid or incurred in moving household goods and personal effects to a taxpayer's new residence from a place other than his former residence are allowable, but only to the extent that such expenses do not exceed the amount which would be allowable had such goods and effects been moved from the taxpayer's former residence. Examples of items not deductible as moving expenses include, but are not limited to, storage charges (other than in-transit), costs incurred in the acquisition of property, costs incurred and losses sustained in the disposition of property, penalties for breaking leases,

mortgage penalties, expenses of refitting rugs or draperies, expenses of connecting or disconnecting utilities, losses sustained on the disposal of memberships in clubs, tuition fees, and similar items.

(4) *Expenses of traveling.* Expenses of traveling include the cost of transportation and of meals and lodging en route (including the date of arrival) of both the taxpayer and members of his household, who have both the taxpayer's former residence and the taxpayer's new residence as their principal place of abode, from the taxpayer's former residence to his new place of residence. Expenses of traveling do not include, for example: living or other expenses of the taxpayer and members of his household following their date of arrival at the new place of residence and while they are waiting to enter the new residence or waiting for their household goods to arrive; expenses in connection with house or apartment hunting; living expenses preceding the date of departure for the new place of residence; expenses of trips for purposes of selling property; expenses of trips to the former residence by the taxpayer pending the move by his family to the new place of residence; or any allowance for depreciation. The deduction for traveling expenses is allowable for only one trip made by the taxpayer and members of his household; however, it is not necessary that the taxpayer and all members of his household travel together or at the same time.

(5) *Residence.* The term *former residence* refers to the taxpayer's principal residence before his departure for his new principal place of work. The term *new residence* refers to the taxpayer's principal residence within the general location of his new principal place of work. Thus, neither term includes other residences owned or maintained by the taxpayer or members of his family or seasonal residences such as a summer beach cottage. Whether or not property is used by the taxpayer as his residence, and whether or not property is used by the taxpayer as his principal residence (in the case of a taxpayer using more than one property as a residence), depends upon all the facts and circumstances in each case. Property used by the taxpayer as his principal residence may include a houseboat, a house trailer, or similar dwelling. The term *new place of residence* generally includes the area within which the taxpayer might reasonably be expected to commute to his new principal place of work. The application of the terms *former residence*, *new residence* and *new place of residence* as defined in this paragraph and as used in section 217(b)(1) may be illustrated in the following manner: Expenses of moving household goods and personal effects are moving expenses when paid or incurred for transporting such items from the taxpayer's former residence to the taxpayer's new residence (such as from one street address to another). Expenses of traveling, on the other hand, are limited to those incurred between the taxpayer's former residence (a geographic point) and his new place of residence (a commuting area) up to and including the date of arrival. The date of arrival is the day the taxpayer secures lodging within that commuting area, even if on a temporary basis.

(6) *Individuals other than taxpayer.* In addition to the expenses set forth in section 217(b)(1) which are attributable to the taxpayer alone, the same type of expenses attributable to certain individuals other than the taxpayer, if paid or incurred by the taxpayer, are deductible. Those other individuals must (i) be members of the taxpayer's household, and (ii) have both the taxpayer's former residence and his new residence as their principal place of abode. A member of the taxpayer's household may not be, for example, a tenant residing in the taxpayer's residence, nor an individual such as a servant, governess, chauffeur, nurse, valet, or personal attendant.

(c) *Conditions for allowance*—(1) *In general.* Section 217(c) provides two conditions which must be satisfied in order for a deduction of moving expenses to be allowed under section 217(a). The first is a minimum distance requirement prescribed by section 217(c)(1), and the second is a minimum period of employment requirement prescribed by section 217(c)(2).

(2) *Minimum distance.* For purposes of applying the minimum distance requirement of section 217(c)(1) all taxpayers are divided into one or the other of the following categories: taxpayers having a former principal place of work, and taxpayers not having a former principal place of work. In this latter category are individuals who are seeking full-time employment for the first time (for example, recent high school or college graduates), or individuals who are re-entering the labor force after a substantial period of unemployment or part-time employment.

(i) In the case of a taxpayer having a former principal place of work, section 217(c)(1)(A) provides that no deduction is allowable unless the distance between his new principal place of work and his former residence exceeds by at least 20 miles the distance between his former principal place of work and such former residence.

(ii) In the case of a taxpayer not having a former principal place of work, section 217(c)(1)(B) provides that no deduction is allowable unless the distance between his new principal place of work and his former residence is at least 20 miles.

(iii) For purposes of measuring distances under section 217(c)(1) all computations are to be made on the basis of a straight-line measurement.

(3) *Principal place of work.* (i) A taxpayer's ''principal place of work'' usually is the place at which he spends most of his working time. Generally, where a taxpayer performs services as an employee, his principal place of work is his employer's plant, office, shop, store or other property. However, a taxpayer may have a principal place of work even if there is no one place at which he spends a substantial portion of his working time. In such case, the taxpayer's principal place of work is the place at which his business activities are centered— for example, because he reports there for work, or is otherwise required either by his employer or the nature of his employment to ''base'' his employment there. Thus, while a member of a railroad crew, for example, may spend most of his working time aboard a train, his principal place of work is his home terminal, station, or other such central point where he reports in, checks out, or receives instructions. In those cases where the taxpayer is employed by a number of employers on a relatively short-term basis, and secures employment by means of a union hall system (such as a construction or building trades worker), the taxpayer's principal place of work would be the union hall.

(ii) In cases where a taxpayer has more than one employment (i.e., more than one employer at any particular time) his principal place of work is usually determined with reference to his principal employment. The location of a taxpayer's principal place of work is necessarily a question of fact which must be determined on the basis of the particular circumstances in each case. The more important factors to be considered in making a factual determination regarding the location of a taxpayer's principal place of work are *(a)* the total time ordinarily spent by the taxpayer at each place, *(b)* the degree of the taxpayer's business activity at each place, and *(c)* the relative significance of the financial return to the taxpayer from each place.

(iii) In general, a place of work is not considered to be the taxpayer's principal place of work for purposes of this section if the taxpayer maintains an inconsistent position, for example, by claiming an allowable deduction under section 162 (relating to trade or business expenses) for traveling expenses ''while away from home'' with respect to expenses incurred while he is not away from such place of work and after he has incurred moving expenses for which a deduction is claimed under this section.

(4) *Minimum period of employment.* Under section 217(c)(2), no deduction is allowed unless, during the 12-month period immediately following the taxpayer's arrival in the general location of his new principal place of work, he is a full-time employee, in such general location, during at least 39 weeks.

(i) The 12-month period and the 39-week period set forth in section 217(c)(2) are measured from the date of the taxpayer's arrival in the general location of his new principal place of work. Generally, the taxpayer's date of arrival is the date of the termination of the last trip preceding the taxpayer's commencement of work on a regular basis, regardless of the date on which the taxpayer's family or household goods and effects arrive.

(ii) It is not necessary that the taxpayer remain in the employ of the same employer for 39 weeks, but only that he be employed in the same general location of his new principal place of work during such period. The *general location* of the new principal place of work refers to the area within which an individual might reasonably be expected to commute to such place of work, and will usually be the same area as is known as the *new place of residence*; see paragraph (b)(5) of this section.

(iii) Only a week during which the taxpayer is a full-time employee qualifies as a week of work for purposes of the 39-week requirement of section 217(c)(2). Whether an employee is a full-time employee during any particular week depends upon the customary practices of the occupation in the geographic area in which the taxpayer works. In the case of occupations where employment is on a seasonal basis, weeks occuring in the off-season when no work is required or available (as the case may be) may be counted as weeks of full-time employment only if the employee's contract or agreement of employment covers the off-season period and the off-season period is less than 6 months. Thus, a school teacher whose employment contract covers a 12-month period and who teaches on a full-time basis for more than 6 months in fulfillment of such contract is considered a full-time employee during the entire 12-month period. A taxpayer will not be deemed as other than a full-time employee during any week merely because of periods of involuntary temporary absence from work, such as those due to illness, strikes, shutouts, layoffs, natural disasters, etc.

(iv) In the case of taxpayers filing a joint return, either spouse may satisfy this 39-week requirement. However, weeks worked by one spouse may not be added to weeks worked by the other spouse in order to satisfy such requirement.

(v) The application of this subparagraph may be illustrated by the following examples:

Example 1. A is an electrician residing in New York City. Having heard of the possibility of better employment prospects in Denver, Colorado, he moves himself, his family and his household goods and personal effects, at his own expense, to Denver where he secures employment with the M Aircraft Corporation. After working full-time for 30 weeks his job is terminated, and he subsequently moves to and secures employment in Los Angeles, California, which employment lasts for more than 39 weeks. Since A was not employed in the general location of his new principal place of employment while in Denver for at least 39 weeks, no deduction is allowable for moving expenses paid or incurred between New York City and Denver. A will be allowed to deduct only those moving expenses attributable to his move from Denver to Los Angeles, assuming all other conditions of section 217 are met.

Example 2. Assume the same facts as in *Example (1)*, except that B, A's wife, secures employment in Denver at the same time as A, and that she continues to work in Denver for at least 9 weeks after A's departure for Los Angeles. Since she has met the 39-week requirement in Denver, and assuming all other requirements of section 217 are met, the moving expenses paid by A attributable to the move from New York City to Denver will be allowed as a deduction, provided A and B filed a joint return.

Example 3. Assume the same facts as in *Example (1)*, except that B, A's wife, secures employment in Denver on the same day that A departs for Los Angeles, and continues to work in Denver for 9 weeks thereafter. Since neither A (who has worked 30 weeks) nor B (who has worked 9 weeks) has independently satisfied the 39-week requirement, no deduction for moving expenses attributable to the move from New York City to Denver is allowable.

(d) *Rules for application of section 217(c)(2)*—(1) *Inapplicability of 39-week test to reimbursed expenses.* (i) Paragraph (1) of section 217(d) provides that the 39-week employment condition of section 217(c)(2) does not apply to any moving expense item to the extent that the taxpayer receives reimbursement or other allowance from his employer for such item. A reimbursement or other allowance to an employee for expenses of moving, in the absence of a specific allocation by the employer, is allocated first to items deductible under section 217(a) and then, if a balance remains, to items not so deductible.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example 1. A, a recent college graduate, with his residence in Washington, DC, is hired by the M Corporation in San Francisco, California. Under the terms of the employment contract, M agrees to reimburse A for three-fifths of his moving expenses from Washington to San Francisco. A moves to San Francisco, and pays $1,000 for expenses incurred, for which he is reimbursed $600 by M. After working for M for a period of 3 months, A becomes dissatisfied with the job and returns to Washington to continue his education. Since he has failed to satisfy the 39-week requirement of section 217(c)(2) the expenses totaling $400 for which A has received no reimbursement are not deductible. Under the special rule of section 217(d)(1), however, the deduction for the $600 reimbursed moving expenses is not disallowed by reason of section 217(c)(2).

Example 2. B, a self-employed accountant, who works and resides in Columbus, Ohio, is hired by the N Company in St. Petersburg, Florida. Pursuant to its policy with respect to newly hired employees, N agrees to reimburse B to the extent of $1,000 of the expenses incurred by him in connection with his move to St. Petersburg, allocating $700 for the items specified in section 217(b)(1), and $300 for ‘‘temporary living expenses.’’ B moves to St. Petersburg, and incurs $800 of ‘‘moving expenses’’ and $300 of ‘‘temporary living expenses’’ in St. Petersburg. B receives reimbursement of $1,000 from N, which amount is included in his gross income. Assuming B fails to satisfy the 39-week test of section 217(c)(2), he will nevertheless be allowed to deduct $700 as a moving expense. On the other hand, had N made no allocation between deductible and non-deductible items, B would have been allowed to deduct $800 since, in the absence of a specific allocation of the reimbursement by N, it is presumed that the reimbursement was for items specified in section 217(b)(1) to the extent thereof.

(2) *Election of deduction before 39-week test is satisfied.* (i) Paragraph (2) of section 217(d) provides a special rule which applies in those cases where a taxpayer paid or incurred, in a particular taxable year, moving expenses which would be deductible in that taxable year except for the fact that the 39-week employment condition of section 217(c)(2) has not been satisfied before the time prescribed by law (including extensions thereof) for filing the return for such taxable year. The rule provides that where a taxpayer has paid or incurred moving expenses and as of the date prescribed by section 6072 for filing his return for such taxable year, including extensions thereof as may be allowed under section 6081, there remains unexpired a sufficient portion of the 12-month period so that it is still possible for the taxpayer to satisfy the 39-week requirement, then the taxpayer may elect to claim a deduction for such moving expenses on the return for such taxable year. The election shall be exercised by taking the deduction on the return filed within the time prescribed by section 6072 (including extensions as may be allowed under section 6081). It is not necessary that the taxpayer wait until the date prescribed by law for filing his return in order to make the election. He may make the election on an early return based upon the facts known on the date such return is filed. However, an election made on an early return will become invalid if, as of the date prescribed by law for filing the return, it is not possible for the taxpayer to satisfy the 39-week requirement.

(ii) In the event that a taxpayer does not elect to claim a deduction for moving expenses on the return for the taxable year in which such expenses were paid or incurred in accordance with (i) of this subparagraph, and the 39-week employment condition of section 217(c)(2) (as well as all other requirements of section 217) is subsequently satisfied, then the taxpayer may file an amended return for the taxable year in which such moving expenses were paid or incurred on which he may claim a deduction under section 217. The taxpayer may, in lieu of filing an amended return, file a claim for refund based upon the deduction allowable under section 217.

(iii) The application of this subparagraph may be illustrated by the following examples:

Example 1. A is transferred by his employer, M, from Boston, Massachusetts, to Cleveland, Ohio, and begins working there on November 1, 1964, followed by his family and household goods and personal effects on November 15, 1964. Moving expenses are paid or incurred by A in 1964 in connection with this move. On April 15, 1965, when A files his income tax return for the year 1964, A has been a full-time employee in Cleveland for approximately 24 weeks. Notwithstanding the fact that as of April 15, 1965, A has not satisfied the 39-week employment condition of section 217(c)(2) he may nevertheless elect to claim his 1964 moving expenses on his 1964 income tax return since there is still sufficient time remaining before November 1, 1965, within which to satisfy the 39-week requirement.

Example 2. Assume the facts are the same as in *Example (1),* except that as of April 15, 1965, A has left the employ of M, and is in the process of seeking further employment in Cleveland. Since, under these conditions, A may be unsure whether or not he will be able to satisfy the 39-week requirement by November 1, 1965, he may not wish to avail himself of the election provided by section 217(d)(2). In such event, A may wait until he has actually satisfied the 39-week requirement, at which time he may file an amended return claiming as a deduction the moving expenses paid or incurred in 1964. A may, in lieu of filing an amended return, file a claim for refund based upon a deduction for such expenses. Should A fail to satisfy the 39-week requirement on or before November 1, 1965, no deduction is allowable for moving expenses incurred in 1964.

(3) *Recapture of deduction where 39-week test is not met.* Paragraph (3) of section 217(d) provides a special rule which applies in cases where a taxpayer has deducted moving expenses under the election provided in section 217(d)(2) prior to his satisfying the 39-week employment condition of section 217(c)(2), and the 39-week test is not satisfied during the taxable year immediately following the taxable year in which the expenses were deducted. In such cases an amount equal to the expenses which were deducted must be included in the taxpayer's gross income for the taxable year immediately following the taxable year in which the expenses were deducted. In the event the taxpayer has deducted moving expenses under the election provided in section 217(d)(2) for the taxable year, and subsequently files an amended return for such year on which he eliminates such deduction, such expenses will not be deemed to have been deducted for purposes of the recapture rule of the preceding sentence.

(e) *Disallowance of deduction with respect to reimbursements not included in gross income.* Section 217(e) provides that no deduction shall be allowed under section 217 for any item to the extent that the taxpayer receives reimbursement or other expense allowance for such item unless the amount of such reimbursement or other expense allowance is included in his gross income. A reimbursement or other allowance to an employee for expenses of moving, in the absence of a specific allocation by the employer, is allocated first to items deductible under section 217(a) and then, if a balance remains, to items not so deductible. For purposes of this section, moving services furnished in-kind, directly or indirectly, by a taxpayer's employer to the taxpayer or members of his household are considered as being a reimbursement or other allowance received by the taxpayer for moving expenses. If a taxpayer pays or incurs moving expenses and either prior or subsequent thereto receives reimbursement or other expense allowance for such item, no deduction is allowed for such moving expenses unless the amount of the reimbursement or other expense allowance is included in his gross income in the year in which such reimbursement or other expense allowance is received. In those cases where the reimbursement or other expense allowance is received by a taxpayer for an item of moving expense subsequent to his having claimed a deduction for such item, and such reimbursement or other expense allowance is properly excluded from gross income in the year in which received, the taxpayer must file an amended return for the taxable year in which the moving expenses were deducted and decrease such deduction by the amount of the reimbursement or other expense allowance not included in gross income. This does not mean, however, that a taxpayer has an option to include or not include in his gross income an amount received as reimbursement or other expense allowance in connection with his move as an employee. This question remains one which must be resolved under section 61(a) (relating to the definition of gross income).

[T.D. 6796, 30 FR 1038, Feb. 2, 1965, as amended by T.D. 7195, 37 FR 13535, July 11, 1972]

§ 1.217–2 Deduction for moving expenses paid or incurred in taxable years beginning after December 31, 1969.

(a) *Allowance of deduction*—(1) *In general.* Section 217(a) allows a deduction from gross income for moving expenses paid or incurred by the taxpayer during the taxable year in connection with his commencement of work as an employee or as a self-employed individual at a new principal place of work. For purposes of this section, amounts are considered as being paid or incurred by an individual whether goods or services are furnished to the taxpayer directly (by an employer, a client, a customer, or similar person) or indirectly (paid to a third party on behalf of the taxpayer by an employer, a client, a customer, or similar person). A cash basis taxpayer will treat moving expenses as being paid for purposes of section 217 and this section in the year in which the taxpayer is considered to have received such payment under section 82 and §1.82–1. No deduction is allowable under section 162 for any expenses incurred by the taxpayer in connection with moving from one residence to another residence unless such expenses are deductible under section 162 without regard to such change in residence. To qualify for the deduction under section 217 the expenses must meet the definition of the term *moving expenses* provided in section 217(b) and the taxpayer must meet the conditions set forth in section 217(c). The term *employee* as used in this section has the same meaning as in §31.3401(c)–1 of this chapter (Employment Tax Regulations). The term *self-employed individual* as used in this section is defined in paragraph (f)(1) of this section.

(2) *Expenses paid in a taxable year other than the taxable year in which reimbursement representing such expenses is received.* In general, moving expenses are deductible in the year paid or incurred. If a taxpayer who uses the cash receipts and disbursements method of accounting receives reimbursement for a moving expense in a taxable year other than the taxable year the taxpayer pays such expense, he may elect to deduct such expense in the taxable year that he receives such reimbursement, rather than the taxable year when he paid such expense in any case where:

(i) The expense is paid in a taxable year prior to the taxable year in which the reimbursement is received, or

(ii) The expense is paid in the taxable year immediately following the taxable year in which the reimbursement is received, provided that such expense is paid on or before the due date prescribed for filing the return (determined with regard to any extension of time for such filing) for the taxable year in which the reimbursement is received.

An election to deduct moving expenses in the taxable year that the reimbursement is received shall be made by claiming the deduction on the return, amended return, or claim for refund for the taxable year in which the reimbursement is received.

(3) *Commencement of work.* (i) To be deductible the moving expenses must be paid or incurred by the taxpayer in connection with his commencement of work at a new principal place of work (see paragraph (c)(3) of this section for a discussion of the term *principal place of work*). Except for those expenses described in section 217(b)(1) (C) and (D) it is not necessary for the taxpayer to have made arrangements to work prior to his moving to a new location; however, a deduction is not allowable unless employment or self-employment actually does occur. The term *commencement* includes *(a)* the beginning of work by a taxpayer as an employee or as a self-employed individual for the first time or after a substantial period of unemployment or part-time employment, *(b)* the beginning of work by a taxpayer for a different employer or in the case of a self-employed individual in a new trade or business, or *(c)* the beginning of work by a taxpayer for the same employer or in the case of a self-employed individual in the same trade or business at a new location. To qualify as being in connection with the commencement of work, the move must bear a reasonable proximity both in time and place to such commencement at the new principal place of work. In general, moving expenses incurred within 1 year of the date of the commencement of work are considered to be reasonably proximate in time to such commencement. Moving expenses incurred after the 1-year period may be considered reasonably proximate in time if it can be shown that circumstances existed which prevented the taxpayer from incurring the expenses of moving within the 1-year period allowed. Whether circumstances

existed which prevented the taxpayer from incurring the expenses of moving within the period allowed is dependent upon the facts and circumstances of each case. The length of the delay and the fact that the taxpayer may have incurred part of the expenses of the move within the 1-year period allowed shall be taken into account in determining whether expenses incurred after such period are allowable. In general, a move is not considered to be reasonably proximate in place to the commencement of work at the new princpal place of work where the distance between the taxpayer's new residence and his new principal place of work exceeds the distance between his former residence and his new principal place of work. A move to a new residence which does not satisfy this test may, however, be considered reasonably proximate in place to the commencement of work if the taxpayer can demonstrate, for example, that he is required to live at such residence as a condition of employment or that living at such residence will result in an actual decrease in commuting time or expense. For example, assume that in 1977 A is transferred by his employer to a new principal place of work and the distance between his former residence and his new principal place of work is 35 miles greater than was the distance between his former residence and his former principal place of work. However, the distance between his new residence and his new principal place of work is 10 miles greater than was the distance between his former residence and his new principal place of work. Although the minimum distance requirement of section 217(c)(1) is met the expenses of moving to the new residence are not considered as incurred in connection with A's commencement of work at his new principal place of work since the new residence is not proximate in place to the new place of work. If, however, A can demonstrate, for example, that he is required to live at such new residence as a condition of employment or if living at such new residence will result in an actual decrease in commuting time or expense, the expenses of the move may be considered as incurred in connection with A's commencement of work at his new principal place of work.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. Assume that A is tranferred by his employer from Boston, MA, to Washington, DC. A moves to a new residence in Washington, DC, and commences work on February 1, 1971. A's wife and his two children remain in Boston until June 1972 in order to allow A's children to complete their grade school education in Boston. On June 1, 1972, A sells his home in Boston and his wife and children move to the new residence in Washington, DC. The expenses incurred on June 1, 1972, in selling the old residence and in moving A's family, their household goods, and personal effects to the new residence in Washington are allowable as a deduction although they were incurred 16 months after the date of the commencement of work by A since A has moved to and established a new residence in Washington, DC, and thus incurred part of the total expenses of the move prior to the expiration of the 1-year period.

Example 2. Assume that A is transferred by his employer from Washington, DC, to Baltimore, MD. A commences work on January 1, 1971, in Baltimore. A commutes from his residence in Washington to his new principal place of work in Baltimore for a period of 18 months. On July 1, 1972, A decides to move to and establish a new residence in Baltimore. None of the moving expenses otherwise allowable under section 217 may be deducted since A neither incurred the expenses within 1 year nor has shown circumstances under which he was prevented from moving within such period.

(b) *Definition of moving expenses*—(1) *In general.* Section 217(b) defines the term *moving expenses* to mean only the reasonable expenses (i) of moving household goods and personal effects from the taxpayer's former residence to his new residence, (ii) of traveling (including meals and lodging) from the taxpayer's former residence to his new place of residence, (iii) of traveling (including meals and lodging), after obtaining employment, from the taxpayer's former residence to the general location of his new principal place of work and return, for the principal purpose of searching for a new residence, (iv) of meals and lodging while occupying temporary quarters in the general location of the new principal place of work during any period of 30 consecutive days after obtaining employment, or (v) of a nature constituting qualified residence sale, purchase, or lease expenses. Thus, the test of deductibility is whether the expenses are reasonable and are incurred for the items set forth in subdivisions (i) through (v) of this subparagraph.

(2) *Reasonable expenses.* (i) The term *moving expenses* includes only those expenses which are reasonable under the circumstances of the particular move. Expenses paid or incurred in excess of a reasonable amount are not deductible. Generally, expenses paid or incurred for movement of household goods and personal effects or for travel (including meals and lodging) are reasonable only to the extent that they are paid or incurred for such movement or travel by the shortest and most direct route available from the former residence to the new residence by the conventional mode or modes of transportation actually used and in the shortest period of time commonly required to travel the distance involved by such mode. Thus, if moving or travel arrangements are made to provide a circuitous route for scenic, stopover, or other similar reasons, additional expenses resulting therefrom are not deductible since they are not reasonable nor related to the commencement of work at the new principal place of work. In addition, expenses paid or incurred for meals and lodging while traveling from the former residence to the new place of residence or to the general location of the new principal place of work and return or occupying temporary quarters in the general location of the new principal place of work are reasonable only if under the facts and circumstances involved such expenses are not lavish or extravagant.

(ii) The application of this subparagraph may be illustrated by the following example:

Example. A, an employee of the M Company works and maintains his residence in Boston, MA. Upon receiving orders from his employer that he is to be transferred to M's Los Angeles, CA, office, A motors to Los Angeles with his family with stopovers at various cities between Boston and Los Angeles to visit friends and relatives. In addition, A detours into Mexico for sightseeing. Because of the stopovers and tour into Mexico, A's travel time and distance are increased over what they would have been had he proceeded directly to Los Angeles. To the extent that A's route of travel between Boston and Los Angeles is in a generally southwesterly direction it may be said that he is traveling by the shortest and most direct route available by motor vehicle. Since A's excursion into Mexico is away from the usual Boston-Los Angeles route, the portion of the expenses paid or incurred attributable to such excursion is not deductible. Likewise, that portion of the expenses attributable to A's delay en route in visiting personal friends and sightseeing are not deductible.

(3) *Expense of moving household goods and personal effects.* Expenses of moving household goods and personal effects include expenses of transporting such goods and effects from the taxpayer's former residence to his new residence, and expenses of packing, crating, and in-transit storage and insurance for such goods and effects. Such expenses also include any costs of connecting or disconnecting utilities required because of the moving of household goods, appliances, or personal effects. Expenses of storing and insuring household goods and personal effects constitute in-transit expenses if incurred within any consecutive 30-day period after the day such goods and effects are moved from the taxpayer's former residence and prior to delivery at the taxpayer's new residence. Expenses paid or incurred in moving household goods and personal effects to the taxpayer's new residence from a place other than his former residence are allowable, but only to the extent that such expenses do not exceed the amount which would be allowable had such goods and effects been moved from the taxpayer's former residence. Expenses of moving household goods and personal effects do not include, for example, storage charges (other than in-transit), costs incurred in the acquisition of property, costs incurred and losses sustained in the disposition of property, penalties for breaking leases, mortgage penalties, expenses of refitting rugs or draperies, losses sustained on the disposal of memberships in clubs, tuition fees, and similar items. The above expenses may, however, be described in other provisions of section 217(b) and if so a deduction may be allowed for them subject to the allowable dollar limitations.

(4) *Expenses of traveling from the former residence to the new place of residence.* Expenses of traveling from the former residence to the new place of

residence include the cost of transportation and of meals and lodging en route (including the date of arrival) from the taxpayer's former residence to his new place of residence. Expenses of meals and lodging incurred in the general location of the former residence within 1 day after the former residence is no longer suitable for occupancy because of the removal of household goods and personal effects shall be considered as expenses of traveling for purposes of this subparagraph. The date of arrival is the day the taxpayer secures lodging at the new place of residence, even if on a temporary basis. Expenses of traveling from the taxpayer's former residence to his new place of residence do not include, for example, living or other expenses following the date of arrival at the new place of residence and while waiting to enter the new residence or waiting for household goods to arrive, expenses in connection with house or apartment hunting, living expenses preceding date of departure for the new place of residence (other than expenses of meals and lodging incurred within 1 day after the former residence is no longer suitable for occupancy), expenses of trips for purposes of selling property, expenses of trips to the former residence by the taxpayer pending the move by his family to the new place of residence, or any allowance for depreciation. The above expenses may, however, be described in other provisions of section 217(b) and if so a deduction may be allowed for them subject to the allowable dollar limitations. The deduction for traveling expenses from the former residence to the new place of residence is allowable for only one trip made by the taxpayer and members of his household; however, it is not necessary that the taxpayer and all members of his household travel together or at the same time.

(5) *Expenses of traveling for the principal purpose of looking for a new residence.* Expenses of traveling, after obtaining employment, from the former residence to the general location of the new principal place of work and return, for the principal purpose of searching for a new residence include the cost of transportation and meals and lodging during such travel and while at the general location of the new place of work for the principal purpose of searching for a new residence. However, such expenses do not include, for example, expenses of meals and lodging of the taxpayer and members of his household before departing for the new principal place of work, expenses for trips for purposes of selling property, expenses of trips to the former residence by the taxpayer pending the move by his family to the place of residence, or any allowance for depreciation. The above expenses may, however, be described in other provisions of section 217(b) and if so a deduction may be allowed for them. The deduction for expenses of traveling for the principal purpose of looking for a new residence is not limited to any number of trips by the taxpayer and by members of his household. In addition, the taxpayer and all members of his household need not travel together or at the same time. Moreover, a trip need not result in acquisition of a lease of property or purchase of property. An employee is considered to have obtained employment in the general location of the new principal place of work after he has obtained a contract or agreement of employment. A self-employed individual is considered to have obtained employment when he has made substantial arrangements to commence work at the new principal place of work (see paragraph (f)(2) of this section for a discussion of the term *made substantial arrangements to commence to work*).

(6) *Expenses of occupying temporary quarters.* Expenses of occupying temporary quarters include only the cost of meals and lodging while occupying temporary quarters in the general location of the new principal place of work during any period of 30 consecutive days after the taxpayer has obtained employment in such general location. Thus, expenses of occupying temporary quarters do not include, for example, the cost of entertainment, laundry, transportation, or other personal, living family expenses, or expenses of occupying temporary quarters in the general location of the former place of work. The 30 consecutive day period is any one period of 30 consecutive days which can begin, at the option of the taxpayer, on any day after the day the

taxpayer obtains employment in the general location of the new principal place of work.

(7) *Qualified residence sale, purchase, or lease expenses.* Qualified residence sale, purchase, or lease expenses (hereinafter ''qualified real estate expenses'') are only reasonable amounts paid or incurred for any of the following purposes:

(i) Expenses incident to the sale or exchange by the taxpayer or his spouse of the taxpayer's former residence which, but for section 217 (b) and (e), would be taken into account in determining the amount realized on the sale or exchange of the residence. These expenses include real estate commissions, attorneys' fees, title fees, escrow fees, so called ''points'' or loan placement charges which the seller is required to pay, State transfer taxes and similar expenses paid or incurred in connection with the sale or exchange. No deduction, however, is permitted under section 217 and this section for the cost of physical improvements intended to enhance salability by improving the condition or appearance of the residence.

(ii) Expenses incident to the purchase by the taxpayer or his spouse of a new residence in the general location of the new principal place of work which, but for section 217 (b) and (e), would be taken into account in determining either the adjusted basis of the new residence or the cost of a loan. These expenses include attorney's fees, escrow fees, appraisal fees, title costs, so-called ''points'' or loan placement charges not representing payments or prepayments of interest, and similar expenses paid or incurred in connection with the purchase of the new residence. No deduction, however, is permitted under section 217 and this section for any portion of real estate taxes or insurance, so-called ''points'' or loan placement charges which are, in essence, prepayments of interest, or the purchase price of the residence.

(iii) Expenses incident to the settlement of an unexpired lease held by the taxpayer or his spouse on property used by the taxpayer as his former residence. These expenses include consideration paid to a lessor to obtain a release from a lease, attorneys' fees, real estate commissions, or similar expenses incident to obtaining a release from a lease or to obtaining an assignee or a sublessee such as the difference between rent paid under a primary lease and rent received under a sublease. No deduction, however, is permitted under section 217 and this section for the cost of physical improvement intended to enhance marketability of the leasehold by improving the condition or appearance of the residence.

(iv) Expenses incident to the acquisition of a lease by the taxpayer or his spouse. These expenses include the cost of fees or commissions for obtaining a lease, a sublease, or an assignment of an interest in property used by the taxpayer as his new residence in the general location of the new principal place of work. No deduction, however, is permitted under section 217 and this section for payments or prepayments of rent or payments representing the cost of a security or other similar deposit.

Qualified real estate expenses do not include losses sustained on the disposition of property or mortgage penalties, to the extent that such penalties are otherwise deductible as interest.

(8) *Residence.* The term *former residence* refers to the taxpayer's principal residence before his departure for his new principal place of work. The term *new residence* refers to the taxpayer's principal residence within the general location of his new principal place of work. Thus, neither term includes other residences owned or maintained by the taxpayer or members of his family or seasonal residences such as a summer beach cottage. Whether or not property is used by the taxpayer as his principal residence depends upon all the facts and circumstances in each case. Property used by the taxpayer as his principal residence may include a houseboat, a housetrailer, or similar dwelling. The term *new place of residence* generally includes the area within which the taxpayer might reasonably be expected to commute to his new principal place of work.

(9) *Dollar limitations.* (i) Expenses described in subparagraphs (A) and (B) of section 217(b)(1) are not subject to an overall dollar limitation. Thus, assuming all other requirements of section

217 are satisfied, a taxpayer who, in connection with his commencement of work at a new principal place of work, pays or incurs reasonable expenses of moving household goods and personal effects from his former residence to his new place of residence and reasonable expenses of traveling, including meals and lodging, from his former residence to his new place of residence is permitted to deduct the entire amount of these expenses.

(ii) Expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) are subject to an overall dollar limitation for each commencement of work of 3,000 ($2,500 in the case of a commencement of work in a taxable year beginning before January 1, 1977), of which the expenses described in subparagraphs (C) and (D) of section 217(b)(1) cannot exceed $1,500 ($1,000 in the case of a commencement of work in a taxable year beginning before January 1, 1977). The dollar limitation applies to the amount of expenses paid or incurred in connection with each commencement of work and not to the amount of expenses paid or incurred in each taxable year. Thus, for example, a taxpayer who paid or incurred $2,000 of expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) in taxable year 1977 in connection with his commencement of work at a principal place of work and paid or incurred an additional $2,000 of such expenses in taxable year 1978 in connection with the same commencement of work is permitted to deduct the $2,000 of such expenses paid or incurred in taxable year 1977 and only $1,000 of such expenses paid or incurred in taxable year 1978.

(iii) A taxpayer who pays or incurs expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) in connection with the same commencement of work may choose to deduct any combination of such expenses within the dollar amounts specified in subdivision (ii) of this subparagraph. For example, a taxpayer who pays or incurs such expenses in connection with the same commencement of work may either choose to deduct: *(a)* Expenses described in subparagraphs (C) and (D) of section 217(b)(1) to the extent of $1,500 ($1,000 in the case of a commencement of work in a taxable year beginning before January 1, 1977) before deducting any of the expenses described in subparagraph (E) of such section, or *(b)* expenses described in subparagraph (E) of section 217(b)(1) to the extent of $3,000 ($2,500 in the case of a commencement of work in a taxable year beginning before January 1, 1977) before deducting any of the expenses described in subparagraphs (C) and (D) of such section.

(iv) For the purpose of computing the dollar limitation contained in subparagraph (A) of section 217(b)(3) a commencement of work by a taxpayer at a new principal place of work and a commencement of work by his spouse at a new principal place of work which are in the same general location constitute a single commencement of work. Two principal places of work are treated as being in the same general location where the taxpayer and his spouse reside together and commute to their principal places of work. Two principal places of work are not treated as being in the same general location where, as of the close of the taxable year, the taxpayer and his spouse have not shared the same new residence nor made specific plans to share the same new residence within a determinable time. Under such circumstances, the separate commencements of work by a taxpayer and his spouse will be considered separately in assigning the dollar limitations and expenses to the appropriate return in the manner described in subdivisions (v) and (vi) of this subparagraph.

(v) Moving expenses (described in subparagraphs (C), (D), and (E) of section 217(b)(1)), paid or incurred with respect to the commencement of work by both a husband and wife which is considered a single commencement of work under subdivision (iv) of this subparagraph are subject to an overall dollar limitation of $3,000 ($2,500 in the case of a commencement of work in a taxable year beginning before January 1, 1977), per move of which the expenses described in subparagraphs (C) and (D) of section 217(b)(1) cannot exceed $1,500 ($1,000 in the case of a commencement of work in a taxable year beginning before January 1, 1977). If separate returns are filed with respect to the commencement of work by both a husband and wife which is considered a single commencement of work under subdivision (iv) of this subparagraph, moving expenses (described in subparagraphs (C), (D), and (E) of section 217(b)(1)) are subject to an overall dollar limitation of $1,500 ($1,250 in the case of a commencement of work in a taxable year beginning before January 1, 1977), per move of which the expenses described in subparagraphs (C) and (D) of section 217(b)(1) cannot exceed $750 ($500 in the case of a commencement of work in a taxable year beginning before January 1, 1977) with respect to each return. Where moving expenses are paid or incurred in more than 1 taxable year with respect to a single commencement of work by a husband and wife they shall, for purposes of applying the dollar limitations to such move, be subject to a $3,000 and $1,500 limitation ($2,500 and $1,000, respectively, in the case of a commencement of work in a taxable year beginning before January 1, 1977) for all such years that they file a joint return and shall be subject to a separate $1,500 and $750 limitation ($1,250 and $500, respectively, in the case of a commencement of work in a taxable year beginning before January 1, 1977) for all such years that they file separate returns. If a joint return is filed for the first taxable year moving expenses are paid or incurred with respect to a move but separate returns are filed in a subsequent year, the unused portion of the amount which may be deducted shall be allocated equally between the husband and wife in the later year. If separate returns are filed for the first taxable year such moving expenses are paid or incurred but a joint return is filed in a subsequent year, the deductions claimed on their separate returns shall be aggregated for purposes of determining the unused portion of the amount which may be deducted in the later year.

(vi) The application of subdivisions (iv) and (v) of this subparagraph may be illustrated by the following examples:

Example 1. A, who was transferred by his employer, effective January 15, 1977, moved from Boston, MA, to Washington, DC. A's wife was transferred by her employer, effective January 15, 1977, from Boston, MA, to Baltimore, MD. A and his wife reside together at the same new residence. A and his wife are cash basis taxpayers and file a joint return for taxable year 1977. Because A and his wife reside together at the new residence, the commencement of work by both is considered a single commencement of work under subdivision (iv) of this subparagraph. They are permitted to deduct with respect to their commencement of work in Washington and Baltimore up to $3,000 of the expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) of which the expenses described in subparagraphs (C) and (D) of such section cannot exceed $1,500.

Example 2. Assume the same facts as in *Example (1)* except that for taxable year 1977, A and his wife file separate returns. Because A and his wife reside together, the commencement of work by both is considered a single commencement of work under subdivision (iv) of this subparagraph. A is permitted to deduct with respect to his commencement of work in Washington up to $1,500 of the expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) of which the expenses described in subparagraphs (C) and (D) cannot exceed $750. A is not permitted to deduct any of the expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) paid by his wife in connection with her commencement of work at a new principal place of work. A's wife is permitted to deduct with respect to her commencement of work in Baltimore up to $1,500 of the expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) that are paid by her of which the expenses described in subparagraphs (C) and (D) cannot exceed $750. A's wife is not permitted to deduct any of the expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) paid by A in connection with his commencement of work in Washington, DC.

Example 3. Assume the same facts as in *Example (1)* except that A and his wife take up separate residences in Washington and Baltimore, do not reside together during the entire taxable year, and have no specific plans to reside together. The commencement of work by A in Washington, DC, and by his wife in Baltimore are considered separate commencements of work since their principal places of work are not treated as being in the same general location. If A and his wife file a joint return for taxable year 1977, the moving expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) paid in connection with the commencement of work by A in Washington, DC, and his wife in Baltimore, MD, are subject to an overall limitation of $6,000 of which the expenses described in subparagrahs (C) and (D) cannot exceed $3,000. If A and his wife file separate returns for taxable year 1977, A may deduct up to $3,000 of the expenses described in subparagraphs (C), (D), and (E) of which the expenses described in subparagraphs (C) and (D) cannot exceed $1,500. A's wife may deduct up to $3,000 of the expenses described in subparagraphs (C), (D), and (E) of which the expenses described in subparagraphs (C) and (D) cannot exceed $1,500.

(10) *Individuals other than taxpayer.* (i) In addition to the expenses set forth in subparagraphs (A) through (D) of section 217(b)(1) attributable to the taxpayer alone, the same type of expenses attributable to certain individuals other than the taxpayer, if paid or incurred by the taxpayer, are deductible. These other individuals must be members of the taxpayer's household, and have both the taxpayer's former residence and his new residence as their principal place of abode. A member of the taxpayer's household includes any individual residing at the taxpayer's residence who is neither a tenant nor an employee of the taxpayer. Thus, for example, a member of the taxpayer's household may not be an individual such as a servant, governess, chauffeur, nurse, valet, or personal attendant. However, for purposes of this paragraph, a tenant or employee will be considered a member of the taxpayer's household where the tenant or employee is a dependent of the taxpayer as defined in section 152.

(ii) In addition to the expenses set forth in section 217(b)(2) paid or incurred by the taxpayer attributable to property sold, purchased, or leased by the taxpayer alone, the same type of expenses paid or incurred by the taxpayer attributable to property sold, purchased, or leased by the taxpayer's spouse or by the taxpayer and his spouse are deductible providing such property is used by the taxpayer as his principal place of residence.

(c) *Conditions for allowance*—(1) *In general.* Section 217(c) provides two conditions which must be satisfied in order for a deduction of moving expenses to be allowed under section 217(a). The first is a minimum distance condition prescribed by section 217(c)(1), and the second is a minimum period of employment condition prescribed by section 217(c)(2).

(2) *Minimum distance.* For purposes of applying the minimum distance condition of section 217(c)(1) all taxpayers are divided into one or the other of the following categories: Taxpayers having a former principal place of work, and taxpayers not having a former principal place of work. Included in this latter category are individuals who are seeking fulltime employment for the first time either as an employee or on a self- employed basis (for example, recent high school or college graduates), or individuals who are reentering the labor force after a substantial period of unemployment or part-time employment.

(i) In the case of a taxpayer having a former principal place of work, section 217(c)(1)(A) provides that no deduction is allowable unless the distance between the former residence and the new principal place of work exceeds by at least 35 miles (50 miles in the case of expenses paid or incurred in taxable years beginning before January 1, 1977) the distance between the former residence and the former principal place of work.

(ii) In the case of a taxpayer not having a former principal place of work, section 217(c)(1)(B) provides that no deduction is allowable unless the distance between the former residence and the new principal place of work is at least 35 miles (50 miles in the case of expenses paid or incurred in taxable years beginning before January 1, 1977).

(iii) For purposes of measuring distances under section 217(c)(1) the distance between two geographic points is measured by the shortest of the more commonly traveled routes between such points. The shortest of the more commonly traveled routes refers to the line of travel and the mode or modes of transportation commonly used to go between two geographic points comprising the shortest distance between such points irrespective of the route used by the taxpayer.

(3) *Principal place of work.* (i) A taxpayer's *principal place of work* usually is the place where he spends most of his working time. The principal place of work of a taxpayer who performs services as an employee is his employer's plant, office, shop, store, or other property. The principal place of work of a taxpayer who is self-employed is the plant, office, shop, store, or other

property which serves as the center of his business activities. However, a taxpayer may have a principal place of work even if there is no one place where he spends a substantial portion of his working time. In such case, the taxpayer's principal place of work is the place where his business activities are centered—for example, because he reports there for work, or is required either by his employer or the nature of his employment to ''base'' his employment there. Thus, while a member of a railroad crew may spend most of his working time aboard a train, his principal place of work is his home terminal, station, or other such central point where he reports in, checks out, or receives instructions. The principal place of work of a taxpayer who is employed by a number of employers on a relatively short-term basis, and secures employment by means of a union hall system (such as a construction or building trades worker) would be the union hall.

(ii) Where a taxpayer has more than one employment (i.e., the taxpayer is employed by more than one employer, or is self-employed in more than one trade or business, or is an employee and is self-employed at any particular time) his principal place of work is determined with reference to his principal employment. The location of a taxpayer's principal place of work is a question of fact determined on the basis of the particular circumstances in each case. The more important factors to be considered in making this determination are *(a)* the total time ordinarily spent by the taxpayer at each place, *(b)* the degree of the taxpayer's business activity at each place, and *(c)* the relative significance of the financial return to the taxpayer from each place.

(iii) Where a taxpayer maintains inconsistent positions by claiming a deduction for expenses of meals and lodging while away from home (incurred in the general location of the new principal place of work) under section 162 (relating to trade or business expenses) and by claiming a deduction under this section for moving expenses incurred in connection with the commencement of work at such place of work, it will be a question of facts and circumstances as to whether such new place of work will be considered a principal place of work, and accordingly, which category of deductions he will be allowed.

(4) *Minimum period of employment.* (i) Under section 217(c)(2) no deduction is allowed unless:

(a) Where a taxpayer is an employee, during the 12-month period immediately following his arrival in the general location of the new principal place of work, he is a full-time employee, in such general location, during at least 39 weeks, or

(b) Where a taxpayer is a self-employed individual (including a taxpayer who is also an employee, but is unable to satisfy the requirements of the 39-week test of (a) of this subdivision (i)), during the 24-month period immediately following his arrival in the general location of the new principal place of work, he is a full-time employee or performs services as a self-employed individual on a full-time basis, in such general location, during at least 78 weeks, of which not less than 39 weeks are during the 12-month period referred to above.

Where a taxpayer works as an employee and at the same time performs services as a self-employed individual his principal employment (determined according to subdivision (i) of subparagraph (3) of this paragraph) governs whether the 39-week or 78-week test is applicable.

(ii) The 12-month period and the 39-week period set forth in subparagraph (A) of section 217(c)(2) and the 12- and 24-month periods as well as 39- and 78-week periods set forth in subparagraph (B) of such section are measured from the date of the taxpayer's arrival in the general location of the new principal place of work. Generally, date of arrival is the date of the termination of the last trip preceding the taxpayer's commencement of work on a regular basis and is not the date the taxpayer's family or household goods and effects arrive.

(iii) The taxpayer need not remain in the employ of the same employer or remain self-employed in the same trade or business for the required number of weeks. However, he must be employed in the same general location of the new principal place of work during such period. The *general location* of the new principal place of work refers to a general commutation area and is usually the same area as the ‘‘new place of residence’’; see paragraph (b)(8) of this section.

(iv) Only those weeks during which the taxpayer is a full-time employee or during which he performs services as a self-employed individual on a full-time basis qualify as a week of work for purposes of the minimum period of employment condition of section 217(c)(2).

(a) Whether an employee is a full-time employee during any particular week depends upon the customary practices of the occupation in the geographic area in which the taxpayer works. Where employment is on a seasonal basis, weeks occurring in the off-season when no work is required or available may be counted as weeks of full-time employment only if the employee's contract or agreement of employment covers the off-season period and such period is less than 6 months. Thus, for example, a schoolteacher whose employment contract covers a 12-month period and who teaches on a full-time basis for more than 6 months is considered a full-time employee during the entire 12-month period. A taxpayer will be treated as a full-time employee during any week of involuntary temporary absence from work because of illness, strikes, shutouts, layoffs, natural disasters, etc. A taxpayer will, also, be treated as a full-time employee during any week in which he voluntarily absents himself from work for leave or vacation provided for in his contract or agreement of employment.

(b) Whether a taxpayer performs services as a self-employed individual on a full-time basis during any particular week depends on the practices of the trade or business in the geographic area in which the taxpayer works. For example, a self-employed dentist maintaining office hours 4 days a week is considered to perform services as a self-employed individual on a full-time basis providing it is not unusual for other self-employed dentists in the geographic area in which the taxpayer works to maintain office hours only 4 days a week. Where a trade or business is seasonal, weeks occurring during the off-season when no work is required or available may be counted as weeks of performance of services on a full-time basis only if the off-season is less than 6 months and the taxpayer performs services on a full-time basis both before and after the off-season. For example, a taxpayer who owns and operates a motel at a beach resort is considered to perform services as a self-employed individual on a full-time basis if the motel is closed for a period not exceeding 6 months during the off-season and if he performs services on a full-time basis as the operator of a motel both before and after the off-season. A taxpayer will be treated as performing services as a self-employed individual on a full-time basis during any week of involuntary temporary absence from work because of illness, strikes, natural disasters, etc.

(v) Where taxpayers file a joint return, either spouse may satisfy the minimum period of employment condition. However, weeks worked by one spouse may not be added to weeks worked by the other spouse in order to satisfy such condition. The taxpayer seeking to satisfy the minimum period of employment condition must satisfy the condition applicable to him. Thus, if a taxpayer is subject to the 39-week condition and his spouse is subject to the 78-week condition and the taxpayer satisfies the 39-week condition, his spouse need not satisfy the 78-week condition. On the other hand, if the taxpayer does not satisfy the 39-week condition, his spouse in such case must satisfy the 78-week condition.

(vi) The application of this subparagraph may be illustrated by the following examples:

Example 1. A is an electrician residing in New York City. He moves himself, his family, and his household goods and personal effects, at his own expense, to Denver where he commences employment with the M Aircraft Corporation. After working full-time for 30 weeks he voluntarily leaves his job, and he subsequently moves to and commences employment in Los Angeles, CA, which employment lasts for more than 39 weeks. Since A was not employed in the general location of his new principal place of employment in Denver for at least 39 weeks, no deduction is allowable for moving expenses paid or incurred between New York City and Denver. A will be allowed to deduct only those moving expenses attributable to his move from Denver to Los Angeles, assuming all other conditions of section 217 are met.

Example 2. Assume the same facts as in *Example (1)*, except that A's wife commences employment in Denver at the same time as A, and that she continues to work in Denver for at least 9 weeks after A's departure for Los Angeles. Since she has met the 39-week requirement in Denver, and assuming all other requirements of section 217 are met, the moving expenses paid by A attributable to the move from New York City to Denver will be allowed as a deduction, provided A and his wife file a joint return. If A and his wife file separate returns moving expenses paid by A's wife attributable to the move from New York City to Denver will be allowed as a deduction on A's wife's return.

Example 3. Assume the same facts as in *Example (1)*, except that A's wife commences employment in Denver on the same day that A departs for Los Angeles, and continues to work in Denver for 9 weeks thereafter. Since neither A (who has worked 30 weeks) nor his wife (who has worked 9 weeks) has independently satisfied the 39-week requirement, no deduction for moving expenses attributable to the move from New York City to Denver is allowable.

(d) *Rules for application of section 217(c)(2)*—(1) *Inapplicability of minimum period of employment condition in certain cases.* Section 217(d)(1) provides that the minimum period of employment condition of section 217(c)(2) does not apply in the case of a taxpayer who is unable to meet such condition by reason of:

(i) Death or disability, or

(ii) Involuntary separation (other than for willfull misconduct) from the service of an employer or separation by reason of transfer for the benefit of an employer after obtaining full-time employment in which the taxpayer could reasonably have been expected to satisfy such condition.

For purposes of subdivision (i) of this paragraph disability shall be determined according to the rules in section 72(m)(7) and §1.72–17(f). Subdivision (ii) of this subparagraph applies only where the taxpayer has obtained full-time employment in which he could reasonably have been expected to satisfy the minimum period of employment condition. A taxpayer could reasonably have been expected to satisfy the minimum period of employment condition if at the time he commences work at the new principal place of work he could have been expected, based upon the facts known to him at such time, to satisfy such condition. Thus, for example, if the taxpayer at the time of transfer was not advised by his employer that he planned to transfer him within 6 months to another principal place of work, the taxpayer could, in the absence of other factors, reasonably have been expected to satisfy the minimum employment period condition at the time of the first transfer. On the other hand, a taxpayer could not reasonably have been expected to satisfy the minimum employment condition if at the time of the commencement of the move he knew that his employer's retirement age policy would prevent his satisfying the minimum employment period condition.

(2) *Election of deduction before minimum period of employment condition is satisfied.* (i) Paragraph (2) of section 217(d) provides a rule which applies where a taxpayer paid or incurred, in a taxable year, moving expenses which would be deductible in that taxable year except that the minimum period of employment condition of section 217(c)(2) has not been satisfied before the time prescribed by law for filing the return for such taxable year. The rule provides that where a taxpayer has paid or incurred moving expenses and as of the date prescribed by section 6072 for filing his return for such taxable year (determined with regard to extensions of time for filing) there remains unexpired a sufficient portion of the 12-month or the 24-month period so that it is still possible for the taxpayer to satisfy the applicable period of employment condition, the taxpayer may elect to claim a deduction for such moving expenses on the return for such taxable year. The election is exercised by taking the deduction on the return.

(ii) Where a taxpayer does not elect to claim a deduction for moving expenses on the return for the taxable year in which such expenses were paid or incurred in accordance with subdivision (i) of this subparagraph and the applicable minimum period of employment condition of section 217(c)(2) (as well as all other requirements of section 217) is subsequently satisfied, the taxpayer may file an amended return or a claim for refund for the taxable year such moving expenses were paid or incurred on which he may claim a deduction under section 217.

(iii) The application of this subparagraph may be illustrated by the following examples:

Example 1. A is transferred by his employer from Boston, MA, to Cleveland, OH. He begins working there on November 1, 1970. Moving expenses are paid by A in 1970 in connection with this move. On April 15, 1971, when he files his income tax return for the year 1970, A has been a full-time employee in Cleveland for approximately 24 weeks. Although he has not satisfied the 39-week employment condition at this time, A may elect to claim his 1970 moving expenses on his 1970 income tax return as there is still sufficient time remaining before November 1, 1971, to satisfy such condition.

Example 2. Assume the same facts as in *Example (1)*, except that on April 15, 1971, A has voluntarily left his employer and is looking for other employment in Cleveland. A may not be sure he will be able to meet the 39-week employment condition by November 1, 1971. Thus, he may if he wishes wait until such condition is met and file an amended return claiming as a deduction the expenses paid in 1970. Instead of filing an amended return A may file a claim for refund based on a deduction for such expenses. If A fails to meet the 39-week employment condition on or before November 1, 1971, no deduction is allowable for such expenses.

Example 3. B is a self-employed accountant. He moves from Rochester, NY, to New York, NY, and begins to work there on December 1, 1970. Moving expenses are paid by B in 1970 and 1971 in connection with this move. On April 15, 1971, when he files his income tax return for the year 1970, B has been performing services as a self-employed individual on a full-time basis in New York City for approximately 20 weeks. Although he has not satisfied the 78-week employment condition at this time, A may elect to claim his 1970 moving expenses on his 1970 income tax return as there is still sufficient time remaining before December 1, 1972, to satisfy such condition. On April 15, 1972, when he files his income tax return for the year 1971, B has been performing services as a self-employed individual on a full-time basis in New York City for approximately 72 weeks. Although he has not met the 78-week employment condition at this time, B may elect to claim his 1971 moving expenses on his 1971 income tax return as there is still sufficient time remaining before December 1, 1972, to satisfy such requirement.

(3) *Recapture of deduction.* Paragraph (3) of section 217(d) provides a rule which applies where a taxpayer has deducted moving expenses under the election provided in section 217(d)(2) prior to satisfying the applicable minimum period of employment condition and such condition cannot be satisfied at the close of a subsequent taxable year. In such cases an amount equal to the expenses deducted must be included in the taxpayer's gross income for the taxable year in which the taxpayer is no longer able to satisfy such minimum period of employment condition. Where the taxpayer has deducted moving expenses under the election provided in section 217(d)(2) for the taxable year and subsequently files an amended return for such year on which he does not claim the deduction, such expenses are not treated as having been deducted for purposes of the recapture rule of the preceding sentence.

(e) *Denial of double benefit*—(1) *In general.* Section 217(e) provides a rule for computing the amount realized and the basis where qualified real estate expenses are allowed as a deduction under section 217(a).

(2) *Sale or exchange of residence.* Section 217(e) provides that the amount realized on the sale or exchange of a residence owned by the taxpayer, by the taxpayer's spouse, or by the taxpayer and his spouse and used by the taxpayer as his principal place of residence is not decreased by the amount of any expenses described in subparagraph (A) of section 217(b)(2) and deducted under section 217(a). For the purposes of section 217(e) and of this paragraph the term amount realized'' has the same meaning as under section 1001(b) and the regulations thereunder. Thus, for example, if the taxpayer sells a residence used as his principal place of residence and real estate commissions or similar expenses described in subparagraph (A) of section 217(b)(2) are deducted by him pursuant to section 217(a), the amount realized on the sale of the residence is not reduced by the amount of such real estate commissions or such similar expenses described in subparagraph (A) of section 217(b)(2).

(3) *Purchase of a residence.* Section 217(e) provides that the basis of a residence purchased or received in exchange for other property by the taxpayer, by the taxpayer's spouse, or by

the taxpayer and his spouse and used by the taxpayer as his principal place of residence is not increased by the amount of any expenses described in subparagraph (B) of section 217(b)(2) and deducted under section 217(a). For the purposes of section 217(e) and of this paragraph the term *basis* has the same meaning as under section 1011 and the regulations thereunder. Thus, for example, if a taxpayer purchases a residence to be used as his principal place of residence and attorneys' fees or similar expenses described in subparagraph (B) of section 217(b)(2) are deducted pursuant to section 217(a), the basis of such residence is not increased by the amount of such attorneys' fees or such similar expenses described in subparagraph (B) of section 217(b)(2).

(4) *Inapplicability of section 217(e).* (i) Section 217(e) and subparagraphs (1) through (3) of this paragraph do not apply to any expenses with respect to which an amount is included in gross income under section 217(d)(3). Thus, the amount of any expenses described in subparagraph (A) of section 217(b)(2) deducted in the year paid or incurred pursuant to the election under section 217(d)(2) and subsequently recaptured pursuant to section 217(d)(3) may be taken into account in computing the amount realized on the sale or exchange of the residence described in such subparagraph. Also, the amount of expenses described in subparagraph (B) of section 217(b)(2) deducted in the year paid or incurred pursuant to such election under section 217(d)(2) and subsequently recaptured pursuant to section 217(d)(3) may be taken into account as an adjustment to the basis of the residence described in such subparagraph.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. A was notified of his transfer effective December 15, 1972, from Seattle, WA, to Philadelphia, PA. In connection with the transfer A sold his house in Seattle on November 10, 1972. Expenses incident to the sale of the house of $2,500 were paid by A prior to or at the time of the closing of the contract of sale on December 10, 1972. The amount realized on the sale of the house was $47,500 and the adjusted basis of the house was $30,000. Pursuant to the election provided in section 217(d)(2), A deducted the expenses of moving from Seattle to Philadelphia including the expenses incident to the sale of his former residence in taxable year 1972. Dissatisfied with his position with his employer in Philadelphia, A took a position with an employer in Chicago, IL, on July 15, 1973. Since A was no longer able to satisfy the minimum period employment condition at the close of taxable year 1973 he included an amount equal to the amount deducted as moving expenses including the expenses incident to the sale of his former residence in gross income for taxable year 1973. A is permitted to decrease the amount realized on the sale of the house by the amount of the expenses incident to the sale of the house deducted from gross income and subsequently included in gross income. Thus, the amount realized on the sale of the house is decreased from $47,500 to $45,000 and thus, the gain on the sale of the house is reduced from $17,500 to $15,000. A is allowed to file an amended return or a claim for refund in order to reflect the recomputation of the amount realized.

Example 2. B, who is self-employed decided to move from Washington, DC, to Los Angeles, CA. In connection with the commencement of work in Los Angeles on March 1, 1973, B purchased a house in a suburb of Los Angeles for $65,000. Expenses incident to the purchase of the house in the amount of $1,500 were paid by B prior to or at the time of the closing of the contract of sale on September 15, 1973. Pursuant to the election provided in section 217(d)(2), B deducted the expenses of moving from Washington to Los Angeles including the expenses incident to the purchase of his new residence in taxable year 1973. Dissatisfied with his prospects in Los Angeles, B moved back to Washington on July 1, 1974. Since B was no longer able to satisfy the minimum period of employment condition at the close of taxable year 1974 he included an amount equal to the amount deducted as moving expenses incident to the purchase of the former residence in gross income for taxable year 1974. B is permitted to increase the basis of the house by the amount of the expenses incident to the purchase of the house deducted from gross income and subsequently included in gross income. Thus, the basis of the house is increased to $66,500.

(f) *Rules for self-employed individuals*—(1) *Definition.* Section 217(f)(1) defines the term *self-employed individual* for purposes of section 217 to mean an individual who performs personal services either as the owner of the entire interest in an unincorporated trade or business or as a partner in a partnership carrying on a trade or business. The term *self-employed individual* does not include the semiretired, part-time students, or other similarly situated taxpayers who work only a few hours each week. The application of this subparagraph may be illustrated by the following example:

Example. A is the owner of the entire interest in an unincorporated construction business. A hires a manager who performs all of the daily functions of the business including the negotiation of contracts with customers, the hiring and firing of employees, the purchasing of materials used on the projects, and other similar services. A and his manager discuss the operations of the business about once a week over the telephone. Otherwise A does not perform any managerial services for the business. For the purposes of section 217, A is not considered to be a self-employed individual.

(2) *Rule for application of subsection (b)(1) (C)* and *(D).* Section 217(f)(2) provides that for purposes of subparagraphs (C) *and* (D) of section 217(b)(1) an individual who commences work at a new principal place of work as a self-employed individual is treated as having obtained employment when he has made substantial arrangements to commence such work. Whether the taxpayer has made substantial arrangements to commence work at a new principal place of work is determined on the basis of all the facts and circumstances in each case. The factors to be considered in this determination depend upon the nature of the taxpayer's trade or business and include such considerations as whether the taxpayer has: (i) Leased or purchased a plant, office, shop, store, equipment, or other property to be used in the trade or business, (ii) made arrangements to purchase inventory or supplies to be used in connection with the operation of the trade or business, (iii) entered into commitments with individuals to be employed in the trade or business, and (iv) made arrangements to contact customers or clients in order to advertise the business in the general location of the new principal place of work. The application of this subparagraph may be illustrated by the following examples:

Example 1. A, a partner in a growing chain of drug stores decided to move from Houston, TX, to Dallas, TX, in order to open a drug store in Dallas. A made several trips to Dallas for the purpose of looking for a site for the drug store. After the signing of a lease on a building in a shopping plaza, suppliers were contacted, equipment was purchased, and employees were hired. Shortly before the opening of the store A and his wife moved from Houston to Dallas and took up temporary quarters in a motel until the time their apartment was available. By the time he and his wife took up temporary quarters in the motel A was considered to have made substantial arrangements to commence work at the new principal place of work.

Example 2. B, who is a partner in a securities brokerage firm in New York, NY, decided to move to Rochester, NY, to become the resident partner in the firm's new Rochester office. After a lease was signed on an office in downtown Rochester B moved to Rochester and took up temporary quarters in a motel until his apartment became available. Before the opening of the office B supervised the decoration of the office, the purchase of equipment and supplies necessary for the operation of the office, the hiring of personnel for the office, as well as other similar activities. By the time B took up temporary quarters in the motel he was considered to have made substantial arrangements to commence to work at the new principal place of work.

Example 3. C, who is about to complete his residency in ophthalmology at a hospital in Pittsburgh, PA, decided to fly to Philadelphia, PA, for the purpose of looking into opportunities for practicing in that city. Following his arrival in Philadelphia C decided to establish his practice in that city. He leased an office and an apartment. At the time he departed Pittsburgh for Philadelphia C was not considered to have made substantial arrangements to commence work at the new principal place of work, and, therefore, is not allowed to deduct expenses described in subparagraph (C) of section 217(b)(1) (relating to expenses of traveling (including meals and lodging), after obtaining employment, from the former residence to the general location of the new principal place of work and return, for the principal purpose of searching for a new residence).

(g) *Rules for members of the Armed Forces of the United States*—(1) *In general.* The rules in paragraphs (a)(1) and (2), (b), and (e) of this section apply to moving expenses paid or incurred by members of the Armed Forces of the United States on active duty who move pursuant to a military order and incident to a permament change of station, except as provided in this paragraph (g). However, if the moving expenses are not paid or incurred incident to a permanent change of station, this paragraph (g) does not apply, but all other paragraphs of this section do apply.

The provisions of this paragraph apply to taxable years beginning December 31, 1975.

(2) *Treatment of services or reimbursement provided by Government*—(i) *Services in kind.* The value of any moving or storage services furnished by the United States Government to members of the Armed Forces, their spouses, or their dependents in connection with a permanent change of station is not includible in gross income. The Secretary of Defense and (in cases involving members of the peacetime Coast Guard) the Secretary of Transportation are not required to report or withhold taxes with respect to those services. Services furnished by the Government include services rendered directly by the Government or rendered by a third party who is compensated directly by the Government for the services.

(ii) *Reimbursements.* The following rules apply to reimbursements or allowances by the Government to members of the Armed Forces, their spouses, or their dependents for moving or storage expenses paid or incurred by them in connection with a permanent change of station. If the reimbursement or allowance exceeds the actual expenses paid or incurred, the excess is includible in the gross income of the member, and the Secretary of Defense or Secretary of Transportation must report the excess as payment of wages and withhold income taxes under section 3402 and the employee taxes under section 3102 with respect to that excess. If the reimbursemet or allowance does not exceed the actual expenses, the reimbursement or allowance in not includible in gross income, and no reporting or withholding by the Secretary of Defense or Secretary of Transportation is required. If the actual expenses, as limited by paragraph (b)(9) of this section, exceed the reimbursement of allowance, the member may deduct the excess if the other requirements of this section, as modified by this paragraph, are met. The determination of the limitation on actual expenses under paragraph (b)(9) of this section is made without regard to any services in kind furnished by the Government.

(3) *Permanent change of station.* For purposes of this section, the term *permanent change of station* includes the following situations.

(i) A move from home to the first post of duty when appointed, reappointed, reinstated, or inducted.

(ii) A move from the last post of duty to home or a nearer point in the United States in connection with retirement, discharge, resignation, separation under honorable conditions, transfer, relief from active duty, temporary disability retirement, or transfer to a Fleet Reserve, if such move occurs within 1 year of such termination of active duty or within the period prescribed by the Joint Travel Regulations promulgated under the authority contained in sections 404 through 411 of Title 37 of the United States Code.

(iii) A move from one permanent post of duty to another permanent post of duty at a different duty station, even if the member separates from the Armed Forces immediately or shortly after the move.

The term *permanent, post of duty, duty station,* and *honorable* have the meanings given them in appropriate Department of Defense or Department of Transportation rules and regulations.

(4) *Storage expenses.* This paragraph applies to storage expenses as well as to moving expenses described in paragraph (b)(1) of this section. the term *storage expenses* means the cost of storing personal effects of members of the Armed Forces, their spouses, and their dependents.

(5) *Moves of spouses and dependents.* (i) The following special rule applies for purposes of paragraphs (b)(9) and (10) of this section, if the spouse or dependents of a member of the Armed Forces move to or from a different location than does the member. In this case, the spouse is considered to have commenced work as an employee at a new principal place of work that is within the same general location as the location to which the member moves.

(ii) The following special rule applies for purposes of this paragraph to moves by spouses or dependents of members of the Armed Forces who die, are imprisoned, or desert while on active duty. In these cases, a move to a member's place of enlistment or induction or the member's, spouse's, or dependent's home of record or nearer point in the

United States is considered incident to a permanent change of station.

(6) *Disallowance of deduction.* No deduction is allowed under this section for any moving or storage expense reimbursed by an allowance that is excluded from gross income.

(h) *Special rules for foreign moves*—(1) *Increase in limitations.* In the case of a foreign move (as defined in paragraph (h)(3) of this section), paragraph (b)(6) of this section shall be applied by substituting ''90 consecutive'' for ''30 consecutive'' each time it appears. Paragraph (b)(9) (ii), (iii) and (v) of this section shall be applied by substituting ''$6,000'' for ''$3,000'' each time it appears and by substituting ''$4,500'' for ''$1,500'' each time it appears. Paragraph (b)(9)(ii) of this section shall be applied by substituting ''$5,000'' for ''$2,000'' each time it appears and by substituting ''1979'' for ''1977'' and ''1980'' for ''1978'' each time they appear in the last sentence. Paragraph (b)(9)(v) of this section shall be applied by substituting ''$2,250'' for ''$750'' each time it appears. Paragraph (b)(9)(vi) of this section does not apply.

(2) *Allowance of certain storage fees.* In the case of a foreign move, for purposes of this section, the moving expenses described in paragraph (b)(3) of this section shall include the reasonable expenses of moving household goods and personal effects to and from storage, and of storing such goods and effects for part or all of the period during which the new place of work continues to be the taxpayer's principal place of work.

(3) *Foreign move.* For purposes of this paragraph, the term *foreign move* means a move in connection with the commencement of work by the taxpayer at a new principal place of work located outside the United States. Thus, a move from the United States to a foreign country or from one foreign country to another foreign country qualifies as a foreign move. A move within a foreign country also qualifies as a foreign move. A move from a foreign country to the United States does not qualify as a foreign move.

(4) *United States.* For purposes of this paragraph, the term *United States* includes the possessions of the United States.

(5) *Effective date.* The provisions of this paragraph apply to expenses paid or incurred in taxable years beginning after December 31, 1978. The paragraph also applies to the expenses paid or incurred in the taxable year beginning during 1978 of taxpayers who do not make an election pursuant to section 209(c) of the Foreign Earned Income Act of 1978 (Pub. L. 95–615, 92 Stat. 3109) to have section 911 under prior law apply to that taxable year.

(i) *Allowance of deductions in case of retirees or decedents who were working abroad*—(1) *In general.* In the case of any qualified retiree moving expenses or qualified survivor moving expenses, this section (other than paragraph (h)) shall be applied to such expenses as if they were incurred in connection with the commencement of work by the taxpayer as an employee at a new principal place of work located within the United States and the limitations of paragraph (c)(4) of this section (relating to the minimum period of employment) shall not apply.

(2) *Qualified retiree moving expenses.* For purposes of this paragraph, the term *qualified retiree moving expenses* means any moving expenses which are incurred by an individual whose former principal place of work and former residence were outside the United States and which are incurred for a move to a new residence in the United States in connection with the bona fide retirement of the individual. *Bona fide retirement* means the permanent withdrawal from gainful full-time employment and self-employment. An individual who at the time of withdrawal from gainful full-time employment or self-employment, intends the withdrawal to be permanent shall be considered to be a *bona fide retiree* even though the individual ultimately resumes gainful full-time employment or self-employment. An individual's intention may be evidenced by relevant facts and circumstances which include the age and health of the individual, the customary retirement age of employees engaged in similar work, whether the individual is receiving a retirement allowance under a pension annuity, retirement or similar fund or system, and the length of time before resuming full-time employment or self-employment.

(3) *Qualified survivor moving expenses.* (i) For purposes of this paragraph, the term *qualified survivor moving expenses* means any moving expenses:

(A) Which are paid or incurred by the spouse or any dependent (as defined in section 152) of any decedent who (as of the time of his death) had a principal place of work outside the United States, and

(B) Which are incurred for a move which begins within 6 months after the death of the decedent and which is to a residence in the United States from a former residence outside the United States which (as of the time of the decedent's death) was the residence of such decedent and the individual paying or incurring the expense.

(ii) For purposes of paragraph (i)(3)(i) (B) of this section, a move begins when:

(A) The taxpayer contracts for the moving of his or her household goods and personal effects to a residence in the United States but only if the move is completed within a reasonable time thereafter;

(B) The taxpayer's household goods and personal effects are packed and in transit to a residence in the United States; or

(C) The taxpayer leaves the former residence to travel to a new place of residence in the United States.

(4) *United States.* For purposes of this paragraph, the term *United States* includes the possessions of the United States.

(5) *Effective date.* The provisions of this paragraph apply to expenses paid or incurred in taxable years beginning after December 31, 1978. The paragraph also applies to the expenses paid or incurred in the taxable year beginning during 1978 of taxpayers who do not make an election pursuant to section 209(c) of the Foreign Earned Income Act of 1978 (Pub. L. 95–615, 92 Stat. 3109) to have section 911 under prior law apply to that taxable year.

(j) *Effective date*—(1) *In general.* This section, except as provided in subparagraphs (2) and (3) of this paragraph, is applicable to items paid or incurred in taxable years beginning after December 31, 1969.

(2) *Reimbursement not included in gross income.* This section does not apply to items to the extent that the taxpayer received or accrued in a taxable year beginning before January 1, 1970, a reimbursement or other expense allowance for such items which was not included in his gross income.

(3) *Election in cases of expenses paid or incurred before January 1, 1971, in connection with certain moves*—(i) *In general.* A taxpayer who was notified by his employer on or before December 19, 1969, of a transfer to a new principal place of work and who pays or incurs moving expenses after December 31, 1969, but before January 1, 1971, in connection with such transfer may elect to have the rules governing moving expenses in effect prior to the effective date of section 231 of the Tax Reform Act of 1969 (83 Stat. 577) govern such expenses. If such election is made, this section and section 82 and the regulations thereunder do not apply to such expenses. A taxpayer is considered to have been notified on or before December 19, 1969, by his employer of a transfer, for example, if before such date the employer has sent a notice to all employees or a reasonably defined group of employees, which includes such taxpayer, of a relocation of the operations of such employer from one plant or facility to another plant or facility. An employee who is transferred to a new principal place of work for the benefit of his employer and who makes an election under this paragraph is permitted to exclude amounts received or accrued, directly or indirectly, as payment for or reimbursement of expenses of moving household goods and personal effects from the former residence to the new residence and of traveling (including meals and lodging) from the former residence to the new place of residence. Such exclusion is limited to amounts received or accrued, directly or indirectly, as a payment for or reimbursement of the expenses described above. Amounts in excess of actual expenses paid or incurred must be included in gross income. No deduction is allowable under section 217 for expenses representing amounts excluded from gross income. Also, an employee who is transferred to a new principal place of work which is less than 50 miles but at least 20 miles farther from his former residence than was his

former principal place of work and who is not reimbursed, either directly or indirectly, for the expenses described above is permitted to deduct such expenses providing all of the requirements of section 217 and the regulations thereunder prior to the effective date of section 231 of the Tax Reform Act of 1969 (83 Stat. 577) are satisfied.

(ii) *Election made before the date of publication of this notice as a Treasury decision.* An election under this subparagraph made before the date of publication of this notice as a Treasury decision shall be made pursuant to the procedure prescribed in temporary income tax regulations relating to treatment of payments of expenses of moving from one residence to another residence (Part 13 of this chapter) T.D. 7032 (35 FR 4330), approved Mar. 11, 1970.

(iii) *Election made on or after the date of publication of this notice as a Treasury decision.* An election made under this subparagraph on or after the date of publication of this notice as a Treasury decision shall be made not later than the time, including extensions thereof, prescribed by law for filing the income tax return for the year in which the expenses were paid or 30 days after the date of publication of this notice as a Treasury decision, whichever occurs last. The election shall be made by a statement attached to the return (or the amended return) for the taxable year, setting forth the following information:

(a) The items to which the election relates;

(b) The amount of each item;

(c) The date each item was paid or incurred; and

(d) The date the taxpayer was informed by his employer of his transfer to the new principal place of work.

(iv) *Revocation of election.* An election made in accordance with this subparagraph is revocable upon the filing by the taxpayer of an amended return or a claim for refund with the district director, or the director of the Internal Revenue service center with whom the election was filed not later than the time prescribed by law, including extensions thereof, for the filing of a claim for refund with respect to the items to which the election relates.

[T.D. 7195, 37 FR 13535, July 11, 1972, 37 FR 14230, July 18, 1972 as amended by T.D. 7578 43 FR 59355, Dec. 20, 1978; T.D. 7605, 44 FR 18970, Mar. 30, 1979; T.D. 7689, 45 FR 20796, Mar. 31, 1980; T.D. 7810, 47 FR 6003, Feb. 10, 1982; T.D. 8607, 60 FR 40077, Aug. 7, 1995]

§ 1.218–0 Deduction for political and newsletter fund contributions.

See §§ 1.41–0A through 1.41–8A for regulations that apply to section 218.

(Secs. 41(b)(3), 218(b)(2) and (c), and 7805 of the Internal Revenue Code of 1954 (26 U.S.C. 41(b)(3), 218(b)(2), (c), 7805))

[T.D. 7603, 44 FR 18223, Mar. 27, 1979, as amended by T.D. 8251, 54 FR 21204, May 17, 1989]

§ 1.219–1 Deduction for retirement savings.

(a) *In general.* Subject to the limitations and restrictions of paragraph (b) and the special rules of paragraph (c)(3) of this section, there shall be allowed a deduction under section 62 from gross income of amounts paid for the taxable year of an individual on behalf of such individual to an individual retirement account described in section 408(a), for an individual retirement annuity described in section 408(b), or for a retirement bond described in section 409. The deduction described in the preceding sentence shall be allowed only to the individual on whose behalf such individual retirement account, individual retirement annuity, or retirement bond is maintained. The first sentence of this paragraph shall apply only in the case of a contribution of cash. A contribution of property other than cash is not allowable as a deduction under this section. In the case of a retirement bond, a deduction will not be allowed if the bond is redeemed within 12 months of its issue date.

(b) *Limitations and restrictions*—(1) *Maximum deduction.* The amount allowable as a deduction under section 219(a) to an individual for any taxable year cannot exceed an amount equal to 15 percent of the compensation includible in the gross income of the individual for such taxable year, or $1,500, whichever is less.

(2) *Restrictions*—(i) *Individuals covered by certain other plans.* No deduction is

allowable under section 219(a) to an individual for the taxable year if for any part of such year:

(A) He was an active participant in:

(*1*) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a),

(*2*) An annuity plan described in section 403(a),

(*3*) A qualified bond purchase plan described in section 405(a), or

(*4*) A retirement plan established for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing, or

(B) Amounts were contributed by his employer for an annuity contract described in section 403(b) (whether or not the individual's rights in such contract are nonforfeitable).

(ii) *Contributions after age 70½.* No deduction is allowable under section 219 (a) to an individual for the taxable year of the individual, if he has attained the age of 70½ before the close of such taxable year.

(iii) *Rollover contributions.* No deduction is allowable under section 219 for any taxable year of an individual with respect to a rollover contribution described in section 402(a)(5), 402(a)(7), 403(a)(4), 403(b)(8), 408(d)(3), or 409(b)(3)(C).

(3) *Amounts contributed under endowment contracts.* (i) For any taxable year, no deduction is allowable under section 219(a) for amounts paid under an endowment contract described in §1.408–3(e) which is allocable under subdivision (ii) of this subparagraph to the cost of life insurance.

(ii) For any taxable year, the cost of current life insurance protection under an endowment contract described in paragraph (b)(3)(i) of this section is the product of the net premium cost, as determined by the Commissioner, and the excess, if any, of the death benefit payable under the contract during the policy year beginning in the taxable year over the cash value of the contract at the end of such policy year.

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

Example 1. A, an individual who is otherwise entitled to the maximum deduction allowed under section 219, purchases, at age 20, an endowment contract described in §1.408–3(e) which provides for the payment of an annuity of $100 per month, at age 65, with a minimum death benefit of $10,000, and an annual premium of $220. The cash value at the end of the first policy year is 0. The net premium cost, as determined by the Commissioner, for A's age is $1.61 per thousand dollars of life insurance protection. The cost of current life insurance protection is $16.10 ($1.61×10). A's maximum deduction under section 219 with respect to amounts paid under the endowment contract for the taxable year in which the first policy year begins is $203.90 ($220 − $16.10).

Example 2. Assume the same facts as in *Example (1),* except that the cash value at the end of the second policy year is $200 and the net premium cost is $1.67 per thousand for A's age. The cost of current life insurance protection is $16.37 ($1.67×9.8). A's maximum deduction under section 219 with respect to amounts paid under the endowment contract for the taxable year in which the second policy year begins is $203.63 ($220 − $16.37).

(c) *Definitions and special rules*—(1) *Compensation.* For purposes of this section, the term *compensation* means wages, salaries, professional fees, or other amounts derived from or received for personal service actually rendered (including, but not limited to, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, and bonuses) and includes earned income, as defined in section 401 (c) (2), but does not include amounts derived from or received as earnings or profits from property (including, but not limited to, interest and dividends) or amounts not includible in gross income.

(2) *Active participant.* For the definition of active participant, see §1.219–2.

(3) *Special rules.* (i) The maximum deduction allowable under section 219(b)(1) is computed separately for each individual. Thus, if a husband and wife each has compensation of $10,000 for the taxable year and they are each otherwise eligible to contribute to an individual retirement account and they file a joint return, then the maximum amount allowable as a deduction under section 219 is $3,000, the sum of the individual maximums of $1,500. However, if, for example, the husband has compensation of $20,000, the wife has no compensation, each is otherwise eligible to contribute to an individual retirement account for the taxable year,

and they file a joint return, the maximum amount allowable as a deduction under section 219 is $1,500.

(ii) Section 219 is to be applied without regard to any community property laws. Thus, if, for example, a husband and wife, who are otherwise eligible to contribute to an individual retirement account, live in a community property jurisdiction and the husband alone has compensation of $20,000 for the taxable year, then the maximum amount allowable as a deduction under section 219 is $1,500.

(4) *Employer contributions.* For purposes of this chapter, any amount paid by an employer to an individual retirement account or for an individual retirement annuity or retirement bond constitutes the payment of compensation to the employee (other than a self-employed individual who is an employee within the meaning of section 401(c)(1)) includible in his gross income, whether or not a deduction for such payment is allowable under section 219 to such employee after the application of section 219(b). Thus, an employer will be entitled to a deduction for compensation paid to an employee for amounts the employer contributes on the employee's behalf to an individual retirement account, for an individual retirement annuity, or for a retirement bond if such deduction is otherwise allowable under section 162.

[T.D. 7714, 45 FR 52788, Aug. 8, 1980]

§ 1.219–2 Definition of active participant.

(a) *In general.* This section defines the term *active participant* for individuals who participate in retirement plans described in section 219(b)(2). Any individual who is an active participant in such a plan is not allowed a deduction under section 219(a) for contributions to an individual retirement account.

(b) *Defined benefit plans*—(1) *In general.* Except as provided in subparagraphs (2), (3) and (4) of this paragraph, an individual is an active participant in a defined benefit plan if for any portion of the plan year ending with or within such individual's taxable year he is not excluded under the eligibility provisions of the plan. An individual is not an active participant in a particular taxable year merely because the individual meets the plan's eligibility requirements during a plan year beginning in that particular taxable year but ending in a later taxable year of the individual. However, for purposes of this section, an individual is deemed not to satisfy the eligibility provisions for a particular plan year if his compensation is less than the minimum amount of compensation needed under the plan to accrue a benefit. For example, assume a plan is integrated with Social Security and only those individuals whose compensation exceeds a certain amount accrue benefits under the plan. An individual whose compensation for the plan year ending with or within his taxable year is less than the amount necessary under the plan to accrue a benefit is not an active participant in such plan.

(2) *Rules for plans maintained by more than one employer.* In the case of a defined benefit plan described in section 413(a) and funded at least in part by service-related contributions, *e.g.,* so many cents-per-hour, an individual is an active participant if an employer is contributing or is required to contribute to the plan an amount based on that individual's service taken into account for the plan year ending with or within the individual's taxable year. The general rule in paragraph (b)(1) of this section applies in the case of plans described in section 413(a) and funded only on some non-service-related unit, *e.g.*, so many cents-per-ton of coal.

(3) *Plans in which accruals for all participants have ceased.* In the case of a defined benefit plan in which accruals for all participants have ceased, an individual in such a plan is not an active participant. However, any benefit that may vary with future compensation of an individual provides additional accruals. For example, a plan in which future benefit accruals have ceased, but the actual benefit depends upon final average compensation will not be considered as one in which accruals have ceased.

(4) *No accruals after specified age.* An individual in a defined benefit plan who accrues no additional benefits in a plan year ending with or within such individual's taxable year by reason of attaining a specified age is not an active

participant by reason of his participation in that plan.

(c) *Money purchase plan.* An individual is an active participant in a money purchase plan if under the terms of the plan employer contributions must be allocated to the individual's account with respect to the plan year ending with or within the individual's taxable year. This rule applies even if an individual is not employed at any time during the individual's taxable year.

(d) *Profit-sharing and stock-bonus plans*—(1) *In general.* This paragraph applies to profit-sharing and stock bonus plans. An individual is an active participant in such plans in a taxable year if a forfeiture is allocated to his account as of a date in such taxable year. An individual is also an active participant in a taxable year in such plans if an employer contribution is added to the participant's account in such taxable year. A contribution is added to a participant's account as of the later of the following two dates: the date the contribution is made or the date as of which it is allocated. Thus, if a contribution is made in an individual's taxable year 2 and allocated as of a date in individual's taxable year 1, the later of the relevant dates is the date the contribution is made. Consequently, the individual is an active participant in year 2 but not in year 1 as a result of that contribution.

(2) *Special rule.* An individual is not an active participant for a particular taxable year by reason of a contribution made in such year allocated to a previous year if such individual was an active participant in such previous year by reason of a prior contribution that was allocated as of a date in such previous year.

(e) *Employee contributions.* If an employee makes a voluntary or mandatory contribution to a plan described in paragraphs (b), (c), or (d) of this section, such employee is an active participant in the plan for the taxable year in which such contribution is made.

(f) *Certain individuals not active participants.* For purposes of this section, an individual is not an active participant under a plan for any taxable year of such individual for which such individual elects, pursuant to the plan, not to participate in such plan.

(g) *Retirement savings for married individuals.* The provisions of this section apply in determining whether an individual or his spouse is an active participant in a plan for purposes of section 220 (relating to retirement savings for certain married individuals).

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

Example 1. The X Corporation maintains a defined benefit plan which has the following rules on participation and accrual of benefits. Each employee who has attained the age of 25 or has completed one year of service is a participant in the plan. The plan further provides that each participant shall receive upon retirement $12 per month for each year of service in which the employee completes 1,000 hours of service. The plan year is the calendar year. B, a calendar-year taxpayer, enters the plan on January 2, 1980, when he is 27 years of age. Since B has attained the age of 25, he is a participant in the plan. However, B completes less than 1,000 hours of service in 1980 and 1981. Although B is not accruing any benefits under the plan in 1980 and 1981, he is an active participant under section 219(b)(2) because he is a participant in the plan. Thus, B cannot make deductible contributions to an individual retirement arrangement for his taxable years of 1980 and 1981.

Example 2. The Y Corporation maintains a profit-sharing plan for its employees. The plan year of the plan is the calendar year. C is a calendar-year taxpayer and a participant in the plan. On June 30, 1980, the employer makes a contribution for 1980 which as allocated on July 31, 1980. In 1981 the employer makes a second contribution for 1980, allocated as of December 31, 1980. Under the general rule stated in §1.219–2(d)(1), C is an active participant in 1980. Under the special rule stated in §1.219–2(d)(2), however, C is not an active participant in 1981 by reason of that contribution made in 1981.

(i) *Effective date.* The provisions set forth in this section are effective for taxable years beginning after December 31, 1978.

[T.D. 7714, 45 FR 52789, Aug. 8, 1980]

Special Deductions for Corporations

§1.241–1 Allowance of special deductions.

A corporation, in computing its taxable income, is allowed as deductions the items specified in Part VIII (section 242 and following), Subchapter B, Chapter 1 of the Code, in addition to the deductions provided in part VI (section 161 and following) Subchapter B, Chapter 1 of the Code.

§1.242–1 Deduction for partially tax-exempt interest.

A corporation is allowed a deduction under section 242(a) in an amount equal to certain interest received on obligations of the United States, or an obligation of corporations organized under Acts of Congress which are instrumentalities of the United States. The interest for which a deduction shall be allowed is interest which is included in gross income and which is exempt from normal tax under the act, as amended and supplemented, which authorized the issuance of the obligations. The deduction allowed by section 242(a) is allowed only for the purpose of computing normal tax, and therefore, no deduction is allowed for such interest in the computation of any surtax imposed by Subtitle A of the Internal Revenue Code of 1954.

[T.D. 7100, 36 FR 5333, Mar. 20, 1971]

§1.243–1 Deduction for dividends received by corporations.

(a)(1) A corporation is allowed a deduction under section 243 for dividends received from a domestic corporation which is subject to taxation under Chapter 1 of the Internal Revenue Code of 1954.

(2) Except as provided in section 243(c) and in section 246, the deduction is:

(i) For the taxable year, an amount equal to 85 percent of the dividends received from such domestic corporations during the taxable year (other than dividends to which subdivision (ii) or (iii) of this subparagraph applies).

(ii) For a taxable year beginning after September 2, 1958, an amount equal to 100 percent of the dividends received from such domestic corporations if at the time of receipt of such dividends the recipient corporation is a Federal licensee under the Small Business Investment Act of 1958 (15 U.S.C. ch. 14B). However, to claim the deduction provided by section 243(a)(2) the company must file with its return a statement that it was a Federal licensee under the Small Business Investment Act of 1958 at the time of the receipt of the dividends.

(iii) For a taxable year ending after December 31, 1963, an amount equal to 100 percent of the dividends received which are *qualifying dividends,* as defined in section 243(b) and §1.243–4.

(3) To determine the amount of the distribution to a recipient corporation and the amount of the dividend, see §§1.301–1 and 1.316–1.

(b) For limitation on the dividends received deduction, see section 246 and the regulations thereunder.

[T.D. 6992, 34 FR 817, Jan. 18, 1969]

§1.243–2 Special rules for certain distributions.

(a) *Dividends paid by mutual savings banks, etc.* In determining the deduction provided in section 243(a), any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, cooperative banks, and domestic building and loan associations) shall not be considered as a dividend.

(b) *Dividends received from regulated investment companies.* In determining the deduction provided in section 243(a), dividends received from a regulated investment company shall be subject to the limitations provided in section 854.

(c) *Dividends received from real estate investment trusts.* See section 857(c) and paragraph (d) of §1.857–6 for special rules which deny a deduction under section 243 in the case of dividends received from a real estate investment trust with respect to a taxable year for which such trust is taxable under Part II, Subchapter M, Chapter 1 of the Code.

(d) *Dividends received on preferred stock of a public utility.* The deduction allowed by section 243(a) shall be determined without regard to any dividends described in section 244 (relating to dividends on the preferred stock of a public utility). That is, such deduction shall be determined without regard to any dividends received on the preferred stock of a public utility which is subject to taxation under Chapter 1 of the Code and with respect to which a deduction is allowed by section 247 (relating to dividends paid on certain preferred stock of public utilities). For a deduction with respect to such dividends received on the preferred stock of a public utility, see section 244. If a deduction for dividends paid is not allowable to the distributing corporation under section 247 with respect to the dividends on its preferred stock, such dividends received from a domestic public utility corporation subject to taxation under Chapter 1 of the Code are includible in determining the deduction allowed by section 243(a).

[T.D. 6598, 27 FR 4092, Apr. 28, 1962, as amended by T.D. 6992, 34 FR 817, Jan. 18, 1969; T.D. 7767, 46 FR 11264, Feb. 6, 1981]

§1.243–3 Certain dividends from foreign corporations.

(a) *In general.* (1) In determining the deduction provided in section 243(a), section 243(d) provides that a dividend received from a foreign corporation after December 31, 1959, shall be treated as a dividend from a domestic corporation which is subject to taxation under chapter 1 of the Code, but only to the extent that such dividend is out of earnings and profits accumulated by a domestic corporation during a period with respect to which such domestic corporation was subject to taxation under Chapter 1 of the Code (or corresponding provisions of prior law). Thus, for example, if a domestic corporation accumulates earnings and profits during a period or periods with respect to which it is subject to taxation under Chapter 1 of the Code (or corresponding provisions of prior law) and subsequently such domestic corporation reincorporates in a foreign country, any dividends paid out of such earnings and profits after such reincorporation are eligible for the deduction provided in section 243(a) (1) and (2).

(2) Section 243(d) and this section do not apply to dividends paid out of earnings and profits accumulated (i) by a corporation organized under the China Trade Act, 1922, (ii) by a domestic corporation during any period with respect to which such corporation was exempt from taxation under section 501 (relating to certain charitable, etc. organizations) or 521 (relating to farmers' cooperative associations), or (iii) by a domestic corporation during any period to which section 931 (relating to income from sources within possessions of the United States) applied.

(b) *Establishing separate earnings and profits accounts.* A foreign corporation shall, for purposes of section 243(d), maintain a separate account for earnings and profits to which it succeeds which were accumulated by a domestic corporation, and such foreign corporation shall treat such earnings and profits as having been accumulated during the accounting periods in which earned by such domestic corporation. Such foreign corporation shall also maintain such a separate account for the earnings and profits, or deficit in earnings and profits, accumulated by it or accumulated by any other corporations to the earnings and profits of which it succeeds.

(c) *Effect of dividends on earnings and profits accounts.* Dividends paid out of the accumulated earnings and profits (see section 316(a)(1) of such foreign corporation shall be treated as having been paid out of the most recently accumulated earnings and profits of such corporation. A deficit in an earnings and profits account for any accounting period shall reduce the most recently accumulated earnings and profits for a prior accounting period in such account. If there are no accumulated earnings and profits in an earnings and profits account because of a deficit incurred in a prior accounting period, such deficit must be restored before earnings and profits can be accumulated in a subsequent accounting period. If a dividend is paid out of earnings and profits of a foreign corporation which maintains two or more accounts (established under the provisions of paragraph (b) of this section) with respect to two or more accounting periods ending on the same day, then the portion of such dividend considered as paid out of each account shall be the same proportion of the total dividend as the amount of earnings and profits in that account bears to the sum of the earnings and profits in all such accounts.

(d) *Illustration.* The application of the principles of this section in the determination of the amount of the dividends received deduction may be illustrated by the following example:

Example. On December 31, 1960, corporation X, a calendar-year corporation organized in the United States on January 1, 1958, consolidated with corporation Y, a foreign corporation organized on January 1, 1958, which used an annual accounting period based on the calendar year, to form corporation Z, a foreign corporation not engaged in trade or business within the United States. Corporation Z is a wholly-owned subsidiary of corporation M, a domestic corporation. On January 1, 1961, corporation Z's accumulated earnings and profits of $31,000 are, under the provisions of paragraph (b) of this section, maintained in separate earnings and profits accounts containing the following amounts:

Earnings and profits accumulated for—	Domestic corp. X	Foreign corp. Y
1958	($1,000)	$11,000
1959	10,000	9,000
1960	5,000	(3,000)

Corporation Z had earnings and profits of $10,000 in each of the years 1961, 1962, and 1963 and makes distributions with respect to its stock to corporation M for such years in the following amounts:

1961	$14,000
1962	23,000
1963	16,000

(1) For 1961, a deduction of $3,400 is allowable to M with respect to the $14,000 distribution from Z, computed as follows:

(i) Dividend from current year earnings and profits (1961)	$10,000
(ii) Dividend from earnings and profits of corporation X accumulated for 1960	4,000
(iii) Deduction: 85 percent of $4,000 (the amount distributed from the accumulated earnings and profits of corporation X)	3,400

(2) For 1962, a deduction of $6,970 is allowable to corporation M with respect to the $23,000 distribution from corporation Z, computed as follows:

(i) Dividend from current year earnings and profits (1962)		$10,000
(ii) Dividend from earnings and profits of corporation X accumulated for:		
1960	$1,000	
1959: $9,000 (i.e., $10,000 − $1,000) divided by $15,000 (i.e., $9,000+$9,000 − $3,000) multiplied by $12,000 (i.e., $23,000 − $11,000)		7,200
Total	8,200	
(iii) Dividend from earnings and profits of corporation Y accumulated for:		
1959: $6,000/$15,000×$12,000		4,800
(iv) Deduction: 85 percent of $8,200 (the amount distributed from the accumulated earnings and profits of corporation X)		6,970

(3) For 1963, a deduction of $1,530 is allowable to M with respect to the $16,000 distribution from Z, computed as follows:

(i) Dividend from current year earnings and profits (1963)	$10,000
(ii) Dividend from earnings and profits of corporation X accumulated for 1959:	
Earnings and profits remaining after 1962 distribution (i.e., $9,000 − $7,200)	1,800
(iii) Dividend from earnings and profits of corporation Y accumulated for 1959:	
Earnings and profits remaining after 1962 distribution (i.e., $6,000 − $4,800)	1,200
1958	8,000
(iv) Deduction: 85 percent of $1,800 (the amount distributed from the accumulated earnings and profits of corporation X)	1,530

[T.D. 6830, 30 FR 8045, June 23, 1965]

§ 1.243–4 Qualifying dividends.

(a) *Definition of qualifying dividends*—(1) *General.* For purposes of section 243(a)(3), the term *qualifying dividends* means dividends received by a corporation if:

(i) At the close of the day the dividends are received, such corporation is a member of the same affiliated group of corporations (as defined in paragraph (b) of this section) as the corporation distributing the dividends,

(ii) An election by such affiilated group under section 243(b)(2) and paragraph (c) of this section is effective for the taxable years of its members which include such day, and

(iii) The dividends are distributed out of earnings and profits specified in subparagraph (2) of this paragraph.

(2) *Earnings and profits.* The earnings and profits specified in this subparagraph are earnings and profits of a taxable year of the distributing corporation (or a predecessor corporation) which satisfies each of the following conditions:

(i) Such year must end after December 31, 1963;

(ii) On each day of such year the distributing corporation (or the predecessor corporation) and the corporation receiving the dividends must have been members of the affiliated group of which the distributing corporation and the corporation receiving the dividends are members on the day the dividends are received; and

(iii) An election under section 1562 (relating to the election of multiple surtax exmptions) was never effective (or is no longer effective pursuant to section 1562(c)) for such year.

(3) *Special rule for insurance companies.* Notwithstanding the provisions of

subparagraph (2) of this paragraph, if an insurance company subject to taxation under section 802 or 821 distributes a dividend out of earnings and profits of a taxable year with respect to which the company would have been a component member of a controlled group of corporations within the meaning of section 1563 were it not for the application of section 1563(b)(2)(D), such dividend shall not be treated as a qualifying dividend unless an election under section 243(b)(2) is effective for such taxable year.

(4) *Predecessor corporations.* For purposes of this paragraph, a corporation shall be considered to be a predecessor corporation with respect to a distributing corporation if the distributing corporation succeeds to the earnings and profits of such corporation, for example, as the result of a transaction to which section 381(a) applies. A distributing corporation shall, for purposes of this section, maintain, in respect of each predecessor corporation, a separate account for earnings and profits to which it succeeds, and such earnings and profits shall be considered to be earnings and profits of the predecessor's taxable year in which the earnings and profits were accumulated.

(5) *Mere change in form.* (i) For purposes of subparagraph (2)(ii) of this paragraph, the affiliated group in existence during the taxable year out of the earnings and profits of which the dividend is distributed shall not be considered as a different group from that in existence on the day on which the dividend is received merely because:

(a) The common parent corporation has undergone a mere change in identity, form, or place of organization (within the meaning of section 368(a)(1)(F)), or

(b) A newly organized corporation (the ‘‘acquiring corporation’’) has acquired substantially all of the outstanding stock of the common parent corporation (the ‘‘acquired corporation’’) solely in exchange for stock of such acquiring corporation, and the stockholders (immediately before the acquisition) of the acquired corporation, as a result of owning stock of the acquired corporation, own (immediately after the acquisition) all of the outstanding stock of the acquiring corporation.

If a transaction described in the preceding sentence has occurred, the acquiring corporation shall be treated as having been a member of the affiliated group for the entire period during which the acquired corporation was a member of such group.

(ii) For purposes of subdivision (i) (b) of this subparagraph, if immediately before the acquisition:

(a) The stockholders of the acquired corporation also owned all of the outstanding stock of another corporation (the ‘‘second corporation’’), and

(b) Stock of the acquired corporation and of the second corporation could be acquired or transferred only as a unit (hereinafter referred to as the ‘‘limitation on transferability’’), then the second corporation shall be treated as an acquired corporation and such second corporation shall be treated as having been a member of the affiliated group for the entire period (while such group was in existence) during which the limitation on transferability was in existence, and if the second corporation is itself the common parent corporation of an affiliated group (the ‘‘second group’’) any other member of the second group shall be treated as having been a member of the affiliated group for the entire period during which it was a member of the second group while the limitation on transferability existed. For purposes of *(a)* of this subdivision and subdivision (i)*(b)* of this subparagraph, if the limitation on transferability of stock of the acquired corporation and the second corporation is achieved by using a voting trust, then the stock owned by the trust shall be considered as owned by the holders of the beneficial interests in the trust.

(6) *Source of distributions.* In determining from what year's earnings and profits a dividend is treated as having been distributed for purposes of this section, the principles of paragraph (a) of §1.316–2 shall apply. A dividend shall be considered to be distributed, first, out of the earnings and profits of the taxable year which includes the date the dividend is distributed, second, out of the earnings and profits accumulated for the immediately preceding taxable year, third, out of the earnings

and profits accumulated for the second preceding taxable year, etc. A deficit in an earnings and profits account for any taxable year shall reduce the most recently accumulated earnings and profits for a prior year in such account. If there are no accumulated earnings and profits in an earnings and profits account because of a deficit incurred in a prior year, such deficit must be restored before earnings and profits can be accumulated in a subsequent year. If a dividend is distributed out of separate earnings and profits accounts (established under the provisions of subparagraph (4) of this paragraph) for two or more taxable years ending on the same day, then the portion of such dividend considered as distributed out of each account shall be the same proportion of the total dividend as the amount of earnings and profits in that account bears to the sum of the earnings and profits in all such accounts.

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

Example 1. On March 1, 1965, corporation P, a publicly owned corporation, acquires all of the stock of corporation S and continues to hold the stock throughout the remainder of 1965 and all of 1966. P and S are domestic corporations which file separate returns on the basis of a calendar year. The affiliated group consisting of P and S makes an election under section 243(b)(2) which is effective for the 1966 taxable years of P and S. A multiple surtax exemption election under section 1562 is not effective for their 1965 taxable years. On February 1, 1966, S distributes $50,000 with respect to its stock which is received by P on the same date. S had earnings and profits of $40,000 for 1966 (computed without regard to distributions during 1966). S also had earnings and profits accumulated for 1965 of $70,000. Since $40,000 was distributed out of earnings and profits for 1966 and since each of the conditions prescribed in subparagraphs (1) and (2) of this paragraph is satisfied, P is entitled to a 100-percent dividends received deduction with respect to $40,000 of the $50,000 distribution. However, since $10,000 was distributed out of earnings and profits accumulated for 1965, and since on each day of 1965 S and P were not members of the affiliated group of which S and P were members on February 1, 1966, $10,000 of the $50,000 distribution does not satisfy the condition specified in subparagraph (2)(ii) of this paragraph and thus does not qualify for the 100-percent dividends received deduction.

Example 2. Assume the same facts as in *Example (1),* except that corporation P acquires all the stock of corporation S on January 1, 1965, and sells such stock on November 1, 1966. Since $10,000 is distributed out of earnings and profits for 1965, and since each of the conditions prescribed in subparagraphs (1) and (2) of this paragraph is satisfied, P is entitled to a 100-percent dividends received deduction with respect to $10,000 of the $50,000 distribution. However, since $40,000 of the $50,000 distribution was made out of earnings and profits of S for its 1966 taxable year, and on each day of such year S and P were not members of the affiliated group of which S and P were members on February 1, 1966, $40,000 of the distribution does not satisfy the condition specified in subparagraph (2)(ii) of this paragraph and thus does not qualify for the 100-percent dividends received deduction.

Example 3. Assume the same facts as in *Example (1),* except that corporation P acquires all the stock of corporation S on January 1, 1965, and that a multiple surtax exemption election under section 1562 is effective for P's and S's 1965 taxable years. Further assume that the section 1562 election is terminated effective with respect to their 1966 taxable years, and that an election under section 243(b) (2) is effective for such taxable years. Since $10,000 of the February 1, 1966, distribution was made out of earnings and profits of S for its 1965 taxable year and since a multiple surtax exemption election is effective for such year, $10,000 of the distribution does not satisfy the condition specified in subparagraph (2) (iii) of this paragraph and thus does not qualify for the 100-percent dividends received deduction. However, the portion of the distribution which was distributed out of earnings and profits of S's 1966 year ($40,000) qualifies for the 100-percent dividends received deduction.

Example 4. Assume the same facts as in *Example (1),* except that corporation P acquires all the stock of corporation S on January 1, 1965, and that S is a life insurance company subject to taxation under section 802. Accordingly, S would have been a member of a controlled group of corporations except for the application of section 1563(b)(2)(D). Since $10,000 of the distribution was made out of earnings and profits of S for its 1965 taxable year, and since with respect to such year an election under section 243(b)(2) was not effective, $10,000 of the distribution is not a qualifying dividend by reason of subparagraph (3) of this paragraph. On the other hand, the portion of the distribution which was distributed out of earnings and profits for S's 1966 year ($40,000) does qualify for the 100-percent dividends received deduction because the distribution was out of earnings and profits of a year for which an election under section 243(b) (2) is effective, and because the other conditions specified in subparagraphs (1) and (2) of this paragraph are satisfied. However, if P were also a life insurance company subject to taxation under section 802, then subparagraph (3) of this paragraph would not result in the disqualification of the portion of the distribution made out of S's 1965 earnings and profits because S would be a component member of an insurance group of corporations (as defined in section 1563(a)(4)), consisting of P and S, with respect to its 1965 year.

Example 5. Corporation X owns all the stock of corporation Y from January 1, 1965, through December 31, 1969. X and Y are domestic corporations which file separate returns on the basis of a calendar year. On June 30, 1965, Y acquired all the stock of domestic corporation Z, a calendar year taxpayer, and on December 31, 1967, Y acquired the assets of Z in a transaction to which section 381(a) applied. A multiple surtax exemption election under section 1562, was not effective for any taxable year of X, Y, or Z, and an election under section 243(b)(2) is effective for the 1968 and 1969 taxable years of X and Y. On January 1, 1968, Y's accumulated earnings and profits are, under the provisions of subparagraph (4) of this paragraph, maintained in separate earnings and profits accounts containing the following amounts:

Earnings and profits accumulated for	Corp	Corp
	Y	Z
1964	$60,000	$40,000
1965	30,000	15,000
1966	(5,000)	2,000
1967	12,000	6,000

Corporation Y had earnings and profits of $10,000 in each of the years 1968 and 1969, and made distributions during such years in the following amounts:

1968	$29,000
1969	31,000

(i) The source of the 1968 distribution, determined in accordance with the rules of subparagraph (6) of this paragraph, is as follows:

(a) Dividend from Y's current year's earnings and profits (1968)	$10,000
(b) Dividend from earnings and profits of Y accumulated for 1967	12,000
(c) Dividend from earnings and profits of Z accumulated for:.	
1967	6,000
1966	1,000
	29,000

Since the 1968 dividend is considered paid out of earnings and profits of Y's 1968 and 1967 years, and Z's 1967 and 1966 years, and since each of these years satisfies each of the conditions specified in subparagraph (2) of this paragraph, X is entitled to a 100-percent dividends received deduction with respect to the entire 1968 distribution of $29,000 from Y.

(ii) The source of the 1969 distribution of $31,000, determined in accordance with the rules of subparagraph (6) of this paragraph, is as follows:

(*a*) Dividend from Y's current year's earnings and profits (1969)	$10,000
(*b*) Dividend from earnings and profits of Z accumulated for 1966 (1966 earnings and profits remaining after 1968 distribution, i.e., $2,000 − $1,000	1,000
(*c*) Dividend from earnings and profits of Y and Z accumulated for 1965:	
Corporation Y: $25,000 (i.e., $30,000 − $5,000 deficit) divided by $40,000 (i.e., the sum of the 1965 earnings and profits of Y and Z) multiplied by $20,000 (the portion of the distribution from the 1965 earnings and profits of Y and Z)	12,500
Corporation Z: $15,000 divided by $40,000 multiplied by $20,000	7,500
	31,000

The sum of the dividends from Y's 1969 year ($10,000), Z's 1966 year ($1,000), and Y's 1965 year ($12,500), or $23,500, qualifies for the 100-percent dividends received deduction. However, the dividends paid out of Z's 1965 year ($7,500) do not qualify because on each day of 1965 Z and X were not members of the affiliated group of which Y (the distributing corporation) and X (the corporation receiving the dividends) were members on the day in 1969 when the dividends were received by X.

(b) *Definition of affiliated group.* For purposes of this section and §1.243–5, the term *affiliated group* shall have the meaning assigned to it by section 1504(a), except that insurance companies subject to taxation under section 802 or 821 shall be treated as includible corporations (notwithstanding section 1504(b)(2)), and the provisions of section 1504(c) shall not apply.

(c) *Election*—(1) *Manner and time of making election*—(i) *General.* The election provided by section 243(b)(2) shall be made for an affiliated group by the common parent corporation and shall be made for a particular taxable year of the common parent corporation. Such election may not be made for any taxable year of the common parent corporation for which a multiple surtax exemption election under section 1562 is effective. The election shall be made by means of a statement, signed by any person who is duly authorized to act on behalf of the common parent corporation, stating that the affiliated group elects under section 243(b)(2) for such taxable year. The statement shall be filed with the district director for the internal revenue district in which is located the principal place of business or principal office or agency of the common parent. The statement shall set forth the name, address, taxpayer account number, and taxable year of each corporation (including wholly-owned subsidiaries) that is a member of the affiliated group at the time the election is filed. The statement may be filed at any time, provided that, with respect to each corporation the tax liability of which for its matching taxable year of election (or for any subsequent taxable year) would be increased because of the election, at the time of filing there is at least 1 year remaining in the statutory period (including any extensions thereof) for the assessment of a deficiency against such corporation for such year. (If there is less than 1 year remaining with respect to any taxable year, the district director for the internal revenue district in which is located the principal place of business or principal office or agency of the corporation will ordinarily, upon request, enter into an agreement to extend such statutory period for assessment and collection of deficiencies.

(ii) *Information statement by common parent.* If a corporation becomes a member of the affiliated group after the date on which the election is filed and during its matching taxable year of election, then the common parent shall file, within 60 days after such corporation becomes a member of the affiliated group, an additional statement containing the name, address, taxpayer account number, and taxable year of such corporation. Such additional statement shall be filed with the internal revenue officer with whom the election was filed.

(iii) *Definition of matching taxable year of election.* For purposes of this paragraph and paragraphs (d) and (e) of this section, the term *matching taxable year of election* shall mean the taxable year of each member (including the common parent corporation) of the electing affiliated group which includes the last day of the taxable year of the common parent corporation for which an election by the affiiliated group is made under section 243(b)(2).

(2) *Consents by subsidiary corporations*—(i) *General.* Each corporation (other than the common parent corporation) which is a member of the electing affiliated group (including any member which joins in the filing of a consolidated return) at any time during its matching taxable year of election must consent to such election in the manner and time provided in subdivision (ii) or (iii) of this subparagraph, whichever is applicable.

(ii) *Wholly owned subsidiary.* If all of the stock of a corporation is owned by a member or members of the affiliated group on each day of such corporation's matching taxable year of election, then such corporation (referred to in this paragraph as a ''wholly owned subsidiary'') shall be deemed to consent to such election.

(iii) *Other members.* The consent of each member of the affiliated group (other than a wholly owned subsidiary) shall be made by means of a statement, signed by any person who is duly authorized to act on behalf of the consenting member, stating that such member consents to the election under section 243(b)(2). The statement shall set forth the name, address, taxpayer account number, and taxable year of the consenting member and of the common parent corporation, and in the case of a statement filed after December 31, 1968, the identity of the internal revenue district in which is located the principal place of business or principal office or agency of the common parent corporation. The consent of more than one such member may be incorporated in a single statement. The statement (or statements) shall be attached to the election filed by the common parent corporation. The consent of a corporation that, after the date the election was filed and during its matching taxable year of election, either *(a)* becomes a member, or *(b)* ceases to be a wholly owned subsidiary but continues to be a member, shall be filed with the internal revenue officer with whom the election was filed and shall be filed on or before the date prescribed by law (including extensions of time) for the filing of the consenting member's income tax return for such taxable year, or on or before June 10, 1964, whichever is later.

(iv) *Statement attached to return.* Each corporation that consents to an election by means of a statement described in subdivision (iii) of this subparagraph should attach a copy of the statement to its income tax return for its matching taxable year of election, or, if such return has already been filed, to its first income tax return filed on or after the date on which the statement is filed. However, if such return is filed on or before June 10, 1964, a copy of such statement should be filed on or before June 10, 1964, with the district director with whom such return is filed. Each wholly owned subsidiary should attach a statement to its income tax return for its matching taxable year of election, or, if such return has already been filed, to its first income tax return filed on or after the date on which the statement is filed stating that it is subject to an election under section 243(b)(2) and the taxable year to which the election applies, and setting forth the name, address, taxpayer account number, and taxable year of the common parent corporation, and in the case of a statement filed after December 31, 1968, the identity of the internal revenue district in which is located the principal place of business or principal office or agency of the common parent corporation. However, if the due date for such return (including extensions of time) is before June 10, 1964, such statement should be filed on or before June 10, 1964, with the district director with whom such return is filed.

(3) *Information statement by member.* If a corporation becomes a member of the affiliated group during a taxable year that begins after the last day of the common parent corporation's matching taxable year of election, then (unless such election has been terminated) such corporation should attach a statement to its income tax return for such taxable year stating that it is subject to an election under section 243(b)(2) for such taxable year and setting forth the name, address, taxpayer account number, and taxable year of the common parent corporation, and the identity of the internal revenue district in which is located the principal place of business or principal office or agency of the common parent corporation. In the case of an affiliated group that made an election under the rules provided in Treasury Decision 6721, approved April 8, 1964 (29 FR 4997, C.B. 1964–1 (Part 1), 625), such statement shall be filed, on or before March 15, 1969, with the district director for the internal revenue district in which is located such member's principal place of business or principal office or agency.

(4) *Years for which election effective*—(i) *General rule.* An election under section 243(b)(2) by an affiliated group shall be effective:

(a) In the case of each corporation which is a member of such group at any time during its matching taxable year of election, for such taxable year, and

(b) In the case of each corporation which is a member of such group at any time during a taxable year ending after the last day of the common parent's taxable year of election but which does not include such last day, for such taxable year, unless the election is terminated under section 243(b)(4) and paragraph (e) of this section. Thus, the election has a continuing effect and need not be renewed annually.

(ii) *Special rule for certain taxable years ending in 1964.* In the case of a taxable year of a member (other than the common parent corporation) of the affiliated group *(a)* which begins in 1963 and ends in 1964, and *(b)* for which an election is not effective under subdivision (i)*(a)* of this subparagraph, if an election under section 243(b)(2) is effective for the taxable year of the common parent corporation which includes the last day of such taxable year of such member, then such election shall be effective for such taxable year of such member if such member files a separate consent with respect to such taxable year. However, in order for a dividend distributed by such member during such taxable year to meet the requirements of section 243(b)(1), an election under section 243(b)(2) must be effective for the taxable year of each member of the affiliated group which includes the date such dividend is received. See section 243(b)(1)(A) and paragraph (a)(1) of this section. Accordingly, if the dividend is to qualify for the 100-percent dividends received deduction under section 243(a)(3), a consent must be filed under this subdivision by each member of the affiliated group with respect to its taxable year which includes the day the dividend is received (unless an election is effective for such taxable year under subdivision (i)*(a)* of this subparagraph). For purposes of this subdivision, a consent shall be made by means of a statement meeting the requirements of subparagraph (2)(iii) of this paragraph, and shall be attached to the election made by the common parent corporation for its taxable year which includes the last day of the taxable year of the member with respect to which the consent is made. A copy of the statement should be filed, within 60 days after such election is filed by the common parent corporation, with the district director with whom the consenting member filed its income tax return for such taxable year.

(iii) *Examples.* The provisions of subdivision (ii) of this subparagraph, relating to the special rule for certain taxable years ending in 1964, may be illustrated by the following examples:

Example 1. P Corporation owns all the stock of S–1 Corporation on each day of 1963, 1964, and 1965. P uses the calendar year as its taxable year and S–1 uses a fiscal year ending June 30 as its taxable year. P makes an election under section 243(b)(2) for 1964. Since S–1 is a wholly owned subsidiary for its taxable year ending June 30, 1965, it is deemed to consent to the election. However, in order for the election to be effective with respect to S–1's taxable year ending June 30, 1964, a statement specifying that S–1 consents to the election with respect to such taxable year and containing the information required in a statement of consent under subparagraph (2)(iii) of this paragraph must be attached to the election.

Example 2. Assume the same facts as in *Example (1),* except that P also owns all the stock of S–2 Corporation on each day of 1963, 1964, and 1965. S–2 uses a fiscal year ending May 31 as its taxable year. If S–1 distributes a dividend to P on January 15, 1964, the dividend may qualify under section 243(a)(3) only if S–1 and S–2 both consent to the election made by P for 1964 with respect to their taxable years ending in 1964.

Example 3. Assume the same facts as in *Example (1),* except that P uses a fiscal year ending on January 31 as its taxable year and makes an election under subparagraph (1) of this paragraph for its taxable year ending January 31, 1964. Since S–1's taxable year beginning in 1963 and ending in 1964 includes January 31, 1964, the last day of P's taxable year for which the election was made, the election is effective under subdivision (i)*(a)* of this subparagraph, for S–1's taxable year ending June 30, 1964. Accordingly, the special rule of subdivision (ii) of this subparagraph has no application.

(d) *Effect of election.* For restrictions and limitations applicable to corporations which are members of an electing affiliated group on each day of their taxable years, see § 1.243–5.

(e) *Termination of election*—(1) *In general.* An election under section 243(b)(2) by an affiliated group may be terminated with respect to any taxable year of the common parent corporation after the matching taxable year of election of the common parent corporation. The election is terminated as a result of one of the occurrences described in subparagraph (2) or (3) of this paragraph. For years affected by termination, see subparagraph (4) of this paragraph.

(2) *Consent of members*—(i) *General.* An election may be terminated for an affiliated group by its common parent corporation with respect to a taxable year of the common parent corporation provided each corporation (other than the common parent) that was a member of the affiliated group at any time during its taxable year that includes the last day of such year of the common parent (the ''matching taxable year of termination'') consents to such termination. The statement of termination may be filed by the common parent corporation at any time, provided that, with respect to each corporation the tax liability of which for its matching taxable year of termination (or for any subsequent taxable year) would be increased because of the termination, at the time of filing there is at least 1 year remaining in the statutory period (including any extensions thereof) for the assessment of a deficiency against such corporation for such year. (If there is less than 1 year remaining with respect to any taxable year, the district director for the internal revenue district in which is located the principal place of business or principal office or agency of the corporation will ordinarily, upon request, enter into agreement to extend such statutory period for assessment and collection of deficiencies.)

(ii) *Statements filed after December 31, 1968.* With respect to statements of termination filed after December 31, 1968:

(a) The statement shall be filed with the district director for the internal revenue district in which is located the principal place of business or principal office or agency of the common parent corporation;

(b) The statement shall be signed by any person who is duly authorized to act on behalf of the common parent corporation and shall state that the affiliated group terminates the election under section 243(b)(2) for such taxable year;

(c) The statement shall set forth the name, address, taxpayer account number, and taxable year of each corporation (including wholly owned subsidiaries) which is a member of the affiliated group at the time the termination is filed; and

(d) The consents to the termination shall be given in accordance with the rules prescribed in paragraph (c)(2) of this section, relating to manner and time for giving consents to an election under section 243(b)(2).

(3) *Refusal by new member to consent*—(i) *Manner of giving refusal.* If any corporation which is a new member of an affiliated group with respect to a taxable year of the common parent corporation (other than the matching taxable year of election of the common parent corporation) files a statement that it does not consent to an election under section 243(b)(2) with respect to such taxable year, then such election shall terminate with respect to such taxable year. Such statement shall be signed by any person who is duly authorized to act on behalf of the new member, and shall be filed with the timely filed income tax return of such new member for its taxable year within which falls the last day of such taxable year of the common parent corporation. In the event of a termination under this subparagraph, each corporation (other than such new member) that is a member of the affiliated group at any time during its taxable year which includes such last day should, within 30 days after such new member files the statement of refusal to consent, notify the district director of such termination. Such notification should be filed with the district director for the internal revenue district in which is located the principal place of business or principal office or agency of the corporation.

(ii) *Corporation considered as new member.* For purposes of subdivision (i) of this subparagraph, a corporation shall be considered to be a new member of an affiliated group of corporations with respect to a taxable year of the common parent corporation if such corporation:

(a) Is a member of the affiliated group at any time during such taxable year of the common parent corporation, and

(b) Was not a member of the affiliated group at any time during the common parent corporation's immediately preceding taxable year.

(4) *Effect of termination.* A termination under subparagraph (2) or (3) of this paragraph is effective with respect to (i) the common parent corporation's taxable year referred to in the particular subparagraph under which the termination occurs, and (ii) the taxable years of the other members of the affiliated group which include the last day of such taxable year of the common parent. An election, once terminated, is no longer effective. Accordingly, the termination is also effective with respect to the succeeding taxable years of the members of the group. However, the affiliated group may make a new election in accordance with the provisions of section 243(b)(2) and paragraph (c) of this section.

[T.D. 6992, 34 FR 817, Jan. 18, 1969]

§1.243–5 Effect of election.

(a) *General*—(1) *Corporations subject to restrictions and limitations.* If an election by an affiliated group under section 243(b)(2) is effective with respect to a taxable year of the common parent corporation, then each corporation (including the common parent corporation) which is a member of such group on each day of its matching taxable year shall be subject to the restrictions and limitations prescribed by paragraphs (b), (c), and (d) of this section for such taxable year. For purposes of this section, the term *matching taxable year* shall mean the taxable year of each member (including the common parent corporation) of an affiliated group which includes the last day of a particular taxable year of the common parent corporation for which an election by the affiliated group under section 243(b)(2) is effective. If a corporation is a member of an affiliated group on each day of a short taxable year which does not include the last day of a taxable year of the common parent corporation, and if an election under section 243(b)(2) is effective for such short year, see paragraph (g) of this section. In the case of taxable years beginning in 1963 and ending in 1964 for which an election under section 243(b)(2) is effective under paragraph (c)(4)(ii) of § 1.243–4, see paragraph (f)(9) of this section.

(2) *Members filing consolidated returns.* The restrictions and limitations prescribed by this section shall apply notwithstanding the fact that some of the corporations which are members of the electing affiliated group (within the meaning of section 243(b)(5)) join in the filing of a consolidated return. Thus, for example, if an electing affiliated group includes one or more corporations taxable under section 11 of the Code and two or more insurance companies taxable under section 802 of the Code, and if the insurance companies join in the filing of a consolidated return, the amount of such companies' exemptions from estimated tax (for purposes of sections 6016 and 6655) shall be the amounts determined under paragraph (d)(5) of this section and not the amounts determined pursuant to the regulations under section 1502.

(b) *Multiple surtax exemption election*—(1) *General rule.* If an election by an affiliated group under section 243(b)(2) is effective with respect to a taxable year of the common parent corporation, then no corporation which is a member of such affiliated group on each day of its matching taxable year may consent (or shall be deemed to consent) to an election under section 1562(a)(1), relating to election of multiple surtax exemptions, which would be effective for such matching taxable year. Thus, each corporation which is a component member of the controlled group of corporations with respect to its matching taxable year (determined by applying section 1563(b) without regard to paragraph (2)(D) thereof) shall determine its surtax exemption for such taxable year in accordance with section 1561 and the regulations thereunder.

(2) *Special rule for certain insurance companies.* Under section 243(b)(6)(A), if the provisions of subparagraph (1) of this paragraph apply with respect to the taxable year of an insurance company subject to taxation under section 802 or 821, then the surtax exemption of such insurance company for such taxable year shall be determined by applying part II (section 1561 and following), subchapter B, chapter 6 of the Code, with respect to such insurance company and the other corporations which are component members of the controlled group of corporations (as determined under section 1563 without regard to subsections (a)(4) and (b)(2)(D) thereof) of which such insurance company is a member, without regard to section 1563(a)(4) (relating to certain insurance companies treated as a separate controlled group) and section 1563(b)(2)(D) (relating to certain insurance companies treated as excluded members).

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

Example. Throughout 1965 corporation M owns all the stock of corporations L–1, L–2, S–1, and S–2. M is a domestic mutual insurance company subject to tax under section 821 of the Code, L–1 and L–2 are domestic life insurance companies subject to tax under section 802 of the Code, and S–1 and S–2 are domestic corporations subject to tax under section 11 of the Code. Each corporation uses the calendar year as its taxable year. M makes a valid election under section 243(b)(2) for the affiliated group consisting of M, L–1, L–2, S–1, and S–2. If part II, subchapter B, chapter 6 of the Code were applied with respect to the 1965 taxable years of the corporations without regard to section 243(b)(6)(A), the following would result: S–1 and S–2 would be treated as component members of a controlled group of corporations on such date; L–1 and L–2 would be treated as component members of a separate controlled group on such date; and M would be treated as an excluded member. However, since section 243(b)(6)(A) requires that part II of subchapter B be applied without regard to section 1563(a)(4) and (b)(2)(D), for purposes of determing the surtax exemptions of M, L–1, L–2, S–1, and S–2 for their 1965 taxable years, such corporations are treated for purposes of such part II as component members of a single controlled group of corporations on December 31, 1965. Moreover, by reason of having made the election under section 243(b)(2), M, L-1, L–2, S–1, and S–2 cannot consent to multiple surtax exemption elections under section 1562 which would be effective for their 1965 taxable years. Thus, such corporations are limited to a single $25,000 surtax exemption for such taxable years (to be apportioned among such corporations in accordance with section 1561 and the regulations thereunder).

(c) *Foreign tax credit*—(1) *General.* If an election by an affiliated group under section 243(b)(2) is effective with respect to a taxable year of the common parent corporation, then:

(i) The credit under section 901 for taxes paid or accrued to any foreign country or possession of the United States shall be allowed to a corporation which is a member of such affiliated group for each day of its matching taxable year only if each other corporation which pays or accrues such foreign taxes to any foreign country or possession, and which is a member of such group on each day of its matching taxable year, does not deduct such taxes in computing its tax liability for its matching taxable year, and

(ii) A corporation which is a member of such affiliated group on each day of its matching taxable year may use the overall limitation provided in section 904(a)(2) for such matching taxable year only if each other corporation which pays or accrues foreign taxes to any foreign country or possession, and which is a member of such group on each day of its matching taxable year, uses such limitation for its matching taxable year.

(2) *Consent of the Commissioner.* In the absence of unusual circumstances, a request by a corporation for the consent of the Commissioner to the revocation of an election of the overall limitation, or to a new election of the overall limitation, for the purpose of satisfying the requirements of subparagraph (1)(ii) of this paragraph will be given favorable consideration, notwithstanding the fact that there has been no change in the basic nature of the corporation's business or changes in conditions in a foreign country which substantially affect the corporation's business. See paragraph (d)(3) of § 1.904–1.

(d) *Other restrictions and limitations*—(1) *General rule.* If an election by an affilated group under section 243(b)(2) is effective with respect to a taxable year of the common parent corporation, then, except to the extent that an apportionment plan adopted under paragraph (f) of this section for such taxable year provides otherwise with respect to a restriction or limitation described in this paragraph, the rules provided in subparagraphs (2), (3), (4), and (5) of this paragraph shall apply to each corporation which is a member of such affiliated group on each day of its matching taxable year for the purpose of computing the amount of such restriction or limitation for its matching taxable year. For purposes of this paragraph, each corporation which is a member of an electing affiliated group (including any member which joins in filing a consolidated return) shall be treated as a separate corporation for purposes of determining the amount of such restrictions and limitations.

(2) *Accumulated earnings credit*—(i) *General.* Except as provided in subdivision (ii) of this subparagraph, in determining the minimum accumulated earnings credit under section 535(c)(2) (or the accumulated earnings credit of a mere holding or investment company under section 535(c)(3) for each corporation which is a member of the affiliated group on each day of its matching taxable year, in lieu of the $150,000 amount ($100,000 amount in the case of taxable years beginning before January 1, 1975) mentioned in such sections there shall be substituted an amount equal to (*a*) $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975), divided by (*b*) the number of such members.

(ii) *Allocation of excess.* If, with respect to one or more members, the amount determined under subdivision (i) of this subparagraph exceeds the sum of *(a)* such member's accumulated earnings and profits as of the close of the preceding taxable year, plus *(b)* such member's earnings and profits for the taxable year which are retained (within the meaning of section 535(c)(1), then any such excess shall be subtracted from the amount determined under subdivision (i) of this subparagraph and shall be divided equally among those remaining members of the affiliated group that do not have such an excess (until no such excess remains to be divided among those remaining members that have not had such an excess). The excess so divided among such remaining members shall be added to the amount determined under subdivision (i) with respect to such members.

(iii) *Apportionment plan not allowed.* An affiliated group may not adopt an apportionment plan, as provided in paragraph (f) of this section, with respect to the amounts computed under the provisions of this subparagraph.

(iv) *Example.* The provisions of this subparagraph may be illustrated by the following example;

Example. An affiliated group is composed of four member corporations, W, X, Y, and Z. The sum of the accumulated earnings and profits (as of the close of the preceding taxable year ending December 31, 1975) plus the earnings and profits for the taxable year ending December 31, 1976 which are retained is $15,000, $75,000, $37,500, and $300,000 in the case of W, X, Y, and Z, respectively. The amounts determined under this subparagraph for W, X, Y, and Z are $15,000, $48,750, $37,500 and $48,750, respectively, computed as follows:

	Component members			
	W	X	Y	Z
Earnings and profits	$15,000	$75,000	$37,500	$300,000
Amount computed under subpar. (1)	37,500	37,500	37,500	37,500
Excess	22,500	0	0	0
Allocation of excess	....	7,500	7,500	7,500
New excess	....	....	7,500	
Reallocation of new excess	....	3,750	....	3,750
Amount to be used for purposes of sec. 535(c) (2) and (3)	15,000	48,750	37,500	48,750

(3) *Mine exploration expenditures*—(i) *Limitation under section 615(a).* If the aggregate of the expenditures to which section 615(a) applies, which are paid or incurred by corporations which are members of the affiliated group on each day of their matching taxable years (during such taxable years) exceeds $100,000, then the deduction (or amount deferrable) under section 615 for any such member for its matching taxable year shall be limited to an amount equal to the amount which bears the same ratio to $100,000 as the amount deductible or deferrable by such member under section 615 (computed without regard to this subdivision) bears to the aggregate of the amounts deductible or deferrable under section 615 (as so computed) by all such members.

(ii) *Limitation under section 615(c).* If the aggregate of the expenditures to which section 615(a) applies which are paid or incurred by the corporations which are members of such affiliated group on each day of their matching taxable years (during such taxable years) would, when added to the aggregate of the amounts deducted or deferred in prior taxable years which are taken into account by such corporations in applying the limitation of section 615(c), exceed $400,000, then section 615 shall not apply to any such expenditure so paid or incurred by any such member to the extent such expenditure would exceed the amount which bears the same ratio to *(a)* the amount, if any, by which $400,000 exceeds the amounts so deducted or deferred in prior years, as *(b)* such member's deduction (or amount deferrable) under section 615 (computed without regard to this subdivision) for such expenditures paid or incurred by such member during its matching taxable year, bears to *(c)* the aggregate of the amounts deductible or deferrable under section 615 (as so computed) by all such members during their matching taxable years.

(iii) *Treatment of corporations filing consolidated returns.* For purposes of making the computations under subdivisions (i) and (ii) of this subparagraph, a corporation which joins in the filing of a consolidated return shall be treated as if it filed a separate return.

(iv) *Estimate of exploration expenditures.* If, on the date a corporation (which is a member of an affiliated group on each day of its matching taxable year) files its income tax return for such taxable year, it cannot be determined whether or not the $100,000 limitation prescribed by subdivision (i) of this subparagraph, or the $400,000 limitation prescribed by subdivision (ii) of this subparagraph, will apply with respect to such taxable year, then such member shall, for purposes of such return, apply the provisions of such subdivisions (i) and (ii) with respect to such taxable year on the basis of an estimate of the aggregate of the exploration expenditures by all such members of the affiliated group for their matching taxable years. Such estimate shall be made on the basis of the facts and circumstances known at the time of such estimate. If an estimate is used by any such member of the affiliated group pursuant to this subdivision, and if the actual expenditures by all such members differ from the estimate, then each such member shall file as soon as possible an original or amended return reflecting an amended apportionment (either pursuant to an apportionment plan adopted under paragraph (f) of this section or pursuant to the application of the rule provided by subdivision (i) or (ii) of this subparagraph) based upon such actual expenditures.

(v) *Amount apportioned under apportionment plan.* If an electing affiliated group adopts an apportionment plan as provided in paragraph (f) of this section with respect to the limitation under section 615(a) or 615(c), then the amount apportioned under such plan to any corporation which is a member of such group may not exceed the amount which such member could have deducted (or deferred) under section 615 had such affiliated group not filed an election under section 243(b)(2).

(4) *Small business deductions of life insurance companies.* In the case of a life insurance company taxable under section 802 which is a member of such affiliated group on each day of its matching taxable year, the small business deduction under sections 804(a)(4) and 809(d)(10) shall not exceed an amount equal to $25,000 divided by the number of life insurance companies taxable under section 802 which are members of such group on each day of their matching taxable years.

(5) *Estimated tax*—(i) *Exemption from estimated tax.* Except as otherwise provided in subdivision (ii) of this subparagraph, the exemption from estimated tax (for purposes of estimated tax filing requirements under section 6016 and the addition to tax under section 6655 for failure to pay estimated tax) of each corporation which is a member of such affiliated group on each day of its matching taxable year shall be (in lieu of the $100,000 amount specified in section 6016(a) and (b)(2)(A) and in section 6655(d)(1) and (e)(2)(A) an amount equal to $100,000 divided by the number of such members.

(ii) *Nonapplication to certain taxable years beginning in 1963 and ending in 1964.* For purposes of this section, if a corporation has a taxable year beginning in 1963 and ending in 1964 the last day of the eighth month of which falls on or before April 10, 1964, then (notwithstanding the fact that an election under section 243(b)(2) is effective for such taxable year) subdivision (i) of this subparagraph shall not apply to such corporation for such taxable year. Thus, such corporation shall be entitled to a $100,000 exemption from estimated tax for such taxable year. Also, with respect to a taxable year described in the first sentence of this subdivision, any such corporation shall not be considered to be a member of the affiliated group for purposes of determining the number of members referred to in subdivision (i) of this subparagraph.

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

Example 1. Corporation P owns all the stock of corporation S–1 on each day of 1965. On March 1, 1965, P acquires all the stock of corporation S–2. Corporations P, S–1, and S–2 file separate returns on a calendar year basis. On March 31, 1965, the affiliated group consisting of P, S–1, and S–2 anticipates making an election under section 243(b)(2) for P's 1965 taxable year. If the affiliated group does make a valid election under section 243(b)(2) for P's 1965 year, under subdivision (i) of this subparagraph the exemption from estimated tax of P for 1965, and the exemption from estimated tax of S–1 for 1965, will be (assuming an apportionment plan is not filed pursuant to paragraph (f) of this section) an amount equal to $50,000 ($100,000÷2). (Since S–2 is not a member of the affiliated group on each day of 1965, S–2's exemption from estimated tax will be determined for the year 1965 without regard to subdivision (i) of this subparagraph, whether or not the affiliated group makes the election under section 243(b)(2).) P and S–1 file declarations of estimated tax on April 15, 1965, on such basis and make payments with respect to such declarations on such basis. Thus, if the affiliated group does make a valid election under section 243(b)(2) for P's 1965 year, P and S–1 will not incur (as a result of the application of subdivision (i) of this subparagraph to their 1965 years) additions to tax under section 6655 for failure to pay estimated tax.

Example 2. Assume the same facts as in *Example (1)*, except that, on March 31, 1965, S–1 anticipates that it will incur a loss for its 1965 year. Accordingly, in anticipation of making an election under section 243(b)(2) for P's 1965 year and adopting an apportionment plan under paragraph (f) of this section, P computes its estimated tax liability for 1965 on the basis of a $100,000 exemption, and S–1 computes its estimated tax liability for 1965 on the basis of a zero exemption. Assume S–1 incurs a loss for 1965 as anticipated. Thus, if P does make the election for 1965, and an apportionment plan is adopted apportioning $100,000 to P and zero to S–1 (for their 1965 years), P and S–1 will not incur (as a result of the application of subdivision (i) of this subparagraph to their 1965 years) additions to tax under section 6655 for failure to pay estimated tax.

Example 3. Assume the same facts as in *Example (1)*, except that P and S–1 file declarations of estimated tax on April 15, 1965, on the basis of separate $100,000 exemptions from estimated tax for their 1965 years, and make payments with respect to such declarations on such basis. Assume that the affiliated group makes an election under section 243(b)(2) for P's 1965 year. Under subdivision (i) of this subparagraph, P and S–1 are limited in the aggregate to a single $100,000 exemption from estimated tax for their 1965 years. The provisions of section 6655 will be applied to the 1965 year of P and the 1965 year of S–1 on the basis of a $50,000 exemption from estimated tax for each corporation, unless a different apportionment of the $100,000 amount is adopted under paragraph (f) of this section. Since the election was made under section 243(b)(2), regardless of whether or not the affiliated group anticipated making the election, P or S–1 (or both) may incur additions to tax under section 6655 for failure to pay estimated tax.

(e) *Effect of election for certain taxable years beginning in 1963 and ending in 1964.* If an election under section 243(b)(2) by an affiliated group is effective for a taxable year of a corporation under paragraph (c)(4)(ii) of § 1.243–4 (relating to election for certain taxable years beginning in 1963 and ending in 1964), and if such corporation is a member of such group on each day of such taxable year, then the restrictions and limitations prescribed by paragraphs (b), (c), and (d) of this section shall apply to all such members having such taxable years (for such taxable years). For purposes of this paragraph, such paragraphs shall be applied with respect to such taxable years as if such taxable years included the last day of a taxable year of the common parent corporation for which an election was effective under section 243(b)(2), *i.e.*, as if such taxable years were matching taxable years. For apportionment plans with respect to such taxable years, see paragraph (f) (9) of this section.

(f) *Apportionment plans*—(1) *In general.* In the case of corporations which are members of an affiliated group of corporations on each day of their matching taxable years:

(i) The $100,000 amount referred to in paragraph (d)(3)(i) of this section (relating to limitation under section 615(a)),

(ii) The amount determined under paragraph (d)(3)(ii)*(a)* of this section (relating to limitation under section 615(c)),

(iii) The $25,000 amount referred to in paragraph (d)(4) of this section (relating to small business deduction of life insurance companies), and

(iv) The $100,000 amount referred to in paragraph (d)(5)(i) of this section (relating to exemption from estimated tax), may be apportioned among such members (for such taxable years) if the common parent corporation files an apportionment plan with respect to such taxable years in the manner provided in subparagraph (4) of this paragraph, and if all other members consent to the plan, in the manner provided in subparagraph (5) or (6) of this paragraph (whichever is applicable). The plan may provide for the apportionment to one or more of such members, in fixed dollar amounts, of one or more of the amounts referred to in subdivisions (i), (ii), (iii), and (iv) of this subparagraph, but in no event shall the sum of the amounts so apportioned in respect to any such subdivision exceed the amount referred to in such subdivision. See also paragraph (d)(3)(v) of this section, relating to the maximum amount that may be apportioned to a corporation under this subparagraph with respect to exploration expenditures to which section 615 applies.

(2) *Time for adopting plan.* An affiliated group may adopt an apportionment plan with respect to the matching taxable years of its members only if, at the time such plan is sought to be adopted, there is at least 1 year remaining in the statutory period (including any extensions thereof) for the assessment of a deficiency against any corporation the tax liability of which for any taxable year would be increased by the adoption of such plan. (If there is less than 1 year remaining with respect to any taxable year, the district director for the internal revenue district in which is located the principal place of business or principal office or agency of the corporation will ordinarily, upon request, enter into an agreement to extend such statutory period for assessment and collection of deficiencies.)

(3) *Years for which effective.* A valid apportionment plan with respect to matching taxable years of members of an affiliated group shall be effective for such matching taxable years, and for all succeeding matching taxable years of such members, unless the plan is amended in accordance with subparagraph (8) of this paragraph or is terminated. Thus, the apportionment plan (including any amendments thereof) has a continuing effect and need not be renewed annually. An apportionment plan with respect to a particular taxable year of the common parent shall terminate with respect to the taxable years of the members of the affiliated group which include the last day of a succeeding taxable year of the common parent if:

(i) Any corporation which was a member of the affiliated group on each day of its matching taxable year which included the last day of the particular taxable year of the common parent is not a member of such group on each day of its taxable year which includes the last day of such succeeding taxable year of the common parent, or

(ii) Any corporation which was not a member of such group on each day of its taxable year which included the last day of the particular taxable year of the common parent is a member of such group on each day of its taxable year which includes the last day of such succeeding taxable year of the common parent.

An apportionment plan, once terminated, is no longer effective. Accordingly, unless a new apportionment plan is filed and consented to (or the section 243(b)(2) election is terminated) the amounts referred to in subparagraph (1) of this paragraph will be apportioned among the corporations which are members of the affiliated group on each day of their matching taxable years in accordance with the rules provided in paragraphs (d)(3)(i), (d)(3)(ii), (d)(4), and (d)(5)(i) of this section.

(4) *Filing of plan.* The apportionment plan shall be in the form of a statement filed by the common parent corporation with the district director for the internal revenue district in which is located the principal place of business or principal office or agency of such common parent. The statement shall be signed by any person who is duly authorized to act on behalf of the common parent corporation and shall set forth the name, address, internal revenue district, taxpayer account number, and taxable year of each member to whom the common parent could apportion an amount under subparagraph (1) of this paragraph (or, in the case of an apportionment plan referred to in subparagraph (9) of this paragraph, each member to whom the common parent could apportion an amount under such subparagraph) and the amount (or amounts) apportioned to each such member under the plan.

(5) *Consent of wholly owned subsidiaries.* If all the stock of a corporation which is a member of the affiliated group on each day of its matching taxable year is owned on each such day by another corporation (or corporations) which is a member of such group on each day of its matching taxable year, such corporation (hereinafter in this paragraph referred to as a ‘‘wholly owned subsidiary’’) shall be deemed to consent to the apportionment plan. Each wholly owned subsidiary should attach a copy of the plan filed by the common parent corporation to an income tax return, amended return, or

claim for refund for its matching taxable year.

(6) *Consent of other members.* The consent of each member (other than the common parent corporation and wholly owned subsidiaries) to an apportionment plan shall be in the form of a statement, signed by any person who is duly authorized to act on behalf of the member consenting to the plan, stating that such member consents to the plan. The consent of more than one such member may be incorporated in a single statement. The statement (or statements) shall be attached to the apportionment plan filed by the common parent corporation. The consent of any such member which, after the date the apportionment plan was filed and during its matching taxable year referred to in subparagraph (1) of this paragraph, ceases to be a wholly owned subsidiary but continues to be a member, shall be filled with the district director with whom the apportionment plan is filed (as soon as possible after it ceases to be a wholly owned subsidiary). Each consenting member should attach a copy of the apportionment plan filed by the common parent to an income tax return, amended return, or claim for refund for its matching taxable year which includes the last day of the taxable year of the common parent corporation for which the apportionment plan was filed.

(7) *Members of group filing consolidated return*—(i) *General rule.* Except as provided in subdivision (ii) of this subparagraph, if the members of an affiliated group of corporations include one or more corporations taxable under section 11 of the Code and one or more insurance companies taxable under section 802 or 821 of the Code and if the affiliated group includes corporations which join in the filing of a consolidated return, then, for purposes of determining the amount to be apportioned to a corporation under an apportionment plan adopted under this paragraph, the corporations filing the consolidated return shall be treated as a single member.

(ii) *Consenting to an apportionment plan.* For purposes of consenting to an apportionment plan under subparagraphs (5) and (6) of this paragraph, if the members of an affiliated group of corporations include corporations which join in the filing of a consolidated return, each corporation which joins in filing the consolidated return shall be treated as a separate member.

(8) *Amendment of plan.* An apportionment plan, which is effective for the matching taxable years of members of an affiliated group, may be amended if an amended plan is filed (and consented to) within the time and in accordance with the rules prescribed in this paragraph for the adoption of an original plan with respect to such taxable years.

(9) *Certain taxable years beginning in 1963 and ending in 1964.* In the case of corporations which are members of an affiliated group of corporations on each day of their taxable years referred to in paragraph (e) of this section:

(i) The $100,000 amount referred to in paragraph (d)(3)(i) of this section (relating to limitation under section 615(a)),

(ii) The amount determined under paragraph (d)(3)(ii)*(a)* of this section (relating to limitation under section 615(c)),

(iii) The $25,000 amount referred to in paragraph (d)(4) of this section (relating to small business deduction of life insurance companies), and

(iv) The $100,000 amount referred to in paragraph (d)(5)(i) of this section (relating to exemption from estimated tax), may be apportioned among such members (for such taxable years) if an apportionment plan is filed (and consented to) with respect to such taxable years in accordance with the rules provided in subparagraphs (2), (4), (5), (6), (7), and (8) of this paragraph. For purposes of this subparagraph, such subparagraphs shall be applied as if such taxable years included the last day of a taxable year of the common parent corporation, i.e., as if such taxable years were matching taxable years. An apportionment plan adopted under this subparagraph shall be effective only with respect to taxable years referred to in paragraph (e) of this section. The plan may provide for the apportionment to one or more of such members, in fixed dollar amounts, of one or more of the amounts referred to in subdivisions (i), (ii), (iii), and (iv) of this subparagraph, but in no event shall the sum of the amounts so apportioned in respect of any such subdivision exceed the amount referred to in such subdivision. See also paragraph (d)(3)(v) of this section, relating to the maximum amount that may be apportioned to a corporation under an apportionment plan described in this subparagraph with respect to exploration expenditures to which section 615 applies.

(g) *Short taxable years*—(1) *General.* If:

(i) The return of a corporation is for a short period (ending after December 31, 1963) on each day of which such corporation is a member of an affiliated group,

(ii) The last day of the common parent's taxable year does not end with or within such short period, and

(iii) An election under section 243(b)(2) by such group is effective under paragraph (c) (4) (i) of § 1.243–4 for the taxable year of the common parent within which falls such short period, then the restrictions and limitations prescribed by section 243(b)(3) shall be applied in the manner provided in subparagraph (2) of this paragraph.

(2) *Manner of applying restrictions.* In the case of a corporation described in subparagraph (1) of this paragraph having a short period described in such subparagraph:

(i) Such corporation may not consent to an election under section 1562, relating to election of multiple surtax exemptions, which would be effective for such short period;

(ii) The credit under section 901 shall be allowed to such corporation for such short period if, and only if, each corporation, which pays or accrues foreign taxes and which is a member of the affiliated group on each day of its taxable year which includes the last day of the common parent's taxable year within which falls such short period, does not deduct such taxes in computing its tax liability for its taxable year which includes such last day;

(iii) The overall limitation provided in section 904(a)(2) shall be allowed to such corporation for such short period if, and only if, each corporation, which pays or accrues foreign taxes and which is a member of the affiliated group on each day of its taxable year which includes the last day of the common parent's taxable year within which falls such short period, uses such limitation for its taxable year which includes such last day;

(iv) The minimum accumulated earnings credit provided by section 535(c)(2) (or in the case of a mere holding or investment company, the accumulated earnings credit provided by section 535(c)(3)) allowable for such short period shall be the amount computed by dividing (a) the amount (if any) by which $100,000 exceeds the aggregate of the accumulated earnings and profits of the corporations, which are members of the affiliated group on the last day of such short period, as of the close of their taxable years preceding the taxable year which includes the last day of such short period, by (b) the number of such members on the last day of such short period;

(v) The deduction allowable under section 615(a) for such short period shall be limited to an amount equal to $100,000 divided by the number of corporations which are members of the affiliated group on the last day of such short period;

(vi) If the expenditures to which section 615(a) applies which are paid or incurred by such corporation during such short period would, when added to the aggregate of the amounts deducted or deferred (in taxable years ending before the last day of such short period) which are taken into account in applying the limitation of section 615(c) by corporations which are members of the affiliated group on the last day of such short period exceed $400,000, then section 615 shall not apply to any such expenditure so paid or incurred by such corporation to the extent such expenditure would exceed an amount equal to *(a)* the amount (if any) by which $400,000 exceeds the aggregate of the amounts so deducted or deferred in such taxable years (computed as if each member filed a separate return), divided by *(b)* the number of corporations in the group which have taxable years ending on such last day;

(vii) If such corporation is a life insurance company taxable under section 802, the small business deduction under sections 804(a)(4) and 809(d)(10) shall not exceed an amount equal to *(a)* $25,000, divided by *(b)* the number of life insurance companies taxable under section 802 which are members of the affiliated group on the last day of such short period; and

(viii) The exemption from estimated tax (for purposes of estimated tax filing requirements under section 6016 and the addition to tax under section 6655 for failure to pay estimated tax) for such short period shall be an amount equal to $100,000 divided by the number of corporations which are members of the affiliated group on the last day of such short period.

[T.D. 6992, 34 FR 821, Jan. 18, 1969, as amended by T.D. 7376, 40 FR 42745, Sept. 16, 1975]

§ 1.244–1 Deduction for dividends received on certain preferred stock.

A corporation is allowed a deduction under section 244 for dividends received on certain preferred stock of certain public utility corporations subject to taxation under chapter 1 of the Code. The deduction is allowable only for dividends received on the preferred stock of a public utility with respect to which the deduction for dividends paid provided in section 247 (relating to dividends paid on certain preferred stock of public utilities) is allowable to the distributing corporation.

§ 1.244–2 Computation of deduction.

(a) *General rule.* Section 244(a) provides a formula for the computation of the deduction for dividends received on the preferred stock of a public utility. For purposes of this computation, the normal tax rate referred to in section 244(a)(2)(B) shall be determined without regard to any additional tax imposed by section 1562(b). See section 1562(b)(4). The deduction computed under section 244(a) is subject to the limitation provided in section 246.

(b) *Qualifying dividends.* Section 244(b) provides that in the case of dividends received on the preferred stock of a public utility in taxable years ending after December 31, 1963, which are ‘‘qualifying dividends’’(as defined in section 243(b)(1), but determined without regard to section 243(c)(4)), the computation of the deduction for dividends received shall be made by applying the formula provided by section 244(a) separately to such qualifying dividends. For such purposes, 100 percent shall be used in lieu of the 85 percent specified in section 244(a)(3).

(c) *Examples.* The computation of the deduction provided in section 244 may be illustrated by the following examples:

Example 1. Corporation X, which files its income tax returns on the calendar year basis, received in 1965 $100,000 as dividends on the preferred stock of corporation Y, a public utility corporation which is subject to taxation under chapter 1 of the Code. The deduction provided in section 247 is allowable to Y, the distributing corporation, with respect to these dividends and they are not ‘‘qualifying dividends’’(as defined in section 243(b)(1) but determined without regard to section 243(c)(4)). The corporation normal tax rate and the surtax rate for the calendar year 1965 are 22 percent and 26 percent, respectively. The deduction allowable to X under section 244(a) for the year 1965 with respect to these dividends is $60,208.33, computed as follows:

Dividends received on preferred stock of corporation Y	$100,000.00
Less: The fraction specified in section 244(a)(2): 14/48×$100,000	29,166.67
Amount subject to 85-percent deduction	70,833.33
Deduction—85 percent of $70,833.33	60,208.33

The result would be the same if X or Y(or both) were subject to the 6-percent additional tax imposed by section 1562(b) for 1965.

Example 2. Assume the same facts as in *Example (1)* and also assume that in 1965 corporation X received $200,000 as dividends on the preferred stock of Corporation Z, a public utility corporation which is subject to taxation under chapter 1 of the Code. Assume further that such dividends are ‘‘qualifying dividends’’ (as defined in section 243(b)(1) but determined without regard to section 243(c)(4)). The deduction provided in section 247 is allowable to Z, the distributing corporation, with respect to these dividends. The deduction allowable to X under section 244 for the year 1965 is $201,875, computed as follows:

Deduction allowable under section 244(a) with respect to the dividend received from Y (see *Example (1)*)	$60,208.33
Deduction allowable under section 244(b) with respect to the dividend received from Z: Qualifying dividends received on preferred stock of corporation Z	200,000.00
Less: The fraction specified in section 244(a)(2): 14/48×$200,000	58,333.33
Deduction	141,666.67
Deduction allowable under section 244 for 1965	201,875.00

[T.D. 6992, 34 FR 825, Jan. 18, 1969]

§1.245–1 Dividends received from certain foreign corporations.

(a) *General rule.* (1) A corporation is allowed a deduction under section 245(a) for dividends received from a foreign corporation (other than a foreign personal holding company as defined in section 552) which is subject to taxation under chapter 1 of the Code if, for an uninterrupted period of not less than 36 months ending with the close of the foreign corporation's taxable year in which the dividends are paid, (i) the foreign corporation is engaged in trade or business in the United States, and (ii) 50 percent or more of the foreign corporation's entire gross income is effectively connected with the conduct of a trade or business in the United States by that corporation. If the foreign corporation has been in existence less than 36 months as of the close of the taxable year in which the dividends are paid, then the applicable uninterrupted period to be taken into consideration in lieu of the uninterrupted period of 36 or more months is the entire period such corporation has been in existence as of the close of such taxable year. An uninterrupted period which satisfied the twofold requirement with respect to business activity and gross income may start at a date later than the date on which the foreign corporation first commenced an uninterrupted period of engaging in trade or business within the United States, but the applicable uninterrupted period is in any event the longest uninterrupted period which satisfies such twofold requirement. The deduction under section 245(a) is allowable to any corporation, whether foreign or domestic, receiving dividends from a distributing corporation which meets the requirements of that section.

(2) Any taxable year of a foreign corporation which falls within the uninterrupted period described in section 245(a)(2) shall not be taken into account in applying section 245(a)(2) and this paragraph if the 100 percent dividends received deduction would be allowable under paragraph (b) of this section, whether or not in fact allowed, with respect to any dividends payable, whether or not in fact paid, out of the earnings and profits of such foreign corporation for that taxable year. Thus, in such case the foreign corporation shall be treated as having no earnings and profits for that taxable year for purposes of determining the dividends received deduction allowable under section 245(a) and this paragraph. However, that taxable year may be taken into account for purposes of determining whether the foreign corporation meets the requirements of section 245(a) that, for the uninterrupted period specified therein, the foreign corporation is engaged in trade or business in the United States and meets the 50 percent gross income requirement.

(b) *Dividends from wholly owned foreign subsidiaries.* (1) A domestic corporation is allowed a deduction under section 245(b) for any taxable year beginning after December 31, 1966, for dividends received from a foreign corporation (other than a foreign personal holding company as defined in section 552) which is subject to taxation under Chapter 1 of the Code if:

(i) The domestic corporation owns either directly or indirectly all of the outstanding stock of the foreign corporation during the entire taxable year of the domestic corporation in which the dividends are received, and

(ii) The dividends are paid out of earnings and profits of a taxable year of the foreign corporation during which *(a)* the domestic corporation receiving the dividends owns directly or indirectly throughout such year all of the outstanding stock of the foreign corporation, and *(b)* all of the gross income of the foreign corporation from all sources is effectively connected for that year with the conduct of a trade or business in the United States by that corporation.

(2) The deduction allowed by section 245(b) does not apply if an election under section 1562, relating to the privilege of a controlled group of corporations to elect multiple surtax exemptions, is effective for either the taxable year of the domestic corporation in which the dividends are received or the taxable year of the foreign corporation out of the earnings and profits of which the dividends are paid.

(c) *Rules of application.* (1) Except as provided in section 246, the deduction provided by section 245 for any taxable year is the sum of the amounts computed under paragraphs (1) and (2) of section 245(a) plus, in the case of a domestic corporation for any taxable year beginning after December 31, 1966, the sum of the amounts computed under section 245(b)(2).

(2) To the extent that a dividend received from a foreign corporation is treated as a dividend from a domestic corporation in accordance with section 243(d) and § 1.243–3, it shall not be treated as a dividend received from a foreign corporation for purposes of this section.

(3) For purposes of section 245 (a) and (b), the amount of a distribution shall be determined under subparagraph (B) (without reference to subparagraph (C)) of section 301(b)(1).

(4) In determining from what year's earnings and profits a dividend is treated as having been distributed for purposes of this section, the principles of paragraph (a) of § 1.316–2 shall apply. A dividend shall be considered to be distributed, first, out of the earnings and profits of the taxable year which includes the date the dividend is distributed, second, out of the earnings and profits accumulated for the immediately preceding taxable year, third, out of the earnings and profits accumulated for the second preceding taxable year, etc. A deficit in an earnings and profits account for any taxable year shall reduce the most recently accumulated earnings and profits for a prior year in such account. If there are no accumulated earnings and profits in an earnings and profits account because of a deficit incurred in a prior year, such deficit must be restored before earnings and profits can be accumulated in a subsequent accounting year. See also paragraph (c) of § 1.243–3 and paragraph (a)(6) of § 1.243–4.

(5) For purposes of this section the gross income of a foreign corporation for any period before its first taxable year beginning after December 31, 1966, which is from sources within the United States shall be treated as gross income which is effectively connected for that period with the conduct of a trade or business in the United States by that corporation.

(6) For the determination of the source of income and the income which is effectively connected with the conduct of a trade or business in the United States, see sections 861 through 864, and the regulations thereunder.

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

Example 1. Corporation A (a foreign corporation filing its income tax returns on a calendar year basis) whose stock is 100 percent owned by Corporation B (a domestic corporation filing its income tax returns on a calendar year basis) for the first time engaged in trade or business within the United States on January 1, 1943, and qualifies under section 245 for the entire period beginning on that date and ending on December 31, 1954. Corporation A had accumulated earnings and profits of $50,000 immediately prior to January 1, 1943, and had earnings and profits of $10,000 for each taxable year during the uninterrupted period from January 1, 1943, through December 31, 1954. It derived for the period from January 1, 1943, through December 31, 1953, 90 percent of its gross income from sources within the United States and in 1954 derived 95 percent of its gross income from sources within the United States. During the calendar years 1943, 1944, 1945, 1946, and 1947 Corporation A distributed in each year $15,000; during the calendar years 1948, 1949, 1950, 1951, 1952, and 1953 it distributed in each year $5,000; and during the year 1954, $50,000. An analysis of the accumulated earnings and profits under the above statement of facts discloses that at December 31, 1953, the accumulation amounted to $55,000, of which $25,000 was accumulated prior to the ‘‘uninterrupted period’’ and $30,000 was accumulated during the uninterrupted period. (See section 316(a) and paragraph (c) of this section.) For 1954 a deduction under section 245 of $31,025 ($8,075 on 1954 earnings of the foreign corporation, plus $22,950 from the $30,000 accumulation at December 31, 1953) for dividends received from a foreign corporation is allowable to Corporation B with respect to the $50,000 received from Corporation A, computed as follows:

(i) $8,075, which is $8,500 (85 percent— the percent specified in section 243 for the calendar year 1954—of the $10,000 of earnings and profits of the taxable year) multiplied by 95 percent (the portion of the gross income of Corporation A derived during the taxable year 1954 from sources within the United States), plus

(ii) $22,950, which is $25,500 (85 percent— the percent specified in section 243 for the calendar year 1954—of $30,000, the part of the earnings and profits accumulated after the beginning of the uninterrupted period) multiplied by 90 percent (the portion of the gross income of Corporation A derived from sources within the United States during that portion of the uninterrupted period ending at the beginning of the taxable year 1954).

Example 2. If in *Example (1),* Corporation A for the taxable year 1954 had incurred a deficit of $10,000 (shown to have been incurred before December 31) the amount of the earnings and profits accumulated after the beginning of the uninterrupted period would be $20,000. If Corporation A had distributed $50,000 on December 31, 1954, the deduction under section 245 for dividends received from a foreign corporation allowable to Corporation B for 1954 would be $15,300, computed by multiplying $17,000 (85 percent—the percent specified in section 243 for the calendar year 1954—of $20,000 earnings and profits accumulated after the beginning of the uninterrupted period) by 90 percent (the portion of the gross income of Corporation A derived from United States sources during that portion of the uninterrupted period ending at the beginning of the taxable year 1954).

Example 3. Corporation A (a foreign corporation filing its income tax returns on a calendar year basis) whose stock is 100 percent owned by corporation B (a domestic corporation filing its income tax returns on a calendar year basis) for the first time engaged in trade or business within the United States on January 1, 1960, and qualifies under section 245 for the entire period beginning on that date and ending on December 31, 1963. In 1963, A derived 75 percent of its gross income from sources within the United States. A's earnings and profits for 1963 (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year) are $200,000. On December 31, 1963, corporation A distributes to corporation B 100 shares of corporation C stock which have an adjusted basis in A's hands of $40,000 and a fair market value of $100,000. For purposes of computing the deduction under section 245 for dividends received from a foreign corporation, the amount of the distribution is $40,000. B is allowed a deduction under section 245 of $25,500, i.e., $34,000 ($40,000 multiplied by 85 percent, the percent specified in section 243 for 1963), multiplied by 75 percent (the portion of the gross income of corporation A derived during 1963 from sources within the United States).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6752, 29 FR 12701, Sept. 9, 1964, T.D. 6830; 30 FR 8046, June 23, 1965; T.D. 7293, 38 FR 32793, Nov. 28, 1973]

§1.246–1 Deductions not allowed for dividends from certain corporations.

The deductions provided in sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock), and 245 (relating to dividends received from certain foreign corporations), are not allowable with respect to any dividend received from:

(a) A corporation organized under the China Trade Act, 1922 (15 U.S.C. ch. 4) (see section 941); or

(b) A corporation which is exempt from tax under section 501 (relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations) for the taxable year of the corporation in which the distribution is made or for its next preceding taxable year; for

(c) A corporation to which section 931 (relating to income from sources within possessions of the United States) applies for the taxable year of the corporation in which the distribution is made or for its next preceding taxable year; or

(d) A real estate investment trust which, for its taxable year in which the distribution is made, is taxable under Part II, Subchapter M, Chapter 1 of the Code. See section 243(c)(3), paragraph (c) of §1.243–2, section 857(c), and paragraph (d) of §1.857–6.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4092, Apr. 28, 1962; T.D. 7767, 46 FR 11264, Feb. 6, 1981]

§1.246–2 Limitation on aggregate amount of deductions.

(a) *General rule.* The sum of the deductions allowed by sections 243(a)(1) (relating to dividends received by corporations), 244(a) (relating to dividends received on certain preferred stock), and 245 (relating to dividends received from certain foreign corporations), except as provided in section 246(b)(2) and in paragraph (b) of this section, is limited to 85 percent of the taxable income of the corporation. The taxable income of the corporation for this purpose is computed without regard to the net operating loss deduction allowed by section 172, the deduction for dividends paid on certain preferred stock of public utilities allowed by section 247, any capital loss carryback under section 1212(a)(1), and the deductions provided in sections 243(a)(1), 244(a), and 245. For definition of the term *taxable income,* see section 63.

(b) *Effect of net operating loss.* If the shareholder corporation has a net operating loss (as determined under sec. 172) for a taxable year, the limitation provided in section 246(b)(1) and in paragraph (a) of this section is not applicable for such taxable year. In that event, the deductions provided in sections 243(a)(1), 244(a), and 245 shall be allowable for all tax purposes to the shareholder corporation for such taxable year without regard to such limitation. If the shareholder corporation does not have a net operating loss for the taxable year, however, the limitation will be applicable for all tax purposes for such taxable year. In determining whether the shareholder corporation has a net operating loss for a taxable year under section 172, the deductions allowed by sections 243(a)(1), 244(a), and 245 are to be computed without regard to the limitation provided in section 246(b)(1) and in paragraph (a) of this section.

[T.D. 6992, 34 FR 825, Jan. 18, 1969, as amended by T.D. 7301, 39 FR 963, Jan. 4, 1974]

§ 1.246–3 Exclusion of certain dividends.

(a) *In general.* Corporate taxpayers are denied, in certain cases, the dividends-received deduction provided by section 243 (dividends received by corporations), section 244 (dividends received on certain preferred stock), and section 245 (dividends received from certain foreign corporations). The above-mentioned dividends-received deductions are denied, under section 246(c)(1), to corporate shareholders:

(1) If the dividend is in respect of any share of stock which is sold or otherwise disposed of in any case where the taxpayer has held such share for 15 days or less; or

(2) If and to the extent that the taxpayer is under an obligation to make corresponding payments with respect to substantially identical stock or securities. It is immaterial whether the obligation has arisen pursuant to a short sale or otherwise.

(b) *Ninety-day rule for certain preference dividends.* In the case of any stock having a preference in dividends, a special rule is provided by section 246(c)(2) in lieu of the 15-day rule described in section 246(c)(1) and paragraph (a)(1) of this section. If the taxpayer receives dividends on such stock which are attributable to a period or periods aggregating in excess of 366 days, the holding period specified in section 246(c)(1)(A) shall be 90 days (in lieu of 15 days).

(c) *Definitions*—(1) *''Otherwise disposed of''.* As used in this section the term *otherwise disposed of* includes disposal by gift.

(2) *''Substantially identical stock or securities''.* The term *substantially identical stock or securities* is to be applied according to the facts and circumstances in each case. In general, the term has the same meaning as the corresponding terms in sections 1091 and 1233 and the regulations thereunder. See paragraph (d)(1) of § 1.1233–1.

(3) *Obligation to make corresponding payments.* (i) Section 246(c)(1)(B) of the Code denies the dividends-received deduction to a corporate taxpayer to the extent that such taxpayer is under an obligation, with respect to substantially identical stock or securities, to make payments corresponding to the dividend received. Thus, for example, where a corporate taxpayer is in both a ''long'' and ''short'' position with respect to the same stock on the date that such stock goes ex-dividend, the dividend received on the stock owned by the taxpayer will not be eligible for the dividends-received deduction to the extent that the taxpayer is obligated to make payments to cover the dividends with respect to its offsetting short position in the same stock. The dividends-received deduction is denied in such a case without regard to the length of time the taxpayer has held the stock on which such dividends are received.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. Y Corporation owns 100 shares of the Z Corporation's common stock on January 1, 1959. Z Corporation on January 15, 1959, declares a dividend of $1.00 per share payable to shareholders of record on January 30, 1959. On January 21, 1959, Y Corporation sells short 25 shares of the Z Corporation's common stock and remains in the short position on January 31, 1959, the day that Z Corporation's common stock goes ex-dividend. Y Corporation is therefore obligated to make a payment to the lender of the 25 shares of Z

Corporation's common stock which were sold short, corresponding to the $1.00 a share dividend that the lender would have received on those 25 shares, or $25.00. Therefore, $25.00 of the $100.00 that the Y Corporation receives as dividends from the Z Corporation with respect to the 100 shares of common stock in which it has a long position is not eligible for the dividends-received deduction.

(d) *Determination of holding period*—(1) *In general.* Special rules are provided by paragraph (3) of section 246(c) for determining the period for which the taxpayer has held any share of stock for purposes of the restriction provided by such section. In computing the holding period the day of disposition but not the day of acquisition shall be taken into account. Also, there shall not be taken into account any day which is more than 15 days after the date on which the share of stock becomes ex-dividend. Thus, the holding period is automatically terminated at the end of such 15-day period without regard to how long the stock may be held after that date. In the case of stock qualifying under paragraph (2) of section 246(c) (as having preference in dividends) a 90-day period is substituted for the 15-day period prescribed in this subparagraph. Finally, section 1223(4), relating to holding periods in the case of wash sales, shall not apply. Therefore, tacking of the holding period of the stock disposed of to the holding period of the stock acquired where a wash sale occurs is not permitted for purposes of determining the holding period described in section 246(c).

(2) *Special rules.* Section 246(c) requires that the holding periods determined thereunder shall be appropriately reduced for any period that the taxpayer's stock holding is offset by a corresponding short position resulting from an option to sell, a contractual obligation to sell, or a short sale of, substantially identical stock or securities. The holding periods of stock held for a period of 15 days or less on the date such short position is created shall accordingly be reduced to the extent of such short position. Where the amount of stock acquired within such period exceeds the amount as to which the taxpayer establishes a short position, the stock the holding period of which must be reduced because of such short position shall be that most recently acquired within such period. If, on the date the short position is created, the amount of stock subject to the short position exceeds the amount, if any, of stock held by the taxpayer for 15 days or less, the excess shares of stock sold short shall, to the extent thereof, postpone until the termination of the short position the commencement of the holding periods of subsequently acquired stock. Stock having a preference in dividends is also subject to the rules prescribed in this subparagraph, except that the 90-day period provided by paragraph (b) of this section shall apply in lieu of the 15-day period otherwise applicable. The rules prescribed in this subparagraph may be illustrated by the following examples:

Example 1. L Company purchased 100 shares of Z Corporation's common stock during January 1959. On November 26, 1959, L Company purchased an additional 100 shares of the same stock. On December 1, 1959, Z Corporation declared a dividend payable on its common stock to shareholders of record on December 20, 1959. Also on December 1, L Company sold short 150 shares of Z Corporation's common stock. On December 16, 1959 (before the stock went ex-dividend), L Company closed its short sale with 150 shares purchased on that date. In determining, for purposes of section 246(c), whether L Company has held the 100 shares of stock acquired on November 26 for a period in excess of 15 days, the period of the short position (from December 2 through December 16) shall be excluded. Thus, if on or before December 26, 1959, L Company sold the 100 shares of Z Corporation stock which it purchased on November 26, 1959, it would not be entitled to a dividends-received deduction for the dividends received on such shares because it would have held such shares for 15 days or less on the date of the sale. Since L Company had held the 100 shares acquired during January 1959 for more than 15 days on December 2, 1959, and since it was under no obligation to make payments corresponding to the dividends received thereon, section 246(c) is inapplicable to the dividends received with respect to those shares.

Example 2. Assume the same facts as in *Example (1)* above except that the additional 100 shares of Z Corporation common stock were purchased by L Company on December 10, 1959, rather than November 26, 1959. In determining, for purposes of section 246(c), whether L Company has held such shares for a period in excess of 15 days, the period from December 11, 1959, until December 16, 1959 (the date the short sale made on December 1 was closed), shall be excluded.

(e) *Effective date.* The provisions of this section shall apply to stock acquired after December 31, 1957, or with respect to stock acquired before that date where the taxpayer has made a short sale of substantially identical stock or securities after that date.

§ 1.246–4 Dividends from a DISC or former DISC.

The deduction provided in section 243 (relating to dividends received by corporations) is not allowable with respect to any dividend (whether in the form of a deemed or actual distribution or an amount treated as a dividend pursuant to section 995(c)) from a corporation which is a DISC or former DISC (as defined in section 992(a)(1) or (3) as the case may be) to the extent such dividend is from the corporation's accumulated DISC income (as defined in section 996(f)(1)) or previously taxed income (as defined in section 996(f)(2)) or is a deemed distribution pursuant to section 995(b)(1) in a taxable year for which the corporation qualifies (or is treated) as a DISC. To the extent that a dividend is paid out of earnings and profits which are not made up of accumulated DISC income or previously taxed income, the corporate recipient is entitled to the deduction provided in section 243 in the same manner and to the same extent as a dividend from a domestic corporation which is not a DISC or former DISC.

[T.D. 7283, 38 FR 20824, Aug. 3, 1973]

§ 1.246–5 Reduction of holding periods in certain situations.

(a) *In general.* Under section 246(c)(4)(C), the holding period of stock for purposes of the dividends received deduction is appropriately reduced for any period in which a taxpayer has diminished its risk of loss by holding one or more other positions with respect to substantially similar or related property. This section provides rules for applying section 246(c)(4)(C).

(b) *Definitions*—(1) *Substantially similar or related property.* The term substantially similar or related property is applied according to the facts and circumstances in each case. In general, property is substantially similar or related to stock when—

(i) The fair market values of the stock and the property primarily reflect the performance of—

(A) A single firm or enterprise;

(B) The same industry or industries; or

(C) The same economic factor or factors such as (but not limited to) interest rates, commodity prices, or foreign-currency exchange rates; and

(ii) Changes in the fair market value of the stock are reasonably expected to approximate, directly or inversely, changes in the fair market value of the property, a fraction of the fair market value of the property, or a multiple of the fair market value of the property.

(2) *Diminished risk of loss.* A taxpayer has diminished its risk of loss on its stock by holding positions with respect to substantially similar or related property if changes in the fair market values of the stock and the positions are reasonably expected to vary inversely.

(3) *Position.* For purposes of this section, a position with respect to property is an interest (including a futures or forward contract or an option) in property or any contractual right to a payment, whether or not severable from stock or other property. A position does not include traditional equity rights to demand payment from the issuer, such as the rights traditionally provided by mandatorily redeemable preferred stock.

(4) *Reasonable expectations.* For purposes of paragraphs (b)(1)(i), (b)(2), or (c)(1)(vi) of this section, reasonable expectations are the expectations of a reasonable person, based on all the facts and circumstances at the later of the time the stock is acquired or the positions are entered into. Reasonable expectations include all explicit or implicit representations made with respect to the marketing or sale of the position.

(c) *Special rules*—(1) *Positions in more than one stock*—(i) *In general.* This paragraph (c)(1) provides rules for the treatment of positions that reflect the value of more than one stock. In general, positions that reflect the value of a portfolio of stocks are treated under the rules of paragraphs (c)(1) (ii) through (iv) of this section, and positions that reflect the value of more than one stock but less than a portfolio are treated under the rules of paragraph (c)(1)(v) of this section. A portfolio for this purpose is any group of stocks of 20 or more unrelated issuers. Paragraph (c)(1)(vi) of this section provides an anti-abuse rule.

(ii) *Portfolios.* Notwithstanding paragraph (b)(1) of this section, a position reflecting the value of a portfolio of stocks is substantially similar or related to the stocks held by the taxpayer only if the position and the taxpayer's holdings substantially overlap as of the most recent testing date. A position may be substantially similar or related to a taxpayer's entire stock holdings or a portion of a taxpayer's stock holdings.

(iii) *Determining substantial overlap.* This paragraph (c)(1)(iii) provides rules for determining whether a position and a taxpayer's stock holdings or a portion of a taxpayer's stock holdings substantially overlap. Paragraphs (c)(1)(iii) (A) through (C) of this section determine whether there is substantial overlap as of any testing date.

(A) *Step One.* Construct a subportfolio (the Subportfolio) that consists of stock in an amount equal to the lesser of the fair market value of each stock represented in the position and the fair market value of the stock in the taxpayer's stock holdings. (The Subportfolio may contain fewer than 20 stocks.)

(B) *Step Two.* If the fair market value of the Subportfolio is equal to or greater than 70 percent of the fair market value of the stocks represented in the position, the position and the Subportfolio substantially overlap.

(C) *Step Three.* If the position does not substantially overlap with the Subportfolio, repeat Steps One and Two (paragraphs (c)(1)(iii)(A) and (B) of this section) reducing the size of the position. The largest percentage of the position that results in a substantial overlap is substantially similar or related to the Subportfolio determined with respect to that percentage of the position.

(iv) *Testing date.* A testing date is any day on which the taxpayer purchases or sells any stock if the fair market value of the stock or the fair market value of substantially similar or related property is reflected in the position, any day on which the taxpayer changes the position, or any day on which the composition of the position changes.

(v) *Nonportfolio positions.* A position that reflects the fair market value of more than one stock but not of a portfolio of stocks is treated as a separate position with respect to each of the stocks the value of which the position reflects.

(vi) *Anti-abuse rule.* Notwithstanding paragraphs (c)(1)(i) through (v) of this section, a position that reflects the value of more than one stock is a position in substantially similar or related property to the appropriate portion of the taxpayer's stock holdings if—

(A) Changes in the value of the position or the stocks reflected in the position are reasonably expected to virtually track (directly or inversely) changes in the value of the taxpayer's stock holdings, or any portion of the taxpayer's stock holdings and other positions of the taxpayer; and

(B) The position is acquired or held as part of a plan a principal purpose of which is to obtain tax savings (including by deferring tax) the value of which is significantly in excess of the expected pre-tax economic profits from the plan.

(2) *Options*—(i) *Options that are significantly out of the money.* For purposes of paragraph (b)(2) of this section, an option to sell that is significantly out of the money does not diminish the taxpayer's risk of loss on its stock unless the option is held as part of a strategy to substantially offset changes in the fair market value of the stock.

(ii) *Conversion rights.* Notwithstanding paragraphs (b)(1) and (2) of this section, a taxpayer is treated as diminishing its risk of loss by holding substantially similar or related property if it engages in the following transactions or their substantial equivalents—

(A) A short sale of common stock while holding convertible preferred stock of the same issuer and the price changes of the convertible preferred stock and the common stock are related;

(B) A short sale of a convertible debenture while holding convertible preferred stock into which the debenture is convertible or common stock; or

(C) A short sale of convertible preferred stock while holding common stock.

(3) *Stacking rule.* If a taxpayer diminishes its risk of loss by holding a position in substantially similar or related property with respect to only a portion of the shares that the taxpayer holds in a particular stock, the holding period of those shares having the shortest holding period is reduced.

(4) *Guarantees, surety agreements, or similar arrangements.* A taxpayer has diminished its risk of loss on stock by holding a position in substantially similar or related property if the taxpayer is the beneficiary of a guarantee, surety agreement, or similar arrangement and the guarantee, surety agreement, or similar arrangement provides for payments that will substantially offset decreases in the fair market value of the stock.

(5) *Hedges counted only once.* A position established as a hedge of one outstanding position, transaction, or obligation of the taxpayer (other than stock) is not treated as diminishing the risk of loss with respect to any other position held by the taxpayer. In determining whether a position is established to hedge an outstanding position, transaction, or obligation of the taxpayer, substantial deference will be given to the relationships that are established in its books and records at the time the position is entered into.

(6) *Use of related persons or pass-through entities.* Positions held by a party related to the taxpayer within the meaning of sections 267(b) or 707(b)(1) are treated as positions held by the taxpayer if the positions are held with a view to avoiding the application of this section or § 1.1092(d)–2. In addition, a taxpayer is treated as diminishing its risk of loss by holding substantially similar or related property if the taxpayer holds an interest in, or is the beneficiary of, a pass-through entity, intermediary, or other arrangement with a view to avoiding the application of this section or § 1.1092(d)–2.

(7) *Notional principal contracts.* For purposes of this section, rights and obligations under notional principal contracts are considered separately even though payments with regard to those rights and obligations are generally netted for other purposes. Therefore, if a taxpayer is treated under the preceding sentence as receiving payments under a notional principal contract when the fair market value of the taxpayer's stock declines, the taxpayer has diminished its risk of loss by holding a position in substantially similar or related property regardless of the netting of the payments under the contract for any other purposes.

(d) *Examples.* The following examples illustrate the provisions of this section:

Example 1. General application to common stock. Corporation A and Corporation B are both automobile manufacturers. The fair market values of Corporation A and Corporation B common stock primarily reflect the value of the same industry. Because Corporation A and Corporation B common stock are affected not only by the general level of growth in the industry but also by individual corporate management decisions and corporate capital structures, changes in the fair market value of Corporation A common stock are not reasonably expected to approximate changes in the fair market value of the Corporation B common stock. Under paragraph (b)(1) of this section, Corporation A common stock is not substantially similar or related to Corporation B common stock.

Example 2. Common stock value primarily reflects commodity price. Corporation C and Corporation D both hold gold as their primary asset, and historically changes in the fair market value of Corporation C common stock approximated changes in the fair market value of Corporation D common stock. Corporation M purchased Corporation C common stock and sold short Corporation D common stock. Corporation C common stock is substantially similar or related to Corporation D common stock because their fair market values primarily reflect the performance of the same economic factor, the price of gold, and changes in the fair market value of Corporation C common stock are reasonably expected to approximate changes in the fair market value of Corporation D common stock. It was reasonably expected that changes in the fair market values of the Corporation C common stock and the short position in Corporation D common stock would vary inversely. Thus, Corporation M has diminished its risk of loss on its Corporation C common stock for purposes of section

246(c)(4)(C) and this section by holding a position in substantially similar or related property.

Example 3. Portfolios of stocks —(i) Corporation Z holds a portfolio of stocks and acquires a short position on a publicly traded index through a regulated futures contract (RFC) that reflects the value of a portfolio of stocks as defined in paragraph (c)(1)(i) of this section. The index reflects the fair market value of stocks A through T. The values of stocks reflected in the index and the values of the same stocks in Corporation Z's holdings are as follows:

Stock	Z's holdings	RFC	Subportfolio
A	$300	$300	$300
B	300	300	300
C	—	300	—
D	400	500	400
E	300	500	300
F	300	500	300
G	500	600	500
H	300	300	300
I	—	300	—
J	400	450	400
K	200	500	200
L	200	400	200
M	200	500	200
N	100	200	100
O	—	200	—
P	200	200	200
Q	100	300	100
R	200	100	100
S	100	100	100
T	100	200	100
Totals	$4,200	$6,750	$4,100

(ii) The position is substantially similar or related to Z's stock holdings only if they substantially overlap. To determine whether they substantially overlap, Corporation Z must construct a Subportfolio of stocks with the lesser of the value of the stock as reflected in the RFC and its holdings. The Subportfolio is given in the rightmost column above. The value of the Subportfolio is 60.74 percent of the value of the stocks represented in the position ($4100÷$6750), so the position and the Subportfolio do not substantially overlap.

(iii) To determine whether any portion of the position substantially overlaps with any portion of the Z's stock holdings, the values of the stocks in the RFC are reduced for purposes of the above steps. Eighty percent of the position and the corresponding subportfolio (consisting of stocks with a value of the lesser of the stocks represented in Z's holdings and in 80 percent of the RFC) substantially overlap, computed as follows:

Stock	Z's holdings	80% of RFC	Subportfolio
A	$300	$240	$240
B	300	240	240
C	—	240	—
D	400	400	400
E	300	400	300
F	300	400	300
G	500	480	480
H	300	240	240
I	—	240	—
J	400	360	360
K	200	400	200
L	200	320	200
M	200	400	200
N	100	160	100
O	—	160	—
P	200	160	160
Q	100	240	100
R	200	80	80
S	100	80	80
T	100	160	100
Totals	$4,200	$5,400	$3,780

(iv) Because $3,780 is 70 percent of $5,400, the Subportfolio substantially overlaps with 80 percent of the position. Under paragraph (c)(3) of this section, Z's stocks having the shortest holding period are treated as included in the Subportfolio. A larger portion of Z's stocks may be treated as substantially similar or related property under the anti-abuse rule of paragraph (c)(1)(vi) of this section.

Example 4. Hedges counted only once January 1, 1996, Corporation X owns a $100 million portfolio of stocks all of which would substantially overlap with a $100 million regulated futures contract (RFC) on a commonly used index (the Index). On January 15, Corporation X enters into a $100 million short position in an RFC on the Index with a March delivery date and enters into a $75 million long position in an RFC on the Index for June delivery. Also on January 15, 1996, Corporation X indicates in its books and records that the long and short RFC positions are intended to offset one another. Under paragraph (c)(5) of this section, $75 million of the short position in the RFC is not treated as diminishing the risk of loss on the stock portfolio and instead is treated as a straddle or a hedging transaction, as appropriate, with respect to the $75 million long position in the RFC, under section 1092. The remaining $25 million short position is treated as diminishing the risk of loss on the portfolio by holding a position in substantially similar or related property. The rules of paragraph (c)(1) determine how much of the portfolio is subject to this rule and the rules of paragraph (c)(3) determine which shares have their holding periods tolled.

(e) *Effective date*—(1) *In general.* The provisions of this section apply to dividends received on or after March 17, 1995, on stock acquired after July 18, 1984.

(2) *Special rule for dividends received on certain stock.* Notwithstanding paragraph (e)(1) of this section, this section applies to any dividends received by a taxpayer on stock acquired after July 18, 1984, if the taxpayer has diminished its risk of loss by holding substantially similar or related property involving the following types of transactions—

(i) The short sale of common stock when holding convertible preferred stock of the same issuer and the price changes of the two stocks are related, or the short sale of a convertible debenture while holding convertible preferred stock into which the debenture is convertible (or common stock), or a short sale of convertible preferred stock while holding common stock; or

(ii) The acquisition of a short position in a regulated futures contract on a stock index, or the acquisition of an option to sell the regulated futures contract or the stock index itself, or the grant of a deep-in-the-money option to buy the regulated futures contract or the stock index while holding the stock of an investment company whose principal holdings mimic the performance of the stocks included in the stock index; or alternatively, while holding a portfolio composed of stocks that mimic the performance of the stocks included in the stock index.

[T.D. 8590, 60 FR 14638, Mar. 20, 1995]

§ 1.247–1 Deduction for dividends paid on preferred stock of public utilities.

(a) *Amount of deduction.* (1) A deduction is provided in section 247 for dividends paid during the taxable year by certain public utility corporations (see paragraph (b) of this section) on certain preferred stock (see paragraph (c) of this section). This deduction is an amount equal to the product of a specified fraction times the lesser of (i) the amount of the dividends paid during the taxable year by a public utility on its preferred stock (as defined in paragraph (c) of this section), or (ii) the taxable income of the public utility for such taxable year (computed without regard to the deduction allowed by section 247). The specified fraction for any taxable year is the fraction the numerator of which is 14 and the denominator of which is the sum of the corporation normal tax rate and the surtax rate for such taxable year specified in section 11. Since section 11 provides that for the calendar year 1954 the corporation normal tax rate is 30 percent and the surtax rate is 22 percent, the sum of the two tax rates is 52 percent and the specified fraction for the calendar year 1954 is 14/52. If, for example, section 11 should specify that the corporation's normal tax rate is 25 percent and the surtax rate is 22 percent for the calendar year, the sum of the two tax rates will be 47 percent and the specified fraction for the calendar year will be 14/47. If Corporation A, a public utility which files its income tax return on the calendar year basis, pays $100,000 dividends on its preferred stock in the calendar year 1954 and if its taxable income for such year is greater than $100,000 the deduction allowable to Corporation A under section 247 for 1954 is $100,000 times 14/52, or $26,923.08. If in 1954 Corporation A's taxable income, computed without regard to the deduction provided in section 247, had been $90,000 (that is, less than the amount of the dividends which it paid on its preferred stock in that year), the deduction allowable under section 247 for 1954 would have been $90,000 times 14/52, or $24,230.77.

(2) For the purpose of determining the amount of the deduction provided in section 247(a) and in subparagraph (1) of this paragraph, the amount of dividends paid in a given taxable year shall not include any amount distributed in such year with respect to dividends unpaid and accumulated in any taxable year ending before October 1, 1942. If any distribution is made in the current taxable year with respect to dividends unpaid and accumulated for a prior taxable year, such distribution will be deemed to have been made with respect to the earliest year or years for which there are dividends unpaid and accumulated. Thus, if a public utility makes a distribution with respect to a prior taxable year, it shall be considered that such distribution was made with respect to the earliest year or years for which there are dividends unpaid and accumulated, whether or not the public utility states that the distribution was made with respect to

such year or years and even though the public utility stated that the distribution was made with respect to a later year. Even though it has dividends unpaid and accumulated with respect to a taxable year ending before October 1, 1942, a public utility may, however, include the dividends paid with respect to the current taxable year in computing the deduction under section 247. If there are no dividends unpaid and accumulated with respect to a taxable year ending before October 1, 1942, a public utility may include the dividends paid with respect to a prior taxable year which ended after October 1, 1942, in computing the deduction under section 247; such public utility in addition may include the dividends paid with respect to the current taxable year in computing the deduction under section 247. However, if local law or its own charter requires a public utility to pay all unpaid and accumulated dividends before any dividends can be paid with respect to the current taxable year, such public utility may not include any distribution in the current year in computing the deduction under section 247 to the extent that there are dividends unpaid and accumulated with respect to taxable years ending before October 1, 1942.

(3) If a corporation which is engaged in one or more of the four types of business activities (called utility activities in this section) enumerated in section 247(b)(1) (the furnishing of telephone service or the sale of electrical energy, gas, or water) is also engaged in some other business that does not fall within any of the enumerated categories, the deduction under section 247 is allowable only for such portion of the amount computed under section 247(a) as is allocable to the income from utility activities. For this purpose, the allocation may be made on the basis of the ratio which the total income from the utility activities bears to total income from all sources (total income being considered either gross income or gross receipts, whichever method results in the higher deduction). However, if such an allocation reaches an inequitable result and the books of the corporation are so kept that the taxable income attributable to the utility activities can be readily determined, particularly where the books of the corporation are required by governmental bodies to be so kept for rate making or other purposes, the allocation may be made upon the basis of taxable income. No such apportionment will be required if the income from sources other than utility activities is less than 20 percent of the total income of the corporation, irrespective of the method used in determining such total income.

(b) *Public utility.* As used in section 247 and this section, public utility means a corporation engaged in the furnishing of telephone service, or in the sale of electric energy, gas, or water if the rates charged by such corporation for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof or by an agency or instrumentality of the United States or by a public utility or public service commission or other similar body of the District of Columbia or of any State or political subdivision thereof. If a schedule of rates has been filed with any of the above bodies having the power to disapprove such rates, then such rates shall be considered as established or approved rates even though such body has taken no action on the filed schedule. Rates fixed by contract between the corporation and the purchaser, except where the purchaser is the United States, a State, the District of Columbia, or an agency or political subdivision of the United States, a State, or the District of Columbia, shall not be considered as established or approved rates in those cases where they are not subject to direct control, or where no maximum rate for such contract rates has been established by the United States, a State, the District of Columbia, or by an agency or political subdivision thereof. The deduction provided in section 247 will not be denied solely because part of the gross income of the corporation consists of revenue derived from such furnishing or sale at rates which are not so regulated, provided the corporation establishes to the satisfaction of the Commissioner (1) that the revenue from regulated rates and the revenue from unregulated rates are derived from the operation of a single interconnected and coordinated system within a single area or region in one or more States, or from the operation of more than one such system and (2) that the regulation to which it is subject in part of its operating territory in one such system is effective to control rates within the unregulated territory of the same system so that the rates within the unregulated territory have been and are substantially as favorable to users and consumers as are the rates within the regulated territory.

(c) *Preferred stock.* (1) For the purposes of section 247 and this section, preferred stock means stock (i) which was issued before October 1, 1942, (ii) the dividends in respect of which (during the whole of the taxable year, or the part of the taxable year after the actual date of the issue of such stock) were cumulative, nonparticipating as to current distributions, and payable in preference to the payment of dividends on other stock, and (iii) the rate of return on which is fixed and cannot be changed by a vote of the board of directors or by some similar method. However, if there are several classes of preferred stock, all of which meet the above requirements, the deduction provided in section 247 shall not be denied in the case of a given class of preferred stock merely because there is another class of preferred stock whose dividends are to be paid before those of the given class of stock. Likewise, it is immaterial for the purposes of section 247 and this section whether the stock be voting or nonvoting stock.

(2) Preferred stock issued on or after October 1, 1942, under certain circumstances will be considered as having been issued before October 1, 1942, for purposes of the deduction provided in section 247. If the new stock is issued on or after October 1, 1942, to refund or replace bonds or debentures which were issued before October 1, 1942, or to refund or replace other stock which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), such new stock shall be considered as having been issued before October 1, 1942. If preferred stock is issued to refund or replace stock which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), it shall be immaterial whether the preferred stock so refunded or replaced was issued before, on, or after October 1, 1942. If stock issued on or after October 1, 1942, to refund or replace stock which was issued before October 1, 1942, and which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), is not itself preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), no stock issued to refund or replace such stock can be considered preferred stock for purposes of the deduction provided in section 247.

(3) In the case of any preferred stock issued on or after October 1, 1942, to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other stock which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), only that portion of the stock issued on or after October 1, 1942, will be considered as having been issued before October 1, 1942, the par or stated value of which does not exceed the par, stated, or face value of such bonds, debentures, or other preferred stock which the new stock was issued to refund or replace. In such case no shares of the new stock issued on or after October 1, 1942, shall be earmarked in determining the deduction allowable under section 247, but the appropriate allocable portion of the total amount of dividends paid on such stock will be considered as having been paid on stock which was issued before October 1, 1942.

(4) The provisions of section 247(b)(2) may be illustrated by the following example:

Example. A public utility has outstanding 1,000 bonds which were issued before October 1, 1942, and each of which has a face value of $100. On or after October 1, 1942, each of such bonds is retired in exchange for 1 1/10 shares of preferred stock issued on or after October 1, 1942, and having a par value of $100 per share. Only 10/11 of the dividends paid on the preferred stock thus issued in exchange for the bonds will be considered as having been paid on stock which was issued before October 1, 1942. Likewise, if preferred stock which is issued on or after October 1, 1942, has no par value but a stated value of $50 per share and such stock is issued in a ratio of three shares to one share to refund or replace preferred stock having a par value of $100 per share, only two-thirds of the dividends paid on the new shares of stock will be considered as having been paid on stock which was issued before October 1, 1942.

(5) Whether or not preferred stock issued on or after October 1, 1942, was issued to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock, is in each case a question of fact. Among the factors to be considered is whether such stock is new in an economic sense to the corporation or whether it was issued merely to take the place, directly or indirectly, of bonds, debentures, or other preferred stock of such corporation. It is not necessary that the new preferred stock be issued in exchange for such bonds, debentures, or other preferred stock. The mere fact that the bonds, debentures, or other preferred stock remain in existence for a short period of time after the issuance of the new stock (or were retired before the issuance of the new stock) does not necessarily mean that such new stock was not issued to refund or replace such bonds, debentures, or other preferred stock. It is necessary to consider the entire transaction, including the issuance of the new preferred stock, the date of such issuance, the retirement of the old bonds, debentures, or preferred stock, and the date of such retirement, in order to determine whether such new stock really was issued to take the place of bonds, debentures, or other preferred stock of the corporation or whether it represents something essentially new in an economic sense in the corporation's financial structure. If, for example, a public utility, which has outstanding bonds issued before October 1, 1942, issues new preferred stock on October 1, 1954, in order to secure funds with which to retire such bonds and with the money paid in for such stock retires the bonds on November 1, 1954, such stock may be considered as having been issued to refund or replace bonds issued before October 1, 1942. Whether the money used to retire the bonds can be traced back and identified as the money paid in for the stock will have evidentiary value, but will not be conclusive, in determining whether the stock was issued to refund or replace the bonds. Similarly, whether the amount of money used to retire the bonds was smaller than, equal to, or greater than that paid in for the stock, or whether the entire issue of bonds is retired, will be important, but not decisive, in making such determination.

(6) Preferred stock issued on or after October 1, 1942, by a corporation to refund or replace bonds or debentures of a second corporation which were issued before October 1, 1942, or to refund or replace other preferred stock of such second corporation, may be considered as having been issued before October 1, 1942, if such new stock was issued (i) in a transaction which is a reorganization within the meaning of section 368(a) or the corresponding provisions of the Internal Revenue Code of 1939; or (ii) in a transaction to which section 371 (relating to insolvency reorganizations), or the corresponding provisions of the Internal Revenue Code of 1939, is applicable; or (iii) in a transaction which is subject to the provisions of Part VI, Subchapter O, Chapter 1 of the Code (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission) or to the corresponding provisions of the Internal Revenue Code of 1939. Whether the stock actually was issued to refund or replace bonds or debentures of the second corporation issued before October 1, 1942, or to refund or replace preferred stock of such second corporation, shall be determined under the same principles as if only one corporation were involved. A corporation may issue stock to refund or replace its own bonds, debentures, or other preferred stock in a transaction which is a reorganization within the meaning of section 368(a) or the corresponding provisions of the Internal Revenue Code of 1939, in a transaction to which section 371 or the corresponding provisions of the Internal Revenue Code of 1939 is applicable, or in a transaction which is subject to the provisions of Part VI, Subchapter O, Chapter 1 of the Code, or to the corresponding provisions of the Internal Revenue Code of 1939. The provisions of this paragraph, in addition, are applicable in case a corporation

issues stock on or after October 1, 1942, to refund or replace its own bonds, debentures, or other preferred stock even though the issuance of such stock may not fall within one of the categories enumerated above.

(7) Even though stock issued on or after October 1, 1942, is considered as having been issued before October 1, 1942, by reason of having been issued to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock, such stock will not be deemed to be preferred stock within the meaning of section 247(b)(2), and no deduction will be allowable in respect of dividends paid on such stock, unless the stock fulfills all the other requirements of a preferred stock set forth in section 247(b)(2) and in this paragraph.

§ 1.248–1 Election to amortize organizational expenditures.

(a) *In general.* (1) Section 248(a) provides that a corporation may elect for any taxable year beginning after December 31, 1953, to treat its organizational expenditures, as defined in subsection (b) of section 248 and in paragraph (b) of this section, as deferred expenses. A corporation which exercises such election must, at the time it makes the election, select a period of not less than 60 months, beginning with the month in which it began business, over which it will amortize its organizational expenditures. The period selected by the corporation may be equal to or greater, but not less, than 60 months, but in any event it must begin with the month in which the corporation began business. The organizational expenditures of the corporation which are treated as deferred expenses under the provisions of section 248 and this section shall then be allowed as a deduction in computing taxable income ratably over the period selected by the taxpayer. The period selected by the taxpayer in making its election may not be subsequently changed but shall be adhered to in computing taxable income for the taxable year for which the election is made and all subsequent taxable years.

(2) If a corporation exercises the election provided in section 248(a), such election shall apply to all of its expenditures which are organizational expenditures within the meaning of subsection (b) of section 248 and paragraph (b) of this section. The election shall apply, however, only with respect to expenditures incurred before the end of the taxable year in which the corporation begins business (without regard to whether the corporation files its returns on the accrual or cash method of accounting or whether the expenditures are paid in the taxable year in which they are incurred), if such expenditures are paid or incurred on or after August 16, 1954 (the date of enactment of the Internal Revenue Code of 1954).

(3) The deduction allowed under section 248 must be spread over a period beginning with the month in which the corporation begins business. The determination of the date the corporation begins business presents a question of fact which must be determined in each case in light of all the circumstances of the particular case. The words *begins business,* however, do not have the same meaning as ‘‘in existence.’’ Ordinarily, a corporation begins business when it starts the business operations for which it was organized; a corporation comes into existence on the date of its incorporation. Mere organizational activities, such as the obtaining of the corporate charter, are not alone sufficient to show the beginning of business. If the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, however, it will be deemed to have begun business. For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business.

(b) *Organizational expenditures defined.* (1) Section 248(b) defines the term *organizational expenditures.* Such expenditures, for purposes of section 248 and this section, are those expenditures which are directly incident to the creation of the corporation. An expenditure, in order to qualify as an organizational expenditure, must be (i) incident to the creation of the corporation, (ii) chargeable to the capital account of the corporation, and (iii) of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life. An expenditure which fails to meet each of these three tests may not be considered an organizational expenditure for purposes of section 248 and this section.

(2) The following are examples of organizational expenditures within the meaning of section 248 and this section: legal services incident to the organization of the corporation, such as drafting the corporate charter, by-laws, minutes of organizational meetings, terms of original stock certificates, and the like; necessary accounting services; expenses of temporary directors and of organizational meetings of directors or stockholders; and fees paid to the State of incorporation.

(3) The following expenditures are not organizational expenditures within the meaning of section 248 and this section:

(i) Expenditures connected with issuing or selling shares of stock or other securities, such as commissions, professional fees, and printing costs. This is so even where the particular issue of stock to which the expenditures relate is for a fixed term of years;

(ii) Expenditures connected with the transfer of assets to a corporation.

(4) Expenditures connected with the reorganization of a corporation, unless directly incident to the creation of a corporation, are not organizational expenditures within the meaning of section 248 and this section.

(c) *Time and manner of making election.* The election provided by section 248(a) and paragraph (a) of this section shall be made in a statement attached to the taxpayer's return for the taxable year in which it begins business. Such taxable year must be one which begins after December 31, 1953. The return and statement must be filed not later than the date prescribed by law for filing the return (including any extensions of time) for the taxable year in which the taxpayer begins business. The statement shall set forth the description and amount of the expenditures involved, the date such expenditures were incurred, the month in which the corporation began business, and the number of months (not less than 60 and beginning with the month in which the taxpayer began business) over which such expenditures are to be deducted ratably.

§1.249–1 Limitation on deduction of bond premium on repurchase.

(a) *Limitation*—(1) *General rule.* No deduction is allowed to the issuing corporation for any ''repurchase premium'' paid or incurred to repurchase a convertible obligation to the extent the repurchase premium exceeds a ''normal call premium.''

(2) *Exception.* Under paragraph (e) of this section, the preceding sentence shall not apply to the extent the corporation demonstrates that such excess is attributable to the cost of borrowing and not to the conversion feature.

(b) *Obligations*—(1) *Definition.* For purposes of this section, the term *obligation* means any bond, debenture, note, or certificate or other evidence of indebtedness.

(2) *Convertible obligation.* Section 249 applies to an obligation which is convertible into the stock of the issuing corporation or a corporation which, at the time the obligation is issued or repurchased, is in control of or controlled by the issuing corporation. For purposes of this subparagraph, the term *control* has the meaning assigned to such term by section 368(c).

(3) *Comparable nonconvertible obligation.* A nonconvertible obligation is comparable to a convertible obligation if both obligations are of the same grade and classification, with the same issue and maturity dates, and bearing the same rate of interest. The term *comparable nonconvertible obligation* does not include any obligation which is convertible into property.

(c) *Repurchase premium.* For purposes of this section, the term *repurchase premium* means the excess of the repurchase price paid or incurred to repurchase the obligation over its adjusted issue price (within the meaning of §1.1275–1(b)) as of the repurchase date. For the general rules applicable to the deductibility of repurchase premium, see §1.163–7(c). This paragraph (c) applies to convertible obligations repurchased on or after March 2, 1998.

(d) *Normal call premium*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, for purposes of this section, a *normal call premium* on a convertible obligation is an amount equal to a normal call premium on a nonconvertible obligation which is comparable to the convertible obligation. A normal call premium on a comparable nonconvertible obligation is a call premium specified in dollars under the terms of such obligation. Thus, if such a specified call premium is constant over the entire term of the obligation, the normal call premium is the amount specified. If, however, the specified call premium varies during the period the comparable nonconvertible obligation is callable or if such obligation is not callable over its entire term, the normal call premium is the amount specified for the period during the term of such comparable nonconvertible obligation which corresponds to the period during which the convertible obligation was repurchased.

(2) *One-year's interest rule.* For a convertible obligation repurchased on or after March 2, 1998, a call premium specified in dollars under the terms of the obligation is considered to be a normal call premium on a nonconvertible obligation if the call premium applicable when the obligation is repurchased does not exceed an amount equal to the interest (including original issue discount) that otherwise would be deductible for the taxable year of repurchase (determined as if the obligation were not repurchased). The provisions of this subparagraph shall not apply if the amount of interest payable for the corporation's taxable year is subject under the terms of the obligation to any contingency other than repurchase prior to the close of such taxable year.

(e) *Exception*—(1) *In general.* If a repurchase premium exceeds a normal call premium, the general rule of paragraph (a) (1) of this section does not apply to the extent that the corporation demonstrates to the satisfaction of the Commissioner or his delegate that such repurchase premium is attributable to the cost of borrowing and is not attributable to the conversion feature. For purposes of this paragraph, if a normal call premium cannot be established under paragraph (d) of this section, the amount thereof shall be considered to be zero.

(2) *Determination of the portion of a repurchase premium attributable to the cost of borrowing and not attributable to the conversion feature.* (i) For purposes of subparagraph (1) of this paragraph, the portion of a repurchase premium which is attributable to the cost of borrowing and which is not attributable to the conversion feature is the amount by which the selling price of the convertible obligation increased between the dates it was issued and repurchased by reason of a decline in yields on comparable nonconvertible obligations traded on an established securities market or, if such comparable traded obligations do not exist, by reason of a decline in yields generally on nonconvertible obligations which are as nearly comparable as possible.

(ii) In determining the amount under subdivision (i) of this subparagraph, appropriate consideration shall be given to all factors affecting the selling price or yields of comparable nonconvertible obligations. Such factors include general changes in prevailing yields of comparable obligations between the dates the convertible obligation was issued and repurchased and the amount (if any) by which the selling price of the nonconvertible obligation was affected by reason of any change in the issuing corporation's credit rating or the credit rating of the obligation during such period (determined on the basis of widely published ratings of recognized credit rating services or on the basis of other relevant facts and circumstances which reflect the relative credit ratings of the corporation or the comparable obligation).

(iii) The relationship between selling price and yields in subdivision (i) of this subparagraph shall ordinarily be determined by means of standard bond tables.

(f) *Effective date*—(1) *In general.* Under section 414(c) of the Tax Reform Act of 1969, the provisions of section 249 and this section shall apply to any repurchase of a convertible obligation occurring after April 22, 1969, other than a convertible obligation repurchased pursuant to a binding obligation incurred on or before April 22, 1969, to repurchase such convertible obligation at a specified call premium. A binding obligation on or before such date may arise if, for example, the issuer irrevocably obligates itself, on or before such date, to repurchase the convertible obligation at a specified price after such date, or if, for example, the issuer, without regard to the terms of the convertible obligation, negotiates a contract which, on or before such date, irrevocably obligates the issuer to repurchase the convertible obligation at a specified price after such date. A binding obligation on or before such date does not include a privilege in the convertible obligation permitting the issuer to call such convertible obligation after such date, which privilege was not exercised on or before such date.

(2) *Effect on transactions not subject to this section.* No inferences shall be drawn from the provisions of section 249 and this section as to the proper treatment of transactions not subject to such provisions because of the effective date limitations thereof. For provisions relating to repurchases of convertible bonds or other evidences of indebtedness to which section 249 and this section do not apply, see §§1.163–3(c) and 1.163–4(c).

(g) *Example.* The provisions of this section may be illustrated by the following example:

Example. On May 15, 1968, corporation A issues a callable 20-year convertible bond at face for $1,000 bearing interest at 10 percent per annum. The bond is convertible at any time into 2 shares of the common stock of corporation A. Under the terms of the bond, the applicable call price prior to May 15, 1975, is $1,100. On June 1, 1974, corporation A calls the bond for $1,100. Since the repurchase premium, $100 (i.e., $1,100 minus $1,000), was specified in dollars in the obligation and does not exceed 1 year's interest at the rate fixed in the obligation, the $100 is considered under paragraph (d) (2) of this section to be a normal call premium on a comparable nonconvertible obligation. Accordingly, A may deduct the $100 under §1.163–3(c).

[T.D. 7259, 38 FR 4254, Feb. 12, 1973, as amended by T.D. 8746, 62 FR 68182, Dec. 31, 1997]

ITEMS NOT DEDUCTIBLE

§1.261–1 General rule for disallowance of deductions.

In computing taxable income, no deduction shall be allowed, except as otherwise expressly provided in Chapter 1 of the Code, in respect of any of the items specified in Part IX (section 262 and following), Subchapter B, Chapter 1 of the Code, and the regulations thereunder.

§1.262–1 Personal, living, and family expenses.

(a) *In general.* In computing taxable income, no deduction shall be allowed, except as otherwise expressly provided in chapter 1 of the Code, for personal, living, and family expenses.

(b) *Examples of personal, living, and family expenses.* Personal, living, and family expenses are illustrated in the following examples:

(1) Premiums paid for life insurance by the insured are not deductible. See also section 264 and the regulations thereunder.

(2) The cost of insuring a dwelling owned and occupied by the taxpayer as a personal residence is not deductible.

(3) Expenses of maintaining a household, including amounts paid for rent, water, utilities, domestic service, and the like, are not deductible. A taxpayer who rents a property for residential purposes, but incidentally conducts business there (his place of business being elsewhere) shall not deduct any part of the rent. If, however, he uses part of the house as his place of business, such portion of the rent and other similar expenses as is properly attributable to such place of business is deductible as a business expense.

(4) Losses sustained by the taxpayer upon the sale or other disposition of property held for personal, living, and family purposes are not deductible. But see section 165 and the regulations thereunder for deduction of losses sustained to such property by reason of casualty, etc.

(5) Expenses incurred in traveling away from home (which include transportation expenses, meals, and lodging) and any other transportation expenses are not deductible unless they qualify as expenses deductible under section 162, §1.162–2, and paragraph (d) of §1.162–5 (relating to trade or business expenses), section 170 and paragraph (a)(2) of §1.170–2 or paragraph (g) of §1.170A–1 (relating to charitable contributions), section 212 and §1.212–1 (relating to expenses for production of income), section 213(e) and paragraph (e)

of § 1.213–1 (relating to medical expenses) or section 217(a) and paragraph (a) of § 1.217–1 (relating to moving expenses). The taxpayer's costs of commuting to his place of business or employment are personal expenses and do not qualify as deductible expenses. The costs of the taxpayer's lodging not incurred in traveling away from home are personal expenses and are not deductible unless they qualify as deductible expenses under section 217. Except as permitted under section 162, 212, or 217, the costs of the taxpayer's meals not incurred in traveling away from home are personal expenses.

(6) Amounts paid as damages for breach of promise to marry, and attorney's fees and other costs of suit to recover such damages, are not deductible.

(7) Generally, attorney's fees and other costs paid in connection with a divorce, separation, or decree for support are not deductible by either the husband or the wife. However, the part of an attorney's fee and the part of the other costs paid in connection with a divorce, legal separation, written separation agreement, or a decree for support, which are properly attributable to the production or collection of amounts includible in gross income under section 71 are deductible by the wife under section 212.

(8) The cost of equipment of a member of the armed services is deductible only to the extent that it exceeds nontaxable allowances received for such equipment and to the extent that such equipment is especially required by his profession and does not merely take the place of articles required in civilian life. For example, the cost of a sword is an allowable deduction in computing taxable income, but the cost of a uniform is not. However, amounts expended by a reservist for the purchase and maintenance of uniforms which may be worn only when on active duty for training for temporary periods, when attending service school courses, or when attending training assemblies are deductible except to the extent that nontaxable allowances are received for such amounts.

(9) Expenditures made by a taxpayer in obtaining an education or in furthering his education are not deductible unless they qualify under section 162 and § 1.162–5 (relating to trade or business expenses).

(c) *Cross references.* Certain items of a personal, living, or family nature are deductible to the extent expressly provided under the following sections, and the regulations under those sections:

(1) Section 163 (interest).

(2) Section 164 (taxes).

(3) Section 165 (losses).

(4) Section 166 (bad debts).

(5) Section 170 (charitable, etc., contributions and gifts).

(6) Section 213 (medical, dental, etc., expenses).

(7) Section 214 (expenses for care of certain dependents).

(8) Section 215 (alimony, etc., payments).

(9) Section 216 (amounts representing taxes and interest paid to cooperative housing corporation).

(10) Section 217 (moving expenses).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6796, 30 FR 1041, Feb. 2, 1965; T.D. 6918, 32 FR 6681, May 2, 1967; T.D. 7207, 37 FR 20795, Oct. 4, 1972]

§ 1.263(a)–1 Capital expenditures; In general.

(a) Except as otherwise provided in chapter 1 of the Code, no deduction shall be allowed for:

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate, or

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of a deduction for depreciation, amortization, or depletion.

(b) In general, the amounts referred to in paragraph (a) of this section include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the meaning of subparagraphs (1) and (2) of this paragraph. See section 162 and § 1.162–4. See section 263A and the regulations thereunder for cost capitalization rules which apply to amounts referred to in paragraph (a) of this section with respect to the production of real and tangible personal property (as defined in §1.263A–1T (a)(5)(iii)), including films, sound recordings, video tapes, books, or similar properties. An amount referred to in paragraph (a) of this section is a capital expenditure that is taken into account through inclusion in inventory costs or a charge to capital accounts or basis no earlier than the taxable year during which the amount is incurred within the meaning of §1.446–1(c)(1)(ii). See section 263A and the regulations thereunder for cost capitalization rules that apply to amounts referred to in paragraph (a) of this section with respect to the production of real and tangible personal property (as defined in §1.263A–2(a)(2)), including films, sound recordings, video tapes, books, or similar properties.

(c) The provisions of paragraph (a) (1) of this section shall not apply to expenditures deductible under:

(1) Section 616 and §§1.616–1 through 1.616–3, relating to the development of mines or deposits,

(2) Section 174 and §§1.174–1 through 1.174–4, relating to research and experimentation,

(3) Section 175 and §§1.175–1 through 1.175–6, relating to soil and water conservation,

(4) Section 179 and §§1.179–1 through 1.179–5, relating to election to expense certain depreciable business assets,

(5) Section 180 and §§1.180–1 and 1.180–2, relating to expenditures by farmers for fertilizer, lime, etc., and

(6) Section 182 and §§1.182–1 through 1.182–6, relating to expenditures by farmers for clearing land.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6794, 30 FR 792, Jan. 26, 1965; T.D. 8121, 52 FR 414, Jan. 6, 1987; T.D. 8131, 52 FR 10084, Mar. 30, 1987; T.D. 8408, 57 FR 12419, Apr. 10, 1992; T.D. 8482, 58 FR 42207, Aug. 9, 1993]

§1.263(a)–2 Examples of capital expenditures.

The following paragraphs of this section include examples of capital expenditures:

(a) The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

(b) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments. See section 263A and the regulations thereunder for capitalization rules which apply to amounts expended in securing and producing a copyright and plates in connection with the production of property, including films, sound recordings, video tapes, books, or similar properties.

(c) The cost of defending or perfecting title to property.

(d) The amount expended for architect's services.

(e) Commissions paid in purchasing securities. Commissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commissions may be treated as an ordinary and necessary business expense.

(f) Amounts assessed and paid under an agreement between bondholders or shareholders of a corporation to be used in a reorganization of the corporation or voluntary contributions by shareholders to the capital of the corporation for any corporate purpose. Such amounts are capital investments and are not deductible. See section 118 and §1.118–1.

(g) A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stockholdings in the subsidiary shall not deduct amounts paid in carrying out this guaranty in computing its taxable income, but such payments are capital expenditures to be added to the cost of its stock in the subsidiary.

(h) The cost of good will in connection with the acquisition of the assets of a going concern is a capital expenditure.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 8131, 52 FR 10084, Mar. 30, 1987]

§ 1.263(a)–3 Election to deduct or capitalize certain expenditures.

(a) Under certain provisions of the Code, taxpayers may elect to treat capital expenditures as deductible expenses or as deferred expenses, or to treat deductible expenses as capital expenditures.

(b) The sections referred to in paragraph (a) of this section include:

(1) Section 173 (circulation expenditures).

(2) Section 174 (research and experimental expenditures).

(3) Section 175 (soil and water conservation expenditures).

(4) Section 177 (trademark and trade name expenditures).

(5) Section 179 (election to expense certain depreciable business assets).

(6) Section 180 (expenditures by farmers for fertilizer, lime, etc.).

(7) Section 182 (expenditures by farmers for clearing land).

(8) Section 248 (organizational expenditures of a corporation).

(9) Section 266 (carrying charges).

(10) Section 615 (exploration expenditures).

(11) Section 616 (development expenditures).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6794, 30 FR 792, Jan. 26, 1965; T.D. 8121, 52 FR 414, Jan. 6, 1987]

§ 1.263(b)–1 Expenditures for advertising or promotion of good will.

See § 1.162–14 for the rules applicable to a corporation which has elected to capitalize expenditures for advertising or the promotion of good will under the provisions of section 733 or section 451 of the Internal Revenue Code of 1939, in computing its excess profits tax credit under Subchapter E, Chapter 2, or Subchapter D, Chapter 1, of the Internal Revenue Code of 1939.

§ 1.263(c)–1 Intangible drilling and development costs in the case of oil and gas wells.

For rules relating to the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells, see § 1.612–4.

§ 1.263(e)–1 Expenditures in connection with certain railroad rolling stock.

(a) *Allowance of deduction*—(1) *Election.* Under section 263(e), for any taxable year beginning after December 31, 1969, a taxpayer may elect to treat certain expenditures paid or incurred during such taxable year as deductible repairs under section 162 or 212. This election applies only to expenditures described in paragraph (c) of this section in connection with the rehabilitation of a unit of railroad rolling stock (as defined in paragraph (b)(2) of this section) used by a domestic common carrier by railroad (as defined in paragraph (b) (3) and (4) of this section). However, an election under section 263(e) may not be made with respect to expenditures in connection with any unit of railroad rolling stock for which an election under section 263(f) and the regulations thereunder is in effect. An election made under section 263(e) is an annual election which may be made with respect to one or more of the units of railroad rolling stock owned by the taxpayer.

(2) *Special 20 percent rule.* Section 263(e) shall not apply if, under paragraph (d) of this section, expenditures paid or incurred during any period of 12 calendar months in connection with the rehabilitation of a unit exceed 20 percent of the basis (as defined in paragraph (b)(1) of this section) of such unit in the hands of the taxpayer. However, section 263(e) does not constitute a limit on the deduction of expenditures for repairs which are deductible without regard to such section. Accordingly, amounts otherwise deductible as repairs will continue to be deductible even though such amounts exceed 20 percent of the basis of the unit of railroad rolling stock in the hands of the taxpayer.

(3) *Time and manner of making election.* (i) An election by a taxpayer under section 263(e) shall be made by a statement to that effect attached to its income tax return or amended income tax return for the taxable year for which the election is made if such return or amended return is filed no later than the time prescribed by law (including extensions thereof) for filing

the return for the taxable year of election. An election under section 263(e) may be made with respect to one or more of the units of railroad rolling stock owned by the taxpayer. If an election is not made within the time and in the manner prescribed in this subparagraph, no election may be made (by the filing of an amended return or in any other manner) with respect to the taxable year.

(ii) If the taxpayer has filed a return on or before March 14, 1973, and has claimed a deduction under section 162 or 212 by reason of section 263(e), and if the taxpayer does not desire to make an election under section 263(e) for the taxable year with respect to which such return was filed, the taxpayer shall file an amended return for such taxable year on or before May 14, 1973, and shall pay any additional tax due for such year. The taxpayer shall also file an amended return for each taxable year which is affected by the filing of an amended return under the preceding sentence and shall pay any additional tax due for such year. Nothing in this subdivision shall be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(iii) If an election under section 263(e) was not made at the time the return for a taxable year was filed, and it is subsequently determined that an expenditure was erroneously treated as an expenditure which was not in connection with rehabilitation (as determined under paragraph (c) of this section), an election under section 263(e) may be made with respect to the unit of railroad rolling stock for which such expenditure was made for such taxable year, notwithstanding any provision in this subparagraph (3) to the contrary. Nothing in this subdivision shall be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(iv) The statement required by subdivision (i) of this subparagraph shall include the following information:

(a) The total number of units of railroad rolling stock with respect to which an election is being made under section 263(e).

(b) The aggregate basis (as defined in paragraph (b) (1) of this section) of the units described in (a) of this subdivision (iv), and

(c) The total deduction being claimed under section 263(e) for the taxable year.

(b) *Definitions*—(1) *Basis.* (i) In general, for purposes of section 263(e) the basis of a unit of railroad rolling stock shall be the adjusted basis of such unit determined without regard to the adjustments provided in paragraphs (1), (2), and (3) of section 1016(a) and section 1017. Thus, the basis of property would generally be its cost without regard to adjustments to basis such as for depreciation or for capital improvements. If the basis of a unit in the hands of a transferee is determined in whole or in part by reference to its basis in the hands of the transferor, for example, by reason of the application of section 362 (relating to basis to corporations), 374 (relating to gain or loss not recognized in certain railroad reorganizations), or 723 (relating to the basis of property contributed to a partnership), then the basis of such unit in the hands of the transferor for purposes of section 263(e) shall be its basis for purposes of section 263(e) in the hands of the transferee. Similarly, when the basis of a unit of railroad rolling stock in the hands of the taxpayer is determined in whole or in part by reference to the basis of another unit, for example, by reason of the application of the first sentence of section 1033(c) (relating to involuntary conversions), then the basis of the latter unit for purposes of section 263(e) shall be the basis for purposes of section 263(e) of the former unit. The question whether a capital expenditure in connection with a unit of railroad rolling stock results in the retirement of such unit and the creation of another unit of railroad rolling stock shall be determined without regard to rules under the uniform system of accounts prescribed by the Interstate Commerce Commission.

(ii) For example, if a unit of railroad rolling stock has a cost to M of $10,000 and because of depreciation adjustments of $4,000 and capital expenditures of $3,000, such unit has an adjusted basis in the hands of M of $9,000, the basis for purposes of section 263(e) of such unit in the hands of M is $10,000. Further, if M transfers such unit to N in a transaction in which no gain or loss is recognized such as, for example, a transaction to which section 351(a) (relating to a transfer to a corporation controlled by the transferor) applies, the basis of such unit for purposes of section 263(e) is $10,000 in the hands of N.

(2) *Railroad rolling stock.* For purposes of this section, the term *unit* or *unit of railroad rolling stock* means a unit of transportation equipment the expenditures for which are of a type chargeable (or in the case of property leased to a domestic common carrier by railroad, would be chargeable) to the equipment investment accounts in the uniform system of accounts for railroad companies prescribed by the Interstate Commerce Commission (49 CFR Part 1201), but only if (i) such unit exclusively moves on, moves under, or is guided by rail, and (ii) such unit is not a locomotive. Thus, for example, a unit of railroad rolling stock includes a box car, a gondola car, a passenger car, a car designed to carry truck trailers and containerized freight, a wreck crane, and a bunk car. However, such term does not include equipment which does not exclusively move on, move under, or is not exclusively guided by rail such as, for example, a barge, a tugboat, a container which is used on cars designed to carry containerized freight, a truck trailer, or an automobile. A locomotive is self-propelled equipment, the sole function of which is to push or pull railroad rolling stock. Thus, a self-propelled passenger or freight car is not a locomotive.

(3) *Domestic common carrier by railroad.* The term *domestic common carrier by railroad* means a railroad subject to regulation under Part I of the Interstate Commerce Act (49 U.S.C. 1 *et seq.*) or a railroad which would be subject to regulation under Part I of the Interstate Commerce Act if it were engaged in interstate commerce.

(4) *Use.* For purposes of this section, a unit of railroad rolling stock is not used by a domestic common carrier by railroad if it is owned by a person other than a domestic common carrier by railroad and (i) is exclusively used for transportation by the owner or (ii) is exclusively used for transportation by another person which is not a domestic common carrier by railroad. Thus, for example, a unit of railroad rolling stock which is owned by a person which is not a domestic common carrier by railroad and is leased to a manufacturing company by the owner is not a unit of railroad rolling stock used by a domestic common carrier by railroad.

(c) *Expenditures considered in connection with rehabilitation.* For purposes of section 263(e) and this section all expenditures which would be properly chargeable to capital account but for the application of section 263 (e) or (f) shall be considered to be expenditures in connection with the rehabilitation of a unit of railroad rolling stock. Expenditures which are paid or incurred in connection with incidental repairs or maintenance of a unit of railroad rolling stock and which are deductible without regard to section 263 (e) or (f) shall not be included in any determination or computation under section 263(e) and shall not be treated as paid or incurred in connection with the rehabilitation of a unit of railroad rolling stock for purposes of section 263(e). The determination of whether an item would be, but for section 263 (e) or (f), properly chargeable to capital account shall be made in a manner consistent with the principles for classification of expenditures as between capital and expenses under the Internal Revenue Code. See, for example, §§ 1.162–4, 1.263(a)–1, 1.263(a)–2, and paragraph (a)(4) (ii) and (iii) of § 1.446–1. An expenditure shall be classified as capital or as expense without regard to its classification under the uniform system of accounts prescribed by the Interstate Commerce Commission.

(d) *20-percent limitation*—(1) *In general.* No expenditures in connection with the rehabilitation of a unit of railroad rolling stock shall be treated as a deductible repair by reason of an election under section 263(e) if, during any period of 12 calendar months in which the month the expenditure is included falls, all such expenditures exceed an amount equal to 20 percent of the basis (as defined in paragraph (b)(1) of this section) of such unit in the hands of the taxpayer. All such expenditures shall be included in the computation of the 20-percent limitation even if such expenditures were deducted under section 263(f) in either the preceding or succeeding taxable year. Solely for purposes of the 20-percent limitation in this paragraph, such expenditures shall be deemed to be included in the month in which a rehabilitation of the unit of railroad rolling stock is completed. For the requirement that expenditures treated as repairs solely by reason of an election under section 263(e) be deducted in the taxable year paid or incurred, see paragraph (a) of this section.

(2) *12-month period.* For purposes of this section, any period of 12 calendar months shall consist of any 12 consecutive calendar months except that calendar months prior to the calendar month of January 1970 shall not be included in determining such period.

(3) *Period for certain corporate acquisitions.* If a unit of railroad rolling stock to which section 263(e) applies is sold, exchanged, or otherwise disposed of in a transaction in which its basis in the hands of the transferee is determined in whole or in part by reference to its basis in the hands of the transferor (see paragraph (b)(1) of this section), calendar months during which such unit is in the hands of the transferor and in the hands of such transferee shall both be included in the calendar months used by the transferor and the transferee to determine any period of 12 calendar months for purposes of section 263(e).

(4) *Deduction allowed in year paid or incurred.* If, based on the information available when the income tax return for a taxable year is filed, an expenditure paid or incurred in such taxable year would be deductible by reason of the application of section 263(e) but for the fact that it cannot be established whether the 20-percent limitation in subparagraph (1) of this paragraph will be exceeded, the expenditure shall be deducted for such taxable year. If by reason of the application of such 20-percent limitation it is subsequently determined that such expenditure is not deductible as a repair, an amended return shall be filed for the year in which such deduction was treated as a deductible repair and additional tax, if any, for such year shall be paid. Appropriate adjustment with respect to the taxpayer's tax liability for any other affected year shall be made. Nothing in this subparagraph shall be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(e) *Recordkeeping requirements*—(1) *In general.* Such records as will enable the accurate determination of the expenditures which may be subject to the treatment provided in section 263(e) shall be maintained. No deduction shall be allowed under section 162 or 212 by reason of section 263(e) with respect to a unit unless the taxpayer substantiates by adequate records that expenditures in connection with such unit of railroad rolling stock meet the requirements and limitations of this section.

(2) *Separate records.* A separate section 263(e) record shall be maintained for each unit with respect to which an election under section 263(e) is made. Such record shall:

(i) Identify the unit,

(ii) State the basis (as defined in paragraph (b)(1) of this section) and the date of acquisition of the unit,

(iii) Enumerate for each unit the amount of all expenditures incurred in connection with rehabilitation of such unit which would, but for section 263 (e) or (f), be properly chargeable to capital account (including expenditures incurred by the taxpayer in connection with rehabilitation of such unit undertaken by a person other than the taxpayer) regardless of whether such expenditures during any 12-month period exceed 20 percent of the basis of such unit,

(iv) Describe the nature of the work in connection with each expenditure, and

(v) Specify the calendar month in which the rehabilitation is completed and the taxable year in which each expenditure is paid or incurred.

A section 263(e) record need only be prepared for a unit of railroad rolling stock for the period beginning on the first day of the eleventh calendar month immediately preceding the month in which the rehabilitation of such unit is completed and ending on the last day of the eleventh calendar month immediately succeeding such month. No section 263(e) record need be prepared for calendar months before January 1970.

(3) *Records for certain expenditures:* Expenditures determined to be incidental repairs and maintenance (referred to in paragraph (c) of this section) shall not be entered in the section 263(e) record. However, each taxpayer shall maintain records to reflect that such expenditures are properly deductible.

(4) *Convenience rule.* In general, expenditures and information maintained in compliance with subparagraphs (1) and (2) of this paragraph shall be recorded in the section 263(e) record of the specific unit with respect to which such expenditures are incurred. However, when a group of units of the same type are rehabilitated in a single project and the expenditure for each unit in the project will approximate the average expenditure per unit for the project, expenditures for the project may be aggregated without regard to the unit in the project with respect to which each expenditure is connected, and an amount equal to the aggregate expenditures for the project divided by the number of units in the project may be entered in the section 263(e) account of each unit in the project.

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

Example 1. M Corporation, a domestic common carrier by railroad, uses the calendar year as its taxable year. M owns and uses several gondola cars to which an election under section 263(e) applies for its taxable years 1970–1972. Gondola car No.1 has a basis (defined in paragraph (b)(1) of this section) of $10,000. No expenditures properly chargeable to the section 263(e) record are made on gondola car No. 1 in 1970 and 1971, except in January 1971. In January 1971, M at a cost of $1,500 performed rehabilitation work on gondola car No. 1. Such amount was properly entered in the section 263(e) record for gondola car No.1. Since the expenditures in such record do not exceed an amount equal to 20 percent of the basis of gondola car No. 1 ($2,000) during any period of 12 calendar months in which January 1971 falls, the expenditures during January 1971 shall be treated as a deductible expense regardless of what the treatment would have been if section 263(e) had not been enacted.

Example 2. Assume the same facts as in *Example (1).* Assume further that for 1970, 1971, and 1972, only the following expenditures in connection with rehabilitation which would, but for section 263(e), be properly chargeable to capital account were deemed included for gondola car No. 2:

(a) December 1970	$1,500
(b) November 1971	600
(c) December 1971	400
(d) January 1972	1,050

Assume further that gondola car No. 2 has a basis (as defined in paragraph (b) (1) of this section) equal to $10,000, that M files its tax return by September 15 following each taxable year, and that each rehabilitation was completed in the month in which expenditures in connection with it were incurred. Any expenditures in connection with each gondola car (No. 1 or No. 2) have no effect on the treatment of expenditures in connection with the other gondola car. With respect to gondola car No. 2, the expenditures of December 1970 are treated as deductible repairs at the time M's income tax return for 1970 is filed because, based on the information available when the income tax return for 1970 is filed, such expenditure would be deductible by reason of application of section 263(e) but for the fact that it cannot be established whether the 20-percent limitation in paragraph (d)(1) of this section will be exceeded. Nevertheless, because such expenditures during the period of 12 calendar months including calendar months December 1970 and November 1971 exceed $2,000, the December 1970 rehabilitation expenditures are not subject to the provisions of section 263(e). Because such rehabilitation expenditures during the period of 12 calendar months including calendar months February 1971 and January 1972 exceed $2,000, rehabilitation expenditures in 1971 are not subject to the provisions of section 263(e). Similarly, the 1972 rehabilitation expenditures are not subject to the provisions of section 263(e).

[T.D. 7257, 38 FR 4255, Feb. 12, 1973]

§ 1.263(f)–1 Reasonable repair allowance.

(a) For rules regarding the election of the repair allowance authorized by section 263(f), the definition of repair allowance property, and the conditions under which an election may be made, see paragraphs (d) (2) and (f) of § 1.167(a)–11. An election may be made under this section for a taxable year only if the taxpayer makes an election under § 1.167(a)–11 for such taxable year.

(Sec. 263(f), 85 Stat. 509 (26 U.S.C. 263))

[T.D. 7272, 38 FR 9986, Apr. 23, 1973; 38 FR 12919, May 17, 1973; as amended by T.D. 7593, 44 FR 5421, Jan. 26, 1979]

§1.263A–0 Outline of regulations under section 263A.

This section lists the paragraphs in §§1.263A–1 through 1.263A–3 and §1.263A–7 through 1.263A–15.

§1.263A–1 Uniform Capitalization of Costs.

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§ 1.263A–15 Effective dates, transitional rules, and anti-abuse rule.

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§ 1.263A–0T Outline of regulations under section 263A (temporary).

This section lists the paragraphs in § 1.263A–4T.

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[T.D. 8729, 62 FR 44546, Aug. 22, 1997]

§1.263A–1 Uniform capitalization of costs.

(a) *Introduction*—(1) *In general.* The regulations under §§1.263A–1 through 1.263A–6 provide guidance to taxpayers that are required to capitalize certain costs under section 263A. These regulations generally apply to all costs required to be capitalized under section 263A except for interest that must be capitalized under section 263A(f) and the regulations thereunder. Statutory or regulatory exceptions may provide that section 263A does not apply to certain activities or costs; however, those activities or costs may nevertheless be subject to capitalization requirements under other provisions of the Internal Revenue Code and regulations.

(2) *Effective dates.* (i) In general, this section and §§1.263A–2 and 1.263A–3 apply to costs incurred in taxable years beginning after December 31, 1993. In the case of property that is inventory in the hands of the taxpayer, however, these sections are effective for taxable years beginning after December 31, 1993. Changes in methods of accounting necessary as a result of the rules in this section and §§1.263A–2 and 1.263A–3 must be made under terms and conditions prescribed by the Commissioner. Under these terms and conditions, the principles of §1.263A–7 must be applied in revaluing inventory property.

(ii) For taxable years beginning before January 1, 1994, taxpayers must take reasonable positions on their federal income tax returns when applying section 263A. For purposes of this paragraph (a)(2)(iii), a reasonable position is a position consistent with the temporary regulations, revenue rulings, revenue procedures, notices, and announcements concerning section 263A applicable in taxable years beginning before January 1, 1994. See §601.601(d)(2)(ii)(*b*) of this chapter.

(3) *General scope*—(i) *Property to which section 263A applies.* Taxpayers subject to section 263A must capitalize all direct costs and certain indirect costs properly allocable to—

(A) Real property and tangible personal property produced by the taxpayer; and

(B) Real property and personal property described in section 1221(1), which is acquired by the taxpayer for resale.

(ii) *Property produced.* Taxpayers that produce real property and tangible personal property (producers) must capitalize all the direct costs of producing the property and the property's properly allocable share of indirect costs (described in paragraphs (e)(2)(i) and (3) of this section), regardless of whether the property is sold or used in the taxpayer's trade or business. See § 1.263A–2 for rules relating to producers.

(iii) *Property acquired for resale.* Retailers, wholesalers, and other taxpayers that acquire property described in section 1221(1) for resale (resellers) must capitalize the direct costs of acquiring the property and the property's properly allocable share of indirect costs (described in paragraphs (e)(2)(ii) and (3) of this section). See § 1.263A–3 for rules relating to resellers. See also section 263A(b)(2)(B), which excepts from section 263A personal property acquired for resale by a small reseller.

(iv) *Inventories valued at market.* Section 263A does not apply to inventories valued at market under either the market method or the lower of cost or market method if the market valuation used by the taxpayer generally equals the property's fair market value. For purposes of this paragraph (a)(3)(iv), the term fair market value means the price at which the taxpayer sells its inventory to its customers (e.g., as in the market value definition provided in § 1.471–4(b)) less, if applicable, the direct cost of disposing of the inventory. However, section 263A does apply in determining the market value of any inventory for which market is determined with reference to replacement cost or reproduction cost. See §§ 1.471–4 and 1.471–5.

(v) *Property produced in a farming business.* Section 263A generally requires taxpayers engaged in a farming business to capitalize certain costs. See section 263A(d) and § 1.263A–4T(c) for rules relating to taxpayers engaged in a farming business.

(vi) *Creative property.* Section 263A generally requires taxpayers engaged in the production and resale of creative property to capitalize certain costs.

(vii) *Property produced or property acquired for resale by foreign persons.* Section 263A generally applies to foreign persons.

(b) *Exceptions*—(1) *Small resellers.* See section 263A(b)(2)(B) for the $10,000,000 gross receipts exception for small resellers of personal property. See § 1.263A–3(b) for rules relating to this exception. See also the exception for small resellers with de minimis production activities in § 1.263A–3(a)(2)(ii) and the exception for small resellers that have property produced under contract in § 1.263A–3(a)(3).

(2) *Long-term contracts.* Except for certain home construction contracts described in section 460(e)(1), section 263A does not apply to any property produced by the taxpayer pursuant to a long-term contract as defined in section 460(f), regardless of whether the taxpayer uses an inventory method to account for such production.

(3) *Costs incurred in certain farming businesses.* See section 263A(d) for an exception for costs paid or incurred in certain farming businesses. See § 1.263A–4T for specific rules relating to taxpayers engaged in the trade or business of farming.

(4) *Costs incurred in raising, harvesting, or growing timber.* See section 263A(c)(5) for an exception for costs paid or incurred in raising, harvesting, or growing timber and certain ornamental trees. See § 1.263A–4T, however, for rules relating to taxpayers producing certain trees to which section 263A applies.

(5) *Qualified creative expenses.* See section 263A(h) for an exception for qualified creative expenses paid or incurred by certain free-lance authors, photographers, and artists.

(6) *Certain not-for-profit activities.* See section 263A(c)(1) for an exception for property produced by a taxpayer for use by the taxpayer other than in a trade or business or an activity conducted for profit. This exception does not apply, however, to property produced by an exempt organization in connection with its unrelated trade or business activities.

(7) *Intangible drilling and development costs.* See section 263A(c)(3) for an exception for intangible drilling and development costs. Additionally, section 263A does not apply to any amount allowable as a deduction under section 59(e) with respect to qualified expenditures under sections 263(c), 616(a), or 617(a).

(8) *Natural gas acquired for resale.* Under this paragraph (b)(8), section 263A does not apply to any costs incurred by a taxpayer relating to natural gas acquired for resale to the extent such costs would otherwise be allocable to cushion gas.

(i) *Cushion gas.* Cushion gas is the portion of gas stored in an underground storage facility or reservoir that is required to maintain the level of pressure necessary for operation of the facility. However, section 263A applies to costs incurred by a taxpayer relating to natural gas acquired for resale to the extent such costs are properly allocable to emergency gas.

(ii) *Emergency gas.* Emergency gas is natural gas stored in an underground storage facility or reservoir for use during periods of unusually heavy customer demand.

(9) *Research and experimental expenditures.* See section 263A(c)(2) for an exception for any research and experimental expenditure allowable as a deduction under section 174 or the regulations thereunder. Additionally, section 263A does not apply to any amount allowable as a deduction under section 59(e) with respect to qualified expenditures under section 174.

(10) *Certain property that is substantially constructed.* Section 263A does not apply to any property produced by a taxpayer for use in its trade or business if substantial construction occurred before March 1, 1986.

(i) For purposes of this section, substantial construction is deemed to have occurred if the lesser of—

(A) 10 percent of the total estimated costs of construction; or

(B) The greater of $10 million or 2 percent of the total estimated costs of construction, was incurred before March 1, 1986.

(ii) For purposes of the provision in paragraph (b)(10)(i) of this section, the total estimated costs of construction shall be determined by reference to a reasonable estimate, on or before March 1, 1986, of such amount. Assume, for example, that on March 1, 1986, the estimated costs of constructing a facility were $150 million. Assume that before March 1, 1986, $12 million of construction costs had been incurred. Based on the above facts, substantial construction would be deemed to have occurred before March 1, 1986, because $12 million (the costs of construction incurred before such date) is greater than $10 million (the lesser of $15 million; or the greater of $10 million or $3 million). For purposes of this provision, construction costs are defined as those costs incurred after construction has commenced at the site of the property being constructed (unless the property will not be located on land and, therefore, the initial construction of the property must begin at a location other than the intended site). For example, in the case of a building, construction commences when work begins on the building, such as the excavation of the site, the pouring of pads for the building, or the driving of foundation pilings into the ground. Preliminary activities such as project engineering and architectural design do not constitute the commencement of construction, nor are such costs considered construction costs, for purposes of this paragraph (b)(10).

(11) *Certain property provided incident to services*—(i) *In general.* Under this paragraph (b)(11), section 263A does not apply to property that is provided to a client (or customer) incident to the provision of services by the taxpayer if the property provided to the client is—

(A) De minimis in amount; and

(B) Not inventory in the hands of the service provider.

(ii) *Definition of services.* For purposes of this paragraph (b)(11), services is defined with reference to its ordinary and accepted meaning under federal income tax principles. In determining whether a taxpayer is a bona-fide service provider under this paragraph (b)(11), the nature of the taxpayer's trade or business and the facts and circumstances surrounding the taxpayer's trade or business activities must be considered. Examples of taxpayers qualifying as service providers under this paragraph include taxpayers performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

(iii) *De minimis property provided incident to services.* In determining whether property provided to a client by a service provider is de minimis in amount, all facts and circumstances, such as the nature of the taxpayer's trade or business and the volume of its service activities in the trade or business, must be considered. A significant factor in making this determination is the relationship between the acquisition or direct materials costs of the property that is provided to clients and the price that the taxpayer charges its clients for its services and the property. For purposes of this paragraph (b)(11), if the acquisition or direct materials cost of the property provided to a client incident to the services is less than or equal to five percent of the price charged to the client for the services and property, the property is de minimis. If the acquisition or direct materials cost of the property exceeds five percent of the price charged for the services and property, the property may be de minimis if additional facts and circumstances so indicate.

(12) *De minimis rule for certain producers with total indirect costs of $200,000 or less.* See §1.263A–2(b)(3)(iv) for a de minimis rule that treats producers with total indirect costs of $200,000 or less as having no additional section 263A costs (as defined in paragraph (d)(3) of this section) for purposes of the simplified production method.

(13) *Exception for the origination of loans.* For purposes of section 263A(b)(2)(A), the origination of loans is not considered the acquisition of intangible property for resale. (But section 263A(b)(2)(A) does include the acquisition by a taxpayer of pre-existing loans from other persons for resale.)

(c) *General operation of section 263A*—(1) *Allocations.* Under section 263A, taxpayers must capitalize their direct costs and a properly allocable share of their indirect costs to property produced or property acquired for resale. In order to determine these capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production or resale activities. After section 263A costs are allocated to the appropriate production or resale activities, these costs are generally allocated to the items of property produced or property acquired for resale during the taxable year and capitalized to the items that remain on hand at the end of the taxable year. See however, the simplified production method and the simplified resale method in §§1.263A–2(b) and 1.263A–3(d).

(2) *Otherwise deductible.* (i) Any cost which (but for section 263A and the regulations thereunder) may not be taken into account in computing taxable income for any taxable year is not treated as a cost properly allocable to property produced or acquired for resale under section 263A and the regulations thereunder. Thus, for example, if a business meal deduction is limited by section 274(n) to 80 percent of the cost of the meal, the amount properly allocable to property produced or acquired for resale under section 263A is also limited to 80 percent of the cost of the meal.

(ii) The amount of any cost required to be capitalized under section 263A may not be included in inventory or charged to capital accounts or basis any earlier than the taxable year during which the amount is incurred within the meaning of §1.446–1(c)(1)(ii).

(3) *Capitalize.* Capitalize means, in the case of property that is inventory in the hands of a taxpayer, to include in inventory costs and, in the case of other property, to charge to a capital account or basis.

(4) *Recovery of capitalized costs.* Costs that are capitalized under section 263A are recovered through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time the property is used, sold, placed in service, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable Internal Revenue Code and regulation provisions relating to the use, sale, or disposition of property.

(d) *Definitions*—(1) *Self-constructed assets.* Self-constructed assets are assets produced by a taxpayer for use by the taxpayer in its trade or business. Self-constructed assets are subject to section 263A.

(2) *Section 471 costs*—(i) *In general.* Except as otherwise provided in paragraphs (d)(2)(ii) and (iii) of this section, for purposes of the regulations under section 263A, a taxpayer's section 471 costs are the costs, other than interest, capitalized under its method of accounting immediately prior to the effective date of section 263A. Thus, although section 471 applies only to inventories, section 471 costs include any non-inventory costs, other than interest, capitalized or included in acquisition or production costs under the taxpayer's method of accounting immediately prior to the effective date of section 263A.

(ii) *New taxpayers.* In the case of a new taxpayer, section 471 costs are those acquisition or production costs, other than interest, that would have been required to be capitalized by the taxpayer if the taxpayer had been in existence immediately prior to the effective date of section 263A.

(iii) *Method changes.* If a taxpayer included a cost described in §1.471–11(c)(2)(iii) in its inventoriable costs immediately prior to the effective date of section 263A, that cost is included in the taxpayer's section 471 costs under paragraph (d)(2)(i) of this section. Except as provided in the following sentence, a change in the financial reporting practices of a taxpayer for costs described in §1.471–11(c)(2)(iii) subsequent to the effective date of section 263A does not affect the classification of these costs as section 471 costs. A taxpayer may change its established methods of accounting used in determining section 471 costs only with the consent of the Commissioner as required under section 446(e) and the regulations thereunder.

(3) *Additional section 263A costs.* Additional section 263A costs are defined as the costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of section 263A (adjusted as appropriate for any changes in methods of accounting for section 471 costs under paragraph (d)(2)(iii) of this section), but that are required to be capitalized under section 263A. For new taxpayers, additional section 263A costs are defined as the costs, other than interest, that the taxpayer must capitalize under section 263A, but which the taxpayer would not have been required to capitalize if the taxpayer had been in existence prior to the effective date of section 263A.

(4) *Section 263A costs.* Section 263A costs are defined as the costs that a taxpayer must capitalize under section 263A. Thus, section 263A costs are the sum of a taxpayer's section 471 costs, its additional section 263A costs, and interest capitalizable under section 263A(f).

(e) *Types of costs subject to capitalization*—(1) *In general.* Taxpayers subject to section 263A must capitalize all direct costs and certain indirect costs properly allocable to property produced or property acquired for resale. This paragraph (e) describes the types of costs subject to section 263A.

(2) *Direct costs*—(i) *Producers.* Producers must capitalize direct material costs and direct labor costs.

(A) *Direct material costs* include the costs of those materials that become an integral part of specific property produced and those materials that are consumed in the ordinary course of production and that can be identified or associated with particular units or groups of units of property produced.

(B) *Direct labor costs* include the costs of labor that can be identified or associated with particular units or groups of units of specific property produced. For this purpose, labor encompasses full-time and part-time employees, as well as contract employees and independent contractors. Direct labor costs include all elements of compensation other than employee benefit costs described in paragraph (e)(3)(ii)(D) of this section. Elements of direct labor costs include basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan.

(ii) *Resellers.* Resellers must capitalize the acquisition costs of property acquired for resale. In the case of inventory, the acquisition cost is the cost described in §1.471–3(b).

(3) *Indirect costs*—(i) *In general.* Indirect costs are defined as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale). Taxpayers subject to section 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale. Indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities. Indirect costs may be allocable to both production and resale activities, as well as to other activities that are not subject

to section 263A. Taxpayers subject to section 263A must make a reasonable allocation of indirect costs between production, resale, and other activities.

(ii) *Examples of indirect costs required to be capitalized.* The following are examples of indirect costs that must be capitalized to the extent they are properly allocable to property produced or property acquired for resale:

(A) *Indirect labor costs.* Indirect labor costs include all labor costs (including the elements of labor costs set forth in paragraph (e)(2)(i) of this section) that cannot be directly identified or associated with particular units or groups of units of specific property produced or property acquired for resale (e.g., factory labor that is not direct labor). As in the case of direct labor, indirect labor encompasses full-time and part-time employees, as well as contract employees and independent contractors.

(B) *Officers' compensation.* Officers' compensation includes compensation paid to officers of the taxpayer.

(C) *Pension and other related costs.* Pension and other related costs include contributions paid to or made under any stock bonus, pension, profit-sharing or annuity plan, or other plan deferring the receipt of compensation, whether or not the plan qualifies under section 401(a). Contributions to employee plans representing past services must be capitalized in the same manner (and in the same proportion to property currently being acquired or produced) as amounts contributed for current service.

(D) *Employee benefit expenses.* Employee benefit expenses include all other employee benefit expenses (not described in paragraph (e)(3)(ii)(C) of this section) to the extent such expenses are otherwise allowable as deductions under chapter 1 of the Internal Revenue Code. These other employee benefit expenses include: worker's compensation; amounts otherwise deductible or allowable in reducing earnings and profits under section 404A; payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983; amounts includible in the gross income of employees under a method or arrangement of employer contributions or compensation that has the effect of a stock bonus, pension, profit-sharing or annuity plan, or other plan deferring receipt of compensation or providing deferred benefits; premiums on life and health insurance; and miscellaneous benefits provided for employees such as safety, medical treatment, recreational and eating facilities, membership dues, etc. Employee benefit expenses do not, however, include direct labor costs described in paragraph (e)(2)(i) of this section.

(E) *Indirect material costs.* Indirect material costs include the cost of materials that are not an integral part of specific property produced and the cost of materials that are consumed in the ordinary course of performing production or resale activities that cannot be identified or associated with particular units or groups of units of property. Thus, for example, a cost described in § 1.162–3, relating to the cost of a material or supply, is an indirect material cost.

(F) *Purchasing costs.* Purchasing costs include costs attributable to purchasing activities. See § 1.263A–3(c)(3) for a further discussion of purchasing costs.

(G) *Handling costs.* Handling costs include costs attributable to processing, assembling, repackaging and transporting goods, and other similar activities. See § 1.263A–3(c)(4) for a further discussion of handling costs.

(H) *Storage costs.* Storage costs include the costs of carrying, storing, or warehousing property. See § 1.263A–3(c)(5) for a further discussion of storage costs.

(I) *Cost recovery.* Cost recovery includes depreciation, amortization, and cost recovery allowances on equipment and facilities (including depreciation or amortization of self-constructed assets or other previously produced or acquired property to which section 263A or section 263 applies).

(J) *Depletion.* Depletion includes allowances for depletion, whether or not in excess of cost. Depletion is, however, only properly allocable to property that has been sold (i.e., for purposes of determining gain or loss on the sale of the property).

(K) *Rent.* Rent includes the cost of renting or leasing equipment, facilities, or land.

(L) *Taxes.* Taxes include those taxes (other than taxes described in paragraph (e)(3)(iii)(F) of this section) that are otherwise allowable as a deduction to the extent such taxes are attributable to labor, materials, supplies, equipment, land, or facilities used in production or resale activities.

(M) *Insurance.* Insurance includes the cost of insurance on plant or facility, machinery, equipment, materials, property produced, or property acquired for resale.

(N) *Utilities.* Utilities include the cost of electricity, gas, and water.

(O) *Repairs and maintenance.* Repairs and maintenance include the cost of repairing and maintaining equipment or facilities.

(P) *Engineering and design costs.* Engineering and design costs include preproduction costs, such as costs attributable to research, experimental, engineering, and design activities (to the extent that such amounts are not research and experimental expenditures as described in section 174 and the regulations thereunder).

(Q) *Spoilage.* Spoilage includes the costs of rework labor, scrap, and spoilage.

(R) *Tools and equipment.* Tools and equipment include the costs of tools and equipment which are not otherwise capitalized.

(S) *Quality control.* Quality control includes the costs of quality control and inspection.

(T) *Bidding costs.* Bidding costs are costs incurred in the solicitation of contracts (including contracts pertaining to property acquired for resale) ultimately awarded to the taxpayer. The taxpayer must defer all bidding costs paid or incurred in the solicitation of a particular contract until the contract is awarded. If the contract is awarded to the taxpayer, the bidding costs become part of the indirect costs allocated to the subject matter of the contract. If the contract is not awarded to the taxpayer, bidding costs are deductible in the taxable year that the contract is awarded to another party, or in the taxable year that the taxpayer is notified in writing that no contract will be awarded and that the contract (or a similar or related contract) will not be rebid, or in the taxable year that the taxpayer abandons its bid or proposal, whichever occurs first. Abandoning a bid does not include modifying, supplementing, or changing the original bid or proposal. If the taxpayer is awarded only part of the bid (for example, the taxpayer submitted one bid to build each of two different types of products, and the taxpayer was awarded a contract to build only one of the two types of products), the taxpayer shall deduct the portion of the bidding costs related to the portion of the bid not awarded to the taxpayer. In the case of a bid or proposal for a multi-unit contract, all bidding costs must be included in the costs allocated to the subject matter of the contract awarded to the taxpayer to produce or acquire for resale any of such units. For example, where the taxpayer submits one bid to produce three similar turbines and the taxpayer is awarded a contract to produce only two of the three turbines, all bidding costs must be included in the cost of the two turbines. For purposes of this paragraph (e)(3)(ii)(T), a contract means—

(*1*) In the case of a specific unit of property, any agreement under which the taxpayer would produce or sell property to another party if the agreement is entered into before the taxpayer produces or acquires the specific unit of property to be delivered to the party under the agreement; and

(*2*) In the case of fungible property, any agreement to the extent that, at the time the agreement is entered into, the taxpayer has on hand an insufficient quantity of completed fungible items of such property that may be used to satisfy the agreement (plus any other production or sales agreements of the taxpayer).

(U) *Licensing and franchise costs.* Licensing and franchise costs include fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced or property acquired for resale. These costs include the otherwise deductible portion (e.g., amortization) of the initial fees incurred to obtain the license or franchise and any minimum annual payments and royalties that are incurred by a licensee or a franchisee.

(V) *Interest.* Interest includes interest on debt incurred or continued during the production period to finance the production of real property or tangible personal property to which section 263A(f) applies.

(W) *Capitalizable service costs.* Service costs that are required to be capitalized include capitalizable service costs and capitalizable mixed service costs as defined in paragraph (e)(4) of this section.

(iii) *Indirect costs not capitalized.* The following indirect costs are not required to be capitalized under section 263A:

(A) *Selling and distribution costs.* These costs are marketing, selling, advertising, and distribution costs.

(B) *Research and experimental expenditures.* Research and experimental expenditures are expenditures described in section 174 and the regulations thereunder.

(C) *Section 179 costs.* Section 179 costs are expenses for certain depreciable assets deductible at the election of the taxpayer under section 179 and the regulations thereunder.

(D) *Section 165 losses.* Section 165 losses are losses under section 165 and the regulations thereunder.

(E) *Cost recovery allowances on temporarily idle equipment and facilities—(1) In general.* Cost recovery allowances on temporarily idle equipment and facilities include only depreciation, amortization, and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle. Equipment and facilities are temporarily idle when a taxpayer takes them out of service for a finite period. However, equipment and facilities are not considered temporarily idle—

(*i*) During worker breaks, non-working hours, or on regularly scheduled non-working days (such as holidays or weekends);

(*ii*) During normal interruptions in the operation of the equipment or facilities;

(*iii*) When equipment is enroute to or located at a job site; or

(*iv*) When under normal operating conditions, the equipment is used or operated only during certain shifts.

(*2*) *Examples.* The provisions of this paragraph (e)(3)(iii)(E) are illustrated by the following examples:

Example 1. Equipment operated only during certain shifts. Taxpayer A manufactures widgets. Although A's manufacturing facility operates 24 hours each day in three shifts, A only operates its stamping machine during one shift each day. Because A only operates its stamping machine during certain shifts, A's stamping machine is not considered temporarily idle during the two shifts that it is not operated.

Example 2. Facility shut down for retooling. Taxpayer B owns and operates a manufacturing facility. B closes its manufacturing facility for two weeks to retool its assembly line. B's manufacturing facility is considered temporarily idle during this two-week period.

(F) *Taxes assessed on the basis of income.* Taxes assessed on the basis of income include only state, local, and foreign income taxes, and franchise taxes that are assessed on the taxpayer based on income.

(G) *Strike expenses.* Strike expenses include only costs associated with hiring employees to replace striking personnel (but not wages of replacement personnel), costs of security, and legal fees associated with settling strikes.

(H) *Warranty and product liability costs.* Warranty costs and product liability costs are costs incurred in fulfilling product warranty obligations for products that have been sold and costs incurred for product liability insurance.

(I) *On-site storage costs.* On-site storage costs are storage and warehousing costs incurred by a taxpayer at an on-site storage facility, as defined in § 1.263A–3(c)(5)(ii)(A), with respect to property produced or property acquired for resale.

(J) *Unsuccessful bidding expenses.* Unsuccessful bidding costs are bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer.

(K) *Deductible service costs.* Service costs that are not required to be capitalized include deductible service costs and deductible mixed service costs as defined in paragraph (e)(4) of this section.

(4) *Service costs*—(i) *Introduction.* This paragraph (e)(4) provides definitions and categories of service costs. Paragraph (g)(4) of this section provides specific rules for determining the amount of service costs allocable to property produced or property acquired for resale. In addition, paragraph (h) of this section provides a simplified method for determining the amount of service costs that must be capitalized.

(A) *Definition of service costs.* Service costs are defined as a type of indirect costs (e.g., general and administrative costs) that can be identified specifically with a service department or function or that directly benefit or are incurred by reason of a service department or function.

(B) *Definition of service departments.* Service departments are defined as administrative, service, or support departments that incur service costs. The facts and circumstances of the taxpayer's activities and business organization control whether a department is a service department. For example, service departments include personnel, accounting, data processing, security, legal, and other similar departments.

(ii) *Various service cost categories*—(A) *Capitalizable service costs.* Capitalizable service costs are defined as service costs that directly benefit or are incurred by reason of the performance of the production or resale activities of the taxpayer. Therefore, these service costs are required to be capitalized under section 263A. Examples of service departments or functions that incur capitalizable service costs are provided in paragraph (e)(4)(iii) of this section.

(B) *Deductible service costs.* Deductible service costs are defined as service costs that do not directly benefit or are not incurred by reason of the performance of the production or resale activities of the taxpayer, and therefore, are not required to be capitalized under section 263A. Deductible service costs generally include costs incurred by reason of the taxpayer's overall management or policy guidance functions. In addition, deductible service costs include costs incurred by reason of the marketing, selling, advertising, and distribution activities of the taxpayer. Examples of service departments or functions that incur deductible service costs are provided in paragraph (e)(4)(iv) of this section.

(C) *Mixed service costs.* Mixed service costs are defined as service costs that are partially allocable to production or resale activities (capitalizable mixed service costs) and partially allocable to non-production or non-resale activities (deductible mixed service costs). For example, a personnel department may incur costs to recruit factory workers, the costs of which are allocable to production activities, and it may incur costs to develop wage, salary, and benefit policies, the costs of which are allocable to non-production activities.

(iii) *Examples of capitalizable service costs.* Costs incurred in the following departments or functions are generally allocated among production or resale activities:

(A) The administration and coordination of production or resale activities (wherever performed in the business organization of the taxpayer).

(B) Personnel operations, including the cost of recruiting, hiring, relocating, assigning, and maintaining personnel records or employees.

(C) Purchasing operations, including purchasing materials and equipment, scheduling and coordinating delivery of materials and equipment to or from factories or job sites, and expediting and follow-up.

(D) Materials handling and warehousing and storage operations.

(E) Accounting and data services operations, including, for example, cost accounting, accounts payable, disbursements, and payroll functions (but excluding accounts receivable and customer billing functions).

(F) Data processing.

(G) Security services.

(H) Legal services.

(iv) *Examples of deductible service costs.* Costs incurred in the following departments or functions are not generally allocated to production or resale activities:

(A) Departments or functions responsible for overall management of the taxpayer or for setting overall policy for all of the taxpayer's activities or trades or businesses, such as the board of directors (including their immediate staff), and the chief executive, financial, accounting, and legal officers (including their immediate staff) of the taxpayer, provided that no substantial part of the cost of such departments or functions benefits a particular production or resale activity.

(B) Strategic business planning.

(C) General financial accounting.

(D) General financial planning (including general budgeting) and financial management (including bank relations and cash management).

(E) Personnel policy (such as establishing and managing personnel policy in general; developing wage, salary, and benefit policies; developing employee training programs unrelated to particular production or resale activities; negotiating with labor unions; and maintaining relations with retired workers).

(F) Quality control policy.

(G) Safety engineering policy.

(H) Insurance or risk management policy (but not including bid or performance bonds or insurance related to activities associated with property produced or property acquired for resale).

(I) Environmental management policy (except to the extent that the costs of any system or procedure benefits a particular production or resale activity).

(J) General economic analysis and forecasting.

(K) Internal audit.

(L) Shareholder, public, and industrial relations.

(M) Tax services.

(N) Marketing, selling, or advertising.

(f) *Cost allocation methods*—(1) *Introduction.* This paragraph (f) sets forth various detailed or specific (facts-and-circumstances) cost allocation methods that taxpayers may use to allocate direct and indirect costs to property produced and property acquired for resale. Paragraph (g) of this section provides general rules for applying these allocation methods to various categories of costs (i.e., direct materials, direct labor, and indirect costs, including service costs). In addition, in lieu of a facts-and-circumstances allocation method, taxpayers may use the simplified methods provided in §§ 1.263A–2(b) and 1.263A–3(d) to allocate direct and indirect costs to eligible property produced or eligible property acquired for resale; see those sections for definitions of eligible property. Paragraph (h) of this section provides a simplified method for determining the amount of mixed service costs required to be capitalized to eligible property. The methodology set forth in paragraph (h) of this section for mixed service costs may be used in conjunction with either a facts-and-circumstances or a simplified method of allocating costs to eligible property produced or eligible property acquired for resale.

(2) *Specific identification method.* A specific identification method traces costs to a cost objective, such as a function, department, activity, or product, on the basis of a cause and effect or other reasonable relationship between the costs and the cost objective.

(3) *Burden rate and standard cost methods*—(i) *Burden rate method*—(A) *In general.* A burden rate method allocates an appropriate amount of indirect costs to property produced or property acquired for resale during a taxable year using predetermined rates that approximate the actual amount of indirect costs incurred by the taxpayer during the taxable year. Burden rates (such as ratios based on direct costs, hours, or similar items) may be developed by the taxpayer in accordance with acceptable accounting principles and applied in a reasonable manner. A taxpayer may allocate different indirect costs on the basis of different burden rates. Thus, for example, the taxpayer may use one burden rate for allocating the cost of rent and another burden rate for allocating the cost of utilities. Any periodic adjustment to a burden rate that merely reflects current operating conditions, such as increases in automation or changes in operation or prices, is not a change in method of accounting under section 446(e). A change, however, in the concept or base upon which such rates are developed, such as a change from basing the rates on direct labor hours to basing them on direct machine hours, is a change in method of accounting to which section 446(e) applies.

(B) *Development of burden rates.* The following factors, among others, may be used in developing burden rates:

(*1*) The selection of an appropriate level of activity and a period of time upon which to base the calculation of rates reflecting operating conditions for purposes of the unit costs being determined.

(*2*) The selection of an appropriate statistical base, such as direct labor hours, direct labor dollars, machine hours, or a combination thereof, upon which to apply the overhead rate.

(*3*) The appropriate budgeting, classification, and analysis of expenses (for example, the analysis of fixed versus variable costs).

(C) *Operation of the burden rate method.* The purpose of the burden rate method is to allocate an appropriate amount of indirect costs to production or resale activities through the use of predetermined rates intended to approximate the actual amount of indirect costs incurred. Accordingly, the proper use of the burden rate method under this section requires that any net negative or net positive difference between the total predetermined amount of costs allocated to property and the total amount of indirect costs actually incurred and required to be allocated to such property (i.e., the under or over-applied burden) must be treated as an adjustment to the taxpayer's ending inventory or capital account (as the case may be) in the taxable year in which such difference arises. However, if such adjustment is not significant in amount in relation to the taxpayer's total indirect costs incurred with respect to production or resale activities for the year, such adjustment need not be allocated to the property produced or property acquired for resale unless such allocation is made in the taxpayer's financial reports. The taxpayer must treat both positive and negative adjustments consistently.

(ii) *Standard cost method*—(A) *In general.* A standard cost method allocates an appropriate amount of direct and indirect costs to property produced by the taxpayer through the use of preestablished standard allowances, without reference to costs actually incurred during the taxable year. A taxpayer may use a standard cost method to allocate costs, provided variances are treated in accordance with the procedures prescribed in paragraph (f)(3)(ii)(B) of this section. Any periodic adjustment to standard costs that merely reflects current operating conditions, such as increases in automation or changes in operation or prices, is not a change in method of accounting under section 446(e). A change, however, in the concept or base upon which standard costs are developed is a change in method of accounting to which section 446(e) applies.

(B) *Treatment of variances.* For purposes of this section, net positive overhead variance means the excess of total standard indirect costs over total actual indirect costs and net negative overhead variance means the excess of total actual indirect costs over total standard indirect costs. The proper use of a standard cost method requires that a taxpayer must reallocate to property a pro rata portion of any net negative or net positive overhead variances and any net negative or net positive direct cost variances. The taxpayer must apportion such variances to or among the property to which the costs are allocable. However, if such variances are not significant in amount relative to the taxpayer's total indirect costs incurred with respect to production and resale activities for the year, such variances need not be allocated to property produced or property acquired for resale unless such allocation is made in the taxpayer's financial reports. A taxpayer must treat both positive and negative variances consistently.

(4) *Reasonable allocation methods.* A taxpayer may use the methods described in paragraph (f) (2) or (3) of this section if they are reasonable allocation methods within the meaning of this paragraph (f)(4). In addition, a taxpayer may use any other reasonable method to properly allocate direct and indirect costs among units of property produced or property acquired for resale during the taxable year. An allocation method is reasonable if, with respect to the taxpayer's production or resale activities taken as a whole—

(i) The total costs actually capitalized during the taxable year do not differ significantly from the aggregate costs that would be properly capitalized using another permissible method described in this section or in §§ 1.263A–2 and 1.263A–3, with appropriate consideration given to the volume and value of the taxpayer's production or resale activities, the availability of costing information, the time and cost of using various allocation methods, and the accuracy of the allocation method chosen as compared with other allocation methods;

(ii) The allocation method is applied consistently by the taxpayer; and

(iii) The allocation method is not used to circumvent the requirements of the simplified methods in this section or in § 1.263A–2, § 1.263A–3, or the principles of section 263A.

(g) *Allocating categories of costs*—(1) *Direct materials.* Direct material costs (as defined in paragraph (e)(2) of this section) incurred during the taxable year must be allocated to the property produced or property acquired for resale by the taxpayer using the taxpayer's d of accounting for materials (e.g., specific identification; first-in, first-out (FIFO); or last-in, first-out (LIFO)), or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section).

(2) *Direct labor.* Direct labor costs (as defined in paragraph (e)(2) of this section) incurred during the taxable year are generally allocated to property produced or property acquired for resale using a specific identification method, standard cost method, or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section). All elements of compensation, other than basic compensation, may be grouped together and then allocated in proportion to the charge for basic compensation. Further, a taxpayer is not treated as using an erroneous method of accounting if direct labor costs are treated as indirect costs under the taxpayer's allocation method, provided such costs are capitalized to the extent required by paragraph (g)(3) of this section.

(3) *Indirect costs.* Indirect costs (as defined in paragraph (e)(3) of this section) are generally allocated to intermediate cost objectives such as departments or activities prior to the allocation of such costs to property produced or property acquired for resale. Indirect costs are allocated using either a specific identification method, a standard cost method, a burden rate method, or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section).

(4) *Service costs*—(i) *In general.* Service costs are a type of indirect costs that may be allocated using the same allocation methods available for allocating other indirect costs described in paragraph (g)(3) of this section. Generally, taxpayers that use a specific identification method or another reasonable allocation method must allocate service costs to particular departments or activities based on a factor or relationship that reasonably relates the service costs to the benefits received from the service departments or activities. For example, a reasonable factor for allocating legal services to particular departments or activities is the number of hours of legal services attributable to each department or activity. See paragraph (g)(4)(iv) of this section for other illustrations. Using reasonable factors or relationships, a taxpayer must allocate mixed service costs under a direct reallocation method described in paragraph (g)(4)(iii)(A) of this section, a step-allocation method described in paragraph (g)(4)(iii)(B) of this section, or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section).

(ii) *De minimis rule.* For purposes of administrative convenience, if 90 percent or more of a mixed service department's costs are deductible service costs, a taxpayer may elect not to allocate any portion of the service department's costs to property produced or property acquired for resale. For example, if 90 percent of the costs of an electing taxpayer's industrial relations department benefit the taxpayer's overall policy-making activities, the taxpayer is not required to allocate any portion of these costs to a production activity. Under this election, however, if 90 percent or more of a mixed service department's costs are capitalizable service costs, a taxpayer must allocate 100 percent of the department's costs to the production or resale activity benefitted. For example, if 90 percent of the costs of an electing taxpayer's accounting department benefit the taxpayer's manufacturing activity, the taxpayer must allocate 100 percent of the costs of the accounting department to the manufacturing activity. An election under this paragraph (g)(4)(ii) applies to all of a taxpayer's mixed service departments and constitutes the adoption of a (or a change in) method of accounting under section 446 of the Internal Revenue Code.

(iii) *Methods for allocating mixed service costs*—(A) *Direct reallocation method.* Under the direct reallocation method, the total costs (direct and indirect) of all mixed service departments are allocated only to departments or cost centers engaged in production or resale activities and then from those departments to particular activities. This direct reallocation method ignores benefits provided by one mixed service department to other mixed service departments, and also excludes other mixed service departments from the base used to make the allocation.

(B) *Step-allocation method.* (*1*) Under a step-allocation method, a sequence of allocations is made by the taxpayer. First, the total costs of the mixed service departments that benefit the greatest number of other departments are allocated to—

(*i*) Other mixed service departments;

(*ii*) Departments that incur only deductible service costs; and

(*iii*) Departments that exclusively engage in production or resale activities.

(*2*) A taxpayer continues allocating mixed service costs in the manner described in paragraph (g)(4)(iii)(B)(*1*) of this section (i.e., from the service departments benefitting the greatest number of departments to the service departments benefitting the least number of departments) until all mixed service costs are allocated to the types of departments listed in this paragraph (g)(4)(iii). Thus, a step-allocation method recognizes the benefits provided by one mixed service department to another mixed service department and also includes mixed service departments that have not yet been allocated in the base used to make the allocation.

(C) *Examples.* The provisions of this paragraph (g)(4)(iii) are illustrated by the following examples:

Example 1. Direct reallocation method. (i) Taxpayer E has the following five departments: the Assembling Department, the Painting Department, and the Finishing Department (production departments), and the Personnel Department and the Data Processing Department (mixed service departments). E allocates the Personnel Department's costs on the basis of total payroll costs and the Data Processing Department's costs on the basis of data processing hours.

(ii) Under a direct reallocation method, E allocates the Personnel Department's costs directly to its Assembling, Painting, and Finishing Department, and not to its Data Processing department.

Department	Total dept. costs	Amount of payroll costs	Allocation ratio	Amount allocated
Personnel	$500,000	$50,000		<$500,000>
Data Proc'g	250,000	15,000		
Assembling	250,000	15,000	15,000/285,000	26,315
Painting	1,000,000	90,000	90,000/285,000	157,895
Finishing	2,000,000	180,000	180,000/285,000	315,790
Total	$4,000,000	$350,000		

(iii) After E allocates the Personnel Department's costs, E then allocates the costs of its Data Processing Department in the same manner.

Department	Total dept. cost after initial allocation	Total data proc. hours	Allocation ratio	Amount allocated	Total dept. cost after final allocation
Personnel	0	2,000			0
Data Proc'g	$250,000			<$250,000>	

Department	Total dept. cost after initial allocation	Total data proc. hours	Allocation ratio	Amount allocated	Total dept. cost after final allocation
Assembling	276,315	2,000	2,000/10,000	50,000	$326,315
Painting	1,157,895	0	0/10,000	0	1,157,895
Finishing	2,315,790	8,000	8,000/10,000	200,000	2,515,790
Total	$4,000,000	12,000			$4,000,000

Example 2. Step-allocation method. (i) Taxpayer F has the following five departments: the Manufacturing Department (a production department), the Marketing Department and the Finance Department (departments that incur only deductible service costs), the Personnel Department and the Data Processing Department (mixed service departments). F uses a step-allocation method and allocates the Personnel Department's costs on the basis of total payroll costs and the Data Processing Department's costs on the basis of data processing hours. F's Personnel Department benefits all four of F's other departments, while its Data Processing Department benefits only three departments. Because F's Personnel Department benefits the greatest number of other departments, F first allocates its Personnel Department's costs to its Manufacturing, Marketing, Finance and Data Processing departments, as follows:

Department	Total cost of dept.	Total payroll costs	Allocation ratio	Amount allocated
Personnel	$500,000	$50,000		<$500,000>
Data Proc'g	250,000	15,000	15,000/300,000	25,000
Finance	250,000	15,000	15,000/300,000	25,000
Marketing	1,000,000	90,000	90,000/300,000	150,000
Manufac'g	2,000,000	180,000	180,000/300,000	300,000
	4,000,000	350,000		

(ii) Under a step-allocation method, the denominator of F's allocation ratio includes the payroll costs of its Manufacturing, Marketing, Finance, and Data Processing departments.

(iii) Next, F allocates the costs of its Data Processing Department on the basis of data processing hours. Because the costs incurred by F's Personnel Department have already been allocated, no allocation is made to the Personnel Department.

Department	Total dept. cost after initial allocation	Total data proc. hours	Allocation		
ratio.					
Personnel	$0	2,000			$0
Data Proc'g	275,000			<$275,000>	0
Finance	275,000	2,000	2,000/10,000	55,000	330,000
Marketing	1,150,000	0	0/10,000	0	1,150,000
Manufac'g	2,300,000	8,000	8,000/10,000	220,000	2,520,000
	4,000,000	12,000			4,000,000

(iv) Under the second step of F's step-allocation method, the denominator of F's allocation ratio includes the data processing hours of its Manufacturing, Marketing, and Finance Departments, but does not include the data processing hours of its Personnel Department (the other mixed service department) because the costs of that department have previously been allocated.

(iv) *Illustrations of mixed service cost allocations using reasonable factors or relationships.* This paragraph (g)(4)(iv) illustrates various reasonable factors and relationships that may be used in allocating different types of mixed service costs. Taxpayers, however, are permitted to use other reasonable factors and relationships to allocate mixed service costs. In addition, the factors or relationships illustrated in this paragraph (g)(4)(iv) may be used to allocate other types of service costs not illustrated in this paragraph (g)(4)(iv).

(A) *Security services.* The costs of security or protection services must be allocated to each physical area that receives the services using any reasonable method applied consistently (e.g., the size of the physical area, the number of employees in the area, or the relative fair market value of assets located in the area).

(B) *Legal services.* The costs of legal services are generally allocable to a particular production or resale activity on the basis of the approximate number of hours of legal service performed in connection with the activity, including research, bidding, negotiating, drafting, reviewing a contract, obtaining necessary licenses and permits, and resolving disputes. Different hourly rates may be appropriate for different services. In determining the number of hours allocable to any activity, estimates are appropriate, detailed time records are not required to be kept, and insubstantial amounts of services provided to an activity by senior legal staff (such as administrators or reviewers) may be ignored. Legal costs may also be allocated to a particular production or resale activity based on the ratio of the total direct costs incurred for the activity to the total direct costs incurred with respect to all production or resale activities. The taxpayer must also allocate directly to an activity the cost incurred for any outside legal services. Legal costs relating to general corporate functions are not required to be allocated to a particular production or resale activity.

(C) *Centralized payroll services.* The costs of a centralized payroll department or activity are generally allocated to the departments or activities benefitted on the basis of the gross dollar amount of payroll processed.

(D) *Centralized data processing services.* The costs of a centralized data processing department are generally allocated to all departments or activities benefitted using any reasonable basis, such as total direct data processing costs or the number of data processing hours supplied. The costs of data processing systems or applications developed for a particular activity are directly allocated to that activity.

(E) *Engineering and design services.* The costs of an engineering or a design department are generally directly allocable to the departments or activities benefitted based on the ratio of the approximate number of hours of work performed with respect to the particular activity to the total number of hours of engineering or design work performed for all activities. Different services may be allocated at different hourly rates.

(F) *Safety engineering services.* The costs of a safety engineering departments or activities generally benefit all of the taxpayer's activities and, thus, should be allocated using a reasonable basis, such as: the approximate number of safety inspections made in connection with a particular activity as a fraction of total inspections, the number of employees assigned to an activity as a fraction of total employees, or the total labor hours worked in connection with an activity as a fraction of total hours. However, in determining the allocable costs of a safety engineering department, costs attributable to providing a safety program relating only to a particular activity must be directly assigned to such activity. Additionally, the cost of a safety engineering department only responsible for setting safety policy and establishing safety procedures to be used in all of the taxpayer's activities is not required to be allocated.

(v) *Accounting method change.* A change in the method or base used to allocate service costs (such as changing from an allocation base using direct labor costs to a base using direct labor hours), or a change in the taxpayer's determination of what functions or departments of the taxpayer are to be allocated, is a change in method of accounting to which section 446(e) and the regulations thereunder apply.

(h) *Simplified service cost method*—(1) *Introduction.* This paragraph (h) provides a simplified method for determining capitalizable mixed service costs incurred during the taxable year with respect to eligible property (i.e., the aggregate portion of mixed service costs that are properly allocable to the taxpayer's production or resale activities).

(2) *Eligible property*—(i) *In general.* Except as otherwise provided in paragraph (h)(2)(ii) of this section, the simplified service cost method, if elected for any trade or business of the taxpayer, must be used for all production and resale activities of the trade or business associated with any of the following categories of property that are subject to section 263A:

(A) *Inventory property.* Stock in trade or other property properly includible in the inventory of the taxpayer.

(B) *Non-inventory property held for sale.* Non-inventory property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(C) *Certain self-constructed assets.* Self-constructed assets substantially identical in nature to, and produced in the same manner as, inventory property produced by the taxpayer or other property produced by the taxpayer and held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(D) *Self-constructed assets produced on a repetitive basis.* Self-constructed assets produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business.

(ii) *Election to exclude self-constructed assets.* At the taxpayer's election, the simplified service cost method may be applied within a trade or business to only the categories of inventory property and non-inventory property held for sale described in paragraphs (h)(2)(i)(A) and(B) of this section. Taxpayers electing to exclude the self-constructed assets described in paragraphs (h)(2)(i)(C) and (D) of this section from application of the simplified service cost method must, however, allocate service costs to such property in accordance with paragraph (g)(4) of this section.

(3) *General allocation formula.* (i) Under the simplified service cost method, a taxpayer computes its capitalizable mixed service costs using the following formula:

$$\text{Allocation ratio} \times \text{total mixed service costs}$$

(ii) A producer may elect one of two allocation ratios, the labor-based allocation ratio or the production cost allocation ratio. A reseller that satisfies the requirements for using the simplified resale method of § 1.263A–3(d) (whether or not that method is elected) may elect the simplified service cost method, but must use a labor-based allocation ratio. (See § 1.263A–3(d) for labor-based allocation ratios to be used in conjunction with the simplified resale method.) The allocation ratio used by a trade or business of a taxpayer is a method of accounting which must be applied consistently within the trade or business.

(4) *Labor-based allocation ratio.* (i) The labor-based allocation ratio is computed as follows:

$$\frac{\text{Section 263A labor costs}}{\text{Total labor costs}}$$

(ii) Section 263A labor costs are defined as the total labor costs (excluding labor costs included in mixed service costs) allocable to property produced and property acquired for resale under section 263A that are incurred in the taxpayer's trade or business during the taxable year. Total labor costs are defined as the total labor costs (excluding labor costs included in mixed service costs) incurred in the taxpayer's trade or business during the taxable year. Total labor costs include labor costs incurred in all parts of the trade or business (i.e., if the taxpayer has both property produced and property acquired for resale, the taxpayer must include labor costs from resale activities as well as production activities). For example, taxpayer G incurs $1,000 of total mixed service costs during the taxable year. G's section 263A labor costs are $5,000 and its total labor costs are $10,000. Under the labor-based allocation ratio, G's capitalizable mixed service costs are $500 (i.e., $1,000 × ($5,000 divided by $10,000)).

(5) *Production cost allocation ratio.* (i) Producers may use the production cost allocation ratio, computed as follows:

$$\frac{\text{Section 263A production costs}}{\text{Total costs}}$$

(ii) Section 263A production costs are defined as the total costs (excluding mixed service costs and interest) allocable to property produced (and property acquired for resale if the producer is also engaged in resale activities) under section 263A that are incurred in the taxpayer's trade or business during the taxable year. Total costs are defined as all costs (excluding mixed service costs and interest) incurred in the taxpayer's trade or business during the taxable year. Total costs include all direct and indirect costs allocable to property produced (and property acquired for resale if the producer is also engaged in resale activities) as well as all other costs of the taxpayer's trade or business, including, but not limited to: salaries and other labor costs of all personnel; all depreciation taken for federal income tax purposes; research and experimental expenditures; and selling, marketing, and distribution costs. Such costs do not include, however, taxes described in paragraph (e)(3)(iii)(F) of this section. For example, taxpayer H, a producer, incurs $1,000 of total mixed service costs in the taxable year. H's section 263A production costs are $10,000 and its total costs are $20,000. Under the production cost allocation ratio, H's capitalizable mixed service costs are $500 (i.e., $1,000 X ($10,000 divided by $20,000)).

(6) *Definition of total mixed service costs.* Total mixed service costs are defined as the total costs incurred during the taxable year in all departments or functions of the taxpayer's trade or business that perform mixed service activities. See paragraph (e)(4)(ii)(C) of this section which defines mixed service costs. In determining the total mixed service costs of a trade or business, the taxpayer must include all costs incurred in its mixed service departments and cannot exclude any otherwise deductible service costs. For example, if the accounting department within a trade or business is a mixed service department, then in determining the total mixed service costs of the trade or business, the taxpayer cannot exclude the costs of personnel in the accounting department that perform services relating to non-production activities (e.g., accounts receivable or customer billing activities). Instead, the entire cost of the accounting department must be included in the total mixed service costs.

(7) *Costs allocable to more than one business.* To the extent mixed service costs, labor costs, or other costs are incurred in more than one trade or business, the taxpayer must determine the amounts allocable to the particular trade or business for which the simplified service cost method is being applied by using any reasonable allocation method consistent with the principles of paragraph (f)(4) of this section.

(8) *De minimis rule.* If the taxpayer elects to apply the de minimis rule of paragraph (g)(4)(ii) of this section to any mixed service department, the department is not considered a mixed service department for purposes of the simplified service cost method. Instead, the costs of such department are allocated exclusively to the particular activity satisfying the 90-percent test.

(9) *Separate election.* A taxpayer may elect the simplified service cost method in conjunction with any other allocation method used at the trade or business level, including the simplified methods described in §§1.263A–2(b) and 1.263A–3(d). However, the election of the simplified service cost method must be made independently of the election to use those other simplified methods.

(i) [Reserved]

(j) *Special rules*—(1) *Costs provided by a related person*—(i) *In general.* A taxpayer subject to section 263A must capitalize an arm's-length charge for any section 263A costs (e.g., costs of materials, labor, or services) incurred by a related person that are properly allocable to the property produced or property acquired for resale by the taxpayer. Both the taxpayer and the related person must account for the transaction as if an arm's-length charge had been incurred by the taxpayer with respect to its property produced or property acquired for resale.

For purposes of this paragraph (j)(1)(i), a taxpayer is considered related to another person if the taxpayer and such person are described in section 482. Further, for purposes of this paragraph (j)(1)(i), arm's-length charge means the arm's-length charge (or other appropriate charge where permitted and applicable) under the principles of section 482. Any correlative adjustments necessary because of the arm's-length charge requirement of this paragraph (j)(1)(i) shall be determined under the principles of section 482.

(ii) *Exceptions.* The provisions of paragraph (j)(1)(i) of this section do not apply if, and to the extent that—

(A) It would be inappropriate under the principles of section 482 for the Commissioner to adjust the income of the taxpayer or the related person with respect to the transaction at issue; or

(B) A transaction is accounted for under an alternative Internal Revenue Code section resulting in the capitalization (or deferral of the deduction) of the costs of the items provided by the related party and the related party does not deduct such costs earlier than the costs would have been deducted by the taxpayer if the costs were capitalized under section 263A. See § 1.1502–13.

(2) *Optional capitalization of period costs*—(i) *In general.* Taxpayers are not required to capitalize indirect costs that do not directly benefit or are not incurred by reason of the production of property or acquisition of property for resale (i.e., period costs). A taxpayer may, however, elect to capitalize certain period costs if: The method is consistently applied; is used in computing beginning inventories, ending inventories, and cost of goods sold; and does not result in a material distortion of the taxpayer's income. A material distortion relates to the source, character, amount, or timing of the cost capitalized or any other item affected by the capitalization of the cost. Thus, for example, a taxpayer may not capitalize a period cost under section 263A if capitalization would result in a material change in the computation of the foreign tax credit limitation under section 904. An election to capitalize a period cost is the adoption of (or a change in) a method of accounting under section 446 of the Internal Revenue Code.

(ii) *Period costs eligible for capitalization.* The types of period costs eligible for capitalization under this paragraph (j)(2) include only the types of period costs (e.g., under paragraph (e)(3)(iii) of this section) for which some portion of the costs incurred is properly allocable to property produced or property acquired for resale in the year of the election. Thus, for example, marketing or advertising costs, no portion of which are properly allocable to property produced or property acquired for resale, do not qualify for elective capitalization under this paragraph (j)(2).

(3) *Trade or business application.* Notwithstanding the references generally to taxpayer throughout this section and §§ 1.263A–2 and 1.263A–3, the methods of accounting provided under section 263A are to be elected and applied independently for each separate and distinct trade or business of the taxpayer in accordance with the provisions of section 446(d) and the regulations thereunder.

(4) *Transfers with a principal purpose of tax avoidance.* The District Director may require appropriate adjustments to valuations of inventory and other property subject to section 263A if a transfer of property is made to another person for a principal purpose of avoiding the application of section 263A. Thus, for example, the District Director may require a taxpayer using the simplified production method of § 1.263A–2(b) to apply that method to transferred inventories immediately prior to a transfer under section 351 if a principal purpose of the transfer is to avoid the application of section 263A.

[T.D. 8482, 58 FR 42209, Aug. 9, 1993, as amended by T.D. 8559, 59 FR 39961, Aug. 5, 1994; T.D. 8584, 59 FR 67197, Dec. 29, 1994; T.D. 8597, 60 FR 36680, July 18, 1995; T.D. 8728, 62 FR 42054, Aug. 5, 1997; T.D. 8729, 62 FR 44546, Aug. 22, 1997]

§ 1.263A–2 Rules relating to property produced by the taxpayer.

(a) *In general.* Section 263A applies to real property and tangible personal property produced by a taxpayer for use in its trade or business or for sale to its customers. In addition, section 263A applies to property produced for a taxpayer under a contract with another party. The principal terms related to the scope of section 263A with respect to producers are provided in this paragraph (a). See §1.263A–1(b)(11) for an exception in the case of certain de minimis property provided to customers incident to the provision of services.

(1) *Produce*—(i) *In general.* For purposes of section 263A, produce includes the following: construct, build, install, manufacture, develop, improve, create, raise, or grow.

(ii) *Ownership*—(A) *General rule.* Except as provided in paragraphs (a)(1)(ii)(B) and (C) of this section, a taxpayer is not considered to be producing property unless the taxpayer is considered an owner of the property produced under federal income tax principles. The determination as to whether a taxpayer is an owner is based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxpayer. A taxpayer may be considered an owner of property produced, even though the taxpayer does not have legal title to the property.

(B) *Property produced for the taxpayer under a contract*—(*1*) *In general.* Property produced for the taxpayer under a contract with another party is treated as property produced by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs with respect to the property. A taxpayer has made payment under this section if the transaction would be considered payment by a taxpayer using the cash receipts and disbursements method of accounting.

(*2*) *Definition of a contract*—(*i*) *General rule.* Except as provided under paragraph (a)(1)(ii)(B)(*2*)(*ii*) of this section, a contract is any agreement providing for the production of property if the agreement is entered into before the production of the property to be delivered under the contract is completed. Whether an agreement exists depends on all the facts and circumstances. Facts and circumstances indicating an agreement include, for example, the making of a prepayment, or an arrangement to make a prepayment, for property prior to the date of the completion of production of the property, or the incurring of significant expenditures for property of specialized design or specialized application that is not intended for self-use.

(*ii*) *Routine purchase order exception.* A routine purchase order for fungible property is not treated as a contract for purposes of this section. An agreement will not be treated as a routine purchase order for fungible property, however, if the contractor is required to make more than de minimis modifications to the property to tailor it to the customer's specific needs, or if at the time the agreement is entered into, the customer knows or has reason to know that the contractor cannot satisfy the agreement within 30 days out of existing stocks and normal production of finished goods.

(C) *Home construction contracts.* Section 460(e)(1) provides that section 263A applies to a home construction contract unless that contract will be completed within two years of the contract commencement date and the taxpayer's average annual gross receipts for the three preceding taxable years do not exceed $10,000,000. Section 263A applies to such a contract even if the contractor is not considered the owner of the property produced under the contract under federal income tax principles.

(2) *Tangible personal property*—(i) *General rule.* In general, section 263A applies to the costs of producing tangible personal property, and not to the costs of producing intangible property. For example, section 263A applies to the costs manufacturers incur to produce goods, but does not apply to the costs financial institutions incur to originate loans.

(ii) *Intellectual or creative property.* For purposes of determining whether a taxpayer producing intellectual or creative property is producing tangible personal property or intangible property, the term tangible personal property includes films, sound recordings, video tapes, books, and other similar property embodying words, ideas, concepts, images, or sounds by the creator thereof. Other similar property for this purpose generally means intellectual or creative property for which, as costs are incurred in producing the property, it is intended (or is reasonably likely) that any tangible medium in which the property is embodied will be mass distributed by the creator or any one or more third parties in a form that is not substantially altered. However, any intellectual or creative property that is embodied in a tangible medium that is mass distributed merely incident to the distribution of a principal product or good of the creator is not other similar property for these purposes.

(A) *Intellectual or creative property that is tangible personal property.* Section 263A applies to tangible personal property defined in this paragraph (a)(2) without regard to whether such property is treated as tangible or intangible property under other sections of the Internal Revenue Code. Thus, for example, section 263A applies to the costs of producing a motion picture or researching and writing a book even though these assets may be considered intangible for other purposes of the Internal Revenue Code. Tangible personal property includes, for example, the following:

(*1*) *Books.* The costs of producing and developing books (including teaching aids and other literary works) required to be capitalized under this section include costs incurred by an author in researching, preparing, and writing the book. (However, see section 263A(h), which provides an exemption from the capitalization requirements of section 263A in the case of certain free-lance authors.) In addition, the costs of producing and developing books include prepublication expenditures incurred by publishers, including payments made to authors (other than commissions for sales of books that have already taken place), as well as costs incurred by publishers in writing, editing, compiling, illustrating, designing, and developing the books. The costs of producing a book also include the costs of producing the underlying manuscript, copyright, or license. (These costs are distinguished from the separately capitalizable costs of printing and binding the tangible medium embodying the book (e.g., paper and ink).) See § 1.174–2(a)(1), which provides that the term research or experimental expenditures does not include expenditures incurred for research in connection with literary, historical, or similar projects.

(*2*) *Sound recordings.* A sound recording is a work that results from the fixation of a series of musical, spoken, or other sounds, regardless of the nature of the material objects, such as discs, tapes, or other phonorecordings, in which such sounds are embodied.

(B) *Intellectual or creative property that is not tangible personal property.* Items that are not considered tangible personal property within the meaning of section 263A(b) and paragraph (a)(2)(ii) of this section include:

(*1*) *Evidences of value.* Tangible personal property does not include property that is representative or evidence of value, such as stock, securities, debt instruments, mortgages, or loans.

(*2*) *Property provided incident to services.* Tangible personal property does not include de minimis property provided to a client or customer incident to the provision of services, such as wills prepared by attorneys, or blueprints prepared by architects. See § 1.263A–1(b)(11).

(3) *Costs required to be capitalized by producers*—(i) *In general.* Except as specifically provided in section 263A(f) with respect to interest costs, producers must capitalize direct and indirect costs properly allocable to property produced under section 263A, without regard to whether those costs are incurred before, during, or after the production period (as defined in section 263A(f)(4)(B)).

(ii) *Pre-production costs.* If property is held for future production, taxpayers must capitalize direct and indirect costs allocable to such property (e.g., purchasing, storage, handling, and other costs), even though production has not begun. If property is not held for production, indirect costs incurred prior to the beginning of the production period must be allocated to the property and capitalized if, at the time the costs are incurred, it is reasonably likely that production will occur at some future date. Thus, for example, a manufacturer must capitalize the costs of storing and handling raw materials before the raw materials are committed to production. In addition, a real estate developer must capitalize property taxes incurred with respect to property if, at the time the taxes are incurred, it is reasonably likely that the property will be subsequently developed.

(iii) *Post-production costs.* Generally, producers must capitalize all indirect costs incurred subsequent to completion of production that are properly allocable to the property produced. Thus, for example, storage and handling costs incurred while holding the property produced for sale after production must be capitalized to the property to the extent properly allocable to the property. However, see §1.263A–3(c) for exceptions.

(4) *Practical capacity concept.* Notwithstanding any provision to the contrary, the use, directly or indirectly, of the practical capacity concept is not permitted under section 263A. For purposes of section 263A, the term practical capacity concept means any concept, method, procedure, or formula (such as the practical capacity concept described in §1.471–11(d)(4)) whereunder fixed costs are not capitalized because of the relationship between the actual production at the taxpayer's production facility and the practical capacity of the facility. For purposes of this section, the practical capacity of a facility includes either the practical capacity or theoretical capacity of the facility, as defined in §1.471–11(d)(4), or any similar determination of productive or operating capacity. The practical capacity concept may not be used with respect to any activity to which section 263A applies (i.e., production or resale activities). A taxpayer shall not be considered to be using the practical capacity concept solely because the taxpayer properly does not capitalize costs described in §1.263A–1(e)(3)(iii)(E), relating to certain costs attributable to temporarily idle equipment.

(5) *Taxpayers required to capitalize costs under this section.* This section generally applies to taxpayers that produce property. If a taxpayer is engaged in both production activities and resale activities, the taxpayer applies the principles of this section as if it read production or resale activities, and by applying appropriate principles from §1.263A–3. If a taxpayer is engaged in both production and resale activities, the taxpayer may elect the simplified production method provided in this section, but generally may not elect the simplified resale method discussed in §1.263A–3(d). If elected, the simplified production method must be applied to all eligible property produced and all eligible property acquired for resale by the taxpayer.

(b) *Simplified production method*—(1) *Introduction.* This paragraph (b) provides a simplified method for determining the additional section 263A costs properly allocable to ending inventories of property produced and other eligible property on hand at the end of the taxable year.

(2) *Eligible property*—(i) *In general.* Except as otherwise provided in paragraph (b)(2)(ii) of this section, the simplified production method, if elected for any trade or business of a producer, must be used for all production and resale activities associated with any of the following categories of property to which section 263A applies:

(A) *Inventory property.* Stock in trade or other property properly includible in the inventory of the taxpayer.

(B) *Non-inventory property held for sale.* Non-inventory property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(C) *Certain self-constructed assets.* Self-constructed assets substantially identical in nature to, and produced in the same manner as, inventory property produced by the taxpayer or other property produced by the taxpayer and held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(D) *Self-constructed assets produced on a repetitive basis.* Self-constructed assets produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business.

(ii) *Election to exclude self-constructed assets.* At the taxpayer's election, the simplified production method may be applied within a trade or business to only the categories of inventory property and non-inventory property held for sale described in paragraphs (b)(2)(i) (A) and (B) of this section. Taxpayers electing to exclude the self- constructed assets, defined in paragraphs (b)(2)(i) (C) and (D) of this section, from application of the simplified production method must, however, allocate additional section 263A costs to such property in accordance with § 1.263A–1 (f).

(3) *Simplified production method without historic absorption ratio election*—(i) *General allocation formula*—(A) *In general.* Except as otherwise provided in paragraph (b)(3)(iv) of this section, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year under the simplified production method are computed as follows:

$$\text{Absorption ratio} \times \text{section 471 costs remaining on hand at year end}$$

(B) *Effect of allocation.* The absorption ratio generally is multiplied by the section 471 costs remaining in ending inventory or otherwise on hand at the end of each taxable year in which the simplified production method is applied. The resulting product is the additional section 263A costs that are added to the taxpayer's ending section 471 costs to determine the section 263A costs that are capitalized. See, however, paragraph (b)(3)(iii) of this section for special rules applicable to LIFO taxpayers. Except as otherwise provided in this section or in § 1.263A–1 or 1.263A–3, additional section 263A costs that are allocated to inventories on hand at the close of the taxable year under the simplified production method of this paragraph (b) are treated as inventory costs for all purposes of the Internal Revenue Code.

(ii) *Definitions*—(A) *Absorption ratio.* Under the simplified production method, the absorption ratio is determined as follows:

$$\frac{\text{Additional section 263A costs incurred during the taxable year}}{\text{Section 471 costs incurred during the taxable year}}$$

(*1*) *Additional section 263A costs incurred during the taxable year.* Additional section 263A costs incurred during the taxable year are defined as the additional section 263A costs described in § 1.263A–1(d)(3) that a taxpayer incurs during its current taxable year.

(*2*) *Section 471 costs incurred during the taxable year.* Section 471 costs incurred during the taxable year are defined as the section 471 costs described in § 1.263A–1(d)(2) that a taxpayer incurs during its current taxable year.

(B) *Section 471 costs remaining on hand at year end.* Section 471 costs remaining on hand at year end means the section 471 costs, as defined in § 1.263A–1(d)(2), that a taxpayer incurs during its current taxable year which remain in its ending inventory or are otherwise on hand at year end. For LIFO inventories of a taxpayer, the section 471 costs remaining on hand at year end means the increment, if any, for the current year stated in terms of section 471 costs. See paragraph (b)(3)(iii) of this section.

(iii) *LIFO taxpayers electing the simplified production method*—(A) *In general.* Under the simplified production method, a taxpayer using a LIFO method must calculate a particular year's index (e.g., under § 1.472–8(e)) without regard to its additional section 263A costs. Similarly, a taxpayer that adjusts current-year costs by applicable indexes to determine whether there has been an inventory increment or decrement in the current year for a particular LIFO pool must disregard the additional section 263A costs in making that determination.

(B) *LIFO increment.* If the taxpayer determines there has been an inventory increment, the taxpayer must state the amount of the increment in current-year dollars (stated in terms of section 471 costs). The taxpayer then multiplies this amount by the absorption ratio. The resulting product is the additional section 263A costs that must be added to the taxpayer's increment for the year stated in terms of section 471 costs.

(C) *LIFO decrement.* If the taxpayer determines there has been an inventory decrement, the taxpayer must state the amount of the decrement in dollars applicable to the particular year for which the LIFO layer has been invaded. The additional section 263A costs incurred in prior years that are applicable to the decrement are charged to cost of goods sold. The additional section 263A costs that are applicable to the decrement are determined by multiplying the additional section 263A costs allocated to the layer of the pool in which the decrement occurred by the ratio of the decrement (excluding additional section 263A costs) to the section 471 costs in the layer of that pool.

(iv) *De minimis rule for producers with total indirect costs of $200,000 or less*—(A) *In general.* If a producer using the simplified production method incurs $200,000 or less of total indirect costs in a taxable year, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year are deemed to be zero. Solely for purposes of this paragraph (b)(3)(iv), taxpayers are permitted to exclude any category of indirect costs (listed in § 1.263A–1(e)(3)(iii)) that is not required to be capitalized (e.g., selling and distribution costs) in determining total indirect costs.

(B) *Related party and aggregation rules.* In determining whether the producer incurs $200,000 or less of total indirect costs in a taxable year, the related party and aggregation rules of § 1.263A–3(b)(3) are applied by substituting total indirect costs for gross receipts wherever gross receipts appears.

(v) *Examples.* The provisions of this paragraph (b) are illustrated by the following examples.

Example 1—FIFO inventory method. (i) Taxpayer J uses the FIFO method of accounting for inventories. J's beginning inventory for 1994 (all of which is sold during 1994) is $2,500,000 (consisting of $2,000,000 of section 471 costs and $500,000 of additional section 263A costs). During 1994, J incurs $10,000,000 of section 471 costs and $1,000,000 of additional section 263A costs. J's additional section 263A costs include capitalizable mixed service costs computed under the simplified service cost method as well as other allocable costs. J's section 471 costs remaining in ending inventory at the end of 1994 are $3,000,000. J computes its absorption ratio for 1994, as follows:

$$\frac{\text{Additional section 263A costs incurred during 1994}}{\text{Section 471 costs incurred during 1994}} = \frac{\$1{,}000{,}000}{\$10{,}000{,}000} = 10\%$$

(ii) Under the simplified production method, J determines the additional section 263A costs allocable to its ending inventory by multiplying the absorption ratio by the section 471 costs remaining in its ending inventory:

$$\text{Additional section 263A costs} = 10\% \times \$3{,}000{,}000 = \$300{,}000$$

(iii) J adds this $300,000 to the $3,000,000 of section 471 costs remaining in its ending inventory to calculate its total ending inventory of $3,300,000. The balance of J's additional section 263A costs incurred during 1994, $700,000, ($1,000,000 less $300,000) is taken into account in 1994 as part of J's cost of goods sold.

Example 2—LIFO inventory method. (i) Taxpayer K uses a dollar-value LIFO inventory method. K's beginning inventory for 1994 is $2,500,000 (consisting of $2,000,000 of section 471 costs and $500,000 of additional section 263A costs). During 1994, K incurs $10,000,000 of section 471 costs and $1,000,000 of additional section 263A costs. K's 1994 LIFO increment is $1,000,000 ($3,000,000 of section 471 costs in ending inventory less $2,000,000 of section 471 costs in beginning inventory).

(ii) To determine the additional section 263A costs allocable to its ending inventory, K multiplies the 10% absorption ratio ($1,000,000 of additional section 263A costs divided by $10,000,000 of section 471 costs) by the $1,000,000 LIFO increment. Thus, K's additional section 263A costs allocable to its ending inventory are $100,000 ($1,000,000 multiplied by 10%). This $100,000 is added to the $1,000,000 to determine a total 1994 LIFO increment of $1,100,000. K's ending inventory is $3,600,000 (its beginning inventory of $2,500,000 plus the $1,100,000 increment). The balance of K's additional section 263A costs incurred during 1994, $900,000 ($1,000,000 less $100,000), is taken into account in 1994 as part of K's cost of goods sold.

(iii) In 1995, K sells one-half of the inventory in its 1994 LIFO increment. K must include in its cost of goods sold for 1995 the amount of additional section 263A costs relating to this inventory, $50,000 (one-half of the tional section 263A costs capitalized in 1994 ending inventory, or $100,000).

Example 3—LIFO pools. (i) Taxpayer U begins its business in 1994 and adopts the LIFO inventory method. During 1994, L incurs $10,000 of section 471 costs and $1,000 of additional section 263A costs. At the end of 1994, L's ending inventory includes $3,000 of section 471 costs contained in three LIFO pools (X, Y, and Z) as shown below. Under the simplified production method, L computes its absorption ratio and inventory for 1994 as follows:

$$\frac{\text{Additional section 263A costs incurred during 1994}}{\text{Section 471 costs incurred during 1994}} = \frac{\$1{,}000}{\$10{,}000} = 10\%$$

	Total	X	Y	Z
1994:				
Ending section 471 costs	$3,000	$1,600	$600	$800
Additional section 263A costs (10%)	300	160	60	80
1994 ending inventory	$3,300	$1,760	$660	$880

(ii) During 1995, L incurs $2,000 of section 471 costs as shown below and $400 of additional section 263A costs. Moreover, L sells goods from pools X, Y, and Z having a total cost of $1,000. L computes its absorption ratio and inventory for 1995:

$$\frac{\text{Additional section 263A costs incurred during 1995}}{\text{Section 471 costs incurred during 1995}} = \frac{\$400}{\$2{,}000} = 20\%$$

	Total	X	Y	Z
1995:				
Beginning section 471 costs	$3,000	$1,600	$600	$800
1995 section 471 costs	2,000	1,500	300	200
Section 471 cost of goods sold	(1,000)	(300)	(300)	(400)
1995 ending section 471 costs	$4,000	$2,800	$600	$600
Consisting of:				
1994 layer	$2,800	$1,600	$600	$600
1995 layer	1,200	1,200	....	....
	$4,000	$2,800	$600	$600
Additional section 263A costs:				
1994 (10%)	$280	$160	$60	$60
1995 (20%)	240	240	....	....
	$520	$400	$60	$60
1995 ending inventory	$4,520	$3,200	$660	$660

(iii) In 1995, L experiences a $200 decrement in pool Z. Thus, L must charge the additional section 263A costs incurred in prior years applicable to the decrement to 1995's cost of goods sold. To do so, L determines a ratio by dividing the decrement by the section 471 costs in the 1994 layer ($200 divided by $800, or 25%). L then multiplies this ratio (25%) by the additional section 263A costs in the 1994 layer ($80) to determine the additional section 263A costs applicable to the decrement ($20). Therefore, $20 is taken into account by L in 1995 as part of its cost of goods sold ($80 multiplied by 25%).

(4) *Simplified production method with historic absorption ratio election*—(i) *In general.* This paragraph (b)(4) generally permits producers using the simplified production method to elect a historic absorption ratio in determining additional section 263A costs allocable to eligible property remaining on hand at the close of their taxable years. Except as provided in paragraph (b)(4)(v) of this section, a taxpayer may only make a historic absorption ratio election if it has used the simplified production method for three or more consecutive taxable years immediately prior to the year of election and has capitalized additional section 263A costs using an actual absorption ratio (as defined under paragraph (b)(3)(ii) of this section) for its three most recent consecutive taxable years. This method is not available to a taxpayer that is deemed to have zero additional section 263A costs under paragraph (b)(3)(iv) of this section. The historic absorption ratio is used in lieu of an actual absorption ratio computed under paragraph (b)(3)(ii) of this section and is based on costs capitalized by a taxpayer during its test period. If elected, the historic absorption ratio must be used for each taxable year within the qualifying period described in paragraph (b)(4)(ii)(C) of this section.

(ii) *Operating rules and definitions*—(A) *Historic absorption ratio.* (*1*) The historic absorption ratio is equal to the following ratio:

$$\frac{\text{Additional section 263A costs incurred during the test period}}{\text{Section 471 costs incurred during the test period}}$$

(*2*) Additional section 263A costs incurred during the test period are defined as the additional section 263A costs described in §1.263A–1(d)(3) that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(*3*) Section 471 costs incurred during the test period mean the section 471 costs described in §1.263A–1(d)(2) that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(*B*) *Test period—(1) In general.* The test period is generally the three taxable-year period immediately prior to the taxable year that the historic absorption ratio is elected.

(*2*) *Updated test period.* The test period begins again with the beginning of the first taxable year after the close of a qualifying period. This new test period, the updated test period, is the three taxable-year period beginning with the first taxable year after the close of the qualifying period as defined in paragraph (b)(4)(ii)(C) of this section.

(C) *Qualifying period*—(*1*) *In general.* A qualifying period includes each of the first five taxable years beginning with the first taxable year after a test period (or an updated test period).

(*2*) *Extension of qualifying period.* In the first taxable year following the close of each qualifying period, (e.g., the sixth taxable year following the test period), the taxpayer must compute the actual absorption ratio under the simplified production method. If the actual absorption ratio computed for this taxable year (the recomputation year) is within one-half of one percentage point (plus or minus) of the historic absorption ratio used in determining capitalizable costs for the qualifying period (i.e., the previous five taxable years), the qualifying period is extended to include the recomputation year and the following five taxable years, and the taxpayer must continue to use the historic absorption ratio throughout the extended qualifying period. If, however, the actual absorption ratio computed for the recomputation year is not within one-half of one percentage point (plus or minus) of the historic absorption ratio, the taxpayer must use actual absorption ratios beginning with the recomputation year under the simplified production method and throughout the updated test period. The taxpayer must resume using the historic absorption ratio (determined with reference to the updated test period) in the third taxable year following the recomputation year.

(iii) *Method of accounting*—(A) *Adoption and use.* The election to use the historic absorption ratio is a method of accounting. A taxpayer using the simplified production method may elect the historic absorption ratio in any taxable year if permitted under this paragraph (b)(4), provided the taxpayer has not obtained the Commissioner's consent to revoke the historic absorption ratio election within its prior six taxable years. The election is to be effected on a cut-off basis, and thus, no adjustment under section 481(a) is required or permitted. The use of a historic absorption ratio has no effect on other methods of accounting adopted by the taxpayer and used in conjunction with the simplified production method in determining its section 263A costs. Accordingly, in computing its actual absorption ratios, the taxpayer must use the same methods of accounting used in computing its historic absorption ratio during its most recent test period unless the taxpayer obtains the consent of the Commissioner. Finally, for purposes of this paragraph (b)(4)(iii), the recomputation of the historic absorption ratio during an updated test period and the change from a historic absorption ratio to an actual absorption ratio by reason of the requirements of this paragraph (b)(4) are not considered changes in methods of accounting under section 446(e) and, thus, do not require the consent of the Commissioner or any adjustments under section 481(a).

(B) *Revocation of election.* A taxpayer may only revoke its election to use the historic absorption ratio with the consent of the Commissioner in a manner prescribed under section 446(e) and the regulations thereunder. Consent to the change for any taxable year that is included in the qualifying period (or an extended qualifying period) will be granted only upon a showing of unusual circumstances.

(iv) *Reporting and recordkeeping requirements*—(A) *Reporting.* A taxpayer making an election under this paragraph (b)(4) must attach a statement to its federal income tax return for the taxable year in which the election is made showing the actual absorption ratios determined under the simplified production method during its first test period. This statement must disclose the historic absorption ratio to be used by the taxpayer during its qualifying period. A similar statement must be attached to the federal income tax return for the first taxable year within any subsequent qualifying period (i.e., after an updated test period).

(B) *Recordkeeping.* A taxpayer must maintain all appropriate records and details supporting the historic absorption ratio until the expiration of the statute of limitations for the last year for which the taxpayer applied the particular historic absorption ratio in determining additional section 263A costs capitalized to eligible property.

(v) *Transition rules.* Taxpayers will be permitted to elect a historic absorption ratio in their first, second, or third taxable year beginning after December 31, 1993, under such terms and conditions as may be prescribed by the Commissioner. Taxpayers are eligible to make an election under these transition rules whether or not they previously used the simplified production method. A taxpayer making such an election must recompute (or compute) its additional section 263A costs, and thus, its historic absorption ratio for its first test period as if the rules prescribed in this section and §§ 1.263A–1 and 1.263A–3 had applied throughout the test period.

(vi) *Example.* The provisions of this paragraph (b)(4) are illustrated by the following example:

Example. (i) Taxpayer M uses the FIFO method of accounting for inventories and for 1994 elects to use the historic absorption ratio with the simplified production method. After recomputing its additional section

263A costs in accordance with the transition rules of paragraph (b)(4)(v) of this section, M identifies the following costs incurred during the test period:

1991:
Add'l section 263A costs—$100
Section 471 costs—$3,000
1992:
Add'l section 263A costs—$200
Section 471 costs—$4,000
1993:
Add'l section 263A costs—$300
Section 471 costs—$5,000

(ii) Therefore, M computes a 5% historic absorption ratio determined as follows:

$$\text{Historic absorption ratio} = \frac{\$100+200+300}{\$3{,}000+4{,}000+5{,}000} = \frac{\$600}{\$12{,}000} = 5\%$$

(iii) In 1994, M incurs $10,000 of section 471 costs of which $3,000 remain in inventory at the end of the year. Under the simplified production method using a historic absorption ratio, M determines the additional section 263A costs allocable to its ending inventory by multiplying its historic absorption ratio (5%) by the section 471 costs remaining in its ending inventory as follows:

$$\text{Additional section 263A costs} = 5\% \times \$3{,}000 = \$150$$

(iv) To determine its ending inventory under section 263A, M adds the additional section 263A costs allocable to ending inventory to its section 471 costs remaining in ending inventory ($3,150=$150+$3,000). The balance of M's additional section 263A costs incurred during 1994 is taken into account in 1994 as part of M's cost of goods sold.

(v) M's qualifying period ends with the close of its 1998 taxable year. Therefore, 1999 is a recomputation year in which M must compute its actual absorption ratio. M determines its actual absorption ratio for 1999 to be 5.25% and compares that ratio to its historic absorption ratio (5.0%). Therefore, M must continue to use its historic absorption ratio of 5.0% throughout an extended qualifying period, 1999 through 2004 (the recomputation year and the following five taxable years).

(vi) If, instead, M's actual absorption ratio for 1999 were not between 4.5% and 5.5%, M's qualifying period would end and M would be required to compute a new historic absorption ratio with reference to an updated test period of 1999, 2000, and 2001. Once M's historic absorption ratio is determined for the updated test period, it would be used for a new qualifying period beginning in 2002.

(c) *Additional simplified methods for producers.* The Commissioner may prescribe additional elective simplified methods by revenue ruling or revenue procedure.

(d) *Cross reference.* See §1.6001–1(a) regarding the duty of taxpayers to keep such records as are sufficient to establish the amount of gross income, deductions, etc.

[T.D. 8482, 58 FR 42219, Aug. 9, 1993, as amended by 59 FR 3318, 3319, Jan. 21, 1994; T.D. 8584, 59 FR 67197, Dec. 29, 1994]

§1.263A–3 Rules relating to property acquired for resale.

(a) *Capitalization rules for property acquired for resale*—(1) *In general.* Section 263A applies to real property and personal property described in section 1221(1) acquired for resale by a retailer, wholesaler, or other taxpayer (reseller). However, section 263A does not apply to personal property described in section 1221(1) acquired for resale by a reseller whose average annual gross receipts for the three previous taxable years do not exceed $10,000,000 (small reseller). For this purpose, personal property includes both tangible and intangible property. Property acquired for resale includes stock in trade of the taxpayer or other property which is includible in the taxpayer's inventory if on hand at the close of the taxable year, and property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. See, however,

§1.263A–1(b)(11) for an exception for certain de minimis property provided to customers incident to the provision of services.

(2) *Resellers with production activities*—(i) *In general.* Generally, a taxpayer must capitalize all direct costs and certain indirect costs associated with real property and tangible personal property it produces. See §1.263A–2(a). Thus, except as provided in paragraphs (a)(2)(ii) and (3) of this section, a reseller, including a small reseller, that also produces property must capitalize the additional section 263A costs associated with any property it produces.

(ii) *Exception for small resellers.* Under this paragraph (a)(2)(ii), a small reseller is not required to capitalize additional section 263A costs associated with any personal property that is produced incident to its resale activities, provided the production activities are de minimis (within the meaning of paragraph (a)(2)(iii) of this section).

(iii) *De minimis production activities*—(A) *In general.* (*1*) In determining whether a taxpayer's production activities are de minimis, all facts and circumstances must be considered. For example, the taxpayer must consider the volume of the production activities in its trade or business. Production activities are presumed de minimis if—

(*i*) The gross receipts from the sale of the property produced by the reseller are less than 10 percent of the total gross receipts of the trade or business; and

(ii) The labor costs allocable to the trade or business' production activities are less than 10 percent of the reseller's total labor costs allocable to its trade or business.

(*2*) For purposes of this de minimis presumption, gross receipts has the same definition as provided in paragraph (b) of this section except that gross receipts are measured at the trade-or-business level rather than at the single-employer level.

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

Example—Small reseller with de minimis production activities. Taxpayer N is a small reseller in the retail grocery business whose average annual gross receipts for the three previous taxable years are less than $10,000,000. N's grocery stores typically contain bakeries where customers may purchase baked goods produced by N. N's gross receipts from its bakeries are 5% of the entire grocery business. N's labor costs from its bakeries are 3% of its total labor costs allocable to the entire grocery business. Because both ratios are less than 10%, N's production activities are de minimis. Further, because N's production activities are incident to its resale activities, N is not required to capitalize any additional section 263A costs associated with its produced property.

(3) *Resellers with property produced under contract.* Generally, property produced for a taxpayer under a contract (within the meaning of §1.263A–2(a)(1)(ii)(B)(*2*)) is treated as property produced by the taxpayer. See §1.263A–2(a)(1)(ii)(B). However, a small reseller is not required to capitalize additional section 263A costs to personal property produced for it under contract with an unrelated person if the contract is entered into incident to the resale activities of the small reseller and the property is sold to its customers. For purposes of this paragraph, persons are related if they are described in section 267(b) or 707(b).

(4) *Use of the simplified resale method*—(i) *In general.* Except as provided in paragraphs (a)(4)(ii) and (iii) of this section, a taxpayer may elect the simplified production method (as described in §1.263A–2(b)) but may not elect the simplified resale method (as described in paragraph (d) of this section) if the taxpayer is engaged in both production and resale activities with respect to the items of eligible property listed in §1.263A–2(b)(2).

(ii) *Resellers with de minimis production activities.* A reseller otherwise permitted to use the simplified resale method in paragraph (d) of this section may use the simplified resale method if its production activities with respect to the items of eligible property listed in §1.263A–2(b)(2) are de minimis (within the meaning of paragraph (a)(2)(iii) of this section) and incident to its resale of personal property described in section 1221(1).

(iii) *Resellers with property produced under a contract.* A reseller otherwise permitted to use the simplified resale method in paragraph (d) of this section may use the simplified resale method even though it has personal property produced for it (e.g., private label goods) under a contract with an unrelated person if the contract is entered into incident to its resale activities and the property is sold to its customers. For purposes of this paragraph (a)(4)(iii), persons are related if they are described in section 267(b) or 707(b).

(iv) *Application of simplified resale method.* A taxpayer that uses the simplified resale method and has de minimis production activities incident to its resale activities or property produced under contract must capitalize all costs allocable to eligible property produced using the simplified resale method.

(b) *Gross receipts exception for small resellers*—(1) *In general.* Section 263A does not apply to any personal property acquired for resale during any taxable year if the taxpayer's (or its predecessors') average annual gross receipts for the three previous taxable years (test period) do not exceed $10,000,000. However, taxpayers that acquire real property for resale are subject to section 263A with respect to real property regardless of their gross receipts. See section 263A(b)(2)(B).

(i) *Test period for new taxpayers.* For purposes of applying this exception, if a taxpayer has been in existence for less than three taxable years, the taxpayer determines its average annual gross receipts for the number of taxable years (including short taxable years) that the taxpayer (or its predecessor) has been in existence.

(ii) *Treatment of short taxable year.* In the case of a short taxable year, the taxpayer's gross receipts are annualized by—

(A) Multiplying the gross receipts of the short taxable year by 12; and

(B) Dividing the product determined in paragraph (b)(1)(ii)(A) of this section by the number of months in the short taxable year.

(2) *Definition of gross receipts*—(i) *In general.* Gross receipts are the total amount, as determined under the taxpayer's method of accounting, derived from all of the taxpayer's trades or businesses (e.g., revenues derived from the sale of inventory before reduction for cost of goods sold).

(ii) *Amounts excluded.* For purposes of this paragraph (b), gross receipts do not include amounts representing—

(A) Returns or allowances;

(B) Interest, dividends, rents, royalties, or annuities, not derived in the ordinary course of a trade or business;

(C) Receipts from the sale or exchange of capital assets, as defined in section 1221;

(D) Repayments of loans or similar instruments (e.g., a repayment of the principal amount of a loan held by a commercial lender);

(E) Receipts from a sale or exchange not in the ordinary course of business, such as the sale of an entire trade or business or the sale of property used in a trade or business as defined under section 1221(2); and

(F) Receipts from any activity other than a trade or business or an activity engaged in for profit.

(3) *Aggregation of gross receipts*—(i) *In general.* In determining gross receipts, all persons treated as a single employer under section 52(a) or (b), section 414(m), or any regulation prescribed under section 414 (or persons that would be treated as a single employer under any of these provisions if they had employees) shall be treated as one taxpayer. The gross receipts of a single employer (or the group) are determined by aggregating the gross receipts of all persons (or the members) of the group, excluding any gross receipts attributable to transactions occurring between group members.

(ii) *Single employer defined.* A controlled group, which is treated as a single employer under section 52(a), includes members of a controlled group within the meaning of section 1563(a), regardless of whether such members would be treated as component members of such group under section 1563(b). (See §1.52–1(c).) Thus, for example, the gross receipts of a franchised corporation that is treated as an excluded member for purposes of section 1563(b) are included in the single employer's gross receipts under this aggregation rule, if such corporation and the taxpayer were members of the same controlled group under section 1563(a).

(iii) *Gross receipts of a single employer.* The gross receipts of a single employer for the test period include the gross receipts of all group members (or their predecessors) that are members of the group as of the first day of the taxable year in issue, regardless of whether such persons were members of the group for any of the three preceding taxable years. The gross receipts of the single employer for the test period do not, however, include the gross receipts of any member that was a group member (including any predecessor) for any or all of the three preceding taxable years, and is no longer a group member as of the first day of the taxable year in issue. Any group member that has a taxable year of less than 12 months must annualize its gross receipts in accordance with paragraph (b)(1)(ii) of this section.

(iv) *Examples.* The provisions of this paragraph (b)(3) are illustrated by the following examples:

Example 1. Subsidiary acquired during the taxable year. A parent corporation, (P), has owned 100% of the stock of another corporation, (S1), continually since 1989. P and S1 are calendar year taxpayers. S1 acquires property for resale. On January 1, 1994, P acquires 100% of the stock of another calendar year corporation (S2). In determining whether S1's resale activities are subject to the provisions of section 263A for 1994, the gross receipts of P, S1, and S2 for 1991, 1992, and 1993 are aggregated, excluding the gross receipts, if any, attributable to transactions occurring between the three corporations.

Example 2. Subsidiary sold during the taxable year. Since 1989, a parent corporation, (P), has continually owned 100% of the stock of two other corporations, (S1) and (S2). The three corporations are calendar year taxpayers. S1 acquires property for resale. On December 31, 1993, P sells all of its stock in S2. In determining whether S1's resale activities are subject to the provisions of section 263A for 1994, only the gross receipts of P and S1 for 1991, 1992, and 1993 must be aggregated, excluding the gross receipts, if any, attributable to transactions occurring between the two corporations.

(c) *Purchasing, handling, and storage costs*—(1) *In general.* Generally, § 1.263A–1(e) describes the types of costs that must be capitalized by taxpayers. Resellers must capitalize the acquisition cost of property acquired for resale, as well as indirect costs described in § 1.263A–1(e)(3), which are properly allocable to property acquired for resale. The indirect costs most often incurred by resellers are purchasing, handling, and storage costs. This paragraph (c) provides additional guidance regarding each of these categories of costs. As provided in § 1.263A–1(e), this paragraph (c) also applies to producers incurring purchasing, handling, and storage costs.

(2) *Costs attributable to purchasing, handling, and storage.* The costs attributable to purchasing, handling, and storage activities generally consist of direct and indirect labor costs (including the costs of pension plans and other fringe benefits); occupancy expenses including rent, depreciation, insurance, security, taxes, utilities and maintenance; materials and supplies; rent, maintenance, depreciation, and insurance of vehicles and equipment; tools; telephone; travel; and the general and administrative costs that directly benefit or are incurred by reason of the taxpayer's activities.

(3) *Purchasing costs*—(i) *In general.* Purchasing costs are costs associated with operating a purchasing department or office within a trade or business, including personnel costs (e.g., of buyers, assistant buyers, and clerical workers), relating to—

(A) The selection of merchandise;

(B) The maintenance of stock assortment and volume;

(C) The placement of purchase orders;

(D) The establishment and maintenance of vendor contacts; and

(E) The comparison and testing of merchandise.

(ii) *Determination of whether personnel are engaged in purchasing activities.* The determination of whether a person is engaged in purchasing activities is based upon the activities performed by that person and not upon the person's title or job classification. Thus, for example, although an employee's job function may be described in such a way as to indicate activities outside the area of purchasing (e.g., a marketing representative), such activities must be analyzed on the basis of the activities performed by that employee. If a person performs both purchasing and non-purchasing activities, the taxpayer must reasonably allocate the person's labor costs between these activities. For example, a reasonable allocation is one based on the amount of time the person spends on each activity.

(A) *⅓–⅔ rule for allocating labor costs.* A taxpayer may elect the ⅓–⅔ rule for allocating labor costs of persons performing both purchasing and non-purchasing activities. If elected, the taxpayer must allocate the labor costs of all such persons using the ⅓–⅔ rule. Under this rule—

(*1*) If less than one-third of a person's activities are related to purchasing, none of that person's labor costs are allocated to purchasing;

(*2*) If more than two-thirds of a person's activities are related to purchasing, all of that person's labor costs are allocated to purchasing; and

(*3*) In all other cases, the taxpayer must reasonably allocate labor costs between purchasing and non-purchasing activities.

(B) *Example.* The application of paragraph (c)(3)(ii)(A) of this section may be illustrated by the following example:

Example. Taxpayer O is a reseller that employs three persons, A, B, and C, who perform both purchasing and non- purchasing activities. These persons spend the following time performing purchasing activities: A–25 %; B–70 %; and C–50 %. Under the ⅓–⅔ rule, Taxpayer O treats none of A's labor costs as purchasing costs, all of B's labor costs as purchasing costs, and Taxpayer O allocates 50 % of C's labor costs as purchasing costs.

(4) *Handling costs*—(i) *In general.* Handling costs include costs attributable to processing, assembling, repackaging, transporting, and other similar activities with respect to property acquired for resale, provided the activities do not come within the meaning of the term produce as defined in §1.263A–2(a)(1). Handling costs are generally required to be capitalized under section 263A. Under this paragraph (c)(4)(i), however, handling costs incurred at a retail sales facility (as defined in paragraph (c)(5)(ii)(B) of this section) with respect to property sold to retail customers at the facility are not required to be capitalized. Thus, for example, handling costs incurred at a retail sales facility to unload, unpack, mark, and tag goods sold to retail customers at the facility are not required to be capitalized. In addition, handling costs incurred at a dual-function storage facility (as defined in paragraph (c)(5)(ii)(G) of this section) with respect to property sold to customers from the facility are not required to be capitalized to the extent that the costs are incurred with respect to property sold in on-site sales. Handling costs attributable to property sold to customers from a dual-function storage facility in on-site sales are determined by applying the ratio in paragraph (c)(5)(iii)(B) of this section.

(ii) *Processing costs.* Processing costs are the costs a reseller incurs in making minor changes or alterations to the nature or form of a product acquired for resale. Minor changes to a product include, for example, monogramming a sweater, altering a pair of pants, and other similar activities.

(iii) *Assembling costs.* Generally, assembling costs are costs associated with incidental activities that are necessary in readying property for resale (e.g., attaching wheels and handlebars to a bicycle acquired for resale).

(iv) *Repackaging costs.* Repackaging costs are the costs a taxpayer incurs to package property for sale to its customers.

(v) *Transportation costs.* Generally, transportation costs are the costs a taxpayer incurs moving or shipping property acquired for resale. These costs include the cost of dispatching trucks; loading and unloading shipments; and sorting, tagging, and marking property. Transportation costs may consist of depreciation on trucks and equipment and the costs of fuel, insurance, labor, and similar costs. Generally, transportation costs required to be capitalized include costs incurred in transporting property—

(A) From the vendor to the taxpayer;

(B) From one of the taxpayer's storage facilities to another of its storage facilities;

(C) From the taxpayer's storage facility to its retail sales facility;

(D) From the taxpayer's retail sales facility to its storage facility; and

(E) From one of the taxpayer's retail sales facilities to another of its retail sales facilities.

(vi) *Costs not required to be capitalized as handling costs*—(A) *Distribution costs*—(*1*) *In general.* Distribution costs are not required to be capitalized. Distribution costs are any transportation costs incurred outside a storage facility in delivering goods to a customer. For this purpose, any costs incurred on a loading dock are treated as incurred outside a storage facility.

(*2*) *Costs incurred in transporting goods to a related person.* Distribution costs do not include costs incurred by a taxpayer in delivering goods to a related person. Thus, for example, when a taxpayer sells goods to a related person, the costs of transporting the goods are included in determining the basis of the goods that are sold, and hence in determining the resulting gain or loss from the sale, for all purposes of the Internal Revenue Code and the regulations thereunder. See, e.g., sections 267, 707, and 1502. For purposes of this provision, persons are related if they are described in section 267(b) or section 707(b).

(B) *Delivery of custom-ordered items.* Generally, costs incurred in transporting goods from a taxpayer's storage facility to its retail sales facility must be capitalized. However, costs incurred outside a storage facility in delivering custom-ordered items to a retail sales facility are not required to be capitalized. For this purpose, any costs incurred on a loading dock are treated as incurred outside a storage facility. Delivery of custom-ordered items occurs when a taxpayer can demonstrate that a delivery to the taxpayer's retail sales facility is made to fill an identifiable order of a particular customer (placed by the customer before the delivery of the goods occurs) for the particular goods in question. Factors that may demonstrate the existence of a specific, identifiable delivery include the following—

(*1*) The customer has paid for the item in advance of the delivery;

(*2*) The customer has submitted a written order for the item;

(*3*) The item is not normally available at the retail sales facility for onsite customer purchases; and

(*4*) The item will be returned to the storage facility (and not held for sale at the retail sales facility) if the customer cancels an order.

(C) *Pick and pack costs*—(*1*) *In general.* Generally, handling costs incurred inside a storage or warehousing facility must be capitalized. However, costs attributable to pick and pack activities inside a storage or warehousing facility are not required to be capitalized. Pick and pack activities are activities undertaken in preparation for imminent shipment to a particular customer after the customer has ordered the specific goods in question. Examples of pick and pack activities include:

(*i*) Moving specific goods from a storage location in preparation for shipment to the customer;

(*ii*) Packing or repacking those goods for shipment to the customer; and

(*iii*) Staging those goods for shipment to the customer.

(*2*) *Activities that are not pick and pack activities.* Pick and pack activities do not include:

(*i*) Unloading goods that are received for storage;

(*ii*) Checking the quantity and quality of goods received;

(*iii*) Comparing the quantity of goods received to the amounts ordered and preparing the receiving documents;

(*iv*) Moving the goods to their storage location, e.g., bins, racks, containers, etc.; and

(*v*) Storing the goods.

(*3*) *Costs not attributable to pick and pack activities.* Occupancy costs, such as rent, depreciation, insurance, security, taxes, utilities, and maintenance costs properly allocable to the storage or warehousing facility, are not costs attributable to pick and pack activities.

(5) *Storage costs*—(i) *In general.* Generally, storage costs are capitalized under section 263A to the extent they are attributable to the operation of an off-site storage or warehousing facility (an off-site storage facility). However, storage costs attributable to the operation of an on-site storage facility (as defined in paragraph (c)(5)(ii)(A) of this section) are not required to be capitalized under section 263A. Storage costs attributable to a dual-function storage facility (as defined in paragraph (c)(5)(ii)(G) of this section) must be capitalized to the extent that the facility's costs are allocable to off-site storage.

(ii) *Definitions*—(A) *On-site storage facility.* An on-site storage facility is defined as a storage or warehousing facility that is physically attached to, and an integral part of, a retail sales facility.

(B) *Retail sales facility.* (*1*) A retail sales facility is defined as a facility where a taxpayer sells merchandise exclusively to retail customers in on-site sales. For this purpose, a retail sales facility includes those portions of any specific retail site—

(*i*) Which are customarily associated with and are an integral part of the operations of that retail site;

(*ii*) Which are generally open each business day exclusively to retail customers;

(*iii*) On or in which retail customers normally and routinely shop to select specific items of merchandise; and

(*iv*) Which are adjacent to or in immediate proximity to other portions of the specific retail site.

(*2*) Thus, for example, two lots of an automobile dealership physically separated by an alley or an access road would generally be considered one retail sales facility, provided customers routinely shop on both of the lots to select the specific automobiles that they wish to acquire.

(C) *An integral part of a retail sales facility.* A storage facility is considered an integral part of a retail sales facility when the storage facility is an essential and indispensable part of the retail sales facility. For example, if the storage facility is used exclusively for filling orders or completing sales at the retail sales facility, the storage facility is an integral part of the retail sales facility.

(D) *On-site sales.* On-site sales are defined as sales made to retail customers physically present at a facility. For example, mail order and catalog sales are made to customers not physically present at the facility, and thus, are not on-site sales.

(E) *Retail customer*—(*1*) *In general.* A retail customer is defined as the final purchaser of the merchandise. A retail customer does not include a person who resells the merchandise to others, such as a contractor or manufacturer that incorporates the merchandise into another product for sale to customers.

(*2*) *Certain non-retail customers treated as retail customers.* For purposes of this section, a non-retail customer is treated as a retail customer with respect to a particular facility if the following requirements are satisfied—

(*i*) The non-retail customer purchases goods under the same terms and conditions as are available to retail customers (e.g., no special discounts);

(*ii*) The non-retail customer purchases goods in the same manner as a retail customer (e.g., the non-retail customer may not place orders in advance and must come to the facility to examine and select goods);

(*iii*) Retail customers shop at the facility on a routine basis (i.e., on most business days), and no special days or hours are reserved for non-retail customers; and

(*iv*) More than 50 percent of the gross sales of the facility are made to retail customers.

(F) *Off-site storage facility.* An off-site storage facility is defined as a storage facility that is not an on-site storage facility.

(G) *Dual-function storage facility.* A dual-function storage facility is defined as a storage facility that serves as both an off-site storage facility and an on-site storage facility. For example, a dual-function storage facility would include a regional warehouse that serves the taxpayer's separate retail sales outlets and also contains a sales outlet therein. A dual-function storage facility also includes any facility where sales are made to retail customers in on-site sales and to—

(*1*) Retail customers in sales that are not on-site sales; or

(*2*) Other customers.

(iii) *Treatment of storage costs incurred at a dual-function storage facility*—(A) *In general.* Storage costs associated with a dual-function storage facility must be allocated between the off-site storage function and the on-site storage function. To the extent that the dual-function storage facility's storage costs are allocable to the off-site storage function, they must be capitalized. To the extent that the dual-function storage facility's storage costs are allocable to the on-site storage function, they are not required to be capitalized.

(B) *Dual-function storage facility allocation ratio*—(*1*) *In general.* Storage costs associated with a dual-function storage facility must be allocated between the off-site storage function and the on-site storage function using the ratio of—

(*i*) Gross on-site sales of the facility (i.e., gross sales of the facility made to retail customers visiting the premises in person and purchasing merchandise stored therein); to

(*ii*) Total gross sales of the facility. For this purpose, the total gross sales of the facility include the value of items shipped to other facilities of the taxpayer.

(*2*) *Illustration of ratio allocation.* For example, if a dual-function storage facility's on-site sales are 40 percent of the total gross sales of the facility, then 40 percent of the facility's storage costs are allocable to the on-site storage function and are not required to be capitalized under section 263A.

(*3*) *Appropriate adjustments for other uses of a dual-function storage facility.* Prior to computing the allocation ratio in paragraph (c)(5)(iii)(B) of this section, a taxpayer must apply the principles of paragraph (c)(5)(iv) of this section in determining the portion of the facility that is a dual-function storage facility (and the costs attributable to such portion).

(C) *De minimis 90–10 rule for dual-function storage facilities.* If 90 percent or more of the costs of a facility are attributable to the on-site storage function, the entire storage facility is deemed to be an on-site storage facility. In contrast, if 10 percent or less of the costs of a storage facility are attributable to the on-site storage function, the entire storage facility is deemed to be an off-site storage facility.

(iv) *Costs not attributable to an off-site storage facility.* To the extent that costs incurred at an off-site storage facility are not properly allocable to the taxpayer's storage function, the costs are not accounted for as off-site storage costs. For example, if a taxpayer has an office attached to its off-site storage facility where work unrelated to the storage function is performed, such as a sales office, costs associated with this office are not off-site storage costs. However, if a taxpayer uses a portion of an off-site storage facility in a manner related to the storage function, for example, to store equipment or supplies that are not offered for sale to customers, costs associated with this portion of the facility are off-site storage costs.

(v) *Examples.* The provisions of this paragraph (c)(5) are illustrated by the following examples:

Example 1. Catalog or mail order center. Taxpayer P operates a mail order catalog business. As part of its business, P stores merchandise for shipment to customers who purchase the merchandise through orders placed by telephone or mail. P's storage facility is not an on-site storage facility because no on-site sales are made at the facility.

Example 2. Pooled-stock facility. Taxpayer Q maintains a pooled-stock facility, which functions as a back-up regional storage facility for Q's retail sales outlets in the nearby area. Q's pooled stock facility is an off-site storage facility because it is neither physically attached to nor an integral part of a retail sales facility.

Example 3. Wholesale warehouse. Taxpayer R operates a wholesale warehouse where wholesale sales are made to customers physically present at the facility. R's customers resell the goods they purchase from R to final retail customers. Because no retail sales are conducted at the facility, all storage costs attributable to R's wholesale warehouse must be capitalized.

(d) *Simplified resale method*—(1) *Introduction.* This paragraph (d) provides a simplified method for determining the additional section 263A costs properly allocable to property acquired for resale and other eligible property on hand at the end of the taxable year.

(2) *Eligible property.* Generally, the simplified resale method is only available to a trade or business exclusively engaged in resale activities. However, certain resellers with property produced as a result of de minimis production activities or property produced under contract may elect the simplified resale method, as described in paragraph (a)(4) of this section. Eligible property for purposes of the simplified resale method, therefore, includes any real or personal property described in section 1221(1) that is acquired for resale and any eligible property (within the meaning of § 1.263A–

2(b)(2)) that is described in paragraph (a)(4) of this section.

(3) *Simplified resale method without historic absorption ratio election*—(i) *General allocation formula*—(A) *In general.* Under the simplified resale method, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year are computed as follows:

$$\text{Combined absorption ratio} \times \text{section 471 costs remaining on hand at year end}$$

(B) *Effect of allocation.* The resulting product under the general allocation formula is the additional section 263A costs that are added to the taxpayer's ending section 471 costs to determine the section 263A costs that are capitalized.

(C) *Definitions*—(*1*) *Combined absorption ratio.* The combined absorption ratio is defined as the sum of the storage and handling costs absorption ratio as defined in paragraph (d)(3)(i)(D) of this section and the purchasing costs absorption ratio as defined in paragraph (d)(3)(i)(E) of this section.

(*2*) *Section 471 costs remaining on hand at year end.* Section 471 costs remaining on hand at year end mean the section 471 costs, as defined in §1.263A–1(d)(2), that the taxpayer incurs during its current taxable year, which remain in its ending inventory or are otherwise on hand at year end. For LIFO inventories of a taxpayer, the section 471 costs remaining on hand at year end means the increment, if any, for the current year stated in terms of section 471 costs. See paragraph (d)(3)(ii) of this section for special rules applicable to LIFO taxpayers. Except as otherwise provided in this section or in §1.263A–1 or 1.263A–2, additional section 263A costs that are allocated to inventories on hand at the close of the taxable year under the simplified resale method of this paragraph (d) are treated as inventory costs for all purposes of the Internal Revenue Code.

(D) *Storage and handling costs absorption ratio.*

(*1*) Under the simplified resale method, the storage and handling costs absorption ratio is determined as follows:

$$\frac{\text{Current year's storage and handling costs}}{\text{Beginning inventory plus current year's purchases}}$$

(*2*) Current year's storage and handling costs are defined as the total storage costs plus the total handling costs incurred during the taxable year that relate to the taxpayer's property acquired for resale and other eligible property. See paragraph (c) of this section, which discusses storage and handling costs. Storage and handling costs must include the amount of allocable mixed service costs as described in paragraph (d)(3)(i)(F) of this section. Beginning inventory in the denominator of the storage and handling costs absorption ratio refers to the section 471 costs of any property acquired for resale or other eligible property held by the taxpayer as of the beginning of the taxable year. Current year's purchases generally mean the taxpayer's section 471 costs incurred with respect to purchases of property acquired for resale during the current taxable year. In computing the denominator of the storage and handling costs absorption ratio, a taxpayer using a dollar-value LIFO method of accounting, must state beginning inventory amounts using the LIFO carrying value of the inventory and not current-year dollars.

(E) *Purchasing costs absorption ratio.* (*1*) Under the simplified resale method, the purchasing costs absorption ratio is determined as follows:

$$\frac{\text{Current year's purchasing costs}}{\text{Current year's purchases}}$$

(*2*) Current year's purchasing costs are defined as the total purchasing costs incurred during the taxable year that relate to the taxpayer's property acquired for resale and eligible property. See paragraph (c)(3) of this section, which discusses purchasing costs. Purchasing costs must include the amount of allocable mixed service costs determined in paragraph (d)(3)(i)(F) of this section. Current year's purchases generally mean the taxpayer's section 471 costs incurred with respect to purchases of property acquired for resale during the current taxable year.

(F) *Allocable mixed service costs.* (*1*) If a taxpayer allocates its mixed service costs to purchasing costs, storage costs, and handling costs using a method described in §1.263A–1(g)(4), the taxpayer is not required to determine its allocable mixed service costs under this paragraph (d)(3)(i)(F). However, if the taxpayer uses the simplified service cost method, the amount of mixed service costs allocated to and included in purchasing costs, storage costs, and handling costs in the absorption ratios in paragraphs (d)(3)(i) (D) and (E) of this section is determined as follows:

$$\frac{\text{Labor costs allocable to activity}}{\text{Total labor costs}} \times \text{Total mixed service costs}$$

(*2*) Labor costs allocable to activity are defined as the total labor costs allocable to each particular activity (i.e., purchasing, handling, and storage), excluding labor costs included in mixed service costs. Total labor costs are defined as the total labor costs (excluding labor costs included in mixed service costs) that are incurred in the taxpayer's trade or business during the taxable year. See §1.263A–1(h)(6) for the definition of total mixed service costs.

(ii) *LIFO taxpayers electing simplified resale method*—(A) *In general.* Under the simplified resale method, a taxpayer using a LIFO method must calculate a particular year's index (e.g., under §1.472–8(e)) without regard its additional section 263A costs. Similarly, a taxpayer that adjusts current-year costs by applicable indexes to determine whether there has been an inventory increment or decrement in the current year for a particular LIFO pool must disregard the additional section 263A costs in making that determination.

(B) *LIFO increment.* If the taxpayer determines there has been an inventory increment, the taxpayer must state the amount of the increment in current-year dollars (stated in terms of section 471 costs). The taxpayer then multiplies this amount by the combined absorption ratio. The resulting product is the additional section 263A costs that must be added to the taxpayer's increment for the year stated in terms of section 471 costs.

(C) *LIFO decrement.* If the taxpayer determines there has been an inventory decrement, the taxpayer must state the amount of the decrement in dollars applicable to the particular year for which the LIFO layer has been invaded. The additional section 263A costs incurred in prior years that are applicable to the decrement are charged to cost of goods sold. The additional section 263A costs that are applicable to the decrement are determined by multiplying the additional section 263A costs allocated to the layer of the pool in which the decrement occurred by the ratio of the decrement (excluding additional section 263A costs) to the section 471 costs in the layer of that pool.

(iii) *Permissible variations of the simplified resale method.* The following variations of the simplified resale method are permitted:

(A) The exclusion of beginning inventories from the denominator in the storage and handling costs absorption ratio formula in paragraph (d)(3)(i)(D) of this section; or

(B) Multiplication of the storage and handling costs absorption ratio in paragraph (d)(3)(i)(D) of this section by the total of section 471 costs included in a LIFO taxpayer's ending inventory (rather than just the increment, if any, experienced by the LIFO taxpayer during the taxable year) for purposes of determining capitalizable storage and handling costs.

(iv) *Examples.* The provisions of this paragraph (d)(3) are illustrated by the following examples:

Example 1. FIFO inventory method. (i) Taxpayer S uses the FIFO method of accounting for inventories. S's beginning inventory for 1994 (all of which was sold during 1994) was $2,100,000 (consisting of $2,000,000 of section 471 costs and $100,000 of additional section 263A costs). During 1994, S makes purchases of $10,000,000. In addition, S incurs purchasing costs of $460,000, storage costs of $110,000, and handling costs of $90,000. S's purchases (section 471 costs) remaining in ending inventory at the end of 1994 are $3,000,000.

(ii) In 1994, S incurs $400,000 of total mixed service costs and $1,000,000 of total labor costs (excluding labor costs included in mixed service costs). In addition, S incurs the following labor costs (excluding labor costs included in mixed service costs): purchasing—$100,000, storage—$200,000, and handling—$200,000. Accordingly, the following mixed service costs must be included in purchasing costs, storage costs, and handling costs as capitalizable mixed service costs: purchasing— $40,000 ([$100,000 divided by $1,000,000] multiplied by $400,000); storage—$80,000 ([$200,000 divided by $1,000,000] multiplied by $400,000); and handling— $80,000 ([$200,000 divided by $1,000,000] multiplied by $400,000).

(iii) S computes its purchasing costs absorption ratio for 1994 as follows:

$$\frac{\text{1994 purchasing costs}}{\text{1994 purchases}} = \frac{\$460{,}000 + \$40{,}000}{\$10{,}000{,}000}$$

$$= \frac{\$500{,}000}{\$10{,}000{,}000}$$

$$= 5.0\%$$

(iv) S computes its storage and handling costs absorption ratio for 1994 as follows:

$$\frac{\text{Storage and handling costs}}{\begin{array}{c}\text{Beginning inventory}\\ \text{plus 1994 purchases}\end{array}} = \frac{(\$110{,}000 + \$80{,}000) + (\$90{,}000 + \$80{,}000)}{\$2{,}000{,}000 + \$10{,}000{,}000}$$

$$= \frac{\$190{,}000 + \$170{,}000}{\$12{,}000{,}000}$$

$$= \frac{\$360{,}000}{\$12{,}000{,}000}$$

$$= 3.0\%$$

(v) S's combined absorption ratio is 8.0 %, or the sum of the purchasing costs absorption ratio (5.0 %) and the storage and handling costs absorption ratio (3.0 %). Under the simplified resale method, S determines the additional section 263A costs allocable to its ending inventory by multiplying the combined absorption ratio by its section 471 costs with respect to current year's purchases remaining in ending inventory:

$$\text{Additional section 263A costs} = 8.0\% \times \$3{,}000{,}000 = \$240{,}000$$

(vi) S adds this $240,000 to the $3,000,000 of purchases remaining in its ending inventory to determine its total ending FIFO inventory of $3,240,000.

Example 2. LIFO inventory method. (i) Taxpayer T uses a dollar-value LIFO inventory method. T's beginning inventory for 1994 is $2,100,000 (consisting of $2,000,000 of section 471 costs and $100,000 of additional section 263A costs). During 1994, T makes purchases of $10,000,000. In addition, T incurs purchasing costs of $460,000, storage costs of $110,000, and handling costs of $90,000. T's 1994 LIFO increment is $1,000,000 ($3,000,000 of section 471 costs in ending inventory less $2,000,000 of section 471 costs in beginning inventory).

(ii) In 1994, T incurs $400,000 of total mixed service costs and $1,000,000 of total labor costs (excluding labor costs included in mixed service costs). In addition, T incurs the following labor costs (excluding labor costs included in mixed service costs): purchasing—$100,000, storage—$200,000, and handling—$200,000. Accordingly, the following mixed service costs must be included in purchasing costs, storage costs, and handling costs as capitalizable mixed service costs: purchasing—$40,000 ([$100,000 divided by $1,000,000] multiplied by $400,000); storage—$80,000 ([$200,000 divided by $1,000,000] multiplied by $400,000); and handling— $80,000 ([$200,000 divided by $1,000,000] multiplied by $400,000).

(iii) Based on these facts, T determines that it has a combined absorption ratio of 8.0 %. To determine the additional section 263A costs allocable to its ending inventory, T multiplies its combined absorption ratio (8.0 %) by the $1,000,000 LIFO increment. Thus, T's additional section 263A costs allocable to its ending inventory are $80,000 ($1,000,000 multiplied by 8.0 %). This $80,000 is added to the $1,000,000 to determine a total 1994 LIFO increment of $1,080,000. T's ending inventory is $3,180,000 (its beginning inventory of $2,100,000 plus the $1,080,000 increment).

(iv) In 1995, T sells one-half of the inventory in its 1994 LIFO increment. T must include in its cost of goods sold for 1995 the amount of additional section 263A costs relating to this inventory, i.e., one-half of the $80,000 additional section 263A costs capitalized in 1994 ending inventory, or $40,000.

Example 3. LIFO Pools. (i) Taxpayer U begins its business in 1994, and adopts the LIFO inventory method. During 1994, U makes purchases of $10,000, and incurs $400 of purchasing costs, $350 of storage costs and $250 of handling costs. U's purchasing costs, storage costs, and handling costs include their proper allocable share of mixed service costs.

(ii) U computes its purchasing costs absorption ratio for 1994, as follows:

$$\frac{\text{1994 purchasing costs}}{\text{1994 purchases}} = \frac{\$400}{\$10{,}000}$$

$$= 4.0\%$$

(iii) U computes its storage and handling costs absorption ratio for 1994, as follows:

$$\frac{\text{1994 storage and handling costs}}{\text{Beginning inventory plus 1994 purchases}} = \frac{\$350 + \$250}{\$0 + \$10{,}000}$$

$$= \frac{\$600}{\$10{,}000}$$

$$= 6.0\%$$

(iv) U's combined absorption ratio is 10%, or the sum of the purchasing costs absorption ratio (4.0%) and the storage and handling costs absorption ratio (6.0%). At the end of 1994, U's ending inventory included $3,000 of current year purchases, contained in three LIFO pools (X, Y, and Z) as shown below. Under the simplified resale method, U computes its ending inventory for 1994 as follows:

1994	Total	X	Y	Z
Ending section 471 costs	$3,000	$1,600	$600	$800
Additional section 263A costs (10%)	300	160	60	80
1994 ending inventory	3,300	1,760	660	880

(v) During 1995, U makes purchases of $2,000 as shown below, and incurs $200 of purchasing costs, $325 of storage costs and $175 of handling costs. U's purchasing costs, storage costs, and handling costs include their proper share of mixed service costs. Moreover, U sold goods from pools X, Y, and Z having a total cost of $1,000. U computes its ending inventory for 1995 as follows.

(vi) U computes its purchasing costs absorption ratio for 1995:

$$\frac{\text{1995 purchasing costs}}{\text{1995 purchases}} = \frac{\$200}{\$2,000}$$
$$= 10.0\%$$

(vii) U computes its storage and handling costs absorption ratio for 1995:

$$\frac{\text{1995 storage and handling costs}}{\text{Beginning inventory plus 1995 purchases}} = \frac{\$325 + \$175}{\$3,000 + \$2,000}$$
$$= \frac{\$500}{\$5,000}$$
$$= 10.0\%$$

(viii) U's combined absorption ratio is 20.0%, or the sum of the purchasing costs absorption ratio (10.0%) and the storage and handling costs absorption ratio (10.0%).

1995	Total	X	Y	Z
Beginning section 471 costs	$3,000	$1,600	$600	$800
1995 section 471 costs	2,000	1,500	300	200
Section 471 cost of goods sold	(1,000)	(300)	(300)	(400)
1995 ending section 471 costs	4,000	2,800	600	600
Consisting of:				
1994 layer	2,800	1,600	600	600
1995 layer	1,200	1,200	....	....
	4,000	2,800	600	600
Additional section 263A costs:				
1994 (10%)	280	160	60	60
1995 (20%)	240	240	....	....
	520	400	60	60
1995 ending inventory	4,520	3,200	660	660

(ix) In 1995, U experiences a $200 decrement in Pool Z. Thus, U must charge the additional section 263A costs incurred in prior years applicable to the decrement to 1995's cost of goods sold. To do so, U determines a ratio by dividing the decrement by the section 471 costs in the 1994 layer ($200 divided by $800, or 25%). U then multiplies this ratio (25%) by the additional section 263A costs in the 1994 layer ($80) to determine the additional section 263A costs applicable to the decrement ($20). Therefore, $20 is taken into account by U in 1995 as part of its cost of goods sold ($80 multiplied by 25%).

(4) *Simplified resale method with historic absorption ratio election*—(i) *In general.* This paragraph (d)(4) permits resellers using the simplified resale method to elect a historic absorption ratio in determining additional section 263A costs allocable to eligible property remaining on hand at the close of their taxable years. Except as provided in paragraph (d)(4)(v) of this section, a taxpayer may only make a historic absorption ratio election if it has used the simplified resale method for three or more consecutive taxable years immediately prior to the year of election. The historic absorption ratio is used in lieu of an actual combined absorption ratio computed under paragraph (d)(3)(i)(C)(*1*) of this section and is based on costs capitalized by a taxpayer during its test period. If elected, the historic absorption ratio must be used for the qualifying period described in paragraph (d)(4)(ii)(C) of this section.

(ii) *Operating rules and definitions*—(A) *Historic absorption ratio.* (*1*) The historic absorption ratio is equal to the following ratio:

$$\frac{\text{Additional section 263A costs incurred during the test period}}{\text{Section 471 costs incurred during the test period}}$$

(*2*) Additional section 263A costs incurred during the test period are defined as the sum of the products of the combined absorption ratios (defined in paragraph (d)(3)(i)(C)(*1*) of this section) multiplied by a taxpayer's section 471 costs incurred with respect to purchases, for each taxable year of the test period.

(*3*) Section 471 costs incurred during the test period mean the section 471 costs described in § 1.263A–1(d)(2) that a taxpayer incurs generally with respect to its purchases during the test period described in paragraph (d)(4)(ii)(B) of this section.

(B) *Test period*—(*1*) *In general.* The test period is generally the three taxable-year period immediately prior to the taxable year that the historic absorption ratio is elected.

(*2*) *Updated test period.* The test period begins again with the beginning of the first taxable year after the close of a qualifying period (as defined in paragraph (d)(4)(ii)(C) of this section). This new test period, the updated test period, is the three taxable-year period beginning with the first taxable year after the close of the qualifying period.

(C) *Qualifying period*—(*1*) *In general.* A qualifying period includes each of the first five taxable years beginning with the first taxable year after a test period (or updated test period).

(*2*) *Extension of qualifying period.* In the first taxable year following the close of each qualifying period (e.g., the sixth taxable year following the test period), the taxpayer must compute the actual combined absorption ratio under the simplified resale method. If the actual combined absorption ratio computed for this taxable year (the recomputation year) is within one-half of one percentage point (plus or minus) of the historic absorption ratio used in determining capitalizable costs for the qualifying period (i.e., the previous five taxable years), the qualifying period must be extended to include the recomputation year and the following five taxable years, and the taxpayer must continue to use the historic absorption ratio throughout the extended qualifying period. If, however, the actual combined absorption ratio computed for the recomputation year is not within one-half of one percentage point (plus or minus) of the historic absorption ratio, the taxpayer must use actual combined absorption ratios beginning with the recomputation year under the simplified resale method and throughout the updated test period. The taxpayer must resume using the historic absorption ratio (determined with reference to the updated test period) in the third taxable year following the recomputation year.

(iii) *Method of accounting*—(A) *Adoption and use.* The election to use the historic absorption ratio is a method of accounting. A taxpayer using the simplified resale method may elect the historic absorption ratio in any taxable year if permitted under this paragraph (d)(4), provided the taxpayer has not obtained the Commissioner's consent to revoke the historic absorption ratio election within its prior six taxable years. The election is to be effected on a cut-off basis, and thus, no adjustment under section 481(a) is required or permitted. The use of a historic absorption ratio has no effect on other methods of accounting adopted by the taxpayer and used in conjunction with the simplified resale method in determining its section 263A costs. Accordingly, in computing its actual combined absorption ratios, the taxpayer must use the same methods of accounting used in computing its historic absorption ratio during its most recent test period unless the taxpayer obtains the consent of the Commissioner. Finally, for purposes of this paragraph (d)(4)(iii)(A), the recomputation of the historic absorption ratio during an updated test period and the change from a historic absorption ratio to an actual combined absorption ratio during an updated test period by reason of the requirements of this paragraph (d)(4) are not considered changes in methods of accounting under section 446(e) and, thus, do not require the consent of the Commissioner or any adjustments under section 481(a).

(B) *Revocation of election.* A taxpayer may only revoke its election to use the historic absorption ratio with the consent of the Commissioner in a manner prescribed under section 446(e) and the regulations thereunder. Consent to the change for any taxable year that is included in the qualifying period (or an extended qualifying period) will be granted only upon a showing of unusual circumstances.

(iv) *Reporting and recordkeeping requirements*—(A) *Reporting.* A taxpayer making an election under this paragraph (d)(4) must attach a statement to its federal income tax return for the taxable year in which the election is made showing the actual combined absorption ratios determined under the simplified resale method during its first test period. This statement must disclose the historic absorption ratio to be used by the taxpayer during its qualifying period. A similar statement must be attached to the federal income tax return for the first taxable year within any subsequent qualifying period (i.e., after an updated test period).

(B) *Recordkeeping.* A taxpayer must maintain all appropriate records and details supporting the historic absorption ratio until the expiration of the statute of limitations for the last year for which the taxpayer applied the particular historic absorption ratio in determining additional section 263A costs capitalized to eligible property.

(v) *Transition rules.* Taxpayers will be permitted to elect a historic absorption ratio in their first, second, or third taxable year beginning after December 31, 1993, under such terms and conditions as may be prescribed by the Commissioner. Taxpayers are eligible to make an election under these transition rules whether or not they previously used the simplified resale method. A taxpayer making such an election must recompute (or compute) its additional section 263A costs, and thus, its historic absorption ratio for its first test period as if the rules prescribed in this section and §§1.263A–1 and 1.263A–2 had applied throughout the test period.

(vi) *Example.* The provisions of this paragraph (d)(4) are illustrated by the following example:

Example. (i) Taxpayer V uses the FIFO method of accounting for inventories and in 1994 elects to use the historic absorption ratio with the simplified resale method. After recomputing its additional section 263A costs in accordance with the transition rules of paragraph (d)(4)(v) of this section, V identifies the following costs incurred during the test period:

1991:
Add'l section 263A costs—$100
Section 471 costs—$3,000
1992:
Add'l section 263A costs—$200
Section 471 costs—$4,000
1993:
Add'l section 263A costs—$300
Section 471 costs—$5,000

(ii) Therefore, V computes a 5% historic absorption ratio determined as follows:

$$\text{Historic absorption ratio} = \frac{\$100 + 200 + 300}{\$3000 + 4{,}000 + 5{,}000} = \frac{\$600}{\$12{,}000} = 5\%$$

(iii) In 1994, V incurs $10,000 of section 471 costs of which $3,000 remain in inventory at the end of the year. Under the simplified resale method using a historic absorption ratio, V determines the additional section 263A costs allocable to its ending inventory by multiplying its historic ratio (5%) by the section 471 costs remaining in its ending inventory:

$$\text{Additional section 263A costs} = 5\% \times \$3{,}000 = \$150$$

(iv) To determine its ending inventory under section 263A, V adds the additional section 263A costs allocable to ending inventory to its section 471 costs remaining in ending inventory ($3,150=$150+$3,000). The balance of V's additional section 263A costs incurred during 1994 is taken into account in 1994 as part of V's cost of goods sold.

(v) V's qualifying period ends as of the close of its 1998 taxable year. Therefore, 1999 is a recomputation year in which V must compute its actual combined absorption ratio. V determines its actual absorption ratio for 1999 to be 5.25% and compares that ratio to its historic absorption ratio (5.0%). Therefore, V must continue to use its historic absorption ratio of 5.0% throughout an extended qualifying period, 1999 through 2004 (the recomputation year and the following five taxable years).

(vi) If, instead, V's actual combined absorption ratio for 1999 were not between 4.5% and 5.5%, V's qualifying period would end and V would be required to compute a new historic absorption ratio with reference to an updated test period of 1999, 2000, and 2001. Once V's historic absorption ratio is determined for the updated test period, it would be used for a new qualifying period beginning in 2002.

(5) *Additional simplified methods for resellers.* The Commissioner may prescribe additional elective simplified methods by revenue ruling or revenue procedure.

(e) *Cross reference.* See § 1.6001–1(a) regarding the duty of taxpayers to keep such records as are sufficient to establish the amount of gross income, deductions, etc.

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§ 1.263A–4 Rules for property produced in a farming trade or business. [Reserved]

§ 1.263A–4T Rules for property produced in a farming business (temporary).

(a) *Introduction*—(1) *In general.* The regulations under this section provide guidance with respect to the application of section 263A to property produced in a farming business as defined in paragraph (a)(3) of this section. Except as otherwise provided by the rules of this section, the general rules of §§ 1.263A–1 through 1.263A–3 and 1.263A–7 through 1.263A–15 apply to property produced in a farming business. A taxpayer that engages in the raising or growing of any agricultural or horticultural commodity, including both plants and animals, is engaged in the production of property. Section 263A generally requires the capitalization of the direct costs and an allocable portion of the indirect costs that benefit or are incurred by reason of the production of this property. Taxpayers that do not qualify for the exception described in paragraph (a)(2) of this section must capitalize these costs of producing all plants and animals unless the election described in paragraph (d) of this section is made.

(2) *Exception*—(i) *In general.* A taxpayer is not required to capitalize the preproductive period costs of producing plants with a preproductive period of 2 years or less or the costs of producing animals, if the taxpayer is not—

(A) A corporation or partnership required to use an accrual method of accounting (accrual method) under section 447 in computing its taxable income from farming; or

(B) A tax shelter required to use an accrual method under section 448(a)(3).

(ii) *Tax shelter.* A farming business is considered a tax shelter, and thus a taxpayer required to use an accrual method under section 448(a)(3), if the farming business is—

(A) A farming syndicate as defined in section 464(c); or

(B) A tax shelter, within the meaning of section 6662(d)(2)(C)(iii).

(iii) *Presumption.* Marketed arrangements in which persons carry on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance, within the meaning of section 6662(d)(2)(C)(iii), if such persons prepay a substantial portion of their farming expenses with borrowed funds.

(iv) *Costs required to be capitalized or inventoried under another provision.* The exception from capitalization provided in this paragraph (a)(2) does not apply to any cost that is required to be capitalized or inventoried under another Code or regulatory provision, such as section 263 or section 471.

(v) *Examples.* The following examples illustrate the provisions of this paragraph (a)(2):

Example 1. Farmer A grows trees that have a preproductive period in excess of 2 years, and that produce an annual crop. Farmer A is not required by section 447 or 448(a)(3) to use an accrual method. Accordingly, Farmer A qualifies for the exception described in this paragraph (a)(2). Since the trees have a preproductive period in excess of 2 years, Farmer A must capitalize the direct costs and an allocable portion of the indirect costs that benefit or are incurred by reason of the production of the trees. Since the annual crop has a preproductive period of 2 years or less, Farmer A is not required to capitalize the costs of the crops.

Example 2. Assume the same facts as *Example 1,* except that Farmer A is required by section 447 or 448(a)(3) to use an accrual method. Farmer A does not qualify for the exception described in this paragraph (a)(2). Farmer A is required to capitalize the direct costs and an allocable portion of the indirect costs that benefit or are incurred by reason of the production of the trees and crops, including all preproductive period costs.

(3) *Farming business*—(i) *In general.* A farming business means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than 6 years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals. For purposes of this section, the term harvesting does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another. Similarly, the trade or business of merely buying and reselling plants or animals grown or raised by another is not a farming business.

(A) *Plant.* A plant produced in a farming business includes, but is not limited to, a fruit, nut, or other crop bearing tree, an ornamental tree, a vine, a bush, sod, and the crop or yield of a plant that will have more than one crop or yield. Sea plants are produced in a farming business if they are tended and cultivated as opposed to merely harvested.

(B) *Animal.* An animal produced in a farming business includes, but is not limited to, any stock, poultry or other bird, and fish or other sea life raised by the taxpayer. Thus, for example, the term animal may include a cow, chicken, emu, or salmon raised by the taxpayer. Fish and other sea life are produced in a farming business if they are raised on a fish farm.

A fish farm is an area where fish or other sea life are grown or raised as opposed to merely caught or harvested.

(ii) *Incidental activities*—(A) *In general.* Farming business includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural products. For example, a taxpayer in the trade or business of growing fruits and vegetables may harvest, wash, inspect, and package the fruits and vegetables for sale. Such activities are normally incident to the raising of these crops by farmers. The taxpayer will be considered to be in the trade or business of farming with respect to the growing of fruits and vegetables and the processing activities incident to their harvest.

(B) *Activities that are not incidental*—(*1*) *In general.* Farming business does not include the processing of commodities or products beyond those activities that are normally incident to the growing, raising, or harvesting of such products.

(*2*) *Examples.* The following examples illustrate the provisions of this paragraph (a)(3)(ii):

Example 1. Individual A is in the business of growing and harvesting wheat and other grains. Individual A also processes grain that Individual A has harvested in order to produce breads, cereals, and other similar food products, which Individual A then sells to customers in the course of its business. Although Individual A is in the farming business with respect to the growing and harvesting of grain, Individual A is not in the farming business with respect to the processing of such grain to produce the food products.

Example 2. Individual B is in the business of raising poultry and other livestock. Individual B also operates a meat processing operation in which the poultry and other livestock are slaughtered, processed, and packaged or canned. The packaged or canned meat is sold to Individual B's customers. Although Individual B is in the farming business with respect to the raising of poultry and other livestock, Individual B is not in the farming business with respect to the slaughtering, processing, packaging, and canning of such animals to produce the food products.

(b) *Application of section 263A to property produced in a farming business*—(1) *In general.* Unless otherwise provided in this section, section 263A requires the capitalization of the direct costs and an allocable portion of the indirect costs that benefit or are incurred by reason of the production of any property in a farming business (including animals and plants without regard to the length of their preproductive period).

(i) *Plants.* Costs typically required to be capitalized under section 263A include the acquisition costs of the seed, seedling, or plant, and the costs of planting, cultivating, maintaining, or developing such plant during the preproductive period. These costs include, but are not limited to, management, irrigation, pruning, fertilizing (including costs that the taxpayer has elected to deduct under section 180), soil and water conservation (including costs that the taxpayer has elected to deduct under section 175), frost protection, spraying, upkeep, electricity, tax depreciation and repairs on buildings and equipment used in raising the plants, farm overhead, taxes (except state and federal income taxes), and interest required to be capitalized under section 263A(f).

(ii) *Animals.* Costs typically required to be capitalized under section 263A include the acquisition cost of the animal, and the costs of raising or caring for such animal during the preproductive period. Preproductive period costs include, but are not limited to, the costs of management, feed (such as grain, silage, concentrates, supplements, haylage, hay, pasture and other forages), maintaining pasture or pen areas (including costs that the taxpayer has elected to deduct under sections 175 or 180), breeding, artificial insemination, veterinary services and medicine, livestock hauling, bedding, fuel, electricity, hired labor, tax depreciation and repairs on buildings and equipment used in raising the animals (for example, barns, trucks, and trailers), farm overhead, taxes (except state and federal income taxes), and interest required to be capitalized under section 263A(f).

(2) *Preproductive period*—(i) *Plant*—(A) *In general.* The preproductive period of property produced in a farming business means—

(*1*) In the case of a plant that will have more than one crop or yield, the period before the first marketable crop or yield from such plant;

(*2*) In the case of the crop or yield of a plant that will have more than one crop or yield, the period before such crop or yield is disposed of; or

(*3*) In the case of any other plant, the period before such plant is disposed of.

(B) *Applicability of section 263A.* For purposes of determining whether a plant has a preproductive period in excess of 2 years, the preproductive period of plants grown in commercial quantities in the United States is based on the nationwide weighted average preproductive period for such plant.

For all other plants, the taxpayer is required, at or before the time the seed or plant is acquired or planted, to reasonably estimate the preproductive period of the plant. If the taxpayer estimates a preproductive period in excess of 2 years, the taxpayer must capitalize preproductive period costs. If the estimate is reasonable, based on the facts in existence at the time it is made, the determination of whether section 263A applies is not modified at a later time even if the actual length of the preproductive period differs from the estimate. The actual length of the preproductive period will, however, be considered in evaluating the reasonableness of the taxpayer's future estimates. Thus, the nationwide weighted average preproductive period or the estimated preproductive period are only used for purposes of determining whether the preproductive period of a plant is greater than 2 years.

(C) *Actual preproductive period.* The plant's actual preproductive period is used for purposes of determining the period during which a taxpayer must capitalize preproductive period costs with respect to a particular plant.

(*1*) *Beginning of the preproductive period.* The actual preproductive period of a plant begins when the taxpayer first incurs costs that directly benefit or are incurred by reason of the plant. Generally, this occurs when the taxpayer plants the seed or plant. In the case of a taxpayer that acquires plants that have already been planted, or plants that are tended, by the taxpayer or another, prior to permanent planting, the actual preproductive period of the plant begins upon acquisition of the plant by the taxpayer. In the case of the crop or yield of a plant that will have more than one crop or yield and that has become productive in marketable quantities, the actual preproductive period begins when the crop or yield first appears, for example, in the form of a sprout, bloom, blossom, or bud.

(*2*) *End of the preproductive period*—(*i*) *In general.* In the case of a plant that will have more than one crop or yield, the actual preproductive period ends when the plant first becomes productive in marketable quantities. In the case of any other plant (including the crop or yield of a plant that will have more than one crop or yield), the actual preproductive period ends when the plant, crop, or yield is sold or otherwise disposed of.

(*ii*) *Marketable quantities.* A plant that will have more than one crop or yield becomes productive in marketable quantities when it is (or would be considered) placed in service for purposes of section 168 (without regard to the applicable convention).

(D) *Examples.* The following examples illustrate the provisions of this paragraph (b)(2)(i):

Example 1. (i) Farmer A, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are grown in commercial quantities in the United States. Farmer A acquires the plants by purchasing them from an unrelated party, Corporation B, and plants them immediately. The nationwide weighted average preproductive period of the plant is 4 years. The particular plants grown by Farmer A do not begin to produce in marketable quantities until 4 years and 6 months after they are planted by Farmer A.

(ii) Since the plants are deemed to have a preproductive period in excess of 2 years, Farmer A is required to capitalize the preproductive period costs of the plants. See paragraphs (a)(2) and (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer A must begin to capitalize such costs when the plants are planted. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer A must continue to capitalize costs to the plants until the plants begin to produce in marketable quantities. Thus, Farmer A must capitalize the preproductive period costs of the plants for a period of 4 years and 6 months, notwithstanding the fact that the plants, in general, have a nationwide weighted average preproductive period of 4 years.

Example 2. (i) Farmer B, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are grown in commercial quantities in the United States. The nationwide weighted average preproductive period of the plant is 2 years and 5 months. Farmer B acquires the plants by purchasing them from an unrelated party, Corporation B. Farmer B enters into a contract with Corporation B under which Corporation B will retain and tend the plants for 7 months following the sale. At the end of 7 months, Farmer B takes possession of the plants and plants them in the permanent orchard. The plants become productive in marketable quantities 1 year and 11 months after they are planted by Farmer B.

(ii) Since the plants are deemed to have a preproductive period in excess of 2 years, Farmer B is required to capitalize the preproductive period costs of the plants. See paragraphs (a)(2) and (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer B must begin to capitalize such costs when the purchase occurs. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer B must continue to capitalize costs to the plants until the plants begin to produce in marketable quantities. Thus, Farmer B must capitalize the preproductive period costs of the plants for a period of 2 years and 6 months (the 7 months the plants are tended by Corporation B and the 1 year and 11 months after the plants are planted by Farmer B), notwithstanding the fact that the plants, in general, have a nationwide weighted average preproductive period of 2 years and 5 months.

Example 3. Assume the same facts as in *Example 2,* except that Farmer B acquires the plants by purchasing them from Corporation B when the plants are 7 months old and that the plants are planted by Farmer B upon acquisition.

(ii) Since the plants are deemed to have a preproductive period in excess of 2 years, Farmer B is required to capitalize the preproductive period costs of the plants. See paragraphs (a)(2) and (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer B must begin to capitalize such costs when the plants are planted. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer B must continue to capitalize costs to the plants until the plants begin to produce in marketable quantities. Thus, Farmer B must capitalize the preproductive period costs of the plants for a period of 1 year and 11 months.

Example 4. (i) Farmer C, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are grown in commercial quantities in the United States. Farmer C acquires the plants from an unrelated party and plants them immediately. The nationwide weighted average preproductive period of the plant is 2 years and 3 months. The particular plants grown by Farmer C begin to produce in marketable quantities 1 year and 10 months after they are planted by Farmer C.

(ii) Since the plants are deemed to have a nationwide weighted average preproductive period in excess of 2 years, Farmer C is required to capitalize the preproductive period costs of the plants, notwithstanding the fact that the particular plants grown by Farmer C become productive in less than 2 years. See paragraph (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer C must begin to capitalize such costs when it plants the plants. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer C properly ceases capitalization of preproductive period costs when the plants become productive in marketable quantities (i.e., after 1 year and 10 months).

Example 5. (i) Farmer D, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are not grown in commercial quantities in the United States. At the time the plants are planted Farmer D reasonably estimates that the plants will have a preproductive period of 4 years. The actual plants grown by Farmer D do not begin to produce in marketable quantities until 4 years and 6 months after they are planted by Farmer D.

(ii) Since the plants have an estimated preproductive period in excess of 2 years, Farmer D is required to capitalize the preproductive period costs of the plants. See paragraph (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer D must begin to capitalize such costs when it plants the plants. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer D must continue to capitalize costs until the plants begin to produce in marketable quantities. Thus, Farmer D must capitalize the preproductive period costs of the plants for a period of 4 years and 6 months, notwithstanding the fact that Farmer D estimated that the plants would become productive after 4 years.

Example 6. (i) Farmer E, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section grows plants that are not grown in commercial quantities in the United States. The plants do not have more than 1 crop or yield. At the time the plants are planted Farmer E reasonably estimates that the plants will have a preproductive period of 1 year and 10 months. The actual plants grown by Farmer E are not ready for harvesting and disposal until 2 years and 2 months after the seeds are planted by Farmer E.

(ii) Because Farmer E's estimate of the preproductive period (which was 2 years or less) was reasonable at the time made based on the facts, Farmer E will not be required to capitalize the preproductive period costs of the plants notwithstanding the fact that the actual preproductive period of the plants exceeded 2 years. See paragraph (b)(2)(i)(B) of this section. However, Farmer E must take the actual preproductive period of the plants into consideration when making future estimates of the preproductive period of such plants.

Example 7. Farmer F, a calendar year taxpayer that does not qualify for the exception in paragraph (a)(2) of this section, grows trees that will have more than one crop. Farmer F acquires and plants the trees in April, 1998. On October 1, 2003, the trees are placed in service within the meaning of section 168. Under paragraph (b)(2)(i)(C)(*2*)(*ii*) of this section, the trees become productive in marketable quantities on October 1, 2003. The preproductive period costs incurred by Farmer F on or before October 1, 2003, are capitalized to the trees. Preproductive period costs incurred after October 1, 2003, are capitalized to a crop when incurred during the preproductive period of the crop and expensed when incurred between the disposal of one crop and the appearance of the next crop. *See* paragraphs (b)(2)(i)(A), (b)(2)(i)(C)(*1*) and (b)(2)(i)(C)(*2*) of this section.

(ii) *Animal.* An animal's actual preproductive period is used to determine the period that the taxpayer must capitalize preproductive period expenses with respect to a particular animal.

(A) *Beginning of the preproductive period.* The preproductive period of an animal begins at the time of acquisition, breeding, or embryo implantation.

(B) *End of the preproductive period.* In the case of an animal that will be used in the trade or business of farming (e.g., a dairy cow), the preproductive period generally ends when the animal is (or would be considered) placed in service for purposes of section 168 (without regard to the applicable convention). However, in the case of an animal that will have more than one yield (e.g., a breeding cow), the preproductive period ends when the animal produces (e.g., gives birth to) its first yield. In the case of any other animal, the preproductive period ends when the animal is sold or otherwise disposed of.

(C) *Allocation of costs between animal and first yield.* In the case of an animal that will have more than one yield, the costs incurred after the beginning of the preproductive period of the first yield but before the end of the preproductive period of the animal must be allocated between the animal and the yield on a reasonable basis. Any depreciation allowance on the animal may be allocated entirely to the yield. The allocation method used by a taxpayer is a method of accounting that must be used consistently and is subject to the rules of section 446 and the regulations thereunder.

(c) *Inventory methods*—(1) *In general.* Except as otherwise provided, the costs required to be allocated to any plant or animal under this section may be determined using reasonable inventory valuation methods such as the farm-price method or the unit-livestock-price method. See §1.471–6. Under the unit-livestock-price method, unit prices must include all costs required to be capitalized under section 263A. A taxpayer using the unit-livestock-price method may elect to use the cost allocation methods in §1.263A–1(f) or 1.263A–2(b) to allocate its direct and indirect costs to the property produced in the business of farming. In such a situation, section 471 costs are the costs taken into account by the taxpayer under the unit-livestock-price method using the taxpayer's standard unit price as modified by this paragraph (c)(1). The term additional section 263A costs includes all additional costs required to be capitalized under section 263A. Tax shelters, as defined in paragraph (a)(2)(ii) of this section, that use the unit-livestock-price method for inventories must include in inventory the annual standard unit price for all animals that are acquired during the taxable year, regardless of whether the purchases are made during the last 6 months of the taxable year. Taxpayers required by section 447 or 448(a)(3) to use an accrual method that use the unit-livestock-price method must modify the annual standard price in order to reasonably reflect the particular period in the taxable year in which purchases of livestock are made, if such modification is necessary in order to avoid significant distortions in income that would otherwise occur through operation of the unit livestock method.

(2) *Available for property used in a trade or business.* The farm price method or the unit livestock method may be used by any taxpayer to allocate costs to any plant or animal under this section, regardless of whether the plant or animal is held or treated as inventory property by the taxpayer. Thus, for example, a taxpayer may use the unit livestock method to account for the costs of raising livestock that will be used in the trade or business of farming

(e.g., a breeding animal or a dairy cow) even though the property in question is not inventory property.

(3) *Exclusion of property to which section 263A does not apply.* Notwithstanding a taxpayer's use of the farm price method with respect to farm property to which the provisions of section 263A apply, that taxpayer is not required, solely by such use, to use the farm price method with respect to farm property to which the provisions of section 263A do not apply. Thus, for example, assume Farmer A raises fruit trees that have a preproductive period in excess of 2 years and to which the provisions of section 263A, therefore, apply. Assume also that Farmer A raises cattle and is not required to use an accrual method by section 447 or 448(a)(3). Because Farmer A qualifies for the exception in paragraph (a)(2) of this section, Farmer A is not required to capitalize the costs of raising the cattle. Although Farmer A may use the farm price method with respect to the fruit trees, Farmer A is not required to use the farm price method with respect to the cattle. Instead, Farmer A's accounting for the cattle is determined under other provisions of the Code and regulations.

(d) *Election not to have section 263A apply*—(1) *Introduction.* This paragraph (d) permits certain taxpayers to make an election not to have the rules of this section apply to any plant produced in a farming business conducted by the electing taxpayer. The election is a method of accounting under section 446, and once an election is made, it is revocable only with the consent of the Commissioner.

(2) *Availability of the election.* The election described in this paragraph (d) is available to any taxpayer that produces plants in a farming business, except that no election may be made by a corporation, partnership, or tax shelter required to use the accrual method under section 447 or 448(a)(3). Moreover, the election does not apply to the costs of planting, cultivation, maintenance, or development of a citrus or almond grove (or any part thereof) incurred prior to the close of the fourth taxable year beginning with the taxable year in which the trees were planted in the permanent grove (including costs incurred prior to the permanent planting). If a citrus or almond grove is planted in more than one taxable year, the portion of the grove planted in any one taxable year is treated as a separate grove for purposes of determining the year of planting.

(3) *Time and manner of making the election.* A taxpayer makes the election under this paragraph (d) by not capitalizing the preproductive period costs of producing property in a farming business and by applying the special rules in paragraph (d)(4) of this section, on its timely filed original return (including extensions) for the first taxable year in which the taxpayer is otherwise required to capitalize preproductive period costs under section 263A. Thus, in order to be treated as having made the election under this paragraph (d), it is necessary to report both income and expenses in accordance with the rules of this paragraph (d) (e.g., it is necessary to use the alternative depreciation system as provided in paragraph (d)(4)(ii) of this section). Thus, for example, a farmer who deducts preproductive period costs that are otherwise required to be capitalized under section 263A but fails to use the alternative depreciation system under section 168(g)(2) for applicable property placed in service has not made an election under this paragraph (d) and is not in compliance with the provisions of section 263A. In the case of a partnership or S corporation, the election must be made by the partner, shareholder, or member.

(4) *Special rules.* If the election under this paragraph (d) is made, the taxpayer is subject to the special rules in this paragraph (d)(4).

(i) *Section 1245 treatment.* The plant produced by the taxpayer is treated as section 1245 property and any gain resulting from any disposition of the plant is recaptured (i.e., treated as ordinary income) to the extent of the total amount of the deductions that, but for the election, would have been required to be capitalized with respect to the plant. In calculating the amount of gain that is recaptured under this paragraph (d)(4)(i), a taxpayer may use the farm price method or another simplified method permitted under these regulations in determining the deductions that otherwise would have been capitalized with respect to the plant.

(ii) *Required use of alternative depreciation system.* If the taxpayer or a related person makes an election under this paragraph (d), the alternative depreciation system (as defined in section 168(g)(2)) must be applied to all property used predominantly in any farming business of the taxpayer or related person and placed in service in any taxable year during which the election is in effect. The requirement to use the alternative depreciation system by reason of an election under this paragraph (d) will not prevent a taxpayer from making an election under section 179 to deduct certain depreciable business assets.

(iii) *Related person*—(A) *In general.* For purposes of this paragraph (d)(4), related person means—

(*1*) The taxpayer and members of the taxpayer's family;

(*2*) Any corporation (including an S corporation) if 50 percent or more of the stock (in value) is owned directly or indirectly (through the application of section 318) by the taxpayer or members of the taxpayer's family;

(*3*) A corporation and any other corporation that is a member of the same controlled group (within the meaning of section 1563(a)(1)); and

(*4*) Any partnership if 50 percent or more (in value) of the interests in such partnership is owned directly or indirectly by the taxpayer or members of the taxpayer's family.

(B) *Members of family.* For purposes of this paragraph (d)(4)(iii), *members of the taxpayer's family,* and *members of family* (for purposes of applying section 318(a)(1)), means the spouse of the taxpayer (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance) and any of the taxpayer's children (including legally adopted children) who have not reached the age of 18 as of the last day of the taxable year in question.

(5) *Examples.* The following examples illustrate the provisions of this paragraph (d):

Example 1. (i) Farmer A, an individual, is engaged in the trade or business of farming. Farmer A grows apple trees that have a preproductive period greater than 2 years. In addition, Farmer A grows and harvests wheat and other grains. Farmer A elects under this paragraph (d) not to have the rules of section 263A apply to the preproductive period costs of growing the apple trees.

(ii) In accordance with paragraph (d)(4) of this section, Farmer A is required to use the alternative depreciation system described in section 168(g)(2) with respect to all property used predominantly in any farming business in which Farmer A engages (including the growing and harvesting of wheat) if such property is placed in service during a year for which the election is in effect. Thus, for example, all assets and equipment (including trees and any equipment used to grow and harvest wheat) placed in service during a year for which the election is in effect must be depreciated as provided in section 168(g)(2).

Example 2. Assume the same facts as in *Example 1,* except that Farmer A and members of Farmer A's family (as defined in paragraph (d)(4)(iii)(B) of this section) also own 51 percent (in value) of the interests in Partnership P, which is engaged in the trade or business of growing and harvesting corn. Partnership P is a related person to Farmer A under the provisions of paragraph (d)(4)(iii) of this section. Thus, the requirements to use the alternative depreciation system under section 168(g)(2) also apply to any property used predominantly in a trade or business of farming which Partnership P places in service during a year for which an election made by Farmer A is in effect.

(e) *Exception for certain costs resulting from casualty losses*—(1) *In general.* Section 263A does not require the capitalization of costs that are attributable to the replanting, cultivating, maintaining, and developing of any plants bearing an edible crop for human consumption (including, but not limited to, plants that constitute a grove, orchard, or vineyard) that were lost or damaged while owned by the taxpayer by reason of freezing temperatures, disease, drought, pests, or other casualty (replanting costs). Such replanting costs may be incurred with respect to property other than the property on which the damage or loss occurred to the extent the acreage of the property with respect to which the replanting costs are incurred is not in excess of the acreage of the property on which the damage or loss occurred. This paragraph (e) applies only to the replanting of plants of the same type as those lost or damaged. This paragraph (e) applies to plants replanted on the property on which the damage or loss occurred or property of the same or lesser acreage in the United States irrespective of differences in density between the lost or damaged and replanted plants. Plants bearing crops for human consumption are those crops normally eaten or drunk by humans. Thus, for example, costs incurred with respect to replanting plants bearing jojoba beans do not qualify for the exception provided in this paragraph (e) because that crop is not normally eaten or drunk by humans.

(2) *Ownership.* Replanting costs described in paragraph (e)(1) of this section generally must be incurred by the taxpayer that owned the property at the time the plants were lost or damaged. Paragraph (e)(1) of this section will apply, however, to costs incurred by a person other than the taxpayer that owned the plants at the time of damage or loss if—

(i) The taxpayer that owned the plants at the time the damage or loss occurred owns an equity interest of more than 50 percent in such plants at all times during the taxable year in which the replanting costs are paid or incurred; and

(ii) Such other person owns any portion of the remaining equity interest and materially participates in the replanting, cultivating, maintaining, or developing of such plants during the taxable year in which the replanting costs are paid or incurred. A person will be treated as materially participating for purposes of this provision if such person would otherwise meet the requirements with respect to material participation within the meaning of section 2032A(e)(6).

(3) *Examples.* The following examples illustrate the provisions of this paragraph (e):

Example 1. (i) Farmer T grows cherry trees that have a preproductive period in excess of 2 years and produce an annual crop. These cherries are normally eaten by humans. Farmer T grows the trees on a 100 acre parcel of land (parcel 1) and the groves of trees cover the entire acreage of parcel 1. Farmer T also owns a 150 acre parcel of land (parcel 2) that Farmer T holds for future use. Both parcels are in the United States. In 1998, the trees and the irrigation and drainage systems that service the trees are destroyed in a casualty (within the meaning of paragraph (e)(1) of this section). Farmer T installs new irrigation and drainage systems on parcel 1, purchases young trees (seedlings), and plants the seedlings on parcel 1.

(ii) The costs of the irrigation and drainage systems and the seedlings must be capitalized under section 263A. In accordance with paragraph (e)(1) of this section, the costs of planting, cultivating, developing, and maintaining the seedlings during their preproductive period are not required to be capitalized by section 263A.

Example 2. (i) Assume the same facts as in *Example 1* except that Farmer T decides to replant the seedlings on parcel 2 rather than on parcel 1. Accordingly, Farmer T installs the new irrigation and drainage systems on 100 acres of parcel 2 and plants seedlings on those 100 acres.

(ii) The costs of the irrigation and drainage systems and the seedlings must be capitalized under section 263A. Because the acreage of the related portion of parcel 2 does not exceed the acreage of the destroyed orchard on parcel 1, the costs of planting, cultivating, developing, and maintaining the seedlings during their preproductive period are not required to be capitalized by section 263A. See paragraph (e)(1) of this section.

Example 3. (i) Assume the same facts as in *Example 1* except that Farmer T replants the seedlings on parcel 2 rather than on parcel 1, and Farmer T additionally decides to expand its operations by growing 125 rather than 100 acres of trees. Accordingly, Farmer T installs new irrigation and drainage systems on 125 acres of parcel 2 and plants seedlings on those 125 acres.

(ii) The costs of the irrigation and drainage systems and the seedlings must be capitalized under section 263A. The costs of planting, cultivating, developing, and maintaining 100 acres of the trees during their preproductive period are not required to be capitalized by section 263A. The costs of planting, cultivating, maintaining, and developing the additional 25 acres are, however, subject to capitalization. See paragraph (e)(1) of this section.

(4) *Special rule for citrus and almond groves*—(i) *In general.* The exception in this paragraph (e) is available with respect to a citrus or almond grove, notwithstanding the taxpayer's election not to have section 263A apply (described in paragraph (d) of this section).

(ii) *Example.* The following example illustrates the provisions of this paragraph (e)(4):

Example. (i) Farmer A, an individual, is engaged in the trade or business of farming. Farmer A grows citrus trees that have a preproductive period of 5 years. Farmer A elects, under paragraph (d) of this section, not to have section 263A apply to the preproductive period costs. This election, however, is unavailable with respect to the preproductive period costs of a citrus grove incurred within the first 4 years after the trees were planted. See paragraph (d)(2) of this section. After the citrus grove has become productive in marketable quantities, the citrus grove is destroyed by a casualty within the meaning of paragraph (e)(1) of this section.

(ii) Farmer A must capitalize the preproductive period costs incurred before the close of the fourth taxable year beginning with the year in which the trees were permanently planted. As a result of the election not to have section 263A apply to preproductive period costs, Farmer A may deduct the preproductive period costs incurred in the fifth year. The costs of replanting, cultivating, maintaining, and developing the trees destroyed by a casualty are exempted from capitalization under this paragraph (e).

(f) *Effective date and transition rule.* In the case of property that is not inventory in the hands of the taxpayer, this section is generally effective for costs incurred on or after August 22, 1997, in taxable years ending after such date. In the case of inventory property, this section is generally effective for taxable years beginning after August 22, 1997. However, taxpayers in compliance with §1.263A–4T in effect prior to August 22, 1997 (See 26 CFR part 1 edition revised as of April 1, 1997.), and other administrative guidance, that continue to comply with §1.263A–4T in effect prior to August 22, 1997 (See 26 CFR part 1 edition revised as of April 1, 1997.), and other administrative guidance, will not be required to apply these new temporary rules until final regulations are published in the FEDERAL REGISTER.

[T.D. 8729, 62 FR 44546, Aug. 22, 1997]

§1.263A–5 Exception for qualified creative expenses incurred by certain free-lance authors, photographers, and artists. [Reserved]

§1.263A–6 Rules for foreign persons. [Reserved]

§1.263A–7 Changing a method of accounting under section 263A.

(a) *Introduction*—(1) *Purpose.* These regulations provide guidance to taxpayers changing their methods of accounting for costs subject to section 263A. The principal purpose of these regulations is to provide guidance regarding how taxpayers are to revalue property on hand at the beginning of the taxable year in which they change their method of accounting for costs subject to section 263A. Paragraph (c) of this section provides guidance regarding how items or costs included in beginning inventory in the year of change must be revalued. Paragraph (d) of this section provides guidance regarding how non-inventory property should be revalued in the year of change.

(2) *Taxpayers that adopt a method of accounting under section 263A.* Taxpayers may adopt a method of accounting for costs subject to section 263A in the first taxable year in which they engage in resale or production activities. For purposes of this section, the adoption of a method of accounting has the same meaning as provided in §1.446–1(e)(1). Taxpayers are not subject to the provisions of these regulations to the extent they adopt, as opposed to change, a method of accounting.

(3) *Taxpayers that change a method of accounting under section 263A.* Taxpayers changing their method of accounting for costs subject to section 263A are subject to the revaluation and other provisions of this section. Taxpayers subject to these regulations include, but are not limited to—

(i) Resellers of personal property whose average annual gross receipts for the immediately preceding 3-year period (or lesser period if the taxpayer was not in existence for the three preceding taxable years) exceed $10,000,000 where the taxpayer was not subject to section 263A in the prior taxable year;

(ii) Resellers of real or personal property that are using a method that fails to comply with section 263A and desire to change to a method of accounting that complies with section 263A;

(iii) Producers of real or tangible personal property that are using a method that fails to comply with section 263A and desire to change to a method of accounting that complies with section 263A; and

(iv) Resellers and producers that desire to change from one permissible method of accounting for costs subject to section 263A to another permissible method.

(4) *Effective date.* The provisions of this section are effective for taxable years beginning on or after August 5, 1997. For taxable years beginning before August 5, 1997, the rules of § 1.263A–7T contained in the 26 CFR part 1 edition revised as of April 1, 1997, as modified by other administrative guidance, will apply.

(5) *Definition of change in method of accounting.* For purposes of this section, a change in method of accounting has the same meaning as provided in § 1.446–1(e)(2)(ii). Changes in method of accounting for costs subject to section 263A include changes to methods required or permitted by section 263A and the regulations thereunder. Changes in method of accounting may be described in the preceding sentence irrespective of whether the taxpayer's previous method of accounting resulted in the capitalization of more (or fewer) costs than the costs required to be capitalized under section 263A and the regulations thereunder, and irrespective of whether the taxpayer's previous method of accounting was a permissible method under the law in effect when the method was being used. However, changes in method of accounting for costs subject to section 263A do not include changes relating to factors other than those described therein. For example, a change in method of accounting for costs subject to section 263A does not include a change from one inventory identification method to another inventory identification method, such as a change from the last-in, first-out (LIFO) method to the first-in, first-out (FIFO) method, or vice versa, or a change from one inventory valuation method to another inventory valuation method under section 471, such as a change from valuing inventory at cost to valuing the inventory at cost or market, whichever is lower, or vice versa. In addition, a change in method of accounting for costs subject to section 263A does not include a change within the LIFO inventory method, such as a change from the double extension method to the link-chain method, or a change in the method used for determining the number of pools. Further, a change from the modified resale method set forth in Notice 89–67 (1989–1 C.B. 723), see § 601.601(d)(2) of this chapter, to the simplified resale method set forth in § 1.263A–3(d) is not a change in method of accounting within the meaning of § 1.446–1(e)(2)(ii) and is therefore not subject to the provisions of this section. However, a change from the simplified resale method set forth in former § 1.263A–1T(d)(4) to the simplified resale method set forth in § 1.263A–3(d) is a change in method of accounting within the meaning of § 1.446–1(e)(2)(ii) and is subject to the provisions of this section.

(b) *Rules applicable to a change in method of accounting*—(1) *General rules.* All changes in method of accounting for costs subject to section 263A are subject to the rules and procedures provided by the Code, regulations, and administrative procedures applicable to such changes. The Internal Revenue Service has issued specific revenue procedures that govern certain accounting method changes for costs subject to section 263A. Where a specific revenue procedure is not applicable, changes in method of accounting for costs subject to section 263A are subject to the same rules and procedures that govern other accounting method changes. See Rev. Proc. 97–27 (1997–21 I.R.B. 10) and § 601.601(d)(2) of this chapter.

(2) *Special rules*—(i) *Ordering rules when multiple changes in method of accounting occur in the year of change*—(A) *In general.* A change in method of accounting for costs subject to section 263A is generally deemed to occur (including the computation of the adjustment under section 481(a)) before any other change in method of accounting is deemed to occur for that same taxable year.

(B) *Exceptions to the general ordering rule*—(*1*) *Change from the LIFO inventory method.* In the case of a taxpayer that is discontinuing its use of the LIFO inventory method in the same taxable year it is changing its method of accounting for costs subject to section 263A, the change from the LIFO method may be made before the change in method of accounting (and the computation of the corresponding adjustment under section 481 (a)) under section 263A is made.

(*2*) *Change from the specific goods LIFO inventory method.* In the case of a taxpayer that is changing from the specific goods LIFO inventory method to the dollar-value LIFO inventory method in the same taxable year it is changing its method of accounting for costs subject to section 263A, the change from the specific goods LIFO inventory method may be made before the change in method of accounting under section 263A is made.

(*3*) *Change in overall method of accounting.* In the case of a taxpayer that is changing its overall method of accounting from the cash receipts and disbursements method to an accrual method in the same taxable year it is changing its method of accounting for costs subject to section 263A, the taxpayer must change to an accrual method for capitalizable costs (see §1.263A–1(c)(2)(ii)) before the change in method of accounting (and the computation of the corresponding adjustment under section 481(a)) under section 263A is made.

(*4*) *Change in method of accounting for depreciation.* In the case of a taxpayer that is changing its method of accounting for depreciation in the same taxable year it is changing its method of accounting for costs subject to section 263A and any portion of the depreciation is subject to section 263A, the change in method of accounting for depreciation must be made before the change in method of accounting (and the computation of the corresponding adjustment under section 481(a)) under section 263A is made.

(ii) *Adjustment required by section 481(a).* In the case of any taxpayer required or permitted to change its method of accounting for any taxable year under section 263A and the regulations thereunder, the change will be treated as initiated by the taxpayer for purposes of the adjustment required by section 481(a). The adjustment required by section 481(a) is to be taken into account in computing taxable income over a period not to exceed 4 taxable years.

(iii) *Base year*—(A) *Need for a new base year.* Certain dollar-value LIFO taxpayers (whether using double extension or link-chain) must establish a new base year when they revalue their inventories under section 263A.

(*1*) *Facts and circumstances revaluation method used.* A dollar-value LIFO taxpayer that uses the facts and circumstances revaluation method is permitted, but not required, to establish a new base year.

(*2*) *3-year average method used*—(*i*) *Simplified method not used.* A dollar-value LIFO taxpayer using the 3-year average method but not the simplified production method or the simplified resale method to revalue its inventory is required to establish a new base year.

(*ii*) *Simplified method used.* A dollar-value LIFO taxpayer using the 3-year average method and either the simplified production method or the simplified resale method to revalue its inventory is permitted, but not required, to establish a new base year.

(B) *Computing a new base year.* For purposes of determining future indexes, the year of change becomes the new base year (that is, the index at the beginning of the year of change generally must be 1.00) and all costs are restated in new base year costs for purposes of extending such costs in future years. However, when a new base year is established, costs associated with old layers retain their separate identity within the base year, with such layers being restated in terms of the new base year index. For example, for purposes of determining whether a particular layer has been invaded, each layer must retain its separate identity. Thus, if a decrement in an inventory pool occurs, layers accumulated in more recent years must be viewed as invaded first, in order of priority.

(c) *Inventory*—(1) *Need for adjustments.* When a taxpayer changes its method of accounting for costs subject to section 263A, the taxpayer generally must, in computing its taxable income for the year of change, take into account the adjustments required by section 481(a). The adjustments required by section 481(a) relate to revaluations of inventory property, whether the taxpayer produces the inventory or acquires it for resale. See paragraph (d) of this section in regard to the adjustments required by section 481(a) that relate to non-inventory property.

(2) *Revaluing beginning inventory*—(i) *In general.* If a taxpayer changes its method of accounting for costs subject to section 263A, the taxpayer must revalue the items or costs included in its beginning inventory in the year of change as if the new method (that is, the method to which the taxpayer is changing) had been in effect during all prior years. In revaluing inventory costs under this procedure, all of the capitalization provisions of section 263A and the regulations thereunder apply to all inventory costs accumulated in prior years. The necessity to revalue beginning inventory as if these capitalization rules had been in effect for all prior years includes, for example, the revaluation of costs or layers incurred in taxable years preceding the transition period to the full absorption method of inventory costing as described in § 1.471–11(e), regardless of whether a taxpayer employed a cut-off method under those regulations. The difference between the inventory as originally valued using the former method (that is, the method from which the taxpayer is changing) and the inventory as revalued using the new method is equal to the amount of the adjustment required under section 481(a).

(ii) *Methods to revalue inventory.* There are three methods available to revalue inventory. The first method, the facts and circumstances revaluation method, may be used by all taxpayers. Under this method, a taxpayer determines the direct and indirect costs that must be assigned to each item of inventory based on all the facts and circumstances. This method is described in paragraph (c)(2)(iii) of this section. The second method, the weighted average method, is available only in certain situations to taxpayers using the FIFO inventory method or the specific goods LIFO inventory method. This method is described in paragraph (c)(2)(iv) of this section. The third method, the 3-year average method, is available to all taxpayers using the dollar-value LIFO inventory method of accounting. This method is described in paragraph (c)(2)(v) of this section. The weighted average method and the 3-year average method revalue inventory through processes of estimation and extrapolation, rather than based on the facts and circumstances of a particular year's data. All three methods are available regardless of whether the taxpayer elects to use a simplified method to capitalize costs under section 263A.

(iii) *Facts and circumstances revaluation method*—(A) *In general.* Under the facts and circumstances revaluation method, a taxpayer generally is required to revalue inventories by applying the capitalization rules of section 263A and the regulations thereunder to the production and resale activities of the taxpayer, with the same degree of specificity as required of inventory manufacturers under the law immediately prior to the effective date of the Tax Reform Act of 1986 (Pub. L. 99–514, 100 Stat. 2085, 1986–3 C.B. (Vol. 1)). Thus, for example, with respect to any prior year that is relevant in determining the total amount of the revalued balance as of the beginning of the year of change, the taxpayer must analyze the production and resale data for that particular year and apply the rules and principles of section 263A and the regulations thereunder to determine the appropriate revalued inventory costs. However, under the facts and circumstances revaluation method, a taxpayer may utilize reasonable estimates and procedures in valuing inventory costs if—

(*1*) The taxpayer lacks, and is not able to reconstruct from its books and records, actual financial and accounting data which is required to apply the capitalization rules of section 263A and the regulations thereunder to the relevant facts and circumstances surrounding a particular item of inventory or cost; and

(*2*) The total amounts of costs for which reasonable estimates and procedures are employed are not significant in comparison to the total restated value (including costs previously capitalized under the taxpayer's former method) of the items or costs for the period in question.

(B) *Exception.* A taxpayer that is not able to comply with the requirement of paragraph (c)(2)(iii)(A)(2) of this section because of the existence of a significant amount of costs that would require the use of estimates and procedures must revalue its inventories under the procedures provided in paragraph (c)(2) (iv) or (v) of this section.

(C) *Estimates and procedures allowed.* The estimates and procedures of this paragraph (c)(2)(iii) include—

(*1*) The use of available information from more recent years to estimate the amount and nature of inventory costs applicable to earlier years; and

(*2*) The use of available information with respect to comparable items of inventory produced or acquired during the same year in order to estimate the costs associated with other items of inventory.

(D) *Use by dollar-value LIFO taxpayers.* Generally, a dollar-value LIFO taxpayer must recompute its LIFO inventory for each taxable year that the LIFO inventory method was used.

(E) *Examples.* The provisions of this paragraph (c)(2)(iii) are illustrated by the following three examples. The principles set forth in these examples are applicable both to production and resale activities and the year of change in all three examples is 1997. The examples read as follows:

Example 1. Taxpayer X lacks information for the years 1993 and earlier, regarding the amount of costs incurred in transporting finished goods from X's factory to X's warehouse and in storing those goods at the warehouse until their sale to customers. X determines that, for 1994 and subsequent years, these transportation and storage costs constitute 4 percent of the total costs of comparable goods under X's method of accounting for such years. Under this paragraph (c)(2)(iii), X may assume that transportation and storage costs for the years 1993 and earlier constitute 4 percent of the total costs of such goods.

Example 2. Assume the same facts as in *Example 1,* except that for the year 1993 and earlier, X used a different method of accounting for inventory costs whereunder significantly fewer costs were capitalized than amounts capitalized in later years. Thus, the application of transportation and storage based on a percentage of costs for 1994 and later years would not constitute a reasonable estimate for use in earlier years. X may use the information from 1994 and later years, if appropriate adjustments are made to reflect the differences in inventory costs for the applicable years, including, for example—

(i) Increasing the percentage of costs that are intended to represent transportation and storage costs to reflect the aggregate differences in capitalized amounts under the two methods of accounting; or

(ii) Taking the absolute dollar amount of transportation and storage costs for comparable goods in inventory and applying that amount (adjusted for changes in general price levels, where appropriate) to goods associated with 1993 and prior periods.

Example 3. Taxpayer Z lacks information for certain years with respect to factory administrative costs, subject to capitalization under section 263A and the regulations thereunder, incurred in the production of inventory in factory A. Z does have sufficient information to determine factory administrative costs with respect to production of inventory in factory B, wherein inventory items were produced during the same years as factory A. Z may use the information from factory B to determine the appropriate amount of factory administrative costs to capitalize as inventory costs for comparable items produced in factory A during the same years.

(iv) *Weighted average method*—(A) *In general.* A taxpayer using the FIFO method or the specific goods LIFO method of accounting for inventories may use the weighted average method as provided in this paragraph (c)(2)(iv) to estimate the change in the amount of costs that must be allocated to inventories for prior years. The weighted average method under this paragraph (c)(2)(iv) is only available to a taxpayer that lacks sufficient data to revalue its inventory costs under the facts and circumstances revaluation method provided for in paragraph (c)(2)(iii) of this section. Moreover, a taxpayer that qualifies for the use of the weighted average method under this paragraph (c)(2)(iv) must utilize such method only with respect to items or costs for which it lacks sufficient information to revalue under the facts and circumstances revaluation method. Particular items or costs must be revalued under the facts and circumstances revaluation method if sufficient information exists to make such a revaluation. If a taxpayer lacks sufficient information to otherwise apply the weighted average method under this paragraph (c)(2)(iv) (for example, the taxpayer is unable to revalue the costs of any of its items in inventory due to a lack of information), then the taxpayer must use reasonable estimates and procedures, as described in the facts and circumstances revaluation method, to whatever extent is necessary to allow the taxpayer to apply the weighted average method.

(B) *Weighted average method for FIFO taxpayers*—(*1*) *In general.* This paragraph (c)(2)(iv)(B) sets forth the mechanics of the weighted average method as applicable to FIFO taxpayers. Under the weighted average method, an item in ending inventory for which sufficient data is not available for revaluation under section 263A and the regulations thereunder must be revalued by using the weighted average percentage increase or decrease with respect to such item for the earliest subsequent taxable year for which sufficient data is available. With respect to an item for which no subsequent data exists, such item must be revalued by using the weighted average percentage increase or decrease with respect to all reasonably comparable items in the taxpayer's inventory for the same year or the earliest subsequent taxable year for which sufficient data is available.

(*2*) *Example.* The provisions of this paragraph (c)(2)(iv)(B) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. Taxpayer A manufactures bolts and uses the FIFO method to identify inventories. Under A's former method, A did not capitalize all of the costs required to be capitalized under section 263A. A maintains inventories of bolts, two types of which it no longer produces. Bolt A was last produced in 1994. The revaluation of the costs of Bolt A under this section for bolts produced in 1994 results in a 20 percent increase of the costs of Bolt A. A portion of the inventory of Bolt A, however, is attributable to 1993. A does not have sufficient data for revaluation of the 1993 cost for Bolt A. With respect to Bolt A, A may apply the 20 percent increase determined for 1994 to the 1993 production as an acceptable estimate. Bolt B was last produced in 1992 and no data exists that would allow revaluation of the inventory cost of Bolt B. The inventories of all other bolts for which information is available are attributable to 1994 and 1995. Revaluation of the costs of these other bolts using available data results in an average increase in inventory costs of 15 percent for 1994 production. With respect to Bolt B, the overall 15 percent increase for A's inventory for 1994 may be used in revaluing the cost of Bolt B.

(C) *Weighted average method for specific goods LIFO taxpayers*—(*1*) *In general.* This paragraph (c)(2)(iv)(C) sets forth the mechanics of the weighted average method as applicable to LIFO taxpayers using the specific goods method of valuing inventories. Under the weighted average method, the inventory layers with respect to an item for which data is available are revalued under this section and the increase or decrease in amount for each layer is expressed as a percentage of change from the cost in the layer as originally valued. A weighted average of the percentage of change for all layers for each type of good is computed and applied to all earlier layers for each type of good that lack sufficient data to allow for revaluation. In the case of earlier layers for which sufficient data exists, such layers are to be revalued using actual data. In cases where sufficient data is not available to make a weighted average estimate with respect to a particular item of inventory, a weighted average increase or decrease is to be determined using all other inventory items revalued by the taxpayer in the same specific goods grouping. This percentage increase or decrease is then used to revalue the cost of the item for which data is lacking. If the taxpayer lacks sufficient data to revalue any of the inventory items contained in a specific goods grouping, then the weighted average increase or decrease of substantially similar items (as determined by principles similar to the rules applicable to dollar-value LIFO taxpayers in § 1.472–8(b)(3)) must be applied in the revaluation of the items in such grouping. If insufficient data exists with respect to all the items in a specific goods grouping and to all items that are substantially similar (or such items do not exist), then the weighted average for all revalued items in the taxpayer's inventory must be applied in revaluing items for which data is lacking.

(*2*) *Example.* The provisions of this paragraph (c)(2)(iv)(C) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. (i) Taxpayer M is a manufacturer that produces two different parts. Under M's former method, M did not capitalize all of the costs required to be capitalized under section 263A. Work-in-process inventory is recorded in terms of equivalent units of finished goods. M's records show the following at the end of 1996 under the specific goods LIFO inventory method:

LIFO Product and layer	Number	Cost	Carrying values
Product #1:			
1993	150	$5.00	$750
1994	100	6.00	600
1995	100	6.50	650
1996	50	7.00	350
			$2,350
Product #2:			
1993	200	$4.00	$800
1994	200	4.50	900
1995	100	5.00	500
1996	100	6.00	600
			2,800
Total carrying value of Products #1 and #2 under M's former method			5,150

(ii) M has sufficient data to revalue the unit costs of Product #1 using its new method for 1994, 1995 and 1996. These costs are: $7.00 in 1994, $7.75 in 1995, and $9.00 in 1996. This data for Product #1 results in a weighted average percentage change of 20.31 percent ((100×($7.00−$6.00))+(100×($7.75−$6.50))+(50×($9.00−$7.00)) divided by (100×$6.00)+(100×$6.50) + (50×$7.00)]. M has sufficient data to revalue the unit costs of Product #2 only in 1995 and 1996. These costs are: $6.00 in 1995 and $7.00 in 1996. This data for Product #2 results in a weighted average percentage change of 18.18 percent [(100×($6.00−$5.00))+(100×($7.00−$6.00)) divided by (100×$5.00)+(100×$6.00)].

(iii) M can estimate its revalued costs for Product #1 for 1993 by applying the weighted average increase computed for Product #1 (20.31 percent) to the unit costs originally carried on M's records for 1993 under M's former method. The estimated revalued unit cost of Product #1 would be $6.02 ($5.00×1.2031). M estimates its revalued costs for Product #2 for 1993 and 1994 in a similar fashion. M applies the weighted average increase determined for Product #2 (18.18 percent) to the unit costs of $4.00 and $4.50 for 1993 and 1994 respectively. The revalued unit costs of Product #2 are $4.73 for 1993 ($4.00×1.1818) and $5.32 for 1994 ($4.50×1.1818).

(iv) M's inventory would be revalued as follows:

LIFO product and layer	Number	Cost	Carrying values
Product #1:			
1993	150	$6.02	$903
1994	100	7.00	700
1995	100	7.75	775
1996	50	9.00	450
			$2,828
Product #2:			
1993	200	4.73	946
1994	200	5.32	1,064
1995	100	6.00	600
1996	100	7.00	700
			3,310
Total value of Products #1 and #2 as revalued under M's new method			6,138
Total amount of adjustment required under section 481(a) [$6,138 − $5,150]			988

(D) *Adjustments to inventory costs from prior years.* For special rules applicable when a revaluation using the weighted average method includes costs not incurred in prior years, see paragraph (c)(2)(v)(E) of this section.

(v) *3-year average method*—(A) *In general.* A taxpayer using the dollar-value LIFO method of accounting for inventories may revalue all existing LIFO layers of a trade or business based on the 3-year average method as provided in this paragraph (c)(2)(v). The 3-year average method is based on the average percentage change (the 3-year revaluation factor) in the current costs of inventory for each LIFO pool based on the three most recent taxable years for which the taxpayer has sufficient information (typically, the three most recent taxable years of such trade or business). The 3-year revaluation factor is applied to all layers for each pool in beginning inventory in the year of change. The 3-year average method is available to any dollar-value taxpayer that complies with the requirements of this paragraph (c)(2)(v) regardless of whether such taxpayer lacks sufficient data to revalue its inventory costs under the facts and circumstances revaluation method prescribed in paragraph (c)(2)(iii) of this section. The 3-year average method must be applied with respect to all inventory in a taxpayer's trade or business. A taxpayer is not permitted to apply the method for the revaluation of some, but not all, inventory costs on the basis of pools, business units, or other measures of inventory amounts that do not constitute a separate trade or business. Generally, a taxpayer revaluing its inventory using the 3-year average method must establish a new base year. See, paragraph (b)(2)(iii)(A)(*2*)(*i*) of this section. However, a dollar-value LIFO taxpayer using the 3-year average method and either the simplified production method or the simplified resale method to revalue its inventory is permitted, but not required, to establish a new base year. See, paragraph (b)(2)(iii)(A)(*2*)(*ii*) of this section. If a taxpayer lacks sufficient information to otherwise apply the 3-year average method under this paragraph (c)(2)(v) (for example, the taxpayer is unable to revalue the costs of any of its LIFO pools for three years due to a lack of information), then the taxpayer must use reasonable estimates and procedures, as described in the facts and circumstances revaluation method under paragraph (c)(2)(iii) of this section, to whatever extent is necessary to allow the taxpayer to apply the 3-year average method.

(B) *Consecutive year requirement.* Under the 3-year average method, if sufficient data is available to calculate the revaluation factor for more than three years, the taxpayer may use data from such additional years in determining the average percentage increase or decrease only if the additional years are consecutive to and prior to the year of change. The requirement under the preceding sentence to use consecutive years is applicable under this method regardless of whether any inventory costs in beginning inventory as of the year of change are viewed as incurred in, or attributable to, those consecutive years under the LIFO inventory method. Thus, the requirement to use data from consecutive years may result in using information from a year in which no LIFO increment occurred. For example, if a taxpayer is changing its method of accounting in 1997 and has sufficient data to revalue its inventory for the years 1991 through 1996, the taxpayer may calculate the revaluation factor using all six years. If, however, the taxpayer has sufficient data to revalue its inventory for the years 1990 through 1992, and 1994 through 1996, only the three years consecutive to the year of change, that is, 1994 through 1996, may be used in determining the revaluation factor. Similarly, for example, a taxpayer with LIFO increments in 1995, 1993, and 1992 may not calculate the revaluation factor based on the data from those years alone, but instead must use the data from consecutive years for which the taxpayer has information.

(C) *Example.* The provisions of this paragraph (c)(2)(v) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. (i) Taxpayer G, a calendar year taxpayer, is a reseller that is required to change its method of accounting under section 263A. G will not use either the simplified production method or the simplified resale method. G adopted the dollar-value LIFO inventory method in 1991, using a single pool and the double extension method. G's beginning LIFO inventory as of January 1, 1997, computed using its former method, for the year of change is as follows:

	Base year costs	Index	LIFO carrying value
Base layer	$14,000	1.00	$14,000
1991 layer	4,000	1.20	4,800
1992 layer	5,000	1.30	6,500
1993 layer	2,000	1.35	2,700
1994 layer	0	1.40	0
1995 layer	4,000	1.50	6,000
1996 layer	5,000	1.60	8,000
Total	34,000		42,000

(ii) G is able to recompute total inventoriable costs incurred under its new method for the three preceding taxable years as follows:

	Current cost as recorded (former method)	Current cost as adjusted (new method)	Percentage change
1994	$35,000	$45,150	.29
1995	43,500	54,375	.25
1996	54,400	70,720	.30
Total	132,900	170,245	.28

(iii) Applying the average revaluation factor of .28 to each layer, G's inventory is restated as follows:

	Restated base year costs	Index	Restated LIFO carrying value
Base layer	$17,920	1.00	$17,920
1991 layer	5,120	1.20	6,144
1992 layer	6,400	1.30	8,320
1993 layer	2,560	1.35	3,456
1994 layer	0	1.40	0
1995 layer	5,120	1.50	7,680
1996 layer	6,400	1.60	10,240
Total	43,520		53,760

(iv) The adjustment required by section 481(a) is $11,760. This amount may be computed by multiplying the average percentage of .28 by the LIFO carrying value of G's inventory valued using its former method ($42,000). Alternatively, the adjustment required by section 481(a) may be computed by the difference between—

(A) The revalued costs of the taxpayer's inventory under its new method ($53,760), and

(B) The costs of the taxpayer's inventory using its former method ($42,000).

(v) In addition, the inventory as of the first day of the year of change (January 1, 1997) becomes the new base year cost for purposes of determining the LIFO index in future years. See, paragraphs (b)(2)(iii)(A)(*2*)(*i*) and (b)(2)(iii)(B) of this section. This requires that layers in years prior to the base year be restated in terms of the new base year index. The current year cost of G's inventory, as adjusted, is $70,720. Such cost must be apportioned to each layer in proportion to the restated base year cost of that layer to total restated base year costs ($43,520), as follows:

	Restated base year costs	Restated index	Restated LIFO carrying value
Old base layer	$29,120	.615	$17,920
1991 layer	8,320	.738	6,144
1992 layer	10,400	.80	8,320
1993 layer	4,160	.831	3,456
1994 layer	0		0
1995 layer	8,320	.923	7,680
1996 layer	10,400	.985	10,240
Total	70,720		53,760

(D) *Short taxable years.* A short taxable year is treated as a full 12 months.

(E) *Adjustments to inventory costs from prior years*—(*1*) *General rule.* (*i*) The use of the revaluation factor, based on current costs, to estimate the revaluation of prior inventory layers under the 3-year average method, as described in paragraph (c)(2)(v) of this section, may result in an allocation of costs that include amounts attributable to costs not incurred during the year in which the layer arose. To the extent a taxpayer can demonstrate that costs that contributed to the determination of the revaluation factor could not have affected a prior year, the revaluation factor as applied to that year may be adjusted under the restatement adjustment procedure, as described in paragraph (c)(2)(v)(F) of this section. The determination that a cost could not have affected a prior year must be made by a taxpayer only upon showing that the type of cost incurred during the years used to calculate the revaluation factor (revaluation years) was not present during such prior year. An item of cost will not be eligible for the restatement adjustment procedure simply because the cost varies in amount from year to year or the same type of cost is described or referred to by a different name from year to year. Thus, the restatement adjustment procedure allowed under paragraph (c)(2)(v)(F) of this section is not available in a prior year with respect to a particular cost if the same type of cost was incurred both in the revaluation years and in such prior year, although the amount of such cost and the name or description thereof may vary.

(*ii*) The provisions of this paragraph (c)(2)(v)(E) are also applicable to taxpayers using the weighted average method in revaluing inventories under paragraph (c)(2)(iv) of this section. Thus, to the extent a taxpayer can demonstrate that costs that contributed to the determination of the restatement of a particular year or item could not have affected a prior year or item, the taxpayer may adjust the revaluation of that prior year or item accordingly under the weighted average method. All the requirements and definitions, however, applicable to the restatement adjustment procedure under this paragraph (c)(2)(v)(E) fully apply to a taxpayer using the weighted average method to revalue inventories.

(*2*) *Examples of costs eligible for restatement adjustment procedure.* The provisions of this paragraph (c)(2)(v)(E) are illustrated by the following four examples. The principles set forth in these examples are applicable both to production and resale activities and the year of change in the four examples is 1997. The examples read as follows:

Example 1. Taxpayer A is a reseller that introduced a defined benefit pension plan in 1994, and made the plan available to personnel whose labor costs were (directly or indirectly) properly allocable to resale activities. A determines the revaluation factor based on data available for the years 1994 through 1996, for which the pension plan was in existence. Based on these facts, the costs of the pension plan in the revaluation years are eligible for the restatement adjustment procedure for years prior to 1994.

Example 2. Assume the same facts as in *Example 1,* except that a defined contribution plan was available, during prior years, to personnel whose labor costs were properly allocable to resale activities. The defined contribution plan was terminated before the introduction of the defined benefit plan in 1994. Based on these facts, the costs of the defined benefit pension plan in the revaluation years are not eligible for the restatement adjustment procedure with respect to years for which the defined contribution plan existed.

Example 3. Taxpayer C is a manufacturer that established a security department in

1995 to patrol and safeguard its production and warehouse areas used in C's trade or business. Prior to 1995, C had not been required to utilize security personnel in its trade or business; C established the security department in 1995 in response to increasing vandalism and theft at its plant locations. Based on these facts, the costs of the security department are eligible for the restatement adjustment procedure for years prior to 1995.

Example 4. Taxpayer D is a reseller that established a payroll department in 1995 to process the company's weekly payroll. In the years 1991 through 1994, D engaged the services of an outside vendor to process the company's payroll. Prior to 1991, D's payroll processing was done by D's accounting department, which was responsible for payroll processing as well as for other accounting functions. Based on these facts, the costs of the payroll department are not eligible for the restatement adjustment procedure. D was incurring the same type of costs in earlier years as D was incurring in the payroll department in 1995 and subsequent years, although these costs were designated by a different name or description.

(F) *Restatement adjustment procedure*—(*1*) *In general.* (*i*) This paragraph (c)(2)(v)(F) provides a restatement adjustment procedure whereunder a taxpayer may adjust the restatement of inventory costs in prior taxable years in order to produce a different restated value than the value that would otherwise occur through application of the revaluation factor to such prior taxable years.

(*ii*) Under the restatement adjustment procedure as applied to a particular prior year, a taxpayer must determine the particular items of cost that are eligible for the restatement adjustment with respect to such prior year. The taxpayer must then recompute, using reasonable estimates and procedures, the total inventoriable costs that would have been incurred for each revaluation year under the taxpayer's former method and the taxpayer's new method by making appropriate adjustments in the data for such revaluation year to reflect the particular costs eligible for adjustment.

(*iii*) The taxpayer must then compute the total percentage change with respect to each revaluation year, using the revised estimates of total inventoriable costs for such year as described in paragraph (c)(2)(v)(F)(*1*)(*ii*) of this section. The percentage change must be determined by calculating the ratio of the revised total of the inventoriable costs for such revaluation year under the taxpayer's new method to the revised total of the inventoriable costs for such revaluation year under the taxpayer's former method.

(*iv*) An average of the resulting percentage change for all revaluation years is then calculated, and the resulting average is applied to the prior year in issue.

(*2*) *Examples of restatement adjustment procedure.* The provisions of this paragraph (c)(2)(v)(F) are illustrated by the following two examples. The principles set forth in these examples are applicable both to production and resale activities and the year of change in the two examples is 1997. The examples read as follows:

Example 1. Taxpayer A is a reseller that is eligible to make a restatement adjustment by reason of the costs of a defined benefit pension plan that was introduced in 1994, during the revaluation period. The revaluation factor, before adjustment of data to reflect the pension costs, is as provided in the example in paragraph (c)(2)(v)(C) of this section. Thus, for example, with respect to the year 1994, the total inventoriable costs under A's former method is $35,000, the total inventoriable costs under A's new method is $45,150, and the percentage change is .29. Under the method of accounting used by A during 1994 (the former method), none of the pension costs were included as inventoriable costs. Thus, under the restatement adjustment procedure, the total inventoriable cost under A's former method would remain at $35,000 if the pension plan had not been in existence. Similarly, A determines that the total inventoriable costs for 1994 under A's new method, if the pension plan had not been in existence, would have been $42,000. The restatement adjustment for 1994 determined under this paragraph (c)(2)(v)(F) would then be equal to .20 ([$42,000–$35,000]/$35,000). A would make similar calculations with respect to 1995 and 1996. The average of such amounts for each of the three years in the revaluation period would then be determined as in the example in paragraph (c)(2)(v)(C) of this section. Such average would be used to revalue cost layers for years for which the pension plan was not in existence. Such revalued layers would then be viewed as restated in compliance with the requirements of this paragraph. With respect to cost layers incurred during years for which the pension plan was in existence, no adjustment of the revaluation factor would occur.

Example 2. Assume the same facts as in *Example 1,* except that a portion of the pension costs were included as inventoriable costs under the method used by A during 1994 (the former method). Under the restatement adjustment procedure, A determines that the total inventoriable costs for 1994 under the former method, if the pension plan had not been in existence, would have been $34,000. Similarly, A determines that the total inventoriable costs for 1994 under A's new method, if the pension plan had not been in existence, would have been $42,000. The restatement adjustment for 1994 determined under this paragraph (c)(2)(v)(F) would then be equal to .24 ([$42,000–$34,000]/$34,000). A would make similar calculations with respect to 1995 and 1996. The average of such amounts for each of the three years in the revaluation period would then be determined as in the example in paragraph (c)(2)(v)(C) of this section. Such average would be used to revalue cost layers for years for which the pension plan was not in existence.

(3) *Intercompany items*—(i) *Revaluing intercompany transactions.* Pursuant to any change in method of accounting for costs subject to section 263A, taxpayers are required to revalue the amount of any intercompany item resulting from the sale or exchange of inventory property in an intercompany transaction to an amount equal to the intercompany item that would have resulted, had the cost of goods sold for that inventory property been determined under the taxpayer's new method. The requirement of the preceding sentence applies with respect to both inventory produced by a taxpayer and inventory acquired by the taxpayer for resale. In addition, the requirements of this paragraph (c)(3) apply only to any intercompany item of the taxpayer as of the beginning of the year of change in method of accounting. See § 1.1502–13(b)(2)(ii). A taxpayer must revalue the amount of any intercompany item only if the inventory property sold in the intercompany transaction is held as inventory by a buying member as of the date the taxpayer changes its method of accounting under section 263A. Corresponding changes to the adjustment required under section 481(a) must be made with respect to any adjustment of the intercompany item required under this paragraph (c)(3). Moreover, the requirements of this paragraph (c)(3) apply regardless of whether the taxpayer has any items in beginning inventory as of the year of change in method of accounting. See § 1.1502–13 for the definition of intercompany transaction.

(ii) *Example.* The provisions of this paragraph (c)(3) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. (i) Assume that S, a member of a consolidated group filing its federal income tax return on a calendar year, manufactures and sells inventory property to B, a member of the same consolidated group, in 1996. The sale between S and B is an intercompany transaction as defined under § 1.1502–13(b)(1). The gain from the intercompany transaction is an intercompany item to S under § 1.1502–13(b)(2). As of the beginning of the year of change in method of accounting (January 1, 1997), the inventory property is still held by B based on the particular inventory method of accounting used by B for federal income tax purposes (for example, the LIFO or FIFO inventory method). The property was sold by S to B in 1996 for $150; the cost of goods sold with respect to the property under the method in effect at the time the inventory was produced was $100, resulting in an intercompany item of $50 to S under § 1.1502–13. As of January 1, 1997, S still has an intercompany item of $50.

(ii) S is required to revalue the amount of its intercompany item to an amount equal to what the intercompany item would have been had the cost of goods sold for that inventory property been determined under S's new method. Assume that the cost of the inventory under this method would have been $110, had the method applied to S's manufacture of the property in 1996. Thus, S is required to revalue the amount of its intercompany item to $40 (that is, $150 less $110), necessitating a negative adjustment to the intercompany item of $10. Moreover, S is required to increase its adjustment under section 481(a) by $10 in order to prevent the omission of such amount by virtue of the decrease in the intercompany item.

(iii) *Availability of revaluation methods.* In revaluing the amount of any intercompany item resulting from the sale or exchange of inventory property in an intercompany transaction to an amount equal to the intercompany item that would have resulted had the cost of goods sold for that inventory property been determined under the taxpayer's new method, a taxpayer may use the other methods and procedures otherwise properly available to that particular taxpayer in revaluing inventory under section 263A and the regulations thereunder, including, if appropriate, the various simplified methods provided in section 263A and the regulations thereunder and the various procedures described in this paragraph (c).

(4) *Anti-abuse rule*—(i) *In general.* Section 263A(i)(1) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 263A, including regulations to prevent the use of related parties, pass-thru entities, or intermediaries to avoid the application of section 263A and the regulations thereunder. One way in which the application of section 263A and the regulations thereunder would be otherwise avoided is through the use of entities described in the preceding sentence in such a manner as to effectively avoid the necessity to restate beginning inventory balances under the change in method of accounting required or permitted under section 263A and the regulations thereunder.

(ii) *Deemed avoidance of this section*—(A) *Scope.* For purposes of this paragraph (c), the avoidance of the application of section 263A and the regulations thereunder will be deemed to occur if a taxpayer using the LIFO method of accounting for inventories, transfers inventory property to a related corporation in a transaction described in section 351, and such transfer occurs:

(*1*) On or before the beginning of the transferor's taxable year beginning in 1987; and

(*2*) After September 18, 1986.

(B) *General rule.* Any transaction described in paragraph (c)(4)(ii)(A) of this section will be treated in the following manner:

(*1*) Notwithstanding any provision to the contrary (for example, section 381), the transferee corporation is required to revalue the inventories acquired from the transferor under the provisions of this paragraph (c) relating to the change in method of accounting and the adjustment required by section 481(a), as if the inventories had never been transferred and were still in the hands of the transferor; and

(*2*) Absent an election as described in paragraph (c)(4)(iii) of this section, the transferee must account for the inventories acquired from the transferor by treating such inventories as if they were contained in the transferee's LIFO layer(s).

(iii) *Election to use transferor's LIFO layers.* If a transferee described in paragraph (c)(4)(ii) of this section so elects, the transferee may account for the inventories acquired from the transferor by allocating such inventories to LIFO layers corresponding to the layers to which such properties were properly allocated by the transferor, prior to their transfer. The transferee must account for such inventories for all subsequent periods with reference to such layers to which the LIFO costs were allocated. Any such election is to be made on a statement attached to the timely filed federal income tax return of the transferee for the first taxable year for which section 263A and the regulations thereunder applies to the transferee.

(iv) *Tax avoidance intent not required.* The provisions of paragraph (c)(4)(ii) of this section will apply to any transaction described therein, without regard to whether such transaction was consummated with an intention to avoid federal income taxes.

(v) *Related corporation.* For purposes of this paragraph (c)(4), a taxpayer is related to a corporation if—

(A) the relationship between such persons is described in section 267(b)(1), or

(B) such persons are engaged in trades or businesses under common control (within the meaning of paragraphs (a) and (b) of section 52).

(d) *Non-inventory property*—(1) *Need for adjustments.* A taxpayer that changes its method of accounting for costs subject to section 263A with respect to non-inventory property must revalue the non-inventory property on hand at the beginning of the year of change as set forth in paragraph (d)(2) of this section, and compute an adjustment under section 481(a). The adjustment under section 481(a) will equal the difference between the adjusted basis of the property as revalued using the taxpayer's new method and the adjusted basis of the property as originally valued using the taxpayer's former method.

(2) *Revaluing property.* A taxpayer must revalue its non-inventory property as of the beginning of the year of change in method of accounting. The facts and circumstances revaluation method of paragraph (c)(2)(iii) of this section must be used to revalue this property. In revaluing non-inventory property, however, the only additional section 263A costs that must be taken into account are those additional section 263A costs incurred after the later of December 31, 1986, or the date the taxpayer first becomes subject to section 263A, in taxable years ending after that date. See §1.263A–1(d)(3) for the definition of additional section 263A costs.

[T.D. 8728, 62 FR 42054, Aug. 5, 1997]

§1.263A–8 Requirement to capitalize interest.

(a) *In general*—(1) *General rule.* Capitalization of interest under the avoided cost method described in §1.263A–9 is required with respect to the production of designated property described in paragraph (b) of this section.

(2) *Treatment of interest required to be capitalized.* In general, interest that is capitalized under this section is treated as a cost of the designated property and is recovered in accordance with §1.263A–1(c)(4). Interest capitalized by reason of assets used to produce designated property (within the meaning of §1.263A–11(d)) is added to the basis of the designated property rather than the bases of the assets used to produce the designated property. Interest capitalized with respect to designated property that includes both components subject to an allowance for depreciation or depletion and components not subject to an allowance for depreciation or depletion is ratably allocated among, and is treated as a cost of, components that are subject to an allowance for depreciation or depletion.

(3) *Methods of accounting under section 263A(f).* Except as otherwise provided, methods of accounting and other computations under §§1.263A–8 through 1.263A–15 are applied on a taxpayer, as opposed to a separate and distinct trade or business, basis.

(4) *Special definitions*—(i) *Related person.* Except as otherwise provided, for purposes of §§1.263A–8 through 1.263A–15, a person is related to a taxpayer if their relationship is described in section 267(b) or 707(b).

(ii) *Placed in service.* For purposes of §§1.263A–8 through 1.263A–15, *placed in service* has the same meaning as set forth in §1.46–3(d).

(b) *Designated property*—(1) *In general.* Except as provided in paragraphs (b)(3) and (b)(4) of this section, *designated property* means any property that is produced and that is either:

(i) Real property; or

(ii) Tangible personal property (as defined in §1.263A–2(a)(2)) which meets any of the following criteria:

(A) Property with a class life of 20 years or more under section 168 (long-lived property), but only if the property is not property described in section 1221(l) in the hands of the taxpayer or a related person,

(B) Property with an estimated production period (as defined in §1.263A–12) exceeding 2 years (2-year property), or

(C) Property with an estimated production period exceeding 1 year and an estimated cost of production exceeding $1,000,000 (1-year property).

(2) *Special rules*—(i) *Application of thresholds.* The thresholds described in paragraphs (b)(l)(ii)(A), (B), and (C) of this section are applied separately for each unit of property (as defined in §1.263A–10).

(ii) *Relevant activities and costs.* For purposes of determining whether property is designated property, all activities and costs are taken into account if they are performed or incurred by, or for, the taxpayer or any related persons and they directly benefit or are incurred by reason of the production of the property.

(iii) *Production period and cost of production.* For purposes of applying the classification thresholds under paragraphs (b)(l)(ii) (B) and (C) of this section to a unit of property, the taxpayer is required, at the beginning of the production period, to reasonably estimate the production period and the total cost of production for the unit of property. The taxpayer must maintain contemporaneous written records supporting the estimates and classification. If the estimates are reasonable based on the facts in existence at the beginning of the production period, the taxpayer's classification of the property is not modified in subsequent periods, even if the actual length of the production period or the actual cost of production differs from the estimates. To be considered reasonable, estimates of the production period and the total cost of production must include anticipated expense and time for delay, rework, change orders, and technological, design or other problems. To the extent that several distinct activities related to the production of the property are expected to occur simultaneously, the period during which these distinct activities occur is not counted more than once. The bases of assets used to produce a unit of property (within the meaning of §1.263A–11(d)) and any interest that would be required to be capitalized if a unit of property were designated property are disregarded in making estimates of the total cost of production for purposes of this paragraph (b)(2)(iii).

(3) *Excluded property*. Designated property does not include:

(i) Timber and evergreen trees that are more than 6 years old when severed from the roots, or

(ii) Property produced by the taxpayer for use by the taxpayer other than in a trade or business or an activity conducted for profit.

(4) *De minimis rule*—(i) *In general.* Designated property does not include property for which—

(A) The production period does not exceed 90 days; and

(B) The total production expenditures do not exceed $1,000,000 divided by the number of days in the production period.

(ii) *Determination of total production expenditures.* For purposes of determining whether the condition of paragraph (b)(4)(i)(B) of this section is met with respect to property, the cost of land, the adjusted basis of property used to produce property, and interest that would be capitalized with respect to property if it were designated property are excluded from total production expenditures.

(c) *Definition of real property*—(1) *In general.* Real property includes land, unsevered natural products of land, buildings, and inherently permanent structures. Any interest in real property of a type described in this paragraph (c), including fee ownership, co-ownership, a leasehold, an option, or a similar interest is real property under this section. Real property includes the structural components of both buildings and inherently permanent structures, such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property. Tenant improvements to a building that are inherently permanent or otherwise classified as real property within the meaning of this paragraph (c)(1) are real property under this section. However, property produced for sale that is not real property in the hands of the taxpayer or a related person, but that may be incorporated into real property by an unrelated buyer, is not treated as real property by the producing taxpayer (e.g., bricks, nails, paint, and windowpanes).

(2) *Unsevered natural products of land.* Unsevered natural products of land include growing crops and plants, mines, wells, and other natural deposits. Growing crops and plants, however, are real property only if the preproductive period of the crop or plant exceeds 2 years.

(3) *Inherently permanent structures.* Inherently permanent structures include property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as swimming pools, roads, bridges, tunnels, paved parking areas and other pavements, special foundations, wharves and docks, fences, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, railroad tracks and signals, telephone poles, power generation and transmission facilities, permanently installed telecommunications cables, broadcasting towers, oil and gas pipelines, derricks and storage equipment, grain storage bins and silos. For purposes of this section, affixation to real property may be accomplished by weight alone. Property may constitute an inherently permanent structure even though it is not classified as a building for purposes of former section

48(a)(1)(B) and § 1.48–1. Any property not othewise described in this paragraph (c)(3) that constitutes other tangible property under the principles of former section 48(a)(1)(B) and § 1.48–1(d) is treated for the purposes of this section as an inherently permanent structure.

(4) *Machinery*—(i) *Treatment.* A structure that is property in the nature of machinery or is essentially an item of machinery or equipment is not an inherently permanent structure and is not real property. In the case, however, of a building or inherently permanent structure that includes property in the nature of machinery as a structural component, the property in the nature of machinery is real property.

(ii) *Certain factors not determinative.* A structure may be an inherently permanent structure, and not property in the nature of machinery or essentially an item of machinery, even if the structure is necessary to operate or use, supports, or is otherwise associated with, machinery.

(d) *Production*—(1) *Definition of produce. Produce* is defined as provided in section 263A(g) and § 1.263A–2(a)(1)(i).

(2) *Property produced under a contract*—(i) *Customer.* A taxpayer is treated as producing any property that is produced for the taxpayer (the customer) by another party (the contractor) under a contract with the taxpayer or an intermediary. Property produced under a contract is designated property to the customer if it is real property or tangible personal property that satisfies the classification thresholds described in paragraph (b)(1)(ii) of this section. If property produced under a contract will become part of a unit of designated property produced by the customer in the customer's hands, the property produced under the contract is designated property to the customer.

(ii) *Contractor.* Property produced under a contract is designated property to the contractor if it is real property, 2-year property, or 1-year property and the property produced under the contract is not excluded by reason of paragraph (d)(2)(v) of this section.

(iii) *Definition of a contract.* For purposes of this paragraph (d)(2), *contract* has the same meaning as under § 1.263A–2(a)(1)(ii)(B)(*2*).

(iv) *Determination of whether thresholds are satisfied.* In the case of tangible personal property produced under a contract, the customer and the contractor each determine under this paragraph (d)(2), whether the property satisfies the classification thresholds described in paragraph (b)(1)(ii) of this section. Thus, tangible personal property may be designated property with respect to either, or both, the customer and the contractor. The provisions of paragraph (b)(2)(iii) of this section are modified as set forth in this paragraph (d)(2)(iv) for purposes of determining whether tangible personal property produced under a contract is 2-year property or 1-year property.

(A) *Customer.* In determining a customer's estimated cost of production, the customer takes into account costs and payments that are reasonably expected to be incurred by the customer, but does not take into account costs incurred (or to be incurred) by an unrelated contractor. In determining the customer's estimated length of the production period, the production period is treated as beginning on the earlier of the date the contract is executed or the date that the customer's accumulated production expenditures for the unit are at least 5 percent of the customer's total estimated production expenditures for the unit. The customer, however, may elect to treat the production period as beginning on the date the sum of the accumulated production expenditures of the contractor (or contractors if more than one contractor is producing components for the unit of property) and of the customer are at least 5 percent of the customer's estimated production expenditures for the unit.

(B) *Contractor.* In determining a contractor's estimated cost of production, the contractor takes into account only the costs that are reasonably expected to be incurred by the contractor, without any reduction for payments from the customer. In determining the contractor's estimated length of the production period, the production period is treated as beginning on the date the contractor's accumulated production expenditures (without any reduction for payments from the customer) are at least 5 percent of the contractor's total estimated accumulated production expenditures.

(v) *Exclusion for property subject to long-term contract rules.* Property described in paragraph (b) of this section is designated property with respect to a contractor only if—

(A) The contract is not a long-term contract (within the meaning of section 460(f)); or

(B) The contract is a home construction contract (within the meaning of section 460(e)(6)(A)) with respect to which the requirements of section 460(e)(1)(B) (i) and (ii) are not met.

(3) *Improvements to existing property*—(i) *In general.* Any improvement to property described in §1.263(a)–1(b) constitutes the production of property. Generally, any improvement to designated property constitutes the production of designated property. An improvement is not treated as the production of designated property, however, if the de minimis exception described in paragraph (b)(4) of this section applies to the improvement. In addition, paragraph (d)(3)(iii) of this section provides an exception for certain improvements to tangible personal property. Incidental maintenance and repairs are not treated as improvements under this paragraph (d)(3). See §1.162–4.

(ii) *Real property.* The rehabilitation or preservation of a standing building, the clearing of raw land prior to sale, and the drilling of an oil well are activities constituting improvements to real property and, therefore, the production of designated property. Similarly, the demolition of a standing building generally constitutes an activity that is an improvement to real property and, therefore, the production of designated property. See the exceptions, however, in paragraphs (b)(3) and (b)(4) of this section.

(iii) *Tangible personal property.* If the taxpayer has treated a unit of tangible personal property as designated property under this section, an improvement to such property constitutes the production of designated property regardless of the remaining useful life of the improved property (or the improvement) and, except as provided in paragraph (b)(4) of this section, regardless of the estimated length of the production period or the estimated cost of the improvement. If the taxpayer has not treated a unit of tangible personal property as designated property under this section, an improvement to such property constitutes the production of designated property only if the improvement independently meets the classification thresholds described in paragraph (b)(1)(ii) of this section.

[T.D. 8584, 59 FR 67198, Dec. 29, 1994; 60 FR 16574, Mar. 31, 1995]

§1.263A–9 The avoided cost method.

(a) *In general*—(1) *Description.* The avoided cost method described in this section must be used to calculate the amount of interest required to be capitalized under section 263A(f). Generally, any interest that the taxpayer theoretically would have avoided if accumulated production expenditures (as defined in §1.263A–11) had been used to repay or reduce the taxpayer's outstanding debt must be capitalized under the avoided cost method. The application of the avoided cost method does not depend on whether the taxpayer actually would have used the amounts expended for production to repay or reduce debt. Instead, the avoided cost method is based on the assumption that debt of the taxpayer would have been repaid or reduced without regard to the taxpayer's subjective intentions or to restrictions (including legal, regulatory, contractual, or other restrictions) against repayment or use of the debt proceeds.

(2) *Overview*—(i) *In general.* For each unit of designated property (within the meaning of §1.263A–8(b)), the avoided cost method requires the capitalization of—

(A) The traced debt amount under paragraph (b) of this section, and

(B) The excess expenditure amount under paragraph (c) of this section.

(ii) *Rules that apply in determining amounts.* The traced debt and excess expenditure amounts are determined for each taxable year or shorter computation period that includes the production period (as defined in §1.263A–12) of a unit of designated property. Paragraph (d) of this section provides an election not to trace debt to specific units of designated property. Paragraph (f) of this section provides rules for selecting the computation period, for calculating averages, and for determining measurement dates within the computation period. Special rules are in paragraph (g) of this section.

(3) *Definitions of interest and incurred.* Except as provided in the case of certain expenses that are treated as a substitute for interest under paragraphs (c)(2)(iii) and (g)(2)(iv) of this section, *interest* refers to all amounts that are characterized as interest expense under any provision of the Code, including, for example, sections 482, 483, 1272, 1274, and 7872. *Incurred* refers to the amount of interest that is properly accruable during the period of time in question determined by taking into account the loan agreement and any applicable provisions of the Internal Revenue laws and regulations such as section 163, § 1.446–2, and sections 1271 through 1275.

(4) *Definition of eligible debt.* Except as provided in this paragraph (a)(4), *eligible debt* includes all outstanding debt (as evidenced by a contract, bond, debenture, note, certificate, or other evidence of indebtedness). Eligible debt does not include—

(i) Debt (or the portion thereof) bearing interest that is disallowed under a provision described in § 1.163–8T(m)(7)(ii);

(ii) Debt, such as accounts payable and other accrued items, that bears no interest, except to the extent that such debt is traced debt (as defined in paragraph (b)(2) of this section);

(iii) Debt that is borrowed directly or indirectly from a person related to the taxpayer and that bears a rate of interest that is less than the applicable Federal rate in effect under section 1274(d) on the date of issuance;

(iv) Debt (or the portion thereof) bearing personal interest within the meaning of section 163(h)(2);

(v) Debt (or the portion thereof) bearing qualified residence interest within the meaning of section 163(h)(3);

(vi) Debt incurred by an organization that is exempt from Federal income tax under section 501(a), except to the extent interest on such debt is directly attributable to an unrelated trade or business of the organization within the meaning of section 512;

(vii) Reserves, deferred tax liabilities, and similar items that are not treated as debt for Federal income tax purposes, regardless of the extent to which the taxpayer's applicable financial accounting or other regulatory reporting principles require or support treating these items as debt; and

(viii) Federal, State, and local income tax liabilities, deferred tax liabilities under section 453A, and hypothetical tax liabilities under the look-back method of section 460(b) or similar provisions.

(b) *Traced debt amount*—(1) *General rule.* Interest must be capitalized with respect to a unit of designated property in an amount (the traced debt amount) equal to the total interest incurred on the traced debt during each measurement period (as defined in paragraph (f)(2)(ii) of this section) that ends on a measurement date described in paragraph (f)(2)(iii) of this section. See the example in paragraph (b)(3) of this section. If any interest incurred on the traced debt is not taken into account for the taxable year that includes the measurement period because of a deferral provision, see paragraph (g)(2) of this section for the time and manner for capitalizing and recovering that amount. This paragraph (b)(1) does not apply if the taxpayer elects under paragraph (d) of this section not to trace debt.

(2) *Identification and definition of traced debt.* On each measurement date described in paragraph (f)(2)(iii) of this section, the taxpayer must identify debt that is traced debt with respect to a unit of designated property. On each such date, traced debt with respect to a unit of designated property is the outstanding eligible debt (as defined in paragraph (a)(4) of this section) that is allocated, on that date, to accumulated production expenditures with respect to the unit of designated property under the rules of § 1.163–8T. Traced debt also includes unpaid interest that has been capitalized with respect to such unit under paragraph (b)(1) of this section and that is included in accumulated production expenditures on the measurement date.

(3) *Example.* The provisions of paragraphs (b)(1) and (b)(2) of this section

are illustrated by the following example.

Example. Corporation X, a calendar year taxpayer, is engaged in the production of a single unit of designated property during 1995 (unit A). Corporation X adopts a taxable year computation period and quarterly measurement dates. Production of unit A starts on January 14, 1995, and ends on June 16, 1995. On March 31, 1995 and on June 30, 1995, Corporation X has outstanding a $1,000,000 loan that is allocated under the rules of §1.163–8T to production expenditures with respect to unit A. During the period January 1, 1995, through June 30, 1995, Corporation X incurs $50,000 of interest related to the loan. Under paragraph (b)(1) of this section, the $50,000 of interest Corporation X incurs on the loan during the period January 1, 1995, through June 30, 1995, must be capitalized with respect to unit A.

(c) *Excess expenditure amount*—(1) *General rule.* If there are accumulated production expenditures in excess of traced debt with respect to a unit of designated property on any measurement date described in paragraph (f)(2)(iii) of this section, the taxpayer must, for the computation period that includes the measurement date, capitalize with respect to this unit the excess expenditure amount calculated under this paragraph (c)(1). However, if the sum of the excess expenditure amounts for all units of designated property of a taxpayer exceeds the total interest described in paragraph (c)(2) of this section, only a prorata amount (as determined under paragraph (c)(7) of this section) of such interest must be capitalized with respect to each unit. For each unit of designated property, the excess expenditure amount for a computation period equals the product of—

(i) The average excess expenditures (as determined under paragraph (c)(5)(ii) of this section) for the unit of designated property for that period, and

(ii) The weighted average interest rate (as determined under paragraph (c)(5)(iii) of this section) for that period.

(2) *Interest required to be capitalized.* With respect to an excess expenditure amount, interest incurred during the computation period is capitalized from the following sources and in the following sequence but not in excess of the excess expenditure amount for all units of designated property:

(i) Interest incurred on nontraced debt (as defined in paragraph (c)(5)(i) of this section);

(ii) Interest incurred on borrowings described in paragraph (a)(4)(iii) of this section (relating to certain borrowings from related persons); and

(iii) In the case of a partnership, guaranteed payments for the use of capital (within the meaning of section 707(c)) that would be deductible by the partnership if section 263A(f) did not apply.

(3) *Example.* The provisions of paragraph (c)(1) and (2) of this section are illustrated by the following example.

Example. (i) P, a partnership owned equally by Corporation A and Individual B, is engaged in the construction of an office building during 1995. Average excess expenditures for the office building for 1995 are $2,000,000. When P was formed, A and B agreed that A would be entitled to an annual guaranteed payment of $70,000 in exchange for A's capital contribution. The only borrowing of P, A, and B for 1995 is a loan to P from an unrelated lender of $1,000,000 (loan #1). The loan is nontraced debt and bears interest at an annual rate of 10 percent. Thus, P's weighted average interest rate (determined under paragraph (c)(5)(iii) of this section) is 10 percent and interest incurred during 1995 is $100,000.

(ii) In accordance with paragraph (c)(1) of this section, the excess expenditure amount is $200,000 ($2,000,000 × 10%). The interest capitalized under paragraph (c)(2) of this section is $170,000 ($100,000 of interest plus $70,000 of guaranteed payments).

(4) *Treatment of interest subject to a deferral provision.* If any interest described in paragraph (c)(2) of this section is not taken into account for the taxable year that includes the computation period because of a deferral provision described in paragraph (g)(1)(ii) of this section, paragraph (c)(2) of this section is first applied without regard to the amount of the deferred interest. After applying paragraph (c)(2) without regard to the deferred interest, if the amount of interest capitalized with respect to all units of designated property for the computation period is less than the amount that would have been capitalized if a deferral provision did not apply, see paragraph (g)(2) of this section for the time and manner for capitalizing and

recovering the difference (the shortfall amount).

(5) *Definitions*—(i) *Nontraced debt*—(A) *Defined. Nontraced debt* means all eligible debt on a measurement date other than any debt that is treated as traced debt with respect to any unit of designated property on that measurement date. For example, nontraced debt includes eligible debt that is allocated to expenditures that are not capitalized under section 263A(a) (*e.g.*, expenditures deductible under section 174(a) or 263(c)). Similarly, even if eligible debt is allocated to a production expenditure for a unit of designated property, the debt is included in nontraced debt on measurement dates before the first or after the last measurement date for that unit of designated property. Thus, nontraced debt may include debt that was previously treated as traced debt or that will be treated as traced debt on a future measurement date.

(B) *Example.* The provisions of paragraph (c)(5)(i)(A) of this section are illustrated by the following example.

Example. In 1995, Corporation X begins, but does not complete, the construction of two office buildings that are separate units of designated property as defined in § 1.263A–10 (Property D and Property E). At the beginning of 1995, X borrows $2,500,000 (the $2,500,000 loan), which will be used exclusively to finance production expenditures for Property D. Although interest is paid currently, the entire principal amount of the loan remains outstanding at the end of 1995. Corporation X also has outstanding during all of 1995 a long-term loan with a principal amount of $2,000,000 (the $2,000,000 loan). The proceeds of the $2,000,000 loan were used exclusively to finance the production of Property C, a unit of designated property that was completed in 1994. Under the rules of paragraph (b)(2) of this section, the portion of the $2,500,000 loan allocated to accumulated production expenditures for property D at each measurement date during 1995 is treated as traced debt for that measurement date. The excess, if any, of $2,500,000 over the amount treated as traced debt at each measurement date during 1995 is treated as nontraced debt for that measurement date, even though it is expected that the entire $2,500,000 will be treated as traced debt with respect to Property D on subsequent measurement dates as more of the proceeds of the loan are used to finance additional production expenditures. In addition, the entire principal amount of the $2,000,000 loan is treated as nontraced debt for 1995, even though it was treated as traced debt with respect to Property C in a previous period.

(ii) *Average excess expenditures*—(A) *General rule.* The average excess expenditures for a unit of designated property for a computation period are computed by—

(*1*) Determining the amount (if any) by which accumulated production expenditures exceed traced debt at each measurement date during the computation period; and

(*2*) Dividing the sum of these amounts by the number of measurement dates during the computation period.

(B) *Example.* The provisions of paragraph (c)(5)(ii)(A) of this section are illustrated by the following example.

Example. Corporation X, a calendar year taxpayer, is engaged in the production of a single unit of designated property during 1995 (unit A). Corporation X adopts the taxable year as the computation period and quarterly measurement dates. The production period for unit A begins on January 14, 1995, and ends on June 16, 1995. On March 31, 1995, and on June 30, 1995, Corporation X has outstanding $1,000,000 of traced debt with respect to unit A. Accumulated production expenditures for unit A on March 31, 1995, are $1,400,000 and on June 30, 1995, are $1,600,000. Accumulated production expenditures in excess of traced debt for unit A on March 31, 1995, are $400,000 and on June 30, 1995, are $600,000. Average excess expenditures for unit A during 1995 are therefore $250,000 ([$400,000 + $600,000 + $0 +$0] ÷ 4).

(iii) *Weighted average interest rate*—(A) *Determination of rate.* The weighted average interest rate for a computation period is determined by dividing interest incurred on nontraced debt during the period by average nontraced debt for the period.

(B) *Interest incurred on nontraced debt.* Interest incurred on nontraced debt during the computation period is equal to the total amount of interest incurred during the computation period on all eligible debt minus the amount of interest incurred during the computation period on traced debt. Thus, all interest incurred on nontraced debt during the computation period is included in the numerator of the weighted average interest rate, even if the underlying nontraced debt is repaid before the end of a measurement period and excluded from nontraced debt outstanding for measurement dates after repayment, in determining the denominator of the weighted average interest rate. However, see paragraph (g)(7) of this section for an election to treat eligible debt that is repaid within the 15-day period immediately preceding a quarterly measurement date as outstanding on that measurement date. See paragraph (a)(3) of this section for the definitions of interest and incurred.

(C) *Average nontraced debt.* The average nontraced debt for a computation period is computed by—

(*1*) Determining the amount of nontraced debt outstanding on each measurement date during the computation period; and

(*2*) Dividing the sum of these amounts by the number of measurement dates during the computation period.

(D) *Special rules if taxpayer has no nontraced debt or rate is contingent.* If the taxpayer does not have nontraced debt outstanding during the computation period, the weighted average interest rate for purposes of applying paragraphs (c)(1) and (c)(2) of this section is the highest applicable Federal rate in effect under section 1274(d) during the computation period. If interest is incurred at a rate that is contingent at the time the return for the year that includes the computation period is filed, the amount of interest is determined using the higher of the fixed rate of interest (if any) on the underlying debt or the applicable Federal rate in effect under section 1274(d) on the date of issuance.

(6) *Examples.* The following examples illustrate the principles of this paragraph (c):

Example 1. (i) W, a calendar year taxpayer, is engaged in the production of a unit of designated property during 1995. For purposes of applying the avoided cost method of this section, W uses the taxable year as the computation period. During 1995, W's only debt is a $1,000,000 loan bearing interest at a rate of 7 percent from Y, a person that is related to W. Assuming the applicable Federal rate in effect under section 1274(d) on the date of issuance of the loan is 10 percent, the loan is not eligible debt under paragraph (a)(4) of this section. However, even though W has no eligible debt, W incurs $70,000 ($1,000,000×7%) of interest during the computation period. This interest is described in paragraph (c)(2) of this section and must be capitalized under paragraph (c)(1) of this section to the extent it does not exceed W's excess expenditure amount for the unit of property.

(ii) W determines, under paragraph (c)(5)(ii) of this section, that average excess expenditures for the unit of property are $600,000. Assuming the highest applicable Federal rate in effect under section 1274(d) during the computation period is 10 percent, W uses 10 percent as the weighted average interest rate for purposes of determining the excess expenditure amount. See paragraph (c)(5)(iii)(D) of this section. In accordance with paragraph (c)(1) of this section, the excess expenditure amount is therefore $60,000. Because this amount does not exceed the total amount of interest described in paragraph (c)(2) of this section ($70,000), W is required to capitalize $60,000 of interest with respect to the unit of designated property for the 1995 computation period.

Example 2. (i) Corporation X, a calendar year taxpayer, is engaged in the production of a single unit of designated property during 1955 (unit A). Corporation X adopts the taxable year as the computation period and quarterly measurement dates. Production of unit A begins in 1994 and ends on June 30, 1995. On March 31, 1995, and on June 30, 1995, Corporation X has outstanding $1,000,000 of eligible debt (loan #1) that is allocated under the rules of §1.163–8T to production expenditures for unit A. During each of the first two quarters of 1995, $30,000 of interest is incurred on loan #1. The loan is repaid on July 1, 1995. Throughout 1995, Corporation X also has outstanding $2,000,000 of eligible debt (loan #2) which is not allocated under the rules of §1.163–8T to the production of unit A. During 1995, $200,000 of interest is incurred on this nontraced debt. Accumulated production expenditures on March 31, 1995, are $1,400,000 and on June 30, 1995, are $1,600,000. Accumulated production expenditures in excess of traced debt on March 31, 1995, are $400,000 and on June 30, 1995, are $600,000.

(ii) Under paragraph (b)(1) of this section, the amount of interest capitalized with respect to traced debt is $60,000 ($30,000 for the measurement period ending March 31, 1995, and $30,000 for the measurement period ending June 30, 1995). Under paragraph (c)(5)(ii) of this section, average excess expenditures for unit A are $250,000 ([($1,400,000 − $1,000,000) + ($1,600,000 − $1,000,000) + $0 + $0]÷4). Under paragraph (c)(5)(iii)(C) of this section, average nontraced debt is $2,000,000 ([$2,000,000 + $2,000,000 + $2,000,000 + $2,000,000]÷4). Under paragraph (c)(5)(iii)(B) of this section, interest incurred on nontraced debt is $200,000 ($260,000 of interest incurred on all eligible debt less $60,000 of interest incurred on traced debt). Under paragraph (c)(5)(iii)(A) of this section, the weighted average interest rate is 10 percent ($200,000÷$2,000,000). Under paragraph (c)(1) of this section, Corporation X capitalizes the excess expenditure amount of $25,000 ($250,000×10%), because it does not exceed the total amount of interest subject to capitalization under paragraph (c)(2) of this section ($200,000). Thus, the total interest capitalized with respect to unit A during 1995 is $85,000 ($60,000+$25,000).

(7) *Special rules where the excess expenditure amount exceeds incurred interest*—(i) *Allocation of total incurred interest to units.* For a computation period in which the sum of the excess expenditure amounts under paragraph (c)(1) of this section for all units of designated property exceeds the total amount of interest (including deferred interest) available for capitalization, as determined under paragraph (c)(2) of this section, the amount of interest that is allocated to a unit of designated property is equal to the product of—

(A) The total amount of interest (including deferred interest) available for capitalization, as determined under paragraph (c)(2) of this section; and

(B) A fraction, the numerator of which is the average excess expenditures for the unit of designated property and the denominator of which is the sum of the average excess expenditures for all units of designated property.

(ii) *Application of related person rules to average excess expenditure.* Certain excess expenditures must be taken into account by the persons (if any) required to capitalize interest with respect to production expenditures of the taxpayer under applicable related person rules. For each computation period, the amount of average excess expenditures that must be taken into account by such persons for each unit of the taxpayer's property is computed by—

(A) Determining, for the computation period, the amount (if any) by which the excess expenditure amount for the unit exceeds the amount of interest allocated to the unit under paragraph (c)(7)(i) of this section; and

(B) Dividing the excess by the weighted average interest rate for the period.

(iii) *Special rule for corporations.* If a corporation is related to another person for the purposes of the applicable related party rules, the District Director upon examination may require that the corporation apply this paragraph (c)(7) and other provisions of the regulations by excluding deferred interest from the total interest available for capitalization.

(d) *Election not to trace debt*—(1) *General rule.* Taxpayers may elect not to trace debt. If the election is made, the average excess expenditures and weighted average interest rate under paragraph (c)(5) of this section are determined by treating all eligible debt as nontraced debt. For this purpose, debt specified in paragraph (a)(4)(ii) of this section (e.g., accounts payable) may be included in eligible debt, provided it would be treated as traced debt but for an election under this paragraph (d). The election not to trace debt is a method of accounting that applies to the determination of capitalized interest for all designated property of the taxpayer. The making or revocation of the election is a change in method of accounting requiring the consent of the Commissioner under section 446(e) and § 1.446–1(e).

(2) *Example.* The provisions of paragraph (d)(1) of this section are illustrated by the following example.

Example. (i) Corporation X, a calendar year taxpayer, is engaged in the production of a single unit of designated property during 1995 (unit A). Corporation X adopts the taxable year as the computation period and quarterly measurement dates. At each measurement date (March 31, June 30, September 30, and December 31) Corporation X has the following outstanding indebtedness:

Noninterest-bearing accounts payable traced to unit A	$100,000
Noninterest-bearing accounts payable that are not traced to unit A	$300,000
Interest-bearing loans that are eligible debt within the meaning of paragraph (a)(4) of this section	$900,000

(ii) Corporation X elects under this paragraph (d) not to trace debt. Eligible debt at each measurement date for purposes of calculating the weighted average interest rate under paragraph (c)(5)(iii) of this section is $1,000,000 ($100,000 + $900,000).

(e) *Election to use external rate*—(1) *In general.* An eligible taxpayer may elect to use the highest applicable Federal rate (AFR) under section 1274(d) in effect during the computation period plus 3 percentage points (AFR plus 3) as a substitute for the weighted average interest rate determined under paragraph (c)(5)(iii) of this section. A taxpayer that makes this election may not trace debt. The use of the AFR plus 3 as provided under this paragraph (e)(1) constitutes a method of accounting. A taxpayer makes the election to use the AFR plus 3 method by using the AFR plus 3 as the taxpayer's weighted average interest rate, and any change to the AFR plus 3 method by a taxpayer that has never previously used the method does not require the consent of the Commissioner. Any other change to or from the use of the AFR plus 3 method under this paragraph (e)(1) (other than by reason of a taxpayer ceasing to be an eligible taxpayer) is a change in method of accounting requiring the consent of the Commissioner under section 446(e) and §1.446–1(e). All changes to or from the AFR plus 3 method are effected on a cut-off basis.

(2) *Eligible taxpayer.* A taxpayer is an eligible taxpayer for a taxable year for purposes of this paragraph (e) if the average annual gross receipts of the taxpayer for the three previous taxable years do not exceed $10,000,000 (the $10,000,000 gross receipts test) and the taxpayer has met the $10,000 gross receipts for all prior taxable years beginning after December 31, 1994. For purposes of this paragraph (e)(2), the principles of section 263A(b)(2)(B) and (C) and §1.263A–3(b) apply in determining whether a taxpayer is an eligible taxpayer for a taxable year.

(f) *Selection of computation period and measurement dates and application of averaging conventions*—(1) *Computation period*—(i) *In general.* A taxpayer may (but is not required to) make the avoided cost calculation on the basis of a full taxable year. If the taxpayer uses the taxable year as the computation period, a single avoided cost calculation is made for each unit of designated property for the entire taxable year. If the taxpayer uses a computation period that is shorter than the full taxable year, an avoided cost calculation is made for each unit of designated property for each shorter computation period within the taxable year. If the taxpayer uses a shorter computation period, the computation period may not include portions of more than one taxable year and, except as provided in the case of short taxable years, each computation period within a taxable year must be the same length. In the case of a short taxable year, a taxpayer may treat a period shorter than the taxpayer's regular computation period as the first or last computation period, or as the only computation period for the year if the year is shorter than the taxpayer's regular computation period. A taxpayer must use the same computation periods for all designated property produced during a single taxable year.

(ii) *Method of accounting.* The choice of a computation period is a method of accounting. Any change in the computation period is a change in method of accounting requiring the consent of the Commissioner under section 446(e) and §1.446–1(e).

(iii) *Production period beginning or ending during the computation period.* The avoided cost method applies to the production of a unit of designated property on the basis of a full computation period, regardless of whether the production period for the unit of designated property begins or ends during the computation period.

(2) *Measurement dates*—(i) *In general.* If a taxpayer uses the taxable year as the computation period, measurement dates must occur at quarterly or more frequent regular intervals. If the taxpayer uses computation periods that are shorter than the taxable year, measurement dates must occur at least twice during each computation period and at least four times during the taxable year (or consecutive 12-month period in the case of a short taxable year). The taxpayer must use the same measurement dates for all designated property produced during a computation period. Except in the case of a computation period that differs from the taxpayer's regular computation period by reason of a short taxable year (see paragraph (f)(1)(i) of this section), measurement dates must occur at equal intervals during each computation period that falls within a single taxable year. For any computation period that differs from the taxpayer's regular computation period by reason of a short taxable year, the measurement dates used by the taxpayer during that period must be consistent with the principles and purposes of section 263A(f). A taxpayer is permitted to

modify the frequency of measurement dates from year to year.

(ii) *Measurement period.* For purposes of this section, *measurement period* means the period that begins on the first day following the preceding measurement date and that ends on the measurement date.

(iii) *Measurement dates on which accumulated production expenditures must be taken into account.* The first measurement date on which accumulated production expenditures must be taken into account with respect to a unit of designated property is the first measurement date following the beginning of the production period for the unit of designated property. The final measurement date on which accumulated production expenditures with respect to a unit of designated property must be taken into account is the first measurement date following the end of the production period for the unit of designated property. Accumulated production expenditures with respect to a unit of designated property must also be taken into account on all intervening measurement dates. See §1.263A–12 to determine when the production period begins and ends.

(iv) *More frequent measurement dates.* When in the opinion of the District Director more frequent measurement dates are necessary to determine capitalized interest consistent with the principles and purposes of section 263A(f) for a particular computation period, the District Director may require the use of more frequent measurement dates. If a significant segment of the taxpayer's production activities (the first segment) requires more frequent measurement dates than another significant segment of the taxpayer's production activities, the taxpayer may request a ruling from the Internal Revenue Service permitting, for a taxable year and all subsequent taxable years, a segregation of the two segments and, notwithstanding paragraph (f)(2)(i) of this section, the use of the more frequent measurement dates for only the first segment. The request for a ruling must be made in accordance with any applicable rules relating to submissions of ruling requests. The request must be filed on or before the due date (including extensions) of the original Federal income tax return for the first taxable year to which it will apply.

(3) *Examples.* The following examples illustrate the principles of this paragraph (f):

Example 1. Corporation X, a calendar year taxpayer, is engaged in the production of designated property during 1995. Corporation X adopts the taxable year as the computation period and quarterly measurement dates. Corporation X must identify traced debt, accumulated production expenditures, and nontraced debt at each quarterly measurement date (March 31, June 30, September 30, and December 31). Under paragraph (c)(5)(ii) of this section, Corporation X must calculate average excess expenditures for each unit of designated property by determining the amount by which accumulated production expenditures exceed traced debt for each unit at the end of each quarter and dividing the sum of these amounts by four. Under paragraph (c)(5)(iii) (C) of this section, Corporation X must calculate average nontraced debt by determining the amount of nontraced debt outstanding at the end of each quarter and dividing the sum of these amounts by four.

Example 2. Corporation X, a calendar year taxpayer, is engaged in the production of designated property during 1995. Corporation X adopts a 6-month computation period with two measurement dates within each computation period. Corporation X must identify traced debt, accumulated production expenditures, and nontraced debt at each measurement date (March 31 and June 30 for the first computation period and September 30 and December 31 for the second computation period). Under paragraph (c)(5)(ii) of this section, Corporation X must, for each computation period, calculate average excess expenditures for each unit of designated property by determining the amount by which accumulated production expenditures exceed traced debt for each unit at each measurement date during the period and dividing the sum of these amounts by two. Under paragraph (c)(5)(iii)(C) of this section, Corporation X must calculate average nontraced debt for each computation period by determining the amount of nontraced debt outstanding at each measurement date during the period and dividing the sum of these amounts by two.

Example 3. (i) Corporation X, a calendar year taxpayer, is engaged in the production of two units of designated property during 1995. Production of Unit A starts in 1994 and ends on June 20, 1995. Production of Unit B starts on April 15, 1995, but does not end until 1996. Corporation X adopts the taxable year as its computation period and does not elect under paragraph (d) of this section not to trace debt. Corporation X uses quarterly measurement dates and pays all interest on eligible debt in the quarter in which the interest is incurred. During 1995, Corporation X has two items of eligible debt. The debt and the manner in which it is used are as follows:

No.	Principal	Annual rate (percent)	Period outstanding	Use of proceeds
1	$1,000,000	9	1/01–9/01	Unit A.
2	2,000,000	11	6/01–12/31	Nontraced.

(ii) Based on the annual 9 percent rate of interest, Corporation X incurs $7,500 of interest during each month that Loan #1 is outstanding.

(iii) Accumulated production expenditures at the end of each quarter during 1995 are as follows:

Measurement date	Unit A	Unit B
March 31	$1,200,000	$0
June 30	1,800,000	500,000
Sept. 30	0	1,000,000
Dec. 31	0	1,600,000

(iv) Corporation X must first determine the amount of interest incurred on traced debt and capitalize the interest incurred on this debt (the traced debt amount). Loan #1 is allocated to Unit A on the March 31 and June 30 measurement dates. Accordingly, Loan #1 is treated as traced debt with respect to unit A for the measurement periods beginning January 1 and ending June 30. The interest incurred on Loan #1 during the period that Loan #1 is treated as traced debt must be capitalized with respect to Unit A. Thus, $45,000 ($7,500 per month for 6 months) is capitalized with respect to Unit A.

(v) Second, Corporation X must determine average excess expenditures for Unit A and Unit B. For Unit A, this amount is $250,000 ([$200,000 + $800,000 + $0 +$0] ÷ 4). For Unit B, this amount is $775,000 ([$0 + $500,000 + $1,000,000 + $1,600,000]÷4).

(vi) Third, Corporation X must determine the weighted average interest rate and apply that rate to the average excess expenditures for Units A and B. The rate is equal to the total amount of interest incurred on nontraced debt (i.e., interest incurred on all eligible debt reduced by interest incurred on traced debt) divided by the average nontraced debt. The interest incurred on nontraced debt equals $143,333 ([$1,000,000 × 9% × 8⁄12] + [$2,000,000 × 11% × 7⁄12] − $45,000). The average nontraced debt equals $1,500,000 ([$0 + $2,000,000 + $2,000,000 + $2,000,000] ÷ 4). The weighted average interest rate of 9.56 percent ($143,333 ′ $1,500,000), is then applied to average excess expenditures for Units A and B. Accordingly, Corporation X capitalizes an additional $23,900 ($250,000 × 9.56%) with respect to Unit A and $74,090 ($775,000 × 9.56%) with respect to Unit B (the excess expenditure amounts).

(g) *Special rules*—(1) *Ordering rules*—(i) *Provisions preempted by section 263A(f).* Interest must be capitalized under section 263A(f) before the application of section 163(d) (regarding the investment interest limitation), section 163(j) (regarding the limitation on interest paid to a tax-exempt related person), section 266 (regarding the election to capitalize carrying charges), section 469 (regarding the limitation on passive losses), and section 861 (regarding the allocation of interest to United States sources). Any interest that is capitalized under section 263A(f) is not taken into account as interest under those sections. However, in applying section 263A(f) with respect to the excess expenditure amount, the taxpayer must capitalize all interest that is neither investment interest under section 163(d), exempt related person interest under section 163(j), nor passive interest under section 469 before capitalizing any interest that is either investment interest, exempt related person interest, or passive interest. Any interest that is not required to be capitalized after the application of section 263A(f) is then taken into account as interest subject to sections 163(d), 163(j), 266, 469, and 861. If, after the application of section 263A(f), interest is deferred under sections 163(d), 163(j), 266, or 469, that interest is not subject to capitalization under section 263A(f) in any subsequent taxable year.

(ii) *Deferral provisions applied before this section.* Interest (including contingent interest) that is subject to a deferral provision described in this paragraph (g)(1)(ii) is subject to capitalization under section 263A(f) only in the taxable year in which it would be deducted if section 263A(f) did not apply. Deferral provisions include sections 163(e)(3), 267, 446, and 461, and all other deferral or limitation provisions that are not described in paragraph (g)(1)(i) of this section. In contrast to the provisions of paragraph (g)(1)(i) of this section, deferral provisions are applied before the application of section 263A(f).

(2) *Application of section 263A(f) to deferred interest*—(i) *In general.* This paragraph (g)(2) describes the time and manner of capitalizing and recovering the deferral amount. The deferral amount for any computation period equals the sum of—

(A) The amount of interest that is incurred on traced debt that is deferred during the computation period and is not deductible for the taxable year that includes the computation period because of a deferral provision described in paragraph (g)(1)(ii) of this section, and

(B) The shortfall amount described in paragraph (c)(4) of this section.

(ii) *Capitalization of deferral amount.* The rules described in paragraph (g)(2)(iii) of this section apply to the deferral amount unless the taxpayer elects under paragraph (g)(2)(iv) of this section to capitalize substitute costs.

(iii) *Deferred capitalization.* If the taxpayer does not elect under paragraph (g)(2)(iv) of this section to capitalize substitute costs, deferred interest to which the deferral amount is attributable (determined under any reasonable method) is capitalized in the year or years in which the deferred interest would have been deductible but for the application of section 263A(f) (the capitalization year). For this purpose, any interest that is deferred from a prior computation period is taken into account in subsequent capitalization years in the same order in which the interest was deferred. If a unit of designated property to which previously deferred interest relates is sold before the capitalization year, the deferred interest applicable to that unit of property is taken into account in the capitalization year and treated as if recovered from the sale of the property. If the taxpayer continues to hold, throughout the capitalization year, a unit of depreciable property to which previously deferred interest relates, the adjusted basis and applicable recovery percentages for the unit of property are redetermined for the capitalization year and subsequent years so that the increase in basis is accounted for over the remaining recovery periods beginning with the capitalization year. See *Example 2* of paragraph (g)(2)(v) of this section.

(iv) *Substitute capitalization*—(A) *General rule.* In lieu of deferred capitalization under paragraph (g)(2)(iii) of this section, the taxpayer may elect the substitute capitalization method described in this paragraph (g)(2)(iv). Under this method, the taxpayer capitalizes for the computation period in which interest is incurred and deferred (the deferral period) costs that would be deducted but for this paragraph (g)(2)(iv) (substitute costs). The taxpayer must capitalize an amount of substitute costs equal to the deferral amount for each unit of designated property, or if less, a prorata amount (determined in accordance with the principles of paragraph (c)(7)(i) of this section) of the total substitute costs that would be deducted but for this paragraph (g)(2)(iv) during the deferral period. If the entire deferral amount is capitalized pursuant to this paragraph (g)(2)(iv) in the deferral period, any interest incurred and deferred in the deferral period is neither capitalized nor deducted during the deferral period and, unless subsequently capitalized as a substitute cost under this paragraph (g)(2)(iv), is deductible in the appropriate subsequent period without regard to section 263A(f).

(B) *Capitalization of amount carried forward.* If the taxpayer has an insufficient amount of substitute costs in the deferral period, the amount by which substitute costs are insufficient with respect to each unit of designated property is a deferral amount carryforward to succeeding computation periods beginning with the next computation period. In any carryforward year, the taxpayer must capitalize an amount of substitute costs equal to the deferral amount carryforward or, if less, a prorata amount (determined in accordance with the principles of paragraph (c)(7)(i) of this section) of the total substitute costs that would be deducted during the carryforward year or years (the carryforward capitalization year) but for this paragraph (g)(2)(iv) (after applying the substitute cost method of this paragraph (g)(2)(iv) to the production of designated property in the carryforward period). If a unit of designated property to which the deferral amount carryforward relates is sold prior to the carryforward capitalization year, substitute costs applicable to that unit of property are taken into account in the carryforward capitalization year and treated as if recovered from the sale of the property. If the taxpayer continues to hold, throughout the capitalization year, a unit of depreciable property to which a deferral amount carryforward relates, the adjusted basis and applicable recovery percentages for the unit of property are redetermined for the carryforward capitalization year and subsequent years so that the increase in basis is accounted for over the remaining recovery periods beginning with the carryforward capitalization year. See *Example 2* of paragraph (g)(2)(v) of this section.

(C) *Method of accounting.* The substitute capitalization method under this paragraph (g)(2)(iv) is a method of accounting that applies to all designated property of the taxpayer. A change to or from the substitute capitalization method is a change in method of accounting requiring the consent of the Commissioner under section 446(e) and §1.446–1(e).

(v) *Examples.* The following examples illustrate the application of the avoided cost method when interest is subject to a deferral provision:

Example 1. (i) Corporation X is a calendar year taxpayer and uses the taxable year as it computation period. During 1995, X is engaged in the construction of a warehouse which X will use in its storage business. The warehouse is completed and placed in service in December 1995. X's average excess expenditures for 1995 equal $1,000,000. Throughout 1995, X's only outstanding debt is nontraced debt of $900,000 and $1,200,000, bearing interest at 15 percent and 9 percent, respectively, per year. Of the $243,000 interest incurred during the year ([$900,000×15%] + [$1,200,000×9%] = [$135,000+$108,000]), $75,000 is deferred under section 267(a)(2).

(ii) X must first determine the amount of interest required to be capitalized under paragraph (c)(1) of this section for 1995 (the deferral period) without applying section 267(a)(2). The weighted average interest rate is 11.6 percent ([$135,000+$108,000]÷ $2,100,000), and the excess expenditure amount under paragraph (c)(1) of this section is $116,000 ($1,000,000×11.6%). Under paragraph (c)(4) of this section, X must then determine the amount of interest that would be capitalized by applying paragraph (c)(2) of this section without regard to the amount of deferred interest. Disregarding deferred interest, the amount of interest available for capitalization is $168,000 ([$900,000×15%] + [$1,200,000×9%]− $75,000). Thus, the full excess expenditure amount ($116,000) is capitalized from interest that is not deferred under section 267(a)(2) and there is no shortfall amount.

Example 2. (i) The facts are the same as in *Example 1,* except that $140,000 of interest is deferred under section 267 (a)(2) in 1995. The taxpayer does not elect to use the substitute capitalization method. This interest is also deferred in 1996 but would be deducted in 1997 if section 263A(f) did not apply. As in *Example 1,* the excess expenditure amount is $116,000. However, the amount of interest available for capitalization after excluding the amount of deferred interest is $103,000 ([$900,000×15%] + [$1,200,000×9%]− $140,000). Thus, only $103,000 of interest is capitalized with respect to the warehouse in 1995. Since $116,000 of interest would be capitalized if section 267(a)(2) did not apply, the deferral amount determined under paragraphs (c)(2) and (g)(2)(i) of this section is $13,000 ($116,000 −$103,000), and $13,000 of deferred interest must be capitalized in the year in which it would be deducted if section 263A(f) did not apply.

(ii) The $140,000 of interest deferred under section 267(a)(2) in 1995 would be deducted in 1997 if section 263A(f) did not apply. X is therefore required to capitalize an additional $13,000 of interest with respect to the warehouse in 1997 and must redetermine its basis and recovery percentage.

(3) *Simplified inventory method*—(i) *In general.* This paragraph (g)(3) provides a simplified method of capitalizing interest expense with respect to designated property that is inventory. Under this method, the taxpayer determines beginning and ending inventory and cost of goods sold applying all other capitalization provisions, including, for example, the simplified production method of §1.263A–2(b), but without regard to the capitalization of interest with respect to inventory. The taxpayer must establish a separate capital asset, however, in an amount equal to the aggregate interest capitalization amount (as defined in paragraph (g)(3)(iii)(C) of this section). Under the simplified inventory method, increases in the aggregate interest capitalization amount from one year to

the next generally are treated as reductions in interest expense, and decreases in the aggregate interest capitalization amount from one year to the next are treated as increases to cost of goods sold.

(ii) *Segmentation of inventory*—(A) *General rule.* Under the simplified inventory method, the taxpayer first separates its total ending inventory value into segments that are equal to the total ending inventory value divided by the inverse inventory turnover rate. Each inventory segment is then assigned an age starting with one year and increasing by one year for each additional segment. The inverse inventory turnover rate is determined by finding the average of beginning and ending inventory, dividing the average by the cost of goods sold for the year, and rounding the result to the nearest whole number. Beginning and ending inventory amounts are determined using total current cost of inventory for the year (rather than carrying value). Cost of goods sold, however, may be determined using either total current cost or the taxpayer's inventory method. In addition, for purposes of this paragraph (g)(3)(ii), current costs for a year (and, if applicable, the cost of goods sold for the year under the taxpayer's inventory method) are determined without regard to the capitalization of interest with respect to inventory.

(B) *Example.* The provisions of paragraph (g)(3)(ii)(A) of this section are illustrated by the following example.

Example. X, a taxpayer using the FIFO inventory method, determines that total cost of goods sold for 1995 equals $900, and the cost of both beginning and ending inventory equals $3,000. Thus, X's inverse inventory turnover rate equals 3 (3.33 rounded to the nearest whole number). Total ending inventory of $3,000 is divided into three segments of $1,000 each. One segment is treated as 3-year-old inventory, one segment is treated as 2-year-old inventory, and one segment is treated as 1-year-old inventory.

(iii) *Aggregate interest capitalization amount*—(A) *Computation period and weighted average interest rate.* If a taxpayer elects the simplified inventory method, the taxpayer must use the taxable year as its computation period and use the weighted average interest rate determined under this paragraph (g)(3)(iii)(A) in determining the aggregate interest capitalization amount defined in paragraph (g)(3)(iii)(C) of this section and in determining the amount of interest capitalized with respect to any designated property that is not inventory. Under the simplified inventory method, the taxpayer determines the weighted average interest rate in accordance with paragraph (c)(5)(iii) of this section, treating all eligible debt (other than debt traced to noninventory property in the case of a taxpayer tracing debt) as nontraced debt (i.e., without tracing debt to inventory). A taxpayer that has elected under paragraph (e) of this section to use an external rate as a substitute for the weighted average interest rate determined under paragraph (c)(5)(iii) of this section uses the rate described in paragraph (e)(1) as the weighted average interest rate.

(B) *Computation of the tentative aggregate interest capitalization amount.* The weighted average interest rate is compounded annually by the number of years assigned to a particular inventory segment to produce an interest factor (applicable interest factor) for that segment. The amounts determined by multiplying the value of each inventory segment by its applicable interest factor are then combined to produce a tentative aggregate interest capitalization amount.

(C) *Coordination with other interest capitalization computations*—(*1*) *In general.* If the tentative aggregate interest capitalization amount for a year exceeds the aggregate interest capitalization amount (defined in paragraph (g)(3)(iii)(D) of this section) as of the close of the preceding year, then, for purposes of applying the rules of paragraph (c)(7) of this section, the excess is treated as an excess expenditure amount and the inventory to which the simplified inventory method of this paragraph (g)(3) applies is treated as a single unit of designated property. If, after these modifications, no paragraph (c)(7) interest allocation is necessary (i.e., the excess expenditure amounts for all units of designated property do not exceed the total amount of interest (including deferred interest) available for capitalization), the aggregate interest capitalization amount generally equals the tentative aggregate interest capitalization amount. If, on the other hand, a paragraph (c)(7) allocation is necessary, the tentative aggregate interest capitalization amount is generally adjusted to reflect the results of that allocation (i.e., the increase in the aggregate interest capitalization amount is limited to the amount of interest allocated to inventory, reduced, however, by any substitute costs that are capitalized with respect to inventory under applicable related party rules).

(*2*) *Deferred interest.* In determining the aggregate interest capitalization amount, the tentative aggregate interest capitalization amount is adjusted (after the application of paragraph (c)(7) of this section) as appropriate to reflect the deferred interest rules of paragraph (g)(2) of this section. The tentative aggregate interest capitalization amount would be reduced, for example, by the amount of a taxpayer's deferred interest for a taxable year unless the taxpayer has elected the substitute capitalization method under paragraph (g)(2)(iv).

(*3*) *Other coordinating provisions.* The Commissioner may prescribe, by revenue ruling or revenue procedure, additional provisions to coordinate the election and use of the simplified inventory method with other interest capitalization requirements and methods. See §601.601(d)(2)(ii)(*b*) of this chapter.

(D) *Treatment of increases or decreases in the aggregate interest capitalization amount.* Except as otherwise provided in this paragraph (g)(3)(iii)(D), increases in the aggregate interest capitalization amount from one year to the next are treated as reductions in interest expense, and decreases in the aggregate interest capitalization amount from one year to the next are treated as increases to cost of goods sold. To the extent a taxpayer capitalizes substitute costs under either applicable related party rules or the deferred interest rules in paragraph (g)(2) of this section, increases in the aggregate interest capitalization amount are treated as reductions in applicable substitute costs, rather than interest expense.

(E) *Example.* The provisions of this paragraph (g)(3)(iii) are illustrated by the following example.

Example. The facts are the same as in the example in paragraph (g)(3)(ii)(B) of this section, and, in addition, X determines that its weighted average interest rate for 1995 is 10 percent. Additionally, assume that X has no deferred interest in 1995 or 1996 and no deferral amount carryforward to either 1995 or 1996. (See paragraph (g)(2) of this section.) Also assume that no allocation is necessary under paragraph (c)(7) of this section in either 1995 or 1996. Under the rules of paragraph (g)(3)(ii) of this section, X divides ending inventory into segments of $1,000 each. One segment is 1-year old inventory, one segment is 2-year old inventory, and one segment is 3-year old inventory. Under paragraph (g)(3)(iii)(B) of this section, X must compute the applicable interest factor for each segment. The applicable interest factor for the 1-year old inventory is not compounded. The applicable interest factor for the 2-year old inventory is compounded for 1 year. The applicable interest factor for the 3-year old inventory is compounded for 2 years. The interest factor applied to the 1-year old inventory segment is .1. The interest factor applied to the 2-year old inventory segment is .21 [(1.1×1.1)−1]. The interest factor applied to the 3-year old inventory is .331 [(1.1×1.1×1.1)−1]. Thus, the tentative aggregate interest capitalization amount for 1995 is $641 (1,000 × [.1 + .21 + .331]). Because X has no deferred interest in 1995, no deferral amount carryforward to 1995, and no required allocation under paragraph (c)(7) of this section in 1995, X's aggregate interest capitalization amount equals its $641 tentative aggregate interest capitalization amount. If, in 1996, X computes an aggregate interest capitalization amount of $750, the $109 increase in the amount from 1995 to 1996 would be treated as a reduction in interest expense for 1996.

(iv) *Method of accounting.* The simplified inventory method is a method of accounting that must be elected for and applied to all inventory within a single trade or business of the taxpayer (within the meaning of section 446(d) and §1.446–1(d)). This method may be elected only if the inventory in that trade or business consists only of designated property and only if the taxpayer's inverse inventory turnover rate for that trade or business (as defined in paragraph (g)(3)(ii)(A) of this section) is greater than or equal to one. A change from or to the simplified inventory method is a change in method of accounting requiring the consent of the

Commissioner under section 446(e) and §1.446–(1)(e).

(4) *Financial accounting method disregarded.* The avoided cost method is applied under this section without regard to any financial or regulatory accounting principles for the capitalization of interest. For example, this section determines the amount of interest that must be capitalized without regard to Financial Accounting Standards Board (FASB) Statement Nos. 34, 71, and 90, issued by the Financial Accounting Standards Board, Norwalk, CT 06856–5116. Similarly, taxpayers are not permitted to net interest income and interest expense in determining the amount of interest that must be capitalized under this section with respect to certain restricted tax-exempt borrowings even though netting is permitted under FASB Statement No. 62.

(5) *Treatment of intercompany transactions*—(i) *General rule.* If interest capitalized under section 263A(f) by a member of a consolidated group (within the meaning of §1.1502–1(h)) with respect to a unit of designated property is attributable to a loan from another member of the group (the lending member), the intercompany transaction provisions of the consolidated return regulations do not apply to the lending member's interest income with respect to that loan, except as provided in paragraph (g)(5)(ii) of this section. For this purpose, the capitalized interest expense that is attributable to a loan from another member is determined under any method that reasonably reflects the principles of the avoided cost method, including the traced and nontraced concepts. For purposes of this paragraph (g)(5)(i) and paragraph (g)(5)(ii) of this section, in order for a method to be considered reasonable it must be consistently applied.

(ii) *Special rule for consolidated group with limited outside borrowing.* If, for any year, the aggregate amount of interest income described in paragraph (g)(5)(i) of this section for all members of the group with respect to all units of designated property exceeds the total amount of interest that is deductible for that year by all members of the group with respect to debt of a member owed to nonmembers (group deductible interest) after applying section 263A(f), the intercompany transaction provisions of the consolidated return regulations are applied to the excess, and the amount of interest income that must be taken into account by the group under paragraph (g)(5)(i) of this section is limited to the amount of the group deductible interest. The amount to which the intercompany transaction provisions of the consolidated return regulations apply by reason of this paragraph (g)(5)(ii) is allocated among the lending members under any method that reasonably reflects each member's share of interest income described in paragraph (g)(5)(i) of this section. If a lending member has interest income that is attributable to more than one unit of designated property, the amount to which the intercompany transaction provisions of the consolidated return regulations apply by reason of this paragraph (g)(5)(ii) with respect to the member is allocated among the units in accordance with the principles of paragraph (c)(7)(i) of this section.

(iii) *Example.* The provisions of paragraph (g)(5)(ii) of this section are illustrated by the following example.

Example. (i) P and S1 are the members of a consolidated group. In 1995, S1 begins and completes the construction of a shopping center and is required to capitalize interest with respect to the construction. S1's average excess expenditures for 1995 are $5,000,000. Throughout 1995, S1's only borrowings include a $6,000,000 loan from P bearing interest at an annual rate of 10 percent ($600,000 per year). Under the avoided cost method, S1 is required to capitalize interest in the amount of $500,000 ([$600,000÷$6,000,000×5,000,000).

(ii) P's only borrowing from unrelated lenders is a $2,000,000 loan bearing interest at an annual rate of 10 percent ($200,000 per year). Under the principles of paragraph (g)(5)(ii) of this section, because the aggregate amount of interest described in paragraph (g)(5)(i) of this section ($500,000) exceeds the aggregate amount of currently deductible interest of the group ($200,000), the intercompany transaction provisions of the consolidated return regulations apply to the excess of $300,000 and the amount of P's interest income that is subject to current inclusion by reason of paragraph (g)(5)(i) of this section is limited to $200,000.

(6) *Notional principal contracts and other derivatives.* [Reserved]

(7) *15-day repayment rule.* A taxpayer may elect to treat any eligible debt that is repaid within the 15-day period immediately preceding a quarterly measurement date as outstanding as of that measurement date for purposes of determining traced debt, average nontraced debt, and the weighted average interest rate. This election may be made or discontinued for any computation period and is not a method of accounting.

[T.D. 8584, 59 FR 67200, Dec. 29, 1994; 60 FR 16574, Mar. 31, 1995, as amended by T.D. 8584, 60 FR 47053, Sept. 11, 1995]

§1.263A–10 Unit of property.

(a) *In general.* The unit of property as defined in this section is used as the basis to determine accumulated production expenditures under §1.263A–11 and the beginning and end of the production period under §1.263A–12. Whether property is 1-year or 2-year property under §1.263A–8(b)(1)(ii) is also determined separately with respect to each unit of property as defined in this section.

(b) *Units of real property*—(1) *In general.* A unit of real property includes any components of real property owned by the taxpayer or a related person that are functionally interdependent and an allocable share of any common feature owned by the taxpayer or a related person that is real property even though the common feature does not meet the functional interdependence test. When the production period begins with respect to any functionally interdependent component or any common feature of the unit of real property, the production period has begun for the entire unit of real property. See, however, paragraph (b)(5) of this section for rules under which the costs of a common feature or benefitted property are excluded from accumulated production expenditures for one or more measurement dates. The portion of land included in a unit of real property includes land on which real property (including a common feature) included in the unit is situated, land subject to setback restrictions with respect to such property, and any other contiguous portion of the tract of land other than land that the taxpayer holds for a purpose unrelated to the unit being produced (e.g., investment purposes, personal use purposes, or specified future development as a separate unit of real property).

(2) *Functional interdependence.* Components of real property produced by, or for, the taxpayer, for use by the taxpayer or a related person are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person. In the case of property produced for sale, components of real property are functionally interdependent if they are customarily sold as a single unit. For example, the real property components of a single-family house (e.g., the land, foundation, and walls) are functionally interdependent. In contrast, components of real property that are expected to be separately placed in service or held for resale are not functionally interdependent. Thus, dwelling units within a multi-unit building that are separately placed in service or sold (within the meaning of §1.263A–12(d)(1)) are treated as functionally independent of any other units, even though the units are located in the same building.

(3) *Common features.* For purposes of this section, a common feature generally includes any real property (as defined in §1.263A–8(c)) that benefits real property produced by, or for, the taxpayer or a related person, and that is not separately held for the production of income. A common feature need not be physically contiguous to the real property that it benefits. Examples of common features include streets, sidewalks, playgrounds, clubhouses, tennis courts, sewer lines, and cables that are not held for the production of income separately from the units of real property that they benefit.

(4) *Allocation of costs to unit.* Except as provided in paragraph (b)(5) of this section, the accumulated production expenditures for a unit of real property include, in all cases, the costs that directly benefit, or are incurred by reason of the production of, the unit of real property. Accumulated production expenditures also include the adjusted basis of property used to produce the unit of real property. The accumulated

costs of a common feature or land that benefits more than one unit of real property, or that benefits designated property and property other than designated property, is apportioned among the units of designated property, or among the designated property and property other than designated property, in determining accumulated production expenditures. The apportionment of the accumulated costs of the common feature (allocable share) or land (attributable land costs) generally may be made using any method that is applied on a consistent basis and that reasonably reflects the benefits provided. For example, an apportionment based on relative costs to be incurred, relative space to be occupied, or relative fair market values may be reasonable.

(5) *Treatment of costs when a common feature is included in a unit of real property*—(i) *General rule.* Except as provided in this paragraph (b)(5), the accumulated production expenditures of a unit of real property include the costs of functionally interdependent components (benefitted property) and an allocable share of the cost of common features throughout the entire production period of the unit. See § 1.263A–12, relating to the production period of a unit of property.

(ii) *Production activity not undertaken on benefitted property*—(A) *Direct production activity not undertaken—(1) In general.* The costs of land attributable to a benefitted property may be treated as not included in accumulated production expenditures for a unit of real property for measurement dates prior to the first date a production activity (direct production activity), including the clearing and grading of land, has been undertaken with respect to the land attributable to the benefitted property. Thus, the costs of land attributable to a benefitted property (as opposed to land attributable to the common features) with respect to which no direct production activities have been undertaken may be treated as not included in the accumulated production expenditures of a unit of real property even though a production activity has begun on a common feature allocable to the unit.

(2) Land attributable to a benefitted property. For purposes of this paragraph (b)(5)(ii), land attributable to a benefitted property includes all land in the unit of real property that includes the benefitted property other than land for a common feature. (Thus, land attributable to a benefitted property does not include land attributable to a common feature.)

(B) *Suspension of direct production activity after clearing and grading undertaken—(1) General rule.* This paragraph (b)(5)(ii)(B) may be used to determine the accumulated production expenditures for a unit of real property, if the only production activity with respect to a benefitted property has been clearing and grading and no further direct production activity is undertaken with respect to the benefitted property for at least 120 consecutive days (i.e., direct production activity has ceased). Under this paragraph (b)(5)(ii)(B), the accumulated production expenditures attributable to a benefitted property qualifying under this paragraph (b)(5)(ii)(B) may be excluded from the accumulated production expenditures of the unit of real property even though production continues on a common feature allocable to the unit. For purposes of this paragraph (b)(5)(ii)(B), production activity is considered to occur during any time which would not qualify as a cessation of production activities under the suspension period rules of § 1.263A–12(g).

(2) Accumulated production expenditures. If this paragraph (b)(5)(ii)(B) applies, accumulated production expenditures attributable to the benefitted property of the unit of real property may be treated as not included in the accumulated production expenditures for the unit starting with the first measurement period beginning after the first day of the 120 consecutive day period, but must be included in the accumulated production expenditures for the unit beginning in the measurement period in which direct production activity has resumed on the benefitted property. Accumulated production expenditures with respect to common features allocable to the unit of real property may not be excluded under this paragraph (b)(5)(ii)(B).

(iii) *Common feature placed in service before the end of production of a benefitted property.* To the extent that a common feature with respect to which all production activities to be undertaken by, or for, a taxpayer or a related person are completed is placed in service before the end of the production period of a unit that includes an allocable share of the costs of the common feature, the costs of the common feature are not treated as included in accumulated production expenditures of the unit for measurement periods beginning after the date the common feature is placed in service.

(iv) *Benefitted property sold before production completed on common feature.* If a unit of real property is sold before common features included in the unit are completed, the production period of the unit ends on the date of sale. Thus, common feature costs actually incurred and properly allocable to the unit as of the date of sale are excluded from accumulated production expenditures for measurement periods beginning after the date of sale. Common feature costs properly allocable to the unit and actually incurred after the sale are not taken into account in determining accumulated production expenditures.

(v) *Benefitted property placed in service before production completed on common feature.* Where production activities remain to be undertaken on a common feature allocable to a unit of real property that includes benefitted property, the costs of the benefitted property are not treated as included in the accumulated production expenditures for the unit for measurement periods beginning after the date the benefitted property is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person with respect to the benefitted property are completed.

(6) *Examples.* The principles of paragraph (b) of this section are illustrated by the following examples:

Example 1. B, an individual, is in the trade or business of constructing custom-built houses for sale. B owns a 10-acre tract upon which B intends to build four houses on 2-acre lots. In addition, on the remaining 2 acres B plans to construct a perimeter road that benefits the four houses and is not held for the production of income separately from the sale of the houses. In 1995, B begins constructing the perimeter road and clears the land for one house. Under the principles of paragraph (b)(1) of this section, each planned house (including attributable land) is part of a separate unit of real property (house unit). Under the principles of paragraph (b)(3) of this section, the perimeter road (including attributable land) constitutes a common feature with respect to each planned house (i.e., benefitted property). In accordance with paragraph (b)(1), the production period for all four house units begins when production commences on the perimeter road in 1995. In addition, under the principles of paragraph (b)(4) of this section, the accumulated production expenditures for the four house units include the allocable costs of the road. In addition, for the house with respect to which B has cleared the land, the accumulated production expenditures for the house unit include the land costs attributable to the house. See paragraph (b)(5)(i) of this section. However, the accumulated production expenditures for each of the three house units that include a house for which B has not yet undertaken a direct production activity do not include the land costs attributable to the house. See paragraph (b)(5)(ii) of this section.

Example 2. Assume the same facts as *Example 1,* except that B undertakes no further direct production activity with respect to the house for which the land was cleared for a period of at least 120 days but continues constructing the perimeter road during this period. In accordance with paragraph (b)(5)(ii)(B) of this section, B may exclude the accumulated production expenditures attributable to the benefitted property from the accumulated production expenditures of the house unit starting with the first measurement period that begins after the first day of the 120 consecutive day period. B must include the accumulated production expenditures attributable to the benefitted property in the accumulated production expenditures for the house unit beginning with the measurement period in which direct production resumes on the benefitted property. The house unit will continue to include the accumulated production expenditures attributable to the perimeter road during the period in which direct production activity was suspended on the benefitted property.

Example 3. (i) D, a corporation, is in the trade or business of developing commercial real property. D owns a 20-acre tract upon which D intends to build a shopping center with 150 stores. D intends to lease the stores. D will also provide on the 20 acres a 1500-car parking lot, which is not held by D for the production of income separately from the stores in the shopping center. Additionally, D will not produce any other common features as part of the project. D intends to complete the shopping center in phases and expects that each store will be placed in service independently of any other store.

(ii) Under paragraphs (b)(1) and (b)(2) of this section, each store (including attributable land) is part of a separate unit of real property (store unit). The 1500-car parking lot is a common feature benefitting each store, and D must include an allocable share of the parking lots in each store unit. See paragraphs (b)(1) and (b)(3). In accordance with paragraph (b)(5)(i), D includes in the accumulated production expenditures for each store unit during each store unit's production period: the costs capitalized with respect to the store (including attributable land costs in accordance with paragraph (b)(5) of this section) and an allocable share of the parking lot costs (including attributable land costs in accordance with paragraph (b)(5) of this section). Under paragraph (b)(4), the portion of the parking lot costs that is included in the accumulated production expenditures of a store unit is determined using a reasonable method of allocation.

Example 4. X, a real estate developer, begins a project to construct a condominium building and a convenience store for the benefit of the condominium. X intends to separately lease the convenience store. Because the convenience store is held for the production of income separately from the condominium units that it benefits, the convenience store is not a common feature with respect to the condominium building. Instead, the convenience store is a separate unit of property with a separate production period and for which a separate determination of accumulated production expenditures must be made.

Example 5. (i) In 1995, X, a real estate developer, begins a project consisting of a condominium building and a common swimming pool that is not held for the production of income separately from the condominium sales. The condominium building consists of 10 stories, and each story is occupied by a single condominium. Production of the swimming pool begins in January. No direct production activity is undertaken on any condominium until September, when direct production activity commences on each condominium. On December 31, 1995, 1 condominium that was completed in December has been sold, 3 condominiums that were completed in December have not been sold, and 6 condominiums are only partially complete; additionally, the swimming pool is completed. X is a calendar year taxpayer that uses a full taxable year as the computation period, and quarterly measurement dates.

(ii) Under paragraphs (b)(1) and (b)(2) of this section, each condominium (including attributable land) is part of a separate unit of real property. Under the principles of paragraph (b)(3) of this section, the swimming pool is a common feature with respect to each condominium and under paragraph (b)(4) of this section the cost of the swimming pool is allocated equally among the condominiums.

(iii) Under paragraph (b)(1) of this section, the production period of each of the 10 condominium units begins in January when production of the swimming pool begins. On X's March 31, 1995, and June 30, 1995, measurement dates, the accumulated production expenditures for each condominium unit include the allocable costs of the swimming pool, but not the land costs attributable to the condominium because no direct production activity has been undertaken on the condominium. See paragraph (b)(5)(ii)(A) of this section. On X's September 30, 1995, and December 31, 1995, measurement dates, the accumulated production expenditures for each unit include the allocable costs of the swimming pool, and the costs of the condominium (including attributable land costs) because a direct production activity has commenced on the condominium. See paragraph (b)(5)(i) of this section.

(iv) The production period for the condominium unit that includes the condominium that is sold as of the end of 1995 ends on the date the condominium is sold. See paragraph (b)(5)(iv) of this section. The production period of each unit that is ready to be held for sale ends when all production activities have been completed on the unit, in this case on December 31, 1995, the date that the swimming pool included in the unit is completed. See § 1.263A–12(d). Accordingly, interest capitalization ceases for each such unit that is sold or ready to be held for sale as of the end of 1995 (including each unit's allocable share of the completed swimming pool).

(v) The production periods for the condominium units that include the condominiums that are only partially complete at the end of 1995 continue after 1995. The accumulated production expenditures for each partially completed condominium unit continue to include the costs of the condominium (including attributable land costs) in addition to the costs of an allocable share of the completed swimming pool (including attributable land costs).

Example 6. Assume the same facts as in *Example 5*, except that the swimming pool is only partially complete as of the end of 1995. Under these facts, X capitalizes no interest during 1996 for the 1 unit that includes the condominium sold during 1995 (including the costs of the allocable share of the swimming pool). See paragraph (b)(5)(iv) of this section. However, with respect to the 6 condominiums that are partially complete and the 3 condominiums that are completed but unsold, interest capitalization continues after the end of 1995. The accumulated production expenditures for each of these 9 units include the costs of an allocable share of the swimming pool. See paragraph (b)(5)(i) of this section. In determining the costs of an allocable share of the swimming pool included in the accumulated production expenditures for each of the 9 units, X includes all costs of the swimming pool properly allocable to each unit, including those cost incurred as of the date of the sale of unit 1 that may have been used under applicable administrative procedures (e.g., Rev. Proc. 92–29, 1992–1 C.B. 748) in determining the basis of unit 1 solely for purposes of computing gain or loss on the sale of unit 1. See §601.601(d)(2)(ii)(*b*) of this chapter.

Example 7. (i) Assume the same facts as in *Example 5*, except that X intends to lease rather than sell the condominiums and the completed swimming pool is placed in service for depreciation purposes on December 31, 1995. Additionally, assume that all 10 condominiums are partially completed at the end of 1995.

(ii) Under these facts, because the swimming pool is a common feature that is placed in service separately from the condominiums that it benefits, under paragraph (b)(5)(iii) of this section, the accumulated production expenditures of each of the condominium units do not include the costs of the allocable share of the swimming pool after 1995.

(c) *Units of tangible personal property*. Components of tangible personal property are a single unit of property if the components are functionally interdependent. Components of tangible personal property that are produced by, or for, the taxpayer, for use by the taxpayer or a related person, are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person. In the case of tangible personal property produced for sale, components of tangible personal property are functionally interdependent if they are customarily sold as a single unit. For example, if an aircraft manufacturer customarily sells completely assembled aircraft, the unit of property includes all components of a completely assembled aircraft. If the manufacturer also customarily sells aircraft engines separately, any engines that are reasonably expected to be sold separately are treated as single units of property.

(d) *Treatment of installations*. If the taxpayer produces or is treated as producing any property that is installed on or in other property, the production activity and installation activity relating to each unit of property generally are not aggregated for purposes of this section. However, if the taxpayer is treated as producing and installing any property for use by the taxpayer or a related person or if the taxpayer enters into a contract requiring the taxpayer to install property for use by a customer, the production activity and installation activity are aggregated for purposes of this section.

[T.D. 8584, 59 FR 67207, Dec. 29, 1994; 60 FR 16574, 16575, Mar. 31, 1995]

§1.263A–11 Accumulated production expenditures.

(a) *General rule. Accumulated production expenditures* generally means the cumulative amount of direct and indirect costs described in section 263A(a) that are required to be capitalized with respect to the unit of property (as defined in §1.263A–10), including interest capitalized in prior computation periods, plus the adjusted bases of any assets described in paragraph (d) of this section that are used to produce the unit of property during the period of their use. Accumulated production expenditures may also include the basis of any property received by the taxpayer in a nontaxable transaction.

(b) *When costs are first taken into account*—(1) *In general*. Except as provided in paragraph (c)(1) of this section, costs are taken into account in the computation of accumulated production expenditures at the time and to the extent they would otherwise be taken into account under the taxpayer's method of accounting (e.g., after applying the requirements of section 461, including the economic performance requirement of section 461(h)). Costs that have been incurred and capitalized with respect to a unit of property prior to the beginning of the production period are taken into account as accumulated production expenditures beginning on the date on which the production period of the property begins (as defined in §1.263A–12(c)). Thus, for example, the cost of raw land acquired for development, the cost of a leasehold in mineral properties acquired for development, and the capitalized cost of planning and design activities are taken into account as accumulated production expenditures beginning on the first day of the production period. For purposes of determining accumulated production expenditures on any measurement date during a computation period, the interest required to be capitalized for the computation period is deemed to be capitalized on the day immediately following the end of the computation period. For any subsequent measurement dates and computation periods, that interest is included in accumulated production expenditures. If the cost of land or common features is allocated among planned units of property that are completed in phases, any portion of the cost properly allocated to completed units is not reallocated to any incomplete units of property.

(2) *Dedication rule for materials and supplies.* The costs of raw materials, supplies, or similar items are taken into account as accumulated production expenditures when they are incurred and dedicated to production of a unit of property. *Dedicated* means the first date on which the raw materials, supplies, or similar items are specifically associated with the production of any unit of property, including by record, assignment to the specific job site, or physical incorporation. In contrast, in the case of a component or subassembly that is reasonably expected to be become a part of (e.g., be incorporated into) any unit of property, costs incurred (including dedicated raw materials) for the component or subassembly are taken into account as accumulated production expenditures during the production of any portion of the component or subassembly and prior to its connection with (e.g., incorporation into) any specific unit of property. For purposes of the preceding sentence, components and subassemblies must be aggregated at each measurement date in a reasonable manner that is consistent with the purposes of section 263A(f).

(c) *Property produced under a contract*—(1) *Customer.* If a unit of property produced under a contract is designated property under § 1.263A–8(d)(2)(i) with respect to the customer, the customer's accumulated production expenditures include any payments under the contract that represent part of the purchase price of the unit of designated property or, to the extent costs are incurred earlier than payments are made (determined on a cumulative basis for each unit of designated property), any part of such price for which the requirements of section 461 have been satisfied. The customer has made a payment under this section if the transaction would be considered a payment by a taxpayer using the cash receipts and disbursements method of accounting. The customer's accumulated production expenditures also include any other costs incurred by the customer, such as interest, or any other direct or indirect costs that are required to be capitalized under section 263A(a) and the regulations thereunder with respect to the production of the unit of designated property.

(2) *Contractor.* If a unit of property produced under a contract is designated property under § 1.263A–8(d)(2)(ii) with respect to the contractor, the contractor must treat the cumulative amount of payments made by the customer under the contract attributable to the unit of property as a reduction in the contractor's accumulated production expenditures. The customer has made a payment under this section if the transaction would be considered a payment by a taxpayer using the cash receipts and disbursements method of accounting.

(d) *Property used to produce designated property*—(1) *In general.* Accumulated production expenditures include the adjusted bases (or portion thereof) of any equipment, facilities, or other similar assets, used in a reasonably proximate manner for the production of a unit of designated property during any measurement period in which the asset is so used. Examples of assets used in a reasonably proximate manner include machinery and equipment used directly or indirectly in the production process, such as assembly-line structures, cranes, bulldozers, and buildings. A taxpayer apportions the adjusted basis of an asset used in the production of more than one unit of designated property in a measurement period among such units of designated property using reasonable criteria corresponding to the use of the asset, such as machine hours, mileage, or units of production. If an asset used in a reasonably proximate manner for the production of a unit of designated property is temporarily idle (within the meaning of § 1.263A–1(e)(3)(iii)(E)) for an entire measurement period, the adjusted basis of the asset is excluded from the accumulated production expenditures for the unit during that measurement period. Notwithstanding this paragraph (d)(1), the portion of the depreciation allowance for equipment, facilities, or any other asset that is capitalized with respect to a unit of designated property in accordance with § 1.263A–1(e)(3)(ii)(I) is included in accumulated production expenditures without regard to the extent of use under this paragraph (d)(1) (i.e., without regard to whether the asset is used in a reasonably proximate manner for the production of the unit of designated property).

(2) *Example.* The following example illustrates how the basis of an asset is allocated on the basis of time:

Example. In 1995, X uses a bulldozer exclusively to clear the land on several adjacent real estate development projects, A, B, and C. A, B, and C are treated as separate units of property under the principles of § 1.263A–10. X decides to allocate the basis of the bulldozer among the three projects on the basis of time. At the end of the first quarter of 1995, the production period has commenced for all three projects. The bulldozer was operated for 30 hours on project A, 80 hours on project B, and 10 hours on project C, for a total of 120 hours for the entire period. For purposes of determining accumulated production expenditures as of the end of the first quarter, ¼ of the adjusted basis of the bulldozer is allocated to project A, ⅔ to project B, and 1⁄12 to project C. Nonworking hours, regularly scheduled nonworking days, or other periods in which the bulldozer is temporarily idle (within the meaning of § 1.263A–1(e)(3)(iii)(E)) during the measurement period are not taken into account in allocating the basis of the bulldozer.

(3) *Excluded equipment and facilities.* The adjusted bases of equipment, facilities, or other assets that are not used in a reasonably proximate manner to produce a unit of property are not included in the computation of accumulated production expenditures. For example, the adjusted bases of equipment and facilities, including buildings and other structures, used in service departments performing administrative, purchasing, personnel, legal, accounting, or similar functions, are excluded from the computation of accumulated production expenditures under this paragraph (d)(3).

(e) *Improvements*—(1) *General rule.* If an improvement constitutes the production of designated property under $1.263A–8(d)(3), accumulated production expenditures with respect to the improvement consist of—

(i) All direct and indirect costs required to be capitalized with respect to the improvement,

(ii) In the case of an improvement to a unit of real property—

(A) An allocable portion of the cost of land, and

(B) For any measurement period, the adjusted basis of any existing structure, common feature, or other property that is not placed in service or must be temporarily withdrawn from service to complete the improvement (associated property) during any part of the measurement period if the associated property directly benefits the property being improved, the associated property directly benefits from the improvement, or the improvement was incurred by reason of the associated property. See, however, the de minimis rule under paragraph (e)(2) of this section that applies in the case of associated property.

(iii) In the case of an improvement to a unit of tangible personal property, the adjusted basis of the asset being improved if that asset either is not placed in service or must be temporarily withdrawn from service to complete the improvement.

(2) *De minimis rule.* For purposes of paragraph (e)(1)(ii) of this section, the total costs of all associated property for an improvement unit (associated property costs) are excluded from the accumulated production expenditures for the improvement unit during its production period if, on the date the production period of the unit begins, the taxpayer reasonably expects that at no time during the production period of the unit will the accumulated production expenditures for the unit, determined without regard to the associated property costs, exceed 5 percent of the associated property costs.

(f) *Mid-production purchases.* If a taxpayer purchases a unit of property for further production, the taxpayer's accumulated production expenditures include the full purchase price of the property plus, in accordance with the principles of paragraph (e) of this section, additional direct and indirect costs incurred by the taxpayer.

(g) *Related person costs.* The activities of a related person are taken into account in applying the classification thresholds under § 1.263A–8(b)(1)(ii)(B) and (C), and in determining the production period of a unit of designated property under § 1.263A–12. However, only those costs incurred by the taxpayer are taken into account in the taxpayer's accumulated production expenditures under this section because the related person includes its own capitalized costs in the related person's accumulated production expenditures with respect to any unit of designated property upon which the parties engage in mutual production activities. For purposes of the preceding sentence, the accumulated production expenditures of any property transferred to a taxpayer in a nontaxable transaction are treated as accumulated production expenditures incurred by the taxpayer.

(h) *Installation.* If the taxpayer installs property that is purchased by the taxpayer, accumulated production expenditures include the cost of the property that is installed in addition to the direct and indirect costs of installation.

[T.D. 8584, 59 FR 67210, Dec. 29, 1994; 60 FR 16575, Mar. 31, 1995]

§ 1.263A–12 Production period.

(a) *In general.* Capitalization of interest is required under § 1.263A–9 for computation periods (within the meaning of § 1.263A–9(f)(1)) that include the production period of a unit of designated property. In contrast, section 263A(a) requires the capitalization of all other direct or indirect costs, such as insurance, taxes, and storage, that directly benefit or are incurred by reason of the production of property without regard to whether they are incurred during a period in which production activity occurs.

(b) *Related person activities.* Activities performed and costs incurred by a person related to the taxpayer that directly benefit or are incurred by reason of the taxpayer's production of designated property are taken into account in determining the taxpayer's production period (regardless of whether the related person is performing only a service or is producing a subassembly or component that the related person is required to treat as an item of designated property). These activities and the related person's costs are also taken into account in determining whether tangible personal property produced by the taxpayer is 1-year or 2-year property under § 1.263A–8(b)(1)(ii) (B) and (C).

(c) *Beginning of production period*—(1) *In general.* A separate production period is determined for each unit of property defined in § 1.263A–10. The production period begins on the date that production of the unit of property begins.

(2) *Real property.* The production period of a unit of real property begins on the first date that any physical production activity (as defined in paragraph (e) of this section) is performed with respect to a unit of real property. See § 1.263A–10(b)(1). The production period of a unit of real property produced under a contract begins for the contractor on the date the contractor begins physical production activity on the property. The production period of a unit of real property produced under a contract begins for the customer on the date either the customer or the contractor begins physical production activity on the property.

(3) *Tangible personal property.* The production period of a unit of tangible personal property begins on the first date by which the taxpayer's accumulated production expenditures, including planning and design expenditures, are at least 5 percent of the taxpayer's total estimated accumulated production expenditures for the property unit. Thus, the beginning of the production period is determined without regard to whether physical production activity has commenced. The production period of a unit of tangible personal property produced under a contract begins for the contractor when the contractor's accumulated production expenditures, without any reduction for payments

from the customer, are at least 5 percent of the contractor's total estimated accumulated production expenditures. The production period for a unit of tangible personal property produced under a contract begins for the customer when the customer's accumulated production expenditures are at least 5 percent of the customer's total estimated accumulated production expenditures.

(d) *End of production period*—(1) *In general.* The production period for a unit of property produced for self use ends on the date that the unit is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. The production period for a unit of property produced for sale ends on the date that the unit is ready to be held for sale and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. See, however, §1.263A–10(b)(5)(iv) providing an exception for common features in the case of a benefitted property that is sold. In the case of a unit of property produced under a contract, the production period for the customer ends when the property is placed in service by the customer and all production activities reasonably expected to be undertaken are complete (i.e., generally, no earlier than when the customer takes delivery). In the case of property that is customarily aged (such as tobacco, wine, or whiskey) before it is sold, the production period includes the aging period.

(2) *Special rules.* The production period does not end for a unit of property prior to the completion of physical production activities by the taxpayer even though the property is held for sale or lease, since all production activities reasonably expected to be undertaken by the taxpayer with respect to such property have not in fact been completed. See, however, §1.263A–10(b)(5) regarding separation of certain common features.

(3) *Sequential production or delivery.* The production period ends with respect to each unit of property (as defined in §1.263A–10) and its associated accumulated production expenditures as the unit of property is completed within the meaning of paragraph (d)(1) of this section, without regard to the production activities or costs of any other units of property. Thus, for example, in the case of separate apartments in a multi-unit building, each of which is a separate unit of property within the meaning of §1.263A–10, the production period ends for each separate apartment when it is ready to be held for sale or placed in service within the meaning of paragraph (d)(1) of this section. In the case of a single unit of property that merely undergoes separate and distinct stages of production, the production period ends at the same time (i.e., when all separate stages of production are completed with respect to the entire amount of accumulated production expenditures for the property).

(4) *Examples.* The provisions of paragraph (d) of this section are illustrated by the following examples:

Example 1. E is engaged in the original construction of a high-rise office building with two wings. At the end of 1995, Wing #1, but not Wing #2, is placed in service. Moreover, at the end of 1995, all production activities reasonably expected to be undertaken on Wing #1 are completed. In accordance with §1.263A–10(b)(1), Wing #1 and Wing #2 are separate units of designated property. E may stop capitalizing interest on Wing #1 but not on Wing #2.

Example 2. F is in the business of constructing finished houses. F generally paints and finishes the interior of the house, although this does not occur until a potential buyer is located. Because F reasonably expects to undertake production activity (painting and finishing), the production period of each house does not end until these activities are completed.

(e) *Physical production activities*—(1) *In general.* The term *physical production activities* includes any physical activity that constitutes production within the meaning of §1.263A–8(d)(1). The production period begins and interest must be capitalized with respect to real property if any physical production activities are undertaken, whether alone or in preparation for the construction of buildings or other structures, or with respect to the improvement of existing structures. For example, the clearing of raw land constitutes the production of designated property, even if only cleared prior to resale.

(2) *Illustrations.* The following is a partial list of activities any one of which constitutes a physical production activity with respect to the production of real property:

(i) Clearing, grading, or excavating of raw land;

(ii) Demolishing a building or gutting a standing building;

(iii) Engaging in the construction of infrastructure, such as roads, sewers, sidewalks, cables, and wiring;

(iv) Undertaking structural, mechanical, or electrical activities with respect to a building or other structure; or

(v) Engaging in landscaping activities.

(f) *Activities not considered physical production.* The activities described in paragraphs (f)(1) and (f)(2) of this section are not considered physical production activities:

(1) *Planning and design.* Soil testing, preparing architectural blueprints or models, or obtaining building permits.

(2) *Incidental repairs.* Physical activities of an incidental nature that may be treated as repairs under § 1.162–4.

(g) *Suspension of production period*—(1) *In general.* If production activities related to the production of a unit of designated property cease for at least 120 consecutive days (cessation period), a taxpayer may suspend the capitalization of interest with respect to the unit of designated property starting with the first measurement period that begins after the first day in which production ceases. The taxpayer must resume the capitalization of interest with respect to a unit beginning with the measurement period during which production activities resume. In addition, production activities are not considered to have ceased if they cease because of circumstances inherent in the production process, such as normal adverse weather conditions, scheduled plant shutdowns, or delays due to design or construction flaws, the obtaining of a permit or license, or the settlement of groundfill to construct property. Interest incurred on debt that is traced debt with respect to a unit of designated property during the suspension period is subject to capitalization with respect to the production of other units of designated property as interest on nontraced debt. See § 1.263A–9(c)(5)(i) of this section. For applications of the avoided cost method after the end of the suspension period, the accumulated production expenditures for the unit include the balance of accumulated production expenditures as of the beginning of the suspension period, plus any additional capitalized costs incurred during the suspension period. No further suspension of interest capitalization may occur unless the requirements for a new suspension period are satisfied.

(2) *Special rule.* If a cessation period spans more than one taxable year, the taxpayer may suspend the capitalization of interest with respect to a unit beginning with the first measurement period of the taxable year in which the 120-day period is satisfied.

(3) *Method of accounting.* An election to suspend interest capitalization under paragraph (g)(1) of this section is a method of accounting that must be consistently applied to all units that satisfy the requirements of paragraph (g)(1) of this section. However, the special rule in paragraph (g)(2) of this section is applied on an annual basis to all units of an electing taxpayer that satisfy the requirements of paragraph (g)(2) of this section.

(4) *Example.* The provisions of paragraph (g)(1) of this section are illustrated by the following example.

Example. (i) D, a calendar-year taxpayer, began production of a residential housing development on January 1, 1995. D, in applying the avoided cost method, chose a taxable year computation period and quarterly measurement dates. On April 10, 1995, all production activities ceased with respect to the units in the development until December 1, 1996. The cessation, which occurred for a period of at least 120 consecutive days, was not attributable to circumstances inherent in the production process. With respect to the units in the development, D incurred production expenditures of $2,000,000 from January 1, 1995 through April 10, 1995. D incurred interest of $100,000 on traced debt with respect to the units for the period beginning January 1, 1995, and ending June 30, 1995. D did not incur any production expenditures for the more than 20-month cessation beginning April 10, 1995, and ending December 1, 1996, but incurred $200,000 of production expenditures from December 1, 1996, through December 31, 1996.

(ii) D is required to capitalize the $100,000 interest on traced debt incurred during the two measurement periods beginning January 1, 1995, and ending June 30, 1995. Because D satisfied the 120-day rule under this paragraph (g), D is not required to capitalize interest with respect to the accumulated production expenditures for the units for the measurement period beginning July 1, 1995, and ending September 30, 1995, which is the first measurement period that begins after the date production activities cease. D is rquired to resume interest capitalization with respect to the $2,300,000 (2,000,000+100,000+200,000) of accumulated production expenditures for the units for the measurement period beginning October 1, 1996, and ending December 31, 1996 (the measurement period during which production activities resume). Accordingly, D may suspend the capitalization of interest with respect to the units from July 1, 1995, through September 30, 1996.

[T.D. 8584, 59 FR 67212, Dec. 29, 1994; 60 FR 16575, Mar. 31, 1995]

§1.263A–13 Oil and gas activities.

(a) *In general.* This section provides rules that are to be applied in tandem with §§1.263A–8 through 1.263A–12, 1.263A–14, and 1.263A–15 in capitalizing interest with respect to the development (within the meaning of section 263A(g)) of oil or gas property. For this purpose, oil or gas property consists of each separate operating mineral interest in oil or gas as defined in section 614(a), or, if a taxpayer makes an election under section 614(b), the aggregate of two or more separate operating mineral interests in oil or gas as described in section 614(b) (section 614 property). Thus, an oil or gas property is designated property unless the de minimis rule applies. A taxpayer must apply the rules in paragraph (c) of this section if the taxpayer cannot establish, at the beginning of the production period of the first well drilled on the property, a definite plan that identifies the number and location of other wells planned with respect to the property. If a taxpayer can establish such a plan at the beginning of the production period of the first well drilled on the property, the taxpayer may either apply the rules of paragraph (c) of this section or treat each of the planned wells as a separate unit and partition the leasehold acquisition costs and costs of common features based on the number of planned well units.

(b) *Generally applicable rules*—(1) *Beginning of production period*—(i) *Onshore activities.* In the case of onshore oil or gas development activities, the production period for a unit begins on the first date physical site preparation activities (such as building an access road, leveling a site for a drilling rig, or excavating a mud pit) are undertaken with respect to the unit.

(ii) *Offshore activities.* In the case of offshore development activities, the production period for a unit begins on the first date physical site preparation activities, other than activities undertaken with respect to expendable wells, are undertaken with respect to the unit. For purposes of the preceding sentence, the first physical site preparation activity undertaken with respect to a section 614 property is generally the first activity undertaken with respect to the anchoring of a platform (e.g., drilling to drive the piles). For purposes of this section, an expendable well is a well drilled solely to determine the location and delineation of offshore hydrocarbon deposits.

(2) *End of production period.* The production period ends for a productive well unit on the date the well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. See §1.263A–12(d).

(3) *Accumulated production expenditures*—(i) *Costs included.* Accumulated production expenditures for a well unit include the following costs (to the extent they are not intangible drilling and development costs allowable as a deduction under section 263(c), 263(i), or 291(b)(2)): the costs of acquiring the section 614 leasehold and the costs of taxes and similar items that are required to be capitalized under section 263A(a) with respect to the section 614 leasehold; the cost of real property associated with developing the section 614 property (e.g., casing); the basis of real property that constitutes a common feature within the meaning of §1.263A–10(b)(3); and the adjusted basis of property used to produce property (such as a mobile rig, drilling ship, or an offshore drilling platform).

(ii) *Improvement unit.* To the extent section 614 costs are allocated to a well unit, the undepleted portion of those section 614 costs must also be included in the accumulated production expenditures for any improvement unit (within the meaning of § 1.263A–8(d)(3)) with respect to that well unit.

(c) *Special rules when definite plan not established*—(1) *In general.* The special rules of this paragraph (c) must be applied by a taxpayer that cannot establish, at the beginning of the production period of the first well drilled on the property, a definite plan that identifies the number and location of the wells planned with respect to the property. A taxpayer than can establish such a plan is permitted, but not required, to apply the rules of this paragraph (c), provided the rules of this paragraph (c) are consistently applied for all the taxpayer's oil or gas properties for which a definite plan can be established.

(2) *Oil and gas units*—(i) *First productive well unit.* Until the first productive well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed, a first productive well unit includes the section 614 property and all real property associated with the development of the section 614 property. Thus, for example, a first productive well unit includes the section 614 property and real property associated with any nonproductive well drilled on the section 614 property on or before the date the first productive well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. For purposes of this section, a productive well is a well that produces in commercial quantities. See paragraph (c)(5) of this section, which provides a special rule whereby the costs of a section 614 property and common feature costs for a section 614 property generally are included only in the accumulated production expenditures for the first productive well unit.

(ii) *Subsequent units.* Generally, real property associated with each productive or nonproductive well with respect to which production activities begin after the date the first productive well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed, constitutes a unit of real property. Additionally, a productive or nonproductive well that is included in a first productive well unit and for which development continues after the date the first productive well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed, generally is treated as a separate unit of property after that date. See, however, paragraph (c)(5) of this section, which provides rules for the treatment of costs included in the accumulated production expenditures of a first productive well unit.

(3) *Beginning of production period*—(i) *First productive well unit.* The beginning of the production period of the first productive well unit is determined as provided in paragraph (b) of this section.

(ii) *Subsequent wells.* In applying paragraph (b) of this section to subsequent well units (as described in paragraph (c)(2)(ii) of this section), any activities occurring prior to the date the production period ends for the first productive well unit are not taken into account in determining the beginning of the production period for the subsequent well units.

(4) *End of production period.* The end of the production period for both the first productive well unit and subsequent productive well units is determined as provided in paragraph (b)(2) of this section. See § 1.263A–12(d). Nonproductive wells included in the first productive well unit need not be plugged and abandoned for the production period to end for a first productive well unit.

(5) *Accumulated production expenditures*—(i) *First productive well unit.* The accumulated production expenditures for a first productive well unit include all costs incurred with respect to the section 614 property and associated real property at any time through the end of the production period for the first productive well unit. Thus, the costs of acquiring the section 614 property, the costs of taxes and similar items that are required to be capitalized under section 263A(a) with respect to the section 614 property, and the costs of common features, that are incurred at any

time through the end of the production period of the first productive well unit (section 614 costs) are included in the accumulated production expenditures for the first productive well unit.

(ii) *Subsequent well unit.* The accumulated production expenditures for a subsequent well do not include any costs included in the accumulated production expenditures for a first productive well unit. In the event that section 614 costs or common feature costs with respect to a section 614 property are incurred subsequent to the end of the production period of the first productive well unit, those common feature costs and undepleted section 614 costs are allocated among the accumulated production expenditures of wells being drilled as of the date such costs are incurred.

(6) *Allocation of interest capitalized with respect to first productive well unit.* Interest attributable to any productive or nonproductive well included in the first productive well unit (within the meaning of paragraph (c)(2)(ii) of this section) is allocated among and capitalized to the basis of the property associated with the first productive well unit. See §1.263A–8(a)(2).

(7) *Example.* The provisions of this paragraph (c) are illustrated by the following example.

Example. (i) Corporation Z, an oil company, acquired a section 614 property in an onshore tract, Tract B, for development. In 1995, Corporation Z began site preparation activities on Tract B and also commenced drilling Well 1 on Tract B. Corporation Z was unable to establish, as provided in paragraph (a) of this section, a definite plan identifying the number and location of other wells planned on Tract B. In 1996, Corporation Z began drilling Well 2. On May 1, 1997, Well 2, a productive well, was placed in service and all production activities reasonably expected to be undertaken with respect to Well 2 were completed. By that date, also, Well 1 was abandoned.

(ii) Well 2 is a first productive well (within the meaning of paragraph (c)(2)(i) of this section). Well 1 is a nonproductive well drilled prior to a first productive well. Under paragraph (c) of this section, Corporation Z must treat both Well 1 and Well 2 as part of the first productive well unit on the section 614 property. In accordance with paragraphs (c)(3) and (c)(4) of this section, the production period of the first productive well unit begins on the date physical site preparation activities are undertaken with respect to Well 1 in 1995 and ends on May 1, 1997, the date that Well 2 is placed in service and all production activities reasonably expected to be undertaken are completed. In accordance with paragraph (c)(5) of this section, the accumulated production expenditures for the first productive well unit include, among other capitalized costs, the entire section 614 property costs capitalized with respect to Tract B and all common feature costs incurred with respect to the section 614 property through May 1, 1997.

(iii) Any well that Corporation Z begins after May 1, 1997, is a separate unit of property. See paragraph (c)(2)(ii) of this section. Under paragraph (c)(3)(ii) of this section, the production period for any such well unit begins on the first day after May 1, 1997, on which Corporation Z undertakes physical site preparation activities with respect to the well unit. Moreover, Corporation Z does not include any of the section 614 property costs in the accumulated production expenditures for any well unit begun after May 1, 1997.

[T.D. 8584, 59 FR 67213, Dec. 29, 1994; 60 FR 16575, Mar. 31, 1995]

§1.263A–14 Rules for related persons.

Taxpayers must account for average excess expenditures allocated to related persons under applicable administrative pronouncements interpreting section 263A(f). See §601.601(d)(2)(ii)(*b*) of this chapter.

[T.D. 8584, 59 FR 67215, Dec. 29, 1994]

§1.263A–15 Effective dates, transitional rules, and anti-abuse rule.

(a) *Effective dates*—(1) Sections 1.263A–8 through 1.263A–15 generally apply to interest incurred in taxable years beginning on or after January 1, 1995. In the case of property that is inventory in the hands of the taxpayer, however, these sections are effective for taxable years beginning on or after January 1, 1995. Changes in methods of accounting necessary as a result of the rules in §§1.263A–8 through 1.263A–15 must be made under the terms and conditions prescribed by the Commissioner. Under these terms and conditions, the principles of §1.263A–7 must be applied in revaluing inventory property.

(2) For taxable years beginning before January 1, 1995, taxpayers must take reasonable positions on their federal income tax returns when applying section 263A(f). For purposes of this paragraph (a)(2), a reasonable position

is a position consistent with the temporary regulations, revenue rulings, revenue procedures, notices, and announcements concerning section 263A applicable in taxable years beginning before January 1, 1995. See § 601.601(d)(2)(ii)(*b*) of this chapter. For this purpose, Notice 88–99, 1988–2 C.B. 422, applies to taxable years beginning after August 17, 1988, in the case of inventory, and to interest incurred in taxable years beginning after August 17, 1988, in all other cases. Finally, under administrative procedures issued by the Commissioner, taxpayers may elect early application of §§ 1.263A–8 through 1.263A–15 to taxable years beginning on or after January 1, 1994, in the case of inventory property, and to interest incurred in taxable years beginning on or after January 1, 1994, in the case of property that is not inventory in the hands of the taxpayer.

(b) *Transitional rule for accumulated production expenditures*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, costs incurred before the effective date of section 263A are included in accumulated production expenditures (within the meaning of § 1.263A–11) with respect to noninventory property only to the extent those costs were required to be capitalized under section 263 when incurred and would have been taken into account in determining the amount of interest required to be capitalized under former section 189 (relating to the capitalization of real property interest and taxes) or pursuant to an election that was in effect under section 266 (relating to the election to capitalize certain carrying charges).

(2) *Property used to produce designated property.* The basis of property acquired prior to 1987 and used to produce designated noninventory property after December 31, 1986, is included in accumulated production expenditures in accordance with § 1.263A–11(d) without regard to whether the basis would have been taken into account under former section 189 or section 266.

(c) *Anti-abuse rule.* The interest capitalization rules contained in §§ 1.263A–8 through 1.263A–15 must be applied by the taxpayer in a manner that is consistent with and reasonably carries out the purposes of section 263A(f). For example, in applying § 1.263A–10, regarding the definition of a unit of property, taxpayers may not divide a single unit of property to avoid property classifying the property as designated property. Similarly, taxpayers may not use loans in lieu of advance payments, tax-exempt parties, loan restructurings at measurement dates, or obligations bearing an unreasonably low rate of interest (even if such rate equals or exceeds the applicable Federal rate under section 1274(d)) to avoid the purposes of section 263A(f). For purposes of this paragraph (c), the presence of back-to-back loans with different rates of interest, and other uses of related parties to facilitate an avoidance of interest capitalization, evidences abuse. In such cases, the District Director may, based upon all the facts and circumstances, determine the amount of interest that must be capitalized in a manner that is consistent with and reasonably carries out the purposes of section 263A(f).

[T.D. 8584, 59 FR 67215, Dec. 29, 1994, as amended by T.D. 8728, 62 FR 42062, Aug. 5, 1997]

§ 1.264–1 Premiums on life insurance taken out in a trade or business.

(a) *When premiums are not deductible.* Premiums paid by a taxpayer on a life insurance policy are not deductible from the taxpayer's gross income, even though they would otherwise be deductible as trade or business expenses, if they are paid on a life insurance policy covering the life of any officer or employee of the taxpayer, or any person (including the taxpayer) who is financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary of the policy. For additional provisions relating to the nondeductibility of premiums paid on life insurance policies (whether under section 162 or any other section of the Code), see section 262, relating to personal, living, and family expenses, and section 265, relating to expenses allocable to tax-exempt income.

(b) *When taxpayer is a beneficiary.* If a taxpayer takes out a policy for the purpose of protecting himself from loss in the event of the death of the insured, the taxpayer is considered a beneficiary directly or indirectly under the policy. However, if the taxpayer is not a beneficiary under the policy, the premiums so paid will not be disallowed as deductions merely because the taxpayer may derive a benefit from the increased efficiency of the officer or employee insured. See section 162 and the regulations thereunder. A taxpayer is considered a beneficiary under a policy where, for example, he, as a principal member of a partnership, takes out an insurance policy on his own life irrevocably designating his partner as the sole beneficiary in order to induce his partner to retain his investment in the partnership. Whether or not the taxpayer is a beneficiary under a policy, the proceeds of the policy paid by reason of the death of the insured may be excluded from gross income whether the beneficiary is an individual or a corporation, except in the case of (1) certain transferees, as provided in section 101(a)(2); (2) portions of amounts of life insurance proceeds received at a date later than death under the provisions of section 101(d); and (3) life insurance policy proceeds which are includible in the gross income of a husband or wife under section 71 (relating to alimony) or section 682 (relating to income of an estate or trust in case of divorce, etc.). (See section 101(e).) For further reference, see, generally, section 101 and the regulations thereunder.

§1.264–2 Single premium life insurance, endowment, or annuity contracts.

Amounts paid or accrued on indebtedness incurred or continued, directly or indirectly, to purchase or to continue in effect a single premium life insurance or endowment contract, or to purchase or to continue in effect a single premium annuity contract purchased (whether from the insurer, annuitant, or any other person) after March 1, 1954, are not deductible under section 163 or any other provision of chapter 1 of the Code. This prohibition applies even though the insurance is not on the life of the taxpayer and regardless of whether or not the taxpayer is the annuitant or payee of such annuity contract. A contract is considered a single premium life insurance, endowment, or annuity contract, for the purposes of this section, if substantially all the premiums on the contract are paid within four years from the date on which the contract was purchased, or if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract.

§1.264–3 Effective date; taxable years ending after March 1, 1954, subject to the Internal Revenue Code of 1939.

Pursuant to section 7851(a)(1)(C), the regulations prescribed in §1.264–2, to the extent that they relate to amounts paid or accrued on indebtedness incurred or continued to purchase or carry a single premium annuity contract purchased after March 1, 1954, and to the extent they consider a contract a single premium life insurance, endowment, or annuity contract if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract, shall also apply to taxable years beginning before January 1, 1954, and ending after March 1, 1954, and to taxable years beginning after December 31, 1953, and ending after March 1, 1954, but before August 17, 1954, although such years are subject to the Internal Revenue Code of 1939.

§1.264–4 Other life insurance, endowment, or annuity contracts.

(a) *General rule.* Except as otherwise provided in paragraphs (d) and (e) of this section, no deduction shall be allowed under section 163 or any other provision of chapter 1 of the Code for any amount (determined under paragraph (b) of this section) paid or accrued during the taxable year on indebtedness incurred or continued to purchase or continue in effect a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) if such indebtedness is incurred pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise). For the purposes of the preceding sentence, the term *of purchase* includes the payment of part or all of the premiums on a contract, and not merely payment of the premium due upon inital issuance of the contract. The rule of this paragraph applies whether or not the taxpayer is the insured, payee, or annuitant under the contract. the rule of this paragraph does not apply to contracts purchased by the taxpayer on or before August 6, 1963, even though there is a substantial increase in premiums after such date. The rule of this paragraph does not apply to any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract (including a contract treated as a single premium contract); the treatment of such amounts is governed by § 1.264–2.

(b) *Determination of amount not allowed.* The amount not allowed as a deduction under paragraph (a) of this section is determined with reference to the entire amount of borrowing to purchase or carry the contract, and is not limited with reference to the amount of borrowing of increases in the cash value. The rule of this paragraph may be illustrated by the following example:

Example. A, a calendar year taxpayer using the cash receipts and disbursements method of accounting, on January 1, 1964, purchases from a life insurance company a policy in the amount of $100,000 with an annual gross premium of $2,200. For the first policy year, A pays the annual premium by means other than by borrowing. For the second, third, fourth, and fifth policy years, A continues the policy in effect by incurring indebtedness pursuant to a plan referred to in paragraph (a) of this section. The years and amounts applicable to the policy are as follows:

Years	Cumulative cash value of contract	Total loan outstanding	Interest paid at 4.8 percent
1964	$370	0	0
1965	2,175	$2,200	$105.60
1966	4,000	4,400	211.20
1967	5,865	6,600	316.80
1968	7,745	8,800	422.40

On these facts (assuming that none of the exceptions contained in paragraph (d) of this section are applicable), no deduction is allowed for the interest paid during the year 1968. Moreover, the interest deduction will be disallowed for the taxable years 1965 through 1967 if such taxable years are not closed by reason of the statute of limitations or other rule of law.

(c) *Special rules.* For purposes of this section:

(1) *Determination of existence of a plan which contemplates systematic borrowing*—(i) *In general.* The determination of whether indebtedness is incurred or continued pursuant to a plan referred to in paragraph (a) of this section shall be made on the basis of all the facts and circumstances in each case. Unless the taxpayer shows otherwise, in the case of borrowing in connection with premiums for more than three years, the existence of a plan referred to in paragraph (a) of this section will be presumed. The mere fact that a taxpayer does not borrow to pay a premium in a particular year does not in and of itself preclude the existence of a plan referred to in paragraph (a) of this section. A plan referred to in paragraph (a) of this section need not exist at the time the contract is entered into, but may come into existence at any time during the 7-year period following the taxpayer's purchase of the contract or following a substantial increase (referred to in paragraph (d)(1) of this section) in premiums on the contract.

(ii) *Premium attributable to more than one year.* For purposes of subdivision (i) of this subparagraph, if the stated annual premiums due on a contract vary in amount, borrowing in connection with any premium, the amount of which exceeds the amount of any other premium, on such contract may be considered borrowing to pay premiums for more than one year. The preceding sentence shall not apply where the borrowing is in connection with a substantially increased premium within the meaning of paragraph (d)(1) of this section.

(2) *Direct or indirect.* A plan referred to in paragraph (a) of this section may contemplate direct or indirect borrowing of increases in cash value of the contract directly or indirectly to pay premiums and many contemplate borrowing either from an insurance carrier, from a bank, or from any other person. Thus, for example, if a taxpayer borrows $100,000 from a bank and uses the funds to purchase securities, later borrows $100,000 from a second

bank and uses the funds to repay the first bank, later sells the securities and uses the funds as a part of a plan referred to in paragraph (a) of this section to pay premiums on a contract of cash value life insurance, the deduction for interest paid in continuing the loan from the second bank shall not be allowed (assuming that none of the exceptions contained in paragraph (d) of this section are applicable). Moreover, a plan referred to in paragraph (a) of this section need not involve a pledge of the contract, but may contemplate unsecured borrowing or the use of other property.

(d) *Exceptions.* No deduction shall be denied under paragraph (a) of this section with respect to any amount paid or accrued during a taxable year on indebtedness incurred or continued as part of a plan referred to in paragraph (a) of this section if any of the following exceptions apply.

(1) *The 7-year exception*—(i) *In general.* No part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness. For purposes of this exception, in the event of a substantial increase in any annual premium on a contract, a new 7-year period begins on the date such increased premium is paid. If premiums on a contract are payable other than on an annual basis (for example, monthly), the annual premium is the aggregate of premiums due for the year. See paragraph (c)(1)(ii) of this section for cases where one premium on a contract paid by means of indebtedness may be considered as more than one annual premium.

(ii) *Application of borrowings.* For purposes of subdivision (i) of this subparagraph, if during a 7-year period referred to in such subdivision the taxpayer, directly or indirectly, borrows with respect to more than one annual premium on a contract, such borrowing shall be considered first attributable to the premium for the current policy year (within the meaning of subdivision (iii) of this subparagraph) and then attributable to premiums for prior policy years beginning with the most recent prior policy year (but not including any prior policy year to the extent that such taxpayer has indebtedness outstanding with respect to the premium for such prior policy year). If such borrowing exceeds the premiums paid for the current policy year and for prior policy years and the taxpayer has, with respect to the current policy year, deposited premiums in advance of the due date of such premiums, such excess borrowing shall be considered indebtedness incurred to carry the contract which is attributable to the premiums deposited for succeeding policy years beginning with the premium for the next succeeding policy year. The preceding sentence shall not apply to a single premium contract referred to in § 1.264–2.

(iii) *Current policy year.* For purposes of subdivision (ii) of this subparagraph, the term *current policy year* refers to the policy year which begins with or within the taxable year of the taxpayer.

(iv) *Illustrations.* The provisions of subdivision (ii) of this subparagraph may be illustrated by the following examples:

Example 1. A, a calendar year taxpayer using the cash receipts and disbursements method of accounting, on January 1, 1964, purchases from a life insurance company a policy in the amount of $100,000 with an annual gross premium of $2,200. For the first four policy years, A initially pays the annual premium by means other than borrowing. On January 1, 1968, pursuant to a plan referred to in paragraph (a) of this section, A borrows $10,000 with respect to the policy. Such borrowing is considered first attributable to paying the premium for the year 1968 and then attributable to paying the premiums for the years 1967, 1966, 1965, and 1964 (in part). No deduction is allowed for the interest paid by A on the $10,000 indebtedness during the year 1968.

Example 2. The facts are the same as in *Example (1),* except that on January 1, 1964, A pays the first annual premium and deposits an amount equal to the second and third annual premiums, all such amounts initially being paid or deposited by means other than borrowing. On January 1, 1965, A deposits an amount equal to the fourth, fifth, and sixth annual premiums, and borrows $4,400 pursuant to a plan referred to in paragraph (a) of this section. Such borrowing is considered attributable to the premiums paid for the policy years 1965 and 1964. On January 1, 1966, A deposits an amount equal to the seventh, eighth, and ninth annual premiums, and borrows $6,600 pursuant to such plan. Such borrowing is considered attributable to the premium paid for the policy year 1966 and deposited for the policy years 1967 and 1968. No deduction is allowed for interest paid by A on the $11,000 indebtedness during 1966. Moreover, the interest deduction will be disallowed for the taxable year 1965. However, if this contract is treated as a single premium contract under § 1.264–2 (by reason of deposit with the insurer of an amount for payment of a substantial number of future premiums), the deduction for interest on indebtedness incurred or continued to purchase or carry the contract would be denied without reference to this section.

(2) *The $100 exception.* The total amount paid or accrued during the taxable year by the taxpayer who has entered one or more plans referred to in paragraph (a) of this section for which (without regard to this subparagraph) no deduction would be allowable under paragraph (a) of this section does not exceed $100. Where the amount so paid or accrued during the taxable year exceeds $100, the entire amount shall be subject to the general rule of paragraph (a) of this section.

(3) *The unforeseen events exception.* The amount is paid or accrued by the taxpayer on indebtedness incurred because of an unforeseen substantial loss of such taxpayer's income or an unforeseen substantial increase in such taxpayer's financial obligations. A loss of income or increase in financial obligations is not unforeseen, within the meaning of this subparagraph, if at the time of the purchase of the contract such event was or could have been foreseen. College education expenses are foreseeable; however, if college expenses substantially increase, then to the extent that such increases are unforeseen, this exception will apply. This exception applies only if the plan referred to in paragraph (a) of this section arises because of the unforeseen event. Thus, for example, if a taxpayer or his family incur substantial unexpected medical expenses or the taxpayer is laid off from his job, and for that reason systematically borrows against the cash value of a previously purchased contract, the deduction for the interest paid on the loan will not be denied, whether or not the loan is used to pay a premium on the contract.

(4) *The trade or business exception.* The indebtedness is incurred by the taxpayer in connection with his trade or business. To be within this exception, the indebtedness must be incurred to finance business obligations rather than to finance cash value life insurance. Thus, if a taxpayer pledges a life insurance, endowment, or annuity contract as part of the collateral for a loan to finance the expansion of inventory or capital improvements for his business, no part of the deduction for interest on such loan will be denied under paragraph (a) of this section. Borrowing by a business taxpayer to finance business life insurance such as under so-called keyman, split dollar, or stock retirement plans is not considered to be incurred in connection with the taxpayer's trade or business within the meaning of this subparagraph. The determination of whether the indebtedness is incurred in connection with the taxpayer's trade or business, within the meaning of this exception, rather than to finance cash value life insurance shall be made on the basis of all the facts and circumstances. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Corporation M each year borrows substantial sums to carry on its business. Corporation M agrees to provide a retirement plan for its employees and purchases level premium life insurance to fund its obligation under the plan. The mere fact that M Corporation purchases a cash value life insurance policy will not cause its deduction for interest paid on its normal indebtedness to be denied even though the policy is later used as part of the collateral for its normal indebtedness.

Example 2. Corporation R has $200,000 of bonds outstanding and purchases cash value life insurance policies on several of its key employees. Such purchase by R Corporation will not, of itself, cause its deduction for interest on its bonded indebtedness to be denied. If, however, the premiums on the life insurance policies are $10,000 each year, the cash value increases by $8,000 each year, and R Corporation increases its indebtedness by $10,000 each year, its deduction for interest on such indebtedness will not be allowed under the rule of paragraph (a) of this section. On the other hand, the absence of such a directly parallel increase will not of itself establish that the deduction for interest is allowable.

(e) *Applicability of section.* The rules of this section apply with respect to taxable years beginning after December 31, 1963, but only with respect to contracts purchased after August 6, 1963. With respect to contracts entered into on or before August 6, 1963, but purchased or acquired whether from the insurer, insured, or any other person (other than by gift, bequest, or inheritance, or in a transaction to which section 381(a) of the Code applies) after such date, the rules of this section apply after such purchase or acquisition.

[T.D. 6773, 29 FR 15751, Nov. 24, 1964]

§1.265–1 Expenses relating to tax-exempt income.

(a) *Nondeductibility of expenses allocable to exempt income.* (1) No amount shall be allowed as a deduction under any provision of the Code for any expense or amount which is otherwise allowable as a deduction and which is allocable to a class or classes of exempt income other than a class or classes of exempt interest income.

(2) No amount shall be allowed as a deduction under section 212 (relating to expenses for production of income) for any expense or amount which is otherwise allowable as a deduction and which is allocable to a class or classes of exempt interest income.

(b) *Exempt income and nonexempt income.* (1) As used in this section, the term *class of exempt income* means any class of income (whether or not any amount of income of such class is received or accrued) wholly exempt from the taxes imposed by Subtitle A of the Code. For purposes of this section, a class of income which is considered as wholly exempt from the taxes imposed by subtitle A includes any class of income which is:

(i) Wholly excluded from gross income under any provision of Subtitle A, or

(ii) Wholly exempt from the taxes imposed by Subtitle A under the provisions of any other law.

(2) As used in this section the term *nonexempt income* means any income which is required to be included in gross income.

(c) *Allocation of expenses to a class or classes of exempt income.* Expenses and amounts otherwise allowable which are directly allocable to any class or classes of exempt income shall be allocated thereto; and expenses and amounts directly allocable to any class or classes of nonexempt income shall be allocated thereto. If an expense or amount otherwise allowable is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in the light of all the facts and circumstances in each case shall be allocated to each.

(d) *Statement of classes of exempt income; records.* (1) A taxpayer receiving any class of exempt income or holding any property or engaging in any activity the income from which is exempt shall submit with his return as a part thereof an itemized statement, in detail, showing (i) the amount of each class of exempt income, and (ii) the amount of expenses and amounts otherwise allowable allocated to each such class (the amount allocated by apportionment being shown separately) as required by paragraph (c) of this section. If an item is apportioned between a class of exempt income and a class of nonexempt income, the statement shall show the basis of the apportionment. Such statement shall also recite that each deduction claimed in the return is not in any way attributable to a class of exempt income.

(2) The taxpayer shall keep such records as will enable him to make the allocations required by this section. See section 6001 and the regulations thereunder.

§1.265–2 Interest relating to tax exempt income.

(a) *In general.* No amount shall be allowed as a deduction for interest on any indebtedness incurred or continued to purchase or carry obligations, the interest on which is wholly exempt from tax under subtitle A of the Code, such as municipal bonds, Panama Canal loan 3-percent bonds, or obligations of the United States, the interest on which is wholly exempt from tax under Subtitle A, and which were issued after September 24, 1917, and not originally subscribed for by the taxpayer. Interest paid or accrued within the taxable year on indebtedness incurred or continued to purchase or carry (1) obligations of the United States issued after September 24, 1917, the interest on which is not wholly exempt from the taxes imposed under Subtitle A of the Code, or (2) obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer, the interest on which is wholly exempt from the taxes imposed by Subtitle A of the Code, is deductible. For rules as to the inclusion in gross income of interest on certain governmental obligations, see section 103 and the regulations thereunder.

(b) *Special rule for certain financial institutions.* (1) No deduction shall be disallowed, for taxable years ending after February 26, 1964, under section 265(2) for interest paid or accrued by a financial institution which is a face-amount certificate company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 and following) and which is subject to the banking laws of the State in which it is incorporated, on face-amount certificates (as defined in section 2(a)(15) of the Investment Company Act of 1940) issued by such institution and on amounts received for the purchase of such certificates to be issued by the institution, if the average amount of obligations, the interest on which is wholly exempt from the taxes imposed by Subtitle A of the Code, held by such institution during the taxable year, does not exceed 15 percent of the average amount of the total assets of such institution during such year. See subparagraph (3) of this paragraph for treatment of interest paid or accrued on face-amount certificates where the figure is in excess of 15 percent. Interest expense other than that paid or accrued on face-amount certificates or on amounts received for the purchase of such certificates does not come within the rules of this paragraph.

(2) This subparagraph is prescribed under the authority granted the Secretary or his delegate under section 265(2) to prescribe regulations governing the determination of the average amount of tax-exempt obligations and of the total assets held during an institution's taxable year. The average amount of tax-exempt obligations held during an institution's taxable year shall be the average of the amounts of tax-exempt obligations held at the end of each month ending within such taxable year. The average amount of total assets for a taxable year shall be the average of the total assets determined at the beginning and end of the institution's taxable year. If the Commissioner, however, determines that any such amount is not fairly representative of the average amount of tax-exempt obligations or total assets, as the case may be, held by such institution during such taxable year, then the Commissioner shall determine the amount which is fairly representative of the average amount of tax-exempt obligations or total assets, as the case may be. The percentage which the average amount of tax-exempt obligations is of the average amount of total assets is determined by dividing the average amount of tax-exempt obligations by the average amount of total assets, and multiplying by 100. The amount of tax-exempt obligations means that portion of the total assets of the institution which consists of obligations the interest on which is wholly exempt from tax under Subtitle A of the Code, and valued at their adjusted basis, appropriately adjusted for amortization of premium or discount. Total assets means the sum of the money, plus the aggregate of the adjusted basis of the property other than money held by the taxpayer in good faith for the purpose of the business. Such adjusted basis for any asset is its adjusted basis for determining gain upon sale or exchange for Federal income tax purposes.

(3) If the percentage computation required by subparagraph (2) of this paragraph results in a figure in excess of 15 percent for the taxable year, there is interest that does not come within the special rule for certain financial institutions contained in section 265(2). The amount of such interest is obtained by multiplying the total interest paid or accrued for the taxable year on face-amount certificates and on amounts received for the purchase of such certificates by the percentage figure equal to the excess of the percentage figure computed under subparagraph (2) of this paragraph over 15 percent. See

paragraph (a) for the disallowance of interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from tax under Subtitle A of the Code.

(4) Every financial institution claiming the benefits of the special rule for certain financial institutions contained in section 265(2) shall file with its return for the taxable year:

(i) A statement showing that it is a face-amount certificate company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 and following) and that it is subject to the banking laws of the State in which it is incorporated.

(ii) A detailed schedule showing the computation of the average amount of tax-exempt obligations, the average amount of total assets of such institutions, and the total amount of interest paid or accrued on face-amount certificates and on amounts received for the purchase of such certificates for the taxable year.

[T.D. 6927, 32 FR 13221, Sept. 19, 1967]

§1.265–3 Nondeductibility of interest relating to exempt-interest dividends.

(a) *In general.* No deduction is allowed to a shareholder of a regulated investment company for interest on indebtedness that relates to exempt-interest dividends distributed by the company to the shareholder during the shareholder's taxable year.

(b) *Interest relating to exempt-interest dividends.* (1) All or a portion of the interest on an indebtedness relates to exempt-interest dividends if the indebtedness is either incurred or continued to purchase or carry shares of stock of a regulated investment company that distributes exempt-interest dividends (as defined in section 852(b)(5) of the Code) to the holder of the shares during the shareholder's taxable year.

(2) To determine the amount of interest that relates to the exempt-interest dividends the total amount of interest paid or accrued on the indebtedness is multiplied by a fraction. The numerator of the fraction is the amount of exempt-interest dividends received by the shareholder. The denominator of the fraction is the sum of the exempt-interest dividends and taxable dividends received by the shareholder (excluding capital gain dividends received by the shareholder and capital gains required to be included in the shareholder's computation of long-term capital gains under section 852(b)(3)(D)).

[T.D. 7601, 44 FR 16013, Mar. 16, 1979]

§1.266–1 Taxes and carrying charges chargeable to capital account and treated as capital items.

(a)(1) *In general.* In accordance with section 266, items enumerated in paragraph (b)(1) of this section may be capitalized at the election of the taxpayer. Thus, taxes and carrying charges with respect to property of the type described in this section are chargeable to capital account at the election of the taxpayer, notwithstanding that they are otherwise expressly deductible under provisions of Subtitle A of the Code. No deduction is allowable for any items so treated.

(2) See §§1.263A–8 through 1.263A–15 for rules regarding the requirement to capitalize interest, that apply prior to the application of this section. After applying §§1.263A–8 through 1.263A–15, a taxpayer may elect to capitalize interest under section 266 with respect to designated property within the meaning of §1.263A–8(b), provided a computation under any provision of the Internal Revenue Code is not thereby materially distorted, including computations relating to the source of deductions.

(b) *Taxes and carrying charges.* (1) The taxpayer may elect, as provided in paragraph (c) of this section, to treat the items enumerated in this subparagraph which are otherwise expressly deductible under the provisions of Subtitle A of the Code as chargeable to capital account either as a component of original cost or other basis, for the purposes of section 1012, or as an adjustment to basis, for the purposes of section 1016(a)(1). The items thus chargeable to capital account are:

(i) In the case of unimproved and unproductive real property: Annual taxes, interest on a mortgage, and other carrying charges.

(ii) In the case of real property, whether improved or unimproved and whether productive or unproductive:

(a) Interest on a loan (but not theoretical interest of a taxpayer using his own funds),

(b) Taxes of the owner of such real property measured by compensation paid to his employees,

(c) Taxes of such owner imposed on the purchase of materials, or on the storage, use, or other consumption of materials, and

(d) Other necessary expenditures, paid or incurred for the development of the real property or for the construction of an improvement or additional improvement to such real property, up to the time the development or construction work has been completed. The development or construction work with respect to which such items are incurred may relate to unimproved and unproductive real estate whether the construction work will make the property productive of income subject to tax (as in the case of a factory) or not (as in the case of a personal residence), or may relate to property already improved or productive (as in the case of a plant addition or improvement, such as the construction of another floor on a factory or the installation of insulation therein).

(iii) In the case of personal property:

(a) Taxes of an employer measured by compensation for services rendered in transporting machinery or other fixed assets to the plant or installing them therein,

(b) Interest on a loan to purchase such property or to pay for transporting or installing the same, and

(c) Taxes of the owner thereof imposed on the purchase of such property or on the storage, use, or other consumption of such property, paid or incurred up to the date of installation or the date when such property is first put into use by the taxpayer, whichever date is later.

(iv) Any other taxes and carrying charges with respect to property, otherwise deductible, which in the opinion of the Commissioner are, under sound accounting principles, chargeable to capital account.

(2) The sole effect of section 266 is to permit the items enumerated in subparagraph (1) of this paragraph to be chargeable to capital account notwithstanding that such items are otherwise expressly deductible under the provisions of Subtitle A of the Code. An item not otherwise deductible may not be capitalized under section 266.

(3) In the absence of a provision in this section for treating a given item as a capital item, this section has no effect on the treatment otherwise accorded such item. Thus, items which are otherwise deductible are deductible notwithstanding the provisions of this section, and items which are otherwise treated as capital items are to be so treated. Similarly, an item not otherwise deductible is not made deductible by this section. Nor is the absence of a provision in this section for treating a given item as a capital item to be construed as withdrawing or modifying the right now given to the taxpayer under any other provisions of subtitle A of the Code, or of the regulations thereunder, to elect to capitalize or to deduct a given item.

(c) *Election to charge taxes and carrying charges to capital account.* (1) If for any taxable year there are two or more items of the type described in paragraph (b)(1) of this section, which relate to the same project to which the election is applicable, the taxpayer may elect to capitalize any one or more of such items even though he does not elect to capitalize the remaining items or to capitalize items of the same type relating to other projects. However, if expenditures for several items of the same type are incurred with respect to a single project, the election to capitalize must, if exercised, be exercised as to all items of that type. For purposes of this section, a *project* means, in the case of items described in paragraph (b)(1)(ii) of this section, a particular development of, or construction of an improvement to, real property, and in the case of items described in paragraph (b)(1)(iii) of this section, the transportation and installation of machinery or other fixed assets.

(2)(i) An election with respect to an item described in paragraph (b)(1)(i) of this section is effective only for the year for which it is made.

(ii) An election with respect to an item described in:

(a) Paragraph (b)(1)(ii) of this section is effective until the development or

construction work described in that subdivision has been completed;

(b) Paragraph (b)(1)(iii) of this section is effective until the later of either the date of installation of the property described in that subdivision, or the date when such property is first put into use by the taxpayer;

(*c*) Paragraph (b)(1)(iv) of this section is effective as determined by the Commissioner.

Thus, an item chargeable to capital account under this section must continue to be capitalized for the entire period described in this subdivision applicable to such election although such period may consist of more than one taxable year.

(3) If the taxpayer elects to capitalize an item or items under this section, such election shall be exercised by filing with the original return for the year for which the election is made a statement indicating the item or items (whether with respect to the same project or to different projects) which the taxpayer elects to treat as chargeable to capital account. Elections filed for taxable years beginning before January 1, 1954, and for taxable years ending before August 17, 1954, under section 24(a)(7) of the Internal Revenue Code of 1939, and the regulations thereunder, shall have the same effect as if they were filed under this section. See section 7807(b)(2).

(d) The following examples are illustrative of the application of the provisions of this section:

Example 1. In 1956 and 1957 A pays annual taxes and interest on a mortgage on a piece of real property. During 1956, the property is vacant and unproductive, but throughout 1957 A operates the property as a parking lot. A may capitalize the taxes and mortgage interest paid in 1956, but not the taxes and mortgage interest paid in 1957.

Example 2. In February 1957, B began the erection of an office building for himself. B in 1957, in connection with the erection of the building, paid $6,000 social security taxes, which in his 1957 return he elected to capitalize. B must continue to capitalize the social security taxes paid in connection with the erection of the building until its completion.

Example 3. Assume the same facts as in *Example (2)* except that in November 1957, B also begins to build a hotel. In 1957 B pays $3,000 social security taxes in connection with the erection of the hotel. B's election to capitalize the social security taxes paid in erecting the office building started in February 1957 does not bind him to capitalize the social security taxes paid in erecting the hotel; he may deduct the $3,000 social security taxes paid in erecting the hotel.

Example 4. In 1957, M Corporation began the erection of a building for itself, which will take three years to complete. M Corporation in 1957 paid $4,000 social security taxes and $8,000 interest on a building loan in connection with this building. M Corporation may elect to capitalize the social security taxes although it deducts the interest charges.

Example 5. C purchases machinery in 1957 for use in his factory. He pays social security taxes on the labor for transportation and installation of the machinery, as well as interest on a loan to obtain funds to pay for the machinery and for transportation and installation costs. C may capitalize either the social security taxes or the interest, or both, up to the date of installation or until the machinery is first put into use by him, whichever date is later.

(e) *Allocation.* If any tax or carrying charge with respect to property is in part a type of item described in paragraph (b) of this section and in part a type of item or items with respect to which no election to treat as a capital item is given, a reasonable proportion of such tax or carrying charge, determined in the light of all the facts and circumstances in each case, shall be allocated to each item. The rule of this paragraph may be illustrated by the following example:

Example. N Corporation, the owner of a factory in New York on which a new addition is under construction, in 1957 pays its general manager, B, a salary of $10,000 and also pays a New York State unemployment insurance tax of $81 on B's salary. B spends nine-tenths of his time in the general business of the firm and the remaining one-tenth in supervising the construction work. N Corporation treats as expenses $9,000 of B's salary, and charges the remaining $1,000 to capital account. N Corporation may elect to capitalize $8.10 of the $81 New York State unemployment insurance tax paid in 1957 since such tax is deductible under section 164.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8584, 59 FR 67215, Dec. 29, 1994]

§ 1.267(a)–1 Deductions disallowed.

(a) *Losses.* Except in cases of distributions in corporate liquidations, no deduction shall be allowed for losses arising from direct or indirect sales or exchanges of property between persons who, on the date of the sale or exchange, are within any one of the relationships specified in section 267(b). See § 1.267(b)–1.

(b) *Unpaid expenses and interest.* (1) No deduction shall be allowed a taxpayer for trade or business expenses otherwise deductible under section 162, for expenses for production of income otherwise deductible under section 212, or for interest otherwise deductible under section 163:

(i) If, at the close of the taxpayer's taxable year within which such items are accrued by the taxpayer or at any time within 2 1/2 months thereafter, both the taxpayer and the payee are persons within any one of the relationships specified in section 267(b) (see § 1.267(b)–1); and

(ii) If the payeee is on the cash receipts and disbursements method of accounting with respect to such items of gross income for his taxable year in which or with which the taxable year of accrual by the debtor-taxpayer ends; and

(iii) If, within the taxpayer's taxable year within which such items are accrued by the taxpayer and 2 1/2 months after the close thereof, the amount of such items is not paid and the amount of such items is not otherwise (under the rules of constructive receipt) includible in the gross income of the payee.

(2) The provisions of section 267(a)(2) and this paragraph do not otherwise affect the general rules governing the allowance of deductions under an accrual method of accounting. For example, if the accrued expenses or interest are paid after the deduction has become disallowed under section 267(a)(2), no deduction would be allowable for the taxable year in which payment is made, since an accrual item is deductible only in the taxable year in which it is properly accruable.

(3) The expenses and interest specified in section 267(a)(2) and this paragraph shall be considered as paid for purposes of that section to the extent of the fair market value on the date of issue of notes or other instruments of similar effect received in payment of such expenses or interest if such notes or other instruments were issued in such payment by the taxpayer within his taxable year or within 2 1/2 months after the close thereof. The fair market value on the date of issue of such notes or other instruments of similar effect is includible in the gross income of the payee for the taxable year in which he receives the notes or other instruments.

(4) The provisions of this paragraph may be illustrated by the following example:

Example. A, an individual, is the holder and owner of an interest-bearing note of the M Corporation, all the stock of which was owned by him on December 31, 1956. A and the M Corporation make their income tax returns for a calendar year. The M Corporation uses an accrual method of accounting. A uses a combination of accounting methods permitted under section 446(c)(4) in which he uses the cash receipts and disbursements method in respect of items of gross income. The M Corporation does not pay any interest on the note to A during the calendar year 1956 or within 2 1/2 months after the close of that year, nor does it credit any interest to A's account in such a manner that it is subject to his unqualified demand and thus is constructively received by him. M Corporation claims a deduction for the year 1956 for the interest accruing on the note in that year. Since A is on the cash receipts and disbursements method in respect of items of gross income, the interest is not includible in his return for the year 1956. Under the provisions of section 267(a)(2) and this paragraph, no deduction for such interest is allowable in computing the taxable income of the M Corporation for the taxable year 1956 or for any other taxable year. However, if the interest had actually been paid to A on or before March 15, 1957, or if it had been made available to A before that time (and thus had been constructively received by him), the M Corporation would be allowed to deduct the amount of the payment in computing its taxable income for 1956.

(c) *Scope of section.* Section 267(a) requires that deductions for losses or unpaid expenses or interest described therein be disallowed even though the transaction in which such losses, expenses, or interest were incurred was a bona fide transaction. However, section 267 is not exclusive. No deduction for losses or unpaid expenses or interest arising in a transaction which is not bona fide will be allowed even though section 267 does not apply to the transaction.

§1.267(a)–2T Temporary regulations; questions and answers arising under the Tax Reform Act of 1984 (temporary).

(a) *Introduction*—(1) *Scope.* This section prescribes temporary question and answer regulations under section 267(a) and related provisions as amended by section 174 of the Tax Reform Act of 1984, Pub. L. No. 98–369.

(2) *Effective date.* Except as otherwise provided by *Answer 2* or *Answer 3* in paragraph (c) of this section, the effective date set forth in section 174(c) of the Tax Reform Act of 1984 applies to this section.

(b) *Questions applying section 267(a)(2) and (b) generally.* The following questions and answers deal with the application of section 267(a)(2) and (b) generally:

Question 1: Does section 267(a)(2) ever apply to defer the deduction of an otherwise deductible amount if the person to whom the payment is to be made properly uses the completed contract method of accounting with respect to such amount?

Answer 1: No. Section 267(a)(2) applies only if an otherwise deductible amount is owed to a related person under whose method of accounting such amount is not includible in income unless paid to such person. Regardless of when payment is made, an amount owed to a contractor using the completed contract method of accounting is includible in the income of the contractor in accordance with §1.451–3(d) in the year in which the contract is completed or in which certain disputes are resolved.

Question 2: Does section 267(a)(2) ever apply to defer the deduction of otherwise deductible original issue discount as defined in sections 163(e) and 1271 through 1275 (‘‘the OID rules’’)?

Answer 2. No. Regardless of when payment is made, an amount owed to a lender that constitutes original issue discount is included in the income of the lender periodically in accordance with the OID rules. Similarly, section 267(a)(2) does not apply to defer an otherwise deductible amount to the extent section 467 or section 7872 requires periodic inclusion of such amount in the income of the person to whom payment is to be made, even though payment has not been made.

Question 3: Does section 267(a)(2) ever apply to defer the deduction of otherwise deductible unstated interest determined to exist under section 483?

Answer 3: Yes. If section 483 recharacterizes any amount as unstated interest and the other requirements of section 267(a)(2) are met, a deduction for such unstated interest will be deferred under section 267.

Question 4: Does section 267(a)(2) ever apply to defer the deduction of otherwise deductible cost recovery, depreciation, or amortization?

Answer 4: Yes, in certain cases. In general, section 267(a)(2) does not apply to defer the deduction of otherwise deductible cost recovery, depreciation, or amortization. Notwithstanding this general rule, if the other requirements of section 267(a)(2) are met, section 267(a)(2) does apply to defer deductions for cost recovery, depreciation, or amortization of an amount owed to a related person for interest or rent or for the performance or nonperformance of services, which amount the taxpayer payor capitalized or treated as a deferred expense (unless the taxpayer payor elected to capitalize or defer the amount and section 267(a)(2) would not have deferred the deduction of such amount if the taxpayer payor had not so elected). Amounts owed for services that may be subject to this provision include, for example, amounts owed for acquisition, development, or organizational services or for covenants not to compete. In applying this rule, payments made between persons described in any of the paragraphs of section 267(b) (as modified by section 267(e)) will be closely scrutinized to determine whether they are made in respect of capitalized costs (or costs treated as deferred expenses) that are subject to deferral under section 267(a)(2), or in respect of other capitalized costs not so subject.

Question 5: If a deduction in respect of an otherwise deductible amount is deferred by section 267(a)(2) and, prior to the time the amount is includible in the gross income of the person to whom payment is to be made, such person and the payor taxpayer cease to be persons specified in any of the paragraphs of section 267(b) (as modified by section 267(e)), is the deduction allowable as of the day on which the relationship ceases?

Answer 5: No. The deduction is not allowable until the day as of which the amount is includible in the gross income of the person to whom payment of the amount is made, even though the relationship ceases to exist at an earlier time.

Question 6: Do references in other sections to persons described in section 267(b) incorporate changes made to section 267(b) by section 174 of the Tax Reform Act of 1984?

Answer 6: Yes. References in other sections to persons described in section 267(b) take into account changes made to section 267(b) by section 174 of the Tax Reform Act of 1984 (without modification by section 267(e)(1)). For example, a transfer after December 31, 1983 (the effective date of the new section 267(b)(3) relationship added by the Tax Reform Act of 1984) of section 1245 class property placed in service before January 1, 1981, from one corporation to another corporation, 11 percent of the stock of which is owned by the first corporation, will not constitute recovery property (as defined in section 168) in the hands of the second corporation by reason of section 168(e)(4) (A)(i) and (D).

(c) *Questions applying section 267(a) to partnerships.* The following questions and answers deal with the application of section 267(a) to partnerships:

Question 1: Does section 267(a) disallow losses and defer otherwise deductible amounts at the partnership (entity) level?

Answer 1: Yes. If a loss realized by a partnership from a sale or exchange of property is disallowed under section 267(a)(1), that loss shall not enter into the computation of the partnership's taxable income. If an amount that otherwise would be deductible by a partnership is deferred by section 267(a)(2), that amount shall not enter into the computation of the partnership's taxable income until the taxable year of the partnership in which falls the day on which the amount is includible in the gross income of the person to whom payment of the amount is made.

Question 2: Does section 267(a)(1) ever apply to disallow a loss if the sale or exchange giving rise to the loss is between two partnerships even though the two partnerships are not persons specified in any of the paragraphs of section 267(b)?

Answer 2: Yes. If the other requirements of section 267(a)(1) are met, section 267(a)(1) applies to such losses arising as a result of transactions entered into after December 31, 1984 between partnerships not described in any of the paragraphs of section 267(b) as follows, and § 1.267(b)–1(b) does not apply. If the two partnerships have one or more common partners (*i.e.,* if any person owns directly, indirectly, or constructively any capital or profits interest in each of such partnerships), or if any partner in either partnership and one or more partners in the other partnership are persons specified in any of the paragraphs of section 267(b) (without modification by section 267(e)), a portion of the selling partnership's loss will be disallowed under section 267(a)(1). The amount disallowed under this rule is the greater of: (1) The amount that would be disallowed if the transaction giving rise to the loss had occurred between the selling partnership and the separate partners of the purchasing partnership (in proportion to their respective interests in the purchasing partnership); or (2) the amount that would be disallowed if such transaction had occurred between the separate partners of the selling partnership (in proportion to their respective interests in the selling partnership) and the purchasing partnership. Notwithstanding the general rule of this paragraph (c) *Answer 2,* no disallowance shall occur if the amount that would be disallowed pursuant to the immediately preceding sentence is less than 5 percent of the loss arising from the sale or exchange.

Question 3: Does section 267(a)(2) ever apply to defer an otherwise deductible amount if the taxpayer payor is a partnership and the person to whom payment of such amount is to be made is a partnership even though the two partnerships are not persons specified in any of the paragraphs of section 267(b) (as modified by section 267(e))?

Answer 3: Yes. If the other requirements of section 267(a)(2) are met, section 267(a)(2) applies to such amounts arising as a result of transactions entered into after December 31, 1984 between partnerships not described in any of the paragraphs of section 267(b) (as modified by section 267(e)) as follows, and §1.267(b)–1(b) does not apply. If the two partnerships have one or more common partners (*i.e.*, if any person owns directly, indirectly, or constructively any capital or profits interest in each of such partnerships), or if any partner in either partnership and one or more partners in the other partnership are persons specified in any of the paragraphs of section 267(b) (without modification by section 267(e)), a portion of the payor partnership's otherwise allowable deduction will be deferred under section 267(a)(2). The amount deferred under this rule is the greater of: (1) The amount that would be deferred if the transaction giving rise to the otherwise allowable deduction had occurred between the payor partnership and the separate partners of the payee partnership (in proportion to their respective interests in the payee partnership); or (2) the amount that would be deferred if such transaction had occurred between the separate partners of the payor partnership (in proportion to their respective interests in the payor partnership) and the payee partnership. Notwithstanding the general rule of this paragraph (c) *Answer 3*, no deferral shall occur if the amount that would be deferred pursuant to the immediately preceding sentence is less than 5 percent of the otherwise allowable deduction.

Example. On May 1, 1985, partnership AB enters into a transaction whereby it accrues an otherwise deductible amount to partnership AC. AC is on the cash receipts and disbursements method of accounting. A holds a 5 percent capital and profits interest in AB and a 49 percent capital and profits interest in AC, and A's interest in each item of the income, gain, loss, deduction, and credit of each partnership is 5 percent and 49 percent, respectively. B and C are not related. Notwithstanding that AB and AC are not persons specified in section 267(b), 49 percent of the deduction in respect of such amount will be deferred under section 267(a)(2). The result would be the same if A held a 49 percent interest in AB and a 5 percent interest in AC. However, if A held more than 50 percent of the capital or profits interest of either AB or AC, the entire deduction in respect of such amount would be deferred under section 267(a)(2).

Question 4: What does the phrase *incurred at an annual rate not in excess of 12 percent* mean as used in section 267(e)(5)(C)(ii)?

Answer 4: The phrase refers to interest that accrues but is not includible in the income of the person to whom payment is to be made during the taxable year of the payor. Thus, in determining whether the requirements of section 267(e)(5) (providing an exception to certain provisions of section 267 for certain expenses and interest of partnerships owning low income housing) are met with respect to a transaction, the requirement of section 267(e)(5)(C)(ii) will be satisfied, even though the total interest (both stated and unstated) paid or accrued in any taxable year of the payor taxpayer exceeds 12 percent, if the interest in excess of 12 percent per annum, compounded semi-annually, on the outstanding loan balance (principal and accrued but unpaid interest) is includible in the income of the person to whom payment is to be made no later than the last day of such taxable year of the payor taxpayer.

(98 Stat. 704, 26 U.S.C. 267; 98 Stat. 589, 26 U.S.C. 706; 68A Stat. 367, 26 U.S.C. 1502; 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7991, 49 FR 46995, Nov. 30, 1984]

§1.267(a)–3 Deduction of amounts owed to related foreign persons.

(a) *Purpose and scope.* This section provides rules under section 267(a) (2) and (3) governing when an amount owed to a related foreign person that is otherwise deductible under Chapter 1 may be deducted. Paragraph (b) of this section provides the general rules, and paragraph (c) of this section provides exceptions and special rules.

(b) *Deduction of amount owed to related foreign person*—(1) *In general.* Except as provided in paragraph (c) of this section, section 267(a)(3) requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to a related foreign person. An amount that is owed to a related foreign person and that is otherwise deductible under Chapter 1 thus may not be deducted by the taxpayer until such amount is paid to the related foreign person. For purposes of this section, a related foreign person is any person that is not a United States person within the meaning of section 7701(a)(30), and that is related (within the meaning of section 267(b)) to the taxpayer at the close of the taxable year in which the amount incurred by the taxpayer would otherwise be deductible. Section 267(f) defines *controlled group* for purposes of section 267(b) without regard to the limitations of section 1563(b). An amount is treated as paid for purposes of this section if the amount is considered paid for purposes of section 1441 or section 1442 (including an amount taken into account pursuant to section 884(f)).

(2) *Amounts covered.* This section applies to otherwise deductible amounts that are of a type described in section 871(a)(1) (A), (B) or (D), or in section 881(a) (1), (2) or (4). The rules of this section also apply to interest that is from sources outside the United States. Amounts other than interest that are from sources outside the United States, and that are not income of a related foreign person effectively connected with the conduct by such related foreign person of a trade or business within the United States, are not subject to the rules of section 267(a) (2) or (3) or this section. See paragraph (c) of this section for rules governing the treatment of amounts that are income of a related foreign person effectively connected with the conduct of a trade or business within the United States by such related foreign person.

(3) *Change in method of accounting.* A taxpayer that uses a method of accounting other than that required by the rules of this section must change its method of accounting to conform its method to the rules of this section. The taxpayer's change in method must be made pursuant to the rules of section 446(e), the regulations thereunder, and any applicable administrative procedures prescribed by the Commissioner. Because the rules of this section prescribe a method of accounting, these rules apply in the determination of taxpayer's earnings and profits pursuant to § 1.1312–6(a).

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

Example 1. (i) FC, a corporation incorporated in Country X, owns 100 percent of the stock of C, a domestic corporation. C uses the accrual method of accounting in computing its income and deductions, and is a calendar year taxpayer. In Year 1, C accrues an amount owed to FC for interest. C makes an actual payment of the amount owed to FC in Year 2.

(ii) Regardless of its source, the interest owed to FC is an amount to which this section applies. Pursuant to the rules of this paragraph (b), the amount owed to FC by C will not be allowable as a deduction in Year 1. Section 267 does not preclude the deduction of this amount in Year 2.

Example 2. (i) RS, a domestic corporation, is the sole shareholder of FSC, a foreign sales corporation. Both RS and FSC use the accrual method of accounting. In Year 1, RS accrues $z owed to FSC for commissions earned by FSC in Year 1. Pursuant to the foreign sales company provisions, sections 921 through 927, a portion of this amount, $x, is treated as effectively connected income of FSC from sources outside the United States. Accordingly, the rules of section 267(a)(3) and paragraph (b) of this section do not apply. See paragraph (c) of this section for the rules governing the treatment of amounts that are effectively connected income of FSC.

(ii) The remaining amount of the commission, $y, is classified as exempt foreign trade income under section 923(a)(3) and is treated as income of FSC from sources outside the United States that is not effectively connected income. This amount is one to which the provisions of this section do not apply, since it is an amount other than interest from sources outside the United States and is not effectively connected income. Therefore, a deduction for $y is allowable to RS as of the day on which it accrues the otherwise deductible amount, without regard to section 267 (a)(2) and (a)(3) and the regulations thereunder.

(c) *Exceptions and special rules*—(1) *Effectively connected income subject to United States tax.* The provisions of section 267(a)(2) and the regulations thereunder, and not the provisions of paragraph (b) of this section, apply to an amount that is income of the related foreign person that is effectively connected with the conduct of a United States trade or business of such related foreign person. An amount described in this paragraph (c)(1) thus is allowable as a deduction as of the day on which the amount is includible in the gross income of the related foreign person as effectively connected income under sections 872(a)(2) or 882(b) (or, if later, as of the day on which the deduction would be so allowable but for section 267(a)(2)). However, this paragraph (c)(1) does not apply if the related foreign person is exempt from United States income tax on the amount owed, or is subject to a reduced rate of tax, pursuant to a treaty obligation of the United States (such as under an article relating to the taxation of business profits).

(2) *Items exempt from tax by treaty.* Except with respect to interest, neither paragraph (b) of this section nor section 267 (a)(2) or (a)(3) applies to any amount that is income of a related foreign person with respect to which the related foreign person is exempt from United States taxation on the amount owed pursuant to a treaty obligation of the United States (such as under an article relating to the taxation of business profits). Interest that is effectively connected income of the related foreign person under sections 872(a)(2) or 882(b) is an amount covered by paragraph (c)(1) of this section. Interest that is not effectively connected income of the related foreign person is an amount covered by paragraph (b) of this section, regardless of whether the related foreign person is exempt from United States taxation on the amount owed pursuant to a treaty obligation of the United States.

(3) *Items subject to reduced rate of tax by treaty.* Paragraph (b) of this section applies to amounts that are income of a related foreign person with respect to which the related foreign person claims a reduced rate of United States income tax on the amount owed pursuant to a treaty obligation of the United States (such as under an article relating to the taxation of royalties).

(4) *Amounts owed to a foreign personal holding company, controlled foreign corporation, or passive foreign investment company*—(i) *Foreign personal holding companies.* If an amount to which paragraph (b) of this section otherwise applies is owed to a related foreign person that is a foreign personal holding company within the meaning of section 552, then the amount is allowable as a deduction as of the day on which the amount is includible in the income of the foreign personal holding company. The day on which the amount is includible in income is determined with reference to the method of accounting under which the foreign personal holding company computes its taxable income and earnings and profits for purposes of sections 551 through 558. See section 551(c) and the regulations thereunder for the reporting requirements of the foreign personal holding company provisions (sections 551 through 558).

(ii) *Controlled foreign corporations.* If an amount to which paragraph (b) of this section otherwise applies is owed to a related foreign person that is a controlled foreign corporation within the meaning of section 957, then the amount is allowable as a deduction as of the day on which the amount is includible in the income of the controlled foreign corporation. The day on which the amount is includible in income is determined with reference to the method of accounting under which the controlled foreign corporation computes its taxable income and earnings and profits for purposes of sections 951 through 964. See section 6038 and the regulations thereunder for the reporting requirements of the controlled foreign corporation provisions (sections 951 through 964).

(iii) *Passive foreign investment companies.* If an amount to which paragraph (b) of this section otherwise applies is owed to a related foreign person that is a passive foreign investment company within the meaning of section 1296, then the amount is allowable as a deduction as of the day on which amount is includible in the income of the passive foreign investment company. The day on which the amount is includible in income is determined with reference to the method of accounting under which the earnings and profits of the passive foreign investment company are computed for purposes of sections 1291 through 1297. See sections 1291 through 1297 and the regulations thereunder for the reporting requirements of the passive foreign investment company provisions. This exception shall apply, however, only if the person that owes the amount at issue has made and has in effect an election pursuant to section 1295 with respect to the passive foreign investment company to which the amount at issue is owed.

(iv) *Examples.* The rules of this paragraph (c)(4) may be illustrated by the following examples. Application of the provisions of sections 951 through 964 are provided for illustration only, and do not provide substantive rules concerning the operation of those provisions. The principles of these examples apply equally to the provisions of paragraphs (c)(4) (i) through (iii) of this section.

Example 1. P, a domestic corporation, owns 100 percent of the total combined voting power and value of the stock of both FC1 and FC2. P is a calendar year taxpayer that uses the accrual method of accounting in computing its income and deductions. FC1 is incorporated in Country X, and FC2 is incorporated in Country Y. FC1 and FC2 are controlled foreign corporations within the meaning of section 957, and are both calendar year taxpayers. FC1 computes its taxable income and earnings and profits, for purposes of sections 951 through 964, using the accrual method of accounting, while FC2 uses the cash method. In Year 1 FC1 has gross income of $10,000 that is described in section 952 (a) (''subpart F income''), and which includes interest owed to FC1 by P that is described in paragraph (b) of this section and that is otherwise allowable as a deduction to P under chapter 1. The interest owed to FC1 is allowable as a deduction to P in Year 1.

Example 2. The facts are the same as in *Example 1,* except that in Year 1 FC1 reports no subpart F income because of the application of section 954 (b)(3)(A) (the subpart F de minimis rule). Because the amount owed to FC1 by P is includible in FC1's gross income in Year 1, the interest owed to FC1 is allowable as a deduction to P in Year 1.

Example 3. The facts are the same as in *Example 1.* In Year 1, FC1 accrues interest owed to FC2 that would be allowable as a deduction by FC1 under chapter 1 if FC1 were a domestic corporation. The interest owed to FC2 by FC1 is paid by FC1 in Year 2. Because FC2 uses the cash method of accounting in computing its taxable income for purposes of subpart F, the interest owed by FC1 is allowable as a deduction by FC1 in Year 2, and not in Year 1.

(d) *Effective date.* The rules of this section are effective with respect to interest that is allowable as a deduction under chapter 1 (without regard to the rules of this section) in taxable years beginning after December 31, 1983, but are not effective with respect to interest that is incurred with respect to indebtedness incurred on or before September 29, 1983, or incurred after that date pursuant to a contract that was binding on that date and at all times thereafter (unless the indebtedness or the contract was renegotiated, extended, renewed, or revised after that date). The regulations in this section issued under section 267 apply to all other deductible amounts that are incurred after July 31, 1989, but do not apply to amounts that are incurred pursuant to a contract that was binding on September 29, 1983, and at all times thereafter (unless the contract was renegotiated, extended, renewed, or revised after that date).

[T.D. 8465, 58 FR 237, Jan. 5, 1993]

§ 1.267(b)–1 Relationships.

(a) *In general.* (1) The persons referred to in section 267(a) and § 1.267 (a)–1 are specified in section 267(b).

(2) Under section 267(b)(3), it is not necessary that either of the two corporations be a personal holding company or a foreign personal holding company for the taxable year in which the sale or exchange occurs or in which the expenses or interest are properly accruable, but either one of them must be such a company for the taxable year next preceding the taxable year in which the sale or exchange occurs or in which the expenses or interest are accrued.

(3) Under section 267(b)(9), the control of certain educational and charitable organizations exempt from tax under section 501 includes any kind of control, direct or indirect, by means of which a person in fact controls such an organization, whether or not the control is legally enforceable and regardless of the method by which the control is exercised or exercisable. In the case of an individual, control possessed by the individual's family, as defined in section 267(c)(4) and paragraph (a)(4) of § 1.267 (c)–1, shall be taken into account.

(b) *Partnerships.* (1) Since section 267 does not include members of a partnership and the partnership as related persons, transactions between partners and partnerships do not come within the scope of section 267. Such transactions are governed by section 707 for the purposes of which the partnership is considered to be an entity separate from the partners. See section 707 and §1.707–1. Any transaction described in section 267(a) between a partnership and a person other than a partner shall be considered as occurring between the other person and the members of the partnership separately. Therefore, if the other person and a partner are within any one of the relationships specified in section 267(b), no deductions with respect to such transactions between the other person and the partnership shall be allowed:

(i) To the related partner to the extent of his distributive share of partnership deductions for losses or unpaid expenses or interest resulting from such transactions, and

(ii) To the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by such other person at a loss, or to the extent of the related partner's distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of such transaction.

(2) The provisions of this paragraph may be illustrated by the following examples:

Example 1. A, an equal partner in the ABC partnership, personally owns all the stock of M Corporation. B and C are not related to A. The partnership and all the partners use an accrual method of accounting, and are on a calendar year. M Corporation uses the cash receipts and disbursements method of accounting and is also on a calendar year. During 1956 the partnership borrowed money from M Corporation and also sold property to M Corporation, sustaining a loss on the sale. On December 31, 1956, the partnership accrued its interest liability to the M Corporation and on April 1, 1957 (more than 2 1/2 months after the close of its taxable year), it paid the M Corporation the amount of such accrued interest. Applying the rules of this paragraph, the transactions are considered as occurring between M Corporation and the partners separately. The sale and interest transactions considered as occurring between A and the M Corporation fall within the scope of section 267 (a) and (b), but the transactions considered as occurring between partners B and C and the M Corporation do not. The latter two partners may, therefore, deduct their distributive shares of partnership deductions for the loss and the accrued interest. However, no deduction shall be allowed to A for his distributive shares of these partnership deductions. Furthermore, A's adjusted basis for his partnership interest must be decreased by the amount of his distributive share of such deductions. See section 705(a)(2).

Example 2. Assume the same facts as in *Example (1)* of this subparagraph except that the partnership and all the partners use the cash receipts and disbursements method of accounting, and that M Corporation uses an accrual method. Assume further, that during 1956 M Corporation borrowed money from the partnership and that on a sale of property to the partnership during that year M Corporation sustained a loss. On December 31, 1956, the M Corporation accrued its interest liability on the borrowed money and on April 1, 1957 (more than 2 1/2 months after the close of its taxable year) it paid the accrued interest to the partnership. The corporation's deduction for the accrued interest is not allowed to the extent of A's distributive share (one-third) of such interest income. M Corporation's deduction for the loss on the sale of the property to the partnership is not allowed to the extent of A's one-third interest in the purchased property.

§1.267(c)–1 Constructive ownership of stock.

(a) *In general.* (1) The determination of stock ownership for purposes of section 267(b) shall be in accordance with the rules in section 267(c).

(2) For an individual to be considered under section 267(c)(2) as constructively owning the stock of a corporation which is owned, directly or indirectly, by or for members of his family it is not necessary that he own stock in the corporation either directly or indirectly. On the other hand, for an individual to be considered under section 267(c)(3) as owning the stock of a corporation owned either actually, or constructively under section 267(c)(1), by or for his partner, such individual must himself actually own, or constructively own under section 267(c)(1), stock of such corporation.

(3) An individual's constructive ownership, under section 267(c) (2) or (3), of stock owned directly or indirectly by or for a member of his family, or by or for his partner, is not to be considered as actual ownership of such stock, and the individual's constructive ownership of the stock is not to be attributed to another member of his family or to another partner. However, an individual's

constructive ownership, under section 267(c)(1), of stock owned directly or indirectly by or for a corporation, partnership, estate, or trust shall be considered as actual ownership of the stock, and the individual's ownership may be attributed to a member of his family or to his partner.

(4) The family of an individual shall include only his brothers and sisters, spouse, ancestors, and lineal descendants. In determining whether any of these relationships exist, full effect shall be given to a legal adoption. The term *ancestors* includes parents and grandparents, and the term *lineal descendants* includes children and grandchildren.

(b) *Examples.* The application of section 267(c) may be illustrated by the following examples:

Example 1. On July 1, 1957, A owned 75 percent, and AW, his wife, owned 25 percent, of the outstanding stock of the M Corporation. The M Corporation in turn owned 80 percent of the outstanding stock of the O Corporation. Under section 267(c)(1), A and AW are each considered as owning an amount of the O Corporation stock actually owned by M Corporation in proportion to their respective ownership of M Corporation stock. Therefore, A constructively owns 60 percent (75 percent of 80 percent) of the O Corporation stock and AW constructively owns 20 percent (25 percent of 80 percent) of such stock. Under the family ownership rule of section 267(c)(2), an individual is considered as constructively owning the stock actually owned by his spouse. A and AW, therefore, are each considered as constructively owning the M Corporation stock actually owned by the other. For the purpose of applying this family ownership rule, A's and AW's constructive ownership of O Corporation stock is considered as actual ownership under section 267(c)(5). Thus, A constructively owns the 20 percent of the O Corporation stock constructively owned by AW, and AW constructively owns the 60 percent of the O Corporation stock constructively owned by A. In addition, the family ownership rule may be applied to make AWF, AW's father, the constructive owner of the 25 percent of the M Corporation stock actually owned by AW. As noted above, AW's constructive ownership of 20 percent of the O Corporation stock is considered as actual ownership for purposes of applying the family ownership rule, and AWF is thereby considered the constructive owner of this stock also. However, AW's constructive ownership of the stock constructively and actually owned by A may not be considered as actual ownership for the purpose of again applying the family ownership rule to make AWF the constructive owner of these shares. The ownership of the stock in the M and O Corporations may be tabulated as follows:

Person	Stock ownership in M Corporation		Total under Section 267 (Percent)	Stock ownsership in O Corporation		Total under Section 267 (Percent)
	Actual (Percent)	Constructive (Percent)		Actual (Percent)	Constructive (Percent)	
A	75	25	100	None	60 20	80
A W (A's wife)	25	75	100	None	20 60	80
A W F (AW's father)	None	25	25	None	20	20
M Corporation				80	None	80
O Corporation	None	None	None			

Assuming that the M Corporation and the O Corporation make their income tax returns for calendar years, and that there was no distribution in liquidation of the M or O Corporation, and further assuming that other corporation was a personal holding company under section 542 for the calendar year 1956, no deduction is allowable with respect to losses from sales or exchanges of property made on July 1, 1957, between the two corporations. Moreover, whether or not either corporation was a personal holding company, no loss would be allowable on a sale or exchange between A or AW and either corporation. A deduction would be allowed, however, for a loss sustained in an arm's length sale or exchange between A and AWF, and between AWF and the M or O Corporation.

Example 2. On June 15, 1957, all of the stock of the N Corporation was owned in equal proportions by A and his partner, AP. Except in the case of distributions in liquidation by the N Corporation, no deduction is allowable with respect to losses from sales or exchanges of property made on June 15, 1957, between A and the N Corporation or AP and the N Corporation since each partner is considered as owning the stock owned by the other; therefore, each is considered as owning more than 50 percent in value of the outstanding stock of the N Corporation.

Example 3. On June 7, 1957, A owned no stock in X Corporation, but his wife, AW, owned 20 percent in value of the outstanding stock of X, and A's partner, AP, owned 60 percent in value of the outstanding stock of X. The partnership firm of A and AP owned no stock in X Corporation. The ownership of AW's stock is attributed to A, but not that of AP since A does not own any X Corporation stock either actually, or constructively under section 267(c)(1). A's constructive ownership of AW's stock is not the ownership required for the attribution of AP's stock. Therefore, deductions for losses from sales or exchanges of property made on June 7, 1957, between X Corporation and A or AW are allowable since neither person owned more than 50 percent in value of the outstanding stock of X, but deductions for losses from sales or exchanges between X Corporation and AP would not be allowable by section 267(a) (except for distributions in liquidation of X Corporation).

§1.267(d)–1 Amount of gain where loss previously disallowed.

(a) *General rule.* (1) If a taxpayer acquires property by purchase or exchange from a transferor who, on the transaction, sustained a loss not allowable as a deduction by reason of section 267(a)(1) (or by reason of section 24(b) of the Internal Revenue Code of 1939), then any gain realized by the taxpayer on a sale or other disposition of the property after December 31, 1953, shall be recognized only to the extent that the gain exceeds the amount of such loss as is properly allocable to the property sold or otherwise disposed of by the taxpayer.

(2) The general rule is also applicable to a sale or other disposition of property by a taxpayer when the basis of such property in the taxpayer's hands is determined directly or indirectly by reference to other property acquired by the taxpayer from a transferor through a sale or exchange in which a loss sustained by the transferor was not allowable. Therefore, section 267(d) applies to a sale or other disposition of property after a series of transactions if the basis of the property acquired in each transaction is determined by reference to the basis of the property transferred, and if the original property was acquired in a transaction in which a loss to a transferor was not allowable by reason of section 267(a)(1) (or by reason of section 24(b) of the Internal Revenue Code of 1939).

(3) The benefit of the general rule is available only to the original transferee but does not apply to any original transferee (e.g., a donee) who acquired the property in any manner other than by purchase or exchange.

(4) The application of the provisions of this paragraph may be illustrated by the following examples:

Example 1. H sells to his wife, W, for $500, certain corporate stock with an adjusted basis for determining loss to him of $800. The loss of $300 is not allowable to H by reason of section 267(a)(1) and paragraph (a) of §1.267 (a)–1. W later sells this stock for $1,000. Although W's realized gain is $500 ($1,000 minus $500, her basis), her recognized gain under section 267(d) is only $200, the excess of the realized gain of $500 over the loss of $300 not allowable to H. In determining capital gain or loss W's holding period commences on the date of the sale from H to W.

Example 2. Assume the same facts as in *Example (1)* except that W later sells her stock for $300 instead of $1,000. Her recognized loss is $200 and not $500 since section 267(d) applies only to the nonrecognition of gain and does not affect basis.

Example 3. Assume the same facts as in *Example (1)* except that W transfers her stock as a gift to X. The basis of the stock in the hands of X for the purpose of determining gain, under the provisions of section 1015, is the same as W's, or $500. If X later sells the stock for $1,000 the entire $500 gain is taxed to him.

Example 4. H sells to his wife, W, for $5,500, farmland, with an adjusted basis for determining loss to him of $8,000. The loss of $2,500 is not allowable to H by reason of section 267(a)(1) and paragraph (a) of §1.267 (a)–1. W exchanges the farmland, held for investment purposes, with S, an unrelated individual, for two city lots, also held for investment purposes. The basis of the city lots in the hands of W ($5,500) is a substituted basis determined under section 1031(d) by reference to the basis of the farmland. Later W sells the city lots for $10,000. Although W's realized gain is $4,500 (10,000 minus $5,500), her recognized gain under section 267(d) is only $2,000, the excess of the realized gain of $4,500 over the loss of $2,500 not allowable to H.

(b) *Determination of basis and gain with respect to divisible property*—(1)

Taxpayer's basis. When the taxpayer acquires divisible property or property that consists of several items or classes of items by a purchase or exchange on which loss is not allowable to the transferor, the basis in the taxpayer's hands of a particular part, item, or class of such property shall be determined (if the taxpayer's basis for that part is not known) by allocating to the particular part, item, or class a portion of the taxpayer's basis for the entire property in the proportion that the fair market value of the particular part, item, or class bears to the fair market value of the entire property at the time of the taxpayer's acquisition of the property.

(2) *Taxpayer's recognized gain.* Gain realized by the taxpayer on sales or other dispositions after December 31, 1953, of a part, item, or class of the property shall be recognized only to the extent that such gain exceeds the amount of loss attributable to such part, item, or class of property not allowable to the taxpayer's transferor on the latter's sale or exchange of such property to the taxpayer.

(3) *Transferor's loss not allowable.* (i) The transferor's loss on the sale or exchange of a part, item, or class of the property to the taxpayer shall be the excess of the transferor's adjusted basis for determining loss on the part, item, or class of the property over the amount realized by the transferor on the sale or exchange of the part, item, or class. The amount realized by the transferor on the part, item, or class shall be determined (if such amount is not known) in the same manner that the taxpayer's basis for such part, item, or class is determined. See subparagraph (1) of this paragraph.

(ii) If the transferor's basis for determining loss on the part, item, or class cannot be determined, the transferor's loss on the particular part, item, or class transferred to the taxpayer shall be determined by allocating to the part, item, or class a portion of his loss on the entire property in the proportion that the fair market value of such part, item, or class bears to the fair market value of the entire property on the date of the taxpayer's acquisition of the entire property.

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

Example 1. During 1953, H sold class A stock which had cost him $1,100, and common stock which had cost him $2,000, to his wife W for a lump sum of $1,500. Under section 24(b)(1)(A) of the 1939 Code, the loss of $1,600 on the transaction was not allowable to H. At the time the stocks were purchased by W, the fair market value of class A stock was $900 and the fair market value of common stock was $600. In 1954, W sold the class A stock for $2,500. W's recognized gain is determined as follows:

Amount realized by W on sale of class A stock		$2,500
Less: Basis allocated to class A stock—$900/ $1,500 × $1,500		900
Realized gain on transaction		1,600
Less: Loss sustained by H on sale of class A stock to W not allowable as a deduction:		
Basis to H of class A stock	$1,100	
Amount realized by H on class A stock—$900/ $1,500 × $1,500	900	
Unallowable loss to H on sale of class A stock		200
Recognized gain on sale of class A stock by W		1,400

Example 2. Assume the same facts as those stated in *Example (1)* of this subparagraph except that H originally purchased both classes of stock for a lump sum of $3,100. The unallowable loss to H on the sale of all the stock to W is $1,600 ($3,100 minus $1,500). An exact determination of the unallowable loss sustained by H on sale to W of class A stock cannot be made because H's basis for class A stock cannot be determined. Therefore, a determination of the unallowable loss is made by allocating to class A stock a portion of H's loss on the entire property transferred to W in the proportion that the fair market value of class A stock at the time acquired by W ($900) bears to the fair market value of both classes of stock at that time ($1,500). The allocated portion is $900/$1,500 × $1,600, or $960. W's recognized gain is, therefore, $640 (W's realized gain of $1,600 minus $960).

(c) *Special rules.* (1) Section 267(d) does not affect the basis of property for determining gain. Depreciation and other items which depend on such basis are also not affected.

(2) The provisions of section 267(d) shall not apply if the loss sustained by the transferor is not allowable to the transferor as a deduction by reason of section 1091, or section 118 of the Internal Revenue Code of 1939, which relate to losses from wash sales of stock or securities.

(3) In determining the holding period in the hands of the transferee of property received in an exchange with a transferor with respect to whom a loss on the exchange is not allowable by reason of section 267, section 1223(2) does not apply to include the period during which the property was held by the transferor. In determining such holding period, however, section 1223(1) may apply to include the period during which the transferee held the property which he exchanged where, for example, he exchanged a capital asset in a transaction which, as to him, was nontaxable under section 1031 and the property received in the exchange has the same basis as the property exchanged.

§1.267(d)–2 Effective date; taxable years subject to the Internal Revenue Code of 1939.

Pursuant to section 7851(a)(1)(C), the regulations prescribed in §1.267(d)–1, to the extent that they relate to determination of gain resulting from the sale or other disposition of property after December 31, 1953, with respect to which property a loss was not allowable to the transferor by reason of section 267(a)(1) (or by reason of section 24(b) of the Internal Revenue Code of 1939), shall also apply to taxable years beginning before January 1, 1954, and ending after December 31, 1953, and taxable years beginning after December 31, 1953, and ending before August 17, 1954, which years are subject to the Internal Revenue Code of 1939.

§1.267(f)–1 Controlled groups.

(a) *In general*—(1) *Purpose.* This section provides rules under section 267(f) to defer losses and deductions from certain transactions between members of a controlled group (intercompany sales). The purpose of this section is to prevent members of a controlled group from taking into account a loss or deduction solely as the result of a transfer of property between a selling member (S) and a buying member (B).

(2) *Application of consolidated return principles.* Under this section, S's loss or deduction from an intercompany sale is taken into account under the *timing* principles of §1.1502–13 (intercompany transactions between members of a consolidated group), treating the intercompany sale as an intercompany transaction. For this purpose:

(i) The matching and acceleration rules of §1.1502–13 (c) and (d), the definitions and operating rules of §1.1502–13 (b) and (j), and the simplifying rules of §1.1502–13(e)(1) apply with the adjustments in paragraphs (b) and (c) of this section to reflect that this section—

(A) Applies on a controlled group basis rather than consolidated group basis; and

(B) Generally affects only the *timing* of a loss or deduction, and not *it's attributes* (*e.g., its source* and *character*) or the holding period of property.

(ii) The special rules under §1.1502–13(f) (stock of members) and (g) (obligations of members) apply under this section only to the extent the transaction is also an intercompany transaction to which §1.1502–13 applies.

(iii) Any election under §1.1502–13 to take items into account on a separate entity basis does not apply under this section. See §1.1502–13(e)(3).

(3) *Other law.* The rules of this section apply in addition to other applicable law (including nonstatutory authorities). For example, to the extent a loss or deduction deferred under this section is from a transaction that is also an intercompany transaction under §1.1502–13(b)(1), attributes of the loss or deduction are also subject to recharacterization under §1.1502–13. See also, sections 269 (acquisitions to evade or avoid income tax) and 482 (allocations among commonly controlled taxpayers). Any loss or deduction taken into account under this section can be deferred, disallowed, or eliminated under other applicable law. See, for example, section 1091 (loss eliminated on wash sale).

(b) *Definitions and operating rules.* The definitions in §1.1502–13(b) and the operating rules of §1.1502–13(j) apply under this section with appropriate adjustments, including the following:

(1) *Intercompany sale.* An intercompany sale is a sale, exchange, or other transfer of property between members of a controlled group, if it would be an intercompany transaction under the principles of §1.1502–13, determined by

treating the references to a consolidated group as references to a controlled group and by disregarding whether any of the members join in filing consolidated returns.

(2) *S's losses or deductions.* Except to the extent the intercompany sale is also an intercompany transaction to which § 1.1502–13 applies, S's losses or deductions subject to this section are determined on a separate entity basis. For example, the principles of § 1.1502–13(b)(2)(iii) (treating certain amounts not yet recognized as items to be taken into account) do not apply. A loss or deduction is from an intercompany sale whether it is directly or indirectly from the intercompany sale.

(3) *Controlled group; member.* For purposes of this section, a controlled group is defined in section 267(f). Thus, a controlled group includes a FSC (as defined in section 922) and excluded members under section 1563(b)(2), but does not include a DISC (as defined in section 992). Corporations remain members of a controlled group as long as they remain in a controlled group relationship with each other. For example, corporations become nonmembers with respect to each other when they cease to be in a controlled group relationship with each other, rather than by having a separate return year (described in § 1.1502–13(j)(7)). Further, the principles of § 1.1502–13(j)(6) (former common parent treated as continuation of group) apply to any corporation if, immediately before it becomes a nonmember, it is both the selling member and the owner of property with respect to which a loss or deduction is deferred (whether or not it becomes a member of a different controlled group filing consolidated or separate returns). Thus, for example, if S and B merge together in a transaction described in section 368(a)(1)(A), the surviving corporation is treated as the successor to the other corporation, and the controlled group relationship is treated as continuing.

(4) *Consolidated taxable income.* References to consolidated taxable income (and consolidated tax liability) include references to the combined taxable income of the members (and their combined tax liability). For corporations filing separate returns, it ordinarily will not be necessary to actually combine their taxable incomes (and tax liabilities) because the taxable income (and tax liability) of one corporation does not affect the taxable income (or tax liability) of another corporation.

(c) *Matching and acceleration principles of § 1.1502–13*—(1) *Adjustments to the timing rules.* Under this section, S's losses and deductions are deferred until they are taken into account under the timing principles of the matching and acceleration rules of § 1.1502–13(c) and (d) with appropriate adjustments. For example, if S sells depreciable property to B at a loss, S's loss is deferred and taken into account under the principles of the matching rule of § 1.1502–13(c) to reflect the difference between B's depreciation taken into account with respect to the property and the depreciation that B would take into account if S and B were divisions of a single corporation; if S and B subsequently cease to be in a controlled group relationship with each other, S's remaining loss is taken into account under the principles of the acceleration rule of § 1.1502–13(d). For purposes of this section, the adjustments to § 1.1502–13 (c) and (d) include the following:

(i) *Application on controlled group basis.* The matching and acceleration rules apply on a controlled group basis, rather than a consolidated group basis. Thus if S and B are wholly-owned members of a consolidated group and 21% of the stock of S is sold to an unrelated person, S's loss continues to be deferred under this section because S and B continue to be members of a controlled group even though S is no longer a member of the consolidated group. Similarly, S's loss would continue to be deferred if S and B remain in a controlled group relationship after both corporations become nonmembers of their former consolidated group.

(ii) *Different taxable years.* If S and B have different taxable years, the taxable years that include a December 31 are treated as the same taxable years. If S or B has a short taxable year that does not include a December 31, the short year is treated as part of the succeeding taxable year that does include a December 31.

(iii) *Transfer to a section 267(b) or 707(b) related person.* To the extent S's loss or deduction from an intercompany sale of property is taken into account under this section as a result of B's transfer of the property to a nonmember that is a person related to any member, immediately after the transfer, under sections 267(b) or 707(b), or as a result of S or B becoming a nonmember that is related to any member under section 267(b), the loss or deduction is taken into account but allowed only to the extent of any income or gain taken into account as a result of the transfer. The balance not allowed is treated as a loss referred to in section 267(d) if it is from a sale or exchange by B (rather than from a distribution).

(iv) *B's item is excluded from gross income or noncapital and nondeductible.* To the extent S's loss would be redetermined to be a noncapital, nondeductible amount under the principles of §1.1502–13 but is not redetermined because of paragraph (c)(2) of this section, then, if paragraph (c)(1)(iii) of this section does not apply, S's loss continues to be deferred and is not taken into account until S and B are no longer in a controlled group relationship. For example, if S sells all of the stock of corporation T to B at a loss and T subsequently liquidates into B in a transaction qualifying under section 332, S's loss is deferred until S and B (including their successors) are no longer in a controlled group relationship. See §1.1502–13(c)(6)(ii).

(v) *Circularity of references.* References to deferral or elimination under the Internal Revenue Code or regulations do not include references to section 267(f) or this section. See, e.g., §1.1502–13(a)(4) (applicability of other law).

(2) *Attributes generally not affected.* The matching and acceleration rules are not applied under this section to affect the attributes of S's intercompany item, or cause it to be taken into account before it is taken into account under S's separate entity method of accounting. However, the attributes of S's intercompany item may be redetermined, or an item may be taken into account earlier than under S's separate entity method of accounting, to the extent the transaction is also an intercompany transaction to which §1.1502–13 applies. Similarly, except to the extent the transaction is also an intercompany transaction to which §1.1502–13 applies, the matching and acceleration rules do not apply to affect the timing or attributes of B's corresponding items.

(d) *Intercompany sales of inventory involving foreign persons*—(1) *General rule.* Section 267(a)(1) and this section do not apply to an intercompany sale of property that is inventory (within the meaning of section 1221(1)) in the hands of both S and B, if—

(i) The intercompany sale is in the ordinary course of S's trade or business;

(ii) S or B is a foreign corporation; and

(iii) Any income or loss realized on the intercompany sale by S or B is not income or loss that is recognized as effectively connected with the conduct of a trade or business within the United States within the meaning of section 864 (unless the income is exempt from taxation pursuant to a treaty obligation of the United States).

(2) *Intercompany sales involving related partnerships.* For purposes of paragraph (d)(1) of this section, a partnership and a foreign corporation described in section 267(b)(10) are treated as members, provided that the income or loss of the foreign corporation is described in paragraph (d)(1)(iii) of this section.

(3) *Intercompany sales in ordinary course.* For purposes of this paragraph (d), whether an intercompany sale is in the ordinary course of business is determined under all the facts and circumstances.

(e) *Treatment of a creditor with respect to a loan in nonfunctional currency.* Sections 267(a)(1) and this section do not apply to an exchange loss realized with respect to a loan of nonfunctional currency if—

(1) The loss is realized by a member with respect to nonfunctional currency loaned to another member;

(2) The loan is described in §1.988–1(a)(2)(i);

(3) The loan is not in a hyperinflationary currency as defined in §1.988–1(f); and

(4) The transaction does not have as a significant purpose the avoidance of Federal income tax.

(f) *Receivables.* If S acquires a receivable from the sale of goods or services to a nonmember at a gain, and S sells the receivable at fair market value to B, any loss or deduction of S from its sale to B is not deferred under this section to the extent it does not exceed S's income or gain from the sale to the nonmember that has been taken into account at the time the receivable is sold to B.

(g) *Earnings and profits.* A loss or deduction deferred under this section is not reflected in S's earnings and profits before it is taken into account under this section. See, e.g., §§ 1.312–6(a), 1.312–7, and 1.1502–33(c)(2).

(h) *Anti-avoidance rule.* If a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany sale or by distorting the timing of losses or deductions), adjustments must be made to carry out the purposes of this section.

(i) [Reserved]

(j) *Examples.* For purposes of the examples in this paragraph (j), unless otherwise stated, corporation P owns 75% of the only class of stock of subsidiaries S and B, X is a person unrelated to any member of the P controlled group, the taxable year of all persons is the calendar year, all persons use the accrual method of accounting, tax liabilities are disregarded, the facts set forth the only activity, and no member has a special status. If a member acts as both a selling member and a buying member (e.g., with respect to different aspects of a single transaction, or with respect to related transactions), the member is referred as to M (rather than as S or B). This section is illustrated by the following examples.

Example 1. Matching and acceleration rules. (a) *Facts.* S holds land for investment with a basis of $130. On January 1 of Year 1, S sells the land to B for $100. On a separate entity basis, S's loss is long-term capital loss. B holds the land for sale to customers in the ordinary course of business. On July 1 of Year 3, B sells the land to X for $110.

(b) *Matching rule.* Under paragraph (b)(1) of this section, S's sale of land to B is an intercompany sale. Under paragraph (c)(1) of this section, S's $30 loss is taken into account under the timing principles of the matching rule of § 1.1502–13(c) to reflect the difference for the year between B's corresponding items taken into account and the recomputed corresponding items. If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's $130 basis in the land and would have a $20 loss from the sale to X in Year 3. Consequently, S takes no loss into account in Years 1 and 2, and takes the entire $30 loss into account in Year 3 to reflect the $30 difference in that year between the $10 gain B takes into account and its $20 recomputed loss. The attributes of S's intercompany items and B's corresponding items are determined on a separate entity basis. Thus, S's $30 loss is long-term capital loss and B's $10 gain is ordinary income.

(c) *Acceleration resulting from sale of B stock.* The facts are the same as in paragraph (a) of this *Example 1,* except that on July 1 of Year 3 P sells all of its B stock to X (rather than B's selling the land to X). Under paragraph (c)(1) of this section, S's $30 loss is taken into account under the timing principles of the acceleration rule of § 1.1502–13(d) immediately before the effect of treating S and B as divisions of a single corporation cannot be produced. Because the effect cannot be produced once B becomes a nonmember, S takes its $30 loss into account in Year 3 immediately before B becomes a nonmember. S's loss is long-term capital loss.

(d) *Subgroup principles applicable to sale of S and B stock.* The facts are the same as in paragraph (a) of this *Example 1,* except that on July 1 of Year 3 P sells all of its S and B stock to X (rather than B's selling the land to X). Under paragraph (b)(3) of this section, S and B are considered to remain members of a controlled group as long as they remain in a controlled group relationship with each other (whether or not in the original controlled group). P's sale of their stock does not affect the controlled group relationship of S and B with each other. Thus, S's loss is not taken into account as a result of P's sale of the stock. Instead, S's loss is taken into account based on subsequent events (e.g., B's sale of the land to a nonmember).

Example 2. Distribution of loss property. (a) *Facts.* S holds land with a basis of $130 and value of $100. On January 1 of Year 1, S distributes the land to P in a transaction to which section 311 applies. On July 1 of Year 3, P sells the land to X for $110.

(b) *No loss taken into account.* Under paragraph (b)(2) of this section, because P and S are not members of a consolidated group, § 1.1502–13(f)(2)(iii) does not apply to cause S to recognize a $30 loss under the principles of section 311(b). Thus, S has no loss to be taken into account under this section. (If P and S were members of a consolidated group,

§1.1502–13(f)(2)(iii) would apply to S's loss in addition to the rules of this section, and the loss would be taken into account in Year 3 as a result of P's sale to X.)

Example 3. Loss not yet taken into account under separate entity accounting method. (a) *Facts.* S holds land with a basis of $130. On January 1 of Year 1, S sells the land to B at a $30 loss but does not take into account the loss under its separate entity method of accounting until Year 4. On July 1 of Year 3, B sells the land to X for $110.

(b) *Timing.* Under paragraph (b)(2) of this section, S's loss is determined on a separate entity basis. Under paragraph (c)(1) of this section, S's loss is not taken into account before it is taken into account under S's separate entity method of accounting. Thus, although B takes its corresponding gain into account in Year 3, S has no loss to take into account until Year 4. Once S's loss is taken into account in Year 4, it is not deferred under this section because B's corresponding gain has already been taken into account. (If S and B were members of a consolidated group, S would be treated under §1.1502–13(b)(2)(iii) as taking the loss into account in Year 3.)

Example 4. Consolidated groups. (a) *Facts.* P owns all of the stock of S and B, and the P group is a consolidated group. S holds land for investment with a basis of $130. On January 1 of Year 1, S sells the land to B for $100. B holds the land for sale to customers in the ordinary course of business. On July 1 of Year 3, P sells 25% of B's stock to X. As a result of P's sale, B becomes a nonmember of the P consolidated group but S and B remain in a controlled group relationship with each other for purposes of section 267(f). Assume that if S and B were divisions of a single corporation, the items of S and B from the land would be ordinary by reason of B's activities.

(b) *Timing and attributes.* Under paragraph (a)(3) of this section, S's sale to B is subject to both §1.1502–13 and this section. Under §1.1502–13, S's loss is redetermined to be an ordinary loss by reason of B's activities. Under paragraph (b)(3) of this section, because S and B remain in a controlled group relationship with each other, the loss is not taken into account under the acceleration rule of §1.1502–13(d) as modified by paragraph (c) of this section. See §1.1502–13(a)(4). Nevertheless, S's loss is redetermined by §1.1502–13 to be an ordinary loss, and the character of the loss is not further redetermined under this section. Thus, the loss continues to be deferred under this section, and will be taken into account as ordinary loss based on subsequent events (e.g., B's sale of the land to a nonmember).

(c) *Resale to controlled group member.* The facts are the same as in paragraph (a) of this *Example 4*, except that P owns 75% of X's stock, and B resells the land to X (rather than P's selling any B stock). The results for S's loss are the same as in paragraph (b) of this *Example 4*. Under paragraph (b) of this section, X is also in a controlled group relationship, and B's sale to X is a second intercompany sale. Thus, S's loss continues to be deferred and is taken into account under this section as ordinary loss based on subsequent events (e.g., X's sale of the land to a nonmember).

Example 5. Intercompany sale followed by installment sale. (a) *Facts.* S holds land for investment with a basis of $130x. On January 1 of Year 1, S sells the land to B for $100x. B holds the land for investment. On July 1 of Year 3, B sells the land to X in exchange for X's $110x note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for principal payments of $55x in Year 4 and $55x in Year 5. Section 453A applies to X's note.

(b) *Timing and attributes.* Under paragraph (c) of this section, S's $30x loss is taken into account under the timing principles of the matching rule of §1.1502–13(c) to reflect the difference in each year between B's gain taken into account and its recomputed loss. Under section 453, B takes into account $5x of gain in Year 4 and in Year 5. Therefore, S takes $20x of its loss into account in Year 3 to reflect the $20x difference in that year between B's $0 loss taken into account and its $20x recomputed loss. In addition, S takes $5x of its loss into account in Year 4 and in Year 5 to reflect the $5x difference in each year between B's $5x gain taken into account and its $0 recomputed gain. Although S takes into account a loss and B takes into account a gain, the attributes of B's $10x gain are determined on a separate entity basis, and therefore the interest charge under section 453A(c) applies to B's $10x gain on the installment sale beginning in Year 3.

Example 6. Section 721 transfer to a related nonmember. (a) *Facts.* S owns land with a basis of $130. On January 1 of Year 1, S sells the land to B for $100. On July 1 of Year 3, B transfers the land to a partnership in exchange for a 40% interest in capital and profits in a transaction to which section 721 applies. P also owns a 25% interest in the capital and profits of the partnership.

(b) *Timing.* Under paragraph (c)(1)(iii) of this section, because the partnership is a nonmember that is a related person under sections 267(b) and 707(b), S's $30 loss is taken into account in Year 3, but only to the extent of any income or gain taken into account as a result of the transfer. Under section 721, no gain or loss is taken into account as a result of the transfer to the partnership, and thus none of S's loss is taken into account. Any subsequent gain recognized by the partnership with respect to the property is limited under section 267(d). (The results would be the same if the P group were a consolidated group, and S's sale to B were also subject to §1.1502–13.)

Example 7. Receivables. (a) *Controlled group.* S owns goods with a $60 basis. In Year 1, S sells the goods to X for X's $100 note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for payment of principal in Year 5. S takes into account $40 of income in Year 1 under its method of accounting. In Year 2, the fair market value of X's note falls to $90 due to an increase in prevailing market interest rates, and S sells the note to B for its $90 fair market value.

(b) *Loss not deferred.* Under paragraph (f) of this section, S takes its $10 loss into account in Year 2. (If the sale were not at fair market value, paragraph (f) of this section would not apply and none of S's $10 loss would be taken into account in Year 2.)

(c) *Consolidated group.* Assume instead that P owns all of the stock of S and B, and the P group is a consolidated group. In Year 1, S sells to X goods having a basis of $90 for X's $100 note (bearing a market rate of interest in excess of the applicable Federal rate, and providing for payment of principal in Year 5), and S takes into account $10 of income in Year 1. In Year 2, S sells the receivable to B for its $85 fair market value. In Year 3, P sells 25% of B's stock to X. Although paragraph (f) of this section provides that $10 of S's loss (i.e., the extent to which S's $15 loss does not exceed its $10 of income) is not deferred under this section, S's entire $15 loss is subject to § 1.1502–13 and none of the loss is taken into account in Year 2 under the matching rule of § 1.1502–13(c). See paragraph (a)(3) of this section (continued deferral under § 1.1502–13). P's sale of B stock results in B becoming a nonmember of the P consolidated group in Year 3. Thus, S's $15 loss is taken into account in Year 3 under the acceleration rule of § 1.1502–13(d). Nevertheless, B remains in a controlled group relationship with S and paragraph (f) of this section permits only $10 of S's loss to be taken into account in Year 3. See § 1.1502–13(a)(4) (continued deferral under section 267). The remaining $5 of S's loss continues to be deferred under this section and taken into account under this section based on subsequent events (e.g., B's collection of the note or P's sale of the remaining B stock to a nonmember).

Example 8. Selling member ceases to be a member. (a) *Facts.* P owns all of the stock of S and B, and the P group is a consolidated group. S has several historic assets, including land with a basis of $130 and value of $100. The land is not essential to the operation of S's business. On January 1 of Year 1, S sells the land to B for $100. On July 1 of Year 3, P transfers all of S's stock to newly formed X in exchange for a 20% interest in X stock as part of a transaction to which section 351 applies. Although X holds many other assets, a principal purpose for P's transfer is to accelerate taking S's $30 loss into account. P has no plan or intention to dispose of the X stock.

(b) *Timing.* Under paragraph (c) of this section, S's $30 loss ordinarily is taken into account immediately before P's transfer of the S stock, under the timing principles of the acceleration rule of § 1.1502–13(d). Although taking S's loss into account results in a $30 negative stock basis adjustment under § 1.1502–32, because P has no plan or intention to dispose of its X stock, the negative adjustment will not immediately affect taxable income. P's transfer accelerates a loss that otherwise would be deferred, and an adjustment under paragraph (h) of this section is required. Thus, S's loss is never taken into account, and S's stock basis and earnings and profits are reduced by $30 under §§ 1.1502–32 and 1.1502–33 immediately before P's transfer of the S stock.

(c) Nonhistoric assets. Assume instead that, with a principal purpose to accelerate taking into account any further loss that may accrue in the value of the land without disposing of the land outside of the controlled group, P forms M with a $100 contribution on January 1 of Year 1 and S sells the land to M for $100. On December 1 of Year 1, when the value of the land has decreased to $90, M sells the land to B for $90. On July 1 of Year 3, while B still owns the land, P sells all of M's stock to X and M becomes a nonmember. Under paragraph (c) of this section, M's $10 loss ordinarily is taken into account under the timing principles of the acceleration rule of § 1.1502–13(d) immediately before M becomes a nonmember. (S's $30 loss is not taken into account under the timing principles of § 1.1502–13(c) or § 1.1502–13(d) as a result of M becoming a nonmember, but is taken into account based on subsequent events such as B's sale of the land to a nonmember or P's sale of the stock of S or B to a nonmember.) The land is not an historic asset of M and, although taking M's loss into account reduces P's basis in the M stock under § 1.1502–32, the negative adjustment only eliminates the $10 duplicate stock loss. Under paragraph (h) of this section, M's loss is never taken into account. M's stock basis, and the earnings and profits of M and P, are reduced by $10 under §§ 1.1502–32 and 1.1502–33 immediately before P's sale of the M stock.

(k) *Cross-reference.* For additional rules applicable to the disposition or deconsolidation of the stock of members of consolidated groups, see §§ 1.337(d)–1, 1.337(d)–2, 1.1502–13(f)(6), and 1.1502–20.

(l) *Effective dates*—(1) *In general.* This section applies with respect to transactions occurring in S's years beginning on or after July 12, 1995. If both this section and prior law apply to a transaction, or neither applies, with the result that items are duplicated, omitted, or eliminated in determining taxable income (or tax liability), or items are treated inconsistently, prior law (and not this section) applies to the transaction.

(2) *Avoidance transactions.* This paragraph (l)(2) applies if a transaction is engaged in or structured on or after April 8, 1994, with a principal purpose to avoid the rules of this section (and instead to apply prior law). If this paragraph (l)(2) applies, appropriate adjustments must be made in years beginning on or after July 12, 1995, to prevent the avoidance, duplication, omission, or elimination of any item (or tax liability), or any other inconsistency with the rules of this section.

(3) *Prior law.* For transactions occurring in S's years beginning before July 12, 1995 see the applicable regulations issued under sections 267 and 1502. See, e.g., §§1.267(f)–1, 1.267(f)–1T, 1.267(f)–2T, 1.267(f)–3, 1.1502–13, 1.1502–13T, 1.1502–14, 1.1502–14T, and 1.1502–31 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

[T.D. 8597, 60 FR 36680, July 18, 1995, as amended by T.D. 8660, 61 FR 10499, Mar. 14, 1996; 62 FR 12097, Mar. 14, 1997]

§1.268–1 Items attributable to an unharvested crop sold with the land.

In computing taxable income no deduction shall be allowed in respect of items attributable to the production of an unharvested crop which is sold, exchanged, or involuntarily converted with the land and which is considered as property used in the trade or business under section 1231(b)(4). Such items shall be so treated whether or not the taxable year involved is that of the sale, exchange, or conversion of such crop and whether they are for expenses, depreciation, or otherwise. If the taxable year involved is not that of the sale, exchange, or conversion of such crop, a recomputation of the tax liability for such year shall be made; such recomputation should be in the form of an ''amended return'' if necessary. For the adjustments to basis as a result of such disallowance, see section 1016(a)(11) and the regulations thereunder.

§1.269–1 Meaning and use of terms.

As used in section 269 and §§1.269–2 through 1.269–7:

(a) *Allowance.* The term *allowance* refers to anything in the internal revenue laws which has the effect of diminishing tax liability. The term includes, among other things, a deduction, a credit, an adjustment, an exemption, or an exclusion.

(b) *Evasion or avoidance.* The phrase *evasion or avoidance* is not limited to cases involving criminal penalties, or civil penalties for fraud.

(c) *Control.* The term *control* means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock of the corporation. For control to be ''acquired on or after October 8, 1940'', it is not necessary that all of such stock be acquired on or after October 8, 1940. Thus, if A, on October 7, 1940, and at all times thereafter, owns 40 percent of the stock of X Corporation and acquires on October 8, 1940, an additional 10 percent of such stock, an acquisition within the meaning of such phrase is made by A on October 8, 1940. Similarly, if B, on October 7, 1940, owns certain assets and transfers on October 8, 1940, such assets to a newly organized Y Corporation in exchange for all the stock of Y Corporation, an acquisition within the meaning of such phrase is made by B on October 8, 1940. If, under the facts stated in the preceding sentence, B is a corporation, all of whose stock is owned by Z Corporation, then an acquisition within the meaning of such phrase is also made by Z Corporation on October 8, 1940, as well as by the shareholders of Z Corporation taken as a group on such date, and by any of such shareholders if such shareholders as a group own 50 percent of the stock of Z on such date.

(d) *Person.* The term *person* includes an individual, a trust, an estate, a partnership, an association, a company or a corporation.

[T.D. 6595, 27 FR 3596, Apr. 14, 1962, as amended by T.D. 8388, 57 FR 345, Jan. 6, 1992]

§1.269–2 Purpose and scope of section 269.

(a) *General.* Section 269 is designed to prevent in the instances specified therein the use of the sections of the Internal Revenue Code providing deductions, credits, or allowances in evading or avoiding Federal income tax. See §1.269–3.

(b) *Disallowance of deduction, credit, or other allowance.* Under the Code, an amount otherwise constituting a deduction, credit, or other allowance becomes unavailable as such under certain circumstances. Characteristic of such circumstances are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate. The distortion may be evidenced, for example, by the fact that the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer, by the unreal nature of the transaction such as its sham character, or by the unreal or unreasonable relation which the deduction, credit, or other allowance bears to the transaction. The principle of law making an amount unavailable as a deduction, credit, or other allowance in cases in which the effect of making an amount so available would be to distort the liability of the taxpayer, has been judicially recognized and applied in several cases. Included in these cases are Gregory v. Helvering (1935) (293 U.S. 465; Ct. D. 911, C.B. XIV–1, 193); Griffiths v. Helvering (1939) (308 U.S. 355; Ct. D. 1431, C.B. 1940–1, 136); Higgins v. Smith (1940) (308 U.S. 473; Ct. D. 1434, C.B. 1940–1, 127); and J. D. & A. B. Spreckles Co. v. Commissioner (1940) (41 B.T.A. 370). In order to give effect to such principle, but not in limitation thereof, several provisions of the Code, for example, section 267 and section 270, specify with some particularity instances in which disallowance of the deduction, credit, or other allowance is required. Section 269 is also included in such provisions of the Code. The principle of law and the particular sections of the Code are not mutually exclusive and in appropriate circumstances they may operate together or they may operate separately. See, for example, §1.269–6.

[T.D. 6595, 27 FR 3596, Apr. 14, 1962]

§1.269–3 Instances in which section 269(a) disallows a deduction, credit, or other allowance.

(a) *Instances of disallowance.* Section 269 specifies two instances in which a deduction, credit, or other allowance is to be disallowed. These instances, described in paragraphs (1) and (2) of section 269(a), are those in which:

(1) Any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) Any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation (not controlled, directly or indirectly, immediately before such acquisition by such acquiring corporation or its stockholders), the basis of which property in the hands of the acquiring corporation is determined by reference to the basis in the hands of the transferor corporation.

In either instance the principal purpose for which the acquisition was made must have been the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person, or persons, or corporation, would not otherwise enjoy. If this requirement is satisfied, it is immaterial by what method or by what conjunction of events the benefit was sought. Thus, an acquiring person or corporation can secure the benefit of a deduction, credit, or other allowance within the meaning of section 269 even though it is the acquired corporation that is entitled to such deduction, credit, or other allowance in the determination of its tax. If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose. This does not mean that only those acquisitions fall within the provisions of section 269 which would not have been made if the evasion or avoidance purpose was not present. The determination of the purpose for which an acquisition was made requires a scrutiny of the entire circumstances in which the transaction or course of conduct occurred, in connection with the tax result claimed to arise therefrom.

(b) *Acquisition of control; transactions indicative of purpose to evade or avoid tax.* If the requisite acquisition of control within the meaning of paragraph (1) of section 269(a) exists, the transactions set forth in the following subparagraphs are among those which, in the absence of additional evidence to the contrary, ordinarily are indicative that the principal purpose for acquiring control was evasion or avoidance of Federal income tax:

(1) A corporation or other business enterprise (or the interest controlling such corporation or enterprise) with large profits acquires control of a corporation with current, past, or prospective credits, deductions, net operating losses, or other allowances and the acquisition is followed by such transfers or other action as is necessary to bring the deduction, credit, or other allowance into conjunction with the income (see further § 1.269–6). This subparagraph may be illustrated by the following example:

Example. Individual A acquires all of the stock of L Corporation which has been engaged in the business of operating retail drug stores. At the time of the acquisition, L Corporation has net operating loss carryovers aggregating $100,000 and its net worth is $100,000. After the acquisition, L Corporation continues to engage in the business of operating retail drug stores but the profits attributable to such business after the acquisition are not sufficient to absorb any substantial portion of the net operating loss carryovers. Shortly after the acquisition, individual A causes to be transferred to L Corporation the assets of a hardware business previously controlled by A which business produces profits sufficient to absorb a substantial portion of L Corporation’s net operating loss carryovers. The transfer of the profitable business, which has the effect of using net operating loss carryovers to offset gains of a business unrelated to that which produced the losses, indicates that the principal purpose for which the acquisition of control was made is evasion or avoidance of Federal income tax.

(2) A person or persons organize two or more corporations instead of a single corporation in order to secure the benefit of multiple surtax exemptions (see section 11(c)) or multiple minimum accumulated earnings credits (see section 535(c)(2) and (3)).

(3) A person or persons with high earning assets transfer them to a newly organized controlled corporation retaining assets producing net operating losses which are utilized in an attempt to secure refunds.

(c) *Acquisition of property; transactions indicative of purpose to evade or avoid tax.* If the requisite acquisition of property within the meaning of paragraph (2) of section 269(a) exists, the transactions set forth in the following subparagraphs are among those which, in the absence of additional evidence to the contrary, ordinarily are indicative that the principal purpose for acquiring such property was evasion or avoidance of Federal income tax:

(1) A corporation acquires property having in its hands an aggregate carryover basis which is materially greater than its aggregate fair market value at the time of such acquisition and utilizes the property to create tax-reducing losses or deductions.

(2) A subsidiary corporation, which has sustained large net operating losses in the operation of business X and which has filed separate returns for the taxable years in which the losses were sustained, acquires high earning assets, comprising business Y, from its parent corporation. The acquisition occurs at a time when the parent would not succeed to the net operating loss carryovers of the subsidiary if the subsidiary were liquidated, and the profits of business Y are sufficient to offset a substantial portion of the net operating loss carryovers attributable to business X (see further *Example (3)* of § 1.269–6).

(d) *Ownership changes to which section 382(l)(5) applies; transactions indicative of purpose to evade or avoid tax*—(1) *In general.* Absent strong evidence to the contrary, a requisite acquisition of control or property in connection with an ownership change to which section 382(l)(5) applies is considered to be made for the principal purpose of evasion or avoidance of Federal income tax unless the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to the title 11 or similar case (as defined in section 382(l)(5)(G)). The determination of whether the corporation carries on more than an insignificant amount of an active trade or business is made without regard to the continuity of business enterprise set forth in § 1.368–1(d). The determination is based on all the facts and circumstances, including, for example, the amount of business assets that continue to be used, or the number of employees in the work force who continue employment, in an active trade or business (although not necessarily the historic trade or business). Where the corporation continues to utilize a significant amount of its business assets or work force, the requirement of carrying on more than an insignificant amount of an active trade or business may be met even though all trade or business activities temporarily cease for a period of time in order to address business exigencies.

(2) *Effective date.* The presumption under paragraph (d) of this section applies to acquisitions of control or property effected pursuant to a plan of reorganization confirmed by a court in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) after August 14, 1990.

(e) *Relationship of section 269 to 11 U.S.C. 1129(d).* In determining for purposes of section 269 of the Internal Revenue Code whether an acquisition pursuant to a plan of reorganization in a case under title 11 of the United States Code was made for the principal purpose of evasion or avoidance of Federal income tax, the fact that a governmental unit did not seek a determination under 11 U.S.C. 1129(d) is not taken into account and any determination by a court under 11 U.S.C. 1129(d) that the principal purpose of the plan is not avoidance of taxes is not controlling.

[T.D. 6595, 27 FR 3596, Apr. 14, 1962, as amended by T.D. 8388, 57 FR 345, Jan. 6, 1992]

§ 1.269–4 Power of district director to allocate deduction, credit, or allowance in part.

The district director is authorized by section 269(b) to allow a part of the amount disallowed by section 269(a), but he may allow such part only if and to the extent that he determines that the amount allowed will not result in the evasion or avoidance of Federal income tax for which the acquisition was made. The district director is also authorized to use other methods to give effect to part of the amount disallowed under section 269(a), but only to such extent as he determines will not result in the evasion or avoidance of Federal income tax for which the acquisition was made. Whenever appropriate to give proper effect to the deduction, credit, or other allowance, or such part of it which may be allowed, this authority includes the distribution, apportionment, or allocation of both the gross income and the deductions, credits, or other allowances the benefit of which was sought, between or among the corporations, or properties, or parts thereof, involved, and includes the disallowance of any such deduction, credit, or other allowance to any of the taxpayers involved.

[T.D. 6595, 27 FR 3597, Apr. 14, 1962]

§ 1.269–5 Time of acquisition of control.

(a) *In general.* For purposes of section 269, an acquisition of control occurs when one or more persons acquire beneficial ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of share of all classes of stock of the corporation.

(b) *Application of general rule to certain creditor acquisitions.* (1) For purposes of section 269, creditors of an insolvent or bankrupt corporation (by themselves or in conjunction with other persons) acquire control of the corporation when they acquire beneficial ownership of the requisite amount of stock. Although insolvency or bankruptcy may cause the interests of creditors to predominate as a practical matter, creditor interests do not constitute beneficial ownership of the corporation's stock. Solely for purposes of section 269, creditors of a bankrupt corporation are treated as acquiring beneficial ownership of stock of the corporation no earlier than the time a bankruptcy court confirms a plan of reorganization.

(2) The provisions of this section are illustrated by the following example.

Example. Corporation *L* files a petition under chapter 11 of the Bankruptcy Code on January 5, 1987. A creditors' committee is formed. On February 22, 1987, and upon the request of the creditors, the bankruptcy court removes the debtor-in-possession from business management and operations and appoints a trustee. The trustee consults regularly with the creditors' committee in formulating both short-term and long-term management decisions. After three years, the creditors approve a plan of reorganization in which the outstanding stock of Corporation *L* is canceled and its creditors receive shares of stock constituting all of the outstanding shares. The bankruptcy court confirms the plan of reorganization on March 23, 1990, and the plan is put into effect on May 25, 1990. For purposes of section 269, the creditors acquired control of Corporation *L* than March 23, 1990. Similarly, the determination of whether the creditors acquired control of Corporation *L* no earlier with the principal purpose of evasion or avoidance of Federal income tax is made by reference to the creditors' purposes as of no earlier than March 23, 1990.

[T.D. 8388, 57 FR 346, Jan. 6, 1992]

§1.269–6 Relationship of section 269 to section 382 before the Tax Reform Act of 1986.

Section 269 and §§1.269–1 through 1.269–5 may be applied to disallow a net operating loss carryover even though such carryover is not disallowed (in whole or in part) under section 382 and the regulations thereunder. This section may be illustrated by the following examples:

Example 1. L Corporation has computed its taxable income on a calendar year basis and has sustained heavy net operating losses for a number of years. Assume that A purchases all of the stock of L Corporation on December 31, 1955, for the principal purpose of utilizing its net operating loss carryovers by changing its business to a profitable new business. Assume further that A makes no attempt to revitalize the business of L Corporation during the calendar year 1956 and that during January 1957 the business is changed to an entirely new and profitable business. The carryovers will be disallowed under the provisions of section 269(a) without regard to the application of section 382.

Example 2. L Corporation has sustained heavy net operating losses for a number of years. In a merger under State law, P Corporation acquires all of the assets of L Corporation for the principal purpose of utilizing the net operating loss carryovers of L Corporation against the profits of P Corporation's business. As a result of the merger, the former stockholders of L Corporation own, immediately after the merger, 12 percent of the fair market value of the outstanding stock of P Corporation. If the merger qualifies as a reorganization to which section 381(a) applies, the entire net operating loss carryovers will be disallowed under the provisions of section 269(a) without regard to the application of section 382.

Example 3. L Corporation has been sustaining net operating losses for a number of years. P Corporation, a profitable corporation, on December 31, 1955, acquires all the stock of L Corporation for the purpose of continuing and improving the operation of L Corporation's business. Under the provisions of sections 334(b)(2) and 381(a)(1), P Corporation would not succeed to L Corporation's net operating loss carryovers if L Corporation were liquidated pursuant to a plan of liquidation adopted within two years after the date of the acquisition. During 1956, P Corporation transfers a profitable business to L Corporation for the principal purpose of using the profits of such business to absorb the net operating loss carryovers of L Corporation. The transfer is such as to cause the basis of the transferred assets in the hands of L Corporation to be determined by reference to their basis in the hands of P Corporation. L Corporation's net operating loss carryovers will be disallowed under the provisions of section 269(a) without regard to the application of section 382.

[T.D. 6595, 27 FR 3597, Apr. 14, 1962, as amended by T.D. 8388, 57 FR 346, Jan. 6, 1992]

§1.269–7 Relationship of section 269 to sections 382 and 383 after the Tax Reform Act of 1986.

Section 269 and §§1.269–1 through 1.269–5 may be applied to disallow a deduction, credit, or other allowance notwithstanding that the utilization or amount of a deduction, credit, or other allowance is limited or reduced under section 382 or 383 and the regulations thereunder. However, the fact that the amount of taxable income or tax that may be offset by a deduction, credit, or other allowance is limited under section 382(a) or 383 and the regulations thereunder is relevant to the determination of whether the principal purpose of an acquisition is the evasion or avoidance of Federal income tax.

[T.D. 8388, 57 FR 346, Jan. 6, 1992]

§ 1.270–1 Limitation on deductions allowable to individuals in certain cases.

(a) *Recomputation of taxable income.* (1) Under certain circumstances, section 270 limits the deductions (other than certain deductions described in subsection (b) thereof) attributable to a trade or business carried on by an individual which are otherwise allowable to such individual under the provisions of chapter 1 of the Code or the corresponding provisions of prior revenue laws. If, in each of five consecutive taxable years (including at least one taxable year beginning after December 31, 1953, and ending after August 16, 1954), the deductions attributable to a trade or business carried on by an individual (other than the specially treated deductions described in paragraph (b) of this section) exceed the gross income derived from such trade or business by more than $50,000, the taxable income computed under section 63 (or the net income computed under the corresponding provisions of prior revenue laws) of such individual shall be recomputed for each of such taxable years.

(2) In recomputing the taxable income (or the net income, in the case of taxable years which are otherwise subject to the Internal Revenue Code of 1939) for each of the five taxable years, the deductions (other than the specially treated deductions described in paragraph (b) of this section with the exception of the net operating loss deduction) attributable to the trade or business carried on by the individual shall be allowed only to the extent of (i) the gross income derived from such trade or business, plus (ii) $50,000. The specially treated deductions described in paragraph (b) of this section (other than the net operating loss deduction) shall each be allowed in full. The net operating loss deduction, to the extent attributable to such trade or business, shall be disallowed in its entirety. Thus, a carryover or a carryback of a net operating loss so attributable, either from a year within the period of five consecutive taxable years or from a taxable year outside of such period, shall be ignored in making the recomputation of taxable income or net income, as the case may be.

(3) The limitations on deductions provided by section 270 are also applicable in determining under section 172, or the corresponding provisions of prior revenue laws, the amount of any net operating loss carryover or carryback from any year which falls within the provisions of section 270 to any year which does not fall within such provisions. Also, in determining under section 172, or the corresponding provisions of prior revenue laws, the amount of any net operating loss carryover from a year which falls within the provisions of section 270 to a year which does not fall within such provisions, the amount of net operating loss is to be reduced by the taxable income or net income, as the case may be (computed as provided in § 1.172–5, or 26 CFR (1939) 39.122–4(c) (Regulations 118), as the case may be and, in the case of any taxable year which falls within the provisions of section 270, determined after the application of section 270), of any taxable year preceding or succeeding the taxable year of the net operating loss to which such loss must first be carried back or carried over under the provisions of section 172(b), or the corresponding provisions of prior revenue laws, even though the net operating loss deduction is not an allowable deduction for such preceding or succeeding taxable year.

(4) If an individual carries on several trades or businesses, the deductions attributable to such trades or businesses and the gross income derived therefrom shall not be aggregated in determining whether the deductions (other than the specially treated deductions) exceed the gross income derived from such trades or businesses by more than $50,000 in any taxable year. For the purposes of section 270, each trade or business shall be considered separately. However, where a particular business of an individual is conducted in one or more forms such as a partnership, joint venture, or individual proprietorship, the individual's share of the profits and losses from each business unit must be aggregated to determine the applicability of section 270. See paragraphs (a)(8)(ii) and (b) of § 1.702–1, relating to applicability of section 270 to a partner. Where it is established that for tax

purposes a husband and wife are partners in the same trade or business or that each is participating independently of the other in the same trade or business with his and her own money, the husband's gross income and deductions from that trade or business shall be considered separately from the wife's gross income and deductions from that trade or business even though they file a joint return. Where a taxpayer is engaged in a trade or business in a community property State under circumstances such that the income therefrom is considered to be community income, the taxpayer and his spouse are treated for purposes of section 270 as two individuals engaged separately in the same trade or business and the gross income and deductions attributable to the trade or business are allocated one-half to the taxpayer and one-half to the spouse. Where several business activities emanate from a single commodity, such as oil or gas or a tract of land, it does not necessarily follow that such activities are one business for the purposes of section 270. However, in order to be treated separately, it must be established that such business activities are actually conducted separately and are not closely interrelated with each other. For the purposes of section 270, the trade or business carried on by an individual must be the same in each of the five consecutive years in which the deductions (other than the specially treated deductions) exceed the gross income derived from such trade or business by more than $50,000.

(5) For the purposes of section 270, a taxable year may be part of two or more periods of five consecutive taxable years. Thus, if the deductions (other than the specially treated deductions) attributable to a trade or business carried on by an individual exceed the gross income therefrom by more than $50,000 for each of six consecutive taxable years, the fifth year of such six consecutive taxable years shall be considered to be a part both of a five-year period beginning with the first and ending with the fifth taxable year and of a five-year period beginning with the second and ending with the sixth taxable year.

(6) For the purposes of section 270, a short taxable year required to effect a change in accounting period constitutes a taxable year. In determining the applicability of section 270 in the case of a short taxable year, items of income and deduction are not annualized.

(b) *Specially treated deductions.* (1) For the purposes of section 270 and paragraph (a) of this section, the specially treated deductions are:

(i) Taxes,

(ii) Interest,

(iii) Casualty and abandonment losses connected with a trade or business deductible under section 165(c)(1) or the corresponding provisions of prior revenue laws,

(iv) Losses and expenses of the trade or business of farming which are directly attributable to drought,

(v) The net operating loss deduction allowed by section 172, or the corresponding provisions of prior revenue laws, and

(vi) Expenditures as to which a taxpayer is given the option, under law or regulations, either *(a)* to deduct as expenses when incurred, or *(b)* to defer or capitalize.

(2) For the purpose of subparagraph (1)(iv) of this paragraph, an individual is engaged in the ''trade or business of farming'' if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant. An individual who receives a rental (either in cash or in kind) which is based upon farm production is engaged in the trade or business of farming. However, an individual who receives a fixed rental (without reference to production) is engaged in the trade or business of farming only if he participates to a material extent in the operation or management of the farm. An individual engaged in forestry or the growing of timber is not thereby engaged in the trade or business of farming. An individual cultivating or operating a farm for recreation or pleasure rather than a profit is not engaged in the trade or business of farming. The term *farm* is used in its ordinarily accepted sense and includes stock, dairy, poultry, fruit, crop, and truck farms, and also plantations,

ranches, ranges, and orchards. An individual is engaged in the trade or business of farming if he is a member of a partnership engaged in the trade or business of farming.

(3) In order for losses and expenses of the trade or business of farming to qualify as specially treated deductions under subparagraph (1)(iv) of this paragraph such losses and expenses must be directly attributable to drought conditions and not to other causes such as faulty management or unfavorable market conditions. In general, the following are the types of losses and expenses which, if otherwise deductible, may qualify as specially treated deductions under subparagraph (1)(iv) of this paragraph:

(i) Losses for damages to or destruction of property as a result of drought conditions, if such property is used in the trade or business of farming or is purchased for resale in the trade or business of farming;

(ii) Expenses directly related to raising crops or livestock which are destroyed or damaged by drought. Included in this category are, for example, payments for labor, fertilizer, and feed used in raising such crops or livestock. If such crops or livestock to which the expenditures relate are only partially destroyed or damaged by drought then only a proportionate part of the expenditures is regarded as specially treated deductions; and

(iii) Expenses which would not have been incurred in the absence of drought conditions, such as expenses for procuring pasture or additional supplies of water or feed.

(4) The expenditures referred to in subparagraph (1)(vi) of this paragraph include, but are not limited to, intangible drilling and development costs in the case of oil and gas wells as provided in section 263(c) and the regulations thereunder, and expenditures for the development of a mine or other natural deposit (other than an oil or gas well) as provided in section 616 and the regulations thereunder.

(5) The provisions of section 270(b) do not operate to make an expenditure a deductible item if it is not otherwise deductible under the law applicable to the particular year in which it was incurred. Thus, for example, if it is necessary, pursuant to the provisions of section 270, to recompute the taxable or net income of an individual for the taxable years 1950 through 1954, the individual in making the recomputation may not deduct expenditures paid or incurred in the years 1950 through 1953 which must be capitalized under the law applicable to those years, even though the expenditures are deductible under the Code.

(c) *Applicability to taxable years otherwise subject to the Internal Revenue Code of 1939.* The net income of a taxable year otherwise subject to the Internal Revenue Code of 1939 shall be recomputed pursuant to section 270 if (i) such taxable year is included in a period of five consecutive taxable years which includes at least one taxable year beginning after December 31, 1953, and ending after August 16, 1954, and (ii) the deductions (other than the specially treated deductions specified in section 270(b)) for each taxable year in such five-year period exceed the $50,000 limitation specified in section 270. As described in paragraph (a)(5) of this section, a taxable year may be part of two or more periods of five consecutive taxable years, one meeting the requirements for recomputation pursuant to section 130 of the Internal Revenue Code of 1939 and the other meeting the requirements for recomputation pursuant to section 270 of the Internal Revenue Code of 1954, then the recomputation for such taxable year shall be made pursuant to section 270. For example, if a calendar year taxpayer sustains a loss from a trade or business for each of the years 1949 through 1954, the years 1950, 1951, 1952, and 1953 may be a part of two such periods of five consecutive taxable years. If, however, a taxable year is part of a period of five consecutive taxable years which meets the requirements for recomputation pursuant to section 130 of the Internal Revenue Code of 1939, but is not part of a period which meets the requirements for recomputation, pursuant to section 270, then a recomputation of net income for such taxable year must be made pursuant to section 130.

(d) *Redetermination of tax.* The tax imposed by Chapter 1 of the Code, or by the corresponding provisions of prior revenue laws, for each of the five consecutive taxable years specified in paragraph (a) of this section shall be redetermined upon the basis of the taxable income or net income of the individual, as the case may be, recomputed in the manner described in paragraph (a) of this section. If the assessment of a deficiency is prevented (except for the provisions of Part II (section 1311 and following), Subchapter Q, Chapter 1 of the Code, relating to the effect of limitations and other provisions in income tax cases) by the operation of any provision of law (e.g., sections 6501 and 6502, or the corresponding provisions of prior revenue laws, relating to the period of limitations upon assessment and collection) except section 7122, or the corresponding provisions of prior revenue laws, relating to compromises, or by any rule of law (e.g., res judicata), then the excess of the tax for such year as recomputed over the tax previously determined for such year shall be considered a deficiency for the purposes of section 270. The term *tax previously determined* shall have the same meaning as that assigned to such term by section 1314(a). See §1.1314 (a)–1.

(e) *Assessment of tax.* Any amount determined as a deficiency in the manner described in paragraph (d) of this section in respect of any taxable year of the five consecutive taxable years specified in paragraph (a) of this section may be assessed and collected as if on the date of the expiration of the period of limitation for the assessment of a deficiency for the fifth taxable year of such five consecutive taxable years, one year remained before the expiration of the period of limitation upon assessment for the taxable year in respect of which the deficiency is determined. If the taxable year is one in respect of which an assessment could be made without regard to section 270, the amount of the actual deficiency as defined in section 6211(a) (whether it is greater than, equal to, or less than the deficiency determined under section 270(c)) shall be assessed and collected. However, if the assessment of a deficiency for such taxable year would be prevented by any provision of law (e.g., the period of limitation upon the assessment of tax) except section 7122, or the corresponding provision of prior revenue laws, relating to compromises, or by the operation of any rule of law (e.g., res judicata), then the excess of the tax recomputed as described in paragraph (d) of this section over the tax previously determined may be assessed and collected even though in fact there is no actual deficiency, as defined in section 6211(a), in respect of the given taxable year.

(f) *Effective date; cross reference.* The provisions of section 270 and this section apply to taxable years beginning before January 1, 1970. Thus, for instance, if the taxpayer had a profit of $2,000 attributable to a trade or business in 1965, section 270 and this section would not apply to the taxable years 1966 through 1970, even though he had losses of more than $50,000 in each of the 5 years ending with 1970. For provisions relating to activities not engaged in for profit applicable to taxable years beginning after December 31, 1969, see section 183 and the regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7198, 37 FR 13685, July 13, 1972]

§1.271–1 Debts owed by political parties.

(a) *General rule.* In the case of a taxpayer other than a bank (as defined in section 581 and the regulations thereunder), no deduction shall be allowed under section 166 (relating to bad debts) or section 165(g) (relating to worthlessness of securities) by reason of the worthlessness of any debt, regardless of how it arose, owed by a political party. For example, it is immaterial that the debt may have arisen as a result of services rendered or goods sold or that the taxpayer included the amount of the debt in income. In the case of a bank, no deduction shall be allowed unless, under the facts and circumstances, it appears that the bad debt was incurred to or purchased by, or the worthless security was acquired by, the taxpayer in accordance with its usual commercial practices. Thus, if a bank makes a loan to a political party not in accordance with its usual commercial practices but solely because the president of the bank has been active in the party no bad debt deduction will be allowed with respect to the loan.

(b) *Definitions*—(1) *Political party.* For purposes of this section and § 1.276–1, the term *political party* means a political party (as commonly understood), a National, State, or local committee thereof, or any committee, association, or organization, whether incorporated or not, which accepts contributions (as defined in subparagraph (2) of this paragraph) or makes expenditures (as defined in subparagraph (3) of this paragraph) for the purpose of influencing or attempting to influence the election of presidential or vice-presidential electors, or the selection, nomination, or election of any individual to any Federal, State, or local elective public office, whether or not such individual or electors are selected, nominated, or elected. Accordingly, a political party includes a committee or other group which accepts contributions or makes expenditures for the purpose of promoting the nomination of an individual for an elective public office in a primary election, or in any convention, meeting, or caucus of a political party. It is immaterial whether the contributions or expenditures are accepted or made directly or indirectly. Thus, for example, a committee or other group, is considered to be a political party, if, although it does not expend any funds, it turns funds over to another organization, which does expend funds for the purpose of attempting to influence the nomination of an individual for an elective public office. An organization which engages in activities which are truly nonpartisan in nature will not be considered a political party merely because it conducts activities with respect to an election campaign if, under all the facts and circumstances, it is clear that its efforts are not directed to the election of the candidates of any particular party or parties or to the selection, nomination or election of any particular candidate. For example, a committee or group will not be treated as a political party if it is organized merely to inform the electorate as to the identity and experience of all candidates involved, to present on a nonpreferential basis the issues or views of the parties or candidates as described by the parties or candidates, or to provide a forum in which the candidates are freely invited on a nonpreferential basis to discuss or debate the issues.

(2) *Contributions.* For purposes of this section and § 1.276–1, the term *contributions* includes a gift, subscription, loan, advance, or deposit, of money or anything of value, and includes a contract, promise, or agreement to make a contribution, whether or not legally enforceable.

(3) *Expenditures.* For purposes of this section and § 1.276–1, the term *expenditures* includes a payment, distribution, loan, advance, deposit, or gift, of money or anything of value, and includes a contract, promise, or agreement to make an expenditure, whether or not legally enforceable.

[T.D. 6996, 34 FR 832, Jan. 18, 1969]

§ 1.272–1 Expenditures relating to disposal of coal or domestic iron ore.

(a) *Introduction.* Section 272 provides special treatment for certain expenditures paid or incurred by a taxpayer in connection with a contract (hereafter sometimes referred to as a ‘‘coal royalty contract’’ or ‘‘iron ore royalty contract’’) for the disposal of coal or iron ore the gain or loss from which is treated under section 631(c) as a section 1231 gain or loss on the sale of coal or iron ore. See paragraph (e) of § 1.631–3 for special rules relating to iron ore. The expenditures covered by section 272 are those which are attributable to the making and administering of such a contract or to the preservation of the economic interest retained under the contract. For examples of such expenditures, see paragraph (d) of this section. For a taxable year in which gross royalty income is realized under the contract of disposal, such expenditures shall not be allowed as a deduction. Instead, they are to be added to the adjusted depletion basis of the coal or iron ore disposed of in the taxable year in computing gain or loss under section 631(c). However, where no gross royalty income is realized under the contract of disposal in a particular taxable year, such expenditure shall be treated without regard to section 272.

(b) *In general.* (1) Where the disposal of coal or iron ore is covered by section 631(c), the provisions of section 272 and this section shall be applicable for a taxable year in which there is income under the contract of disposal. (For purposes of section 272 and this section, the term *income* means gross amounts received or accrued which are royalties or bonuses in connection with a contract to which section 631(c) applies.) All expenditures paid or incurred by the taxpayer during the taxable year which are attributable to the making and administering of the contract disposing of the coal or iron ore and all expenditures paid or incurred during the taxable year in order to preserve the owner's economic interest retained under the contract shall be disallowed as deductions in computing taxable income for the taxable year. The sum of such expenditures and the adjusted depletion basis of the coal or iron ore disposed of in the taxable year shall be used in determining the amount of gain or loss with respect to the disposal. See §1.631–3. For special rule in case of loss, see paragraph (c) of this section. Section 272 and this section do not apply to capital expenditures, and such expenditures are not taken into account in computing gain or loss under section 631(c) except to the extent they are properly part of the depletable basis of the coal or iron ore.

(2) The expenditures covered under section 272 and this section are disallowed as a deduction only with respect to a taxable year in which income is realized under the coal royalty contract (or iron ore royalty contract) to which such expenditures are attributable. Where no income is realized under the contract in a taxable year, these expenditures shall be deducted as expenses for the production of income, or as a business expense, or they may be treated under section 266 (relating to taxes and carrying charges) if applicable.

(3) The provisions of section 272 and this section apply to a taxable year in which income from the disposal by the owner of coal or iron ore held by him for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) is subject to the provisions of section 631(c) even though the actual mining of coal or iron ore under the coal royalty contract (or iron ore royalty contract) does not take place during the taxable year. Where the right under the contract to mine coal or iron ore for which advance payment has been made expires, terminates, or is abandoned before the coal or iron ore is mined, and paragraph (c) of §1.631–3 requires the owner to recompute his tax with respect to such payment, the recomputation must be made without applying the provisions of section 272 and this section.

(c) *Losses.* If, in any taxable year, the expenditures referred to in section 272 and this section plus the adjusted depletion basis (as defined in paragraph (b)(2) of §1.631–3) of the coal or iron ore disposed of during the taxable year exceed the amount realized under the contract which is subject to section 631(c) during the taxable year, such excess shall be considered under section 1231 as a loss from the sale of property used in the trade or business and, to the extent not availed of as a reduction of gain under that section, shall be a loss deductible under section 165(a) (relating to the deduction of losses generally).

(d) *Examples of expenditures.* (1) The expenditures referred to in section 272 include, but are not limited to, the following items, if such items are attributable to the making or administering of the contract or preserving the economic interest therein: Ad valorem taxes imposed by State or local authorities, costs of fire protection, costs of insurance (other than liability insurance), costs incurred in administering the contract (including costs of bookkeeping and technical supervision), interest on loans, expenses of flood control, legal and technical expenses, and expenses of measuring and checking quantities of coal or iron ore disposed of under the contract. Whether the interest on loans is attributable to the making or administering of the contract or preserving the economic interest therein will depend upon the use to which the borrowed monies are put.

(2) Any expenditure referred to in this section which is applicable to more than one coal royalty contract or iron ore royalty contract shall be reasonably apportioned to each of such contracts. Furthermore, if an expenditure applies only in part to the making

or administering of the contract or the preservation of the economic interest, then only such part shall be treated under section 272. The apportionment of the expenditure shall be made on a reasonable basis. For example, where a taxpayer has other income (such as income from oil or gas royalties, rentals, right of way fees, interest, or dividends) as well as income under section 631(c), and where the salaries of some of its employees or other expenses relate to both classes of income, such expenses shall be allocated reasonably between the income subject to section 631(c) and the other income. Where a taxpayer has more than one coal royalty contract or iron ore royalty contract, expenditures under this section relating to a contract from which no income has been received in the taxable year may not be allocated to income from another contract from which income has been received in the taxable year.

(3) The taxpayer may have expenses which are not attributable even partly to making and administering a coal royalty contract or iron ore royalty contract or to the preservation of the economic interest retained under the contract and, accordingly, are not included in the expenditures described in section 272. These include such items as ad valorem taxes imposed by State or local authorities on property not covered by the contract, salaries, wages, or other expenses entirely incident to the ownership and protection of such property and depreciation of improvements thereon, fire insurance on such property, charitable contributions, and similar expenses unrelated to the making or to the administering of coal royalty contracts or iron ore royalty contracts or preserving the taxpayer's economic interest retained therein.

(e) *Nonapplication of section.* For purposes of section 543, the provisions of section 272 shall have no application. For example, the taxpayer may, for the purposes of section 543(a)(3)(C) or the corresponding provisions of prior income tax laws, include in the sum of the deductions which are allowable under section 162 an amount paid to an attorney as compensation for legal services rendered in connection with the making of a coal royalty contract or iron ore royalty contract (assuming the expenditure otherwise qualifies under section 162 as an ordinary and necessary expense incurred in the taxpayer's trade or business), even though such expenditure is disallowed as a deduction under section 272.

[T.D. 6841, 30 FR 9304, July 27, 1965, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§1.273–1 Life or terminable interests.

Amounts paid as income to the holder of a life or a terminable interest acquired by gift, bequest, or inheritance shall not be subject to any deduction for shrinkage (whether called by depreciation or any other name) in the value of such interest due to the lapse of time. In other words, the holder of such an interest so acquired may not set up the value of the expected future payments as corpus or principal and claim deduction for shrinkage or exhaustion thereof due to the passage of time. For the treatment generally of distributions to beneficiaries of an estate or trust, see Subparts A, B, C, and D (section 641 and following), Subchapter J, Chapter 1 of the Code, and the regulations thereunder. For basis of property acquired from a decedent and by gifts and transfers in trust, see sections 1014 and 1015, and the regulations thereunder.

§1.274–1 Disallowance of certain entertainment, gift and travel expenses.

Section 274 disallows in whole, or in part, certain expenditures for entertainment, gifts and travel which would otherwise be allowable under Chapter 1 of the Code. The requirements imposed by section 274 are in addition to the requirements for deductibility imposed by other provisions of the Code. If a deduction is claimed for an expenditure for entertainment, gifts, or travel, the taxpayer must first establish that it is otherwise allowable as a deduction under Chapter 1 of the Code before the provisions of section 274 become applicable. An expenditure for entertainment, to the extent it is lavish or extravagant, shall not be allowable as a deduction. The taxpayer should then substantiate such an expenditure in accordance with the rules under section

274(d). See §1.274–5. Section 274 is a disallowance provision exclusively, and does not make deductible any expense which is disallowed under any other provision of the Code. Similarly, section 274 does not affect the includability of an item in, or the excludability of an item from, the gross income of any taxpayer. For specific provisions with respect to the deductibility of expenditures: for an activity of a type generally considered to constitute entertainment, amusement, or recreation, and for a facility used in connection with such an activity, as well as certain travel expenses of a spouse, etc., see §1.274–2; for expenses for gifts, see §1.274–3; for expenses for foreign travel, see §1.274–4; for expenditures deductible without regard to business activity, see §1.274–6; and for treatment of personal portion of entertainment facility, see §1.274–7.

[T.D. 6659, 28 FR 6499, June 25, 1963, as amended by T.D. 8666, 61 FR 27006, May 30, 1996]

§1.274–2 Disallowance of deductions for certain expenses for entertainment, amusement, recreation, or travel.

(a) *General rules*—(1) *Entertainment activity.* Except as provided in this section, no deduction otherwise allowable under Chapter 1 of the Code shall be allowed for any expenditure with respect to entertainment unless the taxpayer establishes:

(i) That the expenditure was directly related to the active conduct of the taxpayer's trade or business, or

(ii) In the case of an expenditure directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that the expenditure was associated with the active conduct of the taxpayer's trade or business.

Such deduction shall not exceed the portion of the expenditure directly related to (or in the case of an expenditure described in subdivision (ii) of this subparagraph, the portion of the expenditure associated with) the active conduct of the taxpayer's trade or business.

(2) *Entertainment facilities*—(i) *Expenditures paid or incurred after December 31, 1978, and not with respect to a club.* Except as provided in this section with respect to a club, no deduction otherwise allowable under chapter 1 of the Code shall be allowed for any expenditure paid or incurred after December 31, 1978, with respect to a facility used in connection with entertainment.

(ii) *Expenditures paid or incurred before January 1, 1979, with respect to entertainment facilities, or paid or incurred before January 1, 1994, with respect to clubs*—(*a*) *Requirements for deduction.* Except as provided in this section, no deduction otherwise allowable under chapter 1 of the Internal Revenue Code shall be allowed for any expenditure paid or incurred before January 1, 1979, with respect to a facility used in connection with entertainment, or for any expenditure paid or incurred before January 1, 1994, with respect to a club used in connection with entertainment, unless the taxpayer establishes—

(*1*) That the facility or club was used primarily for the furtherance of the taxpayer's trade or business; and

(*2*) That the expenditure was directly related to the active conduct of that trade or business.

(*b*) *Amount of deduction.* The deduction allowable under paragraph (a)(2)(ii)(*a*) of this section shall not exceed the portion of the expenditure directly related to the active conduct of the taxpayer's trade or business.

(iii) *Expenditures paid or incurred after December 31, 1993, with respect to a club*—(*a*) *In general.* No deduction otherwise allowable under chapter 1 of the Internal Revenue Code shall be allowed for amounts paid or incurred after December 31, 1993, for membership in any club organized for business, pleasure, recreation, or other social purpose. The purposes and activities of a club, and not its name, determine whether it is organized for business, pleasure, recreation, or other social purpose. Clubs organized for business, pleasure, recreation, or other social purpose include any membership organization if a principal purpose of the organization is to conduct entertainment activities for members of the organization or their guests or to provide members or their guests with access to entertainment facilities within the meaning of paragraph (e)(2) of this section. Clubs organized for business, pleasure, recreation, or other social purpose include, but are not limited to, country clubs, golf and athletic clubs, airline clubs, hotel clubs, and clubs operated to provide meals under circumstances generally considered to be conducive to business discussion.

(*b*) *Exceptions.* Unless a principal purpose of the organization is to conduct entertainment activities for members or their guests or to provide members or their guests with access to entertainment facilities, business leagues, trade associations, chambers of commerce, boards of trade, real estate boards, professional organizations (such as bar associations and medical associations), and civic or public service organizations will not be treated as clubs organized for business, pleasure, recreation, or other social purpose.

(3) *Cross references.* For definition of the term *entertainment*, see paragraph (b)(1) of this section. For the disallowance of deductions for the cost of admission to a dinner or program any part of the proceeds of which inures to the use of a political party or political candidate, and cost of admission to an inaugural event or similar event identified with any political party or political candidate, see § 1.276–1. For rules and definitions with respect to:

(i) ‘‘Directly related entertainment’’, see paragraph (c) of this section,

(ii) ‘‘Associated entertainment’’, see paragraph (d) of this section,

(iii) ‘‘Expenditures paid or incurred before January 1, 1979, with respect to entertainment facilities or before January 1, 1994, with respect to clubs’’, see paragraph (e) of this section, and

(iv) ‘‘Specific exceptions’’ to the disallowance rules of this section, see paragraph (f) of this section.

(b) *Definitions*—(1) *Entertainment defined*—(i) *In general.* For purposes of this section, the term *entertainment* means any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family. The term *entertainment* may include an activity, the cost of which is claimed as a business expense by the taxpayer, which satisfies the personal, living, or family needs of any individual, such as providing food and beverages, a hotel suite, or an automobile to a business customer or his family. The term *entertainment* does not include activities which, although satisfying personal, living, or family needs of an individual, are clearly not regarded as constituting entertainment, such as *(a)* supper money provided by an employer to his employee working overtime, *(b)* a hotel room maintained by an employer for lodging of his employees while in business travel status, or *(c)* an automobile used in the active conduct of trade or business even though used for routine personal purposes such as commuting to and from work. On the other hand, the providing of a hotel room or an automobile by an employer to his employee who is on vacation would constitute entertainment of the employee.

(ii) *Objective test.* An objective test shall be used to determine whether an activity is of a type generally considered to constitute entertainment. Thus, if an activity is generally considered to be entertainment, it will constitute entertainment for purposes of this section and section 274(a) regardless of whether the expenditure can also be described otherwise, and even though the expenditure relates to the taxpayer alone. This objective test precludes arguments such as that *entertainment* means only entertainment of others or that an expenditure for entertainment should be characterized as an expenditure for advertising or public relations. However, in applying this test the taxpayer's trade or business shall be considered. Thus, although attending a theatrical performance would generally be considered entertainment, it would not be so considered in the case of a professional theater critic, attending in his professional capacity. Similarly, if a manufacturer of dresses conducts a fashion show to introduce his products to a group of store buyers, the show would not be generally considered to constitute entertainment. However, if an appliance distributor conducts a fashion show for the wives of his retailers, the fashion show would be generally considered to constitute entertainment.

(iii) *Special definitional rules—(a) In general.* Except as otherwise provided in *(b)* or *(c)* of this subdivision, any expenditure which might generally be considered either for a gift or entertainment, or considered either for travel or entertainment, shall be considered an expenditure for entertainment rather than for a gift or travel.

(*b*) *Expenditures deemed gifts.* An expenditure described in *(a)* of this subdivision shall be deemed for a gift to which this section does not apply if it is:

(*1*) An expenditure for packaged food or beverages transferred directly or indirectly to another person intended for consumption at a later time.

(*2*) An expenditure for tickets of admission to a place of entertainment transferred to another person if the taxpayer does not accompany the recipient to the entertainment unless the taxpayer treats the expenditure as entertainment. The taxpayer may change his treatment of such an expenditure as either a gift or entertainment at any time within the period prescribed for assessment of tax as provided in section 6501 of the Code and the regulations thereunder.

(*3*) Such other specific classes of expenditure generally considered to be for a gift as the Commissioner, in his discretion, may prescribe.

(*c*) *Expenditures deemed travel.* An expenditure described in *(a)* of this subdivision shall be deemed for travel to which this section does not apply if it is:

(*1*) With respect to a transportation type facility (such as an automobile or an airplane), even though used on other occasions in connection with an activity of a type generally considered to constitute entertainment, to the extent the facility is used in pursuit of a trade or business for purposes of transportation not in connection with entertainment. See also paragraph (e)(3)(iii)*(b)* of this section for provisions covering nonentertainment expenditures with respect to such facilities.

(*2*) Such other specific classes of expenditure generally considered to be for travel as the Commissioner, in his discretion, may prescribe.

(2) *Other definitions*—(i) *Expenditure.* The term *expenditure* as used in this section shall include expenses paid or incurred for goods, services, facilities, and items (including items such as losses and depreciation).

(ii) *Expenses for production of income.* For purposes of this section, any reference to *trade or business* shall include any activity described in section 212.

(iii) *Business associate.* The term *business associate* as used in this section means a person with whom the taxpayer could reasonably expect to engage or deal in the active conduct of the taxpayer's trade or business such as the taxpayer's customer, client, supplier, employee, agent, partner, or professional adviser, whether established or prospective.

(c) *Directly related entertainment*—(1) *In general.* Except as otherwise provided in paragraph (d) of this section (relating to associated entertainment) or under paragraph (f) of this section (relating to business meals and other specific exceptions), no deduction shall be allowed for any expenditure for entertainment unless the taxpayer establishes that the expenditure was directly related to the active conduct of his trade or business within the meaning of this paragraph.

(2) *Directly related entertainment defined.* Any expenditure for entertainment, if it is otherwise allowable as a deduction under chapter 1 of the Code, shall be considered directly related to the active conduct of the taxpayer's trade or business if it meets the requirements of any one of subparagraphs (3), (4), (5), or (6) of this paragraph.

(3) *Directly related in general.* Except as provided in subparagraph (7) of this paragraph, an expenditure for entertainment shall be considered directly related to the active conduct of the taxpayer's trade or business if it is established that it meets all of the requirements of subdivisions (i), (ii), (iii) and (iv) of this subparagraph.

(i) At the time the taxpayer made the entertainment expenditure (or committed himself to make the expenditure), the taxpayer had more than a general expectation of deriving some income or other specific trade or business benefit (other than the goodwill of the person or persons entertained) at some indefinite future time from the making of the expenditure. A taxpayer, however, shall not be required to show that income or other business benefit actually resulted from each and every expenditure for which a deduction is claimed.

(ii) During the entertainment period to which the expenditure related, the taxpayer actively engaged in a business meeting, negotiation, discussion, or other bona fide business transaction, other than entertainment, for the purpose of obtaining such income or other specific trade or business benefit (or, at the time the taxpayer made the expenditure or committed himself to the expenditure, it was reasonable for the taxpayer to expect that he would have done so, although such was not the case solely for reasons beyond the taxpayer's control).

(iii) In light of all the facts and circumstances of the case, the principal character or aspect of the combined business and entertainment to which the expenditure related was the active conduct of the taxpayer's trade or business (or at the time the taxpayer made the expenditure or committed himself to the expenditure, it was reasonable for the taxpayer to expect that the active conduct of trade or business would have been the principal character or aspect of the entertainment, although such was not the case solely for reasons beyond the taxpayer's control). It is not necessary that more time be devoted to business than to entertainment to meet this requirement. The active conduct of trade or business is considered not to be the principal character or aspect of combined business and entertainment activity on hunting or fishing trips or on yachts and other pleasure boats unless the taxpayer clearly establishes to the contrary.

(iv) The expenditure was allocable to the taxpayer and a person or persons with whom the taxpayer engaged in the active conduct of trade or business during the entertainment or with whom the taxpayer establishes he would have engaged in such active conduct of trade or business if it were not for circumstances beyond the taxpayer's control. For expenditures closely connected with directly related entertainment, see paragraph (d)(4) of this section.

(4) *Expenditures in clear business setting.* An expenditure for entertainment shall be considered directly related to the active conduct of the taxpayer's trade or business if it is established that the expenditure was for entertainment occurring in a clear business setting directly in furtherance of the taxpayer's trade or business. Generally, entertainment shall not be considered to have occurred in a clear business setting unless the taxpayer clearly establishes that any recipient of the entertainment would have reasonably known that the taxpayer had no significant motive, in incurring the expenditure, other than directly furthering his trade or business. Objective rather than subjective standards will be determinative. Thus, entertainment which occurred under any circumstances described in subparagraph (7)(ii) of this paragraph ordinarily will not be considered as occurring in a clear business setting. Such entertainment will generally be considered to be socially rather than commercially motivated. Expenditures made for the furtherance of a taxpayer's trade or business in providing a ‘‘hospitality room’’ at a convention (described in paragraph (d)(3)(i)*(b)* of this section) at which goodwill is created through display or discussion of the taxpayer's products, will, however, be treated as directly related. In addition, entertainment of a clear business nature which occurred under circumstances where there was no meaningful personal or social relationship between the taxpayer and the recipients of the entertainment may be considered to have occurred in a clear business setting. For example, entertainment of business representatives and civic leaders at the opening of a new hotel or theatrical production, where the clear purpose of the taxpayer is to obtain business publicity rather than to create or maintain the goodwill of the recipients of the entertainment, would generally be considered to be in a clear business setting. Also, entertainment which has the principal effect of a price rebate in connection

with the sale of the taxpayer's products generally will be considered to have occurred in a clear business setting. Such would be the case, for example, if a taxpayer owning a hotel were to provide occasional free dinners at the hotel for a customer who patronized the hotel.

(5) *Expenditures for services performed.* An expenditure shall be considered directly related to the active conduct of the taxpayer's trade or business if it is established that the expenditure was made directly or indirectly by the taxpayer for the benefit of an individual (other than an employee), and if such expenditure was in the nature of compensation for services rendered or was paid as a prize or award which is required to be included in gross income under section 74 and the regulations thereunder. For example, if a manufacturer of products provides a vacation trip for retailers of his products who exceed sales quotas as a prize or award which is includible in gross income, the expenditure will be considered directly related to the active conduct of the taxpayer's trade or business.

(6) *Club dues, etc., allocable to business meals.* An expenditure shall be considered directly related to the active conduct of the taxpayer's trade or business if it is established that the expenditure was with respect to a facility (as described in paragraph (e) of this section) used by the taxpayer for the furnishing of food or beverages under circumstances described in paragraph (f)(2)(i) of this section (relating to business meals and similar expenditures), to the extent allocable to the furnishing of such food or beverages. This paragraph (c)(6) applies to club dues paid or incurred before January 1, 1987.

(7) *Expenditures generally considered not directly related.* Expenditures for entertainment, even if connected with the taxpayer's trade or business, will generally be considered not directly related to the active conduct of the taxpayer's trade or business, if the entertainment occurred under circumstances where there was little or no possibility of engaging in the active conduct of trade or business. The following circumstances will generally be considered circumstances where there was little or no possibility of engaging in the active conduct of a trade or business:

(i) The taxpayer was not present;

(ii) The distractions were substantial, such as:

(*a*) A meeting or discussion at night clubs, theaters, and sporting events, or during essentially social gatherings such as cocktail parties, or

(*b*) A meeting or discussion, if the taxpayer meets with a group which includes persons other than business associates, at places such as cocktail lounges, country clubs, golf and athletic clubs, or at vacation resorts.

An expenditure for entertainment in any such case is considered not to be directly related to the active conduct of the taxpayer's trade or business unless the taxpayer clearly establishes to the contrary.

(d) *Associated entertainment*—(1) *In general.* Except as provided in paragraph (f) of this section (relating to business meals and other specific exceptions) and subparagraph (4) of this paragraph (relating to expenditures closely connected with directly related entertainment), any expenditure for entertainment which is not directly related to the active conduct of the taxpayer's trade or business will not be allowable as a deduction unless:

(i) It was associated with the active conduct of trade or business as defined in subparagraph (2) of this paragraph, and

(ii) The entertainment directly preceded or followed a substantial and bona fide business discussion as defined in subparagraph (3) of this paragraph.

(2) *Associated entertainment defined.* Generally, any expenditure for entertainment, if it is otherwise allowable under Chapter 1 of the Code, shall be considered associated with the active conduct of the taxpayer's trade or business if the taxpayer establishes that he had a clear business purpose in making the expenditure, such as to obtain new business or to encourage the continuation of an existing business relationship. However, any portion of an expenditure allocable to a person who was not closely connected with a person who engaged in the substantial and bona fide business discussion (as defined in subparagraph (3)(i) of this

paragraph) shall not be considered associated with the active conduct of the taxpayer's trade or business. The portion of an expenditure allocable to the spouse of a person who engaged in the discussion will, if it is otherwise allowable under chapter 1 of the Code, be considered associated with the active conduct of the taxpayer's trade or business.

(3) *Directly preceding or following a substantial and bona fide business discussion defined*—(i) *Substantial and bona fide business discussion*—(*a*) *In general.* Whether any meeting, negotiation or discussion constitutes a ''substantial and bona fide business discussion'' within the meaning of this section depends upon the facts and circumstances of each case. It must be established, however, that the taxpayer actively engaged in a business meeting, negotiation, discussion, or other bona fide business transaction, other than entertainment, for the purpose of obtaining income or other specific trade or business benefit. In addition, it must be established that such a business meeting, negotiation, discussion, or transaction was substantial in relation to the entertainment. This requirement will be satisfied if the principal character or aspect of the combined entertainment and business activity was the active conduct of business. However, it is not necessary that more time be devoted to business than to entertainment to meet this requirement.

(*b*) *Meetings at conventions, etc.* Any meeting officially scheduled in connection with a program at a convention or similar general assembly, or at a bona fide trade or business meeting sponsored and conducted by business or professional organizations, shall be considered to constitute a substantial and bona fide business discussion within the meaning of this section provided:

(*1*) *Expenses necessary to taxpayer's attendance.* The expenses necessary to the attendance of the taxpayer at the convention, general assembly, or trade or business meeting, were ordinary and necessary within the meaning of section 162 or 212;

(*2*) *Convention program.* The organization which sponsored the convention, or trade or business meeting had scheduled a program of business activities (including committee meetings or presentation of lectures, panel discussions, display of products, or other similar activities), and that such program was the principal activity of the convention, general assembly, or trade or business meeting.

(ii) *Directly preceding or following.* Entertainment which occurs on the same day as a substantial and bona fide business discussion (as defined in subdivision (i) of this subparagraph) will be considered to directly precede or follow such discussion. If the entertainment and the business discussion do not occur on the same day, the facts and circumstances of each case are to be considered, including the place, date and duration of the business discussion, whether the taxpayer or his business associates are from out of town, and, if so, the date of arrival and departure, and the reasons the entertainment did not take place on the day of the business discussion. For example, if a group of business associates comes from out of town to the taxpayer's place of business to hold a substantial business discussion, the entertainment of such business guests and their wives on the evening prior to, or on the evening of the day following, the business discussion would generally be regarded as directly preceding or following such discussion.

(4) *Expenses closely connected with directly related entertainment.* If any portion of an expenditure meets the requirements of paragraph (c)(3) of this section (relating to directly related entertainment in general), the remaining portion of the expenditure, if it is otherwise allowable under Chapter 1 of the Code, shall be considered associated with the active conduct of the taxpayer's trade or business to the extent allocable to a person or persons closely connected with a person referred to in paragraph (c)(3)(iv) of this section. The spouse of a person referred to in paragraph(c)(3)(iv) of this section will be considered closely connected to such a person for purposes of this subparagraph. Thus, if a taxpayer and his wife entertain a business customer and the customer's wife under circumstances where the entertainment of the customer is considered directly related to the active conduct of the taxpayer's

trade or business (within the meaning of paragraph (c)(3) of this section) the portion of the expenditure allocable to both wives will be considered associated with the active conduct of the taxpayer's trade or business under this subparagraph.

(e) *Expenditures paid or incurred before January 1, 1979, with respect to entertainment facilities or before January 1, 1994, with respect to clubs*—(1) *In general.* Any expenditure paid or incurred before January 1, 1979, with respect to a facility, or paid or incurred before January 1, 1994, with respect to a club, used in connection with entertainment shall not be allowed as a deduction except to the extent it meets the requirements of paragraph (a)(2)(ii) of this section.

(2) *Facilities used in connection with entertainment*—(i) *In general.* Any item of personal or real property owned, rented, or used by a taxpayer shall (unless otherwise provided under the rules of subdivision (ii) of this subparagraph) be considered to constitute a facility used in connection with entertainment if it is used during the taxable year for, or in connection with, entertainment (as defined in paragraph (b)(1) of this section). Examples of facilities which might be used for, or in connection with, entertainment include yachts, hunting lodges, fishing camps, swimming pools, tennis courts, bowling alleys, automobiles, airplanes, apartments, hotel suites, and homes in vacation resorts.

(ii) *Facilities used incidentally for entertainment.* A facility used only incidentally during a taxable year in connection with entertainment, if such use is insubstantial, will not be considered a ''facility used in connection with entertainment'' for purposes of this section or for purposes of the recordkeeping requirements of section 274(d). See §1.274–5(c)(6)(iii).

(3) *Expenditures with respect to a facility used in connection with entertainment*—(i) *In general.* The phrase *expenditures with respect to a facility used in connection with entertainment* includes depreciation and operating costs, such as rent and utility charges (for example, water or electricity), expenses for the maintenance, preservation or protection of a facility (for example, repairs, painting, insurance charges), and salaries or expenses for subsistence paid to caretakers or watchmen. In addition, the phrase includes losses realized on the sale or other disposition of a facility.

(ii) *Club dues*—(*a*) *Club dues paid or incurred before January 1, 1994.* Dues or fees paid before January 1, 1994, to any social, athletic, or sporting club or organization are considered expenditures with respect to a facility used in connection with entertainment. The purposes and activities of a club or organization, and not its name, determine its character. Generally, the phrase *social, athletic, or sporting club or organization* has the same meaning for purposes of this section as that phrase had in section 4241 and the regulations thereunder, relating to the excise tax on club dues, prior to the repeal of section 4241 by section 301 of Public Law 89–44. However, for purposes of this section only, clubs operated solely to provide lunches under circumstances of a type generally considered to be conducive to business discussion, within the meaning of paragraph (f)(2)(i) of this section, will not be considered social clubs.

(*b*) *Club dues paid or incurred after December 31, 1993.* See paragraph (a)(2)(iii) of this section with reference to the disallowance of deductions for club dues paid or incurred after December 31, 1993.

(iii) *Expenditures not with respect to a facility.* The following expenditures shall not be considered to constitute expenditures with respect to a facility used in connection with entertainment:

(*a*) *Out of pocket expenditures.* Expenses (exclusive of operating costs and other expenses referred to in subdivision (i) of this subparagraph) incurred at the time of an entertainment activity, even though in connection with the use of facility for entertainment purposes, such as expenses for food and beverages, or expenses for catering, or expenses for gasoline and fishing bait consumed on a fishing trip;

(*b*) *Non-entertainment expenditures.* Expenses or items attributable to the use of a facility for other than entertainment purposes such as expenses for an automobile when not used for entertainment; and

(*c*) *Expenditures otherwise deductible.* Expenses allowable as a deduction without regard to their connection with a taxpayer's trade or business such as taxes, interest, and casualty losses. The provisions of this subdivision shall be applied in the case of a taxpayer which is not an individual as if it were an individual. See also § 1.274–6.

(iv) *Cross reference.* For other rules with respect to treatment of certain expenditures for entertainment-type facilities, see § 1.274–7.

(4) *Determination of primary use*—(i) *In general.* A facility used in connection with entertainment shall be considered as used primarily for the furtherance of the taxpayer's trade or business only if it is established that the primary use of the facility during the taxable year was for purposes considered ordinary and necessary within the meaning of sections 162 and 212 and the regulations thereunder. All of the facts and circumstances of each case shall be considered in determining the primary use of a facility. Generally, it is the actual use of the facility which establishes the deductibility of expenditures with respect to the facility; not its availability for use and not the taxpayer's principal purpose in acquiring the facility. Objective rather than subjective standards will be determinative. If membership entitles the member's entire family to use of a facility, such as a country club, their use will be considered in determining whether business use of the facility exceeds personal use. The factors to be considered include the nature of each use, the frequency and duration of use for business purposes as compared with other purposes, and the amount of expenditures incurred during use for business compared with amount of expenditures incurred during use for other purposes. No single standard of comparison, or quantitative measurement, as to the significance of any such factor, however, is necessarily appropriate for all classes or types of facilities. For example, an appropriate standard for determining the primary use of a country club during a taxable year will not necessarily be appropriate for determining the primary use of an airplane. However, a taxpayer shall be deemed to have established that a facility was used primarily for the furtherance of his trade or business if he establishes such primary use in accordance with subdivision (ii) or (iii) of this subparagraph. Subdivisions (ii) and (iii) of this subparagraph shall not preclude a taxpayer from otherwise establishing the primary use of a facility under the general provisions of this subdivision.

(ii) *Certain transportation facilities.* A taxpayer shall be deemed to have established that a facility of a type described in this subdivision was used primarily for the furtherance of his trade or business if:

(*a*) *Automobiles.* In the case of an automobile, the taxpayer establishes that more than 50 percent of mileage driven during the taxable year was in connection with travel considered to be ordinary and necessary within the meaning of section 162 or 212 and the regulations thereunder.

(*b*) *Airplanes.* In the case of an airplane, the taxpayer establishes that more than 50 percent of hours flown during the taxable year was in connection with travel considered to be ordinary and necessary within the meaning of section 162 or 212 and the regulations thereunder.

(iii) *Entertainment facilities in general.* A taxpayer shall be deemed to have established that:

(*a*) A facility used in connection with entertainment, such as a yacht or other pleasure boat, hunting lodge, fishing camp, summer home or vacation cottage, hotel suite, country club, golf club or similar social, athletic, or sporting club or organization, bowling alley, tennis court, or swimming pool, or,

(*b*) A facility for employees not falling within the scope of section 274(e) (2) or (5) was used primarily for the furtherance of his trade or business if he establishes that more than 50 percent of the total calendar days of use of the facility by, or under authority of, the taxpayer during the taxable year were days of business use. Any use of a facility (of a type described in this subdivision) during one calendar day shall be considered to constitute a ''day of business use'' if the primary use of the facility on such day was ordinary and necessary within the meaning of section 162 or 212 and the regulations thereunder. For the purposes of this subdivision, a facility shall be deemed to have been primarily used for such pruposes on any one calendar day if the facility was used for the conduct of a substantial and bona fide business discussion (as defined in paragraph (d)(3)(i) of this section) notwithstanding that the facility may also have been used on the same day for personal or family use by the taxpayer or any member of the taxpayer's family not involving entertainment of others by, or under the authority of, the taxpayer.

(f) *Specific exceptions to application of this section*—(1) *In general.* The provisions of paragraphs (a) through (e) of this section (imposing limitations on deductions for entertainment expenses) are not applicable in the case of expenditures set forth in subparagraph (2) of this paragraph. Such expenditures are deductible to the extent allowable under chapter 1 of the Code. This paragraph shall not be construed to affect the allowability or nonallowability of a deduction under section 162 or 212 and the regulations thereunder. The fact that an expenditure is not covered by a specific exception provided for in this paragraph shall not be determinative of the allowability or nonallowability of the expenditure under paragraphs (a) through (e) of this section. Expenditures described in subparagraph (2) of this paragraph are subject to the substantiation requirements of section 274(d) to the extent provided in §1.274–5.

(2) *Exceptions.* The expenditures referred to in subparagraph (1) of this paragraph are set forth in subdivisions (i) through (ix) of this subparagraph.

(i) *Business meals and similar expenditures paid or incurred before January 1, 1987*—(*a*) *In general.* Any expenditure for food or beverages furnished to an individual under circumstances of a type generally considered conducive to business discussion (taking into account the surroundings in which furnished, the taxpayer's trade, business, or income-producing activity, and the relationship to such trade, business or activity of the persons to whom the food or beverages are furnished) is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. There is no requirement that business actually be discussed for this exception to apply.

(*b*) *Surroundings.* The surroundings in which the food or beverages are furnished must be such as would provide an atmosphere where there are no substantial distractions to discussion. This exception applies primarily to expenditures for meals and beverages served during the course of a breakfast, lunch or dinner meeting of the taxpayer and his business associates at a restaurant, hotel dining room, eating club or similar place not involving distracting influences such as a floor show. This exception also applies to expenditures for beverages served apart from meals if the expenditure is incurred in surroundings similarly conducive to business discussion, such as an expenditure for beverages served during the meeting of the taxpayer and his business associates at a cocktail lounge or hotel bar not involving distracting influences such as a floor show. This exception may also apply to expenditures for meals or beverages served in the taxpayer's residence on a clear showing that the expenditure was commercially rather than socially motivated. However, this exception, generally, is not applicable to any expenditure for meals or beverages furnished in circumstances where there are major distractions not conducive to business discussion, such as at night clubs, sporting events, large cocktail parties, sizeable social gatherings, or other major distracting influences.

(*c*) *Taxpayer's trade or business and relationship of persons entertained.* The taxpayer's trade, business, or income-producing activity and the relationship of the persons to whom the food or beverages are served to such trade, business or activity must be such as will reasonably indicate that the food or beverages were furnished for the primary purpose of furthering the taxpayer's trade or business and did not primarily serve a social or personal purpose. Such a business purpose would be indicated, for example, if a salesman employed by a manufacturing supply company meets for lunch during a normal business day with a purchasing agent for a manufacturer which is a prospective customer. Such a purpose would also be indicated if a life insurance agent meets for lunch during a normal business day with a client.

(*d*) *Business programs.* Expenditures for business luncheons or dinners which are part of a business program, or banquets officially sponsored by business or professional associations, will be regarded as expenditures to which the exception of this subdivision (i) applies. In the case of such a business luncheon or dinner it is not always necessary that the taxpayer attend the luncheon or dinner himself. For example, if a dental equipment supplier purchased a table at a dental association banquet for dentists who are actual or prospective customers for his equipment, the cost of the table would not be disallowed under this section. See also paragraph (c)(4) of this section relating to expenditures made in a clear business setting.

(ii) *Food and beverages for employees.* Any expenditure by a taxpayer for food and beverages (or for use of a facility in connection therewith) furnished on the taxpayer's business premises primarily for his employees is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. This exception applies not only to expenditures for food or beverages furnished in a typical company cafeteria or an executive dining room, but also to expenditures with respect to the operation of such facilities. This exception applies even though guests are occasionally served in the cafeteria or dining room.

(iii) *Certain entertainment and travel expenses treated as compensation*—(A) *In general.* Any expenditure by a taxpayer for entertainment (or for use of a facility in connection therewith) or for travel described in section 274(m)(3), if an employee is the recipient of the entertainment or travel, is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section to the extent that the expenditure is treated by the taxpayer—

(*1*) On the taxpayer's income tax return as originally filed, as compensation paid to the employee; and

(*2*) As wages to the employee for purposes of withholding under chapter 24 (relating to collection of income tax at source on wages).

(B) *Expenses includible in income of persons who are not employees.* Any expenditure by a taxpayer for entertainment (or for use of a facility in connection therewith), or for travel described in section 274(m)(3), is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section to the extent the expenditure is includible in gross income as compensation for services rendered, or as a prize or award under section 74, by a recipient of the expenditure who is not an employee of the taxpayer. The preceding sentence shall not apply to any amount paid or incurred by the taxpayer if such amount is required to be included (or would be so required except that the amount is less that $600) in any information return filed by such taxpayer under part III of subchapter A of chapter 61 and is not so included. See section 274(e)(9).

(C) *Example.* The following example illustrates the provisions this paragraph (f):

Example. If an employer rewards the employee (and the employee's spouse) with an expense paid vacation trip, the expense is deductible by the employer (if otherwise allowable under section 162 and the regulations thereunder) to the extent the employer treats the expenses as compensation and as wages. On the other hand, if a taxpayer owns a yacht which the taxpayer uses for the entertainment of business customers, the portion of salary paid to employee members of the crew which is allocable to use of the yacht for entertainment purposes (even though treated on the taxpayer's tax return as compensation and treated as wages for withholding tax purposes) would not come within this exception since the members of the crew were not recipients of the entertainment. If an expenditure of a type described in this subdivision properly constitutes a dividend paid to a shareholder or if it constitutes unreasonable compensation paid to an employee, nothing in this exception prevents disallowance of the expenditure to the taxpayer under other provisions of the Internal Revenue Code.

(iv) *Reimbursed entertainment expenses—(a) Introductory.* In the case of any expenditure for entertainment paid or incurred by one person in connection with the performance by him of services for another person (whether or not such other person is an employer) under a reimbursement or other expense allowance arrangement, the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section shall be applied only once, either *(1)* to the person who makes the expenditure or *(2)* to the person who actually bears the expense, but not to both. For purposes of this subdivision (iv), the term *reimbursement or other expense allowance arrangement* has the same meaning as it has in section 62(2)(A), but without regard to whether the taxpayer is the employee of a person for whom services are performed. If an expenditure of a type described in this subdivision properly constitutes a dividend paid to a shareholder, unreasonable compensation paid to an employee, or a personal, living or family expense, nothing in this exception prevents disallowance of the expenditure to the taxpayer under other provisions of the Code.

(*b*) *Reimbursement arrangements between employee and employer.* In the case of an expenditure for entertainment paid or incurred by an employee under a reimbursement or other expense allowance arrangement with his employer, the limitations on deductions provided for in paragraphs (a) through (e) of this section shall not apply:

(*1*) *Employees.* To the employee except to the extent his employer has treated the expenditure on the employer's income tax return as originally filed as compensation paid to the employee and as wages to such employee for purposes of withholding under Chapter 24 (relating to collection of income tax at source on wages).

(*2*) *Employers.* To the employer to the extent he has treated the expenditure as compensation and wages paid to an employee in the manner provided in *(b)(1)* of this subdivision.

(*c*) *Reimbursement arrangements between independent contractors and clients or customers.* In the case of an expenditure for entertainment paid or incurred by one person (hereinafter termed ‘‘independent contractor’’) under a reimbursement or other expense allowance arrangement with another person other than an employer (hereinafter termed ‘‘client or customer’’), the limitations on deductions provided for in paragraphs (a) through (e) of this section shall not apply:

(*1*) *Independent contractors.* To the independent contractor to the extent he accounts to his client or customer within the meaning of section 274(d) and the regulations thereunder. See §1.274–5.

(*2*) *Clients or customers.* To the client or customer if the expenditure is disallowed to the independent contractor under paragraphs (a) through (e) of this section.

(v) *Recreational expenses for employees generally.* Any expenditure by a taxpayer for a recreational, social, or similar activity (or for use of a facility in connection therewith), primarily for the benefit of his employees generally, is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. This exception applies only to expenditures made primarily for the benefit of employees of the taxpayer other than employees who are officers, shareholders on other owners who own a 10-percent or greater interest in the business, or other highly compensated employees. For purposes of the preceding sentence, an employee shall be treated as owning any interest owned by a member of his family (within the meaning of section 267(c)(4) and the regulations thereunder). Ordinarily, this exception applies to usual employee benefit programs such as expenses of a taxpayer *(a)* in holding Christmas parties, annual picnics, or summer outings, for his employees generally, or *(b)* of maintaining a swimming pool, baseball diamond, bowling alley, or golf course available to his employees generally. Any expenditure for an activity which is made under circumstances which discriminate in favor of employees who are officers, shareholders or other owners, or highly compensated employees shall not be considered made primarily for the benefit of employees generally. On the other hand, an expenditure for an activity will not be considered outside of this exception merely because, due to the large number of employees involved, the activity is intended to benefit only a limited number of such employees at one time, provided the activity does not discriminate in favor of officers, shareholders, other owners, or highly compensated employees.

(vi) *Employee, stockholder, etc., business meetings.* Any expenditure by a taxpayer for entertainment which is directly related to bona fide business meetings of the taxpayer's employees, stockholders, agents, or directors held principally for discussion of trade or business is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. For purposes of this exception, a partnership is to be considered a taxpayer and a member of a partnership is to be considered an agent. For example, an expenditure by a taxpayer to furnish refreshments to his employees at a bona fide meeting, sponsored by the taxpayer for the principal purpose of instructing them with respect to a new procedure for conducting his business, would be within the provisions of this exception. A similar expenditure made at a bona fide meeting of stockholders of the taxpayer for the election of directors and discussion of corporate affairs would also be within the provisions of this exception. While this exception will apply to bona fide business meetings even though some social activities are provided, it will not apply to meetings which are primarily for social or nonbusiness purposes rather than for the transaction of the taxpayer's business. A meeting under circumstances where there was little or no possibility of engaging in the active conduct of trade or business (as described in paragraph (c)(7) of this section) generally will not be considered a business meeting for purposes of this subdivision. This exception will not apply to a meeting or convention of employees or agents, or similar meeting for directors, partners or others for the principal purpose of rewarding them for their services to the taxpayer. However, such a meeting or convention of employees might come within the scope of subdivisions (iii) or (v) of this subparagraph.

(vii) *Meetings of business leagues, etc.* Any expenditure for entertainment directly related and necessary to attendance at bona fide business meetings or conventions of organizations exempt from taxation under section 501(c)(6) of the Code, such as business leagues, chambers of commerce, real estate boards, boards of trade, and certain professional associations, is not subject to the limitations on allowability of deductions provided in paragraphs (a) through (e) of this section.

(viii) *Items available to the public.* Any expenditure by a taxpayer for entertainment (or for a facility in connection therewith) to the extent the entertainment is made available to the general public is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. Expenditures for entertainment of the general public by means of television, radio, newspapers and the like, will come within this exception, as will expenditures for distributing samples to the general public. Similarly, expenditures for maintaining private parks, golf courses and similar facilities, to the extent that they are available for public use, will come within this exception. For example, if a corporation maintains a swimming pool which it makes available for a period of time each week to children participating in a local public recreational program, the portion of the expense relating to such public use of the pool will come within this exception.

(ix) *Entertainment sold to customers.* Any expenditure by a taxpayer for entertainment (or for use of a facility in connection therewith) to the extent the entertainment is sold to customers in a bona fide transaction for an adequate and full consideration in money or money's worth is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. Thus, the cost of producing night club entertainment (such as salaries paid to employees of night clubs and amounts paid to performers) for sale to customers or the cost of operating a pleasure cruise ship as a business will come within this exception.

(g) *Additional provisions of section 274—travel of spouse, dependent or others.*

Section 274(m)(3) provides that no deduction shall be allowed under this chapter (except section 217) for travel expenses paid or incurred with respect to a spouse, dependent, or other individual accompanying the taxpayer (or an officer or employee of the taxpayer) on business travel, unless certain conditions are met. As provided in section 274(m)(3), the term *other individual* does not include a business associate (as defined in paragraph (b)(2)(iii) of this section) who otherwise meets the requirements of sections 274(m)(3)(B) and (C).

[T.D. 6659, 28 FR 6499, June 25, 1963, as amended by T.D. 6996, 34 FR 835, Jan. 18, 1969; T.D. 8051, 50 FR 36576, Sept. 9, 1985; T.D. 8601, 60 FR 36994, July 19, 1995; T.D. 8666, 61 FR 27006, May 30, 1996]

§1.274–3 Disallowance of deduction for gifts.

(a) *In general.* No deduction shall be allowed under section 162 or 212 for any expense for a gift made directly or indirectly by a taxpayer to any individual to the extent that such expense, when added to prior expenses of the taxpayer for gifts made to such individual during the taxpayer's taxable year, exceeds $25.

(b) *Gift defined*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph the term *gift*, for purposes of this section, means any item excludable from the gross income of the recipient under section 102 which is not excludable from his gross income under any other provision of chapter 1 of the Code. Thus, a payment by an employer to a deceased employee's widow is not a gift, for purposes of this section, to the extent the payment constitutes an employee's death benefit excludable by the recipient under section 101(b). Similarly, a scholarship which is excludable from a recipient's gross income under section 117, and a prize or award which is excludable from a recipient's gross income under section 74(b), are not subject to the provisions of this section.

(2) *Items not treated as gifts.* The term *gift*, for purposes of this section, does not include the following:

(i) An item having a cost to the taxpayer not in excess of $4.00 on which the name of the taxpayer is clearly and permanently imprinted and which is one of a number of identical items distributed generally by such a taxpayer.

(ii) A sign, display rack, or other promotional material to be used on the business premises of the recipient, or

(iii) In the case of a taxable year of a taxpayer ending on or after August 13, 1981, an item of tangible personal property which is awarded before January 1, 1987, to an employee of the taxpayer by reason of the employee's length of service (including an award upon retirement), productivity, or safety achievement, but only to the extent that—

(A) The cost of the item to the taxpayer does not exceed $400; or

(B) The item is a qualified plan award (as defined in paragraph (d) of this section); or

(iv) In the case of a taxable year of a taxpayer ending before August 13, 1981, an item of tangible personal property having a cost to the taxpayer not in excess of $100 which is awarded to an employee of the taxpayer by reason of the employee's length of service (including an award upon retirement) or safety achievement.

For purposes of paragraphs (b)(2) (iii) and (iv) of this section, the term *tangible personal property* does not include cash or any gift certificate other than a nonnegotiable gift certificate conferring only the right to receive tangible personal property. Thus, for example, if a nonnegotiable gift certificate entitles an employee to choose between selecting an item of merchandise or receiving cash or reducing the balance due on his account with the issuer of the gift certificate, the gift certificate is not tangible personal property for purposes of this section. To the extent that an item is not treated as a gift for purposes of this section, the deductibility of the expense of the item is not governed by this section, and the taxpayer need not take such item into account in determining whether the $25 limitation on gifts to any individual has been exceeded. For example, if an employee receives by reason of his length of service a gift of an item of tangible personal property that costs the employer $450, the deductibility of only $50 ($450 minus $400) is governed by this section, and the employer takes the $50 into account for purposes of the $25 limitation on gifts to that employee. The fact that an item is wholly or partially excepted from the applicability of this section has no effect in determining whether the value of the item is includible in the gross income of the recipient. For rules relating to the taxability to the recipient of any item described in this subparagraph, see sections 61, 74, and 102 and the regulations thereunder. For rules relating to the deductibility of employee achievement awards awarded after December 31, 1986, see section 274 (j).

(c) *Expense for a gift.* For purposes of this section, the term *expense for a gift* means the cost of the gift to the taxpayer, other than incidental costs such as for customary engraving on jewelry, or for packaging, insurance, and mailing or other delivery. A related cost will be considered ‘‘incidental’’ only if it does not add substantial value to the gift. Although the cost of customary gift wrapping will be considered an incidental cost, the purchase of an ornamental basket for packaging fruit will not be considered an incidental cost of packaging if the basket has a value which is substantial in relation to the value of the fruit.

(d) *Qualified plan award*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph the term *qualified plan award,* for purposes of this section, means an item of tangible personal property that is awarded to an employee by reason of the employee’s length of service (including retirement), productivity, or safety achievement, and that is awarded pursuant to a permanent, written award plan or program of the taxpayer that does not discriminate as to eligibility or benefits in favor of employees who are officers, shareholders, or highly compensated employees. The ‘‘permanency’’ of an award plan shall be determined from all the facts and circumstances of the particular case, including the taxpayer’s ability to continue to make the awards as required by the award plan. Although the taxpayer may reserve the right to change or to terminate an award plan, the actual termination of the award plan for any reason other than business necessity within a few years after it has taken effect may be evidence that the award plan from its inception was not a ‘‘permanent’’ award plan. Whether or not an award plan is discriminatory shall be determined from all the facts and circumstances of the particular case. An award plan may fail to qualify because it is discriminatory in its actual operation even though the written provisions of the award plan are not discriminatory.

(2) *Items not treated as qualified plan awards.* The term *qualified plan award,* for purposes of this section, does not include an item qualifying under paragraph (d)(1) of this section to the extent that the cost of the item exceeds $1,600. In addition, that term does not include any items qualifying under paragraph (d)(1) of this section if the average cost of all items (whether or not tangible personal property) awarded during the taxable year by the taxpayer under any plan described in paragraph (d)(1) of this section exceeds $400. The average cost of those items shall be computed by dividing (i) the sum of the costs for those items (including amounts in excess of the $1,600 limitation) by (ii) the total number of those items.

(e) *Gifts made indirectly to an individual*—(1) *Gift to spouse or member of family.* If a taxpayer makes a gift to the wife of a man who has a business connection with the taxpayer, the gift generally will be considered as made indirectly to the husband. However, if the wife has a bona fide business connection with the taxpayer independently of her relationship to her husband, a gift to her generally will not be considered as made indirectly to her husband unless the gift is intended for his eventual use or benefit. Thus, if a taxpayer makes a gift to a wife who is engaged with her husband in the active conduct of a partnership business, the gift to the wife will not be considered an indirect gift to her husband unless it is intended for his eventual use or benefit. The same rules apply to gifts to any other member of the family of an individual who has a business connection with the taxpayer.

(2) *Gift to corporation or other business entity.* If a taxpayer makes a gift to a corporation or other business entity intended for the eventual personal use or

benefit of an individual who is an employee, stockholder, or other owner of the corporation or business entity, the gift generally will be considered as made indirectly to such individual. Thus, if a taxpayer provides theater tickets to a closely held corporation for eventual use by any one of the stockholders of the corporation, and if such tickets are gifts, the gifts will be considered as made indirectly to the individual who eventually uses such ticket. On the other hand, a gift to a business organization of property to be used in connection with the business of the organization (for example, a technical manual) will not be considered as a gift to an individual, even though, in practice, the book will be used principally by a readily identifiable individual employee. A gift for the eventual personal use or benefit of some undesignated member of a large group of individuals generally will not be considered as made indirectly to the individual who eventually uses, or benefits from, such gifts unless, under the circumstances of the case, it is reasonably practicable for the taxpayer to ascertain the ultimate recipient of the gift. Thus, if a taxpayer provides several baseball tickets to a corporation for the eventual use by any one of a large number of employees or customers of the corporation, and if such tickets are gifts, the gifts generally will not be treated as made indirectly to the individuals who use such tickets.

(f) *Special rules*—(1) *Partnership.* In the case of a gift by a partnership, the $25 annual limitation contained in paragraph (a) of this section shall apply to the partnership as well as to each member of the partnership. Thus, in the case of a gift made by a partner with respect to the business of the partnership, the $25 limitation will be applied at the partnership level as well as at the level of the individual partner. Consequently, deductions for gifts made with respect to partnership business will not exceed $25 annually for each recipient, regardless of the number of partners.

(2) *Husband and wife.* For purposes of applying the $25 annual limitation contained in paragraph (a) of this section, a husband and wife shall be treated as one taxpayer. Thus, in the case of gifts to an individual by a husband and wife, the spouses will be treated as one donor; and they are limited to a deduction of $25 annually for each recipient. This rule applies regardless of whether the husband and wife file a joint return or whether the husband and wife make separate gifts to an individual with respect to separate businesses. Since the term *taxpayer* in paragraph (a) of this section refers only to the donor of a gift, this special rule does not apply to treat a husband and wife as one individual where each is a recipient of a gift. See paragraph (e)(1) of this section.

(g) *Cross reference.* For rules with respect to whether this section or §1.274–2 applies, see §1.274–2(b)(1) (iii).

[T.D. 6659, 28 FR 6505, June 25, 1963, as amended by T.D. 8230, 53 FR 36451, Sept. 20, 1988]

§1.274–4 Disallowance of certain foreign travel expenses.

(a) *Introductory.* Section 274(c) and this section impose certain restrictions on the deductibility of travel expenses incurred in the case of an individual who, while traveling outside the United States away from home in the pursuit of trade or business (hereinafter termed ‘‘business activity’’), engages in substantial personal activity not attributable to such trade or business (hereinafter termed ‘‘nonbusiness activity’’). Section 274(c) and this section are limited in their application to individuals (whether or not an employee or other person traveling under a reimbursement or other expense allowance arrangement) who engage in nonbusiness activity while traveling outside the United States away from home, and do not impose restrictions on the deductibility of travel expenses incurred by an employer or client under an advance, reimbursement, or other arrangement with the individual who engages in nonbusiness activity. For purposes of this section, the term *United States* includes only the States and the District of Columbia, and any reference to ‘‘trade or business’’ or ‘‘business activity’’ includes any activity described in section 212. For rules governing the determination of travel outside the United States away from home, see paragraph (e) of this section.

For rules governing the disallowance of travel expense to which this section applies, see paragraph (f) of this section.

(b) *Limitations on application of section.* The restrictions on deductibility of travel expenses contained in paragraph (f) of this section are applicable only if:

(1) The travel expense is otherwise deductible under section 162 or 212 and the regulations thereunder,

(2) The travel expense is for travel outside the United States away from home which exceeds 1 week (as determined under paragraph (c) of this section), and

(3) The time outside the United States away from home attributable to nonbusiness activity (as determined under paragraph (d) of this section) constitutes 25 percent or more of the total time on such travel.

(c) *Travel in excess of 1 week.* This section does not apply to an expense of travel unless the expense is for travel outside the United States away from home which exceeds 1 week. For purposes of this section, 1 week means 7 consecutive days. The day in which travel outside the United States away from home begins shall not be considered, but the day in which such travel ends shall be considered, in determining whether a taxpayer is outside the United States away from home for more than 7 consecutive days. For example, if a taxpayer departs on travel outside the United States away from home on a Wednesday morning and ends such travel the following Wednesday evening, he shall be considered as being outside the United States away from home only 7 consecutive days. In such a case, this section would not apply because the taxpayer was not outside the United States away from home for more than 7 consecutive days. However, if the taxpayer travels outside the United States away from home for more than 7 consecutive days, both the day such travel begins and the day such travel ends shall be considered a ‘‘business day’’ or a ‘‘nonbusiness day’’, as the case may be, for purposes of determining whether nonbusiness activity constituted 25 percent or more of travel time under paragraph (d) of this section and for purposes of allocating expenses under paragraph (f) of this section. For purposes of determining whether travel is outside the United States away from home, see paragraph (e) of this section.

(d) *Nonbusiness activity constituting 25 percent or more of travel time*—(1) *In general.* This section does not apply to any expense of travel outside the United States away from home unless the portion of time outside the United States away from home attributable to nonbusiness activity constitutes 25 percent or more of the total time on such travel.

(2) *Allocation on per day basis.* The total time traveling outside the United States away from home will be allocated on a day-by-day basis to (i) days of business activity or (ii) days of nonbusiness activity (hereinafter termed ‘‘business days’’ or ‘‘nonbusiness days’’ respectively) unless the taxpayer establishes that a different method of allocation more clearly reflects the portion of time outside the United States away from home which is attributable to nonbusiness activity. For purposes of this section, a day spent outside the United States away from home shall be deemed entirely a business day even though spent only in part on business activity if the taxpayer establishes:

(i) *Transportation days.* That on such day the taxpayer was traveling to or returning from a destination outside the United States away from home in the pursuit of trade or business. However, if for purposes of engaging in nonbusiness activity, the taxpayer while traveling outside the United States away from home does not travel by a reasonably direct route, only that number of days shall be considered business days as would be required for the taxpayer, using the same mode of transportation, to travel to or return from the same destination by a reasonably direct route. Also, if, while so traveling, the taxpayer interrupts the normal course of travel by engaging in substantial diversions for nonbusiness reasons of his own choosing, only that number of days shall be considered business days as equals the number of days required for the taxpayer, using the same mode of transportation, to travel to or return from the same destination without engaging in such diversion. For example, if a taxpayer residing in New York departs on an evening on a direct flight to Quebec for a business meeting to be held in Quebec the next morning, for purposes of determining whether nonbusiness activity constituted 25 percent or more of his travel time, the entire day of his departure shall be considered a business day. On the other hand, if a taxpayer travels by automobile from New York to Quebec to attend a business meeting and while en route spends 2 days in Ottawa and 1 day in Montreal on nonbusiness activities of his personal choice, only that number of days outside the United States shall be considered business days as would have been required for the taxpayer to drive by a reasonably direct route to Quebec, taking into account normal periods for rest and meals.

(ii) *Presence required.* That on such day his presence outside the United States away from home was required at a particular place for a specific and bona fide business purpose. For example, if a taxpayer is instructed by his employer to attend a specific business meeting, the day of the meeting shall be considered a business day even though, because of the scheduled length of the meeting, the taxpayer spends more time during normal working hours of the day on nonbusiness activity than on business activity.

(iii) *Days primarily business.* That during hours normally considered to be appropriate for business activity, his principal activity on such day was the pursuit of trade or business.

(iv) *Circumstances beyond control.* That on such day he was prevented from engaging in the conduct of trade or business as his principal activity due to circumstances beyond his control.

(v) *Weekends, holidays, etc.* That such day was a Saturday, Sunday, legal holiday, or other reasonably necessary standby day which intervened during that course of the taxpayer's trade or business while outside the United States away from home which the taxpayer endeavored to conduct with reasonable dispatch. For example, if a taxpayer travels from New York to London to take part in business negotiations beginning on a Wednesday and concluding on the following Tuesday, the intervening Saturday and Sunday shall be considered business days whether or not business is conducted on either of such days. Similarly, if in the above case the meetings which concluded on Tuesday evening were followed by business meetings with another business group in London on the immediately succeeding Thursday and Friday, the intervening Wednesday will be deemed a business day. However, if at the conclusion of the business meetings on Friday, the taxpayer stays in London for an additional week for personal purposes, the Saturday and Sunday following the conclusion of the business meeting will not be considered business days.

(e) *Domestic travel excluded*—(1) *In general.* For purposes of this section, travel outside the United States away from home does not include any travel from one point in the United States to another point in the United States. However, travel which is not from one point in the United States to another point in the United States shall be considered travel outside the United States. If a taxpayer travels from a place within the United States to a place outside the United States, the portion, if any, of such travel which is from one point in the United States to another point in the United States is to be disregarded for purposes of determining:

(i) Whether the taxpayer's travel outside the United States away from home exceeds 1 week (see paragraph (c) of this section),

(ii) Whether the time outside the United States away from home attributable to nonbusiness activity constitutes 25 percent or more of the total time on such travel (see paragraph (d) of this section), or

(iii) The amount of travel expense subject to the allocation rules of this section (see paragraph (f) of this section).

(2) *Determination of travel from one point in the United States to another point in the United States.* In the case of the following means of transportation, travel from one point in the United

States to another point in the United States shall be determined as follows:

(i) *Travel by public transportation.* In the case of travel by public transportation, any place in the United States at which the vehicle makes a scheduled stop for the purpose of adding or discharging passengers shall be considered a point in the United States.

(ii) *Travel by private automobile.* In the case of travel by private automobile, any such travel which is within the United States shall be considered travel from one point in the United States to another point in the United States.

(iii) *Travel by private airplane.* In the case of travel by private airplane, any flight, whether or not constituting the entire trip, where both the takeoff and the landing are within the United States shall be considered travel from one point in the United States to another point in the United States.

(3) *Examples.* The provisions of subparagraph (2) may be illustrated by the following examples:

Example 1. Taxpayer A flies from Los Angeles to Puerto Rico with a brief scheduled stopover in Miami for the purpose of adding and discharging passengers and A returns by airplane nonstop to Los Angeles. The travel from Los Angeles to Miami is considered travel from one point in the United States to another point in the United States. The travel from Miami to Puerto Rico and from Puerto Rico to Los Angeles is not considered travel from one point in the United States to another point in the United States and, thus, is considered to be travel outside the United States away from home.

Example 2. Taxpayer B travels by train from New York to Montreal. The travel from New York to the last place in the United States where the train is stopped for the purpose of adding or discharging passengers is considered to be travel from one point in the United States to another point in the United States.

Example 3. Taxpayer C travels by automobile from Tulsa to Mexico City and back. All travel in the United States is considered to be travel from one point in the United States to another point in the United States.

Example 4. Taxpayer D flies nonstop from Seattle to Juneau. Although the flight passes over Canada, the trip is considered to be travel from one point in the United States to another point in the United States.

Example 5. If in *Example (4)* above, the airplane makes a scheduled landing in Vancouver, the time spent in traveling from Seattle to Juneau is considered to be travel outside the United States away from home. However, the time spent in Juneau is not considered to be travel outside the United States away from home.

(f) *Application of disallowance rules*—(1) *In general.* In the case of expense for travel outside the United States away from home by an individual to which this section applies, except as otherwise provided in subparagraph (4) or (5) of this paragraph, no deduction shall be allowed for that amount of travel expense specified in subparagraph (2) or (3) of this paragraph (whichever is applicable) which is obtained by multiplying the total of such travel expense by a fraction:

(i) The numerator of which is the number of nonbusiness days during such travel, and

(ii) The denominator of which is the total number of business days and nonbusiness days during such travel.

For determination of ‘‘business days’’ and ‘‘nonbusiness days’’, see paragraph (d)(2) of this section.

(2) *Nonbusiness activity at, near, or beyond business destination.* If the place at which the individual engages in nonbusiness activity (hereinafter termed ‘‘nonbusiness destination’’) is at, near, or beyond the place to which he travels in the pursuit of a trade or business (hereinafter termed ‘‘business destination’’), the amount of travel expense referred to in subparagraph (1) of this paragraph shall be the amount of travel expense, otherwise allowable as a deduction under section 162 or section 212, which would have been incurred in traveling from the place where travel outside the United States away from home begins to the business destination, and returning. Thus, if the individual travels from New York to London on business, and then takes a vacation in Paris before returning to New York, the amount of the travel expense subject to allocation is the expense which would have been incurred in traveling from New York to London and returning.

(3) *Nonbusiness activity on the route to or from business destination.* If the nonbusiness destination is on the route to or from the business destination, the amount of the travel expense referred

to in subparagraph (1) of this paragraph shall be the amount of travel expense, otherwise allowable as a deduction under section 162 or 212, which would have been incurred in traveling from the place where travel outside the United States away from home begins to the nonbusiness destination and returning. Thus, if the individual travels on business from Chicago to Rio de Janeiro, Brazil with a scheduled stop in New York for the purpose of adding and discharging passengers, and while en route stops in Caracas, Venezuela for a vacation and returns to Chicago from Rio de Janeiro with another scheduled stop in New York for the purpose of adding and discharging passengers, the amount of travel expense subject to allocation is the expense which would have been incurred in traveling from New York to Caracas and returning.

(4) *Other allocation method.* If a taxpayer establishes that a method other than allocation on a day-by-day basis (as determined under paragraph (d)(2) of this section) more clearly reflects the portion of time outside the United States away from home which is attributable to nonbusiness activity, the amount of travel expense for which no deduction shall be allowed shall be determined by such other method.

(5) *Travel expense deemed entirely allocable to business activity.* Expenses of travel shall be considered allocable in full to business activity, and no portion of such expense shall be subject to disallowance under this section, if incurred under circumstances provided for in subdivision (i) or (ii) of this subparagraph.

(i) *Lack of control over travel.* Expenses of travel otherwise deductible under section 162 or 212 shall be considered fully allocable to business activity if, considering all the facts and circumstances, the individual incurring such expenses did not have substantial control over the arranging of the business trip. A person who is required to travel to a business destination will not be considered to have substantial control over the arranging of the business trip merely because he has control over the timing of the trip. Any individual who travels on behalf of his employer under a reimbursement or other expense allowance arrangement shall be considered not to have had substantial control over the arranging of his business trip, provided the employee is not:

(*a*) A managing executive of the employer for whom he is traveling (and for this purpose the term *managing executive* includes only an employee who, by reason of his authority and responsibility, is authorized, without effective veto procedures, to decide upon the necessity for his business trip), or

(*b*) Related to his employer within the meaning of section 267(b) but for this purpose the percentage referred to in section 267(b)(2) shall be 10 percent.

(ii) *Lack of major consideration to obtain a vacation.* Any expense of travel, which qualifies for deduction under section 162 or 212, shall be considered fully allocable to business activity if the individual incurring such expenses can establish that, considering all the facts and circumstances, he did not have a major consideration, in determining to make the trip, of obtaining a personal vacation or holiday. If such a major consideration were present, the provisions of subparagraphs (1) through (4) of this paragraph shall apply. However, if the trip were primarily personal in nature, the traveling expenses to and from the destination are not deductible even though the taxpayer engages in business activities while at such destination. See paragraph (b) of §1.162–2.

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

Example 1. Individual A flew from New York to Paris where he conducted business for 1 day. He spent the next 2 days sightseeing in Paris and then flew back to New York. The entire trip, including 2 days for travel en route, took 5 days. Since the time outside the United States away from home during the trip did not exceed 1 week, the disallowance rules of this section do not apply.

Example 2. Individual B flew from Tampa to Honolulu (from one point in the United States to another point in the United States) for a business meeting which lasted 3 days and for personal matters which took 10 days. He then flew to Melbourne, Australia where he conducted business for 2 days and went sightseeing for 1 day. Immediately thereafter he flew back to Tampa, with a scheduled landing in Honolulu for the purpose of adding and discharging passengers. Although the trip exceeded 1 week, the time spent outside the United States away from home, including 2 days for traveling from Honolulu to Melbourne and return, was 5 days. Since the time outside the United States away from home during the trip did not exceed 1 week, the disallowance rules of this section do not apply.

Example 3. Individual C flew from Los Angeles to New York where he spent 5 days. He then flew to Brussels where he spent 14 days on business and 5 days on personal matters. He then flew back to Los Angeles by way of New York. The entire trip, including 4 days for travel en route, took 28 days. However, the 2 days spent traveling from Los Angeles to New York and return, and the 5 days spent in New York are not considered travel outside the United States away from home and, thus, are disregarded for purposes of this section. Although the time spent outside the United States away from home exceeded 1 week, the time outside the United States away from home attributable to nonbusiness activities (5 days out of 21) was less than 25 percent of the total time outside the United States away from home during the trip. Therefore, the disallowance rules of this section do not apply.

Example 4. D, an employee of Y Company, who is neither a managing executive of, nor related to, Y Company within the meaning of paragraph (f)(5)(i) of this section, traveled outside the United States away from home on behalf of his employer and was reimbursed by Y for his traveling expense to and from the business destination. The trip took more than a week and D took advantage of the opportunity to enjoy a personal vacation which exceeded 25 percent of the total time on the trip. Since D, traveling under a reimbursement arrangement, is not a managing executive of, or related to, Y Company, he is not considered to have substantial control over the arranging of the business trip, and the travel expenses shall be considered fully allocable to business activity.

Example 5. E, a managing executive and principal shareholder of X Company, travels from New York to Stockholm, Sweden, to attend a series of business meetings. At the conclusion of the series of meetings, which last 1 week, E spends 1 week on a personal vacation in Stockholm. If E establishes either that he did not have substantial control over the arranging of the trip or that a major consideration in his determining to make the trip was not to provide an opportunity for taking a personal vacation, the entire travel expense to and from Stockholm shall be considered fully allocable to business activity.

Example 6. F, a self-employed professional man, flew from New York to Copenhagen, Denmark, to attend a convention sponsored by a professional society. The trip lasted 3 weeks, of which 2 weeks were spent on vacation in Europe. F generally would be regarded as having substantial control over arranging this business trip. Unless F can establish that obtaining a vacation was not a major consideration in determining to make the trip, the disallowance rules of this section apply.

Example 7. Taxpayer G flew from Chicago to New York where he spent 6 days on business. He then flew to London where he conducted business for 2 days. G then flew to Paris for a 5 day vacation after which he flew back to Chicago, with a scheduled landing in New York for the purpose of adding and discharging passengers. G would not have made the trip except for the business he had to conduct in London. The travel outside the United States away from home, including 2 days for travel en route, exceeded a week and the time devoted to nonbusiness activities was not less than 25 percent of the total time on such travel. The 2 days spent traveling from Chicago to New York and return, and the 6 days spent in New York are disregarded for purposes of determining whether the travel outside the United States away from home exceeded a week and whether the time devoted to nonbusiness activities was less than 25 percent of the total time outside the United States away from home. If G is unable to establish either that he did not have substantial control over the arranging of the business trip or that an opportunity for taking a personal vacation was not a major consideration in his determining to make the trip, 5/9ths (5 days devoted to nonbusiness activities out of a total 9 days outside the United States away from home on the trip) of the expenses attributable to transportation and food from New York to London and from London to New York will be disallowed (unless G establishes that a different method of allocation more clearly reflects the portion of time outside the United States away from home which is attributable to nonbusiness activity).

(h) *Cross reference.* For rules with respect to whether an expense is travel or entertainment, see paragraph (b)(1)(iii) of § 1.274–2.

[T.D. 6758, 29 FR 12768, Sept. 10, 1964]

§ 1.274–5T Substantiation requirements (temporary).

(a) *In general.* For taxable years beginning on or after January 1, 1986, no deduction or credit shall be allowed with respect to—

(1) Traveling away from home (including meals and lodging),

(2) Any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, including the items specified in section 274(e),

(3) Gifts defined in section 274(b), or

(4) Any listed property (as defined in section 280F(d)(4) and §1.280F–6T(b)), unless the taxpayer substantiates each element of the expenditure or use (as described in paragraph (b) of this section) in the manner provided in paragraph (c) of this section. This limitation supersedes the doctrine found in *Cohan v. Commissioner*, 39 F. 2d 540 (2d Cir. 1930). The decision held that, where the evidence indicated a taxpayer incurred deductible travel or entertainment expenses but the exact amount could not be determined, the court should make a close approximation and not disallow the deduction entirely. Section 274(d) contemplates that no deduction or credit shall be allowed a taxpayer on the basis of such approximations or unsupported testimony of the taxpayer. For purposes of this section, the term *entertainment* means entertainment, amusement, or recreation, and use of a facility therefor; and the term *expenditure* includes expenses and items (including items such as losses and depreciation).

(b) *Elements of an expenditure or use*—(1) *In general.* Section 274(d) and this section contemplate that no deduction or credit shall be allowed for travel, entertainment, a gift, or with respect to listed property unless the taxpayer substantiates the requisite elements of each expenditure or use as set forth in this paragraph (b).

(2) *Travel away from home.* The elements to be provided with respect to an expenditure for travel away from home are—

(i) *Amount.* Amount of each separate expenditure for traveling away from home, such as cost of transportation or lodging, except that the daily cost of the traveler's own breakfast, lunch, and dinner and of expenditures incidental to such travel may be aggregated, if set forth in reasonable categories, such as for meals, for gasoline and oil, and for taxi fares;

(ii) *Time.* Dates of departure and return for each trip away from home, and number of days away from home spent on business;

(iii) *Place.* Destinations or locality of travel, described by name of city or town or other similar designation; and

(iv) *Business purpose.* Business reason for travel or nature of the business benefit derived or expected to be derived as a result of travel.

(3) *Entertainment in general.* The elements to be proved with respect to an expenditure for entertainment are—

(i) *Amount.* Amount of each separate expenditure for entertainment, except that such incidental items as taxi fares or telephone calls may be aggregated on a daily basis;

(ii) *Time.* Date of entertainment;

(iii) *Place.* Name, if any, address or location, and destination of type of entertainment, such as dinner or theater, if such information is not apparent from the designation of the place;

(iv) *Business purpose.* Business reason for the entertainment or nature of business benefit derived or expected to be derived as a result of the entertainment and, except in the case of business meals described in section 274(e)(1), the nature of any business discussion or activity;

(v) *Business relationship.* Occupation or other information relating to the person or persons entertained, including name, title, or other designation, sufficient to establish business relationship to the taxpayer.

(4) *Entertainment directly preceding or following a substantial and bona fide business discussion.* If a taxpayer claims a deduction for entertainment directly preceding or following a substantial and bona fide business discussion on the ground that such entertainment was associated with the active conduct of the taxpayer's trade or business, the elements to be proved with respect to such expenditure, in addition to those enumerated in paragraph (b)(3) (i), (ii), (iii), and (v) of this section are—

(i) *Time.* Date and duration of business discussion;

(ii) *Place.* Place of business discussion;

(iii) *Business purpose.* Nature of business discussion, and business reason for the entertainment or nature of business benefit derived or expected to be derived as the result of the entertainment.

(iv) *Business relationship.* Identification of those persons entertained who participated in the business discussion.

(5) *Gifts.* The elements to be proved with respect to an expenditure for a gift are—

(i) *Amount.* Cost of the gift to the taxpayer;

(ii) *Time.* Date of the gift;

(iii) *Description.* Description of the gift;

(iv) *Business purpose.* Business reason for the gift or nature of business benefit derived or expected to be derived as a result of the gift; and

(v) *Business relationship.* Occupation or other information relating to the recipient of the gift, including name, title, or other designation, sufficient to establish business relationship to the taxpayer.

(6) *Listed property.* The elements to be proved with respect to any listed property are—

(i) *Amount*—(A) *Expenditures.* The amount of each separate expenditure with respect to an item of listed property, such as the cost of acquisition, the cost of capital improvements, lease payments, the cost of maintenance and repairs, or other expenditures, and

(B) *Uses.* The amount of each business/investment use (as defined in § 1.280F–6T (d)(3) and (e)), based on the appropriate measure (i.e., mileage for automobiles and other means of transportation and time for other listed property, unless the Commissioner approves an alternative method), and the total use of the listed property for the taxable period.

(ii) *Time.* Date of the expenditure or use with respect to listed property, and

(iii) *Business or investment purpose.* The business purpose for an expenditure or use with respect to any listed property (see § 1.274–5T(c)(6)(i) (B) and (C) for special rules for the aggregation of expenditures and business use and § 1.280F–6T(d)(2) for the distinction between qualified business use and business/investment use).

See also § 1.274–5T(e) relating to the substantiation of business use of employer-provided listed property and § 1.274–6T for special rules for substantiating the business/investment use of certain types of listed property.

(c) *Rules of substantiation*—(1) *In general.* Except as otherwise provided in this section and § 1.274–6T, a taxpayer must substantiate each element of an expenditure or use (described in paragraph (b) of this section) by adequate records or by sufficient evidence corroborating his own statement. Section 274(d) contemplates that a taxpayer will maintain and produce such substantiation as will constitute proof of each expenditure or use referred to in section 274. Written evidence has considerably more probative value than oral evidence alone. In addition, the probative value of written evidence is greater the closer in time it relates to the expenditure or use. A contemporaneous log is not required, but a record of the elements of an expenditure or of a business use of listed property made at or near the time of the expenditure or use, supported by sufficient documentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequent thereto when generally there is a lack of accurate recall. Thus, the corroborative evidence required to support a statement not make at or near the time of the expenditure or use must have a high degree of probative value to elevate such statement and evidence to the level of credibility reflected by a record made at or near the time of the expenditure or use supported by sufficient documentary evidence. The substantiation requirements of section 274(d) are designed to encourage taxpayers to maintain the records, together with documentary evidence, as provided in paragraph (c)(2) of this section.

(2) *Substantiation by adequate records*—(i) *In general.* To meet the ‘‘adequate records’’ requirements of section 274(d), a taxpayer shall maintain an account book, diary, log, statement of expense, trip sheets, or similar record (as provided in paragraph (c)(2)(ii) of this section), and documentary evidence (as provided in paragraph (c)(2)(iii) of this section) which, in combination, are sufficient to establish each element of an expenditure or use

specified in paragraph (b) of this section. It is not necessary to record information in an account book, diary, log, statement of expense, trip sheet, or similar record which duplicates information reflected on a receipt so long as the account book, etc. and receipt complement each other in an orderly manner.

(ii) *Account book, diary, etc.* An account book, diary, log, statement of expense, trip sheet, or similar record must be prepared or maintained in such manner that each recording of an element of an expenditure or use is made at or near the time of the expenditure or use.

(A) *Made at or near the time of the expenditure or use.* For purposes of this section, the phrase *made at or near the time of the expenditure or use* means the element of an expenditure or use are recorded at a time when, in relation to the use or making of an expenditure, the taxpayer has full present knowledge of each element of the expenditure or use, such as the amount, time, place, and business purpose of the expenditure and business relationship. An expense account statement which is a transcription of an account book, diary, log, or similar record prepared or maintained in accordance with the provisions of this paragraph (c)(2)(ii) shall be considered a record prepared or maintained in the manner prescribed in the preceding sentence if such expense account statement is submitted by an employee to his employer or by an independent contractor to his client or customer in the regular course of good business practice. For example, a log maintained on a weekly basis, which accounts for use during the week, shall be considered a record made at or near the time of such use.

(B) *Substantiation of business purpose.* In order to constitute an adequate record of business purpose within the meaning of section 274(d) and this paragraph (c)(2), a written statement of business purpose generally is required. However, the degree of substantiation necessary to establish business purpose will vary depending upon the facts and circumstances of each case. Where the business purpose is evident from the surrounding facts and circumstances, a written explanation of such business purpose will not be required. For example, in the case of a salesman calling on customers on an established sales route, a written explanation of the business purpose of such travel ordinarily will not be required. Similarly, in the case of a business meal described in section 274(e)(1), if the business purpose of such meal is evident from the business relationship to the taxpayer of the persons entertained and other surrounding circumstances, a written explanation of such business purpose will not be required.

(C) *Substantiation of business use of listed property*—(*1*) *Degree of substantiation.* In order to constitute an adequate record (within the meaning of section 274(d) and this paragraph (c)(2)(ii)), which substantiates business/investment use of listed property (as defined in §1.280F–6T(d)(3)), the record must contain sufficient information as to each element of every business/investment use. However, the level of detail required in an adequate record to substantiate business/investment use may vary depending upon the facts and circumstances. For example, a taxpayer who uses a truck for both business and personal purposes and whose only business use of a truck is to make deliveries to customers on an established route may satisfy the adequate record requirement by recording the total number miles driven during the taxable year, the length of the delivery route once, and the date of each trip at or near the time of the trips. Alternatively, the taxpayer may establish the date of each trip with a receipt, record of delivery, or other documentary evidence.

(*2*) *Written record.* Generally, an adequate record must be written. However, a record of the business use of listed property, such as a computer or automobile, prepared in a computer memory device with the aid of a logging program will constitute an adequate record.

(D) *Confidential information.* If any information relating to the elements of an expenditure or use, such as place, business purpose, or business relationship, is of a confidential nature, such information need not be set forth in the account book, diary, log, statement of expense, trip sheet, or similar record, provided such information is recorded at or near the time of the expenditure or use and is elsewhere available to the district director to substantiate such element of the expenditure or use.

(iii) *Documentary evidence.* Documentary evidence, such as receipts, paid bills, or similar evidence sufficient to support an expenditure shall be required for—

(A) Any expenditure for lodging while traveling away from home, and

(B) Any other expenditure of $75 or more ($25 or more for expenditures incurred before October 1, 1995) except, for transportation charges, documentary evidence will not be required if not readily available, provided, however, that the Commissioner, in his discretion, may prescribe rules waiving such requirements in circumstances where he determines it is impracticable for such documentary evidence to be required. Ordinarily, documentary evidence will be considered adequate to support an expenditure if it includes sufficient information to establish the amount, date, place, and the essential character of the expenditure. For example, a hotel receipt is sufficient to support expenditures for business travel if it contains the following: name, location, date, and separate amounts for charges such as for lodging, meals, and telephone. Similarly, a restaurant receipt is sufficient to support an expenditure for a business meal if it contains the following: name and location of the restaurant, the date and amount of the expenditure, the number of people served, and, if a charge is made for an item other than meals and beverages, an indication that such is the case. A document may be indicative of only one (or part of one) element of an expenditure. Thus, a cancelled check together with a bill from the payee, ordinarily would establish the element of cost. In contrast, a cancelled check drawn payable to a named payee would not by itself support a business expenditure without other evidence showing that the check was used for a certain business purpose.

(iv) *Retention of written evidence.* The Commissioner may, in his discretion, prescribe rules under which an employer may dispose of the adequate records and documentary evidence submitted to him by employees who are required to, and do, make an adequate accounting to the employer (within the meaning of paragraph (f)(4) of this section) if the employer maintains adequate accounting procedures with respect to such employees (within the meaning of paragraph (f)(5) of this section.

(v) *Substantial compliance.* If a taxpayer has not fully substantiated a particular element of an expenditure or use, but the taxpayer establishes to the satisfaction of the district director that he has substantially complied with the ‘‘adequate records’’ requirements of this paragraph (c)(2) with respect to the expenditure or use, the taxpayer may be permitted to establish such element by evidence which the district director shall deem adequate.

(3) *Substantiation by other sufficient evidence*—(i) *In general.* If a taxpayer fails to establish to the satisfaction of the district director that he has substantially complied with the ‘‘adequate records’’ requirements of paragraph (c)(2) of this section with respect to an element of an expenditure or use, then, except as otherwise provided in this paragraph, the taxpayer must establish such element—

(A) By his own statement, whether written or oral, containing specific information in detail as to such element; and

(B) By other corrobative evidence sufficient to establish such element.

If such element is the description of a gift, or the cost or amount, time, place, or date of an expenditure or use, the corrobative evidence shall be direct evidence, such as a statement in writing or the oral testimony of persons entertained or other witnesses setting forth detailed information about such element, or the documentary evidence described in paragraph (c)(2) of this section. If such element is either the business relationship to the taxpayer of persons entertained, or the business purpose of an expenditure, the corrobative evidence may be circumstantial evidence.

(ii) *Sampling*—(A) *In general.* Except as provided in paragraph (c)(3)(ii)(B) of this section, a taxpayer may maintain an adequate record for portions of a taxable year and use that record to substantiate the business/investment use of listed property for all or a portion of the taxable year if the taxpayer can demonstrate by other evidence that the periods for which an adequate record is maintained are representative of the use for the taxable year or a portion thereof.

(B) *Exception for pooled vehicles.* The sampling method of paragraph (c)(3)(ii)(A) of this section may not be used to substantiate the business/investment use of an automobile or other vehicle of an employer that is made available for use by more than one employee for all or a portion of a taxable year.

(C) *Examples.* The following examples illustrate this paragraph (c)(3)(ii).

Example 1. A, a sole proprietor and calendar year taxpayer, operates an interior decorating business out of her home. A uses an automobile for local business travel to visit the homes or offices of clients, to meet with suppliers and other subcontractors, and to pick up and deliver certain items to clients when feasible. There is no other business use of the automobile but A and other members of her family also use the automobile for personal purposes. A maintains adequate records for the first three months of 1986 that indicate that 75 percent of the use of the automobile was in A's business. Invoices from subcontractors and paid bills indicate that A's business continued at approximately the same rate for the remainder of 1986. If other circumstances do not change (e.g., A does not obtain a second car for exclusive use in her business), the determination that the business/investment use of the automobile for the taxable year is 75 percent is based on sufficient corroborative evidence.

Example 2. The facts are the same as in *Example (1),* except that A maintains adequate records during the first week of every month, which indicate that 75 percent of the use of the automobile is in A's business. The invoices from A's business indicate that A's business continued at the same rate during the subsequent weeks of each month so that A's weekly records are representative of each month's business use of the automobile. Thus, the determination that the business/investment use of the automobile for the taxable year is 75 percent is based on sufficient corroborative evidence.

Example 3. B, a sole proprietor and calendar year taxpayer, is a salesman in a large metropolitan area for a company that manufactures household products. For the first three weeks of each month, B uses his own automobile occasionally to travel within the metropolitan area on business. During these three weeks, B's use of the automobile for business purposes does not follow a consistent pattern from day to day or week to week. During the fourth week of each month, B delivers to his customers all the orders taken during the previous month. B's use of his automobile for business purposes, as substantiated by adequate records, is 70 percent of the total use during that fourth week. In this example, a determination based on the records maintained during that fourth week that the business/investment use of the automobile for the taxable year is 70 percent is not based on sufficient corroborative evidence because use during this week is not representative of use during other periods.

(iii) *Special rules.* See §1.274–6T for special rules for substantiation by sufficient corroborating evidence with respect to certain listed property.

(4) *Substantiation in exceptional circumstances.* If a taxpayer establishes that, by reason of the inherent nature of the situation—

(i) He was unable to obtain evidence with respect to an element of the expenditure or use which conforms fully to the ''adequate records'' requirements of paragraph (c)(2) of this section,

(ii) He is unable to obtain evidence with respect to such element which conforms fully to the ''other sufficient evidence'' requirements of paragraph (c)(3) of this section, and

(iii) He has presented other evidence, with respect to such element, which possesses the highest degree of probative value possible under the circumstances, such other evidence shall be considered to satisfy the substantiation requirements of section 274(d) and this paragraph.

(5) *Loss of records due to circumstances beyond control of the taxpayer.* Where the taxpayer establishes that the failure to produce adequate records is due to the loss of such records through circumstances beyond the taxpayer's control, such as destruction by fire, flood, earthquake, or other casualty, the taxpayer shall have a right to substantiate a deduction by reasonable reconstruction of his expenditures or use.

(6) *Special rules*—(i) *Separate expenditure or use*—(A) *In general.* For the purposes of this section, each separate payment or use by the taxpayer shall ordinarily be considered to constitute a separate expenditure. However, concurrent or repetitious expenses or uses

may be substantiated as a single item. To illustrate the above rules, where a taxpayer entertains a business guest at dinner and thereafter at the theater, the payment for dinner shall be considered to constitute one expenditure and the payment for the tickets for the theater shall be considered to constitute a separate expenditure. Similarly, if during a day of business travel a taxpayer makes separate payments for breakfast, lunch, and dinner, he shall be considered to have made three separate expenditures. However, if during entertainment at a cocktail lounge the taxpayer pays separately for each serving of refreshments, the total amount expended for the refreshments will be treated as a single expenditure. A tip may be treated as a separate expenditure.

(B) *Aggregation of expenditures.* Except as otherwise provided in this section, the account book, diary, log, statement of expense, trip sheet, or similar record required by paragraph (c)(2)(ii) of this section shall be maintained with respect to each separate expenditure and not with respect to aggregate amounts for two or more expenditures. Thus, each expenditure for such items as lodging and air or rail travel shall be recorded as a separate item and not aggregated. However, at the option of the taxpayer, amounts expended for breakfast, lunch, or dinner, may be aggregated. A tip or gratuity which is related to an underlying expense may be aggregated with such expense. In addition, amounts expended in connection with the use of listed property during a taxable year, such as for gasoline or repairs for an automobile, may be aggregated. If these expenses are aggregated, the taxpayer must establish the date and amount, but need not prove the business purpose of each expenditure. Instead, the taxpayer may prorate the expenses based on the total business use of the listed property. For other provisions permitting recording of aggregate amounts in an account book, diary, log, statement of expense, trip sheet, or similar record, see paragraphs (b)(2)(i) and (b)(3) of this section (relating to incidental costs of travel and entertainment).

(C) *Aggregation of business use.* Uses which may be considered part of a single use, for example, a round trip or uninterrupted business use, may be accounted for by a single record. For example, use of a truck to make deliveries at several different locations which begins and ends at the business premises and which may include a stop at the business premises in between two deliveries may be accounted for by a single record of miles driven. In addition, use of a passenger automobile by a salesman for a business trip away from home over a period of time may be accounted for by a single record of miles traveled. De minimis personal use (such as a stop for lunch on the way between two business stops) is not an interruption of business use.

(ii) *Allocation of expenditure.* For purposes of this section, if a taxpayer has established the amount of an expenditure, but is unable to establish the portion of such amount which is attributable to each person participating in the event giving rise to the expenditure, such amount shall ordinarily be allocated to each participant on a pro rata basis, if such determination is material. Accordingly, the total number of persons for whom a travel or entertainment expenditure is incurred must be established in order to compute the portion of the expenditure allocable to such person.

(iii) *Primary use of a facility.* Section 274(a) (1)(B) and (2)(C) deny a deduction for any expenditure paid or incurred before January 1, 1979, with respect to a facility, or paid or incurred before January 1, 1994, with respect to a club, used in connection with an entertainment activity unless the taxpayer establishes that the facility (including a club) was used primarily for the furtherance of the taxpayer's trade or business. A determination whether a facility before January 1, 1979, or a club before January 1, 1994, was used primarily for the furtherance of the taxpayer's trade or business will depend upon the facts and circumstances of each case. In order to establish that a facility was used primarily for the furtherance of his trade or business, the taxpayer shall maintain records of the use of the facility, the cost of using the facility, mileage or its equivalent (if appropriate), and such other information as shall tend to establish such primary use. Such records of use shall contain—

(A) For each use of the facility claimed to be in furtherance of the taxpayer's trade or business, the elements of an expenditure specified in paragraph (b)(3) of this section, and

(B) For each use of the facility not in furtherance of the taxpayer's trade or business, an appropriate description of such use, including cost, date, number of persons entertained, nature of entertainment and, if applicable, information such as mileage or its equivalent. A notation such as ''personal use'' or ''family use'' would, in the case of such use, be sufficient to describe the nature of entertainment.

If a taxpayer fails to maintain adequate records concerning a facility which is likely to serve the personal purposes of the taxpayer, it shall be presumed that the use of such facility was primarily personal.

(iv) *Additional information.* In a case where it is necessary to obtain additional information, either—

(A) To clarify information contained in records, statements, testimony, or documentary evidence submitted by a taxpayer under the provisions of paragraph (c)(2) or (c)(3) of this section, or

(B) To establish the reliability or accuracy of such records, statements, testimony, or documentary evidence, the district director may, notwithstanding any other provision of this section, obtain such additional information by personal interview or otherwise as he determines necessary to implement properly the provisions of section 274 and the regulations thereunder.

(7) *Specific exceptions.* Except as otherwise prescribed by the Commissioner, substantiation otherwise required by this paragraph is not required for—

(i) Expenses described in section 274(e)(2) relating to food and beverages for employees, section 274(e)(3) relating to expenses treated as compensation, section 274(e)(8) relating to items available to the public, and section 274(e)(9) relating to entertainment sold to customers, and

(ii) Expenses described in section 274(e)(5) relating to recreational, etc., expenses for employees, except that a taxpayer shall keep such records or other evidence as shall establish that such expenses were for activities (or facilities used in connection therewith) primarily for the benefit of employees other than employees who are officers, shareholders or other owners (as defined in section 274(e)(5)), or highly compensated employees.

(d) *Disclosure on returns*—(1) *In general.* The Commissioner may, in his discretion, prescribe rules under which any taxpayer claiming a deduction or credit for entertainment, gifts, travel, or with respect to listed property, or any other person receiving advances, reimbursements, or allowances for such items, shall make disclosure on his tax return with respect to such items. The provisions of this paragraph shall apply notwithstanding the provisions of paragraph (f) of this section.

(2) *Business use of passenger automobiles and other vehicles.* (i) On returns for taxable years beginning after December 31, 1984, taxpayers that claim a deduction or credit with respect to any vehicle are required to answer certain questions providing information about the use of the vehicle. The information required on the tax return relates to mileage (total, business, commuting, and other personal mileage), percentage of business use, date placed in service, use of other vehicles, after-work use, whether the taxpayer has evidence to support the business use claimed on the return, and whether or not the evidence is written.

(ii) Any employer that provides the use of a vehicle to an employee must obtain information from the employee sufficient to complete the employer's tax return. Any employer that provides more than five vehicles to its employees need not include any information on its return. The employer, instead, must obtain the information from its employees, indicate on its return that it has obtained the information, and retain the information received. Any employer—

(A) That can satisfy the requirements of §1.274–6T(a)(2), relating to vehicles not used for personal purposes,

(B) That can satisfy the requirements of §1.274–6T(a)(3), relating to vehicles not used for personal purposes other than commuting, or

(C) That treats all use of vehicles by employees as personal use need not obtain information with respect to those vechicles, but instead must indicate on its return that it has vehicles exempt from the requirements of this paragraph (d)(2).

(3) *Business use of other listed property.* On returns for taxable years beginning after December 31, 1984, taxpayers that claim a deduction or credit with respect to any listed property other than a vehicle (for example, a yacht, airplane, or certain computers) are required to provide the following information:

(i) The date that the property was placed in service,

(ii) The percentage of business use,

(iii) Whether evidence is available to support the percentage of business use claimed on the return, and

(iv) Whether the evidence is written.

(e) *Substantiation of the business use of listed property made available by an employer for use by an employee*—(1) *Employee*—(i) *In general.* An employee may not exclude from gross income as a working condition fringe any amount of the value of the availability of listed property provided by an employer to the employee, unless the employee substantiates for the period of availability the amount of the exclusion in accordance with the requirements of section 274(d) and either this section or § 1.274–6T.

(ii) *Vehicles treated as used entirely for personal purposes.* If an employer includes the value of the availability of a vehicle (as defined in § 1.61–21(e)(2)) in an employee's gross income without taking into account any exclusion for a working condition fringe allowable under section 132 and the regulations thereunder with respect to the vehicle, the employee must substantiate any deduction claimed under §§ 1.162–25 and 1.162–25T for the business/investment use of the vehicle in accordance with the requirements of section 274(d) and either this section or § 1.274–6T.

(2) *Employer*—(i) *In general.* An employer substantiates its business/investment use of listed property by showing either—

(A) That, based on evidence that satisfies the requirements of section 274(d) or statements submitted by employees that summarize such evidence, all or a portion of the use of the listed property is by employees in the employer's trade or business and, if any employee used the property for personal purposes, the employer included an appropriate amount in the employee's income, or

(B) In the case of a vehicle, the employer treats all use by employees as personal use and includes an appropriate amount in the employees' income.

(ii) *Reliance on employee records.* For purposes of substantiating the business/investment use of listed property that an employer provides to an employee and for purposes of the information required by paragraph (d)(2) and (3) of this section, the employer may rely on adequate records maintained by the employee or on the employee's own statement if corroborated by other sufficient evidence unless the employer knows or has reason to know that the statement, records, or other evidence are not accurate. The employer must retain a copy of the adequate records maintained by the employee or the other sufficient evidence, if available. Alternatively, the employer may rely on a statement submitted by the employee that provides sufficient information to allow the employer to determine the business/investment use of the property unless the employer knows or has reason to know that the statement is not based on adequate records or on the employee's own statement corroborated by other sufficient evidence. If the employer relies on the employee's statement, the employer must retain only a copy of the statement. The employee must retain a copy of the adequate records or other evidence.

(f) *Reporting and substantiation of expenses of certain employees for travel, entertainment, gifts, and with respect to listed property*—(1) *In general.* The purpose of this paragraph is to provide rules for reporting and substantiation of certain expenses paid or incurred by employees in connection with the performance of services as employees. For purposes of this paragraph, the term *business expenses* means ordinary and necessary expenses for travel, entertainment, gifts, or with respect to listed property which are deductible under section 162, and the regulations thereunder, to the extent not disallowed by section 262, 274(c), and 280F. Thus, the term *business expenses* does not include personal, living, or family expenses disallowed by section 262, travel expenses disallowed by section 274(c), or cost recovery deductions and credits with respect to listed property disallowed by section 280F(d)(3) because the use of such property is not for the convenience of the employer and required as a condition of employment. Except as provided in paragraph (f)(2), advances, reimbursements, or allowances for such expenditures must be reported as income by the employee.

(2) *Reporting of expenses for which the employee is required to make an adequate accounting to his employer*—(i) *Reimbursements equal to expenses.* For purposes of computing tax liability, an employee need not report on his tax return business expenses for travel, transportation, entertainment, gifts, or with respect to listed property, paid or incurred by him solely for the benefit of his employer for which he is required to, and does, make an adequate accounting to his employer (as defined in paragraph (f)(4) of this section) and which are charged directly or indirectly to the employer (for example, through credit cards) or for which the employee is paid through advances, reimbursements, or otherwise, provided that the total amount of such advances, reimbursements, and charges is equal to such expenses.

(ii) *Reimbursements in excess of expenses.* In case the total of the amounts charged directly or indirectly to the employer or received from the employer as advances, reimbursements, or otherwise, exceeds the business expenses paid or incurred by the employee and the employee is required to, and does, make an adequate accounting to his employer for such expenses, the employee must include such excess (including amounts received for expenditures not deductible by him) in income.

(iii) *Expenses in excess of reimbursements.* If an employee incurs deductible business expenses on behalf of his employer which exceed the total of the amounts charged directly or indirectly to the employer and received from the employer as advances, reimbursements, or otherwise, and the employee makes an adequate accounting to his employer, the employee must be able to substantiate any deduction for such excess with such records and supporting evidence as will substantiate each element of an expenditure (described in paragraph (b) of this section) in accordance with paragraph (c) of this section.

(3) *Reporting of expenses for which the employee is not required to make an adequate accounting to his employer.* If the employee is not required to make an adequate accounting to his employer for his business expenses or, though required, fails to make an adequate accounting for such expenses, he must submit, as a part of his tax return, the appropriate form issued by the Internal Revenue Service for claiming deductions for employee business expenses (e.g., Form 2106, Employee Business Expenses, for 1985) and provide the information requested on that form, including the information required by paragraph (d)(2) and (3) of this section if the employee's business expenses are with respect to the use of listed property. In addition, the employee must maintain such records and supporting evidence as will substantiate each element of an expenditure or use (described in paragraph (b) of this section) in accordance with paragraph (c) of this section.

(4) *Definition of an ''adequate accounting'' to the employer*—(i) *In general.* For purposes of this paragraph an adequate accounting means the submission to the employer of an account book, diary, log, statement of expense, trip sheet, or similar record maintained by the employee in which the information as to each element of an expenditure or use (described in paragraph (b) of this section) is recorded at or near the time of the expenditure or use, together with supporting documentary evidence, in a manner which conforms to all the ''adequate records'' requirements of paragraph (c)(2) of this section. An adequate accounting requires that the employee account for all amounts received from his employer during the

taxable year as advances, reimbursements, or allowances (including those charged directly or indirectly to the employer through credit cards or otherwise) for travel, entertainment, gifts, and the use of listed property. The methods of substantiation allowed under paragraph (c)(4) or (c)(5) of this section also will be considered to be an adequate accounting if the employer accepts an employee's substantiation and establishes that such substantiation meets the requirements of such paragraph (c)(4) or (c)(5). For purposes of an adequate accounting, the method of substantiation allowed under paragraph (c)(3) of this section will not be permitted.

(ii) *Procedures for adequate accounting without documentary evidence.* The Commissioner may, in his discretion, prescribe rules under which an employee may make an adequate accounting to his employer by submitting an account book, log, diary, etc., alone, without submitting documentary evidence.

(iii) *Employer.* For purposes of this section, the term *employer* includes an agent of the employer or a third party payor who pays amounts to an employee under a reimbursement or other expense allowance arrangement.

(5) *Substantiation of expenditures by certain employees.* An employee who makes an adequate accounting to his employer within the meaning of this paragraph will not again be required to substantiate such expense account information except in the following cases:

(i) An employee whose business expenses exceed the total of amounts charged to his employer and amounts received through advances, reimbursements or otherwise and who claims a deduction on his return for such excess,

(ii) An employee who is related to his employer within the meaning of section 267(b), but for this purpose the percentage referred to in section 267(b)(2) shall be 10 percent, and

(iii) Employees in cases where it is determined that the accounting procedures used by the employer for the reporting and substantiation of expenses by such employees are not adequate, or where it cannot be determined that such procedures are adequate. The district director will determine whether the employer's accounting procedures are adequate by considering the facts and circumstances of each case, including the use of proper internal controls. For example, an employer should require that an expense account be verified and approved by a reasonable person other than the person incurring such expenses. Accounting procedures will be considered inadequate to the extent that the employer does not require an adequate accounting from his employees as defined in paragraph (f)(4) of this section, or does not maintain such substantiation. To the extent an employer fails to maintain adequate accounting procedures he will thereby obligate his employees to substantiate separately their expense account information.

(g) Substantiation by reimbursement arrangements or per diem, mileage, and other traveling allowances. For guidance, see § 1.274(d)–1.

(h) *Reporting and substantiation of certain reimbursements of persons other than employees*—(1) *In general.* The purpose of this paragraph is to provide rules for the reporting and substantiation of certain expenses for travel, entertainment, gifts, or with respect to listed property paid or incurred by one person (hereinafter termed "independent contractor") in connection with services performed for another person other than an employer (hereinafter termed "client or customer") under a reimbursement or other expense allowance arrangement with such client or customer. For purposes of this paragraph, the term *business expenses* means ordinary and necessary expenses for travel, entertainment, gifts, or with respect to listed property which are deductible under section 162, and the regulations thereunder, to the extent not disallowed by sections 262 and 274(c). Thus, the term *business expenses* does not include personal, living, or family expenses disallowed by section 262 or travel expenses disallowed by section 274(c), and reimbursements for such expenditures must be reported as income by the independent contractor. For purposes of this paragraph, the term *reimbursements* means advances, allowances, or reimbursements received by an independent contractor for travel, entertainment, gifts, or with respect to listed property in connection with the performance by him of services for his client or customer, under a reimbursement or other expense allowance arrangement with his client or customer, and includes amounts charged directly or indirectly to the client or customer through credit card systems or otherwise. See paragraph (j) of this section relating to the substantiation of meal expenses while traveling away from home.

(2) *Substantiation by independent contractors.* An independent contractor shall substantiate, with respect to his reimbursements, each element of an expenditure (described in paragraph (b) of this section) in accordance with the requirements of paragraph (c) of this section; and, to the extent he does not so substantiate, he shall include such reimbursements in income. An independent contractor shall so substantiate a reimbursement for entertainment regardless of whether he accounts (within the meaning of paragraph (h)(3) of this section) for such entertainment.

(3) *Accounting to a client or customer under section 274(e)(4)(B).* Section 274(e)(4)(B) provides that section 274(a) (relating to disallowance of expenses for entertainment) shall not apply to expenditures for entertainment for which an independent contractor has been reimbursed if the independent contractor accounts to his client or customer, to the extent provided by section 274(d). For purposes of section 274(e)(4)(B), an independent contractor shall be considered to account to his client or customer for an expense paid or incurred under a reimbursement or other expense allowance arrangement with his client or customer if, with respect to such expense for entertainment, he submits to his client or customer adequate records or other sufficient evidence conforming to the requirements of paragraph (c) of this section.

(4) *Substantiation by client or customer.* A client or customer shall not be required to substantiate, in accordance with the requirements of paragraph (c) of this section, reimbursements to an independent contractor for travel and gifts, or for entertainment unless the independent contractor has accounted to him (within the meaning of section 274(e)(4)(B) and paragraph (h)(3) of this section) for such entertainment. If an independent contractor has so accounted to a client or customer for entertainment, the client or customer shall substantiate each element of the expenditure (as described in paragraph (b) of this section) in accordance with the requirements of paragraph (c) of this section.

(i) [Reserved]

(j) *Authority for an optional method of computing meal expenses while traveling away from home.* The Commissioner may establish a method under which a taxpayer may elect to use a specified amount or amounts for meals while traveling away from home in lieu of substantiating the actual cost of meals. The taxpayer would not be relieved of substantiating the actual cost of other travel expenses as well as the time, place, and business purpose of the travel. See paragraphs (b)(2) and (c) of this section.

(k) *Exceptions for qualified nonpersonal use vehicles*—(1) *In general.* The substantiation requirements of section 274(d) and this section do not apply to any qualified nonpersonal use vehicle (as defined in paragraph (k)(2) of this section).

(2) *Qualified nonpersonal use vehicle*—(i) *In general.* For purposes of section 274(d) and this section, the term *qualified nonpersonal use vehicle* means any vehicle which, by reason of its nature (i.e., design), is not likely to be used more than a de minimis amount for personal purposes.

(ii) *List of vehicles.* Vehicles which are qualified nonpersonal use vehicles include the following—

(A) Clearly marked police and fire vehicles (as defined and to the extent provided in paragraph (k)(3) of this section),

(B) Ambulances used as such or hearses used as such,

(C) Any vehicle designed to carry cargo with a loaded gross vehicle weight over 14,000 pounds,

(D) Bucket trucks (‘‘cherry pickers’’),

(E) Cement mixers,

(F) Combines,

(G) Cranes and derricks,

(H) Delivery trucks with seating only for the driver, or only for the driver plus a folding jump seat,

(I) Dump trucks (including garbage trucks),

(J) Flatbed trucks,

(K) Forklifts,

(L) Passenger buses used as such with a capacity of at least 20 passengers,

(M) Qualified moving vans (as defined in paragraph (k)(4) of this section),

(N) Qualified specialized utility repair trucks (as defined in paragraph (k)(5) of this section),

(O) Refrigerated trucks,

(P) School buses (as defined in section 4221(d)(7)(C)),

(Q) Tractors and other special purpose farm vehicles,

(R) Unmarked vehicles used by law enforcement officers (as defined in paragraph (k)(6) of this section) if the use is officially authorized, and

(S) Such other vehicles as the Commissioner may designate.

(3) *Clearly marked police or fire vehicles.* A police or fire vehicle is a vehicle, owned or leased by a governmental unit, or any agency or instrumentality thereof, that is required to be used for commuting by a police officer or fire fighter who, when not on a regular shift, is on call at all times, provided that any personal use (other than commuting) of the vehicle outside the limit of the police officer's arrest powers or the fire fighter's obligation to respond to an emergency is prohibited by such governmental unit. A police or fire vehicle is clearly marked if, through painted insignia or words, it is readily apparent that the vehicle is a police or fire vehicle. A marking on a license plate is not a clear marking for purposes of this paragraph (k).

(4) *Qualified moving van.* The term *qualified moving van* means any truck or van used by a professional moving company in the trade or business of moving household or business goods if—

(i) No personal use of the van is allowed other than for travel to and from a move site (or for de minimis personal use, such as a stop for lunch on the way between two move sites),

(ii) Personal use for travel to and from a move site is an irregular practice (i.e., not more than five times a month on average), and

(iii) Personal use is limited to situations in which it is more convenient to the employer, because of the location of the employee's residence in relation to the location of the move site, for the van not to be returned to the employer's business location.

(5) *Qualified specialized utility repair truck.* The term *qualified specialized utility repair truck* means any truck (not including a van or pickup truck) specifically designed and used to carry heavy tools, testing equipment, or parts if—

(i) The shelves, racks, or other permanent interior construction which has been installed to carry and store such heavy items is such that it is unlikely that the truck will be used more than a de minimis amount for personal purposes, and

(ii) The employer requires the employee to drive the truck home in order to be able to respond in emergency situations for purposes of restoring or maintaining electricity, gas, telephone, water, sewer, or steam utility services.

(6) *Unmarked law enforcement vehicles*—(i) *In general.* The substantiation requirements of section 274(d) and this section do not apply to officially authorized uses of an unmarked vehicle by a "law enforcement officer". To qualify for this exception, any personal use must be authorized by the Federal, State, county, or local governmental agency or department that owns or leases the vehicle and employs the officer, and must be incident to law-enforcement functions, such as being able to report directly from home to a stakeout or surveillance site, or to an emergency situation. Use of an unmarked vehicle for vacation or recreation trips cannot qualify as an authorized use.

(ii) *Law enforcement officer.* The term *law enforcement officer* means an individual who is employed on a full-time basis by a governmental unit that is responsible for the prevention or investigation of crime involving injury to persons or property (including apprehension or detention of persons for such crimes), who is authorized by law to carry firearms, execute search warrants, and to make arrests (other than merely a citizen's arrest), and who regularly carries firearms (except when it is not possible to do so because of the requirements of undercover work). The term *law enforcement officer* may include an arson investigator if the investigator otherwise meets the requirements of this paragraph (k)(6)(ii), but does not include Internal Revenue Service special agents.

(7) *Trucks and vans.* The substantiation requirements of section 274(d) and this section apply generally to any pickup truck or van, unless the truck or van has been specially modified with the result that it is not likely to be used more than a de minimis amount for personal purposes. For example, a van that has only a front bench for seating, in which permanent shelving that fills most of the cargo area has been installed, that constantly carries merchandise or equipment, and that has been specially painted with advertising or the company's name, is a vehicle not likely to be used more than a de minimis amount for personal purposes.

(8) *Examples.* The following examples illustrate the provisions of paragraph (k)(3) and (6) of this section:

Example 1. Detective C, who is a ''law enforcement officer'' employed by a state police department, headquartered in city M, is provided with an unmarked vehicle (equipped with radio communication) for use during off-duty hours because C must be able to communicate with headquarters and be available for duty at any time (for example, to report to a surveillance or crime site). The police department generally has officially authorized personal use of the vehicle by C but has prohibited use of the vehicle for recreational purposes or for personal purposes outside the state. Thus, C's use of the vehicle for commuting between headquarters or a surveillance site and home and for personal errands is authorized personal use as described in paragraph (k)(6)(i) of this section. With respect to these authorized uses, the vehicle is not subject to the substantiation requirements of section 274(d) and the value of these uses is not included in C's gross income.

Example 2. Detective T is a ''law enforcement officer'' employed by city M. T is authorized to make arrests only within M's city limits. T, along with all other officers on the force, is ordinarily on duty for eight hours each work day and on call during the other sixteen hours. T is provided with the use of a clearly marked police vehicle in which T is required to commute to his home in city M. The police department's official policy regarding marked police vehicles prohibits personal use (other than commuting) of the vehicles outside the city limits. When not using the vehicle on the job, T uses the vehicle only for commuting, personal errands on the way between work and home, and personal errands within city M. All use of the vehicle by T conforms to the requirements of paragraph (k)(3) of this section. Therefore, the value of that use is excluded from T's gross income as a working condition fringe and the vehicle is not subject to the substantiation requirements of section 274(d).

(l) *Definitions.* For purposes of section 274(d) and this section, the terms *automobile* and *vehicle* have the same meanings as prescribed in §1.61–21(d)(1)(ii) and §1.61–21(e)(2), respectively. Also, for purposes of section 274(d) and this section, the terms *employer, ''employee,* and *personal use* have the same meanings as prescribed in §1.274–6T(e).

(m) *Effective date.* Section 274(d), as amended by the Tax Reform Act of 1984 and Public Law 99–44, and this section (except as provided in paragraph (d)(2) and (3) of this section) apply with respect to taxable years beginning after December 31, 1985. Section 274(d) and this section apply to any deduction or credit claimed in a taxable year beginning after December 31, 1985, with respect to any listed property, regardless of the taxable year in which the property was placed in service. However, except as provided in §1.132–5(h) with respect to qualified nonpersonal use vehicles, the substantiation requirements of section 274(d) and this section do not apply to the determination of an employee's working condition fringe exclusion or to the determination under §1.162–25(b) of an employee's deduction before the date that those requirements apply, under this paragraph (m), to the employer, if the employer is taxable.

[T.D. 8061, 50 FR 46014, Nov. 6, 1985; as amended by T.D. 8063, 50 FR 52312, Dec. 23, 1985; T.D. 8276, 54 FR 51027, Dec. 12, 1989; T.D. 8451, 57 FR 57669, Dec. 7, 1992; T.D. 8601, 60 FR 36995, July 19, 1995; T.D. 8715, 62 FR 13990, Mar. 25, 1997]

§1.274–6 Expenditures deductible without regard to trade or business or other income producing activity.

The provisions of §§1.274–1 through 1.274–5, inclusive, do not apply to any deduction allowable to the taxpayer without regard to its connection with the taxpayer's trade or business or other income producing activity. Examples of such items are interest, taxes such as real property taxes, and casualty losses. Thus, if a taxpayer owned a fishing camp, the taxpayer could still deduct mortgage interest and real property taxes in full even if deductions for its use are not allowable under section 274(a) and § 1.274–2. In the case of a taxpayer which is not an individual, the provisions of this section shall be applied as if it were an individual. Thus, if a corporation sustains a casualty loss on an entertainment facility used in its trade or business, it could deduct the loss even though deductions for the use of the facility are not allowable.

[T.D. 8051, 50 FR 36576, Sept. 9, 1985]

§ 1.274–6T Substantiation with respect to certain types of listed property for taxable years beginning after 1985 (temporary).

(a) *Written policy statements as to vehicles*—(1) *In general.* Two types of written policy statements satisfying the conditions described in paragraph (a)(2) and (3) of this section, if initiated and kept by an employer to implement a policy of no personal use, or no personal use except for commuting, of a vehicle provided by the employer, qualify as sufficient evidence corroborating the taxpayer's own statement and therefore will satisfy the employer's substantiation requirements under section 274(d). Therefore, the employee need not keep a separate set of records for purposes of the employer's substantiation requirements under section 274(d) with respect to use of a vehicle satisfying these written policy statement rules. A written policy statement adopted by a governmental unit as to employee use of its vehicles is eligible for these exceptions to the section 274(d) substantiation rules. Thus, a resolution of a city council or a provision of state law or a state constitution would qualify as a written policy statement, as long as the conditions described in paragraph (a)(2) and (3) of this section are met.

(2) *Vehicles not used for personal purposes*—(i) *Employers.* A policy statement that prohibits personal use by an employee satisfies an employer's substantiation requirements under section 274(d) if all the following conditions are met—

(A) The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business,

(B) When the vehicle is not used in the employer's trade or business, it is kept on the employer's business premises, unless it is temporarily located elsewhere, for example, for maintenance or because of a mechanical failure,

(C) No employee using the vehicle lives at the employer's business premises,

(D) Under a written policy of the employer, neither an employee, nor any individual whose use would be taxable to the employee, may use the vehicle for personal purposes, except for de minimis personal use (such as a stop for lunch between two business deliveries), and

(E) The employer reasonably believes that, except for de minimis use, neither the employee, nor any individual whose use would be taxable to the employee, uses the vehicle for any personal purpose.

There must also be evidence that would enable the Commissioner to determine whether the use of the vehicle meets the preceding five conditions.

(ii) *Employees.* An employee, in lieu of substantiating the business/investment use of an employer-provided vehicle under § 1.274–5T, may treat all use of the vehicle as business/investment use if the following conditions are met—

(A) The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business,

(B) When the vehicle is not used in the employer's trade or business, it is kept on the employer's business premises, unless it is temporarily located elsewhere, for example, for maintenance or because of a mechanical failure,

(C) No employee using the vehicle lives at the employer's business premises,

(D) Under a written policy of the employer, neither the employee, nor any individual whose use would be taxable to the employee, may use the vehicle for personal purposes, except for de minimis personal use (such as a stop for lunch between two business deliveries), and

(E) Except for de minimis personal use, neither the employee, nor any individual whose use would be taxable to the employee, uses the vehicle for any personal purpose.

There must also be evidence that would enable the Commissioner to determine whether the use of the vehicle meets the preceding five conditions.

(3) *Vehicles not used for personal purposes other than commuting*—(i) *Employers.* A policy statement that prohibits personal use by an employee, other than commuting, satisfies an employer's substantiation requirements under section 274(d) if all the following conditions are met—

(A) The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business and is used in the employer's trade or business,

(B) For bona fide noncompensatory business reasons, the employer requires the employee to commute to and/or from work in the vehicle,

(C) The employer has established a written policy under which neither the employee, nor any individual whose use would be taxable to the employee, may use the vehicle for personal purposes, other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home),

(D) The employer reasonably believes that, except for de minimis personal use, neither the employee, nor any individual whose use would be taxable to the employee, uses the vehicle for any personal purpose other than commuting,

(E) The employee required to use the vehicle for commuting is not a control employee (as defined in §1.61–2T(f) (5) and (6)) required to use an automobile (as defined in §1.61–2T(d)(1)(ii)), and

(F) The employer accounts for the commuting use by including in the employee's gross income the commuting value provided in §1.61–2T(f)(3) (to the extent not reimbursed by the employee).

There must be evidence that would enable the Commissioner to determine whether the use of the vehicle met the preceding six conditions.

(ii) *Employees.* An employee, in lieu of substantiating the business/investment use of an employer-provided vehicle under §1.274–5T, may substantiate any exclusion allowed under section 132 for a working condition fringe by including in income the commuting value of the vehicle (determined by the employer pursuant to §1.61–2T(f)(3)) if all the following conditions are met:

(A) The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business and is used in the employer's trade or business,

(B) For bona fide noncompensatory business reasons, the employer requires the employee to commute to and/or from work in the vehicle,

(C) Under a written policy of the employer, neither the employee, nor any individual whose use would be taxable to the employee, may use the vehicle for personal purposes, other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home),

(D) Except for de minimis personal use, neither the employee, nor any individual whose use would be taxable to the employee, uses the vehicle for any personal purpose other than commuting,

(E) The employee required to use the vehicle for commuting is not a control employee (as defined in §1.61–2T(f) (5) and (6) required to use an automobile (as defined in §1.61–2T(d)(1)(ii)), and

(F) The employee includes in gross income the commuting value determined by the employer as provided in §1.61–2T(f)(3) (to the extent that the employee does not reimburse the employer for the commuting use).

There must also be evidence that would enable the Commissioner to determine whether the use of the vehicle met the preceding six conditions.

(b) *Vehicles used in connection with the business of farming*—(1) *In general.* If, during a taxable year or shorter period, a vehicle, not otherwise described in section 274(i), § 1.274–5T(k), or paragraph (a) (2) or (3) of this section, is owned or leased by an employer and used during most of a normal business day directly in connection with the business of farming (as defined in paragraph (b)(2) of this section), the employer, in lieu of substantiating the use of the vehicle as prescribed in § 1.274–5T(b)(6)(i)(B), may determine any deduction or credit with respect to the vehicle as if the business/investment use (as defined in § 1.280F–6T(d)(3)(i)) and the qualified business use (as defined in § 1.280F–6T(d)(2)) of the vehicle in the business of farming for the taxable year or shorter period were 75 percent plus that percentage, if any, attributable to an amount included in an employee's gross income. If the vehicle is also available for personal use by employees, the employer must include the value of that personal use in the gross income of the employees, allocated among them in the manner prescribed in § 1.132–5T(g).

(2) *Directly in connection with the business of farming.* The phrase *directly in connection with the business of farming* means that the vehicle must be used directly in connection with the business of operating a farm (i.e., cultivating land or raising or harvesting any agricultural or horticultural commodity, or the raising, shearing, feeding, caring for, training, and management of animals) or incidental thereto (for example, trips to the feed and supply store).

(3) *Substantiation by employees.* If an employee is provided with the use of a vehicle to which this paragraph (b) applies, the employee may, in lieu of substantiating the business/investment use of the vehicle in the manner prescribed in § 1.274–5T, substantiate any exclusion allowed under section 132 for a working condition fringe as if the business/investment use of the vehicle were 75 percent, plus that percentage, if any, determined by the employer to be attributable to the use of the vehicle by individuals other than the employee, provided that the employee includes in gross income the amount determined by the employer as includible in the employee's gross income. *See* § 1.132–5T(g)(3) for examples illustrating the allocation of use of a vehicle among employees.

(c) *Vehicles treated as used entirely for personal purposes.* An employer may satisfy the substantiation requirements under section 274(d) for a taxable year or shorter period with respect to the business use of a vehicle that is provided to an employee by including the value of the availability of the vehicle during the relevant period in the employee's gross income without any exclusion for a working condition fringe with respect to the vehicle and, if required, by withholding any taxes. Under these circumstances, the employer's business/investment use of the vehicle during the relevant period is 100 percent. The employer's qualified business use of the vehicle is dependent upon the relationship of the employee to the employer (*see* § 1.280F–6T(d)(2)).

(d) *Limitation.* If a taxpayer chooses to satisfy the substantiation requirements of section 274(d) and § 1.274–5T by using one of the methods prescribed in paragraphs (a) (2) or (3), (b), or (c) of this section and files a return with the Internal Revenue Service for a taxable year consistent with such choice, the taxpayer may not later use another of these methods. Similarly, if a taxpayer chooses to satisfy the substantiation requirements of section 274(d) in the manner prescribed in § 1.274–5T and files a return with the Internal Revenue Service for a taxable year consistent with such choice, the taxpayer may not later use a method prescribed in paragraph (a) (2) or (3), (b), or (c) of this section. This rule applies to an employee for purposes of substantiating any working condition fringe exclusion as well as to an employer. For example, if an employee excludes on his federal income tax return for a taxable year 90 percent of the value of the availability of an employer-provided automobile on the basis of records that allegedly satisfy the ''adequate records'' requirement of § 1.274–5T(c)(2), and that requirement is not satisfied, then the employee may not satisfy the substantiation requirements of section 274(d) for the taxable year by any method prescribed in this section, but may present other corroborative evidence as prescribed in § 1.274–5T(c)(3).

(e) *Definitions*—(1) *In general.* The definitions provided in this paragraph (e) apply for purposes of section 274(d), §1.274–5T, and this section.

(2) *Employer and employee.* The terms *employer* and *employee* include the following:

(i) A sole proprietor shall be treated as both an employer and employee,

(ii) A partnership shall be treated as an employer of its partners, and

(iii) A partner shall be treated as an employee of the partnership.

(3) *Automobile.* The term *automobile* has the same meaning as prescribed in §1.61–2T(d)(1)(ii).

(4) *Vehicle.* The term *vehicle* has the same meaning as prescribed in §1.61–2T(e)(2).

(5) *Personal use. Personal use* by an employee of an employer-provided vehicle includes use in any trade or business other than the trade or business of being the employee of the employer providing the vehicle.

(f) *Effective date.* This section is effective for taxable years beginning after December 31, 1985.

[T.D. 8061, 50 FR 46037, Nov. 6, 1985; as amended by T.D. 8063, 50 FR 52312, Dec. 23, 1985]

§1.274–7 Treatment of certain expenditures with respect to entertainment-type facilities.

If deductions are disallowed under §1.274–2 with respect to any portion of a facility, such portion shall be treated as an asset which is used for personal, living, and family purposes (and not as an asset used in a trade or business). Thus, the basis of such a facility will be adjusted for purposes of computing depreciation deductions and determining gain or loss on the sale of such facility in the same manner as other property (for example, a residence) which is regarded as used partly for business and partly for personal purposes.

[T.D. 6659, 28 FR 6507, June 25, 1963]

§1.274–8 Effective date.

Except as provided in §1.274–2 (a) and (e), §§1.274–1 through 1.274–7 apply with respect to taxable years ending after December 31, 1962, but only in respect of periods after such date.

[T.D. 8051, 50 FR 36576, Sept. 9, 1985]

§1.274(d)–1 Substantiation requirements.

(a) *Substantiation by reimbursement arrangements or per diem, mileage, and other traveling allowances*—(1) *In general.* The Commissioner may, in his discretion, prescribe rules in pronouncements of general applicability under which allowances for expenses described in paragraph (a)(2) of this section will, if in accordance with reasonable business practice, be regarded as equivalent to substantiation by adequate records or other sufficient evidence for purposes of §1.274–5T(c) of the amount of such expenses and as satisfying, with respect to the amount of such expenses, the requirements of an adequate accounting to the employer for purposes of §1.274–5T(f)(4). If the total allowance received exceeds the deductible expenses paid or incurred by the employee, such excess must be reported as income on the employee's return. See §1.274–5T(j) relating to the substantiation of meal expenses while traveling away from home.

(2) *Allowances for expenses described.* An allowance for expenses is described in this paragraph (a)(2) if it is a—

(i) Reimbursement arrangement covering ordinary and necessary expenses of traveling away from home (exclusive of transportation expenses to and from destination);

(ii) Per diem allowance providing for ordinary and necessary expenses of traveling away from home (exclusive of transportation costs to and from destination); or

(iii) Mileage allowance providing for ordinary and necessary expenses of local travel and transportation while traveling away from home.

(3) *Limitation.* A mileage allowance described in paragraph (a)(2)(iii) of this section is available only to the owner of a vehicle.

(b) *Effective date.* This section applies to allowances described in paragraph (a)(2) of this section for expenses paid or incurred on or before December 31, 1997. For allowances for expenses paid or incurred after December 31, 1997, see §1.274(d)–1T.

[T.D. 8451, 57 FR 57669, Dec. 7, 1992, as amended by T.D. 8784, 63 FR 52601, Oct. 1, 1998]

§ 1.274(d)–1T Substantiation requirements (temporary).

(a) (1) and (2) [Reserved]. For further guidance, see § 1.274(d)–1(a)(1) and (2).

(a)(3) [Reserved].

(b) *Effective date.* This section applies to allowances described in § 1.274(d)–1(a)(2) for expenses paid or incurred after December 31, 1997. For allowances for expenses paid or incurred on or before December 31, 1997, see § 1.274(d)–1(a).

[T.D. 8784, 63 FR 52601, Oct. 1, 1998; 63 FR 64187, Nov. 19, 1998]

§ 1.275–1 Deduction denied in case of certain taxes.

For description of the taxes for which a deduction is denied under section 275, see paragraphs (a), (b), (c), (e), and (h) of § 1.164–2.

[T.D. 6780, 29 FR 18148, Dec. 22, 1964, as amended by T.D. 7767, 46 FR 11264, Feb. 6, 1981]

§ 1.276–1 Disallowance of deductions for certain indirect contributions to political parties.

(a) *In general.* Notwithstanding any other provision of law, no deduction shall be allowed for income tax purposes in respect of any amount paid or incurred after March 15, 1966, in a taxable year of the taxpayer beginning after December 31, 1965, for any expenditure to which paragraph (b)(1), (c), (d), or (e) of this section is applicable. Section 276 is a disallowance provision exclusively and does not make deductible any expenses which are not otherwise allowed under the Code. For certain other rules in respect of deductions for expenditures for political purposes, see §§ 1.162–15(b), 1.162–20, and 1.271–1.

(b) *Advertising in convention program*—(1) *General rule.* (i) Except as provided in subparagraph (2) of this paragraph, no deduction shall be allowed for an expenditure for advertising in a convention program of a political party. For purposes of this subparagraph it is immaterial who publishes the convention program or to whose use the proceeds of the program inure (or are intended to inure). A convention program is any written publication (as defined in paragraph (c) of this section) which is distributed or displayed in connection with or at a political convention, conclave, or meeting. Under certain conditions payments to a committee organized for the purpose of bringing a political convention to an area are deductible under paragraph (b) of § 1.162–15. This rule is not affected by the provisions of this section. For example, such payments may be deductible notwithstanding the fact that the committee purchases from a political party the right to publish a pamphlet in connection with a convention and that the deduction of costs of advertising in the pamphlet is prohibited under this section.

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

Example. M Corporation publishes the convention program of the Y political party for a convention not described in subparagraph (2) of this paragraph. The corporation makes no payment of any kind to or on behalf of the party or any of its candidates and no part of the proceeds of the publication and sale of the program inures directly or indirectly to the benefit of any political party or candidate. P Corporation purchases an advertisement in the program. P Corporation may not deduct the cost of such advertisement.

(2) *Amounts paid or incurred on or after January 1, 1968, for advertising in programs of certain national political conventions.* (i) Subject to the limitations in subdivision (ii) of this subparagraph, a deduction may be allowed for any amount paid or incurred on or after January 1, 1968, for advertising in a convention program of a political party distributed in connection with a convention held for the purpose of nominating candidates for the offices of President and Vice President of the United States, if the proceeds from the program are actually used solely to defray the costs of conducting the convention (or are set aside for such use at the next convention of the party held for such purpose) and if the amount paid or incurred for the advertising is reasonable. If such amount is not reasonable or if any part of the proceeds is used for a purpose other than that of defraying such convention costs, no part of the amount is deductible. Whether or not an amount is reasonable shall be determined in light of the business the taxpayer may expect to

receive either directly as a result of the advertising or as a result of the convention being held in an area in which the taxpayer has a principal place of business. For these purposes, an amount paid or incurred for advertising will not be considered as reasonable if it is greater than the amount which would be paid for comparable advertising in a comparable convention program of a nonpolitical organization. Institutional advertising (e.g., advertising of a type not designed to sell specific goods or services to persons attending the convention) is not advertising which may be expected to result directly in business for the taxpayer sufficient to make the expenditures reasonable. Accordingly, an amount spent for institutional advertising in a convention program may be deductible only if the taxpayer has a principal place of business in the area where the convention is held. An official statement made by a political party after a convention as to the use made of the proceeds from its convention program shall constitute prima facie evidence of such use.

(ii) No deduction may be taken for any amount described in this subparagraph which is not otherwise allowable as a deduction under section 162, relating to trade or business expenses. Therefore, in order for any such amount to be deductible, it must first satisfy the requirements of section 162, and, in addition, it must also satisfy the more restrictive requirements of this subparagraph.

(c) *Advertising in publication other than convention program.* No deduction shall be allowed for an expenditure for advertising in any publication other than a convention program if any part of the proceeds of such publication directly or indirectly inures (or is intended to inure) to or for the use of a political party or a political candidate. For purposes of this paragraph, a publication includes a book, magazine, pamphlet, brochure, flier, almanac, newspaper, newsletter, handbill, billboard, menu, sign, scorecard, program, announcement, radio or television program or announcement, or any similar means of communication. For the definition of inurement of proceeds to a political party or a political candidate, see paragraph (f)(3) of this section.

(d) *Admission to dinner or program.* No deduction shall be allowed for an expenditure for admission to any dinner or program, if any part of the proceeds of such event directly or indirectly inures (or is intended to inure) to or for the use of a political party or a political candidate. For purposes of this paragraph, a dinner or program includes a gala, dance, ball, theatrical or film presentation, cocktail or other party, picnic, barbecue, sporting event, brunch, tea, supper, auction, bazaar, reading, speech, forum, lecture, fashion show, concert, opening, meeting, gathering, or any similar event. For the definition of inurement of proceeds to a political party or a political candidate and of admission to a dinner or program, see paragraph (f) of this section.

(e) *Admission to inaugural event.* (1) No deduction shall be allowed for an expenditure for admission to an inaugural ball, inaugural gala, inaugural parade, or inaugural concert, or to any similar event (such as a dinner or program, as defined in paragraph (d) of this section), in connection with the inauguration or installation in office of any official, or any equivalent event for an unsuccessful candidate, if the event is identified with a political party or a political candidate. For purposes of this paragraph, the sponsorship of the event and the use to which the proceeds of the event are or may be put are irrelevant, except insofar as they may tend to identify the event with a political party or a political candidate. For the definition of admission to an inaugural event, see paragraph (f)(4) of this section.

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

Example. An inaugural reception for A, a prominent member of Y party who has been recently elected judge of the municipal court of F city, is held with the proceeds going to the city treasury. The price of admission to such affair is not deductible.

(f) *Definitions*—(1) *Political party.* For purposes of this section the term *political party* has the same meaning as that provided for in paragraph (b)(1) of §1.271–1.

(2) *Political candidate.* For purposes of this section, the term *political candidate* is to be construed in accordance with the purpose of section 276 to deny tax deductions for certain expenditures which may be used directly or indirectly to finance political campaigns. The term includes a person who, at the time of the event or publication with respect to which the deduction is being sought, has been selected or nominated by a political party for any elective office. It also includes an individual who is generally believed, under the facts and circumstances at the time of the event or publication, by the persons making expenditures in connection therewith to be an individual who is or who in the reasonably foreseeable future will be seeking selection, nomination, or election to any public office. For purposes of the preceding sentence, the facts and circumstances to be considered include, but are not limited to, the purpose of the event or publication and the disposition to be made of the proceeds. In the absence of evidence to the contrary it shall be presumed that persons making expenditures in connection with an event or publication generally believe that an incumbent of an elective public office will run for reelection to his office or for election to some other public office.

(3) *Inurement of proceeds to political party or political candidate*—(i) *In general.* Subject to the special rules presented in subdivision (iii) of this subparagraph (relating to a political candidate), proceeds directly or indirectly inure to or for the use of a political party or a political candidate *(a)* if the party or candidate may order the disposition of any part of such proceeds, regardless of what use is actually made thereof, or *(b)* if any part of such proceeds is utilized by any person for the benefit of the party or candidate. These conditions are equally applicable in determining whether the proceeds are intended to inure. Accordingly, it is immaterial whether the event or publication operates at a loss if, had there been a profit, any part of the proceeds would have inured to or for the use of a political party or a political candidate. Moreover, it shall be presumed that where a dinner, program, or publication is sponsored by or identified with a political party or political candidate, the proceeds of such dinner, program, or publication directly or indirectly inure (or are intended to inure) to or for the use of the party or candidate. On the other hand, proceeds are not considered to directly or indirectly inure to the benefit of a political party or political candidate if the benefit derived is so remote as to be negligible or merely a coincidence of the relationship of a political candidate to a trade or business profiting from an expenditure of funds. For example, the proceeds of expenditures made by a taxpayer in the ordinary course of his trade or business for advertising in a publication, such as a newspaper or magazine, are not considered as inuring to the benefit of a political party or political candidate merely because the publication endorses a particular political candidate or candidates of a particular political party, the publisher independently contributes to the support of a political party or candidate out of his own personal funds, or the principal stockholder of the publishing firm is a candidate for public office.

(ii) *Proceeds to political party.* If a political party may order the disposition of any part of the proceeds of a publication or event described in paragraph (c) or (d) of this section, such proceeds inure to the use of the party regardless of what the proceeds are to be used for or that their use is restricted to a particular purpose unrelated to the election of specific candidates for public office. Accordingly, where a political party holds a dinner for the purpose of raising funds to be used in a voter registration drive, voter education program, or nonprofit political research program, partisan or nonpartisan, the proceeds are considered to directly or indirectly inure to or for the use of the political party. Proceeds may inure to or for the use of a political party even though they are to be used for purposes which may not be directly related to any particular election (such as to pay office rent for its permanent quarters, salaries to permanent employees, or utilities charges, or to pay the cost of an event such as a dinner or program as defined in paragraph (d) of this section).

(iii) *Proceeds to political candidate.* Proceeds directly or indirectly inure (or are intended to inure) to or for the use of a political candidate if, in addition to meeting the conditions described in subdivision (i) of this subparagraph, *(a)* some part of the proceeds is or may be used directly or indirectly for the purpose of furthering his candidacy for selection, nomination, or election to any elective public office, and *(b)* they are not received by him in the ordinary course of a trade or business (other than the trade or business of holding public office). Proceeds may so inure whether or not the expenditure sought to be deducted was paid or incurred before the commencement of political activities with respect to the selection, nomination, or election referred to in *(a)* of this subdivision, or after such selection, nomination, or election has been made or has taken place. For example, proceeds of an event which may be used by an individual who, under the facts and circumstances at the time of the event, the persons making expenditures in connection therewith generally believe will in the reasonably foreseeable future run for a public office, and which may be used in furtherance of such individual's candidacy, generally will be deemed to inure (or to be intended to inure) to or for the use of a political candidate for the purpose of furthering such individual's candidacy. Or, as another example, proceeds of an event occurring after an election, which may be used by a candidate in that election to repay loans incurred in directly or indirectly furthering his candidacy, or in reimbursement of expenses incurred in directly or indirectly furthering his candidacy, will be deemed to directly or indirectly inure (or to be intended to inure) to or for the use of a political candidate for the purpose of furthering his candidacy. For purposes of this subdivision, if the proceeds received by a candidate exceed substantially the fair market value of the goods furnished or services rendered by him, the proceeds are not received by the candidate in the ordinary course of his trade or business.

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

Example 1. Corporation O pays the Y political party $100,000 per annum for the right to publish the Y News, and retains the entire proceeds from the sale of the publication. Amounts paid or incurred for advertising in the Y News are not deductible because a part of the proceeds thereof indirectly inures to or for the use of a political party.

Example 2. The X political party holds a highly publicized ball honoring one of its active party members and admission tickets are offered to all. The guest of honor is a prominent national figure and a former incumbent of a high public office. The price of admission is designed to cover merely the cost of entertainment, food, and the ballroom, and all proceeds are paid to the hotel where the function is held, with the political party bearing the cost of any deficit. No deduction may be taken for the price of admission to the ball since the proceeds thereof inure to or for the use of a political party.

Example 3. Taxpayer A, engaged in a trade or business, purchases a number of tickets for admission to a fundraising affair held on behalf of political candidate B. The funds raised by this affair can be used by B for the purpose of furthering his candidacy. These expenditures are not deductible by A notwithstanding that B donates the proceeds of the affair to a charitable organization.

Example 4. A, an individual taxpayer who publishes a newspaper, is a candidate for elective public office. X Corporation advertises its products in A's newspaper, paying substantially more than the normal rate for such advertising. X Corporation may not deduct any portion of the cost of that advertising.

(4) *Admission to dinners, programs, inaugural events.* For purposes of this section, the cost of admission to a dinner, program, or inaugural event includes all charges, whether direct or indirect, for attendance and participation at such function. Thus, for example, amounts spent to be eligible for door prizes, for the privilege of sitting at the head table, or for transportation furnished as part of such an event, or any separate charges for food or drink, are amounts paid for admission.

[T.D. 6996, 34 FR 833, Jan. 18, 1969, as amended by T.D. 7010, 34 FR 7145, May 1, 1969]

§1.278–1 Capital expenditures incurred in planting and developing citrus and almond groves.

(a) *General rule.* (1)(i) Except as provided in subparagraph (2)(iii) of this paragraph and paragraph (b) of this section, there shall be charged to capital account any amount (allowable as a deduction without regard to section 278 or this section) which is attributable to the planting, cultivation, maintenance, or development of any citrus or almond grove (or part thereof), and which is incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted. For purposes of section 278 and this section, such an amount shall be considered as ''incurred'' in accordance with the taxpayer's regular tax accounting method used in reporting income and expenses connected with the citrus or almond grove operation. For purposes of this paragraph, the portion of a citrus or almond grove planted in 1 taxable year shall be treated separately from the portion of such grove planted in another taxable year. The provisions of section 278 and this section apply to taxable years beginning after December 31, 1969, in the case of a citrus grove, and to taxable years beginning after January 12, 1971, in the case of an almond grove.

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

Example 1. T, a fiscal year taxpayer plants a citrus grove 5 weeks before the close of his taxable year ending in 1971. T is required to capitalize any amount (allowable as a deduction without regard to section 278 or this section) attributable to the planting, cultivation, maintenance, or development of such grove until the close of his taxable year ending in 1974.

Example 2. Assume the same facts as in *Example (1),* except that T plants one portion of such grove 5 weeks before the close of his taxable year ending in 1971 and another portion of such grove at the beginning of his taxable year ending in 1972. The required capitalization period for expenses attributable to the first portion of such grove shall run until the close of T's taxable year ending in 1974. The required capitalization period for expenses attributable to the second portion of such grove shall run until the close of T's taxable year ending in 1975.

(2)(i) For purposes of section 278 and this section a *citrus grove* is defined as one or more trees of the rue family, often thorny and bearing large fruit with hard, usually thick peel and pulpy flesh, such as the orange, grapefruit, lemon, lime, citron, tangelo, and tangerine.

(ii) For purposes of section 278 and this section, an *almond grove* is defined as one or more trees of the species *Prunus amygdalus.*

(iii) An amount attributable to the cultivation, maintenance, or development of a citrus or almond grove (or part thereof) shall include, but shall not be limited to, the following developmental or cultural practices expenditures: Irrigation, cultivation, pruning, fertilizing, management fees, frost protection, spraying, and upkeep of the citrus or almond grove. The provisions of section 278(a) and this paragraph shall apply to expenditures for fertilizer and related materials notwithstanding the provisions of section 180, but shall not apply to expenditures attributable to real estate taxes or interest, to soil and water conservation expenditures allowable as a deduction under section 175, or to expenditures for clearing land allowable as a deduction under section 182. Further, the provisions of section 278(a) and this paragraph apply only to expenditures allowable as deductions without regard to section 278 and have no application to expenditures otherwise chargeable to capital account, such as the cost of the land and preparatory expenditures incurred in connection with the citrus or almond grove.

(iv) For purposes of section 278 and this section, a citrus or almond tree shall be considered to be ''planted'' on the date on which the tree is placed in the permanent grove from which production is expected.

(3)(i) The period during which expenditures described in section 278(a) and this paragraph are required to be capitalized shall, once determined, be unaffected by a sale or other disposition of the citrus or almond grove. Such period shall, in all cases, be computed by reference to the taxable years of the owner of the grove at the time that the citrus or almond trees were planted. Therefore, if a citrus or almond grove subject to the provisions of section 278 or this paragraph is sold or otherwise transferred by the original owner of the grove before the close of his fourth taxable year beginning with the taxable year in which the trees were planted, expenditures described in section 278(a) or this paragraph made by the purchaser or other transferee of the citrus or almond grove from the date of his acquisition until the close of the original holder's fourth such taxable year are required to be capitalized.

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

Example. T, a fiscal year taxpayer, plants a citrus grove at the beginning of his taxable year ending in 1971. At the beginning of his taxable year ending in 1972, T sells the grove to X. The required period during which expenditures described in section 278 (a) are required to be capitalized runs from the date on which T planted the grove until the end of T's taxable year ending in 1974. Therefore, X must capitalize any such expenditures incurred by him from the time he purchased the grove from T until the end of T's taxable year ending in 1974.

(b) *Exceptions.* (1) Paragraph (a) of this section shall not apply to amounts allowable as deductions (without regard to section 278 or this section) and attributable to a citrus or almond grove (or part thereof) which is replanted by a taxpayer after having been lost or damaged (while in the hands of such taxpayer) by reason of freeze, disease, drought, pests, or casualty.

(2)(i) Paragraph (a) of this section shall not apply to amounts allowable as deductions (without regard to section 278 or this section), and attributable to a citrus grove (or part thereof) which was planted or replanted prior to December 30, 1969, or to an almond grove (or part thereof) which was planted or replanted prior to December 30, 1970.

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

Example 1. T, a fiscal year taxpayer with a taxable year of July 1, 1969, through v June 30, 1970, plants a citrus grove on August 1, 1969. Since the grove was planted prior to December 30, 1969, no expenses incurred with respect to the grove shall be subject to the provisions of paragraph (a).

Example 2. Assume the same facts as in *Example (1)*, except that T plants the grove on March 1, 1970. Since the grove was planted after December 30, 1969, all amounts allowable as deductions (without regard to section 278 or this section) and attributable to the grove shall be subject to the provisions of paragraph (a). However, since paragraph (a) applies only to taxable years beginning after December 31, 1969, T must capitalize only those amounts incurred during his taxable years ending in 1971, 1972, and 1973.

[T.D. 7098, 36 FR 5214, Mar. 18, 1971, as amended by T.D. 7136, 36 FR 14731, Aug. 11, 1971]

§1.279–1 General rule; purpose.

An obligation issued to provide a consideration directly or indirectly for a corporate acquisition, although constituting a debt under section 385, may have characteristics which make it more appropriate that the participation in the corporation which the obligation represents be treated for purposes of the deduction of interest as if it were a stockholder interest rather than a creditors interest. To deal with such cases, section 279 imposes certain limitations on the deductibility of interest paid or incurred on obligations which have certain equity characteristics and are classified as corporate acquisition indebtedness. Generally, section 279 provides that no deduction will be allowed for any interest paid or incurred by a corporation during the taxable year with respect to its corporate acquisition indebtedness to the extent such interest exceeds $5 million. However, the $5 million limitation is reduced by the amount of interest paid or incurred on obligations issued under the circumstances described in section 279(a)(2) but which are not corporate acquisition indebtedness. Section 279(b) provides that an obligation will be corporate acquisition indebtedness if it was issued under certain circumstances and meets the four tests enumerated therein. Although an obligation may satisfy the conditions referred to in the preceding sentence, it may still escape classification as corporate acquisition indebtedness if the conditions as described in sections 279(d) (3), (4), and (5), 279(f), or 279(i) are present. However, no inference should be drawn from the rules of section 279 as to whether a particular instrument labeled a bond, debenture, note, or other evidence of indebtedness is in fact a debt. Before the determination as to whether the deduction for payments pursuant to an obligation as described in this section is to be disallowed, the obligation must first qualify as debt in accordance with section 385. If the obligation is not debt under section 385, it will be unnecessary to apply section 279 to any payments pursuant to such obligation.

[T.D. 7262, 38 FR 5844, Mar. 5, 1973]

§ 1.279–2 Amount of disallowance of interest on corporate acquisition indebtedness.

(a) *In general.* Under section 279(a), no deduction is allowed for any interest paid or incurred by a corporation during the taxable year with respect to its corporate acquisition indebtedness to the extent that such interest exceeds:

(1) $5 million, reduced by

(2) The amount of interest paid or incurred by such corporation during such year on any obligation issued after December 31, 1967, to provide consideration directly or indirectly for an acquisition described in section 279(b)(1) but which is not corporate acquisition indebtedness. Such an obligation is not corporate acquisition indebtedness if it:

(i) Was issued prior to October 10, 1969, or

(ii) Was issued after October 9, 1969, but does not meet any one or more of the tests of section 279(b) (2), (3), or (4), or

(iii) Was originally deemed to be corporate acquisition indebtedness but is no longer so treated by virtue of the application of paragraphs (3) or (4) of section 279(d) or

(iv) Is specifically excluded from treatment as corporate acquisition indebtedness by virtue of sections 279(d)(5), (f), or (i).

The computation of the amount by which the $5 million limitation described in this paragraph is to be reduced with respect to any taxable year is to be made as of the last day of the taxable year in which an acquisition described in section 279(b)(1) occurs. In no case shall the $5 million limitation be reduced below zero.

(b) *Certain terms defined.* When used in section 279 and the regulations thereunder:

(1) The term *issued* includes the giving of a note or other evidence of indebtedness to a bank or other lender as well as an issuance of a bond or debenture. In the case of obligations which are registered with the Securities and Exchange Commission, the date of issue is the date on which the issue is first offered to the public. In the case of obligations which are not so registered, the date of issue is the date on which the obligation is sold to the first purchaser.

(2) The term *interest* includes both stated interest and unstated interest (such as original issue discount as defined in paragraph (a)(1) of § 1.163–4 and amounts treated as interest under section 483).

(3) The term *money* means cash and its equivalent.

(4) The term *control* shall have the meaning assigned to such term by section 368(c).

(5) The term *affiliated group* shall have the meaning assigned to such term by section 1504(a), except that all corporations other than the acquired corporation shall be treated as includible corporations (without any exclusion under section 1504(b)) and the acquired corporation shall not be treated as an includible corporation. This definition shall apply whether or not some or all of the members of the affiliated group file a consolidated return.

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

Example 1. On March 4, 1973, X Corporation, a calendar year taxpayer, issues an obligation which satisfies the test of section 279(b)(1) but fails to satisfy either of the tests of section 279(b) (2) or (3). Since at least one of the tests of section 279(b) is not satisfied the obligation is not corporate acquisition indebtedness. However, since the test of section 279(b)(1) is satisfied, the interest on the obligation will reduce the $5 million limitation provided by section 279 (a)(1).

Example 2. On January 1, 1969, X Corporation, a calendar year taxpayer, issues an obligation, which satisfies all the tests of section 279(b), requiring it to pay $3.5 million of interest each year. Since the obligation was issued before October 10, 1969, the obligation cannot be corporate acquisition indebtedness, and a deduction for the $3.5 million of interest attributable to such obligation is not subject to disallowance under section 279(a). However, since the obligation was issued after December 31, 1967, in an acquisition described in section 279(b)(1), under section 279(a)(2) the $3.5 million of interest attributable to such obligation reduces the $5 million limitation provided by section 279(a)(1) to $1.5 million.

Example 3. Assume the same facts as in *Example (2)*. Assume further that on January 1, 1970, X Corporation issues more obligations which are classified as corporate acquisition indebtedness and which require X Corporation to pay $4 million of interest each year. For 1970 the amount of interest paid or accrued on corporate acquisition indebtedness, which may be deducted is $1.5 million ($5 million maximum provided by section 279(a)(1) less $3.5 million, the reduction required under section 279(a)(2)). Thus, $2.5 million of the $4 million interest incurred on a corporate acquisition indebtedness is subject to disallowance under section 279(a) for the taxable year 1970.

Example 4. Assume the same facts as in *Example (3)*. Assume further that on the last day of each of the taxable years 1971, 1972, and 1973 of X Corporation neither of the conditions described in section 279(b)(4) was present.

Under these circumstances, such obligations for all taxable years after 1973 are not corporate acquisition indebtedness under section 279(d)(4). Therefore, the $2.5 million of interest previously not deductible is not deductible for all taxable years after 1973. Although such obligations are no longer treated as corporate acquisition indebtedness, the interest attributable thereto must be applied in further reduction of the $5 million limitation. The $5 million limitation of section 279(a)(1) is therefore reduced to zero. While the limitation is at the zero level any interest paid or incurred on corporate acquisition indebtedness will be disallowed.

[T.D. 7262, 38 FR 5844, Mar. 5, 1973]

§1.279–3 Corporate acquisition indebtedness.

(a) *Corporate acquisition indebtedness.* For purposes of section 279, the term *corporate acquisition indebtedness* means any obligation evidenced by a bond, debenture, note, or certificate or other evidence of indebtedness issued after October 9, 1969, by a corporation (referred to in section 279 and the regulations thereunder as ‘‘issuing corporation’’) if the obligation is issued to provide consideration directly or indirectly for the acquisition of stock in, or certain assets of, another corporation (as described in paragraph (b) of this §1.279–3), is ‘‘subordinated’’ (as described in paragraph (c) of this §1.279–3), is ‘‘convertible’’ (as described in paragraph (d) of this §1.279–3), and satisfies either the ratio of debt to equity test (as described in paragraph (f) of §1.279–5) or the projected earnings test (as described in paragraph (d) of §1.279–5).

(b) *Acquisition of stock or assets.* (1) Section 279(b)(1) describes one of the tests to be satisfied if an obligation is to be classified as corporate acquisition indebtedness. Under section 279(b)(1), the obligation must be issued to provide consideration directly or indirectly for the acquisition of:

(i) Stock (whether voting or nonvoting) in another corporation (referred to in section 279 and the regulations thereunder as ‘‘acquired corporation’’), or

(ii) Assets of another corporation (referred to in section 279 and the regulations thereunder as ‘‘acquired corporation’’) pursuant to a plan under which at least two-thirds (in value) of all the assets (excluding money) used in trades or businesses carried on by such corporation are acquired.

The fact that the corporation that issues the obligation is not the same corporation that acquires the acquired corporation does not prevent the application of section 279. For example, if X Corporation acquires all the stock of Y Corporation through the utilization of an obligation of Z Corporation, a wholly owned subsidiary of X Corporation, this section will apply.

(2) *Direct or indirect consideration.* Obligations are issued to provide direct consideration for an acquisition within the meaning of section 279(b)(1) where the obligations are issued to the shareholders of an acquired corporation in exchange for stock in such acquired corporation or where the obligations are issued to the acquired corporation in exchange for its assets. The application of the provisions of this subsection relating to indirect consideration for an acquisition of stock or assets depends upon the facts and circumstances surrounding the acquisition and the issuance of the obligations. Obligations are issued to provide indirect consideration for an acquisition of stock or assets within the meaning of section 279(b)(1) where (i) at the time of the issuance of the obligations the issuing corporation anticipated the acquisition of such stock or assets and the obligations would not have been issued if the issuing corporation had not so anticipated such acquisition, or where (ii) at

the time of the acquisition the issuing corporation foresaw or reasonably should have foreseen that it would be required to issue obligations, which it would not have otherwise been required to issue if the acquisition had not occurred, in order to meet its future economic needs.

(3) *Stock acquisition.* (i) For purposes of section 279, an acquisition in which the issuing corporation issues an obligation to provide consideration directly or indirectly for the acquisition of stock in the acquired corporation shall be treated as a stock acquisition within the meaning of section 279(b)(1)(A). Where the stock of one corporation is acquired from another corporation and such stock constitutes at least two-thirds (in value) of all the assets (excluding money) of the latter corporation, such acquisition shall be deemed an asset acquisition as described in section 279(b)(1)(B) and subparagraph (4) of this section. If the issuing corporation acquires less than two-thirds (in value) of all the assets (excluding money) used in trades or businesses carried on by the acquired corporation within the meaning of section 279(b)(1)(B) and subparagraph (4) of this paragraph and such assets include stock of another corporation, the acquisition of such stock is a stock acquisition within the meaning of section 279(b)(1)(A) and of this subparagraph. In such a case the amount of the obligation which is characterized as corporate acquisition indebtedness shall bear the same relationship to the total amount of the obligation issued as the fair market value of the stock acquired bears to the total of the fair market value of the assets acquired and stock acquired, as of the date of acquisition. For rules with respect to acquisitions of stock, where the total amount of stock of the acquired corporation held by the issuing corporation never exceeded 5 percent of the total combined voting power of all classes of stock of the acquired corporation entitled to vote, see § 1.279–4(b)(1).

(ii) If the issuing corporation acquired stock of an acquired corporation in an acquisition described in section 279(b)(1)(A), and liquidated the acquired corporation under section 334(b)(2) and the regulations thereunder before the last day of the taxable year in which such stock acquisition is made, such obligation issued to provide consideration directly or indirectly to acquire such stock of the acquired corporation shall be considered as issued in an acquisition described in section 279(b)(1)(B).

(4) *Asset acquisition.* (i) For purposes of section 279, an acquisition in which the issuing corporation issues an obligation to provide consideration directly or indirectly for the acquisition of assets of an acquired corporation pursuant to a plan under which at least two-thirds of the gross value of all the assets (excluding money) used in trades and businesses carried on by such acquired corporation are acquired shall be treated as an asset acquisition within the meaning of section 279(b)(1)(B). For purposes of section 279(b)(1)(B), the gross value of any acquired asset shall be its fair market value as of the day of its acquisition. In determining the fair market value of an asset, no reduction shall be made for any liabilities, mortgages, liens, or other encumbrances to which the asset or any part thereof may be subjected. For purposes of this subparagraph, an asset which has been actually used in the trades and businesses of a corporation but which is temporarily not being used in such trades and businesses shall be treated as if it is being used in such manner. For purposes of this paragraph, the day of acquisition will be determined by reference to the facts and circumstances surrounding the transaction.

(ii) For purposes of the two-thirds test described in section 279(b)(1)(B), the stock of any corporation which is controlled by the acquired corporation shall be considered as an asset used in the trades and businesses of such acquired corporation.

(5) *Certain nontaxable transactions.* (i) Under section 279(e), an acquisition of stock of a corporation of which the issuing corporation is in control in a transaction in which gain or loss is not recognized shall be deemed an acquisition described in section 279(b)(1)(A) only if immediately before such transaction the acquired corporation was in existence, and the issuing corporation was not in control of such corporation.

If the issuing corporation is a member of an affiliated group, then in accordance with section 279(g), the affiliated group shall be treated as the issuing corporation. Thus, any stock of the acquired corporation, owned by members of the affiliated group, shall be aggregated in determining whether the issuing corporation was in control of the acquired corporation.

(ii) The $5 million limitation provided by section 279(a)(1) is not reduced by the interest on an obligation issued in a transaction which, under section 279 (e), is deemed not to be an acquisition described in section 279(b)(1).

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

Example 1. On January 1, 1973, W Corporation, a calendar year taxpayer, issues to the public 10,000 10 year convertible bonds each with a principal of $1,000 for $9 million. On June 6, 1973, W Corporation transfers the $9 million proceeds of such bond issue to X Corporation in exchange for X Corporation's common stock in a transaction that satisfies the provisions of section 351(a). On December 31, 1973, W Corporation's ratio of debt to equity is 1 1/2 to 1 and its project earnings exceed three times the annual interest to be paid or incurred. Immediately prior to the transaction between the two corporations W Corporation owned no stock in X Corporation which had been in existence for several years. However, immediately after this transaction W Corporation is in control of X Corporation. Since X Corporation, the acquired corporation, was in existence and W Corporation, the issuing corporation, was not in control of X Corporation immediately before the section 351 transaction (a transaction in which gain or loss is not recognized) and since W Corporation is now in control of X Corporation, the acquisition of X Corporation's common stock by W Corporation is not protected from treatment as an acquisition described in section 279(b)(1)(A). However, the obligation will not be deemed to be corporate acquisition indebtedness since the test of section 279(b)(4) is not met. The interest on the obligation will reduce the $5 million limitation of section 279(a).

Example 2. Assume the facts are the same as described in *Example (1)*, except that X Corporation was not in existence prior to June 6, 1973, but rather is newly created by W Corporation on such date. Since X Corporation, the acquired corporation, was not in existence before June 6, 1973, the date on which W Corporation, the issuing corporation, acquired control of X Corporation in a transaction on which gain or loss is not recognized, the acquisition is not deemed to be an acquisition described in section 279(b)(1)(A). Thus, under the provisions of subdivision (ii) of this subparagraph, the $5 million limitation provided by section 279(a)(1) will not be reduced by the yearly interest incurred on the convertible bonds issued by W Corporation.

Example 3. Assume that the facts are the same as described in *Example (1)*, except that W Corporation was in control of X Corporation immediately before the transaction. Since W Corporation was in control of X Corporation immediately before the section 351(a) transaction and is in control of X Corporation after such transaction, the result will be the same as in *Example (2)*.

(c) *Subordinated obligation*—(1) *In general.* An obligation which is issued to provide consideration for an acquisition described in section 279(b)(1) is subordinated within the meaning of section 279(b)(2) if it is either:

(i) Subordinated to the claims of trade creditors of the issuing corporation generally, or

(ii) Expressly subordinated in right of payment to the payment of any substantial amount of unsecured indebtedness, whether outstanding or subsequently issued, of the issuing corporation, irrespective of whether such subordination relates to payment of interest, or principal, or both. In applying section 279 (b)(2) and this paragraph in any case where the issuing corporation is a member of an affiliated group of corporations, the affiliated group shall be treated as the issuing corporation.

(2) *Expressly subordinated obligation.* In applying subparagraph (1)(ii) of this paragraph, an obligation is considered expressly subordinated whether the terms of the subordination are provided in the evidence of indebtedness itself, or in another agreement between the parties to such obligation. An obligation shall be considered to be expressly subordinated within the meaning of subparagraph (1)(ii) of this paragraph if such obligation by its terms can become subordinated in right of payment to the payment of any substantial amount of unsecured indebtedness which is outstanding or which may be issued subsequently. However, an obligation shall not be considered expressly subordinated if such subordination occurs solely by operation of law, such as in the case of bankruptcy laws. For purposes of this paragraph,

the term *substantial amount of unsecured indebtedness* means an amount of unsecured indebtedness equal to 5 percent or more of the face amount of the obligations issued within the meaning of section 279(b)(1).

(d) *Convertible obligation.* An obligation which is issued to provide consideration directly or indirectly for an acquisition described in section 279 (b)(1) is convertible within the meaning of section 279(b)(3) if it is either— (1) Convertible directly or indirectly into stock of the issuing corporation, or (2) Part of an investment unit or other arrangement which includes, in addition to such bond or other evidence of indebtedness, an option to acquire directly or indirectly stock in the issuing corporation. Stock warrants or convertible preferred stock included as part of an investment unit constitute options within the meaning of the preceding sentence. Indebtedness is indirectly convertible if the conversion feature gives the holder the right to convert into another bond of the issuing corporation which is then convertible into the stock of the issuing corporation. In any case where the corporation which in fact issues an obligation to provide consideration for an acquisition described in section 279(b)(1) is a member of an affiliated group, the provisions of section 279(b)(3) and this paragraph are deemed satisfied if the stock into which either the obligation or option which is part of an investment unit or other arrangement is convertible, directly or indirectly, is stock of any member of the affiliated group.

(e) *Ratio of debt to equity and projected earnings test.* For rules with respect to the application of section 279(b)(4) (relating to the ratio of debt to equity and the ratio of projected earnings to annual interest to be paid or incurred), see paragraphs (d), (e), and (f) of § 1.279–5.

(f) *Certain obligations issued after October 9, 1969*—(1) *In general.* Under section 279(i), an obligation shall not be corporate acquisition indebtedness if such obligation is issued after October 9, 1969, to provide consideration for the acquisition of:

(i) Stock or assets pursuant to a binding written contract which was in effect on October 9, 1969, and at all times thereafter before such acquisition, or

(ii) Stock in any corporation where the issuing corporation, on October 9, 1969, and at all times thereafter before such acquisition, owned at least 50 percent of the total combined voting power of all classes of stock entitled to vote of the acquired corporation.

Subdivision (ii) of this subparagraph shall cease to apply when (at any time on or after October 9, 1969) the issuing corporation has acquired control of the acquired corporation. The interest attributable to any obligation which satisfies the conditions stated in the first sentence of this subparagraph shall reduce the $5 million limitation of section 279(a)(1).

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

Example 1. On September 5, 1969, M Corporation, a calendar year taxpayer, entered into a binding written contract with N Corporation to purchase 20 percent of the voting stock of N Corporation. The contract was in effect on October 9, 1969, and at all times thereafter before the acquisition of the stock on January 1, 1970. Pursuant to such contract M Corporation issued on January 1, 1970, to N Corporation an obligation which satisfies the tests of section 279(b) requiring it to pay $1 million of interest each year. However, under the provisions of subparagraph (1)(i) of this paragraph, such obligation is not corporate acquisition indebtedness since it was issued to provide consideration for the acquisition of stock pursuant to a binding written contract which was in effect on October 9, 1969, and at all times thereafter before such acquisition. The $1 million of yearly interest on the obligation reduces the $5 million limitation provided for in section 279(a)(1) to $4 million since such interest is attributable to an obligation which was issued to provide consideration for the acquisition of stock in an acquired corporation.

Example 2. On October 9, 1969, O Corporation, a calendar year taxpayer, owned 50 percent of the total combined voting power of all classes of stock entitled to vote of P Corporation. P Corporation has no other class of stock. On January 1, 1970, while still owning such voting stock O Corporation issued to the shareholders of P Corporation to provide consideration for an additional 40 percent of P Corporation's voting stock an obligation which satisfied the tests of section 279(b) requiring it to pay $4 million of interest each year. Hence, O Corporation acquired control of P Corporation, and the provisions of subparagraph (1)(ii) of this paragraph ceased to apply to O Corporation. Thus, 75 percent of the obligation issued by O Corporation to provide consideration for the stock of P Corporation is not corporate acquisition indebtedness (that is, of the 40 percent of the voting stock of P Corporation which was acquired, only 30 percent was needed to give O Corporation control). Since 25 percent of the obligation is corporate acquisition indebtedness, $1 million of interest attributable to such obligation is subject to disallowance under section 279(a) for the taxable year 1970. The remaining $3 million of interest attributable to the obligation will reduce the $5 million limitation provided by in section 279(a)(1).

(g) *Exemptions for certain acquisitions of foreign corporations*—(1) *In general.* Under section 279(f), the term *corporate acquisition indebtedness* does not include any indebtedness issued to any person to provide consideration directly or indirectly for the acquisition of stock in, or assets of, any foreign corporation substantially all the income of which, for the 3-year period ending with the date of such acquisition or for such part of such period as the foreign corporation was in existence, is from sources without the United States. The interest attributable to any obligation excluded from treatment as corporate acquisition indebtedness by reason of this paragraph shall reduce the $5 million limitation of 279(a)(1).

(2) *Foreign corporation.* For purposes of this paragraph, the term *foreign corporation* shall have the same meaning as in section 7701(a)(5).

(3) *Income from sources without the United States.* For purposes of this paragraph, the term *income from sources without the United States* shall be determined in accordance with sections 862 and 863. If more than 80 percent of a foreign corporation's gross income is derived from sources without the United States, such corporation shall be considered to be deriving substantially all of its income from sources without the United States.

[T.D. 7262, 38 FR 5845, Mar. 5, 1973]

§1.279–4 Special rules.

(a) *Special 3-year rule.* Under section 279(d)(4), if an obligation which has been deemed to be corporate acquisition indebtedness for any taxable year would not be such indebtedness for each of any 3 consecutive taxable years thereafter if the ratio of debt to equity and the ratio of projected earnings to annual interest to be paid or incurred of section 279 (b)(4) were applied as of the close of each of such 3 years, then such obligation shall not be corporate acquisition indebtedness for any taxable years after such 3 consecutive taxable years. The test prescribed by section 279(b)(4) shall be applied as of the close of any taxable year whether or not the issuing corporation issues any obligation to provide consideration for an acquisition described in section 279(b)(1) in such taxable year. Thus, for example, if a corporation, reporting income on a calendar year basis, has an obligation outstanding as of December 31, 1975, which was classified as a corporate acquisition indebtedness as of the close of 1972 and such obligation would not have been classified as corporate acquisition indebtedness as of the close of 1973, 1974, and 1975 because neither of the conditions of section 279(b)(4) were present as of such dates, then such obligation shall not be corporate acquisition indebtedness for 1976 and all taxable years thereafter. Such obligation shall not be reclassified as corporate acquisition indebtedness in any taxable year following 1975, even if the issuing corporation issues more obligations (whether or not found to be corporate acquisition indebtedness) in such later years to provide consideration for the acquisition of additional stock in, or assets of, the same acquired corporation with respect to which the original obligation was issued. The interest attributable to such obligation shall reduce the $5 million limitation provided by section 279(a)(1) for 1976 and all taxable years thereafter.

(b) *Five percent stock rule*—(1) *In general.* Under section 279(d)(5), if an obligation issued to provide consideration for an acquisition of stock in another corporation meets the tests of section 279(b), such obligation shall be corporate acquisition indebtedness for a taxable year only if at sometime after October 9, 1969, and before the close of such year the issuing corporation owns or has owned 5 percent or more of the total combined voting power of all classes of stock entitled to vote in the acquired corporation. If the issuing corporation is a member of an affiliated group, then in accordance with section 279(g) the affiliated group shall be treated as the issuing corporation. Thus, any stock of the acquired corporation owned by members of the affiliated group shall be aggregated to determine if the percentage limitation provided by this subparagraph is exceeded. Once an obligation is deemed to be corporate acquisition indebtedness such obligation will continue to be deemed corporate acquisition indebtedness for all taxable years thereafter unless the provisions of section 279(d) (3) or (4) apply, notwithstanding the fact that the issuing corporation owns less than 5 percent of the combined voting power of all classes of stock entitled to vote of the acquired corporation in any or all taxable years thereafter.

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

Example 1. Corporation Y uses the calendar year as its taxable year and has only one class of stock outstanding. On June 1, 1972, X Corporation which is also a calendar year taxpayer and which has never been a shareholder of Y Corporation acquires from the shareholders of Y Corporation 4 percent of the stock of Y Corporation in exchange for obligations which satisfy the conditions of section 279(b). At no time during 1972 does X Corporation own 5 percent or more of the stock of Y Corporation. Accordingly, under the provisions of subparagraph (1) of this paragraph, for 1972 the obligations issued by X Corporation to provide consideration for the acquisition of Y Corporation's stock do not constitute corporate acquisition indebtedness.

Example 2. Assume the same facts as in *Example (1).* Assume further that on February 24, 1973, X Corporation acquires from the shareholders of Y Corporation an additional 7 percent of the stock of Y Corporation in exchange for obligations which satisfy all of the tests of section 279(b). On December 28, 1973, X Corporation sells all of its stock in Y Corporation. For 1973, the obligations issued by X Corporation in 1972 and in 1973 constitute corporate acquisition indebtedness since X Corporation at some time after October 9, 1969, and before the close of 1973 owned 5 percent or more of the voting stock of Y Corporation. Furthermore, such obligations shall be corporate acquisition indebtedness for all taxable years thereafter unless the special provisions of section 279(d) (3) or (4) could apply.

(c) *Changes in obligation*—(1) *In general.* Under section 279(h), for purposes of section 279:

(i) Any extension, renewal, or refinancing of an obligation evidencing a preexisting indebtedness shall not be deemed to be the issuance of a new obligation, and

(ii) Any obligation which is corporate acquisition indebtedness of the issuing corporation is also corporate acquisition indebtedness of any corporation which in any transaction or by operation of law assumes liability for such obligation or becomes liable for such obligation as guarantor, endorser, or indemnitor.

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

Example 1. On January 1, 1971, X Corporation, which files its return on the basis of a calendar year, issues an obligation, which satisfies the tests of section 279(b), and is deemed to be corporate acquisition indebtedness. On January 1, 1973, an agreement is concluded between X Corporation and the holder of the obligation whereby the maturity date of such obligation is extended until December 31, 1979. Under the provisions of subparagraph (1)(i) of this paragraph such extended obligation is not deemed to be a new obligation, and still constitutes corporate acquisition indebtedness.

Example 2. On June 12, 1971, X Corporation, a calendar year taxpayer, issued convertible and subordinated obligations to acquire the stock of Z Corporation. The obligations were deemed corporate acquisition indebtedness on December 31, 1971. On March 4, 1973, X Corporation and Y Corporation consolidated to form XY Corporation in accordance with State law. Corporation XY is liable for the obligations issued by X Corporation by operation of law and the obligations continue to be corporate acquisition indebtedness. In 1975 XY Corporation exchanges its own nonconvertible obligations for the obligations X Corporation issued. The obligations of XY Corporation issued in exchange for those of X Corporation will be deemed to be corporate acquisition indebtedness.

[T.D. 7262, 38 FR 5847, Mar. 5, 1973; 38 FR 6893, Mar. 14, 1973]

§ 1.279–5 Rules for application of section 279(b).

(a) *Taxable years to which applicable*—(1) *First year of disallowance.* Under section 279(d)(1), the deduction of interest on any obligation shall not be disallowed under section 279(a) before the first taxable year of the issuing corporation as of the last day of which the application of either section 279(b)(4) (A) or (B) results in such obligation being classified as corporate acquisition indebtedness. See section 279(c)(1) and paragraph (b)(2) of this section for the time when an obligation is subjected to the test of section 279(b)(4).

(2) *General rule for succeeding years.* Under section 279(d)(2), except as provided in paragraphs (3), (4), and (5) of section 279(d), if an obligation is determined to be corporate acquisition indebtedness as of the last day of any taxable year of the issuing corporation, such obligation shall be corporate acquisition indebtedness for such taxable year and all subsequent taxable years.

(b) *Time of determination*—(1) *In general.* The determination of whether an obligation meets the conditions of section 279(b) (1), (2), and (3) shall be made as of the day on which the obligation is issued.

(2) *Ratio of debt to equity, projected earnings, and annual interest to be paid or incurred.* (i) Under section 279(c)(1), the determination of whether an obligation meets the conditions of section 279(b)(4) is first to be made as of the last day of the taxable year of the issuing corporation in which it issues the obligation to provide consideration directly or indirectly for an acquisition described in section 279(b)(1) of stock in, or assets of, the acquired corporation. An obligation which is not corporate acquisition indebtedness only because it does not satisfy the test of section 279(b)(4) in the taxable year of the issuing corporation in which the obligation is issued for stock in, or assets of, the acquired corporation may be subjected to the test of section 279(b)(4) again. A retesting will occur in any subsequent taxable year of the issuing corporation in which the issuing corporation issues any obligation to provide consideration directly or indirectly for an acquisition described in section 279(b)(1) with respect to the same acquired corporation, irrespective of whether such subsequent obligation is itself classified as corporate acquisition indebtedness. If the issuing corporation is a member of an affiliated group, then in accordance with section 279(g) the affiliated group shall be treated as the issuing corporation. Thus, if any member of the affiliated group issues an obligation to acquire additional stock in, or assets of, the acquired corporation, this paragraph shall apply.

(ii) For purposes of section 279(b)(4) and this paragraph, in any case where the issuing corporation is a member of an affiliated group (see section 279(g) and §1.279–6 for rules regarding application of section 279 to certain affiliated groups) which does not file a consolidated return and all the members of which do not have the same taxable year, determinations with respect to the ratio of debt to equity of, and projected earnings of, and annual interest to be paid or incurred by, any member of the affiliated group shall be made as of the last day of the taxable year of the corporation which in fact issues the obligation to provide consideration for an acquisition described in section 279(b)(1).

(3) *Redetermination where control or substantially all the properties have been acquired.* Under section 279(d)(3), if an obligation is determined to be corporate acquisition indebtedness as of the close of a taxable year of the issuing corporation in which section 279(c)(3)(A)(i) (relating to the projected earnings of the issuing corporation only) applied, but would not be corporate acquisition indebtedness if the determination were made as of the close of the first taxable year of such corporation thereafter in which section 279(c)(3)(A)(ii) (relating to the projected earnings of both the issuing corporation and the acquired corporation) could apply, such obligation shall be considered not to be corporate acquisition indebtedness for such later taxable year and all taxable years thereafter. Where an obligation ceases to be corporate acquisition indebtedness as a result of the application of this paragraph, the interest on such obligation shall not be disallowed under section 279(a) as a deduction for the taxable year in which the obligation ceases to be corporate acquisition indebtedness and all taxable years thereafter. However, under section 279(a)(2) the interest paid or incurred on such obligation

which is allowed as a deduction will reduce the $5 million limitation provided by section 279(a)(1).

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

Example 1. In 1971, X Corporation, which files its Federal income tax return on the basis of a calendar year, issues its obligations to provide consideration for the acquisition of 15 percent of the voting stock of both Y Corporation and Z Corporation. Y Corporation and Z Corporation each have only one class of stock. When issued, such obligations satisfied the tests prescribed in section 279(b) (1), (2), and (3) and would have constituted corporate acquisition indebtedness but for the test prescribed in section 279(b)(4). On December 31, 1971, the application of section 279(b)(4) results in X Corporation's obligations issued in 1971 not being treated as corporate acquisition indebtedness for that year.

Example 2. Assume the same facts as in *Example (1),* except that in 1972, X Corporation issues more obligations which come within the tests of section 279(b) (1), (2), and (3) to acquire an additional 10 percent of the voting stock of Y Corporation. No stock of Z Corporation is acquired after 1971. The application of section 279(b)(4)(B) (relating to the projected earnings of X Corporation) as of the end of 1972 results in the obligations issued in 1972 to provide consideration for the acquisition of the stock of Y Corporation being treated as corporate acquisition indebtedness. Since X Corporation during 1972 did issue obligations to acquire more stock of Y Corporation, under the provisions of section 279(c)(1) and subparagraph (2) of this paragraph the obligations issued by X Corporation in 1971 to acquire stock in Y Corporation are again tested to determine whether the test of section 279(b)(4) with respect to such obligations is satisfied for 1972. Thus, since such obligations issued by X Corporation to acquire Y Corporation's stock in 1971 previously came within the provisions of section 279(b) (1), (2), and (3) and the projected earnings test of section 279(b)(4)(B) is satisfied for 1972, all of such obligations are to be deemed to constitute corporate acquisition indebtedness for 1972 and subsequent taxable years. The obligations issued in 1971 to acquire stock in Z Corporation continue not to constitute corporate acquisition indebtedness.

Example 3. Assume the same facts as in *Examples (1)* and *(2).* In 1973, X Corporation issues more obligations which come within the tests of section 279(b) (1), (2), and (3) to acquire more stock (but not control) in Y Corporation. On December 31, 1973, it is determined with respect to X Corporation that neither of the conditions described in section 279(b)(4) are present. Thus, the obligations issued in 1973 do not constitute corporate acquisition indebtedness. However, the obligations issued in 1971 and 1972 by X Corporation to acquire stock in Y Corporation continue to be treated as corporate acquisition indebtedness.

Example 4. Assume the same facts as in *Example (3),* except that X Corporation acquires control of Y Corporation in 1973. Since X Corporation has acquired control of Y Corporation, the average annual earnings (as defined in section 279(c)(3)(B) and the annual interest to be paid or incurred (as provided by section 279(c)(4)) of both X Corporation and Y Corporation under section 279(c)(3)(A)(ii) are taken into account in computing for 1973 the ratio of projected earnings to annual interest to be paid or incurred described in section 279(b)(4)(B). Assume further that after applying section 279(b)(4)(B) the obligations issued in 1973 escape treatment as corporate acquisition indebtedness for 1973. Under section 279(d)(3), all of the obligations issued by X Corporation to acquire stock in Y Corporation in 1971 and 1972 are removed from classification as corporate acquisition indebtedness for 1973 and all subsequent taxable years.

Example 5. In 1975, M Corporation, which files its Federal income tax return on the basis of a calendar year, issues its obligations to acquire 30 percent of the voting stock of N Corporation. N Corporation has only one class of stock. Such obligations satisfy the tests prescribed in section 279(b) (1), (2), and (3). Additionally, as of the close of 1975, M Corporation's ratio of debt to equity exceeds the ratio of 2 to 1 and its projected earnings do not exceed three times the annual interest to be paid or incurred. The obligations issued by M Corporation are corporate acquisition indebtedness for 1975 since all the provisions of section 279(b) are satisfied. In 1976 M Corporation issues its obligations to acquire from the shareholders of N Corporation an additional 60 percent of the voting stock of N Corporation, thereby acquiring control of N Corporation. However, with respect to the obligations issued by M Corporation in 1975, there is no redetermination under section 279(d)(3) and subparagraph (3) of this paragraph as to whether such obligations may escape classification as corporate acquisition indebtedness because in 1975 it was the ratio of debt to equity test which caused such obligations to be corporate acquisition indebtedness. If in 1975, M Corporation met the conditions of section 279(b)(4) solely because of the ratio of projected earnings to annual interest to be paid or incurred described in section 279(b)(4)(B), its obligation issued in 1975 could be retested in 1976.

(c) *Acquisition of stock or assets of several corporations.* An issuing corporation which acquires stock in, or assets of, more than one corporation during any taxable year must apply the tests described in section 279(b) (1), (2), and (3) separately with respect to each obligation issued to provide consideration for the acquisition of the stock in, or assets of, each such acquired corporation. Thus, if an acquisition is made with obligations of the issuing corporation that satisfy the tests described in section 279(b) (2) and (3) and obligations that fail to satisfy such tests, only those obligations satisfying such tests need be further considered to determine whether they constitute corporate acquisition indebtedness. Those obligations which meet the test of section 279(b)(1) but which are not deemed corporate acquisition indebtedness shall be taken into account for purposes of determining the reduction in the $5 million limitation of section 279(a)(1).

(d) *Ratio of debt to equity and projected earnings*—(1) *In general.* One of the four tests to determine whether an obligation constitutes corporate acquisition indebtedness is contained in section 279(b)(4). An obligation will meet the test of section 279(b)(4) if, as of a day determined under section 279(c)(1) and paragraph (b)(2) of this section, either:

(i) The ratio of debt to equity (as defined in paragraph (f) of this section) of the issuing corporation exceeds 2 to 1, or

(ii) The projected earnings (as defined in subparagraph (2) of this paragraph) of the issuing corporation, or of both the issuing corporation and acquired corporation in any case where subparagraph (2)(ii) of this paragraph is applicable, do not exceed three times the annual interest to be paid or incurred (as defined in paragraph (e) of this section) by such issuing corporation, or, where applicable, by such issuing corporation and acquired corporation. Where paragraphs (d)(2)(ii) and (e)(1)(ii) of this section are applicable in computing projected earnings and annual interest to be paid or incurred, 100 percent of the acquired corporation's projected earnings and annual interest to be paid or incurred shall be included in such computation, even though less than all of the stock or assets of the acquired corporation have been acquired.

(2) *Projected earnings.* The term *projected earnings* means the ‘‘average annual earnings’’ (as defined in subparagraph (3) of this paragraph) of:

(i) The issuing corporation only, if subdivision (ii) of this subparagraph, does not apply, or

(ii) Both the issuing corporation and the acquired corporation, in any case where the issuing corporation as of the close of its taxable year has acquired control, or has acquired substantially all of the properties, of the acquired corporation.

For purposes of subdivision (ii) of this subparagraph, an acquisition of ‘‘substantially all of the properties’’ of the acquired corporation means the acquisition of assets representing at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by the acquired corporation immediately prior to the acquisition.

(3) *Average annual earnings.* (i) The term *average annual earnings* referred to in subparagraph (2) of this paragraph is, for any corporation, the amount of its earnings and profits for any 3-year period ending with the last day of a taxable year of the issuing corporation in which it issues any obligation to provide consideration for an acquisition described in section 279(b)(1), computed without reduction for:

(*a*) Interest paid or incurred,

(*b*) Depreciation or amortization allowed under Chapter 1 of the Code,

(*c*) Liability for tax under Chapter 1 of the Code, and

(*d*) Distributions to which section 301(c)(1) apply (other than such distributions from the acquired corporation to the issuing corporation), and reduced to an annual average for such 3-year period. For the rules to determine the amount of earnings and profits of any corporation, see section 312 and the regulations thereunder.

(ii) Except as provided for in subdivision (iii) of this subparagraph, for purposes of subdivision (i) of this subparagraph in the case of any corporation, the earnings and profits for such 3-year period shall be reduced to an annual average by dividing such earnings and profits by 36 and multiplying the quotient by 12. If a corporation was not in existence during the entire 36-month period as of the close of the taxable year referred to in subdivision (i) of this subparagraph, its average annual earnings shall be determined by dividing its earnings and profits for the period of its existence by the number of whole calendar months in such period and multiplying the quotient by 12.

(iii) Where the issuing corporation acquires substantially all of the properties of an acquired corporation, the computation of earnings and profits of such acquired corporation shall be made for the period of such corporation beginning with the first day of the 3-year period of the issuing corporation and ending with the last day prior to the date on which substantially all of the properties were acquired. In determining the number of whole calendar months for such acquired corporation where the period for determining its earnings and profits includes 2 months which are not whole calendar months and the total number of days in such 2 fractional months exceeds 30 days, the number of whole calendar months for such period shall be increased by one. Where the number of days in the 2 fractional months total 30 days or less such fractional months shall be disregarded. After the number of whole calendar months is determined, the calculation for average annual earnings shall be made in the same manner as described in the last sentence of subdivision (ii) of this subparagraph.

(e) *Annual interest to be paid or incurred*—(1) *In general.* For purposes of section 279(b)(4)(B), the term *annual interest to be paid or incurred* means:

(i) If subdivision (ii) of this subparagraph does not apply, the annual interest to be paid or incurred by the issuing corporation only, for the taxable year beginning immediately after the day described in section 279(c)(1), determined by reference to its total indebtedness outstanding as of such day, or

(ii) If projected earnings are determined under paragraph (d)(2)(ii) of this section, the annual interest to be paid or incurred by both the issuing corporation and the acquired corporation for 1 year beginning immediately after the day described in section 279(c)(1), determined by reference to their combined total indebtedness outstanding as of such day. However, where the issuing corporation acquires substantially all of the properties of the acquired corporation, the annual interest to be paid or incurred will be determined by reference to the total indebtedness outstanding of the issuing corporation only (including any indebtedness it assumed in the acquisition) as of the day described in section 279(c)(1).

The term *annual interest to be paid or incurred* refers to both actual interest and unstated interest. Such unstated interest includes original issue discount as defined in paragraph (a)(1) of § 1.163–4 and amounts treated as interest under section 483. For purposes of this paragraph and paragraph (f) of this section (relating to the ratio of debt to equity), the indebtedness of any corporation shall be determined in accordance with generally accepted accounting principles. Thus, for example, the indebtedness of a corporation includes short-term liabilities, such as accounts payable to suppliers, as well as long-term indebtedness. Contingent liabilities, such as those arising out of discounted notes, the assignment of accounts receivable, or the guarantee of the liability of another, shall be included in the determination of the indebtedness of a corporation if the contingency is likely to become a reality. In addition, the indebtedness of a corporation includes obligations issued by the corporation, secured only by property of the corporation, and with respect to which the corporation is not personally liable. See section 279(g) and § 1.279–6 for rules with respect to the computation of annual interest to be paid or incurred in regard to members of an affiliated group of corporations.

(2) *Examples.* The provisions of these paragraphs may be illustrated by the following examples:

Example 1. Corporation X's earnings and profits calculated in accordance with section 279(c)(3)(B) for 1972, 1971, and 1970 respectively were $29 million, $23 million, and $20 million. The interest to be paid or incurred during the calendar year of 1973 as determined by reference to the issuing corporation's total outstanding indebtedness as of December 31, 1972, was $10 million. By dividing the sum of the earnings and profits for the 3 years by 36 (the number of whole calendar months in the 3-year period) and multiplying the quotient by 12, the average annual earnings for X Corporation is $24 million. Since the projected earnings of X Corporation do not exceed by three times the annual interest to be paid or incurred (they exceed by only 2.4 times), one of the circumstances described in section 279(b)(4) is present.

Example 2. On March 1, 1972, W Corporation acquires substantially all of the properties of Z Corporation in exchange for W Corporation's bonds which satisfy the tests of section 279(b) (2) and (3). W Corporation files its income tax returns on the basis of fiscal years ending June 30. Z Corporation, which was formed on September 1, 1969, is a calendar year taxpayer. The earnings and profits of W Corporation for the last 3 fiscal years ending June 30, 1972, calculated in accordance with the provisions of section 279(c)(3)(B) were $300 million, $400 million, and $380 million, respectively. The average annual earnings of W Corporation is $360 million ($1,080 million ÷ 36×12). The earnings and profits of Z Corporation calculated in accordance with the provisions of section 279(c)(3)(B) were $4 million for the period of September 1, 1969 to December 31, 1969, $10 million and $14 million for the calendar years of 1970 and 1971, respectively, and $2 million for the period of January 1, 1972, through February 29, 1972, or a total of $30 million. To arrive at the average annual earnings, the sum of the earnings and profits, $30 million, must be divided by 30 (the number of whole calendar months that Z Corporation was in existence during W Corporation's 3-year period ending with the day prior to the date substantially all the assets were acquired) and the quotient is multiplied by 12, which results in an average annual earnings of $12 million ($30 million÷30×12) for Z Corporation. The combined average annual earnings of W Corporation and Z Corporation is $372 million. The interest for the fiscal year ending June 30, 1973, to be paid or incurred by W Corporation on its outstanding indebtedness as of June 30, 1972, is $110 million. Since the projected earnings exceed the annual interest to be paid or incurred by more than three times, the obligation will not be corporate acquisition indebtedness, unless the issuing corporation's debt to equity ratio exceeds 2 to 1.

(f) *Ratio of debt to equity*—(1) *In general.* The condition described in section 279(b)(4)(A) is present if the ratio of debt to equity of the issuing corporation exceeds 2 to 1. Under section 279(c)(2), the term *ratio of debt to equity* means the ratio which the total indebtedness of the issuing corporation bears to the sum of its money and all its other assets (in an amount equal to adjusted basis for determining gain) less such total indebtedness. For the meaning of the term *indebtedness,* see paragraph (e)(1) of this section. See section 279(g) and §1.279–6 for rules with respect to the computation of the ratio of debt to equity in regard to an affiliated group of corporations.

(2) *Examples.* The provisions of section 279(b)(4)(A) and this paragraph may be illustrated by the following example:

[$5 million interest to be paid or incurred × $80 million owed to X Bank by its customers/ $100 million total indebtedness]

Example 1. On June 1, 1971, X Corporation, which files its federal income tax returns on a calendar year basis, issues an obligation for $45 million to the shareholders of Y Corporation to provide consideration for the acquisition of all of the stock of Y Corporation. Such obligation has the characteristics of corporate acquisition indebtedness described in section 279(b) (2) and (3). The projected earnings of X Corporation and Y Corporation exceed 3 times the annual interest to be paid or incurred by those corporations and, accordingly, the condition described in section 279(b)(4)(B) is not present. Also, on December 31, 1971, X Corporation has total assets with an adjusted basis of $150 million (including the newly acquired stock of Y Corporation having a basis of $45 million) and total indebtedness of $90 million. Hence, X Corporation's equity is $60 million computed by subtracting its $90 million of total indebtedness from its $150 million of total assets. Since X Corporation's ratio of debt to equity of 1.5 to 1 ($90 million of total indebtedness over $60 million equity) does not exceed 2 to 1, the condition described in section 279(b)(4)(A) is not present. Therefore, X Corporation's obligation for $45 million is not corporate acquisition indebtedness because on December 31, 1971, neither of the conditions specified in section 279(b)(4) existed.

(g) *Special rules for banks and lending or finance companies*—(1) *Debt to equity and projected earnings.* Under section 279(c)(5), with respect to any corporation which is a bank (as defined in section 581) or is primarily engaged in a lending or finance business, the following rules are to be applied:

(i) In determining under paragraph (f) of this section the ratio of debt to equity of such corporation (or of the affiliated group of which such corporation is a member), the total indebtedness of such corporation (and the assets of such corporation) shall be reduced by an amount equal to the total indebtedness owed to such corporation which arises out of the banking business of such corporation, or out of the lending or finance business of such corporation, as the case may be;

(ii) In determining under paragraph (e) of this section the annual interest to be paid or incurred by such corporation (or by the issuing corporation and acquired corporation referred to in section 279(c)(4)(B) or by the affiliated group of corporations of which such corporation is a member), the amount of such interest (determined without regard to this subparagraph) shall be reduced by an amount which bears the same ratio to the amount of such interest as the amount of the reduction for the taxable year under subdivision (i) of this subparagraph bears to the total indebtedness of such corporation; and

(iii) In determining under section 279(c)(3)(B) the average annual earnings, the amount of the earnings and profits for the 3-year period shall be reduced by the sum of the reductions under subdivision (ii) of this subparagraph for such period.

For purposes of this paragraph, the term *lending or finance business* means a business of making loans or purchasing or discounting accounts receivable, notes, or installment obligations. Additionally, the rules stated in this paragraph regarding the application of the ratio of debt to equity, the determination of the annual interest to be paid or incurred, and the determination of the average annual earnings also apply if the bank or lending or finance company is a member of an affiliated group of corporations. However, the rules are to be applied only for purposes of determining the debt, equity, projected earnings and annual interest of the bank or lending or finance company which then are taken into account in determining the debt to equity ratio and ratio of projected earnings to annual interest to be paid or incurred by the affiliated group as a whole. Thus, these rules are to be applied to reduce the bank's or lending or finance corporation's indebtedness, annual interest to be paid or incurred, and average annual earnings which are taken into account with respect to the group, but are not to reduce the indebtedness of, annual interest to be paid or incurred by, and average annual earnings of, any corporation in the affiliated group which is not a bank or a lending or finance company. In determining whether any corporation which is a member of an affiliated group is primarily engaged in a lending or finance business, only the activities of such corporation, and not those of the whole group, are to be taken into account. See § 1.279–6 for the application of section 279 to certain affiliated groups of corporations.

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

Example 1. As of the close of the taxable year, X Bank has a total indebtedness of $100 million, total assets of $115 million, and $80 million is owed to X Bank by its customers. Bank X's indebtedness is $20 million ($100 million total indebtedness less $80 million owed to the X Bank by its customers) and its assets are $35 million ($115 million total assets less $80 million owed to the bank by its customers). If its annual interest to be paid or incurred is $5 million, such amount is reduced by $4 million. Thus, X Bank's annual interest to be paid or incurred is $1 million.

Example 2. Assume the same facts as in *Example (1).* X Bank has earnings and profits of $23 million for the 3-year period used to determine projected earnings. In computing the average annual earnings, the $23 million amount will be reduced by $12 million (three times the $4 million reduction of interest in *Example (1),* assuming that the reduction was the same for each year). Thus X Bank's earnings and profits for such 3-year period are $11 million ($23 million total earnings and profits less $12 million reduction).

(h) *Statement to be attached to return.* In any case where any corporation claims a deduction in excess of $5 million for interest paid or incurred during the taxable year on obligations issued to provide consideration for acquisitions described in section 279(b)(1) of stock in, or assets of, an acquired corporation, the corporation shall attach to its return for such taxable year a statement which includes the particular provisions of section 279 and, in sufficient detail, the facts establishing that such obligations were not corporate acquisition indebtedness, or that the amount of the deduction for interest on its corporate acquisition indebtedness did not exceed the amount of interest which may be deducted on such obligations under section 279(a).

[T.D. 7262, 38 FR 5847, Mar. 7, 1973]

§1.279–6 Application of section 279 to certain affiliated groups.

(a) *In general.* Under section 279(g), in any case in which the issuing corporation is a member of an affiliated group, the application of section 279 shall be determined by treating all of the members of the affiliated group in the aggregate as the issuing corporation, except that the ratio of debt to equity of, projected earnings of, and the annual interest to be paid or incurred by any corporation (other than the issuing corporation determined without regard to this paragraph) shall be included in the determinations required under section 279(b)(4) as of any day only if such corporation is a member of the affiliated group on such day, and, in determining projected earnings of such corporation under section 279(c)(3), there shall be taken into account only the earnings and profits of such corporation for the period during which it was a member of the affiliated group. The total amount of an affiliated member's assets, indebtedness, projected earnings, and interest to be paid or incurred will enter into the computation required by this section, irrespective of any minority ownership in such member.

(b) *Aggregate money and other assets.* In determining the aggregate money and all the other assets of the affiliated group, the money and all the other assets of each member of such group shall be separately computed and such separately computed amounts shall be added together, except that adjustments shall be made, as follows:

(1) There shall be eliminated from the aggregate money and all the other assets of the affiliated group intercompany receivables as of the date described in section 279(c)(1);

(2) There shall be eliminated from the total assets of the affiliated group any amount which represents stock ownership in any member of such group;

(3) In any case where gain or loss is not recognized on transactions between members of an affiliated group under paragraph (d)(3) of this section, the basis of any asset involved in such transaction shall be the transferor's basis;

(4) The basis of property in a transaction to which §1.1502–13 applies is the basis of the property determined under that section; and

(5) There shall be eliminated from the money and all the other assets of the affiliated group any other amount which, if included, would result in a duplication of amounts in the aggregate money and all the other assets of the affiliated group.

(c) *Aggregate indebtedness.* For purposes of applying section 279(c), in determining the aggregate indebtedness of an affiliated group of corporations the total indebtedness of each member of such group shall be separately determined, and such separately determined amounts shall be added together, except that there shall be eliminated from such total indebtedness as of the date described in section 279(c)(1):

(1) The amount of intercompany accounts payable,

(2) The amount of intercompany bonds or other evidences of indebtedness, and

(3) The amount of any other indebtedness which, if included, would result in a duplication of amounts in the aggregate indebtedness of such affiliated group.

(d) *Aggregate projected earnings.* In the case of an affiliated group of corporations (whether or not such group files a consolidated return under section 1501), the aggregate projected earnings of such group shall be computed by separately determining the projected earnings of each member of such group under paragraph (d) of §1.279–5, and then adding together such separately determined amounts, except that:

(1) A dividend (a distribution which is described in section 301(c)(1) other than a distribution described in section 243(c)(1)) distributed by one member to another member shall be eliminated, and

(2) In determining the earnings and profits of any member of an affiliated group, there shall be eliminated any amount of interest income received or accrued, and of interest expense paid or incurred, which is attributable to intercompany indebtedness,

(3) No gain or loss shall be recognized in any transaction between members of the affiliated group, and

(4) Members of an affiliated group who file a consolidated return shall not apply the provisions of § 1.1502–18 dealing with inventory adjustments in determining earnings and profits for purposes of this section.

(e) *Aggregate interest to be paid or incurred.* For purposes of section 279(c)(4), in determining the aggregate annual interest to be paid or incurred by an affiliated group of corporations, the annual interest to be paid or incurred by each member of such affiliated group shall be separately calculated under paragraph (e) of § 1.279–5, and such separately calculated amounts shall be added together, except that any amount of annual interest to be paid or incurred on any intercompany indebtedness shall be eliminated from such aggregate interest.

[T.D. 7262, 38 FR 5850, Mar. 5, 1973, as amended by T.D. 8560, 59 FR 41675, Aug. 15, 1994; T.D. 8597, 60 FR 36679, July 18, 1995]

§ 1.279–7 Effect on other provisions.

Under section 279(j), no inference is to be drawn from any provision in section 279 and the regulations thereunder that any instrument designated as a bond, debenture, note, or certificate or other evidence of indebtedness by its issuer represents an obligation or indebtedness of such issuer in applying any other provision of this title. Thus, for example, an instrument, the interest on which is not subject to disallowance under section 279 could, under section 385 and the regulations thereunder, be found to constitute a stock interest, so that any amounts paid or payable thereon would not be deductible.

[T.D. 7262, 38 FR 5851, Mar. 5, 1973]

§ 1.280B–1 Demolition of structures.

(a) *In general.* Section 280B provides that, in the case of the demolition of any structure, no deduction otherwise allowable under chapter 1 of subtitle A shall be allowed to the owner or lessee of such structure for any amount expended for the demolition or any loss sustained on account of the demolition, and that the expenditure or loss shall be treated as properly chargeable to the capital account with respect to the land on which the demolished structure was located.

(b) *Definition of structure.* For purposes of section 280B, the term *structure* means a building, as defined in § 1.48–1(e)(1), including the structural components of that building, as defined in § 1.48–1(e)(2).

(c) *Effective date.* This section is effective for demolitions commencing on or after December 30, 1997.

[T.D. 8745, 62 FR 67726, Dec. 30, 1997]

§ 1.280C–1 Disallowance of certain deductions for wage or salary expenses.

If an employer elects to claim the targeted jobs credit under section 44B (as amended by the Revenue Act of 1978), or elects to claim the new jobs credit under section 44B (as in effect prior to enactment of the Revenue Act of 1978), the employer must reduce its deduction for wage or salary expenses paid or incurred in the year the credit is earned by the amount allowable as credit (determined without regard to the provisions of section 53). In the case in which wages and salaries are capitalized the amount subject to depreciation must be reduced by an amount equal to the amount of the credit (determined without regard to the provisions of section 53) in determining the depreciation deduction. In the case of an employer who uses the full absorption method of inventory costing under § 1.471–11, the portion of the basis of the inventory attributable to the wage or salary expenses giving rise to the credit and paid or incurred in the year the credit is earned must be reduced by the amount of the credit allowable (determined without regard to the provisions of section 53). If the employer is an organization that is under common control (as described in § 1.52–1), it must reduce its deduction for wage or salary expenses by the amount of the credit apportioned to it under

§1.52–1 (a) or (b). The deduction for wage and salary expenses must be reduced in the year the credit is earned, even if the employer is unable to use the credit in that year because of the limitations imposed by section 53.

(Secs. 44B, 381, and 7805 of the Internal Revenue Code of 1954, 92 Stat. 2834 (28 U.S.C. 44B); 91 Stat. 148 (26 U.S.C. 381(c)(26)); 68A Stat. 917 (28 U.S.C. 7805))

[T.D. 7921, 48 FR 52908, Nov. 23, 1983]

§1.280C–3 Disallowance of certain deductions for qualified clinical testing expenses when section 28 credit is allowable.

(a) *In general.* If a taxpayer is entitled to a credit under section 28 for qualified clinical testing expenses (as defined in section 28(b)), it must reduce the amount of any deduction for qualified clinical testing expenses paid or incurred in the year the credit is earned by the amount allowable as credit for such expenses (determined without regard to section 28(d)(2)).

(b) *Capitalization of qualified clinical testing expenses.* In a case in which qualified clinical testing expenses are capitalized, the amount chargeable to the capital account for a taxable year must be reduced by the excess of the amount of the credit allowable for the taxable year under section 28 (determined without regard to section 28(d)(2)) over the amount allowable as a deduction for qualified clinical testing expenses (determined without regard to paragraph (a) of this section) for the taxable year. See section 174 and the regulations thereunder.

(c) *Controlled group of corporations; organizations under common control.* In the case of a taxpayer described in paragraph (d)(5) of §1.28–1 of this chapter (relating to controlled groups of corporations and organizations under common control), paragraphs (a) and (b) of this section shall be applied in accordance with the rules prescribed for aggregation of expenditures under that paragraph.

(d) *Example.* The following example illustrates the application of paragraphs (a) and (b) of this section:

Example. A incurs $1,000 in clinical testing expenses for which a $500 credit is allowable under section 28. A also elects under section 174 of the Code to amortize these expenses over a 5-year period beginning in the year the credit is claimed. Under paragraph (a), the current year amortization deduction of $200 ($1,000÷5) is disallowed. Moreover, the amount which would otherwise be capitalized, $800, is reduced by the excess of the amount of the section 28 credit claimed for the taxable year over the amount of the allowable section 174 amortization deduction for the taxable year, or $300 ($500–$200). Thus, the amount chargeable to the capital account for the taxable year is $500 ($800–$300). A is entitled to amortize $500 over the remaining amortization period resulting in a deduction of $125 for each of the remaining four years.

[T.D. 8232, 53 FR 38715, Oct. 3, 1988]

§1.280C–4 Credit for increasing research activities.

(a) *In general.* The election under section 280C(c)(3) to have the provisions of section 280C(c) (1) and (2) not apply shall be made by claiming the reduced credit under section 41(a) determined by the method provided in section 280C(c)(3)(B) on an original return for the taxable year, filed at any time on or before the due date (including extensions) for filing the income tax return for such year. An election, once made for any taxable year, shall be irrevocable for that taxable year.

(b) *Transition rule*—(1) *In general.* In the case of a taxable year beginning after December 31, 1988, for which the due date (including extensions) for filing the return is on or before March 4, 1990, the election under section 280C(c)(3) shall be made by claiming the reduced credit under section 41(a) determined by the method provided in section 280C(c)(3)(B) on an original or amended return for such taxable year filed on or before March 3, 1990.

(2) *Taxpayers who made an election under former section 41(h).* If a taxpayer—

(i) Prior to December 19, 1989, made an election for a taxable year described in paragraph (b)(1) of this section under section 41(h) (as it existed before it was repealed by section 7814(e) of the Revenue Reconciliation Act of 1989) by not claiming any credit allowable under section 41(a), and

(ii) Has not filed an amended return on or before March 3, 1990 claiming the full credit allowable under section 41(a), the taxpayer will be treated as having made an election under section 280C(c)(3). Therefore, the provisions of section 280C(c) (1) and (2) shall not apply in such taxable year. However, in order to obtain the benefit of the reduced credit under section 41(a) determined by the method provided in section 280C(c)(3)(B), such a taxpayer must claim the reduced credit on an amended return filed before the expiration of the period prescribed in section 6511 for filing a claim for credit or refund of the tax imposed by chapter 1 of the Code.

(c) *Effective date.* The provisions of this section are effective for taxable years beginning after December 31, 1988.

[T.D. 8282, 55 FR 2376, Jan. 24, 1990; 55 FR 4049, Feb. 6, 1990]

§ 1.280F–1T Limitations on investment tax credit and recovery deductions under section 168 for passenger automobiles and certain other listed property; overview of regulations (temporary).

(a) *In general.* Section 280F(a) limits the amount of investment tax credit determined under section 46(a) and recovery deductions under section 168 for passenger automobiles. Section 280F(b) denies the investment tax credit and requires use of the straight line method of recovery for listed property that is not predominantly used in a qualified business use. In certain circumstances, section 280F(b) requires the recapture of an amount of cost recovery deductions previously claimed by the taxpayer. Section 280F(c) provides that lessees are to be subject to restrictions substantially equivalent to those imposed on owners of such property under section 280F (a) and (b). Section 280F(d) provides definitions and special rules; note that section 280F(d) (2) and (3) apply with respect to all listed property, even if the other provisions of section 280F do not affect the treatment of the property.

(b) *Key to Code provisions.* The following table identifies the provisions of section 280F under which regulations are provided, and lists each provision below with its corresponding regulation section:

Section 1.280F–2T	Section 1.280F–3T	Section 1.280F–4T	Sections 1.280F–5T and 1.280F–7	Section 1.280F–6T
(a) (d)(1) (d)(8) (d)(10)	(b) (d)(1)	(d)(2)	(c)	(d)(3) (d)(4) (d)(5) (d)(6)

Sections 1.280F–2T(f) and 1.280F–4T(b) also provide special rules for improvements to passenger automobiles and other listed property that qualify as capital expenditures.

(c) *Effective dates*—(1) *In general.* This section and §§ 1.280F–2T through 1.280F–6T apply to property placed in service or leased after June 18, 1984, in taxable years ending after that date. Section 1.280F–7 applies to property leased after December 31, 1986, in taxable years ending after that date.

(2) *Exception.* This section and §§ 1.280F–2T through 1.280F–6T shall not apply to any property:

(i) Acquired pursuant to a binding contract in effect on June 18, 1984, and at all times thereafter, or under construction by the taxpayer on that date, but only if the property is placed in service before January 1, 1985 (January 1, 1987, in the case of 15-year real property), or

(ii) Leased pursuant to a binding contract in effect on June 18, 1984, and at all times thereafter, but only if the lessee first uses such property under the lease before January 1, 1985 (January 1, 1987, in the case of 15-year real property).

(3) *Leased passenger automobiles.* Section 1.280F–5T(e) generally applies to passenger automobiles leased after April 2, 1985, and before January 1, 1987, in taxable years ending after April 2, 1985. Section 1.280F–5T(e) generally applies to passenger automobiles leased after April 2, 1985, in taxable years ending after that date. Section 1.280F–5T(e) does not apply to any passenger automobile that is leased pursuant to a binding contract, which is entered into no later than April 2, 1985, and which is

in effect at all times thereafter, but only if the automobile is used under the lease before August 1, 1985. If §1.280F–5T(e) does not apply to a passenger automobile, *see* paragraph (c) (1) and (2) of this section. Section 1.280F–7(a) applies to passenger automobiles leased after December 31, 1986, in taxable years ending after that date.

[T.D. 7986, 49 FR 42704, Oct. 24, 1984; as amended by T.D. 8061, 50 FR 46038, Nov. 6, 1985; T.D. 8218, 53 FR 29881, Aug. 9, 1988; T.D. 8473, 58 FR 19060, Apr. 12, 1993]

§1.280F–2T Limitations on recovery deductions and the investment tax credit for certain passenger automobiles (temporary).

(a) *Limitation on amount of investment tax credit*—(1) *General rule.* The amount of the investment tax credit determined under section 46(a) for any passenger automobile shall not exceed $1,000. For a passenger automobile placed in service after December 31, 1984, the $1,000 amount shall be increased by the automobile price inflation adjustment (as defined in section 280F(d)(7)) for the calendar year in which the automobile is placed in service.

(2) *Election of reduced investment tax credit.* If the taxpayer elects under section 48(q)(4) to reduce the amount of the investment tax credit in lieu of adjusting the basis of the passenger automobile under section 48(q)(1), the amount of the investment tax credit for any passenger automobile shall not exceed two-thirds of the amount determined under paragraph (a)(1) of this section.

(b) *Limitations on allowable recovery deductions*—(1) *Recovery deduction for year passenger automobile is placed in service.* For the taxable year that a taxpayer places a passenger automobile in service, the allowable recovery deduction under section 168(a) shall not exceed $4,000. See paragraph (b)(3) of this section for the adjustment to this limitation.

(2) *Recovery deduction for remaining taxable years during the recovery period.* For any taxable year during the recovery period remaining after the year that the property is placed in service, the allowable recovery deduction under section 168(a) shall not exceed $6,000. See paragraph (b)(3) of this section for the adjustment to this limitation.

(3) *Adjustment to limitation by reason of automobile price inflation adjustment.* The limitations on the allowable recovery deductions prescribed in paragraph (b) (1) and (2) of this section are increased by the automobile price inflation adjustment (as defined in section 280F(d)(7)) for the calendar year in which the automobile is placed in service.

(4) *Coordination with section 179.* For purposes of section 280F(a) and this section, any deduction allowable under section 179 (relating to the election to expense certain depreciable trade or business assets) is treated as if that deduction were a recovery deduction under section 168. Thus, the amount of the section 179 deduction is subject to the limitations described in paragraph (b) (1) and (2) of this section.

(c) *Disallowed recovery deductions allowed for years subsequent to the recovery period*—(1) *In general.* (i) Except as otherwise provided in this paragraph (c), the ‘‘unrecovered basis’’ (as defined in paragraph (c)(1)(ii) of this section) of any passenger automobile is treated as a deductible expense in the first taxable year succeeding the end of the recovery period.

(ii) The term *unrecovered basis* means the excess (if any) of:

(A) The unadjusted basis (as defined in section 168(d)(1)(A), except that there is no reduction by reason of an election to expense a portion of the basis under section 179) of the passenger automobile, over

(B) The amount of the recovery deductions (including any section 179 deduction elected by the taxpayer) which would have been allowable for taxable years in the recovery period (determined after the application of section 280F (a) and paragraph (b) of this section and as if all use during the recovery period were used described in section 168(c)(1)).

(2) *Special rule when taxpayer elects to use the section 168(b)(3) optional recovery percentages.* If the taxpayer elects to use the optional recovery percentages under section 168(b)(3) or must use the straight line method over the earnings and profits life (as defined and described in §1.280F–3T(f)), the second

succeeding taxable year after the end of the recovery period is treated as the first succeeding taxable year after the end of the recovery period for purposes of this paragraph (c) because of the half-year convention. For example, assume a calendar-year taxpayer places in service on July 1, 1984, a passenger automobile (*i.e.*, 3-year recovery property) and elects under section 168(b)(3) to recover its cost over 5 years using the straight line optional percentages. Based on these facts, calendar year 1990 is treated as the first succeeding taxable year after the end of the recovery period.

(3) *Deduction limited to $6,000 for any taxable year.* The amount that may be treated as a deductible expense under this paragraph (c) in the first taxable year succeeding the recovery period shall not exceed $6,000. Any excess shall be treated as an expense for the succeeding taxable years. However, in no event may any deduction in a succeeding taxable year exceed $6,000. The limitation on amounts deductible as an expense under this paragraph (c) with respect to any passenger automobile is increased by the automobile price inflation adjustment (as defined in section 280F(d)(7)) for the calendar year in which such automobile is placed in service.

(4) *Deduction treated as a section 168 recovery deduction.* Any amount allowable as an expense in a taxable year after the recovery period by reason of this paragraph (c) shall be treated as a recovery deduction allowable under section 168. However, a deduction is allowable by reason of this paragraph (c) with respect to any passenger automobile for a taxable year only to the extent that a deduction under section 168 would be allowable with respect to the automobile for that year. For example, no recovery deduction is allowable for a year during which a passenger automobile is disposed of or is used exclusively for personal purposes.

(d) *Additional reduction in limitations by reason of personal use of passenger automobile or by reason of a short taxable year.* See paragraph (i) of this section for rules regarding the additional reduction in the limitations prescribed by paragraphs (a) through (c) of this section by reason of the personal use of a passenger automobile or by reason of a short taxable year.

(e) *Examples.* The provisions of paragraphs (a) through (c) of this section may be illustrated by the following examples. For purposes of these examples, assume that all taxpayers use the calendar year and that no short taxable years are involved.

Example 1. (i) On July 1, 1984, B purchases for $45,000 and places in service a passenger automobile which is 3-year recovery property under section 168. In 1984, B does not elect under section 179 to expense a portion of the cost of the automobile. The automobile is used exclusively in B's business during taxable years 1984 through 1990.

(ii) The maximum amount of B's investment tax credit is $1,000 (*i.e.*, the lesser of $1,000 or .06×$45,000). B's unadjusted basis for purposes of section 168 is $44,500 (*i.e.*, $45,000 reduced under section 48(q)(1) by $500). B selects the use of the accelerated recovery percentages under section 168(b)(1).

(iii) The maximum amount of B's recovery deduction for 1984 is $4,000 (*i.e,* the lesser of $4,000 or .25×$44,500); for 1985, $6,000 (*i.e.*, the lesser of $6,000 or .38×$44,500); and for 1986, $6,000 (*i.e.*, the lesser of $6,000 or .37×$44,500).

(iv) At the beginning of taxable year 1987, B's unrecovered basis in the automobile is $28,500 (*i.e.*, $44,500−$16,000). Under paragraph (c) of this section, B may expense $6,000 of the unrecovered basis in the automobile in 1987. This expense is treated as a recovery deduction under section 168. For taxable years 1988 through 1990, B may deduct $6,000 of the unrecovered basis per year. At the beginning of 1991, B's unrecovered basis in the automobile is $4,500. During that year, B disposes of the automobile. B is not allowed a deduction for 1991 because no deduction would be allowable under section 168 based on these facts.

Example 2. (i) On July 1, 1984, C purchases for $50,000 and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclusively in C's business during taxable years 1984 through 1992. In 1984, C does not elect under section 179 to expense a portion of the automobile's cost. C elects under section 48(q)(4) to take a reduced investment tax credit in lieu of the section 48(q)(1) basis adjustment.

(ii) The maximum amount of C's investment tax credit is $666.67 (*i.e.*, the lesser of ⅔ of $1,000 or .04×$50,000). C's unadjusted basis for purposes of section 168 is $50,000. C elects to use the optional recovery percentages under section 168(b)(3) based on a 5-year recovery period.

(iii) The maximum amount of C's recovery deduction for 1984 is $4,000 (*i.e.*, the lesser of $4,000 or .10×$50,000); for taxable years 1985 through 1988, $6,000 per year (*i.e.,* the lesser of $6,000 or .20 of $50,000). C's recovery deduction for 1989 is $5,000 (*i.e.,* the lesser of .10×$50,000 or $6,000).

(iv) At the beginning of taxable year 1990, C's unrecovered basis in the automobile is $17,000. Under paragraph (c) of this section, C may expense $6,000 of the unrecovered basis in the automobile in 1990. this expense is treated as a recovery deduction under section 168. For taxable years 1991 and 1992, C may deduct $6,000, and $5,000, respectively of the unrecovered basis per year.

Example 3. Assume the same facts as in *Example (2),* except that C disposes of the passenger automobile on July 1, 1990. Under paragraph (c) of this section, C is not allowed a deduction for 1990 or for any succeeding taxable year because no deduction would be allowable under section 168 based on these facts.

Example 4. (i) On July 1, 1984, G purchases for $15,000 and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclusively in G's business during taxable years 1984 through 1987. In 1984, G elects under section 179 to expense $5,000 of the cost of the property.

(ii) The maximum amount of G's investment tax credit is $600 (*i.e.,* the lesser of .06×$10,000 or $1,000).

(iii) G's unadjusted basis for purposes of section 168 is $9,700 (*i.e.,* $15,000 minus the sum of $5,000 (the amount of the expense elected under section 179) and $300 (one-half of the investment tax credit under section 48(q)(1))). Under paragraph (b)(4) of this section, the allowable deduction under section 179 is treated as a recovery deduction under section 168 for purposes of this section. Thus, the maximum amount of G's section 179 deduction is $4,000 (*i.e.,* the lesser of $4,000 or $5,000+.25×$9,700). G is entitled to no further recovery deduction under section 168 for 1984. The amount of G's 1985 and 1986 recovery deductions are $3,686 (*i.e.,* the lesser of .38×$9,700 or $6,000) and $3,589 (*i.e.,* the lesser of .37×$9,700 or $6,000), respectively. At the beginning of 1987, G's unrecovered basis in the automobile is $3,425 (*i.e.,* $14,700 − $11,275). Under paragraph (c) of this section, G may expense the remaining $3,425 in 1987.

Example 5. (i) On July 1, 1984, D purchases for $55,000 and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclususvely in D's business during taxable years 1984 through 1993. In 1984, D elects under section 179 to expense $5,000 of the cost of the property.

(ii) The maximum amount of D's investment tax credit is $1,000 (*i.e.,* the lesser of $1,000 or .06×$50,000).

(iii) D's unadjusted basis for purposes of section 168 is $49,500 (*i.e.,* $55,000 minus the sum of $5,000 (the amount of the expense elected under section 179) and $500 (one-half of the investment tax credit under section 48 (q)(1))). Under paragraph (b)(4) of this section, the allowable deduction under section 179 is treated as a recovery deduction under section 168 for purposes of this section. Thus, the maximum amount of D's section 179 deduction is $4,000 (*i.e.,* the lesser of $4,000 or $5,000+.25×$49,500). D is entitled to no further recovery deduction under section 168 for 1984. The maximum amount of D's 1985 recovery deduction is $6,000 (*i.e.,* the lesser of $6,000 or .38×$49,500); and for 1986, $6,000 (*i.e.,* the lesser of $6,000 or .37 of $49,500).

(iv) At the beginning of 1987, D's unrecovered basis is $38,500. D may expense the remaining unrecovered basis at the rate of $6,000 per year through 1992 and $2,500 in 1993.

Example 6. Assume the same facts as in *Example (5),* except that in 1993, D uses the automobile only 60 percent in his business. Under paragraph (c)(4) of this section for 1993, D may expense $1,500 (*i.e.,* .60×$2,500). D is entitled to no further deductions with respect to the automobile in any later year.

Example 7. (i) On July 1, 1984, F purchases for $44,500 and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclusively in F's business during taxable years 1984 through 1992. In 1984, F elects under section 179 to expense $5,000 of the cost of the property.

(ii) F elects under section 48(q)(4) to take a reduced investment tax credit in lieu of the section 48(q)(1) basis adjustment. The maximum amount of F's investment tax credit is $666.67 (*i.e.,* the lesser of ⅔ of $1,000 or .04×$39,500).

(iii) F's unadjusted basis for purposes of section 168 is $39,500 (*i.e.,* $44,500–$5,000 (the amount of the expense elected under section 179)). F elects to use the optional recovery percentage under section 168(b)(3) based on a 5-year recovery period. Under paragraph (b)(4) of this section, the allowable section 179 deduction is treated as a recovery deduction under section 168 for purposes of this section. Thus, the maximum amount of F's section 179 deduction is $4,000 (*i.e.,* the lesser of $4,000 or $5,000+.10×$39,500). F is entitled to no further recovery deduction under section 168 for 1984. The maximum amounts of F's recovery deductions for 1985 through 1988 are $6,000 per year (*i.e.,* the lesser of $6,000 or .20×$39,500). F's recovery deduction for 1989 (the first taxable year after the 5-year recovery period but the sixth recovery year for purposes of section 168) is $3,950 (*i.e.,* the lesser of .10×$39,500 or $6,000).

(iv) Under paragraph (c), taxable year 1990 is considered to be the first taxable year succeeding the end of the recovery period. At the beginning of taxable year 1990, F's unrecovered basis in the automobile is $12,550 (*i.e.,* $44,500 − $31,950). Under paragraph (c), F may expense $6,000 of his unrecovered basis in the automobile in 1990 and in 1991. This expense is treated as a recovery deduction under section 168. For taxable year 1992, F may expense the remaining $550 of his unrecovered basis in the automobile.

(f) *Treatment of improvements that qualify as capital expenditures.* An improvement to a passenger automobile that qualifies as a capital expenditure under section 263 is treated as a new item of recovery property placed in service in the year the improvement is made. However, the limitations in paragraph (b) of this section on the amount of recovery deductions allowable are determined by taking into account as a whole both the improvement and the property of which the improvement is a part. If that improvement also qualifies as an investment in new section 38 property under section 48(b) and § 1.48–2(b)(2), the limitation in paragraph (a)(1) of this section on the amount of the investment tax credit for that improvement is determined by taking into account any investment tax credit previously allowed for the passenger automobile (including any prior improvement considered part of the passenger automobile). Thus, the maximum credit allowable for the automobile (including the improvement) will be $1,000 (or ⅔ of $1,000, in the case of an election to take a reduced credit under section 48(q)(4)) (adjusted under section 280F(d)(7) to reflect the automobile price inflation adjustment for the year the property of which the improvement is a part is placed in service).

(g) *Treatment of section 1031 or section 1033 transactions*—(1) *Treatment of exchanged passenger automobile.* For a taxable year in which a transaction described in section 1031 or section 1033 occurs, the unadjusted basis of an exchanged or converted passenger automobile shall cease to be taken into account in determining any recovery deductions allowable under section 168 as of the beginning of the taxable year in which the exchange or conversion occurs. Thus, no recovery deduction is allowable for the exchanged or converted automobile in the year of the exchange or conversion.

(2) *Treatment of acquired passenger automobile*—(i) *In general.* The acquired automobile is treated as new property placed in service in the year of the exchange (or in the replacement year) and that year is its first recovery year.

(ii) *Limitations on recovery deductions.* If the exchanged (or converted) automobile was acquired after the effective date of section 280F (as set out in § 1.280F–1(c)), the basis of that automobile as determined under section 1031(d) or section 1033(b) (whichever is applicable) must be reduced for purposes of computing recovery deductions with respect to the acquired automobile (but not for purposes of determining the amount of the investment tax credit and gain or loss on the sale or other disposition of the property) by the excess (if any) of:

(A) The sum of the amounts that would have been allowable as recovery deductions with respect to the exchanged (or converted) automobile during taxable years preceding the year of the exchange (or conversion) if all of the use of the automobile during those years was use described in section 168(c), over

(B) The sum of the amounts allowable as recovery deductions during those years.

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

Example 1. (i) In 1982, F purchases and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclusively in F's business.

(ii) On July 1, 1984, F exchanges the passenger automobile and $1,000 cash for a new passenger automobile (“like kind” property). Under paragraph (g)(1) of this section, no recovery deduction is allowed in 1984 for the exchanged automobile. Any investment tax credit claimed with respect to that automobile is subject to recapture under section 47.

(iii) F's basis in the acquired property (as determined under section 1031(d) and F's qualified investment are $20,000. Under the provisions of paragraph (g)(2)(i) of this section, the acquired property is treated as new recovery property placed in service in 1984 to the extent of the full $20,000 of basis. The maximum amount of F's investment tax credit is limited to $1,000 (*i.e.*, the lesser of $1,000 or .06×$20,000). Cost recovery deductions are computed pursuant to paragraph (b) of this section.

Example 2. (i) On July 1, 1984, E purchases for $30,000 and places in service a passenger automobile which is 3-year recovery property under section 168. In 1984, E's business use percentage is 80 percent and such use constitutes his total business/investment use.

(ii) E elects under section 48(q)(4) to take a reduced investment tax credit in lieu of the section 48 (q)(1) basis adjustment. The maximum amount of E's investment tax credit is $533.33 (*i.e.,* the lesser of ⅔ of $1,000×.80 or .80×.04×$30,000).

(iii) E's unadjusted basis for purposes of section 168 is $30,000. E selects the use of the accelerated recovery percentages under section 168(b)(1). The maximum amount of E's recovery deduction for 1984 is $3,200 (*i.e.,* the lesser of .80×$4,000 or .80×.25×$30,000).

(iv) On June 10, 1985, E exchanges the passenger automobile and $1,000 cash for a new passenger automobile (''like kind'' property). Under paragraph (g)(1) of this section, no recovery deduction is allowable in 1985 for the exchanged automobile. The investment tax credit claimed is subject to recapture under section 47. Under paragraph (g)(2)(ii) of this section, E's basis in the acquired property for purposes of computing recovery deductions under section 280F is $27,000 (*i.e.,* $27,800 (section 1031(d) basis)—$800). The acquired automobile is used exclusively in F's business during taxable years 1985 through 1988. Under paragraph (g)(2) of this section, the acquired property is treated as new recovery property placed in service in 1985. Assume that the automobile price inflation adjustment (as described under section 280F(d)(7)) is zero. E's qualified investment in the property, as determined under §1.46–3(c)(1), is $27,800. The maximum amount of E's investment tax credit is $1,000 (*i.e.,* the lesser of $1,000 or .06×$27,800). E's unadjusted basis for purposes of section 168 is $26,500 (*i.e.,* $27,000 reduced under section 48(q)(1) by $500). Cost recovery deductions are computed pursuant to paragraph (b) of this section.

(h) *Other nonrecognition transactions.* [Reserved]

(i) *Limitation under this section applies before other limitations*—(1) *Personal use.* The limitations imposed upon the maximum amount of the allowable investment tax credit and the allowable recovery deductions (as described in paragraphs (a) through (c) of this section) must be adjusted during any taxable year in which a taxpayer makes any use of a passenger automobile other than for business/investment use (as defined in §1.280F–6T(d)(3)). The limitations on the amount of the allowable investment tax credit (as described in paragraph (a) of this section) and the allowable cost recovery deductions (as described in paragraphs (b) and (c) of this section) are redetermined by multiplying the limitations by the percentage of business/investment use (determined on an annual basis) during the taxable year.

(2) *Short taxable year.* The limitations imposed upon the maximum amount of the allowable recovery deductions (as described in paragraphs (a) through (c) of this section) must be adjusted during any taxable year in which a taxpayer has a short taxable year. In this case, the limitation is adjusted by multiplying the limitation that would have been applied if the taxable year were not a short taxable year by a fraction, the numerator of which is the number of months and part-months in the short taxable year and the denominator of which is 12.

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

Example 1. On July 1, 1984, A purchases and places in service a passenger automobile and uses it 80 percent for business/investment use during 1984. Under paragraph (i)(1) of this section, the maximum amount of the investment tax credit that A may claim for the automobile is $800 (*i.e.,* .80×$1,000).

Example 2. Assume the same facts as in *Example (1),* except that A elects under section 48(q)(4) to take a reduced investment tax credit in lieu of the section 48(q)(1) basis adjustment. Under paragraph (i)(1) of this section, the maximum amount of the investment tax credit that A may claim for the automobile is $533.33 (*i.e.,* .80×⅔×$1,000).

Example 3. On July 1, 1984, B purchases and places in service a passenger automobile and uses it 60 percent for business/investment use during 1984. Under paragraph (i)(1) of this section, the maximum amount of the investment tax credit that B may claim for the automobile is $600 (*i.e.,* .60×$1,000). B uses the car 70 percent for business/investment use during 1985 and 80 percent during 1986. Under paragraph (i)(1) of this section, the maximum amount of recovery deductions that B may claim for 1984, 1985, and 1986 are $2,400 (*i.e.,* .60×$4,000), $4,200 (*i.e.,* .70×$6,000), and $4,800 (*i.e.,* .80×$6,000), respectively.

Example 4. Assume the same facts as in *Example (3)* with the added facts that B's unrecovered basis at the beginning of 1987 is $6,000 and that B uses the automobile 85 percent for business/investment use during 1987. Under paragraph (i)(1) of this section, the maximum amount that B may claim as an expense for 1987 is $5,000 (*i.e.,* .85×$6,000).

Example 5. On August 1, 1984, C purchases and places in service a passenger automobile and uses it exclusively for business. Taxable year 1984 for C is a short taxable year which consists of 6 months. Under paragraph (i)(2) of this section, the maximum amount that C may claim as a recovery deduction for 1984 is $2,000 (*i.e.,* 6⁄12×$4,000).

Example 6. Assume the same facts as in *Example (5),* except that C uses the passenger automobile 70 percent for business/investment use during 1984. Under paragraph (i) (1) and (2) of this section, the maximum amount that C may claim as a recovery deduction for 1984 is $1,400 (*i.e.,* .70×6⁄12×$4,000).

(98 Stat. 494, 26 U.S.C. 280F; 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7986, 49 FR 42704, Oct. 24, 1984]

§ 1.280F–3T Limitations on recovery deductions and the investment tax credit when the business use percentage of listed property is not greater than 50 percent (temporary).

(a) *In general.* Section 280F(b), generally, imposes limitations with respect to the amount allowable as an investment tax credit under section 46(a) and the amount allowable as a recovery deduction under section 168 in the case of listed property (as defined in § 1.280F–6T(b)) if certain business use of the property (referred to as ‘‘qualified business use’’) does not exceed 50 percent during a taxable year. *Qualified business use* generally means use in a trade or business, rather than use in an investment or other activity conducted for the production of income within the meaning of section 212. See § 1.280F–6T(d) for the distinction between ‘‘business/ investment use’’ and ‘‘qualified business use.’’

(b) *Limitation on the amount of investment tax credit*—(1) *Denial of investment tax credit when business use percentage not greater than 50 percent.* Listed property is not treated as section 38 property to any extent unless the business use percentage (as defined in section 280F(d)(6) and § 1.280F–6T(d)(1)) is greater than 50 percent. For example, if a taxpayer uses listed property in a trade or business in the taxable year in which it is placed in service, but the business use percentage is not greater than 50 percent, no investment tax credit is allowed for that listed property. If, in the taxable year in which listed property is placed in service, the only business/investment use (as defined in § 1.280F–6T(d)(3)) of that property is qualified business use (as defined in § 1.280F–6T(d)(2)(i)), and the business use percentage is 55 percent, the investment tax credit is allowed for the 55 percent of the listed property that is treated as section 38 property. The credit allowed is unaffected by any increase in the business use percentage in a subsequent taxable year.

(2) *Recapture of investment tax credit.* Listed property ceases to be section 38 property to the extent that the business/investment use (as defined in § 1.280F–6T(d)(3)) for any taxable year is less than the business/investment use for the taxable year in which the property is placed in service. *See* § 1.47–2(c). If the business use percentage (as defined in § 1.280F–6T(d)(1)) of listed property is greater than 50 percent for the taxable year in which the property is placed in service, and less than or equal to 50 percent for any subsequent taxable year, that property ceases to be section 38 property in its entirety in that subsequent taxable year. Under § 1.47–1(c)(1)(ii)(*b*), the property (or a portion thereof) is treated as ceasing to be section 38 property on the first day of the taxable year in which the cessation occurs.

(c) *Limitation on the method of cost recovery under section 168 when business use of property not greater than 50 percent*—(1) *Year of acquisition.* If any listed property (as defined in § 1.280F–6T(b)) is not predominantly used in a qualified business use (as defined in § 1.280F–6T(d)(4)) in the year it is acquired, the recovery deductions allowed under section 168 for the property for that taxable year and for succeeding taxable years are to be determined using the straight line method over its earnings and profits life (as defined in paragraph (f) of this section). Additionally, the taxpayer is not entitled to make any election under section 179 with respect to the property for that year.

(2) *Subsequent years.* If any listed property is not subject to paragraph (c)(1) of this section because such property is predominantly used in a qualified business use (as defined in § 1.280F–6T(d)(4)) during the year it is acquired but is not predominantly used in a qualified business use during a subsequent taxable year, the rules of this

paragraph (c)(2) apply. In such a case, the taxpayer must determine the recovery deductions allowed under section 168 for the taxable year that the listed property is not predominantly used in a qualified business use and for any subsequent taxable year as if such property was not predominantly used in a qualified business use in the year in which it was acquired and there had been no section 179 election with respect to the property. Thus, the recovery deductions allowable under section 168 for the remaining taxable years are computed by determining the applicable recovery percentage that would apply if the taxpayer had used the straight line method over the property's earnings and profits life beginning with the year the property was placed in service.

(3) *Effect of rule on recovery property that is not listed property.* The mandatory use of the straight line method over the property's earnings and profits life under paragraphs (d) (1) and (2) of this section does not have any effect on the proper method of cost recovery for other recovery property of that same class placed in service in the same taxable year by the taxpayer and does not constitute an election to use an optional recovery period under section 168(b)(3).

(d) *Recapture of excess recovery deductions claimed*—(1) *In general.* If paragraph (c)(2) of this section is applicable, any excess depreciation (as defined in paragraph (d)(2) of this section) must be included in the taxpayer's gross income and added to the property's adjusted basis for the first taxable year in which the property is not predominantly used in a qualified business use (as defined in § 1.280F–6T(d)(4)).

(2) *Definition of excess depreciation.* For purposes of this section, the term *excess depreciation* means the excess (if any) of:

(i) The amount of the recovery deductions allowable with respect to the property for taxable years before the first taxable year in which the property was not predominantly used in a qualified business use, over

(ii) The amount of the recovery deductions which would have been allowable for those years if the property had not been predominantly used in a qualified business use for the year it was acquired and there had been no section 179 election with respect to the property.

For purposes of paragraph (d)(2)(i), any deduction allowable under section 179 (relating to the election to expense certain depreciable trade or business assets) is treated as if that deduction was a recovery deduction under section 168.

(3) *Recordkeeping requirement.* A taxpayer must be able to substantiate the use of any listed property, as prescribed in section 274(d)(4) and § 1.274–5T or § 1.274–6T, for any taxable year for which recapture under section 280F(b)(3) and paragraph (d) (1) and (2) of this section may occur even if the taxpayer has fully depreciated (or expensed) the listed property in a prior year. For example, in the case of 3-year recovery property, the taxpayer shall maintain a log, journal, etc. for six years even though the taxpayer fully depreciated the property in the first three years.

(e) *Earnings and profits life*—(1) *Definition.* The earnings and profits life with respect to any listed property is generally the following:

In the case of—	The applicable recovery period is—
3-year property	5 years.
5-year property	12 years.
10-year property	25 years.
18-year real property and low-income housing	40 years.
15-year public utility property	35 years.

However, if the recovery period applicable to any recovery property under section 168 is longer than the above assigned recovery period, such longer recovery period shall be used. For example, generally, the recovery period for recovery property used predominantly outside the United States is the property's present class life (as defined in section 168(g)(2)). In many cases, a property's present class life is longer than the recovery period assigned to the property under the above table. Pursuant to this paragraph (e)(1), the property's recovery period is its present class life.

(2) *Applicable recovery percentages.* If the applicable recovery period is determined pursuant to the table prescribed

in paragraph (e)(1) of this section, the applicable recovery percentage is:

(i) For property other than 18-year real property or low-income housing:

If the recovery year is—	And the recovery period is—			
	5	12	25	35
1	10	4	2	1
2	20	9	4	3
3	20	9	4	3
4	20	9	4	3
5	10	8	4	3
7	....	8	4	3
8	....	8	4	3
9	....	8	4	3
10	....	8	4	3
11	....	8	4	3
12	....	8	4	3
13	....	4	4	3
14	....	....	4	3
15	....	....	4	3
16	....	....	4	3
17	....	....	4	3
18	....	....	4	3
19	....	....	4	3
20	....	....	4	3
21	....	....	4	3
22	....	....	4	3
23	....	....	4	3
24	....	....	4	3
25	....	....	4	3
26	....	....	2	3
27	....	....	....	3
28	....	....	....	3
29	....	....	....	3
30	....	....	....	3
31	....	....	....	3
32	....	....	....	2
33	....	....	....	2
34	....	....	....	2
35	....	....	....	2
36	....	....	....	1

(ii) For 18-year real property: [Reserved]

(iii) For low-income housing: [Reserved]

(f) *Examples.* The provisions of this section may be illustrated by the following examples. For purposes of these examples, assume that all taxpayers use the calendar year and that no short taxable years are involved.

Example 1. On July 1, 1984, B purchases for $50,000 and places in service an item of listed property (other than a passenger automobile) which is 3-year recovery property under section 168. For the first taxable year that the property is in service, B used the property 40 percent in a trade or business, 40 percent for the production of income, and 20 percent for personal purposes. Although B's total business/investment use is greater than 50 percent, the business use percentage for that taxable year is only 40 percent. Under paragraph (b)(1) of this section, no investment tax credit is allowed for the property.

Example 2. (i) On January 1, 1985, C purchases for $40,000 and places in service an item of listed property (other than a passenger automobile) that is 3-year recovery property under section 168. Seventy percent of the use of the property is in C's trade or business and 30 percent of the use is for personal purposes. C does not elect a reduced investment tax credit under section 48(q)(4). The amount of C's investment tax credit is $1,680 (*i.e.*, $40,000 × .60 × .10 × .70).

(ii) In addition, in 1986, only 55 percent of the use of the property is in C's trade or business and 45 percent of the use is for personal purposes. Under paragraph (b)(2) of this section, the property ceases to be section 38 property to the extent that the use in a trade or business decreased below 70 percent. As a result, a portion of the investment tax credit must be recaptured as an increase in tax liability for 1986 under the rules of section 47 (relating to the recapture of investment tax credit). *See* section 47(a)(5) and § 1.47–2(e) for rules relating to the computation of the recapture amount.

Example 3. On July 1, 1984, B purchases and places in service an item of listed property (other than a passenger automobile) that is 3-year recovery property. B elects to take a reduced investment tax credit under section 48(q)(4). In 1984, B uses the property exclusively in his business. Assume that B's 1984 allowable recovery deduction is $12,500. In 1985 and 1986, the property is not predominantly used in a qualified business use. The investment tax credit claimed is subject to recapture in full under section 47 in 1985 since the property ceases to be section 38 property in its entirety on January 1, 1985. Under paragraph (c)(2) of this section, B must treat the property for 1985 and subsequent taxable years as if he recovered its cost over a 5-year recovery period (*i.e.*, its earnings and profits life) using the straight line method (with the half-year convention) from the time it was placed in service. Therefore, taxable year 1985 is treated as the property's second recovery year (of its 5-year recovery period) and the applicable recovery deduction using the straight line method must be used to determine the recovery deduction. Under paragraph (d) of this section, B must recapture any excess depreciation claimed for taxable year 1984. If B had used the straight line method over a 5-year recovery period his recovery deduction for 1984 would have been $5,000. Under paragraph (d)(2) of this section, B's excess depreciation is $7,500 (*i.e.*, $12,500 − $5,000) and that amount must be included in B's 1985 gross income and added to the property's basis. The taxable years 1986 through 1989 are the property's second through sixth recovery years, respectively, of such property's 5-year recovery period.

Example 4. Assume the same facts as in *Example (3)*, except that in 1986 B used the property exclusively in his business. B is entitled to no investment tax credit with respect to the property in 1986 and must continue to recover the property's cost over a 5-year recovery period using the straight line method.

Example 5. On July 1, 1984, H purchases and places in service listed property (other than a passenger automobile) which is 3-year recovery property under section 168. H selects the use of the accelerated recovery percentages under section 168. In 1984 through 1986, H uses the property exclusively for business. In 1987, the property is not predominantly used in a qualified business use. Under paragraph (c)(2) of this section, H must compute his 1987 and subsequent taxable year's recovery deductions using the straight line method over a 5-year recovery period with 1987 treated as the fourth recovery year. Under paragraph (d) of this section, H must recapture any excess depreciation claimed for taxable years 1984 through 1986 even though by 1987 the full cost of the property had already been recovered.

Example 6. Assume the same facts as in *Example (5)*, except that H uses the property exclusively for personal purposes in 1987. Under paragraph (d) of this section, H must recapture any excess depreciation claimed for taxable years 1984 through 1986. H is entitled to no cost recovery deduction under the 5-year straight line method for 1987. Assume further that in 1988 H uses the property 70 percent in his business. Thus, H's business use percentage for that year is 70 percent. Under paragraph (c)(2) of this section, H must compute his 1988 cost recovery deduction using the straight line method over a 5-year recovery period with 1988 treated as the fifth recovery year.

Example 7. (i) On July 1, 1984, F purchases for $70,000 and places in service listed property (other than a passenger automobile) which is 3-year recovery property under section 168. F's business use percentage for 1984 through 1986 is 60 percent. F elects under section 179 to expense $5,000 of the cost of the property.

(ii) F elects a reduced investment tax credit under section 48(q)(4). The maximum amount of F's investment tax credit is $1,560 (*i.e.*, $65,000×.04×.60).

(iii) F's unadjusted basis for purposes of section 168 is $65,000 (*i.e.*, $70,000 reduced by the $5,000 section 179 expense). F selects the use of the accelerated recovery percentages under section 168(b)(1). F's recovery deduction for 1984 is $9,750 (*i.e.*, $65,000×.25×.60).

(iv) In 1985, the property is not predominantly used in a qualified business use. The investment tax credit claimed is subject to recapture in full under section 47 in 1985 since the property ceases to be section 38 property in its entirety on January 1, 1985. Under paragraph (c)(2) of this section, F must treat the property for 1985 and subsequent taxable years as if he recovered its cost over a 5-year recovery period (*i.e.*, its earnings and profits life) using the straight line method (with the half year convention) from the time it was placed in service. Under paragraph (d) of this section, F must recapture any excess depreciation claimed for taxable year 1984. F's excess depreciation is $10,550 [*i.e.*, ($65,000×.25×.60+$5,000)−($70,000×.10×.60)]. This amount must be included in F's 1985 gross income and added to the property's adjusted basis.

Example 8. (i) On July 1, 1984, G purchases for $60,000 and places in service a passenger automobile which is 3-year recovery property under section 168.

(ii) In 1984, G's business use percentage is 80 percent and such use constitutes his total business/investment use. G elects under section 48(q)(4) to take a reduced investment tax credit in lieu of the basis adjustment under section 48(q)(1). The maximum amount of G's investment tax credit is $533.33 (*i.e.*, the lesser of .80×⅔×$1,000 or $60,000×.80×.04).

(iii) In 1984, G does not elect under section 179 to expense a portion of the automobile's cost. G selects the use of the accelerated recovery percentages under section 168. G's unadjusted basis for purposes of section 168 is $60,000. The maximum amount of G's 1984 recovery deduction is $3,200 (*i.e.*, the lesser of .80×$4,000 or .80×.25×$60,000).

(iv) In 1985, G's business use percentage is 80 percent and such use constitutes his total business/investment use. The maximum amount of G's 1985 recovery deduction is $4,800 (*i.e.*, the lesser of .80×$6,000 or .80×.38×$60,000).

(v) In 1986, G's business use percentage is 45 percent and such use constitutes his total business/investment use. Under paragraph (b)(2) of this section, as a result of the decline in the business use percentage to 50 percent or less, the automobile ceases to be section 38 property in its entirety and G must recapture (pursuant to §§ 1.47–1(c) and 1.47–2(e)) the investment tax credit previously claimed. Since G's business use percentage in 1986 is not greater than 50 percent, under the provisions of paragraph (d) of this section, G must recompute (for recapture purposes) his recovery deductions for 1984 and 1985 using the straight line method over a 5-year recovery period (*i.e.*, earnings and profits life for 3-year recovery property using the half-year convention) to determine if any excess depreciation must be included in his 1986 taxable income. G's recomputed recovery deductions for 1984 and 1985 are $3,200 (*i.e.*, the lesser of .80×$4,000 or .80×.10×$60,000), and $4,800 (*i.e.*, the lesser of .80×$6,000 or .80×.20×$60,000), respectively. G does not have to recapture any excess depreciation since his recovery deductions for 1984 and 1985 computed using the straight line method over a 5-year recovery period are the same as the amounts actually claimed during those years.

(vi) Under paragraph (c)(2) of this section, for 1986 and succeeding taxable years G must compute his remaining recovery deductions using the straight line method over a 5-year recovery period beginning with the third recovery year. The maximum amount of G's 1986 recovery deduction is $2,700 (*i.e.*, the lesser of .45×$6,000 or .45×.20×$60,000). For taxable years 1987 through 1993, G's business use percentage is 55 percent and such use constitutes his total business/investment use. G's 1987 and 1988 recovery deductions are $3,300 per year (*i.e.*, the lesser of .55×$6,000 or .55×.20×$60,000). For taxable year 1989 (the last recovery year), G's recovery deduction is $3,300 (*i.e.*, .55×.10×$60,000 or .55×$6,000).

(vii) As of the beginning of 1990, G will have claimed a total of $20,600 of recovery deductions. Under § 1.280F–2T(c), G may expense his remaining unrecovered basis (up to a certain amount per year) in the first succeeding taxable year after the end of the recovery period and in taxable years thereafter. If G had used his automobile for 100 percent business use in taxable years 1984 through 1989, G could have claimed a recovery deduction of $4,000 in 1984 and a recovery deduction of $6,000 in each of those remaining years. At the beginning of 1990, therefore, G's unrecovered basis (as defined in section 280F(d)(8)) is $26,000 (*i.e.*, $60,000 − $34,000). The maximum amount of G's 1990 recovery deduction is $3,300 (*i.e.*, .55×$6,000). At the beginning of 1991, G's unrecovered basis is $20,000 (*i.e.*, $26,000 adjusted under section 280F(d)(2) and § 1.280F–4T(a) to account for the amount that would have been claimed in 1990 for 100 percent business/investment use during that year). The maximum amount of G's 1991 recovery deduction is $3,300 (*i.e.*, .55×$6,000) and his unrecovered basis as of the beginning of 1992 is $14,000 (*i.e.*, $20,000 − $6,000). In 1992, G disposes of the automobile. G is not allowed a recovery deduction for 1992.

(98 Stat. 494, 26 U.S.C. 280F; 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7986, 49 FR 42707, Oct. 24, 1984; as amended by T.D. 8061, 50 FR 46038, Nov. 6, 1985]

§ 1.280F–4T Special rules for listed property (temporary).

(a) *Limitations on allowable recovery deductions in subsequent taxable years*—(1) *Subsequent taxable years affected by reason of personal use in prior years.* For purposes of computing the amount of the recovery deduction for ''listed property'' for a subsequent taxable year, the amount that would have been allowable as a recovery deduction during an earlier taxable year if all of the use of the property was use described in section 168(c) is treated as the amount of the recovery deduction allowable during that earlier taxable year. The preceding sentence applies with respect to all earlier taxable years, beginning with the first taxable year in which some or all use of the ''listed property'' is use described in section 168(c). For example, on July 1, 1984, B purchases and places in service listed property (other than a passenger automobile) which is 5-year recovery property under section 168. B selects the use of the accelerated percentages under section 168. B's business/investment use of the property (all of which is qualified business use as defined in section 280F(d)(6)(B) and § 1.280F–6T(d)(2)) in 1984 through 1988 is 80 percent, 70 percent, 60 percent, and 55 percent, respectively, and B claims recovery deductions for those years based on those percentages. B's qualified business use for the property for 1989 and taxable years thereafter increases to 100 percent. Pursuant to this rule, B may not claim a recovery deduction in 1989 (or for any subsequent taxable year) for the increase in business use because there is no adjusted basis remaining to be recovered for cost recovery purposes after 1988.

(2) *Special rule for passenger automobiles.* In the case of a passenger automobile that is subject to the limitations of § 1.280F–2T, the amount treated as the amount that would have been allowable as a recovery deduction if all of the use of the automobile was use described in section 168(c) shall not exceed $4,000 for the year the passenger automobile is placed in service and $6,000 for each succeeding taxable year (adjusted to account for the automobile price inflation adjustment, if any, under section 280F(d)(7) and for short taxable year under § 1.280F–2T(i)(2)). *See.* § 1.280F–3T(g). *Example 8.*

(b) *Treatment of improvements that qualify as capital expenditures*—(1) *In general.* In the case of any improvement that qualifies as a capital expenditure under section 263 made to any listed property other than a passenger automobile, the rules of this paragraph (b) apply. See § 1.280F–2T(f) for the treatment of an improvement made to a passenger automobile.

(2) *Investment tax credit allowed for the improvement.* If the improvement qualifies as an investment in new section 38 property under section 48(b) and § 1.48–2(b), the investment tax credit for that improvement is limited by paragraph (b)(1) of § 1.280F–3T, as applied to the item of listed property as a whole.

(3) *Cost recovery of the improvement.* The improvement is treated as a new item of recovery property. The method of cost recovery with respect to that improvement is limited by § 1.280F–3T(c), as applied to the item of listed property as a whole.

(98 Stat. 494, 26 U.S.C. 280F; 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7986, 49 FR 42710, Oct. 24, 1984]

§ 1.280F–5T Leased property (temporary).

(a) *In general.* Except as otherwise provided in this section, the limitation on cost recovery deductions and the investment tax credit provided in section 280F (a) and (b) and §§ 1.280F–2T and 1.280F–3T do not apply to any listed property leased or held for leasing by any person regularly engaged in the business of leasing listed property. If a person is not regularly engaged in the business of leasing listed property, the limitations on cost recovery deductions and the investment tax credit provided in section 280F and §§ 1.280F–2T and 1.280F–3T apply to such property leased or held for leasing by such person. The special rules for lessees set out in this section apply with respect to all lessees of listed property, even those whose lessors are not regularly engaged in the business of leasing listed property. For rules on determining inclusion amounts with respect to passenger automobiles, see paragraphs (d), (e) and (g) of this section, and see § 1.280F–7(a). For rules on determining inclusion amounts with respect to other listed property, see paragraphs (f) and (g) of this section, and see § 1.280F–7(b).

(b) *Section 48(d) election.* If a lessor elects under section 48(d) with respect to any listed property to treat the lessee as having acquired such property, the amount of the investment tax credit allowed to the lessee is subject to the limitation prescribed in § 1.280F–3T(b) (1) and (2). If a lessor elects under section 48(d) with respect to any passenger automobile to treat the lessee as having acquired such automobile, the amount of the investment tax credit allowed to the lessee is also subject to the limitations prescribed in § 1.280F–2T (a) and (i).

(c) *Regularly engaged in the business of leasing.* For purposes of paragraph (a) of this section, a person shall be considered regularly engaged in the business of leasing listed property only if contracts to lease such property are entered into with some frequency over a continuous period of time. The determination shall be made on the basis of the facts and circumstances in each case, taking into account the nature of the person's business in its entirety. Occasional or incidental leasing activity is insufficient. For example, a person leasing only one passenger automobile during a taxable year is not regularly engaged in the business of leasing automobiles. In addition, an employer that allows an employee to use the employer's property for personal purposes and charges such employee for the use of the property is not regularly engaged in the business of leasing with respect to the property used by the employee.

(d) *Inclusions in income of lessees of passenger automobiles leased after June 18, 1984, and before April 3, 1985*—(1) *In general.* If a taxpayer leases a passenger automobile after June 18, 1984, but before April 3, 1985, for each taxable year (except the last taxable year) during which the taxpayer leases the automobile, the taxpayer must include in gross income an inclusion amount (prorated for the number of days of the lease term included in that taxable year), determined under this paragraph (d)(1), and multiplied by the business/investment use (as defined in § 1.280F–6T(d)(3)(i)) for the particular taxable year. The inclusion amount:

(i) Is 7.5 percent of the excess (if any) of the automobile's fair market value over $16,500 for each of the first three taxable years during which a passenger automobile is leased.

(ii) Is 6 percent of the excess (if any) of the automobile's fair market value over $22,500 for the fourth taxable year during which a passenger automobile is leased.

(iii) Is 6 percent of the excess (if any) of the automobile's fair market value over $28,500 for the fifth taxable year during which a passenger automobile is leased.

(iv) Is 6 percent of the excess (if any) of the automobile's fair market value over $34,500 for the sixth taxable year during which a passenger automobile is leased.

For the seventh and subsequent taxable years during which a passenger automobile is leased, the inclusion amount is 6 percent of the excess (if any) of the automobile's fair market value over the sum of (A) $16,500 and (B) $6,000 multiplied by the number of such taxable years in excess of three years. *See* paragraph (g)(2) of this section for the definition of fair market value.

(2) *Additional inclusion amount when less than predominant use in a qualified business use.* (i) If a passenger automobile, which is leased after June 18, 1984, and before April 3, 1985, is not used predominantly in a qualified business use during a taxable year, the lessee must add to gross income in the first taxable year that the automobile is not so used (and only in that year) an inclusion amount determined under this paragraph (d)(2). This inclusion amount is in addition to the amount required to be included in gross income under paragraph (d)(1) of this section.

(ii) If the fair market value (as defined in paragraph (h)(2) of this section) of the automobile is greater than $16,500, the inclusion amount is determined by multiplying the average of the business/investment use (as defined in paragraph (h)(3) of this section) by the appropriate dollar amount from the table in paragraph (d)(2)(iii) of this section. If the fair market value (as defined in paragraph (h)(2) of this section) of the automobile is $16,500 or less, the inclusion amount is the product of the fair market value of the automobile, the average business/investment use, and the applicable percentage from the table in paragraph (d)(2)(iv) of this section.

(iii) The dollar amount is determined under the following table:

If a passenger automobile is not predominantly used in a qualified business use during—	The dollar amount:			
	Lease term (years)			
	1	2	3	4 or more
The first taxable year of the lease term	$350	$700	$1,350	$1,850
The second taxable year of the lease term	....	....	650	1,250
The third taxable year of the lease term	....	....	....	650

(iv) The applicable percentage is determined under the following table:

If a passenger automobile is not predominantly used in a qualified business use during—	The applicable percentage:			
	Lease term (years)			
	1	2	3	4 or more
The first taxable year of the lease term	3.0	6.0	10.2	13.2
The second taxable year of the lease term	....	1.25	6.2	10.4
The third taxable year of the lease term	....	....	2.25	6.5
The fourth taxable year of the lease term	....	....	....	1.7
The fifth taxable year of the lease term	....	....	....	0.5

(e) *Inclusions in income of lessees of passenger automobiles leased after April 2, 1985, and before January 1, 1987*—(1) *In general.* For any passenger automobile that is leased after April 2, 1985, and before January 1, 1987, for each taxable year (except the last taxable year) during which the taxpayer leases the automobile, the taxpayer must include in gross income an inclusion amount determined under subparagraphs (2) through (5) of this paragraph (e). Additional inclusion amounts when a passenger automobile is not used predominantly in a qualified business use during a taxable year are determined under paragraph (e)(6) of this section. *See* paragraph (h)(2) of this section for the definition of fair market value.

(2) *Fair market value not greater than $50,000: years one through three.* For any passenger automobile that has a fair market value not greater than $50,000,

the inclusion amount for each of the first three taxable years during which the automobile is leased is determined as follows:

(i) For the appropriate range of fair market values in the table in paragraph (e)(2)(iv) of this section, select the dollar amount from the column for the quarter of the taxable year in which the automobile is first used under the lease,

(ii) Prorate the dollar amount for the number of days of the lease term included in the taxable year, and

(iii) Multiply the prorated dollar amount by the business/investment use for the taxable year.

(iv) *Dollar amounts: Years 1–3:*

DOLLAR AMOUNTS: YEARS 1–3

Fair market value		Taxable year quarter			
Greater than—	But not greater than—	4th	3d	2d	1st
$11,250	$11,500	$8	$7	$6	$6
11,500	11,750	24	21	19	17
11,750	12,000	40	35	32	29
12,000	12,250	56	49	44	40
12,250	12,500	72	64	57	52
12,500	12,750	88	78	70	63
12,750	13,000	104	92	83	75
13,000	13,250	120	106	95	86
13,250	13,500	144	128	115	104
13,500	13,750	172	153	137	124
13,750	14,000	200	177	159	145
14,000	14,250	228	202	182	165
14,250	14,500	256	227	204	185
14,500	14,750	284	252	226	206
14,750	15,000	312	277	249	226
15,000	15,250	340	302	271	246
15,250	15,500	369	327	293	266
15,500	15,750	397	352	316	287
15,750	16,000	425	377	338	307
16,000	16,250	453	402	360	327
16,250	16,500	481	426	383	348
16,500	16,750	509	451	405	368
16,750	17,000	537	476	428	388
17,000	17,500	579	514	461	419
17,500	18,000	635	563	506	459
18,000	18,500	691	613	550	500
18,500	19,000	748	663	595	541
19,000	19,500	804	713	640	581
19,500	20,000	860	763	685	622
20,000	20,500	916	812	729	662
20,500	21,000	972	862	774	703
21,000	21,500	1,028	912	819	744
21,500	22,000	1,084	962	863	784
22,000	23,000	1,169	1,036	930	845
23,000	24,000	1,281	1,136	1,020	926
24,000	25,000	1,393	1,236	1,109	1,007
25,000	26,000	1,506	1,335	1,199	1,089
26,000	27,000	1,618	1,435	1,288	1,170
27,000	28,000	1,730	1,534	1,377	1,251
28,000	29,000	1,842	1,634	1,467	1,332
29,000	30,000	1,955	1,734	1,556	1,413
30,000	31,000	2,067	1,833	1,646	1,495
31,000	32,000	2,179	1,933	1,735	1,576
32,000	33,000	2,292	2,032	1,824	1,657
33,000	34,000	2,404	2,132	1,914	1,738
34,000	35,000	2,516	2,232	2,003	1,819
35,000	36,000	2,629	2,331	2,093	1,901
36,000	37,000	2,741	2,431	2,182	1,982
37,000	38,000	2,853	2,530	2,271	2,063
38,000	39,000	2,965	2,630	2,361	2,144
39,000	40,000	3,078	2,730	2,450	2,225
40,000	41,000	3,190	2,829	2,540	2,307
41,000	42,000	3,302	2,929	2,629	2,388
42,000	43,000	3,415	3,028	2,718	2,469
43,000	44,000	3,527	3,128	2,808	2,550
44,000	45,000	3,639	3,228	2,897	2,631
45,000	46,000	3,752	3,327	2,987	2,713
46,000	47,000	3,864	3,427	3,076	2,794
47,000	48,000	3,976	3,526	3,165	2,875
48,000	49,000	4,088	3,626	3,255	2,956
49,000	50,000	4,201	3,726	3,344	3,037

(3) *Fair market value not greater than $50,000: years four through six.* For any passenger automobile that has a fair market value greater than $18,000, but not greater than $50,000, the inclusion amount for the fourth, fifth, and sixth taxable years during which the automobile is leased is determined as follows:

(i) For the appropriate range of fair market values in the table in paragraph (e)(3)(iv) of this section, select the dollar amount from the column for the taxable year in which the automobile is used under the lease,

(ii) Prorate the dollar amount for the number of days of the lease term included in the taxable year, and

(iii) Multiply this dollar amount by the business/investment use for the taxable year.

(iv) Dollar Amounts: Years 4–6:

DOLLAR AMOUNTS: YEARS 4–6

Fair market value		Year		
Greater than—	But not greater than—	4	5	6
$18,000	$18,500	$15	....	....
18,500	19,000	45	....	....
19,000	19,500	75	....	....
19,500	20,000	105	....	....
20,000	20,500	135	....	....
20,500	21,000	165	....	....
21,000	21,500	195	....	....
21,500	22,000	225	....	....
22,000	23,000	270	....	....
23,000	24,000	330	$42	....
24,000	25,000	390	102	....
25,000	26,000	450	162	....
26,000	27,000	510	222	....
27,000	28,000	570	282	....
28,000	29,000	630	342	$54

DOLLAR AMOUNTS: YEARS 4–6—Continued

Fair market value		Year		
Greater than—	But not greater than—	4	5	6
29,000	30,000	690	402	114
30,000	31,000	750	462	174
31,000	32,000	810	522	234
32,000	33,000	870	582	294
33,000	34,000	930	642	354
34,000	35,000	990	702	414
35,000	36,000	1,050	762	474
36,000	37,000	1,110	822	534
37,000	38,000	1,170	882	594
38,000	39,000	1,230	942	654
39,000	40,000	1,290	1,002	714
40,000	41,000	1,350	1,062	774
41,000	42,000	1,410	1,122	834
42,000	43,000	1,470	1,182	894
43,000	44,000	1,530	1,242	954
44,000	45,000	1,590	1,302	1,014
45,000	46,000	1,650	1,362	1,074
46,000	47,000	1,710	1,422	1,134
47,000	48,000	1,770	1,482	1,194
48,000	49,000	1,830	1,542	1,254
49,000	50,000	11,890	1,602	1,314

(4) *Fair market value greater than $50,000: years one through six.* (i) For any passenger automobile that has a fair market value greater than $50,000, the inclusion amount for the first six taxable years during which the automobile is leased is determined as follows:

(A) Determine the dollar amount by using the appropriate formula in paragraph (e)(4)(ii) of this section,

(B) Prorate the dollar amount for the number of days of the lease term included in the taxable year, and

(C) Multiply this dollar amount by the business/investment use for the taxable year.

(ii) The dollar amount is computed as follows:

(A) If the automobile is first used under the lease in the fourth quarter of a taxable year, the dollar amount for each of the first three taxable years during which the automobile is leased is the sum of—

(*1*) $124, and

(*2*) 11 percent of the excess of the automobile's fair market value over $13,200.

(B) If the automobile is first used under the lease in the third quarter of a taxable year, the dollar amount for each of the first three taxable years during which the automobile is leased is the sum of—

(*1*) $110, and

(*2*) 10 percent of the excess of the automobile's fair market value over $13,200.

(C) If the automobile is first used under the lease in the second quarter of a taxable year, the dollar amount for each of the first three taxable years during which the automobile is leased is the sum of—

(*1*) $100, and

(*2*) 9 percent of the excess of the automobile's fair market value over $13,200.

(D) If the automobile is first used under the lease in the first quarter of a taxable year, the dollar amount for each of the first three taxable years during which the automobile is leased is the sum of—

(*1*) $90, and

(*2*) 8 percent of the excess of the automobile's fair market value over $13,200.

(E) For the fourth taxable year during which the automobile is leased, the dollar amount is 6 percent of the excess of the automobile's fair market value over $18,000.

(F) For the fifth taxable year during which the automobile is leased, the dollar amount is 6 percent of the excess of the automobile's fair market value over $22,800.

(G) For the sixth taxable year during which the automobile is leased, the dollar amount is 6 percent of the excess of the automobile's fair market value over $27,600.

(5) *Seventh and subsequent taxable years.* (i) For any passenger automobile that has a fair market value less than or equal to $32,400, the inclusion amount for the seventh and subsequent taxable years during which the automobile is leased is zero.

(ii) For any passenger automobile that has a fair market value greater than $32,400, the inclusion amount for the seventh and subsequent taxable years during which the automobile is leased is 6 percent of—

(A) The excess (if any) of the automobile's fair market value, over

(B) The sum of—

(*1*) $13,200 and

(*2*) $4,800 multiplied by the number of taxable years in excess of three years.

(6) *Additional inclusion amount when less than predominant use in a qualified business use.* (i) If a passenger automobile, which is leased after April 2,

1985, and before January 1, 1987, is not predominantly used in a qualified business use during a taxable year, the lessee must add to gross income in the first taxable year that the automobile is not so used (and only in that year) an inclusion amount determined under this paragraph (e)(6). This inclusion amount is in addition to the amount required to be included in gross income under paragraph (e) (2), (3), (4), and (5) of this section.

(ii) If the fair market value (as defined in paragraph (h)(2) of this section) of the automobile is greater than $11,250, the inclusion amount is determined by multiplying the average of the business/investment use (as defined in paragraph (h)(3) of this section) by the appropriate dollar amount from the table in paragraph (e)(6)(iii) of this section. If the fair market value of the automobile is $11,250 or less, the inclusion amount is the product of the fair market value of the automobile, the average business/investment use, and the applicable percentage from the table in paragraph (e)(6)(iv) of this section.

(iii) The dollar amount is determined under the following table:

If a passenger automobile is not predominantly used in a qualified business use during—	The dollar amount is:			
	Lease term (years)—			
	1	2	3	4 or more
The first taxable year of the lease term	$350	$700	$1,150	$1,500
The second taxable year of the lease term	....	150	700	1,200
The third taxable year of the lease term	....	....	250	750

(iv) The applicable percentage is determined under the following table:

If a passenger automobile is not predominantly used in a qualified business use during—	The applicable percentage:			
	Lease term (years)—			
	1	2	3	4 or more
The first taxable year of the lease term	3.0	6.0	10.2	13.2
The second taxable year of the lease term	....	1.25	6.2	10.4
The third taxable year of the lease term	....	....	2.25	6.5
The fourth taxable year of the lease term	....	....	....	1.7
The fifth taxable year of the lease term	....	....	....	0.5

(f) *Inclusions in income of lessees of listed property other than passenger automobiles*—(1) *In general.* If listed property other than a passenger automobile is not used predominantly in a qualified business use in any taxable year in which such property is leased, the lessee must add an inclusion amount to gross income in the first taxable year in which such property is not so predominantly used (and only in that year). This inclusion amount is determined under paragraph (f)(2) of this section for property leased after June 18, 1984, and before January 1, 1987. The inclusion amount is determined under §1.280F–7(b) for property leased after December 31, 1986.

(2) *Inclusion amount for property leased after June 18, 1984, and before January 1, 1987.* The inclusion amount for property leased after June 18, 1984, and before January 1, 1987, is the product of the following amounts:

(i) The fair market value (as defined in paragraph (h)(2) of this section) of the property,

(ii) The average business/investment use (as defined in paragraph (h)(3) of this section), and

(iii) The applicable percentage (as determined under paragraph (f)(3) of this section).

(3) *Applicable percentages.* The applicable percentages for 3-, 5-, and 10-year recovery property are determined according to the following tables:

(i) In the case of 3-year recovery property:

Taxable year during lease term	For the first taxable year in which the business use percentage is 50 percent or less, the applicable percentage for such taxable year is—					
	1	2	3	4	5	6 and later
For a lease term of:						
1 year	3.0	....	....	....	....	....
2 years	6.0	1.25	....	....	....	....
3 years	10.2	6.2	2.25	....	....	....
4 or more years	13.2	10.4	6.5	1.7	0.5	0

(ii) In the case of 5-year recovery property:

Taxable year during lease term	For the first taxable year in which the business use percentage is 50 percent or less, the applicable percentage for such taxable year is—											
	1	2	3	4	5	6	7	8	9	10	11	12
For a lease term of:												
1 year	2.7	....	....	....	....	....	....	....	....	....	....	....
2 years	5.3	1.2	....	....	....	....	....	....	....	....	....	....
3 years	9.9	6.1	1.6	....	....	....	....	....	....	....	....	....
4 years	14.4	11.1	7.3	2.3	....	....	....	....	....	....	....	....
5 years	18.4	15.7	12.4	8.2	3.0	....	....	....	....	....	....	....
6 or more years	21.8	19.6	16.7	13.5	9.6	5.25	4.4	3.6	2.8	1.8	1.0	0

(iii) In the case of 10-year recovery property:

Taxable year during lease term	For the first taxable year in which the business use percentage is 50 pct or less, the applicable percentage for such taxable year is—														
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
For a lease term of:															
1 year	2.5	....	....	....	....	....	....	....	....	....	....	....	....	....	....
2 years	5.1	.6	....	....	....	....	....	....	....	....	....	....	....	....	....
3 years	9.8	5.6	1.0	....	....	....	....	....	....	....	....	....	....	....	....
4 years	14.0	10.3	6.2	1.4	....	....	....	....	....	....	....	....	....	....	....
5 years	17.9	14.5	10.9	6.7	1.8	....	....	....	....	....	....	....	....	....	....
6 years	21.3	18.3	15.1	11.4	7.1	2.1	....	....	....	....	....	....	....	....	....
7 years	21.9	19.0	15.9	12.4	8.4	3.9	2.4	....	....	....	....	....	....	....	....
8 years	22.4	19.6	16.7	13.4	9.7	5.5	4.5	2.7	....	....	....	....	....	....	....
9 years	22.9	20.2	17.4	14.3	10.9	7.0	6.4	5.1	3.0	....	....	....	....	....	....
10 years	23.5	20.9	18.2	15.2	11.9	8.3	8.1	7.2	5.7	3.3	....	....	....	....	....
11 years	23.9	21.4	18.8	16.0	12.8	9.3	9.4	8.9	7.7	5.9	3.1	....	....	....	....
12 years	24.3	21.9	19.3	16.5	13.4	10.1	10.3	10.0	9.3	7.8	5.5	2.9	....	....	....
13 years	24.7	22.2	19.7	16.9	14.0	10.7	11.1	11.0	10.4	9.2	7.4	5.2	2.7	....	....
14 years	25.0	22.5	20.1	17.3	14.4	11.1	11.6	11.7	11.3	10.3	8.8	6.9	4.8	2.5	....
15 or more years	25.3	22.8	20.3	17.5	14.7	11.5	12.0	12.2	11.9	11.1	9.8	8.2	6.5	4.5	2.3

(g) *Special rules applicable to inclusions in income of lessees.* This paragraph (g) applies to the inclusions in gross income of lessees prescribed under paragraphs (d)(2), (e)(6), or (f) of this section, or prescribed under § 1.280F–7(b).

(1) *Lease term commences within 9 months of the end of lessee's taxable year.* If:

(i) The lease term commences within 9 months before the close of the lessee's taxable year,

(ii) The property is not predominantly used in a qualified business use during that portion of the taxable year, and

(iii) The lease term continues into the lessee's subsequent taxable year, then the inclusion amount is added to gross income in the lessee's subsequent taxable year and the amount is determined by taking into account the average of the business/investment use for both taxable years and the applicable percentage for the taxable year in which the lease term begins (or, in the case of a passenger automobile with a fair market value greater than $16,500, the appropriate dollar amount for the taxable year in which the lease term begins).

(2) *Lease term less than one year.* If the lease term is less than one year, the amount which must be added to gross income is an amount that bears the same ratio to the inclusion amount determined before the application of this paragraph (g)(2) as the number of days in the lease term bears to 365.

(3) *Maximum inclusion amount.* The inclusion amount shall not exceed the sum of all deductible amounts in connection with the use of the listed property properly allocable to the lessee's taxable year in which the inclusion amount must be added to gross income.

(h) *Definitions*—(1) *Lease term.* In determining the term of any lease for purposes of this section, the rules of section 168(i)(3)(A) shall apply.

(2) *Fair market value.* For purposes of this section, the fair market value of listed property is such value on the first day of the lease term. If the capitalized cost of listed property is specified in the lease agreement, the lessee shall treat such amount as the fair market value of the property.

(3) *Average business/investment use.* For purposes of this section, the average business/investment use of any listed property is the average of the business/investment use for the first taxable year in which the business use percentage is 50 percent or less and all preceding taxable years in which such property is leased. See paragraph (g)(1) of this section for special rule when lease term commences within 9 months before the end of the lessee's taxable year.

(i) *Examples.* This section may be illustrated by the following examples.

Example 1. On January 1, 1985, A, a calendar year taxpayer, leases and places in service a passenger automobile with a fair market value of $55,000. The lease is to be for a period of four years. During taxable years 1985 and 1986, A uses the automobile exclusively in a trade or business. Under paragraph (d)(1) of this section, A must include in gross income in both 1985 and 1986, $2,887.50 (*i.e.*, ($55,000−$16,500)×7.5%).

Example 2. The facts are the same as in *Example (1)*, and in addition, A uses the automobile only 45 percent in a trade or business during 1987. Under paragraph (d)(1) of this section for 1987, A must include in gross income $1,299.38 (*i.e.*, ($55,000−$16,500)×7.5%×45%). In addition, under paragraph (d)(2) of this section, A must also include in gross income in 1987, $530.85 (*i.e.*, $650×81.67%, average business/investment use).

Example 3. On August 1, 1985, B, a calendar year taxpayer, leases and places in service an item of listed property which is 5-year recovery property, with a fair market value of $10,000. The lease is to be for a period of 5 years. B's qualified business use of the property is 40 percent in 1985, 100 percent in 1986, and 90 percent in 1987. Under paragraphs (f)(1) and (g)(1) of this section, before the application of paragraph (g)(3) of this section, B must include in gross income in 1986, $1,288.00 (*i.e.*, $10,000×70%×18.4%, the product of the fair market value, the average business use for both taxable years, and the applicable percentage for year one from the table in paragraph (f)(3)(iii) of this section).

Example 4. On October 1, 1985, C, a calendar year taxpayer, leases and places in service an item of listed property which is 3-year recovery property with a fair market value of $15,000. The lease term is 6 months (ending March 31, 1986) during which C uses the property 45 percent in a trade or business, the only business/investment use. Under paragraphs (f)(1) and (g) (1) and (2) of this section, before the application of paragraph (g)(3) of this section, C must include in gross income in 1986, $100.97 (*i.e.*, $15,000×45%×3%×182/365, the product of the fair market value, the average business use for both taxable years, and the applicable percentage for year one from the table in paragraph (f)(3)(i) of this section, prorated for the length of the lease term).

Example 5. On July 15, 1985, A, a calendar year taxpayer, leases and places in service a passenger automobile with a fair market value of $45,300. The lease is for a period of 5 years, during which A uses the automobile exclusively in a trade or business. Under paragraph (e) (2) and (3) of this section, for taxable years 1985 through 1989, A must include the following amounts in gross income:

Taxable year	Dollar amount	Proration	Business use (percent)	Inclusion
1985	$3,327	170/365	100	$1,550
1986	3,327	365/365	100	3,327
1987	3,327	365/365	100	3,327
1988	1,650	366/366	100	1,650
1989	1,362	365/365	100	1,362

Example 6. The facts are the same as in *Example (1)*, except that A uses the automobile only 45 percent in a trade or business during 1987 through 1990. Under §1.280F–5T(e)(6), A must include in gross income for taxable year 1987, the first taxable year in which the automobile is not used predominantly in a trade or business, an additional amount based on the average business/investment

use for taxable years 1985 through 1987. For taxable years 1985 through 1989, A must include the following amounts in gross income:

Taxable year	Dollar amount	Proration	Business use (percent)	Inclusion
1985	$3,327	170/365	100	$1,550
1986	3,327	365/365	100	3,327
1987	3,327	365/365	45	1,497
	750	....	81.67	612
1988	1,650	366/366	45	743
1989	1,362	365/365	45	613

(98 Stat. 494, 26 U.S.C. 280F; 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7986, 49 FR 42710, Oct. 24, 1984; as amended by T.D. 8061, 50 FR 46038, Nov. 6, 1985; T.D. 8218, 53 FR 29881, Aug. 9, 1988; T.D. 8473, 58 FR 19060, Apr. 12, 1993]

§ 1.280F–6T Special rules and definitions (temporary).

(a) *Deductions of employee*—(1) *In general.* Employee use of listed property shall not be treated as business/investment use (as defined in paragraph (d)(3) of this section) for purposes of determining the amount of any credit allowable under section 38 to the employee or the amount of any recovery deduction allowable (including any deduction under section 179) to the employee unless that use is for the convenience of the employer and required as a condition of employment.

(2) *''Convenience of the employer'' and ''condition of employment'' requirements*—(i) *In general.* The terms *convenience of the employer* and *condition of employment* generally have the same meaning for purposes of section 280F as they have for purposes of section 119 (relating to the exclusion from gross income for meals or lodging furnished for the convenience of the employer).

(ii) *''Condition of employment.''* In order to satisfy the ''condition of employment'' requirement, the use of the property must be required in order for the employee to perform the duties of his or her employment properly. Whether the use of the property is so required depends on all the facts and circumstances. Thus, the employer need not explicitly require the employee to use the property. Similarly, a mere statement by the employer that the use of the property is a condition of employment is not sufficient.

(iii) *''Convenience of employer''.* [Reserved]

(3) *Employee use.* For purposes of this section, the term *employee use* means any use in connection with the performance of services by the employee as an employee.

(4) *Examples.* The principles of this paragraph are illustrated in the following examples:

Example 1. A is employed as a courier with W, which provides local courier services. A owns and uses a motorcycle to deliver packages to downtown offices for W. W does not provide delivery vehicles and explicitly requires all of its couriers to own a car or motorcycle for use in their employment with the company. A's use of the motorcycle for delivery purposes is for the convenience of W and is required as a condition of employment.

Example 2. B is an inspector for X, a construction company with many construction sites in the local area. B is required to travel to the various construction sites on a regular basis; B uses her automobile to make these trips. Although X does not furnish B an automobile, X does not explicitly require B to use here own automobile. However, X reimburses B for any costs she incurs in traveling to the various job sites. B's use of here automobile in here employment is for the convenience of X and is required as a condition of employment.

Example 3. Assume the same facts as in *Example (2),* except that X makes an automobile available to B who chooses to use her own automobile and receive reimbursement. B's use of her own automobile is not for the convenience of X and is not required as a condition of employment.

Example 4. C is a pilot for Y, a small charter airline. Y requires its pilots to obtain x hours of flight time annually in addition to the number of hours of flight time spent with the airline. Pilots can usually obtain these hours by flying with a military reserve unit or by flying part-time with another airline. C owns his own airplane. C's use of his airplane to obtain the required flight hours is not for the convenience of the employer and is not required as a condition of employment.

Example 5. D is employed as an engineer with Z, an engineering contracting firm. D occasionally takes work home at night rather than working late in the office. D owns and uses a computer which is virtually identical to the one she uses at the office to complete her work at home. D's use of the computer is not for the convenience of here employer and is not required as a condition of employment.

(b) *Listed property*—(1) *In general.* Except as otherwise provided in paragraph (b)(5) of this section, the term *listed property* means:

(i) Any passenger automobile (as defined in paragraph (c) of this section),

(ii) Any other property used as a means of transportation (as defined in paragraph (b)(2) of this section),

(iii) Any property of a type generally used for purposes of entertainment, recreation, or amusement, and

(iv) Any computer or peripheral equipment (as defined in section 168(j)(5)(D)), and

(v) Any other property specified in paragraph (b)(4) of this section.

(2) *Means of transportation*—(i) *In general.* Except as otherwise provided in paragraph (b)(2)(ii) of this section, property used as a *means of transportation* includes trucks, buses, trains, boats, airplanes, motorcycles, and any other vehicles for transporting persons or goods.

(ii) *Exception.* The term *listed property* does not include any vehicle that is a qualified nonpersonal use vehicle as defined in section 274(i) and § 1.274–5T(k).

(3) *Property used for entertainment, etc.*—(i) *In general.* Property of a type generally used for purposes of entertainment, recreation, or amusement includes property such as photographic, phonographic, communication, and video recording equipment.

(ii) *Exception.* The term *listed property* does not include any photographic, phonographic, communication, or video recording equipment of a taxpayer if the equipment is use either exclusively at the taxpayer's regular business establishment or in connection with the taxpayer's principal trade or business.

(iii) *Regular business establishment.* The regular business establishment of an employee is the regular business establishment of the employer of the employee. For purposes of this paragraph (b)(3), a portion of a dwelling unit is treated as a regular business establishment if the requirements of section 280A(c)(1) are met with respect to that portion.

(4) *Other property.* [Reserved]

(5) *Exception for computers.* The term *listed property* shall not include any computer (including peripheral equipment) used exclusively at a regular business establishment. For purposes of the preceding sentence, a portion of a dwelling unit shall be treated as a regular business establishment if (and only if) the requirements of section 280A(c)(1) are met with respect to that portion.

(c) *Passenger automobile*—(1) *In general.* Except as provided in paragraph (c)(3) of this section, the term *passenger automobile* means any 4-wheeled vehicle which is:

(i) Manufactured primarily for use on public streets, roads, and highways, and

(ii) Rated at 6,000 pounds gross vehicle weight or less.

(2) *Parts, etc. of automobile.* The term *passenger automobile* includes any part, component, or other item that is physically attached to the automobile or is traditionally included in the purchase price of an automobile. The term does not include repairs that are not capital expenditures within the meaning of section 263.

(3) *Exception for certain vehicles.* The term *passenger automobile* shall not include any:

(i) Ambulance, hearse, or combination ambulance-hearse used by the taxpayer directly in a trade or business,

(ii) Vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire, or

(iii) Commuter highway vehicle as defined in section 46(c)(6)(B).

(d) *Business use percentage*—(1) *In general.* The term *business use percentage* means the percentage of the use of any listed property which is qualified business use as described in paragraph (d)(2) of this section.

(2) *Qualified business use*—(i) *In general.* Except as provided in paragraph (d)(2)(ii) of this section, the term *qualified business use* means any use in a trade or business of the taxpayer. The term *qualified business use* does not include use for which a deduction is allowable under section 212. Whether the amount of qualified business use exceeds 50 percent is determinative of whether the investment tax credit and

the accelerated percentages under section 168 are available for listed property (or must be recaptured). *See* § 1.280F–3T.

(ii) *Exception for certain use by 5-percent owners and related persons*)—(A) *In general.* The term *qualified business use* shall not include:

(*1*) Leasing property to any 5-percent owner or related person,

(*2*) Use of property provided as compensation for the performance of services by a 5-percent owner or related person, or

(*3*) Use of property provided as compensation for the performance of services by any person not described in paragraph (d)(2)(ii)(A)(*2*) of this section unless an amount is properly reported by the taxpayer as income to such person and, where required, there was withholding under chapter 24.

Paragraph (d)(2)(ii)(A)(*1*) of this section shall apply only to the extent that the use of the listed property is by an individual who is a related party or a 5-percent owner with respect to the owner or lessee of the property.

(B) *Special rule for aircraft.* Paragraph (d)(2)(ii)(A) of this section shall not apply with respect to any aircraft if at least 25 percent of the total use of the aircraft during the taxable year consists of qualified business use not described in paragraph (d)(2)(ii)(A).

(C) *Definitions.* For purposes of this paragraph:

(*1*) *5-percent owner.* The term *5-percent owner* means any person who is a 5-percent owner with respect to the taxpayer (as defined in section 416 (i)(1)(B)(i)).

(*2*) *Related person.* The term *related person* means any person related to the taxpayer (within the meaning of section 267(b)).

(3) *Business/investment use*—(i) *In general.* The term *business/investment use* means the total business or investment use of listed property that may be taken into account for purposes of computing (without regard to section 280F(b)) the percentage of investment tax credit or cost recovery deduction for a passenger automobile or other listed property for the taxable year. Whether the investment tax credit and the accelerated percentages under section 168 (as opposed to use of the straight line method of cost recovery) are available with respect to listed property or must be recaptured is determined, however, by reference to qualified business use (as defined in paragraph (d)(2) of this section) rather than by reference to business/investment use. Whether a particular use of property is a business or investment use shall generally be determined under the rules of section 162 or 212.

(ii) *Entertainment use.* The use of listed property for entertainment, recreation, or amusement purposes shall be treated as business use to the extent that expenses (other than interest and property tax expenses) attributable to that use are deductible after application of section 274.

(iii) *Employee use.* See paragraph (a) of this section for requirements to be satisfied for employee use of listed property to be considered business/investment use of the property.

(iv) *Use of taxpayer's automobile by another person.* Any use of the taxpayer's automobile by another person shall not be treated, for purposes of section 280F, as use in a trade or business under section 162 unless that use:

(A) Is directly connected with the business of the taxpayer,

(B) Is properly reported by the taxpayer as income to the other person and, where required, there was withholding under chapter 24, or

(C) Results in a payment of fair market rent.

For purposes of this paragraph (d)(4)(iv)(C), payment to the owner of the automobile in connection with such use is treated as the payment of rent.

(4) *Predominantly used in qualified business use*—(i) *Definition.* Property is predominantly used in a qualified business use for any taxable year if the business use percentage (as defined in paragraph (d)(1) of this section) is greater than 50 percent.

(ii) *Special rule for transfers at death.* Property does not cease to be used predominantly in a qualified business use by reason of a transfer at death.

(iii) *Other dispositions of property.* [Reserved]

(5) *Examples.* The following examples illustrate the principles set forth in this paragraph.

Example 1. E uses a home computer 50 percent of the time to manage her investments. The computer is listed property within the meaning of section 280F(d)(4). E also uses the computer 40 percent of the time in her part-time consumer research business. Because E's business use percentage for the computer does not exceed 50 percent, the computer is not predominantly used in a qualified business use for the taxable year. Her aggregate business/investment use for purposes of determining the percent of the total allowable straight line depreciation that she can claim is 90 percent.

Example 2. Assume that E in *Example (1)* uses the computer 30 percent of the time to manage her investments and 60 percent of the time in her consumer research business. E's business use percentage exceeds 50 percent. Her aggregrate business/investment use for purposes of determining her allowable investment tax credit and cost recovery deductions is 90 percent.

Example 3. F is the proprietor of a plumbing contracting business. F's brother is employed with F's company. As part of his compensation, F's brother is allowed to use one of the company automobiles for personal use. The use of the company automobiles by F's brother is not a qualified business use because F and F's brother are related parties within the meaning of section 267(b).

Example 4. F, in *Example (3),* allows employees unrelated to him to use company automobiles as part of their compensation. F, however, does not include the value of these automobiles in the employees' gross income and F does not withhold with respect to the use of these automobiles. The use of the company automobiles by the employees in this case is not business/investment use.

Example 5. X Corporation owns several automobiles which its employees use for business purposes. The employees are also allowed to take the automobiles home at night. However, the fair market value of the use of the automobile for any personal purpose, *e.g.,* commuting to work, is reported by X as income to the employee and is withheld upon by X. The use of the automobile by the employee, even for personal purposes, is a qualified business use the respect to X.

(e) *Method of allocating use of property*—(1) *In general.* For purposes of section 280F, the taxpayer shall allocate the use of any listed property that is used for more than one purpose during the taxable year to the various uses in the manner prescribed in paragraph (e) (2) and (3) of this section.

(2) *Passenger automobiles and other means of transportation.* In the case of a passenger automobile or any other means of transportation, the taxpayer shall allocate the use of the property on the basis of mileage. Thus, the percentage of use in a trade or business for the year shall be determined by dividing the number of miles the vehicle is driven for purposes of that trade or business during the year by the total number of miles the vehicle is driven during the year for any purpose.

(3) *Other listed property.* In the case of other listed property, the taxpayer shall allocate the use of that property on the basis of the most appropriate unit of time the property is actually used (rather than merely being available for use). For example, the percentage of use of a computer in a trade or business for a taxable year is determined by dividing the number of hours the computer is used for business purposes during the year by the total number of hours the computer is used for any purpose during the year.

(98 Stat. 494, 26 U.S.C. 280F; 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7986, 49 FR 42713, Oct. 24, 1984, as amended by T.D. 8061, 50 FR 46041, Nov. 6, 1985]

§1.280F–7 Property leased after December 31, 1986.

(a) *Inclusions in income of lessees of passenger automobiles leased after December 31, 1986*—(1) *In general.* If a taxpayer leases a passenger automobile after December 31, 1986, the taxpayer must include in gross income an inclusion amount determined under this paragraph (a), for each taxable year during which the taxpayer leases the automobile. This paragraph (a) applies only to passenger automobiles for which the taxpayer's lease term begins after December 31, 1986. See §§1.280F–5T(d) and 1.280F–5T(e) for rules on determining inclusion amounts for passenger automobiles for which the taxpayer's lease term begins before January 1, 1987. See §1.280F–5T(h)(2) for the definition of fair market value.

(2) *Inclusion Amount.* For any passenger automobile leased after December 31, 1986, the inclusion amount for each taxable year during which the automobile is leased is determined as follows:

(i) For the appropriate range of fair market values in the applicable table, select the dollar amount from the column for the taxable year in which the automobile is used under the lease (but for the last taxable year during any lease that does not begin and end in the same taxable year, use the dollar amount for the preceding taxable year).

(ii) Prorate the dollar amount for the number of days of the lease term included in the taxable year.

(iii) Multiply the prorated dollar amount by the business/investment use (as defined in §1.280F–6T(d)(3)(i)) for the taxable year.

(iv) The following table is the applicable table in the case of a passenger automobile leased after December 31, 1986, and before January 1, 1989:

DOLLAR AMOUNTS FOR AUTOMOBILES WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 1987 OR 1988

Fair market value of automobile	Taxable year during lease					
	1st	2nd	3rd	4th	5 and later	
Over	Not over					
$12,800	$13,100	$2	$5	$7	$8	$9
13,100	13,400	6	14	20	24	28
13,400	13,700	10	23	34	41	47
13,700	14,000	15	32	47	57	65
14,000	14,300	19	41	61	73	84
14,300	14,600	23	50	74	89	103
14,600	14,900	27	59	88	105	122
14,900	15,200	31	68	101	122	140
15,200	15,500	35	77	115	138	159
15,500	15,800	40	87	128	154	178
15,800	16,100	44	96	142	170	196
16,100	16,400	48	105	155	186	215
16,400	16,700	52	114	169	203	234
16,700	17,000	56	123	182	219	253
17,000	17,500	62	135	200	240	277
17,500	18,000	69	150	223	267	309
18,000	18,500	76	166	246	294	340
18,500	19,000	83	181	268	321	371
19,000	19,500	90	196	291	348	402
19,500	20,000	97	211	313	375	433
20,000	20,500	104	226	336	402	465
20,500	21,000	111	242	358	429	496
21,000	21,500	117	257	381	456	527
21,500	22,000	124	272	403	483	558
22,000	23,000	135	295	437	524	605
23,000	24,000	149	325	482	578	667
24,000	25,000	163	356	527	632	729
25,000	26,000	177	386	572	686	792
26,000	27,000	190	416	617	740	854
27,000	28,000	204	447	662	794	917
28,000	29,000	218	477	707	848	979
29,000	30,000	232	507	752	902	1,041
30,000	31,000	246	538	797	956	1,104
31,000	32,000	260	568	842	1,010	1,166
32,000	33,000	274	599	887	1,064	1,228
33,000	34,000	288	629	933	1,118	1,291
34,000	35,000	302	659	978	1,172	1,353
35,000	36,000	316	690	1,023	1,226	1,415
36,000	37,000	329	720	1,068	1,280	1,478
37,000	38,000	343	751	1,113	1,334	1,540
38,000	39,000	357	781	1,158	1,388	1,602
39,000	40,000	371	811	1,203	1,442	1,665
40,000	41,000	385	842	1,248	1,496	1,727
41,000	42,000	399	872	1,293	1,550	1,789
42,000	43,000	413	902	1,338	1,604	1,852
43,000	44,000	427	933	1,383	1,658	1,914
44,000	45,000	441	963	1,428	1,712	1,976
45,000	46,000	455	994	1,473	1,766	2,039
46,000	47,000	468	1,024	1,518	1,820	2,101
47,000	48,000	482	1,054	1,563	1,874	2,164
48,000	49,000	496	1,085	1,608	1,928	2,226
49,000	50,000	510	1,115	1,653	1,982	2,288
50,000	51,000	524	1,146	1,698	2,036	2,351

DOLLAR AMOUNTS FOR AUTOMOBILES WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 1987 OR 1988—Continued

Fair market value of automobile	Taxable year during lease					
	1st	2nd	3rd	4th	5 and later	
51,000	52,000	538	1,176	1,743	2,090	2,413
52,000	53,000	552	1,206	1,788	2,144	2,475
53,000	54,000	566	1,237	1,834	2,198	2,538
54,000	55,000	580	1,267	1,879	2,252	2,600
55,000	56,000	594	1,297	1,924	2,306	2,662
56,000	57,000	607	1,328	1,969	2,360	2,725
57,000	58,000	621	1,358	2,014	2,414	2,787
58,000	59,000	635	1,389	2,059	2,468	2,849
59,000	60,000	649	1,419	2,104	2,522	2,912
60,000	62,000	670	1,465	2,171	2,603	3,005
62,000	64,000	698	1,525	2,262	2,711	3,130
64,000	66,000	726	1,586	2,352	2,819	3,255
66,000	68,000	753	1,647	2,442	2,927	3,379
68,000	70,000	781	1,708	2,532	3,035	3,504
70,000	72,000	809	1,768	2,622	3,143	3,629
72,000	74,000	837	1,829	2,712	3,251	3,753
74,000	76,000	865	1,890	2,802	3,359	3,878
76,000	78,000	892	1,951	2,892	3,468	4,003
78,000	80,000	920	2,012	2,982	3,576	4,128
80,000	85,000	969	2,118	3,140	3,765	4,346
85,000	90,000	1,038	2,270	3,365	4,035	4,658
90,000	95,000	1,108	2,422	3,590	4,305	4,969
95,000	100,000	1,177	2,574	3,816	4,575	5,281
100,000	110,000	1,282	2,802	4,154	4,980	5,749
110,000	120,000	1,421	3,105	4,604	5,520	6,372
120,000	130,000	1,560	3,409	5,055	6,060	6,996
130,000	140,000	1,699	3,713	5,505	6,600	7,619
140,000	150,000	1,838	4,017	5,956	7,140	8,243
150,000	160,000	1,977	4,321	6,406	7,680	8,866
160,000	170,000	2,116	4,625	6,857	8,221	9,490
170,000	180,000	2,255	4,929	7,307	8,761	10,113
180,000	190,000	2,394	5,232	7,758	9,301	10,737
190,000	200,000	2,533	5,536	8,208	9,841	11,360

(v) The applicable table in the case of a passenger automobile first leased after December 31, 1988, will be contained in a revenue ruling or revenue procedure published in the Internal Revenue Bulletin.

(3) *Example.* The following example illustrates the application of this paragraph (a):

Example. On April 1, 1987, A, a calendar year taxpayer, leases and places in service a passenger automobile with a fair market value of $31,500. The lease is to be for a period of three years. During taxable years 1987 and 1988, A uses the automobile exclusively in a trade or business. During 1989 and 1990, A's business/investment use is 45 percent. The appropriate dollar amounts from the table in paragraph (a)(2)(iv) of this section are $260 for 1987 (first taxable year during the lease), $568 for 1988 (second taxable year during the lease), $842 for 1989 (third taxable year during the lease), and $842 for 1990. Since 1990 is the last taxable year during the lease, the dollar amount for the preceding year (the third year) is used, rather than the dollar amount for the fourth year. For taxable years 1987 through 1990, A's inclusion amounts are determined as follows:

Tax year	Dollar amount	Proration	Business use (percent)	Inclusion amount
1987	$260	275/365	100	$196
1988	568	366/366	100	568
1989	842	365/365	45	379
1990	842	90/365	45	93

(b) *Inclusions in income of lessees of listed property (other than passenger automobiles) leased after December 31, 1986*—(1) *In general.* If listed property other than a passenger automobile is not used predominantly in a qualified business use in any taxable year in which such property is leased, the lessee must add an inclusion amount to gross income in the first taxable year in which such property is not so predominantly used (and only in that year). This year is the first taxable year in which the business use percentage (as defined in §1.280F–6T(d)(1)) of the property is 50 percent or less. This inclusion amount is determined under this paragraph (b) for property for which the taxpayer's lease term begins after December 31, 1986 (and under §1.280F–5T(f) for property for which the taxpayer's lease term begins before January 1, 1987). See also §1.280F–5T(g).

(2) *Inclusion amount.* The inclusion amount for any listed property (other than a passenger automobile) leased after December 31, 1986, is the sum of the amounts determined under subdivisions (i) and (ii) of this subparagraph (2).

(i) The amount determined under this subdivision (i) is the product of the following amounts:

(A) The fair market value (as defined in §1.280F–5T(h)(2)) of the property,

(B) The business/investment use (as defined in §1.280F–6T(d)(3)(i)) for the first taxable year in which the business use percentage (as defined in §1.280F–6T(d)(1)) is 50 percent or less, and

(C) The applicable percentage from the following table:

Type of property	First taxable year during lease in which business use percentage is 50% or less											
	1	2	3	4	5	6	7	8	9	10	11	12 and Later
Property with a recovery period of less than 7 years under the alternative depreciation system (such as computers, trucks and airplanes)	2.1	−7.2	−19.8	−20.1	−12.4	−12.4	−12.4	−12.4	−12.4	−12.4	−12.4	−12.4
Property with a 7- to 10-year recovery period under the alternative depreciation system (such as recreation property)	3.9	−3.8	−17.7	−25.1	−27.8	−27.2	−27.1	−27.6	−23.7	−14.7	−14.7	−14.7
Property with a recovery period of more than 10 years under the alternative depreciation system (such as certain property with no class life)	6.6	−1.6	−16.9	−25.6	−29.9	−31.1	−32.8	−35.1	−33.3	−26.7	−19.7	−12.2

(ii) The amount determined under this subdivision (ii) is the product of the following amounts:

(A) The fair market value of the property,

(B) The average of the business/investment use for all taxable years (in which such property is leased) that precede the first taxable year in which the business use percentage is 50 percent or less, and

(C) The applicable percentage from the following table:

Type of property	First taxable year during lease in which business use percentage is 50% or less											
	1	2	3	4	5	6	7	8	9	10	11	12 and Later
Property with a recovery period of less than 7 years under the alternative depreciation system (Such as computers, trucks and airplanes)	0.0	10.0	22.0	21.2	12.7	12.7	12.7	12.7	12.7	12.7	12.7	12.7
Property with a 7- to 10-year recovery period under the alternative depreciation system (such as recreation property)	0.0	9.3	23.8	31.3	33.8	32.7	31.6	30.5	25.0	15.0	15.0	15.0
Property with a recovery period of more than 10 years under the alternative depreciation system (such as certain property with no class life)	0.0	10.1	26.3	35.4	39.6	40.2	40.8	41.4	37.5	29.2	20.8	12.5

(3) *Example.* The following example illustrates the application of this paragraph (b):

Example. On February 1, 1987, B, a calendar year taxpayer, leases and places in service a computer with a fair market value of $3,000. The lease is to be for a period of two years. B's qualified business use of the property, which is the only business/investment use, is 80 percent in taxable year 1987, 40 percent in taxable year 1988, and 35 percent in taxable year 1989. B must add an inclusion amount to gross income for taxable year 1988, the first taxable year in which B does not use the computer predominantly for business (*i.e.*, the first taxable year in which B's business use percentage is 50 percent or less). Since 1988 is the second taxable year during the lease, and since the computer has a 5-year recovery period under the General and Alternative Depreciation Systems, the applicable percentage from the table in subdivision (i) of paragraph (b)(2) is −7.2%, and the applicable percentage from the table in subdivision (ii) is 10%. B's inclusion amount is $154, which is the sum of the amounts determined under subdivisions (i) and (ii) of subparagraph (b)(2) of this paragraph. The amount determined under subdivision (i) is −$86 [$3,000 × 40% × (−7.2%)], and the amount determined under subdivision (ii) is $240 [$3,000 × 80% × 10%].

[T.D. 8218, 53 FR 29881, Aug. 9, 1988; 53 FR 32821, Aug. 26, 1988, as amended by T.D. 8298, 55 FR 13370, Apr. 12, 1990; Redesignated and amended at T.D. 8473, 58 FR 19060, Apr. 12, 1993]

§ 1.280H–0T Table of contents (temporary).

This section lists the captions that appear in the temporary regulations under section 280H.

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(f) Effective date.

[T.D. 8205, 53 FR 19711, May 27, 1988]

§1.280H–1T Limitation on certain amounts paid to employee-owners by personal service corporations electing alternative taxable years (temporary).

(a) *Introduction.* This section applies to any taxable year that a personal service corporation has a section 444 election in effect (an ‘‘applicable election year’’). For purposes of this section, the term *personal service corporation* has the same meaning given such term in §1.441–4T(d).

(b) *Limitation on certain deductions of personal service corporations*—(1) *In general.* If, for any applicable election year, a personal service corporation does not satisfy the minimum distribution requirement in paragraph (c) of this section, the deduction otherwise allowable under chapter 1 of the Internal Revenue Code of 1986 (the Code) for applicable amounts, as defined in paragraph (b)(4) of this section, shall not exceed the maximum deductible amount, as defined in paragraph (d) of this section.

(2) *Carryover of nondeductible amounts.* Any amount not allowed as a deduction in an applicable election year under paragraph (b)(1) of this section shall be allowed as a deduction in the succeeding taxable year.

(3) *Disallowance inapplicable for certain purposes.* The disallowance of deductions under paragraph (b)(1) of this section shall not apply for purposes of subchapter G of chapter 1 of the Code (relating to corporations used to avoid income tax on shareholders) nor for determining whether the compensation of employee-owners is reasonable. Thus, for example, in determining whether a personal service corporation is subject to the accumulated earnings tax imposed by section 531, deductions disallowed under paragraph (b)(1) of this section are treated as allowed in computing accumulated taxable income.

(4) *Definition of applicable amount*—(i) *In general.* For purposes of section 280H and the regulations thereunder, the term *applicable amount* means, with respect to a taxable year, any amount that is otherwise deductible by a personal service corporation in such year and includable at any time, directly or indirectly, in the gross income of a taxpayer that during such year is an employee-owner. Thus, an amount includable in the gross income of an employee-owner will be considered an applicable amount even though such employee owns no stock of the corporation on the date the employee includes the amount in income. See *Example (1)* in paragraph (b)(4)(iii) of this section.

(ii) *Special rule for certain indirect payments.* For purposes of paragraph (b)(4)(i) of this section, amounts are indirectly includable in the gross income of an employee-owner of a personal service corporation that has made a section 444 election (an electing personal service corporation) if the amount is includable in the gross income of—

(A) The spouse (other than a spouse who is legally separated from the partner or shareholder under a decree of divorce or separate maintenance) or child (under age 14) of such employee-owner, or

(B) A corporation more than 50 percent (measured by fair market value) of which is owned in the aggregate by employee-owners (and individuals related under paragraph (b)(4)(ii)(A) of this section to such employee-owners), of the electing personal service corporation, or

(C) A partnership more than 50 percent of the profits and capital of which is owned by employee-owners (and individuals related under paragraph (b)(4)(ii)(A) of this section to such employee-owners) of the electing personal service corporation, or

(D) A trust more than 50 percent of the beneficial ownership of which is owned in the aggregate by employee-owners (and individuals related under paragraph (b)(4)(ii)(A) of this section to any such employee-owners), of the electing personal service corporation.

For purposes of this paragraph (b)(4)(ii), ownership by any person described in this paragraph (b)(4)(ii) shall be treated as ownership by the employee-owners of the electing personal service corporation. Paragraph (b)(4)(ii)(B) of this section will not apply if the corporation has made a section 444 election to use the same taxable year as that of the electing personal service corporation. Similarly, paragraph (b)(4)(ii)(C) of this section will not apply if the partnership has made a section 444 election to use the same taxable year as that of the electing personal service corporation. Notwithstanding the general effective date provision of paragraph (f) of this section, this paragraph (b)(4)(ii) is effective for amounts deductible on or after June 1, 1988.

(iii) *Example.* The provisions of paragraph (b)(4) of this section may be illustrated by the following examples.

Example 1. A is an employee of P, an accrual basis personal service corporation with a taxable year ending September 30. P makes a section 444 election for its taxable year beginning October 1, 1987. On October 1, 1987, A owns no stock of P; However, on March 31, 1988, A acquires 10 of the 200 outstanding shares of P stock. During the period October 1, 1987 to March 31, 1988, A earned $40,000 of compensation as an employee of P. During the period April 1, 1988 to September 30 1988, A earned $60,000 of compensation as an employee-owner of P. If paragraph (b) of this section does not apply, P would deduct for its taxable year ended September 30, 1988 the $100,000 earned by A during such year. Based upon these facts, the $100,000 otherwise deductable amount is considered an applicable amount under this section.

Example 2. I1 and I2, calendar year individuals, are employees of PSC1, a personal service corporation that has historically used a taxable year ending January 31. I1 and I2 also own all the stock, and are employees, of PSC2, a calendar year personal service corporation. For its taxable years beginning February 1, 1987, 1988, and 1989, PSC1 has a section 444 election in effect to use a January 31 taxable year. During its taxable years beginning February 1, 1986, 1987, and 1988, PSC1 deducted $10,000, $11,000, and $12,000, respectively, that was included in PSC2's gross income. Furthermore, of the $12,000 deducted by PSC1 for its taxable year beginning February 1, 1988, $7,000 was deducted during the period June 1, 1988 to January 31, 1989. Pursuant to paragraph (b)(4)(ii)(B) of this section, the $7,000 deducted by PSC1 on or after June 1, 1988, and included in PSC2's gross income is considered an applicable amount for PSC1's taxable year beginning February 1, 1988. Amounts deducted by PSC1 prior to June 1, 1988, are not subject to paragraph (b)(4)(ii)(B) of this section.

Example 3. The facts are the same as in *Example (2),* except that for its taxable years beginning February 1, 1987, 1988, and 1989, PSC2 has a section 444 election in effect to use a January 31 taxable year. Since both PSC1 and PSC2 have the same taxable year and both have section 444 elections in effect, paragraph (b)(4)(ii)(B) of this section does not apply to the $7,000 deducted by PSC1 for its taxable year beginning February 1, 1988.

(c) *Minimum distribution requirement*—(1) *Determination of whether requirement satisfied*—(i) *In general.* A personal service corporation meets the minimum distribution requirement of this paragraph (c) for an applicable election year if, during the deferral period of such taxable year, the applicable amounts (determined without regard to paragraph (b)(2) of this section) for all employee-owners in the aggregate equal or exceed the lesser of—

(A) The amount determined under the ''preceding year test'' (see paragraph (c)(2) of this section), or

(B) The amount determined under the ''3-year average test'' (see paragraph (c)(3) of this section).

The following example illustrates the application of this paragraph (c)(1)(i).

Example. Q, an accrual-basis personal service corporation, makes a section 444 election to retain a year ending January 31 for its taxable year beginning February 1, 1987. Q has 4 employee-owners, B, C, D, and E. For Q's applicable election year beginning February 1, 1987 and ending January 31, 1988, B earns $6,000 a month plus a $45,000 bonus on January 15, 1988; C earns $5,000 a month plus a $40,000 bonus on January 15, 1988; D and E each earn $4,500 a month plus a $4,000 bonus on January 15, 1988. Q meets the minimum distribution requirement for such applicable election year if the applicable amounts during the deferral period (*i.e.*, $220,000) equal or exceed the amount determined under the preceding year test or the 3-year average test.

(ii) *Employee-owner defined.* For purposes of section 280H and the regulations thereunder, a person is an employee-owner of a corporation for a taxable year if—

(A) On any day of the corporation's taxable year, the person is an employee of the corporation or performs personal services for or on behalf of the corporation, even if the legal form of that person's relationship to the corporation is that of an independent contractor, and

(B) On any day of the corporation's taxable year, the person owns any outstanding stock of the corporation.

(2) *Preceding year test*—(i) *In general.* The amount determined under the preceding year test is the product of—

(A) The applicable amounts during the taxable year preceding the applicable election year (the ''preceding taxable year''), divided by the number of months (but not less than one) in the preceding taxable year, multiplied by

(B) The number of months in the deferral period of the applicable election year.

(ii) *Example.* The provisions of paragraph (c)(2) of this section may be illustrated by the following example.

Example. R, a personal service corporation, has historically used a taxable year ending January 31. For its taxable year beginning February 1, 1987, R makes a section 444 election to retain its January 31 taxable year. R is an accrual basis taxpayer and has one employee-owner, F. For R's taxable year ending January 31, 1987, F earns $5,000 a month plus a $40,000 bonus on January 15, 1987. The amount determined under the preceding year test for R's applicable election year beginning February 1, 1987 is $91,667 ($100,000, the applicable amounts during R's taxable year ending January 31, 1987, divided by 12, the number of months in R's taxable year ending January 31, 1987, multiplied by 11, the number of months in R's deferral period for such year).

(3) *3-year average test*—(i) *In general.* The amount determined under the 3-year average test is the applicable percentage multiplied by the adjusted taxable income for the deferral period of the applicable election year.

(ii) *Applicable percentage.* The term *applicable percentage* means the percentage (not in excess of 95 percent) determined by dividing—

(A) The applicable amounts during the 3 taxable years of the corporation (or, if fewer, the taxable years the corporation has been in existence) immediately preceding the applicable election year, by

(B) The adjusted taxable income of such corporation for such 3 taxable years (or, if fewer, the taxable years of existence).

(iii) *Adjusted taxable income*—(A) *In general.* The term *adjusted taxable income* means taxable income determined without regard to applicable amounts.

(B) *Determination of adjusted taxable income for the deferral period of the applicable election year.* Adjusted taxable income for the deferral period of the applicable election year equals the adjusted taxable income that would result if the personal service corporation filed an income tax return for the deferral period of the applicable election year under its normal method of accounting. However, a personal service corporation may make a reasonable estimate of such amount.

(C) *NOL carryovers.* For purposes of determining adjusted taxable income for any period, any NOL carryover shall be reduced by the amount of such carryover that is attributable to the deduction of applicable amounts. The portion of the NOL carryover attributable to the deduction of applicable amounts is the difference between the NOL carryover computed with the deduction of such amounts and the NOL carryover computed without the deduction of such amounts. For purposes of determining the adjusted taxable income for the deferral period, an NOL carryover to the applicable election year, reduced as provided in this paragraph (c)(3)(iii)(C), shall be allowed first against the income of the deferral period.

(D) *Examples.* The provisons of this paragraph (c)(3)(iii) may be illustrated by the following examples.

Example 1. S is a personal service corporation that has historically used a taxable year ending January 31. For its taxable year beginning February 1, 1987, S makes a section 444 election to retain its taxable year ending January 31. S does not satisfy the minimum distribution requirement for its first applicable election year, and the applicable amounts for that year exceed the maximum deductible amount by $54,000. Under paragraph (b)(2) of this section, the $54,000 excess is carried over to S's taxable year beginning February 1, 1988. Furthermore, if S continues its section 444 election for its taxable year beginning February 1, 1988, and desires to use the 3-year average test provided in this paragraph for such year, pursuant to paragraph (c)(3)(iii)(A) of this section the $54,000 will not be allowed to reduce adjusted taxable income for such year. See also section 280H(e) regarding the disallowance of net operating loss carrybacks to (or from) any taxable year of a corporation personal service election under section 444 applies.

Example 2. T, a personal service corporation with a section 444 election in effect, is determining whether it satisfies the 3-year average test for its second applicable election year. T had a net operating loss (NOL) for its first applicable election year of $45,000. The NOL resulted from $150,000 of gross income less the sum of $96,000 of salary, $45,000 of other expenses, and $54,000 of deductible applicable amounts. Pursuant to paragraph (c)(3)(iii)(C) of this section, the entire amount of the $45,000 NOL is attributable to applicable amounts since the applicable amounts deducted in arriving at the NOL (*i.e.*, $54,000) were greater than the NOL (*i.e.*, $45,000). Thus, for purposes of computing the adjusted taxable income for the deferral period of T's second applicable election year, the NOL carryover to that year is $0 ($45,000 NOL less $45,000 amount of NOL attributable to applicable amounts).

(d) *Maximum deductible amount*—(1) *In general.* For purposes of this section, the term *maximum deductible amount* means the sum of—

(i) The applicable amounts during the deferral period of the applicable election year, plus

(ii) An amount equal to the product of—

(A) The amount determined under paragraph (d)(1)(i) of this section divided by the number of months in the deferral period of the applicable election year, multiplied by

(B) The number of months in the nondeferral period of the applicable election year. For purposes of the preceding sentence, the term *nondeferral period* means the portion of the applicable election year that occurs after the portion of such year constituting the deferral period.

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

Example. U, an accrual basis personal service corporation with a taxable year ending January 31, makes a section 444 election to retain a year ending January 31 for its taxable year beginning February 1, 1987. For its applicable election year beginning February 1, 1987, U does not satisfy the minimum distribution requirement in paragraph (c) of this section. Furthermore, U has 3 employee-owners, G, H, and I. G and H have been employee-owners of U for 10 years. Although I has been an employee of U for 4 years, I did not become an employee-owner until December 1, 1987, when I acquired 5 of the 20 outstanding shares of U stock. For U's applicable election year beginning February 1, 1987, G earns $5,000 a month plus a $40,000 bonus on January 15, 1988, and H and I each earn $4,000 a month plus a $32,000 bonus on January 15, 1988. Thus, the total of the applicable amounts during the deferral period of the applicable election year beginning February 1, 1987 is $143,000. Based on these facts, U's deduction for applicable amounts is limited to $156,000, determined as follows—$143,000 (applicable amounts during the deferral period) plus $13,000 (applicable amounts during the deferral period, divided by the number of months in the deferral period, multiplied by the number of months in the nondeferral period).

(e) *Special rules and definition*—(1) *Newly organized personal service corporations.* A personal service corporation is deemed to satisfy the preceding year test and the 3-year average test for the first year of the corporation's existence.

(2) *Existing corporations that become personal service corporations.* If an existing corporation becomes a personal service corporation and makes a section 444 election, the determination of whether the corporation satisfies the preceding year test and the 3-year average test is made by treating the corporation as though it were a personal service corporation for each of the 3 years preceding the applicable election year.

(3) *Disallowance of NOL carryback.* No net operating loss carryback shall be allowed to (or from) any applicable election year of a personal service corporation.

(4) *Deferral period.* For purposes of section 280H and the regulations thereunder, the term *deferral period* has the same meaning as under § 1.444–1T(b)(4).

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

Example 1. V is a personal service corporation with a taxable year ending September

30. V makes a section 444 election for its taxable year beginning October 1, 1987, and incurs a net operating loss (NOL) for such year. Because an NOL is not allowed to be carried back from an applicable election year, V may not carry back the NOL from its first applicable election year to reduce its 1985, 1986, or 1987 taxable income.

Example 2. W, a personal service corporation, commences operations on July 1, 1990. Furthermore, for its taxable year beginning July 1, 1990, W makes a section 444 election to use a year ending September 30. Pursuant to paragraph (e)(1) of this section, W satisfies the preceding year test and the 3-year average test for its first year in existence. Thus, W may deduct, without limitation under this section, any applicable amounts for its taxable year beginning July 1, 1990.

Example 3. The facts are the same as in *Example (2)*. For its taxable year beginning October 1, 1990, W incurs an NOL and is not a personal service corporation. Furthermore, W desires to carry back the NOL to its preceding taxable year (a year that was an applicable election year). Pursuant to paragraph (e)(3) of this section, W may not carry back an NOL ‘‘to’’ its taxable year beginning July 1, and ending September 30, 1990, because such year was an applicable election year.

(f) *Effective date.* The provisions of this section are effective for taxable years beginning after December 31, 1986.

[T.D. 8205, 53 FR 19711, May 27, 1988]

TAXABLE YEARS BEGINNING PRIOR TO JANUARY 1, 1986

§1.274–5A Substantiation requirements.

(a) *In general.* No deduction shall be allowed for any expenditure with respect to:

(1) Traveling away from home (including meals and lodging) deductible under section 162 or 212,

(2) Any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, including the items specified in section 274(e), or

(3) Gifts defined in section 274, unless the taxpayer substantiates such expenditure as provided in paragraph (c) of this section. This limitation supersedes with respect to any such expenditure the doctrine of Cohan v. Commissioner (C.C.A. 2d 1930) 39 F. 2d 540. The decision held that, where the evidence indicated a taxpayer incurred deductible travel or entertainment expense but the exact amount could not be determined, the court should make a close approximation and not disallow the deduction entirely. Section 274(d) contemplates that no deduction shall be allowed a taxpayer for such expenditures on the basis of such approximations or unsupported testimony of the taxpayer. For purposes of this section, the term *entertainment* means entertainment, amusement, or recreation, and use of a facility therefore; and the term *expenditure* includes expenses and items (including items such as losses and depreciation).

(b) *Elements of an expenditure*—(1) *In general.* Section 274(d) and this section contemplate that no deduction shall be allowed for any expenditure for travel, entertainment, or a gift unless the taxpayer substantiates the following elements for each such expenditure:

(i) Amount;

(ii) Time and place of travel or entertainment (or use of a facility with respect to entertainment), or date and description of a gift;

(iii) Business purpose; and

(iv) Business relationship to the taxpayer of each person entertained, using an entertainment facility or receiving a gift.

(2) *Travel.* The elements to be proved with respect to an expenditure for travel are:

(i) *Amount.* Amount of each separate expenditure for traveling away from home, such as cost of transportation or lodging, except that the daily cost of the traveler's own breakfast, lunch, and dinner and of expenditures incidental to such travel may be aggregated, if set forth in reasonable categories, such as for meals, for gasoline and oil, and for taxi fares;

(ii) *Time.* Dates of departure and return for each trip away from home, and number of days away from home spent on business;

(iii) *Place.* Destinations or locality of travel, described by name of city or town or other similar designation; and

(iv) *Business purpose.* Business reason for travel or nature of the business benefit derived or expected to be derived as a result of travel.

(3) *Entertainment in general.* Elements to be proved with respect to an expenditure for entertainment are:

(i) *Amount.* Amount of each separate expenditure for entertainment, except that such incidental items as taxi fares or telephone calls may be aggregated on a daily basis;

(ii) *Time.* Date of entertainment;

(iii) *Place.* Name, if any, address or location, and designation of type of entertainment, such as dinner or theater, if such information is not apparent from the designation of the place;

(iv) *Business purpose.* Business reason for the entertainment or nature of business benefit derived or expected to be derived as a result of the entertainment and, except in the case of business meals described in section 274(e)(1), the nature of any business discussion or activity;

(v) *Business relationship.* Occupation or other information relating to the person or persons entertained, including name, title, or other designation, sufficient to establish business relationship to the taxpayer.

(4) *Entertainment directly preceding or following a substantial and bona fide business discussion.* If a taxpayer claims a deduction for entertainment directly preceding or following a substantial and bona fide business discussion on the ground that such entertainment was associated with the active conduct of the taxpayer's trade or business, the elements to be proved with respect to such expenditure, in addition to those enumerated in subparagraph (3)(i), (ii), (iii), and (v) of this paragraph, are:

(i) *Time.* Date and duration of business discussion;

(ii) *Place.* Place of business discussion;

(iii) *Business purpose.* Nature of business discussion, and business reason for the entertainment or nature of business benefit derived or expected to be derived as the result of the entertainment;

(iv) *Business relationship.* Identification of those persons entertained who participated in the business discussion.

(5) *Gifts.* Elements to be proved with respect to an expenditure for a gift are:

(i) *Amount.* Cost of the gift to the taxpayer;

(ii) *Time.* Date of the gift;

(iii) *Description.* Description of the gift;

(iv) *Business purpose.* Business reason for the gift or nature of business benefit derived or expected to be derived as a result of the gift; and

(v) *Business relationship.* Occupation or other information relating to the recipient of the gift, including name, title, or other designation, sufficient to establish business relationship to the taxpayer.

(c) *Rules for substantiation*—(1) *In general.* A taxpayer must substantiate each element of an expenditure (described in paragraph (b) of this section) by adequate records or by sufficient evidence corroborating his own statement except as otherwise provided in this section. Section 274(d) contemplates that a taxpayer will maintain and produce such substantiation as will constitute clear proof of an expenditure for travel, entertainment, or gifts referred to in section 274. A record of the elements of an expenditure made at or near the time of the expenditure, supported by sufficient documentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequent thereto when generally there is a lack of accurate recall. Thus, the corroborative evidence required to support a statement not made at or near the time of the expenditure must have a high degree of probative value to elevate such statement and evidence to the level of credibility reflected by a record made at or near the time of the expenditure supported by sufficient documentary evidence. The substantiation requirements of section 274(d) are designed to encourage taxpayers to maintain the records, together with documentary evidence, as provided in subparagraph (2) of this paragraph. To obtain a deduction for an expenditure for travel, entertainment, or gifts, a taxpayer must substantiate, in accordance with the provisions of this paragraph, each element of such an expenditure.

(2) *Substantiation by adequate records*—(i) *In general.* To meet the ''adequate records'' requirements of section 274(d), a taxpayer shall maintain an account book, diary, statement

of expense or similar record (as provided in subdivision (ii) of this subparagraph) and documentary evidence (as provided in subdivision (iii) of this subparagraph) which, in combination, are sufficient to establish each element of an expenditure specified in paragraph (b) of this section. It is not necessary to record information in an account book, diary, statement of expense or similar record which duplicates information reflected on a receipt so long as such account book and receipt complement each other in an orderly manner.

(ii) *Account book, diary, etc.* An account book, diary, statement of expense or similar record must be prepared or maintained in such manner that each recording of an element of an expenditure is made at or near the time of the expenditure.

(*a*) *Made at or near the time of the expenditure.* For purposes of this section, the phrase *made at or near the time of the expenditure* means the elements of an expenditure are recorded at a time when, in relation to the making of an expenditure, the taxpayer has full present knowledge of each element of the expenditure, such as the amount, time, place and business purpose of the expenditure and business relationship to the taxpayer of any person entertained. An expense account statement which is a transcription of an account book, diary, or similar record prepared or maintained in accordance with the provisions of this subdivision shall be considered a record prepared or maintained in the manner prescribed in the preceding sentence if such expense account statement is submitted by an employee to his employer or by an independent contractor to his client or customer in the regular course of good business practice.

(*b*) *Substantiation of business purpose.* In order to constitute an adequate record of business purpose within the meaning of section 274(d) and this subparagraph, a written statement of business purpose generally is required. However, the degree of substantiation necessary to establish business purpose will vary depending upon the facts and circumstances of each case. Where the business purpose of an expenditure is evident from the surrounding facts and circumstances, a written explanation of such business purpose will not be required. For example, in the case of a salesman calling on customers on an established sales route, a written explanation of the business purpose of such travel ordinarily will not be required. Similarly, in the case of a business meal described in section 274(e)(1), if the business purpose of such meal is evident from the business relationship to the taxpayer of the persons entertained and other surrounding circumstances, a written explanation of such business purpose will not be required.

(*c*) *Confidential information.* If any information relating to the elements of an expenditure, such as place, business purpose or business relationship, is of a confidential nature, such information need not be set forth in the account book, diary, statement of expense or similar record, provided such information is recorded at or near the time of the expenditure and is elsewhere available to the district director to substantiate such element of the expenditure.

(iii) *Documentary evidence.* Documentary evidence, such as receipts, paid bills, or similar evidence sufficient to support an expenditure shall be required for:

(*a*) Any expenditure for lodging while traveling away from home, and

(*b*) Any other expenditure of $25 or more, except, for transportation charges, documentary evidence will not be required if not readily available.

Provided, however, that the Commissioner, in his discretion, may prescribe rules waiving such requirements in circumstances where he determines it is impracticable for such documentary evidence to be required. Ordinarily, documentary evidence will be considered adequate to support an expenditure if it includes sufficient information to establish the amount, date, place, and the essential character of the expenditure. For example, a hotel receipt is sufficient to support expenditures for business travel if it contains the following: name, location, date, and separate amounts for charges such as for lodging, meals, and telephone. Similarly, a restaurant receipt is sufficient to support an expenditure for a business meal if it contains the following: name and location of the restaurant, the date and amount of the expenditure, and, if a charge is made for an item other than meals and beverages, an indication that such is the case. A document may be indicative of only one (or part of one) element of an expenditure. Thus, a cancelled check, together with a bill from the payee, ordinarily would establish the element of cost. In contrast, a cancelled check drawn payable to a named payee would not by itself support a business expenditure without other evidence showing that the check was used for a certain business purpose.

(iv) *Retention of documentary evidence.* The Commissioner may, in his discretion, prescribe rules under which an employer may dispose of documentary evidence submitted to him by employees who are required to, and do, make an adequate accounting to the employer (within the meaning of paragraph (e)(4) of this section) if the employer maintains adequate accounting procedures with respect to such employees (within the meaning of paragraph (e)(5) of this section).

(v) *Substantial compliance.* If a taxpayer has not fully substantiated a particular element of an expenditure, but the taxpayer establishes to the satisfaction of the district director that he has substantially complied with the *adequate records* requirements of this subparagraph with respect to the expenditure, the taxpayer may be permitted to establish such element by evidence which the district director shall deem adequate.

(3) *Substantiation by other sufficient evidence.* If a taxpayer fails to establish to the satisfaction of the district director that he has substantially complied with the ‘‘adequate records’’ requirements of subparagraph (2) of this paragraph with respect to an element of an expenditure, then, except as otherwise provided in this paragraph, the taxpayer must establish such element:

(i) By his own statement, whether written or oral, containing specific information in detail as to such element; and

(ii) By other corroborative evidence sufficient to establish such element. If such element is the description of a gift, or the cost, time, place, or date of an expenditure, the corroborative evidence shall be direct evidence, such as a statement in writing or the oral testimony of persons entertained or other witness setting forth detailed information about such element, or the documentary evidence described in subparagraph (2) of this paragraph. If such element is either the business relationship to the taxpayer of persons entertained or the business purpose of an expenditure, the corroborative evidence may be circumstantial evidence.

(4) *Substantiation in exceptional circumstances.* If a taxpayer establishes that, by reason of the inherent nature of the situation in which an expenditure was made:

(i) He was unable to obtain evidence with respect to an element of the expenditure which conforms fully to the ‘‘adequate records’’ requirements of subparagraph (2) of this paragraph,

(ii) He is unable to obtain evidence with respect to such element which conforms fully to the ‘‘other sufficient evidence’’ requirements of subparagraph (3) of this paragraph, and

(iii) He has presented other evidence, with respect to such element, which possesses the highest degree of probative value possible under the circumstances, such other evidence shall be considered to satisfy the substantiation requirements of section 274(d) and this paragraph.

(5) *Loss of records due to circumstances beyond control of taxpayer.* Where the taxpayer establishes that the failure to produce adequate records is due to the loss of such records through circumstances beyond the taxpayer’s control, such as destruction by fire, flood, earthquake, or other casualty, the taxpayer shall have a right to substantiate a deduction by reasonable reconstruction of his expenditures.

(6) *Special rules*—(i) *Separate expenditure*—(*a*) *In general.* For the purposes of this section, each separate payment by the taxpayer shall ordinarily be considered to constitute a separate expenditure. However, concurrent or repetitious expenses of a similar nature occurring during the course of a single event shall be considered a single expenditure. To illustrate the above

rules, where a taxpayer entertains a business guest at dinner and thereafter at the theater, the payment for dinner shall be considered to constitute one expenditure and the payment for the tickets for the theater shall be considered to constitute a separate expenditure. Similarly, if during a day of business travel a taxpayer makes separate payments for breakfast, lunch, and dinner, he shall be considered to have made three separate expenditures. However, if during entertainment at a cocktail lounge the taxpayer pays separately for each serving of refreshments, the total amount expended for the refreshments will be treated as a single expenditure. A tip may be treated as a separate expenditure.

(*b*) *Aggregation.* Except as otherwise provided in this section, the account book, diary, statement of expense, or similar record required by subparagraph (2)(ii) of this paragraph shall be maintained with respect to each separate expenditure and not with respect to aggregate amounts for two or more expenditures. Thus, each expenditure for such items as lodging and air or rail travel shall be recorded as a separate item and not aggregated. However, at the option of the taxpayer, amounts expended for breakfast, lunch, or dinner, may be aggregated. A tip or gratuity which is related to an underlying expense may be aggregated with such expense. For other provisions permitting recording of aggregate amounts in an account book, diary, statement of expense or similar record see paragraph (b)(2)(i) and (b)(3) of this section (relating to incidental costs of travel and entertainment).

(ii) *Allocation of expenditure.* For purposes of this section, if a taxpayer has established the amount of an expenditure, but is unable to establish the portion of such amount which is attributable to each person participating in the event giving rise to the expenditure, such amount shall ordinarily be allocated to each participant on a pro rata basis, if such determination is material. Accordingly, the total number of persons for whom a travel or entertainment expenditure is incurred must be established in order to compute the portion of the expenditure allocable to each such person.

(iii) *Primary use of a facility.* Section 274(a) (1)(B) and (2)(C) denies a deduction for any expenditure paid or incurred before January 1, 1979, with respect to a facility, or paid or incurred at any time with respect to a club, used in connection with an entertainment activity unless the taxpayer establishes that the facility (including a club) was used primarily for the furtherance of his trade or business. A determination whether a facility before January 1, 1979, or a club at any time was used primarily for the futherance of the taxpayer's trade or business will depend upon the facts and circumstances of each case. In order to establish that a facility was used primarily for the furtherance of his trade or business, the taxpayer shall maintain records of the use of the facility, the cost of using the facility, mileage or its equivalent (if appropriate), and such other information as shall tend to establish such primary use. Such records of use shall contain:

(*a*) For each use of the facility claimed to be in furtherance of the taxpayer's trade or business, the elements of an expenditure specified in paragraph (b) of this section, and

(*b*) For each use of the facility not in furtherance of the taxpayer's trade or business, an appropriate description of such use, including cost, date, number of persons entertained, nature of entertainment and, if applicable, information such as mileage or its equivalent. A notation such as ''personal use'' or ''family use'' would, in the case of such use, be sufficient to describe the nature of entertainment.

If a taxpayer fails to maintain adequate records concerning a facility which is likely to serve the personal purposes of the taxpayer, it shall be presumed that the use of such facility was primarily personal.

(iv) *Additional information.* In a case where it is necessary to obtain additional information, either:

(*a*) To clarify information contained in records, statements, testimony, or documentary evidence submitted by a taxpayer under the provisions of paragraph (c)(2) or (c)(3) of this section, or

(*b*) To establish the reliability or accuracy of such records, statements, testimony, or documentary evidence, the district director may, notwithstanding any other provision of this section, obtain such additional information as he determines necessary to properly implement the provisions of section 274 and the regulations thereunder by personal interview or otherwise.

(7) *Specific exceptions.* Except as otherwise prescribed by the Commissioner, substantiation otherwise required by this paragraph is not required for:

(i) Expenses described in section 274 (e)(2) relating to food and beverages for employees, section 274(e)(3) relating to expenses treated as compensation, section 274(e)(8) relating to items available to the public, and section 274(e)(9) relating to entertainment sold to customers, and

(ii) Expenses described in section 274(e)(5) relating to recreational, etc., expenses for employees, except that a taxpayer shall keep such records or other evidence as shall establish that such expenses were for activities (or facilities used in connection therewith) primarily for the benefit of employees other than employees who are officers, shareholders or other owners (as defined in section 274(e)(5)), or highly compensated employees.

(d) *Disclosure on returns.* The Commissioner may, in his discretion, prescribe rules under which any taxpayer claiming a deduction for entertainment, gifts, or travel or any other person receiving advances, reimbursements, or allowances for such items, shall make disclosure on his tax return with respect to such items. The provisions of this paragraph shall apply notwithstanding the provisions of paragraph (e) of this section.

(e) *Reporting and substantiation of expenses of certain employees for travel, entertainment, and gifts*—(1) *In general.* The purpose of this paragraph is to provide rules for reporting and substantiation of certain expenses paid or incurred by taxpayers in connection with the performance of services as employees. For purposes of this paragraph, the term *business expenses* means ordinary and necessary expenses for travel, entertainment, or gifts which are deductible under section 162, and the regulations thereunder, to the extent not disallowed by section 274(c). Thus, the term *business expenses* does not include personal, living or family expenses disallowed by section 262 or travel expenses disallowed by section 274(c), and advances, reimbursements, or allowances for such expenditures must be reported as income by the employee.

(2) *Reporting of expenses for which the employee is required to make an adequate accounting to his employer*—(i) *Reimbursements equal to expenses.* For purposes of computing tax liability, an employee need not report on his tax return business expenses for travel, transportation, entertainment, gifts, and similar purposes, paid or incurred by him solely for the benefit of his employer for which he is required to, and does, make an adequate accounting to his employer (as defined in subparagraph (4) of this paragraph) and which are charged directly or indirectly to the employer (for example, through credit cards) or for which the employee is paid through advances, reimbursements, or otherwise, provided that the total amount of such advances, reimbursements, and charges is equal to such expenses.

(ii) *Reimbursements in excess of expenses.* In case the total of the amounts charged directly or indirectly to the employer or received from the employer as advances, reimbursements, or otherwise, exceeds the business expenses paid or incurred by the employee and the employee is required to, and does, make an adequate accounting to his employer for such expenses, the employee must include such excess (including amounts received for expenditures not deductible by him) in income.

(iii) *Expense in excess of reimbursements.* If an employee incurs deductible business expenses on behalf of his employer which exceed the total of the amounts charged directly or indirectly to the employer and received from the employer as advances, reimbursements, or otherwise, and the employee wishes to claim a deduction for such excess, he must:

(*a*) Submit a statement as part of his tax return showing all of the information required by subparagraph (3) of this paragraph, and,

(*b*) Maintain such records and supporting evidence as will substantiate each element of an expenditure (described in paragraph (b) of this section) in accordance with paragraph (c) of this section.

(3) *Reporting of expenses for which the employee is not required to make an adequate accounting to his employer.* If the employee is not required to make an adequate accounting to his employer for his business expenses or, though required, fails to make an adequate accounting for such expenses, he must submit, as a part of his tax return, a statement showing the following information:

(i) The total of all amounts received as advances or reimbursements from his employer, including amounts charged directly or indirectly to the employer through credit cards or otherwise; and

(ii) The nature of his occupation, the number of days away from home on business, and the total amount of business expenses paid or incurred by him (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such categories as transportation, meals and lodging while away from home overnight, entertainment, gifts, and other business expenses.

In addition, he must maintain such records and supporting evidence as will substantiate each element of an expenditure (described in paragraph (b) of this section) in accordance with paragraph (c) of this section.

(4) *Definition of an ''adequate accounting'' to the employer.* For purposes of this paragraph an adequate accounting means the submission to the employer of an account book, diary, statement of expense, or similar record maintained by the employee in which the information as to each element of an expenditure (described in paragraph (b) of this section) is recorded at or near the time of the expenditure, together with supporting documentary evidence, in a manner which conforms to all the ''adequate records'' requirements of paragraph (c)(2) of this section. An adequate accounting requires that the employee account for all amounts received from his employer during the taxable year as advances, reimbursements, or allowances (including those charged directly or indirectly to the employer through credit cards or otherwise) for travel, entertainment, and gifts. The methods of substantiation allowed under paragraph (c)(4) or (c)(5) of this section also will be considered to be an adequate accounting if the employer accepts an employee's substantiation and establishes that such substantiation meets the requirements of such paragraph (c)(4) or (c)(5). For purposes of an adequate accounting the method of substantiation allowed under paragraph (c)(3) of this section will not be permitted.

(5) *Substantiation of expenditures by certain employees.* An employee who makes an adequate accounting to his employer within the meaning of this paragraph will not again be required to substantiate such expense account information except in the following cases:

(i) An employee whose business expenses exceed the total of amounts charged to his employer and amounts received through advances, reimbursements or otherwise and who claims a deduction on his return for such excess;

(ii) An employee who is related to his employer within the meaning of section 267(b) but for this purpose the percentage referred to in section 267(b)(2) shall be 10 percent; and

(iii) Employees in cases where it is determined that the accounting procedures used by the employer for the reporting and substantiation of expenses by such employees are not adequate, or where it cannot be determined that such procedures are adequate. The district director will determine whether the employer's accounting procedures are adequate by considering the facts and circumstances of each case, including the use of proper internal controls. For example, an employer should require that an expense account must be verified and approved by a responsible person other than the person incurring such expenses. Accounting procedures will be considered inadequate to the extent that the employer does not require an adequate accounting from his employees as defined in subparagraph (4) of this paragraph, or does not maintain such substantiation. To the extent an employer fails to maintain adequate accounting procedures he will thereby obligate his employees to separately substantiate their expense account information.

(f) *Substantiation by reimbursement arrangements or per diem, mileage, and other traveling allowances.* The Commissioner may, in his discretion, prescribe rules under which:

(1) Reimbursement arrangements covering ordinary and necessary expenses of traveling away from home (exclusive of transportation expenses to and from destination),

(2) Per diem allowances providing for ordinary and necessary expenses of traveling away from home (exclusive of transportation costs to and from destination), and

(3) Mileage allowances providing for ordinary and necessary expenses of transportation while traveling away from home, will, if in accordance with reasonable business practice, be regarded as equivalent to substantiation by adequate records or other sufficient evidence for purposes of paragraph (c) of this section of the amount of such traveling expenses and as satisfying, with respect to the amount of such traveling expenses, the requirements of an adequate accounting to the employer for purposes of paragraph (e)(4) of this section. If the total travel allowance received exceeds the deductible traveling expenses paid or incurred by the employee, such excess must be reported as income on the employee's return. See paragraph (h) of this section relating to the substantiation of meal expenses while traveling.

(g) *Reporting and substantiation of certain reimbursements of persons other than employees*—(1) *In general.* The purpose of this paragraph is to provide rules for the reporting and substantiation of certain expenses for travel, entertainment, and gifts paid or incurred by one person (hereinafter termed ‘‘independent contractor’’) in connection with services performed for another person other than an employer (hereinafter termed ‘‘client or customer’’) under a reimbursement or other expense allowance arrangement with such client or customer. For purposes of this paragraph, the term *business expenses* means ordinary and necessary expenses for travel, entertainment, or gifts which are deductible under section 162, and the regulations thereunder, to the extent not disallowed by section 274(c). Thus, the term *business expenses* does not include personal, living or family expenses disallowed by section 262 or travel expenses disallowed by section 274(c), and reimbursements for such expenditures must be reported as income by the independent contractor. For purposes of this paragraph, the term *reimbursements* means advances, allowances, or reimbursements received by an independent contractor for travel, entertainment, or gifts, in connection with the performance by him of services for his client or customer, under a reimbursement or other expense allowance arrangement with his client or customer, and includes amounts charged directly or indirectly to the client or customer through credit card systems or otherwise. See paragraph (h) of this section relating to the substantiation of meal expenses while traveling.

(2) *Substantiation by independent contractors.* An independent contractor shall substantiate, with respect to his reimbursements, each element of an expenditure (described in paragraph (b) of this section) in accordance with the requirements of paragraph (c) of this section; and, to the extent he does not so substantiate, he shall include such reimbursements in income. An independent contractor shall so substantiate a reimbursement for entertainment regardless of whether he accounts (within the meaning of subparagraph (3) of this paragraph) for such entertainment.

(3) *Accounting to a client or customer under section 274(e)(4)(B).* Section 274(e)(4)(B) provides that section 274(a) (relating to disallowance of expenses for entertainment) shall not apply to expenditures for entertainment for which an independent contractor has been reimbursed if the independent contractor accounts to his client or customer to the extent provided by section 274(d). For purposes of section 274(e)(4)(B), an independent contractor shall be considered to account to his client or customer for an expense paid or incurred under a reimbursement or other expense allowance arrangement

with his client or customer if, with respect to such expense for entertainment, he submits to his client or customer adequate records or other sufficient evidence conforming to the requirements of paragraph (c) of this section.

(4) *Substantiation by client or customer.* A client or customer shall not be required to substantiate, in accordance with the requirements of paragraph (c) of this section, reimbursements to an independent contractor for travel and gifts, or for entertainment unless the independent contractor has accounted to him (within the meaning of section 274(e)(4)(B) and subparagraph (3) of this paragraph) for such entertainment. If an independent contractor has so accounted to a client or customer for entertainment, the client or customer shall substantiate each element of the expenditure (as described in paragraph (b) of this section) in accordance with the requirements of paragraph (c) of this section.

(h) *Authority for an optional method of computing meal expenses while traveling.* The Commissioner may establish a method under which a taxpayer may elect to use a specified amount or amounts for meals while traveling in lieu of substantiating the actual cost of meals. The taxpayer would not be relieved of substantiating the actual cost of other travel expenses as well as the time, place, and business purpose of the travel. See paragraph (b)(2) and (c) of this section.

(i) *Effective date*—(1) *In general.* Section 274(d) and this section apply with respect to taxable years ending after December 31, 1962, but only with respect to period after that date.

(2) *Certain meal expenses.* Paragraph (h) of this section is effective for expenses paid or incurred after December 31, 1982.

[T.D. 6630, 27 FR 12931, Dec. 29, 1972, as amended by T.D. 7226, 37 FR 26711, Dec. 15, 1972; T.D. 7909, 48 FR 40370, Sept. 7, 1983; 48 FR 41017, Sept. 13, 1983; T.D. 8051, 50 FR 36576, Sept. 9, 1985. Redesignated by T.D. 8715, 62 FR 13990, Mar. 25, 1997]

Terminal Railroad Corporations and Their Shareholders

§1.281–1 In general.

Section 281 provides special rules for the computation of the taxable incomes of a terminal railroad corporation and its shareholders when the terminal railroad corporation, as a result of taking related terminal income into account, reduces a charge which was made or which would be made for related terminal services furnished to a railroad corporation. Section 281 and paragraphs (a) and (b) of §1.281–2 provide that the ‘‘reduced amount’’ described in paragraph (c) of §1.281–2 is not includable in gross income of the terminal railroad corporation, is not treated as a dividend or other distribution to its railroad shareholders, and is not treated as an amount paid -or incurred by the railroad shareholders to the terminal railroad corporation. Section 281 and paragraph (a)(2) of §1.281–2 provide that no deduction otherwise allowable to a terminal railroad corporation shall be disallowed as a result of the ‘‘reduced amount’’ described in paragraph (c) of §1.281–2. Section 1.281–3 defines the terms *terminal railroad corporation, related terminal income, related terminal services, agreement,* and *railroad corporation.* Section 1.281–4 describes the effective dates and special rules for application of section 281 to taxable years ending before October 23, 1962.

[T.D. 7356, 40 FR 23732, June 2, 1975]

§1.281–2 Effect of section 281 upon the computation of taxable income.

(a) *Computation of taxable income of terminal railroad corporations*—(1) *Income not considered received or accrued.* A terminal railroad corporation (as defined in paragraph (a) of §1.281–3) shall not be considered to have received or accrued the ‘‘reduced amount’’ described in paragraph (c) of this section in the computation of its taxable income. Thus, income is not to be considered accrued or actually or constructively received by a terminal railroad corporation where, in the manner described in paragraph (c) of this section, (i) a charge which would be made to any railroad corporation for related terminal services is not made, or (ii) a portion of any liability payable by any railroad corporation with respect to related terminal services is discharged.

(2) *Deduction not disallowed.* In the computation of the taxable income of a terminal railroad corporation, a deduction relating to a ''reduced amount'', described in paragraph (c) of this section, which is otherwise allowable to it under chapter 1 of the Code (without regard to sec. 277) shall not be disallowed by reason of section 281. Thus, deductions for expenses attributable to services rendered to a shareholder are not to be disallowed to a terminal railroad corporation merely because, in the manner described in paragraph (c) of this section, (i) a charge which would be made to any railroad corporation for related terminal services is not made, or (ii) a portion of any liability payable by any railroad corporation with respect to related terminal services is discharged. To the extent that section 281 applies to a deduction relating to a ''reduced amount'', such deduction shall not be disallowed under section 277.

(b) *Computation of taxable income of shareholders*—(1) *Income not considered received or accrued.* A shareholder of a terminal railroad corporation shall not be considered to have received or accrued any ''reduced amount'' (described in paragraph (c) of this section) in the computation of the shareholder's taxable income. Thus a dividend is not to be considered actually or constructively received by a shareholder of a terminal railroad corporation merely because, in the manner described in paragraph (c) of this section, (i) a charge which would be made to the shareholder or any other railroad corporation for related terminal services is not made, or (ii) a portion of any liability payable by it or any other railroad corporation with respect to related terminal services is discharged.

(2) *Expenses not considered paid or incurred.* In the computation of the taxable income of a shareholder of a terminal railroad corporation, the shareholder shall not be considered to have paid or incurred any ''reduced amount'' (described in paragraph (c) of this section). Thus, a shareholder of the terminal railroad corporation may not deduct as an expense for related terminal services (as defined in paragraph (c) of § 1.281–3) an amount in excess of the net cost to it of such services.

(c) *Amounts to which section 281 applies*—(1) *Reduced amount.* For purposes of this section, the term *reduced amount* means, subject to the limitation of paragraph (c)(4) of this section, the amount by which:

(i) A charge which would be made by a terminal railroad corporation for its taxable year for related terminal services provided to a railroad corporation; or

(ii) A liability of a railroad corporation, resulting from a charge made by a terminal railroad corporation for its taxable year, with respect to related terminal services provided by the terminal railroad corporation, is reduced by reason of the terminal railroad corporation's taking into account, pursuant to an agreement (as defined in paragraph (d) of § 1.281–3), related terminal income (as defined in paragraph (b) of § 1.281–3) received or accrued (without regard to section 281) during such taxable year.

(2) *Charge which would be made.* For purposes of this section, a ''charge which would be made'' by a terminal railroad corporation is the amount that would be charged to any railroad corporation for related terminal services provided if the terminal railroad corporation made the charge without taking related terminal income into account.

(3) *Reduction resulting from related terminal income.* For purposes of subparagraph (1) of this section, a charge or a liability is reduced by taking related terminal income into account to the extent that:

(i) Related terminal income is received or accrued (without regard to section 281) by the terminal railroad corporation for its taxable year in which the charge or liability is reduced; and

(ii) The charge or liability in question would have been larger than it is had such income not been received or accrued (without regard to section 281).

The reduction must be made (directly or indirectly) on the books of the terminal railroad corporation, and in fact, for the same taxable year for which the charge would be made or for which the liability is incurred. The reduction of the charge or liability must be taken into account by the terminal railroad corporation in ascertaining the income, profit, or loss for such taxable year for the purpose of reports to shareholders and the Interstate Commerce Commission, and for credit purposes.

(4) *Limitation.* To the extent that a reduced amount (as described in paragraph (c)(1) of this section but without regard to the limitation under this subparagraph) would operate either to create or to increase a net operating loss for the terminal railroad corporation, this section shall not apply. Therefore, if a portion of a liability is discharged (in the manner described in this paragraph) and the discharged portion of the liability exceeds an amount equal to the terminal railroad corporation's gross income minus the deductions allowed by chapter 1 of the Code (computed with regard to the modifications specified in section 172(d) but without regard to section 281 and this section), then section 281 and this section shall not apply to such excess. The limitation described in this subparagraph shall apply only to taxable years of terminal railroad corporations ending after October 23, 1962.

(d) *Examples.* The provisions of this section may be illustrated by the following examples. In these examples, references to ''before the application of section 281'', ''after the application of section 281'', ''taxable income'', and ''allowable deductions'' take no account of section 277, which may apply to deductions to which section 281 does not apply.

Example 1 (i) *Facts.* The T Company is a terminal railroad corporation which charges its three equal shareholders, the X, Y, and Z railroad corporations, a rental calculated monthly on a wheelage or user basis for the use of its services and facilities. The T Company and each of its shareholders report income on the calendar year basis. A written lease agreement to which all of the shareholders were parties was entered into in 1947. The agreement provides that at the end of each year the liabilities of each of the shareholders resulting from charges for rental obligations with respect to related terminal services shall be reduced by the shareholder's one-third share of the net income from each source of revenue that produced income (computed before reduction for Federal income taxes). For the calendar year 1973, the T Company's charges to its shareholders include the following charges for related terminal services: $35,000 to the X Company, $25,000 to the Y Company, and $20,000 to the Z Company. Thus, prior to reduction, total shareholder liabilities to the T Company for related terminal services are $80,000 at the end of 1973. The T Company's net income from all sources (before reduction of liabilities pursuant to the 1947 agreement and before reduction for Federal income taxes) and its taxable income, before the application of section 281, for 1973 are $36,000 determined as follows:

Source	Gross income	Allowable deductions	Income (or loss)
Related terminal services performed:			
For shareholders	$80,000	$65,000	$15,000
For nonshareholders	46,000	37,000	9,000
Related terminal income	126,000	102,000	24,000
Nonrelated terminal income	30,000	18,000	12,000
Total	156,000	120,000	36,000

The liability of each shareholder is, pursuant to the agreement, discharged in part by the T Company crediting $12,000 against the rental due from each shareholder for a total discharge of liabilities of $36,000 (the net income from all sources), resulting in net shareholder liabilities owing to the T Company at the end of 1973 of $44,000 ($80,000 less $36,000): $23,000 from the X Company, $13,000 from the Y Company, and $8,000 from the Z Company.

(ii) *Effect on terminal railroad corporation.* The reduced amount to which this section applies is $24,000 (related terminal income of $9,000 from nonshareholders and $15,000 from shareholders). Thus, to the extent of $24,000, the T Company is not considered to have received or accrued income from the discharged liabilities of $36,000. Similarly, to the extent of the same $24,000, the T Company is not disallowed deductions for expenses merely by reason of the discharge. The T Company's taxable income for 1973 after application of section 281 is $12,000, computed as follows:

Gross income ($156,000 less $24,000)	$132,000
Less allowable deductions	120,000
Taxable income	12,000

(iii) *Effect on shareholders*—The reduced amount of $24,000 shall not be deemed to constitute either a dividend to the shareholders of the T Company or an expense paid or incurred by them. Thus, under the facts described, neither the X Company, the Y Company, nor the Z Company shall be considered to have received or accrued a dividend of $8,000, or to have paid or incurred an expense of $8,000. Assuming the X Company's taxable income for 1973 before the application of section 281 would have been $43,200, computed in the following manner, its taxable income for 1973 after the application of section 281 is $50,000, determined as follows:

	Before the application of sec. 281	After the application of sec. 281
Gross income:		
From sources other than T Co ..	$146,000	$146,000
Dividend considered received because of T Co.'s discharge of liabilities of $12,000	12,000	4,000
Total	158,000	150,000
Less allowable deductions:		
From sources other than T Co ..	69,600	69,600
85 percent dividend received deduction under sec. 243 attributable to dividend considered received because of T Co.'s discharge of liabilities	10,200	3,400
Expenses for accrued charges for related terminal services performed by T Co	35,000	27,000
	114,800	100,000
Taxable income	43,200	50,000

Example 2. Assume the same facts as in *Example (1)*, except that the charges to each of the shareholders for related terminal services for 1973 were as follows: $35,000 to the X Company, $40,000 to the Y Company, and $5,000 to the Z Company. Assume further that the Z Company, prior to the reduction in liabilities at the end of 1973, owed the T Company an additional $4,000 resulting from charges for 1972 for related terminal services and $6,000 resulting from the purchase of equipment. Since only $21,000 (X Company $8,000, Y Company $8,000, Z Company $5,000) of the liabilities which were discharged resulted from charges made for 1973 for related terminal services, the reduced amount to which this section applies is $21,000 (instead of $24,000 as in *Example (1)*). Thus, the T Company's taxable income for 1973 would be $15,000 ($36,000 less $21,000 reduced amount) and the amount which shall be considered not to have been received or accrued as a dividend nor paid or incurred as an expense of each shareholder is $8,000 for the X Company, $8,000 for the Y Company, and $5,000 for the Z Company.

Example 3. Assume the same facts as in *Example (1)*, except that the allowable deductions with respect to nonrelated terminal activities were $39,000 instead of $18,000. The T Company's net income from all sources (before reduction for Federal income taxes) and its taxable income, before the application of section 281, is therefore $15,000, determined as follows:

Source	Gross income	Allowable deductions	Income (or loss)
Related terminal income	$126,000	$102,000	$24,000
Nonrelated terminal income	30,000	39,000	(9,000)
Total	156,000	141,000	15,000

The liability of each shareholder is nevertheless discharged in part, pursuant to the agreement, by the T Company crediting $8,000 against the rental due from each shareholder for a total discharge of liabilities of $24,000 (the net income from each source of revenue that produced income). Assume further that none of the modifications specified in section 172(d) apply. If the limitation under paragraph (c)(4) of this section were not applied, the reduced amount for the purposes of this section would be $24,000, and the operation of this section would result in a net operating loss of $9,000, since the allowable deductions of $141,000 would exceed the gross income of $132,000 ($156,000 less discharged liabilities of $24,000) by that amount. Because of the limitation under paragraph (c)(4) of this section, however, $9,000 is not included in the reduced amount to which this section applies. Accordingly, the reduced amount is $15,000 (instead of $24,000 as in *Example (1)*). Thus, the T Company's taxable income for 1973 would be zero ($15,000 less the $15,000 reduced amount), and the amount which each shareholder shall be considered not to have received or accrued as a dividend nor paid or incurred as an expense is $5,000.

Example 4. Assume the same facts as in *Example (1)*, except that under the agreement income from the terminal parking lot would not reduce the shareholders' liabilities. Assume further that such income amounted to $3,000 of the total related terminal income of $24,000 for the taxable year 1973. The liability of each shareholder therefore is discharged by crediting $11,000 against its rental due for a total discharge of liabilities of $33,000. The reduced amount to which this section applies is $21,000 ($24,000 less $3,000) since only to the extent of $21,000 would there have been no such reduction under the agreement if there were no related terminal income.

Example 5. Assume the same facts as in *Example (1)*, except that, pursuant to the agreement, the A Company, a nonshareholder railroad corporation, is to have its liabilities resulting from charges for rental obligations reduced equally with each of the shareholders. Assume further that the T Company's charges to the A Company for the calendar year 1973 included $15,000 for related terminal services and that the liability of each shareholder and the A Company is discharged in part pursuant to the agreement by the T Company crediting $9,000 against the rental due from each. The reduced amount to which this section applies is $24,000. Thus, the T Company's taxable income for 1973 is $12,000, and each shareholder shall not be considered to have received or accrued as a dividend nor paid or incurred as an expense $6,000 ($24,000/ $36,000 × $9,000) merely because of the discharge of its own liability. Similarly, each shareholder shall not be considered to have received or accrued as a dividend nor paid or incurred as an expense $2,000 (1/3 × ($24,000/$36,000 × $9,000)) merely because of the discharge of the liability of the A Company. Section 281 does not apply to the determination of the tax consequences of the transaction to the A Company. Similarly, the section does not apply to the determination of the tax consequences to the shareholders resulting from that portion of the discharge of the liability of the A Company which is attributable to the application of income which is not related terminal income ($3,000). Hence, such consequences shall be determined under the sections of the Internal Revenue Code which govern in the absence of section 281.

Example 6. (i) Facts. The TR Company is a terminal railroad corporation with three equal shareholders, the M, N, and O Railroad Corporations. The TR Company and each of its shareholders report income on the calendar year basis. Pursuant to a written agreement entered into in 1947 to which all shareholders were parties, the TR Company makes one annual charge to each of the three shareholders at the end of each year for the difference between the cost of operations, allocated on a wheelage or user basis for the use of its services and facilities provided to the shareholder during the year, and one-third of its net income from all other sources (computed before reduction for Federal income taxes). The TR Company's taxable income, before the application of section 281, for 1973 is $21,000 determined as follows:

Source	Gross income	Allowable deductions	Income (or loss)
Related terminal services performed:			
For shareholders ..	$65,000	$65,000	0
For nonshareholders	46,000	37,000	$9,000
Related terminal income	111,000	102,000	9,000
Nonrelated terminal income from nonshareholders	30,000	18,000	12,000
Total	141,000	120,000	21,000

For the calendar year 1973, the TR company's charges to its shareholders are $23,000 ($30,000 less $7,000) to the M company, $13,000 ($20,000 less $7,000) to the N company, and $8,000 ($15,000 less $7,000) to the O company for a total of $44,000 for related terminal services.

(ii) *Effect on terminal railroad corporation.* The reduced amount to which this section applies is $9,000. The TR company is not considered to have received or accrued income of $9,000 (related terminal income) merely because the charge of $21,000 (net income from all sources other than shareholders) was not made. Similarly, to the extent of $9,000, the TR company is not disallowed deductions for expenses merely because the full cost of services was not charged. The TR company's taxable income for 1973 after application of section 281, is $12,000, computed as follows:

Gross income ($141,000 less $9,000 charges not made)	$132,000
Less allowable deductions	120,000
Taxable income	12,000

(iii) *Effect on shareholders.* Neither the M company, the N company, nor the O company shall be considered to have received or accrued a dividend of $3,000 nor to have paid or incurred an expense of $3,000 merely by reason of the reduced charges. Thus, assuming the M company's taxable income for 1973 before the application of section 281 would have been $47,450, computed in the following manner, its taxable income for 1973 after the application of section 281 is $50,000, determined as follows:

	Before the application of sec. 281	After the application of sec. 281
Gross income:		
From sources other than TR Co	$146,000	$146,000
Dividend considered received because of TR Co.'s reduction of charges	7,000	4,000
Total	153,000	150,000
Less allowable deductions:		
From sources other than TR Co	69,600	69,600
85 percent dividend received deduction under sec. 243 attributable to dividend considered received because of TR Co.'s reduction of charges	5,950	3,400

	Before the application of sec. 281	After the application of sec. 281
Expenses for accrued charges for related terminal services performed by TR Co	30,000	27,000
	105,550	100,000
Taxable income	47,450	50,000

[T.D. 7356, 40 FR 23733, June 2, 1975]

§ 1.281–3 Definitions.

(a) *Terminal railroad corporation.* The term *terminal railroad corporation* means a corporation which, in the taxable year, meets all of the following conditions:

(1) The corporation and each of its shareholders must be domestic corporations. Thus, all of the shareholders of the corporation, as well as the corporation itself, must be corporations which were organized or created in the United States, including only the States and the District of Columbia, or under the law of the United States or of any State or territory.

(2) All of the shareholders must be railroad corporations which are subject to Part I of the Interstate Commerce Act. Thus, if any shareholder of the corporation, regardless of the class or percentage of stock owned, is not subject to the jurisdiction of the Interstate Commerce Commission under part I of that Act, the corporation cannot qualify as a terminal railroad corporation.

(3) The corporation must not be a member of an affiliated group of corporations (as defined in section 1504), other than as a common parent corporation. For this purpose it is immaterial whether or not the affiliated group has ever made a consolidated income tax return. Thus, if the X railroad corporation owns 80 percent of all of the outstanding stock of the Y railroad corporation, the X railroad corporation may qualify, but the Y railroad corporation cannot qualify, as a terminal railroad corporation.

(4) The primary business of the corporation must be that of providing to domestic railroad corporations subject to Part I of the Interstate Commerce Act and to the shippers and passengers of such railroad corporations one or more of the following facilities or services: (i) Railroad terminal facilities, (ii) railroad switching facilities, (iii) railroad terminal services, or (iv) railroad switching services. The designated facilities and services include the furnishing of terminal trackage, the operation of stockyards or a union passenger or freight station, and the operation of railroad bridges and ferries. The providing of the designated facilities includes the leasing of those facilities. A corporation shall be considered as having established that its primary business is that of providing the designated facilities and services if more than 50 percent of its gross income (computed without regard to section 281, and excluding dividends and gains and losses from the disposition of capital assets or property described in section 1231(b)) for the taxable year is derived from those sources. The fact that income from a service or facility is included within the definition of related terminal income is immaterial for purposes of determining whether that service or facility is one which is designated in this subparagraph. Thus, although income from the operation of a commuter railroad line may be related terminal income, a corporation whose primary business is the operation of that facility is not a terminal railroad corporation, since its primary business is not the providing of the designated facilities or services.

(5) A substantial part of the services rendered by the corporation for the taxable year must be rendered to one or more of its shareholders. For purposes of this requirement, providing the use of facilities shall be considered the rendering of services.

(6) Each shareholder of the corporation must compute its taxable income on the basis of a taxable year which either begins or ends on the same day as the taxable year of the corporation.

(b) *Related terminal income*—(1) *In general.* Related terminal income is, generally, the type of income normally earned from the operation of a railroad terminal. The term *related terminal income* means the taxable income (computed without regard to sections 172, 277, or 281) which the terminal railroad corporation derives for the taxable year from the sources enumerated in paragraph (b)(2) of this section. Related terminal income must be derived from direct provision of the specified facilities or services by the terminal corporation itself. Thus, income consisting of rent from a lease of a terminal facility by a terminal corporation to a railroad user would qualify; but dividends from a corporation in which the terminal corporation owned stock and which provided such facilities or services to others would not qualify. The term does not include gain or loss derived from the sale, exchange, or other disposition of capital assets or section 1231 assets, whether or not section 1245 or section 1250 applies to part or all of that gain. For example, the term does not apply to gain from the sale of a terminal building or terminal equipment. All direct and indirect expenses and other deductible items attributable to related terminal services or facilities shall be deducted in determining related terminal income. Attribution shall be determined in accordance with customary railroad accounting practices accepted by the Interstate Commerce Commission, except that interest paid with respect to the indebtedness of a terminal railroad corporation shall be deducted from related terminal income to the extent that the proceeds from the indebtedness were directly or indirectly applied to facilities or activities producing such income. The district director may either accept the use of the taxpayer's method of determining the application of the proceeds of all indebtedness of such corporation or prescribe the use of another method which, under all the facts and circumstances, appears to reflect more accurately the probable application of such proceeds.

(2) *Sources of related terminal income.* The term *related terminal income* includes only income derived from one or more of the following sources:

(i) From services or facilities of a character ordinarily and regularly provided by terminal railroad corporations for railroad corporations or for the employees, passengers, or shippers of railroad corporations. Whether the services or facilities are of a character ordinarily and regularly provided by terminal railroad corporations is to be determined by accepted industry practice. The fact that nonterminal businesses may also provide such services or facilities is immaterial. However, there must be a direct relationship between the service or facility provided and the operation of the terminal, including the operation of its trackage and switching facilities. Thus, the term *related terminal income* includes income derived from operating or leasing switching facilities and terminal facilities, such as income from charges to railroad corporations for the use of a union passenger or freight station. Also included for this purpose is income derived from charges to railroad shippers, including express companies and freight forwarders, for the use of sheds or warehouses, even though not directly intended for railroad use. The term includes income derived from leasing or operating restaurants, drugstores, barbershops, newsstands, ticket agencies, banking facilities, car rental facilities, or other similar facilities for passengers, in waiting rooms or along passenger concourses. Similarly, the term includes income derived from operating or leasing passenger parking facilities, and from renting taxicab space, located on or adjacent to the terminal premises. Although the term does include income derived from the operation of a small hotel operated primarily for and usually occupied primarily by the employees of the railroad corporations, it does not include income derived from the operation of a hotel for passengers or other persons.

(ii) From any railroad corporation for services or facilities provided by the terminal railroad corporation in connection with railroad operations. A service or a facility is provided in connection with railroad operations if it is of a character ordinarily and regularly availed of by railroad corporations. For purposes of this subdivision, the income must be derived from railroad corporations. Thus, in addition to the income derived from sources described in paragraph (b)(2)(i) of this section, the term *related terminal income* includes income derived from switching facilities or leasing to any railroad corporation, or operating for the benefit of such corporation, a beltline or bypass railroad leading to or from the terminal premises. Also included are income derived from the rental of office space (whether or not services are provided to the occupants) in the terminal building to any railroad corporation for that corporation's administrative or operating divisions, and income derived from tolls charged to any railroad corporation for the use of a railroad bridge or ferry.

(iii) From the use by persons other than railroad corporations of a portion of a facility, or of a service, which is used primarily for railroad purposes. A facility or service is used primarily for railroad purposes if the predominant reason for its continued operation or provision is the furnishing of facilities or services described in either subdivision (i) or (ii) of this subparagraph. The determination required by this subdivision is to be made independently for each separate facility or service. Two substantial portions of a single structure may be considered separate facilities, depending upon the respective uses made of each. Moreover, any substantial addition, constructed after October 23, 1962, to a facility shall be considered a separate facility.

The term *related terminal income* includes income produced by operating a commuter service or by renting tracks and facilities for a commuter service to an independent operator. The term also includes the sale or rental of advertising space at a terminal facility. If the conditions described in this subdivision are satisfied, the term *related terminal income* may include income which has no connection with the operation of the terminal. Thus, if a terminal railroad corporation operates a railroad bridge primarily to provide railroad corporations a means of crossing a river and the lower level of the bridge contains a roadway for similar use by automobiles, the term includes income derived from the tolls charged to the automobiles for the use of the bridge roadway. However, upon the discontinuance of operations of the railroad level of the bridge, the term would cease to include the automobile tolls. If excess steam from a steam plant operated primarily to supply steam to the terminal is sold to another business in the neighborhood, the term would include the income derived from such sale. However, because an oil or gas well or a mine constitutes a separate facility, the term *related terminal income* does not include income derived in any form from a deposit of oil, natural gas, or any other mineral located on property owned or leased by the terminal railroad corporation.

Similarly, while the term includes income derived from the rental of a small number of offices located in the terminal building (whether or not the lessees are railroad corporations), it does not include income derived from the leasing or operation, for the use of the general public, of a large number of offices or a large number of rooms for lodging, whether or not the space is physically part of the same structure as the terminal. Moreover, the term does not include income derived from the rental of offices to the general public in an addition to the terminal building constructed after October 23, 1962, unless the addition is primarily used for railroad purposes and the offices rented to the general public do not constitute a separate facility in the addition. Whether or not income from the addition is determined to be related terminal income, the income from the small number of offices which were included in the terminal building before the addition was constructed shall continue to be related terminal income.

(iv) From the United States in payment for facilities or services in connection with mail handling. The income must be derived directly from the U.S. Government, or any agency thereof (including for this purpose the U.S. Postal Service), through the receipt of payments for mail-handling facilities or services. Thus, the term would include income derived from the rental of space for a post office for use by the general public on the terminal premises or from the sorting of mail in a railroad box car.

(3) *Illustration*. The provisions of this paragraph may be illustrated by the following example:

Example. For its calendar year 1973, the R Company, a terminal railroad corporation, has taxable income of $36,000, before the application of section 281 and taking no account of section 277, determined as follows:

Gross income:	
Switching charges	$50,000
Express companies	2,000
Commuter line	4,000
U.S. mail handling	4,000
Railroad bridge tolls:.	
From railroads	2,000
From automobiles	1,000
Total	3,000
Station and train charges	47,000
Terminal parking lot	4,000
Rent from terminal building:	
Passenger facilities (ground level)	8,000
Offices leased to railroads (2d floor)	3,000
Offices leased to others (2d floor)	1,000
Hotel open to public (3d through 6th floors)	14,000
Total	26,000
Interest received from bond investments	1,500
Dividends received from wholly owned subsidiary	10,000
Amount realized from sale of equipment	6,000
Less:	
Adjusted basis	1,000
Expenses of sale	500
	1,500
	4,500
	156,000
Allowable deductions:	
Dividend received deduction	8,500
Interest paid:	
On loan for hotel furnishings	1,500
On loan for rolling stock	2,000
	3,500
Maintenance, depreciation, management and other expenses:	
Attributable to hotel	3,000
Attributable to parking lot	1,000
Attributable to U.S. mail handling	1,000
All other	98,000
	103,000
Loss from sale of securities	3,000
Charitable contribution	500
Net operating loss deduction	1,500
	120,000
Taxable income before the application of sec. 281	36,000

The R Co.'s related terminal income for 1973 is $24,000, computed as follows:

Taxable income (before the application of sec. 281)	36,000
Less:	
Dividend received	10,000
Minus dividend received deduction	8,500
	1,500
Interest received	1,500
Amount realized from sale of equipment	6,000
Less:	
Adjusted basis	1,000
Expense of sale	500
	1,500
	4,500
Hotel income	14,000
Less:	
Interest paid on loan for hotel	1,500
Other hotel expenses	3,000
	4,500
	9,500
	17,000
	19,000
Add:	
Loss from sale of securities	3,000
Charitable contribution	500
Net operating loss deduction	1,500
	5,000
Related terminal income	24,000

(c) *Related terminal services.* The term *related terminal services* means only the services or the use of facilities, provided by the terminal railroad corporation, which are taken into account in computing related terminal income. Thus, the term includes the providing of terminal and switching services, the furnishing of terminal and switching facilities including the furnishing of terminal trackage, and the operation of bridges and ferries for railroad purposes. For example, upon the facts of the example in the preceding paragraph, the charges for related terminal services are $126,000, determined as follows:

Switching charges	$50,000
Express companies	2,000
Commuter line	4,000
U.S. mail handling	4,000
Railroad bridge tolls	3,000
Station and train charges	47,000
Terminal parking lot	4,000
Rent from:	
Passenger facilities	8,000
Offices	4,000
Total	126,000

(d) *Agreement.* As used in section 281 and §1.281–2 the term *agreement* means a written contract, entered into before the beginning of the terminal railroad corporation's taxable year in question, to which all shareholders of the terminal railroad corporation are parties. The fact that other railroad corporations or persons are also parties will not disqualify an agreement. Section 281 applies only if, and to the extent that, the reduction of the liability or charge that would be made, as described in paragraph (c) of §1.281–2, results from the agreement. Thus, where the other conditions of the statute are met, section 281 applies if a written agreement, to which all of the shareholders were parties and which was entered into prior to the beginning of the terminal railroad corporation's taxable year, provides that the net revenues of the terminal railroad corporation are to be applied as a reduction of what would otherwise be the charge for the taxable year for related terminal services provided to the shareholders. Similarly, section 281 applies, where its other requirements are fulfilled, if the agreement provides that the net revenues are to be credited against rental obligations resulting from related terminal services furnished to shareholders. However, section 281 does not apply where the agreement provides that the net revenues are to be divided among the shareholders and distributed to them in cash or held subject to their unconditional right of withdrawal instead of being applied to the computation of charges, or in reduction of liabilities incurred, for related terminal services.

(e) *Railroad corporation.* For purposes of section 281, § 1.281–2, and this section, the term *railroad corporation* means any corporation (regardless of whether it is a shareholder of the terminal railroad corporation) that is engaged as a common carrier in the furnishing or sale of transportation by railroad, or is a lessor of railroad equipment or facilities. For purposes of the preceding sentence, a corporation is a lessor of railroad equipment or facilities only if (1) it is subject to part I of the Interstate Commerce Act, (2) substantially all of its railroad properties have been leased to a railroad corporation or corporations, (3) each lease is for a term of more than 20 years, and (4) 80 percent or more of its gross income for the taxable year is derived for such leases.

[T.D. 7356, 40 FR 23735, June 2, 1975]

§ 1.281–4 Taxable years affected.

(a) *In general.* Except as provided in paragraph (b) of this section, the provisions of section 281 and §§ 1.281–2 and 1.281–3 shall apply to all taxable years to which either the Internal Revenue Code of 1954 or the Internal Revenue Code of 1939 apply.

(b) *Taxable years ending before October 23, 1962.* (1)(i) In the case of a taxable year of a terminal railroad corporation ending before October 23, 1962, section 281 (a) shall apply only to the extent that the terminal railroad corporation *(a)* computed its taxable income on its return for such taxable year as if the ''reduced amount'', described in paragraph (c) of § 1.281–2, were not received or accrued, and *(b)* did not decrease its otherwise allowable deductions for such taxable year on account of that ''reduced amount''. Similarly, in the case of a taxable year of a shareholder of a terminal railroad corporation ending before October 23, 1962, section 281(b) shall apply only to the extent that such shareholder computed its taxable income on its return for such taxable year as if the shareholder had neither received or accrued as a dividend nor paid or incurred as an expense the ''reduced amount'' described in paragraph (c) of § 1.281–2. Such return must have been filed on or before the due date (including the period of any extension of time) for filing the return for the applicable taxable year. The fact that an amended return or claim for refund or credit of overpayment was subsequently filed, or a deficiency subsequently assessed, based upon a computation of taxable income which is inconsistent with the manner in which the taxable income was computed on the timely filed return, is immaterial.

(ii) The provisions of this paragraph may be illustrated by the following examples:

Example 1. The G Company is a terminal railroad corporation which in 1960 reduced the liabilities resulting from charges to its shareholders, pursuant to a 1947 written agreement, by its income from nonshareholder sources. For the calendar year 1960, the G Company's related terminal income was $24,000, of which $3,000 is attributable to income from the United States in payment for facilities and services in connection with mail handling. Although the shareholders' liabilities were reduced by $24,000 as a result of taking related terminal income earned during the taxable year into account, on its timely filed 1960 income tax return the G Company treated the $3,000 of liabilities which were reduced on account of income from mail handling as gross income received or accrued during the year. Assuming that the provisions of § 1.281–2 otherwise apply, their application to the determination of the 1960 tax liability of the G Company shall not extend to the entire ''reduced amount'' of

$24,000, but shall be limited to $21,000 of that amount.

Example 2. Assume the same facts as in *Example (1),* and the following additional facts. The G Company had three shareholders in 1960, and an equal discharge of liability of $8,000 resulted for each of them on account of related terminal income. Each shareholder treated, on its timely filed 1960 income tax return, $1,000 of its liabilities, which were so reduced and were attributable to income from the United States in payment for facilities and services in connection with mail handling, as if it had received $1,000 from the G Company as a dividend and paid that $1,000 to the G Company for services. Each shareholder treated the remaining $7,000 of its liabilities which were so reduced as if the liabilities which were reduced had never been incurred. Assuming that the provisions of §1.281–2 otherwise apply, each shareholder shall not be considered to have received or accrued as a dividend, nor to have paid or incurred as an expense $7,000 (instead of $8,000).

(2) For any taxable year of a terminal railroad corporation ending before October 23, 1962, a claim for refund or credit of overpayment of income tax based upon section 281 may be filed, even though such refund or credit of overpayment was otherwise barred by operation of any law or rule of law on October 23, 1962, subject to the conditions set forth in paragraph (b)(2)(i) through (v) of this section.

(i) The claim for refund or credit of overpayment must not have been barred by a closing agreement (under either section 3760 of the Internal Revenue Code of 1939 or section 7121 of the Internal Revenue Code of 1954), or by a compromise (under section 3761 of the Internal Revenue Code of 1939 or section 7122 of the Internal Revenue Code of 1954);

(ii) The claim for refund or credit of overpayment shall be allowed only to the extent that the overpayment of income tax results from the recomputation of the terminal railroad corporation's taxable income in the manner described in paragraph (a) of §1.281–2;

(iii) The claim for refund or credit of the overpayment must have been filed prior to October 23, 1963;

(iv) The claim for refund or credit of overpayment shall be allowed only to the extent that the manner in which the terminal railroad corporation's taxable income is recomputed is the manner in which the terminal railroad corporation's taxable income was computed on its timely filed income tax return for such taxable year; and

(v) Each railroad corporation which was a shareholder of the terminal railroad corporation during such taxable year must consent in writing to the assessment, within such period as may be agreed upon with the district director, of any deficiency for any year (even though assessment of the deficiency would otherwise be prevented by the operation of any law or rule of law at the time of filing the consent) to the extent that:

(A) The deficiency is attributable to the recomputation of the shareholder's taxable income in the manner described in paragraph (b) of §1.281–2, and

(B) The deficiency results from the shareholder's allocable portion of the ''reduced amount'' (described in paragraph (c) of §1.281–2) which gives rise to the refund or credit granted to the terminal railroad corporation under this subparagraph.

[T.D. 7356, 40 FR 23737, June 2, 1975]

SUBCHAPTER A—INCOME TAX (Continued)

PART 1—INCOME TAXES (Continued)

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1.382–2T Definition of ownership change under section 382, as amended by the Tax Reform Act of 1986 (temporary).
1.382–3 Definitions and rules relating to a 5–percent shareholder.
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1.382–6 Allocation of income and loss to periods before and after the change date for purposes of section 382.
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1.382–8 Controlled groups. [Reserved]
1.382–8T Controlled groups (temporary).
1.382–9 Special rules under section 382 for corporations under the jurisdiction of a court in a title 11 or similar case.
1.382–10 [Reserved]
1.382–11 Effective dates. [Reserved]
1.383–0 Effective date.
1.383–1 Special limitations on certain capital losses and excess credits.
1.383–2 Limitations on certain capital losses and excess credits in computing alternative minimum tax. [Reserved]

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Section 1.304–5 also issued under 26 U.S.C. 304.

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Section 1.367(b)–1 also issued under 26 U.S.C. 367(a) and (b).

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Section 1.367(b)–4 also issued under 26 U.S.C. 367(a) and (b).

Section 1.367(b)–7 also issued under 26 U.S.C. 367(a) and (b).

Section 1.367(b)–8 also issued under 26 U.S.C. 367(b).

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Section 1.367(e)–1T also issued under 26 U.S.C. 367(e)(1).

Section 1.382–2 also issued under 26 U.S.C. 382(k)(1), (l)(3), (m), and 26 U.S.C. 383.

Section 1.382–2T also issued under 26 U.S.C. 382(g)(4)(C), (i), (k)(1) and (6), (l)(3), (m), and 26 U.S.C. 383.

Section 1.382–3 also issued under 26 U.S.C. 382(m).

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Section 1.382–5T also issued under 26 U.S.C. 382(m).

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Section 1.382–8T also issued under 26 U.S.C. 382(m).

Section 1.382–9 also issued under 26 U.S.C. 382(l)(3) and (m).

Section 1.383–1 also issued under 26 U.S.C. 383.

Section 1.383–2 also issued under 26 U.S.C. 383.

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CORPORATE DISTRIBUTIONS AND ADJUSTMENTS

DISTRIBUTIONS BY CORPORATIONS

EFFECTS ON RECIPIENTS

§ 1.301–1 Rules applicable with respect to distributions of money and other property.

(a) *General.* Section 301 provides the general rule for treatment of distributions on or after June 22, 1954, of property by a corporation to a shareholder with respect to its stock. The term *property* is defined in section 317(a). Such distributions, except as otherwise provided in this chapter, shall be treated as provided in section 301(c). Under section 301(c), distributions may be included in gross income, applied against and reduce the adjusted basis of the stock, treated as gain from the sale or exchange of property, or (in the case of certain distributions out of increase in value accrued before March 1, 1913) may be exempt from tax. The amount of the distributions to which section 301 applies is determined in accordance with the provisions of section 301(b). The basis of property received in a distribution to which section 301 applies is determined in accordance with the provisions of section 301(d). Accordingly, except as otherwise provided in this chapter, a distribution on or after June 22, 1954, of property by a corporation to a shareholder with respect to its stock shall be included in gross income to the extent the amount distributed is considered a dividend under section 316. For examples of distributions treated otherwise, see sections 116, 301(c)(2), 301(c)(3)(B), 301(e), 302(b), 303, and 305. See also part II (relating to distributions in partial or complete liquidation), part III (relating to corporate organizations and reorganizations), and part IV (relating to insolvency reorganizations), subchapter C, chapter 1 of the Code.

(b) *Time of inclusion in gross income and of determination of fair market value.* A distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands. However, if such distribution is a distribution other than in cash, the fair market value of the property shall be determined as of the date of distribution without regard to whether such date is the same as that on which the distribution is includible in gross income. For example, if a corporation distributes a taxable dividend in property (the adjusted basis of which exceeds its fair market value on December 31, 1955) on December 31, 1955, which is received by, or unqualifiedly made subject to the demand of, its shareholders on January 2, 1956, the amount to be included in the gross income of the shareholders will be the fair market value of such property on December 31, 1955, although such amount will not be includible in the gross income of the shareholders until January 2, 1956.

(c) *Application of section to shareholders.* Section 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such.

(d) *Distributions to corporate shareholders.* (1) If the shareholder is a corporation, the amount of any distribution to be taken into account under section 301(c) shall be:

(i) The amount of money distributed,

(ii) An amount equal to the fair market value of any property distributed which consists of any obligations of the distributing corporation, stock of the distributing corporation treated as property under section 305(b), or rights to acquire such stock treated as property under section 305(b), plus

(iii) In the case of a distribution not described in subdivision (iv) of this subparagraph, an amount equal to (*a*) the fair market value of any other property distributed or, if lesser, (*b*) the adjusted basis of such other property in the hands of the distributing corporation (determined immediately before the distribution and increased for any gain recognized to the distributing corporation under section 311 (b), (c), or (d), or under section 341(f), 617(d), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a)), or

(iv) In the case of a distribution made after November 8, 1971, to a shareholder which is a foreign corporation, an amount equal to the fair market value of any other property distributed, but only if the distribution received by such shareholder is not effectively connected for the taxable year with the conduct of a trade or business in the United States by such shareholder.

(2) In the case of a distribution the amount of which is determined by reference to the adjusted basis described in subparagraph (1)(iii)(*b*) of this paragraph:

(i) That portion of the distribution which is a dividend under section 301(c)(1) may not exceed such adjusted basis, or

(ii) If the distribution is not out of earnings and profits, the amount of the reduction in basis of the shareholder's stock, and the amount of any gain resulting from such distribution, are to be determined by reference to such adjusted basis of the property which is distributed.

(3) Notwithstanding paragraph (d)(1)(iii), if a distribution of property described in such paragraph is made after December 31, 1962, by a foreign corporation to a shareholder which is a corporation, the amount of the distribution to be taken into account under section 301(c) shall be determined under section 301(b)(1)(C) and paragraph (n) of this section.

(e) *Adjusted basis.* In determining the adjusted basis of property distributed in the hands of the distributing corporation immediately before the distribution for purposes of section 301(b)(1)(B)(ii), (b)(1)(C)(i), and (d)(2)(B), the basis to be used shall be the basis for determining gain upon a sale or exchange.

(f) *Examples.* The application of this section (except paragraph (n)) may be illustrated by the following examples:

Example (1). On January 1, 1955, A, an individual owned all of the stock of Corporation M with an adjusted basis of $2,000. During 1955, A received distributions from Corporation M totaling $30,000, consisting of $10,000 in cash and listed securities having a basis in the hands of Corporation M and a fair market value on the date distributed of $20,000. Corporation M's taxable year is the calendar year. As of December 31, 1954, Corporation M had earnings and profits accumulated after February 28, 1913, in the amount of $26,000, and it had no earnings and profits and no deficit for 1955. Of the $30,000 received by A, $26,000 will be treated as an ordinary dividend; the remaining $4,000 will be applied against the adjusted basis of his stock; the $2,000 in excess of the adjusted basis of his stock will either be treated as gain from the sale or exchange of property (under section 301(c)(3)(A)) or, if out of increase in value accrued before March 1, 1913, will (under section 301(c)(3)(B)) be exempt from tax. If A subsequently sells his stock in Corporation M, the basis for determining gain or loss on the sale will be zero.

Example (2). The facts are the same as in Example 1 with the exceptions that the shareholder of Corporation M is Corporation W and that the securities which were distributed had an adjusted basis to Corporation M of $15,000. The distribution received by Corporation W totals $25,000 consisting of $10,000 in cash and securities with an adjusted basis of $15,000. The total $25,000 will be treated as a dividend to Corporation W since the earnings and profits of Corporation M ($26,000) are in excess of the amount of the distribution.

Example (3). Corporation X owns timber land which it acquired prior to March 1, 1913, at a cost of $50,000 with $5,000 allocated as the separate cost of the land. On March 1, 1913, this property had a fair market value of $150,000 of which $135,000 was attributable to the timber and $15,000 to the land. All of the timber was cut prior to 1955 and the full appreciation in the value thereof, $90,000 ($135,000 − $45,000), realized through depletion allowances based on March 1, 1913, value. None of this surplus from realized appreciation had been distributed. In 1955, Corporation X sold the land for $20,000 thereby realizing a gain of $15,000. Of this gain, $10,000 is due to realized appreciation in value which accrued before March 1, 1913 ($15,000 − $5,000). Of the gain of $15,000, $5,000 is taxable. Therefore, at December 31, 1955, Corporation X had a surplus from realized appreciation in the amount of $100,000. It had no accumulated earnings and profits and no deficit at January 1, 1955. The net earnings for 1955 (including the $5,000 gain on the sale of the land) were $20,000. During 1955, Corporation X distributed $75,000 to its stockholders. Of this amount, $20,000 will be treated as a dividend. The remaining $55,000, which is a distribution of realized appreciation, will be applied against and reduce the adjusted basis of the shareholders' stock. If any part of the $55,000 is in excess of the adjusted basis of a shareholder's stock, such part will be exempt from tax.

(g) *Reduction for liabilities.* For the purpose of section 301(a), the amount of any distribution shall be reduced by—

(1) The amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and

(2) The amount of any liability to which the property received by the shareholder is subject immediately before and immediately after the distribution.

Such reduction, however, shall not cause the amount of the distribution to be reduced below zero.

(h) *Basis.* The basis of property received in the distribution to which section 301 applies shall be—

(1) If the shareholder is not a corporation, the fair market value of such property;

(2) If the shareholder is a corporation—

(i) In the case of a distribution of the obligations of the distributing corporation or of the stock of such corporation or rights to acquire such stock (if such stock or rights are treated as property under section 305(b)), the fair market value of such obligations, stock, or rights;

(ii) In the case of the distribution of any other property, except as provided in subdivision (iii) (relating to certain distributions by a foreign corporation) or subdivision (iv) (relating to certain distributions to foreign corporate distributees) of this subparagraph, whichever of the following is the lesser—

(*a*) The fair market value of such property; or

(*b*) The adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property increased in the amount of gain to the distributing corporation which is recognized under section 311(b) (relating to distributions of LIFO inventory), section 311(c) (relating to distributions of property subject to liabilities in excess of basis), section 311(d) (relating to appreciated proterty used to redeem stock), section 341(f) (relating to certain sales of stock of consenting corporations), section 617(d) (relating to gain from dispositions of certain mining property), section 1245(a) or 1250(a) (relating to gain from dispositions of certain depreciable property), section 1251(c) (relating to gain from disposition of farm recapture property), section 1252(a) (relating to gain from disposition of farm land), or 1254(a) (relating to gain from disposition of interest in natural resource recapture property);

(iii) In the case of the distribution by a foreign corporation of any other property after December 31, 1962, in a distribution not described in subdivision (iv) of this subparagraph, the amount determined under paragraph (n) of this section;

(iv) In the case of the distribution of any other property made after November 8, 1971, to a shareholder which is a foreign corporation, the fair market value of such property, but only if the distribution received by such shareholder is not effectively connected for the taxable year with the conduct of a trade or business in the United States by such shareholder.

(i) [Reserved]

(j) *Transfers for less than fair market value.* If property is transferred by a corporation to a shareholder which is not a corporation for an amount less than its fair market value in a sale or exchange, such shareholder shall be treated as having received a distribution to which section 301 applies. In such case, the amount of the distribution shall be the difference between the amount paid for the property and its fair market value. If property is transferred in a sale or exchange by a corporation to a shareholder which is a corporation, for an amount less than its fair market value and also less than its adjusted basis, such shareholder shall be treated as having received a distribution to which section 301 applies, and—

(1) Where the fair market value of the property equals or exceeds its adjusted basis in the hands of the distributing corporation the amount of the distribution shall be the excess of the adjusted basis (increased by the amount of gain recognized under section 311 (b), (c), or (d), or under section 341(f), 617(d), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a) to the distributing corporation) over the amount paid for the property;

(2) Where the fair market value of the property is less than its adjusted basis in the hands of the distributing corporation, the amount of the distribution shall be the excess of such fair market value over the amount paid for the property. If property is transferred in a sale or exchange after December 31, 1962, by a foreign corporation to a shareholder which is a corporation for an amount less than the amount which would have been computed under paragraph (n) of this section if such property had been received in a distribution to which section 301 applied, such shareholder shall be treated as having received a distribution to which section 301 applies, and the amount of the distribution shall be the excess of the amount which would have been computed under paragraph (n) of this section with respect to such property over the amount paid for the property. In all cases, the earnings and profits of the distributing corporation shall be decreased by the excess of the basis of the property in the hands of the distributing corporation over the amount received therefor. In computing gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of the distribution.

If property is transferred in a sale or exchange after December 31, 1962, by a foreign corporation to a shareholder which is a corporation for an amount less than the amount which would have been computed under paragraph (n) of this section if such property had been received in a distribution to which section 301 applied, such shareholder shall be treated as having received a distribution to which section 301 applies, and the amount of the distribution shall be the excess of the amount which would have been computed under paragraph (n) of this section with respect to such property over the amount paid for the property. Notwithstanding the preceding provisions of this paragraph, if property is transferred in a sale or exchange after November 8, 1971, by a corporation to a shareholder which is a foreign corporation, for an amount less than its fair market value, and if paragraph (d)(1)(iv) of this section would apply if such property were received in a distribution to which section 301 applies, such shareholder shall be treated as having received a distribution to which section 301 applies and the amount of the distribution shall be the difference between the amount paid for the property and its fair market value. In all cases, the earnings and profits of the distributing corporation shall be decreased by the excess of the basis of the property in the hands of the distributing corporation over the amount received therefor. In computing gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of the distribution.

(k) *Application of rule respecting transfers for less than fair market value.* The application of paragraph (j) of this section may be illustrated by the following examples:

Example (1). On January 1, 1955, A, an individual shareholder of corporation X, purchased property from that corporation for $20. The fair market value of such property was $100, and its basis in the hands of corporation X was $25. The amount of the distribution determined under section 301(b) is $80. If A were a corporation, the amount of the distribution would be $5 (assuming that sections 311 (b) and (c), 1245(a), and 1250(a) do not apply), the excess of the basis of the property in the hands of corporation X over the amount received therefor. The basis of such property to corporation A would be $25. If the basis of the property in the hands of corporation X were $10, the corporate shareholder, A, would not receive a distribution. The basis of such property to corporation A would be $20. Whether or not A is a corporation, the excess of the amount paid over the basis of the property in the hands of corporation X ($20 over $10) would be a taxable gain to corporation X.

Example (2). On January 1, 1963, corporation A, which is a shareholder of corporation B (a foreign corporation engaged in business within the United States), purchased one share of corporation X stock from B for $20. The fair market value of the share was $100, and its adjusted basis in the hands of B was $25. Assume that if the share of corporation X stock had been received by A in a distribution to which section 301 applied, the amount of the distribution under paragraph (n) of this section would have been $55. The amount of the distribution under section 301 is $35, i.e., $55 (amount computed under paragraph (n) of this section) minus $20 (amount paid for the property). The basis of such property to A is $55.

(l) *Transactions treated as distributions.* A distribution to shareholders with respect to their stock is within the terms of section 301 although it takes place at the same time as another transaction if the distribution is in substance a separate transaction whether or not connected in a formal sense. This is most likely to occur in the case of a recapitalization, a reincorporation, or a merger of a corporation with a newly organized corporation having substantially no property. For example, if a corporation having only common stock outstanding, exchanges one share of newly issued common stock and one bond in the principal amount of $10 for each share of outstanding common stock, the distribution of the bonds will be a distribution of property (to the extent of their fair market value) to which section 301 applies, even though the exchange of common stock for common stock may be pursuant to a plan of reorganization under the terms of section 368(a)(1)(E) (recapitalization) and even though the exchange of common stock for common stock may be tax free by virtue of section 354.

(m) *Cancellation of indebtedness.* The cancellation of indebtedness of a shareholder by a corporation shall be treated as a distribution of property.

(n) [Reserved]

(o) *Distributions of certain property by DISC's to corporate shareholders.* See § 1.997–1 for the rule that if a corporation which is a DISC or former DISC (as defined in section 992(a)(1) or (3) as the case may be) makes a distribution of property (other than money and other than the obligations of the DISC or former DISC) out of accumulated DISC income (as defined in section 996(f)(1)) or previously taxed income (as defined in section 996(f)(2)), such distribution of property shall be treated as if it were made to an individual and that the basis of the property distributed, in the hands of the recipient corporation, shall be determined as if such property were distributed to an individual.

(p) *Cross references.* For certain rules relating to adjustments to earnings and profits and for determining the extent to which a distribution is a dividend, see sections 312 and 316 and regulations thereunder.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6752, 29 FR 12701, Sept. 9, 1964; T.D. 7084, 36 FR 267, Jan. 8, 1971; T.D. 7209, 37 FR 20800, Oct. 5, 1972; 38 FR 20824, Aug. 3, 1973; 38 FR 32794, Nov. 28, 1973; T.D. 7556, 44 FR 1376, Jan. 5, 1979; T.D. 8474, 58 FR 25557, Apr. 27, 1993; T.D. 8586, 60 FR 2500, Jan. 10, 1995]

§1.302–1 General.

(a) Under section 302(d), unless otherwise provided in subchapter C, chapter 1 of the Code, a distribution in redemption of stock shall be treated as a distribution of property to which section 301 applies if the distribution is not within any of the provisions of section 302(b). A distribution in redemption of stock shall be considered a distribution in part or full payment in exchange for the stock under section 302(a) provided paragraph (1), (2), (3), or (4) of section 302(b) applies. Section 318(a) (relating to constructive ownership of stock) applies to all redemptions under section 302 except that in the termination of a shareholder's interest certain limitations are placed on the application of section 318(a)(1) by section 302(c)(2). The term *redemption of stock* is defined in section 317(b). Section 302 does not apply to that portion of any distribution which qualifies as a distribution in partial liquidation under section 346. For special rules relating to redemption of stock to pay death taxes see section 303. For special rules relating to redemption of section 306 stock see section 306. For special rules relating to redemption of stock in partial or complete liquidation see section 331.

(b) If, in connection with a partial liquidation under the terms of section 346, stock is redeemed in an amount in excess of the amount specified by section 331(a)(2), section 302(b) shall first apply as to each shareholder to which it is applicable without limitation because of section 331(a)(2). That portion of the total distribution which is used in all redemptions from specific shareholders which are within the terms of section 302(a) shall be excluded in determining the application of sections 346 and 331(a)(2). For example, Corporation X has $50,000 which is attributable to the sale of one of two active businesses and which, if distributed in redemption of stock, would qualify as a partial liquidation under the terms of section 346(b). Corporation X distributes $60,000 to its shareholders in redemption of stock, $20,000 of which is in redemption of all of the stock of shareholder A within the meaning of section 302(b)(3). The $20,000 distributed in redemption of the stock of shareholder A will be excluded in determining the application of sections 346 and 331(a)(2). The entire $60,000 will be treated as in part or full payment for stock ($20,000 qualifying under section 302(a) and $40,000 qualifying under sections 346 and 331(a)(2)).

§1.302–2 Redemptions not taxable as dividends.

(a) The fact that a redemption fails to meet the requirements of paragraph (2), (3) or (4) of section 302(b) shall not be taken into account in determining whether the redemption is not essentially equivalent to a dividend under section 302(b)(1). See, however, paragraph (b) of this section. For example, if a shareholder owns only nonvoting stock of a corporation which is not section 306 stock and which is limited and preferred as to dividends and in liquidation, and one-half of such stock is redeemed, the distribution will ordinarily meet the requirements of paragraph (1) of section 302(b) but will not meet the requirements of paragraph (2), (3) or (4) of such section. The determination of whether or not a distribution is within the phrase ‘‘essentially equivalent to a dividend’’ (that is, having the same effect as a distribution without any redemption of stock) shall be made without regard to the earnings and profits of the corporation at the time of the distribution. For example, if A owns all the stock of a corporation and the corporation redeems part of his stock at a time when it has no earnings and profits, the distribution shall be treated as a distribution under section 301 pursuant to section 302(d).

(b) The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. One of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a). All distributions in pro rata redemptions of a part of the stock of a corporation generally will be treated as distributions under section 301 if the corporation has only one class of stock outstanding. However, for distributions in partial liquidation, see section 346. The redemption of all of one class of stock (except section 306 stock) either at one time or in a series of redemptions generally will be considered as a distribution under section 301 if all classes of stock outstanding at the time of the redemption are held in the same proportion. Distribution in redemption of stock may be treated as distributions under section 301 regardless of the provisions of the stock certificate and regardless of whether all stock being redeemed was acquired by the stockholders from whom the stock was redeemed by purchase or otherwise. In every case in which a shareholder transfers stock to the corporation which issued such stock in exchange for property, the facts and circumstances shall be reported on his return except as provided in paragraph (d) of § 1.331–1. See sections 346(a) and 6043 for requirements relating to returns by corporations.

(c) In any case in which an amount received in redemption of stock is treated as a distribution of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed. (For adjustments to basis required for certain redemptions of corporate shareholders that are treated as extraordinary dividends, see section 1059 and the regulations thereunder.) The following examples illustrate the application of this rule:

Example (1). A, an individual, purchased all of the stock of Corporation X for $100,000. In 1955 the corporation redeems half of the stock for $150,000, and it is determined that this amount constitutes a dividend. The remaining stock of Corporation X held by A has a basis of $100,000.

Example (2). H and W, husband and wife, each own half of the stock of Corporation X. All of the stock was purchased by H for $100,000 cash. In 1950 H gave one-half of the stock to W, the stock transferred having a value in excess of $50,000. In 1955 all of the stock of H is redeemed for $150,000, and it is determined that the distribution to H in redemption of his shares constitutes the distribution of a dividend. Immediately after the transaction, W holds the remaining stock of Corporation X with a basis of $100,000.

Example (3). The facts are the same as in *Example (2)* with the additional facts that the outstanding stock of Corporation X consists of 1,000 shares and all but 10 shares of the stock of H is redeemed. Immediately after the transaction, H holds 10 shares of the stock of Corporation X with a basis of $50,000, and W holds 500 shares with a basis of $50,000.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 8724, 62 FR 38028, July 26, 1997]

§ 1.302–3 Substantially disproportionate redemption.

(a) Section 302(b)(2) provides for the treatment of an amount received in redemption of stock as an amount received in exchange for such stock if—

(1) Immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock as provided in section 302(b)(2)(B),

(2) The redemption is a substantially disproportionate redemption within the meaning of section 302(b)(2)(C), and

(3) The redemption is not pursuant to a plan described in section 302(b)(2)(D).

Section 318(a) (relating to constructive ownership of stock) shall apply both in making the disproportionate redemption test and in determining the percentage of stock ownership after the redemption. The requirements under section 302(b)(2) shall be applied to each shareholder separately and shall be applied only with respect to stock which is issued and outstanding in the hands of the shareholders. Section 302(b)(2) only applies to a redemption of voting stock or to a redemption of both voting stock and other stock. Section 302(b)(2) does not apply to the redemption solely of nonvoting stock (common or preferred). However, if a redemption is treated as an exchange to a particular shareholder under the terms of section 302(b)(2), such section will apply to the simultaneous redemption of nonvoting preferred stock (which is not section 306 stock) owned by such shareholder and such redemption will also be treated as an exchange. Generally, for purposes of this section, stock which does not have voting rights until the happening of an event, such as a default in the payment of dividends on preferred stock, is not voting stock until the happening of the specified event. Subsection 302(b)(2)(D) provides that a redemption will not be treated as substantially disproportionate if made pursuant to a plan the purpose or effect of which is a series of redemptions which result in the aggregate in a distribution which is not substantially disproportionate. Whether or not such a plan exists will be determined from all the facts and circumstances.

(b) The application of paragraph (a) of this section is illustrated by the following example:

Example. Corporation M has outstanding 400 shares of common stock of which A, B, C and D each own 100 shares or 25 percent. No stock is considered constructively owned by A, B, C or D under section 318. Corporation M redeems 55 shares from A, 25 shares from B, and 20 shares from C. For the redemption to be disproportionate as to any shareholder, such shareholder must own after the redemptions less than 20 percent (80 percent of 25 percent) of the 300 shares of stock then outstanding. After the redemptions, A owns 45 shares (15 percent), B owns 75 shares (25 percent), and C owns 80 shares (26 2/3 percent). The distribution is disproportionate only with respect to A.

§1.302–4 Termination of shareholder's interest.

Section 302(b)(3) provides that a distribution in redemption of all of the stock of the corporation owned by a shareholder shall be treated as a distribution in part or full payment in exchange for the stock of such shareholder. In determining whether all of the stock of the shareholder has been redeemed, the general rule of section 302(c)(1) requires that the rules of constructive ownership provided in section 318(a) shall apply. Section 302(c)(2), however, provides that section 318(a)(1) (relating to constructive ownership of stock owned by members of a family) shall not apply where the specific requirements of section 302(c)(2) are met. The following rules shall be applicable in determining whether the specific requirements of section 302(c)(2) are met:

(a)(1) The agreement specified in section 302(c)(2)(A)(iii) shall be in the form of a separate statement in duplicate signed by the distributee and attached to the first return filed by the distributee for the taxable year in which the distribution described in section 302(b)(3) occurs. The agreement shall recite that the distributee has not acquired, other than by bequest or inheritance, any interest in the corporation (as described in section 302(c)(2)(A)(i)) since the distribution and that the distributee agrees to notify the district director for the internal revenue district in which the distributee resides of any acquisition, other than by bequest or inheritance, of such an interest in the corporation within 30 days after the acquisition, if the acquisition occurs within 10 years from the date of the distribution.

(2) If the distributee fails to file the agreement specified in section 302(c)(2)(A)(iii) at the time provided in paragraph (a)(1) of this section, then the district director for the internal revenue district in which the distributee resided at the time of filing the first return for the taxable year in which the distribution occurred shall grant a reasonable extension of time for filing such agreement, provided (i) it is established to the satisfaction of the district director that there was reasonable cause for failure to file the agreement within the prescribed time and (ii) a request for such extension is filed within such time as the district director considers reasonable under the circumstances.

(b) The distributee who files an agreement under section 302(c)(2)(A)(iii) shall retain copies of income tax returns and any other records indicating fully the amount of tax which would have been payable had the redemption been treated as a distribution subject to section 301.

(c) If stock of a parent corporation is redeemed, section 302(c)(2)(A), relating to acquisition of an interest in the corporation within 10 years after termination shall be applied with reference to an interest both in the parent corporation and any subsidiary of such parent corporation. If stock of a parent corporation is sold to a subsidiary in a transaction described in section 304, section 302(c)(2)(A) shall be applicable to the acquisition of an interest in such subsidiary corporation or in the parent corporation. If stock of a subsidiary corporation is redeemed, section 302(c)(2)(A) shall be applied with reference to an interest both in such subsidiary corporation and its parent. Section 302(c)(2)(A) shall also be applied with respect to an interest in a corporation which is a successor corporation to the corporation the interest in which has been terminated.

(d) For the purpose of section 302(c)(2)(A)(i), a person will be considered to be a creditor only if the rights of such person with respect to the corporation are not greater or broader in scope than necessary for the enforcement of his claim. Such claim must not in any sense be proprietary and must not be subordinate to the claims of general creditors. An obligation in the form of a debt may thus constitute a proprietary interest. For example, if under the terms of the instrument the corporation may discharge the principal amount of its obligation to a person by payments, the amount or certainty of which are dependent upon the earnings of the corporation, such a person is not a creditor of the corporation. Furthermore, if under the terms of the instrument the rate of purported interest is dependent upon earnings, the holder of such instrument may not, in some cases, be a creditor.

(e) In the case of a distributee to whom section 302(b)(3) is applicable, who is a creditor after such transaction, the acquisition of the assets of the corporation in the enforcement of the rights of such creditor shall not be considered an acquisition of an interest in the corporation for purposes of section 302(c)(2) unless stock of the corporation, its parent corporation, or, in the case of a redemption of stock of a parent corporation, of a subsidiary of such corporation is acquired.

(f) In determining whether an entire interest in the corporation has been terminated under section 302(b)(3), under all circumstances paragraphs (2), (3), (4), and (5) of section 318(a) (relating to constructive ownership of stock) shall be applicable.

(g) Section 302(c)(2)(B) provides that section 302(c)(2)(A) shall not apply—

(1) If any portion of the stock redeemed was acquired directly or indirectly within the 10-year period ending on the date of the distribution by the distributee from a person, the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section 318(a), or

(2) If any person owns (at the time of the distribution) stock, the ownership of which is attributable to the distributee under section 318(a), such person acquired any stock in the corporation directly or indirectly from the distributee within the 10-year period ending on the date of the distribution, and such stock so acquired from the distributee is not redeemed in the same transaction,unless the acquisition (described in subparagraph (1) of this paragraph) or the disposition by the distributee (described in subparagraph (2) of this paragraph) did not have as one of its principal purposes the avoidance of Federal income tax. A transfer of stock by the transferor, within the 10-year period ending on the date of the distribution, to a person whose stock would be attributable to the transferor shall not be deemed to have as one of its principal purposes the avoidance of Federal income tax merely because the transferee is in a lower income tax bracket than the transferor.

(Sec. 302(c)(2)(A)(iii) (68A Stat. 87; 26 U.S.C. 302 (c)(2)(A)(iii)))

[T.D. 7535, 43 FR 10686, Mar. 15, 1978]

§ 1.303–1 General.

Section 303 provides that in certain cases a distribution in redemption of stock, the value of which is included in determining the value of the gross estate of a decedent, shall be treated as a distribution in full payment in exchange for the stock so redeemed.

§ 1.303–2 Requirements.

(a) Section 303 applies only where the distribution is with respect to stock of a corporation the value of whose stock in the gross estate of the decedent for Federal estate tax purposes is an amount in excess of (1) 35 percent of the value of the gross estate of such decedent, or (2) 50 percent of the taxable estate of such decedent. For the purposes of such 35 percent and 50 percent requirements, stock of two or more corporations shall be treated as the stock of a single corporation if more than 75 percent in value of the outstanding stock of each such corporation is included in determining the value of the decedent's gross estate. For the purpose of the 75 percent requirement, stock which, at the decedent's death, represents the surviving spouse's interest in community property shall be considered as having been included in determining the value of the decedent's gross estate.

(b) For the purpose of section 303(b)(2)(A)(i), the term *gross estate* means the gross estate as computed in accordance with section 2031 (or, in the case of the estate of a decedent nonresident not a citizen of the United States, in accordance with section 2103). For the purpose of section 303(b)(2)(A)(ii), the term *taxable estate* means the taxable estate as computed in accordance with section 2051 (or, in the case of the estate of a decedent nonresident not a citizen of the United States, in accordance with section 2106). In case the value of an estate is determined for Federal estate tax purposes under section 2032 (relating to alternate valuation), then, for purposes of section 303(b)(2), the value of the gross estate, the taxable estate, and the stock shall each be determined on the applicable date prescribed in section 2032.

(c)(1) In determining whether the estate of the decedent is comprised of stock of a corporation of sufficient value to satisfy the percentage requirements of section 303(b)(2)(A) and section 303(b)(2)(B), the total value, in the aggregate, of all classes of stock of the corporation includible in determining the value of the gross estate is taken into account. A distribution under section 303(a) may be in redemption of the stock of the corporation includible in determining the value of the gross estate, without regard to the class of such stock.

(2) The above may be illustrated by the following example:

Example. The gross estate of the decedent has a value of $1,000,000, the taxable estate is $700,000, and the sum of the death taxes and funeral and administration expenses is $275,000. Included in determining the gross estate of the decedent is stock of three corporations which, for Federal estate tax purposes, is valued as follows:

Corporation A:	
Common stock	$100,000
Preferred stock	100,000
Corporation B:	
Common stock	50,000
Preferred stock	350,000
Corporation C: Common stock	200,000

The stock of Corporation A and Corporation C included in the estate of the decedent constitutes all of the outstanding stock of both corporations. The stock of Corporation A and the stock of Corporation C, treated as the stock of a single corporation under section 303(b)(2)(B), has a value in excess of $350,000 (35 percent of the gross estate or 50 percent of the taxable estate). Likewise, the stock of Corporation B has a value in excess of $350,000. The distribution by one or more of the above corporations, within the period prescribed in section 303(b)(1), of amounts not exceeding, in the aggregate, $275,000, in redemption of preferred stock or common stock of such corporation or corporations, will be treated as in full payment in exchange for the stock so redeemed.

(d) If stock includible in determining the value of the gross estate of a decedent is exchanged for new stock, the basis of which is determined by reference to the basis of the old stock, the redemption of the new stock will be treated the same under section 303 as the redemption of the old stock would have been. Thus section 303 shall apply with respect to a distribution in redemption of stock received by the estate of a decedent (1) in connection with a reorganization under section 368, (2) in a distribution or exchange under section 355 (or so much of section 356 as relates to section 355), (3) in an exchange under section 1036 or (4) in a distribution to which section 305(a) applies. Similarly, a distribution in redemption of stock will qualify under section 303, notwithstanding the fact that the stock redeemed is section 306 stock to the extent that the conditions of section 303 are met.

(e) Section 303 applies to distributions made after the death of the decedent and (1) before the expiration of the 3-year period of limitations for the assessment of estate tax provided in section 6501(a) (determined without the application of any provisions of law extending or suspending the running of such period of limitations), or within 90 days after the expiration of such period, or (2) if a petition for redetermination of a deficiency in such estate tax has been filed with the Tax Court within the time prescribed in section 6213, at any time before the expiration of 60 days after the decision of the Tax Court becomes final. The extension of the period of distribution provided in section 303(b)(1)(B) has reference solely to bona fide contests in the Tax Court and will not apply in the case of a petition for redetermination of a deficiency which is initiated solely for the purpose of extending the period within which section 303 would otherwise be applicable.

(f) While section 303 will most frequently have application in the case where stock is redeemed from the executor or administrator of an estate, the section is also applicable to distributions in redemption of stock included in the decedent's gross estate and held at the time of the redemption by any person who acquired the stock by any of the means comprehended by part III, subchapter A, chapter 11 of the Code, including the heir, legatee, or donee of the decedent, a surviving joint tenant, surviving spouse, appointee, or taker in default of appointment, or a trustee of a trust created by the decedent. Thus section 303 may apply with respect to a distribution in redemption of stock from a donee to whom the decedent has transferred stock in contemplation of death where the value of such stock is included in the decedent's gross estate under section 2035. Similarly, section 303 may apply to the redemption of stock from a beneficiary of the estate to whom an executor has distributed the stock pursuant to the terms of the will of the decedent. However, section 303 is not applicable to the case where stock is redeemed from a stockholder who has acquired the stock by gift or purchase from any person to whom such stock has passed from the decedent. Nor is section 303 applicable to the case where stock is redeemed from a stockholder who has acquired the stock from the executor in satisfaction of a specific monetary bequest.

(g)(1) The total amount of the distributions to which section 303 may apply with respect to redemptions of stock included in the gross estate of a decedent may not exceed the sum of the estate, inheritance, legacy, and succession taxes (including any interest collected as a part of such taxes) imposed because of the decedent's death and the amount of funeral and administration expenses allowable as deductions to the estate. Where there is more than one distribution in redemption of stock described in section 303(b)(2) during the period of time prescribed in section 303(b)(1), the distributions shall be applied against the total amount which qualifies for treatment under section 303 in the order in which the distributions are made. For this purpose, all distributions in redemption of such stock shall be taken into account, including distributions which under another provision of the Code are treated as in part or full payment in exchange for the stock redeemed.

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. (i) The gross estate of the decedent has a value of $800,000, the taxable estate is $500,000, and the sum of the death taxes and funeral and administrative expenses is $225,000. Included in determining the gross estate of the decedent is the stock of a corporation which for Federal estate tax purposes is valued at $450,000. During the first year of administration, one-third of such stock is distributed to a legatee and shortly thereafter this stock is redeemed by the corporation for $150,000. During the second year of administration, another one-third of such stock includible in the estate is redeemed for $150,000.

(ii) The first distribution of $150,000 is applied against the $225,000 amount that qualifies for treatment under section 303, regardless of whether the first distribution was treated as in payment in exchange for stock under section 302(a). Thus, only $75,000 of the second distribution may be treated as in full payment in exchange for stock under section 303. The tax treatment of the remaining $75,000 would be determined under other provisions of the Code.

(h) For the purpose of section 303, the estate tax or any other estate, inheritance, legacy, or succession tax shall be ascertained after the allowance of any credit, relief, discount, refund, remission or reduction of tax.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6724, 29 FR 5343, Apr. 21, 1964; T.D. 7346, 40 FR 10669, Mar. 7, 1975]

§ 1.303–3 Application of other sections.

(a) The sole effect of section 303 is to exempt from tax as a dividend a distribution to which such section is applicable when made in redemption of stock includible in a decedent's gross estate. Such section does not, however, in any other manner affect the principles set forth in sections 302 and 306.

Thus, if stock of a corporation is owned equally by A, B, and the C Estate, and the corporation redeems one-half of the stock of each shareholder, the determination of whether the distributions to A and B are essentially equivalent to dividends shall be made without regard to the effect which section 303 may have upon the taxability of the distribution to the C Estate.

(b) See section 304 relative to redemption of stock through the use of related corporations.

§1.304–1 General.

(a) Except as provided in paragraph (b) of this section, section 304 is applicable where a shareholder sells stock of one corporation to a related corporation as defined in section 304. Sales to which section 304 is applicable shall be treated as redemptions subject to sections 302 and 303.

(b) In the case of—

(1) Any acquisition of stock described in section 304 which occurred before June 22, 1954, and

(2) Any acquisition of stock described in section 304 which occurred on or after June 22, 1954, and on or before December 31, 1958, pursuant to a contract entered into before June 22, 1954.

The extent to which the property received in return for such acquisition shall be treated as a dividend shall be determined as if the Internal Revenue Code of 1939 continued to apply in respect of such acquisition and as if the Internal Revenue Code of 1954 had not been enacted. See section 391. In cases to which this paragraph applies, the basis of the stock received by the acquiring corporation shall be determined as if the Internal Revenue Code of 1939 continued to apply in respect of such acquisition and as if the Internal Revenue Code of 1954 had not been enacted.

[T.D. 6533, 26 FR 401, Jan. 19, 1961]

§1.304–2 Acquisition by related corporation (other than subsidiary).

(a) If a corporation, in return for property, acquires stock of another corporation from one or more persons, and the person or persons from whom the stock was acquired were in control of both such corporations before the acquisition, then such property shall be treated as received in redemption of stock of the acquiring corporation. The stock received by the acquiring corporation shall be treated as a contribution to the capital of such corporation. See section 362(a) for determination of the basis of such stock. The transferor's basis for his stock in the acquiring corporation shall be increased by the basis of the stock surrendered by him. (But see below in this paragraph for subsequent reductions of basis in certain cases.) As to each person transferring stock, the amount received shall be treated as a distribution of property under section 302(d), unless as to such person such amount is to be treated as received in exchange for the stock under the terms of section 302(a) or section 303. In applying section 302(b), reference shall be had to the shareholder's ownership of stock in the issuing corporation and not to his ownership of stock in the acquiring corporation (except for purposes of applying section 318(a)). In determining control and applying section 302(b), section 318(a) (relating to the constructive ownership of stock) shall be applied without regard to the 50-percent limitation contained in section 318(a)(2)(C) and (3)(C). A series of redemptions referred to in section 302(b)(2)(D) shall include acquisitions by either of the corporations of stock of the other and stock redemptions by both corporations. If section 302(d) applies to the surrender of stock by a shareholder, his basis for his stock in the acquiring corporation after the transaction (increased as stated above in this paragraph) shall not be decreased except as provided in section 301. If section 302(d) does not apply, the property received shall be treated as received in a distribution in payment in exchange for stock of the acquiring corporation under section 302(a), which stock has a basis equal to the amount by which the shareholder's basis for his stock in the acquiring corporation was increased on account of the contribution to capital as provided for above in this paragraph. Accordingly, such amount shall be applied in reduction of the shareholder's basis for his stock in the acquiring corporation. Thus, the basis of each share of the shareholder's stock in the acquiring corporation will be the same as the basis of such share before the entire transaction. The holding period of the stock which is considered to have been redeemed shall be the same as the holding period of the stock actually surrendered.

(b) In any case in which two or more persons, in the aggregate, control two corporations, section 304(a)(1) will apply to sales by such persons of stock in either corporation to the other (whether or not made simultaneously) provided the sales by each of such persons are related to each other. The determination of whether the sales are related to each other shall be dependent upon the facts and circumstances surrounding all of the sales. For this purpose, the fact that the sales may occur during a period of one or more years (such as in the case of a series of sales by persons who together control each of such corporations immediately prior to the first of such sales and immediately subsequent to the last of such sales) shall be disregarded, provided the other facts and circumstances indicate related transactions.

(c) The application of section 304(a)(1) may be illustrated by the following examples:

Example (1). Corporation X and corporation Y each have outstanding 200 shares of common stock. One-half of the stock of each corporation is owned by an individual, A, and one-half by another individual, B, who is unrelated to A. On or after August 31, 1964, A sells 30 shares of corporation X stock to corporation Y for $50,000, such stock having an adjusted basis of $10,000 to A. After the sale, A is considered as owning corporation X stock as follows: (i) 70 shares directly, and (ii) 15 shares constructively, since by virtue of his 50-percent ownership of Y he constructively owns 50 percent of the 30 shares owned directly by Y. Since A's percentage of ownership of X's voting stock after the sale (85 out of 200 shares, or 42.5%) is not less than 80 percent of his percentage of ownership of X's voting stock before the sale (100 out of 200 shares, or 50%), the transfer is not ''substantially disproportionate'' as to him as provided in section 302(b)(2). Under these facts, and assuming that section 302(b)(1) is not applicable, the entire $50,000 is treated as a dividend to A to the extent of the earnings and profits of corporation Y. The basis of the corporation X stock to corporation Y is $10,000, its adjusted basis to A. The amount of $10,000 is added to the basis of the stock of corporation Y in the hands of A.

Example (2). The facts are the same as in *Example (1)* except that A sells 80 shares of corporation X stock to corporation Y, and the sale occurs before August 31, 1964. After the sale, A is considered as owning corporation X stock as follows: (i) 20 shares directly, and (ii) 90 shares indirectly, since by virtue of his 50-percent ownership of Y he constructively owns 50 percent of the 80 shares owned directly by Y and 50 percent of the 100 shares attributed to Y because they are owned by Y's stockholder, B. Since after the sale A owns a total of more than 50 percent of the voting power of all of the outstanding stock of X (110 out of 200 shares, or 55%), the transfer is not ''substantially disproportionate'' as to him as provided in section 302(b)(2).

Example (3). Corporation X and corporation Y each have outstanding 100 shares of common stock. A, an individual, owns one-half the stock of corporation X, and C owns one-half the stock of corporation Y. A, B, and C are unrelated. A sells 30 shares of the stock of corporation X to corporation Y for $50,000, such stock having an adjusted basis of $10,000 to him. After the sale, A is considered as owning 35 shares of the stock of corporation X (20 shares directly and 15 constructively because one-half of the 30 shares owned by corporation Y are attributed to him). Since before the sale he owned 50 percent of the stock of corporation X and after the sale he owned directly and constructively only 35 percent of such stock, the redemption is substantially disproportionate as to him pursuant to the provisions of section 302(b)(2). He, therefore, realizes a gain of $40,000 ($50,000 minus $10,000). If the stock surrendered is a capital asset, such gain is long-term or short-term capital gain depending on the period of time that such stock was held. The basis to A for the stock of corporation Y is not changed as a result of the entire transaction. The basis to corporation Y for the stock of corporation X is $50,000, i.e., the basis of the transferor ($10,000), increased in the amount of gain recognized to the transferor ($40,000) on the transfer.

Example (4). Corporation X and corporation Y each have outstanding 100 shares of common stock. H, an individual, W, his wife, S, his son, and G, his grandson, each own 25 shares of stock of each corporation. H sells all of his 25 shares of stock of corporation X to corporation Y. Since both before and after the transaction H owned directly and constructively 100 percent of the stock of corporation X, and assuming that section 302(b)(1) is not applicable, the amount received by him for his stock of corporation X is treated as a dividend to him to the extent of the earnings and profits of corporation Y.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6969, 33 FR 11997, Aug. 23, 1968]

§1.304–3 Acquisition by a subsidiary.

(a) If a subsidiary acquires stock of its parent corporation from a shareholder of the parent corporation, the acquisition of such stock shall be treated as though the parent corporation had redeemed its own stock. For the purpose of this section, a corporation is a parent corporation if it meets the 50 percent ownership requirements of section 304(c). The determination whether the amount received shall be treated as an amount received in payment in exchange for the stock shall be made by applying section 303, or by applying section 302(b) with reference to the stock of the issuing parent corporation. If such distribution would have been treated as a distribution of property (pursuant to section 302(d)) under section 301, the entire amount of the selling price of the stock shall be treated as a dividend to the seller to the extent of the earnings and profits of the parent corporation determined as if the distribution had been made to it of the property that the subsidiary exchanged for the stock. In such cases, the transferor's basis for his remaining stock in the parent corporation will be determined by including the amount of the basis of the stock of the parent corporation sold to the subsidiary.

(b) Section 304(a)(2) may be illustrated by the following example:

Example. Corporation M has outstanding 100 shares of common stock which are owned as follows: B, 75 shares, C, son of B, 20 shares, and D, daughter of B, 5 shares. Corporation M owns the stock of Corporation X. B sells his 75 shares of Corporation M stock to Corporation X. Under section 302(b)(3) this is a termination of B's entire interest in Corporation M and the full amount received from the sale of his stock will be treated as payment in exchange for this stock, provided he fulfills the requirements of section 302(c)(2) (relating to an acquisition of an interest in the corporations).

§1.304–4T Special rule for use of a related corporation to acquire for property the stock of another commonly owned corporation (temporary).

(a) *In general.* At the discretion of the District Director, for purposes of determining the amount constituting a dividend, and source thereof, under section 304(b)(2), a corporation (deemed acquiring corporation) will be considered to have acquired for property the stock of a corporation (issuing corporation) acquired for property by another corporation (acquiring corporation) that is controlled by the deemed acquiring corporation, if one of the principal purposes for creating, organizing, or funding the acquiring corporation, through capital contributions or debt, is to avoid the application of section 304 to the deemed acquiring corporation. The following example illustrates the application of this paragraph (a).

Example. P, a domestic corporation, owns all of the stock of CFC1, a controlled foreign corporation with substantial accumulated earnings and profits. CFC1 is organized in Country X, which imposes a high rate of tax on CFC1's income. P also owns all of the stock of CFC2, another controlled foreign corporation, which has accumulated earnings and profits of $200x. CFC2 is organized in Country Y which imposes a low rate of tax on CFC2's income. P wishes to own all of its foreign corporations in a direct chain and to effectuate a repatriation of CFC2's cash to P. In order to avoid having to obtain Country X approval for the acquisition of CFC1 (a Country X corporation) by CFC2 (a Country Y corporation) and to avoid a dividend to P out of CFC2's earnings and profits that would otherwise occur as a result of the application of section 304, P causes CFC2 to form RFC as a Country X wholly-owned subsidiary and to contribute $100x to RFC. RFC will purchase, for $100x, all of the stock of CFC1 from P. Because one of P's principal purposes for having CFC1 owned by RFC is to avoid section 304, under §1.304–4T(a), CFC2 is considered to have acquired the stock of CFC1 for $100x for purposes of determining the amount constituting a dividend (and source thereof) for purposes of section 304(b)(2).

(b) *Availability to taxpayers.* Nothing in this regulation shall be construed to provide a taxpayer the right to compel the Internal Revenue Service to disregard the form of its transaction for Federal income tax purposes.

(c) *Effective date.* This section is effective June 14, 1988, with respect to acquisitions of stock occurring on or after June 14, 1988.

[T.D. 8209, 53 FR 22171, June 14, 1988]

§1.304–5 Control.

(a) *Control requirement in general.* Section 304(c)(1) provides that, for purposes of section 304, control means the ownership of stock possessing at least

50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock. Section 304(c)(3) makes section 318(a) (relating to constructive ownership of stock), as modified by section 304(c)(3)(B), applicable to section 304 for purposes of determining control under section 304(c)(1).

(b) *Effect of section 304(c)(2)(B)*—(1) *In general.* In determining whether the control test with respect to both the issuing and acquiring corporations is satisfied, section 304(a)(1) considers only the person or persons that—

(i) Control the issuing corporation before the transaction;

(ii) Transfer issuing corporation stock to the acquiring corporation for property; and

(iii) Control the acquiring corporation thereafter.

(2) *Application.* Section 317 defines property to include money, securities, and any other property except stock (or stock rights) in the distributing corporation. However, section 304(c)(2)(B) provides a special rule to extend the relevant group of persons to be tested for control of both the issuing and acquiring corporations to include the person or persons that do not acquire property, but rather solely stock from the acquiring corporation in the transaction. Section 304(c)(2)(B) provides that if two or more persons in control of the issuing corporation transfer stock of such corporation to the acquiring corporation, and if the transferors are in control of the acquiring corporation after the transfer, the person or persons in control of each corporation include each of those transferors. Because the purpose of section 304(c)(2)(B) is to include in the relevant control group the person or persons that retain or acquire acquiring corporation stock in the transaction, only the person or persons transferring stock of the issuing corporation that retain or acquire any proprietary interest in the acquiring corporation are taken into account for purposes of applying section 304(c)(2)(B).

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

Example (a) A, the owner of 20% of T's only class of stock, transfers that stock to P solely in exchange for all of the P stock. Pursuant to the same transaction, P, solely in exchange for cash, acquires the remaining 80% of the T stock from T's other shareholder, B, who is unrelated to A and P.

(b) Although A and B together were in control of T (the issuing corporation) before the transaction and A and B each transferred T stock to P (the acquiring corporation), sections 304(a)(1) and (c)(2)(B) do not apply to B because B did not retain or acquire any proprietary interest in P in the transaction. Section 304(a)(1) also does not apply to A because A (or any control group of which A was a member) did not control T before the transaction and P after the transaction.

(c) *Effective date.* This section is effective on January 20, 1994.

[T.D. 8515, 59 FR 2960, Jan. 20, 1994]

§ 1.305–1 Stock dividends.

(a) *In general.* Under section 305, a distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock is not included in gross income except as provided in section 305(b) and the regulations promulgated under the authority of section 305(c). A distribution made by a corporation to its shareholders in its stock or rights to acquire its stock which would not otherwise be included in gross income by reason of section 305 shall not be so included merely because such distribution was made out of Treasury stock or consisted of rights to acquire Treasury stock. See section 307 for rules as to basis of stock and stock rights acquired in a distribution.

(b) *Amount of distribution.* (1) In general, where a distribution of stock or rights to acquire stock of a corporation is treated as a distribution of property to which section 301 applies by reason of section 305(b), the amount of the distribution, in accordance with section 301(b) and § 1.301–1, is the fair market value of such stock or rights on the date of distribution. See *Example (1)* of § 1.305–2(b).

(2) Where a corporation which regularly distributes its earnings and profits, such as a regulated investment company, declares a dividend pursuant to which the shareholders may elect to receive either money or stock of the distributing corporation of equivalent value, the amount of the distribution of the stock received by any shareholder electing to receive stock will be

considered to equal the amount of the money which could have been received instead. See *Example (2)* of §1.305–2(b).

(3) For rules for determining the amount of the distribution where certain transactions, such as changes in conversion ratios or periodic redemptions, are treated as distributions under section 305(c), see *Examples (6), (8), (9), and (15)* of §1.305–3(e).

(c) *Adjustment in purchase price.* A transfer of stock (or rights to acquire stock) or an increase or decrease in the conversion ratio or redemption price of stock which represents an adjustment of the price to be paid by the distributing corporation in acquiring property (within the meaning of section 317(a)) is not within the purview of section 305 because it is not a distribution with respect to its stock. For example, assume that on January 1, 1970, pursuant to a reorganization, corporation X acquires all the stock of corporation Y solely in exchange for its convertible preferred class B stock. Under the terms of the class B stock, its conversion ratio is to be adjusted in 1976 under a formula based upon the earnings of corporation Y over the 6-year period ending on December 31, 1975. Such an adjustment in 1976 is not covered by section 305.

(d) *Definitions.* (1) For purposes of this section and §§1.305–2 through 1.305–7, the term *stock* includes rights or warrants to acquire such stock.

(2) For purposes of §§1.305–2 through 1.305–7, the term *shareholder* includes a holder of rights or warrants or a holder of convertible securities.

[T.D. 7281, 38 FR 18532, July 12, 1973; 38 FR 19910, July 25, 1973]

§1.305–2 Distributions in lieu of money.

(a) *In general.* Under section 305(b)(1), if any shareholder has the right to an election or option with respect to whether a distribution shall be made either in money or any other property, or in stock or rights to acquire stock of the distributing corporation, then, with respect to all shareholders, the distribution of stock or rights to acquire stock is treated as a distribution of property to which section 301 applies regardless of—

(1) Whether the distribution is actually made in whole or in part in stock or in stock rights;

(2) Whether the election or option is exercised or exercisable before or after the declaration of the distribution;

(3) Whether the declaration of the distribution provides that the distribution will be made in one medium unless the shareholder specifically requests payment in the other;

(4) Whether the election governing the nature of the distribution is provided in the declaration of the distribution or in the corporate charter or arises from the circumstances of the distribution; or

(5) Whether all or part of the shareholders have the election.

(b) *Examples.* The application of section 305(b)(1) may be illustrated by the following examples:

Example (1). (i) Corporation X declared a dividend payable in additional shares of its common stock to the holders of its outstanding common stock on the basis of two additional shares for each share held on the record date but with the provision that, at the election of any shareholder made within a specified period prior to the distribution date, he may receive one additional share for each share held on the record date plus $12 principal amount of securities of corporation Y owned by corporation X. The fair market value of the stock of corporation X on the distribution date was $10 per share. The fair market value of $12 principal amount of securities of corporation Y on the distribution date was $11 but such securities had a cost basis to corporation X of $9.

(ii) The distribution to all shareholders of one additional share of stock of corporation X (with respect to which no election applies) for each share outstanding is not a distribution to which section 301 applies.

(iii) The distribution of the second share of stock of corporation X to those shareholders who do not elect to receive securities of corporation Y is a distribution of property to which section 301 applies, whether such shareholders are individuals or corporations. The amount of the distribution to which section 301 applies is $10 per share of stock of corporation X held on the record date (the fair market value of the stock of corporation X on the distribution date).

(iv) The distribution of securities of corporation Y in lieu of the second share of stock of corporation X to the shareholders of corporation X whether individuals or corporations, who elect to receive such securities, is also a distribution of property to which section 301 applies.

(v) In the case of the individual shareholders of corporation X who elects to receive such securities, the amount of the distribution to which section 301 applies is $11 per share of stock of corporation X held on the record date (the fair market value of the $12 principal amount of securities of corporation Y on the distribution date).

(vi) In the case of the corporate shareholders of corporation X electing to receive such securities, the amount of the distribution to which section 301 applies is $9 per share of stock of corporation X held on the record date (the basis of the securities of corporation Y in the hands of corporation X).

Example (2). On January 10, 1970, corporation X, a regulated investment company, declared a dividend of $1 per share on its common stock payable on February 11, 1970, in cash or in stock of corporation X of equivalent value determined as of January 22, 1970, at the election of the shareholder made on or before January 22, 1970. The amount of the distribution to which section 301 applies is $1 per share whether the shareholder elects to take cash or stock and whether the shareholder is an individual or a corporation. Such amount will also be used in determining the dividend paid deduction of corporation X and the reduction in earnings and profits of corporation X.

[T.D. 7281, 38 FR 18532, July 12, 1973]

§ 1.305–3 Disproportionate distributions.

(a) *In general.* Under section 305(b)(2), a distribution (including a deemed distribution) by a corporation of its stock or rights to acquire its stock is treated as a distribution of property to which section 301 applies if the distribution (or a series of distributions of which such distribution is one) has the result of (1) the receipt of money or other property by some shareholders, and (2) an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation. Thus, if a corporation has two classes of common stock outstanding and cash dividends are paid on one class and stock dividends are paid on the other class, the stock dividends are treated as distributions to which section 301 applies.

(b) *Special rules.* (1) As used in section 305(b)(2), the term *a series of distributions* encompasses all distributions of stock made or deemed made by a corporation which have the result of the receipt of cash or property by some shareholders and an increase in the proportionate interests of other shareholders.

(2) In order for a distribution of stock to be considered as one of a series of distributions it is not necessary that such distribution be pursuant to a plan to distribute cash or property to some shareholders and to increase the proportionate interests of other shareholders. It is sufficient if there is an actual or deemed distribution of stock (of which such distribution is one) and as a result of such distribution or distributions some shareholders receive cash or property and other shareholders increase their proportionate interests. For example, if a corporation pays quarterly stock dividends to one class of common shareholders and annual cash dividends to another class of common shareholders the quarterly stock dividends constitute a series of distributions of stock having the result of the receipt of cash or property by some shareholders and an increase in the proportionate interests of other shareholders. This is so whether or not the stock distributions and the cash distributions are steps in an overall plan or are independent and unrelated. Accordingly, all the quarterly stock dividends are distributions to which section 301 applies.

(3) There is no requirement that both elements of section 305(b)(2) (i.e., receipt of cash or property by some shareholders and an increase in proportionate interests of other shareholders) occur in the form of a distribution or series of distributions as long as the result of a distribution or distributions of stock is that some shareholders' proportionate interests increase and other shareholders in fact receive cash or property. Thus, there is no requirement that the shareholders receiving cash or property acquire the cash or property by way of a corporate distribution with respect to their shares, so long as they receive such cash or property in their capacity as shareholders, if there is a stock distribution which results in a change in the proportionate interests of some shareholders and other shareholders receive cash or property. However, in order for a distribution of property to meet the requirement of section 305(b)(2), such

distribution must be made to a shareholder in his capacity as a shareholder, and must be a distribution to which section 301, 356(a)(2), 871(a)(1)(A), 881(a)(1), 852(b), or 857(b) applies. (Under section 305(d)(2), the payment of interest to a holder of a convertible debenture is treated as a distribution of property to a shareholder for purposes of section 305(b)(2).) For example if a corporation makes a stock distribution to its shareholders and, pursuant to a prearranged plan with such corporation, a related corporation purchases such stock from those shareholders who want cash, in a transaction to which section 301 applies by virtue of section 304, the requirements of section 305(b)(2) are satisfied. In addition, a distribution of property incident to an isolated redemption of stock (for example, pursuant to a tender offer) will not cause section 305(b)(2) to apply even though the redemption distribution is treated as a distribution of property to which section 301, 871(a)(1)(A), 881(a)(1), or 356(a)(2) applies.

(4) Where the receipt of cash or property occurs more than 36 months following a distribution or series of distributions of stock, or where a distribution or series of distributions of stock is made more than 36 months following the receipt of cash or property, such distribution or distributions will be presumed not to result in the receipt of cash or property by some shareholders and an increase in the proportionate interest of other shareholders, unless the receipt of cash or property and the distribution or series of distributions of stock are made pursuant to a plan. For example, if, pursuant to a plan, a corporation pays cash dividends to some shareholders on January 1, 1971 and increases the proportionate interests of other shareholders on March 1, 1974, such increases in proportionate interests are distributions to which section 301 applies.

(5) In determining whether a distribution or a series of distributions has the result of a disproportionate distribution, there shall be treated as outstanding stock of the distributing corporation (i) any right to acquire such stock (whether or not exercisable during the taxable year), and (ii) any security convertible into stock of the distributing corporation (whether or not convertible during the taxable year).

(6) In cases where there is more than one class of stock outstanding, each class of stock is to be considered separately in determining whether a shareholder has increased his proportionate interest in the assets or earnings and profits of a corporation. The individual shareholders of a class of stock will be deemed to have an increased interest if the class of stock as a whole has an increased interest in the corporation.

(c) *Distributions of cash in lieu of fractional shares.* (1) Section 305(b)(2) will not apply if—

(i) A corporation declares a dividend payable in stock of the corporation and distributes cash in lieu of fractional shares to which shareholders would otherwise be entitled, or

(ii) Upon a conversion of convertible stock or securities a corporation distributes cash in lieu of fractional shares to which shareholders would otherwise be entitled.

Provided the purpose of the distribution of cash is to save the corporation the trouble, expense, and inconvenience of issuing and transferring fractional shares (or scrip representing fractional shares), or issuing full shares representing the sum of fractional shares, and not to give any particular group of shareholders an increased interest in the assets or earnings and profits of the corporation. For purposes of paragraph (c)(1)(i) of this section, if the total amount of cash distributed in lieu of fractional shares is 5 percent or less of the total fair market value of the stock distributed (determined as of the date of declaration), the distribution shall be considered to be for such valid purpose.

(2) In a case to which subparagraph (1) of this paragraph applies, the transaction will be treated as though the fractional shares were distributed as part of the stock distribution and then were redeemed by the corporation. The treatment of the cash received by a shareholder will be determined under section 302.

(d) *Adjustment in conversion ratio.* (1)(i) Except as provided in subparagraph (2) of this paragraph, if a corporation has convertible stock or convertible securities outstanding (upon which it pays or is deemed to pay dividends or interest in money or other property) and distributes a stock dividend (or rights to acquire such stock) with respect to the stock into which the convertible stock or securities are convertible, an increase in proportionate interest in the assets or earnings and profits of the corporation by reason of such stock dividend shall be considered to have occurred unless a full adjustment in the conversion ratio or conversion price to reflect such stock dividend is made. Under certain circumstances, however, the application of an adjustment formula which in effect provides for a ''credit'' where stock is issued for consideration in excess of the conversion price may not satisfy the requirement for a ''full adjustment.'' Thus, if under a ''conversion price'' antidilution formula the formula provides for a ''credit'' where stock is issued for consideration in excess of the conversion price (in effect as an offset against any decrease in the conversion price which would otherwise be required when stock is subsequently issued for consideration below the conversion price) there may still be an increase in proportionate interest by reason of a stock dividend after application of the formula, since any downward adjustment of the conversion price that would otherwise be required to reflect the stock dividend may be offset, in whole or in part, by the effect of prior sales made at prices above the conversion price. On the other hand, if there were no prior sales of stock above the conversion price then a full adjustment would occur upon the application of such an adjustment formula and there would be no change in proportionate interest. Similarly, if consideration is to be received in connection with the issuance of stock, such as in the case of a rights offering or a distribution of warrants, the fact that such consideration is taken into account in making the antidilution adjustment will not preclude a full adjustment. See paragraph (*b*) of the example in this subparagraph for a case where the application of an adjustment formula with a cumulative feature does not result in a full adjustment and where a change in proportionate interest therefore occurs. See paragraph (*c*) for a case where the application of an adjustment formula with a cumulative feature does result in a full adjustment and where no change in proportionate interest therefore occurs. See paragraph (*d*) for an application of an antidilution formula in the case of a rights offering. See paragraph (*e*) for a case where the application of a noncumulative type adjustment formula will in all cases prevent a change in proportionate interest from occurring in the case of a stock dividend, because of the omission of the cumulative feature.

(ii) The principles of this subparagraph may be illustrated by the following example.

Example. (a) Corporation S has two classes of securities outstanding, convertible debentures and common stock. At the time of issuance of the debentures the corporation had 100 shares of common stock outstanding. Each debenture is interest-paying and is convertible into common stock at a conversion price of $2. The debenture's conversion price is subject to reduction pursuant to the following formula:

(Number of common shares outstanding at date of issue of debentures times initial conversion price) *plus* (Consideration received upon issuance of additional common shares) *divided by* (Number of common shares outstanding at date of issue of debentures) *plus* (Number of additional common shares issued)

Under the formula, common stock dividends are treated as an issue of common stock for zero consideration. If the computation results in a figure which is less than the existing conversion price the conversion price is reduced. However, under the formula, the existing conversion price is never increased. The formula works upon a cumulative basis since the numerator includes the consideration received upon the issuance of all common shares subsequent to the issuance of the debentures, and the reduction effected by the formula because of a sale or issuance of common stock below the existing conversion price is thus limited by any prior sales made above the existing conversion price.

(*b*) In 1972 corporation S sells 100 common shares at $3 per share. In 1973 the corporation declares a stock dividend of 20 shares to all holders of common stock. Under the antidilution formula no adjustment will be made to the conversion price of the debentures to reflect the stock dividend to common stockholders since the prior sale of common stock in excess of the conversion price in 1972 offsets the reduction in the conversion price which would otherwise result, as follows:

100×$2+$300÷100+120=$500÷220=$2.27

Since $2.27 is greater than the existing conversion price of $2 no adjustment is required. As a result, there is an increase in proportionate interest of the common stockholders by reason of the stock dividend and the additional shares of common stock will be treated, pursuant to section 305(b)(2), as a distribution of property to which section 301 applies.

(*c*) Assume the same facts as above, but instead of selling 100 common shares at $3 per share in 1972, assume corporation S sold no shares. Application of the antidilution formula would give rise to an adjustment in the conversion price as follows:

100×$2+$0÷100+20=$200÷120=$1.67

The conversion price, being reduced from $2 to $1.67, fully reflects the stock dividend distributed to the common stockholders. Hence, the distribution of common stock is not treated under section 305(b)(2) as one to which section 301 applies because the distribution does not increase the proportionate interests of the common shareholders as a class.

(*d*) Corporation S distributes to its shareholders rights entitling the shareholders to purchase a total of 20 shares at $1 per share. Application of the antidilution formula would produce an adjustment in the conversion price as follows:

100×$2+20×$1÷100+20=$220÷120=$1.83

The conversion price, being reduced from $2 to $1.83, fully reflects the distribution of rights to purchase stock at a price lower than the conversion price. Hence, the distribution of the rights is not treated under section 305(b)(2) as one to which section 301 applies because the distribution does not increase the proportionate interests of the common shareholders as a class.

(*e*) Assume the same facts as in (*b*) above, but instead of using a ‘‘conversion price’’ antidilution formula which operates on a cumulative basis, assume corporation S has employed a formula which operates as follows with respect to all stock dividends: The conversion price in effect at the opening of business on the day following the dividend record date is reduced by multiplying such conversion price by a fraction the numerator of which is the number of shares of common stock outstanding at the close of business on the record date and the denominator of which is the sum of such shares so outstanding and the number of shares constituting the stock dividend. Under such a formula the following adjustment would be made to the conversion price upon the declaration of a stock dividend of 20 shares in 1973:

200÷200+20=200÷220×$2=$1.82

The conversion price, being reduced from $2 to $1.82, fully reflects the stock dividend distributed to the common stockholders. Hence, the distribution of common stock is not treated under section 305(b)(2) as one to which section 301 applies because the distribution does not increase the proportionate interests of the common shareholders as a class.

(2)(i) A distributing corporation either must make the adjustment required by subparagraph (1) of this paragraph as of the date of the distribution of the stock dividend, or must elect (in the manner provided in subdivision (iii) of this subparagraph) to make such adjustment within the time provided in subdivision (ii) of this subparagraph.

(ii) If the distributing corporation elects to make such adjustment, such adjustment must be made no later than the earlier of (*a*) 3 years after the date of the stock dividend, or (*b*) that date as of which the aggregate stock dividends for which adjustment of the conversion ratio has not previously been made total at least 3 percent of the issued and outstanding stock with respect to which such stock dividends were distributed.

(iii) The election provided by subdivision (ii) of this subparagraph shall be made by filing with the income tax return for the taxable year during which the stock dividend is distributed—

(*a*) A statement that an adjustment will be made as provided by that subdivision, and

(*b*) A description of the antidilution provisions under which the adjustment will be made.

(3) Notwithstanding the preceding subparagraph, if a distribution has been made before July 12, 1973, and the adjustment required by subparagraph (1) or the election to make such adjustment was not made before such date, the adjustment or the election to make such adjustment, as the case may be, shall be considered valid if made no later than 15 days following the date of the first annual meeting of the shareholders after July 12, 1973, or July 12, 1974, whichever is earlier. If the election is made within such period, and, if the income tax return has been filed before the time of such election, the statement of adjustment and the description of the antidilution provisions required by subparagraph (2)(iii) shall

be filed with the Internal Revenue Service Center with which the income tax return was filed.

(4) See § 1.305–7(b) for a discussion of antidilution adjustments in connection with the application of section 305(c) in conjunction with section 305(b).

(e) *Examples.* The application of section 305(b)(2) to distributions of stock and section 305(c) to deemed distributions of stock may be illustrated by the following examples:

Example 1. Corporation X is organized with two classes of common stock, class A and class B. Each share of stock is entitled to share equally in the assets and earnings and profits of the corporation. Dividends may be paid in stock or in cash on either class of stock without regard to the medium of payment of dividends on the other class. A dividend is declared on the class A stock payable in additional shares of class A stock and a dividend is declared on class B stock payable in cash. Since the class A shareholders as a class will have increased their proportionate interests in the assets and earnings and profits of the corporation and the class B shareholders will have received cash, the additional shares of class A stock are distributions of property to which section 301 applies. This is true even with respect to those shareholders who may own class A stock and class B stock in the same proportion.

Example 2. Corporation Y is organized with two classes of stock, class A common, and class B, which is nonconvertible and limited and preferred as to dividends. A dividend is declared upon the class A stock payable in additional shares of class A stock and a dividend is declared on the class B stock payable in cash. The distribution of class A stock is not one to which section 301 applies because the distribution does not increase the proportionate interests of the class A shareholders as a class.

Example 3. Corporation K is organized with two classes of stock, class A common, and class B, which is nonconvertible preferred stock. A dividend is declared upon the class A stock payable in shares of class B stock and a dividend is declared on the class B stock payable in cash. Since the class A shareholders as a class have an increased interest in the assets and earnings and profits of the corporation, the stock distribution is treated as a distribution to which section 301 applies. If, however, a dividend were declared upon the class A stock payable in a new class of preferred stock that is subordinated in all respects to the class B stock, the distribution would not increase the proportionate interests of the class A shareholders in the assets or earnings and profits of the corporation and would not be treated as a distribution to which section 301 applies.

Example 4. (i) Corporation W has one class of stock outstanding, class A common. The corporation also has outstanding interest paying securities convertible into class A common stock which have a fixed conversion ratio that is not subject to full adjustment in the event stock dividends or rights are distributed to the class A shareholders. Corporation W distributes to the class A shareholders rights to acquire additional shares of class A stock. During the year, interest is paid on the convertible securities.

(ii) The stock rights and convertible securities are considered to be outstanding stock of the corporation and the distribution increases the proportionate interests of the class A shareholders in the assets and earnings and profits of the corporation. Therefore, the distribution is treated as a distribution to which section 301 applies. The same result would follow if, instead of convertible securities, the corporation had outstanding convertible stock. If, however, the conversion ratio of the securities or stock were fully adjusted to reflect the distribution of rights to the class A shareholders, the rights to acquire class A stock would not increase the proportionate interests of the class A shareholders in the assets and earnings and profits of the corporation and would not be treated as a distribution to which section 301 applies.

Example 5. (i) Corporation S is organized with two classes of stock, class A common and class B convertible preferred. The class B is fully protected against dilution in the event of a stock dividend or stock split with respect to the class A stock; however, no adjustment in the conversion ratio is required to be made until the stock dividends equal 3 percent of the common stock issued and outstanding on the date of the first such stock dividend except that such adjustment must be made no later than 3 years after the date of the stock dividend. Cash dividends are paid annually on the class B stock.

(ii) Corporation S pays a 1 percent stock dividend on the class A stock in 1970. In 1971, another 1 percent stock dividend is paid and in 1972 another 1 percent stock dividend is paid. The conversion ratio of the class B stock is increased in 1972 to reflect the three stock dividends paid on the class A stock. The distributions of class A stock are not distributions to which section 301 applies because they do not increase the proportionate interests of the class A shareholders in the assets and earnings and profits of the corporation.

Example 6. (i) Corporation M is organized with two classes of stock outstanding, class A and class B. Each class B share may be converted, at the option of the holder, into class A shares. During the first year, the conversion ratio is one share of class A stock for each share of class B stock. At the beginning of each subsequent year, the conversion ratio is increased by 0.05 share of class A stock for each share of class B stock. Thus, during the second year, the conversion ratio would be 1.05 shares of class A stock for each share of class B stock, during the third year, the ratio would be 1.10 shares, etc.

(ii) M pays an annual cash dividend on the class A stock. At the beginning of the second year, when the conversion ratio is increased to 1.05 shares of class A stock for each share of class B stock, a distribution of 0.05 shares of class A stock is deemed made under section 305(c) with respect to each share of class B stock, since the proportionate interests of the class B shareholders in the assets or earnings and profits of M are increased and the transaction has the effect described in section 305(b)(2). Accordingly, sections 305(b)(2) and 301 apply to the transaction.

Example 7. (i) Corporation N has two classes of stock outstanding, class A and class B. Each class B share is convertible into class A stock. However, in accordance with a specified formula, the conversion ratio is decreased each time a cash dividend is paid on the class B stock to reflect the amount of the cash dividend. The conversion ratio is also adjusted in the event that cash dividends are paid on the class A stock to increase the number of class A shares into which the class B shares are convertible to compensate the class B shareholders for the cash dividend paid on the class A stock.

(ii) In 1972, a $1 cash dividend per share is declared and paid on the class B stock. On the date of payment, the conversion ratio of the class B stock is decreased. A distribution of stock is deemed made under section 305(c) to the class A shareholders, since the proportionate interest of the class A shareholders in the assets or earnings and profits of the corporation is increased and the transaction has the effect described in section 305(b)(2). Accordingly, sections 305(b)(2) and 301 apply to the transaction.

(iii) In the following year a cash dividend is paid on the class A stock and none is paid on the class B stock. The increase in conversion rights of the class B shares is deemed to be a distribution under section 305(c) to the class B shareholders since their proportionate interest in the assets or earnings and profits of the corporation is increased and since the transaction has the effect described in section 305(b)(2). Accordingly, sections 305(b)(2) and 301 apply to the transaction.

Example 8. Corporation T has 1,000 shares of stock outstanding. C owns 100 shares. Nine other shareholders each owns 100 shares. Pursuant to a plan for periodic redemptions, T redeems up to 5 percent of each shareholder's stock each year. During the year, each of the nine other shareholders has 5 shares of his stock redeemed for cash. Thus, C's proportionate interest in the assets and earnings and profits of T is increased. Assuming that the cash received by the nine other shareholders is taxable under section 301, C is deemed under section 305(c) to have received a distribution under section 305(b)(2) of 5.25 shares of T stock to which section 301 applies. The amount of C's distribution is measured by the fair market value of the number of shares which would have been distributed to C had the corporation sought to increase his interest by 0.47 percentage points (C owned 10 percent of the T stock immediately before the redemption and 10.47 percent immediately thereafter) and the other shareholders continued to hold 900 shares (i.e.,

(a) 100÷955=10.47% (percent of C's ownership after redemption)

(b) 100+x÷1000+x=10.47%; x=5.25 (additional shares considered to be distributed to C)).

Since in computing the amount of additional shares deemed to be distributed to C the redemption of shares is disregarded, the redemption of shares will be similarly disregarded in determining the value of the stock of the corporation which is deemed to be distributed. Thus, in the example, 1,005.25 shares of stock are considered as outstanding after the redemption. The value of each share deemed to be distributed to C is then determined by dividing the 1,005.25 shares into the aggregate fair market value of the actual shares outstanding (955) after the redemption.

Example 9. (i) Corporation O has a stock redemption program under which, instead of paying out earnings and profits to its shareholders in the form of dividends, it redeems the stock of its shareholders up to a stated amount which is determined by the earnings and profits of the corporation. If the stock tendered for redemption exceeds the stated amount, the corporation redeems the stock on a pro rata basis up to the stated amount.

(ii) During the year corporation O offers to distribute $10,000 in redemption of its stock. At the time of the offering, corporation O has 1,000 shares outstanding of which E and F each owns 150 shares and G and H each owns 350 shares. The corporation redeems 15 shares from E and 35 shares from G. F and H continue to hold all of their stock.

(iii) F and H have increased their proportionate interests in the assets and earnings and profits of the corporation. Assuming that the cash E and G receive is taxable under section 301, F will be deemed under section 305(c) to have received a distribution under section 305(b)(2) of 16.66 shares of stock to which section 301 applies and H will be deemed under section 305(c) to have received a distribution under section 305(b)(2) of 38.86 shares of stock to which section 301 applies. The amount of the distribution to F and H is measured by the number of shares which would have been distributed to F and H had the corporation sought to increase the interest of F by 0.79 percentage points (F owned 15 percent of the stock immediately before the redemption and 15.79 percent immediately thereafter) and the interest of H by 1.84 percentage points (H owned 35 percent of the stock immediately before the redemption and 36.84 percent immediately thereafter) and E and G had continued to hold 150 shares and 350 shares, respectively (i.e.,

(a) $150 \div 950 + 350 \div 950 = 52.63\%$ (percent of F and H's ownership after redemption)

(b) $500 + y \div 1000 + y = 52.63\%$; $y = 55.52$ (additional shares considered to be distributed to F and H)

(c)(1) $150 \div 500 \times 55.52 = 16.66$ (shares considered to be distributed to F)

(2) $350 \div 500 \times 55.52 = 38.86$ (shares considered to be distributed to H)).

Since in computing the amount of additional shares deemed to be distributed to F and H the redemption of shares is disregarded, the redemption of shares will be similarly disregarded in determining the value of the stock of the corporation which is deemed to be distributed. Thus, in the example, 1,055.52 shares of stock are considered as outstanding after the redemption. The value of each share deemed to be distributed to F and H is then determined by dividing the 1,055.52 shares into the aggregate fair market value of the actual shares outstanding (950) after the redemption.

Example 10. Corporation P has 1,000 shares of stock outstanding. T owns 700 shares of the P stock and G owns 300 shares of the P stock. In a single and isolated redemption to which section 301 applies, the corporation redeems 150 shares of T's stock. Since this is an isolated redemption and is not a part of a periodic redemption plan, G is not treated as having received a deemed distribution under section 305(c) to which sections 305(b)(2) and 301 apply even though he has an increased proportionate interest in the assets and earnings and profits of the corporation.

Example 11. Corporation Q is a large corporation whose sole class of stock is widely held. However, the four largest shareholders are officers of the corporation and each owns 8 percent of the outstanding stock. In 1974, in a distribution to which section 301 applies, the corporation redeems 1.5 percent of the stock from each of the four largest shareholders in preparation for their retirement. From 1970 through 1974, the corporation distributes annual stock dividends to its shareholders. No other distributions were made to these shareholders. Since the 1974 redemptions are isolated and are not part of a plan for periodically redeeming the stock of the corporation, the shareholders receiving stock dividends will not be treated as having received a distribution under section 305(b)(2) even though they have an increased proportionate interest in the assets and earnings and profits of the corporation and whether or not the redemptions are treated as distributions to which section 301 applies.

Example 12. Corporation R has 2,000 shares of class A stock outstanding. Five shareholders own 300 shares each and five shareholders own 100 shares each. In preparation for the retirement of the five major shareholders, corporation R, in a single and isolated transaction, has a recapitalization in which each share of class A stock may be exchanged either for five shares of new class B nonconvertible preferred stock plus 0.4 share of new class C common stock, or for two shares of new class C common stock. As a result of the exchanges, each of the five major shareholders receives 1,500 shares of class B nonconvertible preferred stock and 120 shares of class C common stock. The remaining shareholders each receives 200 shares of class C common stock. None of the exchanges are within the purview of section 305.

Example 13. Corporation P is a widely-held company whose shares are listed for trading on a stock exchange. P distributes annual cash dividends to its shareholders. P purchases shares of its common stock directly from small stockholders (holders of record of 100 shares or less) or through brokers where the holders may not be known at the time of purchase. Where such purchases are made through brokers, they are pursuant to the rules and regulations of the Securities and Exchange Commission. The shares are purchased for the purpose of issuance to employee stock investment plans, to holders of convertible stock or debt, to holders of stock options, or for future acquisitions. Provided the purchases are not pursuant to a plan to increase the proportionate interest of some shareholders and distribute property to other shareholders, the remaining shareholders of P are not treated as having received a deemed distribution under section 305(c) to which section 305(b)(2) and 301 apply, even though they have an increased proportionate interest in the assets and earnings and profits of the corporation.

Example 14. Corporation U is a large manufacturing company whose products are sold through independent dealers. In order to assist individuals who lack capital to become dealers, the corporation has an established investment plan under which it provides 75 percent of the capital necessary to form a dealership corporation and the individual dealer provides the remaining 25 percent. Corporation U receives class A stock and a note representing its 75 percent interest. The individual dealer receives class B stock representing his 25 percent interest. The class B stock is nonvoting until all the class A shares are redeemed. At least 70 percent of the earnings and profits of the dealership corporation must be used each year to retire the note and to redeem the class A stock. The class A stock is redeemed at a fixed price. The individual dealer has no control over the redemption of stock and has no right to have his stock redeemed during the period the plan is in existence. U's investment is thus systematically eliminated and the individual becomes the sole owner of the dealership corporation. Since this type of plan is akin to a security arrangement, the redemptions of the class A stock will not be deemed under section 305(c) as distributions taxable under sections 305(b)(2) and 301 during the years in which the class A stock is redeemed.

Example 15. (i) *Facts.* Corporation V is organized with two classes of stock, class A common and class B convertible preferred. The class B stock is issued for $100 per share and is convertible at the holder's option into class A at a fixed ratio that is not subject to full adjustment in the event stock dividends or rights are distributed to the class A shareholders. The class B stock pays no dividends but it is mandatorily redeemable in 10 years for $200. Under sections 305(c) and 305(b)(4), the entire redemption premium (i.e., the excess of the redemption price over the issue price) is deemed to be a distribution of preferred stock on preferred stock which is taxable as a distribution of property under section 301. This amount is considered to be distributed over the 10-year period under principles similar to the principles of section 1272(a). During the year, the corporation declares a dividend on the class A stock payable in additional shares of class A stock.

(ii) *Analysis.* The distribution on the class A stock is a distribution to which sections 305(b)(2) and 301 apply since it increases the proportionate interests of the class A shareholders in the assets and earnings and profits of the corporation and the class B shareholders have received property (i.e., the constructive distribution described above). If, however, the conversion ratio of the class B stock were subject to full adjustment to reflect the distribution of stock to class A shareholders, the distribution of stock dividends on the class A stock would not increase the proportionate interest of the class A shareholders in the assets and earnings and profits of the corporation and such distribution would not be a distribution to which section 301 applies.

(iii) *Effective date.* This *Example 15* applies to stock issued on or after December 20, 1995. For previously issued stock, see §1.305–3(e) *Example (15)* (as contained in the 26 CFR part 1 edition revised April 1, 1995).

[T.D. 7281, 38 FR 18532, July 12, 1973; 38 FR 19910, 19911, July 25, 1973; as amended by T.D. 7329, 39 FR 36860, Oct. 15, 1974; T.D. 8643, 60 FR 66136, Dec. 21, 1995]

§1.305–4 Distributions of common and preferred stock.

(a) *In general.* Under section 305(b)(3), a distribution (or a series of distributions) by a corporation which results in the receipt of preferred stock whether or not convertible into common stock) by some common shareholders and the receipt of common stock by other common shareholders is treated as a distribution of property to which section 301 applies. For the meaning of the term *a series of distribution,* see subparagraphs (1) through (6) of §1.305–3(b).

(b) *Examples.* The application of section 305(b)(3) may be illustrated by the following examples:

Example (1). Corporation X is organized with two classes of common stock, class A and class B. Dividends may be paid in stock or in cash on either class of stock without regard to the medium of payment of dividends on the other class. A dividend is declared on the class A stock payable in additional shares of class A stock and a dividend is declared on class B stock payable in newly authorized class C stock which is nonconvertible and limited and preferred as to dividends. Both the distribution of class A shares and the distribution of new class C shares are distributions to which section 301 applies.

Example (2). Corporation Y is organized with one class of stock, class A common. During the year the corporation declares a dividend on the class A stock payable in newly authorized class B preferred stock which is convertible into class A stock no later than 6 months from the date of distribution at a price that is only slightly higher than the market price of class A stock on the date of distribution. Taking into account the dividend rate, redemption provisions, the marketability of the convertible stock, and the conversion price, it is reasonable to anticipate that within a relatively short period of time some shareholders will exercise their conversion rights and some will not. Since the distribution can reasonably be expected to result in the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders, the distribution is a distribution of property to which section 301 applies.

[T.D. 7281, 38 FR 18536, July 12, 1973]

§1.305–5 Distributions on preferred stock.

(a) *In general.* Under section 305(b)(4), a distribution by a corporation of its stock (or rights to acquire its stock) made (or deemed made under section 305(c)) with respect to its preferred stock is treated as a distribution of property to which section 301 applies unless the distribution is made with respect to convertible preferred stock to take into account a stock dividend, stock split, or any similar event (such as the sale of stock at less than the fair market value pursuant to a rights offering) which would otherwise result in the dilution of the conversion right. For purposes of the preceding sentence, an adjustment in the conversion ratio of convertible preferred stock made solely to take into account the distribution by a closed end regulated investment company of a capital gain dividend with respect to the stock into which such stock is convertible shall not be considered a ''similar event.'' The term *preferred stock* generally refers to stock which, in relation to other classes of stock outstanding, enjoys certain limited rights and privileges (generally associated with specified dividend and liquidation priorities) but does not participate in corporate growth to any significant extent. The distinguishing feature of *preferred stock* for the purposes of section 305(b)(4) is not its privileged position as such, but that such privileged position is limited, and that such stock does not participate in corporate growth to any significant extent. However, a right to participate which lacks substance will not prevent a class of stock from being treated as preferred stock. Thus, stock which enjoys a priority as to dividends and on liquidation but which is entitled to participate, over and above such priority, with another less privileged class of stock in earnings and profits and upon liquidation, may nevertheless be treated as preferred stock for purposes of section 305 if, taking into account all the facts and circumstances, it is reasonable to anticipate at the time a distribution is made (or is deemed to have been made) with respect to such stock that there is little or no likelihood of such stock actually participating in current and anticipated earnings and upon liquidation beyond its preferred interest. Among the facts and circumstances to be considered are the prior and anticipated earnings per share, the cash dividends per share, the book value per share, the extent of preference and of participation of each class, both absolutely and relative to each other, and any other facts which indicate whether or not the stock has a real and meaningful probability of actually participating in the earnings and growth of the corporation. The determination of whether stock is preferred for purposes of section 305 shall be made without regard to any right to convert such stock into another class of stock of the corporation. The term *preferred stock*, however, does not include convertible debentures.

(b) *Redemption premium*—(1) *In general.* If a corporation issues preferred stock that may be redeemed under the circumstances described in this paragraph (b) at a price higher than the issue price, the difference (the redemption premium) is treated under section 305(c) as a constructive distribution (or series of constructive distributions) of additional stock on preferred stock that is taken into account under principles similar to the principles of section 1272(a). However, constructive distribution treatment does not result under this paragraph (b) if the redemption premium does not exceed a de minimis amount, as determined under the principles of section 1273(a)(3). For purposes of this paragraph (b), preferred stock that may be acquired by a person other than the issuer (the third person) is deemed to be redeemable under the circumstances described in this paragraph (b), and references to the issuer include the third person, if—

(i) This paragraph (b) would apply to the stock if the third person were the issuer; and

(ii) Either—

(A) The acquisition of the stock by the third person would be treated as a redemption for federal income tax purposes (under section 304 or otherwise); or

(B) The third person and the issuer are members of the same affiliated group (having the meaning for this purpose given the term by section 1504(a), except that section 1504(b) shall not apply) and a principal purpose of the arrangement for the third person to acquire the stock is to avoid the application of section 305 and paragraph (b)(1) of this section.

(2) *Mandatory redemption or holder put.* Paragraph (b)(1) of this section applies to stock if the issuer is required

to redeem the stock at a specified time or the holder has the option (whether or not currently exercisable) to require the issuer to redeem the stock. However, paragraph (b)(1) of this section will not apply if the issuer's obligation to redeem or the holder's ability to require the issuer to redeem is subject to a contingency that is beyond the legal or practical control of either the holder or the holders as a group (or through a related party within the meaning of section 267(b) or 707(b)), and that, based on all of the facts and circumstances as of the issue date, renders remote the likelihood of redemption. For purposes of this paragraph, a contingency does not include the possibility of default, insolvency, or similar circumstances, or that a redemption may be precluded by applicable law which requires that the issuer have a particular level of capital, surplus, or similar items. A contingency also does not include an issuer's option to require earlier redemption of the stock. For rules applicable if stock may be redeemed at more than one time, see paragraph (b)(4) of this section.

(3) *Issuer call*—(i) *In general.* Paragraph (b)(1) of this section applies to stock by reason of the issuer's right to redeem the stock (even if the right is immediately exercisable), but only if, based on all of the facts and circumstances as of the issue date, redemption pursuant to that right is more likely than not to occur. However, even if redemption is more likely than not to occur, paragraph (b)(1) of this section does not apply if the redemption premium is solely in the nature of a penalty for premature redemption. A redemption premium is not a penalty for premature redemption unless it is a premium paid as a result of changes in economic or market conditions over which neither the issuer nor the holder has legal or practical control.

(ii) *Safe harbor.* For purposes of this paragraph (b)(3), redemption pursuant to an issuer's right to redeem is not treated as more likely than not to occur if—

(A) The issuer and the holder are not related within the meaning of section 267(b) or 707(b) (for purposes of applying sections 267(b) and 707(b) (including section 267(f)(1)), the phrase ''20 percent'' shall be substituted for the phrase ''50 percent'');

(B) There are no plans, arrangements, or agreements that effectively require or are intended to compel the issuer to redeem the stock (disregarding, for this purpose, a separate mandatory redemption obligation described in paragraph (b)(2) of this section); and

(C) Exercise of the right to redeem would not reduce the yield of the stock, as determined under principles similar to the principles of section 1272(a) and the regulations under sections 1271 through 1275.

(iii) *Effect of not satisfying safe harbor.* The fact that a redemption right is not described in paragraph (b)(3)(ii) of this section does not affect the determination of whether a redemption pursuant to the right to redeem is more likely than not to occur.

(4) *Coordination of multiple redemption provisions.* If stock may be redeemed at more than one time, the time and price at which redemption is most likely to occur must be determined based on all of the facts and circumstances as of the issue date. Any constructive distribution under paragraph (b)(1) of this section will result only with respect to the time and price identified in the preceding sentence. However, if redemption does not occur at that identified time, the amount of any additional premium payable on any later redemption date, to the extent not previously treated as distributed, is treated as a constructive distribution over the period from the missed call or put date to that later date, to the extent required under the principles of this paragraph (b).

(5) *Consistency.* The issuer's determination as to whether there is a constructive distribution under this paragraph (b) is binding on all holders of the stock, other than a holder that explicitly discloses that its determination as to whether there is a constructive distribution under this paragraph (b) differs from that of the issuer. Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed federal income tax return for the taxable year that includes the

date the holder acquired the stock. The issuer must provide the relevant information to the holder in a reasonable manner. For example, the issuer may provide the name or title and either the address or telephone number of a representative of the issuer who will make available to holders upon request the information required for holders to comply with this provision of this paragraph (b).

(c) *Cross reference.* For rules for applying sections 305(b)(4) and 305(c) to recapitalizations, see § 1.305–7(c).

(d) *Examples.* The application of sections 305(b)(4) and 305(c) may be illustrated by the following examples:

Example 1. (i) Corporation T has outstanding 1,000 shares of $100 par 5-percent cumulative preferred stock and 10,000 shares of no-par common stock. The corporation is 4 years in arrears on dividends to the preferred shareholders. The issue price of the preferred stock is $100 per share. Pursuant to a recapitalization under section 368(a)(1)(E), the preferred shareholders exchange their preferred stock, including the right to dividend arrearages, on the basis of one old preferred share for 1.20 newly authorized class A preferred shares. Immediately following the recapitalization, the new class A shares are traded at $100 per share. The class A shares are entitled to a liquidation preference of $100. The preferred shareholders have increased their proportionate interest in the assets or earnings and profits of corporation T since the fair market value of 1.20 shares of class A preferred stock ($120) exceeds the issue price of the old preferred stock ($100). Accordingly, the preferred shareholders are deemed under section 305(c) to receive a distribution in the amount of $20 on each share of old preferred stock and the distribution is one to which sections 305(b)(4) and 301 apply.

(ii) The same result would occur if the fair market value of the common stock immediately following the recapitalization were $20 per share and each share of preferred stock were exchanged for one share of the new class A preferred stock and one share of common stock.

Example 2. Corporation A, a publicly held company whose stock is traded on a securities exchange (or in the over-the-counter market) has two classes of stock outstanding, common and cumulative preferred. Each share of preferred stock is convertible into .75 shares of common stock. There are no dividend arrearages. At the time of issue of the preferred stock, there was no plan or prearrangement by which it was to be exchanged for common stock. The issue price of the preferred stock is $100 per share. In order to retire the preferred stock, corporation A recapitalizes in a transaction to which section 368(a)(1)(E) applies and each share of preferred stock is exchanged for one share of common stock. Immediately after the recapitalization the common stock has a fair market value of $110 per share. Notwithstanding the fact that the fair market value of the common stock received in the exchange (determined immediately following the recapitalization) exceeds the issue price of the preferred stock surrendered, the recapitalization is not deemed under section 305(c) to result in a distribution to which sections 305(b)(4) and 301 apply since the recapitalization is not pursuant to a plan to periodically increase a shareholder's proportionate interest in the assets or earnings and profits and does not involve dividend arrearages.

Example 3. Corporation V is organized with two classes of stock, 1,000 shares of class A common and 1,000 shares of class B convertible preferred. Each share of class B stock may be converted into two shares of class A stock. Pursuant to a recapitalization under section 368(a)(1)(E), the 1,000 shares of class A stock are surrendered in exchange for 500 shares of new class A common and 500 shares of newly authorized class C common. The conversion right of class B stock is changed to one share of class A stock and one share of class C stock for each share of class B stock. The change in the conversion right is not deemed under section 305(c) to be a distribution on preferred stock to which sections 305(b)(4) and 301 apply.

Example 4 —(i) *Facts.* Corporation X is a domestic corporation with only common stock outstanding. In connection with its acquisition of Corporation T, X issues 100 shares of its 4% preferred stock to the shareholders of T, who are unrelated to X both before and after the transaction. The issue price of the preferred stock is $40 per share. Each share of preferred stock is convertible at the shareholder's election into three shares of X common stock. At the time the preferred stock is issued, the X common stock has a value of $10 per share. The preferred stock does not provide for its mandatory redemption or for redemption at the option of the holder. It is callable at the option of X at any time beginning three years from the date of issuance for $100 per share. There are no other plans, arrangements, or agreements that effectively require or are intended to compel X to redeem the stock.

(ii) *Analysis.* The preferred stock is described in the safe harbor rule of paragraph (b)(3)(ii) of this section because X and the former shareholders of T are unrelated, there are no plans, arrangements, or agreements that effectively require or are intended to compel X to redeem the stock, and calling the stock for $100 per share would not reduce the yield of the preferred stock. Therefore, the $60 per share call premium is not treated as a constructive distribution to the shareholders of the preferred stock under paragraph (b) of this section.

Example 5 —(i) *Facts*—(A) Corporation Y is a domestic corporation with only common stock outstanding. On January 1, 1996, Y issues 100 shares of its 10% preferred stock to a holder. The holder is unrelated to Y both before and after the stock issuance. The issue price of the preferred stock is $100 per share. The preferred stock is—

(1) Callable at the option of Y on or before January 1, 2001, at a price of $105 per share plus any accrued but unpaid dividends; and

(2) Mandatorily redeemable on January 1, 2006, at a price of $100 per share plus any accrued but unpaid dividends.

(B) The preferred stock provides that if Y fails to exercise its option to call the preferred stock on or before January 1, 2001, the holder will be entitled to appoint a majority of Y's directors. Based on all of the facts and circumstances as of the issue date, Y is likely to have the legal and financial capacity to exercise its right to redeem. There are no other facts and circumstances as of the issue date that would affect whether Y will call the preferred stock on or before January 1, 2001.

(ii) *Analysis.* Under paragraph (b)(3)(i) of this section, paragraph (b)(1) of this section applies because, by virtue of the change of control provision and the absence of any contrary facts, it is more likely than not that Y will exercise its option to call the preferred stock on or before January 1, 2001. The safe harbor rule of paragraph (b)(3)(ii) of this section does not apply because the provision that failure to call will cause the holder to gain control of the corporation is a plan, arrangement, or agreement that effectively requires or is intended to compel Y to redeem the preferred stock. Under paragraph (b)(4) of this section, the constructive distribution occurs over the period ending on January 1, 2001. Redemption is most likely to occur on that date, because that is the date on which the corporation minimizes the rate of return to the holder while preventing the holder from gaining control. The de minimis exception of paragraph (b)(1) of this section does not apply because the $5 per share difference between the redemption price and the issue price exceeds the amount determined under the principles of section 1273(a)(3) (5×.0025×$105 = $1.31). Accordingly, $5 per share, the difference between the redemption price and the issue price, is treated as a constructive distribution received by the holder on an economic accrual basis over the five-year period ending on January 1, 2001, under principles similar to the principles of section 1272(a).

Example 6. Corporation A, a publicly held company whose stock is traded on a securities exchange (or in the over-the-counter market) has two classes of stock outstanding, common and preferred. The preferred stock is nonvoting and nonconvertible, limited and preferred as to dividends, and has a fixed liquidation preference. There are no dividend arrearages. At the time of issue of the preferred stock, there was no plan or prearrangement by which it was to be exchanged for common stock. In order to retire the preferred stock, corporation A recapitalizes in a transaction to which section 368(a)(1)(E) applies and the preferred stock is exchanged for common stock. The transaction is not deemed to be a distribution under section 305(c) and sections 305(b) and 301 do not apply to the transaction. The same result would follow if the preferred stock was exchanged in any reorganization described in section 368(a)(1) for a new preferred stock having substantially the same market value and having no greater call price or liquidation preference than the old preferred stock, whether the new preferred stock has voting rights or is convertible into common stock of corporation A at a fixed ratio subject to change solely to take account of stock dividends, stock splits, or similar transactions with respect to the stock into which the preferred stock is convertible.

Example 7 —(i) *Facts*—(A) Corporation Z is a domestic corporation with only common stock outstanding. On January 1, 1996, Z issues 100 shares of its 10% preferred stock to C, an individual unrelated to Z both before and after the stock issuance. The issue price of the preferred stock is $100 per share. The preferred stock is—

(1) Not callable for a period of 5 years from the issue date;

(2) Callable at the option of Z on January 1, 2001, at a price of $110 per share plus any accrued but unpaid dividends;

(3) Callable at the option of Z on July 1, 2002, at a price of $120 per share plus any accrued but unpaid dividends; and

(4) Mandatorily redeemable on January 1, 2004, at a price of $150 per share plus any accrued but unpaid dividends.

(B) There are no other plans, arrangements, or agreements between Z and C concerning redemption of the stock. Moreover, there are no other facts and circumstances as of the issue date that would affect whether Z will call the preferred stock on either January 1, 2001, or July 1, 2002.

(ii) *Analysis.* This stock is described in paragraph (b)(2) of this section because it is mandatorily redeemable. It is also potentially described in paragraph (b)(3)(i) of this section because it is callable at the option of the issuer. The safe harbor rule of paragraph (b)(3)(ii) of this section does not apply to the option to call on January 1, 2001, because the call would reduce the yield of the stock when compared to the yield produced by the January 1, 2004, mandatory redemption feature. Moreover, absent any other facts indicating a contrary result, the fact that redemption on January 1, 2001, would produce the lowest yield indicates that redemption is most likely to occur on that date. Under paragraph (b)(4) of this section, paragraph (b)(1) of this section applies with respect to the issuer's right to call on January 1, 2001, because redemption is most likely to occur on January 1, 2001, for $110 per share. The de minimis exception of paragraph (b)(1) of this section does not apply because the $10 per share difference between the redemption price payable in 2001 and the issue price exceeds the amount determined under the principles of section 1273(a)(3) (5×.0025×$110=$1.38). Accordingly, $10 per share, the difference between the redemption price and the issue price, is treated as a constructive distribution received by the holder on an economic accrual basis over the five-year period ending January 1, 2001, under principles similar to the principles of section 1272(a).

(iii) *Coordination rules*—(A) If Z does not exercise its option to call the preferred stock on January 1, 2001, paragraph (b)(4) of this section provides that the principles of paragraph (b) of this section must be applied to determine if any remaining constructive distribution occurs. Under paragraphs (b)(3)(i) and (b)(4) of this section, paragraph (b)(1) of this section applies because, absent any other facts indicating a contrary result, the fact that redemption on July 1, 2002, would produce a lower yield than the yield produced by the mandatory redemption feature indicates that redemption on that date is most likely to occur. The safe harbor rule of paragraph (b)(3)(ii) of this section does not apply to the option to call on July 1, 2002, because, as of January 1, 2001, a call by Z on July 1, 2002, for $120 would reduce the yield of the stock. The de minimis exception of paragraph (b)(1) of this section does not apply because the $10 per share difference between the redemption price and the issue price (revised as of the missed call date as provided by paragraph (b)(4) of this section) exceeds the amount determined under the principles of section 1273(a)(3) (1×.0025×$120=$.30). Accordingly, the $10 per share of additional redemption premium that is payable on July 1, 2002, is treated as a constructive distribution received by the holder on an economic accrual basis over the period between January 1, 2001, and July 1, 2002, under principles similar to the principles of section 1272(a).

(B) If Z does not exercise its second option to call the preferred stock on July 1, 2002, then the $30 additional redemption premium that is payable on January 1, 2004, is treated as a constructive distribution under paragraphs (b)(2) and (b)(1) of this section. The de minimis exception of paragraph (b)(1) of this section does not apply because the $30 per share difference between the redemption price and the issue price (revised as of the second missed call date) exceeds the amount determined under the principles of section 1273(a)(3) (1×.0025×$150=$.38). The holder is treated as receiving the constructive distribution on an economic accrual basis over the period between July 1, 2002, and January 1, 2004, under principles similar to the principles of section 1272(a).

Example 8 —(i) *Facts.* The facts are the same as in paragraph (i) of Example 7, except that, based on all of the facts and circumstances as of the issue date (including an expected lack of funds on the part of Z), it is unlikely that Z will exercise the right to redeem on either January 1, 2001, or July 1, 2002.

(ii) *Analysis.* The safe harbor rule of paragraph (b)(3)(ii) of this section does not apply to the option to call on either January 1, 2001, or July 1, 2002, because each call would reduce the yield of the stock. Under paragraph (b)(3)(i) of this section, neither option to call is more likely than not to occur, because, based on all of the facts and circumstances as of the issue date (including an expected lack of funds on the part of Z), it is not more likely than not that Z will exercise either option. However, the $50 per share redemption premium that is payable on January 1, 2004, is treated as a constructive distribution under paragraphs (b)(1) and (2) of this section, regardless of whether Z is anticipated to have sufficient funds to redeem on that date, because Z is required to redeem the stock on that date. The de minimis exception of paragraph (b)(1) of this section does not apply because the $50 per share difference between the redemption price and the issue price exceeds the amount determined under the principles of section 1273(a)(3)(8×.0025×$150=$3).

Example 9. Corporation Q is organized with 10,000 shares of class A stock and 1,000 shares of class B stock. The terms of the class B stock require that the class B have a preference of $5 per share with respect to dividends and $100 per share with respect to liquidation. In addition, upon a distribution of $10 per share to the class A stock, class B participates equally in any additional dividends. The terms also provide that upon liquidation the class B stock participates equally after the class A stock receives $100 per share. Corporation Q has no accumulated earnings and profits. In 1971 it earned $10,000, the highest earnings in its history. The corporation is in an industry in which it is reasonable to anticipate a growth in earnings of 5 percent per year. In 1971 the book value of corporation Q's assets totalled $100,000. In that year the corporation paid a dividend of $5 per share to the class B stock and $.50 per share to the class A. In 1972 the corporation had no earnings and in lieu of a $5 dividend distributed one share of class B stock for each outstanding share of class B. No distribution was made to the class A stock.

Since, in 1972, it was not reasonable to anticipate that the class B stock would participate in the current and anticipated earnings and growth of the corporation beyond its preferred interest, the class B stock is preferred stock and the distribution of class B shares to the class B shareholders is a distribution to which sections 305(b)(4) and 301 apply.

Example 10. Corporation P is organized with 10,000 shares of class A stock and 1,000 shares of class B stock. The terms of the class B stock require that the class B have a preference of $5 per share with respect to dividends and $100 per share with respect to liquidation. In addition, upon a distribution of $5 per share to the class A stock, class B participates equally in any additional dividends. The terms also provide that upon liquidation the class B stock participates equally after the class A receives $100 per share. Corporation P has accumulated earnings and profits of $100,000. In 1971 it earned $75,000. The corporation is in an industry in which it is reasonable to anticipate a growth in earnings of 10 percent per year. In 1971 the book value of corporation P's assets totalled $5 million. In that year the corporation paid a dividend of $5 per share to the class B stock, $5 per share to the class A stock, and it distributed an additional $1 per share to both class A and class B stock. In 1972 the corporation had earnings of $82,500. In that year it paid a dividend of $5 per share to the class B stock and $5 per share to the class A stock. In addition, the corporation declared stock dividends of one share of class B stock for every 10 outstanding shares of class B and one share of class A stock for every 10 outstanding shares of class A. Since, in 1972, it was reasonable to anticipate that both the class B stock and the class A stock would participate in the current and anticipated earnings and growth of the corporation beyond their preferred interests, neither class is preferred stock and the stock dividends are not distributions to which section 305(b)(4) applies.

(e) *Effective date.* The rules of paragraph (b) of this section and *Examples 4, 5, 7,* and *8* of paragraph (d) of this section apply to stock issued on or after December 20, 1995. For rules applicable to previously issued stock, see §1.305–5 (b) and (d) *Examples (4), (5),* and (*7*) (as contained in the 26 CFR part 1 edition revised April 1, 1995). Although the rules of paragraph (b) of this section and the revised examples do not apply to stock issued before December 20, 1995, the rules of sections 305(c)(1), (2), and (3) apply to stock described therein issued on or after October 10, 1990, except as provided in section 11322(b)(2) of the Revenue Reconciliation Act of 1990 (Public Law 101–508 Stat.). Moreover, except as provided in section 11322(b)(2) of the Revenue Reconciliation Act of 1990 (Public Law 101–508 Stat.), with respect to stock issued on or after October 10, 1990, and issued before December 20, 1995, the economic accrual rule of section 305(c)(3) will apply to the entire call premium on stock that is not described in paragraph (b)(2) of this section if the premium is considered to be unreasonable under the principles of §1.305–5(b) (as contained in the 26 CFR part 1 edition revised April 1, 1995). A call premium described in the preceding sentence will be accrued over the period of time during which the preferred stock cannot be called for redemption.

[T.D. 7281, 38 FR 18536, July 12, 1973, as amended by T.D. 7329, 39 FR 36860, Oct. 15, 1974; T.D. 8643, 60 FR 66136, Dec. 21, 1995]

§1.305–6 Distributions of convertible preferred.

(a) *In general.* (1) Under section 305(b)(5), a distribution by a corporation of its convertible preferred stock or rights to acquire such stock made or considered as made with respect to its stock is treated as a distribution of property to which section 301 applies unless the corporation establishes that such distribution will not result in a disproportionate distribution as described in §1.305–3.

(2) The distribution of convertible preferred stock is likely to result in a disproportionate distribution when both of the following conditions exist: (i) The conversion right must be exercised within a relatively short period of time after the date of distribution of the stock; and (ii) taking into account such factors as the dividend rate, the redemption provisions, the marketability of the convertible stock, and the conversion price, it may be anticipated that some shareholders will exercise their conversion rights and some will not. On the other hand, where the conversion right may be exercised over a period of many years and the dividend rate is consistent with market conditions at the time of distribution of the stock, there is no basis for predicting at what time and the extent to which the stock will be converted and

it is unlikely that a disproportionate distribution will result.

(b) *Examples.* The application of section 305(b)(5) may be illustrated by the following examples:

Example (1). Corporation Z is organized with one class of stock, class A common. During the year the corporation declares a dividend on the class A stock payable in newly authorized class B preferred stock which is convertible into class A stock for a period of 20 years from the date of issuance. Assuming dividend rates are normal in light of existing conditions so that there is no basis for predicting the extent to which the stock will be converted, the circumstances will ordinarily be sufficient to establish that a disproportionate distribution will not result since it is impossible to predict the extent to which the class B stock will be converted into class A stock. Accordingly, the distribution of class B stock is not one to which section 301 applies.

Example (2). Corporation X is organized with one class of stock, class A common. During the year the corporation declares a dividend on the class A stock payable in newly authorized redeemable class C preferred stock which is convertible into class A common stock no later than 4 months from the date of distribution at a price slightly higher than the market price of class A stock on the date of distribution. By prearrangement with corporation X, corporation Y, an insurance company, agrees to purchase class C stock from any shareholder who does not wish to convert. By reason of this prearrangement, it is anticipated that the shareholders will either sell the class C stock to the insurance company (which expects to retain the shares for investment purposes) or will convert. As a result, some of the shareholders exercise their conversion privilege and receive additional shares of class A stock, while other shareholders sell their class C stock to corporation Y and receive cash. The distribution is a distribution to which section 301 applies since it results in the receipt of property by some shareholders and an increase in the proportionate interests of other shareholders.

[T.D. 7281, 38 FR 18538, July 12, 1973]

§ 1.305–7 Certain transactions treated as distributions.

(a) *In general.* Under section 305(c), a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption which is treated as a distribution to which section 301 applies, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder may be treated as a distribution with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by such change, difference, redemption, or similar transaction. In general, such change, difference, redemption, or similar transaction will be treated as a distribution to which sections 305(b) and 301 apply where—

(1) The proportionate interest of any shareholder in the earnings and profits or assets of the corporation deemed to have made such distribution is increased by such change, difference, redemption, or similar transaction; and

(2) Such distribution has the result described in paragraph (2), (3), (4), or (5) of section 305(b).

Where such change, difference, redemption, or similar transaction is treated as a distribution under the provisions of this section, such distribution will be deemed made with respect to any shareholder whose interest in the earnings and profits or assets of the distributing corporation is increased thereby. Such distribution will be deemed to be a distribution of the stock of such corporation made by the corporation to such shareholder with respect to his stock. Depending upon the facts presented, the distribution may be deemed to be made in common or preferred stock. For example, where a redemption premium exists with respect to a class of preferred stock under the circumstances described in § 1.305–5(b) and the other requirements of this section are also met, the distribution will be deemed made with respect to such preferred stock, in stock of the same class. Accordingly, the preferred shareholders are considered under sections 305(b)(4) and 305(c) to have received a distribution of preferred stock to which section 301 applies. See the examples in §§ 1.305–3(e) and 1.305–5(d) for further illustrations of the application of section 305(c).

(b) *Antidilution provisions.* (1) For purposes of applying section 305(c) in conjunction with section 305(b), a change in the conversion ratio or conversion price of convertible preferred stock (or securities), or in the exercise price of rights or warrants, made pursuant to a bona fide, reasonable, adjustment formula (including, but not limited to, either the so-called ''market price'' or ''conversion price'' type of formulas) which has the effect of preventing dilution of the interest of the holders of such stock (or securities) will not be considered to result in a deemed distribution of stock. An adjustment in the conversion ratio or price to compensate for cash or property distributions to other shareholders that are taxable under section 301, 356(a)(2), 871(a)(1)(A), 881(a)(1), 852(b), or 857(b) will not be considered as made pursuant to a bona fide adjustment formula.

(2) The principles of this paragraph may be illustrated by the following example:

Example. (i) Corporation U has two classes of stock outstanding, class A and class B. Each class B share is convertible into class A stock. In accordance with a bonafide, reasonable, antidilution provision, the conversion price is adjusted if the corporation transfers class A stock to anyone for a consideration that is below the conversion price.

(ii) The corporation sells class A stock to the public at the current market price but below the conversion price. Pursuant to the antidilution provision, the conversion price is adjusted downward. Such a change in conversion price will not be deemed to be a distribution under section 305(c) for the purposes of section 305(b).

(c) *Recapitalizations.* (1) A recapitalization (whether or not an isolated transaction) will be deemed to result in a distribution to which section 305(c) and this section apply if—

(i) It is pursuant to a plan to periodically increase a shareholder's proportionate interest in the assets or earnings and profits of the corporation, or

(ii) A shareholder owning preferred stock with dividends in arrears exchanges his stock for other stock and, as a result, increases his proportionate interest in the assets or earnings and profits of the corporation. An increase in a preferred shareholder's proportionate interest occurs in any case where the fair market value or the liquidation preference, whichever is greater, of the stock received in the exchange (determined immediately following the recapitalization), exceeds the issue price of the preferred stock surrendered.

(2) In a case to which subparagraph (1)(ii) of this paragraph applies, the amount of the distribution deemed under section 305(c) to result from the recapitalization is the lesser of (i) the amount by which the fair market value or the liquidation preference, whichever is greater, of the stock received in the exchange (determined immediately following the recapitalization) exceeds the issue price of the preferred stock surrendered, or (ii) the amount of the dividends in arrears.

(3) For purposes of applying subparagraphs (1) and (2) of this paragraph with respect to stock issued before July 12, 1973, the term *issue price of the preferred stock surrendered* shall mean the greater of the issue price or the liquidation preference (not including dividends in arrears) of the stock surrendered.

(4) For an illustration of the application of this paragraph, see Example (12) of §1.305–3(e) and *Examples (1), (2), (3), and (6)* of §1.305–5(d).

(5) For rules relating to redemption premiums on preferred stock, see §1.305–5(b).

[T.D. 7281, 38 FR 18538, July 12, 1973, as amended by T.D. 8643, 60 FR 66138, Dec. 21, 1995]

§1.305–8 Effective dates.

(a) *In general.* Section 421(b) of the Tax Reform Act of 1969 (83 Stat. 615) provides as follows:

(b) *Effective dates.* (1) Except as otherwise provided in this subsection, the amendment made by subsection (a) shall apply with respect to distributions (or deemed distributions) made after January 10, 1969, in taxable years ending after such date.

(2)(A) Section 305(b)(2) of the Internal Revenue Code of 1954 (as added by subsection (a) shall not apply to a distribution (or deemed distribution) of stock made before January 1, 1991, with respect to stock (i) outstanding on January 10, 1969, (ii) issued pursuant to a contract binding on January 10, 1969, on the distributing corporation, (iii) which is additional stock of that class of stock which (as of January 10, 1969) had the largest fair market value of all classes of stock of the corporation (taking into account only stock outstanding on January 10, 1969, or issued pursuant to a contract binding on January 10, 1969), (iv) described in subparagraph (c)(iii), or (v) issued in a prior distribution described in clause (i), (ii), (iii), or (iv).

(B) Subparagraph (A) shall apply only if—

(i) The stock as to which there is a receipt of property was outstanding on January 10, 1969 (or was issued pursuant to a contract binding on January 10, 1969, on the distributing corporation), and

(ii) If such stock and any stock described in subparagraph (A)(i) were also outstanding on January 10, 1968, a distribution of property was made on or before January 10, 1969, with respect to such stock, and a distribution of stock was made on or before January 10, 1969, with respect to such stock described in subparagraph (A)(i).

(C) Subparagraph (A) shall cease to apply when at any time after October 9, 1969, the distributing corporation issues any of its stock (other than in a distribution of stock with respect to stock of the same class) which is not—

(i) Nonconvertible preferred stock,

(ii) Additional stock of that class of stock which meets the requirements of subparagraph (A)(iii), or

(iii) Preferred stock which is convertible into stock which meets the requirements of subparagraph (A)(iii) at a fixed conversion ratio which takes account of all stock dividends and stock splits with respect to the stock into which such convertible stock is convertible.

(D) For purposes of this paragraph, the term *stock* includes rights to acquire such stock.

(3) In cases to which Treasury Decision 6990 (promulgated January 10, 1969) would not have applied, in applying paragraphs (1) and (2) April 22, 1969, shall be substituted for January 10, 1969.

(4) Section 305(b)(4) of the Internal Revenue Code of 1954 (as added by subsection (a)) shall not apply to any distribution (or deemed distribution) with respect to preferred stock (including any increase in the conversation ratio of convertible stock) made before January 1, 1991, pursuant to the terms relating to the issuance of such stock which were in effect on January 10, 1969.

(5) With respect to distributions made or considered as made after January 10, 1969, in taxable years ending after such date, to the extent that the amendment made by subsection (a) does not apply by reason of paragraph (2), (3), or (4) of this subsection, section 305 of the Internal Revenue Code of 1954 (as in effect before the amendment made by subsection (a)) shall continue to apply.

(b) *Rules of application.* (1) The rules contained in section 421(b)(2) of the Tax Reform Act of 1969 (83 Stat. 615), hereinafter called ‘‘the Act’’, shall apply with respect to the application of section 305(b)(2), section 305(b)(3), and section 305(b)(5). Thus, for example, section 305(b)(5) of the Code will not apply to a distribution of convertible preferred stock made before January 1, 1991, with respect to stock outstanding on January 10, 1969 (or which was issued pursuant to a contract binding on the distributing corporation on January 10, 1969), provided the distribution is pursuant to the terms relating to the issuance of such stock which were in effect on January 10, 1969.

(2)(i) For purposes of section 421(b)(2)(A), (B)(i), and (C) of the Act, stock is considered as outstanding on January 10, 1969, if it could be acquired on such date or some future date by the exercise of a right or conversion privilege in existence on such date (including a right or conversion privilege with respect to stock issued pursuant to a contract binding, on January 10, 1969, on the distributing corporation). Thus, if on January 10, 1969, corporation X has outstanding 1,000 shares of class A common stock and 3,000 shares of class B common stock which are convertible on a one-to-one basis into class A stock, corporation X is considered for purposes of section 421(b)(2)(A), (B)(i), and (C) of the Act to have outstanding on January 10, 1969, 4,000 shares of class A stock (1,000 shares actually outstanding and 3,000 shares that could be acquired by the exercise of the conversion privilege contained in the class B stock) and 3,000 shares of class B stock.

(ii) For the purposes of section 421(b)(2)(A) (other than for the purpose of determining under section 421(b)(2)(A)(iii) that class of stock which as of January 10, 1969, had the largest fair market value of all classes of stock of the corporation), (B)(i), and (C) of the Act, stock will be considered as outstanding on January 10, 1969, if it is issued pursuant to a conversion privilege contained in stock issued, mediately or immediately, as a stock dividend with respect to stock outstanding on January 10, 1969.

(3) If, after applying subparagraph (2) of this paragraph, the class of stock which as of January 10, 1969, had the largest fair market value of all classes of stock of the corporation is a class of stock which is convertible into another class of nonconvertible stock, then for purposes of section 421(b)(2)(C)(ii) of the Act stock issued upon conversion of any such convertible stock (whether

or not outstanding on January 10, 1969) into stock of such other class shall be deemed to be stock which meets the requirements of section 421(b)(2)(A)(iii) of the Act.

(4) For purposes of section 421(b) of the Act, stock of a corporation held in its treasury will not be considered as outstanding and a distribution of such stock will be considered to be an issuance of such stock on the date of distribution. Stock of a parent corporation held by its subsidiary is not considered treasury stock.

(5) The following stock shall not be taken into account for purposes of applying section 421(b)(2)(B)(i) of the Act: (i) Stock issued after January 10, 1969, and before October 10, 1969 (other than stock which was issued pursuant to a contract binding on January 10, 1969, on the distributing corporation); (ii) stock described in section 421(b)(2)(C)(i), (ii), or (iii) of the Act; and (iii) stock issued, mediately or immediately, as a stock dividend with respect to stock of the same class outstanding on January 10, 1969. For example, if on June 1, 1970, corporation Y issues additional stock of that class of stock which as of January 10, 1969, had the largest fair market value of all classes of stock of the corporation, such additional stock will not be taken into account for the purpose of meeting the requirement under section 421(b)(2)(B)(i) of the Act that the stock as to which there is a receipt of property must have been outstanding on January 10, 1969, and thus subparagraph (A) of section 421(b)(2) of the Act will not, where otherwise applicable, cease to apply.

(6) Section 421(b)(2)(A) of the Act, if otherwise applicable, will not cease to apply if the distributing corporation issues after October 9, 1969, securities which are convertible into stock that meets the requirements of section 421(b)(2)(A)(iii) of the Act at a fixed conversion ratio which takes account of all stock dividends and stock splits with respect to the stock into which the securities are convertible.

(7) Under section 421(b)(4) of the Act, section 305(b)(4) does not apply to any distribution (or deemed distribution) by a corporation with respect to preferred stock made before January 1, 1991, if such distribution is pursuant to the terms relating to the issuance of such stock which were in effect on January 10, 1969. For example, if as of January 10, 1969, a corporation had followed the practice of paying stock dividends on preferred stock (or of periodically increasing the conversion ratio of convertible preferred stock) or if the preferred stock provided for a redemption price in excess of the issue price, then section 305(b)(4) would not apply to any distribution of stock made (or which would be considered made if section 305(b)(4) applied) before January 1, 1991, pursuant to such practice.

(8) If section 421(b)(2) is not applicable and, for that reason, a distribution (or deemed distribution) is treated as a distribution to which section 301 applies by virtue of the application of section 305(b)(2), (b)(3), or (b)(5), it is irrelevant that, by reason of the application of section 421(b)(4) of such Act, section 305(b)(4) is not applicable to the distribution.

[T.D. 7281, 38 FR 18539, July 12, 1973]

§1.306–1 General.

(a) Section 306 provides, in general, that the proceeds from the sale or redemption of certain stock (referred to as ''section 306 stock'') shall be treated either as ordinary income or as a distribution of property to which section 301 applies. Section 306 stock is defined in section 306(c) and is usually preferred stock received either as a nontaxable dividend or in a transaction in which no gain or loss is recognized. Section 306(b) lists certain circumstances in which the special rules of section 306(a) shall not apply.

(b)(1) If a shareholder sells or otherwise disposes of section 306 stock (other than by redemption or within the exceptions listed in section 306(b)), the entire proceeds received from such disposition shall be treated as ordinary income to the extent that the fair market value of the stock sold, on the date distributed to the shareholder, would have been a dividend to such shareholder had the distributing corporation distributed cash in lieu of stock. Any excess of the amount received over the sum of the amount treated as ordinary income plus the adjusted basis of the stock disposed of, shall be treated as gain from the sale of a capital asset or noncapital asset as the case may be. No loss shall be recognized. No reduction of earnings and profits results from any disposition of stock other than a redemption. The term *disposition* under section 306(a)(1) includes, among other things, pledges of stock under certain circumstances, particularly where the pledgee can look only to the stock itself as its security.

(2) Section 306(a)(1) may be illustrated by the following examples:

Example (1). On December 15, 1954, A and B owned equally all of the stock of Corporation X which files its income tax return on a calendar year basis. On that date Corporation X distributed pro rata 100 shares of preferred stock as a dividend on its outstanding common stock. On December 15, 1954, the preferred stock had a fair market value of $10,000. On December 31, 1954, the earnings and profits of Corporation X were $20,000. The 50 shares of preferred stock so distributed to A had an allocated basis to him of $10 per share or a total of $500 for the 50 shares. Such shares had a fair market value of $5,000 when issued. A sold the 50 shares of preferred stock on July 1, 1955, for $6,000. Of this amount $5,000 will be treated as ordinary income; $500 ($6,000 minus $5,500) will be treated as gain from the sale of a capital or noncapital asset as the case may be.

Example (2). The facts are the same as in *Example 1* except that A sold his 50 shares of preferred stock for $5,100. Of this amount $5,000 will be treated as ordinary income. No loss will be allowed. There will be added back to the basis of the common stock of Corporation X with respect to which the preferred stock was distributed, $400, the allocated basis of $500 reduced by the $100 received.

Example (3). The facts are the same as in *Example 1* except that A sold 25 of his shares of preferred stock for $2,600. Of this amount $2,500 will be treated as ordinary income. No loss will be allowed. There will be added back to the basis of the common stock of Corporation X with respect to which the preferred stock was distributed, $150, the allocated basis of $250 reduced by the $100 received.

(c) The entire amount received by a shareholder from the redemption of section 306 stock shall be treated as a distribution of property under section 301. See also section 303 (relating to distribution in redemption of stock to pay death taxes).

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7556, 43 FR 34128, Aug. 3, 1978]

§ 1.306–2 Exception.

(a) If a shareholder terminates his entire stock interest in a corporation—

(1) By a sale or other disposition within the requirements of section 306(b)(1)(A), or

(2) By redemption under section 302(b)(3) (through the application of section 306(b)(1)(B)),

the amount received from such disposition shall be treated as an amount received in part or full payment for the stock sold or redeemed. In the case of a sale, only the stock interest need be terminated. In determining whether an entire stock interest has been terminated under section 306(b)(1)(A), all of the provisions of section 318(a) (relating to constructive ownership of stock) shall be applicable. In determining whether a shareholder has terminated his entire interest in a corporation by a redemption of his stock under section 302(b)(3), all of the provisions of section 318(a) shall be applicable unless the shareholder meets the requirements of section 302(c)(2) (relating to termination of all interest in the corporation). If the requirements of section 302(c)(2) are met, section 318(a)(1) (relating to members of a family) shall be inapplicable. Under all circumstances paragraphs (2), (3), (4), and (5) of section 318(a) shall be applicable.

(b) Section 306(a) does not apply to—

(1) Redemptions of section 306 stock pursuant to a partial or complete liquidation of a corporation to which part II (section 331 and following), subchapter C, chapter 1 of the Code applies,

(2) Exchanges of section 306 stock solely for stock in connection with a reorganization or in an exchange under section 351, 355, or section 1036 (relating to exchanges of stock for stock in the same corporation) to the extent that gain or loss is not recognized to the shareholder as the result of the exchange of the stock (see paragraph (d)

of §1.306–3 relative to the receipt of other property), and

(3) A disposition or redemption, if it is established to the satisfaction of the Commissioner that the distribution, and the disposition or redemption, was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. However, in the case of a prior or simultaneous disposition (or redemption) of the stock with respect to which the section 306 stock disposed of (or redeemed) was issued, it is not necessary to establish that the distribution was not in pursuance of such a plan. For example, in the absence of such a plan and of any other facts the first sentence of this subparagraph would be applicable to the case of dividends and isolated dispositions of section 306 stock by minority shareholders. Similarly, in the absence of such a plan and of any other facts, if a shareholder received a distribution of 100 shares of section 306 stock on his holdings of 100 shares of voting common stock in a corporation and sells his voting common stock before he disposes of his section 306 stock, the subsequent disposition of his section 306 stock would not ordinarily be considered a disposition one of the principal purposes of which is the avoidance of Federal income tax.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6969, 33 FR 11998, Aug. 23, 1968]

§1.306–3 Section 306 stock defined.

(a) For the purpose of subchapter C, chapter 1 of the code, the term *section 306 stock* means stock which meets the requirements of section 306(c)(1). Any class of stock distributed to a shareholder in a transaction in which no amount is includible in the income of the shareholder or no gain or loss is recognized may be section 306 stock, if a distribution of money by the distributing corporation in lieu of such stock would have been a dividend in whole or in part. However, except as provided in section 306(g), if no part of a distribution of money by the distributing corporation in lieu of such stock would have been a dividend, the stock distributed will not constitute section 306 stock.

(b) For the purpose of section 306, rights to acquire stock shall be treated as stock. Such rights shall not be section 306 stock if no part of the distribution would have been a dividend if money had been distributed in lieu of the rights. When stock is acquired by the exercise of rights which are treated at section 306 stock, the stock acquired is section 306 stock. Upon the disposition of such stock (other than by redemption or within the exceptions listed in section 306(b)), the proceeds received from the disposition shall be treated as ordinary income to the extent that the fair market value of the stock rights, on the date distributed to the shareholder, would have been a dividend to the shareholder had the distributing corporation distributed cash in lieu of stock rights. Any excess of the amount realized over the sum of the amount treated as ordinary income plus the adjusted basis of the stock, shall be treated as gain from the sale of the stock.

(c) Section 306(c)(1)(A) provides that section 306 stock is any stock (other than common issued with respect to common) distributed to the shareholder selling or otherwise disposing thereof if, under section 305(a) (relating to distributions of stock and stock rights) any part of the distribution was not included in the gross income of the distributee.

(d) Section 306(c)(1)(B) includes in the definition of section 306 stock any stock except common stock, which is received by a shareholder in connection with a reorganization under section 368 or in a distribution or exchange under section 355 (or so much of section 356 as relates to section 355) provided the effect of the transaction is substantially the same as the receipt of a stock dividend, or the stock is received in exchange for section 306 stock. If, in a transaction to which section 356 is applicable, a shareholder exchanges section 306 stock for stock and money or other property, the entire amount of such money and of the fair market value of the other property (not limited to the gain recognized) shall be treated as a distribution of property to which section 301 applies. Common stock received in exchange for section 306 stock in a recapitalization shall not be considered section 306 stock. Ordinarily, section 306 stock includes stock which is not common stock received in pursuance of a plan of reorganization (within the meaning of section 368(a)) or received in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies if cash received in lieu of such stock would have been treated as a dividend under section 356(a)(2) or would have been treated as a distribution to which section 301 applies by virtue of section 356(b) or section 302(d). The application of the preceding sentence is illustrated by the following examples:

Example (1). Corporation A, having only common stock outstanding, is merged in a statutory merger (qualifying as a reorganization under section 368(a)) with Corporation B. Pursuant to such merger, the shareholders of Corporation A received both common and preferred stock in Corporation B. The preferred stock received by such shareholders is section 306 stock.

Example (2). X and Y each own one-half of the 2,000 outstanding shares of preferred stock and one-half of the 2,000 outstanding shares of common stock of Corporation C. Pursuant to a reorganization within the meaning of section 368(a)(1)(E) (recapitalization) each shareholder exchanges his preferred stock for preferred stock of a new issue which is not substantially different from the preferred stock previously held. Unless the preferred stock exchanged was itself section 306 stock the preferred stock received is not section 306 stock.

(e) Section 306(c)(1)(C) includes in the definition of section 306 stock any stock (except as provided in section 306(c)(1)(B)) the basis of which in the hands of the person disposing of such stock, is determined by reference to section 306 stock held by such shareholder or any other person. Under this paragraph common stock can be section 306 stock. Thus, if a person owning section 306 stock in Corporation A transfers it to Corporation B which is controlled by him in exchange for common stock of Corporation B in a transaction to which section 351 is applicable, the common stock so received by him would be section 306 stock and subject to the provisions of section 306(a) on its disposition. In addition, the section 306 stock transferred is section 306 stock in the hands of Corporation B, the transferee. Section 306 stock transferred by gift remains section 306 stock in the hands of the donee. Stock received in exchange for section 306 stock under section 1036(a) (relating to exchange of stock for stock in the same corporation) or under so much of section 1031(b) as relates to section 1036(a) becomes section 306 stock and acquires, for purposes of section 306, the characteristics of the section 306 stock exchanged. The entire amount of the fair market value of the other property received in such transaction shall be considered as received upon a disposition (other than a redemption) to which section 306(a) applies. Section 306 stock ceases to be so classified if the basis of such stock is determined by reference to its fair market value on the date of the decedent-stockholder's death or the optional valuation date under section 1014.

(f) If section 306 stock which was distributed with respect to common stock is exchanged for common stock in the same corporation (whether or not such exchange is pursuant to a conversion privilege contained in section 306 stock), such common stock shall not be section 306 stock. This paragraph applies to exchanges not coming within the purview of section 306(c)(1)(B). Common stock which is convertible into stock other than common stock or into property, shall not be considered common stock. It is immaterial whether the conversion privilege is contained in the stock or in some type of collateral agreement.

(g) If there is a substantial change in the terms and conditions of any stock, then, for the purpose of this section—

(1) The fair market value of such stock shall be the fair market value at the time of distribution or the fair market value at the time of such change, whichever is higher;

(2) Such stock's ratable share of the amount which would have been a dividend if money had been distributed in lieu of stock shall be determined by reference to the time of distribution or by reference to the time of such change, whichever ratable share is higher; and

(3) Section 306(c)(2) shall be inapplicable if there would have been a dividend to any extent if money had been distributed in lieu of the stock either

at the time of the distribution or at the time of such change.

(h) When section 306 stock is disposed of, the amount treated under section 306(a)(1)(A) as ordinary income, for the purposes of part I, subchapter N, chapter 1 of the Code, be treated as derived from the same source as would have been the source if money had been received from the corporation as a dividend at the time of the distribution of such stock. If the amount is determined to be derived from sources within the United States, the amount shall be considered to be fixed or determinable annual or periodic gains, profits, and income within the meaning of section 871(a) or section 881(a), relating, respectively, to the tax on nonresident alien individuals and on foreign corporations not engaged in business in the United States.

(i) Section 306 shall be inapplicable to stock received before June 22, 1954, and to stock received on or after June 22, 1954, in transactions subject to the provisions of the Internal Revenue Code of 1939.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7281, 38 FR 18540, July 12, 1973; T.D. 7556, 43 FR 34128, Aug. 3, 1978]

§1.307–1 General.

(a) If a shareholder receives stock or stock rights as a distribution on stock previously held and under section 305 such distribution is not includible in gross income then, except as provided in section 307(b) and §1.307–2, the basis of the stock with respect to which the distribution was made shall be allocated between the old and new stocks or rights in proportion to the fair market values of each on the date of distribution. If a shareholder receives stock or stock rights as a distribution on stock previously held and pursuant to section 305 part of the distribution is not includible in gross income, then (except as provided in section 307(b) and §1.307–2) the basis of the stock with respect to which the distribution is made shall be allocated between (1) the old stock and (2) that part of the new stock or rights which is not includible in gross income, in proportion to the fair market values of each on the date of distribution. The date of distribution in each case shall be the date the stock or the rights are distributed to the stockholder and not the record date. The general rule will apply with respect to stock rights only if such rights are exercised or sold.

(b) The application of paragraph (a) of this section is illustrated by the following example:

Example A taxpayer in 1947 purchased 100 shares of common stock at $100 per share and in 1954 by reason of the ownership of such stock acquired 100 rights entitling him to subscribe to 100 additional shares of such stock at $90 a share. Immediately after the issuance of the rights, each of the shares of stock in respect of which the rights were acquired had a fair market value, ex-rights, of $110 and the rights had a fair market value of $19 each. The basis of the rights and the common stock for the purpose of determining the basis for gain or loss on a subsequent sale or exercise of the rights or a sale of the old stock is computed as follows:

100 (shares)×$100=$10,000, cost of old stock (stock in respect of which the rights were acquired).

100 (shares)×$110=$11,000, market value of old stock.

100 (rights)×$19=$1,900, market value of rights.

11,000/12,900 of $10,000=$8,527.13, cost of old stock apportioned to such stock.

1,900/12,900 of $10,000=$1,472.87, cost of old stock apportioned to rights.

If the rights are sold, the basis for determining gain or loss will be $14.7287 per right. If the rights are exercised, the basis of the new stock acquired will be the subscription price paid therefor ($90) plus the basis of the rights exercised ($14.7287 each) or $104.7287 per share. The remaining basis of the old stock for the purpose of determining gain or loss on a subsequent sale will be $85.2713 per share.

§1.307–2 Exception.

The basis of rights to buy stock which are excluded from gross income under section 305(a), shall be zero if the fair market value of such rights on the date of distribution is less than 15 percent of the fair market value of the old stock on that date, unless the shareholder elects to allocate part of the basis of the old stock to the rights as provided in paragraph (a) of §1.307–1. The election shall be made by a shareholder with respect to all the rights received by him in a particular distribution in respect of all the stock of the same class owned by him in the issuing corporation at the time of such distribution. Such election to allocate basis to rights shall be in the form of a statement attached to the shareholder's return for the year in which the rights are received. This election, once made, shall be irrevocable with respect to the rights for which the election was made. Any shareholder making such an election shall retain a copy of the election and of the tax return with which it was filed, in order to substantiate the use of an allocated basis upon a subsequent disposition of the stock acquired by exercise.

EFFECTS ON CORPORATION

§ 1.312–1 Adjustment to earnings and profits reflecting distributions by corporations.

(a) In general, on the distribution of property by a corporation with respect to its stock, its earnings, and profits (to the extent thereof) shall be decreased by—

(1) The amount of money,

(2) The principal amount of the obligations of such corporation issued in such distribution, and

(3) The adjusted basis of other property.

For special rule with respect to distributions to which section 312(e) applies, see § 1.312–5.

(b) The adjustment provided in section 312(a)(3) and paragraph (a)(3) of this section with respect to a distribution of property (other than money or its own obligations) shall be made notwithstanding the fact that such property has appreciated or depreciated in value since acquisition.

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

Example (1). Corporation A distributes to its sole shareholder property with a value of $10,000 and a basis of $5,000. It has $12,500 in earnings and profits. The reduction in earnings and profits by reason of such distribution is $5,000. Such is the reduction even though the amount of $10,000 is includible in the income of the shareholder (other than a corporation) as a dividend.

Example (2). The facts are the same as in *Example (1)* above except that the property has a basis of $15,000 and the earnings and profits of the corporation are $20,000. The reduction in earnings and profits is $15,000. Such is the reduction even though only the amount of $10,000 is includible in the income of the shareholder as a dividend.

(d) In the case of a distribution of stock or rights to acquire stock a portion of which is includible in income by reason of section 305(b), the earnings and profits shall be reduced by the fair market value of such portion. No reduction shall be made if a distribution of stock or rights to acquire stock is not includible in income under the provisions of section 305.

(e) No adjustment shall be made in the amount of the earnings and profits of the issuing corporation upon a disposition of section 306 stock unless such disposition is a redemption.

§ 1.312–2 Distribution of inventory assets.

Section 312(b) provides for the increase and the decrease of the earnings and profits of a corporation which distributes, with respect to its stock, inventory assets as defined in section 312(b)(2), where the fair market value of such assets exceeds their adjusted basis. The rules provided in section 312(b) (relating to distributions of certain inventory assets) shall be applicable without regard to the method used in computing inventories for the purpose of the computation of taxable income. Section 312(b) does not apply to distributions described in section 312(e).

§ 1.312–3 Liabilities.

The amount of any reductions in earnings and profits described in section 312 (a) or (b) shall be (a) reduced by the amount of any liability to which the property distributed was subject and by the amount of any other liability of the corporation assumed by the shareholder in connection with such distribution, and (b) increased by the amount of gain recognized to the corporation under section 311 (b), (c), or (d), or under section 341(f), 617(d), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a).

[T.D. 7209, 37 FR 20804, Oct. 5, 1972, as amended by T.D. 8586, 60 FR 2500, Jan. 10, 1995]

§1.312–4 Examples of adjustments provided in section 312(c).

The adjustments provided in section 312(c) may be illustrated by the following examples:

Example (1). On December 2, 1954, Corporation X distributed to its sole shareholder, A, an individual, as a dividend in kind a vacant lot which was not an inventory asset. On that date, the lot had a fair market value of $5,000 and was subject to a mortgage of $2,000. The adjusted basis of the lot was $3,100. The amount of the earnings and profits was $10,000. The amount of the dividend received by A is $3,000 ($5,000, the fair market value, less $2,000, the amount of the mortgage) and the reduction in the earnings and profits of Corporation X is $1,100 ($3,100, the basis, less $2,000, the amount of mortgage).

Example (2). The facts are the same as in *Example (1)* above with the exception that the amount of the mortgage to which the property was subject was $4,000. The amount of the dividend received by A is $1,000, and there is no reduction in the earnings and profits of the corporation as a result of the distribution (disregarding such reduction as may result from an increase in tax to Corporation X because, of gain resulting from the distribution). There is a gain of $900 recognized to Corporation X, the difference between the basis of the property ($3,100) and the amount of the mortgage ($4,000), under section 311(c) and an increase in earnings and profits of $900.

Example (3). Corporation A, having accumulated earnings and profits of $100,000, distributed in kind to its shareholders, not in liquidation, inventory assets which had a basis to it on the ‘‘Lifo’’ method (section 472) of $46,000 and on the basis of cost or market (section 471) of $50,000. The inventory had a fair market value of $55,000 and was subject to a liability of $35,000. This distribution results in a net decrease in earnings and profits of Corporation A of $11,000, (without regard to any tax on Corporation A) computed as follows:

“Fifo” basis of inventory	$50,000	
Less: “Lifo” basis of inventory	46,000	
Gain recognized—addition to earnings and profits (section 311(b))		$4,000
Adjustment to earnings and profits required by section 312(b)(1)(A):		
Fair market value of inventory	$55,000	
Less: “Lifo” basis plus adjustment under section 311(b)	50,000	5,000
Total increase in earnings and profits		9,000
Decrease in earnings and profits—under section 312(b)(1)(B)(i)	$55,000	
Less: Liability assumed	35,000	
Net amount of distribution (decrease in earnings)		20,000
Net decrease in earnings and profits		11,000

§1.312–5 Special rule for partial liquidations and certain redemptions.

The part of the distribution properly chargeable to capital account within the provisions of section 312(e) shall not be considered a distribution of earnings and profits within the meaning of section 301 for the purpose of determining taxability of subsequent distributions by the corporation.

§1.312–6 Earnings and profits.

(a) In determining the amount of earnings and profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated before March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings and profits in any case will be dependent upon the method of accounting properly employed in computing taxable income (or net income, as the case may be). For instance, a corporation keeping its books and filing its income tax returns under subchapter E, chapter 1 of the Code, on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 453 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 831 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 832(b)(4) and which is segregated accordingly in the unearned premium reserve.

(b) Among the items entering into the computation of corporate earnings and profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 61 or corresponding provisions of prior revenue acts. Gains and losses within the purview of section 1002 or corresponding provisions of prior revenue acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

(c)(1) In the case of a corporation in which depletion or depreciation is a factor in the determination of income, the only depletion or depreciation deductions to be considered in the computation of the total earnings and profits are those based on cost or other basis without regard to March 1, 1913, value. In computing the earnings and profits for any period beginning after February 28, 1913, the only depletion or depreciation deductions to be considered are those based on (i) cost or other basis, if the depletable or depreciable asset was acquired subsequent to February 28, 1913, or (ii) adjusted cost or March 1, 1913, value, whichever is higher, if acquired before March 1, 1913. Thus, discovery or percentage depletion under all revenue acts for mines and oil and gas wells is not to be taken into consideration in computing the earnings and profits of a corporation. Similarly, where the basis of property in the hands of a corporation is a substituted basis, such basis, and not the fair market value of the property at the time of the acquisition by the corporation, is the basis for computing depletion and depreciation for the purpose of determining earnings and profits of the corporation.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example Oil producing property which A had acquired in 1949 at a cost of $28,000 was transferred to Corporation Y in December 1951, in exchange for all of its capital stock. The fair market value of the stock and of the property as of the date of the transfer was $247,000. Corporation Y, after four years' operation, effected in 1955 a cash distribution to A in the amount of $165,000. In determining the extent to which the earnings and profits of Corporation Y available for dividend distributions have been increased as the result of production and sale of oil, the depletion to be taken into account is to be computed upon the basis of $28,000 established in the nontaxable exchange in 1951 regardless of the fair market value of the property or of the stock issued in exchange therefor.

(d) A loss sustained for a year before the taxable year does not affect the earnings and profits of the taxable year. However, in determining the earnings and profits accumulated since February 28, 1913, the excess of a loss sustained for a year subsequent to February 28, 1913, over the undistributed earnings and profits accumulated since February 28, 1913, and before the year for which the loss was sustained, reduces surplus as of March 1, 1913, to the extent of such excess. If the surplus as of March 1, 1913, was sufficient to absorb such excess, distributions to shareholders after the year of the loss are out of earnings and profits accumulated since the year of the loss to the extent of such earnings.

(e) With respect to the effect on the earnings and profits accumulated since February 28, 1913, of distributions made on or after January 1, 1916, and before August 6, 1917, out of earnings or profits accumulated before March 1, 1913, which distributions were specifically declared to be out of earnings and profits accumulated before March 1, 1913, see section 31(b) of the Revenue Act of 1916, as added by section 1211 of the Revenue Act of 1917 (40 Stat. 336).

§ 1.312–7 Effect on earnings and profits of gain or loss realized after February 28, 1913.

(a) In order to determine the effect on earnings and profits of gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation, section 312(f)(1) prescribed certain rules for—

(1) The computation of the total earnings and profits of the corporation of most frequent application in determining invested capital; and

(2) The computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions.

Such rules are applicable whenever under any provision of subtitle A of the Code it is necessary to compute either the total earnings and profits of the corporation or the earnings and profits for any period beginning after February 28, 1913. For example, since the earnings and profits accumulated after

February 28, 1913, or the earnings and profits of the taxable year, are earnings and profits for a period beginning after February 28, 1913, the determination of either must be in accordance with the regulations prescribed by this section for the ascertainment of earnings and profits for any period beginning after February 28, 1913. Under subparagraph (1) of this paragraph, such gain or loss is determined by using the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, but disregarding value as of March 1, 1913. Under subparagraph (2) of this paragraph, there is used such adjusted basis for determining gain, giving effect to the value as of March 1, 1913, whenever applicable. In both cases the rules are the same as those governing depreciation and depletion in computing earnings and profits (see §1.312–6). Under both subparagraphs (1) and (2) of this paragraph, the adjusted basis is subject to the limitations of the third sentence of section 312(f)(1) requiring the use of adjustments proper in determining earnings and profits. The proper adjustments may differ under section 312(f)(1)(A) and (B) depending upon the basis to which the adjustments are to be made. If the application of section 312(f)(1)(B) results in a loss and if the application of section 312(f)(1)(A) to the same transaction reaches a different result, then the loss under section 312(f)(1)(B) will be subject to the adjustment thereto required by section 312(g)(2). (See §1.312–9.)

(b)(1) The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was recognized in computing taxable income (or net income, as the case may be) under the law applicable to the year in which such sale or disposition was made. As used in this paragraph, the term ‘‘recognized’’ has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized. For example, see section 356. A loss (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of section 1091 or corresponding provisions of prior revenue laws) may be recognized though not allowed as a deduction (by reason, for example, of the operation of sections 267 and 1211 and corresponding provisions of prior revenue laws) but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under section 1091 and corresponding provisions of prior revenue laws, are deemed nonrecognized losses and do not reduce earnings or profits. The *recognized* gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 312(f)(1) as distinguished from the realized gain or loss used in computing taxable income (or net income, as the case may be).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). Corporation X on January 1, 1952, owned stock in Corporation Y which it had acquired from Corporation Y in December 1951, in an exchange transaction in which no gain or loss was recognized. The adjusted basis to Corporation X of the property exchanged by it for the stock in Corporation Y was $30,000. The fair market value of the stock in Corporation Y when received by Corporation X was $930,000. On April 9, 1955, Corporation X made a cash distribution of $900,000 and, except for the possible effect of the transaction in 1951, had no earnings or profits accumulated after February 28, 1913, and had no earnings or profits for the taxable year. The amount of $900,000 representing the excess of the fair market value of the stock of Corporation Y over the adjusted basis of the property exchanged therefor was not recognized gain to Corporation X under the provisions of section 112 of the Internal Revenue Code of 1939. Accordingly, the earnings and profits of Corporation X are not increased by $900,000, the amount of the gain realized but not recognized in the exchange, and the distribution was not a taxable dividend. The basis in the hands of Corporation Y of the property acquired by it from Corporation X is $30,000. If such property is thereafter sold by Corporation Y, gain or loss will be computed on such basis of $30,000, and earnings and profits will be increased or decreased accordingly.

Example (2). On January 2, 1910, Corporation M acquired nondepreciable property at a cost of $1,000. On March 1, 1913, the fair market value of such property in the hands of Corporation M was $2,200. On December 31, 1952, Corporation M transfers such property to Corporation N in exchange for $1,900 in cash and all Corporation N's stock, which has a fair market value of $1,100. For the purpose of computing the total earnings and profits of Corporation M, the gain on such transaction is $2,000 (the sum of $1,900 in cash and stock worth $1,100 minus $1,000, the adjusted basis for computing gain, determined without regard to March 1, 1913, value), $1,900 of which is recognized under section 356, since this was the amount of money received, although for the purpose of computing net income the gain is only $800 (the sum of $1,900 in cash and stock worth $1,100, minus $2,200, the adjusted basis for computing gain determined by giving effect to March 1, 1913, value). Such earnings and profits will therefore be increased by only $800 as a reputing the earnings and profits of Corporation M for any period beginning after February 28, 1913, however, the gain arising from the transaction, like the taxable gain, is only $800, all of which is recognized under section 112(c) of the Internal Revenue Code of 1939, the money received being in excess of such amount. Such earnings and profits will therefore be increased by only $800 as a result of the transaction. For increase in that part of the earnings and profits consisting of increase in value of property accrued before, but realized on or after March 1, 1913, see § 1.312–9.

Example (3). On July 31, 1955, Corporation R owned oil-producing property acquired after February 28, 1913, at a cost of $200,000, but having an adjusted basis (by reason of taking percentage depletion) of $100,000 for determining gain. However, the adjusted basis of such property to be used in computing gain or loss for the purpose of earnings and profits is, because of the provisions of the third sentence of section 312(f)(1), $150,000. On such day Corporation R transferred such property to Corporation S in exchange for $25,000 in cash and all of the stock of Corporation S, which had a fair market value of $100,000. For the purpose of computing taxable income, Corporation R has realized a gain of $25,000 as a result of this transaction, all of which is recognized under section 356. For the purpose of computing earnings and profits, however, Corporation R has realized a loss of $25,000, none of which is recognized owing to the provisions of section 356(c). The earnings and profits of Corporation R are therefore neither increased nor decreased as a result of the transaction. The adjusted basis of the Corporation S stock in the hands of Corporation R for purposes of computing earnings and profits, however, will be $125,000 (though only $100,000 for the purpose of computing taxable income), computed as follows:

Basis of property transferred	$200,000
Less money received on exchange	25,000
Plus gain or minus loss recognized on exchange	None
Basis of stock	175,000
Less adjustments (same as those used in determining adjusted basis of property transferred)	50,000
Adjusted basis of stock	125,000

If, therefore, Corporation R should subsequently sell the Corporation S stock for $100,000, a loss of $25,000 will again be realized for the purpose of computing earnings and profits, all of which will be recognized and will be applied to decrease the earnings and profits of Corporation R.

(c)(1) The third sentence of section 312(f)(1) provides for cases in which the adjustments, prescribed in section 1016, to the basis indicated in section 312(f)(1)(A) or (B), as the case may be, differ from the adjustments to such basis proper for the purpose of determining earnings or profits. The adjustments provided by such third sentence reflect the treatment provided by §§ 1.312–6 and 1.312–15 relative to cases where the deductions for depletion and depreciation in computing taxable income (or net income, as the case may be) differ from the deductions proper for the purpose of computing earnings and profits.

(2) The effect of the third sentence of section 312(f)(1) may be illustrated by the following examples:

Example (1). Corporation X purchased on January 2, 1931, an oil lease at a cost of $10,000. The lease was operated only for the years 1931 and 1932. The deduction for depletion in each of the years 1931 and 1932 amounted to $2,750, of which amount $1,750 represented percentage depletion in excess of depletion based on cost. The lease was sold in 1955 for $15,000. Under section 1016(a)(2), in determining the gain or loss from the sale of the property, the basis must be adjusted for cost depletion of $1,000 in 1931 and percentage depletion of $2,750 in 1932. However, the adjustment of such basis, proper for the determination of earnings and profits, is $1,000 for each year, or $2,000. Hence, the cost is to be adjusted only to the extent of $2,000, leaving an adjusted basis of $8,000 and the earnings and profits will be increased by $7,000, and not by $8,750. The difference of $1,750 is equal to the amount by which the percentage depletion for the year 1932 ($2,750) exceeds the depletion on cost for that year ($1,000) and has already been applied in the computation of earnings and profits for the year 1932 by taking into account only $1,000 instead of $2,750 for depletion in the computation of such earnings and profits. (See § 1.316–1.)

Example (2). If, in *Example (1)*, above, the property, instead of being sold, is exchanged in a transaction described in section 1031 for like property having a fair market value of $7,750 and cash of $7,250, then the increase in earnings and profits amounts to $7,000, that is, $15,000 ($7,750 plus $7,250) minus the basis of $8,000. However, in computing taxable income of Corporation X, the gain is $8,750, that is, $15,000 minus $6,250 ($10,000 less depletion of $3,750), of which only $7,250 is recognized because the recognized gain cannot exceed the sum of money received in the transaction. See section 1031(b) and the corresponding provisions of prior revenue laws. If, however, the cash received was only $2,250 and the value of the property received was $12,750, then the increase in earnings and profits would be $2,250, that amount being the gain recognized under section 1031.

Example (3). On January 1, 1973, corporation X purchased for $10,000 a depreciable asset with an estimated useful life of 20 years and no salvage value. In computing depreciation on the asset, corporation X used the declining balance method with a rate twice the straight line rate. On December 31, 1976, the asset was sold for $9,000. Under section 1016(a)(2), the basis of the asset is adjusted for depreciation allowed for the years 1973 through 1976, or a total of $3,439. Thus, X realizes a gain of $2,439 (the excess of the amount realized, $9,000, over the adjusted basis, $6,561). However, the proper adjustment to basis for the purpose of determining earnings and profits is only $2,000, i.e., the total amount which, under §1.312–15, was applied in the computation of earnings and profits for the years 1973–76. Hence, upon sale of the asset, earnings and profits are increased by only $1,000, i.e., the excess of the amount realized, $9,000, over the adjusted basis for earnings and profits purposes, $8,000.

(d) For adjustment and allocation of the earnings and profits of the transferor as between the transferor and the transferee in cases where the transfer of property by one corporation to another corporation results in the nonrecognition in whole or in part of gain or loss, see §1.312–10; and see section 381 for earnings and profits of successor corporations in certain transactions.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7221, 37 FR 24746, Nov. 21, 1972]

§1.312–8 Effect on earnings and profits of receipt of tax-free distributions requiring adjustment or allocation of basis of stock.

(a) In order to determine the effect on earnings and profits, where a corporation receives (after February 28, 1913) from a second corporation a distribution which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, section 312(f) prescribes certain rules. It provides that the amount of such distribution shall not increase the earnings and profits of the first or receiving corporation in the following cases: (1) No such increase shall be made in respect of the part of such distribution which (under the law applicable to the year in which the distribution was made) is directly applied in reduction of the basis of the stock in respect of which the distribution was made and (2) no such increase shall be made if (under the law applicable to the year in which the distribution was made) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received (or such basis would but for section 307(b) be so allocated). Where, therefore, the law (applicable to the year in which the distribution was made, as, for example, a distribution in 1934 from earnings and profits accumulated before March 1, 1913) requires that the amount of such distribution shall be applied against and reduce the basis of the stock with respect to which the distribution was made, there is no increase in the earnings and profits by reason of the receipt of such distribution. Similarly, where there is received by a corporation a distribution from another corporation in the form of a stock dividend and the law applicable to the year in which such distribution was made requires the allocation, as between the old stock and the stock received as a dividend, of the basis of the old stock (or such basis would but for section 307(b) be so allocated), then there is no increase in the earnings and profits by reason of the receipt of such stock dividend even though such stock dividend constitutes income within the meaning of the sixteenth amendment to the Constitution.

(b) The principles set forth in paragraph (a) of this section may be illustrated by the following examples:

Example (1). Corporation X in 1955 distributed to Corporation Y, one of its shareholders, $10,000 which was out of earnings or profits accumulated before March 1, 1913, and did not exceed the adjusted basis of the stock in respect of which the distribution was made. This amount of $10,000 was, therefore, a tax-free distribution and under the provisions of section 301(c)(2) must be applied against and reduce the adjusted basis of the stock in respect of which the distribution was made. The earnings and profits of Corporation Y are not increased by reason of the receipt of this distribution.

Example (2). Corporation Z in 1955 had outstanding common and preferred stock of which Corporation Y held 100 shares of the common and no preferred. The stock had a cost basis to Corporation Y of $100 per share, or a total cost of $10,000. In December of that year it received a dividend of 100 shares of the preferred stock of Corporation Z. Such distribution is a stock dividend which, under section 305, was not taxable and was accordingly not included in the gross income of Corporation Y. The original cost of $10,000 is allocated to the 200 shares of Corporation Z none of which has been sold or otherwise disposed of by Corporation Y. See section 307 and § 1.307–1. The earnings and profits of Corporation Y are not increased by reason of the receipt of such stock dividend.

§ 1.312–9 Adjustments to earnings and profits reflecting increase in value accrued before March 1, 1913.

(a) In order to determine, for the purpose of ascertaining the source of dividend distributions, that part of the earnings and profits which is represented by increase in value of property accrued before, but realized on or after, March 1, 1913, section 312(g) prescribes certain rules.

(b)(1) Section 312(g)(1) sets forth the general rule with respect to computing the increase to be made in that part of the earnings and profits consisting of increase in value of property accrued before, but realized on or after, March 1, 1913.

(2) The effect of section 312(g)(1) may be illustrated by the following examples:

Example (1). Corporation X acquired nondepreciable property before March 1, 1913, at a cost of $10,000. Its fair market value as of March 1, 1913, was $12,000 and it was sold in 1955 for $15,000. The increase in earnings and profits based on the value as of March 1, 1913, representing earnings and profits accumulated since February 28, 1913, is $3,000. If the basis is determined without regard to the value as of March 1, 1913, there would be an increase in earnings and profits of $5,000. The difference of $2,000 ($5,000 minus $3,000) represents the increase to be made in that part of the earnings and profits of Corporation X consisting of the increase in value of property accrued before, but realized on or after, March 1, 1913.

Example (2). Corporation Y acquired depreciable property in 1908 at a cost of $100,000. Assuming no additions or betterments, and that the depreciation sustained before March 1, 1913, was $10,000, the adjusted cost as of that date was $90,000. Its fair market value as of March 1, 1913, was $94,000 and on February 28, 1955, it was sold for $25,000. For the purpose of determining gain from the sale, the basis of the property is the fair market value of $94,000 as of March 1, 1913, adjusted for depreciation for the period subsequent to February 28, 1913, computed on such fair market value. If the amount of the depreciation deduction allowed after February 28, 1913, and properly allowable for each of such years to the date of the sale in 1955 is the aggregate sum of $81,467, the adjusted basis for determining gain in 1955 ($94,000 less $81,467) is $12,533 and the gain would be $12,467 ($25,000 less $12,533). The increase in earnings and profits accumulated since February 28, 1913, by reason of the sale, based on the value as of March 1, 1913, adjusted for depreciation is $12,467. If the depreciation since February 28, 1913, had been based on the adjusted cost of $90,000 ($100,000 less $10,000) instead of the March 1, 1913, value of $94,000, the depreciation sustained from that date to the date of sale would have been $78,000 instead of $81,467 and the actual gain on the sale based on the cost of $100,000 adjusted by depreciation on such cost to $12,000 ($100,000 reduced by the sum of $10,000 and $78,000) would be $13,000 ($25,000 less $12,000). If the adjusted basis of the property was determined without regard to the value as of March 1, 1913, there would be an increase in earnings and profits of $13,000. The difference of $533 ($13,000 minus $12,467) represents the increase to be made in that part of the earnings and profits of Corporation Y consisting of the increase in value of property accrued before, but realized on or after, March 1, 1913 (assuming that the proper increase in such surplus had been made each year for the difference between depreciation based on cost and the depreciation based on March 1, 1913, value). Thus, the total increase in that part of earnings and profits consisting of the increase in value of property accrued before, but realized on or after, March 1, 1913, is $4,000 ($94,000 less $90,000).

(c)(1) Section 312(g)(2) is an exception to the general rule in section 312(g)(1) and also operates as a limitation on the application of section 312(f). It provides that, if the application of section 312(f)(1)(B) to a sale or other disposition after February 28, 1913, results in a loss which is to be applied in decrease of earnings and profits for any period beginning after February 28, 1913, then, notwithstanding section 312(f) and in lieu of the rule provided in section 312(g)(1), the amount of such loss so to be applied shall be reduced by the amount, if any, by which the adjusted basis of the property used in determining the loss, exceeds the adjusted basis computed without regard to the fair market value of the property on March 1, 1913. If the amount so applied in reduction of the loss exceeds such loss, the excess over such loss shall increase that part of the earnings and profits consisting of increase in value of property accrued before, but realized on or after March 1, 1913.

(2) The application of section 312(g)(2) may be illustrated by the following examples:

Example (1). Corporation Y acquired non-depreciable property before March 1, 1913, at a cost of $8,000. Its fair market value as of March 1, 1913, was $13,000, and it was sold in 1955 for $10,000. Under section 312(f)(1)(B) the adjusted basis would be $13,000 and there would be a loss of $3,000. The application of section 312(f)(1)(B) would result in a loss from the sale in 1955 to be applied in decrease of earnings and profits for that year. Section 312(g)(2), however, applies and the loss of $3,000 is reduced by the amount by which the adjusted basis of $13,000 exceeds the cost of $8,000 (the adjusted basis computed without regard to the value on March 1, 1913), namely $5,000. The amount of the loss is, accordingly, reduced from $3,000 to zero and there is no decrease in earnings and profits of Corporation Y for the year 1955 as a result of the sale. The amount applied in reduction of the decrease, namely, $5,000, exceeds $3,000. Accordingly, as a result of the sale the excess of $2,000 increases that part of the earnings and profits of Corporation Y consisting of increase in value of property accrued before, but realized on or after March 1, 1913.

Example (2). Corporation Z acquired non-depreciable property before March 1, 1913, at a cost of $10,000. Its fair market value as of March 1, 1913, was $12,000, and it was sold in 1955 for $8,000. Under section 312(f)(1)(B) the adjusted basis would be $12,000 and there would be a loss of $4,000. The application of section 312(f)(1)(B) would result in a loss from the sale in 1955 to be applied in decrease of earnings and profits for that year. Section 312(g)(2), however, applies and the loss of $4,000 is reduced by the amount by which the adjusted basis of $12,000 exceeds the cost of $10,000 (the adjusted basis computed without regard to the value on March 1, 1913), namely, $2,000. The amount of the loss is, accordingly, reduced from $4,000 to $2,000 and the decrease in earnings and profits of Corporation Z for the year 1955 as a result of the sale is $2,000 instead of $4,000. The amount applied in reduction of the decrease, namely, $2,000, does not exceed $4,000. Accordingly, as a result of the sale there is no increase in that part of the earnings and profits of Corporation Z consisting of increase in value of property accrued before, but realized on or after, March 1, 1913.

§1.312–10 Allocation of earnings in certain corporate separations.

(a) If one corporation transfers part of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(1)(4) applies and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, the earnings and profits of the distributing corporation immediately before the transaction shall be allocated between the distributing corporation and the controlled corporation. In the case of a newly created controlled corporation, such allocation generally shall be made in proportion to the fair market value of the business or businesses (and interests in any other properties) retained by the distributing corporation and the business or businesses (and interests in any other properties) of the controlled corporation immediately after the transaction. In a proper case, allocation shall be made between the distributing corporation and the controlled corporation in proportion to the net basis of the assets transferred and of the assets retained or by such other method as may be appropriate under the facts and circumstances of the case. The term *net basis* means the basis of the assets less liabilities assumed or liabilities to which such assets are subject. The part of the earnings and profits of the taxable year of the distributing corporation in which the transaction occurs allocable to the controlled corporation shall be included in the computation of the earnings and profits of the first taxable year of the controlled corporation ending after the date of the transaction.

(b) If a distribution or exchange to which section 355 applies (or so much of section 356 as relates to section 355) is not in pursuance of a plan meeting the requirements of a reorganization as defined in section 368(a)(1)(D), the earnings and profits of the distributing corporation shall be decreased by the lesser of the following amounts:

(1) The amount by which the earnings and profits of the distributing corporation would have been decreased if it had transferred the stock of the controlled corporation to a new corporation in a reorganization to which section 368(a)(1)(D) applied and immediately thereafter distributed the stock of such new corporation or,

(2) The net worth of the controlled corporation. (For this purpose the term *net worth* means the sum of the basis of all of the properties plus cash minus all liabilities.)

If the earnings and profits of the controlled corporation immediately before the transaction are less than the amount of the decrease in earnings and profits of the distributing corporation (including a case in which the controlled corporation has a deficit) the earnings and profits of the controlled corporation, after the transaction, shall be equal to the amount of such decrease. If the earnings and profits of the controlled corporation immediately before the transaction are more than the amount of the decrease in the earnings and profits of the distributing corporation, they shall remain unchanged.

(c) In no case shall any part of a deficit of a distributing corporation within the meaning of section 355 be allocated to a controlled corporation.

§ 1.312–11 Effect on earnings and profits of certain other tax-free exchanges, tax-free distributions, and tax-free transfers from one corporation to another.

(a) If property is transferred by one corporation to another, and, under the law applicable to the year in which the transfer was made, no gain or loss was recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings and profits of the transferor shall be made as between the transferor and the transferee. Transfers to which the preceding sentence applies include contributions to capital, transfers under section 351, transfers in connection with reorganizations under section 368, transfers in liquidations under section 332 and intercompany transfers during a period of affiliation. However, if, for example, property is transferred from one corporation to another in a transaction under section 351 or as a contribution to capital and the transfer is not followed or preceded by a reorganization, a transaction under section 302(a) involving a substantial part of the transferor's stock, or a total or partial liquidation, then ordinarily no allocation of the earnings and profits of the transferor shall be made. For specific rules as to allocation of earnings and profits in certain reorganizations under section 368 and in certain liquidations under section 332 see section 381 and the regulations thereunder. For allocation of earnings and profits in certain corporate separations see section 312(i) and § 1.312–10.

(b) The general rule provided in section 316 that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, or in a transaction subject to section 355, to its shareholders—

(i) Of stock or securities in such corporation or in another corporation a party to the reorganization in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112(g) of the Revenue Act of 1932 (47 Stat. 197)); or

(ii) Of stock (other than preferred stock) in another corporation which is a party to the reorganization without the surrender by the distributees of stock in the distributing corporation if the distribution occurs after October 20, 1951, and is subject to section 112(b)(11) of the Internal Revenue Code of 1939; or

(iii) Of stock or securities in such corporation or in another corporation a party to the reorganization in any taxable year beginning before January 1, 1939, or on or after such date, in exchange for its stock or securities in a transaction to which section 112(b)(3) of the Internal Revenue Code of 1939 was applicable; or

(iv) Of stock or securities in such corporation or in another corporation in exchange for its stock or securities in a transaction subject to section 354 or 355,

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1939, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under the circumstances described in section 112(b)(6) of the Revenue Act of 1936 (49 Stat. 1679), the Revenue Act of 1938 (52 Stat. 485), of the Internal Revenue Code of 1939, or section 332 of the Internal Revenue Code of 1954.

(3) The distribution in any taxable year (beginning after December 31, 1938), of stock or securities, or other property or money, in the case of an exchange or distribution described in section 371 of the Internal Revenue Code of 1939 or in section 1081 of the Internal Revenue Code of 1954 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributee from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 (48 Stat. 712) or a corresponding provision of a prior Revenue Act, or section 305 of the Code.

(5) The distribution, in a taxable year of the distributee beginning after December 31, 1931, by or on behalf of an insolvent corporation, in connection with a section 112(b)(10) reorganization under the Internal Revenue Code of 1939, or in a transaction subject to section 371 of the Internal Revenue Code of 1954, of stock or securities in a corporation organized or made use of to effectuate the plan of reorganization, if under section 112(e) of the Internal Revenue Code of 1939 or section 371 of the Internal Revenue Code of 1954 no gain to the distributee from the receipt of such stock or securities was recognized by law.

(c) A distribution described in paragraph (b) of this section does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a taxfree liquidation or reorganization described in paragraph (b)(1), (2), (3), or (5) of this section) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

(d) For the purposes of this section, the terms *reorganization* and *party to the reorganization* shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932 (47 Stat. 196); for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934 (48 Stat. 704); for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in section 112 of the Revenue Act of 1936 (49 Stat. 1678); for any taxable year beginning after December 31, 1937, and before January 1, 1939, have the meanings assigned to such terms in section 112 of the Revenue Act of 1938 (52 Stat. 485); and for any taxable year beginning after December 31, 1938, and ending before June 22, 1954, providing no election is made under section 393(b)(2) of the Internal Revenue Code of 1954, have the meanings assigned to such terms in section 112(g)(1) of the Internal Revenue Code of 1939.

§ 1.312–12 Distributions of proceeds of loans guaranteed by the United States.

(a) The provisions of section 312(j) are applicable with respect to a loan, any portion of which is guaranteed by an agency of the United States Government without regard to the percentage of such loan subject to such guarantee.

(b) The application of section 312(j) is illustrated by the following example:

Example. Corporation A borrowed $1,000,000 for the purpose of construction of an apartment house, the cost and adjusted basis of which was $900,000. This loan was guaranteed by an agency of the United States Government. One year after such loan was made and after the completion of construction of the building (but before such corporation had received any income) it distributed $100,000 cash to its shareholders. The earnings and profits of the taxable year of such corporation are increased (pursuant to section 312(j)) by $100,000 immediately prior to such distribution and are decreased by $100,000 immediately after such distribution. Such decrease, however, does not reduce the earnings and profits below zero. Two years later, it has no accumulated earnings and has earnings of the taxable year of $100,000. Before it has made any payments on the loan, it distributes $200,000 to its shareholders. The earnings and profits of the taxable year of the corporation ($100,000) are increased by $100,000, the excess of the amount of the guaranteed loan over the adjusted basis of the apartment house (calculated without adjustment for depreciation). The entire amount of each distribution is treated as a distribution out of earnings and profits and, accordingly, as a taxable dividend.

§ 1.312–15 Effect of depreciation on earnings and profits.

(a) *Depreciation for taxable years beginning after June 30, 1972*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph and paragraph (c) of this section, for purposes of computing the earnings and profits of a corporation (including a real estate investment trust as defined in section 856) for any taxable year beginning after June 30, 1972, the allowance for depreciation (and amortization, if any) shall be deemed to be the amount which would be allowable for such year if the straight line method of depreciation had been used for all property for which depreciation is allowable for each taxable year beginning after June 30, 1972. Thus, for taxable years beginning after June 30, 1972, in determining the earnings and profits of a corporation, depreciation must be computed under the straight line method, notwithstanding that in determining taxable income the corporation uses an accelerated method of depreciation described in subparagraph (A), (B), or (C) of section 312(m)(2) or elects to amortize the basis of property under section 169, 184, 187, or 188, or any similar provision.

(2) *Exception.* (i) If, for any taxable year beginning after June 30, 1972, a method of depreciation is used by a corporation in computing taxable income which the Secretary or his delegate has determined results in a reasonable allowance under section 167(a) and which is not a declining balance method of depreciation (described in § 1.167(b)–2), the sum of the years-digits method (described in § 1.167(b)–3), or any other method allowed solely by reason of the application of subsection (b)(4) or (j)(1)(C) of section 167, then the adjustment to earnings and profits for depreciation for such year shall be determined under the method so used (in lieu of the straight line method).

(ii) The Commissioner has determined that the ‘‘unit of production’’ (see §1.167(b)–0(b)), and the ‘‘machine hour’’ methods of depreciation, when properly used under appropriate circumstances, meet the requirements of subdivision (i) of this subparagraph. Thus, the adjustment to earnings and profits for depreciation (for the taxable year for which either of such methods is properly used under appropriate circumstances) shall be determined under whichever of such methods is used to compute taxable income.

(3) *Determinations under straight line method.* (i) In the case of property with respect to which an allowance for depreciation is claimed in computing taxable income, the determination of the amount which would be allowable under the straight line method shall be

based on the manner in which the corporation computes depreciation in determining taxable income. Thus, if an election under §1.167(a)–11 is in effect with respect to the property, the amount of depreciation which would be allowable under the straight line method shall be determined under §1.167(a)–11(g)(3). On the other hand, if property is not depreciated under the provisions of §1.167(a)–11, the amount of depreciation which would be allowable under the straight line method shall be determined under §1.167(b)–1. Any election made under section 167(f), with respect to reducing the amount of salvage value taken into account in computing the depreciation allowance for certain property, or any convention adopted under §1.167(a)–10(b) or §1.167(a)–11(c)(2), with respect to additions and retirements from multiple asset accounts, which is used in computing depreciation for taxable income shall be used in computing depreciation for earnings and profits purposes.

(ii) In the case of property with respect to which an election to amortize is in effect under section 169, 184, 187, or 188, or any similar provision, the amount which would be allowable under the straight line method of depreciation shall be determined under the provisions of §1.167(b)–1. Thus, the cost or other basis of the property, less its estimated salvage value, is to be deducted in equal annual amounts over the period of the estimated useful life of the property. In computing the amount of depreciation for earnings and profits purposes, a taxpayer may utilize the provisions of section 167(f) (relating to the reduction in the amount of salvage value taken into account in computing the depreciation allowance for certain property) and any convention which could have been adopted for such property under §1.167(a)–10(b) (relating to additions and retirements from multiple asset accounts).

(b) *Transitional rules*—(1) *Depreciation*. If, for the taxable year which includes June 30, 1972, (i) the allowance for depreciation of any property is computed under a method other than the straight line method or a method described in paragraph (a)(2) of this section, and (ii) paragraph (a)(1) of this section applies to such property for the first taxable year beginning after June 30, 1972, then adjustments to earnings and profits for depreciation of such property for taxable years beginning after June 30, 1972, shall be determined as if the corporation changed to the straight line method with respect to such property as of the first day of the first taxable year beginning after June 30, 1972. Thus, if an election under §1.167 (a)–11 is in effect with respect to the property, the change shall be made under the provisions of §1.167(a)–11(c)(1)(iii), except that no statement setting forth the vintage accounts for which the change is made shall be furnished with the income tax return of the year of change if the change is only for purposes of computing earnings and profits. In all other cases, the unrecovered cost or other basis of the property (less a reasonable estimate for salvage) as of such first day shall be recovered through equal annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time. See paragraph (a)(3)(i) of this section for rules relating to the applicability of section 167(f) in determining salvage value.

(2) *Amortization*. If, for the taxable year which includes June 30, 1972, the basis of any property is amortized under section 169, 184, 187, or 188, or any similar provision, then adjustments to earnings and profits for depreciation or amortization of such property for taxable years beginning after June 30, 1972, shall be determined as if the unrecovered cost or other basis of the property (less a reasonable estimate for salvage) as of the first day of the first taxable year beginning after June 30, 1972, were recovered through equal annual allowances over the estimated remaining useful life of the property determined in accordance with the circumstances existing at that time. See paragraph (a)(3)(ii) of this section for rules relating to the applicability of section 167(f).

(c) *Certain foreign corporations*. Paragraphs (a) and (b) of this section shall not apply in computing the earnings and profits of a foreign corporation for any taxable year for which less than 20 percent of the gross income from all sources of such corporation is derived from sources within the United States.

(d) *Books and records.* Wherever different methods of depreciation are used for taxable income and earnings and profits purposes, records shall be maintained which show the depreciation taken for earnings and profits purposes each year and which will allow computation of the adjusted basis of the property in each account using the depreciation taken for earnings and profits purposes.

[T.D. 7221, 37 FR 24746, Nov. 21, 1972]

DEFINITIONS; CONSTRUCTIVE OWNERSHIP OF STOCK

§ 1.316–1 Dividends.

(a)(1) The term *dividend* for the purpose of subtitle A of the Code (except when used in subchapter L, chapter 1 of the Code, in any case where the reference is to dividends and similar distributions of insurance companies paid to policyholders as such) comprises any distribution of property as defined in section 317 in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either—

(i) Earnings and profits accumulated since February 28, 1913, or

(ii) Earnings and profits of the taxable year computed without regard to the amount of the earnings and profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

The earnings and profits of the taxable year shall be computed as of the close of such year, without diminution by reason of any distributions made during the taxable year. For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since February 28, 1913, if the earnings and profits of the taxable year are equal to or in excess of the total amount of the distributions made within such year.

(2) Where a corporation distributes property to its shareholders on or after June 22, 1954, the amount of the distribution which is a dividend to them may not exceed the earnings and profits of the distributing corporation.

(3) The rule of (2) above may be illustrated by the following example:

Example X and Y, individuals, each own one-half of the stock of Corporation A which has earnings and profits of $10,000. Corporation A distributes property having a basis of $6,000 and a fair market value of $16,000 to its shareholders, each shareholder receiving property with a basis of $3,000 and with a fair market value of $8,000 in a distribution to which section 301 applies. The amount taxable to each shareholder as a dividend under section 301(c) is $5,000.

(b)(1) In the case of a corporation which, under the law applicable to the taxable year in which a distribution is made, is a personal holding company or which, for the taxable year in respect of which a distribution is made under section 563 (relating to dividends paid within 2 1/2 months after the close of the taxable year), or section 547 (relating to deficiency dividends), or corresponding provisions of a prior income tax law, was under the applicable law a personal holding company, the term *dividend*, in addition to the meaning set forth in the first sentence of section 316, also means a distribution to its shareholders as follows: A distribution within a taxable year of the corporation, or of a shareholder, is a dividend to the extent of the corporation's undistributed personal holding company income (determined under section 545 without regard to distributions under section 316(b)(2)) for the taxable year in which, or, in the case of a distribution under section 563 or section 547, the taxable year in respect of which, the distribution was made. This subparagraph does not apply to distributions in partial or complete liquidation of a personal holding company. In the case of certain complete liquidations of a personal holding company see subparagraph (2) of this paragraph.

(2) In the case of a corporation which, under the law applicable to the taxable year in which a distribution is made, is a personal holding company or which, for the taxable year in respect of which a distribution is made under section 563, or section 547, or corresponding provisions of a prior income tax law, was under the applicable law a personal holding company, the term *dividend*, in addition to the meaning set forth in the first sentence of section 316, also

means, in the case of a complete liquidation occurring within 24 months after the adoption of a plan of liquidation, a distribution of property to its shareholders within such period, but—

(i) Only to the extent of the amounts distributed to distributees other than corporate shareholders, and

(ii) Only to the extent that the corporation designates such amounts as a dividend distribution and duly notifies such distributees in accordance with subparagraph (5) of this paragraph, but

(iii) Not in excess of the sum of such distributees' allocable share of the undistributed personal holding company income for such year (determined under section 545 without regard to sections 562(b) and 316(b)(2)(B)).

Section 316(b)(2)(B) and this subparagraph apply only to distributions made in any taxable year of the distributing corporation beginning after December 31, 1963. The amount designated with respect to a noncorporate distributee may not exceed the amount actually distributed to such distributee. For purposes of determining a noncorporate distributee's gain or loss on liquidation, amounts distributed in complete liquidation to such distributee during a taxable year are reduced by the amounts designated as a dividend with respect to such distributee for such year. For purposes of section 333(e)(1), a shareholder's ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, shall be reduced by the amounts designated as a dividend with respect to such shareholder (even though such designated amounts are distributed during the 1-month period referred to in section 333).

(3) For purposes of subparagraph (2)(iii) of this paragraph—

(i) Except as provided in subdivision (ii) of this subparagraph, the sum of the noncorporate distributees' allocable share of undistributed personal holding company income for the taxable year in which, or in respect of which, the distribution was made (computed without regard to sections 562(b) and 316(b)(2)(B)) shall be determined by multiplying such undistributed personal holding company income by the ratio which the aggregate value of the stock held by all noncorporate shareholders immediately before the record date of the last liquidating distribution in such year bears to the total value of all stock outstanding on such date. For rules applicable in a case where the distributing corporation has more than one class of stock, see subdivision (iii) of this subparagraph.

(ii) If more than one liquidating distribution was made during the year, and if, after the record date of the first distribution but before the record date of the last distribution, there was a change in the relative shareholdings as between noncorporate shareholders and corporate shareholders, then the sum of the noncorporate distributees' allocable share of undistributed personal holding company income for the taxable year in which, or in respect of which, the distributions were made (computed without regard to sections 562(b) and 316(b)(2)(B)) shall be determined as follows:

(*a*) First, allocate the corporation's undistributed personal holding company income among the distributions made during the taxable year by reference to the ratio which the aggregate amount of each distribution bears to the total amount of all distributions during such year;

(*b*) Second, determine the noncorporate distributees' allocable share of the corporation's undistributed personal holding company income for each distribution by multiplying the amount determined under (*a*) of this subdivision (ii) for each distribution by the ratio which the aggregate value of the stock held by all noncorporate shareholders immediately before the record date of such distribution bears to the total value of all stock outstanding on such date; and

(*c*) Last, determine the sum of the noncorporate distributees' allocable share of the corporation's undistributed personal holding company income for all such distributions.

For rules applicable in a case where the distributing corporation has more than one class of stock, see subdivision (iii) of this subparagraph.

(iii) Where the distributing corporation has more than one class of stock—

(*a*) The undistributed personal holding company income for the taxable year in which, or in respect of which the distribution was made shall be treated as a fund from which dividends may properly be paid and shall be allocated between or among the classes of stock in a manner consistent with the dividend rights of such classes under local law and the pertinent governing instruments, such as, for example, the distributing corporation's articles or certificate of incorporation and bylaws;

(*b*) The noncorporate distributees' allocable share of the undistributed personal holding company income for each class of stock shall be determined separately in accordance with the rules set forth in subdivisions (i) or (ii) of this subparagraph, as if each class of stock were the only class of stock outstanding; and

(*c*) The sum of the noncorporate distributees' allocable share of the undistributed personal holding company income for the taxable year in which, or in respect of which, the distribution was made shall be the sum of the noncorporate distributees' allocable share of the undistributed personal holding company income for all classes of stock.

(iv) For purposes of this subparagraph, in any case where the record date of a liquidating distribution cannot be ascertained, the record date of the distribution shall be the date on which the liquidating distribution was actually made.

(4) The amount designated as a dividend to a noncorporate distributee for any taxable year of the distributing corporation may not exceed an amount equal to the sum of the noncorporate distributees' allocable share of undistributed personal holding company income (as determined under subparagraph (3) of this paragraph) for such year multiplied by the ratio which the aggregate value of the stock held by such distributee immediately before the record date of the liquidating distribution or, if the record date cannot be ascertained, immediately before the date on which the liquidating distribution was actually made, bears to the aggregate value of stock outstanding held by all noncorporate distributees on such date. In any case where more than one liquidating distribution is made during the taxable year, the aggregate amount which may be designated as a dividend to a noncorporate distributee for such year may not exceed the aggregate of the amounts determined by applying the principle of the preceding sentence to the amounts determined under subparagraphs (3)(ii)(*a*) and (*b*) of this paragraph for each distribution. Where the distributing corporation has more than one class of stock, the limitation on the amount which may be designated as a dividend to a noncorporate distributee for any taxable year shall be determined by applying the rules of this subparagraph separately with respect to the noncorporate distributees' allocable share of the undistributed personal holding company income for each class of stock (as determined under subparagraphs (3)(iii)(*a*) and (*b*) of this paragraph).

(5) A corporation may designate as a dividend to a shareholder all or part of a distribution in complete liquidation described in section 316(b)(2)(B) of this paragraph by:

(i) Claiming a dividends paid deduction for such amount in its return for the year in which, or in respect of which, the distribution is made,

(ii) Including such amount as a dividend in Form 1099 filed in respect of such shareholder pursuant to section 6042(a) and the regulations thereunder and in a written statement of dividend payments furnished to such shareholder pursuant to section 6042(c) and § 1.6042–4, and

(iii) Indicating on the written statement of dividend payments furnished to such shareholder the amount included in such statement which is designated as a dividend under section 316(b)(2)(B) and this paragraph.

If a corporation complies with the procedure prescribed in the preceding sentence, it satisfies both the designation and notification requirements of section 316(b)(2)(B)(ii) and paragraph (b)(2)(ii) of this section. An amount designated as a dividend shall not be included as a distribution in liquidation on Form 1099L filed pursuant to § 1.6043–2 (relating to returns of information respecting distributions in liquidation). If a corporation designates a dividend in accordance with this subparagraph, it shall attach to the return in which it claims a deduction for such designated dividend a schedule indicating all facts necessary to determine the sum of the noncorporate distributees' allocable share of undistributed personal holding company income (determined in accordance with subparagraph (3) of this paragraph) for the year in which, or in respect of which, the distribution is made.

(c) Except as provided in section 316(b)(1), the term *dividend* includes any distribution of property to shareholders to the extent made out of accumulated or current earnings and profits. See, however, section 331 (relating to distributions in complete or partial liquidation), section 301(e) (relating to distributions by personal service corporations), section 302(b) (relating to redemptions treated as amounts received from the sale or exchange of stock), and section 303 (relating to distributions in redemption of stock to pay death taxes). See also section 305(b) for certain distributions of stock or stock rights treated as distributions of property.

(d) In the case of a corporation which, under the law applicable to the taxable year in respect of which a distribution is made under section 860 (relating to deficiency dividends), was a regulated investment company (within the meaning of section 851), or a real estate investment trust (within the meaning of section 856), the term *dividend*, in addition to the meaning set forth in paragraphs (a) and (b) of section 316, means a distribution of property to its shareholders which constitutes a ''deficiency dividend'' as defined in section 860(f).

(e) The application of section 316 may be illustrated by the following examples:

Example (1). At the beginning of the calendar year 1955, Corporation M had an operating deficit of $200,000 and the earnings and profits for the year amounted to $100,000. Beginning on March 16, 1955, the corporation made quarterly distributions of $25,000 during the taxable year to its shareholders. Each distribution is a taxable dividend in full, irrespective of the actual or the pro rata amount of the earnings and profits on hand at any of the dates of distribution, since the total distributions made during the year ($100,000) did not exceed the total earnings and profits of the year ($100,000).

Example (2). At the beginning of the calendar year 1955, Corporation N, a personal holding company, had no accumulated earnings and profits. During that year it made no earnings and profits but, due to the disallowance of certain deductions, its undistributed personal holding company income (determined under section 545 without regard to distributions under section 316(b)(2)) was $16,000. It distributed to shareholders on December 15, 1955, $15,000, and on February 1, 1956, $1,000, the latter amount being claimed as a deduction under section 563 in its personal holding company schedule for 1955 filed with its return for 1955 on March 15, 1956. Both distributions are taxable dividends in full, since they do not exceed the undistributed personal holding company income (determined without regard to such distributions) for 1955, the taxable year in which the distribution of $15,000 was made and with respect to which the distribution of $1,000 was made. It is immaterial whether Corporation N is a personal holding company for the taxable year 1956 or whether it had any income for that year.

Example (3). In 1959, a deficiency in personal holding company tax was established against Corporation O for the taxable year 1955 in the amount of $35,500 based on an undistributed personal holding company income of $42,000. Corporation O complied with the provisions of section 547 and in December 1959 distributed $42,000 to its stockholders as ''deficiency dividends.'' The distribution of $42,000 is a taxable dividend since it does not exceed $42,000 (the undistributed personal holding company income for 1955, the taxable year with respect to which the distribution was made). It is immaterial whether Corporation O is a personal holding company for the taxable year 1959 or whether it had any income for that year.

Example (4). At the beginning of the taxable year 1955, Corporation P, a personal holding company, had a deficit in earnings and profits of $200,000. During that year it made earnings and profits of $90,000. For that year, however, it had an undistributed personal holding income (determined under section 545 without regard to distributions under section 316(b)(2)) of $80,000. During such taxable year it distributed to its shareholders $100,000. The distribution of $100,000 is a taxable dividend to the extent of $90,000 since its earnings and profits for that year, $90,000, exceed $80,000, the undistributed personal holding company income determined without regard to such distribution.

Example (5). Corporation O, a calendar year taxpayer, is completely liquidated on December 31, 1964, pursuant to a plan of liquidation adopted July 1, 1964. No distributions in liquidation were made pursuant to the plan of liquidation adopted July 1, 1964, until the distribution in complete liquidation on December 31, 1964. Corporation O has undistributed personal holding company income of $300,000 for the year 1964 (computed without regard to section 562(b) or section 316(b)(2)(B)). On December 31, 1964, immediately before the record date of the distribution in complete liquidation, individual A owns 200 shares of Corporation O's outstanding stock and Corporation P owns the remaining 100 shares of outstanding stock. All shares are equal in value. The noncorporate distributees' allocable share of undistributed personal holding company income for 1964 is $200,000

200 shares÷300 shares × $300,000.

If at least $200,000 is distributed to A in the liquidation, then Corporation O may designate $200,000 to A as a dividend in accordance with paragraph (b)(5) of this section, and, if such amount is designated, then A must treat $200,000 as a dividend to which section 301 applies. For an example of the treatment of the distribution to Corporation P see paragraph (b)(2)(iii) of § 1.562–1.

Example (6). Corporation Q, a calendar year taxpayer, is completely liquidated on December 31, 1964, pursuant to a plan of liquidation adopted July 1, 1964. No distributions in liquidation were made pursuant to the plan of liquidation adopted July 1, 1964, until the distribution in complete liquidation on December 31, 1964. Corporation Q has undistributed personal holding company income of $40,000 for the year 1964 (computed without regard to section 562(b) or section 316(b)(2)(B)). On December 31, 1964, immediately before the record date of the distribution in complete liquidation, Corporation Q has outstanding 300 shares of common stock and 100 shares of noncumulative preferred stock. Corporation Q's articles of incorporation provide that the preferred stock is entitled to dividends of $10 per share per year. Of Corporation Q's stock, individual B owns 200 shares of the common stock and 50 shares of the preferred stock, and Corporation R owns all remaining shares. All of the common shares are equal in value, and all of the preferred shares are equal in value. No dividends had been paid on the preferred stock during the year 1964. Of the $40,000 of undistributed personal holding company income, $1,000 must be allocated to the preferred stock because of the rights of the holders of such stock, under Q's articles of incorporation, to receive that amount in dividends for the year 1964. The noncorporate distributees' allocable share of undistributed personal holding company income for 1964 is $26,500.

50 preferred shares÷100 preferred shares×$1,000+200 common shares ÷ 300 common shares×$39,000

If at least $26,500 is distributed to B in the liquidation, then corporation Q may designate $26,500 to B as a dividend in accordance with paragraph (b)(5) of this section, and, if such amount is designated, then B must treat $26,500 as a dividend to which section 301 applies.

Example (7). In 1979, a deficiency of $46,000 in the tax on real estate investment trust taxable income is established against corporation R for the taxable year 1977, based on an increase in real estate investment trust taxable income of $100,000. Corporation R complied with the provisions of section 860 and in December 1979 distributed to its stockholders $100,000, which qualified as ''deficiency dividends'' under section 860. The distribution of $100,000 is a taxable dividend. It is immaterial whether corporation R is a real estate investment trust for the taxable year 1979 or whether it had accumulated or current earnings and profits in 1979. See section 316(b)(3).

(Sec. 860(l) (92 Stat. 2849, 26 U.S.C. 860(l)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)); and sec. 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6625, 27 FR 12541, Dec. 19, 1962; T.D. 6949, 33 FR 5519, Apr. 9, 1968; T.D. 7767, 46 FR 11264, Feb. 6, 1981; T.D. 7936, 49 FR 2105, Jan. 18, 1984]

§ 1.316–2 Sources of distribution in general.

(a) For the purpose of income taxation every distribution made by a corporation is made out of earnings and profits to the extent thereof and from the most recently accumulated earnings and profits. In determining the source of a distribution, consideration should be given first, to the earnings and profits of the taxable year; second, to the earnings and profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings and profits of that year; third, to the earnings and profits accumulated before March 1, 1913, only after all the earnings and profits of the taxable year and all the earnings and profits accumulated since February 28, 1913, have been distributed; and, fourth, to sources other than earnings and profits only after the earnings and profits have been distributed.

(b) If the earnings and profits of the taxable year (computed as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of earnings and profits at the time of the distribution) are sufficient in amount to cover all the distributions made during that year, then each distribution is a taxable dividend. See §1.316–1. If the distributions made during the taxable year consist only of money and exceed the earnings and profits of such year, then that proportion of each distribution which the total of the earnings and profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings and profits of that year. The portion of each such distribution which is not regarded as out of earnings and profits of the taxable year shall be considered a taxable dividend to the extent of the earnings and profits accumulated since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings and profits accumulated since February 28, 1913, and the actual earnings and profits to the date of a distribution within any taxable year (whether beginning before January 1, 1936, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made.

(c) The provisions of the section may be illustrated by the following example:

Example At the beginning of the calendar year 1955, Corporation M had $12,000 in earnings and profits accumulated since February 28, 1913. Its earnings and profits for 1955 amounted to $30,000. During the year it made quarterly cash distributions of $15,000 each. Of each of the four distributions made, $7,500 (that portion of $15,000 which the amount of $30,000, the total earnings and profits of the taxable year, bears to $60,000, the total distributions made during the year) was paid out of the earnings and profits of the taxable year; and of the first and second distributions, $7,500 and $4,500, respectively, were paid out of the earnings and profits accumulated after February 28, 1913, and before the taxable year, as follows:

Distributions during 1955		Portion out of earnings and profits of the taxable year	Portion out of earnings accumulated since Feb. 28, 1913, and before the taxable year	Taxable amt. of each distribution
Date	Amount			
March 10	$15,000	$7,500	$7,500	$15,000
June 10	15,000	7,500	4,500	12,000
September 10	15,000	7,500		7,500
December 10	15,000	7,500		7,500
Total amount taxable as dividends				42,000

(d) Any distribution by a corporation out of earnings and profits accumulated before March 1, 1913, or out of increase in value of property accrued before March 1, 1913 (whether or not realized by sale or other disposition, and, if realized, whether before, on, or after March 1, 1913), is not a dividend within the meaning of subtitle A of the Code.

(e) A reserve set up out of gross income by a corporation and maintained for the purpose of making good any loss of capital assets on account of depletion or depreciation is not a part of surplus out of which ordinary dividends may be paid. A distribution made from a depletion or a depreciation reserve based upon the cost or other basis of the property will not be considered as having been paid out of earnings and profits, but the amount thereof shall be applied against and reduce the cost or other basis of the stock upon which declared. If such a distribution is in excess of the basis, the excess shall be taxed as a gain from the sale or other disposition of property as provided in section 301(c)(3)(A). A distribution from a depletion reserve based upon discovery value to the extent that such reserve represents the excess of the discovery value over the cost or other basis for determining gain or loss, is, when received by the shareholders, taxable as an ordinary dividend. The amount by which a corporation's percentage depletion allowance for any year exceeds depletion sustained on cost or other basis, that is, determined without regard to discovery or percentage depletion allowances for the year of distribution or prior years, constitutes a part of the corporation's ''earnings and profits accumulated after February 28, 1913,'' within the meaning of section 316, and, upon distribution to shareholders, is taxable to them as a dividend. A distribution made from that portion of a depletion reserve based upon a valuation as of March 1, 1913, which is in excess of the depletion reserve based upon cost, will not be considered as having been paid out of earnings and profits, but the amount of the distribution shall be applied against and reduce the cost or other basis of the stock upon which declared. See section 301. No distribution, however, can be made from such a reserve until all the earnings and profits of the corporation have first been distributed.

§ 1.317–1 Property defined.

The term *property*, for purposes of part 1, subchapter C, chapter 1 of the Code, means any property (including money, securities, and indebtedness to the corporation) other than stock, or rights to acquire stock, in the corporation making the distribution.

§ 1.318–1 Constructive ownership of stock; introduction.

(a) For the purposes of certain provisions of chapter 1 of the Code, section 318(a) provides that stock owned by a taxpayer includes stock constructively owned by such taxpayer under the rules set forth in such section. An individual is considered to own the stock owned, directly or indirectly, by or for his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and by or for his children, grandchildren, and parents. Under section 318(a)(2) and (3), constructive ownership rules are established for partnerships and partners, estates and beneficiaries, trusts and beneficiaries, and corporations and stockholders. If any person has an option to acquire stock, such stock is considered as owned by such person. The term *option* includes an option to acquire such an option and each of a series of such options.

(b) In applying section 318(a) to determine the stock ownership of any person for any one purpose—

(1) A corporation shall not be considered to own its own stock by reason of section 318(a)(3)(C);

(2) In any case in which an amount of stock owned by any person may be included in the computation more than one time, such stock shall be included only once, in the manner in which it will impute to the person concerned the largest total stock ownership; and

(3) In determining the 50-percent requirement of section 318(a)(2)(C) and (3)(C), all of the stock owned actually and constructively by the person concerned shall be aggregated.

[T.D. 6969, 33 FR 11999, Aug. 23, 1968]

§ 1.318–2 Application of general rules.

(a) The application of paragraph (b) of § 1.318–1 may be illustrated by the following examples:

Example (1). H, an individual, owns all of the stock of corporation A. Corporation A is not considered to own the stock owned by H in corporation A.

Example (2). H, an individual, his wife, W, and his son, S, each own one-third of the stock of the Green Corporation. For purposes of determining the amount of stock owned by H, W, or S for purposes of section 318(a)(2)(C) and (3)(C), the amount of stock held by the other members of the family shall be added pursuant to paragraph (b)(3) of § 1.318–1 in applying the 50-percent requirement of such section. H, W, or S, as the case may be, is for this purpose deemed to own 100 percent of the stock of the Green Corporation.

(b) The application of section 318(a)(1), relating to members of a family, may be illustrated by the following example:

Example An individual, H, his wife, W, his son, S, and his grandson (S's son), G, own the 100 outstanding shares of stock of a corporation, each owning 25 shares. H, W, and S are each considered as owning 100 shares. G is considered as owning only 50 shares, that is, his own and his father's.

(c) The application of section 318(a)(2) and (3), relating to partnerships, trusts and corporations, may be illustrated by the following examples:

Example (1). A, an individual, has a 50 percent interest in a partnership. The partnership owns 50 of the 100 outstanding shares of stock of a corporation, the remaining 50 shares being owned by A. The partnership is considered as owning 100 shares. A is considered as owning 75 shares.

Example (2). A testamentary trust owns 25 of the outstanding 100 shares of stock of a corporation. A, an individual, who holds a vested remainder in the trust having a value, computed actuarially equal to 4 percent of the value of the trust property, owns the remaining 75 shares. Since the interest of A in the trust is a vested interest rather than a contingent interest (whether or not remote), the trust is considered as owning 100 shares. A is considered as owning 76 shares.

Example (3). The facts are the same as in (2), above, except that A's interest in the trust is a contingent remainder. A is considered as owning 76 shares. However, since A's interest in the trust is a remote contingent interest, the trust is not considered as owning any of the shares owned by A.

Example (4). A and B, unrelated individuals, own 70 percent and 30 percent, respectively, in value of the stock of Corporation M. Corporation M owns 50 of the 100 outstanding shares of stock of Corporation O, the remaining 50 shares being owned by A. Corporation M is considered as owning 100 shares of Corporation O, and A is considered as owning 85 shares.

Example (5). A and B, unrelated individuals, own 70 percent and 30 percent, respectively, of the stock of corporation M. A, B, and corporation M all own stock of corporation O. Since B owns less than 50 percent in value of the stock of corporation M, neither B nor corporation M constructively owns the stock of corporation O owned by the other. However, for purposes of certain sections of the Code, such as sections 304 and 856(d), the 50-percent limitation of section 318(a)(2)(C) and (3)(C) is disregarded or is reduced to less than 30 percent. For such purposes, B constructively owns his proportionate share of the stock of corporation O owned directly by corporation M, and corporation M constructively owns the stock of corporation O owned by B.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6969, 33 FR 11999, Aug. 23, 1968]

§1.318–3 Estates, trusts, and options.

(a) For the purpose of applying section 318(a), relating to estates, property of a decedent shall be considered as owned by his estate if such property is subject to administration by the executor or administrator for the purpose of paying claims against the estate and expenses of administration notwithstanding that, under local law, legal title to such property vests in the decedent's heirs, legatees or devisees immediately upon death. The term *beneficiary* includes any person entitled to receive property of a decedent pursuant to a will or pursuant to laws of descent and distribution. A person shall no longer be considered a beneficiary of an estate when all the property to which he is entitled has been received by him, when he no longer has a claim against the estate arising out of having been a beneficiary, and when there is only a remote possibility that it will be necessary for the estate to seek the return of property or to seek payment from him by contribution or otherwise to satisfy claims against the estate or expenses of administration. When, pursuant to the preceding sentence, a person ceases to be a beneficiary, stock owned by him shall not thereafter be considered owned by the estate, and stock owned by the estate shall not thereafter be considered owned by him. The application of section 318(a) relating to estates may be illustrated by the following examples:

Example (1). (a) A decedent's estate owns 50 of the 100 outstanding shares of stock of corporation X. The remaining shares are owned by three unrelated individuals, A, B, and C, who together own the entire interest in the estate. A owns 12 shares of stock of corporation X directly and is entitled to 50 percent of the estate. B owns 18 shares directly and has a life estate in the remaining 50 percent of the estate. C owns 20 shares directly and also owns the remainder interest after B's life estate.

(b) If section 318(a)(5)(C) applies (see paragraph (c)(3) of §1.318–4), the stock of corporation X is considered to be owned as follows: the estate is considered as owning 80 shares, 50 shares directly, 12 shares constructively through A, and 18 shares constructively through B; A is considered as owning 37 shares, 12 shares directly, and 25 shares constructively (50 percent of the 50 shares owned directly by the estate); B is considered as owning 43 shares, 18 shares directly and 25 shares constructively (50 percent of the 50 shares owned directly by the estate); C is considered as owning 20 shares directly and no shares constructively. C is not considered a beneficiary of the estate under section 318(a) since he has no direct present interest in the property held by the estate nor in the income produced by such property.

(c) If section 318(a)(5)(C) does not apply, A is considered as owning nine additional shares (50 percent of the 18 shares owned constructively by the estate through B), and B is considered as owning six additional shares

(50 percent of the 12 shares owned constructively by the estate through A).

Example (2). Under the will of A, Blackacre is left to B for life, remainder to C, an unrelated individual. The residue of the estate consisting of stock of a corporation is left to D. B and D are beneficiaries of the estate under section 318(a). C is not considered a beneficiary since he has no direct present interest in Blackacre nor in the income produced by such property. The stock owned by the estate is considered as owned proportionately by B and D.

(b) For the purpose of section 318(a)(2)(B) stock owned by a trust will be considered as being owned by its beneficiaries only to the extent of the interest of such beneficiaries in the trust. Accordingly, the interest of income beneficiaries, remainder beneficiaries, and other beneficiaries will be computed on an actuarial basis. Thus, if a trust owns 100 percent of the stock of Corporation A, and if, on an actuarial basis, W's life interest in the trust is 15 percent, Y's life interest is 25 percent, and Z's remainder interest is 60 percent, under this provision W will be considered to be the owner of 15 percent of the stock of Corporation A, Y will be considered to be the owner of 25 percent of such stock, and Z will be considered to be the owner of 60 percent of such stock. The factors and methods prescribed in § 20.2031–7 of this chapter (Estate Tax Regulations) for use in ascertaining the value of an interest in property for estate tax purposes shall be used in determining a beneficiary's actuarial interest in a trust for purposes of this section. See § 20.2031–7 of this chapter (Estate Tax Regulations) for examples illustrating the use of these factors and methods.

(c) The application of section 318(a) relating to options may be illustrated by the following example:

Example. A and B, unrelated individuals, own all of the 100 outstanding shares of stock of a corporation, each owning 50 shares. A has an option to acquire 25 of B's shares and has an option to acquire a further option to acquire the remaining 25 of B's shares. A is considered as owning the entire 100 shares of stock of the corporation.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6969, 33 FR 11999, Aug. 23, 1968]

§ 1.318–4 Constructive ownership as actual ownership; exceptions.

(a) *In general.* Section 318(a)(5)(A) provides that, except as provided in section 318(a)(5) (B) and (C), stock constructively owned by a person by reason of the application of section 318(a) (1), (2), (3), or (4) shall be considered as actually owned by such person for purposes of applying section 318(a) (1), (2), (3), and (4). For example, if a trust owns 50 percent of the stock of corporation X, stock of corporation Y owned by corporation X which is attributed to the trust may be further attributed to the beneficiaries of the trust.

(b) *Constructive family ownership.* Section 318(a)(5)(B) provides that stock constructively owned by an individual by reason of ownership by a member of his family shall not be considered as owned by him for purposes of making another family member the constructive owner of such stock under section 318(a)(1). For example, if F and his two sons, A and B, each own one-third of the stock of a corporation, under section 318(a)(1), A is treated as owning constructively the stock owned by his father but is not treated as owning the stock owned by B. Section 318(a)(5)(B) prevents the attribution of the stock of one brother through the father to the other brother, an attribution beyond the scope of section 318(a)(1) directly.

(c) *Reattribution.* (1) Section 318(a)(5)(C) provides that stock constructively owned by a partnership, estate, trust, or corporation by reason of the application of section 318(a)(3) shall not be considered as owned by it for purposes of applying section 318(a)(2) in order to make another the constructive owner of such stock. For example, if two unrelated individuals are beneficiaries of the same trust, stock held by one which is attributed to the trust under section 318(a)(3) is not reattributed from the trust to the other beneficiary. However, stock constructively owned by reason of section 318(a)(2) may be reattributed under section 318(a)(3). Thus, for example, if all the stock of corporations X and Y is owned by A, stock of corporation Z held by X is attributed to Y through A.

(2) Section 318(a)(5)(C) does not prevent reattribution under section 318(a)(2) of stock constructively owned

by an entity under section 318(a)(3) if the stock is also constructively owned by the entity under section 318(a)(4). For example, if individuals A and B are beneficiaries of a trust and the trust has an option to buy stock from A, B is considered under section 318(a)(2)(B) as owning a proportionate part of such stock.

(3) Section 318(a)(5)(C) is effective on and after August 31, 1964, except that for purposes of sections 302 and 304 it does not apply with respect to distributions in payment for stock acquisitions or redemptions if such acquisitions or redemptions occurred before August 31, 1964.

[T.D. 6969, 33 FR 11999, Aug. 23, 1968]

CORPORATE LIQUIDATIONS

EFFECTS ON RECIPIENTS

§1.331–1 Corporate liquidations.

(a) Section 331 contains rules governing the extent to which gain or loss is recognized to a shareholder receiving a distribution in complete or partial liquidation of a corporation. Under section 331(a)(1), it is provided that amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock. Under section 331(a)(2), it is provided that amounts distributed in partial liquidation of a corporation shall be treated as in full or part payment in exchange for the stock. For this purpose, the term *partial liquidation* shall have the meaning ascribed in section 346. If section 331 is applicable to the distribution of property by a corporation, section 301 (relating to the effects on a shareholder of distributions of property) has no application other than to a distribution in complete liquidation to which section 316(b)(2)(B) applies. See paragraph (b)(2) of §1.316–1.

(b) The gain or loss to a shareholder from a distribution in partial or complete liquidation is to be determined under section 1001 by comparing the amount of the distribution with the cost or other basis of the stock. The gain or loss will be recognized to the extent provided in section 1002 and will be subject to the provisions of parts I, II, and III (section 1201 and following), subchapter P, chapter 1 of the Code.

(c) A liquidation which is followed by a transfer to another corporation of all or part of the assets of the liquidating corporation or which is preceded by such a transfer may, however, have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of ‘‘other property.’’ See sections 301 and 356.

(d) In every case in which a shareholder transfers stock in exchange for property to the corporation which issued such stock, the facts and circumstances shall be reported on his return unless the property is part of a distribution made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation and the corporation is completely liquidated and dissolved within one year after the distribution. See section 6043 for requirements relating to returns by corporations.

(e) The provisions of this section may be illustrated by the following example:

Example A, an individual who makes his income tax returns on the calendar year basis, owns 20 shares of stock of the P Corporation, a domestic corporation, 10 shares of which were acquired in 1951 at a cost of $1,500 and the remainder of 10 shares in December 1954 at a cost of $2,900. He receives in April 1955 a distribution of $250 per share in complete liquidation, or $2,500 on the 10 shares acquired in 1951, and $2,500 on the 10 shares acquired in December 1954. The gain of $1,000 on the shares acquired in 1951 is a long-term capital gain to be treated as provided in parts I, II, and III (section 1201 and following), subchapter P, chapter 1 of the Code. The loss of $400 on the shares acquired in 1954 is a short-term capital loss to be treated as provided in parts I, II, and III (section 1201 and following), subchapter P, chapter 1 of the Code.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6949, 33 FR 5521, Apr. 9, 1968]

§1.332–1 Distributions in liquidation of subsidiary corporation; general.

Under the general rule prescribed by section 331 for the treatment of distributions in liquidation of a corporation, amounts received by one corporation in complete liquidation of another corporation are treated as in full payment in exchange for stock in such other corporation, and gain or loss from the receipt of such amounts is to be determined as provided in section 1001. Section 332 excepts from the general rule property received, under certain specifically described circumstances, by one corporation as a distribution in complete liquidation of the stock of another corporation and provides for the nonrecognition of gain or loss in those cases which meet the statutory requirements. Section 367 places a limitation on the application of section 332 in the case of foreign corporations. See section 334(b) for the basis for determining gain or loss from the subsequent sale of property received upon complete liquidations such as described in this section. See section 453(d)(4)(A) relative to distribution of installment obligations by subsidiary.

§ 1.332–2 Requirements for nonrecognition of gain or loss.

(a) The nonrecognition of gain or loss is limited to the receipt of such property by a corporation which is the actual owner of stock (in the liquidating corporation) possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends). The recipient corporation must have been the owner of the specified amount of such stock on the date of the adoption of the plan of liquidation and have continued so to be at all times until the receipt of the property. If the recipient corporation does not continue qualified with respect to the ownership of stock of the liquidating corporation and if the failure to continue qualified occurs at any time prior to the completion of the transfer of all the property, the provisions for the nonrecognition of gain or loss do not apply to any distribution received under the plan.

(b) Section 332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock which it owns in the liquidating corporation. If section 332 is not applicable, see section 165(g) relative to allowance of losses on worthless securities.

(c) To constitute a distribution in complete liquidation within the meaning of section 332, the distribution must be (1) made by the liquidating corporation in complete cancellation or redemption of all of its stock in accordance with a plan of liquidation, or (2) one of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation. Where there is more than one distribution, it is essential that a status of liquidation exist at the time the first distribution is made under the plan and that such status continue until the liquidation is completed. Liquidation is completed when the liquidating corporation and the receiver or trustees in liquidation are finally divested of all the property (both tangible and intangible). A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders. A liquidation may be completed prior to the actual dissolution of the liquidating corporation. However, legal dissolution of the corporation is not required. Nor will the mere retention of a nominal amount of assets for the sole purpose of preserving the corporation's legal existence disqualify the transaction. (See 26 CFR (1939) 39.22(a)–20 (Regulations 118).)

(d) If a transaction constitutes a distribution in complete liquidation within the meaning of the Internal Revenue Code of 1954 and satisfies the requirements of section 332, it is not material that it is otherwise described under the local law. If a liquidating corporation distributes all of its property in complete liquidation and if pursuant to the plan for such complete liquidation a corporation owning the specified amount of stock in the liquidating corporation receives property constituting amounts distributed in complete liquidation within the meaning of the Code and also receives other property attributable to shares not owned by it, the transfer of the property to the recipient corporation shall not be treated, by reason of the receipt of such other property, as not being a distribution (or one of a series of distributions) in complete cancellation or redemption of all of the stock of the liquidating corporation within the meaning of section 332, even though for purposes of those provisions relating to corporate reorganizations the amount received by the recipient corporation in excess of its ratable share is regarded as acquired upon the issuance of its stock or securities in a tax-free exchange as described in section 361 and the cancellation or redemption of the stock not owned by the recipient corporation is treated as occurring as a result of a taxfree exchange described in section 354.

(e) The application of these rules may be illustrated by the following example:

Example On September 1, 1954, the M Corporation had outstanding capital stock consisting of 3,000 shares of common stock, par value $100 a share, and 1,000 shares of preferred stock, par value $100 a share, which preferred stock was limited and preferred as to dividends and had no voting rights. On that date, and thereafter until the date of dissolution of the M Corporation, the O Corporation owned 2,500 shares of common stock of the M Corporation. By statutory merger consummated on October 1, 1954, pursuant to a plan of liquidation adopted on September 1, 1954, the M Corporation was merged into the O Corporation, the O Corporation under the plan issuing stock which was received by the other holders of the stock of the M Corporation. The receipt by the O Corporation of the properties of the M Corporation is a distribution received by the O Corporation in complete liquidation of the M Corporation within the meaning of section 332, and no gain or loss is recognized as the result of the receipt of such properties.

§1.332–3 Liquidations completed within one taxable year.

If in a liquidation completed within one taxable year pursuant to a plan of complete liquidation, distributions in complete liquidation are received by a corporation which owns the specified amount of stock in the liquidating corporation and which continues qualified with respect to the ownership of such stock until the transfer of all the property within such year is completed (see paragraph (a) of §1.332–2), then no gain or loss shall be recognized with respect to the distributions received by the recipient corporation. In such case no waiver or bond is required of the recipient corporation under section 332.

§1.332–4 Liquidations covering more than one taxable year.

(a) If the plan of liquidation is consummated by a series of distributions extending over a period of more than one taxable year, the nonrecognition of gain or loss with respect to the distributions in liquidation shall, in addition to the requirements of §1.332–2, be subject to the following requirements:

(1) In order for the distribution in liquidation to be brought within the exception provided in section 332 to the general rule for computing gain or loss with respect to amounts received in liquidation of a corporation, the entire property of the corporation shall be transferred in accordance with a plan of liquidation, which plan shall include a statement showing the period within which the transfer of the property of the liquidating corporation to the recipient corporation is to be completed. The transfer of all the property under the liquidation must be completed within three years from the close of the taxable year during which is made the first of the series of distributions under the plan.

(2) For each of the taxable years which falls wholly or partly within the period of liquidation, the recipient corporation shall, at the time of filing its return, file with the district director of internal revenue a waiver of the statute of limitations on assessment. The waiver shall be executed on such form as may be prescribed by the Commissioner and shall extend the period of assessment of all income and profits taxes for each such year to a date not earlier than one year after the last date of the period for assessment of such taxes for the last taxable year in which the transfer of the property of such liquidating corporation to the controlling corporation may be completed in accordance with section 332. Such waiver shall also contain such other terms with respect to assessment as may be considered by the Commissioner to be necessary to insure the assessment and collection of the correct tax liability for each year within the period of liquidation.

(3) For each of the taxable years which falls wholly or partly within the period of liquidation, the recipient corporation may be required to file a bond, the amount of which shall be fixed by the district director. The bond shall contain all terms specified by the Commissioner, including provisions unequivocally assuring prompt payment of the excess of income and profits taxes (plus penalty, if any, and interest) as computed by the district director without regard to the provisions of sections 332 and 334(b) over such taxes computed with regard to such provisions, regardless of whether such excess may or may not be made the subject of a notice of deficiency under section 6212 and regardless of whether it may or may not be assessed. Any bond required under section 332 shall have such surety or sureties as the Commissioner may require. However, see 6 U.S.C. 15, providing that where a bond is required by law or regulations, in lieu of surety or sureties there may be deposited bonds or notes of the United States. Only surety companies holding certificates of authority from the Secretary as acceptable sureties on Federal bonds will be approved as sureties. The bonds shall be executed in triplicate so that the Commissioner, the taxpayer, and the surety or the depositary may each have a copy. On and after September 1, 1953, the functions of the Commissioner with respect to such bonds shall be performed by the district director for the internal revenue district in which the return was filed and any bond filed on or after such date shall be filed with such district director.

(b) Pending the completion of the liquidation, if there is a compliance with paragraph (a) (1), (2), and (3) of this section and § 1.332–2 with respect to the nonrecognition of gain or loss, the income and profits tax liability of the recipient corporation for each of the years covered in whole or in part by the liquidation shall be determined without the recognition of any gain or loss on account of the receipt of the distributions in liquidation. In such determination, the basis of the property or properties received by the recipient corporation shall be determined in accordance with section 334(b). However, if the transfer of the property is not completed within the three-year period allowed by section 332 or if the recipient corporation does not continue qualified with respect to the ownership of stock of the liquidating corporation as required by that section, gain or loss shall be recognized with respect to each distribution and the tax liability for each of the years covered in whole or in part by the liquidation shall be recomputed without regard to the provisions of section 332 or section 334(b) and the amount of any additional tax due upon such recomputation shall be promptly paid.

§ 1.332–5 Distributions in liquidation as affecting minority interests.

Upon the liquidation of a corporation in pursuance of a plan of complete liquidation, the gain or loss of minority shareholders shall be determined without regard to section 332, since it does not apply to that part of distributions in liquidation received by minority shareholders.

§ 1.332–6 Records to be kept and information to be filed with return.

(a) Permanent records in substantial form shall be kept by every corporation receiving distributions in complete liquidation within the exception provided in section 332 showing the information required by this section to be submitted with its return. The plan of liquidation must be adopted by each of the corporations parties thereto; and the adoption must be shown by the acts of its duly constituted responsible officers, and appear upon the official records of each such corporation.

(b) For the taxable year in which the liquidation occurs, or, if the plan of liquidation provides for a series of distributions over a period of more than one year, for each taxable year in which a distribution is received under the plan the recipient must file with its return a complete statement of all facts pertinent to the nonrecognition of gain or loss, including:

(1) A certified copy of the plan for complete liquidation, and of the resolutions under which the plan was adopted and the liquidation was authorized, together with a statement under oath

showing in detail all transactions incident to, or pursuant to, the plan.

(2) A list of all the properties received upon the distribution, showing the cost or other basis of such properties to the liquidating corporation at the date of distribution and the fair market value of such properties on the date distributed.

(3) A statement of any indebtedness of the liquidating corporation to the recipient corporation on the date the plan of liquidation was adopted and on the date of the first liquidating distribution. If any such indebtedness was acquired at less than face value, the cost thereof to the recipient corporation must also be shown.

(4) A statement as to its ownership of all classes of stock of the liquidating corporation (showing as to each class the number of shares and percentage owned and the voting power of each share) as of the date of the adoption of the plan of liquidation, and at all times since, to and including the date of the distribution in liquidation. The cost or other basis of such stock and the date or dates on which purchased must also be shown.

§1.332–7 Indebtedness of subsidiary to parent.

If section 332(a) is applicable to the receipt of the subsidiary's property in complete liquidation, then no gain or loss shall be recognized to the subsidiary upon the transfer of such properties even though some of the properties are transferred in satisfaction of the subsidiary's indebtedness to its parent. However, any gain or loss realized by the parent corporation on such satisfaction of indebtedness, shall be recognized to the parent corporation at the time of the liquidation. For example, if the parent corporation purchased its subsidiary's bonds at a discount and upon liquidation of the subsidiary the parent corporation receives payment for the face amount of such bonds, gain shall be recognized to the parent corporation. Such gain shall be measured by the difference between the cost or other basis of the bonds to the parent and the amount received in payment of the bonds.

§1.334–1 Basis of property received in liquidations.

(a) *In general.* Section 334 sets forth rules prescribing the basis of property received in a distribution in partial or complete liquidation of a corporation. The general rule of section 334 is set forth in section 334(a) to the effect that if property is received in a distribution in partial or complete liquidation and if gain or loss is recognized on the receipt of such property, then the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution. Such general rule has no application to a liquidation to which section 332 or section 333 applies. See section 334 (b) and (c).

(b) *Transferor's basis.* Unless section 334(b)(2) and subsection (c) of this section apply, property received by a parent corporation in a complete liquidation to which section 332 is applicable shall, under section 334(b)(1), have the same basis in the hands of the parent as its adjusted basis in the hands of the subsidiary. The rule stated above is applicable even though the subsidiary was indebted to the parent on the date the plan of liquidation was adopted and part of such property was received in satisfaction of such indebtedness in a transfer to which section 332(c) is applicable.

[T.D. 7231, 37 FR 28287, Dec. 22, 1972, as amended at T.D. 8474, 58 FR 25557, Apr. 27, 1993]

EFFECTS ON CORPORATION

§1.337(d)–1 Transitional loss limitation rule.

(a) *Loss limitation rule for transitional subsidiary*—(1) *General rule.* No deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a transitional subsidiary.

(2) *Allowable loss*—(i) *In general.* Paragraph (a)(1) of this section does not apply to the extent the taxpayer establishes that the loss is not attributable to the recognition of built-in gain by any transitional subsidiary on the disposition of an asset (including stock and securities) after January 6, 1987.

(ii) *Statement of allowable loss.* Paragraph (a)(2)(i) of this section applies only if a separate statement entitled ‘‘Allowable Loss Under § 1.337(d)–1(a)’’ is filed with the taxpayer’s return for the year of the stock disposition. If the separate statement is required to be filed with a return the due date (including extensions) of which is before January 16, 1991, or with a return due (including extensions) after January 15, 1991 but filed before that date, the statement may be filed with an amended return for the year of the disposition or with the taxpayer’s first subsequent return the due date (including extensions) of which is after January 15, 1991.

(iii) *Contents of statement.* The statement required under paragraph (a)(2)(ii) of this section must contain—

(A) The name and employer identification number (E.I.N.) of the transitional subsidiary.

(B) The basis of the stock of the transitional subsidiary immediately before the disposition.

(C) The amount realized on the disposition.

(D) The amount of the deduction not disallowed under paragraph (a)(1) of this section by reason of this paragraph (a)(2).

(E) The amount of loss disallowed under paragraph (a)(1) of this section.

(3) *Coordination with loss deferral and other disallowance rules.* (i) For purposes of this section, the rules of § 1.1502–20(a)(3) apply, with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502–20.

(ii) *Other loss deferral rules.* If paragraph (a)(1) of this section applies to a loss subject to deferral or disallowance under any other provision of the Code or the regulations, the other provision applies to the loss only to the extent it is not disallowed under paragraph (a)(1).

(4) *Definitions.* For purposes of this section—

(i) The definitions in § 1.1502–1 apply.

(ii) *Transitional subsidiary* means any corporation that became a subsidiary of the group (whether or not the group was a consolidated group) after January 6, 1987. Notwithstanding the preceding sentence, a subsidiary is not a transitional subsidiary if the subsidiary (and each predecessor) was a member of the group at all times after the subsidiary’s (and each predecessor’s) organization.

(iii) *Built-in gain* of a transitional subsidiary means gain attributable, directly or indirectly, in whole or in part, to any excess of value over basis, determined immediately before the transitional subsidiary became a subsidiary, with respect to any asset owned directly or indirectly by the transitional subsidiary at that time.

(iv) *Disposition* means any event in which gain or loss is recognized, in whole or in part.

(v) *Value* means fair market value.

(5) *Examples.* For purposes of the examples in this section, unless otherwise stated, the group files consolidated returns on a calendar year basis, the facts set forth the only corporate activity, and all sales and purchases are with unrelated buyers or sellers. The basis of each asset is the same determining earnings and profits adjustments and taxable income. Tax liability and its effect on basis, value, and earnings and profits are disregarded. *Investment adjustment system* means the rules of § 1.1502–32. The principles of this paragraph (a) are illustrated by the following examples:

Example 1. Loss attributable to recognized built-in gain.

(i) P buys all the stock of T for $100 on February 1, 1987, and T becomes a member of the P group. T has an asset with a value of $100 and basis of $0. T sells the asset in 1989 and recognizes $100 of built-in gain on the sale (*i.e.,* the asset’s value exceeded its basis by $100 at the time T became a member of the P group). Under the investment adjustment system, P’s basis in the T stock increases to $200. P sells all the stock of T on December 31, 1989, and recognizes a loss of $100. Under paragraph (a)(1) of this section, no deduction is allowed to P for the $100 loss.

(ii) Assume that, after T sells its asset but before P sells the T stock, T issues additional stock to unrelated persons and ceases to be a member of the P group. P then sells all its stock of T in 1997. Although T ceases to be a subsidiary within the meaning of § 1.1502–1, T continues to be a transitional subsidiary within the meaning of this section. Consequently, under paragraph (a)(1) of this section, no deduction is allowed to P for its $100 loss.

Example 2. Loss attributable to post-acquisition loss.

P buys all the stock of T for $100 on February 1, 1987, and T becomes a member of the

P group. T has $50 cash and an asset with $50 of built-in gain. During 1988, T retains the asset but loses $40 of the cash. The P group is unable to use the loss, and the loss becomes a net operating loss carryover attributable to T. Under the investment adjustment system, P's basis in the stock of T remains $100. P sells all the stock of T on December 31, 1988, for $60 and recognizes a $40 loss. Under paragraph (a)(2)(i) of this section, P establishes that it did not dispose of the built-in gain asset. None of P's loss is disallowed under paragraph (a)(1) if P satisfies the requirements of paragraph (a)(2)(ii) of this section.

Example 3. Stacking rules—postacquisition loss offsets postacquisition gain.

(i) P. buys all the stock of T for $100 on February 1, 1987, and T becomes a member of the P group. T has 2 assets. Asset 1 has a basis and value of $50, and asset 2 has a basis of $0 and a value of $50. During 1989, asset 1 declines in value to $0, and T sells asset 2 for $50, and reinvests the proceeds in asset 3. The value of asset 3 appreciates to $90. Under the investment adjustment system, P's basis in the stock of T increases from $100 to $150 as a result of the gain recognized on the sale of asset 2 but is unaffected by the unrealized post-acquisition decline in the value of asset 1. On December 31, 1989, P sells all the stock of T for $90 and recognizes a $60 loss.

(ii) Although T incurred a $50 post-acquisition loss of built-in gain because of the decline in the value of asset 1, T also recognized $50 of built-in gain. Under paragraph (a)(2) of this section, any loss on the sale of stock is treated first as attributable to recognized built-in gain. Thus, for purposes of determining under paragraph (a)(2) of this section whether P's $60 loss on the disposition of the T stock is attributable to the recognition of built-in gain on the disposition of an asset, T's unrealized post-acquisition gain of $40 offsets $40 of the $50 of unrealized post-acquisition loss. Therefore, $50 of the $60 loss is attributable to the recognition of built-in gain on the disposition of an asset and is disallowed under paragraph (a)(1) of this section.

Example 4. Stacking rules—built-in loss offsets built-in gain.

(i) P buys all the stock of T for $50 on February 1, 1987, and T becomes a member of the P group. T has 2 assets. Asset 1 has a basis of $50 and a value of $0, and asset 2 has a basis of $0 and a value of $50. During 1989, T sells asset 1 for $0 and asset 2 for $50, and reinvests the $50 proceeds in asset 3. The value of asset 3 declines to $40. Under the investment adjustment system, P's basis in the stock of T remains $50 as a result of the offsetting gain and loss recognized on the sale of assets 1 and 2 and is unaffected by the unrealized post-acquisition decline in the value of asset 3. On December 31, 1989, P sells all the stock of T for $40 and recognizes a $10 loss.

(ii) Although T recognized a $50 built-in gain on the sale of asset 2, T also recognized a $50 built-in loss on the sale of asset 1. For purposes of determining under paragraph (a)(2) of this section whether P's $10 loss on the disposition of the T stock is attributable to the recognition of built-in gain on the disposition of an asset, T's recognized built-in gain is offset by its recognized built-in loss. Thus none of P's $10 loss is attributable to the recognition of built-in gain on the disposition of an asset.

(iii) The result would be the same if, instead of a $50 built-in loss in asset 2, T has a $50 net operating loss carryover when P buys the T stock, and the net operating loss carryover is used to offset the built-in gain.

Example 5. Outside basis partially corresponds to inside basis.

(i) Individual A owns all the stock of T, for which A has a basis of $60. On February 1, 1987, T owns 1 asset with a basis of $0 and a value of $100, P acquires all the stock of T from A in an exchange to which section 351(a) applies, and T becomes a member of the P group. P has a carryover basis of $60 in the T stock. During 1988, T sells the asset and recognizes $100 of gain. Under the investment adjustment system, P's basis in the T stock increases from $60 to $160. T reinvests the $100 proceeds in another asset, which declines in value to $90. On January 1, 1989, P sells all the stock of T for $90 and recognizes a loss of $70.

(ii) Although P's basis in the T stock was increased by $100 as a result of the recognition of built-in gain on the disposition of T's asset, only $60 of the $70 loss on the sale of the stock is attributable under paragraph (a)(2) of this section to the recognition of built-in gain from the disposition of the asset. (Had T's asset not declined in value to $90, the T stock would have been sold for $100, and a $60 loss would have been attributable to the recognition of the built-in gain.) Therefore, $60 of the $70 loss is disallowed under paragraph (a)(2), and $10 is not disallowed if P satisfies the requirements of paragraph (a)(2). If P had sold the stock of T for $95 because T's other assets had unrealized appreciation of $5, $60 of the $65 loss would still be attributable to T's recognition of built-in gain on the disposition of assets.

Example 6. Creeping acquisition.

P owns 60 percent of the stock of S on January 6, 1987. On February 1, 1987, P buys an additional 20 percent of the stock of S, and S becomes a member of the P group. P sells all the S stock on March 1, 1989 and recognizes a loss of $100. All 80 percent of the stock of S owned by P is subject to the rules of this section and, under paragraph (a) (1) and (2) of this section, P is not allowed to deduct the $100 loss, except to the extent P establishes the loss is not attributable to the recognition by S of built-in gain on the disposition of assets.

Example 7. Effect of post-acquisition appreciation. P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases to $200. T reinvests the proceeds of the sale in an asset that appreciates in value to $180. Five years after the sale, P sells all the stock of T for $180 and recognizes a $20 loss. Under paragraph (a)(1) of this section, no deduction is allowed to P for the $20 loss.

Example 8. Deferred loss and recognized gain.

(i) P is the common parent of a consolidated group, S is a wholly owned subsidiary of P, and T is a wholly owned subsidiary of S. S purchased all of the T stock on February 1, 1987 for $100, and T has an asset with a basis of $40 and a value of $100. T sells the asset for $100, recognizing $60 of gain. Under the investment adjustment system, S's basis in the T stock increases from $100 to $160. S sells its T stock to P for $100 in a deferred intercompany transaction, recognizing a $60 loss that is deferred under section 267(f) and § 1.1502–13. P subsequently sells all the stock of T for $100 to X, a member of the same controlled group (as defined in section 267(f)) as P but not a member of the P consolidated group.

(ii) Under paragraph (a)(3) of this section, the application of paragraph (a)(1) of this section to S's $60 loss is deferred, because S's loss is deferred under section 267(f) and § 1.1502–13. Although P's sale of the T stock to X would cause S's deferred loss to be taken into account under § 1.1502–13, § 1.267(f)–1 provides that the loss is not taken into account because X is a member of the same controlled group as P and S. Nevertheless, under paragraph (a)(3) of this section, because the T stock ceases to be owned by a member of the P consolidated group, S's deferred loss is disallowed immediately before the sale and is never taken into account under section 267(f).

(b) *Indirect disposition of transitional subsidiary*—(1) *Loss limitation rule for transitional parent.* No deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a transitional parent.

(2) *Allowable loss*—(i) *In general.* Paragraph (b)(1) of this section does not apply to the extent the taxpayer establishes that the loss exceeds the amount that would be disallowed under paragraph (a) of this section if each highest tier transitional subsidiary's stock in which the transitional parent has a direct or indirect interest had been sold immediately before the disposition of the transitional parent's stock. In applying the preceding sentence, appropriate adjustments shall be made to take into account circumstances where less than all the stock of a transitional parent owned by members of a consolidated group is disposed of in the same transaction, or the stock of a transitional subsidiary or a transitional parent is directly owned by more than 1 member.

(ii) *Statement of allowable loss.* Paragraph (b)(2)(i) of this section applies only if a separate statement entitled ''Allowable Loss Under Section 1.337(d)–1(b)'' is filed with the taxpayer's return for the year of the stock disposition. If the separate statement is required to be filed with a return the due date (including extensions) of which is before January 16, 1991, or with a return due (including extensions) after January 15, 1991 but filed before that date, the statement may be filed with an amended return for the year of the disposition or with the taxpayer's first subsequent return the due date (including extensions) of which is after January 15, 1991.

(iii) *Contents of statement.* The statement required under paragraph (b)(2)(ii) of this section must contain—

(A) The name and employer identification number (E.I.N.) of the transitional parent.

(B) The basis of the stock of the transitional parent immediately before the disposition.

(C) The amount realized on the disposition.

(D) The amount of the deduction not disallowed under paragraph (b)(1) of this section by reason of this paragraph (b)(2).

(E) The amount of loss disallowed under paragraph (b)(1) of this section.

(3) *Coordination with loss deferral and other disallowance rules.* (i) For purposes of this section, the rules of § 1.1502–20(a)(3) apply, with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502–20.

(ii) *Other loss deferral rules.* If paragraph (b)(1) of this section applies to a loss subject to deferral or disallowance under any other provision of the Code or the regulations, the other provision applies to the loss only to the extent it is not disallowed under paragraph (b)(1).

(4) *Definitions.* For purposes of this section—

(i) *Transitional parent* means any subsidiary, other than a transitional subsidiary, that owned at any time after January 6, 1987, a direct or indirect interest in the stock of a corporation that is a transitional subsidiary.

(ii) *Highest tier transitional subsidiary* means the transitional subsidiary (or subsidiaries) in which the transitional parent has a direct or indirect interest and that is the highest transitional subsidiary (or subsidiaries) in a chain of members.

(5) *Examples.* The principles of this paragraph (b) are illustrated by the following examples:

Example 1. Ownership of chain of transitional subsidiaries. (i) P forms S with $200 on January 1, 1985, and S becomes a member of the P group. On February 1, 1987, S buys all the stock of T, and T buys all the stock of T1, and both T and T1 become members of the P group. On January 1, 1988, P sells all the stock of S and recognizes a $90 loss on the sale.

(ii) Under paragraph (a)(4)(ii) of this section, both T and T1 are transitional subsidiaries, because they became members of the P group after January 6, 1987. Under paragraph (b)(4)(i) of this section, S is a transitional parent, because it owns a direct interest in stock of transitional subsidiaries and is not itself a transitional subsidiary.

(iii) Under paragraph (b) (1) and (2) of this section, because S is a transitional parent, no deduction is allowed to P for its $90 loss except to the extent the loss exceeds the amount of S's loss that would have been disallowed if S had sold all the stock of T, S's highest tier transitional subsidiary, immediately before P's sale of all the S stock. Assume all the T stock would have been sold for a $90 loss and that all the loss would be attributable to the recognition of built-in gain from the disposition of assets. Because in that case $90 of loss would be disallowed, all of P's loss on the sale of the S stock is disallowed under paragraph (b).

Example 2. Ownership of brother-sister transitional subsidiaries.

(i) P forms S with $200 on January 1, 1985, and S becomes a member of the P group. On February 1, 1987, S buys all the stock of both T and T1, and T and T1 become members of the P group. On January 1, 1988, P sells all the stock of S and recognizes a $90 loss on the sale.

(ii) Under paragraph (b) (1) and (2) of this section, no deduction is allowed to P for its $90 loss except to the extent P establishes that the loss exceeds the amount of S's stock losses that would be disallowed if S sold all the stock of T and T1, S's highest tier transitional subsidiaries, immediately before P's sale of all the S stock. Assume that all the T stock would have been sold for a $50 loss, all the T1 stock of a $40 loss, and that the entire amount of each loss would be attributable to the recognition of built-in gain on the disposition of assets. Because $90 of loss would be disallowed with respect to the sale of S's T and T1 stock, P's $90 loss on the sale of all the S stock is disallowed under paragraph (b).

(c) *Successors*—(1) *General rule.* This section applies, to the extent necessary to effectuate the purposes of this section, to—

(i) Any property owned by a member or former member, the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis in a subsidiary's stock, and

(ii) Any property owned by any other person whose basis in the property is determined, directly or indirectly, in whole or in part, by reference to a member's (or former member's) basis in a subsidiary's stock.

(2) *Examples.* The principles of this paragraph (c) are illustrated by the following examples:

Example 1. Merger into grandfathered subsidiary. P, the common parent of a group, owns all the stock of T, a transitional subsidiary. On January 1, 1989, T merges into S, a wholly owned subsidiary of P that is not a transitional subsidiary. Under paragraph (c)(1) of this section, all the stock of S is treated as stock of a transitional subsidiary. As a result, no deduction is allowed for any loss recognized by P on the disposition of any S stock, except to the extent the P group establishes under paragraph (a)(2) that the loss is not attributable to the recognition of built-in gain on the disposition of assets of T.

Example 2. Nonrecognition exchange of transitional stock.

(i) P, the common parent of a group, owns all the stock of T, a transitional subsidiary. On January 1, 1989, P transfers the stock of T to X, a corporation that is not a member of the P group, in exchange for 20 percent of its stock in a transaction to which section 351(a) applies. T and X file separate returns.

(ii) Under paragraph (c)(1) of this section, all the stock of X owned by P is treated as stock of a transitional subsidiary because P's basis for the X stock is determined by reference to its basis for the T stock. As a result, no deduction is allowed to P for any loss recognized on the disposition of the X stock, except to the extent permitted under paragraph (a) of this section.

(iii) Under paragraph (c)(1), X is treated as a member subject to paragraph (a) of this section with respect to the T stock because X's basis for the stock is determined by reference to P's basis for the stock. Moreover, all of the T stock owned by X continues to be stock of a transitional subsidiary. As a result, no deduction is allowed to X for any loss recognized on the disposition of any T stock, except to the extent permitted under paragraph (a) of this section.

(d) *Investment adjustments and earnings and profits*—(1) *In general.* For purposes of determining investment adjustments under § 1.1502–32 and earnings and profits under § 1.1502–33(c) with respect to a member of a consolidated group that owns stock in a subsidiary, any deduction that is disallowed under this section is treated as a loss arising and absorbed by the member in the tax year in which the disallowance occurs.

(2) *Example.* (i) In 1986, P forms S with a contribution of $100, and S becomes a member of the P group. On February 1, 1987, S buys all the stock of T for $100. T has an asset with a basis of $0 and a value of $100. In 1988, T sells the asset for $100. Under the investment adjustment system, S's basis in the T stock increases to adjustment system, S's basis in the T stock increases to $200, P's basis in the S stock increases to $200, and P's earnings and profits and S's earnings and profits increase by $100. In 1989, S sells all of the T stock for $100, and S's recognized loss of $100 is disallowed under paragraph (a)(1) of this section.

(ii) Under paragraph (d)(1) of this section, S's earnings and profits for 1989 are reduced by $100, the amount of the loss disallowed under paragraph (a)(1). As a result, P's basis in the S stock is reduced from $200 to $100 under the investment adjustment system. P's earnings and profits for 1989 are correspondingly reduced by $100.

(e) *Effective dates*—(1) *General rule.* This section applies with respect to dispositions after January 6, 1987. For dispositions on or after November 19, 1990, however, this section applies only if the stock was deconsolidated (as that term is defined in § 1.337(d)–2(b)(2)) before November 19, 1990, and only to the extent the disposition is not subject to § 1.337(d)–2 or § 1.1502–20.

(2) *Binding contract rule.* For purposes of this paragraph (e), if a corporation became a subsidiary pursuant to a binding written contract entered into before January 6, 1987, and in continuous effect until the corporation became a subsidiary, or a disposition was pursuant to a binding written contract entered into before March 9, 1990, and in continuous effect until the disposition, the date the contract became binding shall be treated as the date the corporation became a subsidiary or as the date of disposition.

(3) *Application of § 1.1502–20T to certain transactions*—(i) *In general.* If a group files the certification described in paragraph (e)(3)(ii) of this section, it may apply § 1.1502–20T (as contained in the CFR edition revised as of April 1, 1990), to all of its members with respect to all dispositions and deconsolidations by the certifying group to which § 1.1502–20T otherwise applied by its terms occurring—

(A) On or after March 9, 1990 (but only if not pursuant to a binding contract described in § 1.337(d)–1T(e)(2) (as contained in the CFR edition revised as of April 1, 1990) that was entered into before March 9, 1990); and

(B) Before November 19, 1990 (or thereafter, if pursuant to a binding contract described in § 1.1502–20T(g)(3) that was entered into on or after March 9, 1990 and before November 19, 1990).

The certification under this paragraph (e)(3)(i) with respect to the application of § 1.1502–20T to any transaction described in this paragraph (e)(3)(i) may not be withdrawn and, if the certification is filed, § 1.1502–20T must be applied to all such transactions on all returns (including amended returns) on which such transactions are included.

(ii) *Time and manner of filing certification.* The certification described in paragraph (e)(3)(i) of this section must be made in a separate statement entitled ''[insert name and employer identification number of common parent] hereby certifies under § 1.337(d)–1 (e)(3) that the group of which it is the common parent is applying § 1.1502–20T to all transactions to which that section otherwise applied by it terms.'' The statement must be signed by the common parent and filed with the group's income tax return for the taxable year of the first disposition or deconsolidation to which the certification applies. If the separate statement required under this paragraph (e)(3) is to be filed with a return the due date (including extensions) of which is before November 16, 1991, the statement may be filed with an amended return for the year of the disposition or deconsolidation that is filed within 180 days after September 13, 1991. Any other filings required under §1.1502–20T, such as the statement required under §1.1502–20T(f)(5), may be made with the amended return, regardless of whether §1.1502–20T permits such filing by amended return.

[T.D. 8319, 55 FR 49031, Nov. 26, 1990, as amended by T.D. 8364, 56 FR 47389, Sept. 19, 1991; 57 FR 53550, Nov. 12, 1992; T.D. 8560, 59 FR 41674, 41675, Aug. 15, 1994; T.D. 8597, 60 FR 36679, July 18, 1995]

§1.337(d)–1T [Reserved]

§1.337(d)–2 Loss limitation window period.

(a) *Loss disallowance*—(1) *General rule.* No deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary.

(2) *Definitions.* For purposes of this section—

(i) The definitions in §1.1502–1 apply.

(ii) *Disposition* means any event in which gain or loss is recognized, in whole or in part.

(3) *Coordination with loss deferral and other disallowance rules.* For purposes of this section, the rules of §1.1502–20(a)(3) apply, with appropriate adjustments to reflect differences between the approach of this section and that of §1.1502–20.

(b) *Basis reduction on deconsolidation*—(1) *General rule.* If the basis of a member of a consolidated group in a share of stock of a subsidiary exceeds its value immediately before a deconsolidation of the share, the basis of the share is reduced at that time to an amount equal to its value. If both a disposition and a deconsolidation occur with respect to a share in the same transaction, paragraph (a) of this section applies and, to the extent necessary to effectuate the purposes of this section, this paragraph (b) applies following the application of paragraph (a) of this section.

(2) *Deconsolidation.* ‘‘Deconsolidation’’ means any event that causes a share of stock of a subsidiary that remains outstanding to be no longer owned by a member of any consolidated group of which the subsidiary is also a member.

(3) *Value.* ‘‘Value’’ means fair market value.

(4) *Loss within 2 years after basis reduction*—(i) *In general.* If a share is deconsolidated and a direct or indirect disposition of the share occurs within 2 years after the date of the deconsolidation, a separate statement entitled ‘‘statement pursuant to §1.337(d)–2(b)(4)’’ must be filed with the taxpayer's return for the year of disposition. If the taxpayer fails to file the statement as required, no deduction is allowed for any loss recognized with respect to the disposition. If the separate statement is required to be filed with a return the due date (including extensions) of which is before January 16, 1991, or with a return due (including extensions) after January 15, 1991 but filed before that date, the statement may be filed with an amended return for the year of the disposition or with the taxpayer's first subsequent return the due date (including extensions) of which is after January 15, 1991. A disposition after the 2-year period described in this paragraph (b)(4) that is pursuant to an agreement, option, or other arrangement entered into within the 2-year period is treated as a disposition within the 2-year period for purposes of this section.

(ii) *Contents of statement.* The statement required under paragraph (b)(4)(i) of this section must contain—

(A) The name and employer identification number (E.I.N.) of the subsidiary.

(B) The amount of prior basis reduction with respect to the stock of the subsidiary under paragraph (b)(1) of this section.

(C) The basis of the stock of the subsidiary immediately before the disposition.

(D) The amount realized on the disposition.

(E) The amount of the loss recognized on the disposition.

(c) *Allowable loss*—(1) *Application.* This paragraph (c) applies with respect to stock of a subsidiary only if—

(i) Before February 1, 1991, the consolidated group either—

(A) Disposes (in one or more transactions) of its entire equity interest in the subsidiary to persons not related to any member of the consoldiated group within the meaning of section 267(b) or section 707(b)(1) (substituting ''10 percent'' for ''50 percent'' each place that it appears); or

(B) Sustains a worthless stock loss under section 165(g); and

(ii) A separate statement entitled ''allowed loss under § 1.337(d)–2(c)'' is filed in accordance with paragraph (c)(3) of this section.

(2) *General rule.* Loss is not disallowed under paragraph (a)(1) of this section and basis is not reduced under paragraph (b)(1) of this section to the extent the taxpayer establishes that the loss or basis is not attributable to the recognition of built-in gain on the disposition of an asset (including stock and securities). Loss or basis may be attributable to the recognition of built-in gain on the disposition of an asset by a prior group. For purposes of this section, gain recognized on the disposition of an asset is built-in gain to the extent attributable, directly or indirectly, in whole or in part, to any excess of value over basis that is reflected, before the disposition of the asset, in the basis of the share, directly or indirectly, in whole or in part, after applying section 1503(e) and other applicable provisions of the Code and regulations.

(3) *Contents of statement and time of filing.* The statement required under paragraph (c)(1)(ii) of this section must be filed with the taxpayer's return for the year of the disposition or deconsolidation, and must contain—

(i) The name and employer identification number (E.I.N.) of the subsidiary.

(ii) The basis of the stock of the subsidiary immediately before the disposition or deconsolidation.

(iii) The amount realized on the disposition and the amount of fair market value on the deconsolidation.

(iv) The amount of the deduction not disallowed under paragraph (a)(1) of this section by reason of this paragraph (c) and the amount of basis not reduced under paragraph (b)(1) of this section by reason of this paragraph (c).

(v) The amount of loss disallowed under paragraph (a)(1) of this section and the amount of basis reduced under paragraph (b)(1) of this section.

If the separate statement is required to be filed with a return the due date (including extensions) of which is before January 16, 1991, or with a return due (including extensions) after January 15, 1991 but filed before that date, the statement may be filed with an amended return for the year of the disposition or deconsolidation or with the taxpayer's first subsequent return the due date (including extensions) of which is after January 15, 1991.

(4) *Example.* The principles of paragraphs (a), (b), and (c) of this section are illustrated by the examples in §§ 1.337(d)–1(a) and 1.1502–20(a) (other than *Examples 3, 4,* and *5*) and (b), with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502–20, and by the following example. For purposes of the examples in this section, unless otherwise stated, the group files consolidated returns on a calendar year basis, the facts set forth the only corporate activity, and all sales and purchases are with unrelated buyers or sellers. The basis of each asset is the same for determining earnings and profits adjustments and taxable income. Tax liability and its effect on basis, value, and earnings and profits are disregarded. *Investment adjustment system* means the rules of § 1.1502–32.

Example. Loss offsetting built-in gain in a prior group. (i) P buys all the stock of T for $50 in Year 1, and T becomes a member of the P group. T has 2 assets. Asset 1 has a basis of $50 and a value of $0, and asset 2 has a basis of $0 and a value of $50. T sells asset 2 during Year 3 for $50, and recognizes a $50 gain. Under the investment adjustment system, P's basis in the T stock increases to $100 as a result of the recognition of gain. In year 5, all of the stock of P is acquired by the P1 group, and the former members of the P group become members of the P1 group. T then sells asset 1 for $0, and recognizes a $50 loss. Under the investment adjustment system. P's basis in the T stock decreases to $50 as a result of the loss. T's assets decline in value from $50 to $40. P then sells all the stock of T for $40 and recognizes a $10 loss.

(ii) P's basis in the T stock reflects both T's unrecognized gain and unrecognized loss with respect to its assets. The gain T recognizes on the disposition of asset 2 is built-in gain with respect to both the P and the P1 groups for purposes of paragraph (c)(2) of this section. In addition, the loss T recognizes on the disposition of asset 2 is built-in loss with respect to the P and P1 groups for purposes of paragraph (c)(2) of this section. T's recognition of the built-in loss while a member of the P1 group offsets the effect on T's stock basis of T's recognition of the built-in gain while a member of the P group. Thus, P's $10 loss on the sale of the T stock is not attributable to the recognition of built-in gain, and the loss is therefore not disallowed under paragraph (c)(2) of this section.

(iii) The result would be the same if, instead of having a $50 built-in loss in asset 2 when it becomes a member of the P group, T has a $50 net operating loss carryover and the carryover is used by the P group.

(d) *Successors.* For purposes of this section, the rules and examples of §1.1502–20(d) apply, with appropriate adjustments to reflect differences between the approach of this section and that of §1.1502–20.

(e) *Anti-avoidance rules.* For purposes of this section, the rules and examples of §1.1502–20(e) apply, with appropriate adjustments to reflect differences between the approach of this section and that of §1.1502–20.

(f) *Investment adjustments and earnings and profits.* For purposes of this section, the rules and examples of §1.1502–20 (f) apply, with appropriate adjustments to reflect differences between the approach of this section and that of §1.1502–20.

(g) *Effective dates*—(1) *General rule.* Except as otherwise provided in this paragraph (g), this section applies with respect to dispositions and deconsolidations on or after November 19, 1990, but only to the extent the disposition or deconsolidation is not subject to §1.1502–20. For this purpose, dispositions deferred under §§1.1502–13 and 1.1502–14 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995) are deemed to occur at the time the deferred gain or loss is taken into account unless the stock was deconsolidated before November 19, 1990. If stock of a subsidiary became worthless during a taxable year including November 19, 1990, the disposition with respect to the stock is treated as occurring on the date the stock became worthless.

(2) *Binding contract rule.* For purposes of this paragraph (g), if a disposition or deconsolidation is pursuant to a binding written contract entered into before March 9, 1990, and in continuous effect until the disposition or deconsolidation, the date the contract became binding is treated as the date of the disposition or deconsolidation.

(3) *Application of §1.1502–20T to certain transactions*—(i) *In general.* If a group files the certification described in paragraph (g)(3)(ii) of this section, it may apply §1.1502–20T (as contained in the CFR edition revised as of April 1, 1990), to all of its members with respect to all dispositions and deconsolidations by the certifying group to which §1.1502–20T otherwise applied by its terms occurring—

(A) On or after March 9, 1990 (but only if not pursuant to a binding contract described in §1.337(d)–1T(e)(2) (as contained in the CFR edition revised as of April 1, 1990) that was entered into before March 9, 1990); and

(B) Before November 19, 1990 (or thereafter, if pursuant to a binding contract described in §1.1502–20T(g)(3) that was entered into on or after March 9, 1990 and before November 19, 1990).

The certification under this paragraph (g)(3)(i) with respect to the application of §1.1502–20T to any transaction described in this paragraph (g)(3)(i) may not be withdrawn and, if the certification is filed, §1.1502–20T must be applied to all such transactions on all returns (including amended returns) on which such transactions are included.

(ii) *Time and manner of filing certification.* The certification described in paragraph (g)(3)(i) of this section must be made in a separate statement entitled "[insert name and employer identification number of common parent] hereby certifies under §1.337(d)–2(g)(3) that the group of which it is the common parent is applying §1.1502–20T to all transactions to which that section otherwise applied by its terms." The statement must be signed by the common parent and filed with the group's income tax return for the taxable year of the first disposition or deconsolidation to which the certification applies. If the separate statement required under this paragraph (g)(3) is to be filed with a return the due date (including extensions) of which is before November 16, 1991, the statement may be filed with an amended return for the year of the disposition or deconsolidation that is filed within 180 days after September 13, 1991. Any other filings required under § 1.1502–20T, such as the statement required under § 1.1502–20T(f)(5), may be made with the amended return, regardless of whether § 1.1502–20T permits such filing by amended return.

[T.D. 8364, 56 FR 47390, Sept. 19, 1991; 57 FR 53550, Nov. 12, 1992; T.D. 8560, 59 FR 41674, Aug. 15, 1994; T.D. 8597, 60 FR 36679, July 18, 1995]

§ 1.337(d)–4 Taxable to tax-exempt.

(a) *Gain or loss recognition*—(1) *General rule.* Except as provided in paragraph (b) of this section, if a taxable corporation transfers all or substantially all of its assets to one or more tax-exempt entities, the taxable corporation must recognize gain or loss immediately before the transfer as if the assets transferred were sold at their fair market values. But see section 267 and paragraph (d) of this section concerning limitations on the recognition of loss.

(2) *Change in corporation's tax status treated as asset transfer.* Except as provided in paragraphs (a)(3) and (b) of this section, a taxable corporation's change in status to a tax-exempt entity will be treated as if it transferred all of its assets to a tax-exempt entity immediately before the change in status becomes effective in a transaction to which paragraph (a)(1) of this section applies. For example, if a State, a political subdivision thereof, or an entity any portion of whose income is excluded from gross income under section 115, acquires the stock of a taxable corporation and thereafter any of the taxable corporation's income is excluded from gross income under section 115, the taxable corporation will be treated as if it transferred all of its assets to a tax-exempt entity immediately before the stock acquisition.

(3) *Exceptions for certain changes in status*—(i) *To whom available.* Paragraph (a)(2) of this section does not apply to the following corporations—

(A) A corporation previously tax-exempt under section 501(a) which regains its tax-exempt status under section 501(a) within three years from the later of a final adverse adjudication on the corporation's tax exempt status, or the filing by the corporation, or by the Secretary or his delegate under section 6020(b), of a federal income tax return of the type filed by a taxable corporation;

(B) A corporation previously tax-exempt under section 501(a) or that applied for but did not receive recognition of exemption under section 501(a) before January 15, 1997, if such corporation is tax-exempt under section 501(a) within three years from January 28, 1999;

(C) A newly formed corporation that is tax-exempt under section 501(a) (other than an organization described in section 501(c)(7)) within three taxable years from the end of the taxable year in which it was formed;

(D) A newly formed corporation that is tax-exempt under section 501(a) as an organization described in section 501(c)(7) within seven taxable years from the end of the taxable year in which it was formed;

(E) A corporation previously tax-exempt under section 501(a) as an organization described in section 501(c)(12), which, in a given taxable year or years prior to again becoming tax-exempt, is a taxable corporation solely because less than 85 percent of its income consists of amounts collected from members for the sole purpose of meeting losses and expenses; if, in a taxable year, such a corporation would be a taxable corporation even if 85 percent or more of its income consists of amounts collected from members for the sole purpose of meeting losses and expenses (a non-85 percent violation), paragraph (a)(3)(i)(A) of this section shall apply as if the corporation became a taxable corporation in its first taxable year that a non-85 percent violation occurred; or

(F) A corporation previously taxable that becomes tax-exempt under section 501(a) as an organization described in section 501(c)(15) if during each taxable year in which it is described in section

501(c)(15) the organization is the subject of a court supervised rehabilitation, conservatorship, liquidation, or similar state proceeding; if such a corporation continues to be described in section 501(c)(15) in a taxable year when it is no longer the subject of a court supervised rehabilitation, conservatorship, liquidation, or similar state proceeding, paragraph (a)(2) of this section shall apply as if the corporation first became tax-exempt for such taxable year.

(ii) *Application for recognition.* An organization is deemed to have or regain tax-exempt status within one of the periods described in paragraph (a)(3)(i)(A), (B), (C), or (D) of this section if it files an application for recognition of exemption with the Commissioner within the applicable period and the application either results in a determination by the Commissioner or a final adjudication that the organization is tax-exempt under section 501(a) during any part of the applicable period. The preceding sentence does not require the filing of an application for recognition of exemption by any organization not otherwise required, such as by §1.501(a)-1, §1.505(c)-1T, and §1.508–1(a), to apply for recognition of exemption.

(iii) *Anti-abuse rule.* This paragraph (a)(3) does not apply to a corporation that, with a principal purpose of avoiding the application of paragraph (a)(1) or (a)(2) of this section, acquires all or substantially all of the assets of another taxable corporation and then changes its status to that of a tax-exempt entity.

(4) *Related transactions.* This section applies to any series of related transactions having an effect similar to any of the transactions to which this section applies.

(b) *Exceptions.* Paragraph (a) of this section does not apply to—

(1) Any assets transferred to a tax-exempt entity to the extent that the assets are used in an activity the income from which is subject to tax under section 511(a) (referred to hereinafter as a ‘‘section 511(a) activity’’). However, if assets used to any extent in a section 511(a) activity are disposed of by the tax-exempt entity, then, notwithstanding any other provision of law (except section 1031 or section 1033), any gain (not in excess of the amount not recognized by reason of the preceding sentence) shall be included in the tax-exempt entity’s unrelated business taxable income. To the extent that the tax-exempt entity ceases to use the assets in a section 511(a) activity, the entity will be treated for purposes of this paragraph (b)(1) as having disposed of the assets on the date of the cessation for their fair market value. For purposes of paragraph (a)(1) of this section and this paragraph (b)(1)—

(i) If during the first taxable year following the transfer of an asset or the corporation’s change to tax-exempt status the asset will be used by the tax-exempt entity partly or wholly in a section 511(a) activity, the taxable corporation will recognize an amount of gain or loss that bears the same ratio to the asset’s built-in gain or loss as 100 percent reduced by the percentage of use for such taxable year in the section 511(a) activity bears to 100 percent. For purposes of determining the gain or loss, if any, to be recognized, the taxable corporation may rely on a written representation from the tax-exempt entity estimating the percentage of the asset’s anticipated use in a section 511(a) activity for such taxable year, using a reasonable method of allocation, unless the taxable corporation has reason to believe that the tax-exempt entity’s representation is not made in good faith;

(ii) If for any taxable year the percentage of an asset’s use in a section 511(a) activity decreases from the estimate used in computing gain or loss recognized under paragraph (b)(1)(i) of this section, adjusted for any decreases taken into account under this paragraph (b)(1)(ii) in prior taxable years, the tax-exempt entity shall recognize an amount of gain or loss that bears the same ratio to the asset’s built-in gain or loss as the percentage point decrease in use in the section 511(a) activity for the taxable year bears to 100 percent;

(iii) If property on which all or a portion of the gain or loss is not recognized by reason of the first sentence of paragraph (b)(1) of this section is disposed of in a transaction that qualifies for nonrecognition treatment under section 1031 or section 1033, the tax-exempt entity must treat the replacement property as remaining subject to paragraph (b)(1) of this section to the extent that the exchanged or involuntarily converted property was so subject;

(iv) The tax-exempt entity must use the same reasonable method of allocation for determining the percentage that it uses the assets in a section 511(a) activity as it uses for other tax purposes, such as determining the amount of depreciation deductions. The tax-exempt entity also must use this same reasonable method of allocation for each taxable year that it holds the assets; and

(v) An asset's built-in gain or loss is the amount that would be recognized under paragraph (a)(1) of this section except for this paragraph (b)(1);

(2) Any transfer of assets to the extent gain or loss otherwise is recognized by the taxable corporation on the transfer. See, for example, sections 336, 337(b)(2), 367, and 1001;

(3) Any transfer of assets to the extent the transaction qualifies for nonrecognition treatment under section 1031 or section 1033; or

(4) Any forfeiture of a taxable corporation's assets in a criminal or civil action to the United States, the government of a possession of the United States, a state, the District of Columbia, the government of a foreign country, or a political subdivision of any of the foregoing; or any expropriation of a taxable corporation's assets by the government of a foreign country.

(c) *Definitions.* For purposes of this section:

(1) *Taxable corporation.* A *taxable corporation* is any corporation that is not a tax-exempt entity as defined in paragraph (c)(2) of this section.

(2) *Tax-exempt entity.* A *tax-exempt entity* is—

(i) Any entity that is exempt from tax under section 501(a) or section 529;

(ii) A charitable remainder annuity trust or charitable remainder unitrust as defined in section 664(d);

(iii) The United States, the government of a possession of the United States, a state, the District of Columbia, the government of a foreign country, or a political subdivision of any of the foregoing;

(iv) An Indian Tribal Government as defined in section 7701(a)(40), a subdivision of an Indian Tribal Government determined in accordance with section 7871(d), or an agency or instrumentality of an Indian Tribal Government or subdivision thereof;

(v) An Indian Tribal Corporation organized under section 17 of the Indian Reorganization Act of 1934, 25 U.S.C. 477, or section 3 of the Oklahoma Welfare Act, 25 U.S.C. 503;

(vi) An international organization as defined in section 7701(a)(18);

(vii) An entity any portion of whose income is excluded under section 115; or

(viii) An entity that would not be taxable under the Internal Revenue Code for reasons substantially similar to those applicable to any entity listed in this paragraph (c)(2) unless otherwise explicitly made exempt from the application of this section by statute or by action of the Commissioner.

(3) *Substantially all.* The term *substantially all* has the same meaning as under section 368(a)(1)(C).

(d) *Loss limitation rule.* For purposes of determining the amount of gain or loss recognized by a taxable corporation on the transfer of its assets to a tax-exempt entity under paragraph (a) of this section, if assets are acquired by the taxable corporation in a transaction to which section 351 applied or as a contribution to capital, or assets are distributed from the taxable corporation to a shareholder or another member of the taxable corporation's affiliated group, and in either case such acquisition or distribution is made as part of a plan a principal purpose of which is to recognize loss by the taxable corporation on the transfer of such assets to the tax-exempt entity, the losses recognized by the taxable corporation on such assets transferred to the tax-exempt entity will be disallowed. For purposes of the preceding sentence, the principles of section 336(d)(2) apply.

(e) *Effective date.* This section is applicable to transfers of assets as described in paragraph (a) of this section occurring after January 28, 1999, unless the transfer is pursuant to a written agreement which is (subject to customary conditions) binding on or before January 28, 1999.

[T.D. 8802, 63 FR 71594, Dec. 29, 1998]

§1.338–0 Outline of topics.

This section lists the captions contained in the regulations under section 338.

§1.338–1 Elections under section 338.

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(10) Section 338 election.
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(13) Target; old target; new target.
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(2) Acquisition period.
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(B) Exception for certain redemptions from related corporations.
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(1) In general.

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(1) In general.

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§ 1.338(h)(10)–1 Deemed asset sale and liquidation.

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(b) Nomenclature.
(c) Definitions.
(1) Section 338(h)(10) target.
(2) S corporation shareholders.
(3) Selling consolidated group.
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(d) Section 338(h)(10) election.
(1) In general.
(2) Simultaneous joint election requirement.
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(1) Old T.
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(2) Formula.
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§ 1.338(i)–1 Effective dates.

(a) In general.
(b) Elective retroactive application.
(c) MADSP.
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§ 1.338–1 Elections under section 338.

(a) *Scope.* This section prescribes rules relating to elections under section 338. Paragraphs (c)(6), (e), and (g) of this section do not apply to a target for which a section 338(h)(10) election is made.

(b) *Nomenclature.* For purposes of the regulations under section 338 (except as otherwise provided):

(1) T is a domestic corporation that has only one class of stock outstanding.

(2) P is a domestic corporation that purchases stock of T in a qualified stock purchase.

(3) The P group is an affiliated group of which P is a member.

(4) P1, P2, etc., are domestic corporations that are members of the P group.

(5) T1, T2, etc., are domestic corporations that are target affiliates of T. These corporations (T1, T2, etc.) have only one class of stock outstanding and may also be targets.

(6) S is a domestic corporation (unrelated to P and B) that owns T prior to the purchase of T by P. (S is referred to in cases in which it is appropriate to consider the effects of having all of the outstanding stock of T owned by a domestic corporation.)

(7) A, a U.S. resident or citizen, is an individual (unrelated to P and B) who owns T prior to the purchase of T by P. (A is referred to in cases in which it is appropriate to consider the effects of having all of the outstanding stock of T owned by an individual who is a U.S. resident or citizen. Ownership of T by A and ownership of T by S are mutually exclusive circumstances.)

(8) B, a U.S. resident or citizen, is an individual (unrelated to T, S, and A) who owns the stock of P.

(9) F, used as a prefix with the other terms in this paragraph (b), connotes foreign, rather than domestic, status. For example, FT is a foreign corporation (as defined in section 7701(a)(5)) and FA is an individual other than a U.S. citizen or resident.

(10) CFC, used as a prefix with the other terms in this paragraph (b) referring to a corporation, connotes a controlled foreign corporation (as defined in section 957, taking into account section 953(c)). A corporation identified with the prefix F may be a controlled foreign corporation. The prefix CFC is used when the corporation's status as a controlled foreign corporation is significant.

(c) *Definitions.* For purposes of the regulations under section 338 (except as otherwise provided):

(1) *Acquisition date.* The term *acquisition date* has the same meaning as in section 338(h)(2).

(2) *Affiliated group.* The term *affiliated group* has the same meaning as in section 338(h)(5). Corporations are affiliated on any day they are members of the same affiliated group with each other.

(3) *Common parent.* The term *common parent* has the same meaning as in section 1504.

(4) *Consistency period.* The *consistency period* is the period described in section 338(h)(4)(A) unless extended pursuant to § 1.338–4(j)(1).

(5) *Domestic corporation.* A *domestic* corporation is a corporation—

(i) That is domestic within the meaning of section 7701(a)(4) or that is treated as domestic for purposes of subtitle A of the Internal Revenue Code (e.g., to which an election under section 953(d) or 1504(d) applies); and

(ii) That is not a DISC, a corporation described in section 1248(e), or a corporation to which an election under section 936 applies.

(6) *Old target's final return. Old target's final return* is the income tax return of old target for the taxable year ending at the close of the acquisition date that includes the deemed sale of assets under section 338. If the disaffiliation rule of paragraph (e)(2)(i) of this section applies, target's *deemed sale return* is considered old target's final return.

(7) *Purchasing corporation.* The term *purchasing corporation* has the same meaning as in section 338(d)(1). Unless otherwise provided, any reference to the purchasing corporation is a reference to all members of the affiliated group of which the purchasing corporation is a member. See sections 338(h) (5) and (8).

(8) *Qualified stock purchase.* The term *qualified stock purchase* has the same meaning as in section 338(d)(3).

(9) *Related persons.* Two persons are related if stock in a corporation owned by one of the persons would be attributed under section 318(a) (other than section 318(a)(4)) to the other.

(10) *Section 338 election.* A *section 338 election* is an election to apply section 338(a) to target. A section 338 election may be made by filing a statement of section 338 election pursuant to § 1.338–1(d). The form on which this statement is filed is referred to in the regulations under section 338 as the *Form 8023.*

(11) *Section 338(h)(10) election.* A *section 338(h)(10) election* is an election to apply section 338(h)(10) to target. A section 338(h)(10) election may be made by making a joint election for target under § 1.338(h)(10)–1.

(12) *Selling group.* The *selling group* is the affiliated group (as defined in section 1504) that is eligible to file a consolidated return that includes target for the target's taxable period that includes the acquisition date and that does not have a target as common parent for the taxable year including the acquisition date.

(13) *Target; old target; new target. Target* is the target corporation as defined in section 338(d)(2). *Old target* refers to target for periods ending as of the close of the date of target's deemed sale of assets. *New target* refers to target for subsequent periods.

(14) *Target affiliate.* The term *target affiliate* has the same meaning as in section 338(h)(6) (applied without section 338(h)(6)(B)(i)). Thus, a corporation described in section 338(h)(6)(B)(i) is considered a target affiliate for all purposes of section 338. If a target affiliate is acquired in a qualified stock purchase, it is also a target.

(15) *12-month acquisition period.* The *12-month acquisition period* is the period

described in section 338(h)(1), unless extended pursuant to § 1.338–4(j)(2).

(d) *Time and manner of making election.* The purchasing corporation makes a section 338 election for target by filing a statement of section 338 election on Form 8023 in accordance with the instructions to the form. The section 338 election must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs. A section 338 election is irrevocable.

(e) *Returns including tax liability from deemed sale*—(1) *In general.* Except as provided in paragraphs (e)(2) and (3) of this section, any tax liability resulting from the deemed sale of assets under section 338 is included in the final return of old target filed for old target's taxable year that ends at the close of the acquisition date. If old target is the common parent of an affiliated group, the final return may be a consolidated return (any such consolidated return must also include any tax liability from any deemed sales under section 338 by subsidiaries in the consolidated group that have the same acquisition date as old target and that are acquired by the purchasing corporation).

(2) *Old target's final taxable year otherwise included in consolidated return of selling group*—(i) *General rule.* If the selling group files a consolidated return for the period that includes the acquisition date, old target is disaffiliated from that group immediately before its deemed sale of assets under section 338 and must file a separate final return that includes only the items resulting from the deemed sale and the carryover items specified in paragraph (e)(2)(iii) of this section (deemed sale return). The deemed sale occurs at the close of the acquisition date and is the last transaction of old target. Any transactions of old target occurring on the acquisition date other than the deemed sale are included in the selling group's consolidated return. A deemed sale return includes a *combined return* as defined in paragraph (e)(4) of this section.

(ii) *Separate taxable year.* The deemed sale included in the deemed sale return under this paragraph (e)(2) occurs in a separate taxable year, except that old target's taxable year of the sale and the consolidated year of the selling group that includes the acquisition date are treated as the same year for purposes of determining the number of years in a carryover or carryback period.

(iii) *Carryover and carryback of tax attributes.* Target's attributes may be carried over to, and carried back from, the deemed sale return under the rules applicable to a corporation that ceases to be a member of a consolidated group.

(iv) *Old target is a component member of purchasing corporation's controlled group.* For purposes of its deemed sale return, target is a component member of the controlled group of corporations including the purchasing corporation unless target is treated as an excluded member under section 1563(b)(2).

(3) *Old target an S corporation.* If target is an S corporation for the period that ends on the day before the acquisition date, old target must file a deemed sale return as a C corporation. For this purpose, the principles of paragraph (e)(2) of this section apply.

(4) *Combined deemed sale return*—(i) *General rule.* Under section 338(h)(15), a combined deemed sale return (combined return) may be filed for all targets from a single selling consolidated group (as defined in § 1.338(h)(10)–1(c)(3)) that are acquired by the purchasing corporation on the same acquisition date and that otherwise would be required to file separate deemed sale returns. The combined return must include all such targets. For example, T and T1 may be included in a combined return if—

(A) T and T1 are directly owned subsidiaries of S;

(B) S is the common parent of a consolidated group; and

(C) P makes qualified stock purchases of T and T1 on the same acquisition date.

(ii) *Gain and loss offsets.* Gains and losses recognized on the deemed sale of assets by targets included in a combined return are treated as the gains and losses of a single target. In addition, loss carryovers of a target that were not subject to the separate return limitation year restrictions (SRLY restrictions) of the consolidated return regulations while that target was a member of the selling consolidated group may be applied without limitation to the gains of other targets included in the combined return. If, however, a target has loss carryovers that were subject to the SRLY restrictions while that target was a member of the selling consolidated group, the use of those losses in the combined return continues to be subject to those restrictions, applied in the same manner as if the combined return were a consolidated return. A similar rule applies, when appropriate, to other tax attributes.

(iii) *Procedure for filing a combined return.* A combined return is made by filing a single corporation income tax return in lieu of separate deemed sale returns for all targets required to be included in the combined return. The combined return reflects the deemed sales of all targets required to be included in the combined return. If the targets included in the combined return constitute a single affiliated group within the meaning of section 1504(a), the income tax return is signed by an officer of the common parent of that group. Otherwise, the return must be signed by an officer of each target included in the combined return. Rules similar to the rules in §1.1502–75(j) apply for purposes of preparing the combined return. The combined return must include an attachment prominently identified as an ‘‘ELECTION TO FILE A COMBINED RETURN UNDER SECTION 338(h)(15).’’ The attachment must—

(A) Contain the name, address, and employer identification number of each target required to be included in the combined return;

(B) Contain the following declaration (or a substantially similar declaration): ‘‘EACH TARGET IDENTIFIED IN THIS ELECTION TO FILE A COMBINED RETURN CONSENTS TO THE FILING OF A COMBINED RETURN’’; and

(C) For each target, be signed by a person who states under penalties of perjury that he or she is authorized to act on behalf of such target.

(iv) *Consequences of filing a combined return.* Each target included in a combined return is severally liable for any tax associated with the combined return. See §1.338–2(d)(1).

(5) *Deemed sale excluded from purchasing corporation's consolidated return.* Old target may not be considered a member of any affiliated group that includes the purchasing corporation with respect to the deemed sale of target assets under section 338.

(6) *Due date for old target's final return*—(i) *General rule.* Old target's final return is generally due on the 15th day of the third calendar month following the month in which the acquisition date occurs. See section 6072 (time for filing income tax returns).

(ii) *Application of §1.1502–76(c)*—(A) *In general.* Section 1.1502–76(c) applies to old target's final return if old target was a member of a selling group that did not file consolidated returns for the taxable year of the common parent that precedes the year that includes old target's acquisition date. If the selling group has not filed a consolidated return that includes old target's taxable period that ends on the acquisition date, target may, on or before the final return due date (including extensions), either—

(*1*) File a deemed sale return on the assumption that the selling group will file the consolidated return; or

(*2*) File a return for so much of old target's taxable period as ends at the close of the acquisition date on the assumption that the consolidated return will not be filed.

(B) *Deemed extension.* For purposes of applying §1.1502–76(c)(2), an extension of time to file old target's final return is considered to be in effect until the last date for making the election under section 338.

(C) *Erroneous filing of deemed sale return.* If, pursuant to this paragraph (e)(6)(ii), target files a deemed sale return but the selling group does not file a consolidated return, target must file a substituted return for old target not later than the due date (including extensions) for the return of the common parent with which old target would have been included in the consolidated return. The substituted return is for so much of old target's taxable year as ends at the close of the acquisition date. Under §1.1502–76(c)(2), the deemed sale return is not considered a return for purposes of section 6011 (relating to the general requirement of filing a return) if a substituted return must be filed.

(D) *Erroneous filing of return for regular tax year.* If, pursuant to this paragraph (e)(6)(ii), target files a return for so much of old target's regular taxable year as ends at the close of the acquisition date but the selling group files a consolidated return, target must file an amended return for old target not later than the due date (including extensions) for the selling group's consolidated return. (The amended return is a deemed sale return.)

(E) *Last date for payment of tax.* If either a substituted or amended final return of old target is filed pursuant to this paragraph (e)(6)(ii), the last date prescribed for payment of tax is the final return due date (as defined in paragraph (e)(6)(i) of this section).

(7) *Examples.* This paragraph (e) may be illustrated by the following examples:

Example 1. (a) S is the common parent of a consolidated group that includes T. The S group files calendar year consolidated returns. At the close of June 30 of Year 1, P makes a qualified stock purchase of T from S. P makes a section 338 election for T, and the deemed sale of T's assets occurs as of the close of T's acquisition date (June 30).

(b) T is considered disaffiliated for purposes of reporting the deemed sale. Accordingly, T is included in the S group's consolidated return through T's acquisition date except that the tax liability resulting from the deemed sale of assets is reported in a separate deemed sale return of T. Provided that T is not treated as an excluded member under section 1563(b)(2), T is a component member of P's controlled group for the taxable year represented by the deemed sale, and the taxable income bracket amounts available in calculating tax on the deemed sale return must be limited accordingly.

(c) If P purchased the stock of T at 10 a.m. on June 30 of Year 1, the results would be the same. See paragraph (e)(2)(i) of this section.

Example 2. The facts are the same as in *Example 1*, except that the S group does not file consolidated returns. T must file a separate return for its taxable year ending on June 30 of Year 1, which includes the deemed sale.

(f) *Waiver*—(1) *Certain additions to tax.* An addition to tax or additional amount (addition) under subchapter A of chapter 68 of the Internal Revenue Code arising on or before the last day for making the election under section 338, by reason of circumstances that would not exist but for an election under section 338, is waived if—

(i) Under the particular statute the addition is excusable upon a showing of reasonable cause; and

(ii) Corrective action is taken on or before the last day.

(2) *Notification.* The Service should be notified at the time of correction (e.g., by attaching a statement to a return that constitutes corrective action) that the waiver rule of this paragraph (f) is being asserted.

(3) *Elections or other actions required to be specified on a timely filed return*—(i) *In general.* If paragraph (f)(1) of this section applies or would apply if there was an underpayment, any election or other action that must be specified on a timely filed return for the taxable period covered by the late filed return described in paragraph (f)(1) of this section is considered timely if specified on a late-filed return filed on or before the last day for making the election under section 338.

(ii) *New target in purchasing corporation's consolidated return.* If new target is includible for its first taxable year in a consolidated return filed by the affiliated group of which the purchasing corporation is a member on or before the last day for making the election under section 338, any election or other action that must be specified in a timely filed return for new target's first taxable year (but which is not specified in the consolidated return) is considered timely if specified in an amended return filed on or before such last day, at the place where the consolidated return was filed.

(4) *Examples.* This paragraph (f) may be illustrated by the following examples:

Example 1. T is an unaffiliated corporation with a tax year ending March 31. At the close of September 20 of Year 1, P makes a qualified stock purchase of T. P does not join in filing a consolidated return. P makes a section 338 election for T on or before June 15 of Year 2, which causes T's taxable year to end as of the close of September 20 of Year 1. An income tax return for T's taxable period ending on September 20 of Year 1 was due on December 15 of Year 1. Additions to tax for failure to file a return and to pay tax shown on a return will not be imposed if T's return is filed and the tax paid on or before June 15 of

Year 2. (This waiver applies even if the acquisition date coincides with the last day of T's former taxable year, i.e., March 31 of Year 2.) Interest on any underpayment of tax for old T's short taxable year ending September 20 of Year 1 runs from December 15 of Year 1. A statement indicating that the waiver rule of §1.338–1(f) is being asserted should be attached to T's return.

Example 2. Assume the same facts as in *Example 1.* Assume further that new T adopts the calendar year by filing, on or before June 15 of Year 2, its first return (for the period beginning on September 21 of Year 1 and ending on December 31 of Year 1) indicating that a calendar year is chosen. See §1.338–2(d)(8). Any additions to tax or amounts described in this paragraph (f) which arise by reason of the late filing of a return for the period ending on December 31 of Year 1 are waived, because they are based on circumstances that would not exist but for the section 338 election. Notwithstanding this waiver, however, the return is still considered due March 15 of Year 2, and interest on any underpayment runs from that date.

Example 3. Assume the same facts as in *Example 2,* except that T's former taxable year ends on October 31. Although prior to the election old T had a return due on January 15 of Year 2 for its year ending October 31 of Year 1, that return need not be filed because a timely election under section 338 was made. Instead, old T must file a final return for the period ending on September 20 of Year 1, which is due on December 15 of Year 1.

(g) *Special rules for foreign corporations or DISCs*—(1) *Elections by certain foreign purchasing corporations*—(i) *General rule.* A qualifying foreign purchasing corporation is not required to file a statement of section 338 election for a qualifying foreign target before the earlier of 3 years after the acquisition date and the 180th day after the close of the purchasing corporation's taxable year within which a triggering event occurs.

(ii) *Qualifying foreign purchasing corporation.* A purchasing corporation is a *qualifying foreign purchasing corporation* only if, during the acquisition period of a qualifying foreign target, all the corporations in the purchasing corporation's affiliated group are foreign corporations that are not subject to United States tax.

(iii) *Qualifying foreign target.* A target is a *qualifying foreign target* only if target and its target affiliates are foreign corporations that, during target's acquisition period, are not subject to United States tax (and will not become subject to United States tax during such period by reason of a section 338 election). A target affiliate is taken into account for purposes of the preceding sentence only if, during target's 12-month acquisition period, it is or becomes a member of the affiliated group that includes the purchasing corporation.

(iv) *Triggering event.* A triggering event occurs in the taxable year of the qualifying foreign purchasing corporation in which either that corporation or any corporation in its affiliated group becomes subject to United States tax.

(v) *Subject to United States tax.* For purposes of this paragraph (g)(1), a foreign corporation is considered *subject to United States tax*—

(A) For the taxable year for which that corporation is required under §1.6012–2(g) (other than §1.6012–2(g)(2)(i)(*b*)(*2*)) to file a United States income tax return; or

(B) For the period during which that corporation is a controlled foreign corporation, a passive foreign investment company for which an election under section 1295 is in effect, a foreign investment company, or a foreign corporation the stock ownership of which is described in section 552(a)(2).

(2) *Acquisition period.* For purposes of this paragraph (g), the term *acquisition period* means the period beginning on the first day of the 12-month acquisition period and ending on the acquisition date.

(3) *Statement of section 338 election may be filed by United States shareholders in certain cases.* The United States shareholders (as defined in section 951(b)) of a foreign purchasing corporation that is a controlled foreign corporation (as defined in section 957 (taking into account section 953(c))) may file a statement of section 338 election on behalf of the purchasing corporation if the purchasing corporation is not required under §1.6012–2(g) (other than §1.6012–2(g)(2)(i)(*b*)(*2*)) to file a United States income tax return for its taxable year that includes the acquisition date. Form 8023 must be filed as described in the form and its instructions and also must be attached to the Form 5471 (information return with respect to a foreign corporation) filed with respect to

the purchasing corporation by each United States shareholder for the purchasing corporation's taxable year that includes the acquisition date (or, if paragraph (g)(1)(i) of this section applies to the election, for the purchasing corporation's taxable year within which it becomes a controlled foreign corporation). The provisions of § 1.964–1(c) (including § 1.964–1(c)(7)) do not apply to an election made by the United States shareholders.

(4) *Notice requirement for U.S. persons holding stock in foreign target*—(i) *General rule.* If a target subject to a section 338 election was a controlled foreign corporation, a passive foreign investment company, or a foreign personal holding company at any time during the portion of its taxable year that ends on its acquisition date, the purchasing corporation must deliver written notice of the election (and a copy of Form 8023, its attachments and instructions) to—

(A) Each U.S. person (other than a member of the affiliated group of which the purchasing corporation is a member (the purchasing group member)) that, on the acquisition date of the foreign target, holds stock in the foreign target; and

(B) Each U.S. person (other than a purchasing group member) that sells stock in the foreign target to a purchasing group member during the foreign target's 12-month acquisition period.

(ii) *Limitation.* The notice requirement of this paragraph (g)(4) applies only where the section 338 election for the foreign target affects income, gain, loss, deduction, or credit of the U.S. person described in paragraph (g)(4)(i) of this section under section 551, 951, 1248, or 1293.

(iii) *Form of notice.* The notice to U.S. persons must be identified prominently as a notice of section 338 election and must—

(A) Contain the name, address, and employer identification number (if any) of, and the country (and, if relevant, the lesser political subdivision) under the laws of which is organized, the purchasing corporation and the relevant target (i.e., target the stock of which the particular U.S. person held or sold under the circumstances described in paragraph (g)(4)(i) of this section);

(B) Identify those corporations as the purchasing corporation and the foreign target, respectively; and

(C) Contain the following declaration (or a substantially similar declaration): "THIS DOCUMENT SERVES AS NOTICE OF AN ELECTION UNDER SECTION 338 FOR THE ABOVE CITED FOREIGN TARGET THE STOCK OF WHICH YOU EITHER HELD OR SOLD UNDER THE CIRCUMSTANCES DESCRIBED IN TREASURY REGULATIONS § 1.338–1(g)(4). FOR POSSIBLE UNITED STATES FEDERAL INCOME TAX CONSEQUENCES UNDER SECTION 551, 951, 1248, OR 1293 OF THE INTERNAL REVENUE CODE OF 1986 THAT MAY APPLY TO YOU, SEE TREASURY REGULATIONS § 1.338–5(b). YOU MAY BE REQUIRED TO ATTACH THE INFORMATION ATTACHED TO THIS NOTICE TO CERTAIN RETURNS".

(iv) *Timing of notice.* The notice required by this paragraph (g)(4) must be delivered to the U.S. person on or before the later of the 120th day after the acquisition date of the particular target or the day on which Form 8023 is filed. If notice is delivered by United States mail, the date of the United States postmark is deemed to be the date of delivery.

(v) *Consequence of failure to comply.* A statement of section 338 election is not valid if timely notice is not given to one or more U.S. persons described in this paragraph (g)(4). If the form of notice fails to comply with all requirements of this paragraph (g)(4), the section 338 election is valid, but the waiver rule of paragraph (f)(1) of this section does not apply.

(vi) *Good faith effort to comply.* The purchasing corporation will be considered to have complied with this paragraph (g)(4), even though it failed to provide notice or provide timely notice to each person described in this paragraph (g)(4), if the Commissioner determines that the purchasing corporation made a good faith effort to identify and provide timely notice to those U.S. persons.

[T.D. 8515, 59 FR 2963, Jan. 20, 1994]

§1.338–2 Miscellaneous issues under section 338.

(a) *Scope.* This section provides guidance on miscellaneous issues under section 338.

(b) *Rules relating to qualified stock purchases*—(1) *Purchasing corporation requirement.* An individual cannot make a qualified stock purchase of target. Section 338(d)(3) requires, as a condition of a qualified stock purchase, that a corporation purchase the stock of target. If an individual forms a corporation (new P) to acquire target stock, new P can make a qualified stock purchase of target if new P is considered for tax purposes to purchase the target stock. Facts that may indicate that new P does not purchase the target stock include that new P merges downstream into target, liquidates, or otherwise disposes of the target stock following the purported qualified stock purchase.

(2) *Purchase*—(i) *Definition.* The term *purchase* has the same meaning as in section 338(h)(3).

(ii) *Examples.* This paragraph (b)(2) may be illustrated by the following examples:

Example 1. A, who owns all of the stock of P and T, sells the T stock to P for cash. A is treated under section 304(a)(1) as receiving a distribution in redemption of the P stock to which section 301 applies. P is treated as receiving the T stock as a contribution to its capital. Under section 362(a) and §1.304–2(a), P's basis in the T stock is determined by reference to A's adjusted basis in the stock. Further, stock owned by A would be attributed to P under section 318(a)(3)(C). Thus, P is not considered to have acquired the T stock by purchase. See sections 338(h)(3)(A)(i) and (iii).

Example 2. P exchanges cash for all of the stock of N, a newly formed corporation. N was formed for the sole purpose of acquiring all of the T stock by means of a reverse subsidiary cash merger. Prior to the merger, N conducted no activities other than those required for the merger. Pursuant to the plan, N merges into T, and the T shareholders receive cash for their T stock. No T shareholder is related to P, and no group of T shareholders controls P within the meaning of section 304(c). The existence of N is disregarded, and P is considered to acquire the T stock directly from the T shareholders for cash. Thus, P is considered to have acquired the T stock by purchase.

(3) *Date of purchase from related corporations*—(i) *In general.* Stock acquired by a purchasing corporation from a related corporation (R) is generally not considered acquired by purchase. See section 338(h)(3)(A)(iii). However, if section 338(h)(3)(C) applies and the purchasing corporation is treated as acquiring stock by purchase from R, solely for purposes of determining when the stock is considered acquired—

(A) Target stock acquired from R is considered to have been acquired by the purchasing corporation on the day on which the purchasing corporation is first considered to own that stock under section 318(a) (other than section 318(a)(4)); and

(B) If such stock first may be considered owned by the purchasing corporation on more than one date, such stock is deemed acquired on the earliest date first to the extent thereof, then on the next earliest date, and so on.

(ii) *Examples.* This paragraph (b)(3) may be illustrated by the following examples:

Example 1. (a) On January 1 of Year 1, P purchases 75% in value of the R stock. On that date, R owns 4 of the 100 shares of T stock. On June 1 of Year 1, R acquires an additional 16 shares of T stock. On December 1 of Year 1, P purchases 70 shares of T stock from an unrelated person and 12 of the 20 shares of T stock held by R.

(b) Of the 12 shares of T stock purchased by P from R on December 1 of Year 1, 3 of those shares are deemed to have been acquired by P on January 1 of Year 1, the date on which 3 of the 4 shares of T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e., 4×.75). The remaining 9 shares of T stock purchased by P from R on December 1 of Year 1, are deemed to have been acquired by P on June 1 of Year 1, the date on which an additional 12 of the 20 shares of T stock owned by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e., (20×.75) −3). Because stock acquisitions by P sufficient for a qualified stock purchase of T occur within a 12-month period (i.e., 3 shares constructively on January 1 of Year 1, 9 shares constructively on June 1 of Year 1, and 70 shares actually on December 1 of Year 1), a qualified stock purchase is made on December 1 of Year 1.

Example 2. (a) On February 1 of Year 1, P acquires 25% in value of the R stock from B (the sole shareholder of P). That R stock is not acquired by purchase. See section 338(h)(3)(A)(iii). On that date, R owns 4 of the 100 shares of T stock. On June 1 of Year 1, P purchases an additional 25% in value of the

R stock, and on January 1 of Year 2, P purchases another 25% in value of the R stock. On June 1 of Year 2, R acquires an additional 16 shares of the T stock. On December 1 of Year 2, P purchases 68 shares of the T stock from an unrelated person and 12 of the 20 shares of the T stock held by R.

(b) Of the 12 shares of the T stock purchased by P from R on December 1 of Year 2, 2 of those shares are deemed to have been acquired by P on June 1 of Year 1, the date on which 2 of the 4 shares of the T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e., 4×.5). For purposes of this attribution, the R stock need not be acquired by P by purchase. See section 338(h)(1). (By contrast, the acquisition of the T stock by P from R does not qualify as a purchase unless P has acquired at least 50% in value of the R stock by purchase. Section 338(h)(3)(C)(i).) Of the remaining 10 shares of the T stock purchased by P from R on December 1 of Year 2, 1 of those shares is deemed to have been acquired by P on January 1 of Year 2, the date on which an additional 1 share of the 4 shares of the T stock held by R on that date was first considered owned by P under section 318(a)(2)(C) (i.e., (4×.75) −2). The remaining 9 shares of the T stock purchased by P from R on December 1 of Year 2, are deemed to have been acquired by P on June 1 of Year 2, the date on which an additional 12 shares of the T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e., (20×.75) −3). Because a qualified stock purchase of T by P is made on December 1 of Year 2, only if all 12 shares of the T stock purchased by P from R on that date are considered acquired during a 12-month period ending on that date (so that, in conjunction with the 68 shares of the T stock P purchased on that date from the unrelated person, 80 of T's 100 shares are acquired by P during a 12-month period) and because 2 of those 12 shares are considered to have been acquired by P more than 12 months before December 1 of Year 2 (i.e., on June 1 of Year 1), a qualified stock purchase is not made. (Under §1.338–4(j)(2), for purposes of applying the consistency rules, P is treated as making a qualified stock purchase of T if, pursuant to an arrangement, P purchases T stock satisfying the requirements of section 1504(a)(2) over a period of more than 12 months.)

Example 3. Assume the same facts as in *Example 2,* except that on February 1 of Year 1, P acquires 25% in value of the R stock by purchase. The result is the same as in *Example 2.*

(4) *Acquisition date for tiered targets*—(i) *Stock sold in deemed asset sale.* If an election under section 338 is made for target, old target is deemed to sell target's assets and new target is deemed to acquire those assets. Under section 338(h)(3)(B), new target's deemed purchase of stock of another corporation is a purchase for purposes of section 338(d)(3) on the acquisition date of target. If new target's deemed purchase causes a qualified stock purchase of the other corporation and if a section 338 election is made for the other corporation, the acquisition date for the other corporation is the same as the acquisition date of target. However, the deemed sale and purchase of the other corporation's assets is considered to take place after the deemed sale and purchase of target's assets.

(ii) *Examples.* This paragraph (b)(4) may be illustrated by the following examples:

Example 1. A owns all of the T stock. T owns 50 of the 100 shares of X stock. The other 50 shares of X stock are owned by corporation Y, which is unrelated to A, T, or P. On January 1 of Year 1, P makes a qualified stock purchase of T from A and makes a section 338 election for T. On December 1 of Year 1, P purchases the 50 shares of X stock held by Y. A qualified stock purchase of X is made on December 1 of Year 1, because the deemed purchase of 50 shares of X stock by new T by reason of the section 338 election for T and the actual purchase of 50 shares of X stock by P are treated as purchases made by one corporation. Section 338(h)(8). For purposes of determining whether those purchases occur within a 12-month acquisition period as required by section 338(d)(3), T is deemed to purchase its X stock on T's acquisition date, i.e., January 1 of Year 1.

Example 2. On January 1 of Year 1, P makes a qualified stock purchase of T and makes a section 338 election for T. On that day, T sells all of the stock of T1 to A. Although T held all of the T1 stock on T's acquisition date, T is not considered to have purchased the T1 stock by reason of the section 338 election for T. In order for T to be treated as purchasing the T1 stock, T must hold the T1 stock when T's deemed sale of assets occurs pursuant to section 338(a). The deemed sale of assets is considered the last transaction of old T at the close of T's acquisition date. Accordingly, the T1 stock actually disposed of by T on the acquisition date is not included in the deemed sale of assets. Thus, T does not make a qualified stock purchase of T1.

(5) *Effect of redemptions*—(i) *General rule.* Except as provided in this paragraph (b)(5), a qualified stock purchase is made on the first day on which the percentage ownership requirements of

section 338(d)(3) are satisfied by reference to target stock that is both—

(A) Held on that day by the purchasing corporation; and

(B) Purchased by the purchasing corporation during the 12-month period ending on that day.

(ii) *Redemptions from persons unrelated to the purchasing corporation.* Target stock redemptions from persons unrelated to the purchasing corporation that occur during the 12-month acquisition period are taken into account as reductions in target's outstanding stock for purposes of determining whether target stock purchased by the purchasing corporation in the 12-month acquisition period satisfies the percentage ownership requirements of section 338(d)(3).

(iii) *Redemptions from the purchasing corporation or related persons during 12-month acquisition period*—(A) *General rule.* For purposes of the percentage ownership requirements of section 338(d)(3), a redemption of target stock during the 12-month acquisition period from the purchasing corporation or from any person related to the purchasing corporation is not taken into account as a reduction in target's outstanding stock.

(B) *Exception for certain redemptions from related corporations.* A redemption of target stock during the 12-month acquisition period from a corporation related to the purchasing corporation is taken into account as a reduction in target's outstanding stock to the extent that the redeemed stock would have been considered purchased by the purchasing corporation (by reason of section 338(h)(3)(C)) during the 12-month acquisition period if the redeemed stock had been acquired by the purchasing corporation from the related corporation on the day of the redemption. See paragraph (b)(3) of this section.

(iv) *Examples.* This paragraph (b)(5) may be illustrated by the following examples:

*Example 1. QSP on stock purchase date; redemption from unrelated person during 12-month period.*A owns all 100 shares of T stock. On January 1 of Year 1, P purchases 40 shares of the T stock from A. On July 1 of Year 1, T redeems 25 shares from A. On December 1 of Year 1, P purchases 20 shares of the T stock from A. P makes a qualified stock purchase of T on December 1 of Year 1, because the 60 shares of T stock purchased by P within the 12-month period ending on that date satisfy the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/75 shares), determined by taking into account the redemption of 25 shares.

*Example 2. QSP on stock redemption date; redemption from unrelated person during 12-month period.*The facts are the same as in *Example 1,* except that P purchases 60 shares of T stock on January 1 of Year 1 and none on December 1 of Year 1. P makes a qualified stock purchase of T on July 1 of Year 1, because that is the first day on which the T stock purchased by P within the preceding 12-month period satisfies the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/75 shares), determined by taking into account the redemption of 25 shares.

*Example 3. Redemption from unrelated person more than 12 months before stock purchase.*A owns all 100 shares of T stock. On January 1 of Year 1, T redeems 25 of its shares. On January 15 of Year 2, P purchases 60 shares of T stock from A. P makes a qualified stock purchase of T on January 15 of Year 2. The 60 shares of T stock purchased by P within the 12-month period ending on that date satisfy the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/75 shares), determined by taking into account the redemption of 25 shares. It is irrelevant that the redemption occurred before the 12-month acquisition period.

*Example 4. Redemption from unrelated person more than 12 months after stock purchase.*The facts are the same as in *Example 3,* except that the redemption occurs on April 1 of Year 3. P does not make a qualified stock purchase of T on April 1 of Year 3, because 80% of the T stock, as of April 1 of Year 3 had not been purchased in the preceding 12 months. (Under §1.338–4(j)(2), for purposes of applying the consistency rules, P is treated as making a qualified stock purchase of T if, pursuant to an arrangement, P purchases T stock satisfying the requirements of section 1504(a)(2) over a period of more than 12 months.)

*Example 5. Redemption from purchasing corporation not taken into account.*On December 15 of Year 1, T redeems 30% of its stock from P. The redeemed stock was held by P for several years and constituted P's total interest in T. On December 1 of Year 2, P purchases the remaining T stock from A. P does not make a qualified stock purchase of T on December 1 of Year 2. For purposes of the 80-percent ownership requirements of section 338(d)(3), the redemption of P's T stock on December 15 of Year 1 is not taken into account as a reduction in T's outstanding stock.

*Example 6. Redemption from related person taken into account.*On January 1 of Year 1, P purchases 60 of the 100 shares of X stock. On that date, X owns 40 of the 100 shares of T stock. On April 1 of Year 1, T redeems X's T stock and P purchases the remaining 60 shares of T stock from an unrelated person. For purposes of the 80-percent ownership requirements of section 338(d)(3), the redemption of the T stock from X (a person related to P) is taken into account as a reduction in T's outstanding stock. If P had purchased the 40 redeemed shares from X on April 1 of Year 1, all 40 of the shares would have been considered purchased (by reason of section 338(h)(3)(C)(i)) during the 12-month period ending on April of Year 1 (24 of the 40 shares would have been considered purchased by P on January 1 of Year 1 and the remaining 16 shares would have been considered purchased by P on April 1 of Year 1). See paragraph (b)(3) of this section. Accordingly, P makes a qualified stock purchase of T on April 1 of Year 1, because the 60 shares of T stock purchased by P on that date satisfy the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/60 shares), determined by taking into account the redemption of 40 shares.

(c) *Effect of post-acquisition events on eligibility for section 338 election*—(1) *Post-acquisition elimination of target.* (i) The purchasing corporation may make an election under section 338 for target even though target is liquidated on or after the acquisition date. If target liquidates on the acquisition date, the liquidation is considered to occur on the following day and immediately after new target's deemed purchase of assets. The purchasing corporation may also make an election under section 338 for target even though target is merged into another corporation, or otherwise disposed of by the purchasing corporation provided that, under the facts and circumstances, the purchasing corporation is considered for tax purposes as the purchaser of the target stock.

(ii) This paragraph (c)(1) may be illustrated by the following examples:

Example 1. On January 1 of Year 1, P makes a qualified stock purchase of T. On June 1 of Year 1, P sells the T stock to an unrelated person. Assuming that P is considered for tax purposes as the purchaser of the T stock, P remains eligible, after June 1 of Year 1, to make a section 338 election for T that results in a deemed sale of T's assets on January 1 of Year 1.

Example 2. On January 1 of Year 1, P makes a qualified stock purchase of T. On that date, T owns the stock of T1. On March 1 of Year 1, T sells the T1 stock to an unrelated person. On April 1 of Year 1, P makes a section 338 election for T. Notwithstanding that the T1 stock was sold on March 1 of Year 1, the section 338 election for T on April 1 of Year 1, results in a qualified stock purchase by T of T1 on January 1 of Year 1. See paragraph (b)(4)(i) of this section.

(2) *Post-acquisition elimination of the purchasing corporation.* An election under section 338 may be made for target after the acquisition of assets of the purchasing corporation by another corporation in a transaction described in section 381(a), provided that the purchasing corporation is considered for tax purposes as the purchaser of the target stock. The acquiring corporation in the section 381(a) transaction may make an election under section 338 for target.

(3) *Consequences of post-acquisition elimination of target*—(i) *Scope.* The rules of this paragraph (c)(3) apply to the transfer of target assets to the purchasing corporation (or another member of the same affiliated group as the purchasing corporation) (the transferee) following a qualified stock purchase of target stock, if the purchasing corporation does not make a section 338 election for target. Notwithstanding the rules of this paragraph (c)(3), section 354(a) (and so much of section 356 as relates to section 354) cannot apply to any person other than the purchasing corporation or another member of the same affiliated group as the purchasing corporation unless the transfer of target assets is pursuant to a reorganization as determined without regard to this paragraph (c)(3).

(ii) *Continuity of interest.* By virtue of section 338, in determining whether the continuity of interest requirement of § 1.368–1 (b) and (e) is satisfied on the transfer of assets from target to the transferee, the purchasing corporation's target stock acquired in the qualified stock purchase shall be treated as though it was not acquired in connection with the transfer of target assets.

(iii) *Control requirement.* By virtue of section 338, the acquisition of target stock in the qualified stock purchase will not prevent the purchasing corporation from qualifying as a shareholder of the target transferor for the purpose of determining whether, immediately after the transfer of target assets, a shareholder of the transferor is in control of the corporation to which the assets are transferred within the meaning of section 368(a)(1)(D).

(iv) *Example.* This paragraph (c)(3) is illustrated by the following example:

Example (A) *Facts.* P, T, and X are domestic corporations. T and X each operate a trade or business. A and K, individuals unrelated to P, own 85 and 15 percent, respectively, of the stock of T. P owns all of the stock of X. The total adjusted basis of T's property exceeds the sum of T's liabilities plus the amount of liabilities to which T's property is subject. P purchases all of A's T stock for cash in a qualified stock purchase. P does not make an election under section 338(g) with respect to its acquisition of T stock. Shortly after the acquisition date, and as part of the same plan, T merges under applicable state law into X in a transaction that, but for the question of continuity of interest, satisfies all the requirements of section 368(a)(1)(A). In the merger, all of T's assets are transferred to X. P and K receive X stock in exchange for their T stock. P intends to retain the stock of X indefinitely.

(B) *Status of transfer as a reorganization.* By virtue of section 338, for the purpose of determining whether the continuity of interest requirement of § 1.368–1(b) is satisfied, P's T stock acquired in the qualified stock purchase shall be treated as though it was not acquired in connection with the transfer of T assets to X. Thus, the continuity of interest requirement is satisfied and the merger of T into X is a reorganization within the meaning of section 368(a)(1)(A). Moreover, by virtue of section 338, the requirement of section 368(a)(1)(D) that a target shareholder control the transferee immediately after the transfer is satisfied because P controls X immediately after the transfer. In addition, all of T's assets are transferred to X in the merger and P and K receive the X stock exchanged therefor in pursuance of the plan of reorganization. Thus, the merger of T into X is also a reorganization within the meaning of section 368(a)(1)(D).

(C) *Treatment of T and X.* Under section 361(a), T recognizes no gain or loss in the merger. Under section 362(b), X's basis in the assets received in the merger is the same as the basis of the assets in T's hands. X succeeds to and takes into account the items of T as provided in section 381.

(D) *Treatment of P.* By virtue of section 338, the transfer of T assets to X is a reorganization. Pursuant to that reorganization, P exchanges its T stock solely for stock of X, a party to the reorganization. Because P is the purchasing corporation, section 354 applies to P's exchange of T stock for X stock in the merger of T into X. Thus, P recognizes no gain or loss on the exchange. Under section 358, P's basis in the X stock received in the exchange is the same as the basis of P's T stock exchanged therefor.

(E) *Treatment of K.* Because K is not the purchasing corporation (or an affiliate thereof), section 354 cannot apply to K's exchange of T stock for X stock in the merger of T into X unless the transfer of T's assets is pursuant to a reorganization as determined without regard to § 1.338–2(c)(3). Under general income tax principles applicable to reorganizations, the continuity of interest requirement is not satisfied because P's stock purchase and the merger of T into X are pursuant to an integrated transaction in which A, the owner of 85 percent of the stock of T, received solely cash in exchange for A's T stock. See, e.g., *Yoc Heating* v. *Commissioner,* 61 T.C. 168 (1973); *Kass* v. *Commissioner,* 60 T.C. 218 (1973), *aff'd,* 491 F.2d 749 (3d Cir. 1974). Thus, the requisite continuity of interest under § 1.368–1(b) is lacking and section 354 does not apply to K's exchange of T stock for X stock. K recognizes gain or loss, if any, pursuant to section 1001(c) with respect to its T stock.

(v) *Effective date.* The provisions of this paragraph (c)(3) are effective for transfers of target assets on or after October 26, 1995.

(d) *Miscellaneous matters affecting new target*—(1) *General rule for subtitle A.* Except as provided in this paragraph (d), new target is treated as a new corporation that is unrelated to old target for purposes of subtitle A of the Internal Revenue Code. Thus, in the section 338(a)(1) deemed sale, new target is treated as purchasing assets from an unrelated person, and—

(i) New target is not considered related to old target for purposes of section 168 and may make new elections under section 168 without taking into account the elections made by old target; and—

(ii) New target may adopt, without obtaining prior approval from the Commissioner, any taxable year that meets the requirements of section 441 and any method of accounting that meets the requirements of section 446.

(2) *Exceptions for subtitle A.* New target and old target are treated as the same corporation for purposes of—

(i) The rules applicable to employee benefit plans (including those plans described in sections 79, 104, 105, 120, 125, 127, and 129), qualified pension, profit-sharing, stock bonus and annuity plans (sections 401(a) and 403(a)), simplified employee pensions (section 408(k)), and tax qualified stock option plans (sections 422 and 423);

(ii) Sections 1311–1314 (relating to the mitigation of the effect of limitations) if a section 338(h)(10) election is not made for target; and

(iii) Any other provision identified by the Commissioner.

(3) *Taxable year of new target.* Notwithstanding § 1.441–1T(b)(2), a new target may adopt a taxable year on or before the last day for making the election under section 338 by filing its first return for the desired taxable year on or before that date.

(4) *General rule for other provisions of the Internal Revenue Code.* Except as provided in the regulations under section 338 or by the Commissioner, new target is treated as a continuation of old target for purposes other than subtitle A. For example—

(i) New target is liable for old target's federal income tax liabilities, including tax liabilities resulting from the deemed asset sale and those tax liabilities of the other members of any consolidated group that included old target that are attributable to taxable years in which those corporations and old target joined in the same consolidated return (see § 1.1502–6(a));

(ii) Wages earned by the employees of old target are considered wages earned by such employees from new target for purposes of sections 3101 and 3111 (Federal Insurance Contributions Act) and section 3301 (Federal Unemployment Tax Act); and

(iii) Old target and new target must use the same employer identification number.

[T.D. 8515, 59 FR 2966, Jan. 20, 1994, as amended by T.D. 8626, 60 FR 54944, Oct. 27, 1995; T.D. 8760, 63 FR 4178, Jan. 28, 1998]

§ 1.338–3 Deemed sale and aggregate deemed sale price.

(a) *Scope.* This section provides guidance regarding the recognition of gain or loss on the deemed sale of target affiliate stock. This section also provides guidance regarding the determination of the price (the aggregate deemed sale price) at which old target is treated as selling its assets in the section 338(a)(1) deemed sale for purposes of determining the gain or loss recognized by target in the deemed sale. Notwithstanding section 338(h)(6)(B)(ii), stock held by a target affiliate in a foreign corporation or in a corporation that is a DISC or that is described in section 1248(e) is not excluded from the operation of section 338.

(b) *Definitions.* For purposes of the regulations under section 338:

(1) *ADSP.* The *ADSP* is the aggregate deemed sale price, i.e., the price at which target is deemed to have sold all of its assets in the deemed sale under section 338(a)(1). See paragraph (d) of this section for the determination of the ADSP.

(2) *Allocable ADSP amount.* The *allocable ADSP amount* is the portion of the ADSP that is allocable to a particular target asset. Deemed sale gain on a target asset is computed by reference to the allocable ADSP amount for that asset. Except as provided in section 7701(g) (relating to fair market value in the case of nonrecourse indebtedness), the ADSP is allocated among target assets for this purpose under the principles of § 1.338(b)–2T (without taking into account § 1.338(b)–2T(c)(2)). Appropriate adjustments to reflect accurately the fair market value of assets must be made if stock of a target affiliate is purchased in the section 338(a)(1) deemed sale, a section 338 election is made for the target affiliate, and target recognizes no gain or loss on the deemed sale of the target affiliate stock under paragraph (c) of this section. See *Example 4* of paragraph (d)(8) of this section.

(3) *Deemed sale gain. Deemed sale gain* is gain (or loss) that is recognized in the section 338(a)(1) deemed sale. For purposes of subtitle A of the Internal Revenue Code, deemed sale gain is taken into account by treating the old target as if, on the acquisition date, it sold all of its assets to an unrelated person in the deemed sale. See § 1.338–2(d)(1). For example, section 267 does not apply to loss recognized on the deemed sale.

(4) *Classes of assets.* The classes of assets are defined in § 1.338(b)–2T(b).

(c) *Deemed sale of target affiliate stock*—(1) *In general.* This paragraph (c) prescribes rules relating to the treatment of gain or loss realized on the deemed sale of stock of a target affiliate where a section 338 election (but not a section 338(h)(10) election) is made for the target affiliate. For purposes of this paragraph (c), the definition of domestic corporation in §1.338–1(c)(5) is applied without the exclusion therein for DISCs, corporations described in section 1248(e), and corporations to which an election under section 936 applies.

(2) *General rule.* Except as otherwise provided in this paragraph (c), if a section 338 election is made for target, no gain or loss is recognized by target on the deemed sale of stock of a target affiliate having the same acquisition date and for which a section 338 election is made if—

(i) Target directly owns stock in the target affiliate satisfying the requirements of section 1504(a)(2);

(ii) Target and the target affiliate are members of a consolidated group filing a final consolidated return described in §1.338–1(e)(1); or

(iii) Target and the target affiliate file a combined return under §1.338–1(e)(4).

(3) *Deemed sale of foreign target affiliate by a domestic target.* Gain or loss is recognized by a domestic target on the deemed sale of stock of a foreign target affiliate. For the proper treatment of such gain or loss, see, e.g., sections 1246, 1248, 1291 *et seq.*, and 338(h)(16) and §1.338–5.

(4) *Deemed sale producing effectively connected income.* Gain or loss is recognized by a foreign target on the deemed sale of stock of a foreign target affiliate to the extent that such gain or loss is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

(5) *Deemed sale of insurance company target affiliate electing under section 953(d).* Gain (but not loss) is recognized by a domestic target on the deemed sale of stock of a target affiliate that has in effect an election under section 953(d) in an amount equal to the lesser of the gain realized or the earnings and profits described in section 953(d)(4)(B).

(6) *Deemed sale of DISC target affiliate.* Gain (but not loss) is recognized by a foreign or domestic target on the deemed sale of stock of a target affiliate that is a DISC or a former DISC (as defined in section 992(a)) in an amount equal to the lesser of the gain realized or the amount of accumulated DISC income determined with respect to such stock under section 995(c). Such gain is included in gross income as a dividend as provided in sections 995(c)(2) and 996(g).

(7) *Anti-stuffing rule.* If an asset the adjusted basis of which exceeds its fair market value is contributed or transferred to a target affiliate as transferred basis property (within the meaning of section 7701(a)(43)) and a purpose of such transaction is to reduce the gain (or increase the loss) recognized on the deemed sale of such target affiliate's stock, the gain or loss recognized by target on the deemed sale of stock of the target affiliate is determined as if such asset had not been contributed or transferred.

(8) *Examples.* This paragraph (c) may be illustrated by the following examples:

Example 1. (a) P makes a qualified stock purchase of T and makes a section 338 election for T. T's sole asset, all of the T1 stock, has a basis of $50 and a fair market value of $150. T's deemed purchase of the T1 stock results in a qualified stock purchase of T1 and a section 338 election is made for T1. T1's assets have a basis of $50 and a fair market value of $150.

(b) T realizes $100 of gain on the deemed sale of the T1 stock, but the gain is not recognized because T directly owns stock in T1 satisfying the requirements of section 1504(a)(2) and a section 338 election is made for T1.

(c) T1 recognizes gain of $100 on the deemed sale of its assets.

Example 2. The facts are the same as in *Example 1,* except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the $100 gain realized by T on the deemed sale of the T1 stock is recognized.

Example 3. (a) P makes a qualified stock purchase of T and makes a section 338 election for T. T owns all of the stock of T1 and T2. T's deemed purchase of the T1 and T2 stock results in a qualified stock purchase of T1 and T2 and a section 338 election is made for T1 and T2. T1 and T2 each own 50% of the vote and value of T3 stock. The deemed purchases by T1 and T2 of the T3 stock result in a qualified stock purchase of T3 and a section 338 election is made for T3. T is the common parent of a consolidated group and all of the deemed sales are reported on the T group's final consolidated return. See § 1.338–1(e)(1).

(b) Because T, T1, T2 and T3 are members of a consolidated group filing a final consolidated return, no gain or loss is recognized by T, T1 or T2 on their respective deemed sales of target affiliate stock.

Example 4. (a) T's sole asset, all of the FT1 stock, has a basis of $25 and a fair market value of $150. FT1's sole asset, all of the FT2 stock, has a basis of $75 and a fair market value of $150. FT1 and FT2 each have $50 of accumulated earnings and profits for purposes of section 1248(c) and (d). FT2's assets have a basis of $125 and a fair market value of $150, and their sale would not generate subpart F income under section 951. The sale of the FT2 stock or assets would not generate income effectively connected with the conduct of a trade or business within the United States. FT1 does not have an election in effect under section 953(d) and neither FT1 nor FT2 is a passive foreign investment company.

(b) P makes a qualified stock purchase of T and makes a section 338 election for T. T's deemed purchase of the FT1 stock results in a qualified stock purchase of FT1 and a section 338 election is made for FT1. Similarly, FT1's deemed purchase of the FT2 stock results in a qualified stock purchase of FT2 and a section 338 election is made for FT2.

(c) T recognizes $125 of gain on the deemed sale of the FT1 stock under paragraph (c)(3) of this section. FT1's $75 of gain on the deemed sale of the FT2 stock is not recognized under paragraph (c)(2) of this section. FT2 recognizes $25 of gain on the deemed sale of its assets. The $125 gain T recognizes on the deemed sale of the FT1 stock is included in T's income as a dividend under section 1248, because FT1 and FT2 have sufficient earnings and profits for full recharacterization ($50 of accumulated earnings and profits in FT1, $50 of accumulated earnings and profits in FT2, and $25 of deemed sale earnings and profits in FT2). § 1.338–5(b). For purposes of sections 901 through 908, the source and foreign tax credit limitation basket of $25 of the recharacterized gain on the deemed sale of the FT1 stock is determined under section 338(h)(16).

(d) *Determination of ADSP*—(1) *General rule.* The ADSP is the sum of—

(i) The grossed-up basis of the purchasing corporation's recently purchased target stock (as defined in section 338(b)(6)(A));

(ii) The liabilities of new target (including any tax liabilities resulting from the deemed sale); and

(iii) Other relevant items.

(2) *Grossed-up basis of the purchasing corporation's recently purchased target stock.* The grossed-up basis of the purchasing corporation's recently purchased target stock is an amount equal to the purchasing corporation's basis in recently purchased target stock, divided by the percentage of target stock (by value) attributable to that recently purchased target stock. If target has a single class of outstanding stock, the grossed-up basis of the purchasing corporation's recently purchased target stock reflects the total price the purchasing corporation would have paid for all outstanding target stock had it purchased all such stock for a price per share equal to the average price per share that it paid for the recently purchased target stock.

(3) *Liabilities.* Liabilities taken into account are the liabilities of new target described in § 1.338(b)–1(f). The amount of the liabilities of new target taken into account to calculate ADSP is determined as if old target had sold its assets to an unrelated person for consideration that included the liabilities. Thus, the ADSP takes into account both tax credit recapture liability arising by reason of the deemed sale and the tax liability on deemed sale gain. The ADSP reflects the fact that deemed sale gain (loss) both increases (decreases) the ADSP by creating (reducing) a tax liability and is computed by reference to the ADSP.

(4) *Other relevant items.* Other relevant items include reductions for acquisition costs of the purchasing corporation incurred in connection with the qualified stock purchase that are capitalized in the basis of recently purchased target stock (e.g., brokerage commissions and any similar costs paid by the purchasing corporation to acquire target stock).

(5) *Calculation of deemed sale gain and loss.* Deemed sale gain on each asset is computed by reference to the ADSP. In certain cases, the determination of the tax liability resulting from the deemed sale and therefore the determination of the ADSP may require trial and error computations.

(6) *Other rules apply in determining ADSP.* The ADSP may not be applied in such a way as to contravene other applicable rules. For example, a capital

loss cannot be applied to reduce ordinary income in calculating the tax liability on the deemed sale for purposes of determining the ADSP.

(7) *Cross-reference.* See §1.338(b)–3T(h) for adjustments to ADSP because of events occurring after the acquisition date and §1.338(h)(10)–1(f) for the determination of modified ADSP.

(8) *Examples.* (i) For purposes of the examples in this paragraph (d)(8), unless otherwise stated, T is a calendar year taxpayer that files separate returns and that has no loss, tax credit, or other carryovers to Year 1. Depreciation for Year 1 is not taken into account. T has no liabilities other than a federal income tax liability resulting from the deemed sale of assets, and T has no other relevant items. Assume that T's tax rate for any ordinary income or net capital gain resulting from the deemed sale of assets is 34 percent and that any capital loss is offset by capital gain. On July 1 of Year 1, P purchases all of the stock of T and makes a section 338 election for T.

(ii) This paragraph (d) may be illustrated by the following examples:

Example 1. One class. (a) On July 1 of Year 1, T's only asset is an item of section 1245 property with an adjusted basis to T of $50,400, a recomputed basis of $80,000, and a fair market value of $100,000. P purchases all of the T stock for $75,000.

(b) The ADSP may be determined as follows. (In the formula below, G is the grossed-up basis in P's recently purchased T stock, L is T's liabilities other than T's tax liabilities for deemed sale gain determined by reference to the ADSP, T_R is the applicable tax rate, and B is the adjusted basis of the asset deemed sold.)

$$\text{ADSP}=G+L+T_R\times(\text{ADSP}-B)$$

$$\text{ADSP}=(\$75{,}000/1)+\$0+.34\times(\text{ADSP}-\$50{,}400)$$

$$\text{ADSP}=\$75{,}000+.34\text{ADSP}-\$17{,}136$$

$$.66\text{ADSP}=\$57{,}864$$

$$\text{ADSP}=\$87{,}672.72$$

(c) Because the ADSP for T ($87,672.72) does not exceed the fair market value of T's asset ($100,000), a Class III asset, T's entire ADSP is allocated to that asset. Thus, T has deemed sale gain of $37,272.72 (consisting of $29,600 of ordinary income and $7,672.72 of capital gain).

(d) The facts are the same as in paragraph (a) of this *Example 1,* except that on July 1 of Year 1, P purchases only 80 of the 100 shares of T stock for $60,000. The grossed-up basis in P's recently purchased T stock (G) is $75,000 ($60,000/.8). Consequently, the ADSP and deemed sale gain are the same as in paragraphs (b) and (c) of this *Example 1.*

(e) The facts are the same as in paragraph (a) of this *Example 1,* except that T also has goodwill (a Class V asset) with an appraised value of $10,000. The results are the same as in paragraphs (b) and (c) of this *Example 1.* Because the ADSP does not exceed the fair market value of the Class III asset, no amount is allocated to the Class V assets (assets in the nature of goodwill and going concern value).

Example 2. More than one class. (a) P purchases all of the T stock for $140,000. On July 1 of Year 1, T has liabilities (not including the tax liability for deemed sale gain of its assets) of $50,000, cash (a Class I asset) of $10,000, readily marketable securities (a Class II asset) with a basis of $4,000 and a fair market value of $10,000, goodwill (a Class V asset) with a basis of $3,000, and the following Class III assets:

Asset	Basis	FMV	Ratio
1. Land	$5,000	$35,000	.14
2. Inventory	10,000	50,000	.20
3. Equipment A (recomputed basis $80,000)	5,000	90,000	.36
4. Equipment B (recomputed basis $20,000)	10,000	75,000	.30
Totals	$30,000	$250,000	1.00

(b) The ADSP exceeds $20,000. Thus, $10,000 of the ADSP is allocated to the cash and $10,000 to the marketable securities. Except as provided in section 7701(g), the amount allocated to an asset (other than a Class V asset) cannot exceed its fair market value. See §1.338(b)–2T(c)(1) (relating to fair market value limitation).

(c) The portion of the ADSP allocable to the Class III assets is preliminarily determined as follows. (In the formula, the amount allocated to the Class I assets is referred to as *I* and the amount allocated to the Class II assets as *II*.)

$$\text{ADSP}_{\text{III}} = (G-(I+II))+L+T_R \times [(II-B_{\text{II}}) + (\text{ADSP}_{\text{III}}-B_{\text{III}})]$$

$$\text{ADSP}_{\text{III}} = (\$140{,}000 - (\$10{,}000+\$10{,}000)) + \$50{,}000 + .34 \times [(\$10{,}000-\$4{,}000) + (\text{ADSP}_{\text{III}} - (\$5{,}000+\$10{,}000+\$5{,}000+\$10{,}000))]$$

$$\text{ADSP}_{\text{III}}=\$161{,}840+.34\text{ADSP}_{\text{III}}$$

$$.66\text{ADSP}_{\text{III}}=\$161{,}840$$

$$\text{ADSP}_{\text{III}}=\$245{,}212.12$$

(d) Because, under the preliminary calculations of the ADSP, the amount to be allocated to the Class I, II, III, and IV assets does not exceed their aggregate fair market value, no ADSP amount is allocated to goodwill. Accordingly, the deemed sale of the goodwill results in a capital loss of $3,000. The portion of the ADSP allocable to the Class III assets is finally determined by taking into account this loss as follows:

$$ADSP_{III} = (G - (I + II)) + L + T_R \times [(II - B_{II}) + (ADSP_{III} - B_{III}) + (ADSP_V - B_V)]$$

$$ADSP_{III} = (\$140,000 - (\$10,000 + \$10,000)) + \$50,000 + .34 \times [(\$10,000 - \$4,000) + (ADSP_{III} - \$30,000) + (\$0 - \$3,000)]$$

$$ADSP_{III} = \$160,820 + .34ADSP_{III}$$

$$.66ADSP_{III} = \$160,820$$

$$ADSP_{III} = \$243,666.67$$

(e) The allocation of $ADSP_{III}$ among the Class III assets is in proportion to their fair market values, as follows:

Asset	ADSP	Gain
1. Land	$34,113.33	$29,113.33 (capital gain)
2. Inventory	48,733.34	38,733.34 (ordinary income)
3. Equipment A	87,720.00	82,720.00 (75,000 ordinary income 7,720 capital gain)
4. Equipment B	73,100.00	63,100.00 (10,000 ordinary income 53,100 capital gain)
Totals	243,666.67	213,666.67

Example 3. More than one class. (a) The facts are the same as in *Example 2,* except that P purchases the T stock for $150,000, rather than $140,000.

(b) As in *Example 2,* the ADSP exceeds $20,000. Thus, $10,000 of the ADSP is allocated to the cash and $10,000 to the marketable securities.

(c) The portion of the ADSP allocable to the Class III assets as preliminarily determined under the formula set forth in paragraph (c) of *Example 2* is $260,363.64. The amount allocated to the Class III assets cannot exceed their aggregate fair market value ($250,000). Thus, preliminarily, the ADSP amount allocated to Class III assets is $250,000.

(d)(1) Based on the preliminary allocation, the ADSP is determined as follows: (In the formula, the amount allocated to the Class I assets is referred to as *I*, the amount allocated to the Class II assets as *II*, and the amount allocated to the Class III assets as *III*.)

$$ADSP = G + L + T_R \times [(II - B_{II}) + (III - B_{III}) + (ADSP - (I + II + III + B_V))]$$

$$ADSP = \$150,000 + \$50,000 + .34 \times [(\$10,000 - \$4,000) + (\$250,000 - \$30,000) + (ADSP - (\$10,000 + \$10,000 + \$250,000 + \$3,000))]$$

$$ADSP = \$200,000 + .34ADSP - \$15,980$$

$$.66ADSP = \$184,020$$

$$ADSP = \$278,818.18$$

(2) Because the ADSP as determined exceeds the aggregate fair market value of the Class I, II, III, and IV assets, the $250,000 amount preliminarily allocated to the Class III assets is appropriate. Thus, the amount of the ADSP allocated to Class III assets equals their aggregate fair market value ($250,000), and the allocated ADSP amount for each Class III asset is its fair market value. Further, because there are no Class IV assets, the allocable ADSP amount for the Class V asset (goodwill) is $8,818.18 (the excess of the ADSP over the aggregate ADSP amounts for the Class I, II, and III assets).

Example 4. Amount allocated to T1 stock. (a) The facts are the same as in *Example 2,* except that T owns all of the T1 stock (instead of the inventory), and T1's only asset is the inventory. The T1 stock and inventory each have a fair market value of $50,000, and the inventory has a basis of $10,000. A section 338 election is made for T1 (as well as T), and T1 has no liabilities other than a tax liability resulting from the deemed sale gain. Under paragraph (c) of this section, T recognizes no gain or loss on its deemed sale of T1 stock.

(b) The ADSP exceeds $20,000. Thus, $10,000 of the ADSP is allocated to the cash and $10,000 to the marketable securities.

(c) T1 stock is purchased in the deemed sale of T assets, T does not recognize any gain on the deemed sale of the T1 stock under paragraph (c) of this section, and a section 338 election is made for T1. Thus, under paragraph (b)(2) of this section, in determining the allocation of ADSP among T's Class III assets, including the T1 stock, appropriate adjustments must be made to reflect accurately the fair market value of the T and T1 assets. In preliminarily calculating $ADSP_{III}$ in this case, the T1 stock can be disregarded and, because T owns all of the T1 stock, the T1 asset can be treated as a T asset. Under this assumption, $ADSP_{III}$ is $243,666.67. See paragraph (d) of *Example 2.*

(d) Because the portion of the preliminary ADSP allocable to Class III assets ($243,666.67) does not exceed their fair market value ($250,000), no amount is allocated to Class V assets for T. Further, this amount ($243,666.67) is allocated among T's Class III assets in proportion to their fair market values. See paragraph (e) of *Example 2.* Tentatively, $48,733.34 of this amount is allocated to the T1 stock.

(e) The amount tentatively allocated to the T1 stock, however, reflects the tax incurred on the deemed sale of the T1 asset equal to $13,169.34 (.34 × ($48,733.34 − $10,000)). Thus, the ADSP allocable to the Class III assets of T, and the allocable ADSP amount for the T1 stock, as preliminarily calculated, each must be reduced by $13,169.34. Consequently, these amounts, respectively, are $230,497.33 and $35,564.00. In determining the ADSP for T1, the grossed-up basis of T's recently purchased T1 stock is $35,564.00.

(f) The facts are the same as in paragraph (a) of this *Example 4,* except that the T1 inventory has a $12,500 basis and a $62,500 value, the T1 stock has a $62,500 value, and T owns 80% of the T1 stock. In preliminarily calculating $ADSP_{III}$, the T1 stock can be disregarded but, because T owns only 80% of the

T1 stock, only 80% of T1 asset basis and value should be taken into account in calculating T's ADSP. By taking into account 80% of these amounts, the remaining calculations and results are the same as in paragraphs (b), (c), (d), and (e) of this *Example 4*, except that the grossed-up basis in T's recently purchased T1 stock is $44,455.00 ($35,564.00/0.8).

[T.D. 8515, 59 FR 2969, Jan. 20, 1994; as amended by T.D. 8711, 62 FR 2268, Jan. 16, 1997]

§1.338–4 Asset and stock consistency.

(a) *Introduction*—(1) *Overview*. This section implements the consistency rules of sections 338(e) and (f). Under this section, no election under section 338 is deemed made or required with respect to target or any target affiliate. Instead, the person acquiring an asset may have a carryover basis in the asset.

(2) *General application*. The consistency rules generally apply if the purchasing corporation acquires an asset directly from target during the target consistency period and target is a subsidiary in a consolidated group. In such a case, gain from the sale of the asset is reflected under the investment adjustment provisions of the consolidated return regulations in the basis of target stock and may reduce gain from the sale of the stock. See §1.1502–32 (investment adjustment provisions). Under the consistency rules, the purchasing corporation generally takes a carryover basis in the asset, unless a section 338 election is made for target. Similar rules apply if the purchasing corporation acquires an asset directly from a lower-tier target affiliate if gain from the sale is reflected under the investment adjustment provisions in the basis of target stock.

(3) *Extensions of the general rules.* If an arrangement exists, paragraph (f) of this section generally extends the carryover basis rule to certain cases in which the purchasing corporation acquires assets indirectly from target (or a lower-tier target affiliate). To prevent avoidance of the consistency rules, paragraph (j) of this section also may extend the consistency period or the 12-month acquisition period and may disregard the presence of conduits.

(4) *Application where certain dividends are paid.* Paragraph (g) of this section extends the carryover basis rule to certain cases in which dividends are paid to a corporation that is not a member of the same consolidated group as the distributing corporation. Generally, this rule applies where a 100 percent dividends received deduction is used in conjunction with asset dispositions to achieve an effect similar to that available under the investment adjustment provisions of the consolidated return regulations.

(5) *Application to foreign target affiliates.* Paragraph (h) of this section extends the carryover basis rule to certain cases involving target affiliates that are controlled foreign corporations.

(6) *Stock consistency*. This section limits the application of the stock consistency rules to cases in which the rules are necessary to prevent avoidance of the asset consistency rules. Following the general treatment of a section 338(h)(10) election, a sale of a corporation's stock is treated as a sale of the corporation's assets if a section 338(h)(10) election is made. Because gain from this asset sale may be reflected in the basis of the stock of a higher-tier target, the carryover basis rule may apply to the assets.

(b) *Consistency for direct acquisitions*—(1) *General rule.* The basis rules of paragraph (d) of this section apply to an asset if—

(i) The asset is disposed of during the target consistency period;

(ii) The basis of target stock, as of the target acquisition date, reflects gain from the disposition of the asset (see paragraph (c) of this section); and

(iii) The asset is owned, immediately after its acquisition and on the target acquisition date, by a corporation that acquires stock of target in the qualified stock purchase (or by an affiliate of an acquiring corporation).

(2) *Section 338(h)(10) elections.* For purposes of this section, if a section 338(h)(10) election is made for a corporation acquired in a qualified stock purchase—

(i) The acquisition is treated as an acquisition of the corporation's assets (see §1.338(h)(10)–1); and

(ii) The corporation is not treated as target.

(c) *Gain from disposition reflected in basis of target stock*. For purposes of this section:

(1) *General rule.* Gain from the disposition of an asset is reflected in the basis of a corporation's stock if the gain is taken into account under § 1.1502–32, directly or indirectly, in determining the basis of the stock, after applying section 1503(e) and other provisions of the Internal Revenue Code.

(2) *Gain not reflected if section 338 election made for target.* Gain from the disposition of an asset that is otherwise reflected in the basis of target stock as of the target acquisition date is not considered reflected in the basis of target stock if a section 338 election is made for target.

(3) *Gain reflected by reason of distributions.* Gain from the disposition of an asset is not considered reflected in the basis of target stock merely by reason of the receipt of a distribution from a target affiliate that is not a member of the same consolidated group as the distributee. See paragraph (g) of this section for the treatment of dividends eligible for a 100 percent dividends received deduction.

(4) *Controlled foreign corporations.* For a limitation applicable to gain of a target affiliate that is a controlled foreign corporation, see paragraph (h)(2) of this section.

(5) *Gain recognized outside the consolidated group.* Gain from the disposition of an asset by a person other than target or a target affiliate is not reflected in the basis of a corporation's stock unless the person is a conduit, as defined in paragraph (j)(4) of this section.

(d) *Basis of acquired assets*—(1) *Carryover basis rule.* If this paragraph (d) applies to an asset, the asset's basis immediately after its acquisition is, for all purposes of the Internal Revenue Code, its adjusted basis immediately before its disposition.

(2) *Exceptions to carryover basis rule for certain assets.* The carryover basis rule of paragraph (d)(1) of this section does not apply to the following assets—

(i) Any asset disposed of in the ordinary course of a trade or business (see section 338(e)(2)(A));

(ii) Any asset the basis of which is determined wholly by reference to the adjusted basis of the asset in the hands of the person that disposed of the asset (see section 338(e)(2)(B));

(iii) Any debt or equity instrument issued by target or a target affiliate (*see* paragraph (h)(3) of this section for an exception relating to the stock of a target affiliate that is a controlled foreign corporation);

(iv) Any asset the basis of which immediately after its acquisition would otherwise be less than its adjusted basis immediately before its disposition; and

(v) Any asset identified by the Internal Revenue Service in a revenue ruling or revenue procedure.

(3) *Exception to carryover basis rule for de minimis assets.* The carryover basis rules of this section do not apply to an asset if the asset is not disposed of as part of the same arrangement as the acquisition of target and the aggregate amount realized for all assets otherwise subject to the carryover basis rules of this section does not exceed $250,000.

(4) *Mitigation rule*—(i) *General rule.* If the carryover basis rules of this section apply to an asset and the asset is transferred to a domestic corporation in a transaction to which section 351 applies or as a contribution to capital and no gain is recognized, the transferor's basis in the stock of the transferee (but not the transferee's basis in the asset) is determined without taking into account the carryover basis rules of this section.

(ii) *Time for transfer.* This paragraph (d)(4) applies only if the asset is transferred before the due date (including extensions) for the transferor's income tax return for the year that includes the last date for which a section 338 election may be made for target.

(e) *Examples*—(1) *In general.* For purposes of the examples in this section, unless otherwise stated, the basis of each asset is the same for determining earnings and profits and taxable income, the exceptions to paragraph (d)(1) of this section do not apply, the taxable year of all persons is the calendar year, and the following facts apply: S is the common parent of a consolidated group that includes T, T1, T2, and T3; S owns all of the stock of T and T3; and T owns all of the stock of T1, which owns all of the stock of T2. B is unrelated to the S group and owns all of the stock of P, which owns all of the stock of P1. Y and Y1 are partnerships that are unrelated to the S group but may be related to the P group. Z is a corporation that is not related to any of the other parties.

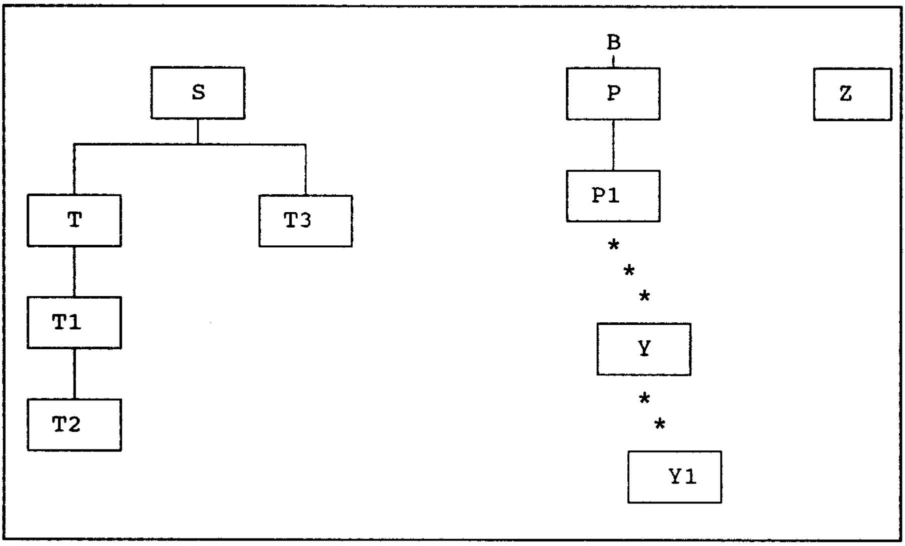

(2) *Direct acquisitions.* Paragraphs (b), (c), and (d) of this section may be illustrated by the following examples:

Example 1. Asset acquired from target by purchasing corporation. (a) On February 1 of Year 1, T sells an asset to P1 and recognizes gain. T's gain from the disposition of the asset is taken into account under §1.1502–32 in determining S's basis in the T stock. On January 1 of Year 2, P1 makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) T disposed of the asset during its consistency period, gain from the asset disposition is reflected in the basis of the T stock as of T's acquisition date (January 1 of Year 2), and the asset is owned both immediately after the asset disposition (February 1 of Year 1) and on T's acquisition date by P1, the corporation that acquired T stock in the qualified stock purchase. Consequently, under paragraph (b) of this section, paragraph (d)(1) of this section applies to the asset and P1's basis in the asset is T's adjusted basis in the asset immediately before the sale to P1.

Example 2. Gain from section 338(h)(10) election reflected in stock basis. (a) On February 1 of Year 1, P1 makes a qualified stock purchase of T2 from T1. A section 338(h)(10) election is made for T2 and T2 recognizes gain on each of its assets. T2's gain is taken into account under §1.1502–32 in determining S's basis in the T stock. On January 1 of Year 2, P1 makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) Under paragraph (b)(2) of this section, the acquisition of the T2 stock is treated as an acquisition of T2's assets on February 1 of Year 1, because a section 338(h)(10) election is made for T2. The gain recognized by T2 under section 338(h)(10) is reflected in S's basis in the T stock as of T's acquisition date. Because the other requirements of paragraph (b) of this section are satisfied, paragraph (d)(1) of this section applies to the assets and new T2's basis in its assets is old T2's adjusted basis in the assets immediately before the disposition.

Example 3. Corporation owning asset ceases affiliation with corporation purchasing target before target acquisition date. (a) On February 1 of Year 1, T sells an asset to P1 and recognizes gain. On December 1 of Year 1, P disposes of all of the P1 stock while P1 still owns the asset. On January 1 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) Immediately after T's disposition of the asset, the asset is owned by P1 which is affiliated on that date with P, the corporation that acquired T stock in the qualified stock purchase. However, the asset is owned by a corporation (P1) that is no longer affiliated with P on T's acquisition date. Although the other requirements of paragraph (b) of this section are satisfied, the requirements of paragraph (b)(1)(iii) of this section are not satisfied. Consequently, the basis rules of paragraph (d) of this section do not apply to the asset by reason of P1's acquisition.

(c) If P acquires all of the Z stock and P1 transfers the asset to Z on or before T's acquisition date (January 1 of Year 2), the asset is owned by an affiliate of P both on February 1 of Year 1 (P1) and on January 1 of Year 2 (Z). Consequently, all of the requirements of paragraph (b) of this section are satisfied and paragraph (d)(1) of this section applies to the asset and P1's basis in the asset is T's adjusted basis in the asset immediately before the sale to P1.

Example 4. Gain reflected in stock basis notwithstanding offsetting loss or distribution. (a) On April 1 of Year 1, T sells an asset to P1 and recognizes gain. In Year 1, T distributes an amount equal to the gain. On March 1 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) Although, as a result of the distribution, there is no adjustment with respect to the T stock under § 1.1502–32 for Year 1, T's gain from the disposition of the asset is considered reflected in S's basis in the T stock. The gain is considered to have been taken into account under § 1.1502–32 in determining the adjustments to S's basis in the T stock because S's basis in the T stock is different from what it would have been had there been no gain.

(c) If T distributes an amount equal to the gain on February 1 of Year 2, rather than in Year 1, the results would be the same because S's basis in the T stock is different from what it would have been had there been no gain. If the distribution in Year 2 is by reason of an election under § 1.1502–32(f)(2), the results would be the same.

(d) If, in Year 1, T does not make a distribution and the S group does not file a consolidated return, but, in Year 2, the S group does file a consolidated return and makes an election under § 1.1502–32(f)(2) for T, the results would be the same. S's basis in the T stock is different from what it would have been had there been no gain. Paragraph (c)(3) of this section (gain not considered reflected by reason of distributions) does not apply to the deemed distribution under the election because S and T are members of the same consolidated group. If T distributes an amount equal to the gain in Year 2 and no election is made under § 1.1502–32(f)(2), the results would be the same.

(e) If, in Year 1, T incurs an unrelated loss in an amount equal to the gain, rather than distributing an amount equal to the gain, the results would be the same because the gain is taken into account under § 1.1502–32 in determining S's basis in the T stock.

Example 5. Gain of a target affiliate reflected in stock basis after corporate reorganization. (a) On February 1 of Year 1, T3 sells an asset to P1 and recognizes gain. On March 1 of Year 1, S contributes the T3 stock to T in a transaction qualifying under section 351. On January 15 of Year 2, P1 makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) T3's gain from the asset sale is taken into account under § 1.1502–32 in determining S's basis in the T3 stock. Under section 358, the gain that is taken into account under § 1.1502–32 in determining S's basis in the T3 stock is also taken into account in determining S's basis in the T stock following S's contribution of the T3 stock to T. Consequently, under paragraph (b) of this section, paragraph (d)(1) of this section applies to the asset and P1's basis in the asset is T3's adjusted basis in the asset immediately before the sale to P1.

(c) If on March 1 of Year 1, rather than S contributing the T3 stock to T, S causes T3 to merge into T in a transaction qualifying under section 368(a)(1)(D), the results would be the same.

Example 6. Gain not reflected if election under section 338 made. (a) On February 1 of Year 1, T1 sells an asset to P1 and recognizes gain. On January 1 of Year 2, P1 makes a qualified stock purchase of T1 from T. A section 338 election (but not a section 338(h)(10) election) is made for T1.

(b) Under paragraph (c)(2) of this section, because a section 338 election is made for T1, T's basis in the T1 stock is considered not to reflect gain from the disposition. Consequently, the requirement of paragraph (b)(1)(ii) of this section is not satisfied. Thus, P1's basis in the asset is not determined under paragraph (d) of this section. Although the section 338 election for T1 results in a qualified stock purchase of T2, the requirement of paragraph (b)(1)(ii) of this section is not satisfied with respect to T2, whether or not a section 338 election is made for T2.

(c) If, on January 1 of Year 2, P1 makes a qualified stock purchase of T from S and a section 338 election for T, rather than T1, S's basis in the T stock is considered not to reflect gain from T1's disposition of the asset. However, the section 338 election for T results in a qualified stock purchase of T1. Because the gain is reflected in T's basis in the T1 stock, the requirements of paragraph (b) of this section are satisfied. Consequently, P1's basis in the asset is determined under paragraph (d)(1) of this section unless a section 338 election is also made for T1.

(f) *Extension of consistency to indirect acquisitions*—(1) *Introduction*. If an arrangement exists (see paragraph (j)(5) of this section), this paragraph (f) generally extends the consistency rules to indirect acquisitions that have the same effect as direct acquisitions. For example, this paragraph (f) applies if, pursuant to an arrangement, target sells an asset to an unrelated person who then sells the asset to the purchasing corporation.

(2) *General rule.* This paragraph (f) applies to an asset if, pursuant to an arrangement—

(i) The asset is disposed of during the target consistency period;

(ii) The basis of target stock as of, or at any time before, the target acquisition date reflects gain from the disposition of the asset; and

(iii) The asset ownership requirements of paragraph (b)(1)(iii) of this section are not satisfied, but the asset is owned, at any time during the portion of the target consistency period following the target acquisition date, by—

(A) A corporation—

(*1*) The basis of whose stock, as of, or at any time before, the target acquisition date, reflects gain from the disposition of the asset; and

(*2*) That is affiliated, at any time during the target consistency period, with a corporation that acquires stock of target in the qualified stock purchase; or

(B) A corporation that at the time it owns the asset is affiliated with a corporation described in paragraph (f)(2)(iii)(A) of this section.

(3) *Basis of acquired assets.* If this paragraph (f) applies to an asset, the principles of the basis rules of paragraph (d) of this section apply to the asset as of the date, following the disposition with respect to which gain is reflected in the basis of target's stock, that the asset is first owned by a corporation described in paragraph (f)(2)(iii) of this section. If the principles of the carryover basis rule of paragraph (d)(1) of this section apply to an asset, the asset's basis also is reduced (but not below zero) by the amount of any reduction in its basis occurring after the disposition with respect to which gain is reflected in the basis of target's stock.

(4) *Examples.* This paragraph (f) may be illustrated by the following examples:

Example 1. Acquisition of asset from unrelated party by purchasing corporation. (a) On February 1 of Year 1, T sells an asset to Z and recognizes gain. On February 15 of Year 1, P1 makes a qualified stock purchase of T from S. No section 338 election is made for T. P1 buys the asset from Z on March 1 of Year 1, before Z has reduced the basis of the asset through depreciation or otherwise.

(b) Paragraph (b) of this section does not apply to the asset because the asset ownership requirements of paragraph (b)(1)(iii) of this section are not satisfied. However, the asset ownership requirements of paragraph (f)(2)(iii) of this section are satisfied because, during the portion of T's consistency period following T's acquisition date, the asset is owned by P1 while it is affiliated with T. Consequently, paragraph (f) of this section applies to the asset if there is an arrangement for T to dispose of the asset during T's consistency period, for the gain to be reflected in S's basis in the T stock as of T's acquisition date, and for P1 to own the asset during the portion of T's consistency period following T's acquisition date. If the arrangement exists, under paragraph (f)(3) of this section, P1's basis in the asset is determined as of March 1 of Year 1, under the principles of paragraph (d) of this section. Consequently, P1's basis in the asset is T's adjusted basis in the asset immediately before the sale to Z.

(c) If P1 acquires the asset from Z on January 15 of Year 2 (rather than on March 1 of Year 1), and Z's basis in the asset has been reduced through depreciation at the time of the acquisition, P1's basis in the asset as of January 15 of Year 2 would be T's adjusted basis in the asset immediately before the sale to Z, reduced (but not below zero) by the amount of the depreciation. Z's basis and depreciation are determined without taking into account the basis rules of paragraph (d) of this section.

(d) If P, rather than P1, acquires the asset from Z, the results would be the same.

(e) If, on March 1 of Year 1, P1 acquires the Z stock, rather than acquiring the asset from Z, paragraph (f) of this section would apply to the asset if an arrangement exists. However, under paragraph (f)(3) of this section, Z's basis in the asset would be determined as of February 1 of Year 1, the date the asset is first owned by a corporation (Z) described in paragraph (f)(2)(iii) of this section. Consequently, Z's basis in the asset as of February 1 of Year 1, determined under the principles of paragraph (d) of this section, would be T's adjusted basis in the asset immediately before the sale to Z.

Example 2. Acquisition of asset from target by target affiliate. (a) On February 1 of Year 1, T contributes an asset to T1 in a transaction qualifying under section 351 and in which T recognizes gain under section 351(b) that is deferred under § 1.1502–13. On March 1 of Year 1, P1 makes a qualified stock purchase of T from S and, pursuant to § 1.1502–13, the deferred gain is taken into account by T immediately before T ceases to be a member of the S group. No section 338 election is made for T.

(b) Paragraph (b) of this section does not apply to the asset because the asset ownership requirements of paragraph (b)(1)(iii) of this section are not satisfied.

(c) T1 is not described in paragraph (f)(2)(iii)(A) of this section because the basis of the T1 stock does not reflect gain from the disposition of the asset. Although, under section 358(a)(1)(B)(ii), T's basis in the T1 stock is increased by the amount of the gain, the gain is not taken into account directly or indirectly under § 1.1502–32 in determining T's basis in the T1 stock.

(d) T1 is described in paragraph (f)(2)(iii)(B) of this section because, during the portion of T's consistency period following T's acquisition date, T1 owns the asset while it is affiliated with T, a corporation described in paragraph (f)(2)(iii)(A) of this section. Consequently, paragraph (f) of this section applies to the asset if there is an arrangement. Under paragraph (j)(5) of this section, the fact that, at the time T1 acquires the asset from T, T1 is related (within the meaning of section 267(b)) to T indicates that an arrangement exists.

Example 3. Acquisition of asset from target and indirect acquisition of target stock. (a) On February 1 of Year 1, T sells an asset to P1 and recognizes gain. On March 1 of Year 1, Z makes a qualified stock purchase of T from S. No section 338 election is made for T. On January 1 of Year 2, P1 acquires the T stock from Z other than in a qualified stock purchase.

(b) The asset ownership requirements of paragraph (b)(1)(iii) of this section are not satisfied because the asset was never owned by Z, the corporation that acquired T stock in the qualified stock purchase (or by a corporation that was affiliated with Z at the time it owned the asset). However, because the asset is owned by P1 while it is affiliated with T during the portion of T's consistency period following T's acquisition date, paragraph (f) of this section applies to the asset if there is an arrangement. If there is an arrangement, the principles of the carryover basis rule of paragraph (d)(1) of this section apply to determine P1's basis in the asset unless Z makes a section 338 election for T. See paragraph (c)(2) of this section.

(c) If P1 also makes a qualified stock purchase of T from Z, the results would be the same. If there is an arrangement, the principles of the carryover basis rule of paragraph (d)(1) of this section apply to determine P1's basis in the asset unless Z makes a section 338 election for T. However, these principles apply to determine P1's basis in the asset if P1, but not Z, makes a section 338 election for T. The basis of the T stock no longer reflects, as of T's acquisition date by P1, the gain from the disposition of the asset.

(d) Assume Z purchases the T stock other than in a qualified stock purchase and P1 makes a qualified stock purchase of T from Z. Paragraph (b) of this section does not apply to the asset because gain from the disposition of the asset is not reflected in the basis of T's stock as of T's acquisition date (January 1 of Year 2). However, because the gain is reflected in S's basis in the T stock before T's acquisition date and the asset is owned by P1 while it is affiliated with T during the portion of T's consistency period following T's acquisition date, paragraph (f) of this section applies to the asset if there is an arrangement. If there is an arrangement, the principles of the carryover basis rule of paragraph (d)(1) of this section apply to determine P1's basis in the asset even if P1 makes a section 338 election for T. The basis of the T stock no longer reflects, as of T's acquisition date, the gain from the disposition of the asset.

Example 4. Asset acquired from target affiliate by corporation that becomes its affiliate.(a) On February 1 of Year 1, T1 sells an asset to P1 and recognizes gain. On February 15 of Year 1, Z makes a qualified stock purchase of T from S. No section 338 election is made for T. On June 1 of Year 1, P1 acquires the T1 stock from T, other than in a qualified stock purchase.

(b) The asset ownership requirements of paragraph (b)(1)(iii) of this section are not satisfied because the asset was never owned by Z, the corporation that acquired T stock in the qualified stock purchase (or by a corporation that was affiliated with Z at the time it owned the asset).

(c) P1 is not described in paragraph (f)(2)(iii)(A) of this section because gain from the disposition of the asset is not reflected in the basis of the P1 stock.

(d) P1 is described in paragraph (f)(2)(iii)(B) of this section because the asset is owned by P1 while P1 is affiliated with T1 during the portion of T's consistency period following T's acquisition date. T1 becomes affiliated with Z, the corporation that acquired T stock in the qualified stock purchase, during T's consistency period, and, as of T's acquisition date, the basis of T1's stock reflects gain from the disposition of the asset. Consequently, paragraph (f) of this section applies to the asset if there is an arrangement.

Example 5. De minimis rules.(a) On February 1 of Year 1, T sells an asset to P and recognizes gain. On February 15 of Year 1, T1 sells an asset to Z and recognizes gain. The aggregate amount realized by T and T1 on their respective sales of assets is not more than $250,000. On March 1 of Year 1, T3 sells an asset to P and recognizes gain. On April 1 of Year 1, P makes a qualified stock purchase of T from S. No section 338 election is made for T. On June 1 of Year 1, P1 buys from Z the asset sold by T1.

(b) Under paragraph (b) of this section, the basis rules of paragraph (d) of this section apply to the asset sold by T. Under paragraph (f) of this section, the principles of the basis rules of paragraph (d) of this section apply to the asset sold by T1 if there is an arrangement. Because T3's gain is not reflected in the basis of the T stock, the basis rules of this section do not apply to the asset sold by T3.

(c) The de minimis rule of paragraph (d)(3) of this section applies to an asset if the asset is not disposed of as part of the same arrangement as the acquisition of T and the aggregate amount realized for all assets otherwise subject to the carryover basis rules does not exceed $250,000. The aggregate amount realized by T and T1 does not exceed $250,000. (The asset sold by T3 is not taken into account for purposes of the de minimis rule.) Thus, the de minimis rule applies to the asset sold by T if the asset is not disposed of as part of the same arrangement as the acquisition of T.

(d) If, under paragraph (f) of this section, the principles of the carryover basis rules of paragraph (d)(1) of this section otherwise apply to the asset sold by T1 because of an arrangement, the de minimis rules of this section do not apply to the asset because of the arrangement.

(e) Assume on June 1 of Year 1, Z acquires the T1 stock from T, other than in a qualified stock purchase, rather than P1 buying the T1 asset, and paragraph (f) of this section applies because there is an arrangement. Because the asset was disposed of and the T1 stock was acquired as part of the arrangement, the de minimis rules of this section do not apply to the asset.

(g) *Extension of consistency if dividends qualifying for 100 percent dividends received deduction are paid*—(1) *General rule for direct acquisitions from target.* Unless a section 338 election is made for target, the basis rules of paragraph (d) of this section apply to an asset if—

(i) Target recognizes gain (whether or not deferred) on disposition of the asset during the portion of the target consistency period that ends on the target acquisition date;

(ii) The asset is owned, immediately after the asset disposition and on the target acquisition date, by a corporation that acquires stock of target in the qualified stock purchase (or by an affiliate of an acquiring corporation); and

(iii) During the portion of the target consistency period that ends on the target acquisition date, the aggregate amount of dividends paid by target, to which section 243(a)(3) applies, exceeds the greater of—

(A) $250,000; or

(B) 125 percent of the yearly average amount of dividends paid by target, to which section 243(a)(3) applies, during the three calendar years immediately preceding the year in which the target consistency period begins (or, if shorter, the period target was in existence).

(2) *Other direct acquisitions having same effect.* The basis rules of paragraph (d) of this section also apply to an asset if the effect of a transaction described in paragraph (g)(1) of this section is achieved through any combination of disposition of assets and payment of dividends to which section 243(a)(3) applies (or any other dividends eligible for a 100 percent dividends received deduction). See paragraph (h)(4) of this section for additional rules relating to target affiliates that are controlled foreign corporations.

(3) *Indirect acquisitions.* The principles of paragraph (f) of this section also apply for purposes of this paragraph (g).

(4) *Examples.* This paragraph (g) may be illustrated by the following examples:

Example 1. Asset acquired from target paying dividends to which section 243(a)(3) applies.(a) The S group does not file a consolidated return. In Year 1, Year 2, and Year 3, T pays dividends to S to which section 243(a)(3) applies of $200,000, $250,000, and $300,000, respectively. On February 1 of Year 4, T sells an asset to P and recognizes gain. On January 1 of Year 5, P makes a qualified stock purchase of T from S. No section 338 election is made for T. During the portion of T's consistency period that ends on T's acquisition date, T pays S dividends to which section 243(a)(3) applies of $1,000,000.

(b) Under paragraph (g)(1) of this section, paragraph (d) of this section applies to the asset. T recognizes gain on disposition of the asset during the portion of T's consistency period that ends on T's acquisition date, the asset is owned by P immediately after the disposition and on T's acquisition date, and T pays dividends described in paragraph (g)(1)(iii) of this section. Consequently, under paragraph (d)(1) of this section, P's basis in the asset is T's adjusted basis in the asset immediately before the sale to P.

(c) If T is a controlled foreign corporation, the results would be the same if T pays dividends in the amount described in paragraph (g)(1)(iii) of this section that qualify for a 100 percent dividends received deduction. See sections 243(e) and 245.

(d) If S and T3 file a consolidated return in which T, T1, and T2 do not join, the results would be the same because the dividends paid by T are still described in paragraph (g)(1)(iii) of this section.

(e) If T, T1, and T2 file a consolidated return in which S and T3 do not join, the results would be the same because the dividends paid by T are still described in paragraph (g)(1)(iii) of this section.

Example 2. Asset disposition by target affiliate achieving same effect.(a) The S group does not file a consolidated return. On February 1 of Year 1, T2 sells an asset to P and recognizes gain. T pays dividends to S described in paragraph (g)(1)(iii) of this section. On January 1 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) Paragraph (g)(1) of this section does not apply to the asset because T did not recognize gain on the disposition of the asset. However, under paragraph (g)(2) of this section, because the asset disposition by T2 and the dividends paid by T achieve the effect of a transaction described in paragraph (g)(1) of this section, the carryover basis rule of paragraph (d)(1) of this section applies to the asset. The effect was achieved because T2 is a lower-tier affiliate of T and the dividends paid by T to S reduce the value to S of T and its lower-tier affiliates.

(c) If T2 is a controlled foreign corporation, the results would be the same because T2 is a lower-tier affiliate of T and the dividends paid by T to S reduce the value to S of T and its lower-tier affiliates.

(d) If P buys an asset from T3, rather than T2, the asset disposition and the dividends do not achieve the effect of a transaction described in paragraph (g)(1) of this section because T3 is not a lower-tier affiliate of T. Thus, the basis rules of paragraph (d) of this section do not apply to the asset. The results would be the same whether or not P also acquires the T3 stock (whether or not in a qualified stock purchase).

Example 3. Dividends by target affiliate achieving same effect.(a) The S group does not file a consolidated return. On February 1 of Year 1, T1 sells an asset to P and recognizes gain. On January 1 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T. T does not pay dividends to S described in paragraph (g)(1)(iii) of this section. However, T1 pays dividends to T that would be described in paragraph (g)(1)(iii) of this section if T1 were a target.

(b) Paragraph (g)(1) of this section does not apply to the asset because T did not recognize gain on the disposition of the asset and did not pay dividends described in paragraph (g)(1)(iii) of this section. Further, paragraph (g)(2) of this section does not apply because the dividends paid by T1 to T do not reduce the value to S of T and its lower-tier affiliates.

(c) If both S and T own T1 stock and T1 pays dividends to S that would be described in paragraph (g)(1)(iii) of this section if T1 were a target, paragraph (g)(2) of this section would apply because the dividends paid by T1 to S reduce the value to S of T and its lower-tier affiliates. If T, rather than T1, sold the asset to P, the results would be the same. Further, if T and T1 pay dividends to S that, only when aggregated, would be described in paragraph (g)(1)(iii) of this section (if they were all paid by T), the results would be the same.

Example 4. Gain reflected by reason of dividends.(a) S and T file a consolidated return in which T1 and T2 do not join. On February 1 of Year 1, T1 sells an asset to P and recognizes gain. On January 1 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T. T1 pays dividends to T that would be described in paragraph (g)(1)(iii) of this section if T1 were a target.

(b) The requirements of paragraph (b) of this section are not satisfied because, under paragraph (c)(3) of this section, gain from T1's sale is not reflected in S's basis in the T stock by reason of the dividends paid by T1 to T.

(c) Although the dividends paid by T1 to T do not reduce the value to S of T and its lower-tier affiliates, paragraph (g)(2) of this section applies because the dividends paid by T1 to T are taken into account under § 1.1502–32 in determining S's basis in the T stock. Consequently, the carryover basis rule of paragraph (d)(1) of this section applies to the asset.

(h) *Consistency for target affiliates that are controlled foreign corporations*—(1) *In general.* This paragraph (h) applies only if target is a domestic corporation. For additional rules that may apply with respect to controlled foreign corporations, see paragraph (g) of this section. The definitions and nomenclature of § 1.338–1 (b) and (c) and paragraph (e) of this section apply for purposes of this section.

(2) *Income or gain resulting from asset dispositions*—(i) *General rule.* Income or gain of a target affiliate that is a controlled foreign corporation from the disposition of an asset is not reflected

in the basis of target stock under paragraph (c) of this section unless the income or gain results in an inclusion under section 951(a)(1)(A), 951(a)(1)(C), 1291 or 1293.

(ii) *Basis of controlled foreign corporation stock.* If, by reason of paragraph (h)(2)(i) of this section, the carryover basis rules of this section apply to an asset, no increase in basis in the stock of a controlled foreign corporation under section 961(a) or 1293(d)(1), or under regulations issued pursuant to section 1297(b)(5), is allowed to target or a target affiliate to the extent the increase is attributable to income or gain described in paragraph (h)(2)(i) of this section. A similar rule applies to the basis of any property by reason of which the stock of the controlled foreign corporation is considered owned under section 958(a)(2) or 1297(a).

(iii) *Operating rule.* For purposes of this paragraph (h)(2)—

(A) If there is an income inclusion under section 951 (a)(1)(A) or (C), the shareholder's income inclusion is first attributed to the income or gain of the controlled foreign corporation from the disposition of the asset to the extent of the shareholder's pro rata share of such income or gain; and

(B) Any income or gain under section 1293 is first attributed to the income or gain from the disposition of the asset to the extent of the shareholder's pro rata share of the income or gain.

(iv) *Increase in asset or stock basis*—(A) If the carryover basis rules under paragraph (h)(2)(i) of this section apply to an asset, and the purchasing corporation disposes of the asset to an unrelated party in a taxable transaction and recognizes and includes in its U.S. gross income or the U.S. gross income of its shareholders the greater of the income or gain from the disposition of the asset by the selling controlled foreign corporation that was reflected in the basis of the target stock under paragraph (c) of this section, or the gain recognized on the asset by the purchasing corporation on the disposition of the asset, then the purchasing corporation or the target or a target affiliate, as appropriate, shall increase the basis of the selling controlled foreign corporation stock subject to paragraph (h)(2)(ii) of this section, as of the date of the disposition of the asset by the purchasing corporation, by the amount of the basis increase that was denied under paragraph (h)(2)(ii) of this section. The preceding sentence shall apply only to the extent that the controlled foreign corporation stock is owned (within the meaning of section 958(a)) by a member of the purchasing corporation's affiliated group.

(B) If the carryover basis rules under paragraph (h)(2)(i) of this section apply to an asset, and the purchasing corporation or the target or a target affiliate, as appropriate, disposes of the stock of the selling controlled foreign corporation to an unrelated party in a taxable transaction and recognizes and includes in its U.S. gross income or the U.S. gross income of its shareholders the greater of the gain equal to the basis increase that was denied under paragraph (h)(2)(ii) of this section, or the gain recognized in the stock by the purchasing corporation or by the target or a target affiliate, as appropriate, on the disposition of the stock, then the purchasing corporation shall increase the basis of the asset, as of the date of the disposition of the stock of the selling controlled foreign corporation by the purchasing corporation or by the target or a target affiliate, as appropriate, by the amount of the basis increase that was denied pursuant to paragraph (h)(2)(i) of this section. The preceding sentence shall apply only to the extent that the asset is owned (within the meaning of section 958(a)) by a member of the purchasing corporation's affiliated group.

(3) *Stock issued by target affiliate that is a controlled foreign corporation.* The exception to the carryover basis rules of this section provided in paragraph (d)(2)(iii) of this section does not apply to stock issued by a target affiliate that is a controlled foreign corporation. After applying the carryover basis rules of this section to the stock, the basis in the stock is increased by the amount treated as a dividend under section 1248 on the disposition of the stock (or that would have been so treated but for section 1291), except to the extent the basis increase is attributable to the disposition of an asset in which a carryover basis is taken under this section.

(4) *Certain distributions*—(i) *General rule.* In the case of a target affiliate that is a controlled foreign corporation, paragraph (g) of this section applies with respect to the target affiliate by treating any reference to a dividend to which section 243(a)(3) applies as a reference to any amount taken into account under § 1.1502–32 in determining the basis of target stock that is—

(A) A dividend;

(B) An amount treated as a dividend under section 1248 (or that would have been so treated but for section 1291); or

(C) An amount included in income under section 951(a)(1)(B).

(ii) *Basis of controlled foreign corporation stock.* If the carryover basis rules of this section apply to an asset, the basis in the stock of the controlled foreign corporation (or any property by reason of which the stock is considered owned under section 958(a)(2)) is reduced (but not below zero) by the sum of any amounts that are treated, solely by reason of the disposition of the asset, as a dividend, amount treated as a dividend under section 1248 (or that would have been so treated but for section 1291), or amount included in income under section 951(a)(1)(B). For this purpose, any dividend, amount treated as a dividend under section 1248 (or that would have been so treated but for section 1291), or amount included in income under section 951(a)(1)(B) is considered attributable first to earnings and profits resulting from the disposition of the asset.

(iii) *Increase in asset or stock basis*—(A) If the carryover basis rules under paragraphs (g) and (h)(4)(i) of this section apply to an asset, and the purchasing corporation disposes of the asset to an unrelated party in a taxable transaction and recognizes and includes in its U.S. gross income or the U.S. gross income of its shareholders the greater of the gain equal to the basis increase denied in the asset pursuant to paragraphs (g) and (h)(4)(i) of this section, or the gain recognized on the asset by the purchasing corporation on the disposition of the asset, then the purchasing corporation or the target or a target affiliate, as appropriate, shall increase the basis of the selling controlled foreign corporation stock subject to paragraph (h)(4)(ii) of this section, as of the date of the disposition of the asset by the purchasing corporation, by the amount of the basis reduction under paragraph (h)(4)(ii) of this section. The preceding sentence shall apply only to the extent that the controlled foreign corporation stock is owned (within the meaning of section 958(a)) by a member of the purchasing corporation's affiliated group.

(B) If the carryover basis rules under paragraphs (g) and (h)(4)(i) of this section apply to an asset, and the purchasing corporation or the target or a target affiliate, as appropriate, disposes of the stock of the selling controlled foreign corporation to an unrelated party in a taxable transaction and recognizes and includes in its U.S. gross income or the U.S. gross income of its shareholders the greater of the amount of the basis reduction under paragraph (h)(4)(ii) of this section, or the gain recognized in the stock by the purchasing corporation or by the target or a target affiliate, as appropriate, on the disposition of the stock, then the purchasing corporation shall increase the basis of the asset, as of the date of the disposition of the stock of the selling controlled foreign corporation by the purchasing corporation or by the target or a target affiliate, as appropriate, by the amount of the basis increase that was denied pursuant to paragraphs (g) and (h)(4)(i) of this section. The preceding sentence shall apply only to the extent that the asset is owned (within the meaning of section 958(a)) by a member of the purchasing corporation's affiliated group.

(5) *Examples.* This paragraph (h) may be illustrated by the following examples:

Example 1. Stock of target affiliate that is a CFC.(a) The S group files a consolidated return; however, T2 is a controlled foreign corporation. On December 1 of Year 1, T1 sells the T2 stock to P and recognizes gain. On January 2 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) Under paragraph (b)(1) of this section, paragraph (d) of this section applies to the T2 stock. Under paragraph (h)(3) of this section, paragraph (d)(2)(iii) of this section does not apply to the T2 stock. Consequently, paragraph (d)(1) of this section applies to the T2 stock. However, after applying paragraph (d)(1) of this section, P's basis in the T2 stock is increased by the amount of T1's gain on the sale of the T2 stock that is treated as a dividend under section 1248. Because P has a carryover basis in the T2 stock, the T2 stock is not considered purchased within the meaning of section 338(h)(3) and no section 338 election may be made for T2.

Example 2. Stock of target affiliate CFC; inclusion under subpart F.(a) The S group files a consolidated return; however, T2 is a controlled foreign corporation. On December 1 of Year 1, T2 sells an asset to P and recognizes subpart F income that results in an inclusion in T1's gross income under section 951(a)(1)(A). On January 2 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) Because gain from the disposition of the asset results in an inclusion under section 951(a)(1)(A), the gain is reflected in the basis of the T stock as of T's acquisition date. See paragraph (h)(2)(i) of this section. Consequently, under paragraph (b)(1) of this section, paragraph (d)(1) of this section applies to the asset. In addition, under paragraph (h)(2)(ii) of this section, T1's basis in the T2 stock is not increased under section 961(a) by the amount of the inclusion that is attributable to the sale of the asset.

(c) If, in addition to making a qualified stock purchase of T, P acquires the T2 stock from T1 on January 1 of Year 2, the results are the same for the asset sold by T2. In addition, under paragraph (h)(2)(ii) of this section, T1's basis in the T2 stock is not increased by the amount of the inclusion that is attributable to the gain on the sale of the asset. Further, under paragraph (h)(3) of this section, paragraph (d)(1) of this section applies to the T2 stock. However, after applying paragraph (d)(1) of this section, P's basis in the T2 stock is increased by the amount of T1's gain on the sale of the T2 stock that is treated as a dividend under section 1248. Finally, because P has a carryover basis in the T2 stock, the T2 stock is not considered purchased within the meaning of section 338(h)(3) and no section 338 election may be made for T2.

(d) If P makes a qualified stock purchase of T2 from T1, rather than of T from S, and T1's gain on the sale of T2 is treated as a dividend under section 1248, under paragraph (h)(1) of this section, paragraphs (h)(2) and (3) of this section do not apply because there is no target that is a domestic corporation. Consequently, the carryover basis rules of paragraph do not apply to the asset sold by T2 or the T2 stock.

Example 3. Gain reflected by reason of section 1248 dividend; gain from non-subpart F asset.(a) The S group files a consolidated return; however, T2 is a controlled foreign corporation. In Years 1 through 4, T2 does not pay any dividends to T1 and no amount is included in T1's income under section 951(a)(1)(B). On December 1 of Year 4, T2 sells an asset with a basis of $400,000 to P for $900,000. T2's gain of $500,000 is not subpart F income. On December 15 of Year 4, T1 sells T2, in which it has a basis of $600,000, to P for $1,600,000. Under section 1248, $800,000 of T1's gain of $1,000,000 is treated as a dividend. However, in the absence of the sale of the asset by T2 to P, only $300,000 would have been treated as a dividend under section 1248. On December 30 of Year 4, P makes a qualified stock purchase of T1 from T. No section 338 election is made for T1.

(b) Under paragraph (h)(4) of this section, paragraph (g)(2) of this section applies by reference to the amount treated as a dividend under section 1248 on the disposition of the T2 stock. Because the amount treated as a dividend is taken into account in determining T's basis in the T1 stock under §1.1502–32, the sale of the T2 stock and the deemed dividend have the effect of a transaction described in paragraph (g)(1) of this section. Consequently, paragraph (d)(1) of this section applies to the asset sold by T2 to P and P's basis in the asset is $400,000 as of December 1 of Year 4.

(c) Under paragraph (h)(3) of this section, paragraph (d)(1) of this section applies to the T2 stock and P's basis in the T2 stock is $600,000 as of December 15 of Year 4. Under paragraphs (h)(3) and (4)(ii) of this section, however, P's basis in the T2 stock is increased by $300,000 (the amount of T1's gain treated as a dividend under section 1248 ($800,000), other than the amount treated as a dividend solely as a result of the sale of the asset by T2 to P ($500,000)) to $900,000.

(i) [Reserved]

(j) *Anti-avoidance rules.* For purposes of this section—

(1) *Extension of consistency period.* The target consistency period is extended to include any continuous period that ends on, or begins on, any day of the consistency period during which a purchasing corporation, or any person related, within the meaning of section 267(b) or 707(b)(1), to a purchasing corporation, has an arrangement—

(i) To purchase stock of target; or

(ii) To own an asset to which the carryover basis rules of this section apply, taking into account the extension.

(2) *Qualified stock purchase and 12-month acquisition period.* The 12-month acquisition period is extended if, pursuant to an arrangement, a corporation acquires by purchase stock of another corporation satisfying the requirements of section 1504(a)(2) over a period of more than 12 months.

(3) *Acquisitions by conduits*—(i) *Asset ownership*—(A) *General rule.* A corporation is treated as owning any portion of an asset attributed to the corporation from a conduit under section 318(a) (treating any asset as stock for this purpose), for purposes of—

(*1*) The asset ownership requirements of this section; and

(*2*) Determining whether a controlled foreign corporation is a target affiliate for purposes of paragraph (h) of this section.

(B) *Application of carryover basis rule.* If the basis rules of this section apply to the asset, the basis rules of this section apply to the entire asset (not just the portion for which ownership is attributed).

(ii) *Stock acquisitions*—(A) *Purchase by conduit.* A corporation is treated as purchasing stock of another corporation attributed to the corporation from a conduit under section 318(a) on the day the stock is purchased by the conduit. The corporation is not treated as purchasing the stock, however, if the conduit purchased the stock more than two years before the date the stock is first attributed to the corporation.

(B) *Purchase of conduit by corporation.* If a corporation purchases an interest in a conduit (treating the interest as stock for this purpose), the corporation is treated as purchasing on that date any stock owned by a conduit on that date and attributed to the corporation under section 318(a) with respect to the interest in the conduit that was purchased.

(C) *Purchase of conduit by conduit.* If a conduit (the *first* conduit) purchases an interest in a second conduit (treating the interest as stock for this purpose), the first conduit is treated as purchasing on that date any stock owned by a conduit on that date and attributed to the first conduit under section 318(a) with respect to the interest in the second conduit that was purchased.

(4) *Conduit.* A person (other than a corporation) is a conduit as to a corporation if—

(i) The corporation would be treated under section 318(a)(2)(A) and (B) (attribution from partnerships, estates, and trusts) as owning any stock owned by the person; and

(ii) The corporation, together with its affiliates, would be treated as owning an aggregate of at least 50 percent of the stock owned by the person.

(5) *Existence of arrangement.* The existence of an arrangement is determined under all the facts and circumstances. For an arrangement to exist, there need not be an enforceable, written, or unconditional agreement, and all the parties to the transaction need not have participated in each step of the transaction. One factor indicating the existence of an arrangement is the participation of a related party. For this purpose, persons are related if they are related within the meaning of section 267(b) or 707(b)(1).

(6) *Predecessor and successor*—(i) *Persons.* A reference to a person (including target, target affiliate, and purchasing corporation) includes, as the context may require, a reference to a predecessor or successor. For this purpose, a predecessor is a transferor or distributor of assets to a person (the successor) in a transaction—

(A) To which section 381(a) applies; or

(B) In which the successor's basis for the assets is determined, directly or indirectly, in whole or in part, by reference to the basis of the transferor or distributor.

(ii) *Assets.* A reference to an asset (the first asset) includes, as the context may require, a reference to any asset the basis of which is determined, directly or indirectly, in whole or in part, by reference to the first asset.

(7) *Examples.* This paragraph (j) may be illustrated by the following examples:

Example 1. Asset owned by conduit treated as owned by purchaser of target stock.(a) P owns a 60-percent interest in Y. On March 1 of Year 1, T sells an asset to Y and recognizes gain. On January 1 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) Under paragraph (j)(4) of this section, Y is a conduit with respect to P. Consequently, under paragraph (j)(3)(i)(A) of this section, P is treated as owning 60% of the asset on March 1 of Year 1 and January 1 of Year 2. Because P is treated as owning part or all of the asset both immediately after the asset disposition and on T's acquisition date, paragraph (b) of this section applies to the asset. Consequently, paragraph (d)(1) of this section applies to the asset and Y's basis in the asset is T's adjusted basis in the asset immediately before the sale to Y.

Example 2. Corporation whose stock is owned by conduit treated as affiliate.(a) P owns an 80-percent interest in Y. Y owns all of the stock of Z. On March 1 of Year 1, T sells an asset to Z and recognizes gain. On January 1 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) Under paragraph (j)(4) of this section, Y is a conduit with respect to P. Consequently, under paragraph (j)(3)(i)(A) of this section, P is treated as owning 80% of the Z stock and Z is therefore treated as an affiliate of P for purposes of applying the asset ownership requirements of paragraph (b)(1)(iii) of this section. Because Z, an affiliate of P, owns the asset both immediately after the asset disposition and on T's acquisition date, paragraph (b) of this section applies to the asset, and the asset's basis is determined under paragraph (d) of this section.

(c) If, instead of owning an 80-percent interest in Y, P owned a 79-percent interest in Y, Z would not be treated as an affiliate of P and paragraph (b) of this section would not apply to the asset.

Example 3. Qualified stock purchase by reason of stock purchase by conduit.(a) P owns a 90-percent interest in Y. Y owns a 60-percent interest in Y1. On February 1 of Year 2, T sells an asset to P and recognizes gain. On January 1 of Year 3, P purchases 70% of the T stock from S and Y1 purchases the remaining 30% of the T stock from S.

(b) Under paragraph (j)(3)(ii)(A) of this section, P is treated as purchasing on January 1 of Year 3, the 16.2% of the T stock that is attributed to P from Y and Y1 under section 318(a). Thus, for purposes of this section, P is treated as making a qualified stock purchase of T on January 1 of Year 3, paragraph (b) of this section applies to the asset, and the asset's basis is determined under paragraph (d) of this section. However, because P is not treated as having made a qualified stock purchase of T for purposes of making an election under section 338, no election can be made for T.

(c) If Y1 purchases 20% of the T stock from S on December 1 of Year 1, rather than 30% on January 1 of Year 3, P would be treated as purchasing 10.8% of the T stock on December 1 of Year 1. Thus, if paragraph (j)(2) of this section (relating to extension of the 12-month acquisition period) does not apply, P would not be treated as making a qualified stock purchase of T, because P is not treated as purchasing T stock satisfying the requirements of section 1504(a)(2) within a 12-month period.

Example 4. Successor asset.(a) On February 1 of Year 1, T sells stock of X to P1 and recognizes gain. On December 1 of Year 1, P1 exchanges its X stock for stock in new X in a reorganization qualifying under section 368(a)(1)(F). On January 1 of Year 2, P1 makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) The asset ownership requirements of paragraph (b)(1)(iii) of this section are satisfied because, under paragraph (j)(6)(ii) of this section, P1 is treated as owning the X stock on T's acquisition date. P1 is treated as owning the X stock on that date because P1 owns the new X stock and P1's basis in the new X stock is determined by reference to P1's basis in the X stock. Consequently, under paragraph (d)(1) of this section, P1's basis in the X stock on February 1 of Year 1 is T's adjusted basis in the X stock immediately before the sale to P1.

[T.D. 8515, 59 FR 2972, Jan. 20, 1994, as amended by T.D. 8597, 60 FR 36679, July 18, 1995; T.D. 8710, 62 FR 3459, Jan. 23, 1997]

§1.338–5 International aspects of section 338.

(a) *Scope.* This section provides guidance regarding international aspects of section 338. As provided in §1.338–1(c)(14), a foreign corporation, a DISC, or a corporation for which a section 936 election has been made is considered a target affiliate for all purposes of section 338. In addition, stock described in section 338(h)(6)(B)(ii) held by a target affiliate is not excluded from the operation of section 338.

(b) *Application of section 338 to foreign targets*—(1) *In general.* For purposes of subtitle A, the deemed sale gain, as defined in §1.338–3(b)(4), of a foreign target for which a section 338 election is made (FT), and the corresponding earnings and profits, are taken into account in determining the taxation of FT and FT's direct and indirect shareholders. See, however, section 338(h)(16). For example, the income and earnings and profits of FT are determined, for purposes of sections 551, 951, 1248, and 1293, by taking into account the deemed sale gain.

(2) *Ownership of FT stock on the acquisition date.* A person who transfers FT stock to the purchasing corporation on FT's acquisition date is considered to own the transferred stock at the close of FT's acquisition date. See, e.g., §1.951–1(f) (relating to determination of holding period for purposes of sections 951 through 964). If on the acquisition date the purchasing corporation owns a block of FT stock that was acquired before FT's acquisition date, the purchasing corporation is considered to

own such block of stock at the close of the acquisition date.

(3) *Carryover FT stock*—(i) *Definition.* FT stock is carryover FT stock if—

(A) FT was a controlled foreign corporation within the meaning of section 957 (taking into account section 953(c)) at any time during the portion of the 12-month acquisition period that ends on the acquisition date; and

(B) Such stock is owned as of the beginning of the day after FT's acquisition date by a person other than a purchasing corporation, or by a purchasing corporation if the stock is nonrecently purchased and is not subject to a gain recognition election under § 1.338(b)–1(e)(2).

(ii) *Carryover of earnings and profits.* The earnings and profits of old FT (and associated foreign taxes) attributable to the carryover FT stock (adjusted to reflect deemed sale gain) carry over to new FT solely for purposes of—

(A) Characterizing an actual distribution with respect to a share of carryover FT stock as a dividend;

(B) Characterizing gain on a post-acquisition date transfer of a share of carryover FT stock as a dividend under section 1248 (if such section is otherwise applicable);

(C) Characterizing an investment of earnings in United States property as income under sections 951(a)(1)(B) and 956 (if such sections are otherwise applicable); and

(D) Determining foreign taxes deemed paid under sections 902 and 960 with respect to the amount treated as a dividend or income by virtue of this paragraph (b)(3)(ii) (subject to the operation of section 338(h)(16)).

(iii) *Cap on carryover of earnings and profits.* The amount of earnings and profits of old FT taken into account with respect to a share of carryover FT stock is limited to the amount that would have been included in gross income of the owner of such stock as a dividend under section 1248 if—

(A) The shareholder transferred that share to the purchasing corporation on FT's acquisition date for a consideration equal to the fair market value of that share on that date; or

(B) In the case of nonrecently purchased FT stock treated as carryover FT stock, a gain recognition election under section 338(b)(3)(A) applied to that share. For purposes of the preceding sentence, a shareholder that is a controlled foreign corporation is considered to be a United States person, and the principle of section 1248(c)(2)(D)(ii) (concerning a United States person's indirect ownership of stock in a foreign corporation) applies in determining the correct holding period.

(iv) *Post-acquisition date distribution of old FT earnings and profits.* A post-acquisition date distribution with respect to a share of carryover FT stock is considered to be derived first from earnings and profits derived after FT's acquisition date and then from earnings and profits derived on or before FT's acquisition date.

(v) *Old FT earnings and profits unaffected by post-acquisition date deficits.* The carryover amount for a share of carryover FT stock is not reduced by deficits in earnings and profits incurred by new FT. This rule applies for purposes of determining the amount of foreign taxes deemed paid regardless of the fact that there are no accumulated earnings and profits. For example, a distribution by new FT with respect to a share of carryover FT stock is treated as a dividend by the distributee to the extent of the carryover amount for that share notwithstanding that new FT has no earnings and profits.

(vi) *Character of FT stock as carryover FT stock eliminated upon disposition.* A share of FT stock is not considered carryover FT stock after it is disposed of provided that all gain realized on the transfer is recognized at the time of the transfer, or that, if less than all of the realized gain is recognized, the recognized amount equals or exceeds the remaining carryover amount for that share.

(4) *Passive foreign investment company stock.* Stock that is owned as of the beginning of the day after FT's acquisition date by a person other than a purchasing corporation, or by a purchasing corporation if the FT stock is nonrecently purchased stock not subject to a gain recognition election under § 1.338(b)–1(e)(2), is treated as passive foreign investment company stock to the extent provided in section 1297(b)(1).

(c) *Dividend treatment under section 1248(e).* The principles of this paragraph (b) apply to shareholders of a domestic corporation subject to section 1248(e).

(d) *Allocation of foreign taxes.* If a section 338 election is made for target (whether foreign or domestic), and target's taxable year under foreign law (if any) does not close at the end of the acquisition date, foreign income taxes attributable to the foreign taxable income earned by target during such foreign taxable year are allocated to old target and new target. Such allocation is made under the principles of § 1.1502–76(b).

(e) *Operation of section 338(h)(16).* [Reserved]

(f) *Examples.* (1) Except as otherwise provided, all corporations use the calendar year as the taxable year, have no earnings and profits (or deficit) accumulated for any taxable year, and have only one class of outstanding stock.

(2) This section may be illustrated by the following examples:

Example 1. Gain recognition election for carryover FT stock.(a) A has owned 90 of the 100 shares of CFCT stock since CFCT was organized on March 13, 1989. P has owned the remaining 10 shares of CFCT stock since CFCT was organized. Those 10 shares constitute nonrecently purchased stock in P's hands within the meaning of section 338(b)(6)(B). On November 1, 1994, P purchases A's 90 shares of CFCT stock for $90,000 and makes a section 338 election for CFCT. P also makes a gain recognition election under section 338(b)(3)(A) and § 1.338(b)–1(e)(2).

(b) CFCT's earnings and profits for its short taxable year ending on November 1, 1994, are $50,000, determined without taking into account the deemed asset sale. Assume A recognizes gain of $81,000 on the sale of the CFCT stock. Further, assume that CFCT recognizes gain of $40,000 by reason of its deemed sale of assets under section 338(a)(1).

(c) A's sale of CFCT stock to P is a transfer to which section 1248 and paragraphs (b)(1) and (2) of this section apply. For purposes of applying section 1248(a) to A, the earnings and profits of CFCT for its short taxable year ending on November 1, 1994, are $90,000 (the earnings and profits for that taxable year as determined under § 1.1248–2(e) ($50,000) plus earnings from the deemed sale ($40,000)). Thus, A's entire gain is characterized as a dividend under section 1248 (but see section 338(h)(16)).

(d) Assume that P recognizes a gain of $9,000 with respect to the 10 shares of nonrecently purchased CFCT stock by reason of the gain recognition election. Because P is treated as selling the nonrecently purchased stock for all purposes of the Internal Revenue Code, section 1248 applies. Thus, under § 1.1248–2(e), $9,000 of the $90,000 of earnings and profits for 1994 are attributable to the block of 10 shares of CFCT stock deemed sold by P at the close of November 1, 1994 ($90,000 × 10/100). Accordingly, P's entire gain on the deemed sale of 10 shares of CFCT stock is included under section 1248(a) in P's gross income as a dividend (but see section 338(h)(16)).

Example 2. No gain recognition election for carryover FT stock.(a) Assume the same facts as in *Example 1,* except that P does not make a gain recognition election.

(b) The 10 shares of nonrecently purchased CFCT stock held by P is carryover FT stock under paragraph (b)(3) of this section. Accordingly, the earnings and profits (and attributable foreign taxes) of old CFCT carry over to new CFCT solely for purposes of that block of 10 shares. The amount of old CFCT's earnings and profits taken into account with respect to that block in the event, for example, of a distribution by new CFCT with respect to that block is the amount of the section 1248 dividend that P would have recognized with respect to that block had it made a gain recognition election under section 338(b)(3)(A). Under the facts of *Example 1,* P would have recognized a gain of $9,000 with respect to that block, all of which would have been a section 1248 dividend ($90,000 × 10/100). Accordingly, the carryover amount for the block of 10 shares of nonrecently purchased CFCT stock is $9,000.

Example 3. Sale of controlled foreign corporation stock prior to and on the acquisition date.(a) X and Y, both U.S. corporations, have each owned 50% of the CFCT stock since 1986. Among CFCT's assets are assets the sale of which would generate subpart F income. On December 31, 1994, X sells its CFCT stock to P. On June 30, 1995, Y sells its CFCT stock to P. P makes a section 338 election for CFCT. In both 1994 and 1995, CFCT has subpart F income resulting from operations.

(b) For taxable year 1994, X and Y are United States shareholders on the last day of CFCT's taxable year, so pursuant to section 951(a)(1)(A) each must include in income its pro rata share of CFCT's subpart F income for 1994. Because P's holding period in the CFCT stock acquired from X does not begin until January 1, 1995, P is not a United States shareholder on the last day of 1994 for purposes of section 951(a)(1)(A) (see § 1.951–1(f)). X must then determine the extent to which section 1248 recharacterizes its gain on the sale of CFCT stock as a dividend.

(c) For the short taxable year ending June 30, 1995, Y is considered to own the CFCT stock sold to P at the close of CFCT's acquisition date. Because the acquisition date is the last day of CFCT's taxable year, Y and P are United States shareholders on the last day of CFCT's taxable year. Pursuant to section 951(a)(1)(A), each must include its pro rata share of CFCT's subpart F income for the short taxable year ending June 30, 1995. This includes any income generated on the deemed sale of CFCT's assets. Y must then determine the extent to which section 1248 recharacterizes its gain on the sale of the CFCT stock as a dividend, taking into account any increase in CFCT's earnings and profits due to the deemed sale of assets.

*Example 4. Acquisition of control for purposes of section 951 prior to the acquisition date.*FS owns 100% of the FT stock. On July 1, 1994, P buys 60% of the FT stock. On December 31, 1994, P buys the remaining 40% of the FT stock and makes a section 338 election for FT. For tax year 1994, FT has earnings and profits of $1,000 (including earnings resulting from the deemed sale). The section 338 election results in $500 of subpart F income. As a result of the section 338 election, P must include in gross income the following amount under section 951(a)(1)(A) (see § 1.951–(b)(2)):

FT's subpart F income for 1994	$500.00
Less: reduction under section 951(a)(2)(A) for period (1–1–94 through 7–1–94) during which FT is not a controlled foreign corporation ($500×182/365)	249.32
Subpart F income as limited by section 951 (a)(2)(A)	250.68
P's pro rata share of subpart F income as determined under section 951(a)(2)(A) (60%×250.68)	150.41

Example 5. Coordination with section 936.(a) T is a corporation for which a section 936 election has been made. P makes a qualified stock purchase of T and makes a section 338 election for T.

(b) T's deemed sale of assets under section 338 constitutes a sale for purposes of subtitle A of the Internal Revenue Code, including section 936(a)(1)(A)(ii). To the extent that the assets deemed sold are used in the conduct of an active trade or business in a possession for purposes of section 936(a)(1)(A)(i), and assuming all the other conditions of section 936 are satisfied, the income from the deemed sale qualifies for the credit granted by section 936(a). The source of income from the deemed sale is determined as if the assets had actually been sold and is not affected for purposes of section 936 by section 338(h)(16).

(c) Because new T is treated a new corporation for purposes of subtitle A of the Internal Revenue Code, the three year testing period in section 936(a)(2)(A) begins again for new T on the day following T's acquisition date. Thus, if the character or source of old T's gross income disqualified it for the credit under section 936, a fresh start is allowed by a section 338 election.

[T.D. 8515, 59 FR 2978, Jan. 20, 1994]

§ 1.338(b)–1 Adjusted grossed-up basis.

(a) *Scope.* This section provides rules under section 338(b) to determine the adjusted grossed-up basis (AGUB) for target. The AGUB is the amount for which new target is deemed to have purchased all of its assets in the deemed purchase under section 338(a)(2). The AGUB is allocated among target's assets in accordance with § 1.338(b)–2T to determine the price at which the assets are deemed to have been purchased. Subsequent adjustments to AGUB and the allocation of such adjustments to target's assets may be made under § 1.338(b)–3T.

(b) *Adjustment events.* Adjustment events are increases (or decreases) in the consideration paid for recently or nonrecently purchased stock, reductions in target's liabilities included in AGUB as of the beginning of the day after the acquisition date, and old target liabilities that become fixed and determinable.

(c) *AGUB*—(1) *In general.* AGUB is the sum of—

(i) The grossed-up basis in the purchasing corporation's recently purchased target stock;

(ii) The purchasing corporation's basis in nonrecently purchased target stock;

(iii) The liabilities of new target; and

(iv) Other relevant items.

(2) *Time when AGUB determined.* AGUB is initially determined at the beginning of the day after the acquisition date of target. However, adjustment events that occur during new target's first taxable year are taken into account for purposes of determining AGUB and the basis of target's assets as if they had occurred at the beginning of the day after the acquisition date.

(d) *Grossed-up basis of recently purchased stock*—(1) *General rule.* The purchasing corporation's grossed-up basis of recently purchased target stock is the product of—

(i) The purchasing corporation's basis in recently purchased target stock (as defined in section 338(b)(6)(A)) at the beginning of the day after the acquisition date; multiplied by

(ii) A fraction the numerator of which is 100 percent minus the percentage of target stock (by value) attributable to the purchasing corporation's nonrecently purchased target stock and the denominator of which is the percentage of target stock (by value) attributable to the purchasing corporation's recently purchased target stock. See section 338(b)(4).

(2) *Application.* If target has a single class of outstanding stock, the grossed-up basis in the purchasing corporation's recently purchased target stock reflects the total price the purchasing corporation would have paid for all outstanding target stock (other than the purchasing corporation's nonrecently purchased target stock, as defined in section 338(b)(6)(B)) had the purchasing corporation purchased all such stock (other than the nonrecently purchased target stock) for a price per share equal to the average price per share that the purchasing corporation paid for the recently purchased target stock.

(e) *Basis of nonrecently purchased stock*—(1) *In general.* In the absence of an election under section 338(b)(3) (gain recognition election), the purchasing corporation retains its basis in the nonrecently purchased stock. A gain recognition election applies to nonrecently purchased stock of target (or a target affiliate) only if a section 338 election is made for target (or the target affiliate).

(2) *Effect of gain recognition election*—(i) *In general.* If the purchasing corporation makes a gain recognition election, for all purposes of the Internal Revenue Code—

(A) The purchasing corporation is treated as if it sold on the acquisition date the nonrecently purchased target stock for the basis amount determined under paragraph (e)(2)(ii) of this section; and

(B) The purchasing corporation's basis on the acquisition date in nonrecently purchased target stock is the basis amount.

(ii) *Basis amount.* The basis amount is equal to the purchasing corporation's grossed-up basis in recently purchased target stock multiplied by a fraction the numerator of which is the percentage of target stock (by value) attributable to the purchasing corporation's nonrecently purchased target stock and the denominator of which is 100 percent minus the numerator amount. Thus, if target has a single class of outstanding stock, the purchasing corporation's basis in each share of nonrecently purchased target stock after the gain recognition election is equal to the average price per share of the purchasing corporation's recently purchased target stock.

(iii) *Losses not recognized.* Only gains (unreduced by losses) on the nonrecently purchased target stock are recognized.

(iv) *Stock subject to election.* The gain recognition election applies to—

(A) All nonrecently purchased target stock; and

(B) Any nonrecently purchased stock in a target affiliate having the same acquisition date as target if such target affiliate stock is held by the purchasing corporation on such date.

(3) *Procedure for making gain recognition election*—(i) *In general.* The gain recognition election is made by attaching a gain recognition statement to a timely filed Form 8023 for target. The gain recognition statement must contain the information specified in the form and its instructions. The gain recognition election is irrevocable.

(ii) *Section 338(h)(10) election.* If a section 338(h)(10) election is made for target, the purchasing corporation is deemed to have made a gain recognition election.

(4) *Comparison with ADSP formula.* Whenever the purchasing corporation holds nonrecently purchased target stock at a basis that differs from the purchasing corporation's basis in recently purchased target stock, the grossed-up basis in the purchasing corporation's recently purchased target stock as calculated for purposes of the AGUB differs from the grossed-up basis of the purchasing corporation's recently purchased target stock as calculated in the ADSP formula. The ADSP formula treats the purchasing corporation's nonrecently purchased target stock in the same manner as

target stock not held by the purchasing corporation. If a gain recognition election is made, the sum of the grossed-up basis in the purchasing corporation's recently purchased target stock and the purchasing corporation's basis in nonrecently purchased target stock equals the grossed-up basis of the purchasing corporation's recently purchased target stock as calculated in the ADSP formula.

(f) *Liabilities of new target*—(1) *In general.* The liabilities of new target are its liabilities (and the liabilities to which target's assets are subject) as of the beginning of the day after the acquisition date (other than liabilities that were neither liabilities of old target nor liabilities to which old target's assets were subject). The amount of the liabilities of new target taken into account to determine AGUB is determined as if new target had acquired old target's assets from an unrelated person and, as part of the transaction, had assumed or taken property subject to the liabilities.

(2) *Excluded obligations*—(i) *In general.* In order to be included in AGUB at the beginning of the day after the acquisition date, an obligation must be a bona fide liability of target as of that date which is properly includible in basis under principles of tax law that would apply if new target had acquired old target's assets from an unrelated person and, as part of the transaction, had assumed or taken property subject to the obligation. For example, if, as of the beginning of the day after the acquisition date, the amount of a contingent or speculative obligation of target is not properly includible in basis under the preceding sentence, the obligation is not initially included in AGUB.

(ii) *Time when excluded obligations taken into account.* Obligations that, under this paragraph (f)(2), are initially excluded from AGUB are taken into account in redetermining AGUB and the basis of target's assets under principles of tax law that would apply if new target had acquired old target's assets directly from an unrelated person and, as part of the transaction, had assumed or taken property subject to those obligations. For the application of these principles of tax law to certain contingent liabilities that are initially excluded from AGUB under this paragraph (f)(2), see § 1.338(b)–3T.

(3) *Liabilities taken into account in determining amount realized on subsequent disposition.* In determining the amount realized on a subsequent sale or other disposition of property deemed purchased by new target, the entire amount of any liability included in AGUB is considered to be an amount taken into account in determining new target's basis in property which secures the liability for purposes of applying § 1.1001–2(a). Thus, if a liability is included in AGUB, § 1.1001–2(a)(3) does not prevent the amount of such liability from being treated as discharged within the meaning of § 1.1001–2(a)(4) as a result of new target's sale or disposition of the property which secures such liability.

(g) *Other relevant items*—(1) *In general.* AGUB may be increased (or decreased) for *other relevant items.* For this purpose, other relevant items may only arise from adjustment events that occur after the close of new target's first taxable year and adjustments under paragraph (g)(3) of this section. See § 1.338(b)–3T (relating to the treatment of certain subsequent adjustments to AGUB). Unlike in the determination of ADSP or MADSP, other relevant items do not include reductions for acquisition costs incurred by the purchasing corporation in connection with the qualified stock purchase that are capitalized in the basis of recently purchased target stock.

(2) *Flow-through of relevant item adjustment to target subsidiary.* If the amount of AGUB of target (T) allocated to the stock of a target affiliate (T1) is subsequently increased (or decreased) by reason of an other relevant item under this paragraph (g), the grossed-up basis of the T1 stock (and, if a section 338 election is made for T1, T1's AGUB) is also increased (or decreased) as if the increase (or decrease) in the basis of the stock was an adjustment to the purchase price deemed paid by T for such stock. The resulting increase (or decrease) in AGUB of T1 is allocated among T1's assets in accordance with §§ 1.338(b)–2T and 1.338(b)–3T.

(3) *Adjustments by the Internal Revenue Service.* In connection with the examination of a return, the District Director may increase (or decrease) AGUB for items other than those described in paragraphs (g)(1) and (2) of this section under the authority of section 338(b)(2) and allocate such amounts to target's assets under the authority of section 338(b)(5) so that AGUB and the basis of target's assets properly reflect the cost to the purchasing corporation of its interest in target's assets. Such items may include distributions from target to the purchasing corporation, capital contributions from the purchasing corporation to target during the 12-month acquisition period, or acquisitions of target stock by purchasing corporation after the acquisition date from minority shareholders.

(h) *Examples.* (1) For purposes of the examples in this paragraph (h), T has no liabilities other than a tax liability resulting from the deemed sale of assets.

(2) This section may be illustrated by the following examples:

Example 1. (a) Before July 1 of Year 1, P purchases 10 of the 100 shares of T stock for $5,000. On July 1 of Year 2, P purchases 80 shares of T stock for $60,000 and makes a section 338 election for T. As of July 1 of Year 2, T's only asset is raw land with an adjusted basis to T of $50,400 and a fair market value of $100,000. T has no loss or tax credit carryovers to Year 2. T's marginal tax rate for any ordinary income or net capital gain resulting from the deemed sale of assets is 34%. The 10 shares purchased before July 1 of Year 1 constitute nonrecently purchased T stock with respect to P's qualified stock purchase of T stock on July 1 of Year 2.

(b) The ADSP formula as applied to these facts is the same as in *Example 2* of §1.338–3(d)(9). Accordingly, the ADSP of T is $87,672.72. The existence of nonrecently purchased T stock is irrelevant for purposes of the ADSP formula, because that formula treats P's nonrecently purchased T stock in the same manner as T stock not held by P.

(c) The total tax liability resulting from T's deemed sale of assets, as calculated under the ADSP formula, is $12,672.72.

(d) If P does not make a gain recognition election, the AGUB of new T's assets is $85,172.72, determined as follows. (In the formula below, GRP is the grossed-up basis in P's recently purchased T stock, BNP is P's basis in nonrecently purchased T stock, L is T's liabilities, and X is other relevant items.)

AGUB=GRP+BNP+L+X
AGUB=$60,000×[(1−.1)/.8]+$5,000+$12,672.72+0
AGUB=$85,172.72

(e) If P makes a gain recognition election, the AGUB of new T's assets is $87,672.72, determined as follows:

AGUB=$60,000×[(1−.1)/.8]+$60,000×[(1−.1)/.8]×[.1/(1−.1)]+$12,672.72
AGUB=$87,672.72

(f) The calculation of AGUB if P makes a gain recognition election may be simplified as follows:

AGUB=$60,000/.8+$12,672.72
AGUB=$87,672.72

(g) As a result of the gain recognition election, P's basis in its nonrecently purchased T stock is increased from $5,000 to $7,500 (i.e., $60,000×[(1−.1)/.8]×[.1/(1−.1)]). Thus, P recognizes a gain in Year 2 with respect to its nonrecently purchased T stock of $2,500 (*i.e.*, $7,500−$5,000).

Example 2. On January 1 of Year 1, P purchases one-third of the T stock. On March 1 of Year 1, T distributes a dividend to all of its shareholders. On April 15 of Year 1, P purchases the remaining T stock and makes a section 338 election for T. In appropriate circumstances, the District Director may decrease the AGUB of T to take into account the payment of the dividend and properly reflect the fair market value of T's assets deemed purchased.

Example 3. (a) T's sole asset is a building worth $100,000. On August 1 of Year 1, P purchases 10 of the 100 shares of T stock for $8,000. On June 1 of Year 2, P purchases 50 shares of T stock for $50,000. On June 15 of Year 2, P contributes a tract of land to the capital of T and receives 10 additional shares of T stock as a result of the contribution. Both the basis and fair market value of the land at that time are $10,800. On June 30 of Year 2, P purchases the remaining 40 shares of T stock for $40,000 and makes a section 338 election for T. The AGUB of T is $108,800.

(b) To prevent the shifting of basis from the contributed property to other assets of T, the District Director may allocate $10,800 of the AGUB to the land, leaving $98,000 to be allocated to the building.

[T.D. 8515, 59 FR 2979, Jan. 20, 1994]

§1.338(b)–2T Allocation of adjusted grossed-up basis among target assets (temporary).

(a) *Introduction*—(1) *In general.* This section prescribes rules under section 338(b)(5) for allocating adjusted grossed-up basis among the assets of a target for which a section 338 election is made.

(2) *Fair market value.* The *fair market value* of an asset is the gross fair market value of that asset (*i.e.*, fair market value determined without regard to mortgages, liens, pledges, or other liabilities).

(b) *General rule for allocating adjusted grossed-up basis*—(1) *Cash and other items designated by the Internal Revenue Service.* Adjusted grossed-up basis is first reduced by the amount of Class I assets. Class I assets are cash, demand deposits and similar accounts in banks, savings and loan associations (and other similar depository institutions), and other items designated in the Internal Revenue Bulletin by the Internal Revenue Service.

(2) *Other assets*—(i) *In general.* Subject to the limitations and other special rules of paragraph (c) of this section, adjusted grossed-up basis (as reduced by Class I assets) is allocated among Class II assets of target held at the beginning of the day after the acquisition date in proportion to their fair market values at such time, then among Class III assets so held in such proportion, then among Class IV assets so held in such proportion, and finally to Class V assets.

(ii) *Class II assets.* Class II assets are certificates of deposit, U.S. Government securities, readily marketable stock or securities (within the meaning of §1.351–1(c)(3)), foreign currency, and other items designated in the Internal Revenue Bulletin by the Internal Revenue Service.

(iii) *Class III assets.* Class III assets are all assets of target other than Class I, II, IV, and V assets.

(iv) *Class IV assets.* Class IV assets are all section 197 intangibles, as defined in section 197, except those in the nature of goodwill and going concern value.

(v) *Class V assets.* Class V assets are section 197 intangibles in the nature of goodwill and going concern value.

(c) *Certain limitations and special rules for basis allocable to an asset*—(1) *Basis not to exceed fair market value.* The amount of adjusted grossed-up basis allocated to an asset (other than Class V assets) shall not exceed the fair market value of that asset at the beginning of the day after the acquisition date. For modification of this fair market value limitation with respect to certain contingent income assets, see § 1.338(b)–3T(g).

(2) *Assets subject to other limitations.* The amount of adjusted grossed-up basis allocated to an asset shall be subject to the limitations under the provisions of the Internal Revenue Code or principles of tax law in the same manner as if such asset were acquired from an unrelated person in a sale or exchange. For example, if the deemed sale (and purchase) of assets is a transaction described in section 1056(a) (relating to basis limitation for player contracts transferred in connection with the sale of a franchise), the amount of adjusted grossed-up basis allocated to a contract for the services of an athlete shall not exceed the limitation imposed by that section. For another example, see § 1.338(b)–1(f)(2), relating to excluded obligations.

(3) *Special rule for allocating adjusted grossed-up basis when purchasing corporation has nonrecently purchased stock*—(i) *Scope.* This paragraph (c)(3) applies if at the beginning of the day after the acquisition date (A) the purchasing corporation holds nonrecently purchased stock for which a gain recognition election under section 338(b)(3) and § 1.338(b)–1(e)(2) is not made and (B) the hypothetical purchase price determined under paragraph (c)(3)(ii) of this section exceeds the adjusted grossed-up basis determined under § 1.338(b)–1(c)(1). The determinations required under the preceding sentence shall be made without regard to adjustment events occurring after the close of new target's first taxable year.

(ii) *Determination of hypothetical purchase price.* Hypothetical purchase price is the sum of the grossed-up basis of recently purchased stock as determined under § 1.338–3(d)(2) and liabilities of target.

(iii) *Allocation of adjusted grossed-up basis.* Subject to the limitations in paragraphs (c)(1) and (2) of this section, adjusted grossed-up basis (after reduction by the amount of Class I assets) is allocated among Class II, III, IV, and V assets of target held at the beginning of the day after the acquisition date in proportion to their fair market values at such time. For this purpose, the fair market value of Class V assets is deemed to be the excess, if any, of the hypothetical purchase price over the sum of the amount of the Class I assets and the fair market values of the Class II, III, and IV assets.

(4) *Effective dates.* This section applies for acquisition dates on or after February 14, 1997. For acquisition dates before February 14, 1997, if section 197 does not apply to any asset deemed acquired, the provisions of the regulations in effect before February 14, 1997, apply (see §1.338(b)–2T as contained in 26 CFR part 1 revised April 1, 1996). For acquisition dates before February 14, 1997, if section 197 applies to any asset deemed acquired, the taxpayer (and all related parties) may consistently (in all transactions in which AGUB, ADSP, MADSP, or consideration must be allocated under section 338 or 1060)—

(i) Apply the provisions of this section;

(ii) Apply the provisions of this section as in effect before February 14, 1997 (see §1.338(b)–2T as contained in 26 CFR part 1 revised April 1, 1996); or

(iii) Apply the provisions of this section as in effect before February 14, 1997 (see §1.338(b)–2T as contained in 26 CFR part 1 revised April 1, 1996), but treat all amortizable section 197 intangibles as Class IV assets.

(d) *Examples.* The provisions of this section and §1.338(b)–1 may be illustrated by the following examples:

Example (1). (i) T owns 90% of the outstanding T1 stock. P purchases 100% of the outstanding T stock for $2,000. A section 338 election is made for T and, as a result, T1 is considered acquired in a qualified stock purchase. A section 338 election is made for T1. The grossed-up basis of the T stock is $2,000 (i.e., $2,000 × 1/1).

(ii) Assume that the liabilities of T as of the beginning of the day after the acquisition date (including income tax liabilities arising on the deemed sale of its assets) are as follows:

Liabilities (nonrecourse mortgage plus unsecured liabilities)	$700
Taxes payable	300
Total	1,000

(iii) The adjusted grossed-up basis (“AGUB”) of T is determined as follows:

Grossed-up basis	$2,000
Total liabilities	1,000
AGUB	3,000

(iv) Assume that, at the beginning of the day after the acquisition date, T’s cash and the fair market values of T’s Class II and III assets are as follows:

Asset class	Asset	Fair market value
I	Cash	*$200
II	Portfolio of marketable securities	300
III	Inventory	300
III	Accounts receivable	600
III	Building	800
III	Land	200
III	Investment in Tl	450
	Total	2,850

*Amount.

(v) Under paragraph (b)(2) of this section the amount of AGUB allocable to T’s Class II and III assets is reduced by the amount of cash to $2,800, *i.e.*, $3,000 − $200. $300 of AGUB is then allocated to marketable securities. Since the remaining amount of AGUB is $2,500 (*i.e.*, $3,000 − ($200 + $300)), an amount which exceeds the sum of the fair market values of T’s Class III assets, the amount allocated to each Class III asset is its fair market value:

Inventory	$300
Accounts receivable	600
Building	800
Land	200
Investment in T1	450
Total	2,350

(vi) T has no Class IV assets. The amount allocated to T’s Class V assets (assets in the nature of goodwill and going concern value) is $150, i.e., $2,500–$2,350.

(vii) The grossed-up basis of the T1 stock is $500, *i.e.*, $450×1/.9.

(viii) Assume that the liabilities of T1 as of the beginning of the day after the acquisition date (including income tax liabilities arising on the deemed sale of its assets) are as follows:

General liabilities	$100
Taxes payable	20
Total	120

(ix) The AGUB of T1 is determined as follows:

Grossed-up basis of T1 stock	$500
Liabilities	120
AGUB	620

(x) Assume that at the beginning of the day after the acquisition date, T1’s cash and the fair market values of its Class III and IV assets are as follows:

Asset class	Asset	Fair market value
I	Cash	$50*
III	Equipment	200
IV	Patent	350
	Total	$600

*Amount

(xi) The amount of AGUB allocable to T1's Class III and IV assets is first reduced by the $50 of cash.

(xii) Since the remaining amount of AGUB ($570) is an amount which exceeds the fair market value of T1's only Class III asset, the equipment, the amount allocated to the equipment is its fair market value ($200). After that, the remaining amount of AGUB ($370) exceeds the fair market value of T1's only Class IV asset, the patent. Thus, the amount allocated to the patent is its fair market value ($350).

(xiii) The amount allocated to T1's Class V assets (assets in the nature of goodwill and going concern value) is $20, i.e., $570−$550.

Example (2). (i) Assume that the facts are the same as in *Example (1)* except that P has, for five years, owned 20% of T's stock, which has a basis in P's hands at the beginning of the day after the acquisition date of $100, and P purchases the remaining 80% of T's stock for $1,600. P does not make a gain recognition election under section 338(b)(3).

(ii) Under § 1.338(b)-1(d), the grossed-up basis of recently purchased T stock is $1,600, *i.e.*, $1,600×(1−.2)/.8.

(iii) The AGUB of T is determined as follows:

Grossed-up basis of recently purchased stock	$1,600
Basis of nonrecently purchased stock	100
Liabilities	1,000
AGUB	2,700

(iv) Since P holds nonrecently purchased stock, the hypothetical purchase price of the T stock must be computed and is determined as follows:

Grossed-up basis of recently purchased stock as determined under § 1.338–3(d)(2) ($1,600/.8)	$2,000
Liabilities	1,000
Total	3,000

(v) Since the hypothetical purchase price ($3,000) exceeds the AGUB (and no gain recognition election is made under section 338(b)(3)), AGUB is allocated under paragraph (c)(3) of this section.

(vi) The amount of AGUB ($2,700) available to allocate to T's assets is reduced by the amount of cash to $2,500, i.e., $2,700−$200. This $2,500 balance is then allocated among the Class II, III, IV, and V assets in proportion to, and not in excess of, their fair market values (as determined under § 1.338(b)–2T(c)(3)(iii)).

(vii) Under paragraph (c)(3) of this section, the fair market value of the Class V assets is deemed to be $150, i.e., the $3,000 hypothetical purchase price minus $2,850 (the sum of T's cash, $200, and the fair market value of its Class II, III, and IV assets, $2,650). The allocation is as follows:

Portfolio of marketable securities	*$268
Inventory	268
Accounts receivable	536
Building	714
Land	178
Investment in T1	402
Goodwill and going concern value	134
Total	$2,500

*All numbers rounded for convenience.

(viii) If the AGUB of T is increased (or decreased) as a result of a subsequent adjustment, the hypothetical purchase price and the deemed fair market value of the Class V assets shall be redetermined and the increase (or decrease) in AGUB shall be allocated among T's acquisition date assets pursuant to § 1.338(b)–3T(f). The increase (or decrease) in AGUB is allocated pursuant to § 1.338(b)–3T(f) even if the hypothetical purchase price, as redetermined, no longer exceeds AGUB, as redetermined.

[T.D. 8072, 51 FR 10624, Mar. 28, 1986 as amended by T.D. 8092, 51 FR 23742, July 1, 1986; 51 FR 33033, Sept. 18, 1986; T.D. 8515, 59 FR 2960, Jan. 20, 1994; T.D. 8515, 59 FR 2981, Jan. 20, 1994; T.D. 8515, 59 FR 2984, Jan. 20, 1994; T.D. 8711, 62 FR 2269, Jan. 16, 1997]

§ 1.338(b)–3T Subsequent adjustments to adjusted grossed-up basis (temporary).

(a) *Scope*—(1) *In general.* This section provides rules for redetermining adjusted grossed-up basis to account for adjustment events that occur after the close of new target's first taxable year. These adjustments must be made upon the payment of contingent amounts for recently or nonrecently purchased stock, the change in a contingent liability of old target to one which is fixed and determinable, reductions in the amounts paid for recently or nonrecently purchased stock, and reductions in liabilities of target (and the liabilities to which its assets are subject) that were taken into account in determining adjusted grossed-up basis. Adjusted grossed-up basis is redetermined under this section only if such an adjustment would be required, under general principles of tax law, in connection with an actual asset purchase by new target from an unrelated person. This section also provides rules for the allocation of such adjustments subsequent to the close of new target's first taxable year. For the treatment of adjustments prior to the close of new target's first taxable year, see §§1.338(b)–1 and 1.338(b)–2T.

(2) *Exceptions to applicability of section.* This section does not apply to a reduction in indebtedness that is (1) includible in gross income as discharge of indebtedness income (or would be includible but for section 108(a)), (2) due to a contribution to capital, (3) payment of a liability, or (4) the discharge of a liability within the meaning of §1.1001–2.

(3) *Adjustment of aggregate deemed sale price.* See paragraph (h) of this section for certain rules relating to a change in the aggregate deemed sale price of target's assets.

(b) *Definitions*—(1) *Contingent liability.* A contingent liability is a liability of target at the beginning of the day after the acquisition date that is not fixed and determinable by the close of new target's first taxable year.

(2) *Contingent amount.* The term *contingent amount* means the amount of the consideration to be paid for recently or nonrecently purchased stock that is not fixed or determinable by the close of new target's first taxable year, plus contingent liabilities of target.

(3) *Reduction amount.* The term *reduction amount* means a reduction after the close of new target's first taxable year in either—

(i) The consideration paid for recently or nonrecently purchased stock; or

(ii) A liability of target (or a liability to which one or more of its assets are subject) that has been taken into account in determining AGUB.

(4) *Acquisition date asset.* The term *acquisition date asset* means any asset held by new target at the beginning of the day after the acquisition date (other than Class I assets).

(c) *General rule*—(1) *Time when increases in adjusted gross-up basis taken into account.* A contingent amount that is taken into account for purposes of calculating adjusted grossed-up basis and the bases of assets of target is taken into account at the time at which such amount becomes fixed and determinable.

(2) *Time when decreases in adjusted grossed-up basis taken into account.* A reduction amount is taken into account for purposes of calculating adjusted grossed-up basis and the bases of assets of target when the reduction in the consideration paid or the reduction of the liability occurs.

(3) *Amount of increases and decreases in adjusted grossed-up basis.* The amount of an increase (or decrease) in adjusted grossed-up basis described in paragraph (c)(1) or (2) of this section is the difference between (i) adjusted grossed-up basis immediately before the increase (or decrease) and (ii) adjusted grossed-up basis recomputed by taking into account the increase (or decrease). For example, if an additional amount is paid for recently purchased stock of target, grossed-up basis of recently purchased stock and adjusted grossed-up basis are recomputed by applying the fraction in section 338(b)(4) to the basis of the recently purchased stock at the beginning of the day after the acquisition date, adjusted for additional amounts paid. Any other adjustments required by a change in grossed-up basis would also be taken into account in making the recomputation, such as a change in the basis of nonrecently purchased stock under section 338(b)(3) and, if there has not been a section 338(h)(10) election, any additional income tax liabilities of target resulting from the additional payment.

(d) *Allocation of increases in adjusted grossed-up basis*—(1) *In general.* An increase in adjusted grossed-up basis (as determined under paragraph (c)(3) of this section) is allocated among target's acquisition date assets under §1.338(b)–2T. Amounts allocable to an acquisition date asset (or with respect to a disposed-of acquisition date asset) are subject to the fair market value limitation and other limitations in §1.338(b)–2T(c)(1) and (2). Except as provided in paragraph (g) of this section, for the purpose of applying §1.338(b)–2T(c)(1) and (2), the fair market value is determined at the beginning of the day after the acquisition date. If adjusted grossed-up basis was allocated among target's assets pursuant to § 1.338(b)–2T(c)(3), an increase in adjusted grossed-up basis (as determined under paragraph (c)(3) of this section) is accounted for in accordance with the rules of paragraph (f) of this section.

(2) *Effect of disposition or depreciation of acquisition date assets.* If an acquisition date asset has been disposed of, depreciated, amortized or depleted by new target before a contingent amount is taken into account in redetermining adjusted grossed-up basis, the contingent amount otherwise allocable to such asset is treated under principles of tax law applicable when part of the cost of an asset (not previously reflected in its basis) is paid after the asset has been disposed of, depreciated, amortized or depleted.

(e) *Allocation of decreases in adjusted grossed-up basis*—(1) *In general.* If adjusted grossed-up basis was allocated in accordance with the rules of § 1.338(b)–2T(b)(2), a decrease in adjusted grossed-up basis (as determined under paragraph (c)(3) of this section) is allocated in the following order: first, as a reduction in the bases of target's Class V acquisition date assets, second, as a reduction of the bases of target's Class IV acquisition date assets in proportion to their fair market values at the beginning of the day after the acquisition date, third, as a reduction of the bases of target's Class III acquisition date assets in proportion to their fair market values at the beginning of the day after the acquisition date, and finally, as a reduction of the bases of target's Class II acquisition date assets in proportion to their fair market values at the beginning of the day after the acquisition date. The decrease in adjusted grossed-up basis allocated to an asset shall not exceed the adjusted grossed-up basis of target previously allocated to that asset. If adjusted grossed-up basis was allocated among target's assets pursuant to § 1.338(b)–2T(c)(3), a decrease in adjusted grossed-up basis (as determined under paragraph (c)(3) of this section) is accounted for in accordance with the rules of paragraph (f) of this section.

(2) *Effect of disposition of assets or reduction of basis below zero.* If an acquisition date asset has been disposed of, depreciated, amortized, or depleted by new target before a reduction amount is taken into account in adjusted grossed-up basis, the decrease in adjusted grossed-up basis attributable to such reduction amount otherwise allocable to such asset is treated under principles of tax law applicable when the cost of an asset (previously reflected in its basis) is reduced after the asset has been disposed of or depreciated, amortized, or depleted. For purposes of this subparagraph (2), an asset is considered to have been disposed of to the extent that its allocable portion of the decrease in adjusted grossed-up basis would reduce its basis below zero.

(3) *Section 38 property.* Section 1.47–2(c) applies to a reduction in basis of section 38 property under this section.

(f) *Special rule for allocation of increases (or decreases) in adjusted grossed-up basis when hypothetical purchase price was used in allocating adjusted grossed-up basis*—(1) *Scope.* This paragraph (f) applies if adjusted grossed-up basis was allocated among new target's Class II, III, IV, and V assets in accordance with § 1.338(b)–2T(c)(3) and an adjustment event occurs after the close of the new target's first taxable year.

(2) *Allocation of increases (decreases) in adjusted grossed-up basis.* If an adjustment event after the close of new target's first taxable year increases (or decreases) adjusted grossed-up basis, the following items shall be redetermined, taking into account such adjustment event: the hypothetical purchase price, the deemed fair market value of Class V assets, and the adjusted grossed-up basis allocable to each acquisition date asset under § 1.338(b)–2T(c)(3) (the redetermined (c)(3) amount). (The redetermination of the deemed fair market value of Class V assets under this paragraph (f)(2) is made by taking into account the target's Class I assets and the fair market values of its Class II, III, and IV assets at the beginning of the day after the acquisition date.) If the redetermined (c)(3) amount for an acquisition date asset exceeds the amount of adjusted grossed-up basis previously allocated to such asset (taking into account prior adjustments under this paragraph (f)), an amount of adjusted grossed-up basis equal to such

excess shall be allocated to such asset. If the amount of the adjusted grossed-up basis previously allocated to an acquisition date asset (taking into account prior adjustments under this paragraph (f)) exceeds the redetermined (c)(3) amount for that asset, an amount equal to such excess shall be allocated as a reduction in the basis of such asset. The rules of paragraph (d)(2) of this section (or paragraph (e)(2) of this section) apply for the treatment of amounts allocable under this paragraph (f) to an acquisition date asset that has been disposed of, depreciated, amortized, or depleted.

(3) *Allocation to contingent income assets.* For modification of this rule with respect to certain assets, see paragraph (g) of this section.

(g) *Special rule for allocation of increases (or decreases) in adjusted grossed-up basis to specific assets*—(1) *Patents and similar property*—(i) *Scope.* The rules of this paragraph (g)(1) apply for purposes of allocating an increase (or decrease) in adjusted grossed-up basis to the extent (A) the contingency that results in the increase (or decrease) directly relates to income produced by a particular intangible asset (‘‘contingent income asset’’), such as a patent, a secret process, or a copyright, and (B) the increase (or decrease) is related to such contingent income asset and not to other target assets. Adjusted grossed-up basis, as determined under §1.338(b)–1 at the beginning of the day after the acquisition date, and any increase (or decrease) to adjusted grossed-up basis to which this paragraph (g) does not apply, are allocated among target's acquisition date assets (including contingent income assets) in accordance with the provisions of §1.338(b)–2T and paragraph (d), (e), or (f) of this section.

(ii) *Specific allocation.* Subject to the fair market value limitation and other limitations in §1.338(b)–2T(c)(1) and (2), any increase (or decrease) to adjusted grossed-up basis to which this paragraph (f) applies is allocated (A) first, specifically to the contingent income asset to which the increase (or decrease) relates and, then, (B) in accordance with the provisions of paragraph (d), (e), or (f) of this section. Solely for purposes of applying the fair market value limitation and other limitations of §1.338(b)–2T(c)(1) and (2) to a contingent income asset, the fair market value of such asset at the beginning of the day after the acquisition date shall (may, in the case of qualified stock purchases for which the acquisition date is before September 16, 1988) be redetermined when the contingent amount (or reduction amount) is taken into account under paragraph (c) of this section. (For purposes of this redetermination, only those circumstances that resulted in the increase (or decrease) to adjusted grossed-up basis are taken into account.) However, the fair market value limitation and other limitations of §1.338(b)–2T(c)(1) and (2) as they apply to target's other acquisition date assets are not affected by such adjustments.

(2) *Internal Revenue Service authority.* In connection with the examination of a return, the District Director, in appropriate cases, may apply the principles of paragraph (g)(1) of this section to allocate an increase (or decrease) in adjusted grossed-up basis among particular of target's acquisition date assets to the extent such allocation is necessary to reflect properly the consideration that relates to each of those assets.

(h) *Changes in old target's aggregate deemed sale price of assets*—(1) *General rule*—(i) *In general.* Pursuant to general principles of tax law, the price at which old target is deemed to have sold its assets shall be adjusted to take into account adjustment events occurring after the acquisition date. In making such an adjustment, recognition of income (or loss) under this paragraph (h) with respect to the deemed sale of assets is not precluded because the target is treated as a new corporation after the acquisition date. To the extent general tax law principles require seller to account for adjustment events, target (or a member of the selling consolidated group in the event of an election under section 338(h)(10)) shall make such an accounting, which may result in reporting income, loss, or other amount.

(ii) *Redetermination of aggregate deemed sale price if the elective formula under section 338(h)(11) is used.* If the elective formula under section

338(h)(11) is used to determine the aggregate deemed sale price, that price generally shall be redetermined under § 1.338–3(d) (or § 1.338(h)(10)–1(f) if an election under section 338(h)(10) is in effect) to take into account, to the extent required by general principles of tax law, adjustment events occurring after the acquisition date. For example, the aggregate deemed sale price generally shall be redetermined to take into account any additional payments made to the seller for recently purchased stock. If an increase (or decrease) in adjusted grossed-up basis is specifically allocated to a contingent income asset (or other asset) under paragraph (g) of this section, then any redetermination of the fair market value of the asset under that paragraph (g) is taken into account in making adjustments to the aggregate deemed sale price allocable to such asset.

(iii) *Redetermination of aggregate deemed sale price if the elective formula under section 338(h)(11) is not used.* If the elective formula under section 338(h)(11) is not used to determine the aggregate deemed sale price, an adjustment to aggregate deemed sale price may be required under this paragraph (h) only with respect to assets described in paragraph (g)(1)(i) and (2) of this section. In such a case, the adjustment to the portion of the aggregate deemed sale price allocable to such asset shall be the amount of the increase (or decrease) in adjusted grossed-up basis specifically allocated to the asset. However, the amount of the increase (or decrease) allocated to such asset shall not increase (or decrease) the portion of the aggregate deemed sale price allocable to the asset (taking into account all previous adjustments under this paragraph (h)) above or below the fair market value of such asset as of the date an adjustment under this paragraph (h) is required.

(2) *Procedure for transactions in which section 338(h)(10) is not elected*—(i) *Income or loss included in new target's return.* If an election under section 338(h)(10) is not made, any income, loss, or other amount of old target resulting from a change in the aggregate deemed sale price of old target's assets pursuant to paragraph (h)(1) of this section shall be included in new target's income tax return for new target's taxable year in which such change occurs. The amount of such income, loss, or other amount is determined with reference to old target's deemed sale of assets on the acquisition date. Thus, for example, if after the acquisition date there is an increase in the allocable aggregate deemed sale price of section 1245 property for which the recomputed basis (but not the adjusted basis) exceeded the portion of the aggregate deemed sale price allocable to that particular asset on the acquisition date, the additional gain shall be treated as ordinary income to the extent it does not exceed such excess amount. See paragraph (h)(2)(ii) for the special treatment of old target's carryovers and carrybacks. Although included in new target's income tax return, such income, loss, or other amount is separately accounted for as an item of old target and may not be offset by income, loss, credit, or other amount of new target. The amount of tax on income of old target recognized pursuant to this paragraph (h) is determined as if such income had been recognized in old target's taxable year ending at the close of the acquisition date. Any increase (or decrease) in new target's income tax liability by reason of this paragraph (h)(2)(i) shall be allocated among new target's acquisition date assets in accordance with paragraph (d), (e), (f), or (g) of this section when such liability becomes fixed and determinable.

(ii) *Carryovers and carrybacks*—(A) *Loss carryovers to new target taxable years.* A net operating loss or net capital loss of old target may be carried forward to a taxable year of new target, under the principles of section 172 or 1212, as the case may be, but is allowed as a deduction only to the extent of any recognized income of old target for such taxable year, as described in paragraph (h)(2)(i) of this section. For this purpose, however, taxable years of new target shall not be taken into account in applying the 15-taxable-year limitation (or other similar limitation) in section 172(b)(1) or the 5-taxable-year limitation (or other similar limitation) in section 1212(a)(1)(B). In applying sections 172(b) and 1212(a)(1), only income, deductions, and other amounts of old target shall be taken into account. Thus, if old target has an unexpired net operating loss at the close of its taxable year in which the deemed asset sale occurred that could be carried forward to a subsequent taxable year, such loss may be carried forward until it is absorbed by old target's income.

(B) *Loss carrybacks to taxable years of old target.* An ordinary loss or capital loss accounted for as a separate item of old target under paragraph (h)(2)(i) of this section may be carried back to a taxable year of old target under the principles of section 172 or 1212, as the case may be. For this purpose, taxable years of new target shall not be taken into account in applying the 3-taxable-year limitation (or other similar limitation) in section 172(b) or 1212(a).

(C) *Credit carryovers and carrybacks.* The principles described in paragraph (h)(2)(ii)(A) and (B) of this section apply to carryovers and carrybacks of amounts for purposes of determining the amount of a credit allowable under part IV, subchapter A, chapter 1 of the Code. Thus, for example, credit carryovers of old target may only offset income tax attributable to items described in paragraph (h)(2)(i) of this section.

(3) *Procedure for transactions in which section 338(h)(10) is elected*— If an election under section 338(h)(10) is made, any income, loss, or other amount resulting from a change in the aggregate deemed sale price of old target's assets pursuant to paragraph (h)(1) of this section shall be accounted for in determining the taxable income (or other amount) of the member of the selling consolidated group (or other person) to which such income, loss, or other amount is attributable for the taxable year in which such change occurs. The amount of such income, loss, or other amount is determined with reference to old target's deemed sale of assets on the acquisition date.

(i) [Reserved]

(j) *Examples.* This section is illustrated by the following examples. Any contingent amount or reduction amount described in the following examples is exclusive of interest. For rules characterizing deferred contingent payments as principal or interest, see regulations under section 1274 and 1275 (d) or 483.

Example 1. (i)(A) T's assets other than goodwill and going concern value, and their fair market values at the beginning of the day after the acquisition date, are as follows:

Asset class	Asset	Fair market value
III	Building	$100
III	Stock of X (not a target)	200
	Total	$300

(B) T has no liabilities other than a contingent obligation and T does not use the elective formula under section 338(h)(11).

(ii)(A) On September 1, 1997, P purchases all of the outstanding stock of T for $270 and makes an express election for T. The grossed-up basis of the T stock and T's adjusted grossed-up basis (AGUB) are both $270. The AGUB is ratably allocated among T's Class III assets in proportion to their fair market values as follows:

Asset	Basis
Building ($270×100/300)	$ 90
Stock ($270×200/300)	180
Total	$270

(B) No amount is allocated to the Class V assets. New T is a calendar year taxpayer. Assume that the X stock is a capital asset in the hands of new T.

(iii) On January 1, 1998, new T sells the X stock and uses the proceeds to purchase inventory.

(iv) On June 30, 1999, the contingent liability of old T becomes fixed and determinable. The amount of the liability is $60.

(v) T's AGUB increases by $60 from $270 to $330. This $60 increase in AGUB is first allocated among T's acquisition date assets in accordance with the provisions of §1.338(b)–2T. Since the redetermined AGUB for T ($330) exceeds the sum of the fair market values at the beginning of the day after the acquisition date of the Class III acquisition date assets ($300), AGUB allocated to those assets is limited to those fair market values under §1.338(b)–2T(c)(1). As there are no Class IV assets, the remaining AGUB of $30 is allocated to goodwill and going concern value (Class V assets). The amount of increase in AGUB allocated to each acquisition date asset is determined as follows:

Asset	Original AGUB	Redetermined AGUB	Increase in AGUB
Building	$ 90	$100	$10
X Stock	180	200	20
Goodwill and going concern value	0	30	30
Total	$270	$330	$60

(vi) Since the X stock was disposed of before the contingent liability became fixed and determinable, no amount of the increase in AGUB attributable to such stock may be allocated to any T asset. Rather, such amount, $20, is allowed as a capital loss to T for the taxable year 1999 under the principles of *Arrowsmith v. Commissioner,* 344 U.S. 6 (1952). In addition, the $10 increase in AGUB allocated to the building and the $30 increase in AGUB allocated to the goodwill and going concern value are treated as basis redeterminations in 1999. See paragraph (d)(2) of this section.

Example 2. (i) On January 1, 1998, P purchases all of the outstanding stock of T and makes an express election for T. T does not use the elective formula under section 338(h)(11). Assume that the AGUB of T is $500 and is allocated among T's acquisition date assets as follows:

Asset class	Asset	Basis
III	Machinery	$150
III	Land	250
V	Goodwill and going concern value	100
	Total	$500

(ii) On September 30, 1998, P filed a claim against the selling shareholders of T in a court of appropriate jurisdiction alleging fraud in the sale of the T stock.

(iii) On January 1, 2007, the former shareholders refund part of the purchase price to P in a settlement of the lawsuit. This refund results in a decrease of T's AGUB of $140.

(iv) Under paragraph (e)(1) of this section, the decrease in AGUB is allocated among T's acquisition date assets. First, because $100 was originally allocated to the Class V assets, $100 of the decrease is allocated to those assets. As there were no Class IV assets acquired, the remaining decrease in AGUB ($40) is allocated to the Class III assets in proportion to their fair market values at the beginning of the day after the acquisition date. Thus, $15 is allocated to the machinery ($40 x 150/$400) and $25 to the land ($40 x 250/$400).

(v) Assume that, as a result of deductions under section 168, the adjusted basis of the machinery immediately before the decrease in AGUB is zero. The machinery is treated as if it were disposed of before the decrease is taken into account. In 2007, T recognizes income of $15, the character of which is determined under the principles of *Arrowsmith* v. *Commissioner,* 344 U.S. 6 (1952), and the tax benefit rule. No adjustment to the basis of T's assets is made for any tax paid on this amount. Assume also that, as a result of amortization deductions, the adjusted basis of the goodwill and going concern value immediately before the decrease in AGUB is $40. A similar adjustment to income is made in 2007 with respect to the $60 of previously amortized goodwill and going concern value.

(vi) In summary, the basis of T's acquisition date assets, as of January 1, 2007, is as follows:

Asset	Basis
Machinery	$0
Land	225
Goodwill and going concern value	0

Example 3. (i) Assume that the facts are the same as *Example 2* of §1.338(b)–2T(d) except that the recently purchased stock is acquired for $1,600 plus additional payments that are contingent upon T's future earnings. Thus, T's AGUB, determined as of the beginning of the day after the acquisition date (after reduction by T's cash of $200), is $2,500 and is allocable among T's Class II, III, IV, and V acquisition date assets pursuant to §1.338(b)–2T(c)(3)(iii) as follows:

Asset	Basis
Portfolio of marketable securities	*$268
Inventory	268
Accounts receivable	536
Building	714
Land	178
Investment in T1	402
Goodwill and going concern value	134
Total	$2,500

*All numbers rounded for convenience.

(ii) Subsequent to the close of new target's first taxable year, P pays an additional $200 for its recently purchased T stock.

(iii) T's AGUB increase by $200, from $2,700 to $2,900. This $200 increase in AGUB is accounted for in accordance with the provisions of §1.338(b)–2T (c)(3)(iii) and paragraph (f) of this section.

(iv) The hypothetical purchase price of the T stock is redetermined as follows:

Grossed-up basis of recently purchased stock as determined under §1.338–4T(h) ($1,800/.8)	$2,250
Liabilities	1,000
Total	$3,250

(v) Under §1.338(b)–2T(c)(3) the redetermined fair market value of Class V assets is deemed to be $400, i.e., the hypothetical purchase price, as redetermined, of $3,250 minus $2,850 (the sum of T's cash, $200, and the fair market values of its Class II, III, and IV assets, $2,650).

(vi) The amount of AGUB available to allocate to T's Class II, III, IV, and V acquisition date assets is $2,700 (i.e., redetermined AGUB reduced by cash). AGUB allocable to each of T's acquisition date assets (i.e., the redetermined (c)(3) amount) is redetermined using the deemed fair market value of the Class V assets from paragraph (v) of this Example as follows:

Asset	Basis
Portfolio of marketable securities	*$266
Inventory	266
Accounts receivable	531
Building	708
Land	177
Investment in T1	398
Goodwill and going concern value	354
Total	$2,700

*All numbers rounded for convenience.

(vii) As illustrated by this example, the application of paragraph (f) of this section results in a basis increase for some assets and a basis decrease for other assets. The amount of increase (or decrease) in AGUB allocated to each acquisition date asset is determined as follows:

Asset	Original AGUB	Redetermined (c)(3) amount	Increase (or decrease) in AGUB
Portfolio of marketable securities	$268	$266	$(2)
Inventory	268	266	(2)
Accounts receivable	536	531	(5)
Building	714	708	(6)
Land	178	177	(1)
Investment in T1	402	398	(4)
Goodwill and going concern value	134	354	220
Total	$2,500	$2,700	$200

(viii) If P made a gain recognition election under section 338 (b)(3) with respect to its nonrecently purchased stock, paragraph (f) of this section would be inapplicable.

Example 4. (i) On January 1, 1987, P purchases all of the outstanding T stock and makes an express election for T. The fair market value of T's assets (other than goodwill and going concern value) as of the beginning of the following day is as follows:

Asset class	Assets	Fair market value
III	Equipment	$200
III	Accounts receivable	100
III	Building	500
	Total	800

(ii) T has elected the elective ADSP formula, in accordance with §1.338–4T(h)(3) *Answer 2* (ii)(B) (as contained in the CFR edition revised as of April 1, 1993) to determine the aggregate deemed sale price of old T's assets. Assume that the ADSP as so determined is $700. Assume also that the AGUB is equal to $700. T has no liabilities.

(iii) The AGUB of $700 is ratably allocated among T's Class III acquisition date assets in proportion to their fair market values as follows:

Asset	Basis
Equipment ($700×200/800)	$175.00
Accounts receivable ($700×100/800)	87.50
Building ($700×500/800)	437.50
Total	700.00

No amount is allocated to goodwill (or going concern value).

(iv) P and T file a consolidated return for 1987 and each following year with P as the common parent of the affiliated group.

(v) In 1990, a contingent amount of $117 is paid by P for the stock of old T. As a result, additional income is recognized under section 1245 by old T for 1990 on the deemed sale of old T's assets. This income must be reported on the consolidated return of new T for 1990, but it is separately accounted for and may not be absorbed by losses or deductions of P or of new T. Assume that the tax on this income is $3.

(vi) In 1990, there is an increase in T's AGUB of $120, *i.e.*, $117 + $3. The amount of this increase allocated to each acquisition date asset is determined as follows:

Asset	Original AGUB	Redetermined AGUB	Increase
Equipment	$175.00	$200.00	$25.00
Accounts receivable	87.50	100.00	12.50
Building	437.50	500.00	62.50
Goodwill (and going concern value)	0.00	20.00	20.00
Total	700.00	820.00	120.00

Example 5. (i) On June 1, 1990, P purchases all of the stock of T and makes an express election for T. T has one item of section 38 property whose basis on June 2, 1990 is $100,000. An investment credit of $8,000 is allowed to new T for the equipment because of an election under section 48 (q)(4).

(ii) In 1992, part of the purchase price of the T stock is refunded to P. Assume that the amount of the resulting decrease in AGUB allocated to the machinery is $7,000. Pursuant to § 1.47–2(c), the machinery ceases to be section 38 property to the extent of $7,000 of its original basis.

(iii) The additional tax of $560 (8% ×$7,000) resulting from the machine ceasing to be section 38 property is reported on T's return for 1992. Such amount is not an adjustment to AGUB.

Example 6. (i)(A) T has three assets (other than goodwill and going concern value) whose fair market values as of the beginning of the day after the acquisition date are as follows:

Asset class	Asset	Fair market value
III	Building	$100
III	Equipment	50
IV	Secret process	50
	Total	$200

(B) The secret process is a section 197 intangible. T has no liabilities. Assume that no election under section 338 (h)(10) or (h)(11) is in effect.

(ii) On January 1, 1998, P purchases all of the outstanding T stock for $225 plus 50 percent of the net profits generated by the secret process for each of the next three years, determinable and payable on January 1 of each following year. P and T are calendar year taxpayers.

(iii) As of the beginning of January 2, 1998, T's AGUB is $225, allocated as follows:

Asset class	Asset	Basis
III	Building	$100
III	Equipment	50
IV	Secret process	50
V	Goodwill and going concern value	25
	Total	$225

(iv) On January 1, 1999, $5 is paid by P for the T stock by reason of the net profits from the secret process. The payments are not attributable in any respect to any of T's other acquisition date assets. As a result, T's AGUB on January 1, 1999 is increased by $5.

(v) Assume that on January 1, 1999, the fair market value of the secret process is redetermined to be $52. (For purposes of this redetermination, only those circumstances that resulted in the increase to AGUB are taken into account.)

(vi) On January 1, 1999, only $2 of the $5 increase in AGUB is allocated to the secret process because the increase in AGUB so allocated cannot increase the basis of the secret process above its redetermined fair market value ($52). The balance of the increase is allocated to goodwill and going concern value because the fair market value limitation of § 1.338(b)–2T(c)(1) precludes allocating additional AGUB to the Class III and IV assets.

(vii) The price for which old target is deemed to have sold the secret process is increased to reflect the $2 increase allocated to its basis to new target. See § 1.338–3(d) and paragraph (h)(1) of this section.

(viii) If the fair market value of the secret process as of January 1, 1999, is unchanged from the fair market value as of the beginning of the day after the acquisition date, then the $5 increase in AGUB is allocated to T's goodwill and going concern value.

Example 7. (i) The facts are the same as in *Example 6* except that—

(A) The secret process is valued at $75 as of the beginning of the day after the acquisition date; and

(B) P pays $250 for the T stock and the former T shareholders agree to refund a portion of the purchase price to P for each of the three years that the net income from the secret process is less than $15 per year, determinable and payable on January 1 of the next year.

(ii) Assume that the secret process in the hands of new T is an amortizable section 197 intangible and, therefore, on January 1, 1999, new T's adjusted basis in the secret process is $70 (i.e., $75–$5 of allowable amortization).

(iii) Assume the net income from the process is less than $15 for 1998, and on January 1, 1999, P receives a refund that reduces the stock purchase price by $3.

(iv) Assume that as of January 1, 1999, the fair market value of the secret process is redetermined to be $65. (For purposes of this redetermination, only those circumstances that resulted in the decrease to AGUB are taken into account.)

(v) As of January 1, 1999, the AGUB of T is decreased by $3. This decrease is allocated to the secret process, the basis of which becomes $67 (i.e., $70–$3) and is amortizable over the remaining 14 years.

(vi) The price for which old target is deemed to have sold the secret process is decreased to reflect the $3 decrease allocated to its basis to new target. See §1.338–3(d) and paragraph (h)(1) of this section.

Example 8. The facts are the same as in *Example 6* except that the intangible Class IV asset is a patent instead of a secret process. The redetermination of the fair market value of the patent on January 1, 1999, is made without regard to the decrease in the remaining life of the patent because that is not a circumstance that resulted in the increase in AGUB.

[T.D. 8072, 51 FR 10626, Mar. 28, 1986, as amended by T.D. 8215, 53 FR 27043, July 18, 1988; T.D. 8515, 59 FR 2981, Jan. 20, 1994; T.D. 8515, 59 FR 2984, Jan. 20, 1994; T.D. 8711, 62 FR 2270, Jan. 16, 1997]

§1.338(h)(10)–1 Deemed asset sale and liquidation.

(a) *Scope.* This section prescribes rules relating to section 338(h)(10) elections. If an election is made, target generally is deemed to sell all of its assets and distribute the proceeds in complete liquidation. Thus, the sale of target stock included in the qualified stock purchase generally is ignored. A section 338(h)(10) election may be made for target only if it is a member of a selling consolidated group, a member of a selling affiliated group filing separate returns, or an S corporation.

(b) *Nomenclature.* For purposes of this section, the nomenclature in §1.338–1(b) does not apply; instead:

(1) T is a section 338(h)(10) target. Old T refers to T for periods ending on or before the close of T's acquisition date; new T refers to T for subsequent periods.

(2) P is the purchasing corporation. Unless the context otherwise requires, any reference to P is a reference to all purchasing corporations. See sections 338(h)(5) and (8).

(c) *Definitions*—(1) *Section 338(h)(10) target.* A *section 338(h)(10) target* is a domestic corporation that is a target for which a section 338(h)(10) election is made.

(2) *S corporation shareholders. S corporation shareholders* are the T shareholders if T is an S corporation immediately before T's acquisition date. Thus, if T is an S corporation, for T to be a section 338(h)(10) target, P can purchase no T stock before the acquisition date.

(3) *Selling consolidated group.* A *selling consolidated group* is a selling group that files a consolidated return for the period that includes T's acquisition date. Thus, T is a member of the selling consolidated group on the acquisition date.

(4) *Selling affiliate.* A *selling affiliate* is a domestic corporation that is not a member of the selling consolidated group and from which, on the acquisition date, P purchases an amount of T stock that satisfies the requirements of section 1504(a)(2). Thus, on the acquisition date, the selling affiliate and T are affiliated (within the meaning of section 1504) but are not includible members of the same consolidated group.

(d) *Section 338(h)(10) election*—(1) *In general.* A section 338(h)(10) election may be made for T if P acquires T in a qualified stock purchase from—

(i) A selling consolidated group;

(ii) A selling affiliate; or

(iii) S corporation shareholders.

(2) *Simultaneous joint election requirement.* A section 338(h)(10) election is made jointly by P and the selling consolidated group (or the selling affiliate or the S corporation shareholders) on Form 8023 in accordance with the instructions to the form. The section 338(h)(10) election must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs.

(3) *Irrevocability.* A section 338(h)(10) election is irrevocable. If a section 338(h)(10) election is made for T, a section 338 election is deemed made for T.

(4) *Effect of invalid election.* If a section 338(h)(10) election for T is not valid, the section 338 election for T is also not valid.

(e) *Certain consequences of section 338(h)(10) election.* This paragraph (e) applies if an election under section 338(h)(10) is made.

(1) *Old T.* Old T recognizes gain or loss as if, while old T was a member of the selling consolidated group (or owned by the selling affiliate or S corporation shareholders), it sold all of its assets in a single transaction at the close of the acquisition date (but before the deemed liquidation). Old T's gain or loss on each asset is determined under paragraph (f) of this section. If P makes a qualified stock purchase from a selling affiliate or S corporation shareholders, the principles of §§ 1.338–1(c)(6) and (e)(1), (5), and (6)(i) apply to the return filed by old T that includes the gain or loss and tax liability from the deemed sale.

(2) *Selling consolidated group, selling affiliate, or S corporation shareholders*—(i) *In general.* This paragraph (e)(2) describes the treatment of members of the selling consolidated group, the selling affiliate, and S corporation shareholders.

(ii) *Deemed liquidation for old T.* For purposes of subtitle A of the Internal Revenue Code, old T is treated as if, while T is a member of the selling consolidated group (or owned by the selling affiliate or S corporation shareholders), it distributed all of its assets in complete liquidation. If T is an S corporation immediately before the acquisition date, nothing in this section prevents a holder of T stock from taking deemed sale gain into account under section 1366 and 1367. See section 331 or 332 for gain or loss recognized by the old T shareholders as a result of the deemed liquidation.

(iii) *Basis of T stock not acquired.* The basis of T stock retained by the selling consolidated group (or the selling affiliate or an S corporation shareholder) is its fair market value. For purposes of this paragraph, the fair market value of all of the T stock equals G less any reductions in determining MADSP for acquisition costs of P incurred in connection with the qualified stock purchase that are capitalized in the basis of recently purchased T stock. See paragraph (f) of this section for the definition of G and a description of MADSP.

(iv) *T stock sale.* No gain or loss is recognized on the sale or exchange by the selling consolidated group (or the selling affiliate or an S corporation shareholder) of T stock included in the qualified stock purchase. If T is an S corporation immediately before T's acquisition date, the sale or exchange of old T stock to P on the acquisition date does not result in a termination of the section 1362(a) election for the S corporation.

(v) *Example.* This paragraph (e)(2) may be illustrated by the following example.

Example. (a) S1 owns all of the T stock and T owns all of the stock of T1 and T2. S1 is the common parent of a consolidated group that includes T, T1, and T2. P makes a qualified stock purchase of all of the T stock from S1. A section 338(h)(10) election is made for T. A section 338(h)(10) election also is made for the deemed purchase of T1. A section 338 election is not made for T2.

(b) S1 does not recognize gain or loss on the sale of the T stock and T does not recognize gain or loss on the sale of the T1 stock because T and T1 are section 338(h)(10) targets. Thus, for example, gain or loss realized on the sale of the T or T1 stock is not taken into account in earnings and profits. However, because a section 338 election is not made for T2, T must recognize any gain or loss realized on the deemed sale of the T2 stock. See § 1.338–3(c).

(c) The results would be the same if S1, T, T1, and T2 are not members of any consolidated group, because S1 and T are selling affiliates.

(3) *Certain minority shareholders*—(i) *In general.* This paragraph (e)(3) describes the treatment of shareholders of old T other than members of the selling consolidated group, the selling affiliate, S corporation shareholders, and P. A shareholder to which this paragraph (e)(3) applies is called a *minority shareholder.*

(ii) *T stock sale.* Notwithstanding paragraph (e)(2)(iv) of this section, a minority shareholder recognizes gain or loss on the shareholder's sale or exchange of T stock included in the qualified stock purchase.

(iii) *T stock not acquired.* A minority shareholder does not recognize gain or loss under this section with respect to shares of T stock retained by the shareholder. The shareholder's basis and holding period for that T stock is not affected by the section 338(h)(10) election.

(4) *P.* P is treated as making a gain recognition election for its nonrecently purchased T stock. See § 1.338(b)–1(e)(2)

(effect of a gain recognition election) and § 1.338(b)–1(e)(3)(ii) (gain recognition election deemed made).

(5) *New T.* The adjusted grossed-up basis for new T's assets is determined in accordance with § 1.338(b)–1(c) and is allocated among the assets in accordance with §§ 1.338(b)–2T and 1.338(b)–3T. Notwithstanding paragraph (e)(2)(ii) of this section, new T remains liable for the tax liabilities of old T (including tax liabilities resulting from the deemed sale of assets). For example, new T remains liable for the tax liabilities of the members of any consolidated group that are attributable to taxable years in which those corporations and old T joined in the same consolidated return. See § 1.1502–6(a).

(6) *Consolidated return of selling consolidated group.* If P acquires T in a qualified stock purchase from a selling consolidated group—

(i) The selling consolidated group must file a consolidated return for the taxable period that includes the acquisition date;

(ii) A consolidated return for the selling consolidated group for that period may not be withdrawn on or after the day that a section 338(h)(10) election is made for T; and

(iii) Permission to discontinue filing consolidated returns cannot be granted for, and shall not apply to, that period or any of the immediately preceding taxable periods during which consolidated returns continuously have been filed.

(f) *Deemed sale price*—(1) *General rule.* The price at which each asset of old T is deemed to have been sold is calculated by—

(i) Determining the modified ADSP (MADSP); and

(ii) Then allocating MADSP among the assets of old T in accordance with § 1.338(b)–2T (without taking into account § 1.338(b)–2T(c)(2)).

(2) *Formula.* (i) The MADSP formula is as follows:

$$MADSP = G + L + X$$

(ii) For purposes of this formula—

(A) *G* is the grossed-up basis of P's recently purchased T stock determined under § 1.338–3(d)(2).

(B) *L* is new T's liabilities.

(C) *X* is other relevant items.

(3) *Liabilities.* Liabilities taken into account are the liabilities of new target described in § 1.338(b)–1(f). The amount of the liabilities of new T taken into account to determine MADSP is determined as if old T had sold its assets to an unrelated person for consideration that included the liabilities.

(4) *Other relevant items.* Other relevant items include reductions for—

(i) Acquisition costs of P incurred in connection with the qualified stock purchase that are capitalized in the basis of recently purchased T stock (e.g., brokerage commissions and any similar costs incurred by P to acquire T stock); and

(ii) Selling costs of the selling consolidated group (or selling affiliate or S corporation shareholders) incurred in connection with the qualified stock purchase that reduce the amount realized on the sale of recently purchased T stock (e.g., brokerage commissions and any similar costs incurred by the selling group to sell T stock).

(5) *Cross-reference.* For adjustments to MADSP because of events occurring after the acquisition date, see § 1.338(b)–3T(h).

(g) *Examples.* (1) For purposes of the examples in this paragraph (g), unless otherwise provided, T, a member of a selling consolidated group, has only one class of stock, all of which is owned by S1. As of the close of Year 1, old T had no items described in section 381(c) (including no accumulated earnings and profits nor deficit in earnings and profits). On March 1 of Year 2, S1 sells its T stock to P for $80,000, and a section 338(h)(10) election is made for T. As of the close of March 1 of Year 2, old T's current earnings and profits, other than those generated from the deemed sale of its assets, are $21,950.

(2) Paragraphs (e) and (f) of this section may be illustrated by the following examples:

Example 1. (a) On March 1 of Year 2, T owns land with a $50,000 basis and $75,000 fair market value and equipment with a $30,000 adjusted basis, $70,000 recomputed basis, and $60,000 fair market value. T also has a $40,000 liability. S1 pays old T's allocable share of the selling group's consolidated tax liability for Year 2, which is $13,600 and attributable to the deemed sale of T's assets.

(b) The MADSP of $120,000 ($80,000+$40,000+0) is allocated to each asset as follows:

Assets	Basis	FMV	Fraction	Allocable MADSP
Land	$50,000	$75,000	5/9	$66,667
Equipment	30,000	60,000	4/9	53,333
Total	80,000	135,000	1	120,000

(c) Under paragraph (e)(1) of this section, old T has gain on the deemed sale of $40,000 (consisting of $16,667 of capital gain and $23,333 of ordinary income), which produces $40,000 of earnings and profits. As of the close of the acquisition date but after the deemed sale of its assets, old T's earnings and profits are $48,350 ($21,950 (its earnings and profits other than from the deemed sale) plus $40,000 (T's deemed sale gain) less $13,600 (T's allocable share of the consolidated tax liability)).

(d) Under paragraph (e)(2) of this section, S1 does not recognize gain or loss upon its sale of the old T stock to P. See section 332. S1 takes into account old T's earnings and profits of $48,350, determined as of the close of the acquisition date but after the deemed sale.

(e) P's basis in new T stock is P's cost for the stock, $80,000. See section 1012.

(f) Under §1.338(b)–1, the adjusted grossed-up basis for new T is $120,000, i.e., P's cost for the old T stock ($80,000) plus T's liability ($40,000). (Assume there are no other relevant items.) This adjusted grossed-up basis is allocated as basis among the new T assets under §§1.338(b)–2T and 1.338(b)–3T.

Example 2. (a) The facts are the same as in *Example 1,* except that S1 sells 80% of the old T stock to P for $64,000, rather than 100% of the old T stock for $80,000.

(b) The consequences to P, T, and S1 are the same as in *Example 1,* except that:

(i) P's basis for its 80-percent interest in the new T stock is P's $64,000 cost for the stock. See section 1012.

(ii) Under §1.338(b)–1, the adjusted grossed-up basis for new T is $120,000 (i.e., $64,000/.8+$40,000+$0).

(iii) Under paragraph (e)(2) of this section, S1 does not recognize gain or loss with respect to the retained stock in T. See section 332.

(iv) Under paragraph (e)(2)(iii) of this section, the basis of the T stock retained by S1 is $16,000 (i.e., $120,000 − $40,000 (the MADSP amount for the old T assets over the sum of new T's liabilities immediately after the acquisition date) × .20 (the proportion of T stock retained by S1)).

Example 3. (a) The facts are the same as in *Example 2,* except that K, a shareholder unrelated to T or P, owns the 20% of the T stock that is not acquired by P in the qualified stock purchase. K's basis in its T stock is $5,000.

(b) The consequences to P, T, and S1 are the same as in *Example 3,* except that S1 takes into account only $38,680 of T's earnings and profits (80% of $48,350).

(c) Under paragraph (e)(3) of this section, K recognizes no gain or loss, and K's basis in its T stock remains at $5,000.

Example 4. (a) The facts are the same as in *Example 1,* except that the equipment is held by T1, a wholly-owned subsidiary of T, and a section 338(h)(10) election is made for T1. The T1 stock has a fair market value of $60,000. T1 has no assets other than the equipment and no liabilities. S1 pays old T's and old T1's allocable shares of the selling group's consolidated tax liability for Year 2, which are $5,667 and $7,933, respectively, and attributable to the deemed asset sales by T and T1. As of the close of the acquisition date, but before the deemed sale of the equipment, old T1 has none of the attributes listed in section 381(c).

(b) The MADSP for T1 is $53,333 (i.e., $53,333+$0+$0). On the deemed sale, T1 recognizes ordinary income of $23,333. As of the close of the acquisition date, but after the deemed sale of the equipment, T1's earnings and profits are $15,400 ($0 plus $23,333 (T1's deemed sale gain) less $7,933 (T1's allocable share of the consolidated tax liability)).

(c) The MADSP for T is $120,000, allocated $66,667 to the land and $53,333 to the stock. Old T's deemed sale gain is $16,667 (the capital gain on its deemed sale of the land). Under paragraph (e)(2) of this section, old T does not recognize gain or loss on its deemed sale of the T1 stock. See section 332.

(d) Old T takes into account old T1's earnings and profits of $15,400, determined as of the close of the acquisition date but after the deemed sale by T1 of its asset. Thus, as of the close of the acquisition date, but after the deemed sale of old T's assets, old T's earnings and profits are $48,350, ($21,950 (its earnings and profits other than from the deemed sale) plus $15,400 (from T1) plus $16,667 (T's deemed sale gain) less $5,667 (T's allocable share of the consolidated tax liability)).

(e) Under paragraph (e)(2) of this section, S1 does not recognize gain or loss upon its sale of the old T stock to P and takes into account old T's earnings and profits of $48,350, determined as of the close of the acquisition date but after the deemed sale of old T's assets.

Example 5. (a) The facts are the same as in *Example 4,* except that P already owns 20% of the T stock, which is nonrecently purchased stock with a basis of $6,000, and that P purchases the remaining 80% of the T stock from S1 for $64,000.

(b) The results are the same as in *Example 4,* except that:

(i) S1 takes into account only $38,680 of old T's earnings and profits.

(ii) Under paragraph (e)(4) of this section and §1.338(b)–1(e)(2), P is deemed to have made a gain recognition election for its nonrecently purchased T stock. As a result, P recognizes gain of $10,000 and its basis in the nonrecently purchased T stock is increased from $6,000 to $16,000. P's basis in all the T stock is $80,000 (i.e., $64,000+$16,000). The computations are as follows:

(A) P's grossed-up basis for the recently purchased T stock is $64,000 (i.e., $64,000 (the basis of the recently purchased T stock)×(1−.2)/(.8) (the fraction in section 338(b)(4)).

(B) P's basis amount for the nonrecently purchased T stock is $16,000 (i.e., $64,000 (the grossed-up basis in the recently purchased T stock)×(.2)/(1.0−.2) (the fraction in section 338(b)(3)(B)).

(C) The gain recognized on the nonrecently purchased stock is $10,000 (i.e., $16,000−$6,000).

(h) *Inapplicability of provisions.* The provisions of section 6043, §1.331–1(d), and §1.332–6 (relating to information returns and record keeping requirements for corporate liquidations) do not apply to the deemed liquidation of old T under paragraph (e)(2) of this section.

[T.D. 8515, 59 FR 2981, Jan. 20, 1994]

§1.338(i)–1 Effective dates.

(a) *In general.* Sections 1.338–1 through 1.338–5 (except §1.338–4(h)), 1.338(b)–1, and 1.338(h)(10)–1 generally are applicable for targets with acquisition dates on or after January 20, 1994. Section 1.338–4(h) is applicable for targets with acquisition dates on or after January 20, 1997. Section 1.338–4T(h) (as contained in 26 CFR part 1 as revised April 1, 1996) is generally applicable for targets with acquisition dates on or after January 20, 1994, and before January 20, 1997.

(b) *Elective retroactive application.* A target with an acquisition date on or after January 14, 1992 and before January 20, 1994 may apply §§1.338–1 through 1.338–5, 1.338–4T(h) (as contained in 26 CFR part 1 as revised April 1, 1996), 1.338(b)–1, and 1.338(h)(10)–1 by including a statement with its return (including a timely filed amended return) for the period that includes the acquisition date to the effect that it is applying all of these sections pursuant to this paragraph (b). A target with an acquisition date on or after January 14, 1992, and before January 20, 1997, may choose to apply §1.338–4(h) for the period that includes the acquisition date pursuant to paragraph (b) of this section.

(c) *MADSP.* Section 1.338(h)(10)–1(f), which requires use of the MADSP formula to determine deemed sale price, is effective for qualified stock purchases for which the acquisition date is on or after November 10, 1986, unless the acquisition occurs pursuant to a binding contract entered into before that date.

(d) *Deemed election.* The District Director's discretion to impose (without the taxpayer's consent) a deemed election under section 338(e)(1) and §1.338–4T(f)(6)(i) (as contained in the CFR edition revised as of April 1, 1993) is revoked for all open tax years.

[T.D. 8515, 59 FR 2984, Jan. 20, 1994; as amended by T.D. 8710, 62 FR 3461, Jan. 23, 1997]

COLLAPSIBLE CORPORATIONS; FOREIGN PERSONAL HOLDING COMPANIES

§1.341–1 Collapsible corporations; in general.

Subject to the limitations contained in §1.341–4 and the exceptions contained in §1.341–6 and §1.341–7(a), the entire gain from the actual sale or exchange of stock of a collapsible corporation, (b) amounts distributed in complete or partial liquidation of a collapsible corporation which are treated, under section 331, as payment in exchange for stock, and (c) a distribution made by a collapsible corporation which, under section 301(c)(3), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property, shall be considered as ordinary income.

[T.D. 7655, 44 FR 68459, Nov. 29, 1979]

§ 1.341–2 Definitions.

(a) *Determination of collapsible corporation.* (1) A collapsible corporation is defined by section 341(b)(1) to be a corporation formed or availed of principally (i) for the manufacture, construction, or production of property, (ii) for the purchase of property which (in the hands of the corporation) is property described in section 341(b)(3), or (iii) for the holding of stock in a corporation so formed or availed of, with a view to (*a*) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and (*b*) the realization by such shareholders of gain attributable to such property. See § 1.341–5 for a description of the facts which will ordinarily be considered sufficient to establish whether or not a corporation is a collapsible corporation under the rules of this section. See paragraph (d) of § 1.341–5 for examples of the application of section 341.

(2) Under section 341(b)(1) the corporation must be formed or availed of with a view to the action therein described, that is, the sale or exchange of its stock by its shareholders, or a distribution to them prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and the realization by the shareholders of gain attributable to such property. This requirement is satisfied in any case in which such action was contemplated by those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting stock of the corporation or otherwise. The requirement is satisfied whether such action was contemplated, unconditionally, conditionally, or as a recognized possibility. If the corporation was so formed or availed of, it is immaterial that a particular shareholder was not a shareholder at the time of the manufacture, construction, production, or purchase of the property, or if a shareholder at such time, did not share in such view. Any gain of such a shareholder on his stock in the corporation shall be treated in the same manner as gain of a shareholder who did share in such view. The existence of a bona fide business reason for doing business in the corporate form does not, by itself, negate the fact that the corporation may also have been formed or availed of with a view to the action described in section 341(b).

(3) A corporation is formed or availed of with a view to the action described in section 341(b) if the requisite view existed at any time during the manufacture, production, construction, or purchase referred to in that section. Thus, if the sale, exchange, or distribution is attributable solely to circumstances which arose after the manufacture, construction, production, or purchase (other than circumstances which reasonably could be anticipated at the time of such manufacture, construction, production, or purchase), the corporation shall, in the absence of compelling facts to the contrary, be considered not to have been so formed or availed of. However, if the sale, exchange or distribution is attributable to circumstances present at the time of the manufacture, construction, production, or purchase, the corporation shall, in the absence of compelling facts to the contrary, be considered to have been so formed or availed of.

(4) The property referred to in section 341(b) is that property or the aggregate of those properties with respect to which the requisite view existed. In order to ascertain the property or properties as to which the requisite view existed, reference shall be made to each property as to which, at the time of the sale, exchange, or distribution referred to in section 341(b) there has not been a realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property. However, where any such property is a unit of an integrated project involving several properties similar in kind, the determination

whether the requisite view existed shall be made only if a substantial part of the taxable income to be derived from the project has not been realized at the time of the sale, exchange, or distribution, and in such case the determination shall be made by reference to the aggregate of the properties constituting the single project.

(5) A corporation shall be deemed to have manufactured, constructed, produced, or purchased property if it (i) engaged in the manufacture, construction, or production of property to any extent, or (ii) holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased the property, or (iii) holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, produced, or purchased by the corporation. Thus, under subdivision (i) of this subparagraph, for example, a corporation need not have originated nor have completed the manufacture, construction, or production of the property. Under subdivision (ii) of this subparagraph, for example, if an individual were to transfer property constructed by him to a corporation in exchange for all of the capital stock of such corporation, and such transfer qualifies under section 351, then the corporation would be deemed to have constructed the property, since the basis of the property in the hands of the corporation would, under section 362 be determined by reference to the basis of the property in the hands of the individual. Under subdivision (iii) of this subparagraph, for example, if a corporation were to exchange property constructed by it for property of like kind constructed by another person, and such exchange qualifies under section 1031(a), then the corporation would be deemed to have constructed the property received by it in the exchange, since the basis of the property received by it in the exchange would, under section 1031(d), be determined by reference to the basis of the property constructed by the corporation.

(6) In determining whether a corporation is a collapsible corporation by reason of the purchase of property, it is immaterial whether the property is purchased from the shareholders of the corporation or from persons other than such shareholders. The property, however, must be property which, in the hands of the corporation, is property of a kind described in section 341(b)(3). The determination whether property is of a kind described in section 341(b)(3) shall be made without regard to the fact that the corporation is formed or availed of with a view to the action described in section 341(b)(1).

(7) Section 341 is applicable whether the shareholder is an individual, a trust, an estate, a partnership, a company, or a corporation.

(b) *Section 341 assets.* For the purposes of this section, the term ‘‘section 341 assets’’ means the following listed property if held for less than 3 years:

(1) Stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year.

(2) Property held primarily for sale to customers in the ordinary course of a trade or business.

(3) Property used in a trade or business as defined in section 1231(b) and held for less than 3 years, except property that is or has been used in connection with the manufacture, construction, production or sale of property described in subparagraphs (1) and (2) of this paragraph.

(4) Unrealized receivables or fees pertaining to property listed in this paragraph. The term *unrealized receivables or fees* means any rights (contractual or otherwise) to payment for property listed in subparagraphs (1), (2), and (3) of this paragraph which has been delivered or is to be delivered and rights to payments for services rendered or to be rendered, to the extent such rights have not been included in the income of the corporation under the method of accounting used by it. In determining whether the assets referred to in this paragraph have been held for 3 years, the time such assets were held by a transferor shall be taken into consideration (section 1223). However, no such period shall begin before the date the manufacture, construction, production, or purchase of such assets is completed.

§ 1.341–3 Presumptions.

(a) Unless shown to the contrary a corporation shall be considered to be a collapsible corporation if at the time of the transactions described in § 1.341–1 the fair market value of the section 341 assets held by it constitutes 50 percent or more of the fair market value of its total assets and the fair market value of the section 341 assets is 120 percent or more of the adjusted basis of such assets. In determining the fair market value of the total assets, cash, obligations which are capital assets in the hands of the corporation, governmental obligations, and stock in any other corporation shall not be taken into consideration. The failure of a corporation to meet the requirements of this paragraph, shall not give rise to the presumption that the corporation was not a collapsible corporation.

(b) The following example will illustrate the application of this section:

Example A corporation, filing its income tax returns on the accrual basis, on July 31, 1955, owned assets with the following fair market values: Cash, $175,000; note receivable held for investment, $130,000; stocks of other corporations, $545,000; rents receivable, $15,000; and a building constructed by the corporation in 1953 and held thereafter as rental property, $750,000. The adjusted basis of the building on that date was $600,000. The only debt outstanding was a $500,000 mortgage on the building. On July 31, 1955, the corporation liquidated and distributed all of its assets to its shareholders. In computing whether the fair market value of the section 341 assets (only the building) is 50 percent or more of the fair market value of the total assets, the cash, note receivable, and stocks of other corporations are not taken into account in determining the value of the total assets, with the result that the fair market value of the total assets was $765,000 ($750,000 (building) plus $15,000 rents receivable). Therefore, the value of the building is 98 percent of the total assets ($750,000÷$765,000). The value of the building is also 125 percent of the adjusted basis of the building ($750,000÷$600,000). In view of the above facts, there arises a presumption that the corporation is a collapsible corporation.

§ 1.341–4 Limitations on application of section.

(a) *General.* This section shall apply only to the extent that the recognized gain of a shareholder upon his stock in a collapsible corporation would be considered, but for the provisions of this section, as gain from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years before 1977; 9 months for taxable years beginning in 1977). Thus, if a taxpayer sells at a gain stock of a collapsible corporation which he had held for six months or less, this section would not, in any event, apply to such gain. Also, if it is determined, under provisions of law other than section 341, that a sale or exchange at a gain of stock of a collapsible corporation which has been held for more than 1 year (6 months for taxable years before 1977; 9 months for taxable years beginning in 1977) results in ordinary income rather than long-term capital gain, then this section (including the limitations contained herein) has no application whatsoever to such gain.

(b) *Stock ownership rules.* (1) This section shall apply in the case of gain realized by a shareholder upon his stock in a collapsible corporation only if the shareholder, at any time after the actual commencement of the manufacture, construction, or production of the property, or at the time of the purchase of the property described in section 341(b)(3) or at any time thereafter, (i) owned, or was considered as owning, more than 5 percent in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned, or was considered as owning, more than 5 percent in value of the outstanding stock of the corporation.

(2) The ownership of stock shall be determined in accordance with the rules prescribed by section 544(a)(1), (2), (3), (5), and (6), except that, in addition to the persons prescribed by section 544(a)(2), the family of an individual shall include the spouses of that individual’s brothers and sisters, whether such brothers and sisters are by the whole or the half blood, and the spouses of that individual’s lineal descendants.

(3) For the purpose of this limitation, treasury stock shall not be considered as outstanding stock.

(4) It is possible, under this limitation, that a shareholder in a collapsible corporation may have gain upon his

stock in that corporation treated differently from the gain of another shareholder in the same collapsible corporation.

(c) *Seventy-percent rule.* (1) This section shall apply to the gain recognized during a taxable year upon the stock in a collapsible corporation only if more than 70 percent of such gain is attributable to the property referred to in section 341(b)(1). If more than 70 percent of such gain is so attributable, then all of such gain is subject to this section, and, if 70 percent or less of such gain is so attributable, then none of such gain is subject to this section.

(2) For the purpose of this limitation, the gain attributable to the property referred to in section 341(b)(1) is the excess of the recognized gain of the shareholder during the taxable year upon his stock in the collapsible corporation over the recognized gain which the shareholder would have if the property had not been manufactured, constructed, produced, or purchased. In the case of gain on a distribution in partial liquidation or a distribution described in section 301(c)(3)(A), the gain attributable to the property shall not be less than an amount which bears the same ratio to the gain on such distribution as the gain which would be attributable to the property if there had been a complete liquidation at the time of such distribution bears to the total gain which would have resulted from such complete liquidation.

(3) Gain may be attributable to the property referred to in section 341(b)(1) even though such gain is represented by an appreciation in the value of property other than that manufactured, constructed, produced, or purchased. Where, for example, a corporation owns a tract of land and the development of one-half of the tract increases the value of the other half, the gain attributable to the developed half of the tract includes the increase in the value of the other half.

(4) The following example will illustrate the application of the 70 percent rule:

Example: On January 2, 1954, A formed the Z Corporation and contributed $1,000,000 cash in exchange for all of the stock thereof. The Z Corporation invested $400,000 in one project for the purpose of building and selling residential houses. As of December 31, 1954, the residential houses in this project were all sold, resulting in a profit of $100,000 (after taxes). Simultaneously with the development of the first project and in connection with a second and separate project the Z Corporation invested $600,000 in land for the purpose of subdividing such land into lots suitable for sale as home sites and distributing such lots in liquidation before the realization by the corporation of a substantial part of the taxable income to be realized from this second project. As of December 31, 1954, Corporation Z had derived $60,000 in profits (after taxes) from the sale of some of the lots. On January 2, 1955, the Z Corporation made a distribution in complete liquidation to shareholder A who received:

(i) $560,000 in cash and notes, and

(ii) Lots having a fair market value of $940,000.

The gain recognized to shareholder A upon the liquidation is $500,000 ($1,500,000 minus $1,000,000). The gain which would have been recognized to A if the second project had not been undertaken is $100,000 ($1,100,000 minus $1,000,000). Therefore, the gain attributable to the second project which is property referred to in section 341(b)(1), is $400,000 ($500,000 minus $100,000). Since this gain ($400,000) is more than 70 percent of the entire gain ($500,000) recognized to A on the liquidation, the entire gain so recognized is gain subject to section 341(a).

(d) *Three-year rule.* This section shall not apply to that portion of the gain of a shareholder that is realized more than three years after the actual completion of the manufacture, construction, production, or purchase of the property referred to in section 341(b)(1) to which such portion is attributable. However, if the actual completion of the manufacture, construction, production, or purchase of all of such property occurred more than 3 years before the date on which the gain is realized, this section shall not apply to any part of the gain realized.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6738, 29 FR 7671, June 16, 1964; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§1.341–5 Application of section.

(a) Whether or not a corporation is a collapsible corporation shall be determined under the regulations of §§1.341–2 and 1.341–3 on the basis of all the facts and circumstances in each particular case. The following paragraphs of this section set forth those facts which will ordinarily be considered sufficient to establish that a corporation is or is not a collapsible corporation. The facts set forth in the following paragraphs of this section are not exclusive of other facts which may be controlling in any particular case. For example, if the facts in paragraph (b) of this section, but not the facts in paragraph (c) of this section, are present, the corporation may nevertheless not be a collapsible corporation if there are other facts which clearly establish that the regulations of §§ 1.341–2 and 1.341–3 are not satisfied. Similarly, if the facts in paragraph (c) of this section are present, the corporation may nevertheless be a collapsible corporation if there are other facts which clearly establish that the corporation was formed or availed of in the manner described in §§ 1.341–2 and 1.341–3 or if the facts in paragraph (c) of this section are not significant by reason of other facts, such as the fact that the corporation is subject to the control of persons other than those who were in control immediately prior to the manufacture, construction, production, or purchase of the property. See § 1.341–4 for provisions which make section 341 inapplicable to certain shareholders of collapsible corporations.

(b) The following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (a) of this section and paragraph (c) of this section) to establish that a corporation is a collapsible corporation:

(1) A shareholder of the corporation sells or exchanges his stock, or receives a liquidating distribution, or a distribution described in section 301(c)(3)(A),

(2) Upon such sale, exchange, or distribution, such shareholder realizes gain attributable to the property described in subparagraphs (4) and (5) of this paragraph, and

(3) At the time of the manufacture, construction, production, or purchase of the property described in subparagraphs (4) and (5) of this paragraph, such activity was substantial in relation to the other activities of the corporation which manufactured, constructed, produced, or purchased such property.

The property referred to in subparagraphs (2) and (3) of this paragraph is that property or the aggregate of those properties which meet the following two requirements:

(4) The property is manufactured, constructed, or produced by the corporation or by another corporation stock of which is held by the corporation, or is property purchased by the corporation or by such other corporation which (in the hands of the corporation holding such property) is property described in section 341(b)(3), and

(5) At the time of the sale, exchange, or distribution described in subparagraph (1) of this paragraph, the corporation which manufactured, constructed, produced, or purchased such property has not realized a substantial part of the taxable income to be derived from such property.

In the case of property which is a unit of an integrated project involving several properties similar in kind, the rules of this subparagraph shall be applied to the aggregate of the properties constituting the single project rather than separately to such unit. Under the rules of this subparagraph, a corporation shall be considered a collapsible corporation by reason of holding stock in other corporations which manufactured, constructed, produced, or purchased the property only if the activity of the corporation in holding stock in such other corporations is substantial in relation to the other activities of the corporation.

(c) The absence of any of the facts set forth in paragraph (b) of this section or the presence of the following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (a) of this section) to establish that a corporation is not a collapsible corporation:

(1) In the case of a corporation subject to paragraph (b) of this section only by reason of the manufacture, construction, production, or purchase (either by the corporation or by another corporation the stock of which is held by the corporation) of property which is property described in section 341(b)(3)(A) and (B), the amount (both in quantity and value) of such property

is not in excess of the amount which is normal—

(i) For the purpose of the business activities of the corporation which manufactured, constructed, produced, or purchased the property if such corporation has a substantial prior business history involving the use of such property and continues in business, or

(ii) For the purpose of an orderly liquidation of the business if the corporation which manufactured, constructed, produced, or purchased such property has a substantial prior business history involving the use of such property and is in the process of liquidation.

(2) In the case of a corporation subject to paragraph (b) of this section with respect to the manufacture, construction, or production (either by the corporation or by another corporation the stock of which is held by the corporation) of property, the amount of the unrealized taxable income from such property is not substantial in relation to the amount of the taxable income realized (after the completion of a material part of such manufacture, construction, or production, and prior to the sale, exchange, or distribution referred to in paragraph (b)(1) of this section) from such property and from other property manufactured, constructed, or produced by the corporation.

(d) The following examples will illustrate the application of this section:

Example (1). (i) On January 2, 1954, A formed the W Corporation and contributed $50,000 cash in exchange for all of the stock thereof. The W Corporation borrowed $900,000 from a bank and used $800,000 of such sum in the construction of an apartment house on land which it purchased for $50,000. The apartment house was completed on December 31, 1954. On December 31, 1954, the corporation, having determined that the fair market value of the apartment house, separate and apart from the land, was $900,000, made a distribution (permitted under the applicable State law) to A of $100,000. At this time, the fair market value of the land was $50,000. As of December 31, 1954, the corporation has not realized any earnings and profits. In 1955, the corporation began the operation of the apartment house and received rentals therefrom. The corporation has since continued to own and operate the building. The corporation reported on the basis of the calendar year and cash receipts and disbursements.

(ii) Since A received a distribution and realized a gain attributable to the building constructed by the corporation, since, at the time of such distribution, the corporation has not realized a substantial part of the taxable income to be derived from such building, and since the construction of the building was a substantial activity of the corporation, the W Corporation is considered a collapsible corporation under paragraph (b) of §1.341–5. The provisions of section 341(d) do not prohibit the application of section 341(a). Therefore, the distribution, if and to the extent that it may be considered long-term capital gain rather than ordinary income without regard to section 341, will be considered ordinary income under section 341(a).

(iii) In the event of the existence of additional facts and circumstances in the above case, the corporation, notwithstanding the above facts, might not be considered a collapsible corporation. See §1.342–2 and paragraph (a) of §1.341–5.

Example (2). (i) On January 2, 1954, B formed X Corporation and became its sole shareholder. In August 1954, the corporation completed construction of an office building. It immediately sold this building at a gain of $50,000, included this entire gain in its return for 1954, and distributed this entire gain (less taxes) to B. In June 1955, the corporation completed construction of a second office building. In August 1955, B sold the entire stock of X Corporation at a gain of $12,000, which gain is attributable to the second building.

(ii) X Corporation is a collapsible corporation under section 341(b) for the following reasons: The gain realized through the sale of the stock of X Corporation was attributable to the second office building; the construction of that building was a substantial activity of X Corporation during the time of construction and, at the time of sale, the corporation had not realized a substantial part of the taxable income to be derived from such building. Since the provisions of section 341(d) do not prohibit the application of section 341 (a) to B, the gain of $12,000 to B is, accordingly, considered ordinary income.

Example (3). The facts are the same as in *Example (2)*, except that the following facts are shown: B was the president of the X Corporation and active in the conduct of its business. The second building was constructed as the first step in a project of the X Corporation for the development for rental purposes of a large suburban center involving the construction of several buildings by the corporation. The sale of the stock by B was caused by his retiring from all business activity as a result of illness arising after the second building was constructed. Under these additional facts, the corporation is not considered a collapsible corporation. See §1.341–2 and paragraph (a) of §1.341–5.

Example (4). (i) On January 2, 1948, C formed the Y Corporation and became the sole shareholder thereof. The Y Corporation has been engaged solely in the business of producing motion pictures and licensing their exhibition. On January 2, 1955, C sold all of the stock of the Y Corporation at a gain. The Y Corporation has produced one motion picture each year since its organization and before January 2, 1955, it has realized a substantial part of the taxable income to be derived from each of its motion pictures except the last one made in 1954. This last motion picture was completed September 1, 1954. As of January 2, 1955, no license had been made for its exhibition. The fair market value on January 2, 1955, of this last motion picture exceeds the cost of its production by $50,000. A material part of the production of this last picture was completed on January 1, 1954, and between that date and January 2, 1955, the corporation had realized taxable income of $500,000 from other motion pictures produced by it. The corporation has consistently distributed to its shareholder its taxable income when received (after adjustment for taxes).

(ii) Although the corporation is within paragraph (b) of this section with respect to the production of property, the amount of the unrealized income from such property ($50,000) is not substantial in relation to the amount of the income realized, after the completion of a material part of the production of such property and prior to sale of the stock, from such property and other property produced by the corporation ($500,000). Accordingly, the Y Corporation is within paragraph (c)(2) of this section, and is not considered a collapsible corporation.

Example (5). The facts are the same as in *Example (4)* except that C sold all of his stock to D on February 1, 1954. On January 2, 1955, D sold all of the Y Corporation stock at a gain, the gain being attributable to the picture completed September 1, 1954, and not released by the corporation for exhibition. In view of the change of control of the corporation, the provisions of paragraph (c)(2) of this section are not significant at the time of the sale by D, and the Y Corporation would be considered a collapsible corporation on January 2, 1955. See § 1.341–2 and paragraph (a) of § 1.341–5.

§ 1.341–6 Exceptions to application of section.

(a) *In general*—(1) *Transactions excepted.* Section 341(e) excepts 4 types of transactions from the application of the collapsible corporation provisions. These exceptions, where applicable, eliminate the necessity of determining whether a corporation is a collapsible corporation within the meaning of section 341(b) or whether any of the limitations of section 341(d) are applicable. Under section 341(e)(1) and (2), there are 2 exceptions which are designed to allow the shareholders of a corporation either to sell or exchange their stock or to receive distributions in certain complete liquidations without having any gain considered under section 341(a)(1) or (2) as gain from the sale or exchange of property which is not a capital asset. Under section 341(e)(3), a third exception is designed to permit the shareholders of a corporation to make use of section 333, relating to elections as to recognition of gain in certain complete liquidations occurring within one calendar month. Under section 341(e)(4), the fourth exception permits a corporation to make use of section 337, relating to nonrecognition of gain or loss on sales or exchanges of property by a corporation following the adoption of a plan of complete liquidation. Section 341(e) does not apply to distributions in partial liquidation or in redemption of stock (other than any such distribution pursuant to a plan of complete liquidation), or to distributions described in section 301(c)(3)(A).

(2) *Effective date.* The exceptions in section 341(e)(1), (2), and (3) apply only with respect to taxable years of shareholders beginning after December 31, 1957, and only with respect to sales or exchanges of stock and distributions of property occurring after September 2, 1958. The exception in section 341(e)(4) applies only with respect to taxable years of corporations beginning after December 31, 1957, and only if all sales or exchanges of property, and all liquidating distributions, made by the corporation under the plan of complete liquidation occur after September 2, 1958.

(3) *Definition of constructive shareholder and attribution rules.* (i) For purposes of this section, the term *constructive shareholder* means a person who does not actually own any stock but who is considered to own stock by reason of the application of subdivision (ii) of this subparagraph.

(ii) For purposes of this section (other than paragraph (k), relating to definition of related person) a person shall be considered to own the stock he actually owns plus any stock which is attributed to him by reason of applying the rules prescribed in paragraph (b)(2) and (3) of §1.341–4. See section 341(e)(10).

(iii) As an example of this subparagraph, if a husband does not actually own any stock in a corporation but his wife is the actual owner of 5 shares in the corporation, then the husband is a constructive shareholder who is considered to own 5 shares in the corporation.

(4) *General corporate test.* No exception provided in section 341(e) applies unless a general corporate test and, where applicable, a specific shareholder test are satisfied. Under the general corporate test no taxpayer may utilize the provisions of section 341(e) unless the net increase in value (called ‘‘net unrealized appreciation’’) in the corporation's ‘‘subsection (e) assets’’ does not exceed 15 percent of the corporation's net worth. Subsection (e) assets are, in general, those assets of the corporation which, if sold at a gain by the corporation or by any actual or constructive shareholder who is considered to own more than 20 percent in value of the outstanding stock, would result in the realization of ordinary income. See paragraph (b) of this section for the definition of subsection (e) assets, and paragraph (h) of this section for definition of net unrealized appreciation. This subparagraph may be illustrated by the following examples:

Example (1). X Corporation is in the business of selling whiskey. The net unrealized appreciation in its whiskey is $20,000 and the net worth of the corporation is $100,000. Since the corporation's whiskey is a subsection (e) asset and since the net unrealized appreciation in subsection (e) assets ($20,000) exceeds 15 percent of net worth ($15,000), the general corporate test is not satisfied and section 341(e) is inapplicable to the corporation or its shareholders.

Example (2). Assume the same facts as in *Example (1)* except that X Corporation is not in the business of selling whiskey. Assume further that an actual shareholder who owns more than 20 percent in value of the outstanding X stock (or a person who is considered to own such actual shareholder's stock, such as his spouse) is in the business of selling whiskey. The result is the same as in *Example (1).*

(5) *Specific shareholder test.* Even if the general corporate test is met, a shareholder selling or exchanging his stock or receiving a distribution with respect to his stock (referred to as a ‘‘specific shareholder’’) who is considered to own more than 5 percent in value of the outstanding stock of the corporation may not utilize the benefits of the exception in section 341(e)(1) (or the exception in section 341(e)(2)) unless he satisfies the applicable specific shareholder test. In general, the specific shareholder test is satisfied if the net unrealized appreciation in subsection (e) assets of the corporation, plus the net unrealized appreciation in certain other assets of the corporation which would be subsection (e) assets in respect of the specific shareholder under the following circumstances, does not exceed 15 percent of the corporation's net worth:

(i) If the specific shareholder is considered to own more than 5 percent but not more than 20 percent in value of the outstanding stock, he must take into account the net unrealized appreciation in assets of the corporation which would be subsection (e) assets if he was considered to own more than 20 percent in value of the outstanding stock (see paragraph (c)(3)(i) of this section);

(ii) In addition, if the specific shareholder is considered to own more than 20 percent in value of the outstanding stock, he must also take into account the net unrealized appreciation in assets of the corporation which would be subsection (e) assets under section 341(e)(5)(A)(i) and (iii) if his ownership within the preceding 3 years of stock in certain ‘‘related’’ corporations were taken into account in the manner prescribed in paragraphs (c)(3)(ii) and (d) of this section.

(b) *Subsection (e) asset defined*—(1) *General.* The benefits of section 341(e) are unavailable if the net unrealized appreciation (as defined in paragraph (h) of this section) in certain assets of the corporation (hereinafter called ‘‘subsection (e) assets’’) exceeds 15 percent of the corporation's net worth. In determining whether property is a subsection (e) asset, it is immaterial whether the property is described in section 341(b), and there shall not be taken into account sections 617(d) (relating to gain from dispositions of certain mining property), 1245 and 1250 (relating to gain from dispositions of certain depreciable property), 1251 (relating to gain from disposition of farm property where farm losses offset nonfarm income), 1252 (relating to gain from disposition of farm land), and 1254 (relating to gain from disposition of natural resource recapture property).

(2) *Categories of subsection (e) assets.* The term *subsection (e) assets,* as defined in section 341(e)(5)(A)(i), (ii), (iii), and (iv), means the following categories of property held by a corporation:

(i) The first category is property (except property described in section 1231(b), without regard to any holding period prescribed therein) which in the hands of the corporation is, or in the hands of any actual or constructive shareholder who is considered to own more than 20 percent in value of the outstanding stock of the corporation would be, property gain from the sale or exchange of which would under any provision of chapter 1 of the Code (other than section 617(d), 1245, 1250, 1251, 1252, or 1254) be considered in whole or in part as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b). For example, included in this category is property held by a corporation which in its hands is stock in trade, inventory, or property held by it primarily for sale to customers in the ordinary course of its trade or business regardless of whether such property is appreciated or depreciated in value. Also included in this category is property held by a corporation which is a capital asset in its hands but which, in the hands of any actual or constructive shareholder who is considered to own more than 20 percent in value of the outstanding stock, would be stock in trade, inventory, or property held by such actual or constructive shareholder primarily for sale to customers in the ordinary course of his trade or business. For additional rules relating to whether property is a subsection (e) asset under this subdivision, see subparagraphs (3), (4), and (5) of this paragraph.

(ii) The second category of subsection (e) assets is property which in the hands of the corporation is property described in section 1231(b) (without regard to any holding period prescribed therein), but only if there is net unrealized depreciation (within the meaning of paragraph (h)(2) of this section) on all such property. This subdivision may be illustrated by the following example:

Example. X Corporation owns only the following section 1231(b) property (determined without regard to holding period).

Oil leaseholds	Adjusted basis	Fair market value	Unrealized appreciation (depreciation)
No. 1	$16,000	$10,000	($6,000)
No. 2	8,000	5,000	(3,000)
No. 3	5,000	5,000	0
No. 4	3,000	5,000	2,000
Totals	32,000	25,000	(7,000)

Since with respect to such property the unrealized depreciation in property on which there is unrealized depreciation ($9,000) exceeds the unrealized appreciation in property on which there is unrealized appreciation ($2,000), all such property is included in subsection (e) assets under clause (ii) of section 341(e)(5)(A).

(iii) The third category of subsection (e) assets exists only if there is net unrealized appreciation on all property which in the hands of the corporation is property described in section 1231(b) (without regard to any holding period prescribed therein). In such case, any such section 1231(b) property (whether appreciated or depreciated) is a subsection (e) asset of the third category if, in the hands of an actual or constructive shareholder who is considered to own more than 20 percent in value of the outstanding stock of the corporation, such property would be property gain from the sale or exchange of which would under any provision of chapter 1 of the Code (other than section 617(d), 1245, 1250, 1251, 1252, or 1254) be considered in whole or in part as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b). Included in this category, for example, is property which in the hands of the corporation is property described in section 1231(b) (without regard to any holding period prescribed therein), but which in the hands of an actual or constructive more-than-20-percent shareholder would be property used in his trade or business held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), stock in trade, inventory, or property held by such shareholder primarily for sale to customers in the ordinary course of his trade or business. For additional rules relating to whether property is a subsection (e) asset under this subdivision, see subparagraphs (3) and (4) of this paragraph. This subdivision may be further illustrated by the following example:

Example. Assume the same facts as stated in the example under subdivision (ii) of this subparagraph, except that in addition to the oil leaseholds the corporation also owns land which has a fair market value of $30,000 and an adjusted basis of $20,000 and which in the hands of the corporation is property described in section 1231(b) (without regard to any holding period prescribed therein). Assume further that A is a constructive shareholder of the corporation who is considered to own 25 percent in value of its outstanding stock and that A holds land primarily for sale to customers in the ordinary course of his trade or business, and that no actual or constructive shareholder who is considered to own more than 20 percent in value of the stock of corporation X so holds oil leases. Since with respect to the corporation's section 1231(b) property the unrealized appreciation in such property on which there is unrealized appreciation ($12,000) exceeds the unrealized depreciation in such property on which there is unrealized depreciation ($9,000), then clause (iii), and not clause (ii), of section 341(e)(5)(A) is applicable. Therefore, no oil lease of the corporation is a subsection (e) asset. However, since in the hands of A, a more-than-20-percent constructive shareholder, the land would be property gain from the sale or exchange of which would be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b), the land is a subsection (e) asset. Consequently, the net unrealized appreciation on subsection (e) assets of the corporation is $10,000 since the net unrealized depreciation on the oil leases is not taken into account.

(iv) The fourth category of subsection (e) assets is property (unless included under subdivision (i), (ii), or (iii) of this subparagraph) which consists of a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, or any interest in any such property, if the property was created in whole or in part by the personal efforts of, or, in the case of a letter, memorandum, or property similar to a letter or memorandum, was prepared, or produced in whole or in part, for, any individual actual or constructive shareholder who is considered to own more than 5 percent in value of the outstanding stock of the corporation. For items included in the phrase ''similar property'' see paragraph (c) of §1.1221–1. In general, property is created in whole or in part by the personal efforts of an individual if such individual performs literary, theatrical, musical, artistic, or other creative or productive work which affirmatively contributes to the creation of the property, or if such individual directs and guides others in the performance of such work. An individual, such as a corporate executive, who merely has administrative control of writers, actors, artists, or personnel and who does not substantially engage in the direction and guidance of such persons in the performance of their work, does not create property by his personal efforts. However, a letter or memorandum, or property similar to a letter or memorandum, which is prepared by personnel who are under the administrative control of an individual, such as a corporate executive, shall be deemed to have been prepared or produced for him whether or not such letter, memorandum, or similar property is reviewed by him. In addition, a letter, memorandum, or property similar to a letter or memorandum, addressed to an individual shall be considered as prepared or produced for him. In the case of a letter, memorandum, or property similar to a letter or memorandum, this subdivision applies only to sales and other dispositions occurring after July 25, 1969.

(3) *Manner of determination.* For purposes of determining whether property is a subsection (e) asset under subparagraph (2)(i) or (iii) of this paragraph, the determination as to whether property of a corporation in the hands of the corporation is, or in the hands of an actual or constructive shareholder of the corporation would be, property

gain from the sale or exchange of which would under any provision of chapter 1 of the Code (other than section 617(d), 1245, 1250, 1251, 1252, or 1254) be considered in whole or in part as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b) shall be made as if all property of the corporation had been sold or exchanged to one person in one transaction. For example, if a corporation whose sole asset is an interest in a gas well has entered into a long-term contract for the future delivery of gas from the well, the ownership of which will pass to the buyer only after extraction or severance from the well, the determination as to whether such contract is a subsection (e) asset shall be made as if the contract were sold or exchanged to one person in one transaction together with such corporation's interest in the well. An assumed sale under this subparagraph does not affect the character of property which is held for sale to customers in the ordinary course of a person's trade or business or the character of a transaction which would be an anticipatory assignment of income. Thus, for example, if a corporation holds subdivided lots for sale to customers in the ordinary course of its trade or business, this subparagraph shall not be applied to change the manner in which the lots are held.

(4) *Shareholder reference test.* For purposes of subparagraph (2)(i) and (iii) of this paragraph, in determining whether any property of the corporation would, in the hands of a particular actual or constructive shareholder, be property gain from the sale or exchange of which would be considered in whole or in part as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b), all the facts and circumstances of the direct and indirect activities of the shareholder must be taken into account. If the particular shareholder holds property primarily for sale to customers in the ordinary course of his trade or business and if similar property is held by the corporation, then in the hands of the shareholder such corporate property will be treated as held primarily for sale to customers in the ordinary course of his trade or business. Moreover, even if the shareholder does not presently so hold property which is similar to property held by the corporation, it may be determined under the particular facts and circumstances (taking into account an assumed sale of such corporate property by the shareholder, all his other direct and indirect activities, and, if applicable, the fact that he previously so held similar property) that he would hold the corporate property primarily for sale to customers in the ordinary course of his trade or business. See also paragraph (d) of this section, pertaining to effect of stock in related corporations.

(5) *Special rule for stock in shareholder's investment account.* If—

(i) A dealer in stock or securities is an actual shareholder (considered to own more than 20 percent of the outstanding stock of a corporation) and holds such stock which he actually owns in his investment account pursuant to section 1236(a), or

(ii) A dealer in stock or securities is a constructive shareholder who is considered to own more than 20 percent of the outstanding stock of a corporation,

then stock or securities held by such corporation shall not be considered subsection (e) assets under subparagraph (2)(i) of this paragraph solely because such actual or constructive shareholder is a dealer in stock or securities. However, stock held by such corporation shall be considered as a subsection (e) asset if, in the hands of any more-than-20-percent actual or constructive shareholder of the corporation, the gain (or any portion thereof) upon a sale of such stock would (if it were held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), constitute, by reason of the application of section 341, gain from the sale of property which is not a capital asset. This subparagraph may be illustrated by the following example:

Example. Jones, a more-than-20-percent actual shareholder in corporation X holds his X stock in an investment account in the manner prescribed in section 1236(a). Jones is a dealer in stock and securities and holds land for sale to customers in the ordinary course of his trade or business. No other actual or constructive shareholder is a dealer in stock and securities or so holds land. X holds all of the stock in corporation Y, a collapsible corporation within the meaning of section 341(b). Y's sole asset is land on which unrealized appreciation exceeds 15 percent of Y's net worth. Since Jones holds his X stock in an investment account pursuant to section 1236(a), the Y stock cannot be considered a subsection (e) asset of the X Corporation merely because Jones is a dealer in stock and securities. Nevertheless, the Y stock is a subsection (e) asset of the X Corporation because if Jones were treated as having sold the Y stock, his gain would be treated as gain from the sale of property which is not a capital asset by reason of the application of section 341. If, however, the net unrealized appreciation on Y's land did not exceed 15 percent of Y's net worth the Y stock would not be a subsection (e) asset since section 341(e)(1) would except such sale from the application of section 341.

(c) *Sales or exchanges of stock*—(1) *General.* Section 341(e)(1) provides that, if certain requirements are satisfied, the provisions of section 341(a)(1) shall in no event apply to certain sales or exchanges of stock by a shareholder. See subparagraph (5) of this paragraph for sales or exchanges of stock which do not qualify under section 341(e)(1). Section 341(e)(1) applies to a sale or exchange of stock by a shareholder only if, at the time of such sale or exchange, the general corporate test and, if applicable, the specific shareholder test are satisfied.

(2) *General corporate test.* The general corporate test is satisfied if the net unrealized appreciation in subsection (e) assets of the corporation does not exceed an amount equal to 15 percent of the net worth of the corporation. See paragraphs (h), (b), and (j) of this section for the definition of ''net unrealized appreciation,'' ''subsection (e) assets,'' and ''net worth.''

(3) *Specific shareholder test.* The specific shareholder test (if applicable) is satisfied if the following conditions are met:

(i) If the shareholder selling or exchanging the stock is considered to own more than 5 percent but not more than 20 percent in value of the outstanding stock, the sum of the net unrealized appreciation in the following assets of the corporation must not exceed an amount equal to 15 percent of the net worth of the corporation:

(*a*) The subsection (e) assets of the corporation, plus

(*b*) The other assets of the corporation which would be subsection (e) assets under section 341(e)(5)(A)(i) and (iii) if such shareholder were considered to own more than 20 percent in value of the outstanding stock.

(ii) If the shareholder selling or exchanging the stock is considered to own more than 20 percent in value of the outstanding stock, the sum of the net unrealized appreciation in the following assets of the corporation must not exceed an amount equal to 15 percent of the net worth of the corporation:

(*a*) The subsection (e) assets of the corporation, plus

(*b*) The other assets of the corporation which would be subsection (e) assets under section 341(e)(5)(A)(i) and (iii) if the shareholder's ownership of stock in certain related corporations were taken into account in the manner prescribed in paragraph (d) of this section.

(4) *Example.* Subparagraph (3) of this paragraph may be illustrated by the following example:

Example. Assume an individual, A, and his grandfather, G, each actually owns 3 percent in value of the stock of corporation X, a corporation holding apartment houses used in its trade or business on which net unrealized appreciation exceeds 15 percent of X's net worth. A, but not G, holds apartment houses primarily for sale to customers in the ordinary course of trade or business. Assume that X satisfies the general corporate test. A and G desire to sell their stock and to take advantage of section 341(e)(1). Since a grandfather and grandson are each considered to own the other's stock under paragraph (a)(3)(ii) of this section, A and G are each considered to own 6 percent in value of corporation X's outstanding stock. Therefore, A cannot avail himself of section 341(e)(1) since he does not satisfy the specific shareholder test prescribed in subparagraph (3)(i) of this paragraph. G, however, who is considered to own 6 percent in value of the stock, does not hold apartment houses for sale to customers in the ordinary course of trade or business. Therefore, G satisfies the specific shareholder test and may benefit from section 341(e)(1).

(5) *Nonqualifying sales or exchanges.* Section 341(e)(1) does not apply to any

sale or exchange of stock to the issuing corporation. Thus, stock redemptions (including distributions in complete or partial liquidation) cannot qualify under section 341(e)(1). In addition, section 341(e)(1) does not apply in any case where a shareholder who is considered to own more than 20 percent in value of the outstanding stock sells or exchanges stock to any person related (within the meaning of paragraph (k) of this section) to such shareholder. A sale or exchange of stock of the corporation by a shareholder to which section 341(e)(1) does not apply because of this subparagraph shall have no effect on the application of this section to other sales or exchanges of stock of the corporation.

(6) *Example.* For an illustration of the application of this paragraph, see *Example (2)* in paragraph (o) of this section.

(d) *Stock in related corporations*—(1) *General.* This paragraph provides rules for applying the specific shareholder test prescribed in paragraph (c)(3)(ii) of this section for purposes of determining whether section 341(e)(1) (relating to sales or exchanges of stock of a corporation) or section 341(e)(2) (relating to distributions in complete liquidation of a corporation) applies to an actual shareholder who is considered as owning more than 20 percent in value of the corporation's outstanding stock. In general, if such a more-than-20-percent shareholder of such corporation (referred to as a ''first'' corporation) owns, or at any time during the preceding 3 years has owned, more than 20 percent in value of the outstanding stock of a ''related'' corporation (see subparagraph (2) of this paragraph), then certain transactions in respect of the stock of the related corporation are taken into account in the manner prescribed in subparagraph (3) of this paragraph. By taking such transactions into account, such shareholder of the first corporation may be deemed to hold primarily for sale to customers in the ordinary course of trade or business property similar or related in service or use to property owned by the first corporation where his other activities, direct and indirect, are insufficient to treat him as so holding such property. See section 341(e)(1)(C) and (2)(C). The transactions in respect of stock in a related corporation are taken into account solely for the purpose of determining the extent to which assets (other than subsection (e) assets) of the first corporation are treated as subsection (e) assets under the shareholder reference tests of section 341(e)(5)(A)(i) and (iii). For purposes of this paragraph, the term ''similar or related in service or use'' shall have the same meaning as such term has in section 1033 (relating to involuntary conversions), without regard to subsection (g) thereof.

(2) *Related corporation defined.* (i) A corporation (referred to as a ''second'' corporation) is ''related'' to another corporation (referred to as a ''first'' corporation) if the stock ownership test specified in subdivision (ii) of this subparagraph and the more-than-70-percent-asset comparison test specified in subdivision (iii) of this subparagraph are met.

(ii) The stock ownership test specified in this subdivision is met—

(*a*) In the case of a sale or exchange referred to in paragraph (c)(1) of this section, if the shareholder in the first corporation is considered to own on the date of such sale or exchange more than 20 percent in value of the outstanding stock of the first corporation, and if on such date (or at any time during the 3-year period preceding such date) such shareholder in the first corporation is an actual or constructive shareholder in the second corporation who was considered to own more than 20 percent in value of the outstanding stock of the second corporation, or

(*b*) In the case of a distribution pursuant to the adoption by the first corporation of a plan of complete liquidation referred to in paragraph (e) of this section, if the shareholder in the first corporation is considered to own on any date after the adoption of such plan more than 20 percent in value of the outstanding stock of the first corporation, and if on such date (or at any time during the 3-year period preceding such date) such shareholder in the first corporation was an actual or constructive shareholder in the second corporation who was considered to own more than 20 percent in value of the outstanding stock of the second corporation.

(iii) The more-than-70-percent-asset comparison test specified in this subdivision is met if more than 70 percent in value of the assets of the second corporation (at any of the applicable times determined under subdivision (ii) of this subparagraph during which the shareholder of the first corporation is or was considered to own more than 20 percent in value of the outstanding stock of the second corporation) are, or were, assets similar or related in service or use to assets comprising more than 70 percent in value of the assets of the first corporation (at any of the times determined under subdivision (ii) of this subparagraph during which the shareholder of the first corporation is or was considered to own more than 20 percent in value of the outstanding stock of the first corporation).

(iv) This subparagraph may be illustrated by the following example:

Example. X is a first corporation and Y is a second corporation. On January 15, 1960, Jones purchased 21 percent in value of the outstanding stock of X, which he sold on January 1, 1961. On January 15, 1955, Jones had purchased 21 percent in value of the outstanding stock of Y which he sold on December 15, 1959. Since Jones owned 21 percent of the outstanding X stock on January 1, 1961 (the date he sold his X stock) and also owned 21 percent of the outstanding Y stock at some time during the 3-year period preceding January 1, 1961, the stock ownership test specified in subdivision (ii)(*a*) of this subparagraph is met. Assume that more than 70 percent in value of the assets of Y were apartment houses held for rental purposes at some time between January 1, 1958, and December 15, 1959 (the portion of the 3-year period preceding the date Jones sold his X stock during which he was a more-than-20-percent shareholder in Y) and that more than 70 percent in value of the assets of X were apartment houses held for rental purposes at some time during the period January 15, 1960, to January 1, 1961, inclusive (the portion of the 3-year period preceding the date he sold his X stock during which he was a more-than-20-percent shareholder in X). Thus, the more-than-70-percent-asset comparison test specified in subdivision (iii) of this subparagraph is met. Accordingly, corporation Y is related to corporation X within the meaning of this subparagraph.

(3) *Manner of taking into account.* If an actual shareholder in a first corporation who is considered to own more than 20 percent of the first corporation's stock, owns or has owned stock in a related corporation, then—

(i) Any sale or exchange by such shareholder, during the applicable period specified in subparagraph (2)(ii) of this paragraph, of stock in the related corporation shall be treated as a sale or exchange by him of his proportionate share of the assets of the related corporation, if immediately before such sale or exchange he was an actual shareholder of the related corporation who was considered to own more than 20 percent in value of the outstanding stock of the related corporation. A shareholder's proportionate share of the assets of a related corporation shall be that percent of each asset of the related corporation as the fair market value of the stock of the related corporation which he actually sold or exchanged bears, immediately before such sale or exchange, to the total fair market value of the outstanding stock of such related corporation; and

(ii) Any sale or exchange of property by the related corporation during the applicable period specified in subparagraph (2)(ii) of this paragraph, gain or loss on which was not recognized to the related corporation by reason of the application of section 337(a), shall be treated as a sale or exchange by him of his proportionate share of the related corporation's property sold or exchanged, if at the time of such sale or exchange he was an actual or constructive shareholder of the related corporation who was considered to own more than 20 percent in value of the outstanding stock of such related corporation. A shareholder's proportionate share of such related corporation's property sold or exchanged shall be that percent of each such property sold or exchanged as the fair market value of the stock which he was considered to own in the related corporation immediately before such sale or exchange bears to the total fair market value of the outstanding stock of such related corporation at such time.

(4) *Example.* This paragraph may be illustrated by the following example:

Example. (i) A owns 25 percent in value of the outstanding stock of Z Corporation. On

December 31, 1959, he sells all his stock in the corporation and desires to take advantage of section 341(e)(1). The only asset of Z Corporation is an appreciated apartment house held for rental purposes but which is not a subsection (e) asset. However, during the preceding 3-year period A sold 25 percent in value of the outstanding stock of each of 3 related corporations. More than 70 percent in value of the assets of each related corporation consisted of an apartment house.

(ii) In determining whether the apartment house owned by Z Corporation would be a subsection (e) asset under the shareholder reference test of section 341(e)(5)(A)(iii), A is treated as having sold a one-fourth interest in each of 3 apartment houses during the preceding 3-year period and these sales must be taken into account, together with all other facts and circumstances, in determining whether the apartment house owned by Z Corporation would be, in the hands of A, property gain from the sale or exchange of which would under any provision of chapter 1 of the Code (other than section 1245 or 1250) be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b). However, A's sales of related corporation stock are not taken into account in determining whether section 341(e)(1) or (2) would be applicable to sales or exchanges of stock by (or liquidating distributions to) other shareholders of Z Corporation.

(e) *Distributions in certain liquidations pursuant to section 337*—(1) *In general.* Section 341(e)(2) provides that, if certain requirements are met, the provisions of section 341(a)(2) shall in no event apply to certain distributions in complete liquidation of a corporation. Section 341(e)(2) applies with respect to any distribution to a shareholder pursuant to a plan of complete liquidation if the following 3 requirements are satisfied:

(i) By reason of the application of section 341(e)(4) and paragraph (g) of this section, section 337(a) applies to sales or exchanges of property by the corporation within the 12-month period beginning on the date of the adoption of such plan. Thus, for example, section 341(e)(2) is not applicable in any case where depreciable, amortizable, or depletable property is distributed after the date of adoption of the plan or if the corporation does not sell substantially all of the properties held by it on such date within such 12-month period, since such a distribution, or the failure to make such a sale, makes section 337(a) inapplicable under section 341(e)(4).

(ii) At all times within such 12-month period the general corporate test of paragraph (c)(2) of this section is satisfied.

(iii) In respect of the shareholder who receives the distribution—

(*a*) At all times within such 12-month period while such shareholder is considered to own more than 5 percent but not more than 20 percent in value of the outstanding stock of the corporation, the shareholder must satisfy the specific shareholder test of paragraph (c)(3)(i) of this section, and

(*b*) At all times within such 12-month period while such shareholder is considered to own more than 20 percent in value of the outstanding stock of the corporation, the shareholder must satisfy the specific shareholder test of paragraph (c)(3)(ii) of this section.

(2) *Illustration.* For an illustration of this paragraph, see *Example (4)* in paragraph (o) of this section.

(f) *Recognition of gain in certain liquidations under section 333.* Section 341(e)(3) provides that, for purposes of section 333 (relating to elections as to recognition of gain in certain complete liquidations occurring within one calendar month), a corporation is considered not to be a collapsible corporation if, at all times after the adoption of the plan of complete liquidation, the net unrealized appreciation in subsection (e) assets of the corporation does not exceed an amount equal to 15 percent of the net worth of the corporation. For purposes of the preceding sentence, the determination of subsection (e) assets shall be made in accordance with paragraph (b) of this section except that subparagraph (2)(i) and (iii) of such paragraph (b) shall apply in respect of any actual or constructive shareholder who is considered to own more than 5 percent in value of the outstanding stock (in lieu of any actual or constructive shareholder who is considered to own more than 20 percent in value of such stock). Thus, no shareholder of the corporation can qualify under paragraph (3) of section 341(e) for use of section 333 if, because of any actual or constructive shareholder who is considered to own more than 5 percent in value of the stock, this modified general corporate test is not satisfied. On the other hand, once this modified general corporate test is satisfied, all the shareholders can use section 333 (assuming that the requirements of that section are satisfied) since there is no specific shareholder test. For an illustration of this paragraph, see *Example (3)* in paragraph (o) of this section.

(g) *Gain or loss on sales or exchanges in connection with certain liquidations, pursuant to section 337*—(1) *General.* Section 341(e)(4) provides that solely for purposes of section 337, a corporation is considered not to be a collapsible corporation if (i) at all times within the 12-month period beginning on the date of the adoption of a plan of complete liquidation, the net unrealized appreciation in subsection (e) assets of the corporation does not exceed an amount equal to 15 percent of the net worth of the corporation; (ii) within the 12-month period beginning on the date of the adoption of such plan, the corporation sells substantially all of the properties held by it on such date; and (iii) following the adoption of such plan, no distribution is made of any property which in the hands of the corporation or in the hands of the distributee is property in respect of which a deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion is allowable. Thus, if at the time of the adoption of the plan of liquidation the corporation is a collapsible corporation within the meaning of section 341(b) and if the preceding requirements are satisfied, then except as provided in subparagraph (2) of this paragraph section 337(a) will apply to such corporation but the corporation will continue to be a collapsible corporation within the meaning of section 341(b) (including for purposes of section 341(e)(2)) with the result that each shareholder must still satisfy all the tests in paragraph (e) of this section before he can utilize the benefits of section 341(e)(2).

(2) *Exception to section 337 treatment.* Section 341(e)(4) shall not apply with respect to any sale or exchange of property by the corporation to any actual or constructive shareholder who is considered to own more than 20 percent in value of the outstanding stock of the corporation or to any person related (within the meaning of paragraph (k) of this section) to such actual or constructive shareholder if such property in the hands of the corporation, or in the hands of such shareholder or such related person, is property in respect of which a deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion is allowable. Thus, gain or loss will be recognized on such sales or exchanges.

(3) *Cross references.* For effective date of section 341(e)(4) and this paragraph, see paragraph (a)(2) of this section. For an illustration of this paragraph, see *Example (4)* in paragraph (o) of this section.

(h) *Net unrealized appreciation and depreciation defined*—(1) *Net unrealized appreciation.* For purposes of this section, the term *net unrealized appreciation* means, with respect to the assets of a corporation, the amount by which—

(i) The unrealized appreciation in such assets on which there is unrealized appreciation, exceeds

(ii) The unrealized depreciation in such assets on which there is unrealized depreciation.

(2) *Net unrealized depreciation.* For purposes of paragraph (b)(2)(ii) of this section, there is net unrealized depreciation on all property of a corporation which in its hands is property described in section 1231(b) (without regard to any holding period prescribed therein) if—

(i) The unrealized depreciation in such property on which there is unrealized depreciation, exceeds

(ii) The unrealized appreciation in such property on which there is unrealized appreciation.

(3) *Unrealized appreciation or depreciation.* For purposes of this paragraph—

(i) The term *unrealized appreciation* means (except as provided in subparagraph (4) of this paragraph), with respect to any asset, the amount by which (*a*) the fair market value of such asset, exceeds (*b*) the adjusted basis for determining gain from the sale or other disposition of such asset; and

(ii) The term *unrealized depreciation* means, with respect to any asset, the amount by which (*a*) the adjusted basis for determining gain from the sale or other disposition of such asset, exceeds (*b*) the fair market value of such asset.

(4) *Special rule.* For purposes of determining whether the net unrealized appreciation in subsection (e) assets of a corporation exceeds an amount equal to 15 percent of the corporation's net worth under the tests of section 341(e)(1), (2), (3), and (4), in the case of any asset on the sale or exchange of which only a portion of the gain would under any provision of chapter 1 of the Code (other than section 617(d), 1245, 1250, 1251, 1252, or 1254) be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b), there shall be taken into account only an amount equal to the unrealized appreciation in such asset which is equal to such portion of the gain. This subparagraph shall have no effect on whether paragraph (b)(2)(ii) or (iii) of this section applies for purposes of identifying the subsection (e) assets of the corporation.

(i) [Reserved]

(j) *Net worth defined.* For purposes of this section, the net worth of a corporation, as of any day, is the amount by which—

(1) The fair market value of all its assets at the close of such day, plus the amount of any distribution (taken into account at fair market value on the date of such distribution) in complete liquidation made by it on or before such day, exceeds

(2) All its liabilities at the close of such day.

In computing the fair market value of all the assets of a corporation at the close of such day, there shall be excluded any amount attributable to money or property received by it during the one-year period ending on such day for stock, or as a contribution to capital or as paid-in surplus, if it appears that there was not a bona fide business purpose for the transaction in respect of which such money or property was received.

(k) *Related person defined*—(1) *General.* For purposes of paragraphs (c)(5) and (g)(2) of this section, the following persons are considered to be related to a shareholder:

(i) If the shareholder is an individual—

(*a*) His spouse, ancestors, and lineal descendants, and

(*b*) Any corporation which is controlled by him.

(ii) If the shareholder is a corporation—

(*a*) A corporation which controls, or is controlled by, such shareholder, and

(*b*) If more than 50 percent in value of the outstanding stock of such shareholder is owned by any person, any corporation more than 50 percent in value of the outstanding stock of which is owned by the same person.

(2) *Control.* For purposes of this paragraph, control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

(3) *Constructive ownership rules.* In determining the ownership of stock for purposes of this paragraph, the constructive ownership rules of section 267(c) shall apply, except that the family of an individual shall include only his spouse, ancestors, and lineal descendants.

(l) [Reserved]

(m) *Corporations and shareholders not meeting requirements.* In determining whether the provisions of section 341 (a) through (d) apply with respect to any corporation, the fact that such corporation, or such corporation with respect to any of its shareholders, does not meet the requirements of section 341(e)(1), (2), (3), or (4) shall not be taken into account, and such determination shall be made as if section 341(e) had not been enacted.

(n) *Determinations without regard to sections 617(d), 1245, 1250, 1251, 1252, and 1254.* For purposes of this section, the determination of whether gain from the sale or exchange of property would under any provision of chapter 1 of the Code be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b) shall be made without regard to the application of sections 617(d)(1) (relating to gain from dispositions of certain mining property), 1245(a) and 1250(a) (relating to gain from dispositions of certain depreciable property), 1251(c) (relating to gain from the disposition of farm property where farm losses offset nonfarm income), 1252(a) (relating to gain from disposition of farm land), and 1254(a) (relating to gain from disposition of interest in natural resource recapture property).

(o) *Illustrations.* The operation of section 341(e) may be illustrated by the following examples:

Example (1). (i) The outstanding stock of X Corporation is actually owned, on the basis of value, 75 percent by A, 15 percent by B, and 10 percent by C. None of the stock actually owned by one is attributed to another under the constructive ownership rules of paragraph (a)(3) of this section. The corporation owns no property which, in its hands, is property gain from the sale or exchange of which would be considered (without regard to section 617(d), 1245 or 1250, 1251, or 1252) as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b). The corporation owns no property described in section 1231(b) except an apartment house on which the unrealized appreciation is $20,000 and which in the hands of A would be property held primarily for sale to customers in the ordinary course of trade or business. The corporation owns no property of the type described in clause (iv) of section 341(e)(5)(A). The net worth of the corporation is $100,000.

(ii) Although the apartment house in the hands of the corporation is section 1231(b) property, in the hands of A, a more-than-20-percent shareholder, the apartment house would be ordinary-income type property. Therefore, the apartment house is a subsection (e) asset under clause (iii) of section 341(e)(5)(A). Accordingly, since the net unrealized appreciation in subsection (e) assets ($20,000) exceeds 15 percent of net worth ($15,000), the general corporate test is not satisfied and section 341(e) is unavailable to the corporation or its shareholders.

Example (2). (i) Assume the same facts as in *Example (1)*, except that in the hands of B, but not in the hands of A or C, the apartment house would be property held primarily for sale to customers in the ordinary course of trade or business.

(ii) Since B does not own more than 20 percent in value of the outstanding stock, the fact that the apartment house owned by the corporation would, in his hands, be property held primarily for sale to customers in the ordinary course of trade or business does not make the apartment house owned by the corporation a subsection (e) asset. Therefore, since the net unrealized appreciation in subsection (e) assets (zero) does not exceed 15 percent of net worth, the general corporate test is satisfied. C may sell his stock to anyone (other than X Corporation) and will qualify under section 341(e)(1). However, a sale by A of his stock to persons related to A within the meaning of paragraph (k) of this section will not so qualify.

(iii) B, however, since he owns more than 5 percent but not more than 20 percent in value of the outstanding stock, must take into account not only the net unrealized appreciation in subsection (e) assets but also the net unrealized appreciation in any other assets of the corporation which would be subsection (e) assets under section 341(e)(5)(A) if he owned more than 20 percent in value of the outstanding stock. Therefore, since the apartment house owned by the corporation would be, in B's hands, property held primarily for sale to customers in the ordinary course of trade or business, and since the net unrealized appreciation in such property ($20,000) exceeds 15 percent of net worth ($15,000), B does not satisfy the specific shareholder test and therefore cannot avail himself of section 341(e)(1).

Example (3). (i) Assume the same facts as in *Example (1)*, except that in the hands of B, but not in the hands of A or C, the apartment house of the corporation would be property held primarily for sale to customers in the ordinary course of trade or business. Assume further that the shareholders of X Corporation wish to avail themselves of section 333.

(ii) For purposes of section 341(e)(3), section 341(e)(5)(A)(iii) applies in respect of any shareholder who owns more than 5 percent (instead of more than 20 percent) in value of the outstanding stock. Since in the hands of B, a more-than-5-percent shareholder, the apartment house would be held primarily for sale to customers in the ordinary course of trade or business, the corporation's apartment house is a subsection (e) asset. Therefore, since the net unrealized appreciation in subsection (e) assets ($20,000) exceeds 15 percent of net worth ($15,000), no shareholder of the corporation may qualify under section 341(e)(3) for use of section 333. However, if B were not a more-than-5-percent shareholder of the corporation, or if, in his hands, the apartment house would not be held primarily for sale to customers in the ordinary course of trade or business, then all shareholders of the corporation could qualify under section 341(e)(3) for use of section 333 since the apartment house would not be a subsection (e) asset.

Example (4). (i) Assume the same facts as in *Example (1)*, except that in the hands of no shareholder of the corporation would the apartment house be deemed property held primarily for sale to customers in the ordinary course of trade or business (such determination, however, having been made without regard to A's ownership of stock of related corporations). Assume further that (*a*) X Corporation adopts a plan of complete liquidation, (*b*) within the 12-month period beginning on the date of such adoption X Corporation sells substantially all the property held by it on such date and distributes all its assets in complete liquidation, (*c*) following the adoption of such plan, no distribution is made of any property which in the hands of the corporation or in the hands of the distributee is property in respect of which a deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion is allowable, and (*d*) following the adoption of such plan no property is sold or exchanged to A, to a constructive owner of A's stock, or to a person ''related'' (within the meaning of paragraph (k) of this section) to A or such constructive owner.

(ii) Since, under the above-stated facts, the requirements of section 341(e)(4) are satisfied, section 337(a) will apply to sales or exchanges of property by the corporation within the 12-month period beginning on the date of the adoption of the plan of liquidation.

(iii) Any distribution in complete liquidation to B and C, who own 15 and 10 percent, respectively, in value of the outstanding stock, will qualify under section 341(e)(2) because (*a*) by reason of the application of section 341(e)(4), section 337(a) applies to sales or exchanges of property by the corporation, and (*b*) at all times within the 12-month period beginning on the date of the adoption of the plan of complete liquidation the general corporate test is satisfied and B and C each satisfy the specific shareholder test of paragraph (e)(1)(iii)(*a*) of this section.

(iv) Any distribution in complete liquidation to A, who owns 75 percent in value of the outstanding stock, will qualify under section 341(e)(2) if, at all times within the 12-month period beginning on the date of the adoption of the plan of complete liquidation, and after taking into account A's ownership of stock in related corporations in the manner prescribed in paragraph (d) of this section, A satisfies the specific shareholder test of paragraph (e)(1)(iii)(*b*) of this section.

[T.D. 6806, 30 FR 2845, Mar. 5, 1965, as amended by T.D. 7369, 40 FR 29840, July 16, 1975; T.D. 7418, 41 FR 18811, May 7, 1976; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 8586, 60 FR 2500, Jan. 10, 1995]

§ 1.341–7 Certain sales of stock of consenting corporations.

(a) *In general.* (1) Under section 341(f)(1), if a corporation consents (in the manner provided in paragraph (b) of this section) to the application of section 341(f)(2) with respect to dispositions by it of its subsection (f) assets (as defined in paragraph (g) of this section), then section 341(a)(1) does not apply to any sales of stock of such consenting corporation (other than sale to such corporation) made by any of its shareholders within the 6-month period beginning on the date on which such consent is filed.

(2) For purposes of section 341(f)(1) and (5)—(i) The term *sale* means a sale of exchange of stock at a gain, but only if such gain would be recognized as long-term capital gain were section 341 not a part of the Code. Thus, a sale or exchange of stock is not a ''sale'' within the meaning of section 341(f)(1) and (5) if there is no gain on the transaction, or if the sale or exchange gives rise to ordinary income under a provision of the Code other than section 341, or if gain on the transaction is not recognized under any provisions of subtitle A of the Code.

(ii) A sale of stock in a corporation does not include any disposition of such stock by a shareholder, if, by reason of section 341(d)(1), section 341(a) could not have applied to that disposition. (Under section 341(d)(1), section 341(a) does not apply except to more–than–5–percent shareholders.) Except as otherwise provided in paragraph (a)(2)(i) of this section, the term ''sale'' included a disposition of stock in a corporation by a more-than-5-percent shareholders described in section 341(d)(1), even though section 341(a) did not apply to the disposition because the corporation was not collapsible or by reason of the application of section 341(d)(2), (3), or (e).

(3) A corporation which consents to the application of section 341(f)(2) does not thereby become noncollapsible, and the fact that a corporation consents to the application of section 341(f)(2) does not affect the determination as to whether it is a collapsible corporation.

(4) For limitation on the application of section 341(f)(1) see section 341(f)(5) and (6) and paragraphs (h) and (j) of this section.

(b) *Statement of consent.* (1) The consent of a corporation referred to in paragraph (a)(1) or (j)(1) of this section shall be given by means of a statement, signed by any officer who is duly authorized to act on behalf of the consenting corporation stating that the corporation consents to have the provisions of section 341(f)(2) apply to any disposition by it of its subsection (f) assets. The statement shall be filed with the district director having jurisdiction over the income tax return of the consenting corporation for the taxable year during which the statement is filed.

(2)(i) The statement shall contain the name, address, and employer identification number of any corporation 5 percent or more in value of the outstanding stock of which is owned directly by the consenting corporation, and of any other corporation connected to the consenting corporation through a chain of stock ownership described in paragraph (j)(4) of this section. The statement shall also indicate where such 5-percent-or-more corporation (or such ''connected'' corporation) has consented within the 6-month period ending on the date on which the statement filed to the application of section 341 (f)(2) with respect to any dispositions of its subsection (f) assets (see paragraph (j) of this section), and, if so, the district director with whom such consent was filed and the date on which such consent was filed.

(ii) If, during the 6-month period beginning on the date on which the statement is filed, the consenting corporation becomes the owner of 5 percent or more in value of the outstanding stock of another corporation or becomes connected to another corporation through a chain of stock ownership described in paragraph (j)(4) of this section, then the consenting corporation shall, within 5 days after such occurrence, notify the district director with whom it filed the statement of the name, address and employer identification number of such corporation.

(3) A consent under section 341(f)(1) may be filed at any time and there is no limit as to the number of such consents that may be filed. If a consent is filed by a corporation under section 341(f)(1) and if a shareholder sells stock (i) in such corporation, or (ii) in another corporation a sale of whose stock is treated under section 341(f)(6) as a sale of stock in such corporation, at any time during the applicable 6-month period, then the consent cannot thereafter be revoked or withdrawn by the corporation. However, a consent may be revoked or withdrawn at any time prior to a sale during the applicable 6-month period. If no sale is made during such period, the consent will have no effect on the corporation. See paragraph (g) of this section.

(c) *Consenting corporation.* (1) A consenting corporation at the time that is filed a consent under section 341(f)(10) shall notify its shareholders that such consent is being filed. In addition, the consenting corporation shall, at the request of any shareholder, promptly supply the shareholder with a copy of the consent.

(2) A consenting corporation shall maintain records adequate to permit identification of its subsection (F) assets.

(d) *Shareholders of consenting corporation.* (1) A shareholder who sells stock in a consenting corporation within the 6-month period beginning on the date on which the consent is filed shall—

(i) Notify the corporation, within 5 days after such sale, of the date on which such sale is made, and

(ii) Attach a copy of the corporation's consent to the shareholder's income tax return for the taxable year in which the sale is made.

(2) If the sale of stock in a consenting corporation is treated under section 341(f)(6) as the sale of stock in any other corporation, the consenting corporation shall notify such other corporation, within 5 days after receiving notification of a sale of its stock, of the date on which such sale was made.

(e) *Recognition of gain under section 341(f)(2).* (1) Under section 341(f)(2), if a subsection (f) asset (as defined in paragraph (g) of this section) is disposed of any time by a consenting corporation, then, except as provided in section 341(f)(3) and paragraph (f) of this section, the amount by which—

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

(ii) The fair market value of such asset (in the case of any other disposition), exceeds the adjusted base of such asset is treated as gain from the sale of exchange of such asset. Such gain is recognized notwithstanding any contrary non-recognition provisions of subtitle A of the Code, but only to the extent such gain is not recognized under any other provisions of subtitle A of the Code (for example, section 1245 (a)(1) or 1250(a)). Gain recognized under section 341(f)(2) with respect to a disposition of a subsection (f) asset has the same character (i.e., ordinary income or capital gain) that such gain would have if it arose from a sale of such asset.

(2) The nonrecognition provisions of subtitle A of the Code which section 341(f)(2) override include, but are not limited to, sections 311(a), 332(c), 336, 337, 351, 361, 371(a), 374(a), 721, 1031, 1033, 1071, and 1081.

(3) In the case of a foreign corporation which files a statement of consent pursuant to paragraph (b) of this section, such statement, in addition to the information required in paragraph (b) of this section, shall also contain a declaration that the corporation consents that any gain upon the disposition of a subsection (f) asset which would otherwise be recognized under section 341(f)(2) will, for purposes of section 882(a)(2), be considered as gross income which is effectively connected with the conduct of a trade or business which is conducted through a permanent establishment within the United States.

(4) The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example (1). Corporation X, a consenting corporation, distributes a subsection (f) asset to its shareholders in complete or partial liquidation of the corporation. The asset, at the line of the distribution, is held by the corporation primarily for sale to customers in the ordinary course of business and has an adjusted basis of $1,000 and a fair market value of $2,000. Under section 341(f)(2), the excess of the fair market value of the asset over its adjusted basis, or $1,000 is treated as ordinary income. Assuming the gain is not recognized by corporation X under another provision of the Code, corporation X recognizes the $1,000 gain as ordinary income under section 341(f)(2) even though, in the absence of section 341(f)(2), section 336 would preclude the recognition of such gain.

Example (2). Corporation Y, a consenting corporation, distributes a subsection (f) asset to its shareholders as a dividend. The asset at the time of the distribution is properly described in section 1231 and has an adjusted basis of $6,000 and a fair market value of $8,000. Assuming that no other section of the Code would require recognition of gain, under section 341(f)(2) the excess of the fair market value of the asset over its adjusted basis, or $2,000, is recognized by corporation Y as gain from the sale or exchange of property described in section 1231 even though, in the absence of section 341(f)(2), section 311(a) would preclude the recognition of such gain.

Example (3). Assume the same facts as in *Example (2)* except that the subsection (f) asset is section 1245 property having a ‘‘recomputed basis’’ (as defined in section 1245(a)(2)) or $7,200. Since the recomputed basis of the asset is lower than its fair market value, the excess of the recomputed basis over the adjusted basis, or $1,200, is recognized as ordinary income under section 1245(a)(1). The remaining amount, or $800, is recognized under section 341(f)(2) as gain from the sale or exchange or property described in section 1231.

(5) The provisions of section 341(f)(2) apply whether or not (i) on the date on which a consent is filed or at any time thereafter, the consenting corporation was in fact a collapsible corporation within the meaning of section 341(b), or (ii) on the date of any sale of stock of the consenting corporation, the purchaser of such stock was aware that a consent had been filed under section 341(f)(1) within the 6-month period ending on the date of such sale.

(6) Section 341(f)(2) does not apply to losses. Thus, section 341(f)(2) does not apply if a loss is realized upon a sale, exahnger or involuntary conversion of a subsection (f) asset nor does the section appy to a disposition other than by way of sale, exchange, or involuntary conversion if at the time of the disposition the fair market value of such property is not greater than its adjusted basis.

(7) For purposes of this paragraph, the term ‘‘disposition’’ includes an abandonment or retirement, a gift, a sale in a sale-and-leasback transaction, and a transfer upon the foreclosure of a security interest. Such term, however, does not include a mere transfer of title to a creditor upon creation of a security interest or to a debtor upon termination of a security interest. Thus, for example, a disposition occurs upon a sale of property prusuant to a conditional sales contract even though the seller retains legal title to the propoerty for purposes of security, but a disposition does not occur when the seller ultimately gives up his security interest following payment by the purchaser.

(8) The amount of gain required to be recognized by section 341(f)(2) shall be

determined separately for each subsection (f) asset disposed of by the corporation. For purposes of applying section 341(f)(2), the facts and circumstances of each disposition shall be considered in determining whether the transactions involves more than one subsection (f) asset or involves both subsection (f) and nonsubsection (f) assets. In appropriate cases, several subsection (f) assets may be treated as a single asset as long as it is reasonably clear, from the best estimates obtainable on the basis of all the facts and circumstances, that the amount of gain required to be recognized by section 341(f)(2) is not less than the total gain under section 341(f)(2) whish would be computed separately for each subsection (f) asset.

(9) In the case of a sale, exchange, or involuntary conversion of a subsection (f) asset and a nonsubsection (f) asset in one transaction, the total amount realized upon the disposition shall be allocated between the subsection (f) asset any arm's length agreement between the buyer and the seller will establish the allocation. In the absence of such an agreement, the allocation shall be made by taking into account the appropriate facts and circumstances. Some of the facts and circumstances which shall be taken into account to the extent appropriate included, but are not limited to, a comparision between the subsection (f) asset and all property disposed of in such transaction of (i) the original costs and reproduction costs of construction, erection, or production, (ii) the remaining economic useful life, (ii) state of obsolencence, and (iv) anticipated expenditures to maintain, renovate, or modernize.

(10) See §1.1502–13 for the treatment of gain recognized upon a distribution other than in complete liquidation made by one member of a group which files a consolidated return to another such members.

(f) *Exception for certain tax-free transactions.* (1) Under section 341(f)(3), no gain is taken into account under section 341(f)(2) by a transferor corporation on the transfer of a subsection (f) asset to another corporation (other than a corporation exempt from tax imposed by chapter 1 of the Code) if—

(i) The basis of such asset in the hands of the transferee corporation is determined by reference to its basis in the hands of the transferor by reason of the application of section 332 (relating to distributions in liquidation of an 80–percent-or-more controlled subsidairy corporation), section 351 (relating to transfers to a corporation controlled by the transferor), section 361 (relating to exchanges pursuant to certain reorganizations), section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings), or section 374 (a) (relating to exchanges pursuant to certain railroad reorganizations), and

(ii) The transferee corporation agrees (as provided in subparagraph (3) of this paragraph) to have the provisiions of section 341(f)(2) apply to any disposition by it of such asset.

(2) The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). Corporation M. in exchange for its voting stock worth $20,000 and $1,000 in cash, acquires the entire property of corporation N (an unencumbered apartment building) in a transaction which is described in section 368(a)(2)(B) and which, therefore, qualifies as a reorganization under section 368(a)(1)(C). The apartment building, which in the hands of corporation N. a consenting corporation, is a subsection (f) asset, has an adjusted basis of $15,000 and a fair market value of $21,000. The basis of the apartment house in the hands of corporation M is determined by reference to its basis in the hands of corporation N by reason of the application of section 361. Thus, under section 341(f)(3), if corporation M agrees to have the provisions of section 341(f)(2) apply to any disposition by it of the apartment house, then corporation N will recognize no gain under section 341(f)(2) but will recognize $1,000 gain under section 361(b) (assuming the cash it receives is not distributed in pursuance of the plan of reorganization). However, if corporation M does not so agree, the gain recognized by corporation N will be $6,000, that is, the gain of $1,000 recognized under section 361(b) plus $5,000 gain recognized under section 341(f)(2). In either case, if section 1245, 1250, or 1251 applies, some or all of the gain may be recognized under sections in lieu of sections 341(f)(2) and 361(b).

Example (2). Corporation Y, a consenting corporation, is a wholly owned subsidiary of corporation X. In the complete liquidation of Y it distributes to X a subsection (f) asset which is section 1245 property. The asset at the time of the distribution has an adjusted basis of $10,000, a recomputed basis of $14,000, and a fair market value of $10,000. The basis of the asset in the hands of X is determined by reference to its basis in the hands of corporation Y by reason of the application of section 332. Thus, under section 341(f)(3), if corporation X agrees to have the provisions of section 341(f)(2) apply to any disposition by it of the subsection (f) asset, then Y will recognize no gain under section 341(f)(2) and will recognize no gain under section 1245(a)(1) by reason of the application of section 1245(b)(3). Under section 334(b)(1), the basis of the subsection (f) asset to corporation X will be the same as it would be in the hands of Y, or $10,000. However, if corporation X does not so agree, then under section 341(f)(2) $6,000 (the excess of the fair market value of the asset over its adjusted basis) will be treated as gain from the sale or exchange of the asset. Moreover, under section 1245(a)(1) $4,000 (the excess of the recomputed basis over the adjusted basis) of the $6,000 will be recognized as ordinary income. The basis of the asset to corporation X is $16,000, i.e., the same as it would be in the hands of Y ($10,000) increased in the amount of gain recognized by Y on the distribution ($6,000).

(3) The agreement of a transferee corporation referred to in subparagraph (1) of this paragraph shall be filed, on or before the date on which the subsection (f) assets are transferred, with the district director having jurisdiction over its income tax return for the taxable year during which the transfer is to be made. The agreement shall be signed by any officer who is duly authorized to act on behalf of the transferee corporation (if the transaxtion is one to which section 371(a) or 374(a) applies, the fiduciary for the transferee corporation, in appropriate cases, may sign the agreement) and shall apply to all the subsection (f) assets to be transferred pursuant to the applicable transaction described in section 341(f)(3). The agreement shall identify the transaction by which the subsection (f) assets will be acquired, including the names, addresses, and employer identification numbers of the transferor and transferee corporations, and shall contain a schedule of the subsection (f) assets to be acquired. The agreement shall also state that the transferee corporation (i) agrees to have the provisions of section 341(f)(2) apply to any disposition by it of the subsection (f) assets acquired, and (ii) agrees to maintain records adequate to permit identification of such subsection (f) assets.

(4) The transferor corporation shall attach a copy of the agreement to its income tax return for the taxable year in which the subsection (f) assets are transferred.

(g) *Subsection (f) asset defined.* (1) Under section 341(f)(4), a subsection (f) asset is any property which, as of the date of any sale of stock to which paragraph (a) or (j)(3) of this section applies, is not a capital asset and is property owned by, or subject to a binding contract or an option to acquire held by, the consenting corporation. Land or any interest in real property (other than a security interest) is treated as property which is not a capital asset. Also, unrealized receivables or fees (as defined in section 341(b)(4)) are treated as property which are not capital assets.

(2) If, with respect to any property described in subparagraph (1) of this paragraph, manufacture, construction, or production has been commenced by either the consenting corporation or another person before any date of sale of stock described in subparagraph (1) of this paragraph, a consenting corporation's subsection (f) assets include any property resulting from such manufacture, construction, or production. Thus, for example, if, on the date of any sale of stock within the 6-month period, manufacture, construction, or production has been commended on a tract of land to be used for residential housing or on a television series, the term ''subsection (f) asset'' includes the residential homes of the television tapes resulting from such manufacture, construction, or production by the consenting corporation (or by a transferee corporation which has agreed to the application of section 341(f)(2)). If land or any interest in real property (other than a security interest) is owned or held under an option by the consenting corporation on the date of any sale of stock described in subparagraph (1) of this paragraph, the term ''subsection (f) asset'' includes any improvements resulting from construction with respect to such property (by the consenting corporation or by a transferee corporation which has agreed to the application of section 341(f)(2)) if such

construction is commenced within 2 years after the date of any such sale. The property or improvements resulting from any manufacture, construction, or production is a question to be determined on the basis of the particular facts and circumstances of each individual case. Thus, for example, a building which is a part of an integrated project is a subsection (f) asset if construction of the project commenced before the date of sale or within 2 years thereafter even if construction of the building commenced more than 2 years thereafter. Similarly a television tape which is part of a series is a subsection (i) asset if production of the series was commenced on the date of sale even if production of the tape commenced after the sale.

(3) The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example (1). Corporation X files a consent to the application of section 341(f)(2) on January 1, 1985. Shareholder A owns 100 percent of the outstanding stock of the consenting corporation on January 1, 1965, and sells 5 percent of the stock on January 2, 1965, 10 percent on February 10, 1963, and 1 percent on May 1, 1965. No other sales of X stock were made during the 6-month period beginning on January 1, 1965. On such date X owns an apartment building and on March 1 X purchases an office building. X's subsection (f) assets include the apartment building owned on January 1 and the office building purchased on March 1.

Example (2). Assume the same facts as in *Example (1)* except that on January 1, 1965, X also owns a tract of raw land. On April 1, 1965, construction of a residential housing project is commenced on the tract of land. Corporation X's subsection (i) assets will include the tract of land plus the resulting improvements to the land. This result would not be changed if construction of the residential housing project were not commenced until July 1, 1966, since the construction would have been commenced within 2 years after May 1, 1965.

Example (3). Corporation X files a consent to the application of section 341(f)(2) on January 1, 1965. Shareholder B owns 100 percent of the outstanding stock of the consenting corporation on January 1, 1965, and sells 10 percent of the stock on June 1, 1965. On April 1, 1965, Y acquires an option to purchase a motion picture when completed. On May 1, 1965, production is started on the motion picture. On February 1, 1967, production is completed, and Y exercises its option. Y holds the option and the motion picture for use in its trade or business. Y's subsection (f) assets initially include the option and ultimately include the motion picture. However the exercise of the option is not a disposition of the option within the meaning of section 341(f)(2).

(h) *Five-year limitation as to shareholder.* Under section 341(f)(5), section 341(f)(1) does not apply to the sale of stock of a consenting corporation if, during the 5-year period ending on the date of such sale, such shareholder (or any person related to such shareholder within the meaning of section 341(e)(8)(A)) made a sale (as defined in paragraph (a)(2) of this section) of any stock of another consenting corporation within any 6-month period beginning on a date on which a consent was filed under section 341(f)(1) by such other corporation. Section 341(f)(5) does not prevent a shareholder of a consenting corporation from receiving the benefit of section 341(f)(1) on the sale of additional shares of the stock of the same consenting corporation.

(i) [Reserved]

(j) *Special rule for stock ownership in other corporations*—(1) Section 341(f)(6) provides a special rule applicable to a consenting corporation which owns 5 percent or more in value of the outstanding stock of another corporation. In such a case, a consent filed by the consenting corporation shall not be valid with respect to a sale of its stock during the applicable 6-month period unless each corporation, 5 percent or more in value of the outstanding stock of which is owned by the consenting corporation on the date of such sale, file (within the 6-month period ending on the date of such sale) a valid consent under section 341(f)(1) with respect to sales of its own stock.

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

Example: Corporation X files a consent under section 341(f)(1) on November 1, 1965. On January 1, 1966, the date on which a shareholder of corporation X sells stock of X. X owns 80 percent in value of the outstanding stock of corporation Y. In order for the consent filed by corporation X to be valid with respect to the sale of its stock on January 1, 1966, corporation Y must have filed, during the 6-month period ending on January 1, 1966, a valid consent under section 341(f)(1) with respect to sales of its stock.

(3) For purposes of applying section 341(f)(4) (relating to the definition of a subsection (f) asset) to a corporation 5 percent or more in value of the outstanding stock of which is owned by the consenting corporation, a sale of stock of the consenting corporation to which section 341(f)(1) applies shall be treated as a sale of stock of such other corporation. Thus, in the example in subparagraph (2) of this paragraph, the subsection (f) assets of corporation Y would include property described in section 341(f)(4) owned by or held under an option by corporation Y on January 1, 1966.

(4) In the case of a chain of corporations connected by the 5-percent ownership requirement described in subparagraph (1) of this paragraph, rules similar to the rules described in subparagraphs (2) and (3) of this paragraph shall apply. Thus, in the example in subparagraph (2) of this paragraph, if corporation Y owned 5 percent or more of the stock of corporation Z on January 1, 1966, then Z must have filed a valid consent during the 6-month period ending January 1, 1966, in order for the consent filed by X to be valid with respect to the sale of its stock on January 1, 1966. In such case any of stock of either X or Y is treated as a sale of stock of Z for purposes of applying section 341(f)(4) to Z.

(5) If a corporation is a member of an affiliated group (as defined in section 1504(a)) that files a consolidated return, a corporation will be considered to have filed a consent if a consent is filed on its behalf by the common parent under § 1.1502–77(a).

(k) *Effective date.* Paragraphs (b), (c), (e)(3), and (f)(3) of this section apply only with respect to statements and notifications filed more than 30 days after July 6, 1977. Paragraph (d) applies only with respect to sales of stock made more than 30 days after July 6, 1977. All other provisions of this section appy with respect to transactions after August 22, 1964.

[T.D. 7655, 44 FR 68460, Nov. 29, 1979; 45 FR 17982, Mar. 20, 1980; 45 FR 20464, Mar. 28, 1980; T.D. 8597, 60 FR 36679, July 18, 1995]

§ 1.342–1 General.

The determination of whether a foreign corporation was a foreign personal holding company with respect to a taxable year beginning on or before, and ending after August 26, 1937, shall be made under section 331 of the Revenue Act of 1936 (50 Stat. 818) and the regulations thereunder. For the purpose of section 342(a), a liquidation may be completed before the actual dissolution of the liquidating corporation. However, no liquidation shall be considered as completed until the liquidating corporation and the receiver (or trustees in liquidation) are finally divested of all the property, whether tangible or intangible.

DEFINITION

§ 1.346–1 Partial liquidation.

(a) *General.* This section defines a partial liquidation. If amounts are distributed in partial liquidation such amounts are treated under section 331(a)(2) as received in part or full payment in exchange for the stock. A distribution is treated as in partial liquidation of a corporation if:

(1) The distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan of complete liquidation, or

(2) The distribution:

(i) Is not essentially equivalent to a dividend,

(ii) Is in redemption of a part of the stock of the corporation pursuant to a plan, and

(iii) Occurs within the taxable year in which the plan is adopted or within the succeeding taxable year.

An example of a distribution which will qualify as a partial liquidation under subparagraph (2) of this paragraph and section 346(a) is a distribution resulting from a genuine contraction of the corporate business such as the distribution of unused insurance proceeds recovered as a result of a fire which destroyed part of the business causing a cessation of a part of its activities. On the other hand, the distribution of funds attributable to a reserve for an expansion program which has been abandoned does not qualify as a partial liquidation within the meaning of section 346(a). A distribution to which section 355 applies (or so much of section 356 as relates to section 355) is not a distribution in partial liquidation within the meaning of section 346(a).

(b) *Special requirements on termination of business.* A distribution which occurs within the taxable year in which the plan is adopted or within the succeeding taxable year and which meets the requirements of subsection (b) of section 346 falls within paragraph (a)(2) of this section and within section 346(a)(2). The requirements which a distribution must meet to fall within subsection (b) of section 346 are:

(1) Such distribution is attributable to the corporation's ceasing to conduct, or consists of assets of, a trade or business which has been actively conducted throughout the five-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part, and

(2) Immediately after such distribution by the corporation it is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the five-year period ending on the date of such distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

A distribution shall be treated as having been made in partial liquidation pursuant to section 346(b) if it consists of the proceeds of the sale of the assets of a trade or business which has been actively conducted for the five-year period and has been terminated, or if it is a distribution in kind of the assets of such a business, or if it is a distribution in kind of some of the assets of such a business and of the proceeds of the sale of the remainder of the assets of such a business. In general, a distribution which will qualify under section 346(b) may consist of, but is not limited to:

(i) Assets (other than inventory or property described in subdivision (ii) of this subparagraph) used in the trade or business throughout the five-year period immediately before the distribution (for this purpose an asset shall be considered used in the trade or business during the period of time the asset which it replaced was so used), or

(ii) Proceeds from the sale of assets described in subdivision (i) of this subparagraph, and, in addition,

(iii) The inventory of such trade or business or property held primarily for sale to customers in the ordinary course of business, if:

(*a*) The items constituting such inventory or such property were substantially similar to the items constituting such inventory or property during the five-year period immediately before the distribution, and

(*b*) The quantity of such items on the date of distribution was not substantially in excess of the quantity of similar items regularly on hand in the conduct of such business during such five-year period, or

(iv) Proceeds from the sale of inventory or property described in subdivision (iii) of this subparagraph, if such inventory or property is sold in bulk in the course of termination of such trade or business and if with respect to such inventory the conditions of subdivision (iii)(*a*) and (*b*) of this subparagraph would have been met had such inventory or property been distributed on the date of such sale.

(c) *Active conduct of a trade or business.* For the purpose of section 346(b)(1), a corporation shall be deemed to have actively conducted a trade or business immediately before the distribution, if:

(1) In the case of a business the assets of which have been distributed in kind, the business was operated by such corporation until the date of distribution, or

(2) In the case of a business the proceeds of the sale of the assets of which are distributed, such business was actively conducted until the date of sale and the proceeds of such sale were distributed as soon thereafter as reasonably possible.

The term *active conduct of a trade or business* shall have the same meaning in this section as in paragraph (c) of §1.355–1.

§1.346–2 Treatment of certain redemptions.

If a distribution in a redemption of stock qualifies as a distribution in part or full payment in exchange for the stock under both section 302(a) and this section, then only this section shall be applicable. None of the limitations of section 302 shall be applicable to such redemption.

§ 1.346–3 Effect of certain sales.

The determination of whether assets sold in connection with a partial liquidation are sold by the distributing corporation or by the shareholder is a question of fact to be determined under the facts and circumstances of each case.

CORPORATE ORGANIZATIONS AND REORGANIZATIONS

CORPORATE ORGANIZATIONS

§ 1.351–1 Transfer to corporation controlled by transferor.

(a)(1) Section 351(a) provides, in general, for the nonrecognition of gain or loss upon the transfer by one or more persons of property to a corporation solely in exchange for stock or securities in such corporation, if immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred. As used in section 351, the phrase ''one or more persons'' includes individuals, trusts, estates, partnerships, associations, companies, or corporations (see section 7701(a)(1)). To be in control of the transferee corporation, such person or persons must own immediately after the transfer stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation (see section 368(c)). In determining control under this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account. The phrase ''immediately after the exchange'' does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure. For purposes of this section—

(i) Stock or securities issued for services rendered or to be rendered to or for the benefit of the issuing corporation will not be treated as having been issued in return for property, and

(ii) Stock or securities issued for property which is of relatively small value in comparison to the value of the stock and securities already owned (or to be received for services) by the person who transferred such property, shall not be treated as having been issued in return for property if the primary purpose of the transfer is to qualify under this section the exchanges of property by other persons transferring property.

For the purpose of section 351, stock rights or stock warrants are not included in the term ''stock or securities.''

(2) The application of section 351(a) is illustrated by the following examples:

Example (1). C owns a patent right worth $25,000 and D owns a manufacturing plant worth $75,000. C and D organize the R Corporation with an authorized capital stock of $100,000. C transfers his patent right to the R Corporation for $25,000 of its stock and D transfers his plant to the new corporation for $75,000 of its stock. No gain or loss to C or D is recognized.

Example (2). B owns certain real estate which cost him $50,000 in 1930, but which has a fair market value of $200,000 in 1955. He transfers the property to the N Corporation in 1955 for 78 percent of each class of stock of the corporation having a fair market value of $200,000, the remaining 22 percent of the stock of the corporation having been issued by the corporation in 1940 to other persons for cash. B realized a taxable gain of $150,000 on this transaction.

Example (3). E, an individual, owns property with a basis of $10,000 but which has a fair market value of $18,000. E also had rendered services valued at $2,000 to Corporation F. Corporation F has outstanding 100 shares of common stock all of which are held by G. Corporation F issues 400 shares of its common stock (having a fair market value of $20,000) to E in exchange for his property worth $18,000 and in compensation for the services he has rendered worth $2,000. Since immediately after the transaction, E owns 80 percent of the outstanding stock of Corporation F, no gain is recognized upon the exchange of the property for the stock. However, E realized $2,000 of ordinary income as compensation for services rendered to Corporation F.

(3) *Underwritings of stock*—(i) *In general.* For the purpose of section 351, if a

person acquires stock of a corporation from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires stock from the underwriter is treated as transferring cash directly to the corporation in exchange for stock of the corporation and the underwriter is disregarded. A qualified underwriting transaction is a transaction in which a corporation issues stock for cash in an underwriting in which either the underwriter is an agent of the corporation or the underwriter's ownership of the stock is transitory.

(ii) *Effective date.* This paragraph (a)(3) is effective for qualified underwriting transactions occurring on or after May 1, 1996.

(b)(1) Where property is transferred to a corporation by two or more persons in exchange for stock or securities, as described in paragraph (a) of this section, it is not required that the stock and securities received by each be substantially in proportion to his interest in the property immediately prior to the transfer. However, where the stock and securities received are received in disproportion to such interest, the entire transaction will be given tax effect in accordance with its true nature, and in appropriate cases the transaction may be treated as if the stock and securities had first been received in proportion and then some of such stock and securities had been used to make gifts (section 2501 and following), to pay compensation (section 61(a)(1)), or to satisfy obligations of the transferor of any kind.

(2) The application of paragraph (b)(1) of this section may be illustrated as follows:

Example (1). Individuals A and B, father and son, organize a corporation with 100 shares of common stock to which A transfers property worth $8,000 in exchange for 20 shares of stock, and B transfers property worth $2,000 in exchange for 80 shares of stock. No gain or loss will be recognized under section 351. However, if it is determined that A in fact made a gift to B, such gift will be subject to tax under section 2501 and following. Similarly, if B had rendered services to A (such services having no relation to the assets transferred or to the business of the corporation) and the disproportion in the amount of stock received constituted the payment of compensation by A to B, B will be taxable upon the fair market value of the 60 shares of stock received as compensation for services rendered, and A will realize gain or loss upon the difference between the basis to him of the 60 shares and their fair market value at the time of the exchange.

Example (2). Individuals C and D each transferred, to a newly organized corporation, property having a fair market value of $4,500 in exchange for the issuance by the corporation of 45 shares of its capital stock to each transferor. At the same time, the corporation issued to E, an individual, 10 shares of its capital stock in payment for organizational and promotional services rendered by E for the benefit of the corporation. E transferred no property to the corporation. C and D were under no obligation to pay for E's services. No gain or loss is recognized to C or D. E received compensation taxable as ordinary income to the extent of the fair market value of the 10 shares of stock received by him.

(c)(1) The general rule of section 351 does not apply, and consequently gain or loss will be recognized, where property is transferred to an investment company after June 30, 1967. A transfer of property after June 30, 1967, will be considered to be a transfer to an investment company if—

(i) The transfer results, directly or indirectly, in diversification of the transferors' interests, and

(ii) The transferee is (*a*) a regulated investment company, (*b*) a real estate investment trust, or (*c*) a corporation more than 80 percent of the value of whose assets (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts.

(2) The determination of whether a corporation is an investment company shall ordinarily be made by reference to the circumstances in existence immediately after the transfer in question. However, where circumstances change thereafter pursuant to a plan in existence at the time of the transfer, this determination shall be made by reference to the later circumstances.

(3) Stocks and securities will be considered readily marketable if (and only if) they are part of a class of stock or

securities which is traded on a securities exchange or traded or quoted regularly in the over-the-counter market. For purposes of subparagraph (1)(ii)(*c*) of this paragraph, the term ''readily marketable stocks or securities'' includes convertible debentures, convertible preferred stock, warrants, and other stock rights if the stock for which they may be converted or exchanged is readily marketable. Stocks and securities will be considered to be held for investment unless they are (i) held primarily for sale to customers in the ordinary course of business, or (ii) used in the trade or business of banking, insurance, brokerage, or a similar trade or business.

(4) In making the determination required under subparagraph (1)(ii)(*c*) of this paragraph, stock and securities in subsidiary corporations shall be disregarded and the parent corporation shall be deemed to own its ratable share of its subsidiaries' assets. A corporation shall be considered a subsidiary if the parent owns 50 percent or more of (i) the combined voting power of all classes of stock entitled to vote, or (ii) the total value of shares of all classes of stock outstanding.

(5) A transfer ordinarily results in the diversification of the transferors' interests if two or more persons transfer nonidentical assets to a corporation in the exchange. For this purpose, if any transaction involves one or more transfers of nonidentical assets which, taken in the aggregate, constitute an insignificant portion of the total value of assets transfered, such transfers shall be disregarded in determining whether diversification has occurred. If there is only one transferor (or two or more transferors of identical assets) to a newly organized corporation, the transfer will generally be treated as not resulting in diversification. If a transfer is part of a plan to achieve diversification without recognition of gain, such as a plan which contemplates a subsequent transfer, however delayed, of the corporate assets (or of the stock or securities received in the earlier exchange) to an investment company in a transaction purporting to qualify for nonrecognition treatment, the original transfer will be treated as resulting in diversification.

(6)(i) For purposes of paragraph (c)(5) of this section, a transfer of stocks and securities will not be treated as resulting in a diversification of the transferors' interests if each transferor transfers a diversified portfolio of stocks and securities. For purposes of this paragraph(c)(6), a portfolio of stocks and securities is diversified if it satisfies the 25 and 50-percent tests of section 368(a)(2)(F)(ii), applying the relevant provisions of section 368(a)(2)(F). However, Government securities are included in total assets for purposes of the denominator of the 25 and 50-percent tests (unless the Government securities are acquired to meet the 25 and 50-percent tests), but are not treated as securities of an issuer for purposes of the numerator of the 25 and 50-percent tests.

(ii) Paragraph (c)(6)(i) of this section is effective for transfers completed on or after May 2, 1996. Transfers of diversified (within the meaning of paragraph (c)(6)(i) of this section), but nonidentical, portfolios of stocks and securities completed before May 2, 1996, may be treated either—

(A) Consistent with paragraph (c)(6)(i) of this section; or

(B) As resulting in diversification of the transferors' interests.

(7) The application of subparagraph (5) of this paragraph may be illustrated as follows:

Example (1). Individuals A, B, and C organize a corporation with 101 shares of common stock. A and B each transfers to it $10,000 worth of the only class of stock of corporation X, listed on the New York Stock Exchange, in exchange for 50 shares of stock. C transfers $200 worth of readily marketable securities in corporation Y for one share of stock. In determining whether or not diversification has occurred, C's participation in the transaction will be disregarded. There is, therefore, no diversification, and gain or loss will not be recognized.

Example (2). A, together with 50 other transferors, organizes a corporation with 100 shares of stock. A transfers $10,000 worth of stock in corporation X, listed on the New York Stock Exchange, in exchange for 50 shares of stock. Each of the other 50 transferors transfers $200 worth of readily marketable securities in corporations other than X in exchange for one share of stock. In determining whether or not diversification has occurred, all transfers will be taken into account. Therefore, diversification is present, and gain or loss will be recognized.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6942, 32 FR 20977, Dec. 29, 1967; T.D. 8665, 61 FR 19189, May 1, 1996; T.D. 8663, 61 FR 19545, May 2, 1996]

§1.351–2 Receipt of property.

(a) If an exchange would be within the provisions of section 351(a) if it were not for the fact that the property received in exchange consists not only of property permitted by such subsection to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. No loss to the recipient shall be recognized.

(b) See section 357 and the regulations pertaining to that section for applicable rules as to the treatment of liabilities as ‘‘other property’’ in cases subject to section 351, where another party to the exchange assumes a liability, or acquires property subject to a liability.

(c) See sections 358 and 362 and the regulations pertaining to those sections for applicable rules with respect to the determination of the basis of stock, securities, or other property received in exchanges subject to section 351.

(d) See part I (section 301 and following), subchapter C, chapter 1 of the Code, and the regulations thereunder for applicable rules with respect to the taxation of dividends where a distribution by a corporation of its stock or securities in connection with an exchange subject to section 351(a) has the effect of the distribution of a taxable dividend.

§1.351–3 Records to be kept and information to be filed.

(a) Every person who received the stock or securities of a controlled corporation, or other property as part of the consideration, in exchange for property under section 351, shall file with his income tax return for the taxable year in which the exchange is consummated a complete statement of all facts pertinent to such exchange, including—

(1) A description of the property transferred, or of his interest in such property, together with a statement of the cost or other basis thereof, adjusted to the date of transfer.

(2) With respect to stock of the controlled corporation received in the exchange, a statement of—

(i) The kind of stock and preferences, if any;

(ii) The number of shares of each class received; and

(iii) The fair market value per share of each class at the date of the exchange.

(3) With respect to securities of the controlled corporation received in the exchange, a statement of—

(i) The principal amount and terms; and

(ii) The fair market value at the date of exchange.

(4) The amount of money received, if any.

(5) With respect to other property received—

(i) A complete description of each separate item;

(ii) The fair market value of each separate item at the date of exchanges; and

(iii) In the case of a corporate shareholder, the adjusted basis of the other property in the hands of the controlled corporation immediately before the distribution of such other property to the corporate shareholder in connection with the exchange.

(6) With respect to liabilities of the transferors assumed by the controlled corporation, a statement of—

(i) The nature of the liabilities;

(ii) When and under what circumstances created;

(iii) The corporate business reason for assumption by the controlled corporation; and

(iv) Whether such assumption eliminates the transferor’s primary liability.

(b) Every such controlled corporation shall file with its income tax return for the taxable year in which the exchange is consummated—

(1) A complete description of all the property received from the transferors.

(2) A statement of the cost or other basis thereof in the hands of the transferors adjusted to the date of transfer.

(3) The following information with respect to the capital stock of the controlled corporation—

(i) The total issued and outstanding capital stock immediately prior to and immediately after the exchange, with a complete description of each class of stock;

(ii) The classes of stock and number of shares issued to each transferor in the exchange, and the number of shares of each class of stock owned by each transferor immediately prior to and immediately after the exchange, and

(iii) The fair market value of the capital stock as of the date of exchange which was issued to each transferor.

(4) The following information with respect to securities of the controlled corporation—

(i) The principal amount and terms of all securities outstanding immediately prior to and immediately after the exchange,

(ii) The principal amount and terms of securities issued to each transferor in the exchange, with a statement showing each transferor's holdings of securities of the controlled corporation immediately prior to and immediately after the exchange,

(iii) The fair market value of the securities issued to the transferors on the date of the exchange, and

(iv) A statement as to whether the securities issued in the exchange are subordinated in any way to other claims against the controlled corporation.

(5) The amount of money, if any, which passed to each of the transferors in connection with the transaction.

(6) With respect to other property which passed to each transferor—

(i) A complete description of each separate item;

(ii) The fair market value of each separate item at the date of exchange, and

(iii) In the case of a corporate transferor, the adjusted basis of each separate item in the hands of the controlled corporation immediately before the distribution of such other property to the corporate transferor in connection with the exchange.

(7) The following information as to the transferor's liabilities assumed by the controlled corporation in the exchange—

(i) The amount and a description thereof,

(ii) When and under what circumstances created, and

(iii) The corporate business reason or reasons for assumption by the controlled corporation.

(c) Permanent records in substantial form shall be kept by every taxpayer who participates in the type of exchange described in section 351, showing the information listed above, in order to facilitate the determination of gain or loss from a subsequent disposition of stock or securities and other property, if any, received in the exchange.

EFFECTS ON SHAREHOLDERS AND SECURITY HOLDERS

§ 1.354–1 Exchanges of stock and securities in certain reorganizations.

(a) Section 354 provides that under certain circumstances no gain or loss is recognized to a shareholder who surrenders his stock in exchange for other stock or to a security holder who surrenders his securities in exchange for stock. Section 354 also provides that under certain circumstances a security holder may surrender securities and receive securities in the same principal amount or in a lesser principal amount without the recognition of gain or loss to him. The exchanges to which section 354 applies must be pursuant to a plan of reorganization as provided in section 368(a) and the stock and securities surrendered as well as the stock and securities received must be those of a corporation which is a party to the reorganization. Section 354 does not apply to exchanges pursuant to a reorganization described in section 368(a)(1)(D) unless the transferor corporation—

(1) Transfers all or substantially all of its assets to a single corporation, and

(2) Distributes all of its remaining properties (if any) and the stock, securities and other properties received in the exchange to its shareholders or security holders in pursuance of the plan

of reorganization. The fact that properties retained by the transferor corporation, or received in exchange for the properties transferred in the reorganization, are used to satisfy existing liabilities not represented by securities and which were incurred in the ordinary course of business before the reorganization does not prevent the application of section 354 to an exchange pursuant to a plan of reorganization defined in section 368(a)(1)(D).

(b) Except as provided in section 354 (c) and (d), section 354 is not applicable to an exchange of stock or securities if a greater principal amount of securities is received than the principal amount of securities the recipient surrenders, or if securities are received and the recipient surrenders no securities. See, however, section 356 and regulations pertaining to such section. See also section 306 with respect to the receipt of preferred stock in a transaction to which section 354 is applicable.

(c) An exchange of stock or securities shall be subject to section 354(a)(1) even though—

(1) Such exchange is not pursuant to a plan of reorganization described in section 368(a), and

(2) The principal amount of the securities received exceeds the principal amount of the securities surrendered or if securities are received and no securities are surrendered—

if such exchange is pursuant to a plan of reorganization for a railroad corporation as defined in section 77(m) of the Bankruptcy Act (11 U.S.C. 205(m)) and is approved by the Interstate Commerce Commission under section 77 of such act or under section 20b of the Interstate Commerce Act (49 U.S.C. 20b) as being in the public interest. Section 354 is not applicable to such exchanges if there is received property other than stock or securities. See, however, section 356 and regulations pertaining to such section.

(d) The rules of section 354 may be illustrated by the following examples:

Example 1. Pursuant to a reorganization under section 368(a) to which Corporations T and W are parties, A, a shareholder in Corporation T, surrenders all his common stock in Corporation T in exchange for common stock of Corporation W. No gain or loss is recognized to A.

Example 2. Pursuant to a reorganization under section 368(a) to which Corporations X and Y (which are not railroad corporations) are parties, B, a shareholder in Corporation X, surrenders all his stock in X for stock and securities in Y. Section 354 does not apply to this exchange. See, however, section 356.

Example 3. C, a shareholder in Corporation Z (which is not a railroad corporation), surrenders all his stock in Corporation Z in exchange for securities in Corporation Z. Whether or not this exchange is in connection with a recapitalization under section 368(a)(1)(E), section 354 does not apply. See, however, section 302.

Example 4. The facts are the same as in *Example 3* of this paragraph (d), except that C receivies solely rights to acquire stock in Corporation Z. Section 354 does not apply.

(e) Except as provided in §1.356–6T, for purposes of section 354, the term *securities* includes rights issued by a party to the reorganization to acquire its stock. For purposes of this section and section 356(d)(2)(B), a right to acquire stock has no principal amount. For this purpose, rights to acquire stock has the same meaning as it does under sections 305 and 317(a). Other Internal Revenue Code provisions governing the treatment of rights to acquire stock may also apply to certain exchanges occurring in connection with a reorganization. See, for example, sections 83 and 421 through 424 and the regulations thereunder. This paragraph (e) applies to exchanges occurring on or after March 9, 1998.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7616, 44 FR 26869, May 8, 1979; T.D. 8752, 63 FR 410, Jan. 6, 1998]

§1.355–0 In order to facilitate the use of §§1.355–1 through 1.355–6, this section lists the paragraphs, subparagraphs, and subdivisions in those sections.

§1.355–1 DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

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(b) Application of section.

§1.355–2 LIMITATIONS.

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(b) Independent business purpose.

(1) Independent business purpose requirement.

(2) Corporate business purpose.

(3) Business purpose for distribution.

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(5) Examples.

(c) Continuity of interest requirement.
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§ 1.355–3 ACTIVE CONDUCT OF A TRADE OR BUSINESS.
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(4) Special rules for acquisition of a trade or business (Prior to the Revenue Act of 1987 and Technical and Miscellaneous Revenue Act of 1988).
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(iii) Gain or loss recognized in certain transactions.
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(c) Examples.
§ 1.355–4 NON PRO RATA DISTRIBUTIONS, ETC.
§ 1.355–5 RECORDS TO BE KEPT AND INFORMATION TO BE FILED.
§ 1.355–6 [RESERVED]

[T.D. 8238, 54 FR 289, Jan. 5, 1989]

§ 1.355–1 Distribution of stock and securities of a controlled corporation.

(a) *Effective date of certain sections.* Sections 1.355–1 through 1.355–4 apply to transactions occurring after February 6, 1989. For transactions occurring on or before that date, see 26 CFR 1.355–1 through 1.355–4 (revised as of April 1, 1987). Sections 1.355–1 through 1.355–4 do not reflect the amendments to section 355 made by the Revenue Act of 1987 and the Technical and Miscellaneous Revenue Act of 1988.

(b) *Application of section.* Section 355 provides for the separation, without recognition of gain or loss to (or the inclusion in income of) the shareholders and security holders, of one or more existing businesses formerly operated, directly or indirectly, by a single corporation (the ‘‘distributing corporation’’). It applies only to the separation of existing businesses that have been in active operation for at least five years (or a business that has been in active operation for at least five years into separate businesses), and which, in general, have been owned, directly or indirectly, for at least five years by the distributing corporation. A separation is achieved through the distribution by the distributing corporation of stock, or stock and securities, of one or more subsidiaries (the ‘‘controlled corporations’’) to its shareholders with respect to its stock or to its security holders in exchange for its securities. The controlled corporations may be preexisting or newly created subsidiaries. Throughout the regulations under section 355, the term *distribution* refers to a distribution by the distributing corporation of stock, or stock and securities, of one or more controlled corporations, unless the context indicates otherwise. Section 355 contemplates the continued operation of the business or businesses existing prior to the separation. See §1.355–4 for types of distributions that may qualify under section 355, including pro rata distributions and non pro rata distributions.

(c) *Stock rights.* Except as provided in §1.356–6T, for purposes of section 355, the term *securities* includes rights issued by the distributing corporation or the controlled corporation to acquire the stock of that corporation. For purposes of this section and section 356(d)(2)(B), a right to acquire stock has no principal amount. For this purpose, rights to acquire stock has the same meaning as it does under sections 305 and 317(a). Other Internal Revenue Code provisions governing the treatment of rights to acquire stock may also apply to certain distributions occurring in connection with a transaction described in section 355. See, for example, sections 83 and 421 through 424 and the regulations thereunder. This paragraph (c) applies to distributions occurring on or after March 9, 1998.

[T.D. 8238, 54 FR 289, Jan. 5, 1989, as amended by T.D. 8752, 63 FR 410, Jan. 6, 1998]

§1.355–2 Limitations.

(a) *Property distributed.* Section 355 applies to a distribution only if the property distributed consists solely of stock, or stock and securities, of a controlled corporation. If additional property (including an excess principal amount of securities received over securities surrendered) is received, see section 356.

(b) *Independent business purpose*—(1) *Independent business purpose requirement.* Section 355 applies to a transaction only if it is carried out for one or more corporate business purposes. A transaction is carried out for a corporate business purpose if it is motivated, in whole or substantial part, by one or more corporate business purposes. The potential for the avoidance of Federal taxes by the distributing or controlled corporations (or a corporation controlled by either) is relevant in determining the extent to which an existing corporate business purpose motivated the distribution. The principal reason for this business purpose requirement is to provide nonrecognition treatment only to distributions that are incident to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms. This business purpose requirement is independent of the other requirements under section 355.

(2) *Corporate business purpose.* A corporate business purpose is a real and substantial non Federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group (as defined in §1.355–3(b)(4)(iv)) to which the distributing corporation belongs. A purpose of reducing non Federal taxes is not a corporate business purpose if (i) the transaction will effect a reduction in both Federal and non Federal taxes because of similarities between Federal tax law and the tax law of the other jurisdiction and (ii) the reduction of Federal taxes is greater than or substantially coextensive with the reduction of non Federal taxes. See *Examples (7)* and *(8)* of paragraph (b)(5) of this section. A shareholder purpose (for example, the personal planning purposes of a shareholder) is not a corporate business purpose. Depending upon the facts of a particular case, however, a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them. In such a case, the transaction is carried out for one or more corporate business purposes. See *Example (2)* of paragraph (b)(5) of this section.

(3) *Business purpose for distribution.* The distribution must be carried out for one or more corporate business purposes. See *Example (3)* of paragraph (b)(5) of this section. If a corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive, then, for purposes of paragraph (b)(1) of this section, the separation is not carried out for that

corporate business purpose. See *Examples (3)* and *(4)* of paragraph (b)(5) of this section. For rules with respect to the requirement of a business purpose for a transfer of assets to a controlled corporation in connection with a reorganization described in section 368(a)(1)(D), *See* § 1.368–1(b).

(4) *Business purpose as evidence of nondevice.* The corporate business purpose or purposes for a transaction are evidence that the transaction was not used principally as a device for the distribution of earnings and profits within the meaning of section 355(a)(1)(B). *See* paragraph (d)(3)(ii) of this section.

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

Example (1). Corporation X is engaged in the production, transportation, and refining of petroleum products. In 1985, X acquires all of the properties of corporation Z, which is also engaged in the production, transportation, and refining of petroleum products. In 1991, as a result of antitrust litigation, X is ordered to divest itself of all of the properties acquired from Z. X transfers those properties to new corporation Y and distributes the stock of Y pro rata to X's shareholders. In view of the divestiture order, the distribution is carried out for a corporate business purpose. See paragraph (b)(1) of this section.

Example (2). Corporation X is engaged in two businesses: The manufacture and sale of furniture and the sale of jewelry. The businesses are of equal value. The outstanding stock of X is owned equally by unrelated individuals A and B. A is more interested in the furniture business, while B is more interested in the jewelry business. A and B decide to split up the businesses and go their separate ways. A and B anticipate that the operations of each business will be enhanced by the separation because each shareholder will be able to devote his undivided attention to the business in which he is more interested and more proficient. Accordingly, X transfers the jewelry business to new corporation Y and distributes the stock of Y to B in exchange for all of B's stock in X. The distribution is carried out for a corporate business purpose, notwithstanding that it is also carried out in part for shareholder purposes. See paragraph (b)(2) of this section.

Example (3). Corporation X is engaged in the manufacture and sale of toys and the manufacture and sale of candy. The shareholders of X wish to protect the candy business from the risks and vicissitudes of the toy business. Accordingly, X transfers the toy business to new corporation Y and distributes the stock of Y to X's shareholders. Under applicable law, the purpose of protecting the candy business from the risks and vicissitudes of the toy business is achieved as soon as X transfers the toy business to Y. Therefore, the distribution is not carried out for a corporate business purpose. See paragraph (b)(3) of this section.

Example (4). Corporation X is engaged in a regulated business in State T. X owns all of the stock of corporation Y, a profitable corporation that is not engaged in a regulated business. Commission C sets the rates that X may charge its customers, based on its total income. C has recently adopted rules according to which the total income of a corporation includes the income of a business if, and only if, the business is operated, directly or indirectly, by the corporation. Total income, for this purpose, includes the income of a wholly owned subsidiary corporation but does not include the income of a parent or ''brother/sister'' corporation. Under C's new rule, X's total income includes the income of Y, with the result that X has suffered a reduction of the rates that it may charge its customers. It would not be impractical or unduly expensive to create in a nontaxable transaction (such as a transaction qualifying under section 351) a holding company to hold the stock of X and Y. X distributes the stock of Y to X's shareholders. The distribution is not carried out for the purpose of increasing the rates that X may charge its customers because that purpose could be achieved through a nontaxable transaction, the creation of a holding company, that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive. See paragraph (b)(3) of this section.

Example (5). The facts are the same as in *Example (4)*, except that C has recently adopted rules according to which the total income of a corporation includes not only the income included in *Example (3)*, but also the income of any member of the affiliated group to which the corporation belongs. In order to avoid a reduction in the rates that it may charge its customers, X distributes the stock of Y to X's shareholders. The distribution is carried out for a corporate business purpose. See paragraph (b)(3) of this section.

Example (6). (i) Corporation X owns all of the one class of stock of corporation Y. X distributes the stock of Y pro rata to its five shareholders, all of whom are individuals, for the sole purpose of enabling X and/or Y to elect to become an S corporation. The distribution does not meet the corporate business purpose requirement. See paragraph (b)(1) and (2) of this section.

(ii) The facts are the same as in *Example 6(i)*, except that the business of Y is operated as a division of X. X transfers this division to new corporation Y and distributes the stock of Y pro rata to its shareholders, all of whom are individuals, for the sole purpose of enabling X and/or Y to elect to become an S corporation. The distribution does not meet the corporate business purpose requirement. See paragraph (b)(1) and (2) of this section.

Example (7). The facts are the same as in *Example (6)(i),* except that the distribution is made to enable X to elect to become an S corporation both for Federal tax purposes and for purposes of the income tax imposed by State M. State M has tax law provisions similar to subchapter S of the Internal Revenue Code of 1986. An election to be an S corporation for Federal tax purposes will effect a substantial reduction in Federal taxes that is greater than the reduction of State M taxes pursuant to an election to be an S corporation for State M purposes. The purpose of reducing State M taxes is not a corporate business purpose. The distribution does not meet the corporate business purpose requirements. See paragraph (b)(1) and (2) of this section.

Example (8). The facts are the same as *Example (7),* except that the distribution also is made to enable *A,* a key employee of Y, to acquire stock of Y without investing in X. A is considered to be critical to the success of Y and he has indicated that he will seriously consider leaving the company if he is not given the opportunity to purchase a significant amount of stock of Y. As a matter of state law, Y could not issue stock to the employee while it was a subsidiary of X. As in *Example (7),* the purpose of reducing State M taxes is not a corporate business purpose. In order to determine whether the issuance of stock to the key employee, in fact, motivated the distribution of the Y stock, the potential avoidance of Federal taxes is a relevant factor to take into account. If the facts and circumstances establish that the distribution was substantially motivated by the need to issue stock to the employee, the distribution will meet the corporate business purpose requirement.

(c) *Continuity of interest requirement*—(1) *Requirement.* Section 355 applies to a separation that effects only a readjustment of continuing interests in the property of the distributing and controlled corporations. In this regard section 355 requires that one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation. This continuity of interest requirement is independent of the other requirements under section 355.

(2) *Examples.*

Example (1). For more than five years, corporation X has been engaged directly in one business, and indirectly in a different business through its wholly owned subsidiary, S. The businesses are equal in value. At all times, the outstanding stock of X has been owned equally by unrelated individuals A and B. For valid business reasons, A and B cause X to distribute all of the stock of S to B in exchange for all of B's stock in X. After the transaction, A owns all the stock of X and B owns all the stock of S. The continuity of interest requirement is met because one or more persons who were the owners of X prior to the distribution (A and B) own, in the aggregate, an amount of stock establishing a continuity of interest in each of X and S after the distribution.

Example (2). Assume the same facts as in *Example (1),* except that pursuant to a plan to acquire a stock interest in X without acquiring, directly or indirectly, an interest in S, C purchased one-half of the X stock owned by A and immediately thereafter X distributed all of the S stock to B in exchange for all of B's stock in X. After the transactions, A owns 50 percent of X and B owns 100 percent of S. The distribution by X of all of the stock of S to B in exchange for all of B's stock in X will satisfy the continuity of interest requirement for section 355 because one or more persons who were the owners of X prior to the distribution (A and B) own, in the aggregate, an amount of stock establishing a continuity of interest in each of X and S after the distribution.

Example (3). Assume the same facts as in *Examples (1) and (2),* except that C purchased all of the X stock owned by A. After the transactions, neither A nor B own any of the stock of X, and B owns all the stock of S. The continuity of interest requirement is not met because the owners of X prior to the distribution (A and B) do not, in the aggregate, own an amount of stock establishing a continuity of interest in each of X and S after the distribution, *i.e.,* although A and B collectively have retained 50 percent of their equity interest in the former combined enterprise, they have failed to continue to own the minimum stock interest in the distributing corporation, X, that would be required in order to meet the continuity of interest requirement.

Example (4). Assume the same facts as in *Examples (1) and (2),* except that C purchased 80 percent of the X stock owned by A. After the transactions, A owns 20 percent of the stock of X, B owns no X stock, and B owns 100 percent of the S stock. The continuity of interest requirement is not met because the owners of X prior to the distribution (A and B) do not, in the aggregate, have a continuity of interest in each of X and S after the distribution, *i.e.*, although A and B collectively have retained 60 percent of their equity interest in the former combined enterprise, the 20 percent interest of A in X is less than the minimum equity interest in the distributing corporation, X, that would be required in order to meet the continuity of interest requirement.

(d) *Device for distribution of earnings and profits*—(1) *In general.* Section 355 does not apply to a transaction used principally as a device for the distribution of the earnings and profits of the distributing corporation, the controlled corporation, or both (a ''device''). Section 355 recognizes that a tax-free distribution of the stock of a controlled corporation presents a potential for tax avoidance by facilitating the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock of one corporation and the retention of the stock of another corporation. A device can include a transaction that effects a recovery of basis. In this paragraph (d), ''exchange'' includes transactions, such as redemptions, treated as exchanges under the Code. Generally, the determination of whether a transaction was used principally as a device will be made from all of the facts and circumstances, including, but not limited to, the presence of the device factors specified in paragraph (d)(2) of this section (''evidence of device''), and the presence of the nondevice factors specified in paragraph (d)(3) of this section (''evidence of nondevice''). However, if a transaction is specified in paragraph (d)(5) of this section, then it is ordinarily considered not to have been used principally as a device.

(2) *Device factors*—(i) *In general.* The presence of any of the device factors specified in this subparagraph (2) is evidence of device. The strength of this evidence depends on the facts and circumstances.

(ii) *Pro rata distribution.* A distribution that is pro rata or substantially pro rata among the shareholders of the distributing corporation presents the greatest potential for the avoidance of the dividend provisions of the Code and, in contrast to other types of distributions, is more likely to be used principally as a device. Accordingly, the fact that a distribution is pro rata or substantially pro rata is evidence of device.

(iii) *Subsequent sale or exchange of stock*—(A) *In general.* A sale or exchange of stock of the distributing or the controlled corporation after the distribution (a ''subsequent sale or exchange'') is evidence of device. Generally, the greater the percentage of the stock sold or exchanged after the distribution, the stronger the evidence of device. In addition, the shorter the period of time between the distribution and the sale or exchange, the stronger the evidence of device.

(B) *Sale or exchange negotiated or agreed upon before the distribution.* A subsequent sale or exchange pursuant to an arrangement negotiated or agreed upon before the distribution is substantial evidence of device.

(C) *Sale or exchange not negotiated or agreed upon before the distribution.* A subsequent sale or exchange not pursuant to an arrangement negotiated or agreed upon before the distribution is evidence of device.

(D) *Negotiated or agreed upon before the distribution.* For purposes of this subparagraph (2), a sale or exchange is always pursuant to an arrangement negotiated or agreed upon before the distribution if enforceable rights to buy or sell existed before the distribution. If a sale or exchange was discussed by the buyer and the seller before the distribution and was reasonably to be anticipated by both parties, then the sale or exchange will ordinarily be considered to be pursuant to an arrangement negotiated or agreed upon before the distribution.

(E) *Exchange in pursuance of a plan of reorganization.* For purposes of this subparagraph (2), if stock is exchanged for stock in pursuance of a plan of reorganization, and either no gain or loss or only an insubstantial amount of gain is recognized on the exchange, then the exchange is not treated as a subsequent sale or exchange, but the stock received in the exchange is treated as the stock surrendered in the exchange. For this purpose, gain treated as a dividend pursuant to sections 356(a)(2) and 316 shall be disregarded.

(iv) *Nature and use of assets*—(A) *In general.* The determination of whether a transaction was used principally as a device will take into account the nature, kind, amount, and use of the assets of the distributing and the controlled corporations (and corporations controlled by them) immediately after the transaction.

(B) *Assets not used in a trade or business meeting the requirement of section 355(b).* The existence of assets that are not used in a trade or business that satisfies the requirements of section 355(b) is evidence of device. For this purpose, assets that are not used in a trade or business that satisfies the requirements of section 355(b) include, but are not limited to, cash and other liquid assets that are not related to the reasonable needs of a business satisfying such section. The strength of the evidence of device depends on all the facts and circumstances, including, but not limited to, the ratio for each corporation of the value of assets not used in a trade or business that satisfies the requirements of section 355(b) to the value of its business that satisfies such requirements. A difference in the ratio described in the preceding sentence for the distributing and controlled corporation is ordinarily not evidence of device if the distribution is not pro rata among the shareholders of the distributing corporation and such difference is attributable to a need to equalize the value of the stock distributed and the value of the stock or securities exchanged by the distributees.

(C) *Related function.* There is evidence of device if a business of either the distributing or controlled corporation (or a corporation controlled by it) is (*1*) a ‘‘secondary business’’ that continues as a secondary business for a significant period after the separation, and (*2*) can be sold without adversely affecting the business of the other corporation (or a corporation controlled by it). A secondary business is a business of either the distributing or controlled corporation, if its principal function is to serve the business of the other corporation (or a corporation controlled by it). A secondary business can include a business transferred to a newly-created subsidiary or a business which serves a business transferred to a newly-created subsidiary. The activities of the secondary business may consist of providing property or performing services. Thus, in *Example (11)* of §1.355–3(c), evidence of device would be presented if the principal function of the coal mine (satisfying the requirements of the steel business) continued after the separation and the coal mine could be sold without adversely affecting the steel business. Similarly, in *Example (10)* of §1.355–3(c), evidence of device would be presented if the principal function of the sales operation after the separation is to sell the output from the manufacturing operation and the sales operation could be sold without adversely affecting the manufacturing operation.

(3) *Nondevice factors*—(i) *In general.* The presence of any of the nondevice factors specified in this subparagraph (3) is evidence of nondevice. The strength of this evidence depends on all of the facts and circumstances.

(ii) *Corporate business purpose.* The corporate business purpose for the transaction is evidence of nondevice. The stronger the evidence of device (such as the presence of the device factors specified in paragraph (d)(2) of this section), the stronger the corporate business purpose required to prevent the determination that the transaction was used principally as a device. Evidence of device presented by the transfer or retention of assets not used in a trade or business that satisfies the requirements of section 355(b) can be outweighed by the existence of a corporate business purpose for those transfers or retentions. The assessment of the strength of a corporate business purpose will be based on all of the facts and circumstances, including, but not limited to, the following factors:

(A) The importance of achieving the purpose to the success of the business;

(B) The extent to which the transaction is prompted by a person not having a proprietary interest in either corporation, or by other outside factors beyond the control of the distributing corporation; and

(C) The immediacy of the conditions prompting the transaction.

(iii) *Distributing corporation publicly traded and widely held.* The fact that the distributing corporation is publicly traded and has no shareholder who is directly or indirectly the beneficial owner of more than five percent of any class of stock is evidence of nondevice.

(iv) *Distribution to domestic corporate shareholders.* The fact that the stock of the controlled corporation is distributed to one or more domestic corporations that, if section 355 did not apply, would be entitled to a deduction under section 243(a)(1) available to corporations meeting the stock ownership requirements of section 243(c), or a deduction under section 243(a)(2) or (3) or 245(b) is evidence of nondevice.

(4) *Examples.* The provisions of paragraph (d)(1) through (3) of this section may be illustrated by the following examples:

Example (1). Individual A owns all of the stock of corporation X, which is engaged in the warehousing business. X owns all of the stock of corporation Y, which is engaged in the transportation business. X employs individual B, who is extremely knowledgeable of the warehousing business in general and the operations of X in particular. B has informed A that he will seriously consider leaving the company if he is not given the opportunity to purchase a significant amount of stock of X. Because of his knowledge and experience, the loss of B would seriously damage the business of X. B cannot afford to purchase any significant amount of stock of X as long as X owns Y. Accordingly, X distributes the stock of Y to A and A subsequently sells a portion of his X stock to B. However, X could have issued additional shares to B sufficient to give B an equivalent ownership interest in X. There is no other evidence of device or evidence of nondevice. In light of the fact that X could have issued additional shares to B, the sale of X stock by A is substantial evidence of device. The transaction is considered to have been used principally as a device. See paragraph (d)(1), (2)(ii), (iii)(A), (B) and (D), and (3)(i) and (ii) of this section.

Example (2). Corporation X owns and operates a fast food restaurant in State M and owns all of the stock of corporation Y, which owns and operates a fast food restaurant in State N. X and Y operate their businesses under franchises granted by D and E, respectively. X owns cash and marketable securities that exceed the reasonable needs of its business but whose value is small relative to the value of its business. E has recently changed its franchise policy and will no longer grant or renew franchises to subsidiaries (or other members of the same affiliated group) of corporations operating businesses under franchises granted by its competitors. Thus, Y will lose its franchise if it remains a subsidiary of X. The franchise is about to expire. Accordingly, X distributes the stock of Y pro rata among X's shareholders. X retains its business and transfers cash and marketable securities to Y in an amount proportional to the value of Y's business. There is no other evidence of device or evidence of nondevice. The transfer by X to Y and the retention by X of cash and marketable securities is relatively weak evidence of device because after the transfer X and Y hold cash and marketable securities in amounts proportional to the values of their businesses. The fact that the distribution is pro rata is evidence of device. A strong corporate business purpose is relatively strong evidence of nondevice. Accordingly, the transaction is considered not to have been used principally as a device. See paragraph (d)(1), (2)(ii), (iv)(A), and (B) and (3)(i) and (ii)(A), (B) and (C) of this section.

Example (3). Corporation X is engaged in a regulated business in State M and owns all of the stock of corporation Y, which is not engaged in a regulated business in State M. State M has recently amended its laws to provide that affiliated corporations operating in M may not conduct both regulated and unregulated businesses. X transfers cash not related to the reasonable needs of the business of X or Y to Y and then distributes the stock of Y pro rata among X's shareholders. As a result of the transfer of cash, the ratio of the value of its assets not used in a trade or business that satisfies the requirements of section 355(b) to the value of its business is substantially greater for Y than for X. There is no other evidence of device or evidence of nondevice. The transfer of cash by X to Y is relatively strong evidence of device because after the transfer Y holds disproportionately many assets that are not used in a trade or business that satisfies the requirements of section 355(b). The fact that the distribution is pro rata is evidence of device. The strong business purpose is relatively strong evidence of nondevice, but it does not pertain to the transfer. Accordingly, the transaction is considered to have been used principally as a device. See paragraph (d)(1), (2)(ii), (iv)(A) and (B), and (3) and (i) and (ii) of this section.

Example (4). The facts are the same as in *Example (3),* except that, instead of transferring cash to Y, X purchases operating assets unrelated to the business of Y and transfers them to Y prior to the distribution. There is no other evidence of device or evidence of nondevice. The transaction is considered to have been used principally as a device. See paragraph (d)(1), (2)(ii), (iv)(A) and (B), and (3)(i) and (ii) of this section.

(5) *Transactions ordinarily not considered as a device*—(i) *In general.* This subparagraph (5) specifies three distributions that ordinarily do not present the potential for tax avoidance described in paragraph (d)(1) of this section. Accordingly, such distributions are ordinarily considered not to have been used

principally as a device, notwithstanding the presence of any of the device factors described in paragraph (d)(2) of this section. A transaction described in paragraph (d)(5)(iii) or (iv) of this section is not protected by this subparagraph (5) from a determination that it was used principally as a device if it involves the distribution of the stock of more than one controlled corporation and facilitates the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock of one corporation and the retention of the stock of another corporation.

(ii) *Absence of earnings and profits.* A distribution is ordinarily considered not to have been used principally as a device if—

(A) The distributing and controlled corporations have no accumulated earnings and profits at the beginning of their respective taxable years,

(B) The distributing and controlled corporations have no current earnings and profits as of the date of the distribution, and

(C) No distribution of property by the distributing corporation immediately before the separation would require recognition of gain resulting in current earnings and profits for the taxable year of the distribution.

(iii) *Section 303(a) transactions.* A distribution is ordinarily considered not to have been used principally as a device if, in the absence of section 355, with respect to each shareholder distributee, the distribution would be a redemption to which section 303(a) applied.

(iv) *Section 302(a) transactions.* A distribution is ordinarily considered not to have been used principally as a device if, in the absence of section 355, with respect to each shareholder distributee, the distribution would be a redemption to which section 302(a) applied. For purposes of the preceding sentence, section 302(c)(2)(A)(ii) and (iii) shall not apply.

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

Example (1) . The facts are the same as in *Example (3)* of paragraph (d)(4) of this section, except that X and Y had no accumulated earnings and profits at the beginning of its taxable year, X and Y have no current earnings and profits as of the date of the distribution, and no distribution of property by X immediately before the separation would require recognition of gain that would result in earnings and profits for the taxable year of the distribution. The transaction is considered not to have been used principally as a device. See paragraph (d)(5)(i) and (ii) of this section.

Example (2) . Corporation X is engaged in three businesses: a hotel business, a restaurant business, and a rental real estate business. Individuals A, B, and C own all of the stock of X. X transfers the restaurant business to new corporation Y and transfers the rental real estate business to new corporation Z. X then distributes the stock of Y and Z pro rata between B and C in exchange for all of their stock in X. In the absence of section 355, the distribution would be a redemption to which section 302(a) applied. Since this distribution involves the stock of more than one controlled corporation and facilitates the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock in one corporation and the retention of the stock of another corporation, it is not protected by paragraph (d)(5)(i) and (iv) of this section from a determination that it was used principally as a device. Thus, the determination of whether the transaction was used principally as a device must be made from all the facts and circumstances, including the presence of the device factors and nondevice factors specified in paragraph (d)(2) and (3) of this section.

(e) *Stock and securities distributed*—(1) *In general.* Section 355 applies to a distribution only if the distributing corporation distributes—

(i) All of the stock and securities of the controlled corporation that it owns, or

(ii) At least an amount of the stock of the controlled corporation that constitutes control as defined in section 368(c). In such a case, all, or any part, of the securities of the controlled corporation may be distributed, and paragraph (e)(2) of this section shall apply.

(2) *Additional rules.* Where a part of either the stock or the securities of the controlled corporation is retained under paragraph (e)(1)(ii) of this section, it must be established to the satisfaction of the Commissioner that the retention by the distributing corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.

Ordinarily, the corporate business purpose or purposes for the distribution will require the distribution of all of the stock and securities of the controlled corporation. If the distribution of all of the stock and securities of a controlled corporation would be treated to any extent as a distribution of ''other property'' under section 356, this fact tends to establish that the retention of stock or securities is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.

(f) *Principal amount of securities*—(1) *Securities received.* Section 355 does not apply to a distribution if, with respect to any shareholder or security holder, the principal amount of securities received exceeds the principal amount of securities surrendered, or securities are received but no securities are surrendered. In such cases, see section 356.

(2) *Only stock received.* If only stock is received in a distribution to which section 355(a)(1)(A) applies, the principal amount of the securities surrendered, if any, and the par value or stated value of the stock surrendered, if any, are not relevant to the application of that section.

(g) *Period of ownership*—(1) *Other property.* For purposes of section 355(a)(1)(A), stock of a controlled corporation acquired in a transaction in which gain or loss was recognized in whole or in part (other than a transaction described in §1.355–3(b)(4)(iii)) within the five-year period ending on the date of the distribution shall not be treated as stock of the controlled corporation but shall be treated as ''other property.'' See section 356. However, for purposes of section 355(a)(1)(D), the stock so acquired is stock of the controlled corporation.

(2) *Example.* Paragraph (g)(1) of this section may be illustrated by the following example:

Example. Corporation X has held 85 of the 100 outstanding shares of the stock of corporation Y for more than five years on the date of the distribution. Six months before that date, X purchased ten more shares. If X distributes all of its 95 shares of the stock of Y, so much of section 356 as relates to section 355 may apply to the transaction and the ten newly acquired shares are treated as other property. On the other hand, if X retains ten of the shares of the stock of Y then the application of paragraph (e) of this section must take into account all of the stock of Y, including the ten shares newly acquired by X and the five shares owned by others. Similarly, if, by the use of any agency, X acquired any of the stock of Y within the five-year period ending on the date of the distribution in a transaction in which gain or loss was recognized in whole or in part (for example, where another subsidiary of X purchased stock of Y), then that stock is treated as other property. If X had held only 75 of the 100 outstanding shares of the stock of Y for more than five years on the date of the distribution and had purchased the remaining 25 shares six months before that date, then neither section 355 nor section 356 would apply to the distribution.

(h) *Active conduct of a trade or business.* Section 355 applies to a distribution only if the requirements of §1.355–3 (relating to the active conduct of a trade or business) are satisfied.

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§1.355–3 Active conduct of a trade or business.

(a) *General requirements*—(1) *Application of section 355.* Under section 355(b)(1), a distribution of stock, or stock and securities, of a controlled corporation qualifies under section 355 only if—

(i) The distributing and the controlled corporations are each engaged in the active conduct of a trade or business immediately after the distribution (section 355(b)(1)(A)), or

(ii) Immediately before the distribution, the distributing corporation had no assets other than stock or securities of the controlled corporations, and each of the controlled corporations is engaged in the active conduct of a trade or business immediately after the distribution (section 355(b)(1)(B)). A *de minimis* amount of assets held by the distributing corporation shall be disregarded for purposes of this paragraph (a)(1)(ii).

(2) *Examples.* Paragraph (a)(1) of this section may be illustrated by the following examples:

Example (1). Prior to the distribution, corporation X is engaged in the active conduct of a trade or business and owns all of the stock of corporation Y, which also is engaged in the active conduct of a trade or business. X distributes all of the stock of Y to X's shareholders, and each corporation continues the active conduct of its trade or business. The active business requirement of section 355(b)(1)(A) is satisfied.

Example (2). The facts are the same as in *Example (1)*, except that X transfers all of its assets other than the stock of Y to a new corporation in exchange for all of the stock of the new corporation and then distributes the stock of both controlled corporations to X's shareholders. The active business requirement of section 355(b)(1)(B) is satisfied.

(b) *Active conduct of a trade or business defined*—(1) *In general.* Section 355(b)(2) provides rules for determining whether a corporation is treated as engaged in the active conduct of a trade or business for purposes of section 355(b)(1). Under section 355(b)(2)(A), a corporation is treated as engaged in the active conduct of a trade or business if it is itself engaged in the active conduct of a trade or business or if substantially all of its assets consist of the stock, or stock and securities, of a corporation or corporations controlled by it (immediately after the distribution) each of which is engaged in the active conduct of a trade or business.

(2) *Active conduct of a trade or business immediately after distribution*—(i) *In general.* For purposes of section 355(b), a corporation shall be treated as engaged in the ‘‘active conduct of a trade or business’’ immediately after the distribution if the assets and activities of the corporation satisfy the requirements and limitations described in paragraph (b)(2)(ii), (iii), and (iv) of this section.

(ii) *Trade or business.* A corporation shall be treated as engaged in a trade or business immediately after the distribution if a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit. Such group of activities ordinarily must include the collection of income and the payment of expenses.

(iii) *Active conduct.* For purposes of section 355(b), the determination whether a trade or business is actively conducted will be made from all of the facts and circumstances. Generally, the corporation is required itself to perform active and substantial management and operational functions. Generally, activities performed by the corporation itself do not include activities performed by persons outside the corporation, including independent contractors. A corporation may satisfy the requirements of this subdivision (iii) through the activities that it performs itself, even though some of its activities are performed by others. Separations of real property all or substantially all of which is occupied prior to the distribution by the distributing or the controlled corporation (or by any corporation controlled directly or indirectly by either of those corporations) will be carefully scrutinized with respect to the requirements of section 355(b) and this §1.355–3.

(iv) *Limitations.* The active conduct of a trade or business does not include—

(A) The holding for investment purposes of stock, securities, land, or other property, or

(B) The ownership and operation (including leasing) of real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property.

(3) *Active conduct for five-year period preceding distribution.* Under section 355(b)(2)(B), a trade or business that is relied upon to meet the requirements of section 355(b) must have been actively conducted throughout the five-year period ending on the date of the distribution. For purposes of this subparagraph (3)—

(i) Activities which constitute a trade or business under the tests described in paragraph (b)(2) of this section shall be treated as meeting the requirement of the preceding sentence if such activities were actively conducted throughout the 5-year period ending on the date of distribution, and

(ii) The fact that a trade or business underwent change during the five-year period preceding the distribution (for example, by the addition of new or the dropping of old products, changes in production capacity, and the like) shall be disregarded, provided that the changes are not of such a character as to constitute the acquisition of a new or different business. In particular, if a corporation engaged in the active conduct of one trade or business during that five-year period purchased, created, or otherwise acquired another trade or business in the same line of business, then the acquisition of that other business is ordinarily treated as an expansion of the original business, all of which is treated as having been actively conducted during that five-year period, unless that purchase, creation, or other acquisition effects a change of such a character as to constitute the acquisition of a new or different business.

(4) *Special rules for acquisition of a trade or business (Prior to the Revenue Act of 1987 and Technical and Miscellaneous Revenue Act of 1988)*—(i) *In general.* Under section 355(b)(2)(C), a trade or business relied upon to meet the requirements of section 355(b) must not have been acquired by the distributing corporation, the controlled corporation, or another member of the affiliated group during the five-year period ending on the date of the distribution unless it was acquired in a transaction in which no gain or loss was recognized. Similarly, under section 355(b)(2)(D), the trade or business must not have been indirectly acquired by any of those corporations (or a predecessor in interest of any of those corporations) during that five-year period in a transaction in which gain or loss was recognized in whole or in part and which consisted of the acquisition of control of the corporation directly engaged in the trade or business, or the indirect acquisition of control of that corporation through the direct or indirect acquisition of control of one or more other corporations. A trade or business acquired, directly or indirectly, within the five-year period ending on the date of the distribution in a transaction in which the basis of the assets acquired was not determined in whole or in part by reference to the transferor's basis does not qualify under section 355(b)(2), even though no gain or loss was recognized by the transferror.

(ii) *Example.* Paragraph (b)(4)(i) of this section may be illustrated by the following example:

Example. In 1985, corporation X, which operates a business and has cash and other liquid assets, purchases all of the stock of corporation Y, which is engaged in the active conduct of a trade or business. Later in the same year, X merges into Y in a ''downstream'' statutory merger. In 1986, Y transfers the business assets formerly owned by X to a new subsidiary, corporation Z, and then distributes the stock of Z to Y's shareholders. Section 355 does not apply to the distribution of the stock of Z because the trade or business of Y was indirectly acquired by X, a predecessor in interest of Y, during the five-year period preceding the distribution.

(iii) *Gain or loss recognized in certain transactions.* The requirements of section 355(b)(2)(C) and (D) are intended to prevent the direct or indirect acquisition of a trade or business by a corporation in anticipation of a distribution by the corporation of that trade of business in a distribution to which section 355 would otherwise apply. A direct or indirect acquisition of a trade or business by one member of an affiliated group from another member of the group is not the type of transaction to which section 355(b)(2)(C) and (D) is intended to apply. Therefore, in applying section 355(b)(2)(C) or (D), such an acquisition, even though taxable, shall be disregarded.

(iv) *Affiliated group.* For purposes of this subparagraph (4), the term *affiliated group* means an affiliated group as defined in section 1504(a) (without regard to section 1504(b)), except that the term *stock* includes nonvoting stock described in section 1504(a)(4).

(5) *Special rules for acquisition of a trade or business (After the Revenue Act of 1987 and Technical and Miscellaneous Revenue Act of 1988).* [Reserved]

(c) *Examples.* The following examples illustrate section 355(b)(2)(A) and (B) and paragraph (b)(1), (2), and (3) of this section. However, a transaction that satisfies these active business requirements will qualify under section 355 only if it satisfies the other requirements of section 355 (a) and (b).

Example (1). Corporation X is engaged in the manufacture and sale of soap and detergents and also owns investment securities. X transfers the investment securities to new subsidiary Y and distributes the stocks of Y to X's shareholders. Y does not satisfy the requirements of section 355(b) because the holding of investment securities does not constitute the active conduct of a trade or business. See paragraph (b)(2)(iv)(A) of this section.

Example (2). Corporation X owns, manages, and derives rental income from an office building and also owns vacant land. X transfers the land to new subsidiary Y and distributes the stock of Y to X's shareholders. Y will subdivide the land, install streets and utilities, and sell the developed lots to various homebuilders. Y does not satisfy the requirements of section 355(b) because no significant development activities were conducted with respect to the land during the five-year period ending on the date of the distribution. See paragraph (b)(3) of this section.

Example (3). Corporation X owns land on which it conducts a ranching business. Oil has been discovered in the area, and it is apparent that oil may be found under the land on which the ranching business is conducted. X has engaged in no significant activities in connection with its mineral rights. X transfers its mineral rights to new subsidiary Y and distributes the stock of Y to X's shareholders. Y will actively pursue the development of the oil producing potential of the property. Y does not satisfy the requirements of section 355(b) because X engaged in no significant exploitation activities with respect to the mineral rights during the five-year period ending on the date of the distribution. See paragraph (b)(3) of this section.

Example (4). For more than five years, corporation X has conducted a single business of constructing sewage disposal plants and other facilities. X transfers one-half of its assets to new subsidiary Y. These assets include a contract for the construction of a sewage disposal plant in State M, construction equipment, cash, and other tangible assets. X retains a contract for the construction of a sewage disposal plant in State N, construction equipment, cash, and other intangible assets. X then distributes the stock of Y to one of X's shareholders in exchange for all of his stock of X. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section.

Example (5). For the past six years, corporation X has owned and operated two factories devoted to the production of edible pork skins. The entire output of one factory is sold to one customer, C, while the output of the second factory is sold to C and a number of other customers. To eliminate errors in packaging, X opens a new factory. Thereafter, orders from C are processed and packaged at the two original factories, while the new factory handles only orders from other customers. Eight months after opening the new factory, X transfers it and related business assets to new subsidiary Y and distributes the stock of Y to X's shareholders. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) and (ii) of this section.

Example (6). Corporation X has owned and operated a men's retail clothing store in the downtown area of the City of G for nine years and has owned and operated another men's retail clothing store in a suburban area of G for seven years. X transfers the store building, fixtures, inventory, and other assets related to the operations of the suburban store to new subsidiary Y. X also transfers to Y the delivery trucks and delivery personnel that formerly served both stores. Henceforth, X will contract with a local public delivery service to make its deliveries. X retains the warehouses that formerly served both stores. Henceforth, Y will lease warehouse space from an unrelated public warehouse company. X then distributes the stock of Y to X's shareholders. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section.

Example (7). For the past nine years, corporation X has owned and operated a department store in the downtown area of the City of G. Three years ago, X acquired a parcel of land in a suburban area of G and constructed a new department store on it. X transfers the suburban store and related business assets to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, each store has its own manager and is operated independently of the other store. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) and (ii) of this section.

Example (8). For the past six years, corporation X has owned and operated hardware stores in several states. Two years ago, X purchased all of the assets of a hardware store in State M, where X had not previously conducted business. X transfers the State M store and related business assets to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, the State M store has its own manager and is operated independently of the other stores. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) and (ii) of this section.

Example (9). For the past eight years, corporation X has engaged in the manufacture and sale of household products. Throughout this period, X has maintained a research department for use in connection with its manufacturing activities. The research department has 30 employees actively engaged in the development of new products. X transfers the research department to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, Y continues its research operations on a contractual basis with several corporations, including X. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section. The result in this example is the same if, after the distribution, Y continues its research operations but furnishes its services only to X. See paragraph (b)(3)(i) of this section. However, see §1.355–2 (d)(2)(iv)(C) (related function device factor) for possible evidence of device.

Example (10). For the past six years, corporation X has processed and sold meat products. X derives income from no other source. X separates the sales function from the processing function by transferring the business assets related to the sales function and cash for working capital to new subsidiary Y. X then distributes the stock of Y to X's shareholders. After the distribution, Y purchases for resale the meat products processed by X. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section. However, see §1.355–2(d)(2)(iv)(C) (related function device factor) for possible evidence of device.

Example (11) . For the past eight years, corporation X has been engaged in the manufacture and sale of steel and steel products. X owns all of the stock of corporation Y, which, for the past six years, has owned and operated a coal mine for the sole purpose of supplying X's coal requirements in the manufacture of steel. X distributes the stock of Y to X's shareholders. X and Y both satisfy the requirements of section 355 (b). See paragraph (b)(3)(i) of this section. However, see §1 1.355–2 (d)(2)(iv)(C) (related function device factor) for possible evidence of device.

Example (12) . For the past seven years, corporation X, a bank, has owned an eleven-story office building, the ground floor of which X has occupied in the conduct of its banking business. The remaining ten floors are rented to various tenants. Throughout this seven-year period, the building has been managed and maintained by employees of the bank. X transfers the building to new subsidiary Y and distributes the stock of Y to X's shareholders. Henceforth, Y will manage the building, negotiate leases, seek new tenants, and repair and maintain the building. X and Y both satisfy the requirements of section 355 (b). See paragraph (b)(3) of this section.

Example (13) . For the past nine years, corporation X, a bank, has owned a two-story building, the ground floor and one half of the second floor of which X has occupied in the conduct of its banking business. The other half of the second floor has been rented as storage space to a neighboring retail merchant. X transfers the building to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, X leases from Y the space in the building that it formerly occupied. Under the lease, X will repair and maintain its portion of the building and pay property taxes and insurance. Y does not satisfy the requirements of section 355 (b) because it is not engaged in the active conduct of a trade or business immediately after the distribution. See paragraph (b)(2)(iv)(A) of this section. This example does not address the question of whether the activities of X with respect to the building prior to the separation would constitute the active conduct of a trade or business.

[T.D. 8238, 54 FR 294, Jan. 5, 1989]

§1.355–4 Non pro rata distributions, etc.

Section 355 provides for nonrecognition of gain or loss with respect to a distribution whether or not (a) the distribution is pro rata with respect to all of the shareholders of the distributing corporation, (b) the distribution is pursuant to a plan of reorganization within the meaning of section 368 (a) (1)(D), or (c) the shareholder surrenders stock in the distributing corporation. Under section 355, the stock of a controlled corporation may consist of common stock or preferred stock. (See, however, section 306 and the regulations thereunder.) Section 355 does not apply, however, if the substance of a transaction is merely an exchange between shareholders or security holders of stock or securities in one corporation for stock or securities in another corporation. For example, if two individuals, A and B, each own directly 50 percent of the stock of corporation X and 50 percent of the stock of corporation Y, section 355 would not apply to a transaction in which A and B transfer all of their stock of X and Y to a new corporation Z, for all of the stock of Z, and Z then distributes the stock of X to A and the stock of Y to B.

[T.D. 8238, 54 FR 296, Jan. 5, 1989]

§1.355–5 Records to be kept and information to be filed.

(a) Every corporation that makes a distribution of stock or securities of a controlled corporation, as described in section 355, shall attach to its return for the year of the distribution a detailed statement setting forth such data as may be appropriate in order to show compliance with the provisions of such section.

(b) Every taxpayer who receives a distribution of stock or securities of a corporation that was controlled by a corporation in which he holds stock or securities shall attach to his return for the year in which such distribution is received a detailed statement setting forth such data as may be appropriate in order to show the applicability of section 355. Such statement shall include, but shall not be limited to, a description of the stock and securities surrendered (if any) and received, and the names and addresses of all of the corporations involved in the transaction.

§ 1.355–6 Certain distributions qualifying under section 355 made ineligible for norecognition of gain to the distributing corporation under § 337(d). [Reserved]

[T.D. 8238, 54 FR 296, Jan. 5, 1989]

§ 1.356–1 Receipt of additional consideration in connection with an exchange.

(a) If in any exchange to which the provisions of section 354 or section 355 would apply except for the fact that there is received by the shareholders or the security holders other property (in addition to property permitted to be received without recognition of gain by such sections) or money, then—

(1) The gain, if any, to the taxpayer shall be recognized in an amount not in excess of the sum of the money and the fair market value of the other property, but,

(2) The loss, if any, to the taxpayer from the exchange or distribution shall not be recognized to any extent.

(b) If the distribution of such other property or money by or on behalf of a corporation has the effect of the distribution of a dividend, then there shall be chargeable to each distributee (either an individual or a corporation)—

(1) As a dividend, such an amount of the gain recognized as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and

(2) As a gain from the exchange of property, the remainder of the gain so recognized.

(c) This section may be illustrated by the following examples:

Example (1). In an exchange to which the provisions of section 356 apply and to which section 354 would apply but for the receipt of property not permitted to be received without the recognition of gain or loss, A (either an individual or a corporation), received the following in exchange for a share of stock having an adjusted basis to him of $85:

One share of stock worth	$100
Cash	25
Other property (basis $25) fair market value	50
Total fair market value of consideration received	175
Adjusted basis of stock surrendered in exchange	85
Total gain	90
Gain to be recognized, limited to cash and other property received	75
A's pro rata share of earnings and profits accumulated after February 28, 1913 (taxable dividend)	30
Remainder to be treated as a gain from the exchange of property	45

Example (2). If, in *Example (1),* A's stock had an adjusted basis to him of $200, he would have realized a loss of $25 on the exchange, which loss would not be recognized.

(d) Section 301(b)(1)(B) and section 301(d)(2) do not apply to a distribution of ‘‘other property’’ to a corporate shareholder if such distribution is within the provisions of section 356.

(e) See paragraph (1) of § 1.301–1 for certain transactions which are not within the scope of section 356.

§ 1.356–2 Receipt of additional consideration not in connection with an exchange.

(a) If, in a transaction to which section 355 would apply except for the fact that a shareholder (individual or corporate) receives property permitted by section 355 to be received without the recognition of gain, together with other property or money, without the surrender of any stock or securities of the distributing corporation, then the sum of the money and the fair market value of the other property as of the date of the distribution shall be treated as a distribution of property to which the rules of section 301 (other than section 301(b) and section 301(d)) apply. See section 358 for determination of basis of such other property.

(b) Paragraph (a) of this section may be illustrated by the following examples:

Example (1). Individuals A and B each own 50 of the 100 outstanding shares of common stock of Corporation X. Corporation X owns all of the stock of Corporation Y, 100 shares. Corporation X distributes to each shareholder 50 shares of the stock of Corporation Y plus $100 cash without requiring the surrender of any shares of its own stock. The

$100 cash received by each is treated as a distribution of property to which the rules of section 301 apply.

Example (2). If, in the above example, Corporation X distributes 50 shares of stock of Corporation Y to A and 30 shares of such stock plus $100 cash to B without requiring the surrender of any of its own stock, the amount of cash received by B is treated as a distribution of property to which the rules of section 301 apply.

§ 1.356–3 Rules for treatment of securities as "other property".

(a) As a general rule, for purposes of section 356, the term *other property* includes securities. However, it does not include securities permitted under section 354 or section 355 to be received tax free. Thus, when securities are surrendered in a transaction to which section 354 or section 355 is applicable, the characterization of the securities received as ''other property'' does not include securities received where the principal amount of such securities does not exceed the principal amount of securities surrendered in the transaction. If a greater principal amount of securities is received in an exchange described in section 354 (other than subsection (c) or (d) thereof) or section 355 over the principal amount of securities surrendered, the term *other property* includes the fair market value of such excess principal amount as of the date of the exchange. If no securities are surrendered in exchange, the term *other property* includes the fair market value, as of the date of receipt, of the entire principal amount of the securities received.

(b) Except as provided in § 1.356–6T, for purposes of this section, a right to acquire stock that is treated as a security for purposes of section 354 or 355 has no principal amount. Thus, such right is not other property when received in a transaction to which section 356 applies (regardless of whether securities are surrendered in the exchange). This paragraph (b) applies to transactions occurring on or after March 9, 1998.

(c) In the examples in this paragraph (c), stock means common stock and *warrants* means rights to acquire common stock. The following examples illustrate the rules of paragraph (a) of this section:

Example 1. A, an individual, exchanged 100 shares of stock for 100 shares of stock and a security in the principal amount of $1,000 with a fair market value of $990. The amount of $990 is treated as ''other property.''

Example 2. B, an individual, exchanged 100 shares of stock and a security in the principal amount of $1,000 for 300 shares of stock and a security in the principal amount of $1,500. The security had a fair market value on the date of receipt of $1,575. The fair market value of the excess principal amount, or $525, is treated as ''other property.''

Example 3. C, an individual, exchanged a security in the principal amount of $1,000 for 100 shares of stock and a security in the principal amount of $900. No part of the security received is treated as ''other property.''

Example 4. D, an individual, exchanged a security in the principal amount of $1,000 for 100 shares of stock and a security in the principal amount of $1,200 with a fair market value of $1,100. The fair market value of the excess principal amount, or $183.33, is treated as ''other property.''

Example 5. E, an individual, exchanged a security in the principal amount of $1,000 for another security in the principal amount of $1,200 with a fair market value of $1,080. The fair market value of the excess principal amount, or $180, is treated as ''other property.''

Example 6. F, an individual, exchanged a security in the principal amount of $1,000 for two different securities each in the principal amount of $750. One of the securities had a fair market value of $750, the other had a fair market value of $600. One-third of the fair market value of each security ($250 and $200) is treated as ''other property.''

Example 7. G, an individual, exchanged stock for stock and a warrant. The warrant had no principal amount. Thus, G received no excess principal amount within the meaning of section 356(d).

Example 8. H, an individual, exchanged a warrant for stock and a warrant. The warrants had no principal amount. Thus, H received no excess principal amount within the meaning of section 356(d).

Example 9. I, an individual, exchanged a warrant for stock and a debt security. The warrant had no principal amount. The debt security had a $100 principal amount. I received $100 of excess principal amount within the meaning of section 356(d).

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7616, 44 FR 26869, May 8, 1979; T.D. 8752, 63 FR 410, Jan. 6, 1998]

§ 1.356–4 Exchanges for section 306 stock.

If, in a transaction to which section 356 is applicable, other property or money is received in exchange for section 306 stock, an amount equal to the fair market value of the property plus the money, if any, shall be treated as a distribution of property to which section 301 is applicable. The determination of whether section 306 stock is surrendered for other property (including money) is a question of fact to be decided under all of the circumstances of each case. Ordinarily, the other property (including money) received will first be treated as received in exchange for any section 306 stock owned by a shareholder prior to such transaction. For example, if a shareholder who owns a share of common stock (having a basis to him of $100) and a share of preferred stock which is section 306 stock (having a basis to him of $100) surrenders both shares in a transaction to which section 356 is applicable for one share of common stock having a fair market value of $80 and one $100 bond having a fair market value of $100, the bond will be deemed received in exchange for the section 306 stock and it will be treated as a distribution to which section 301 is applicable to the extent of its entire fair market value ($100).

§1.356–5 Transactions involving gift or compensation.

With respect to transactions described in sections 354, 355, or 356, but which—

(a) Result in a gift, see section 2501 and following, and the regulations pertaining thereto, or

(b) Have the effect of the payment of compensation, see section 61(a)(1), and the regulations pertaining thereto.

§1.356–6T Rules for treatment of nonqualified preferred stock as "other property" (temporary).

(a) *In general.* For purposes of §§1.354–1(e), 1.355–1(c), and 1.356–3(b), the terms *stock* and *securities* do not include—

(1) Nonqualified preferred stock, as defined in section 351(g)(2), received in exchange for (or in a distribution with respect to) stock, or a right to acquire stock, other than nonqualified preferred stock; or

(2) A right to acquire such nonqualified preferred stock, received in exchange for (or in a distribution with respect to) stock, or a right to acquire stock, other than nonqualified preferred stock.

(b) *Exceptions.* The following exceptions apply:

(1) *Certain recapitalizations.* Paragraph (a) of this section does not apply in the case of a recapitalization under section 368(a)(1)(E) of a family-owned corporation as described in section 354(a)(2)(C)(ii)(II).

(2) *Transition rule.* Paragraph (a) of this section does not apply to a transaction described in section 1014(f)(2) of the Taxpayer Relief Act of 1997 (111 Stat. 921).

(c) *Effective date.* This section applies to nonqualified preferred stock, or a right to acquire such stock, received in connection with a transaction occurring on or after March 9, 1998.

[T.D. 8753, 63 FR 411, Jan. 6, 1998]

§1.357–1 Assumption of liability.

(a) *General rule.* Section 357(a) does not affect the rule that liabilities assumed are to be taken into account for the purpose of computing the amount of gain or loss realized under section 1001 upon an exchange. Section 357(a) provides, subject to the exceptions and limitations specified in section 357 (b) and (c), that—

(1) Liabilities assumed are not to be treated as ''other property or money'' for the purpose of determining the amount of realized gain which is to be recognized under section 351, 361, 371, or 374, if the transactions would, but for the receipt of ''other property or money'' have been exchanges of the type described in any one of such sections; and

(2) If the only type of consideration received by the transferor in addition to that permitted to be received by section 351, 361, 371, or 374, consists of an assumption of liabilities, the transaction, if otherwise qualified, will be deemed to be within the provisions of section 351, 361, 371, or 374.

(b) *Application of general rule.* The application of paragraph (a) of this section may be illustrated by the following example:

Example. A, an individual, transfers to a controlled corporation property with an adjusted basis of $10,000 in exchange for stock of the corporation with a fair market value of $8,000, $3,000 cash, and the assumption by the corporation of indebtedness of A amounting to $4,000. A's gain is $5,000, computed as follows:

Stock received, fair market value	$8,000
Cash received	3,000
Liability assumed by transferee	4,000
Total consideration received	15,000
Less: Adjusted basis of property transferred	10,000
Gain realized	5,000

Assuming that the exchange falls within section 351 as a transaction in which the gain to be recognized is limited to ''other property or money'' received, the gain recognized to A will be limited to the $3,000 cash received, since, under the general rule of section 357(a), the assumption of the $4,000 liability does not constitute ''other property.''

(c) *Tax avoidance purpose.* The benefits of section 357(a) do not extend to any exchange involving an assumption of liabilities where it appears that the principal purpose of the taxpayer with respect to such assumption was to avoid Federal income tax on the exchange, or, if not such purpose, was not a bona fide business purpose. In such cases, the total amount of liabilities assumed or acquired pursuant to such exchange (and not merely a particular liability with respect to which the tax avoidance purpose existed) shall, for the purpose of determining the amount of gain to be recognized upon the exchange in which the liabilities are assumed or acquired, be treated as money received by the taxpayer upon the exchange. Thus, if in the example set forth in paragraph (b) of this section, the principal purpose of the assumption of the $4,000 liability was to avoid tax on the exchange, or was not a bona fide business purpose, then the amount of gain recognized would be $5,000. In any suit or proceeding where the burden is on the taxpayer to prove that an assumption of liabilities is not to be treated as ''other property or money'' under section 357, which is the case if the Commissioner determines that the taxpayer's purpose with respect thereto was a purpose to avoid Federal income tax on the exchange or was not a bona fide business purpose, and the taxpayer contests such determination by litigation, the taxpayer must sustain such burden by the clear preponderance of the evidence. Thus, the taxpayer must prove his case by such a clear preponderance of all the evidence that the absence of a purpose to avoid Federal income tax on the exchange, or the presence of a bona fide business purpose, is unmistakable.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6528, 26 FR 399, Jan. 19, 1961]

§ 1.357–2 Liabilities in excess of basis.

(a) Section 357(c) provides in general that in an exchange to which section 351 (relating to a transfer to a corporation controlled by the transferor) is applicable, or to which section 361 (relating to the nonrecognition of gain or loss to corporations) is applicable by reason of a section 368(a)(1)(D) reorganization, if the sum of the amount of liabilities assumed plus the amount of liabilities to which the property is subject exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset as the case may be. Thus, if an individual transfers, under section 351, properties having a total basis in his hands of $20,000, one of which has a basis of $10,000 but is subject to a mortgage of $30,000, to a corporation controlled by him, such individual will be subject to tax with respect to $10,000, the excess of the amount of the liability over the total adjusted basis of all the properties in his hands. The same result will follow whether or not the liability is assumed by the transferee. The determination of whether a gain resulting from the transfer of capital assets is long-term or short-term capital gain shall be made by reference to the holding period to the transferor of the assets transferred. An exception to the general rule of section 357(c) is made (1) for any exchange as to which under section 357(b) (relating to assumption of liabilities for tax-avoidance purposes) the entire amount of the liabilities is treated as money received and (2) for an exchange to which section 371 (relating to reorganizations in certain receivership and bankruptcy proceedings) or section 374 (relating to gain or loss not recognized in certain railroad reorganizations) is applicable.

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

Example (1). If all such assets transferred are capital assets and if half the assets (ascertained by reference to their fair market value at the time of the transfer) have been held for less than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), and the remaining half for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), half the excess of the amount of the liability over the total of the adjusted basis of the property transferred pursuant to the exchange shall be treated as short-term capital gain, and the remaining half shall be treated as long-term capital gain.

Example (2). If half of the assets (ascertained by reference to their fair market value at the time of the transfer) transferred are capital assets and half are assets other than capital assets, then half of the excess of the amount of the liability over the total of the adjusted basis of the property transferred pursuant to the exchange shall be treated as capital gain, and the remaining half shall be treated as gain from the sale or exchange of assets other than capital assets.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6528, 26 FR 399, Jan. 19, 1961; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§1.358–1 Basis to distributees.

(a) In the case of an exchange or distribution to which section 354, 355, or 371(b) applies in which, under the law applicable to the year in which the exchange is made, only nonrecognition property is received, the sum of the basis of all of the stock and securities in the corporation whose stock and securities are exchanged or with respect to which the distribution is made, held immediately after the transaction, plus the basis of all stock and securities received in the transaction shall be the same as the basis of all the stock and securities in such corporation held immediately before the transaction allocated in the manner described in §1.358–2. In the case of an exchange to which section 351, 361, or 374 applies in which, under the law applicable to the year in which the exchange was made, only nonrecognition property is received, the basis of all the stock and securities received in the exchange shall be the same as the basis of all property exchange therefor. If in an exchange or distribution to which section 351, 356, 361, 371(b), or 374 applies both nonrecognition property and ‘‘other property’’ are received, the basis of all the property except ‘‘other property’’ held after the transaction shall be determined as described in the preceding two sentences decreased by the sum of the money and the fair market value of the ‘‘other property’’ (as of the date of the transaction) and increased by the sum of the amount treated as a dividend (if any) and the amount of the gain recognized on the exchange, but the term *gain* as here used does not include any portion of the recognized gain that was treated as a dividend. In any case in which a taxpayer transfers property with respect to which loss is recognized, such loss shall be reflected in determining the basis of the property received in the exchange. The basis of the ‘‘other property’’ is its fair market value as of the date of the transaction.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example. A purchased a share of stock in Corporation X in 1935 for $150. Since that date he has received distributions out of other than earnings and profits (as defined in section 316) totalling $60, so that his adjusted basis for the stock is $90. In a transaction qualifying under section 356, A exchanged this share for one share in Corporation Y, worth $100, cash in the amount of $10, and other property with a fair market value of $30. The exchanging had the effect of the distribution of a dividend. A’s ratable share of the earnings and profits of Corporation X accumulated after February 28, 1913, was $5. A realized a gain of $50 on the exchange, but the amount recognized is limited to $40, the sum of the cash received and the fair market value of the other property. Of the gain recognized, $5 is taxable as a dividend, and $35 as a gain from the exchange of property. The basis to A of the one share of stock of Corporation Y is $90. That is, the adjusted basis of the one share of stock Corporation X ($90), decreased by the sum of the cash received ($10) and the fair market value of the other property received ($30) and increased by the sum of the amount treated as a dividend ($5) and the amount treated as a gain from the exchange of property ($35). The basis of the other property received is $30.

[T.D. 6500, 25 FR 11607. Nov. 26, 1960, as amended by T.D. 6533, 26 FR 404, Jan. 19, 1965; T.D. 7616, 44 FR 26869, May 8, 1979]

§1.358–2 Allocation of basis among nonrecognition property.

(a)(1) As used in this paragraph the term *stock* means stock which is not ''other property'' under section 356 or 371(b), stock with respect to which a distribution is made, and, in the case of a surrender of part of the stock of a particular class, the retained part of such stock. The term *securities* means securities (including, where appropriate, fractional parts of securities) which are not ''other property'' under section 356 or 371(b) and in the case of a surrender of part of the securities of a particular class, the retained part of such securities. Stock, or securities, as the case may be, which differ either because they are in different corporations or because the rights attributable to them differ (although they are in the same corporation) are considered different classes of stock or securities, as the case may be, for purposes of this section.

(2) If as the result of an exchange or distribution under the terms of section 354, 355, 356 or 371(b) a shareholder who owned stock of only one class before the transaction owns stock of two or more classes after the transaction, then the basis of all the stock held before the transaction (as adjusted under §1.358–1) shall be allocated among the stock of all classes (whether or not such stock was received in the transaction) held immediately after the transaction in proportion to the fair market values of the stock of each class.

(3) If as the result of an exchange under the terms of section 354, 355, 356 or 371(b) a security holder who owned only securities, all of one class, before the transaction, owns securities or stock of more than one class, or owns both stock and securities, then the basis of all the securities held before the transaction (as adjusted under §1.358–1) shall be allocated among all the stock and securities (whether or not received in the transaction) held immediately after the transaction in proportion to the fair market values of the stock of each class and the securities of each class.

(4) In every case in which, before the transactions, a person owned stock of more than one class or securities of more than one class or owned both stock and securities, a determination must be made, upon the basis of all the facts, of the stock or securities received with respect to stock and securities of each class held (whether or not surrendered). The allocation described in subparagraph (2) of this paragraph shall be separately made as to the stock of each class with respect to which there is an exchange or distribution and the allocation described in subparagraph (3) of this paragraph shall be separately made with respect to the securities of each class, part or all of which are surrendered in the exchange.

(5) Notwithstanding the provisions of subparagraphs (2), (3), and (4) of this paragraph, in any case in which a plan of recapitalization under section 368(a)(1)(E) provides that each holder of stock or securities of a particular class shall have an option to surrender some or none of such stock or securities in exchange for stock or securities, and a shareholder or security holder exchanges an identifiable part of his stock or securities, the basis of the part of the stock or securities retained shall remain unchanged and shall not be taken into account in determining the basis of the stock or securities received.

(b)(1) As used in this paragraph the term *stock* refers only to stock which is not ''other property'' under section 351, 361, or 374 and the term *securities* refers only to securities which are not ''other property'' under section 351, 361, or 374.

(2) If in an exchange to which section 351 or 361 applies property is transferred to a corporation and the transferor receives stock or securities of more than one class or receives both stock and securities, then the basis of the property transferred (as adjusted under §1.358–1) shall be allocated among all of the stock and securities received in proportion to the fair market values of the stock of each class and the securities of each class.

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

Example (1). A, an individual, owns stock in Corporation X with an adjusted basis of

$1,000. In a transaction qualifying under section 356 (so far as such section relates to section 354), he exchanged this stock for 20 shares of stock of Corporation Y worth $1,200 and securities of Corporation Y worth $400. A realizes a gain of $600 of which $400 is recognized. The adjusted basis in A's hands of each share of the stock of Corporation Y is $50 determined by allocating the basis of the stock of Corporation X ratably to the stock of Corporation Y received in the exchange. The securities of Corporation Y have a basis in the hands of A of $400.

Example (2). B, an individual, owns a security in the principal amount of $10,000 with a basis of $5,000. In a transaction to which section 354 is applicable, he exchanges this security for four securities in the principal amount of $750 each, worth $800 each, four securities in the principal amount of $750 each, worth $600 each, class A common stock worth $1,000, and class B common stock worth $400. B realizes a gain of $2,000, none of which is recognized. The basis of his original security, $5,000, will be allocated 32/70ths to the four securities worth $800, 24/70ths to the four securities worth $600, 10/70ths to the class A common stock, and 4/70ths to the class B common stock.

Example (3). C, an individual, owns stock of Corporation Y with a basis of $5,000 and owns a security issued by Corporation Y in the principal amount of $5,000 with a basis of $5,000. In a transaction to which section 354 is applicable, he exchanges the stock of Corporation Y for stock of Corporation Z with a value of $6,000, and he exchanges the security of Corporation Y for stock of Corporation Z worth $1,500 and a security of Corporation Z in the principal amount of $4,500 worth $4,500. No gain is recognized to C on either exchange. The basis of the stock of Corporation Z received for the stock of Corporation Y is $5,000. The bases of the stock and security of Corporation Z received in exchange for the security of Corporation Y are $1,250 and $3,750, respectively.

Example (4). D, an individual, owns stock in Corporation M with a basis of $15,000, worth $40,000, and owns a security issued by Corporation M in the principal amount of $5,000 with a basis of $4,000. In a transaction qualifying under section 356 (so far as such section relates to section 355), he exchanges the security of Corporation M for a security of Corporation O (a controlled corporation) in the principal amount of $5,000, worth $5,000, and exchanges one-half of his stock of Corporation M for stock of Corporation O worth $15,000 and a security of Corporation O in the principal amount of $5,000, worth $5,000. All of the stock and securities of Corporation O are distributed pursuant to the transaction. D realizes a gain of $12,500 on the exchange of the stock of Corporation M for the stock and security of Corporation O of which $5,000 is recognized. D also realizes a gain of $1,000 on the exchange of a security of Corporation M for a security of Corporation O, none of which is recognized. The basis of his stock of Corporation M held before the transaction is allocated 20/35ths to the stock of Corporation M held after the transaction and 15/35ths to the stock of Corporation O. The basis of the security of Corporation O received in exchange for his security of Corporation M is $4,000, the basis of the security of Corporation M exchanged. The basis of the security of Corporation O received with respect to D's stock of Corporation M is $5,000, its fair market value.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7616, 44 FR 26869, May 8, 1979; T.D. 8648, 60 FR 66079, Dec. 21, 1995]

§1.358–3 Treatment of assumption of liabilities.

(a) For purposes of section 358, where a party to the exchange assumes a liability of a distributee or acquires from him property subject to a liability, the amount of such liability is to be treated as money received by the distributee upon the exchange, whether or not the assumption of liabilities resulted in a recognition of gain or loss to the taxpayer under the law applicable to the year in which the exchange was made.

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

Example (1). A, an individual, owns property with an adjusted basis of $100,000 on which there is a purchase money mortgage of $25,000. On December 1, 1945, A organizes Corporation X to which he transfers the property in exchange for all the stock of Corporation X and the assumption by Corporation X of the mortgage. The capital stock of the Corporation X has a fair market value of $150,000. Under sections 351 and 357, no gain or loss is recognized to A. The basis in A's hands of the stock of Corporation X is $75,000, computed as follows:

Adjusted basis of property transferred	$100,000
Less: Amount of money received (amount of liabilities assumed)	—25,000
Basis of Corporation X stock to A	75,000

Example (2). A, an individual, owns property with an adjusted basis of $25,000 on which there is a mortgage of $50,000. On December 1, 1954, A organizes Corporation X to which he transfers the property in exchange for all the stock of Corporation X and the assumption by Corporation X of the mortgage. The stock of Corporation X has a fair market value of $50,000. Under sections 351 and 357, gain is recognized to A in the amount of

$25,000. The basis in A's hands of the stock of Corporation X is zero, computed as follows:

Adjusted basis of property transferred	$25,000
Less: Amount of money received (amount of liabilities)	—50,000
Plus: Amount of gain recognized to taxpayer	25,000
Basis of Corporation X stock to A	0

§ 1.358–4 Exceptions.

(a) *Plan of reorganization adopted after October 22, 1968.* In the case of a plan of reorganization adopted after October 22, 1968, section 358 does not apply in determining the basis of property acquired by a corporation in connection with such reorganization by the exchange of its stock or securities (or by the exchange of stock or securities of a corporation which is in control of the acquiring corporation) as the consideration in whole or in part for the transfer of the property to it. See section 362 and the regulations pertaining to that section for rules relating to basis to corporations of property acquired in such cases.

(b) *Plan of reorganization adopted before October 23, 1968.* In the case of a plan of reorganization adopted before October 23, 1968, section 358 does not apply in determining the basis of property acquired by a corporation in connection with such reorganization by the issuance of stock or securities of such corporation (or by the issuance of stock or securities of another corporation which is in control of such corporation) as the consideration in whole or in part for the transfer of the property to it. The term *issuance of stock or securities* includes any transfer of stock or securities, including stock or securities which were purchased or were acquired as a contribution to capital. See section 362 and the regulations pertaining to that section for rules relating to basis to corporations of property acquired in such cases.

[T.D. 7422, 41 FR 26569, June 28, 1976]

§ 1.358–5 [Reserved]

§ 1.358–6 Stock basis in certain triangular reorganizations.

(a) *Scope.* This section provides rules for computing the basis of a controlling corporation in the stock of a controlled corporation as the result of certain reorganizations involving the stock of the controlling corporation as described in paragraph (b) of this section. The rules of this section are in addition to rules under other provisions of the Internal Revenue Code and principles of law. See, e.g., section 1001 for the recognition of gain or loss by the controlled corporation on the exchange of property for the assets or stock of a target corporation in a reorganization described in section 368.

(b) *Triangular reorganizations*—(1) *Nomenclature.* For purposes of this section—

(i) *P* is a corporation—

(A) That is a party to a reorganization,

(B) That is in control (within the meaning of section 368(c)) of another party to the reorganization, and

(C) Whose stock is transferred pursuant to the reorganization.

(ii) *S* is a corporation—

(A) That is a party to the reorganization, and

(B) That is controlled by *P*.

(iii) *T* is a corporation that is another party to the reorganization.

(2) *Definitions of triangular reorganizations.* This section applies to the following reorganizations (which are referred to collectively as *triangular reorganizations*):

(i) *Forward triangular merger.* A forward triangular merger is a statutory merger of *T* and *S*, with *S* surviving, that qualifies as a reorganization under section 368(a)(1)(A) or (G) by reason of the application of section 368(a)(2)(D).

(ii) *Triangular C reorganization.* A triangular C reorganization is an acquisition by *S* of substantially all of *T*'s assets in exchange for *P* stock in a transaction that qualifies as a reorganization under section 368(a)(1)(C).

(iii) *Reverse triangular merger.* A reverse triangular merger is a statutory merger of *S* and *T*, with *T* surviving, that qualifies as a reorganization under section 368(a)(1)(A) by reason of the application of section 368(a)(2)(E).

(iv) *Triangular B reorganization.* A triangular B reorganization is an acquisition by *S* of *T* stock in exchange for P stock in a transaction that qualifies as a reorganization under section 368(a)(1)(B).

(c) *General rules.* Subject to the special rule provided in paragraph (d) of this section, *P*'s basis in the stock of *S* or *T*, as applicable, as a result of a triangular reorganization, is adjusted under the following rules—

(1) *Forward triangular merger or triangular C reorganization*—(i) *In general.* In a forward triangular merger or a triangular C reorganization, *P*'s basis in its *S* stock is adjusted as if—

(A) *P* acquired the *T* assets acquired by *S* in the reorganization (and *P* assumed any liabilities which *S* assumed or to which the *T* assets acquired by *S* were subject) directly from *T* in a transaction in which *P*'s basis in the *T* assets was determined under section 362(b); and

(B) *P* transferred the *T* assets (and liabilities which *S* assumed or to which the *T* assets acquired by *S* were subject) to *S* in a transaction in which *P*'s basis in *S* stock was determined under section 358.

(ii) *Limitation.* If, in applying section 358, the amount of *T* liabilities assumed by *S* or to which the *T* assets acquired by *S* are subject equals or exceeds *T*'s aggregate adjusted basis in its assets, the amount of the adjustment under paragraph (c)(1)(i) of this section is zero. *P* recognizes no gain under section 357(c) as a result of a triangular reorganization.

(2) *Reverse triangular merger*—(i) *In general*—(A) *Treated as a forward triangular merger.* Except as otherwise provided in this paragraph (c)(2), *P*'s basis in its *T* stock acquired in a reverse triangular merger equals its basis in its *S* stock immediately before the transaction adjusted as if *T* had merged into *S* in a forward triangular merger to which paragraph (c)(1) of this section applies.

(B) *Allocable share.* If *P* acquires less than all of the *T* stock in the transaction, the basis adjustment described in paragraph (c)(2)(i)(A) of this section is reduced in proportion to the percentage of *T* stock not acquired in the transaction. The percentage of *T* stock not acquired in the transaction is determined by taking into account the fair market value of all classes of *T* stock.

(C) *Special rule if P owns T stock before the transaction.* Solely for purposes of paragraphs (c)(2)(i)(A) and (B) of this section, if *P* owns *T* stock before the transaction, *P* may treat that stock as acquired in the transaction or not, without regard to the form of the transaction.

(ii) *Reverse triangular merger that qualifies as a section 351 transfer or section 368(a)(1)(B) reorganization.* Notwithstanding paragraph (c)(2)(i) of this section, if a reorganization qualifies as both a reverse triangular merger and as a section 351 transfer or as both a reverse triangular merger and a reorganization under section 368(a)(1)(B), *P* can—

(A) Determine the basis in its *T* stock as if paragraph (c)(2)(i) of this section applies; or

(B) Determine the basis in the *T* stock acquired as if *P* acquired such stock from the former *T* shareholders in a transaction in which *P*'s basis in the *T* stock was determined under section 362(b).

(3) *Triangular B reorganization.* In a triangular B reorganization, *P*'s basis in its *S* stock is adjusted as if—

(i) *P* acquired the *T* stock acquired by *S* in the reorganization directly from the *T* shareholders in a transaction in which *P*'s basis in the *T* stock was determined under section 362(b); and

(ii) *P* transferred the *T* stock to *S* in a transaction in which *P*'s basis in its *S* stock was determined under section 358.

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

Example 1. Forward triangular merger. (a) *Facts.* T has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. Pursuant to a plan, *P* forms *S* with $5 cash (which S retains), and *T* merges into *S*. In the merger, the *T* shareholders receive *P* stock worth $100 in exchange for their *T* stock. The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(D) apply.

(b) *Basis adjustment.* Under §1.358–6(c)(1), *P*'s $5 basis in its *S* stock is adjusted as if *P* acquired the *T* assets acquired by *S* in the reorganization directly from *T* in a transaction in which *P*'s basis in the *T* assets was determined under section 362(b). Under section 362(b), *P* would have an aggregate basis of $60 in the *T* assets. *P* is then treated as if it transferred the *T* assets to *S* in a transaction in which *P*'s basis in the *S* stock was determined under section 358. Under section 358, *P*'s $5 basis in its *S* stock would be increased by the $60 basis in the *T* assets deemed transferred. Consequently, *P* has a $65 basis in its *S* stock as a result of the reorganization.

(c) *Use of pre-existing S.* The facts are the same as paragraph (a) of this *Example 1,* except that *S* is an operating company with substantial assets that has been in existence for several years. *P* has a $110 basis in the *S* stock. Under § 1.358–6(c)(1), *P*'s $110 basis in its *S* stock is increased by the $60 basis in the *T* assets deemed transferred. Consequently, *P* has a $170 basis in its *S* stock as a result of the reorganization.

(d) *Mixed consideration.* The facts are the same as paragraph (a) of this *Example 1,* except that the *T* shareholders receive *P* stock worth $80 and $20 cash from *P*. Under section 358, *P*'s $5 basis in its *S* stock is increased by the $60 basis in the *T* assets deemed transferred. Consequently, *P* has a $65 basis in its *S* stock as a result of the reorganization.

(e) *Liabilities.* The facts are the same as paragraph (a) of this *Example 1,* except that *T*'s assets are subject to $50 of liabilities, and the *T* shareholders receive $50 of *P* stock in exchange for their *T* stock. Under section 358, *P*'s basis in its *S* stock is increased by the $60 basis in the *T* assets deemed transferred and decreased by the $50 of liabilities to which the *T* assets acquired by *S* are subject. Consequently, *P* has a net basis adjustment of $10, and a $15 basis in its *S* stock as a result of the reorganization.

(f) *Liabilities in excess of basis.* The facts are the same as in paragraph (a) of this *Example 1,* except that *T*'s assets are subject to liabilities of $90, and the *T* shareholders receive $10 of *P* stock in exchange for their *T* stock in the reorganization. Under § 1.358–6(c)(1)(ii), the adjustment under § 1.358–6(c) is zero if the amount of the liabilities which *S* assumed or to which the *T* assets acquired by *S* are subject exceeds the aggregate adjusted basis in *T*'s assets. Consequently, *P* has no adjustment in its *S* stock, and *P* has a $5 basis in its *S* stock as a result of the reorganization.

Example 2. Reverse triangular merger.(a) *Facts. T* has assets with an aggregate basis of $60 and a fair market value of $100 and no liabilities. *P* has a $110 basis in its *S* stock. Pursuant to a plan, *S* merges into *T* with *T* surviving. In the merger, the *T* shareholders receive $10 cash from *P* and *P* stock worth $90 in exchange for their *T* stock. The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(E) apply.

(b) *Basis adjustment.* Under § 1.358–6(c)(2)(i)(A), *P*'s basis in the *T* stock acquired is *P*'s $110 basis in its *S* stock before the transaction, adjusted as if *T* had merged into *S* in a forward triangular merger to which § 1.358–6(c)(1) applies. In such a case, *P*'s $110 basis in its *S* stock before the transaction would have been increased by the $60 basis of the *T* assets deemed transferred. Consequently, *P* has a $170 basis in its *T* stock immediately after the transaction.

(c) *Reverse triangular merger that also qualifies under section 368(a)(1)(B).* The facts relating to *T* are the same as in paragraph (a) of this *Example 2. P,* however, forms *S* pursuant to the plan of reorganization. The *T* shareholders receive $100 worth of *P* stock (and no cash) in exchange for their *T* stock. The *T* shareholders have an aggregate basis in their *T* stock of $85 immediately before the reorganization. The reorganization qualifies as both a reverse triangular merger and a reorganization under section 368(a)(1)(B). Under § 1.358–6(c)(2)(ii), *P* may determine its basis in its *T* stock either as if § 1.358–6(c)(2)(i) applied to the *T* stock acquired, or as if *P* acquired the *T* stock from the former *T* shareholders in a transaction in which *P*'s basis in the *T* stock was determined under section 362(b). Accordingly, *P* may determine a basis in its *T* stock of $60 (*T*'s net asset basis) or $85 (the *T* shareholders' aggregate basis in the *T* stock immediately before the reorganization).

(d) *Allocable share in a reverse triangular merger.* The facts are the same as in paragraph (a) of this *Example 2,* except that *X*, a 10% shareholder of *T*, does not participate in the transaction. The remaining *T* shareholders receive $10 cash from *P* and *P* stock worth $80 for their *T* stock. *P* owns 90% of the *T* stock after the transaction. Under § 1.358–6(c)(2)(i)(A), *P*'s basis in its *T* stock is *P*'s $110 basis in its *S* stock before the reorganization, adjusted as if *T* had merged into *S* in a forward triangular merger. In such a case, *P*'s basis would have been adjusted by the $60 basis in the *T* assets deemed transferred. Under § 1.358–6(c)(2)(i)(B), however, the basis adjustment determined under § 1.358–6(c)(2)(i)(A) is reduced in proportion to the percentage of *T* stock not acquired by *P* in the transaction. The percentage of *T* stock not acquired in the transaction is 10%. Therefore, *P* reduces its $60 basis adjustment by 10%, resulting in a net basis adjustment of $54. Consequently, *P* has a $164 basis in its *T* stock as a result of the transaction.

(e) *P's ownership of T stock.* The facts are the same as in paragraph (a) of this *Example 2,* except that *P* owns 10% of the *T* stock before the transaction. *P*'s basis in that *T* stock is $8. All the *T* shareholders other than *P* surrender their *T* stock for $10 cash from *P* and *P* stock worth $80. *P* does not surrender the stock in the transaction. Under § 1.358–6(c)(2)(i)(C), *P* may treat its *T* stock owned before the transaction as acquired in the transaction or not. If *P* treats that *T* stock as acquired in the transaction, *P*'s basis in that *T* stock and the *T* stock actually acquired in the transaction equals *P*'s $110 basis in its *S* stock before the transaction, adjusted by the $60 basis of the *T* assets deemed transferred, for a total basis of $170. If *P* treats its *T* stock as not acquired, *P* retains its $8 pre-transaction basis in that stock. *P*'s basis in its other *T* shares equals *P*'s $110 basis in its *S* stock before the transaction, adjusted by $54 (the $60 basis in the *T* assets deemed transferred, reduced by 10%), for a total basis of $164 in those shares. See §1.358–6(c)(2)(i)(A) and (B). Consequently, if *P* treats its *T* shares as not acquired, *P*'s total basis in all of its *T* shares is $172.

Example 3. Triangular B reorganization.(a) *Facts. T* has assets with a fair market value of $100 and no liabilities. The *T* shareholders have an aggregate basis in their *T* stock of $85 immediately before the reorganization. Pursuant to a plan, *P* forms *S* with $5 cash and *S* acquires all of the *T* stock in exchange for $100 of *P* stock. The transaction is a reorganization to which section 368(a)(1)(B) applies.

(b) *Basis adjustment.* Under §1.358–6(c)(3), *P* adjusts its $5 basis in its *S* stock by treating *P* as if it acquired the *T* stock acquired by *S* in the reorganization directly from the *T* shareholders in exchange for the *P* stock in a transaction in which *P*'s basis in the *T* stock was determined under section 362(b). Under section 362(b), *P* would have an aggregate basis of $85 in the *T* stock received by *S* in the reorganization. *P* is then treated as if it transferred the *T* stock to *S* in a transaction in which *P*'s basis in the *S* stock was determined under section 358. Under section 358, *P*'s basis in its *S* stock would be increased by the $85 basis in the *T* stock deemed transferred. Consequently, *P* has a $90 basis in its *S* stock as a result of the reorganization.

(d) *Special rule for consideration not provided by P*—(1) *In general.* The amount of *P*'s adjustment to basis in its *S* or *T* stock, as applicable, described in paragraph (c) of this section is decreased by the fair market value of any consideration (including *P* stock in which gain or loss is recognized, see §1.1032–2(c)) that is exchanged in the reorganization and that is not provided by *P* pursuant to the plan of reorganization. This paragraph (d) does not apply to the amount of *T* liabilities assumed by *S* or to which the *T* assets acquired by *S* are subject under paragraph (c)(1) of this section (or deemed assumed or taken subject to by *S* under paragraph (c)(2)(i) of this section).

(2) *Limitation. P* makes no adjustment to basis under this section if the decrease required under paragraph (d)(1) of this section equals or exceeds the amount of the adjustment described in paragraph (c) of this section.

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

Example. (a)*Facts.* T has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. *S* is an operating company with substantial assets that has been in existence for several years. *P* has a $100 basis in its *S* stock. Pursuant to a plan, *T* merges into *S* and the *T* shareholders receive $70 of *P* stock provided by *P* pursuant to the plan and $30 of cash provided by *S* in exchange for their *T* stock. The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(D) apply.

(b) *Basis adjustment.* Under §1.358–6(c)(1), *P*'s $100 basis in its *S* stock is increased by the $60 basis in the *T* assets deemed transferred. Under §1.358–6(d)(1), the $60 adjustment is decreased by the $30 of cash provided by *S* in the reorganization. Consequently, *P* has a net adjustment of $30 in its *S* stock, and *P* has a $130 basis in its *S* stock as a result of the reorganization.

(c) *Appreciated asset.* The facts are the same as in paragraph (a) of this *Example,* except that in the reorganization *S* provides an asset with a $20 adjusted basis and $30 fair market value instead of $30 of cash. The basis results are the same as in paragraph (b) of this *Example.* In addition, *S* recognizes $10 of gain under section 1001 on its disposition of the asset in the reorganization.

(d) *Depreciated asset.* The facts are the same as in paragraph (c) of this *Example,* except that *S* has a $60 adjusted basis in the asset. The basis results are the same as in paragraph (b) of this *Example.* In addition, *S* recognizes $30 of loss under section 1001 on its disposition of the asset in the reorganization.

(e) *P stock.* The facts are the same as in paragraph (a) of this *Example,* except that in the reorganization *S* provides *P* stock with a fair market value of $30 instead of $30 of cash. *S* acquired the *P* stock in an unrelated transaction several years before the reorganization. *S* has a $20 adjusted basis in the *P* stock. The basis results are the same as in paragraph (b) of this *Example.* In addition, *S* recognizes $10 of gain on its disposition of the *P* stock in the reorganization. See §1.1032–2(c).

(e) *Cross-reference.* For rules relating to stock basis adjustments made as a result of a triangular reorganization in which *P* and *S*, or *P* and *T*, as applicable, are, or become, members of a consolidated group, see § 1.1502–30. For rules relating to stock basis adjustments after a group structure change, see § 1.1502–31.

(f) *Effective dates*—(1) *General rule.* Except as otherwise provided in this paragraph (f), this section applies to triangular reorganizations occurring on or after December 23, 1994.

(2) *Special rule for reverse triangular mergers.* For a reverse triangular merger occurring before December 23, 1994, *P* may—

(i) Determine the basis in its *T* stock as if paragraph (c)(2)(i) of this section applied; or

(ii) Determine the basis in its *T* stock acquired as if *P* acquired such stock from the former *T* shareholders in a transaction in which *P*'s basis in the *T* stock was determined under section 362(b).

[T.D. 8648, 60 FR 66079, Dec. 21, 1995; 61 FR 11547, Mar. 21, 1996]

EFFECTS ON CORPORATION

§ 1.361–1 Nonrecognition of gain or loss to corporations.

Section 361 provides the general rule that no gain or loss shall be recognized if a corporation, a party to a reorganization, exchanges property in pursuance of the plan of reorganization solely for stock or securities in another corporation, a party to the reorganization. This provision includes only stock and securities received in connection with a reorganization defined in section 368(a). It also includes nonvoting stock and securities in a corporation, a party to a reorganization, received in a transaction to which section 368(a)(1)(C) is applicable only by reason of section 368(a)(2)(B).

§ 1.362–1 Basis to corporations.

(a) *In general.* Section 362 provides, as a general rule, that if property was acquired on or after June 22, 1954, by a corporation (1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, (2) as paid-in surplus or as a contribution to capital, or (3) in connection with a reorganization to which part III, subchapter C, chapter 1 of the Code applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. (See also § 1.362–2.)

(b) *Exceptions.* (1) In the case of a plan of reorganization adopted after October 22, 1968, section 362 does not apply if the property acquired in connection with such reorganization consists of stock or securities in a corporation a party to the reorganization, unless acquired by the exchange of stock or securities of the transferee (or of a corporation which is in control of the transferee) as the consideration in whole or in part for the transfer.

(2) In the case of a plan of reorganization adopted before October 23, 1968, section 362 does not apply if the property acquired in connection with such reorganization consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee (or, in the case of transactions occurring after December 31, 1963, of a corporation which is in control of the transferee) as the consideration in whole or in part for the transfer. The term *issuance of stock or securities* includes any transfer of stock or securities, including stock or securities which were purchased or were acquired as a contribution to capital.

[T.D. 7422, 41 FR 26569, June 28, 1976]

§ 1.362–2 Certain contributions to capital.

The following regulations shall be used in the application of section 362(c):

(a) Property deemed to be acquired with contributed money shall be that property, if any, the acquisition of which was the purpose motivating the contribution;

(b) In the case of an excess of the amount of money contributed over the cost of the property deemed to be acquired with such money (as defined in paragraph (a) of this section) such excess shall be applied to the reduction of the basis (but not below zero) of other properties held by the corporation, on the last day of the 12-month period beginning on the day the contribution is received, in the following order—

(1) All property of a character subject to an allowance for depreciation (not including any properties as to which a deduction for amortization is allowable),

(2) Property with respect to which a deduction for amortization is allowable,

(3) Property with respect to which a deduction for depletion is allowable under section 611 but not under section 613, and

(4) All other remaining properties.

The reduction of the basis of each of the properties within each of the above categories shall be made in proportion to the relative bases of such properties.

(c) With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property within a particular category adjusted in a manner different from the general rule set forth in paragraph (b) of this section. Variations from such rule may, for example, involve adjusting the basis of only certain units of the taxpayer's property within a given category. A request for variations from the general rule should be filed by the taxpayer with its return for the taxable year for which the transfer of the property has occurred.

§ 1.367(a)–1T Transfers to foreign corporations subject to section 367(a): In general (temporary).

(a) *Purpose and scope of regulations.* These regulations set forth rules relating to the provisions of section 367(a) concerning certain transfers of property to foreign corportions. This section provides general rules explaining the effect of section 367(a)(1) and describing the transfers of property that are subject to the rule of that section. Section 1.367(a)–2T provides rules concerning the exception from the rule of section 367(a)(1) for transfers of property to be used in the active conduct of a trade or business outside of the United States. Rules concerning the application of section 367(a)(1) to transfers of stock or securities are provided in § 1.367(a)–3, while § 1.367(a)–4T provides special rules regarding other specified transfers of property. Section 1.367(a)–5T describes types of property that are subject to the rule of section 367(a)(1) regardless of whether they are transferred for use in a trade or business. Section 1.367(a)–6T provides rules concerning the application of section 367(a) to the transfer of a branch with previously deducted losses. Finally, § 1.367(a)–7T contains transitional rules concerning transfers of intangible property to foreign corporations made after June 6, 1984 and before January 1, 1985. Rules explaining the operation of section 367(d), concerning transfers of intangible property pursuant to an exchange described in section 351 or 361, are provided in § 1.367(d)–1T. Rules concerning the reporting requirements of section 6038B are provided in §§ 1.6038B–1 and 1.6038B–1T.

(b) *General rules*—(1) *Foreign corporation not considered a corporation for purposes of certain transfers.* If a U.S. person transfers property to a foreign corporation in connection with an exchange described in section 332, 351, 354, 355, 356, or 361, then pursuant to section 367(a)(1) the foreign corporation shall not be considered to be a corporation for purposes of determining the extent to which gain shall be recognized on the transfer. Section 367(a)(1) denies nonrecognition treatment only to transfers of items of property on which gain is realized. Thus, the amount of gain recognized because of section 367(a)(1) is unaffected by the transfer of items of property on which loss is realized (but not recognized). The transfers of property that are subject to section 367(a)(1) are further described in paragraph (c) of this section, and relevant definitions are provided in paragraph (d) of this section.

(2) *Cases in which foreign corporate status is not disregarded.* Section 367(a)(1) shall not apply, and a foreign corporate transferee shall, thus, be considered to be a corporation, in the case of any of the following:

(i) [Reserved]

(ii) The transfer of property for use in the active conduct of a trade or business outside of the United States in accordance with the rules of §§ 1.367(a)-2T through 1.367(a)-6T; or

(iii) Certain other transfers of property described in §§ 1.367(a)-2T through 1.367(a)-6T.

(3) *Limitation of gain required to be recognized*—(i) *In general.* If a U.S. person transfers property to a foreign corporation in a transaction on which gain is required to be recognized under section 367(a) and regulations thereunder, then the gain required to be recognized by the U.S. person shall in no event exceed the gain that would have been recognized on a taxable sale of those items of property if sold individually and without offsetting individual losses against individual gains.

(ii) *Losses.* No loss may be recognized by reason of the operation of section 367.

(iii) *Ordinary income and capital gain.* If section 367(a) and regulations thereunder require the recognition of ordinary income and capital gain in excess of the limitation described in paragraph (b)(3)(i) of this section, then the limitation shall be imposed by making proportionate reductions in the amounts or ordinary income and capital gain, regardless of the character of the gain that would have been recognized on a taxable sale of the property.

(4) *Character, source, and adjustments*—(i) *In general.* If a U.S. person is required to recognize gain under section 367 upon a transfer of property to a foreign corporation, then—

(A) The character and source of such gain shall be determined as if the property had been disposed of in a taxable exchange with the transferee foreign corporation (unless otherwise provided by regulation); and

(B) Appropriate adjustments to earnings and profits, basis, and other affected items shall be made according to otherwise applicable rules, taking into account the gain recognized because of section 367(a)(1). Any increase in the basis of the property received by the foreign corporation resulting from the application of section 367(a) and section 362 (a) or (b) shall be allocated over the transferred property with respect to which gain is recognized in proportion to the amount realized by the U.S. person on the transfer of each item of that property. See paragraph (c)(3) of this section for special rules applicable to transfers of partnership interests.

(ii) *Example.* The rules of this paragraph (b)(4) are illustrated by the following example.

Example. Domestic corporation DC transfers inventory with a fair market value of $1 million and adjusted basis of $800,000 to foreign corporation FC in an exchange for stock of FC that is described in section 351 (a). Title passes within the U.S. Pursuant to section 367(a), DC is required to recognize gain of $200,000 upon the transfer. Under the rule of this paragraph (b)(4), such gain shall be treated as ordinary income (sections 1201 and 1221) from sources within the U.S. (section 861) arising from a taxable exchange with FC. Appropriate adjustments to earnings and profits, basis, etc., shall be made as if the transfer were subject to section 351. Thus, for example, DC's basis in the FC stock received, and FC's basis in the transferred inventory, will each be increased by the $200,000 gain recognized by DC, pursuant to sections 358(a)(1) and 362(a), respectively.

(c) *Transfers described in section 367(a)(1)*—(1) *In general.* A transfer described in section 367(a)(1) is any transfer of property by a U.S. person to a foreign corporation pursuant to an exchange described in section 332, 351, 354, 355, 356, or 361. Section 367(a)(1) applies to such a transfer whether it is made directly, indirectly, or constructively. Indirect or constructive transfers that are described in section 367(a)(1) include the transfers described in subparagraphs (2) through (7) of this paragraph (c).

(2) *Indirect transfers in certain reorganizations.* [Reserved] For further guidance, see § 1.367(a)–3(d).

(3) *Indirect transfers involving partnerships and interests therein*—(i) *Transfer by partnership treated as transfer by partners*—(A) *In general.* If a partnership (whether foreign or domestic) transfers property to a foreign corporation in an exchange described in section 367(a)(1), then a U.S. person that is a partner in the partnership shall be treated as having transferred a proportionate share of the property in an exchange described in section 367(a)(1). A U.S. person's proportionate share of partnership property shall be determined under the rules and principles of sections 701 through 761 and the regulations thereunder. The rule of this paragraph (c)(3)(i)(A) is illustrated by the following example.

Example P is a partnership having five equal general partners, two of whom are United States persons. P transfers property to F, a foreign corporation, in connection with an exchange described in section 351. The exchange includes an indirect transfer of property by the partners to F. The transfers of property attributable to those partners who are United States persons, that is, 40 percent of each asset transferred to F, are transfers described in section 367(a)(1). The gain (if any) recognized on the transfer of 40 percent of each asset to F is attributable to the two partners who are United States persons.

(B) *Special adjustments to basis.* If a U.S. person is treated under the rule of this paragraph (c)(3)(i) as having transferred a proportionate share of the property of a partnership in an exchange described in section 367(a), and is therefore required to recognize gain upon the transfer, then—

(*1*) The U.S. person's basis in the partnership shall be increased by the amount of gain recognized by him;

(*2*) Solely for purposes of determining the basis of the partnership in the stock of the transferee foreign corporation, the U.S. person shall be treated as having newly acquired an interest in the partnership (for an amount equal to the gain recognized), permitting the partnership to make an optional adjustment to basis pursuant to sections 743 and 754; and

(*3*) The transferee foreign corporation's basis in the property acquired from the partnership shall be increased by the amount of gain recognized by U.S. persons under this paragraph (c)(3)(i).

(ii) *Transfer of partnership interest treated as transfer of proportionate share of assets*—(A) *In general.* If a U.S. person transfers an interest as a partner in a partnership (whether foreign or domestic) in an exchange described in section 367(a)(1), then that person shall be treated as having transferred a proportionate share of the property of the partnership in an exchange described in section 367(a)(1). Accordingly, the applicability of the exception to section 367(a)(1) provided in §1.367(a)–2T shall be determined with reference to the property of the partnership rather than the partnership interest itself. A U.S. person's proportionate share of partnership property shall be determined under the rules and principles of sections 701 through 761 and the regulations thereunder.

(B) *Special adjustments to basis.* If a U.S. person is treated under the rule of paragraph (c)(3)(ii)(A) of this section as having transferred a proportionate share of the property of a partnership in an exchange described in section 367(a), and is therefore required to recognize gain upon the transfer, then—

(*1*) The U.S. person's basis in the stock of the transferee foreign corporation shall be increased by the amount of gain so recognized by that person;

(*2*) The transferee foreign corporation's basis in the transferred partnership interest shall be increased by the amount of gain recognized by the U.S. person; and

(*3*) Solely for purposes of determining the partnership's basis in the property held by it, the U.S. person shall be treated as having newly acquired an interest in the partnership (for an amount equal to the gain recognized), permitting the partnership to make an optional adjustment to basis pursuant to sections 743 and 754.

(C) *Limited partnership interest.* The transfer by a U.S. person of an interest in a partnership shall not be subject to the rules of paragraph (c)(3)(ii)(A) and (B) if—

(*1*) The interest transferred is a limited partnership interest; and

(*2*) Such interest is regularly traded on an established securities market.

Instead, the transfer of such an interest shall be treated in the same manner as a transfer of stock or securities. Thus, the consequences of such a transfer shall be determined under the rules of §1.367(a)–3. For purposes of this section, a limited partnership interest is an interest as a limited partner in a partnership that is organized under the laws of any State of the United States or the District of Columbia. Whether such an interest is regularly traded on an established securities market shall be determined under the provisions of paragraph (c)(3)(ii)(D) of this section.

(D) *Regularly traded on an established securities market*—(*1*) *Established securities market.* For purposes of this paragraph (c)(3)(ii), an established securities market is—

(*i*) A national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);

(*ii*) A foreign national securities exchange which is officially recognized, sanctioned, or supervised by governmental authority; and

(*iii*) An over-the-counter market. An over-the-counter market is any market reflected by the existence of an interdealer quotation system. An inter-dealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of stock and securities by identified brokers or dealers, other than by quotation sheets which are prepared and distributed by a broker or dealer in the regular course of business and which contain only quotations of such broker or dealer.

(*2*) *Regularly traded.* A class of interests that is traded on an established securities market is considered to be regularly traded if it is regularly quoted by brokers or dealers making a market in such interests. A class of interests shall be presumed to be regularly traded if the entity has a total of 500 or more interest-holders.

(4) *Transfers by trusts and estates*—(i) *In general.* For purposes of section 367(a), a transfer of property by an estate or trust shall be treated as a transfer by the entity itself and not as an indirect transfer by its beneficiaries. Thus, a transfer of property by a foreign trust or estate (as defined in section 7701(a)(31)) is not described in section 367(a)(1), regardless of whether the beneficiaries of the trust or estate are U.S. persons. Similarly, a transfer of property by a domestic trust or estate may be described in section 367(a)(1), regardless of whether the beneficiaries of the trust or estate are foreign persons.

(ii) *Grantor trusts.* A transfer of a portion or all of the assets of a foreign or domestic trust to a foreign corporation in an exchange described in section 367(a)(1) is considered a transfer by any U.S. person who is treated as the owner of any such portion or all of the assets of the trust under sections 671 through 679.

(5) *Termination of election under section 1504(d).* Section 367(A) applies to the constructive reorganization and transfer of property from a domestic corporation to a foreign corporation that occurs upon the termination of an election under section 1504(d), which permits the treatment of certain contiguous country corporations as domestic corporations. The rule of this paragraph (c)(5) is illustrated by the following example.

Example. Domestic corporation Y previously made a valid election under section 1504(d) to have its wholly owned Canadian subsidiary, C, treated as a domestic corporation. On July, 1, 1986, C fails to continue to qualify for the election under section 1504 (d). A constructive reorganization described in section 368(a)(1)(D) occurs. The resulting constructive transfer of assests by ''domestic'' corporation C to Canadian corporation C upon the termination of the election is a transfer of property described in section 367(a)(1).

(6) *Changes in classification of an entity.* If a foreign entity is classified as an entity other than an association taxable as a corporation for United States tax purposes, and subsequently a change is made in the governing documents, articles, or agreements of the entity so that the entity is thereafter classified as an association taxable as a corporation, the change in classification is considered a transfer of property to a foreign corporation in connection with an exchange described in section 351. For purposes of section 367(a)(1), the transfer of property is considered as made by the persons determined under the rules set forth in paragraph (c)(3) of this section with respect to partnerships, and paragraph (c)(4)(i) or (ii), with respect to trusts and estates, and the rules of such paragraphs apply determining whether a transfer described in section 367(a)(1) has been made.

(7) *Contributions to capital.* For rules with respect to the treatment of a contribution to the capital of a foreign corporation as a transfer described in section 367(a)(1), see section 367(c)(2) and the regulations thereunder.

(d) *Definitions.* The following definitions apply for purposes of this section and § 1.367(d)–1T.

(1) *United States person.* The term *United States person* includes those persons described in section 7701(a)(30). The term includes a citizen or resident

of the United States, a domestic partnership, a domestic corporation, and any estate or trust other than a foreign estate or trust. (For definitions of these terms, see section 7701 and regulations thereunder.) For purposes of this section, an individual with respect to whom an election has been made under section 6013 (g) or (h) is considered to be a resident of the United States while such election is in effect. A nonresident alien or a foreign corporation will not be considered a United States person because of its actual or deemed conduct of a trade or business within the United States during a taxable year.

(2) *Foreign corporation.* The term *foreign corporation* has the meaning set forth in section 7701(a)(3) and (5) and §301.7701–5.

(3) *Transfer.* For purposes of section 367 and regulations thereunder, the term *transfer* means any transaction that constitutes a transfer for purposes of sections 332, 351, 354, 355, 356, or 361, as applicable. A person's entering into a bona fide cost-sharing arrangement under §1.482–2(d)(4) or acquiring rights to intangible property under such an arrangement shall not be considered a transfer of property described in section 367(a)(1). See §1.6038B–1T(b)(3) for the date on which the transfer is considered to be made.

(4) *Property.* For purposes of section 367 and regulations thereunder, the term *property* means any item that constitutes property for purposes of sections 332, 351, 354, 355, 356, or 361, as applicable.

(5) *Intangible property*—(i) *In general.* For purposes of section 367 and regulations thereunder, the term *intangible property* means knowledge, rights, documents, and any other intangible item within the meaning of section 936(h)(3)(B) that constitutes property for purposes of sections 332, 351, 354, 355, 356, or 361, as applicable. Such property shall be treated as intangible property for purposes of section 367 (a) and (d) and the regulations thereunder without regard to whether it is used or developed in the United States or in a foreign country and without regard to whether it is used in manufacturing activities or in marketing activities. A working interest in oil and gas properties shall not be considered to be intangible property for purposes of section 367 and the regulations thereunder.

(ii) *Operating intangibles.* An operating intangible is any intangible property of a type not ordinarily licensed or otherwise transferred in transactions between unrelated parties for consideration contingent upon the licensee's or transferee's use of the property. Examples of operating intangibles may include long-term purchase or supply contracts, surveys, studies, and customer lists.

(iii) *Foreign goodwill or going concern value.* Foreign goodwill or going concern value is the residual value of a business operation conducted outside of the United States after all other tangible and intangible assets have been identified and valued. For purposes of section 367 and regulations thereunder the value of the right to use a corporate name in a foreign country shall be treated as foreign goodwill or going concern value.

(iv) *Transitional rule for certain marketing intangibles.* For transfers occurring after December 31, 1984, and before May 16, 1986, for foreign trademarks, tradenames, brandnames, and similar marketing intangibles developed by a foreign branch shall be treated as foreign goodwill or going concern value.

(e) *Close of taxable year in certain section 368(a)(1)(F) reorganizations.* If a domestic corporation is the transferor corporation in a reorganization described in section 368(a)(1)(F) after March 30, 1987, in which the acquiring corporation is a foreign corporation, then the taxable year of the transferor corporation shall end with the close of the date of the transfer and the taxable year of the acquiring corporation shall end with the close of the date on which the transferor's taxable year would have ended but for the occurrence of the transfer. With regard to the consequences of the closing of the taxable year, see section 381 and the regulations thereunder.

(f) *Exchanges under sections 354(a) and 361(a) in certain section 368(a)(1)(F) reorganizations.* In every reorganization under section 368(a)(1)(F), where the transferor corporation is a domestic corporation and the acquiring corporation is a foreign corporation, there is considered to exist—

(1) A transfer of assets by the transferor corporation to the acquiring corporation under section 361(a) in exchange for stock of the acquiring corporation and the assumption by the acquiring corporation of the transferor corporation's liabilities;

(2) A distribution of the stock (or stock and securities) of the acquiring corporation by the transferor corporation to the shareholders (or shareholders and security holders) of the transferor corporation; and

(3) An exchange by the transferor corporation's shareholders (or shareholders and security holders) of the stock of the transferor corporation for stock (or stock and securities) of the acquiring corporation under section 354(a).

For this purpose, it shall be immaterial that the applicable foreign or domestic law treats the acquiring corporation as a continuance of the transferor corporation.

(g) *Effective date of certain section*—

(1) *In general.* Except as specifically provided to the contrary elsewhere in these sections, §§ 1.367(a)–1T through 1.367(a)–6T apply to transfers occurring after December 31, 1984.

(2) *Private rulings.* The taxpayer may rely on a private ruling under section 367(a) received by him before June 16, 1986.

(3) *Certain indirect transfers.* Sections 1.367(a)–1T(c)(2)(i) and (iii) and 1.367(a)–1T(c)(3) apply to transfers made after June 16, 1986. For transfers made before that date, see 26 CFR 1.367(a)–1(b) (revised as of April 1, 1986).

[T.D. 8087, 51 FR 17938, May 16, 1986, as amended at T.D. 8280, 55 FR 1408, Jan. 16, 1990; T.D. 8770, 63 FR 33555, June 19, 1998]

§ 1.367(a)–2T Exception for transfers of property for use in the active conduct of a trade or business (temporary).

(a) *In general.* Section 367(a)(1) shall not apply to property transferred to a foreign corporation if—

(1) Such property is transferred for use by that corporation in the active conduct of a trade or business outside of the United States; and

(2) The U.S. person that transfers the property complies with the reporting requirements of section 6038B and regulations thereunder.

Where these conditions are satisifed, the foreign corporate transferee of the property shall be considered to be a corporation for purposes of determining the extent to which gain or loss is required to be recognized upon the transfer pursuant to section 332, 351, 354 [reserved as to section 355 or so much of section 356 as relates to section 355], 356, or 361. Paragraph (b) of this section provides rules concerning the requirement that property be transferred for use in the active conduct of a trade or business outside of the United States, while paragraph (c) concerns the application of the requirement where the transferee itself retransfers the property. In addition, § 1.367(a)–3T provides rules concerning the treatment of stock or securities transferred to a foreign corporation in an exchange described in section 367(a)(1), and § 1.367(a)–4T provides special rules concerning the treatment of other specified types of property. Finally, §§ 1.367(a)–5T and 1.367(a)–6T provide rules concerning certain transfers of property that are subject to section 367(a)(1) regardless of whether the property is used in the active conduct of a trade or business.

(b) *Active conduct of a trade or business outside the United States*—(1) *In general.* Property qualifies for the exception provided by this section if it is transferred to a foreign corporation for use in the active conduct of a trade or business outside of the United States. Therefore, to determine whether property is subject to the exception provided by this section, four factual determinations must be made:

(i) What is the trade or business of the transferee;

(ii) Do the activities of the transferee constitute the active conduct of that trade or business;

(iii) Is the trade or business conducted outside of the United States; and

(iv) Is the transferred property used or held for use in the trade or business?

Rules concerning these four determinations are provided in paragraphs (b)(2), (3), (4), and (5) of this section.

(2) *Trade or business.* Whether the activities of a foreign corporation constitute a trade or business must be determined under all the facts and circumstances. In general, a trade or business is a specific unified group of activities that constitute (or could constitute) an independent economic enterprise carried on for profit. For example, the activities of a foreign selling subsidiary could constitute a trade or business if they could be independently carried on for profit, even though the subsidiary acts exclusively on behalf of, and has operations fully integrated with, its parent corporation. To constitute a trade or business, a group of activities must ordinarily include every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit. In this regard, one or more of such activities may be carried on by independent contractors under the direct control of the foreign corporation. (However, see paragraph (b)(3) of this section.) The group of activities must ordinarily include the collection of income and the payment of expenses. If the activities of a foreign corporation do not constitute a trade or business, then the exception provided by this section does not apply, regardless of the level of activities carried on by the corporation. The following activities are not considered to constitute by themselves a trade or business for purposes of this section:

(i) Any activity giving rise to expenses that would be deductible only under section 212 if the activities were carried on by an individual; or

(ii) The holding for one's own account of investments in stock, securities, land, or other property, including casual sales thereof.

(3) *Active conduct.* Whether a trade or business is actively conducted must be determined under all the facts and circumstances. In general, a corporation actively conducts a trade or business only if the officers and employees of the corporation carry out substantial managerial and operational activities. A corporation may be engaged in the active conduct of a trade or business even though incidental activities of the trade or business are carried out on behalf of the corporation by independent contractors. In determining whether the officers and employees of the corporation carry out substantial managerial and operational activities, however, the activities of independent contractors shall be disregarded. On the other hand, the officers and employees of the corporation are considered to include the officers and employees of related entities who are made available to and supervised on a day-to-day basis by, and whose salaries are paid by (or reimbursed to the lending related entity by), the transferee foreign corporation. Whether a trade or business that produces rents or royalties is actively conducted shall be determined under the principles of §1.954–2(d)(1) (but without regard to whether the rents or royalties are received from an unrelated person). The rule of this paragraph (b)(3) is illustrated by the following example.

Example. X, a domestic corporation, and Y, a foreign corporation not related to X, transfer property to Z, a newly formed foreign corporation organized for the purpose of combining the research activities of X and Y. Z contracts all of its operational and research activities to Y for an arm's-length fee. Z's activities do not constitute the active conduct of a trade or business.

(4) *Outside of the United States.* Whether a foreign corporation conducts a trade or business outside of the United States must be determined under all the facts and circumstances. Generally, the primary managerial and operational activities of the trade or business must be conducted outside the United States and immediately after the transfer the transferred assets must be located outside the United States. Thus, the exception provided by this section would not apply to the transfer of the assets of a domestic business to a foreign corporation if the domestic business continued to operate in the United States after the transfer. In such a case, the primary operational activities of the business would continue to be conducted in the United States. Moreover, the transferred assets would be located in the United States. However, it is not necessary that every item of property transferred be used outside of the United States. As long as the primary managerial and operational activities of the trade or

business are conducted outside of the United States and substantially all of the transferred assets are located outside the United States, incidental items of transferred property located in the United States may be considered to have been transferred for use in the active conduct of a trade or business outside of the United States.

(5) *Use in the trade or business.* Whether property is used or held for use in a trade or business must be determined under all the facts and circumstances. In general, property is used or held for use in a foreign corporation's trade or business if it is—

(i) Held for the principal purpose of promoting the present conduct of the trade or business;

(ii) Acquired and held in the ordinary course of the trade or business; or

(iii) Otherwise held in a direct relationship to the trade or business. Property is considered held in a direct relationship to a trade or business if it is held to meet the present needs of that trade or business and not its anticipated future needs.

Thus, property will not be considered to be held in a direct relationship to a trade or business if it is held for the purpose of providing for future diversification into a new trade or business, future expansion of trade or business activities, future plant replacement, or future business contingencies.

(c) *Property transferred by transferee corporation*—(1) *General rule.* If a foreign corporation receives property in an exchange described in section 367(a)(1) and as part of the same transaction transfers the property to another person, then the exception provided by this section shall not apply to the initial transfer. For purposes of the preceding sentence, a subsequent transfer within six months of the initial transfer shall be considered to be part of the same transaction, and a subsequent transfer more than six months after the initial transfer may be considered to be part of the same transaction upon the application of step-transaction principles.

(2) *Exception.* Notwithstanding paragraph (c)(1) of this section, the active conduct exception provided by this section shall apply to the initial transfer if—

(i) The initial transfer is followed by one or more subsequent transfers described in section 351 or 721; and

(ii) Each subsequent transferee is either a partnership in which the preceding transferor is a general partner or a corporation in which the preceding transferor owns common stock; and

(iii) The ultimate transferee uses the property in the active conduct of a trade or business outside the United States.

(d) *Transitional rule.* Notwithstanding any other provision of this section, property shall be considered to have been transferred for use in the active conduct of a trade or business outside of the United States, if—

(1) The property was transferred after December 31, 1984, and before June 16, 1986;

(2) The property was, or would have been, considered to be transferred for use by the transferee foreign corporation in the active conduct, in any foreign country, or a trade or business, under the principles of section 3.02(1) of Revenue Procedure 68–23, 1968–1 C.B. 821; and

(3) Based on all of the facts and circumstances, it was, or would have been, determined under section 2.02 of Revenue Procedure 68–23 that tax avoidance was not one of the principal purposes of the transaction.

[T.D. 8087, 51 FR 17942, May 16, 1986]

§ 1.367(a)–3 Treatment of transfers of stock or securities to foreign corporations.

(a) *In general.* This section provides rules concerning the transfer of stock or securities by a U.S. person to a foreign corporation in an exchange described in section 367(a). In general, a transfer of stock or securities by a U.S. person to a foreign corporation that is described in section 351, 354 (including a reorganization described in section 368(a)(1)(B) and including an indirect stock transfer described in paragraph (d) of this section), 356 or section 361(a) or (b) is subject to section 367(a)(1) and, therefore, is treated as a taxable exchange, unless one of the exceptions set forth in paragraph (b) of this section (regarding transfers of foreign stock or securities) or paragraph (c) of this section (regarding transfers of domestic stock or securities) applies. However, if in an exchange described in section 354, a U.S. person exchanges stock of a foreign corporation in a reorganization described in section 368(a)(1)(E), or a U.S. person exchanges stock of a domestic or foreign corporation for stock of a foreign corporation pursuant to an asset reorganization described in section 368(a)(1)(C), (D) or (F) that is not treated as an indirect stock transfer under paragraph (d) of this section, such section 354 exchange is not a transfer to a foreign corporation subject to section 367(a). See, e.g., paragraph (d)(3) *Example 12.* For rules regarding other indirect or constructive transfers of stock or securities subject to section 367(a), see § 1.367(a)–1T(c). For additional rules relating to an exchange involving a foreign corporation in connection with which there is a transfer of stock, see section 367(b) and the regulations under that section. For additional rules regarding a transfer of stock or securities in an exchange described in section 361(a) or (b), see section 367(a)(5) and any regulations under that section. For rules regarding reporting requirements with respect to transfers described under section 367(a), see section 6038B and the regulations thereunder.

(b) *Transfers by U.S. persons of stock or securities of foreign corporations to foreign corporations*—(1) *General rule.* Except as provided in section 367(a)(5), a transfer of stock or securities of a foreign corporation by a U.S. person to a foreign corporation that would otherwise be subject to section 367(a)(1) under paragraph (a) of this section shall not be subject to section 367(a)(1) if either—

(i) *Less than 5-percent shareholder.* The U.S. person owns less than five percent (applying the attribution rules of section 318, as modified by section 958(b)) of both the total voting power and the total value of the stock of the transferee foreign corporation immediately after the transfer; or

(ii) *5-percent shareholder.* The U.S. person enters into a five-year gain recognition agreement with respect to the transferred stock or securities as provided in § 1.367(a)–8.

(2) *Certain transfers subject to sections 367(a) and (b)*—(i) *In general.* A transfer of foreign stock or securities described in section 367(a) or any regulations thereunder as well as in section 367(b) or any regulations thereunder shall be concurrently subject to sections 367(a) and (b) and the regulations thereunder, except to the extent that the transferee foreign corporation is not treated as a corporation under section 367(a)(1). The example in paragraph (b)(2)(ii) of this section illustrates the rules of this paragraph (b)(2). For an illustration of the interaction of the indirect stock transfer rules under section 367(a) (described under paragraph (d) of this section) and the rules of section 367(b), see paragraph (d)(3) *Example 11* of this section.

(ii) *Example.* The following example illustrates the provisions of this paragraph (b)(2):

Example. (i) *Facts.* DC, a domestic corporation, owns all of the stock of FC1, a controlled foreign corporation within the meaning of section 957(a). DC's basis in the stock of FC1 is $50, and the value of such stock is $100. The section 1248 amount with respect to such stock is $30. FC2, also a foreign corporation, is owned entirely by foreign individuals who are not related to DC or FC1. In a reorganization described in section 368(a)(1)(B), FC2 acquires all of the stock of FC1 from DC in exchange for 20 percent of the voting stock of FC2. FC2 is not a controlled foreign corporation after the reorganization.

(ii) *Result without gain recognition agreement.* Under the provisions of this paragraph (b), if DC fails to enter into a gain recognition agreement, DC is required to recognize in the year of the transfer the $50 of gain that it realized upon the transfer, $30 of which will be treated as a dividend under section 1248.

(iii) *Result with gain recognition agreement.* If DC enters into a gain recognition agreement under § 1.367(a)–8 with respect to the transfer of FC1 stock, the exchange will also be subject to the provisions of section 367(b) and the regulations thereunder to the extent that it is not subject to tax under section 367(a)(1). In such case, DC will be required to recognize the section 1248 amount of $30 on the exchange of FC1 for FC2 stock. See § 1.367(b)–4(b). The deemed dividend of $30 recognized by DC will increase its basis in the FC1 stock exchanged in the transaction and, therefore, the basis of the FC2 stock received in the transaction. The remaining gain of $20 realized by DC (otherwise recognizable under section 367(a)) in the exchange of FC1 stock will not be recognized if

DC enters into a gain recognition agreement with respect to the transfer. (The result would be unchanged if, for example, the exchange of FC1 stock for FC2 stock qualified as a section 351 exchange, or as an exchange described in both sections 351 and 368(a)(1)(B).)

(c) *Transfers by U.S. persons of stock or securities of domestic corporations to foreign corporations*—(1) *In general.* Except as provided in section 367(a)(5), a transfer of stock or securities of a domestic corporation by a U.S. person to a foreign corporation that would otherwise be subject to section 367(a)(1) under paragraph (a) of this section shall not be subject to section 367(a)(1) if the domestic corporation the stock or securities of which are transferred (referred to as the U.S. target company) complies with the reporting requirements in paragraph (c)(6) of this section and if each of the following four conditions is met:

(i) Fifty percent or less of both the total voting power and the total value of the stock of the transferee foreign corporation is received in the transaction, in the aggregate, by U.S. transferors (*i.e.,* the amount of stock received does not exceed the 50-percent ownership threshold).

(ii) Fifty percent or less of each of the total voting power and the total value of the stock of the transferee foreign corporation is owned, in the aggregate, immediately after the transfer by U.S. persons that are either officers or directors of the U.S. target company or that are five-percent target shareholders (as defined in paragraph (c)(5)(iii) of this section) (*i.e.,* there is no control group). For purposes of this paragraph (c)(1)(ii), any stock of the transferee foreign corporation owned by U.S. persons immediately after the transfer will be taken into account, whether or not it was received in the exchange for stock or securities of the U.S. target company.

(iii) Either—

(A) The U.S. person is not a five-percent transferee shareholder (as defined in paragraph (c)(5)(ii) of this section); or

(B) The U.S. person is a five-percent transferee shareholder and enters into a five-year agreement to recognize gain with respect to the U.S. target company stock or securities it exchanged in the form provided in § 1.367(a)–8; and

(iv) The active trade or business test (as defined in paragraph (c)(3) of this section) is satisfied.

(2) *Ownership presumption.* For purposes of paragraph (c)(1) of this section, persons who transfer stock or securities of the U.S. target company in exchange for stock of the transferee foreign corporation are presumed to be U.S. persons. This presumption may be rebutted in accordance with paragraph (c)(7) of this section.

(3) *Active trade or business test*—(i) *In general.* The tests of this paragraph (c)(3), collectively referred to as the active trade or business test, are satisfied if:

(A) The transferee foreign corporation or any qualified subsidiary (as defined in paragraph (c)(5)(vii) of this section) or any qualified partnership (as defined in paragraph (c)(5)(viii) of this section) is engaged in an active trade or business outside the United States, within the meaning of § 1.367(a)–2T(b)(2) and (3), for the entire 36-month period immediately before the transfer;

(B) At the time of the transfer, neither the transferors nor the transferee foreign corporation (and, if applicable, the qualified subsidiary or qualified partnership engaged in the active trade or business) have an intention to substantially dispose of or discontinue such trade or business; and

(C) The substantiality test (as defined in paragraph (c)(3)(iii) of this section) is satisfied.

(ii) *Special rules.* For purposes of paragraphs (c)(3)(i)(A) and (B) of this section, the following special rules apply:

(A) The transferee foreign corporation, a qualified subsidiary, or a qualified partnership will be considered to be engaged in an active trade or business for the entire 36-month period preceding the exchange if it acquires at the time of, or any time prior to, the exchange a trade or business that has been active throughout the entire 36-month period preceding the exchange. This special rule shall not apply, however, if the acquired active trade or business assets were owned by the U.S. target company or any affiliate (within the meaning of section 1504(a) but excluding the exceptions contained in section 1504(b) and substituting ‘‘50 percent’’ for ‘‘80 percent’’ where it appears therein) at any time during the 36-month period prior to the acquisition. Nor will this special rule apply if the principal purpose of such acquisition is to satisfy the active trade or business test.

(B) An active trade or business does not include the making or managing of investments for the account of the transferee foreign corporation or any affiliate (within the meaning of section 1504(a) but excluding the exceptions contained in section 1504(b) and substituting ‘‘50 percent’’ for ‘‘80 percent’’ where it appears therein). (This paragraph (c)(3)(ii)(B) shall not create any inference as to the scope of §1.367(a)–2T(b)(2) and (3) for other purposes.)

(iii) *Substantiality test*—(A) *General rule.* A transferee foreign corporation will be deemed to satisfy the substantiality test if, at the time of the transfer, the fair market value of the transferee foreign corporation is at least equal to the fair market value of the U.S. target company.

(B) *Special rules.* (*1*) For purposes of paragraph (c)(3)(iii)(A) of this section, the value of the transferee foreign corporation shall include assets acquired outside the ordinary course of business by the transferee foreign corporation within the 36-month period preceding the exchange only if either—

(*i*) Both—

(*A*) At the time of the exchange, such assets or, as applicable, the proceeds thereof, do not produce, and are not held for the production of, passive income as defined in section 1296(b); and

(*B*) Such assets are not acquired for the principal purpose of satisfying the substantiality test; or

(*ii*) Such assets consist of the stock of a qualified subsidiary or an interest in a qualified partnership. See paragraph (c)(3)(iii)(B)(*2*) of this section.

(*2*) For purposes of paragraph (c)(3)(iii)(A) of this section, the value of the transferee foreign corporation shall not include the value of the stock of any qualified subsidiary or the value of any interest in a qualified partnership, held directly or indirectly, to the extent that such value is attributable to assets acquired by such qualified subsidiary or partnership outside the ordinary course of business and within the 36-month period preceding the exchange unless those assets satisfy the requirements in paragraph (c)(3)(iii)(B)(*1*) of this section.

(*3*) For purposes of paragraph (c)(3)(iii)(A) of this section, the value of the transferee foreign corporation shall not include the value of assets received within the 36-month period prior to the acquisition, notwithstanding the special rule in paragraph (c)(3)(iii)(B)(*1*) of this section, if such assets were owned by the U.S. target company or an affiliate (within the meaning of section 1504(a) but without the exceptions under section 1504(b) and substituting ‘‘50 percent’’ for ‘‘80 percent’’ where it appears therein) at any time during the 36-month period prior to the transaction.

(4) *Special rules*—(i) *Treatment of partnerships.* For purposes of this paragraph (c), if a partnership (whether domestic or foreign) owns stock or securities in the U.S. target company or the transferee foreign corporation, or transfers stock or securities in an exchange described in section 367(a), each partner in the partnership, and not the partnership itself, is treated as owning and as having transferred, or as owning, a proportionate share of the stock or securities. See §1.367(a)–1T(c)(3).

(ii) *Treatment of options.* For purposes of this paragraph (c), one or more options (or an interest similar to an option) will be treated as exercised and thus will be counted as stock for purposes of determining whether the 50-percent threshold is exceeded or whether a control group exists if a principal purpose of the issuance or the acquisition of the option (or other interest) was the avoidance of the general rule contained in section 367(a)(1).

(iii) *U.S. target has a vestigial ownership interest in transferee foreign corporation.* In cases where, immediately after the transfer, the U.S. target company owns, directly or indirectly (applying the attribution rules of sections 267(c)(1) and (5)), stock of the transferee foreign corporation, that stock will not in any way be taken into account (and, thus, will not be treated as outstanding) in determining whether the 50-percent threshold under paragraph (c)(1)(i) of this section is exceeded or whether a control group under paragraph (c)(1)(ii) of this section exists.

(iv) *Attribution rule.* Except as otherwise provided in this section, the rules of section 318, as modified by the rules of section 958(b) shall apply for purposes of determining the ownership or receipt of stock, securities or other property under this paragraph (c).

(5) *Definitions*—(i) *Ownership statement.* An ownership statement is a statement, signed under penalties of perjury, stating—

(A) The identity and taxpayer identification number, if any, of the person making the statement;

(B) That the person making the statement is not a U.S. person (as defined in paragraph (c)(5)(iv) of this section);

(C) That the person making the statement either—

(*1*) Owns less than 1 percent of the total voting power and total value of a U.S. target company the stock of which is described in Rule 13d–1(d) of Regulation 13D (17 CFR 240.13d–1(d)) (or any rule or regulation to generally the same effect) promulgated by the Securities and Exchange Commission under the Securities and Exchange Act of 1934 (15 USC 78m), and such person did not acquire the stock with a principal purpose to enable the U.S. transferors to satisfy the requirement contained in paragraph (c)(1)(i) of this section; or

(*2*) Is not related to any U.S. person to whom the stock or securities owned by the person making the statement are attributable under the rules of section 958(b), and did not acquire the stock with a principal purpose to enable the U.S. transferors to satisfy the requirement contained in paragraph (c)(1)(i) of this section;

(D) The citizenship, permanent residence, home address, and U.S. address, if any, of the person making the statement; and

(E) The ownership such person has (by voting power and by value) in the U.S. target company prior to the exchange and the amount of stock of the transferee foreign corporation (by voting power and value) received by such person in the exchange.

(ii) *Five-percent transferee shareholder.* A five-percent transferee shareholder is a person that owns at least five percent of either the total voting power or the total value of the stock of the transferee foreign corporation immediately after the transfer described in section 367(a)(1). For special rules involving cases in which stock is held by a partnership, see paragraph (c)(4)(i) of this section.

(iii) *Five-percent target shareholder and certain other 5-percent shareholders.* A five-percent target shareholder is a person that owns at least five percent of either the total voting power or the total value of the stock of the U.S. target company immediately prior to the transfer described in section 367(a)(1). If the stock of the U.S. target company (or any company through which stock of the U.S. target company is owned indirectly or constructively) is described in Rule 13d–1(d) of Regulation 13D (17 CFR 240.13d–1(d)) (or any rule or regulation to generally the same effect), promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934 (15 USC 78m), then, in the absence of actual knowledge to the contrary, the existence or absence of filings of Schedule 13–D or 13–G (or any similar schedules) may be relied upon for purposes of identifying five-percent target shareholders (or a five-percent shareholder of a corporation which itself is a five-percent shareholder of the U.S. target company). For special rules involving cases in which U.S. target company stock is held by a partnership, see paragraph (c)(4)(i) of this section.

(iv) *U.S. Person.* For purposes of this section, a U.S. person is defined by reference to § 1.367(a)–1T(d)(1). For application of the rules of this section to stock or securities owned or transferred by a partnership that is a U.S. person, however, see paragraph (c)(4)(i) of this section.

(v) *U.S. Transferor.* A U.S. transferor is a U.S. person (as defined in paragraph (c)(5)(iv) of this section) that transfers stock or securities of one or more U.S. target companies in exchange for stock of the transferee foreign corporation in an exchange described in section 367.

(vi) *Transferee foreign corporation.* A transferee foreign corporation is the foreign corporation whose stock is received in the exchange by U.S. persons.

(vii) *Qualified Subsidiary.* A qualified subsidiary is a foreign corporation whose stock is at least 80-percent owned (by total voting power and total value), directly or indirectly, by the transferee foreign corporation. However, a corporation will not be treated as a qualified subsidiary if it was affiliated with the U.S. target company (within the meaning of section 1504(a) but without the exceptions under section 1504(b) and substituting ‘‘50 percent’’ for ‘‘80 percent’’ where it appears therein) at any time during the 36-month period prior to the transfer. Nor will a corporation be treated as a qualified subsidiary if it was acquired by the transferee foreign corporation at any time during the 36-month period prior to the transfer for the principal purpose of satisfying the active trade or business test, including the substantiality test.

(viii) *Qualified partnership.* (A) Except as provided in paragraph (c)(5)(viii)(B) or (C) of this section, a qualified partnership is a partnership in which the transferee foreign corporation—

(*1*) Has active and substantial management functions as a partner with regard to the partnership business; or –

(*2*) Has an interest representing a 25 percent or greater interest in the partnership’s capital and profits.

(B) A partnership is not a qualified partnership if the U.S. target company or any affiliate of the U.S. target company (within the meaning of section 1504(a) but without the exceptions under section 1504(b) and substituting ‘‘50 percent’’ for ‘‘80 percent’’ where it appears therein) held a 5 percent or greater interest in the partnership’s capital and profits at any time during the 36-month period prior to the transfer.

(C) A partnership is not a qualified partnership if the transferee foreign corporation’s interest was acquired by that corporation at any time during the 36-month period prior to the transfer for the principal purpose of satisfying the active trade or business test, including the substantiality test.

(6) *Reporting requirements of U.S. target company.* (i) In order for a U.S. person that transfers stock or securities of a domestic corporation to qualify for the exception provided by this paragraph (c) to the general rule under section 367(a)(1), in cases where 10 percent or more of the total voting power or the total value of the stock of the U.S. target company is transferred by U.S. persons in the transaction, the U.S. target company must comply with the reporting requirements contained in this paragraph (c)(6). The U.S. target company must attach to its timely filed U.S. income tax return for the taxable year in which the transfer occurs a statement titled ‘‘Section 367(a)—Reporting of Cross-Border Transfer Under Reg. §1.367(a)–3(c)(6),’’ signed under penalties of perjury by an officer of the corporation to the best of the officer’s knowledge and belief, disclosing the following information—

(A) A description of the transaction in which a U.S. person or persons transferred stock or securities in the U.S. target company to the transferee foreign corporation in a transfer otherwise subject to section 367(a)(1);

(B) The amount (specified as to the percentage of the total voting power and the total value) of stock of the transferee foreign corporation received in the transaction, in the aggregate, by persons who transferred stock or securities of the U.S. target company. For additional information that may be required to rebut the ownership presumption of paragraph (c)(2) of this section in cases where more than 50 percent of either the total voting power or the total value of the stock of the transferee foreign corporation is received in the transaction, in the aggregate, by persons who transferred stock or securities of the U.S. target company, see paragraph (c)(7) of this section;

(C) The amount (if any) of transferee foreign corporation stock owned directly or indirectly (applying the attribution rules of sections 267(c)(1) and (5)) immediately after the exchange by the U.S. target company;

(D) A statement that there is no control group within the meaning of paragraph (c)(1)(ii) of this section;

(E) A list of U.S. persons who are officers, directors or five-percent target shareholders and the percentage of the total voting power and the total value of the stock of the transferee foreign corporation owned by such persons both immediately before and immediately after the transaction; and

(F) A statement that includes the following—

(*1*) A statement that the active trade or business test described in paragraph (c)(3) of this section is satisfied by the transferee foreign corporation and a description of such business;

(*2*) A statement that on the day of the transaction, there was no intent on the part of the transferee foreign corporation (or its qualified subsidiary, if relevant) or the transferors of the transferee foreign corporation (or qualified subsidiary, if relevant) to substantially discontinue its active trade or business; and

(*3*) A statement that the substantiality test described in paragraph (c)(3)(iii) of this section is satisfied, and documentation that such test is satisfied, including the value of the transferee foreign corporation and the value of the U.S. target company on the day of the transfer, and either one of the following—

(*i*) A statement demonstrating that the value of the transferee foreign corporation 36 months prior to the acquisition, plus the value of any assets described in paragraph (c)(3)(iii)(B) of this section (including stock) acquired by the transferee foreign corporation within the 36-month period, less the amount of any liabilities acquired during that period, exceeds the value of the U.S. target company on the acquisition date; or

(*ii*) A statement demonstrating that the value of the transferee foreign corporation on the date of the acquisition, reduced by the value of any assets not described in paragraph (c)(3)(iii)(B) of this section (including stock) acquired by the transferee foreign corporation within the 36-month period, exceeds the value of the U.S. target company on the date of the acquisition.

(ii) For purposes of this paragraph (c)(6), an income tax return will be considered timely filed if such return is filed, together with the statement required by this paragraph (c)(6), on or before the last date for filing a Federal income tax return (taking into account any extensions of time therefor) for the taxable year in which the transfer occurs. If a return is not timely filed within the meaning of this paragraph (c)(6), the District Director may make a determination, based on all facts and circumstances, that the taxpayer had reasonable cause for its failure to file a timely filed return and, if such a determination is made, the requirement contained in this paragraph (c)(6) shall be waived.

(7) *Ownership statements.* To rebut the ownership presumption of paragraph (c)(2) of this section, the U.S. target company must obtain ownership statements (described in paragraph (c)(5)(i) of this section) from a sufficient number of persons that transfer U.S. target company stock or securities in the transaction that are not U.S. persons to demonstrate that the 50-percent threshold of paragraph (c)(1)(i) of this section is not exceeded. In addition, the U.S. target company must attach to its timely filed U.S. income tax return (as described in paragraph (c)(6)(ii) of this section) for the taxable year in which the transfer occurs a statement, titled ‘‘Section 367(a)—Compilation of Ownership Statements Under Reg. § 1.367(a)–3(c),’’ signed under penalties of perjury by an officer of the corporation, disclosing the following information:

(i) The amount (specified as to the percentage of the total voting power and the total value) of stock of the transferee foreign corporation received, in the aggregate, by U.S. transferors;

(ii) The amount (specified as to the percentage of total voting power and total value) of stock of the transferee foreign corporation received, in the aggregate, by foreign persons that filed ownership statements;

(iii) A summary of the information tabulated from the ownership statements, including—

(A) The names of the persons that filed ownership statements stating that they are not U.S. persons;

(B) The countries of residence and citizenship of such persons; and

(C) Each of such person’s ownership (by voting power and by value) in the

U.S. target company prior to the exchange and the amount of stock of the transferee foreign corporation (by voting power and value) received by such persons in the exchange.

(8) *Certain transfers in connection with performance of services.* Section 367(a)(1) shall not apply to a domestic corporation's transfer of its own stock or securities in connection with the performance of services, if the transfer is considered to be to a foreign corporation solely by reason of §1.83–6(d)(1).

(9) *Private letter ruling option.* The Internal Revenue Service may, in limited circumstances, issue a private letter ruling to permit the taxpayer to qualify for an exception to the general rule under section 367(a)(1) if—

(i) A taxpayer is unable to satisfy all of the requirements of paragraph (c)(3) of this section relating to the active trade or business test of paragraph (c)(1)(iv) of this section, but such taxpayer meets all of the other requirements contained in paragraphs (c)(1)(i) through (c)(1)(iii) of this section, and such taxpayer is substantially in compliance with the rules set forth in paragraph (c)(3) of this section; or

(ii) A taxpayer is unable to satisfy any requirement of paragraph (c)(1) of this section due to the application of paragraph (c)(4)(iv) of this section. Notwithstanding the preceding sentence, in no event will the Internal Revenue Service rule on the issue of whether the principal purpose of an acquisition was to satisfy the active trade or business test, including the substantiality test.

(10) *Examples.* This paragraph (c) may be illustrated by the following examples:

Example 1. Ownership presumption.(i) FC, a foreign corporation, issues 51 percent of its stock to the shareholders of S, a domestic corporation, in exchange for their S stock, in a transaction described in section 367(a)(1).

(ii) Under paragraph (c)(2) of this section, all shareholders of S who receive stock of FC in the exchange are presumed to be U.S. persons. Unless this ownership presumption is rebutted, the condition set forth in paragraph (c)(1)(i) of this section will not be satisfied, and the exception in paragraph (c)(1) of this section will not be available. As a result, all U.S. persons that transferred S stock will recognize gain on the exchange. To rebut the ownership presumption, S must comply with the reporting requirements contained in paragraph (c)(6) of this section, obtaining ownership statements (described in paragraph (c)(5)(i) of this section) from a sufficient number of non-U.S. persons who received FC stock in the exchange to demonstrate that the amount of FC stock received by U.S. persons in the exchange does not exceed 50 percent.

Example 2. Filing of Gain Recognition Agreement.(i) The facts are the same as in *Example 1,* except that FC issues only 40 percent of its stock to the shareholders of S in the exchange. FC satisfies the active trade or business test of paragraph (c)(1)(iv) of this section. A, a U.S. person, owns 10 percent of S's stock immediately before the transfer. All other shareholders of S own less than five percent of its stock. None of S's officers or directors owns any stock in FC immediately after the transfer. A will own 15 percent of the stock of FC immediately after the transfer, 4 percent received in the exchange, and the balance being stock in FC that A owned prior to and independent of the transaction. No S shareholder besides A owns five percent or more of FC immediately after the transfer. The reporting requirements under paragraph (c)(6) of this section are satisfied.

(ii) The condition set forth in paragraph (c)(1)(i) of this section is satisfied because, even after application of the presumption in paragraph (c)(2) of this section, U.S. transferors could not receive more than 50 percent of FC's stock in the transaction. There is no control group because five-percent target shareholders and officers and directors of S do not, in the aggregate, own more than 50 percent of the stock of FC immediately after the transfer (A, the sole five-percent target shareholder, owns 15 percent of the stock of FC immediately after the transfer, and no officers or directors of S own any stock of FC immediately after the transfer). Therefore, the condition set forth in paragraph (c)(1)(ii) of this section is satisfied. The facts assume that the condition set forth in paragraph (c)(1)(iv) of this section is satisfied. Thus, U.S. persons that are not five-percent transferee shareholders will not recognize gain on the exchange of S shares for FC shares. A, a five-percent transferee shareholder, will not be required to include in income any gain realized on the exchange in the year of the transfer if he files a 5-year gain recognition agreement (GRA) and complies with section 6038B.

Example 3. Control Group.(i) The facts are the same as in *Example 2,* except that B, another U.S. person, is a 5-percent target shareholder, owning 25 percent of S's stock immediately before the transfer. B owns 40 percent of the stock of FC immediately after the transfer, 10 percent received in the exchange, and the balance being stock in FC that B owned prior to and independent of the transaction.

(ii) A control group exists because A and B, each a five-percent target shareholder within the meaning of paragraph (c)(5)(iii) of this section, together own more than 50 percent of FC immediately after the transfer (counting both stock received in the exchange and stock owned prior to and independent of the exchange). As a result, the condition set forth in paragraph (c)(1)(ii) of this section is not satisfied, and all U.S. persons (not merely A and B) who transferred S stock will recognize gain on the exchange.

Example 4. Partnerships.(i) The facts are the same as in *Example 3*, except that B is a partnership (domestic or foreign) that has five equal partners, only two of whom, X and Y, are U.S. persons. Under paragraph (c)(4)(i) of this section, X and Y are treated as the owners and transferors of 5 percent each of the S stock owned and transferred by B and as owners of 8 percent each of the FC stock owned by B immediately after the transfer. U.S. persons that are five-percent target shareholders thus own a total of 31 percent of the stock of FC immediately after the transfer (A's 15 percent, plus X's 8 percent, plus Y's 8 percent).

(ii) Because no control group exists, the condition in paragraph (c)(1)(ii) of this section is satisfied. The conditions in paragraphs (c)(1)(i) and (iv) of this section also are satisfied. Thus, U.S. persons that are not five-percent transferee shareholders will not recognize gain on the exchange of S shares for FC shares. A, X, and Y, each a five-percent transferee shareholder, will not be required to include in income in the year of the transfer any gain realized on the exchange if they file 5-year GRAs and comply with section 6038B.

(11) *Effective date.* This paragraph (c) applies to transfers occurring after January 29, 1997. However, taxpayers may elect to apply this section in its entirety to all transfers occurring after April 17, 1994, provided that the statute of limitations of the affected tax year or years is open.

(d) *Indirect stock transfers in certain nonrecognition transfers*—(1) *In general.* For purposes of this section, a U.S. person who exchanges, under section 354 (or section 356) stock or securities in a domestic or foreign corporation for stock or securities in a foreign corporation in connection with one of the following transactions described in paragraphs (d)(1)(i) through (v) of this section (or who is deemed to make such an exchange under paragraph (d)(1)(vi) of this section) shall be treated as having made an indirect transfer of such stock or securities to a foreign corporation that is subject to the rules of this section, including, for example, the requirement, where applicable, that the U.S. transferor enter into a gain recognition agreement to preserve nonrecognition treatment under section 367(a). If the U.S. person exchanges stock or securities of a foreign corporation, see also section 367(b) and the regulations thereunder. For an example of the concurrent application of the indirect stock transfer rules under section 367(a) and the rules of section 367(b), see, e.g., paragraph (d)(3) *Example 11* of this section.

(i) *Mergers described in sections 368(a)(1)(A) and (a)(2)(D).* A U.S. person exchanges stock or securities of a corporation (the acquired corporation)

for stock or securities of a foreign corporation that controls the acquiring corporation in a reorganization described in sections 368(a)(1)(A) and (a)(2)(D). See, e.g., paragraph (d)(3) *Example 1* of this section.

(ii) *Mergers described in sections 368(a)(1)(A) and (a)(2)(E).* A U.S. person exchanges stock or securities of a corporation (the acquiring corporation) for stock or securities in a foreign corporation that controls the acquired corporation in a reorganization described in sections 368(a)(1)(A) and (a)(2)(E).

(iii) *Triangular reorganizations described in section 368(a)(1)(B).* A U.S. person exchanges stock of the acquired corporation for voting stock of a foreign corporation that is in control (as defined in section 368(c)) of the acquiring corporation in connection with a reorganization described in section 368(a)(1)(B). See, e.g., paragraph (d)(3) *Example 4* of this section.

(iv) *Triangular reorganizations described in section 368(a)(1)(C).* A U.S. person exchanges stock or securities of a corporation (the acquired corporation) for voting stock or securities of a foreign corporation that controls the acquiring corporation in a reorganization described in section 368(a)(1)(C). See, e.g., paragraph (d)(3) *Example 5* of this section (for an example of a triangular section 368(a)(1)(C) reorganization involving domestic acquired and acquiring corporations), and paragraph (d)(3)

Example 7 of this section (for an example involving a domestic acquired corporation and a foreign acquiring corporation). If the acquired corporation is a foreign corporation, see paragraph (d)(3) *Example 11* of this section, and section 367(b) and the regulations thereunder.

(v) *Reorganizations described in sections 368*(*a*)(*1*)(*C*) and (*a*)(*2*)(*C*). A U.S. person exchanges stock or securities of a corporation (the acquired corporation) for voting stock or securities of a foreign acquiring corporation in a reorganization described in sections 368(a)(1)(C) and (a)(2)(C) (other than a triangular section 368(a)(1)(C) reorganization described in paragraph (d)(1)(iv) of this section). In the case of a reorganization in which some but not all of the assets of the acquired corporation are transferred pursuant to section 368(a)(2)(C), the transaction shall be considered to be an indirect transfer of stock or securities subject to this paragraph (d) only to the extent of the assets so transferred. (Other assets shall be treated as having been transferred in an asset transfer rather than an indirect stock transfer, and such asset transfer would be subject to the other provisions of section 367, including sections 367(a)(1), (3), (5) and (d) if the acquired corporation is a domestic corporation). See, e.g., paragraph (d)(3) *Example 5B* of this section.

(vi) *Successive transfers of property to which section 351 applies.* A U.S. person transfers property (other than stock or securities) to a foreign corporation in an exchange described in section 351, and all or a portion of such assets transferred to the foreign corporation by such person are, in connection with the same transaction, transferred to a second corporation that is controlled by the foreign corporation in one or more exchanges described in section 351. For purposes of this paragraph (d)(1) and §1.367(a)–8, the initial transfer by the U.S. person shall be deemed to be a transfer of stock described in section 354. (Any assets transferred to the foreign corporation that are not transferred by the foreign corporation to a second corporation shall be treated as a transfer of assets subject to the general rules of section 367, including sections 367(a)(1), (3), (5) and (d), and not as an indirect stock transfer under the rules of this paragraph (d).) See, e.g., paragraph (d)(3) *Example 10* and *Example 10A* of this section.

(2) *Special rules for indirect transfers.* If a U.S. person is considered to make an indirect transfer of stock or securities described in paragraph (d)(1) of this section, the rules of this section and §1.367(a)–8 shall apply to the transfer. For purposes of applying the rules of this section and §1.367(a)–8:

(i) *Transferee foreign corporation.* The transferee foreign corporation shall be the foreign corporation that issues stock or securities to the U.S. person in the exchange.

(ii) *Transferred corporation.* The transferred corporation shall be the acquiring corporation, except that in the case of a triangular section 368(a)(1)(B) reorganization described in paragraph (d)(1)(iii) of this section, the transferred corporation shall be the acquired corporation; in the case of a triangular section 368(a)(1)(C) reorganization described in paragraph (d)(1)(iv) of this section followed by a section 368(a)(2)(C) transfer or a section 368(a)(1)(C) reorganization followed by a section 368(a)(2)(C) transfer described in paragraph (d)(1)(v) of this section, the transferred corporation shall be the transferee corporation; and in the case of successive section 351 transfers described in paragraph (d)(1)(vi) of this section, the transferred corporation shall be the transferee corporation in the final section 351 transfer. The transferred property shall be the stock or securities of the transferred corporation, as appropriate in the circumstances.

(iii) *Amount of gain.* The amount of gain that a U.S. person is required to include in income in the event of a disposition (or a deemed disposition) of some or all of the stock or securities of the transferred corporation shall be the proportionate share (as determined under §1.367(a)–8(e)) of the U.S. person's gain realized but not recognized in the initial exchange (or deemed exchange) of stock or securities under section 354.

(iv) *Gain recognition agreements involving multiple parties.* The U.S. transferor's agreement to recognize gain, as provided in § 1.367(a)–8, shall include appropriate provisions, consistent with the principles of these rules, requiring the transferor to recognize gain in the event of a direct or indirect disposition of the stock or assets of the transferred corporation. For example, in the case of a triangular section 368(a)(1)(B) reorganization described in paragraph (d)(1)(iii) of this section, a disposition of the transferred stock shall include an indirect disposition of such stock by the transferee foreign corporation, such as a disposition of such stock by the acquiring corporation or a disposition of the stock of the acquiring corporation by the transferee foreign corporation. See, e.g., paragraph (d)(3) *Example 4* of this section.

(v) *Determination of whether the transferred corporation disposed of substantially all of its assets.* For purposes of applying § 1.367(a)–8(e)(3)(i) to determine whether the transferred corporation has disposed of substantially all of its assets, the following assets shall be taken into account (but only if such assets are not fully taxable under section 367 in the taxable year that includes the indirect transfer)—

(A) In the case of a sections 368(a)(1)(A) and (a)(2)(D) reorganization, and a triangular section 368(a)(1)(C) reorganization described in paragraph (d)(1)(i) or (iv) of this section, respectively, the assets of the acquired corporation;

(B) In the case of a sections 368(a)(1)(A) and (a)(2)(E) reorganization described in paragraph (d)(1)(ii) of this section, the assets of the acquiring corporation immediately prior to the transaction;

(C) In the case of a sections 368(a)(1)(C) and (a)(2)(C) reorganization described in paragraph (d)(1)(v) of this section, the assets of the acquired corporation that are subject to a transfer described in section 368(a)(2)(C); and

(D) In the case of successive section 351 exchanges described in paragraph (d)(1)(vi) of this section, the assets that are both transferred initially to the foreign corporation, and transferred by the foreign corporation to a second corporation.

(vi) *Coordination between asset transfer rules and indirect stock transfer rules.* If, pursuant to any of the transactions described in paragraph (d)(1) of this section, a domestic corporation transfers (or is deemed to transfer) assets to a foreign corporation (other than in an exchange described in section 354), the rules of section 367, including sections 367(a)(1), (a)(3) and (a)(5), as well as section 367(d), and the regulations thereunder shall apply prior to the application of the rules of this section. However, if a transaction is described in this paragraph (d), section 367(a) shall not apply in the case of a domestic acquired corporation that transfers its assets to a foreign acquiring corporation, to the extent that such assets are re-transferred to a domestic corporation in a transfer described in section 368(a)(2)(C) or paragraph (d)(1)(vi) of this section, but only if the domestic transferee's basis in the assets is no greater than the basis that the domestic acquired company had in such assets. See, e.g., paragraph (d)(3) *Example 8* and *Example 10A* of this section.

(3) *Examples.* The rules of this paragraph (d) and § 1.367(a)–8 are illustrated by the following examples:

Example 1. Section 368(a)(1)(A)/(a)(2)(D) reorganization—(i) *Facts.* F, a foreign corporation, owns all the stock of Newco, a domestic corporation. A, a domestic corporation, owns all of the stock of W, also a domestic corporation. A and W file a consolidated Federal income tax return. A does not own any stock in F (applying the attribution rules of section 318, as modified by section 958(b)). In a reorganization described in sections 368(a)(1)(A) and (a)(2)(D), Newco acquires all of the assets of W, and A receives 40% of the stock of F in an exchange described in section 354.

(ii) *Result.* Pursuant to paragraph (d)(1)(i) of this section, the reorganization is subject to the indirect stock transfer rules. F is treated as the transferee foreign corporation, and Newco is treated as the transferred corporation. Provided that the requirements of paragraph (c)(1) of this section are satisfied, including the requirement that A enter into a five-year gain recognition agreement as described in § 1.367(a)–8, A's exchange of W stock for F stock under section 354 will not be subject to section 367(a)(1). If F disposes (within the meaning of § 1.367(a)–8(e)) of all (or a portion) of Newco's stock within the five-year term of the agreement (and A has not made a valid election under § 1.367(a)–8(b)(1)(vii)), A is required to file an amended return for the year of the transfer and include in income, with interest, the gain realized but not recognized on the initial section 354 exchange. If A has made a valid election under §1.367(a)–8(b)(1)(vii) to include the amount subject to the gain recognition agreement in the year of the triggering event, A would instead include the gain on its tax return for the taxable year that includes the triggering event, together with interest.

Example 1A. Transferor is a subsidiary in consolidated group—(i) *Facts.* The facts are the same as in *Example 1,* except that A is owned by P, a domestic corporation, and for the taxable year in which the transaction occurred, P, A and W filed a consolidated Federal income tax return.

(ii) *Result.* Even though A is the U.S. transferor, P is required under §1.367(a)–8(a)(3) to enter into the gain recognition agreement and comply with the requirements under §1.367(a)–8. In the event that A leaves the P group, A would make the annual certifications required under §1.367(a)–8(b)(5)(ii). P would remain liable with A under the gain recognition agreement.

Example 2. Taxable inversion pursuant to indirect stock transfer rules—(i) *Facts.* The facts are the same as in *Example 1*, except that A receives more than fifty percent of either the total voting power or the total value of the stock of F in the transaction.

(ii) *Result.* A is required to include in income in the year of the exchange the amount of gain realized on such exchange. See paragraph (c)(1)(i) of this section. If A fails to include the income on its timely-filed return, A will also be liable for the penalty under section 6038B (together with interest and other applicable penalties) unless A's failure to include the income is due to reasonable cause and not willful neglect. See §1.6038B–1(f).

Example 3. Disposition by U.S. transferred corporation of substantially all of its assets—(i) *Facts.* The facts are the same as in *Example 1*, except that, during the third year of the gain recognition agreement, Newco disposes of substantially all (as described in §1.367(a)–8(e)(3)(i)) of the assets described in paragraph (d)(2)(v)(A) of this section for cash and recognizes currently all of the gain realized on the disposition.

(ii) *Result.* Under §1.367(a)–8(e)(3)(i), the gain recognition agreement is generally triggered when the transferred corporation disposes of substantially all of its assets. However, under the special rule contained in §1.367(a)–8(h)(2), because A and W filed a consolidated Federal income tax return prior to the transaction, and Newco, the transferred corporation, is a domestic corporation, the gain recognition agreement is terminated and has no further effect.

Example 4. Triangular section 368(a)(1)(B) reorganization—(i) *Facts.* F, a foreign corporation, owns all the stock of S, a domestic corporation. U, a domestic corporation, owns all of the stock of Y, also a domestic corporation. U does not own any of the stock of F (applying the attribution rules of section 318, as modified by section 958(b)). In a triangular reorganization described in section 368(a)(1)(B) and paragraph (d)(1)(iii) of this section, S acquires all the stock of Y, and U receives 10% of the voting stock of F.

(ii) *Result.* U's exchange of Y stock for F stock will not be subject to section 367(a)(1), provided that all of the requirements of paragraph (c)(1) are satisfied, including the requirement that U enter into a five-year gain recognition agreement. For purposes of this section, F is treated as the transferee foreign corporation and Y is treated as the transferred corporation. See paragraphs (d)(2)(i) and (ii) of this section. Under paragraph (d)(2)(iv) of this section, the gain recognition agreement would be triggered if F sold all or a portion of the stock of S, or if S sold all or a portion of the stock of Y.

Example 5. Triangular section 368(a)(1)(C) reorganization—(i) *Facts.* F, a foreign corporation, owns all of the stock of R, a domestic corporation that operates an historical business. V, a domestic corporation, owns all of the stock of Z, also a domestic corporation. V does not own any of the stock of F (applying the attribution rules of section 318 as modified by section 958(b)). In a triangular reorganization described in section 368(a)(1)(C) (and paragraph (d)(1)(iv) of this section), R acquires all of the assets of Z, and V receives 30% of the voting stock of F.

(ii) *Result.* The consequences of the transfer are similar to those described in *Example 1*; V is required to enter into a 5-year gain recognition agreement under §1.367(a)–8 to secure nonrecognition treatment under section 367(a). Under paragraphs (d)(2)(i) and (ii) of this section, F is treated as the transferee foreign corporation and R is treated as the transferred corporation. In determining whether, in a later transaction, R has disposed of substantially all of its assets under §1.367(a)–8(e)(3)(i), see paragraph (d)(2)(v)(A) of this section.

Example 5A. Section 368(a)(1)(C) reorganization followed by section 368(a)(2)(C) exchange—(i) *Facts.* The facts are the same as in *Example 5*, except that the transaction is structured as a section 368(a)(1)(C) reorganization, followed by a section 368(a)(2)(C) exchange, and R is a foreign corporation. The following additional facts are present. Z has 3 businesses: Business A with a basis of $10 and a value of $50, Business B with a basis of $10 and a value of $40, and Business C with a basis of $10 and a value of $30. V and Z file a consolidated Federal income tax return and V has a basis of $30 in the Z stock, which has a value of $120. Assume that Businesses A and B consist solely of assets that will satisfy the section 367(a)(3) active trade or business exception; none of Business C's assets will satisfy the exception. Z transfers all 3 businesses to F in exchange for 30 percent of the F stock, which Z distributes to V pursuant to a section 368(a)(1)(C) reorganization. F then contributes Businesses B and C to R pursuant to section 368(a)(2)(C).

(ii) *Result.* The transfer of the Business A assets by Z to F is subject to the general rules under section 367, as such transfer does not constitute an indirect stock transfer. The transfer by Z of the Business B and C assets to F must first be tested under sections 367(a)(1), (3) and (5). Z recognizes $20 of gain on the outbound transfer of the Business C assets, as such assets do not qualify for an exception to section 367(a)(1). The Business B assets, which will be used by R in an active trade or business outside the United States, qualify for the exception under section 367(a)(3) and § 1.367(a)–2T(c)(2). V is deemed to transfer the stock of Z to F in a section 354 exchange subject to the rules of paragraph (d). V must enter into the gain recognition agreement in the amount of $30 to preserve Z's nonrecognition treatment with respect to its transfer of Business B assets. Under paragraphs (d)(2)(i) and (ii) of this section, F is the transferee foreign corporation and R is the transferred corporation.

Example 5B. Section 368(a)(1)(C) reorganization followed by section 368(a)(2)(C) exchange with U.S. transferee—(i) *Facts.* The facts are the same as in *Example 5A*, except that R is a U.S. corporation.

(ii) *Result.* As in *Example 5A*, the outbound transfer of Business A assets to F is subject to section 367(a) and is not affected by the rules of this paragraph (d). The Business B assets qualified for nonrecognition treatment; the Business C assets did not. However, pursuant to paragraph (d)(2)(vi) of this section, the Business C assets are not subject to section 367(a)(1), provided that the basis of the assets in the hands of R is no greater than the basis of the assets in the hands of Z. V is deemed to make an indirect transfer under the rules of this paragraph (d). To preserve nonrecognition treatment under section 367(a), V must enter into a 5-year gain recognition agreement in the amount of $50, the amount of the appreciation in the Business B and C assets, as the transfer of such assets by Z were not taxable under section 367(a)(1) but were treated as an indirect stock transfer.

Example 6. Triangular section 368(a)(1)(C) reorganization followed by 351 exchange—(i) *Facts.* The facts are the same as in *Example 5*, except that, during the fourth year of the gain recognition agreement, R transfers substantially all of the assets received from Z to K, a wholly-owned domestic subsidiary of R, in an exchange described in section 351.

(ii) *Result.* The disposition by R, the transferred corporation, of substantially all of its assets would trigger the gain recognition agreement if the assets were disposed of in a taxable transaction. However, because the assets were transferred in a nonrecognition transaction, such transfer does not trigger the gain recognition agreement if V satisfies the reporting requirements contained in § 1.367(a)–8(g)(3) (which includes the requirement that V amend its gain recognition agreement to reflect the transaction). See also paragraph (d)(2)(iv) of this section. To determine whether substantially all of the assets are disposed of, any assets of Z that were transferred by Z to R and then contributed by R to K are taken into account.

Example 6A. Triangular section 368(a)(1)(C) reorganization followed by section 351 exchange with foreign transferee—(i) *Facts.* The facts are the same as in *Example 6* except that K is a foreign corporation.

(ii) *Result.* This transfer of assets by R to K must be analyzed to determine its effect upon the gain recognition agreement, and such transfer is also an outbound transfer of assets that is taxable under section 367(a)(1) unless the active trade or business exception under section 367(a)(3) applies. If the transfer is fully taxable under section 367(a)(1), the transfer is treated as if the transferred company, R, sold substantially all of its assets. Thus, the gain recognition agreement would be triggered (but see § 1.367(a)–8(b)(3)(ii) for potential offsets to the gain to be recognized). If each asset transferred qualifies for nonrecognition treatment under section 367(a)(3) and the regulations thereunder (which require, under § 1.367(a)–2T(a)(2), the transferor to comply with the reporting requirements under section 6038B), the result is the same as in *Example 6*. If a portion of the assets transferred qualify for nonrecognition treatment under section 367(a)(3) and a portion are taxable under section 367(a)(1) (but such portion does not result in the disposition of substantially all of the assets), the gain recognition agreement will not be triggered if such information is reported as required under § 1.367(a)–8(b)(5) and (e)(3)(i).

Example 7. Concurrent application of asset transfer and indirect stock transfer rules in consolidated return setting—(i) *Facts.* Assume the same facts as in *Example 5*, except that R is a foreign corporation and V and Z file a consolidated return for Federal income tax purposes. The properties of Z consist of Business A assets, with an adjusted basis of $50 and fair market value of $90, and Business B assets, with an adjusted basis of $50 and a fair market value of $110. Assume that the Business A assets do not qualify for the active trade or business exception under section 367(a)(3), but that the Business B assets do qualify for the exception. V's basis in the Z stock is $100, and the value of such stock is $200.

(ii) *Result.* Under paragraph (d)(2)(vi), the assets of Businesses A and B that are transferred to R must be tested under sections 367(a)(3) and (a)(5) prior to consideration of the indirect stock transfer rules of this paragraph (d). Thus, Z must recognize $40 of income under section 367(a)(1) on the outbound transfer of Business A assets. Under § 1.1502–32, because V and Z file a consolidated return, V's basis in its Z stock increases from $100 to $140 as a result of Z's $40 gain. Provided that all of the other requirements under paragraph (c)(1) of this section are satisfied, to qualify for nonrecognition treatment with respect to V's indirect transfer of Z stock, V must enter into a gain recognition agreement in the amount of $60 (the gain realized but not recognized by V in the stock of Z after the $40 basis adjustment). If F sells a portion of its stock in R during the term of the agreement, V will be required to recognize a portion of the $60 gain subject to the agreement. To determine whether R disposes of substantially all of its assets (under § 1.367(a)–8(e)(3)(i)), only the Business B assets will be considered (because the transfer of the Business A assets was taxable to Z under section 367). See paragraph (d)(2)(v)(A) of this section.

Example 7A. Concurrent application without consolidated returns—(i) *Facts.* The facts are the same as in *Example 7,* except that V and Z do not file consolidated income tax returns.

(ii) *Result.* Z would still recognize $40 of gain on the transfer of its Business A assets, and the Business B assets would still qualify for the active trade or business exception under section 367(a)(3). However, V's basis in its stock of Z would not be increased by the amount of Z's gain. V's indirect transfer of stock will be taxable unless V enters into a gain recognition agreement (as described in § 1.367(a)–8) for the $100 of gain realized but not recognized with respect to the stock of Z.

Example 7B. Concurrent application with individual U.S. shareholder—(i) *Facts.* The facts are the same as in *Example 7,* except that V is an individual U.S. citizen.

(ii) *Result.* Section 367(a)(5) would prevent the application of the active trade or business exception under section 367(a)(3). Thus, Z's transfer of assets to R would be fully taxable under section 367(a)(1). Z would recognize $100 of income. V's basis in its stock of Z is not increased by this amount. V is taxable with respect to its indirect transfer of its Z stock unless V enters into a gain recognition agreement in the amount of the $100, the gain realized but not recognized with respect to its Z stock.

Example 7C. Concurrent application with nonresident alien shareholder—(i) *Facts.* The facts are the same as in *Example 7,* except that V is a nonresident alien.

(ii) *Result.* Pursuant to section 367(a)(5), the active trade or business exception under section 367(a)(3) is not available with respect to Z's transfer of assets to R. Thus, Z has $100 of gain with respect to the Business A and B assets. Because V is a nonresident alien, however, V is not subject to section 367(a) with respect to its indirect transfer of Z stock.

Example 8. Concurrent application with section 368(a)(2)(C) Exchange—(i) *Facts.* The facts are the same as in *Example 7,* except that R transfers the Business A assets to M, a wholly-owned domestic subsidiary of R, in an exchange described in section 368(a)(2)(C).

(ii) *Result.* Pursuant to paragraph (d)(2)(vi) of this section, section 367(a)(1) does not apply to Z's transfer of Business A assets to R, because such assets are transferred to M, a domestic corporation. Sections 367(a)(1), (3) and (5), as well as section 367(d), apply to Z's transfer of assets to R to the extent that such assets are not transferred to M. However, the Business B assets qualify for an exception to taxation under section 367(a)(3). Thus, if the requirements of paragraph (c)(1) of this section are satisfied, including the requirement that V enter into a 5-year gain recognition agreement and comply with the requirements of § 1.367(a)–8 with respect to the gain realized on the Z stock, $100, the entire transaction qualifies for nonrecognition treatment under section 367(a)(1). See also section 367(a)(5) and any regulations issued thereunder. Under paragraphs (d)(2)(i) and (ii) of this section, the transferee foreign corporation is F and the transferred corporation is M. Pursuant to paragraph (d)(2)(iv) of this section, a disposition by F of the stock of R, or a disposition by R of the stock of M, will trigger the gain recognition agreement. To determine whether substantially all of the assets have been disposed of (as described under § 1.367(a)–8(e)(3)(i)), the Business A assets in M and the Business B assets in R must both be considered.

Example 9. Concurrent application of direct and indirect stock transfer rules—(i) *Facts.* F, a foreign corporation, owns all of the stock of O, also a foreign corporation. D, a domestic corporation, owns all of the stock of E, also a domestic corporation, which owns all of the stock of N, also a domestic corporation. Prior to the transactions described in this *Example 9,* D, E and N filed a consolidated income tax return. D has a basis of $100 in the stock of E, which has a fair market value of $160. The N stock has a fair market value of $100, and E has a basis of $60 in such stock. In addition to the stock of N, E owns the assets of Business X. The assets of Business X have a fair market value of $60, and E has a basis of $50 in such assets. Assume that the Business X assets qualify for nonrecognition treatment under section 367(a)(3). D does not own any stock in F (applying the attribution rules of section 318 as modified by section 958(b)). In a triangular reorganization described in section 368(a)(1)(C) and paragraph (d)(1)(iv) of this section, O acquires all of the assets of E, and

D exchanges its stock in E for 40% of the voting stock of F.

(ii) *Result.* E's transfer of its assets, including the N stock, must be tested under the general rules of section 367(a) before consideration of D's indirect transfer of the stock of E. E's transfer of the assets of Business X qualify for nonrecognition under section 367(a)(3). E could qualify for nonrecognition treatment with respect to its transfer of N stock if it enters into a gain recognition agreement (and all of the requirements of paragraph (c)(1)(i) of this section are satisfied); however under §1.367(a)–8(f)(2)(i), D, the parent of the consolidated group, must enter into the agreement. O is the transferee foreign corporation; N is the transferred corporation. D may also qualify for nonrecognition with respect to its indirect transfer of the stock of E if it enters into a separate gain recognition agreement with respect to the E stock (and all of the requirements of paragraph (c)(1)(i) of this section are satisfied). As to this transfer, F is the transferee foreign corporation; O is the transferred corporation. The amount of the gain recognition agreement is $60. See also section 367(a)(5) and any regulations issued thereunder.

Example 10. Successive section 351 exchanges—(i) *Facts.* D, a domestic corporation, owns all the stock of X, a controlled foreign corporation that operates an historical business, which owns all the stock of Y, a controlled foreign corporation that also operates an historical business. The properties of D consist of Business A assets, with an adjusted basis of $50 and a fair market value of $90, and Business B assets, with an adjusted basis of $50 and a fair market value of $110. Assume that the Business B assets qualify for the exception under section 367(a)(3) and §1.367(a)–2T(c)(2), but that the Business A assets do not qualify for the exception. In an exchange described in section 351, D transfers the assets of Businesses A and B to X, and, in connection with the same transaction, X transfers the assets of Business B to Y in another exchange described in section 351.

(ii) *Result.* Under paragraph (d)(1)(vi) of this section, this transaction is treated as an indirect stock transfer for purposes of section 367(a), but the transaction is not recharacterized for purposes of section 367(b). Moreover, under paragraph (d)(2)(vi) of this section, the assets of Businesses A and B that are transferred to X must be tested under section 367(a)(3). The Business A assets, which were not transferred to Y, are subject to the general rules of section 367(a), and not the indirect stock transfer rules described in this paragraph (d). D must recognize $40 of income on the outbound transfer of Business A assets. The transfer of the Business B assets is subject to both the asset transfer rules (under section 367(a)(3)) and the indirect stock transfer rules of this paragraph (d) and §1.367(a)–8. Thus, D's transfer of the Business B assets will not be subject to section 367(a)(1) if D enters into a five-year gain recognition agreement with respect to the stock of Y. Under paragraphs (d)(2)(i) and (ii) of this section, X will be treated as the transferee foreign corporation and Y will be treated as the transferred corporation for purposes of applying the terms of the agreement. If X sells all or a portion of the stock of Y during the term of the agreement, D will be required to recognize a proportionate amount of the $60 gain that was realized by D on the initial transfer of the Business B assets.

Example 10A. Successive section 351 exchanges with ultimate domestic transferee—(i) *Facts.* The facts are the same as in *Example 10,* except that Y is a domestic corporation.

(ii) *Result.* As in *Example 10,* D must recognize $40 of income on the outbound transfer of the Business A assets. Although the Business B assets qualify for the exception under section 367(a)(3) (and end up in U.S. corporate solution, in Y), the $60 of gain realized on the Business B assets is nevertheless taxable under paragraphs (c)(1) and (d)(1)(vi) of this section because the transaction is considered to be a transfer by D of stock of a domestic corporation, Y, in which D receives more than 50 percent of the stock of the transferee foreign corporation, X. A gain recognition agreement is not permitted.

Example 11. Concurrent application of indirect stock transfer rules and section 367(b)—(i) *Facts.* F, a foreign corporation, owns all of the stock of Newco, which is also a foreign corporation. P, a domestic corporation, owns all of the stock of S, a foreign corporation that is a controlled foreign corporation within the meaning of section 957(a). P's basis in the stock of S is $50 and the value of S is $100. The section 1248 amount with respect to S stock is $30. In a reorganization described in section 368(a)(1)(C) (and paragraph (d)(1)(iv) of this section), Newco acquires all of the properties of S, and P exchanges its stock in S for 49 percent of the stock of F.

(ii) *Result.* P's exchange of S stock for F stock under section 354 will be taxable under section 367(a) (and section 1248 will be applicable) if P fails to enter into a 5-year gain recognition agreement in accordance with §1.367(a)–8. Under paragraph (b)(2) of this section, if P enters into a gain recognition agreement, the exchange will be subject to the provisions of section 367(b) and the regulations thereunder as well as section 367(a). Under §7.367(b)–7(c)(1)(i) of this chapter, P must recognize the section 1248 amount of $30 because P exchanged stock of a controlled foreign corporation, S, for stock of a foreign corporation that is not a controlled foreign corporation, F. The indirect stock transfer rules do not apply with respect to section 367(b). The deemed dividend of $30 recognized by P will increase P's basis in the F stock received in the transaction, and F's basis in the Newco stock. Thus, the amount of the gain recognition agreement is $20 ($50 gain realized on the transfer less the $30 inclusion under section 367(b)). Under paragraphs (d)(2)(i) and (ii) of this section, F is treated as the transferee foreign corporation and Newco is the transferred corporation.

Example 11A. Triangular section 368(a)(1)(C) reorganization involving foreign acquired corporation—(i) *Facts.* Assume the same facts as in Example 11, except that P receives 51 percent of the stock of F.

(ii) *Result.* P may still enter into a gain recognition agreement to avoid taxation under section 367(a). There is, however, no inclusion under section 367(b) because P would be exchanging stock in one controlled foreign corporation for another. The amount of the gain recognition agreement is $50. See, also, §1.367(b)–4(b)(4).

Example 12. Direct asset reorganization not subject to stock transfer rules—(i) *Facts.* D is a publicly traded domestic corporation. D's assets consist of tangible assets, including stock or securities. In a reorganization described in section 368(a)(1)(F), D becomes a foreign corporation, F.

(ii) *Result.* The reorganization is characterized under §1.367(a)–1T(f). D's outbound transfer of assets is taxable under section 367(a)(1). Even if any of D's assets would have otherwise qualified for an exception to section 367(a)(1), section 367(a)(5) provides that no exception can apply. The section 368(a)(1)(F) reorganization is not an indirect stock transfer described in paragraph (d) of this section. Moreover, the exchange by D's shareholders of D stock for F stock in an exchange described under section 354 is not an exchange described under section 367(a). See paragraph (a) of this section.

(e) *Effective dates*—(1) *In general.* The rules in paragraphs (a), (b) and (d) of this section apply to transfers occurring on or after July 20, 1998. The rules in paragraph (c) of this section with respect to transfers of domestic stock or securities are generally applicable for transfers occurring after January 29, 1997. See §1.367(a)–3(c)(11). For rules regarding transfers of domestic stock or securities after December 16, 1987, and before January 30, 1997, and transfers of foreign stock or securities after December 16, 1987, and before July 20, 1998, see paragraph (g) of this section.

(2) *Election.* Notwithstanding paragraphs (e)(1) and (g) of this section, taxpayers may, by timely filing an original or amended return, elect to apply paragraphs (b) and (d) of this section to all transfers of foreign stock or securities occurring after December 16, 1987, and before July 20, 1998, except to the extent that a gain recognition agreement has been triggered prior to July 20, 1998. If an election is made under this paragraph (e)(2), the provisions of §1.367(a)–3T(g) (see 26 CFR part 1, revised April 1, 1998) shall apply, and, for this purpose, the term *substantial portion* under §1.367(a)–3T(g)(3)(iii) (see 26 CFR part 1, revised April 1, 1998) shall be interpreted to mean *substantially all* as defined in section 368(a)(1)(C). In addition, if such an election is made, the taxpayer must apply the rules under section 367(b) and the regulations thereunder to any transfers occurring within that period as if the election to apply §1.367(a)–3(b) and (d) to transfers occurring within that period had not been made, except that in the case of an exchange described in section 351 the taxpayer must apply section 367(b) and the regulations thereunder as if the exchange was described in §7.367(b)–7 of this chapter. For example, if a U.S. person, pursuant to a section 351 exchange, transfers stock of a controlled foreign corporation in which it is a United States shareholder but does not receive back stock of a controlled foreign corporation in which it is a United States shareholder, the U.S. person must include in income under §7.367(b)–7 of this chapter the section 1248 amount attributable to the stock exchanged (to the extent that the fair market value of the stock exchanged exceeds its adjusted basis). Such inclusion is required even though §7.367(b)–7 of this chapter, by its terms, did not apply to section 351 exchanges.

(f) *Former 10-year gain recognition agreements.* If a taxpayer elects to apply the rules of this section to all prior transfers occurring after December 16, 1987, any 10-year gain recognition agreement that remains in effect (has not been triggered in full) on July 20, 1998 will be considered by the Internal Revenue Service to be a 5-year gain recognition agreement with a duration of five full taxable years following the close of the taxable year of the initial transfer.

(g) *Transition rules regarding certain transfers of domestic or foreign stock or* *securities after December 16, 1987, and prior to July 20, 1998*—(1) *Scope.* Transfers of domestic stock or securities described under section 367(a) that occurred after December 16, 1987, and prior to April 17, 1994, and transfers of foreign stock or securities described under section 367(a) that occur after December 16, 1987, and prior to July 20, 1998 are subject to the rules contained in section 367(a) and the regulations thereunder, as modified by the rules contained in paragraph (g)(2) of this section. For transfers of domestic stock or securities described under section 367(a) that occurred after April 17, 1994 and before January 30, 1997, see Temporary Income Regulations under section 367(a) in effect at the time of the transfer (§ 1.367(a)–3T(a) and (c), 26 CFR part 1, revised April 1, 1996) and paragraph (c)(11) of this section. For transfers of domestic stock or securities described under section 367(a) that occur after January 29, 1997, see § 1.367(a)–3(c).

(2) *Transfers of domestic or foreign stock or securities: Additional substantive rules*—(i) *Rule for less than 5-percent shareholders.* Unless paragraph (g)(2)(iii) of this section applies (in the case of domestic stock or securities) or paragraph (g)(2)(iv) of this section applies (in the case of foreign stock or securities), a U.S. transferor that transfers stock or securities of a domestic or foreign corporation in an exchange described in section 367(a) and owns less than 5 percent of both the total voting power and the total value of the stock of the transferee foreign corporation immediately after the transfer (taking into account the attribution rules of section 958) is not subject to section 367(a)(1) and is not required to enter into a gain recognition agreement.

(ii) *Rule for 5-percent shareholders.* Unless paragraph (g)(2)(iii) or (iv) of this section applies, a U.S. transferor that transfers domestic or foreign stock or securities in an exchange described in section 367(a) and owns at least 5 percent of either the total voting power or the total value of the stock of the transferee foreign corporation immediately after the transfer (taking into account the attribution rules under section 958) may qualify for nonrecognition treatment by filing a gain recognition agreement in accordance with § 1.367(a)–3T(g) in effect prior to July 20, 1998 (see 26 CFR part 1, revised April 1, 1998) for a duration of 5 or 10 years. The duration is 5 years if the U.S. transferor (5-percent shareholder) determines that all U.S. transferors, in the aggregate, own less than 50 percent of both the total voting power and the total value of the transferee foreign corporation immediately after the transfer. The duration is 10 years in all other cases. See, however, § 1.367(a)–3(f). If a 5-percent shareholder fails to properly enter into a gain recognition agreement, the exchange is taxable to such shareholder under section 367(a)(1).

(iii) *Gain recognition agreement option not available to controlling U.S. transferor if U.S. stock or securities are transferred.* Notwithstanding the provisions of paragraph (g)(2)(ii) of this section, in no event will any exception to section 367(a)(1) apply to the transfer of stock or securities of a domestic corporation where the U.S. transferor owns (applying the attribution rules of section 958) more than 50 percent of either the total voting power or the total value of the stock of the transferee foreign corporation immediately after the transfer (i.e., the use of a gain recognition agreement to qualify for nonrecognition treatment is unavailable in this case).

(iv) *Loss of United States shareholder status in the case of a transfer of foreign stock.* Notwithstanding the provisions of paragraphs (g)(2)(i) and (ii) of this section, in no event will any exception to section 367(a)(1) apply to the transfer of stock of a foreign corporation in which the U.S. transferor is a United States shareholder (as defined in § 7.367(b)–2(b) of this chapter or section 953(c)) unless the U.S. transferor receives back stock in a controlled foreign corporation (as defined in section 953(c), section 957(a) or section 957(b)) as to which the U.S. transferor is a United States shareholder immediately after the transfer.

[T.D. 8702, 61 FR 68637, Dec. 30, 1996, as amended by T.D. 8770, 63 FR 33556, June 19, 1998; 64 FR 15687, Apr. 1, 1999]

§1.367(a)–4T Special rules applicable to specified transfers of property (temporary).

(a) *In general.* This section provides special rules for determining the applicability of section 367(a)(1) to specified transfers of property. Paragraph (b) of this section provides a special rule requiring the recapture of depreciation upon the transfer abroad of property previously used in the United States. Paragraphs (c) through (f) of this section provide rules for determining whether certain types of property are transferred for use in the active conduct of a trade or business outside of the United States. Paragraph (g) excepts certain transfers to FSCs from the operation of section 367(a)(1). The treatment of any transfer of property described in this section shall be determined exclusively under the rules of this section.

(b) *Depreciated property used in the U.S.*—(1) *In general.* If a U.S. person transfers U.S. depreciated property (as defined in paragraph (b)(2) of this section) to a foreign corporation in an exchange described in section 367(a)(1), then that person shall include in its gross income for the taxable year in which the transfer occurs ordinary income equal to the gain realized that would have been includible in the transferor's gross income as ordinary income under section 617(d)(1), 1245(a), 1250(a), 1252(a), or 1254(a), whichever is applicable, if at the time of the transfer the transferor had sold the property at its fair market value. Recapture of depreciation under this paragraph (b) shall be required regardless of whether any exception to section 367(a)(1) (such as the exception for property transferred for use in the active conduct of a foreign trade or business) would otherwise apply to the transfer. However, any applicable exception shall apply with respect to realized gain that is not included in ordinary income pursuant to this paragraph (b).

(2) *U.S. depreciated property.* U.S. depreciated property subject to the rules of this paragraph (b) is any property that—

(i) Is either mining property (as defined in section 617(f)(2)), section 1245 property (as defined in section 1245(a)(3)), section 1250 property (as defined in section 1250(c)), farm land (as defined in section 1252(a)(2)), or oil, gas, or geothermal property (as defined in section 1254(a)(3)); and

(ii) Has been used in the United States or has qualified as section 38 property by virtue of section 48(a)(2)(B) prior to its transfer.

(3) *Property used within and without the U.S.* If U.S. depreciated property has been used partly within and partly without the United States, then the amount required to be included in ordinary income pursuant to this paragraph (b) shall be reduced to an amount determined in accordance with the following formula:

$$\text{Full recapture amount} \times \frac{\text{U.S. use}}{\text{Total use}}$$

For purposes of the above fraction, the *full recapture amount* is the amount that would otherwise be included in the transferor's income under paragraph (b)(1) of this section. *U.S. use* is the number of months that the property either was used within the United States or qualified as section 38 property by virtue of section 48(a)(2)(B), and was subject to depreciation by the transferor or a related person. *Total use* is the total number of months that the property was used (or available for use), and subject to depreciation, by the transferor or a related person. For purposes of this paragraph (b)(3), property shall not be considered to have been in use outside of the United States during any period in which such property was, for purposes of section 48 or 168, treated as property not used predominantly outside the United States pursuant to the provisions of section 48(a)(2)(B). For purposes of this paragraph (b)(3) the term *related person* shall have the meaning set forth in §1.367(d)–1T(h).

(4) [Reserved]

(5) *Effective date.* This paragraph (b) applies to transfers occurring on or after June 16, 1986.

(c) *Property to be leased*—(1) *Leasing business of transferee.* Tangible property transferred to a foreign corporation that will be leased to other persons by the foreign corporation shall be considered to be transferred for use in the active conduct of a trade or business outside of the United States only if—

(i) The transferee's leasing of the property constitutes the active conduct of a leasing business;

(ii) The lessee of the property is not expected to, and does not, use the property in the United States; and

(iii) The transferee has need for substantial investment in assets of the type transferred.

The active conduct of a leasing business requires that the employees of the foreign corporation perform substantial marketing, customer service, repair and maintenance, and other substantial operational activities with respect to the transferred property outside of the United States. Tangible property subject to the rules of this paragraph (c) includes real property located outside of the United States. The rules of § 1.367(a)–5T(b) shall apply to transfers of property described in that section regardless of satisfaction of the rules of this paragraph (c).

(2) *De minimis leasing by transferee.* Tangible property transferred to a foreign corporation that will be leased to other persons by the foreign corporation and that does not satisfy the conditions of paragraph (b)(1) of this section shall, nevertheless, be considered to be transferred for use in the active conduct of a trade or business if either—

(i) The property transferred will be used by the transferee foreign corporation in the active conduct of a trade or business but will be leased during occasional brief periods when the property would otherwise be idle, such as an airplane leased during periods of excess capacity; or

(ii) The property transferred is real property located outside the United States and—

(A) The property will be used primarily in the active conduct of a trade or business of the transferee foreign corporation; and

(B) Not more than ten percent of the square footage of the property will be leased to others.

(d) *Property to be sold.* Property shall not be considered to be transferred for use in the active conduct of a trade or business and a transfer of stock or securities shall not be excepted from section 367(a)(1) under the rules of § 1.367(a)–3T if, at the time of the transfer, it is reasonable to believe that, in the reasonably foreseeable future, the transferee will sell or otherwise dispose of any material portion of the transferred stock, securities, or other property other than in the ordinary course of business.

(e) *Oil and gas working interests*—(1) *In general.* A working interest in oil and gas properties shall be considered to be transferred for use in the active conduct of a trade or business if—

(i) The transfer satisfies the conditions of paragraph (e)(2) of this section;

(ii) At the time of the transfer, the transferee has no intention to farmout or otherwise transfer any part of the transferred working interest; and

(iii) During the first three years after the transfer there are no farmouts or other transfers of any part of the transferred working interest as a result of which the transferee retains less than a 50 percent share of the transferred working interest.

(2) *Active use of working interest.* Working interests in oil and gas properties shall be considered to be transferred for use in the active conduct of a trade or business if—

(i) The transferor is regularly and substantially engaged in exploration for and extraction of minerals, either directly or through working interests in joint ventures, other than by reason of the property that is transferred;

(ii) The terms of the working interest transferred were actively negotiated among the joint venturers;

(iii) The working interest transferred constitutes at least a five percent working interest;

(iv) Prior to and at the time of the transfer, through its own employees or officers, the transferor was regularly and actively engaged in—

(A) Operating the working interest, or

(B) Analyzing technical data relating to the activities of the venture;

(v) Prior to and at the time of the transfer, through its own employees or officers, the transferor was regularly and actively involved in decision-making with respect to the operations of the venture, including decisions relating to exploration, development, production, and marketing; and

(vi) After the transfer, the transferee foreign corporation will for the foreseeable future satisfy the requirements of subdivisions (iv) and (v) of this paragraph (d)(2).

(3) *Start-up operations.* Working interests in oil and gas properties that do not satisfy the requirements of paragraph (e)(2) of this section shall, nevertheless, be considered to be transferred for use in the active conduct of a trade or business if—

(i) The working interest was acquired by the transferor immediately prior to the transfer and for the specific purpose of transferring it to the transferee foreign corporation;

(ii) The requirements of paragraph (e)(2)(ii) and (iii) of this section are satisfied; and

(iii) The transferee foreign corporation will for the foreseeable future satisfy the requirements of paragraph (e)(2)(iv) and (v) of this section.

(4) *Other applicable rules.* Oil and gas interests not described in this paragraph (e) may nonetheless qualify for the exception to section 367(a)(1) contained in §1.367(a)–2T, relating to transfers of property for use in the active conduct of a trade or business outside of the United States. However, a mere royalty interest in oil and gas properties will not be treated as transferred for use in the active conduct of a trade or business outside the United States. Moreover, a royalty or similar interest that constitutes intangible property will be subject to the rules of §1.367(d)–1T, relating to transfers of intangible property.

(f) *Compulsory transfers.* Property shall be presumed to be transferred for use in the active conduct of a trade or business outside of the United States, if—

(1) The property was previously in use in the country in which the transferee foreign corporation is organized; and

(2) The transfer is either:

(i) Legally required by the foreign government as a necessary condition of doing business in that country; or

(ii) Compelled by a genuine threat of immediate expropriation by the foreign government.

(g) *Relationship to other sections.* The rules of §§1.367(a)–5T, 1.367(a)–6T, and 1.367(d)–1T apply to transfers of property whether or not the property is transferred for use in the active conduct of a trade or business outside the United States. See §1.367(d)–1T(g)(2)(ii) for a special election with respect to compulsory transfers of intangible property.

(h) *Transfers of certain property to FSCs*—(1) *In general.* The provisions of section 367 (a) and (d) and the regulations thereunder shall not apply to a transfer of property by a U.S. person to a foreign corporation that constitutes a FSC, as defined in section 922(a), if—

(i) The transferee FSC uses the property to generate exempt foreign trade income, as defined in section 923(a);

(ii) The property is not excluded property, as defined in section 927(a)(2); and

(iii) The property consists of a corporate name or tangible property that is appropriate for use in the operation of a FSC office.

(2) *Exception.* The general rule in paragraph (g)(1) of this section shall not apply if, within three years after the original transfer, the original transferee FSC (or a subsequent transferee FSC) disposes of the property other than in the ordinary course of business or through a transfer to another FSC. Thus, the U.S. transferor may recognize gain in the taxable year in which the original transfer occurred through the application of section 367 and the regulations thereunder.

[T.D. 8087, 51 FR 17947, May 16, 1986, as amended by T.D. 8515, 59 FR 2960, Jan. 20, 1994]

§1.367(a)–5T Property subject to section 367(a)(1) regardless of use in trade or business (temporary).

(a) *In general.* Section 367(a)(1) shall apply to a transfer of property described in this section regardless of whether the property is transferred for use in the active conduct of a trade or business. Certain exceptions to the operation of this rule are provided in this section, and a special gain limitation rule is provided in paragraph (e). A transfer of property described in this section is subject to section 367(a)(1) even if the transfer is a compulsory transfer described in § 1.367(a)–4T(f).

(b) *Inventory, etc.* Regardless of use in an active trade or business, section 367(a)(1) shall apply to the transfer of—

(1) Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; and

(2) A copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

(i) A taxpayer whose personal efforts created such property;

(ii) In the case of a letter, memorandum, or similar property, a taxpayer from whom such property was prepared or produced; or

(iii) A taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subdivision (i) or (ii) of this paragraph (b)(2).

For purposes of this section, the term *inventory* includes raw materials and supplies, partially completed goods, and finished products.

(c) *Installment obligations, etc.* Regardless of use in an active trade or business, section 367(a)(1) shall apply to the transfer of installment obligations, accounts receivable, or similar property, but only to the extent that the principal amount of any such obligation has not previously been included by the taxpayer in its taxable income.

(d) *Foreign currency, etc.*—(1) *In general.* Regardless of use in an active trade or business, section 367(a)(1) shall apply to the transfer of foreign currency or other property denominated in foreign currency, including installment obligations, futures contracts, forward contracts, accounts receivable, or any other obligation entitling its payee to receive payment in a currency other than U.S. dollars.

(2) *Exception for certain obligations.* If transferred property denominated in a foreign currency—

(i) Is denominated in the currency of the country in which the transferee foreign corporation is organized; and

(ii) Was acquired in the ordinary course of the business of the transferor that will be carried on by the transferee foreign corporation,

then section 367(a)(1) shall apply to the transfer only to the extent that gain is required to be recognized with respect to previously realized income reflected in installment obligations subject to paragraph (c) of this section. The rule of this paragraph (d)(2) shall not apply to transfers of foreign currency.

(3) *Limitation of gain required to be recognized.* If section 367(a)(1) applies to a transfer of property described in this paragraph, then the gain required to be recognized shall be limited to—

(i) The gain realized upon the transfer of property described in this paragraph (d), minus

(ii) Any loss realized as part of the same transaction upon the transfer of property described in this paragraph (d).

This limitation applies in lieu of the rule in § 1.367(a)–1T(b)(1). No loss shall be recognized with respect to property described in this paragraph (d).

(e) *Intangible property.* Regardless of use in an active trade or business, a transfer of intangible property pursuant to section 332 shall be subject to section 367(a)(1), unless it constitutes foreign goodwill or going concern value, as defined in § 1.367(a)–1T(d)(5)(iii). For rules concerning transfers of intangible property pursuant to section 351 or 361, see section 367(d) and § 1.367(d)–1T.

(f) *Leased tangible property.* Regardless of use in an active trade or business, section 367(a)(1) shall apply to a transfer of tangible property with respect to which the transferor is a lessor at the time of the transfer, unless—

(1) With respect to property that will not be leased by the transferee to third persons, the transferee was the lessee of the property at the time of the transfer; or

(2) With respect to property that will be leased by the transferee to third persons, the transferee satisfies the conditions set forth in §1.367(a)–4T(c)(1) or (2).

[T.D. 8087, 51 FR 17949, May 16, 1986]

§1.367(a)–6T Transfer of foreign branch with previously deducted losses (temporary).

(a) *In general.* This section provides special rules relating to the transfer of the assets of a foreign branch with previously deducted losses. Paragraph (b) of this section provides generally that such losses must be recaptured by the recognition of the gain realized on the transfer. Paragraph (c) of this section sets forth rules concerning the character of, and limitations on, the gain required to be recognized. Paragraph (d) of this section defines the term *previously deducted losses.* Paragraph (e) of this section describes certain reductions that are made to the previously deducted losses before they are taken into income under this section. Finally, paragraph (g) of this section defines the term *foreign branch.*

(b) *Recognition of gain required*—(1) *In general.* If a U.S. person transfers any assets of a foreign branch to a foreign corporation in an exchange described in section 367(a)(1), then the transferor shall recognize gain equal to—

(i) The sum of the previously deducted branch ordinary losses as defined and reduced in paragraphs (d) and (e) of this section; and

(ii) The sum of the previously deducted branch capital losses as defined and reduced in paragraphs (d) and (e) of this section.

(2) *No active conduct exception.* The rules of this paragraph (b) shall apply regardless of whether the assets of the foreign branch are transferred for use in the active conduct of a trade or business outside the United States.

(c) *Special rules concerning gain recognized*—(1) *Character and source of gain.* The gain described in paragraph (b)(1)(i) of this section shall be treated as ordinary income of the transferor, and the gain described in paragraph (b)(1)(ii) of this section shall be treated as long-term capital gain of the transferor. Gain that is recognized pursuant to the rules of this section shall be treated as income from sources outside the United States. Such recognized gain shall be treated as foreign oil and gas extraction income (as defined in section 907) in the same proportion that previously deducted foreign oil and gas extraction losses bore to the total amount of previously deducted losses.

(2) *Gain limitation.* For a rule limiting the amount of gain required to be recognized under section 367(a) upon any transfer of property to a foreign corporation, including the transfer of assets of a foreign branch with previously deducted losses, see §1.367(a)–1T(b)(3).

(3) *Foreign goodwill and going concern value.* For purposes of this section, the assets of a foreign branch shall include foreign goodwill and going concern value related to the business of the foreign branch, as defined in §1.367(a)–1T(d)(5)(iii). Thus, gain realized upon the transfer of the foreign goodwill or going concern value of a foreign branch to a foreign corporation will be taken into account in computing the limitation on loss recapture under paragraph (c)(2) of this section.

(4) *Transfers of certain intangible property.* Gain realized on the transfer of intangible property (computed with reference to the fair market value of the intangible property as of the date of the transfer) that is an asset of a foreign branch shall be taken into account in computing the limitation on loss recapture under paragraph (c)(2) of this section. For rules relating to the crediting of gain recognized under this section against income deemed to arise by operation of section 367(d), see §1.367(d)–1T(g)(3).

(d) *Previously deducted losses*—(1) *In general.* This paragraph (d) provides rules for determining, for purposes of paragraph (b)(1) of this section, the previously deducted losses of a foreign branch any of whose assets are transferred to a foreign corporation in an exchange described in section 367(a)(1). Initially, the two previously deducted losses of a foreign branch for a taxable year are the total ordinary loss (''previously deducted branch ordinary loss'') and the total capital loss (''previously deducted branch capital loss'') that were realized by the foreign branch in that taxable year (a ''branch loss year'') prior to the transfer and that were or will be reflected on a U.S. income tax return of the transferor. The previously deducted branch ordinary loss for each branch loss year is reduced by expired net ordinary losses under paragraph (d)(2) of this section, while the previously deducted capital loss for each loss year is reduced by expired net capital losses under paragraph (d)(3) of this section. For each branch loss year, the remaining previously deducted branch ordinary loss and the remaining previously deducted branch capital loss are then reduced, proceeding from the first branch loss year to the last branch loss year, to reflect expired foreign tax credits under paragraph (d)(4) of this section. The reductions are made in the order of the taxable years in which the foreign tax credits arose. Finally, similar reductions are made to reflect expired investment credits under paragraph (d)(5) of this section.

(2) *Reduction by expired net ordinary loss*—(i) *In general.* The previously deducted branch ordinary loss for each branch loss year shall be reduced under this paragraph (d)(2) by the amount of any expired net ordinary loss with respect to that branch loss year. Expired net ordinary losses arising in years other than the branch loss year shall reduce the previously deducted branch ordinary loss for the branch loss year only to the extent that the previously deducted branch ordinary loss exceeds the net operating loss, if any, incurred by the transferor in the branch loss year. The previously deducted branch ordinary losses shall be reduced proceeding from the first branch loss year to the last branch loss year. For each branch loss year, expired net operating losses shall be applied to reduce the previously deducted branch ordinary loss for that year in the order in which the expired net ordinary losses arose.

(ii) *Existence of expired net ordinary loss.* An expired net ordinary loss exists with respect to a branch loss year to the extent that—

(A) The transferor incurred a net operating loss (within the meaning of section 172(c));

(B) That net operating loss arose in the branch loss year or was available for carryover or carryback to the branch loss year under section 172(b)(1);

(C) That net operating loss has neither given rise to a net operating loss deduction (within the meaning of section 172(a)) for any taxable year prior to the year of the transfer, nor given rise to a reduction of any previously deducted branch ordinary loss (pursuant to paragraph (d)(2) of this section) of any foreign branch of the transferor upon a previous transfer to a foreign corporation; and

(D) The period during which the transferor may claim a net operating loss deduction with respect to that net operating loss has expired.

(3) *Reduction by expired net capital loss*—(i) *In general.* The previously deducted branch capital loss for each branch loss year shall be reduced under this paragraph (d)(3) by the amount of any expired net capital loss with respect to that branch loss year. Expired net capital losses arising in years other than the branch loss year shall reduce the previously deducted branch capital loss for the branch loss year only to the extent that the previously deducted branch capital loss exceeds the net capital loss, if any, incurred by the transferor in the branch loss year. The previously deducted branch capital losses shall be reduced proceeding from the first branch loss year to the last branch loss year. For each branch loss year, expired net capital losses shall be applied to reduce the previously deducted branch capital loss for that year in the order in which the expired net capital losses arose.

(ii) *Existence of expired net capital loss.* An expired net capital loss exists with respect to a branch loss year to the extent that—

(A) The transferor incurred a net capital loss (within the meaning of section 1222(10));

(B) That net capital loss arose in the branch loss year or was available for carryover or carryback to the branch loss year under section 1212;

(C) That net capital loss has neither been allowed for any taxable year prior to the year of the transfer, nor given rise to a reduction of any previously deducted branch capital loss (pursuant to paragraph (c)(3) of this section) of any foreign branch of the transferor upon any previous transfer to a foreign corporation; and

(D) The period during which the transferor may claim a capital loss deduction with respect to that net capital loss has expired.

(4) *Reduction for expired foreign tax credit*—(i) *In general.* The previously deducted branch ordinary loss and the previously deducted branch capital loss for each branch loss year remaining after the reductions described in paragraph (d)(2) and (3) of this section shall be further reduced under this paragraph (d)(4) proportionately by the amount of any expired foreign tax credit loss equivalent with respect to that branch loss year. The previously deducted branch losses shall be reduced proceeding from the first branch loss year to the last branch loss year. For each branch loss year, expired foreign tax credit loss equivalents shall be applied to reduce the previously deducted branch loss for that year in the order in which the expired foreign tax credits arose.

(ii) *Existence of foreign tax credit loss equivalent.* A foreign tax credit loss equivalent exists with respect to a branch loss year if—

(A) The transferor paid, accrued, or is deemed under section 902 or 960 to have paid creditable foreign taxes in a taxable year;

(B) The creditable foreign taxes were paid, accrued, or deemed paid in the branch loss year or were available for carryover or carryback to the branch loss year under section 904(c);

(C) No foreign tax credit with respect to the foreign taxes paid, accrued, or deemed paid has been taken because of the operation of section 904(a) or similar limitations provided by the Code or an applicable treaty, and such taxes have not given rise to a reduction (pursuant to this paragraph (d)(5)) of any previously deducted branch loss of the foreign branch for a prior taxable year or of any previously deducted branch losses of any foreign branch of the transferor upon a prior transfer to a foreign corporation; and

(D) The period during which the transferor may claim a foreign tax credit for the foreign taxes paid, accrued, or deemed paid has expired.

(iii) *Amount of foreign tax credit loss equivalent.* The amount of the foreign tax credit loss equivalent for the branch loss year with respect to the creditable foreign taxes described in paragraph (d)(4)(ii) of this section is the amount of those creditable foreign taxes divided by the highest rate of tax to which the transferor was subject in the loss year.

(5) *Reduction for expired investment credits*—(i) *In general.* The previously deducted branch ordinary loss and the previously deducted branch capital loss for each branch loss year shall be further reduced under this paragraph (d)(5) proportionately by the amount of any expired investment credit loss equivalent with respect to that branch year. The previously deducted branch losses shall be reduced proceeding from the first branch loss year to the last branch loss year. For each branch loss year, expired investment credit loss equivalents shall be applied to reduce the previously deducted branch loss for that year in the order in which the expired investment credits were earned.

(ii) *Existence of investment credit loss equivalent.* An investment credit loss equivalent exists with respect to a branch loss year if—

(A) The transferor earned an investment credit (within the meaning of section 46(a)) in a taxable year;

(B) The investment credit was earned in the branch loss year or was available for carryover or carryback to the branch loss year under section 39;

(C) The investment credit earned by the transferor in the credit year has been denied by section 38(a) or by similar provisions of the Code and has not given rise to a reduction (pursuant to this paragraph (d)(5)) of any previously deducted branch loss of the foreign branch for a preceding taxable year or of the previously deducted losses of any foreign branch of the transferor upon any previous transfer to a foreign corporation; and

(D) The period during which the transferor may claim the investment credit has expired.

(iii) *Amount of investment tax credit loss equivalent.* The amount of the investment credit loss equivalent for the branch loss year with respect to the investment credit described in paragraph (d)(5)(ii) of this section is 85 percent of the amount of that investment credit divided by the highest rate of tax to which the transferor was subject in the loss year.

(e) *Amounts that reduce previously deducted losses subject to recapture*—(1) *In general.* This paragraph (e) describes five amounts that reduce the sum of the previously deducted branch ordinary losses and the sum of the previously deducted branch capital losses before they are taken into income under paragraph (b) of this section. Amounts representing ordinary income shall be applied to reduce first the sum of the previously deducted branch ordinary losses to the extent thereof, and then the sum of the previously deducted branch capital losses to the extent thereof. Similarly, amounts representing capital gains shall be applied to reduce first the sum of the previously deducted branch capital losses and then the sum of the previously deducted branch ordinary losses.

(2) *Taxable income.* The previously deducted losses shall be reduced by any taxable income of the foreign branch recognized through the close of the taxable year of the transfer, whether before or after any taxable year in which losses were incurred.

(3) *Amounts currently recaptured under section 904(f)(3).* The previously deducted losses shall be reduced by the amount recognized under section 904(f)(3) on account of the transfer.

(4) *Gain recognized under section 367(a).* The previously deducted branch losses shall be reduced by any gain recognized pursuant to section 367(a)(1) (other than by reason of the provisions of this section) upon the transfer of the assets of the foreign branch to the foreign corporation.

(5) *Amounts previously recaptured under section 904(f)(3)*—(i) *In general.* The previously deducted branch losses shall be reduced by the portion of any amount recognized under section 904(f)(3) upon a previous transfer of property that was attributable to the losses of the foreign branch, provided that the amount did not reduce any gain otherwise required to be recognized under section 367(a)(3)(C) and this section (or Revenue Ruling 78–201, 1978–1 C.B. 91).

(ii) *Portion attributable to the losses of the foreign branch*—(A) *Branch property.* The full amount recognized under section 904(f)(3) upon a previous transfer of property of the branch shall be treated as attributable to the losses of the foreign branch.

(B) *Non-branch property.* The portion of the amount previously recognized under section 904(f)(3) upon a transfer of non-branch property that was attributable to the losses of the foreign branch shall be the sum, over the taxable years in which the transferor sustained an overall foreign loss some portion of which was recaptured on the disposition, of the recaptured portions of those overall foreign losses after multiplication by the following fraction:

$$\frac{\text{Losses of the foreign branch for the year}}{\text{All foreign losses for the year}}$$

For purposes of this fraction, the term *losses of the foreign branch for the year* means the losses of the foreign branch that were taken into account under section 904(f)(2) in determining the amount of the transferor's overall foreign loss for the year, and the term *all foreign losses for the year* means all of the losses of the transferor that were taken into account under section 904(f)(2).

(6) *Amounts previously recognized under the rules of this section.* The previously deducted losses shall be reduced by the amounts previously recognized under the rules of this section upon a previous transfer of assets of the foreign branch.

(f) *Example.* The rules of paragraphs (b) through (e) of this section are illustrated by the following example.

Example. (i) *Facts.* X, a U.S. corporation, is a calendar year taxpayer. On January 1, 1981, X established a branch in foreign country A to manufacture and sell X's products in country A. On July 1, 1986, X organized corporation Y, a country A subsidiary, and transferred to Y all of the assets of its country A branch, including goodwill and going concern value. During the period from January 1, 1981, through July 1, 1986, X's country A branch earned income and incurred losses in the following amounts:

COUNTRY A BRANCH

Year	Ordinary income (loss)	Capital gain (loss)
1981	(200)	0
1982	(300)	(100)
1983	(400)	0
1984	(200)	0
1985	(100)	0
1986	50	0

At the time of the transfer of X's country A branch assets to Y, those assets had a fair market value of $2,500 and an adjusted basis of $1,000. For each of the assets, fair market value exceeded adjusted basis. X had no net capital loss or unused investment credit during any taxable year relevant to the transfer. In 1984, X incurred a net operating loss of $400, $200 of which was carried back to prior years. An additional $50 of the 1984 net operating loss was carried over to 1985. The remaining $150 of the 1984 net operating loss was not used in any year prior to the transfer. In 1979, X paid creditable foreign taxes of $330 that could not be claimed as a credit in that year or any earlier year because of section 904. Of those foreign taxes, $100 were carried over and claimed as a credit in 1983, but the remaining $230 were not used in any year prior to the transfer. X was not required to recognize any gain under section 904(f)(3) on account of the 1986 transfer or any prior transfer. X was not required to recognize gain upon the transfer under section 367(a) (other than by reason of the provisions of this section).

(ii) *Previously deducted losses.* The previously deducted losses of X's country A branch are $575 of ordinary losses and $25 of capital losses, computed as follows: Initially, the branch has previously deducted ordinary losses of $1,000 ($200+$300+$400+$100), and previously deducted capital losses of $100. (See paragraph (d)(1) of this section.)

(iii) *Expired losses and credits.* Under the facts of this example, there are no reductions for expired net ordinary losses or expired net capital losses under paragraph (d)(2) or (3) of this section. However, the previously deducted losses are reduced proceeding from the first branch loss year to the last branch loss year to reflect the expired foreign tax credit from 1979. The amount of the foreign tax credit loss equivalent with respect to 1981 is $500 ($230/.46). It reduces the previously deducted losses for 1981 proportionately. Thus, the previously deducted ordinary loss for 1981 is reduced from $200 to $0. (See paragraph (d)(4) of this section.) The amount of the foreign tax credit loss equivalent with respect to 1982 is $300 ($500−$200, *i.e.*, $138/.46). (See paragraph (d)(4)(ii)(C) of this section.) It reduces the previously deducted losses for 1982 proportionately. Thus, the previously deducted ordinary loss for 1982 is reduced from $300 to $75, and the previously deducted capital loss for 1982 is reduced from $100 to $25.

(iv) *Further reductions.* The previously deducted ordinary losses of $575 and the previously deducted capital losses of $25 are reduced by the taxable income earned by the branch prior to the date of the transfer ($250). (See paragraph (e)(2) of this section.) Since that income was ordinary income, it is applied first to reduce the previously deducted ordinary losses of $575 to $325. (See paragraph (e)(1) of this section.)

(v) *Recapture.* Since the gain realized by X upon its transfer of the branch assets to Y exceeds the sum of the previously deducted branch losses as defined and reduced above $325+$25), the limitation in paragraph (c)(2) of this section does not apply. Thus, X is required to recognize $325 of ordinary income and $25 of long-term capital gain upon the transfer. (See paragraph (b) and (c)(1) of this section.)

(g) *Definition of foreign branch*—(1) *In general.* For purposes of this section, the term *foreign branch* means an integral business operation carried on by a U.S. person outside the United States. Whether the activities of a U.S. person outside the United States constitute a foreign branch operation must be determined under all the facts and circumstances. Evidence of the existence of a foreign branch includes, but is not limited to, the existence of a separate set of books and records, and the existence of an office or other fixed place of business used by employees or officers of the U.S. person in carrying out business activities outside the United States. Activities outside the United States shall be deemed to constitute a foreign branch for purposes of this section if the activities constitute a permanent establishment under the terms of a treaty between the United States and the country in which the activities are carried out. Any U.S. person may be treated as having a foreign branch for purposes of this section, whether that person is a corporation, partnership, trust, estate, or individual.

(2) *More than one branch.* If a U.S. person carries on more than one branch operation outside the United States, then the rules of this section must be separately applied with respect to each foreign branch that is transferred to a foreign corporation. Thus, the previously deducted losses of one branch

may not be offset, for purposes of determining the gain required to be recognized under the rules of this section, by the income of another branch that is also transferred to a foreign corporation. Similarly, the losses of one branch shall not be recaptured upon a transfer of the assets of a separate branch. Whether the foreign activities of a U.S. person are carried out through more than one branch must be determined under all of the facts and circumstances. In general, a separate branch exists if a particular group of activities is sufficiently integrated to constitute a single business that could be operated as an independent enterprise. For purposes of determining the combination of activities that constitute a branch operation as defined in this paragraph (g), the nominal relationship among those activities shall not be controlling. Factors suggesting that nominally separate business operations constitute a single foreign branch include a substantial identity of products, customers, operational facilities, operational processes, accounting and record-keeping functions, management, employees, distribution channels, or sales and purchasing forces. For examples of the application of the principles of this paragraph (g)(2), see Revenue Ruling 81–82, 1981–1 C.B. 127.

(3) *Consolidated group.* For purposes of this section, the activities of each of two domestic corporations outside the United States will be considered to constitute a single foreign branch if—

(i) The two corporations are members of the same consolidated group of corporations; and

(ii) The activities of the two corporations in the aggregate would constitute a single foreign branch if conducted by a single corporation.

Notwithstanding the preceding rule of this paragraph (g)(3), gains of a foreign branch of a domestic corporation arising in a year in which that corporation did not file a consolidated return with a second domestic corporation shall not be applied to reduce the previously deducted losses of a foreign branch of the second corporation (but may be applied to reduce such losses of the foreign branch of the first corporation) upon the transfer of the two branches to a foreign corporation, even though the two domestic corporations file a consolidated return for the year in which the transfer occurs and the two branches are considered at that time to constitute a single foreign branch. For an example of the application of the principles of this paragraph (g)(3), see Revenue Ruling 81–89, 1981–1 C.B. 129.

(4) *Property not transferred.* A U.S. transferor's failure to transfer any property of a foreign branch shall be irrelevant to the determination of the previously deducted losses of the branch subject to recapture under the rules of this section. Thus, if the activities with respect to untransferred property constituted a part of the branch operation under the rules of this paragraph (g), then the losses generated by those activities shall be subject to recapture, notwithstanding the failure to transfer the property. For an example of the application of the principles of this paragraph (g)(4), see Revenue Ruling 80–247, 1980–2 C.B. 127, relating to property abandoned by the U.S. transferor.

(h) *Anti-abuse rule.* If—

(1) A U.S. person transfers property of a foreign branch to a domestic corporation for a principal purpose of avoiding the effect of this section; and

(2) The domestic corporation thereafter transfers the property of the foreign branch to a foreign corporation,

Then, solely for purposes of this section, that U.S. person shall be treated as having transferred the property of the branch directly to the foreign corporation. A U.S. person shall be presumed to have transferred property of a foreign branch for a principal purpose of avoiding the effect of this section if the property is transferred to the domestic corporation less than two years prior to the domestic corporation's transfer of the property to a foreign corporation. This presumption may be rebutted by clear evidence that the subsequent transfer of the property was not contemplated at the time of the initial transfer to the domestic corporation and that avoidance of the effect of this section was not a principal purpose for the transaction. A transfer may have more than one principal purpose.

(i) *Basis adjustments.* Basis adjustments reflecting gain recognized pursuant to this section shall be made as described in §1.367(a)–1T(b)(4)(ii).

[T.D. 8087, 51 FR 17950, May 16, 1986]

§1.367(a)–8 Gain recognition agreement requirements.

(a) *In general.* This section specifies the general terms and conditions for an agreement to recognize gain entered into pursuant to §1.367(a)–3(b) or (c) to qualify for nonrecognition treatment under section 367(a).

(1) *Filing requirements.* A transferor's agreement to recognize gain (described in paragraph (b) of this section) must be attached to, and filed by the due date (including extensions) of, the transferor's income tax return for the taxable year that includes the date of the transfer.

(2) *Gain recognition agreement forms.* Any agreement, certification, or other document required to be filed pursuant to the provisions of this section shall be submitted on such forms as may be prescribed therefor by the Commissioner (or similar statements providing the same information that is required on such forms). Until such time as forms are prescribed, all necessary filings may be accomplished by providing the required information to the Internal Revenue Service in accordance with the rules of this section.

(3) *Who must sign.* The agreement to recognize gain must be signed under penalties of perjury by a responsible officer in the case of a corporate transferor, except that if the transferor is a member but not the parent of an affiliated group (within the meaning of section 1504(a)(1)), that files a consolidated Federal income tax return for the taxable year in which the transfer was made, the agreement must be entered into by the parent corporation and signed by a responsible officer of such parent corporation; by the individual, in the case of an individual transferor (including a partner who is treated as a transferor by virtue of §1.367(a)–1T(c)(3)); by a trustee, executor, or equivalent fiduciary in the case of a transferor that is a trust or estate; and by a debtor in possession or trustee in a bankruptcy case under Title 11, United States Code. An agreement may also be signed by an agent authorized to do so under a general or specific power of attorney.

(b) *Agreement to recognize gain*—(1) *Contents.* The agreement must set forth the following information, with the heading ‘‘GAIN RECOGNITION AGREEMENT UNDER §1.367(a)–8’’, and with paragraphs labeled to correspond with the numbers set forth as follows—

(i) A statement that the document submitted constitutes the transferor's agreement to recognize gain in accordance with the requirements of this section;

(ii) A description of the property transferred as described in paragraph (b)(2) of this section;

(iii) The transferor's agreement to recognize gain, as described in paragraph (b)(3) of this section;

(iv) A waiver of the period of limitations as described in paragraph (b)(4) of this section;

(v) An agreement to file with the transferor's tax returns for the 5 full taxable years following the year of the transfer a certification as described in paragraph (b)(5) of this section;

(vi) A statement that arrangements have been made in connection with the transferred property to ensure that the transferor will be informed of any subsequent disposition of any property that would require the recognition of gain under the agreement; and

(vii) A statement as to whether, in the event all or a portion of the gain recognition agreement is triggered under paragraph (e) of this section, the taxpayer elects to include the required amount in the year of the triggering event rather than in the year of the initial transfer. If the taxpayer elects to include the required amount in the year of the triggering event, such statement must be included with all of the other information required under this paragraph (b), and filed by the due date (including extensions) of the transferor's income tax return for the taxable year that includes the date of the transfer.

(2) *Description of property transferred*—(i) The agreement shall include a description of each property transferred by the transferor, an estimate of the fair market value of the property as of the date of the transfer, a statement of

the cost or other basis of the property and any adjustments thereto, and the date on which the property was acquired by the transferor.

(ii) If the transferred property is stock or securities, the transferor must provide the information contained in paragraphs (b)(2)(ii)(A) through (F) of this section as follows—

(A) The type or class, amount, and characteristics of the stock or securities transferred, as well as the name, address, and place of incorporation of the issuer of the stock or securities, and the percentage (by voting power and value) that the stock (if any) represents of the total stock outstanding of the issuing corporation;

(B) The name, address and place of incorporation of the transferee foreign corporation, and the percentage of stock (by voting power and value) that the U.S. transferor received or will receive in the transaction;

(C) If stock or securities are transferred in an exchange described in section 361(a) or (b), a statement that the conditions set forth in the second sentence of section 367(a)(5) and any regulations under that section have been satisfied, and an explanation of any basis or other adjustments made pursuant to section 367(a)(5) and any regulations thereunder;

(D) If the property transferred is stock or securities of a domestic corporation, the taxpayer identification number of the domestic corporation whose stock or securities were transferred, together with a statement that all of the requirements of § 1.367(a)–3(c)(1) are satisfied;

(E) If the property transferred is stock or securities of a foreign corporation, a statement as to whether the U.S. transferor was a United States shareholder (a U.S. transferor that satisfies the ownership requirements of section 1248(a)(2) or (c)(2)) of the corporation whose stock was exchanged, and, if so, a statement as to whether the U.S. transferor is a United States shareholder with respect to the stock received, and whether any reporting requirements contained in regulations under section 367(b) are applicable, and, if so, whether they have been satisfied; and

(F) If the transaction involved the transfer of assets other than stock or securities and the transaction was subject to the indirect stock transfer rules of § 1.367(a)–3(d), a statement as to whether the reporting requirements under section 6038B have been satisfied with respect to the transfer of property other than stock or securities, and an explanation of whether gain was recognized under section 367(a)(1) and whether section 367(d) was applicable to the transfer of such assets, or whether any tangible assets qualified for nonrecognition treatment under section 367(a)(3) (as limited by section 367(a)(5) and §§ 1.367(a)–4T, 1.367(a)–5T and 1.367(a)–6T).

(3) *Terms of agreement*—(i) *General rule.* If prior to the close of the fifth full taxable year (i.e., not less than 60 months) following the close of the taxable year of the initial transfer, the transferee foreign corporation disposes of the transferred property in whole or in part (as described in paragraphs (e)(1) and (2) of this section), or is deemed to have disposed of the transferred property (under paragraph (e)(3) of this section), then, unless an election is made in paragraph (b)(1)(vii) of this section, by the 90th day thereafter the U.S. transferor must file an amended return for the year of the transfer and recognize thereon the gain realized but not recognized upon the initial transfer, with interest. If an election under paragraph (b)(1)(vii) of this section was made, then, if a disposition occurs, the U.S. transferor must include the gain realized but not recognized on the initial transfer in income on its Federal income tax return for the period that includes the date of the triggering event. In accordance with paragraph (b)(3)(iii) of this section, interest must be paid on any additional tax due. (If a taxpayer properly makes the election under paragraph (b)(1)(vii) of this section but later fails to include the gain realized in income, the Commissioner may, in his discretion, include the gain in the taxpayer's income in the year of the initial transfer.)

(ii) *Offsets.* No special limitations apply with respect to net operating losses, capital losses, credits against tax, or similar items.

(iii) *Interest.* If additional tax is required to be paid, then interest must be paid on that amount at the rates determined under section 6621 with respect to the period between the date that was prescribed for filing the transferor's income tax return for the year of the initial transfer and the date on which the additional tax for that year is paid. If the election in paragraph (b)(1)(vii) of this section is made, taxpayers should enter the amount of interest due, labelled as ''sec. 367 interest'' at the bottom right margin of page 1 of the Federal income tax return for the period that includes the date of the triggering event (page 2 if the taxpayer files a Form 1040), and include the amount of interest in their payment (or reduce the amount of any refund due by the amount of the interest). If the election in paragraph (b)(1)(vii) of this section is made, taxpayers should, as a matter of course, include the amount of gain as taxable income on their Federal income tax returns (together with other income or loss items). The amount of tax relating to the gain should be separately stated at the bottom right margin of page 1 of the Federal income tax return (page 2 if the taxpayer files a Form 1040), labelled as ''sec. 367 tax.''

(iv) *Basis adjustments*—(A) *Transferee.* If a U.S. transferor is required to recognize gain under this section on the disposition by the transferee foreign corporation of the transferred property, then in determining for U.S. income tax purposes any gain or loss recognized by the transferee foreign corporation upon its disposition of such property, the transferee foreign corporation's basis in such property shall be increased (as of the date of the initial transfer) by the amount of gain required to be recognized (but not by any tax or interest required to be paid on such amount) by the U.S. transferor. In the case of a deemed disposition of the stock of the transferred corporation described in paragraph (e)(3)(i) of this section, the transferee foreign corporation's basis in the transferred stock deemed disposed of shall be increased by the amount of gain required to be recognized by the U.S. transferor.

(B) *Transferor.* If a U.S. transferor is required to recognize gain under this section, then the U.S. transferor's basis in the stock of the transferee foreign corporation shall be increased by the amount of gain required to be recognized (but not by any tax or interest required to be paid on such amount).

(C) *Other adjustments.* Other appropriate adjustments to basis that are consistent with the principles of this paragraph (b)(3)(iv) may be made if the U.S. transferor is required to recognize gain under this section.

(D) *Example.* The principles of this paragraph (b)(3) are illustrated by the following example:

Example—(i) Facts. D, a domestic corporation owning 100 percent of the stock of S, a foreign corporation, transfers all of the S stock to F, a foreign corporation, in an exchange described in section 368(a)(1)(B). The section 1248 amount with respect to the S stock is $0. In the exchange, D receives 20 percent of the voting stock of F. All of the requirements of §1.367(a)–3(c)(1) are satisfied, and D enters into a five-year gain recognition agreement to qualify for nonrecognition treatment and does not make the election contained in paragraph (b)(1)(vii) of this section. One year after the initial transfer, F transfers all of the S stock to F1 in an exchange described in section 351, and D complies with the requirements of paragraph (g)(2) of this section. Two years after the initial transfer, D transfers its entire 20 percent interest in F's voting stock to a domestic partnership in exchange for an interest in the partnership. Three years after the initial exchange, S disposes of substantially all (as described in paragraph (e)(3)(i) of this section) of its assets in a transaction that would be taxable under U.S. income tax principles, and D is required by the terms of the gain recognition agreement to recognize all the gain that it realized on the initial transfer of the stock of S.

(ii) *Result.* As a result of this gain recognition and paragraph (b)(3)(iv) of this section, D is permitted to increase its basis in the partnership interest by the amount of gain required to be recognized (but not by any tax or interest required to be paid on such amount), the partnership is permitted to increase its basis in the 20 percent voting stock of F, F is permitted to increase its basis in the stock of F1, and F1 is permitted to increase its basis in the stock of S. S, however, is not permitted to increase its basis in its assets for purposes of determining the direct or indirect U.S. tax results, if any, on the sale of its assets.

(4) *Waiver of period of limitation.* The U.S. transferor must file, with the agreement to recognize gain, a waiver

of the period of limitation on assessment of tax upon the gain realized on the transfer. The waiver shall be executed on Form 8838 (Consent to Extend the Time to Assess Tax Under Section 367—Gain Recognition Agreement) and shall extend the period for assessment of such tax to a date not earlier than the eighth full taxable year following the taxable year of the transfer. Such waiver shall also contain such other terms with respect to assessment as may be considered necessary by the Commissioner to ensure the assessment and collection of the correct tax liability for each year for which the waiver is required. The waiver must be signed by a person who would be authorized to sign the agreement pursuant to the provisions of paragraph (a)(3) of this section.

(5) *Annual certification*—(i) *In general.* The U.S. transferor must file with its income tax return for each of the five full taxable years following the taxable year of the transfer a certification that the property transferred has not been disposed of by the transferee in a transaction that is considered to be a disposition for purposes of this section, including a disposition described in paragraph (e)(3) of this section. The U.S. transferor must include with its annual certification a statement describing any taxable dispositions of assets by the transferred corporation that are not in the ordinary course of business. The annual certification pursuant to this paragraph (b)(5) must be signed under penalties of perjury by a person who would be authorized to sign the agreement pursuant to the provisions of paragraph (a)(3) of this section.

(ii) *Special rule when U.S. transferor leaves its affiliated group.* If, at the time of the initial transfer, the U.S. transferor was a member of an affiliated group (within the meaning of section 1504(a)(1)) filing a consolidated Federal income tax return but not the parent of such group, the U.S. transferor will file the annual certification (and provide a copy to the parent corporation) if it leaves the group during the term of the gain recognition agreement, notwithstanding the fact that the parent entered into the gain recognition agreement, extended the statute of limitations pursuant to this section, and remains liable (with other corporations that were members of the group at the time of the initial transfer) under the gain recognition agreement in the case of a triggering event.

(c) *Failure to comply*—(1) *General rule.* If a person that is required to file an agreement under paragraph (b) of this section fails to file the agreement in a timely manner, or if a person that has entered into an agreement under paragraph (b) of this section fails at any time to comply in any material respect with the requirements of this section or with the terms of an agreement submitted pursuant hereto, then the initial transfer of property is described in section 367(a)(1) (unless otherwise excepted under the rules of this section) and will be treated as a taxable exchange in the year of the initial transfer (or in the year of the failure to comply if the agreement was filed with a timely-filed (including extensions) original (not amended) return and an election under paragraph (b)(1)(vii) of this section was made). Such a material failure to comply shall extend the period for assessment of tax until three years after the date on which the Internal Revenue Service receives actual notice of the failure to comply.

(2) *Reasonable cause exception.* If a person that is permitted under § 1.367(a)–3(b) or (c) to enter into an agreement (described in paragraph (b) of this section) fails to file the agreement in a timely manner, as provided in paragraph (a)(1) of this section, or fails to comply in any material respect with the requirements of this section or with the terms of an agreement submitted pursuant hereto, the provisions of paragraph (c)(1) of this section shall not apply if the person is able to show that such failure was due to reasonable cause and not willful neglect and if the person files the agreement or reaches compliance as soon as he becomes aware of the failure. Whether a failure to file in a timely manner, or materially comply, was due to reasonable cause shall be determined by the district director under all the facts and circumstances.

(d) *Use of security.* The U.S. transferor may be required to furnish a bond or other security that satisfies the requirements of §301.7101–1 of this chapter if the district director determines that such security is necessary to ensure the payment of any tax on the gain realized but not recognized upon the initial transfer. Such bond or security will generally be required only if the stock or securities transferred are a principal asset of the transferor and the director has reason to believe that a disposition of the stock or securities may be contemplated.

(e) *Disposition (in whole or in part) of stock of transferred corporation*—(1) *In general*—(i) *Definition of disposition.* For purposes of this section, a disposition of the stock of the transferred corporation that triggers gain under the gain recognition agreement includes any taxable sale or any disposition treated as an exchange under this subtitle, (e.g., under sections 301(c)(3)(A), 302(a), 311, 336, 351(b) or section 356(a)(1)), as well as any deemed disposition described under paragraph (e)(3) of this section. It does not include a disposition that is not treated as an exchange, (e.g., under section 302(d) or 356(a)(2)). A disposition of all or a portion of the stock of the transferred corporation by installment sale is treated as a disposition of such stock in the year of the installment sale. A disposition of the stock of the transferred corporation does not include certain transfers treated as nonrecognition transfers (under paragraph (g) of this section) in which the gain recognition agreement is retained but modified, or certain transfers (under paragraph (h) of this section) in which the gain recognition agreement is terminated and has no further effect.

(ii) *Example.* The provisions of this paragraph (e) are illustrated by the following example:

Example. Interaction between trigger of gain recognition agreement and subpart F rules—(i) *Facts.* A U.S. corporation (USP) owns all of the stock of two foreign corporations, CFC1 and CFC2. USP's section 1248 amount with respect to CFC2 is $30. USP has a basis of $50 in its stock of CFC2; CFC2 has a value of $100. In a transaction described in section 351 and 368(a)(1)(B), USP transfers the stock of CFC2 in exchange for additional stock of CFC1. The transaction is subject to both sections 367 (a) and (b). See §§1.367(a)–3(b) and 1.367(b)–1(a). To qualify for nonrecognition treatment under section 367(a), USP enters into a 5-year gain recognition agreement for $50 under this section. No election under paragraph 8(b)(1)(vii) of this section is made. USP also complies with the notice requirement under §1.367(b)–1(c).

(ii) *Trigger of gain recognition agreement with no election.* Assume that in year 2, CFC1 sells the stock of CFC2 for $120, and that there were no distributions by CFC2 prior to the sale. USP must amend its return for the year of the initial transfer and include $50 in income (with interest), $30 of which will be recharacterized as a dividend pursuant to section 1248. As a result, CFC1 has a basis of $100 in CFC2. As a result of the sale of CFC2 stock by CFC1, USP will have $20 of subpart F foreign personal holding company income. See section 951, et. seq., and the regulations thereunder.

(iii) *Trigger of gain recognition agreement with election.* Assume the same facts as in paragraphs (i) and (ii) of this *Example,* except that when USP attached the gain recognition agreement to its timely filed Federal income tax return for the year of the initial transfer, it elected under paragraph (b)(1)(vii) of this section to include the amount of gain realized but not recognized on the initial transfer, $50, in the year of the triggering event rather than in the year of the initial transfer. In such case, the result is the same as in paragraph (e)(1)(ii)(B) of this section, except that USP will include the $50 of gain on its year 2 return, together with interest. For purposes of determining the dividend component, if any, of the $50 inclusion, USP will take into account the section 1248 amount of CFC2 at the time of the disposition in Year 2.

(2) *Partial disposition.* If the transferee foreign corporation disposes of (or is deemed to dispose of) only a portion of the transferred stock or securities, then the U.S. transferor is required to recognize only a proportionate amount of the gain realized but not recognized upon the initial transfer of the transferred property. The proportion required to be recognized shall be determined by reference to the relative fair market values of the transferred stock or securities disposed of and retained. Solely for purposes of determining whether the U.S. transferor must recognize income under the agreement described in paragraph (b) of this section, in the case of transferred property (including stock or securities) that is fungible with other property owned by the transferee foreign corporation, a disposition by such corporation of any such property shall be deemed to be a

disposition of no less than a ratable portion of the transferred property.

(3) *Deemed dispositions of stock of transferred corporation*—(i) *Disposition by transferred corporation of substantially all of its assets*—(A) *In general.* Unless an exception applies (as described in paragraph (e)(3)(i)(B) of this section), a transferee foreign corporation will be treated as having disposed of the stock or securities of the transferred corporation if, within the term of the gain recognition agreement, the transferred corporation makes a disposition of substantially all (within the meaning of section 368(a)(1)(C)) of its assets (including stock in a subsidiary corporation or an interest in a partnership). If the initial transfer that necessitated the gain recognition agreement was an indirect stock transfer, see § 1.367(a)–3(d)(2)(v). If the transferred corporation is a U.S. corporation, see paragraph (h)(2) of this section.

(B) The transferee foreign corporation will not be deemed to have disposed of the stock of the transferred corporation if the transferred corporation is liquidated into the transferee foreign corporation under sections 337 and 332, provided that the transferee foreign corporation does not dispose of substantially all of the assets formerly held by the transferred corporation (and considered for purposes of the substantially all determination) within the remaining period during which the gain recognition agreement is in effect. A nonrecognition transfer is not counted for purposes of the substantially all determination as a disposition if the transfer satisfies the requirements of paragraph (g)(3) of this section. A disposition does not include a compulsory transfer as described in § 1.367(a)–4T(f) that was not reasonably forseeable by the U.S. transferor at the time of the initial transfer.

(ii) *U.S. transferor becomes a non-citizen nonresident.* If a U.S. transferor loses U.S. citizenship or a long-term resident ceases to be taxed as a lawful permanent resident (as defined in section 877(e)(2)), then immediately prior to the date that the U.S. transferor loses U.S. citizenship or ceases to be taxed as a long-term resident, the gain recognition agreement will be triggered as if the transferee foreign corporation disposed of all of the stock of the transferred corporation in a taxable transaction on such date. No additional inclusion is required under section 877, and a gain recognition agreement under section 877 may not be used to avoid taxation under section 367(a) resulting from the trigger of the section 367(a) gain recognition agreement.

(f) *Effect on gain recognition agreement if U.S. transferor goes out of existence*—(1) *In general.* If an individual transferor that has entered into an agreement under under paragraph (b) of this section dies, or if a U.S. trust or estate that has entered into an agreement under paragraph (b) of this section goes out of existence and is not required to recognize gain as a consequence thereof with respect to all of the stock of the transferee foreign corporation received in the initial transfer and not previously disposed of, then the gain recognition agreement will be triggered unless one of the following requirements is met—

(i) The person winding up the affairs of the transferor retains, for the duration of the waiver of the statute of limitations relating to the gain recognition agreement, assets to meet any possible liability of the transferor under the duration of the agreement;

(ii) The person winding up the affairs of the transferor provides security as provided under paragraph (d) of this section for any possible liability of the transferor under the agreement; or

(iii) The transferor obtains a ruling from the Internal Revenue Service providing for successors to the transferor under the gain recognition agreement.

(2) *Special rule when U.S. transferor is a corporation*—(i) *U.S. transferor goes out of existence pursuant to the transaction.* If the transferor is a U.S. corporation that goes out of existence in a transaction in which the transferor's gain would have qualified for nonrecognition treatment under § 1.367(a)–3(b) or (c) had the U.S. transferor remained in existence and entered into a gain recognition agreement, then the gain may generally qualify for nonrecognition treatment only if the U.S. transferor is owned by a single U.S. parent corporation and the U.S. transferor and its parent corporation file a consolidated

Federal income tax return for the taxable year that includes the transfer, and the parent of the consolidated group enters into the gain recognition agreement. However, notwithstanding the preceding sentence, a U.S. transferor that was controlled (within the meaning of section 368(c)) by five or fewer domestic corporations may request a ruling that, if certain conditions prescribed by the Internal Revenue Service are satisfied, the transaction may qualify for nonrecognition treatment.

(ii) *U.S. corporate transferor is liquidated after gain recognition agreement is filed.* If a U.S. transferor files a gain recognition agreement but is liquidated during the term of the gain recognition agreement, such agreement will be terminated if the liquidation does not qualify as a tax-free liquidation under sections 337 and 332 and the U.S. transferor includes in income any gain from the liquidation. If the liquidation qualifies for nonrecognition treatment under sections 337 and 332, the gain recognition agreement will be triggered unless the U.S. parent corporation and the U.S. transferor file a consolidated Federal income tax return for the taxable year that includes the dates of the initial transfer and the liquidation of the U.S. transferor, and the U.S. parent enters into a new gain recognition agreement and complies with reporting requirements similar to those contained in paragraph (g)(2) of this section.

(g) *Effect on gain recognition agreement of certain nonrecognition transactions*—(1) *Certain nonrecognition transfers of stock or securities of the transferee foreign corporation by the U.S. transferor.* If the U.S. transferor disposes of any stock of the transferee foreign corporation in a nonrecognition transfer and the U.S. transferor complies with reporting requirements similar to those contained in paragraph (g)(2) of this section, the U.S. transferor shall continue to be subject to the terms of the gain recognition agreement in its entirety.

(2) *Certain nonrecognition transfers of stock or securities of the transferred corporation by the transferee foreign corporation.* (i) If, during the period the gain recognition agreement is in effect, the transferee foreign corporation disposes of all or a portion of the stock of the transferred corporation in a transaction in which gain or loss would not be required to be recognized by the transferee foreign corporation under U.S. income tax principles, such disposition will not be treated as a disposition within the meaning of paragraph (e) of this section if the transferee foreign corporation receives (or is deemed to receive), in exchange for the property disposed of, stock in a corporation, or an interest in a partnership, that acquired the transferred property (or receives stock in a corporation that controls the corporation acquiring the transferred property); and the U.S. transferor complies with the requirements of paragraphs (g)(2)(ii) through (iv) of this section.

(ii) The U.S. transferor must provide a notice of the transfer with its next annual certification under paragraph (b)(5) of this section, setting forth—

(A) A description of the transfer;

(B) The applicable nonrecognition provision; and

(C) The name, address, and taxpayer identification number (if any) of the new transferee of the transferred property.

(iii) The U.S. transferor must provide with its next annual certification a new agreement to recognize gain (in accordance with the rules of paragraph (b) of this section) if, prior to the close of the fifth full taxable year following the taxable year of the initial transfer, either—

(A) The initial transferee foreign corporation disposes of the interest (if any) which it received in exchange for the transferred property (other than in a disposition which itself qualifies under the rules of this paragraph (g)(2)); or

(B) The corporation or partnership that acquired the property disposes of such property (other than in a disposition which itself qualifies under the rules of this paragraph (g)(2)); or

(C) There is any other disposition that has the effect of an indirect disposition of the transferred property.

(iv) If the U.S. transferor is required to enter into a new gain recognition agreement, as provided in paragraph (g)(2)(iii) of this section, the U.S. transferor must provide with its next annual certification (described in paragraph (b)(5) of this section) a statement that arrangements have been made, in connection with the nonrecognition transfer, ensuring that the U.S. transferor will be informed of any subsequent disposition of property with respect to which recognition of gain would be required under the agreement.

(3) *Certain nonrecognition transfers of assets by the transferred corporation.* A disposition by the transferred corporation of all or a portion of its assets in a transaction in which gain or loss would not be required to be recognized by the transferred corporation under U.S. income tax principles, will not be treated as a disposition within the meaning of paragraph (e)(3) of this section if the transferred corporation receives in exchange stock or securities in a corporation or an interest in a partnership that acquired the assets of the transferred corporation (or receives stock in a corporation that controls the corporation acquiring the assets). If the transaction would be treated as a disposition of substantially all of the transferred corporation's assets, the preceding sentence shall only apply if the U.S. transferor complies with reporting requirements comparable to those of paragraphs (g)(2)(ii) through (iv) of this section, providing for notice, an agreement to recognize gain in the case of a direct or indirect disposition of the assets previously held by the transferred corporation, and an assurance that necessary information will be provided to appropriate parties.

(h) *Transactions that terminate the gain recognition agreement*—(1) *Taxable disposition of stock or securities of transferee foreign corporation by U.S. transferor.* (i) If the U.S. transferor disposes of all of the stock of the transferee foreign corporation that it received in the initial transfer in a transaction in which all realized gain (if any) is recognized currently, then the gain recognition agreement shall terminate and have no further effect. If the transferor disposes of a portion of the stock of the transferee foreign corporation that it received in the initial transfer in a taxable transaction, then in the event that the gain recognition agreement is later triggered, the transferor shall be required to recognize only a proportionate amount of the gain subject to the gain recognition agreement that would otherwise be required to be recognized on a subsequent disposition of the transferred property under the rules of paragraph (b)(2) of this section. The proportion required to be recognized shall be determined by reference to the percentage of stock (by value) of the transferee foreign corporation received in the initial transfer that is retained by the United States transferor.

(ii) The rule of this paragraph (h) is illustrated by the following example:

Example. A, a United States citizen, owns 100 percent of the outstanding stock of foreign corporation X. In a transaction described in section 351, A exchanges his stock in X (and other assets) for 100 percent of the outstanding voting and nonvoting stock of foreign corporation Y. A submits an agreement under the rules of this section to recognize gain upon a later disposition. In the following year, A disposes of 60 percent of the fair market value of the stock of Y, thus terminating 60 percent of the gain recognition agreement. One year thereafter, Y disposes of 50 percent of the fair market value of the stock of X. A is required to include in his income in the year of the later disposition 20 percent (40 percent interest in Y multiplied by a 50 percent disposition of X) of the gain that A realized but did not recognize on his initial transfer of X stock to Y.

(2) *Certain dispositions by a domestic transferred corporation of substantially all of its assets.* If the transferred corporation is a domestic corporation and the U.S. transferor and the transferred corporation filed a consolidated Federal income tax return at the time of the transfer, the gain recognition agreement shall terminate and cease to have effect if, during the term of such agreement, the transferred corporation disposes of substantially all of its assets in a transaction in which all realized gain is recognized currently. If an indirect stock transfer necessitated the filing of the gain recognition agreement, such agreement shall terminate if, immediately prior to the indirect transfer, the U.S. transferor and the acquired corporation filed a consolidated return (or, in the case of a section 368(a)(1)(A) and (a)(2)(E) reorganization described in §1.367(a)–3(d)(1)(ii), the U.S. transferor and the

acquiring corporation filed a consolidated return) and the transferred corporation disposes of substantially all of its assets (taking into account §1.367(a)–3(d)(2)(v)) in a transaction in which all realized gain is recognized currently.

(3) *Distribution by transferee foreign corporation of stock of transferred corporation that qualifies under section 355 or section 337.* If, during the term of the gain recognition agreement, the transferee foreign corporation distributes to the U.S. transferor, in a transaction that qualifies under section 355, or in a liquidating distribution that qualifies under sections 332 and 337, the stock that initially necessitated the filing of the gain recognition agreement (and any additional stock received after the initial transfer), the gain recognition agreement shall terminate and have no further effect, provided that immediately after the section 355 distribution or section 332 liquidation, the U.S. transferor's basis in the transferred stock is less than or equal to the basis that it had in the transferred stock immediately prior to the initial transfer that necessitated the GRA.

(i) *Effective date.* The rules of this section shall apply to transfers that occur on or after July 20, 1998. For matters covered in this section for periods before July 20, 1998, the corresponding rules of §1.367(a)–3T(g) (see 26 CFR part 1, revised April 1, 1998) and Notice 87–85 ((1987–2 C.B. 395); see §601.601(d)(2)(ii) of this chapter) apply. In addition, if a U.S. transferor entered into a gain recognition agreement for transfers prior to July 20, 1998, then the rules of §1.367(a)–3T(g) (see 26 CFR part 1, revised April 1, 1998) shall continue to apply in lieu of this section in the event of any direct or indirect nonrecognition transfer of the same property. See, also, §1.367(a)–3(f).

[T.D. 8770, 63 FR 33562, June 19, 1998]

§1.367(b)–1 Other transfers.

(a) *Scope.* Section 367(b) and the regulations thereunder set forth certain rules regarding the extent to which a foreign corporation shall be considered to be a corporation in connection with an exchange to which section 367(b) applies. An exchange to which section 367(b) applies is any exchange described in section 332, 351, 354, 355, 356 or 361, with respect to which the status of a foreign corporation as a corporation is relevant for determining the extent to which income shall be recognized or for determining the effect of the transaction on earnings and profits, basis of stock or securities, or basis of assets. Notwithstanding the preceding sentence, a section 367(b) exchange does not include a transfer to the extent that the foreign corporation fails to be treated as a corporation by reason of section 367(a)(1). See §1.367(a)–3(b)(2)(ii) for an illustration of the interaction of sections 367 (a) and (b). This paragraph applies for transfers occurring on or after July 20, 1998.

(b) [Reserved]. For further guidance, see §7.367(b)–1(b) of this chapter.

(c) *Notice required*—(1) *In general.* If any person referred to in section 6012 (relating to the requirement to make returns of income) realized gain or other income (whether or not recognized) on account of any exchange to which section 367(b) applies, such person must file a notice of such exchange on or before the last date for filing a Federal income tax return (taking into account any extensions of time therefor) for the person's taxable year in which such gain or other income is realized. This notice must be filed with the district director with whom the person would be required to file a Federal income tax return for the taxable year in which the exchange occurs. Notwithstanding anything in this paragraph (c)(1) to the contrary, no notice under this paragraph (c)(1) is required to the extent a transaction is described in both section 367(a) and (b), and the exchanging person is not a United States shareholder of the corporation whose stock is exchanged. This paragraph applies to transfers occurring on or after July 20, 1998.

(c)(2) through (f) [Reserved]. For further guidance, see §7.367(b)–1(c)(2) through (f) of this chapter.

[T.D. 8770, 63 FR 33566, June 19, 1998]

§1.367(b)–2 Definitions.

(a)—(c) [Reserved]

(d) *Section 1248 amount.* In the case of an exchange of stock in a first-tier foreign corporation described in §7.367 (b)–

7 (c)(1)(i) of this chapter or a distribution by a foreign corporation described in § 7.367 (b)–10 (i) of this chapter in which an inclusion in gross income determined by reference to the ''section 1248 amount'' is required by those provisions, the term *section 1248 amount* means the net positive earnings and profits which would have been attributable under section 1248 and the regulations under that section to the stock of the foreign corporation exchanged if the stock has been sold in a transaction to which section 1248(a) applied. For all other purposes of this section, in the case of an exchange of stock in a first-tier foreign corporation to which section 367(b) applies, the term *section 1248 amount* means the earnings and profits or deficit in earnings and profits which would have been attributable under section 1248 and the regulations under that section to the stock of the foreign corporation exchanged if the stock had been sold in a transaction to which section 1248(a) applied.

(e) [Reserved]

(f) *All earnings and profits amounts.* For purposes of asset repatriations covered by §§ 7.367 (b)–5 (b), 7.367 (b)–6 (c), 7.367 (b)–7 (c)(2) and 7.367 (b)–10 (j) of this chapter, the term *all earnings and profits amount* means the net positive earnings and profits, if any, for all taxable years which are attributable to the stock of the foreign corporation exchanged under the principles of section 1246 or 1248 (whichever is applicable) and the regulations under that section. For all other purposes, the term *all earnings and profits amount* means the earnings and profits or deficit in earnings and profits for all taxable years which are attributable to the stock of the foreign corporation exchanged under the principles of section 1246 or 1248 (whichever is applicable) and the regulations under that section. The determination shall be made by applying section 1246 or 1248 as modified by §§ 7.367 (b)–2 through 7.367 (b)–12 of this chapter as if there were no distinction in those sections between earnings and profits accumulated before or after December 31, 1962.

[T.D. 8397, 57 FR 6555, Feb. 26, 1992]

§ 1.367(b)–4 Certain exchanges of stock described in section 354, 351, or sections 354 and 351.

(a) *In general.* This section applies to an exchange of stock in a foreign corporation by a United States shareholder if the exchange is described in section 351, or is described in section 354 and is made pursuant to a reorganization described in section 368(a)(1)(B) (including an exchange that is also described in section 351), without regard to whether the exchange may also be described in section 361.

(b) *Recognition of income.* If an exchange is described in paragraph (b)(1), (2) or (3) of this section, the exchanging shareholder shall include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges. See, also, § 1.367(a)–3(b)(2). However, in the case of a recapitalization described in paragraph (b)(3) of this section that occurred prior to July 20, 1998, the exchanging shareholder shall include the section 1248 amount on its tax return for the taxable year that includes the exchange described in paragraph (b)(2)(iii) of this section (and not in the taxable year of the recapitalization), except that no inclusion is required if both the recapitalization and the exchange described in paragraph (b)(2)(iii) of this section occurred prior to July 20, 1998.

(1) *Loss of United States shareholder or controlled foreign corporation status.* An exchange is described in this paragraph (b)(1) if—

(i) An exchanging shareholder receives stock of a foreign corporation that is not a controlled foreign corporation;

(ii) An exchanging shareholder receives stock of a controlled foreign corporation as to which the exchanging United States shareholder is not a United States shareholder; or

(iii) The corporation whose stock is exchanged is not a controlled foreign corporation immediately after the transfer.

(2) *Receipt by domestic corporation of preferred or other stock in certain instances.* An exchange is described in this paragraph (b)(2) if—

(i) Immediately before the exchange, the foreign acquired corporation and the foreign acquiring corporations are not members of the same affiliated group (within the meaning of section 1504(a), but without regard to the exceptions set forth in section 1504(b), and substituting the words ''more than 50'' in place of the words ''at least 80'' in sections 1504(a)(2)(A) and (B));

(ii) Immediately after the exchange, a domestic corporation meets the ownership threshold specified by section 902(a) or (b) such that it may qualify for a deemed paid foreign tax credit if it receives from the foreign acquiring corporation a distribution (directly or through tiers) of its earnings and profits; and

(iii) The exchanging shareholder receives preferred stock (other than preferred stock that is fully participating with respect to dividends, redemptions and corporate growth) in consideration for common stock or preferred stock that is fully participating with respect to dividends, redemptions and corporate growth, or, in the discretion of the District Director (and without regard to whether the stock exchanged is common stock or preferred stock), receives stock that entitles it to participate (through dividends, redemption payments or otherwise) disproportionately in the earnings generated by particular assets of the foreign acquired corporation or foreign acquiring corporation. See, e.g., paragraph (b)(4) *Example 1* through *Example 3* of this section.

(3) *Certain exchanges involving recapitalizations.* An exchange pursuant to a recapitalization under section 368(a)(1)(E) shall be deemed to be an exchange described in this paragraph (b)(3) if the following conditions are satisfied—

(i) During the 24-month period immediately preceding or following the date of the recapitalization, the corporation that undergoes the recapitalization (or a predecessor of, or successor to, such corporation) also engages in a transaction that would be described in paragraph (b)(2) of this section but for paragraph (b)(2)(iii) of this section, either as the foreign acquired corporation or the foreign acquiring corporation; and

(ii) The exchange in the recapitalization is described in paragraph (b)(2)(iii) of this section.

(4) *Examples.* The rules of paragraph (b)(2) of this section are illustrated by the following examples:

Example 1. (i) *Facts.* FC1 is a foreign corporation. DC is a domestic corporation that is unrelated to FC1. DC owns all of the outstanding stock of FC2, a foreign corporation, and FC2 has no outstanding preferred stock. The value of FC2 is $100 and DC has a basis of $50 in the stock of FC2. The section 1248 amount attributable to the stock of FC2 held by DC is $20. In a reorganization described in section 368(a)(1)(B), FC1 acquires all of the stock of FC2 and, in exchange, DC receives FC1 voting preferred stock that constitutes 10 percent of the outstanding voting stock of FC1 for purposes of section 902(a). Immediately after the exchange, FC1 and FC2 are controlled foreign corporations and DC is a United States shareholder of FC1, so paragraph (b)(1) of this section does not require inclusion in income of the section 1248 amount.

(ii) *Result.* Pursuant to §1.367(a)–3(b)(2), the transfer is subject to both section 367(a) and section 367(b). Under §1.367(a)–3(b)(1), DC will not be subject to tax under section 367(a)(1) if it enters into a gain recognition agreement in accordance with §1.367(a)–8. The amount of the gain recognition agreement is $50 less any inclusion under section 367(b). Even though paragraph (b)(1) of this section does not apply to require inclusion in income by DC of the section 1248 amount, DC must nevertheless include the $20 section 1248 amount in income as a deemed dividend from FC2 under paragraph (b)(2) of this section. Thus, if DC enters into a gain recognition agreement, the amount is $30 (the $50 gain realized less the $20 recognized under section 367(b)). (If DC fails to enter into a gain recognition agreement, it must include in income under section 367(a)(1) the $50 of gain realized; $20 of which is treated as a dividend. Section 367(b) does not apply in such case.)

Example 2. (i) *Facts.* The facts are the same as in *Example 1,* except that DC owns all of the outstanding stock of FC1 immediately before the transaction.

(ii) *Result.* Both section 367(a) and section 367(b) apply to the transfer. Paragraph (b)(2) of this section does not apply to require inclusion of the section 1248 amount. Under paragraph (b)(2)(i) of this section, the transaction is outside the scope of paragraph (b)(2) of this section, because FC1 and FC2 are, immediately before the transaction, members of the same affiliated group (within the meaning of such paragraph). Thus, if DC enters into a gain recognition agreement in accordance with §1.367(a)–8, the amount of such agreement is $50. As in *Example 1,* if DC fails to enter into a gain recognition agreement, it must include in income $50, $20 of which will be treated as a dividend.

Example 3. (i) *Facts.* FC1 is a foreign corporation. DC is a domestic corporation that is unrelated to FC1. DC owns all of the stock of FC2, a foreign corporation. The section 1248 amount attributable to the stock of FC2 held by DC is $20. In a reorganization described in section 368(a)(1)(B), FC1 acquires all of the stock of FC2 in exchange for FC1 voting stock that constitutes 10 percent of the outstanding voting stock of FC1 for purposes of section 902(a). The FC1 voting stock received by DC in the exchange carries voting rights in FC1, but by agreement of the parties the shares entitle the holder to dividends, amounts to be paid on redemption, and amounts to be paid on liquidation, which are to be determined by reference to the earnings or value of FC2 as of the date of such event, and which are affected by the earnings or value of FC1 only if FC1 becomes insolvent or has insufficient capital surplus to pay dividends.

(ii) *Result.* Under § 1.367(a)–3(b)(1), DC will not be subject to tax under section 367(a)(1) if it enters into a gain recognition agreement with respect to the transfer of FC2 stock to FC1. Under § 1.367(a)–3(b)(2), the exchange will be subject to the provisions of section 367(b) and the regulations thereunder to the extent that it is not subject to tax under section 367(a)(1). Furthermore, even if DC would not otherwise be required to recognize income under this section, the District Director may nevertheless require that DC include the $20 section 1248 amount in income as a deemed dividend from FC2 under paragraph (b)(2) of this section.

(5) *Special rules for applying section 1248 to subsequent exchanges.* (i) If income is not required to be recognized under paragraph (b) of this section in a transaction described in paragraph (a) of this section involving a foreign acquiring corporation, then, for purposes of applying section 1248 or 367(b) to subsequent exchanges, the earnings and profits attributable to an exchanging shareholder's stock received in the transaction shall be determined by reference to the exchanging shareholder's pro rata interest in the earnings and profits of the foreign acquiring corporation and foreign acquired corporation that accrue after the transaction, as well as its pro rata interest in the earnings and profits of the foreign acquired corporation that accrued prior to the transaction. See also section 1248(c)(2)(D)(ii). The earnings and profits attributable to an exchanging shareholder's stock received in the transaction shall not include any earnings and profits of the foreign acquiring corporation that accrued prior to the transaction.

(ii) The following example illustrates this paragraph (b)(5):

Example. (i) *Facts.* DC1, a domestic corporation, owns all of the stock of FC1, a foreign corporation. DC1 has owned all of the stock of FC1 since FC1's formation. DC2, a domestic corporation, owns all of the stock of FC2, a foreign corporation. DC2 has owned all of the stock of FC2 since FC2's formation. DC1 and DC2 are unrelated. In a reorganization described in section 368(a)(1)(B), DC1 transfers all of the stock of FC1 to FC2 in exchange for 40 percent of FC2. DC1 enters into a five-year gain recognition agreement under the provisions of §§ 1.367(a)–3(b) and 1.367(a)–8 with respect to the transfer of FC1 stock to FC2.

(ii) *Result.* DC1's transfer of FC1 to FC2 is an exchange described in paragraph (a) of this section. Because the transfer is not described in paragraph (b)(1), 2) or (3) of this section, DC1 is not required to include in income the section 1248 amount attributable to the exchanged FC1 stock and the special rule of this paragraph (b)(5) applies. Thus, for purposes of applying section 1248 or section 367(b) to subsequent exchanges, the earnings and profits attributable to DC1's interest in FC2 will be determined by reference to 40 percent of the post-reorganization earnings and profits of FC1 and FC2, and by reference to 100 percent of the pre-reorganization earnings and profits of FC1. The earnings and profits attributable to DC1's interest in FC2 do not include any earnings and profits accrued by FC2 prior to the transaction. Those earnings and profits are attributed to DC2 under section 1248.

(6) *Effective date.* This section applies to transfers occurring on or after July 20, 1998.

(c) and (d) [Reserved]. For further guidance, see § 7.367(b)–4(c) and (d) of this chapter.

[T.D. 8770, 63 FR 33567, June 19, 1998; 64 FR 15687, Apr. 1, 1999]

§ 1.367(b)–7 Exchange of stock described in section 354.

(a) *Scope.* (1) This section applies to an exchange of stock in a foreign corporation (other than a foreign investment company as defined in section 1246(b)) occurring on or after July 20, 1998.

(i) The exchange is described in section 354 or 356 and is made pursuant to a reorganization described in section 368(a)(1)(B) through (F); and

(ii) The exchanging person is either a United States shareholder or a foreign corporation having a United States shareholder who is also a United States shareholder of the corporation whose stock is exchanged.

(2) However, this section shall not apply if a United States shareholder exchanges stock of a foreign corporation in an exchange described in section 368(a)(1)(B). For further guidance, see §1.367(b)–4.

(b) [Reserved]. For further guidance, see §7.367(b)–7(b) of this chapter.

(c) *Receipt of other stock*—(1) *General rule.* (i) [Reserved]

(ii) If an exchanging foreign corporation receives stock of a domestic corporation, or stock of a foreign corporation which is not a controlled foreign corporation, or stock of a controlled foreign corporation as to which any United States shareholder of the exchanging foreign corporation is not a United States shareholder, then there shall be added to the earnings and profits or deficit of the exchanging foreign corporation the section 1248 (c)(2) amount and the additional earnings and profits amount of the exchanging foreign corporation, computed as if all stock of the corporation whose stock is exchanged is owned by a United States shareholder. The amount added shall not be considered a dividend. Paragraph (c)(1)(iii) of this section, and not this paragraph (c)(1)(ii), applies if the stock received—

(A) Is of a domestic corporation which is a member of an affiliated group (as defined in section 1504(a), without application of section 1504(b)(3)) that also includes the exchanging foreign corporation as a member; and

(B) Is not received in an exchange pursuant to which the foreign corporation whose stock is exchanged transfers its assets to a domestic corporation.

(iii) For exchanges beginning after March 3, 1989, if the stock received is described in the last sentence of paragraph (c)(1)(ii) of this section, then the foreign corporation whose stock is exchanged will be considered to be a foreign corporation for purposes of section 354 or 356. This paragraph (c)(1)(iii) may be illustrated by the following examples:

Example 1. A U.S. parent corporation (USP) owns all of the stock of a foreign corporation (CFC1), which in turn owns all of the stock of a second foreign corporation (CFC2), which in turn owns all of the stock of a third foreign corporation (CFC3). USP also owns all of the stock of a U.S. subsidiary (Subsidiary). CFC2 and CFC3 have accumulated earnings and profits or accumulated deficits in earnings and profits. Subsidiary acquires all of the stock of CFC2 from CFC1 in exchange for stock of Subsidiary in a reorganization described in section 368(a)(1)(B). CFC1 will not recognize gain on the exchange. Moreover, CFC2's and CFC3's accumulated earnings and profits or accumulated deficits in earnings and profits will remain in CFC2 and CFC3, respectively, and will not be added to the earnings and profits or deficits in earnings and profits of CFC1.

Example 2. USP owns all of the stock of CFC1, which in turn owns all of the stock of CFC2. USP also owns all of the stock of a U.S. subsidiary (Subsidiary), which in turn owns all of the stock of CFC3. CFC3 acquires the assets of CFC2 in exchange for voting stock of Subsidiary in a reorganization described in section 368(a)(1)(C). Pursuant to the reorganization, CFC2 distributes the stock of Subsidiary to CFC1. CFC1 will not recognize gain on the exchange. In addition, CFC2's accumulated earnings and profits or accumulated deficits in earnings and profits will be added to CFC3's earnings and profits under section 381(c)(2), subject to the limitations contained in section 381 and in the regulations under that section.

(2) [Reserved]

[T.D. 8397, 57 FR 6555, Feb. 26, 1992, as amended by T.D. 8770, 63 FR 33568, June 19, 1998]

§1.367(b)–8 Transfer of assets by a foreign corporation in an exchange described in section 351.

(a)—(b) [Reserved]

(c) *Transfer of stock in a controlled foreign corporation.* (1) [Reserved]

(2) If the transferor corporation transfers stock in a foreign corporation of which there is a United States shareholder immediately before the exchange, and the transferor receives stock of a domestic corporation, of a foreign corporation which is not a controlled foreign corporation, or of a controlled foreign corporation as to which any United States shareholder of the transferor is not a United States shareholder, paragraph (c)(1)(ii) of §1.367(b)–7 shall apply. This paragraph (c)(2) may

be illustrated by the following examples:

Example 1. A U.S. parent corporation (USP) owns all of the stock of a foreign corporation (CFC1), which in turn owns all of the stock of a second foreign corporation (CFC2). CFC1 and CFC2 have accumulated earnings and profits or accumulated deficits in earnings and profits. CFC1 transfers its CFC2 stock to a newly organized foreign corporation (Newco) that is not a controlled foreign corporation, in an exchange described in section 351(a). CFC1 receives 20 percent of the Newco stock in exchange for its CFC2 stock. Persons unrelated to USP and CFC1 receive the remaining 80 percent of the Newco stock. Pursuant to the first sentence of § 1.367(b)–7 (c)(1)(ii), CFC2's accumulated earnings and profits or accumulated deficits in earnings and profits will be added to CFC1's earnings and profits or deficits in earnings and profits.

Example 2. USP owns all of the stock of CFC1, which in turn owns all of the stock of CFC2. USP also owns all of the stock of a U.S. subsidiary (Subsidiary). Subsidiary has both voting and nonvoting stock outstanding. In a transaction occurring after March 3, 1989, CFC1 transfers its CFC2 stock to Subsidiary in an exchange described in section 351(a). CFC1 receives 80 percent of each class of Subsidiary's stock in exchange for its CFC2 stock. Pursuant to the last sentence of § 1.367(b)–7 (c)(1)(ii), CFC2's accumulated earnings and profits or accumulated deficits in earnings and profits will remain in CFC2, and will not be added to the earnings and profits or deficits in earnings and profits of CFC1.

[T.D. 8397, 57 FR 6555, Feb. 26, 1992]

§ 1.367(b)–9 Attribution of earnings and profits on an exchange described in section 351, 354, or 356.

(a) [Reserved]

(b) *General rule.* (1)—(3) [Reserved]

(4) For exchanges beginning on or after March 3, 1989, paragraph (b)(2) and (3) of § 7.367(b)–9 of this chapter will not apply if a U.S. shareholder described in §§ 7.367(b)–7 (b) or 7.367 (b)–8 (c)(1) of this chapter owns (applying the attribution rules of section 958) more than 50 percent of either the total voting power or the total value of the stock of both the corporation whose stock is received in the exchange and the corporation whose stock is exchanged. If this paragraph (b)(4) applies, the rules of section 381 (a) and the regulations under that section will determine the extent to which the corporation whose stock is received in the exchange (or other acquiring corporation) will succeed to the earnings and profits or a deficit in earnings and profits of the corporation whose stock is exchanged and of lower-tier corporations. This paragraph (b)(4) may be illustrated by the following examples:

Example 1. A U.S. parent owns all of the stock of CFC1 and CFC2. CFC1 has accumulated earnings and profits or an accumulated deficit in earnings and profits. CFC2 acquires all of the stock of CFC1 from the U.S. parent in a reorganization described in section 368 (a)(1)(B). CFC2 will not succeed to the earnings and profits or the accumulated deficit in earnings and profits of CFC1.

Example 2. A U.S. parent owns all of the stock of CFC1, which in turn owns all of the stock of CFC2. The U.S. parent also owns all of the stock of CFC3. CFC2 has accumulated earnings and profits or an accumulated deficit in earnings and profits. CFC3 acquires all of the assets of CFC1, including the stock of CFC2, in a reorganization described in section 368(a)(1)(D). CFC3 will not succeed to the earnings and profits or the accumulated deficit in earnings and profits of CFC2.

[T.D. 8397, 57 FR 6556, Feb. 26, 1992]

§ 1.367(d)–1T Transfers of intangible property to foreign corporations (temporary).

(a) *Purpose and scope.* This section provides rules under section 367(d) concerning transfers of intangible property by U.S. persons to foreign corporations pursuant to section 351 or 361. Paragraph (b) of this section specifies the transfers that are subject to section 367(d) and the rules of this section, while paragraph (c) provides rules concerning the consequences of such a transfer. In general, the U.S. transferor will be treated as receiving annual payments contingent on productivity or use of the transferred property, over the useful life of the property (regardless of whether such payments are in fact made by the transferee). Paragraphs (d), (e), and (f) of this section provide rules for cases in which there is a later direct or indirect disposition of the intangible property transferred. In general, deemed annual license payments will continue if a transfer is made to a related person, while gain must be recognized immediately if the transfer is to an unrelated person. Paragraph (g) of this section provides several special rules, including a rule allowing appropriate adjustments where deemed payments under section 367(d) are not in fact received by the U.S. transferor of the intangible property, and a rule providing for a limited election to treat certain transfers of intangible property as sales at fair market value (in lieu of applying the general useful life-contingent payment rule). In addition, paragraph (g) of this section provides rules coordinating the application of section 367(d) with other relevant Code sections. Paragraph (h) of this section defines the term *related person* for purposes of this section. Finally, paragraph (i) of this section provides the effective date of this section. For rules concerning transfers of intangible property pursuant to section 332, see §1.367(a)–5T(e). For purposes of determining whether a U.S. person has made a transfer of intangible property that is subject to the rules of section 367(d), the rules of §1.367(a)–1T(c) shall apply.

(b) *Intangible property subject to section 367(d).* Section 367(d) and the rules of this section shall apply to the transfer of any intangible property, as defined in §1.367(a)–1T(d)(5)(i). However, section 367(d) and the rules of this section shall not apply to the transfer of foreign goodwill or going concern value, as defined in §1.367(a)–1T(d)(5)(iii), or to the transfer of intangible property described in §1.367(a)–5T(b)(2). However, the transfer of those items to a foreign corporation is subject to the rules set forth in §1.367(a)–6T, and the transfer of intangible property described in §1.367(a)–5T(b)(2) is subject to the rules set forth in §1.367(a)–5T. For a special rule relating to the transfer of operating intangibles, as defined in §1.367(a)–1T(d)(5)(ii), see paragraph (g)(3) of this section. Transfers of intangible property to foreign corporations pursuant to section 351 or 361 are subject to the rules of this section regardless of whether the property is to be used in the United States, in connection with goods to be sold or consumed in the United States, or in connection with a trade or business outside the United States.

(c) *Deemed payments upon transfer of intangible property to foreign corporation*—(1) *In general.* If a U.S. person transfers intangible property that is subject to section 367(d) and the rules of this section to a foreign corporation in an exchange described in section 351 or 361, then such person shall be treated as having transferred that property in exchange for annual payments contingent on the productivity or use of the property. Such person shall, over the useful life of the property, annually include in gross income an amount that represents an appropriate arms-length charge for the use of the property. The appropriate charge shall be determined in accordance with the provisions of section 482 and regulations thereunder. See §1.482–2(d). The amount of the deemed payment thus calculated shall be reduced by any royalty or other periodic payment made or accrued by the transferee to an unrelated person during that taxable year for the right to use the intangible property. Amounts so included in the transferor's income shall be treated as ordinary income from sources within the United States. For purposes of computing estimated tax payments, deemed payments under this paragraph (c) shall be treated as received by the transferor on the last day of its taxable year.

(2) *Required adjustments.* The following adjustments shall be made with respect to a U.S. person's recognition of a deemed payment for the use of intangible property under this paragraph (c):

(i) For purposes of chapter 1 of the Code, the earnings and profits of the transferee foreign corporation shall be reduced by the amount of such deemed payment; and

(ii) For purposes of subpart F of part III of subchapter N of the Code, the transferee foreign corporation may treat such deemed payment as an expense (whether or not that amount is actually paid), properly allocated and apportioned to gross income subject to subpart F, in accordance with the provisions of §§1.954–1(c) and 1.861–8.

No other special adjustments to earning the profits, basis, or gross income shall be permitted by reason of the recognition of a deemed payment under this paragraph (c). However, see paragraph (g)(1) of this section for rules permitting the establishment of an account receivable with respect to deemed payments not actually received by the U.S. person.

(3) *Useful life.* For purposes of this section, the useful life of intangible property is the entire period during which the property has value. However, in no event shall the useful life of an item of intangible property be considered to exceed twenty years. If intangible property derives its value from secrecy or from protections afforded by law, the useful life of such property shall terminate when the property is no longer secret or no longer legally protected.

(4) *Blocked income.* No deemed payment included in a taxpayer's income under paragraph (c)(1) of this section shall be treated as deferrable income for purposes of applying rules relating to blocked foreign income. See Revenue Ruling 74–351, 1974–2 C.B. 144.

(d) *Subsequent transfer of stock of transferee foreign corporation to unrelated person*—(1) *Treatment as sale of intangible property.* If a U.S. person transfers intangible property that is subject to section 367(d) and the rules of this section to a foreign corporation in an exchange described in section 351 or 361, and within the useful life of the intangible property that U.S. transferor subsequently disposes of the stock of the transferee foreign corporation to a person that is not a related person (within the meaning of paragraph (h) of this section), then the U.S. transferor shall be treated as having simultaneously sold the intangible property to the person acquiring the stock of the transferee foreign corporation. The U.S. transferor shall be required to recognize gain (but not loss) from sources within the United States in an amount equal to the difference between the fair market value of the transferred intangible property on the date of the subsequent disposition and the U.S. transferor's former adjusted basis in that property (determined as of the original transfer). If the U.S. transferor's disposition of the stock of the transferee foreign corporation is subject to U.S. tax other than by reason of this paragraph (d), then the amount of gain otherwise required to be recognized with respect to the stock of the transferee foreign corporation shall be reduced by the amount of gain recognized with respect to the intangible property pursuant to this paragraph (d).

(2) *Required adjustments.* If a U.S. person disposes of the stock of a transferee foreign corporation, and under paragraph (d)(1) of this section is treated as having simultaneously sold intangible property, then, for purposes of computing basis and earnings and profits, the person acquiring the stock of the transferee foreign corporation shall be deemed to have purchased that property at fair market value and to have immediately thereafter contributed it to the transferee foreign corporation in a transaction not covered by section 367(d). Therefore, for purposes of chapter 1 of the Code—

(i) The transferee foreign corporation's basis in the intangible property will be equal to its fair market value (as calculated for purposes of determining the gain required to be recognized by the U.S. transferor);

(ii) The acquiring person's basis in the stock of the transferee foreign corporation shall be determined as if no portion of the consideration given by the acquiring person for the stock is attributable to the intangible property; and

(iii) The earnings and profits of the transferee foreign corporation will not be affected by the transfer of its stock or the deemed transfer to it of the intangible property.

(e) *Subsequent transfer of stock of transferee foreign corporation to related person*—(1) *Transfer to related U.S. person treated as disposition of intangible property.* If a U.S. person transfers intangible property that is subject to section 367(d) and the rules of this section to a foreign corporation in an exchange described in section 351 or 361 and, within the useful life of the transferred intangible property, that U.S. transferor subsequently transfers the stock of the transferee foreign corporation to U.S. persons that are related to the transferor within the meaning of paragraph (h) of this section, then the following rules shall apply:

(i) Each such related U.S. person shall be treated as having received (with the stock of the transferee foreign corporation) a right to receive a proportionate share of the contingent annual payments that would otherwise be deemed to be received by the U.S. transferor under paragraph (c) of this section.

(ii) Each such related U.S. person shall, over the useful life of the property, annually include in gross income a proportionate share of the amount that would have been included in the income of the U.S. transferor pursuant to paragraph (c) of this section. Such amounts shall be treated as ordinary income from sources within the United States.

(iii) The amount of income required to be recognized by the U.S. transferor pursuant to the rule of paragraph (d)(1) of this section shall be reduced to the amount determined in accordance with the following formula:

(d)(1) amount×(100% − (e) percentage)

For purposes of the above formula, the (*d*)(*1*) *amount* is the income that would otherwise be required to be recognized by the transferor corporation pursuant to paragraph (d)(1) of this section, and the (*e*) *percentage* is the percentage of the transferor corporation's total deemed rights to receive contingent annual payments under paragraph (c) of this section that is deemed to be transferred to related U.S. persons under the rules of this paragraph (e).

(iv) The rules of paragraphs (d) and (e) of this section shall be reapplied in the case of any later transfer of the stock of the transferee foreign corporation by a related U.S. person that received such stock in a transfer that was subject to the rules of this paragraph (e). For purposes of reapplying the rules of paragraphs (d) and (e), each such related U.S. person shall be treated as a U.S. transferor of intangible property to the transferee foreign corporation (to the extent of the interest attributed to such person pursuant to subdivision (i) of this paragraph (e)(1)).

(2) *Required adjustments.* If a U.S. person transfers stock of a transferee foreign corporation to a U.S. related person in a transaction that is subject to the rules of paragraph (e)(1) of this section, the following adjustments shall be made:

(i) For purposes of chapter 1 of the Code, the earnings and profits of the transferee foreign corporation shall be reduced by the amount of any payment deemed to be received by a related U.S. person under paragraph (e)(1)(ii) of this section;

(ii) For purposes of subpart F of part III of subchapter N of the Code, the transferee foreign corporation may allocate and apportion such deemed payments (whether or not such payments are actually made to gross income subject to subpart F to the extent appropriate under the provisions of §§1.954–1(c) and 1.861–8;

(iii) For purposes of reapplying the rules of paragraph (d) and (e) of this section, if the related U.S. person is deemed to have received a right to contingent annual payments for the use of intangible property, then the U.S. related person shall be deemed to have held a proportionate share of the property with a basis equal to a proportionate share of the U.S. transferor's adjusted basis plus the gain, if any, recognized by the U.S. transferor on the earlier transfer of the stock to the U.S. related person, and then to have transferred that proportionate share of the property to the foreign corporation in a transfer subject to section 367(d); and

(iv) If the U.S. transferor is itself required to recognize gain upon the transfer by reason of the operation of paragraphs (d)(1) and (e)(1)(iii) of this section (because stock of the transferee foreign corporation is also transferred to unrelated persons), then those unrelated persons shall be deemed to have purchased a proportionate share of the transferred intangible property at fair market value and immediately contributed that property to the transferee foreign corporation, consistent with the general rule of paragraph (d)(2) of this section concerning transfers of stock to unrelated persons. Therefore, for purposes of chapter 1 of the Code—

(A) Each unrelated person's basis in the stock of the transferee foreign corporation shall be increased to the extent of the gain recognized by the U.S. transferor upon the deemed purchase of intangible property by that person; and

(B) The transferee foreign corporation will receive an increase in its basis in the transferred intangible property equal to the fair market value of that portion of the intangible property deemed to be contributed to the transferee foreign corporation by unrelated persons (as calculated for purposes of determining the gain required to be recognized by the U.S. transferor).

(3) *Transfer to related foreign person not treated as disposition of intangible property.* If a U.S. person transfers intangible property that is subject to section 367(d) and the rules of this section to a foreign corporation in an exchange described in section 351 or 361, and within the useful life of the transferred intangible property, that U.S. transferor subsequently transfers any of the stock of the transferee foreign corporation to one or more foreign persons that are related to the transferor within the meaning of paragraph (h) of this section, then the U.S. transferor shall continue to include in its income the deemed payments described in paragraph (c) of this section in the same manner as if the subsequent transfer of stock had not occurred. The rule of this paragraph (e)(3) shall not apply with respect to the subsequent transfer by the U.S. person of any of the remaining stock to any related U.S. person or unrelated person.

(4) *Proportionate share.* For purposes of this paragraph (e), any ''proportionate share'' shall be determined by reference to the fair market value (at the time of the original transfer) of the stock of the transferee foreign corporation that was transferred by the U.S. transferor and the fair market value of all of the stock of the transferee foreign corporation originally received by the U.S. transferor.

(f) *Subsequent disposition of transferred intangible property by transferee foreign corporation*—(1) *In general.* If a U.S. person transfers intangible property that is subject to section 367(d) and the rules of this section to a foreign corporation in an exchange described in section 351 or 361, and within the useful life of the intangible property that transferee foreign corporation subsequently disposes of the intangible property to an unrelated person, then—

(i) The U.S. transferor of the intangible property (or any person treated as such pursuant to paragraph (e)(1) of this section) shall be required to recognize gain from U.S. sources (but not loss) in an amount equal to the difference between the fair market value of the transferred intangible property on the date of the subsequent disposition and the U.S. transferor's former adjusted basis in that property (determined as of the orginial transfer); and

(ii) The U.S. transferor shall be required to recognize a deemed payment under paragraph (c) of this section for that part of its taxable year that the intangible property was held by the transferee foreign corporation and thereafter shall not be required to recognize any further deemed payments under paragraph (c) or (e)(1) of this section with respect to the transferred intangible property disposed of by the transferee foreign corporation.

(2) *Required adjustments.* If a U.S. transferor is required to recognize gain under paragraph (f)(1) of this section, then—

(i) For purposes of chapter 1 of the Code, the earnings and profits of the transferee foreign corporation shall be reduced by the amount of gain required to be recognized; and

(ii) The U.S. transferor's recognition of gain will permit the establishment of an account receivable from the transferee foreign corporation, in accordance with paragraph (g)(1) of this section.

(3) *Subsequent transfer of intangible property to related person.* The requirement that a U.S. person recognize gain under paragraph (c) or (e) of this section shall not be affected by the transferee foreign corporation's subsequent disposition of the transferred intangible property to a related person. For purposes of any required adjustments, and of any accounts receivable created under paragraph (g)(1) of this section, the related person that receives the intangible property shall be treated as the transferee foreign corporation.

(g) *Special rules*—(1) *Establishment of accounts receivable*—(i) *In general.* If a U.S. person is required to recognize income under the provisions of paragraph (c), (e), or (f) of this section, and the amount deemed to be received is not actually paid by the transferee foreign corporation, then the U.S. person may establish an account receivable from the transferee foreign corporation equal to the amount deemed paid that was not actually paid. A separate account receivable must be established for each taxable year in which payments deemed to be received are not actually made. Payments received from the transferee foreign corporation must be designated as payments upon a particular account and must be deducted from that account. Accounts receivable under this paragraph (g)(1) may be established and paid without further U.S. income tax consequences to the U.S. transferor or the transferee foreign corporation. No interest shall be paid or accrued on an account receivable created under this paragraph (g)(1), nor shall any bad debt deduction be allowed under section 166 with respect to any failure to receive payment on an account.

(ii) *Unpaid receivable treated as contribution to capital.* If any portion of an account receivable established under this paragraph (g)(1) remains unpaid as of the last day of the third taxable year following the taxable year to which the account relates, then—

(A) Such portion shall be deemed to have been paid on that date; and

(B) The U.S. person shall be deemed to have contributed an equivalent amount to the capital of the foreign corporation, and the U.S. person's basis in the stock of the foreign corporation shall, therefore, be increased by that amount.

(2) *Election to treat transfer as sale.* A U.S. person that transfers intangible property to a foreign corporation in a transaction subject to section 367(d) may elect to recognize income in accordance with the rules of this paragraph (g)(2), if—

(i) The intangible property transferred constitutes an operating intangible, as defined in §1.367(a)–1T(d)(5)(ii); or

(ii) The transfer of the intangible property is either legally required by the government of the country in which the transferee corporation is organized as a condition of doing business in that country, or compelled by a genuine threat of immediate expropriation by the foreign government; or

(iii)(A) The U.S. person transferred the intangible property to the foreign corporation within three months of the organization of that corporation and as part of the original plan of capitalization of that corporation;

(B) Immediately after the transfer, the U.S. person owns at least 40 percent but not more than 60 percent of the total voting power and total value of the stock of the transferee foreign corporation;

(C) Immediately after the transfer, at least 40 percent of the total voting power and total value of the stock of the transferee foreign corporation is owned by foreign persons unrelated to the U.S. person;

(D) Intangible property constitutes at least 50 percent of the fair market value of the property transferred to the foreign corporation by the U.S. transferor; and

(E) The transferred intangible property will be used in the active conduct of a trade or business outside of the United States within the meaning of §1.367(a)–2T and will not be used in connection with the manufacture or sale of products in or for use or consumption in the United States.

A person that makes the election under this paragraph (g)(2) shall not be subject to the provisions of paragraphs (c) through (f) of this section. Such person shall instead recognize in the year of the transfer ordinary income from sources within the United States in an amount equal to the difference between the fair market value of the intangible property transferred and its adjusted basis. A U.S. person shall make an election under this paragraph (g)(2) by notifying the Internal Revenue Service of the election in accordance with the requirements of section 6038B and regulations thereunder, and subsequently including the appropriate amounts in gross income in a timely filed tax return for the year of the transfer.

(3) *Intangible property transferred from branch with previously deducted losses.* If income is required to be recognized under section 904(f)(3) and the regulations thereunder or under §1.367(a)–6T upon the transfer of intangible property of a foreign branch that had previously deducted losses, then the income recognized under those sections with respect to that property shall be credited against amounts that would otherwise be required to be recognized with respect to that same property

under paragraphs (c) through (f) of this section in either the current or future taxable years. The amount recognized under section 904(f)(3) or § 1.367(a)–6T with respect to the transferred intangible property shall be determined in accordance with the following formula:

$$\text{loss recapture income} \times \frac{\text{gain from intangibles}}{\text{gain from all branch assets}}$$

For purposes of the above formula, the *loss recapture income* is the total amount required to be recognized by the U.S. transferor pursuant to section 904(f)(3) or § 1.367(a)–6T. The *gain from intangibles* is the total amount of gain realized by the U.S. transferor pursuant to section 904(f)(3) and § 1.367(a)–6T upon the transfer of items of intangible property that are subject to section 367(d). (''Gain from intangibles'' does not include gain realized upon the transfer of property described in § 1.367(a)–5T(b)(2), foreign goodwill or going concern value, or intangible property with respect to which the taxpayer has made the election provided for in § 1.367(d)–1T(g)(2).) The *gain from all branch assets* is the total amount of gain realized by the transferor upon the transfer of items of property of the branch in which gain is realized. The fraction shall not exceed 1.

(4) *Coordination with section 482*—(i) *In general.* Section 367(d) and the rules of this section shall not apply in the case of an actual sale or license of intangible property by a U.S. person to a foreign corporation. If an adjustment under section 482 is required with respect to an actual sale or license of intangible property, then section 367(d) and the rules of this section shall not apply with respect to the required adjustment. If a U.S. person transfers intangible property to a related foreign corporation without consideration, or in exchange for stock or securities of the transferee in a transaction described in sections 351 or 361, no sale or license subject to adjustment under section 482 will be deemed to have occurred. Instead, the U.S. person shall be treated as having made a transfer of the intangible property that is subject to section 367(d).

(ii) *Sham licenses and sales.* For purposes of paragraph (g)(4)(i) of this section, a purported sale or license of intangible property may be disregarded, and treated as a transfer subject to section 367(d) and the rules of this section, if—

(A) The purported sale or license is made to a foreign corporation in which the transferor holds (or is acquiring) an interest; and

(B) The terms of the purported sale or license differ so greatly from the economic substance of the transaction or the terms that would obtain between unrelated persons that the purported sale or license is a sham.

The terms of a purported sale or license, for purposes of applying the rule of this paragraph (g)(4)(ii), shall be determined by reference not only to the nominal terms of the agreement but also to the actual practice of the parties under that agreement. A sale or license of intangible property shall not be disregarded under this paragraph (g)(4)(ii) solely because other property of an integrated business is simultaneously transferred to the foreign corporation by the U.S. transferor in a transaction described in section 367(a)(1) or any statutory or regulatory exception to section 367(a)(1).

(5) *Determination of fair market value.* For purposes of determining the gain required to be recognized immediately under paragraph (d), (f), or (g)(2) of this section, the fair market value of transferred property shall be the single payment arm's-length price that would be paid for the property by an unrelated purchaser determined in accordance with the principles of section 482 and regulations thereunder. The allocation of a portion of the purchase price to intangible property agreed to by the parties to the transaction shall not necessarily be controlling for this purpose.

(6) *Anti-abuse rule.* If a U.S. person—

(i) Transfers intangible property to a domestic corporation with a principal purpose of avoiding the effect of section 367(d) and the rules of this section; and

(ii) Thereafter transfers the stock of that domestic corporation to a related foreign corporation,

then solely for purposes of section 367(d) that U.S. person shall be treated as having transferred the intangible property directly to the foreign corporation. A U.S. person shall be presumed to have transferred intangible property for a principal purpose of avoiding the effect of section 367(d) if the property is transferred to the domestic corporation less than two years prior to the transfer of the stock of that domestic corporation to a foreign corporation. The presumption created by the previous sentence may be rebutted by clear evidence that the subsequent transfer of the stock of the domestic transferee corporation was not contemplated at the time the intangible property was transferred to that corporation and that avoidance of section 367(d) and the rules of this section was not a principal purpose of the transaction. A transfer may have more than one principal purpose.

(h) *Related person.* For purposes of this section, persons are considered to be related if—

(1) They are partners or partnerships described in section 707(b)(1) of the Code; or

(2) They are related within the meaning of section 267 (b), (c), and (f) of the Code, except that—

(i) ‘‘10 percent or more’’ shall be substituted for ‘‘more than 50 percent’’ each place it appears; and

(ii) Section 1563 shall apply (for purposes of section 267(d)), without regard to section 1563(b)(2).

(i) *Effective date.* Except as specifically provided to the contrary elsewhere in this section, this section applies to transfers occurring after December 31, 1984.

[T.D. 8087, 51 FR 17953, May 16, 1986, as amended by T.D. 8770, 63 FR 33568, June 19, 1998]

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[T.D. 8682, 61 FR 42169, Aug. 14, 1996]

§1.367(e)–1T Treatment of section 355 distributions by U.S. corporations to foreign persons (temporary).

(a) *Purpose and scope.* This section provides rules concerning the recognition of gain by a domestic corporation on a distribution that qualifies for nonrecognition under section 355 of stock or securities of a domestic or foreign corporation to a person who is not a U.S. person. Paragraph (b) of this section states as a general rule that gain recognition is required on the distribution. Paragraph (c) of this section provides exceptions to the gain recognition rule for certain distributions of stock or securities of a domestic corporation. Paragraph (d) of this section refers to other consequences of distributions described in this section. Paragraph (e) of this section provides examples of these rules. Finally, paragraph (f) of this section specifies the effective date of this section.

(b) *Recognition of gain required*—(1) *In general.* (i) If a domestic corporation (distributing corporation) makes a distribution that qualifies for nonrecognition under section 355 of stock or securities of a domestic or foreign corporation (controlled corporation) to a person who is not a qualified U.S. person, then, except as provided in paragraph (c) of this section, the distributing corporation shall recognize gain (but not loss) on the distribution under section 367(e)(1). No gain is required to be recognized under this section with respect to a distribution to a qualified U.S. person of stock or securities that qualifies for nonrecognition under section 355. For purposes of this section, a qualified U.S. person is—

(A) A citizen or resident of the United States; and

(B) A domestic corporation.

(ii) In the case of stock or securities owned through a partnership, trust, or estate, see paragraph (b)(5) of this section.

(2) *Computation of gain of the distributing corporation.* The gain recognized by the distributing corporation under paragraph (b)(1) of this section shall be equal to the excess of the fair market value of the stock or securities distributed to persons who are not qualified U.S. persons (determined as of the time of the distribution) over the distributing corporation's adjusted basis in the stock or securities distributed to such distributees. For purposes of the preceding sentence, the distributing corporation's adjusted basis in each unit of each class of stock or securities distributed to a distributee shall be equal to the distributing corporation's total adjusted basis in all of the units of the respective class of stock or securities owned immediately before the distribution, divided by the total number of units of the class of stock or securities owned immediately before the distribution.

(3) *Treatment of distributee.* If the distribution otherwise qualifies for nonrecognition under section 355, each distributee shall be considered to have received stock or securities in a distribution qualifying for nonrecognition under section 355, even though the distributing corporation may recognize gain on the distribution under this section. Thus, the distributee shall not be considered to have received a distribution described in section 301 or a distribution in an exchange described in section 302(b) upon the receipt of the stock or securities of the controlled corporation. Except where section 897(e)(1) and the regulations thereunder cause gain to be recognized by the distributee, the basis of the distributed domestic or foreign corporation stock in the hands of the foreign distributee shall be the basis of the distributed stock determined under section 358 without any increase for any gain recognized by the domestic corporation on the distribution.

(4) *Nonapplication of section 367(a) principles that provide for exceptions to gain recognition.* Paragraph (b)(1) of this section requires recognition of gain notwithstanding the application of any principles contained in section 367(a) or the regulations thereunder. The only exceptions to paragraph (b)(1) of this section are contained in paragraph (c) of this section. None of these exceptions applies to distributions of stock or securities of a foreign corporation.

(5) *Partnerships, trusts, and estates*—(i) *In general.* For purposes of this section, stock or securities owned by or for a partnership (whether foreign or domestic) shall be considered to be owned proportionately by its partners. In applying this principle, the proportionate share of the stock or securities of the distributing corporation considered to be owned by a partner of the partnership at the time of the distribution shall equal the partner's distributive share of gain that would be realized by the partnership from a sale of stock of

the distributing corporation immediately before the distribution (without regard to whether, under the particular facts, any gain would actually be realized on the sale for U.S. tax purposes), determined under the rules and principles of sections 701 through 761 and the regulations thereunder. For purposes of this section, stock or securities owned by or for a trust or estate (whether foreign or domestic) shall be considered to be owned proportionately by the persons who would be treated as owning such stock or securities under sections 318(a)(2)(A) and (B). In applying section 318(a)(2)(B), if a trust includes interests that are not actuarially ascertainable and a principal purpose of the inclusion of the interests is the avoidance of section 367(e)(1), all such interests shall be considered to be owned by foreign persons. In a case where an interest holder in a partnership, trust, or estate that owns stock of the distributing corporation is itself a partnership, trust, or estate, the rules of this paragraph (b)(5) apply to individuals or corporations that own (direct or indirect) interests in the upper-tier partnership, trust or estate.

(ii) *Written statement.* If, prior to the date on which the distributing corporation must file its income tax return for the year of the distribution, the corporation obtains a written statement, signed under penalties of perjury by an interest holder in a partnership, trust, or estate that receives a distribution described in paragraph (b)(1) of this section from the corporation, which statement certifies that the interest holder is a qualified U.S. person (as defined in paragraph (b)(1)(i) of this section), no liability shall be imposed under paragraph (b)(1) of this section with respect to the distribution to the partnership, trust, or estate to the extent of the interest holder's interest in the partnership, trust, or estate, unless the distributing corporation knows or has reason to know that the statement is false, or it is subsequently determined that the interest holder, in fact, was not a qualified U.S. person at the time of the distribution. The written statement must set forth the amount of the interest holder's proportionate interest in the partnership, trust, or estate as determined under paragraph (b)(5)(i) of this section and must set forth the amount of such entity's proportionate interest in the distributing and controlled corporation, as well as the interest holder's name, taxpayer identification number, home address (in the case of an individual) or office address and place of incorporation (in the case of a corporation). The written statement must be retained by the distributing corporation with its books and records for a period of three calendar years following the close of the last calendar year in which the corporation relied upon the statement.

(6) *Anti-abuse rule.* If a domestic corporation is directly or indirectly formed or availed of by one or more foreign persons to hold the stock of a second domestic corporation for a principal purpose of avoiding the application of section 367(e)(1) and the requirements of this section, any distribution of stock or securities to which section 355 applies by such second domestic corporation shall be treated for Federal income tax purposes as a distribution to such foreign person or persons, followed by a transfer of the stock or securities to the first domestic corporation. The qualification of the distribution to the foreign person for an exception to the general gain recognition rule of paragraph (b)(1) of this section, and the consequences of the transfer to the first domestic corporation under this section, shall be determined in accordance with all of the facts and circumstances.

(c) *Nonrecognition of gain*—(1) *Distribution by a U.S. real property holding corporation of stock in a second U.S. real property holding corporation.* Gain shall not be recognized under paragraph (b) of this section by a domestic corporation making a distribution that qualifies for nonrecognition under section 355 of stock or securities of a domestic controlled corporation to a person who is not a qualified U.S. person (as defined in paragraph (b)(1)(i) of this section) if the conditions specified in paragraphs (c)(1)(i) and (ii) of this section are both satisfied:

(i) Immediately after the distribution, both the distributing and controlled corporations are U.S. real property holding corporations (as defined in section 897(c)(2)). For the treatment of the distribution under section 897, see section 897(e)(1) and the regulations thereunder.

(ii) The distributing corporation attaches to its timely filed Federal income tax return for the taxable year in which the distribution occurs a statement titled ''Section 367(e)(1)—Reporting of Section 355 Distribution by U.S. Real Property Holding Corporation'', signed under penalties of perjury by an officer of the corporation, disclosing the following information—

(A) A statement that the distribution is one to which paragraph (c)(1) of this section applies; and

(B) A description of the transaction in which one U.S. real property holding corporation distributes the stock of another U.S. real property holding corporation in a transaction that is described under section 355.

(iii) For purposes of this paragraph (c)(1), an income tax return (including an amended return) will be considered a timely filed Federal income tax return if it is filed prior to the time that the Internal Revenue Service discovers that the reporting requirements of this paragraph have not been satisfied.

(2) *Distribution by a publicly traded corporation—(i) Conditions for nonrecognition.* Except as provided by paragraph (c)(2)(ii) of this section, gain shall not be recognized under paragraph (b) of this section by a domestic corporation making a distribution that qualifies for nonrecognition under section 355 of stock or securities of a domestic controlled corporation to a person who is not a qualified U.S. person (as defined in paragraph (b)(1)(i) of this section) if both of the following conditions are satisfied:

(A) Stock of the domestic controlled corporation with a value of more than 80 percent of the outstanding stock of the corporation is distributed with respect to one or more classes of the outstanding stock of the distributing corporation that are regularly traded on an established securities market, as defined in § 1.897–1(m)(1) and (3), located in the United States. Stock is considered to be regularly traded if it is regularly quoted by brokers or dealers making a market in such interests. A broker or dealer is considered to make a market only if the broker or dealer holds himself out to buy or sell interests in the stock at the quoted price.

(B) The distributing corporation satisfies the reporting requirements contained in paragraph (c)(2)(iii) of this section.

(ii) *Recognition of gain if distributee owns 5 percent of distributing corporation.* If, at the time of the distribution, the distributing corporation knows or has reason to know that any distributee who is not a qualified U.S. person (as defined in paragraph (b)(1)(i) of this section) owns, directly, indirectly, or constructively (using the rules of sections 897(c)(3) and (c)(6)(C), but subject to the rules of paragraph (b)(5) of this section), more than 5 percent (by value) of a class of stock or securities of the distributing corporation with respect to which the stock or securities of the controlled corporation is distributed (a 5-percent shareholder), the distributing corporation will qualify for nonrecognition under paragraph (c)(2)(i) of this section if, with respect to such 5-percent shareholder, either—

(A) The distribution qualifies for nonrecognition under paragraph (c)(3) of this section; or

(B) The distributing corporation recognizes gain (but not loss) on the distribution under paragraph (b) of this section.

(iii) *Reporting Requirements.* To qualify for nonrecognition treatment under paragraph (c)(2)(i) of this section, the distributing corporation must attach to its timely filed Federal income tax return, for the taxable year in which the distribution occurs a statement titled ''Section 367(e)(1)—Reporting of Section 355 Distribution by U.S. Publicly Traded Corporation to Foreign Persons,'' signed under penalties of perjury by an officer of the corporation, disclosing the following information:

(A) A statement that the distribution is one to which paragraph (c)(2) of this section applies.

(B) A description of the transaction in which the distributing corporation that is publicly traded on a U.S. securities market distributed stock or securities of a domestic controlled corporation.

(C) The U.S. securities market on which the stock of the distributing corporation is publicly traded.

(D) A statement that, at the time of the distribution, either—

(*1*) The distributing corporation does not know or have reason to know that any distributee who is not a qualified U.S. shareholder (as defined in paragraph (b)(1)(i) of this section) is a 5-percent shareholder; or

(*2*) The distributing corporation knows or has reason to know that one or more distributees who are not qualified U.S. persons are 5-percent shareholders, and, that with respect to each such 5-percent shareholder, either—

(*i*) Gain will not be recognized because the requirements of paragraph (c)(3) of this section are satisfied; or

(*ii*) Gain (but not loss) will be recognized in accordance with paragraph (b) of this section.

(iv) *Timely filed return.* For purposes of this paragraph (c)(2), an income tax return (including an amended return) will be considered a timely filed Federal income tax return if it was received prior to the time that the Internal Revenue Service discovers that the reporting requirements of this paragraph (c)(2) have not been satisfied.

(v) *Relation to other nonrecognition provisions.* If the distribution of the stock and securities of the controlled corporation also qualifies for nonrecognition under paragraph (c)(1) of this section, the distributing corporation shall be entitled to nonrecognition under paragraph (c)(1) of this section and not this paragraph (c)(2).

(3) *Distribution of certain domestic stock to 10 or fewer qualified foreign distributees*—(i) *In general.* (A) Gain shall not be recognized under paragraph (b) of this section by a domestic corporation making a distribution that qualifies for nonrecognition under section 355 of stock or securities of a domestic controlled corporation with respect to a foreign distributee (defined in paragraph (c)(3)(i)(B) of this section) that is a qualified foreign distributee (defined in paragraph (c)(3)(i)(C) of this section), provided that each of the conditions contained in paragraph (c)(3)(ii) of this section is satisfied. If one or more foreign distributees are not treated as qualified foreign distributees, the distributing corporation shall recognize a percentage of the gain realized on the distribution, equal to the percentage of its stock owned immediately before the distribution, directly or indirectly, by foreign distributees who are not qualified foreign distributees. See paragraph (b)(5) of this section for rules regarding the ownership of stock held by a partnership, trust, or estate.

(B) For purposes of this paragraph (c)(3), the term *foreign distributee* is any person who is not a qualified U.S. person (as defined in paragraph (b)(1)(i) of this section) if such person—

(*1*) Owned stock or securities of the distributing corporation immediately prior to the distribution;

(*2*) Owned stock or securities of the distributing corporation within two years prior to the distribution and directly, indirectly, or constructively (using the rules of section 318) owns 50 percent or more of either the total voting power or the total value of the stock of the distributing or controlled corporation immediately after the distribution; or

(*3*) Is a transferee or substitute distributee, as defined in paragraph (c)(3)(vi)(C) or (D) of this section.

(C) For purposes of this section, except as provided by paragraph (c)(3)(i)(D) of this section, the term *qualified foreign distributee* is a foreign distributee that, during the entire period for which the agreement to recognize gain (described in paragraph (c)(3)(iii) of this section) is in effect with respect to the distributee, is either an individual or a corporation (as defined in section 7701(a)(3)), resident of a foreign country that maintains a comprehensive income tax treaty with the United States which contains an information exchange provision. However, no more than ten foreign distributees in total may be current or former qualified foreign distributees (including any transferee or substitute distributees as defined in paragraph (c)(3)(vi)(C) or (D) of this section) during the entire term of the gain recognition agreement. See, however, paragraph (c)(3)(vi)(G) of this section for special rules applicable to substitute distributees.

(D) Unless the distributing corporation obtains a ruling from the Internal Revenue Service to the contrary, no foreign distributee shall be treated as a qualified foreign distributee if it holds its interest in the distributing corporation through a partnership, trust or estate, characterized as such under the taxation laws of the United States or any entity that is treated as fiscally transparent under the taxation laws of the foreign country in which it is a resident if such country maintains a comprehensive income tax treaty with the United States which contains an information exchange provision.

(ii) *Conditions for nonrecognition.* A distribution of stock or securities described in paragraph (c)(3)(i) of this section to a qualified foreign distributee shall not result in the recognition of gain if each of the following conditions is satisfied:

(A) If more than ten foreign distributees, at any time during the entire term of the gain recognition agreement, are eligible to be qualified foreign distributees, the distributing corporation shall designate the foreign distributees to be considered qualified foreign distributees for which nonrecognition is claimed under this paragraph (c)(3).

(B) Immediately after the distribution and on each testing date beginning after the distribution and during the period that the agreement to recognize gain (described in paragraph (c)(3)(iii) of this section) is in effect, the value of the distributing corporation (that is, the fair market value of the assets of the distributing corporation, less all liabilities of the distributing corporation) must exceed the amount of gain that the distributing corporation realized, but did not recognize (on or after the distribution) under this paragraph (c)(3), as a consequence of the distribution with respect to qualified foreign distributees. This requirement will be deemed satisfied for any testing date upon which the adjusted basis of the distributing corporation’s assets, less all liabilities of the distributing corporation, exceeds the amount of the deferred gain. A testing date is—

(*1*) The last day of any taxable year of the distributing corporation during which the agreement to recognize gain is in effect; and

(*2*) Any date upon which the distributing corporation distributes property to its shareholders under section 301(a).

(C) At all times until the close of the 120-month period following the end of the taxable year of the distributing corporation in which the distribution was made, except under the circumstances and subject to the consequences prescribed in paragraphs (c)(3)(vi) and (vii) of this section, all qualified foreign distributees must continue to own, directly or indirectly, all of the stock and securities of the distributing and controlled corporations that the qualified foreign distributee owned, directly or indirectly, immediately after the distribution (including any stock and securities of the distributing or controlled corporation later acquired from the distributing or controlled corporation for which the distributee has a holding period determined under section 1223 by reference to the stock or securities).

(D) The distribution of stock or securities described in paragraph (c)(3)(i) of this section must not be a distribution pursuant to which the distributing corporation goes out of existence.

(E) The distributing corporation must file an agreement to recognize gain, and the controlled corporation must agree to be secondarily liable in the event that the distributing corporation does not pay the tax due upon a recognition event described in paragraph (c)(3)(vii) of this section. The agreement is described in paragraph (c)(3)(iii) of this section and filed by the distributing corporation with its Federal income tax return for its taxable year in which the distribution is made.

(F) For each of the taxable years of the distributing corporation, beginning with the taxable year of the distribution and ending with the taxable year that includes the close of the 120-month period following the end of the taxable year of the distributing corporation in which the distribution was made, all qualified foreign distributees and the controlled corporation must provide to the distributing corporation the annual certifications described in paragraph (c)(3)(v) of this section, and the distributing corporation must file the certifications with its tax return.

(iii) *Agreement to recognize gain*. The agreement to recognize gain required by this paragraph (c)(3)(iii) shall be prepared by or on behalf of the distributing corporation and signed under penalties of perjury by an authorized officer of the distributing corporation. An authorized officer of the controlled corporation must also sign the agreement under penalties of perjury, agreeing to extend the statute of limitations and accept liability for the tax in the event that the distributing corporation fails to pay the tax upon a recognition event. The agreement provided by the distributing corporation shall set forth the following items, under the heading ‘‘GAIN RECOGNITION AGREEMENT UNDER §1.367(e)–1T(c)(3)(iii)’’, with paragraphs labeled to correspond with such items:

(A) A declaration that the distribution is one to which paragraph (c)(3) of this section applies.

(B) A description of each qualified foreign distributee, which shall include the qualified foreign distributee's—

(*1*) Name;

(*2*) Address;

(*3*) Taxpayer identification number (if any); and

(*4*) Residence and citizenship (in the case of an individual) or place of incorporation and country of residence (in the case of a qualified foreign distributee that is a corporation for Federal income tax purposes under section 7701(a)(3)).

(C) A description of the stock and securities of the distributing and controlled corporations owned (directly or indirectly) by each qualified foreign distributee, including—

(*1*) The number or amount of shares;

(*2*) The type of stock or securities;

(*3*) The fair market values of the stock and securities of the controlled corporation owned (directly or indirectly) by the qualified foreign distributee(s), determined immediately before and immediately after the distribution;

(*4*) The distributing corporation's adjusted basis (immediately before the distribution) in the stock and securities of the controlled corporation distributed to the qualified foreign distributees;

(*5*) The fair market value of the distributing corporation (fair market value of its assets, less all liabilities of the distributing corporation) immediately after the distribution. Such amount must exceed the amount of gain that the distributing corporation realized, but did not recognize under this paragraph (c)(3), on the distribution to qualified foreign distributees. Alternatively, the fair market value standard will be deemed satisfied if the adjusted basis of the assets of the distributing corporation, less all liabilities of the distributing corporation, exceeds the amount of the deferred gain.

(*6*) For each applicable valuation, a summary of the method (including appraisals, if any) used for determining the fair market values required by this paragraph (c)(3)(iii).

(D) The distributing corporation's agreement to recognize gain in accordance with paragraph (c)(3)(vii) of this section.

(E) The controlled corporation's agreement to be secondarily liable for the distributing corporation's tax liability, pursuant to the gain recognition agreement described in this paragraph (c)(3)(iii).

(F) A waiver of the period of limitations by both the distributing and controlled corporation as described in paragraph (c)(3)(iv) of this section.

(G) An attached statement from each qualified foreign distributee declaring that the qualified foreign distributee will provide to the distributing corporation the annual certifications described in paragraph (c)(3)(v)(A) of this section for each of the taxable years of the distributing corporation, beginning with the taxable year of the distribution and ending with the taxable year that includes the close of the 120-month period following the taxable year of the distributing corporation in which the distribution was made. The attached statements shall be signed under penalties of perjury by an authorized officer in the case of any qualified foreign distributee that is a corporation for Federal income tax purposes or by the individual in the case of a qualified foreign distributee that is an individual.

(H) An attached statement from the controlled corporation declaring that it will provide to the distributing corporation the annual certifications described in paragraph (c)(3)(v)(B) of this section.

(I) An agreement by the distributing corporation to attach to its tax returns the annual certifications of the qualified foreign distributees and the controlled corporation described in paragraphs (c)(3)(v)(A) and (B) of this section, respectively, and to meet any other reporting requirement in accordance with paragraph (c)(3)(v) of this section.

(iv) *Waiver of period of limitation.* The distributing corporation and the controlled corporation must file, with the gain recognition agreement described in paragraph (c)(3)(iii) of this section, a waiver of the period of limitation on the assessment of tax upon the gain realized on the distribution to the qualified foreign distributee(s). The waiver shall be executed on Form 8838, substitute form, or such other form as may be prescribed by the Commissioner for this purpose and shall extend the period for assessment of such tax to a date not earlier than the close of the thirteenth full year following the taxable year that includes the distribution. A properly executed Form 8838, substitute form, or such other form authorized by this paragraph (c)(3)(iv) shall be deemed to be consented to and signed by a Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)–1(d) of this chapter.

(v) *Annual certifications and other reporting requirements.* For each of the taxable years of the distributing corporation, beginning with the taxable year of the distribution and ending with the taxable year that includes the close of the 120-month period following the end of the taxable year of the distributing corporation in which the distribution was made, the distributing corporation must file with its Federal income tax return the annual certifications for that year described in this paragraph (c)(3)(v).

(A) Each current qualified foreign distributee must provide to the distributing corporation an annual certification, signed under penalties of perjury by an authorized officer of the qualified foreign distributee that is a corporation or by the qualified foreign distributee that is an individual (as the case may be). Each annual certification must identify the distribution with respect to which it is given by setting forth the date and a summary description of the distribution. In the annual certification, the qualified foreign distributee must declare that—

(*1*) The qualified foreign distributee continues to satisfy paragraph (c)(3)(i)(C) of this section; and

(*2*) The qualified foreign distributee continues to own, directly or indirectly, without interruption, the stock and securities of the distributing and controlled corporations (except to the extent the stock or securities have been disposed of in a transfer described in paragraph (c)(3)(vi) of this section).

(B) The controlled corporation must provide a certification to the distributing corporation, signed under penalties of perjury by an authorized officer of the corporation, that lists each current qualified foreign distributee holding (directly or indirectly) stock of the controlled corporation and its direct or indirect ownership interest in the controlled corporation at both the first day and the last day of the taxable year for which the distributing corporation files its Federal income tax return, and certifies the accuracy of that list.

(C) The distributing corporation must attach to the annual certifications described in paragraphs (c)(3)(v)(A) and (B) of this section, a statement signed under penalties of perjury by an authorized officer of the corporation, in which the corporation declares that, to the best of its knowledge, the annual certifications are true.

(D) The distributing corporation must also attach to the annual certifications a separate statement indicating—

(*1*) The names and addresses of each current and each former qualified foreign distributee;

(*2*) The percentage of direct or indirect ownership that the qualified foreign distributees retain in the distributing corporation at year-end; and

(*3*) A certification that the value of the distributing corporation (or the adjusted basis of its assets), less all of the liabilities of the distributing corporation on all testing dates, exceeded the amount of the gain deferred as of the testing date.

(vi) *Special rule for nonrecognition transactions.* (A) Gain shall not be recognized under paragraph (c)(3)(vii) of this section if the distributing or controlled corporation is acquired by a successor-in-interest (described in paragraph (c)(3)(vi)(B) of this section), or upon a direct or indirect disposition by a qualified foreign distributee of stock or securities of a distributing or controlled corporation (or a successor-in-interest) that is subject to a gain recognition agreement described in paragraph (c)(3)(iii) of this section, if the requirements of this paragraph (c)(3)(vi) are satisfied and the disposition consists of a transfer described in section 332, 337, 351, 354, 355, 356, or 361 that does not result in a substantial transformation (as defined in paragraph (c)(3)(vii)(B) of this section). For special rules regarding transfers described in section 355, see paragraph (c)(3)(vi)(G) of this section.

(B) For purposes of this section, the term *successor-in-interest* refers to any domestic corporation that acquires the assets of the distributing or controlled corporation in a transaction described in section 381(a) to which this paragraph (c)(3)(vi) applies.

(C) For purposes of this section, the term *transferee distributee* refers to:

(*1*) Any corporation whose stock or securities are exchanged for the stock or securities of the distributing or controlled corporation (or a successor-in-interest), or of another transferee distributee, in a transaction described in section 351, 354, or sections 361 and 381(a)(2), to which this paragraph (c)(3)(vi) applies.

(*2*) Any corporation that acquires the assets of any qualified foreign distributee, transferee distributee or substitute distributee in a transaction described in section 381(a).

(D) For purposes of this section, the term *substitute distributee* refers to any person that acquires the stock or securities of the distributing or controlled corporation (or a successor-in-interest), or of a qualified foreign distributee, in a section 355 distribution.

(E) Gain shall not be recognized under paragraph (c)(3)(vii) of this section in a transaction involving a transfer of the assets of the distributing or controlled corporation to a successor-in-interest, only if the following information and agreements are included with the first annual certification thereafter filed under paragraph (c)(3)(v) of this section:

(*1*) A description of the transaction (including a statement of applicable Internal Revenue Code provisions, and a description of stock or securities transferred, exchanged, or received in the transaction).

(*2*) A description of the successor-in-interest (including the name, address, taxpayer identification number, and place of incorporation of the successor in interest).

(*3*) An agreement of the successor-in-interest, signed under penalties of perjury by an authorized officer of the successor-in-interest corporation, to succeed to all of the responsibilities and duties of the distributing corporation or the controlled corporation (as the case may be) under this paragraph (c)(3) as if the successor-in-interest were the distributing or controlled corporation.

(F) Gain shall not be recognized under paragraph (c)(3)(vii) of this section in a transaction described in paragraph (c)(3)(vi)(A) of this section in which a qualified foreign distributee, directly or indirectly, disposes of, and a transferee distributee acquires, stock or securities of the distributing or controlled corporation (or a successor-in-interest), or another transferee distributee, only if the transferee distributee is either a qualified U.S. person or qualifies as a qualified foreign distributee under this paragraph (c)(3) and the following information and agreements are included with the first annual certification thereafter filed under paragraph (c)(3)(v) of this section:

(*1*) A description of the transaction (including a statement of applicable Internal Revenue Code provisions, and a description of the stock or securities of the distributing or controlled corporation (or a successor-in-interest) owned, directly or indirectly, by qualified foreign distributees immediately after the transaction).

(*2*) An agreement of the distributing corporation and the controlled corporation (amending the agreement described in paragraph (c)(3)(iii) of this section), signed under penalties of perjury by an authorized officer of the corporation, to recognize gain (in the case of the distributing corporation) and to be secondarily liable (in the case of the controlled corporation) in accordance with the provisions of this paragraph (c)(3) upon the occurrence of a disposition, directly or indirectly, by the foreign transferee distributee of any stock or securities of the distributing or controlled corporation (or a successor-in-interest) (other than a disposition that itself satisfies the requirements of this paragraph (c)(3)(vi)).

(*3*) An agreement of each foreign transferee distributee, signed under penalties of perjury by the individual or an authorized officer of the corporation, to comply with all of the responsibilities, qualifications and duties of a qualified foreign distributee under this paragraph (c)(3), with respect to the stock or securities of the distributing or controlled corporation (or a successor-in-interest) owned, directly or indirectly, by the transferee distributee.

(G) Gain shall not be recognized under paragraph (c)(3)(vii) of this section in the case of a section 355 distribution by a qualified foreign distributee of stock or securities of the distributing or controlled corporation (or a successor-in-interest), or of another qualified foreign distributee. The qualified foreign distributee that distributed the stock or securities is no longer required to comply with the rules of this section applicable to qualified foreign distributees, provided such person no longer has any interest, directly or indirectly, in the distributing and controlled corporation. Thus, for example, such person is not counted as a qualified foreign distributee for purposes of limiting gain recognition to 10 or fewer foreign distributees. In order for this provision to apply, the substitute distributee must either be a qualified U.S. person or satisfy the requirements applicable to qualified foreign distributees contained in this paragraph (c)(3) and must include with the first annual certification thereafter filed under paragraph (c)(3)(v) of this section the following information and agreements:

(*1*) A description of the transaction (including a statement of applicable Internal Revenue Code sections, and a description of the stock or securities distributed in the transaction).

(*2*) An agreement of the distributing corporation and the controlled corporation (amending the agreement described in paragraph (c)(3)(iii) of this section), signed under penalties of perjury by an authorized officer of the corporation, to recognize gain (in the case of the distributing corporation) and to be secondarily liable (in the case of the controlled corporation) in accordance with the provisions of this paragraph (c)(3) upon the occurrence of a disposition, directly or indirectly, by a foreign substitute distributee of any stock or securities received by the substitute distributee in the transaction.

(*3*) An agreement of each foreign substitute distributee, signed under penalties of perjury by the individual or authorized officer of the corporation, to succeed to all of the responsibilities, qualifications and duties of a qualified foreign distributee under this paragraph (c)(3), with respect to the stock or securities of the distributing or controlled corporation (or a successor-in-interest) received by such substitute distributee.

(vii) *Recognition of gain.* (A)(*1*) The distributing corporation must file, within 90 days of a transaction described in this paragraph (c)(3)(vii)(A), an amended return for the year of the distribution and recognize gain realized but not recognized upon such distribution, if, prior to the close of the 120-month period following the end of the taxable year of the distributing corporation in which the distribution was made, either—

(*i*) A qualified foreign distributee sells (or otherwise disposes of) the stock or securities of the distributing or controlled corporation that the qualified foreign distributee owned (directly or indirectly) (other than pursuant to a transfer described in paragraph (c)(3)(vi) of this section); or

(*ii*) Any other transaction (e.g., a public offering or reorganization) results in a substantial transformation (as defined in paragraph (c)(3)(vii)(B) of this section) in either the distributing or controlled corporation (or both).

(*2*) For purposes of this paragraph (c)(3)(vii)(A), a disposition includes, but is not limited to, any disposition treated as a sale or exchange under this subtitle (e.g., section 301(c)(3)(A), 302(a), 351(b) or 356(a)(1)). For the computation of gain in the case of a sale (or similar disposition), see paragraph (c)(3)(vii)(C) of this section. For the computation of gain in the case of other transactions, see paragraphs (c)(3)(vii)(D) and (F) of this section. For special rules regarding substitute distributees, see paragraph (c)(3)(vii)(E) of this section.

(B) A transaction is treated as a substantial transformation if, as a result of such transaction, the qualified foreign distributees, transferee distributees and substitute distributees own, in the aggregate, less than 50 percent of either the total voting power or the total value of the stock of the distributing or the controlled corporation, directly or indirectly, that the qualified foreign distributees owned immediately after the distribution.

(C) In the case of a sale (or similar disposition), directly or indirectly, by a qualified foreign distributee of the stock or securities of the distributing or controlled corporation (or a successor-in-interest) that does not result in a substantial transformation, the distributing corporation shall be required to recognize a proportionate amount of the gain realized but not recognized under this paragraph (c)(3), equal to the percentage of stock of the distributing or controlled corporation, as the case may be, sold (or otherwise disposed of), directly or indirectly, by the qualified foreign distributee. However, if the sale (or other disposition) of stock or securities by a qualified foreign distributee results in a substantial transformation, the distributing corporation (or its successor-in-interest) must recognize the entire deferred gain that has not already been recognized under paragraph (c)(3)(vii) of this section.

(D) In the case of a nonrecognition transaction that results in a substantial transformation, the distributing corporation must recognize the entire deferred gain that has not already been recognized under paragraph (c)(3)(vii) of this section. If a nonrecognition transaction does not result in a substantial transformation, the distributing corporation does not recognize any gain provided that the requirements of paragraph (c)(3)(vi) of this section are satisfied.

(E) A sale (or other disposition), directly or indirectly, by a substitute distributee, of all or a portion of the stock or securities of the distributing or controlled corporation (or a successor-in-interest) that the substitute distributee received in the section 355 distribution shall be treated as a disposition of such stock or securities by a qualified foreign distributee (in accordance with paragraph (c)(3)(vii)(C) of this section) for purposes of computing gain under this paragraph (c)(3)(vii).

(F) Other transactions or events shall trigger gain under this paragraph (c)(3)(vii) as follows:

(*1*) If a qualified foreign distributee ceases to satisfy the requirements for a qualified foreign distributee contained in paragraph (c)(3)(i)(C) of this section (or any other specified requirements in paragraph (c)(3) of this section), the qualified foreign distributee shall be treated as if it sold all of the stock and securities that it owned, directly or indirectly, in the distributing and controlled corporation (or a successor-in-interest), on the date that such person ceased to meet the requirements.

(*2*) If a substitute distributee ceases to satisfy the requirements for a qualified foreign distributee contained in paragraph (c)(3)(i)(C) of this section (or any other specified requirements in paragraph (c)(3) of this section), the substitute distributee shall be treated as if it sold all of the stock and securities of the distributing or controlled corporation (or a successor-in-interest) that it received in the distribution, on the date that it ceased to meet the requirements.

(*3*) If the distributing corporation (or a successor-in-interest) fails to satisfy the requirement contained in paragraph (c)(3)(ii)(B) of this section on any testing date during which the agreement to recognize gain is in effect, such failure will be treated as if a substantial transformation has occurred on such date.

(*4*) If either the distributing or controlled corporation (or a successor-in-interest) is acquired in a section 381(a) exchange and the acquirer is not a successor-in-interest that satisfies the requirements of paragraph (c)(3)(vi)(E), such acquisition will be treated as if a substantial transformation has occurred on the date of the acquisition.

(G) A qualified foreign distributee that sells (or otherwise disposes of) all of its interest, directly or indirectly, in the distributing and controlled corporation ceases thereafter to be a qualified foreign distributee. In addition, where one qualified foreign distributee owns all of the stock of another qualified foreign distributee, and both persons have identical direct or indirect interests in the distributing or controlled corporation, the direct or indirect sale (or other disposition) by one qualified foreign distributee of all of its interest in the distributing or controlled corporation (under paragraph (c)(3)(vii) of this section) will terminate the qualified foreign distributee status for the second qualified foreign distributee. The principles of this paragraph (c)(3)(vii) shall generally be applied so that any gain relating to the same stock of the distributing or controlled corporation by more than one person is not taxed more than once under this paragraph (c)(3)(vii). In any event, gain recognized pursuant to this paragraph (c)(3)(vii), on a cumulative basis, shall not exceed the amount of gain that the distributing corporation would have recognized under section 367(e)(1) if its initial distribution of the stock or securities of the controlled corporation was fully taxable under paragraph (b) of this section.

(H) If additional tax is required to be paid by the distributing corporation (or a successor-in-interest) for the year of the distribution, interest must be paid by the distributing corporation (or the controlled corporation if the distributing corporation fails to pay the tax due) on that amount at the rates determined under section 6621(a)(2) with respect to the period between the date that was prescribed for filing the distributing corporation's original income tax return for the year of the distribution and the date on which the additional tax for that year is paid.

(I) Net operating losses, capital losses, or credits against tax that were available in the year of the distribution and that are unused (whether or not they have expired since the distribution) at the time of gain recognition described in this paragraph (c)(3)(vii) may be applied (respectively) by the distributing corporation against any gain recognized or tax owed by reason of this provision, but no other adjustments shall be made with respect to any other items of income or deduction in the year of distribution or other years.

(viii) *Failure to comply.* (A) Except as otherwise provided in paragraph (c)(3)(viii)(B) of this section, if the distributing corporation or the controlled corporation fails to comply in any material respect with the requirements of this paragraph (c)(3) or with the terms of an agreement submitted pursuant hereto, or if the distributing corporation knows or has reason to know of any failure of another person to so comply, the distributing corporation shall treat the initial distribution of the stock or securities of the controlled corporation as a taxable exchange in the year of the distribution. In such event, the period for assessment of tax shall be extended until three years after the date on which the Internal Revenue Service receives actual notice of such failure to comply.

(B) If a person fails to comply in any material respect with the requirements of this paragraph or with the terms of an agreement submitted pursuant thereto, the provisions of paragraph (c)(3)(viii)(A) of this section shall not apply if the person is able to show that such failure was due to reasonable cause and not willful neglect, provided that the person achieves compliance as soon as the person becomes aware of the failure. Whether a failure to materially comply was due to reasonable cause shall be determined by the district director under all the facts and circumstances.

(d) *Other consequences*—(1) *Exchange under section 897(e)(1).* With respect to the treatment under section 897(e)(1) of a foreign distributee on the receipt of stock or securities of a domestic or foreign corporation where the foreign distributee's interest in the distributing domestic corporation is a United States real property interest, see section 897(e)(1) and the regulations thereunder.

(2) *Dividend treatment under section 1248.* With respect to the treatment as a dividend of a portion of the gain recognized by the domestic corporation on the distribution of the stock of certain foreign corporations, see sections 1248(a) and (f) and the regulations thereunder.

(3) *Distribution of stock of a passive foreign investment company.* [Reserved]

(4) *Reporting under section 6038B.* Notice shall be required under section 6038B with respect to a distribution described in this section. See §1.6038B–1T(e).

(e) *Examples.* The rules of paragraphs (b), (c), and (d) of this section are illustrated by the examples below. In all examples, assume that all foreign companies are treated as corporations for Federal income tax purposes and are not treated as fiscally transparent under the taxation laws of the relevant foreign country.

Example 1. (i) FC, a Country Z company, owns all of the outstanding stock of DC1, a domestic corporation. DC1 owns all of the outstanding stock of DC2, another domestic corporation. The fair market value of the DC1 stock is 300x, and FC has a 100x basis in the DC1 stock. The fair market value of the DC2 stock is 180x, and DC1 has a 80x basis in the DC2 stock. Neither DC1 nor DC2 is a U.S. real property holding corporation. Country Z does not maintain an income tax treaty with the United States.

(ii) In a transaction qualifying for nonrecognition under section 355, DC1 distributes all of the stock of DC2 to FC. After the distribution, the DC1 stock has a fair market value of 120x.

(iii) Under paragraphs (b)(1) and (2) of this section, DC1 recognizes gain of 100x, which is the difference between the fair market value (180x) and the adjusted basis (80x) of the stock distributed. Under paragraph (d)(1) of this section and section 358, FC takes a basis of 40x in the DC1 stock, and a basis of 60x in the DC2 stock.

Example 2. (i) C, a citizen and resident of Country F, owns all of the stock of DC1, a domestic corporation. DC1, in turn, owns all of the stock of DC2, also a domestic corporation. The fair market value of the DC1 stock is 500x, and C has a 100x basis in the DC1 stock. The DC2 stock has a fair market value of 200x, and DC1 has a 180x basis in the DC2 stock.

(ii) In a transaction qualifying for nonrecognition under section 355, DC1 distributes to C all of the stock of DC2. DC1 and DC2 are U.S. real property holding corporations immediately after the distribution. After the distribution, the DC1 stock has a fair market value of 300x.

(iii) Under paragraph (c)(1) of this section, provided that DC1 complies with the reporting requirements contained in paragraph (c)(1)(ii) of this section, DC1 does not recognize gain on the distribution of the DC2 stock because DC1 and DC2 are U.S. real property holding corporations immediately after the distribution.

(iv) Under section 897(e) and the regulations thereunder, C is considered to have exchanged DC1 stock with a fair market value of 200x and an adjusted basis of 40x for DC2 stock with a fair market value of 200x. Because DC2 is a U.S. real property holding corporation, and its stock is a U.S. real property interest, C does not recognize any gain under section 897(e) on the distribution. C takes a basis of 40x in the DC2 stock, and its basis in the DC1 stock is reduced to 60x pursuant to section 358.

Example 3. (i) All of the outstanding common stock of DC, a domestic corporation that is not a U.S. real property holding corporation, is regularly traded on an established securities market located in the United States. None of the foreign shareholders of DC (directly, indirectly, or constructively) owns more than five percent of the common stock of DC. DC owns all of the stock of DS, a domestic corporation. The stock of DS has appreciated in the hands of DC.

(ii) In a transaction qualifying for nonrecognition under section 355, DC distributes all of the stock of DS to the common shareholders of DC.

(iii) Under paragraph (c)(2) of this section, DC does not recognize gain on the distribution of the DS stock to any foreign distributee, provided that DC complies with the reporting requirements contained in paragraph (c)(2)(iii) of this section. Each shareholder's basis in the DC and DS stock is determined pursuant to section 358.

Example 4. (i) FC, a company resident in Country X, owns all of the stock of DC1, a domestic corporation. DC1, in turn, owns all of the stock of DC2, a domestic corporation. The fair market value of the DC1 stock is 1,000x, and FC has a basis in the DC1 stock of 800x. The DC2 stock has a fair market value of 500x at the time of the distribution, and DC1 has a 100x basis in the DC2 stock. Neither DC1 nor DC2 is a U.S. real property holding corporation. Country X maintains an income tax treaty with the United States that includes an information exchange provision.

(ii) In a transaction qualifying for nonrecognition under section 355, DC1 distributes to FC all of the stock of DC2. Immediately after the distribution, the DC1 stock has a fair market value of 500x. Thus, the value of DC1 exceeds 400x, the amount of the deferred gain on the distribution.

(iii) Under paragraph (c)(3) of this section, DC1 will not recognize gain on the distribution of the DC2 stock to (foreign distributee) FC if FC is a qualified foreign distributee (as described in paragraph (c)(3)(i)(C) of this section) and DC1 enters into a gain recognition agreement (in which DC2 agrees to be secondarily liable), as described in paragraph (c)(3)(iii) of this section, and DC1, DC2 and FC otherwise comply with all of the provisions of paragraph (c)(3) of this section. Pursuant to section 358, FC will take a 400x basis in the DC2 stock and FC's basis in the DC1 stock will be reduced to 400x.

Example 5. (i) Assume the same facts as in *Example 4.* In addition, two years after DC1's distribution of DC2 stock to FC, FC sells 25 percent of the DC2 stock to Y, an unrelated corporation. One year later, FC sells an additional 30 percent of its DC2 stock to Z, another unrelated corporation.

(ii) Under paragraph (c)(3)(vii) of this section, upon FC's sale of 25 percent of its DC2 stock, DC1 is required to file an amended return for the year in which the DC2 stock was distributed to FC, and recognize 100x of gain, which represents 25 percent of the gain realized but not recognized on the distribution.

(iii) Upon FC's second sale of 30 percent of its DC1 stock, DC1 is required to file another amended return for the year of the distribution and recognize the balance of the deferred gain, or 300x, because such sale results in a substantial transformation (within the meaning of paragraph (c)(3)(vii)(B) of this section).

Example 6. (i) Assume the same facts as in *Example 5,* except that FC did not sell an additional 30 percent of its DC2 stock. Instead, DC2 issued additional stock in a public offering that reduced FC's interest in DC2 to less than 50 percent.

(ii) The public offering caused a substantial transformation because, as a result of the public offering, the interest of FC in DC2 was reduced to less than 50 percent of the amount of stock that FC owned in DC2 immediately after the distribution. Thus, the result is the same as in *Example 5.*

Example 7. (i) Assume the same facts as in *Example 4* In addition, one year after DC1's distribution of DC2 stock to FC, FC transfers all of the DC2 stock to FS, a company resident in Country X, in exchange for all of the FS stock, in a transaction described in section 351.

(ii) FS is described as a transferee distributee under paragraph (c)(3)(vi)(C) of this section. The transfer by FC of DC2 stock to FS is a nonrecognition transaction under paragraph (c)(3)(vi) of this section provided all of the requirements in paragraph (c)(3)(vi)(F) of this section are satisfied. (FS is counted, together with FC, for purposes of limiting nonrecognition treatment to up to ten qualified foreign distributees during the time that the gain recognition agreement is in effect.) DC1 will not recognize gain under the gain recognition agreement upon FC's transfer of the stock of DC2 to FS if DC1 enters into a new agreement, agreeing to recognize gain if FS sells DC2 stock, and the provisions of paragraph (c)(3)(vi) of this section are satisfied. A sale by FC of FS stock would be treated as a recognition event under paragraph (c)(3)(vii) because such sale would constitute an indirect disposition by FC of the DC2 stock.

Example 8. (i) P1, an entity treated as a partnership for Federal income tax purposes, owns all of the outstanding stock of DC1, a domestic corporation. DC1 owns all of the outstanding stock of DC2, another domestic corporation. The fair market value of the DC1 stock is 900x and P1 has an 900x basis in the DC1 stock. The fair market value of the DC2 stock is 600x and DC1 has a 400x basis in the DC2 stock. Neither DC1 nor DC2 is a U.S. real property holding corporation.

(ii) FC, a company resident in country X, and USP, a U.S. corporation, are the sole partners of P1. Under the rules and principles of sections 701 through 761, FC is entitled to a 60 percent, and USP is entitled to a 40 percent, distributive share of each item of P1 income and loss. Country X maintains an income tax treaty with the United States that includes an information exchange provision.

(iii) In a distribution qualifying for nonrecognition under section 355, DC1 distributes all of the stock of DC2 to P1. Paragraph (b)(5)(i) of this section provides that stock owned by a partnership is considered to be owned proportionately by its partners. Under paragraph (b)(5)(ii) of this section, if USP certifies to DC1 that it is a qualified U.S. person (and DC1 does not know or have reason to know that the certification is false), no Federal income tax shall be imposed with respect to the distribution by DC1 of DC2 to P1, to the extent of USP's 40 percent interest in P1.

(iv) Paragraph (c)(3)(i)(D) of this section provides that no foreign distributee may be treated as a qualified foreign distributee with respect to stock of the distributing corporation owned through a partnership, unless the distributing corporation receives a ruling from the Internal Revenue Service to the contrary. Thus, DC1 may not avoid recognition of the remaining 60 percent of the realized gain (relating to the interest of P1 owned by FC) by entering into a gain recognition agreement pursuant to paragraph (c)(3) of this section, unless DC1 obtains a ruling to the contrary.

Example 9. (i) DC1, a domestic corporation, owns all of the stock of DC2, also a domestic corporation. The stock of DC1 is owned equally by three shareholders: A, a domestic corporation, B, a U.S. citizen, and FB, a Country Y company.

(ii) A short time before DC1 adopted a plan to distribute the stock of DC2 to its shareholders, but after the board of directors of DC1 began contemplating the distribution, FB formed Newco, a domestic corporation, and contributed its DC1 stock to Newco in a transaction qualifying for nonrecognition under section 351. A valid business purpose existed for FB's transfer of the DC1 stock to Newco, but this purpose would have been fulfilled irrespective of whether FB transferred the DC1 stock to Newco before the distribution of DC2, or after the distribution of DC2 (in which case FB would have transferred the stock of DC1 and DC2 to Newco).

(iii) Pursuant to paragraph (b)(6) of this section, the District Director may determine that FB formed Newco for a principal purpose of avoiding section 367(e)(1). In such case, for Federal income tax purposes, FB will be treated as having received the stock of DC2 in a section 355 distribution, and then as having transferred the stock to Newco in a section 351 transaction.

(iv) If B was not a shareholder of DC1 so that A and FB were equal (50 percent) shareholders, FB would be treated as a foreign distributee within the meaning of paragraph (c)(3)(i)(B) of this section without the application of paragraph (b)(6) of this section. In such case, DC1 would recognize 50 percent of the gain realized on the distribution of the DC2 stock, unless FB was a qualified foreign distributee within the meaning of paragraph (c)(3)(i) of this section and the conditions under paragraph (c)(3)(ii) of this section were satisfied.

Example 10. (i) DC1, a domestic corporation, owns all of the stock of DC2, also a domestic corporation. The stock of DC1 is owned by FP, a company resident in Country X. Country X maintains in income tax treaty with the United States that includes an information exchange provision. The DC2 stock has a fair market value of 500x at the time of the distribution, and DC1 has a basis of 100x in the DC2 stock. The stock of DC1 has a value of 500x (excluding DC1's investment in DC2). Neither DC1 nor DC2 is a U.S. real property holding corporation.

(ii) FP forms a holding company resident in Country X, Newco, and transfers 50 percent of its DC1 stock to Newco in an exchange described in section 351. Immediately after those transactions, DC1 distributes all of its DC2 stock to FP in exchange for FP's stock of DC1 in a transaction described in section 355. Thus, after the non pro rata distribution, FP owns all of the stock of DC2, and FP also owns all of the stock of Newco, which, in turn, owns all of the stock of DC1.

(iii) Newco and FP are foreign distributees (under paragraph (c)(3)(i)(B)(*1*) of this section) because they owned stock of DC1 immediately prior to the distribution. Assuming that all of the requirements of the gain recognition agreement exception under paragraph (c)(3) of this section are satisfied (so that both FP and Newco are qualified foreign distributees under paragraph (c)(3)(i)(C) of this section), DC1 will not be immediately taxable on the 400x gain realized on the distribution of the stock of DC2. Gain will be triggered under the gain recognition agreement under paragraph (c)(3)(vii) of this section if FP sells stock of Newco (because such sale would be an indirect disposition by FP of the stock of DC1), if Newco sells stock of DC1, or if FP sells stock of DC2.

Example 11. (i) Assume the same facts as in *Example 10,* except that Newco is a company resident of Country Z, and Country Z does not maintain an income tax treaty with the United States that includes an information exchange provision.

(ii) DC1 may still enter into a gain recognition agreement under paragraph (c)(3) of this section. Both FP and Newco are foreign distributees, but Newco is not a qualified foreign distributee. Thus, DC1 must recognize 50 percent, or 200x, of the 400x deferred gain on the distribution of DC2 stock. Such (50 percent) portion equals the percentage of the DC1 stock owned by foreign distributees that are not qualified foreign distributees (the 50 percent of the stock owned by Newco). DC1 may defer 50 percent of the gain, with respect to the portion of its stock owned by FP, a qualified foreign distributee, provided that it meets the requirements of paragraph (c)(3) of this section.

Example 12. (i) FC, a company resident in Country X, owns all of the stock of DC1, a domestic corporation (and has owned DC1 for many years). Country X maintains an income tax treaty with the United States that includes an information exchange provision. DC1, in turn, owns all of the stock of DC2, a domestic corporation. DC1 has a basis of 200x in the DC2 stock, and the DC2 stock has a value of 500x. Immediately after the distribution of DC2 described below, DC1 has a value of more than 300x.

(ii) DC1 distributes all of the stock of DC2 to FC (a qualified foreign distributee) in a transaction described under section 355, and satisfies all of the requirements of paragraph (c)(3) of this section to qualify for an exception to the general rule of taxation under section 367(e)(1). Two years after the initial distribution, FC distributes all of the stock of DC2 to its sole shareholder, FP, a resident of Country X, in a transaction described under section 355.

(iii) Under paragraph (c)(3)(vi)(D) of this section, FP is a substitute distributee with respect to the DC2 stock. Provided that the requirements of paragraph (c)(3)(vi)(G) of this section are satisfied, FP replaces FC as a qualified foreign distributee with respect to the DC2 stock (although FC is still a qualified foreign distributee with respect to the DC1 stock). FC is no longer required to maintain an interest in DC2 for purposes of determining whether a substantial transformation occurs. Thus, a sale by FP of the stock of FC would not trigger gain under paragraph (c)(3)(vii) of this section.

Example 13. (i) DC1, a domestic corporation, owns all of the stock of DC2, also a domestic corporation. The stock of DC1 is owned by two shareholders: FP and FX. FP, a company resident in Country Z, owns 25 percent of the stock of DC1. FX, a company resident in Country X, owns 75 percent of the stock of DC1. Country X maintains an income tax treaty with the United States that includes an information exchange provision; Country Z does not. The fair market value of DC2 is 500x and DC1 has a basis of 100x in the DC2 stock. Immediately after the distribution described below, DC1 has a value in excess of 400x.

(ii) FP formed FS, a company resident in Country X, and transferred its 25 percent interest in DC1 to FS in exchange for all of the stock of FS in an exchange described in section 351. Within two years of the exchange, DC1 distributed all of the stock of DC2 to its shareholders.

(iii) Under paragraph (c)(3) of this section, DC1 may defer a portion of its gain realized on the distribution of DC2. DC1 must immediately recognize 25 percent of the realized gain, or 100x, because FP, a 25 percent (indirect) shareholder is a foreign distributee (within the meaning of paragraph (c)(3)(i)(B) of this section), but may not be treated as a qualified foreign distributee (within the meaning of paragraph (c)(3)(i)(C) of this section). DC1 may defer 75 percent of its realized gain if FX is a qualified foreign distributee and DC1 enters into a gain recognition agreement (in which DC2 agrees to be secondarily liable), and the provisions of paragraph (c)(3) of this section are otherwise met. DC1 need not include FS as a qualified foreign distributee because FP and FS had identical 25 percent ownership interests in DC1, and DC1 is taxable with respect to such 25 percent interest. Thus, under paragraph (c)(3)(vii)(G) of this section, a sale by FS of its DC1 or DC2 stock will not result in an additional trigger of the gain recognition agreement under paragraph (c)(3)(vii) of this section.

(iv) If FP was instead a resident of Country X, DC1 could defer its entire realized gain if both FP and FS were qualified foreign distributees. In such case, DC1 would have three qualified foreign distributees. (DC1 is limited to ten qualified foreign distributees, including transferee and substitute distributees during the term of the gain recognition agreement.) If FS sold its entire interest in either DC1 or DC2, DC1 would be required to amend its Federal income tax return for the year of the transfer and include 100x in income. In such case, neither FP nor FS would be considered a qualified foreign distributee immediately after the sale (and, as a result, FP's sale of its FS stock would not trigger additional gain under paragraph (c)(3)(vii)(G) of this section). The result would be the same if FP sold all of the stock of FS (as such sale is an indirect disposition by FP of all its stock of DC1 and DC2). (In such case, the sale by FS of its stock of DC1 or DC2 would not trigger additional gain under paragraph (c)(3)(vii)(G) of this section.)

(f) *Effective date.* This section shall be effective with respect to distributions occurring on or after September 13, 1996. However, taxpayers may elect to apply the rules of this section with respect to distributions occurring on or after December 31, 1995.

[T.D. 8682, 61 FR 42169, Aug. 14, 1996]

§ 1.367(e)–2T Distributions described in section 367(e)(2) (temporary).

(a) *Purpose and scope*—(1) *In general.* This section provides rules concerning the recognition of gain by a corporation on its distribution to a foreign corporation of property in a complete liquidation to which section 332 applies. Paragraph (b)(1) of this section states as a general rule that gain recognition is required when a domestic corporation makes a distribution of property in complete liquidation under section 332 to a foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in the domestic corporation. Paragraph (b)(2) of this section provides the only exceptions to the gain recognition rule of paragraph (b)(1). Paragraph (b)(3) of this section refers to other consequences of distributions described in paragraphs (b)(1) and (2). Paragraph (c)(1) of this section states as a general rule that gain recognition is not required when a foreign corporation makes a distribution of property in complete liquidation under section 332 to another foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in the distributing foreign corporation. Paragraph (c)(2) of this section provides exceptions to the nonrecognition rule of paragraph (c)(1). Paragraph (c)(3) of this section refers to other consequences of distributions described in paragraphs (c)(1) and (2). Examples of the rules of this section are provided in paragraphs (b)(4) and (c)(4) of this section. Finally, paragraph (d) specifies the effective date for the rules of this section. The rules of this section are issued pursuant to the authority conferred by section 367 (e)(2).

(2) *Nonapplicability of section 367(a).* Section 367(a) shall not apply to a complete liquidation described in section 332 by a domestic corporation into a foreign corporation that meets the stock ownership requirements of section 332(b) and that is subject to section 367(e)(2) or is described in paragraph (b)(2)(iii) of this section.

(b) *Distribution by a domestic corporation*—(1) *Recognition of gain required*—(i) *General rule.* If a domestic corporation makes a distribution of property in a complete liquidation under section 332 to a foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in the domestic corporation, then, except as provided in paragraph (b)(2) of this section, section 337 (a) and (b)(1) shall not apply and the distributing domestic corporation shall recognize gain on the distribution of the item of property under section 367(e)(2). The gain recognized by the domestic corporation shall be equal to the excess of the fair market value of each such item of property distributed over its adjusted basis. Except as provided in paragraphs (b)(2)(iii) and (d) of this section, the recognition of gain required under this paragraph is not prohibited by any treaty to which the United States is a party.

(ii) *Recognition of losses.* If paragraph (b)(1)(i) of this section would apply to a distribution of an item of property but for the fact that the distributing domestic corporation realizes a loss on the distribution of such item of property, then the distributing domestic corporation shall recognize the loss realized on such distribution. However, such loss shall be recognized only to the extent that (A) the total amount of capital losses recognized on such distributions does not exceed the total amount of capital gains recognized by the distributing domestic corporation pursuant to paragraph (b)(1)(i), and (B) the total amount of ordinary losses recognized on such distributions does not exceed the total amount of ordinary income recognized by the distributing domestic corporation pursuant to paragraph (b)(1)(i). Notwithstanding any other provision of this paragraph, losses shall be recognized under this section only on property that the distributing domestic corporation did not acquire within the five year period ending on the date of the liquidation through a capital contribution, a liquidation under section 332, or an exchange under section 351(a) or 361(a). If, pursuant to the rules of this paragraph (b)(1)(ii), only a portion of the capital loss or ordinary loss on the property distributed is recognized because the aggregate capital loss exceeds the aggregate capital gain or the aggregate ordinary loss exceeds the aggregate ordinary gain of the distributing corporation, then the capital loss (and the ordinary loss) recognized shall be treated as being recognized on a pro rata basis with respect to each such capital or ordinary property distributed.

(iii) *Distribution of partnership interest*—(A) *In general.* If a domestic corporation distributes an interest as a partner in a partnership (whether foreign or domestic) in a distribution described in paragraph (b)(1)(i) of this section, then for purposes of applying this section the domestic corporation shall be treated as having distributed a proportionate share of the property of the partnership. Accordingly, the applicability of the nonrecognition rules of paragraph (b)(1)(i) and (ii) and of any exception to recognition provided in this section shall be determined with reference to the property of the partnership rather than to the partnership interest itself. Where the property of the partnership includes an interest in a lower-tier partnership the applicability of any exception with respect to the interest in the lower-tier partnership shall be determined with reference to the property of the lower-tier partnership. In the case of multiple tiers of partnerships, the applicability of an exception shall be determined with reference to the property of the lowest-tier partnership in the partnership chain. A domestic corporation's proportionate share of partnership property shall be determined under the rules and principles of sections 701 through 761 and the regulations thereunder.

(B) *Basis adjustments.* The foreign corporation's basis in the distributed partnership interest shall be equal to the distributing domestic corporation's basis in such partnership interest immediately prior to the distribution, increased by the amount of gain and reduced by the amount of loss recognized by the domestic corporation on the distribution of the partnership interest. Solely for purposes of sections 743 and 754, the foreign corporation shall be treated as having purchased the partnership interest for an amount equal to the foreign corporation's adjusted basis therein.

(C) *Limited partnership interest.* The distribution by a domestic corporation of a limited partnership interest that is regularly traded on an established securities market shall not be subject to the rules of this paragraph (b)(1)(iii). Instead, the distribution of such an interest shall be treated in the same manner as a distribution of stock. For purposes of this section, a limited partnership interest is an interest as a limited partner in a partnership that is organized under the laws of any state of the United States or the District of Columbia. Whether such an interest is regularly traded on an established securities market shall be determined under the provisions of § 1.367(a)–1T(c)(3)(ii)(D).

(2) *Recognition of gain or loss not required*—(i) *Distribution of property used in a United States trade or business*—(A) *Conditions for nonrecognition.* The domestic corporation shall not recognize gain or loss under paragraph (b)(1) of this section on its distribution of property (including inventory) used by the domestic corporation in the conduct of a trade or business within the United States if—

(*1*) The distributee foreign corporation is not a controlled foreign corporation, as defined in section 957(a) or section 953(c) (including a corporation that would be treated as a controlled foreign corporation under section 953(c) but for the provisions of section 953(c)(3)), at the time of the distribution of property;

(*2*) The distributee foreign corporation, for the ten-year period beginning on the date of the distribution of such property, uses the property in the conduct of a trade or business in the United States (or, in the case of inventory, continues to hold the property for sale to customers until disposed of); and

(*3*) The domestic and foreign corporations attach the statement described in paragraph (b)(2)(i)(B) to their U.S. income tax returns for the year of the distribution (or to an amended return filed no later than July 16, 1990).

This nonrecognition rule does not apply to the distribution of intangibles described in section 936(h)(3)(B). Property is considered used by a foreign corporation in the conduct of a trade or business in the United States only if any income from the use of the property and any income or gain from the sale or exchange of the property would be subject to taxation under section 882(a) as effectively connected income. For purposes of this paragraph (b)(2)(i)(A), stock held by a dealer as inventory or for sale in the ordinary course of its trade or business shall be treated as inventory and not as stock in the hands of both the domestic corporation and the distributee foreign corporation. lf a distributing domestic corporation that would otherwise qualify for nonrecognition on the distribution of such property under this paragraph (b)(2)(i) fails to file the statement properly or files a statement that does not comply with the requirements of paragraph (b)(2)(i)(B) of this section, the Commissioner may, nevertheless, in his discretion treat the distributing domestic corporation as if it had, in fact, met all the requirements of paragraph (b)(2)(i)(B) if such treatment is necessary to prevent the taxpayer from otherwise deriving a tax benefit by such failure.

(B) *Required statement.* The statement required by paragraph (b)(2)(i)(A) shall be prepared by the distributing domestic corporation and signed under penalties of perjury by an authorized officer of each of the distributing domestic and distributee foreign corporations. The statement shall set forth the following items:

(*1*) A declaration that the distribution to the foreign corporation is one to which the rules of §1.367(e)–2T(b)(2)(i) apply.

(*2*) A description of all of the property distributed by the domestic corporation (whether or not the property qualifies for nonrecognition). Such description shall identify the property that continues to be used by the distributee foreign corporation in the conduct of a trade or business within the United States, including the location, adjusted basis, estimated fair market value, a summary of the method (including appraisals if any) used for determining such value, and the date of distribution of such items of property.

(*3*) An identification of the distributee foreign corporation, including its name and address, taxpayer identification number (if any), residence and place of incorporation.

(*4*) With respect to property entitled to nonrecognition pursuant to paragraph (b)(2)(i), a declaration by the distributee foreign corporation that it irrevocably waives any right under any treaty (whether or not currently in force at the time of the liquidation) to sell or exchange any item of such property without U.S. income taxation or at a reduced rate of taxation, or to derive income from the use of any item of such property without U.S. income taxation or at a reduced rate of taxation.

(*5*) An agreement by the distributing domestic corporation and the distributee foreign corporation to extend the statute of limitations on assessments and collections (under section 6501) with respect to the distribution of each item of property until three years after the date on which all such items of property have ceased to be used in a trade or business within the United States pursuant to paragraph (b)(2)(i)(C)(*1*), but in no event shall the extension be for a period longer than 13 years from the filing of the original U.S. income tax return for the taxable year of the last distribution of any such item of property. If, however, the distributing domestic corporation files an amended return pursuant to the provisions of paragraph (b)(2)(i)(C), other than an amended return filed for the substitution of property exchanged under section 1031 or converted under section 1033, the agreement to extend the statute of limitations on assessments and collections as to the property with respect to which gain is included on the amended return will not extend beyond three years (except as otherwise provided by section 6501) after the filing of the amended tax return.

(C) *Effect of submitting statement.* By the distributing domestic corporation's claiming nonrecognition under this paragraph (b)(2)(i), the distributing domestic corporation and the distributee foreign corporation agree to be subject to the rules of this paragraph (b)(2)(i)(C).

(*1*) If, within the ten year period from the date of distribution, any item of property entitled to nonrecognition under paragraph (b)(2)(i)(A) ceases to be used by the distributee foreign corporation in the conduct of a trade or business in the United States for any reason (including but not limited to the sale or exchange of such property or the removal of the property from conduct of the trade or business), then, except as provided in paragraph (b)(2)(i)(C)(*3*), the distributee foreign corporation shall cause to be filed on behalf of the domestic corporation an amended U.S. income tax return for the year of the distribution of such item of property, in which return the domestic corporation recognizes the gain (but not loss) realized but not recognized upon the initial distribution of such item of property. On the amended return filed pursuant to paragraph (b)(2)(i)(C)(*1*), the distributing domestic corporation may use any losses (or credits) existing in the year of the distribution, that were otherwise available in that year and not used in another year, to offset the gain (or tax thereon) required to be recognized under such paragraph.

(*2*) The amended return required by paragraph (b)(2)(i)(C)(*1*) shall be filed no later than the due date (including extensions) for the return of the distributee foreign corporation for the taxable year in which the property ceases to be used by the distributee foreign corporation in the conduct of a trade or business in the United States.

(*3*) If property ceases to be used by the distributee foreign corporation in the conduct of a trade or business in the United States by reason of a disposition of such property, and either (*i*) a loss is recognized in whole on such disposition, or (*ii*) a gain is recognized in whole and the distributee foreign corporation reports the full amount of such gain on its timely filed U.S. tax return for the year of the disposition, then the distributing domestic corporation shall not be required to recognize any gain in respect of the distribution of such property on an amended return for the year of the distribution. If a gain is recognized in whole on the disposition of the property and the distributee foreign corporation does not report the full amount of such gain on a timely filed U.S. tax return for the year of the disposition, then the distributing domestic corporation shall be required to recognize and include in income on an amended return for the year of the distribution the full amount of gain realized by such domestic corporation on the distribution of such property. If the domestic corporation is required to recognize gain in the year of the distribution, the foreign corporation shall, nonetheless, be required to recognize any gain realized on the disposition of the property according to generally applicable principles, but the basis of the property in the hands of the foreign corporation shall be adjusted to reflect the recognition of gain by the domestic corporation. Thus, if the property ceases to be used in the active conduct of a trade or business in the United States in a transaction in which gain is recognized, and the distributee foreign corporation includes in income the full amount of such gain on a timely filed return for the taxable year in which gain is recognized, then no amended return shall be required to be filed in respect of such property by the distributing domestic corporation.

(*4*) For purposes of this paragraph (b)(2)(i)(C), property shall not be considered as no longer used in the conduct of a trade or business in the United States if exchanged for, or involuntarily converted into, similar property used in the conduct of a trade or business in the United States, to the extent such exchange or conversion qualifies for nonrecognition under section 1031 or 1033, or distributed to another foreign corporation in a liquidation distribution under section 337(a) qualifying for nonrecognition under paragraph (c)(2)(i) of this section. Further, a cessation of use of property in the conduct of a trade or business in the United States shall not include the abandonment or disposal of essentially worthless or obsolete property. If the distributee foreign corporation exchanges the property under section 1031 for, or converts the property under section 1033 into similar property used in the conduct of a trade or business in the United States, then the domestic corporation and the distributee foreign corporation must file amended returns for the year of the distribution of such property from the domestic corporation to the distributee foreign corporation, in order to substitute on the statement that was required by paragraph (b)(2)(i)(B) the property received in place of the property exchanged or converted. If the distributee foreign corporation distributes the property in a liquidation distribution under section 337(a) qualifying for nonrecognition under paragraph (c)(2)(i), then the rules of such paragraph shall apply to the distribution.

(*5*) If additional tax is required to be paid by the distributing corporation for the year of a liquidating distribution, then interest must be paid on that amount at the rates determined under section 6621 with respect to the period between the date that was prescribed for filing the distributing domestic corporation's U.S. income tax return for the year of the distribution and the date on which the additional tax for that year is paid.

(*6*) The distributee foreign corporation, as successor in interest and liability to the distributing domestic corporation, shall be jointly and severally liable for any tax owed by the distributing domestic corporation as a result of the application of paragraph (b)(2)(i), and shall succeed to the distributing domestic corporation's agreement to extend the statute of limitations and collections under section 6561.

(*7*) The distributee foreign corporation shall attach a statement to its U.S. income tax return for each year after the liquidation of the distributing domestic corporation. The statement shall identify the distributed property that ceased to be used by the distributee foreign corporation in the conduct of a trade or business within the United States during that year (without regard to whether the distributing domestic corporation was required to file an amended return as a result of such disposition pursuant to paragraph (b)(2)(i)(C)(*3*) of this section). The requirement to attach such statement to the return shall not apply to any taxable year of the distributee foreign corporation after the final taxable year in which any distributed property is used by such corporation in the conduct of a trade or business within the United States, and in no event shall the requirement apply to a taxable year later than 13 years from the filing of the original U.S. income tax return for the taxable year of the distribution.

(ii) *Distribution of U.S. real property interests.* The domestic corporation shall not recognize gain under paragraph (b)(1) of this section on the distribution of a U.S. real property interest (other than stock in a former U.S. real property holding corporation which is treated as a U.S. real property interest for five years under §1.897–5T(c)(1)) in a complete liquidation under section 332(a) to the distributee foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in the distributing domestic corporation. See §1.897–5T(b)(3)(iv)(A). If property distributed by the domestic corporation is a U.S. real property interest that qualifies for nonrecognition under this paragraph (b)(2)(ii) in addition to nonrecognition provided by paragraph (b)(2)(i) of this section, then the distributing domestic corporation shall secure nonrecognition pursuant to this paragraph (b)(2)(ii) and not pursuant to the provisions of paragraph (b)(2)(i).

(iii) *Transitional rule for certain treaty provisions.* A distributing domestic corporation shall not recognize gain or loss under paragraph (b)(1) of this section on the distribution of property in a complete liquidation under section 332(a) to a foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in the domestic corporation if—

(A) Such property was distributed by the domestic corporation and received by the foreign corporation after July 31, 1986, and before September 29, 1987 in a distribution that would have been subject to section 367(e)(2) (as enacted by the Tax Reform Act of 1986) but for the provisions of Notice 87–5, 1987–1 C.B. 416, and

(B) The foreign corporation is a resident of a foreign country which had an income tax treaty with the United States in force at the time of the distribution which contained a provision barring discrimination based on capital ownership and the corporation is not denied the benefit of nondiscrimination under that treaty.

See Notice 87–66, 1987–2 C.B. 376.

(3) *Other consequences*—(i) *Distributee basis in property.* The basis of property distributed pursuant to paragraph (b) of this section in the hands of the distributee foreign corporation shall be the basis of such property in the hands of the distributing domestic corporation, increased by the amount of gain (if any), or reduced by the amount of loss (if any), recognized by the domestic corporation on the distribution of each of the respective properties pursuant to paragraph (b)(1) of this section.

(ii) *Dividend treatment under section 1248.* With respect to the treatment as a dividend of a portion of the gain recognized by the domestic corporation on the distribution of the stock of certain domestic and foreign corporations, see section 1248 (a) and (e) and the regulations thereunder. With respect to the treatment as a dividend of a portion of the gain realized but not otherwise recognized under paragraph (b)(1) of this section by the domestic corporation on the distribution of the stock of a foreign corporation (including a foreign corporation, the stock of which is a U.S. real property interest, because such corporation has in effect a valid election under section 897(i)), see section 1248(f) and the regulations thereunder.

(iii) *Exchange under section 897(e)(1).* With respect to the treatment under section 897(e)(1) of a distributee foreign corporation whose interest in the distributing domestic corporation is a U.S. real property interest, see § 1.897–5T(b)(3)(iv)(A).

(iv) *Distribution of stock of a passive foreign investment company.* [Reserved]

(v) *Carryover of tax attributes.* In regard to the carryover of certain tax attributes from the domestic corporation to the distributee foreign corporation, see section 381 and the regulations thereunder.

(4) *Examples.* The rules of this paragraph (b) may be illustrated by the following examples.

Example (1). (i) FC, a Country X corporation, owns all of the outstanding stock of DC, a domestic corporation. All of the property of DC has appreciated in value and is used in the conduct of a trade or business in Country X. None of the DC property is used in connection with the conduct of a trade or business within the United States. In a liquidation under section 332, DC distributes all of its property to FC.

(ii) Under paragraph (b)(1) of this section, DC recognizes gain on the distribution of its property to FC. FC takes a basis in each property equal to DC's basis in the property increased by the amount of any gain recognized by DC on the distribution of the property.

Example (2). (i) FC, a Country X corporation that is not a controlled foreign corporation, owns all of the outstanding stock of DC, a domestic corporation. DC owns Parcel P (a U.S. real property interest), equipment used in the conduct of a trade or business in the United States, and all of the stock in DC1, a domestic corporation, and FS, a foreign corporation that is not a passive foreign investment company. All of the property has appreciated in value since acquired by DC. DC, DC1, and FS have never been U.S. real property holding corporations.

(ii) DC distributes all of its property to FC in complete liquidation under section 332 on March 1, 1988. Beginning immediately after the distribution of the equipment, FC uses the equipment in the conduct of a trade or business in the U.S.

(iii) Under paragraph (b)(2)(ii) of this section, DC does not recognize gain on the distribution of Parcel P. If DC and FC comply with the requirements of paragraph (b)(2)(i) of this section, DC will not recognize gain on the distribution of the equipment, because FC uses the equipment in the conduct of a U.S. trade or business immediately after the distribution. DC must recognize gain pursuant to paragraph (b)(1) of this section on the distribution of the stock of DC1 and FS because there is no exception from gain recognition for the liquidating distribution of stock that is not held by the distributing corporation for sale to customers in the ordinary course or as inventory unless the corporation the stock of which is being distributed is a U.S. real property holding corporation. In regard to the treatment of DC under section 1248, see, however, section 1248 (a) and (e) and the regulations thereunder.

(iv) FC takes DC's basis under paragraph (b)(3)(i) of this section in Parcel P and the equipment because no gain is recognized by DC on the distribution of that property. Under paragraph (b)(3)(i) of this section, FC takes DC's basis in the stock of DC1 and FS, increased by the amount of the gain recognized by DC on the respective stocks.

(c) *Distribution by a foreign corporation*—(1) *Recognition of gain generally not required.* If a foreign corporation makes a distribution of property in complete liquidation under section 332 to another foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in the distributing foreign corporation, then, except as provided in paragraph (c)(2) of this section, section 337 (a) and (b)(1) shall apply and the distributing foreign corporation shall not recognize gain (or loss) on the distribution under section 367(e)(2). If a distributing foreign corporation distributes an interest as a partner in a partnership (whether foreign or domestic), then such corporation shall be treated as having distributed a proportionate share of the property of the partnership in accordance with the principles of paragraph (b)(1)(iii) of this section.

(2) *Recognition of gain required*—(i) *Property used in a United States trade or business*—(A) *In general.* A foreign corporation (including a corporation that has made an effective election under section 897(i)) that makes a distribution of property in complete liquidation under section 332 to another foreign corporation that meets the stock

ownership requirements of section 332(b) with respect to the stock in the distributing foreign corporation shall recognize gain on the distribution of any property (other than U.S. real property interests) used by the distributing foreign corporation at the time of the liquidation in the conduct of a trade or business within the United States unless the distributee foreign corporation for a ten-year period continues to use such property in the conduct of a trade or business within the United States, and the distributing and distributee foreign corporations attach the statement described in paragraph (c)(2)(i)(B) to their U.S. income tax returns for their taxable years that include the distribution. However, this paragraph (c)(2)(i)(A) shall not apply if all of the following conditions exist.

(*1*) At the time of the distribution, the distributing and the distributee foreign corporations are controlled foreign corporations as defined in section 957 (a) or (b) or section 953(c) (including a corporation that would be treated as a controlled foreign corporation under section 953(c) but for the provisions of section 953(c)(3));

(*2*) The distributee foreign corporation uses such property in the conduct of a trade or business within the United States immediately after the distribution;

(*3*) There was no prior liquidation subject to section 367(e)(2) of a corporation into the distributing corporation (or a predecessor corporation) under paragraph (b)(2)(i) or this paragraph (c)(2)(i) (other than a controlled foreign corporation into another controlled foreign corporation); and

(*4*) The distributee foreign corporation is not entitled to benefits under a comprehensive income tax treaty, but if the distributing foreign corporation (or predecessor corporation) was entitled to benefits under a comprehensive income tax treaty, then the distributee foreign corporation may (but need not) be entitled to benefits under a comprehensive income tax treaty.

(B) *Required statement.* The statement required by paragraph (c)(2)(i)(A) shall be prepared by or on behalf of the distributing foreign corporation and signed under penalties of perjury by an authorized officer of each of the distributing and distributee foreign corporations, and shall be identical to the statement described in paragraph (b)(2)(i)(B), except that ''§1.367(e)–2T(c)(2)(i)'' shall be substituted for references to ''§1.367(e)–2T(b)(2)(i)'' and the term *distributing foreign corporation* shall be substituted for either the term *domestic corporation* or the term *distributing domestic corporation* each time it appears. References in the rules of paragraph (b)(2)(i)(B) to various rules in paragraph (b) shall be applied as if such references were to this paragraph (c). However, the distributee foreign corporation shall not be required to waive its income tax treaty benefits as required by §1.367(e)–2T(b)(2)(i)(B)(*4*) unless the distributing foreign corporation was required to waive its treaty benefits under paragraph (b)(2)(i)(B)(*4*) of this section in connection with the distribution of such property in a prior liquidation distribution subject to the provisions of this section; the distributee foreign corporation is entitled to benefits under a treaty to which the distributing foreign corporation was not entitled; or the distributee foreign corporation is incorporated in a country different from the country in which the distributing foreign corporation is incorporated.

(C) *Effect of submitting or failing to submit a statement.* By the distributing foreign corporation's claiming nonrecognition under this paragraph (c)(2)(i), the distributing foreign corporation and the distributee foreign corporation agree to be subject to the rules of this paragraph (c)(2)(i) and the rules of paragraph (b)(2)(i)(C). In applying the rules of paragraph (b)(2)(i)(C), the term *distributing foreign corporation* shall be substituted for either the term *domestic corporation* or the term *distributing domestic corporation* each time it appears. References in the rules of paragraph (b)(2)(i)(C) to various rules in paragraph (b) shall be applied as if such references were to this paragraph (c). However, if a distributing foreign corporation that would otherwise qualify for nonrecognition on the distribution of such property under this paragraph (c)(2)(i) fails to file the statement properly or files a statement that does not comply with the requirements of this paragraph, the Commissioner may, nevertheless, in his discretion treat the distributing foreign corporation as if it had, in fact, met all the requirements of this paragraph if such treatment is necessary to prevent the taxpayer from otherwise deriving a tax benefit by such failure.

(ii) *Property formerly used in a United States trade or business.* A foreign corporation making a distribution of property in complete liquidation under section 332 to another foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in the distributing foreign corporation shall recognize gain (but not loss) on the distribution of any property (other than U.S. real property interests) that ceased, in a taxable year beginning after December 31, 1986, and within ten years prior to the date of liquidation, to be used in connection with the conduct of a trade or business within the United States. Section 864(c)(7) shall govern the treatment of any gain recognized on the distribution of assets described in this paragraph as income effectively connected with the conduct of a trade or business within the United States.

(3) *Other consequences*—(i) *Distributee basis in property.* The basis of distributed property in the hands of the distributee foreign corporation shall be the basis of the distributed property in the hands of the distributing foreign corporation, increased by the amount of gain (if any) recognized by the distributing foreign corporation on the distribution of the property. However, the basis of the distributed property in the hands of the distributee foreign corporation shall not exceed the fair market value of such property where the distributing foreign corporation recognizes gain on the distribution under this section and the distributee foreign corporation recognizes gain under section 897(e) or the regulations thereunder. See § 1.897–5T(b)(3)(iv)(B).

(ii) *Distribution under section 367(b).* With respect to the treatment of certain distributee foreign corporations under section 367(b), see § 7.367(b)–5(c).

(iii) *Distribution or exchange of U.S. real property interests.* With respect to the treatment under section 897(d) of a distributing foreign corporation on the distribution of a U.S. real property interest, see § 1.897–5T(c)(2)(i) and (ii). With respect to the treatment under section 897(e) of the distributee foreign corporation where the distributing foreign corporation has made an election under section 897(i) and the stock of such corporation is treated as a U.S. real property interest, see § 1.897–5T(b)(3)(iv)(B).

(iv) *Distribution of stock of a passive foreign investment company.* [Reserved]

(v) *Carryover of tax attributes.* In regard to the carryover of certain tax attributes from the distributing foreign corporation to the distributee foreign corporation, see section 381 and the regulations thereunder.

(4) *Examples.* The rules of this paragraph (c) may be illustrated by the following examples.

Example (1). (i) FX1, a Country Y corporation, owns all of the outstanding stock of FX2, a Country Y corporation that is not a passive foreign investment company. FX2 owns Parcel P (a U.S. real property interest), Asset #1 that formerly was used by FX2 in its U.S. trade or business, and Asset #2 currently used by FX2 in its U.S. trade or business. Asset #1 ceased to be used in a U.S. trade or business on September 30, 1987. All of the property has appreciated in value since acquired by FX2.

(ii) In a liquidation under section 332, FX2 distributes all of its property to FX1 on December 31, 1989. FX1 uses Asset #2 in the conduct of a trade or business in the United States immediately after the distribution.

(iii) Under paragraphs (c)(1) and (2) of this section, FX2 does not recognize gain under section 367(e)(2) on the distribution of Parcel P. Any gain realized on Parcel P may be subject to taxation under section 897 (d) if certain procedural requirements contained in § 1.897–5T(d)(1)(iii) are not followed. FX2 must recognize gain on the distribution of Asset #1 under paragraph (c)(2)(ii) of this section. Section 864 (c)(7) shall govern the treatment of the gain recognized by FX2 on Asset #1 as income effectively connected with a trade or business in the United States. Because FX2 used and FX1 uses Asset #2 in the conduct of a trade or business in the United States, FX2 will not recognize gain under paragraph (c)(2)(i) of this section on the distribution of Asset #2 if FX1 and FX2 comply with the requirements of that paragraph.

(iv) Under paragraph (c)(3)(i) of this section, FX1 takes FX2's basis in Parcel P and Asset #2 if there is compliance with the requirements. Under paragraph (c)(3)(i) of this section, FX1 takes FX2's basis in Asset #l increased by the gain recognized.

Example (2). (i) FY1, a Country F corporation, owns all of the outstanding stock of FY2, a Country F corporation that is not a passive foreign investment company. FY2 owns Parcel P (a U.S. real property interest held for investment) and machinery used in its U.S. trade or business. FY2 has made an effective election under section 897(i), and the FY2 stock is treated as a U.S. real property interest.

(ii) In a liquidation under section 332, FY2 distributes all of its property to FY1. FY1 will use the machinery in the conduct of a trade or business in the United States immediately after the distribution.

(iii) Under paragraphs (c)(1) and (2) of this section, FY2 does not recognize gain under section 367(e)(2) on the distribution of Parcel P. Any gain realized on Parcel P may be subject to taxation under section 897(d) if certain procedural requirements contained in §1.897–5T(d)(1)(iii) are not followed. Because FY2 used and FY1 continues to use the machinery in the conduct of a trade or business in the United States, FY2 does not recognize gain on the distribution of the machinery under paragraph (c)(2)(i) of this section if FY1 and FY2 comply with the requirements of that paragraph.

(iv) Under paragraph (c)(3)(i) of this section, FY1 takes FY2's basis in Parcel P. Under paragraph (c)(3)(i) of this section, FY1 takes FY2's basis in the machinery. See §1.897–5T(b)(3)(iv)(B) for the treatment of FY1 under section 897 (e).

(d) *Effective date.* This section shall be effective for distributions after July 31, 1986, pursuant to section 337(a) as in effect after the effective dates of the amendments of section 631 of the Tax Reform Act of 1986, except that it shall not apply in the case of any corporation completely liquidated before June 10, 1987, into a corporation organized in a country which then had an income tax treaty with the United States. See section 1006(e)(13) of the Technical and Miscellaneous Revenue Act of 1988 (102 Stat. 3342, Public Law 100–647).

[T.D. 8280, 55 FR 1412, Jan. 16, 1990]

SPECIAL RULE; DEFINITIONS

§1.368–1 Purpose and scope of exception of reorganization exchanges.

(a) *Reorganizations.* As used in the regulations under parts I, II, and III (section 301 and following), subchapter C, chapter 1 of the Code, the terms *reorganization* and *party to a reorganization* mean only a reorganization or a party to a reorganization as defined in subsections (a) and (b) of section 368. In determining whether a transaction qualifies as a reorganization under section 368(a), the transaction must be evaluated under relevant provisions of law, including the step transaction doctrine. But see §§1.368–2 (f) and (k) and 1.338–2(c)(3). The preceding two sentences apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter. With respect to insolvency reorganizations, see part IV, subchapter C, chapter 1 of the Code.

(b) *Purpose.* Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms. Requisite to a reorganization under the Internal Revenue Code are a continuity of the business enterprise through the issuing corporation under the modified corporate form as described in paragraph (d) of this section, and (except as provided in section 368(a)(1)(D)) a continuity of interest as described in paragraph (e) of this section. (For rules regarding the continuity of interest requirement under section 355, see §1.355–2(c).) For purposes of this section, the term *issuing corporation* means the acquiring corporation (as that term is used in section 368(a)), except that, in determining whether a reorganization qualifies as a triangular reorganization (as defined in §1.358–6(b)(2)), the issuing corporation means the corporation in control of the acquiring corporation. The preceding three sentences apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter. The continuity of business enterprise requirement is described in paragraph (d) of this section. The Code recognizes as a reorganization the amalgamation (occurring in a specified way) of two corporate enterprises under a single corporate structure if there exists among the holders of the stock and securities of either of the old corporations the requisite continuity of interest in the new corporation, but there is not a reorganization if the holders of the stock and securities of the old corporation are merely the holders of short-term notes in the new corporation. In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule. Accordingly, under the Code, a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale even though the mechanics of a reorganization have been set up.

(c) *Scope.* The nonrecognition of gain or loss is prescribed for two specifically described types of exchanges, viz: The exchange that is provided for in section 354(a)(1) in which stock or securities in a corporation, a party to a reorganization, are, in pursuance of a plan of reorganization, exchanged for the stock or securities in a corporation, a party to the same reorganization; and the exchange that is provided for in section 361(a) in which a corporation, a party to a reorganization, exchanges property, in pursuance of a plan of reorganization, for stock or securities in another corporation, a party to the same reorganization. Section 368(a)(1) limits the definition of the term *reorganization* to six kinds of transactions and excludes all others. From its context, the term *a party to a reorganization* can only mean a party to a transaction specifically defined as a reorganization by section 368(a). Certain rules respecting boot received in either of the two types of exchanges provided for in section 354(a)(1) and section 361(a) are prescribed in sections 356, 357, and 361(b). A special rule respecting a transfer of property with a liability in excess of its basis is prescribed in section 357(c). Under section 367 a limitation is placed on all these provisions by providing that except under specified conditions foreign corporations shall not be deemed within their scope. The provisions of the Code referred to in this paragraph are inapplicable unless there is a plan of reorganization. A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 368(a) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme, which involves an abrupt departure from normal reorganization procedure in connection with a transaction on which the imposition of tax is imminent, such as a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization.

(d) *Continuity of business enterprise*—(1) *General rule.* Continuity of business enterprise (COBE) requires that the issuing corporation (P), as defined in paragraph (b) of this section, either continue the target corporation's (T's) historic business or use a significant portion of T's historic business assets in a business. The preceding sentence applies to transactions occurring after January 28, 1998, except that it does not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter. The application of this general rule to certain transactions, such as mergers of holding companies, will depend on all facts and circumstances. The policy underlying this general rule, which is to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form, provides the guidance necessary to make these facts and circumstances determinations.

(2) *Business continuity.* (i) The continuity of business enterprise requirement is satisfied if *P* continues *T'* s historic business. The fact *P* is in the same line of business as *T* tends to establish the requisite continuity, but is not alone sufficient.

(ii) If *T* has more than one line of business, continuity of business enterprise requires only that *P* continue a significant line of business.

(iii) In general, a corporation's historic business is the business it has conducted most recently. However, a corporation's historic business is not one the corporation enters into as part of a plan of reorganization.

(iv) All facts and circumstances are considered in determining the time when the plan comes into existence and in determining whether a line of business is ''significant''.

(3) *Asset continuity.* (i) The continuity of business enterprise requirement is satisfied if *P* uses a significant portion of *T'* s historic business assets in a business.

(ii) A corporation's historic business assets are the assets used in its historic business. Business assets may include stock and securities and intangible operating assets such as good will, patents, and trademarks, whether or not they have a tax basis.

(iii) In general, the determination of the portion of a corporation's assets considered ''significant'' is based on the relative importance of the assets to operation of the business. However, all other facts and circumstances, such as the net fair market value of those assets, will be considered.

(4) *Acquired assets or stock held by members of the qualified group or partnerships.* The following rules apply in determining whether the COBE requirement of paragraph (d)(1) of this section is satisfied:

(i) *Businesses and assets of members of a qualified group.* The issuing corporation is treated as holding all of the businesses and assets of all of the members of the qualified group, as defined in paragraph (d)(4)(ii) of this section.

(ii) *Qualified group.* A qualified group is one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of section 368(c) in at least one other corporation, and stock meeting the requirements of section 368(c) in each of the corporations (except the issuing corporation) is owned directly by one of the other corporations.

(iii) *Partnerships*—(A) *Partnership assets.* Each partner of a partnership will be treated as owning the T business assets used in a business of the partnership in accordance with that partner's interest in the partnership.

(B) *Partnership businesses.* The issuing corporation will be treated as conducting a business of a partnership if —

(*1*) Members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that partnership business; or

(*2*) One or more members of the qualified group have active and substantial management functions as a partner with respect to that partnership business.

(C) *Conduct of the historic T business in a partnership.* If a significant historic T business is conducted in a partnership, the fact that P is treated as conducting such T business under paragraph (d)(4)(iii)(B) of this section tends to establish the requisite continuity, but is not alone sufficient.

(iv) *Effective date.* This paragraph (d)(4) applies to transactions occurring after January 28, 1998, except that it does not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter.

(5) *Examples.* The following examples illustrate this paragraph (d). All corporations have only one class of stock outstanding. The preceding sentence and paragraph (d)(5) *Example 6* through *Example 12* apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter.

Example 1. T conducts three lines of business: manufacture of synthetic resins, manufacture of chemicals for the textile industry, and distribution of chemicals. The three lines of business are approximately equal in value. On July 1, 1981, *T* sells the synthetic resin and chemicals distribution businesses to a third party for cash and marketable securities. On December 31, 1981, *T* transfers all of its assets to *P* solely for *P* voting stock. *P* continues the chemical manufacturing business without interruption. The continuity of business enterprise requirement is met. Continuity of business enterprise requires only that *P* continue one of *T'* s three significant lines of business.

Example 2. P manufactures computers and *T* manufactures components for computers. *T* sells all of its output to *P*. On January 1, 1981, *P* decides to buy imported components only. On March 1, 1981, *T* merges into *P*. *P* continues buying imported components but retains *T'* s equipment as a backup source of supply. The use of the equipment as a backup source of supply constitutes use of a significant portion of *T'* s historic business assets, thus establishing continuity of business enterprise. *P* is not required to continue *T'* s business.

Example 3. T is a manufacturer of boys' and men's trousers. On January 1, 1978, as part of a plan of reorganization, *T* sold all of its assets to a third party for cash and purchased a highly diversified portfolio of stocks and bonds. As part of the plan *T* operates an investment business until July 1, 1981. On that date, the plan of reorganization culminates in a transfer by *T* of all its assets to *P,* a regulated investment company, solely in exchange for *P* voting stock. The continuity of business enterprise requirement is not met. *T'* s investment activity is not its historic business, and the stocks and bonds are not *T'* s historic business assets.

Example 4. T manufactures children's toys and *P* distributes steel and allied products. On January 1, 1981, *T* sells all of its assets to a third party for $100,000 cash and $900,000 in notes. On March 1, 1981, *T* merges into *P*. Continuity of business enterprise is lacking. The use of the sales proceeds in *P'* s business is not sufficient.

Example 5. T manufactures farm machinery and *P* operates a lumber mill. *T* merges into *P*. *P* disposes of *T'* s assets immediately after the merger as part of the plan of reorganization. *P* does not continue *T'* s farm machinery manufacturing business. Continuity of business enterprise is lacking.

Example 6. Use of a significant portion of T's historic business assets by the qualified group. (i) *Facts.* T operates an auto parts distributorship. P owns 80 percent of the stock of a holding company (HC). HC owns 80 percent of the stock of ten subsidiaries, S–1 through S–10. S–1 through S–10 each separately operate a full service gas station. Pursuant to a plan of reorganization, T merges into P and the T shareholders receive solely P stock. As part of the plan of reorganization, P transfers T's assets to HC, which in turn transfers some of the T assets to each of the ten subsidiaries. No one subsidiary receives a significant portion of T's historic business assets. Each of the subsidiaries will use the T assets in the operation of its full service gas station. No P subsidiary will be an auto parts distributor.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(i) of this section, P is treated as conducting the ten gas station businesses of S–1 through S–10 and as holding the historic T assets used in those businesses. P is treated as holding all the assets and conducting the businesses of all of the members of the qualified group, which includes S–1 through S–10 (paragraphs (d)(4)(i) and (ii) of this section). No member of the qualified group continues T's historic distributorship business. However, subsidiaries S–1 through S–10 continue to use the historic T assets in a business. Even though no one corporation of the qualified group is using a significant portion of T's historic business assets in a business, the COBE requirement of paragraph (d)(1) of this section is satisfied because, in the aggregate, the qualified group is using a significant portion of T's historic business assets in a business.

Example 7. Continuation of the historic T business in a partnership satisfies continuity of business enterprise. (i) *Facts.* T manufactures ski boots. P owns all of the stock of S–1. S–1 owns all of the stock of S–2, and S–2 owns all of the stock of S–3. T merges into P and the T shareholders receive consideration consisting of P stock and cash. The T ski boot business is to be continued and expanded. In anticipation of this expansion, P transfers all of the T assets to S–1, S–1 transfers all of the T assets to S–2, and S–2 transfers all of the T assets to S–3. S–3 and X (an unrelated party) form a new partnership (PRS). As part of the plan of reorganization, S–3 transfers all the T assets to PRS, and S–3, in its capacity as a partner, performs active and substantial management functions for the PRS ski boot business, including making significant business decisions and regularly participating in the overall supervision, direction, and control of the employees of the ski boot business. S–3 receives a 20 percent interest in PRS. X transfers cash in exchange for an 80 percent interest in PRS.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(B)(*2*) of this section, P is treated as conducting T's historic business because S–3 performs active and substantial management functions for the ski boot business in S–3's capacity as a partner. P is treated as holding all the assets and conducting the businesses of all of the members of the qualified group, which includes S–3 (paragraphs (d)(4)(i) and (ii) of this section).

The COBE requirement of paragraph (d)(1) of this section is satisfied.

Example 8. Continuation of the historic T business in a partnership does not satisfy continuity of business enterprise. (i) *Facts.* The facts are the same as *Example 7* except that S–3 transfers the historic T business to PRS in exchange for a 1 percent interest in PRS.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(B)(*2*) of this section, P is treated as conducting T's historic business because S–3 performs active and substantial management functions for the ski boot business in S–3's capacity as a partner. The fact that a significant historic T business is conducted in PRS, and P is treated as conducting such T business under (d)(4)(iii)(B) tends to establish the requisite continuity, but is not alone sufficient (paragraph (d)(4)(iii)(C) of this section). The COBE requirement of paragraph (d)(1) of this section is not satisfied.

Example 9. Continuation of the T historic business in a partnership satisfies continuity of business enterprise. (i) *Facts.* The facts are the same as *Example 7* except that S–3 transfers the historic T business to PRS in exchange for a 33⅓ percent interest in PRS, and no member of P's qualified group performs active and substantial management functions for the ski boot business operated in PRS.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(B)(*1*) of this section, P is treated as conducting T's historic business because S–3 owns an interest in the partnership representing a significant interest in that partnership business. P is treated as holding all the assets and conducting the businesses of all of the members of the qualified group, which includes S–3 (paragraphs (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied.

Example 10. Use of T's historic business assets in a partnership business. (i) *Facts.* T is a fabric distributor. P owns all of the stock of S–1. T merges into P and the T shareholders receive solely P stock. S–1 and X (an unrelated party) own interests in a partnership (PRS). As part of the plan of reorganization, P transfers all of the T assets to S–1, and S–1 transfers all the T assets to PRS, increasing S–1's percentage interest in PRS from 5 to 33⅓ percent. After the transfer, X owns the remaining 66⅔ percent interest in PRS. Almost all of the T assets consist of T's large inventory of fabric, which PRS uses to manufacture sportswear. All of the T assets are used in the sportswear business. No member of P's qualified group performs active and substantial management functions for the sportswear business operated in PRS.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(A) of this section, S–1 is treated as owning 33⅓ percent of the T assets used in the PRS sportswear manufacturing business. Under paragraph (d)(4)(iii)(B)(*1*) of this section, P is treated as conducting the sportswear manufacturing business because S–1 owns an interest in the partnership representing a significant interest in that partnership business. P is treated as holding all the assets and conducting the businesses of all of the members of the qualified group, which includes S–1 (paragraphs (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied.

Example 11. Aggregation of partnership interests among members of the qualified group: use of T's historic business assets in a partnership business. (i) *Facts.* The facts are the same as *Example 10,* except that S–1 transfers all the T assets to PRS, and P and X each transfer cash to PRS in exchange for partnership interests. After the transfers, P owns 11 percent, S–1 owns 22⅓ percent, and X owns 66⅔ percent of PRS.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(B)(*1*) of this section, P is treated as conducting the sportswear manufacturing business because members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that business. P is treated as owning 11 percent of the assets directly, and S–1 is treated as owning 22⅓ percent of the assets, used in the PRS sportswear business (paragraph (d)(4)(iii)(A) of this section). P is treated as holding all the assets of all of the members of the qualified group, which includes S–1, and thus in the aggregate, P is treated as owning 33⅓ of the T assets (paragraphs (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied because P is treated as using a significant portion of T's historic business assets in its sportswear manufacturing business.

Example 12. Tiered partnerships: use of T's historic business assets in a partnership business. (i) *Facts.* T owns and manages a commercial office building in state Z. Pursuant to a plan of reorganization, T merges into P, solely in exchange for P stock, which is distributed to the T shareholders. P transfers all of the T assets to a partnership, PRS–1, which owns and operates television stations nationwide. After the transfer, P owns a 50 percent interest in PRS–1. P does not have active and substantial management functions as a partner with respect to the PRS–1 business. X, not a member of P's qualified group, owns the remaining 50 percent interest in PRS–1. PRS–1, in an effort to expand its state Z television operation, enters into a joint venture with U, an unrelated party. As part of the plan of reorganization, PRS–1 transfers all the T assets and its state Z television station to PRS–2, in exchange for a 75 percent partnership interest. U contributes cash to PRS–2 in exchange for a 25 percent partnership interest and oversees the management of the state Z television operation. PRS–1 does not actively and substantially manage PRS–2's business. PRS–2's state Z operations are moved into the acquired T office building. All of the assets that P acquired from T are used in PRS–2's business.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(A) of this section, PRS–1 is treated as owning 75 percent of the T assets used in PRS–2's business. P, in turn, is treated as owning 50 percent of PRS–1's interest the T assets. Thus, P is treated as owning 37½ percent (50 percent x 75 percent) of the T assets used in the PRS–2 business. Under paragraph (d)(4)(iii)(B)(*1*) of this section, P is treated as conducting PRS–2's business, the operation of the state Z television station, and under paragraph (d)(4)(iii)(A) of this section, P is treated as using 37½ percent of the historic T business assets in that business. The COBE requirement of paragraph (d)(1) of this section is satisfied because P is treated as using a significant portion of T's historic business assets in its television business.

(e) *Continuity of interest*—(1) *General rule.* (i) The purpose of the continuity of interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. Continuity of interest requires that in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. A proprietary interest in the target corporation is preserved if, in a potential reorganization, it is exchanged for a proprietary interest in the issuing corporation (as defined in paragraph (b) of this section), it is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or it otherwise continues as a proprietary interest in the target corporation. However, a proprietary interest in the target corporation is not preserved if, in connection with the potential reorganization, it is acquired by the issuing corporation for consideration other than stock of the issuing corporation, or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed. All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved. For purposes of the continuity of interest requirement, a mere disposition of stock of the target corporation prior to a potential reorganization to persons not related (as defined in paragraph (e)(3) of this section determined without regard to paragraph (e)(3)(i)(A) of this section) to the target corporation or to persons not related (as defined in paragraph (e)(3) of this section) to the issuing corporation is disregarded and a mere disposition of stock of the issuing corporation received in a potential reorganization to persons not related (as defined in paragraph (e)(3) of this section) to the issuing corporation is disregarded.

(ii) [Reserved] For further guidance see § 1.368–1T(e)(1)(ii)(A) and (B).

(2) *Related person acquisitions.* (i) A proprietary interest in the target corporation is not preserved if, in connection with a potential reorganization, a person related (as defined in paragraph (e)(3) of this section) to the issuing corporation acquires, with consideration other than a proprietary interest in the issuing corporation, stock of the target corporation or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization, except to the extent those persons who were the direct or indirect owners of the target corporation prior to the potential reorganization maintain a direct or indirect proprietary interest in the issuing corporation.

(ii) [Reserved] For further guidance see § 1.368–1T(e)(2)(ii).

(3) *Definition of related person*—(i) *In general.* For purposes of this paragraph (e), two corporations are related persons if either—

(A) The corporations are members of the same affiliated group as defined in section 1504 (determined without regard to section 1504(b)); or

(B) A purchase of the stock of one corporation by another corporation would be treated as a distribution in redemption of the stock of the first corporation under section 304(a)(2) (determined without regard to § 1.1502–80(b)).

(ii) *Special rules.* The following rules apply solely for purposes of this paragraph (e)(3):

(A) A corporation will be treated as related to another corporation if such relationship exists immediately before or immediately after the acquisition of the stock involved.

(B) A corporation, other than the target corporation or a person related (as defined in paragraph (e)(3) of this section determined without regard to paragraph (e)(3)(i)(A) of this section) to the target corporation, will be treated as related to the issuing corporation if the relationship is created in connection with the potential reorganization.

(4) *Acquisitions by partnerships.* For purposes of this paragraph (e), each partner of a partnership will be treated as owning or acquiring any stock owned or acquired, as the case may be, by the partnership in accordance with that partner's interest in the partnership. If a partner is treated as acquiring any stock by reason of the application of this paragraph (e)(4), the partner is also treated as having furnished its share of any consideration furnished by the partnership to acquire the stock in accordance with that partner's interest in the partnership.

(5) *Successors and predecessors.* For purposes of this paragraph (e), any reference to the issuing corporation or the target corporation includes a reference to any successor or predecessor of such corporation, except that the target corporation is not treated as a predecessor of the issuing corporation and the issuing corporation is not treated as a successor of the target corporation.

(6) *Examples.* For purposes of the examples in this paragraph (e)(6), P is the issuing corporation, T is the target corporation, S is a wholly owned subsidiary of P, all corporations have only one class of stock outstanding, A and B are individuals, PRS is a partnership, all reorganization requirements other than the continuity of interest requirement are satisfied, and the transaction is not otherwise subject to recharacterization. The following examples illustrate the application of this paragraph (e):

Example 1. Sale of stock to third party. (i) *Sale of issuing corporation stock after merger.* A owns all of the stock of T. T merges into P. In the merger, A receives P stock having a fair market value of $50x and cash of $50x. Immediately after the merger, and pursuant to a preexisting binding contract, A sells all of the P stock received by A in the merger to B. Assume that there are no facts and circumstances indicating that the cash used by B to purchase A's P stock was in substance exchanged by P for T stock. Under paragraphs (e)(1) and (2) of this section, the sale to B is disregarded because B is not a person related to P within the meaning of paragraph (e)(3) of this section. Thus, the transaction satisfies the continuity of interest requirement because 50 percent of A's T stock was exchanged for P stock, preserving a substantial part of the value of the proprietary interest in T.

(ii) *Sale of target corporation stock before merger.* The facts are the same as paragraph (i) of this *Example 1,* except that B buys A's T stock prior to the merger of T into P and then exchanges the T stock for P stock having a fair market value of $50x and cash of $50x. The sale by A is disregarded. The continuity of interest requirement is satisfied because B's T stock was exchanged for P stock, preserving a substantial part of the value of the proprietary interest in T.

Example 2. Relationship created in connection with potential reorganization. Corporation X owns 60 percent of the stock of P and 30 percent of the stock of T. A owns the remaining 70 percent of the stock of T. X buys A's T stock for cash in a transaction which is not a qualified stock purchase within the meaning of section 338. T then merges into P. In the merger, X exchanges all of its T stock for additional stock of P. As a result of the issuance of the additional stock to X in the merger, X's ownership interest in P increases from 60 to 80 percent of the stock of P. X is not a person related to P under paragraph (e)(3)(i)(B) of this section, because a purchase of stock of P by X would not be treated as a distribution in redemption of the stock of P under section 304(a)(2). However, X is a person related to P under paragraphs (e)(3)(i)(A) and (ii)(B) of this section, because X becomes affiliated with P in the merger. The continuity of interest requirement is not satisfied, because X acquired a proprietary interest in T for consideration other than P stock, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(2) of this section.

Example 3. Participation by issuing corporation in post-merger sale. A owns 80 percent of the T stock and none of the P stock, which is widely held. T merges into P. In the merger, A receives P stock. In addition, A obtains rights pursuant to an arrangement with P to have P register the P stock under the Securities Act of 1933, as amended. P registers A's stock, and A sells the stock shortly after the merger. No person who purchased the P stock from A is a person related to P within the meaning of paragraph (e)(3) of this section. Under paragraphs (e)(1) and (2) of this section, the sale of the P stock by A is disregarded because no person who purchased the P stock from A is a person related to P within the meaning of paragraph (e)(3) of this section. The transaction satisfies the continuity of interest requirement because A's T stock was exchanged for P stock, preserving a substantial part of the value of the proprietary interest in T.

Example 4. Redemptions and purchases by issuing corporation or related persons. (i) *Redemption by issuing corporation.* A owns 100 percent of the stock of T and none of the stock of P. T merges into S. In the merger, A receives P stock. In connection with the merger, P redeems all of the P stock received by A in the merger for cash. The continuity of interest requirement is not satisfied, because, in connection with the merger, P redeemed the stock exchanged for a proprietary interest in T, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section.

(ii) *Purchase of target corporation stock by issuing corporation.* The facts are the same as paragraph (i) of this *Example 4,* except that, instead of P redeeming its stock, prior to and in connection with the merger of T into S, P purchases 90 percent of the T stock from A for cash. The continuity of interest requirement is not satisfied, because in connection with the merger, P acquired a proprietary interest in T for consideration other than P stock, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section. However, see §1.338–2(c)(3) (which may change the result in this case by providing that, by virtue of section 338, continuity of interest is satisfied for certain parties after a qualified stock purchase).

(iii) *Purchase of issuing corporation stock by person related to issuing corporation.* The facts are the same as paragraph (i) of this *Example 4,* except that, instead of P redeeming its stock, S buys all of the P stock received by A in the merger for cash. S is a person related to P under paragraphs (e)(3)(i)(A) and (B) of this section. The continuity of interest requirement is not satisfied, because S acquired P stock issued in the merger, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(2) of this section.

Example 5. Redemption in substance by issuing corporation. A owns 100 percent of the stock of T and none of the stock of P. T merges into P. In the merger, A receives P stock. In connection with the merger, B buys all of the P stock received by A in the merger for cash. Shortly thereafter, in connection with the merger, P redeems the stock held by B for cash. Based on all the facts and circumstances, P in substance has exchanged solely cash for T stock in the merger. The continuity of interest requirement is not satisfied, because in substance P redeemed the stock exchanged for a proprietary interest in T, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section.

Example 6. Purchase of issuing corporation stock through partnership. A owns 100 percent of the stock of T and none of the stock of P. S is an 85 percent partner in PRS. The other 15 percent of PRS is owned by unrelated persons. T merges into P. In the merger, A receives P stock. In connection with the merger, PRS purchases all of the P stock received by A in the merger for cash. Under paragraph (e)(4) of this section, S, as an 85 percent partner of PRS, is treated as having acquired 85 percent of the P stock exchanged for A's T stock in the merger, and as having furnished 85 percent of the cash paid by PRS to acquire the P stock. S is a person related to P under paragraphs (e)(3)(i)(A) and (B) of this section. The continuity of interest requirement is not satisfied, because S is treated as acquiring 85 percent of the P stock issued in the merger, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(2) of this section.

Example 7. Exchange by acquiring corporation for direct interest. A owns 30 percent of the stock of T. P owns 70 percent of the stock of T, which was not acquired by P in connection with the acquisition of T's assets. T merges into P. A receives cash in the merger. The continuity of interest requirement is satisfied, because P's 70 percent proprietary interest in T is exchanged by P for a direct interest in the assets of the target corporation enterprise.

Example 8. Effect of general stock repurchase program. T merges into P, a corporation whose stock is widely held and publicly traded and that has one class of common stock outstanding. In the merger, T shareholders receive common stock of P. Immediately after the merger, P repurchases a small percentage of its common stock in the open market as part of its ongoing stock repurchase program. The repurchase program was not created or modified in connection with the acquisition of T. Continuity of interest is satisfied, because based on all of the facts and circumstances, the redemption of a small percentage of the P stock does not affect the T shareholders' proprietary interest in T, because it was not in connection with the merger, and the value of the proprietary interest in T is preserved. See paragraph (e)(1) of this section.

Example 9. Maintenance of direct or indirect interest in issuing corporation. X, a corporation, owns all of the stock of each of corporations P and Z. Z owns all of the stock of T. T merges into P. Z receives P stock in the merger. Immediately thereafter and in connection with the merger, Z distributes the P stock received in the merger to X. X is a person related to P under paragraph (e)(3)(i)(A) of this section. The continuity of interest requirement is satisfied, because X was an indirect owner of T prior to the merger who maintains a direct or indirect proprietary interest in P, preserving a substantial part of the value of the proprietary interest in T. See paragraph (e)(2) of this section.

(7) *Effective date.* This paragraph (e) applies to transactions occurring after January 28, 1998, except that it does not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7745, 45 FR 86437, Dec. 31, 1980; T.D. 8760, 63 FR 4178, Jan. 28, 1998; T.D. 8783, 63 FR 50758, Sept. 23, 1998]

§1.368–1T Purpose and scope of exception of reorganization exchanges (temporary).

(a) through (e)(1)(i) [Reserved] For further guidance see §1.368–1(a) through (e)(1)(i).

(e)(1)(ii)(A) *General rule.* A proprietary interest in the target corporation (other than one held by the acquiring corporation) is not preserved if, prior to and in connection with a potential reorganization, it is redeemed or to the extent that, prior to and in connection with a potential reorganization, an extraordinary distribution is made with respect to it. The determination of whether a distribution with respect to stock of the target corporation is an extraordinary distribution for purposes of this paragraph (e)(1)(ii) will be made on the basis of all of the facts and circumstances, but the treatment of the distribution under section 1059 (relating to extraordinary dividends) will not be taken into account.

(B) *Exception.* Paragraph (e)(1)(ii)(A) of this section does not apply to a distribution of stock by the target corporation to which section 355(a) (or so much of section 356 as relates to section 355) applies, except to the extent that—

(*1*) The target corporation shareholders receive other property or money to which section 356(a) applies; or

(*2*) The distribution is extraordinary in amount and is a distribution of property or money to which section 356(b) applies.

(2)(i) [Reserved] For further guidance, see §1.368–1(e)(2)(i).

(ii) A proprietary interest in the target corporation is not preserved if, prior to and in connection with a potential reorganization, a person related (as defined in §1.368–1(e)(3) determined without regard to §1.368–1(e)(3)(i)(A)) to the target corporation acquires stock of the target corporation, with consideration other than stock of either the target corporation or the issuing corporation.

(e)(3) through (e)(6) *Example 9.* [Reserved] For further guidance, see §1.368–1(e)(3) through (e)(6) *Example 9.*

Example 10. (e)(6) *Acquisition of target corporation stock before merger.* (i) *Redemption by target corporation.* A owns 85 percent and B owns 15 percent of the stock of T. The fair market value of T is $100x. Neither A nor B own stock of P. Prior to and in connection with the merger of T into P, T redeems A's T stock for $85x and issues to A its promissory note in exchange for the stock. At the time of the merger T has a value of $15x, after giving effect to the redemption of its stock. In the merger, B receives solely P stock. The continuity of interest requirement is not satisfied because T redeemed A's stock, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1)(ii)(A) of this section.

(ii) *Purchase by person related to target corporation.* The facts are the same as paragraph (i) of this *Example 10,* except that X, T's wholly owned subsidiary, acquires A's T stock prior to and in connection with the merger for cash of $85x. Under paragraph (e)(2)(ii) of this section and §1.368–1(e)(3)(i)(B), X's acquisition of A's T stock is an acquisition by a related person. The continuity of interest requirement is not satisfied, because X acquired T stock, for consideration other than P stock, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(2)(ii) of this section.

Example 11. Extraordinary distribution before merger. A owns all of the stock of T. The fair market value of T is $100x. Prior to and in connection with the merger of T into P, T pays A an extraordinary distribution of an $85x note. T merges into P, and A receives solely P stock. P assumes T's obligation on the note. The continuity of interest requirement is not satisfied, because T paid A an extraordinary distribution, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1)(ii)(A) of this section.

(f) *Effective date.* This section applies to transactions occurring after January 28, 1998, except that it does not apply to any transaction occurring pursuant to a written agreement which is (subject to customary conditions) binding on January 28, 1998, and at all times thereafter.

[T.D. 8761, 63 FR 4185, Jan. 28, 1998]

§ 1.368–2 Definition of terms.

(a) The application of the term *reorganization* is to be strictly limited to the specific transactions set forth in section 368(a). The term does not embrace the mere purchase by one corporation of the properties of another corporation. The preceding sentence applies to transactions occurring after January 28, 1998, except that it does not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter. If the properties are transferred for cash and deferred payment obligations of the transferee evidenced by short-term notes, the transaction is a sale and not an exchange in which gain or loss is not recognized.

(b)(1) In order to qualify as a reorganization under section 368(a)(1)(A) the transaction must be a merger or consolidation effected pursuant to the corporation laws of the United States or a State or territory, or the District of Columbia.

(2) In order for the transaction to qualify under section 368(a)(1)(A) by reason of the application of section 368(a)(2)(D), one corporation (the acquiring corporation) must acquire substantially all of the properties of another corporation (the acquired corporation) partly or entirely in exchange for stock of a corporation which is in control of the acquiring corporation (the controlling corporation), provided that (i) the transaction would have qualified under section 368(a)(1)(A) if the merger had been into the controlling corporation, and (ii) no stock of the acquiring corporation is used in the transaction. The foregoing test of whether the transaction would have qualified under section 368(a)(1)(A) if the merger had been into the controlling corporation means that the general requirements of a reorganization under section 368(a)(1)(A) (such as a business purpose, continuity of business enterprise, and continuity of interest) must be met in addition to the special requirements of section 368(a)(2)(D). Under this test, it is not relevant whether the merger into the controlling corporation could have been effected pursuant to State or Federal corporation law. The term *substantially all* has the same meaning as it has in section 368(a)(1)(C). Although no stock of the acquiring corporation can be used in the transaction, there is no prohibition (other than the continuity of interest requirement) against using other property, such as cash or securities, of either the acquiring corporation or the parent or both. In addition, the controlling corporation may assume liabilities of the acquired corporation without disqualifying the transaction under section 368(a)(2(D), and for purposes of section 357(a) the controlling corporation is considered a party to the exchange. For example, if the controlling corporation agrees to substitute its stock for stock of the acquired corporation under an outstanding employee stock option agreement, this assumption of liability will not prevent the transaction from qualifying as a reorganization under section 368(a)(2)(D) and the assumption of liability is not treated as money or other property for purposes of section 361(b). Section 368(a)(2)(D) applies whether or not the controlling corporation (or the acquiring corporation) is formed immediately before the merger, in anticipation of the merger, or after preliminary steps have been taken to merge directly into the controlling

corporation. Section 368(a)(2)(D) applies only to statutory mergers occurring after October 22, 1968.

(3) For regulations under section 368(a)(2)(E), see paragraph (j) of this section.

(c) In order to qualify as a ‘‘reorganization’’ under section 368(a)(1)(B), the acquisition by the acquiring corporation of stock of another corporation must be in exchange solely for all or a part of the voting stock of the acquiring corporation (or, in the case of transactions occurring after December 31, 1963, solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), and the acquiring corporation must be in control of the other corporation immediately after the transaction. If, for example, Corporation X in one transaction exchanges nonvoting preferred stock or bonds in addition to all or a part of its voting stock in the acquisition of stock of Corporation Y, the transaction is not a reorganization under section 368(a)(1)(B). Nor is a transaction a reorganization described in section 368(a)(1)(B) if stock is acquired in exchange for voting stock both of the acquiring corporation and of a corporation which is in control of the acquiring corporation. The acquisition of stock of another corporation by the acquiring corporation solely for its voting stock (or solely for voting stock of a corporation which is in control of the acquiring corporation) is permitted tax-free even though the acquiring corporation already owns some of the stock of the other corporation. Such an acquisition is permitted tax-free in a single transaction or in a series of transactions taking place over a relatively short period of time such as 12 months. For example, Corporation A purchased 30 percent of the common stock of Corporation W (the only class of stock outstanding) for cash in 1939. On March 1, 1955, Corporation A offers to exchange its own voting stock for all the stock of Corporation W tendered within 6 months from the date of the offer. Within the 6-months’ period Corporation A acquires an additional 60 percent of stock of Corporation W solely for its own voting stock, so that it owns 90 percent of the stock of Corporation W. No gain or loss is recognized with respect to the exchanges of stock of Corporation A for stock of Corporation W. For this purpose, it is immaterial whether such exchanges occurred before Corporation A acquired control (80 percent) of Corporation W or after such control was acquired. If Corporation A had acquired 80 percent of the stock of Corporation W for cash in 1939, it could likewise acquire some or all of the remainder of such stock solely in exchange for its own voting stock without recognition of gain or loss.

(d) In order to qualify as a reorganization under section 368(a)(1)(C), the transaction must be one described in subparagraph (1) or (2) of this paragraph:

(1) One corporation must acquire substantially all the properties of another corporation solely in exchange for all or a part of its own voting stock, or solely in exchange for all or a part of the voting stock of a corporation which is in control of the acquiring corporation. For example, Corporation P owns all the stock of Corporation A. All the properties of Corporation W are transferred to Corporation A either solely in exchange for voting stock of Corporation P or solely in exchange for less than 80 percent of the voting stock of Corporation A. Either of such transactions constitutes a reorganization under section 368(a)(1)(C). However, if the properties of Corporation W are acquired in exchange for voting stock of both Corporation P and Corporation A, the transaction will not constitute a reorganization under section 368(a)(1)(C). In determining whether the exchange meets the requirement of ‘‘solely for voting stock’’, the assumption by the acquiring corporation of liabilities of the transferor corporation, or the fact that property acquired from the transferor corporation is subject to a liability, shall be disregarded. Though such an assumption does not prevent an exchange from being solely for voting stock for the purposes of the definition of a reorganization contained in section 368(a)(1)(C), it may in some cases, however, so alter the character of the transaction as to place the transaction outside the purposes and assumptions of the reorganization provisions. Section 368(a)(1)(C) does not

prevent consideration of the effect of an assumption of liabilities on the general character of the transaction but merely provides that the requirement that the exchange be solely for voting stock is satisfied if the only additional consideration is an assumption of liabilities.

(2) One corporation:

(i) Must acquire substantially all of the properties of another corporation in such manner that the acquisition would qualify under (1) above, but for the fact that the acquiring corporation exchanges money, or other property in addition to such voting stock, and

(ii) Must acquire solely for voting stock (either of the acquiring corporation or of a corporation which is in control of the acquiring corporation) properties of the other corporation having a fair market value which is at least 80 percent of the fair market value of all the properties of the other corporation.

(3) For the purposes of subparagraph (2)(ii) only, a liability assumed or to which the properties are subject is considered money paid for the properties. For example, Corporation A has properties with a fair market value of $100,000 and liabilities of $10,000. In exchange for these properties, Corporation Y transfers its own voting stock, assumes the $10,000 liabilities, and pays $8,000 in cash. The transaction is a reorganization even though a part of the properties of Corporation A is acquired for cash. On the other hand, if the properties of Corporation A worth $100,000, were subject to $50,000 in liabilities, an acquisition of all the properties, subject to the liabilities, for any consideration other than solely voting stock would not qualify as a reorganization under this section since the liabilities alone are in excess of 20 percent of the fair market value of the properties. If the transaction would qualify under either subparagraph (1) or (2) of this paragraph and also under section 368(a)(1)(D), such transaction shall not be treated as a reorganization under section 368 (a)(1)(C).

(e) A ‘‘recapitalization’’, and therefore a reorganization, takes place if, for example:

(1) A corporation with $200,000 par value of bonds outstanding, instead of paying them off in cash, discharges them by issuing preferred shares to the bondholders;

(2) There is surrendered to a corporation for cancellation 25 percent of its preferred stock in exchange for no par value common stock;

(3) A corporation issues preferred stock, previously authorized but unissued, for outstanding common stock;

(4) An exchange is made of a corporation’s outstanding preferred stock, having certain priorities with reference to the amount and time of payment of dividends and the distribution of the corporate assets upon liquidation, for a new issue of such corporation’s common stock having no such rights;

(5) An exchange is made of an amount of a corporation’s outstanding preferred stock with dividends in arrears for other stock of the corporation. However, if pursuant to such an exchange there is an increase in the proportionate interest of the preferred shareholders in the assets or earnings and profits of the corporation, then under § 1.305–7(c)(2), an amount equal to the lesser of (i) the amount by which the fair market value or liquidation preference, whichever is greater, of the stock received in the exchange (determined immediately following the recapitalization) exceeds the issue price of the preferred stock surrendered, or (ii) the amount of the dividends in arrears, shall be treated under section 305(c) as a deemed distribution to which sections 305(b)(4) and 301 apply.

(f) The term *a party to a reorganization* includes a corporation resulting from a reorganization, and both corporations, in a transaction qualifying as a reorganization where one corporation acquires stock or properties of another corporation. If a transaction otherwise qualifies as a reorganization, a corporation remains a party to the reorganization even though stock or assets acquired in the reorganization are transferred in a transaction described in paragraph (k) of this section. If a transaction otherwise qualifies as a reorganization, a corporation shall not cease to be a party to the reorganization solely by reason of the fact that part or all of the assets acquired in the reorganization are transferred to a partnership in which the transferor is a partner if the continuity of business enterprise requirement is satisfied. See §1.368–1(d). The preceding three sentences apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter. A corporation controlling an acquiring corporation is a party to the reorganization when the stock of such controlling corporation is used in the acquisition of properties. Both corporations are parties to the reorganization if, under statutory authority, Corporation A is merged into Corporation B. All three of the corporations are parties to the reorganization if, pursuant to statutory authority, Corporation C and Corporation D are consolidated into Corporation E. Both corporations are parties to the reorganization if Corporation F transfers substantially all its assets to Corporation G in exchange for all or a part of the voting stock of Corporation G. All three corporations are parties to the reorganization if Corporation H transfers substantially all its assets to Corporation K in exchange for all or a part of the voting stock of Corporation L, which is in control of Corporation K. Both corporations are parties to the reorganization if Corporation M transfers all or part of its assets to Corporation N in exchange for all or a part of the stock and securities of Corporation N, but only if (1) immediately after such transfer, Corporation M, or one or more of its shareholders (including persons who were shareholders immediately before such transfer), or any combination thereof, is in control of Corporation N, and (2) in pursuance of the plan, the stock and securities of Corporation N are transferred or distributed by Corporation M in a transaction in which gain or loss is not recognized under section 354 or 355, or is recognized only to the extent provided in section 356. Both Corporation O and Corporation P, but not Corporation S, are parties to the reorganization if Corporation O acquires stock of Corporation P from Corporation S in exchange solely for a part of the voting stock of Corporation O, if (1) the stock of Corporation P does not constitute substantially all of the assets of Corporation S, (2) Corporation S is not in control of Corporation O immediately after the acquisition, and (3) Corporation O is in control of Corporation P immediately after the acquisition.

(g) The term *plan of reorganization* has reference to a consummated transaction specifically defined as a reorganization under section 368(a). The term is not to be construed as broadening the definition of *reorganization* as set forth in section 368(a), but is to be taken as limiting the nonrecognition of gain or loss to such exchanges or distributions as are directly a part of the transaction specifically described as a reorganization in section 368(a). Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 368(a), but the readjustments involved in the exchanges or distributions effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 368(a) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms.

(h) As used in section 368, as well as in other provisions of the Internal Revenue Code, if the context so requires, the conjunction ‘‘or’’ denotes both the conjunctive and the disjunctive, and the singular includes the plural. For example, the provisions of the statute are complied with if ‘‘stock and securities’’ are received in exchange as well as if ‘‘stock or securities’’ are received.

(i) [Reserved]

(j)(1) This paragraph (j) prescribes rules relating to the application of section 368 (a)(2)(E).

(2) Section 368(a)(2)(E) does not apply to a consolidation.

(3) A transaction otherwise qualifying under section 368(a)(1)(A) is not disqualified by reason of the fact that stock of a corporation (the controlling corporation) which before the merger was in control of the merged corporation is used in the transaction, if the conditions of section 368(a)(2)(E) are satisfied. Those conditions are as follows:

(i) In the transaction, shareholders of the surviving corporation must surrender stock in exchange for voting stock of the controlling corporation. Further, the stock so surrendered must constitute control of the surviving corporation. Control is defined in section 368(c). The amount of stock constituting control is measured immediately before the transaction. For purposes of this subdivision (i), stock in the surviving corporation which is surrendered in the transaction (by any shareholder except the controlling corporation) in exchange for consideration furnished by the surviving corporation (and not by the controlling corporation of the merged corporation) is considered not to be outstanding immediately before the transaction. For effect on ''substantially all'' test of consideration furnished by the surviving corporation, see paragraph (j)(3)(iii) of this section.

(ii) Except as provided in paragraph (k)(2) of this section, the controlling corporation must control the surviving corporation immediately after the transaction.

(iii) After the transaction, except as provided in paragraph (k)(2) of this section, the surviving corporation must hold substantially all of its own properties and substantially all of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction). The term *substantially all* has the same meaning as in section 368(a)(1)(C). The ''substantially all'' test applies separately to the merged corporation and to the surviving corporation. In applying the ''substantially all'' test to the surviving corporation, consideration furnished in the transaction by the surviving corporation in exchange for its stock is property of the surviving corporation which it does not hold after the transaction. In applying the ''substantially all'' test to the merged corporation, assets transferred from the controlling corporation to the merged corporation in pursuance of the plan of reorganization are not taken into account. Thus, for example, money transferred from the controlling corporation to the merged corporation to be used for the following purposes is not taken into account for purposes of the ''substantially all'' test:

(A) To pay additional consideration to shareholders of the surviving corporation;

(B) To pay dissenting shareholders of the surviving corporation;

(C) To pay creditors of the surviving corporation;

(D) To pay reorganization expenses; or

(E) To enable the merged corporation to satisfy state minimum capitalization requirements (where the money is returned to the controlling corporation as part of the transaction).

(iv) Paragraphs (j)(3)(ii) and (iii) of this section apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter.

(4) The controlling corporation may assume liabilities of the surviving corporation without disqualifying the transaction under section 368(a)(2)(E). An assumption of liabilities of the surviving corporation by the controlling corporation is a contribution to capital by the controlling corporation to the surviving corporation. If, in pursuance of the plan of reorganization, securities of the surviving corporation are exchanged for securities of the controlling corporation, or for other securities of the surviving corporation, see sections 354 and 356.

(5) In applying section 368(a)(2)(E), it makes no difference if the merged corporation is an existing corporation, or is formed immediately before the merger, in anticipation of the merger, or after preliminary steps have been taken to otherwise acquire control of the surviving corporation.

(6) The following examples illustrate the application of this paragraph (j). In each of the examples, Corporation P owns all of the stock of Corporation S and, except as otherwise stated, Corporation T has outstanding 1,000 shares of common stock and no shares of any other class. In each of the examples, it is also assumed that the transaction qualifies under section 368(a)(1)(A) if the conditions of section 368(a)(2)(E) are satisfied.

Example 1. P owns no T stock. On January 1, 1981, S merges into T. In the merger, T's shareholders surrender 950 shares of common stock in exchange for P voting stock. The holders of the other 50 shares (who dissent from the merger) are paid in cash with funds supplied by P. After the transaction, T holds all of its own assets and all of S's assets. Based on these facts, the transaction qualifies under section 368(a)(1)(A) by reason of the application of section 368(a)(2)(E). In the transaction, former shareholders of T surrender, in exchange for P voting stock, an amount of T stock (950/1,000 shares or 95 percent) which constitutes control of T.

Example 2. The facts are the same as in *Example (1)* except that holders of 100 shares in corporation T, who dissented from the merger, are paid in cash with funds supplied by T (and not by P or S) and in the merger, T's remaining shareholders surrender 720 shares of common stock in exchange for P voting stock and 180 shares of common stock for cash supplied by P. The requirements of section 368(a)(2)(E)(ii) are satisfied since, in the transaction, former shareholders of T surrender, in exchange for P voting stock, an amount of T stock (720/900 shares or 80 percent) which constitutes control of T. The T stock surrendered in exchange for consideration furnished by T is not considered outstanding for purposes of determining whether the amount of T stock surrendered by T shareholders for P stock constitutes control of T.

Example 3. T has outstanding 1,000 shares of common stock, 100 shares of nonvoting preferred stock, and no shares of any other class. On January 1, 1981, S merges into T. Prior to the merger, as part of the transaction, T distributes its own cash in redemption of the 100 shares of preferred stock. In the transaction, T's remaining shareholders surrender their 1,000 shares of common stock in exchange for P voting stock. The requirements of section 368(a)(2)(E)(ii) are satisfied since, in the transaction, former shareholders of T surrender, in exchange for P voting stock, an amount of T stock (1,000/1,000 shares or 100 percent) which constitutes control of T. The preferred stock surrendered in exchange for consideration furnished by T is not considered outstanding for purposes of determining whether the amount of T stock surrendered by T shareholders for P stock constitutes control of T. However, the consideration furnished by T for its stock is property of T which T does not hold after the transaction for purposes of the substantially all test in paragraph (j)(3)(iii) of this section.

Example 4. On January 1, 1971, P purchased 201 shares of T's stock. On January 1, 1981, S merges into T. In the merger, T's shareholders (other than P) surrender 799 shares of T stock in exchange for P voting stock. Based on these facts, in the transaction, former shareholders of T do not surrender, in exchange for P voting stock, an amount of T stock which constitutes control of T (799/1,000 shares being less than 80 percent). Therefore, the transaction does not qualify under section 368(a)(1)(A). However, if S is a transitory corporation, formed solely for purposes of effectuating the transaction, the transaction may qualify as a reorganization described in section 368(a)(1)(B) provided all of the applicable requirements are satisfied.

Example 5. On January 1, 1971, P purchased 200 shares of T's stock. On January 1, 1981, S merges into T. Prior to the merger, as part of the transaction, T distributes its own cash in redemption of 1 share of T stock from a T shareholder other than P. In the merger, T's remaining shareholders (other than P) surrender 799 shares of T stock in exchange for P voting stock. Based on these facts, in the transaction, former shareholders of T do not surrender, in exchange for P voting stock, an amount of T stock which constitutes control of T (799/999 shares being less than 80 percent). Therefore, the transaction does not qualify under section 368(a)(1)(A). However, if S is a transitory corporation, formed for purposes of effectuating the transaction, the transaction may qualify as a reorganization described in section 368(a)(1)(B) provided all of the applicable requirements are satisfied.

Example 6. The stock of S has a value of $25,000. The stock of T has a value of $75,000. On January 1, 1984, S merges into T. In the merger, T's shareholders surrender all of their T stock in exchange for P voting stock. After the transaction, T holds all of its own assets and all of S's assets. Based on these facts, the transaction qualifies under section 368(a)(1)(A) by reason of the application of section 368(a)(2)(E). In the transaction, former shareholders of T surrender, in exchange for P voting stock, an amount of T stock (1,000/1,000 shares or 100 percent) which constitutes control of T. The stock of T received by P in exchange for P's prior interest in S is not taken into account for purposes of section 368(a)(2)(E)(ii) since the amount of T stock constituting control of T is measured before the transaction.

Example 7. The stock of T has a value of $75,000. On January 1, 1984, S merges into T. In the merger, T's shareholders surrender all of their T stock in exchange for P voting stock. As part of the transaction, P contributes $25,000 to T in exchange for new shares of T stock. None of the cash received by T is distributed or otherwise paid out to former T shareholders. After the transaction, T holds all of its own assets and all of S's assets. Based on these facts, the transaction qualifies under section 368(a)(1)(A) by reason of the application of section 368(a)(2)(E). In the transaction, former shareholders of T surrender, in exchange for P voting stock, an amount of T stock (1,000/1,000 shares or 100 percent) which constitutes control of T. The T stock received by P in exchange for its contribution to T is not taken into account for purposes of section 368(a)(2)(E)(ii) since the amount of T stock constituting control of T is measured before the transaction.

Example 8. The facts are the same as in *Example (7)* except that, as part of the transaction, corporation R, instead of P, contributes $25,000 to T in exchange for T stock. Based on these facts, the transaction does not qualify under section 368(a)(1)(A) by reason of section 368(a)(2)(E) since P does not control T immediately after the transaction.

Example 9. T stock has a value of $75,000. P owns 500 shares (½) of that stock with a value of $37,500. The stock of S has a value of $125,000. On January 1, 1984, S merges into T. In the merger, T's shareholders (other than P) surrender their T stock in exchange for P voting stock. Based on these facts, in the transaction, former shareholders of T do not surrender, in exchange for P voting stock, an amount of T stock which constitutes control of T (500/1,000 shares being less than 80 percent). Therefore, the transaction does not qualify under section 368(a)(1)(A). The stock of T received by P in exchange for P's prior interest in S does not contribute to satisfaction of the requirement of section 368(a)(2)(E)(ii).

(k) *Transfer of assets or stock in section 368(a)(1)(A), (B), (C), or (G) reorganizations*—(1) *General rule for transfers to controlled corporations.* Except as otherwise provided in this section, a transaction otherwise qualifying under section 368(a)(1)(A), (B), (C), or (G) (where the requirements of sections 354(b)(1)(A) and (B) are met) shall not be disqualified by reason of the fact that part or all of the acquired assets or stock acquired in the transaction are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation. Control is defined under section 368(c).

(2) *Transfers following a reverse triangular merger.* A transaction qualifying under section 368(a)(1)(A) by reason of the application of section 368(a)(2)(E) is not disqualified by reason of the fact that part or all of the stock of the surviving corporation is transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation, or because part or all of the assets of the surviving corporation or the merged corporation are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation.

(3) *Examples.* The following examples illustrate the application of this paragraph (k). P is the issuing corporation and T is the target corporation. P has only one class of stock outstanding. The examples are as follows:

Example 1. Transfers of acquired assets to controlled corporations. (i) *Facts.* T operates a bakery which supplies delectable pastries and cookies to local retail stores. The acquiring corporate group produces a variety of baked goods for nationwide distribution. P owns 80 percent of the stock of S–1. Pursuant to a plan of reorganization, T transfers all of its assets to S–1 solely in exchange for P stock, which T distributes to its shareholders. S–1 owns 80 percent of the stock of S–2; S–2 owns 80 percent of the stock of S–3, which also makes and supplies pastries and cookies. Pursuant to the plan of reorganization, S–1 transfers the T assets to S–2; S–2 transfers the T assets to S–3.

(ii) *Analysis.* Under this paragraph (k), the transaction, otherwise qualifying as a reorganization under section 368(a)(1)(C), is not disqualified by reason of the fact of the successive transfers of all of the acquired assets from S–1 to S–2, and from S–2 to S–3 because in each transfer, the transferee corporation is controlled by the transferor corporation. Control is defined under section 368(c).

Example 2. Transfers of acquired stock to controlled corporations. (i) *Facts.* The facts are the same as Example 1 except that S–1 acquires all of the T stock rather than the T assets, and as part of the plan of reorganization, S–1 transfers all of the T stock to S–2, and S–2 transfers all of the T stock to S–3.

(ii) *Analysis.* Under this paragraph (k), the transaction, otherwise qualifying as a reorganization under section 368(a)(1)(B), is not disqualified by reason of the fact of the successive transfers of all of the acquired stock from S–1 to S–2, and from S–2 to S–3 because in each transfer, the transferee corporation is controlled by the transferor corporation.

Example 3. Transfers of acquired stock to partnerships. (i) *Facts.* The facts are the same as in Example 2. However, as part of the plan of reorganization, S–2 and S–3 form a new partnership, PRS. Immediately thereafter, S–3 transfers all of the T stock to PRS in exchange for an 80 percent partnership interest, and S–2 transfers cash to PRS in exchange for a 20 percent partnership interest.

(ii) *Analysis.* This paragraph (k) describes the successive transfer of the T stock to S–3, but does not describe S–3's transfer of the T stock to PRS. Therefore, the characterization of this transaction must be determined under the relevant provisions of law, including the step transaction doctrine. See § 1.368–

1(a). The transaction fails to meet the control requirement of a reorganization described in section 368(a)(1)(B) because immediately after the acquisition of the T stock, the acquiring corporation does not have control of T.

(4) This paragraph (k) applies to transactions occurring after January 28, 1998, except that it does not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7281, 38 FR 18540, July 12, 1973; T.D. 7422, 41 FR 26570, June 28, 1976; T.D. 8059, 50 FR 42689, Oct. 22, 1985; 51 FR 6400, Feb. 24, 1986; T.D. 8760, 63 FR 4182, Jan. 28, 1998]

§1.368–3 Records to be kept and information to be filed with returns.

(a) The plan of reorganization must be adopted by each of the corporations parties thereto; and the adoption must be shown by the acts of its duly constituted responsible officers, and appear upon the official records of the corporation. Each corporation, a party to a reorganization, shall file as a part of its return for its taxable year within which the reorganization occurred a complete statement of all facts pertinent to the nonrecognition of gain or loss in connection with the reorganization, including:

(1) A copy of the plan of reorganization, together with a statement, executed under the penalties of perjury, showing in full the purposes thereof and in detail all transactions incident to, or pursuant to, the plan.

(2) A complete statement of the cost or other basis of all property, including all stock or securities, transferred incident to the plan.

(3) A statement of the amount of stock or securities and other property or money received from the exchange, including a statement of all distributions or other disposition made thereof. The amount of each kind of stock or securities and other property received shall be stated on the basis of the fair market value thereof at the date of the exchange.

(4) A statement of the amount and nature of any liabilities assumed upon the exchange, and the amount and nature of any liabilities to which any of the property acquired in the exchange is subject.

(b) Every taxpayer, other than a corporation a party to the reorganization, who receives stock or securities and other property or money upon a tax-free exchange in connection with a corporate reorganization shall incorporate in his income tax return for the taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange including:

(1) A statement of the cost or other basis of the stock or securities transferred in the exchange, and

(2) A statement in full of the amount of stock or securities and other property or money received from the exchange, including any liabilities assumed upon the exchange, and any liabilities to which property received is subject. The amount of each kind of stock or securities and other property (other than liabilities assumed upon the exchange) received shall be set forth upon the basis of the fair market value thereof at the date of the exchange.

(c) Permanent records in substantial form shall be kept by every taxpayer who participates in a tax-free exchange in connection with a corporate reorganization showing the cost or other basis of the transferred property and the amount of stock or securities and other property or money received (including any liabilities assumed on the exchange, or any liabilities to which any of the properties received were subject), in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received from the exchange.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6622, 27 FR 11918, Dec. 4, 1962]

INSOLVENCY REORGANIZATIONS

§1.371–1 Exchanges by corporations.

(a) *Exchange solely for stock or securities.* (1) Section 371(a)(1) provides for the nonrecognition of gain or loss by a corporation upon certain exchanges made in connection with the reorganization of an insolvent corporation.

The section does not apply to a railroad corporation as defined in section 77(m) of the Bankruptcy Act (11 U.S.C. 205(m)). In order to qualify as a section 371(a) reorganization, the transaction must satisfy the express statutory requirements as well as the underlying assumptions and purposes for which the exchange is excepted from the general rule requiring the recognition of gain or loss upon the exchange of property.

(2) Section 371(a)(1) applies only with respect to a reorganization effected in one of two specified types of court proceedings: (i) Receivership, foreclosure, or similar proceedings, or (ii) corporate reorganization proceedings under chapter X of the Bankruptcy Act (11 U.S.C. 10). The specific statutory requirements are the transfer of property of a corporation, in pursuance of an order of the court having jurisdiction of the corporation in such proceeding, to another corporation organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, in exchange solely for stock or securities in such other corporation. If the consideration for the transfer consists of other property or money as well as stock and securities, see section 371(a)(2) and (c). As to the assumption of liabilities in an exchange described in section 371(a), see section 371(d).

(3) The application of section 371(a)(1) is to be strictly limited to a transaction of the character set forth in such section. Hence, the section is inapplicable unless there is a bona fide plan of reorganization approved by the court having jurisdiction of the proceeding and the transfer of the property of the insolvent corporation is made pursuant to such plan. It is unnecessary that the transfer be a direct transfer from the insolvent corporation; it is sufficient if the transfer is an integral step in the consummation of the reorganization plan approved by the court. By its terms, the section has no application to a reorganization consummated by adjustment of the capital or debt structure of the insolvent corporation without the transfer of its assets to another corporation.

(4) As used in section 371(a)(1), the term *reorganization* is not controlled by the definition of *reorganization* contained in section 368. However, certain basic requirements, implicit in the statute, which are essential to a reorganization under section 368, are likewise essential to qualify a transaction as a reorganization under section 371(a)(1). Among these requirements are a continuity of the business enterprise under the modified corporate form and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. Thus, the nonrecognition accorded by section 371(a)(1) applies only to a genuine reorganization as distinguished from a liquidation and sale of property to either new or old interests supplying new capital and discharging the obligations of the old corporation. For the purpose of determining whether the requisite continuity of interest exists, the interest of creditors who have, by appropriate legal steps, obtained effective command of the property of an insolvent corporation is considered as the equivalent of a proprietary interest. But the mere possibility of a proprietary interest is not its equivalent. In general, any transaction will be subject to nonrecognition of gain or loss as prescribed by section 371(a)(1) where the property is transferred to a corporation and the stock and securities of such corporation are transferred to persons who were shareholders or creditors of the transferor corporation as if such stock or securities had been transferred to such persons as shareholders pursuant to the nonrecognition provisions of part III, subchapter C, chapter 1 of the Code. The determinative and controlling factors are the corporation's insolvency and the effective command by the creditors over its property. The term *insolvent* as used herein refers to insolvency at any time during the course of the proceeding referred to in section 371(a)(1), either in the sense of excess of liabilities over assets or in the sense of inability to meet obligations as they mature.

(5) A short-term purchase money note is not a security within the meaning of this section, and the transfer of the properties of the insolvent corporation for cash and deferred payment obligations of the transferee evidenced by

short-term notes is a sale and not an exchange.

(b) *Exchange for stock or securities and other property or money.* If an exchange would be within the provisions of section 371(a)(1) if it were not for the fact that the consideration for the transfer of the property of the insolvent corporation consists not only of stock or securities but also of other property or money, then, as provided in section 371(a)(2), if the other property or money received by the corporation is distributed by it pursuant to the plan of reorganization, no gain to the corporation will be recognized. Property is distributed within the meaning of this section if it is paid over or distributed to shareholders or creditors who have by appropriate legal steps obtained effective command of the property of the corporation. If the other property or money received by the corporation is not distributed by it pursuant to the plan of reorganization, the gain, if any, to the corporation from the exchange will be recognized in an amount not in excess of the sum of money and the fair market value of the other property so received which is not distributed. In either case no loss from the exchange will be recognized (see section 371(c)).

(c) *Records to be kept and information to be filed.* (1) Each corporation a party to a section 371(a) reorganization shall furnish a complete statement of all facts pertinent to the nonrecognition of gain or loss in connection with the exchange, including:

(i) A certified copy of the plan of reorganization approved by the court in the proceeding, together with a statement showing in full the purposes thereof and in detail all transactions incident, or pursuant, to the plan;

(ii) A complete statement of the cost or other basis of all property, including all stock or securities, transferred incident to the plan;

(iii) A statement of the amount of stock or securities and other property or money received in the exchange, including a statement of all distributions or other disposition made thereof. The amount of each kind of stock or securities or other property shall be stated on the basis of the fair market value thereof at the date of the exchange;

(iv) A statement of the amount and nature of any liabilities assumed upon the exchange.

The information required by this section shall be filed as a part of the corporation's return for its taxable year within which the reorganization occurred.

(2) Permanent records in substantial form must be kept by every taxpayer who participates in a tax-free exchange in connection with a corporate reorganization showing the cost or other basis of the transferred property and the amount of stock or securities and other property or money received (including any liabilities assumed upon the exchange), in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received from th securities and other property or money received (including any liabilities assumed upon the exchange), in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received from the exchange.

§1.371–2 Exchanges by security holders.

(a) *In general.* (1) Section 371(b) prescribes the rules relative to the recognition of gain or loss upon certain exchanges made by the holders of stock or securities of an insolvent corporation in connection with a reorganization described in section 371(a). Under section 371(b)(1), no gain or loss shall be recognized if, pursuant to the plan of reorganization, stock or securities in the insolvent corporation are exchanged solely for stock or securities in the corporation organized or made use of to effectuate such plan. If, in addition to such stock or securities, other property or money is received upon such exchange, gain is recognized to the extent of such other property or money (section 371(b)(2)), but no loss is recognized (section 371(c)). As to the basis of the stock or securities or other property acquired upon an exchange under section 371(b), see section 358.

(2) By thus characterizing as an exchange, and regarding as a single taxable event, the event or series of events

resulting in the relinquishment or extinguishment of the stock or securities in the old corporation and the acquisition in consideration thereof, in whole or in part, of stock or securities in the new corporation, the Code secures uniformity of treatment for the participating security holders, regardless of the particular steps or the procedural devices by which such exchange is effected. Thus, the transaction which qualified as a reorganization under section 371(a) may take one of several forms. In a typical creditors' reorganization there may be a transfer of the property of the old corporation to its bondholders, or the bondholders' committee, upon surrender of the bonds, followed by the transfer of such property to the new corporation in consideration of stock in the latter; or there may be a transfer of the bonds to the new corporation in exchange for its stocks or securities, followed by the transfer of the property of the old corporation in consideration of the surrender of its bonds. In either event, section 371(b) treats the result to the participating security holders as an exchange of the securities of the old corporation for securities of the new corporation. In order, however, to qualify as an exchange under section 371(b) the various events resulting in the relinquishment or extinguishment of the old securities and the acquisition of the new securities must be embraced within the plan of reorganization and must be undertaken for reasons germane to the plan. If the event, or series of events, qualifies as an exchange under section 371(b), no antecedent event necessarily a component of the relinquishment or extinguishment of the securities of the old corporation in consideration of the acquisition of the securities of the new corporation shall be considered a transaction or event having consequences for income tax purposes.

(b) *Exchange solely for stock or securities.* Section 371(b)(1) provides that no gain or loss shall be recognized upon an exchange consisting of the relinquishment or extinguishment of stock or securities in an insolvent corporation described in section 371(a), in consideration of the acquisition solely of stock or securities in a corporation organized or made use of to effectuate the plan of reorganization. As used in this section, the term security does not include a short-term note.

(c) *Exchanges for stock or securities and other property or money.* If an exchange would be within section 371(b)(1) if it were not for the fact that the property received in the exchange consists not only of stock or securities in the corporation organized or made use of to effectuate the plan of reorganization, but also of other property or money, then

(1) As provided in section 371(b)(2), the gain, if any, to the taxpayer will be recognized in an amount not in excess of the sum of money and the fair market value of the other property. The gain so recognized shall be treated as capital gain.

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent (see section 371(c)).

(d) *Records to be kept and information to be filed.* (1) Every taxpayer who receives stock or securities and other property or money upon an exchange described in section 371(b) in connection with a corporate reorganization, must furnish a complete statement of all facts pertinent to the recognition or nonrecognition of gain or loss upon such exchange, including—

(i) A statement of the cost or other basis of the stock or securities transferred in the exchange, and

(ii) A statement in full of the amount of stock or securities and other property or money received from the exchange, including any liability assumed upon the exchange. The amount of each kind of stock or securities and other property (other than liabilities assumed upon the exchange) received shall be set forth upon the basis of the fair market value thereof at the date of the exchange. The statement shall be incorporated in the taxpayer's income tax return for the taxable year in which the exchange occurs.

(2) Permanent records in substantial form shall be kept by every taxpayer who participates in an exchange described in section 371(b), showing the cost or other basis of the transferred property and the amount of stock or securities and other property or money

received (including any liabilities assumed upon the exchange), in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received from the exchange.

§1.372–1 Corporations.

(a) If, as the result of a transaction described in section 371, so much of section 371(c) as relates to section 371(a), or the corresponding provisions of prior law, the property of an insolvent corporation is transferred, in pursuance of a plan of reorganization, to a corporation organized or made use of to effectuate such plan, the basis of such property in the hands of the acquiring corporation is the same as it would be in the hands of the insolvent corporation, increased in the amount of gain recognized upon such transfer under the law applicable to the year in which the transfer was made. In any such case, the adjustments to basis provided by section 270 of the Bankruptcy Act (11 U.S.C. 670), or section 1017 of the Code, shall not be made in respect of any indebtedness cancelled pursuant to the plan of reorganization under which the transfer was made. If the transaction falls within the provisions of section 372(a), the basis of the property involved shall be determined pursuant to such provisions, notwithstanding that the transaction might otherwise fall within another basis provision.

(b) The provisions of section 372(a) are applicable in the determination of basis for all taxable years beginning after December 31, 1933, except that the basis so determined shall not be given effect in the determination of the tax liability for any taxable year beginning prior to January 1, 1943. With the exception indicated, the basis so prescribed is applicable from the date of acquisition of such property. For example, the provisions of section 1016 relating to adjusted basis shall be applied as if section 372(a) were a part of the Internal Revenue Code of 1939 and prior internal revenue laws applicable to all taxable years beginning after December 31, 1933. Hence, in determining the amount of the adjustments for depreciation, depletion, etc., under the provisions of section 1016(a)(2), the *amount allowable* is the amount computed with reference to the basis provided in section 372(a).

(c) The effect of the application of section 372(a) may be illustrated by the following examples:

Example (1). On January 1, 1935, the Y Corporation, a taxpayer making its returns on the calendar year basis, acquired depreciable property from the X Corporation as the result of a transaction described in section 372(a). On January 1, 1935, the property had, in the hands of the X Corporation, a basis of $200,000, an adjusted basis of $150,000, a fair market value as of January 1, 1935 of $80,000, and an estimated remaining life of 20 years. The 1935 transaction was treated as a taxable exchange and, accordingly, the Y Corporation claimed and was allowed depreciation in the amount of $4,000 for each of the eight taxable years 1935 through 1942, inclusive. For each of the twelve taxable years 1943 through 1954, inclusive, the Y Corporation claimed and was allowed depreciation in the amount of $7,500. On December 31, 1954, the property was sold for $10,000 cash. The amount of the gain realized upon the sale is computed as follows:

Basis to X Corporation		$200,000
Adjustment for depreciation in the hands of X Corporation (sec. 1016)		50,000
Adjusted basis for depreciation in the hands of both X and Y Corporations (sec. 372(b))		150,000
Deduct:		
Depreciation allowable in amount of $7,500 per year (1⁄20 of $150,000) for 8 years, from Jan. 1, 1935, through Dec. 31, 1942	$60,000	
Depreciation allowable Jan. 1, 1943, to Dec. 31, 1954 (12 years at $7,500)	90,000	
		150,000
Adjusted basis for computing gain or loss		0
Sale price		10,000
Gain realized		10,000

For the taxable year 1943 and succeeding taxable years, the Y Corporation is entitled to deductions for depreciation in respect of such property in the amounts of $7,500 in the determination of its tax liabilities for such years. But no change in the tax liability is authorized for preceding taxable years by reason of the difference between the $7,500 depreciation allowable and the $4,000 deduction previously allowed.

Example (2). Assume the same facts as in *Example (1)*, except that the property acquired by the Y Corporation had a fair market value as of January 1, 1935, of $180,000, instead of $80,000, and the Y Corporation claimed and was allowed depreciation in the amount of $9,000 for each of the eight taxable years 1935 to 1942, inclusive, and in the amount of $6,500 for the taxable years 1943 to 1954, inclusive. In such case, the amount of the gain realized upon the sale of the property would be computed as follows:

Adjusted basis for depreciation in the hands of Y Corporation as computed in *Example (1)* ..		$150,000
Deduct:		
Depreciation allowed in the amount of $9,000 per year for 8 years Jan. 1, 1935 to Dec. 31, 1942	$72,000	
Depreciation allowable Jan. 1, 1943, to Dec. 31, 1954, inclusive (12 times $6,500)	78,000	
		150,000
Adjusted basis for computing gain or loss		0
Sale price		$10,000
Gain realized		10,000

No change in the tax liability is authorized for taxable years preceding 1943 by reason of the difference between the $7,500 depreciation allowable and the $9,000 deduction previously allowed.

§ 1.374–1 Exchanges by insolvent railroad corporations.

(a) *Exchange solely for stock or securities.* (1) Section 374(a)(1) provides for the nonrecognition of gain or loss by an insolvent railroad corporation upon certain exchanges made in connection with the reorganization of the corporation. In order to qualify as a section 374(a) reorganization, the transaction must satisfy the express statutory requirements as well as the underlying assumptions and purposes for which the exchange is excepted from the general rule requiring the recognition of gain or loss upon the exchange of property.

(2) Section 374(a)(1) applies only with respect to a reorganization effected in one of two specified types of court proceedings: (i) Receivership proceedings, or (ii) proceedings under section 77 of the Bankruptcy Act (11 U.S.C. 205). The specific statutory requirements are the transfer after July 31, 1955, of property of a railroad corporation, as defined in section 77(m) of the Bankruptcy Act (11 U.S.C. 205(m)), in pursuance of an order of the court having jurisdiction of the corporation in such proceeding, to another railroad corporation, as defined in section 77(m) of the Bankruptcy Act, organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, in exchange solely for stock or securities in such other railroad corporation. If the consideration for the transfer consists of other property or money as well as stock and securities, see section 374(a)(2) and (3) and paragraph (b) of this section. As to the assumption of liabilities in an exchange described in section 374(a), see section 357 and paragraph (a)(1) and (2) of § 1.357–1 and paragraph (a) of § 1.357–2.

(3) The application of section 374(a)(1) is to be strictly limited to a transaction of the character set forth in such section. Hence, the section is inapplicable unless there is a bona fide plan of reorganization approved by the court having jurisdiction of the proceeding and the transfer of the property of the insolvent railroad corporation is made pursuant to such plan. It is unnecessary that the transfer be a direct transfer from the insolvent railroad corporation; it is sufficient if the transfer is an integral step in the consummation of the reorganization plan approved by the court. By its terms, the section has no application to a reorganization consummated by adjustment of the capital or debt structure of the insolvent railroad corporation without the transfer of its assets to another railroad corporation.

(4) As used in section 374(a)(1), the term *reorganization* is not controlled by the definition of *reorganization* contained in section 368. However, certain basic requirements, implicit in the statute, which are essential to a reorganization under section 368, are likewise essential to qualify a transaction as a reorganization under section 374(a)(1). Among these requirements are a continuity of the business enterprise under the modified corporate form and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. Thus, the nonrecognition accorded by section 374(a)(1) applies only to a genuine reorganization as distinguished from a liquidation and sale of property to either new or old interests supplying new capital and discharging the obligations of the old railroad corporation. For the purpose of determining whether the requisite continuity of interest exists, the interest of creditors who have, by

appropriate legal steps, obtained effective command of the property of an insolvent railroad corporation is considered as the equivalent of a proprietary interest. But the mere possibility of a proprietary interest is not its equivalent. In general, any transaction will be subject to nonrecognition of gain or loss as prescribed by section 374(a)(1) where the property is transferred to a railroad corporation and the stock and securities of such corporation are transferred to persons who were shareholders or creditors of the transferor railroad corporation as if such stock or securities had been transferred to such persons as shareholders pursuant to the nonrecognition provisions of part III, subchapter C, chapter 1 of the Code. The determinative and controlling factors are the railroad corporation's insolvency and the effective command by the creditors over its property. The term *insolvent* as used in this section refers to insolvency at any time during the course of the proceeding referred to in section 374(a)(1), either in the sense of excess of liabilities over assets or in the sense of inability to meet obligations as they mature.

(5) A short-term purchase money note is not a security within the meaning of this section, and the transfer of the properties of the insolvent railroad corporation for cash and deferred payment obligations of the transferee evidenced by short-term notes is a sale and not an exchange.

(b) *Exchange for stock or securities and other property or money*. If an exchange would be within the provisions of section 374(a)(1) if it were not for the fact that the consideration for the transfer of the property of the insolvent railroad corporation consists not only of stock or securities but also of other property or money, then, as provided in section 374(a)(2), if the other property or money received by the railroad corporation is distributed by it pursuant to the plan of reorganization, no gain to the railroad corporation will be recognized. Property is distributed within the meaning of this section if it is paid over or distributed to shareholders or creditors who have by appropriate legal steps obtained effective command of the property of the railroad corporation. If the other property or money received by the railroad corporation is not distributed by it pursuant to the plan of reorganization, the gain, if any, to the railroad corporation from the exchange will be recognized in an amount not in excess of the sum of money and the fair market value of the other property so received which is not distributed. In either case no loss from the exchange will be recognized (see section 374(a)(3)). See section 354(c) relative to exchanges by stock or security holders.

[T.D. 6528, 26 FR 400, Jan. 19, 1961]

§1.374–2 Basis of property acquired after December 31, 1938, by railroad corporation in a receivership or railroad reorganization proceeding.

Section 374(b)(1) provides that if property of a railroad corporation, as defined in section 77(m) of the Bankruptcy Act (11 U.S.C. 205(m)), was acquired after July 31, 1955, in pursuance of an order of the court having jurisdiction of such corporation in either a receivership proceeding or a proceeding under section 77 of the Bankruptcy Act, and the acquiring corporation is also a railroad corporation as defined in section 77(m) of such Act, organized or availed of to effectuate a plan of reorganization approved by the court in such proceeding, the basis shall be the same as it would be in the hands of the transferor railroad corporation, increased in the amount of gain recognized to the transferor under section 374(a)(2) and paragraph (b) of §1.374–1. For purposes of section 374(b)(1), it is unnecessary that the acquisition in question be a direct transfer from the corporation undergoing reorganization or that such reorganization constitute a reorganization within the meaning of section 368(a) since that section does not apply to part IV, subchapter C, chapter 1 of the Code. It is sufficient if the acquisition is in pursuance of an order of the court and is an integral step in the consummation of a reorganization plan approved by the court having jurisdiction of the proceeding. If the transaction falls within the provisions of section 374(b)(1), the basis of the property involved shall be determined pursuant to such provisions, notwithstanding that the transaction might also fall within another basis provision.

[T.D. 6528, 26 FR 401, Jan. 19, 1961, as amended by T.D. 7616, 44 FR 26870, May 8, 1979]

§1.374–3 Records to be kept and information to be filed.

(a) *Return information.* Each railroad corporation a party to a section 374(a) reorganization shall furnish a complete statement of all facts pertinent to the recognition or nonrecognition of gain or loss in connection with the exchange, including:

(1) A certified copy of the plan of reorganization approved by the court in the proceeding, together with a statement showing in full the purposes thereof and in detail all transactions incident, or pursuant, to the plan;

(2) A complete statement of the cost or other basis of all property, including all stock or securities, transferred incident to the plan;

(3) A statement of the amount of stock or securities and other property or money received in the exchange, including a statement of all distributions or other disposition made thereof. The amount of each kind of stock or securities or other property shall be stated on the basis of the fair market value thereof at the date of the exchange;

(4) A statement of the amount and nature of any liabilities assumed upon the exchange.

The information required by this paragraph shall be filed as a part of each railroad corporation's return for its taxable year within which the reorganization occurred.

(b) *Permanent records.* Permanent records in substantial form must be kept by every railroad corporation which participates in a tax-free exchange in connection with a section 374(a) reorganization showing the cost or other basis of the transferred property and the amount of stock or securities and other property or money received (including any liabilities assumed upon the exchange), in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received from the exchange.

[T.D. 6528, 26 FR 401, Jan. 19, 1961]

§1.374–4 Property acquired by electric railway corporation in corporate reorganizing proceeding.

Subject to the limitations and conditions set forth in section 374(b)(2), if the reorganization under section 77 of the Bankruptcy Act (11 U.S.C. 501 and following) of an electric railway corporation results in the acquisition of the property of such corporation by another corporation, the basis of such property in the hands of the acquiring corporation is the same as it would be in the hands of the old corporation. It is requisite to the application of the section that both corporations be street, suburban, or interurban electric railway corporations engaged in the transportation of persons or property in interstate commerce, and that the acquisition is in pursuance of an order of the court and is an integral step in the consummation of a reorgnizing plan approved by the court having jurisidiction of the proceeding. If section 374(b)(2) applies, section 270 of the Bankruptcy Act (11 U.S.C. 670), relating to the adjustment of basis by reason of the cancellation or reduction of indebtedness in a corporate reorganization proceeding, is inapplicable. Moreover, if the transaction is within the provisons of section 374(b)(2) and may also be considered to be within any other basis provision, then the provisions of section 374(b)(2) only shall apply.

[T.D. 7616, 44 FR 26870, May 8, 1979]

CARRYOVERS

§1.381(a)–1 General rule relating to carryovers in certain corporate acquisitions.

(a) *Allowance of carryovers.* Section 381 provides that a corporation which acquires the assets of another corporation in certain liquidations and reorganizations shall succeed to, and take into account, as of the close of the date of distribution or transfer, the items described in section 381(c) of the distributor or transferor corporation. These items shall be taken into account by the acquiring corporation subject to the conditions and limitations specified in sections 381, 382(b), and 383 and the regulations thereunder.

(b) *Determination of transactions and items to which section 381 applies*—(1) *Qualified transactions.* Except to the extent provided in section 381(c)(20), relating to the carryover of unused pension trust deductions in certain liquidations, the items described in section 381(c) are required by section 381 to be carried over to the acquiring corporation (as defined in subparagraph (2) of this paragraph) only in the following liquidations and reorganizations:

(i) The complete liquidation of a subsidiary corporation upon which no gain or loss is recognized in accordance with the provisions of section 332, but only if the basis of the assets distributed to the acquiring corporation is not required by section 334(b)(2) to be the adjusted basis of the stock with respect to which the distribution is made;

(ii) A statutory merger or consolidation qualifying under section 368(a)(1)(A) to which section 361 applies;

(iii) A reorganization qualifying under section 368(a)(1)(C);

(iv) A reorganization qualifying under section 368(a)(1)(D) if the requirements of section 354(b)(1)(A) and (B) are satisfied; and

(v) A mere change in identity, form, or place of organization qualifying under section 368(a)(1)(F).

(2) *Acquiring corporation defined.* (i) Only a single corporation may be an acquiring corporation for purposes of section 381 and the regulations thereunder. The corporation which acquires the assets of its subsidiary corporation in a complete liquidation to which section 381(a)(1) applies is the acquiring corporation for purposes of section 381. Generally, in a transaction to which section 381(a)(2) applies, the acquiring corporation is that corporation which, pursuant to the plan of reorganization, ultimately acquires, directly or indirectly, all of the assets transferred by the transferor corporation. If, in a transaction qualifying under section 381(a)(2), no one corporation ultimately acquires all of the assets transferred by the transferor corporation, that corporation which directly acquires the assets so transferred shall be the acquiring corporation for purposes of section 381 and the regulations thereunder, even though such corporation ultimately retains none of the assets so transferred. Whether a corporation has acquired all of the assets transferred by the transferor corporation is a question of fact to be determined on the basis of all the facts and circumstances.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). Y Corporation, a wholly-owned subsidiary of X Corporation, directly acquired all the assets of Z Corporation solely in exchange for voting stock of X Corporation in a transaction qualifying under section 368(a)(1)(C). Y Corporation is the acquiring corporation for purposes of section 381.

Example (2). X Corporation acquired all the assets of Z Corporation solely in exchange for voting stock of X Corporation in a transaction qualifying under section 368(a)(1)(C). Thereafter, pursuant to the plan of reorganization X Corporation transferred all the assets so acquired to Y Corporation, its wholly-owned subsidiary (see section 368(a)(2)(C)). Y Corporation is the acquiring corporation for purposes of section 381.

Example (3). X Corporation acquired all the assets of Z Corporation solely in exchange for the voting stock of X Corporation in a transaction qualifying under section 368(a)(1)(C). Thereafter, pursuant to the plan of reorganization X Corporation transferred one-half of the assets so acquired to Y Corporation, its wholly-owned subsidiary, and retained the other half of such assets. X Corporation is the acquiring corporation for purposes of section 381.

Example (4). X Corporation acquired all the assets of Z Corporation solely in exchange for voting stock of X Corporation in a transaction qualifying under section 368(a)(1)(C). Thereafter, pursuant to the plan of reorganization X Corporation transferred one-half of the assets so acquired to Y Corporation, its wholly-owned subsidiary, and the other half of such assets to M Corporation, another wholly-owned subsidiary of X Corporation. X Corporation is the acquiring corporation for purposes of section 381.

(3) *Transactions and items not covered by section 381.* (i) Section 381 does not apply to partial liquidations, divisive reorganizations, or other transactions not described in subparagraph (1) of this paragraph. Moreover, section 381 does not apply to the carryover of an item or tax attribute not specified in subsection (c) thereof. In a case where section 381 does not apply to a transaction, item, or tax attribute by reason of either of the preceding sentences, no

inference is to be drawn from the provisions of section 381 as to whether any item or tax attribute shall be taken into account by the successor corporation.

(ii) If, pursuant to the provisions of subparagraph (2) of this paragraph, a corporation is considered to be the acquiring corporation even though a part of the acquired assets is transferred to one or more corporations controlled by the acquiring corporation, or all the acquired assets are transferred to two or more corporations controlled by the acquiring corporation, then the carryover of any item described in section 381(c) to such controlled corporation or corporations shall be determined without regard to section 381. Thus, for example, if a parent corporation is the acquiring corporation for purposes of section 381 notwithstanding the fact that, pursuant to the plan of reorganization, it transferred to its wholly-owned subsidiary property acquired from the transferor corporation which the transferor corporation had elected to inventory under the last-in first-out method, then the question whether the subsidiary corporation shall continue to use the same method of inventorying with respect to that property shall be determined without regard to section 381.

(c) *Foreign corporations.* A foreign corporation may be a distributor, transferor, or acquiring corporation for purposes of section 381. Thus, for example, the net operating loss carryovers of a foreign corporation, determined under the provisions of section 172 and subchapter N (section 861 and following), chapter 1 of the Code, may be carried over to a domestic acquiring corporation if the domestic corporation acquires the assets of the foreign corporation in a liquidation or reorganization described in section 381(a) and the requirements of § 1.367–1, if applicable, have been complied with.

(d) *Internal Revenue Code of 1939.* Any reference in the regulations under section 381 to any provision of the Internal Revenue Code of 1954 shall, where appropriate, be deemed also to refer to the corresponding provision of the Internal Revenue Code of 1939.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7343, 40 FR 1698, Jan. 9, 1975]

§ 1.381(b)–1 Operating rules applicable to carryovers in certain corporate acquisitions.

(a) *Closing of taxable year*—(1) *In general.* Except in the case of certain reorganizations qualifying under section 368(a)(1)(F), the taxable year of the distributor or transferor corporation shall end with the close of the date of distribution or transfer. With regard to the closing of the taxable year of the transferor corporation in certain reorganizations under section 368(a)(1)(F) involving a foreign corporation after December 31, 1986, see §§ 1.367(a)–1T(e) and 7.367(b)–(e).

(2) *Reorganizations under section 368(a)(1)(F).* In the case of a reorganization qualifying under section 368(a)(1)(F) (whether or not such reorganization also qualifies under any other provision of section 368(a)(1)), the acquiring corporation shall be treated (for purposes of section 381) just as the transferor corporation would have been treated if there had been no reorganization. Thus, the taxable year of the transferor corporation shall not end on the date of transfer merely because of the transfer; a net operating loss of the acquiring corporation for any taxable year ending after the date of transfer shall be carried back in accordance with section 172(b) in computing the taxable income of the transferor corporation for a taxable year ending before the date of transfer; and the tax attributes of the transferor corporation enumerated in section 381(c) shall be taken into account by the acquiring corporation as if there had been no reorganization.

(b) *Date of distribution or transfer.* (1) The date of distribution or transfer shall be that day on which are distributed or transferred all those properties of the distributor or transferor corporation which are to be distributed or transferred pursuant to a liquidation or reorganization described in paragraph (b)(1) of § 1.381(a)–1. If the distribution or transfer of all such properties is not made on one day, then, except as provided in subparagraph (2) of this paragraph, the date of distribution or transfer shall be that day on which the distribution or transfer of all such properties is completed.

(2) If the distributor or transferor and acquiring corporations file the statements described in subparagraph (3) of this paragraph, the date of distribution or transfer shall be that day as of which (i) substantially all of the properties to be distributed or transferred have been distributed or transferred, and (ii) the distributor or transferor corporation has ceased all operations (other than liquidating activities). Such day also shall be the date of distribution or transfer if the completion of the distribution or transfer is unreasonably postponed beyond the date as of which substantially all the properties to be distributed or transferred have been distributed or transferred and the distributor or transferor corporation has ceased all operations other than liquidating activities. A corporation shall be considered to have distributed or transferred substantially all of its properties to be distributed or transferred even though it retains money or other property in a reasonable amount to pay outstanding debts or preserve the corporation's legal existence. A corporation shall be considered to have ceased all operations, other than liquidating activities, when it ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance of its money or other properties to its shareholders.

(3) The statements referred to in subparagraph (2) of this paragraph shall specify the day considered to be the date of distribution or transfer and shall specify, as of such date (i) the nature and amount of the total assets which were distributed or transferred and the dates so distributed or transferred, (ii) the nature and amount of the assets not distributed or transferred and the purpose for which they were retained, and (iii) the date on which the distributor or transferor corporation ceased all operations other than liquidating activities. Such statements shall be attached to the timely filed income tax return of the distributor or transferor corporation for its taxable year ending with such date of distribution or transfer and to the timely filed income tax return of the acquiring corporation for its first taxable year ending after such date, except that, with respect to any income tax return filed before October 11, 1960, any such statement shall be filed before October 11, 1960, with the district director with whom such return is filed.

(4) If—

(i) The last day of the acquiring corporation's taxable year is a Saturday, Sunday, or legal holiday, and

(ii) The day specified in subparagraph (1) or (2) of this paragraph as the date of distribution or transfer is the last business day before such Saturday, Sunday, or holiday,

then the last day of the acquiring corporation's taxable year shall be the date of distribution or transfer for purposes of section 381(b) and this section. For purposes of this subparagraph, the term *business day* means a day which is not a Saturday, Sunday, or legal holiday, and also means a Saturday, Sunday, or legal holiday if the date of distribution or transfer determined under subparagraph (1) or (2) of this paragraph is such Saturday, Sunday, or holiday.

(c) *Return of distributor or transferor corporation.* The distributor or transferor corporation shall file an income tax return for the taxable year ending with the date of distribution or transfer described in paragraph (b) of this section. If the distributor or transferor corporation remains in existence after such date of distribution or transfer, it shall file an income tax return for the taxable year beginning on the day following the date of distribution or transfer and ending with the date on which the distributor or transferor corporation's taxable year would have ended if there had been no distribution or transfer.

(d) *Carryback of net operating losses.* For provisions relating to the carryback of net operating losses of the acquiring corporation, see paragraph (b) of §1.381(c)(1)–1.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended at T.D. 8280, 55 FR 1417, Jan. 16, 1990]

§ 1.381(c)(1)–1 Net operating loss carryovers in certain corporate acquisitions.

(a) *Carryover requirement.* (1) Section 381(c)(1) requires the acquiring corporation to succeed to, and take into account, the net operating loss carryovers of the distributor or transferor corporation. To determine the amount of these carryovers as of the close of the date of distribution or transfer, and to integrate them with any carryovers and carrybacks of the acquiring corporation for purposes of determining the taxable income of the acquiring corporation for taxable years ending after the date of distribution or transfer, it is necessary to apply the provisions of section 172 in accordance with the conditions and limitations of section 381(c)(1) and this section. See also section 382(b) and the regulations thereunder.

(2) The net operating loss carryovers and carrybacks of the acquiring corporation determined as of the close of the date of distribution or transfer shall be computed without reference to any net operating loss of a distributor or transferor corporation. The net operating loss carryovers of a distributor or transferor corporation as of the close of the date of distribution or transfer shall be determined without reference to any net operating loss of the acquiring corporation.

(3) For purposes of the tax imposed under section 56, the acquiring corporation succeeding to and taking into account any net operating loss carryovers of the distributor or transferor corporation shall also succeed to and take into account along with such net operating loss carryforward any deferred tax liability under section 56(b) and the regulations thereunder attributable to such net operating loss carryover.

(b) *Carryback of net operating losses.* A net operating loss of the acquiring corporation for any taxable year ending after the date of distribution or transfer shall not be carried back in computing the taxable income of a distributor or transferor corporation. However, a net operating loss of the acquiring corporation for any such taxable year shall be carried back in accordance with section 172(b) in computing the taxable income of the acquiring corporation for a taxable year ending on or before the date of distribution or transfer. If a distributor or transferor corporation remains in existence after the date of distribution or transfer, a net operating loss sustained by it for any taxable year beginning after such date shall be carried back in accordance with section 172(b) in computing the taxable income of such corporation for a taxable year ending on or before that date, but may not be carried back or over in computing the taxable income of the acquiring corporation. This paragraph may be illustrated by the following examples:

Example (1). On December 31, 1954, X Corporation merged into Y Corporation in a statutory merger to which section 361 applies, and the charter of Y Corporation continued after the merger. Y Corporation sustained a net operating loss for the calendar year 1955. Y Corporation's net operating loss for 1955 may not be carried back in computing the taxable income of X Corporation but shall be carried back in computing the taxable income of Y Corporation.

Example (2). On December 31, 1954, X Corporation and Y Corporation transferred all their assets to Z Corporation in a statutory consolidation to which section 361 applies. Z Corporation sustained a net operating loss for the calendar year 1955. Z Corporation's net operating loss for 1955 may not be carried back in computing the taxable income of X Corporation or Y Corporation.

Example (3). On December 31, 1954, X Corporation ceased all operations (other than liquidating activities) and transferred substantially all its properties to Y Corporation in a reorganization qualifying under section 368(a)(1)(C). Such properties comprised all of X Corporation's properties which were to be transferred pursuant to the reorganization. In the process of liquidating its assets and winding up its affairs, X Corporation sustained a net operating loss for its taxable year beginning on January 1, 1955. This net operating loss of X Corporation shall be carried back in computing the taxable income of that corporation but may not be carried back or over in computing the taxable income of Y Corporation.

(c) *First taxable year to which carryovers apply.* (1) The net operating loss carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer shall first be carried to the first taxable year of the acquiring corporation ending after that date. This rule applies irrespective of whether the date of distribution or transfer is on the last day, or any other day, of the acquiring corporation's taxable year. Thus, such net operating loss carryovers shall first be used by the acquiring corporation with respect to the computation of its net operating loss deduction under section 172(a), and its taxable income determined under the provisions of section 172(b)(2), for such first taxable year. However, see paragraph (f) of this section.

(2) The net operating loss carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer shall be carried to the acquiring corporation without diminution by reason of the fact that the acquiring corporation does not acquire 100 percent of the assets of the distributor or transferor corporation. Thus, if a parent corporation owning 80 percent of all classes of stock of its subsidiary corporation were to acquire its share of the assets of the subsidiary corporation upon a complete liquidation described in paragraph (b)(1)(i) of §1.381(a)–1, then, subject to the conditions and limitations of this section, 100 percent of the net operating loss carryovers available to the subsidiary corporation as of the close of the date of distribution would be carried over to the parent corporation.

(d) *Limitation on net operating loss deduction for first taxable year ending after date of distribution or transfer.* (1) That part of the acquiring corporation's net operating loss deduction, determined in accordance with sections 172(a) and 381(c)(1), for its first taxable year ending after the date of distribution or transfer which is attributable to the net operating loss carryovers of the distributor or transferor corporation, is limited by section 381(c)(1)(B) and this paragraph to an amount equal to the acquiring corporation's postacquisition part year taxable income. Such postacquisition part year taxable income is the amount which bears the same ratio to the acquiring corporation's taxable income for the first taxable year ending after the date of distribution or transfer (determined under section 63 without regard to any net operating loss deduction but taking into account other items to which the acquiring corporation succeeds under section 381) as the number of days in such first taxable year which follow the date of distribution or transfer bears to the total number of days in such taxable year. Thus, if the date of distribution or transfer is the last day of the acquiring corporation's taxable year, the net operating loss carryovers of the distributor or transferor are allowed in full in computing under section 172(a) the net operating loss deduction of the acquiring corporation for its first taxable year ending after that date. In such instance, the number of days in the first taxable year which follow the date of distribution or transfer is the total number of days in such taxable year.

(2) The limitation provided by section 381(c)(1)(B) applies solely for the purpose of computing the net operating loss deduction of the acquiring corporation under section 172(a) for the acquiring corporation's first taxable year ending after the date of distribution or transfer. The limitation does not apply for purposes of determining the portion of any net operating loss (whether of the distributor, transferor, or acquiring corporation) which may be carried to any taxable year of the acquiring corporation following its first taxable year ending after the date of distribution or transfer since such determination is made pursuant to section 172(b) and section 381(c)(1)(C). See paragraphs (e) and (f) of this section.

(3) The limitation provided by section 381(c)(1)(B) shall be applied to the aggregate of the allowable net operating loss carryovers of the distributor or transferor corporation without reference to the taxable years in which the net operating losses were sustained by such corporation. If the acquiring corporation has acquired the assets of two or more distributor or transferor corporations on the same date of distribution or transfer, then the limitation provided by section 381(c)(1)(B) shall be applied to the aggregate of the net operating loss carryovers from all of such distributor or transferor corporations.

(4) If the acquiring corporation succeeds to the net operating loss carryovers of two or more distributor

or transferor corporations on two or more different dates of distribution or transfer within one taxable year of the acquiring corporation, the limitation to be applied under section 381(c)(1)(B) to the aggregate of such carryovers shall be governed by the rules prescribed in paragraph (b) of § 1.381(c)(1)–2.

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

Example (1). (i) X Corporation and Y Corporation were organized on January 1, 1956, and make their returns on the calendar year basis. On December 16, 1957, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. The net operating losses and taxable income (computed without the net operating loss deduction) of the two corporations are as follows, the assumption being made that none of the modifications specified in section 172(b)(2)(A) apply to any taxable year:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1956	($35,000)	($5,000)
Ending 12–16–57	(30,000)	xxx
1957	xxx	36,500

(ii) The aggregate of the net operating loss carryovers of X Corporation carried under section 381(c)(1)(A) to Y Corporation's taxable year ending December 31, 1957, is $65,000; but pursuant to section 381(c)(1)(B), only $1,500 of such aggregate amount ($36,500× 15/365) may be used in computing the net operating loss deduction of Y Corporation for such taxable year under section 172(a). This limitation applies even though Y Corporation's own net operating loss carryover to such year is only $5,000, with the result that Y Corporation has taxable income under section 63 of $30,000 for its taxable year ending December 31, 1957, that is, $36,500 less the sum of $5,000 and $1,500.

(iii) For rules determining the portion of any given loss of X Corporation or Y Corporation which may be carried to a taxable year of Y Corporation following its taxable year ending December 31, 1957, see sections 172(b)(2) and 381(c)(1)(C) and paragraph (f) of this section.

Example (2). (i) X Corporation was organized on January 1, 1954, and Y Corporation was organized on January 1, 1956. Each corporation makes its return on the basis of the calendar year. On December 31, 1956, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. The net operating losses and the taxable income (computed without any net operating loss deduction) of the two corporations are as follows, the assumption being made that none of the modifications specified in section 172(b)(2)(A) apply to any taxable year:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1954	($5,000)	xxx
1955	(15,000)	xxx
1956	(10,000)	$20,000
1957	xxx	40,000

(ii) The aggregate of the net operating loss carryovers of X Corporation carried under section 381(c)(1)(A) to Y Corporation's taxable year 1957 is $30,000, and the full amount of such carryovers is allowed in such taxable year to Y Corporation as a deduction under section 172(a), since such amount does not exceed the limitation ($40,000× 365/365) for such taxable year under section 381(c)(1)(B).

Example (3). (i) X Corporation, Y Corporation, and Z Corporation were organized on January 1, 1954, and each corporation makes its return on the basis of the calendar year. On September 30, 1956, X Corporation and Y Corporation transferred all their assets to Z Corporation in a statutory merger to which section 361 applies. The net operating losses and the taxable income (computed without any net operating loss deduction) of the three corporations are as follows, the assumption being made that none of the modifications specified in section 172(b)(2)(A) apply to any taxable year:

Taxable year	X Corporation (transferor)	Y Corporation (transferor)	Z Corporation (acquirer)
1954	($5,000)	($3,000)	($40,000)
1955	(4,000)	(2,000)	10,000
Ending 9–30–56	(1,000)	(9,000)	xxx
1956	xxx	xxx	73,200

(ii) The aggregate of the net operating loss carryovers of X Corporation and Y Corporation carried under section 381(c)(1)(A) to Z Corporation's taxable year 1956 is $24,000; but, pursuant to section 381(c)(1)(B), only $18,400 of such aggregate amount ($73,200× 92/366) may be used in computing the net operating loss deduction of Z Corporation for such taxable year under section 172(a). For this purpose, Z Corporation may not use the total of the aggregate carryovers ($10,000) from X Corporation plus the aggregate carryovers ($14,000) from Y Corporation, even though each such aggregate of carryovers is separately less than the limitation ($18,400) applicable under section 381(c)(1)(B) and this section.

(iii) For rules determining the portion of any given loss of X Corporation, Y Corporation, or Z Corporation which may be carried to a taxable year of Z Corporation following its taxable year ending December 31, 1956, see sections 172(b)(2) and 381(c)(1)(C) and paragraph (f) of this section.

(e) *Computation of carryovers and carrybacks; general rule*—(1) *Sequence for applying losses and computation of taxable income.* The portion of any net operating loss which is carried back or carried over to any taxable year is the excess, if any, of the amount of the loss over the sum of the taxable income for each of the prior taxable years to which the loss may be carried under sections 172(b)(1) and 381. In determining the taxable income for each such prior taxable year for this purpose, the various net operating loss carryovers and carrybacks to such prior taxable year are considered to be applied in reduction of the taxable income in the order of the taxable years in which the net operating losses are sustained, beginning with the loss for the earliest taxable year. The application of this rule to the taxable income of the acquiring corporation for any taxable year ending after the date of distribution or transfer involves the use of carryovers of the distributor or transfer corporation, and of carryovers and carrybacks of the acquiring corporation. In such instance, the sequence for the use of loss years remains the same, and the requirement is to begin with the net operating loss of the earliest taxable year, whether or not it is a loss of the distributor, transferor, or acquiring corporation. The taxable income of the acquiring corporation for any taxable year ending after the date of distribution or transfer shall be determined in the manner prescribed by section 172(b)(2), except that, if the date of distribution or transfer is on a day other than the last day of a taxable year of the acquiring corporation, the taxable income of such corporation for the taxable year which includes such date shall be computed in the special manner prescribed by section 381(c)(1)(C) and paragraph (f) of this section.

(2) *Loss year of transferor or distributor considered prior taxable year.* Section 381(c)(1)(C) provides that, for the purpose of determining the net operating loss carryovers under section 172(b)(2), a net operating loss for a loss year of a distributor or transferor corporation which ends on or before the last day of a loss year of the acquiring corporation shall be considered to be a net operating loss for a year prior to such loss year of the acquiring corporation. In a case where the acquiring corporation has acquired the assets of two or more distributor or transferor corporations on the same date of distribution or transfer, the loss years of the distributor or transferor corporations shall be taken into account in the order in which such loss years terminate; if any one of the loss years of a distributor or transferor corporation ends on the same day as the loss year of another distributor or transferor corporation, either loss year may be taken into account before the other.

(3) *Years to which losses may be carried.* The taxable years to which a net operating loss shall be carried back or carried over are prescribed by section 172(b)(1). Since the taxable year of the distributor or transferor corporation ends with the close of the date of distribution or transfer, such taxable year and the first taxable year of the acquiring corporation which ends after that date shall be considered two separate taxable years to which a net operating loss of the distributor or transferor corporation for any taxable year ending before that date may be carried over. This rule applies even though the taxable year of the distributor or transferor corporation which ends on the date of distribution or transfer is a period of less than twelve months. However, for the purpose of determining under section 172(b)(1) the taxable years to which a net operating loss of the acquiring corporation is carried over or carried back, the first taxable year of the acquiring corporation which ends after the date of distribution or transfer shall be treated as only one taxable year even though such taxable year is considered under section 381(c)(1)(C) and paragraph (f)(2) of this section as two taxable years. The application of this subparagraph may be illustrated by the following example:

Example. X Corporation was organized on January 1, 1954, and thereafter it sustained net operating losses in its calendar years 1954, 1955, and 1956. On June 30, 1957, X Corporation transferred all its assets to Y Corporation, which was organized on January 1, 1955, in a statutory merger to which section 361 applies. In its taxable year ending June

30, 1957, X Corporation sustained a net operating loss. Y Corporation sustained net operating losses in its calendar years 1955, 1956, and 1958, but had taxable income for the year 1957. The years to which these losses of X Corporation and Y Corporation shall be carried, and the sequence in which carried, are as follows:

Loss year	
X 1954	X 1955, X 1956, X 6/30/57, Y 1957, Y 1958.
X 1955	X 1954, X 1956, X 6/30/57, Y 1957, Y 1958, Y 1959.
Y 1955	Y 1956, Y 1957, Y 1958, Y 1959, Y 1960.
X 1956	X 1954, X 1955, X 6/30/57, Y 1957, Y 1958, Y 1959, Y 1960.
Y 1956	Y 1955, Y 1957, Y 1958, Y 1959, Y 1960, Y 1961.
X 6–30–57	X 1955, X 1956, Y 1957, Y 1958, Y 1959, Y 1960, Y 1961.
Y 1958	Y 1955, Y 1956, Y 1957, Y 1959, Y 1960, Y 1961, Y 1962, Y 1963.

(4) *Computation of carryovers in a case where the date of distribution or transfer occurs on last day of acquiring corporation's taxable year.* The computation of the net operating loss carryovers from the distributor or transferor corporation and from the acquiring corporation in a case where the date of distribution or transfer occurs on the last day of a taxable year of the acquiring corporation may be illustrated by the following example:

Example. X Corporation and Y Corporation were organized on January 1, 1955, and each corporation makes its return on the basis of the calendar year. On December 31, 1956, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. The net operating losses and the taxable income (computed without any net operating loss deduction) of the two corporations are as follows, the assumption being made that none of the modifications specified in section 172(b)(2)(A) apply to any taxable year:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1955	($2,000)	($11,000)
1956	(3,000)	10,000
1957	xxx	(15,000)

The sequence in which the losses of X Corporation and Y Corporation are applied, and the computation of the carryovers to Y Corporation's calendar year 1958, may be illustrated as follows:

(i) *X Corporation's 1955 loss.* The carryover to 1958 is $2,000, computed as follows:

Net operating loss		$2,000
Less:		
X's 1956 taxable income	0	
Y's 1957 taxable income	0	
		0
Carryover		2,000

(ii) *Y Corporation's 1955 loss.* The carryover to 1958 is $1,000, computed as follows:

Net operating loss		$11,000
Less:		
Y's 1956 taxable income	$10,000	
Y's 1957 taxable income	0	
		10,000
Carryover		1,000

(iii) *X Corporation's 1956 loss.* The carryover to 1958 is $3,000, computed as follows:

Net operating loss		$3,000
Less:		
X's 1955 taxable income	0	
Y's 1957 taxable income	0	
		0
Carryover		3,000

(iv) *Y Corporation's 1957 loss.* The carryover to 1958 is $15,000, computed as follows:

Net operating loss			$15,000
Less:			
Y's 1955 taxable income		0	
Y's 1956 taxable income before net operating loss deduction	$10,000		
Minus Y's 1956 net operating loss deduction (i.e., Y's 1955 carryover)	11,000	0	
		0	
Carryover			15,000

(v) *Summary of carryovers to 1958.* The aggregate of the net operating loss carryovers to 1958 is $21,000, computed as follows:

X's 1955 loss	$2,000
Y's 1955 loss	1,000
X's 1956 loss	3,000
Y's 1957 loss	15,000
Total	21,000

(f) *Computation of carryovers and carrybacks when date of distribution or transfer is not on last day of acquiring corporation's taxable year*—(1) *General rule.* Pursuant to the provisions of section 381(c)(1)(C), the taxable income of the acquiring corporation for its taxable year which is a prior taxable year for purposes of section 172(b)(2) and paragraph (e) of this section shall be determined in the manner prescribed in this paragraph, if the date of distribution or transfer occurs within, but not on the last day of, such taxable year.

(2) *Taxable year considered as two taxable years.* Such taxable year of the acquiring corporation shall be considered as though it were two taxable years, but only for the limited purpose of applying section 172(b)(2). The first of such two taxable years shall be referred to in this section as the preacquisition part year; the second, as the postacquisition part year. For purposes of section 172(b)(2), a net operating loss of the acquiring corporation shall be carried to the preacquisition part year and then to the postacquisition part year, whereas a net operating loss of a distributor or transferor corporation shall be carried to the postacquisition part year and then to the acquiring corporation's subsequent taxable years. In determining under section 172(b)(2) and this paragraph the portion of any net operating loss of a distributor or transferor corporation which is carried to any taxable year of the acquiring corporation ending after the postacquisition part year, the taxable income (as determined under this paragraph) of the postacquisition part year shall be taken into account but the taxable income of the preacquisition part year (as so determined) shall not be taken into account. Though considered as two separate taxable years for purposes of section 172(b)(2), the preacquisition part year and the postacquisition part year are treated as one taxable year in determining the years to which a net operating loss is carried under section 172(b)(1). See paragraph (e)(3) of this section.

(3) *Preacquisition part year.* The preacquisition part year shall begin with the beginning of such taxable year of the acquiring corporation and shall end with the close of the date of distribution or transfer.

(4) *Postacquisition part year.* The postacquisition part year shall begin with the day following the date of distribution or transfer and shall end with the close of such taxable year of the acquiring corporation.

(5) *Division of taxable income.* The taxable income for such taxable year (computed with the modifications specified in section 172(b)(2)(A) but without any net operating loss deduction) of the acquiring corporation shall be divided between the preacquisition part year and the postacquisition part year in proportion to the number of days in each. Thus, if in a statutory merger to which section 361 applies Y Corporation acquires the assets of X Corporation on June 30, 1960, and Y Corporation has taxable income (computed in the manner so prescribed) of $36,600 for its calendar year 1960, then the preacquisition part year taxable income would be $18,200 ($36,600× 182/366) and the postacquisition part year taxable income would be $18,400 ($36,600× 184/366).

(6) *Net operating loss deduction.* After obtaining the taxable income of the preacquisition part year and of the postacquisition part year in the manner described in subparagraph (5) of this paragraph, it is necessary to compute the net operating loss deduction for each such part year. This deduction shall be determined in the manner prescribed by section 172(b)(2)(B) but subject to the provisions of this subparagraph. The net operating loss deduction for the preacquisition part year shall, for purposes of section 172(b)(2) only, be determined in the same manner as that prescribed by section 172(b)(2)(B) but shall be computed without taking into account any net operating loss of the distributor or transferor corporation. Therefore, only net operating loss carryovers and carrybacks of the acquiring corporation to the preacquisition part year shall be taken into account in computing the net operating loss deduction for such part year. The net operating loss deduction for the post- acquisition part year shall, for purposes of section 172(b)(2) only, be determined in the same manner as that prescribed by section 172(b)(2)(B) and shall be computed by taking into account all the net operating loss carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer, as well as the net operating loss carryovers and carrybacks of the acquiring corporation to the postacquisition part year. The sequence in which the net operating losses of the two corporations shall be applied for purposes

of this subparagraph shall be determined in the manner prescribed in paragraph (e) of this section.

(7) *Limitation on taxable income.* In no case shall the taxable income of the preacquisition part year or the postacquisition part year, as computed under this paragraph, be considered to be less than zero.

(8) *Cross reference.* If the acquiring corporation succeeds to the net operating loss carryovers of two or more distributors or transferor corporations on two or more dates of distribution or transfer during the same taxable year of the acquiring corporation, the determination of the taxable income of the acquiring corporation for such year pursuant to section 381(c)(1)(C) shall be governed by the rules prescribed in paragraph (c) of § 1.381(c)(1)–2.

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

Example— (i) *Facts.* X Corporation was organized on January 1, 1955, and Y Corporation was organized on January 1, 1954. Each corporation makes its return on the basis of the calendar year. On June 30, 1956, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. The net operating losses and the taxable income (computed without any net operating loss deduction) of the two corporations are as follows, the assumption being made that none of the modifications specified in section 172(b)(2)(A) apply to any taxable year:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1954	xxx	($5,000)
1955	($65,000)	(20,000)
Ending June 30, 1956	1,000	xxx
1956	xxx	36,600

(ii) *Y Corporation's 1954 loss.* The carryover to 1957 is $0, computed as follows:

Net operating loss		$5,000
Less:		
Y's 1955 taxable income		0
Carryover to Y's preacquisition part year		5,000
Less:		
Y's preacquisition part year taxable income computed under subparagraph (5) of this paragraph ($36,600× 182/366)	$18,200	
Minus Y's net operating loss deduction for preacquisition part year	xxx	18,200
Carryover to Y's postacquisition part year and also to Y 1957		0

(iii) *X Corporation's 1955 loss.* The carryover to 1957 is $45,600, computed as follows:

Net operating loss		$65,000
Less:		
X's 6/30/56 year taxable income		1,000
Carryover to Y's postacquisition part year		64,000
Less:		
Y's postacquisition part year taxable income computed under subparagraph (5) of this paragraph ($36,600×184/366)	$18,400	
Minus Y's net operating loss deduction for postacquisition part year (i.e., Y's 1954 carryover of $0 to such part year)		$18,400
Carryover to Y 1957		45,600

(iv) *Y Corporation's 1955 loss.* The carryover to 1957 is $6,800, computed as follows:

Net operating loss		$20,000
Less:		
Y's 1954 taxable income		0
Carryover to Y's preacquisition part year		20,000
Less:		
Y's preacquisition part year taxable income computed under subparagraph (5) of this paragraph	$18,200	
Minus Y's net operating loss deduction for preacquisition part year (i.e., Y's 1954 carryover to such part year)	5,000	
		13,200
Carryover to Y's postacquisition part year		6,800
Less:		
Y's postacquisition part year taxable income computed under subparagraph (5) of this paragraph	$18,400	
Minus Y's net operating loss deduction for postacquisition part year (i.e., Y's 1954 carryover of $0, and X's 1955 carryover of $64,000, to such part year)	64,000	
		0
Carryover to Y 1957		6,800

(v) *Summary of carryovers to 1957.* The aggregate of the net operating loss carryovers to 1957 is $52,400, determined as follows:

Y's 1954 loss	0
X's 1955 loss	$45,600
Y's 1955 loss	6,800
Total	52,400

(g) *Successive acquiring corporations.* An acquiring corporation which, in a distribution or transfer to which section 381(a) applies, acquires the assets of a distributor or transferor corporation which previously acquired the assets of another corporation in a transaction to which section 381(a) applies, shall succeed to and take into account, subject to the conditions and limitations of sections 172 and 381, the net operating loss carryovers available to the first acquiring corporation under sections 172 and 381.

(h) *Illustration.* The application of this section may be further illustrated by the following example:

Example— (1) *Facts.* X Corporation was organized on January 1, 1954, and Y Corporation was organized on January 1, 1955. Each corporation makes its return on the basis of the calendar year. On August 31, 1957, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. The net operating losses and the taxable income of the two corporations for the taxable years involved are set forth in the tabulation below. The taxable income so shown is computed without the modifications required by section 172(b)(2)(A) and without the benefit of any net operating loss deduction. In its calendar year 1957, Y Corporation had a deduction of $365 which is disallowed by section 172(b)(2)(A).

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1954	($7,000)	xxx
1955	(10,000)	($10,000)
1956	(25,000)	(15,000)
Ending 8–31–57	1,000	xxx
1957	xxx	54,750
1958	xxx	(5,000)
1959	xxx	50,000

(2) *Computation of carryovers and carrybacks.* The sequence in which the losses of X Corporation and Y Corporation are applied and the computation of the carryovers to Y Corporation's calendar year 1959 may be illustrated as follows:

(i) *X Corporation's 1954 loss.* The carryover to 1958, which is the last year to which this loss may be carried, is $0, computed as follows:

Net operating loss		$7,000
Less:		
X's 1955 taxable income	0	
X's 1956 taxable income	0	
		0
Carryover to X's 8/31/57-year		7,000
Less:		
X's 8/31/57-year taxable income		1,000
Carryover to Y's postacquisition part year		6,000
Less:		
Y's postacquisition part year taxable income computed under paragraph (f)(5) of this section (($54,750+$365) × 122/365)	$18,422	
Minus Y's net operating loss deduction for postacquisition part year	xxx	
		18,422
Carryover to Y 1958		0

(ii) *X Corporation's 1955 loss.* The carryover to 1959 is $0, computed as follows:

Net operating loss		$10,000
Less:		
X's 1954 taxable income	0	
X's 1956 taxable income	0	
		0
Carryover to X's 8/31/57-year		10,000
Less:		
X's 8/31/57-year taxable income before net operating loss deduction	$1,000	
Minus X's net operating loss deduction for 8/31/57-year (i.e., X's 1954 carryover)	7,000	
		0
Carryover to Y's postacquisition part year		10,000
Less:		
Y's postacquisition part year taxable income computed under paragraph (f)(5) of this section	$18,422	
Minus Y's net operating loss deduction for postacquisition part year (i.e., X's 1954 carryover to such part year)	6,000	
		12,422
Carryover to Y 1958 and Y 1959		0

(iii) *Y Corporation's 1955 loss.* The carryover to 1959 is $0, computed as follows:

Net operating loss		$10,000
Less:		
Y's 1956 taxable income		0
Carryover to Y's preacquisition part year		10,000
Less:		
Y's preacquisition part year taxable income computed under paragraph (f)(5) of this section (($54,750+$365) × 243/365)	$36,693	
Minus Y's net operating loss deduction for preacquisition part year	xxx	
		36,693
Carryover to Y's postacquisition part year, to Y 1958, and to Y 1959		0

(iv) *X Corporation's 1956 loss.* The carryover to 1959 is $22,578, computed as follows:

Net operating loss		$25,000

Less:			
X's 1954 taxable income		0	
X's 1955 taxable income		0	
X's 8/31/57-year taxable income before net operating loss deduction	$1,000		
Minus X's net operating loss deduction for 8/31/57-year (i.e., X's 1954 carryover of $7,000 and X's 1955 carryover of $10,000)	$17,000	0	0
Carryover to Y's postacquisition part year			$25,000
Less:			
Y's postacquisition part year taxable income computed under paragraph (f)(5) of this section		$18,422	
Minus Y's net operating loss deduction for postacquisition part year (i.e., X's 1954 carryover of $6,000, X's 1955 carryover of $10,000 and Y's 1955 carryover of $0, to such part year)		16,000	
			2,422
Carryover to Y 1958			22,578
Less:			
Y's 1958 taxable income			0
Carryover to Y 1959			22,578

(v) *Y Corporation's 1956 loss.* The carryover to 1959 is $0, computed as follows:

Net operating loss		$15,000
Less:		
Y's 1955 taxable income		0
Carryover to Y's preacquisition part year		15,000
Less:		
Y's preacquisition part year taxable income computed under paragraph (f)(5) of this section	$36,693	
Minus Y's net operating loss deduction for preacquisition part year (i.e., Y's 1955 carryover to such part year)	10,000	
		26,693
Carryover to Y's postacquisition part year, to Y 1958, and to Y 1959		0

(vi) *Y Corporation's 1958 loss.* The carryover to 1959 is $0, computed as follows:

Net operating loss		$5,000
Less:		
Y's 1955 taxable income [1]	0	
Y's 1956 taxable income	0	
		0
Carryback to Y's preacquisition part year		$5,000
Less:		
Y's preacquisition part year taxable income computed under paragraph (f)(5) of this section	$36,693	
Minus Y's net operating loss deduction for preacquisition part year (i.e., Y's 1955 carryover of $10,000, and Y's 1956 carryover of $15,000, to such part year)	25,000	
		11,693
Carryback to Y's postacquisition part year and carryover to Y 1959		0

[1] Three-year carryback in case of loss years ending after December 31, 1957.

(vii) *Summary of carryovers to 1959.* The aggregate of the net operating loss carryovers to 1959 is $22,578, computed as follows:

X's 1955 loss	0
Y's 1955 loss	0
X's 1956 loss	$22,578
Y's 1956 loss	0
Y's 1958 loss	0
Total	22,578

(3) *Net operating loss deduction for 1957.* (i) The net operating loss deduction available to Y Corporation under section 172(a) for the calendar year 1957, determined in accordance with paragraph (d) of this section, is $48,300, computed as follows:

Aggregate of the net operating loss carryovers available to the transferor corporation as of the close of August 31, 1957, but limited by paragraph (d) of this section to $18,300 (Y's 1957 taxable income of $54,750, computed without any net operating loss deduction, multiplied by 122/365)		
Carryover of X's 1954 loss	$6,000	
Carryover of X's 1955 loss	10,000	
Carryover of X's 1956 loss	25,000	
	$41,000	
Aggregate of carryovers, limited as above		$18,300
Carryover of Y's 1955 loss		10,000
Carryover of Y's 1956 loss		15,000
Carryback of Y's 1958 loss		5,000
Net operating loss deduction		48,800

(ii) The taxable income under section 63 for 1957 is $6,450, computed as follows:

Taxable income determined without any net operating loss deduction	$54,750
Less:	
Net operating loss deduction for 1957, as determined under subdivision (i) of this subparagraph	$48,300
Taxable income under section 63	6,450

(4) *Net operating loss deduction for 1959.* The taxable income under section 63 for 1959 is $27,422, computed as follows:

Taxable income determined without any net operating loss deduction	$50,000
Less:	
Net operating loss deduction for 1959 (i.e., the aggregate carryovers determined under subparagraph (2)(vii) of this paragraph)	22,578
Taxable income under section 63	27,422

(5) *Years to which losses may be carried.* The taxable years to which the losses of X Corporation and Y Corporation may be carried, and the sequence in which carried, are as follows:

Loss year	Carried to
X 1954	X 1955, X 1956, X 8/31/57, Y 1957, Y 1958.
X 1955	X 1954, X 1956, X 8/31/57, Y 1957, Y 1958, Y 1959.
Y 1955	Y 1956, Y 1957, Y 1958, Y 1959, Y 1960.
X 1956	X 1954, X 1955, X 8/31/57, Y 1957, Y 1958, Y 1959, Y 1960.
Y 1956	Y 1955, Y 1957, Y 1958, Y 1959, Y 1960, Y 1961.
Y 1958	Y 1955, Y 1956, Y 1957, Y 1959, Y 1960, Y 1961, Y 1962, Y 1963.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7564, 43 FR 40493, Sept. 12, 1978]

§1.381(c)(1)–2 Net operating loss carryovers; two or more dates of distribution or transfer in the taxable year.

(a) *In general.* If the acquiring corporation succeeds to the net operating loss carryovers of two or more distributor or transferor corporations on two or more dates of distribution or transfer within one taxable year of the acquiring corporation, the limitation to be applied under section 381(c)(1)(B) to the aggregate of the net operating loss carryovers to that taxable year from all of the distributor or transferor corporations shall be determined by applying the rules prescribed in paragraph (b) of this section, and the taxable income of the acquiring corporation for that taxable year under sections 381(c)(1)(C) and 172(b)(2) shall be determined by applying the rules prescribed in paragraph (c) of this section. For purposes of this section, the term *postacquisition income* means postacquisition part year taxable income determined under paragraph (d)(1) of §1.381(c)(1)–1 by treating the first date of distribution or transfer as though it were the only date of distribution or transfer during the taxable year of the acquiring corporation.

(b) *Determination of limitation under section 381(c)(1)(B)*—(1) *In general.* If the acquiring corporation succeeds to the net operating loss carryovers of two or more distributor or transferor corporations on two or more dates of distribution or transfer during the same taxable year of the acquiring corporation, and if the amount of the net operating loss carryovers acquired on the first date of distribution or transfer equals or exceeds the postacquisition income, then the limitation under section 381(c)(1)(B) shall be an amount equal to such postacquisition income. If the amount of the net operating loss carryovers acquired on the first date of distribution or transfer is less than such postacquisition income, then the limitation under section 381(c)(1)(B) shall be determined as provided in subparagraphs (2) through (5) of this paragraph.

(2) *Allocation of postacquisition income among partial postacquisition years.* That part of the taxable year of the acquiring corporation beginning on the day following the first date of distribution or transfer and ending with the close of the taxable year of the acquiring corporation shall be divided into the same number of partial postacquisition years as the number of dates of distribution or transfer on which the acquiring corporation succeeds to net operating loss carryovers during its taxable year. The first partial postacquisition year shall begin with the day following the first date of distribution or transfer and shall end with the close of the second date of distribution or transfer. The second and succeeding partial postacquisition years shall begin with the day following the close of the preceding such partial year and shall end with the close of the succeeding date of distribution or transfer, or, if there is no such succeeding date, then with the close of the taxable year of the acquiring corporation. The postacquisition income of the acquiring corporation shall be allocated among the partial postacquisition years in proportion to the number of days in each such partial year.

(3) *Two dates of distribution or transfer.* If the acquiring corporation succeeds to the net operating loss carryovers of two distributor or transferor corporations on two dates of distribution or transfer during the same taxable year of the acquiring corporation, and if the amount of the net operating loss carryovers acquired on the first date equals or exceeds the income for the first partial postacquisition year, the limitation provided by section

381(c)(1)(B) shall be the amount of the postacquisition income. If the income for the first partial postacquisition year exceeds the net operating loss carryovers acquired on the first date of distribution or transfer, the limitation provided by section 381(c)(1)(B) shall be the amount of the postacquisition income reduced by the amount of such excess. The application of this subparagraph may be illustrated by the following example:

Example. (i) X Corporation has taxable income (computed without any net operating loss deduction) of $36,500 for its calendar year 1955. During 1955, X Corporation acquires the assets of Y and Z Corporations in statutory mergers to each of which section 361 applies, the dates of transfer being January 1 and December 1, respectively. The net operating loss carryovers of each transferor corporation and the income for each partial postacquisition year are:

Corp.	Carryovers	Income for partial years	Reduction
Y	$1,000	$33,400 ($36,500×334/365)	$32,400
Z	50,000	3,000 ($36,500×30/365)	0
	51,000	36,400	32,400

(ii) The limitation provided by section 381(c)(1)(B) equals the postacquisition income of $36,400 reduced by $32,400, the excess of the income for the first partial year ($33,400) over the net operating loss carryovers acquired on the first date of transfer ($1,000). Accordingly, the limitation is $4,000 ($36,400 minus $32,400). Therefore, although X Corporation acquired carryovers aggregating $51,000 during 1955, it can utilize only $4,000 of such carryovers in computing its net operating loss deduction for 1955.

(4) *Three dates of distribution or transfer.* If the acquiring corporation succeeds to the net operating loss carryovers of three distributor or transferor corporations on three dates of distribution or transfer during the same taxable year of the acquiring corporation, and if the amount of the net operating loss carryovers acquired on the first date equals or exceeds the income for the first and second partial postacquisition years, the limitation provided by section 381(c)(1)(B) shall be the amount of the postacquisition income. If the amount of the carryovers acquired on the first date equals or exceeds the income for the first partial postacquisition year but does not equal or exceed the income for the first and second partial postacquisition years, the limitation shall be the amount of the postacquisition income reduced by the excess of the income for the first and second partial postacquisition years over the amount of carryovers acquired on the first and second dates of distribution or transfer. If the income for the first partial postacquisition year exceeds the carryovers acquired on the first date, the limitation shall be the postacquisition income reduced by the sum of the amount of such excess plus the amount, if any, by which the income for the second partial postacquisition year exceeds the carryovers acquired on the second date. This subparagraph may be illustrated by the following examples:

Example (1). (i) X Corporation has taxable income (computed without any net operating loss deduction) of $36,500 for its calendar year 1955. During 1955, X Corporation acquires the assets of M, N, and Z Corporations in statutory mergers to each of which section 361 applies, the dates of transfer being January 1, January 31, and December 1, respectively. The net operating loss carryovers of each transferor corporation and the income for each partial postacquisition year are:

Corp.	Carryovers	Income for partial years	Reduction
M	$4,000	$3,000 ($36,500× 30/365)	$23,400
N	6,000	30,400 ($36,500×304/365)	
Z	50,000	3,000 ($36,500× 30/365)	0
	60,000	36,400	23,400

(ii) Since the carryovers of $4,000 acquired on the first date of transfer exceed the income for the first partial year ($3,000), the limitation provided by section 381(c)(1)(B) is the amount of the postacquisition income ($36,400) reduced by the excess of the income for the first and second partial years ($33,400) over the carryovers acquired on the first and second dates of transfer ($10,000). Therefore, the limitation is $13,000 ($36,400 less $23,400).

Example (2). (i) Assume the same facts as in *Example (1)* except that the amount of the net operating loss carryovers acquired from M Corporation is $1,000. The net operating loss carryovers of each transferor corporation and the income for each partial postacquisition year are:

Corp.	Carryovers	Income for partial years	Reduction
M	$1,000	$3,000 ($36,500×30/365)	$2,000
N	6,000	30,400 ($36,500×304/365)	24,400
Z	50,000	3,000 ($36,500×30/365)	0
	57,000	36,400	26,400

(ii) Since the income for the first partial year ($3,000) exceeds the $1,000 of carryovers acquired on the first date by $2,000, the limitation provided by section 381(c)(1)(B) is the postacquisition income of $36,400 reduced by such excess and also reduced by the excess of the income for the second partial year ($30,400) over the carryovers acquired on the second date of transfer ($6,000). Therefore, the limitation is $10,000 ($36,400 less the sum of $2,000 and $24,400).

Example (3). (i) Assume the same facts as in *Example (2)* except that the carryovers acquired from N Corporation are $75,000. The net operating loss carryovers of each transferor corporation and the income for each partial postacquisition year are:

Corp.	Carryovers	Income for partial years	Reduction
M	$1,000	$3,000 ($36,500× 30/365)	$2,000
N	75,000	30,400 ($36,500×304/365)	0
Z	50,000	3,000 ($36,500× 30/365)	0
	126,000	36,400	2,000

(ii) Since the income for the first partial year ($3,000) exceeds the $1,000 of carryovers acquired on the first date by $2,000, the limitation provided by section 381(c)(1)(B) is the postacquisition income of $36,400 reduced by $2,000, or $34,400. No further reduction is made since the income for the second partial year ($30,400) does not exceed the carryovers of $75,000 acquired on the second date of transfer.

(5) *Four or more dates of distribution or transfer.* If the acquiring corporation succeeds to the net operating loss carryovers of four or more distributor or transferor corporations on four or more dates of distribution or transfer during the same taxable year of the acquiring corporation, the limitation provided by section 381(c)(1)(B) shall be determined consistently with the methods prescribed in subparagraphs (3) and (4) of this paragraph. The application of this subparagraph may be illustrated by the following example:

Example. (i) X Corporation has taxable income (computed without any net operating loss deduction) of $36,500 for its calendar year 1955. During 1955, X Corporation acquired the assets of M, N, O, Y, and Z Corporations in statutory mergers to each of which section 361 applied, the dates of transfer being, respectively, January 1, January 31, March 3, April 2, and December 1. The net operating loss carryovers of each transferor corporation and the income for each partial postacquisition year are:

Corp.	Carryovers	Income for partial years	Reduction
M	$1,000	$3,000 ($36,500× 30/365)	$2,000
N	4,000	3,100 ($36,500× 31/365)	
O	1,000	3,000 ($36,500× 30/365)	1,100
Y	10,000	24,300 ($36,500×243/365)	14,300
Z	20,000	3,000 ($36,500× 30/365)	0
	36,000	36,400	17,400

(ii) The limitation provided by section 381(c)(1)(B) equals the postacquisition income of $36,400 reduced by the sum of (a) the $2,000 excess of the income for the first partial year ($3,000) over the carryovers acquired from M Corporation ($1,000), (b) the $1,100 excess of the income for the second and third partial years ($6,100) over the carryovers acquired from N and O Corporations ($5,000), and (c) the $14,300 excess of the income for the fourth partial year ($24,300) over the carryovers acquired from Y Corporation ($10,000). Accordingly, the limitation is $19,000 ($36,400 minus $17,400). Therefore, although X Corporation acquired carryovers aggregating $36,000 during 1955, it can utilize only $19,000 of such carryovers in computing its net operating loss deduction for 1955.

(c) *Determination of taxable income of acquiring corporation under section 381(c)(1)(C)*—(1) *In general.* If the acquiring corporation succeeds to the net operating loss carryovers of two or more distributor or transferor corporations on two or more dates of distribution or transfer within one taxable year of the acquiring corporation, then pursuant to section 381(c)(1)(C) the taxable income of the acquiring corporation for its taxable year which is a prior taxable year for purposes of section 172(b)(2) and paragraph (e) of § 1.381(c)(1)–1 shall be determined as provided in this paragraph.

(2) *Division of taxable income.* The taxable income of the acquiring corporation (computed with the modifications specified in section 172(b)(2)(A) but without any net operating loss deduction) shall be allocated proportionately on a daily basis among a preacquisition part year (determined under paragraph (f)(3) of § 1.381(c)(1)–1 by treating the first date of distribution or transfer as though it were the only date of distribution or transfer during the taxable year of the acquiring corporation) and two or more partial postacquisition years (determined as provided in paragraph (b)(2) of this section). The preacquisition part year and each partial

postacquisition year shall be considered a separate taxable year, but only for the limited purpose of applying sections 172(b)(2) and 381(c)(1)(C).

(3) *Net operating loss deduction.* The net operating loss deduction of the preacquisition part year and the partial postacquisition years shall be determined consistently with the manner described in paragraph (f)(6) of § 1.381(c)(1)–1 but by taking into account, in the case of any partial postacquisition year, only the net operating loss carryovers and carrybacks of the acquiring corporation and those net operating loss carryovers from a distributor or transferor corporation which become available to the acquiring corporation as of the close of those dates of distribution or transfer which occur before the beginning of that specific partial postacquisition year. The sequence in which the net operating losses of the distributor or transferor and acquiring corporations shall be applied for this purpose shall be determined in the manner described in paragraph (e) of § 1.381(c)(1)–1. Subject to the preceding sentence, the net operating loss carryovers to any specific partial postacquisition year, whether from a distributor, transferor, or acquiring corporation, shall be taken into account in the order of the taxable years in which the net operating losses arose, beginning with the loss for the earliest taxable year.

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

Example— (i) *Facts.* X Corporation, which was organized on January 1, 1957, sustained a net operating loss of $20,000 for its calendar year 1957 and had taxable income (computed without any net operating loss deduction) of $36,500 for its calendar year 1958. During 1958, X Corporation acquired the assets of Y and Z Corporations in statutory mergers to each of which section 361 applied, the dates of transfer being June 30 and September 30, respectively. None of the modifications specified in section 172(b)(2)(A) apply to any of the corporations for any taxable year. The taxable income (computed without any net operating loss deduction) and net operating losses of Y and Z Corporations (which were organized on January 1, 1957, and January 1, 1954, respectively) are set forth below:

Taxable year	Acquiring corporation X	Transferor corporation Y	Transferor corporation Z
1954	xxx	xxx	($30,000)
1955	xxx	xxx	1,000
1956	xxx	xxx	1,000
1957	($20,000)	($25,000)	1,000
Ending 6–30–58	xxx	1,000	xxx
Ending 9–30–58	xxx	xxx	1,000
1958	36,500	xxx	xxx

The sequence in which the losses of the acquiring corporation and the transferor corporations are applied and the computation of the carryovers to X Corporation's calendar year 1959 are illustrated in the following subdivisions of this example.

(ii) *Computation of taxable income.* X Corporation's taxable income, determined in the manner described in subparagraph (2) of this paragraph, for the preacquisition part year and for the partial postacquisition years is as follows:

Year	Taxable income	Computation
Preacquisition part year	$18,100	$36,500×181/365
Partial No. 1	9,200	36,500×92/365
Partial No. 2	9,200	36,500×92/365

(iii) *Z Corporation's 1954 loss.* The carryover to 1959 is $0, computed as follows:

Net operating loss	$30,000
Less:	
Z's 1955, 1956, 1957, and 9/30/58-3 year income	4,000
Net operating loss carryover to Partial No. 2 year	26,000
Less:	
Partial No. 2 year taxable income	9,200
	16,800

The balance of $16,800 is not carried over to 1959 since X Corporation's taxable year 1958 is the last of the five years to which Z's 1954 loss may be carried under section 172(b)(1).

(iv) *Y Corporation's 1957 loss.* The carryover to 1959 is $14,800, computed as follows:

Net operating loss		$25,000
Less:		
Y's 6/30/58-year income		1,000
Net operating loss carryover to Partial No. 1 year		24,000
Less:		
Partial No. 1 year taxable income		9,200
Carryover to Partial No. 2 year		14,800
Less:		
X's Partial No. 2 year taxable income	$9,200	
Minus X's net operating loss deduction for Partial No. 2 year (i.e., Z's 1954 carryover of $26,000 to such partial year)	26,000	

	0
Carryover to 1959	14,800

(v) *X Corporation's 1957 loss.* The carryover to 1959 is $1,900, computed as follows:

Net operating loss		$20,000
Less:		
X's preacquisition part year taxable income		18,100
Carryover to Partial No. 1 year		1,900
Less:		
Partial No. 1 year taxable income	$9,200	
Minus X's net operating loss deduction for Partial No. 1 year (i.e., Y's 1957 carryover of $24,000 to such partial year)	24,000	
		0
Carryover to Partial No. 2 year		1,900
Less:		
Partial No. 2 year taxable income	$9,200	
Minus X's net operating loss deduction for Partial No. 2 year (i.e., Z's 1954 carryover of $26,000, and Y's 1957 carryover of $14,800, to such partial year	40,800	
		0
Carryover to 1959		$1,900

(vi) *Summary of carryovers to 1959.* The aggregate of the net operating loss carryovers to 1959 is $16,700, computed as follows:

Z's 1954 loss	xxx
Y's 1957 loss	$14,800
X's 1957 loss	91,900
Total	16,700

§1.381(c)(2)–1 Earnings and profits.

(a) *In general.* (1) Section 381(c)(2) requires the acquiring corporation in a transaction to which section 381(a) applies to succeed to, and take into account, the earnings and profits, or deficit in earnings and profits, of the distributor or transferor corporation as of the close of the date of distribution or transfer. In determining the amount of such earnings and profits, or deficit, to be carried over, and the manner in which they are to be used by the acquiring corporation after such date, the provisions of section 381(c)(2) and this section shall apply. For purposes of section 381(c)(2) and this section, if the distributor or transferor corporation accumulates earnings and profits, or incurs a deficit in earnings and profits, after the date of distribution or transfer and before the completion of the reorganization or liquidation, such earnings and profits, or deficit, shall be deemed to have been accumulated or incurred as of the close of the date of distribution or transfer.

(2) If the distributor or transferor corporation has accumulated earnings and profits as of the close of the date of distribution or transfer, such earnings and profits shall (except as hereinafter provided in this section) be deemed to be received by, and to become a part of the accumulated earnings and profits of, the acquiring corporation as of such time. Similarly, if the distributor or transferor corporation has a deficit in accumulated earnings and profits as of the close of the date of distribution or transfer, such deficit shall (except as hereinafter provided in this section) be deemed to be incurred by the acquiring corporation as of such time. In no event, however, shall the accumulated earnings and profits, or deficit, of the distribution or transferor corporation be taken into account in determining earnings and profits of the acquiring corporation for the taxable year during which occurs the date of distribution or transfer.

(3) Any part of the accumulated earnings and profits, or deficit in accumulated earnings and profits, of the distributor or transferor corporation which consists of earnings and profits, or deficits, accumulated before March 1, 1913, shall be deemed to become earnings and profits, or deficits, of the acquiring corporation accumulated before March 1, 1913, and any part of the accumulated earnings and profits of the distributor or transferor corporation which consists of increase in value of property accrued before March 1, 1913, shall be deemed to become earnings and profits of the acquiring corporation consisting of increase in value of property accrued before March 1, 1913.

(4) If the acquiring corporation and each distributor or transferor corporation has accumulated earnings and profits as of the close of the date of distribution or transfer, or if each of such corporations has a deficit in accumulated earnings and profits as of such time, then the accumulated earnings and profits (or deficit) of each such corporation shall be consolidated as of the close of the date of distribution or transfer in the accumulated earnings

and profits account of the acquiring corporation. See subparagraph (6) of this paragraph for determination of the accumulated earnings and profits (or deficit) of the acquiring corporation as of the close of the date of distribution or transfer.

(5) If (i) one or more corporations a party to a distribution or transfer has accumulated earnings and profits as of the close of the date of distribution or transfer, and (ii) one or more of such corporations has a deficit in accumulated earnings and profits as of such time, the total of any such deficits shall be used only to offset earnings and profits accumulated, or deemed to have been accumulated under subparagraph (6) of this paragraph, by the acquiring corporation after the date of distribution or transfer. In such instance, the acquiring corporation will be considered as maintaining two separate earnings and profits accounts after the date of distribution or transfer. The first such account shall contain the total of the accumulated earnings and profits as of the close of the date of distribution or transfer of each corporation which has accumulated earnings and profits as of such time, and the second such account shall contain the total of the deficits in accumulated earnings and profits of each corporation which has a deficit as of such time. The total deficit in the second account may not be used to reduce the accumulated earnings and profits in the first account (although such earnings and profits may be offset by deficits incurred, or deemed to have been incurred, after the date of distribution or transfer) but shall be used only to offset earnings and profits accumulated, or deemed to have been accumulated under subparagraph (6) of this paragraph, by the acquiring corporation after the date of distribution or transfer.

(6) In any case in which it is necessary to compute the accumulated earnings and profits, or the deficit in accumulated earnings and profits, of the acquiring corporation as of the close of the date of distribution or transfer and such date is a day other than the last day of a taxable year of the acquiring corporation—

(i) If the acquiring corporation has earnings and profits for its taxable year during which occurs the date of distribution or transfer, such earnings and profits (*a*) shall be deemed to have accumulated as of the close of such date in an amount which bears the same ratio to the undistributed earnings and profits of such corporation for such year as the number of days in the taxable year preceding the date following the date of distribution or transfer bears to the total number of days in the taxable year, and (*b*) shall be deemed to have accumulated after the date of distribution or transfer in an amount which bears the same ratio to the undistributed earnings and profits of such corporation for such year as the number of days in the taxable year following such date bears to the total number of days in such taxable year. For purposes of the preceding sentence, the undistributed earnings and profits of the acquiring corporation for such taxable year shall be the earnings and profits for such taxable year reduced by any distributions made therefrom during such taxable year.

(ii) If the acquiring corporation has an operating deficit for its taxable year during which occurs the date of distribution or transfer, then, unless the actual accumulated earnings and profits, or deficit, as of such date can be shown, such operating deficit shall be deemed to have accumulated in a manner similar to that described in subdivision (i) of this subparagraph.

(7) This paragraph may be illustrated by the following examples, in which it is assumed that none of the accumulated earnings and profits, or deficits, consist of earnings and profits or deficits accumulated, or increase in value of property accrued, before March 1, 1913.

Example (1). (i) M and N Corporations make their returns on the basis of the calendar year. On June 30, 1959, M Corporation transfers all its assets to N Corporation in a statutory merger to which section 361 applies. The books of the two corporations reveal the following information:

Description	M Corporation (transferor)	N Corporation (acquirer)
Accumulated earnings and profits at close of calendar year 1958 ..	$100,000	$150,000

Description	M Corporation (transferor)	N Corporation (acquirer)
Earnings and profits of taxable year ending June 30, 1959	15,000	....
Earnings and profits of calendar year 1959	....	36,500
Distributions during calendar year 1959	0	0

(ii) As of the close of June 30, 1959, N acquires from M accumulated earnings and profits of $115,000. Since M and N each has accumulated earnings and profits as of the close of the date of transfer, M's accumulated earnings and profits are added to N's accumulated earnings and profits as of such time. However, no part of M's accumulated earnings and profits is taken into account in determining N's earnings and profits for the calendar year 1959. Therefore, N's earnings and profits for the calendar year 1959 are $36,500.

Example (2). (i) X and Y Corporations make their returns on the basis of the calendar year. On June 30, 1959, X Corporation transfers all its assets to Y Corporation in a statutory merger to which section 361 applies. The books of the two corporations reveal the following information:

Description	X Corporation (transferor)	Y Corporation (acquirer)
Accumulated earnings and profits at close of calendar year 1958	$20,000	$100,000
Deficit in earnings and profits for taxable year ending June 30, 1959	80,000	....
Earnings and profits of calendar year 1959	....	36,500
Distributions during calendar year 1959	0	0

(ii) As of the close of June 30, 1959, Y acquires from X a deficit in accumulated earnings and profits in the amount of $60,000. This deficit may be used only to reduce those earnings and profits of Y which are accumulated, or deemed to have accumulated, after June 30, 1959. Accordingly, as of December 31, 1959, the accumulated earnings and profits of Y amount to $118,100; at such time Y also has a separate deficit in accumulated earnings and profits in the amount of $41,600. These amounts are determined as follows:

Accumulated earnings and profits of Y as of the close of 1958	$100,000
Add:	
Portion of undistributed earnings and profits of Y for 1959 deemed to have accumulated as of close of June 30, 1959 ($36,500×181/365)	18,100
Accumulated earnings and profits of Y as of close of June 30, 1959, and also as of Dec. 31, 1959	118,100
Portion of undistributed earnings and profits of Y for 1959 deemed to have accumulated after June 30, 1959 ($36,500×184/365)	18,400
Less:	
Deficit in accumulated earnings and profits acquired by Y from X Corporation as of close of June 30, 1959	60,000
Separate deficit in accumulated earnings and profits of Y as of Dec. 31, 1959	41,600

Example (3). Assume the same facts as in *Example (2)*, except that on September 15, 1959, Y Corporation makes a cash distribution of $96,500. The entire distribution is a dividend: $36,500 from earnings and profits for the taxable year 1959 and $60,000 from earnings and profits accumulated as of December 31, 1958. Accordingly, as of December 31, 1959, Y has accumulated earnings and profits of $40,000, and also has a separate deficit in accumulated earnings and profits of $60,000. These amounts are determined as follows:

Earnings and profits of Y for calendar year 1959	$36,500
Accumulated earnings and profits of Y as of close of 1958	100,000
Total	136,500
Less:	
Distributions during 1959	96,500
Accumulated earnings and profits of Y as of Dec. 31, 1959	40,000
Deficit in accumulated earnings and profits acquired from X as of close of June 30, 1959	$60,000
Less:	
Portion of Y's undistributed earnings and profits for 1959 deemed to have accumulated after June 30, 1959	0
Separate deficit in accumulated earnings and profits of Y as of Dec. 31, 1959	60,000

Example (4). (i) M and N Corporations make their returns on the basis of the calendar year. On June 30, 1959, M Corporation transfers all its assets to N Corporation in a statutory merger to which section 361 applies. The books of the two corporations reveal the following information:

Description	M Corporation (transferor)	N Corporation (acquirer)
Accumulated earnings and profits at close of calendar year 1958	$100,000	$50,000
Earnings and profits for taxable year ending June 30, 1959	10,000	....
Deficit in earnings and profits for calendar year 1959	....	146,000
Distributions during calendar year 1959	0	0

(ii) Assuming that N has not shown its actual accumulated earnings and profits, or deficit, as of the close of June 30, 1959, N has a deficit in accumulated earnings and profits at such time which amounts to $22,400, determined as follows:

Accumulated earnings and profits of N as of close of 1958	$50,000
Less:	
Portion of deficit in earnings and profits of N for 1959 deemed to have accumulated as of close of June 30, 1959 ($146,000×181/365)	72,400
Deficit in accumulated earnings and profits of N as of close of June 30, 1959, and also as of Dec. 31, 1959	22,400

As of the close of June 30, 1959, N acquires from M accumulated earnings and profits in the amount of $110,000, no part of which may be offset by N's own deficit of $22,400; however, such earnings and profits may be offset by deficits incurred, or deemed incurred, by N after June 30, 1959. Thus, as of December 31, 1959, N has the above-mentioned deficit of $22,400; at such time N also has accumulated earnings and profits in the amount of $36,400, determined as follows:

Accumulated earnings and profits acquired from M as of close of June 30, 1959	$110,000
Less:	
Portion of deficit in earnings and profits of N for 1959 deemed to have accumulated after June 30, 1959 ($146,000×184/365)	73,600
Accumulated earnings and profits of N as of Dec. 31, 1959	36,400

Example (5). Assume the same facts as in *Example (4)*, except that on September 9, 1959, N Corporation makes a cash distribution of $100,000. The amount of $82,000 is a dividend from accumulated earnings and profits, computed as follows:

Accumulated earnings and profits acquired from M as of close of June 30, 1959	$110,000
Less:	
Deficit in earnings and profits of N for 1959 deemed to have accumulated from June 30 through Sept. 8, 1959 ($146,000×70/365)	28,000
Accumulated earnings and profits as of close of Sept. 8, 1959	82,000

As of December 31, 1959, N Corporation has a deficit in accumulated earnings and profits of $68,000, computed as follows:

Deficit in accumulated earnings and profits of N as of close of June 30, 1959	$22,400
Add:	
Portion of N's deficit in earnings and profits for 1959 deemed to have accumulated after Sept. 8, 1959 ($146,000×114/365)	45,600
Deficit in accumulated earnings and profits of N as of Dec. 31, 1959	68,000

Example (6). (i) X, Y, and Z Corporations make their returns on the basis of the calendar year. On June 30, 1959, X Corporation and Y Corporation transfer all their assets to Z Corporation in a statutory merger to which section 361 applies. The books of the three corporations reveal the following information:

Description	X Corporation (transferor)	Y Corporation (transferor)	Z Corporation (acquirer)
Accumulated earnings and profits (or deficit) at close of calendar year 1958	$35,000	($25,000)	($20,000)
Earnings and profits (or deficit) for taxable year ended June 30, 1959	5,000	(5,000)	....
Earnings and profits for calendar year 1959	....	....	36,500
Distributions during 1959	0	0	0

(ii) As of the close of June 30, 1959, Z acquires from Y a deficit in accumulated earnings and profits of $30,000. As of such time, Z's own deficit in accumulated earnings and profits amounts to $1,900, determined as follows:

Deficit in accumulated earnings and profits of Z as of close of 1958	$20,000
Less:	
Portion of undistributed earnings and profits of Z for 1959 deemed to have accumulated as of close of June 30, 1959 ($36,500×181/365)	18,100
Deficit in accumulated earnings and profits as of close of June 30, 1959	1,900

The total deficit of $31,900 may be used only to offset earnings and profits of Z accumulated, or deemed to have accumulated, after June 30, 1959; such deficit may not be used to reduce the accumulated earnings and profits of $40,000 acquired from X as of the close of June 30, 1959. Thus, as of December 31, 1959, the accumulated earnings and profits of Z amount to $40,000; at such time Z Corporation also has a separate deficit in accumulated earnings and profits in the amount of $13,500, determined as follows:

Deficit in accumulated earnings and profits as of close of June 30, 1959	$31,900
Less:	
Portion of undistributed earnings and profits of Z for 1959 deemed to have accumulated after June 30, 1959 ($36,500×184/365)	18,400
Separate deficit in accumulated earnings and profits as of Dec. 31, 1959	13,500

Example (7). X and Y Corporations make their returns on the basis of the calendar year. On December 31, 1954, X transfers all its assets to Y in a statutory merger to which section 361 applies. The books of the two corporations reveal the following information:

Description	X Corporation (transferor)	Y Corporation (acquirer)
Accumulated earnings and profits (or deficit) at close of calendar year 1954	($50,000)	$210,000
Earnings and profits (or deficit) for calendar year:		
1955	....	5,000
1956	....	(20,000)
1957	....	70,000
1958	....	60,000
1959	....	55,000
Cash distributions on:		
Sept. 1, 1957	....	80,000
Sept. 1, 1958	....	40,000
Sept. 1, 1959	....	30,000

The balances in the accumulated earnings and profits account and the separate deficit account of Y Corporation at the close of the taxable year involved are as follows:

Year	Deficit acquired from X Corporation	Accumulated earnings and profits of Y Corporation
1954	$50,000	$210,000
1955	45,000	210,000
1956	45,000	190,000
1957	45,000	180,000
1958	25,000	180,000
1959	None	180,000

(b) *Successive acquisitions.* (1) If, as of the date of distribution or transfer, either the acquiring corporation, or the distributor or transferor corporation, or both, is considered under paragraph (a) of this section to be maintaining separate earnings and profits accounts as the result of a prior transaction or transactions to which section 381(a) applied, the accumulated earnings and profits, or deficit in accumulated earnings and profits, of each such corporation shall be combined with the appropriate earnings and profits account of the other such corporation. For example, if, as of the date of transfer, the acquiring corporation and the transferor corporation are each maintaining separate accounts, one containing accumulated earnings and profits and the other containing a deficit in accumulated earnings and profits, the amounts in the two accumulated earnings and profits accounts shall be combined into one account, and the amounts in the two deficit accounts shall be combined into a second account, and the amount in one combined account may not be used to offset the amount in the other combined account.

(2) This paragraph may be illustrated by the following examples, in which it is assumed that none of the accumulated earnings and profits, or deficits, consist of earnings and profits or deficits accumulated, or increase in value of property accrued, before March 1, 1913.

Example (1). (i) X, Y, and Z Corporations make their returns on the basis of the calendar year. On June 30, 1958, X Corporation transfers all its assets to Z Corporation in a statutory merger to which section 361 applies, and on August 31, 1958, Y Corporation transfers all its assets to Z Corporation in another statutory merger to which section 361 applies. The books of the three corporations reveal the following information:

Description	X Corporation (transferor)	Y Corporation (transferor)	Z Corporation (acquirer)
Accumulated earnings and profits (deficit) at close of calendar year 1957	($40,000	$10,000	$60,000
Deficit in earnings and profits for taxable year ending June 30, 1958	(5,000)	....	....
Earnings and profits for taxable year ending Aug. 31, 1958	....	2,000	....
Earnings and profits of calendar year 1958	....	....	36,500
Distributions during calendar year 1958	0	0	0

(ii) As of the close of June 30, 1958, Z acquires from X a deficit in accumulated earnings and profits in the amount of $45,000, which deficit may be used only to reduce those earnings and profits of Z which are accumulated, or deemed to have been accumulated, after June 30, 1958. As of the close of August 31, 1958, Z acquires from Y earnings and profits of $12,000, no portion of which may be reduced by the deficit acquired by Z from X. Accordingly, as of December 31, 1958, Z has accumulated earnings and profits of $90,100, and also has a separate deficit in accumulated earnings and profits of $26,600. These amounts are determined as follows:

Accumulated earnings and profits of Z as of Dec. 31, 1957	$60,000
Add:	
Portion of undistributed earnings and profits of Z for 1958 deemed to have accumulated as of close of June 30, 1958 ($36,500×181/365)	18,100

Accumulated earnings and profits of Z as of June 30, 1958	78,100
Add:	
Accumulated earnings and profits acquired by Z from Y as of close of Aug. 31, 1958	12,000
Accumulated earnings and profits of Z as of close of Aug. 31, 1958, and also as of Dec. 31, 1958	90,100
Deficit in accumulated earnings and profits acquired by Z from X as of close of June 30, 1958	45,000
Less:	
Portion of undistributed earnings and profits of Z for 1958 deemed to have accumulated from June 30 through Aug. 31, 1958 ($36,500×62/365)	6,200
Separate deficit in accumulated earnings and profits of Z as of Aug. 31, 1958	38,800
Less:	
Portion of undistributed earnings and profits of Z for 1958 deemed to have accumulated after Aug. 31, 1958 ($36,500×122/365)	12,200
Separate deficit in accumulated earnings and profits of Z as of Dec. 31, 1958	26,600

Example (2). (i) Assume the same facts as in *Example (1)*, plus the additional fact that on June 30, 1959, Z Corporation transfers all its assets to M Corporation (which makes its return on the basis of the calendar year) in a statutory merger to which section 361 applies, and that as of such time M Corporation is considered to be maintaining separate earnings and profits accounts as the result of a previous transaction to which section 381(a) applied. The books of the two corporations reveal the following information:

Description	Z Corporation (transferor)	M Corporation (acquirer)
Accumulated earnings and profits as of Dec. 31, 1958	$90,100	$50,000
Separate deficit in accumulated earnings and profits as of Dec. 31, 1958	26,600	30,000
Earnings and profits for taxable year ending June 30, 1959	5,000	....
Earnings and profits of calendar year 1959	....	36,500
Distributions during 1959	0	0

(ii) As of June 30, 1959, M acquires from Z accumulated earnings and profits of $90,100, which amount is combined with M's own accumulated earnings and profits of $50,000; M also acquires from Z a deficit in accumulated earnings and profits of $21,600 ($26,600 minus $5,000), which amount is combined with M's own deficit of $11,900. The total deficit of $33,500 may be used only to reduce earnings and profits of M which are accumulated, or deemed to have accumulated, after June 30, 1959. Accordingly, as of December 31, 1959, M has accumulated earnings and profits of $140,100, and also has a separate deficit in accumulated earnings and profits in the amount of $15,100. These amounts are determined as follows:

Deficit of M as of Dec. 31, 1958	$30,000
Less:	
Portion of M's undistributed earnings and profits for 1959 deemed to have accumulated as of close of June 30, 1959 ($36,500×181/365)	18,100
Deficit of M as of June 30, 1959	11,900
Plus:	
Deficit of Z as of June 30, 1959	21,600
Combined deficit of M as of close of June 30, 1959	33,500
Less:	
Portion of M's undistributed earnings and profits for 1959 deemed to have accumulated after June 30, 1959 ($36,500×184/365)	18,400
Separate deficit of M as of Dec. 31, 1959	15,100
Accumulated earnings and profits of M as of Dec. 31, 1958, and also as of June 30, 1959	50,000
Accumulated earnings and profits of Z as of Dec. 31, 1958, and also as of June 30, 1959	90,100
Combined accumulated earnings and profits of M as of close of June 30, 1959, and also as of Dec. 31, 1959	140,100

(c) *Distribution of earnings and profits pursuant to reorganization or liquidation.* (1) If, in a reorganization to which section 381(a)(2) applies, the transferor corporation pursuant to the plan of reorganization distributes to its stockholders property consisting not only of property permitted by section 354 to be received without recognition of gain, but also of other property or money, then the accumulated earnings and profits of the transferor corporation as of the close of the date of transfer shall be computed by taking into account the amount of earnings and profits properly applicable to the distribution, regardless of whether such distribution occurs before or after the close of the date of transfer.

(2) If, in a distribution to which section 381(a)(1) (relating to certain liquidations of subsidiaries) applies, the acquiring corporation receives less than 100 percent of the assets distributed by the distributor corporation, then the accumulated earnings and profits of the distributor corporation as of the close of the date of distribution shall be computed by taking into account the amount of earnings and

profits properly applicable to the distributions to minority stockholders, regardless of whether such distributions occur before or after the close of the date of distribution.

(d) *Treatment of earnings and profits where assets are transferred to a corporation controlled by the acquiring corporation.* If, pursuant to the provisions of paragraph (b)(2) of §1.381(a)–1, a corporation is considered to be the acquiring corporation even though a part of the acquired assets is transferred to one or more corporations controlled by the acquiring corporation, or all the acquired assets are transferred to two or more corporations controlled by the acquiring corporation, then whether any portion of the earnings and profits received by the acquiring corporation under section 381(c)(2) is allocable to such controlled corporation or corporations shall be determined without regard to section 381. See paragraph (a) of §1.312–11.

[T.D. 6586, 26 FR 12550, Dec. 28, 1961, as amended by T.D. 6692, 28 FR 12817, Dec. 3, 1963]

§1.381(c)(3)–1 Capital loss carryovers.

(a) *Carryover requirement.* (1) Section 381(c)(3) requires the acquiring corporation in a transaction to which section 381(a) applies to succeed to, and take into account, the capital loss carryovers of the distributor or transferor corporation. To determine the amount of these carryovers as of the close of the date of distribution or transfer, and to integrate them with the capital loss carryovers of the acquiring corporation for purposes of determining the taxable income of the acquiring corporation for taxable years ending after the date of distribution or transfer, it is necessary to apply the provisions of section 1212 in accordance with the conditions and limitations of section 381(c)(3) and this section.

(2) The capital loss carryovers of the acquiring corporation as of the close of the date of distribution or transfer shall be determined without reference to any capital gains or capital losses of the distributor or transferor corporation. The capital loss carryovers of a distributor or transferor corporation as of the close of the date of distribution or transfer shall be determined without reference to any capital gains or capital losses of the acquiring corporation.

(3) This section contains rules applicable to capital loss carryovers determined without reference to the amendment of section 1212(a) made by section 7 of the Act of September 2, 1964 (Public Law 88–571, 78 Stat. 860) in respect of foreign expropriation capital losses. If the distributor, transferor, or acquiring corporation sustains a net capital loss in a taxable year ending after December 31, 1958, any portion of which is attributable to a foreign expropriation capital loss, such portion shall be carried over to each of the ten succeeding taxable years consistently with the rules prescribed in this section and paragraph (a)(2) of §1.1212–1.

(b) *First taxable year to which carryovers apply.* (1) The capital loss carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer shall first be carried to the first taxable year of the acquiring corporation ending after that date. This rule applies irrespective of whether the date of distribution or transfer is on the last day, or any other day, of the acquiring corporation's taxable year.

(2) The capital loss carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer shall be carried to the acquiring corporation without diminution by reason of the fact that the acquiring corporation does not acquire 100 percent of the assets of the distributor or transferor corporation.

(c) *Limitation on capital loss carryovers for first taxable year ending after date of distribution or transfer.* (1) Any capital loss carryover of a distributor or transferor corporation which is available to the acquiring corporation as of the close of the date of distribution or transfer shall be a short-term capital loss of the acquiring corporation in each of the taxable years to which the net capital loss giving rise to such carryover may be carried to the extent provided in section 1212 and this section. However, in the first taxable year of the acquiring corporation ending after the date of distribution or transfer, the total capital loss carryovers of the distributor or transferor corporation which may be treated in that year as short-term capital losses of the acquiring corporation is limited by section 381(c)(3)(B) to an amount which bears the same ratio to the acquiring corporation's capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such first taxable year (determined without regard to any capital loss carryovers) as the number of days in such first taxable year which follow the date of distribution or transfer bears to the total number of days in such taxable year. Thus, if the date of distribution or transfer is the last day of the acquiring corporation's taxable year, there is no limitation under section 381(c)(3)(B) on the amount of such carryovers which may be treated as short-term capital losses of the acquiring corporation for its first taxable year ending after that date.

(2) The limitation provided by section 381(c)(3)(B) shall be applied to the aggregate of the capital loss carryovers of the distributor or transferor corporation without reference to the taxable years in which the net capital losses giving rise to the carryovers were sustained. If the acquiring corporation has acquired the assets of two or more distributor or transferor corporations on the same date of distribution or transfer, then the limitation provided by section 381(c)(3)(B) shall be applied to the aggregate of the capital loss carryovers from all of such distributor or transferor corporations.

(3) If the acquiring corporation succeeds to the capital loss carryovers of two or more distributor or transferor corporations on two or more dates of distribution or transfer during the same taxable year of the acquiring corporation, the limitation to be applied under section 381(c)(3)(B) to the aggregate of such carryovers shall be determined consistently with the rules prescribed in paragraph (b) of § 1.381(c)(1)–2.

(4) The application of this paragraph may be illustrated by the following example:

Example. (i) X and Y Corporations are organized on January 1, 1954, and make their returns on the basis of the calendar year. On July 4, 1957, X Corporation transfers all its assets to Y Corporation in a statutory merger to which section 361 applies. The net capital losses and the net capital gains (capital gain net income for taxable years beginning after Dec. 31, 1976), (computed without regard to any capital loss carryovers) of the two corporations are as follows:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1954	($5,000)	0
1955	(10,000)	$5,000
1956	(25,000)	(7,000)
Ending 7–4–57	(8,000)	....
1957	....	36,500

(ii) The capital loss carryovers of X Corporation which are available to Y Corporation as of the close of July 4, 1957, amount to $48,000 in the aggregate; but only $18,000 ($36,500 × 180/365) of such amount may be treated as short-term capital losses of Y Corporation for 1957.

(d) *Computation of carryovers; general rule*—(1) *Sequence for applying losses and determination of capital gain net income.* Section 1212 provides that a net capital loss sustained in any taxable year (hereinafter referred to as the ''loss year'') shall be carried over to each of the five succeeding taxable years and treated in each of such succeeding years as a short-term capital loss to the extent not allowed as a deduction against any capital gain net income (net capital gain for taxable years beginning before January 1, 1977) of any taxable years intervening between the loss year and the taxable year to which such loss is carried. For this purpose, the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) of any intervening taxable year is determined without regard to the net capital loss for the loss year or for any taxable year thereafter, and the various capital loss carryovers from taxable years preceding the loss year to any such intervening taxable year are considered to be applied in reduction of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such year in the order of the taxable years in which the losses were sustained, beginning with the loss for the earliest preceding taxable year. The application of these rules to the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) of the acquiring corporation for any taxable year ending after the date of distribution or transfer involves the use of carryovers of the distributor or transferor corporation and of the acquiring corporation. In determining the order in which the capital loss carryovers of the distributor or transferor and acquiring corporations from taxable years ending on or before the date of distribution or transfer are considered to be applied in reduction of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) of the acquiring corporation for any intervening taxable year ending after such date, the following rules shall apply:

(i) Each taxable year of the distributor or transferor and acquiring corporations which, with respect to the first taxable year of the acquiring corporation ending after the date of distribution or transfer, constitutes a first preceding taxable year, shall be treated as if each such year ended on the same day, whether or not such taxable years actually end on the same day. In like manner, each taxable year of the distributor or transferor and acquiring corporations which, with respect to such first taxable year of the acquiring corporation ending after the date of distribution or transfer, constitutes a second preceding taxable year, shall be treated as if each such year ended on the same day (whether or not such taxable years actually end on the same day), and a similar rule shall be applied with respect to those taxable years of the distributor or transferor and acquiring corporations which constitute third, fourth, and fifth preceding taxable years;

(ii) If in the same preceding taxable year both the distributor or transferor and acquiring corporations incurred a net capital loss which is a carryover to an intervening taxable year of the acquiring corporation ending after the date of distribution or transfer, then in applying such losses in reduction of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such an intervening year, either such loss may be taken into account before the other; and

(iii) The rules of subdivisions (i) and (ii) of this subparagraph shall apply regardless of the number of distributor or transferor corporations the assets of which are acquired by the acquiring corporation on the same date of distribution or transfer.

(2) *Cross reference.* If the date of distribution or transfer is a day other than the last day of a taxable year of the acquiring corporation, then in determining the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) of the acquiring corporation for its first taxable year ending after the date of distribution or transfer, section 1212 and this paragraph shall be applied in the special manner set forth in paragraph (e) of this section.

(3) *Years to which losses may be carried.* The taxable years to which a net capital loss shall be carried are prescribed by section 1212. Since the taxable year of a distributor or transferor corporation ends with the close of the date of distribution or transfer, such taxable year and the first taxable year of the acquiring corporation which ends after that date are considered two separate taxable years to which a net capital loss of the distributor or transferor corporation for any taxable year ending before that date shall be carried. This rule applies even though the taxable year of the distributor or transferor corporation which ends on the date of distribution or transfer is a period of less than twelve months. However, the distribution or transfer has no effect in determining under section 1212 the taxable years to which a net capital loss of the acquiring corporation is carried. For this purpose, the first taxable year of the acquiring corporation which ends after the date of distribution or transfer constitutes only one taxable year even though such taxable year is considered under paragraph (e) of this section as two taxable years for certain purposes. The application of this subparagraph may be illustrated by the following example:

Example. R and S Corporations are organized on January 1, 1954, and both corporations make their returns on the basis of the calendar year. R Corporation has net capital losses for its years 1954, 1955, and 1957, and S Corporation has net capital losses for its years 1954 and 1956. On June 30, 1958, R Corporation transfers all its assets to S Corporation in a statutory merger to which section 361 applies. The taxable years to which these losses of R and S Corporations may be carried are as follows:

Loss year	Carried to
R1954	R1955, R1956, R1957, R6/30/58, S1958.
S1954	S1955, S1956, S1957, S1958, S1959.
R1955	R1956, R1957, R6/30/58, S1958, S1959.
S1956	S1957, S1958, S1959, S1960, S1961.
R1957	R6/30/58, S1958, S1959, S1960, S1961.

(4) *Computation of carryovers in case where date of distribution or transfer occurs on last day of acquiring corporation's taxable year.* The computation of the capital loss carryovers from the distributor or transferor corporation and from the acquiring corporation in a case where the date of distribution or transfer occurs on the last day of a taxable year of the acquiring corporation may be illustrated by the following example:

Example. X and Y Corporations are organized on January 1, 1955, and make their returns on the basis of the calendar year. On December 31, 1956, X Corporation transfers all its assets to Y Corporation in a statutory merger to which section 361 applies. The net capital losses and the net capital gains (capital gain net income for taxable years beginning after December 31, 1976), (computed without regard to any capital loss carryovers) of the two corporations are as follows:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1955	($20,000)	($2,000)
1956	(10,000)	(8,000)
1957	....	25,000
1958	....	10,000

The sequence in which the net capital losses of X and Y Corporations are applied, and the computation of the capital loss carryovers to Y Corporation's taxable year 1959, may be illustrated as follows. (For purposes of this example, the carryover from a preceding taxable year of the transferor corporation will be applied before the carryover from the same preceding taxable year of the acquiring corporation):

(i) *X Corporation's 1955 loss.* The carryover to 1959 is $0, computed as follows:

Net capital loss	$20,000
Less: Y's 1957 net capital gain (computed without regard to any capital loss carryovers)	25,000
Carryover to Y 1958 and Y 1959	0

(ii)*Y Corporation's 1955 loss.* The carryover to 1959 is $0, computed as follows:

Net capital loss		$2,000
Less:		
Y's 1957 net capital gain (computed without regard to any capital loss carryovers)	$25,000	
Minus capital loss carryovers to Y 1957 (i.e., carryover of $20,000 from X 1955)	20,000	
		5,000
Carryover to Y 1958 and Y 1959		0

(iii) *X Corporation's 1956 loss.* The carryover to 1959 is $0, computed as follows:

Net capital loss		$10,000
Less:		
Y's 1957 net capital gain (computed without regard to any capital loss carryovers)	$25,000	
Minus capital loss carryovers to Y 1957 (i.e., carryovers of $20,000 from X 1955 and $2,000 from Y 1955)	22,000	
		3,000
Carryover to Y 1958		7,000
Less:		
Y's 1958 net capital gain (computed without regard to any capital loss carryovers)	$10,000	
Minus capital loss carryovers to Y 1958	0	
		10,000
Carryover to Y 1959		0

(iv) *Y Corporation's 1956 loss.* The carryover to 1959 is $5,000, computed as follows:

Net capital loss		$8,000
Less:		
Y's 1957 net capital gain (computed without regard to any capital loss carryovers)	$25,000	
Minus capital loss carryovers to Y 1957 (i.e., carryovers of $20,000 from X 1955, $2,000 from Y 1955, and $10,000 from X 1956)	32,000	
		0
Carryover to Y 1958		8,000
Less:		
Y's 1958 net capital gain (computed without regard to any capital loss carryovers)	$10,000	
Minus capital loss carryovers to Y 1958 (i.e., carryover of $7,000 from X 1956)	7,000	
		3,000
Carryover to Y 1959		5,000

(e) *Computation of carryovers when date of distribution or transfer is not on last day of acquiring corporation's taxable year*—(1) *General rule.* If, in determining under paragraph (d) of this section the portion of a net capital loss for any taxable year which is carried over to a succeeding taxable year, an intervening taxable year is a taxable year of the acquiring corporation which includes, but does not end on, the date of distribution or transfer, the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) of such intervening year shall be determined by applying section 1212 in the special manner provided by this paragraph.

(2) *Taxable year considered as two taxable years.* Such intervening taxable year of the acquiring corporation shall be considered as though it were two taxable years, but only for the limited purpose of computing capital loss carryovers to subsequent taxable years. The first of such two taxable years shall be referred to in this paragraph as the preacquisition part year; the second, as the postacquisition part year. Though considered as two separate taxable years for purposes of this paragraph, the preacquisition part year and the postacquisition part year are treated as one taxable year in determining the years to which a net capital loss is carried under section 1212. See paragraph (d)(3) of this section.

(3) *Preacquisition part year.* The preacquisition part year shall begin with the beginning of such taxable year of the acquiring corporation and shall end with the close of the date of distribution or transfer.

(4) *Postacquisition part year.* The postacquisition part year shall begin with the day following the date of distribution or transfer and shall end with the close of such taxable year of the acquiring corporation.

(5) *Division of capital gain net income.* The capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such intervening taxable year (computed without regard to any capital loss carryovers) of the acquiring corporation shall be divided between the preacquisition part year and the postacquisition part year in proportion to the number of days in each. Thus, if in a statutory merger to which section 361 applies Y Corporation acquires the assets of X Corporation on June 30, 1956, and Y Corporation has net capital gain (computed in the manner so prescribed) of $36,600 for its calendar year 1956, then the preacquisition part year capital gain net income (net capital gain for taxable years beginning before January 1, 1977) would be $18,200 ($36,600×182/366) and the postacquisition part year capital gain net income (net capital gain for taxable years beginning before January 1, 1977) would be $18,400 ($36,600×184/366).

(6) *Application of capital loss carryovers.* After obtaining the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) of the preacquisition part year and postacquisition part year in the manner described in subparagraph (5) of this paragraph, it is necessary to determine the capital loss carryovers which are taken into account with respect to each such part year. The carryovers to be taken into account and the sequence in which such carryovers are applied, shall be determined in accordance with paragraph (d)(1) of this section but subject to the provisions of this subparagraph. With respect to the preacquisition part year, no capital loss carryovers of the distributor or transferor corporation shall be taken into account; that is, only capital loss carryovers of the acquiring corporation shall be taken into account. With respect to the postacquisition part year, capital loss carryovers of both the distributor or transferor corporation and the acquiring corporation shall be taken into account.

(7) *Cross reference.* If an intervening taxable year is a taxable year of the acquiring corporation during which the acquiring corporation succeeds to the capital loss carryovers of two or more distributor or transferor corporations on two or more dates of distribution or transfer, the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) of the acquiring corporation for such intervening taxable year shall be determined consistently with the rules prescribed in paragraph (c) of § 1.381(c)(1)–2, except that the sequence in which the capital loss carryovers of the distributor or transferor and acquiring corporations shall be applied shall be determined under paragraph (d)(1) of this section.

(8) *Illustration.* The application of this paragraph may be illustrated as follows:

Example. X Corporation is organized on April 1, 1959, and makes its return on the basis of the fiscal year ending March 31. Y Corporation is organized on January 1, 1959, and makes its return on the basis of the calendar year. On June 30, 1961, X Corporation transfers all its assets to Y Corporation in a statutory merger to which section 361 applies. The net capital losses and the net capital gains (capital gain net income for taxable years beginning after December 31, 1976) (computed without regard to any capital loss carryovers) of the two corporations are as follows:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1959		($24,000)
Ending 3–31–60	($19,000)	
1960		(6,000)
Ending 3–31–61	(5,000)	
Ending 6–30–61	0	
1961		36,500
1962		12,000

The following table shows those taxable years of the transferor and acquiring corporations which, with respect to Y Corporation's calendar year 1961, are first, second, and third preceding taxable years:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
First preceding year	Ending June 30, 1961	1960
Second preceding year	Ending March 31, 1961	1959
Third preceding year	Ending March 31, 1960	

The sequence in which the net capital losses of X and Y Corporations are applied, and the computation of the capital loss carryovers to Y Corporation's calendar year 1963, may be illustrated as follows. (For purposes of this example, the carryover from a preceding taxable year of the acquiring corporation will be applied before the carryover from the same preceding taxable year of the transferor corporation):

(i) *X Corporation's 3/31/60 loss.* The carryover to 1963 is $0, computed as follows:

Net capital loss	$19,000
Less: Y's postacquisition part year net capital gain computed under subparagraph (5) of this paragraph ($36,500× 184/365)	18,400
Carryover to Y 1962	600
Less: Y's 1962 net capital gain (computed without regard to any capital loss carryovers)	12,000
Carryover to Y 1963	0

(ii) *Y Corporation's 1959 loss.* The carryover to 1963 is $0, computed as follows:

Net capital loss		$24,000
Less: Y's preacquisition part year net capital gain computed under subparagraph (5) of this paragraph ($36,500× 181/365)		18,100
Carryover to Y's postacquisition part year		5,900
Less:		
Y's postacquisition part year net capital gain computed under subparagraph (5) of this paragraph	$18,400	
Minus capital loss carryovers to postacquisition part year (i.e., carryover of $19,000 from X 3/31/60)	19,000	0
Carryover to Y 1962		5,900
Less:		
Y's 1962 net capital gain (computed without regard to any capital loss carryovers)	$12,000	
Minus capital loss carryovers to Y 1962 (i.e., carryover of $600 from X 3/31/60)	600	11,400
Carryover to Y 1963		0

(iii) *X Corporation's 3/31/61 loss.* The carryover to 1963 is $0, computed as follows:

Net capital loss		$5,000
Less:		
Y's postacquisition part year net capital gain computed under subparagraph (5) of this paragraph	$18,400	
Minus capital loss carryovers to postacquisition part year (i.e., carryovers of $19,000 from X 3/31/60 and $5,900 from Y 1959)	24,900	
		0
Carryover to Y 1962		5,000
Less:		
Y's 1962 net capital gain (computed without regard to any capital loss carryovers)	$12,000	
Minus capital loss carryovers to Y 1962 (i.e., carryovers of $600 from X 3/31/60 and $5,900 from Y 1959)	6,500	
		5,500
Carryover to Y 1963		0

(iv) *Y Corporation's 1960 loss.* The carryover to 1963 is $5,500, computed as follows:

Net capital loss		$6,000
Less:		
Y's preacquisition part year net capital gain computed under subparagraph (5) of this paragraph	$18,100	
Minus capital loss carryovers to preacquisition part year (i.e., carryover of $24,000 from Y 1959)	24,000	
		0
Carryover to Y's postacquisition part year		6,000
Less:		
Y's postacquisition part year net capital gain computed under subparagraph (5) of this paragraph	$18,400	

Minus capital loss carryovers to postacquisition part year (i.e., carryovers of $19,000 from X 3/31/60, $5,900 from Y 1959, and $5,000 from X 3/31/61) ..	29,900	0
		0
Carryover to Y 1962		6,000
Less:		
Y's 1962 net capital gain (computed without regard to any capital loss carryovers)	$12,000	
Minus capital loss carryovers to Y 1962 (i.e., carryovers of $600 from X 3/31/60, $5,900 from Y 1959, and $5,000 from X 3/31/61)	11,5000	
		$500
Carryover to Y 1963		5,500

(f) *Successive acquiring corporations.* An acquiring corporation which, in a transaction to which section 381(a) applies, acquires the assets of a distributor or transferor corporation which previously acquired the assets of another corporation in a transaction to which section 381(a) applies, shall succeed to and take into account, subject to the conditions and limitations of sections 1212 and 381, the capital loss carryovers available to the first acquiring corporation under sections 1212 and 381.

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§1.381(c)(4)–1 Method of accounting.

(a) *Carryover requirement*—(1) *General rule.* (i) Section 381(c)(4) provides that, in a transaction to which section 381(a) applies, an acquiring corporation shall use the same method of accounting used by the distributor or transferor corporation on the date of distribution or transfer unless different methods of accounting were used on that date by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods of accounting were used, the acquiring corporation shall use the method or combination of methods of accounting adopted pursuant to this section.

(ii) The acquiring corporation shall take into its accounts the dollar balances of those accounts of the distributor or transferor corporation representing items of income or deduction which, because of its method of accounting, were not required or permitted to be included or deducted by the distributor or transferor corporation in computing taxable income for taxable years ending on or before the date of distribution or transfer. The acquiring corporation shall similarly take into its accounts the dollar balances of those accounts of the distributor or transferor corporation which represents reserves in respect of which the distributor or transferor corporation has taken a deduction for taxable years ending on or before the date of distribution or transfer. The acquiring corporation shall also take into its accounts the dollar balance of that account of the distributor or transferor corporation which represents a suspense account established by the distributor or transferor corporation under section 166(f)(4) in taxable years ending on or before the date of distribution or transfer. Items of income and deduction shall have the same character in the hands of the acquiring corporation as they would have had in the hands of the distributor or transferor corporation or corporations if no distribution or transfer had occurred. This section shall have no application to items of income or deduction, or dollar balances, to the extent they are attributable to assets or liabilities not distributed or transferred, and shall have no application to items the tax treatment of which is specifically provided for in other paragraphs of section 381(c). In the case of an obligation of the distributor or transferor corporation which is assumed by the acquiring corporation and which gives rise to a liability (within the meaning of paragraph (a)(4) of §1.381(c)(16)–1) after the date of distribution or transfer, the deductibility of such an item is determined under this section if it is not deductible under section 381(c)(16) and the regulations thereunder. The amount of the adjustments necessary to reflect a change in accounting method pursuant to this section, the manner in which they are to be taken into account, and the tax attributable thereto shall be determined and computed under section 481 and the regulations thereunder, subject to the rules provided in paragraphs (c) and (d) of this section. Where such change is a change from the accrual to the installment method by a dealer in personal property, section 453(c) and the regulations thereunder apply.

(2) *Rules of application.* For purposes of section 381(c)(4) and this section, the term *method of accounting* shall have the same meaning as that provided under section 446 and the regulations thereunder. This section shall not be construed as preventing the exercise of any election which may be made by the acquiring corporation without consent of the Commissioner, or preventing the application of section 269 or 482, or the regulations thereunder. For provisions defining the date of distribution or transfer, see paragraph (b) of § 1.381(b)–1. See other paragraphs of section 381(c) and the regulations thereunder for other rules regarding the treatment of the carryover of certain items specifically enumerated therein.

(b) *Conditions for continuation of methods of accounting*—(1) *No differences in methods of accounting.* If all the parties to a section 381(a) transaction used the same method of accounting on the date of distribution or transfer, the acquiring corporation shall continue to use such method of accounting, unless the acquiring corporation has obtained the consent of the Commissioner in accordance with paragraph (e) of § 1.446–1 to use a different method of accounting. This subparagraph may be illustrated by the following examples:

Example (1). X Corporation and Y Corporation use the accrual method as their overall method of accounting. Both corporations have established a reserve for bad debts under section 166(c). Pursuant to elections made by each corporation, they are amortizing trademark and trade name expenditures over a 60-month period under section 177, expensing intangible drilling and development costs under section 263(c), and accruing real property taxes ratably under section 461(c). It is assumed that there are no other items to which paragraph (a) of this section might apply. Y Corporation acquires all of the assets of X Corporation in a transaction to which section 381(a) applies. On and after the date of distribution or transfer Y Corporation must continue, without further election, to use the same overall method of accounting and the same accounting treatment of the specified items, unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446–1 to change the methods of accounting. Thus, Y Corporation shall carry over the balance in X Corporation's reserve for bad debts account, shall continue to amortize and deduct over the remaining portion of the 60-month period the unamortized portion of the trademark and trade name expenditures carried over from X Corporation, and shall continue the same treatment of intangible drilling and development costs and of real property taxes.

Example (2). M Corporation and N Corporation use the cash receipts and disbursements method of accounting. N Corporation acquires all of the assets and assumes all the obligations of M Corporation in a transaction to which section 381(a) applies. M Corporation, immediately prior to the transaction, is entitled to receive $10,000 for unbilled services performed, and has billed but not received payment for services performed in an amount of $20,000. It has received but not paid invoices amounting to $18,000, and has received services in the amount of $5,000 for which no invoices have been received. Since M Corporation and N Corporation are both on the cash receipts and disbursements method, N Corporation must continue to use that method, unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446–1 to change its method of accounting. Accordingly, N Corporation must include in income when received the unrealized receivables of M Corporation and may deduct the payment of those obligations of M Corporation which would have been deductible by such corporation if paid by it. Thus, N Corporation shall treat as ordinary income the receipt by it of M Corporation's $30,000 of receivables, and may deduct upon payment the amount of M Corporation's $23,000 of payables which would have been deductible by it.

Example (3). S Corporation and T Corporation are both publishers and use the accrual method as their overall method of accounting. Both corporations have elected under section 455 to defer prepaid subscription income to the taxable years during which the liability to furnish the newspaper, magazine, or other periodical exists. T Corporation, in a transaction to which section 381(a) applies, acquires all the assets of S Corporation and assumes the liability of such corporation to furnish or deliver the newspaper, magazine, or other periodical. On and after the date of the transfer, T Corporation must continue, without further election, to use the accrual method as its over-all method of accounting and to defer prepaid subscription income under section 455, unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446–1 to change the method of accounting. T Corporation shall carry over the closing balance of S Corporation's prepaid subscription income account. The principles in this example would be equally applicable if both corporations had been deferring prepaid subscription income under a method permitted by subsection (e) of section 455.

(2) *Separate businesses.* If, after the date of distribution or transfer, the trades or businesses of the parties to a transaction described in section 381(a) are operated as separate and distinct trades or businesses within the meaning of paragraph (d) of §1.446–1, then the method of accounting employed by the parties to the transaction on the date of distribution or transfer with respect to each trade or business shall be used by the acquiring corporation, unless the acquiring corporation has obtained the consent of the Commissioner in accordance with paragraph (e) of §1.446–1 to use a different method of accounting, or unless the Commissioner prescribes a different method of accounting under paragraph (b)(1) of §1.446–1. However, if only a single method of accounting may be employed by a taxpayer with respect to a particular item regardless of the number of separate and distinct trades or businesses operated by such taxpayer, but different methods were employed by the several corporations on the date of distribution or transfer with respect to such item, then the acquiring corporation shall adopt the principal method of accounting determined under paragraph (c) of this section (see subparagraph (2)(iv) thereof) for such item, or the method of accounting determined in accordance with paragraph (d) of this section, whichever is applicable. This subparagraph may be illustrated by the following examples:

Example (1). M Corporation is engaged in a personal service business and uses the cash receipts and disbursements method of accounting. N Corporation is engaged in a retail furniture business and uses the accrual method of accounting. N Corporation acquires the assets of M Corporation in a transaction to which section 381(a) applies. In accordance with paragraph (d) of §1.446–1, N Corporation operates as a separate and distinct trade or business the personal service business formerly operated by M Corporation. Unless consent of the Commissioner is obtained in accordance with paragraph (e) of §1.446–1 to change the method of accounting, N Corporation shall continue to use the cash receipts and disbursements method of accounting with respect to the personal service business formerly operated by M Corporation, and shall use the accrual method of accounting with respect to the retail furniture business.

Example (2). Assume the same facts as in *Example (1)*, except that M Corporation has elected under section 171 to amortize bond premium with respect to fully taxable bonds. N Corporation has not made the election to amortize bond premium with respect to such bonds owned by it. N Corporation may not continue separate accounting methods as to amortizable bond premium but must consistently apply only a single method of accounting with respect to such bond premium since the election to amortize bond premium applies to all fully taxable bonds held by the taxpayer. N Corporation shall use the principal method of accounting determined under paragraph (c) of this section for such bond premium, unless it is determined in accordance with paragraph (d) of this section that a different method of accounting is to be used. However, if such principal or different method of accounting is not to amortize bond premium N Corporation is not precluded from making a new election to the extent permitted by section 171.

(3) *Integrated businesses.* (i) If, after the date of distribution or transfer, any of the trades or business of the parties to a transaction in section 381(a) are not operated as separate and distinct trades or businesses within the meaning of paragraph (d) of §1.446–1, then, to the extent that the same methods of accounting were employed on the date of distribution or transfer by the parties to the transaction with respect to any trades or businesses which are integrated or are required to be integrated in accordance with section 446(d) and the regulations thereunder, the acquiring corporation shall continue to employ such methods of accounting, unless the acquiring corporation has obtained the consent of the Commissioner in accordance with paragraph (e) of §1.446–1 to use a different method of accounting, or unless the Commissioner prescribes a different method of accounting under paragraph (b)(1) of §1.446–1.

(ii) If, after the date of distribution or transfer, any of the trades or businesses of the parties to a transaction described in section 381(a) are not operated as separate and distinct trades or businesses within the meaning of paragraph (d) of §1.446–1, then, to the extent that different methods of accounting were employed on the date of distribution or transfer by the parties to the transaction with respect to any trades or businesses which are integrated or required to be integrated in accordance with section 446(d) and the regulations thereunder, this paragraph shall not apply and the acquiring corporation shall adopt the principal method of accounting determined under paragraph (c) of this section or the method of accounting determined in accordance with paragraph (d) of this section, whichever is applicable.

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

Example (1). M Corporation and N Corporation both use the accrual method as an overall method of accounting. M Corporation has established a reserve for bad debts while N Corporation uses the specific charge-off method with respect to its bad debts. N Corporation acquires all of the assets of M Corporation in a transaction to which section 381(a) applies and integrates the business formerly operated by M Corporation into the business operated by N Corporation before the date of distribution or transfer. N Corporation shall continue to use the accrual method as its overall method of accounting, unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446–1 to change its method of accounting. N Corporation shall use the principal method of accounting determined under paragraph (c) of this section with respect to bad debts, or the method of accounting determined in accordance with paragraph (d) of this section, whichever is applicable.

Example (2). X Corporation conducts two separate and distinct trades or businesses, a personal service business with respect to which the cash receipts and disbursements method of accounting is used and a manufacturing business with respect to which the accrual method of accounting is used. Y Corporation conducts a manufacturing business and uses the accrual method of accounting. Y Corporation acquires all of the assets of X Corporation in a transaction to which section 381(a) applies. After the date of distribution or transfer, Y integrates the manufacturing business formerly operated by X Corporation into the manufacturing business operated by it and continues to operate as a separate and distinct trade or business the personal service business formerly operated by X Corporation. Unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446–1 to change the method of accounting, Y Corporation shall continue to use the accrual method of accounting with respect to the integrated manufacturing business and shall continue to use the cash receipts and disbursements method of accounting with respect to the personal service business.

(4) *Rules of application.* In any case where the method of accounting employed on the date of distribution or transfer is continued, it will be unnecessary for the acquiring corporation to renew any election previously made by it or by any distributor or transferor corporation with respect to such method of accounting. Also, the acquiring corporation is bound by any election previously made by it or by any distributor or transferor corporation with respect to such method of accounting which is in effect on the date of distribution or transfer to the same extent as though the distribution or transfer had not occurred. If, on the date of distribution or transfer, any party to a section 381(a) transaction had no established method of accounting for any item, or came into existence as a result of the transaction, such party shall not be considered to be using a method of accounting for such item or having an overall method of accounting different from that used by the other parties to the transaction. Where under other sections of the Internal Revenue Code or regulations thereunder a taxpayer is permitted to elect a method of accounting on a project-by-project, job-by-job, or other similar basis (such as the election to charge taxes and carrying charges to capital account under § 1.266–1), that method elected with respect to each project or job shall be deemed to be an established method of accounting only for the project or job for which it is elected. Accordingly, unless two or more of the parties were working on the same project or job and were using different methods of accounting for such project or job before the date of distribution or transfer, the method of accounting previously elected for each project or job must be continued.

(c) *Change of method of accounting without consent of Commissioner*—(1) *General rule.* If the acquiring corporation may not continue to use, under the provisions of paragraph (b) of this section, the method of accounting used by it or the distributor or transferor corporation or corporations on the date of distribution or transfer, the acquiring corporation shall use the principal method of accounting of such corporation (as determined under subparagraph (2) of this paragraph), provided that (i) such method of accounting clearly reflects the income of the acquiring corporation, and (ii) the use of such method is not inconsistent with the provisions of any closing agreement entered into under section 7121 and the regulations thereunder. If the principal method of accounting does not meet these requirements, or if there is no principal method of accounting, see subdivision (i) of paragraph (d)(1) of this section. If the acquiring corporation wishes to use a method of accounting other than the principal method of accounting, see subdivision (ii) of paragraph (d)(1) of this section. Whenever this paragraph applies, the increase or decrease in tax resulting from the change from the method of accounting previously used by any of the corporations involved shall be taken into account by the acquiring corporation. The adjustments necessary to reflect such change and such increase or decrease in tax shall be determined and computed in the same manner as if on the date of distribution or transfer each of the several corporations whose method or methods of accounting are required to be changed in accordance with this section had initiated a change in accounting method. In addition, the acquiring corporation shall take into account the portion of such adjustments which is attributable to pre-1954 Code years to the extent not taken into account by any of the other corporations in accordance with the rules provided in section 481(b)(4) and this paragraph. If the principal method of accounting is adopted under this paragraph, it will be unnecessary for the acquiring corporation to renew any election previously made by it or by any distributor or transferor corporation with respect to such principal method of accounting. Also, in such event, the acquiring corporation is bound by any election previously made by it or by any distributor or transferor corporation with respect to such principal method of accounting which is in effect on the date of distribution or transfer to the same extent as though the distribution or transfer had not occurred.

(2) *Principal method of accounting.* (i) The determination of the principal method of accounting shall be made with respect to each integrated trade or business operated by the acquiring corporation immediately after the date of distribution or transfer, except with respect to items for which only a single method of accounting may be used by any one taxpayer. See subdivision (iv) of this subparagraph. Such determination for an integrated trade or business shall be made by reference to the methods of accounting used immediately preceding the date of distribution or transfer by each of the component trades or businesses which now constitute the integrated trade or business of the acquiring corporation. The method of accounting for items other than those for which special methods of accounting are provided under chapter 1 of the Code and the regulations thereunder (see §1.446–1(c)(1)(iii)) shall be governed by the principal overall method determined for such trade or business under subdivision (ii) of this subparagraph. The method of accounting for items for which special methods of accounting are provided under chapter 1 of the Code and the regulations thereunder shall be determined under subdivision (iii) of this subparagraph.

(ii) The principal overall method of accounting of an integrated trade or business is determined by making a comparison of—

(*a*) The total of the adjusted bases of the assets (determined under section 1011 and the regulations thereunder) immediately preceding the date of distribution or transfer, and

(*b*) The gross receipts for a representative period (ordinarily the most recent period of 12 consecutive calendar months ending on or prior to the date of distribution or transfer)

of the component trades or businesses which are integrated or are required to be integrated. If more than one component trade or business used the same overall method, then such total assets and gross receipts of each of the component trades or businesses shall be aggregated and compared with the aggregate of such total assets and gross receipts of other component trades or businesses which used a different overall method. If this comparison shows that the one or more component trades or businesses (using a common overall method of accounting) having the greatest total of the adjusted bases of assets also has the greatest amount of gross receipts, then the overall method of accounting of such one or more component trades or businesses shall be the principal overall method of accounting. If this comparison shows that the one or more component trades or businesses (using a common overall method of accounting) having the greatest total of the adjusted bases of assets does not also have the greatest amount of gross receipts, then there is no principal overall method of accounting, and the acquiring corporation shall request the Commissioner to determine the appropriate overall method of accounting for such integrated trade or business in accordance with paragraph (d) of this section.

(iii) The principal method of accounting for an item for which a special method or methods of accounting are provided under chapter 1 of the Code and the regulations thereunder is determined by comparing the amounts of such item and related accounts for the component trades or businesses in accordance with the principles of subdivision (ii) of this subparagraph. Thus, for example, in the case of bad debts, trades or businesses which are components of the integrated trade or business and which had been using the reserve method of accounting will be compared with the other component trades or businesses which had been using the specific charge-off method of accounting. In such a case, the following factors would ordinarily be used in determining the principal method of accounting for bad debts: (*a*) Sales on account for the most recent period of 12 consecutive calendar months ending on or prior to the date of distribution or transfer, (*b*) accounts receivable immediately before the date of distribution or transfer, and (*c*) the amount of debts which became worthless within the meaning of section 166(a) and the regulations thereunder during the most recent period of 12 consecutive calendar months ending on or prior to the date of distribution or transfer. If this comparison shows that the one or more component trades or businesses using the same method of accounting with respect to bad debts have the greater amounts of such sales, accounts receivable, and bad debts, then the method of accounting with respect to bad debts for such one or more component trades or businesses shall be the principal method of accounting. If such comparison shows that the one or more component trades or businesses using the same method of accounting with respect to bad debts do not have the greater amounts of all of such items, then there is no principal method of accounting with respect to bad debts, and the acquiring corporation shall request the Commissioner to determine the appropriate method of accounting for bad debts for such integrated trade or business in accordance with paragraph (d) of this section.

(iv) If a single method of accounting must be employed by a taxpayer with respect to a particular item regardless of the number of separate and distinct trades or businesses operated by the taxpayer, the principal method of accounting for such item shall be determined by comparing the aggregate amount of the item and related accounts for all the parties to the transaction using a common method, with the aggregate amount of the item and related accounts for those parties to the transaction which use a different common method. The method of accounting of the party having the greatest aggregate amount of such item and related accounts shall be the principal method of accounting for such item.

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

Example (1). M Corporation, which commenced business in 1955, uses the cash receipts and disbursements method of accounting, while N Corporation uses the accrual method. On June 30, 1961, N Corporation acquires all of the assets of M Corporation in a transaction to which section 381(a) applies. N Corporation then integrates its own business with that of M Corporation. Immediately prior to the transfer the total of the adjusted bases of the assets of N Corporation was greater than that of M Corporation, and for the 12-month period ending on June 30, 1961, the gross receipts of N Corporation were greater than that of M Corporation. Under such circumstances, the accrual method of accounting is the principal overall method of accounting and N Corporation shall use such method for the integrated business, provided it clearly reflects income, unless consent of the Commissioner is obtained in accordance with paragraph (d) of this section to use a different method of accounting. Except as to items for which N Corporation had no established method of accounting and items for which a special method of accounting is provided under chapter 1 of the Code and the regulations thereunder, all adjustments necessary to place the accounts of M Corporation on the accrual method shall be made in accordance with section 481. Any increase or decrease in tax resulting from such adjustments shall be taken into account by N Corporation. Such adjustments and such increase or decrease in tax shall be determined and computed in the same manner as if M Corporation had initiated a change in method of accounting on June 30, 1961.

Example (2). Assume the same facts as in *Example (1)* except that the gross receipts of M Corporation were greater than those of N Corporation for the 12-month period ending on June 30, 1961. N Corporation must, under such circumstances, request the Commissioner to determine the appropriate overall method of accounting, in accordance with the provisions of paragraph (d) of this section. The necessary adjustments to be made by the corporation whose method of accounting is changed shall be made in accordance with section 481 to place the integrated business on the method so adopted. Any increase or decrease in tax resulting from such adjustments shall be taken into account by N Corporation. Such adjustments and such increase or decrease in tax shall be determined and computed in the same manner as if the corporation whose method is changed had initiated a change in method of accounting on June 30, 1961.

Example (3). Assume the same facts as in *Example (1).* Assume further that M Corporation's deduction for wages and salaries for the 12 calendar months ending on June 30, 1961, is larger than N Corporation's deduction for wages and salaries for such period. Since wages and salaries is not an item for which a special method of accounting is provided under chapter 1 of the Code or the regulations thereunder, the necessary adjustments shall be made in accordance with section 481 to place the wages and salary account of M Corporation on the accrual method of accounting, provided such accrual method clearly reflects income, unless consent of the Commissioner is obtained in accordance with paragraph (d) of this section to use a different method of accounting. Any increase or decrease in tax resulting from such adjustments shall be taken into account by N Corporation. Such adjustments and such increase or decrease in tax shall be determined and computed in the same manner as if M Corporation had initiated a change in method of accounting on June 30, 1961.

Example (4). Assume the same facts as in *Example (1).* Assume further that M Corporation used the specific charge-off method with respect to bad debts, and that N Corporation has established a reserve for bad debts. M Corporation's sales on account and bad debts for the 12 calendar months ending June 30, 1961, were larger than those of N Corporation. Also M Corporation's accounts receivable immediately prior to June 30, 1961, were larger than those of N Corporation. Since the method of accounting for bad debts is a special method of accounting under section 166, M Corporation's method of accounting for bad debts is the principal method of accounting for such item. Assuming such method clearly reflects income, appropriate adjustments shall be made in accordance with section 481 to the accounts of N Corporation to place N Corporation on the specific charge-off method with respect to all of its bad debts, as if N Corporation had initiated a change in method of accounting on June 30, 1961, and N Corporation shall include the amount of its reserve for bad debts in gross income, unless consent of the Commissioner is obtained in accordance with paragraph (d) of this section to use a different method of accounting.

Example (5). Assume the same facts as in *Example (1)* except that M Corporation commenced business in 1945. In addition assume that N Corporation is a calendar-year taxpayer and that of the total amount of the adjustments required by section 481 to place the accounts of M Corporation on the accrual method $40,000 is attributable to pre-1954 Code years as described in section 481(b)(4) and the regulations thereunder. Assume further that M Corporation does not elect, under section 481(b)(6), to take the $40,000 portion of the adjustments into account in the manner described in section 481(b)(1) or (2). In computing the increase in tax of M Corporation attributable to the $40,000 portion of the adjustment for the fiscal year ended June 30, 1961, only one-tenth, or $4,000, will be taken into account. The resulting increase in tax shall be taken into account by N Corporation. The remaining nine-tenths of the $40,000 portion of the adjustments, or $36,000, shall be taken into account by N Corporation in the amount of $4,000 in each of the calender years 1962 through 1970.

(d) *Change of method of accounting with consent of Commissioner*—(1) *General rule.* (i) If the acquiring corporation may not continue to use, under paragraph (b), the method of accounting used by it or the distributor or transferor corporation or corporations on the date of distribution or transfer, and may not under paragraph (c) use the principal method of accounting, or, if there is no principal method of accounting, then the Commissioner shall determine the appropriate method or combination of methods of accounting to be used.

(ii) If an acquiring corporation wishes to use a method or combination of methods of accounting other than the principal method of accounting which is required to be used by paragraph (c) of this section, it shall apply to the Commissioner for permission to use such other method or combination of methods of accounting. Permission to use such other method or combination of methods of accounting will not be granted unless the acquiring corporation and the Commissioner agree to the terms, conditions, and adjustments under which the change to such method or combination of methods will be effected.

(iii) The increase or decrease in tax resulting from the change from the method of accounting previously used by any of the corporations involved shall be taken into account by the acquiring corporation. The adjustments necessary to reflect such change and such increase or decrease in tax shall be determined and computed in the same manner as if, on the date of distribution or transfer, each of the several corporations that were not using the method or combination of methods of accounting adopted pursuant to subdivision (i) or (ii) of this subparagraph had initiated a change in accounting method.

(2) *Time and manner of making application.* Applications under subparagraph (1) of this paragraph for permission to use a method of accounting or requests for determination of the method of accounting to be used shall be filed with the Commissioner of Internal Revenue, Attention: T:R, Washington, DC, 20224, not later than 90 days after the date of distribution or transfer, except that in cases where the date of distribution or transfer occurs before August 5, 1964, such applications or requests shall be filed not later than November 3, 1964. The application shall be accompanied by a copy of the statement described in paragraph (b)(3) of § 1.381(b)–1, and by a statement specifying the nature of the transaction which causes section 381 to apply; the difference in accounting methods used by the corporations concerned; the method or methods of accounting proposed to be used by the acquiring corporation; and the various amounts, if any, of items of income or deduction which will be duplicated or omitted in the computation of taxable income under such proposed method or methods. The Commissioner may also require such other information as may be necessary in order to determine the appropriate method or combination of methods of accounting to be used by the acquiring corporation.

(e) *Special rules applicable to distributions or transfers before August 5, 1964*—(1) *Statute of limitations bars assessment or refund.* If the date of distribution or transfer was before August 5, 1964, and if the assessment of any deficiency or the refund or credit of any overpayment for the taxable year of the acquiring corporation which includes the date of distribution or transfer or any subsequent taxable year is prevented by the operation of any law or rule of law, then this section does not authorize the Commissioner or the acquiring corporation to change any method or methods of accounting in any taxable year of the acquiring corporation. However, the Commissioner or the acquiring corporation may change such method or methods of accounting under the provisions of section 446 and the regulations thereunder or, where applicable, any section of the Internal Revenue Code (other than section 381(c)(4)), or the regulations thereunder, in accordance with which such changes may be made without the consent of the Commissioner.

(2) *Statute of limitations does not bar assessment and refund.* Except as provided in subparagraph (1) of this paragraph—

(i) If the date of distribution or transfer was before August 5, 1964, and the acquiring corporation has, for the taxable year which includes the date of distribution or transfer, (*a*) adopted or continued a method of accounting consistent with the rules of this section, (*b*) been granted permission by the Commissioner in accordance with paragraph (e) of § 1.446–1 to use a method or combination of methods of accounting, or (*c*) adopted a method of accounting that under other sections of the Internal Revenue Code, or regulations thereunder, may be adopted without the consent of the Commissioner, then the method or methods of accounting adopted or continued in the manner described in (*a*), (*b*), and (*c*) shall not be changed, by reason of the rules contained in this section, by the Commissioner or the acquiring corporation for any taxable year ending after the date of distribution or transfer. However, the Commissioner or the acquiring corporation may change such methods of accounting for any such taxable year under the provisions of, and to the extent permitted by, section 446 and the regulations thereunder or, where applicable, any section of the Internal Revenue Code (other than section 381(c)(4)), or regulations thereunder, in accordance with which such change may be made without the consent of the Commissioner.

(ii) If the date of distribution or transfer was before August 5, 1964, and the acquiring corporation has, for the taxable year which includes the date of distribution or transfer, adopted or continued a method or methods of accounting other than in the manner described in (*a*), (*b*), and (*c*) of subdivision (i) of this subparagraph, then the acquiring corporation may—

(*a*) Continue to use the method or methods of accounting so adopted or continued if such method or methods clearly reflect income and if proper adjustments were made to reflect the adoption of such method or methods, or

(*b*) Adopt the method or methods of accounting prescribed by this section. Such method or methods of accounting shall be adopted by filing an amended return (which includes the proper adjustments required by this section) for the taxable year of the acquiring corporation which includes the date of distribution or transfer, and by filing amended returns for all subsequent taxable years of the acquiring corporation for which returns have previously been filed. Such amended return or returns shall be accompanied by a copy of the statement described in paragraph (b)(3) of §1.381(b)–1, and by a statement specifying the nature of the transaction which causes section 381 to apply; the difference in accounting methods used by the corporations concerned; the method or methods of accounting originally adopted by the acquiring corporation; the method or methods of accounting adopted on the amended return or returns; and the computation of the amount of the adjustments and the resulting increase or decrease in tax.

[T.D. 6750, 29 FR 11263, Aug. 5, 1964, as amended by T.D. 8071, 51 FR 2481, Jan. 17, 1986]

§1.381(c)(5)–1 Inventories.

(a) *Carryover requirement*—(1) *General rule.* Section 381(c)(5) provides that in a transaction to which section 381(a) applies and in which inventories are received by the acquiring corporation (as defined in §1.381(a)–1(b)(2)) such inventories shall be taken by the acquiring corporation (in determining its income) on the same basis on which such inventories were taken by the distributor or transferor corporation on the date of distribution or transfer unless different inventory methods were used on that date by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of taking inventories adopted pursuant to the provisions of this section.

(2) *Rules of application.* Reference in this section to a method or methods of taking inventories are to be construed as referring to both the method or methods of identifying the goods and the method or methods of valuing the goods. The method or methods of taking inventories shall be determined on the date of distribution or transfer, and any corporation, a party to a section 381(a) transaction whose taxable year does not end on such date shall be considered as using the method or methods of taking inventories that it would have employed had its taxable year ended on such date. The amount of the adjustments necessary to reflect the change in method of taking inventories pursuant to this section, the manner in which they are to be taken into account by the acquiring corporation, and the tax attributable thereto shall

be determined and computed under section 481 and the regulations thereunder, subject to the rules provided in paragraphs (c) and (d) of this section. However, in the case of any party to a section 381(a) transaction which changes its method of taking inventories to the last-in, first-out method of identification, the adjustments required by section 472(d) shall be applicable. See paragraph (e) of this section. This section shall not be construed as preventing any party to a section 381(a) transaction from adopting an inventory method which, under the provisions of section 471 or 472, and the regulations thereunder, may be adopted without the consent of the Commissioner. For provisions defining the date of distribution or transfer, see paragraph (b) of § 1.381(b)–1.

(b) *Conditions for continuation of methods of taking inventories*—(1) *No difference in method of taking inventories.* (i) If all the parties to a section 381(a) transaction used the same method of taking inventories on the date of distribution or transfer, the acquiring corporation, whether or not immediately after the date of distribution or transfer it operates separate or integrated trades or businesses, shall continue to use such method of taking inventories, unless the acquiring corporation has, in accordance with paragraph (e) of § 1.446–1, obtained the consent of the Commissioner to use a different method of taking inventories. For purposes of this determination, a corporation shall be deemed to be using the last-in, first-out method of taking inventories with respect to a particular type of goods on the date of the distribution or transfer, if such corporation elects, under the provisions of section 472, to adopt the last-in, first-out method with respect to such goods for its taxable year within which or with which the date of distribution or transfer occurs.

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

Example. O and P corporations are manufacturing companies which compute their entire inventories by the use of the last-in, first-out method of identification and the cost basis of valuation. In applying the last-in, first-out method both corporations use the dollar-value method, use the double-extension method, pool under the natural business unit method, and value annual inventory increases by reference to the actual cost of goods most recently purchased. P corporation acquires the assets of O corporation in a transaction to which section 381(a) applies. Under the provisions of this subparagraph, on and after the date of distribution or transfer P corporation must continue to use the last-in, first-out method of identification, the cost basis of valuation, and, in applying the last-in, first-out method, must continue to use the dollar-value method, use the double-extension method, pool under the natural business unit method, and value annual inventory increases by reference to the actual cost of goods most recently purchased, unless, in accordance with paragraph (e) of § 1.446–1, consent of the Commissioner is obtained to change the method of taking inventories.

(2) *Separate businesses.* (i) If, immediately after the date of distribution or transfer, any of the trades or businesses of the parties to a section 381(a) transaction are operated as separate and distinct trades or businesses within the meaning of paragraph (d) of § 1.446–1, then the method or methods of taking inventories employed by such parties to the transaction on the date of distribution or transfer with respect to such trades or businesses shall be used by the acquiring corporation, unless the acquiring corporation has, in accordance with paragraph (e) of § 1.446–1, obtained the consent of the Commissioner to use a different method of taking inventories. This subparagraph shall not be construed as precluding the Commissioner under section 471 or 472, and the regulations thereunder, from requiring that the method of taking inventories used in a particular trade or business be used in another trade or business with respect to similar types of goods, if, in the opinion of the Commissioner, the use of such method of taking inventories is necessary for a clear reflection of income.

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

Example. R Corporation is engaged in the production of radios and television sets and S Corporation is engaged in the production of washers and driers. In computing their inventories both corporations use the cost basis of valuation. R corporation uses the last-in, first-out method of identification, whereas S corporation uses the first-in, first-out method. T corporation acquires the assets of R corporation and S corporation in a transaction to which section 381(a) applies. T corporation operates as a separate and distinct trade or business, within the meaning of paragraph (d) of §1.446–1, each of the businesses formerly operated by R corporation and S corporation. Under the provisions of this subparagraph, T corporation is required to continue to use the method of taking inventories previously used by R corporation and S corporation, respectively, with respect to each trade or business, unless, in accordance with paragraph (e) of §1.446–1, consent of the Commissioner is obtained to change the methods of taking inventories, on and after the dates of transfer. However, the Commissioner may require T corporation, in accordance with §1.472–2, to use the last-in, first-out method with respect to that portion of the goods in the trades or businesses formerly operated by S corporation and T corporation which are similar to goods in the trade or business formerly operated by R corporation, if, in his opinion, the use of the last-in, first-out method with respect to such similar goods is necessary for a clear reflection of income.

(3) *Integrated businesses*—(i) *Same inventory method.* If, immediately after the date of distribution or transfer, any of the trades or businesses of the parties to a section 381(a) transaction are not operated as separate and distinct trades or businesses within the meaning of paragraph (d) of §1.446–1, then, to the extent that the same methods of taking inventories for particular types of goods were employed on the date of distribution or transfer by the parties to the transaction with respect to any trades or businesses which are integrated or are required to be integrated in accordance with paragraph (d) of §1.446–1, the acquiring corporation shall continue to employ such methods of taking inventories for such types of goods, unless, in accordance with paragraph (e) of §1.446–1, the acquiring corporation has obtained the consent of the Commissioner to use a different method of taking inventories. This subdivision shall not be construed as precluding the Commissioner under section 471 or 472, and the regulations thereunder, from requiring that the method of taking inventories used with respect to particular types of goods in a particular trade or business operated by the acquiring corporation after the date of distribution or transfer be used with respect to similar types of goods in another trade or business operated by it after such date if, in the opinion of the Commissioner, the use of such method of taking inventories is necessary for a clear reflection of income.

(ii) *Different inventory methods.* If, immediately after the date of distribution or transfer, any of the trades or businesses of the parties to a section 381(a) transaction are not operated as separate and distinct trades or businesses within the meaning of paragraph (d) of §1.446–1, then, to the extent that different methods of taking inventories for particular types of goods were employed on the date of distribution or transfer by the parties to the transaction with respect to any trades or businesses which are integrated or required to be integrated in accordance with paragraph (d) of §1.446–1, the acquiring corporation shall not be permitted to continue to use such different methods of taking inventories, and shall adopt the method of taking inventories described in paragraph (c) of this section for such types of goods unless, in accordance with paragraph (d) of this section, consent of the Commissioner is obtained to use a different method of taking inventories.

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

Example (1). O and P corporations are manufacturing companies which compute their entire inventories by the use of the last-in, first-out method of identification and the cost basis of valuation. In applying the last-in, first-out method both corporations use the dollar-value method and the double-extension method. However, O corporation pools under the natural business unit method while P corporation pools under the multiple pool method. In addition, O corporation determines the cost of its annual inventory increase by reference to the actual cost of goods most recently purchased, whereas P corporation determines the cost of such increase by reference to the actual cost of the goods purchased during the taxable year in the order of acquisition. P corporation acquires the assets of O corporation in a transaction to which section 381(a) applies and integrates the business formerly operated by O corporation into the business which was operated by P corporation before the date of distribution or transfer. Under the provisions of subdivision (i) of this subparagraph (relating to the same inventory methods in an integrated trade or business), P corporation shall continue to use the last-in, first-out method of identification, the cost basis of valuation, and in applying the last-in, first-out method, shall continue to use the dollar-value method and the double-extension method, unless, in accordance with paragraph (e) of § 1.446–1, consent of the Commissioner is obtained to change the method of taking inventories. However, under the provisions of subdivision (ii) of this subparagraph (relating to different inventory methods in an integrated trade or business), P corporation shall use the method of taking inventories described in paragraph (c) of this section with respect to the method of pooling and the method of determining the cost of annual inventory increases, unless, in accordance with paragraph (d) of this section, consent of the Commissioner is obtained to use a different method of taking inventories.

Example (2). Y and Z corporations are engaged in the manufacture of cereal products. Y corporation uses the first-in, first-out method of identification and the cost or market, whichever is lower, method of valuing its inventories, including oats. Z corporation uses the first-in, first-out method of identification and the cost or market, whichever is lower, method of valuing its inventories, except oats which are valued on the cost method. Y corporation acquires all of the assets of Z corporation in a transaction to which section 381(a) applies and integrates the business formerly operated by Z corporation into the business which was operated by Y corporation before the date of distribution or transfer. Under the provisions of subdivision (i) of this subparagraph (relating to the same inventory methods in an integrated trade or business), Y corporation must continue to use the first-in, first-out method with respect to all of its inventories and must continue to use the cost or market, whichever is lower, method of valuing all inventories except oats, unless, in accordance with paragraph (e) of § 1.446–1, consent of the Commissioner is obtained to change the method of taking inventories. In addition, under the provisions of subdivision (ii) of this subparagraph (relating to different inventory methods in an integrated trade or business), Y corporation shall use the method described in paragraph (c) of this section in valuing its inventory of oats, unless, in accordance with paragraph (d) of this section, consent of the Commissioner is obtained to use a different method of valuing its oats.

(4) *Rules of application.* (i) In any case where the method of taking inventories employed on the date of distribution or transfer is continued, it will be unnecessary for the acquiring corporation to renew any election previously made by it or by any distributor or transferor corporation with respect to such method of taking inventories, and the acquiring corporation is bound by any such elections. If, on the date of distribution or transfer, any party to a section 381(a) transaction had no inventories of a particular type of goods, or such party came into existence as a result of the transaction, such party shall not be considered to be using a method of taking inventories for the particular type of goods different from that used by the other parties to the transaction. If, on the date of distribution or transfer, any one of the parties to the transaction is using the cash receipts and disbursements method of accounting and is not required to take inventories, the determination as to whether such method of accounting is to be continued by the acquiring corporation shall be made in accordance with section 381(c)(4) and the regulations thereunder.

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

Example (1). M corporation is engaged in manufacturing and computes its inventories under the first-in, first-out method of identification and the cost or market, whichever is lower, method of valuation. N corporation is also engaged in manufacturing and computes its inventories under the first-in, first-out method of identification and the cost method of valuation. M corporation acquires the assets of N corporation in a transaction to which section 381(a) applies and M corporation integrates the business formerly operated by N corporation into the business which was operated by M corporation before the date of distribution or transfer. On the date of distribution or transfer, N corporation has inventories of sheet steel while M corporation has no inventories of this particular type of goods. In all other respects the inventories of the two corporations consist of similar types of goods. Under the provisions of this subparagraph, M corporation must use the first-in, first-out method of identification and the cost method of valuation of inventories of sheet steel, unless, in accordance with paragraph (e) of § 1.446–1, consent of the Commissioner is obtained to change the method of taking such inventories. For other goods in its inventories M corporation must use the first-in, first-out method of identification (as required by subparagraph (3)(i) of this paragraph), and with respect to the method of valuation, must use the method of taking inventories described in paragraph (c) of this section, unless, in accordance with paragraph (d) of this section, consent of the Commissioner is obtained to use a different method of taking inventories.

Example (2). W corporation is engaged in the business of raising cattle and uses the cash receipts and disbursements method of computing taxable income. Inventories, therefore, are not required. X corporation is also engaged in the business of raising cattle and uses the accrual method of computing taxable income under which it has elected to use the ''farm-price method'' of valuing inventories. The assets of W corporation are acquired by X corporation in a transaction to which section 381(a) applies and X corporation integrates the business formerly operated by W corporation into the business which was operated by X corporation before the date of distribution or transfer. Under the provisions of this subparagraph, whether X corporation is required to take inventories will depend upon which method of accounting is used by X corporation after the date of distribution or transfer, in accordance with the provisions of section 381(c)(4) and the regulations thereunder. Therefore, if X corporation uses the cash receipts and disbursements method, it will not be required to take inventories into account in computing its taxable income. However, if X corporation uses the accrual method, it must use the ''farm-price method'' of taking inventories, unless, in accordance with paragraph (d) of this section, consent of the Commissioner is obtained to use a different method of taking inventories.

(c) *Change of method of taking inventories without consent of Commissioner*—(1) *General rule.* If, under the provisions of paragraph (b) of this section, the acquiring corporation is not permitted to continue to use the method of taking inventories used by it or by the distributor or transferor corporation or corporations on the date of distribution or transfer, the acquiring corporation shall use the principal method of taking inventories for each particular type of goods of such corporations, as determined under subparagraph (2) of this paragraph: *Provided,* That:

(i) Such method clearly reflects the income of the acquiring corporation after the distribution or transfer as provided by sections 446(a) and 471 and the regulations thereunder, and

(ii) The use of such method is not inconsistent with the provisions of any closing agreement entered into under section 7121 and the regulations thereunder.

If the principal method does not satisfy the requirements of subdivisions (i) and (ii) of this subparagraph, or if the acquiring corporation wishes to use a method other than the principal method, see paragraph (d)(1) of this section. If the principal method of taking inventories is adopted under this paragraph, it will not be necessary for the acquiring corporation or corporations to renew any election previously made by it or by the distributor or transferor corporation with respect to such principal method of taking inventories, and the acquiring corporation is bound by any such election.

(2) *Principal method of taking inventories.* The determination of the principal method of taking inventories shall be made with respect to each particular type of goods of each integrated trade or business operated by the acquiring corporation immediately after the date of distribution or transfer. Such determination for each integrated trade or business shall be made by reference to the methods of taking inventories previously used in the component trades or businesses for such types of goods which constitute the subsequent integrated trade or business of the acquiring corporation. For purposes of this determination, a corporation shall be deemed to be using the last-in, first-out method of taking inventories with respect to a particular type of goods on the date of the distribution or transfer, if such corporation elects, under the provisions of section 472, to adopt the last-in, first-out method with respect to such goods for its taxable year within which or with which the date of distribution or transfer occurs. The fair market value of the particular types of goods of each group of component trades or businesses with respect to which one method of taking inventories common to all was employed shall be compared with the fair market value of comparable types of goods of other groups of component trades or businesses with respect to which another method of taking inventories common to all was employed. For purposes of the above comparison and to the extent that particular types of goods are included in inventory by grouping or pooling, then such group or pool shall be considered as a single unit. The total fair market value of such group or pool shall be the basis

for comparison in determining the principal method of taking inventories. The method of taking inventories of the group of component trades or businesses having the largest fair market value of such inventories shall be the principal method of taking inventories. For purposes of this subparagraph, the fair market value of the inventories of a component trade or business shall be determined immediately after the date of distribution or transfer.

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

Example (1). (i) X, Y, and Z corporations are all engaged in the manufacture of sheet metal. In addition, Y and Z corporations are engaged in the manufacture of paper containers. X and Y corporations use the first-in, first-out method of identifying goods and the cost method of valuing all inventories, while Z corporation uses the first-in, first-out method of identifying goods and the cost or market, whichever is lower, method of valuing all inventories. X, Y, and Z corporations enter into a transaction to which section 381(a) applies, and the acquiring corporation integrates the sheet metal businesses formerly operated by X, Y, and Z corporations and also integrates the paper container businesses formerly operated by Y and Z corporations. Each corporation has the same types of goods in the inventories of its sheet metal business and Y and Z corporations have the same types of goods in the inventories of their paper container businesses. Immediately after the date of distribution or transfer the fair market values of the respective inventories are as follows:

	X	Y	Z
Sheet metal	$10,000	$7,000	$15,000
Paper container	....	6,000	7,000

(ii) Since X, Y, and Z corporations all used the first-in, first-out method of identifying their inventories as of the date of distribution or transfer, then, under the provisions of paragraph (b)(3)(i) of this section, the acquiring corporation shall continue to use the first-in, first-out method of identifying all goods unless, in accordance with paragraph (e) of § 1.446–1, consent of the Commissioner is obtained to change the method of accounting.

(iii) Since the acquired corporations used different methods of valuing inventories in their sheet metal business and their paper container business, when the businesses were integrated the acquiring corporation must, under the provisions of this paragraph, determine which method of inventory valuation used by the acquired corporations on the date of distribution or transfer is the principal method of inventory valuation for each of such businesses.

(*a*) In determining which is the principal method of valuing inventories for the sheet metal business pursuant to subparagraph (2) of this paragraph, the total fair market value of the sheet metal inventories of X and Y corporations, $17,000 (i.e., $10,000 +$7,000=$17,000), is compared with the fair market value of the sheet metal inventory of Z corporation, $15,000. Since the total fair market value of the sheet metal inventories of X and Y corporations ($17,000) exceeds the fair market value of the sheet metal inventory of Z corporation ($15,000), the cost method of valuation used by X and Y corporations is the principal method of taking such inventories, and must be used by the acquiring corporation in valuing such inventories, if the conditions set forth in subparagraph (1) of this paragraph are satisfied.

(*b*) In determining which is the principal method of valuing inventories for the paper container business pursuant to subparagraph (2) of this paragraph, the fair market value of the paper container inventory of Y corporation ($6,000) is compared with the fair market value of the paper container inventory of Z corporation ($7,000). Since the fair market value of the paper container inventory of Z corporation ($7,000) exceeds the fair market value of the paper container inventory of Y corporation ($6,000), the cost or market, whichever is lower, method of valuation used by Z corporation is the principal method of taking such inventories, and must be used by the acquiring corporation in valuing such inventories, if the conditions set forth in subparagraph (1) of this paragraph are satisfied.

Example (2). (i) X, Y, and Z corporations are all engaged in the manufacture of electrical appliances. In addition, X and Z corporations are engaged in the manufacture of plastic containers. X corporation uses the first-in, first-out method of identifying goods and the cost method of valuing all inventories. Y and Z corporations use the last-in, first-out method of identifying goods and the cost method of valuing all inventories. In applying the last-in, first-out method, Y corporation uses the dollar value method, the double-extension method, and pools under the natural business unit method, while Z corporation uses the dollar value method, the double-extension method, and pools under the multiple pooling method for all inventories. X, Y, and Z corporations enter into a transaction to which section 381(a) applies, and the acquiring corporation integrates the electric appliance businesses formerly operated by X, Y, and Z corporations and also integrates the plastic container businesses formerly operated by X and Z corporations. Each corporation has the same types of goods in the inventories of its electric appliance business and X and Z corporations have the same types of goods in the inventories of their plastic container businesses. Immediately after the date of distribution or transfer, the fair market values of the respective inventories are as follows:

	X	Y	Z
Electric appliance	$13,000	$10,000	$5,000
Plastic container	7,000	....	6,000

(ii) Since X, Y, and Z corporations all used the cost method of valuing their inventories as of the date of distribution or transfer, then, under the provisions of paragraph (b)(3)(i) of this section, the acquiring corporation shall continue to use the cost method of valuing all goods unless, in accordance with paragraph (e) of §1.446–1, consent of the Commissioner is obtained to change the method of accounting.

(iii) Since the acquired corporations used different methods of identifying inventories in their electric appliance business and their plastic container business, when the businesses were integrated the acquiring corporation must, under the provisions of this paragraph, determine which method of inventory identification used by the acquired corporations on the date of distribution or transfer is the principal method of inventory identification for each of such businesses.

(*a*)(*1*) In determining which is the principal method of identifying inventories for the electric appliance business pursuant to subparagraph (2) of this paragraph, the fair market value of the electric appliance inventory of X corporation, $13,000, is compared with the total fair market value of the electric appliance inventories of Y and Z corporations, $15,000 (i.e., $10,000+$5,000 =$15,000). Since the total fair market value of the electric appliance inventories of Y and Z corporations ($15,000) exceeds the fair market value of the electric appliance inventory of X corporation ($13,000), the last-in, first-out method of identification is the principal method of taking the electric appliance inventories and must be used by the acquiring corporation, if the conditions set forth in subparagraph (1) of this paragraph are satisfied.

(*2*) Since Y and Z corporations used different pooling methods, in applying the last-in, first-out method, the acquiring corporation must, under the provisions of this paragraph, determine which pooling method as used by Y and Z corporations on the date of distribution or transfer is the principal method. In making such determination pursuant to subparagraph (2) of this paragraph, the fair market value of the electric appliance inventory of Y corporation ($10,000) is compared with the fair market value of the electric appliance inventory of Z corporation ($5,000). Since the fair market value of the electric appliance inventory of Y corporation ($10,000) exceeds the fair market value of the electric appliance inventory of Z corporation ($5,000), the natural business unit method is the principal method of pooling and must be used by the acquiring corporation in applying the last-in, first-out method with respect to the electric appliance business, if the conditions set forth in subparagraph (1) of this paragraph are satisfied.

In addition, under the provisions of paragraph (b)(3)(i) of this section, the acquiring corporation must use the dollar value method and the double-extension method for valuing goods in its electric appliance inventory since Y and Z corporations both used such methods in valuing their electric appliance inventories as of the date of distribution or transfer, unless, in accordance with paragraph (e) of §1.446–1, consent of the Commissioner is obtained to change the method of accounting.

(*b*) In determining which is the principal method of identifying inventories for the plastic container business pursuant to subparagraph (2) of this paragraph, the fair market value of the plastic container inventory of X corporation ($7,000) is compared with the fair market value of the plastic container inventory of Z corporation ($6,000). Since the fair market value of the plastic container inventory of X corporation. ($7,000) exceeds the fair market value of the plastic container inventory of Z corporation ($6,000) the first-in, first-out method of identification, as used by X corporation, is the principal method of taking the plastic container inventories and must be used by the acquiring corporation, if the conditions set forth in subparagraph (1) of this paragraph are satisfied.

(d) *Change of method of taking inventories with consent of the Commissioner*—(1) *General rule*—(i) *Carryover and principal method not permitted.* If the acquiring corporation is not permitted, under paragraph (b) of this section, to continue to use the method of taking inventories used by it or the distributor or transferor corporation or corporations on the date of distribution or transfer, and is not permitted, under paragraph (c) of this section, to use the principal method of taking inventories, then such acquiring corporation must request the Commissioner to determine the appropriate method of taking inventories.

(ii) *Principal method required.* If the acquiring corporation wishes to use a method of taking inventories other than the principal method of taking inventories which is required to be used under paragraph (c) of this section, it shall apply to the Commissioner for permission to use such other method of taking inventories. Permission to use such other method of taking inventories will not be granted unless the acquiring corporation and the Commissioner agree to the terms, conditions, and adjustments under which the change to such method will be effected.

(2) *Time and manner of making application.* Request for a determination of the method of taking inventories to be used under subparagraph (1)(i) of this paragraph or applications for permission to use a method of taking inventories under subparagraph (1)(ii) of this paragraph shall be filed with the Commissioner of Internal Revenue, Attention: T:I:C, Washington, DC 20224, not later than 90 days after the date of distribution or transfer, except that in cases where the date of distribution or transfer occurs before January 15, 1975, such applications or requests shall be filed not later than 90 days after such date. The application shall be accompanied by a copy of the statement described in paragraph (b)(3) of § 1.381(b)–1, and by a statement specifying the nature of the transaction which causes section 381 to apply; the differences in methods of taking inventories used by the corporations concerned; the method of taking inventories proposed to be used by the acquiring corporations; and the amount of adjustments necessary to prevent duplication or omission of items in the computation of taxable income under such proposed method. The Commissioner may also require such other information as may be necessary in order to determine the proper method of taking inventories to be used by the acquiring corporation.

(e) *Treatment of layers of inventories by the acquiring corporation and rules for making adjustments*—(1) *In general.* This paragraph provides rules for treating layers of inventories by the acquiring corporation and rules for making adjustments, once the acquiring corporation's method of taking inventories for its taxable year including the date of distribution or transfer has been determined in accordance with the rules set forth in paragraphs (a) through (d) of this section. Thus, for example, if the acquiring corporation uses the last-in, first-out method of taking inventories for its taxable year including the date of distribution or transfer, either because such corporation elects the last-in, first-out method of taking inventories under the provisions of section 472 for such year or because such method is otherwise determined to be the principal method of taking inventories under paragraph (c)(2) of this section, then such corporation shall integrate its layers of inventories and make the necessary adjustments in accordance with the rules under paragraph (e)(2) of this section.

(2) *Acquiring corporation uses last-in, first-out method*—(i) *Dollar-value method—(a) Distributor or transferor corporation using last-in, first-out method.* In any case where the acquiring corporation is required or permitted to use the dollar value method of pricing inventories on the last-in, first-out method for its taxable year including the date of distribution or transfer, the inventories of each distributor or transferor corporation which used the last-in, first-out method for its taxable year in which the distribution or transfer occurred shall be placed on the dollar value method pursuant to the rules contained in paragraph (f) of § 1.472–8, and then such inventories shall be integrated with the inventories of the acquiring corporation. If pools of each corporation are permitted or required to be combined, they shall be combined in accordance with the principles set forth in paragraph (g)(2) of § 1.472–8. For purposes of combining pools, all base-year inventories or layers of increment which occur in taxable years including the same December 31 shall be combined. A base-year inventory or layer of increment occurring in any short taxable year not including a December 31 or in the final taxable year of a distributor or transferor corporation shall be merged with and considered a layer of increment of its immediately preceding taxable year.

(*b*) *Distributor or transferor corporation not using last-in, first-out method.* In any case where the acquiring corporation is required or permitted to use the last-in, first-out method of taking inventories for its taxable year including the date of distribution or transfer, the inventories of each distributor or transferor corporation which did not use the last-in, first-out method for its taxable year in which the distribution or transfer occurred shall be treated by the acquiring corporation as having been acquired at their average unit cost in a single transaction on the date of distribution or transfer. Thus, where the acquiring corporation is required or permitted to use the dollar value method of pricing inventories, if an item of inventory is to be combined in an existing dollar value pool, such item shall be treated as if it were purchased at its average unit cost on the date of distribution or transfer with respect to such pool. On the other hand, if such item is not to be combined in an existing pool and the taxpayer otherwise uses LIFO with respect to such item, such item will be treated as if it were purchased at its average unit cost on the date of distribution or transfer with respect to a new pool (if any), with the base-year being the year of distribution or transfer. Adjustments resulting from a restoration to cost of any write-down to market value of such inventories of a distributor or transferor corporation shall be taken into account by such corporation in its final taxable year (where such year is closed by reason of section 381(b)). See section 472(d).

(ii) *Specific goods method—(a) Distributor or transferor corporation using last-in, first-out method.* In any case where the acquiring corporation is required or permitted to use the specific goods method of pricing inventories on the last-in, first-out method for its taxable year including the date of distribution or transfer, the inventories of each distributor or transferor corporation which used the last-in, first-out method for its taxable year in which the distribution or transfer occurred shall be treated by the acquiring corporation as having the acquisition dates and costs of the distributor or transferor corporation.

(*b*) *Distributor or transferor not using last-in, first-out method.* See paragraph (e)(1)(i)(*b*) of this section.

(3) *Acquiring corporation uses first-in, first-out method*—(i) *Distributor or transferor corporations not using first-in, first-out method.* In any case where the acquiring corporation is permitted or required to use the first-in, first-out method of taking inventories for its taxable year including the date of distribution or transfer, the inventories of each distributor or transferor corporation which did not use the first-in, first-out method shall be treated by the acquiring corporation as having the same acquisition dates and costs which such inventory would have had if the distributor or transferor corporation had been using the first-in, first-out method for its taxable year in which the distribution or transfer occurred. However, if the acquiring corporation values its inventories at cost or market, whichever is lower, then the acquired inventories shall be treated as having been acquired at cost or market, whichever is lower.

(ii) *Distributor or transferor corporation using first-in, first-out method.* In any case where the acquiring corporation is required or permitted to use the first-in, first-out method of taking inventories for its taxable year including the date of distribution or transfer, the inventories of each distributor or transferor corporation which used such method for its taxable year in which the distribution or transfer occurred shall be treated by the acquiring corporation as having the same acquisition dates and costs as the distributor or transferor corporations. However, where the acquiring corporation values its inventories at cost or market, whichever is lower, then the acquiring corporation shall treat the acquired inventories as having been acquired at cost or market, whichever is lower.

(4) *Adjustments.* Except as provided in paragraph (e)(1) of this section with respect to any adjustments under section 472(d), the adjustments necessary to reflect the change from the method of taking inventories previously used by any of the corporations involved (including any adjustments required by section 481), shall be determined and computed in the same manner as if on the date of distribution or transfer, each of the several corporations that were not using the method of taking inventories used by the acquiring corporation for its taxable year including the date of distribution or transfer had

initiated a change in the method of taking inventories. However, such adjustments (as an item of income or deduction, as the case may be) shall be taken into account solely by the acquiring corporation in computing its taxable income.

(f) *Basis of inventories received.* The basis of inventories received by the acquiring corporation from a distributor or transferor corporation shall be determined in accordance with section 334(b)(1) or 362(b), and the regulations thereunder. See also section 1013, and the regulations thereunder.

(g) *Additional rules applicable to distributions or transfers before January 15, 1975*—(1) *Statute of limitations bars assessment or refund.* If the date of distribution or transfer was before January 15, 1975, and if the assessment of any deficiency or the refund or credit of any overpayment for the taxable year of the acquiring corporation which includes the date of distribution or transfer or any subsequent taxable year is prevented by the operation of any law or rule of law, then this section does not authorize the Commissioner or the acquiring corporation to change any method or methods of computing inventories in any taxable year of the acquiring corporation. However, the Commissioner or the acquiring corporation may change such method or methods of computing inventories under the provisions of section 446, 471, or 472 and the regulations thereunder.

(2) *Statute of limitations does not bar assessment and refund.* Except as provided in subparagraph (1) of this paragraph—

(i) If the date of distribution or transfer was before January 15, 1975, and the acquiring corporation has, for the taxable year which includes the date of distribution or transfer:

(*a*) Adopted or continued a method or methods of taking inventories consistent with the rules of this section,

(*b*) Been granted permission by the Commissioner, in accordance with section 446, 471, or 472 and the regulations thereunder, to use a method or methods of taking inventories, or

(*c*) Adopted a method or methods of taking inventories that, under section 446, 471, or 472 and the regulations thereunder may be adopted without the consent of the Commissioner,

then the method or methods of taking inventories adopted or continued in the manner described in (*a*), (*b*), or (*c*) of this subdivision, shall not be changed, by reason of the rules contained in this section, by the Commissioner or by the acquiring corporation for any taxable year ending after the date of distribution or transfer. However, the Commissioner or the acquiring corporation may change such method or methods of taking inventories for any such taxable year under the provisions of, and to the extent permitted by, section 446, 471, or 472 and the regulations thereunder.

(ii) If the date of distribution or transfer was before January 15, 1975, and the acquiring corporation has, for the taxable year which includes the date of distribution or transfer, adopted or continued a method or methods of taking inventories other than in the manner described in (*a*), (*b*), or (*c*) of subdivision (i) of this subparagraph, then the acquiring corporation may—

(*a*) Continue to use the method or methods of taking inventories so adopted or continued if such method or methods clearly reflect income and if proper adjustments were made to reflect the adoption of such method or methods, or

(*b*) Adopt the method or methods of taking inventories prescribed by this section.

Such method or methods of taking inventories shall be adopted by filing an amended return (which includes the proper adjustments required by this section) for the taxable year of the acquiring corporation which includes the date of distribution or transfer, and by filing amended returns for all subsequent taxable years of the acquiring corporation for which returns have previously been filed. Such amended return or returns shall be accompanied by a copy of the statement described in paragraph (b)(3) of § 1.381(b)–1, and by a statement specifying the nature of the transaction which causes section 381 to apply; the difference in methods of taking inventories used by the corporation concerned; the method or methods of taking inventories originally adopted by the acquiring corporation; the method or methods of taking inventories adopted on the amended return or returns; and the computation of the amount of the adjustments and the resulting increase or decrease in tax.

(h) *Effective date.* This section is applicable with respect to taxable years beginning after January 15, 1975. However, if a taxpayer wishes to rely on the rules stated in this section for taxable years beginning before January 15, 1975 it may do so, subject to the provisions of paragraph (g) of this section.

(Sec. 381(c)(5) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 381(c)(5) and 7805))

[T.D. 7344, 40 FR 2684, Jan. 15, 1975]

§1.381(c)(6)–1 Depreciation method.

(a) *Carryover requirement*—(1) *Distributions in taxable years ending before July 25, 1969.* (i) Section 381(c)(6) provides that if, in a transaction in a taxable year which ends before July 25, 1969, to which section 381(a) applies, an acquiring corporation acquires depreciable property from a distributor or transferor corporation which computes its allowance for the depreciation of the property under section 167(b)(2), (3), or (4), the acquiring corporation shall compute its depreciation allowance by the same method used by the distributor or transferor corporation with respect to such property. Thus, if the distributor or transferor corporation used the sum of the years-digits method under section 167(b)(3) with respect to an asset distributed or transferred to an acquiring corporation, the acquiring corporation will be required to use the sum of the years-digits method with respect to such asset acquired. The computation of the depreciation allowance with respect to the property acquired shall be made under the provisions of section 167 and the regulations thereunder.

(ii) The rules provided in section 381(c)(6) and subdivision (i) of this subparagraph will apply only with respect to that part or all of the basis of the property in the hands of the acquiring corporation immediately after the date of distribution or transfer as does not exceed the basis of the property in the hands of the distributor or transferor corporation on the date of the distribution or transfer. For this purpose, the basis of the property in the hands of the distributor or transferor corporation shall be the adjusted basis provided in section 1011 for the purpose of determining gain on the sale or other disposition of such property. For provisions defining the date of distribution or transfer see §1.381(b)–1(b).

(2) *Distributions in taxable years ending after July 24, 1969.* (i) Section 381(c)(6) provides that if, in a transaction in a taxable year ending after July 24, 1969, to which section 381(a) applies, an acquiring corporation acquires depreciable property from a distributor or transferor corporation which computes its allowances for the depreciation of the property under subsection (b), (j), or (k) of section 167, the acquiring corporation shall compute its depreciation allowance by the same method used by the distributor or transferor corporation with respect to such property. Thus, if the distributor or transferor corporation used the straight line method under section 167(b)(1) with respect to an asset distributed or transferred to an acquiring corporation, the acquiring corporation will be required to use the straight line method with respect to such asset. Similarly, if the distributor or transferor corporation elected to compute depreciation under section 167(k) with respect to property attributable to rehabilitation expenditures, and such property is transferred to an acquiring corporation, the acquiring corporation will be required to compute depreciation under section 167(k) with respect to the property acquired. The computation of the depreciation allowance with respect to the property acquired shall be made under the provisions of section 167 and the regulations thereunder.

(ii) The rules provided in section 381(c)(6) and subdivision (i) of this subparagraph shall apply only with respect to that part or all of the basis of the property in the hands of the acquiring corporation immediately after the date of distribution or transfer as does not exceed the basis of the property in the hands of the distributor or transferor corporation on the date of the distribution or transfer. For this purpose, the basis of the property in the hands of the distributor or transferor corporation shall be the adjusted basis provided in section 1011 for the purpose of determining gain on the sale or other disposition of such property. For provisions defining the date of distribution or transfer see § 1.38(b)–1(b).

(b) *Portion in excess of distributor or transferor corporation's basis*—(1) *General rule.* With respect to that part of the basis of the depreciable property (other than certain section 1250 property described in subparagraph (2) of this paragraph) which in the hands of the acquiring corporation exceeds the adjusted basis to the distributor or transferor corporation, the acquiring corporation may use any reasonable method of computing depreciation, other than the methods provided in section 167(b)(2), (3), or (4). See paragraph (b) of § 1.167(b)–0 for methods which are acceptable under section 167(a) with respect to such property. See also sections 334(b)(1) and 362(b) for the determination of basis of property in the hands of the acquiring corporation in connection with a transaction to which section 381(a) applies.

(2) *Section 1250 property.* With respect to that part of the basis of section 1250 property acquired after July 24, 1969, which in the hands of the acquiring corporation exceeds the adjusted basis to the distributor or transferor corporation, the acquiring corporation shall be subject to the limitations contained in section 167(j)(4) (relating to used section 1250 property) or 167(j)(5) (relating to used residential rental property). Thus, for example, if section 1250 property which is not residential rental property is acquired in a section 381(a) transaction after July 24, 1969, the straight line method of depreciation (or other method allowable under section 167(j)(4)(B)) is the only acceptable method with respect to that portion of the basis of the property which, in the hands of the acquiring corporation, exceeds the adjusted basis to the transferor or distributor corporation.

(c) *Records required.* Records shall be maintained in sufficient detail to identify any depreciable property to which this section applies, and to establish the basis thereof.

(d) *Agreement under section 167(d).* To the extent not inconsistent with paragraph (b) of this section, an acquiring corporation shall be treated as the distributor or transferor corporation in the case of an agreement between the distributor or transferor corporation and the district director under section 167(d) and § 1.167(d)–1 with respect to property to which section 381(c)(6) and this section apply. Thus, in the case where the basis of an asset in the hands of an acquiring corporation exceeds the basis of such asset in the hands of the distributor or the transferor corporation, such an agreement will not have the effect of permitting the acquiring corporation to compute its depreciation allowance with respect to such excess basis under the methods provided in section 167(b)(2), (3), or (4). However, the provisions of the agreement will continue to apply with respect to the useful life of the asset.

(e) *Change of method of depreciation.* Although the acquiring corporation is required to use the method of computing depreciation used by the distributor or transferor with respect to depreciable property to which this section applies, such acquiring corporation may use another method with respect to such property if consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446–1. Further, subject to the provisions of paragraph (b) of § 1.167(e)–1 the acquiring corporation may change from the declining balance method described in section 167(b)(2) to the straight line method without consent of the Commissioner.

(f) *Successive transactions to which* section 381(a) applies. The provisions of this section shall apply in the case of successive transactions to which section 381(a) applies. Thus, for example, if X Corporation, a transferor corporation, used the sum of the years-digits method under section 167(b)(3) with respect to an asset transferred to Y Corporation, an acquiring corporation, in a transaction to which section 381(a) applies, and subsequently Y Corporation, using the same method, transfers such asset to Z Corporation in a transaction to which section 381(a) also applies, then Z Corporation shall be required to use the sum of the years-digits method with respect to such asset.

(g) *Illustration.* The application of this section may be illustrated by the following example:

Example. M and N Corporations compute their taxable incomes on the basis of the calendar year. On December 31, 1959, M Corporation transfers all of its assets to N Corporation in a transaction to which section 381(a) applies. Included among these assets is an item of depreciable property which on that date has an adjusted basis (for determining gain) of $800,000 after M Corporation takes into account for 1959 its allowance for depreciation under section 167(b)(2). The basis attributable to the asset under section 362(b) is determined to be $900,000 in the hands of N Corporation. Under the provisions of section 381(c)(6) and paragraph (a) of this section, N Corporation is required to compute its allowance for the depreciation of the asset under section 167(b)(2) for 1960 and subsequent years but only in respect of $800,000 of its basis. N Corporation may use any reasonable method other than the methods provided in section 167(b)(2), (3), or (4) in computing its depreciation allowance of the remaining $100,000.

[T.D. 6559, 26 FR 2983, Apr. 7, 1961, as amended by T.D. 7166, 37 FR 5246, Mar. 11, 1972; 37 FR 6400, Mar. 29, 1972]

§1.381(c)(8)–1 Installment method.

(a) *Carryover requirement.* (1) Section 381(c)(8) provides that if, in a transaction to which section 381(a) applies, an acquiring corporation acquires installment obligations, the income from which the distributor or transferor corporation has elected under section 453 and the regulations thereunder to report on the installment method, then the acquiring corporation shall be treated as the distributor or transferor corporation would have been treated under section 453 had it not transferred the installment obligations. Thus, if the distributor or transferor corporation had properly elected to return income from the sale or other disposition of property giving rise to the obligations on the installment method, then the acquiring corporation shall be required to return the income from all such installment obligations in the same manner and to the same extent as the distributor or transferor corporation, unless consent of the Commissioner to use another method is obtained in accordance with paragraph (e) of §1.446–1. Amounts received by the acquiring corporation on or after the date of distribution or transfer with respect to an installment sale made by the distributor or transferor corporation will not be taken into account in applying the limitation under section 453(b)(2) with respect to the amount of payments received in the year of sale or other disposition.

(2) Section 381(c)(8) and this section have no application to sales or other dispositions of property made by the acquiring corporation on or after the date of distribution or transfer. For provisions defining the date of distribution or transfer, see §1.381(b)–1(b). See section 381(c)(4) and the regulations thereunder for rules relating to the proper method or combination of methods of accounting to be used by the acquiring corporation.

(b) *Basis of obligations.* The basis in the hands of an acquiring corporation of installment obligations described in section 381(c)(8) and paragraph (a) of this section shall be the same as in the hands of the distributor or transferor corporation.

(c) *Repossession of property sold in prior years.* If the acquiring corporation repossesses property, previously sold by the distributor or transferor corporation, by reason of default by the purchaser in payment of the acquired installment obligations, then the acquiring corporation shall be treated as though it were the vendor corporation for purposes of determining, under section 453 and the regulations thereunder, the gain, loss, income, or deduction with respect to the property repossessed.

[T.D. 6559, 26 FR 2983, Apr. 7, 1961]

§1.381(c)(9)–1 Amortization of bond discount or premium.

(a) *Carryover requirement.* If, in a transaction to which section 381(a) applies, the acquiring corporation assumes liability for the payment of bonds of a distributor or transferor corporation which were issued at a discount or premium, then under the provisions of section 381(c)(9) the acquiring corporation is to be treated as the distributor or transferor corporation after the date of distribution or transfer for purposes of determining the amount of amortization allowable, or includible, with respect to such discount or premium in computing taxable income. Thus, if subsequent to February 28, 1913, a distributor or transferor corporation issues bonds at a premium and the liability for them is assumed by the acquiring corporation in a transaction to which section 381(a) applies, then the net amount of the premium is income which should be prorated or amortized over the life of the bonds, including the period during which the acquiring corporation is liable upon the obligations assumed. On the other hand, if a distributor or transferor corporation issues bonds at a discount and the liability for them is assumed by the acquiring corporation in a transaction to which section 381(a) applies, then the net amount of the discount is deductible in computing taxable income but should be prorated or amortized over the life of the bonds, including the period during which the acquiring corporation is liable upon the obligations assumed.

(b) *Expense incurred upon issuance of bonds.* If, in a transaction to which section 381(a) applies, the acquiring corporation assumes liability for bonds of a distributor or transferor corporation which were issued at a discount or premium, the acquiring corporation shall be treated as the distributor or transferor corporation after the date of distribution or transfer with respect to the expense incurred upon the issuance of such bonds.

(c) *Purchase of bonds.* If, in a transaction to which section 381(a) applies, the acquiring corporation assumes liability for bonds of a distributor or transferor corporation which were issued at a discount or premium and if the acquiring corporation subsequently purchases such bonds, then the acquiring corporation shall be treated as the distributor or transferor corporation for the purpose of determining the amount of any income or deduction resulting from the purchase. See paragraph (c) of § 1.61–12. For rules relating to the exchange or substitution of bonds issued by the acquiring corporation for bonds of a distributor or transferor corporation, see paragraph (d) of this section.

(d) *Exchange of new for old bonds.* Notwithstanding any other provision of this section, if—

(1) In a transaction to which section 381(a) applies, bonds of the acquiring corporation are exchanged or substituted for bonds of a distributor or transferor corporation which were issued at a discount or premium, or

(2) Bonds of the acquiring corporation are exchanged or substituted for bonds of a distributor or transferor corporation which were issued at a discount or premium and in respect of which the acquiring corporation has assumed the liability in a transaction to which section 381(a) applies,

then, with respect to any unamortized discount, premium, or expense of issuance attributable to such bonds of the distributor or transferor corporation, the acquiring corporation shall be treated as the distributor or transferor corporation.

(e) *Bonds of a distributor or transferor corporation.* For purposes of applying section 381(c)(9), the term *bonds of a distributor or transferor corporation* includes not only bonds issued by the distributor or transferor corporation but also bonds for which the distributor or transferor corporation has assumed liability. Thus, if the distributor or transferor corporation has assumed liability for bonds in a transaction in which any unamortized discount or premium attributable to such bonds carried over to such corporation, then the acquiring corporation assuming liability for the bonds shall be treated as the distributor or transferor corporation after the date of distribution or transfer for purposes of determining the amount of amortization allowable, or includible, with respect to such discount or premium. On the other hand, if the distributor or transferor corporation has assumed liability for bonds in a transaction in which any unamortized discount or premium attributable to such bonds did not carry over to such corporation, then there can be no carryover to the acquiring corporation under this section.

[T.D. 6532, 26 FR 405, Jan. 19, 1961]

§1.381(c)(10)–1 Deferred exploration and development expenditures.

(a) *Carryover requirement.* (1) If for any taxable year a distributor or transferor corporation has elected under section 615 or section 616 (or corresponding provisions of prior law) to defer and deduct on a ratable basis any exploration or development expenditures made in connection with any ore, mineral, mine, or other natural deposit transferred to the acquiring corporation in a transaction described in section 381(a), then under the provisions of section 381(c)(10) the acquiring corporation shall be entitled to deduct such expenditures on a ratable basis in the same manner, and to the same extent, as they would have been deductible by the distributor or transferor corporation in the absence of the distribution or transfer. For this purpose, the acquiring corporation shall be treated as though it were the distributor or transferor corporation. The principles set forth in paragraph (e) of §1.615–3 and paragraph (f) of §1.616–2 are applicable in computing the amount of the deduction allowable to the acquiring corporation in respect of expenditures deferred by a distributor or transferor corporation.

Example. X and Y Corporations are both organized on January 1, 1955, and both corporations compute their taxable income on the basis of the calendar year. During 1955, X Corporation purchases a mineral property which it begins to develop in 1956. During 1956, X Corporation incurs development expenditures of $500,000 in respect of such property which it elects to defer under section 616(b). On December 31, 1956, Y Corporation acquires all of the assets of X Corporation in a reorganization to which section 381(a) applies, no gain being recognized to X Corporation on the transfer. In 1957, Y Corporation sells 150,000 units of produced ore benefited by the development expenditures incurred and deferred by X Corporation, and the number of units remaining as of the end of 1957, plus the number of units sold during that year, is estimated to be 1,000,000. In addition to its deduction for depletion, Y Corporation is, in 1957, entitled to a deduction under sections 616(b) and 381(c)(10) of $75,000 of the development expenditures previously deferred by X Corporation, that is, $500,000 × 150,000/1,000,000.

(2) If a distributor or transferor corporation has elected under section 615 or section 616 (or corresponding provisions of prior law) to defer exploration or development expenditures in respect of a mine or other natural deposit which it subsequently disposes of except for a retained economic interest therein, such as the right to royalty income or in-ore payments, and such retained economic interest is transferred to the acquiring corporation in a transaction to which section 381(a) applies, then the acquiring corporation shall be entitled to deduct such deferred expenditures attributable to the economic interest retained on a ratable basis to the same extent they would have been deductible by the distributor or transferor corporation in the absence of the distribution or transfer. See paragraph (c) of §1.615–3 and paragraph (c) of §1.616–2.

(3) For purposes of this section, the terms *exploration expenditures* and *development expenditures* shall have the same meaning as that ascribed to them in the regulations under sections 615 and 616 of the Internal Revenue Code of 1954, or under sections 23(cc) and 23(ff) of the Internal Revenue Code of 1939, whichever applies. See, for example, paragraph (a) of §1.615–1 and paragraph (a) of §1.616–1.

(b) *Effect and identification of election previously made.* (1) The election made by a distributor or transferor corporation under the provisions of section 615 or section 616 (or corresponding provisions of prior law) to defer exploration or development expenditures in respect of any taxable year may not be revoked by the acquiring corporation for any reason whatsoever.

(2) When filing its return for the first taxable year for which it deducts exploration or development expenditures which were deferred under section 615 or section 616 (or corresponding provisions of prior law) by a distributor or transferor corporation, the acquiring corporation shall attach thereto a statement properly identifying the taxable year for which the election to defer was made by the distributor or transferor corporation, the name of the corporation which made the election, and the district director with whom the election was filed.

(3) It is unnecessary for an acquiring corporation to renew an election to

defer exploration or development expenditures which was made by a distributor or transferor corporation.

(c) *Successive transactions to which section 381(a) applies.* If, by virtue of section 381(c)(10), the acquiring corporation is entitled to deduct exploration or development expenditures deferred by a distributor or transferor corporation, then such acquiring corporation shall be deemed to have made the election to defer such expenditures for purposes of applying section 381(c)(10) to any subsequent transaction in which such acquiring corporation is a distributor or transferor corporation.

(d) *Carryover of limitation requirements.* (1) If a distributor or transferor corporation transfers any mineral property to the acquiring corporation in a transaction described in section 381(a) and the acquiring corporation pays or incurs exploration expenditures in a taxable year ending after the date of the distribution or transfer, then in applying the 4-year or $400,000 limitations described in section 615(c) and paragraphs (a) and (b) of § 1.615–4, whichever is applicable, the acquiring corporation shall be deemed to have been allowed any deduction which, for any taxable year ending on or before the date of distribution or transfer, was allowed to the distributor or transferor corporation under section 615(a), or under section 23(ff)(1) of the Internal Revenue Code of 1939, or to have made any election which, for any such preceding year, was made by the distributor or transferor corporation under section 615(b), or under section 23(ff)(2) of the Internal Revenue Code of 1939. Thus, in such instance, the acquiring corporation shall take into account the years in which the distributor or transferor corporation exercised the election to deduct or defer exploration expenditures and any amounts so deducted or deferred. For this purpose, it is immaterial whether the deduction has been allowed to, or the election has been made by, the distributor or transferor corporation with respect to the specific mineral property transferred by that corporation to the acquiring corporation.

(2) Generally, for purposes of applying the 4-year limitation described in paragraph (a) of § 1.615–4, if there are two or more distributor or transferor corporations that transfer any mineral property to the acquiring corporation, each taxable year of any such corporation ending on or before the date of distribution or transfer in which exploration expenditures were deducted or deferred shall be treated as a separate taxable year regardless of the fact that the taxable years of two or more such corporations normally end on the same date. However, if the date of distribution or transfer is the same with respect to more than one distributor or transferor corporation, then the taxable years of such corporations ending on the same date of distribution or transfer shall be considered as one taxable year for purposes of applying the 4-year limitation even though more than one such corporation deducted or deferred exploration expenditures for such taxable years.

(3) For purposes of applying the $400,000 limitation described in paragraph (b) of § 1.615–4, if there are two or more distributor or transferor corporations that transfer any mineral property to the acquiring corporation, any exploration expenditures which were deducted or treated as deferred expenses by such corporations for taxable years ending after December 31, 1950, shall be taken into account by the acquiring corporation.

(4) If a distributor or transferor corporation that transfers any mineral property to the acquiring corporation was required to take into account any taxable years or amounts of its transferor, as provided by paragraph (e) of § 1.615–4, for purposes of either the 4-year limitation described in paragraph (a) of § 1.615–4 or the $400,000 limitation described in paragraph (b) of § 1.615–4, then the acquiring corporation shall also take these taxable years and amounts into account in applying the same limitations.

(5) The provisions of this paragraph may be illustrated by the following examples:

Example (1). M and N Corporations were organized on January 1, 1956, and each corporation computes its taxable income on the basis of the calendar year. For each of its taxable years 1956 and 1957, M Corporation expended $60,000 for exploration expenditures and exercised the option to deduct such amounts under section 615(a). N Corporation made no exploration expenditures during its taxable years 1956 and 1957. On December 31, 1957, M Corporation transferred all of its assets to N Corporation in a transaction to which section 381(a) applies, no gain being recognized to the transferor corporation on the transfer. N Corporation made exploration expenditures of $100,000, $120,000, $110,000, and $100,000 for the years 1958, 1959, 1960, and 1961, respectively, which expenditures it desired to deduct under section 615(a) to the extent allowable. On the basis of these facts, N Corporation may deduct up to $100,000 for each of the years 1958 and 1959. No deduction or deferral is allowable for 1960 since the benefits of section 615(c) were previously availed of for 4 taxable years. However, N Corporation may deduct $80,000 for 1961 (the 4-year limitation not applying to such year) but, if such deduction is made, N Corporation will not be allowed any further deductions or deferrals since the $400,000 limitation of paragraph (b) of § 1.615–4 will have been reached.

Example (2). R and S Corporations were organized on January 1, 1955, and each corporation computes its income on the basis of the calendar year. For the 1955 taxable year neither corporation made any exploration expenditures under section 615(a). On June 30, 1956, R Corporation transferred all its assets to S Corporation in a transaction to which section 381(a) applies, no gain being recognized to the transferor corporation on the transfer. During its short taxable year ending June 30, 1956, R Corporation made exploration expenditures of $60,000 which it elected to deduct under section 615. For its taxable year ending December 31, 1956, S Corporation may deduct or defer exploration expenditures up to $100,000 since this is a separate election for purposes of utilizing section 615 and is not affected by the $60,000 previously deducted by R Corporation. Assuming S Corporation exercises an election under section 615 for its taxable year ending December 31, 1956, S Corporation may elect to apply the benefits of section 615 to exploration expenditures for two more taxable years. However, for taxable years beginning after July 6, 1960 (the 4-year limitation not applying), S Corporation is entitled under section 615 to deduct or defer exploration expenditures made in such years to the extent that the combined deductions and deferrals by R and S Corporations in prior years did not exceed $400,000.

Example (3). O and P Corporations were organized on January 1, 1955, and each corporation computes its taxable income on the basis of the calendar year. For their taxable years 1955, 1956, and 1957, each corporation deducted exploration expenditures made in such years under section 615(a). On June 30, 1958, O Corporation transferred all its assets to P Corporation in a transaction to which section 381(a) applies, no gain being recognized to the transferor corporation on the transfer. If, during its short taxable year ending June 30, 1958, O Corporation made additional exploration expenditures, it may deduct or defer such expenditures (up to $100,000) under section 615 since O Corporation has utilized section 615 in only three previous taxable years. For its taxable years ending after June 30, 1958, and beginning before July 7, 1960, P Corporation may not deduct or defer exploration expenditures under section 615, since the benefits of that section were utilized by O and P Corporations for 4 taxable years. However, for taxable years beginning after July 6, 1960 (the 4-year limitation not applying), P is entitled under section 615 to deduct or defer exploration expenditures made in such years to the extent that the combined deductions and deferrals by O and P Corporations in prior years do not exceed $400,000. See paragraph (b) of § 1.615–4.

Example (4). X, Y, and Z Corporations were organized on January 1, 1955, and each corporation computes its taxable income on the basis of the calendar year. For their taxable years ending December 31, 1955, X and Y Corporations each deferred $100,000 for exploration expenditures made in such taxable years under section 615(b). Z Corporation made no exploration expenditures during its taxable year ending December 31, 1955. On March 31, 1956, X and Y Corporations transferred all their assets to Z Corporation in a transaction to which section 381(a) applies, no gain being recognized to the transferor corporations on the transfer. X and Y Corporations each made exploration expenditures of $75,000 during their short taxable years ending March 31, 1956, which they deducted under section 615(a). For purposes of taxable years beginning before July 7, 1960, Z Corporation must take into account the taxable years in which X and Y Corporations deducted or deferred exploration expenditures. In so doing, each taxable year in which exploration expenditures were deducted or deferred must be taken into account except that the taxable years of X and Y Corporations ending on March 31, 1956, shall be considered as one taxable year. Therefore, Z Corporation may deduct or defer exploration expenditures in accordance with section 615 for any one taxable year ending after March 31, 1956, and beginning before July 7, 1960. However, for taxable years beginning after July 6, 1960 (the 4-year limitation not applying), Z Corporation must take into account for purposes of the $400,000 limitation all of the $350,000 of exploration expenditures deducted or deferred by X, Y, and Z Corporations during taxable years ending after December 31, 1950. Therefore, Z Corporation, assuming it has not deducted or deferred any exploration expenditures, is entitled under section 615 to deduct or defer in taxable years beginning after July 6, 1960, up to

$50,000 for exploration expenditures made in such years.

Example (5). For purposes of this example, assumethat each taxpayer computes taxable income on the basis of the calendar year. Taxpayer A, an individual who has deducted exploration expenditures of $75,000 under section 23(ff) of the Internal Revenue Code of 1939 for each of his taxable years 1952 and 1953, transferred a mineral property to K Corporation on January 1, 1954, in a transaction in which the basis of the mineral property in the hands of K Corporation is determined under section 362(a). For its taxable year 1954 and pursuant to section 615(a)., K Corporation deducted exploration expenditures of $100,000 which it made in such year. K Corporation had made no exploration expenditures in any preceding taxable year. On December 31, 1954, K Corporation transferred all its assets to L Corporation in a reorganization to which section 381(a) applies, no gain being recognized to the transferor corporation on the transfer. Assuming that L Corporation has not deducted or deferred exploration expenditures in any preceding taxable year, L Corporation may deduct or defer exploration expenditures (up to $100,000) in accordance with section 615 for any one taxable year ending after December 31, 1954, and beginning before July 7, 1960, in view of the 4-year limitation. However, if L Corporation does not deduct or defer exploration expenditures in that period, then for taxable years beginning after July 6, 1960 (the 4-year limitation not applying), L Corporation is entitled to deduct or defer up to $150,000 (but not to exceed $100,000 per year) for exploration expenditures made in such years. See paragraph (b) of § 1.615–4.

[T.D. 6552, 26 FR 1988, Mar. 8, 1961, as amended by T.D. 6685, 28 FR 11406, Oct. 24, 1963]

§ 1.381(c)(11)–1 Contributions to pension plan, employees' annuity plans, and stock bonus and profit-sharing plans.

(a) *Carryover requirement.* Section 381(c)(11) provides that, for purposes of determining amounts deductible under section 404 for any taxable year, the acquiring corporation shall be considered after the date of distribution or transfer to be the distributor or transferor corporation in respect of any pension, annuity, stock bonus, or profit-sharing plan.

(b) *Nature of carryover.* (1) Primarily, section 381(c)(11) and this section apply to the amount of any unused deductions or excess contributions carryovers which, in the absence of the transaction causing section 381 to apply, would have been available to the distributor or transferor corporation under section 404. Thus, for example, this section applies to unused deductions under a profit-sharing or stock bonus trust which, in accordance with the second sentence of section 404(a)(3)(A) and § 1.404(a)–9, would have been available in succeeding taxable years to the transferor corporation if the transfer of assets to the acquiring corporation had not occurred.

(2) Section 381(c)(11) also permits or requires the acquiring corporation to be treated as though it were the distributor or transferor corporation for the purpose of satisfying any conditions which would have been required of the distributor or transferor corporation in the absence of the distribution or transfer, so that it may be determined whether the distributor or transferor corporation, or the acquiring corporation, is entitled to take a deduction under section 404 in respect of a trust or plan established by the distributor or transferor corporation. Thus, for example, in a case when the taxable year of the transferor corporation ends on the date of transfer pursuant to section 381(b)(1), that corporation is entitled, pursuant to the provisions of section 404(a)(6) and paragraph (c) of § 1.404(a)–1, to a deduction in such taxable year for a payment to a qualified trust of that corporation made by the acquiring corporation after the close of such taxable year but within the time specified in section 404(a)(6). In further illustration, if the transferor corporation were to establish a qualified plan, and if the plan were maintained as a qualified plan by the acquiring corporation, then any contributions paid under the plan by the acquiring corporation (other than those which are deductible by the transferor corporation by reason of section 404(a)(6)) would be deductible under section 404 by the acquiring corporation even though the plan were exclusively for the benefit of former employees of the transferor corporation. Also, for example, if the transferor corporation were to adopt an annuity plan during its taxable year ending on the date of transfer, the acquiring corporation would be entitled, subject to the provisions of section 401(b) and § 1.401–5, to

amend the plan so as to make it retroactively satisfy the requirements of section 401(a)(3), (4), (5), and (6) for the period beginning with the date on which the plan was put into effect.

(c) *Taxable year of deduction.* The first taxable year of the acquiring corporation in which any amount shall be allowed as a deduction to that corporation by reason of section 381(c)(11) and this section shall be its first taxable year ending after the date of distribution or transfer.

(d) *Requirements for deductions.* (1) In order for any amount paid by the acquiring corporation (other than amounts deductible under section 404(a)(5)) to be deductible by the acquiring corporation by reason of this section in respect of a trust or nontrusteed annuity plan which is established by a distributor or transferor corporation and maintained by the acquiring corporation, the contributions must be paid (or deemed to have been paid under section 404(a)(6)) by the acquiring corporation in a taxable year of that corporation which ends with or within a year of the trust for which it is exempt under section 501(a), or, in the case of a nontrusteed annuity plan, for which it meets the requirements of section 404(a)(2). See, however, section 404(a)(4) and §1.404(a)–11 for rules relating to deductions for contributions to foreign-situs trusts. The trust or plan which is established by the distributor or transferor corporation and maintained by the acquiring corporation may separately satisfy the requirements of section 401(a) or section 404(a)(2) or may, together with other trusts or plans of the acquiring corporation, constitute a single plan which qualifies under section 401(a) or meets the requirements of section 404(a)(2).

(2) Excess contributions paid under a qualified trust or plan established by the transferor or distributor corporation may be carried over and, subject to the applicable limitations, deducted by the acquiring corporation in a taxable year ending after the date of distribution or transfer regardless of whether the trust is exempt, or the plan meets the requirements of section 404(a)(2), during such taxable year. There are, however, special rules for computing the limitations on the amount of excess contributions which are deductible in a taxable year ending after the trust or plan has terminated (see §1.404(a)–7, paragraph (e) of §1.404(a)–9, and paragraph (a) of §1.404(a)–13). For this purpose, the pension, annuity, stock bonus, or profit-sharing plan of the distributor or transferor corporation under which the excess contributions were made shall be considered continued (and not terminated) by the acquiring corporation if, after the date of distribution or transfer, the acquiring corporation continues the plan as a separate and distinct plan of its own which continues to qualify under section 401(a), or to meet the requirements of section 404(a)(2), or consolidates or replaces that plan with a comparable plan. See subparagraph (4) of this paragraph for rules relating to what constitutes a ‘‘comparable’’ plan.

(3) In order for any amount paid by the acquiring corporation to be deductible by the acquiring corporation as an unused deduction carried over from a qualified profit-sharing or stock bonus trust established by a distributor or transferor corporation, the acquiring corporation must continue such trust established by the distributor or transferor corporation as a separate and distinct trust of its own which continues to qualify under section 401(a), or must consolidate or replace that trust with a comparable trust. In addition, the amount paid by the acquiring corporation will be deductible as an unused deduction carried over from the transferor or distributor corporation only if it is paid into the profit-sharing or stock bonus trust established by the transferor or distributor corporation, or the comparable trust, in a taxable year of the acquiring corporation which ends with or within a year of such trust (or such comparable trust) for which it meets the requirements of section 401(a) and is exempt under section 501(a). See subparagraph (4) of this paragraph for rules relating to what constitutes a ‘‘comparable’’ trust.

(4) For purposes of subparagraphs (2) and (3) of this paragraph, a plan under which deductions are determined pursuant to paragraph (1) or (2) of section 404(a) shall be considered comparable

to another plan under which deductions are determined pursuant to either of those paragraphs, and a plan under which deductions are determined pursuant to paragraph (3) of section 404(a) shall be considered comparable to another plan under which deductions are determined pursuant to such paragraph (3). Thus, a profit-sharing plan (which qualifies under section 401(a)) established by the transferor or distributor corporation shall, for purposes of subparagraphs (2) and (3) of this paragraph, be considered terminated if, after the date of distribution or transfer, the acquiring corporation transfers the funds accumulated under the profit-sharing plan into a pension plan covering the same employees. In such a case, excess contributions paid under the profit-sharing plan by the distributor or transferor corporation may be carried over and deducted by the acquiring corporation in a taxable year ending after the date of distribution or transfer subject to the limitations in section 404(a)(3)(A) computed in accordance with the rules in paragraph (e)(2) of § 1.404(a)–9 for computing limitations when a profit-sharing plan has terminated. On the other hand, unused deductions attributable to the profit sharing plan may not be carried over and used by the acquiring corporation as a basis for deducting amounts contributed by it to the pension plan.

(e) *Effect of consolidation or replacement of plan on prior contributions.* If a pension, annuity, stock bonus, or profit-sharing plan which was established by a distributor or transferor corporation is terminated after the date of distribution or transfer because of consolidation or replacement with a comparable plan of the acquiring corporation, then the contributions paid to or under its plan by the distributor or transferor corporation on or before the date of distribution or transfer shall not be disallowed under section 404 merely because of the termination of the plan which was established by that corporation, provided that the termination does not cause the plan to fail to qualify under section 401(a).

(f) *Amounts deductible under section 404.* Section 381(c)(11) and this section apply only to amounts which are otherwise deductible under section 404 and the regulations thereunder. See §§ 1.404(a)–1 through 1.404(d)–1. Thus, to be deductible by reason of this section, contributions paid by the acquiring corporation must be expenses which otherwise satisfy the conditions of section 162 (relating to trade or business expenses). No deduction shall be allowed by reason of section 381(c)(11) and this section for a contribution which is allowable under section 162 but is not allowable under section 404. Thus, the acquiring corporation shall not be allowed a deduction by reason of this section in respect of a plan established by a distributor or transferor corporation if the contribution would not otherwise be deductible under section 404 by reason of section 404(c) and § 1.404(c)–1. On the other hand, any unused deductions or excess contributions of a distributor or transferor corporation which are carried over from 1939 Code years shall be deductible by the acquiring corporation if the requirements of this section, section 404(d), and § 1.404(d)–1 are satisfied.

(g) *Cost of past service credits.* In computing the cost of past service credits under a plan with respect to employees of the distributor or transferor corporation, the acquiring corporation may include the cost of credits for periods during which the employees were in the service of the distributor or transferor corporation.

(h) *Separate carryovers required.* The excess contributions which are available to a distributor or transferor corporation under the provisions of section 404(a)(1)(D) and section 404(a)(3)(A) at the close of the date of distribution or transfer and are carried over to the acquiring corporation under this section shall be kept separate and distinct from each other and from any excess contributions which are available to the distributor or transferor corporation at that time under the provisions of section 404(a)(7) and are carried over to the acquiring corporation under this section. If there are excess contributions carried over to the acquiring corporation from more than one transferor or distributor corporation, the excess contributions of each transferor or distributor corporation shall be kept separate and distinct from those of the other transferor or distributor corporations and, with respect to each such transferor or distributor corporation, shall be kept separate and distinct as provided in the preceding sentence. See, however, paragraph (i) of this section for rules for applying the provisions of section 404(a)(3)(A) when the acquiring corporation maintains two or more profit-sharing or stock bonus trusts, one or more of which was established by a distributor or transferor corporation. The requirements in this paragraph shall apply with respect to any excess contributions which are carried over to the acquiring corporation from a distributor or transferor corporation under the provisions of section 404(d) and this section.

(i) *Limitations applicable to profit-sharing or stock bonus trusts.* When contributions are paid by the acquiring corporation after the date of distribution or transfer to two or more profit-sharing or stock bonus trusts, and one or more of such trusts was established by a distributor or transferor corporation, such trusts shall be considered as a single trust in applying the provisions of section 404(a)(3)(A) under this section. Accordingly, in determining its secondary limitation, and its excess contributions carryover, under section 404(a)(3)(A) and §1.404(a)–9 in any taxable year ending after the date of distribution or transfer, the acquiring corporation shall take into accounts its primary limitations, and the deductions allowed or allowable to it, for all prior years under the limitations provided in those sections, and also the primary limitations of, and deductions allowed or allowable to, the distributor or transferor corporation or corporations for all prior years under the limitations provided in those sections.

(j) *Successive carryovers.* The provisions of section 381(c)(11) and this section shall apply to an acquiring corporation which, in a distribution or transfer to which section 381(a) applies acquires the assets of a distributor or transferor corporation which has previously acquired the assets of another corporation in a transaction to which section 381(a) applies, even though, in computing an unused deductions or excess contributions carryover to the second acquiring corporation, it is necessary to take into account contributions paid by, and limitations applicable to, the first distributor or transferor corporation.

(k) *Information to be furnished by acquiring corporation.* The acquiring corporation shall furnish such information with respect to a plan established by a distributor or transferor corporation as will, consistently with the principles of section 404, establish that the provisions of such section and this section apply. For purposes of this section, the district director may require any other information that he considers necessary to determine deductions allowable under section 404 and this section or qualification under section 401. Any unused deductions or excess contributions carried over from a distributor or transferor corporation pursuant to this section shall be properly identified with the corporation which would have been permitted to use those deductions or contributions in the absence of the transaction causing section 381 to apply.

(l) *Illustration.* The application of this section may be illustrated by the following example:

Example. In 1955, X Corporation, which makes its return on the basis of the calendar year, paid $400,000 to completely fund past service credits under a qualified pension plan and deducted 10 percent ($40,000) of that cost in each of the taxable years 1955, 1956, and 1957. The pension plan established by X Corporation had an anniversary date of January 1. On December 31, 1957, on which date the undeducted part of the cost amounted to $280,000, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. Y Corporation, which also makes its return on the basis of the calendar year, had a qualified pension plan and trust which also had an anniversary date of January 1. Since Y Corporation had many more employees than X Corporation on the date of transfer, it covered the former employees of X Corporation under its own plan. Y Corporation is entitled to deductions under section 404(a)(1)(D) and this section in 1958 and succeeding taxable years, in order of time, with respect to the undeducted balance of $280,000, to the extent of the difference between the amount paid and deductible by that corporation in each such taxable year and the maximum amount deductible by that corporation for such taxable year in accordance with the applicable limitations of section 404(a)(1). In computing the maximum amount deductible by Y Corporation for 1958 and 1959 under section 404(a)(1)(C), that corporation may include $40,000 for each year, the amount that X Corporation could have included for each of those years in computing the maximum amount that would have been deductible by X Corporation under section 404(a)(1)(C) if the merger had not occurred. Thus, assuming that Y Corporation's appropriate limitation so computed under section 404(a)(1)(C) is $1,000,000 (including the $40,000 carried over from X Corporation under this section) for each of those taxable years, and that Y Corporation contributed $925,000 to its trust in 1958 and $975,000 in 1959, then Y Corporation is entitled under section 404(a)(1)(D) and this section to deduct in 1958 $75,000, and in 1959 $25,000, of the amount ($280,000) carried over from X Corporation. The undeducted balance of such amount ($180,000) available to Y Corporation on December 31, 1959, would be deductible by that corporation in succeeding taxable years in accordance with section 404(a)(1)(D) and this section.

[T.D. 6556, 26 FR 2405, Mar. 22, 1961, as amended by T.D. 7168, 37 FR 5024, Mar. 9, 1972]

§ 1.381(c)(12)–1 Recovery of bad debts, prior taxes, or delinquency amounts.

(a) *Carryover requirement.* (1) If, as a result of a distribution or transfer to which section 381(a) applies, the acquiring corporation is entitled to the recovery of a bad debt, prior tax, or delinquency amount on account of which a deduction or credit was allowed to a distributor or transferor corporation for a prior taxable year, and such debt, tax, or amount is recovered by the acquiring corporation after the date of distribution or transfer, then under the provisions of section 381(c)(12) the acquiring corporation is required to include in its gross income for the taxable year of recovery the same amount of income attributable to the recovery as the distributor or transferor corporation would have been required to include under section 111 and the regulations thereunder had the distribution or transfer not occurred.

(2) The rule prescribed by paragraph (a)(1) of this section and by section 381(c)(12) with respect to bad debts, prior taxes, and delinquency amounts applies equally with respect to the recovery by the acquiring corporation of all other losses, expenditures, and accruals made on the basis of deductions from the gross income of a distributor or transferor corporation for prior taxable years, including war losses referred to in section 127 of the Internal Revenue Code of 1939, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. An item which is not a ''section 111 item'' for purposes of the regulations under section 111 is not subject to the provisions of section 381(c)(12). The provisions of section 111(c) shall be applied with respect to a recovery by the acquiring corporation in the same manner as they would have been applied by the distributor or transferor corporation.

(b) *Amount of recovery exclusion allowable for year of recovery.* For the year of any recovery by the acquiring corporation, the amount of the recovery exclusion for the original taxable year shall be determined in accordance with paragraph (b) of § 1.111–1. For the purpose of this paragraph and section 381(c)(12), the recovery exclusion for any year with respect to section 111 items of the acquiring corporation shall be kept separate from the recovery exclusion for any year with respect to section 111 items of each distributor or transferor corporation. The recovery by the acquiring corporation of any section 111 item of such corporation after the date of the distribution or transfer shall be considered separately from recoveries by the acquiring corporation of any such item which was deducted or credited by a distributor or transferor corporation. Any recovery by the acquiring corporation of a section 111 item shall be excluded from the gross income of the acquiring corporation to the extent of the recovery exclusion (1) determined for the original year for which that item was deducted or credited by the specific corporation which claimed the deduction or credit and (2) reduced by the excludable recoveries (whether made by the acquiring corporation, or by the distributor or transferor corporation) in intervening years with respect to the recovery exclusion of such corporation for such original year. There shall be taken into account the effect of net operating loss carryovers and carrybacks or capital loss carryovers.

(c) *Illustration of carryover of recovery exclusion*—(1) *Facts.* (i) The application of section 381(c)(12) may be illustrated by the following example. M and N Corporations are both organized on January 1, 1957, and both corporations compute their taxable income on the basis of the calendar year. On December 31, 1959, M Corporation transfers all its assets to N Corporation in a reorganization to which section 381(a) applies.

(ii) The section 111 items of the two corporations for the following taxable years are as follows, identification of such items being made by an appropriate letter:

Taxable year of deduction or credit	M Corporation (transferor)	N Corporation (acquirer)
1957	$500(g)	$200(h)
1958	300(i)	400(j)
1959	600(k)	100(m)

(iii) The recovery exclusions in respect of such taxable years, computed in accordance with § 1.111–1(b)(2), are assumed to be as follows:

Taxable year	M Corporation (transferor)	N Corporation (acquirer)
1957	$400	$150
1958	200	300
1959	500	75

(iv) The recoveries of the above-mentioned section 111 items by the two corporations are as follows:

Taxable year of recovery	M Corporation (transferor)	N Corporation (acquirer)
1958	$25 (g)	$50 (h)
1959	50 (g) 30 (i)	20 (h) 15 (j)
1960		350 (g) 225 (i) 550 (k) 100 (h) 350 (j) 85 (m)

(2) *M Corporation's 1958 recovery.*

Total recovery of section 111 items for 1957	$25
Less: Recovery exclusion for 1957	400
Amount included in gross income of M Corporation for 1958	0

(3) *M Corporation's 1959 recoveries.*

(i) Total recovery of section 111 items for 1957		$50
Less: Recovery exclusion for 1957	$400	
Minus excludable recovery	25	
		375
Amount included in gross income of M Corporation for 1959		0
(ii) Total recovery of section 111 items for 1958		30
Less: Recovery exclusion for 1958		200
Amount included in gross income of M Corporation for 1959		0

(4) *N Corporation's 1958 recovery.*

Total recovery of section 111 items for 1957	$50
Less: Recovery exclusion for 1957	150
Amount included in gross income of N Corporation for 1958	0

(5) *N Corporation's 1959 recoveries.*

(i) Total recovery of section 111 items for 1957		$20
Less: Recovery exclusion for 1957	$150	
Minus excludable recovery in 1958	50	
		100
Amount included in gross income of N Corporation for 1959		0
(ii) Total recovery of section 111 items for 1958		15
Less: Recovery exclusion for 1958		300
Amount included in gross income of N Corporation for 1959		0

(6) *N Corporation's 1960 recoveries.*

(i) Total recovery of section 111 items of M Corporation for 1957			$350
Less: Recovery exclusion of M Corporation for 1957			$400
Minus:			
Excludable recovery in 1959	$50		
Excludable recovery in 1958	25		
		75	
			325
Amount included in gross income of N Corporation for 1960			25
(ii) Total recovery of section 111 items of M Corporation for 1958			225
Less: Recovery exclusion of M Corporation for 1958		$200	
Minus excludable recovery in 1959		30	
			170
Amount included in gross income of N Corporation for 1960			55
(iii) Total recovery of section 111 items of M Corporation for 1959			550
Less: Recovery exclusion of M Corporation for 1959			500
Amount included in gross income of N Corporation for 1960			50
(iv) Total recovery of section 111 items of N Corporation for 1957			100
Less: Recovery exclusion of N Corporation for 1957		$150	
Minus:			
Excludable recovery in 1959	$20		
Excludable recovery in 1958	50		
		70	
			80
Amount included in gross income of N Corporation for 1960			20
(v) Total recovery of section 111 items of N Corporation for 1958			$350
Less: Recovery exclusion of N Corporation for 1958		$300	
Minus excludable recovery in 1959		15	

	285
Amount included in gross income of N Corporation for 1960	65
(vi) Total recovery of section 111 items of N Corporation for 1959	85
Less: Recovery exclusion of N Corporation for 1959	75
Amount included in gross income of N Corporation for 1960	10

(7) *Summary of recoveries included in gross income of N Corporation for 1960.*

(i) Recovery of M Corporation items for:		
1957	$25	
1958	55	
1959	50	
		$130
(ii) Recovery of N corporation items for:		
1957	20	
1958	65	
1959	10	
		95
Total amount included in gross income		225

[T.D. 6559, 26 FR 2984, Apr. 7, 1961]

§ 1.381(c)(13)–1 Involuntary conversions.

(a) *Carryover requirement*—(1) *General rule.* Section 381(c)(13) requires that after the date of distribution or transfer the acquiring corporation, in a transaction to which section 381(a) applies, shall be treated as the distributor or transferor corporation for purposes of applying section 1033, relating to involuntary conversions. This rule shall apply even though the property similar or related in service or use to the property converted, or the stock of a corporation owning such similar property, is purchased by the acquiring corporation after the date of distribution or transfer and is not received from the distributor or transferor corporation in the transaction to which section 381(a) applies. Accordingly, if any factor essential to the application of section 1033 occurs on or before the date of distribution or transfer and any other such factor also occurs after that date, then, in accordance with section 381(c)(13) and this section, the provisions of section 1033 shall apply to the acquiring corporation in the same manner that they would have applied to the distributor or transferor corporation in the absence of the distribution or transfer. For purposes of this section, the terms *involuntary conversion* and *disposition of the converted property* shall have the meaning ascribed to them by the regulations under section 1033.

(2) *Application to other transactions.* The provisions of this section shall apply to any transaction which, under provisions of the Internal Revenue Code of 1954, is treated as though it were an involuntary conversion within the meaning of section 1033. See, for example, section 1071, relating to gain from a sale or exchange to effectuate the policies of the Federal Communications Commission; and sections 1332(b)(3) and 1333(3), relating to war loss recoveries.

(b) *Conversion into similar property.* Section 1033(a)(1) provides that no gain shall be recognized if property is involuntarily converted only into property which is similar or related in service or use to the property so converted. If there is a disposition of property of a distributor or transferor corporation and, subsequent to the date of distribution or transfer, property similar or related in service or use to the property disposed of is received by the acquiring corporation as compensation for the property so disposed of, then no gain shall be recognized to the acquiring corporation, provided that no gain would have been recognized under section 1033(a)(1) if the similar property had been received directly by the distributor or transferor corporation.

Example. Property of S Corporation with an adjusted basis of $100 is condemned by the local government. Shortly after the property is so condemned, S Corporation liquidates and distributes its assets to P Corporation in a distribution to which section 381(a) applies. Subsequent to the date of distribution, P Corporation receives from the government (in settlement of the condemnation proceedings) property with a market value of $500 which is similar or related in service or use to the property so condemned. No gain is recognized to either corporation upon P Corporation's receipt of the similar property, and the property so received has a basis of $100 in the hands of P Corporation on the date of its acquisition.

(c) *Conversion into money or dissimilar property when disposition occurs after December 31, 1950*—(1) *General rule.* Section 1033(a)(3) and § 1.1033(a)–2 provide rules for involuntary conversions of property into money or dissimilar property where the disposition of the converted property occurs after December 31, 1950. In such a case, the gain on the conversion, if any, shall be recognized, at the election of the taxpayer, only to the extent that the amount realized on the conversion exceeds the cost of other property purchased by the taxpayer which is similar or related in service or use to the property so converted, or exceeds the cost of stock purchased by the taxpayer in the acquisition of control of a corporation owning such other property, provided (i) the taxpayer purchases such other property or stock for the purpose of replacing the property so converted and (ii) the purchase occurs during the period of time specified in section 1033(a)(3)(B). The provisions of this paragraph shall apply to involuntary conversions where the disposition of the property occurs after December 31, 1950, and where the election to have section 1033(a)(3) apply to the treatment of the gain upon the conversion is contingent upon activities of both the distributor or transferor corporation and the acquiring corporation. For purposes of section 381(c)(13), the period of time specified in section 1033(a)(3)(B) shall be determined by taking into account taxable years of, and extensions of time granted to, both the distributor or transferor corporation and the acquiring corporation.

(2) *Replacement period.* The period during which the purchase of similar property or stock must be made in order to prevent the recognition of gain on the involuntary conversion terminates 2 years (or, in the case of a disposition occurring before Dec. 31, 1969, 1 year) after the close of the first taxable year in which any part of the gain upon the conversion is realized, or at the close of such later date as may be designated pursuant to an application of the taxpayer. See paragraph (c)(3) of §1.1033(a)–2. Therefore, if, in a case to which this subparagraph applies, the first taxable year in which gain is realized is the taxable year of the distributor or transferor corporation ending with the close of the date of distribution or transfer, the acquiring corporation will have a maximum of only 2 years (or, in the case of a disposition occurring before Dec. 31, 1969, 1 year) after that date in which to purchase the similar property or stock, unless an extension of time has been granted upon application by the distributor, transferor, or acquiring corporation within the time prescribed. See paragraph (a) of §1.381(b)–1 as to the termination of the taxable year of the distributor or transferor corporation. See paragraph (c)(3) of §1.1033(a)–2 as to applications to extend the period within which to replace the converted property. In addition to the information otherwise required under paragraph (c)(3) of §1.1033(a)–2, the application shall contain sufficient detail in connection with the distribution or transfer to establish that section 381(c)(13) applies to the involuntary conversion involved.

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

Example (1). A and B Corporations compute their taxable income on the basis of the calendar year, and both corporations use the cash method of accounting. During 1970 property of A Corporation is destroyed by fire, and in January 1971, A Corporation receives $15,000 from an insurance company as compensation for its loss of property. The adjusted basis of the property on the date of destruction is $10,000; as a consequence, A Corporation realizes a gain of $5,000 on the involuntary conversion. On June 30, 1971, B Corporation acquires all of the assets of A Corporation in a reorganization to which section 381(a) applies. In accordance with paragraph (c)(2) of §1.1033(a)–2, A Corporation reports in its return for the short taxable year ending June 30, 1971, all the details in connection with the involuntary conversion but does not include the realized gain in gross income, thereby electing to have the gain recognized only to the extent provided in section 1033(a)(3). On June 15, 1973, B Corporation purchases for $20,000 property which is similar or related in service or use to the property previously destroyed. In its return for 1973, B Corporation reports all of the details in connection with its replacement of the property, as required by paragraph (c)(2) of §1.1033(a)–2. As a result of this replacement by B Corporation, none of the gain realized by A Corporation is recognized. The replacement property which is purchased by B Corporation has a basis to that corporation of $15,000 on the date of its purchase, that is, the cost of such property ($20,000) decreased by the amount of gain not recognized to A Corporation on the involuntary conversion ($5,000).

Example (2). Assume the same facts as in *Example (1),* except that B Corporation does not purchase similar property on or before June 30, 1973, and does not apply on or before that date (in accordance with paragraph (c)(3) of § 1.1033(a)–2) for an extension of time in which to make a replacement. In such event, the gain realized by A Corporation is recognized to that corporation for its taxable year ending June 30, 1971. A Corporation's tax liability for such taxable year must be recomputed in accordance with paragraph (c)(2) of § 1.1033(a)–2 in order to reflect this additional income.

Example (3). Assume the same facts as in *Example (1),* except that the property of A Corporation is destroyed in 1968, A Corporation receives the $15,000 from an insurance company in January 1969, B Corporation acquires all of the assets of A Corporation on June 30, 1969, and A Corporation's return is filed for the short taxable year ending June 30, 1969. B Corporation would have to purchase property which is similar or related in service or use to the property previously destroyed by June 30, 1970, in order to take advantage of the provisions of section 1033.

Example (4). M and N Corporations compute their taxable income on the basis of the calendar year, and both corporations use the cash method of accounting. During 1970, property of M Corporation is destroyed by fire. The adjusted basis of the property on the date of destruction is $10,000. The property is insured against loss by fire, but the insurance claim is not satisfied on or before June 30, 1971, the date on which N Corporation acquires all of the assets (including the insurance claim) of M Corporation in a reorganization to which section 381(a) applies. On September 1, 1972, N Corporation receives $15,000 from the insurance company as compensation for the fire loss suffered by M Corporation. Upon receipt of the insurance proceeds, N Corporation realizes a gain of $5,000 upon the involuntary conversion; however, in its return for 1972, N Corporation elects under the provisions of paragraph (c)(2) of § 1.1033(a)–2 to have the gain recognized only to the extent provided by section 1033(a)(3). On December 30, 1974, N Corporation purchases for $20,000 property which is similar or related in service or use to the property previously destroyed in the hands of M Corporation. As a result of this replacement by N Corporation, none of the gain realized by N Corporation in 1972 is recognized. The replacement property which is purchased by N Corporation has a basis to that corporation of $15,000 on the date of its purchase, that is, the cost of such property ($20,000) decreased by the amount of gain not recognized to N Corporation on the involuntary conversion ($5,000).

Example (5). R and S Corporations compute their taxable income on the basis of the calendar year, and both corporations use the cash method of accounting. During 1970 property of R Corporation is destroyed by fire. The adjusted basis of the property on the date of destruction is $10,000. In anticipation of taking the benefit of section 1033(a)(3), R Corporation purchases for $20,000 on June 1, 1971, property which is similar or related in service or use to the destroyed property. In its return for 1971, R Corporation reports all of the details in connection with the replacement of the property, as required by paragraph (c)(2) of § 1.1033(a)–2. The property destroyed in 1970 is insured against loss by fire, but the insurance claim is not satisfied on or before March 1, 1972, the date on which S Corporation acquires all of the assets (including the insurance claim) of R Corporation in a reorganization to which section 381(a) applies. On October 1, 1972, S Corporation receives $12,000 from the insurance company as compensation for the fire loss suffered by R Corporation. Upon receipt of the insurance proceeds, S Corporation realizes a gain of $2,000 upon the involuntary conversion; however, in its return for 1972, S Corporation elects under the provisions of paragraph (c)(2) of § 1.1033(a)–2 to have the gain recognized only to the extent provided by section 1033(a)(3). As a result of the replacement by R Corporation, none of the gain realized by S Corporation in 1972 is recognized. Assuming there are no adjustments for depreciation, the replacement property has a basis on October 1, 1972, of $18,000, that is, the cost of such property ($20,000) decreased by the amount of gain not recognized to S Corporation on the involuntary conversion ($2,000)

(d) *Conversion into money when disposition occurs before January 1, 1951.* Section 1033(a)(2) provides that, if property is disposed of in an involuntary conversion before January 1, 1951, and money is received as compensation for the conversion, no gain shall be recognized if such money is forthwith expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund. That section also provides that, if any part of the money is not so expended, the gain, if any, shall be recognized to the extent of the money which is not so expended. For example, if, pursuant to section 381(c)(13) and section 1033(a)(2), property of a distributor or transferor corporation is disposed of before January 1, 1951, in an involuntary conversion, and the proceeds from the conversion are received by the acquiring corporation so that the gain on the conversion is realized by that corporation, the acquiring corporation may avoid recognition of the gain if it complies with the provisions of section 1033(a)(2) for nonrecognition of gain. Thus, the acquiring corporation must forthwith expend the proceeds in the acquisition of similar property or stock, or in the establishment of a replacement fund, in order to avoid recognition of the gain, if the disposition occurred before January 1, 1951. See the provisions of §§1.1033(a)–3 and 1.1033(a)–4 relating to involuntary conversions and replacement funds when disposition of the converted property occurred before January 1, 1951.

(e) *Successive acquiring corporations.* An acquiring corporation which, in a transaction to which section 381(a) applies, acquires the assets of a corporation which previously acquired the assets of another corporation in a transaction to which section 381(a) applies, shall be treated as such other corporation for purposes of applying sections 381(c)(13) and 1033 (relating to involuntary conversions). Thus, for example, if any factor essential to the application of section 1033 occurs on or before the date of distribution or transfer in one transaction to which section 381(a) applies, and any other such factor occurs after the date of distribution or transfer in a subsequent transaction to which section 381(a) applies, then the acquiring corporation in such subsequent transaction shall be treated as the first distributor or transferor corporation subject to the rules and limitations of this section for purposes of sections 381(c)(13) and 1033.

[T.D. 6552, 26 FR 1989, Mar. 8, 1961, as amended by T.D. 7075, 35 FR 17995, Nov. 24, 1970]

§1.381(c)(14)–1 Dividend carryover to personal holding company.

(a) *Carryover requirement.* Section 381(c)(14) provides that an acquiring corporation shall succeed to and take into account the dividend carryover (described in section 564) of a distributor or transferor corporation in computing its dividends paid deduction under section 561 for taxable years ending after the date of distribution or transfer for which the acquiring corporation is a personal holding company under section 542. To determine the amount of such dividend carryover and to integrate it with the dividend carryover of the acquiring corporation in computing the dividends paid deduction for taxable years ending after the date of distribution or transfer, it is necessary to apply the provisions of section 564 and §1.564–1 in accordance with this section.

(b) *Manner of computing dividend carryover*—(1) *Preceding taxable years.* If the acquiring corporation is a personal holding company under section 542 for its first taxable year ending after the date of distribution or transfer, the taxable year of the distributor or transferor corporation ending with such date is a first preceding taxable year for purposes of section 564, and the taxable year of the distributor or transferor corporation immediately preceding such first preceding year is a second preceding taxable year for purposes of section 564. If the acquiring corporation is a personal holding company for its second taxable year ending after the date of distribution or transfer, the taxable year of the distributor or transferor corporation ending with such date is a second preceding taxable year for purposes of section 564.

(2) *Determination of dividends paid deduction and taxable income.* The dividends paid deduction of any distributor or transferor corporation (determined under section 561 but without regard to any dividend carryover) and the taxable income of any such corporation (adjusted as provided in section 545(b)) for any taxable year ending on or before the date of distribution or transfer shall be determined without reference to any dividends paid deduction, or taxable income, of the acquiring corporation or any other distributor or transferor corporation; in like manner, the dividends paid deduction and the taxable income of the acquiring corporation for any such taxable year shall be determined without reference to any dividends paid deduction, or taxable income, of a distributor or transferor corporation.

(3) *Computation of dividend carryover.* (i) For the purpose of determining the dividend carryover to the first taxable year of the acquiring corporation ending after the date of distribution or transfer, the amount of the dividend carryover from the distributor or

transferor corporation shall be determined under section 564 without reference to the dividends paid deduction or taxable income of the acquiring corporation or any other corporation. If two or more transactions to which section 381(a) applies have the same date of distribution or transfer, or if a particular taxable year of the acquiring corporation is the first taxable year ending after the dates of distribution or transfer of two or more such transactions occurring on different dates, the amount of the dividend carryover from each distributor or transferor corporation shall be determined separately as provided in the preceding sentence. Except as provided in subdivision (iii) of this subparagraph, the aggregate of the dividend carryovers from each distributor or transferor corporation and the dividend carryover of the acquiring corporation (computed without regard to this section) shall constitute the dividend carryover under section 561(a)(3) of the acquiring corporation for its first taxable year ending after the date (or dates) of distribution or transfer.

(ii) For the purpose of determining the dividend carryover to the second taxable year of the acquiring corporation ending after the date (or dates) of distribution or transfer, the excess, if any, of the dividends paid deduction (determined under section 561 without regard to any dividend carryover) over the taxable income (adjusted as provided in section 545(b)) for the taxable year of each distributor or transferor corporation and the acquiring corporation referred to as a second preceding taxable year shall be determined separately without reference to the dividends paid deduction or taxable income of any other of such corporations. The excesses thus determined shall be aggregated, and such aggregate shall be—

(*a*) Increased by the excess of the dividends paid deduction (determined without regard to any dividend carryover) over the taxable income (adjusted as provided in section 545(b)), or

(*b*) Reduced by the excess of the taxable income (adjusted as provided in section 545(b)) over the dividends paid deduction (determined without regard to any dividend carryover),

for the first preceding taxable year of the acquiring corporation. Except as provided in subdivision (iii) of this subparagraph, the amount thus determined shall constitute the dividend carryover under section 561(a)(3) of the acquiring corporation for its second taxable year ending after the date (or dates) of distribution or transfer.

(iii) If a particular taxable year of the acquiring corporation is its first taxable year ending after the date (or dates) of distribution or transfer of one or more transactions to which section 381(a) applies, and if the same taxable year of the acquiring corporation is also its second taxable year ending after the date (or dates) of distribution or transfer of one or more other transactions to which section 381(a) applies, then, for the purpose of determining the dividend carryover to such taxable year of the acquiring corporation, the rules contained in both subdivisions (i) and (ii) of this subparagraph shall be applied. Insofar as such taxable year constitutes the first taxable year ending after the date (or dates) of distribution or transfer of any transaction, the amount of the dividend carryover from any distributor or transferor corporation involved in such transaction shall be determined separately as provided in subdivision (i) of this subparagraph. Insofar as such taxable year constitutes the second taxable year ending after the date (or dates) of distribution or transfer of any transaction, the amount of the dividend carryover from any distributor or transferor corporation involved in the transaction and the acquiring corporation shall be determined as provided in subdivision (ii) of this subparagraph. The aggregate of the dividend carryovers thus determined shall constitute the dividend carryover under section 561(a)(3) of the acquiring corporation for such taxable year. See *Example (4)* in paragraph (c) of this section.

(c) *Illustrations.* The rules set forth in paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1) —(i) *Facts.* N Corporation acquired on June 30, 1960, all the assets of M Corporation in a reorganization to which section 381(a) applies. Both corporations compute taxable income on the basis of the calendar year. N Corporation is a personal holding company for its taxable years ending December 31, 1960, and December 31, 1961.

(ii) *Dividend carryover to N Corporation's taxable year ending December 31, 1960.* With respect to N Corporation's taxable year ending December 31, 1960, the taxable years referred to as first preceding taxable years and second preceding taxable years are—

(*a*) M Corporation's taxable years ending June 30, 1960, and December 31, 1959, respectively; and

(*b*) N Corporation's taxable years ending December 31, 1959, and December 31, 1958, respectively.

The dividend carryover to N Corporation's taxable year ending December 31, 1960, is $22,000 computed as follows, assuming the dividends paid deduction before dividend carryovers, and the taxable income after section 545(b) adjustments, to be as stated in the computation:

	M Corporation		N Corporation
Second preceding taxable year:			
Dividends paid deduction	$25,000		$12,000
Taxable income	15,000		13,000
Excess dividends paid deduction		$10,000	
First preceding taxable year:			
Dividends paid deduction	23,000		20,000
Taxable income	21,000		10,000
Excess dividends paid deduction	2,000		$10,000
Separate dividend carryovers	12,000		10,000

The aggregate dividend carryover of $22,000 is the sum of $12,000 (the separate dividend carryover from M Corporation) and $10,000 (the separate dividend carryover from N Corporation's own preceding taxable years).

(iii) *Dividend carryover to N Corporation's taxable year ending December 31, 1961.* With respect to N Corporation's taxable year ending December 31, 1961, the first preceding taxable year is N Corporation's taxable year ending December 31, 1960; and the taxable years referred to as second preceding taxable years are M Corporation's taxable year ending June 30, 1960, and N Corporation's taxable year ending December 31, 1959. The dividend carryover to N Corporation's taxable year ending December 31, 1961, is $17,000 computed as follows, assuming the dividends paid deduction before dividend carryovers, and the taxable income after section 545(b) adjustments, to be as stated in the computation:

Second preceding taxable year	M Corporation	N Corporation
Dividends paid deduction	$23,000	$20,000
Taxable income	21,000	10,000
Separate excess of dividends paid deduction over taxable income	2,000	10,000

The aggregate excess of dividends paid deduction over taxable income for the second preceding taxable year is $12,000, the sum of $2,000 (separate excess from N Corporation) and $10,000 (separate excess from N Corporation). Such aggregate excess is increased by the excess dividends paid deduction, or is reduced by the excess of taxable income, for the first preceding taxable year as follows:

Aggregate excess of dividends paid deduction for second preceding taxable year		$12,000
Dividends paid deduction of N Corporation for first preceding taxable year	$50,000	
Taxable income of N Corporation for first preceding taxable year	45,000	
		$5,000
Dividend carryover to N Corporation's taxable year ending December 31, 1961		17,000

Example (2) —(i) *Facts.* X Corporation is organized on May 1, 1956, and computes its taxable income on the basis of the fiscal year ending April 30. Y Corporation and Z Corporation are both organized on January 1, 1955, and both compute their taxable income on the basis of the calendar year. On July 31, 1957, X Corporation and Y Corporation transfer all their assets to Z Corporation in a statutory merger to which section 381(a) applies. For its taxable years ending December 31, 1957, and December 31, 1958, Z Corporation is a personal holding company.

(ii) *Dividend carryover to Z Corporation's taxable year ending December 31, 1957.* With respect to Z Corporation's taxable year ending December 31, 1957, the taxable years referred to as first preceding taxable years and second preceding taxable years are—

(*a*) X Corporation's taxable years ending July 31, 1957, and April 30, 1957, respectively;

(*b*) Y Corporation's taxable years ending July 31, 1957, and December 31, 1956, respectively; and

(*c*) Z Corporation's taxable years ending December 31, 1956, and December 31, 1955, respectively.

The dividend carryover to Z Corporation's taxable year ending December 31, 1957, is $40,000 computed as follows, assuming the dividends paid deduction before dividend carryovers, and the taxable income after section 545(b) adjustments, to be as stated in the computation:

	X Corporation		*Y Corporation*		*Z Corporation*	
Second preceding taxable year:						
Dividends paid deduction	$56,000		$19,000		$6,000	
Taxable income	24,000		17,000		5,000	....
Excess		$32,000		$2,000		$1,000
First preceding taxable year:						
Dividends paid deduction	9,000		4,000		10,000	
Taxable income	7,000		8,000		5,000	
Excess		2,000		(4,000)		5,000
Separate dividend carryovers		34,000		0		6,000

The aggregate dividend carryover of $40,000 is the sum of $34,000 (the separate dividend carryover from X Corporation) and $6,000 (the separate dividend carryover from Z Corporation's own preceding taxable years).

(iii) *Dividend carryover to Z Corporation's taxable year ending December 31, 1958.* With respect to Z Corporation's taxable year ending December 31, 1958, the first preceding taxable year is Z Corporation's taxable year ending December 31, 1957; and the taxable years referred to as second preceding taxable years are X Corporation's taxable year ending July 31, 1957, Y Corporation's taxable year ending July 31, 1957, and Z Corporation's taxable year ending December 31, 1956. The dividend carryover to Z Corporation's taxable year ending December 31, 1958, is $1,000 computed as follows, assuming the dividends paid deduction before dividend carryovers, and the taxable income after section 545(b) adjustments, to be as stated in the computation:

	X Corporation	*Y Corporation*	*Z Corporation*
Second preceding taxable year:			
Dividends paid deduction	$9,000	$4,000	$10,000
Taxable income	7,000	8,000	5,000
Separate excess of dividends paid deduction over taxable income	2,000	0	5,000

The aggregate excess of dividends paid deduction over taxable income for the second preceding taxable year is $7,000, the sum of $2,000 (separate excess from X Corporation) and $5,000 (separate excess from Z Corporation). Such aggregate excess is increased by the excess dividends paid deduction, or is reduced by the excess of taxable income, for the first preceding taxable year as follows:

Aggregate excess of dividends paid deduction for second preceding taxable year	....	$7,000
Dividends paid deduction of Z Corporation for first preceding taxable year	$102,000	
Taxable income of Z Corporation for first preceding taxable year	108,000	(6,000)
Dividend carryover to Z Corporation's taxable year ending December 31, 1958	....	1,000

Example (3). Assume the facts stated in *Example (2),* except that Y Corporation transferred all its assets to Z Corporation on May 31, 1957. Assume also that the facts for Y Corporation's taxable year ending May 31, 1957, are otherwise the same as those stated for its taxable year in *Example (2)* ending July 31, 1957. In such case, the dividend carryovers to Z Corporation's taxable years ending on December 31, 1957, and December 31, 1958, are the same as in *Example (2)* notwithstanding the fact that the transfers from X Corporation and Y Corporation occurred on the different dates.

Example (4) —(i) *Facts.* T Corporation acquired on June 30, 1960, all the assets of U Corporation in a statutory merger to which section 381(a) applies, and in a like transaction acquired on June 30, 1961, all the assets of V Corporation. Such corporations all compute taxable income on the basis of the calendar year. T Corporation is a personal holding company for its taxable years 1960 and 1961.

(ii) *Dividend carryover to T Corporation's taxable year 1960.* With respect to T Corporation's taxable year ending December 31, 1960, the taxable years referred to as first preceding taxable years and second preceding taxable years are—

(*a*) U Corporation's taxable years ending June 30, 1960, and December 31, 1959, respectively; and

(*b*) T Corporation's taxable years ending December 31, 1959, and December 31, 1958, respectively.

The dividend carryover to T Corporation's taxable year ending December 31, 1960, is $7,000 computed as follows, assuming the dividends paid deduction before dividend carryovers, and the taxable income after section 545(b) adjustments, to be as stated in the computation:

	U Corporation		*T Corporation*	
Second preceding taxable year:				
Dividends paid deduction	$16,000		$10,000	
Taxable income	12,000		13,000	
Excess		$4,000		0
First preceding taxable year:				
Dividends paid deduction	7,000		17,000	
Taxable income	5,000		16,000	
Excess		2,000		$1,000
Separate dividend carryovers		6,000		1,000

The aggregate dividend carryover of $7,000 is the sum of $6,000 (the separate dividend carryover from U Corporation) and $1,000 (the separate dividend carryover from T Corporation's own first preceding taxable year).

(iii) *Dividend carryover to T Corporation's taxable year 1961.* Inasmuch as T Corporation's taxable year 1961 is the second taxable year ending after the date of distribution or transfer from U Corporation, paragraph (b)(3)(ii) of this section governs the determination of the dividend carryover from taxable years of T Corporation and U Corporation. On the other hand, inasmuch as T Corporation's taxable year 1961 is the first taxable year ending after the date of distribution or transfer from V Corporation, paragraph (b)(3)(i) governs the determination of the dividend carryover from taxable years of V Corporation.

(*a*) *Application of paragraph (b)(3)(ii) of this section.* With respect to T Corporation's taxable year 1961, the first preceding taxable year is T Corporation's taxable year ending December 31, 1960; and the taxable years referred to as second preceding taxable year are T Corporation's taxable year ending December 31, 1959, and U Corporation's taxable year ending June 30, 1960. The dividend carryover from taxable years of T Corporation and U Corporation is $1,500 computed as follows, assuming the dividends paid deduction before dividend carryovers, and the taxable income after section 545(b) adjustments, to be as stated in the computation:

Second preceding taxable year	U Corporation	T Corporation
Dividends paid deduction	$7,000	$17,000
Taxable income	5,000	16,000
Separate excess of dividends paid deduction over taxable income	2,000	1,000

The aggregate excess of dividends paid deduction over taxable income for the second preceding taxable year is $3,000, the sum of $2,000 (separate excess from U Corporation) and $1,000 (separate excess from T Corporation). Such aggregate is increased by the excess dividends paid deduction, or is reduced by the excess of taxable income, for the first preceding taxable year as follows:

		T Corporation
Aggregate excess of dividends paid deduction for second preceding taxable year		$3,000
First preceding taxable year:		
Dividends paid deduction of T Corporation	$21,000	
Taxable income of T Corporation	22,500	
Excess taxable income		(1,500)
Separate dividend carryover (without regard to V Corporation)		1,500

(*b*) *Application of paragraph (b)(3)(i) of this section.* With respect to T Corporation's taxable year 1961, V Corporation's taxable year ending June 30, 1961, is a first preceding taxable year, and its taxable year ending December 31, 1960, is a second preceding taxable year. The separate dividend carryover from V Corporation is $8,000 computed as follows, assuming the dividends paid deduction before dividend carryovers, and the taxable income after section 545(b) adjustments, to be as stated in the computation:

	V Corporation	
Second preceding taxable year		
Dividends paid deduction	$11,000	
Taxable income	6,000	
Excess		$5,000
First preceding taxable year:		
Dividends paid deduction	$9,000	
Taxable income	6,000	

	V Corporation	
Second preceding taxable year		
Excess	3,000	
Separate dividend carryover from V Corporation		8,000

(*c*) *Dividend carryover.* The dividend carryover to T Corporation's taxable year 1961 is $9,500, the sum of $8,000 (the separate dividend carryover from V Corporation) and $1,500 (the aggregate dividend carryover from T Corporation and U Corporation).

(d) *Successive carryovers.* The provisions of this section shall apply for the purpose of determining a dividend carryover to an acquiring corporation which, in a distribution or transfer to which section 381(a) applies, acquires the assets of a distributor or transferor corporation which has previously acquired the assets of another corporation in a transaction to which section 381(a) applies; even though, in computing the dividend carryover to such second acquiring corporation, it is necessary to take into account the deduction for dividends paid, and the adjusted taxable income, of the first distributor or transferor corporation.

(e) *Acquiring corporation not receiving all the assets.* The dividend carryover acquired from a distributor or transferor corporation by an acquiring corporation in a transaction to which section 381(a) applies is not reduced by reason of the fact that the acquiring corporation does not acquire 100 percent of the assets of the distributor or transferor corporation.

(f) *Dividends paid after the close of taxable year.* A transaction to which section 381(a) applies does not prevent the application of section 563(b) to a dividend paid by a distributor or transferor corporation after the close of its taxable year ending with the date of distribution or transfer but on or before the 15th day of the third month following the close of such taxable year. However, dividends paid by the acquiring corporation may not be taken into account under section 563(b) for the purpose of determining the dividends paid deduction of the distributor or transferor corporation for its taxable year ending with the date of distribution or transfer.

[T.D. 6532, 26 FR 406, Jan. 19, 1961]

§ 1.381(c)(15)–1 Indebtedness of certain personal holding companies.

(a) *Qualified indebtedness*—(1) *Carryover requirement.* If, in a transaction to which section 381(a) applies, the acquiring corporation assumes liability for any indebtedness which was qualified indebtedness (as defined in section 545(c) and § 1.545–3) in the hands of the distributor or transferor corporation immediately before the assumption of such indebtedness, then, under section 381(c)(15), in computing its undistributed personal holding company income for any taxable year beginning after December 31, 1963, and ending after the date of distribution or transfer, the acquiring corporation shall be considered the distributor or transferor corporation for purposes of computing the deduction under section 545(c) and § 1.545–3. Such deduction shall be allowed to the acquiring corporation in accordance with section 545(c) and § 1.545–3.

(2) *Successive transactions to which section 381(a) applies.* If in a transaction to which section 381(a) applies, an acquiring corporation assumes liability for qualified indebtedness, such acquiring corporation shall be deemed to have incurred such qualified indebtedness for the purpose of applying section 381(c)(15) to any subsequent transaction in which such acquiring corporation is the distributor or transferor corporation.

(b) *Pre-1934 indebtedness*—(1) *Carryover requirement.* If, in a transaction to which section 381(a) applies, the acquiring corporation assumes liability for any indebtedness incurred, or assumed, before January 1, 1934, by a distributor or transferor corporation, then under section 381(c)(15) the acquiring corporation shall be allowed, in computing its undistributed personal holding company income for any taxable year ending after the date of distribution or transfer, a deduction under section 545(b)(7) for amounts used or irrevocably set aside to pay or to retire such indebtedness. Such deduction shall be allowed to the acquiring corporation in accordance with section 545(b)(7) and paragraph (g) of § 1.545–2 as though the indebtedness had been incurred, or assumed, by the acquiring corporation before January 1, 1934.

(2) *Successive transactions to which section 381(a) applies.* If, in a transaction to which section 381(a) applies, an acquiring corporation assumes liability for indebtedness described in subparagraph (1) of this paragraph, such acquiring corporation shall be deemed to have incurred the indebtedness before January 1, 1934, for the purpose of applying section 381(c)(15) to any subsequent transaction in which such acquiring corporation is the distributor or transferor corporation.

(c) *Special rule.* For purposes of this section, if, in a transaction otherwise described in this section, an acquiring corporation acquires real estate—(1) of which the distributor or transferor corporation is the legal or equitable owner immediately before the acquisition, and (2) which is subject to indebtedness that, with respect to the distributor or transferor corporation, is indebtedness described in this section immediately before the acquisition, then the acquiring corporation will be treated as having assumed such indebtedness, provided it shows to the satisfaction of the Commissioner that under all the facts and circumstances it bears the burden of discharging such indebtedness.

[T.D. 6949, 33 FR 5524, Apr. 9, 1968; 33 FR 6091, Apr. 20, 1968]

§ 1.381(c)(16)–1 Obligations of distributor or transferor corporation.

(a) *Deduction allowed to acquiring corporation.* (1) If, in a transaction to which section 381(a) applies, the acquiring corporation assumes an obligation of a distributor or transferor corporation which gives rise to a liability after the date of distribution or transfer and if the distributor or transferor corporation would be entitled to deduct such liability in computing taxable income were it paid or accrued after that date by such corporation, then, under the provisions of section 381(c)(16) and this section, the acquiring corporation shall be entitled to deduct such liability as if it were the distributor or transferor corporation. However, in the case of a transaction to which section 381(a)(2) applies, section 381(c)(16) shall not apply to an obligation which is reflected in the amount of consideration, that is, the stock, securities, or other property, transferred by the acquiring corporation to a transferor corporation or its shareholders in exchange for the property of that transferor corporation. An obligation which is so reflected in the amount of consideration will be treated as an item or tax attribute not specified in section 381(c)(16). Such an obligation is subject to section 381(c)(4). See subparagraph (2) of this paragraph. Any deduction allowed under section 381(c)(16) to the acquiring corporation shall be taken by that corporation in the taxable year ending after the date of distribution or transfer in which the liability is paid or accrued by that corporation, as the case may be.

(2) In order to determine whether, in the case of obligations of a distributor or transferor corporation assumed by an acquiring corporation, section 381(c)(16) and this section, or section 381(c)(4) and the regulations thereunder, apply, the following rules shall govern:

(i) If the obligation gave rise to a liability before the date of distribution or transfer, see section 381(c)(4) and the regulations thereunder.

(ii) If the obligation gives rise to a liability after the date of distribution or transfer, and the obligation was not reflected in the amount of consideration transferred by the acquiring corporation to the distributor or transferor corporation or its shareholders in exchange for the property of the distributor or transferor corporation, then section 381(c)(16) and this section shall apply.

(iii) In the case of a transaction to which section 381(a)(1) applies, if the obligation gives rise to a liability after the date of a distribution, and the obligation was reflected in the amount of consideration transferred by the acquiring corporation to the distributor corporation or its shareholders in exchange for the property of the distributor corporation, then section 381(c)(16) and this section shall apply.

(iv) In the case of a transaction to which section 381(a)(2) applies, if the obligation gives rise to a liability after the date of a transfer, and the obligation was reflected in the amount of consideration transferred by the acquiring corporation to the transferor corporation or its shareholders in exchange for the property of the transferor corporation, then see section 381(c)(4) and the regulations thereunder.

(3) The rules of this section apply to obligations assumed by agreement of the parties as well as by operation of law.

(4) For purposes of this section, an obligation of a distributor or transferor corporation gives rise to a liability when the liability would be accruable by a taxpayer using the accrual method of accounting notwithstanding the fact that the distributor or transferor corporation is not using the accrual method of accounting. See paragraph (a)(2) of § 1.461–1.

(5) In the case of a transaction to which section 381(a)(2) applies, the determination as to whether or not an obligation was reflected in the amount of consideration transferred by the acquiring corporation to the transferor corporation or its shareholders in exchange for the property of the transferor corporation shall be made on the basis of all the facts of each particular transfer. Where, on the date of distribution or transfer, the parties were aware of the existence of a specific obligation and reduced the amount of consideration to be transferred by the acquiring corporation by a specific amount because of the existence of such obligation, then such obligation shall be considered to have been reflected in the amount of consideration transferred. In the absence of such facts, it shall be presumed that the obligation was not reflected in the amount of consideration transferred.

(b) *Distribution or transfer occurring under the Internal Revenue Code of 1939.* Subject to the provisions of section 381(c)(16) and this section, a corporation which would have been an acquiring corporation (under the provisions of paragraph (b) of § 1.381(a)–1) in a transaction to which section 381(a) applies if the date of distribution or transfer had occurred on or after the effective date of the provisions of subchapter C, chapter 1 of the Internal Revenue Code of 1954, applicable to a liquidation or reorganization, as the case may be, shall be entitled to take a deduction for amounts paid or accrued in any taxable year beginning after December 31, 1953, in respect of any obligation which it has assumed from a corporation which would have been a distributor or transferor corporation in such transaction. However, this paragraph shall have no application to a situation described in paragraph (a)(2)(iv) of this section.

(c) *Examples.* The application of the foregoing rules may be illustrated by the following examples:

Example (1). X Corporation and Y Corporation compute their taxable income on the basis of the calendar year, and both corporations use an accrual method of accounting. On December 31, 1954, Y Corporation acquires the assets of X Corporation in a transfer to which section 381(a)(2) applies. By reason of State law, Y Corporation assumes responsibility for all of the obligations for which X Corporation is then, or may become, liable. The parties have no knowledge of any specific obligations of X Corporation which are not yet fixed and ascertainable, but it is agreed to reduce the amount of consideration that Y Corporation is to transfer in exchange for the assets of X Corporation by $5,000 to reflect any unforeseen contingent liabilities of X Corporation for which Y Corporation might subsequently become liable. After the date of the transfer, a claim for damages on account of the alleged negligence of an alleged agent of X Corporation is filed. After commencement of legal action by the claimant and in order to eliminate the possibility of injury to its business, Y Corporation settles the claim in 1955 by paying the claimant the amount of $3,000. Assuming that such sum would have been deductible under section 162 if paid by X Corporation, Y Corporation is entitled to deduct such sum in accordance with the provisions of section 381(c)(16) and this section in computing its taxable income for 1955, since the claim gave rise to a liability after the date of transfer, the parties were not aware of a specific obligation, and the specific obligation was not reflected in the consideration transferred by Y Corporation in exchange for the assets of X Corporation.

Example (2). Assume the same facts as in *Example (1)*, except that the claim for damages was filed prior to the transfer of X Corporation's assets to Y Corporation, but the parties considered the chances for recovery by the claimant so remote that no specific amount other than the $5,000 reduction in consideration for all contingent liabilities as a whole is reflected in the consideration transferred by Y Corporation in exchange for the assets of X Corporation. Assuming that such sum would have been deductible under section 162 if paid by X Corporation, the

$3,000 paid by Y Corporation in 1955 is deductible in accordance with the provisions of section 381(c)(16) and this section in 1955.

Example (3). Assume the same facts as in *Example (1)*, except that the parties consider the chances of recovery by the claimant of sufficient probability that Y Corporation reduces the amount of consideration it transfers in exchange for the assets of X Corporation by $1,000 in addition to the $5,000 reduction for all other contingent liabilities. The $3,000 paid by Y Corporation in 1955 is not deductible under section 381(c)(16) and this section, since the specific obligation was reflected in the consideration transferred by Y Corporation in exchange for the assets of X Corporation. The deductibility of the payment is accordingly governed by the provisions of section 381(c)(4) and the regulations thereunder. Similarly, if in this case Y Corporation had transferred $10,000 less in consideration for the assets of X Corporation because of this particular claim, Y Corporation would not be entitled to any deduction for the $3,000 paid in 1955 under section 381(c)(16) and this section, and the deductibility of the payment would be governed by the provisions of section 381(c)(4) and the regulations thereunder. If the date of transfer of X Corporation's assets had occurred prior to the effective date of subchapter C, chapter 1 of the Internal Revenue Code of 1954, applicable to a reorganization, no deduction would be allowed to Y Corporation under that section.

[T.D. 6750, 29 FR 11267, Aug. 5, 1964]

§1.381(c)(17)–1 Deficiency dividend of personal holding company.

(a) *Carryover requirement.* If a determination (as defined in section 547(c)) establishes that a distributor or transferor corporation in a transaction to which section 381(a) applies is liable for personal holding company tax imposed by section 541 (or by a corresponding provision of prior income tax law) for any taxable year ending on or before the date of distribution or transfer, then in computing such tax the deduction described in section 547 shall be allowed pursuant to section 381(c)(17) to such corporation for the amount of deficiency dividends paid by the acquiring corporation with respect to the distributor or transferor corporation. Except as otherwise provided in this section, the provisions of section 547 and the regulations thereunder apply with respect to a deficiency dividend deduction allowable pursuant to section 381(c)(17).

(b) *Deficiency dividends paid by the acquiring corporation with respect to the distributor or transferor corporation.* A deficiency dividend paid by the acquiring corporation with respect to the distributor or transferor corporation is a distribution that would satisfy the definition of a deficiency dividend under section 547(d)(1) if paid by the distributor or transferor corporation to its own shareholders except that it shall be paid by the acquiring corporation to its own shareholders and shall be paid after the date of distribution or transfer and on, or within 90 days after, the date of the determination but before the acquiring corporation files claim under paragraph (c) of this section.

(c) *Claim for deduction.* A claim for a deduction under this section shall be made by the acquiring corporation on Form 976, and shall be filed within 120 days after the date of the determination. The form shall contain, or be accompanied by, the information required under paragraph (b)(2) of §1.547–2 in sufficient detail to properly identify the facts with the distributor or transferor corporation and the acquiring corporation. The statement required with respect to the shareholders on the date of payment of the deficiency dividend shall relate to the shareholders of the acquiring corporation, and the required certified copy of the resolution authorizing the payment of the dividend shall be that of the board of directors, or other authority, of the acquiring corporation. Necessary changes may be made in Form 976 in order to carry out the provisions of this paragraph. The claim shall be filed with the district director for the internal revenue district in which the return of the distributor or transferor corporation to which such claim relates was filed.

(d) *Effect on dividends paid deduction.* A deficiency dividend paid by the acquiring corporation, which is allowable as a deduction to a distributor or transferor corporation pursuant to section 381(c)(17), shall not become a part of the dividends paid deduction of the acquiring corporation under section 561 for any taxable year.

(e) *Successive transactions to which section 381(a) applies.* The provisions of this section shall apply in the case of successive transactions to which section 381(a) applies. Thus, if X Corporation transfers its assets to Y Corporation in a transaction to which section 381(a) applies and if Y Corporation transfers its assets to Z Corporation in a subsequent transaction to which section 381(a) applies, then, subject to the provisions of this section, X Corporation may take a deficiency dividend deduction for the amount of deficiency dividends paid by Z Corporation with respect to X Corporation.

(f) *Example.* The provisions of this section may be illustrated by the following example:

Example. M Corporation, a personal holding company, computes its taxable income on the basis of the calendar year. On December 31, 1956, N Corporation acquires the assets of M Corporation in a transaction to which section 381(a) applies. On July 31, 1958, a determination (as defined in section 547(c)) establishes that M Corporation is liable for the taxable year 1955 for personal holding company tax in the amount of $35,500 based on undistributed personal holding company income of $42,000 for such taxable year. N Corporation complies with the provisions of this section and on September 30, 1958, distributes $42,000 to its shareholders as deficiency dividends with respect to M Corporation's taxable year 1955. The distribution of $42,000 by N Corporation is a taxable dividend under section 316(b)(2) regardless of whether N Corporation is a personal holding company for the taxable year 1958 or whether it had any current or accumulated earnings and profits. See *Example (3)* in paragraph (e) of § 1.316–1. Because N Corporation has paid deficiency dividends of $42,000 in accordance with this section, M Corporation is entitled to a deficiency dividend deduction of $42,000 for the taxable year 1955 and is thus relieved of its liability for personal holding company tax of $35,500 for such taxable year. To prevent a duplication of deductions, the amount distributed by N Corporation in 1958 does not become a part of N Corporation's dividends paid deduction under section 561 for any taxable year.

[T.D. 6532, 26 FR 409, Jan. 19, 1961, as amended by T.D. 7604, 44 FR 18661, Mar. 29, 1979; T.D. 7767, 45 FR 11264, Feb. 6, 1981]

§ 1.381(c)(18)–1 Depletion on extraction of ores or minerals from the waste or residue of prior mining.

(a) *Carryover requirement.* Section 381(c)(18) provides that the acquiring corporation in a transaction described in section 381(a) shall be considered as though it were the distributor or transferor corporation after the date of distribution or transfer for the purpose of determining the applicability of section 613(c)(3) (relating to extraction of ores or minerals from the ground). Thus, an acquiring corporation which has acquired the waste or residue of prior mining from a distributor or transferor corporation in a transaction described in section 381(a) shall be entitled, after the date of distribution or transfer, to an allowance for depletion under section 611 in respect of ores or minerals extracted from such waste or residue if the distributor or transferor corporation would have been entitled to such an allowance for depletion in the absence of the distribution or transfer. See paragraph (f) of § 1.613–4 to determine whether a distributor or transferor corporation is entitled to an allowance for depletion with respect to the waste or residue of prior mining.

(b) *Application of section 614 to waste or residue of prior mining.* If, in a transaction described in section 381(a), the acquiring corporation acquires waste or residue of prior mining from a distributor or transferor corporation, then the acquiring corporation shall be considered as though it were the distributor or transferor corporation for the purpose of applying section 614 and the regulations thereunder to the waste or residue so acquired. Thus, if the distributor or transferor corporation was required under paragraph (c) of § 1.614–1 to treat the waste or residue as part of the mineral deposit from which it was extracted and if the acquiring corporation acquires both the waste or residue and the mineral deposit from which it was extracted in a transaction described in section 381(a), then such waste or residue shall be treated as a part of such mineral deposit in the hands of the acquiring corporation. On the other hand, if the waste or residue was required to be treated as a separate mineral deposit in the hands of the distributor or transferor corporation, such waste or residue shall be treated as a separate mineral deposit in the hands of the acquiring corporation.

[T.D. 6552, 26 FR 1991, Mar. 8, 1961, as amended by T.D. 7170, 37 FR 5373, Mar. 15, 1972]

§1.381(c)(19)–1 Charitable contribution carryovers in certain acquisitions.

(a) *Carryover requirement.* Section 381(c)(19) provides that, in computing taxable income for its taxable years which begin after the date of distribution or transfer to which section 381(a) applies, the acquiring corporation shall take into account any charitable contributions made by a distributor or transferor corporation during the taxable year ending on the date of distribution or transfer, and in certain immediately preceding taxable years, which are in excess of the maximum amount deductible for those taxable years under section 170(b)(2) in the following manner:

(1) If the taxable year of the distributor or transferor corporation ending on the date of distribution or transfer begins before January 1, 1962, the acquiring corporation shall, in computing taxable income for its first 2 taxable years which begin after the date of such distribution or transfer, take into account the excess contributions made by the distributor or transferor corporation in the taxable year ending on the date of distribution or transfer and in the immediately preceding taxable year;

(2) If the taxable year of the distributor or transferor corporation ending on the date of distribution or transfer begins after December 31, 1961, the acquiring corporation shall, in computing taxable income for certain taxable years which begin after the date of distribution or transfer, take into account the excess contributions made by the distributor or transferor corporation in the taxable year ending on such date of distribution or transfer and in any of the four taxable years immediately preceding such taxable year but excluding any taxable year beginning before January 1, 1962 (see paragraph (c)(3) of this section). Notwithstanding the preceding sentence, if the taxable year of the distributor or transferor corporation ending on the date of distribution or transfer begins after December 31, 1961, and before January 1, 1963, the acquiring corporation shall, in computing taxable income for its first taxable year which begins after the date of distribution or transfer, also take into account the excess contributions made by the distributor or transferor corporation in the taxable year immediately preceding the taxable year of the distributor or transferor corporation ending on the date of distribution or transfer (see paragraph (c)(2) of this section).

To determine the amount of excess contributions made by a distributor or transferor corporation and to integrate them with contributions made by the acquiring corporation for the purpose of determining the charitable contributions deductible by the acquiring corporation for its taxable years beginning immediately after the date of distribution or transfer, it is necessary to apply the provisions of section 170(b)(2) and §1.170–3 (or, if applicable, section 170(b)(2) and (d)(2) and §1.170A–11) in accordance with the conditions and limitations of section 381(c)(19) and this section. For taxable years beginning before January 1, 1970, see section 170 for provisions of section 170(b)(2) as referred to in this section. For taxable years beginning after December 31, 1969, see section 170A for provisions of section 170(b)(2) or (d)(2) as referred to in this section. For special rules for applying section 170(d)(2) with respect to contributions paid, or treated as paid, in taxable years beginning before January 1, 1970, see paragraph (d) of §1.170A–11.

(b) *Manner of computing excess charitable contribution carryovers.* (1) The amount of any charitable contribution made by a distributor or transferor corporation in any taxable year ending on or before the date of distribution or transfer, or made by the acquiring corporation in any taxable year before its taxable year beginning after the date of distribution or transfer, in excess of the amount allowable as a deduction to such corporation for such taxable year under section 170(b)(2) shall be determined by taking into account the taxable income of, and the contributions made by, that corporation only.

(2) An acquiring corporation which, in a distribution or transfer to which section 381(a) applies, acquires the assets of a distributor or transferor corporation which previously acquired the assets of another corporation in a

transaction to which section 381(a) applies, shall succeed to and take into account, subject to the conditions and limitations of sections 170 and 381, the charitable contribution carryovers available to the first acquiring corporation under sections 170 and 381, including those derived by such first acquiring corporation from its distributor or transferor corporation.

(3) The excess charitable contributions made by a distributor or transferor corporation in its taxable year ending on the date of distribution or transfer and in certain immediately preceding taxable years (see paragraph (c) of this section) which are not deductible by the distributor or transferor corporation because of the 5-percent limitation of section 170(b)(2) shall be available to the acquiring corporation without diminution by reason of the fact that the acquiring corporation does not acquire 100 percent of the assets of the distributor or transferor corporation. Thus, if a parent corporation owning 80 percent of all classes of stock of its subsidiary corporation were to acquire its share of the assets of the subsidiary corporation upon a complete liquidation described in paragraph (b)(1)(i) of § 1.381(a)–1, then, subject to the conditions and limitations of this section, 100 percent of the excess contributions made by the subsidiary corporation would be available to the acquiring corporation.

(c) *Taxable years to which carryovers apply and amount deductible*—(1) *Taxable years beginning before January 1, 1962.* If the taxable year of the distributor or transferor corporation ending on the date of distribution or transfer begins before January 1, 1962:

(i) The excess charitable contributions made by a distributor or transferor corporation in its taxable year immediately preceding that ending on the date of distribution or transfer, to the extent not deductible by it because of the limitations of section 170(b)(2) in its taxable year ending on that date, shall be deductible by the acquiring corporation to the extent prescribed by section 170(b)(2) in its first taxable year beginning after the date of distribution or transfer. Any portion of such excess which is not deductible under this section by the acquiring corporation in such first taxable year shall not be deducted by that corporation in any other taxable year.

(ii) The excess charitable contributions made by a distributor or transferor corporation in its taxable year ending on the date of distribution or transfer shall first be deductible by the acquiring corporation to the extent prescribed by section 170(b)(2) and this section in its first taxable year beginning after that date and then, to the extent prescribed by section 170(b)(2) and this section, in its second taxable year beginning after that date. Any portion of such excess which is not deductible under this section by the acquiring corporation in such first and second taxable years shall not be deducted by that corporation in any other taxable year.

(2) *Taxable years beginning in 1962.* If the taxable year of the distributor or transferor corporation ending on the date of distribution or transfer begins after December 31, 1961, and before January 1, 1963:

(i) The excess charitable contributions made by a distributor or transferor corporation in its taxable year immediately preceding that ending on the date of distribution or transfer, to the extent not deductible by it because of the limitations of section 170(b)(2) in its taxable year ending on that date, shall be deductible by the acquiring corporation to the extent prescribed by section 170(b)(2) in its first taxable year beginning after the date of distribution or transfer. Any portion of such excess which is not deductible under this section by the acquiring corporation in such first year shall not be deducted by that corporation in any other taxable year.

(ii) The excess charitable contributions made by a distributor or transferor corporation in its taxable year ending on the date of distribution or transfer and beginning after December 31, 1961, and before January 1, 1963, shall first be deductible by the acquiring corporation to the extent prescribed by section 170(b)(2) and this section in its first taxable year beginning after that date and then, to the extent prescribed by section 170(b)(2) and this section, in its second, third, fourth, and fifth taxable year, in order of time, beginning after that date. Any portion of such excess which is not deductible under this section by the acquiring corporation in such 5 taxable years shall not be deducted by that corporation in any other taxable year.

(3) *Taxable years beginning after December 31, 1962.* (i) If the taxable year of the distributor or transferor corporation ending on the date of distribution or transfer begins after December 31, 1962, the excess charitable contributions made by a distributor or transferor corporation in its taxable year ending on the date of distribution or transfer and in each of its four immediately preceding taxable years (excluding any taxable year beginning before January 1, 1962), to the extent not deductible by it because of the limitations of section 170(b)(2) in its taxable year ending on the date of distribution or transfer or its prior taxable years, shall be deductible by the acquiring corporation to the extent prescribed by section 170(b)(2) (or, if applicable, section 170(d)(2)) and subdivision (ii) of this subparagraph, in its taxable years which begin after the date of distribution or transfer. However, any portion of the excess charitable contributions made by a distributor or transferor corporation in a particular taxable year, to which this subparagraph is applicable, which is not deductible under this section within the 5 taxable years immediately following the taxable year in which the contribution was paid by the distributor or transferor corporation shall not be deductible by the acquiring corporation in any other taxable year.

(ii) For purposes of determining the 5 taxable years in which the excess contributions may be deducted, all taxable years of the distributor or transferor corporation subsequent to the taxable year in which the excess contribution was made, including the taxable year ending on the date of distribution or transfer shall be treated as taxable years of the acquiring corporation.

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

Example. X Corporation and Y Corporation both compute taxable income on the calendar year basis. X Corporation has excess charitable contributions for 1962 and 1964. On December 31, 1966, X Corporation distributes all its assets to Y Corporation in a complete liquidation to which section 381(a) applies. The excess 1962 charitable contributions of X Corporation (to the extent not deductible by X because of the limitations of section 170(b)(2) in its taxable years 1963 through 1966) may be deducted by Y Corporation only in 1967. Y Corporation's taxable year 1967 is the fifth taxable year succeeding the taxable year 1962 (the year in which the excess contributions were made), and the portion of such excess contributions which is not deductible in the 5 taxable years immediately succeeding 1962 (1963 through 1967) is not deductible by Y Corporation in any other taxable year. Any excess charitable contributions for 1964 to which Y Corporation may be entitled must be deducted by Y Corporation (if deductible at all) in 1967, 1968, and 1969 since such years are the third, fourth, and fifth taxable years succeeding the taxable year 1964 (the year in which the excess contributions were paid).

(4) *General rules.* No excess charitable contributions made by a distributor or transferor corporation shall be deductible by the acquiring corporation in its taxable year which includes the date of distribution or transfer. In addition, an excess charitable contribution made by a distributor or transferor corporation in a taxable year prior to the taxable year of the transfer is only deductible by the distributor or transferor corporation, subject to the limitations of section 170(b)(2) (or, if applicable, section 170(d)(2)), in its subsequent taxable years which begin on or before the date of distribution or transfer, and by the acquiring corporation in its taxable year or years beginning after the date of distribution or transfer.

(d) *Rules governing amounts deductible by acquiring corporations.* (1) In applying the provisions of section 170(b)(2) (or, if applicable, section 170(d)(2)) for the purpose of determining the amount of excess charitable contributions which are deductible by the acquiring corporation in its taxable years beginning after the date of distribution or transfer, all taxable years of the distributor or tranferor and acquiring corporations which, with respect to a particular taxable year beginning after the date of distribution or transfer, constitute the same numbered preceding taxable year shall together be considered as a 1 taxable year even though the taxable years involved may not end on the same date. Thus, for example, all taxable years of the distributor or transferor and acquiring corporations which, with respect to the first taxable year of the acquiring corporation beginning after the date of distribution or transfer, constitutes the second preceding taxable year shall together be considered as 1 taxable year even though the taxable years involved may not end on the same date. Any excess charitable contributions carried over from preceding taxable years which are considered as 1 taxable year shall be taken into account by the acquiring corporation as one amount, without regard to the extent to which the contributions were made by a distributor or transferor corporation or the acquiring corporation.

(2) For purposes of this paragraph, each taxable year of the distributor or transferor corporation beginning on or before the date of distribution or transfer shall be treated as a preceding taxable year with reference to the acquiring corporation's taxable years beginning after such date. For example, the taxable year of a distributor or transferor corporation which ends on the date of distribution or transfer shall be considered a first preceding taxable year with reference to the acquiring corporation's first taxable year beginning after that date, a second preceding taxable year with reference to the acquiring corporation's second taxable year beginning after that date, and so forth with respect to succeeding taxable years of the acquiring corporation. Also, for example, the taxable year of a distributor or transferor corporation which immediately precedes its taxable year ending on the date of distribution or transfer shall be considered a second preceding taxable year with reference to the acquiring corporation's first taxable year beginning after that date.

(e) *Illustration.* The application of this section may be illustrated by the following example:

Example. (i) X Corporation is organized on April 1, 1956, and computes its taxable income on the basis of the fiscal year ending March 31. Y Corporation is organized on July 1, 1955, and computes its taxable income on the basis of the fiscal year ending June 30. Z Corporation is organized on January 1, 1956, and computes its taxable income on the basis of the calendar year. On June 30, 1957, X Corporation distributes all its assets to Y Corporation in a complete liquidation to which section 381(a) applies. On November 30, 1957, Y Corporation transfers all its assets to Z Corporation in a statutory merger to which section 381(a) applies.

(ii) The 5-percent limitation (computed in the manner prescribed by section 170(b)(2)), the charitable contributions actually paid, and the excess contributions with respect to each such corporation during the taxable years involved are as follows:

Name of corporation	*X*	*X*
Taxable year ending	*3–31–57*	*6–30–57*
5-percent limitation	$20,000	$9,000
Current contributions	32,000	15,000
(Excess contributions)	(12,000)	(6,000)

Name of corporation	*Y*	*Y*	*Y*
Taxable year ending	*6–30–56*	*6–30–57*	*11–30–57*
5-percent limitation	$15,000	$10,000	$18,000
Current contributions	29,000	0	17,000
(Excess contributions)	(14,000)	....	....
Balance of 5-percent limitation	....	10,000	1,000

Name of corporation	*Z*	*Z*	*Z*
Taxable year ending	*12–31–56*	*12–31–57*	*12–31–58*
5-percent limitation	$10,000	$30,000	$58,000
Current contributions	40,000	28,000	92,000
(Excess contributions)	(30,000)	....	....
Balance of 5-percent limitation	....	2,000	56,000

(iii) X Corporation was in existence for two taxable years, in each of which it made charitable contributions in excess of the maximum amount deductible for those years under section 170(b)(2). The excess contributions made in the year ending March 31, 1957, of $12,000, are deductible by X Corporation in its short taxable year ending June 30, 1957, and then by Y Corporation in its short taxable year ending November 30, 1957, in each instance in the manner and to the extent prescribed by section 170(b)(2) and this section. The excess contributions made by X Corporation in the year ending June 30, 1957, of $6,000, are deductible by Y Corporation in its short taxable year ending November 30, 1957, and then by Z Corporation in its taxable year 1958, in each instance in the manner and to the extent prescribed by section 170(b)(2) and this section.

(iv) Y Corporation was in existence for three taxable years. In the year ended June 30, 1956, its contributions in excess of the amount deductible for that year under section 170(b)(2) amounted to $14,000. Such excess is deductible by Y Corporation in its taxable year ending June 30, 1957, and, together with X Corporation's excess contributions of $18,000, in its short taxable year ending November 30, 1957, in each instance in the manner and to the extent prescribed by section 170(b)(2) and this section. Accordingly, since Y Corporation made no contributions in its taxable year ending June 30, 1957, its deduction for that year on account of excess contributions carried over is $10,000, an amount equal to the 5-percent limitation of section 170(b)(2). The deduction is attributable to excess contributions made by Y Corporation in the taxable year ended June 30, 1956; thus, the excess of those contributions over $10,000, namely, $4,000, is deductible by Y Corporation in its short taxable year ending November 30, 1957, in the manner and to the extent prescribed by section 170(b)(2) and this section. With respect to the short taxable year ending November 30, 1957, the excess contributions of the second preceding year are X Corporation's excess contributions of $12,000 made in the year ending March 31, 1957, and Y Corporation's excess contributions of $4,000 made in the year ending June 30, 1956, which were not deductible by Y Corporation in the taxable year ending June 30, 1957, because of the 5-percent limitation prescribed by section 170(b)(2), an aggregate of $16,000. Inasmuch as Y Corporation's limitation for the short taxable year ended November 30, 1957, exceeds the contributions made in that year by $1,000, the excess contributions of the second preceding taxable year are deductible in the taxable year ending November 30, 1957, to the extent of $1,000 and the remainder ($15,000) is not deductible by any corporation in any taxable year. The excess contributions of the first preceding taxable year, namely, X Corporation's excess contributions made in the short taxable year ending June 30, 1957, are deductible by Z Corporation in its taxable year 1958, in the manner and to the extent prescribed in section 170(b)(2) and this section.

(v) Z Corporation has been in existence for 3 taxable years. The contributions made in 1956 in excess of the amount deductible for that year under section 170(b)(2) amounted to $30,000. Such excess is deductible by Z Corporation in its taxable year 1957 and, together with X Corporation's excess contributions of $6,000 (derived through Y Corporation) made in the taxable year ending June 30, 1957, in the taxable year 1958, in each instance in the manner and to the extent prescribed by section 170(b)(2) and this section. Thus, $2,000 of the $30,000 excess contributions made in the year 1956 are deducted in 1957 and the remainder ($28,000), together with X Corporation's excess contributions of $6,000 made in the short taxable year ending June 30, 1957, are deducted in 1958 since the aggregate of such amounts plus the contributions actually made in that year does not exceed the 5-percent limitation prescribed by section 170(b)(2).

[T.D. 6552, 26 FR 1992, Mar. 8, 1961, as amended by T.D. 6900, 31 FR 14642, Nov. 17, 1966; T.D. 7207, 37 FR 20795, Oct. 5, 1972]

§1.381(c)(21)–1 Pre-1954 adjustments resulting from change in method of accounting.

(a) *Carryover requirement.* Section 381(c)(21) provides that, in a transaction to which section 381(a) applies, an acquiring corporation shall take into account the net amount of any adjustments described in section 481(b)(4) (relating to adjustments arising from changes in accounting methods initiated by the taxpayer attributable to pre-1954 Code years) of the distributor or transferor corporation to the extent that such net amount of such adjustments has not been taken into account in any taxable year, including a short taxable year, by the distributor or transferor corporation. The acquiring corporation shall take into account in each taxable year beginning with the taxable year ending after the date of distribution or transfer the net amount of such adjustments in the same manner and at the same time as such net amount would have been taken into account by the distributor or transferor corporation. Thus, the amount of any such adjustment which the acquiring corporation shall take into account in each taxable year shall be the same amount that would have been taken into account in each taxable year by the distributor or transferor corporation.

(b) This section may be illustrated by the following example:

Example. On January 1, 1960, X Corporation, a calendar year taxpayer, voluntarily changed its method of accounting giving rise to a $50,000 adjustment under section 481(a), of which $20,000 is attributable to pre-1954 Code years. Under section 481(b)(4) the $20,000 adjustment is to be spread over 1960 and the following 9 years at the rate of $2,000 each year. On November 1, 1963, all the assets of X Corporation are acquired by Y Corporation in a transaction to which section 381(a) applies. Y Corporation reports its income on a fiscal year ending June 30. X and Y Corporations must take into account the $20,000 adjustment at the rate of $2,000 in each taxable year in the following time and manner:

X Corporation	
Calendar years 1960–62 ($2,000×3)	$6,000

X Corporation		
Short taxable year ending Nov. 1, 1963 ($2,000×1)	2,000	$8,000
Y Corporation		
Fiscal years ending:		
June 30, 1964 ($2,000×1)	2,000	
June 30, 1965–69 ($2,000×5)	10,000	12,000
		20,000

(c) *Successive transactions to which section 381(a) applies.* The provisions of this section shall apply in the case of successive transactions to which section 381(a) applies. Thus, if R Corporation, which was taking into account adjustments described in section 481(b)(4), distributes or transfers its assets to S Corporation in a transaction to which section 381(a) applies, and S Corporation was required to take into account any remaining portion of such adjustments under section 381(c)(21) and this section, and if subsequently S Corporation distributes or transfers its assets to T Corporation in a transaction to which section 381(a) applies, then T Corporation, under section 381(c)(21) and this section, shall take into account any remaining portion of such adjustments not previously taken into account by R and S Corporations.

(d) *Acquiring corporation not receiving all the assets.* The adjustments described in this section acquired from a distributor or transferor corporation by an acquiring corporation in a transaction to which section 381(a) applies is not reduced by reason of the fact that the acquiring corporation does not acquire 100 percent of the assets of the distributor or transferor corporation.

[T.D. 6553, 26 FR 2171, Mar. 15, 1961]

§ 1.381(c)(22)–1 Successor life insurance company.

(a) *Carryover requirement.* If in a taxable year beginning after December 31, 1957, a distributor or transferor corporation which is a life insurance company (as defined in section 801(a)) is acquired by a corporation which is a life insurance company (as defined in section 801(a)), in a transaction to which section 381(a) applies, section 381(c)(22) provides that the acquiring corporation shall take into account the appropriate items which the distributor or transferor corporation was required to take into account for purposes of part I, subchapter L, chapter 1 of the Code. Furthermore, except as otherwise provided by this section, the acquiring corporation shall take into account the items described in paragraphs (2) through (21), other than paragraphs (14), (15), and (17), of section 381(c) and the regulations thereunder. For example, the acquiring corporation shall take into account the reserves described in section 810(c) distributed or transferred to it as of the close of the date of distribution or transfer by the distributor or transferor corporation in accordance with the provisions of section 381(c)(4) and the regulations thereunder. For provisions defining the date of distribution or transfer, see paragraph (b) of § 1.381(b)–1.

(b) *Items required to be taken into account by acquiring corporation.* If a transaction meets the requirements of paragraph (a) of this section, the acquiring corporation shall, except as otherwise provided, take into account as of the close of the date of distribution or transfer the following items of the distributor or transferor corporation:

(1) The operations loss carryovers (as determined under section 812), subject to conditions and limitations consistent with the conditions and limitations prescribed in section 381(c)(1) and the regulations thereunder. For example, a loss from operations for a loss year of a distributor or transferor corporation which ends on or before the last day of a loss year of the acquiring corporation shall be considered to be a loss from operations for a year prior to such loss year of the acquiring corporation. All references in section 381(c)(1) and the regulations thereunder to section 172 shall be construed as referring to the appropriate corresponding provisions of section 812. Thus, a reference to section 172(b) shall be construed as referring to section 812 (b) and (d). In determining the span of years for which a loss from operations may be carried, the number of taxable years for which the distributor or transferor corporation was authorized to do business as an insurance company shall be taken into account. For purposes of this determination, the taxable year of

the distributor or transferor corporation which ends on the date of distribution or transfer shall be taken into account even though such taxable year is a period of less than 12 months.

(2)(i) The investment yield and the beginning of the year asset balance for the distributor or transferor corporation's taxable year ending with the close of the date of distribution or transfer. Such items shall be integrated with the investment yield and beginning of the year asset balance of the acquiring corporation for its first taxable year ending after such date of distribution or transfer for purposes of determining the current earnings rate of the acquiring corporation for such taxable year. Furthermore, for purposes of determining the average earnings rate of the acquiring corporation, the investment yield and mean of the assets of the distributor or transferor corporation for its 4 taxable years immediately preceding its taxable year which closes with the date of distribution or transfer shall be integrated with the investment yield and mean of the assets of the acquiring corporation for such corresponding taxable years.

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

Example (1). X qualified as a life insurance company in 1949. Y qualified as a life insurance company in 1951. On June 30, 1961, at which time both X and Y were life insurance companies (as defined in section 801(a)), X transferred all its assets to Y in a statutory merger to which section 361 applies. For its taxable year ending on June 30, 1961, X had investment yield of $15 and assets at the beginning of such taxable year of $450. For purposes of determining its current earnings rate for its taxable year ending on December 31, 1961, Y had investment yield of $45 (including the $15 of investment yield of X), assets at the beginning of such taxable year of $1,250 (including the $450 of X's assets at the beginning of its taxable year 1961), and assets at the end of such taxable year of $1,750 (after the application of section 806(a)). Under the provisions of subdivision (i) of this subparagraph, the current earnings rate of Y for the taxable year 1961 would be 3 percent, determined by dividing the investment yield of Y, $45, by the mean of the assets of Y, $1,500 ($1,250+$1,750÷2). In order to determine its average earnings rate and adjusted reserves rate for the taxable year 1961, Y would make up the following schedule:

Taxable year	Investment yield			Mean of assets			Current earnings rate of Y
	Column 1—X	Column 2—Y	Column 3 (Col. 1 + Col. 2) integrated investment yield	Column 4—X	Column 5—Y	Column 6 (Col. 4 + Col. 5) integrated means of assets	Column 7 (Col. 3 ÷ Col. 6)
1960	$16	$26	$42	$400	$800	$1,200	3.5
1959	16	24	40	500	750	1,250	3.2
1958	17	22	39	650	650	1,300	3.0
1957	19	21	40	700	500	1,200	3.3

For the taxable year 1961, Y would have an average earnings rate of 3.2 percent, computed by taking into account the current earnings rates for the taxable year 1961 and each of the 4 taxable years immediately preceding such taxable year. The adjusted reserves rate for such taxable year would be 3 percent since the current earnings rate of 3 percent for 1961 is lower than the average earnings rate of 3.2 percent.

Example (2). The facts are the same as in *Example (1)*, except that the taxable year in issue is 1962, and the current earnings rate of Y for such taxable year was 3.8 percent. For the taxable year 1962, Y would have an average earnings rate of 3.3 percent, computed by taking into account only the current earnings rates for the taxable year 1962 and each of the 4 taxable years immediately preceding such taxable year. The adjusted reserves rate for such taxable year would be 3.3 percent since the average earnings rate of 3.3 percent is lower than the 1962 current earnings rate of 3.8 percent.

(3) To the extent there are any amounts accrued for discounts in the nature of interest which have not been included as interest paid under section 805(e)(3), the acquiring corporation shall be treated as the distributor or transferor corporation for purposes of including such amounts as interest paid.

(4) Any adjustment required by section 806(b) with respect to an item described in section 810(c) shall be made

by the acquiring corporation in its first taxable year which begins after the date of distribution or transfer.

(5) The amount of the deduction provided by section 809(d)(6), as limited by section 809(f), for all taxable years of the distributor or transferor corporation which end on and before the date of distribution or transfer (irrespective of whether or not the distributor or transferor corporation claimed this deduction for such taxable years) for the purpose of determining the limitation under section 809(d)(6).

(6)(i) To the extent there are any remaining net increases or net decreases in reserves required to be taken into account by the distributor or transferor corporation under section 810(d)(1), the acquiring corporation shall be treated as the distributor or transferor corporation as of its first taxable year which begins after the date of distribution or transfer.

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

Example. Assume that the amount of an item described in section 810(c) of X, a life insurance company, at the beginning of the taxable year 1959 is $100. Assume that at the end of the taxable year 1959, as a result of a change in the basis used in computing such item during the taxable year, the amount of the item (computed on the new basis) is $200 but computed on the old basis would have been $150. Since the amount of the item at the end of the taxable year computed on the new basis, $200, exceeds the amount of the item at the end of the taxable year computed on the old basis, $150, by $50, section 810(d)(1) provides that one-tenth of the amount of such excess, or $5, shall be taken into account by X as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations for each of the 10 taxable years immediately following the taxable year 1959. Assume further that on June 30, 1961, X transferred all its assets to Y, a life insurance company, in a statutory merger to which section 361 applies. Under the provisions of section 810(d)(1), X would include $5 as a net increase under section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations for its taxable years 1960 and 1961. Thus, the remaining net increase to be taken into account by X under section 810(d)(1) is $40 (eight-tenths of $50). Accordingly, Y shall take into account $5 as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations for each of its 8 taxable years beginning in 1962 ($5×8=$40).

(7)(i) The dollar balances in the shareholders surplus account, policyholders surplus account, and other accounts provided, however, that the acquiring corporation is a stock life insurance company. The dollar balance in the policyholders surplus account shall reflect the amount (if any) treated as a subtraction from such account by reason of the application of the limitation provided under section 815(d)(4) immediately prior to the close of the date of distribution or transfer. To the extent that any amount must be added to the shareholders surplus account as a result of the application of the limitation provided under section 815(d)(4), the acquiring corporation shall be treated as the distributor or transferor corporation as of its first taxable year which begins after the date of distribution or transfer.

(ii) If the acquiring corporation is a mutual life insurance company, the dollar balances in the shareholders surplus account, policyholders surplus account, and other accounts shall not be taken into account by such acquiring corporation and the distributor or transferor corporation shall be subject to the provisions of section 815(d)(2)(A) as of the close of the date of distribution or transfer.

(8) To the extent that any amount must be added to the shareholders surplus account as a result of an election made under section 815(d)(1) by the distributor or transferor corporation, the acquiring corporation shall be treated as the distributor or transferor corporation as of its first taxable year which begins after the date of distribution or transfer.

(9) The amount of the life insurance reserves at the end of 1958, but only for the purpose of applying the limitation provided under section 815(d)(4)(B).

(10) To the extent there are amounts subject to the provisions of section 817(d), the acquiring corporation shall be treated as the distributor or transferor corporation.

(11) To the extent there are any installments of tax imposed by section 818(e)(3)(A) remaining to be paid, the acquiring corporation shall be treated

as the distributor or transferor corporation for the purpose of paying such installments.

(12) The capital loss carryovers, subject to conditions and limitations consistent with the conditions and limitations prescribed in section 381(c)(3) and the regulations thereunder, except that any net capital loss of the distributor or transferor corporation for a taxable year beginning before January 1, 1959, shall not be taken into account. See section 817(c).

[T.D. 6625, 27 FR 12541, Dec. 19, 1962]

§1.381(c)(23)–1 Investment credit carryovers in certain corporate acquisitions.

(a) *Carryover requirement.* (1) Section 381(c)(23) requires the acquiring corporation in a transaction to which section 381 applies to succeed to and take into account under such regulations as may be prescribed by the Secretary or his delegate, the investment credit carryovers of the distributor or transferor corporation. To determine the amount of these carryovers as of the close of the date of distribution or transfer, and to integrate them with any carryovers and carrybacks of the acquiring corporation for purposes of determining the amount of credit allowed by section 38 to the acquiring corporation for taxable years ending after the date of distribution or transfer, it is necessary to apply the provisions of sections 46, 47, and 48 in accordance with the conditions and limitations of this section.

(2) The investment credit carryovers and carrybacks of the acquiring corporation determined as of the close of the date of distribution or transfer shall be computed without reference to any unused credit of a distributor or transferor corporation. The investment credit carryovers of a distributor or transferor corporation as of the close of the date of distribution or transfer shall be determined without reference to any unused credit of the acquiring corporation.

(b) *Carryback of unused credits.* An unused credit of the acquiring corporation for any taxable year ending after the date of distribution or transfer shall not be carried back in computing the credit allowed by section 38 to a distributor or transferor corporation. However, an unused credit of the acquiring corporation for any such taxable year shall be carried back in accordance with section 46(b)(1) in computing the credit allowed to the acquiring corporation for a taxable year ending on or before the date of distribution or transfer. If a distributor or transferor corporation remains in existence after the date of distribution or transfer, an unused credit sustained by it for any taxable year beginning after such date shall be carried back in accordance with section 46(b)(1) in computing the credit allowed by section 38 to such corporation for a taxable year ending on or before that date, but may not be carried back or over in computing the credit allowed by section 38 to the acquiring corporation.

(c) *Computation of carryovers and carrybacks.* (1) Subject to the modifications set forth in this paragraph, the provisions of §1.46–2 shall apply in computing carryovers and carrybacks of unused credits to taxable years of the acquiring corporation.

(2)(i) The investment credit carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer shall first be carried to the first taxable year of the acquiring corporation ending after that date. This rule applies whether the date of distribution or transfer is on the last day, or any other day, of the acquiring corporation's taxable year.

(ii) The investment credit carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer shall be carried to the acquiring corporation without diminution by reason of the fact that the acquiring corporation does not acquire 100 percent of the assets of the distributor or transferor corporation.

(3) An unused credit of a distributor or transferor corporation for a taxable year which ends on or before the last day of a taxable year of the acquiring corporation shall be considered to be an unused credit for a year prior to such taxable year of the acquiring corporation. If the acquiring corporation has acquired the assets of two or more distributor or transferor corporations

on the same date of distribution or transfer, the unused credit years of the distributor or transferor corporations shall be taken into account in the order in which such years terminate. If any one of the unused credit years of a distributor or transferor corporation ends on the same day as the unused credit year of another distributor or transferor corporation, either unused credit year may be taken into account before the other.

(4) The extent to which an investment credit carryover of a distributor or transferor corporation or of an acquiring corporation from an unused credit year ending before January 1, 1971, may be taken into account by the acquiring corporation for a taxable year beginning after December 31, 1970, shall be determined without regard to the credit earned by the acquiring corporation for such year. Thus, in such a case, the amount of unused credit from such unused credit years which may be taken into account in a taxable year of the acquiring corporation beginning after December 31, 1970, shall be determined solely with reference to the limitation based on amount of tax for such taxable year (without reduction for the credit earned for such year).

(d) *Computation of carryovers when date of distribution or transfer occurs on last day of acquiring corporation's taxable year.* The computation of the investment credit carryovers from the distributor or transferor corporation and from the acquiring corporation in a case where the date of distribution or transfer occurs on the last day of a taxable year of the acquiring corporation may be illustrated by the following example:

Example. X Corporation and Y Corporation were organized on January 1, 1971, and each corporation files its return on the calendar year basis. On December 31, 1972, X transfers all its assets to Y in a statutory merger to which section 361 applies. X's credit earned and its limitation based on amount of tax for its taxable years 1971 and 1972 are as follows:

X Corporation's taxable year	Credit earned	Limitation based on amount of tax
1971	$10,000	$5,000
1972	5,000	3,000

Y's credit earned and its limitation based on amount of tax for its taxable years 1971 through 1973 are as follows:

Y Corporation's	Credit earned	Limitation based on amount of tax
1971	$6,000	$5,000
1972	5,000	3,000
1973	3,000	10,000

The sequence for the allowance of unused credits of X Corporation and Y Corporation, and the computation of the carryovers to Y Corporation's calendar year 1974, may be illustrated as follows:

(1) *X Corporation's 1971 unused credit.*— The carryover to Y 1974 is $0, computed as follows:

Unused credit	$5,000
Excess of X's 1972 limitation based on tax over credit earned	0
Carryover to Y's year 1973	5,000
Excess of Y's 1973 limitation based on tax over credit earned	7,000
Carryover to Y's year 1974	0

(2) *Y Corporation's 1971 unused credit.*— The carryover to Y 1974 is $0, computed as follows:

Unused credit	$1,000
Excess of Y's 1972 limitation based on tax over credit earned	0
Carryover to Y's year 1973	1,000
Excess of Y's 1973 limitation based on tax over credit earned	7,000
Less: X's $5,000 carryover from 1971	5,000
	2,000
Carryover to Y's year 1974	0

(3) *X Corporation's 1972 unused credit.*— The carryover to Y 1974 is $1,000, computed as follows:

Unused credit	$2,000
Excess of Y's 1973 limitation based on tax over credit earned	7,000
Less: X's $5,000 carryover from 1971 and Y's $1,000 carryover from 1971	6,000
	1,000
Carryover to Y's year 1974	1,000

(4) *Y Corporation's 1972 unused credit.*— The carryover to Y 1974 is $2,000, computed as follows:

Unused credit	$2,000
Excess of Y's 1973 limitation based on tax over credit earned	7,000
Less: X's $5,000 carryover from 1971 Y's $1,000 carryover from 1971 and X's $1,000 carryover from 1972	7,000
	0
Carryover to Y's year 1974	2,000

(5) The aggregate of the investment credit carryovers to Y's year 1974 is $3,000, computed as follows:

X's 1972 unused credit	$1,000
Y's 1972 unused credit	2,000
Total	3,000

(e) *Computation of carryovers when date of distribution or transfer is not on last day of acquiring corporation's taxable year.* (1) If the date of distribution or transfer occurs on any day other than the last day of a taxable year of the acquiring corporation, the amount which may be added to the amount allowable as a credit by section 38 for the first taxable year of the acquiring corporation ending after the date of distribution or transfer (hereinafter called the "year of acquisition") shall be determined in the following manner. The year of acquisition shall be considered as though it were 2 taxable years. The first of such 2 taxable years shall be referred to in this paragraph as the preacquisition part year and shall begin with the beginning of the year of acquisition and end with the close of the date of distribution or transfer. The second of such 2 taxable years shall be referred to in this paragraph as the postacquisition part year and shall begin with the day following the date of distribution or transfer and shall end with the close of the year of acquisition.

(2) The excess limitation for the year of acquisition (i.e., the excess of the limitation based on the amount of tax for such year over the amount of credit earned for such year) shall be divided between the preacquisition part year and the postacquisition part year in proportion to the number of days in each. Thus, if in a statutory merger to which section 361 applies Y Corporation, a calendar year taxpayer, acquires the assets of X Corporation on June 30, 1975, and Y Corporation has an excess limitation of $36,500 for its calendar year 1975, then the excess limitation for the preacquisition part year would be $18,100 ($36,500×181/365) and the excess limitation for the postacquisition part year would be $18,400 ($36,500×184/365).

(3) An unused credit of the acquiring corporation shall be carried to and applied against the excess limitation for the preacquisition part year and then carried to and applied against the excess limitation for the postacquisition part year, whereas an unused credit of the distributor or transferor corporation shall not be carried to the preacquisition part year but shall only be carried to and applied against the excess limitation for the postacquisition part year. For special rule relating to carryovers from taxable years ending before January 1, 1971, to taxable years beginning after December 31, 1970, see subparagraph (6) of this paragraph.

(4) Though considered as two separate taxable years for purposes of this paragraph, the preacquisition part year and the postacquisition part year are treated as one taxable year in determining the years to which an unused credit is carried under section 46(b)(1).

(5) The preceding subparagraphs may be illustrated by the following example:

Example. X Corporation and Y Corporation were organized on January 1, 1971, and each corporation files its return on the calendar year basis. On May 1, 1972, X transfers all its assets to Y in a statutory merger to which section 361 applies. X's credit earned and its limitation based on amount of tax for its taxable years 1971 and ending May 1, 1972, are as follows:

X Corporation's taxable year	Credit earned	Limitation based on amount of tax
1971	$11,000	$5,000
Ending 5–1–72	3,000	6,000

Y's credit earned and its limitation based on amount of tax for its taxable years 1971 and 1972 are as follows:

Y Corporation's taxable year	Credit earned	Limitation based on amount of tax
1971	$7,000	$3,000
1972	3,000	9,000

The sequence for the allowance of unused credits of X Corporation and Y Corporation, and the computation of carryovers to Y Corporation's calendar year 1973, may be illustrated as follows:

(i) *X Corporation's 1971 unused credit.* The carryover to Y 1973 is $0, computed as follows:

Unused credit	$6,000
Excess of X's 5–1–72 limitation based on tax over credit earned	3,000
Carryover to Y's postacquisition part year 1972	3,000

Excess limitation for Y's postacquisition part year ($6,000× 244/366)	4,000
Carryover to Y's year 1973	0

(ii) *Y Corporation's 1971 unused credit.* The carryover to Y 1973 is $1,000, computed as follows:

Unused credit	$4,000
Excess limitation for Y's preacquisition part year ($6,000×122/ 366)	2,000
Carryover to Y's postacquisition part year	2,000
Excess limitation for Y's postacquisition part year ($6,000× 244/366)	4,000
Less: X's $3,000 carryover from 1971	3,000
	1,000
Carryover to Y's year 1973	1,000

(iii) The aggregate of the investment credit carryovers to Y's year 1973 is $1,000, computed as follows:

X's 1971 unused credit	0
Y's 1971 unused credit	$1,000
Total	1,000

(6) If the year of acquisition is a taxable year beginning after December 31, 1970, and if there is an unused credit of the distributor or transferor corporation or of the acquiring corporation arising in an unused credit year ending before January 1, 1971, which may be carried to such year of acquisition (see paragraph (c)(4) of this section), then in applying subparagraphs (1), (2), and (3) of this paragraph, in lieu of dividing the excess limitation for the year of acquisition between the preacquisition and postacquisition part years, only the limitation based on the amount of tax for such year (i.e., without reduction for the credit earned) shall be divided between the preacquisition and postacquisition part years. If there is also an unused credit arising in an unused credit year ending after December 31, 1970, which may be carried to the year of acquisition, then for the purpose of determining the amount of such unused credit which may be taken into account for such year of acquisition, the credit earned for the year of acquisition shall first be applied against the limitation based on amount of tax for the preacquisition part year (reduced by any investment credit carryovers to such part year from unused credit years ending before January 1, 1971) and the excess, if any, shall then be applied against the limitation based on amount of tax for the postacquisition part year (also reduced by any investment credit carryovers to such part year from unused credit years ending before January 1, 1971).

(7) Subparagraph (6) of this paragraph may be illustrated by the following example:

Example. X Corporation and Y Corporation were organized on January 1, 1970, and each corporation files its return on the calendar year basis. On May 1, 1972, X transfers all its assets to Y in a statutory merger to which section 361 applies. X's credit earned and its limitation based on amount of tax for its taxable years 1970, 1971, and ending May 1, 1972, are as follows:

X Corporation's taxable year	Credit earned	Limitation based on amount of tax
1970	$300	
1971	100	
Ending 5–1–72	200	

Y's credit earned and its limitation based on amount of tax for its taxable years 1970 through 1972 are as follows:

Y Corporation's taxable year	Credit earned	Limitation based on amount of tax
1970	$100	
1971	200	
1972	300	$900

The sequence for the allowance of unused credits of X Corporation and Y Corporation, and the computation of carryovers to Y Corporation's calendar year 1973, may be illustrated as follows:

(i) *X Corporation's 1970 unused credit.*— The carryover to Y 1973 is $0, computed as follows:

Unused credit	$300
X Corporation's 1971 limitation based on tax	0
X Corporation's 5–1–72 limitation based on tax	0
Carryover to Y's postacquisition part year 1972	300
Limitation based on tax for Y's postacquisition part year 1972 ($900×244/366)	600
Carryover to Y's year 1973	0

(ii) *Y Corporation's 1970 unused credit.*— The carryover to Y 1973 is $0, computed as follows:

Unused credit	$100
Y Corporation's 1971 limitation based on tax	0
Carryover to Y's preacquisition part year 1972	100
Limitation based on tax for Y's preacquisition part year 1972 ($900×122/366)	300
Carryover to Y's postacquisition part year 1972	0

(iii) *Y Corporation's credit earned for 1972.*— The carryover to Y 1973 is $0, computed as follows:

Credit earned	$300
Limitation based on tax for preacquisition part year 1972 ($900×122/366)	300
Less: Y's $100 carryover from 1970	100
	$200
Carryover to Y's postacquisition part year 1972	100
Limitation based on tax for postacquisition part year 1972 ($900×244/366)	600
Less: X's $300 carryover from 1970	$300
	300
Carryover to Y's year 1973	0

(iv) *X Corporation's 1971 unused credit.*— The carryover to Y 1973 is $0, computed as follows:

Unused credit	$100
Excess of X's 1972 limitation based on tax over credit earned	0
Carryover to Y's postacquisition part year 1972	100
Limitation based on tax for postacquisition part year 1972 ($900×244/366)	600
Less:	
X's $300 carryover from 1970	300
Y's 1972 credit earned for postacquisition part year	100
	400
	200
Carryover to Y's year 1973	0

(v) *Y Corporation's 1971 unused credit.*— The carryover to Y 1973 is $100, computed as follows:

Unused credit	$200
Limitation based on tax for preacquisition part year 1972 ($900×122/366)	300
Less:	
Y's $100 carryover from 1970	100
Y's 1972 credit earned for preacquisition part year 1972	200
	300
	0
Carryover to Y's postacquisition part year	200
Limitation based on tax for postacquisition part year 1972 ($900×244/366)	600
Less:	
X's $300 carryover from 1970	300
Y's 1972 credit earned for postacquisition part year 1972	100
X's $100 carryover from 1971	100
	500
	100
Carryover to Y's year 1973	100

(vi) *X Corporation's 5–1–72 unused credit.*— The carryover to Y 1973 is $200, computed as follows:

Unused credit	$200
Limitation based on tax for postacquisition part year 1972 ($900×244/366)	600
Less:	
X's $300 carryover from 1970	300
Y's 1972 credit earned for postacquisition part year 1972	100
X's $100 carryover from 1971, and Y's $100 carryover from 1971	200
	600
	0
Carryover to Y's year 1973	200

(vii) The aggregate of the investment credit carryovers to Y 1973 is $300, computed as follows:

Y's 1971 unused credit	$100
X's 1972 unused credit	200
Total	300

(8) If the year of acquisition is a taxable year to which the limitation provided in § 1.46–2(b)(2) (relating to 20-percent limitation on carryovers and carrybacks to certain taxable years) applies, then for purposes of applying such limitation the preacquisition part year and the postacquisition part year shall each be considered a fractional part of a year, but, if the date of distribution or transfer is not on the last day of a month, the entire month in which the date of distribution or transfer occurs shall be considered as included in the preacquisition part year and no portion thereof shall be considered as included in the postacquisition part year.

(9) If the acquiring corporation succeeds to the investment credit carryovers of two or more distributor or transferor corporations on two or more dates of distribution or transfer during the same taxable year of the acquiring corporation, the manner in which the unused credits of the distributor or transferor corporations shall be applied shall be determined consistently with the rules prescribed in paragraph (c) of § 1.381(c)(1)–2.

(f) *Successive acquiring corporations.* An acquiring corporation which, in a distribution or transfer to which section 381(a) applies, acquires the assets of a distributor or transferor corporation which previously acquired the assets of another corporation in a transaction to which section 381(a) applies, shall succeed to and take into account, subject to the conditions and limitations of § 1.46–2 and this section, the investment credit carryovers available to the first acquiring corporation under § 1.46–2 and this section.

(g) *Recomputation of credit allowed by section 38 on certain property of acquiring corporation.* If section 38 property acquired by an acquiring corporation in a transaction to which section 381(a) applies is disposed of, or otherwise ceases to be section 38 property (or becomes public utility property) with respect to the acquiring corporation, before the close of the estimated useful life which was taken into account in computing the distributor or transferor corporation's qualified investment, see paragraph (e) of § 1.47–3.

(h) *Electing small business corporation.* An unused credit of a distributor or transferor corporation arising in an unused credit year for which such corporation is not an electing small business corporation (as defined in section 1371(b)) may not be carried over in a transaction to which section 381 applies to a taxable year of the acquiring corporation for which such corporation is an electing small business corporation and may not be added to the amount allowable as a credit under section 38 to the shareholders of the acquiring corporation for such taxable year. However, in such a case, a taxable year for which the acquiring corporation is an electing small business corporation shall be counted as a taxable year for purposes of determining the taxable years to which such unused credit may be carried.

(i) [Reserved]

(j) *Carryover of operating capacity for qualified intercity bus.* For rules for determining an acquiring corporation's qualified investment for the energy credit for a qualified intercity bus, see § 1.48–9(q)(11).

(Sec. 38(b) (76 Stat. 963, 26 U.S.C. 38(b)), 48(l)(16) (94 Stat. 264, 26 U.S.C. 48(l)(16)), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7289, 38 FR 30554, Nov. 6, 1973, as amended by T.D. 7982, 49 FR 39544, Oct. 9, 1984; 49 FR 41246, Oct. 22, 1984]

§ 1.381(c)(24)–1 Work incentive program credit carryovers in certain corporate acquisitions.

The computation of carryovers and carrybacks of unused WIN credits in a transaction to which section 381 applies shall be made under the principles of § 1.381(c)(23)–1 (relating to the computation of carryovers and carrybacks of unused investment credits), except that the provisions of paragraph (c)(4) and paragraph (e)(6), (7), and (8) of such section shall not apply.

(Secs. 381(c)(23), 76 Stat. 971 (26 U.S.C. 381(c)(23), 381(c)(24)) 85 Stat. 557 (26 U.S.C. 381(c)(24)), 7805, 68A Stat. 917 (26 U.S.C. 7805))

[T.D. 7289, 38 FR 30557, Nov. 6, 1973]

§ 1.381(c)(25)–1 Deficiency dividend of a qualified investment entity.

(a) *Carryover requirement.* If a distributor or transferor corporation in a transaction to which section 381(a) applies—

(1) Was a qualified investment entity (within the meaning of section 860(b)) for any taxable year ending on or before the date of distribution or transfer, and

(2) A determination (as defined in section 860(e)) establishes that the transferor or distributor corporation is liable for the tax imposed by section 11(a), 56(a), 852(b), 857(b)(1), 857(b)(3)(A), or 1201(a) for such taxable year,then in determining the liability for such tax the deduction described in section 860 shall be allowed pursuant to section 381(c)(25) to such corporation for the amount of deficiency dividends paid by the acquiring corporation with respect to the distributor or transferor corporation. Except as otherwise provided

in this section, the provisions of section 860 and the regulations thereunder apply with respect to a deficiency dividend deduction allowable pursuant to section 381(c)(25).

(b) *Deficiency dividends paid by the acquiring corporation with respect to the distributor or transferor corporation.* A deficiency dividend paid by the acquiring corporation with respect to the distributor or transferor corporation must be a distribution that would satisfy the definition of a deficiency dividend under section 860(f) if paid by the distributor or transferor corporation to its own shareholders. The distribution, however, shall be paid by the acquiring corporation to its own shareholders. The distribution also shall be paid after the date of distribution or transfer and on, or within 90 days after, the date of the determination but before the acquiring corporation files a claim under paragraph (c) of this section.

(c) *Claim for deduction.* A claim for deduction under this section shall be made by the acquiring corporation on Form 976 and shall be filed within 120 days after the date of the determination. The form shall contain, or be accompanied by, the information required under §1.860–2(b)(2) in sufficient detail to properly identify the facts with respect to the distributor or transferor corporation and the acquiring corporation. The required certified copy of the resolution authorizing the payment of the dividend shall be that of the trustees, board of directors, or other authority, of the acquiring corporation. Necessary changes may be made in Form 976 in order to carry out the provisions of this paragraph. The claim shall be filed with the district director, or director of the internal revenue service center, with whom the return of the distributor or transferor corporation to which the claim relates was filed.

(d) *Effect on dividends paid deduction.* A deficiency dividend paid by the acquiring corporation that is allowable as a deduction to a distributor or transferor corporation pursuant to section 381(c)(25) shall not become a part of the dividends paid deduction of the acquiring corporation under section 561 for any taxable year.

(e) *Successive transactions to which section 381(a) applies.* The provisions of this section shall apply in the case of successive transactions to which section 381(a) applies. Thus, if X corporation transfers its assets to Y corporation in a transaction to which section 381(a) applies and if Y corporation transfers its assets to Z corporation in a subsequent transaction to which section 381(a) applies, then, subject to the provisions of this section, X corporation may take a deficiency dividend deduction for the amount of deficiency dividends paid by Z corporation with respect to X corporation.

(Sec. 860(l) (92 Stat. 2849, 26 U.S.C. 860(l)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)); and sec. 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7767, 46 FR 11264, Feb. 6, 1981, as amended by T.D. 7936, 49 FR 2106, Jan. 18, 1984]

§1.381(c)(26)–1 Credit for employment of certain new employees.

(a) *Carryovers and carrybacks.* For taxable years beginning before January 1, 1984, the computation of carryovers and carrybacks of unused targeted jobs credit (new jobs credit in the case of wages paid before 1979) under section 44B (as in effect prior to enactment of the Tax Reform Act of 1984) in a transaction to which section 381(a) applies shall be made under the principles of §1.381(c)(23)–1 (relating to the computation of carryovers and carrybacks of unused investment credit), except that the provisions of paragraph (c)(4) and paragraph (e)(6), (7) and (8) of such section shall not apply.

(b) *Other items.* See §1.51–1(h) for a rule that applies to certain transfers of a trade or business in which a member of a targeted group is employed.

[T.D. 8062, 50 FR 46003, Nov. 6, 1985]

§1.381(d)–1 Operations loss carryovers of life insurance companies.

For the application of part V, subchapter C, chapter 1 of the Code to operations loss carryovers of life insurance companies, see section 812(f) and §1.812–7 and section 381(c)(22) and §1.381(c)(22)–1.

[T.D. 6625, 27 FR 12543, Dec. 19, 1962]

§ 1.382–1 Table of contents.

This section lists the captions that appear in the regulations for §§ 1.382–1T, 1.382–2, 1.382–2T, and 1.382–3 through 1.382–11.

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(i) [Reserved]
(j) *Aggregation and segregation rules.* (1) Aggregation of public shareholders and public owners into public groups.
(i) Public group.
(ii) Treatment of public group that is a 5-percent shareholder.
(iii) Presumption of no cross-ownership.
(iv) Identification of the public groups treated as 5-percent shareholders.
(A) Analysis of highest tier entities.
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(C) Aggregation of the public shareholders.
(v) Appropriate adjustments.
(vi) Examples.
(2) Segregation rules applicable to transactions involving the loss corporation.
(i) In general.
(ii) Direct public group.
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(*1*) In general.
(*2*) Examples.
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(*1*) In general.
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(D) Acquisition of loss corporation stock as the result of the ownership of a right to acquire stock.
(*1*) In general.
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(*1*) In general.
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(A) In general.
(B) Example.
(vi) Acquistions made by either a 5-percent shareholder or the loss corporation following application of the segregation rules.
(3) Segregation rules applicable to transactions involving first tier entities or higher tier entities.
(i) Dispositions.
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(iii) Other transactions affecting direct public groups of a first tier entity or higher tier entity.
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(v) Acquistions made by a 5-percent shareholder, a higher tier entity, or a first tier entity following application of the segregation rules.
(k) *Operating rules.* (1) Presumptions regarding stock ownership.
(i) Stock subject to regulation by the Securities and Exchange Commission.
(ii) Statements under penalties of perjury.
(2) Actual knowledge regarding stock ownership.
(3) Duty to inquire as to actual stock ownership in the loss corporation.

(4) Ownership interests structured to avoid the section 382 limitation.

(5) Example.

(6) First tier entity or higher tier entity that is a foreign corporation or entity. [Reserved.]

(l) *Changes in percentage ownership which are attributable to fluctuations in value.* [Reserved]

(m) *Effective date.* (1) In general.

(2) Plan of reorganization.

(3) Earliest commencement of the testing period.

(4) Transitional rules.

(i) Rules provided in paragraph (j) of this section for testing dates before September 4, 1987.

(ii) Example.

(iii) Rules provided in paragraph (j) of this section for testing dates on or after September 4, 1987.

(iv) Rules provided in paragraphs (f)(18)(ii) and (iii) of this section.

(v) Rules provided in paragraph (a)(2)(ii) of this section.

(vi) Rules provided in paragraph (h)(4) of this section.

(vii) Rules provided in paragraph (a)(2)(i) of this section.

(5) Bankruptcy proceedings.

(i) In general.

(ii) Example.

(6) Transactions of domestic building and loan associations.

(7) Transactions not subject to section 382.

(i) Application of old section 382.

(ii) Effect on testing period.

(iii) Termination of old section 382. [Reserved]

(8) Options issued or transferred before January 1, 1987.

(i) Options issued before May 6, 1986.

(ii) Options issued on or after May 6, 1986 and before September 18, 1986.

(iii) Options issued on or after September 18, 1986 and before January 1, 1987.

(9) Examples.

§ 1.382–3 Definitions and rules relating to a 5-percent shareholder.

(a) Definitions.

(1) Entity.

(i) In general.

(ii) Examples.

(iii) Effective date.

(A) In general

(B) Special rule.

(C) Example.

(2) [Reserved]

(b) through (i) [Reserved]

(j) Modification of the segregation rules of § 1.382–2T(j)(2)(iii) in the case of certain issuances of stock.

(1) Introduction.

(2) Small issuance exception.

(i) In general.

(ii) Small issuance defined.

(iii) Small issuance limitation.

(A) In general.

(B) Class of stock defined.

(C) Adjustments for stock splits and similar transactions.

(D) Exception.

(iv) Short taxable years.

(3) Other issuances of stock for cash.

(i) In general.

(ii) Solely for cash.

(A) In general.

(B) Related issuances.

(iii) Coordination with paragraph (j)(2) of this section.

(4) Limitation on exempted stock.

(5) Proportionate acquisition of exempted stock.

(i) In general.

(ii) Actual knowledge of greater overlapping ownership.

(6) Exception for equity structure shifts.

(7) Transitory ownership by underwriter disregarded.

(8) Certain related issuances.

(9) Application to options.

(10) Issuance of stock pursuant to the exercise of certain options.

(11) Application to first tier and higher tier entities.

(12) Certain non-stock ownership interests.

(13) Examples.

(14) Effective date.

(i) In general.

(ii) Effective date for paragraph (j)(10) of this section.

(iii) Election to apply this paragraph (j) retroactively.

(A) Election.

(B) Amended returns.

(C) Revised information statements.

(k) Special rules for certain regulated investment companies.

(1) In general.

(2) Effective date.

(i) General rule.

(ii) Election to apply prospectively.

§ 1.382–4 Constructive ownership of stock.

(a) In general. [Reserved]

(b) Attribution from corporations, partnerships, estates and trusts. [Reserved]

(c) Attribution to corporations, partnerships, estates and trusts. [Reserved]

(d) Treatment of options as exercised.

(1) General rule.

(2) Options treated as exercised.

(i) Issuance or transfer.

(ii) Subsequent testing dates.

(3) The ownership test.

(4) The control test.

(i) In general.

(ii) Operating rules.

(A) Person and related persons.

(B) Indirect ownership interest.

(5) The income test.

(6) Application of the ownership, control, and income tests.

(i) In general.
(ii) Application of ownership test.
(iii) Application of control test.
(iv) Application of income test.
(7) Safe harbors.
(i) Contracts to acquire stock.
(ii) Escrow, pledge, or other security agreements.
(iii) Compensatory options.
(iv) Options exercisable only upon death, disability, mental incompetency or retirement.
(v) Rights of first refusal.
(vi) Options designated in the Internal Revenue Bulletin.
(8) Additional rules.
(i) Contracts to acquire stock.
(ii) Indirect transfer of an option.
(iii) Options related to interests in noncorporate entities.
(iv) Puts.
(9) Definition of option.
(i) In general.
(ii) Convertible stock.
(iii) Series of options.
(iv) General principles of tax law.
(10) Subsequent treatment of options treated as exercised on a change date.
(i) In general.
(ii) Alternative look-back rule for options exercised within 3 years after change date.
(11) Transfers not subject to deemed exercise.
(12) Certain rules regarding non-stock interests as stock.
(e) Stock transferred under certain agreements. [Reserved]
(f) Family attribution. [Reserved]
(g) Definitions.
(h) Effective date.
(1) In general. [Reserved]
(2) Option attribution rules.
(i) General rule.
(ii) Special rule for control test.
(iii) Convertible stock issued prior to July 20, 1988.
(A) In general.
(B) Exceptions.
(*1*) Nonvoting convertible preferred stock.
(*2*) Other convertible stock.
(iv) Convertible stock issued on or after July 20, 1988, and before November 5, 1992.
(v) Certain options in existence immediately before and after an ownership change.
(vi) Election to apply §1.382–2T(h)(4).
(A) In general.
(B) Additional consequences of election.
(C) Time and manner of making the election.
(D) Amended returns.
(3) Special rule for options subject to attribution under §1.382–2T(h)(4).

§1.382–5 Section 382 limitation. [Reserved]

§1.382–5T Section 382 limitation (temporary).

(a) Scope.
(b) Computation of value.
(c) Short taxable year.
(d) Successive ownership changes and absorption of a section 382 limitation.
(1) In general.
(2) Recognized built-in gains and losses.
(3) Effective date.
(e) Controlled groups.
(f) Effective date.

§1.382–6 Allocation of income and loss to periods before and after the change date for purposes of section 382.

(a) General rule.
(b) Closing-of-the-books election.
(1) In general.
(2) Making the closing-of-the-books election.
(i) Time and manner.
(ii) Election irrevocable.
(3) Special rules relating to consolidated and controlled groups.
(i) Consolidated groups.
(ii) Controlled groups.
(c) Operating rules for determining net operating loss, taxable income, net capital loss, modified capital gain net income, and special allocations.
(1) In general.
(2) Adjustment to net operating loss.
(i) Determination of remaining capital gain.
(ii) Reduction of net operating loss by remaining capital gain.
(d) Coordination with rules relating to the allocation of income under §1.1502–76(b).
(e) Allocation of certain credits.
(f) Examples.
(g) Definitions and nomenclature.
(1) Change year.
(2) Pre-change period.
(3) Post-change period.
(4) Modified capital gain net income.
(h) Effective date.

§1.382–7 Built-in gains and losses. [Reserved]

§1.382–8 Controlled groups. [Reserved]

§1.382–8T Controlled groups (temporary).

(a) Introduction.
(b) Controlled group loss and controlled group with respect to a controlled group loss.
(c) Computation of value.
(1) Reduction in value by the amount restored.
(2) Restoration of value.
(3) Reduction in value by the amount restored.
(4) Appropriate adjustments.
(5) Certain reductions in the value of members of a controlled group.

(d) No double reduction.

(e) Definitions and nomenclature.

(1) Definitions in Section 382 and the regulations thereunder.

(2) Controlled group.

(3) Component member.

(4) Predecessor and successor corporation.

(f) Coordination between consolidated groups and controlled groups.

(g) Examples.

(h) Time and manner of filing election to restore.

(1) Statement required.

(2) Revocation of election.

(3) Filing by component member.

(i) [Reserved]

(j) Effective date.

(1) In general.

(2) Transition rule.

(i) In general.

(ii) Special transition rules for controlled groups that had ownership changes before January 29, 1991.

(3) Amended returns.

§ 1.382–9 Special rules under section 382 for corporations under the jurisdiction of a court in a title 11 or similar case.

(a) Introduction.

(b) Application of section 382(1)(5).

(c) [Reserved]

(d) Rules for determining whether stock of the loss corporation is owned as a result of being a qualified creditor.

(1) Qualified creditor.

(2) General rules for determining whether indebtedness is qualified indebtedness.

(i) Definition.

(ii) Determination of beneficial ownership.

(iii) Duty of inquiry.

(iv) Ordinary course indebtedness.

(3) Treatment of certain indebtedness as continuously owned by the same owner.

(i) In general.

(ii) Operating rules.

(iii) Indebtedness owned by beneficial owner who becomes a 5-percent shareholder or 5-percent entity.

(iv) Example.

(4) Special rule if indebtedness is a large portion of creditor's assets.

(i) In general.

(ii) Applicable period.

(iii) Determination of ownership change.

(iv) Reliance on statement.

(5) Tacking of ownership periods.

(i) Transferee treated as owning indebtedness for period owned by transferor.

(ii) Qualified transfer.

(iii) Exception.

(iv) Debt-for-debt exchanges.

(6) Effective date.

(i) In general.

(ii) Elections and amended returns.

(A) Election to apply this paragraph (d) retroactively.

(B) Election to revoke section 382(l)(5)(H) election.

(C) Amended returns.

(e) Option attribution for purposes of determining stock ownership under section 382(1)(5)(A)(ii).

(1) In general.

(2) Special rules.

(i) Lapse or forfeiture of options deemed exercised.

(ii) Actual exercise of options not deemed exercised.

(iii) Amended returns.

(3) Examples.

(4) Effective dates.

(i) In general.

(ii) Special rule for interest or dividends.

(f) through (h) [Reserved].

(i) Election not to apply section 382(l)(5).

(j) Value of the loss corporation in an ownership change to which section 382(l)(6) applies.

(k) Rules for determining the value of the stock of the loss corporation.

(1) Certain ownership interests treated as stock.

(2) Coordination with section 382(e)(2).

(3) Coordination with section 382(e)(3).

(4) Coordination with section 382(l)(1).

(5) Coordination with section 382(l)(4).

(6) Special rule for stock not subject to the risk of corporate business operations.

(i) In general.

(ii) Coordination of special rule and other rules affecting value.

(7) Limitation on value of stock.

(l) Rules for determining the value of the loss corporation's pre-change assets.

(1) In general.

(2) Coordination with section 382(e)(2).

(3) Coordination with section 382(e)(3).

(4) Coordination with section 382(l)(1).

(5) Coordination with section 382(l)(4).

(m) Continuity of business requirement.

(1) Under section 382(1)(5).

(2) Under section 382(l)(6).

(n) Ownership change in a title 11 or similar case succeeded by another ownership change within two years.

(1) Section 382(l)(5) applies to the first ownership change.

(2) Section 382(l)(6) applies to the first ownership change.

(o) Options not subject to attribution.

(p) Effective date for rules relating to section 382(l)(6).

(1) In general.

(2) Ownership change to which section 382(l)(6) applies occurring before March 17, 1994.

§1.382–10 [Reserved]

§1.382–11 Effective dates. [Reserved]

[T.D. 8149, 52 FR 29674, Aug. 11, 1987, as amended by T.D. 8264, 54 FR 38666, Sept. 20, 1989; T.D. 8352, 56 FR 29434, June 27, 1991. Redesignated by T.D. 8440, 57 FR 45711, Oct. 5, 1992; T.D. 8490, 58 FR 51573, Oct. 4, 1993; T.D. 8531, 59 FR 12835, Mar. 18, 1994; T.D. 8530, 59 FR 12842, Mar. 18, 1994; T.D. 8529, 59 FR 12846, Mar. 18, 1994; T.D. 8546, 59 FR 32080, June 22, 1994; T.D. 8679, 61 FR 33314, June 27, 1996]

§1.382–1T [Reserved]

§1.382–2 General rules for ownership change.

(a) *Certain definitions for purposes of sections 382 and 383 and the regulations thereunder.* The following definitions apply for purposes of sections 382 and 383 and the regulations thereunder.

(1) *Loss corporation*—(i) *In general.* The term *loss corporation* means a corporation which—

(A) Is entitled to use a net operating loss carryforward, a capital loss carryover, a carryover of excess foreign taxes under section 904(c), a carryforward of a general business credit under section 39, or a carryover of a minimum tax credit under section 53,

(B) For the taxable year that includes a testing date, as defined in paragraph (a)(4) of this section or §1.382–2T(a)(2)(i), whichever is applicable (determined for purposes of this paragraph (a)(1) without regard to whether the corporation is a loss corporation), has a net operating loss, a net capital loss, excess foreign taxes under section 904(c), unused general business credits under section 38, or an unused minimum tax credit under section 53, or

(C) Has a net unrealized built-in loss (determined for purposes of this paragraph (a)(1) by treating the date on which such determination is made as the change date). See section 382(h)(3) for the definition of net unrealized built-in loss.

See section 383 and §1.383–1 for rules relating to a loss corporation that has an ownership change and has capital losses, excess foreign taxes, general business credits or minimum tax credits. Any predecessor or successor to a loss corporation described in this paragraph (a)(1) is also a loss corporation.

(ii) *Distributor or transferor loss corporation in a transaction under section 381.* Notwithstanding that a loss corporation ceases to exist under state law, if its net operating loss carryforwards, excess foreign taxes, or other items described in section 381(c) are succeeded to and taken into account by an acquiring corporation in a transaction described in section 381(a), such loss corporation shall be treated as continuing in existence until—

(A) Any pre-change losses (excluding pre-change credits described in §1.383–1(c)(3)), determined as if the date of such transaction were the change date, are fully utilized or expire under either section 172 or section 1212,

(B) Any net unrealized built-in losses, determined as if the date of such transaction were the change date, may no longer be treated as pre-change losses, and

(C) Any pre-change credits (described in §1.383–1(c)(3)), determined as if the date of such transaction were the change date, are fully utilized or expire under sections 39, 53, or 904(c).

Following a transaction described in the preceding sentence, the stock of the acquiring corporation shall be treated as the stock of the loss corporation for purposes of determining whether an ownership change occurs with respect to the pre-change losses and net unrealized built-in losses that may be treated as pre-change losses of the distributor or transferor corporation.

(iii) *Separate accounting required for losses and credits of an acquiring corporation and a distributor or transferor loss corporation.* Except as provided in §1.382–2T(f)(1)(ii), pre-change losses (determined as if the testing date were the change date and treating the amount of any net unrealized built-in loss as a pre-change loss), that are succeeded to and taken into account by an acquiring corporation in a transaction to which section 381(a) applies must be accounted for separately from losses and credits of the acquiring corporation for purposes of applying this section. See *Example (2)* of §1.382–2T(e)(2)(iv) of this section.

(iv) *End of separate accounting for losses and credits of distributor or transferor loss corporation.* For further guidance, see § 1.382–2T(f)(1)(ii).

(2) *Pre-change loss.* The term *pre-change loss* means—

(i) Any net operating loss carryforward of the old loss corporation to the taxable year ending on the change date or in which the change date occurs,

(ii) Any net operating loss of the old loss corporation for the taxable year in which the ownership change occurs to the extent such loss is allocable to the period in such year on or before the change date.

(iii) Any recognized built-in loss for any recognition period taxable year (within the meaning of 382(h)),

(iv) Any pre-change capital losses described in §1.383-1T(c)(2)(i) and (ii), and

(v) Any pre-change credits described in 1.383-1T(c)(3).

(3) *Stock*—(i) *In general.* Except as provided in this paragraph (f)(18), the term *stock* means stock other than stock described in section 1504(a)(4). Notwithstanding the preceding sentence, stock that is not described in section 1504(a)(4) solely because it is entitled to vote as a result of dividend arrearages shall be treated as so described and thus shall not be considered stock. Stock described in section 1504(a)(4), however, is not excluded for purposes of determining the value of the loss corporation under section 382(e). The determination of the percentage of stock of any corporation owned by any person shall be made on the basis of the relative fair market value of the stock owned by such person to the total fair market value of the outstanding stock of the corporation. Solely for purposes of determining the percentage of stock owned by a person, each share of all the outstanding shares of stock that have the same material terms is treated as having the same value. Thus, for example, a control premium or blockage discount is disregarded in determining the percentage of stock owned by any person. The previous two sentences of this paragraph (a)(3)(i) apply to any testing date occurring on or after January 29, 1991.

(ii) *Convertible stock.* The term *stock* includes any convertible stock. For rules regarding the treatment of certain convertible stock as an option, see § 1.382–4(d)(9)(ii).

(4) *Testing date*—(i) *In general.* Except as provided in paragraph (a)(4)(ii) of this section, a loss corporation is required to determine whether an ownership change has occurred immediately after any owner shift, or issuance or transfer (including an issuance or transfer described in § 1.382–4(d)(8)(i) or (ii)) of an option with respect to stock of the loss corporation that is treated as exercised under § 1.382–4(d)(2). Each date on which a loss corporation is required to make a determination of whether an ownership change has occurred is referred to as a testing date. All computations of increases in percentage ownership are to be made as of the close of the testing date and any transactions described in this paragraph (a)(4) that occur on that date are treated as occurring simultaneously at the close of the testing date. See § 1.382–2T(e)(1) for the definition of owner shift. The term *option,* as used in this paragraph (a)(4), includes interests that are treated as options under § 1.382–4(d)(9). For rules regarding the determination of whether dates prior to November 5, 1992, are testing dates, see § 1.382–2T(a)(2)(i).

(ii) *Exceptions.* A loss corporation is not required to determine whether an ownership change has occurred immediately after—

(A) Any transfer of stock, or an option with respect to stock, of the loss corporation in any of the circumstances described in section 382(l)(3)(B) (death, gift, divorce, *etc.*); or

(B) The transfer of an option described in § 1.382–4(d)(11)(i) or (ii) (relating to transfers between persons who are not 5-percent shareholders or between members of certain public groups).

(b) *Effective dates*—(1) *In general.* [Reserved]

(2) *Rules provided in paragraph (a)(3)(ii) of this section*—(i) *In general.* Except as provided in paragraph (b)(2)(ii) of this section, the rules provided in paragraph (a)(3)(ii) of this section apply with respect to any convertible stock.

(ii) *Certain convertible preferred stock.* Convertible stock that, when issued, would be described in section 1504(a)(4) by disregarding subparagraph (D) thereof and by ignoring the potential participation in corporate growth that the conversion feature may offer is treated as stock described in that section (and thus is not treated as stock for the purpose of determining whether an ownership change occurs, but is taken into account for the purpose of determining the value of the loss corporation immediately before an ownership change; see sections 382(e)(1) and 382(k)(6)(A)) if—

(A) The stock was issued on or after July 20, 1988, and prior to November 5, 1992; or

(B) The stock was issued prior to July 20, 1988, and the loss corporation makes the election described in Notice 88–67, 1988–1 C.B. 555, (see §601.601(d)(2)(ii)(*b*) of this chapter for availability of Cumulative Bulletins (C.B.)) on or before the earlier of the date prescribed in the Notice or December 7, 1992.

(3) *Rules provided in paragraph (a)(4) of this section.* The rules provided in paragraph (a)(4) of this section apply to determine whether dates on or after November 5, 1992, are testing dates.

[T.D. 8352, 56 FR 29434, June 27, 1991, as amended by T.D. 8405, 57 FR 10740, Mar. 30, 1992; 57 FR 24188, June 8, 1992; T.D. 8531, 59 FR 12836, Mar. 18, 1994; T.D. 8679, 61 FR 33315, June 27, 1996]

§1.382–2T Definition of ownership change under section 382, as amended by the Tax Reform Act of 1986 (temporary).

(a) *Ownership change*—(1) *In general.* A corporation is a new loss corporation and thus subject to limitation under section 382 only if an ownership change has occurred with respect to such corporation. An ownership change occurs with respect to a corporation if it is a loss corporation on a testing date and, immediately after the close of the testing date, the percentage of stock of the corporation owned by one or more 5-percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock of such corporation owned by such shareholders at any time during the testing period. See paragraph (a)(2)(i) of this section for the definition of testing date. See paragraph (d) of this section for the definition of testing period. See §1.382–2(a)(1) and paragraph (f)(3) of this section for the respective definition of loss corporation and new loss corporation. See paragraph (g) of this section for the definition of 5-percent shareholder. See section 383 and §1.383–1 for rules relating to loss corporations that have an ownership change and have capital loss carryovers, excess foreign taxes carried over under section 904(c), carryovers of general business credits under section 39, or unused minimum tax credits under section 53.

(2) *Events requiring a determination of whether an ownership change has occurred*—(i) *Testing dates prior to November 5, 1992.* Except as otherwise provided in this paragraph (a)(2)(i), a loss corporation is required to determine whether an ownership change has occurred immediately after any owner shift, any equity structure shift, or any transaction in which an option with respect to stock of the loss corporation is—

(A) Transferred to (or by) a 5-percent shareholder (or a person who would be 5-percent shareholder if the option were treated as exercised), or

(B) Issued by the loss corporation, a first tier entity, or a higher tier entity that owns five percent or more of the loss corporation (determined without regard to the application of paragraph (h)(2)(i)(A) of this section). Notwithstanding the preceding sentence, any transfer of stock of the loss corporation (or an option with respect to such stock) in any of the circumstances described in section 382(l)(3)(B), or any equity structure shift that is not also an owner shift, is not an event that requires the loss corporation to make a determination of whether an ownership change has occurred. For purposes of this section, each date on which a loss corporation is required to make a determination of whether an ownership change has occurred is referred to as a testing date, all computations of increases in percentage ownership are to be made as of the close of the testing date, and any transactions described in this paragraph (a)(2)(i) that occur on that date are treated as occurring simultaneously at the close of the testing date. See paragraphs (e)(1) and (2) of this section for the respective definitions of owner shift and equity structure shift. See paragraphs (f)(9) and (14) of this section for the respective definitions of first tier entity and higher tier entity. See paragraph (m)(4)(vii) of this section for special rules regarding the effective date of the provisions of this paragraph (a)(2)(i).

(ii) *Information statement required.* A loss corporation must file a statement with its income tax return for each taxable year that it is a loss corporation in which an owner shift, equity structure shift or other transaction described in paragraph (a)(2)(i) of this section occurs. The statement must—

(A) Indicate whether any testing dates occurred during the taxable year;

(B) Identify each testing date, if any, on which an ownership change occurred;

(C) Identify the testing date, if any, that occurred during and closest to the end of each of the three month periods ending on March 31, June 30, September 30 and December 31 during the taxable year, regardless of whether an ownership change occurred on the testing date,

(D) Identify each 5-percent shareholder on each such testing date;

(E) State the percentage ownership of the stock of the loss corporation for each 5-percent shareholder as of each such testing date and the increase, if any, in such ownership during the testing period; and

(F) Disclose the extent to which the loss corporation relied upon the presumptions regarding stock ownership under paragraph (k)(i) of this section to determine whether an ownership change occurred on any identified testing date.

See § 1.383–1(k) and paragraph (m)(4)(v) of this section for transitional rules regarding the filing of information statements.

(iii) *Records to be maintained by loss corporation.* A loss corporation shall keep such records as are necessary to determine: (A) The identity of its 5-percent shareholders, (B) the percentage of its stock owned by each such 5-percent shareholder, and (C) whether the section 382 limitation is applicable. Such records shall be retained so long as they may be material in the administration of any internal revenue law.

(b) *Nomenclature and assumptions.* For purposes of the example in this section—

(1) L is a loss corporation, and, if there is more than one loss corporation, they are designated as L_1, L_2, L_3, etc.

(2) P is a corporation that is not a loss corporation, and, if there is more than one such corporation, they are designated as P_1, P_2, P_3, etc.

(3) HC is a corporation whose assets consist solely of the stock of other corporations.

(4) E is an entity other than a corporation (e.g., a partnership), and, if there is more than one such entity, they are designated as E_1, E_2, E_3, etc.

(5) Unless otherwise stated—

(i) A, B, C, D, AA, BB, CC, and DD are unrelated individuals who own interests in corporations or other entities only to the extent expressly stated,

(ii) All corporations have one class of stock outstanding and each share of stock has the same fair market value as each other share,

(iii) The capital structure of the loss corporation and its business do not change over time, and

(iv) The rules of paragraphs (k)(2) and (4) of this section are not applicable.

(6) Public L represents a group of unrelated individuals and entities that own direct (and not indirect) stock ownership interests in loss corporation L, each of whom owns less than five percent of the stock of the loss corporation, and, if there is more than one loss corporation, such groups are designated as Public L_1, Public L_2, Public L_3, etc.

(7) Public P represents a group of unrelated individuals and entities that own direct (and not indirect) stock ownership interests in corporation P, each of whom owns less than five percent of the stock of the corporation, and, if there is more than one corporation, such groups are designated as Public P_1, P_2, P_3, etc.

(8) Public E represents a group of unrelated individuals and entities that own direct (and not indirect) ownership interests in entity E, each of whom

owns less than five percent of the entity, and, if there is more than one entity, such groups are designated as Public E_1, Public E_2, Public E_3, etc.

(c) *Computing the amount of increases in percentage ownership*—(1) *In general.* In order to determine whether an ownership change has occurred on a testing date, the loss corporation must identify each 5-percent shareholder whose percentage of stock ownership in the loss corporation immediately after the close of the testing date has increased, compared to such shareholder's lowest percentage of stock ownership in such corporation at any time during the testing period. The amount of the increase in the percentage of stock ownership in the loss corporation of each 5-percent shareholder must be computed separately by comparing the percentage ownership of each such 5-percent shareholder immediately after the close of the testing date to such shareholder's lowest percentage ownership at any time during the testing period. Each such increase in the percentage ownership of a 5-percent shareholder is then added together with any other such increases of other 5-percent shareholders to determine whether an ownership change has occurred. Because only those 5-percent shareholders whose percentages of stock ownership have increased are taken into account, a 5-percent shareholder is disregarded if his percentage of stock ownership, immediately after the close of the testing date, has decreased (or has remained the same), compared to his lowest percentage ownership interest on any previous date during the testing period.

(2) *Example.*

Example. (i) A and B each own 40 percent of the outstanding L stock. The remaining 20 percent of the L stock is owned by 100 unrelated individuals, none of whom own as much as five percent of L stock (''Public L''). C negotiates with A and B to purchase all their stock in L.

(ii) The acquisitions from both A and B are completed on September 13, 1990. C's acquisition of 80 percent of L stock results in an ownership change because C's percentage ownership has increased by 80 percentage points as of the testing date, compared to his lowest percentage ownership in L at any time during the testing period (0 percent).

(3) *Related and unrelated increases in percentage stock ownership.* The determination whether an ownership change has occurred is made without regard to whether the changes in stock ownership of the loss corporation (by one or more 5-percent shareholders) result from related or unrelated events.

(4) *Example.*

Example. (i) L has outstanding 200 shares of common stock. A, B and C respectively own 100, 50 and 50 shares of the L stock. On January 2, 1988, A sells 60 shares of L stock to B. Thus, B's percentage ownership interest in L increases by 30 percentage points, from 50 shares to 110 shares. On January 1, 1989, A purchases C's entire interest in L. Thus, A's percentage ownership interest in L increases by 25 percentage points, compared to his lowest percentage ownership interest in L, from 40 shares immediately following the January 2, 1988 sale to B to 90 shares. Even though A's ownership interest in L as of January 1, 1989 has decreased, compared to his 50 percent ownership interest at the beginning of the testing period, A is a 5-percent shareholder who must be taken into account for purposes of the computation required under paragraph (c)(1) of this section because his interest in L on that testing date (45 percent) has increased, compared to his lowest percentage ownership interest in L at any time during the testing period (20 percent following the sale to B).

(ii) Accordingly, although A and B jointly have increased their aggregate total ownership interest in L between January 2, 1988 and January 1, 1989 by only 25 percentage points (*i.e.*, the total ownership interest in L held by A and B at all times is not less than a 75 percent interest), the total of their separate increases in the percentage stock ownership of L, compared to their respective lowest percentage ownership interests at any time during the testing period, is 55 percentage points. Thus, an ownership change occurs as a result of A's acquisition of L stock on January 1, 1989.

(d) *Testing period*—(1) *In general.* Except as otherwise provided in paragraphs (d) and (m) of this section, the testing period for any testing date is the three-year period ending on the testing date. See paragraph (a)(2)(i) of this section for the definition of testing date.

(2) *Effect of a prior ownership change.* Following an ownership change, the testing period for determining whether a subsequent ownership change has occurred shall begin no earlier than the first day following the change date of the most recent ownership change. See

paragraph (f)(19) of this section for the definition of change date.

(3) *Commencement of the testing period*—(i) *In general.* Except as otherwise provided in paragraph (d)(3)(ii) of this section, the testing period for any loss corporation shall not begin before the earlier of the first day of either—

(A) The first taxable year from which there is a loss or excess credit carryforward to the first taxable year ending after the testing date, or

(B) The taxable year in which the testing date occurs.

(ii) *Exception for corporations with net unrealized built-in loss.* Paragraph (d)(3)(i) of this section shall not apply if the corporation has a net unrealized built-in loss (determined after application of section 382(h)(3)(B)) on the testing date, unless the loss corporation establishes the taxable year in which the net unrealized built-in loss first accrued.

In that event, the testing period shall not begin before the earlier of—

(A) The first day of the taxable year in which the net unrealized built-in loss first accrued, or

(B) The day described in paragraph (d)(3)(i) of this section. See section 382(h) for the definition of net unrealized built-in loss.

(4) *Disregarding testing dates.* Any testing date that occurs before the beginning of the testing period shall be disregarded for purposes of this section.

(5) *Example.*

Example. (i) A owns all 100 outstanding shares of L stock. A sells 40 shares to B on January 1, 1988. C purchases 20 shares of L stock from A on July 1, 1991. In determining if an ownership change occurs on the July 1, 1991 testing date, B's acquisition of L stock is disregarded because it occurred before the testing period that ends on such testing date. Thus, B's ownership interest in L does not increase during the testing period, and no ownership change results from C's acquisition.

(ii) The facts are the same as in (i), except that throughout the period during which B negotiated his stock purchase transaction with A, B knew that C intended to attempt to acquire a significant stock interest in L. Also, B and C have been partners in a number of significant business ventures. The result is the same as in (i).

(e) *Owner shift and equity structure shift*—(1) *Owner shift*—(i) *Defined.* For purposes of this section, an owner shift is any change in the ownership of the stock of a loss corporation that affects the percentage of such stock owned by any 5-percent shareholder. See paragraph (g) of this section for the definition of a 5-percent shareholder. An owner shift includes, but is not limited to, the following transactions:

(A) A purchase of disposition of loss corporation stock by a 5-percent shareholder,

(B) A section 351 exchange that affects the percentage of stock owned by a 5-percent shareholder,

(C) A redemption or a recapitalization that affects the percentage of stock owned by a 5-percent shareholder,

(D) An issuance of loss corporation stock that affects the percentage of stock owned by a 5-percent shareholder, and

(E) An equity structure shift that affects the percentage of stock owned by a 5-percent shareholder.

(ii) *Transactions between persons who are not 5-percent shareholders disregarded.* Transfers of loss corporation stock between persons who are not 5-percent shareholders of such corporation (and between members of separate public groups resulting from the application of the segregation rules of paragraphs (j)(2) and (3)(iii) of this section) are not owner shifts and thus are not taken into account. See paragraph (h)(4)(xi) of this section for a similar rule applicable to transfers of options.

(iii) *Examples.*

Example (1) . A has owned all 1000 shares of outstanding L stock for more than three years. On June 15, 1988, A sells 300 of his L shares to B. This transaction is an owner shift. No other 5-percent shareholder has increased his percentage ownership of L stock during the testing period. Thus, the owner shift resulting from B's acquisition does not result in an ownership change, because B has increased his stock ownership in L by only 30 percentage points.

Example (2). The facts are the same as in *Example (1).* In addition, on June 15, 1989, L issues 100 shares to each of C, D and AA. The stock issuance is an owner shift. The transaction, however, does not result in an ownership change, because B, C, D and AA (the 5-percent shareholders whose stock ownership has increased as of the testing date, compared to any other time during the testing period) have increased their percentage of stock ownership in L by a total of only 46.2 percentage points during the testing period (by 23.1 percentage points [300 shares/1300 shares] for B, and 7.7 percentage points [100 shares/1300 shares] for each of C, D and AA).

Example (3). All 1000 shares of L stock are owned by a group of 100 unrelated individuals, none of whom own as much as five percent of L stock (''Public L''). Several of the members of Public L sell their L stock, amounting to a 30 percent ownership interest in L, to B on June 15, 1988. The sale of stock to B is an owner shift. Between June 16, 1988 and June 15, 1989, each of the remaining individuals in Public L sells his stock to another person who is not a 5-percent shareholder. Under paragraph (e)(1)(ii) of this section, trading activity among the members of Public L is disregarded and does not result in an owner shift. On June 15, 1989, L issues 100 shares to each of C, D and AA. The only sale transactions by members of Public L that are taken into account in determining whether an ownership change occurs on June 15, 1989 are the sales to B on June 15, 1988. Because B, C, D and AA together have increased their percentage ownership of L stock as a result of B's purchase and the stock issuance by an amount not in excess of 50 percentage points during the testing period ending on June 15, 1988, an ownership change does not occur on that date.

Example (4). The facts are the same as in *Example (2).* In addition, on December 15, 1989, L redeems 200 of the L shares from A. The redemption is an owner shift that results in an ownership change, because B, C, D and AA are 5-percent shareholders whose percentage ownership of L increase by a total of 54.6 percentage points during the testing period (by 27.3 percentage points [300 shares/1100 shares] for B and 9.1 percentage points [100 shares/1100 shares] for each of C, D and AA).

Example (5). L is owned entirely by 10,000 unrelated shareholders, none of whom owns as much as five percent of the stock of L (''Public L''). Accordingly, Public L is L's only 5-percent shareholder. See paragraph (j)(1) of this section. There are one million shares of common stock outstanding. On December 1, 1988, L issues two million new shares of its common stock to members of the public, none of whom owned any L stock prior to the issuance. Following the public offering, no shareholder of L owns, directly or indirectly, five percent or more of L stock. Under paragraph (j)(2) of this section, however, all of the newly issued stock is treated as acquired by a 5-percent shareholder (''Public NL'') that is unrelated to Public L. Therefore, the public offering constitutes an owner shift that results in an ownership change because Public NL's percentage of stock ownership in L increased by 66⅔ percentage points (two million shares acquired in the public offering/three million shares outstanding following the offering) over its lowest percentage ownership during the testing period (0 percent prior to the offering).

Example (6). The facts are the same as in *Example (5),* except that L issues only 500,000 new shares of L stock on December 1, 1988, and Public NL's percentage ownership interest in L increases by only 33⅓ percentage points (500,000 shares acquired in the public offering/1.5 million shares outstanding following the offering). During the two years following December 2, 1988, 14 percent of the stock outstanding on that date is sold over a public stock exchange. On December 3, 1990, A purchases five percent of L stock (75,000 shares) over a public stock exchange. The purchase of five percent of L stock by A is an owner shift and is presumed to have been made proportionately from Public L and Public NL under paragraph (j)(1)(vi) of this section. Under paragraph (e)(1)(ii) of this section, transfers of L stock in transactions not involving A (*i.e.,* in transactions among or between members of separate public groups resulting from the application of paragraphs (j)(2) and (3) of this section) are not taken into account, and do not constitute owner shifts. (Transfers between members of Public NL and Public L, which are treated as separate 5-percent shareholders solely by virtue of paragraph (j)(2) of this section, are disregarded even if L has actual knowledge of any such transfers.) A and Public NL, the only 5-percent shareholders whose interests in L have increased during the testing period, have increased their respective stock ownership by only 36⅔ percentage points—five percentage points for A [75,000 shares/1.5 million shares outstanding] and 31⅔ percentage points for Public NL [((500,000 shares issued in the public offering)—(5 percent × 500,000 shares presumed to have been acquired by A)) /1.5 million shares outstanding]. Accordingly, there is no ownership change with respect to L notwithstanding that, taking into account the public trading, a change of more than 50 percentage points in the ultimate beneficial ownership of L stock occurred during the three-year period ending on the December 3, 1990 testing date.

Example 7. The facts are the same as in *Example 6,* except that five percent of the L stock has always been owned by P which, in turn, has always been owned by Public P. On December 6, 1990, P sells all of its L stock over a public stock exchange. Although the trading of P stock among persons that are not 5-percent share-holders (without regard to the segregation rules of paragraph (j) of this section) are disregarded under paragraph (e)(1)(ii) of this section, the disposition of the L stock by P is not disregarded because the L stock is transferred in a transaction that is subject to paragraph (j)(3)(i) of this section.

(2) *Equity structure shift*—(i) *Tax-free reorganizations.* An equity structure shift is any reorganization within the meaning of section 368 with respect to which the loss corporation is a party to the reorganization, except that such term does not include a reorganization described in—

(A) Section 368(a)(1)(D) or (G) unless the requirements of section 354(b)(1) are met, or

(B) Section 368(a)(1)(F).

(ii) *Transactions designated under section 382(g)(3)(B) treated as equity structure shifts.* [Reserved]

(iii) *Overlap of owner shift and equity structure shift.* Any equity structure shift that affects the percentage of loss corporation stock owned by a 5-percent shareholder also constitutes an owner shift. See paragraph (e)(i)(E) of this section

(iv) *Examples.*

Example (1). A owns all of the stock of L and B owns all of the stock of P. On October 13, 1988, L merges into P in a reorganization described in section 368a(1)(A). As a result of the merger, A and B own 25 and 75 percent, respectively, of the stock of P. The merger is an equity structure shift (and, because it affects the percentage of L stock owned by 5-percent shareholders, it also constitutes an owner shift). On the October 13, 1988 testing date, B is a 5-percent shareholder whose stock ownership in the loss corporation following the merger has increased by 75 percentage points over his lowest percentage of stock ownership in L at any time during the testing period (0 percent prior to the merger). Accordingly, an ownership change occurs as a result of the merger. P is thus a new loss corporation and L's pre-change losses are subject to limitation under section 382.

Example (2). (i) A owns 100 percent of L_1 stock and B owns 100 percent of L_2 stock. On January 1, 1988, L_1 merges into L_2 in a reorganization described in section 368(a)(1)(A). Immediately after the merger, A and B own 40 percent and 60 percent, respectively, of the L_2 stock. There is an equity structure shift (as well as an owner shift) with respect to both L_1 and L_2 on January 1, 1988.

(*ii*) Because the percentage of L_2 stock owned by B immediately after the merger (60 percent) increases by more than 50 percentage points over the lowest percentage of the stock of L_1 owned by B during the testing period (0 percent prior to the merger), there is an ownership change with respect to L_1. L_2 is a new loss corporation and thus, under §1.382–2(a)(1)(iii) of this section, the pre-change losses of L_1 must be accounted for separately by L_2 from the losses of L_2 (immediately before the ownership change) and are subject to limitation under section 382. See paragraph (f)(1)(ii) of this section for rules that end separate accounting for L_1's pre-change losses on any testing date occurring on or after January 29, 1991.

(*iii*) L_2 is a new loss corporation because it is a successor corporation to L_1. There is no ownership change with respect to L_2, however, because A's stock ownership in L_2 increased by only 40 percentage points (to 40 percent) over the amount owned by A prior to the merger (0 percent). Therefore, the pre-change losses of L_2 are not limited under section 382 as a result of the merger.

Example (3). The result in *Example (2)* would be the same if L_1 had survived the merger (*i.e.*, L_2 merged into L_1) with A and B owning 40 and 60 percent, respectively, of L_1 stock. L_1's pre-change losses would be accounted for separately and limited under section 382 and the pre-change losses of ^{2} would be accounted for separately under §1.382–2(a)(1)(iii) of this section, but would not be limited under section 382. See §1.382–2(a)(1)(ii) for the treatment of ^{2} following the transaction.

Example (4). The facts are the same as *Example (2)*, except, instead of acquiring ^{1} in a merger, ^{2} acquires all of the ^{1} stock from A on January 1, 1988, solely in exchange for stock representing a 40 percent interest in ^{2}, in a reorganization described in section 368(a)(1)(B). The acquisition of stock by ^{2} is an equity structure shift (as well as an owner shift) with respect to ^{1} that results in an ownership change with respect to ^{1} because the percentage of ^{1} stock owned by B immediately after the reorganization (60 percent, by virtue of B's ownership of ^{2}, through the operation of the constructive ownership rules of paragraph (h) of this section) increases by more than 50 percentage points over the lowest percentage of ^{1} stock owned by B at any time during the testing period (0 percent prior to the reorganization). The acquisition also results in an equity structure shift and an owner shift with respect to ^{2}, but ^{2} incurs no ownership change, because A's stock ownership in ^{2} increased by only 40 percentage points over the percentage of ^{2} stock owned by A prior to the reorganization (0 percent).

(f) *Definitions.* For purposes of this section—

(1) *Loss corporation*—(i) *In General.* See section 382 and § 1.382–2(a)(1) for the definition of a loss corporation.

(ii) *End of separate accounting for losses and credits of distributor or transferor loss corporation.* The separate tracking of owner shifts of the stock of an acquiring corporation required by § 1.382–2(a)(1)(iii) with respect to the net operating loss carryovers and other attributes described in § 1.382–2(a)(1)(ii) ends when a fold-in event occurs. A fold-in event is either an ownership change of the distributor or transferor corporation in connection with, or after, the transaction to which section 381(a) applies, or a period of 5 consecutive years following the section 381(a) transaction during which the distributor or transferor corporation has not had an ownership change. Starting on the day after the earlier of the change date (but not earlier than the day of the section 381(a) transaction) or the last day of the 5 consecutive year period, the losses and other attributes of the distributor or transferor corporation are treated as losses and attributes of the acquiring corporation for purposes of determining whether an ownership change occurs with respect to such losses. Also, for purposes of determining the beginning of the acquiring corporation's testing period, such losses are considered to arise either in a taxable year that begins not earlier than the later of the day following the change date or the day of the section 381(a) transaction, or in a taxable year that begins 3 years before the end of the 5 consecutive year period. Prechange losses of a distributor or transferor corporation that are subject to a limitation under section 382 continue to be subject to the limitation notwithstanding the occurrence of a fold-in event. Any ownership change that occurs in connection with, or subsequent to, the section 381 transaction may result in an additional, lesser limitation with respect to such pre-change losses. This paragraph (f)(1)(ii) applies to any testing date occurring on or after January 29, 1991.

(iii) *Application to other successor corporations.* Section 1.382–2(a)(1) (relating to the definition of loss corporation) and this paragraph (f)(1) also apply, as the context may require, to successor corporations other than successors in section 381(a) transactions. For example, if a corporation receives assets from the loss corporation that have basis in excess of value, the recipient corporation's basis for the assets is determined, directly or indirectly, in whole or in part, by reference to the loss corporation's basis, and the amount by which basis exceeds value is material, the recipient corporation is a successor corporation subject to § 1.382–2(a)(1) and this paragraph (f)(1). This paragraph (f)(1)(iii) applies to any testing date occurring on or after January 1, 1997.

(2) *Old loss corporation.* The term *old loss corporation* means any corporation with respect to which there is an ownership change and that was a loss corporation immediately before the ownership change.

(3) *New loss corporation.* The term *new loss corporation* means a corporation with respect to which there is an ownership change if, immediately after such change, it is a loss corporation. A successor corporation to the corporation described in the preceding sentence also is a new loss corporation.

(4) *Successor corporation.* A successor corporation is a distributee or transferee corporation that succeeds to and takes into account items described in section 381(c) from a corporation as the result of an acquisition of assets described in section 381(a). A successor corporation also includes, as the context may require, a corporation which receives an asset or assets from another corporation if the corporation's basis for the asset(s) is determined, directly or indirectly, in whole or in part, by reference to the other corporation's basis and the amount by which basis differs from value is, in the aggregate, material. The previous sentence of this paragraph (f)(4) applies to any testing date occurring on or after January 1, 1997.

(5) *Predecessor corporation.* A predecessor corporation is a distributor or transferor corporation that distributes or transfers its assets to an acquiring corporation in a transaction described in section 381(a). A predecessor corporation also includes, as the context may require, a corporation which transfers an asset or assets to another corporation if the transferee's basis for the asset(s) is determined, directly or indirectly, in whole or in part, by reference to the corporation's basis and the amount by which basis differs from value is, in the aggregate, material.

The previous sentence of this paragraph (f)(5) applies to any testing date occurring on or after January 1, 1997.

(6) *Shift.* As the context may require, a shift means an equity structure shift, an owner shift or both.

(7) *Entity.* See § 1.382–3(a)(1) for the definition of an entity.

(8) *Direct ownership interest.* A *direct ownership interest* means the interest a person owns in an entity, including a loss corporation, without regard to the constructive ownership rules of paragraph (h) of this section.

(9) *First tier entity.* A first tier entity is an entity that, at any time during the testing period, owns a five percent or more direct ownership interest in the loss corporation.

(10) *5-percent owner.* A 5-percent owner is any individual that, at any time during the testing period, owns a five percent or more direct ownership interest in a first tier entity or a higher tier entity. See paragraph (g) of this section for rules to determine whether, as a result of the constructive ownership rules of paragraph (h) of this section, a 5-percent owner is a 5-percent shareholder.

(11) *Public shareholder.* A public shareholder is any individual, entity, or other person with a direct ownership interest in a loss corporation of less than five percent at all times during the testing period.

(12) *Public owner.* A public owner is any individual, entity, or other person that, at all times during the testing period, owns less than a five percent direct ownership interest in a first tier entity or any higher tier entity.

(13) *Public group.* A public group is a group of individuals, entities, or other persons each of whom owns, directly or constructively, less than five percent of the loss corporation. See paragraphs (g) and (j) of this section for the rules applicable to identify public groups and to determine whether a public group is a 5-percent shareholder.

(14) *Higher tier entity.* A higher tier entity is any entity that, at any time during the testing period, owns a five percent or more direct ownership interest in a first tier entity or in any higher tier entity.

(15) *Indirect ownership interest.* An indirect ownership is an interest a person owns in an entity determined solely as a result of the application of the constructive ownership rules of paragraph (h) of this section and without regard to any direct ownership interest (or other beneficial ownership interest) in the entity.

(16) *Highest tier entity.* A highest tier entity is a first tier entity or a higher tier entity that is not owned, in whole or in part, at any time during the testing period by a higher tier entity.

(17) *Next lower tier entity.* The next lower tier entity with respect to a first tier entity is the loss corporation. The next lower tier entity with respect to a higher tier entity is any first tier entity or other higher tier entity in which the higher tier entity owns, at any time during the testing period, a five percent or more direct ownership interest.

(18) *Stock*—(i) *In general.* For further guidance, see § 1.382–2(a)(3)(i).

(ii) *Treating stock as not stock.* Any ownership interest that otherwise would be treated as stock under paragraph (f)(18)(i) of this section shall not be treated as stock if—

(A) As of the time of its issuance or transfer to (or by) a 5-percent shareholder, the likely participation of such interest in future corporate growth is disproportionately small when compared to the value of such stock as a proportion of the total value of the outstanding stock of the corporation,

(B) Treating the interest as not constituting stock would result in an ownership change, and

(C) The amount of the pre-change loss (determined as if the testing date were the change and treating the amount of any net unrealized built-in loss as a pre-change loss) is more than twice the amount determined by multiplying

(*1*) the value of the loss corporation (as determined under section 382(e)) on the testing date, by

(*2*) the long-term tax exempt rate (as defined in section 382(f)) for the calendar month in which the testing date occurs.

Stock that is not treated as stock under this paragraph (f)(18)(ii), however, is taken into account for purposes of determining the value of the loss corporation under section 382(e).

(iii) *Treating interests not constituting stock as stock.* Any ownership interest that would not be treated as stock under paragraph (f)(18)(i) of this section (other than an option that is subject to paragraph (h)(4) of this section) shall be treated as constituting stock if—

(A) As of the time of its issuance or transfer to (or by) a 5-percent shareholder (or a person who would be a 5-percent shareholder if the interest not constituting stock were treated as stock), such interest offers a potential significant participation in the growth of the corporation,

(B) Treating the interest as constituting stock would result in an ownership change, and

(C) The amount of the pre-change losses (determined as if the testing date were the change date and treating the amount of any net unrealized built-in loss as a pre-change loss) is more than twice the amount determined by multiplying

(*1*) The value of the loss corporation (as determined under section 382(e)) on the testing date, by

(*2*) The long-term tax exempt rate (as defined in section 382(f)) for the calendar month in which the testing date occurs.

An ownership interest is that treated as stock under this paragraph (f)(18)(iii) is taken into account for purposes of determining the value of the loss corporation under section 382(e). See §1.382–4(d)(12) for rules that apply with respect to options and this paragraph (f)(18)(iii).

(iv) *Stock of the loss corporation.* The *stock of the loss corporation* means stock of such corporation within the meaning of this paragraph (f)(18) and, as the context may require, includes any indirect ownership interest in the loss corporation.

(19) *Change date.* The *change date* means the date on which a shift (or any other transaction described in paragraph (a)(2)(i) of this section) that is the last component of an ownership change occurs.

(20) *Year.* A *year,* or any multiple thereof, means a 365-day period (or a 366-day period in the case of a leap year), or any multiple thereof, unless the year is specifically identified as a taxable year.

(21) *Old section 382.* ''Old section 382'' means section 382, as in effect prior to the effective date of section 382 in the Tax Reform Act of 1986 (the ''Act''), but taking into account section 621(f)(2) of the Act.

(22) *Pre-change loss.* See section 382 and §1.382–2(a)(2) for the definition of pre-change loss.

(23) *Unrelated.* Any two persons are unrelated if the constructive ownership rules of paragraph (h) of this section do not apply to treat either person as owning stock that is owned, directly or constructively, by the other person.

(24) *Percentage ownership interest.* A person's percentage ownership interest in—

(i) A corporation shall be determined under the rules of this section that are applicable to the determination of a shareholder's percentage stock ownership interest in a loss corporation (see paragraphs (f)(18)(i) through (iii) of this section),

(ii) A partnership shall be equal to the relative fair market value of such person's partnership interest to the total fair market value of all outstanding partnership interests, determined without regard to any limited and preferred partnership interest that is described in paragraph (h)(2)(ii)(C) of this section,

(iii) A trust shall be determined in accordance with the principles of section 318(a)(2)(B) for determining the constructive ownership of stock,

(iv) An estate shall be determined in accordance with the principles of section 318(a)(2)(A) for determining the constructive ownership of stock, and

(v) All other entities shall be determined by reference to the person's relative economic interest in the entity, taking into account all of the relevant facts and circumstances.

(g) *5-percent shareholder*—(1) *In general.* Subject to the rules of paragraphs (k)(2) and (4) of this section, the term *5-percent shareholder* means—

(i) An individual that owns, at any time during the testing period,

(A) A direct ownership interest in the stock of the loss corporation of five percent or more or

(B) An indirect ownership interest in the stock of the loss corporation of five percent or more by virtue of an ownership interest in any one first tier entity or higher tier entity,

(ii) A public group, of either a first tier entity or a higher tier entity, identified as a 5-percent shareholder under paragraph (j)(1)(iv)(A) or (B) of this section,

(iii) A public group of the loss corporation identified as a 5-percent shareholder under paragraph (j)(1)(iv)(C) of this section, and

(iv) A public group, of the loss corporation, a first tier entity or a higher tier entity, identified as a 5-percent shareholder under paragraph (j)(2) or (3) of this section. An individual owning five percent or more of the stock of the loss corporation at any time during the testing period is a 5-percent shareholder notwithstanding that the individual may own less than five percent of the stock of the loss corporation on the testing date. See paragraph (g)(5)(i)(B) of this section for rules permitting a loss corporation to make an adjustment in cases described in the preceding sentence.

(2) *Determination of whether a person is a 5-percent shareholder.* Except as provided in paragraphs (k)(2) and (4) of this section, a person shall be treated as constructively owning stock of the loss corporation pursuant to paragraph (h)(2) of this section only if the loss corporation stock is attributed to such person in the person's capacity as a higher tier entity or a 5-percent owner of the first tier entity or higher tier entity from which such stock is attributed. See paragraph (k)(3) of this section for rules explaining the extent of the obligation of the loss corporation to determine the identity of its 5-percent shareholders. Nothing in this paragraph (g)(2), however, shall limit the attribution of loss corporation stock under section 318(a)(2) and paragraph (h) of this section to a public owner.

(3) *Determination of the percentage stock ownership interest of a 5-percent shareholder.* Subject to the rules of paragraphs (k)(2) and (4) of this section, in determining a 5-percent shareholder's percentage ownership interest in the loss corporation, the shareholder's direct ownership interest, if any, and each indirect ownership interest that he may have in the loss corporation in his capacity as a 5-percent owner of any one first tier entity or higher tier entity, if any, are required to be added together and taken into account with respect to such shareholder only to the extent that each such direct or indirect ownership interest constitutes five percent or more of the stock of the loss corporation.

(4) *Examples.*

Example (1) (i) Twenty percent of L stock is owned by A, 10 percent is owned by P_1, 20 percent is owned by E, a joint venture, and the remaining 50 percent of L stock is owned by Public L. P_1 is owned 15 percent by B and 85 percent by Public P_1. E is owned 30 percent by P_2 and 70 percent by P_3, which, in turn, are owned by Public P_2 and Public P_3, respectively.

(ii) The ownership structure of L is illustrated by the following chart:

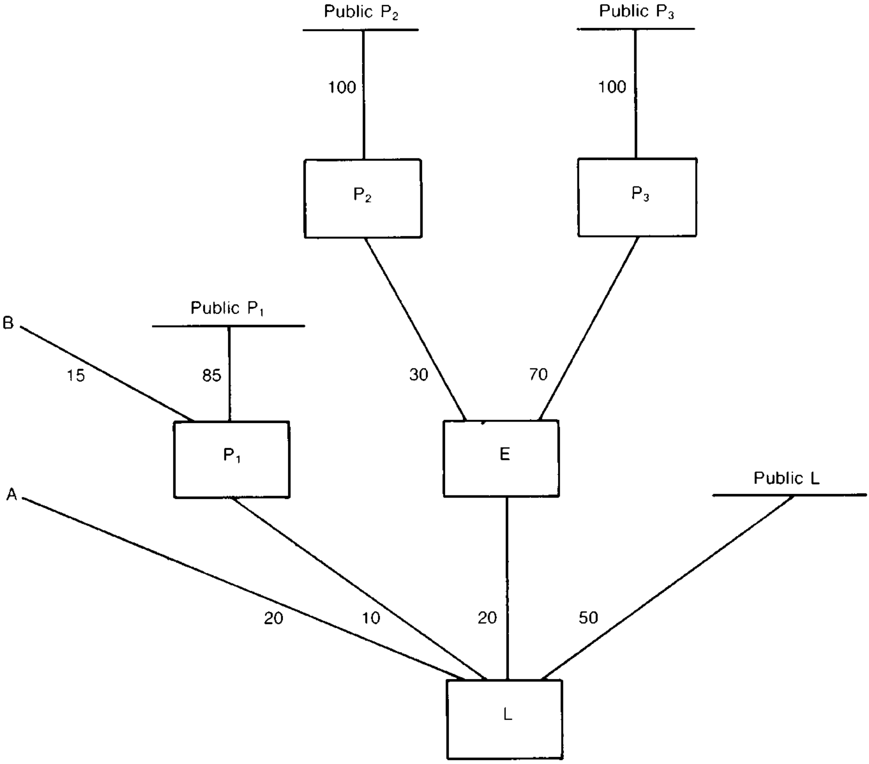

(iii) P_1 and E, each of which has a direct ownership interest in L of five percent or more, are first tier entities. The shareholders with direct ownership interests in L who individually own less than five percent of L are public shareholders (Public L). B, who has a direct ownership interest of five percent or more in P_1, is a 5-percent owner of P . P_2 and P_3, and P_3, each of which has a direct ownership interest in a first tier entity (E) of five percent or more, are higher tier entities with respect to L and, because neither entity is owned at any time during the testing period by a higher tier entity, they also are highest tier entities. The shareholders of P_2 and P_3 (Public P_2 and Public P_3, respectively) are public owners of such entities, because none of those shareholders own five percent or more of either entity at any time during the testing period.

(iv) A, who has a 20 percent direct ownership interest in L, is a 5-percent shareholder of L. Because, by application of the constructive ownership rules of paragraph (h) of this section, B owns only 1.5 percent of L stock in his capacity as a 5-percent owner of P_1 (15 percent ownership of P_1 × 10 percent ownership of L), B is not a 5-percent shareholder of L, even though he is a 5-percent owner of P_1. Under the rules of paragraph (j) of this section, therefore, B is treated as a member of Public P_1. See *Example (3)* of paragraph (j)(1)(vi) of this section for a determination of which public owners and public shareholders constitute public groups that are treated as 5-percent shareholders of L.

Example (2) (i) The facts are the same as in *Example (1)*, except that P_3 is owned 60 percent by C, 30 percent by P_4, and 10 percent by Public P_3. The stock of P_4 is owned by a group of persons (Public P_4), none of whom own five percent or more of the stock of P_4.

(ii) The ownership structure of L is illustrated by the following chart:

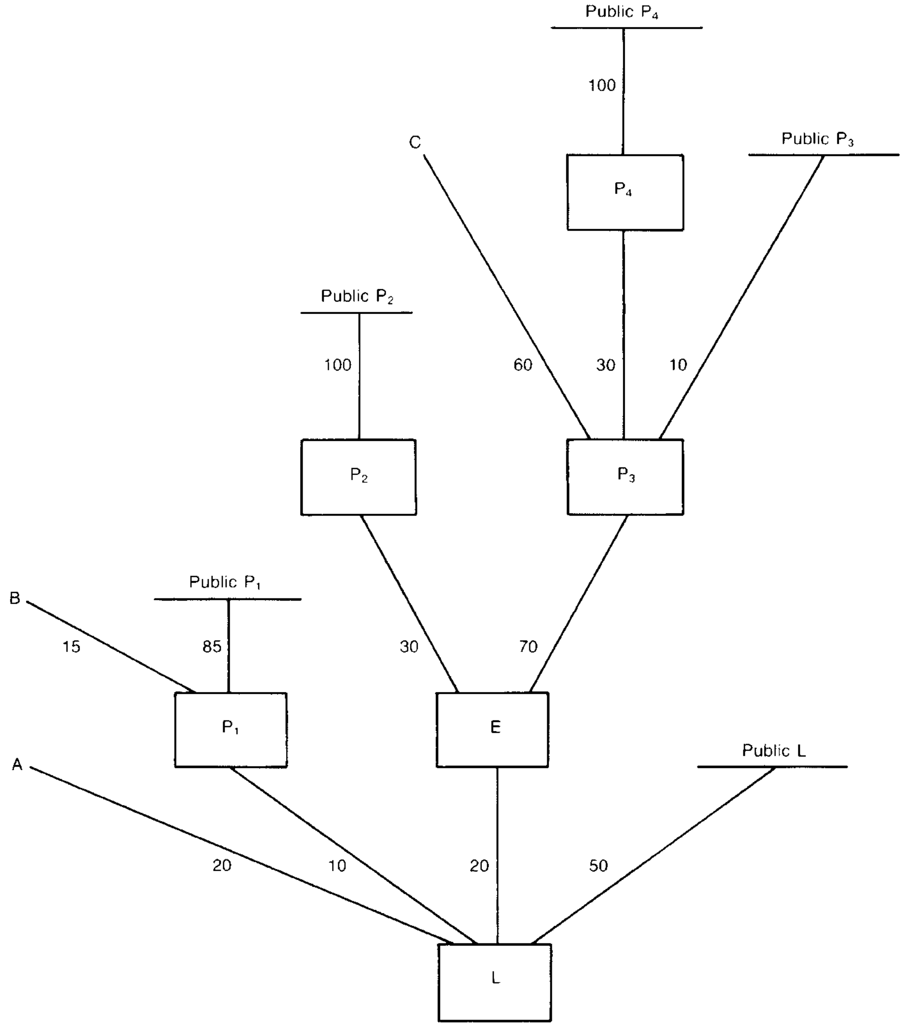

(iii) The defined terms are the same as in *Example (1)*, except that P_3 is a higher tier entity, not a highest tier entity, because five percent or more of P_3 is, in turn, owned by another entity (P_4). P_4, which owns five percent or more of a higher tier entity (P_3), also is a higher tier entity and, because it is not owned at any time during any testing period by any entity that is also a higher tier entity, P_4 is a highest tier entity. All of the shareholders of P_4, none of which own a direct ownership interest of five percent or more in P_4, are public owners of P_4.

(iv) C is a 5-percent owner of P_3 and, under the constructive ownership rules of paragraph (h) of this section, C indirectly owns 8.4 percent of L ([60 percent ownership of P_3] × [70 percent ownership of E] × [20 percent ownership of L]), in his capacity as a 5-percent owner of P_3. B is a 5-percent owner of P_1 and, under the constructive ownership rules of paragraph (h) of his section, B owns 1.5 percent of L ([15 percent ownership of P_1] × [10 percent ownership of L]) in his capacity as a 5-percent owner of P_1. Therefore, C is a 5-percent shareholder of L, but B is not a 5-percent shareholder of L, even though he is a 5-percent owner of P_1. See *Example (4)* of paragraph (j)(1)(vi) of this section for a determination of which public owners and public shareholders constitute public groups that are treated as separate 5-percent shareholders of L.

Example (3) (i) L is owned 30 percent by A and 70 percent by P. A owns six percent of P stock and the balance (94 percent) is owned equally by 500 unrelated shareholders (‘‘Public P’’).

(ii) A is a 5-percent shareholder because he directly owns 30 percent of L. Even though A is a 5-percent owner of P, A’s 4.2 percent indirect ownership interest in L (six percent ownership interest in P × P’s 70 percent ownership of L) is generally not taken into account in determining A’s ownership interest, because such indirect ownership interest is less than five percent. Instead, A’s 4.2 percent indirect interest is treated under paragraph (j)(1)(iv) of this section as owned by Public P. If, however, L has actual knowledge of A’s less-than-five-percent indirect ownership interest in L and is thus subject to paragraph (k)(2) of this section, or paragraph (k)(4) of this section otherwise applies, L must take A’s total 34.2 percent ownership interest into account in determining A’s percentage ownership in L.

Example (4). The facts are the same as in *Example (3),* except that A owns ten percent of P’s stock. Because A’s indirect ownership interest in L in his capacity as a 5-percent owner of P is five percent or more, both A’s 30 percent direct ownership interest in L and his seven percent indirect ownership interest in L (10 percent ownership interest in P × P’s 70 percent ownership of L) are taken into account in determining his ownership interest in L, without regard to L’s actual knowledge or whether paragraph (k)(4) of this section applies.

Example 5— See §1.382–3(a)(1)(ii) for additional examples with respect to the definition of an entity.

(5) *Stock ownership presumptions in connection with certain acquisitions, and dispositions of loss corporation stock*—(i) *In general.* For purposes of this section—

(A) If an individual owns less than five percent of the stock of a loss corporation during the testing period (excluding the testing date) and acquires an amount of such stock so that the individual becomes a 5-percent shareholder on the testing date, the loss corporation may treat any interest in the loss corporation owned by such individual prior to that acquisition as owned by a public group during the period of such individual’s ownership of that interest and as not owned by the 5-percent shareholder during the same period, and

(B) If a 5-percent shareholder’s percentage ownership interest in the loss corporation is reduced to less than five percent, the loss corporation may presume that the remaining stock owned by such 5-percent shareholder immediately after such reduction is the stock owned by such shareholder for each subsequent testing date having a testing period that includes the date on which the reduction occurred as long as such shareholder continues to own less than five percent of the stock of the loss corporation. In that event, such ownership interest shall be treated as owned by a separate public group for purposes of the rules of paragraph (j)(2)(vi) of this section.

(ii) *Example.*

L has 100,000 shares of stock outstanding. All of the L stock is owned equally by 40 unrelated, individual shareholders, including A (who owns 2.5 percent of L stock). Because no person owns as much as five percent of L stock, Public L is the only 5-percent shareholder of L. See paragraph (j)(1) of this section. A purchases 5,000 shares of L stock over a public stock exchange on June 8, 1989. The purchase is an owner shift. When added to his ownership interest before that date (the testing date), A owns 7,500 shares of L stock (7.5 percent). Under paragraph (g)(5)(i)(A) of this section, L may treat A and Public L as having owned 0 percent and 100 percent, respectively, at all times prior to June 8, 1989 (rather than having owned 2.5 percent by A and 97.5 percent by Public L, even if L has actual knowledge of A’s less than five percent ownership interest). The increase in A’s stock ownership of L as of June 8, 1989 thus would be 7.5 percentage points, rather than 5.0 percentage points, for purposes of determining whether an ownership change occurs on that testing date and any subsequent testing date.

(h) *Constructive ownership of stock*—(1) *In general.* Subject to certain modifications set forth in this section and section 382(l)(3), the constructive ownership rules of section 318(a) generally apply for purposes of determining ownership of loss corporation stock.

(2) *Attribution from corporations, partnerships, estates and trusts*—(i) *In general.* Stock owned (directly or indirectly) by an entity shall be attributed to its owners—

(A) Except as otherwise provided in this section, and solely for the purposes of determining whether a loss corporation has an ownership change by treating the stock attributed pursuant to section 318(a)(2) as no longer being owned by the entity from which it is attributed, and

(B) If attribution is from a corporation, without regard to the 50 percent stock ownership limitation contained in section 318(a)(2)(C).

(ii) *Limitation on attribution from entities with respect to certain interests.* Section 318(a)(2) shall not apply to treat the stock of the loss corporation that is owned directly by a first tier entity (or indirectly by any higher tier entity) as being indirectly owned by any person that has an ownership interest in the first tier entity (or any higher tier entity) to the extent that such interest is (or is attributable to)—

(A) Stock of any such entity that is described in section 1504(a)(4),

(B) Any ownership interest in any such entity that does not constitute stock under paragraph (f)(18)(ii) of this section, or

(C) If the entity is not a corporation, any ownership interest in any such entity that has characteristics similar to the interests described in paragraph (h)(2)(ii)(A) or (B) of this section.

The ownership interests described in this paragraph (h)(2)(ii) shall not be taken into account in determining a person's percentage ownership interest in an entity under paragraph (f)(24) of this section.

(iii) *Limitation on attribution from certain entities.* For purposes of this section, except as provided in paragraphs (k)(2) and (4) of this section, each of the following shall be treated as an individual who is unrelated to any other owner (direct or indirect) of the loss corporation—

(A) Any entity other than a higher tier entity that owns five percent or more of the loss corporation stock (determined without regard to paragraph (h)(2)(i)(A) of this section) on a testing date, a first tier entity or the loss corporation,

(B) A qualified trust described in section 401(a),

(C) Any State, any possession of the United States, the District of Columbia, the United States (or any agency or instrumentality thereof), any foreign government, or any political subdivision of any of the foregoing, and

(D) Any other person designated by the Internal Revenue Service in the Internal Revenue Bulletin.

Stock of a loss corporation that is owned by any such person shall thus not be attributed to any other person for purposes of this section. See paragraph (g)(2) of this section limiting attribution from a first tier entity or a higher tier entity to any person that is not a 5-percent owner or a higher tier entity.

(iv) *Examples.*

Example (1). All the stock of L is owned by A. B and C respectively own 70 and 30 percent of the outstanding P stock. P acquires 60 percent of the outstanding L stock from A on July 1, 1988 (a testing date). After the acquisition, P is a first tier entity and a higher tier entity of L. B and C are each 5-percent owners of P and also are 5-percent shareholders of L having a 42 percent and 18 percent stock ownership interest in L, respectively, through the operation of the constructive ownership rules of paragraph (h) of this section. Because B and C together have increased their ownership in L by more than 50 percentage points during the testing period ending on the testing date (60 percent on the testing date and 0 percent prior thereto), an ownership change occurs with respect to L on July 1, 1988.

Example (2). The facts are the same as in *Example (1),* except that B and C are not shareholders in a corporation, but instead are partners in a general partnership, E. B and C respectively own 70 percent and 30 percent of E. E acquires 60 percent of the L stock on July 1, 1988. The results are the same as in *Example (1).*

Example (3). The facts are the same as in *Example (1),* except that the acquisition is accomplished in a transaction that qualifies under section 351(a). In that transaction, HC is formed through (i) a contribution of money by P in exchange for 60 shares of HC common stock and (ii) a contribution of all the outstanding shares of L stock plus cash by A in exchange for 40 shares of HC common stock and 30 shares of HC preferred stock that is described in section 1504(a)(4). The respective values of each share of HC stock, common and preferred, are equal. The stock of L is attributed to A through his interest in HC common stock, but not through his interest in HC preferred stock (see paragraph (h)(2)(ii)(A) of this section). Thus, A is treated as owning indirectly only 40 percent of L. B and C are 5-percent shareholders of L having indirect ownership interests in L of 42 percent and 18 percent, respectively, through their ownership of HC common stock. The results are therefore the same as in *Example (1)*.

(3) *Attribution to corporations, partnerships, estates and trusts.* Except as otherwise provided by regulation under section 382 or by the Internal Revenue Service in the Internal Revenue Bulletin, the rules of section 318(a)(3) shall not apply in determining the ownership of stock under this section.

(4) *Option attribution*—(i) *In general.* Solely for the purpose of determining whether there is an ownership change on any testing date, stock of the loss corporation that is subject to an option shall be treated as acquired on any such date, pursuant to an exercise of the option by its owner on that date, if such deemed exercise would result in an ownership change. The preceding sentence shall be applied separately with respect to—

(A) Each class of options (*i.e.,* options with terms that are identical, issued by the same issuer, and issued on the same date) owned by each 5-percent shareholder (or person who would be a 5-percent shareholder if the option were treated as exercised), and

(B) Each 5-percent shareholder, each owner of an option who would be a 5-percent shareholder if the option were treated as exercised, and each combination of such persons.

(ii) *Examples.*

Example (*1*)(*i*) A owns all of the 100 shares of outstanding L stock. A grants options for the purchase of his L stock, exercisable for 10 years from the date of issuance, in the following transactions: An option to B for four shares (issued January 1, 1988), an option to C for six shares (issued June 1, 1989), and an option to D for 15 shares (issued July 30, 1989). On July 30, 1990, A sells 41 shares of his L stock to BB.

(*ii*) Pursuant to paragraph (a)(2)(i) of this section, the date on which each option is acquired is a testing date. The issuance of options to acquire L stock to each of B, C, and D is not treated as an acquisition of the underlying stock on any such testing date since such treatment with respect to any one of the option owners (or any combination thereof) would not have resulted in an ownership change on any of those testing dates.

(*iii*) The date on which BB acquires 41 shares also is a testing date. BB's acquisition of 41 percent of the L stock, taken together with the shift in ownership that would result if the options held by B, C and D were exercised, would result in an ownership change, because the stock owned or treated as owned by Public L (a group including only B, the sole shareholder who owns less than five percent of L stock), C, D and BB would have increased by 66 percentage points (four, six, 15, and 41 percentage points, respectively) during the testing period. Subject to paragraph (h)(4)(ix) of this section, the options are treated as exercised and an ownership change occurs on July 30, 1990, pursuant to paragraph (h)(4)(i) of this section. Accordingly, no new testing period can begin before July 31, 1990. Under paragraph (h)(4)(x)(F) of this section, the option attribution rules of paragraph (h)(4)(i) of this section shall not be applicable with respect to any of the options owned by B, C, and D immediately before the ownership change until such time, if any, that such options are transferred to (or by) 5-percent shareholder (or a person who would be a 5-percent shareholder if such option were exercised). In addition, the subsequent exercise of any of those options by A, B, or C (the persons owning such options immediately before the ownership change) is disregarded. See paragraph (h)(4)(vi) of this section. Also see paragraph (h)(4)(viii) of this section for the treatment of options that lapse or are forfeited.

(*iv*) The facts are the same as in (*i*), except that the sale of A's 41 shares of L stock to BB occurs on July 30, 1995. Because the options are treated as exercised and the related stock is treated as acquired on the July 30, 1995 testing date, the results are the same as described in (*iii*).

Example (2) (*i*) A owns all of the outstanding 100 shares of the stock of L. On July 22, 1988, the value of A's stock in L is $500 and the following agreements are entered into: (i) A sells 40 shares of his L stock to B for $200, (ii) in exchange for $10, A grants B an option to acquire the balance of his L stock for $305 at any time before July 22, 1992, and (iii) L grants A an option to acquire 100 shares of L stock at a price of $600 exercisable until such time as B's option is no longer outstanding.

(*ii*) If the stock subject to the options owned by both A and B were treated as acquired on the July 22, 1988 testing date, B would have increased his ownership interest in L by only 50 percentage points to 50 percent ([40 shares purchased + 60 shares acquired pursuant to the option]/200 outstanding shares of L stock, including 100 shares deemed outstanding pursuant to the option issued to A by L) as compared with 0 percent prior to July 22, 1988. In determining whether the options with respect to the stock of L would, if exercised, result in an ownership change, paragraph (h)(4)(i)(B) of this section requires that such options be treated as exercised separately with respect to each 5-percent shareholder, each person who would be a 5-percent shareholder if the option were treated as exercised or each combination of such persons. Therefore, by treating the option owned by A as not having been exercised and the option owned by B as having been exercised, B's interest in L increases by 100 percentage points during the testing period. An ownership change with respect to L therefore results from the transactions occurring on July 22, 1988.

(iii) *Contingencies.* Except as provided in paragraph (h)(4)(x)(D) of this section, the extent to which an option is contingent or otherwise not currently exercisable shall be disregarded for purposes of this section.

(iv) *Series of options.* For purposes of this section, an option to acquire an option with respect to the stock of the loss corporation, and each one of a series of such options, shall be considered as an option to acquire such stock.

(v) *Interests that are similar to options.* For purposes of this section,

(A) An interest that is similar to an option includes, but is not limited to, a warrant, a convertible debt instrument, an instrument other than debt that is convertible into stock, a put, a stock interest subject to risk of forfeiture, and a contract to acquire or sell stock, and

(B) Any such interest shall be treated as an option.

(vi) *Actual exercise of options*—(A) *In general.* The actual exercise of any option in existence immediately before and after an ownership change, whether or not the option was treated as exercised in connection with the ownership change under paragraph (h)(4)(i) of this section, shall be disregarded for purposes of this section, but only if the option is exercised by the 5-percent shareholder (or person who would have been a 5-percent shareholder if the options owned by such person had been exercised immediately before the ownership change) who owned the option immediately before and after such ownership change.

(B) *Actual exercise within 120 days of deemed exercise.* If the actual exercise of an option occurs on or before the end of the period which is 120 days after the date on which the option is treated as exercised under paragraph (h)(4)(i) of this section, the loss corporation may elect to treat paragraphs (h)(4)(i) and (vi)(A) of this section as not applying to such option and take into account only the acquisition of loss corporation stock resulting from the actual exercise of the option. An election under this paragraph (h)(4)(vi)(B) shall have no effect on the determination of whether an ownership change occurs, but shall apply only for the purpose of determining the date on which the change date occurs. An election under this paragraph (h)(4)(vi)(B) shall be made in the statement described in paragraph (a)(2)(ii) of this section.

(vii) *Effect of deemed exercise of options on the outstanding stock of the loss corporation*—(A) *Right or obligation to issue stock.* Solely for purposes of determining whether an ownership change has occurred under paragraph (h)(4)(i) of this section, the deemed exercise of an option with respect to unissued stock (or treasury stock) of a corporation shall result in a corresponding increase in the amount of its total outstanding stock.

(B) *Right or obligation to acquire outstanding stock by the loss corporation.* Solely for purposes of determining whether an ownership change has occurred under paragraph (h)(4)(i) of this section, the deemed exercise of a right to transfer outstanding stock to the issuing corporation (or a right of the issuing corporation to acquire its stock) shall result in a corresponding decrease in the amount of its total outstanding stock.

(C) *Effect on value of old loss corporation.* The deemed exercise of an option with respect to unissued stock (or treasury stock) under paragraph (h)(4)(i) of this section shall have no effect on the determination of the value of the old loss corporation and the computation of the section 382 limitation. See section 382(l)(1)(B) disregarding capital contributions made during the two-year period preceding the change date for purposes of computing the section 382 limitation.

(viii) *Options that lapse or are forfeited.* If an option that is treated as exercised under paragraph (h)(4)(i) of this section lapses unexercised or the owner of such option irrevocably forfeits his right to acquire stock pursuant to the option, the option shall be treated for purposes of this section as if it never had been issued. In that case, the loss corporation may file an amended return for prior years (subject to any applicable statute of limitations) if the section 382 limitation was thus inapplicable. If paragraph (h)(4)(i) of this section applied to an option (or options) with respect to a taxable year for which an income tax return has not been filed by the date that the option (or options) lapses or is irrevocably forfeited, the loss corporation may treat paragraph (h)(4)(i) of this section as inapplicable to such option (or options).

(ix) *Option rule inapplicable if pre-change losses are de minimis.* Paragraph (h)(4)(i) of this section shall not apply to treat the stock of the loss corporation as acquired by the owner of an option if, on a testing date, the amount of pre-change losses (determined as if the testing date were a change date and treating the amount of any net unrealized built-in loss as a pre-change loss) is less than twice the amount determined by multiplying.

(A) The value of the loss corporation (as determined under section 382(e)) on the testing date, by

(B) The long-term tax exempt rate (as defined in section 382(f)) for the calendar month in which the testing date occurs.

(x) *Options not subject to attribution.* Paragraph (h)(4)(i) of this section shall not apply to—

(A) *Long-held options with respect to actively traded stock.* Any option with respect to stock of the loss corporation which stock is actively traded on an established securities market (within the meaning of section 1273(b)) for which market quotations are readily available, if such option has been continuously owned by the same 5-percent shareholder (or a person who would be a 5-percent shareholder if such option were exercised) for at least three years, but only until the earlier of such time as—

(*1*) The option is transferred by or to a 5-percent shareholder (or a person who would be a 5-percent shareholder if such option were exercised), or

(*2*) The fair market value of the stock that is subject to the option exceeds the exercise price for such stock on the testing date. For purposes of this paragraph (h)(4)(x)(A), options with respect to the stock of a loss corporation that are assumed (or substituted) in a reorganization and converted into options with respect to the stock of another party to the reorganization shall not be treated as transferred, provided that there are no changes in the terms of the options, other than that the stock that may be acquired pursuant to the option is that of another party to the reorganization and that the amount of stock subject to the option is adjusted only to reflect the exchange ratio for the exchange of stock of the loss corporation in the reorganization.

(B) *Right to receive or obligation to issue a fixed dollar amount of value of stock upon maturity of certain debt.* Any right to receive or obligation to issue stock pursuant to the terms of a debt instrument that, in economic terms, is equivalent to nonconvertible debt because the right to receive stock of the issuer of a fixed dollar amount is based upon the fair market value for such stock determined at or about the date the stock is transferred pursuant to such right or obligation (*i.e.,* the amount of the stock transferred pursuant to the option is equal to a fixed dollar amount, divided by the value of each share of such stock at or about the date of the stock transfer). This paragraph (h)(4)(x)(B) shall not apply if the method for determining the fair market value of the stock of the issuer is intended to or, in fact, provides the owner of the debt instrument with a participation in any appreciation of any stock of the issuer.

(C) *Right or obligation to redeem stock of the loss corporation.* Any right or obligation of the loss corporation to redeem any of its stock at the time such stock is issued, but only to the extent such stock is issued to persons who are not 5-percent shareholders immediately before the issuance.

(D) *Options exercisable only upon death, disability or mental incompetency.* Any option entered into between owners of the same entity (or an owner and the entity in which the owner has a direct ownership interest) with respect to such owner's ownership interest in the entity that is exercisable only upon the death, complete disability or mental incompetency of such owner.

(E) *Right to receive or obligation to issue stock as interest or dividends.* Any right to receive or obligation to issue stock of a corporation in payment of interest or dividends by the issuing corporation. (For an example illustrating this exception, see paragraph (j)(2)(iv)(B) of this section.)

(F) *Options outstanding following an ownership change*—(*1*) *In general.* Any option in existence immediately before and after an ownership change, whether or not the option was treated as exercised in connection with the ownership change under paragraph (h)(4)(i) of this section, but only so long as the option continues to be owned by the 5-percent shareholder (or person who was treated as a 5-percent shareholder) who owned the option immediately before and after such ownership change.

≤(2) Example (i) A, B, C and D own all of the outstanding stock of L. A owns 70 shares of L stock and each of B, C and D own 10 shares of L stock. On July 12, 1988, L issues warrants to each of its shareholders entitling them to acquire an additional 8.5 shares of L stock for each share of stock owned. (*ii*) If B, C and D, but not A, each exercise their respective rights to acquire an additional 85 shares of L stock (10 shares × 8.5 shares that may be acquired for each share owned) on July 12, 1988, their combined ownership interest in L on that date would exceed 80 percent (255 shares deemed to be acquired + 30 shares actually owned)/355 shares outstanding (actual and deemed)). B, C and D thus would increase their ownership interest in L by 50.3 percentage points during the testing period, causing an ownership change, because, under paragraph (h)(4)(i)(B) of this section, the options are treated as exercised if the exercise would cause an ownership change.

(*iii*) Following the ownership change, paragraph (h)(4)(i) of this section applies to prevent A's right to acquire 595 shares of L stock (70 shares x 8.5 shares that may be acquired for each share owned) or the rights held by B, C, or D, to be treated as exercised on any subsequent testing date, except to the extent that those rights are transferred. To the extent any of those options are transferred following the ownership change, paragraph (h)(4)(i) of this section will apply to any such options on the date of the transfer and on any subsequent testing date.

(G) *Right to acquire loss corporation stock pursuant to a default under a loan agreement.* Any right to acquire stock of a corporation by a bank (as that term is defined in section 581), an insurance company (as that term is defined in § 1.801–3(a)), or a trust qualified under section 401(a) solely as the result of a default under a loan agreement entered into in the ordinary course of the trade or business of such bank, life insurance company or qualified trust.

(H) *Agreement to acquire or sell stock owned by certain shareholders upon retirement.* Any option entered into between noncorporate owners of the same entity (or a noncorporate owner and the entity in which the owner has a direct ownership interest) with respect to such owner's ownership interest in the entity, but only if each of such owners actively participate in the management of the entity's trade or business, the option is issued at a time that the loss corporation is not a loss corporation and the option is exercisable solely upon the retirement of such owner. An option with terms described in both this paragraph (h)(4)(x)(H) and in paragraph (h)(4)(x)(D) of this section shall also not be subject to paragraph (h)(4)(i) of this section.

(I) [Reserved]

(J) *Title 11 or similar case.* See § 1.382–9(o) which excepts certain options created by or under a plan of reorganization in a title 11 or similar case from the operation of paragraph (h)(4)(i) of this section.

(K)—(Y) [Reserved]

(xi) *Certain transfers of options disregarded.* Transfers of options between persons who are not 5-percent shareholders (and between members of separate public groups resulting from the application of the segregation rules of paragraphs (j)(2) and (3)(iii) of this section) are not taken into account. Transfers of options in any of the circumstances described in section 382(l)(3)(B) are also disregarded and the transferee shall be treated as having owned the option for the period that it was owned by the transferor.

(xii) *Exercise of an option that has not been treated as stock.* The acquisition of stock pursuant to the actual exercise of an option (other than an option described in paragraph (h)(4)(vi)(A) of this section) shall not be disregarded.

(xiii) *Effective date.* See paragraph (m)(4)(vi) of this section for special rules regarding the effective date of the provisions of this paragraph (h)(4).

(5) *Stock transferred under certain agreements.* Notwithstanding paragraph (h)(4) of this section, no shift results solely because under section 1058(a)—

(i) A shareholder transfers stock of a corporation pursuant to an agreement that meets the requirements of section 1058(b), or

(ii) A person having rights under such an agreement exchanges those rights for stock identical to the stock transferred pursuant to the agreement.

(6) *Family attribution.* For purposes of this section—

(i) Paragraphs (1) and (5)(B) of section 318(a) shall not apply,

(ii) An individual and all members of his family described in section 318(a)(1) shall be treated as one individual,

(iii) Subject to paragraph (k)(2) of this section, paragraph (h)(6)(ii) of this section shall not apply to members of a family who, without regard to that paragraph (h)(6)(ii), would not be 5-percent shareholders, and

(iv) If under paragraph (h)(6)(ii) of this section, an individual may be treated as a member of more than one family, and each family that is treated as one individual is a 5-percent shareholder (or would be treated as a 5-percent shareholder if such individual were treated as a member of such family), then such individual shall be treated only as a member of the family that results in the smallest increase in the total percentage stock ownership of the 5-percent shareholders on the testing date and shall not be treated as the member of any other family.

(i) [Reserved]

(j) *Aggregation and segregation rules.* For purposes of this section, except as provided in paragraphs (k)(2) and (4) of this section—

(1) *Aggregation of public shareholders and public owners into public groups*—(i) *Public group.* Under this paragraph (j), a loss corporation or other entity can be treated as owned, in whole or in part, by one or more public groups. A public group can include public shareholders, public owners, and 5-percent owners who are not 5-percent shareholders of the loss corporation.

(ii) *Treatment of a public group that is a 5-percent shareholder.* Each public group that is treated as a 5-percent shareholder under paragraph (g)(1)(ii), (iii) or (iv) of this section shall be treated as one individual. See paragraph (j)(2)(iv) for a rule combining certain de minimis public groups.

(iii) *Presumption of no cross-ownership.* The public owners, 5-percent owners who are not 5-percent shareholders and public shareholders in any public group, subject to paragraphs (j)(2)(iii), (k)(2) and (k)(4) of this section, are presumed not to be members of any other public group. It also is presumed that each such person is unrelated to all other shareholders (direct and indirect) of the loss corporation. See paragraph (h)(6)(iii) of this section. The members of a public group that exists by virtue of its direct ownership interest in an entity are presumed not to be members (and not to be related to a member) of any other public group that exists at any time by virtue of its direct ownership interest in any other entity. To the extent that the presumptions adopted in this paragraph (j)(1)(iii) are not applicable because the loss corporation has actual knowledge of facts to the contrary and is thus subject to paragraph (k)(2) of this section, public shareholders, public owners and 5-percent owners who are not 5-percent shareholders may be aggregated into additional public groups.

(iv) *Identification of the public groups treated as 5-percent shareholders*—(A) *Analysis of highest tier entities.* The loss corporation must identify first tier entities and higher tier entities in order to identify any highest tier entities that must be identified under paragraph (k)(3) of this section. The loss corporation must then identify any 5-percent owners of each such highest tier entity who indirectly own, at any time during the testing period, five percent or more of the loss corporation through the ownership interest in such highest tier entity. Under paragraph (g)(1)(i)(B) of this section, any such 5-percent owner is a 5-percent shareholder. See paragraph (k)(3) of this section for rules explaining the extent of the obligation of the loss corporation to determine the identity of its shareholders. Each person who has an ownership interest in any highest tier entity and who is not treated as a 5-percent shareholder (*i.e.,* persons who are public owners or 5-percent owners who are not 5-percent shareholders) is a member of the public group of that highest tier entity. A public group, so identified, that indirectly owns five percent or more of the loss corporation on the testing date is treated under paragraph (g)(1)(ii) of this section as a 5-percent shareholder. If the public group so identified owns less than five percent of the loss corporation on the testing date, such public group is treated as part of the public group of the next lower tier entity.

(B) *Analysis of other higher tier entities and first tier entities.* The analysis and aggregation of public groups described in paragraph (j)(1)(iv)(A) of this section is repeated for any next lower tier entity and successively for any next lower tier entity of any entity described in this paragraph (j)(1)(iv)(B) until applied to each first tier entity.

(C) *Aggregation of the public shareholders.* The public shareholders are aggregated and, under paragraph (g)(1)(iii) of this section, are treated as a public group that is a 5-percent shareholder without regard to whether such group, at any time during the testing period, owns five percent or more of the loss corporation. For this purpose, if the public group of any first tier entity indirectly owns less than five percent of the loss corporation on the testing date, and is thus not treated as a 5-percent shareholder, but is treated as part of the public group of the loss corporation under paragraph (j)(1)(iv)(A) or (B) of this section, the ownership interest of that group is included in the public group of the loss corporation referred to in the preceding sentence.

(v) *Appropriate adjustments.* A loss corporation may apply the principles of paragraph (g)(5) of this section with respect to—

(A) Any public group that is treated as a 5-percent shareholder on the testing date if such public group, at any time during the testing period, was treated as part of the public group of the next lower tier entity, or

(B) Any public group that is treated as part of the public group of a next lower tier entity if such public group, at any time during the testing period, was part of the public group of a higher tier entity that was treated as a 5-percent shareholder and had a direct or indirect ownership interest in such lower tier entity.

(vi) *Examples.*

Example (1) (*i*) All of the stock of L is owned by 1,000 shareholders, none of whom own as much as five percent of L stock (‘‘Public L’’). All of the stock of P is owned by 150,000 shareholders, none of whom own as much as five percent of P stock (‘‘Public P’’). Between July 12, 1988 and August 13, 1988, P purchases all of the L stock through a series of transactions on the public stock exchange. P’s percentage of direct stock ownership in L increases from 4.9 percent to five percent on July 15, 1988, and from 50 percent to 51 percent on July 30, 1988.

(*ii*) Before July 15, 1988, P is a public shareholder of L. On and after July 15, 1988, P is a first tier entity (and a highest tier entity) of L. Accordingly, under the rules of paragraph (j)(1) of this section, Public P, on and after July 15, 1988, is treated as a public group that is a 5-percent shareholder. Each acquisition by P on and after such date affects the percentage of L stock that is owned by Public P and thus constitutes an owner shift.

(*iii*) Immediately after the transaction on July 30, 1988, P owns 51 percent of L stock. Under paragraph (j)(1)(iv)(A) of this section, Public P thus owns 51 percent of L. Under paragraph (j)(1)(iv)(C) of this section, Public L, the public group that includes the public shareholders of L, is treated as a 5-percent shareholder that owns 49 percent of L. Under paragraph (j)(1)(iii) of this section, Public L and Public P are presumed not to have any common members and it is also presumed that no member of either public group is related to any other member of either of the two public groups.

(*iv*) Assuming that the presumption provided in paragraph (j)(1)(iii) of this section (*i.e.,* that no person owns stock in both P and L) is not rebutted to any extent, Public P is treated as a 5-percent shareholder whose stock ownership in L, as of the July 30, 1988 testing date, has increased by 51 percentage points over its lowest percentage of stock ownership in L at any time during the testing period (0 percent prior to July 12, 1988). Accordingly, an ownership change with respect to L occurs as a result of P’s acquisition on July 30, 1988. L is thus a new loss corporation and its pre-change losses are subject to limitation under section 382.

Example (2) (*i*) All of the stock of P is owned by 1,000 unrelated shareholders, none of whom owns as much as five percent of P stock. L_1 is a wholly owned subsidiary of P. On January 2, 1988, P distributes all of the L_1 stock pro rata to its shareholders.

(*ii*) Prior to the stock distribution, the public owners of P are members of a public group (''Public P'') that is treated as a 5-percent shareholder owning 100 percent of the stock of L_1.

See paragraph (j)(1)(iv)(A) of this section. Following the stock distribution to the P shareholders, L_1 is owned by 1,000 public shareholders that are members of a public group (''Public L_1'') that is treated as a 5-percent shareholder owning 100 percent of the stock of L_1. See paragraph (j)(1)(iv)(C) of this section.

(*iii*) Public P and Public L_1 are treated as unrelated, individual 5-percent shareholders under paragraph (j)(1)(iii) of this section. Although the members of one public group are presumed not to be members of any other public group under paragraph (j)(1)(iii) of this section, L_1 has actual knowledge that all of its public shareholders immediately following the distribution (Public L_1) received L_1 stock pro rata in respect to the outstanding P stock and thus were also members of Public P. Applying paragraph (k)(2) of this section, the loss corporation may take into account the identity of ownership interests between Public L_1 and Public P to establish that Public L_1 did not increase its percentage ownership in L_1. Accordingly, the transaction would not constitute an owner shift.

Example (3) (*i*) The facts are the same as in *Example (1)* of paragraph (g)(4) of this section. Thus, 20 percent of L stock is owned by A, 10 percent is owned by P_1, 20 percent is owned by E, a joint venture, and the remaining 50 percent of L stock is owned by Public L. P_1 is owned 15 percent by B and 85 percent by Public P_1. E is owned 30 percent by P_2 and 70 percent by P_3, which are owned by Public P_2 and Public P_3, respectively. See *Example (1)(ii)* of paragraph (g)(4) of this section for a chart illustrating this ownership structure.

(*ii*) The public owners of P_2 and P_3 (Public P_2 and Public P_3, respectively), are public groups that are treated as 5-percent shareholders of L, because each such public group indirectly owns five percent or more of L stock (six percent by Public P_2 [(30 percent ownership of E)×(20 percent ownership of L)] and 14 percent by Public P_3 [(70 percent ownership of E)×(20 percent ownership of L)]). The public owners of P_1 (''Public P_1''), who indirectly own 8.5 percent of L stock [(85 percent ownership of P_1)×(10 percent ownership of L)] and B, who indirectly owns 1.5 percent of L and is thus included in Public P_1 under paragraph (j)(1)(iv)(A) of this section, are members of a public group that is treated as a 5-percent shareholder of L that owns ten percent of L stock. Finally, the public group of L (''Public L'') is a 5-percent shareholder that owns 50 percent of L. Accordingly, A, Public L, Public P_1 (including B), Public P_2, and Public P_3 are the only 5-percent shareholders of L.

Example (4) (*i*) The facts are the same as *Example (3)* above, except that P_3 is owned 60 percent by C, 30 percent by P_4, and 10 percent by P_3. The stock of P_4 is publicly traded and is owned by Public P_4. The facts are thus the same as in *Example (2)* in paragraph (g)(4) of this section. See *Example (2)(ii)* of paragraph (g)(4) of this section for a chart illustrating this ownership structure.

(*ii*) The public owners of P_4 (a highest tier entity) are members of a public group that indirectly owns 4.2 percent of L ([30 percent ownership of P_3]×[70 percent ownership of E]×[20 percent ownership of L]). For purposes of identifying public groups that are 5-.percent shareholders, L is not required to identify P_4 as a highest tier entity under paragraph (k)(3) of this section because P_4 does not own five percent or more of L stock. Moreover, under paragraph (h)(2)(iii) of this section, P_4 generally is treated as an individual from which there is no attribution of loss corporation stock. The public group of P_3 (including P_4) indirectly owns 5.6 percent of L ([40 percent of P_3]×[70 percent ownership of E]×[20 percent of L]), and is thus a 5-percent shareholder of L. The public groups of P_2 and P_1 (both Public P_1 and B), respectively, also own five percent or more of L stock and are thus 5-percent shareholders of L. In addition, the public group of L is a 5-percent shareholder regardless of whether it owns five percent of L stock. Accordingly, A, Public L, Public P_3 (including P_4), Public P_2, and Public P_1 (including B), are the only 5-percent shareholders of L.

Example (5)(i) On September 4, 1987, L is owned 14 percent by each of A and B, 30 percent by each of P_1 and P_2, four percent by each of C and P_3, and two percent by each of D and AA. P_1 is owned 30 percent by each of A, B, and P_4 and 10 percent by D. P_2 is owned 70 percent by A, 10 percent by each of B and D, six percent by DD and four percent by C. AA owns 100 percent of the stock of P_3. P_4 is owned 60 percent by C and 20 percent by each of BB and CC.

(*ii*) The ownership structure of L is illustrated by the following chart:

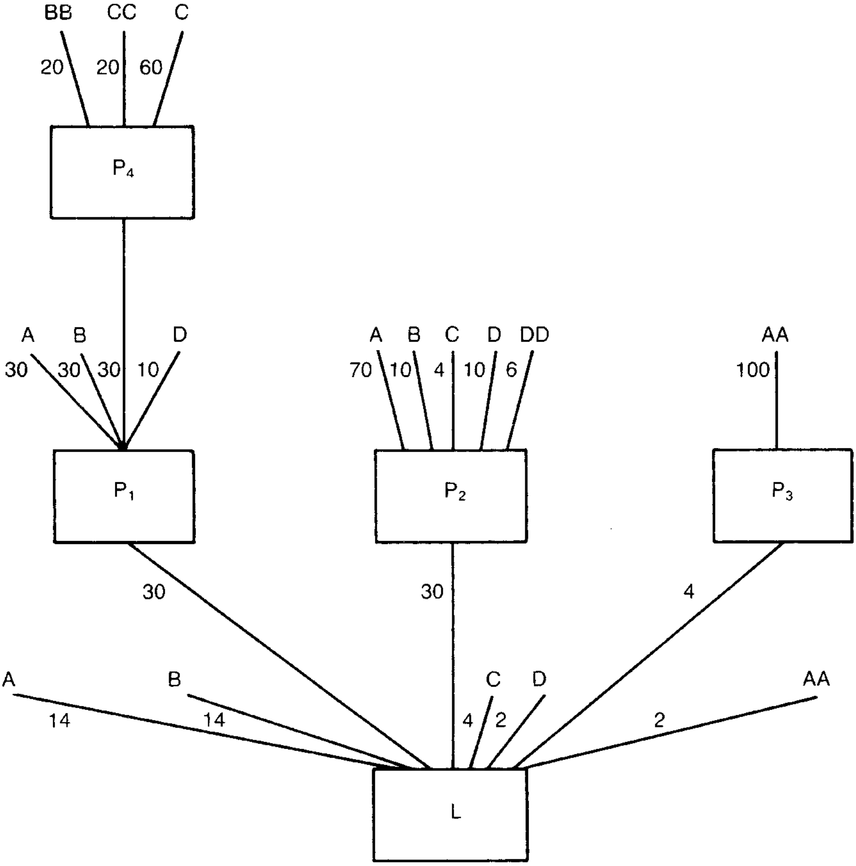

(*iii*) In order to identify L's 5-percent shareholders and their respective ownership interests in L on September 4, 1987, the rules of paragraph (j)(1) of this section apply to identify the public groups that are treated as separate 5-percent shareholders. Analysis begins with any highest tier entity, such as P_4. Each of P_4's shareholders is a 5-percent owner of P_4. C^4 owns 5.4 percent of L in his capacity as a 5-percent owner of P_4 and therefore is a 5-percent shareholder. Notwithstanding that C actually owns, directly and by attribution, 10.6 percent of L (four percent directly, 5.4 percent indirectly through P_4, and 1.2 percent through P_2), C's ownership interest in L as a 5-percent shareholder is presumed to include only the 5.4 percent indirect ownership through P_4. (Under paragraphs (g) and (k)(2) of this section, however, L must account for C's direct and indirect ownership interests in determining whether an ownership change occurs on any testing date if it has actual knowledge of such ownership on or berfore the date that its income tax return is filed for the taxable year that includes the testing date). Although BB and CC are each 5-percent owners of P_4, they are not 5-percent shareholders and therefore are members of the public group of P_4. Because the public group of P_4 indirectly owns only 3.6 percent of L, it is treated under paragraph (j)(1)(iv)(A) of this section as part of the public group of the next lower tier entity, P_1.

(*iv*) With respect to P_1, a first tier entity, each of its shareholders are 5-percent owners. Because A and B each indirectly own nine percent of L as 5-percent owners of P_1 and A indirectly owns 21 percent of L as a 5-percent owner of P_2, they are each 5-percent shareholders without regard to their direct ownership interests in L. A's ownership interest in L as a 5-percent shareholder is 44 percent (14 percent directly, nine percent in his capacity as a 5-percent owner of P_1, and 21 percent in his capacity as a 5-percent owner of P_2). B's ownership interest in L as a 5-percent shareholder is 23 percent (14 percent directly and nine percent in his capacity as a 5-percent and nine percent in his capacity as a 5-percent owner of P_1). B's ownership interest as a 5-percent shareholder does not include the three percent interest he owns indirectly through P_2. (Under paragraphs (g) and (k)(2) of this section, however, L must account for B's direct and indirect ownership interests, including his three percent interest through P_2, in determining whether an ownership change occurs on any testing date if L has actual knowledge of such ownership on or before the date that its income tax return is filed for the taxable year that includes the testing date.) D is a 5-percent owner of P_1. Although D owns eight percent of L (two percent directly, three percent indirectly through P_1, and three percent indirectly through P_2), he is not a 5-percent shareholder because he does not own five percent or more of L stock either directly or in his capacity as a 5-percent owner of either P_1 or P_2. (Under paragraphs (g) and (k)(2) of this section, however, L must account for D's direct and indirect ownership interests in determining whether an ownership change occurs on any testing date to the extent L has actual knowledge of such ownership amounting to five percent or more of L stock before the date that its income tax return is filed for the taxable year that includes the testing date.) The public group of P_1 (comprised of the public group of P_4 and D's direct ownership interest in P_1) has a 6.6 percent interest in L and is therefore treated as a separate 5-percent shareholder.

(*v*) With respect to highest tier entity P_2, D is a 5-percent owner who is not a 5-percent shareholder for the reason described in the preceding subdivision. DD is a 5-percent owner of P_2, who is not a 5-percent shareholder, because DD indirectly owns only 1.8 percent of L. Assuming that L does not have actual knowledge of B's and C's direct ownership interest in P_2, those interests are accounted for in computing the ownership interest are accounted for in computing the ownership interest of the public group of P_2. Therefore, each of P_2's shareholders, except A who is a 5-percent shareholder in his capacity as a 5-percent owner of P_2, are treated as members of the public group of P_2 that owns nine percent of L and is thus treated as a separate 5-percent shareholder.

(*vi*) Because the direct ownership interest of P_3 is less than five percent, it is a public shareholder. Therefore, assuming that L does not have actual knowledge of C's, D's, or AA's direct and/or indirect ownership interests in L, the public group of L is a separate 5-percent shareholder owning 12 percent of L (comprised of the direct ownership interests of C, D, AA and P_3).

(2) *Segregation rules applicable to transactions involving the loss corporation*—(i) *In general.* For purposes of this section, if—

(A) A transaction is described in paragraph (j)(2)(iii) of this section, and

(B) The loss corporation has one or more direct public groups immediately before and after the transaction,

the stock owned by such direct public group or groups is subject to the segregation rules described in paragraph (j)(2)(iii) of this section for purposes of determining whether an ownership change has occurred on the date of the transaction (and on any subsequent testing date with a testing period that includes the date of such transaction). See paragraph (j)(3) of this section for the application of the rules of this paragraph (j)(2) to transactions involving first tier entities or higher tier entities.

(ii) *Direct public group.* For purposes of this section, a direct public group is any public group of the loss corporation described in paragraph (j)(1)(iv)(C) of this section or any public group of the loss corporation resulting from the application of paragraph (j)(2)(iii) or (j)(3)(i) of this section.

(iii) *Transactions to which segregation rules apply*—(A) *In general.* The segregation rules of this paragraph (j)(2)(iii) apply to any transaction described in paragraph (j)(2)(iii)(B), (C), (D), (E), or (F) of this section in the manner specified. The presumptions adopted by this paragraph (j)(2)(iii) shall not apply only if, and to the extent that, the loss corporation either has actual knowledge of facts to the contrary regarding its stock ownership and is thus subject to paragraph (k)(2) of this section, or is subject to paragraph (k)(4) of this section. Any direct public group that is required to be identified as a result of a transaction described in paragraph (j)(2)(iii) of this section shall be treated as a 5-percent shareholder under paragraph (g)(1)(iv) of this section without regard to whether such group, at any time during the testing period, owns five percent or more of the loss corporation stock. To the extent that the presumptions are rebutted, the public shareholders, public owners and 5-percent owners who are not 5-percent shareholders may be aggregated into additional public groups. For an exception applicable to certain regulated investment companies, see § 1.382–3(k)(1).

(B) *Certain equity structure shifts and transactions to which section 1032 applies*—(*1*) *In general.* In the case of—

(*i*) A transaction that is an equity structure shift that also is described in section 381(a)(2) and in which the loss corporation is a party to the reorganization, or

(*ii*) A transfer of the stock of the loss corporation (including treasury stock) by the loss corporation in any other transaction to which section 1032 applies,

each direct public group that exists immediately after such transaction shall be segregated so that each direct public group that existed immediately before the transaction is treated separately from the direct public group that acquires stock of the loss corporation in the transaction. The direct public group that acquires stock of the loss corporation in the transaction is presumed not to include any members of any direct public group that existed immediately before the transaction. For purposes of this paragraph (j)(2)(iii)(B), a person is treated as acquiring stock of the loss corporation in a reorganization as the result of the person's ownership interest in another corporation that succeeds to the loss corporation's pre-change losses (determined as if the testing date were the change date and treating the amount of any net unrealized built-in loss as a pre-change loss) in a transaction to which section 381(a)(2) applies. In determining whether a transaction is described in section 1032 for purposes of this paragraph (j)(2)(iii)(B), the transfer by the loss corporation of any interest not constituting stock that is treated as stock under paragraph (f)(18)(iii) of this section shall be treated as the transfer of stock. See § 1.382–3(j) for exceptions to the segregation rules of this paragraph (j)(2)(iii)(B)(*1*).

(*2*) *Examples.*

Example (1) (*i*) P_1 owns 60 percent of the stock of L. The remaining L stock (40 percent) is owned by Public L. A owns 40 percent of the P_1 stock. The remaining P_1 stock (60 percent) is owned by Public P_1. P_2 is a publicly traded corporation owned by shareholders who each own less than five percent of P_2 stock (Public P_2).

(*ii*) On May 22, 1988, L merges into P_2 in a transaction described in section 368(a)(1)(A), with the shareholders of L receiving an amount of P_2 stock equal to 70 percent of the value of P_2 immediately after the reorganization.

(*iii*) Immediately before the merger, L's 5-percent shareholders were Public L (40 percent), Public P_1 (36 percent), and A (24 percent). Although the shareholders of P_2 (immediately before the merger) do not acquire any stock in the merger, they are treated as acquiring a direct ownership interest in the loss corporation in the reorganization because P_2 succeeds to the pre-change losses of L in a transaction to which section 381(a)(2) applies. As a result of the merger, which constitutes a transaction described in (j)(2)(iii)(B)(*1*) of this section, L's direct public group, Public L, must be segregated from the direct public group that would otherwise exist after the transaction (Public L and Public P_2). Public L, the direct public group that exists before the merger, has a continuing 28 percent interest in the loss corporation [70 percent of P_2 shares received in the merger x 40 percent shares of L owned prior to the merger] that must be segregated from the interests acquired by Public P_2.

(*iv*) In addition, Public P_1, which owns five percent or more of the stock of P_2 through P_1's ownership interest in P_2, also is segregated from any other public group (*i.e.*, both Public L and Public P_2) under paragraph (j)(1) of this section. Therefore, under paragraphs (j)(1) and (2) of this section, Public P_2 (excluding the members of Public L and Public P_1 immediately before the merger) is treated as a separate public group and 5-percent shareholder.

(*v*) The only 5-percent shareholder whose interest in the loss corporation, P_2, has increased during the testing period is Public P_2. Its interest has increased by 30 percentage points. Accordingly, no ownership change results from the merger. For purposes of measuring the shift in ownership of P_2 on any subsequent testing date with a testing period that includes May 22, 1988 (the date on which L merged into P_2), Public P_2 will continue to be treated as a direct public group, separate from Public L (the members of which own P_2 stock as a result of the merger) and Public P_1.

Example (2) (*i*) P and L are each owned by 21 equal shareholders. Each of 14 of the shareholders of P and L are owners of both corporations (''common owners''). L has actual knowledge of this cross ownership. therefore, as a group, these persons own 66⅔ percent of each of P and L. P stock has a value of $600 and L stock has a value of $400.

(*ii*) P merges into L under section 368(a)(1)(A) on June 10, 1988. Ordinarily, the direct public group of L that exists immediately before the transaction would be segregated from the direct public group that acquires stock in the merger (the public group of P immediately before the merger). In view of the common ownership of P and L, however, a third group may be created under paragraph (j)(2)(iii)(A) of this section so that L's owners following the merger would be: The common owners (66⅔ percent), Public L, less the common owners, 13 1/3 percent), and Public P, less the common owners (20 percent). Accordingly, the only 5-percent shareholder increasing its ownership interest by 20 percentage points and no ownership change occurs as a result of the merger.

Example (3) (*i*) L is entirely owned by Public L. L commences and completes a public offering of common stock on January 22, 1988, with the result that its outstanding stock increases from 100,000 shares to 300,000 shares. No person owns as much as five percent of L stock following the public offering.

(*ii*) The public offering of L stock is a transaction to which section 1032 applies. Immediately before the public offering, L's only 5-percent shareholder was Public L, a direct public group. Therefore, Public L (as in existence immediately before the transaction) must be segregated from the direct public group that would otherwise exist immediately after the transaction. Under paragraph (j)(2)(iii)(B)(*1*) of this section, the acquisition of 200,000 shares of L stock in the public offering must be treated as acquired by a direct public group (''New Public L'') that is separate from Public L. Each such public group is treated as an individual that is a separate 5-percent shareholder. See paragraphs (g)(1)(iv) and (j)(1)(ii) of this section.

(*iii*) As a result of the public offering, L has two 5-percent shareholders, Public L and New Public L, which own 33⅓ percent and 66⅔ percent of the stock of L, respectively. Because the members of New Public L are presumed not to be members of Public L (and not to be related to any such members), the ownership interest of New Public L immediately prior to the offering of stock was 0 percent.

(*iv*) New Public L is a 5-percent shareholder that has increased its ownership interest in L by more than 50 percentage points during the testing period (by 66⅔ percentage points). Thus, there is an ownership change with respect to L. For purposes of subsequent transactions, Public L and New Public L will not be segregated into two public groups because a new testing period commences on the day following the change date, January 23, 1988 (*i.e.*, any subsequent testing date will not have a testing period that includes the date of the public offering).

Example (4). The facts are the same as in *Example (3)*, but L establishes that 60,000 shares of the newly issued L stock were acquired by its shareholders of record on the date of the stock issuance (*i.e.*, members of Public L, referred to as Acquiring Public L) by persons owning 27 percent of the L stock immediately before the stock issuance. Accordingly, L has actual knowledge that New Public L acquired no more than 140,000 shares of L stock in the public offering. Under paragraphs (j)(2)(iii) and (k)(2) of this section, New Public L may be treated as having increased its ownership interest in L by 46⅔ percentage points (140,000 shares acquired in the offering/300,000 shares outstanding). L also has actual knowledge that the members of Public L owning 27 percent of L stock immediately before the stock issuance (27,000 shares/100,000 shares outstanding) own 29 percent of L stock immediately after such issuance ([27,000 shares + 60,000 shares acquired in the offering]/300,000 shares outstanding). Assuming that L chooses to take its actual knowledge into account for purposes of determining whether an ownership change occurred on January 22, 1988, Public L is segregated into two direct public groups immediately before the stock issuance so that the two percentage point increase in the ownership interest in L by Acquiring Public L is taken into account. The total increased ownership interest in L by New Public L and Acquiring Public L on the testing date over their lowest ownership interest during the testing period is 48 2/3 percent. Thus, no ownership change occurs with respect to L.

Example (5) (*i*) L is owned entirely by 10,000 unrelated individuals, none of whom own as much as five percent of L stock (''Public L''). P is owned entirely by 1,500 unrelated individuals, none of whom own as much as five percent of P stock (''Public P''). On December 22, 1988, L acquires all of the P stock from Public P in exchange for L stock representing 25 percent of the value of L, in a transaction described in section 368(a)(1)(B).

(*ii*) Under paragraph (j)(2)(iii)(B)(*1*) of this section, Public L, the direct public group that owns L stock immediately before and after the transaction to which section 1032 applies, is treated separately from Public P, the direct public group that acquires L stock in the transaction. Because Public P's percentage ownership interest in L increases to only 25 percent (as compared with 0 percent before the acquisition), no ownership change occurs. For purposes of determining whether an ownership change occurs on any testing date with a testing period that includes December 22, 1988, Public L and Public P will continue to be treated as separate 5-percent shareholders.

(*iii*) See *Example (4)* in paragraph (j)(3)(iv) of this section for the application of paragraph (j)(2)(iii)(B) of this section to a reorganization under section 368(a)(1)(B) in which the loss corporation is acquired.

(C) *Redemption-type transactions*—(*1*) *In general.* In the case of a transaction in which the loss corporation acquires its stock in exchange for property, each direct public group that exists immediately before the transaction shall be segregated at that time (and thereafter) so that the stock that is acquired in the transaction is treated as owned by a separate public group from each public group that owns the stock that is not acquired. For purposes of the preceding sentence, the term property shall include stock described in section 1504(a)(4) and stock described in paragraph (f)(18)(ii) of this section. Each direct public group that owned the stock that is acquired in the transaction is presumed not to own any such stock immediately after the transaction.

(*2*) *Examples.*

Example (1). L is entirely owned by Public L. There are 500,000 shares of L stock outstanding. On July 12, 1988, L acquires 150,000 shares of its stock for cash. Because L's acquisition is a redemption, Public L is segregated into two different public groups immediately before the transaction (and thereafter) so that the redeemed interests (''Public RL'') are treated as part of a public group that is separate from the ownership interests that are not redeemed (''Public CL''). Therefore, as a result of the redemption, Public CL's interest in L increases by 30 percentage points (from 70 percent (350,000/500,000) to 100 percent) on the July 12, 1988 testing date. Because the resulting increase is not more than 50 percentage points, no ownership change occurs. For purposes of determining whether an ownership change occurs on any subsequent testing date having a testing period that includes such redemption, Public CL is treated as a 5-percent shareholder whose percentage ownership interests in L increased by 30 percentage points as a result of the redemption.

Example (2). L is entirely owned by Public L. There are 250,000 shares of L common stock outstanding. On April 22, 1988, L acquires 100,000 shares of its outstanding common stock in exchange for 100,000 shares of preferred stock described in section 1504(a)(4). (The transaction thus constitutes a recapitalization within the meaning of section 368(a)(1)(E).) As a result of the recapitalization, which is a transaction described in paragraph (j)(2)(iii)(C) of this section, Public L is segregated into two different public groups immediately before the transaction (and thereafter) so that the stock acquired by L is treated as owned by a public group (''Public RL'') that is separate from the public group that owns the stock that is not so acquired (''Public CL''). Therefore, as a result of the transaction, Public CL's interest in L increases by 40 percentage points (from 60 percent to 100 percent). Because the resulting increase is not more than 50 percentage points, no ownership change occurs. For purposes of determining whether an ownership change occurs on any subsequent testing date with a testing period that includes the date of the recapitalization, Public CL is treated as a separate 5-percent shareholder whose percentage ownership interest increased by 40 percentage points as a result of the redemption type transaction.

(D) *Acquisition of loss corporation stock as the result of the ownership of a right to acquire stock—(1) In general.* In the case of a deemed acquisition of stock of the loss corporation as the result of the ownership of a right issued by the loss corporation to acquire such stock (see paragraph (h)(4) of this section), each direct public group that exists immediately after such acquisition shall be segregated so that each direct public group that existed immediately before the transaction is treated separately from the direct public group that is deemed to acquire stock of the loss corporation as a result of the ownership of the right to acquire such stock. The direct public group that is treated as acquiring stock of the loss corporation in the transaction is presumed not to include any members of any direct public group that existed immediately before the transaction. In applying the rules of paragraph (h)(4) of this section, the segregation rules of this paragraph (j)(2)(iii)(D) shall apply before making the determination required under that paragraph (h)(4) of this section. See § 1.382–3(j)(9) for rules relating to this paragraph (j)(2)(iii)(D).

(*2*) *Example.*

(i) L has 700,000 shares of common stock outstanding. Public L owns all of the outstanding L common stock. On May 20, 1988, L issues a class of debentures to the public that, in the aggregate, may be converted into 300,000 shares of L common stock. On September 7, 1988, P_1 acquires 210,000 shares of L common stock over a public stock exchange. None of the L debentures have been converted as of that date.

(*ii*) By virtue of L's issuance of convertible debentures, May 20, 1988 is a testing date. See paragraph (a)(2)(i) of this section. Immediately before the issuance of the convertible debentures, L's only 5-percent shareholder was Public L, a direct public group. Therefore, under paragraph (j)(2)(iii)(D) of this section, Public L must be segregated from the direct public group that would otherwise exist immediately after the transaction for the purpose of applying paragraph (h)(4) of this section, so that any acquisition of L stock through the conversion of L's debentures is treated as made by a public group other than Public L (''New Public L''). Assuming the largest increase in the total percentage stock ownership of New Public L on the testing date (see paragraph (h)(4) of this section), New Public L would have increased its ownership interest in L by 30 percentage points. Therefore, the stock of L would not be treated as acquired pursuant to a deemed conversion of the L debentures on May 20, 1988, under paragraph (h)(4) of this section, because the conversion would not cause an ownership change.

(*iii*) P_1's acquisition of L common stock results in second testing date. For the purpose of applying paragraph (h)(4) of this section, Public L must again be segregated from the direct public group that would otherwise result from conversion of the debentures, so that a deemed acquisition of L stock through the conversion of L's debentures on September 7, 1988 is treated as made by a public group other than Public L (''New Public L''). As on the previous testing date, New Public L would have increased its ownership interest in L by 30 percentage points if it were treated as having acquired L common stock pursuant to the conversion of the L debentures. The increase in New Public L's ownership, taken together with P_1's 21 percentage point ownership increase in L during the testing period [210,000 shares deemed converted/(700,000 (actual) + 300,000 (deemed) shares outstanding)], results in an ownership change.

(E) *Transactions identified in the Internal Revenue Bulletin.* Any transaction that is designated by the International Revenue Service in the Internal Revenue Bulletin shall be subject to the rules, as provided in such bulletin, similar to the rules described in this paragraph (j)(2)(iii).

(F) *Issuance of rights to acquire loss corporation stock*—(*1*) *In general.* In the case of any transaction that is described in paragraph (j)(2)(iii)(B), (D) or (E) of this section in which the loss corporation issues rights to acquire its stock to the members of more than one public group, those rights shall be presumed to be exercised pro rata by each such public group as those rights are actually exercised. See §1.382–3(j)(10) for an exception to the application of the rule of this paragraph (j)(2)(iii)(F)(*1*) to stock issued on the exercise of a transferable option.

(*2*) *Example.*

(i) L, which has six million shares outstanding, is owned entirely by Public L and P is owned entirely by Public P. On November 30, 1988, P merges into L in a transaction qualifying under section 368(a)(1)(A) with Public P receiving four million shares of L stock as a result of the reorganization. Under paragraph (j)(2)(iii)(B) of this section, Public L and Public P continue to be treated as separate public groups following the merger. Pursuant to the plan of reorganization, L also issues an amount of warrants in L stock pro rata to Public L and Public P that, if exercised, would result in the issuance of an additional two million shares of L stock. On November 30, 1989, when only one-half of the outstanding warrants have been exercised, A acquires all of the unexercised warrants.

(*ii*) Without regard to the warrants distributed in reorganization, Public P's ownership interest in L increases by 40 percentage points on November 30, 1988, relative to its lowest ownership interest in L at any time during the testing period (0 percent prior to the merger). For purposes of determining whether an ownership change occurs on November 30, 1988, the segregation rules of paragraphs (j)(2)(iii)(B) and (D) of this section does not require that a third direct public group be separately identified and treated as acquiring the warrants, because L has actual knowledge that Public L and Public P acquired the distributed warrants in proportion to their respective ownership interests in L stock. Because the largest increase in the ownership of L on the testing date results from treating only Public P as exercising the distributing warrants, in which event, its ownership interest would increase by 44.4 percentage points ([four million shares acquired in the merger + 800,000 shares deemed acquired]/10.8 million (actual and deemed) shares outstanding), the issuance of the warrants by L does not cause an ownership change on November 30, 1988.

(*iii*) Under paragraph (j)(2)(iii)(F)(*1*) of this section, each actual exercise of warrants to acquire one million shares of L stock between November 30, 1988 and November 30, 1989 is treated as made pro rata by Public L and Public P (600,000 shares to Public L and 400,000 shares to Public P). Accordingly, as a result of the actual exercises of warrants during that period the ownership interests of the only 5-percent shareholders, Public L and Public P, are proportionately increased.

(*iv*) A's acquisition of the all of the outstanding warrants on November 30, 1989 requires the determination whether there has been an ownership change with respect to L, because A would be 5-percent shareholder under paragraph (g)(1)(i) of this section owning 8⅓ percent of the L stock if the acquired warrants were exercised (one million shares deemed acquired/12 million (actual and deemed) shares outstanding). See paragraph (a)(2)(i) of this section. Under paragraph (h)(4)(i) of this section, A is not treated as having exercised those warrants, because an ownership change would not results. (Public P's 36⅔ percentage point increase [(four million shares acquired in the merger + 400,000 shares deemed acquired)/12 million (actual and deemed) shares outstanding] and A's 8⅓ percentage point increase is not greater than 50 percentage points).

(iv) *Combination of de minimis public groups*—(A) *In general.* Notwithstanding paragraph (j)(2)(iii)(A) of this section, any public group first identified during a taxable year, as a result of any transaction described in paragraph (j)(2)(iii)(B), (D), (E), or (F) of this section, that owns less than five percent of loss corporation stock may be combined, at the option of the loss corporation, with any other such groups also first identified as a result of any such transaction that occurs during such taxable year.

(B) *Example.*

(i) L is widely held with no person owning as much as five percent of the L stock at any time (''Public L''). L's taxable year ends on December 31. On January 1, 1989, L issues a class of debt maturing on December 31, 2019 (''Class A Debentures'') with respect to which it will semi-annually issue L stock in discharge of its interest obligation. In addition, L issues an amount of L stock to the public in two separate transactions during 1989. As a percentage of the L stock outstanding at the close of L's taxable year on December 31, 1989, L issued .45 percent of its stock on each of two dates in payment of interest with respect to the Class A Debentures, 4.5 percent of its stock in the first stock offering and six percent of its stock in the second stock offering. During 1990, L did not issue stock other than in payment of interest with respect to the Class A Debentures. As a percentage of L stock outstanding on December 31, 1990, L issued .41 percent of its stock on each of two dates during 1990 with respect to its outstanding debt.

(*ii*) Under paragraph (h)(4)(x)(E) of this section, L's obligation to issue stock in satisfaction of the interest with respect to the Class A Debentures until December 31, 2019, is not subject to paragraph (h)(4)(i) of this section and thus is taken into account only as such stock is issued.

(*iii*) The application of the segregation rules of paragraphs (j)(2)(iii)(B) and (iv) of this section require the identification of at least two additional, separate direct public groups during 1989. First, the persons who acquire six percent of L stock in a public offering to which section 1032 applies must be treated as a separate 5-percent shareholder (''Public 1L''). See paragraph (j)(2)(iii)(B) of this section. Even though this group was first identified in 1989, it may not be combined with other public groups also first identified in 1989 because it owns five percent or more of L stock. Second, although each of the three other issuances of L stock during the year ordinarily result in the identification of an additional, separate direct public group, each such direct public group may be combined with the two other such groups into a single public group (''Public 2L''). As of the end of 1989, Public 2L would own a total of 5.4 percent of the stock of L.

(*iv*) The application of the segregation rules of paragraphs (j)(2)(iii)(B) and (iv) of this section require the identification of at least one additional, direct public group during 1990. Because each additional, direct public group first identified in 1990 acquires less than five percent of L stock, they may be combined into a single public group (''Public 3L'') owning .82 percent of the stock of L. Public 3L is treated as a five percent shareholder even though it owns less than five percent of the stock of L. See paragraph (j)(2)(iv)(A) of this section.

(v) *Multiple transactions*—(A) *In general.* If a transaction (or any part thereof) is described by more than one subdivision of paragraph (j)(2)(iii) of this section, each such subdivision shall apply to the transaction (or each part of the transaction) in the manner that results in the largest increase in the percentage stock ownership by the 5-percent shareholders.

(B) *Example.*

(i) All of the common stock of L is owned by 1,000 unrelated persons, none of whom owns as much as five percent of the L stock (''Public CL''). L has outstanding a class of preferred stock described in section 1504(a)(4) that is owned in equal amounts by 500 unrelated persons (''Public PL'').

(*ii*) On September 4, 1988, L rearranges its capital structure by redeeming 70 percent of the common stock owned by 700 of the shareholders in exchange for cash. In addition, all of the preferred stock is exchanged for a new class of common stock (nonvoting) representing 40 percent of the value of L.

(*iii*) With respect to the part of the transaction that is treated as a redemption under paragraph (j)(2)(iii)(C) of this section (the exchange of common stock for cash), Public CL is segregated into two different public groups immediately before the transaction (and thereafter) so that the owners of the redeemed stock (''Public RCL'') are treated as part of a public group that is separate from the public group comprised of the owners of the stock that is not redeemed (''Public CCL''). As a result of the redemption, Public CCL's percentage ownership interest in L thus increases by 30 percentage points from 30 percent to 60 percent (taking into account all transactions occurring on the testing date, because the change in ownership is measured under paragraph (a)(1)(i) of this section by reference to each 5-percent shareholder's ownership interest immediately after the testing date). In addition, the exchange of preferred stock for nonvoting common stock is a transaction to which section 1032 applies. Under paragraph (j)(2)(v) of this section, the part of the transaction to which section 1032 applies is also subject to the segregation rules in the manner specified in paragraph (j)(2)(iii)(B) of this section. Accordingly, Public PL, the direct public group that acquires L nonvoting common stock in exchange for L preferred stock, must be treated as a separate public group from the other direct public groups, Public CCL and Public RCL. As a separate public group, Public PL's percentage stock ownership in L increases by 40 points (as compared to 0 percent prior to the transaction).

(*iv*) In summary, Public CCL increases its percentage ownership in L by 30 percentage points and Public PL increases its percentage ownership by 40 percentage points. Consequently, an ownership change occurs with respect to L on September 4, 1988.

(vi) *Acquisitions made by either a 5-percent shareholder or the loss corporation following application of the segregation rules.* Unless a different proportion is established by either the loss corporation or the Internal Revenue Service, the acquisition of loss corporation stock by either a 5-percent shareholder or the loss corporation on any date on which more than one public group of the loss corporation exists by virtue of the application of the rules of this paragraph (j)(2) shall be treated as being made proportionately from each public group existing immediately before such acquisition. See paragraph (g)(5)(i)(B) of this section for the application of this paragraph to the ownership interest of a 5-percent shareholder that owns less than five percent of the stock of the loss corporation on the testing date.

(3) *Segregation rules applicable to transactions involving first tier entities or higher tier entities*—(i) *Dispositions.* If a loss corporation is owned, in whole or in part, by a public group (or groups), the rules of paragraphs (j)(2)(iii)(B) and (iv) of this section shall apply to any transaction in which a first tier entity or an individual that owns a direct ownership interest in the loss corporation of five percent or more transfers a direct ownership interest in the loss corporation to public shareholders. Therefore, each direct public group that exists immediately after such a disposition shall be segregated so that the ownership interests of each public group that existed immediately before the transaction are treated separately from the public group that acquires stock of the loss corporation as a result of the disposition by the individual or first tier entity. The principles of this paragraph (j)(3)(i) shall also apply to transactions in which an ownership interest in a higher tier entity that owns five percent or more of the loss corporation (determined without regard to the application of paragraph (h)(2)(i)(A) of this section) or a first tier entity is transferred to a public owner or 5-percent owner who is not a 5-percent shareholder.

(ii) *Example.*

(A) L is owned equally by Public L, P and E. Public L consists of 150 equal, unrelated shareholders. P is owned by Public P, a group consisting of 1,500 equal, unrelated shareholders. E is a partnership and none of its partners are 5-percent owners. On October 22, 1988, E sells its entire interest in L over a public stock exchange. No individual or entity acquires as much as five percent of L's stock as the result of E's disposition of the L stock.

(B) The disposition of the L stock by E is a transaction that causes the segregation of L's direct public group that exists immediately before the transaction (Public L) from the direct public group that acquires L stock in the transaction (Public EL). As a result, L has three 5-percent shareholders, Public L, Public P (through the application of paragraph (j)(1) of this section) and Public EL, each of which owns 33⅓ percent of L stock. Therefore, Public EL is a 5-percent shareholder that has increased its ownership interest in L by 33⅓ percentage points during the testing period. For purposes of subsequent transactions, Public L and Public EL will continue to be treated as separate direct public groups until any subsequent testing date that does not have a testing period that includes E's disposition of L stock.

(iii) *Other transactions affecting direct public groups of a first tier entity or higher tier entity.* The rules of paragraphs (j)(2)(i), (iii), (iv) and (v) of this section shall apply to transactions described in such paragraphs that involve either a higher tier entity that owns five percent or more of the loss corporation (determined without regard to the application of paragraph (h)(2)(i)(A) of this section) or a first tier entity. In applying those rules for purposes of this paragraph (j)(3)(iii), each direct public group of a first tier entity or a higher tier entity is any public group of any such entity identified in paragraph (j)(1)(iv)(A) or (B) of this section or resulting from the application of this paragraph (j)(3)(iii). The principles of paragraph (j)(2)(iii)(C) of this section also shall apply to any transaction that has the effect of a redemption-type transaction (e.g., an acquisition by the loss corporation of stock in a first tier entity).

(iv) *Examples.*

Example (1). The facts are the same as in *Example (1)* of paragraph (j)(2)(iii)(B)(*2*) of this section, except that Public L and P_1 own 40 percent and 60 percent, respectively, of the stock of HC which, in turn, owns 100 percent of L and HC merges into P_2. Under paragraph (j)(3)(iii) of this section, the rules of paragraph (j)(2)(iii)(B) of this section apply to segregate HC's direct public group (Public L) immediately before the merger from the direct public group (Public P_2) that acquires loss corporation stock in the merger. The consequences of the merger of HC into P_2 are thus the same as in *Example (1)* of paragraph (j)(2)(iii)(B)(*2*) of this section.

Example (2) (*i*) Twenty-five individual shareholders each own four percent of L (''Public L''). Public L is therefore the only 5-percent shareholder of L. Each of the shareholders of L contribute their L stock to a newly formed corporation, HC. In exchange for their contribution of L stock, HC issues 100 percent of each of its two classes of common stock (voting and nonvoting).

(*ii*) The formation of HC, a first tier entity of L, is a transaction to which section 1032 applies. Under paragraph (j)(3)(iii) of this section, the rules of paragraphs (j)(1)(iii) and (j)(2)(iii)(B) of this section are applied to this transaction with the result that the shareholders of HC, immediately after the issuance of HC stock, are presumed not to include any persons that previously had a direct or indirect ownership interest in L. The presumption underlying those rules, however, is rebutted by establishing that all of the HC stock outstanding immediately after the transaction was issued solely in exchange for L stock. Thus, Public HC (immediately after the transaction) and Public L (immediately before the transaction) would be treated owned by the same direct public group.

Example (3) (*i*) All of the stock of L is owned by unrelated shareholders, none of whom owns as much as five percent of L stock. P also is owned by unrelated shareholders, none of whom owns as much as five percent of P stock. On November 22, 1988, P incorporates P_1 with a contribution of P stock. Immediately thereafter, P_1 acquires all of the properties of L in exchange for its P stock in a forward triangular merger qualifying under sections 368 (a)(1)(A) and (a)(2)(D). The P stock transferred by P_1 equals 45 percent of the total outstanding P stock.

(*ii*) Immediately before the merger of L into P_1, P's only 5-percent shareholder was Public P, a direct public group of P. The rules of paragraph (j)(2)(iii)(B) of this section thus apply to the transaction under paragraph (j)(3)(i) of this section since P, a first tier entity, is a party to the reorganization described in such paragraph. Although Public P does not acquire any stock in the merger, it is treated as acquiring stock in the loss corporation, P_1, because such corporation succeeds to the pre-change losses of L in a transaction to which 381(a) applies. As a result of the merger, Public P, the direct public group of P that exists immediately before the merger, must be segregated from the direct public groups acquiring P stock in the reorganization. Public P is, therefore, treated as acquiring 55 percent of the outstanding stock of the loss corporation, P_1, in the transaction. The transaction, therefore, results in an ownership change for P_1.

Example (4) (*i*) L is owned 20 percent by A and 80 percent by 1,000 unrelated individuals and entities, none of whom owns as much as five percent of L stock (''Public L''). P is owned 10 percent by B, 40 percent by E, and 50 percent by 5,000 unrelated individuals, none of whom owns as much as five percent of P stock (''Public P''). E is owned 30 percent by C and 70 percent by 30 unrelated individuals, none of whom owns as much as five percent of E (''Public E'').

(*ii*) On October 31, 1987, P acquires all of the L stock from A and Public L in exchange for P stock representing 20 percent of the value of P (determined immediately after the acquisition) in a transaction described in section 368(a)(1)(B). After the acquisition, P is owned eight percent by B, 32 percent by E, four percent by A, and 56 percent by 6,000 unrelated individuals, none of whom owns as much as five percent of P. Because L is wholly owned by P immediately after the acquisition, L, under paragraph (j)(1) of this section, is treated as owned as follows: Eight percent by B, 9.6 percent by C (through C's ownership interest in E, a highest tier entity, and E's ownership interest in P, a first tier entity), 22.4 percent by Public E (through its ownership interest in E and E's ownership interest in P), four percent by A, and 56 percent by the shareholders who each own less than five percent of L through their ownership interest in P.

(*iii*) Under paragraph (j)(3)(iii) of this section, the rules of paragraph (j)(2)(iii)(B) of this section apply to the reorganization since the transaction involved a first tier entity of L. Thus, the direct public group of P that exists immediately after the transaction must be segregated into two public groups—the direct public group of P that existed immediately before the acquisition (Public P) is treated separately from the direct public group consisting of the persons who acquire P stock in the transaction (Public L). Accordingly, immediately after the reorganization, Public P and Public L own 40 percent and 16 percent of L, respectively. See paragraph (h) of this section. (Under paragraph (g)(5)(ii)(B) of this section, L may treat the four percent of L stock owned by A immediately after the reorganization as the amount of L stock owned by A for each subsequent testing date having a testing period that includes the reorganization.)

(*iv*) In summary, after applying the rules of paragraphs (j)(1) and (3) of this section, L is treated as owned as follows:

5-percent shareholder	Percentage ownership interest
A	4.0
B	8.0
C	9.6
Public E	22.4
Public P	40.0
Public L	16.0

(*v*) The reorganization results in an ownership change, because B, C, Public E and Public P, all of whom are 5-percent shareholders, together have increased their percentage ownership in L by 80 percentage points as compared to their lowest percentage ownership in L at any time during the testing period (0 percent prior to the acquisition).

(v) *Acquisitions made by a 5-percent shareholder, a higher tier entity, or a first tier entity following application of the segregation rules.* The rules of paragraph (j)(2)(vi) of this section shall apply to the acquisition of an ownership interest in a first tier entity (or higher tier entity) if more than one direct public group of any such entity are segregated under the rules of this paragraph (j)(3). Accordingly, an acquisition by such an entity or a 5-percent shareholder of any ownership interest in such an entity shall be treated as made proportionately from the direct public groups resulting from the application of this paragraph (j)(3).

(k) *Operating rules*—(1) *Presumptions regarding stock ownership.* Subject to paragraphs (k)(2) and (4) of this section, for purposes of applying paragraphs (f), (g), (h), and (j)(1) of this section—

(i) *Stock subject to regulation by the Securities and Exchange Commission.* With respect to loss corporation stock that is described in Rule 13d–1(d) of Regulation 13D–G (or any rule or regulation to generally the same effect), promulgated by the Securities and Exchange Commission under the Securities and Exchange Act of 1934 (''registered stock''), a loss corporation may rely on the existence and absence of filings of Schedules 13D and 13G (or any similar schedules) as of any date to identify all of the corporation's shareholders who have a direct ownership interest of five percent or more (both individuals and first tier entities) on such date. A loss corporation may similarly rely on the existence and absence of such filings as of any date with respect to registered stock of any first tier entity or any higher tier entity to identify the 5-percent owners of any such entities on such date who indirectly own five percent or more of the loss corporation stock, and are thus 5-percent shareholders, and to identify any higher tier entities of such entities.

(ii) *Statements under penalties of perjury.* A loss corporation may rely on a statement, signed under penalties of perjury, by an officer, director, partner, trustee, executor or similar responsible person, on behalf of a first tier entity or a higher tier entity to establish the extent, if any, to which the ownership interests of any 5-percent owners or higher tier entities with respect to such entities have changed during a testing period. A loss corporation may not rely on such a statement (A) that it knows to be false or (B) that is made by either a first tier entity or higher tier entity that owns 50 percent or more of the stock of the loss corporation. For purposes of the preceding sentence, any first tier entities and higher tier entities that are known by the loss corporation to be members of the same controlled group (within the meaning of section 267(f)) shall be treated as one corporation.

(2) *Actual knowledge regarding stock ownership.* For purposes of this section (other than paragraphs (g)(5) and (j)(1)(v) of this section), to the extent that the loss corporation has actual knowledge of stock ownership on any testing date (or acquires such knowledge before the date that the income tax return is filed for the taxable year in which the testing date occurs) by—

(i) An individual who would be a 5-percent shareholder, but for the application of paragraphs (h)(2)(iii), (h)(6)(iii) or (g)(2) of this section, or

(ii) A 5-percent shareholder that would be taken into account, but for paragraphs (h)(2)(iii), (h)(6)(iii) or (g)(3) of this section,

the loss corporation must take such stock ownership into account for purposes of determining whether an ownership change has occurred on that testing date. If a loss corporation acquires such knowledge after such income tax return is filed, the loss corporation may take such ownership into account for purposes of determining whether an ownership change occurred on that testing date and, if appropriate, file an amended income tax return (subject to any applicable statute of limitations). To the extent the loss corporation has actual knowledge on or after any testing date regarding the ownership interest in the loss corporation by members of one public group (described in paragraphs (g)(1)(ii), (iii) or (iv) of this section) and the ownership interest of those members in the loss corporation as members in another such public group, the loss corporation may take such ownership into account for purposes of determining whether an ownership change occurred on that testing date.

(3) *Duty to inquire as to actual stock ownership in the loss corporation.* For purposes of this section, the loss corporation is required to determine the stock ownership on each testing date (and, except as otherwise provided in this section, the changes in the stock ownership during the testing period) of—

(i) Any individual shareholder who has a direct ownership interest of five percent or more in the loss corporation,

(ii) Any first tier entity,

(iii) Any higher tier entity that has an indirect ownership interest of five percent or more in the loss corporation (determined without regard to paragraph (h)(2)(i)(A) of this section), and

(iv) Any 5-percent owner who indirectly owns five percent or more of the stock of the loss corporation in his capacity as a 5-percent owner in any one first tier entity or higher tier entity.

The loss corporation does not have any obligation to inquire or to determine facts relating to the stock ownership of any shareholders other than those described in the preceding sentence. In addition, the loss corporation does not have any obligation to inquire or to determine if the actual facts relating to the stock ownership of any shareholder are consistent with the ownership interests of the loss corporation as determined by applying the presumptions and other rules of paragraphs (g), (h), (j) or (k)(1) of this section.

(4) *Ownership interest structured to avoid the section 382 limitation.* For purposes of this section, if the ownership interests in a loss corporation are structured by a person with a direct or indirect ownership interest in the loss corporation to avoid treating a person as a 5-percent shareholder (or to permit the loss corporation to rely on the presumption provided in paragraph (g)(5)(i)(B) of this section) for a principal purpose of circumventing the section 382 limitation, then—

(i) Paragraph (h)(2)(iii) of this section shall not apply with respect to the ownership interests so structured and the constructive ownership rules of paragraph (h)(2)(i) of this section shall thus apply to attribute stock from any entity without regard to the amount of stock it owns in the loss corporation or any other corporation,

(ii) Paragraphs (g)(2) and (3) of this section shall be modified with respect to the ownership interests so structured so that the ownership interest of a person includes all of an individual's direct and indirect ownership in the loss corporation, without regard to whether each such interest represents five percent or more of the stock of the loss corporation, and

(iii) Paragraph (g)(5)(i)(B) of this section shall not apply with respect to the ownership interests so structured so that the ownership interest of a person takes into account his actual ownership interest in the loss corporation.

This paragraph (k)(4) shall apply, however, only if application would result in an ownership change.

(5) *Example.*

L is owned by 25 individuals who each own four percent of the outstanding L stock. A purchases 40 percent of L stock from such shareholders on August 13, 1988. Thereafter, B plans to acquire 15 percent of the L stock. B is advised concerning the potential application of section 382 to L. On February 1, 1989, B acquires a 15 percent interest in L pursuant to a program in which each of four corporations, P_1 through P_4, each of which is wholly-owned by B, acquire a 3.75 percent interest in L. A principal purpose of acquiring the L stock through four corporations is to avoid treating B as owning any ownership interest in L amounting to as much as five percent, and thus to circumvent the section 382 limitation by avoiding an ownership change. Under paragraph (k)(4) of this section, the limitation on the constructive ownership rules of paragraph (h)(2)(iii) of this section are disregarded and B is treated as a 5-percent shareholder owning 15 percent of the stock of L by virtue of his ownership interests in P_1 through P_4, notwithstanding paragraph (g)(2) of this section. Accordingly, an ownership change occurs with respect to L.

(6) *First tier entity or higher tier entity that is a foreign corporation or entity.* [Reserved]

(l) *Changes in percentage ownership which are attributable to fluctuations in value.* [Reserved]

(m) *Effective date*—(1) *In general.* Except as provided in this paragraph (m), section 382 shall apply to any ownership change that occurs immediately after an owner shift or an equity structure shift that occurs after December 31, 1986, or any other event occurring after such date that requires the determination of whether an ownership change has occurred under paragraph (a)(2)(i) of this section. In the case of an equity structure shift (including an equity structure shift that also constitutes an owner shift), any equity structure shift completed pursuant to a plan of reorganization adopted before January 1, 1987, shall be treated as occurring on the date such plan was adopted. Therefore, section 382 shall apply to any ownership change occurring immediately after—

(i) An owner shift (excluding an owner shift that also constitutes an equity structure shift) that occurs on or after January 1, 1987,

(ii) An equity structure shift that occurs after December 31, 1986, if it is completed pursuant to a plan of reorganization adopted on or after January 1, 1987, or

(iii) Any transfer or issuance of an option, or other interest that is similar to an option, that occurs on or after January l, 1987 and that is taken into account under paragraph (a)(2)(i) of this section.

With respect to equity structure shifts completed pursuant to plans adopted before January 1, 1987, section 382 shall be inapplicable only if the equity structure shift that is treated as occurring on the date the plan of reorganization for such shift was adopted (or other event occurring after the adoption of such plan) results in an ownership change before January 1, 1987. In that event, a new testing period for the loss corporation shall begin on the day after such ownership change.

(2) *Plan of reorganization.* For purposes of paragraph (m)(1) of this section, a plan of reorganization shall be treated as adopted on the earlier of—

(i) The first date that the boards of directors of all the parties to the reorganization have adopted the plan or have recommended adoption to their shareholders, or

(ii) The date the shareholders approve such reorganization.

If there is an ownership change with respect to a subsidiary as the result of a reorganization of the parent, the treatment of the subsidiary under this paragraph (m)(2) shall be governed by the classification of the parent-level transaction. For purposes of the preceding sentence, a corporation shall be treated as a subsidiary of another corporation only if the other corporation owns stock in that corporation meeting the requirements of section 1504(a)(2).

(3) *Earliest commencement of the testing period.* For purposes of determining if an ownership change has occurred at any time after May 5, 1986, the testing period shall begin no earlier than May

6, 1986. Under paragraph (d)(4) of this section, therefore, shifts in the ownership of stock of the loss corporation prior to May 6, 1986 are disregarded.

(4) *Transitional rules*—(i) *Rules provided in paragraph (j) of this section for testing dates before September 4, 1987.* For purposes of determining whether an ownership change occurs for any testing date before September 4, 1987.

(A) The rules of paragraph (j)(1) of this section shall apply only to stock of the loss corporation acquired after May 5, 1986, by any first tier entity or higher tier entity and shall not apply to any stock acquired by such an entity on or before that date,

(B) The rules of paragraph (j)(2) of this section shall apply only to equity structure shifts in which more than one corporation is a party to the reorganization and shall not apply to any other transactions, and

(C) The rules of paragraph (j)(3) of this section shall apply only to—

(*1*) Dispositions of stock acquired by an individual, a first tier entity or higher tier entity after May 5, 1986 (and shall not apply to dispositions of stock acquired on or before such date), and

(*2*) Equity structure shifts in which more than one corporation is a party to the reorganization (and shall not apply to any other transactions).

For any testing date before September 4, 1987, however, the loss corporation is permitted to apply all of the rules of paragraph (j) of this section. A loss corporation that applies the rules of paragraph (j) of this section under the preceding sentence must apply all of the rules of such paragraph in determining whether any ownership change occurs on any testing dates after May 5, 1986.

(ii) *Example.*

(i) L is owned entirely by 10,000 unrelated individuals, none of whom owns as much as five percent of the stock of L (‘‘Public L’’). P is owned entirely by 1,000 unrelated individuals, none of whom owns as much as five percent of the stock of P (‘‘Public P’’).

(*ii*) Between March 1, 1987 and June 1, 1987, P acquires 45 percent of L stock in a series of transactions. On June 15, 1987, L redeems 20 percent of the L stock from Public L.

(*iii*) Under paragraph (m)(4)(i)(A) of this section, the rules of paragraph (j)(1) of this section apply to the acquisitions made by P, because they occurred after May 5, 1986. Accordingly, following those acquisitions, the stock of L is owned 45 percent by Public P and 55 percent by Public L. Because the increase in the percentage ownership by Public P as a result of P’s stock purchases is not more than 50 percent, no ownership change occurs as the result of P’s purchases.

(*iv*) On or after September 4, 1987, the rules of paragraph (j)(2)(iii)(C) of this section apply to treat any L stock that is redeemed as owned by a public group that is separate from the public group owning the stock that is not redeemed. (Under paragraph (j)(2)(iii)(C) of this section, the continuing shareholders of Public L, who owned 35 percent of the stock of L before the redemption ([55 percent—20 percent]/100 percent) increase their ownership interest in L by 8.8 percentage points as a result of such redemption (43.8 percent—35 percent)). Those rules, however, do not apply to the June 15, 1987 redemption because it occurs before the date that paragraph (j)(2)(iii) of this section generally is effective. (Until September 4, 1987, paragraph (j)(2)(iii) of this section generally is effective only for equity structure shifts in which more than one corporation is a party to the reorganization.) Solely because of the application of paragraph (j)(1) of this section to P’s acquisitions of L stock, Public P’s ownership interest in L as a result of the redemption has increased from 45 percentage points to 56.2 percentage points which, compared to its lowest percentage ownership interest at any time during the testing period (0 percent prior to March 1, 1987), is a more than 50 percentage point increase thus causing an ownership change with respect to L on June 15, 1987.

(iii) *Rules provided in paragraph (j) of this section for testing dates on or after September 4, 1987.* For purposes of determining whether an ownership change occurs for any testing date on or after September 4, 1987, the rules of paragraphs (j)(2) and (3) of this section shall not apply to identify any public group resulting from—

(A) Any transaction described in such paragraphs (j)(2) and (3), unless that transaction is also described in paragraph (m)(4)(i)(B) or (C) of this section, or

(B) Any disposition of stock acquired on or before May 5, 1986, but only if such disposition or other transaction occurs before September 4, 1987. Thus, for example, the rules of paragraph (j)(2)(iii)(D) of this section shall apply only to rights to acquire stock of the loss corporation issued on or after such date.

(iv) *Rules provided in paragraphs (f)(18)(ii) and (iii) of this section.* For purposes of determining whether an ownership change occurs for any testing date, the rules of paragraphs (f)(18)(ii) and (iii) of this section apply only to stock (or any other ownership interest) that is—

(A) Issued on or after September 4, 1987, or

(B) Transferred to (or by) a person who is a 5-percent shareholder (or would be a 5-percent shareholder if paragraph (f)(18)(iii) of this section were applicable) on or after September 4, 1987.

(v) *Rules provided in paragraph (a)(2)(ii) of this section.* The information statement required under paragraph (a)(2)(ii) of this section is not required to be filed with respect to any taxable year for which the due date (including extensions) of the income tax return of the loss corporation is on or before October 5, 1987.

(vi) *Rules provided in paragraph (h)(4) of this section.* The rules provided in paragraph (h)(4) of this section do not apply on any testing date on or after November 5, 1992. The rule provided in paragraph (h)(4)(viii) of this section applies to the lapse or forfeiture of any option treated as exercised under paragraph (h)(4)(i) of this section. If an option is treated as exercised under paragraph (h)(4)(i) of this section, and the option is actually exercised on a day that is within 120 days after the date on which the option is treated as exercised, the rule provided in paragraph (h)(4)(vi)(B) of this section applies (even if the actual exercise of the option occurs on a date on which the rules of paragraph (h)(4) of this section would not otherwise apply). Thus, in such a case, the loss corporation may elect to treat paragraphs (h)(4)(i) and (vi)(A) of this section as not applying to the option and take into account only the acquisition of loss corporation stock resulting from the actual exercise of the option.

(vii) *Rules provided in paragraph (a)(2)(i) of this section.* The rules provided in paragraph (a)(2)(i) of this section apply to determine whether dates prior to November 5, 1992, are testing dates. For rules regarding the determination of whether dates on or after November 5, 1992, are testing dates, see §1.382–2(a)(4).

(5) *Bankruptcy proceedings*—(i) *In general.* In the case of a reorganization described in section 368(a)(1)(G) or an exchange of debt for stock in a title 11 or similar case (within the meaning of section 368(a)(3)), section 382 shall not apply to any ownership change resulting from such a reorganization or proceeding if a petition in such case was filed with the court before August 14, 1986. Accordingly, any shift in ownership in the loss corporation arising out of such reorganization or proceeding shall not be taken into account for purposes of determining whether an ownership change occurs on any testing date that occurs after December 31, 1986.

(ii) *Example.*

(i) L filed a petition in bankruptcy on September 29, 1985. As a result of a title 11 bankruptcy reorganization of L that is confirmed by a court on February 2, 1988, there is a shift in the ownership of L so that JK increased her interest in L by 24 percentage points relative to her lowest ownership interest in L during the testing period. JK is the only 5-percent shareholder of L following the reorganization whose interest in L increased as a result of the transaction. On December 25, 1988, GK purchases 42 percent of the outstanding stock of L from shareholders other than JK.

(*ii*) There is no ownership change on December 25, 1988 because the 24 percentage point increase in JK's ownership interest in L is not taken into account under paragraph (m)(6)(i) of this section.

(*iii*) The facts are the same as in (*i*), except that the acquisitions by JK and GK occurred on August 5, 1986 and September 26, 1986, respectively. Because paragraph (m)(6)(i) of this section is only applicable with respect to the determination of whether an ownership change has occurred on any testing date that occurs after December 31, 1986, there is an ownership change as a result of GK's acquisition on September 26, 1986. Accordingly, section 382 is inapplicable to such ownership change under paragraph (m)(1) of this section because it occurred prior to January 1, 1987. Under paragraph (d)(2) of this section, the testing period for determining whether an ownership change occurs on any subsequent testing date shall commence no earlier than September 27, 1986.

(6) *Transactions of domestic building and loan associations.* The rules of paragraph (j)(2)(iii)(B) of this section (and the application of those rules by virtue of paragraph (j)(3) of this section) shall not apply to a public offering of stock

by a domestic building and loan association described in section 591 (or any corporation that owns stock in the association meeting the requirements of section 1504(a)(2)) prior to January 1, 1989. In the case of any transaction described in the preceding sentence, any transitory ownership of stock by any entity that is an underwriter shall be disregarded so that the rules of paragraph (j)(1) of this section shall not apply to treat such stock as owned by the owners of the underwriter and thus the rules of paragraph (j)(3)(i) of this section shall not apply to the disposition of such stock by the underwriter. For purposes of this paragraph (m)(7)—

(i) Ownership shall be considered transitory only with respect to an underwriter acquiring stock in a firm commitment underwriting to the extent the stock is disposed of pursuant to the offer (but in no event later than sixty (60) days after the initial offering) and,

(ii) To the extent a transaction may be described both by paragraph (j)(2)(iii)(B) of this section and any other provision of paragraph (j)(2)(iii) or (3) of this section, paragraph (j)(2)(v)(A) of this section shall not apply and the transaction shall be treated as described solely by paragraph (j)(2)(iii)(B) of this section.

(7) *Transactions not subject to section 382*—(i) *Application of old section 382.* Old section 382 shall not apply to a loss corporation on or after the date on which an ownership change occurs, but only if such ownership change results in the application of the section 382 limitation (as defined in section 382(b)) with respect to the loss corporation.

(ii) *Effect on testing period.* The application of old section 382 to a transaction is disregarded for purposes of paragraph (d)(2) of this section unless the transaction that results in such application is the last component of an ownership change after May 5, 1986 that is not subject to section 382 under the effective date rules of this paragraph (m) (*e.g.*, an ownership change occurring as the result of an individual's purchase of more than 50 percent of L stock on any date on or before December 31, 1986).

(iii) *Termination of old section 382.* [Reserved]

(8) *Options issued or transferred before January 1, 1987*—(i) *Options issued before May 6, 1986.* An option issued before May 6, 1986, is subject to the rules of paragraph (h)(4) of this section only if it is transferred by (or to) a 5-percent shareholder (or a person who would be a 5-percent shareholder if the option were treated as exercised) on or after such date. In all other cases, such an option shall not be subject to paragraph (h)(4)(i) of this section, but shall be subject to paragraph (h)(4)(xii) of this section. Thus, for example, a warrant to acquire stock of the loss corporation issued before May 6, 1986 shall not be subject to paragraph (h)(4) of this section unless the warrant is transferred by (or to) a 5-percent shareholder. The exercise of such a warrant, however, would be taken into account as required by this paragraph (m)(8)(i) and paragraph (h)(4)(xii) of this section.

(ii) *Options issued on or after May 6, 1986 and before September 18, 1986.* An option issued or transferred on or after May 6, 1986, and before September 18, 1986, is subject to the rules of paragraph (h)(4) of this section.

(iii) *Options issued on or after September 18, 1986 and before January 1, 1987.* An option issued or transferred on or after September 18, 1986, and before January 1, 1987, is subject to the rules of paragraph (h)(4) of this section, except that the option shall be treated for purposes of this section as if it never had been issued in the event that either—

(A) The option lapses unexercised or is irrevocably forfeited by the holder thereof, or

(B) On the date the option was issued, there was no significant likelihood that such option would be exercised within the five-year period from the date of such issuance and a purpose for the issuance of the option was to cause an ownership change prior to January 1, 1987.

(9) *Examples.* The rules of this paragraph (m) may be illustrated by the following examples.

Example (1) (i) A owns all 100 outstanding shares of L stock. A sells 11 shares to B on January 1, 1986. The January 1, 1986 testing date is disregarded under paragraph (m)(3) of this section. A sells another 40 shares to B on

January 1, 1988. B's second stock purchase is an owner shift that does not result in an ownership change. B's percentage ownership interest on the testing date (51 percent) is only 40 percentage points greater than the lowest percentage of L stock owned by B at any time during the testing period (11 percent on and after May 6, 1986).

(ii) The facts are the same as in (i). In addition A sells 20 shares of his L stock to C on July 1, 1990. C's stock purchase is an owner shift. Because B and C together have increased their respective ownership interests in L by 40 and 20 percentage points relative to their lowest percentage stock ownership interests in L at any time during the testing period, C's purchase causes an ownership change. The testing period for any subsequent ownership change begins on the first day following C's acquisition, July 2, 1990.

Example (2) (i) C has owned 100 percent of L since March 22, 1980. On October 13, 1986, P merges into L. As a result of the merger, 40 percent of L stock is acquired by A, the sole shareholder of P. The merger of P into L is both an equity structure shift and an owner shift. The transaction, however, is not an ownership change with respect to L, because A's percentage ownership interest has increased by only 40 percentage points. On August 22, 1987, B purchases 15 percent of the L stock from C. B's purchase constitutes an owner shift resulting in an ownership change that is subject to section 382 because the aggregate increases in percentage ownership by B and C (respectively 40 percent and 15 percent) is more than 50 percentage points.

(ii) The facts are the same as in (i), except that the plan of reorganization is adopted on October 13, 1986, and the merger is completed on July 22, 1987. The result is the same as in (i).

(iii) The facts are the same as in (ii), except that the reorganization is completed on August 22, 1987, and B's purchase of the L stock occurs one month earlier, on July 22, 1987. Assume that after the reorganization on August 22, 1987, A and B own 40 percent and 15 percent, respectively, of L stock. Although the merger occurred pursuant to a plan of reorganization adopted before 1987, L is subject to section 382 following the equity structure shift, because the merger would not have caused an ownership change if it had been completed in 1986 after the commencement of the L's testing period.

(iv) The facts are the same as in (ii), except that B's purchase occurs on June 7, 1986. Assume that immediately after the reorganization on August 22, 1987, A and B own 40 percent and 15 percent, respectively, of L stock. Since the reorganization pursuant to a plan adopted before 1987, taken together with the other shifts in the ownership of L's stock between May 5, 1986, and December 31, 1986, would have caused an ownership change, section 382 does not apply as a result of the merger. Since an ownership change occurs as a result of the merger, L's testing period for purposes of any subsequent ownership change begins on October 14, 1986.

(v) The facts are the same as in (iv), except that B makes an additional purchase from C of one percent of L's stock on February 14, 1987. The result is the same as in (iv). B's additional purchase, however, is taken into account for the purpose of determining whether there is a second ownership change with respect to L.

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§1.382–3 Definitions and rules relating to a 5-percent shareholder.

(a) *Definitions*—(1) *Entity*—(i) *In general.* An entity is any corporation, estate, trust, association, company, partnership or similar organization. An entity includes a group of persons who have a formal or informal understanding among themselves to make a coordinated acquisition of stock. A principal element in determining if such an understanding exists is whether the investment decision of each member of a group is based upon the investment decision of one or more other members. However, the participation by creditors in formulating a plan for an insolvency workout or a reorganization in a title 11 or similar case (whether as members of a creditors' committee or otherwise) and the receipt of stock by creditors in satisfaction of indebtedness pursuant to the workout or reorganization do not cause the creditors to be considered an entity.

(ii) *Examples.* The following examples illustrate the provisions of paragraph (a)(1)(i) of this section.

Example 1. (i) L corporation has 1,000 shares of common stock outstanding. For the three-year period ending on October 1, 1992, L's stock was owned by unrelated individuals, none of whom owned five percent or more of L. A group of 20 individuals who previously owned no stock (the ''Group'') agree among themselves to acquire more than 5 percent of L's stock. The Group is not a corporation, trust, association, partnership or company.

On October 1, 1992, pursuant to their understanding, the members of the Group purchase 600 shares of L common stock from the old shareholders of L (a total of 60 percent of L stock), with each member purchasing 30 shares.

(ii) Before the members of the Group acquired L's stock on October 1, 1992, no individual or entity owned, directly or indirectly, five percent or more of the stock of L. As a result, all shareholders were aggregated into a public group and L was considered to be owned by a single 5-percent shareholder (''Public L'') in accordance with § 1.382–2T (g)(1) and (j)(1).

(iii) Under paragraph (a)(1)(i) of this section, the members of the Group have a formal or informal understanding among themselves to make a coordinated acquisition of stock and, therefore, the Group is an entity. Thus, the acquisition of more than five percent of the stock of L on October 1, 1992, by members of the Group is not disregarded under § 1.382–2T(e)(1)(ii). Because no member of the Group owns, directly or indirectly, five percent or more of the stock of L, §§ 1.382–2T (g)(1) and (j)(1) require that the members of the Group be aggregated into a separate public group, which will be presumed to consist of persons unrelated to the members of Public L. Because there is a shift of more than fifty percentage points in the ownership of L stock during the three-year testing period ending on October 1, 1992, an ownership change occurs on October 1, 1992, as a result of the Group's purchase of the 600 shares.

Example 2. (i) Prior to October 1, 1992, L's 1,000 shares of outstanding stock were owned by unrelated individuals, none of whom owned five percent or more of the stock of L. L's management is concerned that L may become subject to a takeover bid. In separate meetings, L's management meets with potential investors who own no stock and are friendly to management to convince them to acquire L's stock based on an understanding that L will assemble a group that in the aggregate will acquire more than 50 percent of L's stock. On October 1, 1992, 15 of these investors each purchase 4 percent of L's stock.

(ii) Under paragraph (a)(1)(i) of this section, the 15 investors (the ''Group'') are treated as an entity because the members of the Group purchase L stock pursuant to a formal or informal understanding among themselves to make a coordinated acquisition of stock. Sections 1.382–2T (g)(1) and (j)(1) require that on October 1, 1992, the Group be aggregated into a separate public group, which has increased its ownership of L stock by 60 percentage points over its lowest level of ownership in the three-year period ending on October 1, 1992. Accordingly, an ownership change occurs on that date.

Example 3. (i) Prior to October 1, 1992, L's 1,000 shares of outstanding stock were owned by unrelated individuals, none of whom owned five percent or more of the stock of L. On October 1, 1992, an investment advisor advises its clients that it believes L's stock is undervalued and recommends that they acquire L stock. Acting on the investment advisor's recommendation, 20 unrelated individuals purchase 6 percent of L's stock in aggregate, with each individual purchasing less than 5 percent. Each client's decision was not based upon the investment decisions made by one or more other clients.

(ii) Because there is no formal or informal understanding among the clients to make a coordinated acquisition of L stock, their purchase of stock is not made by an entity under paragraph (a)(1)(i) of this section. As a result, they remain part of the public group which owns L stock, and no owner shift results upon their purchase of L stock under § 1.382–2T(e)(1)(ii).

(iii) The result in this example would be the same under paragraph (a)(3)(i) of this section if the only additional fact was that the investment advisor is also the underwriter (without regard to whether it is a firm commitment or best efforts underwriting) for a primary or secondary offering of L stock.

(iv) Assume that the facts are the same except that, instead of an investment advisor recommending that clients purchase L stock, the trustee of several trusts qualified under section 401(a) sponsored by unrelated corporations causes each trust to purchase the L stock. In this case, the result is the same, so long as the investment decision made on behalf of each trust was not based on the investment decision made on behalf of one or more of the other trusts.

(iii) *Effective date.* (A) *In general.* The second, third and fourth sentences of paragraph (a)(1)(i) of this section and *Examples 1, 2* and *3* of paragraph (a)(1)(ii) of this section apply to testing dates (determined by applying such sentence and examples) on or after November 20, 1990, but with respect to any group of persons that pursuant to a formal or informal understanding among themselves makes a coordinated acquisition of stock before November 20, 1990, only if the group increases or decreases its ownership of stock of the loss corporation relative to its percentage ownership interest at the close of November 19, 1990, by five percentage points or more on or after November 20, 1990.

(B) *Special rule.* If pursuant to a formal or informal understanding among themselves a group consisting only of regulated investment companies under section 851, qualified trusts under section 401, common trust funds under section 584, or trusts or estates that are clients of a trust department of a bank under section 581, make a coordinated acquisition of stock before November 20, 1990, the second, third and fourth sentences of paragraph (a)(1)(i) of this section and *Examples 1, 2,* and *3* of paragraph (a)(1)(ii) of this section apply for testing dates (determined by applying such sentences and examples) on or after November 20, 1990, only if the group increases its ownership of stock of the loss corporation relative to its percentage ownership interest at the close of November 19, 1990, by five percentage points or more on or after November 20, 1990.

(C) *Example.* The following example illustrates the provisions of paragraph (a)(1)(iii) of this section.

Example. Prior to November 1, 1990, L, a loss, corporation, is owned entirely by 1,000 unrelated individuals, none of whom owns as much as 5 percent of the stock of L (''Public L''). On November 1, 1990, 15 individuals (the ''Group'') each acquired 3 percent, or 45 percent, in total, of L stock pursuant to an understanding among themselves to make a coordinated acquisition of stock. The Group is not a corporation, trust, association, partnership or company. On March 1, 1992, six members of the Group each purchased an additional one percent of L stock, or 6 percent, in total, pursuant to the understanding. Accordingly, the Group increased its ownership in L stock by 51 percentage points during the three-year testing period ending on March 1, 1992. As a result, an ownership change of L occurs on March 1, 1992.

(2) [Reserved]

(b)—(i) [Reserved]

(j) *Modification of the segregation rules of §1.382–2T(j)(2)(iii) in the case of certain issuances of stock*—(1) *Introduction.* This paragraph (j) exempts, in whole or in part, certain issuances of stock by a loss corporation from the segregation rules of §1.382–2T(j)(2)(iii)(B). Terms and nomenclature used in this paragraph (j), and not otherwise defined herein, have the same meanings as in section 382 and the regulations thereunder.

(2) *Small issuance exception*—(i) *In general.* Section 1.382–2T(j)(2)(iii)(B) does not apply to a small issuance (as defined in paragraph (j)(2)(ii) of this section), except to the extent that the total amount of stock issued in that issuance and all other small issuances previously made in the same taxable year (determined in each case on issuance) exceeds the small issuance limitation. This paragraph (j)(2) does not apply to an issuance of stock that, by itself, exceeds the small issuance limitation.

(ii) *Small issuance defined.* ''Small issuance'' means an issuance (other than an issuance described in paragraph (j)(6) of this section) by the loss corporation of an amount of stock not exceeding the small issuance limitation. For purposes of this paragraph (j)(2)(ii), all stock issued in the issuance is taken into account, including stock owned immediately after the issuance by a 5-percent shareholder that is not a direct public group.

(iii) *Small issuance limitation*—(A) *In general.* For each taxable year, the loss corporation may, at its option, apply this paragraph (j)(2)—

(*1*) On a corporation-wide basis, in which case the small issuance limitation is 10 percent of the total value of the loss corporation's stock outstanding at the beginning of the taxable year (excluding the value of stock described in section 1504(a)(4)); or

(*2*) On a class-by-class basis, in which case the small issuance limitation is 10 percent of the number of shares of the class outstanding at the beginning of the taxable year.

(B) *Class of stock defined.* For purposes of this paragraph (j)(2)(iii), a class of stock includes all stock with the same material terms.

(C) *Adjustments for stock splits and similar transactions.* Appropriate adjustments to the number of shares of a class outstanding at the beginning of a taxable year must be made to take into account any stock split, reverse stock split, stock dividend to which section 305(a) applies, recapitalization, or similar transaction occurring during the taxable year.

(D) *Exception.* The loss corporation may not apply this paragraph (j)(2)(iii) on a class-by-class basis if, during the taxable year, more than one class of stock is issued in a single issuance (or in two or more issuances that are treated as a single issuance under paragraph (j)(8)(ii) of this section).

(iv) *Short taxable years.* In the case of a taxable year that is less than 365 days, the small issuance limitation is reduced by multiplying it by a fraction, the numerator of which is the number of days in the taxable year, and the denominator of which is 365.

(3) *Other issuances of stock for cash*—(i) *In general.* If the loss corporation issues stock solely for cash, § 1.382–2T(j)(2)(iii)(B) does not apply to such stock in an amount equal (as a percentage of the total stock issued) to one-half of the aggregate percentage ownership interest of direct public groups immediately before the issuance.

(ii) *Solely for cash*—(A) *In general.* A share of stock is not issued solely for cash if—

(*1*) The acquiror, as a condition of acquiring that share for cash, is required to purchase other stock for consideration other than cash; or

(*2*) The share is acquired upon the exercise of an option that was not issued solely for cash or was not distributed with respect to stock.

(B) *Related issuances.* Paragraph (j)(8)(i) of this section (relating to the treatment of one or more issuances as a single issuance) does not apply in determining whether stock is issued solely for cash.

(iii) *Coordination with paragraph (j)(2) of this section.* This paragraph (j)(3) does not apply to a small issuance exempted in whole from § 1.382–2T(j)(2)(iii)(B) under paragraph (j)(2) of this section. In the case of a small issuance exempted in part from § 1.382–2T(j)(2)(iii)(B) under paragraph (j)(2) of this section, this paragraph (j)(3) applies only to the portion of the issuance not so exempted, and that portion is treated as a separate issuance for purposes of this paragraph (j)(3).

(4) *Limitation on exempted stock.* The total amount of stock that is exempted from the application of § 1.382–2T(j)(2)(iii)(B) under paragraphs (j)(2) and (j)(3) of this section cannot exceed the total amount of stock issued in the issuance less the amount of that stock owned by a 5-percent shareholder (other than a direct public group) immediately after the issuance. Except to the extent that the loss corporation has actual knowledge to the contrary, any increase in the amount of the loss corporation's stock owned by a 5-percent shareholder on the day of the issuance is considered to be attributable to an acquisition of stock in the issuance.

(5) *Proportionate acquisition of exempted stock*—(i) *In general.* Each direct public group that exists immediately before an issuance to which paragraph (j)(2) or (j)(3) of this section applies is treated as acquiring its proportionate share of the amount of stock exempted from the application of § 1.382–2T(j)(2)(iii)(B) under paragraph (j)(2) or (j)(3) of this section.

(ii) *Actual knowledge of greater overlapping ownership.* Under the last sentence of § 1.382–2T(k)(2), the loss corporation may treat direct public groups existing immediately before an issuance to which paragraph (j)(2) or (j)(3) of this section applies as acquiring in the aggregate more stock than the amount determined under paragraph (j)(5)(i) of this section, but only if the loss corporation actually knows that the aggregate amount acquired by those groups in the issuance exceeds the amount so determined.

(6) *Exception for equity structure shifts.* This paragraph (j) does not apply to any issuance of stock in an equity structure shift, except that paragraph (j)(2) of this section applies (if its requirements are met) to the issuance of stock in a recapitalization under section 368(a)(1)(E).

(7) *Transitory ownership by underwriter disregarded.* For purposes of § 1.382–2T(g)(1) and (j), and this paragraph (j), the transitory ownership of stock by an underwriter of the issuance is disregarded.

(8) *Certain related issuances.* For purposes of this paragraph (j), two or more issuances (including issuances of stock by first tier or higher tier entities) are treated as a single issuance if—

(i) The issuances occur at approximately the same time pursuant to the same plan or arrangement; or

(ii) A principal purpose of issuing the stock in separate issuances rather than in a single issuance is to minimize or avoid an owner shift under the rules of this paragraph (j).

(9) *Application to options.* The principles of this paragraph (j) apply for purposes of applying § 1.382–

2T(j)(2)(iii)(D) (relating to the deemed acquisition of stock as a result of the ownership of an option).

(10) *Issuance of stock pursuant to the exercise of certain options.* If stock is issued on the exercise of a transferable option issued by the loss corporation, §1.382–2T(j)(2)(iii)(F) does not apply and, in applying the last sentence of §1.382–2T(k)(2), the loss corporation must take into account any transfers of the option (including transfers described in §1.382–2T(h)(4)(xi)). Therefore, even if transferable options are distributed pro rata to members of existing public groups, the actual knowledge exception of §1.382–2T(k)(2) applies only to the extent that the loss corporation actually knows that the persons acquiring stock on exercise of the options are members of a pre-existing public group. Moreover, if transferable options are issued to more than one public group, §1.382–2T(j)(2)(iii)(F) does not apply to treat the options as exercised pro rata by each such public group as the options are actually exercised.

(11) *Application to first tier and higher tier entities.* The principles of this paragraph (j) apply to issuances of stock by a first tier entity or a higher tier entity that owns 5 percent or more of the loss corporation's stock (determined without regard to §1.382–2T(h)(2)(i)(A)).

(12) *Certain non-stock ownership interests.* As the context may require, a non-stock ownership interest in an entity other than a corporation is treated as stock for purposes of this paragraph (j).

(13) *Examples.* The provisions of this paragraph (j) are illustrated by the following examples:

Example 1. (i) L corporation is a calendar year taxpayer. On January 1, 1994, L has 1,000 shares of a single class of common stock outstanding, all of which are owned by a single direct public group (Public L). On February 1, 1994, L issues to employees as compensation 60 new common shares of the same class. On May 1, 1994, L issues 50 new common shares of the same class solely for cash. Following each issuance, L's stock is owned entirely by public shareholders. No other changes in the ownership of L's stock occur prior to May 1, 1994. L chooses to determine its small issuance limitation for 1994 on a class-by-class basis under paragraph (j)(2)(iii)(A)(*2*) of this section.

(ii) The February issuance is a small issuance because the number of shares issued (60) does not exceed 100, the small issuance limitation (10 percent of the number of common shares outstanding on January 1, 1994). Under paragraph (j)(2) of this section, the segregation rules of §1.382–2T(j)(2)(iii)(B) do not apply to the February issuance. Under paragraph (j)(5) of this section, Public L is treated as acquiring all 60 shares issued.

(iii) The May issuance is a small issuance because the number of shares issued (50) does not exceed 100, the small issuance limitation (10 percent of the number of common shares outstanding on January 1, 1994). However, under paragraph (j)(2) of this section, only 40 of the 50 shares issued are exempted from the segregation rules of §1.382–2T(j)(2)(iii)(B) because the total number of shares of common stock issued in the February and May issuances exceeds 100, the small issuance limitation, by 10. Because the May issuance is solely for cash, paragraph (j)(3) of this section exempts 5 of the 10 remaining shares from the segregation rules of §1.382–2T(j)(2)(iii)(B) (10 shares multiplied by 50 percent, one-half of Public L's 100 percent ownership interest immediately before the May issuance—1,060 shares/1,060 shares). Accordingly, under paragraph (j)(5) of this section, Public L is treated as acquiring 45 shares in the May issuance. Section 1.382–2T(j)(2)(iii)(B) applies to the remaining 5 shares issued, which are treated as acquired by a direct public group separate from Public L. Each such public group is treated as an individual who is a separate 5-percent shareholder. See §1.382–2T (g)(1)(iv) and (j)(1)(ii).

(iv) Assume that L actually knows that at least 10 shares of the May issuance are acquired by members of Public L. The result is the same. See paragraph (j)(5)(ii) of this section.

(v) Assume instead that L actually knows that all 50 shares of the May issuance are acquired by members of Public L. Under paragraph (j)(5)(ii) of this section, L may treat Public L as acquiring 50 shares in the May issuance.

Example 2. (i) L corporation is a calendar year taxpayer. On January 1, 1995, L has 1,000 shares of Class A common stock outstanding, the aggregate value of which is $1,000. Five hundred shares are owned by one direct public group (Public 1), and 500 shares are owned by another direct public group (Public 2). On August 1, 1995, L issues 200 shares of Class B common stock for $200 cash. A, an individual, acquires 120 Class B shares in the transaction. The remaining 80 Class B shares are acquired by public shareholders. No other changes in ownership of L's stock occur prior to August 1, 1995.

(ii) The August issuance is not a small issuance. The total value of the Class B stock issued ($200) exceeds $100, the small issuance limitation as calculated under paragraph (j)(2)(iii)(A)(*1*) of this section (10 percent of the value of L's stock on January 1, 1995). The total number of Class B shares issued (200) exceeds 0, the small issuance limitation as calculated under paragraph (j)(2)(iii)(A)(*2*) of this section (10 percent of the number of Class B shares outstanding on January 1, 1995). Accordingly, paragraph (j)(2) of this section does not apply to the August issuance.

(iii) Paragraph (j)(3) of this section, as limited by paragraph (j)(4) of this section, exempts 80 Class B shares from the segregation rule of § 1.382–2T(j)(2)(iii)(B). Paragraph (j)(3) of this section, without regard to paragraph (j)(4) of this section, would exempt 100 Class B shares: the product of the 200 Class B shares issued and 50 percent (one-half of the combined 100 percent pre-issuance ownership interest of Public 1 and Public 2). Paragraph (j)(4), however, limits the total number of Class B shares that may be excluded to 80 Class B shares: the difference between the 200 shares issued and the 120 shares acquired by A. Under paragraph (j)(5) of this section, Public 1 and Public 2 are treated as acquiring the 80 exempted Class B shares. Because Public 1 and Public 2 each owned 500 Class A shares prior to the issuance, Public 1 and Public 2 are considered to acquire 40 Class B shares each.

Example 3. (i) L has 1,000 shares of a single class of common stock outstanding, all of which are owned by a direct public group (Public L). At the same time pursuant to the same plan, L issues 500 shares of its stock to its creditors in exchange for its outstanding debt and 500 shares of its stock to the public for cash. Assume that the separate issuances of stock for debt and stock for cash do not have a principal purpose of minimizing or avoiding an owner shift. L has no individual 5-percent shareholders immediately after the issuances.

(ii) The 500 shares of stock issued by L to its former creditors were not issued solely for cash. Therefore, paragraph (j)(3) of this section does not apply to those 500 shares, which are treated as owned by a public group separate from Public L. See § 1.382–2T(j)(2)(iii)(B)(*1*)(*ii*).

(iii) Paragraph (j)(3) of this section applies to the 500 shares of stock issued by L to the public because that stock was issued solely for cash. Because the two issuances occur at the same time pursuant to the same plan, they are generally treated as a single issuance for purposes of this paragraph (j). See paragraph (j)(8)(i) of this section. The treatment of the two issuances as a single issuance does not apply, however, for the purpose of determining whether the stock issued to the public was issued solely for cash. See paragraph (j)(3)(ii)(B) of this section.

(iv) Paragraph (j)(3) of this section applies to exempt 250 of the 500 shares issued solely for cash from the segregation rules of § 1.382–2T(j)(2)(iii)(B) (the product of the 500 shares issued for cash and 50 percent (one-half of the 100 percent pre-issuance ownership interest of Public L)). The creditors that receive stock in exchange for their debt would not be treated as acquiring any of the 250 exempted shares even if their exchange of debt for stock occurs prior to the cash issuance. Paragraph (j)(5)(i) of this section allocates exempted shares among the direct public groups that exist immediately before an issuance. Because the issuance for cash and the issuance for debt are generally treated as a single issuance, the public group comprised of the former creditors of L was not a public group that existed immediately before the issuance.

(v) Three public groups owning L stock exist immediately after the two issuances. Public L owns 1,250 shares—the 1,000 shares it owned prior to the issuances plus the 250 shares it is treated as acquiring in the cash issuance. A separate group comprised of the former creditors of L owns the 500 shares issued for debt. A third public group owns the 250 shares that are not treated as acquired by Public L in the cash issuance.

Example 4. (i) L has 1,000 shares of a single class of common stock outstanding, all of which are owned by a direct public group (Public L). L issues 1,000 shares pursuant to an offer under which 500 shares must be acquired in exchange for debt and the remainder may be acquired for cash. Under the terms of the offer, only persons that acquire stock for debt are eligible to acquire stock for cash. L has no 5-percent shareholders other than direct public groups immediately after the issuance.

(ii) As a condition of acquiring shares for cash, the creditors are required to purchase stock for debt. Therefore, paragraph (j)(3) of this section does not apply to any part of the issuance because it is not an issuance of stock solely for cash. The segregation rules of § 1.382–2T(j)(2)(iii)(B) apply to treat all 1,000 shares as acquired by a new public group separate from Public L.

(14) *Effective date*—(i) *In general.* Except as otherwise provided in this paragraph (j)(14), this paragraph (j) applies to issuances or deemed issuances of stock in taxable years beginning on or after November 4, 1992.

(ii) *Effective date for paragraph (j)(10) of this section.* Paragraph (j)(10) of this section applies to stock issued on the exercise of an option issued on or after November 4, 1992, unless the option was issued before May 4, 1993, and the issuer, on or before November 4, 1992, filed a registration statement with the Securities and Exchange Commission (or a comparable document with a

State agency regulating securities) for the specific purpose of such issuance.

(iii) *Election to apply this paragraph (j) retroactively*—(A) *Election.* A loss corporation may elect to apply paragraphs (j)(1) through (j)(13) of this section to all issuances or deemed issuances of stock to which §1.382–2T(j)(2)(iii)(B) or (D) applied (or would have applied taking paragraph (j)(7) of this section into account) occurring in taxable years beginning prior to November 4, 1992. This election is made by filing with the loss corporation's first income tax return filed more than 60 days after October 4, 1993, the statement, ''This is an Election to Apply §1.382–3(j) Retroactively,'' accompanied by the amended returns and revised information statements described in paragraphs (j)(14)(iii)(B) and (C) of this section. An election under this paragraph (j)(14)(iii) is irrevocable.

(B) *Amended returns.* If the retroactive application of the rules of this paragraph (j) affects the amount of taxable income or loss for a prior taxable year, then, except as precluded by the applicable statute of limitations, the loss corporation (or the common parent of any consolidated group of which the loss corporation was a member for the year) must file an amended return for the year that reflects the effects of the retroactive application of the rules of this paragraph (j). If the statute of limitations precludes the filing of an amended return for one or more such prior taxable years, the loss corporation (or the common parent) must make appropriate adjustments under the principles of section 382(l)(2)(A) in subsequent taxable years to reflect the difference between the losses and credits actually used in such prior taxable years and the amount that would have been used in those years applying the rules of this paragraph (j).

(C) *Revised information statements.* If the retroactive application of the rules of this paragraph (j) affects the information reported on an information statement filed for any prior taxable year pursuant to §1.382–2T(a)(2)(ii), then the loss corporation (or the common parent of any consolidated group of which the loss corporation was a member for the year) must file a revised information statement for the year that reflects the retroactive application of the rules of this paragraph (j).

(k) *Special rules for certain regulated investment companies*—(1) *In general.* The segregation rules of §1.382–2T(j)(2) do not apply to the issuance (as described in §1.382–2T(j)(2)(iii)(B)(1)(*ii*)) or the redemption (as described in §1.382–2T(j)(2)(iii)(C)) of any redeemable security, as defined in 15 U.S.C. 80a–2(a)(32), by a regulated investment company in the ordinary course of business.

(2) *Effective date*—(i) *General rule.* Paragraph (k)(1) of this section applies to testing dates after December 31, 1986. A corporation may file an amended return for taxable years ending before August 21, 1992 (subject to any applicable statute of limitations) to take into account paragraph (k)(1) of this section only if corresponding adjustments are made in amended returns for all affected taxable years ending after December 31, 1986 (subject to any applicable statute of limitations).

(ii) *Election to apply prospectively.* A corporation may elect to apply paragraph (k)(1) of this section only to testing dates on or after October 29, 1991. The election must be made on the first return which is filed after October 20, 1992 by stating on such return, ''This is an Election To Apply §1.382–3(k)(1) Only to Testing Dates on or After October 29, 1991.''

[T.D. 8428, 57 FR 38282, Aug. 24, 1992. Redesignated by T.D. 8440, 57 FR 45712, Oct. 5, 1992; 57 FR 52827, Nov. 5, 1992; T.D. 8490, 59 FR 51573, Oct. 4, 1993]

§1.382–4 Constructive ownership of stock.

(a) *In general.* [Reserved]

(b) *Attribution from corporations, partnerships, estates and trusts.* [Reserved]

(c) *Attribution to corporations, partnerships, estates and trusts.* [Reserved]

(d) *Treatment of options as exercised*—(1) *General rule.* Except as provided in paragraph (d)(2) of this section, an option is not treated as exercised under section 382(l)(3)(A).

(2) *Options treated as exercised*—(i) *Issuance or transfer.* For purposes of determining whether an ownership change occurs, an option is treated as exercised on the date of its issuance or transfer if, on that date, the option satisfies—

(A) The ownership test of paragraph (d)(3) of this section,

(B) The control test of paragraph (d)(4) of this section, or

(C) The income test of paragraph (d)(5) of this section.

(ii) *Subsequent testing dates.* Except as provided in paragraph (d)(10) of this section, an option that is treated as exercised on the date of its issuance or transfer is treated as exercised on any subsequent testing date (as defined in § 1.382–2(a)(4)) for purposes of determining whether an ownership change occurs.

(3) *The ownership test.* An option satisfies the ownership test if a principal purpose of the issuance, transfer, or structuring of the option (alone or in combination with other arrangements) is to avoid or ameliorate the impact of an ownership change of the loss corporation by providing the holder of the option, prior to its exercise or transfer, with a substantial portion of the attributes of ownership of the underlying stock.

(4) *The control test*—(i) *In general.* An option satisfies the control test if—

(A) A principal purpose of the issuance, transfer, or structuring of the option (alone or in combination with other arrangements) is to avoid or ameliorate the impact of an ownership change of the loss corporation, and

(B) The holder of the option and any persons related to the option holder have, in the aggregate, a direct and indirect ownership interest in the loss corporation of more than 50 percent (determined as if the increase in such persons' percentage ownership interest that would result from the exercise of the option in question and any other options to acquire stock held by such persons, and any other intended increases in such persons' percentage ownership interest, actually occurred on the date the option is issued or transferred).

(ii) *Operating rules*—(A) *Person and related persons.* For purposes of this paragraph (d)(4)—

(*1*) The term *person* includes an individual or entity, but not a public group, as defined in § 1.382–2T(f)(13), and

(*2*) Persons are related if they bear a relationship specified in section 267(b) or 707(b) or if they have a formal or informal understanding among themselves to make a coordinated acquisition of stock, within the meaning of § 1.382–3(a)(1)(i).

(B) *Indirect ownership interest.* The indirect ownership interest that the holder of the option and any persons related to the holder have in the loss corporation is determined by applying the constructive ownership rules of § 1.382–2T(h), other than § 1.382–2T(h)(2)(i)(A) (which treats stock attributed pursuant to section 318(a)(2) as no longer being owned by the entity from which it is attributed) and § 1.382–2T(h)(4) (which treats options as exercised in certain circumstances). If, however, the application of such constructive ownership rules without regard to § 1.382–2T(h)(2)(i)(A) would result in the same stock of the loss corporation being owned by two or more such persons, appropriate adjustments must be made so that such stock is not counted more than once in computing the aggregate ownership interests of such persons.

(5) *The income test.* An option satisfies the income test if a principal purpose of the issuance, transfer, or structuring of the option (alone or in combination with other arrangements) is to avoid or ameliorate the impact of an ownership change of the loss corporation by facilitating the creation of income (including accelerating income or deferring deductions) or value (including unrealized built-in gains) prior to the exercise or transfer of the option.

(6) *Application of the ownership, control, and income tests*—(i) *In general.* Whether an option satisfies the ownership, control, or income test depends on all the relevant facts and circumstances. Among the factors that are relevant in applying all three tests are any business purposes for the issuance, transfer, or structure of the option, the likelihood of exercise of the option (taking into account, for example, any contingencies to its exercise), transactions related to the issuance or transfer of the option, and the consequences of treating the option as exercised.

An option is not treated as exercised under any of the three tests, however, if a principal purpose of its issuance, transfer, or structuring is to avoid an ownership change by having it treated as exercised. Paragraphs (d)(6)(ii), (iii) and (iv) of this section describe additional examples of factors that are relevant in applying each test. The weight given to any factor depends on all the facts and circumstances. The presence or absence of any factor described in this paragraph (d)(6) does not create a presumption.

(ii) *Application of ownership test.* Among the additional factors that are taken into account in applying the ownership test are the relationship, at the time of issuance or transfer of the option, between the exercise price of the option and the value of the underlying stock, whether the option provides its holder or a related person with the right to participate in the management of the loss corporation or with other rights that ordinarily would be afforded to owners of the underlying stock, and the existence of reciprocal options (e.g., a call option held by the prospective purchaser and a corresponding put option held by the prospective seller). The ability of the holder of an option with a fixed exercise price to share in future appreciation of the underlying stock is also a relevant factor, but is not sufficient, by itself, for the option to satisfy the ownership test. Conversely, the fact that the holder of such an option does not bear the risk of loss due to declines in value of the underlying stock does not preclude the option from satisfying the ownership test.

(iii) *Application of control test.* Among the additional factors that are taken into account in applying the control test are the economic interests in the loss corporation of the option holder or related persons and the influence of those persons over the management of the loss corporation (in either case, through the option or a related arrangement, or through rights in stock).

(iv) *Application of income test.* Among the additional factors that are taken into account in applying the income test are whether, in connection with the issuance or transfer of the option, the loss corporation engages in income acceleration transactions or the holder of the option or a related person purchases stock (including section 1504(a)(4) stock) from, or makes a capital contribution or loan to, the loss corporation that can reasonably be expected to avoid or ameliorate the impact of an ownership change. Examples of income acceleration transactions are those outside the ordinary course of the loss corporation's business that accelerate income or gain into the period prior to the exercise of the option (or defer deductions to the period after the exercise of the option). A stock purchase, capital contribution, or loan is more probative toward an option satisfying the income test the larger the amount received by the loss corporation in the transaction or related transactions. A stock purchase, capital contribution, or loan is generally not taken into account in applying the income test if it is made to enable the loss corporation to continue basic operations of its business (*e.g.*, to meet the monthly payroll or fund other operating expenses of the loss corporation).

(7) *Safe harbors.* Except as provided in paragraph (d)(7)(i) of this section, an option described in this paragraph (d)(7) is not treated as exercised pursuant to the ownership, control, or income test. The failure of an option to be described in this paragraph (d)(7) does not affect the determination of whether the option satisfies the ownership, income, or control test. The following options are described in this paragraph (d)(7):

(i) *Contracts to acquire stock.* A stock purchase agreement or a similar arrangement, the terms of which are commercially reasonable, in which the parties' obligations to complete the transaction are subject only to reasonable closing conditions, and which is closed on a change date within one year after it is entered into. An option is not exempt from the income test of paragraph (d)(5) of this section solely by reason of its description in this paragraph (d)(7)(i).

(ii) *Escrow, pledge, or other security agreements.* An option that is part of a security arrangement in a typical lending transaction (including a purchase money loan), if the arrangement is subject to customary commercial conditions. For this purpose, a security arrangement includes, for example, an agreement for holding stock in escrow or under a pledge or other security agreement, or an option to acquire stock contingent upon a default under a loan.

(iii) *Compensatory options.* An option to acquire stock in a corporation with customary terms and conditions provided to an employee, director, or independent contractor in connection with the performance of services for the corporation or a related person (and that is not excessive by reference to the services performed) and which—

(A) Is nontransferable within the meaning of § 1.83–3(d); and

(B) Does not have a readily ascertainable fair market value as defined in § 1.83–7(b) on the date the option is issued.

(iv) *Options exercisable only upon death, disability, mental incompetency, or retirement.* An option entered into between stockholders of a corporation (or a stockholder and the corporation) with respect to stock of either stockholder, that is exercisable only upon the death, disability, mental incompetency of the stockholder, or, in the case of stock acquired in connection with the performance of services for the corporation or a related person (and that is not excessive by reference to the services performed), the stockholder's retirement.

(v) *Rights of first refusal.* A bona fide right of first refusal with customary terms, entered into between stockholders of a corporation (or between the corporation and a stockholder), and regarding the corporation's stock.

(vi) *Options designated in the Internal Revenue Bulletin.* An option designated by the Internal Revenue Service in the Internal Revenue Bulletin as being exempt from one or more of the ownership, control, or income tests. See § 601.601(d)(2)(ii) of this chapter (relating to the Internal Revenue Bulletin).

(8) *Additional rules*—(i) *Contracts to acquire stock.* For purposes of this paragraph (d), a contract is considered to be issued or transferred on the date it is entered into or assigned, respectively.

(ii) *Indirect transfer of an option.* If an entity is formed or availed of for a principal purpose of facilitating an indirect transfer of an option by issuing or transferring interests in the entity, an issuance or transfer of an interest in the entity will be treated as a transfer of the option for purposes of applying the ownership, control, and income tests of paragraphs (d)(3) through (5) of this section.

(iii) *Options related to interests in non-corporate entities.* The rules of this paragraph (d) apply, with appropriate adjustments, to options to acquire or transfer interests in non-corporate entities.

(iv) *Puts.* In applying the rules of this section to puts, appropriate adjustments must be made to take into account that the put provides its holder with a right to transfer, instead of acquire, stock.

(9) *Definition of option*—(i) *In general.* Any contingent purchase, warrant, convertible debt, put, stock subject to a risk of forfeiture, contract to acquire stock, or similar interest is treated as an option for purposes of this paragraph (d), regardless of whether it is contingent or otherwise not currently exercisable.

(ii) *Convertible stock.* Convertible stock is treated as an option for purposes of this paragraph (d) (in addition to being treated as stock under § 1.382–2(a)(3)(ii)) only if the terms of the conversion feature permit or require consideration other than the stock being converted.

(iii) *Series of options.* For purposes of this paragraph (d), an option to acquire an option with respect to the stock of the loss corporation, and each one of a series of such options, is treated as an option to acquire such stock.

(iv) *General principles of tax law.* This paragraph (d) does not affect the determination under general principles of tax law (such as substance over form) of whether an instrument is an option or stock.

(10) *Subsequent treatment of options treated as exercised on a change date*—(i) *In general.* The following rules apply to options that are treated as exercised under paragraph (d)(2) of this section on a change date:

(A) The option is not treated as exercised under paragraph (d)(2) of this section on any testing date after the change date and prior to a transfer of the option that would itself (*i.e.,* without regard to the purposes for the issuance or any prior transfers of the option) cause the option to satisfy the ownership test of paragraph (d)(3) of this section, the control test of paragraph (d)(4) of this section, or the income test of paragraph (d)(5) of this section; and

(B) The exercise of the option, if by the person who owned the option immediately after the ownership change (or by a transferee of the option who acquired the option, directly or indirectly, from that person in one or more transfers described in paragraph (d)(11) of this section), does not contribute to another ownership change on any testing date on or after the date of exercise.

(ii) *Alternative look-back rule for options exercised within 3 years after change date.* If a loss corporation, on its return, as originally filed, for a taxable year that includes a change date, properly treats an option as exercised under paragraph (d)(2) of this section on the change date, and the option is actually exercised within three years after the change date, the loss corporation may treat the rules of paragraph (d)(10)(i) of this section as inapplicable to the option and instead treat the option as having been exercised on the change date for the purpose of determining whether an ownership change occurs on any and all testing dates after the change date (filing such amended returns as may be necessary for taxable years ending after the change date and before the date of exercise of the option). A transfer after the change date of an option to which this paragraph (d)(10)(ii) applies is treated as a transfer of the stock subject to the option. The exercise of an option to which this paragraph (d)(10)(ii) applies is not taken into account for the purpose of determining whether an ownership change occurs on or after the date of exercise.

(11) *Transfers not subject to deemed exercise.* Paragraph (d)(2) of this section does not apply to the transfer of an option (including a transfer described in paragraph (d)(8)(i) or (ii) of this section), if—

(i) Neither the transferor nor the transferee is a 5-percent shareholder and neither person would be a 5-percent shareholder if all options held by that person to acquire stock were treated as exercised;

(ii) The transfer is between members of separate public groups resulting from the application of the segregation rules of §1.382–2T(j)(2) and (3)(iii); or

(iii) The transfer occurs in any of the circumstances described in section 382(l)(3)(B) (relating to stock acquired by reason of death, gift, divorce, separation, etc.).

(12) *Certain rules regarding non-stock interests as stock.* Section 1.382–2T(f)(18)(iii) does not apply to treat an option (whether or not treated as exercised under this paragraph (d)) as stock.

(e) *Stock transferred under certain agreements.* [Reserved]

(f) *Family attribution.* [Reserved]

(g) *Definitions.* The terms and nomenclature used in this section, and not otherwise defined herein, have the same meaning as in section 382 and the regulations thereunder.

(h) *Effective date*—(1) *In general.* [Reserved]

(2) *Option attribution rules*—(i) *General rule.* The rules of paragraph (d) of this section apply, instead of the rules of §1.382–2T(h)(4), on any testing date on or after November 5, 1992. See paragraph (h)(2)(vi) of this section for an election relating to the effective date.

(ii) *Special rule for control test.* An option issued on or before March 17, 1994, or an option issued within 60 days after that date pursuant to a plan existing before that date, is not treated as exercised under the control test provided in paragraph (d)(4) of this section on any testing date prior to a transfer of the option after March 17, 1994 that would itself cause the option to satisfy the control test.

(iii) *Convertible stock issued prior to July 20, 1988*—(A) *In general.* Except as provided in paragraph (h)(2)(iii)(B) of this section, convertible stock issued prior to July 20, 1988, is not treated as an option subject to the rules of §1.382–2T(h)(4) or paragraph (d)(2) of this section.

(B) *Exceptions*—(*1*) *Nonvoting convertible preferred stock.* Convertible stock issued prior to July 20, 1988, is treated as an option subject to the rules of §1.382–2T(h)(4) or paragraph (d)(2) of this section if—

(*i*) The stock, when issued, would be described in section 1504(a)(4) by disregarding subparagraph (D) thereof and by ignoring the potential participation in corporate growth that the conversion feature may offer; and

(*ii*) The loss corporation makes the election described in Notice 88–67, 1988–1 C.B. 555 (see § 601.601(d)(2)(ii)(*b*) of this chapter for availability of Cumulative Bulletins (C.B.)), on or before the earlier of the date prescribed in Notice 88–67 or December 7, 1992.

(*2*) *Other convertible stock.* Convertible stock issued prior to July 20, 1988, is treated as an option subject to the rules of § 1.382–2T(h)(4) or paragraph (d)(2) of this section if—

(*i*) The terms of the conversion feature permit or require the tender of consideration other than the stock being converted; and

(*ii*) The loss corporation makes the election described in Notice 88–67 on or before the date prescribed in the Notice.

(iv) *Convertible stock issued on or after July 20, 1988, and before November 5, 1992.* Convertible stock issued on or after July 20, 1988, and before November 5, 1992, is treated as an option subject to the rules of § 1.382–2T(h)(4) or paragraph (d) of this section only if—

(A) The stock, when issued, would be described in section 1504(a)(4) by disregarding subparagraph (D) thereof and by ignoring the potential participation in corporate growth that the conversion feature may offer; or

(B) The terms of the conversion feature permit or require the tender of consideration other than the stock being converted.

(v) *Certain options in existence immediately before and after an ownership change.* If an option existed immediately before and after an ownership change occurring on a testing date to which § 1.382–2T(h)(4) applies—

(A) The option is not treated as exercised under paragraph (d)(2) of this section on any testing date after the change date and prior to a transfer of the option that would itself cause the option to satisfy the ownership test of paragraph (d)(3) of this section, the control test of paragraph (d)(4) of this section, or the income test of paragraph (d)(5) of this section; and

(B) Except as provided in § 1.382–2T(m)(4)(vi) (which relates to the effective date of the rules provided in § 1.382–2T(h)(4) and includes a special rule related to options that are actually exercised within 120 days after they are treated as exercised under that section), the actual exercise of the option, if by the person who owned the option immediately after the ownership change (or by a transferee of the option who acquired the option, directly or indirectly, from that person in one or more transfers described in paragraph (d)(11) of this section), will not contribute to an ownership change on any testing date on or after the date of exercise.

(vi) *Election to apply § 1.382–2T(h)(4)*—(A) *In general.* If a loss corporation makes an election under this paragraph (h)(2)(vi), §§ 1.382–2T(a)(2)(i) and (h)(4) (relating to testing dates and option attribution) apply (instead of the definition of testing date in § 1.382–2(a)(4) and paragraph (d) of this section) for the purpose of determining whether an ownership change occurs—

(*1*) On any testing date on or before May 17, 1994, or

(*2*) In the case of a loss corporation that is under the jurisdiction of a court in a title 11 or similar case filed on or before May 17, 1994, subject to § 1.382–9(o)(1), on any testing date at or before the time the plan of reorganization becomes effective.

(B) *Additional consequences of election.* If a loss corporation makes an election under this paragraph (h)(2)(vi)—

(*1*) In determining whether any convertible preferred stock issued by the loss corporation during the period that the election is in effect is treated as stock or as an option, the convertible preferred stock is treated as if it were issued on November 4, 1992, and

(*2*) The special effective date for the control test provided in paragraph (h)(2)(ii) of this section does not apply to any option with respect to stock of the loss corporation.

(C) *Time and manner of making the election.* The election described in paragraph (h)(2)(vi)(A) of this section is made by attaching a statement to the loss corporation's income tax return for the first taxable year ending after November 4, 1992, in which a testing date (within the meaning of §1.382–2T(a)(2)(i)) occurs, or if such return is filed on or before May 17, 1994, with its first return filed after May 17, 1994. However, a loss corporation that is under the jurisdiction of a court in a title 11 or similar case filed on or before May 17, 1994, may make the election described in paragraph (h)(2)(vi)(A) by attaching a statement to its tax return for its first taxable year ending after that date. The statement must say ''THIS IS AN ELECTION UNDER §1.382–4(h)(2)(vi) TO APPLY §1.382–2T(h)(4) ON OR AFTER NOVEMBER 5, 1992.'' Any amended returns required by paragraph (h)(2)(vi)(D) of this section must accompany the return with which the election is made. An election under paragraph (h)(2)(vi)(A) of this section is irrevocable.

(D) *Amended returns.* If an election under this paragraph (h)(2)(vi) affects the amount of taxable income or loss for a prior taxable year, the loss corporation (or the common parent of any consolidated group of which the loss corporation was a member for the year) must file an amended return for the year that reflects the effect of the election.

(3) *Special rule for options subject to attribution under §1.382–2T(h)(4).* Section §1.382–2T(h)(4)(i) does not apply to any option designated by the Internal Revenue Service in the Internal Revenue Bulletin as being excepted from the operation of §1.382–2T(h)(4)(i).

[T.D. 8531, 59 FR 12837, Mar. 18, 1994]

§1.382–5 Section 382 limitation. [Reserved]

§1.382–5T Section 382 limitation (temporary).

(a) *Scope.* Following an ownership change, the section 382 limitation for any post-change year is an amount equal to the value of the loss corporation multiplied by the long-term tax-exempt rate that applies with respect to the ownership change, and adjusted as required by section 382 and the regulations thereunder. See, for example, section 382(b)(2) (relating to the carryforward of unused section 382 limitation), section 382(b)(3)(B) (relating to the section 382 limitation for the post-change year that includes the change date), section 382(m)(2) (relating to short taxable years), and section 382(h) (relating to recognized built-in gains and section 338 gains).

(b) *Computation of value.* [Reserved]

(c) *Short taxable year.* The section 382 limitation for any post-change year that is less than 365 days is the amount that bears the same ratio to the section 382 limitation determined under section 382(b)(1) as the number of days in the post-change year bears to 365. The section 382 limitation, as so determined, is adjusted as required by section 382 and the regulations thereunder. This paragraph (c) does not apply to a 52–53 week taxable year that is less than 365 days unless a return is required under section 443 (relating to short periods) for such year.

(d) *Successive ownership changes and absorption of a section 382 limitation*—(1) *In general.* If a loss corporation has two (or more) ownership changes, any losses attributable to the period preceding the earlier ownership change are treated as pre-change losses with respect to both ownership changes. Thus, the later ownership change may result in a lesser (but never in a greater) section 382 limitation with respect to such losses. In any case, the amount of taxable income for any post-change year that can be offset by pre-change losses may not exceed the section 382 limitation for such ownership change, reduced by the amount of taxable income offset by pre-change losses subject to any earlier ownership change(s).

(2) *Recognized built-in gains and losses.* [Reserved]

(3) *Effective date.* This paragraph (d) applies to taxable years of a loss corporation beginning on or after January 1, 1997.

(e) *Controlled groups.* See §1.382–8T for rules for determining the value of a loss corporation that is a member of a controlled group.

(f) *Effective date.* Except as otherwise provided, this section applies to a loss corporation that has an ownership change to which section 382(a), as amended by the Tax Reform Act of 1986, applies.

[T.D. 8679, 61 FR 33316, June 27, 1996]

§ 1.382–6 Allocation of income and loss to periods before and after the change date for purposes of section 382.

(a) *General rule.* Except as provided in paragraphs (b) and (d) of this section, a loss corporation must allocate its net operating loss or taxable income (see section 382(k)(4)), and its net capital loss (see section 1222(10)) or modified capital gain net income (as defined in paragraph (g)(4) of this section), for the change year between the pre-change period and the post-change period by ratably allocating an equal portion to each day in the year.

(b) *Closing-of-the-books election*—(1) *In general.* Subject to paragraphs (b)(3)(ii) and (d) of this section, a loss corporation may elect to allocate its net operating loss or taxable income and its net capital loss or modified capital gain net income for the change year between the pre-change period and the post-change period as if the loss corporation's books were closed on the change date. An election under this paragraph (b)(1) does not terminate the loss corporation's taxable year as of the change date (e.g., the change year is a single tax year for purposes of section 172).

(2) *Making the closing-of-the-books election*—(i) *Time and manner.* A loss corporation makes the closing-of-the-books election by including the following statement on the information statement required by § 1.382–2T(a)(2)(ii) for the change year: ''THE CLOSING-OF-THE-BOOKS ELECTION UNDER § 1.382–6(b) IS HEREBY MADE WITH RESPECT TO THE OWNERSHIP CHANGE OCCURRING ON [INSERT DATE].'' The election must be made on or before the due date (including extensions) of the loss corporation's income tax return for the change year.

(ii) *Election irrevocable.* An election under this paragraph (b) is irrevocable.

(3) *Special rules relating to consolidated and controlled groups*—(i) *Consolidated groups.* If an election under this paragraph (b) is made with respect to an ownership change occurring in a consolidated return year, all allocations under this section with respect to that ownership change must be consistent with the election.

(ii) *Controlled groups.* If paragraph (b)(3)(i) of this section does not apply, and if, as part of the same plan or arrangement, two or more members of a controlled group (as defined in section 1563(a), determined by substituting ''50 percent'' for ''80 percent'' each place that it appears, and without regard to section 1563(a)(4)), have ownership changes and continue to be members of the controlled group (or become members of the same other controlled group), a closing-of-the-books election applies only if the election is made by all members having the ownership changes.

(c) *Operating rules for determining net operating loss, taxable income, net capital loss, modified capital gain net income, and special allocations.* For purposes of this section, for the change year—

(1) *In general*—(i) Net operating loss or taxable income is determined without regard to gains or losses on the sale or exchange of capital assets; and

(ii) Net operating loss or taxable income and net capital loss or modified capital gain net income are determined without regard to the section 382 limitation and do not include the following items, which are allocated entirely to the post-change period—

(A) Any income, gain, loss, or deduction to which section 382(h)(5)(A) applies; and

(B) Any income or gain recognized on the disposition of assets transferred to the loss corporation during the post-change period for a principal purpose of ameliorating the section 382 limitation.

(2) *Adjustment to net operating loss*—(i) *Determination of remaining capital gain.* The amount of modified capital gain net income (defined in paragraph (g)(4) of this section) allocated to each period is offset by capital losses to which section 382(h)(5)(A) applies and capital loss carryovers, subject to the section 382 limitation (in the case of modified capital gain net income allocated to the post-change period).

(ii) *Reduction of net operating loss by remaining capital gain.* The amount of net operating loss allocated to each period is reduced (but not below zero) without regard to the section 382 limitation, first by the modified capital gain net income remaining in the same period, and then by the modified capital gain net income remaining in the other period.

(d) *Coordination with rules relating to the allocation of income under §1.1502–76(b).* If §1.1502–76 applies (relating to the taxable year of members of a consolidated group), an allocation of items under paragraph (a) or (b) of this section is determined after applying §1.1502–76. Thus, if a short taxable year under §1.1502–76 is a change year for which an allocation under this section is to be made, the allocation under this section applies only to the items allocated to that short taxable year under §1.1502–76.

(e) *Allocation of certain credits.* The principles of this section apply for purposes of allocating, under section 383, excess foreign taxes under section 904(c), current year business credits under section 38, and the minimum tax credit under section 53. The loss corporation must use the same method of allocation (ratable allocation or closing-of-the-books) for purposes of sections 382 and 383.

(f) *Examples.* The rules of this section are illustrated by the following examples:

Example 1. (i) Assume that the loss corporation, L, a calendar year taxpayer with a May 26, 1995, change date, determines a section 382 limitation under section 382(b)(1) of $100,000. Thus, for the change year, its section 382 limitation is $100,000 × (219/365)=$60,000. L makes the closing-of-the-books election under paragraph (b) of this section.

(ii) Assume that L has a $150,000 capital loss carryover (from its 1994 taxable year) and a $300,000 net operating loss carryover (from its 1994 taxable year) to the change year. L recognizes, in the pre-change period, $200,000 of ordinary loss, and, in the post-change period, $150,000 of capital gain and $100,000 of ordinary income. Assume that section 382(h) does not apply to the capital gain or the ordinary income.

(iii) L has a $100,000 net operating loss for the change year ($200,000 pre-change loss less $100,000 post-change income), as determined under paragraph (c)(1)(i) of this section. Because L has no current year capital losses, L's $150,000 capital gain recognized in the post-change period is its modified capital gain net income for the change year (as defined at paragraph (g)(4) of this section). L allocates $100,000 of net operating loss to the pre-change period and $150,000 of modified capital gain net income to the post-change period.

(iv) Under paragraph (c)(2)(i) of this section, L uses its capital loss carryover to offset its modified capital gain net income allocated to the post-change period, subject to its section 382 limitation. L's section 382 limitation is $60,000, so L uses $60,000 of its capital loss carryover to offset $60,000 of its $150,000 modified capital gain net income. L has absorbed its entire section 382 limitation for the change year and has $90,000 of modified capital gain net income remaining in the post-change period.

(v) Under paragraph (c)(2)(ii) of this section, L offsets its $100,000 net operating loss allocated to the pre-change period by the $90,000 of modified capital gain net income remaining in the post-change period, without regard to the section 382 limitation, thereby reducing its pre-change net operating loss to $10,000.

(vi) From its 1994 taxable year, L will carry over $90,000 of capital loss and $300,000 of net operating loss to its 1996 taxable year. From its 1995 taxable year, L will carry over $10,000 of net operating loss subject to the section 382 limitation to its 1996 taxable year.

Example 2. (i) Assume the facts of *Example 1,* except that L does not make the closing-of-the-books election under paragraph (b) of this section.

(ii) L ratably allocates its $100,000 net operating loss and its $150,000 of modified capital gain net income for the change year. $40,000 of net operating loss ($100,000 × (146/365)) and $60,000 of modified capital gain net income ($150,000 × (146/365)) are allocated to the pre-change period. $60,000 of net operating loss ($100,000 × (219/365)) and $90,000 of modified capital gain net income ($150,000 × (219/365)) are allocated to the post-change period.

(iii) Under paragraph (c)(2)(i) of this section, L uses its capital loss carryovers to offset modified capital gain net income. The capital loss carryovers offset the $60,000 modified capital gain net income allocated to the pre-change period without limitation. Subject to the section 382 limitation, the remaining $90,000 of capital loss carryovers offset the modified capital gain net income allocated to the post-change period. Accordingly, L uses $60,000 of its capital loss carryovers to offset $60,000 of its $90,000 modified capital gain net income allocated to the post-change period. L has absorbed its entire section 382 limitation for the change year.

(iv) Under paragraph (c)(2)(ii) of this section, L's $60,000 net operating loss allocated to the post-change period is offset by its remaining $30,000 of post-change modified capital gain net income, reducing its post-change net operating loss to $30,000.

(v) From its 1994 taxable year, L will carry over $30,000 of capital loss and $300,000 of net operating loss to its 1996 taxable year. From its 1995 taxable year, L will carry over $70,000 of net operating loss ($40,000 pre-change +$30,000 post-change) to its 1996 taxable year. The $40,000 pre-change portion of that carryover is subject to the section 382 limitation.

(g) *Definitions and nomenclature.* The terms and nomenclature used in this section and not otherwise defined herein have the same meanings as in sections 382 and 383 and the regulations thereunder. For purposes of this section:

(1) *Change year.* A loss corporation's taxable year that includes the change date is its *change year.*

(2) *Pre-change period.* The *pre-change period* is the portion of the change year ending on the close of the change date.

(3) *Post-change period.* The *post-change period* is the portion of the change year beginning with the day after the change date.

(4) *Modified capital gain net income.* A loss corporation's *modified capital gain net income* is the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges for the change year, determined by excluding any short-term capital losses under section 1212.

(h) *Effective date.* This section applies to ownership changes occurring on or after June 22, 1994.

[T.D. 8546, 59 FR 32080, June 22, 1994]

§ 1.382–7 Built-in gains and losses. [Reserved]

§ 1.382–8 Controlled groups. [Reserved]

§ 1.382–8T Controlled groups (temporary).

(a) *Introduction.* This section provides rules to adjust the value of a loss corporation that is a member of a controlled group of corporations on a change date so that the same value is not included more than once in computing the limitations under section 382 for the loss corporations that are members of the controlled group. In general, the adjustment is made under paragraph (c) of this section by reducing the value of the loss corporation by the value of the stock of each component member of the controlled group that the loss corporation owns immediately after the ownership change. The loss corporation's value may, however, be increased under paragraph (c) of this section by any amount of value that the other member elects to restore to the loss corporation.

(b) *Controlled group loss and controlled group with respect to a controlled group loss.* A controlled group loss is a pre-change loss (or a net unrealized built-in loss) of a loss corporation that is attributable to a taxable year of the corporation with respect to which the corporation is a component member of a controlled group (as defined by paragraphs (e)(2) and (3) of this section). The controlled group with respect to each controlled group loss is composed of the loss corporation and each other corporation that is a component member of a controlled group that includes the loss corporation both—

(1) With respect to the taxable year to which the controlled group loss is attributable; and

(2) On the date the loss corporation has an ownership change.

(c) *Computation of value.* For purposes of computing the limitation under section 382 with respect to each controlled group loss, the value of the stock of each component member of the controlled group with respect to that loss is determined immediately before the ownership change, and is adjusted by applying the following rules:

(1) *Reduction in value.* The value of the stock of each component member is reduced by the value (immediately before the ownership change and without regard to any restoration of value or other adjustment under this section) of the stock of any other component member directly owned by the component member immediately after the ownership change.

(2) *Restoration of value.* After the value of the stock of each component member is reduced pursuant to paragraph (c)(1) of this section, the value of the stock of each component member is increased by the amount of value, if any, restored to the component member by another component member (the electing member) pursuant to this paragraph (c)(2). The electing member may elect to restore value to another component member in an amount that does not exceed the lesser of—

(i) The sum of—

(A) The value, determined immediately before the ownership change, of the electing member's stock (after adjustment under paragraph (c)(1) of this section and before any restoration of value under this paragraph (c)(2)); plus

(B) Any amount of value restored to the electing member by another component member under this paragraph (c)(2); or

(ii) The value, determined immediately before the ownership change, of the electing member's stock (without regard to any adjustment under this section) that is directly owned by the other component member immediately after the ownership change.

(3) *Reduction in value by the amount restored.* The value of the stock of the electing member is reduced by any amount of value that the electing member elects to restore under paragraph (c)(2) of this section to another component member.

(4) *Appropriate adjustments.* Appropriate additional adjustments consistent with paragraphs (c)(1), (2), and (3) of this section must be made to prevent any duplication of value. Thus, for example, adjustments must be made to reflect—

(i) Any indirect ownership interest in another component member;

(ii) Any cross ownership of stock by component members of the controlled group with respect to the controlled group loss; and

(iii) Any value used to determine a limitation under section 382 with respect to controlled group losses from the same period.

(5) *Certain reductions in the value of members of a controlled group.* A loss corporation that has an ownership change is required to make adjustments consistent with this paragraph (c) with respect to its stock if the stock of another corporation in which it had a direct or indirect ownership interest was disposed of before the ownership change, and;

(i) Both corporations were component members of a controlled group—

(A) With respect to a taxable year to which a controlled group loss of the loss corporation is attributable; and

(B) At any time during the 2 year period before the ownership change; and

(ii) Both corporations are component members of a controlled group at any time during the 2 year period following the ownership change.

(d) *No double reduction.* To the extent consistent with the purposes of this section, section 382 and this section shall not be applied to duplicate a reduction in the value of a loss corporation. Thus, for example, if the value of a loss corporation is reduced under section 382(l)(1) to reflect a capital contribution of stock of a component member, it is not again reduced by such amount under paragraph (c)(1) of this section. If this paragraph (d) applies to prevent a reduction in value from being duplicated, the application of the other rules of this section, such as those relating to the restoration of value, is correspondingly limited in a manner consistent with the principles of this section.

(e) *Definitions and nomenclature*—(1) *Definitions in section 382 and the regulations thereunder.* Except as otherwise provided, the definitions and nomenclature contained in section 382 and the regulations thereunder apply to this section.

(2) *Controlled group.* Controlled group has the same meaning as in section 1563(a), determined by substituting ''50 percent'' for ''80 percent'' each place that it appears, and without regard to section 1563(a)(4).

(3) *Component member.* Component member has the same meaning as in section 1563(b), determined by substituting ''December 31 (or the change date, if earlier)'' for ''December 31'' each place it appears, and without regard to section 1563 (b)(2), (b)(3)(C), and (b)(4).

(4) *Predecessor and successor corporation.* As the context may require, a reference to a corporation, or component member includes a reference to a predecessor or successor corporation.

(f) *Coordination between consolidated groups and controlled groups.* Some or all of the component members of a controlled group may also be members of a consolidated group, and a controlled group loss may be subject to a consolidated section 382 limitation or subgroup section 382 limitation determined under §1.1502–93T. Except as otherwise provided in this paragraph (f) and §§ 1.1502–91T through 1.1502–99T, § 1.1502–93T applies instead of this section when both sections, by their terms, are otherwise applicable. This section is applicable and may require an adjustment to value if a member of a consolidated group, a loss group, or a loss subgroup (as those terms are defined in §§ 1.1502–1(h) and 1.1502–91T) is also a component member of a controlled group with respect to a controlled group loss. Solely for purposes of applying this section, a consolidated group, loss group, or loss subgroup is treated as a single corporation. Thus to determine the limitation with respect to any portion of the pre-change consolidated attributes or pre-change subgroup attributes of the loss group or loss subgroup that is a controlled group loss, the consolidated section 382 limitation or subgroup section 382 limitation is computed by treating the loss group or the loss subgroup as a single corporation, and adjusting value in accordance with paragraph (c) of this section. See paragraph (g) *Example 4* of this section.

(g) *Examples.* For purposes of the examples in this section, unless otherwise stated, the nomenclature and assumptions of the examples in § 1.382–2T(b) apply, all corporations file separate income tax returns on a calendar year basis, the only 5-percent shareholder of a corporation is a public group, and the facts set forth the only owner shifts with respect to the corporations during the testing period.

Example 1. Controlled group with respect to a controlled group loss. (a) Public L owns all of the L stock, L and Public L1 own 30 percent and 70 percent, respectively, of the L1 stock, and L1 owns all of the corporation T stock. L1 has a net operating loss arising in Year 1 that is carried over to Year 4. L has a net operating loss arising in Year 2 that is carried over to Year 4. On August 1, Year 3, L acquires 30 percent of the stock of L1, thereby increasing its percentage ownership interest in L1 to 60 percent. On December 1, Year 3, L1 purchases all of the stock of corporation S from Public S. On November 1, Year 4, P acquires all of the L stock. The acquisition by P of all of the L stock on November 1, Year 4, causes ownership changes of both L and L1 under the rules of § 1.382–2T. The following is a graphic illustration of these facts.

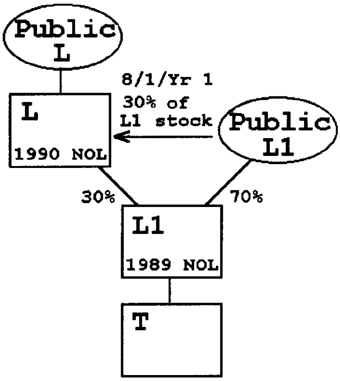
Public L
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1990 NOL
8/1/Yr 1
30% of
L1 stock
Public L1
30%
70%
L1
1989 NOL
T

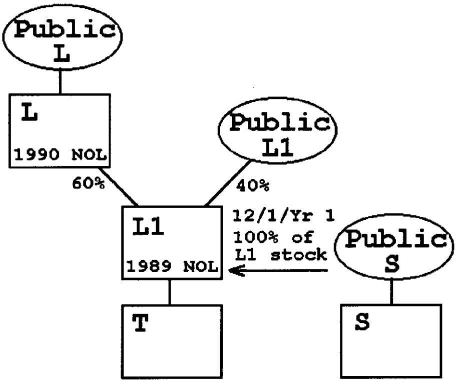
Public L
L
1990 NOL
Public L1
60%
40%
L1
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12/1/Yr 1
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L1 stock
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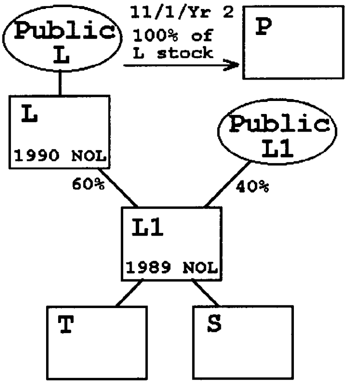
Public L
11/1/Yr 2
100% of
L stock
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Public L1
60%
40%
L1
1989 NOL
T
S

(b)(1) Under paragraph (b) of this section, the Year 1 net operating loss carryover of L1 is a controlled group loss because L1 is a component member of a controlled group with respect to Year 1, the year to which the loss is attributable. L1 and T compose a controlled group with respect to the net operating loss carryover because L1 and T are component members of a controlled group both—

(A) With respect to the taxable year to which L1's net operating loss carryover is attributable (i.e., Year 1); and

(B) On November 1, Year 4, L1's change date. Although L and S are component members of L1's controlled group on L1's change date, they are not component members of the controlled group with respect to the Year 1 net operating loss carryover because they were not component members with respect to the year to which the net operating loss carryover is attributable.

(2) The value of L1's stock must therefore be adjusted in accordance with paragraph (c) of this section to take into account an adjustment with respect to the T stock (but not the S stock) in computing L1's limitation under section 382 with respect to its net operating loss carryover.

(c) Although L is a member of a controlled group composed of L, L1, S, and T on November 1, Year 4, L's change date, it is not a component member of a controlled group with respect to Year 2, the taxable year to which its net operating loss carryover is attributable. Therefore, L's Year 2 net operating loss carryover is not a controlled group loss under paragraph (b) of this section and the value of L's stock is not adjusted in accordance with paragraph (c) of this section to compute L's limitation under section 382 with respect to the Year 2 net operating loss carryover.

Example 2. Adjustments to value of the controlled group members. (a) Since Year 1, A has owned all of the stock of L, L and B have owned 80 percent and 20 percent, respectively, of the stock of corporation P, and P and C have owned 75 percent and 25 percent, respectively, of the stock of L1. L and L1 each has a net operating loss for the Year 6 taxable year that is carried over to its respective Year 7 taxable year. On December 1, Year 7, A sells all of the L stock to D. The sale results in ownership changes of both L and L1. Immediately before the ownership changes, the total value of the L1 stock is $40, the total value of the P stock (including the value of its L1 stock) is $100, and the total value of the L stock (including the value of the P stock) is $200. The following is a graphic illustration of these facts.

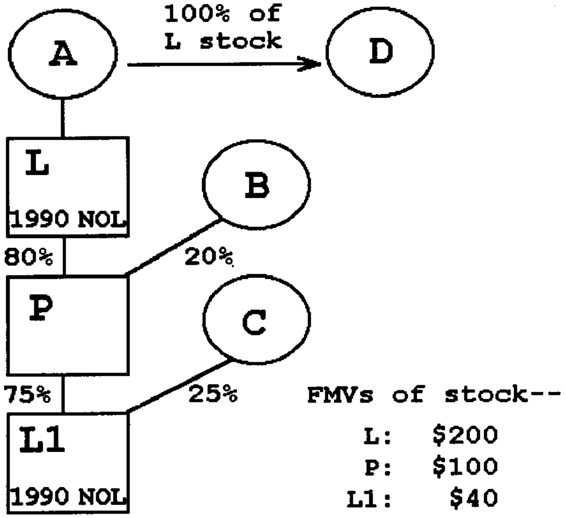

(b) Under paragraph (b) of this section, the Year 6 net operating loss carryovers of each of L and L1 are controlled group losses because each of L and L1 is a component member of a controlled group with respect to Year 6, the year to which the losses are attributable. L, P, and L1 compose controlled groups with respect to both Year 6 net operating loss carryovers because L, P, and L1 are component members of a controlled group both—

(1) With respect to the taxable years to which the net operating loss carryovers are attributable (i.e., Year 6); and

(2) On December 1, Year 7, the change date.

(c) The value of the stock of L1 for purposes of determining its limitation under section 382 with respect to its net operating loss carryover from Year 6 is $40. L1 does not elect to restore any value to P under paragraph (c)(2) of this section.

(d) The value of the stock of P ($100) is reduced under paragraph (c)(1) of this section by the value of the stock of L1 that it directly owns, $30 (75%×$40). Following the adjustment, the value of the stock of P is $70. P elects to restore this entire $70 of value to L.

(e) The value of the stock of L, $200, is reduced under paragraph (c)(1) of this section by the value of the stock of P it directly owns, i.e., $80 (80%×$100), and increased under paragraph (c)(2) of this section by the amount P elects to restore to L, i.e., $70. Thus, the value of the L stock for purposes of determining L's limitation under section 382 with respect to its net operating loss carryover from Year 6 is $190 ($200−$80+$70).

Example 3. Limitation on restoration of value. (a) The facts are the same as in *Example 2,* except that L1 elects to restore $20 to P. For purposes of determining L1's limitation under section 382 with respect to the Year 6 net operating loss carryover, the value of the stock of L1 is $20 ($40−$20) because the value of its stock is reduced under paragraph (c)(3) of this section by the $20 of value it elects to restore to P.

(b) The value of the stock of P ($100) is reduced under paragraph (c)(1) of this section by the value of the L1 stock it directly owns ($30), and is increased under paragraph (c)(2) of this section by the value that L1 elects to restore to P ($20). Thus, the value of the P stock is $90 ($100−$30+$20).

(c)(1) P elects to restore to L the maximum value permitted under this section. The value of the stock of L, $200, is reduced under paragraph (c)(1) of this section by the value of the P stock it directly owns ($80), and is increased by the value that P elects to restore to L. P may elect to restore to L the lesser of—

(A) The sum of the value of its stock immediately after adjustment under paragraph (c)(1) of this section (i.e., $70) plus the value restored to it by L1 (i.e., $20) (a total of $90); or

(B) The value of the P stock (without regard to the adjustment required by paragraphs (c)(1) and (2) of this section) that is directly owned by L immediately before the ownership change (i.e., $80).

(2) Thus, $80 is the maximum amount that P may elect to restore to L. Following the restoration of value by P, the value of the L stock for purposes of determining L's limitation under section 382 is $200 ($200 −$80 + $80).

Example 4. Coordination with consolidated return regulations. (a) P and its wholly owned subsidiary L file a consolidated return. L owns 79 percent of the outstanding stock of L1. P acquired the stock of L in Year 1 and L acquired the stock of L1 in Year 2. The P consolidated group has a consolidated net operating loss arising in the Year 6 consolidated return year that is carried over to Year 8. L1 has a net operating loss arising in its Year 6 taxable year that is also carried over to Year 8. On January 1, Year 8, the P consolidated group has an ownership change under § 1.1502–92T(b)(1)(i) and L1 has an ownership change under § 1.382–2T.

(b)(1) Under paragraph (b) of this section, the Year 6 net operating loss carryover of the P group is a controlled group loss because P, L, and L1 are component members of a controlled group with respect to Year 6, the year to which the loss is attributable. P, L, and L1 compose a controlled group with respect to the Year 6 net operating loss carryover of the P loss group because they are component members of a controlled group both—

(A) With respect to the taxable years to which the net operating loss carryover is attributable (i.e., Year 6); and –

(B) On January 1, Year 8, the P group's change date.

(2) Because P and L compose a loss group (within the meaning of § 1.1502–91T(c)) with respect to its Year 6 net operating loss carryover, the P loss group must compute a consolidated section 382 limitation with respect to its Year 6 net operating loss carryover as a result of the ownership change.

(c) In computing the consolidated section 382 limitation under § 1.1502–93T with respect to the Year 6 net operating loss carryover, the value of the P stock immediately before the ownership change is reduced under paragraphs (c)(1) and (f) of this section by the value immediately before the ownership change of the L1 stock directly owned by L immediately after the ownership change. L1 may, however, elect to restore such value to the P consolidated group to the extent permitted under paragraph (c)(2) of this section.

Example 5. Appropriate adjustments for indirect ownership interest. (a) Individual A owns all of the stock of L, L owns an 80 percent interest in the capital and profits of partnership PS, and PS owns 75 percent of the stock of L1. Both L and L1 have net operating losses for the Year 1 taxable year that are carried over to their respective Year 2 taxable years. On December 19, Year 2, A sells all of the L stock to an unrelated individual. The sale results in an ownership change of L and L1.

(b) Under paragraph (b) of this section, the Year 1 net operating loss carryovers of each of L and L1 are controlled group losses because each of L and L1 is a component member of a controlled group with respect to Year 1, the year to which the losses are attributable. L and L1 compose controlled groups with respect to each corporation's net operating loss carryovers because L and L1 are component members of a controlled group both—

(1) With respect to the taxable years to which the net operating loss carryovers are attributable (i.e., Year 1); and

(2) On December 19, Year 2, the change date.

(c) L has an indirect ownership interest in L1 which, under paragraph (c)(4) of this section, must be taken into account in applying this section. As a result, the value of the L stock for purposes of determining its limitation under section 382 with respect to the Year 1 net operating loss carryover must be reduced by the value of L's indirect ownership interest in the L1 stock (60 percent) that it owns through PS immediately before the ownership change, and is increased by the amount (if any) that L1 elects to restore to L under paragraph (c)(2) of this section. The value of L1 is reduced under paragraph (c)(3) of this section to the extent that L1 elects to restore value to L.

(h) *Time and manner of filing election to restore*—(1) *Statement required.* The election to restore value described in paragraph (c)(2) of this section must be in the form set forth below. It must be signed on behalf of both the electing member and the corporation to which such value is restored by persons authorized to sign their respective income tax returns. (The common parent of a consolidated group must make the election on behalf of the group.) It must be filed by the loss corporation with its income tax return for the taxable year in which the ownership change occurs (or with an amended return for such year filed on or before the due date (including extensions) of the income tax return of any component member with respect to the taxable year in which the ownership change occurs). The statement must provide that: ''THIS IS AN ELECTION UNDER § 1.382–8T OF THE INCOME TAX REGULATIONS TO RESTORE ALL OR PART OF THE VALUE OF [insert name and E.I.N. of the electing member] TO [insert name and E.I.N. of the corporation to which value is restored]. The statement must also—

(i) Identify the change date for the loss corporation in connection with which the election is made;

(ii) State the value of the electing member's stock (without regard to any adjustment under paragraph (c) of this section) immediately before the ownership change;

(iii) State the amount of any reduction required under paragraph (c)(1) of this section with respect to stock of the electing member that is owned directly or indirectly by the corporation to which value is restored;

(iv) State the amount of value that the electing member elects to restore to the corporation; and

(v) State whether the value of either component member's stock was adjusted pursuant to paragraph (c)(4) of this section.

(2) *Revocation of election.* An election made under this section is revocable only with the consent of the Commissioner.

(3) *Filing by component member.* An electing member must attach a copy of the statement described in paragraph (h)(1) of this section to its income tax return (or amended return) for the taxable year which includes the change date in connection with which the election is made.

(i) [Reserved]

(j) *Effective date*—(1) *In general.* This section applies to a loss corporation that has an ownership change with respect to a controlled group loss on or after January 1, 1997.

(2) *Transition rule*—(i) *In general.* The members of a controlled group on January 1, 1997, that have had an ownership change with respect to a controlled group loss before January 1, 1997, must determine the limitations under section 382 for any post-change year with respect to controlled group losses by using a reasonable method to preclude the value of stock of a component member that was owned directly or indirectly by another member immediately after an ownership change from being taken into account more than once in determining the limitations under section 382 with respect to controlled group losses. If such a reasonable method was not used for a post-change year, subject to the exception in paragraph (j)(3) of this section, the members of the controlled group described in the preceding sentence must reduce their limitations under section 382 for post-change years for which the income tax return is filed after January 1, 1997, to recapture, as quickly as possible, any limitation that members took into account in excess of the amount that would be allowable under this section.

(ii) *Special transition rule for controlled groups that had ownership changes before January 29, 1991.* For purposes of this section, in the case of an ownership change occurring before January 29, 1991, the controlled group with respect to a controlled group loss does not include a corporation that is not a component member of the controlled group on January 29, 1991. Thus, in the case of an ownership change occurring before January 29, 1991, paragraph (c) of this section does not require that a loss corporation that is a component member of a controlled group to disregard the value of stock of another corporation directly owned immediately after the ownership change in determining the value of its own stock unless the other corporation is a component member of the controlled group on January 29, 1991.

(3) *Amended returns.* A taxpayer that has had an ownership change before January 1, 1997, may file an amended return for any taxable year to modify the amount of a limitation under section 382 with respect to a controlled group loss only if—

(i) The modification complies with the rules contained in this section for computing a limitation under section 382;

(ii) Any other component member of the controlled group with respect to the controlled group loss who elects to restore value and whose taxable income is affected by the election to restore value also files amended returns that comply with such rules; and

(iii) Corresponding adjustments are made in amended returns for all taxable years ending after December 31, 1986.

[T.D. 8679, 61 FR 33316, June 27, 1996]

§1.382–9 Special rules under section 382 for corporations under the jurisdiction of a court in a title 11 or similar case.

(a) *Introduction.* Either section 382(l)(5) or section 382(l)(6) may apply to an ownership change which occurs in a title 11 or similar case (as defined in section 368(a)(3)(A)) if the transaction resulting in the ownership change is ordered by the court or is pursuant to a plan approved by the court. Terms and nomenclature used in this section, and not otherwise defined herein (including the nomenclature and assumptions in §1.382–2T(b) relating to the examples) have the same respective meanings as in section 382 and the regulations thereunder.

(b) *Application of section 382(l)(5).* section 382(a) does not apply to any ownership change if—

(1) The old loss corporation is (immediately before the ownership change) under the jurisdiction of the court in a title 11 or similar case; and

(2) The pre-change shareholders and qualified creditors of the old loss corporation (determined immediately before the ownership change) own (after the ownership change and as a result of being pre-change shareholders or qualified creditors immediately before the ownership change) stock of the new loss corporation (or stock of a controlling corporation if also in bankruptcy) that meets the requirements of section 1504(a)(2) (determined by substituting ‘‘50 percent’’ for ‘‘80 percent’’ each place it appears).

(c) [Reserved]

(d) *Rules for determining whether stock of the loss corporation is owned as a result of being a qualified creditor*—(1) *Qualified creditor.* A qualified creditor is the beneficial owner, immediately before the ownership change, of qualified indebtedness of the loss corporation. A qualified creditor owns stock of the new loss corporation (or a controlling corporation) as a result of being a qualified creditor only to the extent that the qualified creditor receives stock in full or partial satisfaction of qualified indebtedness (including interest accrued on such indebtedness) in a transaction that is ordered by the court or is pursuant to a plan approved by the court in a title 11 or similar case. For purposes of this paragraph (d)(1), ownership of stock after the ownership change is determined without applying the attribution rules generally applicable under section 382(l)(3)(A) or §1.382–2T(h).

(2) *General rules for determining whether indebtedness is qualified indebtedness*—(i) *Definition.* Indebtedness of the loss corporation is qualified indebtedness if it—

(A) Has been owned by the same beneficial owner since the date that is 18 months before the date of the filing of the title 11 or similar case; or

(B) Arose in the ordinary course of the trade or business of the loss corporation and has been owned at all times by the same beneficial owner.

(ii) *Determination of beneficial ownership.* For purposes of paragraph (d)(2)(i) of this section, beneficial ownership of indebtedness is determined without applying attribution rules.

(iii) *Duty of inquiry.* The loss corporation must determine that indebtedness that the loss corporation treats as qualified indebtedness, other than indebtedness to which paragraph (d)(3)(i) of this section applies, has been owned for the requisite period by the beneficial owner who owns the indebtedness immediately before the ownership change. The loss corporation may rely on a statement, signed under penalties of perjury, by a beneficial owner regarding the amount of indebtedness the beneficial owner owns and the length of time that the beneficial owner has owned the indebtedness.

(iv) *Ordinary course indebtedness.* For purposes of this paragraph (d)(2), indebtedness arises in the ordinary course of the loss corporation's trade or business only if the indebtedness is incurred by the loss corporation in connection with the normal, usual, or customary conduct of business, determined without regard to whether the indebtedness funds ordinary or capital expenditures of the loss corporation. For example, indebtedness (other than indebtedness acquired for a principal purpose of being exchanged for stock) arises in the ordinary course of the loss corporation's trade or business if it is trade debt; a tax liability; a liability arising from a past or present employment relationship, a past or present business relationship with a supplier, customer, or competitor of the loss corporation, a tort, a breach of warranty, or a breach of statutory duty; or indebtedness incurred to pay an expense deductible under section 162 or included in the cost of goods sold. A claim that arises upon the rejection of a burdensome contract or lease pursuant to the title 11 or similar case is treated as arising in the ordinary course of the loss corporation's trade or business if the contract or lease so arose.

(3) *Treatment of certain indebtedness as continuously owned by the same owner*—(i) *In general.* For purposes of paragraph (d)(2) of this section, a loss corporation may treat indebtedness as always having been owned by the beneficial owner of the indebtedness immediately before the ownership change if the beneficial owner is not, immediately after the ownership change, either a 5-percent shareholder or an entity through which a 5-percent shareholder owns an indirect ownership interest in the loss corporation (a *5-percent entity*). This paragraph (d)(3)(i) does not apply to indebtedness beneficially owned by a person whose participation in formulating a plan of reorganization makes evident to the loss corporation (whether or not the loss corporation had previous knowledge) that the person has not owned the indebtedness for the requisite period.

(ii) *Operating rules.* For purposes of paragraph (d)(3)(i) of this section: (A) If a loss corporation has actual knowledge of a coordinated acquisition of its indebtedness by a group of persons, through a formal or informal understanding among themselves, for a principal purpose of exchanging the indebtedness for stock, the indebtedness (and any stock received in exchange therefor) is treated as owned by an entity. A principal element in determining if an understanding exists among members of a group is whether the investment decision of each member is based upon the investment decision of one or more other members.

(B) If the loss corporation has actual knowledge regarding stock ownership described in § 1.382–2T(k)(2), the loss corporation must take that ownership into account in determining which beneficial owners of indebtedness are, immediately after the ownership change, 5-percent shareholders or 5-percent entities. The loss corporation is not required to take into account an ownership interest described in § 1.382–2T(k)(4) unless the loss corporation has actual knowledge of the ownership interest.

(C) The term *5-percent shareholder* includes any person who is a 5-percent shareholder of the loss corporation within the meaning of §1.382–2T(g), without regard to the option attribution rules of section 382(l)(3)(A) or §1.382–4(d) (or, if applicable, §1.382–2T(h)(4)).

(D) Paragraph (d)(3)(i) of this section does not apply to indebtedness if the loss corporation has actual knowledge immediately after the ownership change that the exercise of an option to acquire or dispose of stock of the loss corporation would cause the beneficial owner of the indebtedness immediately before the ownership change to be, after the ownership change, either a 5-percent shareholder or a 5-percent entity. An interest that is treated as an option under §1.382–4(d)(9) (or §1.382–2T(h)(4)(v) if applicable) is treated as an option for purposes of this paragraph (d)(3)(ii)(D).

(iii) *Indebtedness owned by beneficial owner who becomes a 5-percent shareholder or 5-percent entity.* If the beneficial owner of indebtedness immediately before the ownership change is a 5-percent shareholder or 5-percent entity immediately after the ownership change, the general rules of paragraph (d)(2) of this section apply to determine whether the indebtedness has been owned for the requisite period by the beneficial owner.

(iv) *Example.* The following example illustrates paragraph (d)(3) of this section.

(A)(1) L is a loss corporation in a title 11 case. The plan of reorganization of L approved by the bankruptcy court provides for the satisfaction of claims by the issuance of new L common stock to its creditors as follows:

A—2 percent
B—7.5 percent
C—2.5 percent
P1—3 percent
P2—10 percent
P3—4.9 percent
P4—4.9 percent
P5—4.9 percent

(2) P2 is owned by Public P2. B owns 10 percent of the stock of P1 and L has no actual knowledge of this ownership. L has actual knowledge that D owns P3, P4 and P5. In addition, L has actual knowledge, immediately after the ownership change, that C owns an option to acquire newly-issued stock of L that, if exercised, would increase C's percentage ownership of L stock from 2.5 percent to 8 percent. An ownership change of L occurs on the date the plan becomes effective.

(B) Under paragraph (d)(3)(i) of this section, L may treat the indebtedness owned by A and P1 immediately before the ownership change as always having been owned by A and P1. Neither A nor P1 is a 5-percent shareholder immediately after the ownership change. Further, because P1 owns less than 5 percent of the L stock (and L has no actual knowledge of B's ownership interest in P1), P1 is treated as an individual, and the L stock owned by P1 is not attributed to any other person, including B. See §1.382–2T(h)(2)(iii). Therefore, P1 is not a 5-percent entity.

(C) Paragraph (d)(3)(i) of this section does not apply to the indebtedness owned by B, C, P2, P3, P4, or P5. B is a 5-percent shareholder immediately after the ownership change. L has actual knowledge immediately after the ownership change that the exercise of C's option would cause C to be a 5-percent shareholder immediately after the ownership change. (L does not take into account the effect of the exercise of the option, however, in determining the percentage stock ownership of any person other than C because the deemed exercise would not cause any other person to be a 5-percent shareholder or a 5-percent entity after the ownership change.) P2 is a 5-percent entity, because Public P2, a 5-percent shareholder, owns an indirect ownership interest in L through P2. P3, P4, and P5 are 5-percent entities because D, a 5-percent shareholder, owns an indirect ownership interest in L through P3, P4, and P5. Because L has actual knowledge that D would be a 5-percent shareholder but for the application of §1.382–2T(h)(2)(iii), that section does not apply to P3, P4, or P5. See §1.382–2T(k)(2). Thus, under §1.382–2T(h)(2)(i), the L stock owned by P3, P4, and P5 is attributed to D, and D is a 5-percent shareholder. Because paragraph (d)(3)(i) of this section does not apply to the indebtedness owned by B, C, P2, P3, P4, and P5, L may treat as qualified indebtedness only indebtedness that it determines had been owned by such persons for the requisite period. See paragraph (d)(2)(iii) of this section.

(4) *Special rule if indebtedness is a large portion of creditor's assets*—(i) *In general.* Indebtedness is not qualified indebtedness if—

(A) The beneficial owner of the indebtedness is a corporation or other entity that had an ownership change on any day during the applicable period;

(B) The indebtedness represents more than 25 percent of the fair market value of the total gross assets (excluding cash or cash equivalents) of the beneficial owner on its change date; and

(C) The beneficial owner is a 5-percent entity immediately after the ownership change of the loss corporation (determined by applying the rules of paragraph (d)(3) of this section).

(ii) *Applicable period.* For purposes of paragraph (d)(4)(i) of this section, the term *applicable period* means the period beginning on the day 18 months before the filing of the title 11 or similar case (or the day on which the beneficial owner acquired the indebtedness, if later) and ending with the change date of the loss corporation.

(iii) *Determination of ownership change.* For purposes of paragraph (d)(4)(i) of this section, the determination whether a beneficial owner of indebtedness has an ownership change is made under the principles of section 382 and the regulations thereunder, without regard to whether the beneficial owner is a loss corporation and by beginning the testing period no earlier than the latest of the day three years before the change date, the day 18 months before the filing of the title 11 or similar case, or the day on which the beneficial owner acquired the indebtedness.

(iv) *Reliance on statement.* Paragraph (d)(4)(i) of this section does not apply to indebtedness if the loss corporation obtains a statement, signed under penalties of perjury, by the beneficial owner of the indebtedness that states that paragraph (d)(4)(i) of this section does not apply to the indebtedness.

(5) *Tacking of ownership periods*—(i) *Transferee treated as owning indebtedness for period owned by transferor.* To determine whether indebtedness transferred in a qualified transfer is qualified indebtedness, the transferee is treated as having owned the indebtedness for the period that it was owned by the transferor.

(ii) *Qualified transfer.* For purposes of paragraph (d)(5)(i) of this section, a transfer of indebtedness is a qualified transfer if—

(A) The transfer is between parties who bear a relationship to each other described in section 267(b) or 707(b) (substituting at least 80 percent for more than 50 percent each place it appears in section 267(b) (and section 267(f)(1)) or 707(b));

(B) The transfer is a transfer of a loan within 90 days after its origination, pursuant to a customary syndication transaction;

(C) The transfer is a transfer of newly incurred indebtedness by an underwriter that owned the indebtedness for a transitory period pursuant to an underwriting;

(D) The transferee's basis in the indebtedness is determined under section 1014 or 1015 or with reference to the transferor's basis in the indebtedness;

(E) The transfer is in satisfaction of a right to receive a pecuniary bequest;

(F) The transfer is pursuant to any divorce or separation instrument (within the meaning of section 71(b)(2));

(G) The transfer is pursuant to a subrogation in which the transferee acquires a claim against the loss corporation by reason of a payment to the claimant pursuant to an insurance policy or a guarantee, letter of credit or similar security arrangement; or

(H) The transfer is a transfer of an account receivable in a customary commercial factoring transaction made within 30 days after the account arose to a transferee that regularly engages in such transactions.

(iii) *Exception.* A transfer of indebtedness is not a qualified transfer for purposes of paragraph (d)(5)(i) of this section if the transferee acquired the indebtedness for a principal purpose of benefiting from the losses of the loss corporation by—

(A) Exchanging the indebtedness for stock of the loss corporation pursuant to the title 11 or similar case; or

(B) Selling the indebtedness at a profit that reflects the expectation that, by reason of section 382(l)(5), section 382(a) will not apply to any ownership change resulting from the title 11 or similar case.

(iv) *Debt-for-debt exchanges.* If the loss corporation satisfies its indebtedness with new indebtedness, either through an exchange of new indebtedness for old indebtedness or a change in the terms of indebtedness that results in an exchange under section 1001—

(A) The owner of the new indebtedness is treated as having owned that indebtedness for the period that it owned the old indebtedness; and

(B) The new indebtedness is treated as having arisen in the ordinary course of the trade or business of the loss corporation if the old indebtedness so arose.

(6) *Effective date*—(i) *In general.* This paragraph (d) applies to ownership changes occurring on or after March 17, 1994.

(ii) *Elections and amended returns*—(A) *Election to apply this paragraph (d) retroactively.* A loss corporation may elect to apply this paragraph (d) to an ownership change occurring prior to March 17, 1994. This election must be made by the later of the due date (including any extensions of time) of the loss corporation's tax return for the taxable year which includes the change date or the date that the loss corporation files its first tax return after May 16, 1994. The election is made by attaching the following statement to the return: ''This is an Election to Apply §1.382–9(d) Retroactively with Respect to the Ownership Change on [Insert Date of Ownership Change] That Occurred in Connection with the Title 11 or Similar Case filed on [Insert Date of Filing].'' This statement must be accompanied by the amended returns described in paragraph (d)(6)(ii)(C) of this section. An election under this paragraph (d)(6) is irrevocable.

(B) *Election to revoke section 382(l)(5)(H) election.* A loss corporation may elect to revoke a prior election made under section 382(l)(5)(H) with respect to an ownership change occurring before March 17, 1994 by including the following statement with its election to apply §1.382–9(d) retroactively: ''This is an Election to Revoke a Prior Election Made Under Section 382(l)(5)(H) With Respect to the Ownership Change on [Insert Date of Ownership Change] That Occurred in Connection With the Title 11 or Similar Case Filed on [Insert Date of Filing].''

(C) *Amended returns.* If the retroactive application of this paragraph (d) affects the amount of taxable income or loss for a prior taxable year, then, except as precluded by the applicable statute of limitations, the loss corporation (or the common parent of any consolidated group of which the loss corporation was a member for the year) must file an amended return for the year that reflects the effects of the retroactive application of the rules of this paragraph (d). If the statute of limitations precludes the filing of an amended return for one or more such prior taxable years, the loss corporation (or the common parent) must make appropriate adjustments under the principles of section 382(l)(2)(A) in subsequent taxable years to reflect the difference between the losses and credits actually used in such prior taxable years and the amount that would have been used in those years applying the rules of this paragraph (d).

(e) *Option attribution for purposes of determining stock ownership under section 382(l)(5)(A)(ii)*—(1) *In general.* Solely for purposes of determining whether the stock ownership requirements of section 382(l)(5)(A)(ii) are satisfied at the time of an ownership change, stock of the loss corporation (or of a controlling corporation if also in bankruptcy) that is subject to an option is treated as acquired at that time, pursuant to an exercise of the option by its owner, if such deemed exercise would cause the pre-change shareholders and qualified creditors of the loss corporation to own (after such ownership change and as a result of being pre-change shareholders or qualified creditors immediately before such change) less than an amount of such stock sufficient to satisfy the ownership requirements of section 382(l)(5)(A)(ii). An option that is owned as a result of being a pre-change shareholder or qualified creditor and that, if exercised, would result in the ownership of stock by a pre-change shareholder or qualified creditor is not treated as exercised under this paragraph (e). For purposes of this paragraph (e)(1), rules similar to those option attribution rules under §1.382–2T(h)(4)(iii), (iv), (v), (vii), and (x)(A), (B) (except with respect to a debt instrument that was issued after the filing of the petition in the title 11 or similar case), (D), (E) (except with respect to a right to receive or obligation to issue stock as interest or dividends on a debt instrument or stock that was issued after the filing of the petition in the title 11 or similar case), (G), (H), and (Z), apply.

(2) *Special rules*—(i) *Lapse or forfeiture of options deemed exercised.* A loss corporation may apply rules similar to the rules of § 1.382–2T(h)(4)(viii) with respect to an option except to the extent any person owning the option at any time on or after the change date acquires additional stock or an option to acquire additional stock during the period of time on or after the ownership change and on or before the lapse or forfeiture of the option.

(ii) *Actual exercise of options not deemed exercised.* In determining whether the ownership change pursuant to the plan of reorganization qualifies under section 382(l)(5), a loss corporation may take into account stock acquired pursuant to the actual exercise of an option issued pursuant to the plan of reorganization if that option was not deemed exercised under paragraph (e)(1) of this section. However, this paragraph (e)(2)(ii) applies only if the option is actually exercised within the 3 years of the ownership change by the 5-percent shareholder who, as a result of being a pre-change shareholder or qualified creditor, acquired the option under the plan.

(iii) *Amended returns.* A loss corporation may file an amended return for a prior taxable year (subject to any applicable statute of limitations) if it determines that section 382(l)(5) applies to an ownership change as a result of the operation of paragraph (e)(2)(i) or (ii) of this section, but only if the loss corporation makes corresponding adjustments on amended returns for all affected taxable years (subject to any applicable statute of limitations).

(3) *Examples.* In each of the examples in this paragraph (e)(3), assume that there is an ownership change of loss corporation L on the date the plan of reorganization is effective.

Example 1. L is a loss corporation in a title 11 case. The plan of reorganization of L approved by the bankruptcy court provides for the cancellation of all existing L stock, the issuance of 100 shares of new L common stock to qualified creditors, and the issuance of an option to a new investor to acquire, at any time during the next 3 years, 90 shares of new L common stock from L at its fair market value on the date the plan becomes effective. Under paragraph (e)(1) of this section, on the date the plan becomes effective, the option held by the new investor is deemed exercised if the exercise would cause the qualified creditors of L to own less than 50 percent of the total voting power or value of the L stock after the ownership change. Because the qualified creditors would receive at least 50 percent of the voting power and value of the new L common stock even if the option were deemed exercised, the stock ownership requirements of section 382(l)(5)(A)(ii) are satisfied.

Example 2. The facts are the same as in *Example 1*, except that L issues an option to the new investor to acquire 110 shares of new L common stock. This option is deemed exercised under paragraph (e)(1) of this section on the date the plan becomes effective, because, as a result of the deemed exercise, the qualified creditors would own only 100 of 210 shares of the new L common stock (approximately 48 percent) after the ownership change. Accordingly, the stock ownership requirements of section 382(l)(5)(A)(ii) are not satisfied and section 382(a) applies to the ownership change.

Example 3. (a) L is a loss corporation in a title 11 case. The plan of reorganization of L approved by the bankruptcy court provides for the cancellation of all existing L stock, the issuance of new L common stock and 5-year options to acquire L common stock as follows:

(i) To qualified creditors—100 shares of stock and options to acquire 50 shares;

(ii) To a new investor—options to acquire 110 shares.

(b) Under paragraph (e)(1) of this section, the option held by the new investor is deemed exercised on the date the plan becomes effective because the exercise would cause the qualified creditors of L to own less than 50 percent of the total voting power and value of the L stock after the ownership change (100 of 210 shares or approximately 48 percent). Accordingly, the stock ownership requirements of section 382(l)(5)(A)(ii) are not satisfied initially and section 382(a) applies to the ownership change.

(c) Assume, however, that the qualified creditors actually exercise enough options that were acquired pursuant to the plan of reorganization to purchase 30 additional shares during the 3 year period after the plan becomes effective. Under paragraph (e)(2)(ii) of this section, L may take into account the 30 shares purchased by the qualified creditors by the exercise of the options in determining whether the stock ownership requirements of section 382(l)(5)(A)(ii) were satisfied on the date the plan of reorganization became effective. If L takes such purchases into account, the qualified creditors of L are deemed to own as of the date of the ownership change more than 50 percent of the total voting power or value of the L stock after the ownership change (130 of 240 shares or approximately 54 percent), with the result that the stock ownership requirements of section

382(l)(5)(A)(ii) are satisfied and section 382(l)(5) applies to the ownership change as of the effective date of the plan.

(d) Assume instead that the qualified creditors acquire 30 additional shares by exercise of options more than 3 years after the plan becomes effective. Such exercise is not taken into account under paragraph (e)(2)(ii) of this section for purposes of determining whether the stock ownership requirements of section 382(l)(5)(A)(ii) are satisfied as of the effective date of the plan. Thus, the qualified creditors are deemed to own less than 50 percent of the total voting power and value of the L stock after the ownership change (100 of 210 shares) and section 382(l)(5) does not apply to the ownership change.

(e) Assume instead that, during the 3 year period after the plan becomes effective, the new investor exercises part of his option and purchases 105 shares of stock. The exercise causes a lapse of the rights to acquire the remaining 5 shares of stock. Also during that time, the qualified creditors exercise part of their options and acquire 6 additional shares of stock. Under paragraph (e)(2)(i) of this section, L may treat the lapse of that part of the new investor's option to acquire 5 shares of stock as if that part of the option had never been issued for purposes of determining whether the stock ownership requirements of section 382(l)(5)(A)(ii) are satisfied as of the effective date of the plan. Also, under paragraph (e)(2)(ii) of this section, L may take into account the 6 shares purchased by the qualified creditors by the exercise of the options in determining whether the stock ownership requirements of section 382(l)(5)(A)(ii) are satisfied as of the effective date of the plan. If L takes all of this information into account, the qualified creditors are deemed to own more than 50 percent of the total voting power or value of the L stock after the ownership change (106 of 211 shares or approximately 50.2 percent) and section 382(l)(5) applies to the ownership change as of the effective date of the plan.

(4) *Effective dates*—(i) *In general.* This paragraph (e) applies to ownership changes occurring on or after September 5, 1990.

(ii) *Special rule for interest or dividends.* Rules similar to the rules of §1.382–2T(h)(4)(x)(E) (relating to option attribution for purposes of determining whether an ownership change occurs) apply to a right to receive or obligation to issue stock as interest or dividends on a debt instrument or stock that was issued after the filing of the petition in the title 11 or similar case for ownership changes occurring before April 8, 1992.

(f)—(h) [Reserved]

(i) *Election not to apply section 382(l)(5).* Under section 382(l)(5)(H), a loss corporation may elect not to have the provisions of section 382(l)(5) apply to an ownership change in a title 11 or similar case. This election is irrevocable and must be made by the due date (including any extensions of time) of the loss corporation's tax return for the taxable year which includes the change date. The election is to be made by attaching the following statement to the tax return of the loss corporation for that taxable year: ''This is an Election Under §1.382–9(i) not to Apply the Provisions of Section 382(l)(5) to the Ownership Change Occurring Pursuant to a Plan of Reorganization Confirmed by the Court on [Insert Confirmation Date].''

(j) *Value of the loss corporation in an ownership change to which section 382(l)(6) applies.* Section 382(l)(6) applies to any ownership change occurring pursuant to a plan of reorganization in a title 11 or similar case to which section 382(l)(5) does not apply. In such case, the value of the loss corporation under section 382(e) is equal to the lesser of—

(1) The value of the stock of the loss corporation immediately after the ownership change (determined under the rules of paragraph (k) of this section); or

(2) The value of the loss corporation's pre-change assets (determined under the rules of paragraph (l) of this section).

(k) *Rules for determining the value of the stock of the loss corporation*—(1) *Certain ownership interests treated as stock.* For purposes of paragraph (j)(1) of this section—

(i) Stock includes stock described in section 1504(a)(4) and any stock that is not treated as stock under §1.382–2T(f)(18)(ii) for purposes of determining whether a loss corporation has an ownership change; and

(ii) Stock does not include an ownership interest that is treated as stock under §1.382–2T(f)(18)(iii) for purposes of determining whether a loss corporation has an ownership change.

(2) *Coordination with section 382(e)(2).* In the case of a redemption or other corporate contraction occurring after and in connection with the ownership

change, the value of the stock of the loss corporation under paragraph (j)(1) of this section is reduced under section 382(e)(2).

(3) *Coordination with section 382(e)(3).* If the loss corporation is a foreign corporation, in determining the value of the stock under paragraph (j)(1) of this section, only items treated as connected with the conduct of a trade or business in the United States are taken into account.

(4) *Coordination with section 382(l)(1).* Section 382(l)(1) does not apply in determining the value of the stock of the loss corporation under paragraph (j)(1) of this section.

(5) *Coordination with section 382(l)(4).* If, immediately after the ownership change, the loss corporation has substantial nonbusiness assets (as determined under section 382(l)(4)(B) taking into account only those assets the loss corporation held immediately before the ownership change), the value of the stock of the loss corporation under paragraph (j)(1) of this section is reduced by the excess of the value of such nonbusiness assets over those assets' share of the loss corporation's indebtedness (determined under section 382(l)(4)(D) taking into account the loss corporation's assets and liabilities immediately after the ownership change).

(6) *Special rule for stock not subject to the risk of corporate business operations*—(i) *In general.* The value of the stock of the loss corporation under paragraph (j)(1) of this section is reduced by the value of stock that is issued as part of a plan one of the principal purposes of which is to increase the section 382 limitation without subjecting the investment to the entrepreneurial risks of corporate business operations.

(ii) *Coordination of special rule and other rules affecting value.* If the value of the loss corporation is modified under another rule affecting value, appropriate adjustments are to be made so that such modification is not duplicated under this paragraph (k)(6).

(7) *Limitation on value of stock.* For purposes of paragraph (j)(1) of this section, the value of stock of the loss corporation issued in connection with the ownership change cannot exceed the cash and the value of any property (including indebtedness of the loss corporation) received by the loss corporation in consideration for the issuance of that stock.

(l) *Rules for determining the value of the loss corporation's pre-change assets*—(1) *In general.* Except as otherwise provided in this paragraph (l), the value of the loss corporation's pre-change assets is the value of its assets (determined without regard to liabilities) immediately before the ownership change.

(2) *Coordination with section 382(e)(2).* Section 382(e)(2) does not apply in determining the value of the pre-change assets of the loss corporation under paragraph (j)(2) of this section.

(3) *Coordination with section 382(e)(3).* If the loss corporation is a foreign corporation, in determining the value of the pre-change assets under paragraph (j)(2) of this section, only assets treated as connected with the conduct of a trade or business in the United States are taken into account.

(4) *Coordination with section 382(l)(1).* For purposes of paragraph (j)(2) of this section, the value of the pre-change assets of the loss corporation is determined without regard to the amount of any capital contribution to which section 382(l)(1) applies. For purposes of applying this paragraph (l)(4), the receipt of cash or property by the loss corporation in exchange for the issuance of indebtedness is considered a capital contribution if it is part of a plan one of the principal purposes of which is to increase the value of the loss corporation under paragraph (j) of this section.

(5) *Coordination with section 382(l)(4).* If, immediately after the ownership change, the loss corporation has substantial nonbusiness assets (as determined under section 382(l)(4)(B) taking into account only those assets the loss corporation held immediately before the ownership change), the value of the loss corporation's pre-change assets is reduced by the value of the nonbusiness assets.

(m) *Continuity of business requirement*—(1) *Under section 382(l)(5).* If section 382(l)(5) applies to an ownership change of a loss corporation, section 382(c) and the regulations thereunder do not apply with respect to the ownership change.

(2) *Under section 382(l)(6).* If section 382(l)(6) applies to an ownership change of a loss corporation, section 382(c) and the regulations thereunder apply to the ownership change.

(n) *Ownership change in a title 11 or similar case succeeded by another ownership change within two years*—(1) *Section 382(l)(5) applies to the first ownership change.* If section 382(l)(5) applies to an ownership change and, within the two-year period immediately following such ownership change, a second ownership change occurs, section 382(l)(5) cannot apply to the second ownership change and the section 382(a) limitation with respect to the second ownership change is zero.

(2) *Section 382(l)(6) applies to the first ownership change.* If the value of a loss corporation in an ownership change was determined under section 382(l)(6) and a second ownership change occurs within the two-year period immediately following the first ownership change, the value of the loss corporation under section 382(e) with respect to the second ownership change is not reduced under section 382(l)(1) for any increase in value of the loss corporation previously taken into account under section 382(l)(6) with respect to the first ownership change.

(o) *Treatment of certain options for ownership change purposes*—(1) Neither § 1.382–2T(h)(4)(i) nor § 1.382–4(d) (relating to the treatment of options as exercised) applies to the following options to acquire stock of a loss corporation reorganized pursuant to a plan of reorganization that is confirmed in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) but only until the time the plan becomes effective—

(i) Any option created by the solicitation or receipt of acceptances to the plan;

(ii) The option created by the confirmation of the plan; and

(iii) Any option created under the plan.

(2) This paragraph (o) generally applies to any testing date occurring on or after September 5, 1990. However, this paragraph (o) does not apply on any testing date occurring on or after April 8, 1992, if, in connection with the plan of reorganization, the loss corporation issues stock (including stock described in section 1504(a)(4)) or otherwise receives a capital contribution before the effective date of the plan for a principal purpose of using before the effective date losses and credits that would be subject to limitation under section 382(a) or would be eliminated under section 382(l)(5)(B) or (C) if this paragraph (o) did not apply on the testing date. A loss corporation may elect to apply this paragraph (o) to any testing date occurring before September 5, 1990, by filing a statement substantially similar to the following with its income tax return: ‘‘THIS IS AN ELECTION TO APPLY § 1.382–3(o) (OR § 1.382–9(o) AFTER REDESIGNATION) FOR TESTING DATES PRIOR TO SEPTEMBER 5, 1990, TO OPTIONS CREATED BY OR UNDER A PLAN OF REORGANIZATION CONFIRMED IN A TITLE 11 OR SIMILAR CASE.’’ A loss corporation may elect to not apply this paragraph (o) to testing dates occurring on or after September 5, 1990, to April 8, 1992, by filing a statement substantially similar to the following with its income tax return: ‘‘THIS IS AN ELECTION TO NOT APPLY § 1.382–3(o) (OR § 1.382–9(o) AFTER REDESIGNATION) FOR TESTING DATES OCCURRING ON OR AFTER SEPTEMBER 5, 1990, TO APRIL 8, 1992, TO OPTIONS CREATED BY OR UNDER A PLAN OF REORGANIZATION CONFIRMED IN A TITLE 11 OR SIMILAR CASE.’’

(p) *Effective date for rules relating to section 382(l)(6)*—(1) *In general.* Paragraphs (i), (j), (k), (l), (m)(2), and (n)(2) of this section apply to any ownership change occurring on or after March 17, 1994.

(2) *Ownership change to which section 382(l)(6) applies occurring before March 17, 1994.* In the case of an ownership change occurring before March 17, 1994, the loss corporation may elect to apply the rules of paragraphs (j), (k), (l), (m)(2), and (n)(2) of § 1.382–9 in their entirety. The election must be made by the later of the due date (including any extensions of time) of the loss corporation's tax return for the taxable year which includes the change date or the date that the loss corporation files its first tax return after May 16, 1994. The election is made by attaching the following statement to the return: ‘‘This is an Election to Apply §§ 1.382–9 (j), (k),

(l), (m)(2), and (n)(2) of the Income Tax Regulations to the Ownership Change Occurring Pursuant to a Plan of Reorganization Confirmed by the Court on [Insert Confirmation Date].'' In connection with making this election, on the same return the loss corporation may also elect not to apply section 382(l)(5) to the ownership change under paragraph (i) of this section (if the loss corporation has not already done so pursuant to § 301.9100–7T(a) of this chapter). If, under the applicable statute of limitations, the loss corporation may file amended returns for the year of the ownership change and all subsequent years (an open year), an electing loss corporation must file an amended return for each prior affected year to reflect the elections. If, under the applicable statute of limitations, the loss corporation may not file an amended return for the year of the ownership change or any subsequent year (a closed year), an electing loss corporation must file an amended return for each affected open year to reflect the elections and the section 382 limitation resulting from the ownership change must be appropriately adjusted for the earliest open year (or years) to reflect the difference between the amount of pre-change losses actually used in closed years and the amount of pre-change losses that would have been used in such years applying the rules of paragraphs (j), (k), (l), (m)(2), (n)(2) of this section to the ownership change.

[T.D. 8388, 57 FR 346, Jan. 6, 1992; T.D. 8407, 57 FR 12210, Apr. 9, 1992. Redesignated by T.D. 8440, 57 FR 45712, 45713, Oct. 5, 1992; 57 FR 52827, Nov. 5, 1992; T.D. 8531, 59 FR 12840, Mar. 18, 1994; T.D. 8530, 59 FR 12843, Mar. 18, 1994; T.D. 8529, 59 FR 12846, Mar. 18, 1994]

§ 1.382–10 [Reserved]

§ 1.382–11 Effective dates. [Reserved]

§ 1.383–0 Effective date.

(a) The regulations under section 383 (other than the regulations described in paragraph (b) of this section) reflect the amendments made to sections 382 and 383 by the Tax Reform Act of 1986. See § 1.383–1(j) for effective date rules.

(b) Sections 1.383–1A, 1.383–2A, and 1.383–3A do not reflect the amendments made to sections 382 and 383 by the Tax Reform Act of 1986.

[T.D. 8352, 56 FR 29434, June 27, 1991]

§ 1.383–1 Special limitations on certain capital losses and excess credits.

(a) *Outline of topics.* In order to facilitate the use of this section, this paragraph lists the paragraphs, subparagraphs and subdivisions contained in this section.

(a) Outline of topics.
(b) In general.
(c) Definitions.
(1) Coordination with definitions and nomenclature used in section 382.
(2) Pre-change capital loss.
(3) Pre-change credit.
(4) Pre-change loss.
(5) Regular tax liability.
(6) Section 383 credit limitation.
(i) Definition.
(ii) Example.
(d) Limitation on use of pre-change losses and pre-change credits.
(1) In general.
(2) Ordering rules for utilization of pre-change losses and pre-change credits and for absorption of the section 382 limitation and the section 383 credit limitation.
(3) Coordination with other limitations.
(i) In general.
(ii) Examples.
(e) Carryforward of unused section 382 limitation.
(1) Computation of carryforward amount.
(2) Section 383 credit reduction amount.
(3) Computation of section 383 credit reduction amount; illustration using tax rates and brackets in effect for calendar year 1988.
(4) Special rules for determining the section 383 credit reduction amount.
(i) Ordering rules.
(ii) Special rule for credits under section 38(a).
(f) Examples.
(g) Coordination with section 382 and the regulations thereunder.
(h) Alternative minimum tax.
(i) [Reserved]
(j) Effective date.
(k) Transitional rules regarding information statements

(b) *In general.* Under section 383, if an ownership change occurs with respect to a loss corporation, the section 382 limitation and the section 383 credit limitation (as defined in paragraph (c)(6) of this section) for a post-change year shall apply to limit the amount of taxable income and regular tax liability, respectively, that can be offset by pre-change capital losses and pre-change credits of the new loss corporation. The section 383 credit limitation for a post-change year bears a direct relationship to the amount, if any, of the section 382 limitation that remains after taking into account the reduction in the loss corporation's taxable income during a post-change year as a result of its pre-change losses (as defined in paragraph (c)(4) of this section). In general, the section 383 credit limitation is an amount equal to the tax liability of the new loss corporation for the post-change year which is attributable to so much of the corporation's taxable income that would be reduced by allowing as a deduction its section 382 limitation remaining after accounting for the use of pre-change losses. As pre-change losses and pre-change credits of a corporation are used, they absorb the section 382 limitation and the section 383 credit limitation, respectively, in the manner prescribed by paragraph (d) of this section. See also section 382 and the regulations thereunder.

(c) *Definitions*—(1) *Coordination with definitions and nomenclature used in section 382.* Terms and nomenclature used in this section, and not otherwise defined herein, shall have the same respective meanings as in section 382 and the regulations thereunder, taking into account that the limitations of section 383 and this section apply to pre-change capital losses and pre-change credits.

(2) *Pre-change capital loss.* The term *pre-change capital loss* means—

(i) Any capital loss carryover under section 1212 of the old loss corporation to the taxable year ending on the change date or in which the change date occurs,

(ii) Any net capital loss of the old loss corporation for the taxable year in which the ownership change occurs, to the extent such loss is allocable to the period in such year ending on or before the change date, and

(iii) If the old loss corporation has a net unrealized built-in loss, any recognized built-in loss for any recognition period taxable year (within the meaning of section 382(h)) that is a capital loss.

(3) *Pre-change credit.* The term *pre-change credit* means—

(i) Any excess foreign taxes under section 904(c) of the old loss corporation—

(A) carried forward to the taxable year ending on the change date or in which the change date occurs, or

(B) carried forward from the taxable year that includes the change date, to the extent such credit is allocable to the period in such year ending on or before the change date,

(ii) Any credit under section 38 of the old loss corporation—

(A) carried forward to the taxable year ending on the change date or in which the change date occurs, or

(B) carried forward from a taxable year that includes the change date to the extent such credit is allocable to the period in such year ending on or before the change date, and

(iii) The available minimum tax credit of the old loss corporation under section 53 to the extent attributable to periods ending on or before the change date.

(4) *Pre-change loss.* Solely for purposes of this section, the term *prechange loss* means any pre-change loss described in § 1.382–2(a)(2) other than pre-change credits described in paragraph (c)(3) of this section.

(5) *Regular tax liability.* For purposes of this section, the term *regular tax liability* has the same meaning as provided in section 26(b).

(6) *Section 383 credit limitation*—(i) *Definition.* The *section 383 credit limitation* for a post-change year of a new loss corporation is an amount equal to the excess of—

(A) The new loss corporation's regular tax liability for the post-change year, over

(B) The new loss corporation's regular tax liability for the post-change year computed, for this purpose, by allowing as an additional deduction an amount equal to the section 382 limitation remaining after the application of paragraphs (d)(2)(i) through (iv) of this section.

(ii) *Example.*

L, a new loss corporation, is a calendar year taxpayer. L has an ownership change on December 31, 1987. For 1988, L has taxable income (prior to the use of any pre-change losses) of $100,000. In addition, L has a section 382 limitation of $25,000, a pre-change net operating loss carryover of $12,000, a pre-change minimum tax credit of $50,000, and no pre-change capital losses. L's section 383 credit limitation is the excess of its regular tax liability computed after allowing a $12,000 net operating loss deduction (taxable income of $88,000; regular tax liability of $18,170), over its regular tax liability computed after allowing an additional deduction in the amount of L's section 382 limitation remaining after the application of paragraphs (d)(2)(i) through (iv) of this section, or $13,000 (taxable income of $75,000; regular tax liability of $13,750). L's section 383 credit limitation is therefore $4,420 ($18,170 minus $13,750).

(d) *Limitation on use of pre-change losses and pre-change credits*—(1) *In general.* The amount of taxable income of a new loss corporation for any post-change year that may be offset by pre-change losses shall not exceed the amount of the section 382 limitation for the post-change year. The amount of the regular tax liability of a new loss corporation for any post-change year that may be offset by pre-change credits shall not exceed the amount of the section 383 credit limitation for the post-change year.

(2) *Ordering rules for utilization of pre-change losses and pre-change credits and for absorption of the section 382 limitation and the section 383 credit limitation.* Pre-change losses described in any subdivision of this paragraph (d)(2) can offset taxable income in a post-change year only to the extent that the section 382 limitation for that year has not been absorbed by pre-change losses described in any lower-numbered subdivisions. Pre-change credits described in any subdivision of this paragraph (d)(2) can offset regular tax liability in a post-change year only to the extent that the section 383 credit limitation for that year has not been absorbed by pre-change credits described in any lower numbered subdivisions. The section 382 limitation is absorbed by one dollar for each dollar of pre-change loss that is used to offset taxable income. The section 383 credit limitation is absorbed by one dollar for each dollar of pre-change credit that is used to offset regular tax liability. For each post-change year, the section 382 limitation and the section 383 credit limitation of a new loss corporation are absorbed by such corporation's pre-change losses and pre-change credits in the following order:

(i) Pre-change capital losses described in paragraph (c)(2)(iii) of this section that are recognized and are subject to the section 382 limitation in such post-change year,

(ii) Pre-change capital losses described in paragraphs (c)(2)(i) and (ii) of this section,

(iii) Pre-change losses that are described in § 1.382–2(a)(2) (other than losses that are pre-change capital losses) that are recognized and are subject to the section 382 limitation in such post-change year,

(iv) Pre-change losses not described in paragraphs (d)(2)(i) through (iii) of this section,

(v) Pre-change credits described in paragraph (c)(3)(i) of this section (excess foreign taxes),

(vi) Pre-change credits described in paragraph (c)(3)(ii) of this section (business credits), and

(vii) Pre-change credits described in paragraph (c)(3)(iii) of this section (minimum tax credit).

(3) *Coordination with other limitations*—(i) *In general.* Paragraphs (d)(1) and (2) of this section shall be applied after the application of all other limitations contained in subtitle A which are applicable to the use of a pre-change loss or pre-change credit in a post-change year. Thus, only otherwise currently allowable pre-change losses and pre-change credits will result in the absorption of the section 382 limitation and the section 383 credit limitation.

(ii) *Examples:*

Example (1). L is a calendar year taxpayer and has an ownership change on December 31, 1987. For 1988, L has taxable income of $300,000, a regular tax liability of $100,250 and a tentative minimum tax of $90,000. L has no pre-change losses, but has a business credit carryforward from 1985 of $25,000, no portion of which is due to the regular percentage of the investment tax credit under section 46. L has a section 382 limitation for 1988 of $50,000. L's section 383 credit limitation is $19,500, i.e., an amount equal to the excess of L's regular tax liability ($100,250) over its regular tax liability calculated by allowing an additional deduction of $50,000. Pursuant to the limitation contained in section 38(c), however, L is entitled to use only $10,250 of its business credit carryforward in 1988. The unabsorbed portion of L’s section 382 limitation (computed pursuant to paragraph (e) of this section) is carried forward under section 382(b)(2). The unused portion of L’s business credit carryforward, $14,750, is carried forward to the extent provided in section 39.

Example (2). Assume the same facts as in *Example (1),* except that L’s tentative minimum tax is $70,000. L’s use of its investment tax credit carryforward is no longer limited by section 38(c); however, pursuant to section 383 and this section, L is entitled to use only $19,500 of its business credit carryforward in 1988. The unused portion of L’s business credit carryforward, $5,500, is carried forward to the extent provided in section 39. There is no unused section 382 limitation to be carried forward.

(e) *Carryforward of unused section 382 limitation*—(1) *Computation of carryforward amount.* The section 382 limitation that can be carried forward under section 382(b)(2) is the excess, if any, of (i) the section 382 limitation for the post-change year remaining after the application of paragraphs (d)(2)(i) through (iv) of this section, over (ii) the section 383 credit reduction amount for that post-change year.

(2) *Section 383 credit reduction amount.* The section 383 credit reduction amount for a post-change year is equal to the amount of taxable income attributable to the portion of the new loss corporation’s regular tax liability for the year that is offset by pre-change credits. Each dollar of regular tax liability that is offset by a dollar of pre-change credit is divided by the effective marginal rate at which that dollar of tax was imposed to determine the amount of taxable income that resulted in that particular dollar of regular tax liability. The sum of these ‘‘grossed-up’’ amounts for the taxable year is the section 383 credit reduction amount. In determining the effective marginal rate at which a dollar of tax was imposed, special rules regarding rates of tax (*e.g.,* sections 11(b)(2) and (15) or taxable income brackets (*e.g.,* section 1561), or both, shall be taken into account. See *Example (3)* in paragraph (f) of this section illustrating the effect of section 1561(a). Paragraph (e)(3) of this section illustrates the gross-up computation of the section 383 credit reduction amount based on the tax table and the rates of tax prescribed by section 11(b) as in effect for taxable years beginning on January 1, 1988.

(3) *Computation of section 383 credit reduction amount; illustration using tax rates and brackets in effect for calendar year 1988.* (i) Assuming no special rules regarding rates of tax or taxable income brackets apply, the section 383 credit reduction amount for a new loss corporation is the sum of the amounts determined under paragraphs (e)(3)(ii), (iii), (iv), (v), and (vi) of this section.

(ii) The amount determined under this subdivision (ii) is the amount (if any) by which pre-change credits offset so much of the new loss corporation’s regular tax liability as exceeds $113,900, divided by 0.34.

(iii) The amount determined under this subdivision (e)(3)(iii) is the amount (if any) by which pre-change credits offset so much of the new loss corporation’s regular tax liability as exceeds $22,250 (but does not exceed $113,900), divided by 0.39.

(iv) The amount determined under this subdivision (e)(3)(iv) is the amount (if any) by which pre-change credits offset so much of the new loss corporation’s regular tax liability as exceeds $13,750 (but does not exceed $22,250), divided by 0.34.

(v) The amount determined under this subdivision (e)(3)(v) is the amount (if any) by which pre-change credits offset so much of the new loss corporation’s regular tax liability as exceeds $7,500 (but does not exceed $13,750), divided by 0.25.

(vi) The amount determined under this subdivision (e)(3)(vi) is the amount (if any) by which pre-change credits offset so much of the new loss corporation’s regular tax liability as does not exceed $7,500, divided by 0.15.

(4) *Special rules for determining the section 383 credit reduction amount*—(i) *Ordering rules.* For purposes of this paragraph (e), credits, including pre-change credits, are considered to offset regular tax liability in the order that such credits are applied under the ordering rules of part IV of subchapter A of chapter 1 and section 904. For example, for purposes of this paragraph (e), excess foreign taxes carried over under section 904(c) (whether or not a pre-change credit) are considered (under

section 38(c)) to offset regular tax liability before the general business credit carryovers to the taxable year are considered (under section 39) to offset regular tax liability before general business credits arising in the taxable year.

(ii) *Special rule for credits under section 38(a).* For purposes of applying this paragraph (e), credits under section 38(a) that, under section 38(c)(2) as applicable, taking into account amendments made by section 11813 of the Revenue Reconciliation Act of 1990, effectively offset both regular tax liability and the tax imposed by section 55 (relating to minimum tax), are considered to offset regular tax liability.

(f) *Examples.* The following examples illustrate the operation of paragraphs (b) through (e) of this section. For purposes of these examples, the term *modified tax liability* means the amount determined under paragraph (c)(6)(i)(B) of this section.

Example (1). (i) L, a calendar year taxpayer, has an ownership change on December 31, 1987. Before the application of carryovers, L, a new loss corporation, has $60,000 of capital gain, $100,000 of ordinary taxable income and a section 382 limitation of $100,000 for its first post-change year beginning after the change date. L's only carryovers are an $80,000 capital loss carryover and a $100,000 net operating loss carryover. Both carryovers are from taxable years ending before the change date and thus are pre-change losses.

(ii) L first uses $60,000 of its pre-change capital loss carryover to offset its capital gain. This reduces its section 382 limitation to $40,000 (i.e., $100,000−$60,000). L's pre-change net operating loss carryover can therefore be used only to the extent of $40,000. L's remaining $20,000 pre-change capital loss carryover and remaining $60,000 pre-change net operating loss carryover are carried to later years to the extent permitted under this section and sections 172, 382(l)(2) and 1212.

Example (2). (i) L, a calendar year taxpayer, has an ownership change on December 31, 1987. L has $750,000 of ordinary taxable income (before the application of carryovers) and a section 382 limitation of $1,500,000 for 1988. L's only carryovers are from pre-1987 taxable years and consist of a $500,000 net operating loss (''NOL'') carryover and a $200,000 foreign tax credit carryover, all of which may be used under the section 904 limitation. The NOL carryover is a pre-change loss, and the foreign tax credit carryover is a pre-change credit. L has no other credits which can be used for 1988 and is not liable for an alternative minimum tax for 1988.

(ii) The following computation illustrates the application of this section for 1988:

1. Taxable income before carryovers	$750,000
2. Pre-change NOL carryover	500,000
3. Section 382 limitation	1,500,000
4. Amount of pre-change NOL carryover that can be used (lesser of line 1, 2, or 3)	500,000
5. Taxable income (line 1 minus line 4)	250,000
6. Section 382 limitation remaining (line 3 minus line 4)	1,000,000
7. Pre-change credit carryover	200,000
8. Regular tax liability (line 5 × section 11 rates): $50,000×0.15=$7,500 25,000×0.25=6,250 25,000×0.34=8,500 150,000×0.39=58,500	80,750
9. Modified tax liability (line 5 minus line 6 (but not less than zero)) × section 11 rates)	0
10. Section 383 credit limitation (line 8 minus line 9)	80,750
11. Amount of pre-change credits that can be used (lesser of line 7 or line 10)	80,750
12. Amount of pre-change credits to be carried over to 1989 under section 904(c) (line 7 minus line 11)	119,250
13. Section 383 credit reduction amount: ($80,750 minus $22,250)/0.39=$150,000 ($22,250 minus $13,750)/0.34=25,000 ($13,750 minus $7,500)/0.25=25,000 $7,500/0.15=50,000	250,000
14. Section 382 limitation to be carried to 1989 under section 382(b)(2) (Line 6 minus line 13)	750,000

Example (3). (i) Assume the same facts as in *Example (2),* except that, for purposes of section 1561(a), L is a component member of a controlled group of corporations and the taxable income of the controlled group of corporations for 1988 is $2,000,000.

(ii) The following computation illustrates the application of this section for 1988:

1. Taxable income before carryovers	$750,000
2.Pre-change NOL carryover	500,000
3. Section 382 limitation	1,500,000
4. Amount of pre-change NOL carryover that can be used (lesser of line 1, 2, or 3)	500,000
5. Taxable income (line 1 minus line 4)	250,000
6. Section 382 limitation remaining (line 3 minus line 4)	1,000,000

7. Pre-change credit carryover ...	200,000
8. Regular tax liability (line 5×0.34 (the effective section 11 rate under section 1561(a)))	85,000
9. Modified tax liability (line 5 minus line 6 (but not less than zero)) × section 11 rates)	0
10. Section 383 credit limitation (line 8 minus line 9)	85,000
11. Amount of pre-change credits that can be used (lesser of line 7 or line 10)	85,000
12. Amount of pre-change credits to be carried over to 1989 under section 904(c) (line 7 minus line 11)	115,000
13. Section 383 credit reduction amount (line 11 divided by 0.34)	250,000
14. Section 383 limitation to be carried to 1989 under section 382(b)(2) (line 6 minus line 13) ...	750,000

Example (4) . (i) L, a calendar year taxpayer, has an ownership change on December 31, 1987. L has $80,000 of ordinary taxable income (before the application of carryovers) and a section 382 limitation of $25,000 for 1988, a post-change year. L's only carryover is from a pre-1987 taxable year and is a general business credit carryforward under section 39 in the amount of $10,000 (no portion of which is attributable to the investment tax credit under section 46). The general business credit carryforward is a pre-change credit. L has no other credits which can be used for 1988 and is not liable for an alternative minimum tax for 1988.

(ii) The following computation illustrates the application of this section:

1. Taxable income	$80,000
2. Section 382 limitation	25,000
3. Pre-change credit carryover	10,000
4. Regular tax liability (line 1 × section 11 rates): $50,000×0.15=$7,500 25,000×0.25=6,250 5,000×0.34=1,700	15,450
5. Modified tax liability ((line 1 minus line 2) × section 11 rates): $50,000×0.15=$7,500 5,000×0.25=1,250	8,750
6. Section 383 credit limitation (line 4 minus line 5)	6,700
7. Amount of pre-change credits that can be used (lesser of line 3 or line 6)	6,700
8. Amount of pre-change credits to be carried over to 1989 under sections 39 and 382(l)(2) (line 3 minus line 7)	3,300
9. Regular tax payable (line 4 minus line 7)	8,750
10. Section 383 credit reduction amount: ($15,450 minus $13,750)/0.34=$5,000 ($13,750 minus $8,750)/0.25=20,000	25,000
11. Section 382 limitation to be carried to 1989 under section 382(b)(2) (line 2 minus line 10)	0

(g) *Coordination with section 382 and the regulations thereunder.* The rules and principles of section 382 (including, for example, section 382(b)(3) and section 382(l)(2)) and the regulations thereunder shall also apply with respect to section 383 and this section. To the extent section 382(h)(6) applies to credits, the principles of this section apply to such credits. In applying the rules and principles of section 382 and the regulations thereunder, appropriate adjustments shall be made to take into account that section 383 and this section apply to pre-change capital losses and pre-change credits. For example, in applying §1.382–2T (f)(18)(ii)(C), (f)(18)(iii)(C) and (h)(4)(ix), any pre-change credits, as defined in paragraph (c)(3) of this section, must be converted to a deduction equivalent by dividing the amount of such credits by the maximum effective rate of tax provided for under section 11 (e.g., 0.34 for taxable years beginning in 1989).

(h) *Alternative minimum tax.* See §1.383–2T for the application of the limitations contained in sections 382 and 383 in computing the alternative minimum tax under section 55.

(i) [Reserved]

(j) *Effective date.* Subject to any exception from the application of section 382 or the section 382 limitation with respect to a loss corporation, section 383 and this section apply to any loss corporation with respect to which an ownership change occurs after December 31, 1986. See §1.382–2T(m) for effective date rules relating to ownership changes. If section 383 was not taken into account or was applied other than in accordance with this section in a prior taxable year with respect to which section 383 applies, the taxpayer should, within the period of limitation, file an amended return and pay any additional tax due plus interest.

(k) Transitional rules regarding information statements—(1) *Exception.*

An information statement described in § 1.382–2T(a)(2)(ii) of this section that would be required to be filed solely by reason of the loss corporation having pre-change capital losses (as defined in § 1.382–2T (a)(2)(ii)(A) and (B) or pre-change credits (as defined in paragraph (c)(3) of this section) is not required to be filed with the income tax return of the loss corporation for any taxable year for which the due date (including extensions) of the income tax return is on or before November 20, 1989, or for which the income tax return is filed on or before October 10, 1989.

(2) *Statement with respect to prior periods.* A corporation which is a loss corporation for any taxable year ending in 1987, 1988 or 1989 solely because it has pre-change capital losses (as defined in paragraphs (c)(2)(i) and (ii) of this section or pre-change credits (as defined in paragraph (c)(3) of this section) must attach a separate information statement to its 1988 and 1989 income tax returns. Such information statement must (i) include the information specified in § 1.382–2T (a)(2)(ii)(A) and (B) (without regard to testing dates before May 6, 1986) for each taxable year ending on or after May 6, 1986 for which the corporation was a loss corporation, (ii) state whether and to what extent pre-change capital losses (as defined in paragraphs (c)(2)(i) and (ii) of this section) or pre-change credits (as defined in paragraph (c)(3) of this section) utilized by the corporation in a taxable year to which the section 382 limitation applied, exceeded the amount permitted under this section, and (iii) be labeled ‘‘Information Statement with Respect to Transition Periods.’’ For purposes of the preceding sentence, information previously reported in an information statement, including a statement filed with a 1988 return, may be excluded. The requirements of this paragraph (k)(2) apply only with respect to 1988 and 1989 taxable years with respect to which the due date of the income tax return (including extensions) is after November 20, 1989, and for which the income tax return is not filed on or before October 10, 1989.

[T.D. 8264, 54 FR 38668, Sept. 20, 1989; T.D. 8264, 54 FR 46187, Nov. 1, 1989; T.D. 8264, 54 FR 50043, Dec. 4, 1989. Redesignated and amended by T.D. 8352, 56 FR 29434, June 27, 1991]

§ 1.383–2 Limitations on certain capital losses and excess credits in computing alternative minimum tax. [Reserved]

SUBCHAPTER A—INCOME TAX (Continued)

PART 1—INCOME TAXES

NORMAL TAXES AND SURTAXES (CONTINUED)

DEFERRED COMPENSATION, ETC.

PENSION, PROFIT-SHARING, STOCK BONUS PLANS, ETC.

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CERTAIN STOCK OPTIONS

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§1.401–12 also issued under 26 U.S.C. 401(d)(1).

§1.401(a)(5)–1 also issued under 26 U.S.C. 401(a)(5).

§1.401(a)(17)–1 also issued under 26 U.S.C. 401(a)(17).

§§1.401(a)(26)–1 through (a)(26)–9 also issued under 26 U.S.C. 401(a)(26).

§1.401(b)–1 also issued under 26 U.S.C. 401(b).

§1.401(l)–0 through 1.401(l)–6 also issued under 26 U.S.C. 401(l).

§1.408A–1 also issued under 26 U.S.C. 408A.

§1.408A–2 also issued under 26 U.S.C. 408A.

§1.408A–3 also issued under 26 U.S.C. 408A.

§1.408A–4 also issued under 26 U.S.C. 408A.

§1.408A–5 also issued under 26 U.S.C. 408A.

§1.408A–6 also issued under 26 U.S.C. 408A.

§1.408A–7 also issued under 26 U.S.C. 408A.

§1.408A–8 also issued under 26 U.S.C. 408A.

§1.408A–9 also issued under 26 U.S.C. 408A.

§§1.410(b)–2 through 1.410(b)–10 also issued under 26 U.S.C. 410(b)(6).

§1.411(a)–7T also issued under 26 U.S.C. 411(a)(7)(B)(i).

§1.411(d)–4 also issued under 26 U.S.C. 411(d)(6).

§1.411(d)–4T also issued under 26 U.S.C. 411(d)(6).

§1.411(d)–6 is issued under Reorganization Plan No. 4 of 1978, 29 U.S.C. 1001nt.

§§1.414(c)–1 through 1.414(c)–5 also issued under 26 U.S.C. 414(c).

§1.414(q)–1T is also issued under 26 U.S.C. 414(q).

§§1.414(r)–0 through 1.414(r)–7 also issued under 26 U.S.C. 414(r).

§1.414(r)–8 also issued under 26 U.S.C. 410(b) and 414(r).

§1.414(r)–9 also issued under 26 U.S.C. 401(a)(26) and 414(r).

§1.414(r)–10 also issued under 26 U.S.C. 129 and 414(r).

§1.414(r)–1 also issued under 26 U.S.C. 414(r).

§1.414(s)–1 also issued under 26 U.S.C. 414(s).

§1.417(e)–1 also issued under 26 U.S.C. 417(e)(3)(A)(ii)(II).

§1.417(e)–1T also issued under 26 U.S.C. 417(e)(3)(A)(ii)(II).

DEFERRED COMPENSATION, ETC.

PENSION, PROFIT-SHARING, STOCK BONUS PLANS, ETC.

§1.401–0 Scope and definitions.

(a) *In general.* Sections 1.401 through 1.401–14 (inclusive) reflect the provisions of section 401 prior to amendment by the Employee Retirement Income Security Act of 1974. The sections following §1.401–14 and preceding §1.402(a)–1 (hereafter referred to in this section as the ''Post-ERISA Regulations'') reflect the provisions of section 401 after amendment by such Act.

(b) *Definitions.* For purposes of the Post-ERISA regulations—

(1) *Qualified plan.* The term ''qualified plan'' means a plan which satisfies the requirements of section 401(a).

(2) *Qualified trust.* The term ''qualified trust'' means a trust which satisfies the requirements of section 401(a).

(Sec. 411 Internal Revenue Code of 1954 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42320, Aug. 23, 1977]

§1.401–1 Qualified pension, profit-sharing, and stock bonus plans.

(a) *Introduction.* (1) Sections 401 through 405 relate to pension, profit-sharing, stock bonus, and annuity plans, compensation paid under a deferred-payment plan, and bond purchase plans. Section 401(a) prescribes the requirements which must be met for qualification of a trust forming part of a pension, profit-sharing, or stock bonus plan.

(2) A qualified pension, profit-sharing, or stock bonus plan is a definite written program and arrangement which is communicated to the employees and which is established and maintained by an employer—

(i) In the case of a pension plan, to provide for the livelihood of the employees or their beneficiaries after the retirement of such employees through the payment of benefits determined without regard to profits (see paragraph (b)(1)(i) of this section);

(ii) In the case of a profit-sharing plan, to enable employees or their beneficiaries to participate in the profits of the employer's trade or business, or in the profits of an affiliated employer who is entitled to deduct his contributions to the plan under section 404(a)(3)(B), pursuant to a definite formula for allocating the contributions and for distributing the funds accumulated under the plan (see paragraph (b)(1)(ii) of this section); and

(iii) In the case of a stock bonus plan, to provide employees or their beneficiaries benefits similar to those of profit-sharing plans, except that such benefits are distributable in stock of the employer, and that the contributions by the employer are not necessarily dependent upon profits. If the employer's contributions are dependent upon profits, the plan may enable employees or their beneficiaries to participate not only in the profits of the employer, but also in the profits of an affiliated employer who is entitled to deduct his contributions to the plan under section 404(a)(3)(B) (see paragraph (b)(1)(iii) of this section).

(3) In order for a trust forming part of a pension, profit-sharing, or stock bonus plan to constitute a qualified trust under section 401(a), the following tests must be met:

(i) It must be created or organized in the United States, as defined in section 7701(a)(9), and it must be maintained at all times as a domestic trust in the United States;

(ii) It must be part of a pension, profit-sharing, or stock bonus plan established by an employer for the exclusive benefit of his employees or their beneficiaries (see paragraph (b)(2) through (5) of this section);

(iii) It must be formed or availed of for the purpose of distributing to the employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with the plan, and, in the case of a plan which covers (as defined in paragraph (a)(2) of § 1.401–10) any self-employed individual, the time and method of such distribution must satisfy the requirements of section 401(a)(9) with respect to each employee covered by the plan (see paragraph (e) of § 1.401–11);

(iv) It must be impossible under the trust instrument at any time before the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries (see § 1.401–2);

(v) It must be part of a plan which benefits prescribed percentages of the employees, or which benefits such employees as qualify under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of certain specified classes of employees (see § 1.401–3 and, in addition, see § 1.401–12 for special rules as to plans covering owner-employees);

(vi) It must be part of a plan under which contributions or benefits do not discriminate in favor of certain specified classes of employees (see § 1.401–4);

(vii) It must be part of a plan which provides the nonforfeitable rights described in section 401(a)(7) (see § 1.401–6);

(viii) If the trust forms part of a pension plan, the plan must provide that forfeitures must not be applied to increase the benefits any employee would receive under such plan (see § 1.401–7);

(ix) It must, if the plan benefits any self-employed individual who is an owner-employee, satisfy the additional requirements for qualification contained in section 401(a)(10) and (d).

(4) For taxable years beginning after December 31, 1962, self-employed individuals may be included in qualified plans. See §§ 1.401–10 through 1.401–13.

(b) *General rules.* (1)(i) A pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of retirement benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of service, or other reason, may be used to provide increased benefits for the remaining participants (see § 1.401–7, relating to the treatment of forfeitures under a qualified pension plan). A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will, for the purposes of section 401(a), be considered a pension plan if the employer contributions under the plan can be determined actuarially on the basis of definitely determinable benefits, or, as in the case of money purchase pension plans, such contributions are fixed without being geared to profits. A pension plan may provide for the payment of a pension due to disability and may also provide for the payment of incidental death benefits through insurance or otherwise. However, a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan such as layoff benefits or benefits for sickness, accident, hospitalization, or medical expenses (except medical benefits described in section 401(h) as defined in paragraph (a) of §1.401–14).

(ii) A profit-sharing plan is a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries. The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. A formula for allocating the contributions among the participants is definite if, for example, it provides for an allocation in proportion to the basic compensation of each participant. A plan (whether or not it contains a definite predetermined formula for determining the profits to be shared with the employees) does not qualify under section 401(a) if the contributions to the plan are made at such times or in such amounts that the plan in operation discriminates in favor of officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees. For the rules with respect to discrimination, see §§1.401–3 and 1.401–4. A profit-sharing plan within the meaning of section 401 is primarily a plan of deferred compensation, but the amounts allocated to the account of a participant may be used to provide for him or his family incidental life or accident or health insurance.

(iii) A stock bonus plan is a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company. For the purpose of allocating and distributing the stock of the employer which is to be shared among his employees or their beneficiaries, such a plan is subject to the same requirements as a profit-sharing plan.

(iv) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 7701(a)(20).

(2) The term ‘‘plan’’ implies a permanent as distinguished from a temporary program. Thus, although the employer may reserve the right to change or terminate the plan, and to discontinue contributions thereunder, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general. Especially will this be true if, for example, a pension plan is abandoned soon after pensions have been fully funded for persons in favor of whom discrimination is prohibited under section 401(a). The permanency of the plan will be indicated by all of the surrounding facts and circumstances, including the likelihood of the employer’s ability to continue contributions as provided under the plan. In the case of a profit-sharing plan, other than a profit-sharing plan which covers employees and owner-employees (see section 401(d)(2)(B)), it is not necessary that the employer contribute every year or that he contribute the same amount or contribute in accordance with the same ratio every year. However, merely making a single or occasional contribution out of profits for employees does not establish a plan of profit-sharing. To be a profit-sharing plan, there must be recurring and substantial contributions out of profits for the employees. In the event a plan is abandoned, the employer should promptly notify the district director, stating the circumstances which led to the discontinuance of the plan.

(3) If the plan is so designed as to amount to a subterfuge for the distribution of profits to shareholders, it will not qualify as a plan for the exclusive benefit of employees even though other employees who are not shareholders are also included under the plan. The plan must benefit the employees in general, although it need not provide benefits for all of the employees. Among the employees to be

benefited may be persons who are officers and shareholders. However, a plan is not for the exclusive benefit of employees in general if, by any device whatever, it discriminates either in eligibility requirements, contributions, or benefits in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or the highly compensated employees. See section 401(a) (3), (4), and (5). Similarly, a stock bonus or profit-sharing plan is not a plan for the exclusive benefit of employees in general if the funds therein may be used to relieve the employer from contributing to a pension plan operating concurrently and covering the same employees. All of the surrounding and attendant circumstances and the details of the plan will be indicative of whether it is a bona fide stock bonus, pension, or profit-sharing plan for the exclusive benefit of employees in general. The law is concerned not only with the form of a plan but also with its effects in operation. For example, section 401(a)(5) specifies certain provisions which of themselves are not discriminatory. However, this does not mean that a plan containing these provisions may not be discriminatory in actual operation.

(4) A plan is for the exclusive benefit of employees or their beneficiaries even though it may cover former employees as well as present employees and employees who are temporarily on leave, as, for example, in the Armed Forces of the United States. A plan covering only former employees may qualify under section 401(a) if it complies with the provisions of section 401(a)(3)(B), with respect to coverage, and section 401(a)(4), with respect to contributions and benefits, as applied to all of the former employees. The term ''beneficiaries'' of an employee within the meaning of section 401 includes the estate of the employee, dependents of the employee, persons who are the natural objects of the employee's bounty, and any persons designated by the employee to share in the benefits of the plan after the death of the employee.

(5)(i) No specific limitations are provided in section 401(a) with respect to investments which may be made by the trustees of a trust qualifying under section 401(a). Generally, the contributions may be used by the trustees to purchase any investments permitted by the trust agreement to the extent allowed by local law. However, such a trust will be subject to tax under section 511 with respect to any ''unrelated business taxable income'' (as defined in section 512) realized by it from its investments.

(ii) Where the trust funds are invested in stock or securities of, or loaned to, the employer or other person described in section 503(b), full disclosure must be made of the reasons for such arrangement and the conditions under which such investments are made in order that a determination may be made whether the trust serves any purpose other than constituting part of a plan for the exclusive benefit of employees. The trustee shall report any of such investments on the return which under section 6033 it is required to file and shall with respect to any such investment furnish the information required by such return. See § 1.6033–1.

(c) *Portions of years.* A qualified status must be maintained throughout the entire taxable year of the trust in order for the trust to obtain any exemption for such year. But see section 401(a)(6) and § 1.401–3.

(d) *Plan of several employers.* A trust forming part of a plan of several employers for their employees will be qualified if all the requirements are otherwise satisfied.

(e) *Determination of exemptions and returns.* (1) An employees' trust may request a determination letter as to its qualification under section 401 and exemption under section 501. For the procedure for obtaining such a determination letter see paragraph (l) of § 601.201 of this chapter (Statement of Procedural Rules).

(2) A trust which qualifies under section 401(a) and which is exempt under section 501(a) must file a return in accordance with section 6033 and the regulations thereunder. See §§ 1.6033–1 and 1.6033–2(a)(3). In case such a trust realizes any unrelated business taxable income, as defined in section 512, such trust is also required to file a return

with respect to such income. See paragraph (e) of §1.6012–2 and paragraph (a)(5) of §1.6012–3 for requirements with respect to such returns. For information required to be furnished periodically by an employer with respect to the qualification of a plan, see §§1.404(a)–2, 1.404(a)–2A, and 1.6033–2(a)(2)(ii)*(i)*.

[T.D. 6500, 25 FR 11670, Nov. 26, 1960, as amended by T.D. 6675, 28 FR 10118, Sept. 17, 1963; T.D. 6722, 29 FR 5071, Apr. 14, 1964; T.D. 7168, 37 FR 5024, Mar. 9, 1972; T.D. 7428, 41 FR 34619, Aug. 16, 1976]

§1.401–2 Impossibility of diversion under the trust instrument.

(a) *In general.* (1) Under section 401(a)(2) a trust is not qualified unless under the trust instrument it is impossible (in the taxable year and at any time thereafter before the satisfaction of all liabilities to employees or their beneficiaries covered by the trust) for any part of the trust corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of such employees or their beneficiaries. This section does not apply to funds of the trust which are allocated to provide medical benefits described in section 401(h) as defined in paragraph (a) of §1.401–14. For the rules prohibiting diversion of such funds and the requirement of reversion to the employer after satisfaction of all liabilities under the medical benefits account, see paragraph (c) (4) and (5) of §1.401–14. For rules permitting reversion to the employer of amounts held in a section 415 suspense acount, see §1.401(a)–2(b).

(2) As used in section 401(a)(2), the phrase ''if under the trust instrument it is impossible'' means that the trust instrument must definitely and affirmatively make it impossible for the nonexempt diversion or use to occur, whether by operation or natural termination of the trust, by power of revocation or amendment, by the happening of a contingency, by collateral arrangement, or by any other means. Although it is not essential that the employer relinquish all power to modify or terminate the rights of certain employees covered by the trust, it must be impossible for the trust funds to be used or diverted for purposes other than for the exclusive benefit of his employees or their beneficiaries.

(3) As used in section 401(a)(2), the phrase ''purposes other than for the exclusive benefit of his employees or their beneficiaries'' includes all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or their beneficiaries covered by the trust.

(b) *Meaning of ''liabilities''.* (1) The intent and purpose in section 401(a)(2) of the phrase ''prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust'' is to permit the employer to reserve the right to recover at the termination of the trust, and only at such termination, any balance remaining in the trust which is due to erroneous actuarial computations during the previous life of the trust. A balance due to an ''erroneous actuarial computation'' is the surplus arising because actual requirements differ from the expected requirements even though the latter were based upon previous actuarial valuations of liabilities or determinations of costs of providing pension benefits under the plan and were made by a person competent to make such determinations in accordance with reasonable assumptions as to mortality, interest, etc., and correct procedures relating to the method of funding. For example, a trust has accumulated assets of $1,000,000 at the time of liquidation, determined by acceptable actuarial procedures using reasonable assumptions as to interest, mortality, etc., as being necessary to provide the benefits in accordance with the provisions of the plan. Upon such liquidation it is found that $950,000 will satisfy all of the liabilities under the plan. The surplus of $50,000 arises, therefore, because of the difference between the amounts actuarially determined and the amounts actually required to satisfy the liabilities. This $50,000, therefore, is the amount which may be returned to the employer as the result of an erroneous actuarial computation. If, however, the surplus of $50,000 had been accumulated as a result of a change in the benefit provisions or in the eligibility requirements of the plan, the $50,000 could not revert to the employer because such surplus would not be the result of an erroneous actuarial computation.

(2) The term ''liabilities'' as used in section 401(a)(2) includes both fixed and contingent obligations to employees. For example, if 1,000 employees are covered by a trust forming part of a pension plan, 300 of whom have satisfied all the requirements for a monthly pension, while the remaining 700 employees have not yet completed the required period of service, contingent obligations to such 700 employees have nevertheless arisen which constitute ''liabilities'' within the meaning of that term. It must be impossible for the employer (or other non employee) to recover any amounts other than such amounts as remain in the trust because of ''erroneous actuarial computations'' after the satisfaction of all fixed and contingent obligations. Furthermore, the trust instrument must contain a definite affirmative provision to this effect, irrespective of whether the obligations to employees have their source in the trust instrument itself, in the plan of which the trust forms a part, or in some collateral instrument or arrangement forming a part of such plan, and regardless of whether such obligations are, technically speaking, liabilities of the employer, of the trust, or of some other person forming a part of the plan or connected with it.

[T.D. 6500, 25 FR 11672, Nov. 26, 1960, as amended by T.D. 6722, 29 FR 5072, Apr. 14, 1964; T.D. 7748, 46 FR 1695, Jan. 7, 1981]

§ 1.401–3 Requirements as to coverage.

(a)(1) In order to insure that stock bonus, pension, and profit-sharing plans are utilized for the welfare of employees in general, and to prevent the trust device from being used for the principal benefit of shareholders, officers, persons whose principal duties consist in supervising the work of other employees, or highly paid employees, or as a means of tax avoidance, a trust will not be qualified unless it is part of a plan which satisfies the coverage requirements of section 401(a)(3). However, if the plan covers any individual who is an owner- employee, as defined in section 401(c)(3), the requirements of section 401(a)(3) and this section are not applicable to such plan, but the plan must satisfy the requirements of section 401(d) (see § 1.401–12).

(2) The percentage requirements in section 401(a)(3)(A) refer to a percentage of all the active employees, including employees temporarily on leave, such as those in the Armed Forces of the United States, if such employees are eligible under the plan.

(3) The application of section 401(a)(3)(A) may be illustrated by the following example:

Example. A corporation adopts a plan at a time when it has 1,000 employees. The plan provides that all full-time employees who have been employed for a period of two years and have reached the age of 30 shall be eligible to participate. The plan also requires participating employees to contribute 3 percent of their monthly pay. At the time the plan is made effective 100 of the 1,000 employees had not been employed for a period of two years. Fifty of the employees were seasonal employees whose customary employment did not exceed five months in any calendar year. Twenty-five of the employees were part-time employees whose customary employment did not exceed 20 hours in any one week. One hundred and fifty of the full-time employees who had been employed for two years or more had not yet reached age 30. The requirements of section 401(a)(3)(A) will be met if 540 employees are covered by the plan, as shown by the following computation:

(i) Total employees with respect to whom the percentage requirements are applicable (1,000 minus 175 (100 plus 50 plus 25))	825
(ii) Employees not eligible to participate because of age requirements	150
(iii) Total employees eligible to participate	675
(iv) Percentage of employees in item (i) eligible to participate	81+%
(v) Minimum number of participating employees to qualify the plan (80 percent of 675)	540

If only 70 percent, or 578, of the 825 employees satisfied the age and service requirements, then 462 (80 percent of 578) participating employees would satisfy the percentage requirements.

(b) If a plan fails to qualify under the percentage requirements of section 401(a)(3)(A), it may still qualify under section 401(a)(3)(B) provided always that (as required by section 401(a) (3) and (4)) the plan's eligibility conditions, benefits, and contributions do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or the highly compensated employees.

(c) Since, for the purpose of section 401, a profit-sharing plan is a plan which provides for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death, layoff, or severance of employment, employees who receive the amounts allocated to their accounts before the expiration of such a period of time or the occurrence of such a contingency shall not be considered covered by a profit-sharing plan in determining whether the plan meets the coverage requirements of section 401(a)(3) (A) and (B). Thus, in case a plan permits employees to receive immediately the amounts allocated to their accounts, or to have such amounts paid to a profit- sharing plan for them, the employees who receive the shares immediately shall not, for the purpose of section 401, be considered covered by a profit-sharing plan.

(d) Section 401(a)(5) sets out certain classifications that will not in themselves be considered discriminatory. However, those so designated are not intended to be exclusive. Thus, plans may qualify under section 401(a)(3)(B) even though coverage thereunder is limited to employees who have either reached a designated age or have been employed for a designated number of years, or who are employed in certain designated departments or are in other classifications, provided the effect of covering only such employees does not discriminate in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees. For example, if there are 1,000 employees, and the plan is written for only salaried employees, and consequently only 500 employees are covered, that fact alone will not justify the conclusion that the plan does not meet the coverage requirements of section 401(a)(3)(B). Conversely, if a contributory plan is offered to all of the employees but the contributions required of the employee participants are so burdensome as to make the plan acceptable only to the highly paid employees, the classification will be considered discriminatory in favor of such highly paid employees.

(e)(1) Section 401(a)(5) contains a provision to the effect that a classification shall not be considered discriminatory within the meaning of section 401(a)(3)(B) merely because all employees whose entire annual remuneration constitutes ‘‘wages’’ under section 3121(a)(1) (for purposes of the Federal Insurance Contributions Act, chapter 21 of the Code) are excluded from the plan. A reference to section 3121(a)(1) for years after 1954 shall be deemed a reference to section 1426(a)(1) of the Internal Revenue Code of 1939 for years before 1955. This provision, in conjunction with section 401(a)(3)(B), is intended to permit the qualification of plans which supplement the old-age, survivors, and disability insurance benefits under the Social Security Act (42 U.S.C. ch. 7). Thus, a classification which excludes all employees whose entire remuneration constitutes ‘‘wages’’ under section 3121(a)(1), will not be considered discriminatory merely because of such exclusion. Similarly, a plan which includes all employees will not be considered discriminatory solely because the contributions or benefits based on that part of their remuneration which is excluded from wages under section 3121(a)(1) differ from the contributions or benefits based on that part of their remuneration which is not so excluded. However, in making his determination with respect to discrimination in classification under section 401(a)(3)(B), the Commissioner will consider whether the total benefits resulting to each employee under the plan and under the Social Security Act, or under the Social Security Act only, establish an integrated and correlated retirement system satisfying the tests of section 401(a). If, therefore, a classification of employees under a plan results in relatively or proportionately greater benefits for employees earning above any specified salary amount or rate than for those below any such salary amount or rate, it may be found to be discriminatory within the meaning of section 401(a)(3)(B). If, however, the relative or proportionate differences in benefits which result from such classification are approximately offset by the old-age, survivors, and disability insurance benefits which are provided by the Social Security Act and which are not attributable to employee contributions under the Federal Insurance Contributions Act, the plan will be considered to be properly integrated with the Social Security Act and will, therefore, not be considered discriminatory.

(2)(i) For purposes of determining whether a plan is properly integrated with the Social Security Act, the amount of old-age, survivors, and disability insurance benefits which may be considered as attributable to employer contributions under the Federal Insurance Contributions Act is computed on the basis of the following:

(A) The rate at which the maximum monthly old-age insurance benefit is provided under the Social Security Act is considered to be the average of *(1)* the rate at which the maximum benefit currently payable under the Act (i.e., in 1971) is provided to an employee retiring at age 65, and *(2)* the rate at which the maximum benefit ultimately payable under the Act (i.e., in 2010) is provided to an employee retiring at age 65. The resulting figure is 43 percent of the average monthly wage on which such benefit is computed.

(B) The total old-age, survivors, and disability insurance benefits with respect to an employee is considered to be 162 percent of the employee's old-age insurance benefits. The resulting figure is 70 percent of the average monthly wage on which it is computed.

(C) In view of the fact that social security benefits are funded through equal contributions by the employer and employee, 50 percent of such benefits is considered attributable to employer contributions. The resulting figure is 35 percent of the average monthly wage on which the benefit is computed.

Under these assumptions, the maximum old-age, survivors, and disability insurance benefits which may be attributed to employer contributions under the Federal Insurance Contributions Act is an amount equal to 35 percent of the earnings on which they are computed. These computations take into account all amendments to the Society Security Act through the Social Security Amendments of 1971 (85 Stat. 6). It is recognized, however, that subsequent amendments to this Act may increase the percentages described in (A) or (B) of this subdivision (i), or both. If this occurs, the method used in this subparagraph for determining the integration formula may result in a figure under (C) of this subdivision (i) which is greater than 35 percent and a plan could be amended to adopt such greater figure in its benefit formula. In order to minimize future plan amendments of this nature, an employer may anticipate future changes in the Social Security Act by immediately utilizing such a higher figure, but not in excess of 37½ percent, in developing its benefit formula.

(ii) Under the rules provided in this subparagraph, a classification of employees under a noncontributory pension or annuity plan which limits coverage to employees whose compensation exceeds the applicable integration level under the plan will not be considered discriminatory within the meaning of section 401(a)(3)(B), where:

(A) The integration level applicable to an employee is his covered compensation, or is *(1)* in the case of an active employee, a stated dollar amount uniformly applicable to all active employees which is not greater than the covered compensation of any active employee, and *(2)* in the case of a retired employee an amount which is not greater than his covered compensation. (For rules relating to determination of an employee's covered compensation, see subdivision (iv) of this subparagraph.)

(B) The rate at which normal annual retirement benefits are provided for any employee with respect to his average annual compensation in excess of the plan's integration level applicable to him does not exceed 37½ percent.

(C) Average annual compensation is defined to mean the average annual compensation over the highest 5 consecutive years.

(D) There are no benefits payable in case of death before retirement.

(E) The normal form of retirement benefits is a straight life annuity, and if there are optional forms, the benefit payments under each optional form are actuarially equivalent to benefit payments under the normal form.

(F) In the case of any employee who reaches normal retirement age before completion of 15 years of service with the employer, the rate at which normal annual retirement benefits are provided for him with respect to his average annual compensation in excess of the plan's integration level applicable to him does not exceed 2½ percent for each year of service.

(G) Normal retirement age is not lower than age 65.

(H) Benefits payable in case of retirement or any other severance of employment before normal retirement age cannot exceed the actuarial equivalent of the maximum normal retirement benefits, which might be provided in accordance with (A) through (G) of this subdivision (ii), multiplied by a fraction, the numerator of which is the actual number of years of service of the employee at retirement or severance, and the denominator of which is the total number of years of service he would have had if he had remained in service until normal retirement age. A special disabled life mortality table shall not be used in determining the actuarial equivalent in the case of severance due to disability.

(iii) (A) If a plan was properly integrated with old-age and survivors insurance benefits on July 5, 1968 (hereinafter referred to as an ''existing plan''), then, notwithstanding the fact that such plan does not satisfy the requirements of subdivision (ii) of this subparagraph, it will continue to be considered properly integrated with such benefits until January 1, 1972. Such plan will be considered properly integrated after December 31, 1971, so long as the benefits provided under the plan for each employee equal the sum of—

(1) The benefits to which he would be entitled under a plan which, on July 5, 1968, would have been considered properly integrated with old-age and survivors insurance benefits, and under which benefits are provided at the same (or a lesser) rate with respect to the same portion of compensation with respect to which benefits are provided under the existing plan, multiplied by the percentage of his total service with the employer performed before a specified date not later than January 1, 1972; and

(2) The benefits to which he would be entitled under a plan satisfying the requirements of subdivision (ii) of this subparagraph, multiplied by the percentage of his total service with the employer performed on and after such specified date.

(B) A plan which, on July 5, 1968, was properly integrated with old-age and survivors insurance benefits will not be considered not to be properly integrated with such benefits thereafter merely because such plan provides a minimum benefit for each employee (other than an employee who owns, directly or indirectly, stock possessing more than 10 percent of the total combined voting power or value of all classes of stock of the employer corporation) equal to the benefit to which he would be entitled under the plan as in effect on July 5, 1968, if he continued to earn annually until retirement the same amount of compensation as he earned in 1967.

(C) If a plan was properly integrated with old-age and survivors insurance benefits on May 17, 1971, notwithstanding the fact that such plan does not satisfy the requirements of subdivision (ii) of this subparagraph, it will continue to be considered properly integrated with such benefits until January 1, 1972.

(iv) For purposes of this subparagraph, an employee's covered compensation is the amount of compensation with respect to which old-age insurance benefits would be provided for him under the Social Security Act (as in effect at any uniformly applicable date occurring before the employee's separation from the service) if for each year until he attains age 65 his annual compensation is at least equal to the maximum amount of earnings subject to tax in each such year under the Federal Insurance Contributions Act. A plan may provide that an employee's covered compensation is the amount determined under the preceding sentence rounded to the nearest whole multiple of a stated dollar amount which does not exceed $600.

(v) In the case of an integrated plan providing benefits different from those described in subdivision (ii) or (iii) (whichever is applicable) of this subparagraph, or providing benefits related to years of service, or providing benefits purchasable by stated employer contributions, or under the terms of which the employees contribute, or providing a combination of any of the foregoing variations, the plan will be considered to be properly integrated only if, as determined by the Commissioner, the benefits provided thereunder by employer contributions cannot exceed in value the benefits described in subdivision (ii) or (iii) (whichever is applicable) of this subparagraph. Similar principles will govern in determining whether a plan is properly integrated if participation therein is limited to employees earning in excess of amounts other than those specified in subdivision (iv) of this subparagraph, or if it bases benefits or contributions on compensation in excess of such amounts, or if it provides for an offset of benefits otherwise payable under the plan on account of old-age, survivors, and disability insurance benefits. Similar principles will govern in determining whether a profit-sharing or stock bonus plan is properly integrated with the Social Security Act.

(3) A plan supplementing the Social Security Act and excluding all employees whose entire annual remuneration constitutes ‘‘wages’’ under section 3121(a)(1) will not, however, be deemed discriminatory merely because, for administrative convenience, it provides a reasonable minimum benefit not to exceed $20 a month.

(4) Similar considerations, to the extent applicable in any case, will govern classifications under a plan supplementing the benefits provided by other Federal or State laws. See section 401(a)(5).

(5) If a plan provides contributions or benefits for a self-employed individual, the rules relating to the integration of such a plan with the contributions or benefits under the Social Security Act are set forth in paragraph (c) of § 1.401–11 and paragraph (h) of § 1.401–12.

(6) This paragraph (e) does not apply to plan years beginning on or after January 1, 1989.

(f) An employer may designate several trusts or a trust or trusts and an annuity plan or plans as constituting one plan which is intended to qualify under section 401(a)(3), in which case all of such trusts and plans taken as a whole may meet the requirements of such section. The fact that such combination of trusts and plans fails to qualify as one plan does not prevent such of the trusts and plans as qualify from meeting the requirements of section 401(a).

(g) It is provided in section 401(a)(6) that a plan will satisfy the requirements of section 401(a)(3), if on at least one day in each quarter of the taxable year of the plan it satisfies such requirements. This makes it possible for a new plan requiring contributions from employees to qualify if by the end of the quarter-year in which the plan is adopted it secures sufficient contributing participants to meet the requirements of section 401(a)(3). It also affords a period of time in which new participants may be secured to replace former participants, so as to meet the requirements of either subparagraph (A) or (B) of section 401(a)(3).

[T.D. 6500, 25 FR 11672, Nov. 26, 1960, as amended by T.D. 6675, 28 FR 10119, Sept. 17, 1963; T.D. 6982, 33 FR 16499, Nov. 13, 1968; T.D. 7134, 36 FR 13592, July 22, 1971; 36 FR 13990, July 29, 1971; T.D. 8359, 56 FR 47614, Sept. 19, 1991]

§ 1.401–4 Discrimination as to contributions or benefits (before 1994).

(a)(1)(i) In order to qualify under section 401(a), a trust must not only meet the coverage requirements of section 401(a)(3), but, as provided in section 401(a)(4), it must also be part of a plan under which there is no discrimination in contributions or benefits in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees as against other employees whether within or without the plan.

(ii) Since, for the purpose of section 401, a profit-sharing plan is a plan which provides for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death, layoff, or severance of employment, any amount allocated to an employee which is withdrawn before the expiration of such a period of time or the occurrence of such a contingency shall not be considered in determining whether the contributions under the plan discriminate in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees. Thus, in case a plan permits employees to receive immediately the whole or any part of the amounts allocated to their accounts, or to have the whole or any part of such amounts paid to a profit-sharing plan for them, any amounts which are received immediately shall not, for the purpose of section 401, be considered contributed to a profit-sharing plan.

(iii) Funds in a stock bonus or profit-sharing plan arising from forfeitures on termination of service, or other reason, must not be allocated to the remaining participants in such a manner as will effect the prohibited discrimination. With respect to forfeitures in a pension plan, see §1.401–7.

(2)(i) Section 401(a)(5) sets out certain provisions which will not in and of themselves be discriminatory within the meaning of section 401 a) (3) or (4). See §1.401–3. Thus, a plan will not be considered discriminatory merely because the contributions or benefits bear a uniform relationship to total compensation or to the basic or regular rate of compensation, or merely because the contributions or benefits based on that part of the annual compensation of employees which is subject to the Federal Insurance Contributions Act (chapter 21 of the Code) differ from the contributions or benefits based on any excess of such annual compensation over such part. With regard to the application of the rules of section 401(a)(5) in the case of a plan which benefits a self-employed individual, see paragraph (c) of §1.401–11.

(ii) The exceptions specified in section 401(a)(5) are not an exclusive enumeration, but are merely a recital of provisions frequently encountered which will not of themselves constitute forbidden discrimination in contributions or benefits.

(iii) Variations in contributions or benefits may be provided so long as the plan, viewed as a whole for the benefit of employees in general, with all its attendant circumstances, does not discriminate in favor of employees within the enumerations with respect to which discrimination is prohibited. Thus, benefits in a stock bonus or profit-sharing plan which vary by reason of an allocation formula which takes into consideration years of service, or other factors, are not prohibited unless they discriminate in favor of such employees.

(b) A plan which excludes all employees whose entire remuneration constitutes wages under section 3121(a)(1) (relating to the Federal Insurance Contributions Act), or a plan under which the contributions or benefits based on that part of an employee’s remuneration which is excluded from ‘‘wages’’ under such act differs from the contributions or benefits based on that part of the employee’s remuneration which is not so excluded, or a plan under which the contributions or benefits differ because of any retirement benefit created under State or Federal law, will not be discriminatory because of such exclusion or difference, provided the total benefits resulting under the plan and under such law establish an integrated and correlated retirement system satisfying the tests of section 401(a).

(c)(1) Although a qualified plan may provide for termination at will by the employer or discontinuance of contributions thereunder, this will not of itself prevent a trust from being a qualified trust. However, a qualified pension plan must expressly incorporate provisions which comply with the restrictions contained in subparagraph (2) of this paragraph at the time the plan is established, unless (i) it is reasonably certain at the inception of the plan that such restrictions would not affect the amount of contributions which may be used for the benefit of any employee, or (ii) the Commissioner determines that such provisions are not necessary to prevent the prohibited discrimination that may occur in the event of any early termination of the plan. Although these provisions are the only provisions required to be incorporated in the plan to prevent the discrimination that may arise because of an early termination of the plan, the plan may in operation result in the discrimination prohibited by section 401(a)(4), unless other provisions are later incorporated in the plan. Any pension plan containing a provision described in this paragraph shall not fail to satisfy section 411(a), (d)(2) and (d)(3) merely by reason of such a plan provision. Paragraph (c)(7) of this section sets forth special early termination rules applicable to certain qualified defined benefit plans for plan years affected by the Employee Retirement Income Security Act of 1974 (''ERISA''). Paragraph (c)(7) of this section does not contain all the rules required by the enactment of ERISA.

(2)(i) If employer contributions under a qualified pension plan may be used for the benefit of an employee who is among the 25 highest paid employees of the employer at the time the plan is established and whose anticipated annual pension under the plan exceeds $1,500, such plan must provide that upon the occurrence of the conditions described in subdivision (ii) of this subparagraph, the employer contributions which are used for the benefit of any such employee are restricted in accordance with subdivision (iii) of this subparagraph.

(ii) The restrictions described in subdivision (iii) of this subparagraph become applicable if—

(A) The plan is terminated within 10 years after its establishment,

(B) The benefits of an employee described in subdivision (i) of this subparagraph become payable within 10 years after the establishment of the plan, or

(C) The benefits of an employee described in subdivision (i) of this subparagraph become payable after the plan has been in effect for 10 years, and the full current costs of the plan for the first 10 years have not been funded. In the case of an employee described in (B) of this subdivision, the restrictions will remain applicable until the plan has been in effect for 10 years, but if at that time the full current costs have been funded the restrictions will no longer apply to the benefits payable to such an employee. In the case of an employee described in (B) or (C) of this subdivision, if at the end of the first 10 years the full current costs are not met, the restrictions will continue to apply until the full current costs are funded for the first time.

(iii) The restrictions required under subdivision (i) of this subparagraph must provide that the employer contributions which may be used for the benefit of an employee described in such subdivision shall not exceed the greater of $20,000, or 20 percent of the first $50,000 of the annual compensation of such employee multiplied by the number of years between the date of the establishment of the plan and—

(A) The date of the termination of the plan,

(B) In the case of an employee described in subdivision (ii)(B) of this subparagraph, the date the benefit of the employee becomes payable, if before the date of the termination of the plan, or

(C) In the case of an employee described in subdivision (ii)(C) of this subparagraph, the date of the failure to meet the full current costs of the plan. However, if the full current costs of the plan have not been met on the date described in (A) or (B) of this subdivision, whichever is applicable, then the date of the failure to meet such full current costs shall be substituted for the date referred to in (A) or (B) of this subdivision. For purposes of determining the contributions which may be used for the benefit of an employee when (b) of this subdivision applies, the number of years taken into account may be recomputed for each year if the full current costs of the plan are met for such year.

(iv) For purposes of this subparagraph, the employer contributions which, at a given time, may be used for the benefits of an employee include any unallocated funds which would be used for his benefits if the plan were then terminated or the employee were then to withdraw from the plan, as well as all contributions allocated up to that time exclusively for his benefits.

(v) The provisions of this subparagraph apply to a former or retired employee of the employer, as well as to an employee still in the employer's service.

(vi) The following terms are defined for purposes of this subparagraph—

(A) The term ''benefits'' includes any periodic income, any withdrawal values payable to a living employee, and the cost of any death benefits which may be payable after retirement on behalf of an employee, but does not include the cost of any death benefits with respect to an employee before retirement nor the amount of any death benefits actually payable after the death of an employee whether such death occurs before or after retirement.

(B) The term *full current costs* means the normal cost, as defined in §1.404(a)–6, for all years since the effective date of the plan, plus interest on any unfunded liability during such period.

(C) The term *annual compensation* of an employee means either such employee's average regular annual compensation, or such average compensation over the last five years, or such employee's last annual compensation if such compensation is reasonably similar to his average regular annual compensation for the five preceding years.

(3) The amount of the employer contributions which can be used for the benefit of a restricted employee may be limited either by limiting the annual amount of the employer contributions for the designated employee during the period affected by the limitation, or by limiting the amount of funds under the plan which can be used for the benefit of such employee, regardless of the amount of employer contributions.

(4) The restrictions contained in subparagraph (2) of this paragraph may be exceeded for the purpose of making current retirement income benefit payments to retired employees who would otherwise be subject to such restrictions, if—

(i) The employer contributions which may be used for any such employee in accordance with the restrictions contained in subparagraph (2) of this paragraph are applied either (A) to provide level amounts of annuity in the basic form of benefit provided for under the plan for such employee at retirement (or, if he has already retired, beginning immediately), or (B) to provide level amounts of annuity in an optional form of benefit provided under the plan if the level amount of annuity under such optional form of benefit is not greater than the level amount of annuity under the basic form of benefit provided under the plan;

(ii) The annuity thus provided is supplemented, to the extent necessary to provide the full retirement income benefits in the basic form called for under the plan, by current payments to such employee as such benefits come due; and

(iii) Such supplemental payments are made at any time only if the full current costs of the plan have then been met, or the aggregate of such supplemental payments for all such employees does not exceed the aggregate employer contributions already made under the plan in the year then current.

If disability income benefits are provided under the plan, the plan may contain like provisions with respect to the current payment of such benefits.

(5) If a plan has been changed so as to increase substantially the extent of possible discrimination as to contributions and as to benefits actually payable in event of the subsequent termination of the plan or the subsequent discontinuance of contributions thereunder, then the provisions of this paragraph shall be applied to the plan as so changed as if it were a new plan established on the date of such change. However, the provision in subparagraph (2)(iii) of this paragraph that the unrestricted amount of employer contributions on behalf of any employee is at least $20,000 is applicable to the aggregate amount contributed by the employer on behalf of such employee from the date of establishment of the original plan, and, for purposes of determining if the employee's anticipated annual pension exceeds $1,500, both the employer contributions on the employee's behalf prior to the date of the change in the plan and those expected to be made on his behalf subsequent to the date of the change (based on the employee's rate of compensation on the date of the change) are to be taken into account.

(6) This paragraph shall apply to taxable years of a qualified plan commencing after September 30, 1963. In the case of an early termination of a qualified pension plan during any such taxable year, the employer contributions which may be used for the benefit

of any employee must conform to the requirements of this paragraph. However, any pension plan which is qualified on September 30, 1963, will not be disqualified merely because it does not expressly include the provisions prescribed in this paragraph.

(7)(i) A qualified defined benefit plan subject to section 412 (without regard to section 412(h)(2)) shall not be required to contain the restriction described in paragraph (c)(2)(ii)(*c*) of this section applicable to an employee in a plan whose full current costs for the first 10 years have not been funded.

(ii) A qualified defined benefit plan covered by section 4021(a) of ERISA (''qualified Title IV plan'') shall satisfy the restrictions in paragraph (c)(2) of this section only if the plan satisfies this paragraph (c)(7). A plan satisfies this paragraph (c)(7) by providing that employer contributions which may be used for the benefit of an employee described in paragraph (c)(2) of this section who is a substantial owner, as defined in section 4022(b)(5) of ERISA, shall not exceed the greater of the dollar amount described in paragraph (c)(2)(iii) of this section or a dollar amount which equals the present value of the benefit guaranteed for such employee under section 4022 of ERISA, or if the plan has not terminated, the present value of the benefit that would be guaranteed if the plan terminated on the date the benefit commences, determined in accordance with regulations of the Pension Benefit Guaranty Corporation (''PBGC'').

(iii) A plan satisfies this paragraph (c)(7) by providing that employer contributions which may be used for the benefit of all employees described in paragraph (c)(2) of this section (other than an employee who is a substantial owner as defined in section 4022(b)(5) of ERISA) shall not exceed the greater of the dollar amount described in paragraph (c)(2)(iii) of this section or a dollar amount which equals the present value of the maximum benefit described in section 4022(b)(3)(B) of ERISA (determined on the date the plan terminates or on the date benefits commence, whichever is earlier and determined in accordance with regulations of PBGC) without regard to any other limitations in section 4022 of ERISA.

(iv) A plan provision satisfying this paragraph (c)(7) may be adopted by amendment or by incorporation at the time of establishment. Any allocation of assets attributable to employer contributions to an employee which exceeds the dollar limitation in this paragraph (c)(7) may be reallocated to prevent prohibited discrimination.

(v) The early termination rules in the preceding subparagraphs (1) through (6) apply to a qualified Title IV plan except where such rules are determined by the Commissioner to be inconsistent with the rules of this paragraph (c)(7), § 1.411(d)–2, and section 4044(b)(4) of ERISA. The early termination rules of this paragraph (c)(7) contain some of the rules under section 401(a)(4) and (a)(7), as in effect on September 2, 1974, and section 411(d) (2) and (3). Section 1.411(d)–2 also contains certain discrimination and vesting rules which are applicable to plan terminations.

(vi) Paragraph (c)(7) of this section applies to plan terminations occurring on or after March 12, 1984. For distributions not on account of plan terminations, paragraph (c)(7) applies to distributions in plan years beginning after December 31, 1983. However, a plan may elect to apply that paragraph to distributions not on account of plan termination on or after January 10, 1984.

(d)(1) Except as provided in paragraph (d)(2) of this section, the provisions of this section do not apply to plan years beginning on or after January 1, 1994. For rules applicable to plan years beginning on or after January 1, 1994, see §§ 1.401(a)(4)–1 through 1.401(a)(4)–13.

(2) In the case of plans maintained by organizations exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), the provisions of this section do not apply to plan years beginning on or after January 1, 1996.

For rules applicable to plan years beginning on or after January 1, 1996, see §§1.401(a)(4)–1 through 1.401(a)(4)–13.

(Secs. 411 (d)(2) and (3) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 88 Stat. 912; 26 U.S.C. 411(d)(2) and (3) and 7805))

[T.D. 6500, 25 FR 11674, Nov. 26, 1960, as amended by T.D. 6675, 28 FR 10119, Sept. 17, 1963; T.D. 7934, 49 FR 1183, Jan. 10, 1984; 49 FR 2104, Jan. 18, 1984; T.D. 8360, 56 FR 47536, Sept. 19, 1991; T.D. 8485, 58 FR 46778, Sept. 3, 1993]

§1.401–5 Period for which requirements of section 401(a) (3), (4), (5), and (6) are applicable with respect to plans put into effect before September 2, 1974.

A pension, profit-sharing, stock bonus, or annuity plan shall be considered as satisfying the requirements of section 401(a) (3), (4), (5), and (6) for the period beginning with the date on which it was put into effect and ending with the 15th day of the third month following the close of the taxable year of the employer in which the plan was put into effect, if all the provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period. Thus, if an employer in 1954 adopts such a plan as of January 1, 1954, and makes a return on the basis of the calendar year, he will have until March 15, 1955, to amend his plan so as to make it satisfy the requirements of section 401(a) (3), (4), (5), and (6) for the calendar year 1954 provided that by March 15, 1955, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to January 1, 1954, the effective date of the plan. If an employer is on a fiscal year basis, for example, April 1 to March 31, and in 1954 adopts such a plan effective as of April 1, 1954, he will have until June 15, 1955, to amend his plan so as to make it satisfy the requirements of section 401(a) (3), (4), (5), and (6) for the fiscal year beginning April 1, 1954, provided that by June 15, 1955, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to April 1, 1954, the effective date of the plan. It should be noted that under section 401(b) the period in which a plan may be amended to qualify under section 401(a) ends before the date on which taxpayers other than corporations are required to file income tax returns. See section 6072. This section shall not apply to any pension, profit-sharing, stock bonus, or annuity plan put into effect after September 1, 1974, and shall not apply with respect to any disqualifying provision to which §1.401(b)–1 applies.

[T.D. 6500, 25 FR 11674, Nov. 26, 1960; as amended by T.D. 7436, 41 FR 42653, Sept. 28, 1976]

§1.401–6 Termination of a qualified plan.

(a) *General rules.* (1) In order for a pension, profit-sharing, or stock bonus trust to satisfy the requirements of section 401, the plan of which such trust forms a part must expressly provide that, upon the termination of the plan or upon the complete discontinuance of contributions under the plan, the rights of each employee to benefits accrued to the date of such termination or discontinuance, to the extent then funded, or the rights of each employee to the amounts credited to his account at such time, are nonforfeitable. As to what constitutes nonforfeitable rights of an employee, see paragraph (a)(2) of §1.402(b)–1.

(2)(i) A qualified plan must also provide for the allocation of any previously unallocated funds to the employees covered by the plan upon the termination of the plan or the complete discontinuance of contributions under the plan. Such provision may be incorporated in the plan at its inception or by an amendment made prior to the termination of the plan or the discontinuance of contributions thereunder.

(ii) Any provision for the allocation of unallocated funds is acceptable if it specifies the method to be used and does not conflict with the provisions of section 401(a)(4) and the regulations thereunder. The allocation of unallocated funds may be in cash or in the form of other benefits provided under the plan. However, the allocation of the funds contributed by the employer among the employees need not necessarily benefit all the employees covered by the plan. For example, an allocation may be satisfactory if priority is given to benefits for employees over the age of 50 at the time of the termination of the plan, or those who then have at least 10 years of service, if there is no possibility of discrimination in favor of employees who are officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees.

(iii) Subdivisions (i) and (ii) of this subparagraph do not require the allocation of amounts to the account of any employee if such amounts are not required to be used to satisfy the liabilities with respect to employees and their beneficiaries under the plan (see section 401(a)(2)).

(b) *Termination defined.* (1) Whether a plan is terminated is generally a question to be determined with regard to all the facts and circumstances in a particular case. For example, a plan is terminated when, in connection with the winding up of the employer's trade or business, the employer begins to discharge his employees. However, a plan is not terminated, for example, merely because an employer consolidates or replaces that plan with a comparable plan. Similarly, a plan is not terminated merely because the employer sells or otherwise disposes of his trade or business if the acquiring employer continues the plan as a separate and distinct plan of its own, or consolidates or replaces that plan with a comparable plan. See paragraph (d)(4) of § 1.381(c)(11)–1 for the definition of comparable plan. In addition, the Commissioner may determine that other plans are comparable for purposes of this section.

(2) For purposes of this section, the term *termination* includes both a partial termination and a complete termination of a plan. Whether or not a partial termination of a qualified plan occurs when a group of employees who have been covered by the plan are subsequently excluded from such coverage either by reason of an amendment to the plan, or by reason of being discharged by the employer, will be determined on the basis of all the facts and circumstances. Similarly, whether or not a partial termination occurs when benefits or employer contributions are reduced, or the eligibility or vesting requirements under the plan are made less liberal, will be determined on the basis of all the facts and circumstances. However, if a partial termination of a qualified plan occurs, the provisions of section 401(a)(7) and this section apply only to the part of the plan that is terminated.

(c) *Complete discontinuance defined.* (1) For purposes of this section, a complete discontinuance of contributions under the plan is contrasted with a suspension of contributions under the plan, which is merely a temporary cessation of contributions by the employer. A complete discontinuance of contributions may occur although some amounts are contributed by the employer under the plan if such amounts are not substantial enough to reflect the intent on the part of the employer to continue to maintain the plan. The determination of whether a complete discontinuance of contributions under the plan has occurred will be made with regard to all the facts and circumstances in the particular case, and without regard to the amount of any contributions made under the plan by employees.

(2) In the case of a pension plan, a suspension of contributions will not constitute a discontinuance if—

(i) The benefits to be paid or made available under the plan are not affected at any time by the suspension, and

(ii) The unfunded past service cost at any time (which includes the unfunded prior normal cost and unfunded interest on any unfunded cost) does not exceed the unfunded past service cost as of the date of establishment of the plan, plus any additional past service or supplemental costs added by amendment.

(3) In any case in which a suspension of a profit-sharing plan is considered a discontinuance, the discontinuance becomes effective not later than the last day of the taxable year of the employer following the last taxable year of such employer for which a substantial contribution was made under the profit-sharing plan.

(d) *Contributions or benefits which remain forfeitable.* The provisions of this section do not apply to amounts which are reallocated to prevent the discrimination prohibited by section 401(a)(4) (see paragraph (c) of §1.401–4).

(e) *Effective date.* This section shall apply to taxable years of a qualified plan commencing after September 30, 1963. In the case of the termination or complete discontinuance (as defined in this section) of any qualified plan during any such taxable year, the rights accorded to each employee covered under the plan must conform to the requirements of this section. However, a plan which is qualified on September 30, 1963, will not be disqualified merely because it does not expressly include the provisions prescribed by this section.

[T.D. 6675, 28 FR 10120, Sept. 17, 1963]

§1.401–7 Forfeitures under a qualified pension plan.

(a) *General rules.* In the case of a trust forming a part of a qualified pension plan, the plan must expressly provide that forfeitures arising from severance of employment, death, or for any other reason, must not be applied to increase the benefits any employee would otherwise receive under the plan at any time prior to the termination of the plan or the complete discontinuance of employer contributions thereunder. The amounts so forfeited must be used as soon as possible to reduce the employer's contributions under the plan. However, a qualified pension plan may anticipate the effect of forfeitures in determining the costs under the plan. Furthermore, a qualified plan will not be disqualified merely because a determination of the amount of forfeitures under the plan is made only once during each taxable year of the employer.

(b) *Examples.* The rules of paragraph (a) of this section may be illustrated by the following examples:

Example (1). The B Company Pension Trust forms a part of a pension plan which is funded by individual level annual premium annuity contracts. The plan requires ten years of service prior to obtaining a vested right to benefits under the plan. One of the company's employees resigns his position after two years of service. The insurance company paid to the trustees the cash surrender value of the contract—$750. The B Company must reduce its next contribution to the pension trust by this amount.

Example (2). The C Corporation's trusteed pension plan has been in existence for 20 years. It is funded by individual contracts issued by an insurance company, and the premiums thereunder are paid annually. Under such plan, the annual premium accrued for the year 1966 is due and is paid on January 2, 1966, and on July 1 of the same year the plan is terminated due to the liquidation of the employer. Some forfeitures were incurred and collected by the trustee with respect to those participants whose employment terminated between January 2 and July 1. The plan provides that the amount of such forfeitures is to be applied to provide additional annuity benefits for the remaining employees covered by the plan. The pension plan of the C Corporation satisfies the provisions of section 401(a)(8). Although forfeitures are used to increase benefits in this case, this use of forfeitures is permissible since no further contributions will be made under the plan.

(c) *Effective date.* This section applies to taxable years of a qualified plan commencing after September 30, 1963. However, a plan which is qualified on September 30, 1963, will not be disqualified merely because it does not expressly include the provisions prescribed by this section.

[T.D. 6675, 28 FR 10121, Sept. 17, 1963]

§1.401–8 Custodial accounts prior to January 1, 1974.

(a) *Treatment of a custodial account as a qualified trust.* For taxable years of a plan beginning after December 31, 1962, a custodial account may be used, in lieu of a trust, under any pension, profit-sharing, or stock bonus plan, described in section 401 if the requirements of paragraph (b) of this section are met. A custodial account may be used under such a plan, whether the plan covers common-law employees, self-employed individuals who are treated as employees by reason of section 401(c), or both. The use of a custodial account as part of a plan does not preclude the use of a trust or another custodial account as part of the same plan. A plan under which a custodial account is used may be considered in connection with other plans of the employer in determining whether the requirements of section 401 are satisfied. For regulations relating to the period after December 31, 1973, see §1.401(f)–11.

(b) *Rules applicable to custodial accounts.* (1) A custodial account shall be treated for taxable years beginning after December 31, 1962, as a qualified trust under section 401 if such account meets the following requirements described in subdivisions (i) through (iii) of this subparagraph:

(i) The custodial account must satisfy all the requirements of section 401 that are applicable to qualified trusts. See subparagraph (2) of this paragraph.

(ii) The custodian of the custodial account must be a bank.

(iii) The custodial agreement provides that the investment of the funds in the account is to be made—

(A) Solely in stock of one or more regulated investment companies which is registered in the name of the custodian or its nominee and with respect to which an employee who is covered by the plan is the beneficial owner, or

(B) Solely in annuity, endowment, or life insurance contracts, issued by an insurance company and held by the custodian until distributed pursuant to the terms of the plan. For purposes of the preceding sentence, a face-amount certificate described in section 401(g) and § 1.401–9 is treated as an annuity issued by an insurance company.

See subparagraphs (3) and (4) of this paragraph.

(2) As a result of the requirement described in subparagraph (1)(i) of this paragraph (relating to the requirements applicable to qualified trusts), the custodial account must, for example, be created pursuant to a written agreement which constitutes a valid contract under local law. In addition, the terms of the contract must make it impossible, prior to the satisfaction of all liabilities with respect to the employees and their beneficiaries covered by the plan, for any part of the funds of the custodial account to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries as provided for in the plan (see paragraph (a) of § 1.401–2).

(3) The requirement described in subparagraph (1)(iii) of this paragraph, relating to the investment of the funds of the plan, applies, for example, to the employer contributions under the plan, any employee contributions under the plan, and any earnings on such contributions. Such requirement also applies to capital gains realized upon the sale of stock described in (A) of such subdivision, to any capital gain dividends received in connection with such stock, and to any refunds described in section 852(b)(3)(D)(ii) (relating to undistributed capital gains of a regulated investment company) which is received in connection with such stock. However, since such requirement relates only to the investment of the funds of the plan, the custodian may deposit funds with a bank, in either a checking or savings account, while accumulating sufficient funds to make additional investments or while awaiting an appropriate time to make additional investments.

(4) The requirement in subparagraph (1)(iii)(A) of this paragraph that an employee covered by the plan be the beneficial owner of the stock does not mean that the employee who is the beneficial owner must have a nonforfeitable interest in the stock. Thus, a plan may provide for forfeitures of an employee's interest in such stock in the same manner as plans which use a trust. In the event of a forfeiture of an employee's beneficial ownership in the stock of a regulated investment company, the beneficial ownership of such stock must pass to another employee covered by the plan.

(c) *Effects of qualification.* (1) Any custodial account which satisfies the requirements of section 401(f) shall be treated as a qualified trust for all purposes of the Internal Revenue Code of 1954. Accordingly, such a custodial account shall be treated as a separate legal person which is exempt from the income tax by section 501(a). On the other hand, such a custodial account is required to file the returns described in sections 6033 and 6047 and to supply any other information which a qualified trust is required to furnish.

(2) In determining whether the funds of a custodial account are distributed or made available to an employee or his beneficiary, the rules which under section 402(a) are applicable to trusts will also apply to the custodial account as though it were a separate legal person and not an agent of the employee.

(d) *Effect of loss of qualification.* If a custodial account which has qualified under section 401 fails to qualify under such section for any taxable year, such custodial account will not thereafter be treated as a separate legal person, and the funds in such account shall be treated as made available within the meaning of section 402(a)(1) to the employees for whom they are held.

(e) *Definitions.* For purposes of this section—

(1) The term *bank* means a bank as defined in section 401(d)(1).

(2) The term *regulated investment company* means any domestic corporation which issues only redeemable stock and is a regulated investment company within the meaning of section 851(a) (but without regard to whether such corporation meets the limitations of section 851(b)).

(Secs. 401(f)(2), 7805, Internal Revenue Code of 1954 (88 Stat. 939 and 68A Stat. 917; 26 U.S.C. 401(f)(2), 7805))

[T.D. 6675, 28 FR 10121, Sept. 17, 1963, as amended by T.D. 7565, 43 FR 41204, Sept. 15, 1978. Redesignated and amended by T.D. 7748, 46 FR 1695, Jan. 7, 1981]

§1.401–9 Face-amount certificates—nontransferable annuity contracts.

(a) *Face-amount certificates treated as annuity contracts.* Section 401(g) provides that a face-amount certificate (as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C. sec. 80a–2)) which is not transferable within the meaning of paragraph (b)(3) of this section shall be treated as an annuity contract for purposes of sections 401 through 404 for any taxable year of a plan subject to such sections beginning after December 31, 1962. Accordingly, there may be established for any such taxable year a qualified plan under which such face-amount certificates are purchased for the participating employees without the creation of a trust or custodial account. However, for such a plan to qualify, the plan must satisfy all the requirements applicable to a qualified annuity plan (see section 403(a) and the regulations thereunder).

(b) *Nontransferability of face-amount certificates and annuity contracts.* (1)(i) Section 401(g) provides that, in order for any face-amount certificate, or any other contract issued after December 31, 1962, to be subject to any provision under sections 401 through 404 which is applicable to annuity contracts, as compared to other forms of investment, such certificate or contract must be nontransferable at any time when it is held by any person other than the trustee of a trust described in section 401(a) and exempt under section 501(a). Thus, for example, in order for a group or individual retirement income contract to be treated as an annuity contract, if such contract is not held by the trustee of an exempt employees' trust, it must satisfy the requirements of this section. Furthermore, a face-amount certificate or an annuity contract will be subject to the tax treatment under section 403(b) only if it satisfies the requirements of section 401(g) and this section. Any certificate or contract in order to satisfy the provisions of this section must expressly contain the provisions that are necessary to make such certificate or contract not transferable within the meaning of this paragraph.

(ii) In the case of any group contract purchased by an employer under a plan to which sections 401 through 404 apply, the restriction on transferability required by section 401(g) and this section applies to the interest of the employee participants under such group contract but not to the interest of the employer under such contract.

(2) If a trust described in section 401(a) which is exempt from tax under section 501(a) distributes any annuity, endowment, retirement income, or life insurance contract, then the rules relating to the taxability of the distributee of any such contract are set forth in paragraph (a)(2) of §1.402(a)–1.

(3) A face-amount certificate or an annuity contract is transferable if the owner can transfer any portion of his interest in the certificate or contract to any person other than the issuer thereof. Accordingly, such a certificate or contract is transferable if the owner can sell, assign, discount, or pledge as collateral for a loan or as security for the performance of an obligation or for any other purpose his interest in the certificate or contract to any person other than the issuer thereof. On the other hand, for purposes of section 401(g), a face-amount certificate or annuity contract is not considered to be transferable merely because such certificate or contract, or the plan of

which it is a part, contains a provision permitting the employee to designate a beneficiary to receive the proceeds of the certificate or contract in the event of his death, or contains a provision permitting the employee to elect to receive a joint and survivor annuity, or contains other similar provisions.

(4) A material modification in the terms of an annuity contract constitutes the issuance of a new contract regardless of the manner in which it is made.

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

Example (1). The P Employees' Annuity Plan is a nontrusteed plan which is funded by individual annuity contracts issued by the Y Insurance Company. Each annuity contract issued by such company after December 31, 1962, provides, on its face, that it is ''NOT TRANSFERABLE''. The terms of each such contract further provide that, ''This contract may not be sold, assigned, discounted, or pledged as collateral for a loan or as security for the performance of an obligation or for any other purpose, to any person other than this company.'' The annuity contracts of the P Employees' Annuity Plan satisfy the requirements of section 401(g) and this section.

Example (2). The R Company Pension Trust forms a part of a pension plan which is funded by individual level premium annuity contracts. Such contracts are purchased by the trustee of the R Company Pension Trust from the Y Insurance Company. The trustee of the R Company Pension Trust is the legal owner of each such contract at all times prior to the distribution of such contract to a qualifying annuitant. The trustee purchases such a contract on January 3, 1963, in the name of an employee who qualifies on that date for coverage under the plan. At the time such contract is purchased, and while the contract is held by the trustee of the R Company Pension Trust, the contract does not contain any restrictions with respect to its transferability. The annuity contract purchased by the trustee of the R Company Pension Trust satisfies the requirements of section 401(g) and this section while it is held by the trustee.

Example (3). A is the trustee of the X Corporation's Employees' Pension Trust. The trust forms a part of a pension plan which is funded by individual level premium annuity contracts. The trustee is the legal owner of such contracts, but the employees covered under the plan obtain beneficial interests in such contracts after ten years of service with the X Corporation. On January 15, 1980, A distributes to D an annuity contract issued to A in D's name on June 25, 1959, and distributes to E an annuity contract issued to A in E's name on September 30, 1963. The contract issued to D need not be nontransferable, but the contract issued to E must be nontransferable in order to satisfy the requirements of section 401(g) and this section.

Example (4). The corpus of the Y Corporation's Employees' Pension Plan consists of individual insurance contracts in the names of the covered employees and an auxiliary fund which is used to convert such policies to annuity contracts at the time a beneficiary of such trust retires. F retires on June 15, 1963, and the trustee converts the individual insurance contract on F's life to a life annuity which is distributed to him. The life annuity issued on F's life must be nontransferable in order to satisfy the requirements of section 401(g) and this section.

[T.D. 6675, 28 FR 10122, Sept. 17, 1963]

§ 1.401–10 Definitions relating to plans covering self-employed individuals.

(a) *In general.* (1) Certain self-employed individuals may be covered by a qualified pension, annuity, or profit-sharing plan for taxable years beginning after December 31, 1962. This section contains definitions relating to plans covering self-employed individuals. The provisions of §§ 1.401–1 through 1.401–9, relating to requirements which are applicable to all qualified plans, are also generally applicable to any plan covering a self-employed individual. However, in addition to such requirements, any plan covering a self-employed individual is subject to the rules contained in §§ 1.401–11 through 1.401–13. Section 1.401–11 contains general rules which are applicable to any plan covering a self-employed individual who is an employee within the meaning of paragraph (b) of this section. Section 1.401–12 contains special rules which are applicable to plans covering self-employed individuals when one or more of such individuals is an owner-employee within the meaning of paragraph (d) of this section. Section 1.401–13 contains rules relating to excess contributions by, or for, an owner-employee. The provisions of this section and of §§ 1.401–11 through 1.401–13 are applicable to taxable years beginning after December 31, 1962.

(2) A self-employed individual is covered under a qualified plan during the period beginning with the date a contribution is first made by, or for, him

under the qualified plan and ending when there are no longer funds under the plan which can be used to provide him or his beneficiaries with benefits.

(b) *Treatment of a self-employed individual as an employee.* (1) For purposes of section 401, a self-employed individual who receives earned income from an employer during a taxable year of such employer beginning after December 31, 1962, shall be considered an employee of such employer for such taxable year. Moreover, such an individual will be considered an employee for a taxable year if he would otherwise be treated as an employee but for the fact that the employer did not have net profits for that taxable year. Accordingly, the employer may cover such an individual under a qualified plan during years of the plan beginning with or within a taxable year of the employer beginning after December 31, 1962.

(2) If a self-employed individual is engaged in more than one trade or business, each such trade or business shall be considered a separate employer for purposes of applying the provisions of sections 401 through 404 to such individual. Thus, if a qualified plan is established for one trade or business but not the others, the individual will be considered an employee only if he received earned income with respect to such trade or business and only the amount of such earned income derived from that trade or business shall be taken into account for purposes of the qualified plan.

(3)(i) The term *employee*, for purposes of section 401, does not include a self-employed individual when the term ‘‘common-law’’ employee is used or when the context otherwise requires that the term ‘‘employee’’ does not include a self-employed individual. The term ‘‘common- law’’ employee also includes an individual who is treated as an employee for purposes of section 401 by reason of the provisions of section 7701(a)(20), relating to the treatment of certain full-time life insurance salesmen as employees. Furthermore, an individual who is a common-law employee is not a self-employed individual with respect to income attributable to such employment, even though such income constitutes net earnings from self-employment as defined in section 1402(a). Thus, for example, a minister who is a common-law employee is not a self-employed individual with respect to income attributable to such employment, even though such income constitutes net earnings from self-employment as defined in section 1402(a).

(ii) An individual may be treated as an employee within the meaning of section 401(c)(1) of one employer even though such individual is also a common-law employee of another employer. For example, an attorney who is a common-law employee of a corporation and who, in the evenings maintains an office in which he practices law as a self-employed individual is an employee within the meaning of section 401(c)(1) with respect to the law practice. This example would not be altered by the fact that the corporation maintained a qualified plan under which the attorney is benefited as a common-law employee.

(4) For the purpose of determining whether an employee within the meaning of section 401(c)(1) satisfies the requirements for eligibility under a qualified plan established by an employer, such an employer may take into account past services rendered by such an employee both as a self-employed individual and as a common-law employee if past services rendered by other employees, including common-law employees, are similarly taken into account. However, an employer cannot take into account only past services rendered by employees within the meaning of section 401(c)(1) if past services rendered to such employer by individuals who are, or were, common-law employees are not taken into account. Past service as described in this subparagraph may be taken into account for the purpose of determining whether an individual who is, or was, an employee within the meaning of section 401(c)(1) satisfies the requirements for eligibility even if such service was rendered prior to January 1, 1963. On the other hand, past service cannot be taken into account for purposes of determining the contributions which may be made on such an individual’s behalf under a qualified plan.

(c) *Definition of earned income*—(1) *General rule.* For purposes of section 401 and the regulations thereunder, ‘‘earned income’’ means, in general, net earnings from self-employment (as defined in section 1402(a)) to the extent such net earnings constitute compensation for personal services actually rendered within the meaning of section 911(b).

(2) *Net earnings from self-employment.* (i) The computation of the net earnings from self-employment shall be made in accordance with the provisions of section 1402(a) and the regulations thereunder, with the modifications and exceptions described in subdivisions (ii) through (iv) of this subparagraph. Thus, an individual may have net earnings from self-employment, as defined in section 1402(a), even though such individual does not have self-employment income, as defined in section 1402(b), and, therefore, is not subject to the tax on self-employment income imposed by section 1401.

(ii) Items which are not included in gross income for purposes of chapter 1 of the Code and the deductions properly attributable to such items must be excluded from the computation of net earnings from self-employment even though the provisions of section 1402(a) specifically require the inclusion of such items. For example, if an individual is a resident of Puerto Rico, so much of his net earnings from self-employment as are excluded from gross income under section 933 must not be taken into account in computing his net earnings from self-employment which are earned income for purposes of section 401.

(iii) In computing net earnings from self-employment for the purpose of determining earned income, a self-employed individual may disregard only deductions for contributions made on his own behalf under a qualified plan. However, such computation must take into account the deduction allowed by section 404 or 405 for contributions under a qualified plan on behalf of the common-law employees of the trade or business.

(iv) For purposes of determining whether an individual has net earnings from self-employment and, thus, whether he is an employee within the meaning of section 401(c)(1), the exceptions in section 1402(c) (4) and (5) shall not apply. Thus, certain ministers, certain members of religious orders, doctors of medicine, and Christian Science practitioners are treated for purposes of section 401 as being engaged in a trade or business from which net earnings from self-employment are derived. In addition, the exceptions in section 1402(c)(2) shall not apply in the case of any individual who is treated as an employee under section 3121(d)(3) (A), (C), or (D). Therefore, such individuals are treated, for purposes of section 401, as being engaged in a trade or business from which net earnings from self-employment may be derived.

(3) *Compensation for personal services actually rendered.* (i) For purposes of section 401, the term ‘‘earned income’’ includes only that portion of an individual’s net earnings from self-employment which constitutes earned income as defined in section 911(b) and the regulations thereunder. Thus, such term includes only professional fees and other amounts received as compensation for personal services actually rendered by the individual. There is excluded from ‘‘earned income’’ the amount of any item of income, and any deduction properly attributable to such item, if such amount is not received as compensation for personal services actually rendered. Therefore, an individual who renders no personal services has no ‘‘earned income’’ even though such an individual may have net earnings from self-employment from a trade or business.

(ii) If a self-employed individual is engaged in a trade or business in which capital is a material income-producing factor, then, under section 911(b), his earned income is only that portion of the net profits from the trade or business which constitutes a reasonable allowance as compensation for personal services actually rendered. However, such individual’s earned income cannot exceed 30 percent of the net profits of such trade or business. The net profits of the trade or business is not necessarily the same as the net earnings from self-employment derived from such trade or business.

(4) *Minimum earned income when both personal services and capital are material income-producing factors.* (i) If a self-employed individual renders personal

services on a full-time, or substantially full-time, basis to only one trade or business, and if with respect to such trade or business capital is a material income-producing factor, then the amount of such individual's earned income from the trade or business is considered to be not less than so much of his share in the net profits of such trade or business as does not exceed $2,500.

(ii) If a self-employed individual renders substantial personal services to more than one trade or business, and if with respect to all such trades or businesses such self-employed individual actually renders personal services on a full-time, or substantially full-time, basis, then the earned income of the self-employed individual from trades or businesses for which he renders substantial personal services and in which both personal services and capital are material income-producing factors is considered to be not less than—

(A) So much of such individual's share of the net profits from all trades or businesses in which he renders substantial personal services as does not exceed $2,500, reduced by.

(B) Such individual's share of the net profits of any trade or business in which only personal services is a material income-producing factor.

However, in no event shall the share of the net profits of any trade or business in which capital is a material income-producing factor be reduced below the amount which would, without regard to the provisions of this subdivision, be treated as the earned income derived from such trade or business under section 911(b). In making the computation required by this subdivision, any trade or business with respect to which the individual renders substantial personal services shall be taken into account irrespective of whether a qualified plan has been established by such trade or business.

(iii) If the provisions of subdivision (ii) of this subparagraph apply in determining the earned income of a self-employed individual, and such individual is engaged in two or more trades or businesses in which capital and personal services are material income-producing factors, then the total amount treated as the earned income shall be allocated to each such trade or business for which he performs substantial personal services in the same proportion as his share of net profits from each such trade or business bears to his share of the total net profits from all such trades or businesses. Thus, in such case, the amount of earned income attributable to any such trade or business is computed by multiplying the total earned income as determined under subdivision (ii) of this subparagraph by the individual's net profits from such trade or business and dividing that product by the individual's total net profits from all such trades or businesses.

(iv) For purposes of this subparagraph, the determination of whether an individual renders personal services on a full-time, or substantially full-time, basis is to be made with regard to the aggregate of the trades and businesses with respect to which the employee renders substantial personal services as a common-law employee or as a self-employed individual. However, for all other purposes in applying the rules of this subparagraph, a trade or business with respect to which an individual is a common-law employee shall be disregarded.

(d) *Definition of owner-employee.* For purposes of section 401 and the regulations thereunder, the term ''owner-employee'' means a proprietor of a proprietorship, or, in the case of a partnership, a partner who owns either more than 10 percent of the capital interest, or more than 10 percent of the profits interest, of the partnership. Thus, an individual who owns only 2 percent of the profits interest but 11 percent of the capital interest of a partnership is an owner-employee. A partner's interest in the profits and the capital of the partnership shall be determined by the partnership agreement. In the absence of any provision regarding the sharing of profits, the interest in profits of the partners will be determined in the same manner as their distributive shares of partnership taxable income. However, a guaranteed payment (as described in section 707(c)) is not considered a distributive share of partnership income for such purpose. See section 704(b), relating to the determination of the distributive share by the income or loss ratio, and the regulations thereunder. In the absence of a provision in the partnership agreement, a partner's capital interest in a partnership shall be determined on the basis of his interest in the assets of the partnership which would be distributable to such partner upon his withdrawal from the partnership, or upon liquidation of the partnership, whichever is the greater.

(e) *Definition of employer.* (1) For purposes of section 401, a sole proprietor is considered to be his own employer, and the partnership is considered to be the employer of each of the partners. Thus, an individual partner is not an employer who may establish a qualified plan with respect to his services to the partnership.

(2) Regardless of the provision of local law, a partnership is deemed, for purposes of section 401, to be continuing until such time as it is terminated within the meaning of section 708, relating to the continuation of a partnership.

[T.D. 6675, 28 FR 10123, Sept. 17, 1963]

§ 1.401–11 General rules relating to plans covering self-employed individuals.

(a) *Introduction.* This section provides certain rules which supplement, and modify, the rules of §§ 1.401–1 through 1.401–9 in the case of a qualified pension, annuity, or profit-sharing plan which covers a self-employed individual who is an employee within the meaning of section 401(c)(1). The provisions of this section apply to taxable years beginning after December 31, 1962. Except as otherwise provided, paragraphs (b) through (m) of this section apply to taxable years beginning after December 31, 1962. Paragraph (n) of this section applies to plan years determined in accordance with paragraph (n)(1) of this section.

(b) *General rules.* (1) If the amount of employer contributions for common-law employees covered under a qualified plan is related to the earned income (as defined in section 401(c)(2)) of a self-employed individual, or group of self-employed individuals, such a plan is a profit-sharing plan (as described in paragraph (b)(1)(ii) of § 1.401–1) since earned income is dependent upon the profits of the trade or business with respect to which the plan is established. Thus, for example, a plan, which provides that the employer will contribute 10 percent of the earned income of a self-employed individual but no more than $2,500, and that the employer contribution on behalf of common-law employees shall be the same percentage of their salaries as the contribution on behalf of the self-employed individual bears to his earned income, is a profit-sharing plan, since the amount of the employer's contribution for common-law employees covered under the plan is related to the earned income of a self-employed individual and thereby to the profits of the trade or business. On the other hand, for example, a plan which defines the compensation of any self-employed individual as his earned income and which provides that the employer will contribute 10 percent of the compensation of each employee covered under the plan is a pension plan since the contribution on behalf of common-law employees is fixed without regard to whether the self-employed individual has earned income or the amount thereof.

(2) The Self-Employed Individuals Tax Retirement Act of 1962 (76 Stat. 809) permits self-employed individuals to be treated as employees and therefore included in qualified plans, but it is clear that such law requires such self-employed individuals to provide benefits for their employees on a nondiscriminatory basis. Self-employed individuals will not be considered as providing contributions or benefits for an employee to the extent that the wages or salary of the employee covered under the plan are reduced at or about the time the plan is adopted.

(3) In addition to permitting self-employed individuals to participate in qualified plans, the Self-Employed Individuals Tax Retirement Act of 1962 extends to such individuals some of the tax benefits allowed common-law employee-participants in such plans. However, the tax benefits allowed a self-employed individual are restricted by the limits which are placed on the deductions allowed for contributions on such an individual's behalf. In view of these restrictions on the tax benefits

extended to any self-employed individual, a self-employed individual participating in a qualified plan may not participate in any forfeitures. Therefore, in the case of a qualified plan which covers any self-employed individual, a separate account must be established for each self-employed individual to which no forfeitures can be allocated.

(c) *Requirements as to coverage.* (1) In general, section 401(a)(3) and the regulations thereunder prescribe the coverage requirements which a qualified plan must satisfy. However, if such a plan covers self-employed individuals who are not owner-employees, it must, in addition to satisfying such requirements, satisfy the requirements of this paragraph. If any owner-employee is covered under a qualified plan, the provisions of this paragraph do not apply, but the provisions of section 401(d), including section 401(d)(3), do apply (see §1.401–12).

(2)(i) Section 401(a)(3)(B) provides that a plan may satisfy the coverage requirements for qualification if it covers such employees as qualify under a classification which is found not to discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees. Section 401(a)(5) sets forth certain classifications that will not in themselves be considered discriminatory. Under such section, a classification which excludes all employees whose entire remuneration constitutes ‘‘wages’’ under section 3121(a)(1), will not be considered discriminatory merely because of such exclusion. Similarly, a plan which includes all employees will not be considered discriminatory solely because the contributions or benefits based on that part of their remuneration which is excluded from ‘‘wages’’ under section 3121(a)(1) differ from the contributions or benefits based on that part of their remuneration which is not so excluded. However, in determining if a classification is discriminatory under section 401(a)(3)(B), consideration will be given to whether the total benefits resulting to each employee under the plan and under the Social Security Act, or under the Social Security Act only, establish an integrated and correlated retirement system satisfying the tests of section 401(a). A plan which covers self-employed individuals, none of whom is an owner-employee, may also be integrated with the contributions or benefits under the Social Security Act. In such a case, the portion of the earned income (as defined in section 401(c)(2)) of such an individual which does not exceed the maximum amount which may be treated as self-employment income under section 1402(b)(1), and which is derived from the trade or business with respect to which the plan is established, shall be treated as ‘‘wages’’ under section 3121(a)(1) subject to the tax imposed by section 3111 (relating to the tax on employers) for purposes of applying the rules of paragraph (e)(2) of §1.401–3, relating to the determination of whether a plan is properly integrated. However, if the plan covers an owner-employee, the rules relating to the integration of the plan with the contributions or benefits under the Social Security Act contained in paragraph (b) of §1.401–12 apply.

(ii) Certain of the classifications enumerated in section 401(a)(5) do not apply to plans which provide contributions or benefits for any self-employed individual. Since self-employed individuals are not salaried or clerical employees, the provision in section 401(a)(5) permitting a plan, in certain cases to cover only this type of employee is inapplicable to plans which cover any self-employed individual.

(iii) The classifications enumerated in section 401(a)(5) are not exclusive, and it is not necessary that a qualified plan cover all employees or all full-time employees. Plans may qualify even though coverage is limited in accordance with a particular classification incorporated in the plan, provided the effect of covering only such employees as satisfy such eligibility requirement does not result in the prohibited discrimination.

(d) *Discrimination as to contributions or benefits*—(1) *In general.* In order for a plan to be qualified, there must be no discrimination in contributions or benefits in favor of employees who are officers, shareholders, supervisors, or highly compensated, as against other employees whether within or without the plan. A self-employed individual, by reason of the contingent nature of his compensation, is considered to be a highly-compensated employee, and thus is a member of the group in whose favor discrimination is prohibited. In determining whether the prohibited discrimination exists, the total employer contribution on behalf of a self-employed individual shall be taken into account regardless of the fact that only a portion of such contribution is allowed as a deduction. For additional rules relating to discrimination as to contributions or benefits with regard to plans covering any owner-employee, see §1.401–12.

(2) *Base for computing contributions or benefits.* (i) A plan which is otherwise qualified is not considered discriminatory merely because the contributions or benefits provided under the plan bear a uniform relationship to the total compensation, basic compensation, or regular rate of compensation of the employees, including self-employed individuals, covered under the plan.

(ii) In the case of a self-employed individual who is covered under a qualified plan, the total compensation of such individual is the earned income (as defined in section 401(c)(2)) which such individual derives from the employer's trade or business, or trades or businesses, with respect to which the qualified plan is established. Thus, for example, in the case of a partner, his total compensation includes both his distributive share of partnership income, whether or not distributed, and guaranteed payments described in section 707(c) made to him by the partnership establishing the plan, to the extent that such income constitutes earned income as defined in section 401(c)(2).

(iii)(A) The basic or regular rate of compensation of any self-employed individual is that portion of his earned income which bears the same ratio to his total earned income derived from the trade or business, or trades or businesses, with respect to which the qualified plan is established as the aggregate basic or regular compensation of all common-law employees covered under the plan bears to the aggregate total compensation of such employees derived from such trade or business, or trades or businesses.

(B) If an employer establishes two or more plans which satisfy the requirements of section 401(a) separately, and only one such plan covers a self-employed individual, the determination of the basic or regular rate of compensation of such self-employed individual is made with regard to the compensation of common-law employees covered under the plan which provides contributions or benefits for such self-employed individual. On the other hand, if two or more plans must be considered together in order to satisfy the requirements of section 401(a), the computation of the basic or regular rate of compensation of a self-employed individual must be made with regard to the compensation of the common-law employees covered by so many of such plans as are required to be taken together in order to satisfy the qualification requirements of section 401(a).

(3) *Discriminatory contributions.* If a discriminatory contribution is made by, or for, a self-employed individual who is an employee within the meaning of section 401(c)(1) because of an erroneous assumption as to the earned income of such individual, the plan will not be considered discriminatory if adequate adjustment is made to remove such discrimination. In the case of any self-employed individual who is an owner-employee, the amount of any excess contribution to be returned and the manner in which it is to be repaid are determined by the provisions of section 401(d)(8) and (e). However, if any self-employed individual, including any owner-employee, has not made the full contribution permitted to be made on his behalf as an employee, then, if the plan expressly provides, so much of any excess contribution by such self-employed individual's employer as may, under the provisions of the plan, be treated as a contribution made by such individual as an employee can be so treated.

(e) *Distribution of entire interest.* (1) If a trust forms part of a plan which covers a self-employed individual, such trust shall constitute a qualified trust under section 401 only if the plan of which such trust is a part expressly provides that the entire interest of each employee, including any common-law employee, will be distributed in accordance with the provisions of subparagraph (2) or (3) of this paragraph.

(2) Unless the provisions of subparagraph (3) of this paragraph apply, the entire interest of each employee (including contributions he has made on his own behalf, contributions made on his behalf by his employer, and interest thereon) must be actually distributed to such employee—

(i) In the case of an employee, other than an individual who is, or has been, an owner-employee under the plan, not later than the last day of the taxable year of such employee in which he attains the age of 70½, or not later than the last day of the taxable year in which such employee retires, whichever is later, and

(ii) In the case of an employee who is, or has been, an owner-employee under the plan, not later than the last day of the taxable year in which he attains the age of 70½.

(3) In lieu of distributing an employee's entire interest in a qualified plan as provided in subparagraph (2) of this paragraph, such interest may be distributed commencing no later than the last taxable year described in such subparagraph (2). In such case, the plan must expressly provide that the entire interest of such an employee shall be distributed to him and his beneficiaries, in a manner which satisfies the requirements of subparagraph (5) of this paragraph, over any of the following periods (or any combination thereof)—

(i) The life of the employee, or

(ii) The lives of the employee and his spouse, or

(iii) A period certain not longer than the life expectancy of the employee, or

(iv) A period certain not longer than the joint life and last survivor expectancy of the employee and his spouse.

(4) For purposes of subparagraphs (3) and (5) of this paragraph, the determination of the life expectancy of the employee or the joint life and last survivor expectancy of the employee and his spouse is to be made either (i) only once, at the time the employee receives the first distribution of his entire interest under the plan, or (ii) periodically, in a consistent manner. Such life expectancy or joint life and last survivor expectancy cannot exceed the period computed by the use of the expected return multiples in §1.72–9, or, in the case of payments under a contract issued by an insurance company, the period computed by use of the life expectancy tables of such company.

(5) If an employee's entire interest is to be distributed over a period described in subparagraph (3) of this paragraph, then the amount to be distributed each year must be at least an amount equal to the quotient obtained by dividing the entire interest of the employee under the plan at the time the distribution is made (expressed in either dollars or units) by the life expectancy of the employee, or joint life and last survivor expectancy of the employee and his spouse (whichever is applicable), determined in accordance with the provisions of subparagraph (4) of this paragraph. However, no distribution need be made in any year, or a lesser amount may be distributed, if the aggregate amounts distributed by the end of that year are at least equal to the aggregate of the minimum amounts required by this subparagraph to have been distributed by the end of such year.

(6) If an employee's entire interest is distributed in the form of an annuity contract, then the requirements of section 401(a)(9) are satisfied if the distribution of such contract takes place before the end of the latest taxable year described in subparagraph (2) of this paragraph, and if the employee's interest will be paid over a period described in subparagraph (3) of this paragraph and at a rate which satisfies the requirements of subparagraph (5) of this paragraph.

(7) The requirements of section 401(a)(9) do not preclude contributions from being made on behalf of an owner-employee under a qualified plan subsequent to the taxable year in which the distribution of his entire interest is required to commence. Thus, if all other requirements for qualification are satisfied, a qualified plan may provide contributions for an owner-employee

who has already attained age 70½. However, a distribution of benefits attributable to contributions made on behalf of an owner-employee in a taxable year beginning after the taxable year in which he attains the age of 70½ must satisfy the requirements of subparagraph (3) of this paragraph. Thus, if an owner-employee has already attained the age of 70½ at the time the first contribution is made on his behalf, the distribution of his entire interest must commence in the year in which such contribution is first made on his behalf.

(8) This paragraph shall not apply and an otherwise qualified trust will not be disqualified if the method of distribution under the plan is one which was designated by a common-law employee prior to October 10, 1962, and such method of distribution is not in accordance with the provisions of section 401(a)(9). Such exception applies regardless of whether the actual distribution of the entire interest of an employee making such a designation, or any portion of such interest, has commenced prior to October 10, 1962.

[T.D. 6675, 28 FR 10124, Sept. 17, 1963, as amended by T.D. 6982, 33 FR 16500, Nov. 13, 1968]

§ 1.401–12 Requirements for qualification of trusts and plans benefiting owner-employees.

(a) *Introduction.* This section prescribes the additional requirements which must be met for qualification of a trust forming part of a pension or profit-sharing plan, or of an annuity plan, which covers any self-employed individual who is an owner-employee as defined in section 401(c)(3). However, to the extent that the provisions of § 1.401–11 are not modified by the provisions of this section, such provisions are also applicable to a plan which covers an owner-employee. The provisions of this section apply to taxable years beginning after December 31, 1962. Except as otherwise provided, paragraphs (b) through (m) of this section apply to taxable years beginning after December 31, 1962. Paragraph (n) of this section applies to plan years determined in accordance with paragraph (n)(1) of the section.

(b) *General rules.* (1) The qualified plan and trust of an unincorporated trade or business does not have to satisfy the additional requirements for qualification merely because an owner-employee derives earned income (as defined in section 401(c)(2)) from the trade or business with respect to which the plan is established. Such additional requirements need be satisfied only if an owner-employee is actually covered under the plan of the employer. An owner-employee may only be covered under a plan of an employer if such owner-employee has so consented. However, the consent of the owner-employee may be either expressed or implied. Thus, for example, if contributions are, in fact, made on behalf of an owner-employee, such owner-employee is considered to have impliedly consented to being covered under the plan.

(2) A qualified plan covering an owner-employee must be a definite written program and arrangement setting forth all provisions essential for qualification at the time such plan is established. Therefore, for example, even though the owner-employee is the only employee covered under the plan at the time the plan is established, the plan must incorporate all the provisions relating to the eligibility and benefits of future employees.

(c) *Bank trustee.* (1)(i) If a trust created after October 9, 1962, is to form a part of a qualified pension or profit-sharing plan covering an owner-employee, or if a trust created before October 10, 1962, but not exempt from tax on October 9, 1962, is to form part of such a plan, the trustee of such trust must be a bank as defined in paragraph (c)(2) of this section, unless an exception contained in paragraph (c)(4) of this section applies, or paragraph (n) of this section applies.

(ii) The provisions of this paragraph do not apply to an employees' trust created prior to October 10, 1962, if such trust was exempt from tax on October 9, 1962, even though the plan of which such trust forms a part is amended after December 31, 1962, to cover any owner-employee. Although the trustee of a trust described in the preceding sentence need not be a bank, all other requirements for the qualification of such a trust must be satisfied at the time an owner-employee is first covered under such plan.

(2) The term *bank* as used in this paragraph means—

(i) A bank as defined in section 581;

(ii) A corporation which, under the laws of the State of its incorporation or under the laws of the District of Columbia, is subject to both the supervision of, and examination by, the authority in such jurisdiction in charge of the administration of the banking laws;

(iii) In the case of a trust created or organized outside of the United States, that is, outside the States and the District of Columbia, a bank or trust company, wherever incorporated, exercising fiduciary powers and subject to both supervision and examination by governmental authority;

(iv) Beginning on January 1, 1974, an insured credit union (within the meaning of section 101 (6) of the Federal Credit Union Act, 12 U.S.C. 1752 (6)).

(3) Although a bank is required to be the trustee of a qualified trust, another person, including the employer, may be granted the power in the trust instrument to control the investment of the trust funds either by directing investments, including reinvestments, disposals, and exchanges, or by disapproving proposed investments, including reinvestments, disposals, or exchanges.

(4)(i) This paragraph does not apply to a trust created or organized outside the States and the District of Columbia before October 10, 1962, if, on October 9, 1962, such trust is described in section 402(c) as an organization treated as if it was a trust exempt from tax under section 501(a).

(ii) In addition, the requirement that the trustee must be a bank does not apply to a qualified trust forming a part of a pension or profit-sharing plan if—

(A) The investments of all the funds in such trust are in annuity, endowment, or life insurance contracts, issued by a company which is a life insurance company as defined in section 801(a) during the taxable year immediately preceding the year that such contracts are originally purchased;

(B) All the proceeds which are, or may become, payable under the contract are payable directly to the employee or his beneficiary;

(C) The plan contains a provision to the effect that the employer is to substitute a bank as a trustee or custodian of the contracts if the employer is notified by the district director that such substitution is required because the trustee is not keeping such records, or making such returns, or rendering such statements, as are required by forms or regulations.

However, a qualified trust may only purchase insurance protection to the extent permitted under a qualified plan (see paragraph (b)(1) (i) and (ii) of § 1.401–1).

(5) An employer may designate several trusts (or custodial accounts) or a trust or trusts and an annuity plan or plans as constituting parts of a single plan which is intended to satisfy the requirements for qualification. However, each trust (or custodial account) so designated which is part of a plan covering an owner-employee must satisfy the requirements of this paragraph. Thus, for example, if all other requirements for qualification are satisfied by the plan, a qualified profit-sharing plan may provide that a portion of the contributions under the plan will be paid to a custodial account, the custodian of which is a bank, for investment in stock of a regulated investment company, and the remainder of such contributions will be paid to a trust, the trustee of which is not a bank, for investment in annuity contracts.

(d) *Profit-sharing plan*. (1) A profit-sharing plan, as defined in paragraph (b)(1)(ii) of § 1.401–1, which covers any owner-employee must contain a definite formula for determining the contributions to be made by the employer on behalf of employees, other than owner-employees. A formula to be definite must specify the portion of profits to be contributed to the trust and must also define profits for plan purposes. A definite formula may contain a variable factor, if the value of such factor may not vary at the discretion of the employer. For example, the percentage of profits to be contributed each year may differ depending on the amount of profits. On the other hand, a formula which, for example, specifies that profits for plan purposes are not to exceed the cash on hand at the time the employer contribution is made is not a definite formula. The requirement that the plan formula be definite is satisfied if such formula limits the amount to be contributed on behalf of all employees covered under the plan to the amount which permits self-employed individuals to obtain the maximum deduction under section 404(a). However, even though the plan formula is definite, the plan must satisfy all the other requirements for qualification, including the requirement that the contributions under the plan not discriminate in favor of any self-employed individual, and the requirement that the plan be for the exclusive benefit of the employees in general.

(2) A definite contribution formula constitutes an integral part of a qualified profit-sharing plan and may not be amended except for a valid business reason.

(3) The requirement that a profit-sharing plan contain a definite formula for determining the amount of contributions to be made on behalf of employees does not apply to contributions which are made on behalf of owner-employees. However, such contributions are subject to the requirement that they be nondiscriminatory with respect to other employees and must not exceed the limitations on allowable and deductible contributions which may be made by owner-employees.

(e) *Requirements as to coverage*—(1) *Coverage of all employees.* The coverage requirements contained in section 401(a)(3) do not apply to a plan which covers any owner-employee. However, such a plan must satisfy the coverage requirements of section 401(d), including section 401(d)(3). Accordingly, a plan which covers an owner-employee must benefit each employee of the trade or business (other than any owner-employee who does not consent to be covered under the plan) whose customary period of employment has been for more than 20 hours a week for more than five months during each of three consecutive periods of twelve calendar months. Therefore, a plan may not provide, for example, that an employee, other than an owner-employee, is ineligible to participate because he does not consent to be a participant or because he does not consent to make reasonable contributions under the plan.

(2) *Period of service.* (i) In determining whether an employee renders service to the same employer, and, therefore, must be covered under the plan of such employer, a partnership is considered to be one employer during the entire period prior to the time it is terminated within the meaning of section 708 (see paragraph (e)(2) of § 1.401–10).

(ii) In the case of a common-law employee who becomes an employee within the meaning of section 401(c)(1) with respect to the same trade or business, his period of employment is the aggregate of his service as a common-law employee and an employee within the meaning of section 401(c)(1).

(iii) In determining whether any employee, including any owner-employee, has three years of service, past service of any such employee may be taken into account as provided in paragraph (b) of § 1.401–10. Thus, if an employer takes into account past service for any owner-employee, he must take into account the past service of all his other employees to the same extent. However, a plan may provide for coverage after a period of service which is shorter than three years, but in no case may the plan require a waiting period for employees which is longer than that required for the owner-employees.

(f) *Discrimination in contributions or benefits.* (1) Variations in contributions or benefits may be provided under the plan so long as the plan does not discriminate, either as to contributions or benefits, in favor of officers, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees, as against other employees (see § 1.401–4). For the purpose of determining whether the provisions of a plan which provide contributions or benefits for an owner-employee result in the prohibited discrimination, an owner-employee, like other self-employed individuals, is considered a highly compensated employee (see paragraph (d) of § 1.401–11). Whether or not a plan is discriminatory is determined by the actual operation of the plan as well as by its formal provisions.

(2) The provisions of section 401(a)(5), relating to certain plan provisions which will not in and of themselves be considered discriminatory, are not applicable to any plan which covers any owner-employee. Such a plan must, instead, satisfy the requirements of section 401(a)(10) and section 401(d)(6). Accordingly, a plan is not discriminatory within the meaning of section 401(a)(4) merely because the contributions or benefits provided for the employees covered under the plan bear a uniform relationship to the total compensation, or to the basic or regular rate of compensation, of such employees. The total compensation or the basic or regular rate of compensation of an owner-employee is computed in accordance with the provisions of paragraph (d)(2) of §1.401–11.

(3) Even though the contributions under the plan do not bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered thereunder and the plan would otherwise be considered discriminatory within the meaning of section 401(a)(4), the plan shall not be considered discriminatory if such variation is due to employer contributions on behalf of any owner-employee which are required, under the plan, to be applied to pay premiums or other consideration on one or more level premium contracts described in section 401(e)(3)(A). In a taxable year to which the foregoing exception applies and, therefore, one in which the contributions under the plan would otherwise be discriminatory, the employer contributions to pay such premiums or other consideration must be the only employer contributions made for the owner-employee, and the contributions for such taxable year under such plan must not be in excess of the amount permitted to be paid toward the purchase of such a contract under the provisions of section 401(e)(3). Furthermore, the exception described in this subparagraph only applies to contributions made under a plan which otherwise satisfies the requirements of section 401(a)(4) and the regulations thereunder. Thus, if a plan provides for the purchase, in accordance with section 401(e)(3), of a level premium contract for an owner-employee, then such plan must provide either that the benefits for all employees are nondiscriminatory or, in the case of a money-purchase type of plan, that the contributions for all employees are based on compensation determined in a non-discriminatory manner. For example, since the contributions on behalf of the owner-employee are based on his earned income during the period preceding the purchase of the contract, the contributions for other employees must be based on their compensation during the same period if this will result in larger contributions on their behalf.

(4) In the case of a plan which covers any owner-employee, the contributions or benefits provided under the plan cannot vary with respect to years of service except as provided in subparagraph (5) of this paragraph.

(5) The provisions of section 401(d)(3) do not preclude the coverage of employees with less than three years of service if such coverage is provided on a nondiscriminatory basis. However, a plan will not be disqualified merely because the contributions or benefits for employees who have less than three years of service are not as favorable as the contributions or benefits for employees having more than three years of service.

(g) *Nonforfeitable rights.* (1)(i) Except as provided in subparagraph (2) of this paragraph, if an owner-employee is covered under the plan of his employer, each employee's rights to the contributions, or to the benefits derived from the contributions, of such employer must be nonforfeitable at the time such contributions are paid to, or under, the plan. The employees who must obtain such nonforfeitable rights include the self-employed individuals who are covered under the plan. As to what constitutes nonforfeitable rights of an employee, see paragraph (a)(2) of §1.402(b)–1.

(ii) Under section 401(d)(2), it is necessary that each employee obtain nonforfeitable rights to the employer contributions under the plan on his behalf from the time such contributions are paid. Thus, each employee must have a nonforfeitable interest to the portion of the funds under the plan which is allocable to the employer contributions made under the plan on his behalf.

(2) The provisions of subparagraph (1) of this paragraph do not apply to the extent that employer contributions on behalf of any employee must remain forfeitable in order to satisfy the requirements of paragraph (c) of § 1.401–4. However, employer contributions on behalf of employees whose rights are required to remain forfeitable to satisfy such requirements must be nonforfeitable except for such contingency.

(h) *Integration with social security.* (1) If a qualified plan covers any owner-employee, then the rules relating to the integration of such plan with the contributions or benefits under the Social Security Act are provided in this paragraph. Accordingly, the provisions of paragraph (e) of § 1.401–3 and paragraph (c) of § 1.401–11 do not apply to such a plan. In the case of a plan which provides contributions or benefits for any owner-employee, integration of the plan with the Social Security Act for any taxable year of the employer can take place only if not more than one-third of the employer contributions under the plan which are deductible under section 404 for that year are made on behalf of the owner-employees. If such requirement is satisfied, then the plan may be integrated with the contributions or benefits under the Social Security Act in accordance with the rules of subparagraph (3) of this paragraph.

(2)(i) For purposes of subparagraph (1) of this paragraph, in determining the total amount of employer contributions which are deductible under section 404, the provisions of section 404(a), including the provisions of section 404(a)(9) (relating to plans benefiting self-employed individuals), and section 404(e) (relating to the special limitations for self-employed individuals) are taken into account, but the provisions of section 404(a)(10) (relating to the special limitation on the amount allowed as a deduction for self-employed individuals) are not taken into account.

(ii) The amount of deductible employer contributions which are made on behalf of all owner-employees for the year is compared with the amount of deductible employer contributions for the year made on behalf of all employees covered under the plan (including self-employed individuals who are not owner-employees and owner-employees) for the purpose of determining whether the deductible contributions by the employer on behalf of owner-employees are not more than one-third of the total deductible contributions.

(3) If a plan covering an owner-employee satisfies the requirement of subparagraph (1) of this paragraph, and if the employer wishes to integrate such plan with the contributions or benefits under the Social Security Act, then—

(i) The employer contributions under the plan on behalf of any owner-employee shall be reduced by an amount determined by multiplying the earned income of such owner-employee which is derived from the trade or business with respect to which the plan is established and which does not exceed the maximum amount which may be treated as self-employment income under section 1402(b)(1), by the rate of tax imposed under section 1401(a); and

(ii) The employer contributions under the plan on behalf of any employee other than an owner-employee may be reduced by an amount not in excess of the amount determined by multiplying the employee's wages under section 3121(a)(1) by the rate of tax imposed under section 3111(a). For purposes of this subdivision, the earned income of a self-employed individual which is derived from the trade or business with respect to which the plan is established and which is treated as self-employment income under section 1402(b)(1), shall be treated as ''wages'' under section 3121(a)(1).

(4) A money purchase pension plan or a profit-sharing plan may provide that such plan will be integrated with the Social Security Act only for such taxable years of the employer in which the requirements for integration are satisfied. However, a qualified plan cannot provide that employer contributions are only to be made for taxable years in which the integration requirements are satisfied.

(i) *Limit on contributions on behalf of an owner-employee.* (1) Section 401(d)(5) requires that a plan which covers any owner-employee must contain provisions which restrict the employer contributions that may be made on behalf of any owner-employee for each taxable year to an amount no greater than that which is deductible under section 404. In computing the amount deductible under section 404 for purposes of section 401(d)(5) and this paragraph, the limitations contained in section 404(a)(9) and (e), relating to special limitations for self-employed individuals, are taken into account, but such amount is determined without regard to section 404(a)(10), relating to the special limitation on the amount allowed as a deduction for self-employed individuals. Accordingly, a qualified plan which covers any owner-employee cannot permit employer contributions to be made on behalf of such owner-employee in excess of 10 percent of the earned income which is derived by such owner-employee from the trade or business with respect to which the plan is established, or permit the employer to contribute more than $2,500 on behalf of any such owner-employee for any taxable year.

(2)(i) In determining whether the plan permits contributions to be made in excess of the limitations of subparagraph (1) of this paragraph, employer contributions under the plan which are allocable to the purchase of life, accident, health, or other insurance are not to be taken into account. To determine the amount of employer contributions under the plan which are allocable to the purchase of life, accident, health, or other insurance, see paragraph (f) of §1.404(e)–1 and paragraph (b) of §1.72–16. However, contributions for such insurance can be made only to the extent otherwise permitted under sections 401 through 404 and the regulations thereunder.

(ii) A further exception to the limit on the amount of contributions which an employer may make under the plan on behalf of an owner-employee is made in the case of contributions which are required, under the plan, to be applied to pay premiums or other consideration for one or more annuity, endowment, or life insurance contracts described in section 401(e)(3) (see section 401(e)(3) and the regulations thereunder).

(j) *Excess contributions.* The provisions of section 401(e) define the term ‘‘excess contribution’’ and indicate the consequences of making such a contribution (see §1.401–13). However, section 401(d)(8) provides that a qualified plan which provides contributions or benefits for any owner-employee must contain certain provisions which complement the rules contained in section 401(e). Under section 401(d)(8), a qualified plan must provide that—

(1) The net amount of any excess contribution (determined in accordance with the provisions of §1.401–13) must be returned to the owner-employee on whose behalf it is made, together with the net income earned on such excess contribution;

(2) For each taxable year for which the trust is considered to be a nonqualified trust with respect to an owner-employee under section 401(e)(2) because the net amount of an excess contribution and the earnings thereon have not been returned to such owner-employee, the income of the trust for that taxable year attributable to the interest of such owner-employee is to be paid to him.

(3) If an excess contribution is determined to be willfully made (within the meaning of section 401(e)(2)(E)), the entire interest of the owner-employee on whose behalf such contribution was made is required to be distributed to such owner-employee. Furthermore, the plan must require the distribution of an owner-employee’s entire interest under the plan if a willful excess contribution is determined to have been made under any other plan in which the owner-employee is covered as an owner-employee.

(k) *Contributions of property under a qualified plan.* (1) The contribution of property, other than money, prior to January 1, 1975, by the person who is the employer (within the meaning of section 401(c)(4)) to a qualified trust forming a part of a plan which covers employees some or all of whom are owner-employees who control (within the meaning of section 401(d)(9)(B) and the regulations thereunder) the trade or business with respect to which the plan is established is a prohibited transaction between such trust and the employer-grantor of such trust (see section 503(g) prior to its repeal by sec. 2003(b)(5) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978)).

(2) A contribution of property, other than money, prior to January 1, 1975, to a qualified trust by an owner-employee who controls, or a member of a group of owner-employees who together control, the trade or business with respect to which the plan is established, or a contribution of property, other than money, to a qualified trust by a member of such an owner-employee's family (as defined in section 267(c)(4)), is a prohibited transaction. (See section 503(g) prior to its repeal by section 2003(b)(5) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978)).

(3) See section 4975 and the regulations thereunder with respect to rules relating to the contribution of property, other than money, made after December 31, 1974.

(l) *Controlled trades or businesses*— (1) *Plans covering an owner-employee who controls another trade or business.* (i) A plan must not cover any owner-employee, or group of two or more owner-employees, if such owner-employee, or group of owner-employees, control (within the meaning of subparagraph (3) of this paragraph) any other trade or business, unless the employees of such other trade or business controlled by such owner-employee, or such group of owner-employees, are included in a plan which satisfies the requirements of section 401(a), including the qualification requirements of section 401(d). The employees who must be covered under the plan of the trade or business which is controlled include the self-employed individuals who are not owner-employees and the owner-employees who consent to be covered by such plan. Accordingly, the employer must determine whether any owner-employee, or group of owner-employees, who may participate in the plan which is established by such employer controls any other trade or business, and whether the requirements of this subparagraph are satisfied with respect to the plan established in such other trade or business. The plan of an employer may exclude an owner-employee who controls another trade or business from coverage under the plan even though such owner-employee consents to be covered, if a plan which satisfies the requirements of subdivision (ii) of this subparagraph has not been established in the trade or business which such owner-employee controls.

(ii) The qualified plan which the owner-employee, or owner-employees, are required to provide for the employees of the trade or business which they control must provide contributions and benefits which are not less favorable than the contributions and benefits provided for the owner-employee, or owner-employees, under the plan of any trade or business which they do not control. Thus, for example, if the contributions or benefits for the owner-employee under the plan of the trade or business which he does not control are computed on the basis of his total (as compared to basic or regular rate) of compensation, then the contributions or benefits for employees covered under the plan of the trade or business which the owner controls must be computed on the basis of their total compensation. However, the requirements of this subdivision cannot be satisfied if the benefits and contributions provided under the plan for the employees of the trade or business which is controlled are not comparable to those provided under the plan covering the owner-employee, or group of owner-employees, in the trade or business which they do not control. Thus, for example, if the owner-employee is covered by a pension plan in the trade or business which he does not control, he may not satisfy the requirements of this subdivision by establishing a profit-sharing plan in the trade or business which he does control.

(iii) If an individual is covered as an owner-employee under the plans of two or more trades or businesses which he does not control and such individual controls a trade or business, then the contributions or benefits of the employees under the plan of the trade or business which he does control must be as favorable as those provided for him under the most favorable plan of the trade or business which he does not control.

(2) *Owner-employees who control more than one trade or business.* If the plan

provides contributions or benefits for an owner-employee who controls, or group of owner-employees who together control, the trade or business with respect to which the plan is established, and such owner-employee, or group of owner-employees, also control as owner-employees one or more other trades or businesses, plans must be established with respect to such controlled trades or businesses so that when taken together they form a single plan which satisfies the requirements of section 401 (a) and (d) with respect to the employees of all the controlled trades or businesses.

(3) *Control defined.* (i) For purposes of this paragraph, an owner-employee, or a group of two or more owner-employees, shall be considered to control a trade or business if such owner-employee, or such group of two or more owner-employees together—

(A) Own the entire interest in an unincorporated trade or business, or

(B) In the case of a partnership, own more than 50 percent of either the capital interest or the profits interest in such partnership.

In determining whether an owner-employee, or group of owner-employees, control a trade or business within the meaning of the preceding sentence, it is immaterial whether or not such individuals could be covered under a plan established with respect to the trade or business. For example, if an individual who is an owner-employee has a 60-percent capital interest in another trade or business, such individual controls such trade or business and the provisions of this paragraph apply even though the individual derives no earned income, as defined in section 401(c)(2), from the controlled trade or business. For purposes of determining the ownership interest of an owner-employee, or group of owner-employees, an owner-employee, or group of owner-employees, is treated as owning any interest in a partnership which is owned, directly or indirectly, by a partnership controlled by such owner-employee, or group of owner-employees.

(ii) The provisions of subparagraphs (1) and (2) of this paragraph apply only if the owner-employee who controls, or the group of owner-employees who control, a trade or business, or trades or businesses, within the meaning of subdivision (i) of this subparagraph is the same owner-employee, or group of owner-employees, covered under the plan intended to satisfy the requirements for qualification. Thus, for example, if A is a 50-percent partner in both the AB and AC partnership, and if the AB partnership wishes to establish a plan covering A and B, the provisions of subparagraphs (1) and (2) of this paragraph do not apply, since A does not control either partnership, and since B has no interest in the AC partnership.

(m) *Distribution of benefits.* (1)(i) Section 401(d)(4)(B) requires that a qualified plan which provides contributions or benefits for any owner-employee must not provide for the payment of benefits to such owner-employee at any time before he has attained age 59½. An exception to the foregoing rule permits a qualified plan to provide for the distribution of benefits to an owner-employee prior to the time he attains age 59½ if he is disabled. For taxable years beginning after December 31, 1966, see section 72(m)(7) and paragraph (f) of §1.72–17 for the meaning of disabled. For taxable years beginning before January 1, 1967, see section 213(g)(3) for the meaning of disabled. In general, both sections 72(m)(7) and 213(g)(3) provide that an individual is considered disabled if he is unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. In addition, section 401(d)(4)(B) does not preclude the distribution of benefits to the estate or other beneficiary of a deceased owner-employee prior to the time the owner-employee would have attained age 59½ if he had lived.

(ii) A qualified plan must provide that if, despite the restrictions in the plan to the contrary, an amount is prematurely distributed, or made available, to a participant in such plan who is, or has been, an owner-employee, then no contribution shall be made under the plan by, or for, such individual during any of the 5 taxable years of the plan beginning after the distribution is made.

(2)(i) The provisions of subparagraph (1) of this paragraph preclude an owner-employee who is a participant in a qualified pension or profit-sharing plan of his employer from withdrawing any part of the funds accumulated on his behalf except as provided in such subparagraph (1). However, the distribution of an owner-employee's interest, or any portion of such interest, after he attains age 59½ is determined by the provisions of the plan. Thus, for example, if a qualified pension plan provides that the normal retirement age under the plan is age 65, an owner-employee would not be entitled to a distribution of an amount under the plan merely because he attained age 59½.

(ii) The provisions of subparagraph (1) of this paragraph do not preclude the establishment of a profit-sharing plan which provides for the distribution of all, or part, of participants' accounts after a fixed number of years. However, such a plan must not permit a distribution of any amount to any owner-employee prior to the time the owner-employee has attained age 59½ or becomes disabled within the meaning of section 72(m)(7) or section 213(g)(3), whichever is applicable. On the other hand, if a distribution would have been made under the plan to an owner-employee but for the fact that he had not attained age 59½, then the amount of such distribution (including any increment earned on such amount) must be distributed to such owner-employee at such time as he attains age 59½.

(3) A qualified pension, annuity, or profit-sharing plan which covers an owner-employee must provide that the distribution of an owner-employee's entire interest under the plan must begin prior to the end of the taxable year in which he attains the age of 70½, and such distribution must satisfy the requirements of section 401(a)(9) and paragraph (e) of § 1.401–11. Furthermore, section 401(d)(7) provides that, if an owner-employee dies prior to the time his entire interest has been distributed to him, such owner-employee's entire remaining interest under the plan must, in general, either be distributed to his beneficiary, or beneficiaries, within 5 years, or be used within that period to purchase an immediate annuity for his beneficiary, or beneficiaries. However, a distribution within 5 years of the death of the owner-employee is not required if the distribution of his interest has commenced and such distribution is for a term certain over a period not extending beyond the joint life and survivor expectancy of the owner-employee and his spouse. Thus, for example, an annuity for the joint life and survivor expectancy of an owner-employee and his spouse which guarantees payments for 10 years is a distribution which is payable over a period which does not exceed the joint life and survivor expectancy of the owner-employee and his spouse if such expectancy is at least 10 years at the time the distribution first commences.

[T.D. 6675, 28 FR 10126, Sept. 17, 1963, as amended by T.D. 6982, 33 FR 16500, Nov. 13, 1968; T.D. 6985, 33 FR 19815, Dec. 27, 1968; T.D. 7428, 41 FR 34619, Aug. 16, 1976; T.D. 7611, 44 FR 23520, Apr. 20, 1979; T.D. 8635, 60 FR 65549, Dec. 20, 1995]

§ 1.401–13 Excess contributions on behalf of owner-employees.

(a) *Introduction.* (1) The provisions of this section prescribe the rules relating to the treatment of excess contributions made under a qualified pension, annuity, or profit-sharing plan on behalf of a self-employed individual who is an owner-employee (as defined in paragraph (d) of § 1.401–10). Paragraph (b) of this section defines the term ''excess contribution''. Paragraph (c) of this section describes an exception to the definition of an excess contribution in the case of contributions which are applied to pay premiums on certain annuity, endowment, or life insurance contracts. Paragraph (d) of this section describes the effect of making an excess contribution which is not determined to have been willfully made, and paragraph (e) of this section describes the effect of making an excess contribution which is determined to have been willfully made.

(2) Under section 401(c)(1), certain self-employed individuals are treated as employees for purposes of section 401. In addition, under section 401(c)(4), a proprietor is treated as his own employer, and the partnership is treated

as the employer of the partners. Under section 404, certain contributions on behalf of a self-employed individual are treated as deductible and taken into consideration in determining the amount allowed as a deduction under section 404(a). Such contributions are treated under section 401 and the regulations thereunder as employer contributions on behalf of the self-employed individual. However, in some cases, additional contributions may be made on behalf of a self-employed individual. Such contributions are not taken into consideration in determining the amount deductible under section 404 and are not taken into consideration in computing the amount allowed as a deduction under section 404(a). For purposes of section 401 and the regulations thereunder, such contributions are treated as employee contributions by the self-employed individual. If a self-employed individual is an owner-employee within the meaning of section 401(c)(3) and paragraph (d) of § 1.401–10, then this section prescribes the rules applicable if contributions are made in excess of those permitted to be made under section 401.

(b) *Excess contributions defined.* (1)(i) Except as provided in paragraph (c) relating to contributions which are applied to pay premiums on certain annuity, endowment, or life insurance contracts, an excess contribution is any amount described in subparagraphs (2) through (4) of this paragraph.

(ii) For purposes of determining if the amount of any contribution made under the plan on behalf of an owner-employee is an excess contribution, the amount of any contribution made under the plan which is allocable to the purchase of life, accident, health, or other insurance is not taken into account. The amount of any contribution which is allocable to the cost of insurance protection is determined in accordance with the provisions of paragraph (f) of § 1.404 (e)–1 and paragraph (b) of § 1.72–16.

(2)(i) In the case of a taxable year of the plan for which employer contributions are made on behalf of only owner-employees, an excess contribution is the amount of any contribution for such taxable year on behalf of such owner-employee which is not deductible under section 404 (determined without regard to section 404(a)(10)). This rule applies irrespective of whether the plan provides for contributions on behalf of common-law employees, or self-employed individuals who are not owner-employees, when such employees or individuals become eligible for coverage under the plan, and irrespective of whether contributions are in fact made for such employees or such individuals for other taxable years of the plan.

(ii) In the case of a taxable year of the plan for which employer contributions are made on behalf of both owner-employees and either common-law employees or self-employed individuals who are not owner-employees, an excess contribution is the amount of any employer contribution on behalf of any owner-employee for such taxable year which exceeds the amount deductible under section 404 (determined without regard to section 404(a)(10)) unless such amount may be treated as an employee contribution under the plan in accordance with the rules of paragraph (d)(3) of § 1.401–11 and is a permissible employee contribution under subparagraph (3) of this paragraph.

(3)(i) In the case of a taxable year of the plan for which employer contributions are made on behalf of both an owner-employee and either common-law employees or self-employed individuals who are not owner-employees, employee contributions on behalf of an owner-employee may be made for such taxable year of the plan. How-ever, the amount of such contributions, if any, which is described in subdivisions (ii), (iii), or (iv) of this subparagraph is an excess contribution.

(ii) An excess contribution is the amount of any employee contribution made on behalf of any owner-employee during a taxable year of the plan at a rate in excess of the rate of contributions which may be made as employee contributions by common-law employees, or by self-employed individuals who are not owner-employees, during such taxable year of the plan.

(iii) An excess contribution is the amount of any employee contribution made on behalf of an owner-employee which exceeds the lesser of $2,500 or 10 percent of the earned income (as defined in paragraph (c) of § 1.401–10) of such owner-employee for his taxable year in which such contributions are made.

(iv) In the case of a taxable year of an owner-employee in which contributions are made on behalf of such owner-employee under more than one plan, an excess contribution is the amount of any employee contribution made on behalf of such owner-employee under all such plans during such taxable year which exceeds $2,500. If such an excess contribution is made, the amount of the excess contribution made on behalf of the owner-employee with respect to any one of such plans is the amount by which the employee contribution on his behalf under such plan for the year exceeds an amount which bears the same ratio to $2,500 as the earned income of the owner-employee derived from the trade or business with respect to which the plan is established bears to his earned income derived from the trades or businesses with respect to which all such plans are established.

(4) An excess contribution is the amount of any contribution on behalf of an owner-employee for any taxable year of the plan with respect to which the plan is treated, under section 401(e)(2), as not meeting the requirements of section 401(d) with respect to such owner-employee.

(c) *Contributions for premiums on certain annuity, endowment, or life insurance contracts.* (1) The term ''excess contribution'' does not include the amount of any employer contributions on behalf of an owner-employee which, under the provisions of the plan, is expressly required to be applied (either directly or through a trustee) to pay the premiums or other consideration for one or more annuity, endowment, or life insurance contracts, if—

(i) The employer contributions so applied meet the requirements of subparagraphs (2) through (4) of this paragraph, and

(ii) The total employer contributions required to be applied annually to pay premiums on behalf of any owner-employee for contracts described in this paragraph do not exceed $2,500. For purposes of computing such $2,500 limit, the total employer contributions includes amounts which are allocable to the purchase of life, accident, health, or other insurance.

(2)(i) The employer contributions must be paid under a plan which satisfies all the requirements for qualification. Accordingly, for example, contributions can be paid under the plan for life insurance protection only to the extent otherwise permitted under sections 401 through 404 and the regulations thereunder. However, certain of the requirements for qualification are modified with respect to a plan described in this paragraph (see section 401(a)(10)(A)(ii) and (d)(5)).

(ii) A plan described in this paragraph is not disqualified merely because a contribution is made on behalf of an owner-employee by his employer during a taxable year of the employer for which the owner-employee has no earned income. On the other hand, a plan will fail to qualify if a contribution is made on behalf of an owner-employee which results in the discrimination prohibited by section 401(a)(4) as modified by section 401(a)(10)(A)(ii) (see paragraph (f)(3) of § 1.401–12).

(3) The employer contributions must be applied to pay premiums or other consideration for a contract issued on the life of the owner-employee. For purposes of this subparagraph, a contract is not issued on the life of an owner-employee unless all the proceeds which are, or may become, payable under the contract are payable directly, or through a trustee of a trust described in section 401(a) and exempt from tax under section 501(a), to the owner-employee or to the beneficiary named in the contract or under the plan. Accordingly, for example, a nontransferable face-amount certificate (as defined in section 401(g) and the regulations thereunder) is considered an annuity on the life of the owner-employee if the proceeds of such contract are payable only to the owner-employee or his beneficiary.

(4)(i) For any taxable year of the employer, the amount of contributions by the employer on behalf of the owner-employee which is applied to pay premiums under the contracts described in this paragraph must not exceed the average of the amounts deductible under section 404 (determined without regard to section 404(a)(10)) by such employer on behalf of such owner-employee for the most recent three taxable years of the employer (ending prior to the date the latest contract was entered into or modified to provide additional benefits), in which the owner-employee derived earned income from the trade or business with respect to which the plan is established. However, if such owner-employee has not derived earned income for at least three taxable years preceding such date, then, in determining the ''average of the amounts deductible'', only so many of such taxable years as such owner-employee was engaged in such trade or business and derived earned income therefrom are taken into account.

(ii) For the purpose of making the computation described in subdivision (i) of this subparagraph, the taxable years taken into account include those years in which the individual derived earned income from the trade or business but was not an owner-employee with respect to such trade or business. Furthermore, taxable years of the employer preceding the taxable year in which a qualified plan is established are taken into account. If such taxable years began prior to January 1, 1963, the amount deductible is determined as if section 404 included section 404(a) (8), (9), (10), and (e).

(5) The amount of any employer contribution which is not deductible but which is not treated as an excess contribution because of the provisions of this paragraph shall be taken into account as an employee contribution made on behalf of the owner-employee during the owner-employee's taxable year with, or within which, the taxable year of the person treated as his employer under section 401(c)(4) ends. However, such contribution is only treated as an employee contribution made on behalf of the owner-employee for the purpose of determining whether any other employee contribution made on behalf of the owner-employee during such period is an excess contribution described in paragraph (b)(3) of this section.

(d) *Effect of an excess contribution which is not willfully made.* (1) If an excess contribution (as defined in paragraph (b) of this section) is made on behalf of an owner-employee, and if such contribution is not willfully made, then the provisions of this paragraph describe the effect of such an excess contribution. However, if the excess contribution made on behalf of an owner-employee is determined to have been willfully made, then the provisions of paragraph (e) of this section are applicable to such contribution.

(2)(i) This paragraph does not apply to an excess contribution if the net amount of such excess contribution (as defined in subparagraph (4) of this paragraph) and the net income attributable to such amount are repaid to the owner-employee on whose behalf the excess contribution was made at any time before the end of six months beginning on the day on which the district director sends notice (by certified or registered mail) of the amount of the excess contribution to the trust, insurance company, or other person to whom such excess contribution was paid. The net income attributable to the net amount of the excess contribution is the aggregate of the amounts of net income attributable to the net amount of the excess contribution for each year of the plan beginning with the taxable year of the plan within which the excess contribution is made and ending with the close of the taxable year of the plan immediately preceding the taxable year of the plan in which the net amount of the excess contribution is repaid. The amount of net income attributable to the net amount of the excess contribution for each year is the amount of net income earned under the plan during the year which is allocated in a reasonable manner to the net amount of the excess contribution. For example, the amount of net income earned under the plan for the year which is attributable to the net amount of an excess contribution can be computed as the amount which bears the same ratio to the amount of the ''net income attributable to the interest of the owner-employee under the plan'' for such taxable year (determined in accordance with the provisions of subparagraph (5)(ii) of this paragraph) as the net amount of the excess contribution bears to the aggregate amount standing to the account of the owner-employee at the end of that year (including the net amount of any excess contribution).

(ii) The notice described in subdivision (i) of this subparagraph shall not be mailed prior to the time that the amount of the tax under chapter 1 of the Code of the owner-employee to whom the excess contribution is to be repaid has been finally determined for his taxable year in which such excess contribution was made. For purposes of this subdivision, a final determination of the amount of tax liability of the owner-employee includes—

(A)1 A decision by the Tax Court of the United States, or a judgment, decree, or other order by any court of competent jurisdiction, which has become final;

(B) A closing agreement authorized by section 7121; or

(C) The expiration of the period of limitation on suits by the taxpayer for refund, unless suit is instituted prior to the expiration of such period.

(iii) For purposes of this subparagraph, an amount is treated as repaid to an owner-employee if an adequate adjustment is made to the account of the owner-employee. An adequate adjustment is made to the account of an owner-employee, for example, if the amount of the excess contribution (without any reduction for any loading or other administrative charge) and the net income attributable to such amount is taken into account as a contribution under the plan for the current year. In such a case, the gross income of the owner-employee for his taxable year in which such adjustment is made includes the amount of the net income attributable to the excess contribution.

(iv) If the net amount of the excess contribution and the net income attributable thereto is repaid, within the period described in subdivision (i) of this subparagraph, to the owner-employee on whose behalf such contribution was made, then the net income attributable to the excess contribution is, pursuant to section 61(a), includible in the gross income of the owner-employee for his taxable year in which such amount is distributed, or made available, to him. However, such amount is not a distribution to which section 402 or 403 and section 72 apply (see subparagraph (6) of this paragraph).

(3)(i) If the net amount of any excess contribution (as defined in subparagraph (4) of this paragraph) and the net income attributable to that excess contribution are not repaid to the owner-employee on whose behalf the excess contribution was made before the end of the six-month period described in subparagraph (2)(i) of this paragraph, the plan under which the excess contribution has been made is considered, for purposes of section 404, as not satisfying the requirements for qualification with respect to such owner-employee for all taxable years of the plan described in subdivision (ii) of this subparagraph. However, such disqualification only applies to the interest of the owner-employee on whose behalf an excess contribution has been made and does not disqualify the plan with respect to the other participants thereunder.

(ii) The taxable years referred to in subdivision (i) of this subparagraph include the taxable year of the plan within which the excess contribution is made and each succeeding taxable year of the plan until the beginning of the taxable year of the plan in which the trust, insurance company, or other person to whom such excess contribution was paid repays to such owner-employee—

(A) The net amount of the excess contribution, and

(B) The amount of income attributable to his interest under the plan which is includible in his gross income for any taxable year by reason of the provisions of subparagraph (5) of this paragraph.

(4) For purposes of this paragraph, the net amount of an excess contribution is the amount of such excess contribution, as defined in paragraph (b) of this section, reduced by the amount of any loading charge or other administrative charge ratably allocable to such excess contribution.

(5)(i) If a plan is considered as not meeting the requirements for qualification with respect to an owner-employee by reason of the provisions of subparagraph (3) of this paragraph for any taxable year of the plan, such owner-employee's gross income for any of his taxable years with or within which such taxable year of the plan ends shall, for purposes of chapter 1 of the Code, include the portion of the net income earned under the plan for such taxable year of the plan which is attributable to the interest of the owner-employee under the plan.

(ii) For purposes of this subparagraph, the term ''net income'' means the net income earned under the plan determined in accordance with generally accepted accounting principles consistently applied, and the ''net income attributable to the interest of the owner-employee under the plan'' is the amount which bears the same ratio to the aggregate amount of net income earned under the plan for the taxable year of the plan as the amount standing to the account of the owner-employee at the end of that year (including the amount of any excess contribution which is credited to his account) bears to the aggregate amount of all funds under the plan for all employees at the end of that year (including the aggregate amount of excess contributions credited to the accounts of all owner-employees for that year).

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

Example. A is an owner-employee covered under the X Employees' Pension Trust who files his return on the basis of a calendar year. An excess contribution was made on behalf of A during the plan year beginning on January 1, 1966. The net amount of the excess contribution and the net income attributable thereto was not repaid to A before the end of the six-month period described in subparagraph (2)(i) of this paragraph. Accordingly, the net income earned under the plan during 1966 which is attributable to A's interest is to be included in his gross income for 1966. Assume that the trust which forms a part of the pension plan of the X Company also files its returns on a calendar year basis, and that during 1966 the trust had a gross income of $4,000 (including a long-term capital gain of $2,500) and expenses of $500. Assume, further, that the amount standing to A's account on December 31, 1966 (including the amount of the excess contribution), was $20,000, and that on that date the amount funded under the plan for all employees (including A) is $140,000. Then the net income of the trust for 1966 is $3,500 ($4,000 − $500). The net income attributable to the interest of A under the plan is $500 (the amount which bears the same ratio to $3,500 as $20,000 bears to $140,000). Accordingly, $500 is included in A's gross income in accordance with the provisions of section 401(e)(2)(B) as the ''net income attributable to the interest of the owner-employee under the plan''.

(6) The provisions of section 402 or 403 and section 72 do not apply to any amount distributed, or made available, to an owner-employee which is described in this paragraph. Accordingly, for example, the provisions of section 72(m)(5)(A)(i), relating to amounts subject to the penalty tax imposed by section 72(m), do not apply to the amount of the net income attributable to the interest of an owner-employee (as defined in subparagraph (5)(ii) of this paragraph) which is includible in his gross income. Furthermore, in such a case, the provisions of section 401(d)(5)(C) do not apply to such amount.

(7) Certain adjustments will be required with respect to the interest of an owner-employee after any amount previously allocated to his account has been returned to him pursuant to the provisions of this paragraph. For example, if the determination of whether life insurance benefits provided under the plan are incidental is made, in part, with regard to the contributions allocated to the accounts of the participants covered under the plan, an adjustment may have to be made with respect to the life insurance purchased under the plan for any owner-employee after any amount previously allocated to his account has been repaid to him. Furthermore, if, for example, an owner-employee has received annuity payments which were taxable under the exclusion ratio rule of section 72, and if such exclusion ratio took into account any amount credited to the account of the owner-employee which is subsequently repaid to him, then such exclusion ratio must be recomputed after the adjustment in such owner-employee's account has taken place.

(8) Notwithstanding any other provision of law, in any case in which the plan is treated as not satisfying the requirements for qualification with respect to any owner-employee by reason of the provisions of section 401(e), the period for assessing, with respect to such owner-employee, any deficiency arising by reason of—

(i) The disallowance of any deduction under section 404 by reason of the provisions of subparagraph (3) of this paragraph, or

(ii) The inclusion of amounts in the gross income of the owner-employee by reason of the provisions of subparagraph (5) of this paragraph,

shall not expire prior to 18 months after the day the district director mails the notice with respect to the excess contribution (described in subparagraph (2)(i) of this paragraph) which gives rise to such disallowance or inclusion. Thus, for example, notwithstanding the provisions of section 6212(c) (relating to the restriction on the determination of additional deficiencies), if, after a final determination by the Tax Court of the income tax liability of an owner-employee for a taxable year in which an excess contribution was made, the amount of such excess contribution and the net income attributable thereto is not paid to the owner-employee before the end of the six-month period described in subparagraph (2)(i) of this paragraph, an additional deficiency assessment may be made for such taxable year with respect to such excess contribution.

(e) *Effect of an excess contribution which is determined to have been willfully made.* If an excess contribution (as defined in paragraph (b) of this section) on behalf of an owner-employee is determined to have been willful ly made, then—

(1) Only the provisions of this paragraph apply to such contribution;

(2) There shall be distributed to the owner-employee on whose behalf such contribution was willfully made his entire interest in all plans in which he is a participant as an owner-employee;

(3) The amount distributed under each such plan is an amount to which section 72 does apply (see section 72(m)(5)(A)(iii)); and

(4) For purposes of section 404, no plan in which such individual is covered as an owner-employee shall be considered as meeting the requirements for qualification with respect to such owner-employee for any taxable year of the plan beginning with or within the calendar year in which it is determined that the excess contribution has been willfully made and with or within the five calendar years following such year.

(f) *Years to which this section applies.* This section applies to contributions made in taxable years of employers beginning before January 1, 1976. Thus, for example, in the case of willful contributions made in taxable years of employers beginning before January 1, 1976, paragraphs (e) (1), (2), and (3) of this section apply to such taxable years beginning on or after such date. However, in such a case, because the application of paragraph (e)(4) of this section affects contributions made in taxable years of employers beginning on or after January 1, 1976, paragraph (e)(4) of this section does not apply to such taxable years; see paragraph (c) of §1.401(e)–4 (relating to transitional rules for excess contributions).

[T.D. 6676, 28 FR 10139, Sept. 17, 1963; as amended by T.D. 7636, 44 FR 47053, Aug. 10, 1979]

§ 1.401–14 Inclusion of medical benefits for retired employees in qualified pension or annuity plans.

(a) *Introduction.* Under section 401(h) a qualified pension or annuity plan may make provision for the payment of sickness, accident, hospitalization, and medical expenses for retired employees, their spouses, and their dependents. The term ‘‘medical benefits described in section 401(h)’’ is used in this section to describe such payments.

(b) *In general*—(1) *Coverage.* Under section 401(h), a qualified pension or annuity plan may provide for the payment of medical benefits described in section 401(h) only for retired employees, their spouses, or their dependents. To be ‘‘retired’’ for purposes of eligibility to receive medical benefits described in section 401(h), an employee must be eligible to receive retirement benefits provided under the pension plan, or else be retired by an employer providing such medical benefits by reason of permanent disability. For purposes of the preceding sentence, an employee is not considered to be eligible to receive retirement benefits provided under the plan if he is still employed by the employer and a separation from employment is a condition to receiving the retirement benefits.

(2) *Discrimination.* A plan which provides medical benefits described in section 401(h) must not discriminate in favor of officers, shareholders, supervisory employees, or highly compensated employees with respect to coverage and with respect to the contributions or benefits under the plan. The determination of whether such a plan so discriminates is made with reference to the retirement portion of the plan as well as the portion providing the medical benefits described in section 401(h). Thus, for example, a plan will not be qualified under section 401 if it discriminates in favor of employees who are officers or shareholders with respect to either portion of the plan.

(3) *Funding medical benefits.* Contributions to provide the medical benefits described in section 401(h) may be made either on a contributory or noncontributory basis, without regard to whether the contributions to fund the retirement benefits are made on a similar basis. Thus, for example, the contributions to fund the medical benefits described in section 401(h) may be provided for entirely out of employer contributions even though the retirement benefits under the plan are determined on the basis of both employer and employee contributions.

(4) *Definitions.* For purposes of section 401(h) and this section:

(i) The term *dependent* shall have the same meaning as that assigned to it by section 152, and

(ii) The term *medical expense* means expenses for medical care as defined in section 213(e)(1).

(c) *Requirements.* The requirements which must be met for a qualified pension or annuity plan to provide medical benefits described in section 401(h) are set forth in subparagraphs (1) through (5) of this paragraph.

(1) *Benefits.* (i) The plan must specify the medical benefits described in section 401(h) which will be available and must contain provisions for determining the amount which will be paid. Such benefits, when added to any life insurance protection provided for under the plan, must be subordinate to the retirement benefits provided by such plan. For purposes of this section, life insurance protection includes any benefit paid under the plan on behalf of an employee-participant as a result of the employee-participant's death to the extent such payment exceeds the amount of the reserve to provide the retirement benefits for the employee-participant existing at his death. The medical benefits described in section 401(h) are considered subordinate to the retirement benefits if at all times the aggregate of contributions (made after the date on which the plan first includes such medical benefits) to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions (made after such date) other than contributions to fund past service credits.

(ii) The meaning of the term *subordinate* may be illustrated by the following example:

Example. The X Corporation amends its qualified pension plan to provide medical benefits described in section 401(h) effective for the taxable year 1964. The total contributions under the plan (excluding those for past service credits) for the taxable year 1964 are $125,000, allocated as follows: $100,000 for retirement benefits, $10,000 for life insurance protection, and $15,000 for medical benefits described in section 401(h). The medical benefits described in section 401(h) are considered subordinate to the retirement benefits since the portion of the contributions allocated to the medical benefits described in section 401(h) ($15,000) and to life insurance protection after such medical benefits were included in the plan ($10,000), or $25,000, does not exceed 25 percent of $125,000. For the taxable year 1965, the X Corporation contributes $140,000 (exclusive of contributions for past service credits) allocated as follows: $100,000 for retirement benefits, $10,000 for life insurance protection, and $30,000 for medical benefits described in section 401(h). The medical benefits described in section 401(h) are considered subordinate to the retirement benefits since the aggregate contributions allocated to the medical benefits described in section 401(h) ($45,000) and to life insurance protection after such medical benefits were included in the plan ($20,000) or $65,000 does not exceed 25 percent of $265,000, the aggregate of the contributions made in 1964 and 1965.

(2) *Separate accounts.* Where medical benefits described in section 401(h) are provided for under a qualified pension or annuity plan, a separate account must be maintained with respect to contributions to fund such benefits. The separation required by this section

is for recordkeeping purposes only. Consequently, the funds in the medical benefits account need not be separately invested. They may be invested with funds set aside for retirement purposes without identification of which investment properties are allocable to each account. However, where the investment properties are not allocated to each account, the earnings on such properties must be allocated to each account in a reasonable manner.

(3) *Reasonable and ascertainable.* Section 401(h) further requires that amounts contributed to fund medical benefits therein described must be reasonable and ascertainable. For the rules relating to the deduction of such contributions, see paragraph (f) of § 1.404(a)–3. The employer must, at the time he makes a contribution, designate that portion of such contribution allocable to the funding of medical benefits.

(4) *Impossibility of diversion prior to satisfaction of all liabilities.* Section 401(h) further requires that it must be impossible, at any time prior to the satisfaction of all liabilities under the plan to provide for the payment of medical benefits described in section 401(h), for any part of the corpus or income of the medical benefits account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits. Consequently, a plan which, for example, under its terms, permits funds in the medical benefits account to be used for any retirement benefit provided under the plan does not satisfy the requirements of section 401(h) and will not qualify under section 401(a). However, the payment of any necessary or appropriate expenses attributable to the administration of the medical benefits account does not affect the qualification of the plan.

(5) *Reversion upon satisfaction of all liabilities.* The plan must provide that any amounts which are contributed to fund medical benefits described in section 401(h) and which remain in the medical benefits account upon the satisfaction of all liabilities arising out of the operation of the medical benefits portion of the plan are to be returned to the employer.

(6) *Forfeitures.* The plan must expressly provide that in the event an individual's interest in the medical benefits account is forfeited prior to termination of the plan an amount equal to the amount of the forfeiture must be applied as soon as possible to reduce employer contributions to fund the medical benefits described in section 401(h).

(d) *Effective date.* This section applies to taxable years of a qualified pension or annuity plan beginning after October 23, 1962.

[T.D. 6722, 29 FR 5072, Apr. 14, 1964]

§ 1.401(a)–1 Post-ERISA qualified plans and qualified trusts; In general.

(a) *Introduction*—(1) *In general.* This section and the following regulation sections under section 401 reflect the provisions of section 401 after amendment by the Employee Retirement Income Security Act of 1974 (Pub. L. 93–406) (''ERISA'').

(2) [Reserved]

(b) *Requirements for pension plans*—(1) *Definitely determinable benefits.* (i) In order for a pension plan to be a qualified plan under section 401(a), the plan must be established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement.

(ii) Section 1.401–1(b)(1)(i), a pre-ERISA regulation, provides rules applicable to this requirement, and that regulation is applicable except as otherwise provided.

(iii) The use of the type of plan provision described in § 1.415–1(d)(1) which automatically freezes or reduces the rate of benefit accrual or the annual addition to insure that the limitations of section 415 will not be exceeded, will not be considered to violate the requirements of this subparagraph provided that the operation of such provision precludes discretion by the employer.

[T.D. 7748, 46 FR 1695, Jan. 7, 1981]

§ 1.401(a)–2 Impossibility of diversion under qualified plan or trust.

(a) *General rule.* Section 401(a)(2) requires that in order for a trust to be qualified, it must be impossible under the trust instrument (in the taxable year and at any time thereafter before the satisfaction of all liabilities to employees or their beneficiaries covered by the trust) for any part of the trust corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of those employees or their beneficiaries. Section 1.401–2, a pre-ERISA regulation, provides rules under section 401(a)(2) and that regulation is applicable except as otherwise provided.

(b) *Section 415 suspense account.* Paragraph (a) of this section does not apply to amounts properly allocated to a suspense account pursuant to §1.415–6(b)(6). The plan, or the trust forming part of the plan, may provide for the reversion to the employer, upon termination of the plan, of amounts held in the suspense account.

[T.D. 7748, 46 FR 1696, Jan. 7, 1981]

§1.401(a)–4 Optional forms of benefit (before 1994).

Q–1: How does section 401(a)(4) apply to optional forms of benefits?

A–1: (a) *In general*—(1) *Scope.* The nondiscrimination requirements of section 401(a)(4) apply to the amount of contributions or benefits, optional forms of benefit, and other benefits, rights and features (e.g., actuarial assumptions, methods of benefit calculation, loans, social security supplements, and disability benefits) under a plan. This section addresses the application of section 401(a)(4) only to optional forms of benefit under a plan. Generally, the determination of whether an optional form is nondiscriminatory under section 401(a)(4) is made by reference to the availability of such optional form, and not by reference to the utilization or actual receipt of such optional form. See Q&A–2 of this section. Even though an optional form of benefit under a plan may be nondiscriminatory under section 401(a)(4) and this §1.401(a)–4 because the availability of such optional form does not impermissibly favor employees in the highly compensated group, such plan may fail to satisfy section 401(a)(4) with respect to the amount of contributions or benefits or with respect to other benefits, rights and features if, for example, the method of calculation or the amount or value of benefits payable under such optional form impermissibly favors the highly compensated group. See §1.411(d)–4, Q&A–1 for the definition of ‘‘optional form of benefit.’’

(2) *Nondiscrimination requirements.* Each optional form of benefit provided under a plan is subject to the nondiscrimination requirement of section 401(a)(4) and thus the availability of each optional form of benefit must not discriminate in favor of the employees described in section 401(a)(4) in whose favor discrimination is prohibited (the ‘‘highly compensated group’’). See paragraph (b) of this Q&A–1 for a description of the employees included in such group. This is true without regard to whether a particular optional form of benefit is the actuarial equivalent of any other optional form of benefit under the plan. Thus, for example, a plan may not condition, or otherwise limit, the availability of a single sum distribution of an employee's benefit in a manner that impermissibly favors the highly compensated group.

(b) *Highly compensated group.* For plan years commencing prior to the applicable effective date for the amendment made to section 401(a)(4) by section 1114 of the Tax Reform Act of 1986 (TRA '86), the highly compensated group consists of those employees who are officers, shareholders, or highly compensated. For plan years beginning on or after the applicable effective date of the amendments to section 401(a)(4) made by TRA '86, the highly compensated group consists of those employees who are highly compensated within the meaning of section 414(q). The amendment to section 401(a)(4) made by section 1114 of TRA '86 is generally effective for plan years commencing after December 31, 1988. See section 1114(a) of TRA '86.

Q–2: How is it determined whether an optional form of benefit satisfies the nondiscrimination requirements of section 401(a)(4)?

A–2: (a) *Nondiscrimination requirement.*—(1) *In general.* An optional form of benefit under a plan is nondiscriminatory under section 401(a)(4) only if the requirements of paragraphs (a)(2) and (a)(3) of this Q&A–2 are satisfied with respect to such optional form. The determination of whether an optional form of benefit satisfies these requirements is made by reference to the availability of the optional form, and not by reference to the utilization or actual receipt of such optional form. Thus, an optional form of benefit that satisfies the requirements of paragraphs (a)(2) and (a)(3) of this Q&A–2 is nondiscriminatory under section 401(a)(2) even though the highly compensated group disproportionately utilizes such optional form. However, the composition of the group of employees who actually receive benefits in an optional form may be relevant in determining whether such optional form satisfies the requirement of paragraph (a)(3) of this Q&A–2 with respect to effective availability.

(2) *Current availability*—(i) *Plan years prior to TRA '86 effective date.* Except as provided in paragraph (a)(2)(iii) of this Q&A–2, for plan years prior to the effective date of the amendments made to section 401(b) by section 1112(a) of TRA '86, the requirement of this paragraph (a)(2) is satisfied only if the group of employees to whom the optional form is currently available satisfies either the seventy percent test of section 410(b)(1)(A) or the nondiscriminatory classification test of section 410(b)(1)(B).

(ii) *Plan years commencing on or after TRA '86 effective date.* Except as provided in paragraph (a)(2)(iii) of this Q&A–2, for plan years commencing on or after the effective date on which the amendments made to section 410(b) by section 1112(a) of TRA '86 first apply to a plan, the requirement of this paragraph (a)(2) is satisfied only if the group of employees to whom the optional form is currently available satisfies either the percentage test set forth in section 410(b)(1)(A), the ratio test set forth in section 410(b)(1)(B), or the nondiscriminatory classification test set forth in section 410(b)(2)(A)(i). The employer need not satisfy the average benefit percentage test in section 410(b)(2)(A)(ii) in order for the optional form to be currently available to a nondiscriminatory group of employees.

(iii) *Special rule for certain governmental or church plans.* Plans described in section 410(c) will be treated as satisfying the current availability test of this paragraph (a)(2) if the group of employees with respect to whom the optional form is currently available satisfies the requirements of section 401(a)(3) as in effect on September 1, 1974.

(iv) *Effective data for TRA '86 amendments to section 410(b).* The amendments to section 410(b) made by section 1112(a) of TRA '86 are generally effective for plan years commencing after December 31, 1988. See section 1112(e)(1) of TRA '86.

(v) *Elimination of optional forms*—(A) *In general.* Notwithstanding paragraphs (a)(2)(i) and (a)(2)(ii) of this Q&A–2, in the case of an optional form of benefit that has been eliminated under a plan with respect to specified employees for benefits accrued after the later of the eliminating amendment's adoption date or effective date, the determination of whether such optional form satisfies this paragraph (a)(2) with respect to such employees is to be made immediately prior to the elimination. Accordingly, if, as of the later of the adoption date or effective date of an amendment eliminating an optional form with respect to future benefit accruals, the current availability of such optional form immediately prior to such amendment satisfies this paragraph (a)(2), then the optional form will be treated as satisfying this paragraph (a)(2) for all subsequent years.

(B) *Example.* A profit-sharing plan that provides for a single sum distribution available to all employees on termination of employment is amended January 1, 1990, to eliminate such single sum optional form of benefit with respect to benefits accrued after January 1, 1991. As of January 1, 1991, the single sum optional form of benefit is available to a group of employees that satisfies the percentage test of section 410(b)(1)(A). As of January 1, 1995, all nonhighly compensated employees who were entitled to the single sum optional form of benefit have terminated from employment with the employer and taken a distribution of their benefits. The only remaining employees who have a right to take a portion of their benefits in the form of a single sum distribution on termination of employment are highly compensated employees. Because the availability of the single sum optional form of benefit satisfied the current availability test as of January 1, 1991, the availability of such optional form of benefit is deemed to continue to satisfy the current availability test of this paragraph (a)(2).

(3) *Effective availability*—(i) *In general.* The requirement of this paragraph (a)(3) is satisfied only if, based on the facts and circumstances, the group of employees to whom the optional form is effectively available does not substantially favor the highly compensated group. This is the case even if the optional form is, or has been, currently available to a group of employees that satisfies the applicable requirements in paragraph (a)(2) (i) or (ii) of this Q&A–2.

(ii) *Examples.* The provisions of paragraph (a)(3)(i) of this Q&A–2 can be illustrated by the following examples:

Example 1. Employer X maintains a defined benefit plan that covers both of the 2 highly compensated employees of the employer and 8 of the twelve nonhighly compensated employees of the employer. Plan X provides for a normal retirement benefit payable as an annuity and based on a normal retirement age of 65, and an early retirement benefit payable upon termination in the form of an annuity to employees who terminate from service with the employer on or after age 55 with 30 or more years of service. Each of the 2 employees of employer X who are in the highly compensated group currently meet the age and service requirement, or will have 30 years of service by the time they reach age 55. All but 2 of the 8 nonhighly compensated employees of employer X who are covered by the plan were hired on or after age 35 and thus, cannot qualify for the early retirement benefit provision. Even though the group of employees to whom the early retirement benefit is currently available does not impermissibly favor the highly compensated group by reason of disregarding age and service, these facts and circumstances indicate that the effective availability of the early retirement benefit in plan X substantially favors the highly compensated group.

Example 2. Assume the same facts as in *Example 1* except that the early retirement benefit is added by a plan amendment first adopted, announced and effective December 1, 1991, and is available only to employees who terminate from employment with the employer prior to December 15, 1991. Further assume that all employees were hired prior to attaining age 25, and that the group of employees who have, or will have attained age 55 with 30 years of service, by December 15, 1991, satisfies the ratio test of section 410(b)(1)(B). Finally, assume that the only employees who terminate from employment with the employer during the two week period in which the early retirement benefit is available are employees in the highly compensated group. These facts and circumstances indicate that the effective availability of the early retirement benefit substantially favors the highly compensated group. This is the case even though the limitation of the early retirement benefit to a specified period satisfies section 411(d)(6).

Example 3. Employer Y amends plan Y on June 30, 1990, to provide for a single sum distribution for employees who terminate from employment with the employer after June 30, 1990, and prior to January 1, 1991. The availability of this single sum distribution is conditioned on the employee having a particular disability at the time of termination of employment. The only employee of the employer who meets this disability requirement at the time of the amendment and thereafter through December 31, 1990, is a highly compensated employee. Generally, a disability condition with respect to the availability of a single sum distribution may be disregarded in determining whether the current availability of such optional form of benefit is discriminatory. However, these facts and circumstances indicate that the effective availability of the optional form of benefit substantially favors the highly compensated group.

Example 4. Employer Z maintains a money purchase pension plan that covers all employees of the employer. The plan provides for distribution in the form of a joint and survivor annuity, a life annuity, or equal installments over 10 years. During the 1992 calendar year the employer winds up his business. In December of 1992, only two employees remain in the employment of the employer, both of whom are highly compensated. Employer Z then amends the plan to provide for a single sum distribution to employees who terminate from employment on or after the date of the amendment. Both highly compensated employees terminate from employment on December 31, 1992, taking a single sum distribution of their benefits. These facts and circumstances indicate that the effective availability of the single sum optional form of benefit substantially favors the highly compensated group.

(b) *Application of tests*—(1) *Current availability*—(i) *In general.* Except as otherwise provided in this paragraph (b), in determining whether an optional form of benefit that is subject to specified eligibility conditions is currently available to an employee for purposes of paragraph (a) of this Q&A–2, the determination of current availability generally is to be based on the current facts and circumstances with respect to the employee (e.g., the employee's current compensation or the employee's current net worth). Thus, for example, the fact that an employee may, in the future, satisfy an eligibility condition generally does not cause an optional form of benefit to be treated as currently available to such employee.

(ii) *Exceptions for age, service, employment termination and certain other conditions*—(A) *Age and service conditions.* For purposes of applying paragraph (a)(2) of this Q&A–2, except as provided in paragraph (b)(1)(ii)(B) of this Q&A–2, an age condition, a service condition, or both are to be disregarded. For example, an employer that maintains a plan that provides for an early retirement benefit payable as an annuity for employees in division A, subject to a requirement that the employee has attained his or her 55th birthday and has at least twenty years of service with the employer, is to disregard the age and service conditions in determining the group of employees to whom the early retirement annuity benefit is currently available. Thus, the early retirement annuity benefit is treated as currently available to all employees of division A, without regard to their ages or years of service and without regard to whether they could potentially meet the age and service conditions prior to attaining the plan's normal retirement age.

(B) *Exception for certain age and service conditions.* Age and service conditions that must be satisfied within a specified period of time may not be disregarded pursuant to paragraph (b)(1)(ii)(A) of this Q&A–2. However, in determining the current availability of an optional form of benefit subject to such an age condition, service condition, or both, an employer may project the age and service of employees to the last date on which the optional form of benefit subject to the age condition or service condition (or both) is available under the plan. An employer's ability to protect age and service to the last date on which the optional form of benefit is available under the plan is not cut off by a plan termination occurring prior to that date. Thus, for example, assume that an employer maintaining a plan that permits employees terminating from employment on or after age 55 between June 1, 1991 to May 31, 1992, to elect a single sum distribution, decides to terminate the plan on December 31, 1991. In determining the group of employees to whom the single sum optional form of benefit is currently available, this employer may project employees' ages through May 31, 1992.

(C) *Certain other conditions disregarded.* Conditions on the availability of optional forms of benefit requiring termination of employment, death, satisfaction of a specified health condition (or failure to meet such condition), disability, hardship, marital status, default on a plan loan secured by a participant's account balance, or execution of a covenant not to compete may be disregarded in determining the group of employees to whom an optional form of benefit is currently available.

(2) *Employees taken into account.* For purposes of applying paragraph (a) of this Q&A–2, the tests are to be applied on the basis of the employer's nonexcludable employees (whether or not they are participants in the plan) in the same manner as such tests would be applied in determining whether the plan providing the optional form of benefit satisfies the tests under section 410(b).

(3) *Definition of ''plan''.* For purposes of applying paragraph (a) of this Q&A–2, the term ''plan'' has the meaning that such term has for purposes of determining whether the amount of contributions or benefits and whether other benefits, rights, and features are nondiscriminatory under section 401(a)(4).

(4) *Restructuring optional forms of benefit*—(i) *In general.* For purposes of applying paragraph (a) of this Q&A–2, the availability of two or more optional forms of benefit under a plan may be tested by restructuring such benefits into two or more restructured optional forms of benefit and testing the availability of such restructured optional forms of benefit. If two or more optional forms of benefit under a plan contain both common and distinct components, such optional forms of benefit may be restructured as a single optional form of benefit comprising the common component, and one or more optional forms of benefit comprising

each distinct component. Components of optional forms of benefit may be treated as common only if they are identical with respect to all characteristics taken into account under Q&A–1(b) of §1.411(d)–4. The availability of each restructured optional form of benefit must satisfy the applicable nondiscrimination requirements of paragraph (a) of this Q&A–2.

(ii) *Example.* A profit-sharing plan covering all the employees of an employer provides a single sum distribution option upon termination from employment for all employees earning less than $50,000 and a single sum distribution option upon termination from employment after the attainment of age 55 for all employees earning $50,000 or more. These distribution options are identical in all other respects. For purposes of applying section 401(a)(4), such optional forms of benefit may be restructured into two different optional forms of benefit: (A) a single sum distribution option upon termination from employment after the attainment of age 55 for all employees (i.e., the common component), and (B) a single sum distribution option upon termination from employment before the attainment of age 55 for all employees earning less than $50,000. The availability of each of these restructured optional forms of benefit must satisfy section 401(a)(4).

(c) *Commissioner may provide additional tests.* The Commissioner may provide such additional factors, tests, and safe harbors as are necessary or appropriate for purposes of determining whether the availability of an optional form of benefit is discriminatory under section 401(a)(4). In addition, the Commissioner may provide that additional eligibility conditions not related directly or indirectly to compensation or wealth may be disregarded under paragraph (b)(1)(ii)(C) of this Q&A–2 in determining the current availability of an optional form of benefit. The Commissioner may provide such additional guidance only through the publication of revenue rulings, notices or other documents of general applicability.

Q–3: May a plan condition the availability of an optional form of benefit on employer discretion?

A–3: No. Even if the availability of an optional form of benefit that is conditioned on employer discretion satisfies the nondiscrimination requirements of section 401(a)(4), the plan providing the optional form of benefit will fail to satisfy certain other requirements of section 401(a), including, in applicable circumstances, the definitely determinable requirement of section 401(a) and the requirements of section 401(a)(25) and section 411(d)(6). See §1.411(d)–4.

Q–4: Will a plan provision violate section 401(a)(4) merely because it requires that an employee who terminates from service with the employer receive a single sum distribution in the event that the present value of the employee's benefit is not more than $3,500, as permitted by sections 411(a)(11) and 417(e)?

A–4: No. A plan will not be treated as discriminatory under section 401(a)(4) merely because the plan mandates a single sum distribution when the present value of an employee's benefit is not more than $3,500, as permitted by sections 411(a)(11) and 417(e). This is an exception to the general principles of this section. (No similar provision exists excepting such single sum distributions from the limits on employer discretion under section 411(d)(6). See §1.411(d)–4 Q&A–4.)

Q–5: If the availability of an optional form of benefit discriminates, or may reasonably be expected to discriminate, in favor of the highly compensated group, what acceptable alternatives exist for amending the plan without violating section 411(d)(6)?

A–5: (a) *Transitional rules*—(1) *In general.* The following rules apply for purposes of making necessary amendments to existing plans (as defined in Q&A–6 of this section) under which the availability of an optional form of benefit violates the nondiscrimination requirements of section 401(a)(4) or may reasonably be expected to violate such requirements. These transitional rules are provided under the authority of section 411(d)(6), which allows the elimination of certain optional forms of benefit if permitted by regulations, and section 7805(b).

(2) *Nondiscrimination*—(i) *In general.* The determination of whether the availability of an optional form of benefit violates section 401(a)(4) is to be made in accordance with Q&A–2 of this section. In addition, the availability of a particular optional form of benefit may reasonably be expected to violate the nondiscrimination requirements of

section 401(a)(4) if, under the applicable facts and circumstances, there is a significant possibility that the current availability of such optional form of benefit will impermissibly favor the highly compensated group. This determination must be made on the basis of the seventy percent test of section 410(b)(1)(A) or the nondiscriminatory classification test of section 410(b)(1)(B) as such tests existed prior to the effective date of the amendments made to section 410(b) by section 1112(a) of TRA '86. Thus, a condition may not reasonably be expected to discriminate for purposes of these rules merely because it results in a significant possibility that discrimination will result because of the amendments made to section 410(b) by section 1112(a) of TRA '86. In addition, the availability of an optional form of benefit may not reasonably be expected to discriminate merely because of an age or service condition that may be disregarded in determining the current availability of such optional form of benefit under paragraph (b)(1)(ii)(A) of Q&A–2 of this section. Similarly, the availability of an optional form of benefit may not reasonably be expected to discriminate merely because of an age or service condition that, after permitted projection, does not cause such optional form to fail to satisfy the requirement of this paragraph (a)(2).

(ii) *Examples.* The provisions of paragraph (a)(2)(i) of this Q&A–5 can be illustrated by the following examples:

Example (1). A plan provides that a single sum distribution option is available only to (A) employees earning $50,000 or more in the final year of employment, (B) employees who furnish evidence that they have a net worth above a certain specified amount, and (C) employees who present a letter from an accountant or attorney declaring that it is in the employee's best interest to receive a single sum distribution. Whether the availability of such optional form of benefit discriminates depends on whether it meets the requirements of Q&A–2 of this §1.401(a)–4. However, each of the specified conditions limiting the availability of the optional form of benefit may reasonably be expected to discriminate in favor of the highly compensated group in operation because of the likelihood of a significant positive correlation between the ability to meet any of the specified conditions and membership in the highly compensated group.

Example (2). A plan limits the availability of a single sum distribution option to employees employed in one particular division of the employer's company. All the employees of the company are participants in the plan. During the 1988 plan year, the division employs individuals who represent a nondiscriminatory classification of that company's employees (under section 410(b)(1)(B) prior to the effective date of the amendments made to section 410(b) by section 1112(a) of TRA '86) and is unlikely to cease employing such a nondiscriminatory classification in the future. The availability of a single sum distribution under this plan does not result in discrimination during the 1988 plan year and may not reasonably be expected to do so.

(b) *Transitional alternatives.* If the availability of an optional form of benefit under an existing plan is discriminatory under section 401(a)(4), the plan must be amended either to eliminate the optional form of benefit or to make the availability of the optional form of benefit nondiscriminatory. For example, the availability of an optional form of benefit may be made nondiscriminatory by making such benefit available to sufficient additional employees who are not in the highly compensated group or by imposing nondiscriminatory objective criteria on its availability such that the group of employees to whom the benefit is available is nondiscriminatory. See Q&A–6 of §1.411(d)–4 for requirements with respect to such objective criteria. If, under an exisitng plan, the availability of an optional form of benefit may reasonably be expected to discriminate, the plan may be amended in the same manner permitted where the availability of an optional form of benefit is discriminatory. See paragraph (d) of this Q&A–5 for rules limiting the period during which the availability of optional forms of benefit may be eliminated or reduced under this paragraph.

(c) *Compliance and amendment date provisions*—(1) *Operational compliance requirement.* On or before the applicable effective date for the plan (see Q&A–6 of this section), the plan sponsor must select one of the alternatives permitted under paragraph (b) of this Q&A–5 with respect to each affected optional form of benefit and the plan must be operated in accordance with this selection. This is an operational requirement and does not require a plan amendment prior to the period set forth in paragraph (c)(2) of this Q&A–5. There is no special reporting requirement under the Code or this section with respect to this selection.

(2) *Deferred amendment date.* If paragraph (c)(1) of this Q&A–5 is satisfied, a plan amendment conforming the plan to the particular alternative selected under paragraph (b) of this Q&A–5 must be adopted within the time period permitted for amending plans in order to meet the requirements of section 410(b) as amended by TRA '86. Such conforming amendment must be consistent with the sponsor's selection as reflected by plan practice during the period from the effective date to the date the amendment is adopted. Thus, for example, if an existing calendar year noncollectively bargained defined benefit plan has a single sum distribution form subject to a discriminatory condition, that was available as of January 30, 1986 (subject to such condition), and such employer makes one or more single sum distributions available on or after the first day of the first plan year commencing on or after January 1, 1989, and before the plan amendment, then such employer may not adopt a plan amendment eliminating the single sum distribution form. Instead, such employer must adopt an amendment making the distribution form available to a nondiscriminatory group of employees while retaining the availability of such distribution form with respect to the group of employees to whom the benefit is already available. Similarly, any objective criteria that are adopted as part of such amendment must be consistent with the plan practice for the applicable period prior to the amendment. A conforming amendment under this paragraph (c)(2) must be made with respect to each optional form of benefit for which such amendment is required and must be retroactive to the applicable effective date.

(d) *Limitation on transitional alternatives.* The transitional alternatives permitting the elimination or reduction of optional forms of benefit will not violate section 411(d)(6) during the period prior to the applicable effective date for the plan (see Q&A–6 of this section). After the applicable effective date, any amendment (other than one described in paragraph (c)(2) of this Q&A–5) that eliminates or reduces an optional form of benefit or imposes new objective criteria restricting the availability of such optional form of benefit will fail to qualify for the exception to section 411(d)(6) provided in this Q&A–5. This is the case without regard to whether the availability of the optional form of benefit is discriminatory or may reasonably be expected to be discriminatory.

Q–6: For what period are the rules of this section effective?

A–6: (a) *General effective date*—(1) *In general.* Except as otherwise provided in this section, the provisions of this section are effective January 30, 1986, and do not apply to plan years beginning on or after January 1, 1994. For rules applicable to plan years beginning on or after January 1, 1994, see §§1.401(a)(4)–1 through 1.401(a)(4)–13.

(2) *Plans of tax-exempt organizations.* In the case of plans maintained by organizations exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), except as otherwise provided in this section, the provisions of this section are effective January 30, 1986, and do not apply to plan years beginning on or after January 1, 1996. For rules applicable to plan years beginning on or after January 1, 1996, see §§1.401(a)(4)–1 through 1.401(a)(4)–13.

(b) *New plans*—(1) *In general.* Unless otherwise provided in paragraph (b)(2) of this Q&A–6, plans that are either adopted or made effective on or after January 30, 1986, are ‘‘new plans’’. With respect to such new plans, this section is effective January 30, 1986. This effective date is applicable to such plans whether or not they are collectively bargained.

(2) *Exception with respect to certain new plans.* Plans that are new plans as defined in paragraph (b)(1) of this Q&A–6, under which the availability of an optional form of benefit is discriminatory or may reasonably be expected to be discriminatory, and that receive a favorable determination letter that covered such plan provisions with respect to an application submitted prior to July 11, 1988, will be treated as existing plans with respect to such optional

form of benefit for purposes of the transitional rules of this section. Thus, such plans are eligible for the compliance and amendment alternatives set forth in the transitional rule in Q&A–5 of this section.

(c) *Existing plans*—(1) *In general.* Plans that are both adopted and in effect prior to January 30, 1986, are ‘‘existing plans’’. In addition, new plans described in paragraph (b)(2) of this Q&A–6 are treated as existing plans with respect to certain forms of benefit. Subject to the limitations in paragraph (d) of this Q&A–6, the effective dates set forth in paragraphs (c)(2) and (c)(3) of this Q&A–6 apply to these existing plans for purposes of this section.

(2) *Existing noncollectively bargained plans.* With respect to existing noncollectively bargained plans, this section is effective for the first day of the first plan year commencing on or after January 1, 1989.

(3) *Existing collectively bargained plans.* With respect to existing collectively bargained plans, this section is effective for the later of the first day of the first plan year commencing on or after January 1, 1989, or the first day of the first plan year that the requirements of section 410(b) as amended by TRA ’86 apply to such plan.

(d) *Delayed effective dates not applicable to new optional forms of benefit or conditions*—(1) *In general.* The delayed effective dates in paragraph (c) (2) and (3) of this Q&A–6 for existing plans are applicable with respect to an optional form of benefit only if both the optional form of benefit and any applicable condition either causing the availability of such optional form of benefit to be discriminatory or making it reasonable to expect that the availability of such optional form will be discriminatory were both adopted and in effect prior to January 30, 1986. If the preceding sentence is not satisfied with respect to an optional form of benefit, this section is effective with respect to such optional form of benefit as if the plan were a new plan.

(2) *Exception for certain amendments covered by a favorable determination letter.* If a condition causing the availability of an optional form of benefit to be discriminatory, or to be reasonably expected to discriminate, was adopted or made effective on or after January 30, 1986, and a favorable determination letter that covered such plan provision is or was received with respect to an application submitted before July 11, 1988, the effective date of this section with respect to such provision is the applicable effective date determined under the rules with respect to existing plans, as though such provision had been adopted and in effect prior to January 30, 1986.

(e) *Transitional rule effective date.* The transitional rule provided in Q&A–5 of this section is effective January 30, 1986.

[53 FR 26054, July 11, 1988, as amended by T.D. 8360, 56 FR 47536, Sept. 19, 1991; T.D. 8485, 58 FR 46778, Sept. 3, 1993; T.D. 8212, 61 FR 14247, Apr. 1, 1996]

§ 1.401(a)–11 Qualified joint and survivor annuities.

(a) *General rule*—(1) *Required provisions.* A trust, to which section 411 (relating to minimum vesting standards) applies without regard to section 411(e)(2), which is a part of a plan providing for the payment of benefits in any form of a life annuity (as defined in paragraph (b)(1) of this section), shall not constitute a qualified trust under section 401(a)(11) and this section unless such plan provides that:

(i) Unless the election provided in paragraph (c)(1) of this section has been made, life annuity benefits will be paid in a form having the effect of a qualified joint and survivor annuity (as defined in paragraph (b)(2) of this section) with respect to any participant who—

(A) Begins to receive payments under such plan on or after the date the normal retirement age is attained, or

(B) Dies (on or after the date the normal retirement age is attained) while in active service of the employer maintaining the plan, or

(C) In the case of a plan which provides for the payment of benefits before the normal retirement age, begins to receive payments under such plan on or after the date the qualified early retirement age (as defined in paragraph (b)(4) of this section) is attained, or

(D) Separates from service on or after the date the normal retirement age (or the qualified early retirement age) is attained and after satisfaction of eligibility requirements for the payment of benefits under the plan (except for any plan requirement that there be filed a claim for benefits) and thereafter dies before beginning to receive life annuity benefits;

(ii) Any participant may elect, as provided in paragraph (c)(1) of this section, not to receive life annuity benefits in the form of a qualified joint and survivor annuity; and

(iii) If the plan provides for the payment of benefits before the normal retirement age, any participant may elect, as provided in paragraph (c)(2) of this section, that life annuity benefits be payable as an early survivor annuity (as defined in paragraph (b)(3) of this section) upon his death in the event that he—

(A) Attains the qualified early retirement age (as defined in paragraph (b)(4) of this section), and

(B) Dies on or before the day normal retirement age is attained while employed by an employer maintaining the plan.

(2) *Certain cash-outs.* A plan will not fail to satisfy the requirements of section 401(a)(11) and this section merely because it provides that if the present value of the entire nonforfeitable benefit derived from employer contributions of a participant at the time of his separation from service does not exceed $1,750 (or such smaller amount as the plan may specify), such benefit will be paid to him in a lump sum.

(3) *Illustrations.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). The X Corporation Defined Contribution Plan was established in 1960. As in effect on January 1, 1974, the plan provided that, upon the participant's retirement, the participant may elect to receive the balance of his account in the form of (1) a single-sum cash payment, (2) a single-sum distribution consisting of X Corporation stock, (3) five equal annual cash payments, (4) a life annuity, or (5) a combination of options (1) through (4). The plan also provided that, if a participant did not elect another form of distribution, the balance of his account would be distributed to him in the form of a single-sum cash payment upon his retirement. Assume that section 401(a)(11) and this section became applicable to the plan as of its plan year beginning January 1, 1976, with respect to persons who were active participants in the plan as of such date (see paragraph (f) of this section). If X Corporation Defined Contribution Plan continues to allow the life annuity payment option after December 31, 1975, it must be amended to provide that if a participant elects a life annuity option the life annuity benefit will be paid in a form having the effect of a qualified joint and survivor annuity, except to the extent that the participant elects another form of benefit payment. However, the plan can continue to provide that, if no election is made, the balance will be paid as a single-sum cash payment. If the trust is not so amended, it will fail to qualify under section 401(a).

Example (2). The Corporation Retirement Plan provides that plan benefits are payable only in the form of a life annuity and also provides that a participant may retire before the normal retirement age of 65 and receive a benefit if he has completed 30 years of service. Under this plan, an employee who begins employment at the age of 18 will be eligible to receive retirement benefits at the age of 48 if he then has 30 years of service. This plan must allow a participant to elect in the time and manner prescribed in paragraph (c)(2) of this section an early survivor annuity (defined in paragraph (b)(3) of this section) to be payable on the death of the participant if death occurs while the participant is in active service for the employer maintaining the plan and on or after the date the participant reaches the qualified early retirement age of 55 (the later of the date the participant reaches the earliest retirement age (age 48) or 10 years before normal retirement age (age 55)) but before the day after the day the participant reaches normal retirement age (age 65).

Example (3). Assume the same facts as in Example (2). A, B, and C began employment with Y Corporation when they each attained age 18. A retires and begins to receive benefit payments at age 48 after completing 30 years of service. The plan is not required to pay a qualified joint and survivor annuity to A and his spouse at any time. B does not elect an early survivor annuity at age 55, but retires at age 57 after completing 39 years of service. Unless B makes an election under subparagraph (1)(ii) of this paragraph, the plan is required to pay a qualified joint and survivor annuity to B and his spouse. C makes no elections described in subparagraph (1) of this paragraph, and dies while in active service at age 66 after completing 48 years of service. The plan is required to pay a qualified survivor annuity to C's spouse.

(b) *Definitions.* As used in this section—(1) *Life annuity.* (i) The term ''life annuity'' means an annuity that provides retirement payments and requires the survival of the participant or his spouse as one of the conditions for any payment or possible payment under the annuity. For example, annuities that make payments for 10 years or until death, whichever occurs first or whichever occurs last, are life annuities.

(ii) However, the term ''life annuity'' does not include an annuity, or that portion of an annuity, that provides those benefits which, under section 411(a)(9), would not be taken into account in the determination of the normal retirement benefit or early retirement benefit. For example, ''social security supplements'' described in the fourth sentence of section 411(a)(9) are not considered to be life annuities for the purposes of this section, whether or not an early retirement benefit is provided under the plan.

(2) *Qualified joint and survivor annuity.* The term ''qualified joint and survivor annuity'' means an annuity for the life of the participant with a survivor annuity for the life of his spouse which is neither (i) less than one-half of, nor (ii) greater than, the amount of the annuity payable during the joint lives of the participant and his spouse. For purposes of the preceding sentence, amounts described in §1.401(a)–11(b)(1)(ii) may be disregarded. A qualified joint and survivor annuity must be at least the actuarial equivalent of the normal form of life annuity or, if greater, of any optional form of life annuity offered under the plan. Equivalence may be determined, on the basis of consistently applied reasonable actuarial factors, for each participant or for all participants or reasonable groupings of participants, if such determination does not result in discrimination in favor of employees who are officers, shareholders, or highly compensated. An annuity is not a qualified joint and survivor annuity if payments to the spouse of a deceased participant are terminated, or reduced, because of such spouse's remarriage.

(3) *Early survivor annuity.* The term ''early survivor annuity'' means an annuity for the life of the participant's spouse the payments under which must not be less than the payments which would have been made to the spouse under the joint and survivor annuity if the participant had made the election described in paragraph (c)(2) of this section immediately prior to his retirement and if his retirement had occurred on the day before his death and within the period during which an election can be made under such paragraph (c)(2). For example, if a participant would be entitled to a single life annuity of $100 per month or a reduced amount under a qualified joint and survivor annuity of $80 per month, his spouse is entitled to a payment of at least $40 per month. However, the payments may be reduced to reflect the number of months of coverage under the survivor annuity pursuant to paragraph (e) of this section.

(4) *Qualified early retirement age.* The term ''qualified early retirement age'' means the latest of—

(i) The earliest date, under the plan, on which the participant could elect (without regard to any requirement that approval of early retirement be obtained) to receive retirement benefits (other than disability benefits).

(ii) The first day of the 120th month beginning before the participant reaches normal retirement age, or

(iii) The date on which the participant begins participation.

(5) *Normal retirement age.* The term ''normal retirement age'' has the meaning set forth in section 411(a)(8).

(6) *Annuity starting date.* The term ''annuity starting date'' means the first day of the first period with respect to which an amount is received as a life annuity, whether by reason of retirement or by reason of disability.

(7) *Day.* The term ''day'' means a calendar day.

(c) *Elections*—(1) *Election not to take joint and survivor annuity form*—(i) *In general.* (A) A plan shall not be treated as satisfying the requirements of this section unless it provides that each participant may elect, during the election period described in subdivision (ii) of this subparagraph, not to receive a qualified joint and survivor annuity. However, if a plan provides that a qualified joint and survivor annuity is the only form of benefit payable under the plan with respect to a married participant, no election need be provided.

(B) The election shall be in writing and clearly indicate that the participant is electing to receive all or, if permitted by the plan, part of his benefits under the plan in a form other than that of a qualified joint and survivor annuity. A plan will not fail to meet the requirements of this section merely because the plan requires the participant to obtain the written approval of his spouse in order for the participant to make this election or if the plan provides that such approval is not required.

(ii) *Election period.* (A) For purposes of the election described in paragraph (c)(1)(i) of this section, the plan shall provide an election period which shall include a period of at least 90 days following the furnishing of all of the applicable information required by subparagraph (3)(i) of this paragraph and ending prior to commencement of benefits. In no event may the election period end earlier than the 90th day before the commencement of benefits. Thus, for example, the commencement of benefits may be delayed until the end of such election period because the amount of payments to be made to a participant cannot be ascertained before the end of such period; see §1.401(a)–14(d).

If a participant makes a request for additional information as provided in subparagraph (3)(iii) of this paragraph on or before the last day of the election period, the election period shall be extended to the extent necessary to include at least the 90 calendar days immediately following the day the requested additional information is personally delivered or mailed to the participant. Notwithstanding the immediately preceding sentence, a plan may provide in cases in which the participant has been furnished by mail or personal delivery all of the applicable information required by subparagraph (3)(i) of this paragraph, that a request for such additional information must be made on or before a date which is not less than 60 days from the date of such mailing or delivery; and if the plan does so provide, the election period shall be extended to the extent necessary to include at least the 60 calendar days following the day the requested additional information is personally delivered or mailed to the participant.

(B) In the case of a participant in a plan to which this subparagraph applies who separated from service after section 401(a)(11) and this section became applicable to such plan with respect to such participant, and to whom an election required by this subparagraph has not been previously made available (and will not become available in normal course), the plan must provide an election to receive the balance of his benefits (properly adjusted, if applicable, for payments received, prior to the exercise of such election, in the form of a qualified joint and survivor annuity) in a form other than that of a qualified joint and survivor annuity. The provisions of paragraph (c)(1)(ii)(A) shall apply except that in no event shall the election period end before the 90th day after the date on which notice of the availability of such election and the applicable information required by subparagraph (3)(i) of this paragraph is given directly to the participant. If such notice and information is given by mail, it shall be treated as given on the date of mailing. If such participant has died, such election shall be made available to such participant's personal representative.

(2) *Election of early survivor annuity*—(i) *In general.* (A) A plan described in subparagraph (a)(1)(iii) of this section shall not be treated as satisfying the requirements of this section unless it provides that each participant may elect, during the period described in subdivision (ii) of this subparagraph, an early survivor annuity as described in paragraph (a)(1)(iii) of this section. Breaks in service after the participant has attained the qualified early retirement age neither invalidate a previous election or revocation nor prevent an election from being made or revoked during the election period.

(B) The election shall be in writing and clearly indicate that the participant is electing the early survivor annuity form.

(C) A plan is not required to provide an election under this subparagraph if—

(*1*) The plan provides that an early survivor annuity is the only form of benefit payable under the plan with respect to a married participant who dies while employed by an employer maintaining the plan,

(*2*) In the case of a defined contribution plan, the plan provides a survivor benefit at least equal in value to the vested portion of the participant's account balance, if the participant dies while in active service with an employer maintaining the plan, or

(*3*) In the case of a defined benefit plan, the plan provides a survivor benefit at least equal in value to the present value of the vested portion of the participant's normal form of the accrued benefit payable at normal retirement age (determined immediately prior to death), if the participant dies while in active service with an employer maintaining the plan. Any present values must be determined in accordance with either the actuarial assumptions or factors specified in the plan, or a variable standard independent of employer discretion for converting optional benefits specified in the plan.

(ii) *Election period.* (A) For purposes of the election described in paragraph (c)(2)(i) of this section the plan shall provide an election period which, except as provided in the following sentence, shall begin not later than the later of either the 90th day before a participant attains the qualified early retirement age or the date on which his participation begins, and shall end on the date the participant terminates his employment. If such a plan contains a provision that any election made under this subparagraph does not become effective or ceases to be effective if the participant dies within a certain period beginning on the date of such election, the election period prescribed in this subdivision (ii) shall begin not later than the later of (*1*) a date which is 90 days plus such certain period before the participant attains the qualified early retirement age or (*2*) the date on which his participation begins. For example, if a plan provides that an election made under this subparagraph does not become effective if the participant dies less than 2 years after the date of such election, the period for making an election under this subparagraph must begin not later than the later of (*1*) 2 years and 90 days before the participant attains the qualified early retirement age, or (*2*) the date on which his participation begins. However, the election period for an individual who was an active participant on the date this section became effective with regard to the plan need not begin earlier than such effective date.

(B) In the case of a participant in a plan to which this subparagraph applies who dies after section 401(a)(11) and this section became applicable to such plan with respect to such participant and to whom an election required by this subparagraph has not been previously made available, the plan must give the participant's surviving spouse or, if dead, such spouse's personal representative the option of electing an early survivor annuity. The plan may reduce the surviving spouse's annuity to take into account any benefits already received. The period for making such election shall not end before the 90th day after the date on which written notice of the availability of such election and applicable information required by subparagraph (3)(i) of this paragraph is given directly to such surviving spouse or personal representative. If such notice and information is given by mail, if shall be treated as given on the date of mailing.

(3) *Information to be provided by plan administrator.* (i) A plan which is required to provide either or both of the elections described in paragraph (c) (1) or (2) of this section must provide to the participants, at the time and in the manner specified in subdivision (ii) of this subparagraph, the following information, as applicable to the plan, in written nontechnical language:

(A) In the case of the election described in paragraph (c)(1) of this section, a general description or explanation of the qualified joint and survivor annuity, the circumstances in which it will be provided unless the participant has elected not to have benefits provided in that form, and the availability of such election;

(B) In the case of the election described in paragraph (c)(2) of this section, a general description of the early survivor annuity, the circumstances under which it will be paid if elected, and the availability of such election; and

(C) A general explanation of the relative financial effect on a participant's annuity of either or both elections, as the case may be.

Various methods may be used to explain such relative financial effect. With regard to a qualified joint and survivor annuity, they include: information as to the benefits the participant would receive under the qualified joint and survivor annuity stated as an arithmetic or percentage reduction from a single life annuity; a table showing the difference between a straight life annuity and a qualified joint and survivor annuity in terms of a reduction in dollar amounts; a table showing a percentage reduction from the straight life annuity or, in the case of a profit-sharing plan, an approximate dollar amount reduction. The notice and explanation required by this subdivision (i) must also inform the participants of the availability of the additional information specified in subdivision (iii) of this subparagraph and how they may obtain such information.

(ii) The method or methods used to provide the information described in subdivision (i) of this subparagraph may vary. Posting which meets the requirements of §1.7476–2(c)(1) may be used; see §1.7476–2(c)(1) for examples of other methods which may be used. One or more methods may be used to provide the required information provided that all of the required information is provided by one method or a combination of methods by or within the time period specified in this subdivision (ii). If mail or personal delivery is used, then, whether or not the information has been previously provided, there must be a mailing or personal delivery of the information by such time as to reasonably assure that it will be received on or about: (*1*) In the case of a plan which does not provide for the payment of benefits before the normal retirement age, the date which is 9 months before the participant attains normal retirement age; (*2*) in the case of a plan which provides for the payment of benefits before the normal retirement age and which is required to provide the election described in paragraph (c)(2) of this section (whether or not it is also required to provide the election described in paragraph (c)(1) of this section), the date which is 90 days before the latest date prescribed by paragraph (c)(2)(ii)(A) for the beginning of the election period for the early survivor annuity; or (*3*) in the case of a plan which provides for the payment of benefits before the normal retirement age and which is required to provide only the election described in paragraph (c)(1) of this section, the date which is nine months before the participant attains the qualified early retirement age; except that in the case of a plan described in (*2*) or (*3*), if the qualified early retirement age is the date the participant begins participation in the plan, the information may be provided on or about such date. If a method other than mail or personal delivery is used to provide participants with some or all of such information, if must be a method which is reasonably calculated to reach the attention of a participant on or about the date prescribed in the immediately preceding sentence and to continue to reach the attention of such participant during the election period applicable to him for which the information is being provide (as, for example, by permanent posting, repeated publication, etc.).

(iii) The plan administrator must furnish to a particular participant, upon a timely written request, a written explanation in nontechnical language of the terms and conditions of the qualified joint and survivor annuity and the financial effect upon the particular participant's annuity of making any election under this paragraph. Such financial effect shall be given in terms of dollars per annuity payment; and in the case of a defined contribution plan, the projected annuity for a particular participant may be based on his account balance as of the most recent valuation date. The plan administrator need not comply with more than one such request made by a particular participant. This explanation must be personally delivered or mailed (first class mail, postage prepaid) to the participant within 30 days from the date of the participant's written request.

(4) *Election is revocable.* A plan to which this section applies must provide that any election made under this

paragraph may be revoked in writing during the specified election period, and that after such election has been revoked, another election under this paragraph may be made during the specified election period.

(5) *Election by surviving spouse.* A plan will not fail to meet the requirements of section 401(a)(11) and this section merely because it provides that the spouse of a deceased participant may elect to have benefits paid in a form other than a survivor annuity. If the plan provides that such a spouse may make such an election, the plan administrator must furnish to this spouse, within a reasonable amount of time after a written request has been made by this spouse, a written explanation in non-technical language of the survivor annuity and any other form of payment which may be selected. This explanation must state the financial effect (in terms of dollars) of each form of payment. A plan need not respond to more than one such request.

(d) *Permissible additional plan provisions*—(1) *In general.* A plan will not fail to meet the requirements of section 401(a)(11) and this section merely because it contains one or more of the provisions described in paragraphs (d)(2) through (5) of this section.

(2) *Claim for benefits.* A plan may provide that as a condition precedent to the payment of benefits, a participant must express in writing to the plan administrator the form in which he prefers benefits to be paid and provide all the information reasonably necessary for the payment of such benefits. However, if a participant files a claim for benefits with the plan administrator and provides the plan administrator with all the information necessary for the payment of benefits but does not indicate a preference as to the form for the payment of benefits, benefits must be paid in the form of a qualified joint and survivor annuity if the participant has attained the qualified early retirement age unless such participant has made an effective election not to receive benefits in such form. For rules relating to provisions in a plan to the effect that a claim for benefits must be filed before the payment of benefits will commence, see § 1.401(a)–14.

(3) *Marriage requirements.* A plan may provide that a joint and survivor annuity will be paid only if—

(i) The participant and his spouse have been married to each other throughout a period (not exceeding one year) ending on the annuity starting date.

(ii) The spouse of the participant is not entitled to receive a survivor annuity (whether or not the election described in paragraph (c)(2) of this section has been made) unless the participant and his spouse have been married to each other throughout a period (not exceeding one year) ending on the date of such participant's death.

(iii) The same spouse must satisfy the requirements of subdivisions (i) and (ii) of this subparagraph.

(iv) The participant must notify the plan administrator (as defined by section 414(g)) of his marital status within any reasonable time period specified in the plan.

(4) *Effect of participant's death on an election or revocation of an election under paragraph (c).* A plan may provide that any election described in paragraph (c) of this section or any revocation of any such election does not become effective or ceases to be effective if the participant dies within a period, not in excess of 2 years, beginning on the date of such election or revocation. However, a plan containing a provision described in the preceding sentence shall not satisfy the requirements of this section unless it also provides that any such election or any revocation of any such election will be given effect in any case in which—

(i) The participant dies from accidental causes,

(ii) A failure to give effect to the election or revocation would deprive the participant's survivor of a survivor annuity, and

(iii) Such election or revocation is made before such accident occurred.

(5) *Benefit option approval by third party.* (i) A plan may provide that an optional form of benefit elected by a participant is subject to the approval of an administrative committee or similar third party. However, the administrative committee cannot deny a participant any of the benefits required by section 401(a)(11). For example, if a

plan offers a life annuity option, the committee may deny the participant a qualified joint and survivor annuity only by denying the participant access to all life annuity options without knowledge of whether the participant wishes to receive a qualified joint and survivor annuity. Alternatively, if the committee knows which form of life annuity the participant has chosen before the committee makes its decision, the committee cannot withhold its consent for payment of a qualified joint and survivor annuity event though it denies all other life annuity options. This subparagraph (5) only applies before the effective date of the amendment made to section 411(d)(6) by section 301 of the Retirement Equity Act of 1984. See section 411(d)(6) and the regulations thereunder for rules limiting employer discretion.

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

Example. In 1980 plan M provides that the automatic form of benefit is a single sum distribution. The plan also permits, subject to approval by the administrative committee, the election of several optional forms of life annuity. On the election form that is reviewed by the administrative committee the participant indicates whether any life annuity option is preferred, without indicating the particular life annuity chosen. Thus, the committee approves or disapproves the election without knowledge of whether a qualified joint and survivor annuity will be elected. The administrative committee approval provision in Plan M does not cause the plan to fail to satisfy this section. On the other hand, if the form indicates which form of life annuity is preferred, committee disapproval of any election of the qualified joint and survivor annuity would cause the plan to fail to satisfy this section.

(e) *Costs of providing qualified joint and survivor annuity form or early survivor annuity form.* A plan may take into account in any equitable manner consistent with generally accepted actuarial principles applied on a consistent basis any increased costs resulting from providing qualified joint and survivor annuity and early survivor annuity benefits. A plan may give a participant the option of paying premiums only if it provides another option under which an out-of-pocket expense by the participant is not required.

(f) *Application and effective date.* Section 401(a)(11) and this section shall apply to a plan only with respect to plan years beginning after December 31, 1975, and shall apply only if—

(1) The participant's annuity starting date did not fall within a plan year beginning before January 1, 1976, and

(2) The participant was an active participant in the plan on or after the first day of the first plan year beginning after December 31, 1975.

For purposes of this paragraph, the term ''active participant'' means a participant for whom benefits are being accrued under the plan on his behalf (in the case of a defined benefit plan), the employer is obligated to contribute to or under the plan on his behalf (in the case of a defined contribution plan other than a profit-sharing plan), or the employer either is obligated to contribute to or under the plan on his behalf or would have been obligated to contribute to or under the plan on his behalf if any contribution were made to or under the plan (in the case of a profit-sharing plan).

If benefits under a plan are provided by the distribution to the participants of individual annuity contracts, the annuity starting date will be considered for purposes of this paragraph to fall within a plan year beginning before January 1, 1976, with respect to any such individual contract that was distributed to the participant during a plan year beginning before January 1, 1976, if no premiums are paid with respect to such contract during a plan year beginning after December 31, 1975. In the case of individual annuity contracts that are distributed to participants before January 1, 1978, and which contain an option to provide a qualified joint and survivor annuity, the requirements of this section will be considered to have been satisfied if, not later than January 1, 1978, holders of individual annuity contracts who are participants described in the first sentence of this paragraph are given an opportunity to have such contracts amended, so as to provide for a qualified joint and survivor annuity in the absence of a contrary election, within a period of not less than one year from the date such opportunity was offered. In no event, however, shall the preceding sentence apply with respect to benefits attributable to premiums paid after December 31, 1977.

(g) *Effect of REA 1984*—(1) *In general.* The Retirement Equity Act of 1984 (REA 1984) significantly changed the qualified joint and survivor annuity rules generally effective for plan years beginning after December 31, 1984. The new survivor annuity rules are primarily in sections 401(a)(11) and 417 as revised by REA 1984 and §§ 1.401(a)–20 and 417(e)–1.

(2) *Regulations after REA 1984.* (i) REA and the regulations thereunder to the extent inconsistent with pre-REA 1984 section 401(a)(11) and this section are controlling for years to which REA 1984 applies. See *e.g.*, paragraphs (a)(1) and (2) of this section, relating to required provisions and certain cash-outs, respectively and (e), relating to costs of providing annuities, for rules that are inconsistent with REA 1984 and, therefore, are not applicable to REA 1984 years.

(ii) To the extent that the pre-REA 1984 law either is the same as or consistent with REA 1984 and the new regulations hereunder, the rules in this section shall continue to apply for years to which REA 1984 applies. (See, *e.g.*, paragraph (c) (relating to how information is furnished participants and spouses) and paragraph (b) (defining a life annuity) for some of the rules that apply to REA 1984 years.) The rules in this section shall not apply for such years to the extent that they are inconsistent with REA 1984 and the regulations thereunder.

(iii) The Commissioner may provide additional guidance as to the continuing effect of the various rules in this section for years to which REA 1984 applies.

(Secs. 401(a)(11), 7805 Internal Revenue Code of 1954, (88 Stat. 935, 68A Stat. 917; (26 U.S.C. 401(a)(11), 7805)))

[T.D. 7458, 42 FR 1466, Jan. 7, 1977; 42 FR 6367, Feb. 2, 1977; T.D. 7510, 42 FR 53956, Oct. 4, 1977; T.D. 8219, 53 FR 31841, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988]

§ 1.401(a)–12 Mergers and consolidations of plans and transfers of plan assets.

A trust will not be qualified under section 401 unless the plan of which the trust is a part provides that in the case of any merger or consolidation with, or transfer of assets or liabilities to, another plan after September 2, 1974, each participant in the plan would receive a minimum benefit if the plan terminated immediately after the merger, consolidation, or transfer. This benefit must be equal to or greater than the benefit the participant would have been entitled to receive immediately before the merger, consolidation, or transfer if the plan in which he was a participant had then terminated. This section applies to a multiemployer plan only to the extent determined by the Pension Benefit Guaranty Corporation. For additional rules concerning mergers or consolidations of plans and transfers of plan assets, see section 414(l) and § 1.414(l)–1.

[T.D. 7638, 44 FR 48195, Aug. 17, 1979]

§ 1.401(a)–13 Assignment or alienation of benefits.

(a) *Scope of the regulations.* This section applies only to plans to which section 411 applies without regard to section 411(e)(2). Thus, for example, it does not apply to a governmental plan, within the meaning of section 414(d); a church plan, within the meaning of section 414(e), for which there has not been made the election under section 410(a) to have the participation, vesting, funding, etc. requirements apply; or a plan which at no time after September 2, 1974, provided for employer contributions.

(b) *No assignment or alienation*—(1) *General rule.* Under section 401(a)(13), a trust will not be qualified unless the plan of which the trust is a part provides that benefits provided under the plan may not be anticipated, assigned (either at law or in equity), alienated or subject to attachment, garnishment, levy, execution or other legal or equitable process.

(2) *Federal tax levies and judgments.* A plan provision satisfying the requirements of subparagraph (1) of this paragraph shall not preclude the following:

(i) The enforcement of a Federal tax levy made pursuant to section 6331.

(ii) The collection by the United States on a judgment resulting from an unpaid tax assessment.

(c) *Definition of assignment and alienation*—(1) *In general.* For purposes of this section, the terms ''assignment'' and ''alienation'' include—

(i) Any arrangement providing for the payment to the employer of plan benefits which otherwise would be due the participant under the plan, and

(ii) Any direct or indirect arrangement (whether revocable or irrevocable) whereby a party acquires from a participant or beneficiary a right or interest enforceable against the plan in, or to, all or any part of a plan benefit payment which is, or may become, payable to the participant or beneficiary.

(2) *Specific arrangements not considered an assignment or alienation.* The terms ''assignment'' and ''alienation'' do not include, and paragraph (e) of this section does not apply to, the following arrangements:

(i) Any arrangement for the recovery of amounts described in section 4045(b) of the Employee Retirement Income Security Act of 1974, 88 Stat. 1027 (relating to the recapture of certain payments),

(ii) Any arrangement for the withholding of Federal, State or local tax from plan benefit payments,

(iii) Any arrangement for the recovery by the plan of overpayments of benefits previously made to a participant,

(iv) Any arrangement for the transfer of benefit rights from the plan to another plan, or

(v) Any arrangement for the direct deposit of benefit payments to an account in a bank, savings and loan association or credit union, provided such arrangement is not part of an arrangement constituting an assignment or alienation. Thus, for example, such an arrangement could provide for the direct deposit of a participant's benefit payments to a bank account held by the participant and the participant's spouse as joint tenants.

(d) *Exceptions to general rule prohibiting assignments or alienations*—(1) *Certain voluntary and revocable assignments or alienations.* Not withstanding paragraph (b)(1) of this section, a plan may provide that once a participant or beneficiary begins receiving benefits under the plan, the participant or beneficiary may assign or alienate the right to future benefit payments provided that the provision is limited to assignments or alienations which—

(i) Are voluntary and revocable;

(ii) Do not in the aggregate exceed 10 percent of any benefit payment; and

(iii) Are neither for the purpose, nor have the effect, of defraying plan administration costs.

For purposes of this subparagraph, an attachment, garnishment, levy, execution, or other legal or equitable process is not considered a voluntary assignment or alienation.

(2) *Benefits assigned or alienated as security for loans.* (i) Notwithstanding paragraph (b)(1) of this section, a plan may provide for loans from the plan to a participant or a beneficiary to be secured (by whatever means) by the participant's accrued nonforfeitable benefit provided that the following conditions are met.

(ii) The plan provision providing for the loans must be limited to loans from the plan. A plan may not provide for the use of benefits accrued or to be accrued under the plan as security for a loan from a party other than the plan, regardless of whether these benefits are nonforfeitable within the meaning of section 411 and the regulations thereunder.

(iii) The loan, if made to a participant or beneficiary who is a disqualified person (within the meaning of section 4975(e)(2)), must be exempt from the tax imposed by section 4975 (relating to the tax imposed on prohibited transactions) by reason of section 4975(d)(1). If the loan is made to a participant or beneficiary who is not a disqualified person, the loan must be one which would the exempt from the tax imposed by section 4975 by reason of section 4975(d)(1) if the loan were made to a disqualified person.

(e) *Special rule for certain arrangements*—(1) *In general.* For purposes of this section and notwithstanding paragraph (c)(1) of this section, an arrangement whereby a participant or beneficiary directs the plan to pay all, or any portion, of a plan benefit payment to a third party (which includes the participant's employer) will not constitute an ''assignment or alienation'' if—

(i) It is revocable at any time by the participant or beneficiary; and

(ii) The third party files a written acknowledgement with the plan administrator pursuant to subparagraph (2) of this paragraph.

(2) *Acknowledgement requirement for third party arrangements.* In accordance with paragraph (e)(1)(ii) of this section, the third party is required to file a written acknowledgement with the plan administrator. This acknowledgement must state that the third party has no enforceable right in, or to, any plan benefit payment or portion thereof (except to the extent of payments actually received pursuant to the terms of the arrangement). A blanket written acknowledgement for all participants and beneficiaries who are covered under the arrangement with the third party is sufficient. The written acknowledgement must be filed with the plan administrator no later than the later of—

(i) August 18, 1978; or

(ii) 90 days after the arrangement is entered into.

(f) *Effective date.* Section 401(a)(13) is applicable as of January 1, 1976, and the plan provision required by this section must be effective as of that date. However, regardless of when the provision is adopted, it will not affect—

(1) Attachments, garnishments, levies, or other legal or equitable process permitted under the plan that are made before January 1, 1976;

(2) Assignments permitted under the plan that are irrevocable on December 31, 1975, including assignments made before January 1, 1976, as security for loans to a participant or beneficiary from a party other than the plan; and

(3) Renewals or extensions of loans described in subparagraph (2) of this paragraph, if—

(i) The principal amount of the obligation outstanding on December 31, 1975 (or, if less, the principal amount outstanding on the date of renewal or extension), is not increased;

(ii) The loan, as renewed or extended, does not bear a rate of interest in excess of the rate prevailing for similar loans at the time of the renewal or extensions; and

(iii) With respect to loans that are renewed or extended to bear a variable interest rate, the formula for determining the applicable rate is consistent with the formula for formulae prevailing for similar loans at the time of the renewal or extension. For purposes of subparagraphs (2) and (3) of this paragraph, a loan from a party other than the plan made after December 31, 1975, will be treated as a new loan. This is so even if the lender's security interest for the loan arises from an assignment of the participant's accrued nonforfeitable benefit made before that date.

(g) *Special rules for qualified domestic relations orders*—(1) *Definition.* The term ''qualified domestic relations order'' (QDRO) has the meaning set forth in section 414(p). For purposes of the Internal Revenue Code, a QDRO also includes any domestic relations order described in section 303(d) of the Retirement Equity Act of 1984.

(2) *Plan amendments.* A plan will not fail to satisfy the qualification requirements of section 401(a) or 403(a) merely because it does not include provisions with regard to a QDRO.

(3) *Waiver of distribution requirements.* A plan shall not be treated as failing to satisfy the requirements of sections 401 (a) and (k) and 409(d) solely because of a payment to an alternate payee pursuant to a QDRO. This is the case even if the plan provides for payments pursuant to a QDRO to an alternate payee prior to the time it may make payments to a participant. Thus, for example, a pension plan may pay an alternate payee even though the participant may not receive a distribution because he continues to be employed by the employer.

(4) *Coordination with section 417*—(i) *Former spouse.* (A) *In general.* Under section 414(p)(5), a QDRO may provide that a former spouse shall be treated as the current spouse of a participant for all or some purposes under sections 401(a)(11) and 417.

(B) *Consent.* (*1*) To the extent a former spouse is treated as the current spouse of the participant by reason of a QDRO, any current spouse shall not be treated as the current spouse. For example, assume H is divorced from W, but a QDRO provides that H shall be treated as W's current spouse with respect to all of W's benefits under a plan. H will be treated as the surviving spouse under the QPSA and QJSA unless W obtains H's consent to waive the QPSA or QJSA or both. The fact that W married S after W's divorce from H is disregarded. If, however, the QDRO had provided that H shall be treated as W's current spouse only with respect to benefits that accrued prior to the divorce, then H's consent would be needed by W to waive the QPSA or QJSA with respect to benefits accrued before the divorce. S's consent would be required with respect to the remainder of the benefits.

(*2*) In the preceding examples, if the QDRO ordered that a portion of W's benefit (either through separate accounts or a percentage of the benefit) must be distributed to H rather than ordering that H be treated as W's spouse, the survivor annuity requirements of sections 401(a)(11) and 417 would not apply to the part of W's benefit awarded H. Instead, the terms of the QDRO would determine how H's portion of W's accrued benefit is paid. W is required to obtain S's consent if W elects to waive either the QJSA or QPSA with respect to the remaining portion of W's benefit.

(C) *Amount of the QPSA or QJSA.* (*1*) Where, because of a QDRO, more than one individual is to be treated as the surviving spouse, a plan may provide that the total amount to be paid in the form of a QPSA or survivor portion of a QJSA may not exceed the amount that would be paid if there were only one surviving spouse. The QPSA or survivor portion of the QJSA, as the case may be, payable to each surviving spouse must be paid as an annuity based on the life of each such spouse.

(*2*) Where the QDRO splits the participant's accrued benefit between the participant and a former spouse (either through separate accounts or percentage of the benefit), the surviving spouse of the participant is entitled to a QPSA or QJSA based on the participant's accrued benefit as of the date of death or the annuity starting date, less the separate account or percentage that is payable to the former spouse. The calculation is made as if the separate account or percentage had been distributed to the participant prior to the relevant date.

(ii) *Current spouse.* Under section 414(p)(5), even if the applicable election periods (*i.e.,* the first day of the year in which the participant attains age 35 and 90 days before the annuity starting date) have not begun, a QDRO may provide that a current spouse shall not be treated as the current spouse of the participant for all or some purposes under sections 401(a)(11) and 417. A QDRO may provide that the current spouse waives all future rights to a QPSA or QJSA.

(iii) *Effects on benefits.* (A) A plan is not required to provide additional vesting or benefits because of a QDRO.

(B) If an alternate payee is treated pursuant to a QDRO as having an interest in the plan benefit, including a separate account or percentage of the participant's account, then the QDRO cannot provide the alternate payee with a greater right to designate a beneficiary for the alternate payee's benefit amount than the participant's right. The QJSA or QPSA provisions of section 417 do not apply to the spouse of an alternate payee.

(C) If the former spouse who is treated as a current spouse dies prior to the participant's annuity starting date, then any actual current spouse of the participant is treated as the current spouse, except as otherwise provided in a QDRO.

(iv) *Section 415 requirements.* Even though a participant's benefits are awarded to an alternate payee pursuant to a QDRO, the benefits are benefits of the participant for purposes of applying the limitations of section 415 to the participant's benefits.

[T.D. 7534, 43 FR 6943, Feb. 17, 1978, as amended by T.D. 8219, 53 FR 31850, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988]

§1.401(a)–14 Commencement of benefits under qualified trusts.

(a) *In general.* Under section 401(a)(14), a trust to which section 411 applies (without regard to section 411(e)(2) is not qualified under section 401 unless the plan of which such trust is a part provides that the payment of benefits under the plan to the participant will begin not later than the 60th day after the close of the plan year in which the latest of the following events occurs—

(1) The attainment by the participant of age 65, or, if earlier, the normal retirement age specified under the plan,

(2) The 10th anniversary of the date on which the participant commenced participation in the plan,

(3) The termination of the participant's service with the employer, or

(4) The date specified in an election made pursuant to paragraph (b) of this section.

Notwithstanding the preceding sentence, a plan may require that a participant file a claim for benefits before payment of benefits will commence.

(b) *Election of later date*—(1) *General rule.* A plan may permit a participant to elect that the payment to him of any benefit under a plan will commence at a date later than the dates specified under paragraphs (a)(1), (2), and (3) of this section.

(2) *Manner of election.* A plan permitting an election under this paragraph shall require that such election must be made by submitting to the plan administrator a written statement, signed by the participant, which describes the benefit and the date on which the payment of such benefit shall commence.

(3) *Restriction.* An election may not be made pursuant to a plan provision permitted by this paragraph if the exercise of such election will cause benefits payable under the plan with respect to the participant in the event of his death to be more than ''incidental'' within the meaning of paragraph (b)(1)(i) of § 1.401–1.

(c) *Special early retirement rule*—(1) *Separation prior to early retirement age.* A trust forming part of a plan which provides for the payment of an early retirement benefit is not qualified under section 401 unless, upon satisfaction of the age requirement for such early retirement benefit, a participant who—

(i) Satisfied the service requirements for such early retirement benefit, but

(ii) Separated from service (with any nonforfeitable right to an accrued benefit) before satisfying such age requirement,

is entitled to receive not less than the reduced normal retirement benefit described in paragraph (c)(2) of this section. A plan may establish reasonable conditions for payments of early retirement benefits (including for example, a requirement that a claim for benefits be made) if the conditions are equally applicable to participants who separate from service when eligible for an early retirement benefit and participants who separate from service earlier.

(2) *Reduced normal retirement benefit.* For purposes of this section, the reduced normal retirement benefit is the benefit to which the participant would have been entitled under the plan at normal retirement age, reduced in accordance with reasonable actuarial assumptions.

(3) *Separation prior to effective date of this section.* The provisions of this paragraph shall not apply in the case of a plan participant who separates from service before attainment of early retirement age and prior to the effective date of this section set forth in paragraph (e) of this section.

(4) *Illustration.* The provisions of this paragraph may be illustrated by the following example:

Example. The X Corporation Defined Benefit Plan provides that a normal retirement benefit will be payable to a participant upon attainment of age 65. The plan also provides that an actuarially reduced retirement benefit will be payable, upon application, to any participant who has completed 10 years of service with the X Corporation and attained age 60. When he is 55 years of age and has completed 10 years of service with X Corporation, A, a participant in the plan, leaves the service of X Corporation and does not return. The plan will not be qualified under section 401 unless, upon attainment of age 60 and application for benefits, A is entitled to receive a reduced normal retirement benefit described in subparagraph (2) of this paragraph.

(d) *Retroactive payment rule.* If the amount of the payment required to commence on the date determined under this section cannot be ascertained by such date, or if it is not possible to make such payment on such date because the plan administrator has been unable to locate the participant after making reasonable efforts to do so, a payment retroactive to such date may be made no later than 60 days after the earliest date on which the amount of such payment can be ascertained under the plan or the date on which the participant is located (whichever is applicable).

(e) *Effective date.* This section shall apply to a plan for those plan years to which section 411 of the Code applies without regard to section 411(e)(2).

(Secs. 401(a)(14), 7805, Internal Revenue Code of 1954 (88 Stat. 937, 68A Stat. 917; 26 U.S.C. 401(a)(14), 7805))

[T.D. 7436, 41 FR 42651, Sept. 28, 1976; 41 FR 44690, Oct. 12, 1976]

§1.401(a)–15 Requirement that plan benefits are not decreased on account of certain Social Security increases.

(a) *In general.* Under section 401(a)(15), a trust which is part of a plan to which section 411 applies (without regard to section 411(e)(2)) is not qualified under section 401 unless, under the plan of which such trust is a part:

(1) *Benefit being received by participant or beneficiary.* A benefit (including a death or disability benefit) being received under the plan by a participant or beneficiary (other than a participant to whom subparagraph (2)(ii) of this paragraph applies, or a beneficiary of such a participant) is not decreased by reason of any post-separation social security benefit increase effective after the later of—

(i) September 2, 1974, or

(ii) The date of first receipt of any retirement benefit, death benefit, or disability benefit under the plan by the participant or by a beneficiary of the participant (whichever receipt occurs first).

(2) *Benefit to which participant separated from service has nonforfeitable right.* In the case of a benefit to which a participant has a nonforfeitable right under such plan—

(i) If such participant is separated from service and does not subsequently return to service and resume participation in the plan, such benefit is not decreased by reason of any post-separation social security benefit increase effective after the later of September 2, 1974, or separation from service, or

(ii) If such participant is separated from service and subsequently returns to service and resumes participation in the plan, such benefit is not decreased by reason of any post-separation social security benefit increase effective after September 2, 1974, which occurs during separation from service and which would decrease such benefit to a level below the level of benefits to which he would have been entitled had he not returned to service after his separation.

(b) *Post-separation social security benefit increase.* For purposes of this section, the term ‘‘post-separation social security benefit increase’’ means, with respect to a participant or a beneficiary of the participant, an increase in a benefit level or wage base under title II of the Social Security Act (whether such increase is a result of an amendment of such title II or is a result of the application of the provisions of such title II) occurring after the earlier of such participant’s separation from service or commencement of benefits under the plan.

(c) *Illustrations.* The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). A plan to which section 401(a)(15) applies provides an annual benefit at the normal retirement age, 65, in the form of a stated benefit formula amount less a specified percentage of the primary insurance amount payable under title II of the Social Security Act. The plan provides no early retirement benefits. In the case of a participant who separates from service before age 65 with a nonforfeitable right to a benefit under the plan, the plan defines the primary insurance amount as the amount which the participant is entitled to receive under title II of the Social Security Act at age 65, multiplied by the ratio of the number of years of service with the employer to the number of years of service the participant would have had if he had worked for the employer until age 65. The plan does not satisfy the requirements of section 401(a)(15), because social security increases that occur after a participant’s separation from service will reduce the benefit the participant will receive under the plan.

Example (2). A plan to which section 401(a)(15) applies provides an annual benefit at the normal retirement age, 65, in the form of a stated benefit formula amount less a specified percentage of the primary insurance amount payable under title II of the Social Security Act. The plan provides no early retirement benefits. In the case of a participant who separates from service before age 65 with a nonforfeitable right to a benefit under the plan, the plan defines the primary insurance amount as the amount which the participant is entitled to receive under title

II of the Social Security Act at age 65 based upon the assumption that he will continue to receive until reaching age 65 compensation which would be treated as wages for purposes of the Social Security Act at the same rate as he received such compensation at the time he separated from service, but determined without regard to any post-separation social security benefit increase, multiplied by the ratio of the number of years of service with the employer to the number of years of service the participant would have had if he had worked for the employer until age 65. The plan satisfies the requirements of section 401(a)(15), because social security increases that occur after a participant's separation from service will not reduce the benefit the participant will receive under the plan.

(d) *Other Federal or State laws.* To the extent applicable, the rules discussed in this section will govern classifications under a plan supplementing the benefits provided by other Federal or State laws, such as the Railroad Retirement Act of 1937. See section 206(b) of the Employee Retirement Income Security Act of 1974 (Public Law 93–406, 88 Stat. 864).

(e) *Effect on prior law.* Nothing in this section shall be construed as amending or modifying the rules applicable to post-separation social security increases prior to September 2, 1974. See paragraph (e) of § 1.401–3.

(f) *Effective date.* Section 401(a)(15) and this section shall apply to a plan only with respect to plan years to which section 411 (relating to minimum vesting standards) is applicable to the plan without regard to section 411(e)(2).

[T.D. 7434, 41 FR 42650, Sept. 28, 1976]

§ 1.401(a)–16 Limitations on benefits and contributions under qualified plans.

A trust will not be a qualified trust and a plan will not be a qualified plan if the plan provides for benefits or contributions which exceed the limitations of section 415. Section 415 and the regulations thereunder provide rules concerning these limitations on benefits and contributions.

[T.D. 7748, 46 FR 1696, Jan. 7, 1981]

§ 1.401(a)–19 Nonforfeitability in case of certain withdrawals.

(a) *Application of section.* Section 401(a)(19) and this section apply to a plan to which section 411(a) applies. (See section 411(e) and § 1.411(a)–2 for applicability of section 411).

(b) *Prohibited forfeitures*—(1) *General rule.* A plan to which this section applies is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if, under such plan, any part of a participant's accrued benefit derived from employer contributions is forfeitable solely because a benefit derived from the participant's contributions under the plan is voluntarily withdrawn by him after he has become a 50 percent vested participant.

(2) *50 percent vested participant.* For purposes of subparagraph (1) of this paragraph, a participant is a 50 percent vested participant when he has a nonforfeitable right (within the meaning of section 411 and the regulations thereunder) to at least 50 percent of his accrued benefit derived from employer contributions. Whether or not a participant is 50 percent vested shall be determined by the ratio of the participant's total nonforfeitable employer-derived accrued benefit under the plan to his total employer-derived accrued benefit under the plan.

(3) *Certain forfeitures.* Paragraph (b)(1) of this section does not apply in the case of a forfeiture permitted by section 411(a)(3)(D)(iii) and § 1.411(a)–7(d)(3) (relating to forfeitures of certain benefits accrued before September 2, 1974).

(c) *Supersession.* Section 11.401(a)–(19) of the Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974 is superseded by this section.

(Sec. 411 Internal Revenue Code of 1954 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42320, Aug. 23, 1977]

§ 1.401(a)–20 Requirements of qualified joint and survivor annuity and qualified preretirement survivor annuity.

Q–1: What are the survivor annuity requirements added to the Code by the Retirement Equity Act of 1984 (REA 1984)?

A–1: REA 1984 replaced section 401(a)(11) with a new section 401(a)(11) and added section 417. Plans to which new section 401(a)(11) applies must comply with the requirements of sections 401(a)(11) and 417 in order to remain qualified under sections 401(a) or 403(a). In general, these plans must provide both a qualified joint and survivor annuity (QJSA) and a qualified preretirement survivor annuity (QPSA) to remain qualified. These survivor annuity requirements are applicable to any benefit payable under a plan, including a benefit payable to a participant under a contract purchased by the plan and paid by a third party.

Q–2: Must annuity contracts purchased and distributed to a participant or spouse by a plan subject to the survivor annuity requirements of sections 401(a)(11) and 417 satisfy the requirements of those sections?

A–2: Yes. Rights and benefits under section 401(a)(11) or 417 may not be eliminated or reduced because the plan uses annuity contracts to provide benefits merely because (a) such a contract is held by a participant or spouse instead of a plan trustee, or (b) such contracts are distributed upon plan termination. Thus, the requirements of sections 401(a)(11) and 417 apply to payments under the annuity contracts, not to the distributions of the contracts.

Q–3: What plans are subject to the survivor annuity requirements of section 401(a)(11)?

A–3: (a) Section 401(a)(11) applies to any defined benefit plan and to any defined contribution plan that is subject to the minimum funding standards of section 412. This section also applies to any participant under any other defined contribution plan unless all of the following conditions are satisfied—

(1) The plan provides that the participant's nonforfeitable accrued benefit is payable in full, upon the participant's death, to the participant's surviving spouse (unless the participant elects, with spousal consent that satisfies the requirements of section 417(a)(2), that such benefit be provided instead to a designated beneficiary);

(2) The participant does not elect the payment of benefits in the form of a life annuity; and

(3) With respect to the participant, the plan is not a transferee or an offset plan. (See Q&A 5 of this section.)

(b) A defined contribution plan not subject to the minimum funding standards of section 412 will not be treated as satisfying the requirement of paragraph (a)(1) unless both of the following conditions are satisfied—

(1) The benefit is available to the surviving spouse within a reasonable time after the participant's death. For this purpose, availability within the 90-day period following the date of death is deemed to be reasonable and the reasonableness of longer periods shall be determined based on the particular facts and circumstances. A time period longer than 90 days, however, is deemed unreasonable if it is less favorable to the surviving spouse than any time period under the plan that is applicable to other distributions. Thus, for example, the availability of a benefit to the surviving spouse would be unreasonable if the distribution was required to be made by the close of the plan year including the participant's death while distributions to employees who separate from service were required to be made within 90 days of separation.

(2) The benefit payable to the surviving spouse is adjusted for gains or losses occurring after the participant's death in accordance with plan rules governing the adjustment of account balances for other plan distributions. Thus, for example, the plan may not provide for distributions of an account balance to a surviving spouse determined as of the last day of the quarter in which the participant's death occurred with no adjustments of an account balance for gains or losses after death if the plan provides for such adjustments for a participant who separates from service within a quarter.

(c) For purposes of determining the extent to which section 401(a)(11) applies to benefits under an employee stock ownership plan (as defined in section 4975(e)(7)), the portion of a participant's accrued benefit that is subject to section 409(h) is to be treated as though such benefit were provided under a defined contribution plan not subject to section 412.

(d) The requirements set forth in section 401(a)(11) apply to other employee benefit plans that are covered by applicable provisions under Title I of the Employee Retirement Income Security Act of 1974. For purposes of applying the regulations under sections 401(a)(11) and 417, plans subject to ERISA section 205 are treated as if they were described in section 401(a). For example, to the extent that section 205 covers section 403(b) contracts and custodial accounts they are treated as section 401(a) plans. Individual retirement plans (IRAs), including IRAs to which contributions are made under simplified employee pensions described in section 408(k) and IRAs that are treated as plans subject to Title I, are not subject to these requirements.

Q–4: What rules apply to a participant who elects a life annuity option under a defined contribution plan not subject to section 412?

A–4: If a participant elects at any time (irrespective of the applicable election period defined in section 417(a)(6)) a life annuity option under a defined contribution plan not subject to section 412, the survivor annuity requirements of sections 401(a)(11) and 417 will always thereafter apply to all of the participant's benefits under such plan unless there is a separate accounting of the account balance subject to the election. A plan may allow a participant to elect an annuity option prior to the applicable election period described in section 417(a)(6). If a participant elects an annuity option, the plan must satisfy the applicable written explanation, consent, election, and withdrawal rules of section 417, including waiver of the QJSA within 90 days of the annuity starting date. If a participant selecting such an option dies, the surviving spouse must be able to receive the QPSA benefit described in section 417(c)(2) which is a life annuity, the actuarial equivalent of which is not less than 50 percent of the nonforfeitable account balance (adjusted for loans as described in Q&A 24(d) of this section). The remaining account balance may be paid to a designated nonspouse beneficiary.

Q–5: How do sections 401(a)(11) and 417 apply to transferee plans which are defined contribution plans not subject to section 412?

A–5: (a) *Transferee plans.* Although the survivor annuity requirements of sections 401(a)(11) and 417 generally do not apply to defined contribution plans not subject to section 412, such plans are subject to the survivor annuity requirements to the extent that they are transferee plans with respect to any participant. A defined contribution plan is a transferee plan with respect to any participant if the plan is a direct or indirect transferee of such participant's benefits held on or after January 1, 1985, by:

(1) A defined benefit plan,

(2) A defined contribution plan subject to section 412 or

(3) A defined contribution plan that is subject to the survivor annuity requirements of sections 401(a)(11) and 417 with respect to that participant.

If through a merger, spinoff, or other transaction having the effect of a transfer, benefits subject to the survivor annuity requirements of sections 401(a)(11) and 417 are held under a plan that is not otherwise subject to such requirements, such benefits will be subject to the survivor annuity requirements even though they are held under such plan. Even if a plan satisfies the survivor annuity requirements, other rules apply to these transactions. See, *e.g.*, section 411(d)(6) and the regulations thereunder. A transfer made before January 1, 1985, and any rollover contribution made at any time, are not transactions that subject the transferee plan to the survivor annuity requirements with respect to a participant. If a plan is a transferee plan with respect to a participant, the survivor annuity requirements do not apply with respect to other plan participants solely because of the transfer. Any plan that would not otherwise be subject to the survivor annuity requirements of sections 401(a)(11) and 417 whose benefits are used to offset benefits in a plan subject to such requirements is subject to the survivor annuity requirements with respect to those participants whose benefits are offset. Thus, if a stock bonus or profit-sharing plan offsets benefits under a defined benefit plan, such a plan is subject to the survivor annuity requirements.

(b) *Benefits covered.* The survivor annuity requirements apply to all accrued benefits held for a participant with respect to whom the plan is a transferee plan unless there is an acceptable separate accounting between the transferred benefits and all other benefits under the plan. A separate accounting is not acceptable unless gains, losses, withdrawals, contributions, forfeitures, and other credits or charges are allocated on a reasonable and consistent basis between the accrued benefits subject to the survivor annuity requirements and other benefits. If there is an acceptable separate accounting between transferred benefits and any other benefits under the plan, only the transferred benefits are subject to the survivor annuity requirements.

Q–6: Is a frozen or terminated plan required to satisfy the survivor annuity requirements of sections 401(a)(11) and 417?

A–6: In general, benefits provided under a plan that is subject to the survivor annuity requirements of sections 401(a)(11) and 417 must be provided in accordance with those requirements even if the plan is frozen or terminated. However, any plan that has a termination date prior to September 17, 1985, and that distributed all remaining assets as soon as administratively feasible after the termination date, is not subject to the survivor annuity requirements. The date of termination is determined under section 411(d)(3) and §1.411(d)–2(c).

Q–7: If the Pension Benefit Guaranty Corporation (PBGC) is administering a plan, are benefits payable in the form of a QPSA or QJSA-

A–7: Yes, the PBGC will pay benefits in such forms.

Q–8: How do the survivor annuity requirements of sections 401(a)(11) and 417 apply to participants?

A–8: (a) If a participant dies before the annuity starting date with vested benefits attributable to employer or employee contributions (or both), benefits must be paid to the surviving spouse in the form of a QPSA. If a participant survives until the annuity starting date with vested benefits attributable to employer or employee contributions (or both), benefits must be provided to the participant in the form of a QJSA.

(b) A participant may waive the QPSA or the QJSA (or both) if the applicable notice, election, and spousal consent requirements of section 417 are satisfied.

(c) Benefits are not required to be paid in the form of a QPSA or QJSA if at the time of death or distribution the participant was vested only in employee contributions and such death occurred, or distribution commenced, before October 22, 1986.

(d) *Certain mandatory distributions.* A distribution may occur without satisfying the spousal consent requirements of section 417 (a) and (e) if the present value of the nonforfeitable benefit does not exceed the cash-out limit in effect under §1.411(a)–11T(c)(3)(ii). See §1.417(e)–1.

Q–9: May separate portions of a participant's accrued benefit be subject to QPSA and QJSA requirements at any particular point in time?

A–9: (a) *Dual QPSA and QJSA rights.* One portion of a participant's benefit may be subject to the QPSA and another portion to the QJSA requirements at the same time. For example, in order for a money purchase pension plan to distribute any portion of a married participant's benefit to the participant, the plan must distribute such portion in the form of a QJSA (unless the plan satisfies the applicable consent requirements of section 417 (a) and (e) with respect to such portion of the participant's benefit). This rule applies even if the distribution is merely an in-service distribution attributable to voluntary employee contributions and regardless of whether the participant has attained the normal retirement age under the plan. The QJSA requirements apply to such a distribution because the annuity starting date has occurred with respect to this portion of the participant's benefit. In the event of a participant's death following the commencement of a distribution in the form of a QJSA, the remaining payments must be made to the surviving spouse under the QJSA. In addition, the plan must satisfy the QPSA requirements with respect to any portion of the participant's benefits for which the annuity starting date had not yet occurred.

(b) *Example.* Assume that participant A has a $100,000 account balance in a money purchase pension plan. A makes an in-service withdrawal of $20,000 attributable to voluntary employee contributions. The QJSA requirements apply to A's withdrawal of the

$20,000. Accordingly, unless the QJSA form is properly waived such amount must be distributed in the form of a QJSA. A's remaining account balance ($80,000) remains subject to the QPSA requirements because the annuity starting date has not occurred with respect to the $80,000. (If A survives until the annuity starting date, the $80,000 would be subject to the QJSA requirements.) If A died on the day following the annuity starting date for the withdrawal, A's spouse would be entitled to a QPSA with a value equal to at least $40,000 with respect to the $80,000 account balance, in addition to any survivor benefit without respect to the $20,000. If the $20,000 payment to A had been the first payment of an annuity purchased with the entire $100,000 account balance rather than an in-service distribution, then the QJSA requirements would apply to the entire account balance at the time of the annuity starting date. In such event, the plan would have no obligation to provide A's spouse with a QPSA benefit upon A's death. Of course, A's spouse would receive the QJSA benefit (if the QJSA had not been waived) based on the full $100,000.

Q–10: What is the relevance of the annuity starting date with respect to the survivor benefit requirements?

A–10: (a) *Relevance.* The annuity starting date is relevant to whether benefits are payable as either a QJSA or QPSA, or other selected optional form of benefit. If a participant is alive on the annuity starting date, the benefits must be payable as a QJSA. If the participant is not alive on the annuity starting date, the surviving spouse must receive a QPSA. The annuity starting date is also used to determine when a spouse may consent to and a participant may waive a QJSA. A waiver is only effective if it is made 90 days before the annuity starting date. Thus, a deferred annuity cannot be selected and a QJSA waived until 90 days before payments commence under the deferred annuity. In some cases, the annuity starting date will have occurred with respect to a portion of the participant's accrued benefit and will not have occurred with respect to the remaining portion. (See Q&A–9.)

(b) *Annuity starting date*—(1) *General rule.* For purposes of sections 401(a)(11), 411(a)(11) and 417, the annuity starting date is the first day of the first period for which an amount is paid as an annuity or any other form.

(2) *Annuity payments.* The annuity starting date is the first date for which an amount is paid, not the actual date of payment. Thus, if participant A is to receive annuity payments as of the first day of the first month after retirement but does not receive any payments until three months later, the annuity starting date is the first day of the first month. For example, if an annuity is to commence on January 1, January 1 is the annuity starting date even though the payment for January is not actually made until a later date. In the case of a deferred annuity, the annuity starting date is the date for which the annuity payments are to commence, not the date that the deferred annuity is elected or the date the deferred annuity contract is distributed.

(3) *Administrative delay.* A payment shall not be considered to occur after the annuity starting date merely because actual payment is reasonably delayed for calculation of the benefit amount if all payments are actually made.

(4) *Forfeitures on death.* Prior to the annuity starting date, section 411(a)(3)(A) allows a plan to provide for a forfeiture of a participant's benefit, except in the case of a QPSA or a spousal benefit described in section 401(a)(11)(B)(iii)(I). Once the annuity starting date has occurred, even if actual payment has not yet been made, a plan must pay the benefit in the distribution form elected.

(5) *Surviving spouses, alternate payees, etc.* The definition of ''annuity starting date'' for surviving spouses, other beneficiaries and alternate payees under section 414(p) is the same as it is for participants.

(c) *Disability auxiliary benefit*—(1) *General rule.* The annuity starting date for a disability benefit is the first day of the first period for which the benefit becomes payable unless the disability benefit is an auxiliary benefit. The payment of any auxiliary disability benefits is disregarded in determining the annuity starting date. A disability benefit is an auxiliary benefit if upon attainment of early or normal retirement age, a participant receives a benefit that satisfies the accrual and vesting rules of section 411 without taking into account the disability benefit payments up to that date.

Example. (i) Assume that participant A at age 45 is entitled to a vested accrued benefit of $100 per month commencing at age 65 in the form of a joint and survivor annuity under Plan X. If prior to age 65 A receives a disability benefit under Plan X and the payment of such benefit does not reduce the amount of A's retirement benefit of $100 per month commencing at age 65, any disability benefit payments made to A between ages 45 and 65 are auxiliary benefits. Thus, A's annuity starting date does not occur until A attains age 65. A's surviving spouse B would be entitled to receive a QPSA if A died before age 65. B would be entitled to receive the survivor portion of a QJSA (unless waived) if A died after age 65. The QPSA payable to B upon A's death prior to age 65 would be computed by reference to the QJSA that would have been payable to A and B had A survived to age 65.

(ii) If in the above example A's benefit payable at age 65 is reduced to $99 per month because a disability benefit is provided to A prior to age 65, the disability benefit would not be an auxiliary benefit. The benefit of $99 per month payable to A at age 65 would not, without taking into account the disability benefit payments to A prior to age 65, satisfy the minimum vesting and accrual rules of section 411. Accordingly, the first day of the first period for which the disability payments are to be made to A would constitute A's annuity starting date, and any benefit paid to A would be required to be paid in the form of a QJSA (unless waived by A with the consent of B).

(d) *Other rules*—(1) *Suspension of benefits.* If benefit payments are suspended after the annuity starting date pursuant to a suspension of benefits described in section 411(a)(3)(B) after an employee separates from service, the recommencement of benefit payments after the suspension is not treated as a new annuity starting date unless the plan provides otherwise. In such case, the plan administrator is not required to provide new notices nor to obtain new waivers for the recommenced distributions if the form of distribution is the same as the form that was appropriately selected prior to the suspension. If benefits are suspended for an employee who continues in service without a separation and who never receives payments, the commencement of payments after the period of suspension is treated as the annuity starting date unless the plan provides otherwise.

(2) *Additional accruals.* In the case of an annuity starting date that occurs on or after normal retirement age, such date applies to any additional accruals after the annuity starting date, unless the plan provides otherwise. For example, if a participant who continues to accrue benefits elects to have benefits paid in an optional form at normal retirement age, the additional accruals must be paid in the optional form selected unless the plan provides otherwise. In the case of an annuity starting date that occurs prior to normal retirement age, such date does not apply to any additional accruals after such date.

Q–11: Do the survivor annuity requirements apply to benefits derived from both employer and employee contributions?

A–11: Yes. The survivor annuity benefit requirements apply to benefits derived from both employer and employee contributions. Benefits are not required to be paid in the form of a QPSA or a QJSA if the participant was vested only in employee contributions at the time of death or distribution and such death or distribution occurred before October 22, 1986. All benefits provided under a plan, including benefits attributable to rollover contributions, are subject to the survivor annuity requirements.

Q–12: To what benefits do the survivor annuity requirements of sections 401(a)(11) and 417 apply?

A–12: (a) *Defined benefit plans.* Under a defined benefit plan, sections 401(a)(11) and 417 apply only to benefits in which a participant was vested immediately prior to death. They do not apply to benefits to which a participant's beneficiary becomes entitled by reason of death or to the proceeds of a life insurance contract to the extent such proceeds exceed the present value of the participant's nonforfeitable benefits that existed immediately prior to death.

(b) *Defined contribution plans.* Sections 401(a)(11) and 417 apply to all nonforfeitable benefits which are payable under a defined contribution plan, whether nonforfeitable before or upon death, including the proceeds of insurance contracts.

Q–13: Does the rule of section 411(a)(3)(A) which permits forfeitures on account of death apply to a QPSA or the spousal benefit described in section 401(a)(11)(B)(iii)?

A–13: No. Section 411(a)(3)(A) permits forfeiture on account of death prior to the time all the events fixing payment occur. However, this provision does not operate to deprive a surviving spouse of a QPSA or the spousal benefit described in section 401(a)(11)(B)(iii). Therefore, sections 401(a)(11) and 417 apply to benefits that were nonforfeitable immediately prior to death (determined without regard to section 411(a)(3)(A)). Thus, in the case of the death of a married participant in a defined contribution plan not subject to section 412 which provides that, upon a participant's death, the entire nonforfeitable accrued benefit is payable to the participant's spouse, the nonforfeitable benefit is determined without regard to the provisions of section 411(a)(3)(A).

Q–14: Do sections 411(a)(11), 401(a)(11) and 417 apply to accumulated deductible employee contributions, as defined in section 72(o)(5)(B) (Accumulated DECs)?

A–14: (a) *Employee consent, section 411.* The requirements of section 411(a)(11) apply to Accumulated DECs. Thus, Accumulated DECs may not be distributed without participant consent unless the applicable exemptions apply.

(b) *Survior requirements.* Accumulated DECs are treated as though held under a separate defined contribution plan that is not subject to section 412. Thus, section 401(a)(11) applies to Accumulated DECs only as provided in section 401(a)(11)(B)(iii). All Accumulated DECs are treated in this manner, including Accumulated DECs that are the only benefit held under a plan and Accumulated DECs that are part of a defined benefit or a defined contribution plan.

(c) *Effective date.* Sections 401(a)(11) and 411(a)(11) shall not apply to distributions of accumulated DECs until the first plan year beginning after December 31, 1988.

Q–15: How do the survivor annuity requirements of sections 401(a)(11) and 417 apply to a defined benefit plan that includes an accrued benefit based upon a contribution to a separate account or mandatory employee contributions?

A–15: (a) *414(k) plans.* In the case of a section 414(k) plan that includes both a defined benefit plan and a separate account, the rules of sections 401(a)(11) and 417 apply separately to the defined benefit portion and the separate account portion of the plan. The separate account portion is subject to the survivor annuity requirements of sections 401(a)(11) and 417 and the special QPSA rules in section 417(c)(2).

(b) *Employee contributions*—(1) *Voluntary.* In the case of voluntary employee contributions to a defined benefit plan, the plan must maintain a separate account with respect to the voluntary employee contributions. This separate account is subject to the survivor annuity requirements of sections 401(a)(11) and 417 and the special QPSA rules in section 417(c)(2).

(2) *Mandatory.* In the case of a defined benefit plan providing for mandatory employee contributions, the entire accrued benefit is subject to the survivor annuity requirements of sections 401(a)(11) and 417 as a defined benefit plan.

(c) *Accumulated DECs.* See Q&A 14 of this section for the rule applicable to accumulated deductible employee contributions.

Q–16: Can a plan provide a benefit form more valuable than the QJSA and if a plan offers more than one annuity option satisfying the requirements of a QJSA, is spousal consent required when the participant chooses among the various forms?

A–16: In the case of an unmarried participant, the QJSA may be less valuable than other optional forms of benefit payable under the plan. In the case of a married participant, the QJSA must be at least as valuable as any other optional form of benefit payable under the plan at the same time. Thus, if a plan has two joint and survivor annuities that would satisfy the requirements for a QJSA, but one has a greater actuarial value than the other, the more valuable joint and survivor annuity is the QJSA. If there are two or more actuarially equivalent joint and survivor annuities that satisfy the requirements for a QJSA, the plan must designate which one is the QJSA and, therefore, the automatic form of benefit payment. A plan, however, may allow a participant to elect out of such a QJSA, without spousal consent, in favor of another actuarially equivalent joint and survivor annuity that satisfies the QJSA conditions. Such an election is not subject to the requirement that it be made within the 90-day period before the annuity starting date. For example, if a plan designates a joint and 100% survivor annuity as the QJSA and also offers an actuarially equivalent joint and 50% survivor annuity that would satisfy the requirements of a QJSA, the participant may elect the joint and 50% survivor annuity without spousal consent. The participant, however, does need spousal consent to elect a joint and survivor annuity that was not actuarially equivalent to the automatic QJSA.

Q–17: When must distributions to a participant under a QJSA commence?

A–17: (a) *QJSA benefits upon earliest retirement.* A plan must permit a participant to receive a distribution in the form of a QJSA when the participant attains the earliest retirement age under the plan. Written consent of the participant is required. However, the consent of the participant's spouse is not required. Any payment not in the form of a QJSA is subject to spousal consent. For example, if the participant separates from service under a plan that allows for distributions on separation from service or if a plan allows for in-service distributions, the participant may receive a QJSA without spousal consent in such events. Payments in any other form, including a single sum, would require waiver of the QJSA by the participant's spouse.

(b) *Earliest retirement age.* (1) This paragraph (b) defines the term ''earliest retirement age'' for purposes of sections 401(a)(11), 411(a)(11) and 417.

(2) In the case of a plan that provides for voluntary distributions that commence upon the participant's separation from service, earliest retirement age is the earliest age at which a participant could separate from service and receive a distribution. Death of a participant is treated as a separation from service.

(3) In the case of a plan that provides for in-service distributions, earliest retirement age is the earliest age at which such distributions may be made.

(4) In the case of a plan not described in subparagraph (2) or (3) of this paragraph, the rule below applies. Earliest retirement age is the early retirement age determined under the plan, or if no early retirement age, the normal retirement age determined under the plan. If the participant dies or separates from service before such age, then only the participant's actual years of service at the time of the participant's separation from service or death are taken into account. Thus, in the case of a plan under which benefits are not payable until the attainment of age 65, or upon attainment of age 55 and completion of 10 years of service, the earliest retirement age of a participant who died or separated from service with 8 years of service is when the participant would have attained age 65 (if the participant had survived). On the other hand, if a participant died or separated from service after 10 years of service, the earliest retirement age is when the participant would have attained age 55 (if the participant had survived).

Q–18: What is a qualified preretirement survivor annuity (QPSA) in a defined benefit plan?

A–18: A QPSA is an immediate annuity for the life of the surviving spouse of a participant. Each payment under a QPSA under a defined benefit plan is not to be less than the payment that would have been made to the survivor under the QJSA payable under the plan if (a) in the case of a participant who dies after attaining the earliest retirement age under the plan, the participant had retired with a QJSA on the day before the participant's death, and (b) in the case of a participant who dies on or before the participant's earliest retirement age under the plan, the participant had separated from service at the earlier of the actual time of separation or death, survived until the earliest retirement age, retired at that time with a QJSA, and died on the day thereafter. If the participant elects before the annuity starting date a form of joint and survivor annuity that satisfies the requirements for a QJSA and dies before the annuity starting date, the elected form is treated as the QJSA and the QPSA must be based on such form.

Q–19: What rules apply in determining the amount and forfeitability of a QPSA?

A–19: The QPSA is calculated as of the earliest retirement age if the participant dies before such time, or at death if the participant dies after the earliest retirement age. The plan must make reasonable actuarial adjustments to reflect a payment earlier or later than the earliest retirement age. A defined benefit plan may provide that the QPSA is forfeited if the spouse does not survive until the date prescribed under the plan for commencement of the QPSA (*i.e.,* the earliest retirement age). Similarly, if the spouse survives past the participant's earliest retirement age (or other earlier QPSA distribution date under the plan) and elects after the death of the participant to defer the commencement of the QPSA to a later date, a defined benefit plan may provide for a forfeiture of the QPSA benefit if the spouse does not survive until the deferred commencement date. The account balance in a defined contribution plan may not be forfeited even though the spouse does not survive until the time the account balance is used to purchase the QPSA. See Q&A–17 of this section for the meaning of earliest retirement age.

Q–20: What preretirement survivor annuity benefits must a defined contibution plan subject to the survivor annuity requirements of sections 401(a)(11) and 417 provide?

A–20: A defined contribution plan that is subject to the survivor annuity requirements of sections 401(a)(11) and 417 must provide a preretirement survivor annuity with a value which is not less than 50 percent of the nonforfeitable account balance of the participant as of the date of the participant's death. If a contributory defined contribution plan has a forfeiture provision permitted by section 411(a)(3)(A), not more than a proportional percent of the account balance attributable to contributions that may not be forfeited at death (for example, employee and section 401(k) contributions) may be used to satisfy the QPSA benefit. Thus, for example, if the QPSA benefit is to be provided from 50 percent of the account balance, not more than 50 percent of the nonforfeitable contributions may be used for the QPSA.

Q–21: May a defined benefit plan charge the participant for the cost of the QPSA benefit?

A–21: Prior to the later of the time the plan allows the participant to waive the QPSA or provides notice of the ability to waive the QPSA, a defined benefit plan may not charge the participant for the cost of the QPSA by reducing the participant's plan benefits or by any other method. The preceding sentence does not apply to any charges prior to the first plan year beginning after December 31, 1988. Once the participant is given the opportunity to waive the QPSA or the notice of the QPSA is later, the plan may charge the participant for the cost of the QPSA. A charge for the QPSA that reasonably reflects the cost of providing the QPSA will not fail to satisfy section 411 even if it reduces the accrued benefit.

Q–22: When must distributions to a surviving spouse under a QPSA commence?

A–22: (a) In the case of a defined benefit plan, the plan must permit the surviving spouse to direct the commencement of payments under QPSA no later than the month in which the participant would have attained the earliest retirement age. However, a plan may permit the commencement of payments at an earlier date.

(b) In the case of a defined contribution plan, the plan must permit the surviving spouse to direct the commencement of payments under the QPSA within a reasonable time after the participant's death.

Q–23: Must a defined benefit plan obtain the consent of a participant and the participant's spouse to commence payments in the form of a QJSA in order to avoid violating section 415 or 411(b)?

A–23: No. A defined benefit plan may commence distributions in the form of a QJSA without the consent of the participant and spouse, even if consent would otherwise be required (see § 1.417(e)–1(b)), to the extent necessary to avoid a violation of section 415 or 411(b). For example, assume a plan has a normal retirement age of 55. A is a married participant, age 55, and has accrued a $75,000 joint and 100 percent survivor annuity that satisfies section 415. If an actuarial increase would be required under section 411 because of deferred commencement and the increase would cause the benefit to exceed the applicable limit under section 415, the plan may commence payment of a QJSA at age 55 without the participant's election or consent and without the spouse's concent.

Q–24: What are the rules under sections 401(a)(11) and 417 applicable to plan loans?

A–24: (a) *Consent rules.* (1) A plan does not satisfy the survivor annuity requirements of sections 401(a)(11) and 417 unless the plan provides that, at the time the participant's accrued benefit is used as security for a loan, spousal consent to such use is obtained. Consent is required even if the accrued benefit is not the primary security for the loan. No spousal consent is necessary if, at the time the loan is secured, no consent would be required for a distribution under section 417(a)(2)(B). Spousal consent is not required if the plan or the participant is not subject to section 401(a)(11) at the time the accrued benefit is used as security, or if the total accrued benefit subject to the security is not in excess of the cash-out limit in effect under §1.411(a)–11T(c)(3)(ii). The spousal consent must be obtained no earlier than the beginning of the 90-day period that ends on the date on which the loan is to be so secured. The consent is subject to the requirements of section 417(a)(2). Therefore, the consent must be in writing, must acknowledge the effect of the loan and must be witnessed by a plan representative or a notary public.

(2) Participant consent is deemed obtained at the time the participant agrees to use his accrued benefit as security for a loan for purposes of satisfying the requirements for participant consent under sections 401(a)(11), 411(a)(11) and 417.

(b) *Change in status.* If spousal consent is obtained or is not required under paragraph (a) of this Q&A 24 at the time the benefits are used as security, spousal consent is not required at the time of any setoff of the loan against the accrued benefit resulting from a default, even if the participant is married to a different spouse at the time of the setoff. Similarly, in the case of a participant who secured a loan while unmarried, no consent is required at the time of a setoff of the loan against the accrued benefit even if the participant is married at the time of the setoff.

(c) *Renegotiation.* For purposes of obtaining any required spousal consent, any renegotiation, extension, renewal, or other revision of a loan shall be treated as a new loan made on the date of the renegotiation, extension, renewal, or other revision.

(d) *Effect on benefits.* For purposes of determining the amount of a QPSA or QJSA, the accrued benefit of a participant shall be reduced by any security interest held by the plan by reason of a loan outstanding to the participant at the time of death or payment, if the security interest is treated as payment in satisfaction of the loan under the plan. A plan may offset any loan outstanding at the participant's death which is secured by the participant's account balance against the spousal benefit required to be paid under section 401(a)(11)(B)(iii).

(e) *Effective date.* Loans made prior to August 19, 1985, are deemed to satisfy the consent requirements of paragraph (a) of this Q&A 24.

Q–25: How do the survivor annuity requirements of sections 401(a)(11) and 417 apply with respect to participants who are not married or to surviving spouses and participants who have a change in marital status?

A–25: (a) *Unmarried participant rule.* Plans subject to the survivor annuity requirements of sections 401(a)(11) and 417 must satisfy those requirements applicable to QJSAs with respect to participants who are not married. A QJSA for a participant who is not married is an annuity for the life of the participant. Thus, an unmarried participant must be provided the written explanation described in section 417(a)(3)(A) and a single life annuity unless another form of benefit is elected by the participant. An unmarried participant is deemed to have waived the QPSA requirements. This deemed waiver is null and void if the participant later marries.

(b) *Marital status change.*—(1) *Remarriage.* If a participant is married on the date of death, payments to a surviving spouse under a QPSA or QJSA must continue even if the surviving spouse remarries.

(2) *One-year rule.* (i) A plan is not required to treat a participant as married unless the participant and the participant's spouse have been married throughout the one-year period ending on the earlier of (A) the participant's annuity starting date or (B) the date of the participant's death. Nevertheless, for purposes of the preceding sentence, a participant and the participant's spouse must be treated as married throughout the one-year period ending on the participant's annuity starting date even though they are married to each other for less than one year before the annuity starting date if they remain married to each other for at least one year. See section 417(d)(2). If a plan adopts the one-year rule provided in section 417(d), the plan must treat the participant and spouse who are married on the annuity starting date as married and must provide benefits which are to commence on the annuity starting date in the form of a QJSA unless the participant (with spousal consent) elects another form of benefit. The plan is not required to provide the participant with a new or retroactive election or the spouse with a new consent when the one-year period is satisfied. If the participant and the spouse do not remain married for at least one year, the plan may treat the participant as having not been married on the annuity starting date. In such event, the plan may provide that the spouse loses any survivor benefit right; further, no retroactive correction of the amount paid the participant is required.

(ii) *Example.* Plan X provides that participants who are married on the annuity starting date for less than one year are treated as unmarried participants. Plan X provides benefits in the form of a QJSA or an optional single sum distribution. Participant A was married 6 months prior to the annuity starting date. Plan X must treat A as married and must commence payments to A in the form of a QJSA unless another form of benefit is elected by A with spousal consent. If a QJSA is paid and A is divorced from his spouse S, within the first year of the marriage, S will no longer have any survivor rights under the annuity (unless a QDRO provides otherwise). If A continues to be married to S, and A dies within the one-year period, Plan X may treat A as unmarried and forfeit the OJSA benefit payable to S.

(3) *Divorce.* If a participant divorces his spouse prior to the annuity starting date, any elections made while the participant was married to his former spouse remain valid, unless otherwise provided in a QDRO, or unless the participant changes them or is remarried. If a participant dies after the annuity starting date, the spouse to whom the participant was married on the annuity starting date is entitled to the QJSA protection under the plan. The spouse is entitled to this protection (unless waived and consented to by such spouse) even if the participant and spouse are not married on the date of the participant's death, except as provided in a QDRO.

Q–26: In the case of a defined contribution plan not subject to section 412, does the requirement that a participant's nonforfeitable accrued benefit be payable in full to a surviving spouse apply to a spouse who has been married to the participant for less than one year?

A–26: A plan may provide that a spouse who has not been married to a participant throughout the one-year period ending on the earlier of (a) the participant's annuity starting date or (b) the date of the participant's death is not treated as a surviving spouse and is not required to receive the participant's account balance. The special exception described in section 417(d)(2) and Q&A 25 of this section does not apply.

Q–27: Are there circumstances when spousal consent to a participant's election to waive the QJSA or the QPSA is not required?

A–27: Yes. If it is established to the satisfaction of a plan representative that there is no spouse or that the spouse cannot be located, spousal consent to waive the QJSA or the QPSA is not required. If the spouse is legally incompetnent to give consent, the spouse's legal guardian, even if the guardian is the participant, may give consent. Also, if the participant is legally separated or the participant has been abandoned (within the meaning of local law) and the participant has a court order to such effect, spousal consent is not required unless a QDRO provides otherwise. Similar rules apply to a plan subject to the requirements of section 401(a)(11)(B)(iii)(I).

Q–28: Does consent contained in an antenuptial agreement or similar contract entered into prior to marriage satisfy the consent requirements of sections 401(a)(11) and 417?

A–28: No. An agreement entered into prior to marriage does not satisfy the applicable consent requirements, even if the agreement is executed within the applicable election period.

Q–29: If a participant's spouse consents under section 417(a)(2)(A) to the participant's waiver of a survivor annuity form of benefit, is a subsequent spouse of the same participant bound by the consent?

A–29: No. A consent under section 417(a)(2)(A) by one spouse is binding only with respect to the consenting spouse. See Q&A–24 of this section for an exception in the case of plan benefits securing plan loans.

Q–30: Does the spousal consent requirement of section 417(a)(2)(A) require that a spouse's consent be revocable?

A–30: No. A plan may preclude a spouse from revoking consent once it has been given. Alternatively, a plan may also permit a spouse to revoke a consent after it has been given, and thereby to render ineffective the participant's prior election not to receive a QPSA or QJSA. A participant must always be allowed to change his election during the applicable election period. Spousal consent is required in such cases to the extent provided in Q&A 31, except that spousal consent is never required for a QJSA or QPSA.

Q–31: What rules govern a participant's waiver of a QPSA or QJSA under section 417(a)(2)?

A–31: (a) *Specific beneficiary.* Both the participant's waivers of a QPSA and QJSA and the spouse's consents thereto must state the specific nonspouse beneficiary (including any class of beneficiaries or any contingent beneficiaries) who will receive the benefit. Thus, for example, if spouse B consents to participant A's election to waive a QPSA, and to have any benefits payable upon A's death before the annuity starting date paid to A's children, A may not subsequently change beneficiaries without the consent of B (except if the change is back to a QPSA). If the designated beneficiary is a trust, A's spouse need only consent to the designation of the trust and need not consent to the designation of trust beneficiaries or any changes of trust beneficiaries.

(b) *Optional form of benefit*—(1) *QJSA.* Both the participant's waiver of a QJSA (and any required spouse's consent thereto) must specify the particular optional form of benefit. The participant who has waived a QJSA with the spouse's consent in favor of another form of benefit may not subsequently change the optional form of benefit without obtaining the spouse's consent (except back to a QJSA). Of course, the participant may change the form of benefit if the plan so provides after the spouse's death or a divorce (other than as provided in a QDRO). A participant's waiver of a QJSA (and any required spouse's consent thereto) made prior to the first plan year beginning after December 31, 1986, is not required to specify the optional form of benefit.

(2) *QPSA.* A participant's waiver of a QPSA and the spouse's consent thereto are not required to specify the optional form of any preretirement benefit. Thus, a participant who waives the QPSA with spousal consent may subsequently change the form of the preretirement benefit, but not the nonspouse beneficiary, without obtaining the spouse's consent.

(3) *Change in form.* After the participant's death, a beneficiary may change the optional form of survivor benefit as permitted by the plan.

(c) *General consent.* In lieu of satisfying paragraphs (a) and (b) of this Q&A 31, a plan may permit a spouse to execute a general consent that satisfies the requirements of this paragraph (c). A general consent permits the participant to waive a QPSA or QJSA, and change the designated beneficary or the optional form of benefit payment without any requirement of further consent by such spouse. No general consent is valid unless the general consent acknowledges that the spouse has the right to limit consent to a specific beneficiary and a specific optional form of benefit, where applicable, and that the spouse voluntarily elects to relinquish both of such rights. Notwithstanding the previous sentence, a spouse may execute a general consent that is limited to certain beneficiaries or forms of benefit payment. In such case, paragraphs (a) and (b) of this Q&A 31 shall apply to the extent that the limited general consent is not applicable and this paragraph (c) shall apply to the extent that the limited general consent is applicable. A general consent, including a limited general consent, is not effective unless it is made during the applicable election period. A general consent executed prior to October 22, 1986 does not have to satisfy the specificity requirements of this Q&A 31.

Q–32: What rules govern a participant's waiver of the spousal benefit under section 401(a)(11)(B)?

A–32: (a) *Application.* In the case of a defined contribution plan that is not subject to the survivor annuity requirements of sections 401(a)(11) and 417, a participant may waive the spousal benefit of section 401(a)(11)(B)(iii) if the conditions of paragraph (b) are satisfied. In general, a spousal benefit is the nonforfeitable account balance on the participant's date of death.

(b) *Conditions.* In general, the same conditions, other than the age 35 requirement, that apply to the participant's waiver of a QPSA and the spouse's consent thereto apply to the participant's waiver of the spousal benefit and the spouse's consent thereto. See Q&A–31. Thus, the participant's waiver of the spousal benefit must state the specific nonspouse beneficiary who will receive such benefit. The waiver is not required to specify the optional form of benefit. The participant may change the optional form of benefit, but not the nonspouse beneficiary, without obtaining the spouse's consent.

Q–33: When and in what manner, may a participant waive a spousal benefit or a QPSA?

A–33: (a) *Plans not subject to section 401(a)(11).* A participant in a plan that is not subject to the survivor annuity requirements of section 401(a)(11) (because of subparagraph (B)(iii) thereof) may waive the spousal benefit at any time, provided that no such waiver shall be effective unless the spouse has consented to the waiver. The spouse may consent to a waiver of the spousal benefit at any time, even prior to the participant's attaining age 35. No spousal consent is required for a payment to the participant or the use of the accrued benefit as security for a plan loan to the participant.

(b) *Plans subject to section 401(a)(11).* A participant in a plan subject to the survivor annuity requirements of section 401(a)(11) generally may waive the QPSA benefit (with spousal consent) only on or after the first day of the plan year in which the participant attains age 35. However, a plan may provide for an earlier waiver (with spousal consent), provided that a written explanation of the QPSA is given to the participant and such waiver becomes invalid upon the beginning of the plan year in which the participant's 35th birthday occurs. If there is no new waiver after such date, the participant's spouse must receive the QPSA benefit upon the participant's death.

Q–34: Must the written explanations required by section 417(a)(3) be provided to nonvested participants?

A–34: Such written explantions must be provided to nonvested participants who are employed by an employer maintaining the plan. Thus, they are not required to be provided to those nonvested participants who are no longer employed by such an employer.

Q–35: When must a plan provide the written explanation, required by section 417(a)(3)(B), of the QPSA to a participant?

A–35: (a) *General rule.* A plan must provide the written explanation of the QPSA to a participant within the applicable period. Except as provided in paragraph (b), the applicable period means, with respect to a participant, whichever of the following periods ends last:

(1) The period beginning with the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year preceding the plan year in which the participant attains age 35.

(2) A reasonable period ending after the individual becomes a participant.

(3) A reasonable period ending after the QPSA is no longer fully subsidized.

(4) A reasonable period ending after section 401(a)(11) first applies to the participant. Section 401(a)(11) would first apply when a benefit is transferred from a plan not subject to the survivor annuity requirements of section 401(a)(11) to a plan subject to such section or at the time of an election of an annuity under a defined contribution plan described in section 401(a)(11)(B)(iii).

(b) *Pre-35 separations.* In the case of a participant who separates from service before attaining age 35, the applicable period means the period beginning one year before the separation from service and ending one year after such separation. If such a participant returns to service, the plan must also comply with pragraph (a).

(c) *Reasonable period.* For purposes of applying paragraph (a), a reasonable period ending after the enumerated events described in paragraphs (a) (2), (3) and (4) is the end of the one-year period beginning with the date the applicable event occurs. The applicable period for such events begins one year prior to the occurrence of the enumerated events.

(d) *Transition rule.* In the case of an individual who was a participant in the plan on August 23, 1984, and, as of that date had attained age 34, the plan will satisfy the requriement of section 417(a)(3)(B) if it provided the explanation not later than December 31, 1985.

Q–36: How do plans satisfy the requirements of providing participants explanations of QPSAs and QJSAs?

A–36: Section 417(a)(3) sets forth the requirements for providing plan participants written explanations of QPSAs and QJSAs. The requirement that the terms and conditions of the QJSA or QPSA, as the case may be, be furnished to participants is not satisfied unless the written explanation complies with the requirements set forth in §1.401(a)–11(c)(3). Also, for plan years beginning after December 31, 1988, participants must be furnished a general description of the eligibility conditions and other material features of the optional forms of benefit and sufficient additional information to explain the relative values of the optional forms of benefit available under the plan (*e.g.*, the extent to which optional forms are subsidized relative to the normal form of benefit or the interest rates used to calculate the optional forms).

Q–37: What are the consequences of fully subsidizing the cost of either a QJSA or a QPSA in accordance with section 417(a)(5)?

A–37: If a plan fully subsidizes a QJSA or QPSA in accordance with section 417(a)(5) and does not allow a participant to waive such QJSA or QPSA or to select a nonspouse beneficiary, the plan is not required to provide the written explanation required by section 417(a)(3). However, if the plan offers an election to waive the benefit or designate a beneficiary, it must satisfy the election, consent, and notice requirements of section 417(a) (1), (2), and (3), with respect to such subsidized QJSA or QPSA, in accordance with section 417(a)(5).

Q–38: What is a fully subsidized benefit?

A–38: (a) *QJSA*—(1) *General rule.* A fully subsidized QJSA is one under which no increase in cost to, or decrease in actual amounts received by, the participant may result from the participant's failure to elect another form of benefit.

(2) *Examples.*

Example (1). If a plan provides a joint and survivor annuity and a single sum option, the plan does not fully subsidize the joint and survivor annuity, regardless of the actuarial value of the joint and survivor annuity because, in the event of the participant's early death, the participant would have received less under the annuity than he would have received under the single sum option.

Example (2). If a plan provides for a life annuity of $100 per month and a joint and 100% survivor benefit of $99 per month, the plan does not fully subsidize the joint and survivor benefit.

(b) *QPSA.* A QPSA is fully subsidized if the amount of the participant's benefit is not reduced because of the QPSA coverage and if no charge to the participant under the plan is made for the coverage. Thus, a QPSA is fully subsidized in a defined contribution plan.

Q–39: When do the survivor annuity requirements of sections 401(a)(11) and 417 apply to plans?

A–39: Sections 401(a)(11) and 417 generally apply to plan years beginning after December 31, 1984. Sections 302 and 303 of REA 1984 provide specific effective dates and transitional rules under which the QJSA or QPSA (or pre-REA 1984 section 401(a)(11)) requirements may be applicable to particular plans or with respect to benefits provided to (as amended by REA 1984) particular participants. In general, the section 401(a)(11) (as amended by REA 1984) survivor annuity requirements do not apply with respect to a participant who does not have at least one hour of service or one hour of paid leave under the plan after August 22, 1984.

Q–40: Are there special effective dates for plans maintained pursuant to collective bargaining agreements?

A–40: Yes. Section 302(b) of REA 1984 as amended by section 1898(g) of the Tax Reform Act of 1986 provides a special deferred effective date for such plans. Whether a plan is described in section 302(b) of REA 1984 is determined under the principles applied under section 1017(c) of the Employee Retirement Income Security Act of 1974. See H.R. Rep. No. 1280, 93d Cong., 2d Sess. 266 (1974). In addition, a plan will not be treated as maintained under a collective bargaining agreement unless the employee representatives satisfy section 7701(a)(46) of the Internal Revenue Code after March 31, 1984. See § 301.7701–17T for other requirements for a plan to be considered to be collectively bargained. Nothing in section 302(b) of REA 1984 denies a participant or spouse the rights set forth in sections 303(c)(2), 303(c)(3), 303(e)(1), and 303(e)(2) of REA 1984.

Q–41: What is one hour of service or paid leave under the plan for purposes of the transition rules in section 303 of REA 1984?

A–41: One hour of service or paid leave under the plan is one hour of service or paid leave recognized or required to be recognized under the plan for any purpose, *e.g.*, participation, vesting percentage, or benefit accrual purposes. For plans that do not compute hours of service, one hour of service or paid leave means any service or paid leave recognized or required to be recognized under the plan for any purpose.

Q–42: Must a plan be amended to provide for the QPSA required by section 303(c)(2) of REA 1984, or for the survivor annuities required by section 303(e) of REA 1984?

A–42: A plan will not fail to satisfy the qualification requirements of section 401(a) or 403(a) merely because it is not amended to provide the QPSA required by section 303(c)(2) or the survivor annuities required by section 303(e). The plan must, however, satisfy those requirements in operation.

Q–43: Is a participant's election, or a spouse's consent to an election, with respect to a QPSA, made before August 23, 1984, valid?

A–43: No.

Q–44: Is spousal consent required for certain survivor annuity elections made by the participant after December 31, 1984, and before the first plan year to which new sections 401(a)(11) and 417 apply?

A–44: Yes. Section 303(c)(3) of REA 1984 provides that any election not to take a QJSA made after December 31, 1984, and before the date sections 401(a)(11) and 417 apply to the plan by a participant who has 1 hour of service or leave under the plan after August 23, 1984, is not effective unless the spousal consent requirements of section 417 are met with respect to such election. Unless the participant's annuity starting date occurred before January 1, 1985, the spousal consent required by section 417 (a)(2) and (e) must be obtained even though the participant elected the benefit prior to January 1, 1985. The plan is not required to be amended to comply with section 303(c)(3) of REA 1984, but the plan must satisfy this requirement in operation.

Q–45: Are there special rules for certain participants who separated from service prior to August 23, 1984?

A–45: Yes. Section 303(e) of REA 1984 provides special rules for certain participants who separated from service before August 23, 1984. Section 303(e)(1), which applies only to plans subject to section 401(a)(11) of the Code (as in effect on August 22, 1984), provides that participants whose annuity starting date did not occur before August 24, 1984, and who had one hour of service on or after September 2, 1974, but not in a plan year beginning after December 31, 1975, may elect to receive the benefits required to be provided under section 401(a)(11) of the Code (as in effect on August 22, 1984). Section 303(e)(2) provides that certain participants who had one hour of service in a plan year beginning on or after January 1, 1976, but not after August 22, 1984, may elect QPSA coverage under new sections 401(a)(11) and 417 in plans subject to these provisions. Section 303(e)(4)(A) requires plans or plan administrators to notify those participants of the provisions of section 303(e).

Q–46: When must a plan provide the notice required by section 303(e)(4)(A) of REA 1984?

A–46: The notice required by section 303(e)(4)(A) must be provided no later than the earlier of:

(a) The date the first summary annual report provided after September 17, 1985, is distributed to participants; or

(b) September 30, 1985.

A plan will not fail to satisfy the preceding sentence if the plan provides a fully subsidized QPSA with respect to any participant described in section 303(e) who dies on or after July 19, 1985, and before the notice is received. If the plan ceases to fully subsidize the QPSA, the cessation must not be effective until the notice is given. For this purpose, an annuity payable to a nonspouse beneficiary elected by the participant, in lieu of a spouse, shall satisfy the QPSA requirement, so long as the survivor benefit is fully subsidized. The notice required by this paragraph must be in writing and sent to the participant's last known address.

Q–47: Is there another time when plans must provide notice of the right, described in section 303(e)(1) of REA '84, to elect a pre-REA 1984 qualified joint and survivor annuity?

A–47: Yes. Notice of this right must also be provided to a participant at the time the participant applies for benefit payments.

[53 FR 31842, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988, as amended by T.D. 8794, 63 FR 70338, Dec. 21, 1998]

§1.401(a)–30 Limit on elective deferrals.

(a) *General Rule.* A trust that is part of a plan under which elective deferrals may be made during a calendar year is not qualified under section 401(a) unless the plan provides that the elective deferrals on behalf of an individual under the plan and all other plans, contracts, or arrangements of the employer maintaining the plan may not exceed the applicable limit for the individual's taxable year beginning in the calendar year. A plan may incorporate the applicable limit by reference. In the case of a plan maintained by more than one employer to which section 413 (b) or (c) applies, section 401(a)(30) and this section are applied as if each employer maintained a separate plan. See §1.402(g)–1(e) for rules permitting the distribution of excess deferrals to prevent disqualification of a plan or trust for failure to comply in operation with section 401(a)(30).

(b) *Definitions.* For purposes of this section:

(1) *Applicable limit.* The term ''applicable limit'' has the meaning provided in §1.402(g)–1(d).

(2) *Elective deferrals.* The term ''elective deferrals'' has the meaning provided in §1.402(g)–1(b).

(c) *Effective date*—(1) *In general.* Except as otherwise provided in this paragraph (c), this section is effective for plan years beginning after December 31, 1987.

(2) *Transition rule.* For plan years beginning in l988, a plan may rely on a reasonable interpretation of the law as in effect on December 31, 1987.

(3) *Deferrals under collective bargaining agreements.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, this section does not apply to contributions made pursuant to a collective bargaining agreement for plan years beginning before the earlier of:

(i) The later of January 1, 1988, or the date on which the last collective bargaining agreement terminates (determined without regard to any extension thereof after February 28, 1986), or

(ii) January 1, 1989.

[T.D. 8357, 56 FR 40516, Aug. 15, 1991]

§ 1.401(a)–50 Puerto Rican trusts; election to be treated as a domestic trust.

(a) *In general.* Section 401(a) requires, among other things, that a trust forming part of a pension, profit-sharing, or stock bonus plan must be created or organized in the United States to be a qualified trust. Section 1022(i)(2) of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 942) provides that trusts under certain pension, etc., plans created or organized in Puerto Rico whose administrators have made the election referred to in section 1022(i)(2) are to be treated as trusts created or organized in the United States for purposes of section 401(a). Thus, if a plan otherwise satisfies the qualification requirements of section 401(a), any trust forming part of the plan for which an election is made will be treated as a qualified trust under that section.

(b) *Manner and effect of election.* A plan administrator may make an election under ERISA section 1022(i)(2) by filing a statement making the election, along with a copy of the plan, with the Director's Representative of the Internal Revenue Service in Puerto Rico. The statement making the election must indicate that it is being made under ERISA section 1022(i)(2). The statement may also be filed in conjunction with a written request for a determination letter. If the election is made with a written request for a determination letter, the election may be conditioned upon issuance of a favorable determination letter and will be irrevocable upon issuance of such letter. Otherwise, once made, an election is irrevocable. It is generally effective for plan years beginning after the date it has been made. However, an election made before March 3, 1983 may, at the option of the plan administrator at the time he or she makes the election, be considered to have been made on any date between September 2, 1974, and the actual date of the election. The election will then be effective for plan years beginning on or after the date chosen by the plan administrator.

(c) *Annuities, custodial accounts, etc.* See section 401 (f) for rules relating to the treatment of certain annuities, custodial accounts or other contracts, as trusts for purposes of section 401(a).

(d) *Source of plan distributions to participants and beneficiaries residing outside the United States.* Except as provided under section 871(f) (relating to amounts received as an annuity by nonresident aliens), the amount of a distribution from an electing plan that is to be treated as income from sources within the United States is determined as described below. The portion of the distribution considered to be a return of employer contributions is to be treated as income from sources within the United States in an amount equal to the portion of the distribution considered to be a return of employer contributions multiplied by the following fraction:

$$\frac{\text{Days of performance of labor or services within the United States for the employer.}}{\text{Total days of performance of labor or services for the employer.}}$$

The days of performance of labor or services within the United States shall not include the time period for which the employee's compensation is deemed not to be income from sources within the United States under subtitle A of the Code. Thus, for example, if an employee's compensation was not deemed to be income from sources within the United States under section 861(a)(3), then the time the emloyee was present in the United States while such compensation was earned would not be included in determining the days of performance of labor or services within the United States in the numerator of the above fraction. In addition, days of performance of labor or services for the employer in both the numerator and denominator of the above fraction are limited to days of plan participation by the employee and any service used for determining an employee's accrued benefit under the plan. The remaining portion of the distribution, that is, any amount other than the portion of the distribution considered to be a return of employer contributions, is not to be treated as income from sources within the United

States. For example, if a distribution consists of amounts representing employer contributions, employee contributions, and earnings on employer and employee contributions, no part of the portion of the distribution attributable to employee contributions, or earnings on employer and employee contributions, will be treated as income from sources within the United States.

[T.D. 7859, 47 FR 54297, Dec. 2, 1982]

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[T.D. 8485, 58 FR 46778, Sept. 3, 1993]

§1.401(a)(4)–1 Nondiscrimination requirements of section 401(a)(4).

(a) *In general.* Section 401(a)(4) provides that a plan is a qualified plan only if the contributions or the benefits provided under the plan do not discriminate in favor of HCEs. Whether a plan satisfies this requirement depends on the form of the plan and on its effect in operation. In making this determination, intent is irrelevant. This section sets forth the exclusive rules for determining whether a plan satisfies section 401(a)(4). A plan that complies in form and operation with the rules in this section therefore satisfies section 401(a)(4).

(b) *Requirements a plan must satisfy*—(1) *In general.* In order to satisfy section 401(a)(4), a plan must satisfy each of the requirements of this paragraph (b).

(2) *Nondiscriminatory amount of contributions or benefits*—(i) *General rule.* Either the contributions or the benefits provided under the plan must be nondiscriminatory in amount. It need not be shown that both the contributions and the benefits provided are nondiscriminatory in amount, but only that either the contributions alone or the benefits alone are nondiscriminatory in amount.

(ii) *Defined contribution plans*—(A) *General rule.* A defined contribution plan satisfies this paragraph (b)(2) if the contributions allocated under the plan (including forfeitures) are nondiscriminatory in amount under §1.401(a)(4)–2. Alternatively, a defined contribution plan (other than an ESOP) satisfies this paragraph (b)(2) if the equivalent benefits provided under the plan are nondiscriminatory in amount under §1.401(a)(4)–8(b). Section 1.401(a)(4)–8(b) includes a safe-harbor testing method for contributions provided under a target benefit plan.

(B) *Section 401(k) plans and section 401(m) plans.* A section 401(k) plan is deemed to satisfy this paragraph (b)(2) because § 1.410(b)–9 defines a section 401(k) plan as a plan consisting of elective contributions under a qualified cash or deferred arrangement (i.e., one that satisfies section 401(k)(3), the nondiscriminatory amount requirement applicable to qualified cash or deferred arrangements). A section 401(m) plan satisfies this paragraph (b)(2) only if the plan satisfies §§ 1.401(m)–1(b) and 1.401(m)–2. Contributions under a nonqualified cash or deferred arrangement, elective contributions described in § 1.401(k)–1(b)(4)(iv) that fail to satisfy the allocation and compensation requirements of § 1.401(k)–1(b)(4)(i), matching contributions that fail to satisfy § 1.401(m)–1(b)(4)(ii)(A), and qualified nonelective contributions treated as elective or matching contributions for certain purposes under §§ 1.401(k)–1(b)(5) and 1.401(m)–1(b)(5), respectively, are not subject to the special rule in this paragraph (b)(2)(ii)(B), because they are not treated as part of a section 401(k) plan or section 401(m) plan as those terms are defined in § 1.410(b)–9. The contributions described in the preceding sentence must satisfy paragraph (b)(2)(ii)(A) of this section.

(iii) *Defined benefit plans.* A defined benefit plan satisfies this paragraph (b)(2) if the benefits provided under the plan are nondiscriminatory in amount under § 1.401(a)(4)–3. Alternatively, a defined benefit plan satisfies this paragraph (b)(2) if the equivalent allocations provided under the plan are nondiscriminatory in amount under § 1.401(a)(4)–8(c). Section 1.401(a)(4)–8(c) includes a safe-harbor testing method for benefits provided under a cash balance plan. In addition, § 1.401(a)(4)–8(d) provides a safe-harbor testing method for benefits provided under a defined benefit plan that is part of a floor-offset arrangement.

(3) *Nondiscriminatory availability of benefits, rights, and features.* All benefits, rights, and features provided under the plan must be made available in the plan in a nondiscriminatory manner. Rules for determining whether this requirement is satisfied are set forth in § 1.401(a)(4)–4.

(4) *Nondiscriminatory effect of plan amendments and terminations.* The timing of plan amendments must not have the effect of discriminating significantly in favor of HCEs. Rules for determining whether this requirement is satisfied are set forth in § 1.401(a)(4)–5(a). Section 1.401(a)(4)–5(b) provides additional requirements regarding plan terminations.

(c) *Application of requirements*—(1) *In general.* The requirements of paragraph (b) of this section must be applied in accordance with the rules set forth in this paragraph (c).

(2) *Interpretation.* The provisions of §§ 1.401(a)(4)–1 through 1.401(a)(4)–13 must be interpreted in a reasonable manner consistent with the purpose of preventing discrimination in favor of HCEs.

(3) *Plan-year basis of testing.* The requirements of paragraph (b) of this section are generally applied on the basis of the plan year and on the basis of the terms of the plan in effect during the plan year. Thus, unless otherwise provided, the compensation, contributions, benefit accruals, and other items used to apply these requirements must be determined with respect to the plan year being tested. However, § 1.401(a)(4)–11(g) provides rules allowing for corrective amendments made after the close of the plan year to be taken into account in satisfying certain requirements under paragraph (b) of this section.

(4) *Application of section 410(b) rules*—(i) *Relationship between sections 401(a)(4) and 410(b).* To be a qualified plan, a plan must satisfy both sections 410(b) and 401(a)(4). Section 410(b) requires that a plan benefit a nondiscriminatory group of employees, and section 401(a)(4) requires that the contributions or benefits provided to employees benefiting under the plan not discriminate in favor of HCEs. Consistent with this requirement, the definition of a plan subject to testing under section 401(a)(4) is the same as the definition of a plan subject to testing under section 410(b), i.e., the plan determined after applying the mandatory disaggregation rules of § 1.410(b)–7(c) and the permissive aggregation rules of § 1.410(b)–7(d). In addition, whichever testing option is used for the plan year under § 1.410(b)–8(a) (e.g., quarterly testing) must also be used for purposes of determining whether the

plan satisfies section 401(a)(4) for the plan year.

(ii) *Special rules for certain aggregated plans.* Special rules are set forth in §1.401(a)(4)–9(b) for applying the nondiscriminatory amount and availability requirements of paragraphs (b)(2) and (b)(3) of this section to a plan that includes one or more defined benefit plans and one or more defined contribution plans that have been permissively aggregated under §1.410(b)–7(d).

(iii) *Restructuring.* In certain circumstances, a plan may be restructured on the basis of employee groups and treated as comprising two or more plans, each of which is treated as a separate plan that must independently satisfy sections 401(a)(4) and 410(b). Rules relating to restructuring plans for purposes of applying the requirements of paragraph (b) of this section are set forth in §1.401(a)(4)–9(c).

(iv) *References to section 410(b).* Except as otherwise specifically provided, references to satisfying section 410(b) in §§1.401(a)(4)–1 through 1.401(a)(4)–13 mean satisfying §1.410(b)–2 (taking into account any special rules available in satisfying that section, other than the permissive aggregation rules of §1.410(b)–7(d)). In the case of a plan described in section 410(c)(1) that has not made the election described in section 410(d) and is not subject to section 403(b)(12)(A)(i), references in §§1.401(a)(4)–1 through 1.401(a)(4)–13 to satisfying section 410(b) mean satisfying section 410(c)(2).

(5) *Collectively-bargained plans.* The requirements of paragraph (b) of this section are treated as satisfied by a collectively-bargained plan that automatically satisfies section 410(b) under §1.410(b)–2(b)(7).

(6) *Former employees.* In applying the nondiscriminatory amount and availability requirements of paragraphs (b)(2) and (b)(3) of this section, former employees are tested separately from active employees, unless otherwise provided. Rules for applying paragraphs (b)(2) and (b)(3) of this section to former employees are set forth in §1.401(a)(4)–10.

(7) *Employee-provided contributions and benefits.* In applying the nondiscriminatory amount requirement of paragraph (b)(2) of this section, employee-provided contributions and benefits are tested separately from employer-provided contributions and benefits, unless otherwise provided. Rules for determining the amount of employer-provided benefits under a defined benefit plan that include employee contributions not allocated to separate accounts are set forth in §1.401(a)(4)–6(b), and rules for applying paragraph (b)(2) of this section to employee contributions under such a plan are set forth in §1.401(a)(4)–6(c). See paragraph (b)(2)(ii)(B) of this section for rules applicable to employee contributions allocated to separate accounts.

(8) *Allocation of earnings.* Notwithstanding any other provision in §§1.401(a)(4)–1 through 1.401(a)(4)–13, a defined contribution plan does not satisfy paragraph (b)(2) of this section if the manner in which income, expenses, gains, or losses are allocated to accounts under the plan discriminates in favor of HCEs or former HCEs.

(9) *Rollovers, transfers, and buybacks.* In applying the requirements of paragraph (b) of this section, rollover (including direct rollover) contributions described in section 402(c), 402(e)(6), 403(a)(4), 403(a)(5), or 408(d)(3), elective transfers described in §1.411(d)–4, Q&A–3(b), transfers of assets and liabilities described in section 414(l), and employee buybacks are treated in accordance with the rules set forth in §1.401(a)(4)–11(b).

(10) *Vesting.* A plan does not satisfy the nondiscriminatory amount requirement of paragraph (b)(2) of this section unless it satisfies §1.401(a)(4)–11(c) with respect to the manner in which employees vest in their accrued benefits.

(11) *Crediting service.* A plan does not satisfy paragraphs (b)(2) and (b)(3) of this section unless it satisfies §1.401(a)(4)–11(d) with respect to the manner in which employees' service is credited under the plan. Service other than actual service with the employer may not be taken into account in determining whether the plan satisfies paragraphs (b)(2) and (b)(3) of this section except as provided in §1.401(a)(4)–11(d).

(12) *Governmental plans.* The rules of this section apply to a governmental plan within the meaning of section

414(d), except as provided in §§1.401(a)(4)–11(f) and 1.401(a)(4)–13(b).

(13) *Employee stock ownership plans.* [Reserved]

(14) *Section 401(h) benefits.* In applying the requirements of paragraph (b) of this section, the portion of a plan providing benefits described in section 401(h) is tested separately from the portion of the same plan providing retirement benefits, and thus is not required to satisfy this section. Rules applicable to section 401(h) benefits are set forth in §1.401–14(b)(2).

(15) *Definitions.* In applying the requirements of this section, the definitions in §1.401(a)(4)–12 govern.

(16) *Effective dates and fresh-start rules.* In applying the requirements of this section, the effective dates set forth in §1.401(a)(4)–13 govern. Section 1.401(a)(4)–13 also provides certain transition and fresh-start rules that apply for purposes of this section.

(d) *Additional guidance.* The Commissioner may, in revenue rulings, notices, and other guidance, published in the Internal Revenue Bulletin, provide any additional guidance that may be necessary or appropriate in applying the nondiscrimination requirements of section 401(a)(4), including additional safe harbors and alternative methods and procedures for satisfying those requirements. See §601.601(d)(2)(ii)(*b*) of this chapter.

[T.D. 8485, 58 FR 46780, Sept. 3, 1993]

§1.401(a)(4)–2 Nondiscrimination in amount of employer contributions under a defined contribution plan.

(a) *Introduction*—(1) *Overview.* This section provides rules for determining whether the employer contributions allocated under a defined contribution plan are nondiscriminatory in amount as required by §1.401(a)(4)–1(b)(2)(ii)(A). Certain defined contribution plans that provide uniform allocations are permitted to satisfy this requirement by meeting one of the safe harbors in paragraph (b) of this section. Plans that do not provide uniform allocations may satisfy this requirement by satisfying the general test in paragraph (c) of this section. See §1.401(a)(4)–1(b)(2)(ii)(B) for the exclusive tests applicable to section 401(k) plans and section 401(m) plans.

(2) *Alternative methods of satisfying nondiscriminatory amount requirement.* A defined contribution plan is permitted to satisfy paragraph (b)(2) or (c) of this section on a restructured basis pursuant to §1.401(a)(4)–9(c). Alternatively, a defined contribution plan (other than an ESOP) is permitted to satisfy the nondiscriminatory amount requirement of §1.401(a)(4)–1(b)(2)(ii)(A) on the basis of equivalent benefits pursuant to §1.401(a)(4)–8(b).

(b) *Safe harbors*—(1) *In general.* The employer contributions allocated under a defined contribution plan are nondiscriminatory in amount for a plan year if the plan satisfies either of the safe harbors in paragraph (b)(2) or (b)(3) of this section. Paragraph (b)(4) of this section provides exceptions for certain plan provisions that do not cause a plan to fail to satisfy this paragraph (b).

(2) *Safe harbor for plans with uniform allocation formula*—(i) *General rule.* A defined contribution plan satisfies the safe harbor in this paragraph (b)(2) for a plan year if the plan allocates all amounts taken into account under paragraph (c)(2)(ii) of this section for the plan year under an allocation formula that allocates to each employee the same percentage of plan year compensation, the same dollar amount, or the same dollar amount for each uniform unit of service (not to exceed one week) performed by the employee during the plan year.

(ii) *Permitted disparity.* If a plan satisfies section 401(l) in form, differences in employees' allocations under the plan attributable to uniform disparities permitted under §1.401(l)–2 (including differences in disparities that are deemed uniform under §1.401(l)–2(c)(2)) do not cause the plan to fail to satisfy this paragraph (b)(2).

(3) *Safe harbor for plans with uniform points allocation formula*—(i) *General rule.* A defined contribution plan (other than an ESOP) satisfies the safe harbor in this paragraph (b)(3) for a plan year if it satisfies both of the following requirements:

(A) The plan must allocate amounts under a uniform points allocation formula. A uniform points allocation formula defines each employee's allocation for the plan year as the product of the total of all amounts taken into account under paragraph (c)(2)(ii) of this section and a fraction, the numerator of which is the employee's points for the plan year and the denominator of which is the sum of the points of all employees in the plan for the plan year. For this purpose, an employee's points for a plan year equal the sum of the employee's points for age, service, and units of plan year compensation for the plan year. Under a uniform points allocation formula, each employee must receive the same number of points for each year of age, the same number of points for each year of service, and the same number of points for each unit of plan year compensation. (See §1.401(a)(4)–11(d)(3) regarding service that may be taken into account as years of service.) A uniform points allocation formula need not grant points for both age and service, but it must grant points for at least one of them. If the allocation formula grants points for years of service, the plan is permitted to limit the number of years of service taken into account to a single maximum number of years of service. A uniform points allocation formula need not grant points for units of plan year compensation, but if it does, the unit used must be a single dollar amount for all employees that does not exceed $200.

(B) For the plan year, the average of the allocation rates for the HCEs in the plan must not exceed the average of the allocation rates for the NHCEs in the plan. For this purpose, allocation rates are determined in accordance with paragraph (c)(2) of this section, without imputing permitted disparity and without grouping allocation rates under paragraphs (c)(2) (iv) and (v) of this section, respectively.

(ii) *Example.* The following example illustrates the safe harbor in this paragraph (b)(3):

Example. (a) Plan A has a single allocation formula that applies to all employees, under which each employee's allocation for the plan year equals the product of the total of all amounts taken into account for all employees for the plan year under paragraph (c)(2)(ii) of this section and a fraction, the numerator of which is the employee's points for the plan year and the denominator of which is the sum of the points of all employees for the plan year. Plan A grants each employee 10 points for each year of service (including pre-participation service and imputed service credited under Plan A that satisfies §1.401(a)(4)–11(d)(3)) and one point for each $100 of plan year compensation. For the 1994 plan year, the total allocations are $71,200, and the total points for all employees are 7,120. Each employee's allocation for the 1994 plan year is set forth in the table below.

Employee	Years of service	Plan year compensation	Points	Amount of allocation	Allocation rate (percent)
H1	20	$150,000	1,700	$17,000	11.3
H2	10	150,000	1,600	16,000	10.7
H3	30	100,000	1,300	13,000	13.0
H4	3	100,000	1,030	10,300	10.3
N1	10	40,000	500	5,000	12.5
N2	5	35,000	400	4,000	11.4
N3	3	30,000	330	3,300	11.0
N4	1	25,000	260	2,600	10.4
Total			7,120	71,200	

(b) Under these facts, for the 1994 plan year, Plan A allocates amounts under a uniform points allocation formula within the meaning of paragraph (b)(3)(i)(A) of this section.

(c) For the 1994 plan year, the average allocation rate for the HCEs (H1 through H4) is 11.3 percent, and the average allocation rate for NHCEs (N1 through N4) is 11.3 percent. Because the average of the allocation rates for the HCEs does not exceed the average of the allocation rates for the NHCEs, Plan A satisfies paragraph (b)(3)(i)(B) of this section and, thus, the safe harbor in this paragraph (b)(3) for the 1994 plan year.

(4) *Use of safe harbors not precluded by certain plan provisions*—(i) *In general.* A plan does not fail to satisfy this paragraph (b) merely because the plan contains one or more of the provisions described in this paragraph (b)(4). Unless

otherwise provided, any such provision must apply uniformly to all employees.

(ii) *Entry dates.* The plan provides one or more entry dates during the plan year as permitted by section 410(a)(4).

(iii) *Certain conditions on allocations.* The plan provides that an employee's allocation for the plan year is conditioned on either the employee's employment on the last day of the plan year or the employee's completion of a minimum number of hours of service during the plan year (not to exceed 1,000), or both. Such a provision may include an exception from this condition for all employees whose employment terminates during the plan year or only for those employees whose employment terminates during the plan year on account of one or more of the following circumstances: retirement, disability, death, or military service.

(iv) *Certain limits on allocations.* The plan limits allocations otherwise provided under the allocation formula to a maximum dollar amount or a maximum percentage of plan year compensation, limits the dollar amount of plan year compensation taken into account in determining the amount of allocations, or applies the restrictions of section 409(n) or the limits of section 415.

(v) *Lower allocations for HCEs.* The allocations provided to one or more HCEs under the plan are less than the allocations that would otherwise be provided to those employees if the plan satisfied this paragraph (b) (without regard to this paragraph (b)(4)(v)).

(vi) *Multiple formulas*—(A) *General rule.* The plan provides that an employee's allocation under the plan is the greater of the allocations determined under two or more formulas, or is the sum of the allocations determined under two or more formulas. This paragraph (b)(4)(vi) does not apply to a plan unless each of the formulas under the plan satisfies the requirements of paragraph (b)(4)(vi) (B) through (D) of this section.

(B) *Sole formulas.* The formulas must be the only formulas under the plan.

(C) *Separate testing.* Each of the formulas must separately satisfy this paragraph (b). A formula that is available solely to some or all NHCEs is deemed to satisfy this paragraph (b)(4)(vi)(C).

(D) *Availability*—(*1*) *General rule.* All of the formulas must be available on the same terms to all employees.

(*2*) *Formulas for NHCEs.* A formula does not fail to be available on the same terms to all employees merely because the formula is not available to any HCEs, but is available to some or all NHCEs on the same terms as all of the other formulas in the plan.

(*3*) *Top-heavy formulas.* In the case of a plan that provides the greater of the allocations under two or more formulas, one of which is a top-heavy formula, the top-heavy formula does not fail to be available on the same terms to all employees merely because it is available solely to all non-key employees on the same terms as all the other formulas under the plan. Furthermore, the top-heavy formula does not fail to be available on the same terms as the other formulas under the plan merely because it is conditioned on the plan's being top-heavy within the meaning of section 416(g). Finally, the top-heavy formula does not fail to be available on the same terms as the other formulas under the plan merely because it is available to all employees described in §1.416–1, Q&A M–10 (i.e., all non-key employees who have not separated from service as of the last day of the plan year). The preceding sentence does not apply, however, unless the plan would satisfy section 410(b) if all employees who are benefiting under the plan solely as a result of receiving allocations under the top-heavy formula were treated as not currently benefiting under the plan. For purposes of this paragraph (b)(4)(vi)(D)(*3*), a top-heavy formula is a formula that provides the minimum benefit described in section 416(c)(2) (taking into account, if applicable, the modification in section 416(h)(2)(A)(ii)(II)).

(E) *Provisions may be applied more than once.* The provisions of this paragraph (b)(4)(vi) may be applied more than once. For example, a plan satisfies this paragraph (b) if an employee's allocation under the plan is the greater of the allocations under two or more formulas, and one or more of those formulas is the sum of the allocations under two or more other formulas, provided that each of the formulas under the plan satisfies the requirements of paragraph (b)(4)(vi) (B) through (D) of this section.

(F) *Examples.* The following examples illustrate the rules in this paragraph (b)(4)(vi):

Example 1. Under Plan A, each employee's allocation equals the sum of the allocations determined under two formulas. The first formula provides an allocation of five percent of plan year compensation. The second formula provides an allocation of $100. Plan A satisfies this paragraph (b)(4)(vi).

Example 2. Under Plan B, each employee's allocation equals the greater of the allocations determined under two formulas. The first formula provides an allocation of seven percent of plan year compensation and is available to all employees who complete at least 1,000 hours of service during the plan year and who have not separated from service as of the last day of the plan year. The second formula is a top-heavy formula that provides an allocation of three percent of plan year compensation and that is available to all employees described in §1.416–1, Q&A M–10. Plan B does not satisfy the general rule in paragraph (b)(4)(vi)(D)(*1*) of this section because the two formulas are not available on the same terms to all employees (i.e., an employee is required to complete 1,000 hours of service during the plan year to receive an allocation under the first formula, but not under the second formula). Nonetheless, because the second formula is a top-heavy formula, the special availability rules for top-heavy formulas in paragraph (b)(4)(vi)(D)(*3*) of this section apply. Thus, the second formula does not fail to be available on the same terms as the first formula merely because the second formula is available to all employees described in §1.416–1, Q&A M–10, as long as the plan would satisfy section 410(b) if all employees who are benefiting under the plan solely as a result of receiving allocations under the top-heavy formula were treated as not currently benefiting under the plan. This is true even if the plan conditions the availability of the second formula on the plan's being top-heavy for the plan year.

Example 3. The facts are the same as in *Example 2,* except that the first formula is available to all employees who have not separated from service as of the last day of the plan year, regardless of whether they complete at least 1,000 hours of service during the plan year. Plan B still does not satisfy the general rule in paragraph (b)(4)(vi)(D)(*1*) of this section because the two formulas are not available on the same terms to all employees (i.e., the second formula is only available to all non-key employees). Nonetheless, because the second formula is a top-heavy formula, the special availability rules for top-heavy formulas in paragraph (b)(4)(vi)(D)(*3*) of this section apply. Thus, the second formula does not fail to be available on the same terms as the first formula merely because the second formula is available solely to all non-key employees.

(c) *General test for nondiscrimination in amount of contributions*—(1) *General rule.* The employer contributions allocated under a defined contribution plan are nondiscriminatory in amount for a plan year if each rate group under the plan satisfies section 410(b). For purposes of this paragraph (c), a rate group exists under a plan for each HCE and consists of the HCE and all other employees in the plan (both HCEs and NHCEs) who have an allocation rate greater than or equal to the HCE's allocation rate. Thus, an employee is in the rate group for each HCE who has an allocation rate less than or equal to the employee's allocation rate.

(2) *Determination of allocation rates*—(i) *General rule.* The allocation rate for an employee for a plan year equals the sum of the allocations to the employee's account for the plan year, expressed either as a percentage of plan year compensation or as a dollar amount.

(ii) *Allocations taken into account.* The amounts taken into account in determining allocation rates for a plan year include all employer contributions and forfeitures that are allocated or treated as allocated to the account of an employee under the plan for the plan year, other than amounts described in paragraph (c)(2)(iii) of this section. For this purpose, employer contributions include annual additions described in §1.415–6(b)(2)(i) (regarding amounts arising from certain transactions between the plan and the employer). In the case of a defined contribution plan subject to section 412, an employer contribution is taken into account in the plan year for which it is required to be contributed and allocated to employees' accounts under the plan, even if all or part of the required contribution is not actually made.

(iii) *Allocations not taken into account.* Allocations of income, expenses, gains, and losses attributable to the balance in an employee's account are not taken into account in determining allocation rates.

(iv) *Imputation of permitted disparity.* The disparity permitted under section 401(l) may be imputed in accordance with the rules of §1.401(a)(4)–7.

(v) *Grouping of allocation rates*—(A) *General rule.* An employer may treat all employees who have allocation rates within a specified range above and below a midpoint rate chosen by the employer as having an allocation rate equal to the midpoint rate within that range. Allocation rates within a given range may not be grouped under this paragraph (c)(2)(v) if the allocation rates of HCEs within the range generally are significantly higher than the allocation rates of NHCEs in the range. The specified ranges within which all employees are treated as having the same allocation rate may not overlap and may be no larger than provided in paragraph (c)(2)(v)(B) of this section. Allocation rates of employees that are not within any of these specified ranges are determined without regard to this paragraph (c)(2)(v).

(B) *Size of specified ranges.* The lowest and highest allocation rates in the range must be within five percent (not five percentage points) of the midpoint rate. If allocation rates are determined as a percentage of plan year compensation, the lowest and highest allocation rates need not be within five percent of the midpoint rate, if they are no more than one quarter of a percentage point above or below the midpoint rate.

(vi) *Consistency requirement.* Allocation rates must be determined in a consistent manner for all employees for the plan year.

(3) *Satisfaction of section 410(b) by a rate group*—(i) *General rule.* For purposes of determining whether a rate group satisfies section 410(b), the rate group is treated as if it were a separate plan that benefits only the employees included in the rate group for the plan year. Thus, for example, under §1.401(a)(4)–1(c)(4)(iv), the ratio percentage of the rate group is determined taking into account all nonexcludable employees regardless of whether they benefit under the plan. Paragraph (c)(3)(ii) and (iii) of this section provide additional special rules for determining whether a rate group satisfies section 410(b).

(ii) *Application of nondiscriminatory classification test.* A rate group satisfies the nondiscriminatory classification test of §1.410(b)–4 (including the reasonable classification requirement of §1.410(b)–4(b)) if and only if the ratio percentage of the rate group is greater than or equal to the lesser of—

(A) The midpoint between the safe and the unsafe harbor percentages applicable to the plan; and

(B) The ratio percentage of the plan.

(iii) *Application of average benefit percentage test.* A rate group satisfies the average benefit percentage test of §1.410(b)–5 if the plan of which it is a part satisfies §1.410(b)–5 (without regard to §1.410(b)–5(f)). In the case of a plan that relies on §1.410(b)–5(f) to satisfy the average benefit percentage test, each rate group under the plan satisfies the average benefit percentage test (if applicable) only if the rate group separately satisfies §1.410(b)–5(f).

(4) *Examples.* The following examples illustrate the general test in this paragraph (c):

Example 1. Employer X maintains two defined contribution plans, Plan A and Plan B, that are aggregated and treated as a single plan for purposes of sections 410(b) and 401(a)(4) pursuant to §1.410(b)–7(d). For the 1994 plan year, Employee M has plan year compensation of $10,000 and receives an allocation of $200 under Plan A and an allocation of $800 under Plan B. Employee M's allocation rate under the aggregated plan for the 1994 plan year is 10 percent (i.e., $1,000 divided by $10,000).

Example 2. The employees in Plan C have the following allocation rates (expressed as a percentage of plan year compensation): 2.75 percent, 2.80 percent, 2.85 percent, 3.25 percent, 6.65 percent, 7.33 percent, 7.34 percent, and 7.35 percent. Because the first four rates are within a range of no more than one quarter of a percentage point above and below 3.0 percent (a midpoint rate chosen by the employer), under paragraph (c)(2)(v) of this section the employer may treat the employees who have those rates as having an allocation rate of 3.0 percent (provided that the allocation rates of HCEs within the range generally are not significantly higher than the allocation rates of NHCEs within the range). Because the last four rates are within a range of no more than five percent above and below 7.0 percent (a midpoint rate chosen by the employer), the employer may treat the employees who have those rates as having an allocation rate of 7.0 percent (provided that the allocation rates of HCEs within the range generally are not significantly higher than the allocation rates of NHCEs within the range).

Example 3. (a) Employer Y has only six nonexcludable employees, all of whom benefit under Plan D. The HCEs are H1 and H2, and the NHCEs are N1 through N4. For the 1994 plan year, H1 and N1 through N4 have an allocation rate of 5.0 percent of plan year compensation. For the same plan year, H2 has an allocation rate of 7.5 percent of plan year compensation.

(b) There are two rate groups under Plan D. Rate group 1 consists of H1 and all those employees who have an allocation rate greater than or equal to H1's allocation rate (5.0 percent). Thus, rate group 1 consists of H1, H2, and N1 through N4. Rate group 2 consists only of H2 because no other employee has an allocation rate greater than or equal to H2's allocation rate (7.5 percent).

(c) The ratio percentage for rate group 2 is zero percent—i.e., zero percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 50 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group). Therefore rate group 2 does not satisfy the ratio percentage test under §1.410(b)–2(b)(2). Rate group 2 also does not satisfy the nondiscriminatory classification test of §1.410(b)–4 (as modified by paragraph (c)(3) of this section). Rate group 2 therefore does not satisfy section 410(b) and, as a result, Plan D does not satisfy the general test in paragraph (c)(1) of this section. This is true regardless of whether rate group 1 satisfies §1.410(b)–2(b)(2).

Example 4. (a) The facts are the same as in *Example 3*, except that N4 has an allocation rate of 8.0 percent.

(b) There are two rate groups in Plan D. Rate group 1 consists of H1 and all those employees who have an allocation rate greater than or equal to H1's allocation rate (5.0 percent). Thus, rate group 1 consists of H1, H2 and N1 through N4. Rate group 2 consists of H2, and all those employees who have an allocation rate greater than or equal to H2's allocation rate (7.5 percent). Thus, rate group 2 consists of H2 and N4.

(c) Rate group 1 satisfies the ratio percentage test under §1.410(b)–2(b)(2) because the ratio percentage of the rate group is 100 percent—i.e., 100 percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 100 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group).

(d) Rate group 2 does not satisfy the ratio percentage test of §1.410(b)–2(b)(2) because the ratio percentage of the rate group is 50 percent—i.e., 25 percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 50 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group).

(e) However, rate group 2 does satisfy the nondiscriminatory classification test of §1.410(b)–4 because the ratio percentage of the rate group (50 percent) is greater than the safe harbor percentage applicable to the plan under §1.410(b)–4(c)(4) (45.5 percent).

(f) Under paragraph (c)(3)(iii) of this section, rate group 2 satisfies the average benefit percentage test, if Plan D satisfies the average benefit percentage test. (The requirement that Plan D satisfy the average benefit percentage test applies even though Plan D satisfies the ratio percentage test and would ordinarily not need to run the average benefit percentage test.) If Plan D satisfies the average benefit percentage test, then rate group 2 satisfies section 410(b) and thus, Plan D satisfies the general test in paragraph (c)(1) of this section, because each rate group under the plan satisfies section 410(b).

Example 5. (a) Plan E satisfies section 410(b) by satisfying the nondiscriminatory classification test of §1.410(b)–4 and the average benefit percentage test of §1.410(b)–5 (without regard to §1.410(b)–5(f)). See §1.410(b)–2(b)(3). Plan E uses the facts-and-circumstances requirements of §1.410(b)–4(c)(3) to satisfy the nondiscriminatory classification test of §1.410(b)–4. The safe and unsafe harbor percentages applicable to the plan under §1.410(b)–4(c)(4) are 29 and 20 percent, respectively. Plan E has a ratio percentage of 22 percent.

(b) Rate group 1 under Plan E has a ratio percentage of 23 percent. Under paragraph (c)(3)(ii) of this section, the rate group satisfies the nondiscriminatory classification requirement of §1.410(b)–4, because the ratio percentage of the rate group (23 percent) is greater than the lesser of—

(1) The ratio percentage for the plan as a whole (22 percent); and

(2) The midpoint between the safe and unsafe harbor percentages (24.5 percent).

(c) Under paragraph (c)(3)(iii) of this section, the rate group satisfies section 410(b) because the plan satisfies the average benefit percentage test of §1.410(b)–5.

[T.D. 8485, 58 FR 46781, Sept. 3, 1993]

§1.401(a)(4)–3 Nondiscrimination in amount of employer-provided benefits under a defined benefit plan.

(a) *Introduction*—(1) *Overview.* This section provides rules for determining whether the employer-provided benefits under a defined benefit plan are nondiscriminatory in amount as required by §1.401(a)(4)–1(b)(2)(iii). Certain defined benefit plans that provide uniform benefits are permitted to satisfy this requirement by meeting one of the safe harbors in paragraph (b) of this section. Plans that do not provide uniform benefits may satisfy this requirement by satisfying the general test in paragraph (c) of this section. Paragraph (d) of this section provides rules for determining the individual benefit accrual rates needed for the general test. Paragraph (e) of this section provides rules for determining compensation for purposes of applying the requirements of this section. Paragraph (f) of this section provides additional rules that apply generally for purposes of both the safe harbors in paragraph (b) of this section and the general test in paragraph (c) of this section. See § 1.401(a)(4)–6 for rules for determining the amount of employer-provided benefits under a contributory DB plan, and for determining whether the employee-provided benefits under such a plan are nondiscriminatory in amount.

(2) *Alternative methods of satisfying nondiscriminatory amount requirement.* A defined benefit plan is permitted to satisfy paragraph (b) or (c) of this section on a restructured basis pursuant to § 1.401(a)(4)–9(c). Alternatively, a defined benefit plan is permitted to satisfy the nondiscriminatory amount requirement of § 1.401(a)(4)–1(b)(2)(iii) on the basis of equivalent allocations pursuant to § 1.401(a)(4)–8(c). In addition, a defined benefit plan that is part of a floor-offset arrangement is permitted to satisfy this section pursuant to § 1.401(a)(4)–8(d).

(b) *Safe harbors*—(1) *In general.* The employer-provided benefits under a defined benefit plan are nondiscriminatory in amount for a plan year if the plan satisfies each of the uniformity requirements of paragraph (b)(2) of this section and any one of the safe harbors in paragraphs (b)(3) (unit credit plans), (b)(4) (fractional accrual plans), and (b)(5) (insurance contract plans) of this section. Paragraph (b)(6) of this section provides exceptions for certain plan provisions that do not cause a plan to fail to satisfy this paragraph (b). Paragraph (f) of this section provides additional rules that apply in determining whether a plan satisfies this paragraph (b).

(2) *Uniformity requirements*—(i) *Uniform normal retirement benefit.* The same benefit formula must apply to all employees. The benefit formula must provide all employees with an annual benefit payable in the same form commencing at the same uniform normal retirement age. The annual benefit must be the same percentage of average annual compensation or the same dollar amount for all employees who will have the same number of years of service at normal retirement age. (See § 1.401(a)(4)–11(d)(3) regarding service that may be taken into account as years of service.) The annual benefit must equal the employee's accrued benefit at normal retirement age (within the meaning of section 411(a)(7)(A)(i)) and must be the normal retirement benefit under the plan (within the meaning of section 411(a)(9)).

(ii) *Uniform post-normal retirement benefit.* With respect to an employee with a given number of years of service at any age after normal retirement age, the annual benefit commencing at that employee's age must be the same percentage of average annual compensation or the same dollar amount that would be payable commencing at normal retirement age to an employee who had that same number of years of service at normal retirement age.

(iii) *Uniform subsidies.* Each subsidized optional form of benefit available under the plan must be currently available (within the meaning of § 1.401(a)(4)–4(b)(2)) to substantially all employees. Whether an optional form of benefit is considered subsidized for this purpose may be determined using any reasonable actuarial assumptions.

(iv) *No employee contributions.* The plan must not be a contributory DB plan.

(v) *Period of accrual.* Each employee's benefit must be accrued over the same years of service that are taken into account in applying the benefit formula under the plan to that employee. For this purpose, any year in which the employee benefits under the plan (within the meaning of § 1.410(b)–3(a)) is included as a year of service in which a benefit accrues. Thus, for example, a plan does not satisfy the safe harbor in paragraph (b)(4) of this section unless the plan uses the same years of service to determine both the normal retirement benefit under the plan's benefit formula and the fraction by which an employee's fractional rule benefit is multiplied to derive the employee's accrued benefit as of any plan year.

(vi) *Examples.* The following examples illustrate the rules in this paragraph (b)(2):

Example 1. Plan A provides a normal retirement benefit equal to two percent of average annual compensation times each year of service commencing at age 65 for all employees. Plan A provides that employees of Division S receive their benefit in the form of a straight life annuity and that employees of Division T receive their benefit in the form of a life annuity with an automatic cost-of-living increase. Plan A does not provide a uniform normal retirement benefit within the meaning of paragraph (b)(2)(i) of this section because the annual benefit is not payable in the same form to all employees.

Example 2. Plan B provides a normal retirement benefit equal to 1.5 percent of average annual compensation times each year of service at normal retirement age for all employees. The normal retirement age under the plan is the earlier of age 65 or the age at which the employee completes 10 years of service, but in no event earlier than age 62. Plan B does not provide a uniform normal retirement benefit within the meaning of paragraph (b)(2)(i) of this section because the same uniform normal retirement age does not apply to all employees.

Example 3. Plan C is an accumulation plan under which the benefit for each year of service equals one percent of plan year compensation payable in the same form to all employees commencing at the same uniform normal retirement age. Under paragraph (e)(2) of this section, an accumulation plan may substitute plan year compensation for average annual compensation. Plan C provides a uniform normal retirement benefit within the meaning of paragraph (b)(2)(i) of this section, because all employees with the same number of years of service at normal retirement age will receive an annual benefit that is treated as the same percentage of average annual compensation.

Example 4. The facts are the same as in *Example 3*, except that the benefit for each year of service equals one percent of plan year compensation increased by reference to the increase in the cost of living from the year of service to normal retirement age. Plan C does not provide a uniform normal retirement benefit, because the annual benefit defined by the benefit formula can vary for employees with the same number of years of service at normal retirement age, depending on the age at which those years of service were credited to the employee under the plan.

Example 5. Plan D provides a normal retirement benefit of 50 percent of average annual compensation at normal retirement age (age 65) for employees with 30 years of service at normal retirement age. Plan D provides that, in the case of an employee with less than 30 years of service at normal retirement age, the normal retirement benefit is reduced on a pro rata basis for each year of service less than 30. However, if an employee with less than 30 years of service at normal retirement age continues to work past normal retirement age, Plan D provides that the additional years of service worked past normal retirement age are taken into account for purposes of the 30 years of service requirement. Thus, an employee who has 26 years of service at age 65 but who does not retire until age 69 with 30 years of service will receive a benefit of 50 percent of average annual compensation. Plan D provides uniform post-normal retirement benefits within the meaning of paragraph (b)(2)(ii) of this section.

Example 6. (a) Plan E is amended on February 14, 1994, to provide an early retirement window benefit that consists of an unreduced early retirement benefit to employees who terminate employment after attainment of age 55 with 10 years of service and between June 1, 1994, and November 30, 1994. The early retirement window benefit is a single subsidized optional form of benefit. Paragraph (b)(2)(iii) of this section requires that the subsidized optional form of benefit be currently available (within the meaning of §1.401(a)(4)–4(b)(2)) to substantially all employees. Section 1.401(a)(4)–4(b)(2)(ii)(A)(*2*) provides that age and service requirements are not disregarded in determining the current availability of an optional form of benefit if those requirements must be satisfied within a specified period of time. Thus, the early retirement window benefit is not currently available to an employee unless the employee will satisfy the eligibility requirements for the early retirement window benefit by the close of the early retirement window benefit period. Plan E will fail to satisfy paragraph (b)(2)(iii) of this section unless substantially all of the employees satisfy the eligibility requirements for the early retirement window benefit by November 30, 1994. However, see §1.401(a)(4)–9(c)(6), *Example 2*, for an example of how a plan with an early retirement window benefit may be restructured into two component plans, each of which satisfies the safe harbors of this paragraph (b).

(b) A similar analysis would apply if, instead of an unreduced early retirement benefit, the early retirement window benefit consisted of a special schedule of early retirement factors, defined by starting with the plan's usual schedule and then treating each employee eligible for the early retirement window benefit as being five years older than the employee actually is, but not older than the employee's normal retirement age.

Example 7. Plan F generally provides a normal retirement benefit of 1.5 percent of an employee's average annual compensation multiplied by the employee's years of service with the employer. For employees transferred outside of the group of employees covered by the plan, the plan's benefit formula takes into account only years of service prior to the transfer, but determines average annual compensation taking into account section 414(s) compensation both before and after the transfer. Plan F does not satisfy the requirements of paragraph (b)(2)(v) of this section with respect to transferred employees, because their benefits are accrued over years of service (i.e., after transfer) that are not taken into account in applying the plan's benefit formula to them. However, see *Example 2* of paragraph (b)(6)(x)(B) of this section for an example of how a plan that continues to take transferred employees' section 414(s) compensation into account after their transfer may still satisfy this paragraph (b).

(3) *Safe harbor for unit credit plans*—(i) *General rule.* A plan satisfies the safe harbor in this paragraph (b)(3) for a plan year if it satisfies both of the following requirements:

(A) The plan must satisfy the 133⅓ percent accrual rule of section 411(b)(1)(B).

(B) Each employee's accrued benefit under the plan as of any plan year must be determined by applying the plan's benefit formula to the employee's years of service and (if applicable) average annual compensation, both determined as of that plan year.

(ii) *Example.* The following example illustrates the rules in this paragraph (b)(3):

Example. Plan A provides that the accrued benefit of each employee as of any plan year equals the employee's average annual compensation times a percentage that depends on the employee's years of service determined as of that plan year. The percentage is 2 percent for each of the first 10 years of service, plus 1.5 percent for each of the next 10 years of service, plus 2 percent for all additional years of service. Plan A satisfies this paragraph (b)(3).

(4) *Safe harbor for plans using fractional accrual rule*—(i) *General rule.* A plan satisfies the safe harbor in this paragraph (b)(4) for a plan year if it satisfies each of the following requirements:

(A) The plan must satisfy the fractional accrual rule of section 411(b)(1)(C).

(B) Each employee's accrued benefit under the plan as of any plan year before the employee reaches normal retirement age must be determined by multiplying the employee's fractional rule benefit (within the meaning of § 1.411(b)–1(b)(3)(ii)(A)) by a fraction, the numerator of which is the employee's years of service determined as of the plan year, and the denominator of which is the employee's projected years of service as of normal retirement age.

(C) The plan must satisfy one of the following requirements:

(*1*) Under the plan, it must be impossible for any employee to accrue in a plan year a portion of the normal retirement benefit described in paragraph (b)(2)(i) of this section that is more than one-third larger than the portion of the same benefit accrued in that or any other plan year by any other employee, when each portion of the benefit is expressed as a percentage of each employee's average annual compensation or as a dollar amount. In making this determination, actual and potential employees in the plan with any amount of service at normal retirement must be taken into account (other than employees with more than 33 years of service at normal retirement age). In addition, in the case of a plan that satisfies section 401(l) in form, an employee is treated as accruing benefits at a rate equal to the excess benefit percentage in the case of a defined benefit excess plan or at a rate equal to the gross benefit percentage in the case of an offset plan.

(*2*) The normal retirement benefit under the plan must be a flat benefit that requires a minimum of 25 years of service at normal retirement age for an employee to receive the unreduced flat benefit, determined without regard to section 415. For this purpose, a flat benefit is a benefit that is the same percentage of average annual compensation or the same dollar amount for all employees who have a minimum number of years of service at normal retirement age (e.g., 50 percent of average annual compensation), with a pro rata reduction in the flat benefit for employees who have less than the minimum number of years of service at normal retirement age. An employee is permitted to accrue the maximum benefit permitted under section 415 over a period of less than 25 years, provided that the flat benefit under the plan, determined without regard to section 415, can accrue over no less than 25 years.

(*3*) The plan must satisfy the requirements of paragraph (b)(4)(i)(C)(*2*) of this section (other than the requirement that the minimum number of years of service for receiving the unreduced flat benefit is at least 25 years), and, for the plan year, the average of the normal accrual rates for all nonhighly compensated nonexcludable employees must be at least 70 percent of the average of the normal accrual rates for all highly compensated nonexcludable employees. The averages in the preceding sentence are determined taking into account all nonexcludable employees (regardless of whether they benefit under the plan). In addition, contributions and benefits under other plans of the employer are disregarded. For purposes of this paragraph (b)(4)(i)(C)(*3*), normal accrual rates are determined under paragraph (d) of this section.

(ii) *Examples.* The following examples illustrate the rules in this paragraph (b)(4). In each example, it is assumed that the plan has never permitted employee contributions.

Example 1. Plan A provides a normal retirement benefit equal to 1.6 percent of average annual compensation times each year of service up to 25. Plan A further provides that an employee's accrued benefit as of any plan year equals the employee's fractional rule benefit multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year, and the denominator of which is the employee's projected years of service as of normal retirement age. The greatest benefit that an employee could accrue in any plan year is 1.6 percent of average annual compensation (this is the case for an employee with 25 or fewer years of projected service at normal retirement age). Among potential employees with 33 or fewer years of projected service at normal retirement age, the lowest benefit that an employee could accrue in any plan year is 1.212 percent of average annual compensation (this is the case for an employee with 33 years of projected service at normal retirement age). Plan A satisfies paragraph (b)(4)(i)(C)(*1*) of this section because 1.6 percent is not more than one third larger than 1.212 percent.

Example 2. Plan B provides a normal retirement benefit equal to 1.0 percent of average annual compensation up to the integration level, and 1.6 percent of average annual compensation above the integration level, times each year of service up to 35. Plan B further provides that an employee's accrued benefit as of any plan year equals the employee's fractional rule benefit multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year and the denominator of which is the employee's projected years of service as of normal retirement age. For purposes of satisfying the one third larger rule in paragraph (b)(4)(i)(C)(*1*) of this section, because Plan B satisfies section 401(l) in form, all employees with less than 35 projected years of service are assumed to accrue benefits at the rate of 1.6 percent of average annual compensation (the excess benefit percentage under the plan). Plan B satisfies paragraph (b)(4)(i)(C) of this section because all employees with 33 or fewer years of projected service at normal retirement age accrue in each plan year a benefit of 1.6 percent of average annual compensation.

Example 3. Plan C provides a normal retirement benefit equal to four percent of average annual compensation times each year of service up to 10 and one percent of average annual compensation times each year of service in excess of 10 and not in excess of 30. Plan C further provides that an employee's accrued benefit as of any plan year equals the employee's fractional rule benefit multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year, and the denominator of which is the employee's projected years of service as of normal retirement age. The greatest benefit that an employee could accrue in any plan year is four percent of average annual compensation (this is the case for an employee with 10 or fewer years of projected service at normal retirement age). Among employees with 33 or fewer years of projected service at normal retirement age, the lowest benefit that an employee could accrue in a plan year is 1.82 percent of average annual compensation (this is the case of an employee with 33 years of projected service at normal retirement age). Plan C fails to satisfy this paragraph (b)(4) because four percent is more than one third larger than 1.82 percent. See also §1.401(a)(4)–9(c)(6), *Example 3.*

Example 4. Plan D provides a normal retirement benefit of 100 percent of average annual compensation, reduced by four percentage points for each year of service below 25 the employee has at normal retirement age. Plan D further provides that an employee's accrued benefit as of any plan year is equal to the employee's fractional rule benefit multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year, and the denominator of which is the employee's projected years of service at normal retirement age. In the case of an employee who has five years of service as of the current plan year, and who is projected to have 10 years of service at normal retirement age, the employee's fractional rule benefit would be 40 percent of average annual compensation, and the employee's accrued benefit as of the current plan year would be 20 percent of average annual compensation (the fractional rule benefit multiplied by a fraction of five years over 10 years). Plan D satisfies this paragraph (b)(4).

Example 5. The facts are the same as in *Example 4*, except that the normal retirement benefit is 125 percent of average annual compensation, reduced by five percentage points for each year of service below 25 that the employee has at normal retirement age. Plan D satisfies this paragraph (b)(4), even though an employee may accrue the maximum benefit allowed under section 415 (i.e., 100 percent of the participant's average compensation for the high three years of service) in less than 25 years.

Example 6. The facts are the same as in *Example 1*, except that the plan determines each employee's accrued benefit by multiplying the employee's projected normal retirement benefit (rather than the fractional rule benefit) by the fraction described in *Example 1*. In determining an employee's projected normal retirement benefit, the plan defines each employee's average annual compensation as the average annual compensation the employee would have at normal retirement age if the employee's annual section 414(s) compensation in future plan years equaled the employee's plan year compensation for the prior plan year. Under these facts, Plan A does not satisfy paragraph (b)(4)(i)(B) of this section because the employee's accrued benefit is determined on the basis of a projected normal retirement benefit that is not the same as the employee's fractional rule benefit determined in accordance with § 1.411(b)–1(b)(3)(ii)(A).

Example 7. Plan E provides a normal retirement benefit of 50 percent of average annual compensation, with a pro rata reduction for employees with less than 30 years of service at normal retirement age. Plan E further provides that an employee's accrued benefit as of any plan year is equal to the employee's fractional rule benefit multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year, and the denominator of which is the employee's projected years of service at normal retirement age. For purposes of determining this fraction, the plan limits the years of service taken into account for an employee to the number of years the employee has participated in the plan. However, all years of service (including years of service before the employee commenced participation in the plan) are taken into account in determining an employee's normal retirement benefit under the plan's benefit formula. Plan E fails to satisfy this paragraph (b)(4) because the years of service over which benefits accrue differ from the years of service used in applying the benefit formula under the plan. See paragraph (b)(2)(v) of this section.

Example 8. (a) Plan F provides a normal retirement benefit equal to 2.0 percent of average annual compensation, plus 0.65 percent of average annual compensation above covered compensation, for each year of service up to 25. Plan F further provides that an employee's accrued benefit as of any plan year equals the sum of—

(1) The employee's fractional rule benefit (determined as if the normal retirement benefit under the plan equaled 2.0 percent of average annual compensation for each year of service up to 25) multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year and the denominator of which is the employee's projected years of service as of normal retirement age; plus

(2) 0.65 percent of the employee's average annual compensation above covered compensation multiplied by the employee's years of service (up to 25) as of the current plan year.

(b) Although Plan F satisfies the fractional accrual rule of section 411(b)(1)(C), the plan fails to satisfy this paragraph (b)(4) because the plan does not determine employees' accrued benefits in accordance with paragraph (b)(4)(i)(B) of this section.

(5) *Safe harbor for insurance contract plans.* A plan satisfies the safe harbor in this paragraph (b)(5) if it satisfies each of the following requirements:

(i) The plan must satisfy the accrual rule of section 411(b)(1)(F).

(ii) The plan must be an insurance contract plan within the meaning of section 412(i).

(iii) The benefit formula under the plan must be one that would satisfy the requirements of paragraph (b)(4) of this section if the stated normal retirement benefit under the formula accrued ratably over each employee's period of plan participation through normal retirement age in accordance with paragraph (b)(4)(i)(B) of this section. Thus, the benefit formula may not recognize years of service before an employee commenced participation in the plan because, otherwise, the definition of years of service for determining the normal retirement benefit would differ from the definition of years of service for determining the accrued benefit under paragraph (b)(4)(i)(B) of this section. See paragraph (b)(4)(ii), *Example 7,* of this section. Notwithstanding the foregoing, an insurance contract plan adopted and in effect on September 19, 1991, may continue to recognize years of service prior to an employee's participation in the plan for an employee who is a participant in the plan on that date to the extent provided by the benefit formula in the plan on such date.

(iv) The scheduled premium payments under an individual or group insurance contract used to fund an employee's normal retirement benefit must be level annual payments to normal retirement age. Thus, payments may not be scheduled to cease before normal retirement age.

(v) The premium payments for an employee who continues benefiting after normal retirement age must be equal to the amount necessary to fund additional benefits that accrue under the plan's benefit formula for the plan year.

(vi) Experience gains, dividends, forfeitures, and similar items must be used solely to reduce future premiums.

(vii) All benefits must be funded through contracts of the same series. Among other requirements, contracts of the same series must have cash values based on the same terms (including interest and mortality assumptions) and the same conversion rights. A plan does not fail to satisfy this requirement, however, if any change in the contract series or insurer applies on the same terms to all employees. But see §1.401(a)(4)–5(a)(4), *Example 12* (change in insurer considered a plan amendment subject to §1.401(a)(4)–5(a)).

(viii) If permitted disparity is taken into account, the normal retirement benefit stated under the plan's benefit formula must satisfy §1.401(l)–3. For this purpose, the 0.75-percent factor in the maximum excess or offset allowance in §1.401(l)–3(b)(2)(i) or (b)(3)(i), respectively, adjusted in accordance with §1.401(l)–3(d)(9) and (e), is reduced by multiplying the factor by 0.80.

(6) *Use of safe harbors not precluded by certain plan provisions*—(i) *In general.* A plan does not fail to satisfy this paragraph (b) merely because the plan contains one or more of the provisions described in this paragraph (b)(6). Unless otherwise provided, any such provision must apply uniformly to all employees.

(ii) *Section 401(l) permitted disparity.* The plan takes permitted disparity into account in a manner that satisfies section 401(l) in form. Thus, differences in employees' benefits under the plan attributable to uniform disparities permitted under §1.401(l)–3 (including differences in disparities that are deemed uniform under §1.401(l)–3(c)(2)) do not cause a plan to fail to satisfy this paragraph (b).

(iii) *Different entry dates.* The plan provides one or more entry dates during the plan year as permitted by section 410(a)(4).

(iv) *Certain conditions on accruals.* The plan provides that an employee's accrual for the plan year is less than a full accrual (including a zero accrual) because of a plan provision permitted by the year-of-participation rules of section 411(b)(4).

(v) *Certain limits on accruals.* The plan limits benefits otherwise provided under the benefit formula or accrual method to a maximum dollar amount or to a maximum percentage of average annual compensation (e.g., by limiting service taken into account in the benefit formula) or in accordance with section 401(a)(5)(D), applies the limits of section 415, or limits the dollar amount of compensation taken into account in determining benefits.

(vi) *Dollar accrual per uniform unit of service.* The plan determines accruals based on the same dollar amount for each uniform unit of service (not to exceed one week) performed by each employee with the same number of years of service under the plan during the plan year. The preceding sentence applies solely for purposes of the unit credit safe harbor in paragraph (b)(3) of this section.

(vii) *Prior benefits accrued under a different formula.* The plan determines benefits for years of service after a fresh-start date for all employees under a benefit formula and accrual method that differ from the benefit formula and accrual method previously used to determine benefit accruals for employees in a fresh-start group for years of service before the fresh-start date. This paragraph (b)(6)(vii) applies solely to plans that satisfy § 1.401(a)(4)–13(c) with respect to the fresh start.

(viii) *Employee contributions.* The plan is a contributory DB plan that would satisfy the requirements of paragraph (b) of this section if the plan's benefit formula provided benefits at employees' employer-provided benefit rates determined under § 1.401(a)(4)–6(b). This paragraph (b)(6)(viii) does not apply to a plan tested under paragraph (b)(4) or (b)(5) of this section unless the plan satisfies one of the methods in § 1.401(a)(4)–6 (b)(4) through (b)(6). A minimum benefit added to the plan solely to satisfy § 1.401(a)(4)–6(b)(3) is not taken into account in determining whether this paragraph (b)(6)(viii) is satisfied.

(ix) *Certain subsidized optional forms.* The plan provides a subsidized optional form of benefit that is available to fewer than substantially all employees because the optional form of benefit has been eliminated prospectively as provided in § 1.401(a)(4)–4(b)(3).

(x) *Lower benefits for HCEs*—(A) *General rule.* The benefits (including any subsidized optional form of benefit) provided to one or more HCEs under the plan are inherently less valuable to those HCEs (determined by applying the principles of § 1.401(a)(4)–4(d)(4)) than the benefits that would otherwise be provided to those HCEs if the plan satisfied this paragraph (b) (determined without regard to this paragraph (b)(6)(x)). These inherently less valuable benefits are deemed to satisfy this paragraph (b).

(B) *Examples.* The following examples illustrate the rules in this paragraph (b)(6)(x):

Example 1. Plan A would satisfy this paragraph (b) (determined without regard to this paragraph (b)(6)(x)), except for the fact that it fails to satisfy the requirement of paragraph (b)(2)(iii) of this section (i.e., a subsidized optional form must be available to substantially all employees on similar terms). Each subsidized optional form in the plan is available to all the NHCEs on similar terms, but one of the subsidized optional forms of benefit is not available to any of the HCEs. Plan A satisfies this paragraph (b), because Plan A is a safe harbor plan with respect to the NHCEs and provides inherently less valuable benefits to the HCEs.

Example 2. (a) Plan B would satisfy this paragraph (b) (determined without regard to this paragraph (b)(6)(x)), except for the fact that some employees are not being credited with years of service under the plan, but are continuing to accrue benefits as a result of compensation increases. These are employees who have been transferred from the employer that sponsors Plan B to another member of the controlled group whose employees are not covered by Plan B. For these employees, Plan B fails to satisfy the requirement of paragraph (b)(2)(v) of this section (i.e., each employee's benefit must accrue over the same years of service used in applying the benefit formula).

(b) Plan B is restructured into two component plans under the provisions of § 1.401(a)(4)–9(c). One component plan (Component Plan B1) consists of all NHCEs who are not being credited with years of service under the plan's benefit formula but are continuing to accrue benefits as a result of compensation increases, and the other component plan (Component Plan B2) consists of the balance of the employees.

(c) Component Plan B1 satisfies this section and section 410(b), because it benefits only NHCEs.

(d) Component Plan B2 is treated as satisfying this paragraph (b), because Plan B would satisfy this paragraph (b) (determined without regard to this paragraph (b)(6)(x)) with respect to the employees in Component Plan B2 but for the fact that it provides inherently less valuable benefits to some HCEs in that component plan (i.e., the employees who are credited only with compensation increases rather than both years of service and compensation increases).

(e) Under § 1.401(a)(4)–9(c), if Component Plan B2 satisfies section 410(b), then Plan B satisfies this section.

(xi) *Multiple formulas*—(A) *General rule.* The plan provides that an employee's benefit under the plan is the greater of the benefits determined under two or more formulas, or is the sum of the benefits determined under two or more formulas. This paragraph (b)(6)(xi) does not apply to a plan unless each of the formulas under the plan satisfies the requirements of paragraph (b)(6)(xi) (B) through (D) of this section.

(B) *Sole formulas.* The formulas must be the only formulas under the plan.

(C) *Separate testing.* Each of the formulas must separately satisfy the uniformity requirements of paragraph (b)(2) of this section and also separately satisfy one of the safe harbors in paragraphs (b)(3) through (b)(5) of this section. A formula that is available solely to some or all NHCEs is deemed to satisfy this paragraph (b)(6)(xi)(C).

(D) *Availability*—(*1*) *General rule.* All of the formulas must be available on the same terms to all employees.

(*2*) *Formulas for NHCEs.* A formula does not fail to be available on the same terms to all employees merely because the formula is not available to any HCEs, but is available to some or all NHCEs on the same terms as all of the other formulas in the plan.

(*3*) *Top-heavy formulas.* Rules parallel to those in §1.401(a)(4)–2(b)(4)(vi)(D)(*3*) apply in the case of a plan that provides the greater of the benefits under two or more formulas, one of which is a top-heavy formula. For purposes of this paragraph (b)(6)(xi)(D)(*3*), a top-heavy formula is a formula that provides a benefit equal to the minimum benefit described in section 416(c)(1) (taking into account, if applicable, the modification in section 416(h)(2)(A)(ii)(I)).

(E) *Provisions may be applied more than once.* The provisions of this paragraph (b)(6)(xi) may be applied more than once. See §1.401(a)(4)–2(b)(4)(vi)(E) for an example of the application of these provisions more than once.

(F) *Examples.* The following examples illustrate the rules in this paragraph (b)(6)(xi):

Example 1. Under Plan A, each employee's benefit equals the sum of the benefits determined under two formulas. The first formula provides one percent of average annual compensation per year of service. The second formula provides $10 per year of service. Plan A is eligible to apply the rules in this paragraph (b)(6)(xi).

Example 2. Under Plan B, each employee's benefit equals the greater of the benefits determined under two formulas. The first formula provides $15 per year of service and is available to all employees who complete at least 500 hours of service during the plan year. The second formula provides 1.5 percent of average annual compensation per year of service and is available to all employees who complete at least 1,000 hours of service during the plan year. Plan B does not satisfy this paragraph (b)(6)(xi) because the two formulas are not available on the same terms to all employees.

Example 3. Under Plan C, each employee's benefit equals the greater of the benefits determined under two formulas. The first formula provides $15 per year of service and is available to all employees who complete at least 1,000 hours of service during the plan year. The second formula provides the minimum benefit described in section 416(c)(1) and is available to all non-key employees who complete at least 1,000 hours of service during the plan year. Plan C does not satisfy the general rule in paragraph (b)(6)(xi)(D)(*1*) of this section because the two formulas are not available on the same terms to all employees (i.e., the second formula is only available to all non-key employees). Nonetheless, because the second formula is a top-heavy formula, the special availability rules for top-heavy formulas in paragraph (b)(6)(xi)(D)(*3*) of this section apply. Thus, the second formula does not fail to be available on the same terms as the first formula merely because the second formula is available solely to all non-key employees on the same terms. This is true even if the plan conditions the availability of the second formula on the plan's being top-heavy for the plan year.

Example 4. Under Plan D, each employee's benefit equals the greater of the benefits determined under two formulas. The first formula is available to all employees and provides a benefit equal to 1.5 percent of average annual compensation per year of service. The second formula is only available to NHCEs and provides a benefit equal to two percent of average annual compensation per year of service, minus two percent of the primary insurance amount per year of service. The amount of the offset is not limited to the maximum permitted offset under §1.401(l)–3(b). Under paragraph (b)(6)(xi)(D)(*2*) of this section, both formulas are treated as available to all employees on the same terms. Furthermore, even though the second formula does not satisfy any of the safe harbors in this paragraph (b), the formula is deemed to satisfy the separate testing requirement under paragraph (b)(6)(xi)(C) of this section, because the formula is available solely to some or all NHCEs.

Example 5. Plan E is a unit credit plan that provides a benefit of one percent of average annual compensation per year of service to all employees. In 1994, the plan is amended to provide a benefit of two percent of average annual compensation per year of service after 1993, while continuing to provide a benefit of one percent of average annual compensation per year of service for all years of service before 1994. Thus, the plan's amended benefit formula provides a benefit equal to the sum of the benefits determined under two benefit formulas: one percent of average annual compensation per year of service, plus one percent of average annual compensation per year of service after 1993. Plan E satisfies this paragraph (b)(6)(xi).

Example 6. The facts are the same as in *Example 5*, except that the plan amendment in 1994 decreases the benefit to 0.75 percent of average annual compensation per year of service after 1993, while retaining the one-percent formula for all years of service before 1994. Thus, the plan's amended benefit formula provides a benefit equal to the sum of the benefits determined under two benefit formulas: 0.75 percent of average annual compensation per year of service, plus 0.25 percent of average annual compensation per year of service before 1994. Under these facts, the second formula does not separately satisfy any of the safe harbors in this paragraph (b) because the years of service over which each employee's benefit accrues under the second formula (i.e., all years of service) are not the same years of service that are taken into account in applying the benefit formula under the plan to that employee (i.e., years of service before 1994). See paragraph (b)(2)(v) of this section. But see paragraph (b)(6)(vii) of this section and § 1.401(a)(4)–13, which provide rules under which Plan E, as amended, may be able to satisfy this paragraph (b).

Example 7. Plan F provides a benefit to all employees of one percent of average annual compensation per year of service. Employee M was hired as the president of the employer in December 1994 and was not a HCE under section 414(q) during the 1994 calendar plan year. In 1994, Plan F is amended to provide a benefit that is the greater of the benefit determined under the pre-existing formula in the plan and a new formula that is available solely to some NHCEs (including Employee M). The new formula does not satisfy the uniformity requirements of paragraph (b)(2) of this section, because it provides a different benefit for some NHCEs than for other NHCEs. As a result of this change, Employee M receives a higher accrual in 1994 than the NHCEs who are not eligible for the new formula. In 1995, when Employee M first becomes a HCE, the second formula no longer applies to Employee M. It would be inconsistent with the purpose of preventing discrimination in favor of HCEs for Plan F to use the special rule for a formula that is available solely to some or all NHCEs to satisfy the separate testing requirement of paragraph (b)(6)(xi)(C) of this section for the 1994 calendar plan year. See § 1.401(a)(4)–1(c)(2).

(c) *General test for nondiscrimination in amount of benefits*—(1) *General rule.* The employer-provided benefits under a defined benefit plan are nondiscriminatory in amount for a plan year if each rate group under the plan satisfies section 410(b). For purposes of this paragraph (c)(1), a rate group exists under a plan for each HCE and consists of the HCE and all other employees (both HCEs and NHCEs) who have a normal accrual rate greater than or equal to the HCE's normal accrual rate, and who also have a most valuable accrual rate greater than or equal to the HCE's most valuable accrual rate. Thus, an employee is in the rate group for each HCE who has a normal accrual rate less than or equal to the employee's normal accrual rate, and who also has a most valuable accrual rate less than or equal to the employee's most valuable accrual rate.

(2) *Satisfaction of section 410(b) by a rate group.* For purposes of determining whether a rate group satisfies section 410(b), the same rules apply as in § 1.401(a)(4)–2(c)(3). See paragraph (c)(4) of this section and § 1.401(a)(4)–2(c)(4), *Example 3* through *Example 5,* for examples of this rule.

(3) *Certain violations disregarded.* A plan is deemed to satisfy paragraph (c)(1) of this section if the plan would satisfy that paragraph by treating as not benefiting no more than five percent of the HCEs in the plan, and the Commissioner determines that, on the basis of all of the relevant facts and circumstances, the plan does not discriminate with respect to the amount of employer-provided benefits. For this purpose, five percent of the number of HCEs may be determined by rounding to the nearest whole number (e.g., 1.4 rounds to 1 and 1.5 rounds to 2). Among the relevant factors that the Commissioner may consider in making this determination are—

(i) The extent to which the plan has failed the test in paragraph (c)(1) of this section;

(ii) The extent to which the failure is for reasons other than the design of the plan;

(iii) Whether the HCEs causing the failure are five-percent owners or are among the highest paid nonexcludable employees;

(iv) Whether the failure is attributable to an event that is not expected to recur (e.g., a plant closing); and

(v) The extent to which the failure is attributable to benefits accrued under a prior benefit structure or to benefits accrued when a participant was not a HCE.

(4) *Examples.* The following examples illustrate the rules in this paragraph (c):

Example 1. (a) Employer X has 1100 nonexcludable employees, N1 through N1000, who are NHCEs, and H1 through H100, who are HCEs. Employer X maintains Plan A, a defined benefit plan that benefits all of these nonexcludable employees. The normal and most valuable accrual rates (determined as a percentage of average annual compensation) for the employees in Plan A for the 1994 plan year are listed in the following table.

Employee	Normal accrual rate	Most valuable accrual rate
N1 through N100	1.0	1.4
N101 through N500	1.5	3.0
N501 through N750	2.0	2.65
N751 through N1000	2.3	2.8
H1 through H50	1.5	2.0
H51 through H100	2.0	2.65

(b) There are 100 rate groups in Plan A because there are 100 HCEs in Plan A.

(c) Rate group 1 consists of H1 and all those employees who have a normal accrual rate greater than or equal to H1's normal accrual rate (1.5 percent) and who also have a most valuable accrual rate greater than or equal to H1's most valuable accrual rate (2.0 percent). Thus, rate group 1 consists of H1 through H100 and N101 through N1000.

(d) Rate group 1 satisfies the ratio percentage test of §1.410(b)–2(b)(2) because the ratio percentage of the rate group is 90 percent, i.e., 90 percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 100 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group).

(e) Because H1 through H50 have the same normal accrual rates and the same most valuable accrual rates, the rate group with respect to each of them is identical. Thus, because rate group 1 satisfies section 410(b), rate groups 2 through 50 also satisfy section 410(b).

(f) Rate group 51 consists of H51 and all those employees who have a normal accrual rate greater than or equal to H51's normal accrual rate (2.0 percent) and who also have a most valuable accrual rate greater than or equal to H51's most valuable accrual rate (2.65 percent). Thus, rate group 51 consists of H51 through H100 and N501 through N1000. (Even though N101 through N500 have a most valuable accrual rate (3.0 percent) greater than H51's most valuable accrual rate (2.65 percent), they are not included in this rate group because their normal accrual rate (1.5 percent) is less than H51's normal accrual rate (2.0 percent).)

(g) Rate group 51 satisfies the ratio percentage test of §1.410(b)–2(b)(2) because the ratio percentage of the rate group is 100 percent, i.e., 50 percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 50 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group).

(h) Because H51 through H100 have the same normal accrual rates and the same most valuable accrual rates, the rate group with respect to each of them is identical. Thus, because rate group 51 satisfies section 410(b), rate groups 52 through 100 also satisfy section 410(b).

(i) The employer-provided benefits under Plan A are nondiscriminatory in amount because each rate group under the plan satisfies section 410(b).

Example 2. The facts are the same as in *Example 1*, except that H96 has a most valuable accrual rate of 3.5. Each of the rate groups is the same as in *Example 1*, except that rate group 96 consists solely of H96 because no other employee has a most valuable accrual rate greater than 3.5. Because the plan would satisfy the test in paragraph (c)(1) of this section by treating H96 (who constitutes less than five percent of the HCEs in the plan) as not benefiting, the Commissioner may determine under paragraph (c)(3) of this section that, on the basis of all of the relevant facts and circumstances, the plan does not discriminate with respect to the amount of benefits.

(d) *Determination of accrual rates*—(1) *Definitions*—(i) *Normal accrual rate.* The normal accrual rate for an employee for a plan year is the increase in the employee's accrued benefit (within the meaning of section 411(a)(7)(A)(i)) during the measurement period, divided by the employee's testing service during the measurement period, and expressed either as a dollar amount or as a percentage of the employee's average annual compensation.

(ii) *Most valuable accrual rate.* The most valuable accrual rate for an employee for a plan year is the increase in the employee's most valuable optional form of payment of the accrued benefit during the measurement period, divided by the employee's testing service during the measurement period, and expressed either as a dollar amount or as a percentage of the employee's average annual compensation. The employee's most valuable optional form of payment of the accrued benefit is determined by calculating for the employee the normalized QJSA associated with the accrued benefit that is potentially payable in the current or any future plan year at any age under the plan and selecting the largest (per year of testing service). If the plan provides a QSUPP, the most valuable accrual rate also takes into account the QSUPP payable in conjunction with the QJSA at each age under the plan. Thus, the most valuable accrual rate reflects the value of all benefits accrued or treated as accrued under section 411(d)(6) that are payable in any form and at any time under the plan, including early retirement benefits, retirement-type subsidies, early retirement window benefits, and QSUPPs. In addition, the most valuable accrual rate must take into account any such benefits that are available during a plan year, even if the benefits cease to be available before the end of the current or any future plan year.

(iii) *Measurement period.* The measurement period can be—

(A) The current plan year;

(B) The current plan year and all prior years; or

(C) The current plan year and all prior and future years.

(iv) *Testing service*—(A) *General rule.* Testing service means an employee's years of service as defined in the plan for purposes of applying the benefit formula under the plan, subject to the requirements of paragraph (d)(1)(iv)(B) of this section. Alternatively, testing service means service determined for all employees in a reasonable manner that satisfies the requirements of paragraph (d)(1)(iv)(B) of this section. For example, the number of plan years that an employee has benefited under the plan within the meaning of §1.410(b)–3(a) is an acceptable definition of testing service because it determines service in a reasonable manner and satisfies paragraph (d)(1)(iv)(B) of this section. See also §1.401(a)(4)–11(d)(3) (additional limits on service that may be taken into account as testing service).

(B) *Requirements for testing service*—(*1*) *Employees not credited with years of service under the benefit formula.* An employee must be credited with testing service for any year in which the employee benefits under the plan (within the meaning of §1.410(b)–3(a)), unless that year is part of a period of service that may not be taken into account under §1.401(a)(4)–11(d)(3). This rule applies even if the employee does not receive service credit under the benefit formula for that year (e.g., because of a service cap in the benefit formula or because of a transfer out of the group of employees covered by the plan).

(*2*) *Current year testing service.* In the case of a measurement period that is the current plan year, testing service for the plan year equals one (1).

(2) *Rules of application*—(i) *Consistency requirement.* Both normal and most valuable accrual rates must be determined in a consistent manner for all employees for the plan year. Thus, for example, the same measurement periods must be used, and the rules of this paragraph (d)(2) and any available options described in paragraph (d)(3) of this section must be applied consistently. If plan benefits are not expressed as straight life annuities beginning at employees' testing ages, they must be normalized.

(ii) *Determining plan benefits, service and compensation*—(A) *In general.* Potential plan benefits, testing service, and average annual compensation must be determined in a reasonable manner, reflecting actual or projected service and compensation only through the end of the measurement period. The determination of potential plan benefits is not reasonable if it incorporates an assumption that, in future years, an employee's compensation will increase or the employee will terminate employment before the employee's testing age (other than the assumptions under paragraph (d)(1)(ii) of this section that the employee's service will end in connection with the payment of each potential QJSA in future years).

(B) Section 415 limits. For purposes of determining accrual rates under this paragraph (d), plan benefits are generally determined without regard to whether those benefits are permitted to be paid under section 415. However, plan provisions implementing any of the limits of section 415 may be taken into account in applying this paragraph (d) if the plan does not provide for benefit increases resulting from section 415(d)(1) adjustments for former employees who were employees in a plan year in which such plan provisions were taken into account in applying this paragraph (d). If the limits of section 415 are taken into account under this paragraph (d)(2)(ii)(B) as of the end of the measurement period, they must also be taken into account as of the beginning of the measurement period. If the limits of section 415 are not taken into account in testing the plan for the current plan year, but were taken into account in testing the plan for the preceding plan year, any resulting increase in the accrued benefits taken into account in testing the plan is treated as an increase in accrued benefits during the current plan year.

(iii) *Requirements for measurement period that includes future years*—(A) *Discriminatory pattern of accruals.* A measurement period that includes future years (as described in paragraph (d)(1)(iii)(C) of this section) may not be used if the pattern of accruals under the plan discriminates in favor of HCEs (i.e., if projected benefits for HCEs are relatively frontloaded when compared to the degree of front loading or backloading for NHCEs). This determination is made based on all of the relevant facts and circumstances.

(B) *Future-period limitation.* Future years beginning after an employee's attainment of the employee's testing age (or after the employee's assumed termination in the case of most valuable accrual rates) may not be included in the measurement period.

(3) *Optional rules*—(i) *Imputation of permitted disparity.* The disparity permitted under section 401(l) may be imputed in accordance with the rules of §1.401(a)(4)–7.

(ii) *Grouping of accrual rates*—(A) *General rule.* An employer may treat all employees who have accrual rates within a specified range above and below a midpoint rate chosen by the employer as having an accrual rate equal to the midpoint rate within that range. Accrual rates within a given range may not be grouped under this paragraph (d)(3)(ii) if the accrual rates of HCEs within the range generally are significantly higher than the accrual rates of NHCEs in the range. The specified ranges within which all employees are treated as having the same accrual rate may not overlap and may be no larger than provided in paragraph (d)(3)(ii)(B) of this section. Accrual rates of employees that are not within any of these specified ranges are determined without regard to this paragraph (d)(3)(ii).

(B) *Size of specified ranges.* In the case of normal accrual rates, the lowest and highest accrual rates in the range must be within five percent (not five percentage points) of the midpoint rate. In the case of most valuable accrual rates, the lowest and highest accrual rates in the range must be within 15 percent (not 15 percentage points) of the midpoint rate. If accrual rates are determined as a percentage of average annual compensation, the lowest and highest accrual rates need not be within five percent (or 15 percent) of the midpoint rate, if they are no more than one twentieth of a percentage point above or below the midpoint rate.

(iii) *Fresh-start alternative*—(A) *General rule.* Notwithstanding the definition of measurement period provided in paragraph (d)(1)(iii) of this section, a measurement period for a fresh-start group is permitted to be limited to the period beginning after the fresh-start date with respect to that group if the plan makes a fresh start that satisfies §1.401(a)(4)–13(c) (without regard to §1.401(a)(4)–13(c)(2)(i) and (ii)). If the measurement period is so limited or the measurement period is the plan year (whether or not so limited), any compensation adjustments during the measurement period to the frozen accrued benefit as of the fresh-start date that are permitted under the rules of §1.401(a)(4)–13(d) may be disregarded in determining the increase in accrued benefits during the measurement period, but only if—

(*1*) The plan makes a fresh start as of the fresh-start date that satisfies §1.401(a)(4)–13(c) (without regard to §1.401(a)(4)–13(c)(2)(ii)) in conjunction with a bona fide amendment to the benefit formula or accrual method under the plan; and

(*2*) The amendment provides for adjustments to employees' frozen accrued benefits as of the fresh-start date in accordance with the rules of §1.401(a)(4)–13(d).

(B) *Application of consistency requirements.* Limiting the application of the fresh-start alternative in this paragraph (d)(3)(iii) to a fresh-start group that consists of fewer than all employees does not violate the consistency requirement of paragraph (d)(2)(i) of this section.

(iv) *Floor on most valuable accrual rate.* In lieu of determining an employee's most valuable accrual rate in accordance with the definition in paragraph (d)(1)(ii) of this section, an employer may determine an employee's most valuable accrual rate for the current plan year as the employee's highest most valuable accrual rate determined for any prior plan year. This option may be used only if the employee's normal accrual rate has not changed significantly from the normal accrual rate for the relevant prior plan year and, there have been no plan amendments in the interim period since that prior plan year that affect the determination of most valuable accrual rates.

(4) *Examples.* The following examples illustrate the rules in this paragraph (d):

Example 1. The employees in Plan A have the following normal accrual rates (expressed as percentage of average annual compensation): 0.8 percent, 0.83 percent, 0.9 percent, 1.9 percent, 2.0 percent, and 2.1 percent. Because the first three rates are within a range of no more than one twentieth of a percentage point above or below 0.85 percent (a midpoint rate chosen by the employer), the employer may treat the employees who have those rates as having an accrual rate of 0.85 percent (provided that the accrual rates of HCEs within the range are not significantly higher than the accrual rates for NHCEs within the range). Because the last three rates are within a range of no more than five percent above or below 2.0 percent (a midpoint rate chosen by the employer), the employer may treat the employees who have those rates as having an accrual rate of 2.0 percent (provided that the accrual rates of HCEs within the range are not significantly higher than the accrual rates for NHCEs within the range).

Example 2. Employer X maintains a plan under which headquarters employees accrue a benefit of 1.25 percent of average compensation for the first 10 years of service and 0.75 percent of average compensation for subsequent years of service, while all other employees accrue a benefit of one percent of compensation for all years of service. Assume that the group of headquarters employees does not satisfy section 410(b). Under these facts, the pattern of accruals under the plan discriminates in favor of HCEs, and, therefore, under paragraph (d)(2)(iii)(A) of this section, the measurement period for determining accrual rates under the plan may not include future service.

(e) *Compensation rules*—(1) *In general.* This paragraph (e) provides rules for determining average annual compensation. Safe harbor plans that satisfy paragraph (b) of this section must determine benefits either as a dollar amount unrelated to employees' compensation or as a percentage of each employee's average annual compensation. In contrast, plans that must satisfy the general test of paragraph (c) of this section are not required under this section to determine benefits under any particular definition of compensation or in any particular manner, but the accrual rates used in testing these plans must be expressed either as a dollar amount or determined as a percentage of each employee's average annual compensation.

(2) *Average annual compensation*—(i) *General rule.* An employee's average annual compensation is the average of the employee's annual section 414(s) compensation determined over the averaging period in the employee's compensation history during which the average of the employee's annual section 414(s) compensation is the highest. For this purpose, an averaging period must consist of three or more consecutive 12-month periods, but need not be longer than the employee's period of employment. An employee's compensation history may begin at any time, but must be continuous, be no shorter than the averaging period, and end in the current plan year.

(ii) *Certain permitted modifications to average annual compensation*—(A) *Use of plan year compensation.* If the measurement period for determination of accrual rates is the current plan year, or the plan is an accumulation plan that satisfies paragraph (b) of this section, then plan year compensation may be substituted for average annual compensation.

(B) *Drop-out years.* Any of the following types of 12-month periods in an employee's compensation history may be disregarded in determining the employee's average annual compensation (including for purposes of the requirement to average section 414(s) compensation over consecutive 12-month periods), but only if the plan disregards the employee's compensation for those periods in determining benefits—

(*1*) The 12-month period in which the employee terminates employment;

(*2*) All 12-month periods in which the employee performs no services; or

(*3*) All 12-month periods in which the employee performs services for less than a specified number of hours or specified period of time in the 12-month period. The specified number of hours or specified period of time may be selected by the employer, but may not exceed three quarters of the time that an employee in the same job category working on a full-time basis would perform services during that 12-month period.

(C) *Drop-out months within 12-month periods.* If a plan determines an employee's average annual compensation using 12-month periods that do not end on a fixed date (e.g., average annual compensation as of a date is defined as the average of the employee's section 414(s) compensation for the 60 consecutive months within the compensation history in which the average is highest), then, for purposes of determining a 12-month period, any of the following type of months may be disregarded (including for purposes of the requirement to average section 414(s) compensation over consecutive 12-month periods), but only if the plan disregards the employee's compensation for those months in determining benefits—

(*1*) The month in which the employee terminates employment;

(*2*) All months in which the employee performs no services; or

(*3*) All months in which the employee performs services for less than a specified number of hours or specified period of time in the month. The specified number of hours or specified period of time may be selected by the employer, but may not exceed three quarters of the time that an employee in the same job category working on a full-time basis would perform services during that month.

(D) *Employees working less than full-time.* In the case of an employee who normally works less than full-time, the rules in paragraphs (e)(2)(ii)(B)(*3*) and (e)(2)(ii)(C)(*3*) of this section may be applied in relation to that employee's normal work schedule (instead of a full- time employee's work schedule) by prorating the specified number of hours or specified period of time, based on the employee's normal work schedule as a fraction of a full-time schedule.

(E) *Exception from consecutive-periods requirement for certain plans.* The requirement that the periods taken into account under paragraph (e)(2)(i) of this section be consecutive does not apply in the case of a plan that is not a section 401(l) plan, provided that it does not take permitted disparity into account under §1.401(a)(4)–7. This paragraph (e)(2)(ii)(E) applies only if the plan does not take into account whether 12-month periods of compensation are consecutive in determining average compensation for purposes of calculating benefits.

(iii) *Consistency requirements.* Average annual compensation must be determined in a consistent manner for all employees.

(3) *Examples.* The following examples illustrate the rules in this paragraph (e):

Example 1. Plan A is a defined benefit plan. Plan A determines benefits on the basis of the average of each employee's annual compensation for the five consecutive plan years (or the employee's period of employment, if shorter) during the employee's compensation history in which the average of the employee's annual compensation is the highest. The compensation history used for this purpose is the last 10 plan years, plus the current plan year. In determining compensation for each plan year in the compensation history, Plan A defines compensation using a single definition that satisfies section 414(s) as a safe harbor definition under §1.414(s)–1(c). Plan A determines benefits on the basis of average annual compensation.

Example 2. Plan B is a defined benefit plan. Plan B determines benefits on the basis of the average of each employee's compensation for the five consecutive 12-month periods (or the employee's period of employment, if shorter) during the employee's compensation history in which the average of the employee's annual compensation is the highest. The compensation history used for this purpose is the 10 consecutive 12-month periods ending on the employee's termination date. In determining the average, Plan B disregards all months in which the employee performs services for less than 100 hours (60 percent of a full-time work schedule of 173 hours). In the case of an employee whose normal work schedule is less than a full-time schedule, Plan B disregards all months in which that employee performs services for less than 60 percent of the employee's normal work schedule. Plan B defines compensation for each 12-month period using a single definition that satisfies § 1.414(s)–1. Plan B determines benefits on the basis of average annual compensation.

Example 3. (a) The facts are the same as in *Example 1,* except that, for plan years prior to 1996, the compensation for a plan year was determined under a rate of pay definition of compensation that satisfies section 414(s), while, for plan years after 1995, the compensation for a plan year is determined using a definition that satisfies section 414(s) as a safe harbor definition under § 1.414(s)–1(c).

(b) The underlying definition of compensation for each plan year in the employee's compensation history is section 414(s) compensation, because for each plan year the definition satisfies the requirements for section 414(s) compensation under § 1.401(a)(4)–12. Therefore, Plan A determines benefits on the basis of average annual compensation, even though the underlying definition used to measure the amount of compensation for each plan year in an employee's compensation history is not the same for all plan years.

Example 4. The facts are the same as in *Example 1,* except that Plan A determines benefits on the basis of the average of the employee's annual section 414(s) compensation for the five consecutive 12-month periods ending on June 30 during the employee's compensation history in which the average is highest. An employee's compensation history begins when the employee commences participation in the plan and ends in the current plan year. In the case of an employee with less than five consecutive years of plan participation as of June 30, the compensation history is extended prior to the employee's commencement of participation to include the five consecutive 12-month periods ending on June 30 of the current plan year (or the employee's total period of employment, if shorter). Plan A determines benefits on the basis of average annual compensation.

Example 5. The facts are the same as in *Example 4,* except that Plan A determines benefits on the basis of the average of each employee's compensation for the employee's entire compensation history. Plan A determines benefits on the basis of average annual compensation.

(f) *Special rules*—(1) *In general.* The special rules in this paragraph (f) apply for purposes of applying the provisions of this section to a defined benefit plan. Any special rule provided in this paragraph (f) that is optional must, if used, apply uniformly to all employees.

(2) *Certain qualified disability benefits.* In general, qualified disability benefits (within the meaning of section 411(a)(9)) are not taken into account under this section. However, a qualified disability benefit that results from the crediting of compensation or service for a period of disability in the same manner as actual compensation or service is credited under a plan's benefit formula is permitted to be taken into account under this section as an accrued benefit upon the employee's return to service with the employer following the period of disability, provided that the qualified disability benefit is then treated in the same manner as an accrued benefit for all purposes under the plan.

(3) *Accruals after normal retirement age*—(i) *General rule.* An employee's accruals for any plan year after the plan year in which the employee attains normal retirement age are taken into account for purposes of this section. However, any plan provision that provides for increases in an employee's accrued benefit solely because the employee has delayed commencing benefits beyond the normal retirement age applicable to the employee under the plan may be disregarded, but only if—

(A) The same uniform normal retirement age applies to all employees; and

(B) The percentage factor used to increase the employee's accrued benefit is no greater than the largest percentage factor that could be applied to increase actuarially the employee's accrued benefit using any standard mortality table and any standard interest rate.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (f)(3). In each example, it is assumed that the plan satisfies the requirements of paragraph (f)(3)(i)(A) and (B) of this section.

Example 1. Plan A provides a benefit of two percent of average annual compensation per year of service for all employees. In addition, Plan A provides an actuarial increase in an employee's accrued benefit of six percent for each year that an employee defers commencement of benefits beyond normal retirement age. For employees who continue in service beyond normal retirement age, the employee's two-percent accrual for the current plan year is offset by the six-percent actuarial increase, as permitted under section 411(b)(1)(H)(iii)(II). For purposes of this section, the actuarial increase (and hence the offset) may be disregarded, and thus all employees may be treated as if they were accruing at the rate of two percent of average annual compensation per year.

Example 2. The facts are the same as in *Example 1,* except that the employee's two- percent accrual for the current plan year is not offset by the six-percent actuarial increase. The employer may disregard the actuarial increase and thus may treat all employees as if they were accruing at the rate of two percent of average annual compensation per year.

(4) *Early retirement window benefits*—(i) *General rule.* In applying the requirements of this section, all early retirement benefits, retirement-type subsidies, QSUPPs, and other optional forms of benefit under a plan, and changes in the plan's benefit formula, are taken into account regardless of whether they are permanent features of the plan or are offered only to employees whose employment terminates within a limited period of time. Additional rules and examples relevant to the testing of early retirement window benefits are found in *Example 6* of paragraph (b)(2)(vi) of this section; paragraph (b)(2)(ii)(A)(2), *Example 2* of paragraph (c)(2), paragraph (d)(3), and *Example 3* of paragraph (e)(1)(iii) of §1.401(a)(4)–4; paragraph (c)(4)(i) and *Example 2* of paragraph (c)(6) of §1.401(a)(4)–9; and the definition of benefit formula in §1.401(a)(4)–12.

(ii) Special rules—(A) *Year in which early retirement window benefit taken into account.* Notwithstanding paragraph (f)(4)(i) of this section, an early retirement window benefit is disregarded for purposes of determining whether a plan satisfies this section with respect to an employee for all plan years other than the first plan year in which the benefit is currently available (within the meaning of §1.401(a)(4)–4(b)(2)) to the employee. For purposes of this paragraph (f)(4)(ii)(A), in determining which plan years the benefit is currently available, an early retirement window benefit that consists of a temporary change in the plan's benefit formula is treated as an optional form of benefit.

(B) *Treatment of early retirement window benefit that consists of temporary change in benefit formula.* An early retirement window benefit is disregarded for purposes of determining an employee's normal accrual rate, even if the early retirement window benefit consists of a temporary change in a plan's benefit formula. However, if an early retirement window benefit consists of a temporary change in a plan's benefit formula, the plan does not satisfy paragraph (b) of this section during the period for which the change is effective unless the plan satisfies paragraph (b) of this section both reflecting the temporary change in the benefit formula and disregarding that change.

(C) *Effect of early retirement window benefit on most valuable accrual rate.* In determining an employee's most valuable optional form of payment of the accrued benefit (which is used in determining the employee's most valuable accrual rate under paragraphs (d)(1)(ii) and (f)(4)(i) of this section), an early retirement window benefit that is currently available to the employee (within the meaning of paragraph (f)(4)(ii)(A) of this section) and that is not disregarded for a plan year under paragraph (f)(4)(ii)(A) of this section is taken into account in that plan year with respect to the employee's accrued benefit as of the earliest of the employee's date of termination, the close of the early retirement window, or the last day of that plan year.

(D) *Effect of early retirement window benefit on average benefit percentage test.* Notwithstanding paragraph (c)(2) of this section, a rate group under a plan that provides an early retirement window benefit is deemed to satisfy the average benefit percentage test of §1.410(b)–5 if—

(*1*) All rate groups under the plan would satisfy the ratio percentage test of §1.410(b)–2(b)(2) if the early retirement window benefit were disregarded; and

(*2*) The group of employees to whom the early retirement window benefit is currently available (within the meaning of paragraph (f)(4)(ii)(A) of this section) satisfies section 410(b) without regard to the average benefit percentage test of §1.410(b)–5.

(iii) *Early retirement window benefit defined.* For purposes of this paragraph (f)(4), an early retirement window benefit is an early retirement benefit, retirement-type subsidy, QSUPP, or other optional form of benefit under a plan that is available, or a change in the plan's benefit formula that is applicable, only to employees who terminate employment within a limited period specified by the plan (not to exceed one year) under circumstances specified by the plan. A benefit does not fail to be described in the preceding sentence merely because the plan contains provisions under which certain employees may receive the benefit even though, for bona fide business reasons, they terminate employment within a reasonable period after the end of the limited period. An amendment to an early retirement window benefit that merely extends the periods in the preceding sentences is not treated as a separate early retirement window benefit, provided that the periods, as extended, satisfy the preceding sentences. However, any other amendment to an early retirement window benefit creates a separate early retirement window benefit.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (f)(4):

Example 1. (a) Plan A provides a benefit of one percent of average annual compensation per year of service and satisfies the requirements of paragraph (b)(2) of this section. Thus, the plan provides the same benefit to all employees with the same years of service under the Plan. Plan A is amended to treat all employees with ten or more years of service who terminate employment after attainment of age 55 and between March 1, 1999, and January 31, 2000, as if they had an additional five years of service under the benefit formula. However, in order to ensure the orderly implementation of the early retirement window, the plan amendment provides that designated employees in the human resources department who would otherwise be eligible for the early retirement window benefit are eligible to be treated as having the additional five years of service only if they terminate between January 1, 2000, and April 30, 2000.

(b) The additional benefits provided under this amendment are tested as benefits provided to employees rather than former employees. The effect of this amendment is temporarily to change the benefit formula for employees who are eligible for the early retirement window benefit because the amendment changes (albeit temporarily) the amount of the benefit payable to those employees at normal retirement age. See the definition of benefit formula in § 1.401(a)(4)–12. Assume that the additional years of service credited to employees eligible for the window benefit do not represent past service (within the meaning of § 1.401(a)(4)–11(d)(3)(i)(B)) or pre-participation or imputed service (within the meaning of § 1.401(a)(4)–11(d)(3)(ii)(A) or (B), respectively) and thus may not be taken into account as years of service. See § 1.401(a)(4)–11(d)(3)(i)(A) (regarding years of service that may not be taken into account under § 1.401(a)(4)–1(b)(2)). Thus, the window-eligible employees are entitled to a larger benefit (as a percentage of average annual compensation) than other employees with the same number of years of service, and the plan does not satisfy the uniform normal retirement benefit requirement of paragraph (b)(2)(i) of this section.

(c) Plan A is restructured under the provisions of § 1.401(a)(4)–9(c) into two component plans: Component Plan A1, consisting of all employees who are not eligible for the early retirement window benefit and all of their accruals and benefits, rights, and features under the plan, and Component Plan A2, consisting of all employees who are eligible for the early retirement window benefit (including the designated employees in the human resource department) and all of their accruals and benefits, rights, and features under the plan.

(d) Component Plan A1 still satisfies paragraph (b) of this section, because there has been no change for the employees in that component plan. Similarly, Component Plan A2 satisfies paragraph (b) of this section disregarding the change in the benefit formula.

(e) Because the early retirement window benefit consists of a temporary change in the benefit formula, paragraph (f)(4)(ii)(B) of this section requires that the plan satisfy the requirements of paragraph (b) of this section reflecting the change in order to remain a safe harbor plan. After reflecting the change, Component Plan A2 still provides the same benefit (albeit higher than under the regular benefit formula) to all employees with the same years of service that may be taken into account in testing the plan, and thus the benefit formula (as temporarily amended) satisfies the requirements of paragraphs (b)(2) (i) and (ii) of this section.

(f) Since Component Plan A2 also satisfies all of the other requirements of paragraph (b)(2) of this section and the safe harbor of paragraph (b)(3) of this section reflecting the change in the benefit formula, Component Plan A2 satisfies this paragraph (b) both reflecting and disregarding the change in the benefit formula. Thus, Component Plan A2 satisfies paragraph (b) of this section.

Example 2. The facts are the same as in *Example 1,* except that Plan A's benefit formula used the maximum amount of permitted disparity under section 401(l) prior to the amendment. The analysis is the same as in paragraphs (a) through the first sentence of paragraph (e) of *Example 1.* In order to satisfy the requirements of paragraph (b)(2) of this section, a plan that uses permitted disparity must satisfy the requirements of section 401(l) after reflecting the change in the benefit formula. Because, as stated in *Example 1,* the additional five years of service may not be taken into account for purposes of satisfying paragraph (b) of this section, the disparity that results from crediting that service exceeds the maximum permitted disparity under section 401(l). Thus, Component Plan A2 does not satisfy the requirements of paragraph (b) of this section.

Example 3. The facts are the same as in *Example 1,* except that Plan A is tested under the general test in paragraph (c) of this section. The early retirement window benefit is disregarded for purposes of determining the normal accrual rates, but is taken into account in 1999 for purposes of determining the most valuable accrual rates, of employees who were eligible for the early retirement window benefit (regardless of whether they elected to receive it). As stated in *Example 1,* the additional five years of service do not represent past service, pre-participation service, or imputed service, and thus under §1.401(a)(4)–11(d)(3)(i)(A) may not be taken into account as testing service.

(5) *Unpredictable contingent event benefits*—(i) *General rule.* In general, an unpredictable contingent event benefit (within the meaning of section 412(l)(7)(B)(ii)) is not taken into account under this section until the occurrence of the contingent event. Thus, the special rule in §1.401(a)(4)–4(d)(7) (treating the contingent event as having occurred) does not apply for purposes of this section. In the case of an unpredictable contingent event that is expected to result in the termination from employment of certain employees within a period of time consistent with the rules for defining an early retirement window benefit in paragraph (f)(4)(iii) of this section, the unpredictable contingent event benefit available to those employees is permitted to be treated as an early retirement window benefit, thus permitting the rules of paragraph (f)(4) of this section to be applied to it.

(ii) *Example.* The following example illustrates the rules of this paragraph (f)(5):

Example. (a) Employer X operates various manufacturing plants and maintains Plan A, a defined benefit plan that covers all of its nonexcludable employees. Plan A provides an early retirement benefit under which employees who retire after age 55 but before normal retirement age and who have at least 10 years of service receive a benefit equal to their normal retirement benefit reduced by four percent per year for each year prior to normal retirement age. Plan A also provides a plant-closing benefit under which employees who satisfy the conditions for receiving the early retirement benefit and who work at a plant where operations have ceased and whose employment has been terminated will receive an unreduced normal retirement benefit. The plant-closing benefit is an unpredictable contingent event benefit.

(b) During the 1997 plan year, Employer X had no plant closings. Therefore, the plant-closing benefit is not taken into account for the 1997 plan year in determining accrual rates or in applying the safe harbors in paragraph (b) of this section.

(c) During the 1998 plan year, Employer X begins to close one plant. Employees M through Z, who are employees at the plant that is closing, are expected to terminate employment with Employer X during the plan year and will satisfy the conditions for the plant-closing benefit. Therefore, in testing Plan A under this section for the 1998 plan year, the availability of the plant-closing benefit to Employees M through Z must be taken into account in determining their accrual rates or in determining whether the plan satisfies one of the safe harbors under paragraph (b) of this section.

(d) Because the employees eligible for the unpredictable contingent event benefit are expected to terminate employment with Employer X during a period consistent with the rules for defining an early retirement window benefit, in testing Plan A under this section for the 1998 plan year, the special rules in paragraph (f)(4)(ii) of this section may be applied. Thus, for example, normal accrual rates may be determined without reference to the unpredictable contingent event benefit.

(e) Despite the closing of the plant, Employee Q remains an employee into the 1999 plan year. Under paragraph (f)(4)(ii)(A) of this section, the availability of the plant-closing benefit to Employee Q may be disregarded in the 1999 plan year.

(6) *Determination of benefits on other than plan-year basis.* For purposes of this section, accruals are generally determined based on the plan year. Nevertheless, an employer may determine accruals on the basis of any period ending within the plan year as long as the period is at least 12 months in duration. For example, accruals for all employees may be determined based on accrual computation periods ending within the plan year.

(7) *Adjustments for certain plan distributions.* For purposes of this section,

an employee's accrued benefit includes the actuarial equivalent of prior distributions of accrued benefits from the plan to the employee if the years of service taken into account in determining the accrued benefits that were distributed continue to be taken into account under the plan for purposes of determining the employee's current accrued benefit. For purposes of this paragraph (f)(7), actuarial equivalence must be determined in a uniform manner for all employees using reasonable actuarial assumptions. A standard interest rate and a standard mortality table are among the assumptions considered reasonable for this purpose. Thus, for example, if an employee has commenced receipt of benefits in accordance with the minimum distribution requirements of section 401(a)(9), and the plan reduces the employee's accrued benefit to take into account the amount of the distributions, the employee's accrued benefit for purposes of this section is restored to the value it would have had if the distributions had not occurred.

(8) *Adjustment for certain QPSA charges.* For purposes of this section, an employee's accrued benefit includes the cost of a qualified preretirement survivor annuity (QPSA) that reduces the employee's accrued benefit otherwise determined under the plan, as permitted under § 1.401(a)–20, Q&A–21. Thus, an employee's accrued benefit for purposes of this section is determined as if the cost of the QPSA had not been charged against the accrued benefit. This paragraph (f)(8) applies only if the QPSA charges apply uniformly to all employees.

(9) *Disregard of certain offsets*—(i) *General rule.* For purposes of this section, an employee's accrued benefit under a plan includes that portion of the benefit that is offset under an offset provision described in § 1.401(a)(4)–11(d)(3)(i)(D). The rule in the preceding sentence applies only to the extent that the benefit by which the benefit under the plan being tested is offset is attributable to periods for which the plan being tested credits pre-participation service (within the meaning of § 1.401(a)(4)–11(d)(3)(ii)(A)) that satisfies § 1.401(a)(4)–11(d)(3)(iii) or past service (within the meaning of § 1.401(a)(4)–11(d)(3)(i)(B)), and only if—

(A) The benefit under the plan being tested is offset by either—

(*1*) Benefits under a qualified defined benefit plan or defined contribution plan (whether or not terminated); or

(*2*) Benefits under a foreign plan that are reasonably expected to be paid; and,

(B) If any portion of the benefit that is offset is nonforfeitable (within the meaning of section 411), that portion is offset by a benefit (or portion of a benefit) that is also nonforfeitable (or vested, in the case of a foreign plan).

(ii) *Examples.* The following examples illustrate the rules in this paragraph (f)(9):

Example 1. (a) Employer X maintains two qualified defined benefit plans, Plan A and Plan B. Plan B provides that, whenever an employee transfers to Plan B from Plan A, the service that was credited under Plan A is credited in determining benefits under Plan B. The Plan A service credited under Plan B is pre-participation service that satisfies § 1.401(a)(4)–11(d)(3)(iii). Plan B offsets the benefits determined under Plan B by the employee's vested benefits under Plan A. Plan A does not credit additional benefit service or accrual service after employees transfer to Plan B.

(b) The Plan B provision providing for an offset of benefits under Plan A satisfies § 1.401(a)(4)–11(d)(3)(i)(D). This is because the provision applies to similarly-situated employees and the benefits under Plan A that are offset against the Plan B benefits are attributable to pre-participation service taken into account under Plan B.

(c) This paragraph (f)(9) applies in determining the benefits that are taken into account under this section for employees in Plan B who are transferred from Plan A. This is because the offset provision is described in § 1.401(a)(4)–11(d)(3)(i)(D), the benefits under the other plan by which the benefits under the plan being tested are offset are attributable solely to pre-participation service that satisfies § 1.401(a)(4)–11(d)(3)(iii), and the benefits are offset solely by vested benefits under another qualified plan. Thus, for example, the accrual rates of employees in Plan B are determined as if there were no offset, i.e., by adding back the benefits that are offset to the net benefits under Plan B.

(d) The result would be the same even if Plan A continued to recognize compensation paid after the transfer in the determination of benefits under Plan A. However, if Plan A continued to credit benefit or accrual service after the transfer, then, to the extent that

Plan B's offset of benefits under Plan A increased as a result, the additional benefits offset under Plan B would not be added back in determining the benefits under Plan B that are taken into account under this section.

Example 2. The facts are the same as in *Example 1,* except that Plan A is not a plan described in paragraph (f)(9)(i)(A) of this section. None of the benefits under Plan B that are offset by benefits under Plan A may be added back in determining the benefits under Plan B that are taken into account under this section. Thus, benefits under Plan B are tested on a net basis.

(10) *Special rule for multiemployer plans.* For purposes of this section, if a multiemployer plan increases benefits for service prior to a specific date subject to a plan provision requiring employees to complete a specified amount of service (not to exceed five years) after that date, then benefits are permitted to be determined disregarding the service condition, provided that the condition is applicable to all employees in the multiemployer plan (including collectively bargained employees).

[T.D. 8485, 58 FR 46785, Sept. 3, 1993]

§1.401(a)(4)–4 Nondiscriminatory availability of benefits, rights, and features.

(a) *Introduction.* This section provides rules for determining whether the benefits, rights, and features provided under a plan (i.e., all optional forms of benefit, ancillary benefits, and other rights and features available to any employee under the plan) are made available in a nondiscriminatory manner. Benefits, rights, and features provided under a plan are made available to employees in a nondiscriminatory manner only if each benefit, right, or feature satisfies the current availability requirement of paragraph (b) of this section and the effective availability requirement of paragraph (c) of this section. Paragraph (d) of this section provides special rules for applying these requirements. Paragraph (e) of this section defines optional form of benefit, ancillary benefit, and other right or feature.

(b) *Current availability*—(1) *General rule.* The current availability requirement of this paragraph (b) is satisfied if the group of employees to whom a benefit, right, or feature is currently available during the plan year satisfies section 410(b) (without regard to the average benefit percentage test of §1.410(b)–5). In determining whether the group of employees satisfies section 410(b), an employee is treated as benefiting only if the benefit, right, or feature is currently available to the employee.

(2) *Determination of current availability*—(i) *General rule.* Whether a benefit, right, or feature that is subject to specified eligibility conditions is currently available to an employee generally is determined based on the current facts and circumstances with respect to the employee (e.g., current compensation, accrued benefit, position, or net worth).

(ii) *Certain conditions disregarded*—(A) *Certain age and service conditions—(1) General rule.* Notwithstanding paragraph (b)(2)(i) of this section, any specified age or service condition with respect to an optional form of benefit or a social security supplement is disregarded in determining whether the optional form of benefit or the social security supplement is currently available to an employee. Thus, for example, an optional form of benefit that is available to all employees who terminate employment on or after age 55 with at least 10 years of service is treated as currently available to an employee, without regard to the employee's current age or years of service, and without regard to whether the employee could potentially meet the age and service conditions prior to attaining the plan's normal retirement age.

(*2*) *Time-limited age or service conditions not disregarded.* Notwithstanding paragraph (b)(2)(ii)(A)(*1*) of this section, an age or service condition is not disregarded in determining the current availability of an optional form of benefit or social security supplement if the condition must be satisfied within a limited period of time. However, in determining the current availability of an optional form of benefit or a social security supplement subject to such an age or service condition, the age and service of employees may be projected to the last date by which the age condition or service condition must be satisfied in order to be eligible for the optional form of benefit or social security supplement under the plan. Thus, for example, an optional form of benefit that is available only to employees who terminate employment between July 1, 1995, and December 31, 1995, after attainment of age 55 with at least 10 years of service is treated as currently available to an employee only if the employee could satisfy those age and service conditions by December 31, 1995.

(B) *Certain other conditions.* Specified conditions on the availability of a benefit, right, or feature requiring a specified percentage of the employee's accrued benefit to be nonforfeitable, termination of employment, death, satisfaction of a specified health condition (or failure to meet such condition), disability, hardship, family status, default on a plan loan secured by a participant's account balance, execution of a covenant not to compete, application for benefits or similar ministerial or mechanical acts, election of a benefit form, execution of a waiver of rights under the Age Discrimination in Employment Act or other federal or state law, or absence from service, are disregarded in determining the employees to whom the benefit, right, or feature is currently available. In addition, if a multiemployer plan includes a reasonable condition that limits eligibility for an ancillary benefit, or other right or feature, to those employees who have recent service under the plan (e.g., a condition on a death benefit that requires an employee to have a minimum number of hours credited during the last two years) and the condition applies to all employees in the multiemployer plan (including the collectively bargained employees) to whom the ancillary benefit, or other right or feature, is otherwise currently available, then the condition is disregarded in determining the employees to whom the ancillary benefit, or other right or feature, is currently available.

(C) *Certain conditions relating to mandatory cash-outs.* In the case of a plan that provides for mandatory cash-outs of all terminated employees who have a vested accrued benefit with an actuarial present value less than or equal to a specified dollar amount (not to exceed the cash-out limit in effect under §1.411(a)–11T(c)(3)(ii)) as permitted by sections 411(a)(11) and 417(e), the implicit condition on any benefit, right, or feature (other than the mandatory cash-out) that requires the employee to have a vested accrued benefit with an actuarial present value in excess of the specified dollar amount is disregarded in determining the employees to whom the benefit, right, or feature is currently available.

(D) *Other dollar limits.* A condition that the amount of an employee's vested accrued benefit or the actuarial present value of that benefit be less than or equal to a specified dollar amount is disregarded in determining the employees to whom the benefit, right, or feature is currently available.

(E) *Certain conditions on plan loans.* In the case of an employee's right to a loan from the plan, the condition that an employee must have an account balance sufficient to be eligible to receive a minimum loan amount specified in the plan (not to exceed $1,000) is disregarded in determining the employees to whom the right is currently available.

(3) *Benefits, rights, and features that are eliminated prospectively*—(i) *Special testing rule.* Notwithstanding paragraph (b)(1) of this section, a benefit, right, or feature that is eliminated with respect to benefits accrued after the later of the eliminating amendment's adoption or effective date (the elimination date), but is retained with respect to benefits accrued as of the elimination date, and that satisfies this paragraph (b) as of the elimination date, is treated as satisfying this paragraph (b) for all subsequent periods. This rule does not apply if the terms of the benefit, right, or feature (including the employees to whom it is available) are changed after the elimination date.

(ii) *Elimination of a benefit, right, or feature*—(A) *General rule.* For purposes of this paragraph (b)(3), a benefit, right, or feature provided to an employee is eliminated with respect to benefits accrued after the elimination date if the amount or value of the benefit, right, or feature depends solely on the amount of the employee's accrued benefit (within the meaning of section 411(a)(7)) as of the elimination date, including subsequent income, expenses, gains, and losses with respect to that benefit in the case of a defined contribution plan.

(B) *Special rule for benefits, rights, and features that are not section 411(d)(6)-protected benefits.* Notwithstanding paragraph (b)(3)(ii)(A) of this section, in the case of a benefit, right, or feature under a defined contribution plan that is not a section 411(d)(6)-protected benefit (within the meaning of § 1.411(d)–4, Q&A–1), e.g., the availability of plan loans, for purposes of this paragraph (b)(3)(ii) each employee's accrued benefit as of the elimination date may be treated, on a uniform basis, as consisting exclusively of the dollar amount of the employee's account balance as of the elimination date.

(C) *Special rule for benefits, rights, and features that depend on adjusted accrued benefits.* For purposes of this paragraph (b)(3), a benefit, right, or feature provided to an employee under a plan that has made a fresh start does not fail to be eliminated as of an elimination date that is the fresh-start date merely because it depends solely on the amount of the employee's adjusted accrued benefit (within the meaning of § 1.401(a)(4)–13(d)(8)).

(c) *Effective availability*—(1) *General rule.* Based on all of the relevant facts and circumstances, the group of employees to whom a benefit, right, or feature is effectively available must not substantially favor HCEs.

(2) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1. Employer X maintains Plan A, a defined benefit plan that covers both of its highly compensated nonexcludable employees and nine of its 12 nonhighly compensated nonexcludable employees. Plan A provides for a normal retirement benefit payable as an annuity and based on a normal retirement age of 65, and an early retirement benefit payable upon termination in the form of an annuity to employees who terminate from service with the employer on or after age 55 with 30 or more years of service. Both HCEs of Employer X currently meet the age and service requirement, or will have 30 years of service by the time they reach age 55. All but two of the nine NHCEs of Employer X who are covered by Plan A were hired on or after age 35 and, thus, cannot qualify for the early retirement benefit. Even though the group of employees to whom the early retirement benefit is currently available satisfies the ratio percentage test of § 1.410(b)–2(b)(2) when age and service are disregarded pursuant to paragraph (b)(2)(ii)(A) of this section, absent other facts, the group of employees to whom the early retirement benefit is effectively available substantially favors HCEs.

Example 2. Employer Y maintains Plan B, a defined benefit plan that provides for a normal retirement benefit payable as an annuity and based on a normal retirement age of 65. By a plan amendment first adopted and effective December 1, 1998, Employer Y amends Plan B to provide an early retirement benefit that is available only to employees who terminate employment by December 15, 1998, and who are at least age 55 with 30 or more years of service. Assume that all employees were hired prior to attaining age 25 and that the group of employees who have, or will have, attained age 55 with 30 years of service by December 15, 1998, satisfies the ratio percentage test of § 1.410(b)–2(b)(2). Assume, further, that the employer takes no steps to inform all eligible employees of the early retirement option on a timely basis and that the only employees who terminate from employment with the employer during the two-week period in which the early retirement benefit is available are HCEs. Under these facts, the group of employees to whom this early retirement window benefit is effectively available substantially favors HCEs.

Example 3. Employer Z amends Plan C on June 30, 1999, to provide for a single sum optional form of benefit for employees who terminate from employment with Employer Z after June 30, 1999, and before January 1, 2000. The availability of this single sum optional form of benefit is conditioned on the employee's having a particular disability at the time of termination of employment. The only employee of the employer who meets this disability requirement at the time of the amendment and thereafter through December 31, 1999, is a HCE. Under paragraph (b)(2)(ii)(B) of this section, the disability condition is disregarded in determining the current availability of the single sum optional form of benefit. Nevertheless, under these facts, the group of employees to whom the single sum optional form of benefit is effectively available substantially favors HCEs.

(d) *Special rules*—(1) *Mergers and acquisitions*—(i) *Special testing rule.* A benefit, right, or feature available under a plan solely to an acquired group of employees is treated as satisfying paragraphs (b) and (c) of this section during the period that each of the following requirements is satisfied:

(A) The benefit, right, or feature must satisfy paragraphs (b) and (c) of this section (determined without regard to the special rule in section

410(b)(6)(C)) on the date that is selected by the employer as the latest date by which an employee must be hired or transferred into the acquired trade or business for an employee to be included in the acquired group of employees. This determination is made with reference to the plan of the current employer and its nonexcludable employees.

(B) The benefit, right, or feature must be available under the plan of the current employer after the transaction on the same terms as it was available under the plan of the prior employer before the transaction. This requirement is not violated merely because of a change made to the benefit, right, or feature that is permitted by section 411(d)(6), provided that—

(*1*) The change is a replacement of the benefit, right, or feature with another benefit, right, or feature that is available to the same employees as the original benefit, right, or feature, and the original benefit, right, or feature is of inherently equal or greater value (within the meaning of paragraph (d)(4)(i)(A) of this section) than the benefit, right, or feature that replaces it; or

(*2*) The change is made before January 12, 1993.

(ii) *Scope of special testing rule.* This paragraph (d)(1) applies only to benefits, rights, and features with respect to benefits accruing under the plan of the current employer, and not to benefits, rights, and features with respect to benefits accrued under the plan of the prior employer (unless, pursuant to the transaction, the plan of the prior employer becomes the plan of the current employer, or the assets and liabilities with respect to the acquired group of employees under the plan of the prior employer are transferred to the plan of the current employer in a plan merger, consolidation, or other transfer described in section 414(l)).

(iii) *Example.* The following example illustrates the rules of this paragraph (d)(1):

Example. Employer X maintains Plan A, a defined benefit plan with a single sum optional form of benefit for all employees. Employer Y acquires Employer X and merges Plan A into Plan B, a defined benefit plan maintained by Employer Y that does not otherwise provide a single sum optional form of benefit. Employer Y continues to provide the single sum optional form of benefit under Plan B on the same terms as it was offered under Plan A to all employees who were acquired in the transaction with Employer X (and to no other employees). The optional form of benefit satisfies paragraphs (b) and (c) of this section immediately following the transaction (determined without taking into account section 410(b)(6)(C)) when tested with reference to Plan B and Employer Y's nonexcludable employees. Under these facts, Plan B is treated as satisfying this section with respect to the single sum optional form of benefit for the plan year of the transaction and all subsequent plan years.

(2) *Frozen participants.* A plan must satisfy the nondiscriminatory availability requirement of this section not only with respect to benefits, rights, and features provided to employees who are currently benefiting under the plan, but also separately with respect to benefits, rights, and features provided to nonexcludable employees with accrued benefits who are not currently benefiting under the plan (frozen participants). Thus, each benefit, right, and feature available to any frozen participant under the plan is separately subject to the requirements of this section. A plan satisfies paragraphs (b) and (c) of this section with respect to a benefit, right, or feature available to any frozen participant under the plan only if one or more of the following requirements is satisfied:

(i) The benefit, right, or feature must be one that would satisfy paragraphs (b) and (c) of this section if it were not available to any employee currently benefiting under the plan.

(ii) The benefit, right, or feature must be one that would satisfy paragraphs (b) and (c) of this section if all frozen participants were treated as employees currently benefiting under the plan.

(iii) No change in the availability of the benefit, right, or feature may have been made that is first effective in the current plan year with respect to a frozen participant.

(iv) Any change in the availability of the benefit, right, or feature that is first effective in the current plan year with respect to a frozen participant must be made in a nondiscriminatory manner. Thus, any expansion in the availability of the benefit, right, or feature to any highly compensated frozen participant must be applied on a consistent basis to all nonhighly compensated frozen participants. Similarly, any contraction in the availability of the benefit, right, or feature that affects any nonhighly compensated frozen participant must be applied on a consistent basis to all highly compensated frozen participants.

(3) *Early retirement window benefits.* If a benefit, right, or feature meets the definition of an early retirement window benefit in §1.401(a)(4)–3(f)(4)(iii) (or would meet that definition if the definition applied to all benefits, rights, and features), the benefit, right, or feature is disregarded for purposes of applying this section with respect to an employee for all plan years other than the first plan year in which the benefit is currently available to the employee.

(4) *Permissive aggregation of certain benefits, rights, or features*—(i) *General rule.* An optional form of benefit, ancillary benefit, or other right or feature may be aggregated with another optional form of benefit, ancillary benefit, or other right or feature, respectively, and the two may be treated as a single optional form of benefit, ancillary benefit, or other right or feature, if both of the following requirements are satisfied:

(A) One of the two optional forms of benefit, ancillary benefit, or other rights or features must in all cases be of inherently equal or greater value than the other. For this purpose, one benefit, right, or feature is of inherently equal or greater value than another benefit, right, or feature only if, at any time and under any conditions, it is impossible for any employee to receive a smaller amount or a less valuable right under the first benefit, right, or feature than under the second benefit, right, or feature.

(B) The optional form of benefit, ancillary benefit, or other right or feature of inherently equal or greater value must separately satisfy paragraphs (b) and (c) of this section (without regard to this paragraph (d)(4)).

(ii) *Aggregation may be applied more than once.* The aggregation rule in this paragraph (d)(4) may be applied more than once. Thus, for example, an optional form of benefit may be aggregated with another optional form of benefit that itself constitutes two separate optional forms of benefit that are aggregated and treated as a single optional form of benefit under this paragraph (d)(4).

(iii) *Examples.* The following examples illustrate the rules in this paragraph (d)(4):

Example 1. Plan A is a defined benefit plan that provides a single sum optional form of benefit to all employees. The single sum optional form of benefit is available on the same terms to all employees, except that, for employees in Division S, a five-percent discount factor is applied and, for employees of Division T, a seven-percent discount factor is applied. Under paragraph (e)(1) of this section, the single sum optional form of benefit constitutes two separate optional forms of benefit. Assume that the single sum optional form of benefit available to employees of Division S separately satisfies paragraphs (b) and (c) of this section without taking into account this paragraph (d)(4). Because a lower discount factor is applied in determining the single sum optional form of benefit available to employees of Division S than is applied in determining the single sum optional form of benefit available to employees of Division T, the first single sum optional form of benefit is of inherently greater value than the second single sum optional form of benefit. Under these facts, these two single sum optional forms of benefit may be aggregated and treated as a single optional form of benefit for purposes of this section.

Example 2. The facts are the same as in *Example 1,* except that, in order to receive the single sum optional form of benefit, employees of Division S (but not employees of Division T) must have completed at least 20 years of service. The single sum optional form of benefit available to employees of Division S is not of inherently equal or greater value than the single sum optional form of benefit available to employees of Division T, because an employee of Division S who terminates employment with less than 20 years of service would receive a smaller single sum amount (i.e., zero) than a similarly-situated employee of Division T who terminates employment with less than 20 years of service. Under these facts, the two single sum optional forms of benefit may not be aggregated and treated as a single optional form of benefit for purposes of this section.

(5) *Certain spousal benefits.* In the case of a plan that includes two or more plans that have been permissively aggregated under §1.410(b)–7(d), the aggregated plan satisfies this section with respect to the availability of any

nonsubsidized qualified joint and survivor annuities, qualified preretirement survivor annuities, or spousal death benefits described in section 401(a)(11), if each plan that is part of the aggregated plan satisfies section 401(a)(11). Whether a benefit is considered subsidized for this purpose may be determined using any reasonable actuarial assumptions. For purposes of this paragraph (d)(5), a qualified joint and survivor annuity, qualified preretirement survivor annuity, or spousal death benefit is deemed to be nonsubsidized if it is provided under a defined contribution plan.

(6) *Special ESOP rules.* An ESOP does not fail to satisfy paragraphs (b) and (c) of this section merely because it makes an investment diversification right or feature or a distribution option available solely to all qualified participants (within the meaning of section 401(a)(28)(B)(iii)), or merely because the restrictions of section 409(n) apply to certain individuals.

(7) *Special testing rule for unpredictable contingent event benefits.* A benefit, right, or feature that is contingent on the occurrence of an unpredictable contingent event (within the meaning of section 412(l)(7)(B)(ii)) is tested under this section as if the event had occurred. Thus, the current availability of a benefit that becomes an optional form of benefit upon the occurrence of an unpredictable contingent event is tested by deeming the event to have occurred and by disregarding age and service conditions on the eligibility for that benefit to the extent permitted for optional forms of benefit under paragraph (b)(2) of this section.

(e) *Definitions*—(1) *Optional form of benefit*—(i) *General rule.* The term optional form of benefit means a distribution alternative (including the normal form of benefit) that is available under a plan with respect to benefits described in section 411(d)(6)(A) or a distribution alternative that is an early retirement benefit or retirement-type subsidy described in section 411(d)(6)(B)(i), including a QSUPP. Except as provided in paragraph (e)(1)(ii) of this section, different optional forms of benefit exist if a distribution alternative is not payable on substantially the same terms as another distribution alternative. The relevant terms include all terms affecting the value of the optional form, such as the method of benefit calculation and the actuarial assumptions used to determine the amount distributed. Thus, for example, different optional forms of benefit may result from differences in terms relating to the payment schedule, timing, commencement, medium of distribution (e.g., in cash or in kind), election rights, differences in eligibility requirements, or the portion of the benefit to which the distribution alternative applies.

(ii) *Exceptions*—(A) *Differences in benefit formula or accrual method.* A distribution alternative available under a defined benefit plan does not fail to be a single optional form of benefit merely because the benefit formulas, accrual methods, or other factors (including service-computation methods and definitions of compensation) underlying, or the manner in which employees vest in, the accrued benefit that is paid in the form of the distribution alternative are different for different employees to whom the distribution alternative is available. Notwithstanding the foregoing, differences in the normal retirement ages of employees or in the form in which the accrued benefit of employees is payable at normal retirement age under a plan are taken into account in determining whether a distribution alternative constitutes one or more optional forms of benefit.

(B) *Differences in allocation formula.* A distribution alternative available under a defined contribution plan does not fail to be a single optional form of benefit merely because the allocation formula or other factors (including service-computation methods, definitions of compensation, and the manner in which amounts described in § 1.401(a)(4)–2(c)(2)(iii) are allocated) underlying, or the manner in which employees vest in, the accrued benefit that is paid in the form of the distribution alternative are different for different employees to whom the distribution alternative is available.

(C) *Distributions subject to section 417(e).* A distribution alternative available under a defined benefit plan does not fail to be a single optional form of benefit merely because, in determining the amount of a distribution, the plan applies a lower interest rate to determine the distribution for employees with a vested accrued benefit having an actuarial present value not in excess of $25,000, as required by section 417(e)(3) and §1.417(e)–1.

(D) *Differences attributable to uniform normal retirement age.* A distribution alternative available under a defined benefit plan does not fail to be a single optional form of benefit, to the extent that the differences are attributable to differences in normal retirement dates among employees, provided that the differences do not prevent the employees from having the same uniform normal retirement age under the definition of uniform normal retirement age in §1.401(a)(4)–12.

(iii) *Examples.* The following examples illustrate the rules in this paragraph (e)(1):

Example 1. Plan A is a defined benefit plan that benefits all employees of Divisions S and T. The plan offers a qualified joint and 50-percent survivor annuity at normal retirement age, calculated by multiplying an employee's single life annuity payment by a factor. For an employee of Division S whose benefit commences at age 65, the plan provides a factor of 0.90, but for a similarly-situated employee of Division T the plan provides a factor of 0.85. The qualified joint and survivor annuity is not available to employees of Divisions S and T on substantially the same terms, and thus it constitutes two separate optional forms of benefit.

Example 2. Plan B is a defined benefit plan that benefits all employees of Divisions U and V. The plan offers a single sum distribution alternative available on the same terms and determined using the same actuarial assumptions, to all employees. However, different benefit formulas apply to employees of each division. Under the exception provided in paragraph (e)(1)(ii)(A) of this section, the single sum optional form of benefit available to employees of Division U is not a separate optional form of benefit from the single sum optional form of benefit available to employees of Division V.

Example 3. Defined benefit Plan C provides an early retirement benefit based on a schedule of early retirement factors that is a single optional form of benefit. Plan C is amended to provide an early retirement window benefit that consists of a temporary change in the plan's benefit formula (e.g., the addition of five years of service to an employee's actual service under the benefit formula) applicable in determining the benefits for certain employees who terminate employment within a limited period of time. Under the exception provided in paragraph (e)(1)(ii)(A) of this section, the early retirement optional form of benefit available to window-eligible employees is not a separate optional form of benefit from the early retirement optional form of benefit available to the other employees.

(2) *Ancillary benefit.* The term ancillary benefit means social security supplements (other than QSUPPs), disability benefits not in excess of a qualified disability benefit described in section 411(a)(9), ancillary life insurance and health insurance benefits, death benefits under a defined contribution plan, preretirement death benefits under a defined benefit plan, shut-down benefits not protected under section 411(d)(6), and other similar benefits. Different ancillary benefits exist if an ancillary benefit is not available on substantially the same terms as another ancillary benefit. Principles similar to those in paragraph (e)(1)(ii) of this section apply in making this determination.

(3) *Other right or feature*—(i) *General rule.* The term other right or feature generally means any right or feature applicable to employees under the plan. Different rights or features exist if a right or feature is not available on substantially the same terms as another right or feature.

(ii) *Exceptions to definition of other right or feature.* Notwithstanding paragraph (e)(3)(i) of this section, a right or feature is not considered an other right or feature if it—

(A) Is an optional form of benefit or an ancillary benefit under the plan;

(B) Is one of the terms that are taken into account in determining whether separate optional forms of benefit or ancillary benefits exist, or that would be taken into account but for paragraph (e)(1)(ii) of this section (e.g., benefit formulas or the manner in which benefits vest); or

(C) Cannot reasonably be expected to be of meaningful value to an employee (e.g., administrative details).

(iii) *Examples.* Other rights and features include, but are not limited to—

(A) Plan loan provisions (other than those relating to a distribution of an employee's accrued benefit upon default under a loan);

(B) The right to direct investments;

(C) The right to a particular form of investment, including, for example, a particular class or type of employer securities (taking into account, in determining whether different forms of investment exist, any differences in conversion, dividend, voting, liquidation preference, or other rights conferred under the security);

(D) The right to make each rate of elective contributions described in § 1.401(k)–1(g)(3) (determining the rate based on the plan's definition of the compensation out of which the elective contributions are made (regardless of whether that definition satisfies section 414(s)), but also treating different rates as existing if they are based on definitions of compensation or other requirements or formulas that are not substantially the same);

(E) The right to make after-tax employee contributions to a defined benefit plan that are not allocated to separate accounts;

(F) The right to make each rate of after-tax employee contributions described in § 1.401(m)–1(f)(6) (determining the rate based on the plan's definition of the compensation out of which the after-tax employee contributions are made (regardless of whether that definition satisfies section 414(s)), but also treating different rates as existing if they are based on definitions of compensation or other requirements or formulas that are not substantially the same);

(G) The right to each rate of allocation of matching contributions described in § 1.401(m)–1(f)(12) (determining the rate using the amount of matching, elective, and after-tax employee contributions determined after any corrections under §§ 1.401(k)–1(f)(1)(i), 1.401(m)–1(e)(1)(i), and 1.401(m)–2(c), but also treating different rates as existing if they are based on definitions of compensation or other requirements or formulas that are not substantially the same);

(H) The right to purchase additional retirement or ancillary benefits under the plan; and

(I) The right to make rollover contributions and transfers to and from the plan.

[T.D. 8485, 58 FR 46796, Sept. 3, 1993, as amended by T.D. 8794, 63 FR 70338, Dec. 21, 1998]

§ 1.401(a)(4)–5 Plan amendments and plan terminations.

(a) *Introduction*—(1) *Overview.* This paragraph (a) provides rules for determining whether the timing of a plan amendment or series of amendments has the effect of discriminating significantly in favor of HCEs or former HCEs. For purposes of this section, a plan amendment includes, for example, the establishment or termination of the plan, and any change in the benefits, rights, or features, benefit formulas, or allocation formulas under the plan. Paragraph (b) of this section sets forth additional requirements that must be satisfied in the case of a plan termination.

(2) *Facts-and-circumstances determination.* Whether the timing of a plan amendment or series of plan amendments has the effect of discriminating significantly in favor of HCEs or former HCEs is determined at the time the plan amendment first becomes effective for purposes of section 401(a), based on all of the relevant facts and circumstances. These include, for example, the relative numbers of current and former HCEs and NHCEs affected by the plan amendment, the relative length of service of current and former HCEs and NHCEs, the length of time the plan or plan provision being amended has been in effect, and the turnover of employees prior to the plan amendment. In addition, the relevant facts and circumstances include the relative accrued benefits of current and former HCEs and NHCEs before and after the plan amendment and any additional benefits provided to current and former HCEs and NHCEs under other plans (including plans of other employers, if relevant). In the case of a plan amendment that provides additional benefits based on an employee's service prior to the amendment, the relevant facts and circumstances also include the benefits that employees

and former employees who do not benefit under the amendment would have received had the plan, as amended, been in effect throughout the period on which the additional benefits are based.

(3) *Safe harbor for certain grants of benefits for past periods.* The timing of a plan amendment that credits (or increases benefits attributable to) years of service for a period in the past is deemed not to have the effect of discriminating significantly in favor of HCEs or former HCEs if the period for which the service credit (or benefit increase) is granted does not exceed the five years immediately preceding the year in which the amendment first becomes effective, the service credit (or benefit increase) is granted on a reasonably uniform basis to all employees, benefits attributable to the period are determined by applying the current plan formula, and the service credited is service (including pre-participation or imputed service) with the employer or a previous employer that may be taken into account under §1.401(a)(4)–11(d)(3) (without regard to §1.401(a)(4)–11(d)(3)(i)(B)). However, this safe harbor is not available if the plan amendment granting the service credit (or increasing benefits) is part of a pattern of amendments that has the effect of discriminating significantly in favor of HCEs or former HCEs.

(4) *Examples.* The following examples illustrate the rules in this paragraph (a):

Example 1. Plan A is a defined benefit plan that covered both HCEs and NHCEs for most of its existence. The employer decides to wind up its business. In the process of ceasing operations, but at a time when the plan covers only HCEs, Plan A is amended to increase benefits and thereafter is terminated. The timing of this plan amendment has the effect of discriminating significantly in favor of HCEs.

Example 2. Plan B is a defined benefit plan that provides a social security supplement that is not a QSUPP. After substantially all of the HCEs of the employer have benefited from the supplement, but before a substantial number of NHCEs have become eligible for the supplement, Plan B is amended to reduce significantly the amount of the supplement. The timing of this plan amendment has the effect of discriminating significantly in favor of HCEs.

Example 3. Plan C is a defined benefit plan that contains an ancillary life insurance benefit available to all employees. The plan is amended to eliminate this benefit at a time when life insurance payments have been made only to beneficiaries of HCEs. Because all employees received the benefit of life insurance coverage before Plan C was amended, the timing of this plan amendment does not have the effect of discriminating significantly in favor of HCEs or former HCEs.

Example 4. Plan D provides for a benefit of one percent of average annual compensation per year of service. Ten years after Plan D is adopted, it is amended to provide a benefit of two percent of average annual compensation per year of service, including years of service prior to the amendment. The amendment is effective only for employees currently employed at the time of the amendment. The ratio of HCEs to former HCEs is significantly higher than the ratio of NHCEs to former NHCEs. In the absence of any additional factors, the timing of this plan amendment has the effect of discriminating significantly in favor of HCEs.

Example 5. The facts are the same as in *Example 4,* except that, in addition, the years of prior service are equivalent between HCEs and NHCEs who are current employees, and the group of current employees with prior service would satisfy the nondiscriminatory classification test of §1.410(b)–4 in the current and all prior plan years for which past service credit is granted. The timing of this plan amendment does not have the effect of discriminating significantly in favor of HCEs or former HCEs.

Example 6. Employer V maintains Plan E, an accumulation plan. In 1994, Employer V amends Plan E to provide that the compensation used to determine an employee's benefit for all preceding plan years shall not be less than the employee's average annual compensation as of the close of the 1994 plan year. The years of service and percentage increases in compensation for HCEs are reasonably comparable to those of NHCEs. In addition, the ratio of HCEs to former HCEs is reasonably comparable to the ratio of NHCEs to former NHCEs. The timing of this plan amendment does not have the effect of discriminating significantly in favor of HCEs or former HCEs.

Example 7. Employer W currently has six nonexcludable employees, two of whom, H1 and H2, are HCEs, and the remaining four of whom, N1 through N4, are NHCEs. The ratio of HCEs to former HCEs is significantly higher than the ratio of NHCEs to former NHCEs. Employer W establishes Plan F, a defined benefit plan providing a benefit of one percent of average annual compensation per year of service, including years of service prior to the establishment of the plan. H1 and H2 each have 15 years of prior service, N1 has nine years of past service, N2 has five years, N3 has three years, and N4 has one year. The timing of this plan establishment has the effect of discriminating significantly in favor of HCEs.

Example 8. Assume the same facts as in *Example 7,* except that N1 through N4 were hired in the current year, and Employer W never employed any NHCEs prior to the current year. Thus, no NHCEs would have received additional benefits had Plan F been in existence during the preceding 15 years. The timing of this plan establishment does not have the effect of discriminating significantly in favor of HCEs or former HCEs.

Example 9. The facts are the same as in *Example 7,* except that Plan F limits the grant of past service credit to five years, and the grant of past service otherwise satisfies the safe harbor in paragraph (a)(3) of this section. The timing of this plan establishment is deemed not to have the effect of discriminating significantly in favor of HCEs or former HCEs.

Example 10. The facts are the same as in *Example 9,* except that, five years after the establishment of Plan F, Employer W amends the plan to provide a benefit equal to two percent of average annual compensation per year of service, taking into account all years of service since the establishment of the plan. The ratio of HCEs to former HCEs who terminated employment during the five-year period since the establishment of the plan is significantly higher than the ratio of NHCEs to former NHCEs who terminated employment during the five-year period since the establishment of the plan. Although the amendment described in this example might separately satisfy the safe harbor in paragraph (a)(3) of this section, the safe harbor is not available with respect to the amendment because, under these facts, the amendment is part of a pattern of amendments that has the effect of discriminating significantly in favor of HCEs.

Example 11. Employer Y maintains Plan G, a defined benefit plan, covering all its employees. In 1995, Employer Y acquires Division S from Employer Z. Some of the employees of Division S had been covered under a defined benefit plan maintained by Employer Z. Soon after the acquisition, Employer Y amends Plan G to cover all employees of Division S and to credit those who were in Division S's defined benefit plan with years of service for years of employment with Employer Z. Because the timing of the plan amendment was determined by the timing of the transaction, the timing of this plan amendment does not have the effect of discriminating significantly in favor of HCEs or former HCEs. See also § 1.401(a)(4)–11(d)(3) for other rules regarding the crediting of preparticipation service.

Example 12. Plan H is an insurance contract plan within the meaning of section 412(i). For all plan years before 1999, Plan H purchases insurance contracts from Insurance Company J. In 1999, Plan H shifts future purchases of insurance contracts to Insurance Company K. The shift in insurance companies is a plan amendment subject to this paragraph (a).

(b) *Pre-termination restrictions*—(1) *Required provisions in defined benefit plans.* A defined benefit plan has the effect of discriminating significantly in favor of HCEs or former HCEs unless it incorporates provisions restricting benefits and distributions as described in paragraph (b)(2) and (3) of this section at the time the plan is established or, if later, as of the first plan year to which §§ 1.401(a)(4)–1 through 1.401(a)(4)–13 apply to the plan under § 1.401(a)(4)–13(a) or (b). This paragraph (b) does not apply if the Commissioner determines that such provisions are not necessary to prevent the prohibited discrimination that may occur in the event of an early termination of the plan. The restrictions in this paragraph (b) apply to a plan within the meaning of § 1.410(b)–7(b) (i.e., a section 414(l) plan). Any plan containing a provision described in this paragraph (b) satisfies section 411(d)(2) and does not fail to satisfy section 411(a) or (d)(3) merely because of the provision.

(2) *Restriction of benefits upon plan termination.* A plan must provide that, in the event of plan termination, the benefit of any HCE (and any former HCE) is limited to a benefit that is nondiscriminatory under section 401(a)(4).

(3) *Restrictions on distributions*—(i) *General rule.* A plan must provide that, in any year, the payment of benefits to or on behalf of a restricted employee shall not exceed an amount equal to the payments that would be made to or on behalf of the restricted employee in that year under—

(A) A straight life annuity that is the actuarial equivalent of the accrued benefit and other benefits to which the restricted employee is entitled under the plan (other than a social security supplement); and

(B) A social security supplement, if any, that the restricted employee is entitled to receive.

(ii) *Restricted employee defined.* For purposes of this paragraph (b), the term restricted employee generally means any HCE or former HCE. However, an HCE or former HCE need not be treated as a restricted employee in the current year if the HCE or former HCE is not one of the 25 (or a larger number chosen by the employer) nonexcludable employees and former employees of the employer with the largest amount of compensation in the current or any prior year. Plan provisions defining or altering this group can be amended at any time without violating section 411(d)(6).

(iii) *Benefit defined.* For purposes of this paragraph (b), the term benefit includes, among other benefits, loans in excess of the amounts set forth in section 72(p)(2)(A), any periodic income, any withdrawal values payable to a living employee or former employee, and any death benefits not provided for by insurance on the employee's or former employee's life.

(iv) *Nonapplicability in certain cases.* The restrictions in this paragraph (b)(3) do not apply, however, if any one of the following requirements is satisfied:

(A) After taking into account payment to or on behalf of the restricted employee of all benefits payable to or on behalf of that restricted employee under the plan, the value of plan assets must equal or exceed 110 percent of the value of current liabilities, as defined in section 412(l)(7).

(B) The value of the benefits payable to or on behalf of the restricted employee must be less than one percent of the value of current liabilities before distribution.

(C) The value of the benefits payable to or on behalf of the restricted employee must not exceed the amount described in section 411(a)(11)(A) (restrictions on certain mandatory distributions).

(v) *Determination of current liabilities.* For purposes of this paragraph (b), any reasonable and consistent method may be used for determining the value of current liabilities and the value of plan assets.

(4) *Operational restrictions on certain money purchase pension plans.* A money purchase pension plan that has an accumulated funding deficiency, within the meaning of section 412(a), or an unamortized funding waiver, within the meaning of section 412(d), must comply in operation with the restrictions on benefits and distributions as described in paragraphs (b)(2) and (b)(3) of this section. Such a plan does not fail to satisfy section 411(d)(6) merely because of restrictions imposed by the requirements of this paragraph (b)(4).

[T.D. 8485, 58 FR 46800, Sept. 3, 1993]

§1.401(a)(4)–6 Contributory defined benefit plans.

(a) *Introduction.* This section provides rules necessary for determining whether a contributory DB plan satisfies the nondiscriminatory amount requirement of §1.401(a)(4)–1(b)(2). Paragraph (b) of this section provides rules for determining the amount of benefits derived from employer contributions (employer-provided benefits) under a contributory DB plan for purposes of determining whether the plan satisfies §1.401(a)(4)–1(b)(2) with respect to such amounts. Paragraph (c) of this section provides the exclusive rules for determining whether a contributory DB plan satisfies §1.401(a)(4)–1(b)(2) with respect to the amount of benefits derived from employee contributions not allocated to separate accounts (employee-provided benefits). See §1.401(a)(4)–1(b)(2)(ii)(B) for the exclusive tests applicable to employee contributions allocated to separate accounts under a section 401(m) plan.

(b) *Determination of employer-provided benefit*—(1) *General rule.* An employee's employer-provided benefit under a contributory DB plan for purposes of section 401(a)(4) equals the difference between the employee's total benefit and the employee's employee-provided benefit under the plan. The rules of section 411(c) generally must be used to determine the employee's employer-provided benefit for this purpose. However, paragraphs (b)(2) through (b)(6) of this section provide alternative methods for determining the employee's employer-provided benefit.

(2) *Composition-of-workforce method*—(i) *General rule.* A contributory DB plan that satisfies paragraph (b)(2)(ii) (A) and (B) of this section may determine employees' employer-provided benefit rates under the rules of paragraph (b)(2)(iii) of this section.

(ii) *Eligibility requirements*—(A) *Uniform rate of employee contributions.* A contributory DB plan satisfies this paragraph (b)(2)(ii)(A) if all employees make employee contributions at the same rate, expressed as a percentage of plan year compensation (the employee contribution rate). A plan does not fail to satisfy this paragraph (b)(2)(ii)(A) merely because it eliminates employee contributions for all employees with plan year compensation below a specified contribution breakpoint that is either a stated dollar amount or a stated percentage of covered compensation (within the meaning of § 1.401(l)–1(c)(7)); or merely because all employees make employee contributions at the same rate (expressed as a percentage of plan year compensation) with respect to plan year compensation up to the contribution breakpoint (base employee contribution rate) and at a higher rate (expressed as a percentage of plan year compensation) that is the same for all employees with respect to plan year compensation above the contribution breakpoint (excess employee contribution rate). A plan described in paragraph (c)(4)(i) of this section that satisfies paragraph (c)(4)(iii) of this section is deemed to satisfy this paragraph.

(B) *Demographic requirements*—(*1*) *In general.* A contributory DB plan satisfies this paragraph (b)(2)(ii)(B) if it satisfies either of the demographic tests in paragraph (b)(2)(ii)(B) (*2*) or (*3*) of this section.

(*2*) *Minimum percentage test.* This test is satisfied only if more than 40 percent of the NHCEs in the plan have attained ages at least equal to the plan's target age, and more than 20 percent of the NHCEs in the plan have attained ages at least equal to the average attained age of the HCEs in the plan. For this purpose, a plan's target age is the lower of age 50 or the average attained age of the HCEs in the plan minus X years, where X equals 20 minus the product of five times the employee contribution rate under the plan. In no case, however, may X years be fewer than zero (0) years. Thus, for example, if the average attained age of the HCEs in the plan is 53 and the employee contribution rate is two percent of plan year compensation, the plan's target age is 43 years (i.e., $53 - (20 - (5 \times 2))$).

(*3*) *Ratio test.* This test is satisfied only if the percentage of all nonhighly compensated nonexcludable employees, who are in the plan and who have attained ages at least equal to the average attained age of the HCEs in the plan, is at least 70 percent of the percentage of all highly compensated nonexcludable employees, who are in the plan and who have attained ages at least equal to the average attained age of the HCEs in the plan. Attained ages must be determined as of the beginning of the plan year. In lieu of determining the actual distribution of the attained ages of the HCEs, an employer may assume that 50 percent of all HCEs have attained ages at least equal to the average attained age of the HCEs.

(iii) *Determination of employer-provided benefit*—(A) *Safe harbor plans other than section 401(l) plans.* For purposes of applying the exception to the safe harbor in § 1.401(a)(4)–3(b)(6)(viii) with respect to employer-provided benefits under a plan other than a section 401(l) plan, the employee's entire accrued benefit is treated as employer-provided.

(B) *Section 401(l) plans*—(*1*) *General rule.* For purposes of applying the exception to the safe harbor in § 1.401(a)(4)–3(b)(6)(viii) with respect to employer-provided benefits under a section 401(l) plan, an employee's base benefit percentage and excess benefit percentage are reduced, or an employee's gross benefit percentage is reduced, by subtracting the product of the employee contribution rate and the factor determined under paragraph (b)(2)(iv) of this section from the respective percentages for the plan year. For this purpose, the employee contribution rate is the highest rate of employee contributions applicable to any potential level of plan year compensation for that plan year under the plan.

(*2*) *Excess plans with varying contribution rates.* In the case of a defined benefit excess plan described in the second sentence of paragraph (b)(2)(ii)(A) of this section, solely for purposes of reducing an employee's base benefit percentage as required under paragraph (b)(2)(iii)(B)(*1*) of this section, it may be assumed that the employee's employee contribution rate equals the weighted average of the base employee contribution rate and the excess employee contribution rate. In determining this weighted average, the weight of the base employee contribution rate is equal to a fraction, the numerator of which is the lesser of the integration level and the contribution breakpoint and the denominator of which is the integration level. The weight of the excess employee contribution rate is equal to the difference between one and the weight of the base employee contribution rate.

(*3*) *Offset plans with varying contribution rates.* In the case of an offset plan described in the second sentence of paragraph (b)(2)(ii)(A) of this section, an equivalent adjustment to the alternative method in paragraph (b)(2)(iii)(B)(*2*) of this section may be made to the offset percentage.

(C) *Employer-provided benefits under the general test.* For purposes of applying the general test of §1.401(a)(4)–3(c) with respect to employer-provided benefits, an employee's normal and most valuable accrual rates otherwise determined under §1.401(a)(4)–3(d) (without applying any of the options under §1.401(a)(4)–3(d)(3) other than the fresh-start alternative of §1.401(a)(4)–3(d)(3)(iii)) are each reduced by subtracting the product of the employee's contributions (expressed as a percentage of plan year compensation) and the factor determined under paragraph (b)(2)(iv) of this section from the respective accrual rates. A plan may then apply the optional rules in §1.401(a)(4)–3(d)(3) (i) and (ii) to this resulting accrual rate.

(D) *Additional limitation.* A plan may not use the composition-of-workforce method provided in this paragraph (b)(2) to determine an employee's base benefit percentage, excess benefit percentage, gross benefit percentage, offset percentage, or accrual rates unless employee contributions have been made at the same rate (or rates) throughout the period after the fresh-start date or throughout the measurement period used to determine accrual rates.

(iv) *Determination of plan factor.* The factor for a plan is determined under the following table based on the average entry age of the employees in the plan and on whether the plan determines benefits based on average compensation. For this purpose, average entry age equals the average attained age of all employees in the plan, minus the average years of participation of all employees in the plan. A plan is treated as determining benefits based on average compensation if it determines benefits based on compensation averaged over a specified period not exceeding five consecutive years (or the employee's entire period of employment with the employer, if shorter).

TABLE OF FACTORS

Average entry age	Factors	
	Average compensation benefit formula	Other formulas
Less than 30	0.5	0.75
30 to 40	0.4	0.6
Over 40	0.2	0.3

(v) *Examples.* The following examples illustrate the rules of this paragraph (b)(2):

Example 1. Plan A is a contributory DB plan that is a defined benefit excess plan providing a benefit equal to 2.0 percent of employees' average annual compensation at or below covered compensation, plus 2.5 percent of average annual compensation above covered compensation, times years of service up to 35. Under the plan, average annual compensation is determined using a five-consecutive-year period for purposes of §1.401(a)(4)–3(e)(2). The plan requires employee contributions at a rate of four percent of plan year compensation for all employees. Assume that the plan satisfies the demographic requirements of paragraph (b)(2)(ii)(B) of this section. Under these facts, the plan satisfies the eligibility requirements of paragraph (b)(2)(ii) of this section. Assume, further, that the average attained age for all employees in the plan is 55, and that the average years of participation of all employees in the plan is 10. The average entry age for the plan is therefore 45, and, accordingly, the appropriate factor under the table is 0.2. Thus, in applying the safe harbor requirements of §1.401(a)(4)–3(b) to this plan for the plan year (including the requirements of §1.401(l)–3), the employee's base benefit percentage and excess benefit percentage are each reduced by 0.8 percent (4 percent × 0.2) and equal 1.2 percent and 1.7 percent, respectively.

Example 2. The facts are the same as in *Example 1,* except that the employee contribution rate is two percent of plan year compensation up to the covered compensation level, and four percent for plan year compensation at or above that contribution breakpoint. The employer elects to apply the alternative method in paragraph (b)(2)(iii)(B)(*2*) of this section to determine the reduction in the base benefit percentage. Because the contribution breakpoint is equal to the integration level, the weight of the employee contribution rate below the contribution breakpoint is 100 percent, and the weight of the employee contribution rate above the contribution breakpoint is zero. Thus, the weighted average of employee contribution rates is two percent. Under the alternative method in paragraph (b)(2)(iii)(B)(*2*) of this section, the reduction in the employee's base benefit percentage is 0.4. In applying the safe harbor requirements of § 1.401(a)(4)–3(b) to this plan (including the requirements of § 1.401(l)–3), the employee's base benefit percentage is 1.6 percent, and the employee's excess benefit percentage is 1.7.

Example 3. The facts are the same as in *Example 1,* except that the employee contribution rate is two percent of plan year compensation up to 50 percent of the covered compensation level, and four percent for plan year compensation at or above that contribution breakpoint. Because the contribution breakpoint is equal to 50 percent of the integration level, the weight of the employee contribution rate below the contribution breakpoint is 50 percent, and the weight of the employee contribution rate above the contribution breakpoint is 50 percent. Thus, the weighted average of employee contribution rates is three percent. Under the alternative method in paragraph (b)(2)(iii)(B)(*2*) of this section, the reduction in the employee's base benefit percentage is 0.6. In applying the safe harbor requirements of § 1.401(a)(4)–3(b) to this plan (including the requirements of § 1.401(l)–3), the employee's base benefit percentage is 1.4 percent, and the employee's excess benefit percentage is 1.7.

Example 4. The facts are the same as in *Example 1,* except that the plan is tested using the general test in § 1.401(a)(4)–3(c). Assume Employee M benefits under Plan A and has a normal accrual rate for the plan year (calculated with respect to Employee M's total accrued benefit) of 2.2 percent of average annual compensation. In applying the general test in § 1.401(a)(4)–3(c) with respect to employer-provided benefits, this rate is reduced by 0.8 to yield a normal accrual rate of 1.4 percent. This rate may then be adjusted using either of the optional rules in § 1.401(a)(4)–3(d)(3)(i) or (ii).

(3) *Minimum-benefit method*—(i) *Application of uniform factors.* A contributory DB plan that satisfies the uniform rate requirement of paragraph (b)(2)(ii)(A) of this section and the minimum benefit requirement of paragraph (b)(3)(ii) of this section may apply the adjustments provided in paragraph (b)(2)(iii) of this section as if the average entry age of employees in the plan were within the range of 30 to 40, without regard to the actual demographics of the employees in the plan.

(ii) *Minimum benefit requirement.* This requirement is satisfied if the plan provides that, in plan years beginning on or after the effective date of these regulations, as set forth in § 1.401(a)(4)–13(a) and (b), each employee will accrue a benefit that equals or exceeds the sum of—

(A) The accrued benefit derived from employee contributions made for plan years beginning on or after the effective date of these regulations, determined in accordance with section 411(c); and

(B) Fifty percent of the total benefit accrued in plan years beginning on or after the effective date of these regulations, as determined under the plan benefit formula without regard to that portion of the formula designed to satisfy the minimum benefit requirement of this paragraph (b)(3)(ii).

(iii) *Example.* The following example illustrates the minimum-benefit method of this paragraph (b)(3):

Example. Plan A is contributory DB plan. For the plan year beginning in 1994, Employee M participates in Plan A and accrues a benefit under the terms of the plan (without regard to the minimum benefit requirement of paragraph (b)(3)(ii) of this section) of $3,000. The portion of Employee M's benefit accrual for the plan year beginning in 1994 derived from employee contributions is $2,000, determined by applying the rules of section 411(c) to such contributions. The requirement of paragraph (b)(3)(ii) of this section is not satisfied for the plan year beginning in 1994 unless the plan provides that Employee M's benefit accrual for the plan year beginning in 1994 is equal to $3,500 ($2,000 + (50 percent × $3,000)).

(4) *Grandfather rule for plans in existence on May 14, 1990.* A contributory DB plan that satisfies paragraph (c)(4) of

this section may determine an employee's employer-provided benefit by subtracting from the employee's total benefit the employee-provided benefits determined using any reasonable method set forth in the plan, provided that it is the same method used in determining whether the plan satisfies paragraph (c)(4)(ii)(D) of this section.

(5) *Government-plan method.* A contributory DB plan that is established and maintained for its employees by the government of any state or political subdivision or by any agency or instrumentality thereof may treat an employee's total benefit as entirely employer-provided.

(6) *Cessation of employee contributions.* If a contributory DB plan provides that no employee contributions may be made to the plan after the last day of the first plan year beginning on or after the effective date of these regulations, as set forth in §1.401(a)(4)–13 (a) and (b), the plan may treat an employee's total benefit as entirely employer-provided.

(c) *Rules applicable in determining whether employee-provided benefits are nondiscriminatory in amount*—(1) *In general.* A contributory DB plan satisfies §1.401(a)(4)–1(b)(2) with respect to the amount of employee-provided benefits for a plan year only if the plan satisfies the requirements of paragraph (c)(2), (c)(3), or (c)(4) of this section for the plan year. This requirement applies regardless of the method used to determine the amount of employer-provided benefits under paragraph (b) of this section.

(2) *Same rate of contributions.* This requirement is satisfied for a plan year if the employee contribution rate (within the meaning of paragraph (b)(2)(ii)(A) of this section) is the same for all employees for the plan year.

(3) *Total-benefits method.* This requirement is satisfied for a plan year if—

(i) The total benefits (i.e., the sum of employer-provided and employee-provided benefits) under the plan would satisfy §1.401(a)(4)–3 if all benefits were treated as employer-provided benefits; and

(ii) The plan's contribution requirements satisfy paragraph (b)(2)(ii)(A) of this section.

(4) *Grandfather rules for plans in existence on May 14, 1990*—(i) *In general.* This requirement is satisfied for a plan year if the plan contained provisions as of May 14, 1990, that meet the requirements of paragraph (c)(4)(ii) or (c)(4)(iii) of this section.

(ii) *Graded contribution rates.* The plan's provisions meet the requirements of this paragraph (c)(4)(ii) if all the following requirements are met:

(A) The provisions require employee contributions at a greater rate (expressed as a percentage of compensation) at higher levels of compensation than at lower levels of compensation.

(B) The required rate of employee contributions is not increased after May 14, 1990, although the level of compensation at which employee contributions are required may be increased or decreased.

(C) All employees are permitted to make employee contributions under the plan at a uniform rate with respect to all compensation, beginning no later than the last day of the first plan year to which these regulations apply, as set forth in §1.401(a)(4)–13 (a) and (b).

(D) The benefits provided on account of employee contributions at lower levels of compensation are comparable to those provided on account of employee contributions at higher levels of compensation.

(iii) *Prior year compensation.* The plan's provisions meet the requirements of this paragraph (c)(4)(iii) if they are part of a plan maintained by more than one employer that requires employee contributions and the rate of required employee contributions, expressed as a percentage of compensation for the last calendar year ending before the beginning of the plan year, is the same for all employees.

[T.D. 8485, 58 FR 46802, Sept. 3, 1993]

§1.401(a)(4)–7 Imputation of permitted disparity.

(a) *Introduction.* In determining whether a plan satisfies section 401(a)(4) with respect to the amount of contributions or benefits, section 401(a)(5)(C) allows the disparities permitted under section 401(l) to be taken into account. For purposes of satisfying the safe harbors of §§1.401(a)(4)–2(b)(2) and 1.401(a)(4)–3(b), permitted disparity may be taken into account only by satisfying section 401(l) in form in accordance with § 1.401(l)–2 or 1.401(l)–3, respectively. For purposes of the general tests of §§ 1.401(a)(4)–2(c) and 1.401(a)(4)–3(c), permitted disparity may be taken into account only in accordance with the rules of this section. In general, this section allows permitted disparity to be arithmetically imputed with respect to employer-provided contributions or benefits by determining an adjusted allocation or accrual rate that appropriately accounts for the permitted disparity with respect to each employee. Paragraph (b) of this section provides rules for imputing permitted disparity with respect to employer-provided contributions by adjusting each employee's unadjusted allocation rate. Paragraph (c) of this section provides rules for imputing permitted disparity with respect to employer-provided benefits by adjusting each employee's unadjusted accrual rate. Paragraph (d) of this section provides rules of general application.

(b) *Adjusting allocation rates*—(1) *In general.* The rules in this paragraph (b) produce an adjusted allocation rate for each employee by determining the excess contribution percentage under the hypothetical formula that would yield the allocation actually received by the employee, if the plan took into account the full disparity permitted under section 401(l)(2) and used the taxable wage base as the integration level. This adjusted allocation rate is used to determine whether the amount of contributions under the plan satisfies the general test of § 1.401(a)(4)–2(c) and to apply the average benefit percentage test on the basis of contributions under § 1.410(b)–5(d). Paragraphs (b)(2) and (b)(3) of this section apply to employees whose plan year compensation does not exceed and does exceed, respectively, the taxable wage base, and paragraph (b)(4) of this section provides definitions.

(2) *Employees whose plan year compensation does not exceed taxable wage base.* If an employee's plan year compensation does not exceed the taxable wage base, the employee's adjusted allocation rate is the lesser of the A rate and the B rate determined under the formulas below, where the permitted disparity rate and the unadjusted allocation rate are determined under paragraph (b)(4) (ii) and (iv) of this section, respectively.

A Rate=2×unadjusted allocation rate

B Rate=unadjusted allocation rate+permitted disparity rate

(3) *Employees whose plan year compensation exceeds taxable wage base.* If an employee's plan year compensation exceeds the taxable wage base, the employee's adjusted allocation rate is the lesser of the C rate and the D rate determined under the formulas below, where allocations and the permitted disparity rate are determined under paragraph (b)(4) (i) and (ii) of this section, respectively.

$$\text{C Rate} = \frac{\text{allocations}}{\text{plan year compensation} - \frac{1}{2}\ \text{taxable wage base}}$$

$$\text{D Rate} = \frac{\text{allocations} + (\text{permitted disparity rate} \times \text{taxable wage base})}{\text{plan year compensation}}$$

(4) *Definitions.* In applying this paragraph (b), the following definitions govern—

(i) *Allocations.* Allocations means the amount determined by multiplying the employee's plan year compensation by the employee's unadjusted allocation rate.

(ii) *Permitted disparity rate*—(A) *General rule.* Permitted disparity rate means the rate in effect as of the beginning of the plan year under section 401(l)(2)(A)(ii) (e.g., 5.7 percent for plan years beginning in 1990).

(B) *Cumulative permitted disparity limit.* Notwithstanding paragraph (b)(4)(ii)(A) of this section, the permitted disparity rate is zero for an employee who has benefited under a defined benefit plan taken into account under §1.401(l)–5(a)(3) for a plan year that begins on or after one year from the first day of the first plan year to which these regulations apply, as set forth in §1.401(a)(4)–13 (a) and (b), if imputing permitted disparity would result in a cumulative disparity fraction for the employee, as defined in §1.401(l)–5(c)(2), that exceeds 35. See §1.401(l)–5(c)(1) for special rules for determining whether an employee has benefited under a defined benefit plan for this purpose.

(iii) *Taxable wage base.* Taxable wage base means the taxable wage base, as defined in §1.401(l)–1(c)(32), in effect as of the beginning of the plan year.

(iv) *Unadjusted allocation rate.* Unadjusted allocation rate means the employee's allocation rate determined under §1.401(a)(4)–2(c)(2)(i) for the plan year (expressed as a percentage of plan year compensation), without imputing permitted disparity under this section.

(5) *Example.* The following example illustrates the rules in this paragraph (b):

Example. (a) Employees M and N participate in a defined contribution plan maintained by Employer X. Employee M has plan year compensation of $30,000 in the 1990 plan year and has an unadjusted allocation rate of five percent. Employee N has plan year compensation of $100,000 in the 1990 plan year and has an unadjusted allocation rate of eight percent. The taxable wage base in 1990 is $51,300.

(b) Because Employee M's plan year compensation does not exceed the taxable wage base, Employee M's A rate is 10 percent (2×5 percent), and Employee M's B rate is 10.7 percent (5 percent+5.7 percent). Thus, Employee M's adjusted allocation rate is 10 percent, the lesser of the A rate and the B rate.

(c) Employee N's allocations are $8,000 (8 percent×$100,000). Because Employee N's plan year compensation exceeds the taxable wage base, Employee N's C rate is 10.76 percent ($8,000 divided by ($100,000−(½×$51,300))), and Employee N's D rate is 10.92 percent (($8,000+(5.7 percent×$51,300)) divided by $100,000). Thus, Employee N's adjusted allocation rate is 10.76 percent, the lesser of the C rate and the D rate.

(c) *Adjusting accrual rates*—(1) *In general.* The rules in this paragraph (c) produce an adjusted accrual rate for each employee by determining the excess benefit percentage under the hypothetical plan formula that would yield the employer-provided accrual actually received by the employee, if the plan took into account the full permitted disparity under section 401(l)(3)(A) in each of the first 35 years of an employee's testing service under the plan and used the employee's covered compensation as the integration level. This adjusted accrual rate is used to determine whether the amount of employer-provided benefits under the plan satisfies the alternative safe harbor for flat benefit plans under §1.401(a)(4)–3(b)(4)(i)(C)(*3*) or the general test of §1.401(a)(4)–3(c), and to apply the average benefit percentage test on the basis of benefits under §1.410(b)–5. Paragraphs (c)(2) and (c)(3) of this section apply to employees whose average annual compensation does not exceed and does exceed, respectively, covered compensation, and paragraph (c)(4) of this section provides definitions. Paragraph (c)(5) of this section provides a special rule for employees with negative unadjusted accrual rates.

(2) *Employees whose average annual compensation does not exceed covered compensation.* If an employee's average annual compensation does not exceed the employee's covered compensation, the employee's adjusted accrual rate is the lesser of the A rate and the B rate determined under the formulas below, where the permitted disparity factor and the unadjusted accrual rate are determined under paragraph (c)(4)(iii) and (v) of this section, respectively.

$$\text{A Rate} = 2 \times \text{unadjusted accrual rate}$$

$$\text{B Rate} = \text{unadjusted accrual rate} + \text{permitted disparity factor}$$

(3) *Employees whose average annual compensation exceeds covered compensation.* If an employee's average annual compensation exceeds the employee's covered compensation, the employee's adjusted accrual rate is the lesser of the C rate and D rate determined under the formulas below, where the employer-provided accrual and the permitted disparity factor are determined under paragraph (c)(4)(ii) and (iii) of this section, respectively.

$$\text{C Rate} = \frac{\text{employer-provided accrual}}{\text{average annual compensation} - \frac{1}{2}\ \text{covered compensation}}$$

$$\text{D Rate} = \frac{\text{employer-provided accrual} + (\text{permitted disparity factor} \times \text{covered compensation})}{\text{average annual compensation}}$$

(4) *Definitions.* For purposes of this paragraph (c), the following definitions apply.

(i) *Covered compensation.* Covered compensation means covered compensation as defined in § 1.401(l)–1(c)(7). Notwithstanding § 1.401(l)–1(c)(7)(iii), an employee's covered compensation must be automatically adjusted each plan year for purposes of applying this paragraph (c).

(ii) *Employer-provided accrual.* Employer-provided accrual means the amount determined by multiplying the employee's average annual compensation by the employee's unadjusted accrual rate.

(iii) *Permitted disparity factor*—(A) *General rule.* Permitted disparity factor for an employee means the sum of the employee's annual permitted disparity factors determined under paragraph (c)(4)(iii)(B) of this section for each of the years in the measurement period used for determining the employee's accrual rate in § 1.401(a)(4)–3(d)(1), divided by the employee's testing service during that measurement period.

(B) *Annual permitted disparity factor*—(*1*) *Definition.* An employee's annual permitted disparity factor is generally 0.75 percent adjusted, pursuant to § 1.401(l)–3(e), using as the age at which benefits commence the lesser of age 65 or the employee's testing age. No adjustments are made in the annual permitted disparity factor unless an employee's testing age is different from the employee's social security retirement age. An annual permitted disparity factor that is less than the annual permitted disparity factor described in the first sentence of this paragraph (c)(4)(iii)(B)(*1*) may be used if it is a uniform percentage of that factor (e.g., 50 percent of the annual permitted disparity factor) or a fixed percentage (e.g., 0.65 percent) for all employees.

(*2*) *Annual permitted disparity factor after 35 years.* For purposes of determining the sum described in paragraph (c)(4)(iii)(A) of this section, the annual permitted disparity factor for each of the employee's first 35 years of testing service is the amount described in paragraph (c)(4)(iii)(B)(*1*) of this section, and the annual permitted disparity factor in any subsequent year equals zero. This rule applies regardless of whether the end of the measurement period extends beyond an employee's first 35 years of testing service. Thus, for example, if the measurement period is the current plan year and the employee completed 35 years of testing service prior to the beginning of the current plan year, under this paragraph (c)(4)(iii)(B)(*2*) the annual permitted disparity factor in the current plan year (and hence the sum of the annual permitted disparity factors for each year in the measurement period) is zero.

(*3*) *Cumulative permitted disparity limit.* The 35 years used in paragraph (c)(4)(iii)(B)(*2*) of this section must be reduced by the employee's cumulative disparity fraction, as defined in § 1.401(l)–5(c)(2), but determined solely with respect to the employee's total years of service under all plans taken into account under § 1.401(l)–5(a)(3) during the measurement period, other than the plan being tested.

(iv) *Social security retirement age.* Social security retirement age means social security retirement age as defined in section 415(b)(8).

(v) *Unadjusted accrual rate.* Unadjusted accrual rate means the normal or most valuable accrual rate, whichever is being determined for the employee under §1.401(a)(4)–3(d), expressed as a percentage of average annual compensation, without imputing permitted disparity under this section.

(5) *Employees with negative unadjusted accrual rates.* Notwithstanding the formulas in paragraph (c)(2) and (c)(3) of this section, if an employee's unadjusted accrual rate is less than zero, the employee's adjusted accrual rate is deemed to be the employee's unadjusted accrual rate.

(6) *Example.* The following example illustrates the rules in this paragraph (c):

Example. (a) Employees M and N participate in a defined benefit plan that uses a normal retirement age of 65. The plan is being tested for the plan year under §1.401(a)(4)–3(c), using unadjusted accrual rates determined using a plan year measurement period under §1.401(a)(4)–3(d)(1)(iii)(A). Employee M has an unadjusted normal accrual rate of 1.48 percent, average annual compensation of $21,000, and an employer-provided accrual of $311 (1.48 percent×$21,000). Employee N has an unadjusted normal accrual rate of 1.7 percent, average annual compensation of $106,000, and an employer-provided accrual of $1,802 (1.7 percent×$106,000). The covered compensation of both Employees M and N is $25,000, and social security retirement age for both employees is 65. Neither employee has testing service of more than 35 years and neither has ever participated in another plan.

(b) Because Employee M's average annual compensation does not exceed covered compensation, Employee M's A rate is 2.96 percent (2.0×1.48 percent), and Employee M's B rate is 2.23 percent (1.48 percent+0.75 percent). Thus, Employee M's adjusted accrual rate is 2.23 percent, the lesser of the A rate and the B rate.

(c) Because Employee N's average annual compensation exceeds covered compensation, Employee N's C rate is 1.93 percent ($1,802/($106,000−(0.5×$25,000))), and Employee N's D rate is 1.88 percent (($1,802+(0.75 percent×$25,000))/$106,000). Thus, Employee N's adjusted accrual rate is 1.88 percent, the lesser of the C rate and the D rate.

(d) *Rules of general application*—(1) *Eligible plans.* The rules in this section may be used only for those plans to which the permitted disparity rules of section 401(l) are available. See §1.401(l)–1(a)(3).

(2) *Exceptions from consistency requirements.* A plan does not fail to satisfy the consistency requirements of §1.401(a)(4)–2(c)(2)(vi) or §1.401(a)(4)–3(d)(2)(i) merely because the plan does not impute disparity for some employees to the extent required to comply with paragraph (d)(3) of this section, or because the plan does not impute disparity for any employees (including self-employed individuals within the meaning of section 401(c)(1)) who are not covered by any of the taxes under section 3111(a), section 3221, or section 1401.

(3) *Overall permitted disparity.* The annual overall permitted disparity limits of §1.401(l)–5(b) apply to the employer-provided contributions and benefits for an employee under all plans taken into account under §1.401(l)–5(a)(3). Thus, if an employee who benefits under the plan for the current plan year also benefits under a section 401(l) plan for the plan year ending with or within the current plan year, permitted disparity may not be imputed for that employee for the plan year. See §1.401(l)–5(b)(9), *Example 4.* Similarly, if an employee who benefits under the plan for the current plan year also benefits under another plan of the employer for the plan year ending with or within the current plan year, disparity may be imputed for that employee under only one of the plans.

[T.D. 8485, 58 FR 46804, Sept. 3, 1993]

§1.401(a)(4)–8 Cross-testing.

(a) *Introduction.* This section provides rules for testing defined benefit plans on the basis of equivalent employer-provided contributions and defined contribution plans on the basis of equivalent employer-provided benefits under §1.401(a)(4)–1(b)(2). Paragraphs (b)(1) and (c)(1) of this section provide general tests for nondiscrimination based on individual equivalent accrual or allocation rates determined under paragraphs (b)(2) and (c)(2) of this section, respectively. Paragraphs (b)(3), (c)(3), and (d) of this section provide additional safe-harbor testing methods for target benefit plans, cash balance plans, and defined benefit plans that are part of floor-offset arrangements, respectively, that generally may be satisfied on a design basis.

(b) *Nondiscrimination in amount of benefits provided under a defined contribution plan*—(1) *General rule.* Equivalent benefits under a defined contribution plan (other than an ESOP) are nondiscriminatory in amount for a plan year if the plan would satisfy §1.401(a)(4)–2(c)(1) for the plan year if an equivalent accrual rate, as determined under paragraph (b)(2) of this section, were substituted for each employee's allocation rate in the determination of rate groups. A plan does not fail to satisfy this paragraph (b)(1) merely because allocations are made at the same rate for employees who are older than their testing age (determined without regard to the current-age rule in paragraph (4) of the definition of *Testing age* in §1.401(a)(4)–(12) as they are made for employees who are at that age.

(2) *Determination of equivalent accrual rates*—(i) *Basic definition.* An employee's equivalent accrual rate for a plan year is the annual benefit that is the result of normalizing the increase in the employee's account balance during the measurement period, divided by the number of years in which the employee benefited under the plan during the measurement period, and expressed either as a dollar amount or as a percentage of the employee's average annual compensation. A measurement period that includes future years may not be used for this purpose.

(ii) *Rules of application*—(A) *Determination of account balance.* The increase in the account balance during the measurement period taken into account under paragraph (b)(2)(i) of this section does not include income, expenses, gains, or losses allocated during the measurement period that are attributable to the account balance as of the beginning of the measurement period, but does include any additional amounts that would have been included in the increase in the account balance but for the fact that they were previously distributed (including a reasonable adjustment for interest). In the case of a measurement period that is the current plan year, an employer may also elect to disregard the income, expenses, gains, and losses allocated during the current plan year that are attributable to the increase in account balance since the beginning of the year, and thus, determine the increase in account balance during the plan year taking into account only the allocations described in §1.401(a)(4)–2(c)(2)(ii). In addition, an employer may disregard distributions made to a NHCE as well as distributions made to any employee in plan years beginning before a selected date no later than January 1, 1986.

(B) *Normalization.* The account balances determined under paragraph (b)(2)(ii)(A) of this section are normalized by treating them as single-sum benefits that are immediately and unconditionally payable to the employee. A standard interest rate, and a straight life annuity factor that is based on the same or a different standard interest rate and on a standard mortality table, must be used in normalizing these benefits. In addition, no mortality may be assumed prior to the employee's testing age.

(iii) *Options.* Any of the optional rules in §1.401(a)(4)–3(d)(3) (e.g., imputation of permitted disparity) may be applied in determining an employee's equivalent accrual rate by substituting the employee's equivalent accrual rate (determined without regard to the option) for the employee's normal accrual rate (i.e., not most valuable accrual rate) in that section where appropriate. For this purpose, however, the last sentence of the fresh-start alternative in §1.401(a)(4)–3(d)(3)(iii)(A) (dealing with compensation adjustments to the frozen accrued benefit) is not applicable. No other options are available in determining an employee's equivalent accrual rate except those (e.g., selection of alternative measurement periods) specifically provided in this paragraph (b)(2). Thus, for example, none of the optional special rules in §1.401(a)(4)–3(f) (e.g., determination of benefits on other than a plan year basis under §1.401(a)(4)–3(f)(6)) is available.

(iv) *Consistency rule.* Equivalent accrual rates must be determined in a consistent manner for all employees for the plan year. Thus, for example, the same measurement periods and standard interest rates must be used, and any available options must be applied consistently if at all.

(3) *Safe-harbor testing method for target benefit plans*—(i) *General rule.* A target benefit plan is a money purchase pension plan under which contributions to an employee's account are determined by reference to the amounts necessary to fund the employee's stated benefit under the plan. Whether a target benefit plan satisfies section 401(a)(4) with respect to an equivalent amount of benefits is generally determined under paragraphs (b)(1) and (b)(2) of this section. A target benefit plan is deemed to satisfy section 401(a)(4) with respect to an equivalent amount of benefits, however, if each of the following requirements is satisfied:

(A) *Stated benefit formula.* Each employee's stated benefit must be determined as the straight life annuity commencing at the employee's normal retirement age under a formula that would satisfy the requirements of §1.401(a)(4)–3(b)(4)(i)(C) (*1*) or (*2*), and that would satisfy each of the uniformity requirements in §1.401(a)(4)–3(b)(2) (taking into account the relevant exceptions provided in §1.401(a)(4)–3(b)(6)), if the plan were a defined benefit plan with the same benefit formula. In determining whether these requirements are satisfied, the rules of §1.401(a)(4)–3(f) do not apply, and, in addition, except as provided in paragraph (b)(3)(vii) of this section, an employee's stated benefit at normal retirement age under the stated benefit formula is deemed to accrue ratably over the period ending with the plan year in which the employee is projected to reach normal retirement age and beginning with the latest of: the first plan year in which the employee benefited under the plan, the first plan year taken into account in the stated benefit formula, and any plan year immediately following a plan year in which the plan did not satisfy this paragraph (b)(3). Thus, except as provided in paragraph (b)(3)(vii) of this section, under §1.401(a)(4)–3(b)(2)(v) an employee's stated benefit may not take into account service in years prior to the first plan year that the employee benefited under the plan, and an employee's stated benefit may not take into account service in plan years prior to the current plan year unless the plan satisfied this paragraph (b)(3) in all of those prior plan years.

(B) *Employer and employee contributions.* Employer contributions with respect to each employee must be based exclusively on the employee's stated benefit using the method provided in paragraph (b)(3)(iv) of this section, and forfeitures and any other amounts under the plan taken into account under §1.401(a)(4)–2(c)(2)(ii) (other than employer contributions) are used exclusively to reduce employer contributions. Employee contributions (if any) may not be used to fund the stated benefit.

(C) *Permitted disparity.* If permitted disparity is taken into account, the stated benefit formula must satisfy §1.401(l)–3. For this purpose, the 0.75-percent factor in the maximum excess or offset allowance in §1.401(l)–3(b)(2)(i) or (b)(3)(i), respectively, as adjusted in accordance with §1.401(l)–3(d)(9) (and, if the employee's normal retirement age is not the employee's social security retirement age, §1.401(l)–3(e)), is further reduced by multiplying the factor by 0.80.

(ii) *Changes in stated benefit formula.* A plan does not fail to satisfy paragraph (b)(3)(i) of this section merely because the plan determines each employee's stated benefit in the current plan year under a stated benefit formula that differs from the stated benefit formula used to determine the employee's stated benefit in prior plan years.

(iii) *Stated benefits after normal retirement age.* A target benefit plan may limit increases in the stated benefit after normal retirement age consistent with the requirements applicable to defined benefit plans under section 411(b)(1)(H) (without regard to section 411(b)(1)(H)(iii)), provided that the limitation applies on the same terms to all employees. Thus, post-normal retirement benefits required under §1.401(a)(4)–3(b)(2)(ii) must be provided under the stated benefit formula, subject to any uniformly applicable service cap under the formula.

(iv) *Method for determining required employer contributions*—(A) *General rule.*

An employer's required contribution to the account of an employee for a plan year is determined based on the employee's stated benefit and the amount of the employee's theoretical reserve as of the date the employer's required contribution is determined for the plan year (the determination date). Paragraph (b)(3)(iv)(B) of this section provides rules for determining an employee's theoretical reserve. Paragraph (b)(3)(iv) (C) and (D) of this section provides rules for determining an employer's required contributions.

(B) *Theoretical reserve*—(*1*) *Initial theoretical reserve.* An employee's theoretical reserve as of the determination date for the first plan year in which the employee benefits under the plan, the first plan year taken into account under the stated benefit formula (if that is the current plan year), or the first plan year immediately following any plan year in which the plan did not satisfy this paragraph (b)(3), is zero.

(*2*) *Theoretical reserve in subsequent plan years.* An employee's theoretical reserve as of the determination date for a plan year (other than a plan year described in paragraph (b)(3)(iv)(B)(*1*) of this section) is the employee's theoretical reserve as of the determination date for the prior plan year, plus the employer's required contribution for the prior plan year (as limited by section 415, but without regard to the additional contributions described in paragraph (b)(3)(v) of this section) both increased by interest from the determination date for the prior plan year through the determination date for the current plan year, but not beyond the determination date for the plan year that includes the employee's normal retirement date. (Thus, an employee's theoretical reserve as of the determination date for a plan year does not include the amount of the employer's required contribution for the plan year.) The interest rate for determining employer contributions that was in effect on the determination date in the prior plan year must be applied to determine the required interest adjustment for this period. For plan years beginning after the effective date applicable to the plan under § 1.401(a)(4)–13(a) or (b), a standard interest rate must be used, and may not be changed except on the determination date for a plan year.

(C) *Required contributions for employees under normal retirement age.* The required employer contributions with respect to an employee whose attained age is less than the employee's normal retirement age must be determined for each plan year as follows:

(*1*) Determine the employee's fractional rule benefit (within the meaning of § 1.411(b)–1(b)(3)(ii)(A)) under the plan's stated benefit formula as if the plan were a defined benefit plan with the same benefit formula.

(*2*) Determine the actuarial present value of the fractional rule benefit determined in paragraph (b)(3)(iv)(C)(*1*) of this section as of the determination date for the current plan year, using a standard interest rate and a standard mortality table that are set forth in the plan and that are the same for all employees, and assuming no mortality before the employee's normal retirement age.

(*3*) Determine the excess, if any, of the amount determined in paragraph (b)(3)(iv)(C)(*2*) of this section over the employee's theoretical reserve for the current plan year determined under paragraph (b)(3)(iv)(B) of this section.

(*4*) Determine the required employer contribution for the current plan year by amortizing on a level annual basis, using the same interest rate used for paragraph (b)(3)(iv)(C)(*2*) of this section, the result in paragraph (b)(3)(iv)(C)(*3*) of this section over the period beginning with the determination date for the current plan year and ending with the determination date for the plan year in which the employee is projected to reach normal retirement age.

(D) *Required contributions for employees over normal retirement age.* The required employer contributions with respect to an employee whose attained age equals or exceeds the employee's normal retirement age is the excess, if any, of the actuarial present value, as of the determination date for the current plan year, of the employee's stated benefit for the current plan year (determined using an immediate straight life annuity factor based on a standard interest rate and a standard mortality table, for an employee whose attained age equals the employee's normal retirement age) over the employee's theoretical reserve as of the determination date.

(v) *Effect of section 415 and 416 requirements.* A target benefit plan does not fail to satisfy this paragraph (b)(3) merely because required contributions under the plan are limited by section 415 in a plan year. Similarly, a target benefit plan does not fail to satisfy this paragraph (b)(3) merely because additional contributions are made consistent with the requirements of section 416(c)(2) (regardless of whether the plan is top-heavy).

(vi) *Certain conditions on allocations.* A target benefit plan does not fail to satisfy this paragraph (b)(3) merely because required contributions under the plan are subject to the conditions on allocations permitted under §1.401(a)(4)–2(b)(4)(iii).

(vii) *Special rules for target benefit plans qualified under prior law*—(A) S*ervice taken into account prior to satisfaction of this paragraph.* For purposes of determining whether the stated benefit formula satisfies paragraph (b)(3)(i)(A) of this section (e.g., whether the period over which an employee's stated benefit is deemed to accrue is the same as the period taken into account under the stated benefit formula as required by paragraph (b)(3)(i)(A) of this section), a target benefit plan that was adopted and in effect on September 19, 1991, is deemed to have satisfied this paragraph (b)(3), and an employee is treated as benefiting under the plan, in any year prior to the effective date applicable to the plan under §1.401(a)(4)–13 (a) or (b) that was taken into account in the stated benefit formula under the plan on September 19, 1991, if the plan satisfied the applicable nondiscrimination requirements for target benefit plans for that prior year.

(B) *Initial theoretical reserve.* Notwithstanding paragraph (b)(3)(iv)(B)(1) of this section, a target benefit plan under which the stated benefit formula takes into account service for an employee for plan years prior to the first plan year in which the plan satisfied this paragraph (b)(3), as permitted under paragraph (b)(3)(vii)(A) of this section, must determine an initial theoretical reserve for the employee as of the determination date for the last plan year beginning before such plan year under the rules of §1.401(a)(4)–13(e).

(C) *Satisfaction of prior law.* In determining whether a plan satisfied the applicable nondiscrimination requirements for target benefit plans for any period prior to the effective date applicable to the plan under §1.401(a)(4)–13 (a) or (b), no amendments after September 19, 1991, other than amendments necessary to satisfy section 401(l), are taken into account.

(viii) *Examples.* The following examples illustrate the rules in this paragraph (b)(3):

Example 1. (a) Employer X maintains a target benefit plan with a calendar plan year that bases contributions on a stated benefit equal to 40 percent of each employee's average annual compensation, reduced pro rata for years of participation less than 25, payable annually as a straight life annuity commencing at normal retirement age. The UP–84 mortality table and an interest rate of 7.5 percent are used to calculate the contributions necessary to fund the stated benefit. Required contributions are determined on the last day of each plan year. The normal retirement age under the plan is 65. Employee M is 39 years old in 1994, has participated in the plan for six years, and has average annual compensation equal to $60,000 for the 1994 plan year. Assume that Employee M's theoretical reserve as of the last day of the 1993 plan year is $13,909, determined under §1.401(a)(4)–13(e), and that required employer contributions for 1993 were determined using an interest rate of six percent.

(b) Under these facts, Employer X's 1994 required contribution to fund Employee M's stated benefit is $1,318, calculated as follows:

(1) Employee M's fractional rule benefit is $24,000 (40 percent of Employee M's average annual compensation of $60,000).

(2) The actuarial present value of Employee M's fractional rule benefit as of the last day of the 1994 plan year is $30,960 (Employee M's fractional rule benefit of $24,000 multiplied by 1.290, the actuarial present value factor for an annual straight life annuity commencing at age 65 applicable to a 39-year-old employee, determined using the stated interest rate of 7.5 percent and the UP–84 mortality table, and assuming no mortality before normal retirement age).

(3) The actuarial present value of Employee M's fractional rule benefit ($30,960) is reduced by Employee M's theoretical reserve as of the last day of the 1994 plan year. The theoretical reserve on that day is $14,744—the $13,909 theoretical reserve as of the last

day of the 1993 plan year, increased by interest for one year at the rate of six percent. Because the required contribution for the 1993 plan year is taken into account under § 1.401(a)(4)–13(e)(2) in determining the theoretical reserve as of the last day of the 1993 plan year, it is not added to the theoretical reserve again in this paragraph (b)(3) of this *Example 1.* The resulting difference is $16,216 ($30,960 − $14,744).

(4) The $16,216 excess of the actuarial present value of Employee M's fractional rule benefit over Employee M's theoretical reserve is multiplied by 0.0813, the amortization factor applicable to a 39-year-old employee determined using the stated interest rate of 7.5 percent. The product of $1,318 is the amount of the required employer contribution for Employee M for the 1994 plan year.

Example 2. (a) The facts are the same as in *Example 1,* except that as of January 1, 1995, the plan's stated benefit formula is amended to provide for a stated benefit equal to 45 percent of average annual compensation, reduced pro rata for years of participation less than 25, payable annually as a straight life annuity commencing at normal retirement age. For the 1995 plan year, Employee M's average annual compensation continues to be $60,000. The mortality table used for the calculation of the employer's required contributions remains the same as in the prior plan year, but the plan's stated interest rate is changed to 8.0 percent effective as of December 31, 1995.

(b) Under these facts, Employer X's required contribution for Employee M is $1,290, calculated as follows:

(1) Employee M's fractional rule benefit is $27,000 (45 percent of $60,000).

(2) The actuarial present value of Employee M's fractional rule benefit as of the last day of the 1995 plan year is $32,319 ($27,000 multiplied by 1.197, the actuarial present value factor for an annuity commencing at age 65 applicable to a 40-year-old employee, determined using the stated interest rate of 8.0 percent and the UP–84 mortality table, and assuming no mortality before normal retirement age).

(3) The actuarial present value of Employee M's fractional rule benefit ($32,319) is reduced by Employee M's theoretical reserve as of the last day of the 1995 plan year. The theoretical reserve as of that day is $17,267—the $14,744 theoretical reserve as of the last day of the 1994 plan year plus the $1,318 required contribution for the 1994 plan year, both increased by interest for one year at the rate of 7.5 percent. The resulting difference is $15,052 ($32,319 − $17,267).

(4) The result in paragraph (b)(3) of this *Example 2* is multiplied by 0.0857, the amortization factor applicable to a 40-year-old employee determined using the stated interest rate of 8.0 percent. The product, $1,290, is the amount of the required employer contribution for Employee M for the 1995 plan year.

(c) *Nondiscrimination in amount of contributions under a defined benefit plan*—(1) *General rule.* Equivalent allocations under a defined benefit plan are nondiscriminatory in amount for a plan year if the plan would satisfy § 1.401(a)(4)–3(c)(1) (taking into account § 1.401(a)(4)–3(c)(3)) for the plan year if an equivalent normal and most valuable allocation rate, as determined under paragraph (c)(2) of this section, were substituted for each employee's normal and most valuable accrual rate, respectively, in the determination of rate groups.

(2) *Determination of equivalent allocation rates*—(i) *Basic definitions.* An employee's equivalent normal and most valuable allocation rates for a plan year are, respectively, the actuarial present value of the increase over the plan year in the benefit that would be taken into account in determining the employee's normal and most valuable accrual rates for the plan year, expressed either as a dollar amount or as a percentage of the employee's plan year compensation. In the case of a contributory DB plan, the rules in § 1.401(a)(4)–6(b)(1), (b)(5), or (b)(6) must be used to determine the amount of each employee's employer-provided benefit that would be taken into account for this purpose.

(ii) *Rules for determining actuarial present value.* The actuarial present value of the increase in an employee's benefit must be determined using a standard interest rate and a standard mortality table, and no mortality may be assumed prior to the employee's testing age.

(iii) *Options.* The optional rules in § 1.401(a)(4)–2(c)(2)(iv) (imputation of permitted disparity) and (v) (grouping of rates) may be applied to determine an employee's equivalent normal and most valuable allocation rates by substituting those rates (determined without regard to the option) for the employee's allocation rate in that section where appropriate. In addition, the limitations under section 415 may be taken into account under § 1.401(a)(4)–3(d)(2)(ii)(B), and qualified disability benefits may be taken into account as accrued benefits under § 1.401(a)(4)–

3(f)(2), in determining the increase in an employee's accrued benefit during a plan year for purposes of paragraph (c)(2)(i) of this section, if those rules would otherwise be available. No other options are available in determining an employee's equivalent normal and most valuable allocations rate except those (e.g., selection of alternative standard interest rates) specifically provided in this paragraph (c)(2). Thus, while all of the mandatory rules in §1.401(a)(4)–3(d) and (f) for determining the amount of benefits used to determine an employee's normal and most valuable accrual rates (e.g., the treatment of early retirement window benefits in §1.401(a)(4)–3(f)(4)) are applicable in determining an employee's equivalent normal and most valuable allocation rates, none of the optional rules under §1.401(a)(4)–3 is available (except the options relating to the section 415 limits and qualified disability benefits noted above).

(iv) *Consistency rule.* Equivalent allocation rates must be determined in a consistent manner for all employees for the plan year. Thus, for example, the same standard interest rates must be used, and any available options must be applied consistently if at all.

(3) *Safe harbor testing method for cash balance plans*—(i) *General rule.* A cash balance plan is a defined benefit plan that defines benefits for each employee by reference to the employee's hypothetical account. An employee's hypothetical account is determined by reference to hypothetical allocations and interest adjustments that are analogous to actual allocations of contributions and earnings to an employee's account under a defined contribution plan. Because a cash balance plan is a defined benefit plan, whether it satisfies section 401(a)(4) with respect to the equivalent amount of contributions is generally determined under paragraphs (c)(1) and (c)(2) of this section. However, a cash balance plan that satisfies each of the requirements in paragraphs (c)(3)(ii) through (xi) of this section is deemed to satisfy section 401(a)(4) with respect to an equivalent amount of contributions.

(ii) *Plan requirements in general.* The plan must be an accumulation plan. The benefit formula under the plan must provide for hypothetical allocations for each employee in the plan that satisfy paragraph (c)(3)(iii) of this section, and interest adjustments to these hypothetical allocations that satisfy paragraph (c)(3)(iv) of this section. The benefit formula under the plan must provide that these hypothetical allocations and interest adjustments are accumulated as a hypothetical account for each employee, determined in accordance with paragraph (c)(3)(v) of this section. The plan must provide that an employee's accrued benefit under the plan as of any date is an annuity that is the actuarial equivalent of the employee's projected hypothetical account as of normal retirement age, determined in accordance with paragraph (c)(3)(vi) of this section. In addition, the plan must satisfy paragraphs (c)(3)(vii) through (xi) of this section (to the extent applicable) regarding optional forms of benefit, past service credits, post-normal retirement age benefits, certain uniformity requirements, and changes in the plan's benefit formula, respectively.

(iii) *Hypothetical allocations*—(A) *In general.* The hypothetical allocations provided under the plan's benefit formula must satisfy either paragraph (c)(3)(iii)(B) or (C) of this section. Paragraph (c)(3)(iii)(B) of this section provides a design-based safe harbor that does not require the annual comparison of hypothetical allocations under the plan. Paragraph (c)(3)(iii)(C) of this section requires the annual comparison of hypothetical allocations.

(B) *Uniform hypothetical allocation formula.* To satisfy this paragraph (c)(3)(iii)(B), the plan's benefit formula must provide for hypothetical allocations for all employees in the plan for all plan years of amounts that would satisfy §1.401(a)(4)–2(b)(3) for each such plan year if the hypothetical allocations were the only allocations under a defined contribution plan for the employees for those plan years. Thus, the plan's benefit formula must provide for hypothetical allocations for all employees in the plan for all plan years that are the same percentage of plan year compensation or the same dollar amount. In determining whether the hypothetical allocations satisfy

§ 1.401(a)(4)–2(b)(3), the only provisions of § 1.401(a)(4)–2(b)(5) that apply are § 1.401(a)(4)–2(b)(5)(ii) (section 401(l) permitted disparity, (iii) (entry dates), (vi) (certain limits on allocations), and (vii) (dollar allocation per uniform unit of service). Thus, for example, the plan's benefit formula may take permitted disparity into account in a manner allowed under § 1.401(l)–2 for defined contribution plans.

(C) *Modified general test.* To satisfy this paragraph (c)(3)(iii)(C), the plan's benefit formula must provide for hypothetical allocations for all employees in the plan for the plan year that would satisfy the general test in § 1.401(a)(4)–2(c) for the plan year, if the hypothetical allocations were the only allocations for the employees taken into account under § 1.401(a)(4)–2(c)(2)(ii) under a defined contribution plan for the plan year. In determining whether the hypothetical allocations satisfy § 1.401(a)(4)–2(c), the provisions of § 1.401(a)(4)–2(c)(2)(iii) through (v) apply. Thus, for example, permitted disparity may be imputed under § 1.401(a)(4)–2(c)(2)(iv) in accordance with the rules of § 1.401(a)(4)–7(b) applicable to defined contribution plans.

(iv) *Interest adjustments to hypothetical allocations*—(A) *General rule.* The plan benefit formula must provide that the dollar amount of the hypothetical allocation for each employee for a plan year is automatically adjusted using an interest rate that satisfies paragraph (c)(3)(iv)(B) of this section, compounded no less frequently than annually, for the period that begins with a date in the plan year and that ends at normal retirement age. This requirement is not satisfied if any portion of the interest adjustments to a hypothetical allocation are contingent on the employee's satisfaction of any requirement. Thus, for example, the interest adjustments to a hypothetical allocation must be provided through normal retirement age, even though the employee terminates employment or commences benefits before that age.

(B) *Requirements with respect to interest rates.* The interest rate must be a single interest rate specified in the plan that is the same for all employees in the plan for all plan years. The interest rate must be either a standard interest rate or a variable interest rate. If the interest rate is a variable interest rate, it must satisfy paragraph (c)(3)(iv)(C) of this section.

(C) *Variable interest rates*—(*1*) *General rule.* The plan must specify the variable interest rate, the method for determining the current value of the variable interest rate, and the period (not to exceed 1 year) for which the current value of the variable interest rate applies. Permissible variable interest rates are listed in paragraph (c)(3)(iv)(C)(*2*) of this section. Permissible methods for determining the current value of the variable interest rate are provided in paragraph (c)(3)(iv)(C)(*3*) of this section.

(*2*) *Permissible variable interest rates.* The variable interest rate specified in the plan must be one of the following—

(*i*) The rate on 3-month Treasury Bills,

(*ii*) The rate on 6-month Treasury Bills,

(*iii*) The rate on 1-year Treasury Bills,

(*iv*) The yield on 1-year Treasury Constant Maturities,

(*v*) The yield on 2-year Treasury Constant Maturities,

(*vi*) The yield on 5-year Treasury Constant Maturities,

(*vii*) The yield on 10-year Treasury Constant Maturities,

(*viii*) The yield on 30-year Treasury Constant Maturities, or

(*ix*) The single interest rate such that, as of a single age specified in the plan, the actuarial present value of a deferred straight life annuity of an amount commencing at the normal retirement age under the plan, calculated using that interest rate and a standard mortality table but assuming no mortality before normal retirement age, is equal to the actuarial present value, as of the single age specified in the plan, of the same annuity calculated using the section 417(e) rates applicable to distributions in excess of $25,000 (determined under § 1.417(e)–1(d)), and the same mortality assumptions.

(*3*) *Current value of variable interest rate.* The current value of the variable interest rate that applies for a period must be either the value of the variable interest rate determined as of a specified date in the period or the immediately preceding period, or the average of the values of the variable interest rate as of two or more specified dates during the current period or the immediately preceding period. The value as of a date of the rate on a Treasury Bill is the average auction rate for the week or month in which the date falls, as reported in the Federal Reserve Bulletin. The value as of a date of the yield on a Treasury Constant Maturity is the average yield for the week, month, or year in which the date falls, as reported in the Federal Reserve Bulletin. (The Federal Reserve Bulletin is published by the Board of Governors of the Federal Reserve System and is available from Publication Services, Mail Stop 138, Board of Governors of the Federal Reserve System, Washington DC 20551.) The plan may limit the current value of the variable interest rate to a maximum (not less than the highest standard interest rate), or a minimum (not more than the lowest standard interest rate), or both.

(v) *Hypothetical account*—(A) *Current value of hypothetical account.* As of any date, the current value of an employee's hypothetical account must equal the sum of all hypothetical allocations and the respective interest adjustments to each such hypothetical allocation provided through that date for the employee under the plan's benefit formula (without regard to any interest adjustments provided under the plan's benefit formula for periods after that date).

(B) *Value of hypothetical account as of normal retirement age.* Under paragraph (c)(3)(vi) of this section, the value of an employee's hypothetical account must be determined as of normal retirement age in order to determine the employee's accrued benefit as of any date at or before normal retirement age. As of any date at or before normal retirement age, the value of an employee's hypothetical account as of normal retirement age must equal the sum of each hypothetical allocation provided through that date for the employee under the plan's benefit formula, plus the interest adjustments provided through normal retirement age on each of those hypothetical allocations for the employee under the plan's benefit formula (without regard to any hypothetical allocations that might be provided after that date under the plan's benefit formula). If the interest rate specified in the plan is a variable interest rate, the plan must specify that the determination in the preceding sentence is made by assuming that the current value of the variable interest rate for all future periods is either the current value of the variable interest rate for the current period or the average of the current values of the variable interest rate for the current period and one or more periods immediately preceding the current period (not to exceed 5 years in the aggregate).

(vi) *Determination of accrued benefit*—(A) *Definition of accrued benefit.* The plan must provide that at any date at or before normal retirement age the accrued benefit (within the meaning of section 411(a)(7)(A)(i)) of each employee in the plan is an annuity commencing at normal retirement age that is the actuarial equivalent of the employee's hypothetical account as of normal retirement age (as determined under paragraph (c)(3)(v)(B) of this section). The separate benefit that each employee accrues for a plan year is an annuity that is the actuarial equivalent of the employee's hypothetical allocation for that plan year, including the automatic adjustments for interest through normal retirement age required under paragraph (c)(3)(iv) of this section.

(B) *Normal form of benefit.* The annuity specified in paragraph (c)(3)(vi)(A) of this section must provide an annual benefit payable in the same form at the same uniform normal retirement age for all employees in the plan. The annual benefit must be the normal retirement benefit under the plan (within the meaning of section 411(a)(9)) under the plan.

(C) *Determination of actuarial equivalence.* For purposes of this paragraph (c)(3)(vi) and paragraph (c)(3)(ix) of this section, actuarial equivalence must be determined using a standard mortality table and either a standard interest rate or the interest rate specified in the plan for making interest adjustments to hypothetical allocations. If the interest rate used is the interest rate specified in the plan, and that rate is a variable interest rate, the assumed value of the variable interest rate for all future periods must be the same value that would be assumed for purposes of paragraph (c)(3)(v)(B) of this section. The same actuarial assumptions must be used for all employees in the plan.

(D) *Effect of section 415 and 416 requirements.* A plan does not fail to satisfy this paragraph (c)(3)(vi) merely because the accrued benefits under the plan are limited by section 415, or merely because the accrued benefits under the plan are the greater of the accrued benefits otherwise determined under the plan and the minimum benefit described in section 416(c)(1) (regardless of whether the plan is top-heavy).

(vii) *Optional forms of benefit*—(A) *In general.* The plan must satisfy the uniform subsidies requirement of § 1.401(a)(4)–3(b)(2)(iv) with respect to all subsidized optional forms of benefit.

(B) *Limitation on subsidies.* Unless hypothetical allocations are determined under a uniform hypothetical allocation formula that satisfies paragraph (c)(3)(iii)(B) of this section, the actuarial present value of any QJSA provided under the plan must not be greater than the single sum distribution to the employee that would satisfy paragraph (c)(3)(vii)(C) of this section assuming that it was distributed to the employee on the date of commencement of the QJSA.

(C) *Distributions subject to section 417(e).* Except as otherwise required under section 415(b), if the plan provides for a distribution alternative that is subject to the interest rate restrictions under section 417(e), the actuarial present value of the benefit paid to an employee under the distribution alternative must equal the nonforfeitable percentage (determined under the plan's vesting schedule) of the greater of the following two amounts—

(*1*) The current value of the employee's hypothetical account as of the date the distribution commences, calculated in accordance with paragraph (c)(3)(v)(A) of this section.

(*2*) The actuarial present value (calculated in accordance with § 1.417(e)–1(d)) of the employee's accrued benefit.

(D) *Determination of actuarial present value.* For purposes of this paragraph (c)(3)(vii), actuarial present value must be determined using a reasonable interest rate and mortality table. A standard interest rate and a standard mortality table are considered reasonable for this purpose.

(viii) *Past service credit.* The benefit formula under the plan may not provide for hypothetical allocations in the current plan year that are attributable to years of service before the current plan year, unless each of the following requirements is satisfied—

(A) The years of past service credit are granted on a uniform basis to all current employees in the plan.

(B) Hypothetical allocations for the current plan year are determined under a uniform hypothetical allocation formula that satisfies paragraph (c)(3)(iii)(B) of this section.

(C) The hypothetical allocations attributable to the years of past service would have satisfied the uniform hypothetical allocation formula requirement of paragraph (c)(3)(iii)(B) of this section, and the interest adjustments to those hypothetical allocations would have satisfied paragraph (c)(3)(iv)(A) of this section, if the plan provision granting past service had been in effect for the entire period for which years of past service are granted to any employee. In order to satisfy this requirement, the hypothetical allocation attributable to a year of past service must be adjusted for interest in accordance with paragraph (c)(3)(iv) of this section for the period (including the retroactive period) beginning with the year of past service to which the hypothetical allocation is attributable and ending at normal retirement age. If the interest rate specified in the plan is a variable interest rate, the interest adjustments for the period prior to the current plan year either must be based on the current value of the variable interest rate for the period in which the grant of past service first becomes effective or must be reconstructed based on the then current value of the variable interest rate that would have applied during each prior period.

(ix) *Employees beyond normal retirement age.* In the case of an employee who commences receipt of benefits after normal retirement age, the plan must provide that interest adjustments continue to be made to an employee's hypothetical account until the employee's benefit commencement date. In the case of an employee described in the previous sentence, the employee's accrued benefit is defined as an annuity that is the actuarial equivalent of the employee's hypothetical account determined in accordance with paragraph (c)(3)(v)(A) of this section as of the date of benefit commencement.

(x) *Additional uniformity requirements.* In addition to any uniformity requirements provided elsewhere in this paragraph (c)(3), the plan must satisfy the uniformity requirements in §1.401(a)(4)–3(b)(2)(v) (uniform vesting and service requirements) and (vi) (no employee contributions). A plan does not fail to satisfy the uniformity requirements of this paragraph (c)(3)(x) or any other uniformity requirement provided in this paragraph (c)(3) merely because the plan contains one or more of the provisions described in §1.401(a)(4)–3(b)(8)(iv) (prior vesting schedules), (v) (certain conditions on accruals), or (xi) (multiple definitions of service).

(xi) *Changes in benefit formula, allocation formula, or interest rates.* A plan does not fail to satisfy this paragraph (c)(3) merely because the plan is amended to change the benefit formula, hypothetical allocation formula, or the interest rate used to adjust hypothetical allocations for plan years after a fresh-start date, provided that the accrued benefits for plan years beginning after the fresh-start date are determined in accordance with §1.401(a)(4)–13(c), as modified by §1.401(a)(4)–13(f).

(d) *Safe-harbor testing method for defined benefit plans that are part of a floor-offset arrangement*—(1) *General rule.* A defined benefit plan that is part of a floor-offset arrangement is deemed to satisfy the nondiscriminatory amount requirement of §1.401(a)(4)–1(b)(2) if all of the following requirements are satisfied:

(i) Under the floor-offset arrangement, the accrued benefit (as defined in section 411(a)(7)(A)(i)) that would otherwise be provided to an employee under the defined benefit plan must be reduced solely by the actuarial equivalent of all or part of the employee's account balance attributable to employer contributions under a defined contribution plan maintained by the same employer (plus the actuarial equivalent of all or part of any prior distributions from that portion of the account balance). If any portion of the benefit that is being offset is nonforfeitable, that portion may be offset only by a benefit (or portion of a benefit) that is also nonforfeitable. In determining the actuarial equivalent of amounts provided under the defined contribution plan, an interest rate no higher than the highest standard interest rate must be used, and no mortality may be assumed in determining the actuarial equivalent of any prior distributions from the defined contribution plan or for periods prior to the benefit commencement date under the defined benefit plan.

(ii) The defined benefit plan may not be a contributory DB plan (unless it satisfies §1.401(a)(4)–6(b)(6)), and benefits under the defined benefit plan may not be reduced by any portion of the employee's account balance under the defined contribution plan (or prior distributions from that account) that are attributable to employee contributions.

(iii) The defined benefit plan and the defined contribution plan must benefit the same employees.

(iv) The offset under the defined benefit plan must be applied to all employees on the same terms.

(v) All employees must have available to them under the defined contribution plan the same investment options and the same options with respect to the timing of preretirement distributions.

(vi) The defined benefit plan must satisfy the uniformity requirements of §1.401(a)(4)–3(b)(2) and the unit credit safe harbor in §1.401(a)(4)–3(b)(3) without taking into account the offset described in paragraph (d)(1)(i) of this section (i.e., on a gross-benefit basis), and the defined contribution plan must satisfy any of the tests in §1.401(a)(4)–2(b) or (c). Alternatively, the defined benefit plan must satisfy any of the tests in § 1.401(a)(4)–3(b) or (c) without taking into account the offset described in paragraph (d)(1)(i) of this section, and the defined contribution plan must satisfy the uniform allocation safe harbor in § 1.401(a)(4)–2(b)(2).

(vii) The defined contribution plan may not be a section 401(k) plan or a section 401(m) plan.

(2) *Application of safe-harbor testing method to qualified offset arrangements.* A defined benefit plan that is part of a qualified offset arrangement as defined in section 1116(f)(5) of the Tax Reform Act of 1986, Public Law No. 99–514, is deemed to satisfy the requirements of paragraph (d)(1)(vi) and (vii) of this section, if the only defined contribution plans included in the qualified offset arrangement are section 401(k) plans, section 401(m) plans, or both, and the defined benefit plan would satisfy the requirements of paragraph (d)(1)(vi) of this section assuming the elective contributions for each employee under the defined contribution plan were the same (either as a dollar amount or as a percentage of compensation) for all plan years since the establishment of the plan.

[T.D. 8360, 56 FR 47580, Sept. 19, 1991; 57 FR 4720, Feb. 7, 1992; 57 FR 10952, 10953, Mar. 31, 1992, as amended by T.D. 8485, 58 FR 46807, Sept. 3, 1993]

§ 1.401(a)(4)–9 Plan aggregation and restructuring.

(a) *Introduction.* Two or more plans that are permissively aggregated and treated as a single plan under §§ 1.410(b)–7(d) must also be treated as a single plan for purposes of section 401(a)(4). See § 1.401(a)(4)–12 (definition of plan). An aggregated plan is generally tested under the same rules applicable to single plans. Paragraph (b) of this section, however, provides special rules for determining whether a plan that consists of one or more defined contribution plans and one or more defined benefit plans (a DB/DC plan) satisfies section 401(a)(4) with respect to the amount of employer-provided benefits and the availability of benefits, rights, and features. Paragraph (c) of this section provides rules allowing a plan to be treated as consisting of separate component plans and allowing the component plans to be tested separately under section 401(a)(4).

(b) *Application of nondiscrimination requirements to DB/DC plans*—(1) *General rule.* Except as provided in paragraph (b)(2) of this section, whether a DB/DC plan satisfies section 401(a)(4) is determined using the same rules applicable to a single plan. In addition, paragraph (b)(3) of this section provides an optional rule for demonstrating nondiscrimination in availability of benefits, rights, and features provided under a DB/DC plan.

(2) *Special rules for demonstrating nondiscrimination in amount of contributions or benefits*—(i) *Application of general tests.* A DB/DC plan satisfies section 401(a)(4) with respect to the amount of contributions or benefits for a plan year if it would satisfy § 1.401(a)(4)–3(c)(1) (without regard to the special rule in § 1.401(a)(4)–3(c)(3)) for the plan year if an employee's aggregate normal and most valuable allocation rates, as determined under paragraph (b)(2)(ii)(A) of this section, or an employee's aggregate normal and most valuable accrual rates, as determined under paragraph (b)(2)(ii)(B) of this section, were substituted for each employee's normal and most valuable accrual rates, respectively, in the determination of rate groups.

(ii) *Determination of aggregate rates*—(A) *Aggregate allocation rates.* An employee's aggregate normal and most valuable allocation rates are determined by treating all defined contribution plans that are part of the DB/DC plan as a single plan, and all defined benefit plans that are part of the DB/DC plan as a separate single plan; and determining an allocation rate and equivalent normal and most valuable allocation rates for the employee under each plan under §§ 1.401(a)(4)–2(c)(2) and 1.401(a)(4)–8(c)(2), respectively. The employee's aggregate normal allocation rate is the sum of the employee's allocation rate and equivalent normal allocation rate determined in this manner, and the employee's aggregate most valuable allocation rate is the sum of the employee's allocation rate and equivalent most valuable allocation rate determined in this manner.

(B) *Aggregate accrual rates.* An employee's aggregate normal and most valuable accrual rates are determined by treating all defined contribution plans that are part of the DB/DC plan as a single plan, and all defined benefit plans that are part of the DB/DC plan as a separate single plan; and determining an equivalent accrual rate and normal and most valuable accrual rates for the employee under each plan under §§1.401(a)(4)–8(b)(2) and 1.401(a)(4)–3(d), respectively. The employee's aggregate normal accrual rate is the sum of the employee's equivalent accrual rate and the normal accrual rate determined in this manner, and the employee's aggregate most valuable accrual rate is the sum of the employee's equivalent accrual rate and most valuable accrual rate determined in this manner.

(iii) *Options applied on an aggregate basis.* The optional rules in §1.401(a)(4)–2(c)(2)(iv) (imputation of permitted disparity) and (v) (grouping of rates) may not be used to determine an employee's allocation or equivalent allocation rate, but may be applied to determine an employee's aggregate normal and most valuable allocation rates by substituting those rates (determined without regard to the option) for the employee's allocation rate in that section where appropriate. The optional rules in §1.401(a)(4)–3(d)(3) (e.g., imputation of permitted disparity) may not be used to determine an employee's accrual or equivalent accrual rate, but may be applied to determine an employee's aggregate normal and most valuable accrual rate by substituting those rates (determined without regard to the option) for the employee's normal and most valuable accrual rates, respectively, in that section where appropriate.

(iv) *Consistency rule*—(A) *General rule.* Aggregate normal and most valuable allocation rates and aggregate normal and most valuable accrual rates must be determined in a consistent manner for all employees for the plan year. Thus, for example, the same measurement periods and interest rates must be used, and any available options must be applied consistently, if at all, for the entire DB/DC plan. Consequently, options that are not permitted to be used under §1.401(a)(4)–8 in cross-testing a defined contribution plan or a defined benefit plan (such as measurement periods that include future periods, non-standard interest rates, the option to disregard compensation adjustments described in §1.401(a)(4)–13(d), or the option to disregard plan provisions providing for actuarial increases after normal retirement age under §1.401(a)(4)–3(f)(3)) may not be used in testing a DB/DC plan on either a benefits or contributions basis, because their use would inevitably result in inconsistent determinations under the defined contribution and defined benefit portions of the plan.

(B) *Exception for section 415 alternative.* A DB/DC plan does not fail to satisfy the consistency rule in paragraph (b)(2)(iv)(A) of this section merely because the limitations under section 415 are not taken into account, or may not be taken into account, under §1.401(a)(4)–3(d)(2)(ii)(B) in determining employees' accrual or equivalent allocation rates under the defined benefit portion of the plan, even though those limitations are applied in determining employees' allocation and equivalent accrual rates under the defined contribution portion of the plan.

(3) *Optional rules for demonstrating nondiscrimination in availability of certain benefits, rights, and features*—(i) *Current availability.* A DB/DC plan is deemed to satisfy §1.401(a)(4)–4(b)(1) with respect to the current availability of a benefit, right, or feature other than a single sum benefit, loan, ancillary benefit, or benefit commencement date (including the availability of in-service withdrawals), that is provided under only one type of plan (defined benefit or defined contribution) included in the DB/DC plan, if the benefit, right, or feature is currently available to all NHCEs in all plans of the same type as the plan under which it is provided.

(ii) *Effective availability.* The fact that it may be difficult or impossible to provide a benefit, right, or feature described in paragraph (b)(3)(i) of this section under a plan of a different type than the plan or plans under which it is provided is one of the factors taken into account in determining whether the plan satisfies the effective availability requirement of § 1.401(a)(4)–4(c)(1).

(c) *Plan restructuring*—(1) *General rule.* A plan may be treated, in accordance with this paragraph (c), as consisting of two or more component plans for purposes of determining whether the plan satisfies section 401(a)(4). If each of the component plans of a plan satisfies all of the requirements of sections 401(a)(4) and 410(b) as if it were a separate plan, then the plan is treated as satisfying section 401(a)(4).

(2) *Identification of component plans.* A plan may be restructured into component plans, each consisting of all the allocations, accruals, and other benefits, rights, and features provided to a selected group of employees. The employer may select the group of employees used for this purpose in any manner, and the composition of the groups may be changed from plan year to plan year. Every employee must be included in one and only one component plan under the same plan for a plan year.

(3) *Satisfaction of section 401(a)(4) by a component plan*—(i) *General rule.* The rules applicable in determining whether a component plan satisfies section 401(a)(4) are the same as those applicable to a plan. Thus, for this purpose, any reference to a plan in section 401(a)(4) and the regulations thereunder (other than this paragraph (c)) is interpreted as a reference to a component plan. As is true for a plan, whether a component plan satisfies the uniformity and other requirements applicable to safe harbor plans under §§ 1.401(a)(4)–2(b) and 1.401(a)(4)–3(b) is determined on a design basis. Thus, for example, plan provisions are not disregarded merely because they do not currently apply to employees in the component plan if they will apply to those employees as a result of the mere passage of time.

(ii) *Certain testing rules involving averaging.* The safe harbor in § 1.401(a)(4)–2(b)(3) for plans with uniform points allocation formulas are not available in testing (and thus cannot be satisfied by) contributions under a component plan. See §§ 1.401(k)–1(b)(3)(iii) and 1.401(m)–1(b)(3)(iii) for rules regarding the inapplicability of restructuring to section 401(k) plans and section 401(m) plans.

(4) *Satisfaction of section 410(b) by a component plan*—(i) *General rule.* The rules applicable in determining whether a component plan satisfies section 410(b) are generally the same as those applicable to a plan. However, a component plan is deemed to satisfy the average benefit percentage test of § 1.410(b)–5 if the plan of which it is a part satisfies § 1.410(b)–5 (without regard to § 1.410(b)–5(f)). In the case of a component plan that is part of a plan that relies on § 1.410(b)–5(f) to satisfy the average benefit percentage test, the component plan is deemed to satisfy the average benefit percentage test only if the component plan separately satisfies § 1.410(b)–5(f). In addition, all component plans of a plan are deemed to satisfy the average benefit percentage test if the plan makes an early retirement window benefit (within the meaning of § 1.401(a)(4)–3(f)(4)(iii)) currently available (within the meaning of § 1.401(a)(4)–3(f)(4)(ii)(A)) to a group of employees that satisfies section 410(b) (without regard to the average benefit percentage test), and if it would not be necessary for the plan or any rate group or component plan of the plan to satisfy that test in order for the plan to satisfy sections 401(a)(4) and 410(b) in the absence of the early retirement window benefit.

(ii) *Relationship to satisfaction of section 410(b) by the plan.* Satisfaction of section 410(b) by a component plan is relevant solely for purposes of determining whether the plan of which it is a part satisfies section 401(a)(4), and not for purposes of determining whether the plan satisfies section 410(b) itself. The plan must still independently satisfy section 410(b) in order to be a qualified plan. Similarly, satisfaction of section 410(b) by a plan is relevant solely for purposes of determining whether the plan, and not the component plan, satisfies section 410(b). Thus, for example, a component plan that does not satisfy the ratio percentage test of § 1.410(b)–2(b)(2) must still satisfy the average benefit test of § 1.410(b)–2(b)(3), even though the plan of which it is a part satisfies the ratio percentage test.

(5) *Effect of restructuring under other sections.* The restructuring rules provided in this paragraph (c) apply solely for purposes of sections 401(a)(4) and 401(l), and those portions of sections 410(b), 414(s), and any other provisions that are specifically applicable in determining whether the requirements of section 401(a)(4) are satisfied. Thus, for example, a component plan is not treated as a separate plan under section 401(a)(26).

(6) *Examples.* The following examples illustrate the rules in this paragraph (c):

Example 1. Employer X maintains a defined benefit plan. The plan provides a normal retirement benefit equal to 1.0 percent of average annual compensation times years of service to employees at Plant S, and 1.5 percent of average annual compensation times years of service to employees at Plant T. Under paragraph (c)(2) of this section, the plan may be treated as consisting of two component defined benefit plans, one providing retirement benefits equal to 1.0 percent of average annual compensation times years of service to the employees at Plant S, and another providing benefits equal to 1.5 percent of average annual compensation times years of service to employees at Plant T. If each component plan satisfies sections 401(a)(4) and 410(b) as if it were a separate plan under the rules of this paragraph (c), then the entire plan satisfies section 401(a)(4).

Example 2. (a) Employer Y maintains Plan A, a defined benefit plan, for its Employees M, N, O, P, Q, and R. Plan A provides benefits under a uniform formula that satisfies the requirements of §1.401(a)(4)–3 (b)(2) and (b)(3) before it is amended on February 14, 1994. The amendment provides an early retirement window benefit that is a subsidized optional form of benefit under §1.401(a)(4)–3(b)(2)(iii) and that is available on the same terms to all employees who satisfy the eligibility requirements for the window. The early retirement window benefit is available only to employees who retire between June 1, 1994, and November 30, 1994.

(b) Assume that Employees M, N, and O will be eligible to receive the window benefit by the end of the window period and Employees P, Q, and R will not. Because substantially all employees will not satisfy the eligibility requirements for the early retirement window benefit by the close of the early retirement window benefit period, Plan A fails to satisfy the uniform subsidies requirement of §1.401(a)(4)–3(b)(2)(iii). See §1.401(a)(4)–3(b)(2)(vi), *Example 6.*

(c) Under paragraph (c)(2) of this section, Employees M, N, O, P, Q, and R may be grouped into two component plans, one consisting of Employees M, N, and O, and all their accruals and other benefits, rights, and features under the plan (including the early retirement window benefit), and another consisting of Employees P, Q, and R, and all their accruals and other benefits, rights, and features under the plan. Each of the component plans identified in this manner satisfies the uniform subsidies requirement of §1.401(a)(4)–3(b)(2)(iii), and thus satisfies §1.401(a)(4)–3(b). The entire plan satisfies section 401(a)(4) under the rules of this paragraph (c), if each of these component plans also satisfies section 410(b) as if it were a separate plan (including, if applicable, the reasonable classification requirement of §1.410(b)–4(b), and taking into account the special rule of paragraph (c)(4)(i) of this section that forgives the average benefit percentage test in certain situations in which the average benefit percentage test would be required solely as a result of the early retirement window benefit).

Example 3. (a) Employer Z maintains Plan B, a defined benefit plan with a benefit formula that provides two percent of average annual compensation for each year of service up to 20 to each employee. Assume that Plan B would satisfy the fractional accrual rule safe harbor in §1.401(a)(4)–3(b)(4), except that some employees accrue a portion of their normal retirement benefit in the current plan year that is more than one-third larger than the portion of the same benefit accrued by other employees for the current plan year, and the plan therefore fails to satisfy the one-third-larger requirement of §1.401(a)(4)–3(b)(4)(i)(C)(*1*).

(b) Employer Z restructures Plan B into two plans, one covering employees with 30 years or less of service at normal retirement age, and the other covering all other employees. Each component plan would separately satisfy the one-third-larger requirement of §1.401(a)(4)–3(b)(4)(i)(C)(*1*) if the only employees taken into account were those employees included in the component plan in the current plan year. Under paragraph (c)(3)(i) of this section and §1.401(a)(4)–3(b)(4)(i)(C)(*1*), however, the component plans do not satisfy the one-third-larger requirement because the safe harbor determination is made taking into account the effect of the plan benefit formula on any potential employee in the component plan (other than employees with more than 33 years of service at normal retirement age), and not just those employees included in the component plan in the current plan year.

[T.D. 8485, 58 FR 46810, Sept. 3, 1993]

§1.401(a)(4)–10 Testing of former employees.

(a) *Introduction.* This section provides rules for determining whether a plan satisfies the nondiscriminatory amount and nondiscriminatory availability requirements of § 1.401(a)(4)–1(b)(2) and (3), respectively, with respect to former employees. Generally, this section is relevant only in the case of benefits provided through an amendment to the plan effective in the current plan year. See the definitions of employee and former employee in § 1.401(a)(4)–12.

(b) *Nondiscrimination in amount of contributions or benefits*—(1) *General rule.* A plan satisfies § 1.401(a)(4)–1(b)(2) with respect to the amount of contributions or benefits provided to former employees if, under all of the relevant facts and circumstances, the amount of contributions or benefits provided to former employees does not discriminate significantly in favor of former HCEs. For this purpose, contributions or benefits provided to former employees includes all contributions or benefits provided to former employees or, at the employer's option, only those contributions or benefits arising out of the amendment providing the contributions or benefits. A plan under which no former employee currently benefits (within the meaning of § 1.410(b)–3(b)) is deemed to satisfy this paragraph (b).

(2) *Permitted disparity.* Section 401(l) and § 1.401(a)(4)–7 generally apply to benefits provided to former employees in the same manner as those provisions apply to employees. Thus, for example, for purposes of determining a former employee's cumulative permitted disparity limit, the sum of the former employee's total annual disparity fractions (within the meaning of § 1.401(l)–5) as an employee continues to be taken into account. However, the permitted disparity rate applicable to a former employee is determined under § 1.401(l)–3(e) as of the age the former employee commenced receipt of benefits, not as of the date the employee receives the accrual for the current plan year.

(3) *Examples.* The following examples illustrate the rules in this paragraph (b):

Example 1. Employer X maintains a section 401(l) plan, Plan A, that uses maximum permitted disparity. Plan A is amended to increase the benefits of all former employees in pay status. The percentage increase for each former employee is reasonably comparable to the adjustment in social security benefits under section 215(i)(2)(A) of the Social Security Act since the former employee commenced receipt of benefits. Plan A does not fail to satisfy this paragraph (b) merely because of the amendment.

Example 2. The facts are the same as in *Example 1,* except that the amendment provides an across-the-board 20 percent increase in benefits for all former employees in pay status. The cost of living has increased at an average rate of three percent in the two years preceding the amendment, and some HCEs have retired and become former HCEs during that period. Because this amendment increases the disparity in the plan formula beyond the maximum permitted disparity adjusted for any reasonable approximation of the increase in the cost of living since the HCEs retired, Plan A discriminates significantly in favor of former HCEs, and thus does not satisfy this paragraph (b).

Example 3. The facts are the same as in *Example 1,* except that Plan A is only amended to increase the benefits of former employees in pay status who terminated employment with Employer X after attaining early retirement age. The determination of whether the amendment causes Plan A to fail to satisfy this paragraph (b) must take into account the relative numbers of former HCEs and former NHCEs who have terminated employment with Employer X after attaining early retirement age.

(c) *Nondiscrimination in availability of benefits, rights, or features.* A plan satisfies section 401(a)(4) with respect to the availability of benefits, rights, and features provided to former employees if any change in the availability of any benefit, right, or feature to any former employee is applied in a manner that, under all of the relevant facts and circumstances, does not discriminate significantly in favor of former HCEs. For purposes of demonstrating that a plan satisfies section 401(a)(4) with respect to the availability of loans provided to former employees, an employer may treat former employees who are parties in interest within the meaning of section 3(14) of the Employee Retirement Income Security Act of 1974 as employees.

[T.D. 8485, 58 FR 46812, Sept. 3, 1993]

§ 1.401(a)(4)–11 Additional rules.

(a) *Introduction.* This section provides additional rules for determining whether a plan satisfies section 401(a)(4). Paragraph (b) of this section provides rules for the treatment of the portion of an employee's accrued benefit or account balance that is attributable to rollovers, transfers between plans, and employee buybacks. Paragraph (c) of this section provides rules regarding vesting. Paragraph (d) of this section provides rules regarding service crediting. Paragraph (e) of this section, regarding family aggregation, and paragraph (f) of this section, regarding governmental plans, are reserved. Paragraph (g) of this section provides rules regarding the extent to which corrective amendments may be made for purposes of section 401(a).

(b) *Rollovers, transfers, and buybacks*—(1) *Rollovers and elective transfers.* The portion of an employee's accrued benefit or account balance under a plan that is attributable to rollover (including direct rollover) contributions to the plan that are described in section 402(c), 402(e)(6), 403(a)(4), 403(a)(5), or 408(d)(3), or elective transfers to the plan that are described in §1.411(d)–4, Q&A–3(b), is not taken into account in determining whether the plan satisfies the nondiscriminatory amount requirement of §1.401(a)(4)–1(b)(2).

(2) *Other transfers.* [Reserved]

(3) *Employee buybacks*—(i) *Rehired employee buyback of previous service.* An employee's repayment to a plan of a prior distribution from the plan (including reasonable interest from the time of the distribution) that results in the restoration of the employee's accrued benefit under the plan (or the service associated with that accrued benefit) that would otherwise be disregarded in determining the employee's accrued benefit in accordance with section 411 on account of the distribution is not treated as an employee contribution for purposes of §§1.401(a)(4)–1 through 1.401(a)(4)–13.

(ii) *Make-up of missed employee contributions.* If a contributory DB plan gives all employees who did not make employee contributions for a prior period the right to make the missed contributions at a later date (including reasonable interest from the time of the missed contributions) and, once the contributions have been made, determines benefits under the plan by treating the employee contributions (excluding the interest) as if they were actually made during that prior period, then those contributions must satisfy §1.401(a)(4)–6(c) as if they were employee contributions actually made during that prior period. Thus, for example, §1.401(a)(4)–6(c)(2) is not satisfied for the current plan year if the employee contribution rate (within the meaning of §1.401(a)(4)–6(b)(2)(ii)(A) but determined without regard to the interest) for the employees making up missed contributions is different than the employee contribution rate applicable to other employees during the prior period. The rule in this paragraph (b)(3)(ii) may be extended to employees who did not make employee contributions for a period of service that is or would otherwise have been credited under the plan and that preceded their participation in the plan.

(c) *Vesting*—(1) *General rule.* A plan satisfies this paragraph (c) if the manner in which employees vest in their accrued benefits under the plan does not discriminate in favor of HCEs. Whether the manner in which employees vest in their accrued benefits under a plan discriminates in favor of HCEs is determined under this paragraph (c) based on all of the relevant facts and circumstances, taking into account any relevant provisions of sections 401(a)(5)(E), 411(a)(10), 411(d)(1), 411(d)(2), 411(d)(3), 411(e), and 420(c)(2), and taking into account any plan provisions that affect the nonforfeitability of employees' accrued benefits (e.g., plan provisions regarding suspension of benefits permitted under section 411(a)(3)(B)), other than the method of crediting years of service for purposes of applying the vesting schedule provided in the plan.

(2) *Deemed equivalence of statutory vesting schedules.* For purposes of this paragraph (c), the manner in which employees vest in their accrued benefits under the vesting schedules in section 411(a)(2) (A) and (B) are treated as equivalent to one another, and the manner in which employees vest in their accrued benefits under the vesting schedules in section 416(b)(1) (A) and (B) are treated as equivalent to one another.

(3) *Safe harbor for vesting schedules.* The manner in which employees vest in their accrued benefits under a plan is deemed not to discriminate in favor of

HCEs if each combination of plan provisions that affect the nonforfeitability of any employee's accrued benefit would satisfy the nondiscriminatory availability requirements of § 1.401(a)(4)–4 if that combination were an other right or feature.

(4) *Examples.* The following examples illustrate the rules in this paragraph (c):

Example 1. Plan A provides the six-year graded vesting schedule described in section 416(b)(1)(B). In 1996, Plan A is amended to provide the five-year vesting schedule described in section 411(a)(2)(A). To comply with section 411(a)(10)(B), the plan amendment also provides that all employees with at least three years of service may elect to retain the prior vesting schedule. The manner in which employees vest in their accrued benefits under Plan A does not discriminate in favor of HCEs merely because the prior vesting schedule continues to apply to the accrued benefits of electing employees, even if, at the time of the election or in future years, the prior vesting schedule applies only to a group of employees that does not satisfy section 410(b).

Example 2. The facts are the same as in *Example 1,* except that, for administrative convenience in complying with section 411(a)(10)(B), the plan amendment automatically provides all employees employed on the date of the amendment with the higher of the nonforfeitable percentages determined under either schedule. The manner in which employees vest in their accrued benefits under Plan A does not discriminate in favor of HCEs merely because, for administrative convenience in complying with section 411(a)(10), the amendment exceeds the requirements of section 411(a)(10). The result would be the same if the plan amendment automatically provided the higher of the nonforfeitable percentages only to those employees with at least three years of service.

Example 3. (a) Employer Y maintains Plan B covering all of its employees. On January 1, 1996, Employer Y sells Division M to Employer Z, and all of the employees in Division M become employees of Employer Z. Employer Y obtains a determination letter that the resulting cessation of participation by these employees in Plan B constitutes a partial termination. Therefore, in order to satisfy section 411(d)(3), Plan B fully vests the accrued benefit of each of the employees of Division M whose participation in Plan B ceased as a result of the sale on January 1, 1996.

(b) The manner in which employees vest in their accrued benefits under Plan B does not discriminate in favor of HCEs merely because, in order to satisfy section 411(d)(3), the accrued benefits of all employees affected by the partial termination become fully vested. This is true even if the affected group of employees does not satisfy section 410(b).

Example 4. (a) The facts are the same as in *Example 3,* except that Employer Y does not obtain a determination letter that the sale of Division M to Employer Z will cause a partial termination. Instead, based on its reasonable belief that the sale will cause a partial termination, and in order to ensure that Plan B will satisfy section 411(d)(3), Employer Y amends Plan B to vest fully the accrued benefit on January 1, 1996 of each of the employees it reasonably believes to be an affected employee.

(b) The manner in which employees vest in their accrued benefits under Plan B does not discriminate in favor of HCEs merely because, based on Employer Y's reasonable belief that the sale will cause a partial termination, Plan B is amended to vest fully the accrued benefits of each of the employees it reasonably believes to be an affected employee.

(d) *Service-crediting rules*—(1) *Overview*—(i) *In general.* A defined benefit plan or a defined contribution plan does not satisfy this paragraph (d) with respect to the manner in which service is credited under the plan unless the plan satisfies paragraph (d)(2) of this section. Paragraph (d)(3) of this section provides rules for determining whether service other than actual service with the employer may be taken into account in determining whether a defined benefit plan or a defined contribution plan satisfies § 1.401(a)(4)–1 (b)(2) or (b)(3). (However, for purposes of cross-testing a defined contribution plan, only years in which the employee benefited under the plan may be taken into account in determining equivalent accrual rates. See § 1.401(a)(4)–8(b)(2)(i).) The rules of this paragraph (d) apply separately to service credited under a plan for each different purpose under the plan, including, but not limited to: application of the benefit formula (benefit service), application of the accrual method (accrual service), application of the vesting schedule (vesting service), entitlement to benefits, rights, and features (entitlement service), application of the requirements for eligibility to participate in the plan (eligibility service).

(ii) *Special rule for pre-effective date service.* A plan is deemed to satisfy this paragraph (d) with respect to service credited for periods prior to the effective date applicable to the plan under §1.401(a)(4)–13 (a) or (b) under a plan provision adopted and in effect as of February 11, 1993 (and any such service may be taken into account for purposes of satisfying §1.401(a)(4)–1 (b)(2) or (b)(3)), if the plan satisfied the applicable nondiscrimination requirements with respect to the service that were in effect for all relevant periods prior to the applicable effective date.

(2) *Manner of crediting service*—(i) *General rule.* A plan satisfies this paragraph (d)(2) if, on the basis of all of the relevant facts and circumstances, the manner in which employees' service is credited for all purposes under the plan does not discriminate in favor of HCEs.

(ii) *Equivalent service-crediting methods.* For purposes of this paragraph (d)(2), a service-crediting method used for a specified purpose that is based on hours of service, as provided in 29 CFR 2530.200b–2, and a service-crediting method used for the same purpose that is based on one of the equivalencies set forth in 29 CFR 2530.200b–3, are treated as equivalent if the service-crediting methods are otherwise the same.

(iii) *Safe harbor for service-crediting.* The manner in which service is credited under a plan for a specified purpose is deemed to satisfy this paragraph (d)(2) if each combination of service-crediting provisions applied for that purpose would satisfy the nondiscriminatory availability requirements of §1.401(a)(4)–4 if that combination were an other right or feature.

(iv) *Examples.* The following examples illustrate the rules in this paragraph (d)(2):

Example 1. (a) Plan A covers both salaried employees and hourly employees. All of the HCEs in Plan A are salaried employees. For administrative convenience, salaried employees in Plan A (none of whom are part-time) have their years of service calculated in accordance with the elapsed time provisions in §1.410(a)–7. Hourly employees in Plan A (most of whom are scheduled to work 2,000 hours in a year) have their hours of service calculated in accordance with 29 CFR 2530.200b–2 and are credited with a year of service for each plan year in which they complete 1,000 hours of service.

(b) Plan A does not fail to satisfy this paragraph (d)(2) merely because different service-crediting provisions are applied to salaried and hourly employees for administrative convenience. The service-crediting provisions for hourly employees in Plan A are reasonably comparable to the service-crediting provisions for salaried employees. This is because the amount of service credited to hourly employees who complete fewer than 1,000 hours of service before termination of employment (i.e., quit, retirement, discharge, or death) during the plan year (and are treated less favorably than the salaried employees with the same period of employment during the plan year) is balanced by the amount of service credited to hourly employees who complete more than 1,000 hours of service before termination of employment during the plan year (who are treated more favorably than the salaried employees with the same period of employment during the plan year).

Example 2. (a) The facts are the same as in *Example 1,* except Plan A requires hourly employees to complete 2,000 hours of service in order to be credited with a full year of service, with a pro rata reduction for hourly employees who complete fewer than 2,000 hours of service.

(b) Plan A does not fail to satisfy this paragraph (d)(2) merely because different service-crediting provisions are applied to salaried and hourly employees for administrative convenience. The service-crediting provisions for hourly employees in Plan A are reasonably comparable to the service-crediting provisions for salaried employees. This is because the amount of service credited to hourly employees whose employment terminates (i.e., quit, retire, are discharged, or die) during the plan year is reasonably comparable to the amount of service credited to salaried employees whose employment is terminated during the plan year with the same period of employment during the plan year.

(3) *Service-crediting period*—(i) *Limitation on service taken into account*—(A) *General rule.* Except as otherwise provided in this paragraph (d)(3), service for periods in which an employee does not perform services as an employee of the employer or in which the employee did not participate in the plan may not be taken into account in determining whether the plan satisfies §1.401(a)(4)–1 (b)(2) and (b)(3). In addition, in determining whether a plan satisfies §1.401(a)(4)–1 (b)(2) and (b)(3), no more than one year of service may be taken into account with respect to any 12-consecutive-month period (with adjustments for shorter periods, if appropriate) unless the additional service is required to be credited under section 410 or 411, whichever is applicable.

(B) *Past service.* Notwithstanding paragraph (d)(3)(i)(A) of this section, service for periods in which an employee performed services as an employee of the employer and did not participate in a plan, but in which the employee would have participated in the plan but for the fact that the plan (or the plan amendment extending coverage to the employee) was not in existence during that period, may be taken into account in determining whether the plan satisfies § 1.401(a)(4)–1 (b)(2) and (b)(3). This is because service for such periods generally would have been credited for the employee but for the timing of the plan establishment or amendment, and the timing of the plan establishment or amendment must satisfy § 1.401(a)(4)–5(a).

(C) *Pre-participation and imputed service.* Notwithstanding paragraph (d)(3)(i)(A) of this section, to the extent that a plan treats pre-participation service and imputed service as actual service with the employer, such service may be taken into account in determining whether the plan satisfies § 1.401(a)(4)–1 (b)(2) and (b)(3) if the service satisfies each of the requirements in paragraph (d)(3)(iii) of this section taking into account, in the case of imputed service, the additional rules in paragraph (d)(3)(iv) of this section.

(D) *Additional limitations on service-crediting in the case of certain offsets.* Notwithstanding paragraphs (d)(3)(i) (B) and (C) of this section, if a plan credits benefit service or accrual service under paragraph (d)(3)(i) (B) or (C) of this section for a period before an employee becomes a participant in the plan, but offsets the benefits determined under the plan by benefits under another plan (whether or not qualified or terminated) that are attributable to the same period for which that service is credited, then that service may not be taken into account for purposes of determining whether the first plan satisfies § 1.401(a)(4)–1 (b)(2) or (b)(3) unless the offset provision applies on the same basis to all similarly-situated employees (within the meaning of paragraph (d)(3)(iii)(A) of this section).

(ii) *Definitions*—(A) *Pre-participation service.* For purposes of this section, pre-participation service includes all years of service credited under a plan for years of service with the employer or a prior employer for periods before the employee commenced or recommenced participation in the plan (other than past service described in paragraph (d)(3)(i)(B) of this section).

(B) *Imputed service.* For purposes of this section, imputed service includes any service credited for periods after an employee has commenced participation in a plan while the employee is not performing services as an employee for the employer (including a period in which the employee performs services for another employer, e.g., a joint venture), or while the employee has a reduced work schedule and would not otherwise be credited with service at the level being credited under the general terms of the plan.

(iii) *Requirements for pre-participation and imputed service*—(A) *Provision applied to all similarly-situated employees*—(*1*) *General rule.* A plan provision crediting pre-participation service or imputed service to any HCE must apply on the same terms to all similarly-situated NHCEs. Whether two employees are similarly situated for this purpose must be determined based on reasonable business criteria, generally taking into account only the circumstances resulting in the employees being covered under the plan or being granted imputed service and on the situation of the employees (e.g., the plan in which the employees benefit or the employer by which they are employed) during the period for which the pre-participation service or imputed service is credited. For example, employees who enter a plan as a result of a particular merger and who participated in the same plan of a prior employer are generally similarly situated. As another example, employees who are transferred to different joint ventures or different spun-off divisions are generally not similarly situated.

(*2*) *Examples.* The following examples illustrate the rules in this paragraph (d)(3)(iii)(A):

Example 1. Employer X maintains defined benefit Plans A and B and defined contribution Plan C. Plan A covers all employees who work at the headquarters of Employer X. Plan B covers some employees in Division M of Employer X, and Plan C covers the other employees of Division M. Plans B and C have not been aggregated for purposes of satisfying section 401(a)(4) or 410(b) for the period for which service is being credited. Plan A provides that, whenever an employee covered by Plan B transfers from Division M to the headquarters, the employee's service credited under Plan B is credited under Plan A, and the employee's benefit under Plan A is offset by the employee's benefit under Plan B. However, Plan A provides for no similar recognition of service or offset for employees covered by Plan C who transfer from Division M to the headquarters. Plan A does not fail to satisfy this paragraph (d)(3)(iii)(A) merely because it credits service for employees transferring from Plan B but not from Plan C, because it is reasonable to treat employees participating in different plans that have not been aggregated as not being similarly situated.

Example 2. The facts are the same as in *Example 1,* except that Employer X acquires two trades or businesses from different employers. Employees of the acquired trades or businesses become employees of Division M and become covered by Plan B. In addition, Plan B is amended to credit service with one of the trades or businesses but not the other. Plan B does not fail to satisfy this paragraph (d)(3)(iii)(A) merely because it credits service for one acquired trade or business but not another, because it is reasonable to treat employees of one acquired trade or business as not similarly situated to employees of another acquired trade or business.

(B) *Legitimate business reason*—(*1*) *General rule.* There must be a legitimate business reason, based on all of the relevant facts and circumstances, for a plan to credit imputed service or for a plan to credit pre-participation service for a period of service with another employer.

(*2*) *Relevant facts and circumstances when crediting service with another employer.* The following are examples of relevant facts and circumstances for determining whether a legitimate business reason exists for a plan to credit pre-participation or imputed service for a period of service with another employer as service with the employer: whether one employer has a significant ownership, control, or similar interest in, or relationship with, the other employer (though not enough to cause the two employers to be treated as a single employer under section 414); whether the two employers share interrelated business operations; whether the employers maintain the same multiple-employer plan; whether the employers share similar attributes, such as operation in the same industry or the same geographic area; and whether the employees are an acquired group of employees or the employees became employed by the other employer in a transaction between the two employers that was a stock or asset acquisition, merger, or other similar transaction involving a change in the employer of the employees of a trade or business. Other factors may also be relevant for this purpose, such as the plan's treatment of service with other employers with which the employer has a similar relationship and the type of service being credited (e.g., vesting service as compared to benefit service or accrual service). A legitimate business reason is deemed to exist for a plan to credit military service as service with the employer.

(*3*) *Examples.* The following examples illustrate the rules in this paragraph (d)(3)(iii)(B):

Example 1. Twenty unrelated employers jointly sponsor a multiple-employer plan that covers all employees of the employers. From time to time, employees transfer employment among the employers. There is a legitimate business reason for a disaggregated portion of the plan that benefits the employees of one of the employers to treat service with any of the other employers as service with the employer.

Example 2. Employer X owns 20 percent of the outstanding stock of Employer Y. From time to time, employees transfer from Employer X to Employer Y at the request of Employer X. Employer X maintains defined benefit Plan A. Plan A provides that years of service include an employee's years of service with Employer Y. There is a legitimate business reason for Plan A to credit service with Employer Y because Employer X, through its 20-percent ownership interest, benefits from the service that the transferred employees provide to Employer Y.

Example 3. Employer Z manufactures widgets and belongs to the National Widget Manufacturers' Association. From time to time, Employer Z hires employees from other widget manufacturers. Employer Z maintains a defined benefit plan, Plan B, which credits pre-participation service for periods of service with all other members of the Association located in the western half of the United States as service with Employer Z. There is a legitimate business reason for Plan B to treat service with other members of the Association as service with Employer Z.

(C) *No significant discrimination*—(*1*) *General rule.* Based on all of the relevant facts and circumstances, a plan provision crediting pre-participation or imputed service must not by design or in operation discriminate significantly in favor of HCEs.

(*2*) *Relevant facts and circumstances.* The following are examples of relevant facts and circumstances for determining whether a plan provision crediting pre-participation service or imputed service discriminates significantly in favor of HCEs: whether the service credit does not duplicate benefits but merely makes an employee whole (i.e., prevents the employee from being disadvantaged with respect to benefits by a change in job or employer or provides the employee with benefits comparable to those of other employees); the degree of business ties between the current employer and the prior employer, such as the degree of ownership interest or other affiliation; the degree of excess coverage under section 410(b) of NHCEs for the plan crediting the service, taking into account employees who are credited with pre-participation service; whether the other employer maintains a qualified plan for its employees; the existence of reciprocal service credit under other plans of the employer or the prior employer; the circumstances underlying the employee's transfer into the group of employees covered by the plan; the type of service being credited; and the relative number of employees other than five-percent owners or the most highly-paid HCEs of the employer (determined without regard to the one officer rule of section 414(q)(5)(B)) who are being credited with pre-participation service or imputed service. The relative number referred to in the last factor is determined taking into account all employees who have been over time, or are reasonably expected to be in the future, credited with such service.

(*3*) *Examples.* The following examples illustrate the rules in this paragraph (d)(3)(iii)(C). It is assumed that facts not described in an example do not, in the aggregate, suggest that the relevant plan provision either does or does not discriminate significantly in favor of HCEs.

Example 1. (a) Employer U maintains defined benefit Plans A and B. Plan A covers all employees who work at the headquarters of Employer U. Plan B covers all employees of Division M of Employer U. Plan A provides that, whenever an employee transfers from Division M to the headquarters, the employee's service credited under Plan B is credited under Plan A, and the employee's benefit under Plan A is offset by the employee's benefit under Plan B. Employees, including a meaningful number of NHCEs, are periodically transferred from Division M to the headquarters of Employer U for bona fide business reasons.

(b) The Plan A provision crediting service under Plan B does not discriminate significantly in favor of HCEs. The provision is designed only to prevent employees from being disadvantaged by being transferred from Division M to the headquarters, and a meaningful number of NHCEs can be expected to benefit from it.

Example 2. (a) The facts are the same as in *Example 1,* except that the only employees transferred from Division M to the headquarters of Employer U are HCEs (but not the most highly-paid HCEs of Employer U).

(b) Employer U determines that Plan A would have satisfied sections 401(a)(4) and 410(b) for the period for which the transferred employees are being credited with pre-participation service had the employees participated in Plan A during that period. This determination is based on test results under sections 401(a)(4) and 410(b) for the current year, taking into account significant demographic changes over this period.

(c) The Plan A provision crediting service under Plan B does not significantly discriminate in favor of HCEs in the current year. This conclusion is based on the fact that the circumstances underlying the transfers indicate that they were made for bona fide business reasons, that Plan A would have satisfied sections 401(a)(4) and 410(b) had the transferred employees participated in Plan A during the period for which the pre-participation service is credited, and that the transferred employees are not the most highly-paid HCEs of Employer U.

Example 3. (a) The facts are the same as in *Example 1,* except that the only employee who is transferred from Division M to the headquarters of Employer U is Employee P, who is among the most highly-paid HCEs of Employer U. Plan A provides an unreduced early retirement benefit at age 55 for employees with 20 years of service, but Plan B's early retirement benefits are not subsidized. Employee P is transferred to the headquarters with 20 years of service credited under Plan B and shortly before attainment of age 55. Employee P is expected to retire upon reaching age 55.

(b) The Plan A provision crediting service under Plan B discriminates significantly in favor of HCEs in the year of the transfer. This is because the circumstances underlying this transfer (i.e., its occurrence shortly before Employee P's expected retirement and the fact that the transfer significantly increased Employee P's early retirement benefits) indicate that Employee P was transferred to the headquarters primarily to obtain the higher pension benefits provided under Plan A.

(c) Because of this conclusion, the pre-participation service credited to Employee P cannot be taken into account in determining whether Plan A satisfies §1.401(a)(4)–1 (b)(2) and (b)(3). Thus, if Plan A credits the service, it cannot be a safe harbor plan because the benefit formula will take into account service that may not be taken into account under this paragraph (d)(3). In addition, Employee P's accrual rates under the general test in §1.401(a)(4)–3(c) are likely to be higher than those of other employees because, while the pre-participation service may be used to determine Employee P's benefits under Plan A, the service must be disregarded in determining Employee P's testing service. Also, if Employee P's pre-participation service is used in determining Employee P's entitlement to a benefit, right, or feature under Plan A, the fact that the service must be disregarded in determining Employee P's entitlement service for purposes of §1.401(a)(4)–4 may cause the benefit, right, or feature to be treated as a separate benefit, right, or feature that is currently available only to Employee P.

Example 4. (a) Employer V manufactures widgets and belongs to the National Widget Manufacturers' Association. Each member of the Association maintains a defined benefit plan that credits pre-participation service for periods of service with other members and offsets benefits under the plan by benefits under the plans of the other members. Employer V maintains defined benefit Plan C. Employer V periodically hires employees from other widget manufacturers who are not among its most highly-paid HCEs. In 1997, however, the only employee hired by Employer V from another member of the Association is Employee Q, who is among Employer V's most highly-paid HCEs. Employee Q receives pre-participation service credit in accordance with the terms of Plan C. Some of the plans maintained by other members of the Association credited pre-participation service to NHCEs for the same period for which the pre-participation service is credited to Employee Q.

(b) The provision of Plan C crediting pre-participation service with other members of the Association does not discriminate significantly in 1997, despite the fact that the only employee who received pre-participation service credit under the provision in that year was among the most highly-paid HCEs of Employer V. This conclusion is based on the relative number of employees other than Employer V's most highly-paid HCEs who have been credited in the past, or are reasonably expected to be credited in the future, with pre-participation service for periods of service with other members of the Association, and the fact that other employees who are NHCEs are being credited with pre-participation service under a reciprocal agreement.

Example 5. Employer W owns 79 percent of the outstanding stock of Employer X. From time to time, employees transfer from Employer W to Employer X at the request of Employer W. The only employees who have ever been transferred are HCEs. Employer W maintains a defined benefit plan, Plan D, which credits employees transferred to Employer X with imputed benefit and accrual service while employed by Employer X. Employer X maintains no qualified plan. Plan D would fail either section 401(a)(4) or section 410(b) in the current plan year if the individuals employed by Employer X were treated as employed by Employer W. In addition, Plan D would fail either section 401(a)(4) or section 410(b) in the current plan year if the portion of Plan D covering the transferred employees were treated as maintained by Employer X. The Plan D provision crediting imputed benefit and accrual service to employees transferred to Employer X significantly discriminates in favor of HCEs in the current plan year.

Example 6. The facts are the same as in Example 5, except that Plan D credits the individuals who transfer to Employer X only with imputed vesting and entitlement service. The Plan D provision crediting imputed vesting and entitlement service to individuals transferred to Employer X does not significantly discriminate in favor of HCEs in the current plan year, because there is less potential for discrimination when the only types of service being imputed are vesting and entitlement service.

(iv) *Additional rules for imputed service*—(A) *Legitimate business reasons for crediting imputed service*—(*1*) *General rule.* A legitimate business reason does not exist for a plan to impute service after an individual has permanently ceased to perform services as an employee (within the meaning of §1.410(b)–9) for the employer maintaining the plan, i.e., is not expected to resume performing services as an employee for the employer. The preceding sentence does not apply in the case of an individual who is not performing services for the employer because of disability or is performing services for another employer under an arrangement (such as a transfer of the employee to another employer) that provides some ongoing business benefit to the original employer. The first sentence in this paragraph (d)(3)(iv)(A)(*1*) also does not apply in the case of vesting and entitlement service if the employee is performing services for another employer that is being treated under the plan as actual service with the original employer.

(*2*) *Certain presumptions applicable.* Whether an individual has permanently ceased to perform services as an employee for an employer is determined taking into account all of the relevant facts and circumstances. There is a rebuttable presumption for a period of up to two years that an individual who has ceased to perform services as an employee for an employer is nonetheless expected to resume performing services as an employee for the employer, if the employer continues to treat the individual as an employee for significant purposes unrelated to the plan. After two years, there is a rebuttable presumption that an individual who has ceased to perform services as an employee for the employer is not expected to resume performing services as an employee for the employer. The fact that an individual is absent to perform jury duty or military service automatically rebuts the latter presumption. Other evidence, such as the employer's layoff policy, the terms of an employment contract, or specific leave to pursue a degree requiring more than two years of study, may also rebut this presumption.

(*3*) *Imputed service for part-time employees.* Rules similar to the rules in paragraph (d)(3)(iv)(A) (*1*) and (*2*) of this section apply in the case of an employee whose work hours are temporarily reduced and who therefore would normally be credited with service at a reduced rate, but who continues to be credited with service at the same rate as before the reduction (e.g., an employee who continues to be credited with service as if the employee were a full-time employee during a temporary change from a full-time to a part-time work schedule).

(B) *Additional factors for determining whether a provision crediting imputed service discriminates significantly.* In addition to the factors described in paragraph (d)(3)(iii)(C)(*2*) of this section, relevant facts and circumstances for determining whether a plan provision crediting imputed service during a leave of absence or a period of reduced services discriminates significantly include any employer policies or practices that restrict the ability of employees to take leaves of absence or work temporarily on a part-time basis, respectively.

(v) *Satisfaction of other service-crediting rules.* A plan does not fail to satisfy this paragraph (d)(3) merely because it credits service to the extent necessary to satisfy the service-crediting rules in section 410(a), 411(a), 413, or 414(a), § 1.410(a)–7 (elapsed-time method of service-crediting) or 29 CFR 2530.200b–2 (regarding hours of service to be credited), whichever is applicable, or 29 CFR § 2530.204–2(d) (regarding double proration of service and compensation).

(e) *Family aggregation rules.* [Reserved]

(f) *Governmental plans.* [Reserved]

(g) *Corrective amendments*—(1) *In general.* A corrective amendment that satisfies the rules of this paragraph (g) is taken into account for purposes of satisfying certain section 401(a) requirements for a plan year, by treating the corrective amendment as if it were adopted and effective as of the first day of the plan year. These rules apply in addition to the rules of section 401(b). Paragraph (g)(2) of this section describes the scope of the corrective amendments that are permitted to be made. Paragraph (g)(3) of this section specifies the conditions under which a corrective amendment may be made. Paragraph (g)(4) of this section provides a rule prohibiting a corrective amendment from being taken into account to the extent that it does not have substance. Paragraph (g)(5) of this section discusses the effect of the corrective amendments permitted under this paragraph (g) under provisions other than section 401(a).

(2) *Scope of corrective amendments.* For purposes of satisfying the minimum coverage requirements of section 410(b), the nondiscriminatory amount requirement of § 1.401(a)(4)–1(b)(2), or

the nondiscriminatory plan amendment requirement of §1.401(a)(4)–1(b)(4), a corrective amendment may retroactively increase accruals or allocations for employees who benefited under the plan during the plan year being corrected, or may grant accruals or allocations to individuals who did not benefit under the plan during the plan year being corrected. In addition, for purposes of satisfying the nondiscriminatory current availability requirement of §1.401(a)(4)–4(b) for benefits, rights, or features, a corrective amendment may make a benefit, right, or feature available to employees to whom it was previously not available. A corrective amendment may not, however, correct for a failure to incorporate the pre-termination restrictions of §1.401(a)(4)–5(b).

(3) *Conditions for corrective amendments*—(i) *In general.* A corrective amendment is not taken into account prior to its adoption under this paragraph (g) unless it satisfies each of the requirements of paragraph (g)(3) (ii) through (vii) of this section, whichever are applicable. Thus, for example, if any of the applicable requirements are not satisfied, any additional accruals arising from an amendment adopted after the end of a plan year are not given retroactive effect and, thus, are tested in the plan year in which the amendment is adopted.

(ii) *Benefits not reduced.* Except as permitted under paragraph (g)(3)(vi)(C)(*2*) of this section, the corrective amendment may not result in a reduction of an employee's benefits (including any benefit, right, or feature), determined based on the terms of the plan in effect immediately before the amendment.

(iii) *Amendment effective for all purposes.* For purposes of determining an employee's rights and benefits under the plan, the corrective amendment must generally be effective as if the amendment had been made on the first day of the plan year being corrected. Thus, if the corrective amendment is made after the close of the plan year being corrected, an employee's allocations or accruals, along with the associated benefits, rights, and features, must be increased to the level at which they would have been had the amendment been in effect for the entire preceding plan year. Accordingly, such increases are taken into account for testing purposes as if the increases had actually occurred in the prior plan year. However, to the extent that an amendment makes a benefit, right, or feature available to a group of employees, the amendment does not fail to satisfy this paragraph (g)(3)(iii) merely because it is not effective prior to the date of adoption and, therefore, the benefit, right, or feature is not made currently available to those employees before that date.

(iv) *Time when amendment must be adopted and put into effect*—(A) *General rule.* Any corrective amendment intended to apply to the preceding plan year must be adopted and implemented on or before the 15th day of the 10th month after the close of the plan year in order to be taken into account for the preceding plan year.

(B) *Determination letter requested by employer or plan administrator.* If, on or before the end of the period set forth in paragraph (g)(3)(iv)(A) of this section, the employer or plan administrator files a request pursuant to §601.201(o) of this chapter (Statement of Procedural Rules) for a determination letter on the amendment, the initial or continuing qualification of the plan, or the trust that is part of the plan, the period set forth in paragraph (g)(3)(iv)(A) of this section is extended in the same manner as provided for an extension of the remedial amendment period under §1.401(b)–1(d)(3).

(v) *Corrective amendment for coverage or amounts testing*—(A) *Retroactive benefits must be provided to nondiscriminatory group.* Except as provided in paragraph (g)(3)(v)(B) of this section, if the corrective amendment is adopted after the close of the plan year, the additional allocations or accruals for the preceding year resulting from the corrective amendment must separately satisfy section 401(a)(4) for the preceding plan year and must benefit a group of employees that separately satisfies section 410(b) (determined by applying the same rules as are applied in determining whether a component plan separately satisfies section 410(b) under §1.401(a)(4)–9(c)(4)). Thus, for example, in applying the rules of this paragraph (g)(3)(v), an employer may not aggregate the additional accruals or allocations for the preceding plan year resulting from the corrective amendment with the other accruals or allocations already provided under the terms of the plan as in effect during the preceding plan year without regard to the corrective amendment.

(B) *Corrective amendment to conform to safe harbor.* The requirements of paragraph (g)(3)(v)(A) of this section need not be met if the corrective amendment is for purposes of conforming the plan to one of the safe harbors in § 1.401(a)(4)–2(b) or § 1.401(a)(4)–3(b) (including for purposes of applying the requirements of those safe harbors under the optional testing methods in § 1.401(a)(4)–8 (b)(3) or (c)(3)), or ensuring that the plan continues to meet one of those safe harbors.

(vi) *Conditions for corrective amendment of the availability of benefits, rights, and features.* A corrective amendment may not be taken into account under this paragraph (g) for purposes of satisfying § 1.401(a)(4)–4(b) for a given plan year unless—

(A) The corrective amendment is not part of a pattern of amendments being used to correct repeated failures with respect to a particular benefit, right, or feature;

(B) The relevant provisions of the plan immediately after the corrective amendment with respect to the benefit, right, or feature (including a corrective amendment eliminating the benefit, right, or feature) remain in effect until the end of the first plan year beginning after the date of the amendment; and

(C) The corrective amendment either—

(*1*) Expands the group of employees to whom the benefit, right, or feature is currently available so that for each plan year in which the corrective amendment is taken into account in determining whether the plan satisfies § 1.401(a)(4)–4(b), the group of employees to whom the benefit, right, or feature is currently available, after taking into account the amendment, satisfies the nondiscriminatory classification requirement of § 1.410(b)–4 (and thus the current availability requirement of § 1.401(a)(4)–4(b)) with a ratio percentage greater than or equal to the lesser of—

(*i*) The safe harbor percentage applicable to the plan; and

(*ii*) The ratio percentage of the plan; or

(*2*) Eliminates the benefit, right, or feature (to the extent permitted under section 411(d)(6)) on or before the last day of the plan year for which the corrective amendment is taken into account.

(vii) *Special rules for section 401(k) plans and section 401(m) plans*—(A) *Minimum coverage requirements.* In the case of a section 401(k) plan, a corrective amendment may only be taken into account for purposes of satisfying § 1.410(b)–3(a)(2)(i) under this paragraph (g) for a given plan year to the extent that the corrective amendment grants qualified nonelective contributions within the meaning of § 1.401(k)–1(g)(13)(ii) (QNECs) to nonhighly compensated nonexcludable employees who were not eligible employees within the meaning of § 1.401(k)–1(g)(4) for the given plan year, and the amount of the QNECs granted to each nonhighly compensated nonexcludable employee equals the product of the nonhighly compensated nonexcludable employee's plan year compensation and the actual deferral percentage (within the meaning of section 401(k)(3)(B)) for the given plan year for the group of NHCEs who are eligible employees. Similarly, in the case of a section 401(m) plan, a corrective amendment may only be taken into account for purposes of satisfying § 1.410(b)–3(a)(2)(i) under this paragraph (g) for a given plan year to the extent that the corrective amendment grants qualified nonelective contributions (QNECs) to nonhighly compensated nonexcludable employees who were not eligible employees within the meaning of § 1.401(m)–1(f)(4) for the given plan year, and the amount of the QNECs granted to each nonhighly compensated nonexcludable employee equals the product of the nonhighly compensated nonexcludable employee's plan year compensation and the actual contribution percentage (within the meaning of section 401(m)(3)) for the given plan year for the group of NHCEs who are eligible employees.

(B) *Correction of rate of match.* In the case of a section 401(m) plan, allocations for a given plan year granted under a corrective amendment to NHCEs who made contributions for the plan year eligible for a matching contribution may be treated as matching contributions. These allocations treated as matching contributions may be taken into account for purposes of satisfying the current availability requirement of §1.401(a)(4)–4(b) with respect to the right to a rate of match, but may not be taken into account for satisfying other amounts testing.

(4) *Corrective amendments must have substance.* A corrective amendment is not taken into account in determining whether a plan satisfies section 401(a)(4) or 410(b) to the extent the amendment affects nonvested employees whose employment with the employer terminated on or before the close of the preceding year, and who therefore would not have received any economic benefit from the amendment if it had been made in the prior year. Similarly, in determining whether the requirements of paragraph (g)(3)(vi)(C)(*1*) of this section are satisfied, a corrective amendment making a benefit, right, or feature available to employees is not taken into account to the extent the benefit, right, or feature is not currently available to any of those employees immediately after the amendment. However, a plan will not fail to satisfy the requirements of paragraph (g)(3)(vi)(C)(*1*) of this section by operation of the provisions in this paragraph (g)(4) if the benefit, right, or feature is made available to all employees in the plan as of the date of the amendment.

(5) *Effect under other statutory requirements.* A corrective amendment under this paragraph (g) is treated as if it were adopted and effective as of the first day of the plan year only for the specific purposes described in this paragraph (g). Thus, for example, the corrective amendment is taken into account not only for purposes of sections 401(a)(4) and 410(b), but also for purposes of determining whether the plan satisfies sections 401(l). By contrast, the amendment is not given retroactive effect for purposes of section 404 (deductions for employer contributions) or section 412 (minimum funding standards), unless otherwise provided for in rules applicable to those sections.

(6) *Examples.* The following examples illustrate the rules in this paragraph (g):

Example 1. Employer U maintains a calendar year defined benefit plan that in 1994 is tested using the safe harbor for flat benefit plans in §1.401(a)(4)–3(b)(4). In 1996, Employer U is concerned that the plan will not satisfy the demographic requirement in §1.401(a)(4)–3(b)(4)(i)(C)(*3*) for the 1995 plan year because the average of the normal accrual rates for all NHCEs is less than 70 percent of the average of the normal accrual rates for all HCEs. Provided the corrective amendment would otherwise satisfy this paragraph (g), Employer U may make a corrective amendment to the plan to increase the number of NHCEs so that the amended plan satisfies the safe harbor for the 1995 plan year. The corrective amendment need not satisfy paragraph (g)(3)(v)(A) of this section because Employer U is retroactively amending the plan to conform to a safe harbor in §1.401(a)(4)–3(b). See paragraph (g)(3)(v)(B) of this section.

Example 2. (a) Employer V maintains a calendar year defined contribution plan covering all the employees in Division M and Division N. Under the plan, only employees in Division M have the right to direct the investments in their account. For plan years prior to 1996, the plan met the current availability requirement of §1.401(a)(4)–4(b) because the employees in Division M were a group of employees that satisfied the nondiscriminatory classification test of §1.410(b)–4. Because of attrition in the employee population in Division M in 1996, the group of employees to whom the right to direct investments is available during that plan year no longer meets the nondiscriminatory classification test of §1.410(b)–4. Thus, the right to direct investments under the plan does not meet the current availability requirement of §1.401(a)(4)–4(b) during the 1996 plan year.

(b) Employer V may amend the plan in 1997 (but on or before October 15) to make the right to direct investments available from the date of the corrective amendment to a larger group of employees and the corrective amendment may be taken into account for purposes of satisfying the current availability requirement of §1.401(a)(4)–4(b) for 1996 if the amendment satisfies this paragraph (g). Thus, for example, the group of employees to whom the right to direct investments is currently available, after taking into account the corrective amendment, must satisfy the nondiscriminatory classification test of §1.410(b)–4 for 1996 using a safe harbor percentage (or if lower, the ratio percentage of the plan for 1996). In addition, the corrective amendment making the right to direct investments available to a larger group of employees must remain in effect through the end of the 1998 plan year.

(c) In order for Employer V to take the corrective amendment into account for purposes of satisfying the current availability requirement of § 1.401(a)(4)–4(b) for the portion of the 1997 plan year before the amendment, the group of employees to whom the right to direct investments is currently available, taking into account the amendment, must satisfy the nondiscriminatory classification test of § 1.410(b)–4 for 1997 using a safe harbor percentage (or if lower, the ratio percentage of the plan for 1997).

(d) Alternatively, if Employer V adopts the corrective amendment before the end of the 1996 plan year, the corrective amendment need only remain in force through the end of the 1997 plan year, or the corrective amendment may eliminate the right to direct investments (provided that the elimination remains in effect through the end of the 1997 plan year).

Example 3. The facts are the same as in *Example 2.* In 1997, Employer V makes a corrective amendment to extend the plan to employees of Division O as well as Divisions M and N. Assume that the corrective amendment satisfies paragraph (g)(3)(v)(A) of this section, and thus, may be taken into account for purposes of satisfying the nondiscriminatory amounts requirement of § 1.401(a)(4)–1(b)(2) or the minimum coverage requirements of section 410(b). However, the employees in Division O will not be taken into account in determining whether the right to direct investments meets the current availability requirements of § 1.401(a)(4)–4(b) unless the corrective amendment meets the requirements of paragraph (g)(3)(vi) of this section. Thus, for example, the group of employees to whom the right to direct investments is made available as a result of the expansion of coverage, after taking into account the corrective amendment, must satisfy the nondiscriminatory clarification test of § 1.410(b)–4 for 1996 using a safe harbor percentage (or if lower, the ratio percentage of the plan for 1996). In addition, the amendment making the right to direct investments available to a larger group of employees must remain in effect though the end of the 1998 plan year.

Example 4. Employer W maintains a defined benefit plan that covers all employees and that offsets an employee's benefit by the employee's projected primary insurance amount. The plan is not eligible to use the safe harbors under § 1.401(a)(4)–3(b) because the plan does not satisfy section 401(l). Under the plan, the accrual rates for all HCEs (determined under the general test of § 1.401(a)(4)–3(c)) for 1998 are less than 1.5 percent of average annual compensation, and the accrual rates for all NHCEs (determined under the general test of § 1.401(a)(4)–3(c)) for 1998 are two percent of average annual compensation. If Employer W adopts a corrective amendment adopted in 1999 that retroactively increases HCEs' benefits under the plan so that their accrual rates equal those of the NHCEs, the corrective amendment may not be taken into account in testing the 1998 plan year (i.e., the accruals that result from the corrective amendment are treated as 1999 accruals), because the accruals for the 1998 plan year resulting from the corrective amendment would not separately satisfy sections 410(b) and 401(a)(4). This is the case even if, after taking the amendment into account, the plan would satisfy sections 410(b) and 401(a)(4) for the 1998 plan year.

Example 5. Employer X maintains two plans—Plan A and Plan B. Plan A satisfies the ratio percentage test of § 1.410(b)–2(b)(2), but Plan B does not. Thus, in order to satisfy section 410(b), Plan B must satisfy the average benefits test of § 1.410(b)–2(b)(3). The average benefit percentage of Plan B is 60 percent. Employer X may take into account a corrective amendment that increases the accruals under either Plan A or Plan B so that the average benefit percentage meets the 70 percent requirement of the average benefits test, if the amendment satisfies paragraph (g)(3)(v) of this section.

Example 6. Employer Y maintains Plan C, which does not satisfy section 401(a)(4) in a plan year. Under the terms of paragraph (g)(2) of this section, Employer Y amends Plan C to increase the benefits of certain employees retroactively. In designing the amendment, Employer Y identifies those employees who have terminated without vested benefits during the period after the end of the prior plan year and before the adoption date of the amendment, and the amendment provides increases in benefits primarily to those employees. It would be inconsistent with the purpose of preventing discrimination in favor of HCEs for Plan C to treat the amendment as retroactively effective under this paragraph (g). See § 1.401(a)(4)–1(c)(2).

Example 7. Employer Z maintains both a section 401(k) plan and a section 401(m) plan that provides matching contributions at a rate of 50 percent with respect to elective contributions under the section 401(k) plan. In plan year 1995, the section 401(k) plan fails to satisfy the actual deferral percentage test of section 401(k)(3). In order to satisfy section 401(k)(3), Employer Z makes corrective distributions to HCEs H1 through H10 of their excess contributions as provided under § 1.401(k)–1(f). The matching contributions that H1 through H10 had received on account of their excess contributions are not forfeited, however. Thus, the effective rate of matching contributions provided to H1 through H10 is increased as a result of the corrective distributions. See § 1.401(a)(4)–4(e)(3)(iii)(G). Since no NHCE in the section

401(m) plan is provided with an equivalent rate of matching contributions, the rate of matching contributions provided to H1 through H10 does not satisfy the nondiscriminatory availability requirement of §1.401(a)(4)–4 in plan year 1995. Employer Z makes a corrective amendment by October 15, 1996, that grants allocations to NHCEs who made contributions for the 1995 plan year eligible for a matching contribution. Employer Z may treat the allocations granted under the corrective amendment to those NHCEs as matching contributions for the 1995 plan year and, as a result, take them into account in determining whether the availability of the rate of matching contributions provided to H1 through H10 satisfies the current availability requirement of §1.401(a)(4)–4(b) for the 1995 plan year.

[T.D. 8485, 58 FR 46813, Sept. 3, 1993]

§1.401(a)(4)–12 Definitions.

Unless otherwise provided, the definitions in this section govern in applying the provisions of §§1.401(a)(4)–1 through 1.401(a)(4)–13.

Accumulation plan. Accumulation plan means a defined benefit plan under which the benefit of every employee for each plan year is separately determined, using plan year compensation (if benefits are determined as a percentage of compensation rather than a dollar amount) separately calculated for the plan year, and each employee's total accrued benefit as of the end of a plan year is the sum of the separately determined benefit for that plan year and the total accrued benefit as of the end of the preceding plan year.

Acquired group of employees. Acquired group of employees means employees of a prior employer who become employed by the employer in a transaction between the employer and the prior employer that is a stock or asset acquisition, merger, or other similar transaction involving a change in the employer of the employees of a trade or business, plus employees hired by or transferred into the acquired trade or business on or before a date selected by the employer that is within the transition period defined in section 410(b)(6)(C)(ii). In addition, in the case of a transaction prior to the effective date of these regulations, the date by which employees must be hired by or transferred into the acquired trade or business in order to be included in the acquired group of employees may be any date prior to February 11, 1993, without regard to whether it is later than the end of the transition period defined in section 410(b)(6)(C)(ii).

Actuarial equivalent. An amount or benefit is the actuarial equivalent of, or is actuarially equivalent to, another amount or benefit at a given time if the actuarial present value of the two amounts or benefits (calculated using the same actuarial assumptions) at that time is the same.

Actuarial present value. Actuarial present value means the value as of a specified date of an amount or series of amounts due thereafter, where each amount is—

(1) Multiplied by the probability that the condition or conditions on which payment of the amount is contingent will be satisfied; and

(2) Discounted according to an assumed rate of interest to reflect the time value of money.

Ancillary benefit. Ancillary benefit is defined in §1.401(a)(4)–4(e)(2).

Average annual compensation. Average annual compensation is defined in §1.401(a)(4)–3(e)(2).

Base benefit percentage. Base benefit percentage is defined in §1.401(l)–1(c)(3).

Benefit formula. Benefit formula means the formula a defined benefit plan applies to determine the accrued benefit (within the meaning of section 411(a)(7)(A)(i)) in the form of an annual benefit commencing at normal retirement age of an employee who continues in service until normal retirement age. Thus, for example, the benefit formula does not include the accrual method the plan applies (in conjunction with the benefit formula) to determine the accrued benefit of an employee who terminates employment before normal retirement age. For purposes of this definition, a change in plan provisions that applies only to certain employees who terminate within a limited period of time (e.g., an early retirement window benefit) is treated as a change in the plan's benefit formula for the employees to whom the change is potentially applicable during the period that the change is potentially applicable to them. The preceding sentence applies only to the extent that the change in plan provisions would result in a change in the benefit formula if it were permanent and applied without regard to when the employees' employment was terminated.

Benefit, right, or feature. Benefit, right, or feature means an optional form of benefit, an ancillary benefit, or an other right or feature within the meaning of § 1.401(a)(4)–4(e).

Contributory DB plan. Contributory DB plan means a defined benefit plan that includes employee contributions not allocated to separate accounts.

Defined benefit excess plan. Defined benefit excess plan is defined in § 1.401(l)–1(c)(16)(i).

Defined benefit plan. Defined benefit plan is defined in § 1.410(b)–9.

Defined contribution plan. Defined contribution plan is defined in § 1.410(b)–9.

Determination date. Determination date is defined in § 1.401(a)(4)–8(b)(3)(iv)(A).

Employee. With respect to a plan for a given plan year, employee means an employee (within the meaning of § 1.410(b)–9) who benefits as an employee under the plan for the plan year (within the meaning of § 1.410(b)–3).

Employer. Employer is defined in § 1.410(b)–9.

ESOP. ESOP is defined in § 1.410(b)–9.

Excess benefit percentage. Excess benefit percentage is defined in § 1.401(l)–1(c)(14).

Former employee. With respect to a plan for a given plan year, former employee means a former employee (within the meaning of § 1.410(b)–9).

Former HCE. Former HCE means a highly compensated former employee as defined in § 1.410(b)–9.

Former NHCE. Former NHCE means a former employee who is not a former HCE.

Fresh-start date. Fresh-start date is defined in § 1.401(a)(4)–13(c)(5)(iii).

Fresh-start group. Fresh-start group is defined in § 1.401(a)(4)–13(c)(5)(ii).

Gross benefit percentage. Gross benefit percentage is defined in § 1.401(l)–1(c)(18).

HCE. HCE means a highly compensated employee as defined in § 1.410(b)–9 who benefits under the plan for the plan year (within the meaning of § 1.410(b)–3).

Integration level. Integration level is defined in § 1.401(l)–1(c)(20).

Measurement period. Measurement period is defined in § 1.401(a)(4)–3(d)(1)(iii).

Multiemployer plan. Multiemployer plan is defined in § 1.410(b)–9.

NHCE. NHCE means an employee who is not an HCE.

Nonexcludable employee. Nonexcludable employee means an employee within the meaning of § 1.410(b)–9, other than an excludable employee with respect to the plan as determined under § 1.410(b)–6. A nonexcludable employee may be either a highly or nonhighly compensated nonexcludable employee, depending on the nonexcludable employee's status under section 414(q).

Normalize. With respect to a benefit payable to an employee in a particular form, normalize means to convert the benefit to an actuarially equivalent straight life annuity commencing at the employee's testing age. The actuarial assumptions used in normalizing a benefit must be reasonable and must be applied on a gender-neutral basis. A standard interest rate and a standard mortality table are among the assumptions considered reasonable for this purpose.

Offset plan. Offset plan is defined in § 1.401(l)–1(c)(24).

Optional form of benefit. Optional form of benefit is defined in § 1.401(a)(4)–4(e)(1).

Other right or feature. Other right or feature is defined in § 1.401(a)(4)–4(e)(3).

Plan. Plan means a plan within the meaning of § 1.410(b)–7 (a) and (b), after application of the mandatory disaggregation rules of § 1.410(b)–7(c) and the permissive aggregation rules of § 1.410(b)–7(d).

Plan year. Plan year is defined in § 1.410(b)–9.

Plan year compensation—(1) *In general.* Plan year compensation means section 414(s) compensation for the plan year determined by measuring section 414(s) compensation during one of the periods described in paragraphs (2) through (4) of this definition. Whichever period is selected must be applied uniformly to determine the plan year compensation of every employee.

(2) *Plan year.* This period consists of the plan year.

(3) *Twelve-month period ending in the plan year.* This period consists of a specified 12-month period ending with or within the plan year, such as the calendar year or the period for determining benefit accruals described in §1.401(a)(4)–3(f)(6).

(4) *Period of plan participation during the plan year.* This period consists of the portion of the plan year during which the employee is a participant in the plan. This period may be used to determine plan year compensation for the plan year in which participation begins, the plan year in which participation ends, or both. This period may be used to determine plan year compensation when substituted for average annual compensation in §1.401(a)(4)–3(e)(2)(ii)(A) only if the plan year is also the period for determining benefit accruals under the plan rather than another period as permitted under §1.401(a)(4)–3(f)(6). Further, selection of this period must be made on a reasonably consistent basis from plan year to plan year in a manner that does not discriminate in favor of HCEs.

(5) *Special rule for new employees.* Notwithstanding the uniformity requirement of paragraph (1) of this definition, if employees' plan year compensation for a plan year is determined based on a 12-month period ending within the plan year under paragraph (3) of this definition, then the plan year compensation of any employees whose date of hire was less than 12 months before the end of that 12-month period must be determined uniformly based either on the plan year or on the employees' periods of participation during the plan year, as provided in paragraphs (2) and (4), respectively, of this definition.

QJSA. QJSA means a qualified joint and survivor annuity as defined in section 417(b).

QSUPP—(1) *In general.* QSUPP or qualified social security supplement means a social security supplement that meets each of the requirements in paragraphs (2) through (6) of this definition.

(2) *Accrual*—(i) *General rule.* The amount of the social security supplement payable at any age for which the employee is eligible for the social security supplement must be equal to the lesser of—

(A) The employee's old-age insurance benefit, unreduced on account of age, under title II of the Social Security Act; and

(B) The accrued social security supplement, determined under one of the methods in paragraph (2) (ii) through (iv) of this definition.

(ii) *Section 401(l) plans.* In the case of a section 401(l) plan that is a defined benefit excess plan, each employee's accrued social security supplement equals the employee's average annual compensation up to the integration level, multiplied by the disparity provided by the plan for the employee's years of service used in determining the employee's accrued benefit under the plan. In the case of a section 401(l) plan that is an offset plan, each employee's accrued social security supplement equals the dollar amount of the offset accrued for the employee under the plan.

(iii) *PIA offset plan.* In the case of a PIA offset plan, each employee's accrued social security supplement equals the dollar amount of the offset accrued for the employee under the plan. For this purpose, a PIA offset plan is a plan that reduces an employee's benefit by an offset based on a stated percentage of the employee's primary insurance amount under the Social Security Act.

(iv) *Other plans.* In the case of any other plan, each employee's social security supplement accrues ratably over the period beginning with the later of the employee's commencement of participation in the plan or the effective date of the social security supplement and ending with the earliest age at which the social security supplement is payable to the employee. The effective date of the social security supplement is the later of the effective date of the amendment adding the social security supplement or the effective date of the amendment modifying an existing social security supplement to comply with the requirements of this definition. If, by the end of the first plan year to which these regulations apply, as set forth in §1.401(a)(4)–13 (a) and (b), an amendment is made to a social security supplement in existence on September 19, 1991, the employer may treat the accrued portion of the social security supplement, as determined under the plan without regard to amendments made after September 19, 1991, as included in the employee's accrued social security supplement, provided that the remainder of the social security supplement is accrued under the otherwise-applicable method.

(3) *Vesting.* The plan must provide that an employee's right to the accrued social security supplement becomes nonforfeitable within the meaning of section 411 as if it were an early retirement benefit.

(4) *Eligibility.* The plan must impose the same eligibility conditions on receipt of the social security supplement as on receipt of the early retirement benefit in conjunction with which the social security supplement is payable. Furthermore, if the service required for an employee to become eligible for the social security supplement exceeds 15 years, then the ratio percentage of the group of employees who actually satisfy the eligibility conditions on receipt of the QSUPP in the current plan year must equal or exceed the unsafe harbor percentage applicable to the plan under § 1.410(b)–4(c)(4)(ii).

(5) *QJSA.* At each age, the most valuable QSUPP commencing at that age must be payable in conjunction with the QJSA commencing at that age. In addition, the plan must provide that, in the case of a social security supplement payable in conjunction with a QJSA, the social security supplement will be paid after the employee's death on the same terms as the QJSA, but in no event for a period longer than the period for which the social security supplement would have been paid to the employee had the employee not died. For example, if the QJSA is in the form of a joint annuity with a 50-percent survivor's benefit, the social security supplement must provide a 50-percent survivor's benefit. When section 417(c) requires the determination of a QJSA for purposes of determining a qualified pre-retirement survivor's annuity as defined in section 417(c) (QPSA), the social security supplement payable in conjunction with that QJSA must be paid in conjunction with the QPSA.

(6) *Protection.* The plan must specifically provide that the social security supplement is treated as an early retirement benefit that is protected under section 411(d)(6) (other than for purposes of sections 401(a)(11) and 417). Thus, the accrued social security supplement must continue to be payable notwithstanding subsequent amendment of the plan (including the plan's termination), and an employee may meet the eligibility requirements for the social security supplement after plan termination.

Qualified plan. Qualified plan means a plan that satisfies section 401(a). For this purpose, a qualified plan includes an annuity plan described in section 403(a).

Rate group. Rate group is defined in § 1.401(a)(4)–2(c)(1) or is defined in § 1.401(a)(4)–3(c)(1).

Ratio percentage. Ratio percentage is defined in § 1.410(b)–9.

Section 401(a)(17) employee. Section 401(a)(17) employee is defined in § 1.401(a)(17)–1(e)(2)(ii).

Section 401(k) plan. Section 401(k) plan is defined in § 1.410(b)–9.

Section 401(l) plan. Section 401(l) plan is defined in § 1.410(b)–9.

Section 401(m) plan. Section 401(m) plan is defined in § 1.410(b)–9.

Section 414(s) compensation—(1) *General rule.* When used with reference to compensation for a plan year, 12-month period, or other specified period, section 414(s) compensation means compensation measured using an underlying definition that satisfies section 414(s) for the applicable plan year. Whether an underlying definition of compensation satisfies section 414(s) is determined on a year-by-year basis, based on the provisions of section 414(s) in effect for the applicable plan year and, if relevant, the employer's HCEs and NHCEs for that plan year. See § 1.414(s)–1(i) for transition rules for plan years beginning before the effective date applicable to the plan under § 1.401(a)(4)–13 (a) or (b). For a plan year or 12-month period beginning before January 1, 1988, any underlying definition of compensation may be used to measure the amount of employees' compensation for purposes of this definition, provided that the definition was nondiscriminatory based on the facts and circumstances in existence for that plan year or for the plan year in which that 12-month period ends.

(2) *Determination period for section 414(s) nondiscrimination requirement*—(i) *General rule.* If an underlying definition of compensation must satisfy the nondiscrimination requirement in §1.414(s)–1(d)(3) in order to satisfy section 414(s) for a plan year, any one of the following determination periods may be used to satisfy the nondiscrimination requirement—

(A) The plan year;

(B) The calendar year ending in the plan year; or

(C) The 12-month period ending in the plan year that is used to determine the underlying definition of compensation.

(ii) *Exception for partial plan year compensation.* Notwithstanding the general rule in paragraph (2)(i) of this definition, if the period for measuring the underlying compensation is the portion of the plan year during which each employee is a participant in the plan (as provided in paragraph (4) of the definition of plan year compensation in this section), that period must be used as the determination period.

(3) *Plans using permitted disparity.* In the case of a section 401(l) plan or a plan that imputes permitted disparity in accordance with §1.401(a)(4)–7, an underlying definition of compensation is not section 414(s) compensation if the definition results in significant underinclusion of compensation for employees.

(4) *Double proration of service and compensation.* If a defined benefit plan prorates benefit accruals as permitted under section 411(b)(4)(B) by crediting less than full years of participation, then compensation for a plan year, 12-month period, or other specified period that is used to determine the amount of an employee's benefits under the plan will not fail to be section 414(s) compensation, merely because the amount of compensation for that period is adjusted to reflect the equivalent of full-time compensation to the extent necessary to satisfy the requirements of 29 CFR 2530.204–2(d) (regarding double proration of service and compensation). This adjustment is disregarded in determining whether the underlying definition of compensation used satisfies the requirements of section 414(s). Thus, for example, if the underlying definition of compensation is an alternative definition that must satisfy the nondiscrimination requirement of §1.414(s)–1(d)(3), in determining whether that requirement is satisfied with regard to the underlying definition, the compensation included for any employee is determined without any adjustment to reflect the equivalent of full-time compensation required by 29 CFR 2530.204–2(d).

Social security supplement. Social security supplement is defined in §1.411(a)–7(c)(4)(ii).

Standard interest rate. Standard interest rate means an interest rate that is neither less than 7.5 percent nor greater than 8.5 percent, compounded annually. The Commissioner may, in revenue rulings, notices, and other guidance of general applicability, change the definition of standard interest rate.

Standard mortality table. Standard mortality table means one of the following tables: the UP–1984 Mortality Table (Unisex); the 1983 Group Annuity Mortality Table (1983 GAM) (Female); the 1983 Group Annuity Mortality Table (1983 GAM) (Male); the 1983 Individual Annuity Mortality Table (1983 IAM) (Female); the 1983 Individual Annuity Mortality Table (1983 IAM) (Male); the 1971 Group Annuity Mortality Table (1971 GAM) (Female); the 1971 Group Annuity Mortality Table (1971 GAM) (Male); the 1971 Individual Annuity Mortality Table (1971 IAM) (Female); or the 1971 Individual Annuity Mortality Table (1971 IAM) (Male). These standard mortality tables are available from the Society of Actuaries, 475 N. Martingale Road, Suite 800, Schaumberg, Illinois 60173. The Commissioner may, in revenue rulings, notices, and other guidance of general applicability, change the definition of standard mortality table. See §601.601(d)(2)(ii)(*b*) of this Chapter.

Straight life annuity. Straight life annuity means an annuity payable in equal installments for the life of the employee that terminates upon the employee's death.

Testing age. With respect to an employee, testing age means the age determined for the employee under the following rules:

(1) If the plan provides the same uniform normal retirement age for all employees, the employee's testing age is the employee's normal retirement age under the plan.

(2) If a plan provides different uniform normal retirement ages for different employees or different groups of employees, the employee's testing age is the employee's latest normal retirement age under any uniform normal retirement age under the plan, regardless of whether that particular uniform normal retirement age actually applies to the employee under the plan.

(3) If the plan does not provide a uniform normal retirement age, the employee's testing age is 65.

(4) If an employee is beyond the testing age otherwise determined for the employee under paragraphs (1) through (3) of this definition, the employee's testing age is the employee's current age. The rule in the preceding sentence does not apply in the case of a defined benefit plan that fails to satisfy the requirements of § 1.401(a)(4)–3(f)(3)(i) (permitting certain increases in benefits that commence after normal retirement age to be disregarded).

Testing service. Testing service is defined in § 1.401(a)(4)–3(d)(1)(iv).

Uniform normal retirement age—(1) *General rule.* Uniform normal retirement age means a single normal retirement age under the plan that does not exceed the maximum age in paragraph (2) of this definition and that is the same for all of the employees in a given group. A group of employees does not fail to have a uniform normal retirement age merely because the plan contains provisions described in paragraphs (3) and (4) of this definition.

(2) *Maximum age.* The maximum age is generally 65. However, if all employees have the same social security retirement age (within the meaning of section 415(b)(8)), the maximum age is the employees' social security retirement age. Thus, for example, a component plan has a uniform normal retirement age of 67 if it defines normal retirement age as social security retirement age and all employees in the component plan have a social security retirement age of 67.

(3) *Stated anniversary date*—(i) *General rule.* A group of employees does not fail to have a uniform normal retirement age merely because the plan provides that the normal retirement age of all employees in the group is the later of a stated age (not exceeding the maximum age in paragraph (2) of this definition) or a stated anniversary no later than the fifth anniversary of the time each employee commenced participation in the plan. For employees who commenced participation in the plan before the first plan year beginning on or after January 1, 1988, the stated anniversary date may be later than the anniversary described in the preceding sentence if it is no later than the earlier of the tenth anniversary of the date the employee commenced participation in the plan (or such earlier anniversary selected by the employer, if less than 10) or the fifth anniversary of the first day of the first plan year beginning on or after January 1, 1988.

(ii) *Use of service other than anniversary of commencement of participation.* In lieu of using a stated anniversary date as permitted under paragraph (3)(i) of this definition, a plan may use a stated number of years of service measured on another basis, provided that the determination is made on a basis that satisfies section 411(a)(8) and that the stated number of years of service does not exceed the number of anniversaries permitted under paragraph (3)(i) of this definition. For example, a uniform normal retirement age could be based on the earlier of the fifth anniversary of the commencement of participation and the completion of five years of vesting service.

(4) *Conversion of normal retirement age to normal retirement date.* A group of employees does not fail to have a uniform normal retirement age merely because a defined benefit plan provides for the commencement of normal retirement benefits on different retirement dates for different employees if each employee's normal retirement date is determined on a reasonable basis with reference to an otherwise uniform normal retirement age and the

difference between the normal retirement date and the uniform normal retirement age cannot exceed six months for any employee. Thus, for example, benefits under a plan do not fail to commence at a uniform normal retirement age of age 62 for purposes of §1.401(a)(4)–3(b)(2)(i), merely because the plan's normal retirement date is defined as the last day of the plan year nearest attainment of age 62.

Year of service. Year of service means a year of service as defined in the plan for a specific purpose, including the method of crediting service for that purpose under the plan.

[T.D. 8485, 58 FR 46820, Sept. 3, 1993]

§1.401(a)(4)–13 Effective dates and fresh-start rules.

(a) *General effective dates*—(1) *In general.* Except as otherwise provided in this section, §§1.401(a)(4)–1 through 1.401(a)(4)–13 apply to plan years beginning on or after January 1, 1994.

(2) *Plans of tax-exempt organizations.* In the case of plans maintained by organizations exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), §§1.401(a)(4)–1 through 1.401(a)(4)–13 apply to plan years beginning on or after January 1, 1996.

(3) *Compliance during transition period.* For plan years beginning before the effective date of these regulations, as set forth in paragraph (a)(1) and (2) of this section, and on or after the first day of the first plan year to which the amendments made to section 410(b) by section 1112(a) of the Tax Reform Act of 1986 (TRA '86) apply, a plan must be operated in accordance with a reasonable, good faith interpretation of section 401(a)(4), taking into account pre-existing guidance and the amendments made by TRA '86 to related provisions of the Code (including, for example, sections 401(l), 401(a)(17), and 410(b)). Whether a plan is operated in accordance with a reasonable, good faith interpretation of section 401(a)(4) will generally be determined on the basis of all the relevant facts and circumstances, including the extent to which an employer has resolved unclear issues in its favor. A plan will be deemed to be operated in accordance with a reasonable, good faith interpretation of section 401(a)(4) if it is operated in accordance with the terms of §§1.401(a)(4)–1 through 1.401(a)(4)–13.

(b) *Effective date for governmental plans.* In the case of governmental plans described in section 414(d), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), §§1.401(a)(4)–1 through 1.401(a)(4)–13 apply to plan years beginning on or after the later of January 1, 1996, or 90 days after the opening of the first legislative session beginning on or after January 1, 1996, of the governing body with authority to amend the plan, if that body does not meet continuously. Such plans are deemed to satisfy section 401(a)(4) for plan years before that effective date. For purposes of this paragraph (b), the governing body with authority to amend the plan is the legislature, board, commission, council, or other governing body with authority to amend the plan.

(c) *Fresh-start rules for defined benefit plans*—(1) *Introduction.* This paragraph (c) provides rules that must be satisfied in order to use the fresh-start testing options for defined benefit plans in §1.401(a)(4)–3(b)(6)(vii) and (d)(3)(iii), relating to the safe harbors and the general test, respectively. Those fresh-start options are designed to allow a plan to be tested without regard to benefits accrued before a selected fresh-start date. To the extent provided in paragraph (d) of this section, those options also may be used to disregard certain increases in benefits attributable to compensation increases after a fresh-start date. Although this paragraph (c) generally requires a plan to be amended to freeze employees' accrued benefits as of a fresh-start date and to provide any additional accrued benefits after the fresh-start date solely in accordance with certain specified formulas, certain of these requirements do not apply to a plan that is tested under the general test of §1.401(a)(4)–3(c). See §1.401(a)(4)–3(b)(6)(vii) and (d)(3)(iii).

(2) *General rule.* A defined benefit plan satisfies this paragraph (c) if—

(i) Accrued benefits of employees in the fresh-start group are frozen as of the fresh-start date in accordance with paragraph (c)(3) of this section;

(ii) Accrued benefits after the fresh-start date for employees in the fresh-start group are determined under one of the fresh-start formulas in paragraph (c)(4) of this section; and

(iii) Paragraph (c)(5) of this section is satisfied.

(3) *Definition of frozen*—(i) *General rule.* An employee's accrued benefit under a plan is frozen as of the fresh-start date if it is determined as if the employee terminated employment with the employer as of the fresh-start date (or the date the employee actually terminated employment with the employer, if earlier), and without regard to any amendment to the plan adopted after that date, other than amendments recognized as effective as of or before that date under section 401(b) or §1.401(a)(4)–11(g). The assumption that an employee has terminated employment applies solely for purposes of this paragraph (c)(3). Thus, for example, the fresh start has no effect on the service taken into account for purposes of determining vesting and eligibility for benefits, rights, and features under the plan.

(ii) *Permitted compensation adjustments.* An employee's accrued benefit under a plan that satisfies paragraph (d) of this section does not fail to be frozen as of the fresh-start date merely because the plan makes the adjustments described in paragraph (d)(7) and (8) of this section with regard to the fresh-start date. In addition, if the frozen accrued benefit of an employee under the plan includes top-heavy minimum benefits, an employee's accrued benefit under a plan does not fail to be frozen as of the fresh-start date merely because the plan increases the frozen accrued benefit of each employee in the fresh-start group solely to the extent necessary to comply with the average compensation requirement of section 416(c)(1)(D)(i).

(iii) *Permitted changes in optional forms.* An employee's accrued benefit under a plan does not fail to be frozen as of the fresh-start date merely because the plan provides a new optional form of benefit with respect to the frozen accrued benefit, if—

(A) The optional form is provided with respect to each employee's entire accrued benefit (i.e., accrued both before and after the fresh-start date);

(B) The plan provided meaningful coverage as of the fresh-start date, as described in paragraph (d)(4) of this section; and

(C) The plan provides meaningful current benefit accruals as described in paragraph (d)(6) of this section.

(iv) *Floor-offset plans.* In the case of a plan that was a floor-offset plan described in §1.401(a)(4)–8(d) prior to the fresh-start date, an employee's accrued benefit as of the fresh-start date does not fail to be frozen merely because the actuarial equivalent of the account balance in the defined contribution plan that is offset against the defined benefit plan varies as a result of investment return that is different from the assumed interest rate used to determine the actuarial equivalent of the account balance.

(4) *Fresh-start formulas*—(i) *Formula without wear-away.* An employee's accrued benefit under the plan is equal to the sum of—

(A) The employee's frozen accrued benefit; and

(B) The employee's accrued benefit determined under the formula applicable to benefit accruals in the current plan year (current formula) as applied to the employee's years of service after the fresh-start date.

(ii) *Formula with wear-away.* An employee's accrued benefit under the plan is equal to the greater of—

(A) The employee's frozen accrued benefit; or

(B) The employee's accrued benefit determined under the current formula as applied to the employee's total years of service (before and after the fresh-start date) taken into account under the current formula.

(iii) *Formula with extended wear-away.* An employee's accrued benefit under the plan is equal to the greater of—

(A) The amount determined under paragraph (c)(4)(i) of this section; or

(B) The amount determined under paragraph (c)(4)(ii)(B) of this section.

(5) *Rules of application*—(i) *Consistency requirement.* This paragraph (c)(5) is not satisfied unless the fresh-start rules in this paragraph (c) (and paragraph (d) of this section, if applicable) are applied consistently to all employees in the

fresh-start group. Thus, for example, the same fresh-start date and fresh-start formula (within the meaning of paragraph (c)(4) of this section) must apply to all employees in the fresh-start group. Similarly, if a plan makes a fresh start for all employees with accrued benefits on the fresh-start date and, for a later plan year, is aggregated for purposes of section 401(a)(4) with another plan that did not make the same fresh start, the aggregated plan must make a new fresh start in order to use the fresh-start rules for that later plan year or any subsequent plan year.

(ii) *Definition of fresh-start group.* Generally, the fresh-start group with respect to a fresh start consists of all employees who have accrued benefits as of the fresh-start date and have at least one hour of service with the employer after that date. However, a fresh-start group with respect to a fresh start may consist exclusively of all employees who have accrued benefits as of the fresh-start date, have at least one hour of service with the employer after that date, and are—

(A) Section 401(a)(17) employees;

(B) Members of an acquired group of employees (provided the fresh-start date is the date determined under paragraph (c)(5)(iii)(B) of this section); or

(C) Employees with a frozen accrued benefit that is attributable to assets and liabilities transferred to the plan as of a fresh-start date in connection with the transfer (provided the fresh-start date is the date determined under paragraph (c)(5)(iii)(C) of this section) and for whom the current formula is different from the formula used to determine the frozen accrued benefit.

(iii) *Definition of fresh-start date.* Generally, the fresh-start date is the last day of a plan year. However, a plan may use a fresh-start date other than the last day of the plan year if—

(A) The plan satisfied the safe harbor rules of §1.401(a)(4)–3(b) for the period from the beginning of the plan year through the fresh-start date;

(B) The fresh-start group is an acquired group of employees, and the fresh-start date is the latest date of hire or transfer into an acquired trade or business selected by the employer for any employees to be included in the acquired group of employees; or

(C) The fresh-start group is the group of employees with a frozen accrued benefit that is attributable to assets and liabilities transferred to the plan and the fresh-start date is the date as of which the employees begin accruing benefits under the plan.

(6) *Examples.* The following examples illustrate the rules in this paragraph (c):

Example 1. (a) Employer X maintains a defined benefit plan with a calendar plan year. The plan formula provides an employee with a normal retirement benefit at age 65 of one percent of average annual compensation up to covered compensation multiplied by the employee's years of service for Employer X, plus 1.5 percent of average annual compensation in excess of covered compensation, multiplied by the employee's years of service for Employer X up to 40.

(b) For plan years beginning after 1994, Employer X amends the plan formula to provide a normal retirement benefit of 0.75 percent of average annual compensation up to covered compensation multiplied by the employee's total years of service for Employer X up to 35, plus 1.4 percent of average annual compensation in excess of covered compensation multiplied by the employee's years of service for Employer X up to 35. For plan years after 1994, each employee's accrued benefit is determined under the fresh-start formula in paragraph (c)(4)(iii) of this section (formula with extended wear-away), using December 31, 1994, as the fresh-start date.

(c) As of December 31, 1994, Employee M has 10 years of service for Employer X, has average annual compensation of $38,000, and has covered compensation of $30,000. Employee M's accrued benefit as of December 31, 1994, is therefore $4,200 ((1 percent×$30,000×10 years)+(1.5 percent×$8,000×10 years)). As of December 31, 1995, Employee M has 11 years of service for Employer X, has average annual compensation of $40,000 (determined by taking into account compensation before and after the fresh-start date), and has covered compensation of $32,000. Employee M's accrued benefit as of December 31, 1995, is $4,552, the greater of—

(1) $4,552, the sum of Employee M's accrued benefit frozen as of December 31, 1994, ($4,200) and the amended formula applied to Employee M's years of service after 1994 ((0.75 percent×$32,000×1 year)+(1.4 percent×$8,000×1 year), or $352); or

(2) $3,872, the amended formula applied to Employee M's total years of service ((0.75 percent×$32,000×11 years)+(1.4 percent×$8,000×11 years)).

Example 2. (a) Employer Y maintains a defined benefit plan, Plan A, that has a calendar plan year. For the 1995 plan year, Plan A satisfies the requirements for a safe harbor plan in § 1.401(a)(4)–3(b). Employer Y selects a date in 1995 for all the employees, freezes the employees' accrued benefits as of that date under the rules of paragraph (c)(3) of this section, and, in accordance with the rules of this paragraph (c), amends Plan A to determine benefits for all employees after that date using the formula with wear-away described in paragraph (c)(4)(ii) of this section. The new benefit formula would satisfy the requirements for a safe harbor plan in § 1.401(a)(4)–3(b) if all accrued benefits were determined under it.

(b) Because Plan A satisfied the requirements for a safe harbor plan for the period from the beginning of the plan year through the selected date, paragraph (c)(5)(iii)(A) of this section permits the selected date to be a fresh-start date, even if it is not the last day of the plan year. Thus, Plan A satisfies the requirements in this paragraph (c) for a fresh start as of the fresh-start date.

(c) Under § 1.401(a)(4)–3(b)(6)(vii), a plan does not fail to satisfy the requirements of § 1.401(a)(4)–3(b), merely because of benefits accrued under a different formula prior to a fresh-start date. Thus, Plan A still satisfies the safe harbor requirements of § 1.401(a)(4)–3(b) after the amendment to the benefit formula. Because Plan A satisfied the requirements for a safe harbor plan for the period from the beginning of the plan year, taking the amendment into account, Employer Y may select any date within the plan year (which may be the same date as the first fresh-start date) and apply the fresh-start rules in this paragraph (c) a second time as of that date.

(d) *Compensation adjustments to frozen accrued benefits*—(1) *Introduction.* In addition to the fresh-start rules in paragraph (c) of this section, this paragraph (d) sets forth requirements that must be satisfied in order for a plan to disregard increases in benefits accrued as of a fresh-start date that are attributable to increases in employees' compensation after the fresh-start date.

(2) *In general.* In the case of a defined benefit plan that is tested under the safe harbors in § 1.401(a)(4)–3(b) or § 1.401(a)(4)–8(c)(3), an employee's adjusted accrued benefit (determined under the rules in paragraph (d)(8) of this section) may be substituted for the employee's frozen accrued benefit in applying the formulas in paragraph (c)(4) of this section (or paragraph (f)(2) of this section, if applicable) if paragraphs (d)(3) through (d)(7) of this section are satisfied. Thus, for example, in determining whether such a plan satisfies § 1.401(a)(4)–3(b), any compensation adjustments to the employee's frozen accrued benefit described in paragraph (d)(8) of this section are disregarded. Similarly, in the case of a defined benefit plan tested under the general test in § 1.401(a)(4)–3(c), the compensation adjustments described in paragraph (d)(8) of this section may be disregarded under the rules of § 1.401(a)(4)–3(d)(3)(iii) if paragraphs (d)(3) through (d)(7) of this section are satisfied. Of course, any increases in accrued benefits exceeding these adjustments must be taken into account under the general test, and a plan providing such excess increases generally will fail to satisfy the safe harbor requirements of § 1.401(a)(4)–3(b). Where paragraphs (d)(3) through (d)(7) of this section are satisfied with respect to a plan as of the fresh-start date, but one or more of those paragraphs fail to be satisfied for a later plan year, further compensation adjustments described in paragraph (d)(8) of this section may not be disregarded in testing the plan under § 1.401(a)(4)–3.

(3) *Plan requirements*—(i) *Pre-fresh-start date.* As of the fresh-start date, the plan must have contained a benefit formula under which benefits of each employee in the fresh-start group that are accrued as of the fresh-start date and are attributable to service before the fresh-start date would be affected by the employee's compensation after the fresh-start date. A plan satisfies this requirement, for example, if it based benefits on an employee's highest average pay over a fixed period of years or on an employee's average pay over the employee's entire career with the employer. A plan does not satisfy this paragraph (d)(3)(i) if the Commissioner determines, based on all of the relevant facts and circumstances, that the plan provision described in the first sentence of this paragraph (d)(3) was added primarily in order to provide additional benefits to HCEs that are disregarded under the special testing rules described in this paragraph (d).

(ii) *Post-fresh-start date.* The plan by its terms must provide that the accrued benefits of each employee in the fresh-start group after the fresh-start date be at least equal to the employee's adjusted accrued benefit (i.e., the frozen accrued benefit as of the fresh-start date, adjusted as provided under paragraph (d)(7) of this section, plus the compensation adjustments described in paragraph (d)(8) of this section).

(4) *Meaningful coverage as of fresh-start date.* The plan must have provided meaningful coverage as of the fresh-start date. A plan provided meaningful coverage as of the fresh-start date if the group of employees with accrued benefits under the plan as of the fresh-start date satisfied the minimum coverage requirements of section 410(b) as in effect on that date (determined without regard to section 410(b)(6)(C)). In order to satisfy the requirement in the preceding sentence, an employer may amend the plan to grant past service credit under the formula in effect as of the fresh-start date to NHCEs, if the amount of past service granted them is reasonably comparable, on average, to the amount of past service HCEs have under the plan. Any benefit increase that results from the grant of past service credit to a NHCE under this paragraph (d)(4) is included in the employee's frozen accrued benefit.

(5) *Meaningful ongoing coverage*—(i) *General rule.* The fresh-start group must have satisfied the minimum coverage requirements of section 410(b) for all plan years from the first plan year beginning after the fresh-start date through the current plan year. Thus, if a fresh-start group fails to satisfy the minimum coverage requirements of section 410(b) for any plan year, this paragraph (d)(5) is not satisfied for that plan year or any subsequent plan year; however, such a failure is not taken into account in determining whether this paragraph (d)(5) is satisfied for any previous plan year.

(ii) *Alternative rules.* Notwithstanding paragraph (d)(5)(i) of this section, a fresh-start group is deemed to satisfy this paragraph (d)(5) for all plan years following the fresh-start date if any one of the following requirements is satisfied:

(A) *Section 410(b) coverage for first five years.* The fresh-start group must have satisfied the minimum coverage requirements of section 410(b) for the first five plan years beginning after the fresh-start date.

(B) *Ratio percentage coverage as of fresh-start date.* The fresh-start group must have satisfied the ratio percentage test of §1.410(b)–2(b)(2) as of the fresh-start date.

(C) *Fresh start for acquired group of employees.* The fresh-start group must consist of an acquired group of employees that satisfied the minimum coverage requirements of section 410(b) (determined without regard to section 410(b)(6)(C)) as of the fresh-start date.

(D) *Fresh start before applicable effective date.* The fresh-start date with respect to the fresh-start group must have been on or before the effective date applicable to the plan under paragraph (a) or (b) of this section.

(6) *Meaningful current benefit accruals.* The benefit formula and accrual method under the plan that applies to the fresh-start group in the aggregate must provide benefit accruals in the current plan year (other than increases in benefits accrued as of the fresh-start date) at a rate that is meaningful in comparison to the rate at which benefits accrued for the fresh-start group in plan years beginning before the fresh-start date. Whether this requirement is satisfied with respect to a fresh-start group that does not include all employees in the plan with an hour of service after the fresh-start date may be determined taking into account the rate at which benefits are provided to other employees in the plan.

(7) *Minimum benefit adjustment*—(i) *In general.* In the case of a section 401(l) plan or a plan that imputes disparity under §1.401(a)(4)–7, the plan must make the minimum benefit adjustment described in paragraph (d)(7)(ii) or (iii) of this section.

(ii) *Excess or offset plans.* In the case of a plan that is a defined benefit excess plan as of the fresh-start date, each employee's frozen accrued benefit is adjusted so that the base benefit percentage is not less than 50 percent of the excess benefit percentage. In the case of a plan that is a PIA offset plan (as defined in paragraph (2)(iii) of the definition of QSUPP in §1.401(a)(4)–12) as of the fresh-start date, each employee's offset as applied to determine the frozen accrued benefit is adjusted so that it does not exceed 50 percent of the benefit determined without applying the offset.

(iii) *Other plans.* In the case of a plan that is not described in paragraph (d)(7)(ii) of this section, each employee's frozen accrued benefit is adjusted in a manner that is economically equivalent to the adjustment required under that paragraph, taking into account the plan's benefit formula, accrual rate, and relevant employee factors, such as period of service.

(8) *Adjusted accrued benefit*—(i) *General rule.* The term adjusted accrued benefit means an employee's frozen accrued benefit that is adjusted as provided in paragraph (d)(7) of this section and then multiplied by a fraction (not less than one), the numerator of which is the employee's compensation for the current plan year and the denominator of which is the employee's compensation as of the fresh-start date determined under the same definition. For purposes of this adjustment, the compensation definition must be either the same compensation definition and formula used to determine the frozen accrued benefit or average annual compensation (determined without regard to § 1.401(a)(4)–3(e)(2)(ii)(A) (use of plan year compensation)).

(ii) *Alternative formula for pre-effective-date fresh starts.* In the case of a fresh-start date before the effective date that applies to the plan under paragraph (a) or (b) of this section, the adjusted accrued benefit may be determined by multiplying the frozen accrued benefit by a fraction (not less than one) determined under this paragraph (d)(8)(ii). The numerator of the fraction is the employee's average annual compensation for the current plan year. The denominator of the fraction is the employee's reconstructed average annual compensation as of the fresh-start date. An employee's reconstructed average annual compensation is determined by—

(A) Selecting a single plan year beginning after the fresh-start date but beginning not later than the last day of the first plan year to which these regulations apply under paragraph (a) or (b) of this section;

(B) Determining the employee's average annual compensation for the selected plan year under the same method used to determine the employee's average annual compensation for the current plan year under this paragraph (d)(8)(ii); and

(C) Multiplying the employee's average annual compensation for the selected plan year by a fraction, the numerator of which is the employee's compensation as of the fresh-start date determined under the same compensation definition and formula used to determine the employee's frozen accrued benefit and the denominator of which is the employee's compensation for the selected plan year determined under the compensation definition and formula used to determine the employee's frozen accrued benefit.

(iii) *Effect of section 401(a)(17).* In determining the numerators and the denominators of the fractions described in this paragraph (d)(8), the annual compensation limit under section 401(a)(17) generally applies. See, however, § 1.401(a)(17)–1(e)(4) for special rules applicable to section 401(a)(17) employees.

(iv) *Option to make less than the full permitted adjustment.* A plan may limit the increase in an employee's frozen accrued benefit for the current and all future years to a percentage (not more than 100 percent) of the increase otherwise provided under this paragraph (d)(8). Furthermore, the plan may, at any time, terminate all future adjustments permitted under this paragraph (d).

(v) *Alternative determination of adjusted accrued benefit.* In lieu of applying the fractions in paragraph (d)(8)(i) or (ii) of this section, a plan may determine an employee's adjusted accrued benefit by substituting the employee's compensation for the current plan year (determined under the same compensation formula and underlying definition of compensation used to determine the employee's frozen accrued benefit) in the benefit formula used to determine the frozen accrued benefit. For this purpose, insignificant changes in the underlying definition of compensation to reflect current compensation practices will not be treated as a change in the definition of compensation. A plan may apply the alternative in this paragraph (d)(8)(v), only if it is reasonable to expect as of the fresh-start date that, over time, the use of this method instead of the general rule of paragraph (d)(8)(i) will not discriminate significantly in favor of HCEs.

(9) *Examples.* The following examples illustrate the rules of this paragraph (d).

Example 1. (a) Employer X maintains a defined benefit plan that is an excess plan with a calendar plan year. For plan years before 1989, the plan is integrated with benefits provided under the Social Security Act, providing each employee with a normal retirement benefit equal to one percent of the employee's average annual compensation in excess of the employee's covered compensation, multiplied by the employee's years of service for Employer X. The benefit formula thus provides no benefit with respect to average annual compensation up to covered compensation.

(b) As of December 31, 1988, Employee M has 10 years of service for Employer X and has covered compensation of $25,000 and average annual compensation of $20,000. Employee M's average annual compensation has never exceeded $20,000. Therefore, as of December 31, 1988, Employee M's accrued benefit under the plan is zero.

(c) Effective with the 1989 plan year, the plan is amended to provide each employee with a normal retirement benefit of 0.6 percent of average annual compensation up to covered compensation plus 1.2 percent of average annual compensation in excess of covered compensation, multiplied by the employee's years of service up to 35. The plan also provides that, for plan years after 1988, each employee's accrued benefit is determined under the formula in paragraph (c)(4)(i) of this section (formula without wear-away) and, in applying the fresh-start formula, each employee's frozen accrued benefit under paragraph (c)(4)(i) of this section will be adjusted under this paragraph (d), using the same compensation definition and formula used to determine the frozen accrued benefit under paragraph (d)(8)(i) of this section.

(d) The plan uses the permitted disparity of section 401(l) and thus must also make the minimum benefit adjustment under paragraph (d)(7) of this section. Because the excess benefit percentage under the plan for years before 1989 was one percent, the plan must provide a base benefit percentage for those years of at least 0.5 percent. After the minimum benefit adjustment, Employee M's accrued benefit as of December 31, 1988, is $1,000 (0.5 percent×$20,000×10 years).

(e) As of December 31, 1992, Employee M has 14 years of service and has covered compensation of $30,000 and average annual compensation of $35,000. Employee M's adjusted accrued benefit as of December 31, 1992, is $1,750 ($1,000×$35,000/$20,000), and Employee M's accrued benefit as of December 31, 1992, is $2,710 (the sum of $1,750 plus $960 ((0.6 percent×$30,000×4 years) plus (1.2 percent×$5,000×4 years))).

Example 2. (a) The facts are the same as in *Example 1,* except that in determining adjusted accrued benefits, the plan specifies the alternative method of paragraph (d)(8)(v) of this section. This method may be used because it is reasonable to expect as of the fresh-start date that, over time, the use of this method instead of the general rule of paragraph (d)(8)(i) will not discriminate significantly in favor of HCEs.

(b) As of December 31, 1992, Employee M's adjusted accrued benefit is $2,000 (10 years of service prior to the fresh-start date×(0.5 percent of $30,000+1.0 percent of the excess of $35,000 over $30,000)).

(c) Alternatively, Employer X may choose to use the method of paragraph (d)(8)(v) of this section but freezes the covered compensation level at the dollar level in place as of the fresh-start date. In such case, Employee M's adjusted accrued benefit as of December 31, 1992, would have been $2,250 (10 years of service prior to the fresh-start date×(0.5 percent of $25,000+1.0 percent of the excess of $35,000 over $25,000)). This method may be used because it is reasonable to expect as of the fresh-start date that, over time, the use of this method instead of the general rule of paragraph (d)(8)(i) will not discriminate significantly in favor of HCEs.

Example 3. (a) The facts are the same as in *Example 1,* except that for plan years before 1989, the plan provided a minimum benefit to certain employees equal to $120 per year of service. Employee M is entitled to the minimum benefit, and thus, Employee M's frozen accrued benefit as of December 31, 1988 was $1,200 (the greater of 10 years of service×$120 and $1,000, Employee M's benefit under the underlying formula, after the minimum benefit adjustment of paragraph (d)(7) of this section).

(b) Employer X's plan specifies instead the alternative method of adjusting accrued benefits described in paragraph (d)(8)(v) of this section. (The fact that a minimum benefit applying to certain employees is not adjusted under the alternative method of paragraph (d)(8)(v) of this section, but would be adjusted under the general rule of paragraph (d)(8)(i) of this section does not change the conclusion in *Example 2,* that the plan may apply the alternative method).

(e) *Determination of initial theoretical reserve for target benefit plans*—(1) *General rule.* In the case of a target benefit plan the stated benefit formula under which takes into account service for years in which the plan did not satisfy

§ 1.401(a)(4)–8(b)(3), as permitted under § 1.401(a)(4)–8(b)(3)(vii), the theoretical reserve as of the determination date for the last plan year beginning before the first day of the first plan year in which the plan satisfies § 1.401(a)(4)–8(b)(3) of an employee who was a participant in the plan on that determination date, is determined as follows:

(i) Determine the actuarial present value, as of that determination date, of the stated benefit that the employee is projected to have at the employee's normal retirement age, using the actuarial assumptions, the provisions of the plan, and the employee's compensation as of that determination date. For an employee whose attained age equals or exceeds the employee's normal retirement age, determine the actuarial present value of the employee's stated benefit at the employee's current age, but using an immediate straight life annuity factor for an employee whose attained age equals the employee's normal retirement age.

(ii) Calculate the actuarial present value of future required employer contributions (without regard to limitations under section 415 or additional contributions described in § 1.401(a)(4)–8(b)(3)(v)) as of that determination date (i.e., the actuarial present value of the level contributions due for each plan year through the end of the plan year in which the employee attains normal retirement age). This calculation is made assuming that the required contribution in each future year will be equal to the required contribution for the plan year that includes that determination date, and applying the interest rate that was used in determining that required contribution.

(iii) Determine the excess, if any, of the amount determined in paragraph (e)(1)(i) of this section over the amount determined in paragraph (e)(1)(ii) of this section. This excess is the employee's theoretical reserve on that determination date.

(2) *Example.* The following example illustrates the determination of an employee's theoretical reserve.

Example. (a) A target benefit plan was adopted and in effect before September 19, 1991, and satisfied the requirements of Rev. Rul. 76–464, 1976–2 C.B. 115, with respect to all years credited under the stated benefit formula through 1993. The plan provides a stated benefit equal to 40 percent of compensation, payable annually as a straight life annuity beginning at normal retirement age. Normal retirement age under the plan is 65. The stated interest rate under the plan is six percent. The determination date for required contributions under the plan is the last day of the plan year. Employee M is 38 years old on the determination date for the 1993 plan year, has participated in the plan for five years, and has compensation equal to $60,000 in 1993. The amount of employer contribution to Employee M's account for 1993 was $2,468.

(b) Under these facts, Employee M's theoretical reserve is equal to $13,909, calculated as follows:

(1) The actuarial present value of Employee M's stated benefit is calculated using the actuarial assumptions, provisions of the plan and Employee M's compensation as of the determination date for the 1993 plan year. This amount is equal to $46,512, Employee M's stated benefit of $24,000 ($60,000 multiplied by 40 percent), multiplied by 1.938, the actuarial present value factor applicable to a participant who is 38 years old using a stated interest rate of six percent.

(2) The actuarial present value of future employer contributions is calculated assuming that the required contribution in each future year will be equal to the required contribution for the 1993 plan year and assuming the same interest rate as was used in determining that contribution. This amount is equal to $32,603, which is equal to the amount of the level annual employer contribution ($2,468) multiplied by a factor of 13.2105 (the temporary annuity factor for a period of 27 years, assuming the six percent interest rate that was used to determine the required employer contribution).

(3) Employee M's theoretical reserve is $13,909, the excess of the amount determined in paragraph (b)(1) of this *Example* over the amount determined in paragraph (b)(2) of this *Example.*

(f) *Special fresh-start rules for cash balance plans*—(1) *In general.* In order to satisfy the optional testing method of § 1.401(a)(4)–8(c)(3) after a fresh-start date, a cash balance plan must apply the rules of paragraph (c) of this section as modified under this paragraph (f). Paragraph (f)(2) of this section provides an alternative formula that may be used in addition to the formulas in paragraphs (c)(2) through (c)(4) of this section. Paragraph (f)(3) of this section sets forth certain limitations on use of the formulas in paragraph (c) or (f)(2) of this section.

(2) *Alternative formula*—(i) *In general.* An employee's accrued benefit under the plan is equal to the greater of—

(A) The employee's frozen accrued benefit, or

(B) The employee's accrued benefit determined under the plan's benefit formula applicable to benefit accruals in the current plan year as applied to years of service after the fresh-start date, modified in accordance with paragraph (f)(2)(ii) of this section.

(ii) *Addition of opening hypothetical account.* As of the first day after the fresh-start date, the plan must credit each employee's hypothetical account with an amount equal to the employee's opening hypothetical account (determined under paragraph (f)(2)(iii) of this section), adjusted for interest for the period that begins on the first day after the fresh-start date and that ends at normal retirement age. The interest adjustment in the preceding sentence must be made using the same interest rate applied to the hypothetical allocation for the first plan year beginning after the fresh-start date.

(iii) *Determination of opening hypothetical account*—(A) *General rule.* An employee's opening hypothetical account equals the actuarial present value of the employee's frozen accrued benefit as of the fresh-start date. For this purpose, if the plan provides for a single sum distribution as of the fresh-start date, the actuarial present value of the employee's frozen accrued benefit as of the fresh-start date equals the amount of a single sum distribution payable under the plan on that date, assuming that the employee terminated employment on the fresh-start date, the employee's accrued benefit was 100-percent vested, and the employee satisfied all eligibility requirements under the plan for the single sum distribution. If the plan does not offer a single sum distribution as of the fresh-start date, the actuarial present value of the employee's frozen accrued benefit as of the fresh-start date must be determined using a standard mortality table and the applicable section 417(e) rates, as defined in §1.417(e)–1(d).

(B) *Alternative opening hypothetical account.* Alternatively, the employee's opening hypothetical account is the greater of the opening hypothetical account determined under paragraph (f)(2)(ii)(A) of this section and the employee's hypothetical account as of the fresh-start date determined in accordance with §1.401(a)(4)–8(c)(3)(v)(A) calculated under the plan's benefit formula applicable to benefit accruals in the current plan year as applied to the employee's total years of service through the fresh-start date in a manner that satisfies the past service credit rules of §1.401(a)(4)–8(c)(3)(viii).

(3) *Limitations on formulas*—(i) *Past service restriction.* If the plan does not satisfy the uniform hypothetical allocation formula requirement of §1.401(a)(4)–8(c)(3)(iii)(B) as of the fresh-start date, under §1.401(a)(4)–8(c)(3)(viii) the plan may not provide for past service credits, and thus may not use the formula in paragraph (c)(3) of this section (formula with wear-away), the formula in paragraph (c)(4) of this section (formula with extended wear-away), or the alternative determination of the opening hypothetical account in paragraph (f)(2)(iii)(B) of this section.

(ii) *Change in interest rate.* If the interest rate used to adjust employees' hypothetical allocations under §1.401(a)(4)–8(c)(3)(iv) for the plan year is different from the interest rate used for this purpose in the immediately preceding plan year, the plan must use the formula in paragraph (c)(2) of this section (formula without wear-away).

(iii) *Meaningful benefit requirement.* A plan is permitted to use the formula provided in paragraph (f)(2) of this section only if the plan satisfies paragraphs (d)(3) through (d)(5) of this section (regarding coverage as of fresh-start date, current benefit accruals, and minimum benefit adjustment, respectively).

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§1.401(a)(5)–1 Special rules relating to nondiscrimination requirements.

(a) *In general.* Section 401(a)(5) sets out certain provisions that will not of themselves be discriminatory within the meaning of section 410(b)(2)(A)(i) or section 401(a)(4). The exceptions specified in section 401(a)(5) are not an exclusive enumeration, but are merely a recital of provisions frequently encountered that will not of themselves constitute prohibited discrimination in contributions or benefits. See section 401(a)(4) and the regulations thereunder for the basic nondiscrimination rules. See § 1.410(b)–4 for the rule of section 410(b)(2)(A)(i) (relating to the nondiscriminatory classification test that is part of the minimum coverage requirements) referred to in section 401(a)(5)(A). See paragraphs (b) through (f) of this section for special rules used in applying the section 401(a)(4) nondiscrimination requirements under the remaining provisions of section 401(a)(5).

(b) *Salaried or clerical employees.* A plan does not fail to satisfy the nondiscrimination requirements of section 401(a)(4) merely because contributions or benefits provided under the plan are limited to salaried or clerical employees.

(c) *Uniform relationship to compensation.* A plan does not fail to satisfy the nondiscrimination requirements of section 401(a)(4) merely because the contributions or benefits of, or on behalf of, the employees under the plan bear a uniform relationship to the compensation (within the meaning of section 414(s)) of those employees.

(d) *Certain disparity permitted.* Under section 401(a)(5)(C), a plan does not discriminate in favor of highly compensated employees (as defined in section 414(q)), within the meaning of section 401(a)(4), in the amount of employer-provided contributions or benefits solely because—

(1) In the case of a defined contribution plan, employer contributions allocated to the accounts of employees favor highly compensated employees in a manner permitted by section 401(l) (relating to permitted disparity in plan contributions and benefits), and

(2) In the case of a defined benefit plan, employer-provided benefits favor highly compensated employees in a manner permitted by section 401(l) (relating to permitted disparity in plan contributions and benefits).

See §§ 1.401(l)–1 through 1.401(l)–6 for rules under which a plan may satisfy section 401(l) for purposes of the safe harbors of §§ 1.401(a)(4)–2(b)(3) and 1.401(a)(4)–3(b).

(e) *Defined benefit plans integrated with social security*—(1) *In general.* Under section 401(a)(5)(D), a defined benefit plan does not discriminate in favor of highly compensated employees (as defined in section 414(q)) with respect to the amount of employer-provided contributions or benefits solely because the plan provides that, with respect to each employee, the employer-provided accrued retirement benefit under the plan is limited to the excess (if any) of—

(i) The employee's final pay from the employer, over

(ii) The employer-provided retirement benefit created under the Social Security Act and attributable to service by the employee for the employer.

(2) *Final pay.* For purposes of paragraph (e)(1)(i) of this section, an employee's final pay from the employer as of a plan year is the employee's compensation (as defined in section 414(q)(7)) for the year (ending with or within the 5-plan-year period ending with the plan year in which the employee terminates from employment with the employer) in which the employee receives the highest compensation from the employer. Notwithstanding the preceding sentence, final pay for each employee under the plan may be determined with reference to the 5-plan-year period ending with the plan year before the plan year in which the employee terminates from employment with the employer. In determining an employee's final pay, the plan may specify any 12-month period (ending with or within the applicable 5-plan-year period) as a year provided the specified 12-month period is uniformly and consistently applied with respect to all employees. In determining an employee's final pay, compensation for any year in excess of the applicable limit under section 401(a)(17) for the year may not be taken into account.

(3) *Rules for determining amount of employer-provided social security retirement benefit.* For purposes of paragraph (e)(1)(ii) of this section, the following rules apply.

(i) The employer-provided retirement benefit on which any reduction or offset in the employee's accrued retirement benefit is based is limited solely to the employer-provided primary insurance amount payable under section 215 of the Social Security Act attributable to service by the employee for the employer.

(ii) The employer-provided primary insurance amount attributable to service by the employee for the employer is determined by multiplying the employer-provided portion of the employee's projected primary insurance amount by a fraction (not exceeding 1), the numerator of which is the employee's number of complete years of covered service for the employer under the Social Security Act, and the denominator of which is 35.

(4) *Projected primary insurance amount.* (i) As of a plan year, an employee's projected primary insurance amount is the primary insurance amount, determined as of the close of the plan year (the ''determination date''), payable to the employee upon attainment of the employee's social security retirement age (as determined under section 415(b)(8)), assuming the employee's annual compensation from the employer that is treated as wages for purposes of the Social Security Act remains the same from the plan year until the employee's attainment of social security retirement age. With respect to service by the employee for the employer before the determination date, the actual compensation paid to the employee by the employer during all periods of service of the employee for the employer covered by the Social Security Act must be used in determining an employee's projected primary insurance amount. With respect to years before the employee's commencement of service for the employer, in determining the employee's projected primary insurance amount, it may be assumed that the employee received compensation in an amount computed by using a six-percent salary scale projected backwards from the determination date to the employee's 21st birthday. However, if the employee provides the employer with satisfactory evidence of the employee's actual past compensation for the prior years treated as wages under the Social Security Act at the time the compensation was earned and the actual past compensation results in a smaller projected primary insurance amount, the plan must use the actual past compensation. The plan administrator must give clear written notice to each employee of the employee's right to supply actual compensation history and of the financial consequences of failing to supply the history. The notice must be given each time the summary plan description is provided to the employee and must also be given upon the employee's separation from service. The notice must also state that the employee can obtain the actual compensation history from the Social Security Administration. In determining the employee's projected primary insurance amount, the employer may not take into account any compensation from any other employer while the employee is employed by the employer.

(ii) As of a plan year, the employer-provided portion of the employee's projected primary insurance amount under the Social Security Act is 50 percent of the employee's projected primary insurance amount (as determined under paragraph (e)(4)(i) of this section).

(5) *Employer-provided accrued retirement benefit.* For purposes of this section, the employee's employer-provided accrued retirement benefit as of a plan year is the employee's accrued retirement benefit under the plan (determined on an actual basis and not on a projected basis) attributable to employer contributions under the plan. With respect to plans that provide for employee contributions, see section 411(c) for rules relating to the allocation of accrued benefits between employer contributions and employee contributions.

(6) *Additional rules.* (i) As of a plan year, paragraph (e)(1) of this section does not apply to the extent that its application would result in a decrease in an employee's accrued benefit. See sections 411(b)(1)(G) and 411(d)(6).

(ii) Section 401(a)(5)(D) and this paragraph (e) do not apply to a plan maintained by an employer, determined for purposes of the Federal Insurance Contributions Act or the Railroad Retirement Tax Act, as applicable, that does not pay any wages within the meaning of section 3121(a) or compensation within the meaning of section 3231(e). For this purpose, a plan maintained for a self-employed individual within the meaning of section 401(c)(1), who is also subject to the tax under section 1401, is deemed to be a plan maintained by an employer that pays wages within the meaning of section 3121(a).

(iii) If a plan provides for the payment of an employee's accrued retirement benefit (whether or not subsidized) commencing before an employee's social security retirement age, the projected employer-provided primary insurance amount attributable to service by the employee for the employer (as determined under paragraphs (e)(3) and (e)(4) of this section) that may be applied as an offset to limit the employee's accrued retirement benefit must be reduced in accordance with § 1.401(l)–3(e)(1). The reduction is made by multiplying the employee's projected employer-provided primary insurance amount by a fraction, the numerator of which is the appropriate factor under § 1.401(l)–3(e)(1), and the denominator of which is 0.75 percent.

(iv) The Commissioner may, in revenue rulings, notices or other documents of general applicability, prescribe additional rules that may be necessary or appropriate to carry out the purposes of this section, including rules relating to the determination of an employee's projected primary insurance amount attributable to the employee's service for former employers and rules applying section 401(a)(5)(D) with respect to an employer that pays wages within the meaning of section 3121(a) or compensation within the meaning of section 3231(e) for some years and not for other years.

(7) *Examples.* The following examples illustrate this paragraph (e).

Example 1. Employer Z maintains a noncontributory defined benefit plan that uses the calendar year as its plan year. The plan provides a normal retirement benefit, commencing at age 65, equal to $500 a year, multiplied by the employee's years of service for Z, limited to the excess of the amount of the employee's final pay from Z (as determined in accordance with paragraph (e)(2) of this section) over the employee's employer-provided primary insurance amount attributable to the employee's service for Z. If an employee's social security retirement age is greater than 65, the plan provides for reduction of the employee's employer-provided primary insurance amount in accordance with paragraph (e)(6)(iii) of this section. The plan provides no limitation on the number of years of service taken into account in determining benefits under the plan. Employee A retires on July 6, 1995, at A's social security retirement age of 65 with 35 years of service for Z. The plan uses the plan year as the 12–month period for determining an employee's year of final highest pay from the employer. A's compensation for A's final 5 plan years is as follows:

1995 plan year	$10,500
1994 plan year	$20,000
1993 plan year	$18,000
1992 plan year	$17,000
1991 plan year	$16,500

A's annual primary insurance amount under social security, determined as of A's social security retirement age, is $9,000, of which $4,500 is the employer-provided portion attributable to A's service for Z ($9,000 × 50 percent × 35/35). Under the plan's benefit formula (disregarding the final pay limitation), A would be entitled to receive a normal retirement benefit of $17,500 ($500 × 35 years). However, under the plan, A's otherwise determined normal retirement benefit of $17,500 is limited to the excess of the amount of A's final pay from Z over A's employer-provided primary insurance amount under social security attributable to A's service for Z. Accordingly, A's normal retirement benefit is determined to be $15,500 ($20,000 (A's final pay from Z) less $4,500 (A's employer-provided primary insurance amount attributable to A's service for Z)) rather than $17,500. The final pay limitation in Z's plan satisfies section 401(a)(5)(D) and this paragraph (e). Accordingly, the plan maintained by Z does not discriminate in favor of highly compensated employees within the meaning of section 401(a)(4) merely because of the final pay limitation contained in the plan.

Example 2. Assume the same facts as in *Example 1,* except that A has 32 years of service for Z when A retires at A's social security retirement age. Under the plan's benefit formula (disregarding the final pay limitation), A would be entitled to receive an annual normal retirement benefit of $16,000 ($500 × 32 years). However, the plan provides that A's normal retirement benefit of $16,000 will be limited to $15,500 ($20,000 (the amount of A's final pay from Z) less $4,500 (½ of A's primary insurance amount under the Social Security Act)). The final pay limitation does not satisfy this paragraph (e). The portion of A's employer-provided primary insurance amount under the Social Security Act attributable to A's service for Z is 32/35 × $4,500, or $4,114. Therefore, to satisfy this paragraph (e), the final pay provision in Z's plan may not limit A's otherwise determined normal retirement benefit of $16,000 to less than $15,886 ($20,000 (the amount of X's final pay) minus $4,114 (the portion of A's employer-provided primary insurance amount attributable to A's service for Z)).

Example 3. (a) Employer X maintains a noncontributory defined benefit plan that uses the calendar year as its plan year. The formula for determining benefits under the plan provides a normal retirement benefit at age 65 equal to 90 percent of an employee's final average compensation, with the benefit reduced by 1⁄30th for each year of the employee's service less than 30 and limited to the employee's final pay (as determined in accordance with paragraph (e)(2) of this section) less the employee's employer-provided primary insurance amount under social security attributable to the employee's service for X. The plan determines an employee's employer-provided projected primary insurance amount under social security attributable to the employee's service for X in accordance with paragraph (e)(3) of this section and applies the reductions applicable under paragraph (e)(6)(iii) of this section if benefits commence before social security retirement age. The plan determines an employee's accrued benefit under the fractional accrual method of section 411(b)(1)(C).

(b) Employee A commences participation in the plan on January 1, 1990, when A is 35 years of age. A's social security retirement age is 67. As of the close of the 2014 plan year, A's final average compensation from X is $15,000; A's final pay from X is $15,400, and A's projected employer-provided annual primary insurance amount under social security attributable to A's service for X is $4,000 (after the reduction applicable under paragraph (e)(6)(iii) of this section). Under the plan formula, A's accrued benefit as of the close of the 2014 plan year is $11,250 (90 percent × $15,000 × 25/30). As of the close of the 2014 plan year, the plan's final pay limitation does not affect A's benefit because A's benefit under the plan as of the close of the plan year and before application of the final pay limitation ($11,250) does not exceed A's final pay of $15,400 from X, determined as of the close of the plan year, less A's employer-provided projected primary insurance amount under social security attributable to A's service for X ($4,000).

(c) Assume that, as of the close of the 2015 plan year, A's final average compensation from X is $14,500 and A's final pay from X is $15,400. Assume also that as of the close of the 2015 plan year, A's employer-provided primary insurance amount attributable to A's service for X is $4,200 (after the reduction applicable under paragraph (e)(6)(iii) of this section). Accordingly, A's benefit as of the close of the 2015 plan year and before application of the final pay limitation is $11,310 (90 percent × $14,500 × 26/30). Under the plan's final pay limitation, A's benefit of $11,310 would be limited to $11,200, the amount of A's final pay from X ($15,400), less A's employer-provided projected primary insurance amount under social security attributable to A's service for X ($4,200). However, the plan's final pay limitation may not be applied to limit A's accrued benefit for the 2015 plan year to an amount below $11,250, which was A's accrued benefit under the plan at the close of the prior plan year. The foregoing is further illustrated in the following table for the plan years presented above and for additional years of service performed by A for X.

TABLE

[In dollar amounts]

1	2	3	4	5	6	7
Years of service	Final average compensation	Benefit under plan formula (Column 2 × 0.9 × years of service/30)	Final pay	Employer-provided projected primary insurance amount under social security attributable to service for employer	Benefit if final pay reduction is applied in full (Column 4 − Column 5)	Benefit to which A is entitled (smaller of Column 6 or Column 3, but not less than Column 7 for prior year)
25	$15,000	$11,250	$15,400	$4,000	$11,400	$11,250
26	14,500	11,310	15,400	4,200	11,200	11,250
27	15,500	12,555	15,800	4,400	11,400	11,400
28	15,500	13,020	16,000	4,500	11,500	11,500
29	15,000	13,050	16,000	4,800	11,200	11,500
30	14,500	13,050	16,000	5,000	11,000	11,500

(f) *Certain benefits not taken into account.* In determining whether a plan satisfies section 401(a)(4) and this section, other benefits created under state or federal law (e.g., worker's compensation benefits or black lung benefits) may not be taken into account.

(g) *More than one plan treated as single plan.* [Reserved]

(h) *Effective date*—(1) *In general.* Except as provided in paragraph (h)(2) of this section, this section is effective for plan years beginning on or after January 1, 1994.

(2) *Plans of tax-exempt organizations.* In the case of plans maintained by organizations exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), this section is effective for plan years beginning on or after January 1, 1996.

(3) *Compliance during transition period.* For plan years beginning before the effective date of these regulations, as set forth in paragraphs (h)(1) and (h)(2) of this section, and on or after the first day of the first plan year to which the amendments made to section 401(a)(5) by section 1111(b) of the Tax Reform Act of 1986 (TRA '86) apply, a plan must be operated in accordance with a reasonable, good faith interpretation of section 401(a)(5), taking into account pre-existing guidance and the amendments made by TRA '86 to related provisions of the Code. Whether a plan is operated in accordance with a reasonable, good faith interpretation of section 401(a)(5) will generally be determined based on all of the relevant facts and circumstances, including the extent to which an employer has resolved unclear issues in its favor. A plan will be deemed to be operated in accordance with a reasonable, good faith interpretation of section 401(a)(5) if it is operated in accordance with the terms of this section.

[T.D. 8359, 56 FR 47614, Sept. 19, 1991; 57 FR 10817, 10818, 10951, Mar. 31, 1992, as amended by T.D. 8486, 58 FR 46830, Sept. 3, 1993]

§ 1.401(a)(17)–1 Limitation on annual compensation.

(a) *Compensation limit requirement*—(1) *In general.* In order to be a qualified plan, a plan must satisfy section 401(a)(17). Section 401(a)(17) provides an annual compensation limit for each employee under a qualified plan. This limit applies to a qualified plan in two ways. First, a plan may not base allocations, in the case of a defined contribution plan, or benefit accruals, in the case of a defined benefit plan, on compensation in excess of the annual compensation limit. Second, the amount of an employee's annual compensation that may be taken into account in applying certain specified nondiscrimination rules under the Internal Revenue Code is subject to the annual compensation limit. These two limitations are set forth in paragraphs (b) and (c) of this section, respectively. Paragraph (d) of this section provides the effective dates of section 401(a)(17), the amendments made by section 13212 of the Omnibus Budget Reconciliation Act of 1993 (OBRA '93), and this section. Paragraph (e) of this section provides rules for determining post-effective-date accrued benefits under the fresh-start rules.

(2) *Annual compensation limit for plan years beginning before January 1, 1994.* For purposes of this section, for plan years beginning prior to the OBRA '93 effective date, annual compensation limit means $200,000, adjusted as provided by the Commissioner. The amount of the annual compensation limit is adjusted at the same time and in the same manner as under section 415(d). The base period for the annual adjustment is the calendar quarter ending December 31, 1988, and the first adjustment is effective on January 1, 1990. Any increase in the annual compensation limit is effective as of January 1 of a calendar year and applies to any plan year beginning in that calendar year. In any plan year beginning prior to the OBRA '93 effective date, if compensation for any plan year beginning prior to the statutory effective date is used for determining allocations or benefit accruals, or when applying any nondiscrimination rule, then the annual compensation limit for the first plan year beginning on or after the statutory effective date (generally $200,000) must be applied to compensation for that prior plan year.

(3) *Annual compensation limit for plan years beginning on or after January 1, 1994*—(i) *In general.* For purposes of this

section, for plan years beginning on or after the OBRA '93 effective date, annual compensation limit means $150,000, adjusted as provided by the Commissioner. The adjusted dollar amount of the annual compensation limit is determined by adjusting the $150,000 amount for changes in the cost of living as provided in paragraph (a)(3)(ii) of this section and rounding this adjusted dollar amount as provided in paragraph (a)(3)(iii) of this section. Any increase in the annual compensation limit is effective as of January 1 of a calendar year and applies to any plan year beginning in that calendar year. For example, if a plan has a plan year beginning July 1, 1994, and ending June 30, 1995, the annual compensation limit in effect on January 1, 1994 ($150,000), applies to the plan for the entire plan year.

(ii) *Cost of living adjustment.* The $150,000 amount is adjusted for changes in the cost of living by the Commissioner at the same time and in the same manner as under section 415(d). The base period for the annual adjustment is the calendar quarter ending December 31, 1993.

(iii) *Rounding of adjusted compensation limit.* After the $150,000, adjusted in accordance with paragraph (a)(3)(ii) of this section, exceeds the annual compensation limit for the prior calendar year by $10,000 or more, the annual compensation limit will be increased by the amount of such excess, rounded down to the next lowest multiple of $10,000.

(4) *Additional guidance.* The Commissioner may, in revenue rulings and procedures, notices, and other guidance, published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter), provide any additional guidance that may be necessary or appropriate concerning the annual limits on compensation under section 401(a)(17).

(b) *Plan limit on compensation*—(1) *General rule.* A plan does not satisfy section 401(a)(17) unless it provides that the compensation taken into account for any employee in determining plan allocations or benefit accruals for any plan year is limited to the annual compensation limit. For purposes of this rule, allocations and benefit accruals under a plan include all benefits provided under the plan, including ancillary benefits.

(2) *Plan-year-by-plan-year requirement.* For purposes of this paragraph (b), the limit in effect for the current plan year applies only to the compensation for that year that is taken into account in determining plan allocations or benefit accruals for the year. The compensation for any prior plan year taken into account in determining an employee's allocations or benefit accruals for the current plan year is subject to the applicable annual compensation limit in effect for that prior year. Thus, increases in the annual compensation limit apply only to compensation taken into account for the plan year in which the increase is effective. In addition, if compensation for any plan year beginning prior to the OBRA '93 effective date is used for determining allocations or benefit accruals in a plan year beginning on or after the OBRA '93 effective date, then the annual compensation limit for that prior year is the annual compensation limit in effect for the first plan year beginning on or after the OBRA '93 effective date (generally $150,000).

(3) *Application of limit to a plan year*—(i) *In general.* For purposes of applying this paragraph (b), the annual compensation limit is applied to the compensation for the plan year on which allocations or benefit accruals are based.

(ii) *Compensation for the plan year.* If a plan determines compensation used in determining allocations or benefit accruals for a plan year based on compensation for the plan year, then the annual compensation limit that applies to the compensation for the plan year is the limit in effect for the calendar year in which the plan year begins. Alternatively, if a plan determines compensation used in determining allocations or benefit accruals for the plan year on the basis of compensation for a 12-consecutive-month period, or periods, ending no later than the last day of the plan year, then the annual compensation limit applies to compensation for each of those periods based on the annual compensation limit in effect for the respective calendar year in which each 12-month period begins.

(iii) *Compensation for a period of less than 12-months*—(A) *Proration required.* If compensation for a period of less than 12 months is used for a plan year, then the otherwise applicable annual compensation limit is reduced in the same proportion as the reduction in the 12-month period. For example, if a defined benefit plan provides that the accrual for each month in a plan year is separately determined based on the compensation for that month and the plan year accrual is the sum of the accruals for all months, then the annual compensation limit for each month is 1⁄12th of the annual compensation limit for the plan year. In addition, if the period for determining compensation used in calculating an employee's allocation or accrual for a plan year is a short plan year (i.e., shorter than 12 months), the annual compensation limit is an amount equal to the otherwise applicable annual compensation limit multiplied by a fraction, the numerator of which is the number of months in the short plan year, and the denominator of which is 12.

(B) *No proration required for participation for less than a full plan year.* Notwithstanding paragraph (b)(3)(iii)(A) of this section, a plan is not treated as using compensation for less than 12 months for a plan year merely because the plan formula provides that the allocation or accrual for each employee is based on compensation for the portion of the plan year during which the employee is a participant in the plan. In addition, no proration is required merely because an employee is covered under a plan for less than a full plan year, provided that allocations or benefit accruals are otherwise determined using compensation for a period of at least 12 months. Finally, notwithstanding paragraph (b)(3)(iii)(A) of this section, no proration is required merely because the amount of elective contributions (within the meaning of § 1.401(k)–1(g)(3)), matching contributions (within the meaning of § 1.401(m)–1(f)(12)), or employee contributions (within the meaning of § 1.401(m)–1(f)(6)) that is contributed for each pay period during a plan year is determined separately using compensation for that pay period.

(4) *Limits on multiple employer and multiemployer plans.* For purposes of this paragraph (b), in the case of a plan described in section 413(c) or 414(f) (a plan maintained by more than one employer), the annual compensation limit applies separately with respect to the compensation of an employee from each employer maintaining the plan instead of applying to the employee's total compensation from all employers maintaining the plan.

(5) *Family aggregation.* [Reserved]

(6) *Examples.* The following examples illustrate the rules in this paragraph (b).

Example 1. Plan X is a defined benefit plan with a calendar year plan year and bases benefits on the average of an employee's high 3 consecutive years' compensation. The OBRA '93 effective date for Plan X is January 1, 1994. Employee A's high 3 consecutive years' compensation prior to the application of the annual compensation limits is $160,000 (1994), $155,000 (1993), and $135,000 (1992). To satisfy this paragraph (b), Plan X cannot base plan benefits for Employee A in 1994 on compensation in excess of $145,000 (the average of $150,000 (A's 1994 compensation capped by the annual compensation limit), $150,000 (A's 1993 compensation capped by the $150,000 annual compensation limit applicable to all years before 1994), and $135,000 (A's 1992 compensation capped by the $150,000 annual compensation limit applicable to all years before 1994)). For purposes of determining the 1994 accrual, each year (1994, 1993, and 1992), not the average of the 3 years, is subject to the 1994 annual compensation limit of $150,000.

Example 2. Assume the same facts as Example 1, except that Employee A's high 3 consecutive years' compensation prior to the application of the limits is $185,000 (1997), $175,000 (1996), and $165,000 (1995). Assume that the annual compensation limit is first adjusted to $160,000 for plan years beginning on or after January 1, 1997. Plan X cannot base plan benefits for Employee A in 1997 on compensation in excess of $153,333 (the average of $160,000 (A's 1997 compensation capped by the 1997 limit), $150,000 (A's 1996 compensation capped by the 1996 limit), and $150,000 (A's 1995 compensation capped by the 1995 limit)).

Example 3. Plan Y is a defined benefit plan that bases benefits on an employee's high consecutive 36 months of compensation ending within the plan year. Employee B's high 36 months are the period September 1995 to August 1998, in which Employee B earned $50,000 in each month. Assume that the annual compensation limit is first adjusted to $160,000 for plan years beginning on or after January 1, 1997. The annual compensation limit is $150,000, $150,000, and $160,000 in 1995, 1996, and 1997, respectively. To satisfy this paragraph (b), Plan Y cannot base Employee B's plan benefits for the 1998 plan year on compensation in excess of $153,333. This amount is determined by applying the applicable annual compensation limit to compensation for each of the three 12-consecutive-month periods. The September 1995 to August 1996 period is capped by the annual compensation limit of $150,000 for 1995; the September 1996 to August 1997 period is capped by the annual compensation limit of $150,000 for 1996; and the September 1997 to August 1998 period is capped by the annual compensation limit of $160,000 for 1997. The average of these capped amounts is the annual compensation limit applicable in determining benefits for the 1998 year.

Example 4. (a) Employer P is a partnership. Employer P maintains Plan Z, a profit-sharing plan that provides for an annual allocation of employer contributions of 15 percent of plan year compensation for employees other than self-employed individuals, and 13.0435 percent of plan year compensation for self-employed individuals. The plan year of Plan Z is the calendar year. The OBRA '93 effective date for Plan Z is January 1, 1994. In order to satisfy section 401(a)(17), as amended by OBRA '93, the plan provides that, beginning with the 1994 plan year, the plan year compensation used in determining the allocation of employer contributions for each employee may not exceed the annual limit in effect for the plan year under OBRA '93. Plan Z defines compensation for self-employed individuals (employees within the meaning of section 401(c)(1)) as the self-employed individual's net profit from self-employment attributable to Employer P minus the amount of the self-employed individual's deduction under section 164(f) for one-half of self-employment taxes. Plan Z defines compensation for all other employees as wages within the meaning of section 3401(a). Employee C and Employee D are partners of Employer P and thus are self-employed individuals. Neither Employee C nor Employee D owns an interest in any other business or is a common-law employee in any business. For the 1994 calendar year, Employee C has net profit from self-employment of $80,000, and Employee D has net profit from self-employment of $175,000. The deduction for Employee C under section 164(f) for one-half of self-employment taxes is $4,828. The deduction for Employee D under section 164(f) for one-half of self-employment taxes is $6,101

(b) The plan year compensation under the plan formula for Employee C is $75,172 ($80,000 minus $4,828). The allocation of employer contributions under the plan allocation formula for 1994 for Employee C is $9,805 ($75,172 (Employee C's plan year compensation for 1994) multiplied by 13.0435%). The plan year compensation under the plan formula before application of the annual limit under section 401(a)(17) for Employee D is $168,899 ($175,000 minus $6101). After application of the annual limit, the plan year compensation for the 1994 plan year for Employee D is $150,000 (the annual limit for 1994). Therefore, the allocation of employer contributions under the plan allocation formula for 1994 for Employee D is $19,565 ($150,000 (Employee D's plan year compensation after application of the annual limit for 1994) multiplied by 13.0435%).

Example 5. The facts are the same as in *Example 4*, except that Plan Z provides that plan year compensation for self-employed individuals is defined as earned income within the meaning of section 401(c)(2) attributable to Employer P. In addition, Plan Z provides for an annual allocation of employer contributions of 15 percent of plan year compensation for all employees in the plan, including self-employed individuals, such as Employees C and D. The net profit from self-employment for Employee C and the net profit from self-employment for Employee D are the same as provided in *Example 4*. However, the earned income of Employee C determined in accordance with section 401(c)(2) is $65,367 ($80,000 minus $4,828 minus $9,805). The earned income of Employee D determined in accordance with section 401(c)(2) is $146,869 ($175,000 minus $6,101 minus $22,030). Therefore, the allocation of employer contributions under the plan allocation formula for 1994 for Employee C is $9,805 ($65,367 (Employee C's plan year compensation for 1994) multiplied by 15%). Employee D's earned income for 1994 does not exceed the 1994 annual limit of $150,000. Therefore, the allocation of employer contributions under the plan allocation formula for 1994 for Employee D is $22,030 ($146,869 (Employee D's plan year compensation for 1994) multiplied by 15%).

(c) *Limit on compensation for nondiscrimination rules*—(1) *General rule.* The annual compensation limit applies for purposes of applying the nondiscrimination rules under sections 401(a)(4), 401(a)(5), 401(l), 401(k)(3), 401(m)(2), 403(b)(12), 404(a)(2) and 410(b)(2). The annual compensation limit also applies in determining whether an alternative method of determining compensation impermissibly discriminates under section 414(s)(3). Thus, for example, the annual compensation limit applies when determining a self-employed individual's total earned income that is used to determine the equivalent alternative compensation amount under §1.414(s)–1(g)(1). This paragraph (c) provides rules for applying the annual compensation limit for these purposes. For purposes of this paragraph (c), compensation means the compensation used in applying the applicable nondiscrimination rule.

(2) *Plan-year-by-plan-year requirement.* For purposes of this paragraph (c), when applying an applicable nondiscrimination rule for a plan year, the compensation for each plan year taken into account is limited to the applicable annual compensation limit in effect for that year, and an employee's compensation for that plan year in excess of the limit is disregarded. Thus, if the nondiscrimination provision is applied on the basis of compensation determined over a period of more than one year (for example, average annual compensation), the annual compensation limit in effect for each of the plan years that is taken into account in determining the average applies to the respective plan year's compensation. In addition, if compensation for any plan year beginning prior to the OBRA '93 effective date is used when applying any nondiscrimination rule in a plan year beginning on or after the OBRA '93 effective date, then the annual compensation limit for that prior year is the annual compensation limit for the first plan year beginning on or after the OBRA '93 effective date (generally $150,000).

(3) *Plan-by-plan limit.* For purposes of this paragraph (c), the annual compensation limit applies separately to each plan (or group of plans treated as a single plan) of an employer for purposes of the applicable nondiscrimination requirement. For this purpose, the plans included in the testing group taken into account in determining whether the average benefit percentage test of § 1.410(b)–5 is satisfied are generally treated as a single plan.

(4) *Application of limit to a plan year.* The rules provided in paragraph (b)(3) of this section regarding the application of the limit to a plan year apply for purposes of this paragraph (c).

(5) *Limits on multiple employer and multiemployer plans.* The rule provided in paragraph (b)(4) of this section regarding the application of the limit to multiple employer and multiemployer plans applies for purposes of this paragraph (c).

(d) *Effective date*—(1) *Statutory effective date*—(i) *General rule.* Except as otherwise provided in this paragraph (d), section 401(a)(17) applies to a plan as of the first plan year beginning on or after January 1, 1989. For purposes of this section, statutory effective date generally means the first day of the first plan year that section 401(a)(17) is applicable to a plan. In the case of governmental plans, statutory effective date means the first day of the first plan year for which the plan is not deemed to satisfy section 401(a)(17) by reason of paragraph (d)(4) of this section.

(ii) *Exception for collectively bargained plans.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, section 401(a)(17) applies to allocations and benefit accruals for plan years beginning on or after the earlier of—

(A) January 1, 1991; or

(B) The later of January 1, 1989, or the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension or renegotiation of any agreement occurring after February 28, 1986). For purposes of this paragraph (d)(1)(ii), the rules of § 1.410(b)–10(a)(2) apply for purposes of determining whether a plan is maintained pursuant to one or more collective bargaining agreements, and any extension or renegotiation of a collective bargaining agreement, which extension or renegotiation is ratified after February 28, 1986, is to be disregarded in determining the date on which the agreement terminates.

(2) *OBRA '93 effective date*—(i) *In general.* For purposes of this section, OBRA '93 effective date means the first day of the first plan year beginning on or after January 1, 1994, except as provided in this paragraph (d)(2).

(ii) *Exception for collectively bargained plans*—(A) *In general.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and 1 or more employers ratified before August 10, 1993, OBRA '93 effective date means the first day of the first plan year beginning on or after the earlier of—

(*1*) The latest of—

(*i*) January 1, 1994;

(*ii*) The date on which the last of such collective bargaining agreements terminates (without regard to any extension, amendment, or, modification of such agreements on or after August 10, 1993); or

(*iii*) In the case of a plan maintained pursuant to collective bargaining under the Railway Labor Act, the date of execution of an extension or replacement of the last of such collective bargaining agreements in effect on August 10, 1993; or

(*2*) January 1, 1997.

(B) *Determination of whether plan is collectively bargained.* For purposes of this paragraph (d)(2)(ii), the rules of § 1.410(b)–10(a)(2) apply for purposes of determining whether a plan is maintained pursuant to one or more collective bargaining agreements, except that August 10, 1993, is substituted for March 1, 1986, as the date before which the collective bargaining agreements must be ratified.

(3) *Regulatory effective date.* This § 1.401(a)(17)–1 applies to plan years beginning on or after the OBRA '93 effective date. However, in the case of a plan maintained by an organization that is exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), this § 1.401(a)(17)–1 applies to plan years beginning on or after January 1, 1996. For plan years beginning before the effective date of these regulations and on or after the statutory effective date, a plan must be operated in accordance with a reasonable, good faith interpretation of section 401(a)(17), taking into account, if applicable, the OBRA '93 reduction to the annual compensation limit under section 401(a)(17).

(4) *Special rules for governmental plans*—(i) *Deemed satisfaction by governmental plans.* In the case of governmental plans described in section 414(d), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), section 401(a)(17) is considered satisfied for plan years beginning before the later of January 1, 1996, or 90 days after the opening of the first legislative session beginning on or after January 1, 1996, of the governing body with authority to amend the plan, if that body does not meet continuously. For purposes of this paragraph (d)(4), the term governing body with authority to amend the plan means the legislature, board, commission, council, or other governing body with authority to amend the plan.

(ii) *Transition rule for governmental plans*—(A) *In general.* In the case of an eligible participant in a governmental plan (within the meaning of section 414(d)), the annual compensation limit under this section shall not apply to the extent that the application of the limitation would reduce the amount of compensation that is allowed to be taken into account under the plan below the amount that was allowed to be taken into account under the plan as in effect on July 1, 1993. Thus, for example, if a plan as in effect on July 1, 1993, determined benefits without any reference to a limit on compensation, then the annual compensation limit in effect under this section will not apply to any eligible participant in any future year.

(B) *Eligible participant.* For purposes of this paragraph (d)(4)(ii), an eligible participant is an individual who first became a participant in the plan prior to the first day of the first plan year beginning after the earlier of—

(*1*) The last day of the plan year by which a plan amendment to reflect the amendments made by section 13212 of OBRA '93 is both adopted and effective; or

(*2*) December 31, 1995.

(C) *Plan must be amended to incorporate limits.* This paragraph (d)(4)(ii) shall not apply to any eligible participant in a plan unless the plan is amended so that the plan incorporates by reference the annual compensation limit under section 401(a)(17), effective with respect to noneligible participants for plan years beginning after December 31, 1995 (or earlier, if the plan amendment so provides).

(5) *Benefits earned prior to effective date*—(i) *In general.* Allocations under a defined contribution plan or benefits accrued under a defined benefit plan for plan years beginning before the statutory effective date are not subject

to the annual compensation limit. Allocations under a defined contribution plan or benefits accrued under a defined benefit plan for plan years beginning on or after the statutory effective date, but before the OBRA '93 effective date, are subject to the annual compensation limit under paragraph (a)(2) of this section. However, these allocations or accruals are not subject to the OBRA '93 reduction to the annual compensation limit described in paragraph (a)(3) of this section.

(ii) *Allocation for a plan year.* The allocations for a plan year include amounts described in § 1.401(a)(4)–2(c)(ii) or § 1.401(m)–1(f)(6) plus the earnings, expenses, gains, and losses attributable to those amounts.

(iii) *Benefits accrued for years before the effective date.* The benefits accrued for plan years prior to a specified date by any employee are the employee's benefits accrued under the plan, determined as if those benefits had been frozen (as defined in § 1.401(a)(4)–13(c)(3)(i)) as of the day immediately preceding such specified date. Thus, for example, benefits accrued for those plan years generally do not include any benefits accrued under an amendment increasing prior benefits that is adopted after the date on which the employee's benefits under the plan must be treated as frozen.

(e) *Determination of post-effective-date accrued benefits*—(1) *In general.* The plan formula that is used to determine the amount of allocations or benefit accruals for plan years beginning on or after the dates described in paragraph (d)(1) or (2) must comply with section 401(a)(17) as in effect on such date. This paragraph (e) provides rules for applying section 401(a)(17) in the case of section 401(a)(17) employees who accrue additional benefits under a defined benefit plan in a plan year beginning on or after the relevant effective date. Paragraph (e)(2) of this section contains definitions used in applying these rules. Paragraphs (e)(3) and (e)(4) of this section explain the application of the fresh-start rules in § 1.401(a)(4)–13 to the determination of the accrued benefits of section 401(a)(17) employees.

(2) *Definitions.* For purposes of this paragraph (e), the following definitions apply:

(i) *Section 401(a)(17) employee.* An employee is a section 401(a)(17) employee as of a date, on or after the statutory effective date, if the employee's current accrued benefit as of that date is based on compensation for a year prior to the statutory effective date that exceeded the annual compensation limit for the first plan year beginning on or after the statutory effective date. In addition, an employee is a section 401(a)(17) employee as of a date, on or after the OBRA '93 effective date, if the employee's current accrued benefit as of that date is based on compensation for a year prior to the OBRA '93 effective date that exceeded the annual compensation limit for the first plan year beginning on or after the OBRA '93 effective date. For this purpose, a current accrued benefit is not treated as based on compensation that exceeded the relevant annual compensation limit, if a plan makes a fresh start using the formula with wear-away described in § 1.401(a)(4)–13(c)(4)(ii), and the employee's accrued benefit determined under § 1.401(a)(4)–13(c)(4)(ii)(B), taking into account the annual compensation limit, exceeds the employee's frozen accrued benefit (or, if applicable, the employee's adjusted accrued benefit) as of the fresh-start date.

(ii) *Section 401(a)(17) fresh-start date.* Section 401(a)(17) fresh-start date means a fresh-start date as defined in § 1.401(a)(4)–12 not earlier than the last day of the last plan year beginning before the statutory effective date, and not later than the last day of the last plan year beginning before the effective date of these regulations.

(iii) *OBRA '93 fresh-start date.* OBRA '93 fresh-start date means a fresh-start date as defined in § 1.401(a)(4)–12 not earlier than the last day of the last plan year beginning before the OBRA '93 effective date, and not later than the last day of the last plan year beginning before the effective date of these regulations.

(iv) *Section 401(a)(17) frozen accrued benefit.* Section 401(a)(17) frozen accrued benefit means the accrued benefit for any section 401(a)(17) employee frozen (as defined in § 1.401(a)(4)–13(c)(3)(i)) as of the last day of the last plan year beginning before the statutory effective date.

(v) *OBRA '93 frozen accrued benefit.* OBRA '93 frozen accrued benefit means the accrued benefit for any section 401(a)(17) employee frozen (as defined in §1.401(a)(4)–13(c)(3)(i)) as of the OBRA '93 fresh-start date.

(3) *Application of fresh-start rules*—(i) *General rule.* In order to satisfy section 401(a)(17), a defined benefit plan must determine the accrued benefit of each section 401(a)(17) employee by applying the fresh-start rules in §1.401(a)(4)–13(c). The fresh-start rules must be applied using a section 401(a)(17) fresh-start date and using the plan benefit formula, after amendment to comply with section 401(a)(17) and this section, as the formula applicable to benefit accruals in the current plan year. In addition, the fresh-start rules must be applied to determine the accrued benefit of each section 401(a)(17) employee using an OBRA '93 fresh-start date and using the plan benefit formula, after amendment to comply with the reduction in the section 401(a)(17) annual compensation limit described in paragraph (a)(3) of this section, as the formula applicable to benefit accruals in the current plan year.

(ii) *Consistency rules in §1.401(a)(4)–13(c) and (d)*—(A) *General rule.* In applying the fresh-start rules of §1.401(a)(4)–13(c) and (d), the group of section 401(a)(17) employees is a fresh-start group. See §1.401(a)(4)–13(c)(5)(ii)(A). Thus, the consistency rules of those sections govern, unless otherwise provided. For example, if the plan is using a fresh-start date applicable to all employees and is not adjusting frozen accrued benefits under §1.401(a)(4)–13(d) for employees who are not section 401(a)(17) employees, then the frozen accrued benefits for section 401(a)(17) employees may not be adjusted under §1.401(a)(4)–13(d) or this paragraph (e).

(B) *Determination of adjusted accrued benefit.* If the fresh-start rules of §1.401(a)(4)–13(c) and (d) are applied to determine the benefits of all employees after a fresh-start date, the plan will not fail to satisfy the consistency requirement of §1.401(a)(4)–13(c)(5)(i) merely because the plan makes the adjustment described in §1.401(a)(4)–13(d) to the frozen accrued benefits of employees who are not section 401(a)(17) employees, but does not make the adjustment to the frozen accrued benefits of section 401(a)(17) employees. In addition, the plan does not fail to satisfy the consistency requirement of §1.401(a)(4)–13(c)(5)(i) merely because the plan makes the adjustment described in §1.401(a)(4)–13(d) for section 401(a)(17) employees on the basis of the compensation formula that was used to determine the frozen accrued benefit (as required under paragraph (e)(4)(iii) of this section) but makes the adjustment for employees who are not section 401(a)(17) employees on the basis of any other method provided in §1.401(a)(4)–13(d)(8).

(4) *Permitted adjustments to frozen accrued benefit of section 401(a)(17) employees*—(i) *General rule.* Except as otherwise provided in paragraphs (e)(4)(ii) and (iii) of this section, the rules in §1.401(a)(4)–13(c)(3) (permitting certain adjustments to frozen accrued benefits) apply to section 401(a)(17) frozen accrued benefits or OBRA '93 frozen accrued benefits.

(ii) *Optional forms of benefit.* After either the section 401(a)(17) fresh-start date or the OBRA '93 fresh-start date, a plan may be amended either to provide a new optional form of benefit or to make an optional form of benefit available with respect to the section 401(a)(17) frozen accrued benefit or the OBRA '93 frozen accrued benefit, provided that the optional form of benefit is not subsidized. Whether an optional form is subsidized may be determined using any reasonable actuarial assumptions.

(iii) *Adjusting section 401(a)(17) accrued benefits*—(A) *In general.* If the plan adjusts accrued benefits for employees under the rules of §1.401(a)(4)–13(d) as of a fresh-start date, the adjusted accrued benefit (within the meaning of section §1.401(a)(4)–13(d)) for each section 401(a)(17) employee must be determined after the fresh-start date by reference to the plan's compensation formula that was actually used to determine the frozen accrued benefit as of the fresh-start date. For this purpose, the plan's compensation formula incorporates the plan's underlying compensation definition and compensation averaging period. In making the adjustment, the denominator of the adjustment fraction described in § 1.401(a)(4)–13(d)(8)(i) is the employee's compensation as of the fresh-start date using the plan's compensation formula as of that date and, in the case of an OBRA '93 fresh-start date, reflecting the annual compensation limits that applied as of the fresh-start date. The numerator of the adjustment fraction is the employee's updated compensation (i.e., compensation for the current plan year within the meaning of § 1.401(a)(4)–13(d)(8)), determined after applying the annual compensation limits to each year's compensation that is used in the plan's compensation formula as of the fresh-start date. Similarly, in applying the alternative rule in § 1.401(a)(4)–13(d)(8)(v), the updated compensation that is substituted must be determined after applying the annual compensation limits to each year's compensation that is used in the plan's compensation formula. Thus, no adjustment will be permitted unless the updated compensation (determined after applying the annual compensation limit) exceeds the compensation that was used to determine the employee's frozen accrued benefit.

(B) *Multiple fresh starts.* If a plan makes more than one fresh start with respect to a section 401(a)(17) employee, the employee's frozen accrued benefit as of the latest fresh-start date will either be determined by applying the current benefit formula to the employee's total years of service as of that fresh-start date or will consist of the sum of the employee's frozen accrued benefit (or adjusted accrued benefit (as defined in § 1.401(a)(4)–13(d)(8)(i))) as of the previous fresh-start date plus additional frozen accruals since the previous fresh start. If the frozen accrued benefit consists of such a sum, in making the adjustments described in paragraph (e)(4)(iii)(A) of this section, separate adjustments must be made to that previously frozen accrued benefit (or adjusted accrued benefit) and the additional frozen accruals to the extent that the frozen accrued benefit and the additional accruals have been determined using different compensation formulas or different compensation limits (i.e., the section 401(a)(17) limit before and after the reduction in limit described in paragraph (a)(3) of this section). In this case, if the plan is applying the adjustment fraction of § 1.401(a)(4)–13(d)(8)(i), the denominator of the separate adjustment fraction for adjusting each portion of the frozen accrued benefit must reflect the actual compensation formula, and, if applicable, compensation limit, originally used for determining that portion. For example, the frozen accrued benefit of a section 401(a)(17) employee as of the OBRA '93 fresh-start date may be based on the sum of the section 401(a)(17) frozen accrued benefit (determined without any annual compensation limit) plus benefit accruals in the years between the statutory effective date and the OBRA '93 effective date (based on compensation that was subject to the annual compensation limits for those years). In this example, in adjusting the section 401(a)(17) frozen accrued benefit, the denominator of the adjustment fraction does not reflect any annual compensation limit. Similarly, in adjusting the frozen accruals for years between the statutory effective date and the OBRA '93 effective date, the denominator of the adjustment fraction reflects the level of the annual compensation limit in effect for those years.

(5) *Examples.* The following examples illustrate the rules in this paragraph (e).

Example 1. (a) Employer X maintains Plan Y, a calendar year defined benefit plan providing an annual benefit for each year of service equal to 2 percent of compensation averaged over an employee's high 3 consecutive calendar years' compensation. Section 401(a)(17) applies to Plan Y in 1989. As of the close of the last plan year beginning before January 1, 1989 (i.e., the 1988 plan year), Employee A, with 5 years of service, had accrued a benefit of $25,000 which equals 10 percent (2 percent multiplied by 5 years of service) of average compensation of $250,000. Employer X decides to comply with the provisions of this section for plan years before the effective date of this section. Employer X decides to make the amendment effective for plan years beginning on or after January 1, 1989, and uses December 31, 1988 as the section

401(a)(17) fresh-start date. Plan Y, as amended, provides that, in determining an employee's benefit, compensation taken into account is limited in accordance with the provisions of this section to the annual compensation limit under section 401(a)(17), and that, for section 401(a)(17) employees, the employee's accrued benefit is the greater of

(i) The employee's benefit under the plan's benefit formula (after the plan formula is amended to comply with section 401(a)(17)) as applied to the employee's total years of service; and

(ii) The employee's accrued benefit as of December 31, 1988, determined as though the employee terminated employment on that date without regard to any plan amendments after that date.

Employer X decides not to amend Plan Y to provide for the adjustments permitted under §1.401(a)(4)–13(d) to the accrued benefit of section 401(a)(17) employees as of December 31, 1988.

(b) Under Plan Y, Employee A's accrued benefit at the end of 1989 is $25,000, which is the greater of Employee A's accrued benefit as of the last day of the 1988 plan year ($25,000), and $24,000, which is Employee A's benefit based on the plan's benefit formula applied to Employee A's total years of service ($200,000 multiplied by (2 percent multiplied by 6 years of service)). The formula of Plan Y applicable to section 401(a)(17) employees for calculating their accrued benefits for years after the section 401(a)(17) fresh-start date is the formula in §1.401(a)–13(c)(4)(ii) (formula with wear-away). The fresh-start formula is applied using a benefit formula for the 1989 plan year that satisfies section 401(a)(17) and this section, and the December 31, 1988 fresh-start date used for the plan is a section 401(a)(17) fresh-start date within the meaning of paragraph (e)(2)(ii) of this section. Thus, Plan Y, as amended, satisfies paragraph (e)(3)(i) of this section for plan years commencing prior to the OBRA '93 effective date.

Example 2. Assume the same facts as in *Example 1,* except that the plan formula provides that effective January 1, 1989, for section 401(a)(17) employees, an employee's benefit will equal the sum of the employee's accrued benefit as of December 31, 1988 (determined as though the employee terminated employment on that date and without regard to any amendments after that date), and 2 percent of compensation averaged over an employee's high 3 consecutive years' compensation times years of service taking into account only years of service after December 31, 1988. Thus, under Plan Y's formula, Employee A's accrued benefit as of December 31, 1989 is $29,000, which is equal to the sum of $25,000 (Employee A's accrued benefit as of December 31, 1988) plus $4,000 ($200,000 multiplied by (2 percent multiplied by 1 year of service)). The formula of Plan Y applicable to section 401(a)(17) employees for calculating their accrued benefits for years after the section 401(a)(17) fresh-start date is the formula in §1.401(a)–13(c)(4)(i) (formula without wear-away). The fresh-start formula is applied using a benefit formula for the 1989 plan year that satisfies section 401(a)(17) and this section, and the December 31, 1988 fresh-start date used for the plan is a section 401(a)(17) fresh-start date within the meaning of paragraph (e)(2)(ii) of this section. Thus, Plan Y, as amended, satisfies paragraph (e)(3)(i) of this section for plan years commencing prior to the OBRA '93 effective date.

Example 3. (a) Assume the same facts as in *Example 1,* except that the plan formula provides that effective January 1, 1989, an employee's benefit equals the greater of the plan formulas in *Example 1* and *Example 2.* The formula of Plan Y applicable to section 401(a)(17) employees for calculating their accrued benefits for years after the section 401(a)(17) fresh-start date is the formula in §1.401(a)–13(c)(4)(iii) (formula with extended wear-away). The fresh-start formula is applied using a benefit formula for the 1989 plan year that satisfies section 401(a)(17) and this section, and the December 31, 1988 fresh-start date used for the plan is a section 401(a)(17) fresh-start date within the meaning of paragraph (e)(2)(ii) of this section. Thus, Plan Y, as amended, satisfies paragraph (e)(3)(i) of this section for plan years commencing prior to the OBRA '93 effective date.

(b) Assume that for each of the years 1991–93 Employee A's annual compensation under the plan compensation formula, disregarding the amendment to comply with section 401(a)(17) is $300,000. The annual compensation limit is adjusted to $222,220, $228,860, and $235,840 for plan years beginning January 1, 1991, 1992, and 1993, respectively. Because Employer X has decided to amend Plan Y to comply with the provisions of this section effective for plan years beginning on or after January 1, 1989, and has used December 31, 1988 as the section 401(a)(17) fresh-start date, the compensation that may be taken into account for plan benefits in 1993 cannot exceed $228,973 (the average of $222,220, $228,860, and $235,840). Therefore, as of December 31, 1993, the benefit determined under the fresh-start formula with wear-away would be $45,795 ($228,973 multiplied by (2 percent multiplied by 10 years of service)). The benefit determined under the fresh-start formula without wear-away would be $47,897, which is equal to $25,000 (Employee A's section 401(a)(17) frozen accrued benefit) plus $22,897 ($228,973 multiplied by (2 percent multiplied by 5 years of service)). Because Employee A's accrued benefit is being determined using the fresh-start formula with extended wear-away, Employee A's accrued benefit as of December 31, 1993, is equal to $47,897, the greater of the two amounts.

Example 4. (a) Assume the same facts as in *Example 3,* except that Plan Y satisfies § 1.401(a)(4)–13(d)(3) through (d)(7) and that the amendment to Plan Y effective for plan years beginning after December 31, 1988, also provided for adjustments to the section 401(a)(17) frozen accrued benefit in accordance with § 1.401(a)(4)-13(d) using the fraction described in § 1.401(a)(4)-13(d)(8)(i).

(b) As of December 31, 1993, the numerator of Employee A's compensation fraction is $228,973 (the average of Employee A's annual compensation for 1991, 1992, and 1993, as limited by the respective annual limit for each of those years). The denominator of Employee A's compensation fraction determined in accordance with paragraph (e)(4)(iii) of this section is $250,000 (the average of Employee A's high 3 consecutive calendar year compensation as of December 31, 1988, determined without regard to section 401(a)(17)). Therefore, Employee A's compensation fraction is $228,973/$250,000. Because the compensation adjustment fraction is less than 1, Employee A's section 401(a)(17) frozen accrued benefit is not adjusted. Therefore, Employee A's accrued benefit as of December 31, 1993, would still be $47,897, which is equal to $25,000 (Employee A's section 401(a)(17) frozen accrued benefit) plus $22,897 ($228,973 multiplied by (2 percent multiplied by 5 years of service).

Example 5. (a) Assume the same facts as in *Example 3,* except that as of January 1, 1994, Plan Y is amended to provide that benefits will be determined based on compensation of $150,000 (the limit in effect under section 401(a)(17) for plan years beginning on or after the OBRA '93 effective date) and that for section 401(a)(17) employees, each employee's accrued benefit will be determined under § 1.401(a)(4)–13(c)(4)(i) (formula without wear-away) using December 31, 1993 as the OBRA '93 fresh-start date.

(b) Assume that for each of the years 1996–98 Employee A's annual compensation under the plan compensation definition, disregarding the amendment to comply with section 401(a)(17), is $400,000. Assume that the annual compensation limit is first adjusted to $160,000 for plan years beginning on or after January 1, 1997, and is not adjusted for the plan year beginning on or after January 1, 1998. The compensation that may be taken into account for the 1998 plan year cannot exceed $156,667 (the average of $150,000 for 1996, $160,000 for 1997, and $160,000 for 1998).

(c) Therefore, at the end of December 31, 1998, Employee A's accrued benefit is $63,564, which is equal to $47,897 (Employee A's OBRA '93 frozen accrued benefit) plus $15,667 ($156,667 multiplied by (2 percent multiplied by 5 years of service)).

Example 6. (a) Assume the same facts as in *Example 5,* except that, for the fresh-start group (in this case the section 401(a)(17) employees), the amendments to Plan Y provide for adjustments to the section 401(a)(17) frozen accrued benefit and the OBRA '93 frozen accrued benefit in accordance with § 1.401(a)(4)–13(d) using the fraction described in § 1.401(a)(4)–13(d)(8)(i).

(b) Employee A's frozen accrued benefit as of December 31, 1993, is adjusted as of December 31, 1998, as follows:

(1) Employee A's frozen accrued benefit as of December 31, 1993, is the sum of Employee A's section 401(a)(17) frozen accrued benefit ($25,000) and Employee A's frozen accruals for the years 1989–93 ($22,897).

(2) The numerator of Employee A's adjustment fraction is $156,667 (the average of $150,000, $160,000, and $160,000). The denominator of Employee A's adjustment fraction with respect to Employee A's section 401(a)(17) frozen accrued benefit is $250,000, and the denominator of Employee A's adjustment fraction with respect to the rest of Employee A's frozen accrued benefit is $228,973 (the average of Employee A's annual compensation for 1991, 1992, and 1993, as limited by the respective annual limit for each of those years).

(3) Employee A's section 401(a)(17) frozen accrued benefit as adjusted through December 31, 1998, remains $25,000. The compensation adjustment fraction determined in accordance with paragraph (e)(4)(iii) of this section is less than one ($156,667 divided by $250,000).

(4) Employee A's frozen accruals for the years 1989–93, as adjusted through December 31, 1998, remain $22,897 because the adjustment fraction is less than one ($156,667 divided by $228,973).

(5) Employee A's adjusted accrued benefit as of December 31, 1998, equals $47,897 (the sum of the $25,000 and $22,897 amounts from paragraphs (b)(3) and (b)(4), respectively, of this *Example*).

(c) Employee A's section 401(a)(17) frozen accrued benefit will not be adjusted for compensation increases until the numerator of the fraction used to adjust that frozen accrued benefit exceeds the denominator of $250,000 used in determining those accruals.

Similarly, the portion of Employee A's OBRA '93 frozen accrued benefit attributable to the frozen accruals for the years 1989–1993 will not be adjusted for compensation increases until the numerator of the fraction used to adjust those frozen accruals exceeds the denominator of $228,973 used in determining those accruals.

[T.D. 8547, 59 FR 32905, June 27, 1994]

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[T.D. 8375, 56 FR 63413, Dec. 4, 1991]

§1.401(a)(26)–1 Minimum participation requirements.

(a) *General rule.* A plan is a qualified plan for a plan year only if the plan satisfies section 401(a)(26) for the plan year. A plan that satisfies any of the exceptions described in paragraph (b) of this section passes section 401(a)(26) automatically for the plan year. A plan that does not satisfy one of the exceptions in paragraph (b) of this section must satisfy §1.401(a)(26)–2(a). In addition, a defined benefit plan must satisfy §1.401(a)(26)–3 with respect to its prior benefit structure. Finally, a defined benefit plan that benefits former employees (for example, a defined benefit plan that is amended to provide an ad hoc cost-of-living adjustment to former employees) must separately satisfy §1.401(a)(26)–4 with respect to its former employees.

(b) *Exceptions to section 401(a)(26)*—(1) *Plans that do not benefit any highly compensated employees.* A plan, other than a frozen defined benefit plan as defined in §1.401(a)(26)–2(b), satisfies section 401(a)(26) for a plan year if the plan is not a top-heavy plan under section 416 and the plan meets the following requirements:

(i) The plan benefits no highly compensated employee or highly compensated former employee of the employer; and

(ii) The plan is not aggregated with any other plan of the employer to enable the other plan to satisfy section 401(a)(4) or 410(b). The plan may, however, be aggregated with the employer's other plans for purposes of the average benefit percentage test in section 410(b)(2)(A)(ii).

(2) *Multiemployer plans*—(i) *In genera1.* The portion of a multiemployer plan that benefits only employees included in a unit of employees covered by a collective bargaining agreement may be treated as a separate plan that satisfies section 401(a)(26) for a plan year.

(ii) *Multiemployer plans covering noncollectively bargained employees*—(A) *In general.* The rule provided in paragraph (b)(2)(i) does not apply to the portion of a multiemployer plan that benefits employees who are not included in any collective bargaining unit covered by a collective bargaining agreement. Thus, the portion of the plan benefiting these employees must separately satisfy section 401(a)(26).

(B) *Special testing rule.* A multiemployer plan that benefits employees who are not included in any collective bargaining unit covered by a collective bargaining agreement satisfies section 401(a)(26) if the plan benefits 50 employees. For purposes of this special testing rule, employees who are included in a unit of employees covered by a collective bargaining agreement may be included in determining whether the plan benefits 50 employees.

(3) *Certain underfunded defined benefit plans*—(i) *In general.* A defined benefit plan is deemed to satisfy section 401(a)(26) for a plan year if all of the conditions of paragraphs (b)(3)(ii) through (b)(3)(iv) of this section are satisfied with respect to the plan for the plan year.

(ii) *Eligible plans.* This condition is satisfied for a plan year only if the plan is subject to Title IV of the Employee Retirement Income Security Act of 1974 (ERISA) for the plan year or, if the plan is not a Title IV plan under ERISA, it is not a top-heavy plan within the meaning of section 416. This condition does not apply for plan years beginning before January 1, 1992.

(iii) *Actuarial certification.* This condition is satisfied for a plan year only if the employer's timely filed actuarial report, as required by section 6059, evidences that the plan does not have sufficient assets to satisfy all liabilities under the plan (determined in accordance with section 401(a)(2)).

(iv) *Cessation of all benefit accruals.* This condition is satisfied for a plan year only if, for the plan year, no employee or former employee is benefiting within the meaning of §1.401(a)(26)–5(a) or (b). For this purpose, an employee is not treated as benefiting solely by reason of being a non-key employee receiving minimum benefit accruals required by section 416.

(4) *Section 401(k) plan maintained by employers that include certain governmental or tax-exempt entities.* Section 401(k)(4)(B) prevents certain State and local governments and tax-exempt organizations from maintaining a qualified cash or deferred arrangement. A plan (or portion of a plan) that is either a section 401(k) plan or a section 401(m) plan that is provided under the same general arrangement as a section 401(k) plan may be treated as a separate plan that satisfies section 401(a)(26) for a plan year if the following requirements are satisfied:

(i) The section 401(k) plan is maintained by an employer who has employees precluded from being eligible employees under the arrangement by reason of section 401(k)(4)(B), and

(ii) More than 95 percent of the employees of the employer who are not precluded from being eligible employees under a section 401(k) plan by reason of section 401(k)(4)(B) benefit under the section 401(k) plan.

(5) *Certain acquisitions or dispositions*—(i) *General rule.* Rules similar to the rules prescribed under section 410(b)(6)(C) apply under section 401(a)(26). Pursuant to these rules, the requirements of section 401(a)(26) are treated as satisfied for certain plans of an employer involved in an acquisition or disposition (transaction) for the transition period. The transition period begins on the date of the transaction and ends on the last day of the first plan year beginning after the date of the transaction.

(ii) *Special rule for transactions that occur in the plan year prior to the first plan year to which section 401(a)(26) applies.* Where there has been a transaction described in section 410(b)(6)(C) in the plan year prior to the first plan year in which section 401(a)(26) applies to a plan, the plan satisfies section 401(a)(26) for the transition period if the plan benefited 50 employees or 40 percent of the employees of the employer immediately prior to the transaction.

(iii) *Definition of ''acquisition'' and ''disposition.''* For purposes of this paragraph (b)(5), the terms ''acquisition'' and ''disposition'' refer to an asset or stock acquisition, merger, or other similar transaction involving a change in employer of the employees of a trade or business.

(c) *Additional rules.* The Commissioner may, in revenue rulings, notices, and other guidance of general applicability, provide any additional rules that may be necessary or appropriate in applying the minimum participation requirements of section 401(a)(26).

[T.D. 8375, 56 FR 63413, Dec. 4, 1991, as amended by T.D. 8487, 58 FR 46838, Sept. 3, 1993]

§1.401(a)(26)–2 Minimum participation rule.

(a) *General rule.* A plan satisfies this paragraph (a) for a plan year only if the plan benefits at least the lesser of—

(1) 50 employees of the employer, or

(2) 40 percent of the employees of the employer.

(b) *Frozen plans.* A plan under which no employee or former employee benefits (within the meaning of §1.401(a)(26)–5 (a) or (b)), is a frozen plan for purposes of this section and satisfies paragraph (a) of this section automatically. Thus, a frozen defined contribution plan satisfies section 401(a)(26) automatically and a frozen defined benefit plan satisfies section 401(a)(26) for a plan year by satisfying the prior benefit structure requirements in § 1.401(a)(26)–3. For purposes of the rule in this paragraph (b), a defined benefit plan that provides only the minimum benefits for non-key employees required by section 416 is a frozen defined benefit plan.

(c) *Plan.* ''Plan'' means a plan within the meaning of § 1.401(b)–7 (a) and (b), after the application of the mandatory disaggregation rules of paragraph (d)(1) of this section and, if applicable, the permissive disaggregation rules of paragraph (d)(2) of this section.

(d) *Disaggregation of certain plans*—(1) *Mandatory disaggregation*—(i) *ESOPs and non-ESOPs.* The portion of a plan that is an ESOP and the portion of the plan that is not an ESOP are treated as separate plans for purposes of section 401(a)(26), except as otherwise permitted under § 54.4975–11(e) of this Chapter.

(ii) *Plans maintained by more than one employer*—(A) *Multiple employer plans.* If a plan benefits employees of more than one employer and those employees are not included in a unit of employees covered by one or more collective bargaining agreements, the plan is a multiple employer plan. A multiple employer plan is treated as separate plans, each of which is maintained by a separate employer and must separately satisfy section 401(a)(26) by reference only to that employer's employees.

(B) *Multiemployer plans.* The portion of a multiemployer plan that benefits employees who are included in one or more units of employees covered by one or more collective bargaining agreements and the portion of that plan that benefits employees who are not included in a unit of employees covered pursuant to any collective bargaining agreement are treated as separate plans. The portion of a multiemployer plan that benefits employees who are not included in a unit of employees covered by a collective bargaining agreement is a multiple employer plan as described in paragraph (d)(1)(ii)(A) of this section. This paragraph (d)(1)(ii)(B) does not apply to the extent that the special testing rule in § 1.401(a)(26)–1(b)(2)(ii) applies. Also, this paragraph (d)(1)(B)(*2*) does not apply for purposes of prior benefit structure testing under § 1.401 (a)(26)–3.

(iii) *Defined benefit plans with other arrangements*—(A) *In general.* A defined benefit plan is treated as comprising separate plans if, under the facts and circumstances, there is an arrangement (either under or outside the plan) that has the effect of providing any employee with a greater interest in a portion of the assets of a plan in a way that has the effect of creating separate accounts. Separate plans are not created, however, merely because a partnership agreement provides for allocation among partners, in proportion to their partnership interests, of either the cost of funding the plan or surplus assets upon plan termination.

(B) *Examples.* The following examples illustrate certain situations in which other arrangements relating to a defined benefit plan are or are not treated as creating separate plans:

Example 1. Employer A maintains a defined benefit plan under which each highly compensated employee can direct the investment of the portion of the plan's assets that represents the accumulated contributions with respect to that employee's plan benefits. In addition, by agreement outside the plan, if the product of the employee's investment direction exceeds the value needed to fund that employee's benefits, Employer A agrees to make a special payment to the participant. In this case, each separate portion of the pool of assets over which an employee has investment authority is a separate plan for the employee.

Example 2. Employer B is a partnership that maintains a defined benefit plan. The partnership agreement provides that, upon termination of the plan, a special allocation of any excess plan assets after reversion is made to the partnership on the basis of partnership share. This arrangement does not create separate plans with respect to the partners.

(iv) *Plans benefiting employees of qualified separate lines of business.* If an employer is treated as operating qualified separate lines of business for purposes of section 401(a)(26) in accordance with § 1.414(r)–1(b), the portion of a plan that benefits employees of one qualified separate line of business is treated as a separate plan from the portions of the same plan that benefit employees of the other qualified separate lines of business of the employer. See §§ 1.414(r)–1(c)(3) and 1.414(r)–9 (separate application of section 401(a)(26) to the employees of a qualified separate line of business). The rule in this paragraph (d)(6) does not apply to a plan that is tested under the special rule for employer-wide plans in §1.414(r)–1(c)(3)(ii) for a plan year.

(2) *Permissive disaggregation*—(i) *Plans benefiting collectively bargained employees.* For purposes of section 401(a)(26), an employer may treat the portion of a plan that benefits employees who are included in a unit of employees covered by a collective bargaining agreement as a plan separate from the portion of a plan that benefits employees who are not included in such a collective bargaining unit. This paragraph (d)(2)(i) applies separately to each collective bargaining agreement. Thus, for example, the portion of a plan that benefits employees included in a unit of employees covered by one collective bargaining agreement may be treated as a plan that is separate from the portion of the plan that benefits employees included in a unit of employees covered by another collective bargaining agreement.

(ii) *Plans benefiting otherwise excludable employees.* If an employer applies section 401(a)(26) separately to the portion of a plan that benefits only employees who satisfy age and service conditions under the plan that are lower than the greatest minimum age and service conditions permissible under section 410(a), the plan is treated as comprising separate plans, one benefiting the employees who have not satisfied the lower minimum age and service but not the greatest minimum age and service conditions permitted under section 410(a) and one benefiting employees who have satisfied the greatest minimum age and service conditions permitted under section 410(a). See §1.401(a)(26)–6(b)(1)(ii) for rules concerning testing of otherwise excludable employees.

[T.D. 8375, 56 FR 63414, Dec. 4, 1991]

§1.401(a)(26)–3 Rules applicable to a defined benefit plan's prior benefit structure.

(a) *General rule.* A defined benefit plan that does not meet one of the exceptions in §1.401(a)(26)–1(b) must satisfy paragraph (c) of this section with respect to its prior benefit structure. Defined contribution plans are not subject to this section.

(b) *Prior benefit structure.* Each defined benefit plan has only one prior benefit structure, and all accrued benefits under the plan as of the beginning of a plan year (including benefits rolled over or transferred to the plan) are included in the prior benefit structure for the year.

(c) *Testing a prior benefit structure*—(1) *General rule.* A plan's prior benefit structure satisfies this paragraph if the plan provides meaningful benefits to a group of employees that includes the lesser of 50 employees or 40 percent of the employer's employees. Thus, a plan satisfies the requirements of this paragraph (c) if at least 50 employees or 40 percent of the employer's employees currently accrue meaningful benefits under the plan. Alternatively, a plan satisfies this paragraph if at least 50 employees and former employees or 40 percent of the employer's employees and former employees have meaningful accrued benefits under the plan.

(2) *Meaningful benefits.* Whether a plan is providing meaningful benefits, or whether individuals have meaningful accrued benefits under a plan, is determined on the basis of all the facts and circumstances. The relevant factors in making this determination include, but are not limited to, the following: the level of current benefit accruals; the comparative rate of accruals under the current benefit formula compared to prior rates of accrual under the plan; the projected accrued benefits under the current benefit formula compared to accrued benefits as of the close of the immediately preceding plan year; the length of time the current benefit formula has been in effect; the number of employees with accrued benefits under the plan; and the length of time the plan has been in effect. A rule for determining whether an offset plan provides meaningful benefits is provided in §1.401(a)(26)–5(a)(2). A plan does not satisfy this paragraph (c) if it exists primarily to preserve accrued benefits for a small group of employees and thereby functions more as an individual plan for the small group of employees or for the employer.

(d) *Multiemployer plan rule.* A multiemployer plan is deemed to satisfy the prior benefit structure rule in paragraph (c)(1) of this section for a plan year if the multiemployer plan provides meaningful benefits to at least 50 employees for a plan year, or 50 employees have meaningful accrued benefits under the plan. For purposes of this paragraph, all employees benefiting under the multiemployer plan may be considered, whether or not these employees are included in a unit of employees covered pursuant to any collective bargaining agreement.

[T.D. 8375, 56 FR 63415, Dec. 4, 1991]

§ 1.401(a)(26)–4 Testing former employees.

(a) *Scope.* This section applies to any defined benefit plan that benefits former employees in a plan year within the meaning of § 1.401(a)(26)–5(b) and does not meet one of the exceptions in § 1.401(a)(26)–1(b).

(b) *Minimum participation rule for former employees.* Except as set forth in paragraph (c) of this section, a plan that is subject to this section must benefit at least the lesser of:

(1) 50 former employees of the employer, or

(2) 40 percent of the former employees of the employer.

(c) *Special rule.* A plan satisfies the minimum participation rule in paragraph (b) of this section if the plan benefits at least five former employees, and if either:

(1) More than 95 percent of all former employees with vested accrued benefits under the plan benefit under the plan for the plan year, or

(2) At least 60 percent of the former employees who benefit under the plan for the plan year are nonhighly compensated former employees.

(d) *Excludable former employees*—(1) *General rule.* Whether a former employee is an excludable former employee for purposes of this section is determined under § 1.401(a)(26)–6(c).

(2) *Exception.* Solely for purposes of paragraph (c) of this section, the rule in § 1.401(a)(26)–6(c)(4) (regarding vested accrued benefits eligible for mandatory distribution) does not apply to any former employee having a vested accrued benefit. Thus, a former employee who has a vested accrued benefit is not an excludable former employee merely because that vested accrued benefit does not exceed the cash-out limit in effect under § 1.411(a)–11T(c)(3)(ii).

[T.D. 8375, 56 FR 63416, Dec. 4, 1991, as amended by T.D. 8794, 63 FR 70338, Dec. 21, 1998]

§ 1.401(a)(26)–5 Employees who benefit under a plan.

(a) *Employees benefiting under a plan*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, an employee is treated as benefiting under a plan for a plan year if and only if, for that plan year, the employee would be treated as benefiting under the provisions of § 1.410(b)–3(a), without regard to § 1.410(b)–3(a)(iv).

(2) *Sequential or concurrent benefit offset arrangements*—(i) *In general.* An employee is treated as accruing a benefit under a plan that includes an offset or reduction of benefits that satisfies either paragraph (a)(2)(ii) or (a)(2)(iii) of this section if either the employee accrues a benefit under the plan for the year, or the employee would have accrued a benefit if the offset or reduction portion of the benefit formula were disregarded. In addition, an employee is treated as accruing a meaningful benefit for purposes of prior benefit structure testing under § 1.401(a)(26)–3 if the employee would have accrued a meaningful benefit if the offset or reduction portion of the benefit formula were disregarded.

(ii) *Offset by sequential or grandfathered benefits.* An offset or reduction of benefits under a defined benefit plan satisfies this paragraph (a)(2) if the benefit formula provides that an employee will not accrue additional benefits under the current portion of the benefit formula until the employee has accrued, under such portion, a benefit in excess of such employee's benefit under one or more formulas in effect for prior years that are based wholly on prior years of service. The prior benefit may have accrued under the same or a separate plan, may be provided under the same or a separate plan and may relate to service with the same or previous employers. Benefits will not fail to be treated as based wholly on prior years if they are based, directly or indirectly, on compensation earned after such prior years (including compensation earned in the current year), if they are adjusted to reflect increases in the section 415 limitations, or if they are increased to provide an ad hoc cost of living adjustment designed to adjust, in whole or in part, for inflation. Furthermore, benefits do not fail to be treated as based wholly on prior years merely because the benefits (e.g., early retirement benefits) are subject to an age or years-of-service condition and, in applying the condition or conditions, the current and prior years are taken into account.

(iii) *Concurrent benefit offset arrangements*—(A) *General rule.* An offset or reduction of benefits under a defined benefit plan satisfies the requirements of this paragraph (a)(2)(iii) if the benefit formula provides a benefit that is offset or reduced by contributions or benefits under another plan that is maintained by the same employer and the following additional requirements are met:

(*1*) The contributions or benefits under a plan that are used to offset or reduce the benefits under the positive portion of the fomu1a being tested accrued under such other plan;

(*2*) The employees who benefit under the formula being tested also benefit under the other plan on a reasonable and uniform basis; and

(*3*) The contributions or benefits under the plan that are used to offset or reduce the benefits under the formula being tested are not used to offset or reduce that employee's benefits under any other plan or any other formula.

(B) *Special rules for certain section 414(n) employer-recipients.* The same employer requirement in the concurrent benefit offset rule in paragraph (a)(2)(iii)(A) of this section is waived for certain section 414(n) employer-recipients. Under this exception, an employer-recipient (within the meaning of sections 414 (n) and (o)) may treat contributions or benefits under a plan maintained by a leasing organization as contributions or benefits accrued under the recipient organization plan provided the following requirements are met: the employer-recipient maintains a plan covering leased employees (which employees are treated as employees of the employer-recipient within the meaning of sections 414(n)(2) and 414(o)(2)); the leased employees are also covered under a plan maintained by the leasing organization; and contributions or benefits under the plan maintained by the employer-recipient are offset or reduced by the contributions or benefits under the leasing organization plan that are attributable to service with the recipient organization. Also, for purposes of the benefiting condition requirement in paragraph (a)(2)(iii)(A)(*2*) of this section, the employees of the employer-recipient who are not leased from the leasing organization are not required to benefit under the plan of the leasing organization.

(b) *Former employees benefiting under a plan.* A former employee is treated as benefiting for a plan year if and only if the former employee would be treated as benetiting under the rules in § 1.410(b)–3(b).

[T.D. 8375, 56 FR 63416, Dec. 4, 1991]

§ 1.401(a)(26)–6 Excludable employees.

(a) *In general.* For purposes of applying section 401(a)(26) with respect to either employees, former employees, or both employees and former employees, as applicable, all employees other than excludable employees described in paragraph (b) of this section, all former employees other than excludable former employees described in paragraph (c) of this section, or both, as the case may be, must be taken into account. Except as specifically provided otherwise in this section, the rules of this section are applied by reference only to the particular plan and must be applied on a uniform and consistent basis.

(b) *Excludable employees.* An employee is an excludable employee if the employee is covered by one or more of the following exclusions:

(1) *Minimum age and service exclusions*—(i) *In general.* If a plan applies minimum age and service eligibility conditions permissible under section 410(a)(1) and excludes all employees who do not meet those conditions from benefiting under the plan, tbn all employees who fail to satisfy those conditions may be treated as excludable employees with respect to that plan. An employee is treated as meeting the age and service requirements on the date any employee with the same age and

service would be eligible to commence participation in the plan, as provided in section 410(b)(4)(C).

(ii) *Plans benefiting otherwise excludable employees.* An employer may treat a plan benefiting otherwise excludable employees as two separate plans, one for the otherwise excludable employees and one for the other employees benefiting under the plan. The effect of this rule is that employees who would be excludable under paragraph (b)(1) of this section (applied without regard to section 410(a)(1)(B)), but for the fact that the plan does not apply the greatest permissible minimum age and service conditions, may be treated as excludable employees with respect to the plan. This treatment is only available if each of the following conditions is satisfied:

(A) The plan under which the otherwise excludable employees benefit also benefits employees who are not otherwise excludable.

(B) The plan under which the otherwise excludable employees benefit satisfies section 401(a)(26), both by reference only to otherwise excludable employees and by reference only to employees who are not otherwise excludable.

(C) The contributions or benefits provided to the otherwise excludable employees (expressed as percentages of compensation) are not greater than the contributions or benefits provided to the employees who are not otherwise excludable under the plan.

(D) No highly compensated employee is included in the group of otherwise excludable employees for more than one plan year.

(iii) *Examples.* The following examples illustrate some of the minimum-age-and-service exclusion requirements:

Example 1. Employer X maintains a defined contribution plan, Plan X, under which employees who have not completed 1 year of service are not eligible to participate. Employer X has six employees. Two of the employees participate in Plan X. The other four employees have not completed 1 year of service and are therefore not eligible to participate in Plan X. The four employees who have not completed 1 year of service are excludable employees and may be disregarded for purposes of applying the minimum participation test. Therefore, Plan X satisfies section 401(a)(26) because both of the two employees who must be considered are participants in Plan X.

Example 2. Employer Y has 100 employees and maintains two plans, Plan 1 and Plan 2. Plan 1 provides that employees who have not completed 1 year of service are not eligible to participate. Plan 2 has no minimum age or service requirement. Twenty of Y's employees do not meet the minimum service requirement under Plan 1. Each plan satisfies the ratio test under section 410(b)(1)(B). In testing Plan 1 to determine whether it satisfies section 401(a)(26), the 20 employees not meeting the minimum age and service requirement under Plan 1 are treated as excludable employees. In testing Plan 2 to determine whether it satisfies section 401(a)(26), no employees are treated as excludable employees because Plan 2 does not have a minimum age or service requirement.

(2) *Certain air pilots.* An employee who is excluded from consideration under section 410(b)(3)(B) (relating to certain air pilots) may be treated as an excludable employee.

(3) *Certain nonresident aliens*—(i) *In general.* An employee who is excluded from consideration under section 410(b)(3)(C) (relating to certain nonresident aliens) may be treated as an excludable employee.

(ii) *Special treaty rule.* In addition, an employee who is a nonresident alien (within the meaning of section 7701(b)(1)(B)) and who does receive earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3)) is permitted to be excluded, if all of the employee's earned income from the employer from sources within the United States is exempt from United States income tax under an applicable income tax convention. This paragraph (b)(3)(ii) applies only if all employees described in the preceding sentence are so excluded.

(4) *Employees covered pursuant to a collective bargaining agreement.* When testing a plan benefiting only noncollectively bargained employees, an employee who is excluded from consideration under section 410(b)(3)(A) (exclusion for employees included in a unit of employees covered by a collective bargaining agreement) may be treated as an excludable employee. This rule may be applied separately to each collective

bargaining agreement. See §1.401(a)(26)–8 for the definitions of the terms ‘‘collective bargaining agreement’’, ‘‘collectively bargained employee,’’ and ‘‘covered pursuant to a collective bargaining agreement’’.

(5) *Employees not covered pursuant to a collective bargaining agreement.* When testing a plan that benefits only employees who are included in a group of employees who are covered pursuant to a collective bargaining agreement, an employee who is not included in the group of employees who are covered by the collective bargaining agreement may be treated as an excludable employee.

(6) *Examples.* The following examples illustrate the excludable employee rules that relate to employees covered pursuant to collective bargaining agreements. For purposes of these examples assume that no other exclusion rules are applicable.

Example 1. Employer W has 70 collectively bargained employees and 30 non-collectively bargained employees. Employer W maintains Plan W, which benefits only the 30 non-collectively bargained employees. The 70 collectively bargained employees may be treated as excludable employees and thus may be disregarded in applying section 401(a)(26) to Plan W.

Example 2. Assume the same facts as *Example I,* except that the Commissioner has determined that the employee representative is not a bona fide employee representative under section 7701(a)(46) and thus there are no ‘‘collectively bargained employees.’’ In this case, all employees of W must be considered in determining whether section 401(a)(26) is met.

Example 3. Employer X has collectively bargained employees and 70 noncollectively bargained employees. Employer X maintains Plan X, which benefits only the 30 collectively bargained employees. Employer X may treat the non-collectively bargained employees as excludable employees and disregard them in applying section 401(a)(26) to the collectively bargained plan.

Example 4. Assume the same facts as *Example 3,* except that the Commissioner has determined that the employee representative is not a bona fide employee representative under section 7701(a)(46) and thus there is no recognized collective bargaining agreement. In this case, Employer X may not treat the non-collectively bargained employees of X as excludable employees.

Example 5. Assume the same facts as *Example 3,* except that 3 percent of the 30 collectively bargained employees are professionals. In this case, Employer X may not treat the non-collectively bargained employees of X as excludable employees.

Example 6. Employer Y has 100 collectively bargained employees. Thirty of Y’s employees are represented by Collective Bargaining Unit 1 and covered under Plan 1. Seventy of Y’s employees are represented by Collective Bargaining Unit 2 and covered under Plan 2. For purposes of testing Plan 1, the employees of Collective Bargaining Unit 2 may be treated as excludable employees. Similarly, for purposes of testing Plan 2, the employees of Collective Bargaining Unit 1 may be treated as excludable employees.

(7) *Certain terminating employees*—(i) *In general.* An employee may be treated as an excludable employee for a plan year with respect to a particular plan if—

(A) The employee does not benefit under the plan for the plan year,

(B) The employee is eligible to participate in the plan,

(C) The plan has a minimum period of service requirement or a requirement that an employee be employed on the last day of the plan year (last-day requirement) in order for an employee to accrue a benefit or receive an allocation for the plan year,

(D) The employee fails to accrue a benefit or receive an allocation under the plan solely because of the failure to satisfy the minimum period of service or last-day requirement,

(E) The employee terminates employment during the plan year with no more than 500 hours of service, and the employee is not an employee as of the last day of the plan year (for purposes of this paragraph (b)(7)(i)(E), a plan that uses the elapsed time method of determining years of service may use either 91 consecutive calendar days or 3 consecutive calendar months instead of 500 hours of service, provided it uses the same convention for all employees during a plan year), and

(F) If this paragraph (b)(7) is applied with respect to any employee with respect to a plan for a plan year, it is applied with respect to all employees with respect to the plan for the plan year.

(ii) *Hours of service.* For purposes of this paragraph (b)(7), the term ‘‘hour of service’’ has the same meaning as set forth in 29 CFR 2530.200b–2 under the general method of crediting service for the employee. If one of the equivalencies set forth in 29 CFR 2530.200b–3 is used for crediting service under the plan, the 500-hour requirement must be adjusted accordingly.

(8) *Employees of qualified separate lines of business.* If an employer is treated as operating qualified separate lines of business for purposes of section 401(a)(26) in accordance with § 1.414(r)–1(b), in testing a plan that benefits employees of one qualified separate line of business, the employees of the other qualified separate lines of business of the employer are treated as excludable employees. See §§ 1.414(r)–1(c)(3) and 1.414(r)–9 (separate application of section 401(a)(26) to the employees of a qualified separate line of business). The rule in this paragraph (b)(8) does not apply to a plan that is tested under the special rule for employer-wide plans in § 1.414(r)–l(c)(3)(ii) for a plan year.

(c) *Former employees*—(1) *In general.* For purposes of applying section 401(a)(26) with respect to former employees, all former employees of the employer are taken into account, except that the employer may treat a former employee described in paragraph (c)(2) through (c)(4) of this section as an excludable former employee. If any of the former employee exclusion rules under paragraphs (c)(2) through (c)(4) of this section is applied, it must be applied to all former employees for the plan year on a consistent basis.

(2) *Employees terminated before a specified date.* The employer may treat a former employee as excludable if—

(i) The former employee became a former employee either prior to January 1, 1984, or prior to the tenth calendar year preceding the calendar year in which the current plan year begins, and

(ii) The former employee became a former employee in a calendar year that precedes the earliest calendar year in which any former employee who benefits under the plan in the current plan year became a former employee.

(3) *Previously excludable employees.* The employer may treat a former employee as excludable if the former employee was an excludable employee (or would have been an excludable employee if these regulations had been in effect) under the rules of paragraphs (a) and (b) of this section during the plan year in which the former employee became a former employee. If the employer treats a former employee as excludable pursuant to this paragraph (c)(3), the former employee is not taken into account with respect to a plan even if the former employee is benefiting under the plan.

(4) *Vested accrued benefits eligible for mandatory distribution.* A former employee may be treated as an excludable former employee if the present value of the former employee's vested accrued benefit does not exceed the cash-out limit in effect under § 1.411(a)–11T(c)(3)(ii). This determination is made in accordance with the rules of sections 411(a)(11) and 417(e).

(d) *Certain police or firefighters.* An employer may apply section 401(a)(26) separately with respect to any classification of qualified public safety employees for whom a separate plan is maintained. Thus, for purposes of testing a separate plan covering a class of qualified public safety employees, all employees who are not in that classification are treated as excludable employees. Also, such employees need not be taken into account in determining whether or not any other plan satisfies section 401(a)(26). For purposes of this paragraph (d), *qualified public safety employee* means any employee of any police department or fire department organized and operated by a State or political subdivision if the employee provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of a State or political subdivision.

[T.D. 8375, 56 FR 63416, Dec. 4, 1991, as amended by T.D. 8794, 63 FR 70338, Dec. 21, 1998]

§ 1.401(a)(26)–7 Testing methods.

(a) *Testing on each day of the plan year.* A plan satisfies section 401(a)(26) for a plan year only if the plan satisfies section 401(a)(26) on each day of the plan year. An employee benefits on a day if the employee is a participant for such day and the employee benefits under the plan for the year under the rules in § 1.401(a)(26)–5.

(b) *Simplified testing method.* A plan is treated as satisfying the requirements of paragraph (a) of this section if it satisfies section 401(a)(26) on any single plan day during the plan year, but only if that day is reasonably representative of the employer's workforce and the plan's coverage. A plan does not have to be tested on the same day each plan year.

(c) *Retroactive correction.* If a plan fails to satisfy section 401(a)(26) for a plan year, the plan may be retroactively amended during the same period and under the same conditions as provided for in § 1.401(a)(4)–11(g)(3) through (g)(5) to satisfy section 401(a)(26). A plan merger that occurs by the end of the period provided in § l.401(a)(4)–11(g)(3)(iv) is treated solely for purposes of section 401(a)(26) as if it were effective as of the first day of the plan year. The rule of this paragraph (c) may be illustrated by the following example.

Example. Assume that an employer with 500 employees maintains two defined contribution plans. Plan A benefits 45 employees. Plan B benefits 50 employees. Immediately before the end of the period provided for in § 1.401(a)(4)–11(g)(3)(iv), the employer expands coverage under Plan A to benefit 20 more employees retroactively for the plan year. Thus, Plan A satisfies paragraph (a) of this section for the plan year. Alternatively, before the end of the period provided for in § 1.401(a)(4)–11(g)(3)(iv), or later if a later period is applicable under section 401(b), the employer could merge Plan A with Plan B to satisfy section 401(a)(26).

[T.D. 8375, 56 FR 63418, Dec. 4, 1991]

§ 1.401(a)(26)–8 Definitions.

In applying this section and §§ 1.401(a)(26)–1 through 1.401(a)(26)–9 the definitions in this section govern unless otherwise provided.

Collective bargaining agreement. Collective bargaining agreement means an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and the employer that satisfies § 301.7701–17T. Employees described in section 413(b)(8) who are employees of the union or the plan and are treated as employees of an employer are not employees covered pursuant to a collective bargaining agreement for purposes of section 401(a)(26) unless the employees are actually covered pursuant to such an agreement.

Collectively bargained employee. Collectively bargained employee means a collectively bargained employee within the meaning of § 1.410(b)–6(d)(2).

Covered by a collective bargaining agreement. Covered by a collective bargaining agreement means covered by a collective bargaining agreement within the meaning of § 1.410(b)–6(d)(2)(iii).

Defined benefit plan. Defined benefit plan means a defined benefit plan within the meaning of § 1.410(b)–9.

Defined contribution plan. Defined contribution plan means a defined contribution plan within the meaning of § 1.410(b)–9.

Employee. Employee means an employee, within the meaning of § 1.410(b)–9.

Employer. Employer means the employer within the meaning of § 1.410(b)–9.

ESOP. ESOP means an employee stock ownership plan within the meaning of section 4975(e)(7) or a tax credit employee stock ownership plan within the meaning of section 409(a).

Former employee. Former employee means a former employee within the meaning of § 1.410(b)–9.

Highly compensated employee. Highly compensated employee means an employee who is highly compensated within the meaning of section 414(q).

Highly compensated former employee. Highly compensated former employee means a former employee who is highly compensated within the meaning of section 414(q)(9).

Multiemployer plan. Multiemployer plan means a multiemployer plan within the meaning of section 414(f).

Noncollectively bargained employee. Noncollectively bargained employee means an employee who is not a collectively bargained employee.

Nonhighly compensated employee. Nonhighly compensated employee' means an employee who is not a highly compensated employee.

Nonhighly compensated former employee. Nonhighly compensated former employee means a former employee who is not a highly compensated former employee.

Plan. Plan means plan as defined in § 1.401(a)(26)–2(c).

Plan year. Plan year means the plan year of the plan as defined in the written plan document. In the absence of a specifically designated plan year, the plan year is deemed to be the calendar year.

Professional employee. Professional employee means a professional employee as defined in §1.410(b)–9.

Section 401(k) plan. Section 401(k) plan means a plan consisting of elective contributions described in §1.401(k)–1 (g)(3) under a qualified cash or deferred arrangement described in §1.401(k)–1(a)(4)(i).

Section 401(m) plan. Section 401(m) plan means a plan consisting of employee contributions described in §1.401(m)–1(f)(6) or matching contributions described in §1.401(m)–1(f)(12), or both.

[T.D. 8375, 56 FR 63418, Dec. 4, 1991]

§1.401(a)(26)–9 Effective dates and transition rules.

(a) *In general.* Except as provided in paragraphs (b), (c), and (d) of this section, section 401(a)(26) and the regulations thereunder apply to plan years beginning on or after January 1, 1989.

(b) *Transition rules*—(1) *Governmental plans and certain section 403(b) annuities.* Section 401(a)(26) is treated as satisfied for plan years beginning before the later of January 1, 1996, or 90 days after the opening of the first legislative session beginning on or after January 1, 1996, of the governing body with authority to amend the plan, if that body does not meet continuously, in the case of governmental plans described in section 414(d), including plans subject to section 403(b)(12)(A)(i) (nonelective plans). For purposes of this paragraph (b)(1), the term ‘‘governing body with authority to amend the plan’’ means the legislature, board, commission, council, or other governing body with authority to amend the plan.

(2) *Early retirement ‘‘window-period’’ benefits.* Early retirement benefits available under a plan only to employees who retire within a limited period of time, not to exceed one year, are treated as satisfying section 401(a)(26) if such benefits are provided under plan terms that were adopted and in effect on or before March 14, 1989.

(3) *Employees who do not benefit because of a minimum-period-of-service requirement or a last-day requirement.* For the first plan year beginning after December 31, 1988, and before January 1, 1990, employees who are eligible to participate under the plan and who fail to accrue a benefit solely because of the failure to satisfy either a minimum-period-of-service requirement of 1000 hours of service or less or a last-day requirement may be treated as benefiting under the plan.

(4) *Certain plan terminations*—(i) *In general.* Except as provided in paragraph (b)(4)(ii) of this section, if a plan terminates after section 401(a)(26) becomes effective with respect to the plan (as determined under paragraph (a) of this section), the plan is not treated as a qualified plan upon termination unless it complies with section 401(a)(26) and the regulations thereunder (to the extent they are applicable) for all periods for which section 401(a)(26) is effective with respect to the plan.

(ii) *Exception.* Notwithstanding paragraphs (a) and (b)(4)(i) of this section, a plan does not fail to be treated as a qualified plan upon termination merely because the plan fails to satisfy the requirements of section 401(a)(26) and the regulations thereunder if the plan is terminated with a termination date on or before December 31, 1989, and either of the following conditions is satisfied:

(A) In the case of a defined benefit plan, no highly compensated employee has an accrued benefit under the plan exceeding the lesser of either the benefit the employee had accrued as of the close of the last plan year beginning before January 1, 1989, or the benefit the employee would have accrued as of the close of the last plan year under the terms of the plan in effect and applicable with respect to the employee on December 13, 1988.

(B) In the case of a defined contribution plan, no highly compensated employee receives a contribution allocation for any plan year beginning after December 31, 1988. For this purpose, a contribution allocation with respect to an employee for a plan year beginning before January 1, 1989, may be treated as a contribution allocation for a plan year beginning after December 31, 1988, if the allocation for the prior year exceeds the allocation that the employee would have received for such year under the terms of the plan in effect and applicable with respect to the employee on December 13, 1988. An allocation of forfeitures to highly compensated employees with respect to contributions made for plan years beginning before January 1, 1988, does not cause a defined contribution plan to fail to satisfy the conditions of this paragraph (b)(4)(ii)(B).

(5) *ESOPs and non-ESOPs.* Notwithstanding paragraph (a) of this section and §54.4975–11(a)(5) of this Chapter, an employer may treat the rule in §1.401(a)(26)–2(d)(1)(i), regarding mandatory disaggregation of ESOPs and non-ESOPs as not effective for plan years beginning before January 1, 1990.

(c) *Waiver of excise tax on reversions*—(1) *In general.* Pursuant to section 1112(e)(3) of the Tax Reform Act of 1986 (TRA '86), if certain conditions are satisfied, a waiver of the excise tax under section 4980 applies with respect to any employer reversion that occurs by reason of the termination or merger of a plan before the first year to which section 401(a)(26) applies to the plan. In general, the applicable conditions are that the plan must have been in existence on August 16, 1986; that if section 401(a)(26) was in effect for the plan year including August 16, 1986, the plan would have failed to satisfy the requirements of section 401(a)(26) and would have continued to fail the requirements at all times thereafter; that the plan satisfies the applicable conditions in paragraph (b)(4)(ii)(A) or (B) of this section; and that certain requirements regarding asset or liability transfers and mergers and spinoffs involving the plan after August 16, 1986, are satisfied.

(2) *Termination date.* An employer reversion with respect to a plan is eligible for the section 4980 excise tax waiver only if the employer reversion occurs by reason of the termination of the plan with a termination date prior to the first plan year for which section 401(a)(26) applies to the plan. Solely for purposes of this waiver, the employer reversion is treated as satisfying this paragraph (c)(2) even though the plan's termination date is during the first plan year for which section 401(a)(26) applies to the plan if the plan's termination date is on or before May 31, 1989. If the termination date occurs in the first plan year for which section 401(a)(26) applied to the plan and the employer receives a reversion that is eligible for the waiver of the section 4980 tax, the plan is subject to the interest rate restriction set forth in section 11 12(e)(3)(B) of TRA '86 as amended.

(3) *Failure to satisfy section 401(a)(26).* An employer reversion with respect to a plan is eligible for the excise tax waiver only if the plan was in existence on August 16, 1986, and, if section 401(a)(26) had applied to the plan for the plan year including such date, the plan would have failed to satisfy section 401(a)(26) for the plan year and continuously thereafter until the plan's termination or merger. For purposes of this paragraph (c)(3), a plan is treated as though it would have failed to satisfy section 401(a)(26) before such section actually applied to the plan only if the plan (as defined under section 414(1)) failed to benefit at least the lesser of 50 employees or 40 percent of the employer's employees. In general, this determination is to be made on the basis of only the applicable statutory provisions, without regard to the regulations under section 401(a)(26). Thus, for example, the prior benefit structure rules in §1.401(a)(26)–3 do not apply in determining whether a plan would have failed to satisfy section 401(a)(26) for plan years beginning prior to the effective date of section 401(a)(26) with respect to the plan.

(d) *Special rule for collective bargaining agreements.* In the case of a plan maintained pursuant to one or more collective bargaining agreements (as defined in §1.401(a)(26)–8(a)) that were ratified before March 1, 1986, section 401(a)(26) and the regulations thereunder shall not apply to plan years beginning before the earlier of—

(1) January 1, 1991, or

(2) The later of—

(i) January 1, 1989, or

(ii) The date on which the last of such collective bargaining agreements terminates. For purposes of this paragraph (d), any extension or renegotiation of any collective bargaining agreement that is ratified after February 28, 1986, is disregarded in determining the date on which such collective bargaining agreement terminates.

[T.D. 8375, 56 FR 63419, Dec. 4, 1991, as amended by T.D. 8487, 58 FR 46838, Sept. 3, 1993]

§ 1.401(a)(31)–1 Requirement to offer direct rollover of eligible rollover distributions; questions and answers.

The following questions and answers relate to the qualification requirement imposed by section 401(a)(31) of the Internal Revenue Code of 1986, pertaining to the direct rollover option for eligible rollover distributions from pension, profit-sharing, and stock bonus plans. Section 401(a)(31) was added by section 522(a) of the Unemployment Compensation Amendments of 1992, Public Law 102–318, 106 Stat. 290 (UCA). For additional UCA guidance under sections 402(c), 402(f), 403(b)(8) and (10), and 3405(c), see §§ 1.402(c)–2, 1.402(f)–1, and 1.403(b)–2, and § 31.3405(c)–1 of this chapter, respectively.

LIST OF QUESTIONS

Q–1: What are the direct rollover requirements under section 401(a)(31)?

Q–2: Does section 401(a)(31) require that a qualified plan permit a direct rollover to be made to a qualified trust that is not part of a defined contribution plan?

Q–3: What is a *direct rollover* that satisfies section 401(a)(31), and how is it accomplished?

Q–4: Is providing a distributee with a check for delivery to an eligible retirement plan a reasonable means of accomplishing a direct rollover?

Q–5: Is an eligible rollover distribution that is paid to an eligible retirement plan in a direct rollover currently includible in gross income or subject to 20-percent withholding?

Q–6: What procedures may a plan administrator prescribe for electing a direct rollover, and what information may the plan administrator require a distributee to provide when electing a direct rollover?

Q–7: May the plan administrator treat a distributee as having made an election under a default procedure where the distributee does not affirmatively elect to make or not make a direct rollover within a certain time period?

Q–8: May the plan administrator establish a deadline after which the distributee may not revoke an election to make or not make a direct rollover?

Q–9: Must the plan administrator permit a distributee to elect to have a portion of an eligible rollover distribution paid to an eligible retirement plan in a direct rollover and to have the remainder of that distribution paid to the distributee?

Q–10: Must the plan administrator allow a distributee to divide an eligible rollover distribution into two or more separate distributions to be paid in direct rollovers to two or more eligible retirement plans?

Q–11: Will a plan satisfy section 401(a)(31) if the plan administrator does not permit a distributee to elect a direct rollover if his or her eligible rollover distributions during a year are reasonably expected to total less than $200?

Q–12: Is a plan administrator permitted to treat a distributee's election to make or not make a direct rollover with respect to one payment in a series of periodic payments as applying to all subsequent payments in the series?

Q–13: Is the eligible retirement plan designated by a distributee to receive a direct rollover distribution required to accept the distribution?

Q–14: For purposes of applying the plan qualification requirements of section 401(a), is an eligible rollover distribution that is paid to an eligible retirement plan in a direct rollover a distribution and rollover or is it a transfer of assets and liabilities?

Q–15: Must a direct rollover option be provided for an eligible rollover distribution that is in the form of a plan loan offset amount?

Q–16: Must a direct rollover option be provided for an eligible rollover distribution from a qualified plan distributed annuity contract?

Q–17: What assumptions may a plan administrator make regarding whether a benefit is an eligible rollover distribution?

Q–18: When must a qualified plan be amended to comply with section 401(a)(31)?

QUESTIONS AND ANSWERS

Q–1: What are the direct rollover requirements under section 401(a)(31)?

A–1: (a) *General rule.* To satisfy section 401(a)(31), added by UCA, a plan must provide that if the distributee of any eligible rollover distribution elects to have the distribution paid directly to an eligible retirement plan, and specifies the eligible retirement plan to which the distribution is to be paid, then the distribution will be paid to that eligible retirement plan in a direct rollover described in Q&A–3 of this section. Thus, the plan must give the distributee the option of having his or her distribution paid in a direct rollover to an eligible retirement plan specified by the distributee. For purposes of section 401(a)(31) and this section, eligible rollover distribution has the meaning set forth in section 402(c)(4) and §1.402(c)–2, Q&A–3 through Q&A–10 and Q&A–14, except as otherwise provided in Q&A–2 of this section, eligible retirement plan has the meaning set forth in section 402(c)(8)(B) and §1.402(c)–2, Q&A–2.

(b) *Related Internal Revenue Code provisions*—(1) *Mandatory withholding.* If a distributee of an eligible rollover distribution does not elect to have the eligible rollover distribution paid directly from the plan to an eligible retirement plan in a direct rollover under section 401(a)(31), the eligible rollover distribution is subject to 20-percent income tax withholding under section 3405(c). See §31.3405(c)–1 of this chapter for guidance concerning the withholding requirements applicable to eligible rollover distributions.

(2) *Notice requirement.* Section 402(f) requires the plan administrator of a qualified plan to provide, within a reasonable period of time before making an eligible rollover distribution, a written explanation to the distributee of the distributee's right to elect a direct rollover and the withholding consequences of not making that election. The explanation also is required to provide certain other relevant information relating to the taxation of distributions. See §1.402(f)–1 for guidance concerning the written explanation required under section 402(f).

(3) *Section 403(b) annuities.* Section 403(b)(10) provides that requirements similar to those imposed by section 401(a)(31) apply to annuities described in section 403(b). See §1.403(b)–2 for guidance concerning the direct rollover requirements for distributions from annuities described in section 403(b).

(c) *Effective date*—(1) *Statutory effective date.* Section 401(a)(31) applies to eligible rollover distributions made on or after January 1, 1993.

(2) *Regulatory effective date.* This section applies to eligible rollover distributions made on or after October 19, 1995. For eligible rollover distributions made on or after January 1, 1993 and before October 19, 1995, §1.401(a)(31)–1T (as it appeared in the April 1, 1995 edition of 26 CFR part 1), applies. However, for any distribution made on or after January 1, 1993 but before October 19, 1995, a plan may satisfy section 401(a)(31) by substituting any or all provisions of this section for the corresponding provisions of §1.401(a)(31)–1T, if any.

Q–2: Does section 401(a)(31) require that a qualified plan permit a direct rollover to be made to a qualified trust that is not part of a defined contribution plan?

A–2: No. Section 401(a)(31)(D) limits the types of qualified trusts that are treated as eligible retirement plans to defined contribution plans that accept eligible rollover distributions. Therefore, although a plan is permitted, at a participant's election, to make a direct rollover to any type of eligible retirement plan, as defined in section 402(c)(8)(B) (including a defined benefit plan), a plan will not fail to satisfy section 401(a)(31) solely because the plan will not permit a direct rollover to a qualified trust that is part of a defined benefit plan. In contrast, if a distributee elects a direct rollover of an eligible rollover distribution to an annuity plan described in section 403(a), that distribution must be paid to the annuity plan, even if the recipient annuity plan is a defined benefit plan.

Q–3: What is a direct rollover that satisfies section 401(a)(31), and how is it accomplished?

A–3: A direct rollover that satisfies section 401(a)(31) is an eligible rollover distribution that is paid directly to an eligible retirement plan for the benefit of the distributee. A direct rollover may be accomplished by any reasonable means of direct payment to an eligible retirement plan. Reasonable means of direct payment include, for example, a wire transfer or the mailing of a check to the eligible retirement plan. If payment is made by check, the check must be negotiable only by the trustee of the eligible retirement plan. If the payment is made by wire transfer, the wire transfer must be directed only to the trustee of the eligible retirement plan. In the case of an eligible retirement plan that does not have a trustee (such as a custodial individual retirement account or an individual retirement annuity), the custodian of the plan or issuer of the contract under the plan, as appropriate, should be substituted for the trustee for purposes of this Q&A–3, and Q&A–4 of this section.

Q–4: Is providing a distributee with a check for delivery to an eligible retirement plan a reasonable means of accomplishing a direct rollover?

A–4: Providing the distributee with a check and instructing the distributee to deliver the check to the eligible retirement plan is a reasonable means of direct payment, provided that the check is made payable as follows: [Name of the trustee] as trustee of [name of the eligible retirement plan]. For example, if the name of the eligible retirement plan is ''Individual Retirement Account of John Q. Smith,'' and the name of the trustee is ''ABC Bank,'' the payee line of a check would read ''ABC Bank as trustee of Individual Retirement Account of John Q. Smith.'' Unless the name of the distributee is included in the name of the eligible retirement plan, the check also must indicate that it is for the benefit of the distributee. If the eligible retirement plan is not an individual retirement account or an individual retirement annuity, the payee line of the check need not identify the trustee by name. For example, the payee line of a check for the benefit of distributee Jane Doe might read, ''Trustee of XYZ Corporation Savings Plan FBO Jane Doe.''

Q–5: Is an eligible rollover distribution that is paid to an eligible retirement plan in a direct rollover currently includible in gross income or subject to 20-percent withholding?

A–5: No. An eligible rollover distribution that is paid to an eligible retirement plan in a direct rollover is not currently includible in the distributee's gross income under section 402(c) and is exempt from the 20-percent withholding imposed under section 3405(c)(2). However, when any portion of the eligible rollover distribution is subsequently distributed from the eligible retirement plan, that portion will be includible in gross income to the extent required under section 402, 403, or 408.

Q–6: What procedures may a plan administrator prescribe for electing a direct rollover, and what information may the plan administrator require a distributee to provide when electing a direct rollover?

A–6: (a) *Permissible procedures.* Except as otherwise provided in paragraph (b) of this Q&A–6, the plan administrator may prescribe any procedure for a distributee to elect a direct rollover under section 401(a)(31), provided that the procedure is reasonable. The procedure may include any reasonable requirement for information or documentation from the distributee in addition to the items of adequate information specified in §31.3405(c)–1(b), Q&A–7 of this chapter. For example, it would be reasonable for the plan administrator to require that the distributee provide a statement from the designated recipient plan that the plan will accept the direct rollover for the benefit of the distributee and that the recipient plan is, or is intended to be, an individual retirement account, an individual retirement annuity, a qualified annuity plan described in section 403(a), or a qualified trust described in section 401(a), as applicable. In the case of a designated recipient plan that is a qualified trust, it also would be reasonable for the plan administrator to require a statement that the qualified trust is not excepted from the definition of an eligible retirement plan by section 401(a)(31)(D) (i.e., is not a defined benefit plan).

(b) *Impermissible procedures.* A plan will fail to satisfy section 401(a)(31) if the plan administrator prescribes any unreasonable procedure, or requires information or documentation, that effectively eliminates or substantially impairs the distributee's ability to elect a direct rollover. For example, it would effectively eliminate or substantially impair the distributee's ability to elect a direct rollover if the recipient plan required the distributee to obtain an opinion of counsel stating that the eligible retirement plan receiving the rollover is a qualified plan or individual retirement account. Similarly, it would effectively eliminate or substantially impair the distributee's ability to elect a direct rollover if the distributing plan required a letter from the recipient eligible retirement plan stating that, upon request by the distributing plan, the recipient plan will automatically return any direct rollover amount that the distributing plan advises the recipient plan was paid incorrectly. It would also effectively eliminate or substantially impair the distributee's ability to elect a direct rollover if the distributing plan required, as a condition for making a direct rollover, a letter from the recipient eligible retirement plan indemnifying the distributing plan for any liability arising from the distribution.

Q–7: May the plan administrator treat a distributee as having made an election under a default procedure where the distributee does not affirmatively elect to make or not make a direct rollover within a certain time period?

A–7: Yes, the plan administrator may establish a default procedure whereby any distributee who fails to make an affirmative election is treated as having either made or not made a direct rollover election. However, the plan administrator may not make a distribution under any default procedure unless the distributee has received an explanation of the default procedure and an explanation of the direct rollover option as required under section 402(f) and §1.402(f)–1, Q&A–1 and unless the timing requirements described in §1.402(f)–1, Q&A–2 and Q&A–3 have been satisfied with respect to the explanations of both the default procedure and the direct rollover option.

Q–8: May the plan administrator establish a deadline after which the distributee may not revoke an election to make or not make a direct rollover?

A–8: Yes, but the plan administrator is not permitted to prescribe any deadline or time period with respect to revocation of a direct rollover election that is more restrictive for the distributee than that which otherwise applies under the plan to revocation of the form of distribution elected by the distributee.

Q–9: Must the plan administrator permit a distributee to elect to have a portion of an eligible rollover distribution paid to an eligible retirement plan in a direct rollover and to have the remainder of that distribution paid to the distributee?

A–9: Yes, the plan administrator must permit a distributee to elect to have a portion of an eligible rollover distribution paid to an eligible retirement plan in a direct rollover and to have the remainder paid to the distributee. However, the plan administrator is permitted to require that, if the distributee elects to have only a portion of an eligible rollover distribution paid to an eligible retirement plan in a direct rollover, that portion be equal to at least a specified minimum amount, provided the specified minimum amount is less than or equal to $500 or any greater amount as prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(*b*) of this chapter. If the entire amount of the eligible rollover distribution is less than or equal to the specified minimum amount, the plan administrator need not allow the distributee to divide the distribution.

Q–10: Must the plan administrator allow a distributee to divide an eligible rollover distribution into two or more separate distributions to be paid in direct rollovers to two or more eligible retirement plans?

A–10: No. The plan administrator is not required (but is permitted) to allow the distributee to divide an eligible rollover distribution into separate distributions to be paid to two or more eligible retirement plans in direct rollovers. Thus, the plan administrator may require that the distributee select a single eligible retirement plan to which the eligible rollover distribution (or portion thereof) will be distributed in a direct rollover.

Q–11: Will a plan satisfy section 401(a)(31) if the plan administrator does not permit a distributee to elect a direct rollover if his or her eligible rollover distributions during a year are reasonably expected to total less than $200?

A–11: Yes. A plan will satisfy section 401(a)(31) even though the plan administrator does not permit any distributee to elect a direct rollover with respect to eligible rollover distributions during a year that are reasonably expected to total less than $200 or any lower minimum amount specified by the plan administrator. The rules described in §31.3405(c)–1, Q&A–14 of this chapter (relating to whether withholding under section 3405(c) is required for an eligible rollover distribution that is less than $200) also apply for purposes of determining whether a direct rollover election under section 401(a)(31) must be provided for an eligible rollover distribution that is less than $200 or the lower specified amount.

Q–12: Is a plan administrator permitted to treat a distributee's election to make or not make a direct rollover with respect to one payment in a series of periodic payments as applying to all subsequent payments in the series?

A–12: (a) Yes. A plan administrator is permitted to treat a distributee's election to make or not make a direct rollover with respect to one payment in a series of periodic payments as applying to all subsequent payments in the series, provided that:

(1) The employee is permitted at any time to change, with respect to subsequent payments, a previous election to make or not make a direct rollover; and

(2) The written explanation provided under section 402(f) explains that the election to make or not make a direct rollover will apply to all future payments unless the employee subsequently changes the election.

(b) See §1.402(f)–1, Q&A–3 for further guidance concerning the rules for providing section 402(f) notices when eligible rollover distributions are made in a series of periodic payments.

Q–13: Is the eligible retirement plan designated by a distributee to receive a direct rollover distribution required to accept the distribution?

A–13: (a) *General rule.* No. Although section 401(a)(31) requires qualified plans to provide distributees the option to make a direct rollover of their eligible rollover distributions to an eligible retirement plan, it imposes no requirement that any eligible retirement plan accept rollovers. Thus, a plan can refuse to accept rollovers. Alternatively, a plan can limit the circumstances under which it will accept rollovers. For example, a plan can limit the types of plans from which it will accept a rollover or limit the types of assets it will accept in a rollover (such as accepting only cash or its equivalent).

(b) *Qualification of receiving plan.* A plan that accepts a direct rollover from another plan will not fail to satisfy section 401(a) merely because the plan making the distribution is, in fact, not qualified under section 401(a) or section 403(a) at the time of the distribution, if, prior to accepting the rollover, the receiving plan reasonably concluded that the distributing plan was qualified under section 401(a) or section 403(a). For example, the receiving plan may reasonably conclude that the distributing plan was qualified under section 401(a) or section 403(a) if, prior to accepting the rollover, the plan administrator of the distributing plan provided the receiving plan with a statement that the distributing plan had received a determination letter from the Commissioner indicating that the plan was qualified.

Q–14: For purposes of applying the plan qualification requirements of section 401(a), is an eligible rollover distribution that is paid to an eligible retirement plan in a direct rollover a distribution and rollover or is it a transfer of assets and liabilities?

A–14: For purposes of applying the plan qualification requirements of section 401(a), a direct rollover is a distribution and rollover of the eligible rollover distribution and not a transfer of assets and liabilities. For example, if the consent requirements under section 411(a)(11) or sections 401(a)(11) and 417(a)(2) apply to the distribution, they must be satisfied before the eligible rollover distribution may be distributed in a direct rollover. Similarly, the direct rollover is not a transfer of assets and liabilities that must satisfy the requirements of section 414(l). Finally, a direct rollover is not a transfer of benefits for purposes of applying the requirements under section 411(d)(6), as described in §1.411(d)–4, Q&A–3. Therefore, for example, the eligible retirement plan is not required to provide, with respect to amounts paid to it in a direct rollover, the same optional forms of benefits that were provided under the plan that made the direct rollover. The direct rollover requirements of section 401(a)(31) do not affect the ability of a qualified plan to make an elective or nonelective transfer of assets and liabilities to another qualified plan in accordance with applicable law (such as section 414(l)).

Q–15: Must a direct rollover option be provided for an eligible rollover distribution that is in the form of a plan loan offset amount?

A–15: A plan will not fail to satisfy section 401(a)(31) merely because the plan does not permit a distributee to elect a direct rollover of an eligible rollover distribution in the form of a plan loan offset amount. Section 1.402(c)–2(b), Q&A–9 defines a plan loan offset amount, in general, as a distribution that occurs when, under the terms governing a plan loan, the participant's accrued benefit is reduced (offset) in order to repay the loan. A plan administrator is permitted to allow a direct rollover of a participant note for a plan loan to a qualified trust described in section 401(a) or a qualified annuity plan described in section 403(a). See §1.402(c)–2, Q&A–9 for examples illustrating the rules for plan loan offset amounts that are set forth in this Q&A–15. See §31.3405(c)–1, Q&A–11 of this chapter for guidance concerning special withholding rules that apply to a distribution in the form of a plan loan offset amount.

Q–16: Must a direct rollover option be provided for an eligible rollover distribution from a qualified plan distributed annuity contract?

A–16: Yes. If any amount to be distributed under a qualified plan distributed annuity contract is an eligible rollover distribution (in accordance with §1.402(c)–2), Q&A–10 the annuity contract must satisfy section 401(a)(31) in the same manner as a qualified plan under section 401(a). Section 1.402(c)–2, Q&A–10 defines a qualified plan distributed annuity contract as an annuity contract purchased for a participant, and distributed to the participant, by a qualified plan. In the case of a qualified plan distributed annuity contract, the payor under the contract is treated as the plan administrator. See §31.3405(c)–1, Q&A–13 of this chapter concerning the application of mandatory 20-percent withholding requirements to distributions from a qualified plan distributed annuity contract.

Q–17: What assumptions may a plan administrator make regarding whether a benefit is an eligible rollover distribution?

A–17: (a) *General rule.* For purposes of section 401(a)(31), a plan administrator may make the assumptions described in paragraphs (b) and (c) of this Q&A–17 in determining the amount of a distribution that is an eligible rollover distribution for which a direct rollover option must be provided. Section 31.3405(c)–1, Q&A–10 of this chapter provides assumptions for purposes of complying with section 3405(c). See §1.402(c)–2, Q&A–15 concerning the effect of these assumptions for purposes of section 402(c).

(b) *$5,000 death benefit.* A plan administrator is permitted to assume that a distribution from the plan that qualifies for the $5,000 death benefit exclusion under section 101(b) is the only death benefit being paid with respect to a deceased employee that qualifies for that exclusion. Thus, to the extent that such a distribution would be excludible from gross income based on this assumption, the plan administrator is permitted to assume that it is not an eligible rollover distribution.

(c) *Determination of designated beneficiary.* For the purpose of determining the amount of the minimum distribution required to satisfy section 401(a)(9)(A) for any calendar year, the plan administrator is permitted to assume that there is no designated beneficiary.

Q–18: When must a qualified plan be amended to comply with section 401(a)(31)?

A–18: Even though section 401(a)(31) applies to distributions from qualified plans made on or after January 1, 1993, a qualified plan is not required to be amended before the last day by which amendments must be made to comply with the Tax Reform Act of 1986 and related provisions, as permitted in other administrative guidance of general applicability, provided that:

(a) In the interim period between January 1, 1993, and the date on which the plan is amended, the plan is operated in accordance with the requirements of section 401(a)(31); and

(b) The amendment applies retroactively to January 1, 1993.

[T.D. 8619, 60 FR 49204, Sept. 22, 1995]

§ 1.401(b)–1 Certain retroactive changes in plan.

(a) *General rule.* Under section 401(b) a stock bonus, pension, profit-sharing, annuity, or bond purchase plan which does not satisfy the requirements of section 401(a) on any day solely as a result of a disqualifying provision (as defined in paragraph (b) of this section) shall be considered to have satisfied such requirements on such date if, on or before the last day of the remedial amendment period (as determined under paragraphs (d), (e) and (f) of this section) with respect to such disqualifying provision, all provisions of the plan which are necessary to satisfy all requirements of sections 401(a), 403(a), or 405(a) are in effect and have been made effective for all purposes for the whole of such period. Under some facts and circumstances, it may not be possible to amend a plan retroactively so that all provisions of the plan which are necessary to satisfy the requirements of section 401(a) are in fact made effective for the whole remedial amendment period. If it is not possible, the requirements of this section will not be satisfied even if the employer adopts a retroactive plan amendment which, in form, appears to satisfy such requirements. Section 401(b) does not permit a plan to be made retroactively effective, for qualification purposes, for a taxable year prior to the taxable year of the employer in which the plan was adopted by such employer.

(b) *Disqualifying provisions.* For purposes of this section, with respect to a plan described in paragraph (a) of this section, the term ‘‘disqualifying provision’’ means:

(1) A provision of a new plan, the absence of a provision from a new plan, or an amendment to an existing plan, which causes such plan to fail to satisfy the requirements of the Code applicable to qualification of such plan as of the date such plan or amendment is first made effective.

(2) A plan provision which results in the failure of the plan to satisfy the qualification requirements of the Code by reason of a change in such requirements—

(i) Effected by the Employee Retirement Income Security Act of 1974 (Pub. L. 93–406, 88 Stat. 829), hereafter referred to as ‘‘ERISA,’’ or the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. 97–248, 96 Stat. 324), hereafter referred to as ‘‘TEFRA,’’ or

(ii) Effective before the first day of the first plan year beginning after December 31, 1989 and that is effected by the Tax Reform Act of 1986 (Pub. L. 99–514, 100 Stat. 2085, 2489), hereafter referred to as ‘‘TRA ’86,’’ the Omnibus Budget Reconciliation Act of 1986, (Pub. L. 99–509, 100 Stat. 1874), hereafter referred to as ‘‘OBRA ’86,’’ or the Omnibus Budget Reconciliation Act of 1987 (Pub. L. 100–203, 101 Stat. 1330), hereafter referred to as ‘‘OBRA ’87.’’ For purposes of this paragraph (b)(2)(ii), a disqualifying provision includes any plan provision that is integral to a qualification requirement changed by TRA ’86, OBRA ’86, or OBRA ’87 or any requirement treated by the Commissioner, directly or indirectly, as if section 1140 of TRA ’86 applied to it, but only to the extent such provision is effective before the first day of the first plan year beginning after December 31, 1989. With respect to disqualifying provisions described in this paragraph (b)(2)(ii) effective before the first day of the first plan year which begins after December 31, 1988, there must be compliance with the conditions of section 1140 of TRA ’86 (other than the requirement that the plan amendment be made on or before the last day of the first plan year beginning after December 31, 1988), including operation in accordance with the plan provision as of its effective date with respect to the plan.

(3) A plan provision described in § 1.401(b)–1T(b)(3).

(c) *Special rules applicable to disqualifying provisions.* For special rules applicable to disqualifying provisions, see § 1.401(b)–1T(c).

(d) *Remedial amendment period.* (1) The remedial amendment period with respect to a disqualifying provision begins:

(i) In the case of a provision of, or absence of a provision from, a new plan, described in paragraph (b)(1) of this section, the date the plan is put into effect,

(ii) In the case of an amendment to an existing plan, described in paragraph (b)(1) of this section, the date the plan amendment is adopted or put into effect (whichever is earlier),

(iii) In the case of a disqualifying provision described in paragraph (b)(2) of this section, the date on which the change effected by ERISA, TEFRA, TRA '86, OBRA '86, OBRA '87, or a qualification requirement that is treated, directly or indirectly, as subject to the conditions of section 1140 of TRA '86 described in paragraph (b)(2) of this section, became effective with respect to such plan or, in the case of a provision, described in paragraph (b)(2)(ii) of this section, that is integral to such qualification requirement, the first day on which the plan was operated in accordance with such provision, or

(iv) In the case of a disqualifying provision described in §1.401(b)–1T(b)(3), the date described in §1.401(b)–1T(d)(1)(iv) or (v), whichever applies to the disqualifying provision.

(2) Unless further extended as provided by paragraph (e) of this section, the remedial amendment period ends with the latest of:

(i) In the case of a plan maintained by one employer, the time prescribed by law, including extensions, for filing the income tax return (or partnership return of income) of the employer for the employer's taxable year in which falls the latest of:

(A) The date on which the remedial amendment period begins.

(B) The date on which a plan amendment described in paragraph (b)(1) of this section is adopted, or

(C) The date on which a plan amendment described in paragraph (b)(1) of this section is made effective,

(ii) In the case of a plan maintained by one employer, the last day of the plan year within which falls the latest of:

(A) The date on which the remedial amendment period begins,

(B) The date on which a plan amendment described in paragraph (b)(1) of this section is adopted, or

(C) The date on which a plan amendment described in paragraph (b)(1) of this section is made effective,

(iii) In the case of a plan maintained by more than one employer, the last day of the tenth month following the last day of the plan year in which falls the latest of:

(A) The date on which the remedial amendment period begins,

(B) The date on which a plan amendment described in paragraph (b)(1) of this section is adopted, or

(C) The date of which a plan amendment described in paragraph (b)(1) of this section is made effective, or

(iv) December 31, 1976, but only in the case of a plan to which section 411 (relating to minimum vesting standards) applies without regard to section 411(e)(2), and only in the case of a remedial amendment period which began on or after September 2, 1974.

(3) For purposes of paragraphs (d)(2)(i), (d)(2)(ii), and (d)(2)(iii) of this section, for any disqualifying provision described in paragraph (b)(2)(ii) of this section, the remedial amendment period shall be deemed to have begun with the first day of the first plan year which begins after December 31, 1988.

(4) For purposes of this paragraph (d)(2) of this section, a master or prototype plan shall not be considered to be a plan maintained by more than one employer, and whether or not a plan is maintained by more than one employer, shall be determined without regard to section 414 (b) and (c) except that if a plan is maintained solely by an affiliated group of corporations (within the meaning of section 1504) which files a consolidated income tax return pursuant to section 1501 for a taxable year within which falls the latest of the dates described in paragraph (d)(2)(i) of this section, such plan shall be deemed to be maintained by one employer.

(e) *Extensions of remedial amendment period*—(1) *Opinion letter request by sponsoring organization of master or prototype plan*. In the case of an employer who has adopted a master or prototype plan, a remedial amendment period that began on or after September 2, 1974, shall not end prior to the later of:

(i) June 30, 1977, or

(ii) The last day of the month that is six months after the month in which:

(A) The opinion letter with respect to the request of the sponsoring organization is issued by the Internal Revenue Service,

(B) Such request is withdrawn, or

(C) Such request is otherwise disposed of by the Internal Revenue Service. The rules contained in this subparagraph apply only if the sponsoring organization of such master or prototype plan has, after September 2, 1974, and on or before December 31, 1976, filed a request for an opinion letter with respect to the initial or continuing qualification of the plan (or a trust which is part of the plan). The provisions of this paragraph (e)(1) apply to a master or prototype plan adopted to replace another plan even though the remedial amendment period applicable to the replaced plan has expired at the time of adoption of the replacement plan.

(2) *Notification letter request by law firm sponsor of district-approved plan.* In the case of an employer who has adopted a pattern plan, a remedial amendment period that began on or after September 2, 1974, shall not end prior to the later of:

(i) June 30, 1977, or

(ii) The last day of the month that is six months after the month in which:

(A) The notification letter with respect to the request of the sponsoring law firm is issued by the Internal Revenue Service,

(B) Such request is withdrawn, or

(C) Such request is otherwise disposed of by the Internal Revenue Service. The rules contained in this subparagraph shall apply only if the sponsoring law firm of such pattern plan has, on or before December 31, 1976, filed a request for a notification letter with the Internal Revenue Service with respect to the initial or continuing qualification of the plan (or a trust which is part of the plan). The provisions of this paragraph (e)(2) apply to a pattern plan adopted to replace another plan even though the remedial amendment period applicable to the replaced plan has expired at the time of the adoption of the replacement plan.

(3) *Determination letter request by employer or plan administrator.* If on or before the end of a remedial amendment period determined without regard to this paragraph (e), or in a case to which paragraph (e) (1) or (2) of this section applies, on or before the 90th day following the later of the dates described in paragraph (e) (1) or (2) of this section, the employer or plan administrator files a request pursuant to §601.201(s) of this chapter (Statement of Procedural Rules) for a determination letter with respect to the initial or continuing qualification of the plan, or a trust which is part of such plan, such remedial amendment period shall be extended until the expiration of 91 days after:

(i) The date on which notice of the final determination with respect to such request for a determination letter is issued by the Internal Revenue Service, such request is withdrawn, or such request is otherwise finally disposed of by the Internal Revenue Service, or

(ii) If a petition is timely filed with the United States Tax Court for a declaratory judgment under section 7476 with respect to the final determination (or the failure of the Internal Revenue Service to make a final determination) in response to such request, the date on which the decision of the United States Tax Court in such proceeding becomes final.

(4) *Transitional rule.* In the case of a request for a determination letter described in and filed within the time prescribed in paragraph (e)(3) of this section with respect to which a final determination is issued by the Internal Revenue Service on or before September 28, 1976 the remedial amendment period described in paragraph (d) of this section shall not end prior to the expiration of 150 days beginning on the date of such final determination by the Internal Revenue Service.

(5) *Disqualifying provision prior to September 2, 1974.* If the remedial amendment period with respect to a disqualifying provision described in paragraph (b)(1) of this section began prior to September 2, 1974, and the provisions of paragraphs (e)(5)(i), (ii) and (iii) of this section are satisfied, the remedial amendment period described in paragraph (d) shall not end prior to December 31, 1976. This subparagraph shall apply only if—

(i) A request pursuant to §601.201 of this chapter for a determination letter with respect to the initial or continuing qualification of the plan (or a trust which is part of the plan) was filed not later than the later of:

(A) The time prescribed by law, including extensions, for filing the income tax return (or partnership return of income) of the employer for the employer's taxable year in which falls the date on which the remedial amendment period began, or

(B) The date 6 months after the close of such taxable year,

(ii) The employer, either:

(A) While such request for a determination letter is or was under consideration by the Internal Revenue Service or,

(B) Promptly after the date on which notice of the final determination with respect to such request for a determination letter is issued by the Internal Revenue Service, such request is withdrawn, or such request is otherwise finally disposed of by the Internal Revenue Service, adopts or adopted either a plan amendment retroactive to the date on which the remedial amendment period began, or a prospective plan amendment, and

(iii) The amendment described in paragraph (e)(5)(ii) of this section would have resulted in the plan's satisfying the requirements of section 401(a) of the Code from the beginning of the remedial amendment period to the date such amendment was made if this section had been in effect during such period, and in the case of a prospective amendment, if such amendment had been made retroactive to such beginning date.

(f) *Discretionary extensions.* At his discretion, the Commissioner may extend the remedial amendment period or may allow a particular plan to be amended after the expiration of its remedial amendment period and any applicable extension of such period. In determining whether such an extension will be granted, the Commissioner shall consider, among other factors, whether substantial hardship to the employer would result if such an extension were not granted, whether such an extension is in the best interest of plan participants, and whether the granting of the extension is adverse to the interests of the Government. The mere absence of final regulations with respect to issues covered under the Special Reliance Procedure announced by the Internal Revenue Service in Technical Information Release 1416 on November 5, 1975, and as extended by Internal Revenue Service News Release IR–1616 on May 14, 1976, shall not be deemed to satisfy the criteria of this paragraph. With regard to a particular plan, a request for extension of time pursuant to this paragraph shall be submitted prior to the expiration of the remedial amendment period determined without regard to this paragraph, or within such time thereafter as the Internal Revenue Service may consider resonable under the circumstances. The request should be submitted to the appropriate District Director, determined under §601.201(s)(3)(xii) of this chapter (Statement of Procedural Rules). This subparagraph applies to disqualifying provisions that were adopted or became effective prior to September 2, 1974, as well as disqualifying provisions adopted or made effective on or after September 2, 1974.

(Secs. 401(b), 7805, Internal Revenue Code of 1954 (88 Stat. 943, 68A Stat. 917; 26 U.S.C. 401(b), 7805))

[T.D. 7437, 41 FR 42653, Sept. 28, 1976, as amended by T.D. 7896, 48 FR 23817, May 27,1983; T.D. 7997, 49 FR 50645, Dec. 31, 1984; T.D. 8217, 53 FR 29662, Aug. 8, 1988; T.D. 8727, 62 FR 41273, 41274, Aug. 1, 1997]

§1.401(b)–1T Certain retroactive changes in plan (temporary).

(a) [Reserved]. For further information, see §1.401(b)–1(a).

(b) *Disqualifying provisions.* For purposes of §1.401(b)–1, with respect to a plan described in §1.401(b)–1(a), the term ''disqualifying provision'' means:

(1) and (2) [Reserved]. For further information, see §1.401(b)–1(b) (1) and (2).

(3) A plan provision designated by the Commissioner, at the Commissioner's discretion, as a disqualifying provision that either—

(i) Results in the failure of the plan to satisfy the qualification requirements of the Code by reason of a change in those requirements; or

(ii) Is integral to a qualification requirement of the Code that has been changed.

(c) *Special rules applicable to disqualifying provisions*—

(1) *Absence of plan provision.* For purposes of paragraph (b)(3) of this section and § 1.401(b)–1(b)(2), a disqualifying provision includes the absence from a plan of a provision required by, or, if applicable, integral to the applicable change to the qualification requirements of the Internal Revenue Code, if the plan was in effect on the date the change became effective with respect to the plan.

(2) *Method of designating disqualifying provisions.* The Commissioner may designate a plan provision as a disqualifying provision pursuant to paragraph (b)(3) of this section only in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2)(ii)(*b*) of this chapter.

(3) *Authority to impose limitations.* In the case of a provision that has been designated as a disqualifying provision by the Commissioner pursuant to paragraph (b)(3) of this section, the Commissioner may impose limits and provide additional rules regarding the amendments that may be made with respect to that disqualifying provision during the remedial amendment period. The Commissioner may impose these limits and provide these additional rules only in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2)(ii)(*b*) of this chapter.

(d) *Remedial amendment period.* (1) The remedial amendment period with respect to a disqualifying provision begins:

(i) through (iii) [Reserved]. For further information, see § 1.401(b)–1(d)(1) (i) through (iii).

(iv) In the case of a disqualifying provision described in paragraph (b)(3)(i) of this section, the date on which the change effected by an amendment to the Internal Revenue Code became effective with respect to the plan, or

(v) In the case of a disqualifying provision described in paragraph (b)(3)(ii) of this section, the first day on which the plan was operated in accordance with such provision, as amended, unless another time is specified by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2)(ii)(*b*) of this chapter.

(2) [Reserved]

[T.D. 8727, 62 FR 41274, Aug. 1, 1997]

§ 1.401(e)–1 Definitions relating to plans covering self-employed individuals.

(a) *''Keogh'' or ''H.R. 10'' plans, in general*—(1) *Introduction and organization of regulations.* Certain self-employed individuals may be covered by a qualified pension, annuity, or profit-sharing plan. This section contains definitions contained in section 401(c) relating to plans covering self-employed individuals and is applicable to employer taxable years beginning after December 31, 1975, unless otherwise specified.

The provisions of section 401(a) relating to qualification requirements which are generally applicable to all qualified plans, and other provisions relating to the special rules under section 401 (b), (f), (g), (h), and (i), are also generally applicable to any plan covering a self-employed individual. However, in addition to such requirements and special rules, any plan covering a self-employed individual is subject to the rules contained in §§ 1.401 (e)–2, (e)–5, and (j)–1 through (j)–5. Section 1.401(e)–2 contains general rules, § 1.401(e)–5 contains a special rule limiting the contribution and benefit base to the first $100,000 of annual compensation, and § 1.401 (j)–1 through (j)–5 contains special rules for defined benefit plans. Section 1.401(e)–3 contains special rules which are applicable to plans covering self-employed individuals when one or more of such individuals is an owner-employee within the meaning of section 401(c)(3). Section 1.401(e)–4 contains rules relating to contributions on behalf of owner-employees for premiums on annuity, etc., contracts and a transitional rule for certain excess contributions made on behalf of owner-employees for employer taxable years beginning before January 1, 1976. The provisions of this section and of §§ 1.401(e)–2 through 1.401(e)–5 are applicable to employer taxable years beginning after December 31, 1975, unless otherwise specified.

(2) [Reserved]

(b) [Reserved]

[T.D. 7636, 44 FR 47053, Aug. 10, 1979]

§1.401(e)–2 General rules relating to plans covering self-employed individuals.

(a) *''Keogh'' or ''H.R. 10'' plans; introduction and organization of regulations.* This section provides certain rules which supplement, and modify, the qualification requirements of section 401(a) and the special rules provided by §1.401(b)–1 and other special rules under subsections (f), (g), (h), and (i) of section 401 in the case of a qualified pension, annuity, or profit-sharing plan which covers a self-employed individual who is an employee within the meaning of section 401(c)(1). Section 1.401(e)–1(a)(1) sets forth other provisions which also supplement, and modify, these requirements and special rules in the case of a plan described in this section. The provisions of this section apply to employer taxable years beginning after December 31, 1975, unless otherwise specified.

(b) [Reserved]

[T.D. 7636, 44 FR 47053, Aug. 10, 1979]

§1.401(e)–3 Requirements for qualification of trusts and plans benefiting owner-employees.

(a) *''Keogh'' or ''H.R. 10'' plans covering owner-employees; introduction and organization of regulations.* This section prescribes the additional requirements which must be met for qualification of a trust forming part of a pension or profit-sharing plan, or of an annuity plan, which covers any self-employed individual who is an owner-employee as defined in section 401(c)(3). These additional requirements are prescribed in section 401(d) and are made applicable to such a trust by section 401(a)(10)(B) and to an annuity plan by section 404(a)(2). However, to the extent that the provisions of §§1.401(e)–1 and 1.401(e)–2 are not modified by the provisions of this section such provisions are also applicable to a plan which covers an owner-employee. The provisions of this section apply to taxable years beginning after December 31, 1975, unless otherwise specified.

(b) [Reserved]

[T.D. 7636, 44 FR 47053, Aug. 10, 1979]

§1.401(e)–4 Contributions for premiums on annuity, etc., contracts and transitional rule for certain excess contributions.

(a) *In general.* The provisions of this section prescribe the rules specified in section 401(e) relating to certain contributions made under a qualified pension, annuity, or profit-sharing plan on behalf of a self-employed individual who is an owner-employee (as defined in section 401(c)(3) and the regulations thereunder) in taxable years of the employer beginning after December 31, 1975. In addition, such plans are also subject to the limitations on contributions and benefits under section 415 for years beginning after December 31, 1975. However, the defined contribution compensation limitation described in section 415(c)(1)(B) will not apply to any contribution described in this section provided that the requirements specified in section 415(c)(7) and §1.415–6(h) are satisfied. Solely for the purpose of applying section 4972(b) (relating to excise tax on excess contributions for self-employed individuals) to other contributions made by an owner-employee as an employee, the amount of any employer contribution which is not deductible under section 404 for the employer's taxable year but which is described in section 401(e) and this section shall be taken into account as a contribution made by such owner-employee as an employee during the taxable year of his employer in which such contribution is made.

(b) *Contributions described in section 401(e)*—(1) An employer contribution on behalf of an owner-employee is described in section 401(e), if—

(i) Under the provisions of the plan, the contribution is expressly required to be applied (either directly or through a trustee) to pay the premiums or other consideration for one or more annuity, endowment, or life insurance contracts on the life of the owner-employee.

(ii) The employer contributions so applied meet the requirements of subparagraphs (2) through (5) of this paragraph.

(iii) The amount of the contribution exceeds the amount deductible under section 404 with respect to contributions made by the employer on behalf of the owner-employee under the plan, and

(iv) The total employer contributions required to be applied annually to pay premiums on behalf of any owner-employee for contracts described in this paragraph do not exceed $7,500. For purposes of computing such $7,500 limit, the total employer contributions include amounts which are allocable to the purchase of life, accident, health, or other insurance.

(2)(i) The employer contributions must be paid under a plan which satisfies all the requirements for qualification. Accordingly, for example, contributions can be paid under the plan for life insurance protection only to the extent otherwise permitted under sections 401 through 404 and the regulations thereunder. However, certain of the requirements for qualification are modified with respect to a plan described in this paragraph (see section 401(a)(10)(A)(ii) and (d)(5)).

(ii) A plan described in this paragraph is not disqualified merely because a contribution is made on behalf of an owner-employee by his employer during a taxable year of the employer for which the owner-employee has no earned income. On the other hand, a plan will fail to qualify if a contribution is made on behalf of an owner-employee which results in the discrimination prohibited by section 401(a)(4) as modified by section 401(a)(10)(A)(ii).

(3) The employer contributions must be applied to pay premiums or other consideration for a contract issued on the life of the owner-employee. For purposes of this subparagraph, a contract is not issued on the life of an owner-employee unless all the proceeds which are, or may become, payable under the contract are payable directly, or through a trustee of a trust described in section 401(a) and exempt from tax under section 501(a), to the owner-employee or to the beneficiary named in the contract or under the plan. For example, a nontransferable face-amount certificate described in section 401(g) and the regulations thereunder is considered an annuity on the life of the owner-employee if the proceeds of such contract are payable only to the owner-employee or his beneficiary.

(4)(i) For any taxable year of the employer, the amount of contributions by the employer on behalf of the owner-employee which is applied to pay premiums under the contracts described in this paragraph must not exceed the average of the amounts deductible under section 404 by such employer on behalf of such owner-employee for the most recent three taxable years of the employer which are described in the succeeding sentence. The three employer taxable years described in the preceding sentence must be years, ending prior to the date the latest contract was entered into or modified to provide additional, benefits, in which the owner-employee derived earned income from the trade or business with respect to which the plan is established. However, if such owner-employee has not derived earned income for at least three taxable years preceding such date, then, in determining the ‘‘average of the amounts deductible’’, only so many of such taxable years as such owner-employee was engaged in such trade or business and derived earned income therefrom are taken into account.

(ii) For the purpose of making the computation described in subdivision (i) of this subparagraph, the taxable years taken into account include those years in which the individual derived earned income from the trade or business but was not an owner-employee with respect to such trade or business. Furthermore, taxable years of the employer preceding the taxable year in which a qualified plan is established are taken into account.

(iii) For purposes of making the computations described in subdivisions (i) and (ii) of this subparagraph for any taxable year of the employer the average of the amounts deductible under section 404 by the employer on behalf of an owner-employee for the most recent three relevant taxable years of the employer shall be determined as if section 404, as in effect for the taxable year for which the computation is to be made, had been in effect for all three such years.

(5) For any taxable year of an employer in which contributions are made on behalf of an individual as an owner-employee under more than one plan,

the amount of contributions described in this section by the employer on behalf of such an owner-employee under all such plans must not exceed $7,500.

(c) *Transitional rule for excess contributions*—(1)(i) The rules of this paragraph are inapplicable to a plan which was not in existence for any taxable year of an employer which begins before January 1, 1976. For taxable years of an employer which begin before January 1, 1976, the rules with respect to excess contributions on behalf of owner-employees set forth in section 401(d) (5) and (8) and in section 401(e), as these sections were in effect on September 1, 1974, prior to their amendment by section 2001(e) of the Employee Retirement Income Security Act of 1974 (hereinafter in this paragraph referred to as the ‘‘Act’’) (88 Stat. 954), shall apply except as provided by subparagraph (2) of this paragraph. Section 1.401–13 generally provides the rules for excess contributions on behalf of owner-employees set forth in these sections.

(ii) Notwithstanding the provisions of subdivision (i) of this subparagraph, the rules set forth in such subsections (d) (5) and (8) and (e) of section 401 with respect to excess contributions for such taxable years beginning before January 1, 1976, apply even though the application of those rules affects a subsequent taxable year. Thus, for example, if, in 1975, a nonwillful excess contribution described in section 401(e)(1) (prior to such amendment) is made on behalf of an owner-employee, the plan will not be qualified unless the provisions required by subparagraphs (A) and (B) of such 401(d)(8) are contained in the plan and made applicable to excess contributions made for such taxable years beginning before January 1, 1976. In such case, the effect of such contribution on the plan, the employer, and the owner-employee would be determined under paragraph (2) of section 401(e), as in effect on September 1, 1974. By reason of section 401(e)(2)(F), as in effect on September 1, 1974, the period for assessing any deficiency by reason of the excess contribution will not expire until the expiration of the 6-month period described in section 401(e)(2)(C), as in effect on September 1, 1974, even if the first day of such 6-month period falls in a taxable year beginning after December 31, 1975. For the rules applicable to a willful excess contribution, which generally divide an owner-employee’s interest in a plan into two parts on the basis of employer taxable years beginning before and after December 31, 1975, see §1.72–17A(e)(2)(v). In the case of a willful excess contribution, the rule specified in section 401(e)(2)(E)(iii), as in effect on September 1, 1974, shall not apply to any taxable year of an employer beginning on or after January 1, 1976. Thus, for example, if a willful excess contribution was made to a plan on behalf of an owner-employee with respect to his employer’s taxable year beginning January 1, 1975, the plan would not meet, for purposes of section 404, the requirements of section 401(d) with respect to that owner-employee for such year, but the 5 taxable years following such year would be unaffected because those years begin on or after January 1, 1976.

(2)(i) For purposes of applying the excess contribution rules with respect to the employer taxable years specified in subparagraph (1) of this paragraph for such an employer taxable year which begins after December 31, 1973, see section 404(e) and §1.404(e)–1A for rules increasing the limitation on the amount of allowable employer deductions on behalf of owner-employees under section 404. For purposes of applying subparagraphs (A) and (B)(i) of section 401(e)(1) prior to the amendment made by section 2001(e)(3) of the Act (88 Stat. 954), the employer deduction allowable by section 404(e)(4) with respect to an owner-employee in a defined contribution plan shall be deemed not to be an excess contribution (see §1.404(e)–1A(c)(4)).

(ii) For purposes of applying the excess contribution rules with respect to the employer taxable years specified in subparagraph (1) of this paragraph to an employer’s plan which was not in existence on January 1, 1974, or to a plan in existence on January 1, 1974, which elects under section 1017(d) of the Act (88 Stat. 934), in accordance with regulations, to have the funding provisions of section 412 apply to such an existing plan, see section 404 (a) (1), (a)(6), and (a)(7), as amended by section 1013(c)(1), (2), and (3) of the Act (88

Stat. 922 and 923) for rules modifying the amount of employer deductions on behalf of owner-employees.

[T.D. 7636, 44 FR 47053, Aug. 10, 1979]

§ 1.401(e)–5 Limitation of contribution and benefit bases to first $100,000 of annual compensation in case of plans covering self-employed individuals.

(a) *General rules—General rule.* (1) Under section 401(a)(17), a plan maintained by an employer which provided contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1) is a qualified plan only if the annual compensation of each employee taken into account under the plan does not exceed the first $100,000 of such compensation. For purposes of applying section 401(a)(17) and the preceding sentence, all plans maintained by such an employer with respect to the same trade or business shall be treated as a single plan. See also sections 401(d)(9) and (10) (relating to controlled trades or businesses where a plan covers an owner-employee who controls more than one trade or business); section 404(e) (relating to special limitations for self-employed individuals); section 413(b)(7) (relating to determination of limitations provided by section 404(a) in the case of certain plans maintained pursuant to a collective bargaining agreement); and section 413(c)(6) (relating to determination of limitations provided by section 404(a) in the case of certain plans maintained by more than one employer).

(2) *Special section 414(b), (c) rule.* This subparagraph (2) applies to plans maintained by employers that are trades or businesses (whether or not incorporated) that are under common control within the meaning of section 414(c). All such plans that are described in paragraph (a)(1) and § 1.401(e)–6(a) (so called ‘‘Subchapter S plans’’) shall be treated as a single plan in applying the limitation of paragraph (a)(1).

(b) *Integrated plans.* (1) In the case of a qualified plan, other than a plan described in section 414(j), which is integrated with the Social Security Act (chapter 21 of the Code), or with contributions or benefits under chapter 2 of the Code (relating to tax on self-employment income) or under any other Federal of State law, the $100,000 limitation described in subparagraph (a) shall be determined without regard to any adjustments to contributions or benefits under the plan on account of such integration. See also subsections (a)(5), (a)(15), and (d)(6) of section 401 and the regulations thereunder for other rules with respect to plans which are integrated.

(2) In the case of a qualified defined benefit plan described in section 414(j), see section 401(j)(4) for a special prohibition against integration.

(c) *Application of nondiscrimination requirement.* (1) This paragraph shall apply—

(i) In the case of a plan which provides contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1) and

(ii) For a year in which the compensation of any employee covered by the plan exceeds $100,000. In the case of an employee who is an employee within the meaning of section 401(c)(1), compensation includes earned income within the meaning of section 401(c)(2).

(2) In applying section 401(a)(4) under the circumstances described in subparagraph (1) of this paragraph, the determination whether the rate of contributions or benefits under the plan discriminates in favor of highly compensated employees shall be made as if the compensation for the year of each employee described in the first sentence of subparagraph (1)(ii) of this paragraph were $100,000, rather than the compensation actually received by him for such year.

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

Example (*1*). A, a self-employed individual, has established the P Profit-Sharing Plan, which covers A and his two commonlaw employees, B and C. A's taxable year and the plan's plan year are both the calendar year. For 1976, A has earned income of $150,000, and B and C each receive compensation of less than $100,000 from A. If he wishes to contribute $7,500 to the plan on his behalf for 1976, A must also contribute to the accounts of B and C under the plan amounts at least equal to 7½ percent of their respective compensation for 1976.

Example (*2*). D, an owner-employee within the meaning of section 401(c)(3), is a participant in the Q Qualified Defined Contribution Plan, which, in 1975, satisfies the requirements of section 401(d)(6) and all other integration requirements applicable to qualified defined contribution plans. The taxable years of D, the employer of D within the meaning of section 401(c)(4), and the plan are all calendar years. The plan provides for an integration level of $13,200 and a contribution rate of 5 percent of compensation in excess of $13,200. For 1975, D has earned income of $115,000. The maximum amount of earned income upon which D's contribution can be determined is $86,800, and the contribution based upon this maximum amount of earned income is $4,340, computed as follows:

Maximum annual compensation which may be taken into account	$100,000
Less: Social Security Act integration level	13,200
Plan contribution base	$86,800
Multiplied by: Contribution rate (percent)	5
Total	$4,340

(e) *Years to which section applies.* This section applies to taxable years of an employer beginning after December 31, 1975. However, if employer contributions made under a plan for any employee for taxable years of an employer beginning after December 31, 1973, exceed the amounts permitted to be deducted for that employee under section 404(e), as in effect on September 1, 1974, this section applies to such taxable years of an employer.

Thus, for example, a plan of a calendar year employer which was adopted on January 1, 1974, would be subject to this section in 1974, if the employer made a contribution on behalf of any employee within the meaning of section 401(c)(1) for such year in excess of the $2,500 or 10 percent earned income limit, whichever is applicable to that employee, specified in section 404(e)(1) as in effect prior to the amendment to such Code section made by section 2001(a)(1)(A) of the Employee Retirement Income Security Act of 1974 (88 Stat. 952). The plan described in the proceeding sentence would also be subject to this section in 1974, if the employer made a contribution on behalf of any employee within the meaning of section 401(c)(1) which is allowable as a deduction only because of the addition of paragraph (4) to Code section 404(e) made by section 2001(a)(3) of such Act (88 Stat. 952).

(b) [Reserved]

[T.D. 7636, 44 FR 47055, Aug. 10, 1979; T.D. 7636, 60 FR 21435, May 2, 1995]

§1.401(e)–6 Special rules for shareholder-employees.

(a) *Limitation of contributions and benefit bases to first $100,000 of annual compensation in case of plans covering shareholder-employees.* (1) Under section 401(a)(17), a plan which provides contributions or benefits for employees, some or all of whom are shareholder-employees within the meaning of section 1379(d), is subject to the same limitation on annual compensation as a plan which provides such contributions or benefits for employees some or all of whom are self-employed individuals within the meaning of section 401(c)(1). Thus, a plan which provides contributions or benefits for such shareholder-employees is subject to the rules provided by §1.401(e)–5, unless otherwise specified. See also section 1379. In the case of plans maintained by employers that are corporations described in section 414(b) and that are described in this subparagraph (1), the same rule described in §1.401(e)–5(a)(2) shall apply.

(2) Subparagraph (1) applies to taxable years of an electing small business corporation beginning after December 31, 1975. However, if corporate contributions made under a plan on behalf of any shareholder-employee for corporate taxable years beginning after December 31, 1973, exceed the lesser of the amount of contributions specified in section 1379(b)(1) (A) or (B), as in effect on September 1, 1974, for that shareholder-employee, subparagraph (1) applies to such corporate taxable years. Thus, for example if an electing small business corporation whose taxable year is the calendar year adopted a plan on January 1, 1974, the plan would be subject to the provisions of subparagraph (1) of this section in 1974, if the corporation made a contribution in excess of $2,500 on behalf of any shareholder-employee for such year.

(b) [Reserved]

[T.D. 7636, 44 FR 47056, Aug. 10, 1979]

§ 1.401(f)–1 Certain custodial accounts and annuity contracts.

(a) *Treatment of a custodial account or an annuity contract as a qualified trust.* Beginning on January 1, 1974, a custodial account or an annuity contract may be used, in lieu of a trust, under any qualified pension, profitsharing, or stock bonus plan if the requirements of paragraph (b) of this section are met. A custodial account or an annuity contract may be used under such a plan, whether the plan covers common-law employees, self-employed individuals who are treated as employees by reason of section 401(c), or both. The use of a custodial account or annuity contract as part of a plan does not preclude the use of a trust or another custodial account or another annuity contract as part of the same plan. A plan under which a custodial account or an annuity contract is used may be considered in connection with other plans of the employer in determining whether the requirements of section 401 are satisfied. For regulations relating to the period before January 1, 1974, see § 1.401–8.

(b) *Rules applicable to custodial accounts and annuity contracts.* (1) Beginning on January 1, 1974, a custodial account or an annuity contract is treated as a qualified trust under section 401 if the following requirements are met:

(i) The custodial account or annuity contract would, except for that fact that it is not a trust, constitute a qualified trust under section 401; and

(ii) In the case of a custodial account, the custodian either is a bank or is another person who demonstrates, to the satisfaction of the Commissioner, that the manner in which he will hold the assets will be consistent with the requirements of section 401. This demonstration must be made in the same manner as the demonstration required by § 1.408–2(e).

(2) If a custodial account would, except for the fact that it is not a trust, constitute a qualified trust under section 401, it must, for example, be created pursuant to a written agreement which constitutes a valid contract under local law. In addition, the terms of the contract must make it impossible, prior to the satisfaction of all liabilities with respect to the employees and their beneficiaries covered by the plan. For any part of the funds of the custodial account to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries as provided for in the plan (see paragraph (a) of § 1.401–2).

(3) An annuity contract would, except for the fact that it is not a trust, constitute a qualified trust under section 401 if it is purchased by an employer for an employee under a plan which meets the requirements of section 404(a)(2) and the regulations thereunder, except that the plan may be either a pension or a profit-sharing plan.

(c) *Effect of this section.* (1)(i) Any custodial account or annuity contract which satisfies the requirements of paragraph (b) of this section is treated as a qualified trust for all purposes of the Internal Revenue Code of 1954. Such a custodial account or annuity contract is treated as a separate legal person which is exempt from the income tax under section 501(a). In addition, the person holding the assets of such account or holding such contract is treated as the trustee thereof. Accordingly, such person is required to file the returns described in sections 6033 and 6047 and to supply any other information which the trustee of a qualified trust is required to furnish.

(ii) Any procedure which has the effect of merely substituting one custodian for another shall not be considered as terminating or interrupting the legal existence of a custodial account which otherwise satisfies the requirements of paragraph (b) of this section.

(2)(i) The beneficiary of a custodial account which satisfies the requirements of paragraph (b) of this section is taxed in accordance with section 402. In determining whether the funds of a custodial account are distributed or made available to an employee or his beneficiary, the rules which under section 402(a) are applicable to trusts will also apply to the custodial account as though it were a separate legal person and not an agent of the employee.

(ii) If a custodial account which has qualified under section 401 fails to qualify under such section for any taxable year, such custodial account will not thereafter be treated as a separate legal person, and the funds in such account shall be treated as made available within the meaning of section 402(a)(1) to the employees for whom they are held.

(3) The beneficiary of an annuity contract which satisfies the requirements of paragraph (b) of this section is taxed as if he were the beneficiary of an annuity contract described in section 403(a).

(d) *Definitions.* For purposes of this section—

(1) The term *bank* means a bank as defined in section 408(n).

(2) The term *annuity* means an annuity as defined in section 401(g). Thus, any contract or certificate issued after December 31, 1962, which is transferable is not treated as a qualified trust under this section.

(e) *Other contracts.* For purposes of this section, other than the non-transferability restriction of paragraph (d)(2), a contract issued by an insurance company qualified to do business in a state shall be treated as an annuity contract. For purposes of the preceding sentence, the contract does not include a life, health or accident, property, casualty or liability insurance contract. For purposes of this paragraph, a contract which is issued by an insurance company will not be considered a life insurance contract merely because the contract provides incidental life insurance protection. The provisions of this paragraph are effective for taxable years beginning after December 31, 1975.

(f) *Cross reference.* For the requirement that the assets of an employee benefit plan be placed in trust, and exceptions thereto, see section 403 of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1103, and the regulations prescribed thereunder by the Secretary of Labor.

(Secs. 401(f)(2), 7805, Internal Revenue Code of 1954 (88 Stat. 939 and 68A Stat. 917; 26 U.S.C. 401(f)(2), 7805))

[43 FR 41204, Sept. 15, 1978. Redesignated and amended by T.D. 7748, 46 FR 1695–1696, Jan. 7, 1981; T.D. 8635, 60 FR 65549, Dec. 20, 1995]

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[T.D. 8357, 56 FR 40516, Aug. 15, 1991, as amended by T.D. 8376, 56 FR 63431, Dec. 4, 1991; T.D. 8581, 59 FR 66169, Dec. 23, 1994]

§1.401(k)–1 Certain cash or deferred arrangements.

(a) *General rules*—(1) *Certain plans permitted to include cash or deferred arrangements.* A plan, other than a profit-sharing, stock bonus, pre-ERISA money purchase pension or rural cooperative plan, does not satisfy the requirements of section 401(a) if the plan includes a cash or deferred arrangement. A profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan does not fail to satisfy the requirements of section 401(a) merely because the plan includes a cash or deferred arrangement. A cash or deferred arrangement is part of a plan for purposes of this section if any contributions to the plan, or accruals or other benefits under the plan, are made or provided pursuant to the cash or deferred arrangement.

(2) *Rules applicable to cash or deferred arrangements generally*—(i) *Definition of cash or deferred arrangement.* Except as provided in paragraph (a)(2)(ii) of this section, a cash or deferred arrangement is an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions to, or accruals or other benefits under, a plan that is intended to satisfy the requirements of section 401(a) (including a contract that is intended to satisfy the requirements of section 403(a)).

(ii) *Treatment of after-tax employee contributions.* A cash or deferred arrangement does not include an arrangement under which amounts contributed under a plan at an employee's election are designated or treated at the time of contribution as after-tax employee contributions (e.g., by reporting the contributions as taxable income subject to applicable withholding requirements). See also section 414(h)(1). This is the case even if the employee's election to make after-tax employee contributions is made before the amounts subject to the election are currently available to the employee.

(iii) *Treatment of elective contributions as plan assets.* The extent to which elective contributions under a cash or deferred arrangement constitute plan assets for purposes of the prohibited transaction provisions of section 4975 of the Internal Revenue Code and title I of the Employee Retirement Income Security Act of 1974 is determined in accordance with regulations and rulings issued by the Department of Labor.

(3) *Rules applicable to cash or deferred elections generally*—(i) *Definition of cash or deferred election.* A cash or deferred election is any election (or modification of an earlier election) by an employee to have the employer either—

(A) Provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available, or

(B) Contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation.

A cash or deferred election includes a salary reduction agreement between an employee and employer under which a contribution is made under a plan only if the employee elects to reduce cash compensation or to forgo an increase in cash compensation.

(ii) *Requirement that amounts not be currently available.* A cash or deferred election can only be made with respect to an amount that is not currently available to the employee on the date of the election. Further, a cash or deferred election can only be made with respect to amounts that would (but for the cash or deferred election) become currently available after the later of the date on which the employer adopts the cash or deferred arrangement or the date on which the arrangement first becomes effective.

(iii) *Amounts currently available.* Cash or another taxable amount is currently available to the employee if it has been paid to the employee or if the employee is able currently to receive the cash or other taxable amount at the employee's discretion. An amount is not currently available to an employee if there is a significant limitation or restriction on the employee's right to receive the amount currently. Similarly, an amount is not currently available as of a date if the employee may under no circumstances receive the amount before a particular time in the future. The determination of whether an amount is currently available to an employee does not depend on whether it has been constructively received by the employee for purposes of section 451.

(iv) *Certain one-time elections not treated as cash or deferred elections.* A cash or deferred election does not include a one-time irrevocable election upon an employee's commencement of employment with the employer or upon the employee's first becoming eligible under any plan of the employer, to have contributions equal to a specified amount or percentage of the employee's compensation (including no amount of compensation) made by the employer on the employee's behalf to the plan and to any other plan of the employer (including plans not yet established) for the duration of the employee's employment with the employer, or in the case of a defined benefit plan to receive accruals or other benefits (including no benefits) under such plans. Thus, for example, employer contributions pursuant to a one-time irrevocable election described in this paragraph are not treated as having been made pursuant to a cash or deferred election and are not includible in an employee's gross income by reason of § 1.402(a)–1(d). In no event is an election made after December 23, 1994 treated as one-time irrevocable election under this paragraph if the election is made by an employee who previously became eligible under another plan (whether or not terminated) of the employer. See paragraph (a)(6)(ii)(C) of this section for an additional one-time election permitted under a cash or deferred arrangement in which partners may participate.

(v) *Tax treatment of employees.* An amount generally is includible in an employee's gross income for the taxable year in which the employee actually or constructively receives the amount. But for section 402(e)(3) and section 401(k), an employee is treated as having received an amount that is contributed to a plan pursuant to the employee's cash or deferred election. This is the case even if the election to defer is made before the year in which the amount is earned, or before the amount is currently available. See § 1.402(a)–1(d).

(vi) *Examples.* The provisions of this paragraph (a)(3) are illustrated by the following examples:

Example 1. An employer maintains a profit-sharing plan under which each eligible employee has an election to defer an annual bonus payable on January 30 each year. The bonus equals 10 percent of compensation during the previous calendar year. Deferred amounts are not treated as after-tax employee contributions. The bonus is currently available on January 30. An election made prior to January 30 to defer all or part of the bonus is a cash or deferred election, and the bonus deferral arrangement is a cash or deferred arrangement.

Example 2. An employer maintains a profit-sharing plan under which each eligible employee may elect to defer up to 10 percent of compensation for each payroll period during the plan year. An election to defer compensation for a payroll period is a cash or deferred election if the election is made prior to the date on which the compensation is to be paid to the employee and if the deferred amount is not treated as an after-tax employee contribution at the time of deferral.

Example 3. (i) Employer A establishes a qualified money purchase pension plan in 1986. This is the first qualified plan established by Employer A. All salaried employees are eligible to participate under the plan. Hourly-paid employees are not eligible to participate under the plan. In 1996, Employer A establishes a profit-sharing plan under which all employees (both salaried and hourly) are eligible. Employer A permits all employees on the effective date of the profit-sharing plan to make a one-time irrevocable election to have Employer A contribute five percent of compensation on their behalf to the plan and to any other plan of Employer A (including plans not yet established) for the duration of the employee's employment with Employer A, and have their salaries reduced by five percent.

(ii) The election provided under the profit-sharing plan is not a one-time irrevocable election within the meaning of § 1.401(k)–1(a)(3)(iv) with respect to the salaried employees of Employer A who, at any time before becoming eligible to participate under the profit-sharing plan, became eligible to participate under the money purchase pension plan. The election under the profit-sharing plan is a one-time irrevocable election within the meaning of § 1.401(k)– 1(a)(3)(iv) with respect to the hourly employees, because they were not previously eligible to participate under another plan of the employer.

(4) *Rules applicable to qualified cash or deferred arrangements*—(i) *Definition of qualified cash or deferred arrangement.* A qualified cash or deferred arrangement is a cash or deferred arrangement that satisfies the requirements of paragraphs (b), (c), (d), and (e) of this section and that is part of a plan that otherwise satisfies the requirements of section 401(a).

(ii) *Treatment of elective contributions as employer contributions.* Except as provided in paragraph (f) of this section, elective contributions under a qualified cash or deferred arrangement are treated as employer contributions. Thus, for example, elective contributions are treated as employer contributions for purposes of sections 401(a) and 401(k), 402, 404, 409, 411, 412, 415, 416, and 417.

(iii) *Tax treatment of employees.* Except as provided in section 402(g) and paragraph (f) of this section, elective contributions under a qualified cash or deferred arrangement are neither includible in an employee's gross income at the time the cash or other taxable amounts would have been includible in the employee's gross income (but for the cash or deferred election), nor at the time the elective contributions are contributed to the plan. See § 1.402(a)–1(d)(2)(i).

(iv) *Application of nondiscrimination requirements to plan that includes a qualified cash or deferred arrangement.* A plan that includes a qualified cash or deferred arrangement must satisfy the requirements of sections 401(a)(4) and 410(b). Thus, for example, the plan must satisfy section 401(a)(4) with respect to the amount of contributions or benefits and the availability of benefits, rights and features under the plan. See § 1.401(a)(4)–1(b)(3). The right to make each level of elective contributions under a cash or deferred arrangement is a benefit, right or feature subject to this requirement, and each of these rights must therefore generally be available to a group of employees that satisfies section 410(b). See § 1.401(a)(4)–4(e)(3)(i) and (iii)(D). Thus, for example, if all employees are eligible to make a stated level of elective contributions under a cash or deferred arrangement, but that level of contributions can only be made from compensation in excess of a stated amount, such as the Social Security taxable wage base, the arrangement will generally favor highly compensated employees with respect to the availability of elective contributions and thus will generally not satisfy the requirements of section 401(a)(4). For plan years beginning after December 31, 1984, the amount of elective contributions under a qualified cash or deferred arrangement satisfies the requirements of section 401(a)(4) only if the amount of elective contributions satisfies the special nondiscrimination test of section 401(k)(3) and paragraph (b)(2) of this section. See § 1.401(a)(4)–1(b)(2)(ii)(B). See also § 1.401(a)(4)– 11(g)(3)(vii)(A), relating to corrective amendments that may be made to satisfy the minimum coverage requirements of section 410(b).

(5) *Rules applicable to nonqualified cash or deferred arrangements*—(i) *Definition of nonqualified cash or deferred arrangement.* A nonqualified cash or deferred arrangement is a cash or deferred arrangement that is not a qualified cash or deferred arrangement. Thus, if a cash or deferred arrangement fails to satisfy one or more of the requirements in paragraph (b), (c), (d) or (e) of this section, the arrangement is a nonqualified cash or deferred arrangement.

(ii) *Treatment of elective contributions as employer contributions.* Except as specifically provided otherwise, elective contributions under a nonqualified cash or deferred arrangement are treated as nonelective employer contributions. Thus, for example, the elective contributions are treated as nonelective employer contributions for purposes of sections 401(a) (including section 401(a)(4)) and 401(k), 404, 409, 411, 412, 415, 416, and 417 and are not subject to the requirements of section 401(m).

(iii) *Tax treatment of employees.* Elective contributions under a nonqualified cash or deferred arrangement are includible in an employee's gross income at the time the cash or other taxable amount that the employee would have received (but for the cash or deferred election) would have been includible in the employee's gross income. See § 1.402(a)–1(d)(1).

(iv) *Qualification of plan that includes a nonqualified cash or deferred arrangement.* A profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan does not fail to satisfy the requirements of section 401(a) merely because the plan includes a nonqualified cash or deferred arrangement. In determining whether the plan satisfies the requirements of section 401(a)(4), the special nondiscrimination tests of sections 401(k)(3) and 401(m)(2) may not be used. See §§ 1.401(a)(4)–1(b)(2)(ii)(B) and 1.410(b)–9 (definition of section 401(k) plan).

(6) *Rules applicable to partnership cash or deferred arrangements*—(i) *Application of general rules.* A partnership may maintain a cash or deferred arrangement, and individual partners may make cash or deferred elections with respect to compensation attributable to services rendered to the partnership. Generally, the same rules apply to partnership cash or deferred arrangements as apply to other cash or deferred arrangements. Thus, a partnership cash or deferred arrangement is not a qualified cash or deferred arrangement unless the requirements of section 401(k) and this section are satisfied. For example, any contributions made on behalf of an individual partner pursuant to a partnership cash or deferred arrangement are elective contributions unless they are designated or treated as after-tax employee contributions. Consistent with § 1.402(a)–1(d), the elective contributions are includible in income and are not deductible under section 404(a) unless the arrangement is a qualified cash or deferred arrangement. Also, even if the

arrangement is a qualified cash or deferred arrangement, the elective contributions are includible in gross income and are not deductible under section 404(a) to the extent they exceed the applicable limit under section 402(g). See also §1.401(a)–30.

(ii) *Definition of partnership cash or deferred arrangement*—(A) *General rule.* Effective for contributions made for plan years beginning after December 31, 1988, a cash or deferred arrangement includes any arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf.

(B) *Timing of partner's cash or deferred election.* For purposes of paragraph (a)(3)(ii) of this section, a partner's compensation is deemed currently available on the last day of the partnership taxable year. Accordingly, an individual partner may not make a cash or deferred election with respect to compensation for a partnership taxable year after the last day of that year. A partner's compensation for a partnership taxable year ending with or within a plan year beginning before January 1, 1992, is, however, deemed not to be currently available until the due date, including extensions, for filing the partnership's federal income tax return for its taxable year ending with or within the plan year. See §1.401(k)–1(b)(4)(iii) for the rules regarding when contributions are treated as allocated.

(C) *Transition rule for partnership cash or deferred elections.* A one-time irrevocable election to participate or not to participate in a plan in which partners may participate is not a cash or deferred election if the election was made on or before the later of the first day of the first plan year beginning after December 31, 1988, or March 31, 1989. This election may be made after the commencement of employment or after the employee's first becoming eligible under any plan of the employer. In no event, however, may the election be made after December 23, 1994. The election may be made even if the one-time irrevocable election in §1.401(k)–1(a)(3)(iv) was previously made.

(iii) *Treatment of certain matching contributions as elective contributions.* If a partnership makes matching contributions with respect to an individual partner's elective contributions or employee contributions, then the matching contributions are treated as elective contributions made on behalf of the partner. In the case of a plan that, on August 8, 1988, did not treat matching contributions as elective contributions, the preceding sentence applies only to plan years beginning after August 8, 1988. See also §§1.401(m)–1(f)(12) and 1.404(e)–1A(f).

(7) *Rules applicable to collectively bargained plans*—(i) *In general.* The amount of employer contributions under a nonqualified cash or deferred arrangement is treated as satisfying section 401(a)(4) if the arrangement is part of a collectively bargained plan (including a plan adopted by a state or local government before May 6, 1986) that automatically satisfies the requirements of section 410(b). See §§1.401(a)(4)–1(c)(5) and 1.410(b)–2(b)(7). Except as specifically provided otherwise, elective contributions under the arrangement are treated as employer contributions. See §1.401(k)–1(a)(5)(ii). However, elective contributions under the nonqualified cash or deferred arrangement are treated as employee contributions for purposes of section 402(a) for plan years beginning after December 31, 1992, and are therefore not excludable from gross income under section 402(e)(3). See §1.402(a)–1(d)(3)(iv).

(ii) *Example.* The provisions of this paragraph (a)(7) are illustrated by the following example:

Example. For the 1994 plan year, Employer A maintains a collectively bargained plan that includes a cash or deferred arrangement. Employer contributions under the cash or deferred arrangement not satisfy the actual deferral percentage test of section 401(k)(3) and paragraph (b) of this section. Therefore, the arrangement is a nonqualified cash or deferred arrangement. The employer contributions under the cash or deferred arrangement are considered to be nondiscriminatory under section 401(a)(4), and the elective contributions are generally treated as employer contributions. Under §1.402(a)–1(d)(1), however, elective contributions are includible in an employee's gross income.

(b) *Coverage and nondiscrimination requirements*—(1) *In general.* A cash or deferred arrangement satisfies this paragraph (b) for a plan year only if:

(i) The group of eligible employees under the section 401(k) plan and the group of employees benefiting under the plan to which the nonelective employer contributions are made separately satisfy the requirements of section 410(b) (including the average benefit percentage test, if applicable). For special rules governing the application of section 410(b) to a cash or deferred arrangement, see §§ 1.410(b)–7(c)(1) and 1.410(b)–8(a)(1). See also § 1.401(a)(4)–11(g)(3)(vii)(A), relating to corrective amendments that may be made to satisfy the minimum coverage requirements of section 410(b).

(ii) The cash or deferred arrangement satisfies the actual deferral percentage test described in paragraph (b)(2) of this section. This is the exclusive nondiscrimination test applicable to the amount of elective contributions under a qualified cash or deferred arrangement. See § 1.401(a)(4)–1(b)(2)(ii)(B).

(2) *Actual deferral percentage test*—(i) *General rule.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (b) for a plan year only if:

(A) The actual deferral percentage for the group of eligible highly compensated employees is not more than the actual deferral percentage for the group of all other eligible employees multiplied by 1.25; or

(B) The excess of the actual deferral percentage for the group of eligible highly compensated employees over the actual deferral percentage for the group of all other eligible employees is not more than two percentage points, and the actual deferral percentage for the group of eligible highly compensated employees is not more than the actual deferral percentage for the group of all other eligible employees multiplied by two.

An arrangement does not fail to satisfy the requirements of this paragraph (b)(2) merely because all of the eligible employees under an arrangement for a year are highly compensated employees.

(ii) *Rule for plan years beginning after 1979 and before 1987.* For plan years beginning after December 31, 1979, and before January 1, 1987, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (b) for a plan year only if:

(A) The actual deferral percentage for the group of eligible highly compensated employees (top one-third) is not more than the actual deferral percentage for the group of all other eligible employees (lower two-thirds) multiplied by 1.5; or

(B) The excess of the actual deferral percentage for the top one-third over the actual deferral percentage for the lower two-thirds is not more than three percentage points, and the actual deferral percentage for the top one-third is not more than the actual deferral percentage for the lower two-thirds multiplied by 2.5.

(iii) *Plan provision requirement.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (h) of this section, a plan that includes a cash or deferred arrangement does not satisfy the requirements of section 401(a) unless it provides that the actual deferral percentage test of section 401(k)(3) will be met. For purposes of this paragraph (b)(2)(iii), the plan may incorporate by reference the provisions of section 401(k)(3), this paragraph (b), and if applicable, section 401(m)(9) and § 1.401(m)–2.

(3) *Aggregation*—(i) *Aggregation of arrangements and plans.* Except as otherwise specifically provided in this paragraph (b)(3), all cash or deferred arrangements included in a plan are treated as a single cash or deferred arrangement. Thus, for example, if two groups of employees are eligible for separate cash or deferred arrangements under the same plan, the two cash or deferred arrangements are treated as a single cash or deferred arrangement, even if they have significantly different features, such as significantly different limits on elective contributions. See § 1.401(k)–1(g)(11) for the definition of plan used for purposes of this section. That definition contains the exclusive rules for aggregation and disaggregation of plans for purposes of this section. See also paragraph (g)(1)(ii) of this section for rules requiring the aggregation of elective contributions under two or more plans in

computing the actual deferral ratios of certain employees.

(ii) *Restructuring and Permissive Aggregation.* Effective for plan years beginning after December 31, 1991, restructuring under §1.401(a)(4)–9(c) may not be used to demonstrate compliance with the requirements of section 401(k). See §1.401(a)(4)–9(c)(3)(ii). For plan years beginning before January 1, 1992, see §1.401(k)– 1(h)(3)(iii). An employer may, however, treat a plan benefiting otherwise excludable employees as two separate plans for purposes of sections 401(k) and 410(b) in accordance with §§1.410(b)–6(b)(3) and 1.410(b)–7(c)(3).

(4) *Elective contributions taken into account under the actual deferral percentage test*—(i) *General rule.* An elective contribution is taken into account under paragraph (b)(2) of this section for a plan year only if each of the following requirements is satisfied:

(A) The elective contribution is allocated to the employee's account under the plan as of a date within that plan year. For purposes of this rule, an elective contribution is considered allocated as of a date within a plan year only if—

(*1*) The allocation is not contingent upon the employee's participation in the plan or performance of services on any date subsequent to that date, and

(*2*) The elective contribution is actually paid to the trust no later than the end of the 12-month period immediately following the plan year to which the contribution relates.

(B) The elective contribution relates to compensation that either—

(*1*) Would have been received by the employee in the plan year but for the employee's election to defer under the arrangement, or

(*2*) Is attributable to services performed by the employee in the plan year and, but for the employee's election to defer, would have been received by the employee within two and one-half months after the close of the plan year.

(ii) *Elective contributions and qualified nonelective contributions used to satisfy actual contribution percentage test.* Except as provided in §1.401(m)–1(b)(5)(iii), elective contributions treated as matching contributions must satisfy the actual contribution percentage test of section 401(m)(2) and are not taken into account under paragraph (b)(2) of this section. A qualified nonelective contribution that is treated as a matching contribution is subject to the actual contribution percentage test of section 401(m)(2) and is not taken into account as an elective contribution under paragraph (b)(2) or (5) of this section.

(iii) *Elective contributions for partners.* For purposes of paragraph (b)(2) of this section, a partner's distributive share of partnership income is treated as received on the last day of the partnership taxable year. Thus, an elective contribution made on behalf of a partner is treated as allocated to the partner's account for the plan year that includes the last day of the partnership taxable year, provided the requirements of paragraph (b)(4)(i)(A) of this section are met.

(iv) *Elective contributions not taken into account.* Elective contributions that do not satisfy the requirements of paragraph (b)(4)(i) of this section may not use the special nondiscrimination rule of section 401(k)(3) and paragraph (b)(2) of this section for the plan year with respect to which the contributions were made, or for any other plan year. Instead, the amount of the elective contributions must satisfy the requirements of section 401(a)(4) (without regard to the special nondiscrimination test in section 401(k)(3) and paragraph (b)(2) of this section) for the plan year in which they are allocated under the plan as if they were nonelective employer contributions and were the only nonelective employer contributions for the year. See §§1.401(a)(4)–1(b)(2)(ii)(B); 1.410(b)–7(c)(1).

(5) *Qualified nonelective contributions and qualified matching contributions that may be taken into account under the actual deferral percentage test.* Except as specifically provided otherwise, for purposes of paragraph (b)(2) of this section, all or part of the qualified nonelective contributions and qualified matching contributions made with respect to any or all employees who are eligible employees under the cash or deferred arrangement being tested may be treated as elective contributions under the arrangement, provided that

each of the following requirements (to the extent applicable) is satisfied:

(i) The amount of nonelective contributions, including those qualified nonelective contributions treated as elective contributions for purposes of the actual deferral percentage test, satisfies the requirements of section 401(a)(4). See § 1.401(a)(4)–1(b)(2).

(ii) The amount of nonelective contributions, excluding those qualified nonelective contributions treated as elective contributions for purposes of the actual deferral percentage test and those qualified nonelective contributions treated as matching contributions under § 1.401(m)–1(b)(5) for purposes of the actual contribution percentage test, satisfies the requirements of section 401(a)(4). See § 1.401(a)(4)–1(b)(2).

(iii) For plan years beginning before January 1, 1987, or such later date provided in paragraph (h) of this section, the matching contributions, including those qualified matching contributions treated as elective contributions for purposes of the actual deferral percentage test, satisfy the requirements of section 401(a)(4).

(iv) For plan years beginning before January 1, 1987, or such later date provided in paragraph (h) of this section, the matching contributions, excluding those qualified matching contributions treated as elective contributions for purposes of the actual deferral percentage test, satisfy the requirements of section 401(a)(4).

(v) The qualified nonelective contributions and qualified matching contributions satisfy the requirements of paragraph (b)(4)(i)(A) of this section for the plan year as if the contributions were elective contributions.

(vi) For plan years beginning after December 31, 1988, or such later date provided in paragraph (h) of this section, the section 401(k) plan and the plan or plans to which the qualified nonelective contributions and qualified matching contributions are made, could be aggregated under § 1.410(b)–7(d) after application of the mandatory disaggregation rules of § 1.410(b)–7(c), as modified in § 1.401(k)–1(g)(11). If the plan year of the section 401(k) plan is changed to satisfy the requirement under § 1.410(b)–7(d)(5) that aggregated plans have the same plan year, the qualified nonelective contributions and qualified matching contributions may be taken into account in the resulting short plan year only if the contributions satisfy the requirements of paragraph (b)(4)(i) of this section with respect to the short year as if the contributions were elective contributions and the aggregated plans could otherwise be aggregated for purposes of section 410(b).

(6) *Examples.* The provisions of this paragraph (b) are illustrated by the following examples.

Example 1. (i) Employees A, B, and C are eligible employees who earn $30,000, $15,000, and $10,000, respectively, in 1989. ln addition, their employer, X, contributes a bonus of up to 10 percent of their regular compensation to a trust under a profit-sharing plan that includes a cash or deferred arrangement. Under the arrangement, each eligible employee may elect to receive none, all, or any part of the 10 percent in cash. The employer contributes the remainder to the trust. The cash portion of the bonus, if any, is paid after the end of the plan year. The 10 percent is therefore not included in compensation until the year paid. Employee A is highly compensated. For the 1989 plan year, A, B, and C make the following elections:

Employee	Compensation	Elective contribution
A	$30,000	$1,780
B	15,000	750
C	10,000	450

(ii) The ratios of employer contributions to the trust on behalf of each eligible employee to the employee's compensation for the plan year (calculated separately for each employee) are:

Employee	Ratio of elective contribution to compensation	Actual deferral ratio (percent)
A	$1,780/30,000	5.93
B	750/15,000	5.00
C	450/10,000	4.50

(iii) The actual deferral percentage for the highly compensated group (Employee A) is 5.93 percent. The actual deferral percentage for the nonhighly compensated group is 4.75 percent ((5%+4.5%)/2)). Because 5.93 percent is less than 5.94 percent (4.75% multiplied by 1.25), the first percentage test is satisfied.

Example 2. (i) The facts are the same as in *Example 1*, except that elective contributions are made pursuant to a salary reduction agreement and no bonuses are paid. Employer X includes elective contributions in compensation as permitted under § 1.414(s)–

1(c)(4)(i). See §1.401(k)–1(g)(2)(i). In addition, A defers $2,025. Thus, the compensation and elective contributions for A, B, and C are:

Employee	Compensation	Elective contributions	Actual deferral ratio (percent)
A	$30,000	$2,025	6.75
B	15,000	750	5.00
C	10,000	450	4.50

(ii) The actual deferral percentage for the highly compensated group (Employee A) is 6.75 percent. The actual deferral percentage for the nonhighly compensated group is 4.75 percent ((5.00%+4.50%)/2). Because 6.75 percent exceeds 5.94 percent (4.75×1.25), the first percentage test is not satisfied. However, since the actual deferral percentage equals the maximum percentage allowed under the second percentage test, (4.75+2=6.75), the second percentage test is satisfied.

Example 3. (i) Employees D through L are eligible employees in Employer A's profit-sharing plan that contains a cash or deferred arrangement. Employer A includes elective contributions in compensation as permitted under §1.414(s)–1(c)(4)(i). Each eligible employee may elect to defer up to six percent of compensation under the cash or deferred arrangement. Employees D and E are highly compensated. The compensation, elective contributions, and actual deferral ratios of these employees for the 1989 plan year are shown below:

Employee	Compensation	Elective contributions	Actual deferral ratio (percent)
D	$100,000	$6,000	6
E	80,000	4,000	5
F	60,000	3,600	6
G	40,000	1,600	4
H	30,000	1,200	4
I	20,000	600	3
J	20,000	600	3
K	10,000	300	3
L	5,000	150	3

(ii) The actual deferral percentage for the highly compensated group is 5.5 percent. The actual deferral percentage for the nonhighly compensated group is 3.71 percent. Because 5.5 percent is greater than 4.64 percent (3.71%×1.25), the first percentage test is not satisfied. However, because 5.5 percent is less than 5.71 percent (the lesser of 3.71%+2 or 3.71%×2), the second percentage test is satisfied.

Example 4. (i) Employer D maintains a profit-sharing plan that contains a cash or deferred arrangement. Employer D includes elective contributions in compensation as permitted under §1.414(s)–1(c)(4)(i). The following amounts are contributed under the plan:

(A) Six percent of each employee's compensation. These contributions are not qualified nonelective contributions (QNCs).

(B) Two percent of each employee's compensation. These contributions are QNCs.

(C) Three percent of each employee's compensation that the employee may elect to receive as cash or to defer under the plan.

(ii) For the 1990 plan year, the compensation, elective contributions, and actual deferral ratios of employees M through S were:

Employee	Compensation	Elective contributions	Actual deferral ratio (percent)
M	$100,000	$3,000	3
N	80,000	1,600	2
O	60,000	1,800	3
P	40,000	0	0
Q	30,000	0	0
R	20,000	0	0
S	20,000	0	0

(iii) Both types of nonelective contributions are made for all employees. Thus, both the six percent and the two percent employer contributions satisfy the requirements of section 401(a)(4) and paragraph (b)(5)(i) of this section.

(iv) The elective contributions alone do not satisfy the special rules in paragraph (b)(4) of this section because the actual deferral percentage for the highly compensated group, consisting of employees M and N, is 2.5 percent and the actual deferral percentage for the nonhighly compensated group is 0.6 percent. However, the two percent QNCs may be taken into account in applying the special rules. The six percent nonelective contributions may not be taken into account because they are not QNCs.

(v) If the two percent QNCs are taken into account, the actual deferral percentage for the highly compensated group is 4.5 percent, and the actual deferral percentage for the nonhighly compensated group is 2.6 percent. Because 4.5 percent is not more than two percentage points greater than 2.6 percent, and not more than two times 2.6, the actual deferral percentage test of section 401(k)(3) and paragraph (b)(2) of this section is satisfied. Thus, the plan satisfies this paragraph (b).

Example 5. (i) Employer N maintains a plan that contains a cash or deferred arrangement. The plan year and the employer's taxable year are the calendar year. The plan provides for employee contributions, elective contributions, matching contributions, and qualified nonelective contributions (QNCs), all of which meet the applicable requirements of section 401(a)(4). Matching contributions on behalf of nonhighly compensated employees are qualified matching contributions (QMACs). Matching contributions on behalf of highly compensated employees are not QMACs. For the 1988 plan year, elective contributions and matching contributions with respect to highly compensated and nonhighly compensated employees are shown in the following chart.

	Elective contributions (including QNCs) (percent)	Total matching contributions (percent)	QMACs (percent)
Highly compensated	15	5	0
Nonhighly compensated	11	5	5

(ii) The plan fails to meet the requirements of section 401(k)(3)(A) because 15 percent is more than 125 percent of, and more than two percentage points greater than, 11 percent. However, the plan provides that QMACs may be used to meet the requirements of section 401(k)(3)(A)(ii) to the extent needed under that section. Under this provision, the plan takes QMACs of one percent of compensation into account for each nonhighly compensated employee in applying the actual deferral percentage test. After this adjustment, the actual deferral and actual contribution percentages are as follows:

	Actual deferral percentage	Actual contribution percentage
Highly compensated	15	5
Nonhighly compensated	12	4

(iii) The elective contributions and QMACs taken into account under section 401(k) meet the requirements of section 401(k)(3)(A)(ii) because 15 percent is 125 percent of 12 percent. The remaining matching contributions meet the requirements of section 401(m) because five percent is 125 percent of four percent.

(c) *Nonforfeitability requirement*—(1) *General rule.* A cash or deferred arrangement satisfies this paragraph (c) only if the elective contributions meet each of the following requirements:

(i) Each employee's right to the amount attributable to elective contributions is immediately nonforfeitable within the meaning of section 411, and would be nonforfeitable under the plan regardless of the age and service of the employee or whether the employee is employed on a specific date. A contribution that is subject to forfeitures or suspensions permitted by section 411(a)(3) does not satisfy the requirements of this paragraph (c).

(ii) The contributions are disregarded for purposes of applying section 411(a) to other contributions or benefits.

(iii) The contributions remain nonforfeitable even if the employee makes no additional elective contributions under a cash or deferred arrangement.

(2) *Example.* The provisions of this paragraph (c) are illustrated by the following example:

Example. (i) Employees B and C are covered by Employer Y's stock bonus plan, which includes a cash or deferred arrangement. Under the plan, Employer Y makes a nonelective contribution on behalf of each employee equal to four percent of compensation. All employees participating in the plan have a nonforfeitable right to a percentage of their accrued benefit derived from this contribution as shown in the following table:

Years of service	Nonforfeitable percentage
Less than 1	0
1	20
2	40
3	60
4	80
5 or more	100

(ii) B and C have three and six years of service, respectively. Employer Y also permits employees to elect to defer up to 6 percent of compensation through salary reduction agreements. Amounts deferred under these agreements are nonforfeitable at all times. In accordance with paragraph (c)(1)(i) of this section, the nonforfeitable percentage of Employer Y's nonelective contribution on behalf of B and C may not be treated as a qualified nonelective contribution under paragraph (b)(3) of this section, because these amounts are nonforfeitable by reason of the completion by B and C of a stated number of years of service, and not regardless of the age and service of B and C.

(d) *Distribution limitation*—(1) *General rule.* A cash or deferred arrangement satisfies this paragraph (d) only if amounts attributable to elective contributions may not be distributed before one of the following events, and any distributions so permitted also satisfy the requirements of paragraphs (d)(2) through (6) of this section (to the extent applicable):

(i) The employee's retirement, death, disability, or separation from service.

(ii) In the case of a profit-sharing or stock bonus plan, the employee's attainment of age 59½, or the employee's hardship.

(iii) For plan years beginning after December 31, 1984, the termination of the plan.

(iv) For plan years beginning after December 31, 1984, the date of the sale or other disposition by a corporation of substantially all the assets (within the meaning of section 409(d)(2)) used by the corporation in a trade or business of the corporation to an unrelated corporation.

(v) For plan years beginning after December 31, 1984, the date of the sale or other disposition by a corporation of its interest in a subsidiary (within the meaning of section 409(d)(3)) to an unrelated entity or individual.

(2) *Rules applicable to hardship distributions*—(i) *Distribution must be on account of hardship.* A distribution is treated as made after an employee's hardship for purposes of paragraph (d)(1)(ii) of this section only if it is made on account of the hardship. For purposes of this rule, a distribution is made on account of hardship only if the distribution both is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need. The determination of the existence of an immediate and heavy financial need and of the amount necessary to meet the need must be made in accordance with nondiscriminatory and objective standards set forth in the plan. See section 411(d)(6) and the regulations thereunder.

(ii) *Limit on distributable amount.* For plan years beginning after December 31, 1988, a distribution on account of hardship must be limited to the distributable amount. The distributable amount is equal to the employee's total elective contributions as of the date of distribution, reduced by the amount of previous distributions on account of hardship. If the plan so provides, the employee's total elective contributions used in determining the distributable amount may be increased by income allocable to elective contributions, by amounts treated as elective contributions under paragraph (b)(5) of this section, and by income allocable to amounts treated as elective contributions. The distributable amount may only include amounts that were credited to the employee's account as of a date specified in the plan that is no later than December 31, 1988, or if later, the end of the last plan year ending before July 1, 1989 (or such later date provided in paragraph (h) of this section).

(iii) *General hardship distribution standards*—(A) *Immediate and heavy financial need.* Whether an employee has an immediate and heavy financial need is to be determined based on all relevant facts and circumstances. Generally, for example, the need to pay the funeral expenses of a family member would constitute an immediate and heavy financial need. A distribution made to an employee for the purchase of a boat or television would generally not constitute a distribution made on account of an immediate and heavy financial need. A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee.

(B) *Distribution necessary to satisfy financial need.* A distribution is not treated as necessary to satisfy an immediate and heavy financial need of an employee to the extent the amount of the distribution is in excess of the amount required to relieve the financial need or to the extent the need may be satisfied from other resources that are reasonably available to the employee. This determination generally is to be made on the basis of all relevant facts and circumstances. For purposes of this paragraph, the employee's resources are deemed to include those assets of the employee's spouse and minor children that are reasonably available to the employee. Thus, for example, a vacation home owned by the employee and the employee's spouse, whether as community property, joint tenants, tenants by the entirety, or tenants in common, generally will be deemed a resource of the employee. However, property held for the employee's child under an irrevocable trust or under the Uniform Gifts to Minors Act is not treated as a resource of the employee. The amount of an immediate and heavy financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution. A distribution generally may be treated as necessary to satisfy a financial need if the employer relies upon the employee's written representation, unless the employer has actual knowledge to the contrary, that the need cannot reasonably be relieved:

(*1*) Through reimbursement or compensation by insurance or otherwise;

(*2*) By liquidation of the employee's assets;

(*3*) By cessation of elective contributions or employee contributions under the plan; or

(*4*) By other distributions or nontaxable (at the time of the loan) loans from plans maintained by the employer or by any other employer, or by borrowing from commercial sources on reasonable commercial terms, in an amount sufficient to satisfy the need.

For purposes of this paragraph (d)(2)(iii)(B), a need cannot reasonably be relieved by one of the actions listed above if the effect would be to increase the amount of the need. For example, the need for funds to purchase a principal residence cannot reasonably be relieved by a plan loan if the loan would disqualify the employee from obtaining other necessary financing.

(iv) *Deemed hardship distribution standards*—(A) *Deemed immediate and heavy financial need.* A distribution is deemed to be on account of an immediate and heavy financial need of the employee if the distribution is for:

(*1*) Expenses for medical care described in section 213(d) previously incurred by the employee, the employee's spouse, or any dependents of the employee (as defined in section 152) or necessary for these persons to obtain medical care described in section 213(d);

(*2*) Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);

(*3*) Payment of tuition, related educational fees, and room and board expenses, for the next 12 months of post-secondary education for the employee, or the employee's spouse, children, or dependents (as defined in section 152); or

(*4*) Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence.

(B) *Distribution deemed necessary to satisfy financial need.* A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if all of the following requirements are satisfied:

(*1*) The distribution is not in excess of the amount of the immediate and heavy financial need of the employee. The amount of an immediate and heavy financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

(*2*) The employee has obtained all distributions, other than hardship distributions, and all nontaxable (at the time of the loan) loans currently available under all plans maintained by the employer.

(*3*) The plan and all other plans maintained by the employer limit the employee's elective contributions for the next taxable year to the applicable limit under section 402(g) for that year minus the employee's elective contributions for the year of the hardship distribution.

(*4*) The employee is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 12 months after receipt of the hardship distribution. For this purpose the phrase ''all other plans maintained by the employer'' means all qualified and nonqualified plans of deferred compensation maintained by the employer. The phrase includes a stock option, stock purchase, or similar plan, or a cash or deferred arrangement that is part of a cafeteria plan within the meaning of section 125. However, it does not include the mandatory employee contribution portion of a defined benefit plan. It also does not include a health or welfare benefit plan, including one that is part of a cafeteria plan within the meaning of section 125. See §1.401(k)–1(g)(4)(i) for the continued treatment of suspended employees as eligible employees.

(C) *Commissioner may expand standards.* The Commissioner may expand the list of deemed immediate and heavy financial needs and may prescribe additional methods for distributions to be deemed necessary to satisfy an immediate and heavy financial need only in revenue rulings, notices, and other documents of general applicability, and not on an individual basis.

(3) *Rules applicable to distributions upon plan termination.* A distribution may not be made under paragraph (d)(1)(iii) of this section if the employer establishes or maintains a successor plan. For purposes of this rule, the definition of the term ''employer'' contained in paragraph (g)(6) of this section is applied as of the date of plan termination, and a successor plan is any other defined contribution plan maintained by the same employer. However, if at all times during the 24-month period beginning 12 months before the termination, fewer than two percent of the employees who were eligible under the defined contribution plan that includes the cash or deferred arrangement as of the date of plan termination are eligible under the other defined contribution plan, the other plan is not a successor plan. The term ''defined contribution plan'' means a plan that is a defined contribution plan as defined in section 414(i), but does not include an employee stock ownership plan as defined in section 4975(e) or 409(a) or a simplified employee pension as defined in section 408(k). A plan is a successor plan only if it exists at any time during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan.

(4) *Rules applicable to distributions upon sale of assets or subsidiary*—(i) *Seller must maintain the plan.* A distribution may be made under section 401(k)(10) and paragraph (d)(1) (iv) or (v) of this section only from a plan that the seller continues to maintain after the disposition. This requirement is satisfied if and only if the purchaser does not maintain the plan after the disposition. A purchaser maintains the plan of the seller if it adopts the plan or otherwise becomes an employer whose employees accrue benefits under the plan. A purchaser also maintains the plan if the plan is merged or consolidated with, or any assets or liabilities are transferred from the plan to a plan maintained by the purchaser in a transaction subject to section 414(*l*)(1). A purchaser is not treated as maintaining the plan merely because a plan that it maintains accepts elective transfers described in §1.411(d)–4, Q&A–3(b)(1), or rollover contributions of amounts distributed by the plan (including distributions that the recipient elects, under section 401(a)(31), to have paid in a direct rollover to the plan of the purchaser).

(ii) *Employee must continue employment.* A distribution may be made under paragraph (d)(1) (iv) or (v) of this section only to an employee who continues employment with the purchaser of assets or with the subsidiary, whichever is applicable.

(iii) *Distribution must be in connection with disposition of assets or subsidiary.* Elective contributions may not be distributed under paragraph (d)(1) (iv) or (v) of this section except in connection with the disposition that results in the employee's transfer to the purchaser. Whether a distribution is made in connection with the disposition of assets or a subsidiary depends on all of the facts and circumstances. Except in unusual circumstances, however, a distribution will not be treated as having been made in connection with a disposition unless it was made by the end of the second calendar year after the calendar year in which the disposition occurred.

(iv) *Definitions*—(A) *Substantially all.* For purposes of paragraph (d)(1)(iv) of this section, the sale of ''substantially all'' the assets used in a trade or business means the sale of at least 85 percent of the assets.

(B) *Unrelated employer.* For purposes of paragraph (d)(1) (iv) and (v) of this section, an ''unrelated'' entity or individual is one that is not required to be aggregated with the seller under section 414 (b), (c), (m), or (o) after the sale or other disposition.

(5) *Lump sum requirement for certain distributions.* After March 31, 1988, a distribution may be made under paragraph (d)(1) (iii), (iv), or (v) of this section only if it is a lump sum distribution. The term *lump sum distribution* has the meaning provided in section 402(d)(4), without regard to subparagraphs (A) (i) through (iv), (B), and (F) of that section.

(6) *Rules applicable to all distributions*—(i) *Impermissible distributions.* Amounts attributable to elective contributions may not be distributed on

account of any event not described in this paragraph (d), such as completion of a stated period of plan participation or the lapse of a fixed number of years. For example, if excess deferrals (and income) for an employee's taxable year are not distributed within the time prescribed in § 1.402(g)–1(e) (2) or (3), the amounts may be distributed only on account of an event described in this paragraph (d).

(ii) *Deemed distributions.* The cost of life insurance (P.S. 58 costs) is not treated as a distribution for purposes of section 401(k)(2) and this paragraph. The making of a loan is not treated as a distribution, even if the loan is secured by the employee's accrued benefit attributable to elective contributions or is includible in the employee's income under section 72(p). However, the reduction, by reason of default on a loan, of an employee's accrued benefit derived from elective contributions is treated as a distribution.

(iii) *ESOP dividend distributions.* A plan does not fail to satisfy the requirements of this paragraph (d) merely by reason of a dividend distribution described in section 404(k)(2).

(iv) *Limitations apply after transfer.* The limitations of this paraqraph (d) generally continue to apply to amounts attributable to elective contributions (including amounts treated as elective contributions) that are transferred to another qualified plan of the same or another employer. Thus, the transferee plan will generally fail to satisfy the requirements of section 401(a) and this section if transferred amounts may be distributed before the times specified in this paragraph (d). The limitations of paragraph (d) of this section cease to apply after the transfer, however, if the amounts could have been distributed at the time of the transfer (other than on account of hardship), and the transfer is an elective transfer described in § 1.411(d)–4, Q&A–3(b)(1). The limitations of paragraph (d) of this section also do not apply to amounts distributed from another plan that the recipient elects under section 401(a)(31) to have paid in a direct rollover to the plan.

(v) *Required consent.* A distribution may be made under this paragraph (d) only if any consent or election required under section 411(a)(11) or 417 is obtained.

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

Example 1. Employer C maintains a profit-sharing plan that includes a cash or deferred arrangement. Elective contributions under the arrangement may be withdrawn for any reason after two years following the end of the plan year in which the contributions were made. Because the plan permits distributions of elective contributions before the occurrence of one of the events specified in section 401(k)(2)(B) and this paragraph (d), the plan includes a nonqualified cash or deferred arrangement and the elective contributions are currently includible in income under section 402.

Example 2. Employer D maintains a pre-ERISA money purchase plan that includes a cash or deferred arrangement. Elective contributions under the arrangement may be distributed to an employee on account of hardship. Under paragraph (d)(1) of this section, hardship is a distribution event only in a profit-sharing or stock bonus plan. Since elective contributions under the arrangement may be distributed before a distribution event occurs, the cash or deferred arrangement does not satisfy this paragraph (d), and is not a qualified cash or deferred arrangement. Moreover, the plan is not a qualified plan because a pension plan may not provide for payment of benefits upon hardship. See § 1.401–1(b)(1)(i).

(e) *Additional requirements for qualified cash or deferred arrangements*—(1) *Qualified profit-sharing, stock bonus, pre-ERISA money purchase or rural cooperative plan requirement.* A cash or deferred arrangement satisfies this paragraph (e) only if the plan of which it is a part is a profit-sharing, stock bonus, pre-ERISA money purchase or rural cooperative plan that otherwise satisfies the requirements of section 401(a) (taking into account the cash or deferred arrangement). A plan that includes a cash or deferred arrangement may provide for other contributions, including employer contributions (other than elective contributions), employee contributions, or both. See paragraph (e)(7) of this section, however, for limitations on the extent to which elective contributions under a cash or deferred arrangement may be taken into account in determining whether the other contributions satisfy the requirements of section 401(a).

(2) *Cash availability requirement.* A cash or deferred arrangement satisfies this paragraph (e) only if the arrangement provides that the amount that each eligible employee may defer as an elective contribution is available to the employee in cash. Thus, for example, if an eligible employee is provided the option to receive a taxable benefit (other than cash) or to have the employer contribute on the employee's behalf to a profit-sharing plan an amount equal to the value of the taxable benefit, the arrangement is not a qualified cash or deferred arrangement. Similarly, if an employee has the option to receive a specified amount in cash or to have the employer contribute an amount in excess of the specified cash amount to a profit-sharing plan on the employee's behalf, any contribution made by the employer on the employee's behalf in excess of the specified cash amount is not treated as made pursuant to a qualified cash or deferred arrangement. This cash availability requirement applies even if the cash or deferred arrangement is part of a cafeteria plan within the meaning of section 125.

(3) *Separate accounting requirement*—(i) *General rule.* A cash or deferred arrangement satisfies this paragraph (e) only if the portion of an employee's benefit subject to the requirements of paragraphs (c) and (d) of this section is determined by an acceptable separate accounting between that portion and any other benefits. Separate accounting is not acceptable unless gains, losses, withdrawals, and other credits or charges are separately allocated on a reasonable and consistent basis to the accounts subject to the requirements of paragraphs (c) and (d) of this section and to other accounts. Subject to section 401(a)(4), forfeitures are not required to be allocated to the accounts in which benefits are subject to paragraphs (c) and (d) of this section.

(ii) *Failure to satisfy separate accounting requirement.* The requirements of paragraph (e)(3)(i) of this section are treated as satisfied if all amounts held under a plan that includes a cash or deferred arrangement or under another plan, contributions under which are taken into account under the arrangement for purposes of paragraph (b) of this section are treated as attributable to elective contributions subject to the requirements of paragraphs (c) and (d) of this section.

(4) *Limitations on cash or deferred arrangements of state and local governments and tax-exempt organizations*—(i) A cash or deferred arrangement does not satisfy the requirements of this paragraph (e) if the arrangement is adopted:

(A) After May 6, 1986, by a state or local government or political subdivision thereof, or any agency or instrumentality thereof (“a governmental unit”), or

(B) After July 1, 1986, by any organization exempt from tax under subtitle A of the Internal Revenue Code.

For purposes of paragraph (e)(4) of this section, whether an organization is exempt from tax under subtitle A of the Internal Revenue Code is determined without regard to section 414 (b), (c), (m) or (o).

(ii) A cash or deferred arrangement is treated as adopted after the dates described in paragraph (e)(4)(i) of this section with respect to all employees of any employer that adopts the arrangement after such dates. If an employer adopted an arrangement prior to such dates, all employees of the employer may participate in the arrangement.

(iii) For purposes of this paragraph (e)(4), an employer that has made a legally binding commitment to adopt a cash or deferred arrangement is treated as having adopted the arrangement on that date.

(iv) If a governmental unit adopted a cash or deferred arrangement before May 7, 1986, then any cash or deferred arrangement adopted by the unit at any time is treated as adopted before that date.

(v) This paragraph (e)(4) does not apply to a rural cooperative plan.

(vi) For purposes of this paragraph (e)(4), an employee representative is treated as an employee of a tax exempt employer even if the employee could be treated as an employee by another employer under §1.413–1(i)(1).

(5) *One-year eligibility requirement.* For plan years beginning after December 31, 1988, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this

paragraph (e) only if no employee is required to complete a period of service greater than one year (determined without regard to section 410(a)(1)(B)(i)) with the employer maintaining the plan to be eligible to make an election under the arrangement.

(6) *Other benefits not contingent upon elective contributions*—(i) *General rule.* For plan years beginning after December 31, l988, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (e) only if no other benefit is conditioned (directly or indirectly) upon the employee's electing to make or not to make elective contributions under the arrangement. The preceding sentence does not apply to any matching contribution (as defined in section 401(m)) made by reason of such an election or to any benefit that is provided at the employee's election under a plan described in section 125(d) in lieu of an elective contribution under a qualified cash or deferred arrangement.

(ii) *Definition of other benefits.* Other benefits include, but are not limited to, benefits under a defined benefit plan; nonelective employer contributions under a defined contribution plan; the availability, cost, or amount of health benefits; vacations or vacation pay; life insurance; dental plans; legal services plans; loans (including plan loans); financial planning services; subsidized retirement benefits; stock options; property subject to section 83; and dependent care assistance. Also, increases in salary and bonuses (other than those actually subject to the cash or deferred election) are benefits for purposes of this paragraph (e)(6). The ability to make after-tax employee contributions is a benefit, but that benefit is not contingent upon an employee's electing to make or not make elective contributions under the arrangement merely because the amount of elective contributions reduces dollar-for-dollar the amount of after-tax employee contributions that may be made. Benefits under any other plan or arrangement (whether or not qualified) are not contingent upon an employee's electing to make or not to make elective contributions under a cash or deferred arrangement merely because the elective contributions are or are not taken into account as compensation under the other plan or arrangement for purposes of determining benefits.

(iii) *Effect of certain statutory limits.* A benefit under a defined benefit plan that is contingent upon elective contributions solely by reason of the combined plan fraction of section 415(e) is not treated as contingent for purposes of this paragraph (e)(6). Similarly, any benefit under an excess benefit plan described in section 3(36) of the Employee Retirement Income Security Act of l974 that is dependent on the employee's electing to make or not to make elective contributions is not treated as contingent.

(iv) *Nonqualified deferred compensation.* Participation in a nonqualified deferred compensation plan is treated as contingent for purposes of this paragraph (e)(6) only to the extent that an employee may receive additional deferred compensation under the nonqualified plan to the extent the employee makes or does not make elective contributions. Deferred compensation under a nonqualified plan of deferred compensation that is dependent on an employee's having made the maximum elective deferrals under section 402(g) or the maximum elective contributions permitted under the terms of the plan also is not treated as contingent.

(v) *Plan loans and distributions.* A loan or distribution of elective contributions is not a benefit conditioned on an employee's electing to make or not make elective contributions under the arrangement merely because the amount of the loan or distribution is based on the amount of the employee's account balance.

(vi) *Examples.* The provisions of this paragraph (e)(6) are illustrated by the following examples.

Example 1. Employer T maintains a cash or deferred arrangement for all of its employees. Employer T also maintains a nonqualified deferred compensation plan for two highly paid executives, Employees R and C. Under the terms of the nonqualified deferred compensation plan, R and C are eligible to participate only if they do not make elective contributions under the cash or deferred arrangement. Participation in the nonqualified plan is a contingent benefit for purposes of this paragraph (e)(6), because R's and C's participation is conditioned on their electing not to make elective contributions under the cash or deferred arrangement.

Example 2. Employer T maintains a cash or deferred arrangement for all its employees. Employer T also maintains a nonqualified deferred compensation plan for two highly paid executives, Employees R and C. Under the terms of the arrangements, Employees R and C may defer a maximum of 10 percent of their compensation, and may allocate their deferral between the cash or deferred arrangement and the nonqualified deferred compensation plan in any way they choose (subject to the overall 10 percent maximum). Because the maximum deferral available under the nonqualified deferred compensation plan depends on the elective deferrals made under the cash or deferred arrangement, the right to participate in the nonqualified plan is a contingent benefit for purposes of paragraph (e)(6).

(7) *Coordination with other plans.* For plan years beginning after December 31, 1988, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (e) only if no elective contributions (or qualified matching contributions treated as elective contributions under paragraph (b)(5) of this section) under the arrangement are taken into account for purposes of determining whether any other contributions under any plan (including the plan to which the elective contributions are made) satisfy the requirements of section 401(a). Indeed, the portion of a plan that consists of elective contributions is treated as a separate plan for purposes of sections 401(a)(4) and 410(b). See §1.410(b)–7(c)(1). Similarly, elective contributions under a cash or deferred arrangement generally may not be taken into account in determining whether a plan satisfies the minimum contribution or benefit requirements of section 416. See §1.416–1, M–20. However, qualified nonelective contributions that are treated as elective contributions for purposes of section 401(k)(3) under paragraph (b)(5) of this section may be used to enable a plan to satisfy the minimum contribution or benefit requirements under section 416. See §1.416–1, M–18. This paragraph (e) does not apply for purposes of determining whether a plan satisfies the average benefit percentage requirement of section 410(b)(2)(A)(ii). See also §1.401(m)–1(b)(5) for circumstances under which elective contributions may be used to determine whether a plan satisfies the requirements of section 401(m).

(8) *Recordkeeping requirements.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (e) only if the employer maintains the records necessary to demonstrate compliance with the applicable nondiscrimination requirements of paragraph (b) of this section, including the extent to which qualified nonelective contributions and qualified matching contributions are taken into account.

(9) *Consistent application of separate line of business rules.* If an employer is treated as operating qualified separate lines of business under section 414(r) in accordance with §1.414(r)–1(b) for purposes of applying section 410(b), and applies the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) to the portion of the plan that consists of contributions under the cash or deferred arrangement, then the requirements of section 401(k) and this section must be applied on an employer-wide rather than a qualified-separate-line-of-business basis to all of the plans or portions of plans taken into account in determining whether the cash or deferred arrangement is a qualified cash or deferred arrangement, regardless of whether those plans or portions of plans also satisfy the requirements necessary to apply the special rule in §1.414(r)–1(c)(2)(ii). Conversely, if an employer is treated as operating qualified separate lines of business under section 414(r) in accordance with §1.414(r)–1(b) for purposes of applying section 410(b), and does not apply the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) to the portion of the plan that consists of contributions under the cash or deferred arrangement, then the requirements of section 401(k) and this section must be applied on a qualified-separate-line-of-business rather than an employer-wide basis to all of the plans or portions of plans taken into account in determining whether the cash or deferred arrangement is a qualified cash or deferred arrangement, regardless of whether one or more of those plans or portions of

plans is tested under the special rule § 1.414(r)–1(c)(2)(ii). This requirement applies solely for purposes of determining whether the cash or deferred arrangement is a qualified cash or deferred arrangement under section 401(k) and this section. The rules of this paragraph are illustrated by the following example.

Example. (i) Employer A maintains a profit-sharing plan that includes a cash or deferred arrangement in which all of the employees of Employer A are eligible to participate. Employer A is treated as operating qualified separate lines of business under section 414(r) in accordance with § 1.414(r)–1(b) for purposes of applying section 410(b). However, Employer A applies the special rule for employer-wide plans in § 1.414(r)–1(c)(2)(ii) to the portion of its profit-sharing plan that consists of elective contributions under the cash or deferred arrangement (and to no other plans or portions of plans). Employer A makes qualified nonelective contributions to the profit-sharing plan for the 1995 plan year, and the profit-sharing plan provides that these qualified nonelective contributions may be used to satisfy the actual deferral percentage test.

(ii) Under these facts, the requirements of sections 401(a)(4) and 410(b) must be applied on an employer-wide rather than a qualified-separate-line-of-business basis in determining whether the qualified nonelective contributions made to the profit-sharing plan satisfy the requirements of § 1.401(k)–1(b)(5), and thus whether they may be taken into account under the actual deferral percentage test. Therefore, in order for the nonelective contributions to be used to satisfy the actual deferral percentage test, both (1) the total amount of nonelective contributions under the profit-sharing plan, including the qualified nonelective contributions to be used to satisfy the actual deferral percentage test, and (2) the total amount of nonelective contributions under the profit-sharing plan, excluding the qualified nonelective contributions to be used to satisfy the actual deferral percentage test, must satisfy the requirements of section 401(a)(4) on an employer-wide basis. Of course, in order for the profit-sharing plan to satisfy section 401(a), it must still satisfy sections 410(b) and 401(a)(4) on a qualified-separate-line-of-business basis.

(f) *Correction of excess contributions*—(1) *General rule*—(i) *Permissible correction methods.* A cash or deferred arrangement does not fail to satisfy the requirements of section 401(k)(3) or paragraph (b)(2) of this section with respect to the amount of elective contributions under the arrangement if the employer, in accordance with the terms of the plan that includes the cash or deferred arrangement and paragraph (b)(5) of this section, makes qualified nonelective contributions or qualified matching contributions that are treated as elective contributions under the arrangement and that, in combination with the elective contributions, satisfy the requirements of paragraph (b)(2) of this section. In addition, a cash or deferred arrangement does not fail to satisfy the requirements of section 401(k)(3) or paragraph (b)(2) of this section for a plan year with respect to the amount of the elective contributions under the arrangement if, in accordance with the terms of the plan that includes the cash or deferred arrangement, excess contributions are recharacterized in accordance with paragraph (f)(3) of this section, or excess contributions (and income allocable thereto) are distributed in accordance with paragraph (f)(4) of this section.

(ii) *Combination of correction methods.* A plan may use any of the correction methods described in paragraph (f)(1)(i) of this section, may limit elective contributions in a manner designed to prevent excess contributions from being made, or may use a combination of these methods, to avoid or correct excess contributions. Thus, for example, a portion of the excess contributions for a highly compensated employee may be recharacterized under paragraph (f)(3) of this section, and the remaining portion of the excess contributions may be distributed under paragraph (f)(4) of this section. A plan may require or permit a highly compensated employee to elect whether any excess contributions are to be recharacterized or distributed.

(iii) *Impermissible correction methods.* Excess contributions for a plan year may not remain unallocated or be allocated to a suspense account for allocation to one or more employees in any future year. In addition, excess contributions may not be corrected using the retroactive correction rules of § 1.401(a)(4)–11(g). See § 1.401(a)(4)–11(g)(3)(vii) and (5). See paragraph (f)(6) of this section for the effects of a failure to correct excess contributions.

(iv) *Partial distributions.* Any distribution of less than the entire amount of excess contributions with respect to any highly compensated employee is treated as a pro rata distribution of excess contributions and allocable income or loss.

(2) *Amount of excess contributions.* The amount of excess contributions for a highly compensated employee for a plan year is the amount (if any) by which the employee's elective contributions must be reduced for the employee's actual deferral ratio to equal the highest permitted actual deferral ratio under the plan. To calculate the highest permitted actual deferral ratio under a plan, the actual deferral ratio of the highly compensated employee with the highest actual deferral ratio is reduced by the amount required to cause the employee's actual deferral ratio to equal the ratio of the highly compensated employee with the next highest actual deferral ratio. If a lesser reduction would enable the arrangement to satisfy the actual deferral percentage test, only this lesser reduction may be made. This process must be repeated until the cash or deferred arrangement satisfies the actual deferral percentage test. The highest actual deferral ratio remaining under the plan after leveling is the highest permitted actual deferral ratio. Thus, for each highly compensated employee, the amount of excess contributions for a plan year is equal to the employee's elective contributions, plus qualified nonelective contributions and qualified matching contributions taken into account in determining the employee's actual deferral ratio under paragraph (g)(1) of this section, minus the amount determined by multiplying the employee's actual deferral ratio (determined after application of this paragraph (f)(2)) by the compensation used in determining the ratio. In no case may the amount of excess contributions to be recharacterized or distributed for a plan year with respect to any highly compensated employee exceed the amount of elective contributions made on behalf of the highly compensated employee for the plan year.

(3) *Recharacterization of excess contributions*—(i) *General rule.* Excess contributions are recharacterized in accordance with this paragraph (f)(3) only if the excess contributions are treated as described in paragraph (f)(3)(ii) of this section, and all of the conditions set forth in paragraph (f)(3)(iii) of this section are satisfied.

(ii) *Treatment of recharacterized excess contributions.*

(A) Excess contributions recharacterized under this paragraph (f)(3) are includable in the employee's gross income on the earliest dates any elective contribution made on behalf of the employee during the plan year would have been received by the employee had the employee originally elected to receive the amounts in cash, or on such later date permitted in paragraph (f)(3)(iv) of this section. The recharacterized excess contributions must be treated as employee contributions for purposes of section 72, section 401(a)(4) and 401(m), and paragraphs (b) and (d) of this section. This requirement is not treated as satisfied unless:

(*1*) The payor or plan administrator reports the recharacterized excess contributions as employee contributions to the Internal Revenue Service and the employee by—

(*i*) Timely providing such forms as the Commissioner may designate to the employer and to employees whose excess contributions are recharacterized under this paragraph (f)(3); and

(*ii*) Timely taking such other action as the Commissioner may require; and

(*2*) The plan administrator accounts for the amounts as contributions by the employee for purposes of sections 72 and 6047.

(B) Recharacterized excess contributions continue to be treated as employer contributions that are elective contributions for all other purposes under the Internal Revenue Code, including sections 401(a) (other than 401(a)(4) and 401(m)), 404, 409, 411, 412, 415, 416, and 417. Thus, for example, recharacterized excess contributions remain subject to the requirements of paragraph (c) of this section; must be deducted under section 404; and are treated as employer contributions described in section 415(c)(2)(A) and §1.415–6(b). In addition, these amounts are not treated as compensation for purposes of sections 404 and 415, and may be treated as compensation for purposes of sections 401(a)(4), 401(a)(5), 401(k), 401(l) and 414(s) only to the extent that elective contributions may be treated, and are treated under the plan, as compensation. See §1.414(s)–1(c)(4)(i). Recharacterized excess contributions that relate to plan years ending on or before October 24, 1988, may be treated as either employer contributions or employee contributions for purposes of paragraph (d) of this section. The amount of excess contributions included in an employee's gross income is reduced as provided under paragraph (f)(5)(i)(B) of this section.

(iii) *Additional rules*—(A) *Time of recharacterization.* Excess contributions may not be recharacterized under this paragraph (f)(3) after the later of October 24, 1988, or 2½ months after the close of the plan year to which the recharacterization relates. Recharacterization is deemed to have occurred on the date on which the last of those highly compensated employees with excess contributions to be recharacterized is notified in accordance with paragraph (f)(3)(ii)(A) of this section. The Commissioner may designate the means by which this notification is to be provided.

(B) *Employee contributions must be permitted under plan.* The amount of recharacterized excess contributions, in combination with the employee contributions actually made by the highly compensated employee, may not exceed the maximum amount of employee contributions (determined without regard to the actual contribution percentage test of section 401(m)(2)) that the highly compensated employee could have made under the provisions of the plan in effect on the first day of the plan year in the absence of recharacterization. See §1.401(m)–1(a)(2) for requirements relating to the availability of employee contributions.

(C) *Plans under which excess contributions may be recharacterized.* For plan years beginning after December 31, 1991, elective contributions may be recharacterized under this paragraph (f)(3) only under the plan under which they are made or under a plan with which that plan could be aggregated under §1.410(b)–7(d) after application of the mandatory disaggregation rules of §1.410(b)–7(c), as modified in §1.401(k)–1(g)(11). For plan years beginning before that date and after December 31, 1988, or such later date provided under paragraph (h) of this section, elective contributions may be recharacterized under this paragraph (f)(3) only under the plan under which they are made or under a plan with the same plan year as that plan.

(iv) *Transition rules.* If amounts recharacterized for any plan year were not previously included in income, they must be treated as received by employees for income tax purposes on the first day of the first plan year ending after 1987. If notice of recharacterization was provided to the affected highly compensated employees by October 24, 1988, recharacterization is deemed to have occurred 2½ months after the close of the plan year and the penalty tax of section 4979 will not be imposed. The rules in this paragraph (f)(3)(iv) are effective only for plan years ending before August 9, 1988.

(v) *Example.* The provisions of this paragraph (f)(3) are illustrated by the following example:

Example. (i) Employer X maintains Plan Y, a calendar year profit-sharing plan that includes a qualified cash or deferred arrangement. Under Plan Y, each eligible employee may elect to defer up to 10 percent of compensation under a salary reduction agreement. An eligible employee may also make employee contributions of up to 10 percent of compensation. X pays the amounts deferred to the trust on the last day of each month. Employer X includes elective contributions in compensation as permitted under §1.414(s)–1(c)(4)(i). See §1.401(k)–1(g)(2)(i). Salaries are paid on the same date.

(ii) (A) In January 1989, X determines that during 1988 the compensation and actual deferral ratios (ADRs) of X's six employees were as follows:

Employee	Compensation (A)	Elective contribution (B)	ADR (%)(B/A)
A	$70,000	$7,000	10.00
B	60,000	4,500	7.50
C	20,000	1,000	5.00
D	15,000	0	0
E	10,000	350	3.50
F	10,000	350	3.50

(B) The average deferral percentage (ADP) for X's highly compensated group, A and B, is 8.75 percent ((10.00%+7.50%)/2). The ADP for X's other employees is 3 percent ((5.00%+0% + 3.50% + 3.50%)/4). Because 8.75

percent is more than 2 times 3 percent and more than 3 percent plus 2 percentage points, the plan fails to satisfy paragraph (b)(2) of this section. Neither A nor B made any employee contributions for the year.

(iii) Plan Y provides that each highly compensated participant will have excess contributions, as defined in paragraph (g)(7) of this section, recharacterized. The amount to be recharacterized will be determined according to the method described in paragraph (f)(2) of this section.

(iv) In order to satisfy paragraph (b)(2) of this section, Plan Y must reduce the ADP for X's highly compensated employees to not more than 5 percent. This will satisfy the test described in paragraph (b)(2) of this section, because 5 percent is not more than 2 times 3 percent and is not more than 2 percentage points greater than 3 percent. Plan Y first reduces A's ADR to 7.5 percent (the ADR of the highly compensated employee having the next highest ADR). Since this is not sufficient to satisfy the ADP test in paragraph (b)(2) of this section, the ADR of both A and B must be reduced to 5 percent.

(v) The maximum dollar amount that may be deferred by each employee is determined by using the formula D=(ADR×S) where D is the maximum allowable deferral, ADR is the reduced ADR, and S is the compensation. Thus, A's maximum allowable deferral is $3,500 (.05×$70,000), and B's maximum allowable deferral is $3,000 (.05×$60,000). The balance of the original deferrals by A and B ($3,500 and $1,500 respectively) must be included in their taxable wages for 2988, the year in which X would have paid cash to A and B.

(vi) A deferred $583.33 per month, except for January, February, March, and April, when A deferred $583.34. Pursuant to the first-in, first-out rule in paragraph (f)(3)(ii) of this section, the deferrals made in January, February, March, April, and May, as well as $583.31 of the deferral made in June, are treated as employee contributions. A similar procedure is undertaken with respect to B. X and the plan administrator provide A and B with the forms and notices that the Commissioner requires. If A and B had already filed income tax returns for 1988, they must file amended returns. If Plan Y had a plan year ending November 30, 1987, and A and B had made elective deferrals in December 1987, they would also have to file amended returns for 1987. In addition, the plan administrator must satisfy paragraph (f)(3)(ii)(B) of this section. Of course, the actual contribution percentage test of section 401(m)(2) must be satisfied for 1988, taking the recharacterized amounts into account.

(4) *Corrective distribution of excess contributions (and income)*—(i) *General rule.* Excess contributions (and income allocable thereto) are distributed in accordance with this paragraph (f)(4) only if the excess contributions and allocable income are designated by the employer as a distribution of excess contributions (and income), and are distributed to the appropriate highly compensated employees after the close of the plan year in which the excess contributions arose and within 12 months after the close of that plan year. In the event of a complete termination of the plan during the plan year in which an excess contribution arose, the corrective distribution must be made as soon as administratively feasible after the date of termination of the plan, but in no event later than 12 months after the date of termination. If the entire account balance of a highly compensated employee is distributed during the plan year in which an excess contribution arose, the distribution is deemed to have been a corrective distribution of excess contributions (and income) to the extent that a corrective distribution would otherwise have been required.

(ii) *Income allocable to excess contributions*—(A) *General rule.* The income allocable to excess contributions is equal to the sum of the allocable gain or loss for the plan year and, if the plan so provides, the allocable gain or loss for the period between the end of the plan year and the date of distribution (the ‘‘gap period’’).

(B) *Method of allocating income.* A plan may use any reasonable method for computing the income allocable to excess contributions, provided that the method does not violate section 401(a)(4), is used consistently for all participants and for all corrective distributions under the plan for the plan year, and is used by the plan for allocating income to participants' accounts. See §1.401(a)(4)–1(c)(8).

(C) *Alternative method of allocating income.* A plan may allocate income to excess contributions by multiplying the income for the plan year (and the gap period, if the plan so provides) allocable to elective contributions and amounts treated as elective contributions by a fraction. The numerator of the fraction is the excess contributions for the employee for the plan year. The denominator of the fraction is equal to the sum of:

(*1*) The total account balance of the employee attributable to elective contributions and amounts treated as elective contributions as of the beginning of the plan year; plus

(*2*) The employee's elective contributions and amounts treated as elective contributions for the plan year and for the gap period if gap period income is allocated.

(D) *Safe harbor method of allocating gap period income.* Under the safe harbor method, income on excess contributions for the gap period is equal to 10 percent of the income allocable to excess contributions for the plan year (calculated under the method described in paragraph (f)(4)(ii)(C)) of this section, multiplied by the number of calendar months that have elapsed since the end of the plan year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of the month is treated as made on the last day of the preceding month. A distribution made after the fifteenth day of the month is treated as made on the first day of the next month.

(iii) *No employee or spousal consent required.* A corrective distribution of excess contributions (and income) may be made under the terms of the plan without regard to any notice or consent otherwise required under sections 411(a)(11) and 417.

(iv) *Treatment of corrective distributions as employer contributions.* Excess contributions are treated as employer contributions for purposes of sections 404 and 415 even if distributed from the plan.

(v) *Tax treatment of corrective distributions*—(A) *General rule.* Except as provided in paragraph (f)(4)(v) (B) or (C) of this section, a corrective distribution of excess contributions (and income) that is made within 2½ months after the end of the plan year for which the excess contributions were made is includible in the employee's gross income on the earliest dates any elective contributions by the employee during the plan year would have been received by the employee had the employee originally elected to receive the amounts in cash. A corrective distribution of excess contributions (and income) that is made more than 2½ months after the end of the plan year for which the contributions were made is includible in the employee's gross income in the employee's taxable year in which distributed. Regardless of when the corrective distribution is made, it is not subject to the early distribution tax of section 72(t) and is not treated as a distribution for purposes of applying the excise tax under section 4980A. See paragraph (f)(5)(i)(B) of this section for rules relating to the taxation of excess contributions that reduce excess deferrals. See paragraph (f)(6)(i) of this section for additional rules relating to the employer excise tax on amounts distributed more than 2½ months after the end of the plan year.

(B) *Rule for de minimis distributions.* If the total amount of excess contributions and excess aggregate contributions distributed to a recipient under a plan for any plan year is less than $100 (excluding income), a corrective distribution of excess contributions (and income) is includible in the gross income of the recipient in the taxable year of the recipient in which the corrective distribution is made.

(C) *Rule for certain 1987 and 1988 excess contributions.* Distributions for plan years beginning in 1987 and 1988 to which the de minimis rule of this section would otherwise apply may be reported by the recipient, at the recipient's option, either in the year described in paragraph (f)(4)(v)(A) of this section, or in the year described in paragraph (f)(4)(v)(B) of this section. This special rule may be used only for distributions made within 2½ months after the close of the plan year, but in no event later than April 17, 1989.

(vi) *No reduction of required minimum distribution.* A distribution of excess contributions (and income) is not treated as a distribution for purposes of determining whether the plan satisfies the minimum distribution requirements of section 401(a)(9).

(5) *Rules applicable to all corrections*—(i) *Coordination with distribution of excess deferrals*—(A) *In general.* The amount of excess contributions to be recharacterized under paragraph (f)(3) of this section or distributed under

paragraph (f)(4) of this section with respect to an employee for a plan year, is reduced by any excess deferrals previously distributed to the employee for the employee's taxable year ending with or within the plan year in accordance with section 402(g)(2).

(B) *Treatment of excess contributions that reduce excess deferrals.* Under § 1.402(g)–1(e), the amount of excess deferrals that may be distributed with respect to an employee for a taxable year is reduced by any excess contributions previously distributed or recharacterized with respect to the employee for the plan year beginning with or within the taxable year. The amount of excess contributions includible in the gross income of the employee, and the amount of excess contributions reported by the payor or plan administrator as includible in the gross income of the employee, does not include the amount of any reduction under § 1.402(g)–1(e)(6).

(ii) *Correction of family members.* The determination and correction of excess contributions of a highly compensated employee whose actual deferral ratio is determined under the family aggregation rules of paragraph (g)(1)(ii)(C) of this section is accomplished by reducing the actual deferral ratio as required under paragraph (f)(2) of this section and allocating the excess contributions for the family group among the family members in proportion to the elective contribution of each family member that is combined to determine the actual deferral ratio.

(iii) *Matching contributions forfeited because of excess deferral or contribution.* For purposes of section 401(k)(2)(C) and paragraph (c)(1) of this section, a qualified matching contribution is not treated as forfeitable merely because under the plan it is forfeited if the contribution to which it relates is treated as an excess contribution, excess deferral, or excess aggregate contribution.

(6) *Failure to correct*—(i) *Failure to correct within 2½ months after end of plan year.* If a plan does not correct excess contributions within 2½ months after the close of the plan year for which the excess contributions are made, the employer will be liable for a 10-percent excise tax on the amount of the excess contributions. See section 4979 and § 54.4979–1. Qualified nonelective contributions and qualified matching contributions properly taken into account under paragraph (b)(5) of this section for a plan year may enable a plan to avoid having excess contributions, even if the contributions are made after the close of the 2½ month period.

(ii) *Failure to correct within 12 months after end of plan year.* If excess contributions are not corrected within 12 months after close of the plan year for which they were made, the cash or deferred arrangement will fail to satisfy the requirements of section 401(k)(3) for the plan year for which the excess contributions are made and all subsequent plan years during which the excess contributions remain in the trust.

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

Example 1. (i) The Y corporation maintains a cash or deferred arrangement. The plan year is the calendar year. For plan year 1989, all 10 of Y's employees are eligible to participate in the cash or deferred arrangement. The Y corporation includes elective contributions in compensation as permitted under § 1.414(s)–1(c)(4)(i). See § 1.401(k)–1(g)(2)(i). The employees' compensation, elective contributions, and actual deferral ratios are shown in the following table:

Employee	Compensation	Elective contributions	Actual deferral ratio (ADR) (percent)
A	$160,000	$6,400	4.0
B	140,000	7,000	5.0
C	70,000	7,000	10.0
D	65,000	6,500	10.0
E	42,000	2,100	5.0
F	35,000	3,500	10.0
G	28,000	2,800	10.0
H	21,000	700	3.33
I	21,000	0	0
J	21,000	0	0

(ii) Employees A, B, C, and D are highly compensated employees. Employees E, F, G, H, I, and J are nonhighly compensated employees. The actual deferral percentage (ADP) for the highly compensated group is 7.25 percent. The ADP for the nonhighly compensated group is 4.72 percent. These percentages do not meet the requirements of section 401(k)(3)(A)(ii).

(iii) Employees A and C have each received a distribution of excess deferrals of $1,000. However, the ADR for employee A remains 4.0 percent and the actual deferral ratio for Employee C remains 10.0 percent. The ADP for the group of highly compensated employees remains 7.25 percent.

(iv) The ADP for the highly compensated group must be reduced to 6.72 percent. This is done by reducing the ADR of the highly compensated employees with the highest ADR (Employees C and D) to 8.94 percent. This makes Employee C's maximum elective contribution $6,258. This requires a distribution or recharacterization of $742. But since $1,000 has already been distributed as an excess deferral, no additional distribution or recharacterization is required or permitted. Employee D's elective contribution must be reduced by $689 ($6,500—.0894 ($65,000)) to $5,811 through distribution or recharacterization.

Example 2. A, B, and C are highly compensated employees of Employer R. Employer R maintains a cash or deferred arrangement. Employer R includes elective contributions in compensation as permitted under § 1.414(s)–1(c)(4)(i). For the plan year 1990, A, B, and C each earns compensation of $100,000 and contributes $7,000 to the plan during the period January through June. B retires in November of 1990 and makes a withdrawal of B's entire account balance of $200,000. In January of 1991, R computes the ADP test for its employees and learns that the highly compensated employees should have contributed only five percent of compensation. Since B made a contribution of $7,000 for 1990, B's contribution and compensation are used in determining the ADP despite the subsequent $200,000 withdrawal. A, B, and C must each receive a corrective distribution of $2,000 in order to meet the ADP test. Since B has already withdrawn B's total account balance under the plan, only A and C must receive a distribution of $2,000 each in order for the plan to meet the ADP test of section 401(k)(3)(A)(ii). Pursuant to the 1990 Form 1099–R Instructions, the plan must issue two Forms 1099–R to B, one reporting the portion of the distribution that was necessary to correct the excess contribution (including income), and one reporting the balance of the distribution. If B had withdrawn less than the total account balance, B would have to withdraw the lesser of $2,000 or the remaining account balance.

Example 3. Individual A has a child, B. Both participate in a cash or deferred arrangement maintained by Employer X. A is one of the 10 most highly compensated employees and B is a nonhighly compensated employee. Employer X includes elective contributions in compensation as permitted under § 1.414(s)–1(c)(4)(i). A has compensation of $100,000 and defers $7,000 under the cash or deferred arrangement; B has compensation of $40,000 and defers $4,000 under the arrangement. The actual deferral ratio of the family unit is 7.86 percent, calculated by aggregating the contributions and compensation of A and B ($7,000 + $4,000)/($100,000 + $40,000). For the plan, it is determined that under § 1.401(k)–1(f)(2), the actual deferral ratio of the aggregate family unit must be reduced to 7.20 percent. This reduction is applied in proportion to A's and B's contributions. The excess contributions are $920 ($11,000 total contributions minus $10,080 (7.20% x $140,000)). A's share of the excess contributions is $585.45 ($7,000/$11,000 x $920); B's share is $334.55 ($4,000/$11,000 x $920).

Example 4. (i) Employer T maintains a profit-sharing plan containing a cash or deferred arrangement for all employees. Six employees are covered by a collective bargaining agreement, the other seven employees are not. The employee data for 1994 is shown in the following table:

Employee	Collective bargaining unit status	Actual deferral ratio (ADR), (percent)
A	Member	8.0
B	Member	6.0
C	Nonmember	9.0
D	Nonmember	7.0
E–H	Members	4.5
I–M	Nonmembers	6.0

Employees A, B, C, and D are highly compensated.

(ii) For purposes of sections 410(b), 401(a)(4) and 401(k), the portion of T's plan covering collectively bargained unit members must be disaggregated from the portion covering other employees.

Employee	ADR (percent)
Collective Bargaining Unit Members:	
A	8.0
B	6.0
E–H	[1]4.5
Other Employees:	
C	9.0
D	7.0
I–M	[1]6.0

[1] Average.

(iii) The ADPs for the collectively bargained highly compensated group and nonhighly compensated group, respectively, are seven percent and 4.5 percent. The ADPs for the other highly compensated and nonhighly compensated employees, respectively, are eight percent and six percent.

(iv) The non-collectively bargained portion of the disaggregated plan satisfies the ADP test for the 1994 plan year, but the collectively bargained portion does not. Employer T is not required to make corrections to the collectively bargained portion of the cash or deferred arrangement, because a collectively bargained plan automatically satisfies the nondiscrimination requirements of 401(a)(4). However, unless Employer T corrects the ADP test failure in the collectively bargained portion of the plan, either by reducing A's ADR to seven percent or adding QNCs for the nonhighly compensated employees, all elective contributions made by collectively bargained employees for the year will be includible in income in l994.

(g) *Definitions.* The following definitions apply for purposes of this section, unless the context clearly indicates otherwise:

(1) *Actual deferral percentage*—(i) *General rule.* The actual deferral percentage for a group of employees for a plan year is the average of the actual deferral ratios of employees in the group for that plan year. For plan years that begin after December 31, l988, or such later date provided in paragraph (h) of this section, actual deferral ratios and the actual deferral percentage for a group are calculated to the nearest hundredth of a percentage point.

(ii) *Actual deferral ratio*—(A) *General rule.* An employee's actual deferral ratio for the plan year is the sum of the employee's elective contributions and amounts treated as elective contributions for the plan year, divided by the employee's compensation taken into account for the plan year. If an eligible employee makes no elective contributions, and no qualified matching contributions or qualified nonelective contributions are taken into account with respect to the employee, the actual deferral ratio of the employee is zero. See paragraphs (b)(4), (b)(5), and (g)(2) of this section for rules regarding the elective contributions, qualified nonelective contributions, and compensation taken into account in calculating this fraction.

(B) *Employee eligible under more than one arrangement*—(*1*) *Highly compensated employees.* For plan years beginning after December 31, 1984, the actual deferral ratio of a highly compensated employee who is eligible to participate in more than one cash or deferred arrangement of the same employer is generally calculated by treating all the cash or deferred arrangements in which the employee is eligible to participate as one arrangement. However, plans that are not permitted to be aggregated under §1.410(b)–7(c), as modified in paragraph (g)(11) of this section, are not aggregated for this purpose. For example, if a highly compensated employee with compensation of $80,000 could make elective contributions under two separate cash or deferred arrangements, the actual deferral ratio for the employee under each arrangement would generally be calculated by dividing the total elective contributions by the employee under both arrangements by $80,000. If one of the cash or deferred arrangements were part of an ESOP, however, while the other was not, the actual deferral percentage of the employee under each arrangement would be calculated by dividing the employee's elective contributions under each arrangement by $80,000 because the ESOP portion is mandatorily disaggregated from the non-ESOP portion.

(*2*) *Nonhighly compensated employees.* For plan years beginning after December 31, 1984, and before January 1, 1987 (or such later date provided under paragraph (h) of this section), this paragraph (g)(1)(ii)(B) applies to all employees, and not only to highly compensated employees.

(*3*) *Treatment of plans with different plan years.* If the cash or deferred arrangements that are treated as a single arrangement under this paragraph (g)(1)(ii)(B) are parts of plans that have different plan years, the cash or deferred arrangements are treated as a single arrangement with respect to the plan years ending with or within the same calendar year.

(C) *Employees subject to family aggregation rules*—(*1*) *Aggregation of elective contributions and other amounts.* For plan years beginning after December 31, 1986, or any later date provided in paragraph (h) of this section, if a highly compensated employee is subject to the family aggregation rules of section 414(q)(6) because that employee is either a five-percent owner or one of the 10 most highly compensated employees, the combined actual deferral ratio for the family group (which is treated as one highly compensated employee) must be determined by combining the elective contributions, compensation, and amounts treated as elective contributions of all family members.

(*2*) *Effect on actual deferral percentage of nonhighly compensated employees.* The elective contributions, compensation, and amounts treated as elective contributions of all family members are disregarded for purposes of determining the actual deferral percentage for the group of nonhighly compensated employees.

(*3*) *Multiple family groups.* If an employee is required to be aggregated as a member of more than one family group in a plan, all eligible employees who are members of those family groups that include that employee are aggregated as one family group.

(2) *Compensation*—(i) *Years beginning after December 31, 1986.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (h) of this section, the term *compensation* means compensation as defined in section 414(s) and § 1.414(s)–1. The period used to determine an employee's compensation for a plan year must be either the plan year or the calendar year ending within the plan year. Whichever period is selected must be applied uniformly to determine the compensation of every eligible employee under the plan for that plan year for purposes of this section. An employer may, however, limit the period taken into account under either method to that portion of the plan year or calendar year in which the employee was an eligible employee, provided that this limit is applied uniformly to all eligible employees under the plan for the plan year for purposes of this section. See also section 401(a)(17) and § 1.401(a)(17)–1(c)(1).

(ii) *Years beginning before January 1, 1987*—(A) *General rule.* An employee's compensation for a plan year beginning before January 1, 1987, or such later date provided under paragraph (h) of this section, is the amount taken into account under the plan (or plans) in calculating the elective contribution that may be made on behalf of the employee. In a plan that is top-heavy (as defined in section 416), compensation may not exceed $200,000. Compensation may not exclude amounts less than a stated amount, such as the integration level under the plan. Compensation may include all compensation for the plan year, including compensation for the period when an employee was ineligible to make a cash or deferred election.

(B) *Nondiscrimination requirement*—(*1*) If the plan's definition of compensation has the effect of discriminating in favor of employees who are highly compensated, a nondiscriminatory definition shall be determined by the Commissioner.

(*2*) A plan's definition of compensation is treated as nondiscriminatory if the plan defines compensation for a plan year either as—

(*i*) an employee's total nondeferred compensation includible in gross income plus elective contributions under the plan and elective contributions under a plan described in section 125, and/or

(*ii*) an employee's W–2 or total nondeferred compensation includible in gross income.

(3) *Elective contributions.* The term "elective contribution" means employer contributions made to a plan that were subject to a cash or deferred election under a cash or deferred arrangement (whether or not the arrangement is a qualified cash or deferred arrangement under paragraph (a)(4) of this section). No amount that has become currently available to an employee or that is designated or treated, at the time of deferral or contribution, as an after-tax employee contribution may be treated as an elective contribution. See paragraphs (a)(2) and (a)(3) of this section. See also paragraph (a)(6)(iii) of this section for rules relating to the treatment as elective contributions of certain matching contributions made by partnerships.

(4) *Eligible employee*—(i) *General rule.* The term "eligible employee" means an employee who is directly or indirectly eligible to make a cash or deferred election under the plan for all or a portion of the plan year. For example, if an employee must perform purely ministerial or mechanical acts (e.g., formal application for participation or consent to payroll withholding) in order to be eligible to make a cash or deferred election for a plan year, the employee is an eligible employee for the plan year without regard to whether the employee performs the acts. An employee who is unable to make a cash or deferred election because the employee has not contributed to another plan is also an eligible employee. By contrast, if an employee must perform additional service (e.g., satisfy a minimum period of service requirement) in order to be eligible to make a cash or

deferred election for a plan year, the employee is not an eligible employee for the plan year unless the service is actually performed. See paragraph (e)(5) of this section, however, for certain limits on the use of minimum service requirements. An employee who would be eligible to make elective contributions but for a suspension due to a distribution, a loan, or an election not to participate in the plan, is treated as an eligible employee for purposes of section 401(k)(3) for a plan year even though the employee may not make a cash or deferred election by reason of the suspension. Finally, an employee does not fail to be treated as an eligible employee merely because the employee may receive no additional annual additions because of section 415(c)(1) or 415(e).

(ii) *Certain one-time elections.* An employee is not an eligible employee merely because the employee, upon commencing employment with the employer or upon the employee's first becoming eligible to make a cash or deferred election under any arrangement of the employer, is given the one-time opportunity to elect, and the employee does in fact elect, not to be eligible to make a cash or deferred election under the plan or any other plan maintained by the employer (including plans not yet established) for the duration of the employee's employment with the employer. This rule applies in addition to the rules in paragraphs (a)(3)(iv) and (a)(6)(ii)(C) of this section relating to the definition of a cash or deferred election. In no event is an election made after December 23, 1994 treated as a one-time irrevocable election under this paragraph if the election is made by an employee who previously became eligible under another plan (whether or not terminated) of the employer.

(5) *Employee.* The term *employee* means an employee within the meaning of §1.410(b)–9.

(6) *Employer.* The term *employer* means the employer within the meaning of §1.410(b)–9.

(7) *Excess contributions and excess deferrals*—(i) *Excess contributions.* The term ‘‘excess contribution’’ means, with respect to a plan year, the excess of the elective contributions, including qualified nonelective contributions and qualified matching contributions that are treated as elective contributions under paragraph (b)(2) of this section, on behalf of eligible highly compensated employees for the plan year over the maximum amount of the contributions permitted under paragraph (b)(2) of this section. The amount of excess contributions for each highly compensated employee is determined by using the method described in paragraph (f)(2) of this section.

(ii) *Excess deferrals.* The term ‘‘excess deferrals’’ means excess deferrals as defined in §1.402(g)–1(e)(3).

(8) *Highly compensated employees*—(i) *Plan years beginning after December 31, 1986.* For plan years beginning after December 31, 1986, or such later date provided under paragraph (h) of this section, the term ‘‘highly compensated employee’’ has the meaning provided in section 414(q).

(ii) *Plan years beginning after December 31, 1979, and before January 1, 1987.* For plan years beginning after December 31, 1979, and before January 1, 1987, or such later date provided under paragraph (h) of this section, for purposes of the actual deferral percentage test, highly compensated employees are the one-third of all eligible employees (rounded to the nearest integer) who receive the most compensation. When one or more employees of a group would be highly compensated employees except that each member of the group receives the same amount of compensation, the employer must designate which employees of the group are highly compensated, so that one-third of all eligible employees are considered highly compensated.

(9) *Matching contributions.* The term ‘‘matching contribution’’ means matching contributions as defined in §1.401(m)–1(f)(12).

(10) *Nonelective contributions.* The term ‘‘nonelective contribution’’ means employer contributions (other than matching contributions) with respect to which the employee may not elect to have the contributions paid to the employee in cash or other benefits instead of being contributed to the plan.

(11) *Plan*—(i) *Application of section 410(b) rules.* The term *plan* means a plan within the meaning of §1.410(b)–7 (a)

and (b), after application of the mandatory disaggregation rules of § 1.410(b)–7(c) and the permissive aggregation rules of § 1.410(b)–7(d), with the modifications provided in paragraph (g)(11)(ii) of this section. Thus, for example, two plans (within the meaning of § 1.410(b)–7(b)) that are treated as a single plan pursuant to the permissive aggregation rules of § 1.410(b)–7(d) are treated as a single plan for purposes of section 401(k). See also § 1.401(k)–1(b)(3)(ii).

(ii) *Modifications to section 410(b) rules*—(A) *In general.* For purposes of this paragraph (g)(11), § 1.410(b)–7 (c) and (d) are applied without regard to § 1.410(b)–7(c)(1), relating to section 401(k) and 401(m) plans.

(B) *Plans benefiting collective bargaining unit employees.* A plan that benefits employees who are included in a unit of employees covered by a collective bargaining agreement and employees who are not included in such a collective bargaining unit is treated as comprising separate plans. This paragraph (g)(11)(ii)(B) is generally applied separately with respect to each collective bargaining unit. At the option of the employer, however, two or more separate collective bargaining units can be treated as a single collective bargaining unit, provided that the combinations of units are determined on a basis that is reasonable and reasonably consistent from year to year. Thus, for example, if a plan benefits employees in three categories—employees included in collective bargaining unit A, employees included in collective bargaining unit B, and employees who are not included in any collective bargaining unit—the plan can be treated as comprising three separate plans, each of which benefits only one category of employees. However, if collective bargaining units A and B are treated as a single collective bargaining unit, the plan will be treated as comprising only two separate plans, one benefiting all employees who are included in a collective bargaining unit and another benefiting all other employees. Similarly, if a plan benefits only employees who are included in collective bargaining unit A and employees who are included in collective bargaining unit B, the plan can be treated as comprising two separate plans. However, if collective bargaining units A and B are treated as a single collective bargaining unit, the plan will be treated as a single plan. An employee is treated as included in a unit of employees covered by a collective bargaining agreement if and only if the employee is a collectively bargained employee within the meaning of § 1.410(b)–6(d)(2).

(C) *Multiemployer plans.* Consistent with section 413(b), the portion of the plan that is maintained pursuant to a collective bargaining agreement (within the meaning of § 1.413–1(a)(2)) is treated as a single plan maintained by a single employer that employs all the employees benefiting under the same benefit computation formula and covered pursuant to that collective bargaining agreement. The rules of paragraph (g)(11)(ii)(B) of this section (including the optional aggregation of collective bargaining units) apply to the resulting deemed single plan in the same manner as they would to a single employer plan, except that the plan administrator is substituted for the employer where appropriate and appropriate fiduciary obligations are taken into account. The noncollectively bargained portion of the plan is treated as maintained by one or more employers, depending on whether the noncollective bargaining unit employees who benefit under the plan are employed by one or more employers.

(12) *Pre-ERISA money purchase pension plan*—(i) A pre-ERISA money purchase pension plan is a pension plan:

(A) That is a defined contribution plan (as defined in section 414(i));

(B) That was in existence on June 27, 1974, and as in effect on that date, included a salary reduction agreement described in paragraph (a)(3)(i) of this section; and

(C) Under which neither the employee contributions nor the employer contributions, including elective contributions, may exceed the levels (as a percentage of compensation) provided for by the contribution formula in effect on June 27, 1974.

(ii) A plan was in existence on June 27, 1974, if it was a written plan adopted on or before that date, even if no funds had yet been paid to the trust associated with the plan.

(13) *Qualified matching contributions and qualified nonelective contributions*—(i) *Qualified matching contributions.* The term ‘‘qualified matching contribution’’ means matching contributions that satisfy the additional requirements of paragraph (g)(13)(iii) of this section.

(ii) *Qualified nonelective contributions.* The term ‘‘qualified nonelective contribution’’ means employer contributions, other than elective contributions and matching contributions, that satisfy the additional requirements of paragraph (g)(13)(iii) of this section.

(iii) *Additional requirements.* Except to the extent that paragraphs (c) and (d) of this section specifically provide otherwise, the matching contributions and the nonelective contributions must satisfy the requirements of paragraphs (c) and (d) of this section as though the contributions were elective contributions, without regard to whether the contributions are actually taken into account as elective contributions under paragraph (b)(2) of this section. Thus, the matching and nonelective contributions must satisfy the vesting requirements of paragraph (c) of this section and be subject to the distribution requirements of paragraph (d) of this section when they are contributed to the plan. See §1.401(k)–1(f)(5)(iii) for rules regarding matching contributions not treated as forfeitable under section 411(a)(3)(G) because of excess deferrals or contributions.

(14) *Rural cooperative plan.* For purposes of this section, a rural cooperative plan is a plan described in section 401(k)(7).

(15) *Section 401(k) plan.* The term *section 401(k) plan* means a section 401(k) plan within the meaning of §1.410(b)–9.

(16) *Section 401(m) plan.* The term *section 401(m) plan* means a section 401(m) plan within the meaning of §1.401(b)–9.

(h) *Effective dates*—(1) *General rule.* Except as otherwise provided in this paragraph (h) or as specifically provided elsewhere in this section, this section applies to plan years beginning after December 31, 1979.

(2) *Collectively bargained plans.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986:

(i) The provisions of this section first effective for plan years beginning after December 31, 1986, do not apply to years that begin before the earlier of January 1, 1989, or the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986).

(ii) The provisions of this section first effective for plan years beginning after December 31, 1988, do not apply to years beginning before the earlier of:

(A) The later of January 1, 1989, or the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986); or

(B) January 1, 1991.

(3) *Transition rules*—(i) *Cash or deferred arrangements in existence on June 27, 1974.* See §1.402(a)–1(d)(3)(ii) for a transition rule applicable to cash or deferred arrangements in existence on June 27, 1974.

(ii) *Plan years beginning after December 31, 1979, and before January 1, 1992.* For plan years beginning after December 31, 1979 (or, in the case of a pre-ERISA money purchase plan, plan years beginning after July 18, 1984) and before January 1, 1992, a reasonable interpretation of the rules set forth in section 401 (k) and (m) of the Internal Revenue Code (as in effect during those years) may be relied upon to determine whether a cash or deferred arrangement was qualified during those years.

(iii) *Restructuring*—(A) *General rule.* In determining whether the requirements of section 401(k) are satisfied for plan years beginning before January 1, 1992, a plan may be treated as consisting of two or more component plans, each consisting of all of the allocations and other benefits, rights, and features provided to a group of employees under the plan. See §1.401(a)(4)–9(c). An employee may not be included in more than one component plan of the same plan for a plan year under this method. If this method is used for a plan year, the requirements of section 401(k) are applied separately with respect to each component plan for the plan year.

Thus, for example, the actual deferral ratio and the amount of excess contributions, if any, of each eligible employee under each component plan must be determined as if the component plan were a separate plan. This method applies solely for purposes of section 401(k). Thus, for example, the requirements of section 410(b) must still be satisfied by the entire plan.

(B) *Identification of component plans*—(*1*) *Minimum coverage requirement.* The group of eligible employees described in § 1.401(k)–1(g)(4) under each component plan must separately satisfy the requirements of section 410(b) as if the component plan were a separate plan. Component plans may not be aggregated to satisfy this requirement.

(*2*) *Commonality requirement.* The group of employees used to identify a component plan must share some common attribute or attributes, other than similar actual deferral ratios. Permissible common attributes include, for example, employment at the same work site, in the same job category, for the same division or subsidiary, or for a unit acquired in a specific merger or acquisition, employment for the same number of years, compensation under the same method, e.g., salaried or hourly, coverage under the same contribution formula, and attributes that could be used as the basis of a classification that would be treated as reasonable under § 1.410(b)–4(b). Employees whose only common attribute is the same or similar actual deferral ratios, or another attribute having substantially the same effect as the same or similar actual deferral ratios, are not considered as sharing a common attribute for this purpose. This rule applies regardless of whether the component plan or the plan of which it is a part satisfies the ratio or percentage test of section 410(b).

(4) *State and local government plans*—(i) *Plans adopted before May 6, 1986.* A plan adopted by a state or local government prior to May 6, 1986, is subject to the transitional rules of paragraph (h)(4) (ii) or (iii) of this section.

(ii) *Plan years beginning before January 1, 1996.* (A) The plan does not fail to satisfy the requirements of section 401(a) merely because of the nonqualified cash or deferred arrangement.

(B) Employer contributions under the nonqualified cash or deferred arrangement are considered to satisfy the requirements of section 401(a)(4).

(C) Except as provided in paragraphs (a)(7) and (f) of this section, elective contributions under the arrangement are treated as employer contributions under the Internal Revenue Code of 1986, as if the arrangement were a qualified cash or deferred arrangement. See § 1.401(k)–1(a)(4)(ii). See § 1.402(a)–1(d) for rules governing when elective contributions under the arrangement are includible in an employee's gross income.

(iii) *Collectively bargained plans.* The transition rules in paragraph (h)(4)(ii) of this section apply to a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers and adopted by a state or local government before May 6, 1986, effective on the date the provisions of section 401(k) and this section would be effective under paragraph (h)(2) of this section.

[T.D. 8357, 56 FR 40517, Aug. 15, 1991, as amended by T.D. 8376, 56 FR 63432, Dec. 4, 1991; T.D. 8357, 57 FR 10289, 10290, Mar. 25, 1992; 58 FR 14151, Mar. 16, 1993; T.D. 8581, 59 FR 66169, Dec. 23, 1994; T.D. 8581, 60 FR 12416, Mar. 7, 1995; T.D. 8581, 60 FR 15874, Mar. 28, 1995; T.D. 8581, 60 FR 25140, May 11, 1995]

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[T.D. 8359, 56 FR 47617, Sept. 19, 1991; 57 FR 10818, Mar. 31, 1992, as amended by T.D. 8486, 58 FR 46830, Sept. 3, 1993]

§1.401(l)–1 Permitted disparity in employer-provided contributions or benefits.

(a) *Permitted disparity*—(1) *In general.* Section 401(a)(4) provides that a plan is a qualified plan only if the amount of contributions or benefits provided under the plan does not discriminate in favor of highly compensated employees. See §1.401(a)(4)–1(b)(2). Section 401(a)(5)(C) provides that a plan does not discriminate in favor of highly compensated employees merely because of disparities in employer-provided contributions or benefits provided to, or on behalf of, employees under the plan that are permitted under section 401(l). Thus, if a plan satisfies section 401(l), permitted disparities in employer-provided contributions or benefits under a plan are disregarded, by reason of section 401(a)(5)(C), in determining whether the plan satisfies any of the safe harbors under §§1.401(a)(4)–2(b)(2) and 1.401(a)(4)–3(b). However, even if disparities in employer-provided contributions or benefits under a plan are permitted under section 401(l) and thus do not cause the plan to fail to satisfy §1.401(a)(4)–1(b)(2), the plan may still fail to satisfy section 401(a)(4) for other reasons. Similarly, even if disparities in employer-provided contributions or benefits under a plan are not permitted under section 401(l) and thus may not be disregarded under section 401(a)(4) by reason of section 401(l), the plan may still be found to be nondiscriminatory under the tests of section 401(a)(4), including the rules for imputing permitted disparity under §1.401(a)(4)–7.

(2) *Overview.* Rules relating to disparities in employer-provided contributions under a defined contribution plan are provided in §1.401(l)–2. For rules relating to disparities in employer-provided benefits under a defined benefit plan, see §401(l)–3. For rules relating to the application of section 401(l) to a plan maintained by a railroad employer, see §1.401(l)–4. For rules relating to the overall permitted disparity limits, see §1.401(l)–5. For rules relating to the effective date of section 401(l), see §1.401(l)–6.

(3) *Exclusive rules.* The rules provided in §§1.401(l)–1 through 1.401(l)–6 are the exclusive means for a plan to satisfy sections 401(l) and 401(a)(5)(C). Accordingly, a plan that provides disparities in employer-provided contributions or benefits that are not permitted under §§1.401(l)–1 through 1.401(l)–6 does not satisfy section 401(l) or 401(a)(5)(C).

(4) *Exceptions.* Sections 401(a)(5)(C) and 401(l) are not available in the following arrangements—

(i) A plan maintained by an employer, determined for purposes of the Federal Insurance Contributions Act or the Railroad Retirement Tax Act, as applicable, that does not pay any wages within the meaning of section 3121(a) or compensation within the meaning of section 3231(e). For this purpose, a plan maintained for a self-employed individual within the meaning of section 401(c)(1), who is also subject to the tax under section 1401, is deemed to be a plan maintained by an employer that pays wages within the meaning of section 3121(a).

(ii) A plan, or the portion of a plan, that is an employee stock ownership plan described in section 4975(e)(7) (an ESOP) or a tax credit employee stock ownership plan described in section 409(a) (a TRASOP), except as provided in §54.4975–11(a)(7)(ii) of this chapter, which contains a limited exception to this rule for certain ESOPs in existence on November 1, 1977.

(iii) With respect to elective contributions as defined in §1.401(k)–1(g)(3) under a qualified cash or deferred arrangement as defined in §1.401(k)–1(a)(4)(i) or with respect to employee or matching contributions defined in §1.401(m)–1(f)(6) or (f)(12), respectively.

(iv) With respect to contributions to a simplified employee pension made under a salary reduction arrangement described in section 408(k)(6) (a SARSEP).

(5) *Additional rules.* The Commissioner may, in revenue rulings, notices, or other documents of general applicability, prescribe additional rules that may be necessary or appropriate to carry out the purposes of section 401(l),

including rules applying section 401(l) with respect to an employer that pays wages within the meaning of section 3121(a) or compensation within the meaning of section 3231(e) for some years and not other years.

(b) *Relationship to other requirements.* Unless explicitly provided otherwise, section 401(l) does not provide an exception to any other requirement under section 401(a). Thus, for example, even if the plan complies with section 401(l), the plan may not provide a benefit lower than the minimum benefit required under section 416. Moreover, a plan may not adjust benefits in any manner that results in a decrease in any employee's accrued benefit in violation of section 411(d)(6) and section 411(b)(1)(G). However, a plan does not fail to satisfy section 401(l) merely because, in order to ensure compliance with section 411, an employee's accrued benefit under the plan is defined as the greater of the employee's previously accrued benefit and the benefit determined under a strict application of the plan's benefit formula and accrual method. See section 401(a)(15) for additional rules relating to circumstances under which plan benefits may not be decreased because of increases in social security benefits.

(c) *Definitions.* In applying §§ 1.401(l)–1 through 1.401(l)–6, the definitions in this paragraph (c) govern unless otherwise provided.

(1) *Accumulation plan. Accumulation plan* means an accumulation plan within the meaning of § 1.401(a)(4)–12.

(2) *Average annual compensation. Average annual compensation* means average annual compensation within the meaning of § 1.401(a)(4)–3(e)(2).

(3) *Base benefit percentage. Base benefit percentage* means the rate at which employer-provided benefits are determined under a defined benefit excess plan with respect to an employee's average annual compensation at or below the integration level (expressed as a percentage of such average annual compensation).

(4) *Base contribution percentage. Base contribution percentage* means the rate at which employer contributions are allocated to the account of an employee under a defined contribution excess plan with respect to the employee's plan year compensation at or below the integration level (expressed as a percentage of such plan year compensation).

(5) *Benefit formula. Benefit formula* means benefit formula within the meaning of § 1.401(a)(4)–12.

(6) *Benefit, right, or feature. Benefit, right, or feature* means a benefit, right, or feature within the meaning of § 1.401(a)(4)–12.

(7) *Covered compensation*—(i) *In general. Covered compensation* for an employee means the average (without indexing) of the taxable wage bases in effect for each calendar year during the 35-year period ending with the last day of the calendar year in which the employee attains (or will attain) social security retirement age. A 35-year period is used for all individuals regardless of the year of birth of the individual. In determining an employee's covered compensation for a plan year, the taxable wage base for all calendar years beginning after the first day of the plan year is assumed to be the same as the taxable wage base in effect as of the beginning of the plan year. An employee's covered compensation for a plan year beginning after the 35-year period applicable under this paragraph (c)(7)(i) is the employee's covered compensation for the plan year during which the 35-year period ends. An employee's covered compensation for a plan year beginning before the 35-year period applicable under this paragraph (c)(7)(i) is the taxable wage base in effect as of the beginning of the plan year.

(ii) *Special rules*—(A) *Rounded table.* For purposes of determining the amount of an employee's covered compensation under paragraph (c)(7)(i) of this section, a plan may use tables, provided by the Commissioner, that are developed by rounding the actual amounts of covered compensation for different years of birth.

(B) *Proposed regulation definition.* For plan years beginning before January 1, 1995, in lieu of the definition of covered compensation contained in paragraph (c)(7)(i) of this section, a plan may define covered compensation as the average (without indexing) of the taxable wage bases in effect for each calendar year during the 35-year period ending with the last day of the calendar year preceding the calendar year in which the employee attains (or will attain) social security retirement age.

(iii) *Period for using covered compensation amount.* A plan must generally provide that an employee's covered compensation is automatically adjusted for each plan year. However, a plan may use an amount of covered compensation for employees equal to each employee's covered compensation (as defined in paragraph (c)(7)(i) or (c)(7)(ii) of this section) for a plan year earlier than the current plan year, provided the earlier plan year is the same for all employees and is not earlier than the later of—

(A) The plan year that begins 5 years before the current plan year, and

(B) The plan year beginning in 1989.

In the case of an accumulation plan, the benefit accrued for an employee in prior years is not affected by changes in the employee's covered compensation that occur in later years.

(8) *Defined benefit plan. Defined benefit plan* means a defined benefit plan within the meaning of §1.410(b)–9.

(9) *Defined contribution plan. Defined contribution plan* means a defined contribution plan within the meaning of §1.410(b)–9. In addition, for purposes of §§1.401(l)–1 through 1.401(l)–6, a defined contribution plan includes a simplified employee pension as defined in section 408(k) (SEP), other than a SEP (or portion or a SEP) that is a salary reduction arrangement described in section 408(k)(6) (SARSEP).

(10) *Disparity. Disparity* means—

(i) In the case of a defined contribution excess plan, the amount by which the excess contribution percentage exceeds the base contribution percentage,

(ii) In the case of a defined benefit excess plan, the amount by which the excess benefit percentage exceeds the base benefit percentage, and

(iii) In the case of an offset plan, the offset percentage.

(11) *Employee. Employee* means employee within the meaning of §1.401(a)(4)–12.

(12) *Employer. Employer* means the employer within the meaning of §1.410(b)–9.

(13) *Employer contributions. Employer contributions* means all amounts taken into account with respect to an employee under a plan under §1.401(a)(4)–2(c)(2)(ii).

(14) *Excess benefit percentage. Excess benefit percentage* means the rate at which employer-provided benefits are determined under a defined benefit excess plan with respect to an employee's average annual compensation above the integration level (expressed as a percentage of such average annual compensation).

(15) *Excess contribution percentage. Excess contribution percentage* means the rate at which employer contributions are allocated to the account of an employee under a defined contribution excess plan with respect to the employee's plan year compensation above the integration level (expressed as a percentage of such plan year compensation).

(16) *Excess plan*—(i) *Defined benefit excess plan. Defined benefit excess plan* means a defined benefit plan under which the rate at which employer-provided benefits are determined with respect to average annual compensation above the integration level under the plan (expressed as a percentage of such average annual compensation) is greater than the rate at which employer-provided benefits are determined with respect to average annual compensation at or below the integration level (expressed as a percentage of such average annual compensation).

(ii) *Defined contribution excess plan. Defined contribution excess plan* means a defined contribution plan under which the rate at which employer contributions are allocated to the account of an employee with respect to plan year compensation above the integration level (expressed as a percentage of such plan year compensation) is greater than the rate at which employer contributions are allocated to the account of an employee with respect to plan year compensation at or below the integration level (expressed as a percentage of such plan year compensation).

(17) *Final average compensation*—(i) *In general. Final average compensation* for an employee means the average of the employee's annual section 414(s) compensation for the 3-consecutive-year period ending with or within the plan year or for the employee's period of

employment if shorter. The year in which an employee terminates employment may be disregarded in determining final average compensation. The definition of final average compensation used in the plan must be applied consistently with respect to all employees. For example, if the plan provides that the year in which the employee terminates employment is disregarded in determining final average compensation, the year must be disregarded for all employees who terminate employment in that year. The plan may specify any 3-consecutive-year period ending in the plan year, provided the period is determined consistently for all employees. See § 1.401(a)(4)–11(d)(3)(iii) and § 1.414(s)–1(f) for rules permitting service and compensation with another employer to be taken into account for purposes of nondiscrimination testing, including satisfying section 401(l).

(ii) *Limitations.* In determining an employee's final average compensation under this paragraph (c)(17), annual section 414(s) compensation for any year in excess of the taxable wage base in effect at the beginning of that year must not be taken into account. A plan may provide that each employee's final average compensation for a plan year is limited to the employee's average annual compensation for the plan year.

(iii) *Determination of section 414(s) compensation.* A plan must use the same definition of section 414(s) compensation to determine final average compensation as the plan uses to determine average annual compensation (or plan year compensation in the case of an accumulation plan).

(18) *Gross benefit percentage. Gross benefit percentage* means the rate at which employer-provided benefits are determined under an offset plan (before application of the offset) with respect to an employee's average annual compensation (expressed as a percentage of average annual compensation).

(19) *Highly compensated employee. Highly compensated employee* means HCE within the meaning of § 1.401(a)(4)–12.

(20) *Integration level. Integration level* means the dollar amount specified in an excess plan at or below which the rate of employer-provided contributions or benefits (expressed in each case as a percentage of an employee's plan year compensation or average annual compensation up to the specified dollar amount) under the plan is less than the rate of employer-provided contributions or benefits (expressed in each case as a percentage of the employee's plan year compensation or average annual compensation above the specified dollar amount) under the plan above such dollar amount.

(21) *Nonexcludable employee. Nonexcludable employee* means nonexcludable employee within the meaning of § 1.401(a)(4)–12.

(22) *Nonhighly compensated employee. Nonhighly compensated employee* means NHCE within the meaning of § 1.401(a)(4)–12.

(23) *Offset level. Offset level* means the dollar limit specified in the plan on the amount of each employee's final average compensation taken into account in determining the offset under an offset plan.

(24) *Offset percentage. Offset percentage* means the rate at which an employee's employer-provided benefit is reduced or offset under an offset plan (expressed as a percentage of the employee's final average compensation up to the offset level).

(25) *Offset plan. Offset plan* means a defined benefit plan that is not a defined benefit excess plan and that provides that each employee's employer-provided benefit is reduced or offset by a specified percentage of the employee's final average compensation up to the offset level under the plan.

(26) *PIA. PIA* or *primary insurance amount* means the old-age insurance benefit under section 202 of the Social Security Act (42 U.S.C. 402) payable to each employee at a single age that is not earlier than age 62 and not later than age 65. PIA must be determined under the Social Security Act as in effect at the time the employee's offset is determined. Thus, it is determined without assuming any future increases in compensation, any future increases in the taxable wage base, any changes in the formulas used under the Social Security Act to determine PIA (for example, changes in the breakpoints), or any future increases in the consumer

price index. However, it may be assumed that the employee will continue to receive compensation at the same rate as that received at the time the offset is being determined, until reaching the single age described in the first sentence of this paragraph (c)(26). PIA must be determined in a consistent manner for all employees and in accordance with revenue rulings or other guidance provided by the Commissioner.

(27) *Plan. Plan* means a plan within the meaning of §1.401(a)(4)–12 or a component plan treated as a plan under §1.401(a)(4)–9(c).

(28) *Plan year compensation. Plan year compensation* means plan year compensation within the meaning of §1.401(a)(4)–12.

(29) *Qualified plan. Qualified plan* means a qualified plan within the meaning of §1.401(a)(4)–12.

(30) *Section 401(l) plan. Section 401(* l*) plan* means a section 401(l) plan within the meaning of §1.401(a)(4)–12.

(31) *Section 414(s) compensation. Section 414(s) compensation* means section 414(s) compensation within the meaning of §1.401(a)(4)–12.

(32) *Social security retirement age. Social security retirement age* for an employee means the social security retirement age of the employee as determined under section 415(b)(8).

(33) *Straight life annuity. Straight life annuity* means a straight life annuity within the meaning of §1.401(a)(4)–12.

(34) *Taxable wage base. Taxable wage base* means the contribution and benefit base under section 230 of the Social Security Act (42 U.S.C. 430).

(35) *Year of service. Year of service* means a year of service as defined in the plan for purposes of the benefit formula and the accrual method under the plan, unless the context clearly indicates otherwise. See §1.401(a)(4)–11(d)(3) for rules on years of service that may be taken into account for purposes of nondiscrimination testing, including satisfying section 401(l).

[T.D. 8359, 56 FR 47618, Sept. 19, 1991; 57 FR 10818, 10951, Mar. 31, 1992, as amended by T.D. 8486, 58 FR 46831, Sept. 3, 1993]

§1.401(l)–2 Permitted disparity for defined contribution plans.

(a) *Requirements*—(1) *In general.* Disparity in the rates of employer contributions allocated to employees' accounts under a defined contribution plan is permitted under section 401(l) and this section for a plan year only if the plan satisfies paragraphs (a)(2) through (a)(5) of this section. A plan that otherwise satisfies this paragraph (a) will not be considered to fail section 401(l) merely because it contains one or more provisions described in §1.401(a)(4)–2(b)(4). See §1.401(a)(4)–8(b)(3)(i)(C) for special rules applicable to target benefit plans.

(2) *Excess plan requirement.* The plan must be a defined contribution excess plan.

(3) *Maximum disparity.* The disparity for all employees under the plan must not exceed the maximum permitted disparity prescribed in paragraph (b) of this section.

(4) *Uniform disparity.* The disparity for all employees under the plan must be uniform within the meaning of paragraph (c) of this section.

(5) *Integration level.* The integration level specified in the plan must satisfy paragraph (d) of this section.

(b) *Maximum permitted disparity*—(1) *In general.* The disparity provided for the plan year must not exceed the maximum excess allowance as defined in paragraph (b)(2) of this section. In addition, the plan must satisfy the overall permitted disparity limits of §1.401(l)–5.

(2) *Maximum excess allowance.* The maximum excess allowance for a plan year is the lesser of—

(i) The base contribution percentage, or

(ii) The greater of—

(A) 5.7 percent, reduced as required under paragraph (d) of this section, or

(B) The percentage rate of tax under section 3111(a), in effect as of the beginning of the plan year, that is attributable to the old age insurance portion of the Old Age, Survivors and Disability Insurance provisions of the Social Security Act, reduced as required under paragraph (d) of this section. For a year in which the percentage rate of tax described in this paragraph (b)(2)(ii)(B) exceeds 5.7 percent, the

Commissioner will publish the rate of such tax and a revised table under paragraph (d)(4) of this section.

(c) *Uniform disparity*—(1) *In general.* The disparity provided under a plan is uniform only if the plan uses the same base contribution percentage and the same excess contribution percentage for all employees in the plan.

(2) *Deemed uniformity*—(i) *In general.* The disparity under a plan does not fail to be uniform for purposes of this paragraph (c) merely because the plan contains one or more of the provisions described in paragraphs (c)(2) (ii) and (iii) of this section.

(ii) *Overall permitted disparity.* The plan provides that, in the case of each employee who has reached the cumulative permitted disparity limit applicable to the employee under § 1.401(l)–5(c), employer contributions are allocated to the account of the employee with respect to the employee's total plan year compensation at the excess contribution percentage.

(iii) *Non-FICA employees.* The plan provides that, in the case of each employee under the plan with respect to whom none of the taxes under section 3111(a), section 3221, or section 1401 is required to be paid, employer contributions are allocated to the account of the employee with respect to the employee's total plan year compensation at the excess contribution percentage.

(d) *Integration level*—(1) *In general.* The integration level under the plan must satisfy paragraph (d)(2), (d)(3), or (d)(4) of this section, as modified by paragraph (d)(5) of this section in the case of a short plan year. If a reduction applies to the disparity factor under this paragraph (d), the reduced factor is used for all purposes in determining whether the permitted disparity rules for defined contribution plans are satisfied.

(2) *Taxable wage base.* The requirement of this paragraph (d)(2) is satisfied only if the integration level under the plan for each employee is the taxable wage base in effect as of the beginning of the plan year.

(3) *Single dollar amount.* The requirement of this paragraph (d)(3) is satisfied only if the integration level under the plan for all employees is a single dollar amount (either specified in the plan or determined under a formula specified in the plan) that does not exceed the greater of $10,000 or 20 percent of the taxable wage base in effect as of the beginning of the plan year.

(4) *Intermediate amount.* The requirement of this paragraph (d)(4) is satisfied only if—

(i) The integration level under the plan for all employees is a single dollar amount (either specified in the plan or determined under a formula specified in the plan) that is greater than the highest amount determined under paragraph (d)(3) of this section and less than the taxable wage base, and

(ii) The plan adjusts the factor determined under paragraph (b)(2)(ii) of this section in accordance with the table below.

TABLE

If the integration level		The 5.7 percent factor in the maximum excess allowance is reduced to—
Is more than	But not more than	
Greater of $10,000 or 20% of taxable wage base.	80% of taxable wage base.	4.3%
80% of taxable wage base.	Amount less than taxable wage base.	5.4%

(5) *Prorated integration level for short plan year.* If a plan uses paragraph (2) or (4) of the definition of plan year compensation under § 1.401(a)(4)–12 (i.e., section 414(s) compensation for the plan year or the period of plan participation) and has a plan year that comprises fewer than 12 months, the integration level under the plan for each employee must be an amount equal to the otherwise applicable integration level described in paragraph (d)(2), (d)(3), or (d)(4) of this section, multiplied by a fraction, the numerator of which is the number of months in the plan year, and the denominator of which is 12. No adjustment to the maximum excess allowance is required as a result of the application of this paragraph (d)(5), other than any adjustment already required under paragraph (d)(4) of this section.

(e) *Examples.* The following examples illustrate this section. In each example, 5.7 percent exceeds the percentage rate of tax described in paragraph (b)(2)(ii)(B) of this section.

Example 1. Employer X maintains a profit-sharing plan with the calendar year as its plan year. For the 1989 plan year, the plan provides that the account of each employee who has plan year compensation in excess of the taxable wage base in effect at the beginning of the plan year will receive an allocation for the plan year of 5.7 percent of plan year compensation in excess of the taxable wage base. The plan provides that no allocation will be made to the account of any employee for the plan year with respect to plan year compensation not in excess of the taxable wage base. The maximum excess allowance is exceeded for the 1989 plan year because the excess contribution percentage (5.7 percent) for the plan year exceeds the base contribution percentage (0 percent) for the plan year by more than the lesser of the base contribution percentage (0 percent) or the percentage determined under paragraph (b)(2)(ii) of this section (5.7 percent) for the plan year.

Example 2. Employer Y maintains a money purchase pension plan with the calendar year as its plan year. For the 1990 plan year, the plan provides that the account of each employee will receive an allocation of 5 percent of the employee's plan year compensation up to the taxable wage base in effect at the beginning of the plan year plus an allocation of 10 percent of the employee's plan year compensation in excess of the taxable wage base. The maximum excess allowance is not exceeded for the plan year because the excess contribution percentage (10 percent) for the plan year does not exceed the base contribution percentage (5 percent) for the plan year by more than the lesser of the base contribution percentage (5 percent) or the percentage determined under paragraph (b)(2)(ii) of this section (5.7 percent) for the plan year.

Example 3. Assume the same facts as in *Example 2,* except that the plan provides that, with respect to plan year compensation in excess of the taxable wage base, the account of each employee will receive an allocation for the plan year of 12 percent of such compensation. The maximum excess allowance is exceeded for the plan year because the excess contribution percentage (12 percent) for the plan year exceeds the base contribution percentage (5 percent) for the plan year by more than the lesser of the base contribution percentage (5 percent) or the percentage determined under paragraph (b)(2)(ii) of this section (5.7 percent) for the plan year.

Example 4. Employer Z maintains a money purchase pension plan with a plan year beginning July 1 and ending June 30. The taxable wage base for the 1990 calendar year is $51,300 and the taxable wage base for the 1991 calendar year is $53,400. For the plan year beginning July 1, 1990, and ending June 30, 1991, the plan provides that the account of each employee will receive an allocation of 4 percent of the employee's plan year compensation up to $53,400 plus an allocation of 6 percent of the employee's plan year compensation in excess of $53,400. Although the excess contribution percentage (6 percent) for the plan year does not exceed the base contribution percentage (4 percent) for the plan year by more than the lesser of the base contribution percentage (4 percent) or the percentage determined under paragraph (b)(2)(ii) of this section (5.7 percent), the plan does not satisfy paragraph (a)(5) of this section because the integration level of $53,400 exceeds the maximum permitted integration level of $51,300 (the taxable wage base in effect as of the beginning of the plan year).

Example 5. Assume the same facts as in *Example 4,* except that for the plan year beginning July 1, 1990, and ending June 30, 1991, the plan provides that the account of each employee will receive an allocation of 5 percent of the employee's plan year compensation up to $30,000 plus an allocation of 9 percent of the employee's plan year compensation in excess of $30,000. The integration level of $30,000 is 58 percent of the taxable wage base of $51,300 for the 1990 calendar year. The maximum excess allowance is not exceeded for the plan year because the excess contribution percentage (9 percent) for the plan year does not exceed the base contribution percentage (5 percent) for the plan year by more than the lesser of the base contribution percentage (5 percent) or the percentage determined under paragraphs (b)(2)(ii) and (d) of this section (4.3 percent) for the plan year.

[T.D. 8359, 56 FR 47621, Sept. 19, 1991; 57 FR 10818, 10951, Mar. 31, 1992, as amended by T.D. 8486, 58 FR 46832, Sept. 3, 1993]

§1.401(l)–3 Permitted disparity for defined benefit plans.

(a) *Requirements*—(1) *In general.* Disparity in the rates of employer-provided benefits under a defined benefit plan is permitted under section 401(l) and this section for a plan year only if the plan satisfies paragraphs (a)(2) through (a)(6) of this section. A plan that otherwise satisfies this paragraph (a) will not be considered to fail section 401(l) merely because it contains one or more provisions described in §1.401(a)(4)–3(b)(6) (such as multiple formulas). Section 401(a)(5)(D) and §1.401(a)(5)–1(d) provide other rules under which benefits provided under a defined benefit plan (including defined benefit excess and offset plans) may be limited. See §1.401(a)(4)–3(b)(5)(viii) for special rules under which an insurance contract plan may satisfy §1.401(a)(4)–1(b)(2) and section 401(l). See

§1.401(a)(4)–8(c)(3)(iii)(B) for special rules applicable to cash balance plans.

(2) *Excess or offset plan requirement.* The plan must be a defined benefit excess plan or an offset plan.

(3) *Maximum disparity.* The disparity for all employees under the plan must not exceed the maximum permitted disparity prescribed in paragraph (b) of this section.

(4) *Uniform disparity.* The disparity for all employees under the plan must be uniform within the meaning of paragraph (c) of this section.

(5) *Integration or offset level.* The integration or offset level specified in the plan must satisfy paragraph (d) of this section.

(6) *Benefits, rights, and features.* The benefits, rights, and features provided under the plan must satisfy paragraph (f)(1) of this section.

(b) *Maximum permitted disparity*—(1) *In general.* In the case of a defined benefit excess plan, the disparity provided for the plan year may not exceed the maximum excess allowance as defined in paragraph (b)(2) of this section. In the case of an offset plan, the disparity provided for the plan year may not exceed the maximum offset allowance as defined in paragraph (b)(3) of this section. In addition, either type of plan must satisfy the overall permitted disparity limits of §1.401(l)–5.

(2) *Maximum excess allowance.* The maximum excess allowance for a plan year is the lesser of—

(i) 0.75 percent, reduced as required under paragraphs (d) and (e) of this section, or

(ii) The base benefit percentage for the plan year.

(3) *Maximum offset allowance.* The maximum offset allowance for a plan year is the lesser of—

(i) 0.75 percent, reduced as required under paragraphs (d) and (e) of this section, or

(ii) One-half of the gross benefit percentage, multiplied by a fraction (not to exceed one), the numerator of which is the employee's average annual compensation, and the denominator of which is the employee's final average compensation up to the offset level.

(4) *Rules of application*—(i) *Disparity provided for the plan year.* Disparity provided for the plan year generally means the disparity provided under the plan's benefit formula for the employee's year of service with respect to the plan year. However, if a plan determines each employee's accrued benefit under the fractional accrual method of section 411(b)(1)(C), disparity provided under the plan also means the disparity in the benefit accrued for the employee for the plan year. Thus, a plan using the fractional accrual method must satisfy this paragraph (b) with respect to the plan's benefit formula and with respect to the benefits accrued for the plan year.

(ii) *Reduction in disparity rate.* Any reductions in the 0.75–percent factor required under paragraphs (d) and (e) of this section are cumulative.

(iii) *Normal and optional forms of benefit*—(A) *In general.* A plan satisfies the maximum permitted disparity requirement of this paragraph (b) only if the plan satisfies this paragraph (b) with respect to each optional form of benefit (including the normal form of benefit) provided under the plan.

(B) *Level annuity forms.* In the case of an optional form of benefit payable as a level annuity over a period of not less than the life of the employee, the optional form must satisfy the maximum permitted disparity requirement of this paragraph (b). Thus, for example, if the form of a defined benefit plan's normal retirement benefit is an annuity for life with a 10-year certain feature and the plan permits employees to elect an optional form of benefit in the form of a straight life annuity, the plan must satisfy the maximum disparity requirement of this paragraph (b) with respect to each of the optional forms of benefit. An annuity that decreases only after the death of the employee, or that decreases only after the death of either the employee or the joint annuitant, is considered a level annuity for purposes of this paragraph (b).

(C) *Other forms.* In the case of an optional form of benefit that is not described in paragraph (b)(4)(iii)(B) of this section, the optional form must satisfy the maximum permitted disparity requirement of this paragraph (b), when the respective portions of the optional form are normalized under the rules of §1.401(a)(4)–12 to a straight life annuity commencing at the same time as the optional form of benefit, regardless of whether the straight life annuity form is actually provided under the plan. In the case of a defined benefit excess plan, the respective portions are the portion of the optional form attributable to average annual compensation up to the integration level (the ‘‘base portion’’) and the portion of the optional form attributable to average annual compensation in excess of the integration level (the ‘‘excess portion’’). In the case of an offset plan, the respective portions are the optional form determined without regard to the offset (the ‘‘gross amount’’) and the offset applied to the gross amount to determine the optional form (the ‘‘offset amount’’).

(D) *Post-retirement cost-of-living adjustments—(1) In general.* A benefit does not fail to be a level annuity described in paragraph (b)(4)(iii)(B) of this section merely because it provides an automatic post-retirement cost-of-living adjustment that satisfies paragraph (b)(4)(iii)(D)(*2*) of this section. Thus, increases in the employee's annuity pursuant to such a cost-of-living adjustment do not cause the disparity provided under the optional form of benefit to exceed the maximum disparity permitted under this paragraph (b). For rules on ad hoc post-retirement cost-of-living adjustments, see § 1.401(a)(4)–10(b).

(*2*) *Requirements.* A cost-of-living adjustment satisfies this paragaph (b)(4)(iii)(D)(*2*) if—

(*i*) It is included in the accrued benefit of all employees, and.

(*ii*) It increases, on a uniform and consistent basis, the benefits of all former employees who are no younger than age 62, at a rate no greater than adjustments to social security benefits under section 215(i)(2)(A) of the Social Security Act that have occurred since the later of the employee's attainment of age 62 or commencement of benefits.

(E) *Section 417(e) exception.* A plan will not fail to satisfy this paragraph (b) merely because the disparity in a benefit that is subject to the interest rate restrictions of sections 401(a)(11) and 417(e) exceeds the maximum disparity that would otherwise be allowed under this paragraph (b) if the increase in disparity is required to satisfy § 1.417(e)–1(d). In applying the exception in this paragraph (b)(4)(iii)(E), for purposes of determining what is required under § 1.417(e)–1(d), a plan may use the rate described in § 1.417(e)–1(d)(2)(i) for all employees, without regard to whether the present value of an employee's vested benefit exceeds $25,000.

(5) *Examples.* The following examples illustrate this paragraph (b). Unless otherwise provided, the following facts apply. The plan is noncontributory and is the only plan ever maintained by the employer. The plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. In the case of a defined benefit excess plan, the plan uses each employee's covered compensation as the integration level; in the case of an offset plan, the plan uses each employee's covered compensation as the offset level and provides that an employee's final average compensation is limited to the employee's average annual compensation. Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65.

Example 1. Plan N is a defined benefit excess plan that provides a normal retirement benefit of 0.5 percent of average annual compensation in excess of the integration level, for each year of service. The plan provides no benefits with respect to average annual compensation up to the integration level. The disparity provided under the plan exceeds the maximum excess allowance because the excess benefit percentage (0.5 percent) exceeds the base benefit percentage (0 percent) by more than the base benefit percentage (0 percent).

Example 2. Plan O is an offset plan that provides a normal retirement benefit equal to 2 percent of average annual compensation, minus 0.75 percent of final average compensation up to the offset level, for each year of service up to 35. The disparity provided under the plan satisfies this paragraph (b) because the offset percentage (0.75 percent) does not exceed the maximum offset allowance equal to the lesser of 0.75 percent or one-half of the gross benefit percentage (1 percent).

Example 3. Plan P is a defined benefit excess plan that provides a normal retirement benefit of 0.5 percent of average annual compensation up to the integration level, plus 1.25 percent of average annual compensation in excess of the integration level, for each year of service up to 35. The disparity provided under the plan exceeds the maximum excess allowance because the excess benefit percentage (1.25 percent) exceeds the base benefit percentage (0.5 percent) by more than the base benefit percentage (0.5 percent).

Example 4. Plan Q is an offset plan that provides a normal retirement benefit of 1 percent of average annual compensation, minus 0.75 percent of final average compensation up to the offset level, for each year of service up to 35. The disparity under the plan exceeds the maximum offset allowance because the offset percentage exceeds one-half of the gross benefit percentage (0.5 percent).

Example 5. (a) Plan R is an offset plan that provides a normal retirement benefit of 1 percent of average annual compensation, minus 0.5 percent of final average compensation up to the offset level, for each year of service up to 35. The plan determines an employee's average annual compensation using an averaging period comprising five consecutive 12-month periods and taking into account the employee's compensation for the ten consecutive 12-month periods ending with the plan year. The plan does not provide that an employee's final average compensation is limited to the employee's average annual compensation.

(b) Employee A has average annual compensation of $20,000, final average compensation of $25,000, and covered compensation of $32,000. The maximum offset allowance applicable to Employee A for the plan year under paragraph (b)(3) of this section is one-half of the gross benefit percentage multiplied by the ratio, not to exceed one, of Employee A's average annual compensation to Employee A's final average compensation up to the offset level. Thus, the maximum offset allowance is 0.4 percent (½ × 1 percent×$20,000/$25,000). With respect to Employee A, the benefit formula provides an offset that exceeds the maximum offset allowance. The plan must therefore reduce Employee A's offset percentage to 0.4 percent. (Under paragraph (c)(2)(viii) of this section, Employee A's adjusted disparity rate is deemed uniform.)

(c) Alternatively, under § 1.401(l)–1(c)(17)(ii) (the definition of final average compensation), the plan could specify that an employee's final average compensation is limited to the amount of the employee's average annual compensation. Thus, the ratio of average annual compensation to final average compensation would always be equal to at least one, and the maximum offset allowance under the plan would be one-half of the gross benefit percentage.

Example 6. Plan S is a defined benefit excess plan that provides a base benefit percentage of 1 percent of average annual compensation up to the integration level for each year of service. The plan also provides, for each of the first 10 years of service, an excess benefit percentage of 1.85 percent of average annual compensation in excess of the integration level. For each year of service after 10, the plan provides an excess benefit percentage of 1.65 percent of the employee's average annual compensation in excess of the integration level. The disparity provided under the plan exceeds the maximum excess allowance because the excess benefit percentage for each of the first ten years of service (1.85 percent) exceeds the base benefit percentage (1 percent) by more than 0.75 percent.

Example 7. The facts are the same as in *Example 6,* except that the plan provides an excess benefit percentage of 1.65 percent of average annual compensation in excess of the integration level for each of the first 10 years of service and an excess benefit percentage of 1.85 percent of average annual compensation in excess of the integration level for each year of service after 10. The disparity provided under the plan exceeds the maximum excess allowance because the excess benefit percentage for each year of service after 10 (1.85 percent) exceeds the base benefit percentage (1 percent) by more than 0.75 percent.

Example 8. Plan T is a defined benefit excess plan that provides a normal retirement benefit of 1.0 percent of average annual compensation up to the integration level, plus 1.7 percent of average annual compensation in excess of the integration level, for each year of service up to 35, payable in the form of a joint and survivor annuity. The plan also allows an employee to receive the retirement benefit in the form of an actuarially equivalent straight life annuity. The actuarially equivalent straight life annuity equals 1.09 percent of average annual compensation up to the integration level, plus 1.85 percent of average annual compensation in excess of the integration level, for each year of service up to 35. The disparity provided under the plan with respect to the straight life annuity form of benefit (0.76 percent) exceeds the maximum excess allowance because the excess benefit percentage (1.85 percent) exceeds the base benefit percentage (1.09 percent) by more than 0.75 percent.

Example 9. Plan U is a defined benefit excess plan that provides a normal retirement benefit of 1.0 percent of average annual compensation up to the integration level, plus 1.7 percent of average annual compensation in excess of the integration level, for each year of service up to 35, payable in the form of a straight life annuity. Plan U provides a single sum optional form of benefit at normal retirement age equal to 100 times the monthly annuity payable at that age. Thus, if an employee elects the single sum optional form of benefit, the base portion of the single sum benefit is 8.33 percent (100 times 1.0 percent/12) of average annual compensation up to the integration level per year of service, and the excess portion of the single sum benefit is 14.17 percent (100 times 1.7 percent/12) of average annual compensation in excess of the integration level per year of service. Each respective portion of the single sum option is normalized to a straight life annuity commencing at normal retirement age, using 8-percent interest and the UP–84 mortality table. After normalization, the base portion of the benefit is 1.02 percent of average annual compensation up to the integration level, and the excess portion of the benefit is 1.73 percent of average annual compensation in excess of the integration level. The single sum optional form of benefit satisfies this paragraph (b) because the disparity provided in the optional form of benefit does not exceed the maximum excess allowance.

(c) *Uniform disparity*—(1) *In general.* The disparity provided under a defined benefit excess plan is uniform only if the plan uses the same base benefit percentage and the same excess benefit percentage for all employees with the same number of years of service. The disparity provided under an offset plan is uniform only if the plan uses the same gross benefit percentage and the same offset percentage for all employees with the same number of years of service. The disparity provided under a plan that determines each employee's accrued benefit under the fractional accrual method of section 411(b)(1)(C) is uniform only if the plan satisfies one of the deemed uniformity rules of paragraph (c)(2) (ii) or (iii) of this section.

(2) *Deemed uniformity*—(i) *In general.* The disparity provided under a plan does not fail to be uniform for purposes of this paragraph (c) merely because the plan contains one or more of the provisions described in paragraphs (c)(2) (ii) through (ix) of this section.

(ii) *Use of fractional accrual and disparity for 35 years.* The plan contains a benefit formula as described in paragraphs (c)(2)(ii) (A) and (B) of this section, and the plan determines each employee's accrued benefit under the method described in §1.401(a)(4)–3(b)(4)(i)(B), i.e., by multiplying the employee's fractional rule benefit (within the meaning of §1.411(b)–1(b)(3)(ii)(A)) by a fraction, the numerator of which is the employee's years of service determined as of the plan year, and the denominator of which is the employee's projected years of service as of normal retirement age.

(A) For each year of service at least up to 35, the benefit plan formula provides the same base benefit percentage and the same excess benefit percentage for all employees in the case of a defined benefit excess plan or the same gross benefit percentage and the same offset percentage for all employees in the case of an offset plan.

(B) For each additional year of service, the benefit formula provides a uniform percentage of all average annual compensation that is no greater than the excess benefit percentage or the gross benefit percentage under paragraph (c)(2)(ii)(A) of this section, whichever is applicable.

(iii) *Use of fractional accrual and disparity for fewer than 35 years.* The plan contains a benefit formula as described in paragraphs (c)(2)(iii) (A) through (C) of this section, and the plan determines each employee's accrued benefit under the method described in §1.401(a)(4)–3(b)(4)(i)(B).

(A) For each year in the employee's initial period of service comprising fewer than 35 years, the benefit formula provides the same base benefit percentage and the same excess benefit percentage for all employees in the case of a defined benefit excess plan or the same gross benefit percentage and the same offset percentage for all employees in the case of an offset plan.

(B) For each year of service after the initial period and at least up to 35, the benefit formula provides a uniform percentage of all average annual compensation, that is equal to the excess benefit percentage or the gross benefit percentage under paragraph (c)(2)(iii)(A) of this section.

(C) For each year of service after the period described in paragraph (c)(2)(iii)(B) of this section, the benefit formula provides a uniform percentage of all average annual compensation that is no greater than the excess benefit percentage or the gross benefit percentage under paragraph (c)(2)(iii)(A) of this section.

(iv) *Different social security retirement ages.* The benefit formula uses the same excess benefit percentage or the same gross benefit percentage for all employees with the same number of years of service and, for employees with social security retirement ages later than age 65, adjusts the 0.75-percent factor in the maximum excess or offset allowance as required under paragraph (e)(1) of this section, by increasing the base benefit percentage in the case of a defined benefit excess plan, or reducing the offset percentage in the case of an offset plan.

(v) *Reduction for integration level.* The plan uses an integration level or offset level greater than each employee's covered compensation and makes individual reductions in the 0.75-percent factor, as permitted under paragraph (d)(9)(iii)(B) of this section, by increasing the base benefit percentage in the case of a defined benefit excess plan or reducing the offset percentage in the case of an offset plan.

(vi) *Overall permitted disparity*—(A) *In general.* The benefit formula provides that, with respect to each employee's years of service after reaching the cumulative permitted disparity limit applicable to the employee under § 1.401(l)–5(c), employer-provided benefits are determined with respect to the employee's total average annual compensation at a rate equal to the nondisparate percentage. For purposes of this paragraph (c)(2)(vi), the nondisparate percentage is generally the excess benefit percentage or gross benefit percentage otherwise applicable under the benefit formula to an employee with the same number of years of service.

(B) *Unit credit plans.* In the case of a unit credit plan described in § 1.401(a)(4)–3(b)(3), if the 411(b)(1)(B) limit percentage is less than the nondisparate percentage, the 411(b)(1)(B) limit percentage must be substituted for the nondisparate percentage. For this purpose, the 411(b)(1)(B) limit percentage is 133⅓ percent of the smallest base benefit percentage, or 133⅓ percent of the smallest difference between the gross benefit percentage and the offset percentage, whichever is applicable, where the smallest base benefit percentage or difference is determined by reference to the benefit formula as applied to employees with no more years of service than the employee.

(C) *Fractional accrual plans.* In the case of a fractional accrual plan described in § 1.401(a)(4)–3(b)(4), the benefit formula must provide for the nondisparate percentage with respect to years of service after the employee would reach the cumulative permitted disparity limit applicable to the employee under § 1.401(l)–5(c) as modified by this paragraph (c)(2)(vi)(C). Solely for purposes of this paragraph (c)(2)(vi)(C), the employee's annual disparity fractions (and thus the year in which the employee would reach the cumulative permitted disparity limit) are determined using the disparity provided under the benefit formula (rather than the special rule for fractional accrual plans in § 1.401(l)–5(b)(8)(v)).

(vii) *Non-FICA employees.* The plan provides that, in the case of each employee under the plan with respect to whom none of the taxes under section 3111(a), section 3221, or section 1401 is required to be paid, employer-provided benefits are determined with respect to the employee's total average annual compensation at the excess benefit percentage or gross benefit percentage applicable to an employee with the same number of years of service.

(viii) *Average annual compensation adjustment for offset plan.* In the case of each employee whose final average compensation exceeds the employee's average annual compensation, the plan adjusts the offset percentage as required under paragraph (b)(3)(ii) of this section in order to satisfy the maximum offset allowance.

(ix) *PIA offsets.* In the case of an offset plan, the plan provides that the offset applied to each employee's benefit is the lesser of a specified percentage of the employee's PIA and an offset that otherwise satisfies the requirements of this section (the ''section 401(l) overlay''). The specified percentage of PIA must be the same for all employees with the same number of years of service. In the case of a plan that determines each employee's accrued benefit under the fractional accrual method of section 411(b)(1)(C), the specified percentage of PIA is deemed to be the same for all employees with the same number of years of service if the plan satisfies either of the deemed uniformity rules in paragraph (c)(2)(ii) or (iii) of this section, substituting ''offset, expressed as a percentage of PIA, per year of service'' for the term ''offset percentage'' (in addition to satisfying either of those rules with respect to the section 401(l) overlay).

(3) *Examples.* The following examples illustrate this paragraph (c). Unless otherwise provided, the following facts apply. The plan is noncontributory and is the only plan ever maintained by the employer. The plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. In the case of a defined benefit excess plan, the plan uses each employee's covered compensation as the integration level; in the case of an offset plan, the plan uses each employee's covered compensation as the offset level and provides that an employee's final average compensation is limited to the employee's average annual compensation. Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65.

Example 1. Plan M is a defined benefit excess plan that satisfies the 133⅓ percent accrual rule of section 411(b)(1)(B). The plan provides a normal retirement benefit of 1.0 percent of average annual compensation up to the integration level, plus 1.65 percent of average annual compensation in excess of the integration level, for each year of service up to 25. The plan also provides a benefit of 1.0 percent of all average annual compensation for each year of service in excess of 25. The disparity provided under the plan is uniform because the plan uses the same base and excess benefit percentages for all employees with the same number of years of service. If the plan formula were the same except that it used a different excess benefit percentage for some of the years of service between one and 25, the disparity under the plan would continue to be uniform.

Example 2. Plan O is a defined benefit excess plan that provides a normal retirement benefit of 50 percent of average annual compensation up to the integration level and 68.75 percent of average annual compensation in excess of the integration level, multiplied by a fraction, the numerator of which is the employee's service, up to 25 years, and the denominator of which is 25. The plan determines an employee's accrued benefit as described in §1.401(a)(4)–3(b)(4)(i)(B). The benefit formula thus provides a base benefit percentage of 2 percent (50 percent×1⁄25) and an excess benefit percentage of 2.75 percent (68.75 percent×1⁄25) for each of an employee's first 25 years of service and no benefit for years of service after 25. The disparity provided under the plan is not uniform within the meaning of this paragraph (c) because the benefit formula does not satisfy either of the uniform disparity rules for fractional accrual plans under paragraphs (c)(2) (ii) and (iii) of this section.

Example 3. Plan P is an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation for each year of service up to 35, minus 0.75 percent of the final average compensation up to the offset level for each year of service up to 25. The plan determines an employee's accrued benefit under the method described in §1.401(a)(4)–3(b)(4)(i)(B). Because the formula under the plan provides the same gross benefit percentage and offset percentage for 25 years of service (fewer than 35) and, for years of service after 25 and up to 35, provides a benefit at a uniform rate (equal to the gross benefit percentage) of all average annual compensation, and the plan accrues the benefit ratably, the disparity under the plan is deemed to be uniform under paragraph (c)(2)(iii) of this section.

Example 4. Plan Q is an offset plan that benefits employees with social security retirement ages of 65, 66, and 67. For each year of service up to 35, the plan provides a normal retirement benefit equal to 2 percent of average annual compensation, minus an offset based on the employee's final average compensation up to the offset level. For employees with a social security retirement age of 65, the offset percentage is 0.75 percent; for employees with a social security retirement age of 66, the offset percentage is 0.70 percent; and for employees with a social security retirement age of 67, the offset percentage is 0.65 percent. The disparity under the plan is deemed to be uniform under paragraph (c)(2)(iv) of this section because the plan uses the same gross benefit percentage for all employees and reduces the offset percentage for employees with social security retirement ages of 66 and 67 to comply with the adjustments in the 0.75-percent factor in the maximum excess or offset allowance required under paragraph (e)(1) of this section. (Because Plan Q effectively provides unreduced benefits prior to the social security retirement age for employees with social security retirement ages of 66 and 67, the 0.75-percent factor in the maximum offset allowance must be reduced to 0.70 percent and 0.65 percent, respectively.) Alternatively, Plan Q could satisfy this paragraph (c) if it provided a uniform offset percentage of 0.65 percent for all employees because 0.65 percent is the maximum offset allowance under the plan for an employee with a social security retirement age of 67.

Example 5. Plan R is an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation, minus an offset determined as a percentage of total final average compensation, for each year of service up to 35. For an employee whose final average compensation does not exceed the employee's covered compensation, the offset percentage is 0.75 percent. For an employee whose final average compensation exceeds the employee's covered compensation, the plan reduces the offset percentage, as required by paragraph (d) of this section. The reduced offset percentage is determined by comparing the employee's final average compensation to the employee's covered compensation as permitted under paragraph (d)(9)(iii)(B) of this section. The disparity provided under the plan is deemed uniform under paragraph (c)(2)(v) of this section because the plan uses the same gross benefit percentage for all employees and makes individual reductions in the 0.75-percent factor, as permitted under paragraph (d)(9)(iii)(B) of this section, by reducing the offset percentage in the case of an employee whose final average compensation exceeds covered compensation.

(d) *Requirements for integration or offset level*—(1) *In general.* The integration level under a defined benefit excess plan or the offset level under an offset plan must satisfy paragraphs (d)(2), (d)(3), (d)(4), (d)(5) or (d)(6) of this section, as modified by paragraph (d)(7) of this section in the case of a short plan year. Paragraph (d)(8) of this section contains demographic tests that apply to certain defined benefit plans. Paragraph (d)(9) of this section explains certain reductions required in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. Paragraph (d)(10) of this section contains examples. If a reduction applies to the 0.75-percent factor under this paragraph (d), the reduced factor is used for all purposes in determining whether the permitted disparity rules for defined benefit plans are satisfied.

(2) *Covered compensation.* The requirement of this paragraph (d)(2) is satisfied only if the integration or offset level under the plan for each employee is the employee's covered compensation.

(3) *Uniform percentage of covered compensation.* The requirement of this paragraph (d)(3) is satisfied only if—

(i) The integration or offset level under the plan for each employee is a uniform percentage (greater than 100 percent) of each employee's covered compensation,

(ii) In the case of a defined benefit excess plan, the integration level does not exceed the taxable wage base in effect for the plan year, and, in the case of an offset plan, the offset level does not exceed the employee's final average compensation, and

(iii) The plan adjusts the 0.75-percent factor in the maximum excess or offset allowance in accordance with paragraph (d)(9) of this section.

(4) *Single dollar amount.* The requirement of this paragraph (d)(4) is satisfied only if the integration or offset level under the plan for all employees is a single dollar amount (either specified in the plan or determined under a formula specified in the plan) that does not exceed the greater of $10,000 or one-half of the covered compensation of an individual who attains social security retirement age in the calendar year in which the plan year begins. In the case of a calendar year in which no individual could attain social security retirement age, for example, the year 2003, this rule is applied using covered compensation of an individual attaining social security retirement age in the preceding calendar year.

(5) *Intermediate amount.* The requirement of this paragraph (d)(5) is satisfied only if—

(i) The integration or offset level under the plan for all employees is a single dollar amount (either specified in the plan or determined under a formula specified in the plan) that is greater than the highest amount determined under paragraph (d)(4) of this section,

(ii) In the case of a defined benefit excess plan, the single dollar amount does not exceed the taxable wage base in effect for the plan year, and, in the case of an offset plan, the single dollar amount does not exceed the employee's final average compensation,

(iii) The plan satisfies the demographic requirements of paragraph (d)(8) of this section, and

(iv) The plan adjusts the 0.75-percent factor in the maximum excess or offset allowance in accordance with paragraph (d)(9) of this section.

For purposes of this paragraph (d)(5), an offset level of each employee's final average compensation is considered a single dollar amount determined under a formula specified in the plan.

(6) *Intermediate amount safe harbor.* The requirement of this paragraph (d)(6) is satisfied only if—

(i) The integration or offset level under the plan for all employees is a single dollar amount described in paragraph (d)(5) of this section, and

(ii) The 0.75-percent factor in the maximum excess or offset allowance under paragraph (b)(2) or (b)(3) of this section is reduced to the lesser of the adjusted factor determined under paragraph (d)(9) of this section or 80 percent of the otherwise applicable factor under paragraph (b)(2) or (b)(3) of this section, determined without regard to paragraph (d)(9) of this section.

(7) *Prorated integration level for short plan year.* If an accumulation plan uses paragraph (2) or (4) of the definition of plan year compensation under §1.401(a)(4)–12 (i.e., section 414(s) compensation for the plan year or the period of plan participation) and has a plan year that comprises fewer than 12 months, the integration or offset level under the plan for each employee must be an amount equal to the otherwise applicable integration or offset level described in paragraph (d)(2), (d)(3), (d)(4), (d)(5), or (d)(6) of this section, multiplied by a fraction, the numerator of which is the number of months in the plan year and the denominator of which is 12. No adjustment to the maximum excess or offset allowance is required as a result of the application of this paragraph (d)(7), other than any adjustment already required under paragraph (d)(6) or (d)(9) of this section.

(8) *Demographic requirements*—(i) *In general.* A plan that satisfies the demographic requirements of paragraphs (d)(8)(ii) and (iii) of this section may use an integration level described in paragraph (d)(5) of this section.

(ii) *Attained age requirement.* The requirement of this paragraph (d)(8)(ii) is satisfied only if the average attained age of the nonhighly compensated employees in the plan is not greater than the greater of—

(A) Age 50, or

(B) 5 plus the average attained age of the highly compensated employees in the plan. For purposes of this paragraph (d)(8)(ii), attained ages are determined as of the beginning of the plan year.

(iii) *Nondiscrimination requirement.* The requirement of this paragraph (d)(8)(iii) is satisfied only if at least one of the following tests in paragraphs (d)(8)(iii) (A) through (D) of this section is satisfied.

(A) *Minimum percentage test.* This test is satisfied only if more than 50 percent of the nonhighly compensated employees in the plan have average annual compensation at least equal to 120 percent of the integration or offset level.

(B) *Ratio test.* This test is satisfied only if the percentage of nonhighly compensated nonexcludable employees, who are in the plan and who have average annual compensation at least equal to 120 percent of the integration or offset level, is at least 70 percent of the percentage of highly compensated nonexcludable employees who are employees in the plan.

(C) *High dollar amount test.* This test is satisfied only if the integration or offset level exceeds 150 percent of the covered compensation of an individual who attains social security retirement age in the calendar year in which the plan year begins. In the case of a calendar year in which no individual could attain social security retirement age, for example, the year 2003, this rule is applied using covered compensation of an individual attaining social security retirement age in the preceding calendar year.

(D) *Individual disparity reductions.* This test is satisfied only if the plan is an offset plan that uses an offset level of each employee's final average compensation and makes individual disparity reductions as permitted under paragraph (d)(9)(iii)(B) of this section.

(9) *Reduction in the 0.75-percent factor if integration or offset level exceeds covered compensation*—(i) *In general.* If the integration or offset level specified under the plan is each employee's covered compensation as of the plan year, no reduction in the 0.75-percent factor in the maximum excess or offset allowance is required for the plan year under this paragraph (d)(9). If a plan specifies an integration or offset level that exceeds an employee's covered compensation, the 0.75-percent factor in the

maximum excess or offset allowance must be reduced as required in paragraph (d)(9)(ii) or (iii) of this section. Paragraph (d)(9)(iv) of this section contains a table of the applicable reductions.

(ii) *Uniform percentage of covered compensation.* If a plan specifies an integration or offset level that is a uniform percentage (in excess of 100 percent) of each employee's covered compensation, the 0.75-percent factor in the maximum excess or offset allowance must be reduced in accordance with the table in paragraph (d)(9)(iv) of this section. Thus, for example, if a plan specifies an integration or offset level of 120 percent of each employee's covered compensation, the 0.75-percent factor in the maximum excess or offset allowance must be reduced to 0.69 percent in accordance with the table because the specified integration or offset level is more than covered compensation but not more than 125 percent of covered compensation.

(iii) *Single dollar amount.* If a plan specifies an integration or offset level of a single dollar amount as permitted under paragraph (d)(5) of this section (for example, $30,000), the applicable reduction in the maximum excess or offset allowance must be determined under paragraph (d)(9)(iii) (A) or (B) of this section, as specified under the plan.

(A) *Plan-wide reduction.* The applicable reduction in the maximum excess or offset allowance under the table in paragraph (d)(9)(iv) of this section may be determined by comparing the single dollar amount specified in the plan to the covered compensation of an individual attaining social security retirement age in the calendar year in which the plan year begins. Thus, for example, if a plan specifies a single integration or offset level of $30,000 that is uniformly applicable to all employees for a plan year and the covered compensation of an individual attaining social security retirement age in the calendar year in which the plan year begins is $20,000, the 0.75-percent factor in the maximum excess or offset allowance must be reduced to 0.60 percent for all employees in accordance with the table in paragraph (d)(9)(iv) of this section because the specified integration or offset level of $30,000 is more than 125 percent of $20,000 but not more than 150 percent of $20,000. In the case of a calendar year in which no individual could attain social security retirement age (for example, 2003), the comparison is made with covered compensation of an individual who attained social security retirement age in the preceding calendar year. If an offset plan uses an offset level of each employee's final average compensation, the reduction under this paragraph (d)(9)(iii)(A) is determined by comparing the highest possible amount of final average compensation to the covered compensation of an individual attaining social security retirement age in the calendar year in which the plan year begins.

(B) *Individual reductions.* The applicable reduction in the maximum excess or offset allowance under the table in paragraph (d)(9)(iv) of this section may be determined by comparing the single dollar amount specified in the plan to the covered compensation of each employee under the plan. Thus, for example, if a plan specifies a single integration or offset level of $30,000 that is uniformly applicable to all employees for a plan year, the 0.75-percent factor in the maximum excess or offset allowance must be reduced to 0.60 percent for an employee with covered compensation of $20,000, but need not be reduced for an employee whose covered compensation is $30,000 or greater.

(iv) *Reductions*—(A) *Table.*

TABLE

If the integration or offset level is	The permitted disparity factor is
100 percent of covered compensation	0.75 percent
125 percent of covered compensation	0.69 percent
150 percent of covered compensation	0.60 percent
175 percent of covered compensation	0.53 percent
200 percent of covered compensation	0.47 percent
The taxable wage base or final average compensation.	0.42 percent

(B) *Interpolation.* If the integration or offset level used under a plan is between the percentages of covered compensation in the table, the permitted disparity factor applicable to the plan can be determined either by straight-line interpolation between the permitted disparity factors in the table or by rounding the integration or offset level up to the next highest percentage of covered compensation in the table.

(10) *Examples.* The following examples illustrate this paragraph (d). Unless otherwise provided, the following facts apply. The plan is noncontributory and is the only plan ever maintained by the employer. The plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. In the case of an offset plan, the plan provides that an employee's final average compensation is limited to the employee's average annual compensation. Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65.

Example 1. (a) Plan M is a defined benefit excess plan that uses the calendar year as its plan year. For the 1989 plan year, the plan uses an integration level of $20,000, which is 118 percent of the 1989 covered compensation of $16,968 for an individual reaching social security retirement age in 1989. The plan may use that integration level without satisfying paragraph (d)(8) of this section, provided the adjustment to the 0.75-percent factor required under paragraph (d)(6) of this section is made. That adjustment is the lesser of the factor determined under paragraph (d)(9) of this section or 80 percent of the factor otherwise applicable under paragraph (b)(2) or (b)(3) of this section.

(b) The plan determines the factor under paragraph (d)(9) of this section by comparing the integration level to the covered compensation of an individual attaining social security retirement age in the calendar year in which the plan year begins and by rounding the integration level up to 125 percent of that covered compensation amount. The 0.75-percent factor is therefore replaced by 0.69 percent pursuant to the table in paragraph (d)(9) of this section. The 0.69–percent factor is 92 percent of the 0.75-percent factor. Because the lesser of 80 percent and 92 percent is 80 percent, the 0.75-percent factor is reduced to 0.6 percent (80 percent of 0.75 percent) under paragraph (d)(6) of this section. The 0.6–percent factor applies to benefits commencing at age 65 for an employee with a social security retirement age of 65. In determining normal retirement benefits for employees with social security retirement ages of 66 or 67, the applicable factors for benefits commencing at age 65 are, respectively, 0.56 percent (80 percent of 0.7 percent) and 0.52 percent (80 percent of 0.65 percent).

(c) The plan could also determine the factor under paragraph (d)(9) of this section by comparing the integration level to the covered compensation of each employee under the plan, or by straight line interpolation between the disparity factors contained in the table in paragraph (d)(9) of this section, or both. (Of course, if the plan satisfied paragraph (d)(8) of this section, the plan could use the factor determined under paragraph (d)(9) of this section.)

Example 2. (a) Plan N, an accumulation plan, is a defined benefit excess plan that, for each year of service up to 35, accrues a normal retirement benefit of 1 percent of plan year compensation up to the taxable wage base, plus 1.75 percent of plan year compensation above the taxable wage base, for each year of service up to 35. An employee's total retirement benefit is the sum of the accruals for all years. The plan satisfies paragraph (d)(8) of this section.

(b) Because the plan uses the taxable wage base (an amount above covered compensation) as the integration level, it must reduce the 0.75-percent factor in the maximum excess allowance as required under paragraphs (d)(5) and (d)(9) of this section. The reduced factor, if determined on a plan-wide basis under paragraph (d)(9)(iii)(A) of this section, is 0.42 percent. The plan must therefore reduce the disparity in the plan so that it does not exceed 0.42 percent.

Example 3. (a) For the 1990 plan year, Plan O provides a normal retirement benefit of 2 percent of average annual compensation, minus a percentage of final average compensation up to $48,000, for each year of service up to 35. The plan satisfies paragraph (d)(8) of this section. As permitted under paragraph (d)(9) of this section, the plan provides that each employee's offset percentage is determined by comparing $48,000 to the employee's covered compensation and by rounding the result up to the next highest percentage of covered compensation.

(b) Employee A has a social security retirement age of 66 and covered compensation of $40,000. Because the plan provides for commencement of Employee A's benefit at age 65, the 0.75-percent factor in the maximum offset allowance is reduced to 0.7 percent under paragraph (e)(1) of this section (the ‘‘paragraph (e) factor''). In addition, because $48,000 is rounded up to 125 percent of Employee A's covered compensation, the 0.75-percent factor in the maximum offset allowance is reduced to 0.69 percent under paragraph (d)(9) of this section (the ‘‘paragraph (d) factor''). The reductions are cumulative under paragraph (b)(3)(ii) of this section.

(c) The cumulative reductions can be made by multiplying the paragraph (e) facdtor by the ratio of the paragraph (d) factor to 0.75 percent or by multiplying the paragraph (d) factor by the ratio of the paragraph (e) factor to 0.75 percent. The disparity factor for Employee A is therefore 0.64 percent ((0.7 percent × 0.69 percent/0.75 percent) or (0.69 percent x 0.7 percent/0.75 percent)).

Example 4. Plan P is an offset plan that uses the calendar year as the plan year and uses an offset level of each employee's final average compensation. Assume that the taxable wage bases for 1990–1992 are the following:

1990—$51,300
1991—$53.400
1992—$58,000

Employee B's final average compensation, determined as of the close of the 1992 plan year, is the average of Employee B's annual compensation for the period 1990–1992. Employee B's annual compensation for each year is the following:

1990—$47,000
1991—$59,000
1992—$65,000

For purposes of determining the offset applied to Employee B's employer-provided benefit under the plan. Employee's B's final average compensation as of the close of the 1992 plan year is $52,800 ($47,000 + $53,400 + $58,000/3). This is because annual compensation in excess of the taxable wage base in effect at the beginning of the year may not be taken into account in determining an employee's final average compensation or in determining the employee's offset. If the plan determines the offset applied to Employee B's benefit by reference to compensation in excess of $52,800, the plan fails to satisfy this paragraph (d).

(e) *Adjustments to the 0.75-percent factor for benefits commencing at ages other than social security retirement age*—(1) *In general.* The 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance applies to a benefit commencing at an employee's social security retirement age. Except as provided in paragraph (g) of this section, if a benefit payable to an employee under a defined benefit excess plan or a defined benefit offset plan commences at an age before the employee's social security retirement age (including a benefit payable at the normal retirement age under the plan), the 0.75-percent factor in the maximum excess allowance or in the maximum offset allowance, respectively, is reduced in accordance with paragraph (e)(2)(i) of this section. If a benefit payable to an employee under a defined benefit excess plan or a defined offset plan commences at an age after the employee's social security retirement age, the 0.75-percent factor in the maximum excess allowance or in the maximum offset allowance, respectively, may be increased in accordance with paragraph (e)(2)(ii) of this section. Paragraph (e)(4) of this section provides rules on the age at which a benefit commences. See paragraph (f) of this section for the requirements applicable to optional forms of benefit.

(2) *Adjustments*—(i) *Benefits commencing on or after age 55 and before social security retirement age.* If benefits commence before an employee's social security retirement age, the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance must be reduced for such early commencement of benefits in accordance with the tables set forth in paragraph (e)(3) of this section.

(ii) *Benefits commencing after social security retirement age and on or before age 70.* If benefits commence after an employee's social security retirement age, the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance may be increased for such delayed commencement of benefits in accordance with the tables set forth in paragraph (e)(3) of this section.

(iii) *Benefits commencing before age 55.* If benefits commence before the employee attains age 55, the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance is further reduced (on a monthly basis to reflect the month in which benefits commence) to a factor that is the actuarial equivalent of the 0.75-percent factor, as adjusted under the tables in paragraph (e)(3) of this section, applicable to a benefit commencing in the month in which the employee attains age 55. In determining actuarial equivalence for this purpose, a reasonable interest rate must be used. In addition, a reasonable mortality table must be used to determine the actuarial present value, as defined in § 1.401(a)(4)–12, of the benefits commencing at age 55 and at the earlier commencement age, and a reasonable mortality table may be used to determine the actuarial present value at the earlier commencement age of the benefits commencing at age 55. A standard interest rate and a standard mortality table, as defined in § 1.401(a)(4)–12, are considered reasonable.

(iv) *Benefits commencing after age 70.* If benefits commence after the employee attains age 70, the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance may be further increased (on a monthly basis to reflect the month in which benefits commence) to a factor that is the actuarial equivalent of the 0.75-percent factor (as adjusted in accordance with this paragraph (e)) applicable to a benefit commencing in the month in which the employee attains age 70. In determining actuarial equivalence for this purpose, a reasonable interest rate must be used. In addition, a reasonable mortality table must be used to determine the actuarial present value, as defined in §1.401(a)(4)–12, of the benefits commencing at age 70 and at the later commencement age, and a reasonable mortality table may be used to determine the value at the later commencement age of the benefits commencing at age 70. A standard interest rate and a standard mortality table, as defined in §1.401(a)(4)–12, are considered reasonable.

(3) *Tables.* Tables I, II, and III provide the adjustments in the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance applicable to benefits commencing on or after age 55 and on or before age 70 to an employee who has a social security retirement age of 65, 66 or 67. Table IV is a simplified table for a plan that uses a single disparity factor of 0.65 percent for all employees at age 65. The factors in the following tables are applicable to benefits that commence in the month the employee attains the specified age. Accordingly, if benefits commence in a month other than the month in which the employee attains the specified age, appropriate adjustments in the 0.75-percent factor in the maximum excess allowance and the maximum offset allowance must be made. For this purpose, adjustments may be based on straight-line interpolation from the factors in the tables or in accordance with the methods of adjustment specified in paragraphs (e)(2)(iii) and (iv) of this section.

TABLE I

[Social security retirement age 67]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
70	1.002
69	0.908
68	0.825
67	0.750
66	0.700
65	0.650
64	0.600
63	0.550
62	0.500
61	0.475
60	0.450
59	0.425
58	0.400
57	0.375
56	0.344
55	0.316

TABLE II

[Social security retirement age 66]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
70	1.101
69	0.998
68	0.907
67	0.824
66	0.750
65	0.700
64	0.650
63	0.600
62	0.550
61	0.500
60	0.475
59	0.450
58	0.425
57	0.400
56	0.375
55	0.344

TABLE III

[Social security retirement age 65]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
70	1.209
69	1.096
68	0.996
67	0.905
66	0.824
65	0.750
64	0.700
63	0.650
62	0.600
61	0.550
60	0.500
59	0.475

TABLE III—Continued

[Social security retirement age 65]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
58	0.450
57	0.425
56	0.400
55	0.375

TABLE IV

[Simplified table]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
70	1.048
69	0.950
68	0.863
67	0.784
66	0.714
65	0.650
64	0.607
63	0.563
62	0.520
61	0.477
60	0.433
59	0.412
58	0.390
57	0.368
56	0.347
55	0.325

(4) *Benefit commencement date*—(i) *In general.* Except as provided in paragraph (e)(4)(ii) of this section, a benefit commences for purposes of this paragraph (e) on the first day of the period for which the benefit is paid under the plan.

(ii) *Qualified social security supplement.* If a plan uses a qualified social security supplement, as defined in § 1.401(a)(4)–12, to provide an aggregate benefit at retirement before social security retirement age that is a uniform percentage of average annual compensation, benefits will be considered to commence on the first day of the period for which the qualified social security supplement is no longer payable. In order for this paragraph (e)(4)(ii) to apply, the uniform percentage must be equal to the excess benefit percentage in the case of an excess plan or the gross benefit percentage in the case of an offset plan.

(5) *Examples.* The following examples illustrate this paragraph (e). Unless otherwise provided, the following facts apply. The plan is noncontributory and is the only plan ever maintained by the employer. The plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. In the case of a defined benefit excess plan, the plan uses each employee's covered compensation as the integration level; in the case of an offset plan, the plan uses each employee's covered compensation as the offset level and provides that an employee's final average compensation is limited to the employee's average annual compensation. Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65.

Example 1. Plan M is a defined benefit excess plan that, for an employee with a social security retirement age of 65, provides a normal retirement benefit of 1.25 percent of average annual compensation up to the integration level, plus 2.0 percent of average annual compensation in excess of the integration level, for each year of service up to 35. For an employee with at least 20 years of service, the plan provides a benefit commencing at age 55 that is equal to the benefit payable at age 65. For that employee, the disparity provided under the plan at age 55 is 0.75 percent (2 percent–1.25 percent). Because this disparity exceeds the 0.375 percent factor provided in the table for a benefit payable at age 55 to an employee with a social security retirement age of 65, the plan fails to satisfy paragraphs (b) and (e) of this section with respect to the early retirement benefit.

Example 2. Assume the same facts as in *Example 1,* except that the base benefit percentage under the plan is 1.75 percent. Thus, the disparity provided under the plan at age 55 is 0.25 percent (2 percent–1.75 percent). Because the disparity does not exceed the 0.375 percent factor provided in the table for a benefit payable at age 55 to an employee with a social security retirement age of 65, the plan does not fail to satisfy paragraphs (b) and (e) of this section with respect to the early retirement benefit.

Example 3. Plan N is an offset plan that, for an employee with a social security retirement age of 65, provides a normal retirement benefit of 1.75 percent of average annual compensation, minus 0.75 percent of final average compensation up to the offset level, for each year of service up to 35. For an employee with at least 20 years of service, the plan provides a benefit commencing at age 55 that is equal to the benefit payable at age 65. For that employee, the disparity provided under the plan at age 55 is 0.75 percent. Because this disparity exceeds the 0.375–percent factor provided in the table for an offset applied to a benefit payable at age 55 to an employee with a social security retirement age of 65, the plan fails to satisfy paragraphs (b) and (e) of this section with respect to the early retirement benefit. The plan would not fail to satisfy paragraphs (b) and (e) of this section with respect to the early retirement benefit if the applicable factor for determining the offset applied to the benefit were reduced to 0.375 percent.

Example 4. Plan O is a defined benefit excess plan that, for an employee with a social security retirement age of 65, provides a normal retirement benefit of 1.25 percent of average annual compensation up to the integration level, plus 2.0 percent of average annual compensation in excess of the integration level, for each year of service up to 35. The plan provides benefits commencing before normal retirement age with the following reductions:

Age	Percentage of normal retirement benefit (%)
64	90
63	85
62	80

Under the plan, a benefit payable at age 64 is equal to 90 percent of the normal retirement benefit payable at age 65. Thus, the excess benefit percentage under the plan is 1.8 percent, the base benefit percentage under the plan is 1.125 percent, and the disparity provided under the plan at age 64 is 0.675 percent. Similarly, a benefit payable at age 63 is equal to 85 percent of the normal retirement benefit payable at age 65. Thus, the excess benefit percentage under the plan is 1.7 percent, the base benefit percentage under the plan is 1.0625 percent, and the disparity provided under the plan at age 63 is 0.6375 percent. Finally, a benefit payable at age 62 is equal to 80 percent of the normal retirement benefit payable at age 65. Thus, the excess benefit percentage under the plan is 1.6 percent, the base benefit percentage under the plan is 1.0 percent, and the disparity provided under the plan at age 62 is 0.6 percent. Because the disparities provided under the plan at each early commencement age do not exceed the factors provided in the applicable table in paragraph (e)(3) of this section, the plan does not fail to satisfy paragraphs (b) and (e) of this section with respect to the early retirement benefits.

Example 5. Plan P is a defined benefit excess plan that provides a normal retirement benefit of 0.75 percent of average annual compensation up to the integration level, plus 1.5 percent of average annual compensation in excess of the integration level, for each year of service up to 35. The plan does not provide any benefits, other than normal retirement benefits, commencing before an employee's social security retirement age. Employee A, born in 1947, has a social security retirement age of 66. Because the plan provides for the distribution of normal retirement benefits before Employee A's social security retirement age, the 0.75-percent factor in the maximum excess allowance applicable to Employee A must be reduced to 0.70 percent in accordance with this paragraph (e). Accordingly, the disparity provided to A under the plan exceeds the maximum excess allowance because the excess benefit percentage (1.5 percent) exceeds the base benefit percentage (0.75 percent) by more than the maximum excess allowance of 0.70 percent, as reduced in accordance with this paragraph (e).

Example 6. Assume the same facts as in *Example 5,* except that the plan also provides an early retirement benefit, commencing at age 62, to an employee who satisfies the conditions for early retirement specified in the plan. The early retirement benefit is based upon the employee's accrued benefit at early retirement age and equals the amount that would have been paid commencing at the employee's normal retirement age based upon the employee's average annual compensation, covered compensation and years of service at the date of the employee's early retirement. Employee B, who has a social security retirement age of 65, meets the conditions for early retirement under the plan and retires at age 62 with 30 years of service. At the time of early retirement, Employee B has average annual compensation of $20,000 and covered compensation of $16,000. Under the plan's benefit formula, Employee B has accrued a normal retirement benefit, commencing at age 65, of $5,400 ((22.5 percent × $16,000) + (45 percent × $4,000)) based on Employee B's average annual compensation, covered compensation and years of service at early retirement. Accordingly, under the plan's early retirement provisions, Employee B is entitled to receive, commencing at early retirement, a benefit of $5,400. Because the early retirement benefit is a benefit commencing at age 62 (before Employee B's social security retirement age), the 0.75-percent factor in the maximum excess allowance must be reduced to 0.60 percent in accordance with this paragraph (e). Accordingly, the disparity provided to Employee B under the plan at early retirement exceeds the maximum excess allowance.

Example 7. (a) Plan Q is a defined benefit excess plan that provides a normal retirement benefit of 1.35 percent of average annual compensation up to the integration level, plus 2 percent of average annual compensation in excess of the integration level, for each year of service up to 35. The plan provides that an employee with 10 years of service at age 55 may receive an unreduced retirement benefit. The plan also provides that employee with a supplemental benefit of 0.65 percent of average annual compensation up to the integration level for each year of service up to 35, payable from early retirement until age 65. The supplemental benefit is a qualified social security supplement under § 1.401(a)(4)–12. The effect of the supplement is to provide an employee with a uniform benefit of 2 percent of average annual compensation from early retirement until age 65, when the supplement is no longer payable. Therefore, for purposes of this paragraph (e), the employee's benefit will be considered to commence at age 65.

(b) Assume that Plan Q is instead an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation, minus 0.65 percent of final average compensation up to the offset level, for each year of service up to 35. The plan provides the same early retirement benefit on the same conditions, except that the supplement is 0.65 percent of an employee's final average compensation up to the offset level. An employee at age 55 thus receives a uniform benefit of 2 percent of average annual compensation until age 65, when the supplement is no longer payable. Therefore, for purposes of this paragraph (e), the employee's benefit will be considered to commence at age 65.

(f) *Benefits, rights, and features*—(1) *Defined benefit excess plan.* In the case of a defined benefit excess plan, each benefit, right, or feature provided under the plan with respect to employer-provided benefits attributable to average annual compensation above the integration level (an ''excess benefit, right, or feature'') must also be provided on the same terms with respect to employer-provided benefits attributable to average annual compensation up to the integration level (a ''base benefit, right, or feature''). Alternatively, an excess benefit, right, or feature may be provided on different terms than the base benefit, right, or feature, if the terms used to determine the base benefit, right, or feature produce a benefit, right, or feature of inherently equal or greater value than the benefit, right, or feature that would be produced under the terms used to determine the excess benefit, right, or feature.

(2) *Offset plan.* In the case of an offset plan, each benefit, right, or feature provided under the plan with respect to employer-provided benefits before application of the offset (a ''gross benefit, right, or feature'') must be provided on the same terms as those used to determine the offset applied to the gross benefit, right, or feature. Alternatively, a gross benefit, right, or feature may be provided on different terms from those used to determine the offset applied to the gross benefit, right, or feature, if the terms used to determine the gross benefit, right, or feature produce a benefit, right, or feature of inherently equal or greater value than the benefit, right, or feature that would be produced under the terms used to determine the offset applied to the gross benefit, right, or feature. In addition, if benefits commence before an employee's normal retirement age, the gross benefit percentage under the plan must be reduced by a number of percentage points that is not less than the number of percentage points by which the offset percentage must be reduced, from normal retirement age to the age at which benefits commence, under the rules of paragraph (e) of this section.

(3) *Examples.* The following examples illustrate this paragraph (f). Unless otherwise provided, the following facts apply. The plan is noncontributory and is the only plan ever maintained by the employer. The plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. In the case of a defined benefit excess plan, the plan uses each employee's covered compensation as the integration level; in the case of an offset plan, the plan uses each employee's covered compensation as the offset level and provides that an employee's final average compensation is limited to the employee's average annual compensation. Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65. All optional forms of benefit under each plan are provided on the same terms.

Example 1. Plan M is a defined benefit excess plan that provides a normal retirement benefit of 1 percent of average annual compensation up to the integration level, plus 1.65 percent of average annual compensation above the integration level, for each year of service up to 35. The plan provides an early retirement benefit for any employee who terminates employment at or after age 55 with 10 or more years of service. In determining an employee's early retirement, the 1.65 percent excess benefit percentage is reduced in accordance with the table in paragraph (e)(3) of this section for a plan that uses a single disparity factor of 0.65 percent for all employees at age 65. However, a larger reduction factor is applied to determine the base benefit percentage at early retirement. The plan violates this paragraph (f) because the excess early retirement benefit is not provided on the same terms as the base early retirement benefit, nor do the terms used to determine the base early retirement benefit produce an early retirement benefit of inherently equal or greater value than the early retirement benefit that would be produced under the terms used to determine the excess benefit, right, or feature.

Example 2. The facts are the same as in *Example 1* except that the plan determines the early retirement benefit by applying the same reduction factors under paragraph (e)(3) of this section to the base and excess benefit percentages. Furthermore, if an employee terminates employment at or after age 55 with 30 or more years of service, the plan provides that the base benefit percentage of 1 percent is not reduced. Although the excess early retirement benefit is provided on different terms than the base early retirement benefit, the plan satisfies this paragraph (f) because the terms used to determine the base early retirement benefit produce an early retirement of inherently equal or greater value than the early retirement benefit that would be produced under the terms used to determine the excess benefit, right, or feature.

Example 3. Plan N is an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation, minus 0.65 percent of final average compensation up to the offset level, for each year of service up to 35. In determining the qualified joint and survivor (''QJSA'') form of the normal retirement benefit, the plan applies a factor of 80 percent to the gross benefit percentage and a factor of 100 percent to the offset percentage. Thus, the QJSA form is 1.6 percent of average annual compensation, minus 0.65 percent of final average compensation up to the offset level, for each year of service up to 35. The plan violates this paragraph (f) because the gross QJSA form is not provided on the same terms as the terms used to determine the offset applied to the QJSA, nor does it produce a QJSA benefit that is of inherently equal or greater value than the QJSA benefit that would be produced under the terms used to determine the offset under the plan.

Example 4. Plan O is a defined benefit excess plan that provides a normal retirement benefit of 1 percent of average annual compensation up to the integration level, plus 1.65 percent of average annual compensation above the integration level, for each year of service up to 35. The plan also provides a single sum optional form of benefit determined by applying a single interest rate and mortality assumption to the entire normal retirement benefit. The plan satisfies this paragraph (f) because the excess optional form is provided on the same terms as the base optional form. The plan would also satisfy this paragraph (f) if it used a lower interest rate to determine the base optional form than used to determine the excess optional form because the lower interest rate would produce an optional form of inherently equal or greater value than the optional form produced by using the same interest rate.

Example 5. Plan R is a defined benefit excess plan that provides a normal retirement benefit of 1 percent of average annual compensation up to the integration level, plus 1.65 percent of average annual compensation above the integration level, for each year of service up to 35. If an employee continues to work after normal retirement age, the plan provides that the employee receives credit for additional years of service up to the service limit of 35. The plan also provides that the disparity provided under the plan will increase as permitted under paragraph (e) of this section for benefits commencing after social security retirement age. However, the plan does not provide an increase in the base benefit percentage to reflect the fact that the employee has delayed commencement of benefits past normal retirement age. Thus, for example, for an employee at age 68, the plan provides a benefit of 1 percent of average annual compensation up to the integration level, plus 1.86 percent of average annual compensation above the integration level, for each year of service up to 35. The plan violates this paragraph (f) because the excess benefit provided for an employee after normal retirement age is not provided on the same terms as the base benefit, nor do the terms used to determine the base benefit produce a benefit of inherently equal or greater value than the benefit that would be produced under the terms used to determine the excess benefit.

Example 6. Plan Q is an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation, minus 0.65 percent of final average compensation up to the offset level, for each year of service up to 35. In accordance with paragraph (e) of this section, the plan reduces the offset percentage under the plan for early retirement and provides a benefit at age 55 of 2 percent of average annual compensation, minus 0.325 percent of final average compensation up to the offset level, for each year of service up to 35. However, the early retirement benefit does not meet this paragraph (f) because an employee's gross benefit percentage is not reduced for early retirement.

Example 7. The facts are the same as in *Example 6* except that the plan reduces the gross benefit percentage for early retirement at age 55 to 1.675 percent. Because the gross benefit percentage is reduced by 0.325 percent (from 2.0 percent to 1.675 percent), the same percentage point reduction made in the offset percentage (from 0.65 percent to 0.325 percent), the early retirement benefit meets this paragraph (f).

(g) *No reductions in 0.75-percent factor for ancillary benefits.* For purposes of applying the maximum excess allowance or the maximum offset allowance under paragraph (b)(2) or (3) of this section, no reduction is made to the 0.75-percent factor merely because the plan provides disparity in qualified disability benefits (within the meaning of section 411(a)(9)) or preretirement death benefits and the relevant benefits are payable before an employee's social security retirement age.

(h) *Benefits attributable to employee contributions not taken into account.* Benefits attributable to employee contributions to a defined benefit plan are not taken into account in determining whether the disparity provided under a defined benefit excess plan or an offset plan exceeds the maximum permitted disparity described in paragraph (b) of this section. See § 1.401(a)(4)–6(b) for methods of determining the employer-provided benefit under a plan that includes employee contributions not allocated to separate accounts (i.e., a contributory DB plan), including § 1.401(a)(4)–6(b)(2)(iii)(B) for adjustments to the base and excess benefit percentages or the gross benefit percentage under a section 401(l) plan. If, after adjustment, the employee's base benefit percentage or gross benefit percentage (whichever is applicable) is less than zero, such percentage is deemed to be zero for purposes of the maximum excess allowance or maximum offset allowance under paragraph (b)(2) or (3) of this section.

(i) *Multiple integration levels* [Reserved]

(j) *Additional rules.* The Commissioner may, in revenue rulings, notices or other documents of general applicability, prescribe additional rules as may be necessary or appropriate to carry out the purposes of this section, including updated tables under paragraphs (d) and (e) of this section providing for reductions in the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance and rules in paragraph (h) of this section for determining the portion of an employee's benefit attributable to employee contributions.

[T.D. 8359, 56 FR 47622, Sept. 19, 1991; 57 FR 10818, 10819, 10951, 10952, Mar. 31, 1992, as amended by T.D. 8486, 58 FR 46832, Sept. 3, 1993]

§ 1.401(l)–4 Special rules for railroad plans.

(a) *In general.* Section 401(l)(6) provides that, in the case of a plan maintained by a railroad employer that covers employees who are entitled to benefits under the Railroad Retirement Act of 1974, in determining whether such a plan satisfies section 401(l), rules similar to the rules under section 401(l) apply and such rules take into account the employer-derived portion of tier 2 and supplemental annuity benefits provided under the railroad retirement system. In general, for purposes of determining whether a defined contribution plan or a defined benefit plan maintained by a railroad employer and covering employees described in te preceding sentence, satisfies section 401(l), the employer-derived portion of an employee's tier 2 benefits and supplementary annuity benefits under the Railroad Retirement Act of 1974 are treated as though such benefits were provided by the railroad employer under a qualified plan. Paragraph (b) of this section contains rules for defined contribution plans. Paragraph (c) of this section contains rules for defined benefit excess plans. Paragraph (d) of this section contains rules for offset plans. Paragraph (e) of this section contains definitions and additional rules of application.

(b) *Defined contribution plans*—(1) *In general.* A defined contribution plan maintained by a railroad employer satisfies section 401(l) and § 1.401(l)–2 for a plan year only if the plan satisfies paragraph (b)(2) or (b)(3) of this section for the plan year.

(2) *Single integration level method*—(i) *In general.* A plan satisfies this paragraph (b)(2) if—

(A) The plan specifies a single integration level for all employees that does not exceed the railroad retirement taxable wage base in effect as of the beginning of the plan year,

(B) The plan uses the same base contribution percentage and the same excess contribution percentage for all employees, and

(C) The excess contribution percentage does not exceed the sum of 11.4 percentage points and the base contribution percentage.

(ii) *Definitions.* The following definitions govern for purposes of this paragraph (b)(2).

(A) *Base contribution percentage* means the rate at which employer contributions are allocated to the account of an employee under the plan with respect to the employee's plan year compensation at or below the railroad retirement taxable wage base (expressed as a percentage of such plan year compensation).

(B) *Excess contribution percentage* means the rate at which employer contributions are allocated to the account of an employee under the plan with respect to the employee's plan year compensation above the railroad retirement taxable wage base (expressed as a percentage of such plan year compensation).

(3) *Two integration level method*—(i) *In general.* A plan satisfies this paragraph (b)(3) if—

(A) The plan specifies two integration levels for all employees, equal to the railroad retirement taxable wage base in effect as of the beginning of the plan year and the taxable wage base in effect as of the beginning of the plan year, and

(B) The plan satisfies paragraphs (b)(3) (ii) and (iii) of this section.

(ii) *Total disparity requirement.* A plan satisfies this paragraph (b)(3)(ii) if—

(A) The plan uses the same base contribution percentage and the same excess contribution percentage for all employees, and

(B) The excess contribution percentage does not exceed the sum of 11.4 percentage points and the base contribution percentage.

(iii) *Intermediate disparity requirement.* A plan satisfies this paragraph (b)(3)(iii) if—

(A) The plan uses the same base contribution percentage and the same intermediate contribution percentage for all employees, and

(B) The intermediate contribution percentage does not exceed the sum of 5.7 percentage points and the base contribution percentage.

(iv) *Definitions.* The following definitions govern for purposes of this paragraph (b)(3).

(A) *Base contribution percentage* means the rate at which employer contributions are allocated to the account of an employee under the plan with respect to the employee's plan year compensation at or below the railroad retirement taxable wage base (expressed as a percentage of such plan year compensation).

(B) *Intermediate contribution percentage* means the rate at which employer contributions are allocated to the account of an employee under the plan with respect to the employee's plan year compensation between the railroad retirement taxable wage base and the taxable wage base (expressed as a percentage of such plan year compensation).

(C) *Excess contribution percentage* means the rate at which employer contributions are allocated to the account of an employee under the plan with respect to the employee's plan year compensation above the taxable wage base (expressed as a percentage of such plan year compensation).

(c) *Defined benefit excess plans*—(1) *In general.* A defined benefit excess plan maintained by a railroad employer satisfies section 401(l) and §1.401(l)–3 for a plan year only if the plan satisfies paragraph (c)(2) or (c)(3) of this section for the plan year.

(2) *Single integration level method*—(i) *In general.* A plan satisfies this paragraph (c)(2) if—

(A) The plan specifies a single integration level for all employees that does not exceed railroad retirement covered compensation,

(B) The plan uses the same base benefit percentage and the same excess benefit percentage for all employees, and

(C) The excess benefit percentage does not exceed the lesser of—

(*1*) Two times the sum of 0.56 percent and the base benefit percentage, or

(*2*) 0.56 percent plus the base benefit percentage plus 0.75 percent.

(ii) *Definitions.* The following definitions govern for purposes of this paragraph (c)(2).

(A) *Base benefit percentage* means the rate at which employer-provided benefits are determined under the plan with respect to an employee's average annual compensation at or below the employee's railroad retirement covered compensation (expressed as a percentage of such average annual compensation).

(B) *Excess benefit percentage* means the rate at which employer-provided benefits are determined under the plan with respect to an employee's average annual compensation above the employee's railroad retirement covered compensation (expressed as a percentage of such average annual compensation).

(3) *Two integration level method*—(i) *In general.* A plan satisfies this paragraph (c)(3) for a plan year if—

(A) The plan specifies two integration levels for all employees, equal to each employee's railroad retirement covered compensation and each employee's covered compensation, and

(B) The plan satisfies paragraph (c)(3) (ii) and (iii) of this section.

(ii) *Employee with lower covered compensation.* A plan satisfies this paragraph (c)(3)(ii) if, with respect to each employee whose lower integration level is the employee's covered compensation—

(A) The plan uses the same base benefit percentage and the same intermediate benefit percentage for all employees,

(B) The intermediate benefit percentage does not exceed the base benefit percentage by more than the lesser of 0.75 percent or the base benefit percentage,

(C) The plan uses the same intermediate benefit percentage and the same excess benefit percentage for all employees, and

(D) The excess benefit percentage does not exceed the intermediate benefit percentage by more than 0.56 percent.

(iii) *Employee with lower railroad retirement covered compensation.* A plan satisfies this paragraph (c)(3)(iii) if, with respect to each employee whose lower integration level is the employee's railroad retirement covered compensation—

(A) The plan uses the same base benefit percentage and the same excess benefit percentage for all employees,

(B) The excess benefit percentage does not exceed the lesser of—

(*1*) Two times the sum of 0.56 percent and the base benefit percentage, or

(*2*) The sum of 0.56 percent plus the base benefit percentage plus 0.75 percent,

(C) The plan uses the same the base benefit percentage and the same intermediate benefit percentage for all employees, and

(D) The intermediate benefit percentage does not exceed the sum of 0.56 percent plus the base benefit percentage.

(iv) *Definitions.* The following definitions govern for purposes of this paragraph (c)(3).

(A) *Base benefit percentage* means the rate at which employer-provided benefits are determined under the plan with respect to an employee's average annual compensation at or below the lower integration level specified in the plan (expressed as a percentage of such average annual compensation).

(B) *Intermediate benefit percentage* means the rate at which employer-provided benefits are determined under the plan with respect to an employee's average annual compensation between the lower and higher integration levels specified in the plan (expressed as a percentage of such average annual compensation).

(C) *Excess benefit percentage* means the rate at which employer-provided benefits are determined under the plan with respect to an employee's average annual compensation above the higher integration level specified in the plan (expressed as a percentage of such average annual compensation).

(d) *Offset plans*—(1) *In general.* An offset plan maintained by a railroad employer satisfies section 401(l) and § 1.401(l)–3 for a plan year only if—

(i) The plan satisfies § 1.401(l)–3 for the plan year without regard to the offset for the employer-derived portion of tier 2 and supplementary annuity benefits provided under the railroad retirement system, and

(ii) The offset for the employer-derived portion of tier 2 and supplementary annuity benefits provided under the railroad retirement system does not exceed the maximum tier 2 and supplementary annuity offset allowance.

(2) *Maximum tier 2 and supplementary annuity offset allowance.* For purposes of paragraph (d)(1) of this section, the maximum tier 2 and supplementary annuity offset allowance for a plan year is equal to 0.56 percent of the employee's railroad retirement covered compensation for the plan year.

(e) *Additional rules*—(1) *Definitions.* The following definitions govern for purposes of this section.

(i) *Railroad retirement taxable wage base* means the applicable base, as determined under section 3231(e)(2)B)(ii), for purposes of the tax under section 3221(b) (the tier 2 tax).

(ii) *Railroad retirement covered compensation* for an employee means 12 multiplied by the average of the 60 highest monthly railroad retirement taxable wage bases in effect for the employee's period of employment. The monthly railroad retirement taxable wage base is determined by dividing the railroad retirement taxable wage base for the calendar year in which the month occurs by 12. An employee's railroad retirement covered compensation for the plan year is determined as of the beginning of the plan year. A plan must provide that an employee's railroad retirement covered compensation is automatically adjusted for each plan year. See §1.401(l)–1(b) for rules relating to prohibited decreases in an employee's accrued benefit within the meaning of section 411(d)(6) or section 411(b)(1)(G).

(2) *Adjustments to 0.75-percent factor.* The 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance is subject to the reductions prescribed in §1.401(l)–3 (d) and (e), except that in the case of an employee with at least 30 years of service with a railroad employer, the following tables are substituted for Tables I through III contained in §1.401(l)–3(e)(3).

TABLE I

[Social security retirement age 67]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
66	0.750
65	0.750
64	0.750
63	0.750
62	0.750
61	0.525
60	0.525
59	0.508
58	0.490
57	0.472
56	0.433
55	0.398

TABLE II

[Social security retirement age 66]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
65	0.750
64	0.750
63	0.750
62	0.750
61	0.563
60	0.563
59	0.544
58	0.525
57	0.506
56	0.488
55	0.447

TABLE III

[Social security retirement age 65]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
64	0.750
63	0.750
62	0.750
61	0.600
60	0.600
59	0.580
58	0.560
57	0.540
56	0.520
55	0.500

(3) *Adjustments to 0.56-percent factor.* The 0.56-percent factor for defined benefit excess plans and offset plans under paragraphs (c) and (d) of this section respectively is subject to the reductions prescribed in §1.401(l)–3 (d) and (e), except that, for purposes of applying this paragraph (e)(3)—

(i) ‘‘Railroad retirement covered compensation’’ is substituted for ‘‘covered compensation’’ in §1.401(l)–3(d),

(ii) The reductions under § 1.401(l)–3(d) are made by multiplying the 0.56-percent factor by the ratio of the applicable factor from the table in § 1.401(l)–(3)(d)(9)(iv)(A) to 0.75, and

(iii) The following tables are substituted for Tables I through III set forth in § 1.401(l)–3(e)(3).

(A) Tables applicable to 0.56% factor for employees covered by tier 2 of railroad retirement with 30 or more years of railroad service.

TABLE I

[Social security retirement age 67]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
66	0.560
65	0.560
64	0.560
63	0.560
62	0.560
61	0.560
60	0.560
59	0.541
58	0.523
57	0.504
56	0.462
55	0.425

TABLE II

[Social security retirement age 66]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
65	0.560
64	0.560
63	0.560
62	0.560
61	0.560
60	0.560
59	0.541
58	0.523
57	0.504
56	0.485
55	0.445

TABLE III

[Social security retirement age 65]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
64	0.560
63	0.560
62	0.560
61	0.560
60	0.560
59	0.541
58	0.523
57	0.504
56	0.485
55	0.467

(B) Tables applicable to 0.56% factor for employees covered by tier 2 of railroad retirement with less than 30 years of railroad service.

TABLE I

[Social security retirement age 67]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
66	0.523
65	0.485
64	0.448
63	0.420
62	0.392
61	0.379
60	0.366
59	0.353
58	0.340
57	0.327
56	0.300
55	0.275

TABLE II

[Social security retirement age 66]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
65	0.523
64	0.485
63	0.448
62	0.420
61	0.392
60	0.378
59	0.364
58	0.350
57	0.336
56	0.322
55	0.295

TABLE III

[Social security retirement age 65]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
64	0.523
63	0.485
62	0.448
61	0.418
60	0.388
59	0.373
58	0.358
57	0.343
56	0.329

TABLE III—Continued
[Social security retirement age 65]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
55	0.314

(4) *Overall permitted disparity.* The overall permitted disparity rules of §1.401(l)–5 apply to employees who benefit under a plan maintained by a railroad employer.

[T.D. 8359, 56 FR 47632, Sept. 19, 1991; 57 FR 10819, 10952, Mar. 31, 1992]

§1.401(l)–5 Overall permitted disparity limits.

(a) *Introduction*—(1) *In general.* The maximum excess allowance and maximum offset allowance limit the disparity that can be provided under a plan for a plan year. The overall permitted disparity rules apply to limit the disparity provided for a plan year if an employee benefits under more than one plan maintained by the employer (the ‘‘annual overall permitted disparity limit’’) and to limit the disparity provided for an employee's total years of service, either in a single plan or in more than one plan of the employer (the ‘‘cumulative overall permitted disparity limit’’). The overall permitted disparity rules take into account the disparity provided under a section 401(l) plan and the permitted disparity imputed under a plan that satisfies section 401(a)(4) by relying on §1.401(a)(4)–7. A plan that is not a section 401(l) plan is generally deemed to impute permitted disparity under §1.401(a)(4)–7 unless established otherwise. Paragraph (b) of this section provides rules on the annual overall permitted disparity limit. Paragraph (c) of this section provides rules on the cumulative overall permitted disparity limit.

(2) *Plan requirements.* In order to satisfy section 401(l), a plan must provide that the overall permitted disparity limits may not be exceeded and must specify how employer-provided contributions or benefits under the plan are adjusted, if necessary, to satisfy the overall permitted disparity limits. Any adjustments made to satisfy the overall permitted disparity limits must be made in a uniform manner for all employees.

(3) *Plans taken into account.* For purposes of this section, all plans of the employer are taken into account. In addition, all plans of any other employer are taken into account for all periods of service with the other employer for which the employee receives credit for purposes of benefit accrual under any plan of the current employer.

(b) *Annual overall permitted disparity limit*—(1) *In general.* If, in the plan year, an employee benefits under more than one plan, the annual overall permitted disparity limit is satisfied only if the employee's total annual disparity fraction, as defined in paragraph (b)(2) of this section, does not exceed one. Paragraphs (b)(3) through (b)(8) of this section explain the determination of an employee's annual disparity fractions. Paragraph (b)(9) of this section provides examples.

(2) *Total annual disparity fraction.* An employee's total annual disparity fraction is the sum of the employee's annual disparity fractions, as defined in paragraphs (b)(3) through (b)(7) of this section. An employee's total annual disparity fraction is determined as of the end of the current plan year, based on the employee's annual disparity fractions under all plans with plan years ending in the current plan year.

(3) *Annual defined contribution plan disparity fraction.* For a plan year, the annual defined contribution plan disparity fraction for an employee benefiting under a defined contribution plan that is a section 401(l) plan is a fraction—

(i) The numerator of which is the disparity provided under the plan for the plan year, and

(ii) The denominator of which is the maximum excess allowance under §1.401(l)–2(b)(2) for the plan year.

(4) *Annual defined benefit excess plan disparity fraction.* For a plan year, the annual defined benefit excess plan disparity fraction for an employee benefiting under a defined benefit excess plan that is a section 401(l) plan is a fraction—

(i) The numerator of which is the disparity provided under the plan for the plan year, and

(ii) The denominator of which is the maximum excess allowance under § 1.401(l)–3(b)(2) for the plan year.

(5) *Annual offset plan disparity fraction*—(i) *In general.* For a plan year, the annual offset plan disparity fraction for an employee benefiting under an offset plan that is a section 401(l) plan is a fraction—

(A) The numerator of which is the disparity provided under the plan for the plan year; and

(B) The denominator of which is the maximum offset allowance under § 1.401(l)–3(b)(3) for the plan year.

(ii) *PIA offset plans.* In the case of an offset plan that applies an offset of a specified percentage of the employee's PIA, as permitted under § 1.401(l)–3(c)(2)(ix), the numerator of the annual offset plan disparity fraction is the offset percentage used in the section 401(l) overlay under the plan.

(6) *Annual imputed disparity fraction.* For a plan year, the annual imputed disparity fraction for an employee benefiting under a plan that imputes permitted disparity with respect to the employee under § 1.401(a)(4)–7 is one.

(7) *Annual nondisparate fraction.* For a plan year, the annual nondisparate fraction for an employee benefiting under a plan that neither is a section 401(l) plan nor imputes permitted disparity under § 1.401(a)(4)–7 is zero.

(8) *Determination of fraction*—(i) *General rule.* A separate annual disparity fraction is generally determined for each plan under which the employee benefits. Thus, for example, if two plans are aggregated and treated as a single plan for purposes of section 401(a)(4), a single annual disparity fraction applies to the aggregated plan.

(ii) *Multiple formulas.* If a plan provides an allocation or benefit equal to the sum of two or more formulas, each formula is considered a separate plan for purposes of this section. If a plan provides an allocation or benefit equal to the greater of two or more formulas, an annual disparity fraction is calculated for the employee under each formula and the largest of the fractions is the employee's annual disparity fraction under the plan.

(iii) *Offset arrangements*—(A) *In general.* If an employee benefits under two plans taken into account under paragraph (a)(3) of this section as described in paragraph (b)(8)(iii)(B) or (C) of this section, the employee's annual disparity fraction under both plans is the larger of the annual disparity fractions calculated separately under each plan.

(B) *Defined benefit plans.* The employee's employer-provided accrued benefit under a defined benefit plan is offset by the employee's total employer-provided accrued benefit under another defined benefit plan or by the actuarial equivalent (as defined in § 1.401(a)(4)–12) of the employee's total account balance under a defined contribution plan that is attributable to employer contributions.

(C) *Defined contribution plans.* The amount allocated to the employee's account under a defined contribution plan is offset by the total amount allocated to the employee's account under another defined contribution plan.

(iv) *Applicable percentages.* The disparity provided under a plan is determined on the base and excess percentages under an excess plan and the offset percentage under an offset plan, regardless of whether the employee's plan year or average annual compensation exceeds the integration or offset level under the plan.

(v) *Fractional accrual plans.* If a section 401(l) plan determines each employee's accrued benefit under the fractional accrual method of section 411(b)(1)(C), the numerator of an employee's annual disparity fraction is based on the disparity provided in the benefit accrued for the employee for the plan year.

(9) *Examples.* The following examples illustrate this paragraph (b). Except as otherwise provided, each plan is a section 401(l) plan.

Example 1. (a) Employee A benefits for the plan year under a defined contribution excess plan, Plan X, and a defined benefit excess plan, Plan Y, of the employer. Plans X and Y have the same plan year. Employee A benefits under no other plan of the employer for the plan year of any other plan ending in the plan year of Plans X and Y. Plan X provides a base contribution percentage of 5 percent and an excess contribution percentage of 7 percent, thus providing Employee A with disparity of 2 percent for the plan year. The maximum excess allowance for the plan year under Plan X is 5 percent. Plan Y provides a base benefit percentage of 1 percent and an excess benefit percentage of 1.35 percent, thus providing Employee A with disparity of 0.35 percent for the plan year. The maximum excess allowance for the plan year under Plan Y is 0.75 percent.

(b) Employee A's annual defined contribution plan disparity fraction under Plan X for the plan year is 0.4 (2 percent divided by 5 percent). Employee A's annual defined benefit excess plan disparity fraction under Plan Y for the plan year is 0.47 (0.35 percent divided by 0.75 percent). Employee A's total annual disparity fraction is the sum of 0.4 and 0.47 or 0.87. Because Employee A's total annual disparity fraction does not exceed one, the plans satisfy the annual overall permitted disparity limit with respect to Employee A for the plan year.

Example 2. (a) The facts are the same as in *Example 1,* except that Plan Y is a defined contribution plan, rather than a defined benefit plan. Plan X and Plan Y cover the same employees and are identical in their terms except for the base and excess contribution percentages provided under the plans. Plan Y provides a base contribution percentage of 3 percent and an excess contribution percentage of 6 percent, thus providing Employee A with disparity of 3 percent for the plan year. The maximum excess allowance for the plan year under Plan Y is 3 percent.

(b) Employee A's annual defined contribution plan disparity fraction under Plan X for the plan year is 0.4 (2 percent divided by 5 percent). Employee A's annual defined contribution plan disparity fraction under Plan Y for the plan year is 1 (3 percent divided by 3 percent). Because Employee A's total annual disparity fraction (the sum of 0.4 and 1 or 1.4) exceeds one, the plans do not satisfy the annual overall permitted disparity requirements with respect to Employee A for the plan year.

(c) Plan X and Plan Y are aggregated for purposes of section 401(a)(4) and form a single section 401(l) plan. Under the plan, the base contribution percentage is 8 percent (5 percent plus 3 percent), and the excess contribution percentage is 13 percent (7 percent plus 6 percent). A single annual defined contribution plan disparity fraction is determined for Employee A for the plan year, the numerator of which is the disparity of 5 percent provided under the plan (13 percent minus 8 percent), and the denominator of which is 5.7 percent, the maximum excess allowance that applies to the plan. Because Employee A's only annual disparity fraction of 0.88 (5 percent divided by 5.7 percent) does not exceed one, Employee A's total annual disparity fraction also does not exceed one. The plan thus satisfies the annual overall permitted disparity limit with respect to Employee A for the plan year.

Example 3. Assume the same facts as in *Example 2,* except that Plan X and Plan Y use different integration levels. Therefore, when Plan X and Plan Y are aggregated to form a single plan for purposes of section 401(a)(4), the single plan does not satisfy section 401(l). In applying the general test of §1.401(a)(4)–2(c), the plan imputes disparity under §1.401(a)(4)–7. Employee A's only annual disparity fraction is the annual imputed disparity fraction of one. Employee A's total annual disparity fraction is also one, and the plan satisfies the annual overall permitted disparity limit with respect to Employee A for the plan year.

Example 4. (a) Employee B participates in two plans: Plan M, which is a section 401(l) plan, and Plan N, which is subject to the general test under §1.401(a)(4)–3(c). Plan M provides that the disparity provided an employee for the plan year will be reduced to the extent necessary to satisfy the annual overall permitted disparity limits. The employer wishes to impute permitted disparity under §1.401(a)(4)–7 in order for Plan N to satisfy section 401(a)(4). Employee B's imputed disparity fraction under Plan N is therefore one, and Plan M provides no disparity for Employee B for the plan year. As a result, Plan M provides disparity that is neither uniform nor deemed uniform under §1.401(l)–3(c); Plan M therefore does not satisfy section 401(l).

(b) Assume instead that Plan M provides that the annual overall permitted disparity limits must be satisfied without reducing the disparity provided for an employee under Plan M, thus requiring a reduction in the employee's annual disparity fraction under another plan. In that case, the disparity provided under Plan M would be uniform for the plan year and Plan M would continue to satisfy section 401(l). However, imputation of permitted disparity with respect to Employee B would not be allowed under Plan N.

(c) *Cumulative permitted disparity limit*—(1) *In general*—(i) *Employees who benefit under defined benefit plans.* In the case of an employee who has benefited under one or more defined benefit plans for a plan year described in paragraph (c)(1)(v) of this section, the cumulative permitted disparity limit is satisfied if the employee's cumulative disparity fraction, as defined in paragraph (c)(2) of this section, does not exceed 35.

(ii) *Employees who do not benefit under defined benefit plans.* In the case of an employee who has not benefited under a defined benefit plan for any plan year described in paragraph (c)(1)(v) of this section, the cumulative permitted disparity limit is satisfied.

(iii) *Certain plan years disregarded.* For purposes of this paragraph (c), an employee is not treated as benefiting under a defined benefit plan for a plan year described in paragraph (c)(1)(v) of this section if the employer can establish that for that plan year the defined benefit plan was not a section 401(l) plan and did not impute permitted disparity under § 1.401(a)(4)–7.

(iv) *Determination of type of plan.* For purposes of this paragraph (c), a target benefit plan that relies on the special rule of § 1.401(a)(4)–8(b)(3) to satisfy section 401(a)(4) and a DB/DC plan within the meaning of § 1.401(a)(4)–9(a) are treated as defined benefit plans. Similarly, a cash balance plan that relies on the special rule of § 1.401(a)(4)–8(c)(3) to satisfy section 401(a)(4) is treated as a defined contribution plan.

(v) *Applicable plan years.* In applying paragraphs (c)(1) (i), (ii), and (iii) of this section, for purposes of determining whether an employee benefits under a defined benefit plan, the applicable plan years are all plan years that begin on or after the regulatory effective date, as set forth in § 1.401(l)–6(b), or, in the case of governmental plans, as set forth in § 1.401(a)(4)–13(b).

(vi) *Transition rule for defined contribution plans.* A defined contribution plan is deemed to satisfy the cumulative permitted disparity limit for the first plan year to which these regulations apply, as set forth in § 1.401(l)–6(b), or, in the case of governmental plans, as set forth in § 1.401(a)(4)–13(b).

(2) *Cumulative disparity fraction.* An employee's cumulative disparity fraction is the sum of the employee's total annual disparity fractions, as defined in paragraph (b)(2) of this section, attributable to the employee's total years of service under all plans.

(3) *Determination of total annual disparity fractions for prior years.* For each of the employee's years of service credited as of the end of the last plan year beginning before January 1, 1989, not to exceed 35, under all plans as of that time that are taken into account under paragraph (a)(3) of this section (whether or not terminated), the employee's total annual disparity fraction is one. Therefore, if, before the first plan year beginning on or after January 1, 1989, an employee never participated in or benefited under any plan taken into account under paragraph (a)(3) of this section, the employee's total annual disparity fractions are determined without regard to this paragraph (c)(3). An employer may apply the rule in this paragraph (c)(3) with respect to all employees, using a year (including the current year) that is chosen by the employer and is later than 1989. Thus, for example, in lieu of calculating annual disparity fractions for all plan years, the employer may assume that the full disparity limit has been used in each prior plan year for which an employee has been credited with a year of service.

(4) *Special rules for greater of formulas and offset arrangements*—(i) *Greater of formulas*—(A) *In general.* A defined benefit plan that is a section 401(l) plan and that provides a benefit equal to the greater of the benefits determined under two or more formulas is deemed to satisfy the cumulative permitted disparity limit with respect to an employee if each of the requirements in paragraphs (c)(4)(i) (B) and (C) of this section is satisfied. For this purpose, a plan that uses a fresh-start formula that determines the accrued benefit as the greater of two amounts under § 1.401(a)(4)–13(c)(4) (ii) or (iii) provides a benefit equal to the greater of the benefits determined under two or more formulas.

(B) *Separate satisfaction by formulas.* Each formula under the plan would satisfy the cumulative permitted disparity limit if it were the only formula under the plan. In the case of a current formula that applies to the employee's total years of service (as, for example, under § 1.401(a)(4)–13(c)(4) (ii)(B) or (iii)(B)), for purposes of determining whether that formula would satisfy the cumulative permitted disparity limit if it were the only formula under the plan, the special rule for prior years under paragraph (c)(3) of this section may be disregarded.

(C) *Single plan.* The employee has never benefited under another plan taken into account under paragraph (a)(3) of this section that is a section 401(l) plan or that satisfies section 401(a)(4) by relying on § 1.401(a)(4)–7. For this purpose, if the benefit under the plan is offset in an offset arrangement described in paragraph (b)(8)(iii)(B) of this section, the other plan is disregarded. In addition, a plan does not fail the requirements of this paragraph (c)(4)(i)(C) merely because the employee benefits under another defined benefit plan, provided that—

(*1*) With respect to each benefit formula under the plan, no years of service taken into account under that benefit formula are taken into account under a benefit formula of the other plan; and

(*2*) Paragraph (c)(4)(i)(B) of this section would be satisfied if the plans were treated as a single plan that provided a benefit equal to the greater of the benefits provided under two or more formulas. For this purpose, a formula consists of the sum of a formula for the years of service taken into account under one plan and a formula for the years of service taken into account under the other plan. Thus, each possible combination of the formulas under the plans must satisfy paragraph (c)(4)(i)(B) of this section.

(ii) *Offset arrangements*—(A) *In general.* If a defined benefit plan is a section 401(l) plan and the benefit under the plan (the gross benefit plan) is offset by the benefit under another plan (the offsetting plan) in an offset arrangement described in paragraph (b)(8)(iii)(B) of this section, the gross benefit plan is deemed to satisfy the cumulative permitted disparity limit with respect to an employee if each of the requirements in paragraphs (c)(4)(ii) (B) and (C) of this section is satisfied.

(B) *Separate satisfaction by plans.* This requirement is satisfied if the gross benefit plan would satisfy the cumulative disparity limit if no offset applied, and the offsetting plan satisfies the cumulative permitted disparity limit, not taking into account the gross benefit plan.

(C) *No other plan.* Except for the plans in the offset arrangement, the employee has never benefited under another plan taken into account under paragraph (a)(3) of this section that is a section 401(l) plan or that satisfies section 401(a)(4) by relying on §1.401(a)(4)–7. An offset arrangement does not fail the requirements of this paragraph (c)(4)(ii)(C) merely because the employee benefits under another defined benefit plan, provided no years of service taken into account under a benefit formula of any plan in the offset arrangement are also taken into account under a benefit formula of the other plan.

(5) *Examples.* The following examples illustrate this paragraph (c). In each example the plan is noncontributory and, unless provided otherwise, is the only plan ever maintained by the employer. Each plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under §1.401(l)–3(b)(2) or (3). Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65.

Example 1. Plan M is a defined benefit excess plan that provides a normal retirement benefit of 1 percent of average annual compensation up to covered compensation, plus 1.75 percent of average annual compensation above covered compensation, for each year of service without limit. The disparity provided under the plan for the plan year is 0.75 percent, the excess benefit percentage of 1.75 percent minus the base benefit percentage of 1 percent. The maximum excess allowance for the plan year is 0.75 percent. Thus, each employee's annual defined benefit excess plan disparity fraction under the plan for each plan year is one. Because the plan contains no limit on the years of service taken into account under the plan, the sum of the total annual disparity fractions for a potential employee with more than 35 years of service will exceed 35. In addition, the plan does not provide that the overall permitted disparity limits may not be exceeded as required by paragraph (a)(2) of this section. The plan therefore does not satisfy the cumulative permitted disparity limit of this paragraph (c).

Example 2. Plan N is an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation, minus 0.75 percent of final average compensation up to the lesser of covered compensation and average annual compensation, for each year of service up to 35. The disparity provided under the plan for the plan year is 0.75 percent, the offset percentage. The maximum offset allowance for the plan year is 0.75 percent. Thus, each employee's annual offset plan disparity fraction under the plan for each plan year is one. Because the plan limits the years of service taken into account under the plan to 35, the sum of the total annual disparity fractions for an employee cannot exceed 35. The plan therefore satisfies the cumulative permitted disparity limit of this paragraph (c).

Example 3. Plan O is a defined benefit excess plan that provides a normal retirement benefit of 0.75 percent of average annual compensation up to covered compensation, plus 1.25 percent of average annual compensation above covered compensation, for each year of service up to 45. The disparity provided under the plan for the plan year is 0.5 percent, the excess benefit percentage of 1.25 percent minus the base benefit percentage of 0.75 percent. The maximum excess allowance for the plan year is 0.75 percent. Thus, each employee's annual defined benefit excess plan disparity fraction under the plan for each plan year is 0.67 (0.5 percent divided by 0.75 percent). Because the plan limits the years of service taken into account under the plan to 45, the sum of the total annual disparity fractions for an employee cannot exceed 30 (0.67 x 45). The plan therefore satisfies the cumulative permitted disparity limit of this paragraph (c).

Example 4. (a) Plan P is a defined contribution excess plan. Plan P provides a base contribution percentage of 6 percent and an excess contribution percentage of 11.7 percent, thus providing disparity of 5.7 percent for the plan year. Because the maximum excess allowance for each plan year under Plan P is 5.7 percent, each employee's annual defined contribution plan disparity fraction under Plan P for each plan year is one. Plan Q is a defined benefit excess plan maintained by the same employer. Plan Q provides a base benefit percentage of 1 percent and an excess benefit percentage of 1.75 percent for each year of service up to 35, thus providing disparity of 0.75 percent for the plan year. Because the maximum excess allowance for each plan year under Plan Q is 0.75 percent, each employee's annual defined benefit excess plan disparity fraction under Plan Q for each plan year is one.

(b) Employee A benefits under Plan P for the 1980 through the 1994 plan years. The sum of Employee A's total annual disparity fractions under Plan P is 15. (Under paragraph (c)(3)(i) of this section, Employee A's annual disparity fraction for each year of service as of the end of the 1988 plan year is one.) As of the 1995 plan year, Employee A no longer benefits under Plan P and begins to benefit under Plan Q for the first time. In order to satisfy the cumulative permitted disparity limit of this paragraph (c), Plan Q must provide that no disparity will be provided if the sum of an employee's total annual disparity fractions reaches 35, taking into account the employee's annual defined contribution plan disparity fractions under Plan P as well as the employee's annual defined benefit excess plan disparity fractions under Plan Q. Thus, after Employee A has benefited under Plan Q for 20 years, Plan Q may not provide any disparity in additional benefits accrued for Employee A.

Example 5. (a) Plan O is a noncontributory defined benefit excess plan. Plan O provides an employee whose social security retirement age is 65 with the greater of the benefits determined under two formulas. The first formula provides a benefit of 1 percent of average annual compensation up to covered compensation, plus 1.75 percent of average annual compensation above covered compensation, for each year of service up to 35. The second formula provides a benefit of 1 percent of average annual compensation up to covered compensation, plus 1.6 percent of average annual compensation above covered compensation, for each year of service up to 40.

(b) Under paragraph (b)(4) of this section, an employee's annual defined benefit excess plan fraction for each of the 35 years under the first formula is 0.75/0.75 or one, and an employee's annual defined benefit excess plan fraction for each of the 40 years under the second formula is 0.6/0.75 or 0.8. Under paragraph (b)(8)(ii) of this section, an employee's annual defined benefit excess plan fraction (and total annual disparity fraction because the employee benefits only under Plan O) for the plan year is the larger fraction under the two formulas or one. Therefore, after 35 years, the employee has a cumulative disparity fraction of 35. The disparity provided under the second formula for years of service after 35 thus exceeds the cumulative permitted disparity limit unless the plan qualifies for the special rule in paragraph (c)(4)(i) of this section.

(c) Assume the condition in paragraph (c)(4)(i)(C) of this section is satisfied because no employee has benefited under another plan taken into account under paragraph (a)(3) of this section. In addition, the largest cumulative disparity fraction possible under the first formula is 35 times one or 35, and the largest cumulative disparity fraction possible under the second formula is 40 times 0.8 or 32. Thus, the requirement of paragraph (c)(4)(i)(B) of this section is also satisfied because each formula would satisfy the cumulative permitted disparity limit if it were the only formula under the plan. Under paragraph (c)(4)(i) of this section, the plan is deemed to satisfy the cumulative permitted disparity limit with respect to an employee whose social security retirement age is 65.

(d) *Additional rules.* The Commissioner may prescribe additional rules under this section as the Commissioner considers appropriate. Additional rules may include (without being limited to) rules for computing the fractions described in this section with respect to terminated plans, rules for applying the overall permitted disparity limits to employees who benefit under plans maintained by railroad employers, and rules for determining which plans do not satisfy section 401(l) if the overall permitted disparity limits are exceeded.

[T.D. 8359, 56 FR 47634, Sept. 19, 1991; 57 FR 10819, 10952, Mar. 31, 1992, as amended by T.D. 8486, 58 FR 46833, Sept. 3, 1993]

§1.401(l)–6 Effective dates and transition rules.

(a) *Statutory effective date*—(1) *In general.* Except as otherwise provided in paragraph (a)(2) of this section, section 401(a)(5)(C) is effective for plan years beginning on or after January 1, 1989, and section 401(l) is effective with respect to plan years, and benefits attributable to plan years, beginning on or after January 1, 1989. The preceding sentence is applicable to a plan without regard to whether the plan was in existence as of a particular date.

(2) *Collectively bargained plans.* (i) In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified before March 1, 1986, sections 401(a)(5) and 401(l) are applicable for plan years beginning on or after the later of—

(A) January 1, 1989; or

(B) The date on which the last of such collective bargaining agreements terminates (determined without regard to any extension of any such agreement occurring on or after March 1, 1986). However, notwithstanding the preceding sentence, sections 401(a)(5) and 401(l) apply to plans described in this paragraph (a)(2) no later than the first plan year beginning after January 1, 1991.

(ii) For purposes of paragraph (a)(2)(i)(B) of this section, a change made after October 22, 1986, in the terms or conditions of a collectively bargained plan, pursuant to a collective bargaining agreement ratified before March 1, 1986, is not treated as a change in the terms and conditions of the plan.

(iii) In the case of a collectively bargained plan described in paragraph (a)(2)(i) of this section, if the date in paragraph (a)(2)(i)(B) of this section precedes November 15, 1988, then the date in this paragraph (a)(2) is replaced with the date on which the last of any collective bargaining agreements in effect on November 15, 1988, terminates, provided that the plan complies during this period with a reasonable good faith interpretation of section 401(l).

(iv) Whether a plan is maintained pursuant to a collective bargaining agreement is determined under the principles applied under section 1017(c) of the Employee Retirement Income Security Act of 1974. See H.R. Rep. No. 1280, 93d Cong., 2d Sess. 266 (1974). In addition, a plan is not treated as maintained under a collective bargaining agreement unless the employee representatives satisfy section 7701(a)(46) of the Internal Revenue Code after March 31, 1984. See §301.7701–17T of this chapter for other requirements for a plan to be considered to be collectively bargained.

(b) *Regulatory effective date*—(1) *In general.* Except as otherwise provided in paragraph (b)(2) of this section, §§1.401(l)–1 through 1.401(l)–6 apply to plan years beginning on or after January 1, 1994.

(2) *Plans of tax-exempt organizations.* In the case of plans maintained by an organization exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), §§1.401(l)–1 through 1.401(l)–6 apply to plan years beginning on or after January 1, 1996.

(3) *Defined contribution plans.* A defined contribution plan satisfies section 401(l) with respect to a plan year beginning on or after the effective date of these regulations, as set forth in paragraphs (b)(1) and (b)(2) of this section, if it satisfies the applicable requirements of §§1.401(l)–1 through 1.401(l)–5 for the plan year.

(4) *Defined benefit plans.* A defined benefit excess plan or offset plan satisfies section 401(l) with respect to all plan years, and benefits attributable to all plan years, beginning on or after the effective date of these regulations, as set forth in paragraphs (b)(1) and (b)(2) of this section, by satisfying the applicable requirements of §§1.401(l)–1 through 1.401(l)–5 and the requirements of §1.401(a)(4)–13(c) (and §1.401(a)(4)–13(d), if applicable), using a fresh-start date that is on or after December 31, 1988, and before the effective date of

these regulations. A defined benefit excess plan or offset plan that does not satisfy section 401(l) with respect to all plan years beginning on or after the effective date of these regulations may, under the rules of § 1.401(a)(4)–13(c) (and § 1.401(a)(4)–13(d), if applicable), satisfy section 401(l) for plan years beginning after a fresh-start date by satisfying the applicable requirements of §§ 1.401(l)–1 through 1.401(l)–5 after the fresh-start date.

(c) *Compliance during transition period.* For plan years beginning on or after January 1, 1989, and before the effective date of these regulations, as set forth in paragraph (b) of this section, a plan must be operated in accordance with a reasonable, good faith interpretation of section 401(l). Whether a plan is operated in accordance with a reasonable, good faith interpretation of section 401(l) will generally be determined based on all of the relevant facts and circumstances, including the extent to which an employer has resolved unclear issues in its favor. A plan will be deemed to be operated in accordance with a reasonable, good faith interpretation of section 401(*l*) if it is operated in accordance with the terms of §§ 1.401(*l*)–1 through 1.401(*l*)–5.

[T.D. 8486, 58 FR 46835, Sept. 3, 1993]

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(1) General rule.
(2) Transition rule.

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§1.401(m)–1 Employee and matching contributions.

(a) General Rules—(1) *Nondiscriminatory amount of contributions.* A defined contribution plan does not satisfy section 401(a)(4) for a plan year unless the amount of employee and matching contributions to the plan for the plan year satisfies section 401(a)(4). See §1.401(a)(4)–1(b)(2)(ii). Except as specifically provided otherwise, for plan years beginning after December 31, 1986 (or such later date provided in paragraph (g) of this section) the amount of employee and matching contributions under a plan satisfies the requirements of section 401(a)(4) only if the employee and matching contributions under the plan satisfy the actual contribution percentage test of section 401(m)(2) and paragraph (b) of this section. See §1.401(a)(4)–1(b)(2)(ii)(B). Also, except as specifically provided otherwise, for plan years beginning after December 31, 1988 (or such later date provided in §1.401(m)–2(d)), the amount of employee and matching contributions under a plan satisfies the requirements of sections 401(m) and 401(a)(4) only if any multiple use of the alternative methods of compliance with sections 401 (k) and (m) (contained in sections 401(k)(3)(A)(ii)(II) and 401(m)(2)(A)(ii), respectively) is corrected under §1.401(m)– 2(c). See section 401(m)(9) and §1.401(m)–2. For these purposes, the employee and matching contributions are combined with the elective and qualified nonelective contributions, if any, that are treated as matching contributions, and the recharacterized elective contributions, if any, that are treated as employee contributions for purposes of section 401(m).

(2) *Other nondiscrimination rules.* Nondiscrimination requirements in addition to those described in paragraph (a)(1) of this section apply to employee and matching contributions under sections 401(a)(4) and 410(b). For example,

under section 401(a)(4) a plan may not discriminate with respect to the availability of benefits, rights, and features under the plan. See § 1.401(a)(4)–1(b)(3). The right to make each level of employee contributions, and the right to each level of matching contributions, are benefits, rights, or features subject to this requirement, and each level must therefore generally be available to a group of employees that satisfies section 410(b). See § 1.401(a)(4)–4(e)(3) (i) and (iii) (F) through (G). Thus, for example, a plan does not satisfy section 401(a)(4) if it provides a higher rate of matching contributions for highly compensated employees than for nonhighly compensated employees. See paragraph (e)(4) of this section for rules relating to the application of section 401(a)(4) to the correction of excess aggregate contributions. See § 1.401(a)(4)–11(g)(3)(vii) for special rules relating to correction of violations of the minimum coverage requirements or discriminatory rates of match in a section 401(m) plan. For special rules governing the application of section 410(b) to employee and matching contributions, see §§ 1.410(b)–7(c)(1) and 1.410(b)–8(a)(1).

(3) *Rules applicable to collectively bargained plans.* The requirements of this section are treated as satisfied by employee and matching contributions under a collectively bargained plan (or the portion of a plan) that automatically satisfies section 410(b). See §§ 1.401(a)(4)–1(c)(5) and 1.410(b)–2(b)(7). There are no excess aggregate contributions under a plan (or a portion of a plan) that is treated under this paragraph (a)(3) as satisfying the requirements of this section. Thus, the provisions of section 4979 and § 54.4979–1 of this chapter do not apply to contributions described in the first sentence of this paragraph (a)(3).

(b) *Actual contribution percentage test*—(1) *General rule.* (i) For plan years beginning after December 31, 1986, or such later date provided in paragraph (g) of this section, the actual contribution percentage test is satisfied if—

(A) The actual contribution percentage for the group of eligible highly compensated employees is not more than the actual contribution percentage for the group of all other eligible employees multiplied by 1.25; or

(B) The excess of the actual contribution percentage for the group of eligible highly compensated employees over the actual contribution percentage for the group of all other eligible employees is not more than two percentage points, and the actual contribution percentage for the group of eligible highly compensated employees is not more than the actual contribution percentage for the group of all other eligible employees multiplied by two.

(ii) A plan does not fail to satisfy the requirements of this paragraph (b)(1) merely because all of the eligible employees under the plan for a year are highly compensated employees.

(2) *Plan provision requirement.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (g) of this section, a plan that permits employee or matching contributions does not satisfy the requirements of section 401(a) unless it provides that the actual contribution percentage test of section 401(m)(2) will be met. For purposes of this paragraph (b)(2), the plan may incorporate the provisions of section 401(m)(2), this paragraph (b), and, if applicable, section 401(m)(9) and § 1.401(m)–2.

(3) *Aggregation of plans*—(i) *General rule.* See § 1.401(m)–1(f)(14) for the definition of a plan used for purposes of this section and § 1.401(m)–2. That definition contains the exclusive rules for aggregation and disaggregation of plans for purposes of this section and § 1.401(m)–2.

(ii) *Restructuring and Permissive Disaggregation.* Effective for plan years beginning after December 31, 1991, restructuring under § 1.401(a)(4)–9(c) may not be used to demonstrate compliance with the requirements of section 401(m). See § 1.401(a)(4)– 9(c)(3)(ii). For plan years beginning before January 1, 1992, see § 1.401(m)–1(g)(5)(ii). An employer may, however, treat a plan benefiting otherwise excludable employees as two separate plans for purposes of sections 401(m) and 410(b) in accordance with §§ 1.410(b)–6(b)(3) and 1.410(b)–7(c)(3).

(4) *Employee and matching contributions taken into account under the actual contribution percentage test*—(i) *Employee contributions*—(A) *General rule.* An employee contribution is taken into

account under paragraph (b)(1) of this section for the plan year in which the contribution is made to the trust. For this purpose, a payment by the employee to an agent of the plan is treated as a contribution to the trust at the time of payment to the agent if the funds paid are transmitted to the trust within a reasonable period after the payment to the agent.

(B) *Recharacterized elective contributions.* An excess contribution that is recharacterized under §1.401(k)–1(f)(3) is taken into account as an employee contribution for the plan year that includes the time at which the excess contribution is includible in the gross income of the employee under §1.401(k)–1(f)(3)(ii).

(ii) *Matching contributions*—(A) *General rule.* A matching contribution is taken into account under paragraph (b)(1) of this section for a plan year only if the contribution is allocated to the employee's account under the terms of the plan as of any date within the plan year, is actually paid to the trust no later than 12 months after the close of the plan year, and is made on behalf of an employee on account of the employee's elective contributions or employee contributions for the plan year. Matching contributions that do not satisfy these requirements are not taken into account under paragraph (b)(1) of this section for any plan year. Instead, the amount of these matching contributions must satisfy the requirements of section 401(a)(4) (without regard to the special nondiscrimination rule in paragraph (b)(1) of this section) for the plan year for which they are allocated under the plan, as if they were nonelective contributions and were the only nonelective employer contributions for that year. See §§1.401(a)(4)–1(b)(2)(ii)(B); 1.410(b)–7(c)(1).

(B) *Matching contributions and qualified nonelective contributions used to satisfy actual deferral percentage test.* A matching contribution that is treated as an elective contribution is subject to the actual deferral percentage test of section 401(k)(3) and is not taken into account under paragraph (b)(1) of this section. See §1.401(k)–1(b)(5)(iii) for the rule relating to years before January 1, 1987. A qualified nonelective contribution that is treated as an elective contribution is subject to the actual deferral percentage test of section 401(k)(3) and is not taken into account as a matching contribution under paragraph (b)(1) or (5) of this section.

(C) *Treatment of forfeited matching contributions.* A matching contribution that is forfeited to correct excess aggregate contributions, or because the contribution to which it relates is treated as an excess contribution, excess deferral, or excess aggregate contribution, is not taken into account under paragraph (b)(1) of this section.

(5) *Qualified nonelective contributions and elective contributions that may be taken into account under the actual contribution percentage test.* Except as specifically provided otherwise, for purposes of paragraph (b)(1) of this section, all or part of the qualified nonelective contributions and elective contributions made with respect to any or all employees who are eligible employees under the plan of the employer being tested may be treated as matching contributions provided that each of the following requirements (to the extent applicable) is satisfied:

(i) The amount of nonelective contributions, including those qualified nonelective contributions treated as matching contributions for purposes of the actual contribution percentage test, satisfies the requirements of section 401(a)(4). See §1.401(a)(4)–1(b)(2).

(ii) The amount of nonelective contributions, excluding those qualified nonelective contributions treated as matching contributions for purposes of the actual contribution percentage test and those qualified nonelective contributions treated as elective contributions under §1.401(k)–1(b)(5) for purposes of the actual deferral percentage test, satisfies the requirements of section 401(a)(4). See §1.401(a)(4)–1(b)(2).

(iii) The elective contributions, including those treated as matching contributions for purposes of the actual contribution percentage test, satisfy the requirements of section 401(k)(3).

(iv) The qualified nonelective contributions are allocated to the employee under the plan as of a date within the plan year (within the meaning of §1.401(k)–1(b)(4)(i)(A)), and the elective contributions satisfy §1.401(k)–1(b)(4)(i) for the plan year.

(v) For plan years beginning after December 31, 1988, or such later date provided in paragraph (g) of this section, the plan that takes qualified nonelective contributions and elective contributions into account in determining whether employee and matching contributions satisfy the requirements of section 401(m)(2)(A), and the plans to which the qualified nonelective contributions and elective contributions are made, could be aggregated under § 1.410(b)–7(d) after application of the mandatory disaggregation rules of § 1.410(b)–7(c), as modified in § 1.401(k)–1(g)(11). If the plan year of the section 401(m) plan is changed to satisfy the requirement under § 1.410(b)–7(d)(5) that the aggregated plans have the same plan year, the elective contributions may be taken into account in the resulting short plan year only if these contributions satisfy the requirements of § 1.401(k)–1(b)(4) with respect to the short year, and the qualified nonelective contributions may be taken into account in the resulting short plan year only if these contributions satisfy the requirements of § 1.401(k)–1(b)(4)(i)(A) with respect to the short year as if they were elective contributions.

(c) *Additional requirements*—(1) *Coordination with other plans.* Except as expressly permitted under section 401(k) or 401(m), for plan years beginning after December 31, 1988, or such later date provided in paragraph (g) of this section, employee or matching contributions (or elective contributions treated as matching contributions under paragraph (b)(5) of this section) may not be taken into account for purposes of determining whether any other contributions under any plan (including the plan to which the employee or matching contributions are made) satisfy the requirements of section 401(a). Indeed, the portion of a plan that consists of employee and matching contributions is treated as a separate plan for purposes of sections 401(a)(4) and 410(b). See § 1.410(b)–7(c)(1). Similarly, although matching contributions and qualified nonelective contributions may be used to enable a plan to satisfy the minimum contribution or benefit requirements under section 416, matching contributions that are used in this way are not treated as matching contributions, and must therefore satisfy the nondiscrimination requirements of section 401(a)(4) without regard to section 401(k) or 401(m). See § 1.416–1, M–18 & M–19 and paragraph (f)(12)(iii) of this section. See also § 1.401(k)–1(b)(5) for circumstances under which matching contributions may be used to determine whether a plan satisfies the requirements of section 401(k). This paragraph does not apply for purposes of determining whether a plan satisfies the average benefit percentage test of section 410(b)(2)(A)(ii).

(2) *Recordkeeping requirement.* A plan satisfies this section only if the employer maintains the records necessary to demonstrate compliance with the applicable nondiscrimination requirements of paragraph (b) of this section, including records showing the extent to which qualified nonelective contributions and elective contributions are taken into account.

(3) *Consistent application of separate line of business rules.* If an employer is treated as operating qualified separate lines of business under section 414(r) in accordance with § 1.414(r)–1(b) for purposes of applying section 410(b), and applies the special rule for employer-wide plans in § 1.414(r)–1(c)(2)(ii) to the portion of the plan that consists of matching contributions or to the portion of the plan that consists of employee contributions (the ‘‘matching and employee contribution portions’’), then the requirements of this section, section 401(m), and § 1.401(m)–2 must be applied on an employer-wide rather than a qualified-separate-line-of-business basis to all of the plans or portions of plans taken into account in determining whether those requirements are satisfied by the matching and employee contribution portions of the plan (regardless of whether the other plans or portions of plans also satisfy the requirements necessary to apply the special rule in § 1.414(r)–1(c)(2)(ii)). Conversely, if an employer is treated as operating qualified separate lines of business under section 414(r) in accordance with § 1.414(r)–1(b) for purposes of applying section 410(b), and does not apply the special rule for employer-

wide plans in §1.414(r)1–(c)(2)(ii) to either the matching or employee contribution portions of the plan, then the requirements of this section, section 401(m) and §1.401(m)–2 must be applied on a qualified-separate-line-of-business rather than an employer-wide basis to all of the plans or portions of plans taken into account in determining whether those requirements are satisfied by the matching and employee contribution portions of the plan (regardless of whether one or more of the other plans or portions of plans is tested under the special rule §1.414(r)–1(c)(2)(ii)). This requirement applies solely for purposes of determining whether the requirements of this section, section 401(m), and §1.401(m)–2 are satisfied by the matching and employee contribution portions of the plan. The rules of this paragraph are illustrated by the following example.

Example. (i) Employer A maintains a profit-sharing plan that includes a cash or deferred arrangement in which all of the employees of Employer A are eligible to participate. Under the profit-sharing plan, each $1.00 of elective contributions under the cash or deferred arrangement is matched by $0.50 of employer contributions. Employer A is treated as operating qualified separate lines of business under section 414(r) in accordance with §1.414(r)–1(b) for purposes of applying section 410(b). However, Employer A applies the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) to the portion of its profitsharing plan that consists of matching contributions. Employer A makes qualified nonelective contributions to the profit-sharing plan for the 1995 plan year.

(ii) Under these facts, the requirements of sections 401(a)(4) and 410(b) must be applied on an employer-wide rather than a qualified-separate-line-of-business basis in determining whether these qualified nonelective contributions (and any elective contributions under the cash or deferred arrangement) satisfy the requirements of §1.401(m)–1(b)(5), and thus whether they may be taken into account under the actual contribution percentage test. Thus, in order for the nonelective contributions to be used to satisfy the actual contribution percentage test, both (1) the total amount of nonelective contributions under the profit-sharing plan, including the qualified nonelective contributions to be used to satisfy the actual contribution percentage test, and (2) the total amount of nonelective contributions under the profit-sharing plan, excluding the qualified nonelective contributions to be used to satisfy the actual contribution percentage test, must satisfy the requirements of section 401(a)(4) on an employer-wide basis. Further, in order for any elective contributions under the cash or deferred arrangement to be used to satisfy the actual contribution percentage test, the total amount of elective contributions, including any treated as matching contributions under the actual contribution percentage test, must satisfy the requirements of section 401(k)(3) on an employer-wide basis. Of course, in order for the profit-sharing plan to satisfy section 401(a), it must still satisfy sections 410(b) and 401(a)(4) on a qualified-separate-line-of-business basis.

(d) *Examples.* The provisions of paragraphs (a) through (c) of this section are illustrated by the following examples. Assume in each case that the employer is a corporation, and that the employer's taxable year and plan year are the calendar year. Also assume that the employee contributions, elective contributions, matching contributions and qualified nonelective contributions meet the applicable requirements of sections 401(a)(4) and 410. For methods to be used to correct excess aggregate contributions, see paragraph (e) of this section.

Example 1. (i) Employer L maintains a profit-sharing plan providing for voluntary employee contributions. L does not maintain a plan that includes a cash or deferred arrangement. For the 1988 plan year, the actual contribution percentages (ACPs) for the highly compensated employees and nonhighly compensated employees are shown in the following chart:

	Actual contribution percentage
Highly compensated	10
Nonhighly compensated	5

(ii) This plan fails to qualify under either of the tests of section 401(m)(2)(A) because the ACP for highly compensated employees is more than 125 percent of the ACP for nonhighly compensated employees, and exceeds the ACP for the nonhighly compensated employees by more than two percentage points. L must either reduce the ACP for the highly compensated employees to seven percent (to satisfy the 200 percent/two percentage point test) or increase the ACP of the nonhighly compensated employees to eight percent (to satisfy the 125 percent test).

Example 2. (i) Employer M maintains a plan under which each dollar of employee contributions is matched with $.50 of employer contributions. M maintains no other plan. For the 1988 plan year, the average percentage of compensation contributed to the plan for the employees is shown in the following chart:

	Employee contributions (percent)	Matching contributions (percent)	Actual contribution percentage
Highly compensated	10	5	15
Nonhighly compensated	5	2.5	7.5

(ii) This plan fails to satisfy either of the tests of section 401(m)(2)(A). Employer M must either reduce the actual contribution percentage of the highly compensated employees to 9.5 percent (to satisfy the 200 percent/two percentage point test) or increase the actual contribution percentage of the nonhighly compensated employees to 12 percent (to satisfy the 125 percent test).

Example 3. (i) Employer N maintains a plan that contains a cash or deferred arrangement and permits employee contributions. Employer N includes elective contributions in compensation as permitted under § 1.414(s)–1(c)(4)(i). See § 1.401(k)–1(g)(2)(i). For the 1988 plan year, the average percentages of compensation contributed to the plan by the highly compensated and nonhighly compensated employees as elective contributions and employee contributions are shown in the chart below. Elective contributions meet the requirements of paragraph (b)(5) of this section.

	Elective Contributions (percent)	Employee Contributions (percent)
Highly compensated	10	10
Nonhighly compensated	10	6

(ii) The plan fails to meet the requirements of section 401(m) because the actual contribution percentage (ACP) of highly compensated employees is more than 125 percent of the ACP of the other employees, and exceeds the ACP of the other employees by more than two percentage points.

(iii) The plan provides that elective contributions made by nonhighly compensated employees may be used to meet the requirements of section 401(m) to the extent needed under that section. Under this provision, the plan uses elective contributions equal to two percent of the compensation of the nonhighly compensated employees in the ACP test. After this adjustment, the actual deferral percentages (ADPs) and ACPs are as follows:

	ADP (percent)	ACP (percent)
Highly compensated	10	10
Nonhighly compensated	8	8

(iv) The ACP of the highly compensated employees meets the requirements of section 401(m)(2)(A)(i) because it is 125 percent of that for nonhighly compensated employees. The ADP of the highly compensated employees similarly satisfies the 125 percent test. The plan would also meet the requirements of section 401(m) if all elective contributions were used in the ACP test. This is because the ACP for the highly compensated employees (20 percent) would be 125 percent of the ACP for the nonhighly compensated employees (16 percent).

Example 4. (i) Employer P maintains a plan that includes a cash or deferred arrangement. Elective contributions, qualified nonelective contributions (QNCs), employee contributions, and matching contributions are made to the plan. Employer P includes elective contributions in compensation as permitted under § 1.414(s)–1(c)(4)(i). The elective contributions and QNCs meet the requirements of paragraph (b)(5) of this section. For the 1989 plan year, the QNCs, elective contributions, and employee and matching contributions, expressed as a percentage of compensation, are shown in the following table:

	QNCs (percent)	Elective Contributions (percent)	Employee/ Matching Contributions (percent)
Highly compensated	3	5	6
Nonhighly compensated	3	4	2

(ii) The elective contributions meet the test of section 401(k)(3)(A)(ii). The employee and matching contributions, however, do not meet the actual contribution percentage (ACP) test. P may not use any QNCs of the nonhighly compensated employees to meet the ACP test because the remaining QNCs would discriminate in favor of the highly compensated employees. However, P could make additional QNCs or matching contributions of two percent of compensation on behalf of the nonhighly compensated employees. Alternatively, P could treat all QNCs for all employees and elective contributions equal to one percent of compensation for nonhighly compensated employees as matching contributions and make additional QNCs of 1.2 percent of compensation on behalf of nonhighly compensated employees. The ACPs for highly and nonhighly compensated employees would then be nine percent and 7.2 percent, respectively, thus satisfying the 125 percent test. The actual deferral percentages would be five and three percent, respectively, which would satisfy the 200 percent/two percentage point test.

Example 5. (i) Employer P maintains a cash or deferred arrangement. Elective contributions, qualified nonelective contributions (QNCs), employee contributions, and matching contributions are made to the plan. The elective contributions and the QNCs meet the requirements of paragraph (b)(5) of this section. For the 1989 plan year, the contributions are shown in the following table:

	QNCs (percent)	Elective contributions (percent)	Employee/ matching contributions (percent)
Highly compensated	0	6	6
Nonhighly compensated	3	3	3

(ii) The QNCs may be used in the actual deferral percentage (ADP) test, the actual contribution percentage (ACP) test, or a combination of the two. If P treats one-third of the QNCs as elective contributions and two-thirds as matching contributions, the ADPs for the highly compensated and nonhighly compensated employees are six and four percent, respectively, and satisfy the 200 percent/two percentage point test. Similarly, the ACPs for the two groups are six and five percent, respectively, and satisfy the 125 percent test.

(e) *Correction of excess aggregate contributions*—(1) *General rule*—(i) *Permissible correction methods.* A plan satisfies the requirements of section 401(m)(2) and paragraph (b)(1) of this section with respect to the amount of employee and matching contributions under the plan if the employer, in accordance with the terms of the plan and paragraph (b)(5) of this section, makes qualified nonelective contributions or elective contributions that, in combination with employee and matching contributions, satisfy the actual contribution percentage test. In addition, a plan subject to the requirements of section 401(m) satisfies section 401(m)(2) and paragraph (b)(1) of this section if, in accordance with the terms of the plan, excess aggregate contributions on behalf of highly compensated employees (and the income allocable to these contributions) are distributed in accordance with paragraph (e)(3) of this section. Matching contributions (and the income allocable to matching contributions) that are not vested (determined without regard to any increase in vesting that may occur after the date of the forfeiture) may also be forfeited to correct excess aggregate contributions. Finally, a plan may limit employee or matching contributions in a manner that prevents excess aggregate contributions from being made.

(ii) *Combination of correction methods.* The plan may permit a combination of the methods listed in paragraph (e)(1)(i) of this section to avoid or correct excess aggregate contributions.

(iii) *Impermissible correction methods.* Excess aggregate contributions may not be corrected by forfeiting vested matching contributions, recharacterizing matching contributions, or not making matching contributions required under the terms of the plan. Excess aggregate contributions for a plan year may not remain unallocated or be allocated to a suspense account for allocation to one or more employees in any future year. In addition, excess aggregate contributions may not be corrected using the retroactive correction rules of §1.401(a)(4)–11(g). See §1.401(a)(4)–11(g)(3)(vii) and (5). See paragraph (e)(5) of this section for the effects of a failure to correct excess aggregate contributions. See §1.411(a)–4(b)(7) regarding permissible forfeitures of matching contributions.

(iv) *Partial correction.* Any distribution of less than the entire amount of excess aggregate contributions (and income) is treated as a pro rata distribution of excess aggregate contributions and income.

(2) *Amount of excess aggregate contributions*—(i) *General rule.* The amount of excess aggregate contributions for a highly compensated employee for a plan year is the amount (if any) by which the employee's employee and matching contributions must be reduced for the employee's actual contribution ratio to equal the highest permitted actual contribution ratio under the plan. To calculate the highest permitted actual contribution ratio under a plan, the actual contribution ratio of the highly compensated employee with the highest actual contribution ratio is reduced by the amount required to cause the employee's actual contribution ratio to equal the ratio of the highly compensated employee with the next highest actual contribution ratio. If a lesser reduction would enable the arrangement to satisfy the actual contribution percentage test, only this lesser reduction may be made. This process must be repeated until the plan satisfies the actual contribution percentage test. The highest actual contribution ratio remaining under the plan after leveling is the highest permitted actual contribution

ratio. For each highly compensated employee, the amount of excess aggregate contributions for a plan year is equal to the total employee and matching contributions, plus qualified nonelective contributions and elective contributions taken into account in determining the employee's actual contribution ratio under paragraph (f)(1) of this section, minus the amount determined by multiplying the employee's actual contribution ratio (determined after application of this paragraph (e)(2)) by the compensation used in determining the ratio. In no case may the amount of excess aggregate contributions with respect to any highly compensated employee exceed the amount of employee and matching contributions made on behalf of the highly compensated employee for the plan year.

(ii) *Coordination with correction of excess contributions.* The amount of excess aggregate contributions with respect to an employee for a plan year is calculated after determining the excess contributions to be recharacterized as employee contributions for the plan year.

(iii) *Correction of family members.* The determination and correction of excess aggregate contributions of a highly compensated employee whose actual contribution ratio is determined under the family aggregation rules of paragraph (f)(1)(ii)(C) of this section, is accomplished by reducing the actual contribution ratio as required under this paragraph (e)(2) and allocating the excess aggregate contributions for the family group among the family members in proportion to the employee and matching contributions of each family member that are combined to determine the actual contribution ratio.

(3) *Corrective distribution of excess aggregate contributions (and income)*—(i) *Genera1 rule.* Excess aggregate contributions (and income allocable thereto) are distributed in accordance with this paragraph (e)(3) only if the excess aggregate contributions and allocable income are designated by the employer as a distribution of excess aggregate contributions (and income), and are distributed to the appropriate highly compensated employees after the close of the plan year in which the excess aggregate contributions arose and within 12 months after the close of that plan year. In the event of a complete termination of the plan during the plan year in which an excess aggregate contribution arose, the corrective distribution must be made as soon as administratively feasible after the date of termination of the plan, but in no event later than 12 months after the date of termination. If the entire account balance of a highly compensated employee is distributed during the plan year in which the excess aggregate contribution arose, the distribution is deemed to have been a corrective distribution of excess aggregate contributions (and income) to the extent that a corrective distribution would otherwise have been required.

(ii) *Income allocable to excess aggregate contributions*—(A) *General rule.* The income allocable to excess aggregate contributions is equal to the sum of the allocable gain or loss for the plan year and, if the plan so provides, the allocable gain or loss for the period between the end of the plan year and the date of distribution (the ‘‘gap period’’).

(B) *Method of allocating income.* A plan may use any reasonable method for computing the income allocable to excess aggregate contributions, provided that the method does not violate section 401(a)(4), is used consistently for all participants and for all corrective distributions under the plan for the plan year, and is used by the plan for allocating income to participants' accounts. See §1.401(a)(4)–1(c)(8).

(C) *Alternative method of allocating income.* A plan may allocate income to excess aggregate contributions by multiplying the income for the plan year (and the gap period, if the plan so provides) allocable to employee contributions, matching contributions, and amounts treated as matching contributions by a fraction. The numerator of the fraction is the excess aggregate contributions for the employee for the plan year. The denominator of the fraction is equal to the sum of:

(*1*) The total account balance of the employee attributable to employee and matching contributions, and amounts treated as matching contributions as of the beginning of the plan year; plus

(*2*) The employee and matching contributions, and amounts treated as matching contributions for the plan year and for the gap period if gap period income is allocated.

(D) *Safe harbor method of allocating gap period income.* Under the safe harbor method, income on excess aggregate contributions for the gap period is equal to 10 percent of the income allocable to excess aggregate contributions for the plan year (calculated under the method described in paragraph (e)(3)(ii)(C) of this section), multiplied by the number of calendar months that have elapsed since the end of the plan year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of the month is treated as made on the last day of the preceding month. A distribution made after the fifteenth day of the month is treated as made on the first day of the next month.

(E) *Allocable income for recharacterized elective contributions.* If recharacterized elective contributions are distributed as excess aggregate contributions, the income allocable to the excess aggregate contributions is determined as if recharacterized elective contributions had been distributed as excess contributions. Thus, income must be allocated to the recharacterized amounts distributed using the methods in §1.401(k)–1(f)(4)(ii).

(iii) *No employee or spousal consent required.* A distribution of excess aggregate contributions (and income) may be made under the terms of the plan without regard to any notice or consent otherwise required under sections 411(a)(11) and 417.

(iv) *Treatment of corrective distributions and forfeited contributions as employer contributions.* Excess aggregate contributions, including forfeited matching contributions, are treated as employer contributions for purposes of sections 404 and 415 even if distributed from the plan. Forfeited matching contributions that are reallocated to the accounts of other participants for the plan year in which the forfeiture occurs are treated under section 415 as annual additions for the participants to whose accounts they are reallocated and for the participants from whose accounts they are forfeited.

(v) *Tax treatment of corrective distributions*—(A) *Genera1 rule.* Except as otherwise provided in this paragraph (e)(3)(v), a corrective distribution of excess aggregate contributions (and income) that is made within 2½ months after the end of the plan year for which the excess aggregate contributions were made is includible in the employee's gross income for the taxable year of the employee ending with or within the plan year for which the excess aggregate contributions were made. A corrective distribution of excess aggregate contributions (and income) that is made more than 2½ months after the plan year for which the excess aggregate contributions were made is includible in the employee's gross income in the taxable year of the employee in which distributed. The portion of the distribution that is treated as an investment in the contract under section 72 is determined without regard to any plan contributions other than those distributed as excess aggregate contributions. Regardless of when the corrective distribution is made, it is not subject to the early distribution tax of section 72(t) and is not treated as a distribution for purposes of applying the excise tax under section 4980A. See paragraph (e)(5) of this section for additional rules relating to the employer excise tax on amounts distributed more than 2½ months after the end of the plan year.

(B) *Rule for de minimis distributions.* If the total excess contributions and excess aggregate contributions distributed to a recipient under a plan for any plan year are less than $100 (excluding income), a corrective distribution of excess aggregate contributions (and income) is includible in gross income in the recipient's taxable year in which the corrective distribution is made.

(C) *Rule for certain 1987 and 1988 excess aggregate contributions.* Distributions for plan years beginning in 1987 and 1988 to which the de minimis rule of this paragraph (e)(3)(v) of this section would otherwise apply may be reported by the recipient, at the recipient's option, either in the year described in paragraph (e)(3)(v)(A) of this section, or in the year described in paragraph (e)(3)(v)(B) of this section. This special rule may be used only for distributions made within 2½ months after the close of the plan year, but not later than April 17, 1989.

(vi) *No reduction of required minimum distribution.* A distribution of excess aggregate contributions (and income) is not treated as a distribution for purposes of determining whether the plan satisfies the minimum distribution requirements of section 401(a)(9).

(vii) *No corrective distribution of matching contributions other than excess aggregate contributions.* A matching contribution that is an excess aggregate contribution may be distributed as provided in section 401(m)(6) and §1.401(m)–1(e)(3). A matching contribution may not be distributed merely because the contribution to which it relates is treated as an excess contribution, excess deferral, or excess aggregate contribution. See §§1.401(k)–1(f)(5)(iii) and 1.411(a)–4(b)(7) regarding permissible forfeitures of matching contributions that relate to excess contributions, excess deferrals, or excess aggregate contributions.

(4) *Coordination with section 401(a)(4).* A matching contribution is taken into account under section 401(a)(4) even if it is distributed, unless the distributed contribution is an excess aggregate contribution. However, the method of distributing excess aggregate contributions provided in the plan must satisfy the requirements of section 401(a)(4). This requires that after correction each level of matching contributions be currently and effectively available to a group of employees that satisfies section 410(b). See §1.401(a)(4)–4(e)(3)(iii)(G). Thus, a plan that provides the same rate of matching contributions to all employees will not meet the requirements of section 401(a)(4) if employee contributions are distributed under this paragraph (e) to highly compensated employees to the extent needed to meet the requirements of section 401(m)(2), while matching contributions attributable to employee contributions remain allocated to the highly compensated employees' accounts. See §1.411(a)–4(b)(7) for a rule that allows forfeiture of these matching contributions to avoid a violation of section 401(a)(4). See also §1.401(a)(4)–11(g)(3)(vii)(B) regarding the use of additional allocations to the accounts of nonhighly compensated employees for the purpose of correcting a discriminatory rate of matching contributions. A method of distributing excess aggregate contributions will not be considered discriminatory solely because, in accordance with the terms of the plan, unmatched employee contributions that exceed the highest rate at which employee contributions are matched are distributed before matched employee contributions, or matching contributions are distributed (or forfeited) prior to employee contributions. See *Example 6* in paragraph (e)(6) of this section.

(5) *Failure to correct*—(i) *Failure to correct within 2½ months after end of plan year.* If a plan does not correct excess aggregate contributions within 2½ months after the close of the plan year for which the excess aggregate contributions are made, the employer will be liable for a 10 percent excise tax on the amount of the excess aggregate contributions. See section 4979 and §54.4979–1. Qualified nonelective contributions properly taken into account under paragraph (b)(5) of this section for a plan year may enable a plan to avoid having excess aggregate contributions, even if the contributions are made after the close of the 2½ month period.

(ii) *Failure to correct within 12 months after end of plan year.* If excess aggregate contributions are not corrected within 12 months after the close of the plan year for which they were made, the plan will fail to meet the requirements of section 401(a)(4) for the plan year for which the excess aggregate contributions were made and all subsequent plan years in which the excess aggregate contributions remain in the plan.

(6) *Examples.* The principles of this paragraph (e) are illustrated by the following examples. Assume in each example that no income or loss is allocable to elective, employee, or matching contributions.

Example 1. (i) Employer A maintains a thrift plan that does not include a cash or deferred arrangement. In 1990, the actual contribution percentage (ACP) for nonhighly compensated employees is four percent.

Thus, the ACP for the group of highly compensated employees may not exceed six percent. The three highly compensated employees who participate have the following compensation, contributions, and actual contribution ratios (ACRs):

Employee	Compensation	Employee and matching contributions	Actual contribution ratio (percent)
A	100,000	10,000	10
B	90,000	6,300	7
C	75,000	3,750	5
Average			7.33

(ii) The maximum amount of employee and matching contributions permitted on behalf of A, B, and C is determined by reducing contributions in order of their ACRs, beginning with the highest ACR. Thus, A's contribution is first reduced to $7,000 or 7.0 percent. Since the resulting ACP of 6.33 percent still exceeds the permitted highly compensated ACP of six percent, the contributions allocated to A and B must be further reduced to 6.5 percent. This results in an ACP of six percent, which meets the 200 percent/two percentage point test. The excess aggregate contributions for A and B are $3,500 and $450, respectively.

Example 2. (i) Employee A is the sole highly compensated participant in a cash or deferred arrangement maintained by Employer X. The plan that includes the arrangement, Plan X, provides a fully vested matching contribution equal to 50 percent of elective contributions. Plan X is a calendar year plan. Employer X includes elective contributions in compensation as permitted under §1.414(s)–1(c)(4)(i). See §1.401(k)–1(g)(2)(i). Plan X corrects excess contributions by recharacterization. For the 1988 plan year, A's compensation is $58,333, and A's elective contributions are $7,000. The actual deferral percentages and actual contribution percentages of A and other employees under Plan X are shown below:

	Actual deferral percentage	Actual contribution percentage
Employee A	12	6
Nonhighly compensated	8	4

(ii) In February 1989, Employer X determines that A's actual deferral ratio must be reduced to 10 percent, or $5,833, which requires a recharacterization of $1,167 as an employee contribution. This increases A's actual contribution ratio to eight percent ($3,500 in matching contributions plus $1,167 recharacterized as employee contributions, divided by $58,333 in compensation). Since A's actual contribution ratio must be limited to six percent for Plan X to satisfy the actual contribution percentage test, Plan X must distribute $1,167 of A's employee and matching contributions. If $1,167 in matching contributions is distributed, this will correct the excess aggregate contributions and will not result in a discriminatory rate of matching contributions. See *Example 8.*

Example 3. Same as *Example 2,* except that in 1988 A also had elective contributions of $1,313 under Plan Y, maintained by an employer unrelated to X. In January 1989, A requests and receives a distribution of $1,000 in excess deferrals from Plan X. Pursuant to the terms of Plan X, A forfeits the $500 match on the excess deferrals to correct a discriminatory rate of match (see *Example 8*). The $1,167 that would otherwise have been recharacterized for Plan X to satisfy the actual deferral percentage test is reduced by the $1,000 already distributed as an excess deferral, leaving $167 to be recharacterized. See §1.401(k)–1(f)(5)(i). Pursuant to the terms of Plan X, A forfeits the $83.50 match on the recharacterized $167 to correct a discriminatory rate of match. A's actual contribution ratio is now 5.29 percent ($2,916.50 ($3,500–$500–$83.50)) in matching contributions plus $167 in employee contributions, divided by $58,333 in compensation. Since Plan X satisfies the actual contribution percentage test, no further distribution is required or permitted.

Example 4. Same as *Example 3,* except that A does not request a distribution of excess deferrals until March 1989. Employer X has already recharacterized $1,167 as employee contributions. Under §1.402(g)–1(e)(6), the amount of excess deferrals is reduced by the amount of excess contributions that are recharacterized. Because the amount recharacterized is greater than the excess deferrals, Plan X is neither required nor permitted to make a distribution of excess deferrals, and the recharacterization has corrected the excess deferrals.

Example 5. For the 1987 plan year, Employee B defers $7,000 under Plan C and $1,000 under plan D. Plans C and D are maintained by unrelated Employers C and D; both Plans C and D have calendar plan years. Plan C provides a fully vested, 100 percent matching contribution and does not take elective contributions into account under section 401(m) or take matching contributions into account under section 401(k). Employer C determines that B has excess contributions of $600 and excess aggregate contributions of $1,600. B timely requests and receives a distribution of the $1,000 excess deferral from Plan C, and pursuant to the terms of Plan C, forfeits the corresponding $1,000 matching contribution to correct a discriminatory rate of match (see *Example 8*). Plan C provides that excess contributions and excess aggregate contributions are corrected by distribution. No distribution is required or permitted to correct the excess contributions because $1,000 has been distributed from this plan as excess deferrals. The distribution required to correct the excess aggregate contributions (after forfeiting the matching contribution) is $600 ($1,600 in excess aggregate contributions minus $1,000 in forfeited matching contributions). If B had corrected the excess deferrals of $1,000 by withdrawing $1,000 from Plan D, Plan C would have had to correct the $600 excess contributions in Plan C by distributing $600. Since B then would have forfeited $600 (instead of $1,000) in matching contributions, B would have had $1,000 ($1,600 in excess aggregate contributions minus $600 in forfeited matching contributions) remaining of excess aggregate contributions in Plan C. These would have been corrected by distributing an additional $1,000 from Plan C.

Example 6. Employee B is the sole highly compensated employee in a thrift plan under which the employer matches 100 percent of employee contributions up to two percent of compensation, and 50 percent of employee contributions up to the next four percent of compensation. For the 1988 plan year, B has compensation of $100,000. B makes an employee contribution of $7,000, or seven percent, and receives a four percent matching contribution of $4,000. Thus, B's actual contribution ratio (ACR) is 11 percent. The actual contribution percentage for the nonhighly compensated employees is five percent, and the employer determines that B's ACR must be reduced to seven percent to comply with the rules of section 401(m). In this case, the plan satisfies the requirements of this paragraph if it distributes the unmatched employee contributions of $1,000, and $2,000 of matched employee contributions with their related matches of $1,000. This would leave B with four percent employee contributions, and three percent matching contributions, for an ACR of seven percent. The plan could instead distribute all matching contributions. The plan would fail to meet the requirements of this paragraph if it distributed $4,000 (four percent) of B's employee contributions and none of B's matching contributions because this would result in a discriminatory rate of matching contributions. See § 1.401(m)–1(e)(2) and (4). See also *Example 8*.

Example 7. (i) Employee C is a highly compensated employee in Employer X's thrift plan, which matches 100 percent of employee contributions up to five percent of compensation. The matching contribution is vested at the rate of 20 percent per year. In 1991, C makes $5,000 in employee contributions and receives $5,000 of matching contributions. C is 60 percent vested in the matching contributions at the end of the 1991 plan year.

(ii) In February 1992, X determines that C has excess aggregate contributions of $1,000. The plan provides that only matching contributions will be distributed as excess aggregate contributions.

(iii) X has two options available in distributing C's excess contributions. The first option is to distribute $600 of vested matching contributions and forfeit $400 of nonvested matching contributions. These amounts are in proportion to C's vested and nonvested interests in all matching contributions. The second option is to distribute $1,000 of vested matching contributions, leaving the nonvested matching contributions in the plan.

(iv) If the second option is chosen, the plan must also provide a separate vesting schedule for vesting these nonvested matching contributions. This is necessary because the nonvested matching contributions must vest as rapidly as they would have had no distribution been made. Thus, 50 percent must vest in each of the next two years.

(v) The plan will not satisfy the nondiscriminatory availability requirement of section 401(a)(4) if only nonvested matching contributions are distributed because the effect is that matching contributions for highly compensated employees vest more rapidly than those for nonhighly compensated employees. See § 1.401(m)–1(e)(4).

Example 8. (i) Employer B maintains a calendar year profit sharing plan that includes a cash or deferred arrangement. Elective contributions are matched at the rate of 100 percent. After-tax employee contributions are permitted under the plan only for nonhighly compensated employees and are matched at the same rate. No employees make excess deferrals. Employee A, a highly compensated employee, makes an $8,000 elective contribution and receives an $8,000 matching contribution.

(ii) Employer B performs the actual deferral percentage (ADP), the actual contribution percentage (ACP), and the multiple use tests. To correct failures of the ADP and ACP tests, the plan distributes to A $1,000 of excess contributions and $500 of excess aggregate contributions. After the distributions, A's contributions for the year are $7,000 of elective contributions and $7,500 of matching contributions. As a result, A has received a higher effective rate of matching contributions than nonhighly compensated employees ($7,000 of elective contributions matched by $7,500 is an effective matching rate of 107 percent). If this amount remains in A's account without correction, it will cause the plan to fail to satisfy section 401(a)(4), because only a highly compensated employee receives the higher matching contribution rate. The remaining $500 matching contribution may be forfeited (but not distributed) under section 411(a)(3)(G), if the plan so provides. The plan could instead correct the discriminatory rate of matching contributions by making additional allocations to the accounts of nonhighly compensated employees. See §1.401(a)(4)–11(g)(3)(vii)(B) and (6), *Example 7.*

(f) *Definitions.* The following definitions apply for purposes of this section and §1.401(m)–2 except as otherwise specifically provided:

(1) *Actual contribution percentage*—(i) *General rule.* The actual contribution percentage for a group of employees for a plan year is the average of the actual contribution ratios of the employees in the group. For plan years beginning after December 31, 1988, or such later date provided in paragraph (g) of this section, actual contribution ratios and the actual contribution percentage for a group are calculated to the nearest one-hundredth of a percentage point.

(ii) *Actual contribution ratio*—(A) *General rule.* An employee's actual contribution ratio is the sum of the employee and matching contributions allocated to the employee's account for the plan year, and the qualified nonelective and elective contributions treated as matching contributions for the plan year, divided by the employee's compensation for the plan year. If an eligible employee makes no employee contributions and no matching, qualified nonelective contributions, or elective contributions are taken into account with respect to the employee, the actual contribution ratio of the employee is zero. See paragraphs (b)(4), (b)(5), and (f)(2) of this section for rules regarding the employee and matching contributions, qualified nonelective and elective contributions, and compensation that are taken into account in calculating this fraction.

(B) *Highly compensated employee eligible under more than one plan.* The actual contribution ratio of a highly compensated employee who is eligible to participate in more than one plan of an employer to which employee or matching contributions are made is calculated by treating all the plans in which the employee is eligible to participate as one plan. However, plans that are not permitted to be aggregated under §1.410(b)–7(c), as modified in §1.401(k)–1(g)(11), are not aggregated for this purpose. For example, if a highly compensated employee with compensation of $80,000 may receive matching contributions under two plans of an employer, the employee's actual contribution ratio under each plan is calculated by dividing the employee's total matching contributions under both plans by $80,000, unless the plans are required to be disaggregated. In that case, the actual contribution ratio of the employee under each plan is to be calculated by dividing the employee's matching contributions under that plan by $80,000. See paragraph (b)(3) of this section for the treatment of certain multiple plans. For plan years beginning after December 31, 1988, or such later date provided in paragraph (g) of this section, if a highly compensated employee participates in two or more plans that have different plan years, this paragraph (f)(1)(ii) is applied by treating all plans whose plan years end with or within the same calendar year as a single plan.

(C) *Employees subject to family aggregation rules—(1)* Aggregation of employee contributions and other amounts. For plan years beginning after December 31, 1986, or such later date provided in paragraph (g) of this section, if a highly compensated employee is subject to the family aggregation rules of section 414(q)(6) because that employee is either a five-percent owner or one of the 10 most highly compensated employees, the combined actual contribution ratio for the family group (treated as one highly compensated employee) must be determined by combining the employee contributions, matching contributions, amounts treated as matching contributions, and compensation of all family members.

(*2*) *Effect on actual contribution percentage of nonhighly compensated employees.* The employee and matching contributions, amounts treated as matching contributions, and compensation of all family members are disregarded for purposes of determining the actual contribution percentage for the group of highly compensated employees, and the group of nonhighly compensated employees.

(*3*) *Multiple family groups.* If an employee is required to be aggregated as a member of more than one family group in a plan, all eligible employees who are members of those family groups that include that employee are aggregated as one family group.

(2) *Compensation.* The term *compensation* means compensation as defined in § 1.401(k)–1(g)(2)(i).

(3) *Elective contributions.* The term ''elective contribution'' means elective contribution as defined in § 1.401(k)–1(g)(3).

(4) *Eligible employee*—(i) *General rule.* The term ''eligible employee'' means an employee who is directly or indirectly eligible to make an employee contribution or to receive an allocation of matching contributions (including matching contributions derived from forfeitures) under the plan for a plan year. For example, if an employee must perform ministerial or mechanical acts (e.g., formal application for participation or consent to payroll withholding) in order to be eligible to make an employee contribution for a plan year, the employee is an eligible employee for the plan year without regard to whether the employee performs these acts. An employee who is unable to make an employee contribution or to receive an allocation of matching contributions because the employee has not contributed to another plan is also an eligible employee. By contrast, if an employee must perform additional service (e.g., satisfy a minimum period of service requirement) in order to be eligible to make an employee contribution or to receive an allocation of matching contributions for a plan year, the employee is not an eligible employee for the plan year unless the service is actually performed. An employee who would be eligible to make employee contributions but for a suspension due to a distribution, a loan, or an election not to participate in the plan, is an eligible employee for purposes of section 401(m) for a plan year even though the employee may not make an employee contribution or receive an allocation of matching contributions by reason of the suspension. Finally, an employee does not fail to be an eligible employee merely because the employee may receive no additional annual additions because of section 415(c)(1) or 415(e).

(ii) *Certain one-time elections.* An employee is not an eligible employee merely because the employee, upon commencing employment with the employer or upon the employee's first becoming eligible under any plan of the employer providing for employee or matching contributions, is given a one-time opportunity to elect, and the employee does in fact elect, not to be eligible to make employee contributions or to receive allocations of matching contributions under the plan or any other plan maintained by the employer (including plans not yet established) for the duration of the employee's employment with the employer. In no event is an election made after December 23, 1994 treated as a one-time irrevocable election under this paragraph if the election is made by an employee who previously became eligible under another plan (whether or not terminated) of the employer.

(5) *Employee.* The term ''employee'' means an employee as defined in § 1.401(k)–1(g)(5).

(6) *Employee contributions.* The term ''employee contribution'' means any mandatory or voluntary contribution to the plan that is treated at the time of contribution as an after-tax employee contribution (e.g., by reporting the contribution as taxable income subject to applicable withholding requirements) and is allocated to a separate account to which the attributable earnings and losses are allocated. See § 1.401(k)–1(a)(2)(ii). The term includes:

(i) Employee contributions to the defined contribution portion of a plan described in section 414(k);

(ii) Employee contributions to a qualified cost-of-living arrangement described in section 415(k)(2)(B);

(iii) Employee contributions applied to the purchase of whole life insurance protection or survivor benefit protection under a defined contribution plan;

(iv) Amounts attributable to excess contributions within the meaning of section 401(k)(8)(B) that are recharacterized as employee contributions; and

(v) Employee contributions to an annuity contract described in section 403(b).

The term does not include repayment of loans, repayment of distributions described in section 411(a)(7)(C), or employee contributions that are transferred to a plan from another plan. For purposes of this paragraph (f)(6), employee contributions described in paragraph (f)(6)(ii) of this section are deemed contributed to a defined contribution plan.

(7) *Employer.* The term ''employer'' means the employer as defined in §1.401(k)–1(g)(6).

(8) *Excess aggregate contributions.* The term ''excess aggregate contribution'' means, with respect to any plan year, the excess of the aggregate amount of the employee and matching contributions (and any qualified nonelective contribution or elective deferral taken into account in computing the contribution percentage) actually made on behalf of highly compensated employees for the plan year, over the maximum amount of contributions permitted under the limitations of section 401(m)(2)(A). The amount of excess aggregate contributions for each highly compensated employee is determined by using the method described in paragraph (e)(2) of this section. For purposes of this paragraph, qualified matching contributions treated as elective contributions in accordance with §1.401(k)–1(b)(5) are disregarded.

(9) *Excess contributions.* The term ''excess contribution'' means an excess contribution as defined in §1.401(k)–1(g)(7)(i).

(10) *Excess deferrals.* The term ''excess deferrals'' means excess deferral as defined in §1.402(g)–1(e)(1)(iii).

(11) *Highly compensated employee.* The term ''highly compensated employee'' means a highly compensated employee as defined in section 414(q).

(12) *Matching contributions*—(i) *In general.* The term ''matching contribution'' means:

(A) Any employer contribution (including a contribution made at the employer's discretion) to a defined contribution plan on account of an employee contribution to a plan maintained by the employer;

(B) Any employer contribution (including a contribution made at the employer's discretion) to a defined contribution plan on account of an elective deferral (as defined in §1.402(g)–1(b)); and

(C) Any forfeiture allocated on the basis of employee contributions, matching contributions, or elective contributions.

(ii) *Employer contributions made on account of employee or elective contributions.* For purposes of paragraph (f)(12)(i) of this section, whether an employer contribution is made on account of an employee contribution or an elective contribution is determined on the basis of all relevant facts and circumstances, including the relationship between the employer contribution and employee actions outside the plan. Thus, for example, an employer contribution made to a defined contribution plan on account of contributions made by an employee under an employer-sponsored savings arrangement that are not held in a plan that is intended to be a qualified plan or a plan described in §1.402(g)–1(b) is not a matching contribution. Notwithstanding the foregoing, for plan years beginning before January 1, 1992, an employer may elect to take into account as matching contributions, contributions made to a plan pursuant to an arrangement under which the employer makes contributions to the plan on account of either employee contributions to the plan or contributions made by an employee to an employer-sponsored savings arrangement that are not held in the plan, provided that the arrangement was in effect prior to August 8, 1988.

(iii) *Contributions used to meet the requirements of section 416.* For plan years beginning after December 31, 1988, a contribution or allocation that is used to meet the minimum contribution or benefit requirement of section 416 is not treated as made on account of an employee or elective contribution and therefore is not a matching contribution.

(13) *Nonelective contributions.* The term ''nonelective contribution''

means nonelective contributions as defined in § 1.401(k)–1(g)(10).

(14) *Plan.* The term ''plan'' means a plan as defined in § 1.401(k)–1(g)(11).

(15) *Qualified nonelective contributions.* The term ''qualified nonelective contribution'' means qualified nonelective contributions as defined in § 1.401(k)–1(g)(13)(ii).

(16) *Section 401(k) plan.* The term *section 401(k) plan* means a section 401(k) plan within the meaning of § 1.410(b)–9.

(17) *Section 401(m) plan.* The term *section 401(m) plan* means a section 401(m) plan within the meaning of § 1.410(b)–9.

(g) *Effective dates*—(1) *General rule.* Except as provided in paragraphs (g)(2), (g)(3), (g)(4), and (g)(5) of this section, or as specifically provided otherwise in this section, this section is effective for plan years beginning after December 31, 1986.

(2) *Collectively bargained plans.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, this section does not apply to years beginning before the earlier of—

(i) January 1, 1989, or

(ii) The date on which the last collective bargaining agreement terminates (determined without regard to any extension thereof after February 28, 1986).

(3) *Certain annuity contracts*—(i) In the case of an annuity contract under section 403(b), not maintained pursuant to a collective bargaining agreement, except as otherwise provided in paragraph (g)(5) of this section, this section applies to plan years beginning after December 31, 1988.

(ii) In the case of an annuity contract described in section 403(b) maintained pursuant to a collective bargaining agreement described in paragraph (g)(2)(i) of this section, this section does not apply to years beginning before the earlier of

(A) The later of—

(*1*) January 1, 1989, or

(*2*) The date determined under paragraph (g)(2)(ii) of this section; or

(B) January 1, 1991.

(4) *State and local government plans.* A governmental plan described in section 414(d), including a plan subject to section 403(b)(12)(A)(i) (nonelective plan) is treated as satisfying section 401(m) for plan years beginning before the later of January 1, 1996, or 90 days after the opening of the first legislative session beginning on or after January 1, 1996, of the governing body with authority to amend the plan, if that body does not meet continuously. For purposes of this paragraph (g)(4), the term *governing body with authority to amend the plan* means the legislature, board, commission, council, or other governing body with authority to amend the plan.

(5) *Transition rule for plan years beginning before 1992*—(i) *General rule.* For plan years beginning before January 1, 1992, a reasonable interpretation of the rules set forth in section 401 (k) and (m) of the Internal Revenue Code (as in effect during those years) may be relied upon to determine whether a plan was qualified during those years.

(ii) *Restructuring*—(A) *General rule.* In determining whether the requirements of section 401(m) are satisfied for plan years beginning before January 1, 1992, a plan may be treated as consisting of two or more component plans, each consisting of all of the allocations and other benefits, rights, and features provided to a group of employees under the plan. See § 1.401(a)(4)–9(c). An employee may not be included in more than one component plan of the same plan for a plan year under this method. If this method is used for a plan year, the requirements of section 401(m) are applied separately with respect to each component plan for the plan year. Thus, for example, the actual contribution ratio and the amount of excess aggregate contributions, if any, of each eligible employee under each component plan must be determined as if the component plan were a separate plan. This method applies solely for purposes of section 401(m). Thus, for example, the requirements of section 410(b) must still be satisfied by the entire plan.

(B) *Identification of component plans*—(*1*) *Minimum coverage requirement.* The group of eligible employees described in § 1.401(m)–1(f)(4) under each component plan must separately satisfy the requirements of section 410(b) as if the component plan were a separate plan. Component plans may not be aggregated to satisfy this requirement.

(*2*) *Commonality requirement.* The group of employees used to identify a component plan must share some common attribute or attributes, other than similar actual contribution ratios. Permissible common attributes include, for example, employment at the same work site, in the same job category, for the same division or subsidiary, or for a unit acquired in a specific merger or acquisition, employment for the same number of years, compensation under the same method (e.g., salaried or hourly), coverage under the same contribution formula, and attributes that could be used as the basis of a classification that would be treated as reasonable under §1.410(b)–4(b). Employees whose only common attribute is the same or similar actual contribution ratios, or another attribute having substantially the same effect as the same or similar actual contribution ratios, are not considered as sharing a common attribute for this purpose. This rule applies regardless of whether the component plan or the plan of which it is a part satisfies the ratio or percentage test of section 410(b).

[T.D. 8357, 56 FR 40534, Aug. 15, 1991, as amended by T.D. 8376, 56 FR 63432, Dec. 4, 1991; T.D. 8357, 57 FR 10290, Mar. 25, 1992; T.D. 8581, 59 FR 66175, Dec. 23, 1994; TD 8581, 60 FR 12416, Mar. 7, 1995]

§1.401(m)–2 Multiple use of alternative limitation.

(a) *In general.* The rules in this section prevent the multiple use of the alternative methods of compliance with sections 401 (k) and (m) contained in section 401(k)(3)(A)(ii)(II) and 401(m)(2)(A)(ii) respectively. Paragraph (b) of this section discusses the scope of this section and contains the general rule for determination of a multiple use of the alternative limitation. Paragraph (c) of this section contains rules for the correction of multiple use. The consequences of multiple use of the alternative methods of compliance are described in §1.401(m)–1(a)(1).

(b) *General rule for determination of multiple use*—(1) *In general.* (i) Multiple use of the alternative limitation occurs if all of the conditions of this paragraph (b)(1) are satisfied:

(A) One or more highly compensated employees of the employer are eligible employees in both a cash or deferred arrangement subject to section 401(k) and a plan maintained by the employer subject to section 401(m).

(B) The sum of the actual deferral percentage of the entire group of eligible highly compensated employees under the arrangement subject to section 401(k) and the actual contribution percentage of the entire group of eligible highly compensated employees under the plan subject to section 401(m) exceeds the aggregate limit of paragraph (b)(3) of this section.

(C) The actual deferral percentage of the entire group of eligible highly compensated employees under the arrangement subject to section 401(k) exceeds the amount described in section 401(k)(3)(A)(ii)(I).

(D) The actual contribution percentage of the entire group of eligible highly compensated employees under the arrangement subject to section 401(m) exceeds the amount described in section 401(m)(2)(A)(i).

(ii) The actual deferral percentage and actual contribution percentage of the group of eligible highly compensated employees are determined after use of qualified nonelective contributions and qualified matching contributions to meet the requirements of section 401(k)(3)(A)(ii) and after use of qualified nonelective contributions and elective contributions to meet the requirements of section 401(m)(2)(A). The actual deferral percentage and actual contribution percentage of the group of eligible highly compensated employees are determined after any corrective distribution or forfeiture of excess deferrals, excess contributions, or excess aggregate contributions and after any recharacterization of excess contributions required without regard to this section. Only plans and arrangements maintained by the same employer are taken into account under this paragraph (b)(1). If the employer maintains two or more plans after application of the rules under §1.401(k)– 1(g)(11), multiple use is tested separately with respect to each plan. Thus, for example, if an employer maintains a cash or deferred arrangement with matching contributions, under which elective contributions may be made under either an ESOP or a non-ESOP, multiple use is tested separately with respect to elective contributions and matching contributions under the ESOP, and with respect to elective contributions and matching contributions under the non-ESOP.

(2) *Alternative limitation.* For purposes of this section, the term ''alternative limitation'' means the 200 percent or 2 percentage point limits in sections 401(k)(3)(A)(ii)(ii) and 401(m)(2)(A)(ii).

(3) *Aggregate limit*—(i) *In general.* For purposes of this section, the aggregate limit is the greater of:

(A) The sum of—

(*1*) 1.25 times the greater of the relevant actual deferral percentage or the relevant actual contribution percentage, and

(*2*) Two percentage points plus the lesser of the relevant actual deferral percentage or the relevant actual contribution percentage. In no event, however, may this amount exceed twice the lesser of the relevant actual deferral percentage or the relevant actual contribution percentage; or

(B) The sum of—

(*1*) 1.25 times the lesser of the relevant actual deferral percentage or the relevant actual contribution percentage, and

(*2*) Two percentage points plus the greater of the relevant actual deferral percentage or the relevant actual contribution percentage. In no event, however, may this amount exceed twice the greater of the relevant actual deferral percentage or the relevant actual contribution percentage.

(ii) *Relevant actual deferral percentage and relevant actual contribution percentage defined.* For purposes of paragraph (b)(3)(i) of this section, the term ''relevant actual deferral percentage'' means the actual deferral percentage of the group of nonhighly compensated employees eligible under the arrangement subject to section 401(k) for the plan year, and the term ''relevant actual contribution percentage'' means the actual contribution percentage of the group of nonhighly compensated employees eligible under the plan subject to section 401(m) for the plan year beginning with or within the plan year of the arrangement subject to section 401(k).

(iii) *Examples.* The provisions of this paragraph (b) are illustrated by the following examples:

Example 1. (i) Assume that Employer G maintains a plan that contains a cash or deferred arrangement under which the actual deferral percentages of highly compensated and nonhighly compensated employees are 5.5 and four percent respectively. The plan also permits employee contributions, and the actual contribution percentages for the two groups are 4.2 and three percent respectively. The multiple use of the alternative limitation is tested as follows:

(1) Greater of the relevant actual deferral percentage or the relevant actual contribution percentage	4.00
(2) 1.25 times (1)	5.00
(3) Lesser of the relevant actual deferral percentage or the relevant actual contribution percentage	3.00
(4) (3) plus two percentage points	5.00
(5) (2)+(4)	10.00
(6) 1.25 times (3)	3.75
(7) (1) plus two percentage points	6.00
(8) (6)+(7)	9.75
(9) Aggregate limit greater of (5) or (8)	10.00

(ii) In this case, the sum of the actual deferral percentage and the actual contribution percentage of highly compensated employees is 9.70 percent, which is less than the aggregate limit. Therefore, there is no multiple use of the alternative limitation.

Example 2. Employer F maintains a plan subject to section 401(k) with a plan year beginning January 1, and a plan subject to section 401(m) with a plan year beginning July 1. The plan subject to section 401(k) does not correct excess contributions by recharacterization. The first actual deferral percentage taken into account is that for the plan year beginning January 1, 1989. The first actual contribution percentage taken into account is that for the plan year beginning July 1, 1989.

Example 3. (i) Employer E maintains a plan that contains a cash or deferred arrangement and provides for matching contributions. The actual deferral and contribution percentages for a plan year are as follows:

	Actual deferral percentage	Actual contribution percentage
Highly compensated	3.6	1.69
Nonhighly compensated	1.8	1.35

(ii) The actual deferral percentage of the highly compensated employees exceeds the normal limit (1.25 times 1.8, or 2.25%) but not the alternative limit (two plus 1.8, but not more than twice 1.8, or 3.6%). The actual contribution percentage of the highly compensated employees does not exceed the normal limit (1.25 times 1.35, or 1.69%). Accordingly, the plan satisfies both the actual deferral and contribution percentage tests. Since the actual contribution percentage of the highly compensated employees does not exceed the normal limit, condition (iv) of paragraph (b)(1) of this section is not satisfied. Therefore, there is no multiple use of the alternative limitation.

(c) *Correction of multiple use*—(1) *In general.* If multiple use of the alternative limitation occurs with respect to two or more plans or arrangements maintained by an employer, it must be corrected by reducing the actual deferral percentage, the actual contribution percentage of highly compensated employees, or a combination of the two, in the manner described in paragraph (c)(3) of this section. Instead of making this reduction, the employer may eliminate the multiple use of the alternative limitation by making qualified nonelective contributions in accordance with § 1.401(k)–1(b)(5) and (f)(1) or § 1.401(m)–1(b)(5) and (e)(1).

(2) *Treatment of required reduction.* The required reduction is treated as an excess contribution under the arrangement subject to section 401(k) or excess aggregate contribution under the plan subject to section 401(m). However, if an excess contribution arising under this section is recharacterized as an employee contribution, the recharacterized amount is treated as an excess aggregate contribution.

(3) *Required reduction.* The amount of the reduction of the actual deferral percentage of the entire group of highly compensated employees eligible in the arrangement subject to section 401(k) is calculated in the manner described in § 1.401(k)–1(f)(2) or the amount of the reduction of the actual contribution percentage of the entire group of highly compensated employees eligible in the plan subject to section 401(m) is calculated in the manner described in § 1.401(m)–1(e)(2), as designated in the plan, so that there is no multiple use of the alternative limitation. The employer may elect to reduce the actual deferral ratios or the actual contribution ratios, as designated in the plan, either for all highly compensated employees under the plan or arrangements subject to reduction or for only those highly compensated employees who are eligible in both the arrangement subject to section 401(k) and the plan subject to section 401(m).

(4) *Examples.* The principles of this paragraph (c) are illustrated by the following examples. In all cases, the employer maintains both an arrangement subject to section 401(k) and a plan subject to section 401(m). Assume that there is no income or loss allocable to the elective, employee, or matching contributions.

Example 1. (i) All employees of Employer Q are eligible in both an arrangement subject to section 401(k) and a plan subject to section 401(m). Both plans have a calendar plan year. The plans provide that multiple use of the alternative limitation will be corrected in the plan subject to section 401(m) and that any required reduction in actual contribution ratios will apply only to employees eligible to participate in both arrangements. Employer Q includes elective contributions in compensation as permitted under § 1.414(s)–1(c)(4)(i). See § 1.401(k)–1(g)(2)(i). Employees X and Y are highly compensated. Each received compensation of $100,000, deferred $6,000, received a $3,000 matching contribution, and made employee contributions of $3,000. Actual deferral and contribution percentages under the arrangement and plan for the 1989 plan year are shown below. No excess deferrals, excess contributions, or excess aggregate contributions have yet been required to be distributed, forfeited, or recharacterized under the plan.

	Actual deferral percentage	Actual contribution percentage
Highly compensated	6	6
Nonhighly compensated	4	4

(ii) The aggregate limit and amount required, to be corrected are determined as follows:

Step 1: Determination of Aggregate Limit

(1) Greater of relevant actual deferral percentage or relevant actual contribution percentage	4.0
(2) 1.25 times (1)	5.0
(3) Lesser of relevant actual deferral percentage or relevant actual contribution percentage	4.0
(4) (3) plus two percentage points	6.0
(5) (2)+(4)	11.0
(6) 1.25 times (3)	5.0
(7) (1) plus two percentage points	6.0
(8) (6)+(7)	11.0
(9) Aggregate limit Greater of (5) or (8)	11.0

Step 2: Calculation of Correction Amount

(10) Actual deferral percentage of highly compensated	6.0
(11) Maximum permitted actual contribution percentage of highly compensated ((9)–(10))	5.0
(12) Amount taken into account in determining actual contribution percentage of highly compensated Employee X	$6,000
(13) Maximum amount permitted without use of alternative limitation ((11)×compensation of Employee X)	$5,000
(14) Excess aggregate contribution ((12)–(13))	$1,000

(iii) A similar correction must be made for Employee Y.

Example 2. Same as *Example 1,* but the plan corrects the multiple use in the arrangement subject to section 401(k) and provides that excess contributions are recharacterized. In this case, the aggregate limit for the plans will be 11 percent. Similarly, the excess contributions for Employees X and Y, determined in a manner analogous to that used in *Example 1,* will be $1,000. When this is recharacterized, the actual contribution percentage for these employees will increase to seven percent, resulting in an excess aggregate contribution of $1,000 that must be distributed.

Example 3. Same as *Example 1,* except that Employee Y is not eligible to participate in the arrangement subject to section 401(k). No reduction of Y's actual contribution ratio is required because Y is only in the plan subject to section 401(m). In order to reduce the actual contribution percentage of the entire group of highly compensated employees eligible for the plan subject to section 401(m) to five percent, the plan must reduce X's actual contribution percentage to four percent. X's employee and matching contributions are limited to $4,000. Therefore X has an excess aggregate contribution of $2,000.

(d) *Effective date*—(1) *General rule.* This section is effective for plan years beginning after December 31, 1988, or such later date provided in § 1.402(m)–1(g).

(2) *Transition rule.* For plan years beginning before January 1, 1992, a reasonable interpretation of the rules set forth in sections 401 (k) and (m) of the Internal Revenue Code (as in effect during those years) may be relied upon to determine whether a plan was qualified during those years. For plan years beginning before January 1, 1992, a plan may be restructured only in accordance with § 1.401(k)–1(h)(3)(iii) or § 1.401(m)–1(g)(5)(ii).

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§ 1.402(a)–1 Taxability of beneficiary under a trust which meets the requirements of section 401(a).

(a) *In general.* (1)(i) Section 402 relates to the taxation of the beneficiary of an employees' trust. If an employer makes a contribution for the benefit of an employee to a trust described in section 401(a) for the taxable year of the employer which ends within or with a taxable year of the trust for which the trust is exempt under section 501(a), the employee is not required to include such contribution in his income except for the year or years in which such contribution is distributed or made available to him. It is immaterial in the case of contributions to an exempt trust whether the employee's rights in the contributions to the trust are forfeitable or nonforfeitable either at the time the contribution is made to the trust or thereafter.

(ii) The provisions of section 402(a) relate only to a distribution by a trust described in section 401(a) which is exempt under section 501(a) for the taxable year of the trust in which the distribution is made. With two exceptions, the distribution from such an exempt trust when received or made available is taxable to the distributee to the extent provided in section 72 (relating to annuities). First, for taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such distributions. For taxable years beginning after December 31, 1963, such distributions may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). Secondly, certain total distributions described in section 402(a)(2) are taxable as long-term capital gains. For the treatment of such total distributions, see subparagraph (6) of this paragraph. Under certain circumstances, an amount representing the unrealized appreciation in the value of the securities of the employer is excludable from gross income for the year of distribution. For the rules relating to such exclusion, see paragraph (b) of this section. Furthermore, the exclusion provided by section 105(d) is applicable to a distribution from a trust described in section 401(a) and exempt under section 501(a) if such distribution constitutes wages or payments in lieu of wages for a period during which an employee is absent from work on account of a personal injury or sickness. See §1.72–15 for the rules relating to the tax treatment of accident or health benefits received under a plan to which section 72 applies.

(iii) Except as provided in paragraph (b) of this section, a distribution of property by a trust described in section 401(a) and exempt under section 501(a) shall be taken into account by the distributee at its fair market value.

(iv) If a trust is exempt for the taxable year in which the distribution occurs, but was not so exempt for one or more prior taxable years under section 501(a) (or under section 165(a) of the Internal Revenue Code of 1939 for years to which such section was applicable), the contributions of the employer which were includible in the gross income of the employee for the taxable year when made shall, in accordance with section 72(f), also be treated as part of the consideration paid by the employee.

(v) If the trust is not exempt at the time the distribution is received by or made available to the employee, see section 402(b) and paragraph (b) of §1.402(b)–1.

(vi) For the treatment of amounts paid to provide medical benefits described in section 401(h) as defined in paragraph (a) of §1.401–14, see paragraph (h) of §1.72–15.

(2) If a trust described in section 401(a) and exempt under section 501(a) purchases an annuity contract for an employee and distributes it to the employee in a year for which the trust is exempt, the contract containing a cash surrender value which may be available to an employee by surrendering the contract, such cash surrender value will not be considered income to the employee unless and until the contract is surrendered. For the rule as to nontransferability of annuity contracts issued after 1962, see paragraph (b)(2) of §1.401–9. If, however, the contract distributed by such exempt trust is a retirement income, endowment, or other life insurance contract and is distributed after October 26, 1956, the entire cash value of such contract at the time of distribution must be included in the distributee's income in accordance with the provisions of section 402(a), except to the extent that, within 60 days after the distribution of such contract, all or any portion of such value is irrevocably converted into a contract under which no part of any proceeds payable on death at any time would be excludable under section 101(a) (relating to life insurance proceeds). If the contract distributed by such trust is a transferable annuity contract issued after 1962, or a retirement income, endowment, or other life insurance contract which is distributed after 1962 (whether or not transferable), then notwithstanding the preceding sentence the entire cash value of the contract is includible in the distributee's gross income, unless within such 60 days such contract is also made nontransferable.

(3) For the rules applicable to premiums paid by a trust described in section 401(a) and exempt under section 501(a) for the purchase of retirement income, endowment, or other contracts providing life insurance protection payable upon the death of the employee-participant, see paragraph (b) of §1.72–16.

(4) For the rules applicable to the amounts payable by reason of the death of an employee under a contract providing life insurance protection, or an annuity contract, purchased by a trust described in section 401(a) and exempt under section 501(a), see paragraph (c) of §1.72–16.

(5) If pension or annuity payments or other benefits are paid or made available to the beneficiary of a deceased employee or a deceased retired employee by a trust described in section 401(a) which is exempt under section 501(a), such amounts are taxable in accordance with the rules of section 402(a) and this section. In case such amounts are taxable under section 72, the ''investment in the contract'' shall be determined by reference to the amount contributed by the employee

and by applying the applicable rules of sections 72 and 101(b)(2)(D). In case the amounts paid to, or includible in the gross income of, the beneficiaries of the deceased employee or deceased retired employee constitute a distribution to which subparagraph (6) of this paragraph is applicable, the extent to which the distribution is taxable is determined by reference to the contributions of the employee, by reference to any prior distributions which were excludable from gross income as a return of employee contributions, and by applying the applicable rules of sections 72 and 101(b).

(6)(i) If the total distributions payable with respect to any employee under a trust described in section 401(a) which in the year of distribution is exempt under section 501(a) are paid to, or includible in the gross income of, the distributee within one taxable year of the distributee on account of the employee's death or other separation from the service, or death after such separation from service, the amount of such distribution, to the extent it exceeds the net amount contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than six months. The total distributions payable are includible in the gross income of the distributee within one taxable year if they are made available to such distributee and the distributee fails to make a timely election under section 72(h) to receive an annuity in lieu of such total distributions. The ''net amount contributed by the employee'' is the amount actually contributed by the employee plus any amounts considered to be contributed by the employee under the rules of section 72(f), 101(b), and subparagraph (3) of this paragraph, reduced by any amounts theretofore distributed to him which were excludable from gross income as a return of employee contributions. See, however, paragraph (b) of this section for rules relating to the exclusion of amounts representing net unrealized appreciation in the value of securities of the employer corporation. In addition, all or part of the amount otherwise includible in gross income under this paragraph by a non-resident alien individual in respect of a distribution by the United States under a qualified pension plan may be excludable from gross income under section 402(a)(4). For rules relating to such exclusion, see paragraph (c) of this section. For additional rules relating to the treatment of total distributions described in this subdivision in the case of a nonresident alien individual, see sections 871 and 1441 and the regulations thereunder.

(ii) The term ''total distributions payable'' means the balance to the credit of an employee which becomes payable to a distributee on account of the employee's death or other separation from the service or on account of his death after separation from the service. Thus, distributions made before a total distribution (for example, annuity payments received by the employee after retirement), will not defeat application of the capital gains treatment with respect to the total distributions received by a beneficiary upon the death of the employee after retirement. However, a distribution on separation from service will not receive capital gains treatment unless it constitutes the total amount in the employee's account at the time of his separation from service. If the total amount in the employee's account at the time of his death or other separation from the service or death after separation from the service is paid or includible in the gross income of the distributee within one taxable year of the distributee, such amount is entitled to the capital gains treatment notwithstanding that in a later taxable year an additional amount, attributable to the last year of service, is credited to the account of the employee and distributed.

(iii) If an employee retires and commences to receive an annuity but subsequently, in some succeeding taxable year, is paid a lump sum in settlement of all future annuity payments, the capital gains treatment does not apply to such lump sum settlement paid during the lifetime of the employee since it is not a payment on account of separation from the service, or death after separation, but is on account of the settlement of future annuity payments.

(iv) If the ‘‘total distributions payable’’ are paid or includible in the gross income of several distributees within one taxable year on account of the employee's death or other separation from the service or on account of his death after separation from the service, the capital gains treatment is applicable. The total distributions payable are paid within one taxable year of the distributees when, for example, a portion of such total is distributed in cash to one distributee and the balance is used to purchase an annuity contract which is distributed to the other distributee. However, if the share of any distributee is not paid or includible in his gross income within the same taxable year in which the shares of the other distributees are paid or includible in their gross income, none of the distributees is entitled to the capital gains treatment, since the total distributions payable are not paid or includible in the distributees' gross income within one taxable year. For example, if the total distributions payable are made available to each of two distributees and one elects to receive his share in cash while the other makes a timely election under section 72(h) to receive his share in installment payments from the trust, the capital gains treatment does not apply to either distributee.

(v) For regulations as to certain plan terminations, see §1.402(e)–1.

(vi) The term ‘‘total distributions payable’’ does not include United States Retirement Plan Bonds held by a trust to the credit of an employee. Thus, a distribution by a qualified trust may constitute a total distributions payable with respect to an employee even though the trust retains retirement plan bonds registered in the name of such employee. Similarly, the proceeds of a retirement plan bond received as a part of the total amount to the credit of an employee will not be entitled to capital gains treatment. See section 405(e) and paragraph (a)(4) of §1.405–3.

(vii) For purposes of determining whether the total distributions payable to an employee have been distributed within one taxable year, the term ‘‘total distributions payable’’ includes amounts held by a trust to the credit of an employee which are attributable to contributions on behalf of the employee while he was a self-employed individual in the business with respect to which the plan was established. Thus, a distribution by a qualified trust is not a total distributions payable with respect to an employee if the trust retains amounts which are so attributable.

(viii) The term ‘‘total distributions payable’’ does not include any amount which has been placed in a separate account for the funding of medical benefits described in section 401(h) as defined in paragraph (a) of §1.401–14. Thus, a distribution by a qualified trust may constitute a total distributions payable with respect to an employee even though the trust retains amounts attributable to the funding of medical benefits described in section 401(h).

(7) The capital gains treatment provided by section 402(a)(2) and subparagraph (6) of this paragraph is not applicable to distributions paid to a distributee to the extent such distributions are attributable to contributions made on behalf of an employee while he was a self-employed individual in the business with respect to which the plan was established. For the taxation of such amounts, see §1.72–18. For the rules for determining the amount attributable to contributions on behalf of an employee while he was self-employed, see paragraphs (b)(4) and (c)(2) of such section.

(8) For purposes of this section, the term ‘‘employee’’ includes a self-employed individual who is treated as an employee under section 401(c)(1), and paragraph (b) of §1.401–10, and the term ‘‘employer’’ means the person treated as the employer of such individual under section 401(c)(4).

(b) *Distributions including securities of the employer corporation*—(1) *In general.* (i) If a trust described in section 401(a) which is exempt under section 501(a) makes a distribution to a distributee, and such distribution includes securities of the employer corporation, the amount of any net unrealized appreciation in such securities shall be excluded from the distributee's income in the year of such distribution to the following extent:

(A) If the distribution constitutes a total distribution to which the regulations of paragraph (a)(6) of this section are applicable, the amount to be excluded is the entire net unrealized appreciation attributable to that part of the total distribution which consists of securities of the employer corporation; and

(B) If the distribution is other than a total distribution to which paragraph (a)(6) of this section is applicable, the amount to be excluded is that portion of the net unrealized appreciation in the securities of the employer corporation which is attributable to the amount considered to be contributed by the employee to the purchase of such securities.

The amount of net unrealized appreciation which is excludable under the regulations of (A) and (B) of this subdivision shall not be included in the basis of the securities in the hands of the distributee at the time of distribution for purposes of determining gain or loss on their subsequent disposition. In the case of a total distribution the amount of net unrealized appreciation which is not included in the basis of the securities in the hands of the distributee at the time of distribution shall be considered as a gain from the sale or exchange of a capital asset held for more than six months to the extent that such appreciation is realized in a subsequent taxable transaction. However, if the net gain realized by the distributee in a subsequent taxable transaction exceeds the amount of the net unrealized appreciation at the time of distribution, such excess shall constitute a long-term or short-term capital gain depending upon the holding period of the securities in the hands of the distributee.

(ii) For purposes of section 402(a) and of this section, the term ''securities'' means only shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form, and the term ''securities of the employer corporation'' includes securities of a parent or subsidiary corporation (as defined in subsections (e) and (f) of section 425) of the employer corporation.

(2) *Determination of net unrealized appreciation.* (i) The amount of net unrealized appreciation in securities of the employer corporation which are distributed by the trust is the excess of the market value of such securities at the time of distribution over the cost or other basis of such securities to the trust. Thus, if a distribution consists in part of securities which have appreciated in value and in part of securities which have depreciated in value, the net unrealized appreciation shall be considered to consist of the net increase in value of all of the securities included in the distribution. For this purpose, two or more distributions made by a trust to a distributee in a single taxable year of the distributee shall be treated as a single distribution.

(ii) For the purpose of determining the net unrealized appreciation on a distributed security of the employer corporation, the cost or other basis of such security to the trust shall be computed in accordance with whichever of the following rules is applicable:

(A) If a security was earmarked for the account of a particular employee at the time it was purchased by or contributed to the trust so that the cost or other basis of such security to the trust is reflected in the account of such employee, such cost or other basis shall be used.

(B) If as of the close of each taxable year of the trust (or other specified period of time not in excess of 12 consecutive calendar months) the trust allocates among the accounts of participating employees all securities acquired by the trust during the period (exclusive of securities unallocated under a plan providing for allocation in whole shares only), the cost or other basis to the trust of any securities allocated as of the close of a particular allocation period shall be the average cost or other basis to the trust of all securities of the same type which were purchased or otherwise acquired by the trust during such allocation period. For purposes of determining the average cost to the trust of securities included in a subsequent allocation, the actual cost to the trust of the securities unallocated as of the close of a prior allocation period shall be deemed to be the average cost or other basis to the trust of securities of the same type allocated as of the close of such prior allocation period.

(C) In a case where neither *(a)* nor *(b)* of this subdivision is applicable, if the trust fund, or a specified portion thereof, is invested exclusively in one particular type of security of the employer corporation, and if during the period the distributee participated in the plan none of such securities has been sold except for the purpose of paying benefits under the trust or for the purpose of enabling the trustee to obtain funds with which to exercise rights which have accrued to the trust, the cost or other basis to the trust of all securities distributed to such distributee shall be the total amount credited to the account of such distributee (or such portion thereof as was available for investment in such securities) reduced by the amount available for investment but uninvested on the date of distribution. If at the time of distribution to a particular distributee a portion of the amount credited to his account is forfeited, appropriate adjustment shall be made with respect thereto in determining the cost or other basis to the trust of the securities distributed.

(D)(*1*) In all other cases, there shall be used the average cost (or other basis) to the trust of all securities of the employer corporation of the type distributed to the distributee which the trust has on hand at the time of the distribution, or which the trust had on hand on a specified inventory date which date does not precede the date of distribution by more than twelve calendar months. If a distribution includes securities of the employer corporation of more than one type, the average cost (or other basis) to the trust of each type of security distributed shall be determined. The average cost to the trust of securities of the employer corporation on hand on a specified inventory date (or on hand at the time of distribution) shall be computed on the basis of their actual cost, considering the securities most recently purchased to be those on hand, or by means of a moving average calculated by subtracting from the total cost of securities on hand immediately preceding a particular sale or distribution an amount computed by multiplying the number of securities sold or distributed by the average cost of all securities on hand preceding such sale or distribution.

(*2*) These methods of computing average cost may be illustrated by the following examples:

Example 1. A, a distributee who makes his income tax returns on the basis of a calendar year, receives on August 1, 1954, in a total distribution, to which paragraph (a)(6) of this section is applicable, ten shares of class D stock of the employer corporation. On July 1, 1954 (the specified inventory date of the trust), the trust had on hand 80 shares of class D stock. The average cost of the 10 shares distributed, on the basis of the actual cost method, is $100 computed as follows:

Shares	Purchase date	Cost per share	Total cost
20	June 24, 1954	$101	$2,020
40	Jan. 10, 1953	102	4,080
20	Oct. 20, 1952	95	1,900
80	....	8,000	

Example 2. B, a distributee who makes his income tax returns on the basis of a calendar year, receives on October 31, 1954, in a total distribution, to which paragraph (a)(6) of this section is applicable, 20 shares of class E stock of the employer corporation. The specified inventory date of the trust is the last day of each calendar year. The trust had on hand on December 31, 1952, 1,000 shares of class E stock of the employer corporation. During the calendar year 1953 the trust distributed to four distributees a total of 100 shares of such stock and acquired, through a number of purchases, a total of 120 shares. The average cost of the 20 shares distributed to B, on the basis of the moving average method, is $52 computed as follows:

	Shares	Total cost	Average cost
On hand Dec. 31, 1952	1,000	$50,000	$50
Distributed during 1953 at average cost of $50	100	5,000	(0)
	900	45,000	(0)
Purchased during 1953	120	8,000	(0)
On hand Dec. 31, 1953	1,020	53,040	52

(*3*) *Unrealized appreciation attributable to employee contributions.* In any case in which it is necessary to determine the amount of net unrealized appreciation in securities of the employer corporation which is attributable to contributions made by an employee:

(*i*) The cost or other basis of the securities to the trust and the amount of net unrealized appreciation shall first be determined in accordance with the regulations in subparagraph (2) of this paragraph;

(*ii*) The amount contributed by the employee to the purchase of the securities shall be solely the portion of his actual contributions to the trust properly allocable to such securities, and shall not include any part of the increment in the trust fund expended in the purchase of the securities;

(*iii*) The amount of net unrealized appreciation in the securities distributed which is attributable to the contributions of the employee shall be that proportion of the net unrealized appreciation determined under the regulations of subparagraph (2) of this paragraph which the contributions of the employee properly allocable to such securities bear to the cost or other basis to the trust of the securities;

(*iv*) If a distribution consists solely of securities of the employer corporation, the contributions of the employee expended in the purchase of such securities shall be allocated to the securities distributed in a manner consistent with the principles set forth in subparagraph (2)(ii) (*a*), (*b*), (*c*), or (*d*) of this paragraph, whichever is applicable. Thus, the amount of the employee's contribution which can be identified as having been expended in the purchase of a particular security shall be allocated to such security, and the amount of such contribution which cannot be so identified shall be allocated ratably among the securities distributed. If a distribution consists in part of securities of the employer corporation and in part of cash or other property, appropriate allocation of a portion of the employee's contribution to such cash or other property shall be made unless such a location is inconsistent with the terms of the plan or trust.

(*v*) The application of this subparagraph may be illustrated by the following example:

Example. A trust distributes ten shares of stock issued by the employer corporation each of which has an average cost to the trust of $100, consisting of employee contributions in the amount of $60 and employer contributions in the amount of $40, and on the date of distribution has a fair market value of $180. The portion of the net unrealized appreciation attributable to the contributions of the employee with respect to each of the shares of stock is $48 computed as follows:

(1) Value of one share of stock on distribution date	$180
(2) Employee contributions	60
(3) Employer contributions	40
(4) Total contributions	100
(5) Net unrealized appreciation	80
(6) Portion of net unrealized appreciation attributable to employee contributions 60/100 (amount of employee contributions (item 2) over total contributions (item 4) of $80 (item 5)	48

(*vi*) For the purpose of determining gain or loss to the distributee in the year or years in which any share of stock referred to in the example in subdivision (*v*) of this subparagraph is sold or otherwise disposed of in a taxable transaction, the basis of each such share in the hands of the distributee at the time of the distribution by the trust will be $132 computed as follows:

(a) Employee contributions	$60
(b) Employer contributions (taxable as ordinary income in the year the securities were distributed)	40
(c) Portion of net unrealized appreciation attributable to employer contributions (item 5) minus (item 6) (taxable as ordinary income in the year the securities were distributed)	32
(d) Basis of stock	132

(*4*) *Change in exempt status of trust.* For principles applicable in making appropriate adjustments if the trust was not exempt for one or more years before the year of distribution, see paragraph (a) of this section.

(c) *Certain distributions by United States to nonresident alien individuals.* (1) This paragraph applies to a distribution—

(i) Which is made by the United States under a pension plan described in section 401(a);

(ii) Which is made in respect of services performed by an employee of the United States; and

(iii) Which is received by, or made available to, a nonresident alien individual (including a nonresident alien individual who is a beneficiary of a deceased employee) during a taxable year beginning after December 31, 1959.

The amount of such a distribution that is includible in the gross income of the nonresident alien individual under section 402(a) (1) or (2) shall not exceed an amount which bears the same ratio to the amount which would be includible in gross income if it were not for this paragraph, as—

(A) The aggregate basic salary paid by the United States to the employee for his services in respect of which the distribution is being made, reduced by the amount of such basic salary which was not includible in the employee's gross income by reason of being from sources without the United States, bears to

(B) The aggregate basic salary paid by the United States to the employee for his services in respect of which the distribution is being made.

See section 402(a)(4). See, also, paragraph (a) of this section for rules relating to the amount that is includible in gross income under section 402(a) (1) or (2) in the case of a distribution under a pension plan described in section 401(a).

(2) For purposes of applying section 402(a)(4) and this paragraph to distributions under the Civil Service Retirement Act (5 U.S.C. 2251), the term ''basic salary'' shall have the meaning provided in section 1(d) of such Act. In applying section 402(a)(4) and this paragraph to distributions under any other qualified pension plan of the United States, such term shall have a similar meaning. Thus, for example, ''basic salary'' does not, in any case, include bonuses, allowances, or overtime pay.

(3) The rules in this paragraph may be illustrated by the following examples:

Example 1. A, a retired employee of the United States who performed all of his services for the United States in a foreign country, receives, in respect of such services, a monthly pension of $200 under the Civil Service Retirement Act (a pension plan described in section 410(a)). A received an aggregate basic salary for his services for the United States of $100,000. A was a nonresident alien individual during the whole of his employment with the United States and, therefore, his basic salary from the United States was not includible in his gross income by reason of being from sources without the United States. A would be requited, under section 72 but without regard to section 402(a)(4) and this paragraph, to include $60 of each monthly pension payment in his gross income. The amount that is includible in A's gross income under section 402(a)(1) with respect to the monthly payments received during taxable years beginning after December 31, 1959, and while A is a nonresident alien individual, is computed as follows:

(i) Amount of distribution includible in gross income under section 72 without regard to section 402(a)(4)	$60
(ii) Aggregate basic salary for services for United States	100,000
(iii) Aggregate basic salary for services for United States reduced by amount of such salary not includible in A's gross income by reason of being from sources without the United States	0
(iv) Amount includible in A's gross income under section 402(a)(1) ((iii)÷(ii)×(i), or $0/$100,000×$60)	0

Example 2. B, a retired employee of the United States who performed services for the United States both in a foreign country and in the United States, receives, in respect of such services, a monthly pension of $240 under the Civil Service Retirement Act. B received an aggregate basic salary for his services for the United States of $120,000; $80,000 of which was for his services performed in the United States, and $40,000 of which was for his services performed in the foreign country. B was a nonresident alien individual during the whole of his employment with the United States and, consequently, the $40,000 basic salary for his services performed in the foreign country was not includible in his gross income by reason of being from sources without the United States. B would be required, under section 72 but without regard to section 402(a)(4) and this paragraph, to include $165 of each monthly pension in his gross income. The amount that is includible in B's gross income under section 402(a)(1) with respect to the monthly payments received during taxable years beginning after December 31, 1959, and while B is a nonresident alien individual, is computed as follows:

(i) Amount of distribution includible in gross income under section 72 without regard to section 402(a)(4)	$165
(ii) Aggregate basic salary for services for United States	120,000
(iii) Aggregate basic salary for services for United States reduced by amount of such salary not includible in B's gross income by reason of being from sources without the United States ($120,000 − $40,000)	80,000
(iv) Amount includible in B's gross income under section 402(a)(1)(iii)÷(ii)×(i), or $80,000/$120,000×$165)	110

(d) *Salary reduction, cash or deferred arrangements*—(1) *Inclusion in income.*

Whether a contribution to an exempt trust or plan described in section 401(a) or 403(a) is made by the employer or the employee is determined on the basis of the particular facts and circumstances of each case. Nevertheless, an amount contributed to a plan or trust will, except as otherwise provided under paragraph (d)(2) of this section, be treated as contributed by the employee if it was contributed at the employee's election, even though the election was made before the year in which the amount was earned by the employee or before the year in which the amount became currently available to the employee. Any amount treated as contributed by the employee is includible in the gross income of the employee for the year in which the amount would have been received by the employee but for the election. Thus, for example, amounts contributed to an exempt trust or plan by reason of a salary reduction agreement under a cash or deferred arrangement are treated as received by the employee when they would have been received by the employee but for the election to defer. Accordingly, they are includible in the gross income of the employee for that year (except as provided under paragraph (d)(2) of this section). See §1.401(k)–1(a)(3)(iii) and (2)(i) for the meaning of currently available and cash or deferred arrangement, respectively.

(2) *Amounts not included in income*—(i) *Qualified cash or deferred arrangement.* Elective contributions as defined in §1.401(k)–l (g)(3) for a plan year made by an employer on behalf of an employee pursuant to a cash or deferred election under a qualified cash or deferred arrangement, as defined in §1.401(k)–1(a)(4)(i), are not treated as received by or distributed to the employee or as employee contributions. For plan years beginning after December 31, 1992, whether a cash or deferred election is made under a qualified cash or deferred arrangement is determined without regard to the special rules for certain collectively bargained plans contained in §1.401(k)–1(a)(7). As a result, elective contributions under these plans are treated as employee contributions for purposes of this section if the cash or deferred arrangement does not satisfy the actual deferral percentage test of section 401(k)(3) or otherwise fails to be a qualified cash or deferred arrangement.

(ii) *Matching contributions.* Matching contributions described in §1.401(m)–1(f)(12) and section 401(m)(4) are not treated as contributed by an employee merely because they are made by the employer as a result of an employee's election.

(iii) *Effect of certain one-time elections.* Amounts contributed to an exempt plan or trust described in section 401(a) or 403(a) pursuant to the one-time irrevocable employee election to participate in a plan described in §1.401(k)–1(a)(3)(iv) are not treated as contributed by an employee. Similarly, amounts contributed to an exempt plan or trust described in section 401(a) or 403(a) in which self-employed individuals may participate pursuant to the one-time irrevocable election described in §1.401(k)–1(a)(6)(ii)(C) are not treated as contributed by an employee.

(3) *Effective date and transition rules*—(i) *Effective date.* In the case of a plan or trust that does not include a salary reduction or cash or deferred arrangement in existence on June 27, 1974, this paragraph applies to taxable years ending after that date.

(ii) *Transition rule for cash or deferred arrangements in existence on June 27, 1974*—(A) *General rule.* In the case of a plan or trust that includes a salary reduction or a cash or deferred arrangement in existence on June 27, 1974, this paragraph applies to plan years beginning after December 31, 1979 (or, in the case of a pre-ERISA money purchase plan, as defined in §1.401(k)–1(g)(12), plan years beginning after July 18, 1984). For plan years beginning prior to January 1, 1980 (or, in the case of a pre-ERISA money purchase plan, plan years beginning before July 19, 1984), the taxable year of inclusion in gross income of the employee of any amount so contributed by the employer to the trust is determined in a manner consistent with Rev. Rul. 56–497, 1956–2 CB 284, Rev. Rul. 63–180, 1963–2 CB 189, and Rev. Rul. 68–89, 1968–1 CB 402.

(B) *Meaning of cash or deferred arrangement in existence on June 27, 1974.* A cash or deferred arrangement is considered as in existence on June 27, 1974, if, on or before that date, it was reduced to writing and adopted by the employer (including, in the case of a corporate employer, formal approval by the employer's board of directors and, if required, shareholders), even though no amounts had been contributed pursuant to the terms of the arrangement as of that date.

(iii) *Reasonable interpretation for plan years beginning after 1979 and before 1992.* For plan years beginning after December 31, 1979 (or in the case of a pre-ERISA money purchase plan, plan years beginning after July 18, 1984) and before January 1, 1992, a reasonable interpretation of the rules set forth in section 401(k) (as in effect during those years) may be relied upon to determine whether contributions were made under a qualified cash or deferred arrangement.

(iv) *Special rule for collectively bargained plans.* For plan years beginning before January 1, 1993, a nonqualified cash or deferred arrangement will be treated as satisfying section 401(k)(3) solely for purposes of paragraph (d)(2)(i) of this section if it is part of a plan (or portion of a plan) that automatically satisfies section 401(a)(4) under §1.401(k)–1(a)(7), relating to certain collectively bargained plans.

(v) *Special rule for governmental plans.* For plan years beginning before the later of January 1, 1996, or 90 days after the opening of the first legislative session beginning on or after January 1, 1996, of the governing body with authority to amend the plan, if that body does not meet continuously, in the case of governmental plans described in section 414(d), a nonqualified cash or deferred arrangement will be treated as satisfying section 401(k)(3) solely for purposes of paragraph (d)(2)(i) of this section if it is part of a plan adopted by a state or local government before May 6, 1986. For purposes of this paragraph (d)(3)(v), the term *governing body with authority to amend the plan* means the legislature, board, commission, council, or other governing body with authority to amend the plan.

[T.D. 6500, 25 FR 11675, Nov. 26, 1960, as amended by T.D. 6497, 25 FR 10021, Oct. 20, 1960; T.D. 6676, 28 FR 10142, Sept. 17, 1963; T.D. 6717, 29 FR 4092, Mar. 28, 1964; T.D. 6722, 29 FR 5073, Apr. 14, 1964; T.D. 6823, 30 FR 6340, May 6, 1965; T.D. 6885, 31 FR 7800, June 2, 1966; T.D. 6887, 31 FR 8786, June 24, 1966; T.D. 8217, 53 FR 29673, Aug. 8, 1988; T.D. 8357, 56 FR 40545, Aug. 15, 1991; T.D. 8357, 57 FR 10290, Mar. 25, 1992; T.D. 8581, 59 FR 66180, Dec. 23, 1994]

§1.402(a)(5)–1T Rollovers of partial distributions from qualified trusts and annuities. (Temporary)

Q–1: Can an employee or the surviving spouse of a deceased employee roll over to an individual retirement account or annuity, described in section 408 (a) or (b), the taxable portion of a partial distribution from a qualifiedtrust described in section 401(a), a qualified plan described in section 403(a), or a tax-sheltered annuity contract under section 403(b)?

A–1: Yes. For distributions made after July 18, 1984, the taxable portion of a partial distribution may be rolled over within 60 days of the distribution to an individual retirement account or annuity.

Q–2: Are there special requirements applicable to rollovers of partial distributions?

A–2: Yes. Section 402(a)(5)(D)(i) specifies that no part of a partial distribution may be rolled over unless the distribution is equal to at least 50 percent of the balance to the credit of the employee in the contract or plan immediately before the distribution, and the distribution is not one of a series of periodic payments. For purposes of this section, the balance to the credit of an employee does not include any accumulated deductible employee contributions (within the meaning of section 72(o)). In addition, in calculating the balance to the credit for purposes of the 50 percent test, qualified plans are not to be aggregated with other qualified plans and tax-sheltered annuity contracts are not to be aggregated with other tax-sheltered annuity contracts. Also, in applying the 50 percent test to a surviving spouse, the balance to the credit is the maximum amount the spouse is entitled to receive under the plan or contract, rather than the total balance to the credit of the employee. The rollover of a partial distribution may result in adverse tax consequences; see section 402(a)(5)(D) (iii) and (iv).

Q–3: Are there any other requirements applicable to rollovers of partial distribution?

A–3: Yes. Section 402(a)(5)(D)(i)(III) requires the employee to elect, in conformance with Treasury regulations, to treat a contribution of a partial distribution to an IRA as a rollover contribution. An election is made by designating, in writing, to the trustee or issuer of the IRA at the time of the contribution that the contribution is to be treated as a rollover contribution. This requirement of a written designation to the trustee or issuer of the IRA is effective for contributions paid to the trustee or issuer of the IRA after March 20, 1986. For contributions paid to the trustee or issuer before March 21, 1986, an election is made by computing the individual's income tax liability on the income tax return for the taxable year in which the distribution occurs in a manner consistent with not including the distribution (or portion thereof) in gross income. Both such elections are irrevocable, except that an election made on an income tax return filed before March 21, 1986 is revocable.

Q–4: Does the election requirement apply to rollovers of qualified total distributions or rollover contributions described in section 402(a) (5) or (7), 403(a)(4), 403(b)(8), 405(d)(3), or 408(d)(3) to individual retirement accounts and annuities (IRAs)?

A–4: Yes. No amounts may be treated as a rollover contribution to an IRA under section 402(a)(5), 402(a)(7), 403(a)(4), 403(b)(8), 405(d)(3) (as amended by section 491(c) of the TRA of 1984), or 408(d)(3) unless the requirements described in Q & A–3 of this section are satisfied. Thus, once any portion of a total distribution is irrevocably designated as a rollover contribution, such distribution is not taxable under section 402 or 403 and, therefore, is not eligible for the special capital gains and separate tax treatment under section 402 (a) and (e). Election requirements for rollover contributions to IRAs described in this Q &A–4 are subject to the same effective date rules set forth in Q &A–3.

[T.D. 8073, 51 FR 4320, Feb. 4, 1986]

§ 1.402(b)–1 Treatment of beneficiary of a trust not exempt under section 501(a).

(a) *Taxation by reason of employer contributions made after August 1, 1969*—(1) *Taxation of contributions.* Section 402(b) provides rules for taxing an employee on contributions made on his behalf by an employer to an employees' trust that is not exempt under section 501(a). In general, any such contributions made after August 1, 1969, during a taxable year of the employer which ends within or with a taxable year of the trust for which it is not so exempt shall be included as compensation in the gross income of the employee for his taxable year during which the contribution is made, but only to the extent that the employee's interest in such contribution is substantially vested at the time the contribution is made. The preceding sentence does not apply to contracts referred to in the transitional rule of paragraph (d)(1) (ii) or (iii) of this section. For the definition of the terms ''substantially vested'' and ''substantially nonvested'' see § 1.83–3(b).

(2) *Determination of amount of employer contributions.* If, for an employee, the actual amount of employer contributions referred to in paragraph (a)(1) of this section for any taxable year of the employee is not known, such amount shall be either an amount equal to the excess of—

(i) The amount determined in accordance with the formula described in § 1.403(b)–1(d)(4) as the end of such taxable year, over

(ii) The amount determined in accordance with the formula described in § 1.403(b)–1(d)(4) as of the end of the prior taxable year,

or the amount determined under any other method utilizing recognized actuarial principles that are consistent with the provisions of the plan under which such contributions are made and the method adopted by the employer for funding the benefits under the plan.

(b) *Taxability of employee when rights under nonexempt trust change from nonvested to vested*—(1) *In general.* If rights of an employee under a trust become substantially vested during a taxable year of the employee (ending after August 1, 1969), and a taxable year of the trust for which it is not exempt under section 501(a) ends with or within such year, the value of the employee's interest in the trust on the date of such change shall be included in his gross income for such taxable year, to the extent provided in paragraph (b)(3) of this section. When an employees' trust that was exempt under section 501(a) ceases to be so exempt, an employee shall include in his gross income only amounts contributed to the trust during a taxable year of the employer that ends within or with a taxable year of the trust in which it is not so exempt (to the same extent as if the trust had not been so exempt in all prior taxable years).

(2) *Value of an employee's interest in a trust.* (i) For purposes of this section, the term ''the value of an employee's interest in a trust'' means the amount of the employee's beneficial interest in the net fair market value of all the assets in the trust as of any date on which some or all of the employee's interest in the trust becomes substantially vested. The net fair market value of all the assets in the trust is the total amount of the fair market values (determined without regard to any lapse restriction, as defined in §1.83–3(h)) of all the assets in the trust, less the amount of all the liabilities (including taxes) to which such assets are subject or which the trust has assumed (other than the rights of any employee in such assets), as of the date on which some or all of the employee's interest in the trust becomes substantially vested.

(ii) If a separate account in a trust for the benefit of two or more employees is not maintained for each employee, the value of an employee's interest in such trust shall be determined in accordance with the formula described in §403(b)–1(d)(4) or any other method utilizing recognized actuarial principles that are consistent with the provisions of the plan under which the contributions are made and the method adopted by the employer for funding the benefits under the plan.

(iii) If there is no valuation of a nonexempt trust's assets on the date of the change referred to in paragraph (b)(1) of this section, the value of an employee's interest in such trust is determined by taking the weighted average of the values on the nearest valuation dates occurring before and after the date of such change. The average is to be determined in the manner described in §20.2031–2(b)(1).

(3) *Extent to which value of an employee's interest is includible in gross income.* For purposes of paragraph (b)(1) of this section, there shall be included in the gross income of the employee for his taxable year in which his rights under the trust become substantially vested only that portion of the value of his interest in the trust that is attributable to contributions made by the employer after August 1, 1969. However, the preceding sentence shall not apply—

(i) To the extent such value is attributable to a contribution made on the date of such change, and

(ii) To the extent such value is attributable to contributions described in paragraph (d)(1) (ii) or (iii) of this section (relating to contributions made pursuant to a binding contract entered into before April 22, 1969).

For purposes of this (3), if the value of an employee's interest in a trust which is attributable to contributions made by the employer after August 1, 1969, is not known, it shall be deemed to be an amount which bears the same ratio to the value of the employee's interest as the contributions made by the employer after such date bear to the total contributions made by the employer.

(4) *Partial vesting.* For purposes of paragraph (b)(1) of this section, if only part of an employee's interest in the trust becomes substantially vested during any taxable year, then only the corresponding part of the value of the employee's interest in such trust is includible in his gross income for such year. In such a case, it is first necessary to compute, under the rules in

paragraphs (b) (1) and (2) of this section, the amount that would be includdible if his entire interest had changed to a substantially vested interest during such a year. The amount that is includible under this paragraph (4) is the amount determined under the preceding sentence multiplied by the percent of the employee's interest which became substantially vested during the taxable year.

(5) *Basis.* The basis of any employee's interest in a trust to which this section applies shall be increased by the amount included in his gross income under this section.

(6) *Treatment as owner of trust.* In general, a beneficiary of a trust to which this section applies may not be considered to be the owner under subpart E, part I, subchapter J, chapter I of the Code of any portion of such trust which is attributable to contributions to such trust made by the employer after August 1, 1969, or to incidental contributions made by the employee after such date. However, where contributions made by the employee are not incidental when compared to contributions made by the employer, such beneficiary shall be considered to be the owner of the portion of the trust attributable to contributions made by the employee, if the applicable requirements of such subpart E are satisfied. For purposes of this paragraph (6), contributions made by an employee are not incidental when compared to contributions made by the employer if the employee's total contributions as of any date exceed the employer's total contributions on behalf of the employee as of such date.

(7) *Example.* The provisions in this paragraph may be illustrated by the following example:

Example. On January 1, 1968 M corporation establishes an employees' trust, which is not exempt under section 501(a), for some of its employees, including A, reserving the right to discontinue contributions at any time. M corporation contributes $5,000 on A's behalf to the trust on February 1, 1968. At the time of contribution 50 percent of A's interest was substantially vested. On January 1, 1971, and January 1, 1974, M corporation makes additional $5,000 contributions to the trust on A's behalf. A's interest in the trust changed from a 50 percent substantially vested to a 100 percent substantialy vested interest in the trust on December 31, 1974. Assume that the value of A's interest in the trust on December 31, 1974, which is attributable to employer contributions made after August 1, 1969, is calculated to be $11,000 under paragraph (b)(3) of this section. The amount includible in A's gross income for 1971 and 1974 is computed as follows:

(i) Amount of M corporation's contribution made on January 1, 1971, to the trust which is includible in A's gross income under paragraph (b)(1) of this section (50 percent substantially vested interest in the trust times $5,000 contribution)—$2,500.

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(i) Amount of M corporation's contribution made on January 1, 1974, to the trust which is includible in A's gross income under paragraph (b)(1) of this section (50 percent substantially vested interest in the trust times $5,000 contribution)—$2,500.

(ii) Amount which would have been includible if A's entire interest had changed to a substantially vested interest (value of employee's interest in the trust attributable to employer contributions made after August 1, 1969—$11,000.

(iii) Percent of A's interest that became substantially vested on December 31, 1974—50 percent.

(iv) Amount includible in A;s gross income for 1974 in respect of his percentage change from a substantially nonvested to a substantially vested interest in the trust (50 percent of $11,000)—$5,500.

(v) Total amount includible in A's gross income for 1974 ((i) plus (iv))—$8,000.

(c) *Taxation of distributions from trust not exempt under section 501(a)*—(1) *In general.* Any amount actually distributed or made available to any distributee by an employees' trust in a taxable year in which it is not exempt under section 501(a) shall be taxable under section 72 (relating to annuities) to the distributee in the taxable year in which it is so distributed or made available. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). If, for example, the distribution from such a trust consists of an annuity contract, the amount of the distribution shall be considered to be the entire value of the contract at the time of distribution. Such value is includible in the gross income of the distributee to the extent that such value exceeds the investment in the contract, determined by applying sections 72 and 101(b). The distributions by such a trust shall be taxed as provided in section 72 whether or not the employee's rights to the contributions become substantially vested beforehand. For rules relating to the treatment of employer contributions to a nonexempt trust as part of the consideration paid by the employee, see section 72(f). For rules relating to the treatment of the limited exclusion allowable under section 101(b)(2)(D) as additional consideration paid by the employee, see the regulations under that section.

(2) *Distributions before annuity starting date.* Any amount distributed or made available to any distributee before the annuity starting date (as defined in section 72(c)(4)) by an employees' trust in a taxable year in which it is not exempt under section 501(a) shall be treated as distributed in the following order—

(i) First, from that portion of the employee's interest in the trust attributable to contributions made by the employer after August 1, 1969 (other than those referred to in paragraph (d)(1) (ii) or (iii) of this section) that has not been previously includible in the employee's gross income, to the extent that such a distribution is permitted under the trust (or the plan of which the trust is a part);

(ii) Second, from that portion of the employee's interest in the trust attributable to contributions made by the employer on or before August 1, 1969 (or contributions referred to in paragraph (d)(1) (ii) or (iii) of this section);

(iii) Third, from the remaining portion of the employee's interest in the trust attributable to contributions made by the employer.

If the employee has made contributions to the trust, amounts attributable thereto shall be treated as distributed prior to any amounts attributable to the employer's contributions, to the extent provided by the trust (or the plan of which the trust is a part). However, the portion of such amounts attributable to income earned on the employee's contributions made after August 1, 1969, shall be treated as distributed prior to any return of such contributions.

(d) *Taxation by reason of employer contributions made on or before August 1, 1969.* (1) Except as provided in section 402(d) (relating to taxable years beginning before January 1, 1977), any contribution to a trust made by an employer on behalf of an employee—

(i) On or before August 1, 1969, or

(ii) After such date, pursuant to a binding contract (as defined in §1.83–3(b)(2)) entered into before April 22, 1969, or

(iii) After August 1, 1969, pursuant to a written plan in which the employee participated on April 22, 1969, and under which the obligation of the employer on such date was essentially the same as under a binding written contract, during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt under section 501(a) shall be included in income of the employee for his taxable year during which the contribution is made, if the employee's beneficial interest in the contribution is nonforfeitable at the time the contribution is made. If the employee's beneficial interest in the contribution is forfeitable at the time the contribution is made, even though his interest becomes nonforfeitable later the amount of such contribution is not required to be included in the income of the employee at the time his interest becomes nonforfeitable.

(2)(i) An employee's beneficial interest in the contribution is nonforfeitable, within the meaning of sections 402(b), 403(c), and 404(a)(5) prior to the amendments made thereto by the Tax Reform Act of 1969 and section 403(b), at the time the contribution is made if there is no contingency under the plan that may cause the employee to lose his rights in the contribution. Similarly, an employee's rights under an annuity contract purchased for him by his employer change from forfeitable to nonforfeitable rights within the meaning of section 403(d) prior to the repeal thereof by the Tax Reform Act of 1969 at that time when, for the first time, there is no contingency which may cause the employee to lose his rights under the contract. For example, if under the terms of a pension plan, an employee upon termination of his services before the retirement date, whether voluntarily or involuntarily, is entitled to a deferred annuity contract to be purchased with the employer's contributions made on his behalf, or is entitled to annuity payments which the trustee is abligated to make under the terms of the trust instrument based on the contributions made by the employer on his behalf, the employee's beneficial interest in such contributions is nonforfeitable.

(ii) On the other hand, if, under the terms of a pension plan, an employee will lose the right to any annuity purchased from or to be provided by, contributions made by the employer if his services should be terminated before retirement, his beneficial interest in such contributions is nonforfeitable.

(iii) The mere fact that an employee may not live to the retirement date, or may live only a short period after the retirement date, and may not be able to enjoy the receipt of annuity or pension payments, does not make his beneficial interest in the contributions made by the employer on his behalf forfeitable. If the employer's contributions have been irrevocably applied to purchase an annuity contract for the employee, or if the trustee is obligated to use the employer's contributions to provide an annuity for the employee provide only that the employee is alive on the dates the annuity payments are due, the employee's rights in the employer's contributions are nonforfeitable.

(Secs. 83 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 588; 68A Stat. 917; 26 U.S.C. 83 and 7805))

[T.D. 7554, 43 FR 31922, July 24, 1978]

§1.402(c)–1 Taxability of beneficiary of certain foreign situs trusts.

Section 402(c) has the effect of treating, for purposes of section 402, the distributions from a trust which at the time of the distribution is located outside the United States in the same manner as distributions from a trust which is located in the United States. If the trust would qualify for exemption from tax under section 501(a) except for the fact that it fails to comply with the provisions of paragraph (a)(3)(i) of §1.401–1, which restricts qualification to trusts created or organized in the United States and maintained here, section 402(a) and §1.402(a)–1 are applicable to the distributions from such a trust. Thus, for example, a total distribution from such a trust is entitled to the long-term capital gains treatment of section 402(a)(2), except in the case of a nonresident alien individual (see section 871 and 1441 and the regulations thereunder). However, if the plan fails to meet any requirement of section 401 and the regulations thereunder in addition to paragraph (a)(3)(i) of §1.401–1, section 402(b) and §1.402(b)–1 are applicable to the distributions from such a trust.

[T.D. 6500, 25 FR 11679, Nov. 26, 1960]

§1.402(c)–2 Eligible rollover distributions; questions and answers.

The following questions and answers relate to the rollover rules under section 402(c) of the Internal Revenue Code of 1986, as added by sections 521 and 522 of the Unemployment Compensation Amendments of 1992, Public Law 102–318, 106 Stat. 290 (UCA). For additional UCA guidance under sections 401(a)(31), 402(f), 403(b)(8) and (10), and 3405(c), see §§1.401(a)(31)–1, 1.402(f)–1, and 1.403(b)–2, and §31.3405(c)–1 of this chapter, respectively.

LIST OF QUESTIONS

Q–1: What is the rule regarding distributions that may be rolled over to an eligible retirement plan?

Q–2: What is an *eligible retirement plan* and a *qualified plan*?

Q–3: What is an *eligible rollover distribution*?

Q–4: Are there other amounts that are not eligible rollover distributions?

Q–5: For purposes of determining whether a distribution is an eligible rollover distribution, how is it determined whether a series of payments is a series of substantially equal periodic payments over a period specified in section 402(c)(4)(A)?

Q–6: What types of variations in the amount of a payment cause the payment to be independent of a series of substantially equal periodic payments and thus not part of the series?

Q–7: When is a distribution from a plan a required minimum distribution under section 401(a)(9)?

Q–8: How are amounts that are not includible in gross income allocated for purposes of determining the required minimum distribution?

Q–9: What is a distribution of a plan loan offset amount and is it an eligible rollover distribution?

Q–10: What is a qualified plan distributed annuity contract, and is an amount paid under such a contract a distribution of the balance to the credit of the employee in a qualified plan for purposes of section 402(c)?

Q–11: If an eligible rollover distribution is paid to an employee, and the employee contributes all or part of the eligible rollover distribution to an eligible retirement plan within 60 days, is the amount contributed not currently includible in gross income?

Q–12: How does section 402(c) apply to a distributee who is not the employee?

Q–13: Must an employee's (or spousal distributee's) election to treat a contribution of an eligible rollover distribution to an individual retirement plan as a rollover contribution be irrevocable?

Q–14: How is the $5,000 death benefit exclusion under section 101(b) treated for purposes of determining the amount that is an eligible rollover distribution?

Q–15: May an employee (or spousal distributee) roll over more than the plan administrator determines to be an eligible rollover distribution using an assumption described in §1.401(a)(31)–1, Q&A–17?

Q–16: Is a rollover from a qualified plan to an individual retirement account or individual retirement annuity treated as a rollover contribution for purposes of the one-year look-back rollover limitation of section 408(d)(3)(B)?

QUESTIONS AND ANSWERS

Q–1: What is the rule regarding distributions that may be rolled over to an eligible retirement plan?

A–1: (a) *General rule.* Under section 402(c), as added by UCA, any portion of a distribution from a qualified plan that is an eligible rollover distribution described in section 402(c)(4) may be rolled over to an eligible retirement plan described in section 402(c)(8)(B). For purposes of section 402(c) and this section, a rollover is either a direct rollover as described in §1.401(a)(31)–1, Q&A–3 or a contribution of an eligible rollover distribution to an eligible retirement plan that satisfies the time period requirement in section 402(c)(3) and Q&A–11 of this section and the designation requirement described in Q&A–13 of this section. See Q&A–2 of this section for the definition of an eligible retirement plan and a qualified plan.

(b) *Related Internal Revenue Code provisions*—(1) *Direct rollover option.* Section 401(a)(31), added by UCA, requires qualified plans to provide a distributee of an eligible rollover distribution the option to elect to have the distribution paid directly to an eligible retirement plan in a direct rollover. See §1.401(a)(31)–1 for further guidance concerning this direct rollover option.

(2) *Notice requirement.* Section 402(f) requires the plan administrator of a qualified plan to provide, within a reasonable time before making an eligible rollover distribution, a written explanation to the distributee of the distributee's right to elect a direct rollover and the withholding consequences of not making that election. The explanation also is required to provide certain other relevant information relating to the taxation of distributions. See §1.402(f)–1 for guidance concerning the written explanation required under section 402(f).

(3) *Mandatory income tax withholding.* If a distributee of an eligible rollover distribution does not elect to have the eligible rollover distribution paid directly from the plan to an eligible retirement plan in a direct rollover under section 401(a)(31), the eligible rollover distribution is subject to 20-percent income tax withholding under section 3405(c). See §31.3405(c)–1 of this chapter for provisions relating to the withholding requirements applicable to eligible rollover distributions.

(4) *Section 403(b) annuities.* See §1.403(b)–2 for guidance concerning the direct rollover requirements for distributions from annuities described in section 403(b).

(c) *Effective date*—(1) *Statutory effective date.* Section 402(c), added by UCA, applies to eligible rollover distributions made on or after January 1, 1993, even if the event giving rise to the distribution occurred on or before January 1, 1993 (e.g. termination of the employee's employment with the employer maintaining the plan before January 1, 1993), and even if the eligible rollover distribution is part of a series of payments that began before January 1, 1993.

(2) *Regulatory effective date.* This section applies to any distribution made on or after October 19, 1995. For eligible rollover distributions made on or after January 1, 1993 and before October 19,

1995, § 1.402(c)–2T (as it appeared in the April 1, 1995 edition of 26 CFR part 1), applies. However, for any distribution made on or after January 1, 1993 but before October 19, 1995, any or all of the provisions of this section may be substituted for the corresponding provisions of § 1.402(c)–2T, if any.

Q–2: What is an *eligible retirement plan* and a *qualified plan*?

A–2: An eligible retirement plan, under section 402(c)(8)(B), means a qualified plan or an individual retirement plan. For purposes of section 402(c) and this section, a qualified plan is an employees' trust described in section 401(a) which is exempt from tax under section 501(a) or an annuity plan described in section 403(a). An individual retirement plan is an individual retirement account described in section 408(a) or an individual retirement annuity (other than an endowment contract) described in section 408(b).

Q–3: What is an *eligible rollover distribution*?

A–3: (a) *General rule.* Unless specifically excluded, an eligible rollover distribution means any distribution to an employee (or to a spousal distributee described in Q&A–12(a) of this section) of all or any portion of the balance to the credit of the employee in a qualified plan. Thus, except as specifically provided in Q&A–4(b) of this section, any amount distributed to an employee (or such a spousal distributee) from a qualified plan is an eligible rollover distribution, regardless of whether it is a distribution of a benefit that is protected under section 411(d)(6).

(b) *Exceptions.* An eligible rollover distribution does not include the following:

(1) Any distribution that is one of a series of substantially equal periodic payments made (not less frequently than annually) over any one of the following periods—

(i) The life of the employee (or the joint lives of the employee and the employee's designated beneficiary);

(ii) The life expectancy of the employee (or the joint life and last survivor expectancy of the employee and the employee's designated beneficiary); or

(iii) A specified period of ten years or more;

(2) Any distribution to the extent the distribution is a required minimum distribution under section 401(a)(9); or

(3) The portion of any distribution that is not includible in gross income (determined without regard to the exclusion for net unrealized appreciation described in section 402(e)(4)). Thus, for example, an eligible rollover distribution does not include the portion of any distribution that is excludible from gross income under section 72 as a return of the employee's investment in the contract (e.g., a return of the employee's after-tax contributions), but does include net unrealized appreciation.

Q–4: Are there other amounts that are not eligible rollover distributions?

A–4: Yes. The following amounts are not eligible rollover distributions:

(a) Elective deferrals, as defined in section 402(g)(3), that, pursuant to § 1.415–6(b)(6)(iv), are returned as a result of the application of the section 415 limitations, together with the income allocable to these corrective distributions.

(b) Corrective distributions of excess deferrals as described in § 1.402(g)–1(e)(3), together with the income allocable to these corrective distributions.

(c) Corrective distributions of excess contributions under a qualified cash or deferred arrangement described in § 1.401(k)–1(f)(4) and excess aggregate contributions described in § 1.401(m)–1(e)(3), together with the income allocable to these distributions.

(d) Loans that are treated as deemed distributions pursuant to section 72(p).

(e) Dividends paid on employer securities as described in section 404(k).

(f) The costs of life insurance coverage (P.S. 58 costs).

(g) Similar items designated by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2)(ii)(*b*) of this chapter.

Q–5: For purposes of determining whether a distribution is an eligible rollover distribution, how is it determined whether a series of payments is a series of substantially equal periodic payments over a period specified in section 402(c)(4)(A)?

A–5: (a) *General rule.* Generally, whether a series of payments is a series of substantially equal periodic payments over a specified period is determined at the time payments begin, and by following the principles of section 72(t)(2)(A)(iv), without regard to contingencies or modifications that have not yet occurred. Thus, for example, a joint and 50-percent survivor annuity will be treated as a series of substantially equal payments at the time payments commence, as will a joint and survivor annuity that provides for increased payments to the employee if the employee's beneficiary dies before the employee. Similarly, for purposes of determining if a disability benefit payment is part of a series of substantially equal payments for a period described in section 402(c)(4)(A), any contingency under which payments cease upon recovery from the disability may be disregarded.

(b) *Certain supplements disregarded.* For purposes of determining whether a distribution is one of a series of payments that are substantially equal, social security supplements described in section 411(a)(9) are disregarded. For example, if a distributee receives a life annuity of $500 per month, plus a social security supplement consisting of payments of $200 per month until the distributee reaches the age at which social security benefits of not less than $200 a month begin, the $200 supplemental payments are disregarded and, therefore, each monthly payment of $700 made before the social security age and each monthly payment of $500 made after the social security age is treated as one of a series of substantially equal periodic payments for life. A series of payments that are not substantially equal solely because the amount of each payment is reduced upon attainment of social security retirement age (or, alternatively, upon commencement of social security early retirement, survivor, or disability benefits) will also be treated as substantially equal as long as the reduction in the actual payments is level and does not exceed the applicable social security benefit.

(c) *Changes in the amount of payments or the distributee.* If the amount (or, if applicable, the method of calculating the amount) of the payments changes so that subsequent payments are not substantially equal to prior payments, a new determination must be made as to whether the remaining payments are a series of substantially equal periodic payments over a period specified in Q&A–3(b)(1) of this section. This determination is made without taking into account payments made or the years of payment that elapsed prior to the change. However, a new determination is not made merely because, upon the death of the employee, the spouse or former spouse of the employee becomes the distributee. Thus, once distributions commence over a period that is at least as long as either the first annuitant's life or 10 years (e.g., as provided by a life annuity with a five-year or ten-year-certain guarantee), then substantially equal payments to the survivor are not eligible rollover distributions even though the payment period remaining after the death of the employee is or may be less than the period described in section 402(c)(4)(A). For example, substantially equal periodic payments made under a life annuity with a five-year term certain would not be an eligible rollover distribution even when paid after the death of the employee with three years remaining under the term certain.

(d) *Defined contribution plans.* The following rules apply in determining whether a series of payments from a defined contribution plan constitute substantially equal periodic payments for a period described in section 402(c)(4)(A):

(1) *Declining balance of years.* A series of payments from an account balance under a defined contribution plan will be considered substantially equal payments over a period if, for each year, the amount of the distribution is calculated by dividing the account balance by the number of years remaining in the period. For example, a series of payments will be considered substantially equal payments over 10 years if the series is determined as follows. In year 1, the annual payment is the account balance divided by 10; in year 2, the annual payment is the remaining account balance divided by 9; and so on until year 10 when the entire remaining balance is distributed.

(2) *Reasonable actuarial assumptions.* If an employee's account balance under a

defined contribution plan is to be distributed in annual installments of a specified amount until the account balance is exhausted, then, for purposes of determining if the period of distribution is a period described in section 402(c)(4)(A), the period of years over which the installments will be distributed must be determined using reasonable actuarial assumptions. For example, if an employee has an account balance of $100,000, elects distributions of $12,000 per year until the account balance is exhausted, and the future rate of return is assumed to be 8% per year, the account balance will be exhausted in approximately 14 years. Similarly, if the same employee elects a fixed annual distribution amount and the fixed annual amount is less than or equal to $10,000, it is reasonable to assume that a future rate of return will be greater than 0% and, thus, the account will not be exhausted in less than 10 years.

(e) *Series of payments beginning before January 1, 1993.* Except as provided in paragraph (c) of this Q&A, if a series of periodic payments began before January 1, 1993, the determination of whether the post-December 31, 1992 payments are a series of substantially equal periodic payments over a specified period is made by taking into account all payments made, including payments made before January 1, 1993. For example, if a series of substantially equal periodic payments beginning on January 1, 1983, is scheduled to be paid over a period of 15 years, payments in the series that are made after December 31, 1992, will not be eligible rollover distributions even though they will continue for only five years after December 31, 1992, because the pre- January 1, 1993 payments are taken into account in determining the specified period.

Q–6: What types of variations in the amount of a payment cause the payment to be independent of a series of substantially equal periodic payments and thus not part of the series?

A–6: (a) *Independent payments.* Except as provided in paragraph (b) of this Q&A, a payment is treated as independent of the payments in a series of substantially equal payments, and thus not part of the series, if the payment is substantially larger or smaller than the other payments in the series. An independent payment is an eligible rollover distribution if it is not otherwise excepted from the definition of eligible rollover distribution. This is the case regardless of whether the payment is made before, with, or after payments in the series. For example, if an employee elects a single payment of half of the account balance with the remainder of the account balance paid over the life expectancy of the distributee, the single payment is treated as independent of the payments in the series and is an eligible rollover distribution unless otherwise excepted. Similarly, if an employee's surviving spouse receives a survivor life annuity of $1,000 per month plus a single payment on account of death of $7,500, the single payment is treated as independent of the payments in the annuity and is an eligible rollover distribution unless otherwise excepted (e.g., $5,000 of the $7,500 might qualify to be excluded from gross income as a death benefit under section 101(b)).

(b) *Special rules*—(1) *Administrative error or delay.* If, due solely to reasonable administrative error or delay in payment, there is an adjustment after the annuity starting date to the amount of any payment in a series of payments that otherwise would constitute a series of substantially equal payments described in section 402(c)(4)(A) and this section, the adjusted payment or payments will be treated as part of the series of substantially equal periodic payments and will not be treated as independent of the payments in the series. For example, if, due solely to reasonable administrative delay, the first payment of a life annuity is delayed by two months and reflects an additional two months worth of benefits, that payment will be treated as a substantially equal payment in the series rather than as an independent payment. The result will not change merely because the amount of the adjustment is paid in a separate supplemental payment.

(2) *Supplemental payments for annuitants.* A supplemental payment from a defined benefit plan to annuitants (e.g., retirees or beneficiaries) will be treated as part of a series of substantially equal payments, rather than as an

independent payment, provided that the following conditions are met—

(i) The supplement is a benefit increase for annuitants;

(ii) The amount of the supplement is determined in a consistent manner for all similarly situated annuitants;

(iii) The supplement is paid to annuitants who are otherwise receiving payments that would constitute substantially equal periodic payments; and

(iv) The aggregate supplement is less than or equal to the greater of 10% of the annual rate of payment for the annuity, or $750 or any higher amount prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the FEDERAL REGISTER. See §601.601(d)(2)(ii)(*b*) of this chapter.

(3) *Final payment in a series.* If a payment in a series of payments from an account balance under a defined contribution plan represents the remaining balance to the credit and is substantially less than the other payments in the series, the final payment must nevertheless be treated as a payment in the series of substantially equal payments and may not be treated as an independent payment if the other payments in the series are substantially equal and the payments are for a period described in section 402(c)(4)(A) based on the rules provided in paragraph (d)(2) of Q&A–5 of this section. Thus, such final payment will not be an eligible rollover distribution.

Q–7: When is a distribution from a plan a required minimum distribution under section 401(a)(9)?

A–7: (a) *General rule.* Except as provided in paragraphs (b) and (c) of this Q&A, if a minimum distribution is required for a calendar year, the amounts distributed during that calendar year are treated as required minimum distributions under section 401(a)(9), to the extent that the total required minimum distribution under section 401(a)(9) for the calendar year has not been satisfied. Accordingly, these amounts are not eligible rollover distributions. For example, if an employee is required under section 401(a)(9) to receive a required minimum distribution for a calendar year of $5,000 and the employee receives a total of $7,200 in that year, the first $5,000 distributed will be treated as the required minimum distribution and will not be an eligible rollover distribution and the remaining $2,200 will be an eligible rollover distribution if it otherwise qualifies. If the total section 401(a)(9) required minimum distribution for a calendar year is not distributed in that calendar year (e.g., when the distribution for the calendar year in which the employee reaches age 70½ is made on the following April 1), the amount that was required but not distributed is added to the amount required to be distributed for the next calendar year in determining the portion of any distribution in the next calendar year that is a required minimum distribution.

(b) *Distribution before age 70½.* Any amount that is paid before January 1 of the year in which the employee attains (or would have attained) age 70½ will not be treated as required under section 401(a)(9) and, thus, is an eligible rollover distribution if it otherwise qualifies.

(c) *Special rule for annuities.* In the case of annuity payments from a defined benefit plan, or under an annuity contract purchased from an insurance company (including a qualified plan distributed annuity contract (as defined in Q&A–10 of this section)), the entire amount of any such annuity payment made on or after January 1 of the year in which an employee attains (or would have attained) age 70½ will be treated as an amount required under section 401(a)(9) and, thus, will not be an eligible rollover distribution.

Q–8: How are amounts that are not includible in gross income allocated for purposes of determining the required minimum distribution?

A–8: If section 401(a)(9) has not yet been satisfied by the plan for the year with respect to an employee, a distribution is made to the employee that exceeds the amount required to satisfy section 401(a)(9) for the year for the employee, and a portion of that distribution is excludible from gross income, the following rule applies for purposes of determining the amount of the distribution that is an eligible rollover distribution. The portion of the distribution that is excludible from gross income is first allocated toward satisfaction of section 401(a)(9) and then the remaining portion of the required minimum distribution, if any, is satisfied from the portion of the distribution that is includible in gross income. For example, assume an employee is required under section 401(a)(9) to receive a minimum distribution for a calendar year of $4,000 and the employee receives a $4,800 distribution, of which $1,000 is excludible from income as a return of basis. First, the $1,000 return of basis is allocated toward satisfying the required minimum distribution. Then, the remaining $3,000 of the required minimum distribution is satisfied from the $3,800 of the distribution that is includible in gross income, so that the remaining balance of the distribution, $800, is an eligible rollover distribution if it otherwise qualifies.

Q–9: What is a distribution of a plan loan offset amount, and is it an eligible rollover distribution?

A–9: (a) *General rule.* A distribution of a plan loan offset amount, as defined in paragraph (b) of this Q&A, is an eligible rollover distribution if it satisfies Q&A–3 of this section. Thus, an amount equal to the plan loan offset amount can be rolled over by the employee (or spousal distributee) to an eligible retirement plan within the 60-day period under section 402(c)(3), unless the plan loan offset amount fails to be an eligible rollover distribution for another reason. See § 1.401(a)(31)–1, Q&A–15 for guidance concerning the offering of a direct rollover of a plan loan offset amount. See § 31.3405(c)–1, Q&A–11 of this chapter for guidance concerning special withholding rules with respect to plan loan offset amounts.

(b) *Definition of plan loan offset amount.* For purposes of section 402(c), a distribution of a plan loan offset amount is a distribution that occurs when, under the plan terms governing a plan loan, the participant's accrued benefit is reduced (offset) in order to repay the loan (including the enforcement of the plan's security interest in a participant's accrued benefit). A distribution of a plan loan offset amount can occur in a variety of circumstances, e.g., where the terms governing a plan loan require that, in the event of the employee's termination of employment or request for a distribution, the loan be repaid immediately or treated as in default. A distribution of a plan loan offset amount also occurs when, under the terms governing the plan loan, the loan is cancelled, accelerated, or treated as if it were in default (e.g., where the plan treats a loan as in default upon an employee's termination of employment or within a specified period thereafter). A distribution of a plan loan offset amount is an actual distribution, not a deemed distribution under section 72(p).

(c) *Examples.* The rules with respect to a plan loan offset amount in this Q&A–9, § 1.401(a)(31)–1, Q&A–15 and § 31.3405(c)–1, Q&A–11 of this chapter are illustrated by the following examples:

Example 1. (a) In 1996, Employee A has an account balance of $10,000 in Plan Y, of which $3,000 is invested in a plan loan to Employee A that is secured by Employee A's account balance in Plan Y. Employee A has made no after-tax employee contributions to Plan Y. Plan Y does not provide any direct rollover option with respect to plan loans. Upon termination of employment in 1996, Employee A, who is under age 70½ , elects a distribution of Employee A's entire account balance in Plan Y, and Employee A's outstanding loan is offset against the account balance on distribution. Employee A elects a direct rollover of the distribution.

(b) In order to satisfy section 401(a)(31), Plan Y must pay $7,000 directly to the eligible retirement plan chosen by Employee A in a direct rollover. When Employee A's account balance was offset by the amount of the $3,000 unpaid loan balance, Employee A received a plan loan offset amount (equivalent to $3,000) that is an eligible rollover distribution. However, under § 1.401(a)(31)–1, Q&A–15 Plan Y satisfies section 401(a)(31), even though a direct rollover option was not provided with respect to the $3,000 plan loan offset amount.

(c) No withholding is required under section 3405(c) on account of the distribution of the $3,000 plan loan offset amount because no cash or other property (other than the plan loan offset amount) is received by Employee A from which to satisfy the withholding. Employee A may roll over $3,000 to an eligible retirement plan within the 60 day period provided in section 402(c)(3).

Example 2. (a) The facts are the same as in *Example 1*, except that the terms governing the plan loan to Employee A provide that, upon termination of employment, Employee A's account balance is automatically offset by the amount of any unpaid loan balance to repay the loan. Employee A terminates employment but does not request a distribution from Plan Y. Nevertheless, pursuant to the terms governing the plan loan, Employee A's account balance is automatically offset by the amount of the $3,000 unpaid loan balance.

(b) The $3,000 plan loan offset amount attributable to the plan loan in this example is treated in the same manner as the $3,000 plan loan offset amount in *Example 1.*

Example 3. (a) The facts are the same as in *Example 2,* except that, instead of providing for an automatic offset upon termination of employment to repay the plan loan, the terms governing the plan loan require full repayment of the loan by Employee A within 30 days of termination of employment. Employee A terminates employment, does not elect a distribution from Plan Y, and also fails to repay the plan loan within 30 days. The plan administrator of Plan Y declares the plan loan to Employee A in default and executes on the loan by offsetting Employee A's account balance by the amount of the $3,000 unpaid loan balance.

(b) The $3,000 plan loan offset amount attributable to the plan loan in this example is treated in the same manner as the $3,000 plan loan offset amount in *Example 1* and in *Example 2.* The result in this *Example 3* is the same even though the plan administrator treats the loan as in default before offsetting Employee A's accrued benefit by the amount of the unpaid loan.

Example 4. (a) The facts are the same as in *Example 1,* except that Employee A elects to receive the distribution of the account balance that remains after the $3,000 offset to repay the plan loan, instead of electing a direct rollover of the remaining account balance.

(b) In this case, the amount of the distribution received by Employee A is $10,000, not $3,000. Because the amount of the $3,000 offset attributable to the loan is included in determining the amount that equals 20 percent of the eligible rollover distribution received by Employee A, withholding in the amount of $2,000 (20 percent of $10,000) is required under section 3405(c). The $2,000 is required to be withheld from the $7,000 to be distributed to Employee A in cash, so that Employee A actually receives a check for $5,000.

Example 5. The facts are the same as in *Example* 4, except that the $7,000 distribution to Employee A after the offset to repay the loan consists solely of employer securities within the meaning of section 402(e)(4)(E). In this case, no withholding is required under section 3405(c) because the distribution consists solely of the $3,000 plan loan offset amount and the $7,000 distribution of employer securities. This is the result because the total amount required to be withheld does not exceed the sum of the cash and the fair market value of other property distributed, excluding plan loan offset amounts and employer securities. Employee A may roll over the employer securities and $3,000 to an eligible retirement plan within the 60-day period provided in section 402(c)(3).

Example 6. Employee B, who is age 40, has an account balance in Plan Z, a profit sharing plan qualified under section 401(a) that includes a qualified cash or deferred arrangement described in section 401(k). Plan Z provides for no after-tax employee contributions. In 1990, Employee B receives a loan from Plan Z, the terms of which satisfy section 72(p)(2), and which is secured by elective contributions subject to the distribution restrictions in section 401(k)(2)(B). In 1996, the loan fails to satisfy section 72(p)(2) because Employee B stops repayment. In that year, pursuant to section 72(p), Employee B is taxed on a deemed distribution equal to the amount of the unpaid loan balance. Under Q&A–4 of this section, the deemed distribution is not an eligible rollover distribution. Because Employee B has not separated from service or experienced any other event that permits the distribution under section 401(k)(2)(B) of the elective contributions that secure the loan, Plan Z is prohibited from executing on the loan. Accordingly, Employee B's account balance is not offset by the amount of the unpaid loan balance at the time Employee B stops repayment on the loan. Thus, there is no distribution of an offset amount that is an eligible rollover distribution in 1996.

Q–10: What is a qualified plan distributed annuity contract, and is an amount paid under such a contract a distribution of the balance to the credit of the employee in a qualified plan for purposes of section 402(c)?

A–10: (a) *Definition of a qualified plan distributed annuity contract.* A qualified plan distributed annuity contract is an annuity contract purchased for a participant, and distributed to the participant, by a qualified plan.

(b) *Treatment of amounts paid as eligible rollover distributions.* Amounts paid under a qualified plan distributed annuity contract are payments of the balance to the credit of the employee for purposes of section 402(c) and are eligible rollover distributions, if they otherwise qualify. Thus, for example, if the employee surrenders the contract for a single sum payment of its cash surrender value, the payment would be an eligible rollover distribution to the extent it is includible in gross income and not a required minimum distribution under section 401(a)(9). This rule applies even if the annuity contract is distributed in connection with a plan termination. See § 1.401(a)(31)–1, Q&A–16 and § 31.3405(c)–1, Q&A–13 of this chapter concerning the direct rollover requirements and 20-percent withholding requirements, respectively, that apply to eligible rollover distributions from such an annuity contract.

Q–11: If an eligible rollover distribution is paid to an employee, and the employee contributes all or part of the eligible rollover distribution to an eligible retirement plan within 60 days, is the amount contributed not currently includible in gross income?

A–11: Yes, the amount contributed is not currently includible in gross income, provided that it is contributed to the eligible retirement plan no later than the 60th day following the day on which the employee received the distribution. If more than one distribution is received by an employee from a qualified plan during a taxable year, the 60-day rule applies separately to each distribution. Because the amount withheld as income tax under section 3405(c) is considered an amount distributed under section 402(c), an amount equal to all or any portion of the amount withheld can be contributed as a rollover to an eligible retirement plan within the 60-day period, in addition to the net amount of the eligible rollover distribution actually received by the employee. However, if all or any portion of an amount equal to the amount withheld is not contributed as a rollover, it is included in the employee's gross income to the extent required under section 402(a), and also may be subject to the 10-percent additional income tax under section 72(t).

Q–12: How does section 402(c) apply to a distributee who is not the employee?

A–12: (a) *Spousal distributee.* If any distribution attributable to an employee is paid to the employee's surviving spouse, section 402(c) applies to the distribution in the same manner as if the spouse were the employee. The same rule applies if any distribution attributable to an employee is paid in accordance with a qualified domestic relations order (as defined in section 414(p)) to the employee's spouse or former spouse who is an alternate payee. Therefore, a distribution to the surviving spouse of an employee (or to a spouse or former spouse who is an alternate payee under a qualified domestic relations order), including a distribution of ancillary death benefits attributable to the employee, is an eligible rollover distribution if it meets the requirements of section 402(c)(2) and (4) and Q&A–3 through Q&A–10 and Q&A–14 of this section. However, a qualified plan (as defined in Q&A–2 of this section) is not treated as an eligible retirement plan with respect to a surviving spouse. Only an individual retirement plan is treated as an eligible retirement plan with respect to an eligible rollover distribution to a surviving spouse.

(b) *Non-spousal distributee.* A distributee other than the employee or the employee's surviving spouse (or a spouse or former spouse who is an alternate payee under a qualified domestic relations order) is not permitted to roll over distributions from a qualified plan. Therefore, those distributions do not constitute eligible rollover distributions under section 402(c)(4) and are not subject to the 20-percent income tax withholding under section 3405(c).

Q–13: Must an employee's (or spousal distributee's) election to treat a contribution of an eligible rollover distribution to an individual retirement plan as a rollover contribution be irrevocable?

A–13: (a) *In general.* Yes. In order for a contribution of an eligible rollover distribution to an individual retirement plan to constitute a rollover and, thus, to qualify for current exclusion from gross income, a distributee must elect, at the time the contribution is made, to treat the contribution as a rollover contribution. An election is made by designating to the trustee, issuer, or custodian of the eligible retirement plan that the contribution is a rollover contribution. This election is irrevocable. Once any portion of an eligible rollover distribution has been contributed to an individual retirement plan and designated as a rollover distribution, taxation of the withdrawal of the contribution from the individual retirement plan is determined under section 408(d) rather than under section 402 or 403. Therefore, the eligible rollover distribution is not eligible for capital gains treatment, five-year or ten-year averaging, or the exclusion from gross income for net unrealized appreciation on employer stock.

(b) Direct rollover. If an eligible rollover distribution is paid to an individual retirement plan in a direct rollover at the election of the distributee, the distributee is deemed to have irrevocably designated that the direct rollover is a rollover contribution.

Q–14: How is the $5,000 death benefit exclusion under section 101(b) treated for purposes of determining the amount that is an eligible rollover distribution?

A–14: To the extent that a death benefit is a distribution from a qualified plan, the portion of the distribution that is excluded from gross income under section 101(b) is not an eligible rollover distribution. See §1.401(a)(31)-1, Q&A–17 for guidance concerning assumptions that a plan administrator may make with respect to whether and to what extent a distribution of a survivor benefit is excludible from gross income under section 101(b).

Q–15: May an employee (or spousal distributee) roll over more than the plan administrator determines to be an eligible rollover distribution using an assumption described in §1.401(a)(31)-1, Q&A–17?

A–15: Yes. The portion of any distribution that an employee (or spousal distributee) may roll over as an eligible rollover distribution under section 402(c) is determined based on the actual application of section 402 and other relevant provisions of the Internal Revenue Code. The actual application of these provisions may produce different results than any assumption described in §1.401(a)(31)–1, Q&A–17 that is used by the plan administrator. Thus, for example, even though the plan administrator calculates the portion of a distribution that is a required minimum distribution (and thus is not made eligible for direct rollover under section 401(a)(31)), by assuming that there is no designated beneficiary, the portion of the distribution that is actually a required minimum distribution and thus not an eligible rollover distribution is determined by taking into account the designated beneficiary, if any. If, by taking into account the designated beneficiary, a greater portion of the distribution is an eligible rollover distribution, the distributee may rollover the additional amount. Similarly, even though a plan administrator assumes that a distribution from a qualified plan is the only death benefit with respect to an employee that qualifies for the $5,000 death benefit exclusion under section 101(b), to the extent that the death benefit exclusion is allocated to a different death benefit, a greater portion of the distribution may actually be includible in gross income and, thus, be an eligible rollover distribution, and the surviving spouse may roll over the additional amount if it otherwise qualifies.

Q–16: Is a rollover from a qualified plan to an individual retirement account or individual retirement annuity treated as a rollover contribution for purposes of the one-year look-back rollover limitation of section 408(d)(3)(B)?

A–16: No. A distribution from a qualified plan that is rolled over to an individual retirement account or individual retirement annuity is not treated for purposes of section 408(d)(3)(B) as an amount received by an individual from an individual retirement account or individual retirement annuity which is not includible in gross income because of the application of section 408(d)(3).

[T.D. 8619, 60 FR 49208, Sept. 22, 1995]

§1.402(d)–1 Effect of section 402(d).

(a) If the requirements of section 402(d) are met, a contribution made by an employer on behalf of an employee to a trust which is not exempt under section 501(a) shall not be included in the income of the employee in the year in which the contribution is made. Such contribution will be taxable to the employee, when received in later years, as provided in section 72 (relating to annuities). For taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such contributions. For taxable years beginning after December 31, 1963, such contributions, when received, may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). See paragraph (b) of § 1.403(c)–1. The intent and purpose of section 402(d) is to give those employees, covered under certain non-exempt trusts to which such section applies, essentially the same tax treatment as those covered by trusts described in section 401(a) and exempt under section 501(a), except that the capital gains treatment referred to in section 402(a)(2) does not apply.

(b) Every person claiming the benefit of section 402(d) must be able to demonstrate to the satisfaction of the Commissioner that all of the provisions of such section are met. The taxpayer must produce sufficient evidence to prove:

(1) That, before October 21, 1942, he was employed by the particular employer making the contribution in question and was at such time definitely covered by a written agreement, entered into before October 21, 1942, between himself and the employer, or between the employer and the trustee of a trust established by the employer before October 21, 1942, and that the contribution by the employer was made pursuant to such agreement. The fact that an employee may have been potentially covered is not sufficient. Evidence that the employment was entered into, or the agreement executed, ‘‘as of’’ a date before October 21, 1942, or that the agreement or trust instrument which did not theretofore meet the requirements of section 402(d) was modified or amended after October 20, 1942, so as to come within the provisions of such section, will not satisfy the requirements of section 402(d).

(2) That such contribution, pursuant to the terms of such agreement, was to be applied for the purchase of an annuity contract for the taxpayer. In the case of a contribution by the employer of an annuity contract purchased by such employer and transferred by him to the trustee of the trust, evidence should be presented to prove that such contract was purchased for the taxpayer by the employer pursuant to the terms of a written agreement between the employer and the employee or between the employer and the trustee, entered into before October 21, 1942.

(3) That under the written terms of the trust agreement the taxpayer is not entitled during his lifetime, except with the consent of the trustee, to any payments other than annuity payments under the annuity contract or contracts purchased by the trustee or by the employer and transferred to the trustee, and that the trustee may grant or withhold such consent free from control by the taxpayer, the employer, or any other person. However, such control will not be presumed from the fact that the trustee is himself an officer or employee of the employer. As used in section 402(d) the phrase ‘‘if * * * under the terms of the trust agreement the employee is not entitled’’ means that the trust instrument must make it impossible for the prohibited distribution to occur whether by operation or natural termination of the trust, whether by power of revocation or amendment, other than with the consent of the trustee, whether by the happening of a contingency, by collateral arrangement, or any other means. It is not essential that the employer relinquish all power to modify or terminate the trust but it must be impossible, except with the consent of the trustee, to be received by the taxpayer contracts purchased by the trustee, or by the employer and transferred to the trustee, to be received by the taxpayer directly or indirectly, other than as annuity payments.

(4) The nature and amount of such contribution and the extent to which income taxes have been paid thereon before January 1, 1949, and not credited or refunded.

(5) If it is claimed that section 402(d) applies to amounts contributed to a trust after June 1, 1949, the taxpayer must prove to the satisfaction of the Commissioner that the trust did not, on June 1, 1949, qualify for exemption under section 165(a) of the Internal Revenue Code of 1939. Where an employer buys an annuity contract which is transferred to the trustee, the date of the purchase of the annuity contract and not the date of the transfer to the trustee is the controlling date in determining whether or not the contribution was made to the trust after June 1, 1949.

[T.D. 6500, 25 FR 11679, Nov. 26, 1960, as amended by T.D. 6885, 31 FR 7801, June 2, 1966]

§1.402(e)–1 Certain plan terminations.

Distributions made after December 31, 1953, and before January 1, 1955, as a result of the complete termination of an employees' trust described in section 401(a) which is exempt under section 501(a) shall be considered distributions on account of separation form service for purposes of section 402(a)(2) if the employer who established the trust is a corporation, and the termination of the plan is incident to the complete liquidation of the corporation before August 16, 1954, regardless of whether such liquidation is incident to a reorganization as defined in section 368.

[T.D. 6500, 25 FR 11680, Nov. 26, 1960]

§1.402(f)–1 Required explanation of eligible rollover distributions; questions and answers.

The following questions and answers concern the written explanation requirement imposed by section 402(f) of the Internal Revenue Code of 1986 relating to distributions eligible for rollover treatment. Section 402(f) was amended by section 521(a) of the Unemployment Compensation Amendments of 1992, Public Law 102–318, 106 Stat. 290 (UCA). For additional UCA guidance under sections 401(a)(31), 402(c), 403(b)(8) and (10), and 3405(c), see §§1.401(a)(31)–1, 1.402(c)–2, 1.403(b)–2, and 31.3405(c)–1 of this chapter, respectively.

LIST OF QUESTIONS

Q–1: What are the requirements for a written explanation under section 402(f)?

Q–2: When must the plan administrator provide the section 402(f) notice to a distributee?

Q–3: Must the plan administrator provide a separate section 402(f) notice for each distribution in a series of periodic payments that are eligible rollover distributions?

Q–4: May a plan administrator post the section 402(f) notice as a means of providing it to distributees?

QUESTIONS AND ANSWERS

Q–1: What are the requirements for a written explanation under section 402(f)?

A–1: (a) *General rule.* Under section 402(f), as amended by UCA, the plan administrator of a qualified plan is required, within a reasonable period of time before making an eligible rollover distribution, to provide the distributee with the written explanation described in section 402(f) (section 402(f) notice). The section 402(f) notice must be designed to be easily understood and must explain the following: the rules under which the distributee may elect that the distribution be paid in the form of a direct rollover to an eligible retirement plan; the rules that require the withholding of tax on the distribution if it is not paid in a direct rollover; the rules under which the distributee may defer tax on the distribution if it is contributed in a rollover to an eligible retirement plan within 60 days of the distribution; and if applicable, certain special rules regarding the taxation of the distribution as described in section 402(d) (averaging with respect to lump sum distributions) and (e) (other rules including treatment of net unrealized appreciation). See §1.401(a)(31)–1, Q&A–7 for additional information that must be provided if a plan provides a default procedure regarding the election of a direct rollover.

(b) *Model section 402(f) notice.* The plan administrator will be deemed to have complied with the requirements of paragraph (a) of this Q&A–1 relating to the contents of the section 402(f) notice if the plan administrator provides the applicable model section 402(f) notice published by the Internal Revenue Service for this purpose in a revenue ruling, notice, or other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(*b*) of this chapter.

(c) *Delegation to Commissioner.* The Commissioner, in revenue rulings, notices, and other guidance, published in the Internal Revenue Bulletin, may modify, or provide any additional guidance with respect to, the notice requirement of this section. See §601.601(d)(2)(ii)(*b*) of this chapter.

(d) *Effective date*—(1) *Statutory effective date.* Section 402(f) applies to eligible rollover distributions made after December 31, 1992.

(2) *Regulatory effective date.* This section applies to eligible rollover distributions made on or after October 19, 1995. For eligible rollover distributions

made on or after January 1, 1993 and before October 19, 1995, § 1.402(c)–2T, Q&A–11 through 15 (as it appeared in the April 1, 1995 edition of 26 CFR part 1), apply. However, for any distribution made on or after January 1, 1993 but before October 19, 1995, a plan administrator or payor may satisfy the requirements of section 402(f) by substituting any or all provisions of this section for the corresponding provisions of § 1.402(c)–1T, Q&A–11 through 15, if any.

Q–2: When must the plan administrator provide the section 402(f) notice to a distributee?

A–2: The plan administrator must provide a distributee with the section 402(f) notice no less than 30 days and no more than 90 days before the date of distribution. However, if the distributee, after having received the section 402(f) notice, affirmatively elects a distribution, a plan will not fail to satisfy section 402(f) merely because the distribution is made less than 30 days after the section 402(f) notice was provided to the distributee, provided that the following requirement is met. The plan administrator must provide information to the distributee clearly indicating that (in accordance with the first sentence of this Q&A–2) the distributee has a right to consider the decision of whether or not to elect a direct rollover for at least 30 days after the notice is provided. The plan administrator may use any method to inform the distributee of the relevant time period, provided that the method is reasonably designed to attract the attention of the distributee. For example, this information could be provided either in the section 402(f) notice or stated in a separate document (e.g., attached to the election form) that is provided at the same time as the notice. For purposes of satisfying the requirement in the first sentence of this Q&A–2, the plan administrator may substitute the annuity starting date, within the meaning of § 1.401(a)–20, Q&A–10, for the date of distribution.

Q–3: Must the plan administrator provide a separate section 402(f) notice for each distribution in a series of periodic payments that are eligible rollover distributions?

A–3: No. In the case of a series of periodic payments that are eligible rollover distributions, the plan administrator is permitted to satisfy section 402(f) with respect to each payment in the series by providing the section 402(f) notice prior to the first payment in the series, in accordance with the rules in Q&A–1 and Q&A–2 of this section, and providing the notice at least once annually for as long as the payments continue. However, see § 1.401(a)(31)–1, Q&A–12 for additional guidance if the plan administrator intends to treat a distributee's election to make or not make a direct rollover with respect to one payment in a series of periodic payments as applicable to all subsequent payments in the series (absent a subsequent change of election).

Q–4: May a plan administrator post the section 402(f) notice as a means of providing it to distributees?

A–4: No. The posting of the section 402(f) notice will not be considered provision of the notice. The written notice must be provided individually to any distributee of an eligible rollover distribution within the time period described in Q&A–2 and Q&A–3 of this section.

[T.D. 8619, 60 FR 49213, Sept. 22, 1995]

§ 1.402(g)–0 Limitation on exclusion for elective deferrals, table of contents.

This section contains the captions that appear in § 1.402(g)–1.

§ 1.402(g)–1 Limitation on exclusion for elective deferrals.

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[T.D. 8357, 56 FR 40545, Aug. 15, 1991]

§1.402(g)–1 Limitation on exclusion for elective deferrals.

(a) *In general.* The excess of an individual's elective deferrals for any taxable year over the applicable limit for the year may not be excluded from gross income under sections 402(a)(8), 402(h)(1)(B), 403(b), 408(k)(6), or 501(c)(18). Thus, an individual's elective deferrals in excess of the applicable limit for a taxable year (i.e., the individual's excess deferrals for the year) must be included in gross income for the year.

(b) *Elective deferrals.* An individual's elective deferrals for a taxable year are the sum of the following:

(1) Any elective contribution under a qualified cash or deferred arrangement (as defined in section 401(k)) to the extent not includible in the individual's gross income for the taxable year on account of section 402(a)(8) (before applying the limits of section 402(g) or this section).

(2) Any employer contribution to a simplified employee pension (as defined in section 408(k)) to the extent not includible in the individual's gross income for the taxable year on account of section 402(h)(1)(B) (before applying the limits of section 402(g) or this section).

(3) Any employer contribution to an annuity contract under section 403(b) under a salary reduction agreement (within the meaning of section 3121(a)(5)(D)) to the extent not includible in the individual's gross income for the taxable year on account of section 403(b) (before applying the limits of section 402(g) or this section).

(4) Any employee contribution designated as deductible under a trust described in section 501(c)(18) to the extent deductible from the individual's income for the taxable year on account of section 501(c)(18) (before appying the limits of section 402(g) or this section). For purposes of this section, the employee contribution is treated as though it were excluded from the individual's gross income.

(c) *Certain one-time irrevocable elections.* An employer contribution is not treated as an elective deferral under paragraph (b) of this section if the contribution is made pursuant to a one-time irrevocable election made by the employee:

(1) In the case of an annuity contract under section 403(b), at the time of initial eligibility to participate in the salary reduction agreement;

(2) In the case of a qualified cash or deferred arrangement, at a time when, under §1.401(k)–1(a)(3)(iv), the election is not treated as a cash or deferred election;

(3) In the case of a trust described in section 501(c)(18), at the time of initial eligibility to have the employer contribute on the employee's behalf to the trust.

(d) *Applicable limit*—(1) *In general.* Except as adjusted under paragraphs (d)(2) and (d)(3) of this section, the applicable limit for an individual's taxable year beginning in the 1987 calendar year is $7,000. This amount is increased for the taxable year beginning in 1988 and subsequent calendar years in the same manner as the $90,000 amount is adjusted under section 415(d).

(2) *Special adjustment for elective deferrals with respect to a section 403(b) annuity contract.* The applicable limit for an individual who makes elective deferrals described in paragraph (b)(3) of this section for a taxable year is adjusted by increasing the applicable limit otherwise determined under paragraph (d)(1) of this section by the amount of the individual's elective deferrals described in paragraph (b)(3) of this section for the taxable year. This adjustment cannot cause the applicable limit for any taxable year to exceed $9,500.

(3) *Special adjustment for elective deferrals with respect to a section 403(b) annuity contract for certain long-term employees.* The applicable limit for an individual who is a qualified employee (as defined in section 402(g)(8)(C)) and has elective deferrals described in paragraph (b)(3) of this section for a taxable year is adjusted by increasing the applicable limit otherwise determined under paragraphs (d)(1) and (d)(2) of this section in accordance with section 402(g)(8)(A).

(4) *Example.* The provisions of this paragraph (d) are illustrated by the following example.

Example. Employer X maintains a cash or deferred arrangement under section 401(k), and offers its employees section 403(b) contracts to which elective deferrals may be made. For the 1987 taxable year, three of X's employees, A, B, and C, contribute $3,500, $1,000, and $8,500, respectively, as elective deferrals under the section 403(b) contract. The maximum amounts that A, B, and C may contribute to the cash or deferred arrangement are $6,000, $7,000, and $1,000, respectively. B may only contribute $7,000 under the cash or deferred arrangement because the special adjustment under paragraph (d)(2) of this section applies only to section 403(b) annuity contracts. B could, of course, contribute up to $2,500 under the section 403(b) contract (to the extent otherwise permitted), in addition to the $7,000 under the cash or deferred arrangement.

(e) *Treatment of excess deferrals*—(1) *Plan qualification*—(i) *Effect of excess deferrals.* For plan years beginning before January 1, 1988, a plan, annuity contract, simplified employee pension, or trust does not fail to meet the requirements of section 401(a), section 403(b), section 408(k), or section 501(c)(18), respectively, merely because excess deferrals are made with respect to the plan, contract, pension, or trust. For plan years beginning after December 3l, 1987, see section 401(a)(30) and § 1.401(a)–30 for the effect of excess deferrals on the qualification of a plan or trust under section 401(a). For purposes of determining whether a plan or trust complies in operation with section 401(a)(30), excess deferrals that are distributed under paragraph (e)(2) or (3) of this section are disregarded. Similar rules apply to annuity contracts under section 403(b), simplified employee pensions under section 408(k), and plans or trusts under section 501(c)(28).

(ii) *Treatment of excess deferrals as employer contributions.* For other purposes of the Code, including sections 401(a)(4), 401(k)(3), 404, 409, 411, 412, and 416, excess deferrals must be treated as employer contributions even if they are distributed in accordance with paragraph (e)(2) or (3) of this section. However, excess deferrals of a non-highly compensated employee are not taken into account under section 401(k)(3) (the actual deferral percentage test) to the extent the excess deferrals are prohibited under section 401(a)(30). Excess deferrals are also treated as employer contributions for purposes of section 415 unless distributed under paragraph (e)(2) or (3) of this section.

(iii) *Definition of excess deferrals.* The term ''excess deferrals'' means the excess of an individual's elective deferrals for any taxable year, as defined in § 1.402(g)–1(b), over the applicable limit under section 402(g)(1) for the taxable year.

(2) *Correction of excess deferrals after the taxable year.* A plan may provide that if any amount is included in the gross income of an individual under paragraph (a) of this section for a taxable year:

(i) Not later than the first April 15 (or such earlier date specified in the plan) following the close of the individual's taxable year, the individual may notify each plan under which deferrals were made of the amount of the excess deferrals received by that plan. A plan may provide that an individual is deemed to have notified the plan of excess deferrals to the extent the individual has excess deferrals for the taxable year calculated by taking into account only elective deferrals under the plan and other plans of the same employer. A plan may instead provide that the employer may notify the plan on behalf of the individual under these circumstances.

(ii) Not later than the first April 15 following the close of the taxable year, the plan may distribute to the individual the amount designated under paragraph (e)(2)(i) of this section (and any income allocable to that amount).

(3) *Correction of excess deferrals during taxable year*—(i) A plan may provide that an individual who has excess deferrals for a taxable year may receive a corrective distribution of excess deferrals during the same year. This corrective distribution may be made only if all of the following conditions are satisfied:

(A) The individual designates the distribution as an excess deferral. A plan may provide that an individual is deemed to have designated the distribution to the extent the individual has excess deferrals for the taxable year calculated by taking into account only elective deferrals under the plan and other plans of the same employer. A plan may instead provide that the employer may make the designation on behalf of the individual under these circumstances.

(B) The correcting distribution is made after the date on which the plan received the excess deferral.

(C) The plan designates the distribution as a distribution of excess deferrals.

(ii) The provisions of this paragraph (e)(3) are illustrated by the following example:

Example. S is a 62 year old individual who participates in Employer Y's qualified cash or deferred arrangement. In January 1991, S withdraws $5,000 from Y's cash or deferred arrangement. From February through September, S defers $900 per month. On October 1, S leaves Employer Y and becomes employed by Employer Z (unrelated to Y). During the remainder of 1991, S defers $1,800 under Z's qualified cash or deferred arrangement. In January 1992, S realizes that S has deferred a total of $9,000 in 1991, and therefore has a $525 excess deferral ($9,000 minus $8,475, the applicable limit for 1991). An additional $525 must be distributed to S before April 15, 1992, to correct the excess deferral. The $5,000 withdrawal did not correct the excess deferral because it occurred before the excess deferral was made.

(4) *Plan provisions.* In order to distribute excess deferrals pursuant to paragraphs (e)(2) or (e)(3) of this section, a plan must contain language permitting distribution of excess deferrals. A plan may require the notification in paragraphs (e)(2) and (e)(3) of this section to be in writing and may require that the employee certify or otherwise establish that the designated amount is an excess deferral. A plan need not permit distribution of excess deferrals.

(5) *Income allocable to excess deferrals*—(i) *General rule.* The income allocable to excess deferrals is equal to the sum of the allocable gain or loss for the taxable year of the individual and, if the plan so provides, the allocable gain or loss for the period between the end of the taxable year and the date of distribution (the ‘‘gap period’’).

(ii) *Method of allocating income.* A plan may use any reasonable method for computing the income allocable to excess deferrals, provided that the method does not violate section 401(a)(4), is used consistently for all participants and for all corrective distributions under a plan for the plan year, and is used by the plan for allocating income to participants' accounts. See §1.401(a)(4)–1(c)(8).

(iii) *Alternative method of allocating income.* A plan may allocate income to excess deferrals by multiplying the income for the taxable year (and the gap period, if the plan so provides) allocable to elective contributions by a fraction. The numerator of the fraction is the excess deferrals by the employee for the taxable year. The denominator of the fraction is equal to the sum of:

(A) The total account balance of the employee attributable to elective contributions as of the beginning of the taxable year, plus

(B) The employee's elective contributions for the taxable year (and the gap period, if the plan so provides).

(iv) *Safe harbor method of allocating gap period income.* Under the safe harbor method, income on excess deferrals for the gap period is equal to 10 percent of the income allocable to excess deferrals for the taxable year (calculated under the method described in paragraph (e)(5)(iii) of this section), multiplied by the number of calendar months that have elapsed since the end of the taxable year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of the month is treated as made on the last day of the preceding month. A distribution made after the fifteenth day of the month is treated as made on the first day of the next month.

(6) *Coordination with distribution or recharacterization of excess contributions.* The amount of excess deferrals that may be distributed under this paragraph (e) with respect to an employee for a taxable year is reduced by any excess contributions previously distributed or recharacterized with respect to the employee for the plan year beginning with or within the taxable year. In the event of a reduction under this paragraph (e)(6), the amount of excess contributions includible in the gross income of the employee and reported by the employer as a distribution of excess contributions is reduced by the amount of the reduction under this paragraph (e)(6). See § 1.401(k)–1(f)(5)(i). In no case may an individual receive from a plan as a corrective distribution for a taxable year under paragraph (e)(2) or (e)(3) of this section an amount in excess of the individual's total elective deferrals under the plan for the taxable year.

(7) *No employee or spousal consent required.* A corrective distribution of excess deferrals (and income) may be made under the terms of the plan without regard to any notice or consent otherwise required under sections 411(a)(11) or 417.

(8) *Tax treatment*—(i) *Corrective distributions on or before April 15 after close of taxable year.* A corrective distribution of excess deferrals within the period described in paragraph (e)(2) or (e)(3) of this section is excludable from the employee's gross income. However, the income allocable to excess deferrals is includible in the employee's gross income for the taxable year in which the allocable income is distributed. The corrective distribution of excess deferrals (and income) is not subject to the early distribution tax of section 72(t) and is not treated as a distribution for purposes of applying the excise tax under section 4980A.

(ii) *Special rule for 1987 and 1988 excess deferrals.* Income on excess deferrals for 1987 or 1988 that were timely distributed on or before April 17, 1989, may be reported by the recipient either in the year described in paragraph (e)(8)(i) of this section, or in the year in which the employee would have received the elective deferrals had the employee originally elected to receive the amounts in cash.

(iii) *Distributions of excess deferrals after correction period.* If excess deferrals (and income) for a taxable year are not distributed within the period described in paragraphs (e)(2) and (e)(3) of this section, they may only be distributed when permitted under section 401(k)(2)(B). These amounts are includible in gross income when distributed, and are treated for purposes of the distribution rules otherwise applicable to the plan as elective deferrals (and income) that were excludable from the individual's gross income under section 402(g). Thus, any amount includible in gross income for any taxable year under this section that is not distributed by April 15 of the following taxable year is not treated as an investment in the contract for purposes of section 72 and is includible in the employee's gross income when distributed from the plan. Excess deferrals that are distributed under this paragraph (e)(8)(iii) are treated as employer contributions for purposes of section 415 when they are contributed to the plan.

(9) *No reduction of required minimum distribution.* A distribution of excess deferrals (and income) under paragraphs (e)(2) and (e)(3) of this section is not treated as a distribution for purposes of determining whether the plan meets the minimum distribution requirements of section 401(a)(9).

(10) *Partial correction.* Any distribution under paragraphs (e)(2) or (e)(3) of this section of less than the entire

amount of excess deferrals (and income) is treated as a pro rata distribution of excess deferrals and income.

(11) *Examples.* The provisions of this paragraph are illustrated by the following examples. Assume in *Examples 1* and *2* that there is no income or loss allocable to the elective deferrals.

Example 1. Employee A is a 60-year old highly compensated employee who participates in Employer M's cash or deferred arrangement. During the period of January through September of 1988, A contributed $7,000 to the arrangement in elective deferrals. During the same period A also contributed $813 in elective deferrals under a plan of an unrelated employer. In December of 1988, A made a withdrawal of $1,000 from Employer M's plan but did not designate this as a withdrawal of an excess deferral. In January of 1989, A notifies Employer M of an excess deferral, specifying a distribution of $500 for 1988. To correct the excess deferrals, A must receive this additional $500 even though A has already withdrawn $1,000 for 1988. A may exclude from income in 1988 only $7,313. However, if the $500 is distributed by April 25, 1989, the distribution is excludable from A's gross income in 1989. Even if A withdraws the $500, M must take into account the entire $7,000 in computing A's actual deferral percentage for 1988.

Example 2. (i) Corporation X maintains a cash or deferred arrangement. The plan year is the calendar year. For plan year 1989, all 10 of X's employees are eligible to participate in the plan. The employees' compensation, contributions, and actual deferral ratios are shown in the following table:

Employee	Compensation	Contribution	Actual deferral ratio (percent)
A	$140,000	$7,000	5.0
B	70,000	7,000	10.0
C	70,000	7,000	10.0
D	45,000	2,250	5.0
E	40,000	4,000	10.0
F	35,000	1,750	5.0
G	35,000	350	1.0
H	30,000	3,000	10.0
I	17,500	0	0
J	17,500	0	0.0

(ii) Employees A, B, and C are highly compensated employees within the meaning of section 414(q). Employees D, E, F, G, H, I, and J are nonhighly compensated employees. The actual deferral percentages for the highly compensated employees and nonhighly compensated employees are 8.33 percent and 4.43 percent, respectively. These percentages do not satisfy the requirements of section 401(k)(3)(A)(ii). The actual deferral percentage for the highly compensated employees may not exceed 6.43 percent.

(iii) The plan reduces the actual deferral ratios of B and C to 7.14 percent by distributing $2,002 ($7,000 − .0714×$70,000) to each in January 1990. Section 401(k)(3)(A)(ii) is therefore satisfied.

(iv) In February 1990, B notifies X that B made elective deferrals of $2,000 under a qualified cash or deferred arrangement maintained by an unrelated employer in 1989, and requests distribution of $2,000 from X's plan. However, since B has already received a distribution of $2,002 to meet the ADP test, no additional amounts are required or are permitted to be distributed as excess deferrals by this plan, and the prior distribution of excess contributions has corrected the excess deferrals. But X must report $2,000 as a distribution of an excess deferral and $2 as a distribution of an excess contribution.

Example 3. Employee T has excess deferrals of $1,000. The income attributable to excess deferrals is $100. T properly notifies the employer, and requests a distribution of the excess deferral (and income) on February 1. The plan distributes $1,000 to T by April 15. Because the plan did not distribute any additional amount as income, $909 is treated as a distribution of excess deferrals, and $91 is treated as a distribution of earnings. With respect to amounts remaining in the account, $91 is treated as an elective deferral and is not included in T's investment in the contract. Because it was not distributed by the required date, the $91 is includible in gross income upon distribution as well as in the year of deferral.

(f) *Community property laws.* This section is applied without regard to community property laws.

(g) *Effective date*—(1) *In general.* Except as otherwise provided, the provisions of this section are effective for taxable years beginning after December 31, 1986.

(2) *Deferrals under collective bargaining agreements.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, the provisions of this section do not apply to contributions made pursuant to the collective bargaining agreement for taxable years beginning before the earlier of January 1, 1989, or the date on which the agreement terminates (determined without regard to any extension thereof after February 28, 1986). These contributions under a collective bargaining agreement are taken into account for purposes of applying this section to elective deferrals

under plans not described in this paragraph (g)(2).

(3) *Transition rule.* For taxable years beginning before January 1, 1992, a plan or an individual may rely on a reasonable interpretation of the rules set forth in section 402(g), as in effect during those years.

(4) *Partnership cash or deferred arrangements.* For purposes of section 402(g), employer contributions for any plan year beginning after December 31, 1986, and before January 1, 1989, under an arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf will be treated as elective contributions only if the arrangement was intended to satisfy and did satisfy the nondiscrimination test of section 401(k)(3) and § 1.401(k)–1(b) for the plan year.

[T.D. 8357, 56 FR 40546, Aug. 15, 1991, as amended by T.D. 8581, 59 FR 66180, Dec. 23, 1994]

§ 1.403(a)–1 Taxability of beneficiary under a qualified annuity plan.

(a) An employee or retired or former employee for whom an annuity contract is purchased by his employer is not required to include in his gross income the amount paid for the contract at the time such amount is paid, whether or not his rights to the contract are forfeitable, if the annuity contract is purchased under a plan which meets the requirements of section 404(a)(2). For purposes of the preceding sentence, it is immaterial whether the employer deducts the amounts paid for the contract under such section 404(a)(2). See § 1.403(b)–1 for rules relating to annuity contracts which are not purchased under qualified plans but which are purchased by organizations described in section 501(c)(3) and exempt under section 501(a) or which are purchased for employees who perform services for certain public schools.

(b) The amounts received by or made available to any employee referred to in paragraph (a) of this section under such annuity contract shall be included in gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities), except that certain total distributions described in section 403(a)(2) are taxable as long-term capital gains. For the treatment of such total distributions, see § 1.403(a)–2. However, for taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such amounts. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(c) If upon the death of an employee or of a retired employee, the widow or other beneficiary of such employee is paid, in accordance with the terms of the annuity contract relating to the deceased employee, an annuity or other death benefit, the extent to which the amounts received by or made available to the beneficiary must be included in the beneficiary's income under section 403(a) shall be determined in accordance with the rules presented in paragraph (a)(5) of § 1.402(a)–1.

(d) An individual contract issued after December 31, 1962, or a group contract, which provides incidental life insurance protection may be purchased under a qualified annuity plan. For the rules as to nontransferability of such contracts issued after December 31, 1962, see § 1.401–9. For the rules relating to the taxation of the cost of the life insurance protection and the proceeds thereunder, see § 1.72–16. Section 403(a) is not applicable to premiums paid after October 26, 1956, for individual contracts which were issued prior to January 1, 1963, and which provide life insurance protection.

(e) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 7701(a)(20).

(f) For purposes of this section and § 1.403(a)–2, the term ''employee'' includes a self-employed individual who is treated as an employee under section 401(c)(1) and paragraph (b) of § 1.401–10, and the term ''employer'' means the person treated as the employer of such individual under section 401(c)(4). For the rules relating to annuity plans covering self-employed individuals, see section 404(a)(2) and §§ 1.404(a)–8 and 1.401–10 through 1.401–13.

(g) For the treatment of amounts paid to provide medical benefits described in section 401(h) as defined in §1.401–14, see paragraph (h) of §1.72–15.

[T.D. 6500, 25 FR 11680, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10143, Sept. 17, 1963; T.D. 6722, 29 FR 5073, Apr. 14, 1964; T.D. 6783, 29 FR 18359, Dec. 24, 1964; T.D. 6885, 31 FR 7801, June 2, 1966]

§1.403(a)–2 Capital gains treatment for certain distributions.

(a) If the total amounts payable with respect to any employee for whom an annuity contract has been purchased by an employer under a plan which—

(1) Is a plan described in section 403(a)(1) and §1.403(a)–1, and

(2) Requires that refunds of contributions with respect to annuity contracts purchased under such plan be used to reduce subsequent premiums on the contracts under the plan,

are paid to, or includible in gross income of, the payee within one taxable year of the payee by reason of the employee's death or other separation from the service, or death after such separation from the service, such total payments, to the extent they exceed the net amount contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than six months. The ''net amount contributed by the employee'' is the amount actually contributed by the employee plus any amounts considered to be contributed by the employee under the rules of sections 72(f), 101(b), and paragraph (d) of §1.403(a)–1, reduced by any amounts theretofore distributed to him which were excludable from his gross income as a return of employee contributions. For example, if under an annuity contract purchased under a plan described in this section, the total distributions payable to the employee's widow are paid to her in the year in which the employee dies, in the amount of $8,000, and if $5,000 thereof is excludable under section 101(b), and if the employee made contributions of $600 and had received no payments, the remaining amount of $2,400 will be considered a gain from the sale or exchange of a capital asset held for more than six months.

(b)(1) The term ''total amounts'' means the balance to the credit of an employee with respect to all annuities under the annuity plan which becomes payable to the payee by reason of the employee's death or other separation from the service, or by reason of his death after separation from the service. If an employee commences to receive annuity payments on retirement and then a lump sum payment is made to his widow upon his death, the capital gains treatment applies to the lump sum payment, but it does not apply to amounts received before the time the ''total amounts'' become payable. However, if the total amount to the credit of the employee at the time of his death or other separation from the service or death after separation from the service is paid or includible in the gross income of the payee within one taxable year of the payee, such amount is entitled to the capital gains treatment notwithstanding that in a later taxable year an additional amount is credited to the employee and paid to the payee.

(2) If more than one annuity contract is received under the plan, the capital gains treatment does not apply to any amount received on the surrender thereof unless all contracts under the plan with respect to a particular employee are surrendered either at the time of the employee's death or other separation from the service or death after separation from the service. Thus, if an employee receives two contracts on separation from the service and surrenders one of them in the year of separation and receives payments under the other until his death, the capital gains treatment is applicable to the balance paid to his beneficiary on his death if paid within one taxable year of the beneficiary. The amount received by the employee on surrender of the contract in the year of his separation from the service, however, would not receive capital gains treatment since the balance to the credit of the employee with respect to all amounts under the plan did not become payable at that time.

(3) If an employee retires and commences to receive an annuity but subsequently in some succeeding taxable

year, he is paid a lump sum in settlement of all future annuity payments, the capital gains treatment does not apply to such lump sum settlement paid during the lifetime of the employee since it is not a payment on account of separation from the service, or death after separation, but is on account of the settlement of future annuity payments.

(4) If the ''total amounts'' payable under all annuity contracts under the plan with respect to a particular employee are paid or includible in the gross income of several payees within one taxable year on account of the employee's death or other separation from the service or on account of his death after separation from the service, the capital gains treatment is applicable. Thus, if the balance to the credit of a deceased employee under all annuity contracts provided under an annuity plan becomes payable to two payees, the capital gains treatment is applicable provided the ''total amounts'' payable are received by or includible in the gross income of both payees within the same taxable year. However, if the ''total amounts'' payable are made available to each payee and one elects to receive his share in cash while the other makes a timely election under section 72(h) to receive his share as an annuity, the capital gains treatment does not apply to either payee.

(5) For purposes of determining whether the total amounts payable to an employee have been paid within one taxable year, the term ''total amounts'' includes amounts under a plan which are attributable to contributions on behalf of an individual while he was self-employed in the business with respect to which the plan was established. Thus, the ''total amounts'' payable are not paid within one taxable year if amounts remain payable which are so attributable.

(6) The term ''total amounts'' does not include any amount which has been placed in a separate account for the funding of benefits described in section 401(h). Thus, a distribution under a qualified annuity plan may constitute a distribution of the total amounts payable with respect to an employee even though amounts attributable to the funding of section 401(h) medical benefits as defined in paragraph (a) of § 1.401–14 are not so distributed.

(c) The provisions of this section are not applicable to any amounts paid to a payee to the extent such amounts are attributable to contributions made on behalf of an employee while he was a self-employed individual in the business with respect to which the plan was established. For the taxation of such amounts, see § 1.72–18. For the rules for determining the amount attributable to contributions on behalf of an employee while he was self-employed, see paragraphs (b)(4) and (c)(2) of such section.

[T.D. 6500, 25 FR 11681, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10143, Sept. 17, 1963; T.D. 6722, 29 FR 5073, Apr. 14, 1964]

§ 1.403(b)–1 Taxability of beneficiary under annuity purchased by a section 501(c)(3) organization or public school.

(a) *Amounts paid by employer during taxable years beginning before January 1, 1958*—(1) *In general.* If an amount is paid during a taxable year of an employee (or a retired or former employee) beginning before January 1, 1958, toward the purchase for such employee of an annuity contract and such purchase is not part of an annuity plan which meets the requirements of section 404(a)(2), then such amount is not required to be included in the gross income of such employee for such taxable year—

(i) If such amount is paid by an employer which, at the time of the payment, is an organization described in section 501(c)(3) and exempt from tax under section 501(a), and

(ii) If the purchase of the annuity contract is merely a supplement to the past or current compensation of such employee (within the meaning of subparagraph (2) of this paragraph).

For purposes of this paragraph, it is immaterial whether or not the employee's rights to the annuity contract are forfeitable.

(2) *Supplement to past or current compensation.* For purposes of this paragraph, whether the purchase of an annuity contract is merely a ''supplement to past or current compensation'' is to be determined by all the surrounding facts and circumstances. One

of the pertinent facts to be taken into consideration is the ratio of the consideration paid by the employer for an employee's contract to the amount of his past or current compensation. For example, if the annual premium paid for an employee's contract is $1,000 and his annual salary is $10,000, the ratio indicates that the premium paid for the contract is merely a supplement to the employee's current compensation. If, however, an employee receives no current compensation, or the annual premiums paid for his annuity contract approximate his annual salary, the amount paid for his contract will be considered to be current compensation and taxable to the employee in the year in which it is paid by the employer. Other pertinent considerations are whether the annuity contract is purchased as a result of an agreement for a reduction of the employee's annual salary, or whether it is purchased at his request in lieu of an increase in current compensation to which he otherwise might be entitled. In such cases, the amount paid for the contract shall also be considered to be current compensation.

(b) *Amounts paid by employer during taxable years beginning after December 31, 1957*—(1) *In general.* If amounts are contributed by an employer during a taxable year of an employee (or a retired or former employee) beginning after December 31, 1957, toward the purchase for such employee of an annuity contract and such purchase is not part of an annuity plan which meets the requirements of section 404(a)(2), then, to the extent such amounts do not exceed the exclusion allowance for such taxable year, they are not required to be included in the gross income of such employee for such taxable year, if at the time of the contribution—

(i) The employer is an organization described in section 501(c)(3) and exempt from tax under section 501(a), or

(ii) The employer is a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing, and the employee is performing (or has performed) services for an educational institution (as defined in section 151(e)(4)), and

(iii) The employee's rights under the annuity contract are nonforfeitable except for failure to pay future premiums.

See paragraph (d) of this section for rules relating to the computation of an employee's exclusion allowance for a taxable year.

(2) *Forfeitable rights which change to nonforfeitable rights.* If an employee's rights under an annuity contract change from forfeitable to nonforfeitable rights, the amount which, under section 403(d), is includible in the gross income of such employee by reason of such change (computed without regard to subparagraph (1) of this paragraph) shall, for purposes of subparagraph (1) of this paragraph, be considered an amount contributed by the employer for such annuity contract as of the time the employee's rights under the contract change to nonforfeitable rights. Such amount will, therefore, be excludable from the employee's gross income for the taxable year in which the change occurs to the extent that it is so excludable under the rules contained in this section. In determining the extent to which such amount is excludable, this section shall be applied in the same manner as in the case of current employer contributions. Thus, no part of such amount is excludable if the employer is not an employer described in subparagraph (1) of this paragraph at the time the employee's rights under the annuity contract change from forfeitable to nonforfeitable rights. In addition, such amount will be excludable only to the extent it does not exceed the employee's exclusion allowance for the taxable year in which the change occurs. Since such an amount is considered as an amount contributed by the employer at the time the change occurs, it is immaterial whether the employer was an employer described in subparagraph (1) of this paragraph at the time the actual contributions were made.

(3) *Agreement to take a reduction in salary or to forego an increase in salary.* (i) There is no requirement that the purchase of an annuity contract for an employee must be merely a ''supplement to past or current compensation'' in order for the exclusion provided by this

paragraph to apply to employer contributions for such annuity contract. Thus, the exclusion provided by this paragraph is applicable to amounts contributed by an employer for an annuity contract as a result of an agreement with an employee to take a reduction in salary, or to forego an increase in salary, but only to the extent such amounts are earned by the employee after the agreement becomes effective. Such an agreement must be legally binding and irrevocable with respect to amounts earned while the agreement is in effect. Except as provided in subdivision (ii) of this subparagraph, the employee must not be permitted to make more than one agreement with the same employer during any taxable year of such employee beginning after December 31, 1963; the exclusion provided by this paragraph shall not apply to any amounts which are contributed under any further agreement made by such employee during the same taxable year beginning after such date. However, the employee may be permitted to terminate the entire agreement with respect to amounts not yet earned.

(ii) An individual who is employed by an organization described in section 415(c)(4) may make a salary reduction agreement for his taxable year beginning in 1976 or 1977 at any time before the end of the 1976 or 1977 taxable year, respectively, without the agreement's being considered a new agreement within the meaning of this subparagraph. The agreement for 1976 may be made on or before June 15, 1977, and the agreement for 1977 may be made on or before April 17, 1978. This special rule only applies if the individual makes a statement of intention in accordance with § 11.415(c)(4)–1(b) electing, or determines his income tax liability for the taxable year in a way which is consistent with, one of the alternative limitations under section 415(c)(4) for 1976 or 1977 (as the case may be). The salary reduction agreement for 1976 may be made effective with respect to any amount earned during the taxpayer's most recent one-year period of service (as defined in paragraph (f) of this section) ending not later than the end of the 1976 taxable year, notwithstanding subdivision (i) of this subparagraph. Similarly, the salary reduction agreement for 1977 may be made effective with respect to such period of service ending not later than the end of the 1977 taxable year. If the salary reduction agreement for 1976 is entered into at any time after December 31, 1976, or if the salary reduction agreement for 1977 is entered into at any time after December 31, 1977, an amended Form W–2 must be filed on behalf of the individual.

(iii) The rules of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. A is an employee of X Organization (an employer described in section 501(c)(3) and exempt from tax under section 501(a)) for the entire calendar year 1964. A uses the calendar year as a taxable year. A's annual salary as of January 1, 1964, is $12,000. On February 1, 1964, A and his employer enter a binding and irrevocable agreement whereby A is to take a 10-percent reduction in salary (from $1,000 per month to $900 per month) and X Organization is to contribute $100 per month for an annuity contract described in section 403(b). The agreement also provides that A may terminate the entire agreement with respect to amounts not yet earned. Since the agreement to reduce A's salary and invest the amount of such reduction in an annuity contract was made after A earned his salary for January, A's current compensation for January is $1,000 even though the agreement may provide that X Organization shall contribute $100 with respect to January for the benefit of A for an annuity contract described in section 403(b). For February and subsequent months ending before July 1, 1964, X Organization contributes $100 per month for A's annuity. Thus, A's current compensation for each of these months is $900, and the $100 which is contributed during such months by X Organization for an annuity contract for A is an employer contribution to which the exclusion provided in this paragraph applies. On July 1, 1964, A becomes entitled to a salary increase of $200 per month and, pursuant to the agreement of February 1, 1964, X Organization contributes 10 percent of such increase or an additional $20 per month for a section 403(b) annuity. For July and subsequent months ending before October 1, 1964, X Organization contributes $120 per month for A's annuity. Thus, A's current compensation for each of these months is $1,080, and the $120 which is contributed during such months by X Organization for an annuity contract for A is an employer contribution to which the exclusion provided in this paragraph applies. On November 1, 1964, A terminates the entire agreement with respect to amounts not yet earned. Since the termination occurred after A earned his salary for the month of October, the contribution for October is an employer contribution to which the exclusion provided in this paragraph applies. For the months November and December, A's full salary of $1,200 per month is includible in his gross income whether or not his employer makes contributions for a section 403(b) annuity.

(4) *Two or more annuity contracts.* If, during a taxable year of an employee, this paragraph applies to amounts contributed (including amounts which are considered to be contributed under subparagraph (2) of this paragraph) by his employer for two or more annuity contracts for such employee, such two or more annuity contracts shall, for such taxable year, be considered a single contract for purposes of applying the rules contained in this paragraph.

(5) *Employees performing services for public schools.* For purposes of this section, a person shall be considered an employee who performs services for an educational institution (as defined in section 151(e)(4)) if he is performing services as an employee directly or indirectly for such an institution. Thus, for example, the principal, clerical employees, custodial employees, and teachers at a public elementary school are employees performing services directly for such an educational institution. An employee who performs services involving the operation or direction of a State's, or political subdivision's, education program as carried on through educational institutions (as defined in section 151(e)(4)) is an employee performing services indirectly for such institutions. An employee participating in an ''in-home'' teaching program is included since such program is merely an extension of the activities carried on by such educational institutions. On the other hand, a person occupying an elective or appointive public office is not an employee performing services for an educational institution unless such office is one to which an individual is elected or appointed only if he has received training, or is experienced, in the field of education. The term ''public office'' includes any elective or appointive office of a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing. Thus, for example, a regent or trustee of a State university or a member of a board of education is not an employee performing services for an educational institution. On the other hand, a commissioner or superintendent of education will generally be considered an employee performing services for an educational institution.

(c) *Taxation of amounts received under annuity contracts*—(1) *In general.* The amounts received by or made available to any employee under an annuity contract to which paragraph (a) or (b) of this section applies shall be included in the gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities). For taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to any amount received by or made available to any such employee under such an annuity contract. For taxable years beginning after December 31, 1963, amounts received or made available to any such employee under such annuity contract may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(2) *Taxation of beneficiaries.* If, upon the death of an employee or of a retired employee, the widow or other beneficiary of such employee is paid, in accordance with the terms of the annuity contract relating to the deceased employee, an annuity or other death benefit, the extent to which the amounts received by or made available to the beneficiary must be included in the beneficiary's income under subparagraph (1) of this paragraph shall be determined in accordance with the rules presented in paragraph (a)(5) of §1.402(a)–1.

(3) *Life insurance protection.* An individual contract issued after December 31, 1962, or a group contract, which provides incidental life insurance protection may be purchased as an annuity contract to which paragraph (a) or (b) of this section applies. For the rules as to nontransferability of such contracts issued after December 31, 1962, see §1.401–9. For the rules relating to the

taxation of the cost of the life insurance protection and the proceeds thereunder, see § 1.72–16. Section 403(b) is not applicable to premiums paid after October 26, 1956, for individual contracts which were issued prior to January 1, 1963, and which provide life insurance protection.

(d) *Exclusion allowance*—(1) *In general.* For purposes of paragraph (b) of this section, an employee's exclusion allowance for a taxable year is an amount equal to the excess, if any, of—

(i) The amount determined by multiplying *(a)* 20 percent of such employee's includible compensation in respect of such taxable year, by *(b)* such employee's total number of years of service as of the close of such taxable year, over

(ii) The aggregate of (*a*) the amounts which have been contributed by the employer for annuity contracts for such employee and which were excludable from the gross income of the employee for any taxable year prior to the taxable year for which the exclusion allowance is being determined, and (*b*) the amounts of compensation excludable from the gross income of the employee under section 457(a) (relating to eligible State deferred compensation plans) for any prior taxable year that is taken into account as a year of service under paragraph (f) of this section. Compensation deferred under an eligible State deferred compensation plan shall be taken into account as described in subdivision (ii) of this subparagraph even if the entity sponsoring the eligible plan is not the employer purchasing the annuity contract with respect to which the employee's exclusion allowance is to be determined. See paragraph (e) of this section for the definition of an employee's includible compensation in respect of a taxable year and paragraph (f) of this section for rules for computing an employee's total number of years of service for an employer.

(2) *More than one employer.* If, during a taxable year of an employee, amounts are contributed for annuity contracts for such employee by two or more employers described in paragraph (b)(1) (i) or (ii) of this section, a separate exclusion allowance shall be computed with respect to each employer. In such a case, therefore, there shall not be taken into account, in computing the exclusion allowance with respect to one employer, the ''includible compensation'' received by the employee from any other employer, the employee's years of service with any other employer, or amounts which have been contributed by any other employer for annuity contracts for such employee.

(3) *Amounts previously contributed by the employer which were excludable from the employee's gross income.* In computing, for purposes of subparagraph (1)(ii) of this paragraph, the aggregate of the amounts which have been contributed by an employer for annuity contracts for an employee and which were excludable from the gross income of the employee for any taxable year prior to the taxable year for which the exclusion allowance is being determined, there shall be included all contributions made by the employer for the benefit of the employee—

(i) Which, under section 402(a) or section 403(a), were excludable from the employee's gross income for any such prior taxable year by reason of being contributions to a trust described in section 401(a) and exempt from tax under section 501(a) or contributions toward the purchase of an annuity contract under a plan which meets the requirements of section 404(a)(2) (whether forfeitable or nonforfeitable); or

(ii) Which, under section 405(d), were excludable from the employee's gross income for any such prior taxable year by reason of being contributions toward the purchase of United States bonds under a plan which meets the requirements of section 405(a)(1); or

(iii) Which were excludable from the employee's gross income for any such prior taxable year by reason of being contributions described in paragraph (a) or (b) of this section; or

(iv) *(a)* Which were excludable from the employee's gross income for the taxable year when made solely by reason of the fact that the employee's rights to such contributions were forfeitable at the time they were made (and not for any of the reasons described in subdivisions (i), (ii), and (iii) of this subparagraph);

(b) With respect to which the employee's rights changed to nonforfeitable

rights prior to the taxable year for which the exclusion allowance is being determined; and

(c) Which were not, under section 403(d) and without regard to paragraph (b) of this section, includible in the employee's gross income for the taxable year in which his rights to such contributions changed from forfeitable to nonforfeitable rights.

For purposes of subdivisions (i) and (iii) of this subparagraph, all references to provisions of the Internal Revenue Code of 1954 and to provisions of the regulations under such Code shall also be considered references to the corresponding provisions of prior law and regulations. See subparagraph (4) of this paragraph for rules relating to the allocation of employer contributions to an employee where the actual contributions are not allocated among individual employees; or

(v) Which were contributions to a section 403(b) annuity contract for a prior taxable year and which exceeded the limitations of section 415(c)(1) applicable to the employee. See §1.415–6(e)(1)(ii) for a more detailed discussion of this rule. See also §1.415–9(c) for rules relating to the treatment of certain contributions to a section 403(b) annuity contract which are excess contributions because of the aggregation of the annuity contract with a qualified plan.

(4) *Determination of excludable amounts by allocation of contributions.* If, for any employee, the actual amounts of employer contributions to a defined benefit plan described in subparagraph (3) of this paragraph are not known, such amounts shall be determined under the formula described in this subparagraph or under any other method utilizing recognized actuarial principles which are consistent with the provisions of the plan under which such contributions are made and the method adopted by the employer for funding the benefits under the plan. If the formula described in this subparagraph is to be used, the contributions made by the employer for the benefit of the employee as of the end of any taxable year shall be deemed to be the product of the quantities described in subdivisions (i), (ii), (iii), and (iv) of this subparagraph. Such quantities are—

(i) The projected annual amount of the employee's pension (as of the end of the taxable year) to be provided at normal retirement age from employer contributions, based upon the provisions of the plan in effect at such time and upon the assumption of the employee's continued employment with his present employer at his then current salary rate.

(ii) The value, from Table I below, at normal retirement age of an annuity of $1.00 per annum payable in equal monthly installments during the life of the employee, based upon the normal retirement age as defined in the plan.

(iii) The amount from Table II below (representing the level annual contribution which will accumulate to $1.00 at normal retirement age) for the sum of *(a)* the number of years remaining from the end of the taxable year to normal retirement age and *(b)* the lesser of the number of years of service credited through the end of the taxable year or the number of years that the plan has been in existence at such time.

(iv) The lesser of the number of years of service credited through the end of the taxable year or the number of years that the plan has been in existence at such time.

TABLE I—VALUE AT NORMAL RETIREMENT AGES OF ANNUITY OF $1.00 PER ANNUM PAYABLE IN EQUAL MONTHLY INSTALLMENTS DURING THE LIFE OF THE EMPLOYEE

[For taxable years beginning after July 1, 1986]

Ages	Values
40	11.49
41	11.40
42	11.31
43	11.22
44	11.12
45	11.01
46	10.91
47	10.79
48	10.68
49	10.56
50	10.43
51	10.30
52	10.18
53	10.04
54	9.89
55	9.75
56	9.60
57	9.44
58	9.28
59	9.13
60	8.96
61	8.79

TABLE I—VALUE AT NORMAL RETIREMENT AGES OF ANNUITY OF $1.00 PER ANNUM PAYABLE IN EQUAL MONTHLY INSTALLMENTS DURING THE LIFE OF THE EMPLOYEE—Continued

[For taxable years beginning after July 1, 1986]

Ages	Values
62	8.62
63	8.44
64	8.25
65	8.08
66	7.88
67	7.70
68	7.50
69	7.29
70	7.10
71	6.88
72	6.68
73	6.46
74	6.25
75	6.03
76	5.82
77	5.61
78	5.40
79	5.20
80	4.99

NOTE: If the normal form of retirement benefit under the plan is other than a straight life annuity, the value from Table I above should be divided by the figure set forth below opposite the normal form of retirement benefit provided by the plan:

Annuity for 5 years certain and life thereafter	0.97
Annuity for 10 years certain and life thereafter	0.90
Annuity for 15 years certain and life thereafter	0.80
Annuity for 20 years certain and life thereafter	0.70
Life annuity with installment refund	0.80
Life annuity with cash refund[1]	0.75

[1] The term ''cash refund'' refers to refund of accumulated employer contributions, and does not refer to refund of employee contributions only, often referred to as ''modified cash refund''.

TABLE II—LEVEL ANNUAL CONTRIBUTION WHICH WILL ACCUMULATE TO $1.00 AT END OF NUMBER OF YEARS

[For taxable years beginning after July 1, 1986]

Number of years	Amounts
1	$1.0000
2	.4808
3	.3080
4	.2219
5	.1705
6	.1363
7	.1121
8	.0940
9	.0801
10	.0690
11	.0601
12	.0527
13	.0465
14	.0413
15	.0368
16	.0330
17	.0296
18	.0267
19	.0241
20	.0219
21	.0198
22	.0180
23	.0164
24	.0150
25	.0137
26	.0125
27	.0114
28	.0105
29	.0096
30	.0088
31	.0081
32	.0075
33	.0069
34	.0063
35	.0058
36	.0053
37	.0049
38	.0045
39	.0042
40	.0039
41	.0036
42	.0033
43	.0030
44	.0028
45	.0026
46	.0024
47	.0022
48	.0020
49	.0019
50	.0017

(5) *Election to have allowance determined under section 415 rules.* Under section 415(c)(4)(D), an employee may elect to have the provisions of section 415(c)(4)(C) (relating to special limitations for annuity contracts purchased by educational organizations, hospitals and home health service agencies) apply for a taxable year. If the employee so elects, his exclusion allowance is the maximum amount under section 415 that could be contributed by the employer for the benefit of the employee if the annuity contract for the benefit of the employee were treated as a defined contribution plan maintained by the employer. Thus, the exclusion allowance for the taxable year of an employee who makes the election

may not exceed the limitation on contributions and other additions (as described in §1.415–6) applicable to the employee for that taxable year. See §1.415–7 for provisions applicable in the event an employer maintains a defined benefit plan and a defined contribution plan for the same employee. See §1.415–8 for provisions applicable in the event an employer maintains more than one defined contribution plan covering the same employee.

(e) *Includible compensation*—(1) *In general.* For purposes of computing, under paragraph (d) of this section, an employee's exclusion allowance for a taxable year, such employee's includible compensation in respect of such taxable year means the amount of compensation from the employer—

(i) Which was earned during the most recent period (ending not later than the close of the employee's taxable year for which the exclusion allowance is being determined) that, under paragraph (f) of this section, may be counted as one-year of service,

(ii) Which is includible in the employee's gross income, and

(iii) In the case of an employee of an employer described in paragraph (b)(1)(ii) of this section, which is attributable to services performed for an educational institution (as defined in section 151(e)(4)).

See subparagraph (2) of this paragraph for special rules for determining the amount of compensation which is includible in the employee's gross income.

(2) *Special rules for determining the amount of compensation includible in the employee's gross income.* For purposes of subparagraph (1) of this paragraph, the amount of compensation which is includible in the employee's gross income shall be computed without regard to the exclusions allowed by section 105(d) (relating to wage continuation plans) and section 911 (relating to earned income from sources without the United States). Therefore, although amounts received by the employee from the employer while he is absent from work on account of personal injuries or sickness may be excludable from his gross income under section 105(d), such amounts are, nevertheless, considered as includible in his gross income for purposes of computing his includible compensation. On the other hand, in computing the amount which is includible in the gross income of the employee for purposes of subparagraph (1) of this paragraph, there shall not be included any amount which is contributed by the employer for an annuity contract to which paragraph (b) of this section applies. Thus, although the amount of any employer contributions for an annuity contract to which paragraph (b) of this section applies is, to the extent it exceeds in any taxable year the employee's exclusion allowance for such year, includible in the employee's gross income for that year, such amount is not considered as includible in the employee's gross income for purposes of computing his includible compensation for that year.

(3) *Period during which compensation must be earned.* For purposes of computing an employee's exclusion allowance for a taxable year, there may not be taken into account, as includible compensation, any compensation which was earned by the employee during a taxable year ending after the taxable year for which the exclusion allowance is being determined. On the other hand, an employee's includible compensation may include all or part of his compensation earned during a taxable year prior to the taxable year for which the exclusion allowance is being determined. Such a situation can occur, for example, when an employer purchases an annuity contract for a retired employee, or when an employer purchases an annuity contract for a part-time employee whose most recent one-year period of service (within the meaning of paragraph (f) of this section) extends over more than one taxable year of such employee. For purposes of this subparagraph, it is immaterial when the compensation is actually received by the employee or for what taxable year it is includible in his gross income.

(4) *Status of employer.* In computing an employee's exclusion allowance for a taxable year, there is not taken into account, as includible compensation, any compensation which was earned during a period when the employer was not an employer described in paragraph (b)(1) (i) or (ii) of this section since

under paragraph (f)(2) of this section an employee is not considered to be in the service of the employer for any such period. On the other hand, it is immaterial whether the employer is an employer described in paragraph (b)(1) (i) or (ii) of this section at the time the compensation is actually received by the employee. Thus, if an employee receives compensation during his 1961 taxable year for services performed during his 1960 taxable year, such compensation can qualify as includible compensation if his employer was an employer described in paragraph (b)(1) (i) or (ii) of this section during 1960, even though such employer was not such an employer during 1961. See, also, paragraph (b) of this section which provides that the exclusion allowance is only applicable with respect to contributions which are made by an employer at a time when such employer is an employer described in paragraph (b)(1) (i) or (ii) of this section.

(f) *Years of service*—(1) *In general.* In computing an employee's exclusion allowance for a taxable year, it is necessary to determine such employee's number of years of service for the employer as of the close of such taxable year. For this purpose, the number of years of service of an employee for an employer shall be determined in accordance with the rules set forth in this paragraph. In addition, such rules are applicable in determining, for purposes of paragraph (e) of this section, an employee's most recent one-year period of service.

(2) *Exempt status requirement.* For purposes of determining an employee's number of years of service for an employer and his most recent one-year period of service for such employer, an employee shall not be considered to be employed by the employer, or to be in the service of the employer, during any period that the employer is not an employer described in paragraph (b)(1) (i) or (ii) of this section, or, in the case of an employee of an employer described in paragraph (b)(1)(ii) of this section, during any period when the employee is not performing services for an educational institution (as defined in section 151(e)(4)). The rule in this subparagraph may be illustrated by the following example: A was employed on a full-time basis by the X scientific organization during the whole of 1959 and 1960 and during half of 1961. Both A and the X Organization use the calendar year as their taxable year. The X Organization was an organization described in section 501(c)(3) and exempt from tax under section 501(a) during the years 1959 and 1961, but not during the year 1960. For purposes of determining A's exclusion allowance for 1961, he is considered to have 1½ years of service (his service during 1959 and 1961) and his most recent one-year period of service ending not later than the close of 1961 consists of his service during 1961 (which is equal to ½ year of service) and his service during the last half of 1959 (which is equal to another ½ year of service).

(3) *Service included.* For purposes of computing an employee's exclusion allowance for a taxable year, there may be taken into account, in determining his number of years of service, all service performed by him as of the close of such taxable year. Therefore, whenever possible, service performed during each of the employee's taxable years should be considered separately in arriving at his total number of years of service. For example, if an employee who reports his income on a calendar year basis is employed on a full-time basis on July 1, 1959, and continues on a full-time basis through December 31, 1960, his number of years of service as of the close of his 1960 taxable year should, if possible, be computed as follows:

(a) Number of years of service performed during 1959 taxable year	½
(b) Number of years of service performed during 1960 taxable year	1
(c) Total number of years of service as of close of 1960 taxable year (*(a)*+*(b)*)	1½

However, in determining what constitutes a full year of service, the employer's annual work period, and not the employee's taxable year, is the standard of measurement. For example, in determining whether a professor is employed full time, the number of months in the school's academic year shall be the standard of measurement.

(4) *Full-time employee for full year.* (i) Each full year during which an individual was employed full time shall be

considered as one year of service. In determining whether an individual is employed full-time, the amount of work which he is required to perform shall be compared with the amount of work which is normally required of individuals holding the same position with the same employer and who generally derive the major portion of their personal service income from such position.

(ii)*(a)* In measuring the amount of work required of individuals holding a particular position, any method that reasonably and accurately reflects such amount may be used. For example, the number of hours of classroom instruction is only an indication of the amount of work required, but it may be used as a measure.

(b) In determining whether positions with the same employer are the same, all of the facts and circumstances concerning the positions shall be considered, including the work performed, the methods by which compensation is computed, and the descriptions (or titles) of the positions. For example, an assistant professor employed in the English department of a university will be considered a full-time employee if the amount of work that he is required to perform is the same as the amount of work normally required of assistant professors of English at that university who derive the main portion of their personal service income from such position.

(c) In case an individual's position is not the same as another with his employer, the rules of this paragraph shall be applied by considering the same position with similar employers or similar positions with the same employer.

(iii) A full year of service for a particular position means the usual annual work period of individuals employed full-time in that general type of employment at the place of employment. For example, if a doctor employed by a hospital works throughout the 12 months of a year except for a one-month vacation, such doctor will be considered as being employed for a full year, if the other doctors at that hospital work 11 months of the year with a one-month vacation. Similarly, if the usual annual work period at a university consists of the fall and spring semesters, an instructor at that university who teaches those semesters will be considered as working a full year.

(5) *Other employees.* (i) An individual shall be treated as having a fraction of a year of service for each year during which he was a full-time employee for part of the year or for each year during which he was a part-time employee for the entire year or for a part of the year.

(ii) In determining the fraction which represents the fractional year of service for an individual employed full time for part of a year, the numerator shall be the number of weeks (or months) during which the individual was a full-time employee in a position during that year, and the denominator shall be the number of weeks (or months) which is considered under subparagraph (4)(iii) of this paragraph as the usual annual work period for that position. For example, if an instructor is employed full time by a university for the 1959 spring semester (which lasts from February 1959 through May 1959), and the academic year of the university is 8 months long, beginning in October 1958, and ending in May 1959, then he is considered as having completed 4⁄8 of a year of service.

(iii) In determining the fraction which represents the fractional year of service of an individual who is employed part time for a full year, the numerator shall be the amount of work required to be performed by the individual, and the denominator shall be the amount of work normally required of individuals who hold the same position. The amount of work required to be performed by the individual and the amount of work normally required of individuals holding the same position shall be determined in accordance with the principles of subparagraph (4) of this paragraph. Thus, if a practicing physician teaches one course at a local medical school 3 hours per week for two semesters and other faculty members at that medical school teach 9 hours per week for two semesters, then the practicing physician is considered as having completed 3⁄9 of a year of service.

(iv) In determining the fraction representing the fractional year of service of an individual who is employed part time for part of a year, it is necessary to compute the fractional year of service if the individual were a part-time employee for a full year, and the fractional year of service if the individual were a full-time employee for the part of a year. The two fractions shall be multiplied and the product is the fractional year of service of such individual who is employed part time for part of a year. For example, if an attorney who is a specialist in a subject teaches a course in that subject for 3 hours per week for one semester at a nearby law school, and the full-time instructors at that law school teach 12 hours per week for two semesters, then the fractional part of a year of service for such part-time instructor is computed as follows: The fractional year of service if the instructor were a part-time employee for a full year is 3⁄12 (number of hours employed divided by the usual number of hours of work required for that position); the fractional year of service if the instructor were a full-time employee for part of a year is ½ (period worked or one semester, divided by usual work period, or 2 semesters). These fractions are multiplied to obtain the fractional year of service: 3⁄12 times ½, or 3⁄24 (⅛).

(6) *Less than one year of service considered as one year.* If, at the close of a taxable year, an employee has, under the rules in this paragraph, a period of service of less than one year, such employee shall, nevertheless, be considered to have one year of service for purposes of computing his exclusion allowance for that taxable year. Such period of service of less than one year shall also be considered to be such employee's most recent one-year period of service for purposes of determining his includible compensation.

(7) *Most recent one-year period of service.* (i) In determining, for purposes of paragraph (e) of this section (relating to includible compensation), an employee's most recent one-year period of service, there is first taken into account all service performed by the employee during the taxable year for which the exclusion allowance is being determined. For this purpose, therefore, an employee's most recent one-year period of service may not be the same as his employer's most recent annual work period. The rule in this subdivision may be illustrated by the following example: A, a professor who reports his income on a calendar year basis, is employed by a university on a full-time basis during the university's 1959–1960 and 1960–1961 academic years (October through May). For purposes of computing A's exclusion allowance for his 1960 taxable year, his most recent one-year period of service consists of his service performed during January through May, 1960 (which is part of the 1959–1960 academic year) and his service performed during October through December 1960 (which is part of the 1960–1961 academic year).

(ii) In the case of a part-time employee or a full-time employee who is employed for only part of a year, it will be necessary to aggregate his most recent periods of service to determine his most recent one-year period of service. In such a case, there is first taken into account his service during the taxable year for which the exclusion allowance is being determined; then there is taken into account his service during his next preceding taxable year and so forth until his service equals, in the aggregate, one year of service. For example, if an employee, who reports his income on the calendar year basis, is employed on a full-time basis during the months July through December 1959 (½ year of service), July through December 1960 (½ year of service), and October through December 1961 (¼ year of service), his most recent one-year period of service for purposes of computing his exclusion allowance for 1961 consists of his service during 1961 (¼ year of service), his service during 1960 (½ year of service), and his service during the months October through December 1959 (¼ year of service).

(g) *Illustration of computation of exclusion allowance.* The exclusion provided under paragraph (b) of this section may be illustrated by the following example: A, a professor who reports his income on the calendar year basis, became a full-time employee of X University on October 1, 1958 (beginning of X University's 1958–1959 academic year) and continued as a full-time employee for the academic years 1958–1959, 1959–1960, and 1960–1961. X University was, during all such academic years, an organization described in section 501(c)(3) and exempt from tax under section 501(a). X University's academic year runs for a period of 8 months: October through May. A received an annual salary, all of which was includible in his gross income, of $8,000 for the 1958–1959 academic year, $8,800 for the 1959–1960 academic year, and $9,600 for the 1960–1961 academic year. Starting in 1958, X University contributed amounts toward the purchase of annuity contracts for A and such purchase was not part of a qualified annuity plan. X University paid, as premiums for such contracts, $1,000 in 1958, $2,000 in 1959, $2,400 in 1960, and $1,400 in 1961. The amount of such premiums which is excludable from A's gross income for the year in which paid is computed as follows:

1958

(1) Amount contributed by employer for annuity contracts in 1958	$1,000.00
(2) Includible compensation for most recent one-year period of service (since A was employed for only ⅜ of a year at the close of 1958, this period is counted as most recent one-year period of service) ⅜ × $8,000	$3,000.00
(3) 20% × includible compensation	$600.00
(4) Number of years of service (although A was employed for less than a year, he is considered to have one-year of service)	1
(5) Item (4) × item (3)	$600.00
(6) Contributions excludable in prior taxable years of A	None
(7) Amount excludable from A's gross income for 1958 ((5)—(6))	$600.00
(8) Amount includible in A's gross income for 1958 ((1) − (7))	$400.00

1959

(9) Amount contributed by employer for annuity contracts in 1959	$2,000.00
(10) Includible compensation for most recent one-year period of service. (⅜ × $8,800+⅝×$8,000)	$8,800.00
(11) 20% × includible compensation	$1,660.00
(12) Number of years of service	1⅜
(13) Item (12) × item (11)	$2,282.50
(14) Contributions excludable in prior taxable years of A (item 7))	$600.00
(15) Amount excludable from A's gross income for 1959 ((13) − (14))	$1,682.50
(16) Amount includible in A's gross income for 1959 ((9) − (15))	$317.50

1960

(17) Amount contributed by employer for annuity contracts in 1960	$2,400.00
(18) Includible compensation for most recent one-year period of service (⅜×$9,600+⅝×$8,800)	$9,100.00
(19) 20% × includible compensation	$1,820.00
(20) Number of years of service	2⅜
(21) Item (20) × item (19)	$4,322.50
(22) Contributions excludable in prior taxable years ((7) + (15))	$2,282.50
(23) Amount excludable from A's gross income for 1960 ((21) − (22))	$2,040.00
(24) Amount includible in A's gross income for 1960 ((17) − (23))	$360.00

1961

(25) Amount contributed by employer for annuity contracts in 1961	$1,400.00
(26) Includible compensation for most recent one-year period of service (⅝ × $9,600+⅜×$9,600)	$9,600.00
(27) 20% × includible compensation	$1,920.00
(28) Number of years of service	3
(29) Item (28) × item (27)	$5,760.00
(30) Contributions excludable in prior taxable years ((7) + (15) + (23))	$4,322.50
(31) Amount excludable from A's gross income for 1961 (item (25) since it is less than (29) − (30))	$1,400.00
(32) Amount includable in A's gross income for 1961 ((25) − (31))	None

[T.D. 6783, 29 FR 18360, Dec. 24, 1964, as amended by T.D. 6885, 31 FR 7802, June 2, 1966; T.D. 7748, 46 FR 1696, Jan. 7, 1981; T.D. 7836, 47 FR 42337, Sept. 27, 1982; T.D. 8115, 51 FR 45736, Dec. 19, 1986]

§1.403(b)–2 Eligible rollover distributions; questions and answers.

The following questions and answers relate to eligible rollover distributions from annuities, custodial accounts, and retirement income accounts described in section 403(b) of the Internal Revenue Code of 1986, as amended by sections 521 and 522 of the Unemployment Compensation Amendments of 1992 (Public Law 102–318, 106 Stat. 290) (UCA). For additional UCA guidance under sections 401(a)(31), 402(c), 402(f), and 3405(c), see §§1.401(a)(31)–1, 1.402(c)–2, 1.402(f)–1, and §31.3405(c)–1 of this chapter, respectively.

LIST OF QUESTIONS

Q–1: What is the rule regarding distributions that may be rolled over to an eligible retirement plan from annuities, custodial accounts, and retirement income accounts described in section 403(b)?

Q–2: Is a section 403(b) annuity required to provide the direct rollover option described in section 401(a)(31) as a distribution option?

Q–3: Is the payor of a section 403(b) annuity required to provide a distributee of an eligible rollover distribution with an explanation of the direct rollover option?

Q–4: When do sections 403 (b)(8) and (b)(10), as amended by UCA, and this §1.403(b)–2 apply to distributions from section 403(b) annuities?

QUESTIONS AND ANSWERS

Q–1: What is the rule regarding distributions that may be rolled over to an eligible retirement plan from annuities, custodial accounts, and retirement income accounts described in section 403(b)?

A–1: Under section 403(b)(8), as amended by UCA, any eligible rollover distribution from a section 403(b) annuity is permitted to be rolled over to an eligible retirement plan. For purposes of this section, a section 403(b) annuity includes an annuity contract, a custodial account, and a retirement income account described in section 403(b). For purposes of section 403(b)(8) and this section, an eligible retirement plan means another section 403(b) annuity or an individual retirement plan (as defined in § 1.402(c)(2), Q&A–2 but does not include a qualified plan (as defined in § 1.402(c)–2), Q&A–2. Except to the extent otherwise provided in this section, an eligible rollover distribution from a section 403(b) annuity is an eligible rollover distribution described in section 402(c) (2) and (4) and § 1.402(c)–2, Q&A–3 through Q&A–10 and Q&A–14, except that the distribution is from section 403(b) annuity rather than a qualified plan. Thus, for example, to the extent that corrective distributions described in § 1.402(c)–2, Q&A–4 are properly made from a section 403(b) annuity, such distributions are not eligible rollover distributions. Similarly, in the case of annuity distributions from an annuity contract described in section 403(b), the entire amount of any such annuity payment made on or after January 1 of the year in which an employee attains (or would have attained) age 70½ will be treated as an amount required under section 401(a)(9) and, thus, will not be an eligible rollover distribution. The rules with respect to rollovers in sections 402 (c)(1), (c)(3), and (c)(9) and § 1.402(c)–2, Q&A–11 through Q&A–13 and Q&A–15 also apply to eligible rollover distributions from section 403(b) annuities.

Q–2: Is a section 403(b) annuity required to provide the direct rollover option described in section 401(a)(31) as a distribution option?

A–2: (a) *General rule.* Yes. Pursuant to section 403(b)(10), section 403(b) does not apply to an annuity contract, custodial account, or retirement income account unless the annuity contract, custodial account, or retirement income account provides that if the distributee of any eligible rollover distribution elects to have the distribution paid directly to an eligible retirement plan (as defined in Q&A–1 of this section) and specifies the eligible retirement plan to which the distribution is to be paid, then the distribution will be paid to that eligible retirement plan in a direct rollover. For purposes of determining whether a section 403(b) annuity has satisfied this direct rollover requirement, the provisions of § 1.401(a)(31)–1 apply to the section 403(b) annuity as though it were a plan qualified under section 401(a) unless otherwise provided in this section. For example, as described in § 1.401(a)(31)–1, Q&A–14 a direct rollover from a section 403(b) annuity to another section 403(b) annuity is a distribution and a rollover and not a transfer of funds between section 403(b) annuities and, thus, is not subject to the applicable law governing transfers of funds between section 403(b) annuities. In applying the provisions of § 1.401(a)(31)–1, the payor of the eligible rollover distribution is treated as the plan administrator.

(b) *Mandatory withholding.* As in the case of an eligible rollover distribution from a qualified plan, if a distributee of an eligible rollover distribution from a section 403(b) annuity does not elect to have the eligible rollover distribution paid directly to an eligible retirement plan in a direct rollover, the eligible rollover distribution is subject to 20-percent income tax withholding imposed under section 3405(c). See § 31.3405(c)–1 of this chapter for provisions regarding the withholding requirements relating to eligible rollover distributions.

Q–3: Is the payor of a section 403(b) annuity required to provide the distributee of an eligible rollover distribution with an explanation of the direct rollover option?

A–3: Yes. In order to ensure that the distributee of an eligible rollover distribution from a section 403(b) annuity has a meaningful right to elect a direct rollover, the distributee must be informed of the option. Thus, within a reasonable time period before making an eligible rollover distribution, the payor must provide an explanation to the distributee of his or her right to elect a direct rollover and the income tax withholding consequences of not electing a direct rollover. For purposes of satisfying the reasonable time period, the qualified plan timing rule provided in §1.402(f)–1, Q&A–2 does not apply to section 403(b) annuities. However, a payor of a section 403(b) annuity will be deemed to have provided the explanation within a reasonable time period if the payor complies with the time period in that rule.

Q–4: When do sections 403(b)(8) and (b)(10), as amended by UCA, and this §1.403(b)–2 apply to distributions from section 403(b) annuities?

A–4: (a) *General rule*—(1) *Statutory effective date.* Section 403(b)(8), as amended by UCA, and section 403(b)(10), as amended by UCA, apply to distributions made on or after January 1, 1993. In addition, the underlying section 403(b) annuity document must be amended at the time provided in, and the section 403(b) annuity must operate in accordance with the requirements of §1.401(a)(31)–1, Q&A–18. Section 522 of UCA provides a special effective date for governmental section 403(b) annuities. This special effective date is specified in §1.403(b)–2T (as it appeared in the April 1, 1995 edition of 26 CFR part 1).

(2) *Regulatory effective date.* This section applies to distributions made on or after October 19, 1995. For distributions made on or after January 1, 1993 and before October 19, 1995, §1.403(b)–2T (as it appeared in the April 1, 1995 edition of 26 CFR part 1), applies. However, for distributions made on or after January 1, 1993 but before October 19, 1995, a section 403(b) annuity may satisfy section 403(b)(10) by substituting any or all provisions of this section for the corresponding provisions of §1.403(b)–2T, if any.

[T.D. 8619, 60 FR 49214, Sept. 22, 1995]

§1.403(c)–1 Taxability of beneficiary under a nonqualified annuity.

(a) *Taxability of vested interest in premiums.* If after August 1, 1969, an employer (whether or not exempt under section 501(a)) pays premiums for an annuity contract for the benefit of an employee, the amount of such premiums shall be included as compensation in the gross income of the employee for the taxable year during which such premiums are paid, but only to the extent that the employees's rights in such premiums are substantially vested (as defined in §1.83–3(b)) at the time such premiums are paid. The preceding sentence shall not apply to contracts referred to in the transitional rule of paragraph (d) (1), (ii), or (iii) of this section, or to premiums subject to §1.403(a)–1(a) or excludible under §1.403(b)–1(b). If any employer has purchased annuity contracts and transfered them to a trust (other than one described in section 401(a)) that is to provide annuity contracts or benefits for his employees, the amounts so paid shall be treated as contributions to a trust described in section 402(b). For the rules relating to the taxation of the cost of life insurance protection when rights in a life insurance contract are substantially nonvested, see §1.83–1(a)(2).

(b) *Taxability of employee when rights under annuity contract change from nonvested to vested*—(1) *In general.* If, during a taxable year of an employee ending after August 1, 1969, the rights of such employee under an annuity contract purchased for him by an employer (whether or not exempt under section 501(a) or 521(a)) become substantially vested, the value of the annuity contract on the date of such change shall be included in the employee's gross income for such year, to the extent provided in paragraph (b)(2) of this section. The preceding sentence shall not apply, however, to an annuiity contract purchased and held as part of a plan which met at the time of such purchase, and continues to meet, the requirements of section 404(a)(2) or an annuity contract referred to in paragraph (d) (ii) or (iii) of this section. For purposes of this section, the value of an annuity contract on the date the employee's rights become substantially vested means the cash surrender value of such contract on such date.

(2) *Extent to which value of annuity contract is includible in employee's gross income.* For purposes of paragraph (b)(1)

of this section, the only amount includible in the gross income of the employee is that the portion of the value of the contract on the date of the change that is attributable to premiums which were paid by the employer after August 1, 1969, and which were not excludible from the employer's gross income under § 1.403(b)–1(b). However, the includible portion does not include—

(i) The value attributable to a premium paid on the date of such change, and

(ii) The value attributable to premiums described in the transitional rule of paragraph (d)(1) (ii) or (iii) of this section.

See § 1.403(b)–1(b)(2) for the treatment of an amount otherwise includible in gross income under section 403(c) as an employer contribution for purposes of the exclusion under section 403(b).

(3) *Partial vesting.* If, during any taxable year of an employee, only part of his beneficial interest in an annuity contract becomes substantially vested, then only the corresponding part of the value of the annuity contract on the date of such change is includible in the employee's gross income for such taxable year. In such a case, it is first necessary to compute, under the rules in paragraphs (b)(1) and (2) of this section but without regard to any exclusion allowable under § 1.403(b)–1(b), the amount which would be includible in the employee's gross income for the taxable year if his entire beneficial interest in the annuity contract had changed to a substantially vested interest during such year. The amount that is includible under this (3) (without regard to the section 403(b) exclusion) is equal to the amount determined under the preceding sentence multiplied by the percent of the employee's beneficial interest which became substantially vested during the taxable year.

(c) *Amounts paid or made available under an annuity contract.* The amounts paid or made available to the employee under an annuity contract subject to this section shall be included in the gross income of the employee for the taxable year in which paid or made available, as provided in section 72 (relating to annuities). Such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). For rules relating to the treatment of employer contributions as part of the consideration paid by the employee, see section 72(f). See also section 101(b)(2)(D) for rules relating to the treatment of the limited exclusion provided thereunder as part of the consideration paid by the employee.

(d) *Taxability of beneficiary under a nonqualified annuity on or before August 1, 1969.* (1) Except as provided in section 402(d) (relating to taxable years beginning before Janaury 1, 1977), if an employer purchases an annuity contract and if the amounts paid for the contract.

(i) On or before August 1, 1969, or

(ii) After such date, if pursuant to a binding written contract (as defined in § 1.83–8(b)(2)) entered into before April 22, 1969, or

(iii) After August 1, 1969, pursuant to a written plan in which the employee participated on April 22, 1969 and under which the obligation of the employer is essentially the same as under a binding written contract, are not subject to paragraph (a) of § 1.403(a)–1 or paragraph (a) of § 1.403–1, the amount of such contribution shall, to the extent it is not excludible under paragraph (b) of § 1.403(b)–1, be included in the income of the employee for the taxable year during which such contribution is made if, at at the time the contribution is made, the employee's rights under the annuity contract are nonforfeitable, except for failure to pay future premiums. If the annuity contract was purchased by an employer which is not exempt from tax under section 501(a) or section 521(a), and if the employee's rights under the annuity contract in such a case were forfeitable at the time the employer's contribution was made for the annuity contract, even though they become nonforfeitable later the amount of such contribution is not required to be included in the income of the employee at the time his rights under the contract become nonforfeitable. On the other hand, if the annuity contract is purchased by an employer which is exempt from tax under section 501(a) or section 521(a), all or part of the value of the contract may be includible in the employee's gross income at the time his rights under the contract become nonforfeitable (see section 403(d) prior to the repeal thereof by the Tax Reform Act of 1969 and the regulations thereunder). As to what constitutes nonforfeitable rights of an employee, see §1.402(b)–1(d)(2). The amounts received by or made available to the employee under the annuity contract shall be included in the gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities). For taxable years beginning before Janaury 1, 1964, sections 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such amounts. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). For rules relating to the treatment of employer contributions as part of the consideration paid by the employee, see section 72(f). See also section 101(b)(2)(D) for rules relating to the treatment of the limited exclusion provided thereunder as part of the consideration paid by the employee.

(2) If an employer has purchased annuity contracts and transferred them to a trust, or if an employer has made contributions to a trust for the purpose of providing annuity contracts for his employees as provided in section 402(d) (see paragraph (a) of §1.402(D)–1, the amount so paid or contributed is not required to be included in the income of the employee, but any amount received by or made available to the employee under the annuity contract shall be includible in the gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities). For taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to any amount received by or made available to the employee under the annuity contract. For taxable years beginning after December 31, 1963, amounts received by or made available to the employee under the annuity contract may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). In such case the amount paid or contributed by the employer shall not constitute consideration paid by the employee for such annuity contract in determining the amount of annuity payments required to be included in his gross income under section 72 unless the employee has paid income tax for any taxable year beginning before January 1, 1949, with respect to such payment or contribution by the employer for such year and such tax is not credited or refunded to the employee. In the event such tax has been paid and not creditid or refunded the amount paid or contributed by the employer for such year shall constitute consideration paid by the employee for the annuity contract in determining the amount of the annuity required to be included in the income of the employee under section 72.

(3) For taxable years beginning before January 1, 1958, the provisions contained in section 403(c) prior to the amendment made thereto by the Tax Reform Act of 1969 were included in section 403(b) of the Internal Revenue Code of 1954. Therefore, the regulations contained in this paragraph shall, for such taxable years, be considered as the regulations under section 403(b) as in effect for such taxable years. For the rules with respect to contributions paid after August 1, 1969, see paragraphs (a), (b), and (c) of this section.

(Secs. 83 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 588; 68A Stat. 917; 26 U.S.C. 83 and 7805))

[T.D. 7554, 43 FR 31924, July 24, 1978]

§1.403(d)–1 Taxability of employee when rights under contracts purchased by exempt organizations change from forfeitable to nonforfeitable.

(a) *In general.* The provisions of section 403(d), repealed by section 321(b) of the Tax Reform Act of 1969 (83 Stat. 571), applied for taxable years beginning after December 31, 1957, only with respect to amounts paid for an annuity contract—

(1) On or before August 1, 1969, or

(2) After such date, if pursuant to a binding written contract (as defined in

§ 1.83–8(b)(2)) entered into before April 22, 1969, or

(3) After August 1, 1969, pursuant to a written plan in which the employee participated on April 22, 1969, and under which the obligation of the employer is essentially the same as under a binding written contract.

If, during a taxable year of an employee beginning after December 31, 1957, the rights of such employee under an annuity contract purchased for him by an employer which is exempt from tax under section 501(a) or 521(a) change from forfeitable to nonforfeitable rights, then (except in the case of contracts to which § 1.403(c)—1(b) applies for taxable years ending after August 1, 1969) the value of such annuity contract on the date of such change shall be included in the employee's gross income for such taxable year, to the extent provided in paragraph (b) of this section. However, the preceding sentence does not apply to an annuity contract purchased and held as part of a plan that at the time of such purchase and at all times thereafter meets the requirements of section 404(a)(2). For purposes of this section, the value of an annuity contract on the date the employee's rights change from forfeitable to nonforfeitable rights means the cash surrender value of such contract on such date. As to what constitutes nonforfeitable rights of an employee, see § 1.402(b)–1(d)(2). For the rules with respect to amounts paid after August 1, 1969, under an annuity contract purchased for an employee by an employer which is exempt from tax under section 501(a) or 521(a), see generally section 403(c) and the regulations thereunder.

(b) *Extent to which value of annuity contract is includible in employee's gross income.* For purposes of paragraph (a) of this section, there shall be included in the gross income of an employee for his taxable year in which his rights under an annuity contract change from forfeitable to nonforfeitable rights only an amount equal to the portion of the value of such contract on the date of such change (1) that is attributable to contributions:

(i) Which were made by the employer while it was exempt from tax under section 501(a) or 521(a);

(ii) Which were made after December 31, 1957; and

(iii) Which were not, at the time they were made, excludable from the employee's gross income under paragraph (a) of § 1.403(b)–1;

and (2) that is not excludable from the employee's gross income under paragraph (b) of § 1.403(b)–1. Thus, although amounts are contributed by an employer after December 31, 1957, toward the purchase for an employee of an annuity contract and, at the time of the contribution, such employer is an organization described in section 501(c)(3) and exempt from tax under section 501(a), the value of such annuity contract attributable to such contributions would not be includible in the employee's gross income for the taxable year in which his rights under the contract change to nonforfeitable rights if such amounts were contributed during a taxable year of the employee beginning before January 1, 1958, and were, therefore, excludable from the employee's gross income under paragraph (a) of § 1.403(b)–1. Similarly, the value of such an annuity contract is not includible in the gross income of the employee for the year in which the change occurs to the extent that it is excludable under paragraph (b) of § 1.403(b)–1. See paragraph (b)(2) of § 1.403(b)–1 which provides that the amount otherwise includible in gross income under section 403(d) is considered to be a contribution by the employer for purposes of the exclusion provided in paragraph (b) of § 1.403(b)–1. In addition, the portion of the value of an annuity contract attributable to contributions made by the employer while it was not exempt from tax under either section 501(a) or 521(a) is not includible in the gross income of the employee at the time his rights under the contract change to nonforfeitable rights even though the employer is exempt from tax under section 501(a) or 521(a) at the time of such change. On the other hand, the value of the annuity contract purchased by an organization exempt from tax under section 501(a) or 521(a) may be includible in the gross income of an employee for the year during which his rights under the contract change to nonforfeitable rights even though such organization is not exempt on the date of such change.

(c) *Partial vesting*—(1) *General rule.* If, during any taxable year of an employee, only part of his beneficial interest in an annuity contract changes from a forfeitable to a nonforfeitable interest, then only the corresponding part of the value of the annuity contract on the date of such change is includible in the employee's gross income for such taxable year. In such a case, it is first necessary to compute, under the rules in paragraphs (a) and (b) of this section but without regard to any exclusion allowable under paragraph (b) of §1.403(b)–1, the amount which would be includible in the employee's gross income for the taxable year if his entire beneficial interest in the annuity contract had changed to a nonforfeitable interest during such year. The amount that is includible (without regard to any exclusion allowed by paragraph (b) of §1.403(b)–1) in the gross income of the employee for the taxable year in which the change occurs is an amount equal to the amount determined under the preceding sentence multiplied by the percent of the employee's beneficial interest which changed to a nonforfeitable interest during the taxable year. If at the time the employee's interest changes to a nonforfeitable interest, the employer is an organization described in section 501(a)(3) and exempt from tax under section 501(a), then the amount that is includible in the employee's gross income under this subparagraph is considered as an employer contribution to which the exclusion provided in paragraph (b) of §1.403(b)–1 applies (see paragraph (b)(2) of §1.403(b)–1).

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

Example. X organization purchased an annuity contract for A, one of its employees who reports his income on a calendar year basis. X contributed ⅓ of of amount necessary to purchase the contract before January 1, 1958, and the remaining ⅔ after December 31, 1957. At the time of the contributions, X was an organization exempt from tax under section 501(a) and A's rights under the contract were forfeitable. The annuity contract was not purchased as part of a qualified plan and A made no contributions toward the purchase of the contract. On December 31, 1965, 50 percent of A's interest in the contract changed from a forfeitable to a nonforfeitable interest, and on December 31, 1968, the remaining 50 percent of A's interest in the contract changed to a nonforfeitable interest. The cash surrender value of the contract was $9,900 on December 31, 1965, and $12,000 on December 31, 1968. The amount includible in A's gross income for 1965 and 1968 is computed as follows—

1965

(i) Amount which would have been includible if A's entire interest had changed to a nonforfeitable interest (cash surrender value of contract on December 31, 1965, attributable to contributions made after December 31, 1957), ⅔ × $9,900, $6,600.

(ii) Percent of A's interest that changed to a nonforfeitable interest on December 31, 1965, 50 percent.

(iii) Amount includible in A's gross income for 1965 ((ii) × (i)), $3,300.

1968

(iv) Amount which would have been includible if A's entire interest had changed to a nonforfeitable interest (cash surrender value of contract on December 31, 1968, attributable to contributions made after December 31, 1957), ⅔ $12,000, $8,000.

(v) Percent of A's interest that changed to a nonforfeitable interest on December 31, 1968, 50 percent.

(vi) Amount includible in A's gross income for 1968 ((v) × (iv)), $4,500.

If, on December 31, 1965, X is an organization described in section 501(c)(3) and exempt from tax under section 501(a), then only so much of the $3,300 as is not excludable under paragraph (b) of §1.403(b)–1 is includible in A's gross income for 1965. Similarly, if, on December 31, 1968, X is an organization described in section 501(c)(3) and exempt from tax under section 501(a), then only so much of the $4,000 as is not excludable under paragraph (b) of §1.403(b)–1 is includible in A's gross income for 1968.

(Secs. 83 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 588; 68A Stat. 917; 26 U.S.C. 83 and 7805))

[T.D. 6783, 29 FR 18365, Dec. 24, 1964, as amended by T.D. 7554, 43 FR 31925, July 24, 1978]

§1.404(a)–1 Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan; general rule.

(a)(1) Section 404(a) prescribes limitations upon deductions for amounts contributed by an employer under a pension, annuity, stock bonus, or profit-sharing plan, or under any plan of deferred compensation. It is immaterial whether the plan covers present employees only, or present and former employees, or only former employees. Section 404(a) also governs the deductibility of unfunded pensions and death benefits paid directly to former employees or their beneficiaries (see §1.404(a)–12). For taxable years beginning after 1962, certain self-employed individuals may be covered by pension, annuity, or profit-sharing plans. For the rules relating to the deduction of contributions on behalf of such individuals, see paragraph (a)(2) of §1.404(a)–8 and §1.404(e)–1.

(2) Section 404(a) does not apply to a plan which does not defer the receipt of compensation. Furthermore, section 404(a) does not apply to deductions for contributions under a plan which is solely a dismissal wage or unemployment benefit plan, or a sickness, accident, hospitalization, medical expense, recreation, welfare, or similar benefit plan, or a combination thereof. For example, if under a plan an employer contributes 5 percent of each employee's compensation per month to a fund out of which employees who are laid off will be paid benefits for temporary periods, but employees who are not laid off have no rights to the funds, such a plan is an unemployment benefit plan, and the deductibility of the contributions to it is determined under section 162. As to the deductibility of such contributions, see §1.162–9.

(3) If, however, the contributions to a pension, profit-sharing, stock bonus, or other plan of deferred compensation can be used to provide any of the benefits referred to in subparagraph (2) of this paragraph, then, except as provided in section 404(c), section 404(a) applies to the entire contribution to the plan. Thus, if in the example described in subparagraph (2) of this paragraph, the employer's contribution on behalf of each employee is set up as a separate account, and if any amount which remains in an employee's account at the time of retirement is paid to him at such time, the deductibility of the contributions to the plan is determined under section 404(a). For the regulations for determining whether the benefits referred to in subparagraph (2) of this paragraph can be included in a qualified pension or profit-sharing plan, see §1.401–1(b).

(4) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 7701(a)(20).

(b) In order to be deductible under section 404(a), contributions must be expenses which would be deductible under section 162 (relating to trade or business expenses) or 212 (relating to expenses for production of income) if it were not for the provision in section 404(a) that they are deductible, if at all, only under section 404(a). Contributions may therefore be deducted under section 404(a) only to the extent that they are ordinary and necessary expenses during the taxable year in carrying on the trade or business or for the production of income and are compensation for personal services actually rendered. In no case is a deduction allowable under section 404(a) for the amount of any contribution for the benefit of an employee in excess of the amount which, together with other deductions allowed for compensation for such employee's services, constitutes a reasonable allowance for compensation for the services actually rendered. What constitutes a reasonable allowance depends upon the facts in the particular case. Among the elements to be considered in determining this are the personal services actually rendered in prior years as well as the current year and all compensation and contributions paid to or for such employee in prior years as well as in the current year. Thus, a contribution which is in the nature of additional compensation for services performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year. A contribution under a plan which is primarily for the benefit of shareholders of the employer is not deductible. Such a contribution may constitute a dividend within the meaning of section 316. See also §§1.162–6 and 1.162–8. In addition to the limitations referred to above, deductions under section 404(a) are also subject to further conditions and limitations particularly provided therein.

(c) Deductions under section 404(a) are generally allowable only for the year in which the contribution or compensation is paid, regardless of the fact that the taxpayer may make his returns on the accrual method of accounting. Exceptions are made in the case of overpayments as provided in paragraphs (1), (3), and (7) of section 404(a), and, as provided by section 404(a)(6), in the case of payments made by a taxpayer on the accrual method of accounting not later than the time prescribed by law for filing the return for the taxable year of accrual (including extensions thereof). This latter provision is intended to permit a taxpayer on the accrual method to deduct such accrued contribution or compensation in the year of accrual, provided payment is actually made not later than the time prescribed by law for filing the return for the taxable year of accrual (including extensions thereof), but this provision is not applicable unless, during the taxable year on account of which the contribution is made, the taxpayer incurs a liability to make the contribution, the amount of which is accruable under section 461 for such taxable year. See section 461 and the regulations thereunder. There is another exception in the case of certain taxpayers who are required to make additional contributions as a result of the Act of June 15, 1955 (Public Law 74, 84th Cong., 69 Stat. 134), and the regulations thereunder.

[T.D. 6500, 25 FR 11682, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10144, Sept. 17, 1963]

§1.404(a)–1T Questions and answers relating to deductibility of deferred compensation and deferred benefits for employees. (Temporary)

Q–1: How does the amendment of section 404(b) by the Tax Reform Act of 1984 affect the deduction of contributions or compensation under section 404(a)?

A–1: As amended by the Tax Reform Act of 1984, section 404(b) clarifies that section 404(a) shall govern the deduction of contributions paid and compensation paid or incurred by the employer under a plan, or method or arrangement, deferring the receipt of compensation or providing for deferred benefits to employees, their spouses, or their dependents. See section 404(b) and §1.404(b)–1T. Section 404 (a) and (d) requires that such a contribution or compensation be paid or incurred for purposes of section 162 or 212 and satisfy the requirements for deductibility under either of those sections. However, notwithstanding the above, section 404 does not apply to contributions paid or accrued with respect to a ‘‘welfare benefit fund’’ (as defined in section 419(e)) after July 18, 1984, in taxable years of employers (and payors) ending after that date. Also, section 463 shall govern the deduction of vacation pay by a taxpayer that has elected the application of such section. For rules relating to the deduction of contributions paid or accured with respect to a welfare benefit fund, see section 419, §1.419–1T and §1.419A–2T. For rules relating to the deduction of vacation pay for which an election is made under section 463, see §301.9100–16T of this chapter and §1.463–1T.

[T.D. 8073, 51 FR 4320, Feb. 4, 1986, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

§1.404(a)–2 Information to be furnished by employer claiming deductions; taxable years ending before December 31, 1971.

(a) For the first taxable year for which a deduction from gross income is claimed under section 404(a) (1), (2), (3), or (7), the employer must file the following information (unless such information has been previously filed in accordance with the regulations under section 23(p) of the Internal Revenue Code of 1939) for each plan involved to establish that it meets the requirements of section 401(a) or 404(a)(2), and that deductions claimed do not exceed the amount allowable under paragraphs (1), (2), (3), and (7) of section 404(a), as the case may be:

(1) Verified copies of all the instruments constituting or evidencing the plan, including trust indentures, group annuity contracts, specimen copy of each type of individual contract, and specimen copy of formal announcement and comprehensive detailed description to employees, with all amendments to any such instruments.

(2) A statement describing the plan which identifies it and which sets forth the name or names of the employers, the effective date of the plan and of any amendments thereto, the method of distribution or of disbursing benefits (whether by trustee, insurance company, or otherwise), the dates when the instruments or amendments were executed, the date of formal announcement and the dates when comprehensive detailed description of the plan and of each amendment thereto were made available to employees generally, the dates when the plan and when the trust or the contract evidencing the plan and of any amendments thereto were put into effect so that contributions thereunder were irrevocable and a summary of the provisions and rules relating to—

(i) Employee eligibility requirements for participation in the plan,

(ii) Employee contributions,

(iii) Employer contributions,

(iv) The basis or formula for determining the amount of each type of benefit and the requirements for obtaining such benefits and the vesting conditions,

(v) The medium of funding (e. g., self-insured, unit purchase group annuity contract, individual level annual premium retirement endowment insurance contracts, etc.) and, if not wholly insured, the medium of contributions and the kind of investments, and

(vi) The discontinuance or modification of the plan and distributions or benefit payments upon liquidation or termination.

(3) A tabulation in columnar form showing the information specified below with respect to each of the 25 highest paid employees covered by the plan in the taxable year, listed in order of their nondeferred compensation (where there are several plans of deferred compensation, the information for each of the plans may be shown on a single tabulation without repetition of the information common to the several plans):

(i) Name.

(ii) Whether an officer.

(iii) Percentage of each class of stock owned directly or indirectly by the employee or members of his family.

(iv) Whether the principal duties consist in supervising the work of other employees.

(v) Year of birth.

(vi) Length of service for employer to the close of the year.

(vii) Total nondeferred compensation paid or accrued during the taxable year with a breakdown of such compensation into the following components:

(A) Basic compensation and overtime pay,

(B) Other direct payments, such as bonuses and commissions,

(C) Compensation paid other than in cash, such as goods, services, insurance not directly related to the benefits or provided from funds under the plan, etc.

(viii) Amount allocated during the year for the benefit of the employee or his beneficiary (including any insurance provided thereby or directly related thereto), less the employee's contributions during the year, under each other plan of deferred compensation.

(ix) Amount allocated during the year for the benefit of the employee or his beneficiary (including any insurance provided thereby or directly related thereto), less the employee's contributions during the year, under the plan. If a profit-sharing or stock bonus plan, also a breakdown of such amounts into the following components:

(A) Amounts originally allocated in the year, and

(B) Amounts reallocated in the year.

(x) Amounts of employee contributions during the year under the plan,

(xi) If a pension or annuity plan,

(A) The retirement age and date and the form of the retirement benefit,

(B) The annual rate or amount of the retirement benefit, and

(C) The aggregate of all of the employee's contributions under the plan,

all based, in the case of an employee who is not on retirement benefit under the plan, upon the assumption of his continued employment at his current rate of compensation until his normal retirement age (or the end of the current year if later) and retirement on such date with the normal form of retirement benefit under the plan.

(4) The following totals:

(i) Total nondeferred compensation paid or accrued during the taxable year for all employees covered under the plan and also for all employees of the employer.

(ii) Total amount allocated during the year for the benefit of employees, former or retired employees, or their beneficiaries (including any insurance provided thereby or directly related thereto), less employee contributions during the year under the plan and, if a profit-sharing or stock bonus plan, also a breakdown of such total into the following components:

(A) Amount originally allocated in the year, and

(B) Amount reallocated in the year.

(5) A schedule showing the total number of employees as of the close of the year for each of the following groups, based on reasonable estimates:

(i) All employees ineligible for coverage under the plan because of requirements as to employment classification, specifying the reasons applicable to the group (as, for example, temporary, seasonal, part time, hourly pay basis, etc.).

(ii) All employees ineligible for coverage under the plan because of requirements as to length of service and not included in subdivision (i) of this subparagraph.

(iii) All employees ineligible for coverage under the plan because of requirements as to minimum age and not included in subdivision (i) or (ii) of this subparagraph.

(iv) All employees ineligible for coverage under the plan solely because of requirements as to minimum rate of compensation.

(v) All employees ineligible for coverage under the plan other than those employees included in subdivision (i), (ii), (iii), or (iv) of this subparagraph, specifying the reason applicable to the group.

(vi) All employees ineligible for coverage under the plan for any reasons, which should be the sum of subdivisions (i) to (v), inclusive, of this subparagraph.

(vii) All employees eligible for coverage but not covered under the plan.

(viii) All employees covered under the plan.

(ix) All employees of the employer, which should be the sum of subdivisions (vi), (vii), and (viii) of this subparagraph.

If it is claimed that the requirements of section 401(a)(3)(A) are satisfied, also the data and computations necessary to show that such requirements are satisfied.

(6) In the case of a trust, a detailed balance sheet and a detailed statement of receipts and disbursements during the year; in the case of a nontrusteed annuity plan, a detailed statement of the names of the insurers, the contributions paid by the employer and by the employees, and a statement as to the amounts and kinds of premium refunds or similar credits made available and the disposition of such credits in the year.

(7) If a pension or annuity plan, a detailed description of all the methods, factors, and assumptions used in determining costs and in adjusting the costs for actual experience under the plan (including any loadings, contingency reserves, or special factors and the basis of any insured costs or liabilities involved therein) explaining their source and application in sufficient detail to permit ready analysis and verification thereof, and, in the case of a trust, a detailed description of the basis used in valuing the investments held.

(8) A statement of the applicable limitations under section 404(a) (1), (2), (3), or (7) and an explanation of the method of determining such limitations, a summary of the data, and a statement of computations necessary to determine the allowable deductions for the taxable year. Also, in the case of a pension or annuity plan, a summary of the costs or liabilities and adjustments for

the year under the plan based on the application of the methods, factors, and assumptions used under the plan, in sufficient detail to permit ready verification of the reasonableness thereof.

(9) A statement of the contributions paid under the plan for the taxable year showing the date and amount of each payment. Also, a summary of the deductions claimed for the taxable year for the plan with a breakdown of the deductions claimed into the following components:

(i) For contributions paid in the taxable year before giving effect to the provisions of paragraph (7) of section 404(a).

(ii) For contributions paid in prior taxable years beginning after December 31, 1941, in accordance with the carryover provisions of paragraphs (1) and (3) of section 404(a), before giving effect to the provisions of paragraph (7) thereof, and in accordance with the carryover provisions of section 404(d).

(iii) Any reductions or increases in the deductions in accordance with the provisions of paragraph (7) of section 404(a). However, if the information in this subdivision is filed prior to the filing of the information required by subparagraph (8) of this paragraph, then, in determining the limit of deduction under paragraph (7) of section 404(a), the applicable percentage of the compensation otherwise paid or accrued during the year may be used.

(b) For taxable years subsequent to the year for which all of the applicable information under paragraph (a) of this section (or corresponding provisions of prior regulations) has been filed, information is to be filed only to the following extent:

(1) If there is any change in the plan, instruments, methods, factors, or assumptions upon which the data and information specified in paragraph (a) (1), (2), or (7) of this section are based, a detailed statement explaining the change and its effect is to be filed only for the taxable year in which the change is put into effect. However, if there is no such change, unless otherwise requested by the district director, merely a statement that there is no such change is to be filed.

(2) The information specified in paragraph (a)(3) of this section which has been filed for a taxable year, unless otherwise requested by the district director and so long as the plan and the method and basis of allocations are not changed, is to be filed for subsequent years only to the extent of showing in the tabulation such information with respect to employees who, at any time in the taxable year, own, directly or indirectly, more than 5 percent of the voting stock, considering stock so owned by an individual's spouse or minor lineal descendant as owned by the individual for this purpose.

(3) The information specified in paragraph (a) (4), (5), (6), (8), and (9) of this section.

In the case of corporate employers, the information required to be submitted by this paragraph shall, except as otherwise provided by the Commissioner, be filed on Form 2950 for taxable years ending on or after December 31, 1961. In the case of other employers, the information required to be submitted by this paragraph shall, except as otherwise provided by the Commissioner, be filed on Form 2950 for taxable years ending on or after December 31, 1962.

(c) If a deduction is claimed under section 404(a)(5) for the taxable year, the taxpayer shall furnish such information as is necessary to show that the deduction is not allowable under the other paragraphs of section 404(a), that the amount paid is an ordinary and necessary expense or an expense for the production of income, and that the employees' rights to, or derived from, such employer's contribution or such compensation were nonforfeitable at the time the contribution or compensation was paid. In the case of corporate employers, the information required to be submitted by this paragraph shall, except as otherwise provided by the Commissioner, be filed on Form 2950 for taxable years ending on or after December 31, 1961. In the case of other employers, the information required to be submitted by this paragraph shall, except as otherwise provided by the Commissioner, be filed on Form 2950 for taxable years ending on or after December 31, 1962.

(d) For the purpose of the information required by this section, contributions paid in a taxable year shall include those deemed to be so paid in accordance with the provisions of section 404(a)(6) and shall exclude those deemed to be paid in the prior taxable year in accordance with such provisions. As used in this section, ''taxable year'' refers to the taxable year of the employer and, unless otherwise requested by the district director, a ''year'' which is not specified as a ''taxable year'' may be taken as the taxable year of the employer or as the plan, trust, valuation, or group contract year with respect to which deductions are being claimed provided the same rule is followed consistently so that there is no gap or overlap in the information furnished for each item. In any case the date or period to which each item of information furnished relates should be clearly shown. All the information required by this section should be filed with the tax return for the taxable year in which the deduction is claimed, except that, unless sooner requested by the district director, such information, other than that specified in paragraph (a)(4)(i) and (9) of this section, may be filed within 12 months after the close of the taxable year provided there is filed with the tax return a statement that the information cannot reasonably be filed therewith, setting forth the reasons therefor.

(e) In any case all the information and data required by this section must be filed in the office of the district director in which the employer files his tax returns and must be filed independently of any information and data otherwise submitted in connection with a determination of the qualification of the trust or plan under section 401(a). The district director may, in addition, require any further information that he considers necessary to determine allowable deductions under section 404 or qualification under section 401. For taxable years ending on or before December 31, 1961, the district director may waive the filing of such information required by this section which he finds unnecessary in a particular case. For taxable years ending after December 31, 1961, the Commissioner may waive the filing of such information.

(f) Records substantiating all data and information required by this section to be filed must be kept at all times available for inspection by internal revenue officers at the main office or place of business of the employer.

(g) In the case of a plan which covers employees, some or all of whom are self-employed individuals and with respect to which a deduction is claimed under section 404(a) (1), (2), (3), or (7), paragraphs (a) and (b) of this section, and the provision of paragraph (d) of this section relating to the time for filing the information required by this section, shall not apply, but in lieu of the information required to be submitted by paragraphs (a) and (b) of this section, the employer shall, with the return for the taxable year in which the deduction is claimed, submit the information required by the form provided by the Internal Revenue Service for such purpose.

(h) When a custodial account forms a part of a plan for which a deduction is claimed under section 404(a) (1), (2), (3), or (7), the information which under this section is to be submitted with respect to a qualified trust must be submitted with respect to such custodial account. Thus, for purposes of this section—

(1) The term ''trust'' includes custodial account,

(2) The term ''trustee'' includes custodian, and

(3) The term ''trust indenture'' includes custodial agreement.

(i) Except as provided under §1.503(d)–1(a) and §601.201 of this chapter (Statement of Procedural Rules) in the case of a request for the determination of qualification of a trust under section 401 and exemption under section 501, paragraphs (a) through (h) of this section shall not apply for taxable years ending on or after December 31, 1971. For information to be furnished for taxable years ending on or after December 31, 1971, see §1.404(a)–2A.

[T.D. 6500, 25 FR 11683, Nov. 26, 1960, as amended by T.D. 6599, 27 FR 4475, May 10, 1962; T.D. 6676, 28 FR 10144, Sept. 17, 1963; T.D. 7165, 37 FR 5025, Mar. 9, 1972; T.D. 7168, 37 FR 5491, Mar. 16, 1972]

§1.404(a)–2A Information to be furnished by employer; taxable years ending on or after December 31, 1971, and before December 31, 1975.

(a) *In general.* For any taxable year ending on or after December 31, 1971, any employer who maintains a pension, annuity, stock bonus, profit-sharing, or other funded plan of deferred compensation shall file the forms prescribed by this section. An employer (including a self-employed individual) maintaining such a plan shall furnish such information as is required by the forms and the instructions relating thereto. The forms shall be filed in the manner and at the time prescribed under paragraph (c) of this section. See §1.404(a)–2 with respect to information to be furnished for taxable years ending before December 31, 1971. For purposes of this section, in the case of a plan of several employers described in §1.401–1(d), each employer shall be deemed to be maintaining a separate plan corresponding to the plan of which the trust is a part. For information required to be furnished with respect to a funded deferred compensation plan maintained by an employer who is exempt from tax under section 501(a), see §1.6033–2(a)(2)(ii)(i).

(b) *Forms.* The forms prescribed by this section are:

(1) Form 4848, generally relating to information concerning the qualification of the plan, and deductions for contributions made on behalf of employees or self-employed individuals,

(2) Form 4849, generally relating to the financial position of the trust, fund, or custodial or fiduciary account which is a part of the plan, and

(3) For any taxable year ending on or after December 31, 1971, and before December 31, 1972, Forms 2950 and 2950SE, relating to the identification of plans to which an employer has made a contribution and information with respect to a deduction for a contribution made on behalf of a self-employed individual, respectively.

(c) *Filing requirements.* (1) Form 4848 shall be filed by the employer for each taxable year during which he maintains a pension, annuity, stock bonus, profit-sharing, or other funded plan of deferred compensation. Such form shall be filed on or before the 15th day of the 5th month following the close of the employer's taxable year. For rules relating to the extension of time for filing, see section 6081 and the regulations thereunder and the instructions for Form 4848.

(2) Form 4849 shall be filed by the employer as an attachment to Form 4848 for each taxable year during which he maintains a pension, annuity, stock bonus, profit-sharing, or other funded plan of deferred compensation unless the employer (i) has been notified in writing that Form 4849 will be filed by the fiduciary for such plan as an attachment to Form 990-P or (ii) is not required to file Form 4849 under the instructions relating thereto.

(3) For any taxable year ending on or after December 31, 1971, and before December 31, 1972, Form 2950 shall be filed with the employer's tax return for any such taxable year during which a pension, annuity, stock bonus, profit-sharing, or other funded plan of deferred compensation is maintained.

(4) For any taxable year ending on or after December 31, 1971, and before December 31, 1972, Form 2950SE shall be filed by each self-employed individual with his income tax return for any such taxable year in which he claims a deduction for contributions made on his behalf.

(d) *Additional information.* In addition to the information otherwise required to be furnished by this section, the district director may require any further information that he considers necessary to determine allowable deductions under section 404 or qualification under section 401.

(e) *Records.* Records substantiating all data and information required by this section to be filed must be kept at all times available for inspection by internal revenue officers at the main office or place of business of the employer.

[T.D. 7165, 37 FR 5025, Mar. 9, 1972, as amended by T.D. 7223, 37 FR 24748, Nov. 21, 1972; T.D. 7551, 43 FR 29292, July 7, 1978]

§1.404(a)–3 Contributions of an employer to or under an employees' pension trust or annuity plan that meets the requirements of section 401(a); application of section 404(a)(1).

(a) If contributions are paid by an employer to or under a pension trust or annuity plan for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see §1.404(a)–1), the contributions are deductible under section 404(a) (1) or (2) if the further conditions provided therein are also satisfied. As used in this section, a ''pension trust'' means a trust forming part of a pension plan and an ''annuity plan'' means a pension plan under which retirement benefits are provided under annuity or insurance contracts without a trust. This section is also applicable to contributions to a foreign situs pension trust which could qualify for exemption under section 501(a) except that it is not created or organized and maintained in the United States. For the meaning of ''pension plan'' as used in this section, see paragraph (b)(1)(i) of §1.401–1. Where disability pensions, insurance, or survivorship benefits incidental and directly related to the retirement benefits under a pension or annuity plan are provided for the employees or their beneficiaries by contributions under the plan, deductions on account of such incidental benefits are also covered under section 404(a) (1) or (2). See paragraph (b)(2) of §1.72–16 as to taxability to employees of cost of incidental life insurance protection. Similarly, where medical benefits described in section 401(h) as defined in paragraph (a) of §1.401–14 are provided for retired employees, their spouses, or their dependents under the plan, deductions on account of such subordinate benefits are also covered under section 404(a) (1) or (2). In order to be deductible under section 404(a)(1), contributions to a pension trust must be paid in a taxable year of the employer which ends with or within a year of the trust for which it is exempt under section 501(a). Contributions paid in such a taxable year of the employer may be carried over and deducted in a succeeding taxable year of the employer in accordance with section 404(a)(1)(D), whether or not such succeeding taxable year ends with or within a taxable year of the trust for which it is exempt under section 501(a). See §1.404(a)–7 for rules relating to the limitation on the amount deductible in such a succeeding taxable year of the employer. See §1.404(a)–8 as to conditions for deductions under section 404(a)(2) in the case of an annuity plan. In either case, the deductions are also subject to further limitations provided in section 404(a)(1). The limitations provided in section 404(a)(1) are, with an exception provided for certain years under subparagraph (A) thereof (see §1.404(a)–4), based on the actuarial costs of the plan.

(b) In determining costs for the purpose of limitations under section 404(a)(1), the effects of expected mortality and interest must be discounted and the effects of expected withdrawals, changes in compensation, retirements at various ages, and other pertinent factors may be discounted or otherwise reasonably recognized. A properly weighted retirement age based on adequate analyses of representative experience may be used as an assumed retirement age. Different basic assumptions or rates may be used for different classes of risks or different groups where justified by conditions or required by contract. In no event shall costs for the purpose of section 404(a)(1) exceed costs based on assumptions and methods which are reasonable in view of the provisions and coverage of the plan, the funding medium, reasonable expectations as to the effects of mortality and interest, reasonable and adequate regard for other factors such as withdrawal and deferred retirement (whether or not discounted) which can be expected to reduce costs materially, reasonable expenses of operation, and all other relevant conditions and circumstances. In any case, in determining the costs and limitations, an adjustment shall be made on account of any experience more favorable than that assumed in the basis of limitations for prior years. Unless such adjustments are consistently made every year by reducing the limitations otherwise determined by any decrease in liability or cost arising from experience in the next preceding taxable year which was more favorable than the assumptions on which the costs and limitations were based, the adjustment shall be made by some other method approved by the Commissioner.

(c) The amount of a contribution to a pension or annuity plan that is deductible under section 404(a) (1) or (2) depends upon the methods, factors, and assumptions which are used to compute the costs of the plan and the limitation of section 404(a)(1) which is applied. Since the amount that is deductible for one taxable year may affect the amount that is deductible for other taxable years, the methods, factors, and assumptions used in determining costs and the method of determining the limitation which have been used for determining the deduction for a taxable year for which the return has been filed shall not be changed for such taxable year, except when the Commissioner determines that the methods, factors, assumptions, or limitations were not proper, or except when a change is necessitated by reason of the use of different methods, factors, assumptions, or limitations for another taxable year. However, different methods, factors, and assumptions, or a different method of determining the limitation, if they are proper, may be used in determining the deduction for a subsequent taxable year.

(d) Any expenses incurred by the employer in connection with the plan, such as trustee's and actuary's fees, which are not provided for by contributions under the plan are deductible by the employer under section 162 (relating to trade or business expenses), or 212 (relating to expenses for production of income) to the extent that they are ordinary and necessary.

(e) In case deductions are allowable under section 404(a)(3), as well as under section 404(a) (1) or (2), the limitations under section 404(a) (1) and (3) are determined and applied without giving effect to the provisions of section 404(a)(7) but the amounts allowable as deductions are subject to the further limitations provided in section 404(a)(7). See §1.404(a)–13.

(f)(1) Amounts contributed by an employer under the plan for the funding of medical benefits described in section 401(h) as defined in paragraph (a) of §1.401–14 must satisfy the general requirements which are applicable to deductions allowable under section 404 and which are set forth in §1.404(a)–1 including, for example, the requirements described in paragraph (b) of such section. Accordingly, such amounts must constitute an ordinary and necessary expense relating to either the trade or business or the production of income and must not, when added to all other compensation paid by the employer to the employee on whose behalf such a contribution is made, constitute more than reasonable compensation. However, in determining the amount which is deductible with respect to contributions to provide retirement benefits under the plan, amounts contributed for the funding of medical benefits described in section 401(h) shall not be taken into consideration.

(2) The amounts deductible with respect to employer contributions to fund medical benefits described in section 401(h) shall not exceed the total cost of providing such benefits. The total cost of providing such benefits shall be determined in accordance with any generally accepted actuarial method which is reasonable in view of the provisions and coverage of the plan, the funding medium, and other applicable considerations. The amount deductible for any taxable year with respect to such cost shall not exceed the greater of—

(i) An amount determined by distributing the remaining unfunded costs of past and current service credits as a level amount, or as a level percentage of compensation, over the remaining future service of each employee, or

(ii) 10 percent of the cost which would be required to completely fund or purchase such medical benefits.

In determining the amount deductible, an employer must apply either subdivision (i) of this subparagraph for all employees or subdivision (ii) of this subparagraph for all employees. If contributions paid by an employer in a taxable year to fund such medical benefits under a pension or annuity plan exceed the limitations of this subparagraph but otherwise satisfy the conditions for deduction under section 404, then the excess contributions are carried over and are deductible in succeeding taxable years of the employer which end with or within taxable years of the trust for which it is exempt under section 501(a) in order of time to the extent of the difference between the amount paid and deductible in each succeeding year and the limitation applicable to such year under this subparagraph. For purposes of subdivision (i) of this subparagraph, if the remaining future service of an employee is one year or less, it shall be treated as one year.

[T.D. 6500, 25 FR 11685, Nov. 26, 1960, as amended by T.D. 6722, 29 FR 5073, Apr. 14, 1964; T.D. 7165, 37 FR 5025, Mar. 9, 1972]

§1.404(a)–4 Pension and annuity plans; limitations under section 404(a)(1)(A).

(a) Subject to the applicable general conditions and limitations (see §1.404(a)–3), the initial limitation under section 404(a)(1)(A) is 5 percent of the compensation otherwise paid or accrued during the taxable year to all employees under the pension or annuity plan. This initial 5-percent limitation applies to the first taxable year for which a deduction is allowed for contributions to or under such a plan and also applies to any subsequent year (other than one described in paragraph (d) of this section) for which the 5-percent figure is not reduced as provided in this section. For years to which the initial 5-percent limitation applies, no adjustment on account of prior experience is required. If the contributions do not exceed the initial 5-percent limitation in the first taxable year to which this limitation applies, the taxpayer need not submit actuarial data for such year.

(b) For the first taxable year following the first year to which the initial 5-percent limitation applies, and for every fifth year thereafter, or more frequently where preferable to the taxpayer, the taxpayer shall submit with his return an actuarial certification of the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan with a statement explaining all the methods, factors, and assumptions used in determining such amount. This amount may be determined as the sum of (1) the unfunded past service cost as of the beginning of the year, and (2) the normal cost for the year. Such costs shall be determined by methods, factors, and assumptions appropriate as a basis of limitations under section 404(a)(1)(C). Whenever requested by the district director, a similar certification and statement shall be submitted for the year or years specified in such request. The district director will make periodical examinations of such data at not less than 5-year intervals. Based upon such examinations the Commissioner will reduce the limitation under section 404(a)(1)(A) below the 5-percent limitation for the years with respect to which he finds that the 5-percent limitation exceeds the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan. Where the limitation is so reduced, the reduced limitation shall apply until the Commissioner finds that a subsequent actuarial valuation shows a change to be necessary. Such subsequent valuation may be made by the taxpayer at any time and submitted to the district director with a request for a change in the limitation. See, however, paragraph (d) of this section with respect to taxable years to which the limitation under section 404(a)(1)(A) does not apply.

(c) For the purpose of limitations under section 404(a)(1)(A), ‘‘compensation otherwise paid or accrued’’ means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 401(a), including a plan that qualifies under section 404(a)(2). Where two or more pension or annuity plans cover the same employee, under section 404(a)(1)(A) the deductions with respect to each such plan are subject to the limitations applicable to the particular plan and the total deductions for all such plans are also subject to the limitations which would be applicable thereto if they constituted a single plan. Where, because of the particular provisions applicable to a large class of employees under a plan, the costs with respect to such employees are nominal in comparison with their compensation, after the first year to which the initial 5-percent limitation applies, deductions under section 404(a)(1)(A) are subject to limitations determined by considering the plan applicable to such class as if it were a separate plan. Deductions are allowable to the extent of the applicable limitations under section 404(a)(1)(A) even where these are greater than the applicable limitations under section 404(a)(1)(B) or section 404(a)(1)(C).

(d) The limitation under section 404(a)(1)(A) shall not be used for purposes of determining the amount deductible for a taxable year of the employer which ends with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it does not meet the requirements of section 404(a)(2), or which ends after the trust or plan has terminated. See § 1.404(a)–7 for rules relating to the limitation which is applicable for purposes of determining the amount deductible for such a taxable year of the employer.

[T.D. 6500, 25 FR 11685, Nov. 26, 1960, as amended by T.D. 6534, 26 FR 515, Jan. 20, 1961]

§ 1.404(a)–5 Pension and annuity plans; limitations under section 404(a)(1)(B).

(a) Subject to the applicable general conditions and limitations (see § 1.404(a)–3), under section 404(a)(1)(B), deductions may be allowed to the extent of limitations based on costs determined by distributing the remaining unfunded cost of the past and current service credits with respect to all employees covered under the trust or plan as a level amount or level percentage of compensation over the remaining service of each such employee except that, as to any three individuals with respect to whom more than 50 percent of such remaining unfunded cost attributable to such individuals shall be distributed evenly over a period of at least five taxable years. See, however, paragraph (e) of this section with respect to taxable years to which the limitation under section 404(a)(1)(B) does not apply.

(b) The statutory limitation for any taxable year under section 404(a)(1)(B) is any excess of the amount of the costs described in paragraph (a) of this section for the year over the amount allowable as a deduction under section 404(a)(1)(A).

(c) For this purpose, such excess, adjusted for prior experience, may be computed for each year as follows, all determinations being made as of the beginning of the year:

(1) Determine the value of all benefits expected to be paid, after the beginning of the year for all employees, any former employees, and any other beneficiaries, then covered under the plan.

(2) If employees contribute under the plan, determine the value of all contributions expected to be made after the beginning of the year by employees then covered under the plan.

(3) Determine the value of all funds of the plan as of the beginning of the year.

(4) Determine the amount remaining to be distributed as a level amount or as a level percentage of compensation over the remaining future service of each employee by subtracting from subparagraph (1) of this paragraph the sum of subparagraphs (2) and (3) of this paragraph.

(5) Determine the value of all compensation expected to be paid after the beginning of the year to all employees then covered under the plan.

(6) Determine an accrual rate for each employee by dividing subparagraph (5) of this paragraph into subparagraph (4) of this paragraph.

(7) Compute the excess under section 404(a)(1)(B) for the year by multiplying the compensation paid to all employees covered under the plan during the year by any excess of subparagraph (6) of this paragraph over 5 percent. In general, where this method is used, the limitation under section 404(a)(1)(B) will be equal to the excess so computed without further adjustment on account of prior favorable experience, provided all the factors and assumptions used are reasonable in view of all applicable considerations (see § 1.404(a)–3) and provided subparagraph (5) of this paragraph is not less than five times the annual rate of compensation in effect at the beginning of the year.

(d) Instead of determining the excess deductible under section 404(a)(1)(B) by the method shown in paragraph (c), such excess may be based upon cost determined by some other method which is reasonable and appropriate under the circumstances. Thus, such excess may be based on the amounts necessary with respect to each individual covered employee to provide the remaining unfunded cost of all his benefits under the plan distributed as a level amount over the period remaining until the normal commencement of his retirement benefits, in accordance with other generally accepted actuarial methods which are reasonable and appropriate in view of the provisions of the plan, the funding medium, and other applicable considerations.

(e) The limitation under section 404(a)(1)(B) shall not be used for purposes of determining the amount deductible for a taxable year of the employer which ends with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it does not meet the requirements of section 404(a)(2), or which ends after the trust or plan has terminated. See §1.404(a)–7 for rules relating to the limitation which is applicable for purposes of determining the amount deductible for such a taxable year of the employer.

[T.D. 6500, 25 FR 11686, Nov. 26, 1960, as amended by T.D. 6534, 26 FR 515, Jan. 20, 1961]

§1.404(a)–6 Pension and annuity plans; limitations under section 404(a)(1)(C).

(a) *Application to a taxable year of the employer which ends with or within a taxable year of the pension trust or annuity plan for which it is exempt under section 501(a) or meets the requirements of section 404(a)(2).* (1) The rules in this paragraph are applicable with respect to the limitation under section 404(a)(1)(C) for taxable years of the employer which end with or within a taxable year of the pension trust for which it is exempt under section 501(a), or, in the case of an annuity plan, during which it meets the requirements of section 404(a)(2). See paragraph (b) of this section for rules relating to the limitation under section 404(a)(1)(C) for other taxable years of the employer.

(2) Subject to the applicable general conditions and limitations (see §1.404(a)–3), in lieu of amounts deductible under the limitations of section 404(a)(1)(A) and section 404(a)(1)- (B), deductions may be allowed under section 404(a)(1)(C) to the extent of limitations based on normal and past service or supplementary costs of providing benefits under the plan. ‘‘Normal cost’’ for any year is the amount actuarially determined which would be required as a contribution by the employer in such year to maintain the plan if the plan had been in effect from the beginning of service of each then included employee and if such costs for prior years had been paid and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. Past service or supplementary cost at any time is the amount actuarially determined which would be required at such time to meet all the future benefits provided under the plan which would not be met by future normal costs and employee contributions with respect to the employees covered under the plan at such time.

(3) The limitation under section 404(a)(1)(C) for any taxable year to which this paragraph applies is the sum of normal cost for the year plus an amount not in excess of one-tenth of the past service or supplementary cost as of the date the past service or supplementary credits are provided under the plan. For this purpose, the normal cost may be determined by any generally accepted actuarial method and may be expressed either as (i) the aggregate of level amounts with respect to each employee covered under the plan, (ii) a level percentage of payroll with respect to each employee covered under the plan, or (iii) the aggregate of the single premium or unit costs for the unit credits accruing during the year with respect to each employee covered under the plan, provided, in any case, that the method is reasonable in view of the provisions and coverage of the plan, the funding medium, and other applicable considerations. The limitation may include one-tenth of the past service or supplementary cost as of the date the provisions resulting in such cost were put into effect, but it is subject to adjustments

for prior favorable experience. See § 1.404(a)–3. In any case, past service or supplementary costs shall not be included in the limitation for any year in which the amount required to fund fully or to purchase such past service or supplementary credits has been deducted, since no deduction is allowable for any amount (other than the normal cost) which is paid in after such credits are fully funded or purchased.

(b) *Application to a taxable year of the employer which does not end with or within a taxable year of the pension trust or annuity plan for which it is exempt under section 501(a) or meets the requirements of section 404(a)(2).* (1) The rules in this paragraph are applicable with respect to the limitation under section 404(a)(1)(C) for taxable years of the employer which end with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it does not meet the requirements of section 404(a)(2), or which end after the trust or plan has terminated. Since contributions paid in such taxable years of the employer are not deductible under section 404(a) (1) or (2) (except as provided in section 404(a)(6)), the limitation under section 404(a)(1)(C) for such taxable years relates only to the amount of any excess contributions that may be carried over to such taxable years under section 404(a)(1)(D).

(2) Subject to the applicable general conditions and limitations (see § 1.404(a)–3), deductions may be allowed under section 404(a)(1)(C) for taxable years of the employer to which this paragraph applies to the extent of limitations based on past service or supplementary costs of providing benefits under the plan. For definition of the ‘‘past service or supplementary cost at any time’’, see paragraph (a)(2) of this section.

(3) The limitation under section 404(a)(1)(C) for any taxable year to which this paragraph applies is an amount not in excess of one-tenth of the past service or supplementary cost as of the date the past service or supplementary credits are provided under the plan. The limitation under section 404(a)(1)(C) is subject, however, to adjustments for prior favorable experience. In any case, no amounts are deductible under section 404(a)(1)(C) for any year to which this paragraph applies if the amount required to fund fully or to purchase the past service or supplementary credits has been deducted in prior taxable years of the employer.

[T.D. 6534, 26 FR 515, Jan. 20, 1961]

§ 1.404(a)–7 Pension and annuity plans; contributions in excess of limitations under section 404(a)(1); application of section 404(a)(1)(D).

When contributions paid by an employer in a taxable year to or under a pension or annuity plan exceed the limitations applicable under section 404(a)(1) but otherwise satisfy the conditions for deduction under section 404(a) (1) or (2), then in accordance with section 404(a)(1)(D), the excess contributions are carried over and are deductible in succeeding taxable years of the employer in order of time pursuant to the following rules:

(a) In the case of a succeeding taxable year of the employer which ends with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it meets the requirements of section 404(a)(2), such excess contributions are deductible to the extent of the difference between the amount paid and deductible in such succeeding taxable year and the limitation applicable to such year under section 404(a)(1) (A), (B), or (C).

(b) In the case of a succeeding taxable year of the employer which ends with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it does not meet the requirements of section 404(a)(2), or which ends after the trust or plan has terminated, such excess contributions are deductible to the extent of the limitation applicable to such year under section 404(a)(1)(C) (see paragraph (b) of § 1.404(a)–6).

The provisions of section 404(a)(1)(D) are to be applied before giving effect to the provisions of section 404(a)(7) for any year. The carryover provisions of section 404(a)(1)(D), before effect has been given to section 404(a)(7), may be illustrated by the following example for a plan put into effect in a taxable year ending December 31, 1954:

Taxable Year Ending Dec. 31, 1954

Amount of contributions paid in year	$100,000
Limitation applicable to year	60,000
Amount deductible for year	60,000
Excess carried over to succeeding years	40,000

Taxable Year Ending Dec. 31, 1955

Amount of contributions paid in year	$25,000
Carried over from previous years	40,000
Total deductible subject to limitation	65,000
Limitation applicable to year	50,000
Amount deductible for year	50,000
Excess carried over to succeeding years	15,000

Taxable Year Ending Dec. 31, 1956

Amount of contributions paid in year	$10,000
Carried over from previous years	15,000
Total deductible subject to limitation	25,000
Limitation applicable to year	45,000
Amount deductible for year	25,000
Excess carried over to succeeding years	None

§1.404(a)–8 Contributions of an employer under an employees' annuity plan which meets the requirements of section 401(a); application of section 404(a)(2).

(a) If contributions are paid by an employer under an annuity plan for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see §1.404(a)–1), the contributions are deductible under section 404(a)(2) if the further conditions provided therein are satisfied. For the meaning of ''annuity plan'' as used here, see §1.404(a)–3. In order that contributions by the employer may be deducted under section 404(a)(2), all of the following conditions must be satisfied:

(1) The contributions must be paid toward the purchase of retirement annuities (or for disability, severance, insurance, survivorship benefits incidental and directly related to such annuities, or medical benefits described in section 401(h) as defined in paragraph (a) of §1.404(h)–1) under an annuity plan for the exclusive benefit of the employer's employees or their beneficiaries.

(2) The contributions must be paid in a taxable year of the employer which ends with or within a year of the plan for which it meets the applicable requirements set forth in section 401(a) (3), (4), (5), (6), (7), (8), (11), (12), (13), (14), (15), (16), and (19). In the case of a plan which covers a self-employed individual, the contributions must be paid in a taxable year of the employer which ends with or within a year of the plan for which it also meets the requrements of section 401(a), (9), (10), (17), and (18) and of section 401(d) (other than paragraph (1)). In the case of a plan which covers a shareholder-employee within the meaning of section 1379(d), the contributions must be paid in a taxable year of the employer which ends with or within a year of the plan for which it also meets the requirements of section 401(a) (17) and (18). See section 401(a) and the regulations thereunder for the requirements and the applicable effective dates of the respective paragraphs set forth in section 401(a). Any contributions of an employer which are paid in a taxable year of the employer ending with or within a year of the plan for which it meets the applicable requirements of section 401 may be carried over and deducted in a succeeding taxable year of the employer in accordance with section 404(a)(1)(D), whether or not such succeeding taxable year ends with or within a taxable year of the plan for which it meets the requirements set out in section 401 (a) and (d). See section 401(b) and the regulations thereunder for special rules allowing certain plan amendments to be given retroactive effect. See section 404(a)(6) for a special rule for determining the time when a contribution is deemed to have been made.

(3) There must be a definite written arrangement between the employer and the insurer that refunds of premiums, if any, shall be applied within the taxable year of the employer in which received or within the next succeeding taxable year toward the purchase of retirement annuities (or for disability, severance, insurance, survivorship benefits incidental and directly related to such annuities, or medical benefits described in section 401(h) as defined in paragraph (a) of §1.401(h)–1 under the plan. For the purpose of this condition, ''refunds of premiums'' means payments by the insurer on account of

credits such as dividends, experience rating credits, or surrender or cancellation credits. The arrangement may be in the form of contract provisions or written directions of the employer or partly in one form and partly in another. This condition will be considered satisfied where—

(i) All credits are applied regularly, as they are determined, toward the premiums next due under the contracts before any further employer contributions are so applied, and

(ii) Under the arrangement,

(A) No refund of premiums may be made during continuance of the plan unless applied as aforesaid, and

(B) If refunds of premiums may be made after discontinuance or termination, whichever is applicable, of the plan on account of surrenders or cancellations before all retirement annuities provided under the plan with respect to service before its discontinuance or termination have been purchased, such refunds will be applied in the taxable year of the employer in which received, or in the next succeeding taxable year, to purchase retirement annuities for employees by a procedure which does not contravene the conditions of section 401(a)(4). If the plan also includes medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401(h)–1, any refund of premiums attributable to such benefits must, in accordance with these rules, be applied toward the purchase of medical benefits described in section 401(h).

(4) Any amounts described in subparagraph (3) of this paragraph which are attributable to contributions on behalf of a self-employed individual must be applied toward the purchase of retirement benefits. Amounts which are so applied are not contributions and thus are not taken into consideration in determining—

(i) The amount deductible with respect to contributions on his behalf, nor

(ii) In the case of an owner-employee, the maximum amount of contributions that may be made on his behalf.

(b) Where the above conditions are satisfied, the amounts deductible under section 404(a)(2) are governed by the limitations provided in section 404(a)(1). See §§ 1.404(a)–3 to 1.404(a)–7, inclusive.

(Sec. 411 Internal Revenue Code of 1954 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42321, Aug. 23, 1977]

§ 1.404(a)(8)–1T Deductions for plan contributions on behalf of self-employed individuals. (Temporary)

Q: How does the amendment to section 404(a)(8)(D), made by section 713(d)(6) of the Tax Reform Act of 1984 (TRA of 1984), affect section 404(a)(8)(C)?

A: In applying the rules of section 404(a)(8)(C), the Service will treat the amendment to section 404(a)(8)(D) as also having been made to section 404(a)(8)(C), pending enactment of technical corrections to TRA of 1984. The effect of treating the amendment as having also been made to section 404(a)(8)(C) is to increase the amount of contributions on behalf of a self-employed individual that will be treated as satisfying section 162 or 212. Generally, therefore, a contribution on behalf of a self-employed individual is treated as satisfying section 162 or 212 if it is not in excess of the individual's earned income for the year, determined without regard to the deduction allowed by section 404 for the self-employed individual's contribution.

[T.D. 8073, 51 FR 4321, Feb. 4, 1986]

§ 1.404(a)–9 Contributions of an employer to an employees' profit-sharing or stock bonus trust that meets the requirements of section 401(a); application of section 404(a)(3)(A).

(a) If contributions are paid by an employer to a profit-sharing or stock bonus trust for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 1.404(a)–1), the contributions are deductible under section 404(a)(3)(A) if the further conditions provided therein are also satisfied. In order to be deductible under the first, second, or third sentence of section 404(a)(3)(A), the contributions must be paid (or deemed to have been paid under section 404(a)(6)) in a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a) and the trust must not be designed to provide retirement benefits for which the contributions can be determined actuarially. Excess contributions paid in such a taxable year of the employer may be carried over and deducted in a succeeding taxable year of the employer in accordance with the third sentence of section 404(a)(3)(A), whether or not such succeeding taxable year ends with or within a taxable year of the trust for which it is exempt under section 501(a). This section is also applicable to contributions to a foreign situs profit-sharing or stock bonus trust which could qualify for exemption under section 501(a) except that it is not created or organized and maintained in the United States.

(b) The amount of deductions under section 404(a)(3)(A) for any taxable year is subject to limitations based on the compensation otherwise paid or accrued by the employer during such taxable year to employees who are beneficiaries under the plan. For purposes of computing this limitation, the following rules are applicable:

(1) In the case of a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a), the limitation shall be based on the compensation otherwise paid or accrued by the employer during such taxable year of the employer to the employees who, in such taxable year of the employer, are beneficiaries of the trust funds accumulated under the plan.

(2) In the case of a taxable year of the employer which ends with or within a taxable year of the trust during which it is not exempt under section 501(a), or which ends after the trust has terminated, the limitation shall be based on the compensation otherwise paid or accrued by the employer during such taxable year of the employer to the employees who, at any time during the one-year period ending on the last day of the last calendar month during which the trust was exempt under section 501(a), were beneficiaries of the trust funds accumulated under the plan.

For purposes of this paragraph, ‘‘compensation otherwise paid or accrued’’ means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 401(a), including a plan that qualifies under section 404(a)(2). The limitations under section 404(a)(3)(A) apply to the total amount deductible for contributions to the trust regardless of the manner in which the funds of the trust are invested, applied, or distributed, and no other deduction is allowable on account of any benefits provided by contributions to the trust or by the funds thereof. Where contributions are paid to two or more profit-sharing or stock bonus trusts satisfying the conditions for deduction under section 404(a)(3)(A), such trusts are considered as a single trust in applying these limitations.

(c) The primary limitation on deductions for a taxable year is 15 percent of the compensation otherwise paid or accrued by the employer during such taxable year to the employees who are beneficiaries under the plan. See paragraph (b) of this section for rules for determining who are the beneficiaries under the plan.

(d) In order that the deductions may average 15 percent of compensation otherwise paid or accrued over a period of years, where contributions in some taxable year are less than the primary limitation but contributions in some succeeding taxable year exceed the primary limitation, deductions in each succeeding year are subject to a secondary limitation instead of to the primary limitation. The secondary limitation for any year is equal to the lesser of (1) twice the primary limitation for the year, or (2) any excess of (i) the aggregate of the primary limitations for the year and for all prior years over (ii) the aggregate of the deductions allowed or allowable under the limitations provided in section 404(a)(3)(A) for all prior years. Since contributions paid into a profit-sharing or stock bonus trust are deductible under section 404(a)(3)(A) only if they are paid (or deemed to have been paid under section 404(a)(6)) in a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a), the secondary limitation described in this paragraph is not applicable with respect to determining amounts deductible for a taxable year of the employer which ends with or within a taxable year of the trust during which it is not exempt under section 501(a), or which ends after the trust has terminated. See paragraph (e) of this section for rules relating to amounts which are deductible in such a taxable year.

(e) In any case when the contributions in a taxable year exceed the amount allowable as a deduction for the year under section 404(a)(3)(A), the excess is deductible in succeeding taxable years, in order of time, in accordance with the following limitations:

(1) If the succeeding taxable year ends with or within a taxable year of the trust for which it is exempt under section 501(a), such excess is deductible in any such succeeding taxable year in which the contributions are less than the primary limitation for that year; but the total deduction for such succeeding taxable year cannot exceed the lesser of (i) the primary limitation for such year, or (ii) the sum of the contributions in such year and the excess contributions not deducted under the limitations of section 404(a)(3)(A) for prior years.

(2) If the succeeding taxable year ends with or within a taxable year of the trust during which it is not exempt under section 501(a), or if such succeeding taxable year ends after the trust has terminated, the total deduction for such succeeding taxable year cannot exceed the lesser of (i) the primary limitation for such succeeding taxable year, or (ii) the excess contributions not deducted under the limitations of section 404(a)(3)(A) for prior years.

In no case, however, are excess contributions deductible in a succeeding taxable year if such contributions were not paid (or deemed to have been paid under section 404(a)(6)) in a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a).

(f) In case deductions are allowable under section 404(a) (1) or (2), as well as under section 404(a)(3)(A), the limitations under section 404(a) (1) and (3)(A) are determined and applied without giving effect to the provisions of section 404(a)(7), but the amounts allowable as deductions are subject to the further limitations provided in section 404(a)(7). See § 1.404(a)–13.

(g) The provisions of section 404(a)(3)(A) before giving effect to section 404(a)(7), may be illustrated as follows:

Illustration of Provisions of Section 404(a)(3)(A) for a Plan Put Into Effect in the Taxable (Calendar) Year 1954, Before Giving Effect to Section 404(a)(7) (All Figures Represent Thousands of Dollars and All Taxable (Calendar) Years Are Years Which End With or Within a Taxable Year of the Trust For Which it is Exempt Under Section 501(a))

	Taxable (calendar) years						
	1954	1955	1956	1957	1958	1959	1960
1. Amount of contributions:							
(i) In taxable year	$65	$10	$15	$100	$70	$40	$30
(ii) Carried over from prior taxable years	0	8	0	0	4	5	3
2. Primary limitation applicable to year:							
15 percent of covered compensation in year[1]	57	54	51	48	45	42	39
3. Secondary limitation applicable to year:							
(i) Twice primary limitation	....	....	....	96	90	84	....
(ii) (a) Aggregate primary limitations (see item 2)	....	....	....	210	255	297	....
(b) Aggregate prior deductions (see item 4 (iii))	....	....	....	90	186	255	
(c) Excess of (a) over (b)	....	....	....	120	69	42	....
(iii) Lesser of (i) or (ii)	....	....	....	96	69	42	....
4. Amount deductible for year on account of:							
(i) Contributions in year	57	10	15	96	69	40	30
(ii) Contributions carried over	0	8	0	0	0	2	3
(iii) Total	57	18	15	96	69	42	33
5. Excess contributions carried over to succeeding years.	8	0	0	4	5	3	0

[1] Compensation otherwise paid or accrued during the year to the employees who are beneficiaries of trust funds accumulated under the plan in the year.

[T.D. 6500, 25 FR 11687, Nov. 26, 1960, as amended by T.D. 6534, 26 FR 516, Jan. 20, 1961]

§1.404(a)–10 Profit-sharing plan of an affiliated group; application of section 404(a)(3)(B).

(a) Section 404(a)(3)(B) allows a corporation a deduction to the extent provided in paragraphs (b) and (c) of this section for a contribution which it makes for another corporation to a profit-sharing plan or a stock bonus plan under which contributions are determined by reference to profits, provided the following tests are met:

(1) The corporation for which the contribution is made and the contributing corporation are members of an affiliated group of corporations as defined in section 1504, relating to the filing of consolidated returns, and both such corporations participate in the plan. However, it is immaterial whether all the members of such group participate in the plan.

(2) The corporation for which the contribution is made is required under the plan to make the contribution, but such corporation is prevented from making such contribution because it has neither current nor accumulated earnings or profits, or because its current and accumulated earnings or profits are insufficient to make the required contribution. To the extent that such a corporation has any current or accumulated earnings or profits, it is not considered to be prevented from making its required contribution to the plan.

(3) The contribution is made out of the current or accumulated earnings or profits of the contributing corporation.

(b) The amount that is deductible under section 404(a)(3)(B) is determined by applying the rules of section 404(a)(3)(A) and §1.404(a)–9 as if the contribution were made by the corporation for which it is made. For example, the primary limitation described in paragraph (e) of §1.404(a)–9 is determined by reference to the compensation otherwise paid or accrued to the employees of the corporation for which the contribution is made, and the secondary limitation described in paragraph (d) of §1.404(a)–9 and the contribution carryover described in paragraph (c) of §1.404(a)–9 are determined by reference to the prior contributions and deductions of such corporation. The contributing corporation may deduct the amount so determined subject to the limitations contained in paragraph (c) of this section. The contributing corporation shall not treat such amount as a contribution made by it in applying the rules of section 404(a)(3)(A) and §1.404(a)–9 either for the taxable year for which the contribution is made or for succeeding taxable years. The corporation for which the contribution is made shall treat the contribution as having been made by it in applying the rules of section 404(a)(3)(A) and §1.404(a)–9 for succeeding taxable years.

(c) The allowance of the deduction under section 404(a)(3)(B) does not depend upon whether the affiliated group does or does not file a consolidated return. If a consolidated return is filed, it is immaterial which of the participating corporations makes the contribution and takes the deduction or how the contribution or the deduction is allocated among them. However, if a consolidated return is not filed, the contribution which is deductible under section 404(a)(3)(B) by each contributing corporation shall be limited to that portion of its total current and accumulated earnings or profits (adjusted for its contribution deductible without regard to section 404(a)(3)(B)) which the prevented contribution bears to the total current and accumulated earnings or profits of all the participating members of the group having such earnings or profits (adjusted for all contributions deductible without regard to section 404(a)(3)(B)). For the purpose of this section, current earnings or profits shall be computed as of the close of the taxable year without diminution by reason of any dividends during the taxable year, and accumulated earnings or profits shall be computed as of the beginning of the taxable year.

(d) The application of section 404(a)(3)(B) may be illustrated by the following example in which the affiliated group does not file a consolidated return:

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
A	($10,000)	($140,000)	($150,000)	$200,000	⅕	$6,000	....	....	....	....

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
B	(5,000)	105,000	100,000	300,000	3/10	9,000	$9,000	$91,000	6/326× 91,000	$1,674.85
C	75,000	175,000	250,000	500,000	1/2	15,000	15,000	235,000	6/326× 235,000	4,325.15
Total	60,000	140,000	200,000	1,000,000	....	30,000	24,000	326,000	....	6,000.00

Column:
(1) Member.
(2) Earnings and profits of the taxable year.
(3) Accumulated earnings and profits at beginning of taxable year.
(4) Total current and accumulated earnings and profits (column 2 plus column 3).
(5) Compensation of participating employees.
(6) Contribution formula: 50 percent of consolidated earnings and profits, allocated among participating member in proportion of covered payroll of each to covered payroll of consolidated group.
(7) Individual contribution had it not been prevented.
(8) Individual contribution made by each employer for its own employees.
(9) Balance of accumulated earnings and profits (column 4 minus column 8).
(10) Proportion of make-up contribution.
(11) Make-up contribution.

[T.D. 6500, 25 FR 11688, Nov. 26, 1960]

§ 1.404(a)–11 Trusts created or organized outside the United States; application of section 404(a)(4).

In order that a trust may constitute a qualified trust under section 401(a) and be exempt under section 501(a), it must be created or organized in the United States and maintained at all times as a domestic trust. See paragraph (a) of § 1.401–1. Paragraph (4) of section 404(a) provides, however, that an employer which is a resident, a corporation, or other entity of the United States, making contributions to a foreign stock bonus, pension, or profit-sharing trust, shall be allowed deductions for such contributions, under the applicable conditions and within the prescribed limits of section 404(a), if such foreign trust would qualify for exemption under section 501(a) except for the fact that it is a trust created, organized, or maintained outside the United States. Moreover, if a nonresident alien individual, foreign corporation, or other entity is engaged in trade or business within the United States and makes contributions to a foreign stock bonus, pension, or profit-sharing trust, which would qualify under section 401(a) and be exempt under section 501(a) except that it is created, organized, or maintained outside the United States, such contributions are deductible subject to the conditions and limitations of section 404(a) and to the extent allowed by section 873 or 882(c).

[T.D. 6500, 25 FR 11689, Nov. 26, 1960]

§ 1.404(a)–12 Contributions of an employer under a plan that does not meet the requirements of section 401(a); application of section 404(a)(5).

(a) *In general.* Section 404(a)(5) covers all cases for which deductions are allowable under section 404(a) (for contributions paid by an employer under a stock bonus, pension, profit sharing, or annuity plan or for any compensation paid on account of any employee under a plan deferring the receipt of such compensation) but not allowable under paragraph (1), (2), (3), (4), or (7) of such section. For the rules with respect to the taxability of an employee when rights under a nonexempt trust become substantially vested, see section 402(b) and the regulations thereunder.

(b) *Contributions made after August 1, 1969*—(1) *In general.* A deduction is allowable for a contribution paid after August 1, 1969, under section 404(a)(5) only in the taxable year of the employer in which or with which ends the taxable year of an employee in which an amount attributable to such contribution is includible in his gross income as compensation, and then only to the extent allowable under section 404(a). See § 1.404(a)-1. For example, if an employer A contributes $1,000 to the account of its employee E for its taxable (calendar) year 1977, but the amount in the account attributable to that contribution is not includible in E's gross income until his taxable (calendar) year 1980 (at which time the includible amount is $1,150), A's deduction for that contribution is $1,000 in

1980 (if allowable under section 404(a)). For purposes of this (1), a contribution is considered to be so includible where the employee or his beneficiary excludes it from his gross income under section 101(b) or subchapter N. To the extent that property of the employer is transferred in connection with such a contribution, such transfer will constitute a disposition of such property by the employer upon which gain or loss is recognized, except as provided in section 1032 and the regulations thereunder. The amount of gain or loss recognized from such disposition shall be the difference between the value of such property used to measure the deduction allowable under this section and the employer's adjusted basis in such property.

(2) *Special rule for unfunded pensions and certain death benefits.* If unfunded pensions are paid directly to former employees, such payments are includible in their gross income when paid, and accordingly, such amounts are deductible under section 404(a)(5) when paid. Similarly, if amounts are paid as a death benefit to the beneficiaries of an employee (for example, by continuing his salary for a reasonable period), and if such amounts meet the requirements of section 162 or 212, such amounts are deductible under section 404(a)(5) in any case when they are not includible under the other paragraphs of section 404(a).

(3) *Separate accounts for funded plans with more than one employee.* In the case of a funded plan under which more than one employee participates, no deduction is allowable under section 404(a)(5) for any contribution unless separate accounts are maintained for each employee. The requirement of separate accounts does not require that a separate trust be maintained for each employee. However, a separate account must be maintained for each employee to which employer contributions under the plan are allocated, along with any income earned thereon. In addition, such accounts must be sufficiently separate and independent to qualify as separate shares under section 663(c). Nothing shall preclude a trust which loses its exemption under section 501(a) from setting up such acounts and meeting the separate account requirement of section 404(a)(5) with respect to the taxable years in which such accounts are set up and maintained.

(c) *Contributions paid on or before August 1, 1969.* No deduction is allowable under section 404(a)(5) for any contribution paid on or before August 1, 1969, by an employer under a stock bonus, pension, profit-sharing, or annuity plan, or for any compensation paid on account of any employee under plan deferring the receipt of such compensation, except in the year when paid, and then only to the extent allowable under section 404(a). See §1.404(a)–1. If payments are made under such a plan and the amounts are not deductible under the other paragraphs of section 404(a), they are deductible under section 404(a)(5) to the extent that the rights of individual employees to, or derived from, such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid. If unfunded pensions are paid directly to former employees, their rights to such payments are nonforfeitable, and accordingly, such amounts are deductible under section 404(a)(5) when paid. Similarly, if amounts are paid as a death benefit to the beneficiaries of an employee (for example, by continuing his salary for a reasonable period), and if such amounts meet the requirements of section 162 or 212, such amounts are deductible under section 404(a)(5) in any case where they are not deductible under the other paragraphs of section 404(a). As to what constitutes nonforfeitable rights of an employee in other cases, see §1.402(b)–1(d)(2). If an amount is accrued but not paid during the taxable year, no deduction is allowable for such amount for such year. If an amount is paid during the taxable year to a trust or under a plan and the employee's rights to such amount are forfeitable at the time the amount is paid, no deduction is allowable for such amount for any taxable year.

(Secs. 83 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 588; 68A Stat. 917; 26 U.S.C. 83 and 7805))

[T.D. 7554, 43 FR 31926, July 24, 1978]

§ 1.404(a)–13 Contributions of an employer where deductions are allowable under section 404(a) (1) or (2) and also under section 404(a)(3); application of section 404(a)(7).

(a) Where deductions are allowable under section 404(a) (1) or (2) on account of contributions under a pension or annuity plan and deductions are also allowable under section 404(a)(3) for the same taxable year on account of contributions to a profit-sharing or stock bonus trust, the total deductions under these sections are subject to the provisions of section 404(a)(7) unless no employee who is a beneficiary under the trusts or plans for which deductions are allowable under section 404(a) (1) or (2) is also a beneficiary under the trusts for which deductions are allowable under section 404(a)(3). The provisions of section 404(a)(7) apply only to deductions for overlapping trusts or plans, *i.e.*, for all trusts or plans for which deductions are allowable under section 404(a) (1), (2), or (3) except (1) any trust or plan for which deductions are allowable under section 404(a) (1) or (2) and which does not cover any employee who is also covered under a trust for which deductions are allowable under section 404(a) (3), and (2) any trust for which deductions are allowable under section 404(a)(3) and which does not cover any employee who is also covered under a trust or plan for which deductions are allowable under section 404(a) (1) or (2). The limitations under section 404(a)(7) for any taxable year of the employer are based on the compensation otherwise paid or accrued during the year by the employer to all employees who, in such year, are beneficiaries of the funds accumulated under one or more of the overlapping trusts or plans. For purposes of the preceding sentence, if the taxable year of the employer with respect to which the limitation is being computed ends with or within a taxable year of any of the overlapping trusts or plans during which any such trust is not exempt under section 501(a) or, in the case of a plan, during which it does not meet the requirements of section 404(a)(2), or if such taxable year of the employer ends after any such trust or plan has terminated, then, with respect to such trust or plan, those employees, and only those employees, who, at any time during the one-year period ending on the last day of the last calendar month during which the trust was exempt under section 501(a), or the plan met the requirements of section 404(a)(2), were beneficiaries of the funds accumulated under such trust or plan shall be considered the beneficiaries of such trust or plan in the taxable year of the employer with respect to which the limitation is being computed. For purposes of this paragraph, ‘‘compensation otherwise paid or accrued’’ means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 401(a), including a plan that qualifies under section 404(a)(2).

(b) Under section 404(a)(7), any excess of the total amount otherwise deductible for the taxable year under section 404(a) (1), (2), or (3) as contributions to overlapping trusts or plans over 25 percent of the compensation otherwise paid or accrued during the year to all the employees who are beneficiaries under such trusts or plans, is not deductible for such year but is deductible for succeeding taxable years, in order of time, so that the total deduction for contributions to such trusts or plans for a succeeding taxable year is equal to the lesser of—

(1) 30 percent of the compensation otherwise paid or accrued during the taxable year to all the employees who are beneficiaries under such trusts or plans in the year, or

(2) The sum of (i) the smaller of (*a*) 25 percent of the compensation otherwise paid or accrued during the taxable year to all employees who are beneficiaries under such trusts or plans in the year, or (*b*) the total of the amounts otherwise deductible under section 404(a) (1), (2), or (3) for the year for such trusts or plans and (ii) any carryover to the year from prior years under section 404(a)(7), i.e., any excess otherwise deductible under section 404(a) (1), (2), or (3), but not deducted for a prior taxable year because of the limitations under section 404(a)(7).

(c) The limitations under section 404(a)(7) are determined and applied after all the limitations, deductions otherwise allowable, and carryovers under section 404(a) (1), (2), and (3) have been determined and applied, and, in particular, after effect has been given to the carryover provision in section 404(a)(1)(D) and in the second and third sentences of section 404(a)(3)(A). Where the limitations under section 404(a)(7) reduce the total amount deductible, the excess deductible in succeeding years is treated as a carryover which is distinct from, and additional to, any excess contributions carried over and deductible in succeeding years under the provisions in section 404(a)(1)(D) or in the third sentence of section 404(a)(3)(A). The application of the provisions of section 404(a)(7) and the treatment of carryovers for a case where the taxable years are calendar years and the overlapping trusts or plans consist of a pension trust and a profit-sharing trust put into effect in 1954 and covering the same employees may be illustrated as follows:

ILLUSTRATION OF APPLICATION OF PROVISIONS OF SECTION 404(A)(7) AND OF TREATMENT OF CARRYOVERS FOR OVERLAPPING PENSION AND PROFIT-SHARING TRUSTS PUT INTO EFFECT IN 1954 AND COVERING THE SAME EMPLOYEES (ALL FIGURES REPRESENT THOUSANDS OF DOLLARS AND ALL TAXABLE (CALENDAR) YEARS OF THE EMPLOYER ARE YEARS WHICH END WITH OR WITHIN A TAXABLE YEAR OF THE TRUST FOR WHICH IT IS EXEMPT UNDER SECTION 501(A))

	Taxable calendar years			
	1954	1955	1956	1957
BEFORE GIVING EFFECT TO SECTION 404(a)(7)				
Pension trust contributions and limitations, deductions, and carryovers under section 404(a)(1):				
1. Contributions paid in year	$215	$85	$140	$60
2. Contributions carried over from prior years	0	5	0	20
3. Total deductible for year subject to limitation	215	90	140	80
4. Limitation applicable to year	210	175	120	85
5. Amount deductible for year	210	90	120	80
6. Contributions carried over to succeeding years	5	0	20	0
Profit-sharing trust contributions and limitations, deductions, and carryovers under section 404(a)(3):				
7. Contributions paid in year	200	125	105	65
8. Contributions carried over from prior years	0	35	10	0
9. Total deductible for year subject to limitation	200	160	115	65
10. Limitation applicable to year	165	150	135	[1] 110
11. Amount deductible for year	165	150	115	65
12. Contributions carried over to succeeding years	35	10	0	0
APPLICATION OF SECTION 404(a)(7)				
Totals for pension and profit-sharing trust:				
13. Amount deductible for year under section 404(a)(7):				
(1) 30 percent of compensation covered in year[2]	([3])	300	270	180
(2) (i) (a) 25 percent of compensation covered in year[2]	275	250	225	150
(b) Total amount otherwise deductible for year: item 5 plus item 11	375	240	235	145
(c) Smaller of (a) or (b)	275	240	225	145
(ii) Carryover from prior years under section 404(a)(7)	0	100	40	10
(iii) Sum of (i)(c) and (ii)	275	340	265	155
(3) Amount deductible: Lesser of (1) or (2)(iii)	275	300	265	155
14. Carryover to succeeding years under section 404(a)(7): item 13(2)(ii) plus item 3(2)(i)(b) minus item 13(3)	100	40	10	0

[1] Includes carryover of 20 from 1956.

[2] Compensation otherwise paid or accrued during the year to the employees who are beneficiaries under the trusts in the year.

[3] 30 percent limitation not applicable to first year of plan.

[T.D. 6500, 25 FR 11689, Nov. 26, 1960, as amended by T.D. 6534, 26 FR 517, Jan. 20, 1961]

§ 1.404(a)–14 Special rules in connection with the Employee Retirement Income Security Act of 1974.

(a) *Purpose of this section.* This section provides rules for determining the deductible limit under section 404(a)(1)(A) of the Internal Revenue Code of 1954 for defined benefit plans.

(b) *Definitions.* For purposes of this section—

(1) *Section 404(a).* The term ''old section 404(a)'' means section 404(a) as in effect on September 1, 1974. Any reference to section 404 without the designation ''old'' is a reference to section 404 as amended by the Employee Retirement Income Security Act of 1974.

(2) *Ten-year amortization base.* The term ''10-year amortization base'' means either the past service and other supplementary pension and annuity credits described in section 404(a)(1)(A)(iii) or any base established in accordance with paragraph (g) of this section. A plan may have several 10-year amortization bases to reflect different plan amendments, changes in actuarial assumptions, changes in funding method, and experience gains and losses of previous years.

(3) *Limit adjustment.* The term ''limit adjustment'' with respect to any 10-year amortization base is the lesser of—

(i) The level annual amount necessary to amortize the base over 10 years using the valuation rate, or

(ii) The unamortized balance of the base,

in each case using absolute values (solely for the purpose of determining which is the lesser). To compute the level amortization amount, the base may be divided by the present value of an annuity of one dollar, obtained from standard annuity tables on the basis of a given interest rate (the valuation rate) and a known period (the amortization period).

(4) *Absolute value.* The term ''absolute value'' for any number is the value of that number, treating negative numbers as if they were positive numbers. For example, the absolute value of 5 is 5 and the absolute value of minus 3 is 3. On the other hand, the true value of minus 3 is minus 3. This term is relevant to the computation of the limit adjustment described in paragraph (b)(3) and the remaining amortization period of combined bases described in paragraph (i)(3) of this section.

(5) *Valuation rate.* The term ''valuation rate'' means the assumed interest rate used to value plan liabilities.

(c) *Use of plan in determining deductible limit for employer's taxable year.* Although the deductible limit applies for an employer's taxable year, the deductible limit is determined on the basis of a plan year. If the employer's taxable year coincides with the plan year, the deductible limit for the taxable year is the deductible limit for the plan year that coincides with that year. If the employer's taxable year does not coincide with the plan year, the deductible limit under section 404(a)(1)(A) (i), (ii), or (iii) for a given taxable year of the employer is one of the following alternatives:

(1) The deductible limit determined for the plan year commencing within the taxable year.

(2) The deductible limit determined for the plan year ending within the taxable year, or

(3) A weighted average of alternatives (1) and (2). Such an average may be based, for example, upon the number of months of each plan year falling within the taxable year.

The employer must use the same alternative for each taxable year unless consent to change is obtained from the Commissioner under section 446 (e).

(d) *Computation of deductible limit for a plan year*—(1) *General rules.* The computation of the deductible limit for a plan year is based on the funding methods, actuarial assumptions, and benefit structure used for purposes of section 412, determined without regard to section 412(g) (relating to the alternative minimum funding standard), for the plan year. The method of valuing assets for purposes of section 404 must be the same method of valuing assets used for purposes of section 412.

(2) *Special adjustments of computations under section 412.* To apply the rules of this section (*i.e.*, rules regarding the computation of normal cost with aggregate type funding methods, unfunded liabilities, and the full funding limitation described in paragraph (k) of the section, where applicable) with

respect to a given plan year in computing deductible limits under section 404 (a)(1)(A), the following adjustments must be made:

(i) There must be excluded from the total assets of the plan the amount of any plan contribution for a plan year for which the plan was qualified under section 401(a), 403(a) or 405(a) that has not been previously deducted, even though that amount may have been credited to the funding standard account under section 412(b)(3). In the case of a plan using a spread gain funding method which maintains an unfunded liability (e.g., the frozen initial liability method, but not the aggregate method), the amount described in the preceding sentence must be included in the unfunded liability of the plan.

(ii) There must be included in the total assets of the plan for a plan year the amount of any plan contribution that has been deducted with respect to a prior plan year, even though that amount is considered under section 412 to be contributed in a plan year subsequent to that prior plan year. In the case of a plan using a spread gain funding method which does not maintain an unfunded liability, the amount described in the preceding sentence must be excluded from the unfunded liability of the plan.

The special adjustments described in paragraph (d)(2) (i) and (ii) of this section apply on a year-by-year basis for purposes of section 404(a)(1)(A) only. Thus, the adjustments have no effect on the computation of the minimum funding requirement under section 412.

(e) *Special computation rules under section 404(a)(1)(A)(i)*—(1) *In general.* For purposes of determining the deductible limit under section 404(a)(1)(A)(i), the deductible limit with respect to a plan year is the sum of—

(i) The amount required to satisfy the minimum funding standard of section 412(a) (determined without regard to section 412(g)) for the plan year and

(ii) An amount equal to the includible employer contributions. The term ‘‘includible employer contributions’’ means employer contributions which were required by section 412 for the plan year immediately preceding such plan year, and which were not deductible under section 404(a) for the prior taxable year of the employer solely because they were not contributed during the prior taxable year (determine with regard to section 404(a)(6)).

(2) *Rule for an employer using alternative minimum funding standard account and computing its deduction under section 404(a)(1)(A)(i).* This paragraph (e)(2) applies if the minimum funding requirements for the plan are determined under the alternative minimum funding standard described in section 412(g) for both the current plan year and the immediately preceding plan year. In that case, the deductible limit under section 404(a)(1)(A)(i) (regarding the minimum funding requirement of section 412) for the current year is the sum of the amount determined under the rules of paragraph (e)(1) of this section.

(i) Plus the charge under section 412(b)(2)(D), and

(ii) Less the credit under section 412(b)(3)(D),

that would be required if in the current plan year the use of the alternative method were discontinued.

(f) *Special computation rules under section* 404(a)(1)(A) (ii) and (iii)—(1) *In general.* Subject to the full funding limitation described in paragraph (k) of this section, the deductible limit under section 404(a)(1)(A)(ii) and (iii) is the normal cost of the plan (determined in accordance with paragraph (d) of this section).

(2) *Adjustments in calculating limit under section 404 (a)(1)(A)(iii).* In calculating the deductible limit under section 404(a)(1)(A)(iii), the normal cost of the plan is—

(i) Decreased by the limit adjustments to any unamortized bases required by paragraph (g) of this section, for example, bases that are due to a net experience gain, a change in actuarial assumptions, a change in funding method, or a plan provision or amendment which decreases the accrued liability of the plan, and

(ii) Increased by the limit adjustments of any unamortized 10-year amortization bases required by paragraph (g) or (j) of this section, for example, bases that are due to a net experience loss, a change in actuarial assumptions, a change in funding method, or a plan provision or amendment which increases the accrued liability.

(3) *Timing for computations and interest adjustments under section 404(a)(1)(A) (ii) and (iii).* Regardless of the actual time when contributions are made to a plan, in computing the deductible limit under section 404(a)(1)(A) (ii) and (iii) the normal cost and limit adjustments shall be computed as of the date when contributions are assumed to be made (''the computation date'') and adjusted for interest at the valuation rate from the computation date to the earlier of—

(i) The last day of the plan year used to compute the deductible limit for the taxable year, or

(ii) The last day of that taxable year. For additional provisions relating to the timing of computations and interest adjustments, see paragraph (h)(6) of this section (relating to the timing of computations and interest adjustments in the maintenance of 10-year amortization bases). For taxable years beginning before April 22, 1981, computations under the preceding sentence may, as an alternative, be based on prior published positions of the Internal Revenue Service under section 404(a).

(4) *Special limit under section 404(a)(1)(A)(ii).* If the deduction for the plan year is determined solely on the basis of section 404(a)(1)(A)(ii) (that is, without regard to clauses (i) or (iii)), the special limitation contained in section 404(a)(1)(A)(ii), regarding the unfunded cost with respect to any three individuals, applies, notwithstanding the rules contained in paragraphs (d)(2) and (f)(1) of this section.

(g) *Establishment of a 10-year amortization base*—(1) *Experience gains and losses.* In the case of a plan valued by the use of a funding method which is an immediate gain type of funding method (and therefore separately amortizes rather than includes experience gains and losses as a part of the normal cost of the plan), a 10-year amortization base must be established in any plan year equal to the net experience gain or loss required under section 412 to be determined with respect to that plan year. The base is to be maintained in accordance with paragraph (h) of this section. Such a base must not be established if the deductible limit is determined by use of a funding method which is a spread gain type of funding method (under which experience gains and losses are spread over future periods as a part of the plan's normal cost). Examples of the immediate gain type of funding method are the unit credit method, entry age normal cost method, and the individual level premium cost method. Examples of the spread gain type of funding method are the aggregate cost method, frozen initial liability cost method, and the attained age normal cost method.

(2) *Change in actuarial assumptions.* (i) If the creation of an amortization base is required under the rules of section 412(b) (2)(B)(v) or (3)(B)(iii) (as applied to the funding method used by the plan), a 10-year amortization base must be established at the time of a change in actuarial assumptions used to value plan liabilities. The amount of the base is the difference between the accrued liability calculated on the basis of the new assumptions and the accrued liability calculated on the basis of the old assumptions. Both computations of accrued liability are made as of the date of the change in assumptions.

(ii) A plan using a funding method of the spread gain type does not directly determine an accrued liability. If a plan using such a method is required under section 412(b) (2)(B)(v) or (3)(B)(iii) to create an amortization base, it must establish a base as described in paragraph (g)(2)(i) of this section for a change in actuarial assumptions by determining an accrued liability on the basis of another funding method (of the immediate gain type) that does determine an accrued liability. (The aggregate method is an example of a funding method that is not required under section 412(b) (2)(B)(v) or (3)(B)(iii) to create an amortization base.) The funding method chosen to determine the accrued liability of the plan in these cases must be the same method used to establish all other 10-year amortization bases maintained by the plan, if any. These bases must be maintained in accordance with paragraph (h) of this section.

(3) *Past service or supplemental credits.* A 10-year base must be established when a plan is established or amended, if the creation of an amortizable base

is required under the rules of section 412(b)(2)(B) (ii) or (iii), or (b)(3)(B)(i) (as applied to the funding method used by the plan). The amount of the base is the accrued liability arising from, or the decrease in accrued liability resulting from, the establishment or amendment of the plan. The base must be maintained in accordance with paragraph (h) of this section.

(4) *Change in funding method.* If a change in funding method results in an increase or decrease in an unfunded liability required to be amortized under section 412, a 10-year base must be established equal to the increase or decrease in unfunded liability resulting from the change in funding method. The base must be maintained in accordance with paragraph (h) of this section.

(h) *Maintenance of 10-year amortization base*—(1) *In general.* Each time a 10-year amortization base is established, whether by a change in funding method, by plan amendment, by change in actuarial assumptions, or by experience gains and losses, the base must, except as provided in paragraph (i) of this section, be separately maintained in order to determine when the unamortized amount of the base is zero. The sum of the unamortized balances of all of the 10-year bases must equal the plan's unfunded liability with the adjustments described in paragraph (d) of this section, if applicable. When the unamortized amount of a base is zero, the deductible limit is no longer adjusted to reflect the amortization of the base.

(2) *First year's base.* See either paragraph (g) or paragraph (i) of this section for rules applicable with respect to the first year of a base.

(3) *Succeeding year's base.* For any plan year after the first year of a base, the unamortized amount of the base is equal to—

(i) The unamortized amount of the base as of the valuation date in the prior plan year, plus

(ii) Interest at the valuation rate from the valuation date in the prior plan year to the valuation date in the current plan year on the amount described in subdivision (i), minus

(iii) The contribution described in paragraph (h)(4) of this section with respect to the base for the prior plan year.

The valuation date is the date as of which plan liabilities are valued under section 412(c)(9). If such a valuation is performed less often than annually for purposes of section 412, bases must be adjusted for purposes of section 404 each year as of the date on which a section 412 valuation would be performed were it required on an annual basis. See paragraph (b)(3) of this section for the definition of valuation rate.

(4) *Contribution allocation with respect to each base.* A portion of the total contribution for the prior plan year is allocated to each base. Generally, this portion equals the product of—

(i) The total contribution described in paragraph (h)(6) of this section with respect to all bases, and

(ii) The ratio of the amount described in paragraph (b)(3)(i) of this section with respect to the base to the sum (using true rather than absolute values) of such amounts with respect to all remaining bases.

However, if the result of this computation with respect to a particular base exceeds the amount necessary to amortize such base fully, the smaller amount shall be deemed the contribution made with respect to such base. The unallocated excess with respect to a now fully amortized base shall be allocated among the other bases as indicated above.

(5) *Other allocation methods.* The Commissioner may authorize the use of methods other than the method described in paragraph (h)(4) of this section for allocating contributions to bases.

(6) *Total contribution for all bases.* The contribution with respect to all bases for the prior plan year (see paragraph (h)(3)(iii) of this section) is the difference between—

(i) The sum of (A) the total deduction (including a carryover deduction) for the prior year, (B) interest on the actual contributions for the prior year (whether or not deductible) at the valuation rate for the period between the dates as of which the contributions are credited under section 412 and the valuation date in the current plan year, and (C) interest on the carryover described in section 404(a)(1)(D) that is available at the beginning of the prior taxable year at the valuation rate for the period between the current and prior valuation dates, and

(ii) The normal cost for the prior plan year and interest on it at the valuation rate from the date as of which the normal cost is calculated to the current valuation date.

(7) *Effect of failure to contribute normal cost plus interest on unamortized amounts.* The failure to make a contribution at least equal to the sum of the normal cost plus interest on the unamortized amounts has the following effects under the preceding rules of this section—

(i) It does not create a new base.

(ii) It results in an increase in the unamortized amount of each base and consequently extends the time before the base is fully amortized.

(iii) The limit adjustment for any base is not increased (in absolute terms) even if the unamortized amount computed under paragraph (h) of this section exceeds the initial 10-year amortization base. Thus, if the total unamortized amount of the plan's bases at the beginning of the plan year is $100,000 (which is also the unfunded liability of the plan), and a required $50,000 normal cost contribution is not made for the plan year, the following effects occur. The total unamortized balance of the plan's bases increases by the $50,000 normal cost for the year (adjusted for interest), plus interest on the $100,000 balance of the bases; and, because of that increase, it will take a longer period to amortize the remaining balance of the bases. (The annual amortization amount does not change.)

(8) *Required adjustment to a 10-year base limit adjustment if valuation rate changed.* If there is a change in the valuation rate, the limit adjustment for all unamortized 10-year amortization bases must be changed, in addition to establishing a new base as provided in paragraph (g)(2) of this section. The new limit adjustment for any base is the level amount necessary to amortize the unamortized amount of the base over the remaining amortization period using the new valuation rate. The remaining amortization period of the base is the number of years at the end of which the unamortized amount of the base would be zero if the contribution made with respect to that base equaled the limit adjustment each year. This calculation of the remaining period is made on the basis of the valuation rate used before the change. Both the remaining amortization period and the revised limit adjustment may be determined through the use of standard annuity tables. The remaining period may be computed in terms of fractional years, or it may be rounded off to a full year. The unamortized amount of the base as of the valuation date and the remaining amortization period of that base shall not be changed by any change in the valuation rate.

(i) *Combining bases*—(1) *General method.* For purposes of section 404 only, and not for purposes of section 412, different 10-year amortization bases may be combined into a single 10-year amortization base if such single base satisfies all of the requirements of paragraph (i) (2), (3), and (4) of this section at the time of the combining of the different bases.

(2) *Unamortized amount.* The unamortized amount of the single base equals the sum, as of the date the combination is made, of the unamortized amount of the bases being combined (treating negative bases as having negative unamortized amounts).

(3) *Remaining amortization period.* The remaining amortization period of the single base is equal to (i) the sum of the separate products of (A) the unamortized amount of each of these bases (using absolute values) and (B) its remaining amortization period, divided by (ii) the sum of the unamortized amounts of each of the bases (using absolute values). For purposes of this paragraph (i)(3), the remaining amortization period of each base being combined is that number of years at the end of which the unamortized amount of the base would be zero if the contribution made with respect to that base equaled the limit adjustment of that base in each year. This number may be determined through the use of standard annuity tables. The remaining amortization period described in this paragraph may be computed in terms of fractional years, or it may be rounded off to a whole year.

(4) *Limit adjustment.* The limit adjustment for the single base is the level amount necessary to amortize the unamortized amount of the combined base over the remaining amortization period described in paragraph (i)(3) of this section, using the valuation rate. This amount may be determined through the use of standard annuity tables.

(5) *Fresh start alternative.* In lieu of combining different 10-year amortization bases, a plan may replace all existing bases with one new 10-year amortization base equal to the unfunded liability of the plan as of the time the new base is being established. This unfunded liability must be determined in accordance with the general rules of paragraphs (d) and (f) of this section. The unamortized amount of the base and the limit adjustment for the base will be determined as though the base were newly established.

(j) *Initial 10-year amortization base for existing plan*—(1) *In general.* In the case of a plan in existence before the effective date of section 404(a), the 10-year amortization base on the effective date of section 404(a) is the sum of all 10 percent bases existing immediately before section 404(a) became effective for the plan, determined under the rules of old section 404(a).

(2) *Limit adjustment.* The limit adjustment for the initial base is the lesser of the unamortized amount of such base or the sum of the amounts determined under paragraph (b)(3) of this section using the original balances of the remaining bases (under old section 404(a) rules) as the amount to be amortized.

(3) *Unamortized amount.* The employer may choose either to establish a single initial base reflecting both all prior 10-percent bases and the experience gain or loss for the immediately preceding actuarial period, or to establish a separate base for the prior 10-percent bases and another for the experience gain or loss for the immediately preceding period. If the initial 10-year amortization base reflects the net experience gain or loss from the immediately preceding actuarial period, the unamortized amount of the initial base shall equal the total unfunded liability on the effective date of section 404(a) determined in accordance with the general rules of paragraphs (d) and (f) of this section. If, however, a separate base will be used to reflect that gain or loss, the unamortized amount of the initial base shall equal such unfunded liability on the effective date of section 404(a), reduced by the net experience loss or increased by the net experience gain for the immediately preceding actuarial period. In this case, a separate 10-year amortization base must be established on the effective date equal to the net experience gain or loss. Thus, if the effective date unfunded liability is $100,000 and an experience loss of $15,000 is recognized on that date, and if the loss is to be treated as a separate base, the unamortized balances of the two bases would be $85,000 and $15,000. If the unfunded liability were the same $100,000, but a gain of $15,000 instead of a loss were recognized on that date, the unamortized balances of the two bases would be $115,000 and a credit base of $15,000. In both cases, if only one 10-year base is to be established on the effective date, its unamortized balance would be $100,000 (the unfunded liability of the plan). See paragraphs (d) and (f) for rules for determining the unfunded liability of the plan.

(k) *Effect of full funding limit on 10-year-amortization bases.* The amount deductible under section 404(a)(1)(A) (i), (ii), or (iii) for a plan year may not exceed the full funding limitation for that year. See section 412 and paragraphs (d), (e), and (f) of this section for rules to be used in the computation of the full funding limitation. If the total deductible contribution (including carryover) for a plan year equals or exceeds the full funding limitation for the year, all 10-year amortization bases maintained by the plan will be considered fully amortized, and the deductible limit for subsequent plan years will not be adjusted to reflect the amortization of these bases.

(l) *Transitional rules*—(1) *Plan years beginning before April 22, 1981.* In determining the deductible limit for plan years beginning before April 22, 1981, a contribution will be deductible under section 404(a)(1)(A) if the computation of the deductible limit is based on an interpretation of section 404(a)(1)(A) that is reasonable when considered with prior published positions of the

Internal Revenue Service. A computation of the deductible limit may satisfy the preceding sentence even if it does not satisfy the rules contained in paragraphs (c) through (i) of this section.

(2) *Transitional approaches.* The deductible limit determined for the first plan year with respect to which a plan applies the rules contained in paragraphs (c) through (i) of this section must be computed using one of the following approaches—

(i) The plan (whether or not in existence before the effective date of section 404(a)) may apply the rules of paragraph (j) for establishing the initial base for an existing plan, treating 10-year bases (if any) as 10 percent bases in adding bases.

(ii) The plan may apply the fresh start alternative for combining bases under paragraph (i)(5).

(iii) The plan may retroactively establish 10-year amortization bases for years with respect to which section 404(a)(1)(A) and the rules of this section would have applied but for the transition rule contained in paragraph (l)(1) of this section. Contributions actually deducted are used in retroactively establishing and maintaining these bases under paragraph (h). However, a deduction already taken shall not be recomputed because of the retroactive establishment of a base.

(m) *Effective date of section 404(a).* In the case of a plan which was in existence on January 1, 1974, section 404(a) generally applies for contributions on account of taxable years of an employer ending with or within plan years beginning after December 31, 1974. In the case of a plan not in existence on January 1, 1974, section 404(a) generally applies for contributions on account of taxable years of an employer ending with or within plan years beginning after September 4, 1974. See §1.410(a)–2(c) for rules concerning the time of plan existence. See also §1.410(a)–2(d), which provides that a plan in existence on January 1, 1974, may elect to have certain provisions, including the amendments to section 404(a) contained in section 1013 of the Employee Retirement Income Security Act of 1974, apply to a plan year beginning after September 2, 1974, and before the otherwise applicable effective date contained in that section.

[T.D. 7760, 46 FR 6914, Jan. 22, 1981; 46 FR 15685, Mar. 9, 1981]

§1.404(b)–1 Method of contribution, etc., having the effect of a plan; effect of section 404(b).

Section 404(a) is not confined to formal stock bonus, pension, profit- sharing, and annuity plans, or deferred compensation plans, but it includes any method of contributions or compensation having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation. Thus, where a corporation pays pensions to a retired employee or employees or to their beneficiaries in such amounts as may be determined from time to time by the board of directors or responsible officers of the company, or where a corporation is under an obligation, whether funded or unfunded, to pay a pension or other deferred compensation to an employee or his beneficiaries, there is a method having the effect of a plan deferring the receipt of compensation for which deductions are governed by section 404(a). If an employer on the accrual basis defers paying any compensation to an employee until a later year or years under an arrangement having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, he shall not be allowed a deduction until the year in which the compensation is paid. This provision is not intended to cover the case where an employer on the accrual basis defers payment of compensation after the year of accrual merely because of inability to pay such compensation in the year of accrual, as, for example, where the funds of the company are not sufficient to enable payment of the compensation without jeopardizing the solvency of the company, or where the liability accrues in the earlier year, but the amount payable cannot be exactly determined until the later year.

[T.D. 6500, 25 FR 11690, Nov. 26, 1960]

§1.404(b)–1T Method or arrangement of contributions, etc., deferring the receipt of compensation or providing for deferred benefits. (Temporary)

Q–1: As amended by the Tax Reform Act of 1984, what does section 404(b) of the Internal Revenue Code provide?

A–1: As amended, section 404(b) clarifies that any plan, or method or arrangement, deferring the receipt of compensation or providing for deferred benefits (other than compensation) is to be treated as a plan deferring the receipt of compensation for purposes of section 404 (a) and (d). Accordingly, section 404 (a) and (d) (in the case of employees and nonemployees; respectively) shall govern the deduction of contributions paid or compensation paid or incurred with respect to such a plan, or method or arrangement. Section 404 (a) and (d) requires that such a contribution or compensation be paid or incurred for purposes of section 162 or 212 and satisfy the requirements for deductibility under either of those sections. Thus, for example, under section 404 (a)(5) and (b), if otherwise deductible under section 162 or 212, a contribution paid or incurred with respect to a nonqualified plan, or method or arragement, providing for deferred benefits is deductible in the taxable year of the employer in which or with which ends the taxable year of the employee in which the amount attributable to the contribution is includible in the gross income of the employee (without regard to any applicable exclusion under Chapter 1, Subtitle A, of the Internal Revenue Code). Section 404 (a) and (d) applies to all compensation and benefit plans, or methods or arrangements, however denominated, which defer the receipt of any amount of compensation or benefit, including fees or other payments. Thus, a limited partnership (using the accrual method of accounting) may not accrue deductions for a fee owed to an unrelated person (using the cash method of accounting) who performs services for the partnership until the partnership taxable year in which or with which ends the taxable year of the service provider in which the fee is included in income. However, notwithstanding the above, section 404 does not apply to contributions paid or accrued with respect to a ‘‘welfare benefit fund’’ (as defined in section 419(e)) after July 18, 1984, in taxable years of employers (and payors) ending after that date. Also, section 463 shall govern the deduction of vacation pay by a taxpayer that has elected the application of such section. For rules relating to the deduction of contributions paid or accrued with respect to a welfare benefit fund, see section 419, §1.419–1T and §1.419A–2T. For rules relating to the deduction of vacation pay for which an election is made under section 463, see §301.9100–16T of this chapter and §1.463–1T.

Q–2: When does a plan, or method or arrangement, defer the receipt of compensation or benefits for purposes of section 404 (a), (b), and (d)?

A–2: (a) For purposes of section 404 (a), (b), and (d), a plan, or method or arrangement, defers the receipt of compensation or benefits to the extent it is one under which an employee receives compensation or benefits more than a brief period of time after the end of the employer’s taxable year in which the services creating the right to such compensation or benefits are performed. The determination of whether a plan, or method or arrangement, defers the receipts of compensation or benefits is made separately with respect to each employee and each amount of compensation or benefit. Compensation or benefits received by an employee’s spouse or dependent or any other person, but taxable to the employee, are treated as received by the employee for purposes of section 404. An employee is determined to receive compensation or benefits within or beyond a brief period of time after the end of the employer’s taxable year under the rules provided in this Q&A. For the treatment of expenses with respect to transactions between related taxpayers, see section 267.

(b)(1) A plan, or method or arrangement, shall be presumed to be one deferring the receipt of compensation for more than a brief period of time after the end of an employer’s taxable year to the extent that compensation is received after the 15th day of the 3rd calendar month after the end of the employer’s taxable year in which the related services are rendered (‘‘the 2½ month period''). Thus, for example, salary under an employment contract or a bonus under a year-end bonus declaration is presumed to be paid under a plan, or method or arrangement, deferring the receipt of compensation, to the extent that the salary or bonus is received beyond the applicable 2½ month period. Further, salary or a year-end bonus received beyond the applicable 2½ month period by one employee shall be presumed to constitute payment under a plan, or method or arrangement, deferring the receipt of compensation for such employee even though salary or bonus payments to all other employees are not similarly treated because they are received within the 2½ month period. Benefits are ''deferred benefits'' if, assuming the benefits were cash compensation, such benefits would be considered deferred compensation. Thus, a plan, or method or arrangement, shall be presumed to be one providing for deferred benefits to the extent benefits for services are received by an employee after the 2½ month period following the end of the employer's taxable year in which the related services are rendered.

(2) The taxpayer may rebut the presumption established under the previous subparagraph with respect to an amount of compensation or benefits only by setting forth facts and circumstances the preponderance of which demonstrates that it was impracticable, either administratively or economically, to avoid the deferral of the receipt by an employee of the amount of compensation or benefits beyond the applicable 2½ month period and that, as of the end of the employer's taxable year such impracticability was unforeseeable. For example, the presumption may be rebutted with respect to an amount of compensation to the extent that receipt of such amount is deferred beyond the applicable 2½ month period (i) either because the funds of the employer were not sufficient to make the payment within the 2½ month period without jeopardizing the solvency of the employer or because it was not reasonably possible to determine within the 2½ month period whether payment of such amount was to be made, and (ii) the circumstance causing the deferral described in (i) was unforeseeable as of the close of the employer's taxable year. Thus, the presumption with respect to the receipt of an amount of compensation or benefit is not rebutted to the extent it was foreseeable, as of the end of the employer's taxable year, that the amount would be received after the applicable 2½ month period. For example, if, as of the end of the employer's taxable year, it is foreseeable that calculation of a year-end bonus to be paid to an employee under a given formula will not be completed and thus the bonus will not be received (and is in fact not received) by the end of the applicable 2½ month period, the presumption that the bonus is deferred compensation is not rebutted.

(c) A plan, or method or arrangement, shall not be considered as deferring the receipt of compensation or benefits for more than a brief period of time after the end of the employer's taxable year to the extent that compensation or benefits are received by the employee on or before the end of the applicable 2½ month period. Thus, for example, salary under an employment contract or a bonus under a year-end bonus declaration is not considered paid under a plan, or method or arrangement, deferring the receipt of compensation to the extent that such salary or bonus is received by the employee on or before the end of the applicable 2½ month period.

(d) Solely for purposes of applying the rules of paragraphs (b) and (c) of this Q&A, in the case of an employer's taxable year ending on or after July 18, 1984, and on or before March 21, 1986, compensation or benefits that relate to services rendered in such taxable year shall be deemed to have been received within the applicable 2½ month period if such receipt actually occurs after such 2½ month period but on or before March 21, 1986.

Q–3: When does section 404(b), as amended by the Tax Reform Act of 1984, become effective?

A–3: With the exceptions discussed below, section 404(b), as amended, and the rules under Q&A–2 are effective with respect to amounts paid or incurred after July 18, 1984, in taxable years of employers (and payors) ending after that date. In the case of an extended vacation pay plan maintained pursuant to a collective bargaining agreement (a) between employee representatives and one or more employers, and (b) in effect on June 22, 1984, section 404(b) is not effective before the date on which such collective bargaining agreement terminates (determined without regard to any extension thereof agreed to after June 22, 1984). For purposes of the preceding sentence, any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added under section 512 of the Tax Reform Act of 1984 shall not be treated as a termination of such collective bargaining agreement. For purposes of this section, an ‘‘extended vacation pay plan’’ is one under which covered employees gradually over a specified period of years earn the right to additional vacation benefits, no part of which, under the terms of the plan, can be taken until the end of the specified period.

[T.D. 8073, 51 FR 4321, Feb. 4, 1986; 51 FR 7262, Mar. 3, 1986; 51 FR 11303, Apr. 2, 1986, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

§1.404(c)–1 Certain negotiated plans; effect of section 404(c).

(a) Section 404(a) does not apply to deductions for contributions paid by an employer under a negotiated plan which meets the following conditions:

(1) The contributions under the plan are held in trust for the purpose of paying, either from principal or income or both, for the benefit of employees and their families, at least medical or hospital care, and pensions on retirement or death of employees; and

(2) Such plan was established before January 1, 1954, as a result of an agreement between employee representatives and the Government of the United States during a period of Government operation, under seizure powers, of a major part of the productive facilities of the industry in which such employer is engaged.

If these conditions are met, such contributions shall be deductible under section 162, to the extent that they constitute ordinary and necessary business expenses.

(b) The term ‘‘as a result of an agreement’’ is intended primarily to cover a trust established under the terms of an agreement referred to in paragraph (a)(2) of this section. It will also include a trust established under a plan of an employer, or group of employers, who are in competition with the employers whose facilities were seized by reason of producing the same commodity, and who would therefore be expected to establish such a trust as a reasonable measure to maintain a sound position in the labor market producing the commodity. Thus, for example, if a trust was established under such an agreement in the bituminous coal industry, a similar trust established about the same time in the anthracite coal industry would be covered by this provision.

(c) If any such trust becomes qualified for exemption under section 501(a), the deductibility of contributions by an employer to such trust on or after the date of such qualification would no longer be governed by section 404(c), even though the trust may later lose its exemption under section 501(a).

[T.D. 6500, 25 FR 11690, Nov. 26, 1960]

§1.404(d)–1T Questions and answers relating to deductibility of deferred compensation and deferred benefits for independent contractors. (Temporary)

Q–1: How does the amendment of section 404(b) by the Tax Reform Act of 1984 affect the deduction of contributions or compensation under section 404(d)?

A–1: As amended by the Tax Reform Act of 1984, section 404(b) clarifies that section 404(d) shall govern the deduction of contributions paid and compensation paid or incurred by a payor under a plan, or method or arrangement, deferring the receipt of compensation or providing for deferred benefits for service providers with respect to which there is no employer-employee relationship. In such a case, section 404 (a) and (b) and the regulations thereunder apply as if the person providing the services were the employee and the person to whom the services are provided were the employer. Section 404(a) requires that such a contribution or compensation be paid or incurred for purposes of section 162 or 212 and satisfy the requirements for deductibility under either of those sections. However, notwithstanding the above, section 404 does not apply to contributions paid or accrued with respect to a ''welfare benefit fund'' (as defined in section 419(e)) after June 18, 1984, in taxable years of employers (and payors) ending after that date. Also, section 463 shall govern the deduction of vacation pay by a taxpayer that has elected under such section. For rules relating to the deduction of contributions paid or accrued with respect to a welfare benefit fund, see section 419, § 1.419–1T and § 1.419A–2T. For rules relating to the deduction of vacation pay for which an election is made under section 463, see § 301.9100–16T of this chapter and § 1.463–1T.

[T.D. 8073, 51 FR 4322, Feb. 4, 1986, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

§ 1.404(e)–1 Contributions on behalf of a self-employed individual to or under a pension, annuity, or profit-sharing plan meeting the requirements of section 401; application of section 404(a) (8), (9), and (10) and section 404 (e) and (f).

(a) *In general.* (1) The Self-Employed Individuals Tax Retirement Act of 1962 (76 Stat. 809) permits certain self-employed individuals to be treated as employees for purposes of pension, annuity, and profit-sharing plans included in paragraph (1), (2), or (3) of section 404(a). Therefore, for taxable years of an employer beginning after December 31, 1962, employer contributions to qualified plans on behalf of self-employed individuals are deductible under section 404 subject to the limitations of paragraphs (b) and (c) of this section.

(2) In the case of contributions to qualified plans on behalf of self-employed individuals, the amount deductible differs from the amount allowed as a deduction. In general, the amount deductible is 10 percent of the earned income derived by the self-employed individual from the trade or business with respect to which the plan is established, or $2,500, whichever is the lesser. This is the amount referred to in section 401 when reference is made to the amounts which may be deducted under section 404 or the amount of contributions deductible under section 404. Thus, this is the amount taken into consideration in determining whether contributions under the plan are discriminatory. The amount allowed as a deduction with respect to contributions on behalf of a self-employed individual is one-half of the amount deductible. The amount allowed as a deduction is relevant only for purposes of determining the amount an employer may deduct from gross income.

(b) *Determination of the amount deductible.* (1) If a plan covers employees, some of whom are self-employed individuals, the determination of the amount deductible is made on the basis of independent consideration of the common-law employees and of the self-employed individuals. See subparagraphs (2) and (3) of this paragraph. For purposes of determining the amount deductible with respect to contributions on behalf of a self-employed individual, such contributions shall be considered to satisfy the conditions of section 162 (relating to trade or business expenses) or 212 (relating to expenses for the production of income), but only to the extent that such contributions do not exceed the earned income of such individual derived from the trade or business with respect to which the plan is established. However, the portion of such contribution, if any, attributable to the purchase of life, accident, health, or other insurance protection shall be considered payment of a personal expense which does not satisfy the requirements of section 162 or 212. See paragraph (f) of this section. For the additional rules applicable where contributions are made by more than one employer on behalf of a self-employed individual, see paragraph (d) of this section.

(2) If contributions are made to a plan included in section 404(a) (1), (2), or (3) on behalf of employees, some of whom are self-employed individuals, the amount deductible with respect to contributions on behalf of the common-law employees covered under the plan shall be determined as if such employees were the only employees for whom contributions and benefits are provided under the plan. Accordingly, for purposes of such determination, the percentage of compensation limitations of

section 404(a) (1), (3), and (7) are applicable only with respect to the compensation otherwise paid or accrued during the taxable year by the employer to the common-law employees. Similarly, the costs referred to in section 404(a)(1) (B) and (C) shall be the costs of funding the benefits of the common-law employees. Also, the provisions of section 404(a)(1)(D), (3), and (7), relating to certain carryover deductions, shall be applicable only to amounts contributed, or to the amounts deductible, on behalf of such employees.

(3) If contributions are made to a plan included in section 404(a) (1), (2), or (3) on behalf of individuals some or all of whom are self-employed individuals, the amount deductible in any taxable year with respect to contributions on behalf of such individuals shall be determined as follows:

(i) The provisions of section 404(a) (1), (2), (3), and (7) shall be applied as if such individuals were the only participants for whom contributions and benefits are provided under the plan. Thus, the costs referred to in such provisions shall be the costs of funding the benefits of the self-employed individuals. If such costs are less than an amount equal to the amount determined under subdivision (iii) of this subparagraph, the maximum amount deductible with respect to such individuals shall be the costs of their benefits.

(ii) The provisions of section 404(a)(1)(D), the second and third sentences of section 404(a)(3)(A), and the second sentence of section 404(a)(7), relating to certain carryover deductions, are not applicable to contributions on behalf of self-employed individuals. Contributions on behalf of self-employed individuals are deductible, if at all, only in the taxable year in which the contribution is paid or deemed paid under section 404(a)(6).

(iii) The amount deductible for the taxable year of the employer with respect to contributions on behalf of a self-employed individual shall not exceed the lesser of $2,500 or 10 percent of the earned income derived by such individual for such taxable year from the trade or business with respect to which the plan is established.

(iv) If a self-employed individual receives in any taxable year earned income with respect to which deductions are allowable to two or more employers, the aggregate amounts deductible shall not exceed the lesser of $2,500 or 10 percent of such earned income. See paragraph (d) of this section.

(c) *Special limitation on the amount allowed as a deduction for self-employed individuals.* The amount allowed as a deduction under section 404(a) (1), (2), (3), and (7) in any taxable year with respect to contributions made on behalf of a self-employed individual shall be an amount equal to one-half of the amount deductible with respect to such contributions under paragraph (b)(3) of this section. However, for purposes of section 401, the amount which may be deducted, or the amount deductible, under section 404 with respect to contributions made on behalf of self-employed individuals shall be determined without regard to the special limitation of this paragraph.

(d) *Rules applicable where contributions are made by more than one employer on behalf of a self-employed individual.* (1) Under paragraph (b)(3)(iv) of this section, if a self-employed individual receives in any taxable year earned income with respect to which deductions are allowable to two or more employers, the aggregate amounts deductible shall not exceed the lesser of $2,500 or 10 percent of such earned income. This limitation does not apply to contributions made under a plan on behalf of an employee who is not self-employed in the trade or business with respect to which the plan is established, even though such employee may be covered as a self-employed individual under a plan or plans established by other trades or businesses.

(2) In any case in which the application of subparagraph (1) of this paragraph reduces the amount otherwise deductible, the amount deductible by each employer shall be that amount which bears the same ratio to the aggregate amount deductible with respect to all trades or businesses (as determined in subparagraph (1) of this paragraph) as the earned income derived from that employer bears to the aggregate of the earned income derived from all of the trades or businesses

with respect to which plans are established. The amount allowed as a deduction to each employer is one-half of the amount determined (in accordance with the preceding sentence) to be deductible by such employer.

(e) *Partner's distributive share of contributions and deductions.* For purposes of sections 702(a)(8) and 704, a partner's distributive share of contributions on behalf of self-employed individuals under a qualified pension, annuity, or profit-sharing plan is the contribution made on his behalf, and his distributive share of deductions allowed the partnership under section 404 for contributions on behalf of self-employed individuals is that portion of the deduction which is attributable to contributions made on his behalf under the plan. The contribution on behalf of a partner and the deduction with respect thereto must be accounted for separately by such partner, for his taxable year with or within which the partnership's taxable year ends, as an item described in section 702(a)(8).

(f) *Contributions allocable to insurance protection.* For purposes of determining the amount deductible with respect to contributions on behalf of a self-employed individual, amounts allocable to the purchase of life, accident, health, or other insurance protection shall not be taken into account. Such amounts are neither deductible nor considered as contributions for purposes of determining the maximum amount of contributions that may be made on behalf of an owner-employee. The amount of a contribution allocable to insurance shall be an amount equal to a reasonable net premium cost, as determined by the Commissioner, for such amount of insurance for the appropriate period. See paragraph (b)(5) of § 1.72–16.

(g) *Rules applicable to loans.* For purposes of section 404, any amount paid, directly or indirectly, by an owner-employee in repayment of any loan which under section 72(m)(4)(B) was treated as an amount received from a qualified trust or plan shall be treated as a contribution to such trust or under such plan on behalf of such owner-employee.

(h) *Definitions.* For purposes of section 404 and the regulations thereunder—

(1) The term ''employee'' includes an employee as defined in section 401(c)(1) and paragraph (b) of § 1.401–10, and the term ''employer'' means the person treated as the employer of such individual under section 401(c)(4);

(2) The term ''owner-employee'' means an owner-employee as defined in section 401(c)(3) and paragraph (d) of § 1.401–10;

(3) The term ''earned income'' means earned income as defined in section 401(c)(2) and paragraph (c) of § 1.401–10; and

(4) The term ''compensation'' when used with respect to an individual who is an employee described in subparagraph (1) of this paragraph shall be considered to be a reference to the earned income of such individual derived from the trade or business with respect to which the plan is established.

(i) *Years to which this section applies.* This section applies to taxable years of employers beginning before January 1, 1974. For taxable years beginning after December 31, 1973, see § 1.404(e)–1A.

[T.D. 6673, 28 FR 10145, Sept. 17, 1963; as amended by T.D. 7636, 44 FR 47056, Aug. 10, 1979]

§ 1.404(e)–1A Contributions on behalf of a self-employed individual to or under a qualified pension, annuity, or profit-sharing plan.

(a) *In general.* This section provides rules relating to employer contributions to qualified plans on behalf of self-employed individuals described in subsections (a) (8) and (9), (e), and (f) of section 404. Unless otherwise specifically provided, this section applies to taxable years of an employer beginning after December 31, 1973. See section 1.404(e)–1 for rules relating to plans for self-employed individuals for taxable years beginning before January 1, 1974. Paragraph (b) of this section provides general rules of deductibility, paragraph (c) provides rules relating to defined contribution plans, paragraph (d) provides rules relating to defined benefit plans, paragraph (e) provides rules relating to combinations of plans, paragraph (f) provides rules for partnerships, paragraph (g) provides rules for insurance, paragraph (h) provides rules for loans, and paragraph (i) provides definitions.

(b) *Determination of the amount deductible.* (1) If a defined contribution plan covers employees, some of whom are self-employed individuals, the determination of the amount deductible is made on the basis of independent consideration of the common-law employees and of the self-employed individuals. See subparagraphs (2) and (3) of this paragraph. For purposes of determining the amount deductible with respect to contributions on behalf of a self-employed individual, such contributions shall be considered to satisfy the conditions of section 162 (relating to trade or business expenses) or 212 (relating to expenses for the production of income), but only to the extent that such contributions do not exceed the earned income of such individual derived from the trade or business with respect to which the plan is established. However, the portion of such contribution, if any, attributable to the purchase of life, accident, health, or other insurance protection shall be considered payment of a personal expense which does not satisfy the requirements of section 162 or 212. See paragraph (g) of this section.

(2)(i) If contributions are made on behalf of employees, some of whom are self-employed individuals, to a defined contribution plan described in section 414(i) and included in section 404(a) (1), (2), or (3), the amount deductible with respect to contributions on behalf of the common-law employees covered under the plan shall be determined as if such employees were the only employees for whom contributions and benefits are provided under the plan. Accordingly, for purposes of such determination, the percentage of compensation limitations of section 404(a) (3) and (7) are applicable only with respect to the compensation otherwise paid or accrued during the taxable year by the employer with respect to the common-law employees. Similarly, the costs referred to in section 404(a)(1) (A) and (B) shall be the costs of funding the benefits of the common-law employees. Also, the provisions of section 404(a)(1)(D), (3), and (7), relating to certain carryover deductions, shall be applicable only to amounts contributed or to the amounts deductible on behalf of such employees.

(ii) The amount deductible, by reason of contributions on behalf of employees to a defined benefit plan, shall be determined without regard to the self-employed or common law status of each employee.

(3)(i) If contributions are made on behalf of individuals, some or all of whom are self-employed individuals, to a defined contribution plan described in section 414(i) and included in section 404(a) (1), (2), or (3), the amount deductible in any taxable year with respect to contributions on behalf of such individuals shall be determined as follows:

(A) The provisions of section 404(a) (1), (2), (3), and (7) shall be applied as if such individuals were the only participants for whom contributions and benefits are provided under the plan. Thus, the costs referred to in such provisions shall be the costs of funding the benefits of the self-employed individuals. If such costs are less than an amount equal to the amount determined under paragraph (c) of this section, the maximum amount deductible with respect to such individuals shall be the cost of their benefits.

(B) The provisions of section 404(a) (1), (D), the third sentence of section 404(a) (3), (A), and the second sentence of section 404(a)(7), relating to certain carryover deductions are applicable to contributions on behalf of self-employed individuals made in taxable years of an employer beginning after December 31, 1975.

(C) For any employer taxable year in applying the 15 percent limit on deductible contributions set forth section in 404(a)(3) and the 25 percent limit in section 404(a)(7) for any taxable year of the employer, the amount deductible under section 404(e)(4) and paragraph (c)(4) of this section (relating to the minimum deduction of $750 or 100 percent of earned income) shall be substituted for such limits with respect to the self-employed individuals on whose behalf contributions are deductible under section 404(e)(4) for the taxable year of the employer. In addition, although the limitations of section 415 are applicable to the plan for plan years beginning after December 31, 1975, the defined contribution compensation limitation described in section 415(c)(1)(B) shall not be less than the amount deductible under section 404(e)(4) and paragraph (c)(4) of this section with respect to any self-employed individual for the taxable year of the employer wnding with or within the limitation year. The special rule in the second sentence of paragraph (3)(A) of section 404(a) is not applicable in determining the amounts deductible on behalf of self-employed individuals.

(ii) The limitations of this subparagraph are not applicable to a defined benefit plan for self-employed individuals.

(c) *Defined contribution plans.* (1) Under section 404(e)(1) in the case of a defined contribution plan, as defined in section 414(i), the amount deductible for the taxable year of the employer with respect to contributions on behalf of a self-employed individual shall not exceed the lesser of $7,500 or 15 percent of the earned income derived by such individual for such taxable year from the trade or business with respect to which the plan is established.

(2) Under section 404(e)(2)(A) if a self-employed individual receives in any taxable year earned income with respect to which deductions are allowable to two or more employers under two or more defined contribution plans the aggregate amounts deductible shall not exceed the lesser of $7,500 or 15 percent of such earned income. This limitation does not apply to contributions made under a plan on behalf of an employee who is not self-employed in the trade or business with respect to which the plan is established.

(3) Under section 404(e)(2)(B) in any case in which the applicable limitation of subparagraph (2) of this paragraph reduces the amount otherwise deductible with respect to contributions on behalf of any employee within the meaning of section 401(c)(1), the amount deductible by each employer for such employee shall be that amount which bears the same ratio to the aggregate amount deductible for such employee with respect to all trades or businesses (as determined in subparagraph (1) of this paragraph) as his earned income derived from the employer bears to the aggregate of his earned income derived from all of the trades or businesses with respect to which plans are established.

Under section 404(e)(4), notwithstanding the provisions of subparagraphs (1) and (2) of this paragraph, the limitations on the amount deductible for the taxable year of the employer with respect to contributions on behalf of a self-employed individual shall not be less than the lesser of $750 or 100 percent of the earned income derived by such individual for such taxable year from the trade or business with respect to which the plan is established. If such individual receives in any taxable year earned income with respect to which deductions are allowable to two or more employers, 100 percent of such earned income shall be taken into account for purposes of the limitations determined under this subparagraph. This subparagraph does not apply to any taxable year beginning after December 31, 1975, to any employee whose adjusted gross income for that taxable year is greater than $15,000. In applying the preceding sentence, the adjusted gross income of an employee for a taxable year is determined separately for each individual, without regard to any community property laws, and without regard to the deduction allowable under section 404(a).

(d) *Defined benefit plans.* In the case of a defined benefit plan, as defined in section 401(j), the special limitations provided by section 404(e) and paragraph (c) of this section do not apply. See section 401(j) for requirements applicable to defined benefit plans.

(e) *Combination of plans.* For special rules applied if a self-employed individual in any taxable year is a paraticipant in both a defined benefit plan and a defined contribution plan, see section 401(j) and the regulations thereunder.

(f) *Partner's distributive share of contributions and deductions.* (1) For purposes of sections 702(a)(8) and 704 in the case of a defined contribution plan, a partner's distributive share of contributions on behalf of self-employed individuals under such a plan is the contribution made on his behalf, and his distributive share of deductions allowed the partnership under section 404 for contributions on behalf of a self-employed individual is that portion of the deduction which is attributable to contributions made on his behalf under the plan. The contribution on behalf of a partner and the deduction with respect thereto must be accounted for separately by such partner, for his taxable year with or within which the partnership's taxable year ends, as an item described in section 702(a)(8).

(2) In the case of a defined benefit plan, a partner's distributive share of contributions on behalf of self-employed individuals and his distributive share of deductions allowed the partnership under section 404 for such contributions is determined in the same manner as his distributive share of partnership taxable income. See section 704, relating to the determination of the distributive share and the regulations thereunder.

(g) *Contributions allocable to insurance protection.* Under Section 404(e)(3), for purposes of determining the amount deductible with respect to contributions on behalf of a self-employed individual, amounts allocable to the purchase of life, accident, health, or other insurance protection shall not be taken into account. Such amounts are neither deductible nor considered as contributions for purposes of determining the maximum amount of contributions that may be made on behalf of an owner-employee. The amount of a contribution allocable to insurance shall be an amount equal to a reasonable net premium cost, as determined by the Commissioner, for such amount of insurance for the appropriate period. See paragraph (b)(5) of §1.72–16.

(h) *Rules applicable to loans.* Under section 404(f), for purposes of section 404, any amount paid, directly or indirectly, by an owner-employee in repayment of any loan which under section 72(m)(4)(B) was treated as an amount recieved from a qualified trust or plan shall be treated as a contribution to such trust or under such plan on behalf of such owner-employee.

(i) *Definitions.* Under section 404(a)(8), for purposes of section 404 and the regulations thereunder—

(1) The term ''employee'' includes an employee as defined in section 401(c)(1) and the term ''employer'' means the person treated as the employer of such individual under section 401(c)(4);

(2) The term ''owner-employee'' means an owner-employee as defined in section 401(c)(3);

(3) The term ''earned income'' means earned income as defined in section 401(c)(2); and

(4) The term ''compensation'' when used with respect to an individual who is an employee described in subparagraph (1) of this paragraph shall be considered to be a reference to the earned income of such individual derived from the trade or business with respect to which the plan is established.

[T.D. 7636, 44 FR 47056, Aug. 10, 1979]

§1.404(g)–1 Deduction of employer liability payments.

(a) *General rule.* Employer liability payments shall be treated as contributions to a stock bonus, pension, profit-sharing, or annuity plan to which section 404 applies. Such payments that satisfy the limitations of this section shall be deductible under section 404 when paid without regard to any other limitations in section 404.

(b) *Employer liability payments.* For purposes of this section, employer liability payments mean:

(1) Any payment to the Pension Benefit Guaranty Corporation (PBGC) for termination or withdrawal liability imposed under section 4062 (without regard to section 4062(b)(2)), 4063, or 4064 of the Employee Retirement Insurance Security Act of 1974 (ERISA). Any bond or escrow payment furnished under section 4063 of ERISA shall not be considered as a payment of liability until applied against the liability of the employer.

(2) Any payment to a non-multiemployer plan pursuant to a commitment to the PBGC made in accordance with PBGC Determination of Plan Sufficiency and Termination of Sufficient Plans. See PBGC regulations, 29 CFR 2617.13(b) for rules concerning these commitments. Such payments shall not exceed an amount necessary to provide for, and used to fund, the benefits guaranteed under section 4022 of ERISA.

(3) Any payment to a multiemployer plan for withdrawal liability imposed

under part 1 of subtitle E of title IV of ERISA. Any bond or escrow payment furnished under such part shall not be considered as a payment of liability until applied against the liability of the employer.

(c) *Limitations, etc.*—(1) *Permissible expenses.* A payment shall be deductible under section 404(g) and this section only if the payment satisfies the conditions of section 162 or section 212. Payments made by an entity which is liable for such payments because it is a member of a commonly controlled group of corporations, or trades or businesses, within the meaning of section 414 (b) or (c), shall not fail to satisfy such conditions merely because the entity did not directly employ participants in the plan with respect to which the liability payments were made.

(2) *Qualified plan.* A payment shall be deductible under section 404(g) and this section only if the payment is made in a taxable year of the employer ending within or with a taxable year of the trust for which the trust is exempt under section 501(a). For purposes of this paragraph, the payment timing rules of section 404(a)(6) shall apply.

(3) *Full funding limitation.* (i) If the employer liability payment is to a plan, the total amount deductible for such payment and for other plan contributions may not exceed an amount equal to the full funding limitation as defined in section 412(c)(7) for the taxable year with respect to which the contributions are deemed made under section 404.

(ii) If the total contributions to the plan for the taxable year including the employer liability payment exceed the amount equal to this full funding limitation, the employer liability payment shall be deductible first.

(iii) Any amount paid in a taxable year in excess of the amount deductible in such year under the full funding limitation shall be treated as a liability payment and be deductible in the succeeding taxable years in order of time to the extent of the difference between the employer liability payments made in each succeeding year and the maximum amount deductible for such year under the full funding limitation.

(4) *Maximum deduction allowable under section 404.* The amount deductible under section 404 is limited to the higher of the maximum amount deductible by the employer under section 404(a) or the amount otherwise deductible under section 404(g). If the contributions are to a plan to which more than one employer contributes, this limit shall apply to each employer separately rather than all employers in the aggregate. Thus, each employer may deduct the greater of its allocable share of the deduction determined under sections 404(a) and 413(b)(7) or 413(c)(6) or its allocable share of the amount deductible under section 404(g). However, pursuant to the rule in subdivision (ii) of subparagraph (3), in determining each employer's allocable share under section 404(a), the total amount deductible under section 404(a) by all employers shall not exceed the difference between the full funding limitation and the total amount deductible by all employers under section 404(g).

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

Example. In the 1983 taxable year, Employer *A* makes a withdrawal liability payment of $700,000 to multiemployer Plan *X* to which Employer *A* and Employer *B* are required to contribute. Employer *A*'s allocable share of the deduction allowable under sections 404(a) and 413(b)(7) in the 1983 taxable year is $600,000. Employer *B*'s allocable share of the deduction allowable under section 404(a) and 413(b)(7) in the 1983 taxable year is $400,000.

The full funding limitation for the 1983 taxable year is $1,000,000. Based on paragraph (c)(4) of this section, Employer *A* may deduct $700,000, the amount of the withdrawal liability payment. However, the deduction of Employer *B* is limited to $300,000, the difference between the full funding limitation and the amount deductible under section 404(g).

(d) *Effective date etc.*—(1) *General rule.* This section is effective for employer payments made after September 25, 1980.

(2) *Transitional rule.* For employer payments made before September 26, 1980, for purposes of section 404, any amount paid by an employer under section 4062, 4063, or 4064 of the Employee Retirement Income Security Act of 1974 shall be treated as a contribution to which section 404 applies by such

employer to or under a stock bonus, pension, profit-sharing, or annuity plan.

[T.D. 8085, 51 FR 16297, May 2, 1986]

§1.404(k)–1T Questions and answers relating to the deductibility of certain dividend distributions. (Temporary)

Q–1: What does section 404(k) provide?

A–1: Section 404(k) allows a corporation a deduction for dividends actually paid in accordance with section 404(k)(2) with respect to stock of such corporation held by an employee stock ownership plan (as defined in section 4975(e)(7)) maintained by the corporation (or by any other corporation that is a member of a ‘‘controlled group of corporations’’ within the meaning of section 409(l)(4) that includes the corporation), but only if such dividends may be immediately distributed under the terms of the plan and all of the applicable qualification and distribution rules. The deduction is allowed under section 404(k) for the taxable year of the corporation during which the dividends are received by the participants.

Q–2: Is the deductibility of dividends paid to plan participants under section 404(k) affected by a plan provision which permits participants to elect to receive or not receive payment of dividends?

A–2: No. Dividends actually paid in cash to plan participants in accordance with section 404(k) are deductible under section 404(k) despite such an election provision.

Q–3: Are dividends paid in cash directly to plan participants by the corporation and dividends paid to the plan and then distributed in cash to plan participants under section 404(k) treated as distributions under the plan holding stock to which the dividends relate for purposes of sections 72, 401 and 402?

A–3: Generally, yes. However, a deductible dividend under section 404(k) is treated for purposes of section 72 as paid under a contract separate from any other contract that is part of the plan. Thus, a deductible dividend is treated as a plan distribution and as paid under a separate contract providing only for payment of deductible dividends. Therefore, a deductible dividend under section 404(k) is a taxable plan distribution even though an employee has unrecovered employee contributions or basis in the plan.

[T.D. 8073, 51 FR 4322, Feb. 4, 1986]

§1.405–1 Qualified bond purchase plans.

(a) *Introduction.* Section 405 relates to the requirements for qualification of, and the tax treatment of funds contributed to, retirement plans of an employer for the benefit of his employees which are funded through the purchase of United States retirement plan bonds. Such bonds may be purchased under a qualified bond purchase plan described in section 405(a) and paragraph (b) of this section. The qualified bond purchase plan is an alternative method of providing some of the deferred compensation benefits provided by plans described in section 401. In addition, retirement bonds may be purchased under a qualified pension or profit-sharing plan described in section 401. A qualified bond purchase plan or a qualified pension or profit-sharing plan under which retirement bonds are purchased may cover only common-law employees, self-employed individuals, or both. A qualified bond purchase plan may be established after December 31, 1962, and retirement bonds may be purchased by a qualified pension or profit-sharing plan after December 31, 1962. For the terms and conditions of the retirement bonds, see section 405(b) and Treasury Department Circular, Public Debt Series—No. 1–63.

(b) *Qualified bond purchase plans.* (1) A qualified bond purchase plan is a definite written program and arrangement which is communicated to the employees and established and maintained by an employer solely to purchase for and distribute to his employees or their beneficiaries retirement bonds. These bonds must be purchased in the name of the employee on whose behalf the contributions are made. The plan must be a permanent plan which meets the requirements of section 401(a) (3), (4), (5), (6), (7), (8), (16), and (19), and, if applicable, the requirements of section 401(a) (9) and (10) and of section 401(d) (other than paragraphs (1), (5)(B), (8), (16), and (19)). The rules set forth in the regulations relating to those provisions shall be applicable to qualified bond purchase plans.

(2) A qualified bond purchase plan must provide that an employee's right to the proceeds of a bond purchased in his name are nonforfeitable and will in no event inure to the benefit of the employer or be reallocated in any manner.

(c) *Benefits under a qualified bond purchase plan.* (1) Except as provided in subparagraph (2) of this paragraph, a qualified bond purchase plan must conform to the definition of a pension plan in paragraph (b)(1)(i) of § 1.401–1, or the definition of a profit-sharing plan in paragraph (b)(1)(ii) of § 1.401–1. For example, if the qualified bond purchase plan is a profit-sharing plan, the plan must include the definite allocation formula described in paragraph (b)(1)(ii) of § 1.401–1. In addition, if such a profit-sharing plan covers any owner-employee, the plan must also include the definite contribution formula described in section 401(d)(2)(B).

(2)(i) Under a qualified bond purchase plan, the bonds may be distributed to the employees at any time, and the plan need not prohibit the distribution or redemption of the bonds until the retirement of the employee. Accordingly, even though a qualified bond purchase plan is designed as a pension plan, it need not provide systematically for the payment of definitely determinable benefits. However, provisions for distribution must apply in a nondiscriminatory manner.

(ii) A qualified bond purchase plan which is designed as a pension plan may not contain a formula for contributions or benefits which might require the reallocation of amounts to an employee's credit or which might provide for the reversion of any amounts to the employer.

(d) *Contributions under a qualified bond purchase plan.* (1) The retirement bonds will be issued in the denominations of $50, $100, $500, and $1,000. Therefore, the contribution otherwise called for under the plan may not coincide with an amount that can be invested in retirement bonds. Accordingly, the plan must provide that the contributions on behalf of an individual employee for any year shall be rounded to the nearest multiple of $50.

(2) Since the employee's rights to any bonds purchased for him under a qualified bond purchase plan must be nonforfeitable, a qualified bond purchase plan must, in order to conform to the requirements of section 401(a)(4) with respect to the early termination of the plan, restrict the contributions on behalf of any employee to the amount which could be allocated to him under paragraph (c) of § 1.401–4.

(e) *Definitions.* For purposes of this section and §§ 1.405–2 and 1.405–3—

(1) The term ''employee'' includes an employee as defined in section 401(c)(1) and paragraph (b) of § 1.401–10, and the term ''employer'' means the person treated as the employer of such individual under section 401(c)(4);

(2) The term ''owner-employee'' means an owner-employee as defined in section 401(c)(3) and paragraph (d) of § 1.401–10;

(3) The term ''earned income'' means earned income as defined in section 401(c)(2) and paragraph (c) of § 1.401–10; and

(4) The term ''retirement bond'' means a United States Retirement Plan Bond, as described in section 405(b) and Treasury Department Circular, Public Debt Series—No. 1–63.

[T.D. 6675, 28 FR 10131, Sept. 17, 1963, as amended by T.D. 7748, 46 FR 1697, Jan. 7, 1981]

§ 1.405–2 Deduction of contributions to qualified bond purchase plans.

(a) *In general.* An employer shall be allowed a deduction for contributions paid to or under a qualified bond purchase plan in the same manner and to the same extent as if such contributions were made to a trust described in section 401(a) which is exempt from tax under section 501(a). A deduction will be allowed only for the taxable year in which the contributions are paid, or treated as paid, except as provided by section 404(a) (1), (3), and (7). For purposes of the deduction, a contribution is paid at the time the application for the bond is made and the full purchase price paid.

(b) *Rules for applying section 404.* If a qualified bond purchase plan is designed as a pension plan as defined in paragraph (b)(1)(i) of § 1.401–1, the limitations of section 404 applicable to qualified pension trusts shall apply.

See §§1.404(a)–3 through 1.404(a)–7. Similarly, if a qualified bond purchase plan is designed as a profit-sharing plan as defined in paragraph (b)(1)(ii) of §1.401–1, the limitations of section 404 applicable to qualified profit-sharing trusts shall apply. See §§1.404(a)–9 and 1.404(a)–10. In addition, if a qualified bond purchase plan designed as a pension plan covers some or all of the employees who are covered by a qualified profit-sharing plan established and maintained by the same employer, or if a qualified bond purchase plan which is designed as a profit-sharing plan covers some or all the employees who are also covered by a qualified pension or annuity plan established and maintained by the same employer, section 404(a)(7) is applicable. See §1.404(a)–(13). Furthermore, if a qualified bond purchase plan covers employees some or all of whom are employees within the meaning of section 401(c)(1), the provisions of section 404(a) (8), (9), and (10) and 404(e) shall also apply.

(c) *Accrual method taxpayers.* In the case of a taxpayer using the accrual method of accounting, a contribution to a qualified bond purchase plan will be deemed paid on the last day of the year of accrual if—

(1) During the taxable year of accrual the taxpayer incurs a liability to make the contribution, the amount of which is accruable under section 461 for such taxable year, and

(2) Payment is in fact made no later than the time prescribed by the law for filing the return for the taxable year of accrual (including extensions thereof).

[T.D. 6675, 28 FR 10131, Sept. 17, 1963]

§1.405–3 Taxation of retirement bonds.

(a) *In general.* (1) As in the case of employer contributions under a qualified pension, annuity, profit-sharing, or stock bonus plan, employer contributions on behalf of his common-law employees under a qualified bond purchase plan are not includible in the gross income of the employees when made, and employer contributions on behalf of self-employed individuals are deductible as provided in section 405(c) and §1.405–2. Further, an employee or his beneficiary does not realize gross income upon the receipt of a retirement bond pursuant to a qualified bond purchase plan or from a trust described in section 401(a) which is exempt from tax under section 501(a). Upon redemption of such a bond, ordinary income will be realized to the extent the proceeds thereof exceed the basis (determined in accordance with paragraph (b) of this section) of the bond. The proceeds of a retirement bond are not entitled to the special tax treatment of section 72(n) and §1.72–18.

(2) In the event a retirement bond is surrendered for partial redemption and reissuance of the remainder, the person surrendering the bond shall be taxable on the proceeds received to the extent such proceeds exceed the basis in the portion redeemed. In such case, the basis shall be determined (in accordance with paragraph (b) of this section) as if the portion redeemed and the portion reissued had been issued as separate bonds.

(3) In the event a retirement bond is redeemed after the death of the registered owner, the amount taxable (as determined in accordance with subparagraph (1) of this paragraph) is income in respect of a decedent under section 691.

(4) The provisions of section 402(a)(2) are not applicable to a retirement bond. In general, section 402(a)(2) provides for capital gains treatment of certain distributions from a qualified trust which constitute the total distributions payable with respect to any employee. The proceeds of a retirement bond received upon redemption will not be entitled to such capital gain treatment even though the bond is received as a part of, or as the whole of, such a total distribution. Nor will such a bond be taken into consideration in determining whether the distribution represents the total amount payable by the trust with respect to an employee. Thus, a distribution by a qualified trust may constitute a total distribution payable with respect to an employee for purposes of section 402(a)(2) even though the trust retains retirement bonds registered in the name of such employee.

(b) *Basis.* (1) This paragraph is applicable in determining the basis of any retirement bond distributed pursuant to a qualified bond purchase plan or distributed by a trust qualifying under section 401. In the case of such a bond purchased for an individual at the time he is a common-law employee, the basis is that portion of the purchase price attributable to employee contributions. In the case of such a bond purchased for an individual at the time he is a self-employed individual, the basis shall be determined under subparagraph (3) of this paragraph.

(2) At the time a retirement bond is purchased, there shall be indicated on the application for the retirement bond whether the individual for whom the retirement bond is purchased is a common-law employee or a self-employed individual, and in the case of common-law employees the amount of the purchase price, if any, attributable to the employee's contribution. The answers to these questions will appear on the retirement bond, and when the retirement bond is purchased for a common-law employee, the basis for the retirement bond is presumed to be the amount of the purchase price which the retirement bond indicates was contributed by the employee.

(3)(i) Except as provided in subdivision (ii) of this subparagraph, for purposes of determining the basis of retirement bonds purchased for an individual while he was a self-employed individual, all such bonds redeemed during a taxable year shall be considered in the aggregate as a single retirement bond. The basis of such retirement bonds shall be the difference between the aggregate of their face amounts and the lesser of:

(A)1 One-half the aggregate of their face amounts, or

(B) The aggregate of the unused amounts allowed as a deduction at the end of the taxable year (as determined in subparagraph (4) of this paragraph).

(ii) The basis of a retirement bond purchased for a self-employed individual which is redeemed after his death is the amount determined by multiplying the face amount of such retirement bond by a fraction—

(A) The numerator of which is the aggregate of the face amounts of all the bonds registered in the individual's name at his death which were purchased while he was a self-employed individual reduced by the aggregate of the unused amounts allowed as a deduction at his death (as determined in subparagraph (4) of this paragraph), and

(B) The denominator of which is the aggregate of the face amounts of all such bonds.

(4)(i) In the case of retirement bonds purchased under a qualified bond purchase plan, the aggregate of the unused amounts allowed as a deduction at the end of any taxable year shall be an amount equal to the total of the amounts allowable for such taxable year, and the amounts allowed in all prior taxable years, as a deduction under section 405(c) for contributions used to purchase retirement bonds for the registered owner while he was a self-employed individual, reduced by an amount equal to the portion of the face amounts of such retirement bonds redeemed in prior taxable years which were included in the registered owner's gross income.

(ii) In the case of retirement bonds purchased by a trust described in section 401(a) and exempt under section 501(a), there shall be allocated to the retirement bond the deduction under section 404 attributable to the contributions used to purchase the retirement bond. The amount so allocated shall be treated in the same manner as the deduction allowed under section 405(c) for purposes of computing the unused amounts allowed as a deduction under subdivision (i) of this subparagraph. Further, the amount so allocated shall not be included in the investment in the contract for purposes of section 72 in determining the portion of the other assets distributed by the trust included in gross income.

(5) The application of the rule of subparagraphs (3) and (4) of this paragraph may be illustrated by the following examples:

Example (1). B, a self-employed individual, adopts a qualified bond purchase plan in 1963. During 1963 the plan purchased $2,000 worth of retirement bonds in his name. As a result of overestimating his income for 1963, only $400 was allowed B as a deduction pursuant to section 405(c). In 1964, prior to B's retirement in June of that year, the plan purchased a $500 retirement bond in B's name for which a deduction was allowable pursuant to section 405(c) in the amount of $250. B redeemed a retirement bond with a face amount of $500 in September of 1964 and another with a face amount of $500 in October of 1964. Of the proceeds received in 1964 from the redemption of the bonds, $1,000 plus interest, B shall exclude from his gross income $500 (face amount of the retirement bonds, $1,000, less $500, one-half of the face amount, the latter being less than the aggregate of the unused amounts allowed as a deduction, $250 allowable for the taxable year in which the bonds were redeemed plus $400, the unused amounts allowed in prior taxable years, or $650). The aggregate of the unused amounts allowed as a deduction shall be reduced by the amount so excluded ($650−$500=$150). During the following year, B redeems another retirement bond with a face amount of $500. Of the proceeds received from the redemption of such retirement bond, $500 plus interest, B shall exclude from his gross income $350 (face amount of the retirement bonds, $500, less $150, the aggregate of the unused amounts allowed as a deduction, the latter being less than one-half of the face amount of the bond, $250). The aggregate of the unused amounts allowed as a deduction is reduced to zero ($150−$150=0). Upon redemption of the remaining retirement bonds registered in B's name, B shall exclude from his gross income with respect to such proceeds an amount equal to the face amounts of the bonds redeemed.

Example (2). C, a self-employed individual, participated in a qualified bond purchase plan during the years 1963 through 1966. The plan purchased in his name retirement bonds in the aggregate of $10,000. C deducted $4,000 from his gross income for the four years ($1,000 for each year) with respect to the purchase of such retirement bonds. C retired in December of 1966 and during the following year redeemed one retirement bond with a face amount of $1,000. C excluded from his gross income $500 of the proceeds of the bond. C died without redeeming any of the remaining retirement bonds registered in his name. The basis of each remaining retirement bond shall be determined by multiplying the face amount of each retirement bond by $5,500÷$9,000. The numerator is the aggregate of the face amounts registered in C's name (as a self-employed individual) at his death, $9,000, reduced by the aggregate of the unused amounts allowed as a deduction at his death, $3,500 (amounts allowed as a deduction under section 405(c), $4,000, reduced by the portion of the face amount of the retirement bond redeemed by C which was included in C's gross income, $500), or $5,500. The denominator is the face amount of the retirement bonds registered in his name as a self-employed individual at his death, $9,000.

[T.D. 6675, 28 FR 10131, Sept. 17, 1963]

§1.406–1 Treatment of certain employees of foreign subsidiaries as employees of the domestic corporation.

(a) *Scope*—(1) *General rule.* For purposes of applying the rules in part 1 of subchapter D of chapter 1 of subtitle A of the Code and the regulations thereunder with respect to a pension, profit-sharing, or stock bonus plan described in section 401(a), an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a), of a domestic corporation, an individual who is a citizen of the United States and who is an employee of a foreign subsidiary (as defined in section 3121(1)(8) and the regulations thereunder) of such domestic corporation shall be treated as an employee of such domestic corporation if the requirements of paragraph (b) of this section are satisfied.

(2) *Cross-references.* For rules relating to nondiscrimination requirements and the determination of compensation, see paragraph (c) of this section. For rules under which termination of the status of an individual as an employe of the domestic corporation in certain instances will not be considered as separation from service for certain purposes, see paragraph (d) of this section. For rules regarding deductibility of contribution, see paragraph (e) of this section. For rules regarding treatment of such individual as an employee of the domestic corporation under related provisions, see paragraph (f) of this section.

(b) *Application of this section*—(1) *Requirements.* This section shall apply and the employee of the foreign subsidiary shall be treated as an employee of domestic corporation for the purposes set forth in paragraph (a)(1) of this section only if each of the following requirements is satisfied:

(i) The domestic corporation must have entered into an agreement under section 3121(l) to provide social security coverage which applies to the foreign subsidiary of which such individual is an employee and which has not been terminated under section 3121(l)(3) or (4).

(ii) The plan, referred to in paragraph (a)(1) of this section, must expressly provide for contributions or benefits for individuals who are citizens of the United States and who are employees of one or more of its foreign subsidiaries to which an agreement entered into by such domestic corporation under section 3121(l) applies. The plan must apply to all of the foreign subsidiaries to which such agreement applies.

(iii) Contributions under a funded plan of deferred compensation (whether or not a plan described in section 401(a), 403(a), or 405(a)) must not be provided by any other person with respect to the remuneration paid to such individual by the foreign subsidiary.

(2) *Supplementary rules.* Subparagraph (l)(ii) of this paragraph does not modify the requirements for qualification of a plan described in section 401(a), 403(a), or 405(a) and the regulations thereunder. It is not necessary that the plan provide benefits or contributions for all United States citizens who are employees of such foreign subsidiaries. If the plan is amended to cover individuals who are employees by reason of paragraph (a)(1) of this section, the plan will not qualify unless it meets the coverage requirements of section 410(b)(1) (section 401(a)(3), as in effect on September 1, 1974, for plan years to which section 410 does not apply; see § 1.410(a)–2 for the effective dates of section 401) and the nondiscrimination requirements of section 401(a)(4). In addition, the administrative rules contained in § 1.401(a)–3(e) (relating to the determination of the contributions or benefits provided by the employer under the Social Security Act) will also apply for purposes of determining whether the plan meets the requirements of section 401. For purposes of subparagraph (1)(iii) of this paragraph, contributions will not be considered as provided under a funded plan merely because the foreign subsidiary is required under the laws of the foreign jurisdiction to pay social insurance taxes or to make similar payments with respect to the wages paid to the employee.

(c) *Special rules*—(1) *Nondiscrimination requirements.* For purposes of applying sections 401(a)(4) and 410(b)(1)(B) (section 401(a)(3)(B), as in effect on September 1, 1974, for plan years to which section 410 does not apply) and the regulations thereunder (relating to nondiscrimination concerning benefits and contributions and coverage of employees) with respect to an employee of the foreign subsidiary who is treated as an employee of the domestic corporation under paragraph (a)(1) of this section—

(i) If the employee is an officer, shareholder, or (with respect to plan years to which section 410 does not apply) person whose principal duties consist in supervising the work of other employees of the foreign subsidiary of the domestic corporation, he shall be treated as having such capacity with respect to the domestic corporation; and

(ii) The determination as to whether the employee is a highly compensated employee shall be made by comparing his total compensation (determined under subparagraph (2) of this paragraph) with the compensation of all the employees of the domestic corporation (including individuals treated as employees of the domestic corporation pursuant to section 406 and this section).

(2) *Determination of compensation.* For purposes of applying section 401(a)(5) and the regulations thereunder, relating to classifications that will not be considered discriminatory, with respect to an employee of the foreign subsidiary who is treated as an employee of the domestic corporation under paragraph (a)(1) of this section—

(i) The total compensation of the employee shall be the remuneration of the employee from the foreign subsidiary (including any allowances that are paid to the employee because of his employment in a foreign country) which would constitute his total compensation if his services had been performed for the domestic corporation;

(ii) The basic or regular rate of compensation of the employee shall be determined for the employee in the same manner as it is determined under section 401 for other employees of the domestic corporation; and

(iii) The amount paid by the domestic corporation which is equivalent to the tax imposed with respect to the employee by section 3101 (relating to the tax on employees under the Federal Insurance Contributions Act) shall be treated as having been paid by the employee and shall be included in his compensation.

(d) *Termination of status as deemed employee not to be treated as separation from service for purposes of capital gain provisions and limitation of tax.* For purposes of applying the rules, relating to the treatment of certain distributions which are made after an employee's separation from service, set forth in section 72(n) as in effect on September 1, 1974 (with respect to taxable years ending after December 31, 1969, and to which section 402(e) does not apply), and in sections 402(a)(2) and (e) and 403(a)(2) with respect to distributions or payments made after December 31, 1973, and in taxable years beginning after December 31, 1973) with respect to an employee of a foreign subsidiary who is treated as an employee of a domestic corporation under paragraph (a)(1) of this section, the employee shall not be considered as separated from the service of the domestic corporation solely by reason of the occurrence of any one or more of the following events:

(1) The termination, under the provisions of section 3121(l), of the agreement entered into by the domestic corporation under that section which covers the employment of the employee;

(2) The employee's becoming an employee of another foreign subsidiary of the domestic corporation with respect to which such agreement does not apply,

(3) The employee's ceasing to be an employee of the foreign subsidiary by reason of which employment he was treated as an employee of such domestic corporation, if he becomes an employee of another corporation controlled by such domestic corporation; or

(4) The termination of the provision of the plan described in paragraph (b)(1)(ii) of this section, for coverage of United States citizens who are employees of foreign subsidiaries covered by an agreement under section 3121(l).

For purposes of subparagraph (3) of this paragraph, a corporation is considered to be controlled by a domestic corporation if such domestic corporation owns directly or indirectly more than 50 percent of the voting stock of the corporation.

(e) *Deductibility of contributions*—(1) *In general.* For purposes of applying sections 404 and 405(c) with respect to the deduction for contributions made to or under a pension, profit-sharing, or stock bonus plan described in section 401(a), an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a), by a domestic corporation, or by another corporation which is entitled to deduct its contributions under section 404(a)(3)(B), on behalf of an employee of a foreign subsidiary treated as an employee of the domestic corporation under paragraph (a)(1) of this section—

(i) Except as provided in subdivision (ii) of this subparagraph, no deduction shall be allowed to such domestic corporation or to any other corporation which would otherwise be entitled to deduct its contributions on behalf of such employee under one of such sections;

(ii) There shall be allowed as a deduction from the gross income of the foreign subsidiary which is effectively connected with the conduct of a trade or business within the United States (within the meaning of section 882 and the regulations thereunder) an amount which is allocable and apportionable to such gross income under the rules of §1.861–8 and which in no event may exceed the amount which (but for subdivision (i) of this subparagraph) would be deductible under section 404 or section 405(c) by the domestic corporation if the individual were an employee of the domestic corporation and if his compensation were paid by the domestic corporation; and

(iii) Any reference to compensation shall be considered to be a reference to the total compensation of such individual (determined by applying paragraph (c)(2) of this section).

(2) *Year of deduction.* Any amount deductible by the foreign subsidiary under section 406(d) and this paragraph shall be deductible for its taxable year with or within which ends the taxable year of the domestic corporation for which the contribution was made.

(3) *Special rules.* Whether contributions to a plan on behalf of an employee of the foreign subsidiary who is

treated as an employee of the domestic corporation under paragraph (a)(1) of this section, or whether forfeitures with regard to such employee, will require an inclusion in the income of the domestic corporation or an adjustment in the basis of its stock in the foreign subsidiary, shall be determined in accordance with the rules of general application of subtitle A of chapter 1 of the Code (relating to income taxes). For example, an unreimbursed contribution by the domestic corporation to a plan which meets the requirements of section 401(a) will be treated, to the extent each employee's rights to the contribution are nonforfeitable, as a contribution of capital to the foreign subsidiary to the extent that such contributions are made on behalf of the employees of such subsidiary.

(f) *Treatment as an employee of the domestic corporation under related provisions.* An individual who is treated as an employee of a domestic corporation under paragraph (a)(1) of this section shall also be treated as an employee of such domestic corporation, with respect to the plan having the provision described in paragraph (b)(1)(ii) of this section, for purposes of applying section 72(d) (relating to employees' annuities), section 72(f) (relating to special rules for computing employees' contributions), section 101(b) (relating to employees' death benefits), section 2039 (relating to annuities), and section 2517 (relating to certain annuities under qualified plans) and the regulations thereunder.

(g) *Nonexempt trust.* If the plan of the domestic corporation is a qualified plan described under section 401(a), the fact that a trust which forms a part of such plan is not exempt from tax under section 501(a) shall not affect the treatment of an employee of a foreign subsidiary as an employee of a domestic corporation under section 406(a) and paragraph (a)(1) of this section.

(Sec. 411 Internal Revenue Code of 1954 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42321, Aug. 23, 1978]

§ 1.407–1 Treatment of certain employees of domestic subsidiaries engaged in business outside the United States as employees of the domestic parent corporation.

(a) *Scope*—(1) *General rule.* For purposes of applying the rules in part 1 of subchapter D of chapter 1 of subtitle A of the Code and the regulations thereunder with respect to a pension, profit-sharing, or stock bonus plan described in section 401(a), an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a), of a domestic parent corporation (as defined in paragraph (b)(3)(ii) of this section), an individual who is a citizen of the United States and who is an employee of a domestic subsidiary (as defined in paragraph (b)(3)(i) of this section) of such domestic parent corporation shall be treated as an employee of such domestic parent corporation if the requirements of paragraph (b) of this section are satisfied.

(2) *Cross-references.* For rules relating to nondiscrimination requirements and the determination of compensation, see paragraph (c) of this section. For rules under which termination of the status of an individual as an employee of the domestic parent corporation in certain instances will not be considered as separation from service for certain purposes, see paragraph (d) of this section. For rules regarding deductibility of contributions, see paragraph (e) of this section. For rules regarding treatment of such individual as an employee of the domestic parent corporation under related provisions, see paragraph (f) of this section.

(b) *Application of this section*—(1) *Requirements.* This section shall apply and the employee of the domestic subsidiary shall be treated as an employee of the domestic parent corporation for the purposes set forth in paragraph (a)(1) of this section only if each of the following requirements is satisfied:

(i) The plan, referred to in paragraph (a)(1) of this section, must expressly provide for contributions of benefits for individuals who are citizens of the United States and who are employees of one or more of the domestic subsidiaries of the domestic parent corporation. The plan must apply to every domestic subsidiary.

(ii) Contributions under a funded plan of deferred compensation (whether or not a plan described in section 401(a), 403(a), or 405(a)) must not be provided by any other person with respect to the remuneration paid to such individual by the domestic subsidiary.

(2) *Supplementary rules.* Subparagraph (1)(i) of this paragraph does not modify the requirements for qualification of a plan described in section 401(a), 403(a), or 405(a) and the regulations thereunder. It is not necessary that the plan provide benefits or contributions for all United States citizens who are employees of such domestic subsidiaries. It the plan is amended to cover individuals who are employees by reason of paragraph (a)(1) of this section, the plan will not qualify unless it meets the coverage requirements of section 410(b)(1) (section 401(a)(3), as in effect on September 1, 1974, for plan years to which section 410 does not apply; see §1.410 (a)-2 for the effective dates of section 401) and the nondiscrimination requirements of section 410(a)(4). The administrative rules contained in §1.401 (a)–3(e) (relating to the determination of the contributions or benefits provided by the employer under the Social Security Act) will also apply for purposes of determining whether the plan meets the requirements of section 401. For purposes of subparagraph (1)(ii) of this paragraph, contributions will not be considered as provided under a funded plan merely because the domestic subsidiary employer pays the tax imposed by section 3111 (relating to tax on employers under the Federal Insurance Contributions Act) with respect to such employee or is required under the laws of a foreign jurisdiction to pay social insurance taxes or to make similar payments with respect to the wages paid to the employee.

(3) *Definitions*—(i) *Domestic subsidiary.* For purposes of this section, a corporation shall be treated as a domestic subsidiary for any taxable year only if each of the following requirements is satisfied:

(A) It is a domestic corporation 80 percent or more of the outstanding voting stock of which is owned by another domestic corporation;

(B) 95 percent of more of its gross income for the three-year period immediately preceding the close of its taxable year which ends on or before the close of the taxable year of such other domestic corporation (or for such part of such period during which it was in existence) was derived from sources without the United States, determined pursuant to sections 861 through 864 and the regulations thereunder; and

(C) 90 percent or more of its gross income for such period (or such part) was derived from the active conduct of a trade or business.

If for the period (or part thereof) referred to in (B) and (C) of this subdivision such corporation has no gross income, the provisions of (B) and (C) shall be treated as satisfied if it is reasonable to anticipate that, with respect to the first taxable year thereafter for which such corporation has gross income, such provisions will be satisfied.

(ii) *Domestic parent corporation.* The domestic parent corporation of any domestic subsidiary is the domestic corporation which owns 80 percent or more of the outstanding voting stock of such domestic subsidiary.

(c) *Special rules*—(1) *Nondiscrimination requirements.* For purposes of applying sections 401(a)(4) and 410(b)(1)(B) (section 401(a)(3)(B), as in effect on Septemeber 1, 1974, for plan years to which section 410 does not apply) and the regulation thereunder (relating to nondiscrimination concerning benefits and contributions and coverage of employees) with respect to an employee of the domestic subsidiary who is treated as an employee of the domestic parent corporation under paragraph (a)(1) of this section—

(i) If the employee is an officer, shareholder, or (with respect to plan years to which section 410 does not apply) a person whose principal duties consist in supervising the work of other employees of the domestic subsidiary of the domestic parent corporation, he shall be treated as having such capacity with respect to the domestic parent corporation; and

(ii) The determination as to whether the employee is a highly compensated employee shall be made by comparing his total compensation determined under subparagraph (2) of this paragraph with the compensation of all the employees of the domestic parent corporation (including individuals treated as employees of the domestic parent corporation pursuant to section 407 and this section).

(2) *Determination of compensation.* For purposes of applying section 401(a) (5) and the regulations thereunder, relating to classifications that will not be considered discriminatory, with respect to an employee of the domestic subsidiary who is treated as an employee of the domestic parent corporation under paragraph (a)(1) of this section—

(i) The total compensation of the employee shall be the remuneration of the employee from the domestic subsidiary (including any allowances that are paid to the employee because of his employment in a foreign country) which would constitute his total compensation if his services had been performed for such domestic parent corporation; and

(ii) The basic or regular rate of compensation of the employee shall be determined for the employee in the same manner as it is determined under section 401 for other employees of the domestic parent corporation.

(d) *Termination of status as deemed employee not to be treated as separation from service for purposes of captial gain provisions and limitation of tax.* For purposes of applying the rules, relating to treatment of certain distributions which are made after an employee's separation from service, set forth in section 72(n) as in effect on September 1, 1974 (with respect to taxable years ending after December 31, 1969, and to which section 402(e) does not apply), and in sections 402 (a)(2) and (e) and 403(a)(2) (with respect to distributions or payments made after December 31, 1973, and in taxable years beginning after December 31, 1973) with respect to an employee of a domestic subsidiary who is treated as an employee of a domestic parent corporation under paragraph (a)(1) of this section, the employee shall not be considered as separated from the service of the domestic parent corporation solely by reason of the occurrence of any one or more of the following events:

(1) The fact that the corporation of which such individual is an employee ceases, for any taxable year, to be a domestic subsidiary within the mean of paragraph (b)(3)(i) of this section;

(2) The employee' ceasing to be an employee of the domestic subsidiary of such domestic parent corporation, if he becomes an employee of another corporation controlled by such domestic parent corporation; or

(3) The termination of the provision of the plan described in paragraph (b)(1)(i) of this section, requiring coverage of the United States citizens who are employees of domestic subsidiaries of the domestic parent corporation.

For purposes of subparagraph (2) of this paragraph, a corporation is considered to be controlled by a domestic parent corporation if the domestic parent corporation owns directly or indirectly more than 50 percent of the voting stock of the corporation.

(e) *Deductibility of contributions*—(1) *In general.* For purposes of applying sections 404 and 405(c) with respect to the deduction for contributions made to or under a pension, profit-sharing, or stock bonus plan described in section 401(a), and annuity plan described in section 403(a), or a bond purchase plan described in section 405(a), by a domestic parent corporation, or by another corporation which is entitled to deduct its contributions under section 404(a)(3)(B), on behalf of an employee of a domestic subsidiary treated as an employee of the domestic parent corporation under paragraph (a)(1) of this section—

(i) Except as provided in subdivision (ii) of this subparagraph, no deduction shall be allowed to the domestic parent corporation which would otherwise be entitled to deduct its contributions on behalf of such employee under one of such sections;

(ii) There shall be allowed as a deduction to the domestic subsidiary of which such individual is an employee an amount equal to the amount which (but for subdivision (i) of this subparagraph) would be deductible under section 404 or section 405(c) by the domestic parent corporation if the individual were an employee of the domestic parent corporation and if his compensation were paid by the domestic corporation; and

(iii) Any reference to compensation shall be considered to be a reference to the total compensation of such individual determined by applying paragraph (c)(2) of this section).

(2) *Year of deduction.* Any amount deductible by the domestic subsidiary under section 407(d) and this paragraph shall be deductible for its taxable year with or within which ends the taxable year of the domestic parent corporation for which the contribution was made.

(3) *Special rules.* Whether contributions to a plan on behalf of an employee of the domestic subsidiary who is treated as an employee of the domestic parent corporation under paragraph (a)(1) of this section, or whether forfeitures with regard to such employee, will require an inclusion in the income of the domestic parent corporation or an adjustment in the basis of its stock in the domestic subsidiary, shall be determined in accordance with the rules of general application of subtitle A of chapter 1 of the Code (relating to income taxes). For an example, and unreimbursed contribution by the domestic parent corporation to a plan which meets the requirements of section 401(a) will be treated, to the extent each employee's rights to the contribution are nonforfeitable, as a contribution of capital to the domestic subsidiary to the extent that such contributions are made on behalf of the employees of such subsidiary.

(f) *Treatment as an employee of the domestic parent corporation under related provisions.* An individual who is treated as an employee of a domestic parent corporation under paragraph (a)(1) of this section shall also be treated as an employee of such domestic corporation, with respect to the plan having the provision described in paragraph (b)(1)(i) of this section, for purposes of applying section 72(d) (relating to special rules for computing employees' contributions), section 72(f) (relating to special rules for computing employees' contributions), section 101(b) (relating to employees' section 101(b) (relating to employees' death benefits), section 2039 (relating to annuities), and section 2517 (relating to certain annuities under qualified plans) and the regulations thereunder.

(g) *Nonexempt trust.* If the plan of the domestic parent corporation is a qualified plan described under section 401(a), the fact that a trust which forms a part of such plan is not exempt from tax under section 501(a) shall not affect the treatment of an employee of a domestic subsidiary as an employee of a domestic parent corporation under section 407(a) and paragraph (a)(1) of this section.

(Sec. 411 Internal Revenue Code of 1954 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42323, Aug. 23, 1977]

§1.408–1 General rules.

(a) *In general.* Section 408 prescribes rules relating to individual retirement accounts and individual retirement annuities. In addition to the rules set forth in §§1.408–2 and 1.408–3, relating respectively to individual retirement accounts and individual retirement annuities, the rules set forth in this section shall also apply.

(b) *Exemption from tax.* The individual retirement account or individual retirement annuity is exempt from all taxes under subtitle A of the Code other than the taxes imposed under section 511, relating to tax on unrelated business income of charitable, etc., organizations.

(c) *Sanctions*—(1) *Excess contributions.* If an individual retirement account or individual retirement annuity accepts and retains excess contributions, the individual on whose behalf the account is established or who is the owner of the annuity will be subject to the excise tax imposed by section 4973.

(2) *Prohibited transactions by owner or beneficiary of individual retirement account*—(i) Under section 408(e)(2), if, during any taxable year of the individual for whose benefit any individual retirement account is established, that individual or the individual's beneficiary engages in any transaction prohibited by section 4975 with respect to such account, such account ceases to be an individual retirement account as of the first day of such taxable year. In

any case in which any individual retirement account ceases to be an individual retirement account by reason of the preceding sentence as of the first day of any taxable year, section 408(d)(1) applies as if there were a distribution on such first day in an amount equal to the fair market value (on such first day) of all assets in the account (on such first day). The preceding sentence applies even though part of the fair market value of the individual retirement account as of the first day of the taxable year is attributable to excess contributions which may be returned tax-free under section 408(d)(4) or 408(d)(5).

(ii) If the trust with which the individual engages in any transaction described in subdivision (i) of this subparagraph is established by an employer or employee association under section 408(c), only the employee who engages in the prohibited transaction is subject to disqualification of his separate account.

(3) *Prohibited transaction by person other than owner or beneficiary of account.* If any person other than the individual on whose behalf an individual retirement account is established or the individual's beneficiary engages in any transaction prohibited by section 4975 with respect to such account, such person shall be subject to the taxes imposed by section 4975.

(4) *Pledging account as security.* Under section 408(e)(4), if, during any taxable year of the individual for whose benefit an individual retirement account is established, that individual uses the account or any portion thereof as security for a loan, the portion so used is treated as distributed to that individual.

(5) *Borrowing on annuity contract.* Under section 408(e)(3), if during any taxable year the owner of an individual retirement annuity borrows any money under or by use of such contract, the contract ceases to be an individual retirement annuity as of the first day of such taxable year. See § 1.408–3(c).

(6) *Premature distributions.* If a distribution (whether a deemed distribution or an actual distribution) is made from an individual retirement account, or individual retirement annuity, to the individual for whose benefit the account was established, or who is the owner of the annuity, before the individual attains age 59½ (unless the individual has become disabled within the meaning of section 72(m)(7)), the tax under Chapter 1 of the Code for the taxable year in which such distribution is received is increased under section 408(f)(1) or (f)(2). The increase equals 10 percent of the amount of the distribution which is includible in gross income for the taxable year. Except in the case of the credits allowable under section 31, 39, or 42, no credit can be used to offset the increased tax described in this subparagraph. See, however, § 1.408–4(c)(3).

(d) *Limitation on contributions and benefits.* An individual retirement account or individual retirement annuity is subject to the limitation on contributions and benefits imposed by section 415 for years beginning after December 31, 1975.

(e) *Community property laws.* Section 408 shall be applied without regard to any community property laws.

[T.D. 7714, 45 FR 52790, Aug. 8, 1980]

§ 1.408–2 Individual retirement accounts.

(a) *In general.* An individual retirement account must be a trust or a custodial account (see paragraph (d) of this section). It must satisfy the requirements of paragraph (b) of this section in order to qualify as an individual retirement account. It may be established and maintained by an individual, by an employer for the benefit of his employees (see paragraph (c) of this section), or by an employee association for the benefit of its members (see paragraph (c) of this section).

(b) *Requirements.* An individual retirement account must be a trust created or organized in the United States (as defined in section 7701(a)(9)) for the exclusive benefit of an individual or his beneficiaries. Such trust must be maintained at all times as a domestic trust in the United States. The instrument creating the trust must be in writing and the following requirements must be satisfied.

(1) *Amount of acceptable contributions.* Except in the case of a contribution to a simplified employee pension described in section 408(k) and a rollover

contribution described in section 408(d)(3), 402(a)(5), 402(a)(7), 403(a)(4), 403(b)(8) or 409(b)(3)(C), the trust instrument must provide that contributions may not be accepted by the trustee for the taxable year in excess of $1,500 on behalf of any individual for whom the trust is maintained. An individual retirement account maintained as a simplified employee pension may provide for the receipt of up to $7,500 for a calendar year.

(2) *Trustee.* (i) The trustee must be a bank (as defined in section 408(n) and the regulations thereunder) or another person who demonstrates, in the manner described in paragraph (e) of this section, to the satisfaction of the Commissioner, that the manner in which the trust will be administered will be consistent with the requirements of section 408 and this section.

(ii) Section 11.408(a)(2)–1 of the Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974 is superseded by this subparagraph (2).

(3) *Life insurance contracts.* No part of the trust funds may be invested in life insurance contracts. An individual retirement account may invest in annuity contracts which provide, in the case of death prior to the time distributions commence, for a payment equal to the sum of the premiums paid or, if greater, the cash value of the contract.

(4) *Nonforfeitability.* The interest of any individual on whose behalf the trust is maintained in the balance of his account must be nonforfeitable.

(5) *Prohibition against commingling.* (i) The assets of the trust must not be commingled with other property except in a common trust fund or common investment fund.

(ii) For purposes of this subparagraph, the term ‘‘common investment fund’’ means a group trust created for the purpose of providing a satisfactory diversification or investments or a reduction of administrative expenses for the individual participating trusts, and which group trust satisfies the requirements of section 408(c) (except that it need not be established by an employer or an association of employees) and the requirements of section 401(a) in the case of a group trust in which one of the individual participating trusts is an employees’ trust described in section 401(a) which is exempt from tax under section 501(a).

(iii) For purposes of this subparagraph, the term ‘‘individual participating trust’’ means an employees’ trust described in section 401(a) which is exempt from tax under section 501(a) or a trust which satisfies the requirements of section 408(a) provided that in the case of such an employees’ trust, such trust would be permitted to participate in such a group trust if all the other individual participating trusts were employees’ trusts described in section 401(a) which are exempt from tax under section 501(a).

(6) *Distribution of interest.* (i) The trust instrument must provide that the entire interest of the individual for whose benefit the trust is maintained must be distributed to him in accordance with paragraph (b)(6)(ii) or (iii) of this section.

(ii) Unless the provisions of paragraph (b)(6)(iii) of this section apply, the entire interest of the individual must be actually distributed to him not later than the close of his taxable year in which he attains age 70½.

(iii) In lieu of distributing the individual’s entire interest as provided in paragraph (b)(6)(ii) of this section, the interest may be distributed commencing not later than the taxable year described in such paragraph (b)(6)(ii). In such case, the trust must expressly provide that the entire interest of the individual will be distributed to the individual and the individual’s beneficiaries, in a manner which satisfies the requirements of paragraph (b)(6)(v) of this section, over any of the following periods (or any combination thereof)—

(A) The life of the individual,

(B) The lives of the individual and spouse,

(C) A period certain not extending beyond the life expectancy of the individual, or

(D) A period certain not extending beyond the joint life and last survivor expectancy of the individual and spouse.

(iv) The life expectancy of the individual or the joint life and last survivor expectancy of the individual and spouse cannot exceed the period computed by use of the expected return multiples in § 1.72–9, or, in the case of payments under a contract issued by an insurance company, the period computed by use of the mortality tables of such company.

(v) If an individual's entire interest is to be distributed over a period described in paragraph (b)(6)(iii) of this section, beginning in the year the individual attains 70½ the amount to be distributed each year must be not less than the lesser of the balance of the individual's entire interest or an amount equal to the quotient obtained by dividing the entire interest of the individual in the trust at the beginning of such year (including amounts not in the individual retirement account at the beginning of the year because they have been withdrawn for the purpose of making a rollover contribution to another individual retirement plan) by the life expectancy of the individual (or the joint life and last survivor expectancy of the individual and spouse (whichever is applicable)), determined in either case as of the date the individual attains age 70 in accordance with paragraph (b)(6)(iv) of this section, reduced by one for each taxable year commencing after the individual's attainment of age 70½. An annuity or endowment contract issued by an insurance company which provides for non-increasing payments over one of the periods described in paragraph (b)(6)(iii) of this section beginning not later than the close of the taxable year in which the individual attains age 70½ satisfies this provision. However, no distribution need be made in any year, or a lesser amount may be distributed, if beginning with the year the individual attains age 70½ the aggregate amounts distributed by the end of any year are at least equal to the aggregate of the minimum amounts required by this subdivision to have been distributed by the end of such year.

(vi) If an individual's entire interest is distributed in the form of an annuity contract, then the requirements of section 408(a)(6) are satisfied if the distribution of such contract takes place before the close of the taxable year described in subdivision (ii) of this subparagraph, and if the individual's interest will be paid over a period described in subdivision (iii) of this subparagraph and at a rate which satisfies the requirements of subdivision (v) of this subparagraph.

(vii) In determining whether paragraph (b)(6)(v) of this section is satisfied, all individual retirement plans maintained for an individual's benefit (except those under which he is a beneficiary described in section 408(a)(7)) at the close of the taxable year in which he reaches age 70½ must be aggregated. Thus, the total payments which such individual receives in any taxable year must be at least equal to the amount he would have been required to receive had all the plans been one plan at the close of the taxable year in which he attained age 70½.

(7) *Distribution upon death.* (i) The trust instrument must provide that if the individual for whose benefit the trust is maintained dies before the entire interest in the trust has been distributed to him, or if distribution has been commenced as provided in paragraph (b)(6) of this section to the surviving spouse and such spouse dies before the entire interest has been distributed to such spouse, the entire interest (or the remaining part of such interest if distribution thereof has commenced) must, within 5 years after the individual's death (or the death of the surviving spouse) be distributed or applied to the purchase of an immediate annuity for this beneficiary or beneficiaries (or the beneficiary or beneficiaries of the surviving spouse) which will be payable for the life of such beneficiary or beneficiaries (or for a term certain not extending beyond the life expectancy of such beneficiary or beneficiaries) and which annuity contract will be immediately distributed to such beneficiary or beneficiaries. A contract described in the preceding sentence is not includible in gross income upon distribution. Section 1.408–4(e) provides rules applicable to the taxation of such contracts. The first sentence of this paragraph (b)(7) shall have no application if distributions over a term certain commenced before the death of the individual for whose benefit the trust was maintained and the term certain is for a period

permitted under paragraph (b)(6)(iii)(C) or (D) of this section.

(ii) Each such beneficiary (or beneficiary of a surviving spouse) may elect to treat the entire interest in the trust (or the remaining part of such interest if distribution thereof has commenced) as an account subject to the distribution requirements of section 408(a)(6) and paragraph (b)(6) of this section instead of those of section 408(a)(7) and paragraph (b)(7) of this section. Such an election will be deemed to have been made if such beneficiary treats the account in accordance with the requirements of section 408(a)(6) and paragraph (b)(6) of this section. An election will be considered to have been made by such beneficiary if either of the following occurs: (A) any amounts in the account (including any amounts that have been rolled over, in accordance with the requirements of section 408(d)(3)(A)(i), into an individual retirement account, individual retirement annuity, or retirement bond for the benefit of such individual) have not been distributed within the appropriate time period required by section 408(a)(7) and paragraph (b)(7) of this section; or (B) any additional amounts are contributed to the account (or to the account, annuity, or bond to which the beneficiary has rolled such amounts over, as described in (1) above) which are subject, or deemed to be subject, to the distribution requirements of section 408(a)(6) and paragraph (b)(6) of this section.

(8) *Definition of beneficiaries.* The term ‘‘beneficiaries’’ on whose behalf an individual retirement account is established includes (except where the context indicates otherwise) the estate of the individual, dependents of the individual, and any person designated by the individual to share in the benefits of the account after the death of the individual.

(c) *Accounts established by employers and certain association of employees*—(1) *In general.* A trust created or organized in the United States (as defined in section 7701(a)(9)) by an employer for the exclusive benefit of his employees or their beneficiaries, or by an association of employees for the exclusive benefit of its members or their beneficiaries, is treated as an individual retirement account if the requirements of paragraphs (c)(2) and (c)(3) of this section are satisfied under the written governing instrument creating the trust. A trust described in the preceding sentence is for the exclusive benefit of employees or members even though it may maintain an account for former employees or members and employees who are temporarily on leave.

(2) *General requirements.* The trust must satisfy the requirements of paragraphs (b) (1) through (7) of this section.

(3) *Special requirement.* There must be a separate accounting for the interest of each employee or member.

(4) *Definitions*—(i) *Separate accounting.* For purposes of paragraph (c)(3) of this section, the term ‘‘separate accounting’’ means that separate records must be maintained with respect to the interest of each individual for whose benefit the trust is maintained. The assets of the trust may be held in a common trust fund, common investment fund, or common fund for the account of all individuals who have an interest in the trust.

(ii) *Employee association.* For purposes of this paragraph and section 408(c), the term ‘‘employee association’’ means any organization composed of two or more employees, including but not limited to, an employee association described in section 501(c)(4). Such association may include employees within the meaning of section 401(c)(1). There must be, however, some nexus between the employees (e.g., employees of same employer, employees in the same industry, etc.) in order to qualify as an employee association described in this subdivision (ii).

(d) *Custodial accounts.* For purposes of this section and section 408(a), a custodial account is treated as a trust described in section 408(a) if such account satisfies the requirements of section 408(a) except that it is not a trust and if the assets of such account are held by a bank (as defined in section 401(d)(1) and the regulations thereunder) or such other person who satisfies the requirements of paragraph (b)(2)(ii) of this section. For purposes of this chapter, in the case of a custodial account treated as a trust by reason of the preceding sentence, the custodian of such account will be treated as the trustee thereof.

(e)(1) *In general.* The trustee of a trust described in paragraph (b) of this section may be a person other than a bank if the person demonstrates to the satisfaction of the Commissioner that the manner in which the person will administer trusts will be consistent with the requirements of section 408. The person must demonstrate by written application that the requirements of paragraph (e)(2) to (e)(6) of this section will be met. The written application must be sent to address prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter). For procedural and administrative rules, see paragraph (e)(7) of this section.

(2) *Fiduciary ability.* The applicant must demonstrate in detail its ability to act within the accepted rules of fiduciary conduct. Such demonstration must include the following elements of proof:

(i) *Continuity.* (A) The applicant must assure the uninterrupted performance of its fiduciary duties nonwithstanding the death or change of its owners. Thus, for example, there must be sufficient diversity in the ownership of the applicant to ensure that the death or change of its owners will not interrupt the conduct of its business. Therefore, the applicant cannot be an individual.

(B) Sufficient diversity in the ownership of an incorporated applicant is demonstrated in the following circumstances:

(*1*) Individuals each of whom owns more than 20 percent of the voting stock in the applicant own, in the aggregate, no more than 50 percent of such stock;

(*2*) The applicant has issued securities registered under section 12 (b) of the Securities Exchange Act of 1934 (15 U.S.C. 78l (b)) or required to be registered under section 12(g) (1) of that Act (15 U.S.C. 78l (g)(1)); or

(*3*) The applicant has a parent corporation within the meaning of section 1563 (a) (1) that has issued securities registered under section 12 (b) of the Securities Exchange Act of 1934 (15 U.S.C. 78l (b)) or required to be registered under Section 12 (g) (1) of that Act (15 U.S.C. 78l (g)(1)).

(C) Sufficient diversity in the ownership of an applicant that is a partnership means that—

(*1*) Individuals each of whom owns more than 20 percent of the profits interest in the partnership own, in the aggregate, no more than 50 percent of such profits interest, and

(*2*) Individuals each of whom owns more than 20 percent of the capital interest in the partnership own, in the aggregate, no more than 50 percent of such capital interest.

(D) For purposes of this subdivision, the ownership of stock and of capital and profits interests shall be determined in accordance with the rules for constructive ownership of stock provided in section 1563 (e) and (f) (2). For this purpose, the rules for constructive ownership of stock provided in section 1563(e) and (f) (2) shall apply to a capital or profits interest in a partnership as if it were a stock interest.

(ii) *Established location.* The applicant must have an established place of business in the United States where it is accessible during every business day.

(iii) *Fiduciary experience.* The applicant must have fiduciary experience or expertise sufficient to ensure that it will be able to perform its fiduciary duties. Evidence of fiduciary experience must include proof that a significant part of the business of the applicant consists of exercising fiduciary powers similar to those it will exercise if its application is approved. Evidence of fiduciary expertise must include proof that the applicant employs personnel experienced in the administration of fiduciary powers similar to those the applicant will exercise if its application is approved.

(iv) *Fiduciary responsibility.* The applicant must assure compliance with the rules of fiduciary conduct set out in paragraph (e)(5) of this section.

(v) *Financial responsibility.* The applicant must exhibit a high degree of solvency commensurate with the obligations imposed by this paragraph. Among the factors to be taken into account are the applicant's net worth, its liquidity, and its ability to pay its debts as they come due.

(3) *Capacity to account.* The applicant must demonstrate in detail its experience and competence with respect to accounting for the interests of a large number of individuals (including calculating and allocating income earned and paying out distributions to payees). Examples of accounting for the interests of a large number of individuals include accounting for the interests of a large number of shareholders in a regulated investment company and accounting for the interests of a large number of variable annuity contract holders.

(4) *Fitness to handle funds*—(i) *In general.* The applicant must demonstrate in detail its experience and competence with respect to other activities normally associated with the handling of retirement funds.

(ii) *Examples.* Examples of activities normally associated with the handling of retirement funds include:

(A) To Receive, issue receipts for, and safely keep securities;

(B) To collect income;

(C) To execute such ownership certificates, to keep such records, make such returns, and render such statements as are required for Federal tax purposes;

(D) To give proper notification regarding all collections;

(E) To collect matured or called principal and properly report all such collections;

(F) To exchange temporary for definitive securities;

(G) To give proper notification of calls, subscription rights, defaults in principal or interest, and the formation of protective committees;

(H) To buy, sell, receive, or deliver securities on specific directions.

(5) *Rules of fiduciary conduct.* The applicant must demonstrate that under applicable regulatory requirements, corporate or other governing instruments, or its established operating procedures:

(i) *Administration of fiduciary powers.* (A)(*1*) The owners or directors of the applicant will be responsible for the proper exercise of fiduciary powers by the applicant. Thus, all matters pertinent thereto, including the determination of policies, the investment and disposition of property held in a fiduciary capacity, and the direction and review of the actions of all employees utilized by the applicant in the exercise of its fiduciary powers, will be the responsibility of the owners or directors. In discharging this responsibility, the owners or directors may assign to designated employees, by action duly recorded, the administration of such of the applicant's fiduciary powers as may be proper to assign.

(*2*) A written record will be made of the acceptance and of the relinquishment or closing out of all fiduciary accounts, and of the assets held for each account.

(*3*) If the applicant has the authority or the responsibility to render any investment advice with regard to the assets held in or for each fiduciary account, the advisability of retaining or disposing of the assets will be determined at least once during each period of 12 months.

(B) All employees taking part in the performance of the applicant's fiduciary duties will be adequately bonded. Nothing in this subdivision (i)(B) shall require any person to be bonded in contravention of section 412(d) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1112(d)).

(C) The applicant will employ or retain legal counsel who will be readily available to pass upon fiduciary matters and to advise the applicant.

(D) In order to segregate the performance of its fiduciary duties from other business activities, the applicant will maintain a separate trust division under the immediate supervision of an individual designated for that purpose. The trust division may utilize the personnel and facilities of other divisions of the applicant, and other divisions of the applicant may utilize the personnel and facilities of the trust division, as long as the separate identity of the trust division is preserved.

(ii) *Adequacy of net worth*—(A) *Initial net worth requirement.* In the case of applications received after January 5, 1995, no initial application will be accepted by the Commissioner unless the applicant has a net worth of not less than $250,000 (determined as of the end of the most recent taxable year). Thereafter, the applicant must satisfy the adequacy of net worth requirements of paragraph (e)(5)(ii)(B) and (C) of this section.

(B) No fiduciary account will be accepted by the applicant unless the applicant's net worth (determined as of the end of the most recent taxable year) exceeds the greater of—

(*1*) $100,000, or

(*2*) Four percent (or, in the case of a passive trustee described in paragraph (e)(6)(i)(A) of this section, two percent) of the value of all of the assets held by the applicant in fiduciary accounts (determined as of the most recent valuation date).

(C) The applicant will take whatever lawful steps are necessary (including the relinquishment of fiduciary accounts) to ensure that its net worth (determined as of the close of each taxable year) exceeds the greater of—

(*1*) $50,000, or

(*2*) Two percent (or, in the case of a passive trustee described in paragraph (e)(6)(i)(A) of this section, one percent) of the value of all of the assets held by the applicant in fiduciary accounts (determined as of the most recent valuation date).

(D) *Assets held by members of SIPC*—(*1*) For purposes of satisfying the adequacy-of-net-worth requirement of this paragraph, a special rule is provided for nonbank trustees that are members of the Securities Investor Protection Corporation (SIPC) created under the Securities Investor Protection Act of 1970 (SIPA)(15 U.S.C. 78aaa *et seq.*, as amended). The amount that the net worth of a nonbank trustee that is a member of SIPC must exceed is reduced by two percent for purposes of paragraph (e)(5)(ii)(B)(*2*), and one percent for purposes of paragraph (e)(5)(ii)(C)(*2*), of the value of assets (determined on an account-by-account basis) held for the benefit of customers (as defined in 15 U.S.C. 78fff–2(e)(4)) in fiduciary accounts by the nonbank trustee to the extent of the portion of each account that does not exceed the dollar limit on advances described in 15 U.S.C. 78fff–3(a), as amended, that would apply to the assets in that account in the event of a liquidation proceeding under the SIPA.

(*2*) The provisions of this special rule for assets held in fiduciary accounts by members of SIPC are illustrated in the following example.

Example—(a) Trustee X is a broker-dealer and is a member of the Securities Investment Protection Corporation. Trustee X also has been approved as a nonbank trustee for individual retirement accounts (IRAs) by the Commissioner but not as a passive nonbank trustee. Trustee X is the trustee for four IRAs. The total assets of each IRA (for which Trustee X is the trustee) as of the most recent valuation date before the last day of Trustee X's taxable year ending in 1995 are as follows: the total assets for IRA–1 is $3,000,000 (all of which is invested in securities); the value of the total assets for IRA–2 is $500,000 ($200,000 of which is cash and $300,000 of which is invested in securities), the value of the total assets for IRA–3 is $400,000 (all of which is invested in securities); and the value of the total assets of IRA–4 is $200,000 (all of which is cash). The value of all assets held in fiduciary accounts, as defined in § 1.408–2(e)(6)(viii)(A), is $4,100,000.

(b) The dollar limit on advances described in 15 U.S.C. § 78fff–3(a) that would apply to the assets in each account in the event of a liquidation proceeding under the Securities Investor Protection Act of 1970 in effect as of the last day of Trustee X's taxable year ending in 1995 is $500,000 per account (no more than $100,000 of which is permitted to be cash). Thus, the dollar limit that would apply to IRA–1 is $500,000; the dollar limit for IRA–2 is $400,000 ($100,000 of the cash and the $300,000 of the value of the securities); the dollar limit for IRA–3 is $400,000 (the full value of the account because the value of the account is less than $500,000 and no portion of the account is cash); and the dollar limit for IRA–4 is $100,000 (the entire account is cash and the dollar limit per account for cash is $100,000). The aggregate dollar limits of the four IRAs is $1,400,000.

(c) For 1996, the amount determined under § 1.408–2(e)(5)(ii)(B) is determined as follows for Trustee X: (1) four percent of $4,100,000 equals $164,000; (2) two percent of $1,400,000 equals $28,000; and (3) $164,000 minus $28,000 equals $136,000. Thus, because $136,000 exceeds $100,000, the minimum net worth necessary for Trustee X to accept new accounts for 1996 is $136,000.

(d) For 1996, the amount determined under § 1.408–2(e)(5)(ii)(C) for Trustee X is determined as follows: (1) two percent of $4,100,000 equals $82,000; (2) one percent of $1,400,000 equals $14,000; and (3) $82,000 minus $14,000 equals $68,000. Thus, because $68,000 exceeds $50,000, the minimum net worth necessary for Trustee X to avoid a mandatory relinquishment of accounts for 1996 is $68,000.

(E) The applicant will determine the value of the assets held by it in trust at least once in each calendar year and no more than 18 months after the preceding valuation. The assets will be valued at their fair market value, except that the assets of an employee pension benefit plan to which section 103(b)(3)(A) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1023(b)(3)(A)) applies will be considered to have the value stated in the most recent annual report of the plan.

(iii) *Audits.* (A) At least once during each period of 12 months, the applicant will cause detailed audits of the fiduciary books and records to be made by a qualified public accountant. At that time, the applicant will ascertain whether the fiduciary accounts have been administered in accordance with law, this paragraph, and sound fiduciary principles. The audits shall be conducted in accordance with generally accepted auditing standards, and shall involve whatever tests of the fiduciary books and records of the applicant are considered necessary by the qualified public accountant.

(B) In the case of an applicant which is regulated, supervised, and subject to periodic examination by a State or Federal agency, such applicant may adopt an adequate continuous audit system in lieu of the periodic audits required by paragraph (e)(5)(iii)(A) of this section.

(C) A report of the audits and examinations required under this subdivision, together with the action taken thereon, will be noted in the fiduciary records of the applicant.

(iv) *Funds awaiting investment or distribution.* Funds held in a fiduciary capacity by the applicant awaiting investment or distribution will not be held uninvested or undistributed any longer than is reasonable for the proper management of the account.

(v) *Custody of investments.* (A) Except for investments pooled in a common investment fund in accordance with the provisions of paragraph (e)(5)(vi) of this section, the investments of each account will not be commingled with any other property.

(B) Assets of accounts requiring safekeeping will be deposited in an adequate vault. A permanent record will be kept of assets deposited in or withdrawn from the vault.

(vi) *Common investment funds.* The assets of an account may be pooled in a common investment fund (as defined in paragraph (e)(5)(viii)(C) of this section) if the applicant is authorized under applicable law to administer a common investment fund and if pooling the assets in a common investment fund is not in contravention of the plan documents or applicable law. The common investment fund must be administered as follows:

(A) Each common investment fund must be established and maintained in accordance with a written agreement, containing appropriate provisions as to the manner in which the fund is to be operated, including provisions relating to the investment powers and a general statement of the investment policy of the applicant with respect to the fund; the allocation of income, profits and losses; the terms and conditions governing the admission or withdrawal of participations in the funds; the auditing of accounts of the applicant with respect to the fund; the basis and method of valuing assets held by the fund, setting forth specific criteria for each type of asset; the minimum frequency for valuation of assets of the fund; the period following each such valuation date during which the valuation may be made (which period in usual circumstances may not exceed 10 business days); the basis upon which the fund may be terminated; and such other matters as may be necessary to define clearly the rights of participants in the fund. A copy of the agreement must be available at the principal office of the applicant for inspection during all business hours, and upon request a copy of the agreement must be furnished to the employer, the plan administrator, any participant or beneficiary of an account, or the individual for whose benefit the account is established or that individual’s beneficiary.

(B) All participations in the common investment fund must be on the basis of a proportionate interest in all of the investments.

(C) Not less frequently than once during each period of 3 months the applicant must determine the value of the assets in the fund as of the date set for the valuation of assets. No participation may be admitted to or withdrawn from the fund except (*1*) on the basis of such valuation and (*2*) as of such valuation date. No participation may be admitted to or withdrawn from the fund unless a written request for or notice of intention of taking such action has been entered on or before the valuation date in the fiduciary records of the applicant. No request or notice may be canceled or countermanded after the valuation date.

(D)(*1*) The applicant must at least once during each period of 12 months cause an adequate audit to be made of the common investment fund by a qualified public accountant.

(*2*) The applicant must at least once during each period of 12 months prepare a financial report of the fund which, based upon the above audit, must contain a list of investments in the fund showing the cost and current value of each investment; a statement for the period since the previous report showing purchases, with cost; sales, with profit or loss; any other investment changes; income and disbursements; and an appropriate notation as to any investments in default.

(*3*) The applicant must transmit and certify the accuracy of the financial report to the administrator of each plan participating in the common investment fund within 120 days after the end of the plan year.

(E) When participations are withdrawn from a common investment fund, distributions may be made in cash or ratably in kind, or partly in cash and partly in kind: *Provided,* That all distributions as of any one valuation date must be made on the same basis.

(F) If for any reason an investment is withdrawn in kind from a common investment fund for the benefit of all participants in the fund at the time of such withdrawal and such investment is not distributed ratably in kind, it must be segregated and administered or realized upon for the benefit ratably of all participants in the common investment fund at the time of withdrawal.

(vii) *Books and records.* (A) The applicant must keep its fiduciary records separate and distinct from other records. All fiduciary records must be so kept and retained for as long as the contents thereof may become material in the administration of any internal revenue law. The fiduciary records must contain full information relative to each account.

(B) The applicant must keep an adequate record of all pending litigation to which it is a party in connection with the exercise of fiduciary powers.

(viii) *Definitions.* For purposes of this paragraph (e)(5), and paragraph (e)(2)(v), and paragraph (e)(7) of this section—

(A) The term ''account'' or ''fiduciary account'' means a trust described in section 401(a) (including a custodial account described in section 401(f)), a custodial account described in section 403(b)(7), or an individual retirement account described in section 408(a) (including a custodial account described in section 408(h)).

(B) The term ''plan administrator'' means an administrator as defined in § 1.414(g)–1.

(C) The term ''common investment fund'' means a trust that satisfies the following requirements:

(*1*) The trust consists of all or part of the assets of several accounts that have been established with the applicant, and

(*2*) The trust is described in section 401(a) and is exempt from tax under section 501(a), or is a trust that is created for the purpose of providing a satisfactory diversification of investments or a reduction of administrative expenses for the participating accounts and that satisfies the requirements of section 408(c).

(D) The term ''fiduciary records'' means all matters which are written, transcribed, recorded, received or otherwise come into the possession of the applicant and are necessary to preserve information concerning the acts and events relevant to the fiduciary activities of the applicant.

(E) The term ''qualified public accountant'' means a qualified public accountant, as defined in section 103(a)(3)(D) of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1023(a)(3)(D), who is independent of the applicant.

(F) The term ''net worth'' means the amount of the applicant's assets less the amount of its liabilities, as determined in accordance with generally accepted accounting principles.

(6) *Special rules*—(i) *Passive trustee.* (A) An applicant that undertakes to act only as a passive trustee may be relieved of one or more of the requirements of this paragraph upon clear and convincing proof that such requirements are not germane, under all the facts and circumstances, to the manner in which the applicant will administer any trust. A trustee is a passive trustee only if under the written trust instrument the trustee has no discretion to direct the investment of the trust funds or any other aspect of the business administration of the trust, but is merely authorized to acquire and hold particular investments specified by the trust instrument. Thus, for example, in the case of an applicant that undertakes merely to acquire and hold the stock of regulated investment companies, the requirements of paragraph (e)(5)(i)(A)(*3*) in its place, and (i)(D), and (vi) of this section shall not apply and no negative inference shall be drawn from the applicant's failure to demonstrate its experience of competence with respect to the activities described in paragraph (e)(4)(ii)(E) to (H) of this section.

(B) The notice of approval issued to an applicant that is approved by reason of this subdivision shall state that the applicant is authorized to act only as a passive trustee.

(ii) *Federal or State regulation.* Evidence that an applicant is subject to Federal or State regulation with respect to one or more relevant factors shall be given weight in proportion to the extent that such regulatory standards are consonant with the requirements of section 401. Such evidence may be submitted in addition to, or in lieu of, the specific proofs required by this paragraph.

(iii) *Savings account.* (A) An applicant will be approved to act as trustee under this subdivision if the following requirements are satisfied:

(*1*) The applicant is a credit union, industrial loan company, or other financial institution designated by the Commissioner;

(*2*) The investment of the trust assets will be solely in deposits in the applicant;

(*3*) Deposits in the applicant are insured (up to the dollar limit prescribed by applicable law) by an agency or instrumentality of the United States, or by an organization established under a special statute the business of which is limited to insuring deposits in financial institutions and providing related services.

(B) Any applicant that satisfies the requirements of this subdivision is hereby approved, and (notwithstanding subparagraph (2) of this paragraph) is not required to submit a written application. This approval takes effect on the first day after December 22, 1976, on which the applicant satisfies the requirements of this subdivision, and continues in effect for so long as the applicant continues to satisfy those requirements.

(C) If deposits are insured, but not in the manner provided in paragraph (e)(6)(iii)(A)(*3*) of this section, the applicant must submit an application. The application, notwithstanding subparagraph (2) of this paragraph, will be limited to a complete description of the insurance of applicant's deposits. The applicant will be approved if the Commissioner approves of the applicant's insurance.

(iv) *Notification of Commissioner.* The applicant must notify the Commissioner in writing of any change that affects the continuing accuracy of any representation made in the application required by this paragraph, whether the change occurs before or after the applicant receives a notice of approval. The notification must be addressed to address prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter.

(v) *Substitution of trustee.* No applicant will be approved unless the applicant undertakes to act as trustee only under trust instruments which contain a provision to the effect that the grantor is to substitute another trustee upon notification by the Commissioner that such substitution is required because the applicant has failed to comply with the requirements of this paragraph or is not keeping such records, or making such returns, or rendering such statements as are required by forms or regulations.

(7) *Procedure and administration*—(i) *Notice of approval.* If the applicant is approved, a written notice of approval will be issued to the applicant. The notice of approval will state the day on which it becomes effective, and (except as otherwise provided therein) will remain effective until revoked. This paragraph does not authorize the applicant to accept any fiduciary account before such notice of approval becomes effective.

(ii) *Notice of disapproval.* If the applicant is not approved, a written notice will be furnished to the applicant containing a statement of the reasons why the applicant has not been approved.

(iii) *Copy to be furnished.* The applicant must not accept a fiduciary account until after the plan administrator or the person for whose benefit the account is to be established is furnished with a copy of the written notice of approval issued to the applicant. This provision is effective six months after April 20, 1979 for new accounts accepted thereafter. For accounts accepted before that date, the administrator must be notified before the later of the effective date of this provision or six months after acceptance of the account.

(iv) *Grounds for revocation.* The notice of approval issued to an applicant will be revoked if the Commissioner determines that the applicant is unwilling or unable to administer fiduciary accounts in a manner consistent with the requirements of this paragraph. Generally, the notice will not be revoked unless the Commissioner determines that the applicant has knowingly, willfully, or repeatedly failed to administer fiduciary accounts in a manner consistent with the requirements of this paragraph, or has administered a fiduciary account in a grossly negligent manner.

(v) *Procedures for revocation.* The notice of approval issued to an applicant may be revoked in accordance with the following procedures:

(A) If the Commissioner proposes to revoke the notice of approval issued to an applicant, the Commissioner will advise the applicant in writing of the proposed revocation and of the reasons therefor.

(B) Within 60 days after the receipt of such written advice, the applicant may protest the proposed revocation by submitting a written statement of facts, law, and arguments opposing such revocation to address prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter. In addition, the applicant may request a conference in the National Office.

(C) If the applicant consents to the proposed revocation, either before or after a National Office conference, or if the applicant fails to file a timely protest, the Commissioner will revoke the notice of approval that was issued to the applicant.

(D) If, after considering the applicant's protest and any information developed in conference, the Commissioner determines that the applicant is unwilling or unable to administer fiduciary accounts in a manner consistent with the requirements of this paragraph, the Commissioner will revoke the notice of approval that was issued to the applicant and will furnish the applicant with a written statement of findings on which the revocation is based.

(E) If at any time the Commissioner determines that immediate action is necessary to protect the interest of the Internal Revenue Service or of any fiduciary account, the notice of approval issued to the applicant will be suspended at once, pending a final decision to be based on the applicant's protest and any information developed in conference.

[T.D. 7714, 45 FR 52791, Aug. 8, 1980, as amended by T.D. 8635, 60 FR 65549, Dec. 20, 1995; 61 FR 11307, Mar. 20, 1996]

§ 1.408–3 Individual retirement annuities.

(a) *In general.* An individual retirement annuity is an annuity contract or endowment contract (described in paragraph (e)(1) of this section) issued by an insurance company which is qualified to do business under the law of the jurisdiction in which the contract is sold and which satisfies the requirements of paragraph (b) of this section. A participation certificate in a group contract issued by an insurance company described in this paragraph will be treated as an individual retirement annuity if the contract satisfies the requirements of paragraph (b) of this section; the certificate of participation sets forth the requirements of paragraphs (1) through (5) of section 408 (b); the contract provides for a separate accounting of the benefit allocable to each participant-owner; and the group contract is for the exclusive benefit of the participant owners and their beneficiaries. For purposes of this title, a participant-owner of a group contract described in this paragraph shall be treated as the owner of an individual retirement annuity. A contract will not be treated as other than an individual retirement annuity merely because it provides for waiver of premium on disability. An individual retirement annuity contract which satisfies the requirements of section 408 (b) need not be purchased under a trust if the requirements of paragraph (b) of this section are satisfied. An individual retirement endowment contract may not be held under a trust which satisfies the requirements of section 408 (a). Distribution of the contract is not a taxable event. Distributions under the contract are includible in gross income in accordance with the provisions of §1.408–4 (e).

(b) *Requirements*—(1) *Transferability*. The annuity or the endowment contract must not be transferable by the owner. An annuity or endowment contract is transferable if the owner can transfer any portion of his interest in the contract to any person other than the issuer thereof. Accordingly, such a contract is transferable if the owner can sell, assign, discount, or pledge as collateral for a loan or as security for the performance of an obligation or for any other purpose his interest in the contract to any person other than the issuer thereof. On the other hand, a contract is not to be considered transferable merely because the contract contains: a provision permitting the individual to designate a beneficiary to receive the proceeds in the event of his death, a provision permitting the individual to elect a joint and survivor annuity, or other similar provisions.

(2) *Annual premium*. Except in the case of a contribution to a simplified employee pension described in section 408 (k), the annual premium on behalf of any individual for the annuity or the endowment contract cannot exceed $1,500. Any refund of premiums must be applied before the close of the calendar year following the year of the refund toward the payment of future premiums or the purchase of additional benefits.

(3) *Distribution*. The entire interest of the owner must be distributed to him in the same manner and over the same period as described in §1.408–2 (b) (6).

(4) *Distribution upon death*. If the owner dies before the entire interest has been distributed to him, or if distribution has commenced to the surviving spouse, the remaining interest must be distributed in the same manner, over the same period, and to the same beneficiaries as described in §1.408–2 (b) (7).

(5) *Nonforfeitability*. The entire interest of the owner in the annuity or endowment contract must be nonforfeitable.

(6) *Flexible premium*. [Reserved]

(c) *Disqualification*. If during any taxable year the owner of an annuity borrows any money under the annuity or endowment contract or by use of such contract (including, but not limited to, pledging the contract as security for any loan), such contract will cease to be an individual retirement annuity as of the first day of such taxable year, and will not be an individual retirement annuity at any time thereafter. If an annuity or endowment contract which constitutes an individual retirement annuity is disqualified as a result of the preceding sentence, an amount equal to the fair market value of the contract as of the first day of the taxable year of the owner in which such contract is disqualified is deemed to be distributed to the owner. Such owner shall include in gross income for such year an amount equal to the fair market value of such contract as of such first day. The preceding sentence applies even though part of the fair market value of the individual retirement annuity as of the first day of the taxable year is attributable to excess contributions which may be returned tax-free under section 408(d)(4) or 408(d)(5).

(d) *Premature distribution tax on deemed distribution.* If the individual has not attained age 59½ before the beginning of the year in which the disqualification described in paragraph (c) of this section occurs, see section 408(f)(2) for additional tax on premature distributions.

(e) *Endowment contracts*—(1) *Additional requirement for endowment contracts.* No contract providing life insurance protection issued by a company described in paragraph (a) of this section shall be treated as an endowment contract for purposes of this section if—

(i) Such contract matures later than the taxable year in which the individual in whose name the contract is purchased attains the age of 70½;

(ii) Such contract is not for the exclusive benefit of such individual or his beneficiaries;

(iii) Premiums under the contract may increase over the term of the contract;

(iv) When all premiums are paid when due, the case value of such contract at maturity is less than the death benefit payable under the contract at any time before maturity;

(v) The death benefit does not, at some time before maturity, exceed the greater of the cash value or the sum of premiums paid under the contract;

(vi) Such contract does not provide for a cash value;

(vii) Such contract provides that the life insurance element of such contract may increase over the term of such contract, unless such increase is merely because such contract provides for the purchase of additional benefits;

(viii) Such contract provides insurance other than life insurance and waiver of premiums upon disability; or

(ix) Such contract is issued after November 6, 1978.

(2) *Treatment of proceeds under endowment contract upon death of individual.* In the case of the payment of a death benefit under an endowment contract upon the death of the individual in whose name the contract is purchased, the portion of such payment which is equal to the cash value immediately before the death of such individual is not excludable from gross income under section 101(a) and is treated as a distribution from an individual retirement annuity. The remaining portion, if any, of such payment constitutes current life insurance protection and is excludable under section 101(a). If a death benefit is paid under an endowment contract at a date or dates later than the death of the individual, section 101(d) is applicable only to the portion of the benefit which is attributable to the amount excludable under section 101(a).

[T.D. 7714, 45 FR 52792, Aug. 8, 1980]

§ 1.408–4 Treatment of distributions from individual retirement arrangements.

(a) *General rule*—(1) *Inclusion in income.* Except as otherwise provided in this section, any amount actually paid or distributed or deemed paid or distributed from an individual retirement account or individual retirement annuity shall be included in the gross income of the payee or distributee for the taxable year in which the payment or distribution is received.

(2) *Zero basis.* Notwithstanding section 1015(d) or any other provision of the Code, the basis (or investment in the contract) of any person in such an account or annuity is zero. For purposes of this section, an assignment of an individual's rights under an individual retirement account or an individual retirement annuity shall, except as provided in § 1.408–4(g) (relating to transfer incident to divorce), be deemed a distribution to such individual from such account or annuity of the amount assigned.

(b) *Rollover contribution*—(1) *To individual retirement arrangement.* Paragraph (a)(1) of this section shall not apply to any amount paid or distributed from an individual retirement account or individual retirement annuity to the individual for whose benefit the account was established or who is the owner of the annuity if the entire amount received (including the same amount of money and any other property) is paid into an individual retirement account, annuity (other than an endowment contract), or bond created for the benefit of such individual not later than the 60th day after the day on which he receives the payment or distribution.

(2) *To qualified plan.* Paragraph (a)(1) of this section does not apply to any amount paid or distributed from an individual retirement account or individual retirement annuity to the individual for whose benefit the account was established or who is the owner of the annuity if—

(i) No amount in the account or no part of the value of the annuity is attributable to any source other than a rollover contribution from an employees' trust described in section 401(a) which is exempt from tax under section 501(a) or a rollover contribution from an annuity plan described in section 403(a) and the earnings on such sums, and

(ii) The entire amount received (including the same amount of money and any other property) represents the entire amount in the account and is paid into another such trust or plan (for the benefit of such individual) not later than the 60th day after the day on which the payment or distribution is received.

This subparagraph does not apply if any portion of the rollover contribution described in paragraph (b)(2)(i) of this section is attributable to an employees' trust forming part of a plan or an annuity under which the individual was an employee within the meaning of section 401(c)(1) at the time contributions were made on his behalf under the plan.

(3) *To section 403(b) contract.* [Reserved]

(4) *Frequency limitation.* (i) For taxable years beginning on or before December 31, 1977, paragraph (b)(1) of this section does not apply to any amount received by an individual from an individual retirement account, annuity or bond if at any time during the 3-year period ending on the day of receipt, the individual received any other amount from an individual retirement account, annuity or bond which was not includible in his gross income because of the application of paragraph (b)(1) of this section.

(ii) [Reserved]

(c) *Excess contributions returned before due date of return*—(1) *Excess contribution.* For purposes of this paragraph, excess contributions are the excess of the amounts contributed to an individual retirement account or paid for an individual retirement annuity during the taxable year over the amount allowable as a deduction under section 219 or 220 for the taxable year.

(2) *General rule.* (i) Paragraph (a)(1) of this section does not apply to the distribution of any excess contribution paid during a taxable year to an account or annuity if: the distribution is received on or before the date prescribed by law (including extensions) for filing the individual's return for such taxable year; no deduction is allowed under section 219 or section 220 with respect to the excess contribution; and the distribution is accompanied by the amount of net income attributable to the excess contribution as of the date of the distribution as determined under subdivision (ii).

(ii) The amount of net income attributable to the excess contributions is an amount which bears the same ratio to the net income earned by the account during the computation period as the excess contribution bears to the sum of the balance of the account as of the first day of the taxable year in which the excess contribution is made and the total contribution made for such taxable year. For purposes of this paragraph, the term ''computation period'' means the period beginning on the first day of the taxable year in which the excess contribution is made and ending on the date of the distribution from the account.

(iii) For purposes of paragraph (c)(2)(ii), the net income earned by the account during the computation period is the fair market value of the balance of the account immediately after the distribution increased by the amount of distributions from the account during the computation period, and reduced (but not below zero) by the sum of: (A) the fair market value of the balance of the account as of the first day of the taxable year in which the excess contribution is made and (B) the contributions to the account made during the computation period.

(3) *Time of inclusion.* (i) For taxable years beginning before January 1, 1977, the amount of net income determined under subparagraph (2) is includible in the gross income of the individual for the taxable year in which it is received. The amount of net income thus distributed is subject to the tax imposed by section 408(f)(1) for the year includible in gross income.

(ii) [Reserved]

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

Example. On January 1, 1975, A, age 55, who is a calendar-year taxpayer, contributes $1,500 to an individual retirement account established for his benefit. For 1975, A is entitled to a deduction of $1,400 under section 219. For 1975, A does not claim as deductions any other items listed in section 62. A's gross income for 1975 is $9,334. On April 1, 1976, $107 is distributed to A from his individual retirement account. As of such date, the balance of the account is $1,498 [$1,605 − $107]. There were no other distributions from the account as of such date. The net amount of income earned by the account is $105 [$1,498 + $107 − (0 + $1,500)]. The net income attributable to the excess contribution is $7. [$105 × ($100/$1,500)]. A's adjusted gross income for 1975 is his gross income for 1975 ($9,334) reduced by the amount allowable to A as a deduction under section 219 ($1,400), or $7,934. A will include the $7 of the $107 distributed on April 1, 1976, in his gross income for 1976. Further, A will pay an additional income tax of $.70 for 1976 under section 408(f)(1).

(d) *Deemed distribution*—(1) *General rule.* In any case in which an individual retirement account ceases to be an individual retirement account by reason of the application of section 408(e)(2), paragraph (a)(1) of this section shall apply as if there were a distribution on the first day of the taxable year in which such account ceases to be an individual retirement account of an amount equal to the fair market value on such day of all of the assets in the account on such day. In the case of a deemed distribution from an individual retirement annuity, see § 1.408–3(d).

(2) *Using account as security.* In any case in which an individual for whose benefit an individual retirement account is established uses, directly or indirectly, all or any portion of the account as security for a loan, paragraph (a)(1) of this section shall apply as if there were distributed on the first day of the taxable year in which the loan was made an amount equal to that portion of the account used as security for such loan.

(e) *Distribution of annuity contracts.* Paragraph (a)(1) of this section does not apply to any annuity contract which is distributed from an individual retirement account and which satisfies the requirements of paragraphs (b) (1), (3), (4) and (5) of section 408. Amounts distributed under such contracts will be taxable to the distributee under section 72. For purposes of applying section 72 to a distribution from such a contract, the investment in such contract is zero.

(f) *Treatment of assets distributed from an individual retirement account for the purchase of an endowment contract.* Under section 408(e)(5), if all, or any portion, of the assets of an individual retirement account are used to purchase an endowment contract described in § 1.408–3(e) for the benefit of the individual for whose benefit the account is established—

(1) The excess, if any, of the total amount of assets used to purchase such contract over the portion of the assets attributable to life insurance protection shall be treated as a rollover contribution described in section 408(d)(3), and

(2) The portion of the assets attributable to life insurance protection shall be treated as a distribution described in paragraph (a)(91) of this section, except that the provisions of section 408(f) shall not apply to such amount.

(g) *Transfer incident to divorce*—(1) *General rule.* The transfer of an individual's interest, in whole or in part, in an individual retirement account, individual retirement annuity, or a retirement bond, to his former spouse under a valid divorce decree or a written instrument incident to such divorce shall not be considered to be a distribution from such an account or annuity to such individual or his former spouse; nor shall it be considered a taxable transfer by such individual to his former spouse notwithstanding any other provision of Subtitle A of the Code.

(2) *Spousal account.* The interest described in this paragraph (g) which is

transferred to the former spouse shall be treated as an individual retirement account of such spouse if the interest is an individual retirement account; an individual retirement annuity of such spouse if such interest is an individual retirement annuity; and a retirement bond of such spouse if such interest is a retirement bond.

[T.D. 7714, 45 FR 52793, Aug. 8, 1980]

§1.408–5 Annual reports by trustees or issuers.

(a) *In general.* The trustee of an individual retirement account or the issuer of an individual retirement annuity shall make annual calendar year reports concerning the status of the account or annuity. The report shall contain the information required in paragraph (b) and be furnished or filed in the manner and time specified in paragraph (c).

(b) *Information required to be included in the annual reports.* The annual calendar year report shall contain the following information for transactions occurring during the calendar year—

(1) The amount of contributions;

(2) The amount of distributions;

(3) In the case of an endowment contract, the amount of the premium paid allocable to the cost of life insurance;

(4) The name and address of the trustee or issuer; and

(5) Such other information as the Commissioner may require.

(c) *Manner and time for filing.* (1) The annual report shall be furnished to the individual on whose behalf the account is established or in whose name the annuity is purchased (or the beneficiary of the individual or owner). The report shall be furnished on or before the 30th day of June following the calendar year for which the report is required.

(2) The Commissioner may require the annual report to be filed with the Service at the time the Commissioner specifies.

(d) *Penalties.* Section 6693 prescribes penalties for failure to file the annual report.

(e) *Effective date.* This section shall apply to reports for calendar years after 1978.

(f) *Reports for years prior to 1979.* For years prior to 1979, a trustee or issuer shall make reports in the time and manner as the Commissioner requires.

[T.D. 7714, 45 FR 52795, Aug. 8, 1980]

§1.408–6 Disclosure statements for individual retirement arrangements.

(a) *In general*—(1) *General rule.* Trustees and issuers of individual retirement accounts and annuities are, under the authority of section 408(i), required to provide disclosure statements. This section sets forth these requirements.

(2) [Reserved]

(b)–(c) [Reserved]

(d) *Requirements.* (1)—(3) [Reserved]

(4) *Disclosure statements*—(i) Under the authority contained in section 408(i), a disclosure statement shall be furnished in accordance with the provisions of this subparagraph by the trustee of an individual retirement account described in section 408(a) or the issuer of an individual retirement annuity described in section 408(b) or of an endowment contract described in section 408(b) to the individual (hereinafter referred to as the ‘‘benefited individual’’) for whom such an account, annuity, or contract is, or is to be, established.

(ii)(A)*(1)* The trustee or issuer shall furnish, or cause to be furnished, to the benefited individual, a disclosure statement satisfying the requirements of subdivisions (iii) through (viii) of this subparagraph, as applicable, and a copy of the governing instrument to be used in establishing the account, annuity, or endowment contract. The copy of such governing instrument need not be filled in with financial and other data pertaining to the benefited individual; however, such copy must be complete in all other respects. The disclosure statement and copy of the governing instrument must be received by the benefited individual at least seven days preceding the earlier of the date of establishment or purchase of the account, annuity, or endowment contract. A disclosure statement or copy of the governing instrument required by this subparagraph may be received by the benefited individual less than seven days preceding, but no later than, the earlier of the date of establishment or purchase, if the benefited individual is permitted to revoke the account, annuity, or endowment contract pursuant to a procedure which satisfies the requirements of subdivision (ii)(A)(*2*) of this subparagraph.

(*2*) A procedure for revocation satisfies the requirements of this subdivision (ii)(A)(*2*) of this subparagraph if the benefited individual is permitted to revoke the account, or endowment contract by mailing or delivering, at his option, a notice of revocation on or before a day not less than seven days after the earlier of the date of establishment or purchase and, upon revocation, is entitled to a return of the entire amount of the consideration paid by him for the account, annuity, or endowment contract without adjustment for such items as sales commissions, administrative expenses or fluctuation in market value. The procedure may require that the notice be in writing or that it be oral, or it may require both a written and an oral notice. If an oral notice is required or permitted, the procedure must permit it to be delivered by telephone call during normal business hours. If a written notice is required or permitted, the procedure must provide that, if mailed, it shall be deemed mailed on the date of the postmark (or if sent by certified or registered mail, the date of certification or registration) if it is deposited in the mail in the United States in an envelope, or other appropriate wrapper, first class postage prepaid, properly addressed.

(B) If after a disclosure statement has been furnished, or caused to be furnished, to the benefited individual pursuant to paragraph (d)(4)(ii)(A) of this section and—

(*1*) On or before the earlier of the date of establishment or purchase, or

(*2*) On or before the last day on which the benefited individual is permitted to revoke the account, annuity, or endowment contract (if the benefited individual has a right to revoke the account, annuity, or endowment contract pursuant to the rules of subdivision (ii)(A) of this subparagraph).

there becomes effective a material adverse change in the information set forth in such disclosure statement or a material change in the governing instrument to be used in establishing the account, annuity, or contract, the trustee or issuer shall furnish, or cause to be furnished, to the benefited individual such amendments to any previously furnished disclosure statement or governing instrument as may be necessary to adequately inform the benefited individual of such change. The trustee or issuer shall be treated as satisfying this subdivision (ii)(B) of this subparagraph only if material required to be furnished by this subdivision is received by the benefited individual at least seven days preceding the earlier of the date of establishment or purchase of the account, annuity, or endowment contract or if the benefited individual is permitted to revoke the account, annuity, or endowment contract on or before a date not less than seven days after the date on which such material is received, pursuant to a procedure for revocation otherwise satisfying the provisions of subdivision (ii)(A)(*2*) of this subparagraph.

(C) If the governing instrument is amended after the account, annuity, or endowment contract is no longer subject to revocation pursuant to subdivision (ii)(A) or (B) of this subparagraph, the trustee or issuer shall not later than the 30th day after the later of the date on which the amendment is adopted or becomes effective, deliver or mail to the last known address of the benefited individual a copy of such amendment and, if such amendment affects a matter described in subdivisions (iii) through (viii) of this subparagraph, a disclosure statement with respect to such matter meeting the requirements of subdivision (iv) of this subparagraph.

(D) For purposes of subdivision (ii) (A) and (B) of this subparagraph, if a disclosure statement, governing instrument, or an amendment to either, is mailed to the benefited individual, it shall be deemed (in the absence of evidence to the contrary) to be received by the benefited individual seven days after the date of mailing.

(E) In the case of a trust described in section 408(c) (relating to certain retirement savings arrangements for employees or members of associations of employees), the following special rules shall be applied:

(*1*) For purposes of this subparagraph, references to the benefited individual's account, annuity, or endowment contract shall refer to the benefited individual's interest in such trust, and

(*2*) The provisions of subdivision (ii) of this subparagraph shall be applied by substituting ‘‘the date on which the benefited individual's interest in such trust commences'' for ‘‘the earlier of the date of establishment or purchase'' wherever it appear therein.

Thus, for example, if an employer establishes a trust described in section 408(c) for the benefit of employees, and the trustee furnishes an employee with a disclosure statement and a copy of the governing instrument (as required by this subparagraph) on the date such employee's interest in the trust commences, such employee must be given a right to revoke such interest within a period of at least seven days. If any contribution has been made within such period (whether by the employee or by the employer), the full amount of such contribution must be paid to such employee pursuant to subdivision (ii)(A)(*2*) of this subparagraph.

(iii) The disclosure statement required by this subparagraph shall set forth in nontechnical language the following matters as such matters relate to the account, annuity, or endowment contract (as the case may be);

(A) Concise explanations of—

(*1*) The statutory requirements prescribed in section 408(a) (relating to an individual retirement account) or section 408(b) (relating to an individual retirement annuity and an endowment contract), and any additional requirements (whether or not required by law) that pertain to the particular retirement savings arrangement.

(*2*) The income tax consequences of establishing an account, annuity, or endowment contract (as the case may be) which meets the requirements of section 408(a) relating to an individual retirement account) or section 408(b) (relating to an individual retirement annuity and an endowment contract), including the deductibility of contributions to, the tax treatment of distributions (other than premature distributions) from, the availability of income tax free rollovers to and from, and the tax status of such account, annuity, or endowment contract.

(*3*) The limitations and restrictions on the deduction for retirement savings under section 219, including the ineligibility of certain individuals who are active participants in a plan described in section 219(b)(2)(A) or for whom amounts are contributed under a contract described in section 219(b)(2)(B) to make deductible contributions to an account or for an annuity or endowment contract.

(*4*) The circumstances under which the benefited individual may revoke the account, annuity, or endowment contract, and the procedure therefor (including the name, address, and telephone number of the person designated to receive notice of such revocation). Such explanation shall be prominently displayed at the beginning of the disclosure statement.

(B) Statements to the effect that—

(*1*) If the benefited individual or his beneficiary engages in a prohibited transaction, described in section 4975(c) with respect to an individual retirement account, the account will lose its exemption from tax by reason of section 408(e)(2)(A), and the benefited individual must include in gross income, for the taxable year during which the benefited individual or his beneficiary engages in the prohibited transaction the fair market value of the account.

(*2*) If the owner of an individual retirement annuity or endowment contract described in section 408(b) borrows any money under, or by use of, such annuity or endowment contract, then, under section 408(e)(3), such annuity or endowment contract loses its section 408(b) classification, and the owner must include in gross income, for the taxable year during which the owner borrows any money under, or by use of, such annuity or endowment contract, the fair market value of the annuity or endowment contract.

(*3*) If a benefited individual uses all or any portion of an individual retirement account as security for a loan, then, under section 408(e)(4), the portion so used is treated as distributed to such individual and the benefited individual must include such distribution in gross income for the taxable year during which he so uses such account.

(*4*) An additional tax of 10 percent is imposed by section 408(f) on distributions (including amounts deemed distributed as the result of a prohibited loan or use as security for a loan) made before the benefited individual has attained age 59½, unless such distribution is made on account of death or disability, or unless a rollover contribution is made with such distribution.

(*5*) Sections 2039(e) (relating to exemption from estate tax of annuities under certain trusts and plans) and 2517 (relating to exemption from gift tax of specified transfers of certain annuities under qualified plans) apply (including the manner in which such sections apply) to the account, annuity, or endowment contract.

(*6*) Section 402(a)(2) and (e) (relating to tax on lump sum distributions) is not applicable to distributions from an account, annuity, or endowment contract.

(*7*) A minimum distribution is required under section 408(a) (6) or (7) and 408(b) (3) or (4) (including a brief explanation of the amount of minimum distribution) and that if the amount distributed from an account, annuity, or endowment contract during the taxable year of the payee is less than the minimum required during such year, an excise tax, which shall be paid by the payee, is imposed under section 4974, in an amount equal to 50 percent of the excess of the minimum required to be distributed over the amount actually distributed during the year.

(*8*) An excise tax is imposed under section 4973 on excess contributions (including a brief explanation of an excess contribution).

(*9*) The benefited individual must file Form 5329 (Return for Individual Retirement Savings Arrangement) with the Internal Revenue for each taxable year during which the account, annuity, or endowment contract is maintained.

(*10*) The account or contract has or has not (as the case may be) been approved as to form for use as an account, annuity, or endowment contract by the Internal Revenue Service. For purposes of this subdivision, if a favorable opinion or determination letter with respect to the form of a prototype trust, custodial account, annuity, or endowment contract has been issued by the Internal Revenue Service, or the instrument which establishes an individual retirement trust account or an individual retirement custodial account utilizes the precise language of a form currently provided by the Internal Revenue Service (including any additional language permitted by such form), such account or contract may be treated as approved as to form.

(*11*) The Internal Revenue Service approval is a determination only as to the form of the account, annuity, or endowment contract, and does not represent a determination of the merits of such account, annuity, or endowment contract.

(*12*) The proceeds from the account, annuity or endowment contract may be used by the benefited individual as a rollover contribution to another account or annuity or retirement bond in accordance with the provisions of section 408(d)(3).

(*13*) In the case of an endowment contract described in section 408(b), no deduction is allowed under section 219 for that portion of the amounts paid under the contract for the taxable year properly allocable to the cost of life insurance.

(*14*) If applicable, in the event that the benefited individual revokes the account, annuity, or endowment contract, pursuant to the procedure described in the disclosure statement (see subdivision (A)(*4*) of this subdivision (iii)), the benefited individual is entitled to a return of the entire amount of the consideration paid by him for the account, annuity, or endowment contract without adjustment for such items as sales commissions, administrative expenses or fluctuation in market value.

(*15*) Further information can be obtained from any district office of the Internal Revenue Service.

To the extent that information on the matters described in subdivisions (iii) (A) and (B) of this subparagraph is provided in a publication of the Internal Revenue Service relating to individual retirement savings arrangements, such publication may be furnished by the trustee or issuer in lieu of providing information relating to such matters in a disclosure statement.

(C) The financial disclosure required by paragraph (d)(4) (v), (vi), and (vii) of this section.

(iv) In the case of an amendment to the terms of an account, annuity, or endowment contract described in paragraph (d)(4)(i) of this section, the disclosure statement required by this subparagraph need not repeat material contained in the statement furnished pursuant to paragraph (d)(4)(iii) of this section, but it must set forth in nontechnical language those matters described in paragraph (d)(4)(iii) of this section which are affected by such amendment.

(v) With respect to an account, annuity, or endowment contract described in paragraph (d)(4)(i) of this section (other than an account or annuity which is to receive only a rollover contribution described in paragraph (d)(4)(vi) of this section and to which no deductible contributions will be made), the disclosure statement must set forth in cases where either an amount is guaranteed over period of time (such as in the case of a nonparticipating endowment or annuity contract), or a projection of growth of the value of the account, annuity, or endowment contract can reasonably be made (such as in the case of a participating endowment or annuity contract (other than a variable annuity) or passbook savings account), the following:

(A) To the extent that an amount is guaranteed,

(*1*) The amount, determined without regard to any portion of a contribution which is not deductible, that would be guaranteed to be available to the benefited individual if (*i*) level annual contributions in the amount of $1,000 were to be made on the first day of each year, and (*ii*) the benefited individual were to withdraw in a single sum the entire amount of such account, annuity, or endowment contract at the end of each of the first five years during which contributions are to be made, at the end of the year in which the benefited individual attains the ages of 60, 65, and 70, and at the end of any other year during which the increase of the guaranteed available amount is less than the increase of the guaranteed available amount during any preceding year for any reason other than decrease of cessation of contributions, and

(*2*) A statement that the amount described in subdivision (v)(A)(*1*) of this subparagraph is guaranteed, and the period for which guaranteed;

(B) To the extent a projection of growth of the value of the account, annuity, or endowment contract can reasonably be made but the amounts are not guaranteed.

(*1*) The amount, determined without regard to any portion of a contribution which is not deductible, and upon the basis of an earnings rate no greater than, and terms no different from, those currently in effect, that would be available to the benefited individual if (*i*) level annual contributions in the amount of $1,000 were to be made on the first day of each year, and (*ii*) the benefited individual were to withdraw in a single sum the entire amount of such account, annuity, or endowment contract at the end of each of the first five years during which contributions are to be made, at the end of each of the years in which the benefited individual attains the ages of 60, 65, and 70, and at the end of any other year during which the increase of the available amount is less than the increase of the available amount during any preceding year for any reason other than decrease or cessation of contributions, and

(*2*) A statement that the amount described in paragraph (d)(4)(v)(B)(*1*) of this section is a projection and is not guaranteed and a statement of the earnings rate and terms on the basis of which the projection is made;

(C) The portion of each $1,000 contribution attributable to the cost of life insurance, which would not be deductible, for each year during which contributions are to be made; and

(D) The sales commission (including any commission attributable to the sale of life insurance), if any, to be charged in each year, expressed as a percentage of gross annual contributions (including any portion attributable to the cost of life insurance) to be made for each year.

(vi) With respect to an account or annuity described in paragraph (d)(4)(i) of this section to which a rollover contribution described in section 402(a)(5)(A), 403(a)(4)(A), 408(d)(3)(A) or 409(b)(3)(C) will be made, the disclosure statement must set forth, in cases where an amount is guaranteed over a period of time (such as in the case of a non-participating annuity contract, or a projection of growth of the value of the account or annuity can reasonably be made (such as in the case of a participating annuity contract (other than a variable annuity) or a passbook savings account), the following:

(A) To the extent guaranteed,

(1) The amount that would be guaranteed to be available to the benefited individual if *(i)* Such a rollover contribution in the amount of $1,000 were to be made on the first day of the year, *(ii)* No other contribution were to be made, and *(iii)* The benefited individual were to withdraw in a single sum the entire amount of such account or annuity at the end of each of the first five years after the contribution is made, at the end of the year in which the benefited individual attains the ages of 60, 65, and 70, and at the end of any other year during which the increase of the guaranteed available amount is less than the increase of the guaranteed available amount during any preceding year, and

(2) A statement that the amount described in paragraph (d)(vi)(A)(*1*) of this section is guaranteed;

(B) To the extent that a projection of growth of the value of the account or annuity can reasonably be made but the amounts are not guaranteed,

(1) The amount, determined upon the basis of an earnings rate no greater than, and terms no different from, those currently in effect, that would be available to the benefited individual if *(i)* such a rollover contribution in the amount of $1,000 were to be made on the first day of the year, *(ii)* no other contribution were to be made, and *(iii)* the benefited individual were to withdraw in a single sum the entire amount of such account or annuity at the end of each of the first five years after the contribution is made, at the end of each of the years in which the benefited individual attains the ages 60, 65, 70, and at the end of any other year during which the increase of the available amount is less than the increase of the available amount during any preceding year, and

(2) A statement that the amount described in paragraph (d)(4)(vi)(B) *(1)* of this section is a projection and is not guaranteed and a statement of the earnings rate and terms on the basis of which the projection is made; and

(C) The sales commission, if any, to be charged in each year, expressed as a percentage of the assumed $1,000 contribution.

(vii) With respect to an account, annuity, or endowment contract described in paragraph (d)(4)(i) of this section, in all cases not subject to paragraph (d)(4) (v) or (vi) of this section (such as in the case of a mutual fund or variable annuity), the disclosure statement must set forth information described in subdivisions (A) through (C) of this subdivisions (vii) based (as applicable with respect to the type or types of contributions to be received by the account, annuity, or endowment contract) upon the assumption of (1) level annual contributions of $1,000 on the first day of each year, (2) a rollover contribution of $1,000 on the first day of the year and no other contributions, or (3) a rollover contribution of $1,000 on the first day of the year plus level annual contributions of $1,000 on the first day of each year.

(A) A description (in nontechnical language) with respect to the benefited individual's interest in the account, annuity, or endowment contract, of:

(1) Each type of charge, and the amount thereof, which may be made against a contribution,

(2) The method for computing and allocating annual earnings, and

(*3*) Each charge (other than those described in complying with paragraph (d)(4)(vii)(A)(*1*) of this section) which may be applied to such interest in determining the net amount of money available to the benefited individual and the method of computing each such charge;

(B) A statement that growth in value of the account, annuity, or endowment contract is neither guaranteed nor projected; and

(C) The portion of each $1,000 contribution attributable to the cost of life insurance, which would not be deductible, for every year during which contributions are to be made.

(viii) A disclosure statement, or an amendment thereto, furnished pursuant to the provisions of this subparagraph may contain information in addition to that required by paragraph (d)(4)(iii) through (vii) of this section. However, such disclosure statement will not be considered to comply with the provisions of this subparagraph if the substance of such additional material or the form in which it is presented causes such disclosure statement to be false or misleading with respect to the information required to be disclosed by this paragraph.

(ix) The provisions of section 6693, relating to failure to provide reports on individual retirement accounts or annuities, shall apply to any trustee or issuer who fails to furnish, or cause to be furnished, a disclosure statement, a copy of the governing instrument, or an amendment to either, as required by this paragraph.

(x) This section shall be effective for disclosure statements and copies of governing instruments mailed, or delivered without mailing, after February 14, 1977.

(xi) This section does not reflect the amendments made by section 1501 of the Tax Reform Act of 1976 (90 Stat. 1734) relating to retirement savings for certain married individuals.

[T.D. 7714, 45 FR 52795, Aug. 8, 1980; 45 FR 56802, Aug. 26, 1980]

§1.408–7 Reports on distributions from individual retirement plans.

(a) *Requirement of report.* The trustee of an individual retirement account or the issuer of an individual retirement annuity who makes a distribution during any calendar year to an individual from such account or under such annuity shall make a report on Form W–2P (in the case of distributions that are not total distributions) or Form 1099R (in the case of total distributions), and their related transmittal forms, for such year. The return must show the name and address of the person to whom the distribution was made, the aggregate amount of such distribution, and such other information as is required by the forms.

(b) *Amount subject to this section.* The amounts subject to reporting under paragraph (a) include all amounts distributed or made available to which section 408(d) applies.

(c) *Time and place for filing.* The report required under this section for any calendar year shall be filed after the close of that year and on or before February 28 of the following year with the appropriate Internal Revenue Service Center.

(d) *Statement to recipients.* (1) Each trustee or issuer required to file Form 1099R or Form W–2P under this section shall furnish to the person whose identifying number is (or should be) shown on the forms a copy of the form.

(2) Each statement required by this paragraph to be furnished to recipients shall be furnished to such person after November 30 of the year of the distribution and on or before January 31 of the following year.

(e) *Effective date.* This section is effective for calendar years beginning after December 31, 1977.

[T.D. 7714, 45 FR 52798, Aug. 8, 1980]

§1.408A–0 Roth IRAs; table of contents.

This table of contents lists the regulations relating to Roth IRAs under section 408A of the Internal Revenue Code as follows:

§1.408A–1 Roth IRAs in general.
§1.408A–2 Establishing Roth IRAs.
§1.408A–3 Contributions to Roth IRAs.
§1.408A–4 Converting amounts to Roth IRAs.
§1.408A–5 Recharacterized contributions.
§1.408A–6 Distributions.
§1.408A–7 Reporting.
§1.408A–8 Definitions.
§1.408A–9 Effective date.

[T.D. 8816, 64 FR 5601, Feb. 4, 1999]

§1.408A–1 Roth IRAs in general.

This section sets forth the following questions and answers that discuss the background and general features of Roth IRAs:

Q–1. What is a Roth IRA?

A–1. (a) A Roth IRA is a new type of individual retirement plan that individuals can use, beginning in 1998. Roth IRAs are described in section 408A, which was added by the Taxpayer Relief Act of 1997 (TRA 97), Public Law 105–34 (111 Stat. 788).

(b) Roth IRAs are treated like traditional IRAs except where the Internal

Revenue Code specifies different treatment. For example, aggregate contributions (other than by a conversion or other rollover) to all an individual's Roth IRAs are not permitted to exceed $2,000 for a taxable year. Further, income earned on funds held in a Roth IRA is generally not taxable. Similarly, the rules of section 408(e), such as the loss of exemption of the account where the owner engages in a prohibited transaction, apply to Roth IRAs in the same manner as to traditional IRAs.

Q–2. What are the significant differences between traditional IRAs and Roth IRAs?

A–2. There are several significant differences between traditional IRAs and Roth IRAs under the Internal Revenue Code. For example, eligibility to contribute to a Roth IRA is subject to special modified AGI (adjusted gross income) limits; contributions to a Roth IRA are never deductible; qualified distributions from a Roth IRA are not includible in gross income; the required minimum distribution rules under section 408(a)(6) and (b)(3) (which generally incorporate the provisions of section 401(a)(9)) do not apply to a Roth IRA during the lifetime of the owner; and contributions to a Roth IRA can be made after the owner has attained age 70½.

[T.D. 8816, 64 FR 5601, Feb. 4, 1999]

§ 1.408A–2 Establishing Roth IRAs.

This section sets forth the following questions and answers that provide rules applicable to establishing Roth IRAs:

Q–1. Who can establish a Roth IRA?

A–1. Except as provided in A–3 of this section, only an individual can establish a Roth IRA. In addition, in order to be eligible to contribute to a Roth IRA for a particular year, an individual must satisfy certain compensation requirements and adjusted gross income limits (see § 1.408A–3 A–3).

Q–2. How is a Roth IRA established?

A–2. A Roth IRA can be established with any bank, insurance company, or other person authorized in accordance with § 1.408–2(e) to serve as a trustee with respect to IRAs. The document establishing the Roth IRA must clearly designate the IRA as a Roth IRA, and this designation cannot be changed at a later date. Thus, an IRA that is designated as a Roth IRA cannot later be treated as a traditional IRA. However, see § 1.408A–4 A–1(b)(3) for certain rules for converting a traditional IRA to a Roth IRA with the same trustee by redesignating the traditional IRA as a Roth IRA, and see § 1.408A–5 for rules for recharacterizing certain IRA contributions.

Q–3. Can an employer or an association of employees establish a Roth IRA to hold contributions of employees or members?

A–3. Yes. Pursuant to section 408(c), an employer or an association of employees can establish a trust to hold contributions of employees or members made under a Roth IRA. Each employee's or member's account in the trust is treated as a separate Roth IRA that is subject to the generally applicable Roth IRA rules. The employer or association of employees may do certain acts otherwise required by an individual, for example, establishing and designating a trust as a Roth IRA.

Q–4. What is the effect of a surviving spouse of a Roth IRA owner treating an IRA as his or her own?

A–4. If the surviving spouse of a Roth IRA owner treats a Roth IRA as his or her own as of a date, the Roth IRA is treated from that date forward as though it were established for the benefit of the surviving spouse and not the original Roth IRA owner. Thus, for example, the surviving spouse is treated as the Roth IRA owner for purposes of applying the minimum distribution requirements under section 408(a)(6) and (b)(3). Similarly, the surviving spouse is treated as the Roth IRA owner rather than a beneficiary for purposes of determining the amount of any distribution from the Roth IRA that is includible in gross income and whether the distribution is subject to the 10-percent additional tax under section 72(t).

[T.D. 8816, 64 FR 5601, Feb. 4, 1999]

§ 1.408A–3 Contributions to Roth IRAs.

This section sets forth the following questions and answers that provide rules regarding contributions to Roth IRAs:

Q–1. What types of contributions are permitted to be made to a Roth IRA?

A–1. There are two types of contributions that are permitted to be made to a Roth IRA: regular contributions and qualified rollover contributions (including conversion contributions). The term regular contributions means contributions other than qualified rollover contributions.

Q–2. When are contributions permitted to be made to a Roth IRA?

A–2. (a) The provisions of section 408A are effective for taxable years beginning on or after January 1, 1998. Thus, the first taxable year for which contributions are permitted to be made to a Roth IRA by an individual is the individual's taxable year beginning in 1998.

(b) Regular contributions for a particular taxable year must generally be contributed by the due date (not including extensions) for filing a Federal income tax return for that taxable year. (See §1.408A–5 regarding recharacterization of certain contributions.)

Q–3. What is the maximum aggregate amount of regular contributions an individual is eligible to contribute to a Roth IRA for a taxable year?

A–3. (a) The maximum aggregate amount that an individual is eligible to contribute to all his or her Roth IRAs as a regular contribution for a taxable year is the same as the maximum for traditional IRAs: $2,000 or, if less, that individual's compensation for the year.

(b) For Roth IRAs, the maximum amount described in paragraph (a) of this A–3 is phased out between certain levels of modified AGI. For an individual who is not married, the dollar amount is phased out ratably between modified AGI of $95,000 and $110,000; for a married individual filing a joint return, between modified AGI of $150,000 and $160,000; and for a married individual filing separately, between modified AGI of $0 and $10,000. For this purpose, a married individual who has lived apart from his or her spouse for the entire taxable year and who files separately is treated as not married. Under section 408A(c)(3)(A), in applying the phase-out, the maximum amount is rounded up to the next higher multiple of $10 and is not reduced below $200 until completely phased out.

(c) If an individual makes regular contributions to both traditional IRAs and Roth IRAs for a taxable year, the maximum limit for the Roth IRA is the lesser of—

(1) The amount described in paragraph (a) of this A–3 reduced by the amount contributed to traditional IRAs for the taxable year; and

(2) The amount described in paragraph (b) of this A–3. Employer contributions, including elective deferrals, made under a SEP or SIMPLE IRA Plan on behalf of an individual (including a self-employed individual) do not reduce the amount of the individual's maximum regular contribution.

(d) The rules in this A–3 are illustrated by the following examples:

Example 1. In 1998, unmarried, calendar-year taxpayer B, age 60, has modified AGI of $40,000 and compensation of $5,000. For 1998, B can contribute a maximum of $2,000 to a traditional IRA, a Roth IRA or a combination of traditional and Roth IRAs.

Example 2. The facts are the same as in *Example 1.* However, assume that B violates the maximum regular contribution limit by contributing $2,000 to a traditional IRA and $2,000 to a Roth IRA for 1998. The $2,000 to B's Roth IRA would be an excess contribution to B's Roth IRA for 1998 because an individual's contributions are applied first to a traditional IRA, then to a Roth IRA.

Example 3. The facts are the same as in *Example 1,* except that B's compensation is $900. The maximum amount B can contribute to either a traditional IRA or a Roth (or a combination of the two) for 1998 is $900.

Example 4. In 1998, unmarried, calendar-year taxpayer C, age 60, has modified AGI of $100,000 and compensation of $5,000. For 1998, C contributes $800 to a traditional IRA and $1,200 to a Roth IRA. Because C's $1,200 Roth IRA contribution does not exceed the phased-out maximum Roth IRA contribution of $1,340 and because C's total IRA contributions do not exceed $2,000, C's Roth IRA contribution does not exceed the maximum permissible contribution.

Q–4. How is compensation defined for purposes of the Roth IRA contribution limit?

A–4. For purposes of the contribution limit described in A–3 of this section, an individual's compensation is the same as that used to determine the maximum contribution an individual can make to a traditional IRA. This amount is defined in section 219(f)(1) to include wages, commissions, professional fees, tips, and other amounts received for personal services, as well as taxable alimony and separate maintenance payments received under a decree of divorce or separate maintenance. Compensation also includes earned income as defined in section 401(c)(2), but does not include any amount received as a pension or annuity or as deferred compensation. In addition, under section 219(c), a married individual filing a joint return is permitted to make an IRA contribution by treating his or her spouse's higher compensation as his or her own, but only to the extent that the spouse's compensation is not being used for purposes of the spouse making a contribution to a Roth IRA or a deductible contribution to a traditional IRA.

Q–5. What is the significance of modified AGI and how is it determined?

A–5. Modified AGI is used for purposes of the phase-out rules described in A–3 of this section and for purposes of the $100,000 modified AGI limitation described in § 1.408A–4 A–2(a) (relating to eligibility for conversion). As defined in section 408A(c)(3)(C)(i), modified AGI is the same as adjusted gross income under section 219(g)(3)(A) (used to determine the amount of deductible contributions that can be made to a traditional IRA by an individual who is an active participant in an employer-sponsored retirement plan), except that any conversion is disregarded in determining modified AGI. For example, the deduction for contributions to an IRA is not taken into account for purposes of determining adjusted gross income under section 219 and thus does not apply in determining modified AGI for Roth IRA purposes.

Q–6. Is a required minimum distribution from an IRA for a year included in income for purposes of determining modified AGI?

A–6. (a) Yes. For taxable years beginning before January 1, 2005, any required minimum distribution from an IRA under section 408(a)(6) and (b)(3) (which generally incorporate the provisions of section 401(a)(9)) is included in income for purposes of determining modified AGI.

(b) For taxable years beginning after December 31, 2004, and solely for purposes of the $100,000 limitation applicable to conversions, modified AGI does not include any required minimum distributions from an IRA under section 408(a)(6) and (b)(3).

Q–7. Does an excise tax apply if an individual exceeds the aggregate regular contribution limits for Roth IRAs?

A–7. Yes. Section 4973 imposes an annual 6-percent excise tax on aggregate amounts contributed to Roth IRAs that exceed the maximum contribution limits described in A–3 of this section. Any contribution that is distributed, together with net income, from a Roth IRA on or before the tax return due date (plus extensions) for the taxable year of the contribution is treated as not contributed. Net income described in the previous sentence is includible in gross income for the taxable year in which the contribution is made. Aggregate excess contributions that are not distributed from a Roth IRA on or before the tax return due date (with extensions) for the taxable year of the contributions are reduced as a deemed Roth IRA contribution for each subsequent taxable year to the extent that the Roth IRA owner does not actually make regular IRA contributions for such years. Section 4973 applies separately to an individual's Roth IRAs and other types of IRAs.

[T.D. 8816, 64 FR 5601, Feb. 4, 1999]

§ 1.408A–4 Converting amounts to Roth IRAs.

This section sets forth the following questions and answers that provide rules applicable to Roth IRA conversions:

Q–1. Can an individual convert an amount in his or her traditional IRA to a Roth IRA?

A–1. (a) Yes. An amount in a traditional IRA may be converted to an amount in a Roth IRA if two requirements are satisfied. First, the IRA owner must satisfy the modified AGI limitation described in A–2(a) of this section and, if married, the joint filing requirement described in A–2(b) of this section. Second, the amount contributed to the Roth IRA must satisfy the definition of a qualified rollover contribution in section 408A(e) (i.e., it must satisfy the requirements for a rollover contribution as defined in section 408(d)(3), except that the one-rollover-per-year limitation in section 408(d)(3)(B) does not apply).

(b) An amount can be converted by any of three methods—

(1) An amount distributed from a traditional IRA is contributed (rolled over) to a Roth IRA within the 60-day period described in section 408(d)(3)(A)(i);

(2) An amount in a traditional IRA is transferred in a trustee-to-trustee transfer from the trustee of the traditional IRA to the trustee of the Roth IRA; or

(3) An amount in a traditional IRA is transferred to a Roth IRA maintained by the same trustee. For purposes of sections 408 and 408A, redesignating a traditional IRA as a Roth IRA is treated as a transfer of the entire account balance from a traditional IRA to a Roth IRA.

(c) Any converted amount is treated as a distribution from the traditional IRA and a qualified rollover contribution to the Roth IRA for purposes of section 408 and section 408A, even if the conversion is accomplished by means of a trustee-to-trustee transfer or a transfer between IRAs of the same trustee.

(d) A transaction that is treated as a failed conversion under §1.408A–5 A–9(a)(1) is not a conversion.

Q–2. What are the modified AGI limitation and joint filing requirements for conversions?

A–2. (a) An individual with modified AGI in excess of $100,000 for a taxable year is not permitted to convert an amount to a Roth IRA during that taxable year. This $100,000 limitation applies to the taxable year that the funds are paid from the traditional IRA, rather than the year they are contributed to the Roth IRA.

(b) If the individual is married, he or she is permitted to convert an amount to a Roth IRA during a taxable year only if the individual and the individual's spouse file a joint return for the taxable year that the funds are paid from the traditional IRA. In this case, the modified AGI subject to the $100,000 limit is the modified AGI derived from the joint return using the couple's combined income. The only exception to this joint filing requirement is for an individual who has lived apart from his or her spouse for the entire taxable year. If the married individual has lived apart from his or her spouse for the entire taxable year, then such individual can treat himself or herself as not married for purposes of this paragraph, file a separate return and be subject to the $100,000 limit on his or her separate modified AGI. In all other cases, a married individual filing a separate return is not permitted to convert an amount to a Roth IRA, regardless of the individual's modified AGI.

Q–3. Is a remedy available to an individual who makes a failed conversion?

A–3. (a) Yes. See §1.408A–5 for rules permitting a failed conversion amount to be recharacterized as a contribution to a traditional IRA. If the requirements in §1.408A–5 are satisfied, the failed conversion amount will be treated as having been contributed to the traditional IRA and not to the Roth IRA.

(b) If the contribution is not recharacterized in accordance with §1.408A–5, the contribution will be treated as a regular contribution to the Roth IRA and, thus, an excess contribution subject to the excise tax under section 4973 to the extent that it exceeds the individual's regular contribution limit. This is the result regardless of which of the three methods described in A–1(b) of this section applies to this transaction. Additionally, the distribution from the traditional IRA will not be eligible for the 4-year spread and will be subject to the additional tax under section 72(t) (unless an exception under that section applies).

Q–4. Do any special rules apply to a conversion of an amount in an individual's SEP IRA or SIMPLE IRA to a Roth IRA?

A–4. (a) An amount in an individual's SEP IRA can be converted to a Roth IRA on the same terms as an amount in any other traditional IRA.

(b) An amount in an individual's SIMPLE IRA can be converted to a Roth IRA on the same terms as a conversion from a traditional IRA, except that an amount distributed from a SIMPLE IRA during the 2-year period described in section 72(t)(6), which begins on the date that the individual first participated in any SIMPLE IRA Plan maintained by the individual's employer, cannot be converted to a Roth IRA. Pursuant to section 408(d)(3)(G), a distribution of an amount from an individual's SIMPLE IRA during this 2-year period is not eligible to be rolled over into an IRA that is not a SIMPLE IRA and thus cannot be a qualified rollover contribution. This 2-year period of section 408(d)(3)(G) applies separately to the contributions of each of an individual's employers maintaining a SIMPLE IRA Plan.

(c) Once an amount in a SEP IRA or SIMPLE IRA has been converted to a Roth IRA, it is treated as a contribution to a Roth IRA for all purposes. Future contributions under the SEP or under the SIMPLE IRA Plan may not be made to the Roth IRA.

Q–5. Can amounts in other kinds of retirement plans be converted to a Roth IRA?

A–5. No. Only amounts in another IRA can be converted to a Roth IRA. For example, amounts in a qualified plan or annuity plan described in section 401(a) or 403(a) cannot be converted directly to a Roth IRA. Also, amounts held in an annuity contract or account described in section 403(b) cannot be converted directly to a Roth IRA.

Q–6. Can an individual who has attained at least age 70½ by the end of a calendar year convert an amount distributed from a traditional IRA during that year to a Roth IRA before receiving his or her required minimum distribution with respect to the traditional IRA for the year of the conversion?

A–6. (a) No. In order to be eligible for a conversion, an amount first must be eligible to be rolled over. Section 408(d)(3) prohibits the rollover of a required minimum distribution. If a minimum distribution is required for a year with respect to an IRA, the first dollars distributed during that year are treated as consisting of the required minimum distribution until an amount equal to the required minimum distribution for that year has been distributed.

(b) As provided in A–1(c) of this section, any amount converted is treated as a distribution from a traditional IRA and a rollover contribution to a Roth IRA and not as a trustee-to-trustee transfer for purposes of section 408 and section 408A. Thus, in a year for which a minimum distribution is required (including the calendar year in which the individual attains age 70½), an individual may not convert the assets of an IRA (or any portion of those assets) to a Roth IRA to the extent that the required minimum distribution for the traditional IRA for the year has not been distributed.

(c) If a required minimum distribution is contributed to a Roth IRA, it is treated as having been distributed, subject to the normal rules under section 408(d)(1) and (2), and then contributed as a regular contribution to a Roth IRA. The amount of the required minimum distribution is not a conversion contribution.

Q–7. What are the tax consequences when an amount is converted to a Roth IRA?

A–7. (a) Any amount that is converted to a Roth IRA is includible in gross income as a distribution according to the rules of section 408(d)(1) and (2) for the taxable year in which the amount is distributed or transferred from the traditional IRA. Thus, any portion of the distribution or transfer that is treated as a return of basis under section 408(d)(1) and (2) is not includible in gross income as a result of the conversion.

(b) The 10-percent additional tax under section 72(t) generally does not apply to the taxable conversion amount. But see §1.408A–6 A–5 for circumstances under which the taxable conversion amount would be subject to the additional tax under section 72(t).

(c) Pursuant to section 408A(e), a conversion is not treated as a rollover for purposes of the one-rollover-per-year rule of section 408(d)(3)(B).

Q–8. Is there an exception to the income-inclusion rule described in A–7 of this section for 1998 conversions?

A–8. Yes. In the case of a distribution (including a trustee-to-trustee transfer) from a traditional IRA on or before December 31, 1998, that is converted to a Roth IRA, instead of having the entire taxable conversion amount includible in income in 1998, an individual includes in gross income for 1998 only one quarter of that amount and one quarter of that amount for each of the next 3 years. This 4-year spread also applies if the conversion amount was distributed in 1998 and contributed to the Roth IRA within the 60-day period described in section 408(d)(3)(A)(i), but after December 31, 1998. However, see §1.408A–6 A–6 for special rules requiring acceleration of inclusion if an amount subject to the 4-year spread is distributed from the Roth IRA before 2001.

Q–9. Is the taxable conversion amount included in income for all purposes?

A–9. Except as provided below, any taxable conversion amount includible in gross income for a year as a result of the conversion (regardless of whether the individual is using a 4-year spread) is included in income for all purposes. Thus, for example, it is counted for purposes of determining the taxable portion of social security payments under section 86 and for purposes of determining the phase-out of the $25,000 exemption under section 469(i) relating to the disallowance of passive activity losses from rental real estate activities. However, as provided in §1.408A–3 A–5, the taxable conversion amount (and any resulting change in other elements of adjusted gross income) is disregarded for purposes of determining modified AGI for section 408A.

Q–10. Can an individual who makes a 1998 conversion elect not to have the 4-year spread apply and instead have the full taxable conversion amount includible in gross income for 1998?

A–10. Yes. Instead of having the taxable conversion amount for a 1998 conversion included over 4 years as provided under A–8 of this section, an individual can elect to include the full taxable conversion amount in income for 1998. The election is made on Form 8606 and cannot be made or changed after the due date (including extensions) for filing the 1998 Federal income tax return.

Q–11. What happens when an individual who is using the 4-year spread dies, files separately, or divorces before the full taxable conversion amount has been included in gross income?

A–11. (a) If an individual who is using the 4-year spread described in A–8 of this section dies before the full taxable conversion amount has been included in gross income, then the remainder must be included in the individual's gross income for the taxable year that includes the date of death.

(b) However, if the sole beneficiary of all the decedent's Roth IRAs is the decedent's spouse, then the spouse can elect to continue the 4-year spread. Thus, the spouse can elect to include in gross income the same amount that the decedent would have included in each of the remaining years of the 4-year period. Where the spouse makes such an election, the amount includible under the 4-year spread for the taxable year that includes the date of the decedent's death remains includible in the decedent's gross income and is reported on the decedent's final Federal income tax return. The election is made on either Form 8606 or Form 1040, in accordance with the instructions to the applicable form, for the taxable year that includes the decedent's date of death and cannot be changed after the due date (including extensions) for filing the Federal income tax return for the spouse's taxable year that includes the decedent's date of death.

(c) If a Roth IRA owner who is using the 4-year spread and who was married in 1998 subsequently files separately or divorces before the full taxable conversion amount has been included in gross income, the remainder of the taxable conversion amount must be included in the Roth IRA owner's gross income over the remaining years in the 4-year period (unless accelerated because of distribution or death).

Q–12. Can an individual convert a traditional IRA to a Roth IRA if he or she is receiving substantially equal periodic payments within the meaning of section 72(t)(2)(A)(iv) from that traditional IRA?

A–12. Yes. Not only is the conversion amount itself not subject to the early distribution tax under section 72(t), but the conversion amount is also not treated as a distribution for purposes of determining whether a modification within the meaning of section

72(t)(4)(A) has occurred. Distributions from the Roth IRA that are part of the original series of substantially equal periodic payments will be nonqualified distributions from the Roth IRA until they meet the requirements for being a qualified distribution, described in § 1.408A–6 A–1(b). The additional 10-percent tax under section 72(t) will not apply to the extent that these nonqualified distributions are part of a series of substantially equal periodic payments. Nevertheless, to the extent that such distributions are allocable to a 1998 conversion contribution with respect to which the 4-year spread for the resultant income inclusion applies (see A–8 of this section) and are received during 1998, 1999, or 2000, the special acceleration rules of § 1.408A–6 A–6 apply. However, if the original series of substantially equal periodic payments does not continue to be distributed in substantially equal periodic payments from the Roth IRA after the conversion, the series of payments will have been modified and, if this modification occurs within 5 years of the first payment or prior to the individual becoming disabled or attaining age 59½, the taxpayer will be subject to the recapture tax of section 72(t)(4)(A).

Q–13. Can a 1997 distribution from a traditional IRA be converted to a Roth IRA in 1998?

A–13. No. An amount distributed from a traditional IRA in 1997 that is contributed to a Roth IRA in 1998 would not be a conversion contribution. See A–3 of this section regarding the remedy for a failed conversion.

[T.D. 8816, 64 FR 5603, Feb. 4, 1999]

§ 1.408A–5 Recharacterized contributions.

This section sets forth the following questions and answers that provide rules regarding recharacterizing IRA contributions:

Q–1. Can an IRA owner recharacterize certain contributions (i.e., treat a contribution made to one type of IRA as made to a different type of IRA) for a taxable year?

A–1. (a) Yes. In accordance with section 408A(d)(6), except as otherwise provided in this section, if an individual makes a contribution to an IRA (the FIRST IRA) for a taxable year and then transfers the contribution (or a portion of the contribution) in a trustee-to-trustee transfer from the trustee of the FIRST IRA to the trustee of another IRA (the SECOND IRA), the individual can elect to treat the contribution as having been made to the SECOND IRA, instead of to the FIRST IRA, for Federal tax purposes. A transfer between the FIRST IRA and the SECOND IRA will not fail to be a trustee-to-trustee transfer merely because both IRAs are maintained by the same trustee. For purposes of section 408A(d)(6), redesignating the FIRST IRA as the SECOND IRA will be treated as a transfer of the entire account balance from the FIRST IRA to the SECOND IRA.

(b) This recharacterization election can be made only if the trustee-to-trustee transfer from the FIRST IRA to the SECOND IRA is made on or before the due date (including extensions) for filing the individual's Federal income tax return for the taxable year for which the contribution was made to the FIRST IRA. For purposes of this section, a conversion that is accomplished through a rollover of a distribution from a traditional IRA in a taxable year that, 60 days after the distribution (as described in section 408(d)(3)(A)(i)), is contributed to a Roth IRA in the next taxable year is treated as a contribution for the earlier taxable year.

Q–2. What is the proper treatment of the net income attributable to the amount of a contribution that is being recharacterized?

A–2. (a) The net income attributable to the amount of a contribution that is being recharacterized must be transferred to the SECOND IRA along with the contribution.

(b) If the amount of the contribution being recharacterized was contributed to a separate IRA and no distributions or additional contributions have been made from or to that IRA at any time, then the contribution is recharacterized by the trustee of the FIRST IRA transferring the entire account balance of the FIRST IRA to the trustee of the SECOND IRA. In this case, the net income (or loss) attributable to the contribution being recharacterized is the difference between the amount of the original contribution and the amount transferred.

(c) If paragraph (b) of this A–2 does not apply, then the net income attributable to the amount of a contribution is calculated in the manner prescribed by §1.408–4(c)(2)(ii) (disregarding the parenthetical clause in §1.408–4(c)(2)(iii)).

Q–3. What is the effect of recharacterizing a contribution made to the FIRST IRA as a contribution made to the SECOND IRA?

A–3. The contribution that is being recharacterized as a contribution to the SECOND IRA is treated as having been originally contributed to the SECOND IRA on the same date and (in the case of a regular contribution) for the same taxable year that the contribution was made to the FIRST IRA. Thus, for example, no deduction would be allowed for a contribution to the FIRST IRA, and any net income transferred with the recharacterized contribution is treated as earned in the SECOND IRA, and not the FIRST IRA.

Q–4. Can an amount contributed to an IRA in a tax-free transfer be recharacterized under A–1 of this section?

A–4. No. If an amount is contributed to the FIRST IRA in a tax-free transfer, the amount cannot be recharacterized as a contribution to the SECOND IRA under A–1 of this section. However, if an amount is erroneously rolled over or transferred from a traditional IRA to a SIMPLE IRA, the contribution can subsequently be recharacterized as a contribution to another traditional IRA.

Q–5. Can an amount contributed by an employer under a SIMPLE IRA Plan or a SEP be recharacterized under A–1 of this section?

A–5. No. Employer contributions (including elective deferrals) under a SIMPLE IRA Plan or a SEP cannot be recharacterized as contributions to another IRA under A–1 of this section. However, an amount converted from a SEP IRA or SIMPLE IRA to a Roth IRA may be recharacterized under A–1 of this section as a contribution to a SEP IRA or SIMPLE IRA, including the original SEP IRA or SIMPLE IRA.

Q–6. How does a taxpayer make the election to recharacterize a contribution to an IRA for a taxable year?

A–6. (a) An individual makes the election described in this section by notifying, on or before the date of the transfer, both the trustee of the FIRST IRA and the trustee of the SECOND IRA, that the individual has elected to treat the contribution as having been made to the SECOND IRA, instead of the FIRST IRA, for Federal tax purposes. The notification of the election must include the following information: the type and amount of the contribution to the FIRST IRA that is to be recharacterized; the date on which the contribution was made to the FIRST IRA and the year for which it was made; a direction to the trustee of the FIRST IRA to transfer, in a trustee-to-trustee transfer, the amount of the contribution and net income allocable to the contribution to the trustee of the SECOND IRA; and the name of the trustee of the FIRST IRA and the trustee of the SECOND IRA and any additional information needed to make the transfer.

(b) The election and the trustee-to-trustee transfer must occur on or before the due date (including extensions) for filing the individual's Federal income tax return for the taxable year for which the recharacterized contribution was made to the FIRST IRA, and the election cannot be revoked after the transfer. An individual who makes this election must report the recharacterization, and must treat the contribution as having been made to the SECOND IRA, instead of the FIRST IRA, on the individual's Federal income tax return for the taxable year described in the preceding sentence in accordance with the applicable Federal tax forms and instructions.

(c) The election to recharacterize a contribution described in this A–6 may be made on behalf of a deceased IRA owner by his or her executor, administrator, or other person responsible for filing the final Federal income tax return of the decedent under section 6012(b)(1).

Q–7. If an amount is initially contributed to an IRA for a taxable year, then is moved (with net income attributable to the contribution) in a tax-free transfer to another IRA (the FIRST IRA for purposes of A–1 of this section), can the tax-free transfer be disregarded, so that the initial contribution that is transferred from the FIRST IRA to the SECOND IRA is treated as a recharacterization of that initial contribution?

A–7. Yes. In applying section 408A(d)(6), tax-free transfers between IRAs are disregarded. Thus, if a contribution to an IRA for a year is followed by one or more tax-free transfers between IRAs prior to the recharacterization, then for purposes of section 408A(d)(6), the contribution is treated as if it remained in the initial IRA. Consequently, an individual may elect to recharacterize an initial contribution made to the initial IRA that was involved in a series of tax-free transfers by making a trustee-to-trustee transfer from the last IRA in the series to the SECOND IRA. In this case the contribution to the SECOND IRA is treated as made on the same date (and for the same taxable year) as the date the contribution being recharacterized was made to the initial IRA.

Q–8. If a contribution is recharacterized, is the recharacterization treated as a rollover for purposes of the one-rollover-per-year limitation of section 408(d)(3)(B)?

A–8. No, recharacterizing a contribution under A–1 of this section is never treated as a rollover for purposes of the one-rollover-per-year limitation of section 408(d)(3)(B), even if the contribution would have been treated as a rollover contribution by the SECOND IRA if it had been made directly to the SECOND IRA, rather than as a result of a recharacterization of a contribution to the FIRST IRA.

Q–9. If an IRA owner converts an amount from a traditional IRA to a Roth IRA and then transfers that amount back to a traditional IRA in a recharacterization, may the IRA owner subsequently reconvert that amount from the traditional IRA to a Roth IRA?

A–9. (a)(1) Except as otherwise provided in paragraph (b) of this A–9, an IRA owner who converts an amount from a traditional IRA to a Roth IRA during any taxable year and then transfers that amount back to a traditional IRA by means of a recharacterization may not reconvert that amount from the traditional IRA to a Roth IRA before the beginning of the taxable year following the taxable year in which the amount was converted to a Roth IRA or, if later, the end of the 30-day period beginning on the day on which the IRA owner transfers the amount from the Roth IRA back to a traditional IRA by means of a recharacterization (regardless of whether the recharacterization occurs during the taxable year in which the amount was converted to a Roth IRA or the following taxable year). Thus, any attempted reconversion of an amount prior to the time permitted under this paragraph (a)(1) is a failed conversion of that amount. However, see § 1.408A–4 A–3 for a remedy available to an individual who makes a failed conversion.

(2) For purposes of paragraph (a)(1) of this A–9, a failed conversion of an amount resulting from a failure to satisfy the requirements of § 1.408A–4 A–1(a) is treated as a conversion in determining whether an IRA owner has previously converted that amount.

(b)(1) An IRA owner who converts an amount from a traditional IRA to a Roth IRA during taxable year 1998 and then transfers that amount back to a traditional IRA by means of a recharacterization may reconvert that amount once (but no more than once) on or after November 1, 1998 and on or before December 31, 1998; the IRA owner may also reconvert that amount once (but no more than once) during 1999. The rule set forth in the preceding sentence applies without regard to whether the IRA owner's initial conversion or recharacterization of the amount occurred before, on, or after November 1, 1998. An IRA owner who converts an amount from a traditional IRA to a Roth IRA during taxable year 1999 that has not been converted previously and then transfers that amount back to a traditional IRA by means of a recharacterization may reconvert that amount once (but no more than once) on or before December 31, 1999. For purposes of this paragraph (b)(1), a failed conversion of an amount resulting from a failure to satisfy the requirements of § 1.408A–4 A–1(a) is not treated as a conversion in determining whether an IRA owner has previously converted that amount.

(2) A reconversion by an IRA owner during 1998 or 1999 for which the IRA owner is not eligible under paragraph (b)(1) of this A–9 will be deemed an excess reconversion (rather than a failed conversion) and will not change the IRA owner's taxable conversion amount. Instead, the excess reconversion and the last preceding recharacterization will not be taken into account for purposes of determining the IRA owner's taxable conversion amount, and the IRA owner's taxable conversion amount will be based on the last reconversion that was not an excess reconversion (unless, after the excess reconversion, the amount is transferred back to a traditional IRA by means of a recharacterization). An excess reconversion will otherwise be treated as a valid reconversion.

(3) For purposes of this paragraph (b), any reconversion that an IRA owner made before November 1, 1998 will not be treated as an excess reconversion and will not be taken into account in determining whether any later reconversion is an excess reconversion.

(c) In determining the portion of any amount held in a Roth IRA or a traditional IRA that an IRA owner may not reconvert under this A–9, any amount previously converted (or reconverted) is adjusted for subsequent net income thereon.

Q–10. Are there examples to illustrate the rules in this section?

A–10. The rules in this section are illustrated by the following examples:

Example 1. In 1998, Individual C converts the entire amount in his traditional IRA to a Roth IRA. Individual C thereafter determines that his modified AGI for 1998 exceeded $100,000 so that he was ineligible to have made a conversion in that year. Accordingly, prior to the due date (plus extensions) for filing the individual's Federal income tax return for 1998, he decides to recharacterize the conversion contribution. He instructs the trustee of the Roth IRA (FIRST IRA) to transfer in a trustee-to-trustee transfer the amount of the contribution, plus net income, to the trustee of a new traditional IRA (SECOND IRA). The individual notifies the trustee of the FIRST IRA and the trustee of the SECOND IRA that he is recharacterizing his IRA contribution (and provides the other information described in A–6 of this section). On the individual's Federal income tax return for 1998, he treats the original amount of the conversion as having been contributed to the SECOND IRA and not the Roth IRA. As a result, for Federal tax purposes, the contribution is treated as having been made to the SECOND IRA and not to the Roth IRA. The result would be the same if the conversion amount had been transferred in a tax-free transfer to another Roth IRA prior to the recharacterization.

Example 2. In 1998, an individual makes a $2,000 regular contribution for 1998 to his traditional IRA (FIRST IRA). Prior to the due date (plus extensions) for filing the individual's Federal income tax return for 1998, he decides that he would prefer to contribute to a Roth IRA instead. The individual instructs the trustee of the FIRST IRA to transfer in a trustee-to-trustee transfer the amount of the contribution, plus attributable net income, to the trustee of a Roth IRA (SECOND IRA). The individual notifies the trustee of the FIRST IRA and the trustee of the SECOND IRA that he is recharacterizing his $2,000 contribution for 1998 (and provides the other information described in A–6 of this section). On the individual's Federal income tax return for 1998, he treats the $2,000 as having been contributed to the Roth IRA for 1998 and not to the traditional IRA. As a result, for Federal tax purposes, the contribution is treated as having been made to the Roth IRA for 1998 and not to the traditional IRA. The result would be the same if the conversion amount had been transferred in a tax-free transfer to another traditional IRA prior to the recharacterization.

Example 3. The facts are the same as in *Example 2,* except that the $2,000 regular contribution is initially made to a Roth IRA and the recharacterizing transfer is made to a traditional IRA. On the individual's Federal income tax return for 1998, he treats the $2,000 as having been contributed to the traditional IRA for 1998 and not the Roth IRA. As a result, for Federal tax purposes, the contribution is treated as having been made to the traditional IRA for 1998 and not the Roth IRA. The result would be the same if the contribution had been transferred in a tax-free transfer to another Roth IRA prior to the recharacterization, except that the only Roth IRA trustee the individual must notify is the one actually making the recharacterization transfer.

Example 4. In 1998, an individual receives a distribution from traditional IRA 1 and contributes the entire amount to traditional IRA 2 in a rollover contribution described in section 408(d)(3). In this case, the individual cannot elect to recharacterize the contribution by transferring the contribution amount, plus net income, to a Roth IRA, because an amount contributed to an IRA in a tax-free transfer cannot be recharacterized. However, the individual may convert (other than by recharacterization) the amount in traditional IRA 2 to a Roth IRA at any time, provided the requirements of § 1.408A–4 A–1 are satisfied.

[T.D. 8816, 64 FR 5605, Feb. 4, 1999]

§ 1.408A–6 Distributions.

This section sets forth the following questions and answers that provide rules regarding distributions from Roth IRAs:

Q–1. How are distributions from Roth IRAs taxed?

A–1. (a) The taxability of a distribution from a Roth IRA generally depends on whether or not the distribution is a qualified distribution. This A–1 provides rules for qualified distributions and certain other nontaxable distributions. A–4 of this section provides rules for the taxability of distributions that are not qualified distributions.

(b) A distribution from a Roth IRA is not includible in the owner's gross income if it is a qualified distribution or to the extent that it is a return of the owner's contributions to the Roth IRA (determined in accordance with A–8 of this section). A qualified distribution is one that is both—

(1) Made after a 5-taxable-year period (defined in A–2 of this section); and

(2) Made on or after the date on which the owner attains age 59½, made to a beneficiary or the estate of the owner on or after the date of the owner's death, attributable to the owner's being disabled within the meaning of section 72(m)(7), or to which section 72(t)(2)(F) applies (exception for first-time home purchase).

(c) An amount distributed from a Roth IRA will not be included in gross income to the extent it is rolled over to another Roth IRA on a tax-free basis under the rules of sections 408(d)(3) and 408A(e).

(d) Contributions that are returned to the Roth IRA owner in accordance with section 408(d)(4) (corrective distributions) are not includible in gross income, but any net income required to be distributed under section 408(d)(4) together with the contributions is includible in gross income for the taxable year in which the contributions were made.

Q–2. When does the 5-taxable-year period described in A–1 of this section (relating to qualified distributions) begin and end?

A–2. The 5-taxable-year period described in A–1 of this section begins on the first day of the individual's taxable year for which the first regular contribution is made to any Roth IRA of the individual or, if earlier, the first day of the individual's taxable year in which the first conversion contribution is made to any Roth IRA of the individual. The 5-taxable-year period ends on the last day of the individual's fifth consecutive taxable year beginning with the taxable year described in the preceding sentence. For example, if an individual whose taxable year is the calendar year makes a first-time regular Roth IRA contribution any time between January 1, 1998, and April 15, 1999, for 1998, the 5-taxable-year period begins on January 1, 1998. Thus, each Roth IRA owner has only one 5-taxable-year period described in A–1 of this section for all the Roth IRAs of which he or she is the owner. Further, because of the requirement of the 5-taxable-year period, no qualified distributions can occur before taxable years beginning in 2003. For purposes of this A–2, the amount of any contribution distributed as a corrective distribution under A–1(d) of this section is treated as if it was never contributed.

Q–3. If a distribution is made to an individual who is the sole beneficiary of his or her deceased spouse's Roth IRA and the individual is treating the Roth IRA as his or her own, can the distribution be a qualified distribution based on being made to a beneficiary on or after the owner's death?

A–3. No. If a distribution is made to an individual who is the sole beneficiary of his or her deceased spouse's Roth IRA and the individual is treating the Roth IRA as his or her own, then, in accordance with § 1.408A–2 A–4, the distribution is treated as coming from the individual's own Roth IRA and not the deceased spouse's Roth IRA. Therefore, for purposes of determining whether the distribution is a qualified distribution, it is not treated as made to a beneficiary on or after the owner's death.

Q–4. How is a distribution from a Roth IRA taxed if it is not a qualified distribution?

A–4. A distribution that is not a qualified distribution, and is neither contributed to another Roth IRA in a qualified rollover contribution nor constitutes a corrective distribution, is includible in the owner's gross income to the extent that the amount of the distribution, when added to the amount of all prior distributions from the owner's Roth IRAs (whether or not they were qualified distributions) and reduced by the amount of those prior distributions previously includible in gross income, exceeds the owner's contributions to all his or her Roth IRAs. For purposes of this A–4, any amount distributed as a corrective distribution is treated as if it was never contributed.

Q–5. Will the additional tax under 72(t) apply to the amount of a distribution that is not a qualified distribution?

A–5. (a) The 10-percent additional tax under section 72(t) will apply (unless the distribution is excepted under section 72(t)) to any distribution from a Roth IRA includible in gross income.

(b) The 10-percent additional tax under section 72(t) also applies to a nonqualified distribution, even if it is not then includible in gross income, to the extent it is allocable to a conversion contribution, if the distribution is made within the 5-taxable-year period beginning with the first day of the individual's taxable year in which the conversion contribution was made. The 5-taxable-year period ends on the last day of the individual's fifth consecutive taxable year beginning with the taxable year described in the preceding sentence. For purposes of applying the tax, only the amount of the conversion contribution includible in gross income as a result of the conversion is taken into account. The exceptions under section 72(t) also apply to such a distribution.

(c) The 5-taxable-year period described in this A–5 for purposes of determining whether section 72(t) applies to a distribution allocable to a conversion contribution is separately determined for each conversion contribution, and need not be the same as the 5-taxable-year period used for purposes of determining whether a distribution is a qualified distribution under A–1(b) of this section. For example, if a calendar-year taxpayer who received a distribution from a traditional IRA on December 31, 1998, makes a conversion contribution by contributing the distributed amount to a Roth IRA on February 25, 1999 in a qualifying rollover contribution and makes a regular contribution for 1998 on the same date, the 5-taxable-year period for purposes of this A–5 begins on January 1, 1999, while the 5-taxable-year period for purposes of A–1(b) of this section begins on January 1, 1998.

Q–6. Is there a special rule for taxing distributions allocable to a 1998 conversion?

A–6. Yes. In the case of a distribution from a Roth IRA in 1998, 1999 or 2000 of amounts allocable to a 1998 conversion with respect to which the 4-year spread for the resultant income inclusion applies (see §1.408A–4 A–8), any income deferred as a result of the election to years after the year of the distribution is accelerated so that it is includible in gross income in the year of the distribution up to the amount of the distribution allocable to the 1998 conversion (determined under A–8 of this section). This amount is in addition to the amount otherwise includible in the owner's gross income for that taxable year as a result of the conversion. However, this rule will not require the inclusion of any amount to the extent it exceeds the total amount of income required to be included over the 4-year period. The acceleration of income inclusion described in this A–6 applies in the case of a surviving spouse who elects to continue the 4-year spread in accordance with §1.408A–4 A–11(b).

Q–7. Is the 5-taxable-year period described in A–1 of this section redetermined when a Roth IRA owner dies?

A–7. (a) No. The beginning of the 5-taxable-year period described in A–1 of this section is not redetermined when the Roth IRA owner dies. Thus, in determining the 5-taxable-year period, the period the Roth IRA is held in the name of a beneficiary, or in the name of a surviving spouse who treats the decedent's Roth IRA as his or her own, includes the period it was held by the decedent.

(b) The 5-taxable-year period for a Roth IRA held by an individual as a beneficiary of a deceased Roth IRA owner is determined independently of the 5-taxable-year period for the beneficiary's own Roth IRA. However, if a surviving spouse treats the Roth IRA as his or her own, the 5-taxable-year period with respect to any of the surviving spouse's Roth IRAs (including the one that the surviving spouse treats as his or her own) ends at the earlier of the end of either the 5-taxable-year period for the decedent or the 5-taxable-year period applicable to the spouse's own Roth IRAs.

Q–8. How is it determined whether an amount distributed from a Roth IRA is allocated to regular contributions, conversion contributions, or earnings?

A–8. (a) Any amount distributed from an individual's Roth IRA is treated as made in the following order (determined as of the end of a taxable year and exhausting each category before moving to the following category)—

(1) From regular contributions;

(2) From conversion contributions, on a first-in-first-out basis; and

(3) From earnings.

(b) To the extent a distribution is treated as made from a particular conversion contribution, it is treated as made first from the portion, if any, that was includible in gross income as a result of the conversion.

Q–9. Are there special rules for determining the source of distributions under A–8 of this section?

A–9. Yes. For purposes of determining the source of distributions, the following rules apply:

(a) All distributions from all an individual's Roth IRAs made during a taxable year are aggregated.

(b) All regular contributions made for the same taxable year to all the individual's Roth IRAs are aggregated and added to the undistributed total regular contributions for prior taxable years. Regular contributions for a taxable year include contributions made in the following taxable year that are identified as made for the taxable year in accordance with § 1.408A–3 A–2. For example, a regular contribution made in 1999 for 1998 is aggregated with the contributions made in 1998 for 1998.

(c) All conversion contributions received during the same taxable year by all the individual's Roth IRAs are aggregated. Notwithstanding the preceding sentence, all conversion contributions made by an individual during 1999 that were distributed from a traditional IRA in 1998 and with respect to which the 4-year spread applies are treated for purposes of A–8(b) of this section as contributed to the individual's Roth IRAs prior to any other conversion contributions made by the individual during 1999.

(d) A distribution from an individual's Roth IRA that is rolled over to another Roth IRA of the individual in accordance with section 408A(e) is disregarded for purposes of determining the amount of both contributions and distributions.

(e) Any amount distributed as a corrective distribution (including net income), as described in A–1(d) of this section, is disregarded in determining the amount of contributions, earnings, and distributions.

(f) If an individual recharacterizes a contribution made to a traditional IRA (FIRST IRA) by transferring the contribution to a Roth IRA (SECOND IRA) in accordance with § 1.408A–5, then, pursuant to § 1.408A–5 A–3, the contribution to the Roth IRA is taken into account for the same taxable year for which it would have been taken into account if the contribution had originally been made to the Roth IRA and had never been contributed to the traditional IRA. Thus, the contribution to the Roth IRA is treated as contributed to the Roth IRA on the same date and for the same taxable year that the contribution was made to the traditional IRA.

(g) If an individual recharacterizes a regular or conversion contribution made to a Roth IRA (FIRST IRA) by transferring the contribution to a traditional IRA (SECOND IRA) in accordance with § 1.408A–5, then pursuant to § 1.408A–5 A–3, the contribution to the Roth IRA and the recharacterizing transfer are disregarded in determining the amount of both contributions and distributions for the taxable year with respect to which the original contribution was made to the Roth IRA.

(h) Pursuant to §1.408A–5 A–3, the effect of income or loss (determined in accordance with §1.408A–5 A–2) occurring after the contribution to the FIRST IRA is disregarded in determining the amounts described in paragraphs (f) and (g) of this A–9. Thus, for purposes of paragraphs (f) and (g), the amount of the contribution is determined based on the original contribution.

Q–10. Are there examples to illustrate the ordering rules described in A–8 and A–9 of this section?

A–10. Yes. The following examples illustrate these ordering rules:

Example 1. In 1998, individual B converts $80,000 in his traditional IRA to a Roth IRA. B has a basis of $20,000 in the conversion amount and so must include the remaining $60,000 in gross income. He decides to spread the $60,000 income by including $15,000 in each of the 4 years 1998–2001, under the rules of §1.408A–4 A–8. B also makes a regular contribution of $2,000 in 1998. If a distribution of $2,000 is made to B anytime in 1998, it will be treated as made entirely from the regular contributions, so there will be no Federal income tax consequences as a result of the distribution.

Example 2. The facts are the same as in *Example 1,* except that the distribution made in 1998 is $5,000. The distribution is treated as made from $2,000 of regular contributions and $3,000 of conversion contributions that were includible in gross income. As a result, B must include $18,000 in gross income for 1998: $3,000 as a result of the acceleration of amounts that otherwise would have been included in later years under the 4-year-spread rule and $15,000 includible under the regular 4-year-spread rule. In addition, because the $3,000 is allocable to a conversion made within the previous 5 taxable years, the 10-percent additional tax under section 72(t) would apply to this $3,000 distribution for 1998, unless an exception applies. Under the 4-year-spread rule, B would now include in gross income $15,000 for 1999 and 2000, but only $12,000 for 2001, because of the accelerated inclusion of the $3,000 distribution.

Example 3. The facts are the same as in *Example 1,* except that B makes an additional $2,000 regular contribution in 1999 and he does not take a distribution in 1998. In 1999, the entire balance in the account, $90,000 ($84,000 of contributions and $6,000 of earnings), is distributed to B. The distribution is treated as made from $4,000 of regular contributions, $60,000 of conversion contributions that were includible in gross income, $20,000 of conversion contributions that were not includible in gross income, and $6,000 of earnings. Because a distribution has been made within the 4-year-spread period, B must accelerate the income inclusion under the 4-year-spread rule and must include in gross income the $45,000 remaining under the 4-year-spread rule in addition to the $6,000 of earnings. Because $60,000 of the distribution is allocable to a conversion made within the previous 5 taxable years, it is subject to the 10-percent additional tax under section 72(t) as if it were includible in gross income for 1999, unless an exception applies. The $6,000 allocable to earnings would be subject to the tax under section 72(t), unless an exception applies. Under the 4-year-spread rule, no amount would be includible in gross income for 2000 or 2001 because the entire amount of the conversion that was includible in gross income has already been included.

Example 4. The facts are the same as in *Example 1,* except that B also makes a $2,000 regular contribution in each year 1999 through 2002 and he does not take a distribution in 1998. A distribution of $85,000 is made to B in 2002. The distribution is treated as made from the $10,000 of regular contributions (the total regular contributions made in the years 1998–2002), $60,000 of conversion contributions that were includible in gross income, and $15,000 of conversion contributions that were not includible in gross income. As a result, no amount of the distribution is includible in gross income; however, because the distribution is allocable to a conversion made within the previous 5 years, the $60,000 is subject to the 10-percent additional tax under section 72(t) as if it were includible in gross income for 2002, unless an exception applies.

Example 5. The facts are the same as in *Example 4,* except no distribution occurs in 2002. In 2003, the entire balance in the account, $170,000 ($90,000 of contributions and $80,000 of earnings), is distributed to B. The distribution is treated as made from $10,000 of regular contributions, $60,000 of conversion contributions that were includible in gross income, $20,000 of conversion contributions that were not includible in gross income, and $80,000 of earnings. As a result, for 2003, B must include in gross income the $80,000 allocable to earnings, unless the distribution is a qualified distribution; and if it is not a qualified distribution, the $80,000 would be subject to the 10-percent additional tax under section 72(t), unless an exception applies.

Example 6. Individual C converts $20,000 to a Roth IRA in 1998 and $15,000 (in which amount C had a basis of $2,000) to another Roth IRA in 1999. No other contributions are made. In 2003, a $30,000 distribution, that is not a qualified distribution, is made to C. The distribution is treated as made from $20,000 of the 1998 conversion contribution and $10,000 of the 1999 conversion contribution that was includible in gross income. As a result, for 2003, no amount is includible in gross income; however, because $10,000 is allocable to a conversion contribution made within the previous 5 taxable years, that amount is subject to the 10-percent additional tax under section 72(t) as if the amount were includible in gross income for 2003, unless an exception applies. The result would be the same whichever of C's Roth IRAs made the distribution.

Example 7. The facts are the same as in *Example 6,* except that the distribution is a qualified distribution. The result is the same as in Example 6, except that no amount would be subject to the 10-percent additional tax under section 72(t), because, to be a qualified distribution, the distribution must be made on or after the date on which the owner attains age 59½, made to a beneficiary or the estate of the owner on or after the date of the owner's death, attributable to the owner's being disabled within the meaning of section 72(m)(7), or to which section 72(t)(2)(F) applies (exception for a first-time home purchase). Under section 72(t)(2), each of these conditions is also an exception to the tax under section 72(t).

Example 8. Individual D makes a $2,000 regular contribution to a traditional IRA on January 1, 1999, for 1998. On April 15, 1999, when the $2,000 has increased to $2,500, D recharacterizes the contribution by transferring the $2,500 to a Roth IRA (pursuant to § 1.408A–5 A–1). In this case, D's regular contribution to the Roth IRA for 1998 is $2,000. The $500 of earnings is not treated as a contribution to the Roth IRA. The results would be the same if the $2,000 had decreased to $1,500 prior to the recharacterization.

Example 9. In December 1998, individual E receives a distribution from his traditional IRA of $300,000 and in January 1999 he contributes the $300,000 to a Roth IRA as a conversion contribution. In April 1999, when the $300,000 has increased to $350,000, E recharacterizes the conversion contribution by transferring the $350,000 to a traditional IRA. In this case, E's conversion contribution for 1998 is $0, because the $300,000 conversion contribution and the earnings of $50,000 are disregarded. The results would be the same if the $300,000 had decreased to $250,000 prior to the recharacterization. Further, since the conversion is disregarded, the $300,000 is not includible in gross income in 1998.

Q–11. If the owner of a Roth IRA dies prior to the end of the 5-taxable-year period described in A–1 of this section (relating to qualified distributions) or prior to the end of the 5-taxable-year period described in A–5 of this section (relating to conversions), how are different types of contributions in the Roth IRA allocated to multiple beneficiaries?

A–11. Each type of contribution is allocated to each beneficiary on a pro-rata basis. Thus, for example, if a Roth IRA owner dies in 1999, when the Roth IRA contains a regular contribution of $2,000, a conversion contribution of $6,000 and earnings of $1,000, and the owner leaves his Roth IRA equally to four children, each child will receive one quarter of each type of contribution. Pursuant to the ordering rules in A–8 of this section, an immediate distribution of $2,000 to one of the children will be deemed to consist of $500 of regular contributions and $1,500 of conversion contributions. A beneficiary's inherited Roth IRA may not be aggregated with any other Roth IRA maintained by such beneficiary (except for other Roth IRAs the beneficiary inherited from the same decedent), unless the beneficiary, as the spouse of the decedent and sole beneficiary of the Roth IRA, elects to treat the Roth IRA as his or her own (see A–7 and A–14 of this section).

Q–12. How do the withholding rules under section 3405 apply to Roth IRAs?

A–12. Distributions from a Roth IRA are distributions from an individual retirement plan for purposes of section 3405 and thus are designated distributions unless one of the exceptions in section 3405(e)(1) applies. Pursuant to section 3405(a) and (b), nonperiodic distributions from a Roth IRA are subject to 10-percent withholding by the payor and periodic payments are subject to withholding as if the payments were wages. However, an individual can elect to have no amount withheld in accordance with section 3405(a)(2) and (b)(2).

Q–13. Do the withholding rules under section 3405 apply to conversions?

A–13. Yes. A conversion by any method described in § 1.408A–4 A–1 is considered a designated distribution subject to section 3405. However, a conversion occurring in 1998 by means of a trustee-to-trustee transfer of an amount from a traditional IRA to a Roth IRA established with the same or a different trustee is not required to be treated as a designated distribution for purposes of section 3405. Consequently, no withholding is required with respect to such a conversion (without regard to whether or not the individual elected to have no withholding).

Q–14. What minimum distribution rules apply to a Roth IRA?

A–14. (a) No minimum distributions are required to be made from a Roth IRA under section 408(a)(6) and (b)(3) (which generally incorporate the provisions of section 401(a)(9)) while the owner is alive. The post-death minimum distribution rules under section 401(a)(9)(B) that apply to traditional IRAs, with the exception of the at-least-as-rapidly rule described in section 401(a)(9)(B)(i), also apply to Roth IRAs.

(b) The minimum distribution rules apply to the Roth IRA as though the Roth IRA owner died before his or her required beginning date. Thus, generally, the entire interest in the Roth IRA must be distributed by the end of the fifth calendar year after the year of the owner's death unless the interest is payable to a designated beneficiary over a period not greater than that beneficiary's life expectancy and distribution commences before the end of the calendar year following the year of death. If the sole beneficiary is the decedent's spouse, such spouse may delay distributions until the decedent would have attained age 70½ or may treat the Roth IRA as his or her own.

(c) Distributions to a beneficiary that are not qualified distributions will be includible in the beneficiary's gross income according to the rules in A–4 of this section.

Q–15. Does section 401(a)(9) apply separately to Roth IRAs and individual retirement plans that are not Roth IRAs?

A–15. Yes. An individual required to receive minimum distributions from his or her own traditional or SIMPLE IRA cannot choose to take the amount of the minimum distributions from any Roth IRA. Similarly, an individual required to receive minimum distributions from a Roth IRA cannot choose to take the amount of the minimum distributions from a traditional or SIMPLE IRA. In addition, an individual required to receive minimum distributions as a beneficiary under a Roth IRA can only satisfy the minimum distributions for one Roth IRA by distributing from another Roth IRA if the Roth IRAs were inherited from the same decedent.

Q–16. How is the basis of property distributed from a Roth IRA determined for purposes of a subsequent disposition?

A–16. The basis of property distributed from a Roth IRA is its fair market value (FMV) on the date of distribution, whether or not the distribution is a qualified distribution. Thus, for example, if a distribution consists of a share of stock in XYZ Corp. with an FMV of $40.00 on the date of distribution, for purposes of determining gain or loss on the subsequent sale of the share of XYZ Corp. stock, it has a basis of $40.00.

Q–17. What is the effect of distributing an amount from a Roth IRA and contributing it to another type of retirement plan other than a Roth IRA?

A–17. Any amount distributed from a Roth IRA and contributed to another type of retirement plan (other than a Roth IRA) is treated as a distribution from the Roth IRA that is neither a rollover contribution for purposes of section 408(d)(3) nor a qualified rollover contribution within the meaning of section 408A(e) to the other type of retirement plan. This treatment also applies to any amount transferred from a Roth IRA to any other type of retirement plan unless the transfer is a recharacterization described in §1.408A–5.

Q–18. Can an amount be transferred directly from an education IRA to a Roth IRA (or distributed from an education IRA and rolled over to a Roth IRA)?

A–18. No amount may be transferred directly from an education IRA to a Roth IRA. A transfer of funds (or distribution and rollover) from an education IRA to a Roth IRA constitutes a distribution from the education IRA and a regular contribution to the Roth IRA (rather than a qualified rollover contribution to the Roth IRA).

Q–19. What are the Federal income tax consequences of a Roth IRA owner transferring his or her Roth IRA to another individual by gift?

A–19. A Roth IRA owner's transfer of his or her Roth IRA to another individual by gift constitutes an assignment of the owner's rights under the Roth IRA. At the time of the gift, the assets of the Roth IRA are deemed to be distributed to the owner and, accordingly, are treated as no longer held in a Roth IRA. In the case of any such gift of a Roth IRA made prior to October 1, 1998, if the entire interest in the Roth IRA is reconveyed to the Roth IRA owner prior to January 1, 1999, the Internal Revenue Service will treat the gift and reconveyance as never having occurred for estate tax, gift tax, and generation-skipping tax purposes and for purposes of this A–19.

[T.D. 8816, 64 FR 5607, Feb. 4, 1999]

§ 1.408A–7 Reporting.

This section sets forth the following questions and answers that relate to the reporting requirements applicable to Roth IRAs:

Q–1. What reporting requirements apply to Roth IRAs?

A–1. Generally, the reporting requirements applicable to IRAs other than Roth IRAs also apply to Roth IRAs, except that, pursuant to section 408A(d)(3)(D), the trustee of a Roth IRA must include on Forms 1099–R and 5498 additional information as described in the instructions thereto. Any conversion of amounts from an IRA other than a Roth IRA to a Roth IRA is treated as a distribution for which a Form 1099–R must be filed by the trustee maintaining the non-Roth IRA. In addition, the owner of such IRAs must report the conversion by completing Form 8606. In the case of a recharacterization described in § 1.408A–5 A–1, IRA owners must report such transactions in the manner prescribed in the instructions to the applicable Federal tax forms.

Q–2. Can a trustee rely on reasonable representations of a Roth IRA contributor or distributee for purposes of fulfilling reporting obligations?

A–2. A trustee maintaining a Roth IRA is permitted to rely on reasonable representations of a Roth IRA contributor or distributee for purposes of fulfilling reporting obligations.

[T.D. 8816, 64 FR 5610, Feb. 4, 1999]

§ 1.408A–8 Definitions.

This section sets forth the following question and answer that provides definitions of terms used in the provisions of §§ 1.408A–1 through 1.408A–7 and this section:

Q–1. Are there any special definitions that govern in applying the provisions of §§ 1.408A–1 through 1.408A–7 and this section?

A–1. Yes, the following definitions govern in applying the provisions of §§ 1.408A–1 through 1.408A–7 and this section. Unless the context indicates otherwise, the use of a particular term excludes the use of the other terms.

(a) *Different types of IRAs*—(1) *IRA*. Sections 408(a) and (b), respectively, describe an individual retirement account and an individual retirement annuity. The term IRA means an IRA described in either section 408(a) or (b), including each IRA described in paragraphs (a)(2) through (5) of this A–1. However, the term IRA does not include an education IRA described in section 530.

(2) *Traditional IRA*. The term traditional IRA means an individual retirement account or individual retirement annuity described in section 408(a) or (b), respectively. This term includes a SEP IRA but does not include a SIMPLE IRA or a Roth IRA.

(3) *SEP IRA*. Section 408(k) describes a simplified employee pension (SEP) as an employer-sponsored plan under which an employer can make contributions to IRAs established for its employees. The term SEP IRA means an IRA that receives contributions made under a SEP. The term SEP includes a salary reduction SEP (SARSEP) described in section 408(k)(6).

(4) *SIMPLE IRA*. Section 408(p) describes a SIMPLE IRA Plan as an employer-sponsored plan under which an employer can make contributions to SIMPLE IRAs established for its employees. The term SIMPLE IRA means an IRA to which the only contributions that can be made are contributions under a SIMPLE IRA Plan or rollovers or transfers from another SIMPLE IRA.

(5) *Roth IRA*. The term Roth IRA means an IRA that meets the requirements of section 408A.

(b) *Other defined terms or phrases*—(1) *4-year spread*. The term 4-year spread is described in § 1.408A–4 A–8.

(2) *Conversion*. The term conversion means a transaction satisfying the requirements of §1.408A–4 A–1.

(3) *Conversion amount or conversion contribution*. The term conversion amount or conversion contribution is the amount of a distribution and contribution with respect to which a conversion described in §1.408A–4 A–1 is made.

(4) *Failed conversion*. The term failed conversion means a transaction in which an individual contributes to a Roth IRA an amount transferred or distributed from a traditional IRA or Simple IRA (including a transfer by redesignation) in a transaction that does not constitute a conversion under §1.408A–4 A–1.

(5) *Modified AGI*. The term modified AGI is defined in §1.408A–3 A–5.

(6) *Recharacterization*. The term recharacterization means a transaction described in §1.408A–5 A–1.

(7) *Recharacterized amount or recharacterized contribution*.The term recharacterized amount or recharacterized contribution means an amount or contribution treated as contributed to an IRA other than the one to which it was originally contributed pursuant to a recharacterization described in §1.408A–5 A–1.

(8) *Taxable conversion amount*. The term taxable conversion amount means the portion of a conversion amount includible in income on account of a conversion, determined under the rules of section 408(d)(1) and (2).

(9) *Tax-free transfer*. The term tax-free transfer means a tax-free rollover described in section 402(c), 402(e)(6), 403(a)(4), 403(a)(5), 403(b)(8), 403(b)(10) or 408(d)(3), or a tax-free trustee-to-trustee transfer.

(10) *Treat an IRA as his or her own*. The phrase treat an IRA as his or her own means to treat an IRA for which a surviving spouse is the sole beneficiary as his or her own IRA after the death of the IRA owner in accordance with the terms of the IRA instrument or in the manner provided in the regulations under section 408(a)(6) or (b)(3).

(11) *Trustee*. The term trustee includes a custodian or issuer (in the case of an annuity) of an IRA (except where the context clearly indicates otherwise).

[T.D. 8816, 64 FR 5610, Feb. 4, 1999]

§1.408A–9 Effective date.

This section contains the following question and answer providing the effective date of §§1.408A–1 through 1.408A–8:

Q–1. To what taxable years do §§1.408A–1 through 1.408A–8 apply?

A–1 Sections 1.408A–1 through 1.408A–8 apply to taxable years beginning on or after January 1, 1998.

[T.D. 8816, 64 FR 5611, Feb. 4, 1999]

§1.409–1 Retirement bonds.

(a) *In general*. Section 409 authorizes the issuance of bonds under the Second Liberty Bond Act the purchase price of which would be deductible under section 219. Section 409 also prescribes the tax treatment of such bonds. See paragraph (b) of this section.

(b) *Income tax treatment of bonds*—(1) *General rule*. Except as provided in paragraph (b)(2) of this section, the entire proceeds upon redemption of a retirement bond described in section 409(a) shall be included in the gross income of the taxpayer entitled to such proceeds. If a bond has not been tendered for redemption by the registered owner before the close of the taxable year in which he attains age 70½, he must include in his gross income for such taxable year the amount of the proceeds he would have received if the bond had been redeemed at age 70½. The provisions of sections 72 and 1232 do not apply to a retirement bond.

(2) *Exceptions*. (i) If a retirement bond is redeemed within 12 months after the issue date, the proceeds are excluded from gross income if no deduction is allowed under section 219 on account of the purchase of such bond. For definition of issue date, see 31 CFR 346.1(c).

(ii) If a retirement bond is redeemed after the close of the taxable year in which the registered owner attains age 70½ the proceeds from the redemption of the bond are excludable from the gross income of the registered owner or his beneficiary to the extent that such proceeds were includible in the gross income of the registered owner for such taxable year.

(iii) If a retirement bond is surrendered for reissuance in the same or lesser face amount, the difference between current redemption value of the bond surrendered for reissuance and the current surrender value of the bond reissued is includible in the gross income of the registered owner.

(3) *Basis.* The basis of a retirement bond is zero.

(c) *Rollover.* The first sentence of paragraph (b)(1) of this section shall not apply in any case in which a retirement bond is redeemed by the registered owner before the close of the taxable year in which he attains the age of 70½ if he transfers the entire amount of the proceeds of such redemption to—

(1) An individual retirement account described in section 408(a) or an individual retirement annuity described in section 408(b) (other than an endowment contract described in §1.408–3(e)), or

(2) An employees' trust which is described in section 401(a) which is exempt from tax under section 501(a), or an annuity plan described in section 403(a), for the benefit of the registered owner, on or before the 60th day after the day on which he received the proceeds of such redemption. This subparagraph shall not apply in the case of a transfer to a trust or plan described in (c)(2) of this section unless no part of the purchase price of the retirement bond redeemed is attributable to any source other than a rollover contribution from such an employees' trust or annuity plan (other than an annuity plan or employees' trust forming part of a plan under which the individual was an employee within the meaning of section 401(c)(1) at the time contributions were made on his behalf under the plan).

(d) *Additional tax*—(1) *Early redemption.* Except as provided in paragraph (d)(2) of this section, under section 409(c) if a retirement bond is redeemed by the registered owner before he attains age 59½, his tax under chapter 1 of the Code is increased by an amount equal to 10 percent of the proceeds of the redemption includible in his gross income for the taxable year. Except in the case of the credits allowable under sections 31, 39, or 42, no credit can be used to offset the tax described in the preceding sentence.

(2) *Limitations.* Paragraph (d)(1) of this section shall not apply if—

(i) During the taxable year of the registered owner in which a retirement bond is redeemed, the registered owner becomes disabled within the meaning of section 72(m)(7), or

(ii) A retirement bond is tendered for redemption in accordance with paragraph (b)(2)(i) of this section.

[T.D. 7714, 45 FR 52799, Aug. 8, 1980]

§1.410(a)–1 Minimum participation standards; general rules.

(a) *In general.* A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless the plan satisfies—

(1) The minimum age and service requirements of section 410(a)(1) and §1.410(a)–3,

(2) The maximum age requirements of section 410(a)(2) and §1.410(a)–4, and

(3) The minimum coverage requirements of section 410(b)(1) and §1.410(b)–1.

(b) *Organization of regulations relating to minimum participation standards—(*1) *General rules.* This section prescribes general rules relating to the minimum participation standards provided by Section 410.

(2) *Effective dates.* Section 1.410(a)–2 provides rules under section 1017 of the Employee Retirement Income Security Act of 1974 relating to effective dates under section 410.

(3) *Age and service conditions.* Section 1.410(a)–3 provides rules under section 410(a)(1) relating to minimum age and service conditions.

(4) *Maximum age and time of participation.* Section 1.410(a)–4 provides rules under section 410(a) (2) and (4) relating to maximum age and time of participation.

(5) *Year of service; breaks in service.* For rules relating to years of service and breaks in service, see 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans). See §1.410(a)–5 for rules under section 410(a)(3)(B) relating to seasonal industries and for certain rules under section 410(a)(5) relating to breaks in service.

(6) *Breaks in service.* Section 1.410(a)–6 provides special rules under section 1017(f) of the Employee Retirement Income Security Act of 1974 relating to amendment of break in service rules.

(7) *Elapsed time.* Section 1.410 (a)–7 provides rules under sections 410 and 411 relating to the elapsed time method of crediting years of service.

(8) *Coverage.* Section 1.410(b)–1 provides rules relating to the minimum coverage requirements provided by section 410(b)(1).

(9) *Church election.* Section 1.410(d)–1 provides rules relating to the election by a church to have participation, vesting, funding, etc., provisions apply.

(c) *Application of participation standards to certain plans*—(1) *General rule.* Except as provided in subparagraph (2) of this paragraph, section 410 does not apply to—

(i) A governmental plan (within the meaning of section 414(d) and the regulations thereunder),

(ii) A church plan (within the meaning of section 414(e) and the regulations thereunder) which has not made the election provided by section 410(d) and the regulations thereunder,

(iii) A plan which has not provided for employer contributions at any time after September 2, 1974, and

(iv) A plan established and maintained by a society, order, or association described in section 501(c) (8) or (9), if no part of the contributions to or under such plan are made by employers of participants in such plan.

(2) *Participation requirements.* A plan described in subparagraph (1) of this paragraph shall, for purposes of section 401(a), be treated as meeting the requirements of section 410 if such plan meets the coverage requirements resulting from the application of section 401(a)(3) as in effect on September 1, 1974. Such coverage requirements include the rules in §1.410(b)–1(d) (special rules relating to minimum coverage requirements), that interpret statutory provisions substantially identical to section 401(a)(3) as in effect on September 1, 1974. In applying the rules of that paragraph (d) to plans described in this paragraph (c) employees whose principal duties consist in supervising the work of other employees shall be treated as officers, shareholders, and highly compensated employees.

(d) *Supersession.* Section 11.410(a)–1 through 11.410(d)–1 inclusive, of the Temporary Income Tax Regulation under the Employee Retirement Income Security Act of 1974 are superseded by this section and §§1.410(a)–2 through 1.410(d)–1.

(Sec. 410 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7508, 42 FR 47193, Sept. 20, 1977, as amended by T.D. 7703, 45 FR 40980, June 17, 1980; T.D. 7735, 45 FR 74722, Nov. 12, 1980]

§1.410(a)–2 Effective dates.

(a) *Plans not in existence on January 1, 1974.* Under section 1017(a) of the Employee Retirement Income Security Act of 1974, in the case of a plan which was not in existence on January 1, 1974, section 410 and the regulations thereunder apply for plan years beginning after September 2, 1974. See paragraph (c) of this section for time plan is considered in existence.

(b) *Plans in existence on January 1, 1974.* Under section 1017(b) of the Employee Retirement Income Security Act of 1974, in the case of a plan which was in existence on January 1, 1974, section 410 and the regulations thereunder apply for plan years beginning after December 31, 1975. See paragraph (c) of this section for time plan is considered to be in existence.

(c) *Time of plan existence*—(1) *General rule.* For purposes of this section, a plan is considered to be in existence on a particular day if—

(i) The plan on or before that day was reduced to writing and adopted by the employer (including, in the case of a corporate employer, formal approval by the employer's board of directors and, if required, shareholder), even though no amounts had been contributed under the plan as of such day, and

(ii) The plan was not terminated on or before that day.

(2) *Collectively bargained plan.* Notwithstanding subparagraph (1) of this paragraph, a plan described in section 413(a), relating to a plan maintained pursuant to a collective bargaining agreement, is considered to be in existance on a particular day if—

(i) On or before that day there is a legally enforceable agreement to establish such a plan signed by the employer, and

(ii) The employer contributions to be made to the plan are set forth in the agreement.

(3) *Special rule.* If a plan is considered to be in existence on January 1, 1974, under subparagraph (1) of this paragraph, any other plan with which such existing plan is merged or consolidated shall also be considered to be in existence on such date.

(d) *Certain existing plans may elect new provisions*—(1) *In general.* The plan administrator (as defined in section 414(g)) of a plan that was in existence on January 1, 1974, may elect to have the provisions of the Code relating to participation, vesting, funding, and form of benefit (as in effect from time to time) apply to a plan year selected by the plan year selected by the plan administrator which begins after September 2, 1974, but before the otherwise applicable effective dates determined under section 1017 (b) or (c), 1021, or 1024 of the Employee Retirement Income Security Act of 1974, and to all subsequent plan years. The provisions referred to are the amendments to the Code made by sections 1011, 1012, 1013, 1015, 1016(a) (1) through (11) and (13) through (27), 1021, and 1022(b) of the Employee Retirement Income Security Act of 1974.

(2) *Election is irrevocable.* Any election made under this paragraph, once made shall be irrevocable.

(3) *Procedure and time for making election.* An election under this paragraph shall be made by attaching a statement to either the annual return required under section 6058(a) (or an amended return) with respect to the plan which is filed for the first plan year for which the election is effective or to a written request for a determination letter relating to the qualification of the plan under section 401(a), 403(a), or 405(a) of the Code and, if trusteed, the exempt status under section 501(a) of the Code of a trust consituting a part of the plan. If the election is made with a written request for a determination letter, the election may be conditioned upon issuance of a favorable determination letter and will become irrevocable upon issuance of such letter. The statement shall indicate that the election is made under section 1017(d) of the Employee Retirement Income Security Act of 1974 and the first plan year for which the election is effective.

(e) *Examples.* The rules of this section are illustrated by the following examples:

Example (1). A plan is adopted on January 2, 1974, effective as of Janurary 1, 1974. The plan is not considered to have been in existence on Janurary 1, 1974.

Example (2). A plan was in existence on January 1, 1974, and was amended on November 1, 1974, to increase benefits. The fact that the plan was amended is not relevant and the amended plan is considered to be in existence on January 1, 1974.

Example (3). (i) A subsidiary business corporation is a member of a controlled group of corporations within the meaning of IRC section 1563(a). On November 1, 1974, the plan of the parent corporation is amended to provide coverage for employees of the subsidiary corporation. This amendment of the parent corporation's plan does not affect the effective date of section 410 with respect to the parent corporation's plan. No distinction is made for this purpose between employees of the parent corporation and employees of the subsidiary corporation.

(ii) If the subsidiary adopted a separate plan on November 1, 1974, under paragraph (a) of this section, section 410 would apply to that plan for its first plan year beginning after September 2, 1974. However, the adoption of a different plan by the subsidiary would not affect the time section 410 applies to the plan of the parent corporation. If, instead of adopting its own separate plan, the subsidiary merely executed an adoption agreement under the terms of the parent plan providing that a subsidiary, upon the execution of an adoption agreement, will become part of the parent plan, the effective date of section 410 with respect to such plan will not be affected by the adoption of the plan by the subsidiary.

(Sec. 410 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7508, 42 FR 47194, Sept. 20, 1977]

§ 1.410(a)–3 Minimum age and service conditions.

(a) *General rule.* Except as provided by paragraph (b) or (c) of this section, a plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if the plan requires, as a condition of participation in the plan, that an employee complete a period of service with the employer or employers maintaining the plan extending beyond the later of—

(1) *Age 25.* The date on which the employee attains the age of 25; or

(2) *One year of service.* The date on which the employee completes 1 year of service.

(b) *Special rule for plan with 3-year 100 percent vesting.* A plan which provides that after not more than 3 years of service each participant's right to his accrued benefit under the plan is completely nonforfeitable (within the meaning of section 411 and the regulations thereunder) at the time such benefit accrues satisfies the requirements of paragraph (a) of this section if the period of service required by the plan as a condition of participation does not extend beyond the later of—

(1) *Age 25.* The date on which the employee attains the age of 25; or

(2) *Three years of service.* The date on which the employee completes 3 years of service.

(c) *Special rule for employees of certain educational institutions.* A plan maintained exclusively for employees of an educational institution (as defined in section 170(b)(1)(A)(ii)) by an employer exempt from tax under section 501(a) which provides that after 1 year of service each participant's right to his accrued benefit under the plan is completely nonforfeitable (within the meaning of section 411 and the regulations thereunder) at the time such benefit accrues satisfies the requirements of paragraph (a) of this section if the period of service required by the plan as a condition of participation does not extend beyond the later of—

(1) *Age 30.* The date on which the employee attains the age of 30; or

(2) *One year of service.* The date on which the employee completes 1 year of service.

(d) *Other conditions.* Section 410(a), §1.410(a)–4, and this section relate solely to age and service conditions and do not preclude a plan from establishing conditions, other than conditions relating to age or service, which must be satisfied by plan participants. For example, such provisions would not preclude a qualified plan from requiring, as a condition of participation, that an employee be employed within a specified job classification. See section 410(b) and the regulations thereunder for rules with respect to coverage of employees under qualified plans.

(e) *Age and service requirements*—(1) *General rule.* For purposes of applying the rules of this section, plan provisons may be treated as imposing age or service requirements even though the provisions do not specifically refer to age or service. Plan provisions which have the effect of requiring an age or service requirement with the employer or employers maintaing the plan will be treated as if they imposed an age or service requirement. In general, a plan under which an employee cannot participate unless he retires will impose an age and service requirement. However, a plan may provide benefits which supplement benefits provided for employees covered under a pension plan, as defined in section 3(2) of the Employee Retirement Income Security Act of 1974, satisfying the requirements of section 410(a)(1) without violating the age and service rules.

(2) *Examples.* The rules of this paragraph are illustrated by the following examples:

Example (1). Corporation A is divided into two divisions. In order to work in division 2 an employee must first have been employed in division 1 for 5 years. A plan provision which required division 2 employment for participation will be treated as a service requirement because such a provision has the effect of requiring 5 years of service.

Example (2). Plan B requires as a condition of participation that each employee have had a driver's license for 15 years or more. This provision will be treated as an age requirement because such a provision has the effect of requiring an employee to attain a specified age.

Example (3). A plan which requires 1 year of service as a condition of participation also excludes a part-time or seasonal employee if his customary employment is for not more than 20 hours per week or 5 months in any plan year. The plan does not qualify because the provision could result in the exclusion by reason of a minimum service requirement of an employee who has completed a year of service. The plan would not qualify even though after excluding all such employees, the plan satisfied the coverage requirements of section 410(b).

Example (4). Employer A establishes a plan which covers employees after they retire and does not cover current employees unless they retire. Any employee who works past age 60 is treated as retired. The plan fails to satisfy the requirements of section 410(a) because the plan imposes a minimum age and service requirement in excess of that allowed by this section.

Example (5). Employer B establishes plan X, which provides that employees covered by qualified plan Y will receive benefits supplementing their benefits under plan Y to take into account cost of living increases after retirement. Plan X is not treated as imposing an age of service requirement.

Example (6). Employer C establishes a qualified plan satisfying the minimum age and service requirements. At a later time, entry into the plan is frozen so that employees not covered at that time cannot participate in the plan. The limitation on new participants is not treated as imposing a minimum age and service requirement.

(Sec. 410 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7508, 42 FR 47194, Sept. 20, 1977]

§ 1.410(a)–3T Minimum age and service conditions (temporary).

(a) [Reserved]

(b) *Special rule for plan with 2-year 100 percent vesting.* A plan which provides that after not more than 2 years of service each participant's right to his or her accrued benefit under the plan is completely nonforeitable (within the meaning of section 411 and the regulations thereunder) at the time such benefit accrues satisfies the requirements of paragraph (a) of this section if the period of service required by the plan as a condition of participation does not extend beyond the later of—

(1) [Reserved]

(2) *Two years of service.* The date on which the employee completes 2 years of service. For employees not described in § 1.411(a)–3T(e)(1), which describes employees with one hour of service in any plan year beginning after December 31, 1988, or later in the case of certain collectively bargained plans, the preceding sentence shall be applied by substituting ‘‘3 years of service’’ for ‘‘2 years of service’’.

[T.D. 8170, 53 FR 239, Jan. 6, 1988]

§ 1.410(a)–4 Maximum age conditions and time of participation.

(a) *Maximum age conditions*—(1) *General rule.* A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if the plan excludes from participation (on the basis of age) an employee who has attained an age specified by the plan unless—

(i) The plan is a defined benefit plan or a target benefit plan, and

(ii) The employee begins employment with the employer after the employee has attained an age specified by the plan, which age is not more than 5 years before normal retirement age (within the meaning of section 411(a)(8) and § 1.411(a)–7.

For purposes of this paragraph, a target benefit plan is a defined contribution plan under which the amount of employer contributions allocated to each participant is determined under a plan formula which does not allow employer discretion and on the basis of the amount necessary to provide a target benefit specified by the plan for such participant. Such target benefit must be the type of benefit which is provided by a defined benefit plan and the targeted benefit must not discriminate in favor of employees who are officers, shareholders, or highly compensated. For purposes of this paragraph, in the determination of the time an employee begins employment, any such time which is included in a period of service which may be disregarded under the break in service rules need not be taken into account.

(2) *Examples.* The rules provided by this paragraph are illustrated by the following examples:

Example (1). A defined benefit plan provides that an employee will become a participant upon completion of 3 years of service if at such time the employee is less than age 60. The normal retirement age under the plan is age 65. The plan also provides full and immediate vesting for each of the plan's participants. Under the plan, an employee hired at age 58 would be denied participation on account of service for the first 3 years and on account of maximum age for the remaining years even though the employee was hired more than 5 years prior to the normal retirement date. The plan therefore does not satisfy section 410(a)(2).

Example. (2). A defined benefit plan provides a normal retirement age of the later of age 65 or completion of 10 years of service. Because no employee could ever be hired within 5 years of his normal retirement age, the plan could not exclude employees for being over a specified age.

Example (3). Prior to the effective date of section 410, a defined benefit plan with a normal retirement age of 65 contained a maximum age 55 requirement for participation. Because of the maximum age requirement, and employee hired at age 58 was excluded from the plan. This employee is age 61 at the time that section 410 first applies to the plan. The employee cannot be excluded from participation because of age. The exclusion under section 410(a)(2) is not applicable in this instance because the employee's age at the time of hire, 58, was not within 5 years of the normal retirement age specified in the plan.

Example (4). Employee A was hired at age 50 and participated in a defined benefit plan until separating from service at age 55 with 5 years of service and with no vested benefit. At age 61, employee A was rehired within 5 years of the normal retirement age of 65 after he incurred 6 consecutive breaks in service. Because A's consecutive number of 1-year breaks (6) exceeds his years of service prior to such breaks (5), his service before the breaks may be disregarded. Consequently, A's initial employment date falling within such period may be disregarded and the plan could exclude A on account of his age because his employment commenced within 5 years of normal retirement age.

(b) *Time of participation*—(1) *General rule.* A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless under the plan any employee who has satisfied the applicable minimum age and service requirements specified in §1.410(a)–3, and who is otherwise entitled to participate in the plan, commences participation in the plan no later than the earlier of—

(i) The first day of the first plan year beginning after the date on which such employee first satisfied such requirements, or

(ii) The date 6 months after the date on which he first satisfied such requirements,

unless such employee was separated from service and has not returned before the date referred to in subdivision (i) or (ii), whichever is applicable. If such separated employee returns to service after either of such dates without incurring a 1-year break in service, the employee must commence participation immediately upon his return. In the case of a plan using the elapsed time method described in §1.410(a)–7, such an employee who has a period of absence commencing before the date referred to in subdivision (i) or (ii) (whichever is applicable) must commence participation as of such applicable date no later than the date such absence ended. However, if an employee's prior service is disregarded on account of the plan's break-in-service rules then, for purposes of this subparagraph, such service is also disregarded for purposes of determining the date on which such employee first satisfied the minimum age and service requirements.

(2) *Examples.* The rules provided by this paragraph are illustrated by the following examples:

Example (1). A calendar year plan provides that an employee may enter the plan only on the first semi-annual entry date, January 1 or July 1, after he has satisfied the applicable minimum age and service requirements specified in section 410(a)(1). The plan satisfies the requirements of this paragraph because an employee is eligible to participate no later than the earlier of (1) the first day of the first plan year beginning after he satisfied the applicable minimum age and service requirements, or (2) the date 6 months after he satisfied such requirements.

Example (2). A plan provides that an employee is not eligible to participate until the first day of the first plan year beginning after he has satisfied the minimum age and service requirements of section 410(a)(1). In this case, an employee who satisfies the ''6 month'' rule described in subparagraph (1) of this paragraph will not be eligible to participate in the plan. Therefore, the plan does not satisfy the requirements of this paragraph.

Example (3). A calendar year plan provides that an employee may enter the plan only on the first semi-annual entry date, January 1 or July 1, after he has satisfied the applicable minimum age and service requirements specified in section 410(a)(1). Employee A after 10 years of service separated from service in 1976 with a vested benefit. On February 1, 1990, A returns to employment covered by the plan. Assuming A completes a year of service after his return, A must participate immediately on his return, February 1. A's prior service cannot be disregarded, because he had a vested benefit when he separated from service. Therefore, the plan may not postpone his participation until July 1.

Example (4). Assume the same facts as in example (3). The plan has the break-in-service rule described in section 410(a)(5)(D) and §1.410(a)–5(c)(4). Employee B, after he had 5 years of service but no vested benefit incurs 5 consecutive 1-year breaks. Because B's prior service can be disregarded, the plan may postpone B's participation in the plan under the rule described in section 410(a)(4) and this paragraph.

(Sec. 410 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7508, 42 FR 47195, Sept. 20, 1977, as amended by T.D. 7703, 45 FR 40980, June 17, 1980]

§ 1.410(a)–5 Year of service; break in service.

(a) *Year of service.* For the rules relating to years of service under subparagraphs (A), (C), and (D) of section 410(a)(3), see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

Rules relating to a general rule for a year of service, hours of service, and maritime industries apply for purposes of section 410(a) and the regulations thereunder.

(b) *Seasonal industries.* For rules which relate to seasonal industries under section 410(a)(3)(B), see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefits plans.

(c) *Breaks in service*—(1) *General rule.* This paragraph provides rules with respect to breaks in service under section 410(a)(5). Except as provided in subparagraphs (2), (3), (4), and (5) of this paragraph, all of an employee's years of service with the employer or employers maintaining a plan are taken into account in computing his period of service under the plan for purposes of section 410(a)(1) and § 1.410(a)–3.

(2) *Employees under 3-year 100 percent vesting schedule—(* i) *General rule.* In the case of an employee who incurs a 1-year break in service under a plan which provides that after not more than 3 years of service, each participant's right to his accrued benefit under the plan in completely nonforfeitable (within the meaning of section 411 and the regulations thereunder) at the time such benefit accrues, the employee's service before the break in service is not required to be taken into account after the break in service in determining the employee's years of service under section 410(a)(1) and § 1.410(a)-3 if such employee has not satisfied such service requirement.

(ii) *Example.* The rules of this subparagraph are illustrated by the following example.

Example. A qualified plan computing service by the actual counting of hours provides full and immediate vesting. The plan can not require as a condition of participation that an employee complete 3 consecutive years of service with the employer because the requirement as to consecutive years is not permitted under section 410(a) (5). However, such a plan can require 3 years without a break in service, i.e., 3 years with no intervening years in which the employee fails to complete more than 500 hours of service. Under a plan containing such a participation requirement, the following example illustrates when employees whould become eligible to participate.

Year	Hours of service completed		
	Employee A	Employee B	Employee C
1	1,000	1,000	1,000
2	1,000	1,000	500
3	1,000	700	1,000
4	1,000	1,000	700
5	1,000	1,000	1,000
6	1,000	1,000	1,000

NOTE.— Employee A will have satisfied the plan's service requirement at the end of year 3. Employee B at the end of year 4, and Employee C at the end of year 6.

(3) *One-year break in service*—(i) *In general.* In computing the period of service of an employee who has incurred a 1-year break in service, for purposes of section 410(a)(1) and § 1.410(a)–3, a plan may disregard the employee's service before the break until the employee completes a year of service after such break in service.

(ii) *Examples.* The rules provided by this subparagraph are illustrated by the following examples.

Example (1). Employee A completes a year of service under a plan computing service by the actual counting of hours for the 12-month period ending December 31, 1980, and incurs a 1-year break in service for the 12-month period ending December 31, 1981. The plan does not contain the provisions permitted by section 410(a)(5)(B) (relating to 3-year 100 percent vesting) and section 410(a)(5)(D) (relating to nonvested participants). Thereafter, he does not complete a year of service. As of January 1, 1982, in computing his period of service under the plan his service prior to December 31, 1981, is not required to be taken into account for purposes of section 410(a)(1) and § 1.410 (a)–3.

Example (2). The employee in example (1) completes a year of service for the 12-month period ending December 31, 1982. Prior to December 31, 1982, in computing the employee's period of service as of any date occurring in 1982, the employee's service before December 31, 1981, is not required to be taken into account for purposes of section 410(a)(1) and §11.410(a)–3. Because the employee completed a year of service for the 12-month period ending December 31, 1982, however, his period of service is redetermined as of January 1, 1982. Upon completion of a year of service for 1982, the employee's period of service, determined as of any date occurring in 1982, includes service prior to December 31, 1981.

(4) *Nonvested participants*—(i) *General rule.* In the case of a participant in a plan who does not have any nonforfeitable right under the plan to his employer-derived accrued benefit and who incurs a 1-year break in service, for purposes of section 410(a)(1) and §1.410.(a)–3 the plan may disregard his years of service prior to such break if the number of his consecutive 1-year breaks in service equals or exceeds his aggregate number of years of service prior to such break. In the case of a plan using the elapsed time method described in Department of Labor regulations, the plan may disregard such years of service prior to such break if the period of severance is at least 1 year and the period of severance equals or exceeds the prior period of service, whether or not consecutive, completed before such period of severance. The plan may in computing such aggregate number of years of service prior to such break disregard any years of service which could have been disregarded under this subparagraph by reason of any prior break in service.

(ii) *Examples.* The rules of this subparagraph are illustrated by the following example:

Example. In 1980, A, who was hired at age 35, separates from the service of X Corporation after completing 4 years of service. At this time A had no vested benefits. In 1985, after incurring 5 consecutive one-year breaks in service, A was reemployed. Under section 410(a)(5)(D), A's 4 years of service may be disregarded because they are exceeded by the number of years of consecutive one-year breaks (5) after such service.

(d) *Special continuity rule for certain plans.* For special rules for computing years of service in the case of a plan maintained by more than one employer, see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(Sec. 410 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7508, 42 FR 47196, Sept. 20, 1977; T.D. 7508, 42 FR 57123, Nov. 1, 1977, as amended by T.D. 7703, 45 FR 40980, June 17, 1980]

§1.410(a)–6 Amendment of break in service rules; Transition period.

(a) *In general.* Under section 1017(f) (1) of the Employee retirement Income Security Act of 1974, a plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if the rules of the plan relating to breaks in service are amended, and—

(1) Such amendment is effective after January 1, 1974, and before the date on which section 410 becomes applicable to the plan, and

(2) Under such amendment, any employee's participation in the plan commences at any date later than the later of—

(i) The date on which his participation would commence under the break in service rules of section 410(a)(5), or

(ii) The earliest date on which his participation would commence under the plan as in effect on or after January 1, 1974.

(b) *Break in service rules.* For purposes of paragraph (a), the term ''break in service rules'' means the rules provided by a plan relating to circumstances under which a period of an employee's service or plan participation is disregarded for purposes of determining his rights to participate in the plan, if under such rules such service is disregarded by reason of the employee's failure to complete a required period of service within a specified period of time.

(Sec. 410 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7508, 42 FR 47197, Sept. 20, 1977; 43 FR 2721, Jan. 19, 1978]

§1.410(a)–7 Elapsed time.

(a) *In general*—(1) *Introduction to elapsed time method of crediting service.* (i) 29 CFR 2530.200b–2 sets forth the general method of crediting service for an employee. The general method is based upon the actual counting of hours of service during the applicable 12-consecutive-month computation period. The equivalencies set forth in 29 CFR 2530.200b–3 are also methods for crediting hours of service during computaton periods. Under the general method and the equivalencies an employee receives a year's credit (in units of years of service or years of participation) for a computation period during which the employee is credited with a specified number of hours of service. In general, an employee's statutory entitlement with respect to eligibility to participate, vesting and benefit accrual is determined by totalling the number of years' credit to which an employee is entitled.

(ii) Under the alternative method set forth in this section, by contrast, an employee's statutory entitlement with respect to eligibility to participate, vesting and benefit accrual is not based upon the actual completion of a specified number of hours of service during a 12-consecutive-month period. Instead, such entitlement is determined generally with reference to the total period of time which elapses while the employee is employed (i.e., while the employment relationship exists) with the employer or employers maintaining the plan. The alternative method set forth in this section is designed to enable a plan to lessen the administrative burdens associated with the maintenance of records of an employee's hours of service by permitting each employee to be credited with his or her total period of service with the employer or employers maintaining the plan, irrespective of the actual hours of service completed in any 12-consecutive-month period.

(2) *Overview of the operation of the elapsed time method.* (i) Under the elapsed time method of crediting service, a plan is generally required to take into account the period of time which elapses while the employee is employed (*i.e.,* while the employment relationship exists) with the employer or employers maintaining the plan, regardless of the actual number of hours he or she completes during such period. Under this alternative method of crediting service, an employee's service is required to be taken into account for purposes of eligibility to participate and vesting as of the date he or she first performs an hour of service within the meaning of 29 CFR 2530.200b–2 (a) (1) for the employer or employers maintaining the plan. Service is required to be taken into account for the period of time from the date the employee first performs such an hour of service until the date he or she severs from service with the employer or employers maintaining the plan.

(ii) The date the employee severs from service is the earlier of the date the employee quits, is discharged, retires or dies, or the first anniversary of the date the employee is absent from service for any other reason (e.g., disability, vacation, leave of absence, layoff, etc.). Thus, for example, if an employee quits, the severance from service date is the date the employee quits. On the other hand, if an employee is granted a leave of absence (and if no intervening event occurs), the severance from service date will occur one year after the date the employee was first absent on leave, and this one year of absence is required to be taken into account as service for the employer or employers maintaining the plan. Because the severance from service date occurs on the earlier of two possible dates (*i.e.,* quit, discharge, retirement or death *or* the first anniversary of an absence from service for any other reason), a quit, discharge, retirement or death within the year after the beginning of an absence for any other reason results in an immediate severance from service. Thus, for example, if an employee dies at the end of a four-week absence resulting from illness, the severance from service date is the date of death, rather than the first anniversary date of the first day of absence for illness.

(iii) In addition, for purposes of eligibility to participate and vesting under the elapsed time method of crediting service, an employee who has severed from service by reason of a quit, discharge or retirement may be entitled to have a period of time of 12 months or less taken into account by the employer or employers maintaining the plan if the employee returns to service within a certain period of time and performs an hour of service within the meaning of 29 CFR 2530.200b–2 (a) (1). In general, the period of time during which the employee must return to service begins on the date the employee severs from service as a result of a quit, discharge or retirement and ends on the first anniversary of such date. However, if the employee is absent for any other reason (e.g., layoff) and then quits, is discharged or retires, the period of time during which the employee may return and receive credit begins on the severance from service date and ends one year after the first day of absence (e.g., first day of layoff). As a result of the operation of these rules, a severance from service (e.g., a quit), or an absence (e.g., layoff) followed by a severance from service, never results in a period of time of more than one year being required to be taken into account after an employee severs from service or is absent from service.

(iv) For purposes of benefit accrual under the elapsed time method of crediting service, an employee is entitled to have his or her service taken into account from the date he or she begins to participate in the plan until the severance from service date. Periods of severance under any circumstances are not required to be taken into account. For example, a participant who is discharged on December 14, 1980 and rehired on October 14, 1981 is not required to be credited with the 10 month period of severance for benefit accrual purposes.

(3) *Overview of certain concepts relating to the elapsed time method*—(i) *In general.* The rules with respect to the elapsed time method of crediting service are based on certain concepts which are defined in paragraph (b) of this section. These concepts are applied in the substantive rules contained in paragraphs (c), (d), (e), (f) and (g) of this section. The purpose of this subparagraph is to summarize these concepts.

(ii) *Employment commencement date.* (A) A concept which is necessary in order to credit service accurately under any service crediting method is the establishment of a starting point for crediting service. The employment commencement date, which is the date on which an employee first performs an hour of service within the meaning of 29 CFR 2530.200b–2 (a) (1) for the employer or employers maintaining the plan, is used to establish the date upon which an employee must begin to receive credit for certain purposes (e.g., eligibility to participate and vesting).

(B) In order to credit accurately an employee's total service with an employer or employers maintaining the plan, a plan also may provide for an ‘‘adjusted’’ employment commencement date (*i.e.,* a recalculation of the employment commencement date to reflect noncreditable periods of severance) or a reemployment commencement date as defined in paragraph (b) (3) of this section. Fundamentally, all three concepts rely upon the performance of an hour of service to provide a starting point for crediting service. One purpose of these three concepts is to enable plans to satisfy the requirements of this section in a variety of ways.

(C) The fundamental rule with respect to these concepts is that any plan provision is permissible so long as it satisfies the minimum standards. Thus, for example, although the rules of this section provide that credit must begin on the employment commencement date, a plan is permitted to ‘‘adjust’’ the employment commencement date to reflect periods of time for which service is not required to be credited. Similarly, a plan may wish to credit service under the elapsed time method as discrete periods of service and provide for a reemployment commencement date. Certain plans may wish to provide for both concepts, although it is not a requirement of this section that plans so provide.

(iii) *Severance from service date.* Another fundamental concept of the elapsed time method of crediting service is the severance from service date, which is defined as the earlier of the date on which an employee quits, retires, is discharged or dies, or the first anniversary of the first date of absence for any other reason. One purpose of the severance from service date is to provide the endpoint for crediting service under the elapsed time method. As a general proposition, service is credited from the employment commencement date (*i.e.,* the starting point) until the severance from service date (*i.e.,* the endpoint). A complementary purpose of the severance from service date is to establish the starting point for measuring a period of severance from service in order to determine a ''break in service'' (see paragraph (a)(3)(v) of this section). A third purpose of such date is to establish the starting point for measuring the period of time which may be required to be taken into account under the service spanning rules (see paragraph (a)(3)(vi) of this section).

(iv) *Period of service.* A third elapsed time concept is the use of the ''period of service'' rather than the ''year of service'' in determining service to be taken into account for purposes of eligibility to participate, vesting and benefit accrual. For purposes of eligibility to participate and vesting, the period of service runs from the employment commencement date or reemployment commencement date until the severance from service date. For purposes of benefit accrual, a period of service runs from the date that a participant commences participation under the plan until the severance from service date. Because the endpoint of the period of service is marked by the severance from service date, an employee is credited with the period of time which runs during any absence from service (other than for reason of a quit, retirement, discharge or death) which is 12 months or less. Thus, for example, a three week absence for vacation is taken into account as part of a period of service and does not trigger a severance from service date.

(v) *Period of severance.* A period of severance begins on the severance from service date and ends when an employee returns to service with the employer or employers maintaining the plan. The purpose of the period of severance is to apply the statutory ''break in service'' rules to an elapsed time method of crediting service.

(vi) *Service spanning.* Under the elapsed time method of crediting service, a plan is required to credit periods of service and, under the service spanning rules, certain periods of severance of 12 months or less for purposes of eligibility to participate and vesting. Under the first service spanning rule, if an employee severs from service as a result of quit, discharge or retirement and then returns to service within 12 months, the period of severance is required to be taken into account. Also, a situation may arise in which an employee is absent from service for any reason other than quit, discharge, retirement or death and during the absence a quit, discharge or retirement occurs. The second service spanning rule provides in that set of circumstances that a plan is required to take into account the period of time between the severance from service date (*i.e.*, the date of quit, discharge or retirement) and the first anniversary of the date on which the employee was first absent, if the employee returns to service on or before such first anniversary date.

(4) *Organization and applicability.* (i) The substantive rules for crediting service under the elapsed time method with respect to eligibility to participate are contained in paragraph (c), the rules with respect to vesting are contained in subparagraph (d), and the rules with respect to benefit accrual are contained in paragraph (e). The format of the rules is designed to enable a plan to use the elapsed time method of crediting service either for all purposes or for any one or combination of purposes under sections 410 and 411. Thus, for example, a plan may credit service for eligibility to participate purposes by the use of the general method of crediting service set forth in 29 CFR 2530.200b–2 or by the use of any of the equivalences set forth in 29 CFR 2530.200b–3, while the plan may credit service for vesting and benefit accrual purposes by the use of the elapsed time method of crediting service.

(ii) A plan using the elapsed time method of crediting service for one or more classifications of employees covered under the plan may use the general method of crediting service set forth in 29 CFR 2530.200b–2 or any of the equivalencies set forth in 29 CFR 2530.200b–3 for other classifications of employees, provided that such classifications are reasonable and are consistently applied. Thus, for example, a plan may provide that part-time employees are credited under the general method of crediting service set forth in 29 CFR 2530.200b–2 and full-time employees are credited under the elapsed time method. A classification, however, will not be deemed to be reasonable or consistently applied if such classification is designed with an intent to preclude an employee or employees from attaining his or her statutory entitlement with respect to eligibility to participate, vesting or benefit accrual. For example, a classification applied so that any full-time employee credited with less than 1,000 hours of service during a given 12-consecutive-month period would be considered part-time and subject to the general method of crediting service rather than the elapsed time method would not be reasonable.

(iii) Notwithstanding paragraph (a) (4) (i) and (ii) of this section, the use of the elapsed time method for some purposes or the use of the elapsed time method for some employees may, under certain circumstances, result in discrimination prohibited under section 401(a)(4), even though the use of the elapsed time method for such purposes, and for such employees, is permitted under this section.

(5) *More than one employer plans.* For special rules for computing years of service in the case of a plan maintained by more than one employer, see 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(b) *Definitions*—(1) *Employment commencement date.* For purposes of this section, the term ''employment commencement date'' shall mean the date on which the employee first performs an hour of service within the meaning of 29 CFR 2530.200b–2 (a)(1) for the employer or employers maintaining the plan.

(2) *Severance from service date.* For purposes of this section, a ''severance from service'' shall occur on the earlier of—

(i) The date on which an employee quits, retires, is discharged or dies; or

(ii) The first anniversary of the first date of a period in which an employee remains absent from service (with or without pay) with the employer or employers maintaining the plan for any reason other than quit, retirement, discharge or death, such as vacation, holiday, sickness, disability, leave of absence or layoff.

(3) *Reemployment commencement date.* For purposes of this section, the term ''reemployment commencement date'' shall mean the first date, following a period of severance from service which is not required to be taken into account under the service spanning rules in paragraphs (c)(2)(iii) and (d)(1)(iii) of this section, on which the employee performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) for the employer or employers maintaining the plan.

(4) *Participation commencement date.* For purposes of this section, the term ''participation commencement date'' shall mean the date a participant first commences participation under the plan.

(5) *Period of severance.* For purposes of this section, the term ''period of severance'' shall mean the period of time commencing on the severance from service date and ending on the date on which the employee again performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) for an employer or employers maintaining the plan.

(6) *Period of service*—(i) *General rule.* For purposes of this section, the term ''period of service'' shall mean a period of service commencing on the employee's employment commencement date or reemployment commencement date, whichever is applicable, and ending on the severance from service date.

(ii) *Aggregation rule.* Unless a plan provides in some manner for an ''adjusted'' employment commencement date or similar method of consolidating periods of service, periods of service shall be aggregated unless such periods may be disregarded under section 410(a)(5) or 411(a)(4).

(iii) *Other federal law.* Nothing in this section shall be construed to alter, amend, modify, invalidate, impair or supersede any law of the United States or any rule or regulation issued under such law. Thus, for example, nothing in this section shall be construed as denying an employee credit for a ''period of service'' if credit is required by a separate federal law. Furthermore, the nature and extent of such credit shall be determined under such law.

(c) *Eligibility to participate*—(1) *General rule.* For purposes of section 410(a)(1)(A), a plan generally may not require as a condition of participation in the plan that an employee complete a period of service with the employer or employers maintaining the plan extending beyond the later of—

(i) The date on which the employee attains the age of 25; or

(ii) The date on which the employee completes a one-year period of service. See the regulations under section 410(a) (relating to eligibility to participate).

(2) *Determination of one-year period of service.* (i) For purposes of determining the date on which an employee satisfies the service requirement for initial eligibility to participate under the plan, a plan using the elapsed time method of crediting service shall provide that an employee who completes the 1-year period of service requirement on the first anniversary of his employment commencement date satisfies the minimum service requirement as of such date. In the case of an employee who fails to complete a one-year period of service on the first anniversary of his employment commencement date, a plan which does not contain a provision permitted by section 410(a)(5)(D) (rule of parity) shall provide for the aggregation of periods of service so that a one-year period of service shall be completed as of the date the employee completes 12 months of service (30 days are deemed to be a month in the case of the aggregation of fractional months) or 365 days of service.

(ii) For purposes of section 410(a)(1)(B)(i), a ‘‘3-year period of service’’ shall be deemed to be ‘‘3 years of service.’’

(iii) *Service spanning rules.* In determining a 1-year period of service for purposes of initial eligibility to participate and a period of service for purposes of retention of eligibility to participate, in addition to taking into account an employee's period of service, a plan shall take into account the following periods of severance—

(A) If an employee severs from service by reason of a quit, discharge or retirement and the employee then performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) within 12 months of the severance from service date, the plan is required to take into account the period of severance; and

(B) Notwithstanding paragraph (c)(2)(iii)(A) of this section, if an employee severs from service by reason of a quit, discharge or retirement during an absence from service of 12 months or less for any reason other than a quit, discharge, retirement or death, and then performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) within 12 months of the date on which the employee was first absent from service, the plan is required to take into account the period of severance.

(iv) For purposes of determining an employee's retention of eligibility to participate in the plan, a plan shall take into account an employee's entire period of service unless certain periods of service may be disregarded under section 410(a)(5) of the Code.

(v) *Example.* Employee W, age 31, completed 6 months of service and was laid off. After 2 months of layoff, W quit. Five months later, W returned to service. For purposes of eligibility to participate, W was required to be credited with 13 months of service (8 months of service and 5 months of severance). If, on the other hand, W had not returned to service within the first 10 months of severance (*i.e.,* within 12 months after the first day of layoff), W would be required to be credited with only 8 months of service.

(3) *Entry date requirements*—(i) *General rule.* For purposes of section 410(a)(4), it is necessary for a plan to provide that any employee who has satisfied the minimum age and service requirements, and who is otherwise entitled to participate in the plan, commences participation in the plan no later than the earlier of—

(A) The first day of the first plan year beginning after the date on which such employee satisfied such requirements, or

(B) The date six months after the date on which he satisfied such requirements, unless such employee was separated from service before the date referred to in subdivision (i) (A) or (B), whichever is applicable. See the regulations under section 410(a) (relating to eligibility to participate).

(ii) *Separation from service*—(A) *Definition.* For purposes of this section, the term ‘‘separated from service’’ includes a severance from service or an absence from service for any reason other than a quit, discharge, retirement or death, regardless of the duration of such absence. Accordingly, if an employee is laid off for a period of six weeks, the employee shall be deemed to be ‘‘separated from service’’ during such period for purposes of the entry date requirements.

(B) *Application.* A period of severance which is taken into account under the service spanning rules in paragraph (c)(2)(iii) of this section or an absence of 12 months or less may result in an employee satisfying the plan's minimum service requirement during such period of time. In addition, once an employee satisfies the plan's minimum service requirement, either before or during such period of time, such period of time may contain an entry date applicable to such employee. In the case of an employee whose period of severance is taken into account and such period contains an entry date applicable to the employee, he or she shall be made a participant in the plan (if otherwise eligible) no later than the date on which he or she ended the period of severance. In the case of an employee whose period of absence contains an entry date applicable to such employee, he or she, no later than the date such absence ended, shall be made a participant in the plan (if otherwise eligible) as of the first applicable entry date which occurred during such absence from service.

(iii) *Examples.* For purposes of the following examples, assume that the plan provides for a minimum age requirement of 25 and a minimum service requirement of one year, and provides for semi-annual entry dates.

(A) Employee A, age 35, worked for 10 months in a job classification covered under the plan, became disabled for nine consecutive months and then returned to service. During the period of absence, A completed a 1-year period of service and passed a semi-annual entry date after satisfying the minimum service requirement. Accordingly, the plan is required to make A a participant no later than his return to service effective as of the applicable entry date.

(B) Employee B, after satisfying the minimum age and service requirements, quit work before the next semi-annual entry date, and then returned to service before incurring a 1-year period of severance, but after such semi-annual entry date. Employee B is entitled to become a participant immediately upon his return to service effective as of the date of his return.

(4) *Break in service.* For purposes of applying the break in service rules under section 410(a)(5) (B) and (C), the term ‘‘1-year period of severance’’ shall be substituted for the term ‘‘1-year break in service’’. A 1-year period of severance shall be determined on the basis of a 12-consecutive-month period beginning on the severance from service date and ending on the first anniversary of such date, provided that the employee during such 12-consecutive-month period does not perform an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) for the employer or employers maintaining the plan.

(5) *One-year hold-out*—(i) *General rule.* (A) For purposes of section 410(a)(5)(C), in determining the period of service of an employee who has incurred a 1-year period of severance, a plan may disregard the employee's period of service before such period of severance until the employee completes a 1-year period of service after such period of severance.

(B) *Example.* Assume that a plan provides for a minimum service requirement of 1-year and provides for semi-annual entry dates, but does not contain the provisions permitted by section 410(a)(5)(D) (relating to the rule of parity). Employee G, age 40, completed a seven-month period of service, quit and then returned to service 15 months later, thereby incurring a 1-year period of severance. After working four months, G was laid off for nine months and then returned to work again. Although the plan may hold employee G out from participation in the plan until the completion of a 1-year period of service after the 1-year (or greater) period of severance, once the 1-year hold-out is completed, the plan is required to provide the employee with such statutory entitlement as arose during the 1-year hold-out. Accordingly, employee G satisfied the 1-year hold-out requirement as of the eighth month of layoff, and G is entitled to become a participant in the plan immediately upon his return to service after the nine-month layoff effective as of the first applicable entry date occurring after the date on which he satisfied the 1-year of service requirement (*i.e.*, the first applicable entry date after the first month of layoff). See the regulations under section 410 (a) (relating to eligibility to participate).

(6) *Rule of parity*—(i) *General rule.* For purposes of section 410(a)(5)(D), in the case of a participant who does not have any nonforfeitable right under the plan to his accrued benefit derived from employer contributions and who incurs a 1-year period of severance, a plan, in determining an employee's period of service for purposes of section 410(a)(1), may disregard his period of service if his latest period of severance equals or exceeds his prior periods of service, whether or not consecutive, completed before such period of severance. See the regulations under section 410(a) (relating to eligibility to participate).

(ii) In determining whether a completely nonvested employee's service may be disregarded under the rule of parity, a plan is not permitted to apply the rule until the employee incurs a 1-year period of severance. Accordingly, a plan may not disregard a period of service of less than one year until an employee has incurred a period of severance of at least one year.

(iii) *Example.* Assume that a plan provides for a minimum service requirement of one year and provides for the rule of parity. An employee works for three months, quits and then is rehired 10 months later. Such employee is entitled to receive 13 months of credit for purposes of eligibility to participate and vesting (see the service spanning rules). Although the period of severance exceeded the period of service, the three months of service may not be disregarded because no 1-year period of severance occurred.

(d) *Vesting*—(1) *General rule.* (i) For purposes of section 411(a)(2), relating to vesting in accrued benefits derived from employer contributions, a plan which determines service to be taken in account on the basis of elapsed time shall provide that an employee is credited with a number of years of service equal to at least the number of whole years of the employee's period of service, whether or not such periods of service were completed consecutively.

(ii) In order to determine the number of whole years of an employee's period of service, a plan shall provide that non-successive periods of service must be aggregated and that less than whole year periods of service (whether or not consecutive) must be aggregated on the basis that 12 months of service (30 days are deemed to be a month in the case of the aggregation of fractional months) or 365 days of service equal a whole year of service.

(iii) *Service spanning rules.* In determining a participant's period of service for vesting purposes, a plan shall take into account the following periods of severance—

(A) If an employee severs from service by reason of a quit, discharge or retirement and the employee then performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) within 12 months of the severance from service date, the plan is required to take into account the period of severance; and

(B) Nothwithstanding paragraph (d)(1)(iii)(A) of this section, if an employee severs from service by reason of a quit, discharge or retirement during an absence from service of 12 months or less for any reason other than a quit, discharge, retirement or death, and then performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) within 12 months of the date on which the employee was first absent from service, the plan is required to take into account the period of severance.

(iv) For purposes of determining an employee's nonforfeitable percentage of accrued benefits derived from employer contributions, a plan, after calculating an employee's period of service in the manner prescribed in this paragraph, may disregard any remaining less than whole year, 12-month or 365-day period of service. Thus, for example, if a plan provides for the statutory five to fifteen year graded vesting, an employee with a period (or periods) of service which yield 5 whole year periods of service and an additional 321-day period of service is twenty-five percent vested in his or her employer-derived accrued benefits (based solely on the 5 whole year periods of service).

(2) *Service which may be disregarded.* (i) For purposes of section 411(a)(4), in determining the nonforfeitable percentage of an employee's right to his or her accrued benefits derived from employer contributions, all of an employee's period or periods of service with an employer or employers maintaining the plan shall be taken into account unless such service may be disregarded under paragraph (d)(2)(ii) of this section.

(ii) For purposes of paragraph (d)(2)(i) of this section, the following periods of service may be disregarded—

(A) The period of service completed by an employee before the date on which he attains age 22;

(B) In the case of a plan which requires mandatory employee contributions, the period of service which falls within the period of time to which a particular employee contribution relates, if the employee had the opportunity to make a contribution for such period of time and failed to do so;

(C) The period of service during any period for which the employer did not maintain the plan or a predecessor plan;

(D) The period of service which is not required to be taken into account by reason of a period of severance which constitutes a break in service within the meaning of paragraph (d)(4) of this section;

(E) The period of service completed by an employee prior to January 1, 1971, unless the employee completes a period of service of at least 3 years at any time after December 31, 1970; and

(F) The period of service completed before the first plan year for which this section applies to the plan, if such service would have been disregarded under the plan rules relating to breaks in service in effect at that time. See the regulations under section 411(a) (relating to vesting).

(3) *Seasonal industry.* [Reserved]

(4) *Break in service.* For purposes of applying the break in service rules, the term ''1-year period of severance'' shall be substituted for the term ''1-year break in service''. A 1-year period of severance shall be a 12-consecutive-month period beginning on the severance from service date and ending on the first anniversary of such date, provided that the employee during such 12-consecutive-month period fails to perform an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) for an employer or employers maintaining the plan.

(5) *One-year hold-out.* For purposes of section 411(a)(6)(B), in determining the nonforfeitable percentage of the right to accrued benefits derived from employer contributions of an employee who has incurred a 1-year period of severance, the period of service completed before such period of severance is not required to be taken into account until the employee has completed a 1-year period of service after his return to service. See the regulations under section 411(a) (relating to vesting).

(6) *Vesting in pre-break accruals.* For purposes of section 411(a)(6)(C), a ''1-year period of severance'' shall be deemed to constitute a ''1-year break in service.'' See the regulations under section 411(a) (relating to vesting).

(7) *Rule of partity*—(i) *General rule.* For purposes of section 411(a)(6)(D), in the case of an employee who is a nonvested participant in employer-derived benefits at the time he incurs a 1-year period of severance, the period of service completed by such participant before such period of severance is not required to be taken into account for purposes of determining the vested percentage of his or her right to employer-derived benefits if at such time the consecutive period of severance equals or exceeds his prior periods of service, whether or not consecutive, completed before such period of severance. See the regulations under section 411(a) (relating to vesting).

(e) *Benefit accrual.* (1) For purposes of section 411(b), a plan may provide that a participant's service with an employer or employers maintaining the plan shall be determined on the basis of the participant's total period of service beginning on the participation commencement date and ending on the severance from service date.

(2) Under section 411(b)(3)(A), a defined benefit pension plan may determine an employee's service for purposes of benefit accrual on any basis which is reasonable and consistent and which takes into account all service during the employee's participation in the plan which is included in a period of service required to be taken into account under section 410(a)(5) (relating to service which must be taken into account for purposes of determining an employee's eligibility to participate). A plan which provides for the determination of an employee's service with an employer or employers maintaining the plan on the basis permitted under paragraph (e)(1) of this section will be deemed to meet the requirements of section 411(b)(3)(A), provided that the plan meets the requirements of 29 CFR 2530.204–3, relating to plans which determine an employee's service for purposes of benefit accrual on a basis other than computation periods. Specifically, under 29 CFR 2530.204–3, it must be possible to prove that, despite the fact that benefit accrual under such a plan is not based on computation periods, the plan's provisions meet at least one of the three benefit accrual rules of section 411(b)(1) under all circumstances. Further, 29 CFR 2530.204–3 prohibits such a plan from disregarding service under section 411(b)(3)(C) (which would otherwise permit a plan to disregard service performed by an employee during a computation period in which the employee is credited with less than 1,000 hours). See the regulations under section 411(b) (relating to benefit accrual).

(f) *Transfers between methods of crediting service*—(1) *Single plan.* A plan may provide that an employee's service for purposes of eligibility to participate, vesting or benefit accrual shall be determined on the basis of computation periods under the general method set forth in 29 CFR 2530.200b–2 for certain classes of employees but under the alternative method permitted under this section for other classes of employees if the plan provides as follows—

(i) In the case of an employee who transfers from a class of employees whose service is determined on the basis of computation periods to a class of employees whose service is determined on the alternative basis permitted under this section, the employee shall receive credit for a period of service consisting of—

(A) A number of years equal to the number of years of service credited to the employee before the computation period during which the transfer occurs; and

(B) The greater of *(1)* the period of service that would be credited to the employee under the elapsed time method for his service during the entire computation period in which the transfer occurs or *(2)* the service taken into account under the computation periods method as of the date of the transfer.

In addition, the employee shall receive credit for service subsequent to the transfer commencing on the day after the last day of the computation period in which the transfer occurs.

(ii) In the case of an employee who transfers from a class of employees whose service is determined on the alternative basis permitted under this section to a class of employees whose service is determined on the basis of computation periods—

(A) The employee shall receive credit, as of the date of the transfer, for a number of years of service equal to the number of 1-year periods of service credited to the employee as of the date of the transfer, and

(B) The employee shall receive credit, in the computation period which includes the date of the transfer, for a number of hours of service determined by applying one of the equivalencies set forth in 29 CFR 2530.200b–3 (e) (1) to any fractional part of a year credited to the employee under this section as of the date of the transfer. Such equivalency shall be set forth in the plan and shall apply to all similarly situated employees.

(2) *More than one plan.* In the case of an employee who transfers from a plan using either the general method of determining service on the basis of computation periods set forth in 29 CFR 2530.200b–2 or the method of determining service permitted under this section to a plan using the other method of determining service, all service required to be credited under the plan to which the employee transfers shall

be determined by applying the rules of paragraph (f)(1) of this section.

(g) *Amendments to change method of crediting service.* A plan may be amended to change the method of crediting service for any purpose or for any class of employees between the general method set forth in 29 CFR 2530.200–2 and the method permitted under this section, if such amendment contains provisions under which each employee with respect to whom the method of crediting service is changed is treated in the same manner as an employee who transfers from one class of employees to another under paragraph (f)(1) of this section.

(h) *Transitional rule.* For plans in existence on [insert the date of the publication of this document], the provisions of paragraph (f) of this section are effective for plan years beginning after December 31, 1983.

[T.D. 7703, 45 FR 40980, June 17, 1980]

§1.410(a)–8 Five consecutive 1-year breaks in service, transitional rules under the Retirement Equity Act of 1984.

Sections 410(a)(5)(D) and 411(a)(6)(D), as amended by the Retirement Equity Act of 1984 (REA 1984), permit a plan to disregard years of service that were disregarded under the plan provisions satisfying those sections (as in effect on August 22, 1984) as of the day before the REA amendments apply to the plan. Under section 302(a) of REA 1984, the new break-in-service rules generally apply to plan years beginning after December 31, 1984. Thus, for example, assume a plan has a calendar plan year and disregarded years of service as permitted by sections 410(a)(5)(D) and 411(a)(6)(D) as in effect on August 22, 1984. An employee completed two years of service in 1981 and 1982, and then incurred two consecutive 1-year breaks in service in 1983 and 1984. The plans may disregard the prior years of service even though the employee did not incur five consecutive 1-year breaks in service. On the other hand, assume the employee completed three consecutive years of service beginning in 1980, and incurred two 1-year breaks in service in 1983 and 1984. Because, as of December 31, 1984, the years of service credited before 1983 could not be disregarded, whether the plan may subsequently disregard those years of service would be governed by the rules enacted by REA 1984.

[T.D. 8219, 53 FR 31851, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988]

§1.410(a)–8T Year of service; break in service (temporary).

(a)–(b) [Reserved]

(c) *Breaks in service.*

(1) [Reserved]

(2) *Employees under 2-year 100 percent vesting schedule*—(i) *General rule.* In the case of an employee who incurs a 1-year break in service under a plan which provides that after not more than 2 years of service each participant's right to his accrued benefit under the plan is completely nonforfeitable (within the meaning of section 411 and the regulations thereunder) at the time such benefit accrues, the employee's service before the break in service is not required to be taken into account after the break in service in determining the employee's years of service under section 410(a)(1) and §1.410(a)–3 if such employee has not satisfied such service requirement.

(ii) *Example.* The rules of this subparagraph are illustrated by the following example:

Example. A qualified plan computing service by the actual counting of hours provides full and immediate vesting. The plan can not require as a condition of participation that an employee complete 2 consecutive years of service with the employer because the requirement as to consecutive years is not permitted under section 410(a)(5). However, such a plan can require 2 years without a break in service, i.e., 2 years with no intervening years in which the employee fails to complete more than 500 hours of service. Under a plan containing such a participation requirement, the following example illustrates when employees would become eligible to participate.

Year	Hours of service completed		
	Employee A	Employee B	Employee C
1	1,000	1,000	1,000
2	1,000	700	500
3	1,000	1,000	1,000
4	1,000	1,000	700
5	1,000	1,000	1,000

NOTE: Employee A will have satisfied the plan's service requirement at the end of year 2, Employee B at the end of year 3, and Employee C at the end of year 5.

(3) *One-year break in service*—

(i) [Reserved]

(ii) *Examples.* The rules provided by this subparagraph are illustrated by the following examples:

Example (1). Employee A completes a year of service under a plan computing service by the actual counting of hours for the 12-month period ending December 31, 1989, and incurs a 1-year break in service for the 12-month period ending December 31, 1990. The plan does not contain the provisions permitted by section 410(a)(5)(B) (relating to 2-year 100 percent vesting) and section 410(a)(5)(D) (relating to nonvested participants). Thereafter, he does not complete a year of service. As of January 1, 1991, in computing his period of service under the plan his service prior to December 31, 1990, is not required to be taken into account for purposes of section 410(a)(1) and § 1.410(a)–3.

[T.D. 8170, 53 FR 239, Jan. 6, 1988]

§ 1.410(a)–9 Maternity and paternity absence.

(a) *Elapsed time*—(1) *Rule.* For purposes of applying the rules of § 1.410(a)–7 (relating to the elapsed time method of crediting service) to absences described in sections 410(a)(5)(E) and 411(a)(6)(E) (relating to maternity or paternity absence), the severance from service date of an employee who is absent from service beyond the first anniversary of the first day of absence by reason of a maternity or paternity absence described in section 410(a)(5)(E)(i) or 411(a)(6)(E)(i) is the second anniversary of the first day of such absence. The period between the first and second anniversaries of the first day of absence from work is neither a period of service nor a period of severance. This rule applies to maternity and paternity absences beginning on or after the first day of the first plan year in which the plan is required to credit service under sections 410(a)(5)(E) and 411(a)(6)(E).

(2) *Example.* The rules of this section are illustrated by the following example:

Assume an individual works until June 30, 1986; is first absent from employment on July 1, 1986, on account of maternity or paternity absence; and on July 1, 1989, performs an hour of service. The period of service must include the period from employment commencement date until June 30, 1987 (one year after the date of separation for any reason other than a quit, discharge, retirement, or death). The period from July 1, 1987, to June 30, 1988, is neither a period of service nor a period of severance. The period of severance would be from July 1, 1988, to June 30, 1989.

(b) *Other methods.* This paragraph provides a safe harbor for plans that compute years of service under the hours of service methods or permitted equivalencies. Such a plan will be treated as satisfying the requirements of sections 410(a)(5)(E) and 411(a)(6)(E) if the plan increases the minimum period of consecutive 1-year breaks required to disregard any service (or deprive any employee of any right) by one. Thus, a plan will satisfy sections 410(a)(5)(E) and 411(a)(6)(E) without having to compute service for maternity or paternity and sections 410(a)(5)(D) and 411 (a)(4)(D) and (a)(6)(C), by increasing the period of consecutive breaks–in–service from 5 to 6.

[T.D. 8219, 53 FR 31852, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988]

§ 1.410(a)–9T Elapsed time (temporary).

(a)–(b) [Reserved]

(c) *Eligibility to participate.*

(1) [Reserved]

(2) *Determination of one-year period of service.*

(i) [Reserved]

(ii) For purposes of section 410(a)(1)(B)(i), a ''2-year period of service'' shall be deemed to be ''2 years of service.''

(d) *Vesting*—(1) *General rule.*

(i)—(iii) [Reserved]

(iv) For purposes of determining an employee's nonforfeitable percentage of accrued benefits derived from employer contributions, a plan, after calculating an employee's period of service in the manner prescribed in this paragraph, may disregard any remaining less than whole year, 12-month or 365-day period of service. Thus, for example, if a plan provides for the statutory three to seven year graded vesting, an employee with a period (or periods) of service which yields 3 whole year periods of service and an additional 321-day period of service is twenty percent vested in his or her employer-derived accrued benefits (based solely on the 3 whole year periods of service).

[T.D. 8170, 53 FR 239, Jan. 6, 1988]

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[T.D. 8363, 56 FR 47641, Sept. 19, 1991; 57 FR 10954, Mar. 31, 1992, as amended by T.D. 8487, 58 FR 46838, Sept. 3, 1993; T.D. 8548, 59 FR 32914, June 27, 1994]

§1.410(b)–1 Minimum coverage requirements (before 1994).

(a) *In general.* A plan is not a qualified plan (and a trust forming a part of the plan is not a qualified trust) unless the plan satisfies section 410(b)(1). For plan years prior to the applicable effective date set forth in §1.410(b)–10, a plan satisfies section 410(b)(1) if it satisfies the requirements of paragraph (b)(1) or (b)(2) of this section. See also §1.410(b)–2 for plan years beginning on or after the applicable effective date set forth in §1.410(b)–10.

(b) *Coverage tests*—(1) *Percentage test.* A plan satisfies the requirements of this subparagraph if it benefits—

(i) Seventy percent or more of all employees, or

(ii) Eighty percent or more of all employees who are eligible to benefit under the plan if 70 percent or more of all the employees are eligible to benefit under the plan,

excluding in each case employees who have not satisfied the minimum age and service requirements (if any) prescribed by the plan, as of the date coverage is tested, as a condition of participation and employees permitted to be excluded under paragraph (c) of this section. The percentage requirements of this subparagraph refer to a percentage of active employees, including employees temporarily on leave, such as those in the Armed Forces of the United States, if such employees are eligible under the plan.

(2) *Classification test.* A plan satisfies the requirements of section 410(b)(1) and this subparagraph if it benefits such employees as qualify under a classification of employees set up by the employer, which classification is found by the Internal Revenue Service not to be discriminatory in favor of employees who are officers, shareholders, or highly compensated. For purposes of this subparagraph, except as provided by paragraph (c) of this section, all active employees (including employees who do not satisfy the minimum age or service requirements of the plan) are taken into account.

(c) *Exclusion of certain employees.* Under section 410(b)(2), for purposes of section 410(b)(1) and paragraph (b) of this section, there shall be excluded from consideration employees described in subparagraphs (1), (2), and (3) of this paragraph.

(1) *Bargaining unit.* Under section 410(b)(2)(A) and this paragraph, there may be excluded from consideration employees not included in the plan who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if the Internal Revenue Service finds that retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or employers. For purposes of determining whether such bargaining occurred, it is not material that such employees are not covered by another plan or that the plan was not considered in such bargaining.

(2) *Air pilots.* Under section 410(b)(2)(B) and this paragraph there may be excluded from consideration, in the case of a plan established or maintained pursuant to an agreement which the Secretary of Labor finds to be a collective bargaining agreement between air pilots represented in accordance with title II of the Railway Labor Act and one or more employers all employees not covered by such agreement. Section 410(b)(2)(B) and this subparagraph do not apply to a plan if the plan provides contributions or benefits for employees whose principal duties are not customarily performed aboard aircraft in flight.

(3) *Nonresident aliens.* Under section 410(b)(2)(C) and this paragraph, there may be excluded from consideration employees who are nonresident aliens and who receive no earned income (within the meaning of section 911(b) and the regulations thereunder) from

the employer which constitutes income from sources within the United States (within the meaning of section 861(a)(3) and the regulations thereunder).

(d) *Special rules*—(1) *Highly compensated.* The classification of an employee as highly compensated for purposes of section 410(b)(1)(B) and § 1.410(b)–1(b)(2) is made on the basis of the facts and circumstances of each case, taking into account the level of the employee's compensation and the level of compensation paid by the employer to other employees, whether or not covered by the plan. Average compensation levels determined on a local, regional, or national basis, are not relevant for this purpose. Further, the classification of an employee as highly compensated is not made solely on the basis of the number or percentage of employees whose compensation exceeds, or is exceeded by, the employee's.

(2) *Discrimination.* The determination as to whether a plan discriminates in favor of employees who are officers, shareholders, or highly compensated is made on the basis of the facts and circumstances of each case, allowing a reasonable difference between the ratio of such employees benefited by the plan to all such employees of the employer and the ratio of the employees (other than officers, shareholders, or highly compensated) of the employer benefited by the plan to all employees (other than officers, shareholders, or highly compensated). A showing that a specified percentage of employees covered by a plan are not officers, shareholders, or highly compensated, is not in itself sufficient to establish that the plan does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

(3) *Multiple plans*—(i) An employer may designate two or more plans as constituting a single plan which is intended to qualify for purposes of section 410(b)(1) and this section, in which case all plans so designated shall be considered as a single plan in determining whether the requirements of such section are satisfied by each of the separate plans. A determination that the combination of plans so designated does not satisfy such requirements does not preclude a determination that one or more of such plans, considered separately, satisfies such requirements.

(ii) Notwithstanding subdivision (i) of this subparagraph, a plan which is subject to the limitations of section 401(a)(17) of the Code or section 301(d)(3) of the Tax Reduction Act of 1975 cannot be considered with any other plan which covers any employee covered by such plan.

(4) *Profit-sharing plans.* Employees under a profit-sharing plan who receive the amounts allocated to their accounts before the expiration of a period of time or the occurrence of a contingency specified in the plan shall not be considered covered by the plan. Thus, in case a plan permits employees to receive immediately the amounts allocated to their accounts, or to have such amounts paid to a profit-sharing plan for them, the employees who receive the shares immediately shall not be considered covered by the plan.

(5) *Certain classifications.* See section 401(a)(5) and the regulations thereunder for rules relating to classifications of employees which are not considered to be discriminatory per se for purposes of section 410(b)(1)(B) and § 1.410(b)–1(b)(2).

(6) *Integration with Social Security Act.* See section 401(a)(5) and the regulations thereunder for rules relating to integration of plans with the Social Security Act.

(7) *Different age and service requirements*—(i) *Application.* The rules of this subparagraph (7) apply to a plan which must satisfy the minimum age and service requirements of section 410(a)(1)(A) in order to be a qualified plan. Accordingly, the rules are inapplicable to plans described in section 410(c)(1) (see § 1.410(a)–1(c)(1)); plans satisfying the alternative minimum age and service requirements of section 410(a)(1)(B) but not satisfying the requirements of section 410(a)(1)(A); and plans which provide contributions or benefits for employees, some or all of whom are owner-employees (see section 401(a)(10)).

(ii) *General rules.* A provision for different age and service requirements for present and future employees either upon establishment or subsequent amendment is not, of itself, discriminatory under section 410(b)(1)(B) even though present employees who are officers, shareholders, or highly compensated cannot meet the age and service requirements for future employees at the time the plan is established or amended and even though present participants who are officers, shareholders, or highly compensated would not have satisfied the age and service requirements for future employees at the time they became participants in the plan. Furthermore, prohibited discrimination will be deemed not to arise in operation, solely because of such different requirements, when future employees are added to the employer's work force.

(8) *Certain controlled groups.* In applying the percentage test and classification test described in paragraph (b) (1) and (2) of this section for a year, all the employees of corporations or trades and businesses whose employees are treated as employed by a single employer by reason of section 414 (b) or (c) must be taken into account. The preceding sentence shall apply for a plan year if, on 1 day in each quarter of such plan year, such corporations are members of a controlled group of corporations (within the meaning of section 414(b)) of such trades or businesses are under common control (within the meaning of section 414(c)).

(9) *Transitional rule.* In the case of a cash and deferred profit-sharing plan, in existence on June 27, 1974, the requirements of paragraph (b)(2) of this section are satisfied if over one-half of the participants in the plan are among the lowest paid two-thirds of all eligible employees. This subparagraph shall not apply after December 31, 1977.

(e) *Example.* The rules provided by this section are illustrated by the following example:

Example. An employer established a noncontributory defined benefit plan covering all employees of its ABC Division who are hired prior to age 60 and who are at least 25 years old. The normal retirement age under the plan is age 65. The employer has 100 employees including 20 employees who are under age 25 and 10 employees who were hired over age 60. The plan does not cover 15 employees who are over age 25 and were hired before age 60 because they are not in the ABC Division. Of these 15 excluded employees, 3 have less than 1 year of service. In addition, 12 of the 55 employees covered have less than one year of service. The plan can be shown not to satisfy the requirements of IRC section 410(b)(1)(A) as follows:

(i) Number of employees	100
(ii) Number of employees excluded on account of minimum age and service	20
(iii) (i)–(ii)	80
(iv) Number of employees who must be covered if plan is to satisfy IRC section 410(b)(1)(A), 70% of (iii)	56
(v) Number of employees actually covered	55

Because the number of employees covered is less than the number of employees who must be covered, the plan does not satisfy the percentage coverage requirements of IRC section 410(b)(1)(A).

(Sec. 410 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7508, 42 FR 47197, Sept. 20, 1977, as amended by T.D. 7735, 45 FR 74722, Nov. 12, 1980; T.D. 8363, 56 FR 47643, Sept. 19, 1991; T.D. 8487, 58 FR 46839, Sept. 3, 1993]

§1.410(b)–2 Minimum coverage requirements (after 1993).

(a) *In general.* A plan is a qualified plan for a plan year only if the plan satisfies section 410(b) for the plan year. A plan satisfies section 410(b) for a plan year if and only if it satisfies paragraph (b) of this section with respect to employees for the plan year and paragraph (c) of this section with respect to former employees for the plan year. The rules in paragraphs (a), (b), and (c) of this section apply to all plans as a condition of qualification, including plans under which no employee is able to accrue any additional benefits (for example, frozen plans). Paragraphs (d), (e), and (f) of this section provide special rules for nonelective section 403(b) plans subject to section 403(b)(12)(A)(i), for governmental and church plans subject to section 410(c), and for certain acquisitions or dispositions, respectively. See §1.410(b)–7 for rules for determining the ''plan'' subject to section 410(b).

(b) *Requirements with respect to employees*—(1) *In general.* A plan satisfies this paragraph (b) for a plan year if and only if it satisfies at least one of the tests in paragraphs (b)(2) through (b)(7) of this section for the plan year.

(2) *Ratio percentage test*—(i) *In general.* A plan satisfies this paragraph (b)(2) for a plan year if and only if the plan's ratio percentage for the plan year is at least 70 percent. This test incorporates both the percentage test of section 410(b)(1)(A) and the ratio test of section

410(b)(1)(B). See §1.410(b)–9 for the definition of ratio percentage.

(ii) *Examples.* The following examples illustrate the ratio percentage test of this paragraph (b)(2).

Example 1. For a plan year, Plan A benefits 70 percent of an employer's nonhighly compensated employees and 100 percent of the employer's highly compensated employees. The plan's ratio percentage for the year is 70 percent (70 percent/100 percent), and thus the plan satisfies the ratio percentage test.

Example 2. For a plan year, Plan B benefits 40 percent of the employer's nonhighly compensated employees and 60 percent of the employer's highly compensated employees. Plan B fails to satisfy the ratio percentage test because the plan's ratio percentage is only 66.67 percent (40 percent/60 percent).

(3) *Average benefit test.* A plan satisfies this paragraph (b)(3) for a plan year if and only if the plan satisfies both the nondiscriminatory classification test of §1.410(b)–4 and the average benefit percentage test of §1.410(b)–5 for the plan year.

(4) *Certain tax credit employee stock ownership plans.* A plan satisfies this paragraph (b)(4) for a plan year if and only if the plan—

(i) Is a tax credit employee stock ownership plan (as defined in section 409(a)),

(ii) Is the only plan of the employer that is intended to qualify under section 401(a), and

(iii) Is a plan that satisfies the rule set forth in section 410(b)(6)(D).

This paragraph (b)(4) is available only for plan years for which the tax credit employee stock ownership plan receives contributions for which the employer is allowed a tax credit under section 41 (as in effect prior to its repeal by the Tax Reform Act of 1986) or section 48(n) (as in effect prior to its amendment by the Tax Reform Act of 1984). The requirement of this paragraph (b)(4) that the plan be the only plan of the employer that is intended to qualify under section 401(a) is not satisfied if the employer has only one plan, but that plan is treated as two or more separate plans under the mandatory disaggregation rules of §1.410(b)–7(c).

(5) *Employers with no nonhighly compensated employees.* A plan satisfies this paragraph (b)(5) for a plan year if and only if the plan is maintained by an employer that has no nonhighly compensated employees at any time during the plan year.

(6) *Plans benefiting no highly compensated employees.* A plan satisfies this paragraph (b)(6) for a plan year if and only if the plan benefits no highly compensated employees for the plan year.

(7) *Plans benefiting collectively bargained employees.* A plan that benefits solely collectively bargained employees for a plan year satisfies this paragraph (b)(7) for the plan year. If a plan (within the meaning of §1.410(b)–7(b)) benefits both collectively bargained employees and noncollectively bargained employees for a plan year, §1.410(b)–7(c)(4) provides that the portion of the plan that benefits collectively bargained employees is treated as a separate plan from the portion of the plan that benefits noncollectively bargained employees. Thus, the mandatorily disaggregated portion of the plan that benefits the collectively bargained employees automatically satisfies this paragraph (b)(7) for the plan year and hence section 410(b). See §1.410(b)–9 for the definitions of collectively bargained employee and noncollectively bargained employee.

(c) *Requirements with respect to former employees*—(1) *Former employees tested separately.* Former employees are tested separately from employees for purposes of section 410(b). Thus, former employees are disregarded in applying the ratio percentage test, the nondiscriminatory classification test, and the average benefit percentage test with respect to the coverage of employees under a plan, and employees are disregarded in applying this section with respect to the coverage of former employees under a plan.

(2) *Testing former employees.* A plan satisfies section 410(b) with respect to former employees if and only if, under all of the relevant facts and circumstances (including the group of nonexcludable former employees not benefiting under the plan), the group of former employees benefiting under the plan does not discriminate significantly in favor of highly compensated former employees.

(d) *Nonelective contributions under section 403(b) plans.* For plan years beginning on or after January 1, 1989, a plan subject to section 403(b)(12)(A)(i) with respect to nonelective contributions (i.e., contributions not made pursuant to a salary reduction agreement) is treated as a plan subject to the requirements of this section. For this purpose, a plan described in the preceding sentence must satisfy the requirements of this section without regard to section 410(c) and paragraph (e) of this section. For plan years beginning before the effective date set forth in §1.410(b)–10(d), any plan described in section 410(c)(1)(A) (regarding governmental plans) satisfies the requirements of this section.

(e) *Certain governmental and church plans.* The requirements of section 410(b) do not apply to a plan described in section 410(c)(1) (other than a plan subject to section 403(b)(12)(A)(i) or a plan with respect to which an election has been made under section 410(d)). Such a plan must satisfy section 401(a)(3) as in effect on September 1, 1974. For this purpose, a plan that satisfies section 410(b) (without regard to this paragraph (e)) is treated as satisfying section 401(a)(3) as in effect on September 1, 1974. For plan years beginning before the effective date set forth in §1.410(b)–10(d), any plan described in section 410(c)(1)(A) (regarding governmental plans) satisfies the requirements of this section and is thus treated as satisfying the requirements of section 401(a)(3) as in effect on September 1, 1974. See §1.410(b)–10(b)(2) for a special rule for plans of tax-exempt organizations.

(f) *Certain acquisitions or dispositions.* Section 410(b)(6)(C) (relating to certain acquisitions or dispositions) provides a special rule whereby a plan may be treated as satisfying section 410(b) for a limited period of time after an acquisition or disposition if it satisfies section 410(b) (without regard to the special rule) immediately before the acquisition or disposition and there is no significant change in the plan or in the coverage of the plan other than the acquisition or disposition. For purposes of section 410(b)(6)(C) and this paragraph (f), the terms ‘‘acquisition’’ and ‘‘disposition’’ refer to an asset or stock acquisition, merger, or other similar transaction involving a change in employer of the employees of a trade or business.

(g) *Additional rules.* The Commissioner may, in revenue rulings, notices, and other guidance of general applicability, provide any additional rules that may be necessary or appropriate in applying the minimum coverage requirements of section 410(b), including (without limitation) additional rules limiting or expanding the methods in §1.410(b)–5(d) and (e) for determining employee benefit percentages.

[T.D. 8363, 56 FR 47643, Sept. 19, 1991; 57 FR 10817, Mar. 31, 1992, as amended by T.D. 8487, 58 FR 46839, Sept. 3, 1993; T.D. 8548, 59 FR 32914, June 27, 1994]

§1.410(b)–3 Employees and former employees who benefit under a plan.

(a) *Employees benefiting under a plan*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, an employee is treated as benefiting under a plan for a plan year if and only if for that plan year, in the case of a defined contribution plan, the employer receives an allocation taken into account under §1.401(a)(4)–2(c)(2)(ii), or in the case of a defined benefit plan, the employee has an increase in a benefit accrued or treated as an accrued benefit under section 411(d)(6).

(2) *Exceptions to allocation or accrual requirement*—(i) *Section 401(k) and 401(m) plans.* Notwithstanding paragraph (a)(1) of this section, an employee is treated as benefiting under a section 401(k) plan for a plan year if and only if the employee is an eligible employee under the plan as defined in §1.401(k)–1(g)(4) for the plan year. Similarly, an employee is treated as benefiting under a section 401(m) plan for a plan year if and only if the employee is an eligible employee as defined in §1.401(m)–1(f)(4) for the plan year.

(ii) *Section 415 limits*—(A) *General rule for defined benefit plans.* In determining whether an employee is treated as benefiting under a defined benefit plan for a plan year, plan provisions that implement the limits of section 415 are disregarded. Any plan provision that provides for increases in an employee’s accrued benefit under the plan due solely to adjustments under section 415(d)(1), additional years of participation or service under section 415(b)(5), or changes in the defined contribution fraction under section 415(e) is also disregarded, but only if such provision applies uniformly to all employees in the plan.

(B) *Defined benefit plans taking section 415 limits into account under section 401(a)(4) testing.* Paragraph (a)(2)(ii)(A) of this section does not apply in the case of a defined benefit plan that uses the option in § 1.401(a)(4)–3(d)(2)(ii)(B) to take into account plan provisions implementing the provisions of section 415 in determining accrual rates under the section 401(a)(4) general test.

(C) *Defined contribution plans.* A defined contribution plan is permitted to apply the rule in the first sentence of paragraph (a)(2)(ii)(A) of this section in determining whether an employee is treated as benefiting under the plan, provided it applies the rule on a consistent basis for all employees in the plan.

(iii) *Certain employees treated as benefiting*—(A) *In general.* An employee is treated as benefiting under a plan for a plan year if the employee satisfies all of the applicable conditions for accruing a benefit or receiving an allocation for the plan year but fails to have an increase in accrued benefit or to receive an allocation solely because of one or more of the conditions set forth in paragraphs (a)(2)(iii) (B) through (F) of this section.

(B) *Certain plan limits.* The employee's benefit would otherwise exceed a limit that is applicable on a uniform basis to all employees in the plan. Thus, for example, if the formula under a defined benefit plan takes into account only the first 30 years of service for accrual purposes, an employee who has completed more than 30 years of service is still treated as benefiting under the plan.

(C) *Benefits previously accrued.* The benefit previously accrued by the employee is greater than the benefit that would be determined under the plan if the benefit previously accrued were disregarded. This could happen, for example, when the plan is applying the wear-away formula of § 1.401(a)(4)–13(c)(4)(ii) and the employee's frozen accrued benefit exceeds the benefit determined under the current formula.

(D) *Benefit offset arrangements.* The plan offsets the employee's current benefit accrual under an offset arrangement described in § 1.401(a)(4)–3(f)(9) (without regard to whether the offset is attributable to pre-participation service or past service).

(E) *Target benefit plans.* In the case of a target benefit plan that satisfies the nondiscriminatory amount requirement of § 1.401(a)(4)–1(b)(2) by satisfying the safe harbor in § 1.401(a)(4)–8(b)(3), the employee's theoretical reserve is greater than or equal to the actuarial present value of the fractional rule benefit.

(F) *Post-normal retirement age adjustments.* The employee has attained normal retirement age under a defined benefit plan and fails to accrue a benefit because of the provisions of section 411(b)(1)(H)(iii) regarding adjustments for delayed retirement.

(iv) *Section 412(i) plans*—(A) *General rule.* Notwithstanding paragraph (a)(1) of this section, an employee is treated as benefiting under an insurance contract plan within the meaning of section 412(i) for a plan year if and only if a premium is paid on behalf of the employee for the plan year.

(B) *Exceptions.* Notwithstanding paragraph (a)(2)(iv)(A) of this section, an employee is treated as benefiting under an insurance contract plan within the meaning of section 412(i) for a plan year if the sole reason that a premium is not paid on behalf of the employee is one of the reasons described in paragraph (a)(2)(iii) of this section. In addition, an employee is treated as benefiting under an insurance contract plan, within the meaning of section 412(i), that is a defined benefit plan if a premium is not paid on behalf of the employee solely because the insurance contracts that have previously been purchased on behalf of the employee guarantee to provide for the employee's projected normal retirement benefit without regard to future premium payments.

(3) *Examples.* The following examples illustrate the determination of whether an employee is benefiting under a plan for purposes of section 410(b).

Example 1. An employer has 35 employees who are eligible under a defined benefit plan.

The plan requires 1,000 hours of service to accrue a benefit. Only 30 employees satisfy the 1,000-hour requirement and accrue a benefit. The five employees who do not satisfy the 1,000-hour requirement during the plan year are taken into account in testing the plan under section 410(b) but are treated as not benefiting under the plan.

Example 2. An employer maintains a section 401(k) plan. Only employees who are at least age 21 and who complete one year of service are eligible employees under the plan within the meaning of §1.401(k)–1(g)(4). Under the rule of paragraph (a)(2)(i) of this section, only employees who have satisfied these age and service conditions are treated as benefiting under the plan.

Example 3. The facts are the same as in *Example 2,* except that the employer also maintains a section 401(m) plan that provides matching contributions contingent on elective contributions under the section 401(k) plan. The matching contributions are contingent on employment on the last day of the plan year. Under §1.401(m)–1(f)(4), because matching contributions are contingent on employment on the last day of the plan year, not all employees who are eligible employees under the section 401(k) plan are eligible employees under the section 401(m) plan. Thus, employees who have satisfied the age and service conditions but who do not receive a matching contribution because they are not employed on the last day of the plan year are treated as not benefiting under the section 401(m) portion of the plan.

(b) *Former employees benefiting under a plan*—(1) *In general.* A former employee is treated as benefiting for a plan year if and only if the plan provides an allocation or benefit increase described in paragraph (a)(1) of this section to the former employee for the plan year. Thus, for example, a former employee benefits under a defined benefit plan for a plan year if the plan is amended to provide an ad hoc cost-of-living adjustment in the former employee's benefits. In contrast, because an increase in benefits payable under a plan pursuant to an automatic cost-of-living provision adopted and effective before the beginning of the plan year is previously accrued, a former employee is not treated as benefiting in a subsequent plan year merely because the former employee receives an increase pursuant to such an automatic cost-of-living provision. Any accrual or allocation for an individual during the plan year that arises from the individual's status as an employee is treated as an accrual or allocation of an employee. Similarly, any accrual or allocation for an individual during the plan year that arises from the individual's status as a former employee is treated as an accrual or allocation of a former employee. It is possible for an individual to accrue a benefit both as an employee and as a former employee in a given plan year. During the plan year in which an individual ceases performing services for the employer, the individual is treated as an employee in applying section 410(b) with respect to employees and is treated as a former employee in applying section 410(b) with respect to former employees.

(2) *Examples.* The following examples illustrate the determination of whether a former employee benefits under a plan for purposes of section 410(b).

Example 1. Employer A amends its defined benefit plan in the 1995 plan year to provide an ad hoc cost-of-living increase of 5 percent for all retirees. Former employees who receive this increase are treated as benefiting under the plan for the 1995 plan year.

Example 2. Employer B maintains a defined benefit plan with a calendar plan year. In the 1995 plan year, Employer B amends the plan to provide that an employee who has reached early retirement age under the plan and who retires before July 31 of the 1995 plan year will receive an unreduced benefit, even though the employee has not yet reached normal retirement age. This early retirement window benefit is provided to employees based on their status as employees. Thus, although individuals who take advantage of the benefit become former employees, the window benefit is treated as provided to employees and is not treated as a benefit for former employees.

Example 3. The facts are the same as *Example 2,* except that on September 1, 1995, Employer B also amends the defined benefit plan to provide an ad hoc cost-of-living increase effective for all former employees. An individual who ceases performing services for the employer before July 31, 1995, under the early retirement window, and then receives the ad hoc cost-of-living increase, is treated as benefiting for the 1995 plan year both as an employee with respect to the early retirement window, and as a former employee with respect to the ad hoc COLA.

[T.D. 8363, 56 FR 47644, Sept. 19, 1991; 57 FR 10954, Mar. 31, 1992, as amended by T.D. 8487, 58 FR 46839, Sept. 3, 1993]

§ 1.410(b)–4 Nondiscriminatory classification test.

(a) *In general.* A plan satisfies the nondiscriminatory classification test of this section for a plan year if and only if, for the plan year, the plan benefits the employees who qualify under a classification established by the employer in accordance with paragraph (b) of this section, and the classification of employees is nondiscriminatory under paragraph (c) of this section.

(b) *Reasonable classification established by the employer.* A classification is established by the employer in accordance with this paragraph (b) if and only if, based on all the facts and circumstances, the classification is reasonable and is established under objective business criteria that identify the category of employees who benefit under the plan. Reasonable classifications generally include specified job categories, nature of compensation (i.e., salaried or hourly), geographic location, and similar bona fide business criteria. An enumeration of employees by name or other specific criteria having substantially the same effect as an enumeration by name is not considered a reasonable classification.

(c) *Nondiscriminatory classification*—(1) *General rule.* A classification is nondiscriminatory under this paragraph (c) for a plan year if and only if the group of employees included in the classification benefiting under the plan satisfies the requirements of either paragraph (c)(2) or (c)(3) of this section for the plan year.

(2) *Safe harbor.* A plan satisfies the requirement of this paragraph (c)(2) for a plan year if and only if the plan's ratio percentage is greater than or equal to the employer's safe harbor percentage, as defined in paragraph (c)(4)(i) of this section. See § 1.410(b)-9 for the definition of a plan's ratio percentage.

(3) *Facts and circumstances*—(i) *General rule.* A plan satisfies the requirements of this paragraph (c)(3) if and only if—

(A) The plan's ratio percentage is greater than or equal to the unsafe harbor percentage, as defined in paragraph (c)(4)(ii) of this section, and

(B) The classification satisfies the factual determination of paragraph (c)(3)(ii) of this section.

(ii) *Factual determination.* A classification satisfies this paragraph (c)(3)(ii) if and only if, based on all the relevant facts and circumstances, the Commissioner finds that the classification is nondiscriminatory. No one particular fact is determinative. Included among the facts and circumstances relevant in determining whether a classification is nondiscriminatory are the following—

(A) The underlying business reason for the classification. The greater the business reason for the classification, the more likely the classification is to be nondiscriminatory. Reducing the employer's cost of providing retirement benefits is not a relevant business reason.

(B) The percentage of the employer's employees benefiting under the plan. The higher the percentage, the more likely the classification is to be nondiscriminatory.

(C) Whether the number of employees benefiting under the plan in each salary range is representative of the number of employees in each salary range of the employer's workforce. In general, the more representative the percentages of employees benefiting under the plan in each salary range, the more likely the classification is to be nondiscriminatory.

(D) The difference between the plan's ratio percentage and the employer's safe harbor percentage. The smaller the difference, the more likely the classification is to be nondiscriminatory.

(E) The extent to which the plan's average benefit percentage (determined under § 1.410(b)-5) exceeds 70 percent.

(4) *Definitions*—(i) *Safe harbor percentage.* The safe harbor percentage of an employer is 50 percent, reduced by ¾ of a percentage point for each whole percentage point by which the nonhighly compensated employee concentration percentage exceeds 60 percent. See paragraph (c)(4)(iv) for a table that illustrates the safe harbor percentage and unsafe harbor percentage.

(ii) *Unsafe harbor percentage.* The unsafe harbor percentage of an employer is 40 percent, reduced by ¾ of a percentage point for each whole percentage point by which the nonhighly compensated employee concentration percentage exceeds 60 percent. However, in no case is the unsafe harbor percentage less than 20 percent.

(iii) *Nonhighly compensated employee concentration percentage.* The nonhighly compensated employee concentration percentage of an employer is the percentage of all the employees of the employer who are nonhighly compensated employees. Employees who are excludable employees for purposes of the average benefit test are not taken into account.

(iv) *Table.* The following table sets forth the safe harbor and unsafe harbor percentages at each nonhighly compensated employee concentration percentage:

Nonhighly compensated employee concentration percentage	Safe harbor percentage	Unsafe harbor percentage
0–60	50.00	40.00
61	49.25	39.25
62	48.50	38.50
63	47.75	37.75
64	47.00	37.00
65	46.25	36.25
66	45.50	35.50
67	44.75	34.75
68	44.00	34.00
69	43.25	33.25
70	42.50	32.50
71	41.75	31.75
72	41.00	31.00
73	40.25	30.25
74	39.50	29.50
75	38.75	28.75
76	38.00	28.00
77	37.25	27.25
78	36.50	26.50
79	35.75	25.75
80	35.00	25.00
81	34.25	24.25
82	33.50	23.50
83	32.75	22.75
84	32.00	22.00
85	31.25	21.25
86	30.50	20.50
87	29.75	20.00
88	29.00	20.00
89	28.25	20.00
90	27.50	20.00
91	26.75	20.00
92	26.00	20.00
93	25.25	20.00
94	24.50	20.00
95	23.75	20.00
96	23.00	20.00
97	22.25	20.00
98	21.50	20.00
99	20.75	20.00

(5) *Examples.* The following examples illustrate the rules in this paragraph (c).

Example 1. Employer A has 200 nonexcludable employees, of whom 120 are nonhighly compensated employees and 80 are highly compensated employees. Employer A maintains a plan that benefits 60 nonhighly compensated employees and 72 highly compensated employees. Thus, the plan's ratio percentage is 55.56 percent ([60/120]/[72/80]=50%/90%=0.5556), which is below the percentage necessary to satisfy the ratio percentage test of §1.410(b)–2(b)(2). The employer's nonhighly compensated employee concentration percentage is 60 percent (120/200); thus, Employer A's safe harbor percentage is 50 percent and its unsafe harbor percentage is 40 percent. Because the plan's ratio percentage is greater than the safe harbor percentage, the plan's classification satisfies the safe harbor of paragraph (c)(2) of this section.

Example 2. The facts are the same as in *Example 1,* except that the plan benefits only 40 nonhighly compensated employees. The plan's ratio percentage is thus 37.03 percent ([40/120]/[72/80]=33.33%/90%=0.3703). Under these facts, the plan's classification is below the unsafe harbor percentage and is thus considered discriminatory.

Example 3. The facts are the same as in *Example 1,* except that the plan benefits 45 nonhighly compensated employees. The plan's ratio percentage is thus 41.67 percent ([45/120]/[72/80]=37.50%/90%=0.4167), above the unsafe harbor percentage (40 percent) and below the safe harbor percentage (50 percent). The Commissioner may determine that the classification is nondiscriminatory after considering all the relevant facts and circumstances.

Example 4. Employer B has 10,000 nonexcludable employees, of whom 9,600 are nonhighly compensated employees and 400 are highly compensated employees. Employer B maintains a plan that benefits 600 nonhighly compensated employees and 100 highly compensated employees. Thus, the plan's ratio percentage is 25.00 percent ([600/9,600]/[100/400]=6.25%/25%=0.2500), which is below the percentage necessary to satisfy the ratio percentage test of §1.410(b)–2(b)(2). Employer B's nonhighly compensated employee concentration percentage is 96 percent (9,600/10,000); thus, Employer B's safe harbor percentage is 23 percent, and its unsafe harbor percentage is 20 percent. Because the plan's ratio percentage (25.00 percent) is greater than the safe harbor percentage (23.00 percent), the plan's classification satisfies the safe harbor of paragraph (c)(2) of this section.

Example 5. The facts are the same as in *Example 4,* except that the plan benefits only 400 nonhighly compensated employees. The plan's ratio percentage is thus 16.67 percent

([400/9,600]/[100/400]=4.17%/25%=0.1667). The plan's ratio percentage is below the unsafe harbor percentage and thus the classification is considered discriminatory.

Example 6. The facts are the same as in *Example 4*, except that the plan benefits 500 nonhighly compensated employees. The plan's ratio percentage is thus 20.83 percent ([500/9,600]/[100/400]=5.21%/25%=0.2083), above the unsafe harbor percentage (20 percent) and below the safe harbor percentage (23 percent). The Commissioner may determine that the classification is nondiscriminatory after considering all the facts and circumstances.

[T.D. 8363, 56 FR 47645, Sept. 19, 1991; 57 FR 10954, Mar. 31, 1992]

§1.410(b)–5 Average benefit percentage test.

(a) *General rule.* A plan satisfies the average benefit percentage test of this section for a plan year if and only if the average benefit percentage of the plan for the plan year is at least 70 percent. A plan is deemed to satisfy this requirement if it satisfies paragraph (f) of this section for the plan year.

(b) *Determination of average benefit percentage.* The average benefit percentage of a plan for a plan year is the percentage determined by dividing the actual benefit percentage of the nonhighly compensated employees in plans in the testing group for the testing period that includes the plan year by the actual benefit percentage of the highly compensated employees in plans in the testing group for that testing period. See paragraph (d)(3)(ii) of this section for the definition of testing period.

(c) *Determination of actual benefit percentage.* The actual benefit percentage of a group of employees for a testing period is the average of the employee benefit percentages, calculated separately with respect to each of the employees in the group for the testing period. All nonexcludable employees of the employer are taken into account for this purpose, even if they are not benefiting under any plan that is taken into account.

(d) *Determination of employee benefit percentages*—(1) *Overview.* This paragraph (d) provides rules for determining employee benefit percentages. See paragraph (e) of this section for alternative methods for determining employee benefit percentages.

(2) *Employee contributions and employee-provided benefits disregarded.* Only employer-provided contributions and benefits are taken into account in determining employee benefit percentages. Therefore, employee contributions (including both employee contributions allocated to separate accounts and employee contributions not allocated to separate accounts), and benefits derived from such contributions, are not taken into account in determining employee benefit percentages.

(3) *Plans and plan years taken into account*—(i) *Testing group.* All plans included in the testing group under §1.410(b)–7(e)(1), and only those plans, are taken into account in determining an employee's employee benefit percentage.

(ii) *Testing period.* An employee's employee benefit percentage is determined on the basis of plan years ending with or within the same calendar year. These plan years are referred to in this section as the relevant plan years or, in the aggregate, as the testing period.

(4) *Contributions or benefits basis.* Employee benefit percentages may be determined on either a contributions or a benefits basis. Employee benefit percentages for any testing period must be determined on the same basis (contributions or benefits) for all plans in the testing group.

(5) *Determination of employee benefit percentage*—(i) *General rule.* The employee benefit percentage for an employee for a testing period is the rate that would be determined for that employee for purposes of applying the general test for nondiscrimination in §§1.401(a)(4)–2, 1.401(a)(4)–3, 1.401(a)(4)–8 or 1.401(a)(4)–9, if all the plans in the testing group were aggregated for purposes of section 410(b). Thus, if employee benefit percentages are determined on a contributions basis, each employee's employee benefit percentage is the aggregate normal allocation rate that would be determined for the employee under §1.401(a)(4)–9(b)(2)(ii)(A) (if the plans in the testing group include both defined benefit and defined contribution plans), the allocation rate that would be determined for the employee under §1.401(a)(4)–2(c)(2)

(if the plans in the testing group include only defined contribution plans), or the equivalent normal allocation rate that would be determined for the employee under §1.401(a)(4)–8(c)(2) (if the plans in the testing group include only defined benefit plans). Similarly, if employee benefit percentages are determined on a benefits basis, each employee's employee benefit percentage is the aggregate normal accrual rate that would be determined for the employee under §1.401(a)(4)–9(b)(2)(ii)(B), the normal accrual rate that would be determined for the employee under §1.401(a)(4)–3(d), or the equivalent accrual rate that would be determined for the employee under §1.401(a)(4)–8(b)(2), depending on whether the plans in the testing group include both defined benefit and defined contribution plans, only defined benefit plans, or only defined contribution plans.

(ii) *Plans with differing plan years.* If not all the plans in the testing group share the same plan year, §1.410(b)–7(d)(5) would ordinarily prohibit them from being aggregated for purposes of section 410(b). In such a case, employee benefit percentages are determined by applying the rules of paragraph (d)(5)(i) of this section separately to each subset of plans in the testing group that share the same plan year (or the same accrual computation period) and aggregating the results for all plans in the testing group. Thus, an employee's employee benefit percentage is determined as the sum of these separate employee benefit percentages that are determined consistently for all the plans in the testing group (except for differences attributable solely to the differences in plan years).

(iii) *Options and consistency requirements.* In determining employee benefit percentages under this paragraph (d)(5), any optional or alternative methods or rules available for determining rates in §§1.401(a)(4)–2, 1.401(a)(4)–3, 1.401(a)(4)–8, or 1.401(a)(4)–9, whichever is applicable, may be applied. Thus, for example, employee benefit percentages may generally be calculated using any of the alternative methods of determining average annual compensation or plan year compensation under §1.401(a)(4)–12, and using any underlying definition of compensation that satisfies section 414(s). Except as otherwise specifically permitted, the determination of employee benefit percentages must be made on a consistent basis for all employees and for all plans in the testing group as required by §§1.401(a)(4)–2(c)(2)(vi), 1.401(a)(4)–3(d)(2)(i), 1.401(a)(4)–8(b)(2)(iv), 1.401(a)(4)–8(c)(2)(iv) or 1.401(a)(4)–9(b)(2)(iv).

(6) *Permitted disparity*—(i) *In general.* Permitted disparity may be imputed in determining employee benefit percentages as provided in §§1.401(a)(4)–2, 1.401(a)(4)–3, 1.401(a)(4)–8, or 1.401(a)(4)–9, whichever is applicable. When separate employee benefit percentages are determined for individual plans under paragraph (e)(2) of this section (or for subsets of plans that have the same plan year as described in paragraph (d)(5)(ii) of this section), permitted disparity may be imputed for an employee only in one individual plan (or subset of plans) and may not be imputed for the same employee in another individual plan (or subset of plans). However, if the same average annual compensation or plan year compensation is used to determine employee benefit percentages in more than one plan, the employee's employee benefit percentages for those plans may be summed prior to imputing permitted disparity.

(ii) *Plans which may not use permitted disparity.* Permitted disparity may be reflected in the determination of rates only to the extent that the plans for which rates are being determined are plans for which the permitted disparity of section 401(l) is available. Thus, for example, if a section 401(k) plan is included in the testing group and permitted disparity is imputed under §1.401(a)(4)–2(c)(iv), then employee benefit percentages are determined by first calculating an adjusted allocation rate (within the meaning of §1.401(a)(4)–7(b)(1)) without regard to the amount of allocations under the section 401(k) plan and adding to it the allocation rate for the section 401(k) plan. See §1.401(l)–1(a)(4) for a list of types of plans for which permitted disparity is not available.

(7) *Requirements for certain plans providing early retirement benefits*—(i) *General rule.* If any defined benefit plan in

the testing group provides for early retirement benefits in addition to normal retirement benefits to any highly compensated employee, and the average actuarial reduction for any one of these benefits commencing in the five years prior to the plan's normal retirement age is less than four percent per year, then the aggregate most valuable allocation rate, equivalent most valuable allocation rate, aggregate most valuable accrual rate, or most valuable accrual rate must be substituted for the related normal rates in paragraph (d)(5) of this section.

(ii) *Exception*. Paragraph (d)(7)(i) of this section does not apply if early retirement benefits with average actuarial reductions described in that paragraph are currently available, within the meaning of § 1.401(a)(4)–4(b), under plans in the testing group to a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees to whom these benefits are currently available.

(e) *Additional optional rules*—(1) *Overview.* This paragraph (e) contains various alternative methods for determining employee benefit percentages for a testing period.

(2) *Determination of employee benefit percentages as the sum of separately determined rates*—(i) *In general.* Employee benefit percentages may be determined as the sum of separately determined employee benefit percentages for each of the plans in the testing group that are aggregated under paragraphs (d)(5)(i) or (ii) of this section, provided that these employee benefit percentages are determined on a consistent basis for all of these plans pursuant to paragraph (d)(5)(iii) of this section.

(ii) *Exception from consistency requirement.* The consistency requirement of paragraph (e)(2)(i) of this section is not violated merely because employee benefit percentages are not determined in a consistent manner for all of the plans in the testing group and the inconsistencies in determination of rates among plans are described in paragraph (e)(2)(iii) of this section. The exception in this paragraph (e)(2)(ii) applies only if it is reasonable to believe that the inconsistencies do not result in an average benefit percentage that is significantly higher than the average benefit percentage that would be determined had employee benefit percentages been determined on a consistent basis pursuant to paragraph (d)(5)(iii) of this section.

(iii) *Permitted inconsistencies.* The following inconsistencies between plans are permitted under this paragraph (e)(2)—

(A) Use of different underlying definitions of section 414(s) compensation in the determination of rates;

(B) Use of different definitions of average annual compensation;

(C) Use of different testing ages;

(D) Use of different fresh-start dates;

(E) Use of different actuarial assumptions for normalization; or

(F) Disregard of actuarial increases after normal retirement age and QPSA charges without regard to any requirement for uniformity in the actuarial increases or QPSA charges.

(3) *Determination of employee benefit percentages without regard to plans of another type*—(i) *General rule.* Employee benefit percentages may be determined under plans of one type (i.e., defined benefit plans or defined contribution plans) by treating all plans of the other type (i.e., defined contribution plans or defined benefit plans, respectively) as if they were not part of the testing group, using the method provided in this paragraph (e)(3). If this method is used to determine whether a defined contribution plan satisfies the average benefit percentage test, employee benefit percentages under all defined contribution plans in the testing group must be determined on a contributions basis, and benefits under any defined benefit plans may not be included in the employee benefit percentage. Similarly, if this method is used to determine whether a defined benefit plan satisfies the average benefit percentage test, employee benefit percentages under all defined benefit plans in the testing group must be determined on a benefits basis, and allocations under any defined contribution plans may not be included in the employee benefit percentage.

(ii) *Restriction on use of separate testing group determination method.* A plan does not satisfy the average benefit percentage test using the method provided in this paragraph (e)(3) unless each of the plans in the testing group of the other type (i.e., defined benefit plan or defined contribution plan) than the plan being tested satisfies the average benefit test of §1.410(b)–2(b)(3) using the method in this paragraph (e)(3) or satisfies the ratio percentage test of §1.410(b)–2(b)(2).

(iii) *Treatment of permitted disparity.* Although under the general rule of this paragraph (e)(3) plans of another type are disregarded in determining employee benefit percentages, the permitted disparity used by those plans (including any permitted disparity that is used by those plans to satisfy §1.401(a)(4)–1(b)(2)) is nonetheless taken into account in determining the extent to which permitted disparity may be used in determining employee benefit percentages.

(iv) *Example.* The following example illustrates the rules of this paragraph (e)(3):

Example. Employer A maintains two defined benefit plans, neither of which covers a group of employees that satisfies the ratio percentage test of §1.410(b)–2(b)(2), and a profit-sharing plan and a section 401(k) plan, each of which benefits a group of employees that satisfies the ratio percentage test of §1.410(b)–2(b)(2). The defined benefit plans will satisfy the average benefit percentage test if the actual benefit percentage of all nonexcludable nonhighly compensated employees, computed on a benefits basis without regard to contributions under the profit-sharing plan or the section 401(k) plan, is at least 70 percent of the actual benefit percentage of all nonexcludable highly compensated employees, computed on a benefits basis without regard to contributions under the profit-sharing plan or the section 401(k) plan.

(4) *Simplified method for determining employee benefit percentages for certain defined benefit plans*—(i) *In general.* An employee's employee benefit percentage with respect to a plan may be determined under the simplified method of paragraph (e)(4)(ii) of this section, provided the following conditions are satisfied:

(A) The only plans included in the testing group are defined benefit plans, and employee benefit percentages under these plans are determined on a benefits basis.

(B) Employee benefit percentages under the plans in the testing group are not required to be determined by taking into account early retirement benefits under paragraph (d)(7) of this section.

(C) The plan is a safe harbor defined benefit plan described in §1.401(a)(4)–3(b).

(ii) *Simplified method*—(A) *Section 401(l) plans.* Under the simplified method of this paragraph (e)(4)(ii), an employee's employee benefit percentage with respect to a section 401(l) plan described in §1.401(a)(4)–3(b)(3) (i.e., a unit credit plan) may be deemed equal to the employee's excess benefit percentage or gross benefit percentage (as defined in §1.401(*l*)–1(c) (14) or (18), respectively), whichever is applicable under the plan's benefit formula in the plan year. In the case of a section 401(l) plan described in §1.401(a)(4)–3(b)(4) (i.e., a fractional accrual plan), an employee's employee benefit percentage with respect to that plan may be deemed equal to the rate at which the excess or gross benefit, whichever is applicable, accrues for the employee in the plan year, taking into account the plan's benefit formula and the employee's projected service at normal retirement age. The use of this simplified method will be treated as an imputation of permitted disparity. See paragraph (d)(6) of this section for a restriction on multiple use of permitted disparity.

(B) *Other plans.* Under the simplified method of this paragraph (e)(4)(ii), an employee's employee benefit percentage with respect to a plan described in §1.401(a)(4)–3(b)(3) that is not a section 401(*l*) plan and that is not imputing permitted disparity may be deemed equal to the employee's benefit rate in the plan year under the plan's benefit formula. In the case of a plan described in §1.401(a)(4)–3(b)(4) that is not a section 401(*l*) plan and that is not imputing permitted disparity, an employee's employee benefit percentage with respect to that plan may be deemed equal to the rate at which the benefit accrues for the employee in the plan year, taking into account the plan's benefit formula and an employee's projected service at normal retirement age.

(5) *Three-year averaging period.* An employee's employee benefit percentage may be determined for a testing period as the average of the employee's employee benefit percentages determined separately for the testing period and for the immediately preceding one or two testing periods (referred to in this section as an averaging period). Employee benefit percentages of a particular employee that are averaged together within an averaging period must be determined on a consistent basis for all testing periods within the averaging period.

(6) *Alternative methods of determining compensation.* Employee benefit percentages may be determined on the basis of any definition of compensation that satisfies § 1.414(s)–1(d) (without regard to whether the definition satisfies § 1.414(s)–1(d)(3)), provided that the same definition is used for all employees and it is reasonable to believe that the definition does not result in an average benefit percentage that is significantly higher than the average benefit percentage that would be determined had employee benefit percentages been determined using a definition of compensation that also satisfies § 1.414(s)–1(d)(3).

(f) *Special rule for certain collectively bargained plans.* A plan (as determined without regard to the mandatory disaggregation rule of § 1.410(b)–7(c)(5)) that benefits both collectively bargained employees and noncollectively bargained employees is deemed to satisfy the average benefit percentage test of this section if—

(1) The provisions of the plan applicable to each employee in the plan are identical to the provisions of the plan applicable to every other employee in the plan, including the plan benefit or allocation formula, any optional forms of benefit, any ancillary benefit, and any other right or feature under the plan, and

(2) The plan would satisfy the ratio percentage test of § 1.410(b)–2(b)(2), if §§ 1.410(b)–6(d) and 1.410(b)–7(c)(5) (the excludable employee and mandatory disaggregation rules for collectively bargained and noncollectively bargained employees) did not apply.

[T.D. 8363, 56 FR 47646, Sept. 19, 1991; 57 FR 10817, 10954, Mar. 31, 1992, as amended by T.D. 8487, 58 FR 46840, Sept. 3, 1993]

§ 1.410(b)–6 Excludable employees.

(a) *Employees*—(1) *In general.* For purposes of applying section 410(b) with respect to employees, all employees of the employer, other than the excludable employees described in paragraphs (b) through (i) of this section, are taken into account. Excludable employees are not taken into account with respect to a plan even if they are benefiting under the plan, except as otherwise provided in paragraph (b) of this section.

(2) *Rules of application.* Except as specifically provided otherwise, excludable employees are determined separately with respect to each plan for purposes of testing that plan under section 410(b). Thus, in determining whether a particular plan satisfies the ratio percentage test of § 1.410(b)–2(b)(2), paragraphs (b) through (i) of this section are applied solely with reference to that plan. Similarly, in determining whether two or more plans that are permissively aggregated and treated as a single plan under § 1.410(b)–7(d) satisfy the ratio percentage test of § 1.410(b)–2(b)(2), paragraphs (b) through (i) of this section are applied solely with reference to the deemed single plan. In determining whether a plan satisfies the average benefit percentage test of § 1.410(b)–5, the rules of this section are applied by treating all plans in the testing group as a single plan.

(b) *Minimum age and service exclusions*—(1) *In general.* If a plan applies minimum age and service eligibility conditions permissible under section 410(a)(1) and excludes all employees who do not meet those conditions from benefiting under the plan, then all employees who fail to satisfy those conditions are excludable employees with respect to that plan. An employee is treated as meeting the age and service requirements on the date that any employee with the same age and service (including service permitted to be taken into account for purposes of nondiscrimination testing under §1.401(a)(4)–11(d)(3)) would be eligible to commence participation in the plan, as provided in section 410(b)(4)(C).

(2) *Multiple age and service conditions.* If a plan, including a plan for which an employer chooses the treatment under paragraph (b)(3) of this section, has two or more different sets of minimum age and service eligibility conditions, those employees who fail to satisfy all of the different sets of age and service conditions are excludable employees with respect to the plan. Except as provided in paragraph (b)(3) of this section, an employee who satisfies any one of the different sets of conditions is not an excludable employee with respect to the plan. Differences in the manner in which service is credited (e.g., hours of service calculated in accordance with 29 CFR 2530.200b–2 for hourly employees and elapsed time calculated in accordance with §1.410(a)–7 for salaried employees) for purposes of applying a service condition are not taken into account in determining whether multiple age and service eligibility conditions exist.

(3) *Plans benefiting certain otherwise excludable employees*—(i) *In general.* An employer may treat a plan benefiting otherwise excludable employees as two separate plans, one for the otherwise excludable employees and one for the other employees benefiting under the plan. See §1.410(b)–7(c)(3) regarding permissive disaggregation of plans benefiting otherwise excludable employees. The effect of this rule is that employees who would be excludable under paragraph (b)(1) of this section (applied without regard to section 410(a)(1)(B)) but for the fact that the plan does not apply the greatest permissible minimum age and service conditions may be treated as excludable employees with respect to the plan. This treatment is available only if the plan satisfies section 410(b) and §1.410(b)–2 with respect to these otherwise excludable employees in the manner described in paragraph (b)(3)(ii) of this section.

(ii) *Testing portion of plan benefiting otherwise excludable employees.* In determining whether the plan that benefits employees who would otherwise be excludable under paragraph (b)(1) of this section (applied without regard to section 410(a)(1)(B)) satisfies section 410(b) and §1.410(b)–2, employees who have satisfied the greatest permissible minimum age and service conditions with respect to the plan are excludable employees. In addition, if the plan being tested applies minimum age and service conditions and those conditions are less than the maximum permissible minimum age and service conditions, employees who have not satisfied the lower minimum age and service conditions actually provided for in the plan are excludable employees. Thus, for example, if the plan requires attainment of age 18 and 3 months of service, employees who have not attained age 18 or 3 months of service with the employer are excludable employees.

(4) *Examples.* The following examples illustrate the minimum age and service condition rules of this paragraph (b). In each example, the employer is not treated as operating qualified separate lines of business under section 414(r).

Example 1. An employer maintains Plan A for hourly employees and Plan B for salaried employees. Plan A has no minimum age or service condition. Plan B has no minimum age condition and requires 1 year of service. The employer treats Plans A and B as a single plan for purposes of section 410(b). Because Plan A imposes no minimum age or service condition, all employees of the employer automatically satisfy the minimum age and service conditions of Plan A. Therefore, no employees are excludable under this paragraph (b) in testing Plans A and B for purposes of section 410(b).

Example 2. An employer maintains three plans. Plan C benefits employees in Division C who satisfy the plan's minimum age and service condition of age 21 and 1 year of service. Plan D benefits employees in Division D who satisfy the plan's minimum age and service condition of age 18 and 1 year of service. Plan E benefits employees in Division E who satisfy the plan's minimum age and service condition of age 21 and 6 months of service. The employer treats Plans D and E as a single plan for purposes of section 410(b). In testing Plan C under the ratio percentage test or the nondiscriminatory classification test of section 410(b), employees who are not at least age 21 or who do not have at least 1 year of service are excludable employees under paragraph (b)(1) of this section. In testing Plans D and E, employees who do not satisfy the age and service requirements of either of the two plans are excludable employees under paragraph (b)(2) of this section. Thus, an employee is excludable with respect to Plans D and E only if the employee is not at least age 18 with at least 1 year of service or is not at least age 21 with at least 6 months of service. Thus, an employee who is 19 years old and has 11 months of service is excludable. Similarly, an employee who is 17 years old and has performed 2 years of service is also excludable.

Example 3. An employer maintains three plans. Plan F benefits all employees in Division F (the plan does not apply any minimum age or service condition). Plan G benefits employees in Division G who satisfy the plan's minimum age and service condition of age 18 and 1 year of service. Plan H benefits employees in Division H who satisfy the plan's minimum age and service condition of age 21 and 6 months of service. In testing the employer's plans under the average benefit percentage test provided in § 1.410(b)–5, Plans F, G, and H are treated as a single plan and, as such, use the lowest minimum age and service condition under the rule of paragraph (b)(2) of this section. Therefore, because Plan F does not apply any minimum age or service condition, no employee is excludable under this paragraph (b).

Example 4. An employer maintains Plan J, which does not apply any minimum age or service conditions. Plan J benefits all employees in Division 1 but does not benefit employees in Division 2. Although Plan J has no minimum age or service condition, the employer wants to exclude employees whose age and service is below the permissible minimums provided in section 410(b)(1)(A). The employer has 110 employees who either do not have 1 year of service or are not at least age 21. Of these 110 employees, 10 are highly compensated employees and 100 are nonhighly compensated employees. Five of these highly compensated employees, or 50 percent, work in Division 1 and thus benefit under Plan J. Thirty-five of these nonhighly compensated employees, or 35 percent, work in Division 1 and thus benefit under Plan J. Plan J satisfies the ratio percentage test of section 410(b) with respect to employees who do not satisfy the greatest permissible minimum age and service requirement because the ratio percentage of that group of employees is 70 percent. Thus, in determining whether or not Plan J satisfies section 410(b), the 110 employees may be treated as excludable employees in accordance with paragraph (b)(3)(i) of this section.

(c) *Certain nonresident aliens*—(1) *General rule.* An employee who is a nonresident alien (within the meaning of section 7701(b)(1)(B)) and who receives no earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3)) is treated as an excludable employee.

(2) *Special treaty rule.* In addition, an employee who is a nonresident alien (within the meaning of section 7701(b)(1)(B)) and who does receive earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3)) is permitted to be excluded, if all of the employee's earned income from the employer from sources within the United States is exempt from United States income tax under an applicable income tax convention. This paragraph (c)(2) applies only if all employees described in the preceding sentence are so excluded.

(d) *Collectively bargained employees*—(1) *General rule.* A collectively bargained employee is an excludable employee with respect to a plan that benefits solely noncollectively bargained employees. If a plan (within the meaning of § 1.410(b)–7(b)) benefits both collectively bargained employees and noncollectively bargained employees for a plan year, § 1.410(b)–7(c)(4) provides that the portion of the plan that benefits the collectively bargained employees is treated as a separate plan from the portion of the plan that benefits the noncollectively bargained employees. Thus, a collectively bargained employee is always an excludable employee with respect to the mandatorily disaggregated portion of any plan that benefits noncollectively bargained employees.

(2) *Definition of collectively bargained employee*—(i) *In general.* A collectively bargained employee is an employee who is included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, provided that there is evidence that retirement benefits were the subject of good faith bargaining between employee representatives and the employer or employers. An employee is a collectively bargained employee regardless of whether the employee benefits under any plan of the employer. See section 7701(a)(46) and

§301.7701–17T of this chapter for additional requirements applicable to the collective bargaining agreement. An employee who performs hours of service during the plan year as both a collectively bargained employee and a noncollectively bargained employee is treated as a collectively bargained employee with respect to the hours of service performed as a collectively bargained employee and a noncollectively bargained employee with respect to the hours of service performed as a noncollectively bargained employee. See §1.410(b)–7(c) for disaggregation rules for plans benefiting collectively bargained and noncollectively bargained employees.

(ii) *Special rules for certain employees in multiemployer plans*—(A) *In general.* For purposes of this paragraph (d), in testing the disaggregated portion of a multiemployer plan benefiting noncollectively bargained employees, a noncollectively bargained employee who benefits under the plan may be treated as a collectively bargained employee with respect to all of the employee's hours of service under the rules of paragraphs (d)(2)(ii) (B) through (E) of this section, if the employee is or was a member of a unit of employees covered by a collective bargaining agreement and that agreement or a successor agreement provides for the employee to benefit under the plan in the current plan year. For this purpose, provisions of a participation agreement or similar document are taken into account in determining whether a collective bargaining agreement provides for an employee to benefit under a multiemployer plan.

(B) *Employees who were collectively bargained employees during a portion of the current plan year.* An employee described in paragraph (d)(2)(ii)(A) of this section who performs services for one or more employers that are parties to the collective bargaining agreement, for the plan, or for the employee representative both as a collectively bargained employee and as a noncollectively bargained employee during a plan year may be treated as a collectively bargained employee for the plan year, provided that at least half of the employee's hours of service during the plan year are performed as a collectively bargained employee.

(C) *Employees who were collectively bargained employees during the collective bargaining agreement.* An employee described in paragraph (d)(2)(ii)(A) of this section who was a collectively bargained employee with respect to all of the employee's hours of service during a plan year (including employees who are treated as collectively bargained employees with respect to all of their hours of service during a plan year under paragraph (d)(2)(ii) (B) or (E) of this section) may be treated as a collectively bargained employee with respect to all of the employee's hours of service for the duration of the collective bargaining agreement applicable for such plan year or, if later, until the end of the following plan year. For this purpose, a collective bargaining agreement is applicable for a plan year if it provided for the employee to benefit in the plan and was effective for any portion of that plan year. This paragraph (d)(2)(ii)(C) does not apply unless the terms of the plan providing for benefit accruals treat the employee in a manner that is generally no more favorable than similarly-situated employees who are collectively bargained employees.

(D) *Employees who previously were collectively bargained employees.* An employee who was treated as a collectively bargained employee pursuant to paragraph (d)(2)(ii)(C) of this section may be treated as a collectively bargained employee with respect to all of the employee's hours of service after the end of the period described in paragraph (d)(2)(ii)(C) of this section, provided that the employee is performing services for one or more employers that are parties to the collective bargaining agreement, for the plan, or for the employee representative. This paragraph (d)(2)(ii)(D) does not apply unless the terms of the plan providing for benefit accruals treat the employee in a manner that is generally no more favorable than similarly-situated employees who are collectively bargained employees, and no more than five percent of the employees covered under the multiemployer plan are noncollectively bargained employees (determined without regard to this paragraph (d)(2)(ii)(D)). In determining whether more than five percent of the employees covered under the multiemployer plan are noncollectively bargained employees, those employees who are described in paragraphs (d)(2)(ii) (B) and (C) of this section are treated as collectively bargained employees.

(E) *Transition rule.* For a plan year beginning before the applicable effective date of these regulations as set forth in § 1.410(b)–10 (b) or (d), any employee described in paragraph (d)(2)(ii)(A) of this section may be treated as a collectively bargained employee with respect to all of the employee's hours of service for that plan year.

(F) *Consistency requirement.* The rules in paragraphs (d)(2) (i) and (ii) of this section must be applied to all employees on a reasonable and consistent basis for the plan year.

(iii) *Covered by a collective bargaining agreement*—(A) *General rule.* For purposes of paragraph (d)(2)(i) of this section, an employee is included in a unit of employees covered by a collective bargaining agreement if and only if the employee is represented by a bona fide employee representative that is a party to the collective bargaining agreement under which the plan is maintained. Thus, for example, an employee of either a plan or the employee representative that is a party to the collective bargaining agreement under which the plan is maintained is not included in a unit of employees covered by the collective bargaining agreement under which the plan is maintained merely because the employee is covered under the plan pursuant to an agreement entered into by the plan or employee representative on behalf of the employee (other than in the capacity of an employee representative with respect to the employee). This is the case even if all of such employees benefiting under the plan constitute only a de minimis percentage of the total employees benefiting under the plan.

(B) *Plans covering professional employees*—(*1*) *In general.* An employee is not considered included in a unit of employees covered by a collective bargaining agreement for a plan year for purposes of paragraph (d)(2)(iii)(A) of this section if, for the plan year, more than 2 percent of the employees who are covered pursuant to the agreement are professionals. This rule applies to all employees under the agreement, nonprofessionals as well as professionals. Thus, no employees covered by such an agreement are excludable employees with respect to employees who are not covered by a collective bargaining agreement.

(*2*) *Multiple collective bargaining agreements.* This paragraph (d)(2)(iii)(B) is applied separately with respect to each collective bargaining agreement. Thus, for example, if a plan benefits two groups of employees, one included in a unit of employees covered by collective bargaining agreement X, more than 2 percent of whom are professionals, and another included in a unit of employees covered by collective bargaining agreement Y, none of whom are professionals, the group covered by agreement X is not considered covered by a collective bargaining agreement and the group covered by agreement Y is considered covered by a collective bargaining agreement.

(*3*) *Application of minimum coverage tests.* If a plan covers more than 2 percent professional employees, no employees in the plan are treated as covered by a collective bargaining agreement. A plan that covers more than 2 percent professional employees must satisfy section 410(b) without regard to section 413(b) and the special rule in § 1.410(b)–2(b)(7) of this section (regarding collectively bargained plans). In such cases, all nonexcludable employees must be taken into account. For this purpose, employees included in other collective bargaining units are excludable employees. However, the employees who are not covered by a collective bargaining agreement and the employees who are covered by an agreement that has more than 2 percent professionals are not excludable employees.

(iv) *Examples.* The following examples illustrate the collective bargaining unit rules of this section.

Example 1. An employer has 700 collectively bargained employees (none of whom is a professional employee) and 300 noncollectively bargained employees (200 of whom are highly compensated employees). For purposes of applying the ratio percentage test of § 1.410(b)–

2(b)(2) to Plan X, which benefits only the 300 noncollectively bargained employees, the 700 collectively bargained employees are treated as excludable employees pursuant to paragraph (d) of this section.

Example 2. (i) An employer has 1,500 employees in the following categories:

	Noncollectively bargained employees	Collectively bargained employees	Total
Highly compensated employees	100	100	200
Nonhighly compensated employees	900	400	1,300
Total	1,000	500	1,500

The employer maintains Plan Y, which benefits 1,100 employees, including all of the noncollectively bargained employees (except for 100 nonhighly compensated employees who are noncollectively bargained employees), and 200 of the collectively bargained employees (including the 100 highly compensated employees who are collectively bargained employees). There are no professional employees covered by the collective bargaining agreement. In accordance with §1.410(b)–7(c)(4), the employer must apply the ratio percentage test of §1.410(b)–2(b)(2) to Plan Y as if the plan were two separate plans, one benefiting the noncollectively bargained employees and the other benefiting the collectively bargained employees.

(ii) In testing the portion of Plan Y that benefits the noncollectively bargained employees, the collectively bargained employees are excludable employees. That portion's ratio percentage is 88.89 percent ([800/900] /[100/100] = 88.89%/100% =0.8889), and thus it satisfies the ratio percentage test. The portion of Plan Y that benefits collectively bargained employees automatically satisfies section 410(b) under the special rule in §1.410(b)–2(b)(7).

(e) *Employees of qualified separate lines of business.* If an employer is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with §1.414(r)–1 (b), in testing a plan that benefits employees of one qualified separate line of business, the employees of the other qualified separate lines of business of the employer are treated as excludable employees. The rule in this paragraph (e) does not apply for purposes of satisfying the nondiscriminatory classification requirement of section 410(b)(5)(B). See §§1.414(r)–1(c)(2) and 1.414(r)–8 (separate application of section 410(b) to the employees of a qualified separate line of business). In addition, the rule in this paragraph (e) does not apply to a plan that is tested under the special rule for employer-wide plans in §1.414(r)–1(c) (2) (ii) for a plan year.

(f) *Certain terminating employees*—(1) *In general.* An employee may be treated as an excludable employee for a plan year with respect to a particular plan if—

(i) The employee does not benefit under the plan for the plan year,

(ii) The employee is eligible to participate in the plan,

(iii) The plan has a minimum period of service requirement or a requirement that an employee be employed on the last day of the plan year (last-day requirement) in order for an employee to accrue a benefit or receive an allocation for the plan year,

(iv) The employee fails to accrue a benefit or receive an allocation under the plan solely because of the failure to satisfy the minimum period of service or last-day requirement,

(v) The employee terminates employment during the plan year with no more than 500 hours of service, and the employee is not an employee as of the last day of the plan year (for purposes of this paragraph (f)(1)(v), a plan that uses the elapsed time method of determining years of service may use either 91 consecutive calendar days or 3 consecutive calendar months instead of 500 hours of service, provided it uses the same convention for all employees during a plan year), and

(vi) If this paragraph (f) is applied with respect to any employee with respect to a plan for a plan year, it is applied with respect to all employees with respect to the plan for the plan year.

(2) *Hours of service.* For purposes of this paragraph (f), the term ‘‘hours of service’’ has the same meaning as provided for such term by 29 CFR 2530.200b–2 under the general method of crediting service for the employee. If one of the equivalencies set forth in 29 CFR 2530.200b–3 is used for crediting service under the plan, the 500-hour requirement must be adjusted accordingly.

(3) *Examples.* The following examples illustrate the provision of this paragraph (f).

Example 1. An employer has 35 employees who are eligible to participate under a defined contribution plan. The plan provides that an employee will not receive an allocation of contributions for a plan year unless the employee is employed by the employer on the last day of the plan year. Only 30 employees are employed by the employer on the last day of the plan year. Two of the five employees who terminated employment before the last day of the plan year had 500 or fewer hours of service during the plan year, and the remaining three had more than 500 hours of service during the year. Of the five employees who were no longer employed on the last day of the plan year, the two with 500 hours of service or less during the plan year are treated as excludable employees for purposes of section 410(b), and the remaining three who had over 500 hours of service during the plan year are taken into account in testing the plan under section 410(b) but are treated as not benefiting under the plan.

Example 2. An employer has 30 employees who are eligible to participate under a defined contribution plan. The plan requires 1,000 hours of service to receive an allocation of contributions or forfeitures. Ten employees do not receive an allocation because of their failure to complete 1,000 hours of service. Three of the 10 employees who failed to satisfy the minimum service requirement completed 500 or fewer hours of service and terminated their employment. Two of the employees completed more than 500, but fewer than 1,000 hours of service and terminated their employment. The remaining five employees did not terminate employment. Under the rule in paragraph (f) of this section, the three terminated employees who completed 500 or fewer hours of service are treated as excludable employees for the portion of the plan year they are employed. The other seven employees who do not receive an allocation are taken into account in testing the plan under section 410(b) but are treated as not benefiting under the plan.

Example 3. An employer maintains two plans, Plan A for salaried employees and Plan B for hourly employees. Of the 100 salaried employees, two do not receive an allocation under Plan A for the plan year because they terminate employment before completing 500 hours of service. Of the 300 hourly employees, 50 do not receive an allocation under Plan B for the plan year because they terminate employment before completing 500 hours. In applying section 410(b) to Plan A, the two employees who did not receive an allocation under Plan A are excludable employees, but the 50 who did not receive an allocation under Plan B are not excludable employees, because they were not eligible to participate under Plan A.

(g) *Employees of certain governmental or tax-exempt entities precluded from maintaining a section 401(k) plan.* For purposes of testing either a section 401(k) plan or a section 401(m) plan that is provided under the same general arrangement as a section 401(k) plan, an employer may treat as excludable those employees of governmental or tax-exempt entities who are precluded from being eligible employees under a section 401(k) plan by reason of section 401(k)(4)(B), if more than 95 percent of the employees of the employer who are not precluded from being eligible employees by section 401(k)(4)(B) benefit under the plan for the plan year.

(h) *Former employees*—(1) *In general.* For purposes of applying section 410(b) with respect to former employees, all former employees of the employer are taken into account, except that the employer may treat a former employee described in paragraph (h)(2) or (h)(3) of this section as an excludable former employee. If either (or both) of the former employee exclusion rules under paragraphs (h)(2) and (h)(3) of this section is applied, it must be applied to all former employees for the plan year on a consistent basis.

(2) *Employees terminated before a specified date.* The employer may treat a former employee as excludable if—

(i) The former employee became a former employee either prior to January 1, 1984, or prior to the tenth calendar year preceding the calendar year in which the current plan year begins, and

(ii) The former employee became a former employee in a calendar year that precedes the earliest calendar year in which any former employee who benefits under the plan in the current plan year became a former employee.

(3) *Previously excludable employees.* The employer may treat a former employee as excludable if the former employee was an excludable employee (or would have been an excludable employee if these regulations had been in effect) under the rules of paragraphs (b) through (g) of this section during the plan year in which the former employee became a former employee. If the employer treats a former employee as excludable pursuant to this paragraph (h)(3), the former employee is

not taken into account with respect to a plan even if the former employee is benefiting under the plan.

(i) *Former employees treated as employees.* An employer may treat as excludable employees all formerly nonhighly compensated employees who are treated as employees of the employer under §1.410(b)–9 solely because they have increases in accrued benefits under a defined benefit plan that are based on ongoing service or compensation credits (including imputed service or compensation) after they cease to perform services for the employer.

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§1.410(b)–7 Definition of plan and rules governing plan disaggregation and aggregation.

(a) *In general.* This section provides a definition of ‘‘plan.’’ First, this section sets forth a definition of plan within the meaning of section 401(a) or 403(a). Then certain mandatory disaggregation and permissive aggregation rules are applied. The result is the definition of plan that applies for purposes of sections 410(b) and 401(a)(4). Thus, in general, the term ‘‘plan’’ as used in this section initially refers to a plan described in section 414(l) and to an annuity plan described in section 403(a), and the term ‘‘plan’’ as used in other sections under these regulations means the plan determined after application of this section. Paragraph (b) of this section provides that each single plan under section 414(l) is treated as a single plan for purposes of section 410(b). Paragraph (c) of this section describes the rules for certain plans that must be treated as comprising two or more separate plans, each of which is a single plan subject to section 410(b). Paragraph (d) of this section provides a rule permitting an employer to aggregate certain separate plans to form a single plan for purposes of section 410(b). Paragraph (e) of this section provides rules for determining the testing group of plans taken into account in determining whether a plan satisfies the average benefit percentage test of §1.410(b)–5.

(b) *Separate asset pools are separate plans.* Each single plan within the meaning of section 414(l) is a separate plan for purposes of section 410(b). See §1.414(l)–1(b). For example, if only a portion of the assets under a defined benefit plan is available, on an ongoing basis, to provide the benefits of certain employees, and the remaining assets are available only in certain limited cases to provide such benefits (but are available in all cases for the benefit of other employees), there are two separate plans. Similarly, the defined contribution portion of a plan described in section 414(k) is a separate plan from the defined benefit portion of that same plan. A single plan under section 414(l) is a single plan for purposes of section 410(b), even though the plan comprises separate written documents and separate trusts, each of which receives a separate determination letter from the Internal Revenue Service. A defined contribution plan does not comprise separate plans merely because it includes more than one trust, or merely because it provides for separate accounts and permits employees to direct the investment of the amounts allocated to their accounts. Further, a plan does not comprise separate plans merely because assets are separately invested in individual insurance or annuity contracts for employees.

(c) *Mandatory disaggregation of certain plans*—(1) *Section 401(k) and 401(m) plans.* The portion of a plan that is a section 401(k) plan and the portion that is not a section 401(k) plan are treated as separate plans for purposes of section 410(b). Similarly, the portion of a plan that is a section 401(m) plan and the portion that is not a section 401(m) plan are treated as separate plans for purposes of section 410(b). Thus, a plan that consists of elective contributions under a section 401(k) plan, employee and matching contributions under a section 401(m) plan, and contributions other than elective, employee, or matching contributions is treated as three separate plans for purposes of section 410(b). In addition, the portion of a plan that consists of contributions described in §1.401(k)–1(b)(4)(iv) (i.e., contributions that fail to satisfy the allocation or compensation requirements applicable to elective contributions and are therefore required to be tested separately) and the portion of the plan that does not consist of such contributions are treated as separate plans for purposes of section 410(b). Similarly, the portion of a plan that consists of contributions described in § 1.410(m)–1(b)(4)(ii) (i.e., matching contributions that fail to satisfy the allocation and other requirements applicable to matching contributions and are therefore required to be tested separately) and the portion of the plan that does not consist of such contributions are treated as separate plans for purposes of section 410(b).

(2) *ESOPs and non-ESOPs.* The portion of a plan that is an ESOP and the portion of the plan that is not an ESOP are treated as separate plans for purposes of section 410(b), except as otherwise permitted under § 54.4975–11(e) of this Chapter.

(3) *Plans benefiting otherwise excludable employees.* If an employer applies section 410(b) separately to the portion of a plan that benefits only employees who satisfy age and service conditions under the plan that are lower than the greatest minimum age and service conditions permissible under section 410(a), the plan is treated as comprising separate plans, one benefiting the employees who have satisfied the lower minimum age and service conditions but not the greatest minimum age and service conditions permitted under section 410(a) and one benefiting employees who have satisfied the greatest minimum age and service conditions permitted under section 410(a). See § 410(b)–6(b)(3)(ii) for rules about testing otherwise excludable employees.

(4) *Plans benefiting certain disaggregation populations of employees*—(i) *In general*—(A) *Single plan must be treated as separate plans.* If a plan (*i.e.*, a single plan within the meaning of section 414(l)) benefits employees of more than one disaggregation population, the plan must be disaggregated and treated as separate plans, each separate plan consisting of the portion of the plan benefiting the employees of each disaggregation population. See paragraph (c)(4)(ii) of this section for the definition of disaggregation population.

(B) *Benefit accruals or allocations attributable to current status.* Except as otherwise provided in paragraph (c)(4)(i)(C) of this section, in applying the rule of paragraph (c)(4)(i)(A) of this section, the portion of the plan benefiting employees of a disaggregation population consists of all benefits accrued by, or all allocations made to, employees while they were members of the disaggregation population.

(C) *Exceptions for certain benefit accruals*—(*1*) *Attribution of benefits to first disaggregation population.* If employees benefiting under a plan change from one disaggregation population to a second disaggregation population, benefits they accrue while members of the second disaggregation population that are attributable to years of service previously credited while the employees were members of the first disaggregation population may be treated as provided to them in their status as members of the first disaggregation population and thus included in the portion of the plan benefiting employees of the first disaggregation population. This special treatment is available only if it is applied on a consistent basis, if it does not result in significant discrimination in favor of highly compensated employees, and if the plan provision providing the additional benefits applies on the same terms to all similarly-situated employees. For example, if all formerly collectively bargained employees accrue additional benefits under a plan after becoming noncollectively bargained employees, then those benefit increases may be treated as included in the portion of the plan benefiting collectively bargained employees if they are attributable to years of service credited while the employees were collectively bargained (e.g., where the additional benefits result from compensation increases that occur while the employees are noncollectively bargained or from plan amendments affecting benefits earned while collectively bargained that are adopted while the employees are noncollectively bargained) and if such treatment does not result in significant discrimination in favor of highly compensated employees.

(*2*) *Attribution of benefits to current disaggregation population.* If employees benefiting under a plan change from one disaggregation population to another disaggregation population, benefits they accrue while members of the first disaggregation population may be treated as provided to them in their current status and thus included in the portion of the plan benefiting employees of the disaggregation population of which they are currently members. This special treatment is available only if it is applied on a consistent basis and if it does not result in significant discrimination in favor of highly compensated employees.

(D) *Change in disaggregation populations*—(*1*) *Reasonable treatment.* If, in previous years, the configuration of a plan's disaggregation populations differed from their configuration for the current year, for purposes of the benefits accrued by, or allocations made to, an employee for those years, the employee's status as a member of a current disaggregation population for those years must be determined on a reasonable basis. A different configuration occurs, for example, if disaggregation populations exist for the first time, such as when an employer is first treated as operating qualified separate lines of business, or if the existing disaggregation populations change, such as when an employer redesignates its qualified separate lines of business.

(*2*) *Example.* The following example illustrates the application of this paragraph (c)(4)(i)(D).

Example. (a) Employer X operates Divisions M and N, which are treated as qualified separate lines of business for the first time in 1998. Thus, the disaggregation populations of employees of Division M and employees of Division N exist for the first time. Since 1981 Employer X has maintained a defined benefit plan, Plan P, for employees of Division M. Plan P provides a normal retirement benefit of one percent of average annual compensation for each year of service up to 25. Employee A has worked for Division M since 1981 and has never worked for Division N. Employee B has worked for Division N since 1989 and worked for Division M from 1981 to 1988. Employee C has worked in the headquarters of Employer X since 1981. For the period 1981 to 1988 Employee C was credited with years of service under Plan P.

(b) For purposes of the benefits accrued by Employee A under Plan P during years 1981 through 1997, Employee A is reasonably treated as having been a member of the Division M disaggregation population for those years. For purposes of the benefits accrued by Employee B under Plan P during years 1981 through 1988, Employee B is reasonably treated as having been a member of the Division M disaggregation population for 1981 through 1988 and as having changed to the Division N disaggregation population for 1989 through 1997. For purposes of the benefits accrued by Employee C under Plan P during years 1981 through 1988, Employee C is reasonably treated as having been a member of the Division M disaggregation population for those years. Moreover, any benefit accruals for Employee B and Employee C in years after 1988, that result from increases in average annual compensation after 1988 and that are attributable to years of service credited for 1981 through 1988, may be treated as provided to Employee B and Employee C in their status as members of the Division M disaggregation population if the requirements of paragraph (c)(4)(i)(C)(*1*) of this section are otherwise met.

(ii) *Definition of disaggregation population*—(A) *Plan benefiting employees of qualified separate lines of business.* If an employer is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with §1.414(r)–1(b), and a plan benefits employees of more than one qualified separate line of business, the employees of each qualified separate line of business are separate disaggregation populations. In this case, the portion of the plan benefiting the employees of each qualified separate line of business is treated as a separate plan maintained by that qualified separate line of business. However, employees of different qualified separate lines of business who are benefiting under a plan that is tested under the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) for a plan year are not separate disaggregation populations merely because they are employees of different qualified separate lines of business.

(B) *Plan benefiting collectively bargained employees.* If a plan benefits both collectively bargained employees and noncollectively bargained employees, the collectively bargained employees are one disaggregation population and the noncollectively bargained employees are another disaggregation population. If the population of collectively bargained employees includes employees covered under different collective bargaining agreements, the population of employees covered under each collective bargaining agreement is also a separate disaggregation population.

(C) *Plan maintained by more than one employer.* If a plan benefits employees of more than one employer, the employees of each employer are separate disaggregation populations. In this case, the portion of the plan benefiting the employees of each employer is treated as a separate plan maintained by that employer, which must satisfy section 410(b) by reference only to that employer's employees. However, for purposes of this paragraph (c)(4)(ii)(C), if the plan of one employer (or, in the case of a plan maintained by more than one employer, the plan provisions applicable to the employees of one employer) treats compensation or service with another employer as compensation or service with the first employer, then the current accruals attributable to that compensation or service are treated as provided to an employee of the first employer under the plan of the first employer (or the portion of a plan maintained by more than one employer benefiting employees of the first employer), and the provisions of paragraph (c)(4)(i)(C) of this section do not apply to those accruals. Thus, for example, if Plan A maintained by Employer X imputes service or compensation for an employee of Employer Y, then Plan A is not treated as benefiting the employees of more than one employer merely because of this imputation.

(5) *Additional rule for plans benefiting employees of more than one qualified separate line of business.* If a plan benefiting employees of more than one qualified separate line of business satisfies the reasonable classification requirement of § 1.410(b)–4(b) before the application of paragraph (c)(4) of this section, then any portion of the plan that is treated as a separate plan as a result of the application of paragraphs (c)(4)(i)(A) and (ii)(A) of this section is deemed to satisfy that requirement.

(d) *Permissive aggregation for ratio percentage and nondiscriminatory classification tests*—(1) *In general.* Except as provided in paragraphs (d)(2) and (d)(3) of this section, for purposes of applying the ratio percentage test of § 1.410(b)–2(b)(2) or the nondiscriminatory classification test of § 1.410(b)–4, an employer may designate two or more separate plans (determined after application of paragraph (b) of this section) as a single plan. If an employer treats two or more separate plans as a single plan under this paragraph, the plans must be treated as a single plan for all purposes under sections 401(a)(4) and 410(b).

(2) *Rules of disaggregation.* An employer may not aggregate portions of a plan that are disaggregated under the rules of paragraph (c) of this section. Similarly, an employer may not aggregate two or more separate plans that would be disaggregated under the rules of paragraph (c) of this section if they were portions of the same plan. In addition, an employer may not aggregate an ESOP with another ESOP, except as permitted under § 54.4975–11(e) of this Chapter.

(3) *Duplicative aggregation.* A plan may not be combined with two or more plans to form more than one single plan. Thus, for example, an employer that maintains plans A, B, and C may not aggregate plans A and B and plans A and C to form two single plans. However, the employer may apply the permissive aggregation rules of this paragraph (d) to form any one (and only one) of the following combinations: plan ABC, plans AB and C, plans AC and B, or plans A and BC.

(4) *Special rule for plans benefiting employees of a qualified separate line of business.* For purposes of paragraph (d)(1) of this section, an employer that is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with § 1.414(r)–1(b) is permitted to aggregate the portions of two or more plans that benefit employees of the same qualified separate line of business (regardless of whether the employer elects to aggregate the portions of the same plans that benefit employees of the other qualified separate lines of business of the employer), provided that none of the plans is tested under the special rule for employer-wide plans in § 1.414(r)–1 (c)(2)(ii). Thus, the employer is permitted to apply paragraph (d)(1)

of this section with respect to two or more separate plans determined after the application of paragraphs (b) and (c)(4) of this section, but may not aggregate a plan that is tested under the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) for a plan year with any portion of a plan that does not rely on that special rule for the plan year. In all other respects, the provisions of this paragraph (d) regarding permissive aggregation apply, including (but not limited to) the disaggregation rules under paragraph (d)(2) of this section (including the mandatory disaggregation rule of paragraph (c)(4) of this section), and the prohibition on duplicative aggregation under paragraph (d)(3) of this section. This paragraph (d)(4) applies only in the case of an employer that is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with §1.414(r)–1(b). See §§l.414(r)–1(c)(2) and 1.414(r)–8 (separate application of section 410(b) to the employees of a qualified separate line of business).

(5) *Same plan year requirement.* Two or more plans may not be aggregated and treated as a single plan under this paragraph (d) unless they have the same plan year.

(e) *Determination of plans in testing group for average benefit percentage test*—(1) *In general.* For purposes of applying the average benefit percentage test of §1.410(b)–5 with respect to a plan, all plans in the testing group must be taken into account. For this purpose, the plans in the testing group are the plan being tested and all other plans of the employer that could be permissively aggregated with that plan under paragraph (d) of this section. Whether two or more plans could be permissively aggregated under paragraph (d) of this section is determined (i) without regard to the rule in paragraph (d)(4) of this section that portions of two or more plans benefiting employees of the same line of business may not be aggregated if any of the plans is tested under the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii), (ii) without regard to paragraph (d)(5) of this section, and (iii) by applying paragraph (d)(2) of this section without regard to paragraphs (c)(1) and (c)(2) of this section.

(2) *Examples.* The following example illustrates the rules of this paragraph (e).

Example 1. Employer X is treated as operating two qualified separate lines of business for purposes of section 410(b) in accordance with section 414(r), QSLOB1 and QSLOB2. Employer X must apply the rules in §1.414(r)–8 to determine whether its plans satisfy section 410(b) on a qualified-separate-line-of-business basis. Employer X maintains the following plans:

(a) Plan A, the portion of Employer X' s employer-wide section 401(k) plan that benefits all noncollectively bargained employees of QSLOB1,

(b) Plan B, the portion of Employer X' s employer-wide section 401(k) plan that benefits all noncollectively bargained employees of QSLOB2,

(c) Plan C, a defined benefit plan that benefits all hourly noncollectively bargained employees of QSLOB1,

(d) Plan D, a defined benefit plan that benefits all collectively bargained employees of QSLOB1,

(e) Plan E, an ESOP that benefits all noncollectively bargained employees of QSLOB1,

(f) Plan F, a profit-sharing plan that benefits all salaried noncollectively bargained employees of QSLOB1.

Assume that Plan F does not satisfy the ratio percentage test of §1.410(b)–2(b)(2) on a qualified-separate-line-of-business basis, but does satisfy the nondiscriminatory classification test of §1.410(b)–4 on both an employer-wide and a qualified-separate-line-of-business basis. Therefore, to satisfy section 410(b), Plan F must satisfy the average benefit percentage test of §1.410(b)–5 on a qualifiedseparatelineofbu5ine55 basis. The plans in the testing group used to determine whether Plan F satisfies the average benefit percentage test of §1.4 10(b)–5 are Plans A, C, E, and F.

Example 2. The facts are the same as in *Example 1,* except that Employer X applies the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) to its employer-wide section 401(k) plan. To satisfy section 410(b), Plan F must satisfy the average benefit percentage test of §1.4 10(b)–5. Since paragraph (c)(4) of this section no longer applies to Plans A and B, they are treated as a single plan (Plan AB). The plans in the testing group used to determine whether Plan F satisfies the average benefit percentage test of §1.4 10(b)–5 are therefore Plans A, B, C, E, and F. However, the employees of QSLOB 2 continue to be excludable employees for purposes of determining whether Plan F satisfies the average benefit percentage test. See §1.410(b)–6(e).

(f) *Section 403(b) plans.* In determining whether a plan satisfies section 410(b), a plan subject to section 403(b)(12)(A)(i) is disregarded. However, in determining whether a plan subject to section 403(b)(12)(A)(i) satisfied section 410(b), plans that are not subject to section 403(b)(12)(A)(i) may be taken into account.

[T.D. 8363, 56 FR 47655, Sept. 19, 1991, as amended by T.D. 8376, 56 FR 63433, Dec. 4, 1991; T.D. 8363, 57 FR 10819, 10954, Mar. 31, 1992; T.D. 8487, 58 FR 46843, Sept. 3, 1993; T.D. 8548, 59 FR 32914, June 27, 1994]

§ 1.410(b)–8 Additional rules.

(a) *Testing methods*—(1) *In general.* A plan must satisfy section 410(b) for a plan year using one of the testing options in paragraphs (a)(2) through (a)(4) of this section. Whichever testing option is used for the plan year must also be used for purposes of applying section 401(a)(4) to the plan for the plan year. The annual testing option in paragraph (a)(4) of this section must be used in applying section 410(b) to a section 401(k) plan or a section 401(m) plan, and in applying the average benefit percentage test of § 1.410(b)–5. For purposes of this paragraph (a), the plan provisions and other relevant facts as of the last day of the plan year regarding which employees benefit under the plan for the plan year are applied to the employees taken into account under the testing option used for the plan year. For this purpose, amendments retroactively correcting a plan in accordance with § 1.401(a)(4)–11(g) are taken into account as plan provisions in effect as of the last day of the plan year.

(2) *Daily testing option.* A plan satisfies section 410(b) for a plan year if it satisfies § 1.410(b)–2 on each day of the plan year, taking into account only those employees (or former employees) who are employees (or former employees) on that day.

(3) *Quarterly testing option.* A plan is deemed to satisfy section 410(b) for a plan year if the plan satisfies § 1.410(b)–2 on at least one day in each quarter of the plan year, taking into account for each of those days only those employees (or former employees) who are employees (or former employees) on that day. The preceding sentence does not apply if the plan's eligibility rules or benefit formula operate to cause the four quarterly testing days selected by the employer not to be reasonably representative of the coverage of the plan over the entire plan year.

(4) *Annual testing option.* A plan satisfies section 410(b) for a plan year if it satisfies § 1.410(b)–2 as of the last day of the plan year, taking into account all employees (or former employees) who were employees (or former employees) on any day during the plan year.

(5) *Example.* The following example illustrates this paragraph (a).

Example. Plan A is a defined contribution plan that is not a section 401(k) plan or a section 401(m) plan, and that conditions allocations on an employee's employment on the last day of the plan year. Plan A is being tested for the 1995 calendar plan year using the daily testing option in paragraph (a)(2) of this section. In testing the plan for compliance with section 410(b) on March 11, 1995, Employee X is taken into account because he was an employee on that day and was not an excludable employee with respect to Plan A on that day. Employee X was a participant in Plan A on March 11, 1995, was employed on December 31, 1995, and received an allocation under Plan A for the 1995 plan year. Under these facts, Employee X is treated as benefiting under Plan A on March 11, 1995, even though Employee X had not satisfied all of the conditions for receiving an allocation on that day, because Employee X satisfied all of those conditions as of the last day of the plan year.

(b) *Family member aggregation rule.* For purposes of section 410(b), and in accordance with section 414(q)(6), a highly compensated employee who is a 5-percent owner or one of the ten most highly compensated employees and any family member (or members) of such a highly compensated employee who is also an employee of the employer are to be treated as a single highly compensated employee. If any member of that group is benefiting under a plan, the deemed single employee is treated as benefiting under the plan. If no member of that group is benefiting under a plan, the deemed single employee is treated as not benefiting under the plan.

[T.D. 8363, 56 FR 47656, Sept. 19, 1991]

§ 1.410(b)–9 Definitions.

In applying this section and §§ 1.410(b)–2 through 1.410(b)–10, the definitions in this section govern unless otherwise provided.

Collectively bargained employee. Collectively bargained employee means a collectively bargained employee within the meaning of §1.410(b)–6(d)(2).

Defined benefit plan. Defined benefit plan means a defined benefit plan within the meaning of section 414(j). The portion of a plan described in section 414(k) that does not consist of separate accounts is treated as a defined benefit plan.

Defined contribution plan. Defined contribution plan means a defined contribution plan within the meaning of section 414(i). The portion of a plan described in section 414(k) that consists of separate accounts is treated as a defined contribution plan.

Employee. Employee means an individual who performs services for the employer who is either a common law employee of the employer, a self-employed individual who is treated as an employee pursuant to section 401(c)(1), or a leased employee (not excluded under section 414(n)(5)) who is treated as an employee of the employer-recipient under section 414(n)(2) or 414(o)(2). Individuals that an employer treats as employees under section 414(n) pursuant to the requirements of section 414(o) are considered to be leased employees for purposes of this rule. In addition, an individual must be treated as an employee with respect to allocations under a defined contribution plan taken into account under §1.401(a)(4)–2(c)(ii) and with respect to increases in accrued benefits (within the meaning of 411(a)(7)) under a defined benefit plan that are based on ongoing service or compensation (including imputed service or compensation) credits.

Employer. Employer means the employer maintaining the plan and those employers required to be aggregated with the employer under sections 414(b), (c), (m), or (o). An individual who owns the entire interest of an unincorporated trade or business is treated as an employer. Also, a partnership is treated as the employer of each partner and each employee of the partnership.

ESOP. ESOP or *employee stock ownership plan* means an employee stock ownership plan within the meaning of section 4975(e)(7) or a tax credit employee stock ownership plan within the meaning of section 409(a).

Former employee. Former employee means an individual who was, but has ceased to be, an employee of the employer (i.e., the individual has ceased performing services as an employee for the employer). An individual is treated as a former employee beginning on the day after the day on which the individual ceases performing services as an employee for the employer. Thus, an individual who ceases performing services as an employee for an employer during a plan year is both an employee and a former employee for the plan year. Notwithstanding the foregoing, an individual is an employee (and not a former employee) to the extent that the individual is treated as an employee with respect to the plan for the plan year under the definition of employee in this section.

Highly compensated employee. Highly compensated employee means an employee who is a highly compensated employee within the meaning of section 414(q) or a former employee treated as an employee under the definition of employee in this section who is a highly compensated former employee within the meaning of section 414(q).

Highly compensated former employee. Highly compensated former employee means a former employee who is a highly compensated former employee within the meaning of section 414(q).

Multiemployer plan. Multiemployer plan means a multiemployer plan within the meaning of section 414(f).

Noncollectively bargained employee. Noncollectively bargained employee means an employee who is not a collectively bargained employee.

Nonhighly compensated employee. Nonhighly compensated employee means an employee who is not a highly compensated employee.

Nonhighly compensated former employee. Nonhighly compensated former employee means a former employee who is not a highly compensated former employee.

Plan year. Plan year means the plan year of the plan as defined in the written plan document. In the absence of a specifically designated plan year, the plan year is deemed to be the calendar year.

Plan year compensation. Plan year compensation means plan year compensation within the meaning of § 1.401(a)(4)–12.

Professional employee. Professional employee means any highly compensated employee who, on any day of the plan year, performs professional services for the employer as an actuary, architect, attorney, chiropodist, chiropractor, dentist, executive, investment banker, medical doctor, optometrist, osteopath, podiatrist, psychologist, certified or other public accountant, stockbroker, or veterinarian, or in any other professional capacity determined by the Commissioner in a notice or other document of general applicability to constitute the performance of services as a professional.

Ratio percentage. With respect to a plan for a plan year, a plan's *ratio percentage* means the percentage (rounded to the nearest hundredth of a percentage point) determined by dividing the percentage of the nonhighly compensated employees who benefit under the plan by the percentage of the highly compensated employees who benefit under the plan. The percentage of the nonhighly compensated employees who benefit under the plan is determined by dividing the number of nonhighly compensated employees benefiting under the plan by the total number of nonhighly compensated employees of the employer. The percentage of the highly compensated employees who benefit under the plan is determined by dividing the number of highly compensated employees benefiting under the plan by the total number of highly compensated employees of the employer.

Section 401(k) plan. Section 401(k) plan means a plan consisting of elective contributions described in § 1.40(k)–1(g)(3) under a qualified cash or deferred arrangement described in § 1.401(k)–1(a)(4)(i). Thus, a section 401(k) plan does not include a plan (or portion of a plan) that consists of contributions under a nonqualified cash or deferred arrangement, or qualified nonelective or qualified matching contributions treated as elective contributions under § 1.401(k)–1(b)(5).

Section 401(l*) plan. Section 401(* l*) plan* means a plan that—

(1) Provides for a disparity in employer-provided benefits or contributions that satisfies section 401(l) in form, and

(2) Relies on one of the safe harbors of § 1.401(a)(4)–2(b)(2), 1.401(a)(4)–3(b), 1.401(a)(4)–8(b)(3), or 1.401(a)(4)–8(c)(3)(iii)(B) to satisfy section 401(a)(4).

Section 401(m) plan. Section 401(m) plan means a plan consisting of employee contributions described in § 1.401(m)–1(f)(6) or matching contributions described in § 1.40(m)–1(f)(12), or both. Thus, a section 401(m) plan does not include a plan (or portion of a plan) that consists of elective contributions or qualified nonelective contributions treated as matching contributions under § 1.401(m)–1(b)(5).

[T.D. 8363, 56 FR 47657, Sept. 19, 1991; 57 FR 10817, 10954, Mar. 31, 1992, as amended by T.D. 8487, 58 FR 46843, Sept. 3, 1993]

§ 1.410(b)–10 Effective dates and transition rules.

(a) *Statutory effective dates*—(1) *In general.* Except as set forth in paragraph (a)(2) of this section, the minimum coverage rules of section 410(b) as amended by section 1112 of the Tax Reform Act of 1986 apply to plan years beginning on or after January 1, 1989.

(2) *Special statutory effective date for collective bargaining agreements*—(i) *In general.* As provided for by section 1112(e)(2) of the Tax Reform Act of 1986, in the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, the minimum coverage rules of section 410(b) as amended by section 1112 of the Tax Reform Act of 1986 do not apply to employees covered by any such agreement in plan years beginning before the earlier of—

(A) January 1, 1991; or

(B) The later of January 1, 1989, or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986). For purposes of this paragraph (a)(2), any extension or renegotiation of a collective bargaining agreement, which extension or renegotiation is ratified after February 28, 1986, is to be disregarded in determining the date on which the agreement terminates.

(ii) *Example.* The following example illustrates this paragraph (a)(2).

Example. Employer A maintains Plan 1 pursuant to a collective bargaining agreement. Plan 1 covers 100 of Employer A's noncollectively bargained employees and 900 of Employer A's collectively bargained employees. Employer A also maintains Plan 2, which covers Employer A's other 400 noncollectively bargained employees. The collective bargaining agreement under which Plan 1 is maintained was entered into on January 1, 1986, and expires December 31, 1992. Because Plan 1 is a plan maintained pursuant to a collective bargaining agreement, section 410(b) applies to the first plan year beginning on or after January 1, 1991. In applying section 410(b) to Plan 2, the 100 noncollectively bargained employees in Plan 1 must be taken into account. The deferred effective date for plans maintained pursuant to a collective bargaining agreement is not applicable in determining how section 410(b) is applied to a plan that is not maintained pursuant to a collective bargaining agreement.

(iii) *Plan maintained pursuant to a collective bargaining agreement.* For purposes of this paragraph (a)(2), a plan is maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers, if one or more of the agreements were ratified before March 1, 1986. Only plans maintained pursuant to agreements that the Secretary of Labor finds to be collective bargaining agreements and that satisfy section 7701(a)(46) are eligible for the deferred effective date under this paragraph (a)(2). A plan will not be treated as a plan maintained pursuant to one or more collective bargaining agreements eligible for the deferred effective date under this paragraph (a)(2) unless the plan would be a plan maintained pursuant to one or more collective bargaining agreements under the principles applied under section 1017(c) of the Employee Retirement Income Security Act of 1974. See H.R. Rep. No. 1280, 93rd Cong. 2d Sess. 266 (1974).

(b) *Regulatory effective dates*—(1) *In general.* Except as otherwise provided in this section, §§1.410(b)–2 through 1.410(b)–9 apply to plan years beginning on or after January 1, 1994.

(2) *Plans of tax-exempt organizations.* In the case of plans maintained by organizations exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans), §§1.410(b)–2 through 1.410(b)–9 apply to plan years beginning on or after January 1, 1996, to the extent such plans are subject to section 410(b).

(c) *Compliance during transition period.* For plan years beginning before the effective date of these regulations, as set forth in paragraph (b) of this section, and on or after the statutory effective date as set forth in paragraph (a) of this section, a plan must be operated in accordance with a reasonable, good faith interpretation of section 410(b). Whether a plan is operated in accordance with a reasonable, good faith interpretation of section 410(b) will generally be determined based on all of the relevant facts and circumstances, including the extent to which an employer has resolved unclear issues in its favor. If a plan's classification has been determined by the Commissioner to be nondiscriminatory and there have been no significant changes in or omissions of a material fact, the classification will be treated as nondiscriminatory for the relevant plan year. A plan will be deemed to be operated in accordance with a reasonable, good faith interpretation of section 410(b) if it is operated in accordance with the terms of §§1.410(b)–2 through 1.410(b)–9.

(d) *Effective date for governmental plans.* In the case of governmental plans described in section 414(d), including plans subject to section 403(b)(12)(A)(i) (nonelective plans) §1.410(b)–2 through §1.410(b)–10 apply to plan years beginning on or after January 1, 1996, or 90 days after the opening of the first legislative session beginning on or after January 1, 1996, of the governing body with authority to amend the plan, if that body does not meet continuously. Such plans are deemed to satisfy section 410(b) (and in the case of such plans that are not subject to section 403(b)(12)(A)(i), section 401(a)(3) as in effect on September 1, 1974) for plan years before that effective date. For purposes of this section, the governing body with authority to amend the plan is the legislature, board, commission, council, or other governing body with authority to amend the plan. See § 1.410(b)–2(d) and (e).

[T.D. 8487, 58 FR 46844, Sept. 3, 1993]

§ 1.410(d)–1 Election by church to have participation, vesting, funding, etc. provisions apply.

(a) *In general.* If a church or convention or association of churches which maintains any church plan, as defined in section 414(e), makes an election under this section, certain provisions of the Code and Title I of the Employee Retirement Income Security Act of 1974 (the ''Act'') shall apply to such church plan as if such plan were not a church plan. The provisions of the Code referred to are section 410 (relating to minimum participation standards), section 411 (relating to minimum vesting standards), section 412 (relating to minimum funding standards), section 4975 (relating to prohibited transactions), and paragraphs (11), (12), (13), (14), (15), and (19) of section 401(a) (relating to joint and survivor annuities, mergers and consolidations, assignment or alienation of benefits, time of benefit commencement, certain social security increases, and withdrawals of employee contributions, respectively).

(b) *Election is irrevocable.* An election under this section with respect to any church plan shall be binding with respect to such plan and, once made, shall be irrevocable.

(c) *Procedure for making election*—(1) *Time of election.* An election under this section may be made for plan years for which the provisions of section 410(d) of the Code apply to the church plan. By reason of section 1017(b) of the Act section 410(d) does not apply to a plan in existence on January 1, 1974, for plan years beginning before January 1, 1976. Section 1017(d) of the Act permits a plan administrator to elect to have certain provisions of the Code (including section 410(d)) apply to a plan before the otherwise applicable effective dates of such provisions. See § 1.410(a)–2(d). Therefore, for a plan in existence on Janurary 1, 1974, an election under section 410(d) of the Code may be made for a plan year beginning before January 1, 1976, only if an election has been made under section 1017(d) of the Act with respect to that plan year.

(2) *By whom election is to be made.* The election provided by this section may be made only by the plan administrator of the church plan.

(3) *Manner of making election.* The plan administrator may elect to have the provisions of the Code described in paragraph (a) of this section apply to the church plan as it is were not a church plan by attaching the statement described in subparagraph (5) of this paragraph to either (i) the annual return required under section 6058(a) (or an amended return) with respect to the plan which is filed for the first plan year for which the election is effective or (ii) a written request for a determination letter relating to the qualification of the plan under section 401(a), 403(a), or 405(a) of the Code and if trusteed, the exempt status under section 501(a) of the Code of a trust constituting a part of the plan.

(4) *Conditional election.* If an election is made with a written request for a determination letter, the election may be conditioned upon issuance of a favorable determination letter and will become irrevocable upon issuance of such letter.

(5) *Statement.* The statement described in subparagraph (3) of this paragraph shall indicate (i) that the election is made under section 410(d) of the Code and (ii) the first plan year for which it is effective.

(Sec. 410 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7508, 42 FR 47198, Sept. 20, 1977]

§ 1.411(a)–1 Minimum vesting standards; general rules.

(a) *In general.* A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless—

(1) The plan provides that an employee's right to his normal retirement benefit (see § 1.411(a)–7(c)) is nonforfeitable (see § 1.411(a)–4) upon and after the attainment of normal retirement age (see § 1.411(a)–7(b)),

(2) The plan provides that an employee's rights in his accrued benefit derived from his own contributions (see § 1.411(c)–1) are nonforfeitable at all times, and

(3) The plan satisfies the requirements of—

(A) Section 411(a)(2) and §1.411(a)–3 (relating to vesting in accrued benefit derived from employer contributions), and

(B) In the case of a defined benefit plan, section 411(b)(1) and §1.411(b)–1 (relating to accrued benefit).

(b) *Organization of regulations relating to minimum vesting standards*—(1) *General rules.* This section prescribes general rules relating to the minimum vesting standards provided by section 411.

(2) *Effective dates.* Section 1.411(a)–2 provides rules under section 1017 of the Employee Retirement Income Security Act of 1974 relating to effective dates under section 411.

(3) *Employer contributions.* Section 1.411(a)–3 provides rules under section 411(a)(2) relating to vesting in employer-derived accrued benefits.

(4) *Certain forfeitures.* Section 1.411(a)–4 provides rules under section 411(a)(3) relating to certain permitted forfeitures, suspensions, etc. under qualified plans.

(5) *Nonforfeitable percentage.* Section 1.411(a)–5 provides rules under section 411(a)(4) relating to service included in the determination of an employee's nonforfeitable percentage under section 411(a)(2) and §1.411(a)–3.

(6) *Years of service; break in service.* Section 1.411(a)–6 provides rules under section 411(a) (5) and (6) of the Internal Revenue Code of 1954 relating to years of service and breaks in service. Rules prescribed by the Secretary of Labor, relating to years of service and breaks in service under part 2 of subtitle B of title I of the Employee Retirement Income Security Act of 1974 are provided under 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(7) *Definitions and special rules.* Section 1.411(a)–7 provides definitions and special rules under section 411(a) (7), (8), and (9), for purposes of section 411 and the regulations thereunder.

(8) *Changes in vesting schedule.* Section 1.411(a)–8 provides rules under section 411(a)(10) relating to changes in the vesting schedule of a plan.

(9) *Breaks in service.* Section 1.411(a)–9 provides special rules relating to breaks in service.

(10) *Accrued benefits.* See §1.411(b)–1 for rules under section 411(b) relating to accrued benefit requirements under defined benefit plans.

(11) *Allocation of accrued benefits.* See §1.411(c)–1 for rules under section 411(c) relating to allocation of accrued benefits between employer and employee contributions.

(12) *Discrimination, etc.* See §1.411(d)–1 for rules relating to the coordination of section 411 with section 401(a)(4) (relating to discrimination) and other rules under section 411(d).

(c) *Application of standards to certain plans*—(1) *General rule.* Except as provided in subparagraph (2) of this paragraph, section 411 does not apply to—

(i) A governmental plan (within the meaning of section 414(d) and the regulations thereunder),

(ii) A church plan (within the meaning of section 414(e) and the regulations thereunder) which has not made the election provided by section 410(d) and the regulations thereunder,

(iii) A plan which has not provided for employer contributions at any time after September 2, 1974, and

(iv) A plan established and maintained by a society, order, or association described in section 501(c) (8) or (9), if no part of the contributions to or under such plan are made by employers of participants in such plan.

(2) *Vesting requirements.* A plan described in subparagraph (1) of this paragraph shall, for purposes of section 401(a), be treated as meeting the requirements of section 411 if such plan meets the vesting requirements resulting from the application of section 401(a)(4) and section 401(a)(7) as in effect on September 1, 1974.

(d) *Supersession.* Sections 11.411(a)–1 through 11.411(d)–3, inclusive, of the Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974 are superseded by this section and §§1.411(a)–2 through 1.411(d)–3.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42324, Aug. 23, 1977]

§ 1.411(a)–2 Effective dates.

(a) *Plan not in existence on January 1, 1974.* Under section 1017(a) of the Employee Retirement Income Security Act of 1974, in the case of a plan which was not in existence on January 1, 1974, section 411 and the regulations thereunder apply for plan years beginning after September 2, 1974. See paragraph (c) of this section for time plan is considered in existence.

(b) *Plans in existence on January 1, 1974.* Under section 1017(b) of the Employee Retirement Income Security Act of 1974, in the case of a plan which was in existence on January 1, 1974, section 411 and the regulations thereunder apply for plan years beginning after December 31, 1975. See paragraph (c) of this section for time plan is considered to be in existence.

(c) *Time of plan existence*—(1) *General rule.* For purposes of this section, a plan is considered to be in existence on a particular day if—

(i) The plan on or before that day was reduced to writing and adopted by the employer (including, in the case of a corporate employer, formal approval by the employer's board of directors and, if required, shareholders), even though no amounts had been contributed under the plan as of such day, and

(ii) The plan was not terminated on or before that day.

For example, if a plan was adopted on January 2, 1974, effective as of January 1, 1974, the plan is not considered to have been in existence on January 1, 1974, because it was not both adopted and in writing on January 1, 1974.

(2) *Collectively-bargained plan.* Notwithstanding paragraph (c) (1) of this section, a plan described in section 413 (a), relating to a plan maintained pursuant to a collective-bargaining agreement, is considered to be in existence on a particular day if—

(i) On or before that day there is a legally enforceable agreement to establish such a plan signed by the employer, and

(ii) The employer contributions to be made to the plan are set forth in the agreement.

(3) *Special rule.* If a plan is considered to be in existence under subparagraph (1) of this paragraph, any other plan with which such existing plan is merged or consolidated shall also be considered to be in existence on such date.

(d) *Existing plans under collective–bargaining agreements.* For a special effective date rule for certain plans maintained pursuant to a collective bargaining agreement, see section 1017(c)(1) of the Employee Retirement Income Security Act of 1974 (88 Stat. 932).

(e) *Certain existing plans may elect new provisions.* The plan administrator may elect to have the provisions of the Code relating to participation, vesting, funding, and form of benefit apply to a selected plan year. See § 1.410(a)–2(d) for rules relating to such an election.

(f) *Application of rules.* The requirements of section 411 do not apply to employees who separate from service with the employer prior to the first plan year to which such requirements apply and who never return to service with the employer in a plan year to which section 411 applies.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42325, Aug. 23, 1977]

§ 1.411(a)–3 Vesting in employer-derived benefits.

(a) *In general*—(1) *Alternative requirements.* A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless the plan satisfies the requirements of section 411(a)(2) and this section. A plan satisfies the requirements of this section if is satisfies the requirements of paragraph (b), (c), or (d) of this section.

(2) *Composite arrangements.* A plan will not be considered to satisfy the requirements of paragraph (b), (c), or (d) of this section unless it satisfies all requirements of a particular one of such paragraphs with respect to all of an employee's years of service. A plan which, for example, satisfies the requirements of paragraph (b) (but not (c) or (d)) for an employee's first 9 years of service and satisfies the requirements of paragraph (c) (but not (b)) for all of his remaining years of service, does not satisfy the requirements of this section. A plan is not precluded from satisfying the requirement of one such paragraph with respect to one group of employees and another

such paragraph with respect to another group provided that the groups are not so structured as to evade the requirements of this paragraph. For example, if plan A provides that employees who commence participation before age 30 are subject to the ‘‘rule of 45’’ vesting schedule and employees who commence participation after age 30 are subject to the full vesting after 10 years schedule, plan A would be so structured as to evade the requirements of this paragraph.

(3) *Plan amendments.* A plan which satisfies the requirements of a particular one of such paragraphs for each of an employee's years of service and which is amended so that, as amended, it satisfies the requirements of another such paragraph for all such years of service, satisfies the requirements of this section even though, as amended, it does not satisfy the requirements of the paragraph which were satisfied prior to the amendment. See §1.411(a)–8 for rules relating to employee election where the vesting schedule is amended.

(b) *10-year vesting.* A plan satisfies the requirements of section 411(a)(2) (A) and this paragraph if an employee who has completed 10 years of service has a nonforfeitable right to 100 percent of his accrued benefit derived from employer contributions.

(c) *5- to 15-year vesting.* A plan satisfies the requirements of section 411(a)(2) (B) and this paragraph if an employee who has completed at least 5 years of service has a nonforfeitable right to a percentage of his accrued benefit derived from employer contribution which percentage is not less than the nonforfeitable percentage determined under the following table:

Completed years of service	Nonforfeitable percentage
5	25
6	30
7	35
8	40
9	45
10	50
11	60
12	70
13	80
14	90
15 or more	100

(d) *Rule of 45.* A plan satisfies the requirements of section 411(a)(2)(C) and this paragraph if an employee is entitled to the greater of the two percentages determined under paragraph (d) (1) or (2) of this section.

(1) *Age and service test.* An employee who is not separated from the service, who has completed at least 5 years of service, and with respect to whom the sum of his age and years of service equals of exceeds 45, has a nonforfeitable right to a percentage of his accrued benefit derived from employer contributions which is not less than the nonforfeitable percentage corresponding to his number of completed years of service to to the sum of his age and completed years of service (whichever percentage is the lesser) determined under the following table:

Completed years of service	Sum of age and service	Nonforfeitable percentage
5	45 or 46	50
6	47 or 48	60
7	49 or 50	70
8	51 or 52	80
9	53 or 54	90
10 or more	55 or more	100

(2) *Service test.* An employee who has completed at least 10 years of service has a nonforfeitable right to a percentage of his accrued benefit derived from employer contributions determined under the following table:

Completed years of service	Nonforfeitable percentage
10	50
11	60
12	70
13	80
14	90
15	100

(3) *Computation of age.* For purposes of subparagraph (1) of this paragraph, the age of an employee is his age on his last birthday.

(e) *Examples.* The rules provided by this section are illustrated by the following examples:

Example (1). Plan B provides that each employee's rights to his employer-derived accrued benefit are nonforfeitable as follows:

Completed years of service	Nonforfeitable percentage
2 or less	0
3	30
4	35
5	40
6	45
7	50
8	55
9	60
10	65
11	70
12	75
13	80
14	85
15	100

Plan B does not satisfy the requirements of paragraph (c) of this section (relating to 5–15-year vesting) because the nonforfeitable percentage provided by the plan after completion of 14 years of service (85 percent) is less than the percentage required by paragraph (c) of this section at that time (90 percent). The fact that the nonforfeitable percentage provided by the plan for years prior to the 13th year of service is greater than the percentage required under paragraph (c) of this section is immaterial. The plan fails to satisfy the requirements of paragraph (c) of this section even if it is demonstrated that the value of the vesting provided by the plan to the employee is at least equal to the value of the vesting rate required by that paragraph.

Example (2). Plan C provides for plan participation after the completion of 1 year of service. The plan provides that each employee's rights to his employer-derived accrued benefit are 100 percent nonforfeitable after 10 years of plan participation rather than service. The plan does not satisfy the requirements of paragraph (b) of this section because, under the plan, an employee obtains a 100 percent nonforfeitable right to his employer-derived accrued benefit only after completion of more than 10 years of service.

Example (3). Plan D provides that each employee's rights to his employer-derived accrued benefit are nonforfeitable in accordance with the following schedule:

Completed years of service	Nonforfeitable percentage
0–9	0
10	50
11	60
12	70
13	80
14	90
15	100

The plan does not satisfy the requirements of paragraph (b) of this section after the 9th year of service. It does not satisfy the requirements of paragraph (c) of this section for years prior to the 10th year of service. It does not satisfy the requirements of paragraph (d)(1) of this section for any year of service prior to the 10th year. The plan does not satisfy the requirements of this section because it does not satisfy the requirements of a particular one of the three paragraphs for each of an employee's years of service.

Example (4). Plan G provides that each employee's rights to his employer-derived accrued benefit are 100 percent nonforfeitable upon completion of 5 years of service. The plan satisfies the requirements of paragraphs (b), (c), and (d) of this section and, because it satisfies the requirements of at least one of such paragraphs for all of an employee's years of service, it satisfies the requirements of this section.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42325, Aug. 23, 1977]

§ 1.411(a)–3T Vesting in employer-derived benefits (temporary).

(a) *In general*—(1) [Reserved]

(2) *Composite arrangements.* A plan will not be considered to satisfy the requirements of paragraph (b), (c), or (d) of this section unless it satisfies all requirements of a particular one of such paragraphs with respect to all of an employee's years of service. A plan which, for example, satisfies the requirements of paragraph (b) (but not (c) or (d)) for an employee's first 4 years of service and satisfies the requirements of paragraph (c) (but not (b)) for all of his remaining years of service does not satisfy the requirements of this section. A plan is not precluded from satisfying the requirements of one such paragraph with respect to one group of employees and another such paragraph with respect to another group provided that the groups are not so structured as to evade the requirements of this paragraph.

(b) *5-year vesting.* A plan satisfies the requirements of section 411(a)(2)(A) and this paragraph if an employee who has completed 5 years of service has a nonforfeitable right to 100 percent of his or her accrued benefits derived from employer contributions.

(c) *3- to 7-year vesting.* A plan satisfies the requirements of section 411(a)(2)(B) and this paragraph if an employee who has completed at least 3 years of service has a nonforfeitable right to a percentage of his accrued benefit derived from employer contributions, which percentage is not less than the nonforfeitable percentage determined under the following table:

Completed years of service	Nonforfeitable percentage
3	20
4	40
5	60
6	80
7 or more	100

(d) *Multiemployer plans.* A plan satisfies the requirements of section 411(a)(2)(C) and this paragraph if—

(1) The plan is a multiemployer plan (within the meaning of section 414(f)), and

(2) Under the plan—

(i) An employee who is covered pursuant to a collective bargaining agreement described in section 414(f)(1)(B) has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions not later than upon completion of 10 years of service, and

(ii) The requirements of paragraph (b) or (c) of this section are met with respect to employees who are not covered pursuant to a collective bargaining agreement described in section 414(f)(1)(B).

(iii) For purposes of this provision, an employee is not covered pursuant to a collective bargaining agreement unless the employee is represented by a bona fide employee representative that is a party to the collective bargaining agreement pursuant to which the multiemployer plan is maintained. Thus, for example, an employee of either the multiemployer plan or the employee representative is not covered pursuant to the collective bargaining agreement under which the plan is maintained even if the employee is covered pursuant to an agreement entered into by the multiemployer plan or employee representative on behalf of the employee and even if all such employees covered under the plan constitute only a de minimis percentage of the total employees covered under the plan.

(e) *Effective date.* (1) The provisions of this section apply to all employees who have one hour of service in any plan year beginning after—

(i) December 31, 1988, or

(ii) In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, for employees covered by any such agreement, the earlier of—

(A) The later of—

(*1*) January 1, 1989, or

(*2*) The date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986), or

(B) January 1, 1991.

(2) For employees not described in paragraph (e)(1), above, the regulations in effect prior to January 1, 1989, shall be applied to determine the requirements of this section.

(f) *Examples.* The rules provided by this section are illustrated by the following examples:

Example (1). Plan B provides that each employee's rights to his employer-derived accrued benefit are nonforfeitable as follows:

Completed years of service	Nonforfeitable percentage
1	0
2	10
3	25
4	45
5	65
6	75
7	100

Plan B does not satisfy the requirements of paragraph (c) of this section (relating to 3- to 7-year vesting) because the nonforfeitable percentage provided by the plan after completion of 6 years of service (75 percent) is less than the percentage required by paragraph (c) of this section at that time (80 percent). The fact that the nonforfeitable percentage provided by the plan for years prior to the 6th year of service is greater than the percentage required under paragraph (c) of this section is immaterial. The plan fails to satisfy the requirements of paragraph (c) of this section even if it is demonstrated that the value of the vesting provided by the plan to the employees is at least equal to the value of the vesting rate required by this paragraph.

Example (2). Plan C provides for plan participation after the completion of 1 year of service. The plan provides that each employee's rights to his employer-derived accrued benefits are 100 percent nonforfeitable after 5 years of plan participation rather than service. The plan does not satisfy the requirements of paragraph (b) of this section because, under the plan, an employee obtains a 100 percent nonforfeitable right to his or her employer-derived accrued benefit only after completion of more than 5 years of service.

Example (3). Plan D provides that each employee's rights to his employer-derived accrued benefits are nonforfeitable in accordance with the following schedule:

Completed years of service	Nonforfeitable percentage
0 to 4	0
5	60
6	80
7	100

The plan does not satisfy the requirements of paragraph (b) of this section after the 4th year of service. It does not satisfy the requirements of paragraph (c) of this section for years prior to the 5th year of service. The plan does not satisfy the requirements of this section because it does not satisfy the requirements of a particular one of the two paragraphs for each of an employee's years of service.

Example (4). Plan G provides that each employee's rights to his employer-derived accrued benefit are 100 percent nonforfeitable upon completion of 3 years of service. The plan satisfies the requirements of paragraphs (b) and (c) of this section and, because it satisfies the requirements of at least one of such paragraphs for all of an employee's years of service, it satisfies the requirements of this section.

[T.D. 8170, 53 FR 240, Jan. 6, 1988]

§ 1.411(a)–4 Forfeitures, suspensions, etc.

(a) *Nonforfeitability.* Certain rights in an accrued benefit must be nonforfeitable to satisfy the requirements of section 411(a). This section defines the term ''nonforfeitable'' for purposes of these requirements. For purposes of section 411 and the regulations thereunder, a right to an accrued benefit is considered to be nonforfeitable at a particular time if, at that time and thereafter, it is an unconditional right. Except as provided by paragraph (b) of this section, a right which, at a particular time, is conditioned under the plan upon a subsequent event, subsequent performance, or subsequent forbearance which will cause the loss of such right is a forfeitable right at that time. Certain adjustments to plan benefits such as adjustments in excess of reasonable actuarial reductions, can result in rights being forfeitable. Rights which are conditioned upon a sufficiency of plan assets in the event of a termination or partial termination are considered to be forfeitable because of such condition. However, a plan does not violate the nonforfeitability requirements merely because in the event of a termination an employee does not have any recourse toward satisfaction of his nonforfeitable benefits from other than the plan assets or the Pension Benefit Guaranty Corporation. Furthermore, nonforfeitable rights are not considered to be forfeitable by reason of the fact that they may be reduced to take into account benefits which are provided under the Social Security Act or under any other Federal or State law and which are taken into account in determining plan benefits. To the extent that rights are not required to be nonforfeitable to satisfy the minimum vesting standards, or the nondiscrimination requirements of section 401(a)(4), they may be forfeited without regard to the limitations on forfeitability required by this section. The right of an employee to repurchase his accrued benefit for example under section 411(a)(3)(D), is an example of a right which is required to satisfy such standards. Accordingly, such a right is subject to the limitations on forfeitability. Rights which are required to be prospectively nonforfeitable under the vesting standards are nonforfeitable and may not be forfeited until it is determined that such rights are, in fact, in excess of the vesting standards. Thus, employees have a right to vest in the accrued benefits if they continue in employment of employers maintaining the plan unless a forfeitable event recognized by section 411 occurs. For example, if a plan covered employees in Division A of Corporation X under a plan utilizing a 10-year 100 percent vesting schedule, the plan could not forfeit employees' rights on account of their moving to service in Division B of Corporation X prior to completion of 10 years of service even though employees are not vested at that time.

(b) *Special rules.* For purposes of paragraph (a) of this section a right is not treated as forfeitable—

(1) *Death*—(i) *General rule.* In the case of a participant's right to his employer-derived accrued benefit, merely because such accrued benefit is forfeitable by the participant to the extent it has not been paid or distributed to him prior to his death. This subparagraph shall not apply to a benefit which must be paid to a survivor in order to satisfy the requirements of section 401(a)(11).

(ii) *Employee contributions.* A participant's right in his accrued benefit derived from his own contributions must be nonforfeitable at all times. Such a right is not treated as forfeitable merely because, after commencement of annuity or pension payments in a benefit form provided under the plan, the participant dies without receiving payments equal in amount to his nonforfeitable accrued benefit derived from his contributions determined at the time of commencement.

(2) *Suspension of benefits upon reemployment of retiree.* In the case of certain suspensions of benefits under section 411(a)(3)(B), see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(3) *Retroactive plan amendment.* In the case of a participant's right to his employer-derived accrued benefit, merely because such benefit is subject to reduction to the extent provided by a plan amendment described in section 412(c)(8) and the regulations thereunder, which amendment is given retroactive effect in accordance with such section.

(4) *Other forfeiture rules*—(i) *Withdrawal of mandatory contributions.* For rules allowing forfeitures on account of the withdrawal of mandatory contributions, see §1.411(a)–7(d) (2) and (3).

(ii) *Class year plans.* For forfeiture rules pertaining to class year plans, see §1.411(d)–3(b).

(iii) *Additional requirements.* For additional requirements relating to nonforfeitability of benefits in the event of a withdrawal by the employee, see section 401(a)(19) and §1.401(a)–19.

(5) *Multiemployer plan.* In the case of a multiemployer plan described in section 414(f), merely because an employee's accrued benefit which results from service with an employer before such employer was required to contribute to the plan is forfeitable on account of the cessation of contributions by the employer of the employee. This subparagraph shall not apply to an employee's accrued benefit with respect to an employer which accrued under a plan maintained by that employer prior to the adoption by that employer of the multiemployer plan.

(6) *Lost beneficiary; escheat.* In the case of a benefit which is payable, merely because the benefit is forfeitable on account of the inability to find the participant or beneficiary to whom payment is due, provided that the plan provides for reinstatement of the benefit if a claim is made by the participant or beneficiary for the forfeited benefit. In addition, a benefit which is lost by reason of escheat under applicable state law is not treated as a forfeiture.

(7) *Certain matching contributions.* A matching contribution (within the meaning of section 401(m)(4)(A) and §1.40l(m)–1(f)(12)) is not treated as forfeitable even if under the plan it may be forfeited under §1.401(m)–1(e)(1) because the contribution to which it relates is treated as an excess contribution (within the meaning of §1.402(k)–1(f)(2) and (g)(7)), excess deferral (within the meaning of §1.402(g)–1(e)(1)(iii)), or excess aggregate contribution (within the meaning of §1.401(m)–1(f)(8)).

(c) *Examples.* The rules of this section are illustrated by the following examples:

Example (1). Corporation A's plan provides that an employee is fully vested in his employer-derived accrued benefit after completion of 5 years of service. The plan also provides that, if an employee works for a competitor he forfeits his rights in the plan. Such provision could result in the forfeiture of an employee's rights which are required to be nonforfeitable under section 411 and therefore the plan would not satisfy the requirements of section 411. If the plan limited the forfeiture to employees who completed less than 10 years of service, the plan would not fail to satisfy the requirements of section 411 because the forfeitures under this provision are limited to rights which are in excess of the minimum required to be nonforfeitable under section 411(a)(2)(A).

Example (2). Plan B provides that if an employee does not apply for benefits within 5 years after the attainment of normal retirement age, the employee loses his plan benefits. Such a plan provision could result in forfeiture of an employee's rights which are required to be nonforfeitable under section 411 and, therefore, the plan would not satisfy the requirements of section 411.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42326, Aug. 23, 1977, as amended by T.D. 8357, 56 FR 40549, Aug. 15, 1991]

§ 1.411(a)–4T Forfeitures, suspensions, etc. (temporary).

(a) *Nonforfeitability.* Certain rights in an accrued benefit must be nonforfeitable to satisfy the requirements of section 411(a). This section defines the term ''nonforfeitable'' for purposes of these requirements. For purposes of section 411 and the regulations thereunder, a right to an accrued benefit is considered to be nonforfeitable at a particular time if, at that time and thereafter, it is an unconditional right. Except as provided by paragraph (b) of this section, a right which, at a particular time, is conditioned under the plan upon a subsequent event, subsequent performance, or subsequent forbearance which will cause the loss of such right is a forfeitable right at that time. Certain adjustments to plan benefits, such as adjustments in excess of reasonable actuarial reductions, can result in rights being forfeitable. Rights which are conditioned upon a sufficiency of plan assets in the event of a termination or partial termination are considered to be forfeitable because of such condition. However, a plan does not violate the nonforfeitability requirements merely because in the event of a termination an employee does not have any recourse toward satisfaction of his nonforfeitable benefits from other than the plan assets, the Pension Benefit Guaranty Corporation, or a trust established and maintained pursuant to sections 4041(c)(3)(B) (ii) or (iii) and section 4049 of ERISA with respect to the plan. Furthermore, nonforfeitable rights are not considered to be forfeitable by reason of the fact that they may be reduced as allowed under sections 401(a)(5) and 401(l). To the extent that rights are not required to be nonforfeitable to satisfy the minimum vesting standards, or the nondiscrimination requirements of section 401(a)(4), they may be forfeited without regard to the limitations on forfeitability required by this section. The right of an employee to repurchase his accrued benefit for example under section 411(a)(3)(D), is an example of a right which is required to satisfy such standards. Accordingly, such a right is subject to the limitations on forfeitability. Rights which are required to be prospectively nonforfeitable under the vesting standards are nonforfeitable and may not be forfeited until it is determined that such rights are, in fact, in excess of the vesting standards. Thus, employees have a right to vest in the accrued benefits if they continue in employment of employers maintaining the plan unless a forfeitable event recognized by section 411 occurs. For example, if a plan covered employees in Division A of Corporation X under a plan utilizing a 5-year 100 percent vesting schedule, the plan could not forfeit employees' rights on account of their moving to service in Division B of Corporation X prior to completion of 5 years of service even though employees are not vested at that time.

(b) [Reserved]

(c) *Examples.* The rules of this section ae illustrated by the following examples:

Example (1). Corporation A's plan provides that an employee is fully vested in his employer-derived accrued benefit after completion of 3 years of service. The plan also provides that if the employee works for a competitor he forfeits his rights in the plan. Such provision could result in the forfeiture of an employee's rights which are required to be nonforfeitable under section 411 and therefore the plan would not satisfy the requirements of section 411. If the plan limited the forfeiture to employees who completed less than 5 years of service, the plan would not fail to satisfy the requirements of section 411 because the forfeitures under this provision are limited to rights which are in excess of the minimum required to be nonforfeitable under section 411(a)(2)(A).

[T.D. 8170, 53 FR 241, Jan. 6, 1988]

§ 1.411(a)–5 Service included in determination of nonforfeitable percentage.

(a) *In general.* Under section 411(a)(4), for purposes of determining the nonforfeitable percentage of an employee's right to his employer-derived accrued benefit under section 411(a)(2) and §1.411(a)–3, all of an employee's years of service with an employer or employers maintaining the plan shall be taken into account except that years of service described in paragraph (b) of this section may be disregarded.

(b) *Certain service.* For purposes of paragraph (a) of this section, the following years of service may be disregarded:

(1) *Service before age 22.* (i) In the case of a plan which satisfies the requirements of section 411(a)(2) (A) or (B) (relating to 10-year vesting and 5–15-year vesting, respectively), a year of service completed by an employee before he attains age 22.

(ii) In the case of a plan which does not satisfy the requirements of section 411(a)(2) (A) or (B), a year of service completed by an employee before he attains age 22 if the employee is not a participant (for purposes of section 410) in the plan at any time during such year.

(iii) For purposes of this subparagraph in the case of a plan utilizing computation periods, service during a computation period described in section 411(a)(5)(A) within which the employee attains age 22 may not be disregarded. In the case of a plan utilizing the elapsed time method described in §1.410(a)–7, service on or after the date on which the employee attains age 22 may not be disregarded.

(2) *Contributory plans.* In the case of a plan utilizing computation periods, a year of service completed by an employee under a plan which requires mandatory contributions (within the meaning of section 411(c)(2)(C) and §1.411(c)–1(c)(4)) to be made by the employee for such year, if the employee does not participate for such year solely because of his failure to make all mandatory contributions to the plan for such year. If the employee contributes any part of the mandatory contributions for the year, such year may not be excluded by reason of this subparagraph. In the case of a plan utilizing the elapsed time method described in §1.410(a)–7, the service which may be disregarded is the period with respect to which the mandatory contribution is not made.

(3) *Plan not maintained*—(i) *In general.* An employee's years of service with an employer during any period for which the employer did not maintain the plan or a predecessor plan may be disregarded for purposes of section 411(a)(2). Paragraph (b)(3)(ii) of this section provides rules regarding the period prior to the adoption of a plan. Paragraph (b)(3)(iii) of this section provides rules regarding the period after the termination of a plan. Paragraph (b)(3)(iv) of this section provides rules regarding employers who have certain relationships with other employers maintaining the plan.

(ii) *Period prior to adoption.* The period for which a plan is not maintained by an employer includes the period before the plan was established. For purposes of this subdivision, a plan is established on the first day of the plan year in which the plan is adopted even though the plan is adopted after such first day. Except as provided in paragraph (b)(3)(iv) of this section if an employer adopts a plan which has previously been established by another employer or group of employers, the plan is not maintained by the adopting employer prior to the first day of the plan year in which the plan is adopted by the adopting employer. In the case of a transfer of assets or liabilities (including a merger or consolidation) involving two plans maintained by a single employer, the successor (or transferee) plan is treated as if it was established at the same time as the date of the establishment of the earliest component plan. In the case of a plan merger, consolidation, or transfer of plan assets or liabilities involving plans of two or more employers, the successor plan is treated as if it were established on each of the separate dates on which such component plan was established for the employees of each employer. Thus, for example, if employer A establishes a plan January 1, 1970, and employer B establishes a plan January 1, 1980, and the plans were subsequently merged, then the merged plan would be treated as if it were in existence on January 1, 1970, with respect to A's employees and as if it were in existence on January 1, 1980, with respect to B's employees.

(iii) *Period after termination or withdrawal.* The period for which a plan is not maintained by an employer includes the period after the plan is terminated. For purposes of this section, a plan is terminated at the date there is a termination of the plan within the meaning of section 411(d)(3)(A) and the regulations thereunder. Notwithstanding the preceding sentence, if contributions to or under a plan are made after termination, the plan is treated as being maintained until such contributions cease, whether or not accruals are made after such termination. If, after termination of a plan in circumstances under which the employer may be liable to the Pension Benefit Guaranty Corporation under section 4062 of the Act, employer contributions are made to or under the plan to fund benefits accrued at the time of termination, such contributions shall, for purposes of this paragraph, be deemed to be payments in satisfaction of employer liability to such Corporation rather than contributions to or under the plan. In the case of a plan maintained by more than one employer, the period for which the plan is not maintained by the withdrawing employer includes the period after the withdrawal from the plan.

(iv) *Certain employers.* For purposes of this subparagraph—

(A) *Predecessor employers.* Service with a predecessor employer who maintained the plan of the current employer is treated as service with such current employer (see section 414(a)(1) and the regulations thereunder), and certain service with a predecessor employer who did not maintain the plan of the current employer is treated as service with the current employer (see section 414(a)(2) and the regulations thereunder).

(B) *Related employers.* Service with an employer is treated as service for certain related employers for the period during which the employers are related. These related employers include members of a controlled group of corporations (within the meaning of section 1563(a), determined without regard to subsections (a)(4) and (e)(3) (C) thereof) and trades or businesses (whether or not incorporated) which are under common control (see section 414 (b) and (c) and 29 CFR Part 2530, Department of Labor regulations relating to minimum standards for employee pension benefits plans).

(C) *Plan maintained by more than one employer.* Service with an employer who maintains a plan is treated as service for each other employer who maintains that plan for the period during which the employers are maintaining the plan (see section 413 (b)(4) and (c)(3) and 29 CFR Part 2530, Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(v) *Predecessor plan*—(A) *General rule.* In the case of an employee who was covered by a predecessor plan, the time the successor of such plan is maintained for such employee includes the time the predecessor plan was maintained if, as of the later of the time the predecessor plan is terminated or the successor plan is established, the employee's years of service under the predecessor plan are not equalled or exceeded by the aggregate number of consecutive 1-year breaks in service occuring after such years of service. Years of service and breaks in service, without regard to whether the employee has nonforfeitable rights under the predecessor plan, are determined under section 411(a) (5) and (6) except that years between the termination date of the predecessor plan and the date of establishment of the successor plan do not count as years of service.

(B) *Definition of predecessor plan.* For purposes of this section, if—

(1) An employer establishes a retirement plan (within the meaning of section 7476(d)) qualified under subchapter D of chapter 1 of the Code within the 5-year period immediately preceding or following the date another such plan terminates, and

(*2*) The other plan is terminated during a plan year to which this section applies.

The terminated plan is a predecessor plan with respect to such other plan.

(C) *Example.* The rules provided by this subparagraph are illustrated by the following example:

Example. (1) Employer X's qualified plan A terminated on January 1, 1977, Employer X established qualified plan B on January 1,

1981. Under paragraph (b)(3)(v)(B) of this section, plan A is a predecessor plan with respect to plan B because plan B is established within the 5-year period immediately following the date plan A terminated.

(2) Employee C was not covered by the A plan. Under the general rule in subdivision (v)(A) of this subparagraph, plan B is not maintained until January 1, 1981, with respect to Employee C.

(3) Employee D was covered by the A plan. On December 31, 1976, D had 4 years of service. D had 4 consecutive 1-year breaks in service because, during the years between the termination of plan A and the establishment of plan B, he did not have more than 500 hours of service in any applicable computation period. Because D's consecutive 1-year breaks (4) equal his years of service prior to his breaks (4), plan B is not maintained until January 1, 1981, with respect to employee D.

(4) Employee E was covered by the A plan. On December 31, 1975, E had 6 years of service. E had a 1-year break in service in 1976. E also had 4 consecutive 1-year breaks in service for the period between plan A's termination and plan B's establishment. Because E's years of service (6) are not less than his consecutive 1-year breaks (5), plan B is maintained for E as of the establishment date of plan A.

(4) *Break in service.* A year of service which is not required to be taken into account by reason of a break in service (within the meaning of section 411(a)(6) and §1.411(a)–6)).

(5) *Service before January 1, 1971.* A year of service completed by an employee prior to January 1, 1971, unless the employee completes at least 3 years of service at any time after December 31, 1970. For purposes of determining if an employee completes 3 years of service, whether or not consecutive, the exceptions of section 411(a)(4) are not applicable. For the meaning of the term ''year of service'', see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(6) *Service before effective date.* A year of service completed before the first plan year for which this section applies to the plan, if such service would have been disregarded under the plan rules relating to breaks in service (whether or not such rules are so designated in the plan) as such rules were in effect from time to time under the plan. For this purpose, plan rules which result in the loss of prior vesting or benefit accruals of an employee, or which deny an employee eligibility to participate, by reason of separation or failure to complete a required period of service within a specified priod of time (*e.g.*, 300 hours in one year) will be considered break in service rules See §1.411(a)–9 for requirements relating to certain amendments to the break in service rules of a plan.

(i) [Reserved]

(ii) *Examples.* The rules of this subparagraph are illustrated by the following examples:

Example 1. The A plan in 1971 provides for immediate participation and vesting at normal retirement age. Employees accrue a unit benefit based on their compensation in each year. The plan provides that if an employee is not employed on the last day of the calendar year, he loses all accrued benefits. The requirement of employment on the last day of the year is a break in service rule because employees can lose benefits by reason of their separation. Accordingly, in the case of employees who separate and do not return by the close of the year, service which is completed prior to separation may be disregarded.

Example 2. The B plan in 1971 excludes from plan participation employees who work less than 1,200 hours per year. Because years of less than 1,200 hours are not taken into account under the B plan for eligibility to participate, such years are excluded under rules relating to breaks in service. Therefore, the years can be disregarded under this subparagraph.

Example 3. The C plan in 1971 provides for immediate participation and provides accruals and vesting credit for 1,200 hours or more in a given year. The plan provides that if a participant works less than 300 hours in a given year, he loses all prior vesting and benefit credits. The 300 hour rule is a break in service rule because the failure to complete 300 hours results in the loss of vesting and prior service credit. The 1,200 hour requirement is not a break in service rule because even though employees do not increase vesting or accrue benefits for service between 300 and 1,200 hours, they cannot lose prior vesting or benefits for such service. Accordingly, the C plan can disregard completed years only on account of less than 300 hours of service by an employee.

(c) *Special continuity rule for certain plans.* For special rules for computing years of service in the case of a plan maintained by more than one employer, see 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(Sec. 411 (88 Stat. 901, 26 U.S.C. 411))

[T.D. 7501, 42 FR 42327, Aug. 23, 1977, as amended by T.D. 7703, 45 FR 40985, June 17, 1980]

§ 1.411(a)–6 Year of service; hours of service; breaks in service.

(a) *Year of service.* Under section 411 (a)(5)(A), for purposes of the regulations thereunder, the term ''year of service'' is defined in regulations prescribed by the Secretary of Labor under section 203(b)(2)(A) of the Employee Retirement Income Security Act of 1974. For special rules applicable to seasonal industries and maritime industries, see regulations prescribed by the Secretary of Labor under subparagraphs (C) and (D) of section 203(b)(2) of the Employee Retirement Income Security Act of 1974.

(b) *Hours of service.* Under section 411(a)(5)(B), for purposes of the regulations thereunder, the term ''hours of service'' has the meaning provided by section 410(a)(3)(C). See regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(c) *Breaks in service.* Under section 411(a)(6), for purposes of § 1.411(a)–5(b)(4) and of this paragraph—

(1) *In general*—(i) *Year of service after 1-year break in service.* In the case of any employee who has incurred a 1-year break in service, years of service completed before such break are not required to be taken into account until the employee has completed one year of service after his return to service.

(ii) *Defined contribution plan.* In the case of a participant in a defined contribution plan or in an insured defined benefit plan (which plan satisfies the requirements of section 411 (b)(1)(F) and § 1.411(b)–1) who has incurred a 1-year break in service, years of service completed after such break are not required to be taken into account for purposes of determining the nonforfeitable percentage of the participant's right to employer-derived benefits which accrued before such break. This subdivision does not permit years of service completed before a 1-year break in service to be disregarded in determining the nonforfeitable percentage of a participant's right to employer-derived benefits which accrue after such break.

(iii) *Nonvested participants.* In the case of an employee who is a nonvested participant in employer-derived benefits at the time he incurs a 1-year break in service, years of service completed by such participant before such break are not required to be taken into account for purposes of determining the nonforfeitable percentage of his right to employer-derived benefits if at such time the number of consecutive 1-year breaks in service included in his most recent break in service equals or exceeds the aggregate number of his years of service, whether or not consecutive, completed before such break. In the case of a plan utilizing the elapsed time method described in § 1.410(a)–7, the condition in the preceding sentence shall be satisfied if the period of severance is at least one year and the consecutive period of severance equals or exceeds his prior period of service, whether or not consecutive, completed before such period of severance. In computing the aggregate number of years of service prior to such break, years of service which could have been disregarded under this subdivision by reason of any prior break in service may be disregarded.

(2) *One-year break in service defined.* The term ''1-year break in service'' means a calendar year, plan year, or other 12-consecutive month period designated by a plan (and not prohibited under regulations prescribed by the Secretary of Labor) during which the participant has not completed more than 500 hours of service. In the case of a plan utilizing the elapsed time method, the term ''1-year break in service'' means a 12-consecutive month period beginning on the severance from service date or any anniversary thereof and ending on the next succeeding anniversary of such date; provided, however, that the employee during such 12-consecutive-month period does not complete any hours of service within the meaning of 29 CFR Part 2530.200b–2(a) for the employer or employers maintaining the plan. See regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to

minimum standards for employee pension benefit plans.

(d) *Examples.* The rules provided by this section are illustrated by the following examples:

Example (1). (i) X Corporation maintains a defined contribution plan to which section 411 applies. The plan uses the calendar year as the vesting computation period. In 1980, Employee A, who was hired at age 35, separates from the service of X Corporation after completing 4 years of service. At the time of his separation, Employee A had a nonforfeitable right to 25 percent of his employer-derived accrued benefit which was not distributed. In 1985, after incurring 5 consecutive one-year breaks in service. Employee A is reemployed by X Corporation and becomes an active participant in the plan. The plan provides that, for 1985 and all subsequent years, Employee A's previous years of service will not be taken into account for purposes of computing the nonforfeitable percentage of his employer-derived accrued benefit, solely because of his break in service.

(ii) The plan fails to satisfy section 411. Section 411(a)(6)(B) would permit the plan to disregard Employee A's prior service for purposes of computing his nonforfeitable percentage in 1985 only, but such service must be taken into account in subsequent years unless there is another break in service. Under section 411(a)(6)(C), the plan is not required to take Employee A's post-break service into account for purposes of computing his nonforfeitable right to his prebreak employer-derived accrued benefits. This provision, however, would not permit the plan to disregard pre-break service in determining his nonforfeitable right to his benefit accrued after the break. The exception provided by section 411(a)(6)(D) does not apply in the case of a participant who has any nonforfeitable right to his accrued benefit derived from employer contributions.

Example (2). (i) X Corporation maintains a qualified plan to which sections 410 and 411 (relating to minimum participation standards and minimum vesting standards, respectively) apply. The plan permits participation upon completion of a year of service and provides that 100% of an employee's employer-derived accrued benefit vests after 10 years of service. The plan uses the calendar year as the vesting computation period. The plan provides that an employee who completes at least 1,000 hours of service in a 12-month period is credited with a year of service for participation and vesting purposes. The plan also provides that an employee who does not complete more than 500 hours of service in that 12-month period incurs a one-year break in service. The plan includes the rule described in section 411 (a)(6)(D) for participation and vesting purposes. Under this rule, an employee's years of service prior to a break in service may be disregarded under certain circumstances if he has no vested right to any employer-derived benefit under the plan. The plan does not contain the rule described in section 411(a)(6)(B) (relating to the requirement of one year of service after a one-year break in service).

(ii) Employee A commences employment with the X Corporation on January 1, 1977. Employee A's employment history for 1977 through 1989 is as follows:

Year ending December 31	Hours of service completed
1977	1,000
1978	800
1979	1,000
1980	400
1981	1,000
1982	0
1983	400
1984	1,000
1985	0
1986	0
1987	500
1988	200
1989	1,000

Employee A's status as a participant during this period is determined as follows:

1978: Employee A was a plan participant on January 1, 1978, because he completed a year of service (1,000 hours) in 1977. He did not complete a year of service in 1978 because he completed fewer than 1,000 hours in that year. Because he completed more than 500 hours of service in 1978, however, Employee A did not incur a one-year break in service that year.

1979: Employee A completes a year of service in 1979. Because he did not incur a one-year break in service in 1978, the plan may not disregard his 1977 service for purposes of determining his years of service as of January 1, 1979.

1980: Employee A incurs a one-year break in service in 1980.

1981: Because Employee A had completed 2 years of service prior to 1981 and had incurred one 1-year break in service prior to 1981, under section 411(a)(6)(D), the plan may not disregard his pre-1980 service in 1981. Employee A completes a year of service in 1981.

1982: Employee A incurs a one-year break in service in 1982.

1983: Employee A incurs a one-year break in service in 1983. As of the end of 1983, he has completed 3 years of service and has incurred 2 consecutive one-year breaks in service.

1984: Employee A completes a year of service in 1984. Under section 411(a)(6)(D), his pre-1982 service may not be disregarded in 1984 because, as of the beginning of 1984, his pre-1984 years of service (3) exceed his consecutive one-year breaks in service (2).

1984–1988: Employee A incurs 4 consecutive one-year breaks in service during the years 1985 through 1988.

1989: Employee A's pre-1989 service is disregarded in 1989 and all subsequent plan years because his years of service as of January 1, 1989, equal the number of consecutive one-year breaks he has incurred as of that date. Therefore, as of the beginning of 1989, Employee A is not a plan participant. Employee A completes a year of service in 1989. (Although section 411(a)(6)(D) does not prohibit the plan provision under which Employee A's pre-1989 service is disregarded, that section does not require such a provision in a qualified plan.)

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42329, Aug. 23, 1977, as amended by T.D. 7703, 45 FR 40985, June 17, 1980]

§ 1.411(a)–7 Definitions and special rules.

(a) *Accrued benefit.* For purposes of section 411 and the regulations thereunder, the term ''accrued benefit'' means—

(1) *Defined benefit plan.* In the case of a defined benefit plan—

(i) If the plan provides an accrued benefit in the form of an annual benefit commencing at normal retirement age, such accrued benefit, or

(ii) If the plan does not provide an accured benefit in the form described in subdivision (i) of this subparagraph, an annual benefit commencing at normal retirement age which is the actuarial equivalent (determined under section 411(c)(3) and § 1.411(c)–(5) of the accrued benefit determined under the plan. In general, the term ''accrued benefits'' refers only to pension or retirement benefits. Consequently, accrued benefits do not include ancillary benefits not directly related to retirement benefits such as payment of medical expenses (or insurance premiums for such expenses), disability benefits not in excess of the qualified disability benefit (see section 411(a)(9) and paragraph (c)(3) of this section), life insurance benefits payable as a lump sum, incidental death benefits, current life insurance protection, or medical benefits described in section 401(h). For purposes of this paragraph a subsidized early retirement benefit which is provided by a plan is not taken into account, except to the extent of determining the normal retirement benefit under the plan (see section 411(a)(9) and paragraph (c) of this section). The accrued benefit includes any optional settlement at normal retirement age under actuarial assumptions no less favorable than those which would be applied if the employee were terminating his employment at normal retirement age. The accrued benefit does not include any subsidized value in a joint and survivor annuity to the extent that the annual benefit of the joint and survivor annuity does not exceed the annual benefit of a single life annuity.

(2) *Defined contribution plan.* In the case of a defined contribution plan, the balance of the employee's account held under the plan.

(b) *Normal retirement age*—(1) *General rule.* For the purposes of section 411 and the regulations thereunder, the term ''normal retirement age'' means the earlier of—

(i) The time specified by a plan at which a plan participant attains normal retirement age, or

(ii) The later of—

(A) The time the plan participant attains age 65, or

(B) The 10th anniversary of the date the plan participant commences participation in the plan.

If a plan, or the employer sponsoring the plan, imposes a requirement that an employee retire upon reaching a certain age, the normal retirement age may not exceed that mandatory retirement age. The preceding sentence will apply if the employer consistently enforces a mandatory retirement age rule, whether or not set forth in the plan or any related document. For purposes of subdivision (i) of this subparagraph, if an age is not specified by a plan as the normal retirement age then the normal retirement age under the plan is the earliest age beyond which the participant's benefits under the plan are not greater solely on account of his age or service. For purposes of paragraph (b)(1)(ii)(B) of this section, participation commences on the first day of the first year in which the participant commenced his participation in the plan, except that years which may be disregarded under section 410(a)(5)(D) may be disregarded in determining when participation commenced.

(2) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). Plan A defines normal retirement age as age 65. Under the plan, benefits payable to participants who retire at or after age 60 are not reduced on account of early retirement. For purposes of section 411 and the vesting regulations, normal retirement age under Plan A is age 65 (determined under subparagraph (1)(i) of this paragraph). This is true even if in operation all participants retire at age 60.

Example (2). Plan B does not specify any age as the normal retirement age. Under the plan, participants who have attained age 55 are entitled to benefits commencing upon retirement but the benefits of participants who retire before attaining age 70 are subject to reduction on account of early retirement. For purposes of section 411 and the vesting regulations the normal retirement age under Plan B is the later of (i) age 65, or (ii) the 10th anniversary of the date a plan participant commences participation in the plan (assuming such date is prior to age 70).

Example (3). The facts are the same as in example (2). Employee X first became a participant in Plan B on January 1, 1980 at age 53. His participation continued until December 31, 1980, when he separated from the service with no vested benefits. After incurring 5 consecutive 1-year breaks in service, Employee X again becomes an employee and a plan participant on January 1, 1986, at age 59. For purposes of section 411, Employee X's normal retirement age under Plan B is age 69, the 10th anniversary of the date on which his year of plan participation commenced. His participation in 1980 may be disregarded under the last sentence of paragraph (b)(1) of this section.

(c) *Normal retirement benefit*—(1) *In general.* For purposes of section 411 and the regulations thereunder, the term ‘‘normal retirement benefit’’ means the periodic benefit under the plan commencing upon early retirement (if any) or at normal retirement age, whichever benefit is greater.

(2) *Periodic benefit.* For purposes of subparagraph (1) of this paragraph—

(i) In the case of a plan under which a benefit is payable as an annuity in the same form upon early retirement and at normal retirement age, the greater benefit is determined by comparing the amount of such annuity payments.

(ii) In the case of a plan under which an annuity benefit payable upon early retirement is not in the same form as an annuity benefit payable at normal retirement age, the greater benefit is determined by converting the annuity benefit payable upon early retirement age into the same form of annuity benefit as is payable at normal retirement age and by comparing the amount of the converted early retirement benefit payment with the amount of the normal retirement benefit payment.

(iii) In the case of a plan which is integrated with the Social Security Act or any other Federal or State law, the periodic benefit payable upon and after early retirement age is adjusted for any increases in such benefits occurring on or after early retirement age which are taken into account under the plan. See however, section 401(a)(15) and the regulations thereunder.

(3) *Benefits included.* For purposes of this paragraph, the normal retirement benefit under a plan shall be determined without regard to ancillary benefits not directly related to retirement benefits such as medical benefits or disability benefits not in excess of the qualified disability benefit; see section 411(a)(7) and paragraph (a)(1) of this section. For this purpose, a qualified disability benefit is a disability benefit which is not in excess of the amount of the benefit which would be payable to the participant if he separated from service at normal retirement age.

(4) *Early retirement benefit; social security supplement.* (i) For purposes of this paragraph, the early retirement benefit under a plan shall be determined without regard to any social security supplement.

(ii) For purposes of this subparagraph, a social security supplement is a benefit for plan participants which—

(A) Commences before the age and terminates before the age when participants are entitled to old-age insurance benefits, unreduced on account of age, under title II of the Social Security Act, as amended (see section 202 (a) and (g) of such Act), and

(B) Does not exceed such old-age insurance benefit.

(5) *Special limitation.* If a defined benefit plan bases its normal retirement benefits on employee compensation, the compensation must reflect the compensation which would have been paid for a full year of participation within the meaning of section 411(b)(3).

If an employee works less than a full year of participation, the compensation used to determine benefits under the plan for such year of participation must be multiplied by the ratio of the number of hours for a complete year of participation to the number of hours worked in such year. A plan whose benefit formula is computed on a computation base which cannot decrease is not required to adjust employee compensation in the manner described in the previous sentence. Thus, for example, if a plan provided a benefit based on an employee's compensation for his highest five consecutive years or a separate benefit for each year of participation based on the employee's compensation for such year the plan would not have to so adjust compensation. However, if a plan provided a benefit based on an employee's compensation for the employee's last five years or the five highest consecutive years out of the last 10 years, the compensation, would have to be so adjusted. For special rules for applying the limitations on proration of a year of participation for benefit accrual, see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(6) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (*1*). Plan A provides for a benefit equal to 1% of high 5 years compensation for each year of service and a normal retirement age of 65. The plan also provides for a full unreduced accrued benefit without any actuarial reduction for any employee at age 55 with 30 years of service. Even though the actuarial value of the early retirement benefit could exceed the value of the benefit at the normal retirement age, the normal retirement benefit would not include the greater value of the early retirement benefit because actuarial subsidies are ignored.

Example (*2*). Plan B provides the following benefits: (1) at normal retirement age 65, $300/mo. for life and (2) at early retirement age 60, $400/mo. for life. The normal retirement benefit is $400/mo., the greater of the benefit payable at normal retirement age ($300) or early retirement ($400).

Example (*3*). Assume the same facts as example (2) except that the early retirement benefit of $400 is reduced to $300 upon attainment of age 65. If each employee's social security benefit at age 65 is not less than $100, the $100 would be considered to be a social security supplement and would therefore be ignored. Consequently, the normal retirement benefit would be $300.

Example (*4*). Plan C provides a benefit at normal retirement age equal to 1% per year of service, multiplied by the participant's compensation averaged over the 5 years immediately prior to retirement. An early retirement benefit is provided upon attainment of age 60 equal to the benefit accrued to date of early retirement reduced by 4 percent for each year by which the early retirement date precedes the normal retirement age of 65. Employee A was hired at age 30, participated immediately, and retired at age 65. Employee A's annual compensation was $50,000 between ages 55–60 and was reduced to $33,000 after age 60. The following table indicates the amount of annual benefit that would have been provided by the plan formula if the employee retired at or after age 60:

Age	Final average computated	Percent accrued benefit	Reduction	Annual benefit
	(1)—	(2)—	(3)—	(4)—
60	$50,000	30	0.80	*$12,000
61	46,600	31	.84	12,135
62	43,200	32	.88	12,165
63	39,800	33	.92	12,083
64	36,400	34	.96	11,881
65	33,000	35	1.00	11,550

NOTE.— Col. (1) times col. (2) times col. (3) equals col. (4).

The normal retirement benefit is the greater of the benefit payable at normal retirement age or the early retirment benefit. Employee A's normal retirement benefit is $12,165, the greatest annual benefit Employee A would be entitled to.

(d) *Rules relating to certain distributions and cash-outs of accrued benefits*—(1) *In general.* This paragraph sets forth vesting rules applicable to certain distributions from qualified plans and their related trusts (other than class year plans). Subparagraphs (2) and (3) set forth the exceptions to nonforfeitability on account of withdrawal of mandatory contributions provided by section 411(a)(3)(D). When a plan utilizes these exceptions with respect to a given participant's accrued benefit, such accrued benefit is not subject to the cash-out rules or vesting rules of subparagraphs (4) or (5), respectively. Section 411 prescribes certain requirements with respect to accrued benefits under a qualified plan. These requirements would generally not be satisfied if the plan disregarded service in computing accrued benefits even though amounts were distributed on account of such service. Subparagraph (4) of this paragraph sets forth rules under section 411(a)(7)(B) which allow a plan to make distributions and compute accrued benefits without regard to the accrued benefit attributable to the distribution. When a defined contribution plan utilizes this exception with respect to an accrued benefit, the plan is not required to satisfy the rules of subparagraph (5) of this paragraph. Subparagraph (5) of this paragraph sets forth a vesting requirement applicable to certain distributions from defined contribution plans. Subparagraph (6) sets forth other rules which pertain to the distribution rules of this paragraph.

(2) *Withdrawal of mandatory contribution*—(i) *General rule.* In the case of a participant's right to his employer-derived accrued benefit, a right is not treated as forfeitable merely because all or a portion of such benefit may be forfeited on account of the withdrawal by the participant of any amount attributable to his accrued benefit derived from his mandatory contributions (within the meaning of section 411(c)(2)(C) and §1.411(c)–1) before he has become a 50 percent vested participant (within the meaning of §1.401(a)–19(b)(2)). For purposes of determining the vested percentage, the plan may disregard service after the withdrawal. For example, assume that a plan utilizes 1000 hours for computing years of service and that for the computation period employee A had 1000 hours of service. If A was 40 percent vested at the beginning of the period but only had 800 hours at the time of the withdrawal, the plan could treat A as only 40 percent vested because service after the withdrawal can be disregarded. On the other hand, if A had 1000 hours at the time of the withdrawal, he must receive a year of service for the computation period, even though service is not taken into account until the end of such period.

(ii) *Plan repayment provision.* (A) Subdivision (i) of this subparagraph shall not apply unless, at the time the amount described in such subdivision is withdrawn by the participant, the plan provides the employee with a right to restoration of his employer-derived accrued benefit to the extent forfeited in accordance with such subdivision upon repayment to the plan of the full amount of the withdrawal.

(B) In the case of a defined benefit plan (as defined in section 414(j)) the restoration of the employee's employer-derived accrued benefit may be conditioned upon repayment of interest on the full amount of the distribution. Such interest shall be computed on the amount of the distribution from the date of such distribution to the date of repayment, compounded annually from the date of distribution, at the rate determined under section 411(c)(2)(C) in effect on the date of repayment. A plan may provide for repayment of interest which is less than the amount determined under the preceding sentence.

(C) In the case of both defined benefit plans and defined contribution plans, the plan repayment provision described in this subparagraph may provide that the employee must repay the full amount of the distribution in order to have the forfeited benefit restored. The plan provision may not require that such repayment be made sooner than the time described in paragraph (d)(2)(ii)(D) of this section.

(D)(*1*) If a distribution is on account of separation from service, the time for repayment may not end before the earlier of—

(*i*) 5 years after the first day the employee is subsequently employed, or

(*ii*) The close of the first period of consecutive 1-year breaks in service commencing after the distribution.

If the distribution occurs for any other reason, the time for repayment may not end earlier than 5 years after the date of distribution. Nevertheless, a plan provision may provide for a longer period in which the employee may repay. For example, a plan could allow repayments to be made at any time before normal retirement age.

(*2*) In the case of a plan utilizing the elapsed time method, described in §1.410(a)–7, the minimum time for repayment shall be determined as in paragraph (d)(2)(ii)(D)(*1*) of this section except as provided in this subdivision. The 5 consecutive 1-year break periods shall be determined by substituting the term ''1-year period of severance'' for the term ''1-year break in service''.

Also, the repayment period both commences and closes in a manner determined by the Commissioner that is consistent with the rules in § 1.410(a)–7 and the substitution in section 411(a)(6)(C) and (D) of a 5-year break–in–service rule for the former 1-year break–in–service rule.

(E) A defined benefit plan using the break–in–service rule described in section 410(a)(5)(D) or a defined contribution plan using the break–in–service rule described in section 411(a)(6)(C) for determining employees' accrued benefits is not required to provide for repayment by an employee whose accrued benefit is disregarded by reason of a plan provision using these rules.

(iii) *Computation of benefit.* In the case of a defined contribution plan, the employer-derived accrued benefit required to be restored by this subparagraph shall not be less than the amount in the account balance of the employee which was forfeited, unadjusted by any subsequent gains or losses.

(iv) *Delayed forfeiture.* A defined contribution plan may, in lieu of the forfeiture and restoration described in this subparagraph, provide that the forfeiture does not occur until the expiration of the time for repayment described in subdivision (ii) of this subparagraph provided that the conditions of this subparagraph are satisfied.

(3) *Withdrawal of mandatory contributions; accruals before September 2, 1974*—(i) *General rule.* In the case of a participant's right to the portion of the employer-derived benefit which accrued prior to September 2, 1974, a right is not treated as forfeitable merely because all or part of such portion may be forfeited on account of the withdrawal by the participant of an amount attributable to his benefit derived from mandatory contributions (within the meaning of section 411(c)(2)(C) and § 1.411(c)–1(c)(4)) made by the participant before September 2, 1974, if the amount so subject to forfeiture is no more than proportional to such amounts withdrawn. This subparagraph shall not apply to any plan to which any mandatory contribution (within the meaning of section 411(c)(2)(C) and § 1.411(c)–1(c)(4)) is made after September 2, 1974.

(ii) *Defined contribution plan.* In the case of a defined contribution plan, the portion of a participant's employer-derived benefit which accrued prior to September 2, 1974, shall be determined on the basis of a separate accounting between benefits accruing before and after such date. Gains, losses, withdrawals, forfeitures, and other credits or charges must be separately allocated to such benefits. Any allocation made on a reasonable and consistent basis prior to September 1, 1977, shall satisfy the requirements of this subdivision.

(iii) *Defined benefit plan.* In the case of a defined benefit plan, the portion of a participant's employer-derived benefit which accrued prior to September 2, 1974, shall be determined in a manner consistent with the determination of an accrued benefit under section 411(b)(1)(D) (see § 1.411(b)–1(c)). Any method of determining such accrued benefit which the Commissioner finds to be reasonable shall satisfy the requirements of this subdivision.

(4) *Certain cash-outs of accrued benefits*—(i) *Involuntary cash-outs.* For purposes of determining an employee's right to an accrued benefit derived from employer contributions under a plan, the plan may disregard service performed by the employee with respect to which—

(A) The employee receives a distribution of the present value of his entire nonforfeitable benefit at the time of the distribution,

(B) The requirements of section 411(a)(11) are satisfied at the time of the distribution. See § 1.411(a)(11)–1.

(C) The distribution is made due to the termination of the employee's participation in the plan, and

(D) The plan has a repayment provision which satisfies the requirements of subdivision (iv) of this subparagraph in effect at the time of the distribution.

A distribution shall be deemed to be made due to the termination of an employe's participation in the plan if it is made no later than the close of the second plan year following the plan year in which such termination occurs. For purposes of determining the entire nonforfeitable benefit, the plan may disregard service after the distribution, as illustrated in subparagraph (2)(i) of this paragraph. (For distributions made on or after March 22, 1999, see §1.411(a)–7T.)

(ii) *Voluntary cash-outs.* For purposes of determining an employee's accrued benefit derived from employer contributions under a plan, the plan may disregard service performed by the employee with respect to which—

(A) The employee receives a distribution of the present value of his nonforfeitable benefit attributable to such service at the time of such distribution,

(B) The employee voluntarily elects to receive such distribution,

(C) The distribution is made on termination of the employee's participation in the plan, and

(D) The plan has a repayment provision in effect at the time of the distribution which satisfies the requirements of subdivision (iv) of this subparagraph.

A distribution shall be deemed to be made on termination of participation in the plan if it is made not later than the close of the second plan year following the plan year in which such termination occurs. For purposes of determining the nonforfeitable benefit, the plan may disregard service after the distribution as illustrated in subparagraph (2)(i) of this subparagraph.

(iii) *Disregard of service.* Service of an employee permitted to be disregarded under subdivision (i) or (ii) of the subparagraph is not required to be taken into account in computing the employee's accrued benefit under the plan. In the case of a voluntary distribution described in subdivision (ii) of this subparagraph which is less than the present value of the employee's total nonforfeitable benefit immediately prior to the distribution, the accrued benefit not required to be taken into account is such total accrued benefit multiplied by a fraction, the numerator of which is the amount of the distribution and the denominator of which is the present value of his total nonforfeitable benefit immediately prior to such distribution. For example, A who is 50 percent vested in an account balance of $1,000 receives a voluntary distribution of $250. The accrued benefit which can be disregarded equals $1,000 times $250/$500, or $500. However, such service may not by reason of this paragraph be disregarded for purposes of determining an employee's years of service under sections 410(a)(3) and 411(a)(4).

(iv) *Plan repayment provision.* (A) A plan repayment provision satisfies the requirements of this subdivision if, under the provision, the accrued benefit of an employee that is disregarded by a plan under this subparagraph is restored upon repayment to the plan by the employee of the full amount of the distribution. An accrued benefit is not restored unless all of the optional forms of benefit and subsidies relating to such benefit are also restored. A plan is not required to provide for repayment of an accrued benefit unless the employee—

(*1*) Received a distribution that is in a plan year to which section 411 applies (see §1.411(a)–2), which distribution is less than the amount of his accrued benefit determined under the same optional form of benefit as the distribution was made, and

(*2*) Resumes employment covered under the plan.

(B) *Example.* Plan A provides a single sum distribution equal to the present value of the normal form of the accrued benefit payable at normal retirement age which is a single life annuity. Plan A also provides a subsidized joint and survivor annuity and a subsidized early retirement annuity benefit. A participant who is fully vested and receives a single sum distribution equal to the present value of the single life annuity normal retirement benefit is not required to be provided the right under the plan to repay the distribution upon subsequent reemployment even though the participant received a distribution that did not reflect the value of the subsidy in the joint and survivor annuity or the value of the early retirement annuity subsidy. This is true whether or not the participant had satisfied at the time of the distribution all of the conditions necessary to receive the subsidies. However, if a participant does not receive his total accrued benefit in the optional form of benefit under which his benefit was distributed, the plan must provide for repayment. If the employee repays the distribution in accordance with section 411(a)(7), the plan must restore the employee's accrued benefit which would include the right to receive the subsidized joint and survivor annuity and the subsidized early retirement annuity benefit.

(C) A plan may impose the same conditions on repayments for the restoration of employer-derived accrued benefits that are allowed as conditions for restoration of employer-derived accrued benefits upon repayment of mandatory contributions under paragraphs (d)(2)(ii) (B), (C), (D) and (E) of this section.

(v) In the case of a defined contribution plan, the employer-derived accrued benefit required to be restored by this subparagraph shall not be less than the amount in the account balance of the employee, both the amount distributed and the amount forfeited, unadjusted by any subsequent gains or losses. Thus, for example, if an employee received a distribution of $250 when he was 25 percent vested in an account balance of $1,000, upon repayment of $250 the account balance may not be less than $1,000 even if, because of plan losses, the account balance, if not distributed, would have been reduced to $500.

(5) *Vesting requirement for defined contribution plans*—(i) *Application.* The requirements of this subparagraph apply to a defined contribution plan which makes distributions to employees from their accounts attributable to employer contributions at a time when—

(A) Employees are less than 100 percent vested in such accounts, and

(B) Under the plan, employees can increase their percentage of vesting in such accounts after the distributions.

(ii) *Requirements.* In order for a plan, to which this subparagraph applies, to satisfy the vesting requirements of section 411, account balances under the plan (with respect to which percentage vesting can increase) must be computed in a manner which satisfies either subdivision (iii) (A) or (B) of this subparagraph.

(iii) *Permissible methods.* A plan many provide for either of the following methods, but not both, for computing account balances with respect to which percentage vesting can increase and from which distributions are made:

(A)*(1)* A separate account is established for the employee's interest in the plan as of the time of the distribution, and

(*2*) At any relevant time the employee's vested portion of the separate account is not less than an amount (''X'') determined by the formula: $X=P(AB+(R\times D))-(R\times D)$. For purposes of applying the formula: P is the vested percentage at the relevant time; AB is the account balance at the relevant time; D is the amount of the distribution; R is the ratio of the account balance at the relevant time to the account balance after distribution; and the relevant time is the time at which, under the plan, the vested percentage in the account cannot increase.

A plan is not required to provide for separate accounts provided that account balances are maintained under a method that has the same effect as under this subdivision.

(B) At any relevant time the employee's vested portion is not less than an amount (''X'') determined by the formula: $X=P(AB+D)-D$. For purposes of applying the formula, the terms have the same meaning as under subdivision (iii)(A)(*2*) of this subparagraph.

(C) An application of the methods described in subdivisions (iii) (A) and (B) of this subparagraph is illustrated by the following examples:

Example (1). The X defined contribution plan uses the method described in subdivision (iii)(A) of this subparagraph for computing account balances and the break in service rule described in section 411(a)(6)(C) (service after a 1-year break does not increase the vesting percentage in account balances accrued prior to the break). The plan distributes $250 to A when A's account balance prior to the distribution equals $1,000 and he is 25 percent vested. At the time of the distribution, A has not incurred a 1-year break so that his vesting percentage can increase. Six years later, when A is 60 percent vested, he incurs a 1-year break so that his vesting percentage cannot increase. At this time his separate account balance equals $1,500. R=$1,500/$750 or 2. A's separate account must equal 60 percent ($1,500+(2×$250))−(2×$250) or 60 percent ($1,500+$500)−$500, or $1,200−$500 equals $700.

Example (2). The Y defined contribution plan uses the method descirbed in subdivision (iii)(B) of this subparagraph for computing account balances and the break in service rule described in section 411(a)(6)(C). The plan distributes $250 to B when B's account balance prior to the distribution equals $1,000 and he is 25 percent vested. At the time of the distribution, B has not incurred a 1-year break so that his vesting percentage can increase. Six years later, when A is 60 percent vested, he incurs a 1-year break so that his vesting percentage cannot increase. At this time his account balance equals $1,500. B's separate account must equal 60 percent ($1,500+$250)−$250, 60% of $1,750−$250 equals $800.

(6) *Other rules*—(i) *Distributions on separation or other event.* None of the rules of this paragraph preclude distributions to employees upon separation from service or any other event recognized by the plan for commencing distributions. Such a distribution must, of course, satisfy the applicable qualification requirements pertaining to such distributions. For example, a profitsharing plan could pay the vested portion of an account balance to an employee when he separated from service, but in order to satisfy section 411 the plan might not be able to forfeit the nonvested account balance until the employee has a 1-year break in service. Similarly, the fact that a plan cannot disregard an accrued benefit attributable to service for which an employee has received a distribution because the plan does not satisfy the cash-out requirements of subparagraph (4) of this paragraph does not mean that the employee's accrued benefit (computed by taking into account such service) cannot be offset by the accrued benefit attributable to the distribution.

(ii) *Joint and survivor requirements.* See §1.401(a)–11(a)(2) (relating to joint and survivor annuities) for special rules applicable to certain distributions described in this paragraph.

(iii) *Plan repayments.* (A) Under subparagraphs (2) and (4) of this paragraph, a plan may be required to restore accrued benefits in the event of repayment by an employee.

(B) For purposes of applying the limitations of section 415 (c) and (e), in the case of a defined contribution plan, the repayment by the employee and the restoration by the employer shall not be treated as annual additions.

(C) In the case of a defined contribution plan, the permissible sources for restoration of the accrued benefit are: income or gain to the plan, forfeitures, or employer contributions. Notwithstanding the provisions of §1.401–1(b)(1)(ii), contributions may be made for such an accrued benefit by a profit-sharing plan even though there are no profits. In order for such a plan to be qualified, account balances (accrued benefits) generally must correspond to assets in the plan. Accordingly, there cannot be an unfunded account balance. However, an account balance will not be deemed to be unfunded in the case of a restoration if assets for the restored benefit are provided by the end of the plan year following the plan year in which the repayment occurs.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42329, Aug. 23, 1977, as amended by T.D. 8038, 50 FR 29374, July 19, 1985; T.D. 8219, 53 FR 31852, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988; T.D. 8794, 63 FR 70337, Dec. 21, 1998]

§1.411(a)–7T Definitions and special rules (temporary).

(a)–(d)(3) [Reserved] For further guidance, see §1.411(a)–7(a) through (d)(3).

(4) *Certain cash-outs of accrued benefits*—(i) *Involuntary cash-outs.* For purposes of determining an employee's right to an accrued benefit derived from employer contributions under a plan, the plan may disregard service performed by the employee with respect to which—

(A) The employee receives a distribution of the present value of his entire nonforfeitable benefit at the time of the distribution;

(B) The requirements of section 411(a)(11) are satisfied at the time of the distribution;

(C) The distribution is made due to the termination of the employee's participation in the plan; and

(D) The plan has a repayment provision which satisfies the requirements of §1.411(a)–7(d)(4)(iv) in effect at the time of the distribution.

(ii)–(v) [Reserved] For further guidance, see §1.411(a)–7(d)(4)(ii) through (v).

(vi) For purposes of paragraph (d)(4)(i) of this section, a distribution shall be deemed to be made due to the termination of an employee's participation in the plan if it is made no later than the close of the second plan year following the plan year in which such termination occurs, or if such distribution would have been made under the plan by the close of such second plan year but for the fact that the present value of the nonforfeitable accrued benefit then exceeded the cash-out limit in effect under § 1.411(a)–11T(c)(3)(ii). For purposes of determining the entire nonforfeitable benefit, the plan may disregard service after the distribution, as illustrated in § 1.411(a)–7(d)(2)(i).

(vii) *Effective date.* Paragraphs (d)(4)(i) and (vi) of this section apply to distributions made on or after March 22, 1999, through December 18, 2001. For plan years beginning before March 22, 1999, see § 1.411(a)–7(d)(4)(i). However, an employer is permitted to apply paragraphs (d)(4)(i) and (vi) of this section to plan years beginning on or after August 6, 1997.

(5)–(6) [Reserved] For further guidance, see § 1.411(a)–7(d)(5) and (6).

[T.D. 8794, 63 FR 70337, Dec. 21, 1998]

§ 1.411(a)–8 Changes in vesting schedule.

(a) *Requirement of prior schedule.* Under section 411(a)(10)(A), for plan years for which section 411 applies, a plan will be treated as not meeting the minimum vesting standards of section 411(a)(2) if the plan does not satisfy the requirements of this paragraph. If the vesting schedule of a plan is amended, then as of the date such amendment is adopted, the plan satisfies the requirements of this paragraph if, under the plan as amended, in the case of an employee who is a participant on—

(1) The date the amendment is adopted, or

(2) The date the amendment is effective, if later.

The nonforfeitable percentage (determined as of such date) of such employee's right to his employer-derived accrued benefit is not less than his percentage computed under the plan without regard to such amendment.

(b) *Election of former schedule*—(1) *In general.* Under section 411 (a)(10)(B), for plan years for which section 411 applies, if the vesting schedule of a plan is amended, the plan will not be treated as meeting the minimum vesting standards of section 411 (a)(2) unless the plan as amended, provides that each participant whose nonforfeitable percentage of his accrued benefit derived from employer contributions is determined under such schedule, and who has completed at least 5 years of service with the employer, may elect, during the election period, to have the nonforfeitable percentage of his accrued benefit derived from employer contributions determined without regard to such amendment. Notwithstanding the preceding sentence, no election need be provided for any participant whose nonforfeitable percentage under the plan, as amended, at any time cannot be less than such percentage determined without regard to such amendment.

(2) *Election period.* For purposes of subparagraph (1) of this paragraph, the election period under the plan must begin no later than the date the plan amendment is adopted and end no earlier than the latest of the following dates:

(i) The date which is 60 days after the day the plan amendment is adopted,

(ii) The date which is 60 days after the day the plan amendment becomes effective, or

(iii) The date which is 60 days after the day the participant is issued written notice of the plan amendment by the employer or plan administrator.

(3) *Service requirement.* For purposes of subparagraph (1) of this paragraph, a participant shall be considered to have completed 5 years of service if such participant has completed 5 years of service, whether or not consecutive, without regard to the exceptions of section 411(a)(4) prior to the expiration of the election period described in subparagraph (2) of this paragraph. For the meaning of the term ‘‘year of service’’, see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(4) *Election only by participant.* The election described in subparagraph (1) of this paragraph is available only to an individual who is a participant in the plan at the time such election is made.

(5) *Election may be irrevocable.* A plan, as amended, shall not fail to meet the minimum vesting standards of section 411(a)(2) by reason of section 411(a)(10)(B) merely because such plan provides that the election described in subparagraph (1) of this paragraph is irrevocable.

(6) *Relationship with section 411(a)(2).* The election described in subparagraph (1) of this paragraph is available for a vesting schedule which does not satisfy the requirements of section 411(a)(2) only if under such schedule all participants have a 50 percent nonforfeitable right after 10 years of service, and a 100 percent nonforfeitable right after 15 years of service, in their employer-derived accrued benefit. If the vesting schedule provides less vesting than the percentages required by the preceding sentence, the plan can be amended to provide for such vesting.

(c) *Special rules*—(1) *Amendment of vesting schedule.* For purposes of this section, an amendment of a vesting schedule is each plan amendment which directly or indirectly affects the computation of the nonforfeitable percentage of employees' rights to employer-derived accrued benefits. Consequently, such an amendment, for example, includes each change in the plan which affects either the plan's computation of years of service or of vesting percentages for years of service.

(2) *Aggregation of amendments.* All plan amendments which are: (i) amendments of a vesting schedule within the meaning of subparagraph (1) of this paragraph and (ii) adopted and effective at the same time, shall be deemed to be a single amendment for purposes of applying the rules in paragraphs (a) and (b) of this section.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42333, Aug. 23, 1977]

§1.411(a)–8T Changes in vesting schedule (temporary).

(a) [Reserved]

(b) *Election of former schedule*—(1) *In general.* Under section 411(a)(10)(B), for plan years for which section 411 applies, if the vesting schedule of a plan is amended, the plan will not be treated as meeting the minimum vesting standards of section 411(a)(2) unless the plan as amended provides that each participant whose nonforfeitable percentage of his accrued benefit derived from employer contributions is determined under such schedule, and who has completed at least 3 years of service with the employer, may elect, during the election period, to have the nonforfeitable percentage of his accrued benefit derived from employer contributions determined without regard to such amendment. Notwithstanding the preceding sentence, no election need be provided for any participant whose nonforfeitable percentage under the plan, as amended, at any time cannot be less than such percentage determined without regard to such amendment. For employees not described in §1.411(a)–3T(e)(1), this section shall be applied by substituting ‘‘5 years of service’’ for ‘‘3 years of service’’ where such language appears.

(2) *Election period.* For purposes of subparagraph (1) of this paragraph, the election period under the plan must begin no later than the date the plan amendment is adopted and end no earlier than the latest of the following dates:

(i) The date which is 60 days after the day the plan amendment is adopted,

(ii) The date which is 60 days after the day the plan amendment becomes effective, or

(iii) The date which is 60 days after the day the participant is issued written notice of the plan amendment by the employer or plan administrator.

(3) *Service requirement.* For purposes of subparagraph (1) of this paragraph, a participant shall be considered to have completed 3 years of service if such participant has completed 3 years of service, whether or not consecutive, without regard to the exceptions of section 411(a)(4) prior to the expiration of the election period described in subparagraph (2) of this paragraph. For the meaning of the term ‘‘year of service’’, see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

[T.D. 8170, 53 FR 241, Jan. 6, 1988]

§1.411(a)–9 Amendment of break in service rules; transitional period.

(a) *In general.* Under section 1017(f)(2) of the Employee Retirement Income Security Act of 1974, a plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if the rules of the plan relating to breaks in service are amended, and—

(1) Such amendment is effective after January 1, 1974, and before the effective date of section 411, and

(2) Under such amendment, the nonforfeitable percentage of any employee's right to his employer-derived accrued benefit is less than the lesser of the nonforfeitable percentage of such employee's right to such benefit—

(i) Under the break in service rules provided by section 411(a)(6) and § 1.411(a)–6(c), or

(ii) The greatest such percentage under the plan as in effect on or after January 1, 1974 (provided the break in service rules of the plan were not in violation of any law or rule of law on January 1, 1974).

(b) *Break in service rules.* For purposes of paragraph (a), the term ''break in service rules'' means the rules provided by a plan relating to circumstances under which a period of an employee's service or plan participation is disregarded, for purposes of determining the extent to which his rights to his accrued benefit under the plan are unconditional, if under such rules such service is disregarded by reason of the employee's failure to complete a required period of service within a specified period of time. For this purpose, plan rules which result in the loss of prior vesting or benefit accruals of an employee, or which deny an employee eligibility to participate, by reason of separation or failure to complete a required period of service within a specified period of time (e.g., 300 hours in one year) will be considered break in service rules. For purposes of section 411(b)(3), service described under the plan's break in service rules, as in effect before the effective date of section 411, need not be counted.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42333, Aug. 23, 1977]

§ 1.411(a)–11 Restriction and valuation of distributions.

(a) *Scope*—(1) *In general.* Section 411(a)(11) restricts the ability of a plan to distribute any portion of a participant's accrued benefit without the participant's consent. Section 411(a)(11) also restricts the ability of defined benefit plans to distribute any portion of a participant's accrued benefit in optional forms of benefit without complying with specified valuation rules for determining the amount of the distribution. If the consent requirements or the valuation rules of this section are not satisfied, the plan fails to satisfy the requirements of section 411(a).

(2) *Accrued benefit.* For purposes of this section, an accrued benefit is valued taking into consideration the particular optional form in which the benefit is to be distributed. The value of an accrued benefit is the present value of the benefit in the distribution form determined under the plan. For example, a plan that provides a subsidized early retirement annuity benefit may specify that the optional single sum distribution form of benefit available at early retirement age is the present value of the subsidized early retirement annuity benefit. In this case, the subsidized early retirement annuity benefit must be used to apply the valuation requirements of this section and the resulting amount of the single sum distribution. However, if a plan that provides a subsidized early retirement annuity benefit specifies that the single sum distribution benefit available at early retirement age is the present value of the normal retirement annuity benefit, then the normal retirement annuity benefit is used to apply the valuation requirements of this section and the resulting amount of the single sum distribution available at early retirement age.

(b) *General consent rules.* A plan must satisfy the participant consent requirement with respect to the distribution of a participant's nonforfeitable accrued benefit with a present value in excess of the cash-out limit in effect under § 1.411(a)–11T(c)(3)(ii). See paragraphs (c) (3) and (4) for situations where no consent is required.

(c) *Consent, etc. requirements*—(1) *General rule.* If an accrued benefit is immediately distributable, section 411(a)(11) permits plans to provide for the distribution of any portion of a participant's nonforfeitable accrued benefits only if the applicable consent requirements are satisfied.

(2) *Consent.* (i) No consent is valid unless the participant has received a general description of the material features, and an explanation of the relative values of, the optional forms of benefit available under the plan in a manner that would satisfy the notice requirements of section 417(a)(3). *See* §1.401(a)–20 Q&A–36. In addition, so long as a benefit is immediately distributable, a participant must be informed of his right, if any, to defer receipt of the distribution. Furthermore, consent is not valid if a significant detriment is imposed under the plan on any participant who does not consent to a distribution. Whether or not a significant detriment is imposed shall be determined by the Commissioner by examining the particular facts and circumstances.

(ii) Written consent of the participant to the distribution must not be made before the participant receives the notice of his or her rights specified in this paragraph (c)(2) and must not be made more than 90 days before the date the distribution commences.

(iii) A plan must provide participants with notice of their rights specified in this paragraph (c)(2) no less than 30 days and no more than 90 days before the date the distribution commences. However, if the participant, after having received this notice, affirmatively elects a distribution, a plan will not fail to satisfy the consent requirement of section 411(a)(11) merely because the distribution commences less than 30 days after the notice was provided to the participant, provided that the following requirement is met. The plan administrator must provide information to the participant clearly indicating that (in accordance with the first sentence of this paragraph (c)(2)(iii)) the participant has a right to at least 30 days to consider whether to consent to the distribution.

(iv) For purposes of satisfying the requirements of this paragraph (c)(2), the plan administrator may substitute the annuity starting date, within the meaning of §1.401(a)–20, Q&A–10, for the date the distribution commences.

(v) See §1.401(a)–20, Q&A–24 for a special rule applicable to consents to plan loans.

(3) *$3,500.* Written consent of the participant is required before the commencement of the distribution of any portion of an accrued benefit if the present value of the nonforfeitable total accrued benefit is greater than $3,500. The consent requirements are deemed satisfied if such value does not exceed $3,500 and the plan may distribute such portion to the participant as a single sum. Present value for this purpose must be determined in the same manner as under section 417(e); see §1.417(e)–1(d). If the present value determined at the time of a distribution to the participant exceeds $3,500, then the present value at any subsequent time shall be deemed to exceed $3,500. (For distributions made on or after March 22, 1999, see §1.411(a)–11T.)

(4) *Immediately distributable.* Participant consent is required for any distribution while it is immediately distributable, *i.e.*, prior to the later of the time a participant has attained normal retirement age (as defined in section 411(a)(8)) or age 62. Once a distribution is no longer immediately distributable, a plan may distribute the benefit in the form of a QJSA in the case of a benefit subject to section 417 or in the normal form in other cases without consent.

(5) *Death of participant.* The consent requirements of section 411(a)(11) do not apply after the death of the participant.

(6) *QDROs.* The consent requirements of section 411(a)(11) do not apply to payments to an alternate payee, defined in section 414(p)(8), except as provided in a qualified domestic relations order pursuant to section 414(p).

(7) *Section 401(a)(9), etc.* The consent requirements of section 411(a)(11) do not apply to the extent that a distribution is required to satisfy the requirements of section 401(a)(9) or 415. See section 401(a)(9) and the regulations thereunder and §1.401(a)–20 Q&A 23 for guidance on these requirements. Notwithstanding any provision to the contrary in section 401(a)(14) or §1.401(a)–14, a plan may not distribute a participant's nonforfeitable accrued benefit with a present value in excess of the cash-out limit in effect under §1.411(a)–11T(c)(3)(ii) while the benefit is immediately distributable unless the participant consents to such distribution. The

failure of a participant to consent is deemed to be an election to defer commencement of payment of the benefit for purposes of section 401(a)(14) and § 1.401(a)–14.

(8) *Delegation to Commissioner.* The Commissioner, in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin, may modify, or provide additional guidance with respect to, the notice and consent requirements of this section. See § 601.601(d)(2)(ii)(*b*) of this chapter.

(d) *Distribution valuation requirements.* In determining the present value of any distribution of any accrued benefit from a defined benefit plan, the plan must take into account specified valuation rules. For this purpose, the valuation rules are the same valuation rules for valuing distributions as set forth in section 417(e); see § 1.417(e)–1(d). This paragraph (d) applies both before and after the participant's death regardless of whether the accrued benefit is immediately distributable. This paragraph also applies whether or not the participant's consent is required under paragraphs (b) and (c) of this section.

(e) *Special rules*—(1) *Plan termination.* The requirements of this section apply before, on and after a plan termination. If a defined contribution plan terminates and the plan does not offer an annuity option (purchased from a commercial provider), then the plan may distribute a participant's accrued benefit without the participant's consent. The preceding sentence does not apply if the employer, or any entity within the same controlled group as the employer, maintains another defined contribution plan, other than an employee stock ownership plan (as defined in section 4975(e)(7)). In such a case, the participant's accrued benefit may be transferred without the participant's consent to the other plan if the participant does not consent to an immediate distribution from the terminating plan. See section 411(d)(6) and the regulations thereunder for other rules applicable to transferee plans and plan terminations.

(2) *ESOP dividends.* The requirements of this section do not apply to any distribution of dividends to which section 404(k) applies.

(3) *Other rules.* See § 1.401(a)–20 Q&As 14, 17 and 24 for other rules that apply to the section 411(a)(11) requirements.

[T.D. 8219, 53 FR 31853, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988, as amended by T.D. 8620, 60 FR 49221, Sept. 22, 1995; T.D. 8796, 63 FR 70011, Dec. 18, 1998; T.D. 8794, 63 FR 70338, Dec. 21, 1998]

§ 1.411(a)–11T Restriction and valuation of distributions (temporary).

(a)–(b) [Reserved] For further guidance, see § 1.411(a)–11(a) and (b).

(c) *Consent, etc. requirements*—(1) *General rule.* [Reserved] For further guidance, see § 1.411(a)–11(c)(1).

(2) *Consent.* [Reserved] For further guidance, see § 1.411(a)–11(c)(2).

(3) *Cash-out limit.* (i) Written consent of the participant is required before the commencement of the distribution of any portion of an accrued benefit if the present value of the nonforfeitable total accrued benefit is greater than the cash-out limit in effect under paragraph (c)(3)(ii) of this section on the date the distribution commences. The consent requirements are deemed satisfied if such value does not exceed the cash-out limit, and the plan may distribute such portion to the participant as a single sum. Present value for this purpose must be determined in the same manner as under section 417(e); see § 1.417(e)–1(d). If a participant has begun to receive distributions pursuant to an optional form of benefit under which at least one scheduled periodic distribution has not yet been made, and if the present value of the participant's nonforfeitable accrued benefit, determined at the time of the first distribution under that optional form of benefit, exceeded the cash-out limit currently in effect under paragraph (c)(3)(ii) of this section, then the present value of the participant's nonforfeitable accrued benefit is deemed to continue to exceed the cash-out limit. Thus, for example, if the present value of a participant's accrued benefit does not exceed the cash-out limit on the date of a distribution after termination of employment but did, at the time of an earlier in-service hardship withdrawal, exceed the cash-out limit in effect on the date of the post-termination distribution, the plan is permitted to distribute the present value

of the participant's accrued benefit on the date of the post-termination distribution without the participant's consent. However, if a participant began to receive scheduled installment payments under a plan and, at that time, the participant's accrued benefit exceeded the cash-out limit currently in effect, the present value of the participant's accrued benefit is deemed to continue to exceed the cash-out limit and may not be distributed without the participant's consent.

(ii) The cash-out limit in effect for a date is the amount described in section 411(a)(11)(A) for the plan year that includes that date. The cash-out limit in effect for dates in plan years beginning on or after August 6, 1997, is $5,000. The cash-out limit in effect for dates in plan years beginning before August 6, 1997, is $3,500.

(iii) *Effective date.* Paragraphs (c)(3)(i) and (ii) of this section apply to distributions made on or after March 22, 1999, through December 18, 2001. For plan years beginning before March 22, 1999, see §1.411(a)–11(c)(3). However, an employer is permitted to apply paragraph (c)(3)(ii) of this section to plan years beginning on or after August 6, 1997.

(4)–(e) [Reserved] For further guidance, see §1.411(a)–11(c)(4) through (e).

[T.D. 8794, 63 FR 70338, Dec. 21, 1998]

§1.411(b)–1 Accrued benefit requirements.

(a) *Accrued benefit requirements*—(1) *In general.* Under section 411(b), for plan years beginning after the applicable effective date of section 411, rules are provided for the determination of the accrued benefit to which a participant is entitled under a plan. Under a defined contribution plan, a participant's accrued benefit is the balance to the credit of the participant's account. Under a defined benefit plan, a participant's accrued benefit is his accrued benefit determined under the plan. A defined benefit plan is not a qualified plan unless the method provided by the plan for determining accrued benefits satisfies at least one of the alternative methods (described in paragraph (b) of this section) for determining accrued benefits with respect to all active participants under the plan. A defined benefit plan may provide that accrued benefits for participants are determined under more than one plan formula. In such a case, the accrued benefits under all such formulas must be aggregated in order to determine whether or not the accrued benefits under the plan for participants satisfy one of the alternative methods. A plan may satisfy different methods with respect to different classifications of employees, or separately satisfy one method with respect to the accrued benefits for each such classification, provided that such classifications are not so structured as to evade the accrued benefit requirements of section 411(b) and this section. (For example, if a plan provides that employees who commence participation at or before age 40 accrue benefits in a manner which satisfies the 133⅓ percent method of determining accrued benefits and employees who commence participation after age 40 accrue benefits in a manner which satisfies the 3 percent method of determining accrued benefits, the plan would be so structured as to evade the requirements of section 411(b).) A defined benefit plan does not satisfy the requirements of section 411(b) and this section merely because the accrued benefit is defined as the ''reserve under the plan''. Special rules are provided for the first two years of service by a participant, certain insured defined benefit plans, and certain reductions in accrued benefits due to increasing age or service. In addition, a special rule is provided with respect to accruals for service before the effective date of section 411.

(2) *Cross references*—(i) *3 percent method.* For rules relating to the 3 percent method of determining accrued benefits, see paragraph (b)(1) of this section.

(ii) *133⅓ percent method.* For rules relating to the 133⅓ percent method of determining accrued benefits, see paragraph (b)(2) of this section.

(iii) *Fractional method.* For rules relating to the fractional method of determining accrued benefits, see paragraph (b)(3) of this section.

(iv) *Accruals before effective date.* For rules relating to accruals for service before the effective date of section 411, see paragraph (c) of this section.

(v) *First 2 years of service.* For special rules relating to determination of accrued benefit for first 2 continuous years of service, see paragraph (d)(1) of this section.

(vi) *Certain insured plans.* For special rules relating to determination of accrued benefit under a defined benefit plan funded exclusively by insurance contracts, see paragraph (d)(2) of this section.

(vii) *Accruals decreased by increasing age or service.* For special rules relating to prohibition of decrease in accrued benefit on account of increasing age or service, see paragraph (d)(3) of this section.

(viii) *Separate accounting.* For rules relating to requirements for separate accounting, see paragraph (e) of this section.

(ix) *Year of participation.* For definition of ''year of participation'', see paragraph (f) of this section.

(b) *Defined benefit plans.* A defined benefit plan satisfies the requirements of section 411(b)(1) and this paragrah for a plan year to which section 411 and this section apply if it satisfies the requirements of subparagraph (1), (2), or (3) of this paragraph for such year.

(1) *3 percent method*—(i) *General rule.* A defined benefit plan satisfies the requirements of this paragraph for a plan year if, as of the close of the plan year, the accrued benefit to which each participant is entitled, computed as if the participant separated from the service as of the close of such plan year, is not less than 3 percent of the 3 percent method benefit, multiplied by the number of years (not in excess of 33⅓) of his participation in the plan including years after his normal retirement age. For purposes of this subparagraph, the ''3 percent method benefit'' is the normal retirement benefit to which the participant would be entitled if he commenced participation at the earliest possible entry age for any individual who is or could be a participant under the plan and if he served continuously until the earlier of age 65 or the normal retirement age under the plan.

(ii) *Special rules*—(A) *Compensation.* In the case of a plan providing a retirement benefit based upon compensation during any period, the normal retirement benefit to which a participant would be entitled is determined as if he continued to earn annually the average rate of compensation which he earned during consecutive years of service, not in excess of 10, for which his compensation was the highest. For purposes of this subdivision (A), the number of consecutive years of service used in computing average compensation shall be the number of years of service specified under the plan (not in excess of 10) for computing normal retirement benefits.

(B) *Social security, etc.* For purposes of this subparagraph, for any plan year, social security benefits and all relevant factors used to compute benefits, *e.g.*, consumer price index, are treated as remaining constant as of the beginning of the current plan year for all subsequent plan years.

(C) *Computation in certain cases.* In the case of any plan to which the provisions of section 411(b)(1)(D) and paragraph (c) of this section are applicable, for any plan year the accrued benefit of any participant shall not be less than the accrued benefit otherwise determined under this subparagraph, reduced by the excess of the accrued benefit determined under this subparagraph as of the first day of the first plan year to which section 411 applies over the accrued benefit determined under section 411(b)(1)(D) and paragraph (c) of this section and increased by the amount determined under paragraph (c)(2)(v) of this section.

(iii) *Examples.* The application of this subparagraph is illustrated by the following examples.

Example (1). The M Corporation's defined benefit benefit plan provides an annual retirement benefit commencing at age 65 or $4 per month for each year of participation. As a condition of participation, the plan requires that an employee have attained age 25. The normal retirement age specified under the plan is age 65. The plan provides for no limit on the number of years of credited service. A, age 40, is a participant in the M Corporation's plan.

A has completed 12 years of participation in the plan of the M Corporation as of the close of the plan year. Under subdivision (i) of this subparagraph, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age (25) under the plan and served continuously until normal retirement age (65) is an annual benefit of $1,920 [40×(12×$4)]. Under paragraph (b)(1)(i) of this section, the plan does not satisfy the requirements of this subparagraph unless A has accrued an annual benefit of at least $691 [0.03×($1,920×12)] as of the close of the plan year. Under the M Corporation plan, A is entitled to an accrued benefit of $576 [(12×12)×$4] as of the close of the plan year. Thus, with respect to A, the accrued benefit provided under the M Corporation plan does not satisfy the requirements of this subparagraph.

Example (2). Assume the same facts as in example (1) except that the M Corporation's plan provides that only the first 30 years of participation are taken into account. Under subdivision (i) of this subparagraph, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age under the plan (25) and served continuously until normal retirement age (65) is an annual benefit of $1.440 [30×$48]. Under paragraph (b)(1)(i) of this section, the plan does not satisfy the requirements of this subparagraph unless A has accrued an annual benefit of at least $518 [0.03×($1,440×12)] as of the close of the plan year. Under the M Corporation plan, A is entitled to an accrued benefit of $576 [(12×$48]. Thus, with respect to A, the accrued benefit provided under the M Corporation plan satisfies the requirements of this subparagraph.

Example (3). The N Corporation's defined benefit plan provides an annual retirement benefit commencing at age 65 of 50 percent of average compensation for the highest 3 consecutive years of compensation for an employee with 25 years of participation. A participant who separates from service before age 65 is entitled to 2 percent of average compensation for the highest 3 consecutive years of compensation for each year of participation not in excess of 25. The plan has no minimum age or service requirement for participation. The normal retirement age specified under the plan is age 65. On December 31, 1990, B, age 40, is a participant in the N Corporation's plan. B began employment with the N Corporation and became a participant in the N Corporation's plan on January 1, 1980. Under this subparagraph, the normal retirement benefit to which a participant would be entitled if he commenced participation at the earliest possible entry age (0) under the plan and served continuously until normal retirement age (65) is 50 percent of average compensation for the highest 3 consecutive years of compensation per year commencing at age 65. Under this subparagraph, B must have accrued an annual benefit of at least 16.5 percent of his highest 3 consecutive years of compensation per year commencing at age 65 [0.03×50 percent of average compensation for the highest 3 consecutive years of compensation×11] as of the close of the plan year. Under the N Corporation plan, B has accrued an annual benefit of 22 percent of average compensation for his highest 3 consecutive years of compensation per year commencing at age 65. Thus, with respect to B, the accrued benefit under the N Corporation plan satisfies the requirements of this subparagraph.

Example (4). The P Corporation's defined benefit plan provides an annual retirement benefit commencing at age 65 of 50 percent of average compensation for the 3 consecutive years of compensation from the P Corporation next preceding normal retirement age. The plan has no minimum age or service requirement for participation. The normal retirement age under the plan is age 65. On December 31, 1990, C, age 55, separates from service with the P Corporation. C began employment with the P Corporation and became a participant in the P Corporation's plan on January 1, 1980. As of December 31, 1990. C's average compensation for the 3 consecutive years preceding his separation from service is $15,000. Under this subparagraph, the normal retirement benefit to which a participant would be entitled if he commenced participation at the earliest possible entry age (0) under the plan and served continuously until normal retirement age (65) is an annual benefit of 50 percent of average compensation for the 3 consecutive years of compensation from the P Corporation next preceding normal retirement age commencing at age 65. C must have accrued aan annual benefit of at least $2,475 commencing at age 65 [0.03×(0.050×$15,000)×11] as of his separation from the service with the P Corporation in order for the P Corporation's plan to satisfy the requirements of this subparagraph with respect to C.

Example (5). On December 31, 1985, the R Corporation's defined benefit plan provided an annual retirement benefit commencing at age 65 of $100 for each year of participation, not to exceed 30. As a condition of participation, the plan requires that an employee have attained age 25. The normal retirement age specified under the plan is age 65. The appropriate computation period is the calendar year. On January 1, 1986, the plan is amended to provide an annual retirement benefit commencing at age 65 of $200 for each year of participation (before and after the amendment), not to exceed 30. B, age 40, is a participant in the R Corporation's plan. B has completed 15 years of participation in the plan of the R Corporation as of December 31, 1990. Under paragraph (b)(1)(i) of this section, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age (25) under the plan an served continuously until normal retirement age (65) is an annual benefit of $6,000 [30×200]. Under subdivision (i) of this subparagraph, the plan does not satisfy the requirements of this subparagraph unless

B has accrued an annual benefit of at least $2,700 [0.03×$6,000×15] as of December 31, 1990. Under the R Corporation plan, B is entitled to an accrued benefit of $3,000 [$200×15] as of December 31, 1990. Thus, with respect to B, the accrued benefit provided under the R Corporation plan satisfies the requirements of this subparagraph.

Example (6). On December 31, 1995, the J Corporation's defined benefit plan provided an annual retirement benefit commencing at age 65 of $4,800 after 30 years of participation. The normal retirement age specified under the plan is age 65. The appropriate computation period is the calendar year. On January 1, 1996, the plan is amended to provide an annual retirement benefit commencing at age 65 of $6,000. A, age 40, is a participant in the J Corporation's plan since its adoption on January 1, 1986. Under paragraph (b)(1)(i) of this section, on December 31, 1995, the normal retirement benefit commencing at age 5 to which a participant would be entitled if he commenced participation at the earliest possible entry age (0) under the plan and served continuously until normal retirement age (65) is an annual benefit of $4,800. Under paragraph (b)(1)(i) of this section, on January 1, 1996, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age (0) under the plan and served continuously until normal retirement age (65) is an annual benefit of $6,000. Under subdivision (i) of this subparagraph, the plan does not satisfy the requirements of this subparagraph unless A has an accrued benefit on December 31, 1995 of at least $1,440 [$4,800×0.02×10] and an accrued benefit on January 1, 1996 of at least $1,800 [$6,000×0.03×10].

Example (7). The X Company's defined benefit plan provides an annual retirement benefit commencing at age 65 of $4 per month for each year of participation (not to exceed 30). As a condition of participation, the plan requires that an employee have attained age 25. The normal retirement age specified under the plan is age 65. D, age 68, is a participant in the X Company's plan. D has completed 20 years of participation in the X Company plan as of the close of the plan year. Under paragraph (b)(1)(i) of this section, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age (25) under the plan and served continuously until normal retirement age (65) is an annual benefit, commencing at age 65, of $1,440 [30×$48]. Under paragraph (b)(1)(i) of this section, the plan does not satisfy the requirements of this subparagraph unless D has accrued an annual benefit, commencing at age 65, of $864 [0.03×$1,440×20] as of the close of the plan year. Under the X Company plan, D has accrued an annual benefit, commencing at age 65, of $960 [20×$48]. Thus, with respect to D the accrued benefit provided under the X Company plan satisfies the requirements of this subparagraph.

Example (8). Assume the same facts as in example (7) except that for purposes of determining accrued benefits under the plan the X Company's plan disregards all years of participation after normal retirement age. Under paragraph (b)(1)(i) of this section, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age (25) under the plan and served continuously until normal retirement age (65) is an annual benefit of $1,440 [30×$48]. Under paragraph (b)(1)(i) of this section the plan does not satisfy the requirements of this subparagraph unless D has accrued an annual benefit, commencing at age 65, of $864 [0.03×$1,440×20] as of the close of the plan year. Under the X Company's plan D has accrued an annual benefit commencing at age 65, of $816 [17×$48]. Thus, with respect to D, the accrued benefit provided under the X Company plan does not satisfy the requirements of this subparagraph.

(2) *133⅓ percent rule*—(i) *General rule.* A defined benefit plan satisfies the requirements of this subparagraph for a particular plan year if—

(A) Under the plan the accrued benefit payable at the normal retirement age (determined under the plan) is equal to the normal retirement benefit (determined under the plan), and

(B) The annual rate at which any individual who is or could be a participant can accrue the retirement benefits payable at normal retirement age under the plan for any later plan year cannot be more than 133⅓ percent of the annual rate at which he can accrue benefits for any plan year beginning on or after such particular plan year and before such later plan year.

(ii) *Special rules.* For purposes of this subparagraph—

(A) *Plan amendments.* Any amendment to the plan which is in effect for the current plan year shall be treated as if it were in effect for all other plan years.

(B) *Change in accrual rate.* Any change in an accrual rate which change does not apply to any individual who is of could be a participant in the plan year is disregarded. Thus, for example, if for its plan year beginning January 1, 1980, a defined benefit plan provides an accrued benefit in plan year 1980 of 2 percent of a participant's average compensation for his highest 3 years of compensation for each year of service and provides that in plan year 1981 the accrued benefit will be 3 percent of such average compensation, the plan will not be treated as failing to satisfy the requirements of this subparagraph for plan year 1980 because in plan year 1980 the change in the accrual rate does not apply to any individual who is or could be a participant in plan year 1980. However, if, for example, a defined benefit plan provided for an accrued benefit of 1 percent of a participant's average compensation for his highest 3 years of compensation for each of the first 10 years of service and 1.5 percent of such average compensations for each year of service thereafter, the plan will be treated as failing to satisfy the requirements of this subparagraph for the plan year even though no participant is actually accruing at the 1.5 percent rate because an individual who could be a participant and who had over 10 years of service would accrue at the 1.5 percent rate, which rate exceeds 133⅓ percent of the 1 percent rate.

(C) *Early retirement benefits.* The fact that certain benefits under the plan may be payable to certain participants before normal retirement age is disregarded. Thus, the requirements of subdivision (i) of this subparagraph must be satisfied without regard to any benefit payable prior to the normal retirement benefit (such as an early retirement benefit which is not the normal retirement benefit (see §1.411(a)–7(c).

(D) *Social security, etc.* For purposes of this paragraph, for any plan year, social security benefits and all relevant factors used to compute benefits, *e.g.*, consumer price index, are treated as remaining constant as of the beginning of the current plan year for all subsequent plan years.

(E) *Postponed retirement.* A plan shall not be treated as failing to satisfy the requirements of this subparagraph for a plan year merely because no benefits under the plan accrue to a participant who continues service with the employer after such participant has attained normal retirement age.

(F) *Computation of benefit.* A plan shall not satisfy the requirements of this subparagraph if the base for the computation of retirement benefits changes solely by reason of an increase in the number of years of participation. Thus, for example, a plan will not satisfy the requirements of this subparagraph if it provides a benefit, commencing at normal retirement age, of the sum of (*1*) 1 percent of average compensation for a participant's first 3 years of participation multiplied by his first 10 years of participation (or, if less than 10 his total years of participation) and (*2*) 1 percent of average compensation for a participant's 3 highest years of participation multiplied by each year of participation subsequent to the 10th year.

(iii) *Examples.* The application of this subparagraph is illustrated by the following examples:

Example (*1*). On January 1, 1980, the R Corporation's defined benefit plan provides for an annual benefit (commencing at age 65) of a percentage of a participant's average compensation for the period of 5 consecutive years of participation for which his compensation is the highest. The percentage is 2 percent for each of the first 20 years of participation and 1 percent per year thereafter. The appropriate computation period is the calendar year. The R Corporation's plan satisfies the requirements of this subparagraph because the 133⅓ percent rule does not restrict subsequent accrual rate decreases.

Example (*2*). On January 1, 1980, the J Corporation's defined benefit plan provides for an annual benefit (commencing at age 65) of a percentage of a participant's average compensation for the period of his final 5 consecutive years of participation. The percentage is 1 percent for each of the first 5 years of participation; 1⅓ percent for each of the next 5 years of participation; and 1⁷⁄₉ percent for each year thereafter. The appropriate computation period is the calendar year. Even though no single accrual rate under the J Corporation's plan exceeds 133⅓ percent of the immediately preceding accrual rate, the J Corporation's plan does not satisfy the requirements of this subparagraph because the rate of accrual for all years of participation in excess of 10 (1⁷⁄₉ percent) exceeds 133⅓ percent of the rate of accrual for any of the first 5 years of participation (1 percent).

Example (*3*). On January 1, 1980, the C Corporation's defined benefit plan provides for an annual benefit (commencing at age 65) of a percentage of a participant's average compensation for the period of 3 consecutive years of participation for which his compensation is the highest. The percentage is 2 percent for each of the first 5 years of participation; 1 percent for each of the next 5 years of participation; and 1½ percent for each year thereafter. The appropriate computation period is the calendar year. Even though the average rate of accrual under the C Corporation's plan is not less rapidly than ratably, the C Corporation's plan does not satisfy the requirements of this subparagraph because the rate of accrual for all years of participation in excess of 10 (1½ percent) for any employee who is actually accruing benefits or who could accrue benefits exceeds 133⅓ percent of the rate of accrual for the sixth through tenth years of participation, respectively (1 percent).

(3) *Fractional rule*—(i) *In general.* A defined benefit plan satisfies the requirements of this paragraph if the accrued benefit to which any participant is entitled is not less than the fractional rule benefit multiplied by a fraction (not exceeding 1)—

(A) The numerator of which is his total number of years of participation in the plan, and

(B) The denominator of which is the total number of years he would have participated in the plan if he separated from the service at the normal retirement age under the plan.

(ii) *Special rules.* For purposes of this subparagraph—

(A) *Fractional rule benefit.* The ''fractional rule benefit'' is the annual benefit commencing at the normal retirement age under the plan to which a participant would be entitled if he continued to earn annually until such normal retirement age the same rate of compensation upon which his normal retirement benefit would be computed. Such rate of compensation shall be computed on the basis of compensation taken into account under the plan (but taking into account average compensation for no more than the 10 years of service immediately preceding the determination). For purposes of this subdivision (A), the normal retirement benefit shall be determined as if the participant had attained normal retirement age on the date any such determination is made.

(B) *Social security, etc.* For purposes of this subparagraph, for any plan year, social security benefits and all relevant factors used to compute benefits, *e.g.*, consumer price index, are treated as remaining constant as of the beginning of the current plan year for all subsequent plan years.

(C) *Postponed retirement.* A plan shall not be treated as failing to satisfy the requirements of this subparagraph merely because no benefits under the plan accrue to a participant who continues service with the employer after such participant has attained normal retirement age under the plan.

(D) *Computation in certain cases.* In the case of any plan to which the provisions of section 411(b)(1)(D) and paragraph (c) of this section are applicable, for any plan year the accrued benefit of any participant shall not be less than the accrued benefit otherwise determined under this subparagraph, reduced by the excess of the accrued benefit determined under this subparagraph as of the first day of the first plan year to which section 411 applies over the accrued benefit determined under section 411(b)(1)(D) and paragraph (c) of this section and increased by the amount determined under paragraph (c)(2)(v) of this section.

(iii) *Examples.* The application of this subparagraph is illustrated by the following examples:

Example (1). The R Corporation's defined benefit plan provides an annual retirement benefit commencing at age 65 of 30 percent of a participant's average compensation for his highest 3 consecutive years of participation. If a participant separates from service prior to normal retirement age, the R Corporation's plan provides a benefit equal to an amount which bears the same ratio to 30 percent of such average compensation as the participant's actual number of years of participation in the plan bears to the number of years the participant would have participated in the plan had he separated from service at age 65. The plan further provides that normal retirement age is age 65. A, age 55, is a participant in the R Corporation's plan for the current year, and A has 15 years of participation in the R Corporation's plan. As of the current year, A's average compensation for his highest 3 years of compensation is $20,000. The R Corporation's plan satisfies the requirements of this subparagraph because if A separates from the service in the current year he will be entitled to an annual benefit of $3,600 commencing at age 65 [0.3×$20,000×15/25].

Example (2). The J Corporation's defined benefit plan provides a normal retirement benefit of 1 percent per year of a participant's average compensation from the employer. In the case of a participant who separates from service prior to normal retirement age (65), the plan provides that the annual benefit is an amount which is equal to 1 percent of such compensation multiplied by the number of years of plan participation actually completed by the participant. The plan year of the J Corporation's plan is the calendar year. B, age 55, is a participant in the J Corporation's plan for the current year. B became a participant in the J Corporation's plan on January 1, 1980. As of December 31, 1990, B's compensation history is as follows:

Year	Compensation
1980	$17,000
1981	18,000
1982	20,000
1983	20,000
1984	21,000
1985	22,000
1986	23,000
1987	25,000
1988	26,000
1989	29,000
1990	32,000

If B separates from service on December 31, 1990, he would be entitled to an annual benefit of $2,530 commencing at age 65. Because the J Corporation's plan does not limit the number of years of compensation to be taken into account in determining the normal retirement benefit, B's rate of compensation for purposes of determining his normal retirement benefit is $23,600 [$18,000 + $20,000 + $20,000 + $21,000 + $22,000 + $23,000 + $25,000 + $26,000 + $29,000 + $32,000]/10.

Under this subparagraph, B's accrued benefit under the J Corporation's plan as of December 31, 1990 must be not less than $2,561 per year commencing at age 65 [0.01 × ($17,000 + $18,000 + $20,000 + $20,000 + $21,000 + $22,000 + $23,000 + $25,000 + $26,000 + $29,000 + $32,000 + ($23,600 × 10)) × 11/21]. Thus, the J Corporation's plan would not satisfy the requirements of this subparagraph.

(c) *Accruals for service before effective date*—(1) *General rule.* For a plan year to which section 411 applies, a defined benefit plan does not satisfy the requirements of section 411(b)(1) and this section unless, under the plan, the accrued benefit of each participant for plan years beginning before section 411 applies is not less than the greater of—

(i) Such participant's accrued benefit (as of the day before section 411 applies) determined under the plan as in effect from time to time prior to September 2, 1974 (without regard to any amendment adopted after such date), or

(ii) One-half of the accrued benefit that would be determined with respect to the participant as of the day before section 411 applies if the participant's accrued benefit were computed for such prior plan years under a method which satisfies the requirements of section 411(b)(1) (A), (B), or (C) and paragraph (b) (1), (2), or (3) of this section. See 29 CFR Part 2530, Department of Labor regulations relating to minimum standards for employee pension benefit plans, for time participation deemed to begin.

(2) *Special rules*—(i) A plan shall not be deemed to fail to satisfy the requirements of section 411(b) and this section merely because the method for computing the accrued benefit of a participant for years of participation prior to the first plan year for which section 411 is effective with respect to the plan is not the same method for computing the accrued benefit of a participant for years of participation subsequent to such plan year.

(ii) For purposes of paragraph (c)(1)(ii) of this section, section 411(b)(1)(A) and paragraph (b)(1) of this section shall be applied as if the participant separated from service with the employer on the day before the first day of the first plan year to which section 411 applies.

(iii) For purposes of paragraph (c)(1)(ii) of this section, section 411(b)(1)(B) and paragraph (b)(2) of this section shall be applied in the following manner:

(A) Except as provided in (c)(2)(iii)(B) of this section, section 411(b)(1)(B) and paragraph (b)(2) of this section shall be applied as if the participant separated from service with the employer on the day before the first day of the first plan year to which section 411 applies.

(B) In the case that the plan does not satisfy the requirements of section 411(b)(1)(B) and paragraph (b)(2) of this section at any time prior to the day specified in (c)(2)(iii)(A) of this section, the plan shall be deemed revised to the extent necessary to satisfy the requirements of section 411(b)(1)(B) and paragraph (b)(2) of this section for all plan years beginning before the applicable effective date of section 411 and this section. For purposes of the preceding sentence, a plan shall not be deemed revised to the extent necessary to satisfy the requirements of section 411(b)(1)(B) and paragraph (b)(2) of this section for a plan year if the benefit a participant would receive if he were employed until normal retirement age is reduced by such revision or if the revised rate of accrual with respect to such accrued benefit does not otherwise satisfy the requirements of section 411(b)(1)(B) and paragraph (b)(2) of this section.

(iv) For purposes of paragraph (c)(1)(ii) of this section, section 411(b)(1)(C) and paragraph (b)(3) of this section shall be applied as if the participant separated from service on the day before the first day of the first plan year to which section 411 applies.

(v) The excess of the accrued benefit payable at normal retirement age of any participant determined under section 411(b)(1) (A), (B), or (C) (without regard to section 411(b)(1)(D)), and paragraph (b)(1), (2), or (3) of this section (without regard to this paragraph) as of the day before the first day of the first plan year to which section 411 and this section applies over the accrued benefit determined under paragraph (c)(1) of this section shall be accrued in accordance with the provisions of the plan as in effect after the applicable effective date of section 411, as if the plan had been initially adopted on such effective date.

(d) *Special rules*—(1) *First 2 years of service.* Notwithstanding paragraphs (1), (2), and (3) of paragraph (b) of this section, under section 411(b)(1)(E) and this subparagraph, a plan shall not be treated as failing to satisfy the requirements of paragraph (b) of this section solely because the accrual of benefits under the plan does not become effective until the employee has completed 2 continuous years of service. For purposes of this subparagraph, continuous years of service are years of service (within the meaning of section 410(a)(3)((A)) which are not separated by a break in service (within the meaning of section 410(a)(5)). For years of service beginning after such 2 years of service, the accrued benefit of an employee shall not be less than that to which the employee would be entitled if section 411(b)(1)(E) and this subparagraph did not apply. Thus, for example, a plan which otherwise satisfies the requirements of paragraph (b)(2) of this section provides for a rate of accrual of 1 percent of average compensation for the highest 3 years of compensation beginning with the third year of service of a participant shall not be treated as satisfying paragraph (b)(2) of this section because as of the time the employee completes 3 continuous years of service there is no accrual during the first 2 years of service. In addition, a plan which otherwise satisfies the requirements of paragraph (b)(1) of this section and which requires that an employee must attain age 25 and complete 1 year of service prior to becoming a participant will not satisfy the requirements of paragraph (b)(1) of this section if an employee who completes 2 years of service prior to attaining age 25 does not begin accruals immediately upon commencement of participation in the plan. For rules relating to years of service, see 29 CFR part 2530, Department of Labor regulations relating to minimum standards for employee pension benefit plans.

(2) *Certain insured defined benefit plans.* Notwithstanding paragraphs (b) (1), (2), and (3) of this section, a defined benefit plan satisfies the requirements of paragraph (b) of this section if such plan is funded exclusively by the purchase of contracts from a life insurance company and such contracts satisfy the requirements of sections 412(i) (2) and (3) and the regulations thereunder. The preceding sentence is applicable only if an employee's accrued benefit as of any applicable date is not less than the cash surrender value such employee's insurance contracts would have on such applicable date if the requirements of section 412(i) (4), (5), and (6) and the regulations thereunder were satisfied.

(3) *Accrued benefit may not decrease on account of increasing age or service.* Notwithstanding paragraphs (b) (1), (2), and (3) of this section and paragraphs (d) (1) and (2) of this section, a defined benefit plan shall be treated as not satisfying the requirements of paragraphs (b) and (d) of this section if the participant's accrued benefit is reduced on account of any increase in his age or

years of service. The preceding sentence shall not apply to social security supplements described in §1.411(a)–7(c)(4).

(e) *Separate accounting.* A plan satisfies the requirements of this paragraph if the requirements of paragraph (e) (1) or (2) of this paragraph are met.

(1) *Defined benefit plan.* In the case of a defined benefit plan, the requirements of this paragraph are satisfied if the plan requires separate accounting for the portion of each employee's accrued benefit derived from any voluntary employee contributions permitted under the plan. For purposes of this subparagraph the term ''voluntary employee contributions'' means all employee contributions which are not mandatory contributions within the meaning of section 411(c)(2)(C) and the regulations thereunder. See §1.411(c)–1(b)(1) for rules requiring the determination of such an accrued benefit by the use of a separate account.

(2) *Defined contribution plan.* In the case of a defined contribution plan, the requirements of this paragraph are not satisfied unless the plan requires separate accounting for each employee's accrued benefit. If a plan utilizes the break in service rule of section 411(a)(6)(C), an employee could have different percentages of vesting between pre-break and post-break accrued benefits. In such a case, the requirements of this paragraph are not satisfied unless the plan computes accrued benefits in a manner which takes into account different percentages. A plan which provides separate accounts for pre-break and post-break accrued benefits will be deemed to compute benefits in a reasonable manner.

(f) *Year of participation*—(1) *In general.* This paragraph is inapplicable to a defined contribution plan. For purposes of determining an employee's accrued benefit, a ''year of participation'' is a period of service determined under regulations prescribed by the Secretary of Labor in 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(2) *Additional rule relating to year of participation.* A trust shall not constitute a qualified trust if the plan of which such trust is a part provides for the crediting of a year of participation, or part thereof, and such credit results in the discrimination prohibited by section 401(a)(4).

(g) *Additional illustrations.* The application of this section may be illustrated by the following example:

Example. (i) The S Corporation established a defined benefit plan on January 1, 1980. The plan provides a minimum age for participation of age 25. The normal retirement age under the plan is age 65. The appropriate computation periods are the calendar year. The plan provides an annual benefit, commencing at age 65, equal to $96 per year of service for the first 25 years of service, and $48 per year of service for each additional year of service.

(ii) The plan of the S Corporation does not satisfy the requirements of section 411(b)(1)(A) and paragraph (b)(1) of this section because the accrued benefit under the plan at some point will be less than the accrued benefit required under section 411(b)(1)(A) and paragraph (b)(1) of this section (i.e., 3 percent × normal retirement benefit × years of participation).

(iii) The plan of the S Corporation does satisfy the requirements of section 411(b)(1)(B) and paragraph (b)(2) of this section because the rate of benefit accrual is equal in each of the first 25 years of service and the rate decreases thereafter.

(iv) The plan of the S Corporation does satisfy the requirements of section 411(b)(1)(C) and paragraph (b)(3) of this section because the accrued benefit under the plan will equal or exceed the normal retirement benefit multiplied by the fraction described in paragraph (b)(3)(i) of this section.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42334, Aug. 23, 1977]

§1.411(c)–1 Allocation of accrued benefits between employer and employee contributions.

(a) *Accrued benefit derived from employer contributions.* For purposes of section 411 and the regulations thereunder, under section 411(c)(1), an employee's accrued benefit derived from employer contributions under a plan as of any applicable date is the excess, if any, of—

(1) The total accrued benefit under the plan provided for the employee as of such date, over

(2) The accrued benefit provided for the employee, derived from contributions made by the employee under the plan as of such date.

For computation of accrued benefit derived from employee contributions to a defined contribution plan or from voluntary employee contributions to a defined benefit plan, see paragraph (b) of this section. For computation of accrued benefit derived from mandatory employee contributions to a defined benefit plan, see paragraph (c) of this section.

(b) *Accrued benefit derived from employee contribution to defined contribution plan, etc.* For purposes of section 411 and the regulations thereunder, under section 411(c)(2)(A) the accrued benefit derived from employee contributions to a defined contribution plan is determined under paragraph (b) (1) or (2) of this section, whichever applies. Under section 411(d)(5), the accrued benefit derived from voluntary employee contributions to a defined benefit plan is determined under paragraph (b)(1) of this section.

(1) *Separate accounts maintained.* If a separate account is maintained with respect to an employee's contributions and all income, expenses, gains, and losses attributable thereto, the accrued benefit determined under this subparagraph as of any applicable date is the balance of such account as of such date.

(2) *Separate accounts not maintained.* If a separate account is not maintained with respect to an employee's contributions and the income, expenses, gains, and losses attributable thereto, the accrued benefit determined under this subparagraph is the employee's total accrued benefit determined under the plan multiplied by a fraction—

(i) The numerator of which is the total amount of the employee's contributions under the plan less withdrawals, and

(ii) The denominator of which is the sum of (A) the amount described in paragraph (b)(2)(i) of this section, and (B) the total contributions made under the plan by the employer on behalf of the employee less withdrawals.

For purposes of this subparagraph, contributions include all amounts which are contributed to the plan even if such amounts are used to provide ancillary benefits, such as incidental life insurance, health insurance, or death benefits, and withdrawals include only amounts distributed to the employee and do not reflect the cost of any death benefits under the plan.

(c) *Accrued benefit derived from mandatory employee contributions to a defined benefit plan*—(1) *General rule.* In the case of a defined benefit plan (as defined in section 414(j)) the accrued benefit derived from contributions made by an employee under the plan as of any applicable date is an annual benefit, in the form of a single life annuity (without ancillary benefits) commencing at normal retirement age, equal to the amount of the employee's accumulated contributions (determined under paragraph (c)(3) of this section) multiplied by the appropriate conversion factor (determined under paragraph (c)(2) of this section). Paragraph (e) of this section provides rules for actuarial adjustments where the benefit is to be determined in a form other than the form described in this paragraph.

(2) *Appropriate conversion factor.* For purposes of this paragraph, the term ''appropriate conversion factor'' means the factor necessary to convert an amount equal to the accumulated contributions to a single life annuity (without ancillary benefits) commencing at normal retirement age and shall be 10 percent for a normal retirement age of 65 years. For other normal retirement ages the appropriate conversion factor shall be the factor as determined by the Commissioner.

(3) *Accumulated contributions.* For purposes of section 411(c) and this section, the term ''accumulated contributions'' means the total of—

(i) All mandatory contributions made by the employee (determined under paragraph (c)(4) of this section),

(ii) Interest (if any) on such contributions, computed at the rate provided by the plan to the end of the last plan year to which section 411(a)(2) does not apply (by reason of the applicable effective date), and

(iii) Interest on the sum of the amounts determined under paragraphs (c)(3)(i) and (ii) of this section compounded annually at the rate of 5 percent per annum from the beginning of the first plan year to which section 411(a)(2) applies (by reason of the applicable effective date) to the date on which the employee would attain normal retirement age.

For example, if under section 1017 of the Employee Retirement Income Security Act of 1974, section 411(a)(2) of the Code applies for plan years beginning after December 31, 1975, and for plan years beginning before 1975, the plan provided for 3 percent interest on employee contributions, an employee's accumulated contributions would be computed by crediting interest at the rate provided by the plan (3 percent) for plan years beginning before 1976 and by crediting interest at the rate of 5 percent (or another rate prescribed under section 411(c)(2)(D)) thereafter. Section 1017 of the Employee Retirement Income Security Act of 1974 and §1.411(a)–2 provide the effective dates for the application of section 411(a)(2).

(4) *Mandatory contributions.* For purposes of section 411(c) and this section the term ''mandatory contributions'' means amounts contributed to the plan by the employee which are required as a condition of his employment, as a condition of his participation in the plan, or as a condition of obtaining benefits (or additional benefits) under the plan attributable to employer contributions. For example, if the benefit derived from employer contributions depends upon a specified level of employee contributions, employee contributions up to that level would be treated as mandatory contributions. Mandatory contributions, otherwise satisfying the requirements of this subparagraph, include amounts contributed to the plan which are used to provide ancillary benefits such as incidental life insurance, health insurance, or death benefits.

(d) *Limitation on accrued benefit.* The accrued benefit derived from mandatory employee contributions under a defined benefit plan (determined under paragraph (c) of this section) shall not exceed the greater of—

(1) The accrued benefit of the employee under the plan, or

(2) The accrued benefit derived from employee contributions determined without regard to any interest under section 411(c)(2)(C) (ii) and (iii) and under paragraphs (c)(3) (ii) and (iii) of this section.

(e) *Actuarial adjustments for defined benefit plans*—(1) *Accrued benefit.* In the case of a defined benefit plan (as defined in section 414(j)) if an employee's accrued benefit is to be determined as an amount other than an annual benefit commencing at normal retirement age, such benefit (determined under section 411(c)(1) and paragraph (a) of this section) shall be the actuarial equivalent of such benefit, as determined by the Commissioner.

(2) *Accrued benefit derived from employee contributions.* In the case of a defined benefit plan (as defined in section 414(j) if the accrued benefit derived from mandatory contributions made by an employee is to be determined with respect to a benefit other than an annual benefit in the form of a single life annuity (without ancillary benefits) commencing at normal retirement age, such benefit shall be the actuarial equivalent of such benefit (determined under section 411(c)(2)(B) and paragraph (c) of this section) as determined by the Commissioner.

(f) *Suspension of benefits, etc.*—(1) *Suspensions.* No adjustment to an accrued benefit is required on account of any suspension of benefits if such suspension is permitted under section 203(a)(3)(B) of the Employee Retirement Income Security Act of 1974 (88 Stat. 855) (Code section 411(a)(3)(B)).

(2) *Employment after retirement.* No actuarial adjustment to an accrued benefit is required on account of employment after normal retirement age. For example, if a plan with a normal retirement age of 65 provides a benefit of $400 a month payable at age 65 the same $400 benefit (with no upward adjustment) could be paid to an employee who retires at age 68.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42338, Aug. 23, 1977]

§1.411(d)–1 Coordination of vesting and discrimination requirements. [Reserved]

§1.411(d)–2 Termination or partial termination; discontinuance of contributions.

(a) *General rule*—(1) *Required nonforfeitability.* A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless the plan provides that—

(i) Upon the termination or partial termination of the plan, or

(ii) In addition, in the case of a plan to which section 412 (relating to minimum funding standards) does not apply, upon the complete discontinuance of contributions under the plan,

the rights of each affected employee to benefits accrued to the date of such termination or partial termination (or, in the case of a plan to which section 412 does not apply, discontinuance), to the extent funded, or the rights of each employee to the amounts credited to his account at such time, are nonforfeitable (within the meaning of § 1.411(a)–4.

(2) *Required allocation.* (i) A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless the plan provides for the allocation of any previously unallocated funds to the employes covered by the plan upon the termination or partial termination of the plan (or, in the case of a plan to which section 412 does not apply, upon the complete discontinuance of contributions under the plan). Such provision may be incorporated in the plan at its inception or by an amendment made prior to the termination or partial termination of the plan for the discontinuance of contributions thereunder. In the case of a defined contribution plan under which unallocated forfeitures are held in a suspense account in order to satisfy the requirements of section 415, this subdivision shall not require such plan to provide for allocations from the suspense account to the extent that such allocations would result in annual additions to participants' accounts in excess of amounts permitted under section 415 for the year for which such allocations would be made.

(ii) Any provision for the allocation of unallocated funds which is found by the Secretary of Labor or the Pension Benefit Guaranty Corporation (whichever is appropriate) to satisfy the requirements of section 4044 or section 403(d)(1) of the Employee Retirement Income Security Act of 1974 is acceptable if it specifies the method to be used and does not conflict with the provisions of section 401(a)(4) of the Internal Revenue Code of 1954 and the regulations thereunder. Any allocation of funds required by paragraph (1), (2), (3), or (4)(A) of section 4044(a) of such Act shall be deemed not to result in discrimination prohibited by section 401(a)(4) of the Code (see, however, paragraph (e) of this section). Notwithstanding the preceding sentence, in the case of a plan which establishes subclasses or categories pursuant to section 4044(b)(6) of such Act, the allocation of funds by the use of such subclasses or categories shall not be deemed not to result in discrimination prohibited by the Code. The allocation of unallocated funds may be in cash or in the form of other benefits provided under the plan. However, the allocation of the funds contributed by the employer among the employees need not necessarily benefit all the employees covered by the plan.

(iii) Paragraphs (a)(2) (i) and (ii) of this section do not require the allocation of amounts to the account of any employee if such amounts are not required to be used to satisfy the liabilities with respect to employees and their beneficiaries under the plan (see section 401(a)(2)).

(b) *Partial termination*—(1) *General rule.* Whether or not a partial termination of a qualified plan occurs (and the time of such event) shall be determined by the Commissioner with regard to all the facts and circumstances in a particular case. Such facts and circumstances include: the exclusion, by reason of a plan amendment or severance by the employer, of a group of employees who have previously been covered by the plan; and plan amendments which adversely affect the rights of employees to vest in benefits under the plan.

(2) *Special rule.* If a defined benefit plan ceases or decreases future benefit accruals under the plan, a partial termination shall be deemed to occur if, as a result of such cessation or decrease, a potential reversion to the employer, or employers, maintaining the plan (determined as of the date such cessation or decrease is adopted) is created or increased. If no such reversion is created or increased, a partial termination shall be deemed not to occur by reason of such cessation or decrease.

However, the Commissioner may determine that a partial termination of such a plan occurs pursuant to subparagraph (1) of this paragraph for reasons other than such cessation or decrease.

(3) *Effect of partial termination.* If a termination of a qualified plan occurs, the provisions of section 411(d)(3) apply only to the part of the plan that is terminated.

(c) *Termination*—(1) *Application.* This paragraph applies to a plan other than a plan described in section 411(e)(1) (relating to governmental, certain church plans, etc.).

(2) *Plans subject to termination insurance.* For purposes of this section, a plan to which title IV of the Employee Retirement Income Security Act of 1974 applies is considered terminated on a particular date if, as of that date—

(i) The plan is voluntarily terminated by the plan administrator under section 4041 of the Employee Retirement Income Security Act of 1974, or

(ii) The Pension Benefit Guaranty Corporation terminates the plan under section 4042 of the Employee Retirement Income Security Act of 1974.

For purposes of this subparagraph, the particular date of termination shall be the date of termination determined under section 4048 of such Act.

(3) *Other plans.* In the case of a plan not described in paragraph (c)(2) of this section, a plan is considered terminated on a particular date if, as of that date, the plan is voluntarily terminated by the employer, or employers, maintaining the plan.

(d) *Complete discontinuance*—(1) *General rule.* For purposes of this section, a complete discontiuance of contributions under the plan is contrasted with a suspension of contributions under the plan which is merely a temporary cessation of contributions by the employer. A complete discontinuance of contributions may occur although some amounts are contributed by the employer under the plan if such amounts are not substantial enough to reflect the intent on the part of the employer to continue to maintain the plan. The determination of whether a complete discontinuance of contributions under the plan has occurred will be made with regard to all the facts and circumstances in the particular case, and without regard to the amount of any contributions made under the plan by employees. Among the factors to be considered in determining whether a suspension constitutes a discontinuance are:

(i) Whether the employer may merely be calling an actual discontinuance of contributions a suspension of such contributions in order to avoid the requirement of full vesting as in the case of a discontinuance, or for any other reason;

(ii) Whether contributions are recurring and substantial; and

(iii) Whether there is any reasonable probability that the lack of contributions will continue indefinitely.

(2) *Time of discontinuance.* In any case in which a suspension of a profit-sharing plan maintained by a single employer is considered a discontinuance, the discontinuance becomes effective not later than the last day of the taxable year of the employer following the last taxable year of such employer for which a substantial contribution was made under the profit-sharing plan. In the case of a profit-sharing plan maintained by more than one employer, the discontinuance becomes effective not later than the last day of the plan year following the plan year within which any employer made a substantial contribution under the plan.

(e) *Contributions or benefits which remain forfeitable.* Under section 411 (d) (2) and (3), section 411(a) and this section do not apply to plan benefits which may not be provided for designated employees in the event of early termination of the plan under provisions of the plan adopted pursuant to regulations prescribed by the Secretary or his delegate to preclude the discrimination prohibited by section 401(a)(4). Accordingly, in such a case, plan benefits may be required to be reallocated without regard to this section. See §1.401–4(c).

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42339, Aug. 23, 1977]

§1.411(d)–3 Other special rules.

(a) *Class year plans*—(1) *General rule.* Under section 411(d)(4), the requirements of section 411(a)(2) for a class year plan shall be deemed to be satisfied if such plan provides that each employee's rights to or derived from employer contributions on his behalf for any plan year are nonforfeitable no later than the end of the 5th plan year following the plan year for which such contributions were made. For purposes of section 411 and the regulations thereunder, the term ''class year plan'' means a profit-sharing, stock bonus, or money purchase plan which provides that the nonforfeitable rights of employees to or derived from employer contributions are determined separately for each plan year. ''See § 1.411(d)–5 for rules that apply to class year plans for contributions made for plan years beginning after October 22, 1986.''

(2) *Other rules*—(i) *Prohibited forfeiture on withdrawals.* In the case of a class year plan, section 401(a)(19) and the regulations thereunder shall be applied separately to each plan year.

(ii) *Distribution rules.* The rules of § 1.411(a)–7(d) apply to a class year plan. For example, under the rule in § 1.411(a)–7(d)(2)(ii)(D), a class year plan would be permitted to limit the time of repayment to a 5-year period beginning on the date of withdrawal, or under the rule in § 1.411(a)–7(d)(2)(iii), a class year plan would restore the amount of the forfeited account balance in the event of repayment. For purposes of applying subparagraphs (2) and (3) of § 1.411(a)–7(d), relating to withdrawal of mandatory contributions, a withdrawal of employee contributions shall be treated as a withdrawal of such contributions on a plan year by plan year basis in succeeding order of time. Any repayments shall be treated as being on account of plan years in succeeding order of time. For purposes of applying any rule of such paragraph (e.g., paragraph (d)(2)(ii)(C)) the term ''one-year break in service'' means any plan year in which under subparagraph (1) of this paragraph a class year plan may forfeit an employee's rights.

(iii) *Computation of years for withdrawals.* In applying the requirement of paragraph (a)(1) of this section that rights must be nonforfeitable no later than the end of the fifth plan year following the plan year for which contributions are made, any plan year for which there has been a withdrawal of contributions and no repayment of such contributions (determined as of the last day of the plan year) is not required to count toward the five years. For example, assume that contributions are made for A in 1981 to a calendar year plan. Under the general rule of paragraph (a)(1) of this section, the contributions must be nonforfeitable on December 31, 1986. If in 1982, A withdraws the contributions for 1981, and repays these contributions in 1984, 1982 and 1983 are not required to be counted toward the five years because at the end of each year there is a withdrawal and no repayment of such withdrawal. Accordingly, the plan must provide that A's interest in the contribution for 1981 will be vested on December 31, 1988.

(b) *Prohibition against accrued benefit decrease.* Under section 411(d)(6) a plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if a plan amendment decreases the accrued benefit of any plan participant, unless the plan amendment satisfies the requirements of section 412(c)(8) (relating to certain retroactive amendments) and the regulations thereunder. For purposes of determining whether or not any participant's accrued benefit is decreased, all the provisions of a plan affecting directly or indirectly the computation of accrued benefits which are amended with the same adoption and effective dates shall be treated as one plan amendment. Plan provisions indirectly affecting accrued benefits include, for example, provisions relating to years of service and breaks in service for determining benefit accrual, and to actuarial factors for determining optional or early retirement benefits.

(c) *Rules applicable to section 414(k) plan.* For special rules applicable to defined benefit plans which provide a benefit derived from employer contributions which is based partly on a participant's separate account, see section 414(k) and the regulations thereunder.

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42340, Aug. 23, 1977, as amended by T.D. 8038, 50 FR 29375, July 19, 1985; T.D. 8219, 53 FR 31854, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988]

§1.411(d)–4 Section 411(d)(6) protected benefits.

Q–1: What are ''section 411(d)(6) protected benefits''?

A–1: (a) *In general.* The term ''section 411(d)(6) protected benefit'' includes any benefit that is described in one or more of the following categories—

(1) Benefits described in section 411(d)(6)(A),

(2) Early retirement benefits and retirement-type subsidies described in section 411(d)(6)(B)(i), including qualified social security supplements as defined in §1.401(a)(4)–12, and

(3) Optional forms of benefit described in section 411(d)(6)(B)(ii).

Such benefits, to the extent they have accrued, are subject to the protection of section 411(d)(6) and, where applicable, the definitely determinable requirement of section 401(a) (including section 401(a)(25)) and cannot, therefore, be reduced, eliminated, or made subject to employer discretion except to the extent permitted by regulations.

(b) *Optional forms of benefit*—(1) *In general.* An ''optional form of benefit'' is a distribution form with respect to an employee's benefit (described in paragraph (a)(1) and/or (a)(2) of this Q&A–1) that is available under the plan and is identical with respect to all features relating to the distribution form, including the payment schedule, timing, commencement, medium of distribution (e.g., in cash or in-kind), the portion of the benefit to which such distribution features apply and the election rights with respect to such optional forms. To the extent there are any differences in such features, the plan provides separate optional forms of benefit. Differences in amounts of benefits, methods of calculation, or values of distribution forms do not result in optional forms of benefit for purposes of this rule. However, such amounts, methods of calculation, or values may be protected benefits within section 411(d)(6)(A) and/or section 411(d)(6)(B)(i). See §1.401(a)–4 for further discussion and examples relating to optional forms of benefits. See §1.401(a)(4)–4(d) for the definition of an optional form of benefit for plan years beginning on or after January 1, 1994 (or January 1, 1996, in the case of plans maintained by organizations exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans)).

(2) *Examples.* The following examples illustrate the meaning of the term ''optional form of benefit.'' Other issues, such as the requirement that the optional forms satisfy section 401(a)(4), are not addressed in these examples and no inferences are intended with respect to such requirements. Assume that the distribution forms, including those not described in these examples, provided under the plan in each of the following examples are identical in all respects not described.

Example 1. A plan permits each participant to receive his benefit under the plan as a single sum distribution; a level monthly distribution schedule over 15 years; a single life annuity; a joint and 50 percent survivor annuity; a joint and 75 percent survivor annuity; a joint and 50 percent survivor annuity with a benefit increase for the participant if the beneficiary dies before a specified date; and joint and 50 percent survivor annuity with a 10 year certain feature. Each of these benefit distribution options is an optional form of benefit (without regard to whether the values of these options are actuarially equivalent).

Example 2. A plan permits each participant to receive his benefit under the plan as a single life annuity commencing at termination from employment; a joint and 50 percent survivor annuity commencing at termination from employment; a single sum distribution that is actuarially equivalent to the single life annuity determined by using a specified interest rate (X percent) for the employees of division A; and a single sum distributions that is actuarially equivalent to the single life annuity determined by using an interst rate that is 80 percent of X percent for employees of Division B. This plan provides three optional forms of benefit. While the interest rates used to determine the single sum distributions available to the employees of Divisions A and the employees of Division B respectively differ, this difference does not result in two single sum optional forms of benefit.

Example 3. A plan permits each participant who is employed by division A to receive his benefit in a single sum distribution payable upon termination from employment and each participant who is employed by division B in a single sum distribution payable upon termination from employment on or after the attainment of age 50. This plan provides two single sum optional forms of benefit.

Example 4. A plan permits each participant to receive his benefit in a single life annuity that commences in the month after the participant's termination from employment or in a single life annuity that commences upon the completion of five consecutive one year breaks in service. These are two optional forms of benefit.

Example 5. A profit-sharing plan permits each participant who is employed by division A to receive an in-service distribution upon the satisfaction of objective criteria set forth in the plan designed to determine whether the participant has a heavy and immediate financial need, and each participant who is employed by division B to receive an in-service distribution upon the satisfaction of objective criteria set forth in the plan designed to determine whether the participant has a heavy and immediate financial need attributable to extraordinary medical expenses. These in-service distribution options are two optional forms of benefits.

Example 6. A profit-sharing plan permits each participant who is employed by division A to receive an in-service distribution up to $5,000 and each participant who is employed by division B to receive an in-service distribution of up to his total benefit. These in-service distribution options differ as to the portion of the accrued benefit that may be distributed in a particular form and are, therefore, two optional forms of benefit.

Example 7. A profit-sharing plan provides for a single sum distribution on termination of employment. The plan is amended in 1991 to eliminate the single sum optional form of benefit with respect to benefits accrued after the date of amendment. This single sum optional form of benefit continues to be a single optional form of benefit although, over time, the percentage of various employees' accrued benefits that are potentially payable under this single sum may vary because the form is only available with respect to benefits accrued up to and including the date of the amendment.

Example 8. A profit-sharing plan permits each participant to receive a single sum distribution of his benefit in cash or in the form of a specified class of employer stock. This plan provides two single sum distribution optinal forms of benefit.

Example 9. A stock bonus plan permits each participant to receive a single sum distribution of his benefit in cash or in the form of the property in which such participant's benefit was invested prior to the distribution. This plan's single sum distribution option provides two optional forms of benefit.

Example 10. A defined benefit plan provides for an early retirement benefit payable upon termination of employment after attainment of age 55 and either after ten years of service or, if earlier, upon plan termination to employees of Division A and provides for an identical early retirement benefit payable on the same terms with the exception of payment on plan termination to employees of Division B. The plan provides for two optional forms of benefit.

Example 11. A profit-sharing plan provides for loans secured by an employee's account balance. In the event of default on such a loan, there is an execution on such account balances. Such execution is a distribution of the employee's accrued benefits under the plan. A distribution of an accrued benefit contingent on default under a plan loan secured by such accrued benefits is an optional form of benefit under the plan.

(c) *Plan terms*—(1) *General rule.* Generally, benefits described in section 411(d)(6)(A), early retirement benefits, retirement-type subsidies, and optional forms of benefit are section 411(d)(6) protected benefits only if they are provided under the terms of a plan. However, if an employer establishes a pattern of repeated plan amendments providing for similar benefits in similar situations for substantially consecutive, limited periods of time, such benefits will be treated as provided under the terms of the plan, without regard to the limited periods of time, to the extent necessary to carry out the purposes of section 411(d)(6) and, where applicable, the definitely determinable requirement of section 401(a), including section 401(a)(25). A pattern of repeated plan amendments providing that a particular optional form of benefit is available to certain named employees for a limited period of time is within the scope of this rule and may result in such optional form of benefit being treated as provided under the terms of the plan to all employees covered under the plan without regard to the limited period of time and the limited group of named employees.

(2) *Effective date.* The provisions of paragraph (c)(1)of this Q&A-1 are effective as of July 11, 1988. Thus, patterns or repeated plan amendments adopted and effective before July 11, 1988 will be disregarded in determining whether such amendments have created an ongoing optional form of benefit under the plan.

(d) *Benefits that are not section 411(d)(6) protected benefits.* The following benefits are examples of items that are not section 411(d)(6) protected benefits:

(1) Ancillary life insurance protection;

(2) Accident or health insurance benefits;

(3) Social security supplements described in section 411(a)(9), except qualified social security supplements as defined in §1.401(a)(4)–12;

(4) The availability of loans (other than the distribution of an employee's accrued benefit upon default under a loan);

(5) The right to make after-tax employee contributions or elective deferrals described in section 402(g)(3);

(6) The right to direct investments;

(7) The right to a particular form of investment (e.g., investment in employer stock or securities or investment in certain types of securities, commercial paper, or other investment media);

(8) The allocation dates for contributions, forfeitures, and earnings, the time for making contributions (but not the conditions for receiving an allocation of contributions or forfeitures for a plan year after such conditions have been satisfied), and the valuation dates for account balances;

(9) Administrative procedures for distributing benefits, such as provisions relating to the particular dates on which notices are given and by which elections must be made; and

(10) Rights that derive from administrative and operational provisions, such as mechanical procedures for allocating investment experience among accounts in defined contribution plans.

Q–2: To what extent may section 411(d)(6) protected benefits under a plan be reduced or eliminated?

A–2: (a) *Reduction or elimination of section 411(d)(6) protected benefits*—(1) *In general.* A plan may not be amended to eliminate or reduce a section 411(d)(6) protected benefit that has already accrued, except as provided in sections 412(c)(8) and 4281, and in paragraph (b) of this Q&A–2. This is generally the case even if such elimination or reduction is contingent upon the employee's consent. However, a plan may be amended to eliminate or reduce section 411(d)(6) protected benefits with respect to benefits not yet accrued as of the later of the amendment's adoption date or effective date without violating section 411(d)(6).

(2) *Selection of optional forms of benefit*—(i) *General rule.* A plan may treat a participant as receiving his entire nonforfeitable accrued benefit under the plan if the participant receives his benefit in an optional form of benefit in an amount determined under the plan that is at least the actuarial equivalent of the employee's nonforfeitable accrued benefit payable at normal retirement age under the plan. This is true even though the participant could have elected to receive an optional form of benefit with a greater actuarial value than the value of the optional form received, such as an optional form including retirement-type subsidies, and without regard to whether such other, more valuable optional form could have commenced immediately or could have become available only upon the employee's future satisfaction of specified eligibility conditions.

(ii) *Election of an optional form.* Except as provided in paragraph (a)(2)(iii) of this Q&A–2, a plan does not violate section 411(d)(6) merely because an employee's election to receive a portion of his nonforfeitable accrued benefit in one optional form of benefit precludes the employee from receiving that portion of his benefit in another optional form of benefit. Such employee retains all 411(d)(6) protected rights with respect to the entire portion of such employee's nonforfeitable accrued benefit for which no distribution election was made. For purposes of this rule, an elective transfer of an otherwise distributable benefit is treated as the selection of an optional form of benefit. See Q&A–3 of this section.

(iii) *Buy-back rule.* Notwithstanding paragraph (a)(2)(ii) of this Q&A–2, an employee who received a distribution of his nonforfeitable benefit from a plan that is required to provide a repayment opportunity to such employee if he returns to service within the applicable period pursuant to the requirements of section 411(a)(7) and who, upon subsequent reemployment, repays the full amount of such distribution in accordance with section 411(a)(7)(C) must be reinstated in the full array of section 411(d)(6) protected benefits that existed with respect to such benefit prior to distribution.

(iv) *Examples.* The rules in this paragraph (a)(2) can be illustrated by the following examples:

Example 1. Defined benefit plan X provides, among its optional forms of benefit, for a subsidized early retirement benefit payable in the form of an annuity and available to employees who terminate from employment on or after their 55th birthdays. In addition plan X provides for a single sum distribution available on termination from employment or termination of the plan. The single sum distribution is determined on the basis of the present value of the accrued normal retirement benefit and does not take the early retirement subsidy into account. Plan X is terminated December 31, 1991. Employees U, age 47, V, age 55, and W, age 47, all continue in the service of the employer. Employees X, age 47, Y, age 55 and Z, age 47, terminate from employment with the employer during 1991. Employees U and V elect to take the single sum optional form of distribution at the time of plan termination. Employees X and Y elect to take the single sum distribution on termination from employment with the employer. The elimination of the subsidized early retirement benefit with respect to employees U, V, X and Y does not result in a violation of section 411(d)(6). This is the result even though employees U and X had not yet satisfied the conditions for the subsidized early retirement benefit. Because employees W and Z have not selected an optional form of benefit, they continue to have a 411(d)(6) protected right to the full array of section 411(d)(6) protected benefits provided under the plan, including the single sum distribution form and the subsidized early retirement benefit.

Example 2. A partially vested employee receives a single sum distribution of the present value of his entire nonforfeitable benefit on account of separation from service under a defined benefit plan providing for a repayment provision. Upon reemployment with the employer such employee makes repayment in the required amount in accordance with section 411(a)(7). Such employee may, upon subsequent termination of employment, elect to take such repaid benefits in any optional form provided under the plan as of the time of the employee's initial separation from service. If the plan was amended prior to such repayment, to eliminate the single sum optional form of benefit with respect to benefits accrued after the date of the amendment, such participant has a 411(d)(6) protected right to take distribution of the repaid benefit in the form of a single sum distribution.

(3) *Certain transactions*—(i) *Plan mergers and benefit transfers.* The prohibition against the reduction or elimination of section 411(d)(6) protected benefits already accrued applies to plan mergers, spinoffs, transfers, and transactions amending or having the effect of amending a plan or plans to transfer plan benefits. Thus, for example, if plan A, a profit-sharing plan that provides for distribution of plan benefits in annual installments over ten or twenty years, is merged with plan B, a profit-sharing plan that provides for distribution of plan benefits in annual installments over life expectancy at time of retirement, the merged plan must retain the ten or twenty year installment option for participants with respect to benefits already accrued under plan A as of the merger and the installments over life expectancy for participants with benefits already accrued under plan B. Similarly, for example, if an employee's benefit under a defined contribution plan is transferred to another defined contribution plan (whether or not of the same employer), the optional forms of benefit available with respect to the employee's benefit accrued under the transferor plan may not be eliminated or reduced except as otherwise permitted under this regulation. See Q&A–3 of this section with respect to the transfer of benefits between and among defined benefit and defined contribution plans.

(ii) *Annuity contracts*—(A) *General rule.* The protection provided by section 411(d)(6) may not be avoided by the use of annuity contracts. Thus, section 411(d)(6) protected benefits already accrued may not be eliminated or reduced merely because a plan uses annuity contracts to provide such benefits, without regard to whether the plan, a participant, or a beneficiary of a participant holds the contract or whether such annuity contracts are purchased as a result of the termination of the plan. However, to the extent that an annuity contract constitutes payment of benefits in a particular optional form elected by the participant, the plan does not violate section 411(d)(6) merely because it provides that other optional forms are no longer available with respect to such participant. See paragraph (a)(2) of this Q&A–2.

(B) *Examples.* The provisions of this paragraph (a)(3)(ii) can be illustrated by the following examples:

Example 1. A profit-sharing plan that is being terminated satisfies section 411(d)(6) only if the plan makes available to participants annuity contracts that provide for all section 411(d)(6) protected benefits under the plan that may not otherwise be reduced or eliminated pursuant to this Q&A–2. Thus, if such a plan provided for a single sum distribution upon attainment of early retirement age, and a provision for payment in the form of 10 equal annual installments, the plan would satisfy section 411(d)(6) only if the participants had the opportunity to elect to have their benefits provided under an annuity contract that provided for the same single sum distribution upon the attainment of the participant's early retirement age and the same 10 year installment optional form of benefit.

Example 2. A defined benefit plan permits each participant who separates from service on or after age 62 to receive a qualified joint and survivor annuity or a single life annuity commencing 45 days after termination from employment. For a participant who separates from service before age 62, payments under these optional forms of benefit commence 45 days after the participant's 62nd birthday. Under the plan, a participant is to elect among these optional forms of benefit during the 90-day period preceding the annuity starting date. However, during such period, a participant may defer both benefit commencement and the election of a particular benefit form to any later date, subject to section 401(a)(9). In January 1990, the employer decides to terminate the plan as of July 1, 1990. The plan will fail to satisfy section 411(d)(6) unless the optional forms of benefit provided under the plan are preserved under the annuity contract purchased on plan termination. Thus, such annuity contract must provide a participant the same optional benefit commencement rights that the plan provided. In addition, such contract must provide the same election rights with respect to such benefit options. This is the case even if, for example, in conjunction with the termination, the employer amended the plan to permit participants to elect a qualified joint and survivor annuity, single life annuity, or single sum distribution commencing on July 1, 1990.

(4) *Benefits payable to a spouse or beneficiary.* Section 411(d)(6) protected benefits may not be eliminated merely because they are payable with respect to a spouse or other beneficiary.

(b) *Section 411(d)(6) protected benefits that may be eliminated or reduced only as permitted by the Commissioner*—(1) *In general.* The Commissioner may, consistent with the provisions of this section, provide for the elimination or reduction of section 411(d)(6) protected benefits that have already accrued only to the extent that such elimination or reduction does not result in the loss to plan participants of either a valuable right or an employer-subsidized optional form of benefit where a similar optional form of benefit with a comparable subsidy is not provided or to the extent such elimination or reduction is necessary to permit compliance with other requirements of section 401(a) (e.g., sections 401(a)(4), 401(a)(9) and 415). The Commissioner may exercise this authority only through the publication of revenue rulings, notices, and other documents of general applicability.

(2) *Section 411(d)(6) protected benefits that may be eliminated or reduced.* The elimination or reduction of certain section 411(d)(6) protected benefits that have already accrued in the following situations does not violate section 411(d)(6). The rules with respect to permissible eliminations and reductions provided in this paragraph (b)(2) are effective January 30, 1986. These exceptions create no inference with respect to whether any other applicable requirements are satisfied (for example, requirements imposed by section 401(a)(9) and section 401(a)(14)).

(i) *Change in statutory requirement.* A plan may be amended to eliminate or reduce a section 411(d)(6) protected benefit if the following three requirements are met: the amendment constitutes timely compliance with a change in law affecting plan qualification; there is an exercise of section 7805(b) relief by the Commissioner; and the elimination or reduction is made only to the extent necessary to enable the plan to continue to satisfy the requirements for qualified plans. In general, the elimination or reduction of a section 411(d)(6) protected benefit will not be treated as necessary if it is possible through other modifications to the plan (e.g., by expanding the availability of an optional form of benefit to additional employees) to satisfy the applicable qualification requirement.

(ii) *Joint and survivor annuity.* A plan that provides a range of three or more actuarially equivalent joint and survivor annuity options may be amended to eliminate any of such options, other than the options with the largest and smallest optional survivor payment percentages, even if the effect of such amendment is to change which of the options is the qualified joint and survivor annuity under section 417. Thus, for example, if a money purchase pension plan provides three joint and survivor annuity options with survivor payments of 50%, 75% and 100%, respectively, that are uniform with respect to age and are actuarially equivalent, then the employer may eliminate the option with the 75% survivor payment, even if this option had been the qualified joint and survivor annuity under the plan.

(iii) *In-kind distributions after plan termination*—(A) *In general.* If a plan includes an optional form of benefit under which benefits are distributed in specified property (other than cash), such optional form of benefit may be modified for distributions after plan termination by substituting cash for the specified property to the extent that, on plan termination, an employee has the opportunity to receive the optional form of benefit in the specified property. This exception is not available, however, if the employer that maintains the terminating plan also maintains another plan that provides an optional form of benefit in the specified property.

(B) *Example.* This paragraph (b)(2)(iii) can be illustrated by the following example:

Example. An employer maintains a stock bonus plan under which a participant, upon termination from employment, may elect to receive his benefits in a single sum distribution in employer stock. This is the only plan maintained by the employer under which distributions in employer stock are available. The employer decides to terminate the stock bonus plan. If such plan is amended to make available a single sum distribution in employer stock on plan termination, the plan will not fail section 411(d)(6) solely because the optional form of benefit providing a single sum distribution in employer stock on termination from employment is modified to provide that such distribution is available only in cash.

(iv) *Coordination with diversification requirement.* A tax credit employee stock ownership plan (as defined in section 409(a)) or an employee stock ownership plan (as defined in section 4975(e)(7)) may be amended to provide that a distribution is not available in employer securities to the extent that an employee elects to diversify benefits pursuant to section 401(a)(28).

(v) *Involuntary distributions.* A plan may be amended to provide for the involuntary distribution of an employee's benefit to the extent such involuntary distribution is permitted under sections 411(a)(11) and 417(e). Thus, for example, an involuntary distribution provision may be amended to require that an employee who terminates from employment with the employer receive a single sum distribution in the event that the present value of the employee's benefit is not more than $3,500, by substituting the cash-out limit in effect under § 1.411(a)–11T(c)(3)(ii) for $3,500, without violating section 411(d)(6). In addition, for example, the employer may amend the plan to reduce the involuntary distribution threshold from the cash-out limit in effect under § 1.411(a)–11T(c)(3)(ii) to any lower amount and to eliminate the involuntary single sum option for employees with benefits between the cash-out limit in effect under § 1.411(a)–11T(c)(3)(ii) and such lower amount without violating section 411(d)(6). This rule does not permit a plan provision permitting employer discretion with respect to optional forms of benefit for employees the present value of whose benefit is less than the cash-out limit in effect under § 1.411(a)–11T(c)(3)(ii).

(vi) *Distribution exception for certain profit-sharing plans*—(A) *In general.* If a defined contribution plan that is not subject to section 412 and does not provide for an annuity option is terminated, the plan may be amended to provide for the distribution of a participant's accrued benefit upon termination in a single sum optional form without the participant's consent. The preceding sentence does not apply if the employer maintains any other defined contribution plan (other than an employee stock ownership plan as defined in section 4975(e)(7)).

(B) *Examples.* The provisions of this paragraph (b)(2)(vi) can be illustrated by the following examples:

Example 1. Employer X maintains a defined contribution plan that is not subject to section 412. The plan provides for distribution in the form of equal installments over five years or equal installments over twenty years. X maintains no other defined contribution plans. X terminates its defined contribution plan after amending the plan to provide for the distribution of all participants' accrued benefits in the form of single sum distributions, without obtaining participant consent. Pursuant to the rule in this paragraph (b)(2)(iv), this amendment does not violate the requirements of section 411(d)(6).

Example 2. Corporations X and Y are members of controlled group employer XY. Both X and Y maintain defined contribution plans. X's plan, which is not subject to section 412, covers only employees working for X. Y's plan, which is subject to section 412, covers only employees working for Y. X terminates its defined contribution plan. Because employer XY maintains another defined contribution plan, plan X may not provide for the distribution of participants' accrued benefits upon termination without a participants' consent.

(vii) *Distribution of benefits on default of loans.* Notwithstanding that the distribution of benefits arising from an execution on an account balance used to secure a loan on which there has been a default is an optional form of benefit, a plan may be amended to eliminate or change a provision for loans, even if such loans would be secured by an employee's account balance.

(viii) *Provisions for transfer of benefits between and among defined contribution plans and defined benefit plans of the employer.* A plan may be amended to eliminate provisions permitting the transfer of benefits between and among defined contribution plans and defined benefit plans of the employer.

(ix) *De minimis change in the timing of an optional form of benefit.* A plan may be amended to modify an optional form of benefit by changing the timing of the availability of such optional form if, after the change, the optional form is available at a time that is within two months of the time such optional form was available before the amendment. To the extent the optional form of benefit is available prior to termination of employment, six months may be substituted for two months in the prior sentence. Thus, for example, a plan that makes in-service distributions available to employees once every month may be amended to make such in-service distributions available only once every six months. This exception to section 411(d)(6) relates only to the timing of the availability of the optional form of benefit. Other aspects of an optional form of benefit may not be modified and the value of such optional form may not be reduced merely because of an amendment permitted by this exception.

(x) *Amendment of hardship distribution standards.* A qualified cash or deferred arrangement that permits hardship distributions under §1.401(k)–1(d)(2) may be amended to specify or modify nondiscriminatory and objective standards for determining the existence of an immediate and heavy financial need, the amount necessary to meet the need, or other conditions relating to eligibility to receive a hardship distribution. For example, a plan will not be treated as violating section 411(d)(6) merely because it is amended to specify or modify the resources an employee must exhaust to qualify for a hardship distribution or to require employees to provide additional statements or representations to establish the existence of a hardship. A qualified cash or deferred arrangement may also be amended to eliminate hardship distributions. The provisions of this paragraph also apply to profit-sharing or stock bonus plans that permit hardship distributions, whether or not the hardship distributions are limited to those described in §1.401(k)–1(d)(2).

(xi) *Section 415 benefit limitations.* Accrued benefits under a plan as of the first day of the first limitation year beginning after December 31, 1986, that exceed the benefit limitations under section 415 (b) or (e), effective on the first day of the plan's first limitation year beginning after December 31, 1986, because of a change in the terms and conditions of the plan made after May 5, 1986, or the establishment of a plan after that date, may be reduced to the level permitted under section 415 (b) or (e).

(c) *Serial amendments.* A plan amendment that modifies an optional form of benefit with respect to benefits already accrued will be evaluated in light of previous amendments. Thus, for example, amendments made at different times that, when taken together, constitute the elimination or reduction of a valuable right, will be treated as the impermissible elimination or reduction of an optional form of benefit even though each amendment, considered alone, may otherwise be permissible.

(d) *ESOP and stock bonus plan exception*—(1) *In general.* Subject to the limitations in paragraph (d)(2) of this Q&A–2, a tax credit employee stock ownership plan (as defined in section 409(a)) or an employee stock ownership plan (as defined in section 4975(e)(7)) will not be treated as violating the requirements of section 411(d)(6) merely because of any of the circumstances described in paragraphs (d)(1)(i) through (d)(1)(iv) of this Q&A–2. In addition, a stock bonus plan that is not an employee stock ownership plan will not be treated as violating the requirements of section 411(d)(6) merely because of any of the circumstances described in paragraphs (d)(1)(ii) and (d)(1)(iv) of this Q&A–2.

(i) *Single sum or installment optional forms of benefit.* The employer eliminates, or retains the discretion to eliminate, with respect to all participants, a single sum optional form or installment optional form with respect to benefits that are subject to section 409(h)(1)(B), provided such elimination or retention of discretion is consistent with the distribution and payment requirements otherwise applicable to such plans (e.g., those required by section 409).

(ii) *Employer becomes substantially employee-owned.* The employer eliminates, or retains the discretion to eliminate, with respect to all participants, in cases in which the employer becomes substantially employee-owned, optional forms of benefit by substituting cash distributions for distributions in the form of employer stock with respect to benefits subject to section 409(h). This exception is available only if the employer otherwise meets the requirements of section 409(h)(2) with respect to restrictions on the ownership of outstanding employer stock.

(iii) *Employer securities become readily tradable.* The employer eliminates, or retains the discretion to eliminate, with respect to all participants, in cases in which the employer securities become readily tradable, optional forms of benefit by substituting distributions in the form of employer securities for distributions in cash with respect to benefits that are subject to section 409(h).

(iv) *Employer securities cease to be readily tradable or certain sales.* The employer eliminates, or retains the discretion to eliminate, with respect to all participants, optional forms of benefit by substituting cash distributions for distributions in the form of employer stock with respect to benefits that are subject to section 409(h) in the following circumstances:

(A) The employer stock ceases to be readily tradable;

(B) The employer stock continues to be readily tradable but there is a sale of substantially all of the stock of the employer or a sale of substantially all of the assets of a trade or business of the employer and, in either situation, the purchasing employer continues to maintain the plan.

In the situation described in paragraph (d)(1)(iv)(B) of this Q&A–2, the employer may also substitute distributions in the purchasing employer's stock for distributions in the form of employer stock of the predecessor employer.

(2) *Limitations on ESOP and stock bonus plan exceptions*—(i) *Nondiscrimination requirement.* Plan amendments and the retention and exercise of discretion permitted under the exceptions in paragraph (d)(1) must meet the nondiscrimination requirements of section 401(a)(4).

(ii) *Employer becomes substantially employee-owned or is an S corporation.* The employer eliminates, or retains the discretion to eliminate, with respect to all participants, optional forms of benefit by substituting cash distributions for distributions in the form of employer stock with respect to benefits subject to section 409(h) in the circumstances described in paragraph (d)(1)(ii)(A) or (B) of this Q&A–2, but only if the employer otherwise meets the requirements of section 409(h)(2)—

(A) The employer becomes substantially employee-owned; or

(B) For taxable years of the employer beginning after December 31, 1997, the employer is an S corporation as defined in section 1361.

(3) *Effective date.* The provisions of this paragraph (d) are effective beginning with the first day of the first plan year commencing on or after January 1, 1989. Prior to this effective date the reduction or elimination of a section 411(d)(6) protected benefit by a tax credit employee stock ownership plan (as defined in section 409(a)) or an employee stock ownership plan (as defined in section 4975(e)(7)) will not be treated as violating the requirements of section 411(d)(6) if such reduction or elimination reflects a reasonable interpretation of the statutory language of section 411(d)(6)(C).

(4) *Additional exceptions and requirements.* The Commissioner may, in revenue rulings, notices or other documents of general applicability, prescribe such additional rules and exceptions, consistent with the purposes of this section, as may be necessary or appropriate.

Q–3 Does the transfer of benefits between and among defined benefit plans and defined contribution plans (or similar transactions) violate the requirements of section 411(d)(6)?

A–3 (a) *Transfers and similar transactions*—(1) *General rule.* Section 411(d)(6) protected benefits may not be eliminated by reason of transfer or any transaction amending or having the effect of amending a plan or plans to transfer benefits. Thus, for example, except as otherwise provided in this section, an employer who maintains a money purchase pension plan that provides for a single sum optional form of benefit may not establish another plan that does not provide for this optional form of benefit and transfer participants' account balances to such new plan.

(2) *Defined benefit feature and separate account feature.* The defined benefit feature of an employee's benefit under a defined benefit plan and the separate account feature of an employee's benefit under a defined contribution plan are section 411(d)(6) protected benefits. Thus, for example, the elimination of the defined benefit feature of an employee's benefit under a defined benefit plan, through transfer of benefits from a defined benefit plan to a defined contribution plan or plans, will violate section 411(d)(6).

(3) *Waiver prohibition.* In general, an employee may not elect to waive section 411(d)(6) protected benefits. Thus, for example, the elimination of the defined benefit feature of an employee's benefit under a defined plan by reason of a transfer of such benefits to a defined contribution plan pursuant to an employee election, at a time when the benefit is not distributable to the employee, violates section 411(d)(6).

(b) *Elective transfers of benefits between plans*—(1) *Elective transfer.* A transfer of a participant's benefits between qualified plans that results in the elimination or reduction of section 411(d)(6) protected benefits does not violate section 411(d)(6) if the transfer meets the requirements of section 411(l) and the following requirements are met:

(i) *Voluntary election*—(A) *Participant election.* The plan from which the benefits are transferred must provide that the transfer is conditioned upon a voluntary, fully informed election by the participant to transfer such participant's benefit to another plan maintained by the employer.

(B) *Benefit retention alternative.* In making the voluntary election provided for in paragraph (b)(1)(i)(A) of this Q&A–3, the participant must have an alternative that retains such employee's section 411(d)(6) protected benefits (including all optional forms of benefit) under the plan. Thus, either of the following two requirements must be met:

(*1*) If the plan from which the benefits are transferred is terminating, the terminating plan must satisfy the requirements of section 401(a)(2) and section 411(d)(6), or

(*2*) If the plan from which the benefits are transferred is not terminating, the participant must be given the option of leaving his benefit in the ongoing plan to the extent required by section 411(a)(11) and section 417(e);

(C) *Spousal election.* If sections 401(a)(11) and 417 apply to the plan from which the benefits are transferred, the spousal consent requirements of such section must be met with respect to the transfer of benefits.

(D) *Notice requirement.* The notice requirements under section 417, requiring a written explanation with respect to an election not to receive benefits in the form of a qualified joint and survivor annuity, must be met with respect to the participant and spousal transfer election.

(ii) *Distributability of benefits.* The participant whose benefits are transferred must be eligible, under the terms of the plan from which the benefits are transferred, to receive an immediate distribution from such plan under provisions in the plan not inconsistent with section 401(a).

(iii) *Amount of benefit transferred.* The amount of the benefit transferred must equal the entire nonforfeitable accrued benefit under the plan of the participant whose benefit is being transferred, calculated to be at least the greater of the single sum distribution provided for under the plan for which the participant is eligible (if any) or the present value of the participant's accrued payable at normal retirement age and calculated by using an interest rate subject to the restrictions of section 417(e) and subject to the overall limitations imposed by section 415.

(iv) *Benefit under the transferee plan.* The participant must be fully vested in the transferred benefit in the transferee plan. In a transfer from a defined contribution plan to a defined benefit plan, the defined benefit plan must provide a minimum benefit, for each participant whose benefits are transferred, equal to the benefit, expressed as an annuity payable at normal retirement age, that is derived solely on the basis of the amount transferred with respect to such participant.

(2) *Status of elective transfer as distribution.* The transfer of benefits pursuant to the elective transfer rules of this paragraph (b) generally is to be treated as a distribution of a participant's accrued benefit under a plan for purposes of section 401(a). For example, a transfer option is an optional form of benefit under section 411(d)(6); the availability of such optional form of benefit is subject to the nondiscrimination requirements of section 401(a)(4); and the transfer is treated as a distribution subject to the cash-out rules in section 411(a)(7), the early termination requirements of section 411(d)(2) and the requirements of sections 401(a)(11) and 417. However, the transfer is not treated as a distribution for purposes of the minimum distribution requirements of section 401(a)(9).

(3) *Effective date.* The rules with respect to transfers are generally effective January 30, 1986. However, with respect to transfers from defined benefit plans to defined contribution plans and from defined contribution plans to defined benefit plans, the rules of this paragraph (b) are effective beginning August 10, 1988. On or after January 30, 1986, and prior to August 10, 1988 the transitional rules provided in paragraph (c) of this Q&A–3 are effective with respect to such transfers.

(c) *Transitional rule.* Prior to the effective date in paragraph (b)(3) of this Q&A–3, the transfer of benefits from a defined contribution plan to a defined benefit plan, or a defined benefit plan to a defined contribution plan, does not violate section 411(d)(6) solely by reason of the elimination of section 411(d)(6) protected benefits, if the benefits transferred were distributable under the plan or could have been distributable under section 401(a) and either of the following requirements are met:

(1) *Transfer exception.* The transfer satisfies the rules in paragraph (b) of this Q&A–3, or

(2) *Direct transfer.* The plan to which the benefits are to be transferred provides, or is amended to provide, for all section 411(d)(6) protected benefits provided under the transferor plan with respect to the benefits transferred (with the sole exception of the defined benefit feature of the benefit under a defined benefit plan and the defined contribution feature under a defined contribution plan); the transferred benefits are treated as held under a transferee plan for purposes of the requirements of sections 401(a)(11) and 417; the transferred amounts meet the requirements of section 414(l) with respect to the transfer of assets and liabilities, and the benefits transferred do not exceed the limitations imposed by section 415. Amendments required for purposes of satisfying this rule must be made by the date for making any amendments required for purposes of conforming the plan to the requirements of section 410(b) as amended by TRA '86. However, plans covered by

this rule must comply with these requirements in operation and any required amendments must be retroactive to the date on which the benefits were transferred.

(d) *Examples.* If a transfer complying with the elective transfer rules of paragraph (b) of this Q&A–3 is made from a defined benefit plan to a profit-sharing plan that does not provide for a life annuity distribution form, the profit-sharing plan to which the benefits are transferred would not be required to provide for a qualified joint and survivor annuity with respect to the transferred benefits. If the same transfer is made under the direct transfer transitional rule of paragraph (c)(2) of this Q&A–3, the defined contribution plan is treated as a transferee plan with respect to the transferred benefits for purposes of the requirements of section 401(a)(11) and section 417. Thus, for example, if such benefits are transferred without spousal consent to a profit-sharing plan that did not previously provide for a life annuity distribution form, such plan would be required to provide for a qualified joint and survivor annuity for the participants whose benefits were transferred with respect to the transferred benefits.

Q–4: May a plan provide that the employer may, through the exercise of discretion, deny a participant a section 411(d)(6) protected benefit for which the participant is otherwise eligible?

A–4: (a) *In general.* Except as provided in paragraph (d) of Q&A–2 of this section with respect to certain employee stock ownership plans, a plan that permits the employer, either directly or indirectly, through the exercise of discretion, to deny a participant a section 411(d)(6) protected benefit provided under the plan for which the participant is otherwise eligible (but for the employer's exercise of discretion) violates the requirements of section 411(d)(6). A plan provision that makes a section 411(d)(6) protected benefit available only to those employees as the employer may designate is within the scope of this prohibition. Thus, for example, a plan provision under which only employees who are designated by the employer are eligible to receive a subsidized early retirement benefit constitutes an impermissible provision under section 411(d)(6). In addition, a pension plan that permits employer discretion to deny the availability of a section 411(d)(6) protected benefit violates the definitely determinable requirement of section 401(a), including section 401(a)(25). See §1.401–1(b)(1)(i). This is the result even if the plan specifically limits the employer's discretion to choosing among section 411(d)(6) protected benefits, including optional forms of benefit, that are actuarially equivalent. In addition, the provisions of sections 411(a)(11) and 417(e) that allow a plan to make involuntary distributions of certain amounts are not excepted from this limitation on employer discretion. Thus, for example, a plan may not permit employer discretion with respect to whether benefits will be distributed involuntarily in the event that the present value of the employee's benefit is not more than the cash-out limit in effect under §1.411(a)–11T(c)(3)(ii) within the meaning of sections 411(a)(11) and 417(e). (An exception is provided for such provisions with respect to the nondiscrimination requirements of section 401(a)(4). See §1.401(a)(4)–4(b)(2)(ii)(C).)

(b) *Exception for administrative discretion.* A plan may permit limited discretion with respect to the ministerial or mechanical administration of the plan, including the application of objective plan criteria specifically set forth in the plan. Such plan provisions do not violate the requirements of section 411(d)(6) or the definitely determinable requirement of section 401(a), including section 401(a)(25). For example, these requirements are not violated by the following provisions that permit limited administrative discretion:

(1) Commencement of benefit payments as soon as administratively feasible after a stated date or event;

(2) Employer authority to determine whether objective criteria specified in the plan (e.g., objective criteria designed to identify those employees with a heavy and immediate financial need or objective criteria designed to determine whether an employee has a permanent and total disability) have been satisfied; and

(3) Employer authority to determine, pursuant to specific guidelines set forth in the plan, whether the participant or spouse is dead or cannot be located.

Q–5: When will the exercise of discretion by some person or persons, other than the employer, be treated as employer discretion?

A–5: For purposes of applying the rules of this section and § 1.401(a)–4, the term ''employer'' includes plan administrator, fiduciary, trustee, actuary, independent third party, and other persons. Thus, if a plan permits any person, other than the participant (and other than the participant's spouse), the discretion to deny or limit the availability of a section 411(d)(6) protected benefit for which the employee is otherwise eligible under the plan (but for the exercise of such discretion), such plan violates the requirements of sections 401(a), including section 411(d)(6) and, where applicable, the definitely determinable requirement of section 401(a), including section 401(a)(25).

Q–6: May a plan condition the availability of a section 411(d)(6) protected benefit on the satisfaction of objective conditions that are specifically set forth in the plan?

A–6: (a) *Certain objective conditions permissible*—(1) *In general.* The availability of a section 411(d)(6) protected benefit may be limited to employees who satisfy certain objective conditions provided the conditions are ascertainable, clearly set forth in the plan and not subject to the employer's discretion except to the extent reasonably necessary to determine whether the objective conditions have been met. Also, the availability of the section 411(d)(6) protected benefit must meet the nondiscrimination requirements of section 401(a)(4). See § 1.401(a)–4.

(2) *Examples of permissible conditions.* The following examples illustrate of permissible objective conditions: a plan may deny a single sum distribution form to employees for whom life insurance is not available at standard rates as defined under the terms of the plan at the time the single sum distribution would otherwise be payable; a plan may provide that a single sum distribution is available only if the employee is in extreme financial need as defined under the terms of the plan at the time the single sum distribution would otherwise be payable; a plan my condition the availability of a single sum distribution on the execution of a covenant not to compete, provided that objective conditions with respect to the terms of such covenant and the employees and circumstances requiring execution of such covenant are set forth in the plan.

(b) *Conditions based on factors within employer's discretion generally impermissible.* A plan may not limit the availability of section 411(d)(6) protected benefits permitted under the plan on objective conditions that are within the employer's discretion. For example, the availability of section 411(d)(6) protected benefits in a plan may not be conditioned on a determination with respect to the level of the plan's funded status, because the amount of plan funding is within the employer's discretion. However, for example, although conditions based on the plan's funded status are impermissible, a plan may limit the availability of a section 411(d)(6) protected benefit (e.g., a single sum distribution) in an objective manner, such as the following:

(1) Single sum distributions of $25,000 and less are available without limit; and

(2) Single sum distributions in excess of $25,000 are available for a year only to the extent that the total amount of such single sum distributions for the year is not greater than $5,000,000; and

(3) An objective and nondiscriminatory method for determining which particular single sum distributions will not be available during a year in order for the $5,000,000 limit to be satisfied is set forth in the plan.

Q–7: May a plan be amended to add employer discretion or conditions restricting the availability of a section 411(d)(6) protected benefit?

A–7: No. The addition of employer discretion or objective conditions with respect to a section 411(d)(6) protected benefit that has already accrued violates section 411(d)(6). Also, the addition of conditions (whether or not objective) or any change to existing conditions with respect to section 411(d)(6) protected benefits that results in any further restriction violates section 411(d)(6). However, the addition of objective conditions to a section 411(d)(6) protected benefit may be made with respect to benefits accrued after the later of the adoption or effective date of the amendment. In addition, objective conditions may be imposed on section 411(d)(6) protected benefits accrued as of the date of an amendment where permitted under the transitional rules of §1.401(a)–4 Q&A–5 and Q&A–8 of this section. Finally, objective conditions may be imposed on section 411(d)(6) protected benefits to the extent permitted by the permissible benefit cutback provisions of Q&A–2 of this section.

Q–8: If a plan contains an impermissible employer discretion provision with respect to a section 411(d)(6) protected benefit, what acceptable alternative exist for amending the plan without violating the requirements of section 411(d)(6)?

A–8: (a) *In general.* The following rules apply for purposes of making necessary amendments to existing plans (as defined in Q&A–9 of this section) that contain discretion provisions with respect to the availability of section 411(d)(6) protected benefits that violate the requirements of section 401(a), including sections 401(a)(25) and 411(d)(6), and this section. These transitional rules are provided under the authority of section 411(d)(6) and section 7805(b).

(b) *Transitional alternatives.* If the availability of an optional forms of benefit, early or late retirement benefit, or retirement-type subsidy under an existing plan is conditioned on the exercise of employer discretion, the plan must be amended either to eliminate the optional form of benefit, early or late retirement benefit, or retirement-type subsidy to make such benefit available to all participants without limitation, or to apply objective and nondiscriminatory conditions to the availability of the optional form of benefit, early or later retirement benefit, or retirement-type subsidy. See paragraph (d) of this Q&A–8 for rules limiting the period during which section 411(d)(6) protected benefits may be eliminated or reduced under this paragraph.

(c) *Compliance and amendment date provisions*—(1) *Operational compliance requirement.* On or before the applicable effective date for the plan (as determined under Q&A–9 of this section), the plan sponsor must select one of the alternatives permitted under paragraph (b) of the Q&A–8 with respect to each affected section 411(d)(6) protected benefit and the plan must be operated in accordance with this selection. This is an operational requirement and does not require a plan amendment prior to the period set forth in paragraph (c)(2) of this Q&A–8. There are no special reporting requirements under the Code or this section with respect to this selection.

(2) *Deferred amendment date.* If paragraph (c)(1) of this Q&A–8 is satisfied, a plan amendment conforming the plan to the particular alternative selected under paragraph (b) of this Q&A–8 must be adopted within the time period permitted for amending plans in order to meet the requirements of section 410(b) as amended by TRA '86. The plan amendment to conform the plan to these regulations may be made at an earlier date. Such conforming amendment must be consistent with the sponsor's selection as reflected by plan practice during the period from the effective date to the date the amendment is adopted. Thus, for example, if any existing calendar year noncollectively bargained defined benefit plan has a single sum distribution option that is subject to employer discretion as of August 1, 1986, and such employer makes one or more single sum distributions available on or after January 1, 1989 and before the effective date by which plan amendment is required pursuant to this section, then such employer may not adopt a plan amendment eliminating the single sum distribution, but rather must adopt an amendment eliminating the discretion provision. Any objective conditions that are adopted as part of such amendment must not be inconsistent with the plan practice for the applicable period prior to the amendment. A conforming amendment under this paragraph (c)(2) must be made with respect to each section 411(d)(6) protected benefit for which such amendment is

required and must be retroactive to the applicable effective date.

(d) *Limitation on transitional alternatives.* The transitional alternatives permitting the elimination or reduction of section 411(d)(6) protected benefits are only permissible until the applicable effective date for the plan (see Q&A–9 of this section). After the applicable effective date, any amendment (other than one permitted under paragraph (c)(2) of this Q&A–8) that eliminates or reduces a section 411(d)(6) protected benefit or imposes new objective conditions on the availability of such benefit will fail to qualify for the exception to section 411(d)(6) provided in this Q&A–8. This is the case without regard to whether the section 411(d)(6) protected benefit is subject to employer discretion.

Q–9: What are the applicable effective date rules for purposes of this section?

A–9: (a) *General effective date.* Except as otherwise provided in this section, the provisions of this section are effective January 30, 1986.

(b) *New plans*—(1) *In general.* Unless otherwise provided in paragraph (b)(2) of this Q&A–9, plans that are either adopted or made effective on or after August 1, 1986, are ‘‘new plans’’. With respect to such new plans, this section is effective August 1, 1986. This effective date is applicable to such plans whether or not they are collectively bargained.

(2) *Exception with respect to certain new plans.* Plans that are new plans as defined in paragraph (b)(1) of this Q&A–9; under which the availability of a section 411(d)(6) protected benefit is subject to employer discretion; and that receive a favorable determination letter that covered such plan provisions with respect to an application submitted prior to July 11, 1988, will be treated as existing plans with respect to such section 411(d)(6) protected benefit for purposes of the transitional rules of this section. Thus, such plans are eligible for the compliance and amendment alternatives set forth in the transitional rule in Q&A–8 of this section.

(c) *Existing plans*—(1) *In general.* Plans, including plans that are adoptions of master or prototype plans, that are both adopted and in effect prior to August 1, 1986, are ‘‘existing plans’’ for purposes of this section. In addition, a plan that is established after July 31, 1986, but before January 1, 1989, as an initial adoption of a master or prototype plan for which a favorable opinion letter was issued by the Service after July 18, 1985 and before January 1, 1989, will be deemed to be an existing plan for purposes of this section. See sections 4.01 and 4.02 of Rev. Proc. 84–23, 1984–1 C.B. 457, 459, for the definitions of master prototype plans. However, if such plan ceases to be covered under an opinion letter of the type described above, as a result of amendment of the plan or adoption of a new plan, prior to the first day of the first plan year beginning on or after January 1, 1989, then the effective date for such plan will be determined as though the plan were a new plan initially adopted as of the date of such amendment or adoption of a new plan. Finally, new plans described in paragraph (b)(2) of this Q&A–9 are treated as existing plans with respect to certain section 411(d)(6) protected benefits. Subject to the limitations in paragraph (c) of this Q&A–9, the effective dates set forth in paragraphs (c)(2), (c)(3), and (c)(4) of this Q&A–9 apply to these existing plans for purposes of this section:

(2) *Existing noncollectively bargained plans.* With respect to existing plans other than collectively bargained plans this section is effective for the first day of the first plan year commencing on or after January 1, 1989.

(3) *Existing collectively bargained plans.* With respect to existing collectively bargained plans this section is effective for the later of the first day of the first plan year commencing on or after January 1, 1989, or the first day of the first plan year that the requirements of section 410(b) as amended by TRA ’86 apply to such plan.

(4) *Existing master and prototype plans.* With respect to existing plans that are adoptions of master or prototype plans the effective date will be the first day of the first plan year commencing on or after January 1, 1989.

(d) *Delayed effective date not applicable to new alternatives or conditions*—(1) *In general.* The delayed effective dates in paragraphs (c)(2) and (c)(3) of this

Q&A–9 for existing plans are only applicable with respect to a section 411(d)(6) protected benefit if both the section 411(d)(6) protected benefit and the condition providing employer discretion as to the availability of such benefit are both adopted and in effect prior to August 1, 1986. If the preceding sentence is not satisfied with respect to a particular section 411(d)(6) protected benefit, this section is effective with respect to such section 411(d)(6) protected benefit as if the plan were a new plan.

(2) *Addition of discretion on or after January 30, 1986.* The delayed effective dates in paragraphs (c)(2) and (c)(3) of this Q&A–9 are not available with respect to any section 411(d)(6) protected benefit if the section 411(d)(6) protected benefit was provided for in the plan prior to January 30, 1986, and the availability of such benefit was made subject to the exercise of employer discretion on or after January 30, 1986. If the conditions set forth in this paragraph are not satisfied with respect to a particular section 411(d)(6) protected benefit, this section is effective with respect to such section 411(d)(6) protected benefit as if the plan were a new plan. A limited exception is provided with respect to existing plans that provided a particular section 411(d)(6) protected benefit prior to January 30, 1986, and then amended the plan after January 30, 1986, and before August 1, 1986, to add a provision for employer discretion with respect to the availability of such benefit. Such plans are required to have been amended retroactively by December 31, 1987, to remove such provision for employer discretion, and, if the benefit made subject to such discretion was subsequently eliminated, the plan is required to have been further amended, by the same date, to retroactively reinstate the benefit.

(3) *Exception for certain amendments covered by a favorable determination letter.* If an amendment adding a section 411(d)(6) protected benefit subject to employer discretion was adopted or made effective after August 1, 1986, and the plan receives a favorable determination letter covering such provision with respect to an application for such letter made prior to July 11, 1988, then the effective date for purposes of amending such provision under the transitional rules is the applicable effective date determined under the rules with respect to existing plans.

(e) *Transitional rule effective date.* The transitional rule provided in Q&A–8 of this section is effective January 30, 1986.

Q–10: If a plan provides for an age 70½ distribution option that commences prior to retirement from employment with the employer maintaining the plan, to what extent may the plan be amended to eliminate this distribution option?

A–10: (a) *In general.* The right to commence benefit distributions in a particular form and at a particular time prior to retirement from employment with the employer maintaining the plan is a separate optional form of benefit within the meaning of section 411(d)(6)(B) and Q&A–1 of this section, even if the plan provision creating this right was included in the plan solely to comply with section 401(a)(9), as in effect for years before January 1, 1997. Therefore, except as otherwise provided in paragraph (b) of this Q&A–10 or any other Q&A in this section, a plan amendment violates section 411(d)(6) if it eliminates an age 70½ distribution option (within the meaning of paragraph (c) of this Q&A–10) to the extent that it applies to benefits accrued as of the later of the adoption date or effective date of the amendment.

(b) *Permitted elimination of age 70½ distribution option.* An amendment of a plan will not violate the requirements of section 411(d)(6) merely because the amendment eliminates an age 70½ distribution option to the extent that the option provides for distribution to an employee prior to retirement from employment with the employer maintaining the plan, provided that—

(1) The amendment eliminating this optional form of benefit applies only to benefits with respect to employees who attain age 70½ in or after a calendar year, specified in the amendment, that begins after the later of—

(i) December 31, 1998; or

(ii) The adoption date of the amendment;

(2) The plan does not, except to the extent required by section 401(a)(9), preclude an employee who retires after

the calendar year in which the employee attains age 70½ from receiving benefits in any of the same optional forms of benefit (except for the difference in the timing of the commencement of payments) that would have been available had the employee retired in the calendar year in which the employee attained age 70½; and

(3) The amendment is adopted no later than—

(i) The last day of the remedial amendment period that applies to the plan for changes under the Small Business Job Protection Act of 1996 (110 Stat. 1755); or

(ii) Solely in the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before September 3, 1998, the last day of the twelfth month beginning after the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof on or after September 3, 1998), if later than the date described in paragraph (b)(3)(i) of this Q&A–10. For purposes of this paragraph (b)(3)(ii), the rules of § 1.410(b)–10(a)(2) apply for purposes of determining whether a plan is maintained pursuant to one or more collective bargaining agreements, except that September 3, 1998 is substituted for March 1, 1986, as the date before which the collective bargaining agreements must be ratified.

(c) *Age 70½ distribution option*. For purposes of this Q&A–10, an age 70½ distribution option is an optional form of benefit under which benefits payable in a particular distribution form (including any modifications that may be elected after benefit commencement) commence at a time during the period that begins on or after January 1 of the calendar year in which an employee attains age 70½ and ends April 1 of the immediately following calendar year.

(d) *Examples.* The provisions of this Q&A–10 are illustrated by the following examples:

Example 1. Plan A, a defined benefit plan, provides each participant with a qualified joint and survivor annuity (QJSA) that is available at any time after the later of age 65 or retirement. However, in accordance with section 401(a)(9) as in effect prior to January 1, 1997, Plan A provides that if an employee does not retire by the end of the calendar year in which the employee attains age 70½, then the QJSA commences on the following April 1. On October 1, 1998, Plan A is amended to provide that, for an employee who is not a 5-percent owner and who attains age 70½ after 1998, benefits may not commence before the employee retires but must commence no later than the April 1 following the later of the calendar year in which the employee retires or the calendar year in which the employee attains age 70½. This amendment satisfies this Q&A–10 and does not violate section 411(d)(6).

Example 2. Plan B, a money purchase pension plan, provides each participant with a choice of a QJSA or a single sum distribution commencing at any time after the later of age 65 or retirement. In addition, in accordance with section 401(a)(9) as in effect prior to January 1, 1997, Plan B provides that benefits will commence in the form of a QJSA on April 1 following the calendar year in which the employee attains age 70½, except that, with spousal consent, a participant may elect to receive annual installment payments equal to the minimum amount necessary to satisfy section 401(a)(9) (calculated in accordance with a method specified in the plan) until retirement, at which time a participant may choose between a QJSA and a single sum distribution (with spousal consent). On June 30, 1998, Plan B is amended to provide that, for an employee who is not a 5-percent owner and who attains age 70½ after 1998, benefits may not commence prior to retirement but benefits must commence no later than April 1 after the later of the calendar year in which the employee retires or the calendar year in which the employee attains age 70½. The amendment further provides that the option described above to receive annual installment payments prior to retirement will not be available under the plan to an employee who is not a 5-percent owner and who attains age 70½ after 1998. This amendment satisfies this Q&A–10 and does not violate section 411(d)(6).

Example 3. Plan C, a profit-sharing plan, contains two distribution provisions. Under the first provision, in any year after an employee attains age 59½, the employee may elect a distribution of any specified amount not exceeding the balance of the employee's account. In addition, the plan provides a section 401(a)(9) override provision under which, if, during any year following the year that the employee attains age 70½, the employee does not elect an amount at least equal to the minimum amount necessary to satisfy section 401(a)(9) (calculated in accordance with a method specified in the plan), Plan C will distribute the difference by December 31 of that year (or for the year the employee attains age 70½, by April 1 of the following year). On December 31, 1996, Plan C is amended to provide that, for an employee other than an employee who is a 5-percent owner in the year the employee attains age 70½, in applying the section 401(a)(9) override provision, the later of the year of retirement or year of attainment of age 70½, is substituted for the year of attainment of age 70½. After the amendment, Plan C still permits each employee to elect to receive the same amount as was available before the amendment. Because this amendment does not eliminate an optional form of benefit, the amendment does not violate section 411(d)(6). Accordingly, the amendment is not required to satisfy the conditions of paragraph (b) of this Q&A–10.

(e) *Effective date.* This Q&A–10 applies to amendments adopted and effective after June 5, 1998.

Q–11: To what extent may a plan amendment that is made pursuant to the Taxpayer Relief Act of 1997 (TRA '97) (Public Law 105–34, 111 Stat. 788), reduce or eliminate section 411(d)(6) protected benefits?

A–11: A plan amendment does not violate the requirements of section 411(d)(6) merely because the plan amendment reduces or eliminates section 411(d)(6) protected benefits as of the effective date of the plan amendment, provided that—

(a) The plan amendment is made pursuant to an amendment made by title XV, or subtitle H of title X, of TRA '97; and

(b) The plan amendment is adopted no later than the last day of any remedial amendment period that applies to the plan pursuant to §§1.401(b)–1 and 1.401(b)–1T for changes under TRA '97.

[53 FR 26058, July 11, 1988, as amended by T.D. 8360, 56 FR 47602, Sept. 19, 1991; T.D. 8357, 56 FR 40549, Aug. 15, 1991; T.D. 8360, 57 FR 4721, Feb. 7, 1992; T.D. 8485, 58 FR 46828, Sept. 3, 1993; T.D. 8581, 59 FR 66180, Dec. 23, 1994; T.D. 8769, 63 FR 30623, June 5, 1998; T.D. 8781, 63 FR 47173, Sept. 4, 1998; T.D. 8794, 63 FR 70338, Dec. 21, 1998; T.D. 8806, 64 FR 1126, Jan. 8, 1999]

§1.411(d)–5 Class year plans; plan years beginning after October 22, 1986.

(a) *Plan years beginning prior to 1989.* (1) The requirements of section 411(a)(2) shall be treated as satisfied in the case of a class-year plan if such plan provides that 100 percent of each employee's right to or derived from the contributions of the employer on the employee's behalf with respect to any plan year is nonforfeitable not later than when such participant was performing services for the employer as of the close of each of 5 plan years (whether or not consecutive) after the plan year for which the contributions were made.

(2) For purposes of paragraph (a)(1) of this section if—

(i) Any contributions are made on behalf of a participant with respect to any plan year, and

(ii) Before such participant meets the requirements of paragraph (a)(1) of this section, such participant was not performing services for the employer as of the close of each of any 5 consecutive plan years after such plan year, then the plan may provide that the participant forfeits any right to or derived from the contributions made with respect to such plan year.

(3) This paragraph (a) applies to contributions made for plan years beginning after October 22, 1986.

(b) *Plan years beginning after 1988.* (1) The special class year vesting rule in section 411(d)(4) was repealed by section 1113(b) of the Tax Reform Act of 1986 (1986 Act). The repeal is generally effective for plan years beginning after December 31, 1988. See section 1111(e) of the 1986 Act for a special effective date rule applicable to certain plans maintained pursuant to collective bargaining agreements.

(2)(i) This subparagraph (2) provides a special rule for class year plans that were in compliance with section 411(d)(4) immediately before the first plan year beginning after section 411(d)(4) is repealed. These plans are not required to retroactively compute years of service under the general section 411(a)(2) rules. Instead, a participant must receive a year of service for each such prior plan year if the employee was performing services on the last day of such year. Similarly, if the participant was not performing services on the last day of such years, the participant will be treated as if a one-year break– in–service occurred for such plan year. This subdivision (i) applies to plan years to which this section applies.

(ii) In the case of a plan year to which § 1.411(d)–3 applied, a class year plan must compute years of service and breaks in service in a manner consistent with the rules in this paragraph (b)(2)(i), giving appropriate regard to the statutory changes made to section 411(d)(4).

[T.D. 8219, 53 FR 31854, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988]

§ 1.411(d)–6 Section 204(h) notice.

Q–1: What are the requirements of section 204(h) of the Employee Retirement Income Security Act of 1974, as amended (ERISA) (29 U.S.C 1054(h))?

A–1: (a) *Requirements of section 204(h).* Section 204(h) of ERISA (‘‘section 204(h)’’) generally requires written notice of an amendment to certain plans that provides for a significant reduction in the rate of future benefit accrual. Section 204(h) generally requires the notice to be provided to plan participants, alternate payees, and employee organizations. The plan administrator must provide the notice after adoption of the plan amendment and not less than 15 days before the effective date of the plan amendment.

(b) *Other notice requirements.* Other provisions of law may require that certain parties be notified of a plan amendment. See, for example, sections 102 and 104 of ERISA, and the regulations thereunder, for requirements relating to summary plan descriptions and summaries of material modifications.

Q–2: To which plans does section 204(h) apply?

A–2: Section 204(h) applies to defined benefit plans that are subject to part 2 of subtitle B of title I of ERISA and to individual account plans that are subject to both such part 2 and the funding standards of section 302 of ERISA. Accordingly, individual account plans that are not subject to the funding standards of section 302, such as profit-sharing and stock bonus plans, are not subject to section 204(h).

Q–3: What is ‘‘section 204(h) notice’’?

A–3: ‘‘Section 204(h) notice’’ is notice that complies with section 204(h) and the rules in this section.

Q–4: For which amendments is section 204(h) notice required?

A–4: (a) *In general.* Section 204(h) notice is required for an amendment to a plan described in Q&A–2 of this section that provides for a significant reduction in the rate of future benefit accrual.

(b) *Delegation of authority to Commissioner.* The Commissioner of Internal Revenue may provide through publication in the Internal Revenue Bulletin of revenue rulings, notices, or other documents (see § 601.601(d)(2) of this chapter) that section 204(h) notice need not be provided for plan amendments otherwise described in paragraph (a) of this Q&A–4 that the Commissioner determines to be necessary or appropriate, as a result of changes in the law, to maintain compliance with the requirements of the Internal Revenue Code of 1986, as amended (Code) (including requirements for tax qualification), ERISA, or other applicable federal law.

Q–5: What is an amendment that affects the rate of future benefit accrual for purposes of section 204(h)?

A–5: (a) *In general*—(1) *Defined benefit plans.* For purposes of section 204(h), an amendment to a defined benefit plan affects the rate of future benefit accrual only if it is reasonably expected to change the amount of the future annual benefit commencing at normal retirement age. For this purpose, the annual benefit commencing at normal retirement age is the benefit payable in the form in which the terms of the plan express the accrued benefit (or, in the case of a plan in which the accrued benefit is not expressed in the form of an annual benefit commencing at normal retirement age, the benefit payable in the form of a single life annuity commencing at normal retirement age that is the actuarial equivalent of the accrued benefit expressed under the terms of the plan, as determined in accordance with the principles of section 411(c)(3) of the Code).

(2) *Individual account plans.* For purposes of section 204(h), an amendment to an individual account plan affects the rate of future benefit accrual only if it is reasonably expected to change the amounts allocated in the future to participants' accounts. Changes in the investments or investment options under an individual account plan are

not taken into account for this purpose.

(b) *Determination of rate of future benefit accrual.* In accordance with paragraph (a) of this Q&A–5, the rate of future benefit accrual is determined without regard to optional forms of benefit (other than the annual benefit described in paragraph (a) of this Q&A–5), early retirement benefits, or retirement-type subsidies, within the meaning of such terms as used in section 411(d)(6) of the Code (section 204(g) of ERISA). The rate of future benefit accrual is also determined without regard to ancillary benefits and other rights or features as defined in §1.401(a)(4)–4(e).

(c) *Examples.* These examples illustrate the rules in this Q&A–5:

Example 1. A plan is amended with respect to future benefit accruals to eliminate a right to commencement of a benefit prior to normal retirement age. Because the amendment does not change the annual benefit commencing at normal retirement age, it does not reduce the rate of future benefit accrual for purposes of section 204(h).

Example 2. A plan is amended to modify the actuarial factors used in converting an annuity form of distribution to a single sum form of distribution. The use of these modified assumptions results in a lower single sum. Because the amendment does not affect the annual benefit commencing at normal retirement age, it does not change the rate of future benefit accrual for purposes of section 204(h).

Q–6: What plan provisions are taken into account in determining whether there has been a reduction in the rate of future benefit accrual?

A–6: (a) *Plan provisions taken into account.* All plan provisions that may affect the rate of future benefit accrual of participants or alternate payees must be taken into account in determining whether an amendment provides for a significant reduction in the rate of future benefit accrual. Such provisions include, for example, the dollar amount or percentage of compensation on which benefit accruals are based; in the case of a plan using permitted disparity under section 401(l) of the Code, the amount of disparity between the excess benefit percentage or excess contribution percentage and the base benefit percentage or base contribution percentage (all as defined in section 401(l)); the definition of service or compensation taken into account in determining an employee's benefit accrual; the method of determining average compensation for calculating benefit accruals; the definition of normal retirement age in a defined benefit plan; the exclusion of current participants from future participation; benefit offset provisions; minimum benefit provisions; the formula for determining the amount of contributions and forfeitures allocated to participants' accounts in an individual account plan; and the actuarial assumptions used to determine contributions under a target benefit plan (as defined in §1.401(a)(4)–8(b)(3)(i)).

(b) *Plan provisions not taken into account.* Plan provisions that do not affect the rate of future benefit accrual of participants or alternate payees are not taken into account in determining whether there has been a reduction in the rate of future benefit accrual. For example, provisions such as vesting schedules or optional forms of benefit (other than the annual benefit described in Q&A–5(a) of this section) are not taken into account.

(c) *Examples.* The following example illustrates the rules in this Q&A–6:

Example. A defined benefit plan provides a normal retirement benefit equal to 50% of final average compensation times a fraction (not in excess of one), the numerator of which equals the number of years of participation in the plan and the denominator of which is 20. A plan amendment that changes the numerator or denominator of that fraction must be taken into account in determining whether there has been a reduction in the rate of future benefit accrual.

Q–7: What is the basic principle used in determining whether an amendment provides for a significant reduction in the rate of future benefit accrual for purposes of section 204(h)?

A–7: Whether an amendment provides for a significant reduction in the rate of future benefit accrual for purposes of section 204(h) is determined based on reasonable expectations taking into account the relevant facts and circumstances at the time the amendment is adopted. For a defined benefit plan this is done by comparing the amount of the annual benefit commencing at normal retirement age as determined under Q&A–5(a)(1) under the terms of the plan as amended, with the amount of the annual benefit commencing at normal retirement age as determined under Q&A–5(a)(1) under the terms of the plan prior to amendment. For an individual account plan, this is done in accordance with Q&A–5(a)(2) by comparing the amounts to be allocated in the future to participants' accounts under the terms of the plan as amended, with the amounts to be allocated in the future to participants' accounts under the terms of the plan prior to amendment.

Q–8: Are employees who have not yet become participants in a plan at the time an amendment to the plan is adopted taken into account in applying section 204(h) with respect to the amendment?

A–8: No. Employees who have not yet become participants in a plan at the time an amendment to the plan is adopted are not taken into account in applying section 204(h) with respect to the amendment. Thus, if section 204(h) notice is required with respect to an amendment, the plan administrator need not provide section 204(h) notice to such employees.

Q–9: If section 204(h) notice is required with respect to an amendment, must such notice be provided to participants or alternate payees whose rate of future benefit accrual is not reduced by the amendment?

A–9: (a) *In general.* A plan administrator need not provide section 204(h) notice to any participant whose rate of future benefit accrual is reasonably expected not to be reduced by the amendment, nor to any alternate payee under an applicable qualified domestic relations order whose rate of future benefit accrual is reasonably expected not to be reduced by the amendment. A plan administrator need not provide section 204(h) notice to an employee organization unless the employee organization represents a participant to whom section 204(h) notice is required to be provided.

(b) *Facts and circumstances test.* Whether a participant or alternate payee is described in paragraph (a) of this Q&A–9 is determined based on all relevant facts and circumstances at the time the amendment is adopted.

(c) *Examples.* The following examples illustrate the rules in this Q&A–9:

Example 1. Plan A is amended to reduce significantly the rate of future benefit accrual of all current employees who are participants in the plan. It is reasonable to expect based on the facts and circumstances that the amendment will not reduce the rate of future benefit accrual of former employees who are currently receiving benefits or that of former employees who are entitled to vested benefits. Accordingly, the plan administrator is not required to provide section 204(h) notice to such former employees.

Example 2. The facts are the same as in Example 1 except that Plan A also covers two groups of alternate payees. The alternate payees in the first group are entitled to a certain percentage or portion of the former spouse's accrued benefit, and for this purpose the accrued benefit is determined at the time the former spouse begins receiving retirement benefits under the plan. The alternate payees in the second group are entitled to a certain percentage or portion of the former spouse's accrued benefit, and for this purpose the accrued benefit was determined at the time the qualified domestic relations order was issued by the court. It is reasonable to expect that the benefits to be received by the second group of alternate payees will not be affected by any reduction in a former spouse's rate of future benefit accrual. Accordingly, the plan administrator is not required to provide section 204(h) notice to the alternate payees in the second group.

Example 3. Plan B covers hourly employees and salaried employees. Plan B provides the same rate of benefit accrual for both groups. The employer amends Plan B to reduce significantly the rate of future benefit accrual of the salaried employees only. At that time, it is reasonable to expect that only a small percentage of hourly employees will become salaried in the future. Accordingly, the plan administrator is not required to provide section 204(h) notice to the participants who are currently hourly employees.

Example 4. Plan C covers employees in Division M and employees in Division N. Plan C provides the same rate of benefit accrual for both groups. The employer amends Plan C to reduce significantly the rate of future benefit accrual of employees in Division M. At that time, it is reasonable to expect that in the future only a small percentage of employees in Division N will be transferred to Division M. Accordingly, the plan administrator is not required to provide section 204(h) notice to the participants who are employees in Division N.

Example 5. The facts are the same facts as in *Example 4,* except that at the time the amendment is adopted, it is expected that soon thereafter Division N will be merged into Division M in connection with a corporate reorganization (and the employees in Division N will become subject to the plan's amended benefit formula applicable to the employees in Division M). In this instance, the plan administrator must provide section 204(h) notice to the participants who are employees in Division M and to the participants who are employees in Division N.

Q–10: Does a notice fail to comply with section 204(h) if it contains a summary of the amendment and the effective date, without the text of the amendment itself?

A–10: No, the notice does not fail to comply with section 204(h) merely because the notice contains a summary of the amendment, rather than the text of the amendment, if the summary is written in a manner calculated to be understood by the average plan participant and contains the effective date. The summary need not explain how the individual benefit of each participant or alternate payee will be affected by the amendment.

Q–11: How may section 204(h) notice be provided?

A–11: A plan administrator (including a person acting on behalf of the plan administrator such as the employer or plan trustee) may use any method reasonably calculated to ensure actual receipt of the section 204(h) notice. First class mail to the last known address of the party is an acceptable delivery method. Likewise, hand delivery is acceptable. Section 204(h) notice may be enclosed with or combined with other notice provided by the employer or plan administrator. For example, a notice of intent to terminate under title IV of ERISA or a notice to interested parties of the application for a determination letter may also serve as section 204(h) notice if it otherwise meets the requirements of this section.

Q–12: How may the 15-day notice requirement be satisfied?

A–12: (a) *Generally.* A section 204(h) notice is deemed to have been provided at least 15 days before the effective date of the amendment if it has been provided by the end of the 15th day before the effective date. When notice is delivered by first class mail, the notice is considered provided as of the date of the United States postmark stamped on the cover in which the document is mailed.

(b) *Example.* The following example illustrates the provisions of this Q&A–12:

Example. Plan A is amended to reduce significantly the rate of future benefit accruals effective December 1, 1999. The plan administrator causes section 204(h) notice to be mailed to all affected participants. The mailing is postmarked November 16, 1999. Accordingly, the section 204(h) notice is considered to be given not less than 15 days before the effective date of the plan amendment.

Q–13: If a plan administrator fails to provide section 204(h) notice to some participants or alternate payees, will the plan administrator be considered to have complied with section 204(h) with respect to participants and alternate payees who were provided with section 204(h) notice?

A–13: The plan administrator will be considered to have complied with section 204(h) with respect to a participant to whom section 204(h) notice is required to be provided if the participant and any employee organization representing the participant were provided with section 204(h) notice, and if the plan administrator has made a good faith effort to comply with the requirements of section 204(h). The plan administrator will be considered to have complied with section 204(h) with respect to an alternate payee to whom section 204(h) notice is required to be provided if the alternate payee was provided with section 204(h) notice, and if the plan administrator made a good faith effort to comply with the requirements of section 204(h). If these conditions are satisfied the amendment will become effective in accordance with its terms with respect to the participants and alternate payees to whom section 204(h) notice was provided. Except to the extent provided in Q&A–14, the amendment will not become effective with respect to those participants and alternate payees who were not provided with section 204(h) notice.

Q–14: Will a plan be considered to have complied with section 204(h) if the plan administrator provides section 204(h) notice to all but a de minimis percentage of participants and alternate payees to whom section 204(h) notice must be provided?

A–14: The plan will be considered to have complied with section 204(h) and the amendment will become effective in accordance with its terms with respect to all parties to whom section 204(h) notice was required to be provided (including those who did not receive notice prior to discovery of the omission), if the plan administrator—

(a) Has made a good faith effort to comply with the requirements of section 204(h);

(b) Has provided section 204(h) notice to each employee organization that represents any participant to whom section 204(h) notice is required to be provided;

(c) Has failed to provide section 204(h) notice to no more than a de minimis percentage of participants and alternate payees to whom section 204(h) notice is required to be provided; and

(d) Provides section 204(h) notice to those participants and alternate payees promptly upon discovering the oversight.

Q–15: How does section 204(h) apply to the sale of a business?

A–15: (a) *Generally.* Whether section 204(h) notice is required in connection with the sale of a business depends on whether a plan amendment is adopted that significantly reduces the rate of future benefit accrual.

(b) *Examples.* The following examples illustrate the rules of this Q&A–15:

Example 1. Corporation Q maintains Plan A, a defined benefit plan that covers all employees of Corporation Q, including employees in its Division M. Plan A provides that participating employees cease to accrue benefits when they cease to be employees of Corporation Q. On January 1, 2000, Corporation Q sells all of the assets of Division M to Corporation R. Corporation R maintains Plan B, which covers all of the employees of Corporation R. Under the sale agreement, employees of Division M become employees of Corporation R on the date of the sale (and cease to be employees of Corporation Q), Corporation Q continues to maintain Plan A following the sale, and the employees of Division M become participants in Plan B. In this Example, no section 204(h) notice is required because no plan amendment was adopted that reduced the rate of future benefit accrual. The employees of Division M who become employees of Corporation R ceased to accrue benefits under Plan A because their employment with Corporation Q terminated.

Example 2. Subsidiary Y is a wholly owned subsidiary of Corporation S. Subsidiary Y maintains Plan C, a defined benefit plan that covers employees of Subsidiary Y. Corporation S sells all of the stock of Subsidiary Y to Corporation T. At the effective date of the sale of the stock of Subsidiary Y, in accordance with the sale agreement between Corporation S and Corporation T, Subsidiary Y amends Plan C so that all benefit accruals cease. In this Example, section 204(h) notice is required to be provided because Subsidiary Y adopted a plan amendment that significantly reduced the rate of future benefit accrual in Plan C.

Example 3. Corporation U maintains two plans: Plan D covers employees of Division N and Plan E covers the rest of the employees of Corporation U. Plan E provides a significantly lower rate of future benefit accrual than Plan D. Plan D is merged with Plan E, and all of the employees of Corporation U will accrue benefits under the merged plan in accordance with the benefit formula of former Plan E. In this Example, section 204(h) notice is required.

Example 4. Corporation V maintains several plans, including Plan F, which covers employees of Division P. Plan F provides that participating employees cease to accrue further benefits under the plan when they cease to be employees of Corporation V. Corporation V sells all of the assets of Division P to Corporation W, which maintains Plan G for its employees. Plan G provides a significantly lower rate of future benefit accrual than Plan F. Plan F is merged with Plan G as part of the sale, and employees of Division P who become employees of Corporation W will accrue benefits under the merged plan in accordance with the benefit formula of former Plan G. In this Example, no section 204(h) notice is required because no plan amendment was adopted that reduced the rate of future benefit accrual. Under the terms of Plan F as in effect prior to the merger, employees of Division P cease to accrue any further benefits under Plan F after the date of the sale because their employment with Corporation V terminated.

Q–16: How are amendments to cease accruals and terminate a plan treated under section 204(h)?

A–16: (a) *General rule*—(1) *Rule.* An amendment providing for the cessation of benefit accruals on a specified future date and for the termination of a plan is subject to section 204(h).

(2) *Example.* The following example illustrates the rule of paragraph (a)(1) of this Q&A–16:

Example. (i) An employer adopts an amendment that provides for the cessation of benefit accruals under a defined benefit plan on December 31, 2001, and for the termination of the plan pursuant to title IV of ERISA as of a proposed termination date that is also December 31, 2001. As part of the notice of intent to terminate required under title IV in order to terminate the plan, the plan administrator gives section 204(h) notice of the amendment ceasing accruals, which states that benefit accruals will cease ‘‘on December 31, 2001.’’ However, because all the requirements of title IV for a plan termination are not satisfied, the plan cannot be terminated until a date that is later than December 31, 2001.

(ii) Nonetheless, because section 204(h) notice was given stating that the plan was amended to cease accruals on December 31, 2001, section 204(h) does not prevent the amendment to cease accruals from being effective on December 31, 2001. The result would be the same had the section 204(h) notice informed the participants that the plan was amended to provide for a proposed termination date of December 31, 2001, and to provide that ‘‘benefit accruals will cease on the proposed termination date whether or not the plan is terminated on that date.’’ However, the cessation of accruals would not be effective on December 31, 2001, had the section 204(h) notice merely stated that benefit accruals would cease ‘‘on the termination date or on the proposed termination date.

(b) *Terminations in accordance with title IV of ERISA.* A plan that is terminated in accordance with title IV of ERISA is deemed to have satisfied section 204(h) not later than the termination date (or date of termination, as applicable) established under section 4048 of ERISA. Accordingly, section 204(h) would in no event require that any additional benefits accrue after the effective date of the termination.

(c) *Amendment effective before termination date of a plan subject to title IV of ERISA.* To the extent that an amendment providing for a significant reduction in the rate of future benefit accrual has an effective date that is earlier than the termination date (or date of termination, as applicable) established under section 4048 of ERISA, that amendment is subject to section 204(h). Accordingly, the plan administrator must provide section 204(h) notice (either separately or with or as part of the notice of intent to terminate) with respect to such an amendment.

Q–17: When does section 204(h) become effective?

A–17: (a) *Statutory effective date.* With respect to defined benefit plans, section 204(h) generally applies to plan amendments adopted on or after January 1, 1986. With respect to individual account plans, section 204(h) applies to plan amendments adopted on or after October 22, 1986.

(b) *Regulatory effective date*—(1) *General regulatory effective date.* This section is applicable for amendments adopted on or after December 12, 1998.

(2) *Special rule for amendments adopted under the temporary regulations.* Whether an amendment that is adopted on or after December 15, 1995 and before December 12, 1998 complies with section 204(h) is determined under the rules of §1.411(d)–6T in effect prior to December 14, 1998 (See 1.411(d)–6T in 26 CFR part 1 revised as of April 1, 1998).

[T.D. 8795, 63 FR 68680, Dec. 14, 1998]

§1.412(b)–2 Amortization of experience gains in connection with certain group deferred annuity contracts.

(a) *Experience gain treatment.* Dividends, rate credits, and credits for forfeitures arising in a plan described in paragraph (b) of this section are experience gains described in section 412(b)(3)(B)(ii) (relating to the amortization of experience gains).

(b) *Plan.* A plan is described in this paragraph (b) if—

(1) The plan is funded solely through a group deferred annuity contract,

(2) The annual single premium required under the contract for the purchase of the benefits accruing during the plan year is treated as the normal cost of the plan for that year, and

(3) The amount necessary to pay in equal annual installments, over the appropriate amortization period, an amount equal to the single premium necessary to provide all past service benefits not initially funded, together with interest thereon, is treated as the annual amortization amount determined under section 412(b)(2)(B) (i), (ii) or (iii).

(c) *Effective date.* This section applies for the first plan year to which section 412 applies that begins after May 22, 1981.

[T.D. 7764, 46 FR 6923, Jan. 22, 1981]

§ 1.412(b)–5 Election of the alternative amortization method of funding.

(a) *Alternative amortization method in general.* Section 1013(d) of the Employee Retirement Income Security Act of 1974 provides an alternative method which may be used by certain multiemployer plans (as defined in section 414(f)) which were in existence on January 1, 1974, for funding certain unfunded past service liability. The multiemployer plans which may elect to use this alternative method are those plans (1) under which, on January 1, 1974, contributions were based on a percentage of pay, (2) which use actuarial assumptions with respect to pay that are reasonably related to past and projected experience, and (3) which use rates of interest that are determined on the basis of reasonable acturial assumptions. The unfunded past service liability to which this method applies is that amount existing as of the date 12 months after the date on which section 412 first applies to the plan. The alternative method allows the plan to fund this liability over a period of 40 plan years by charging the funding standard account with an equal annual percentage of the aggregate pay of all participants in the plan instead of the level dollar charges required under section 412(b)(2)(B). Paragraphs (b), (c), (d) and (e) of this section contain procedural rules for electing this alternative method.

(b) *Election procedure.* To elect the alternative amortization method, a multiemployer plan must attach a statement to the annual report required under section 6058(a) for the plan year for which the election is made, stating that the alternative method for funding unfunded past service liability is being adopted. Advance approval from the Internal Revenue Service is not required. The alternative method must be adopted on or before the last day prescribed for filing the annual report corresponding to the last plan year beginning before January 1, 1982.

(c) *Charges to which the alternative amortization method is applicable.* Once elected, the alternative amortization method is applicable to the unfunded past service liability existing as of the date 12 months after the date on which section 412 first applies to the plan. This results in charges to the funding standard account which are in lieu of—

(1) Charges required under clause (i) of section 412(b)(2)(B), and

(2) Charges required under clause (iii) of section 412(b)(2)(B) if the plan amendments referred to in such clause result in a net increase in the unfunded past service liability existing as of the date 12 months after the date on which section 412 first applies to the plan. Such charges generally will arise only with respect to plan amendments adopted in the first plan year to which section 412 applies.

If the election is made on an annual report corresponding to a plan year after the first plan year to which section 412 applies, recomputation of the contributions due in the prior years (to which section 412 applied) will be necessary.

(d) *Limitation.* The sum of the charges described in this paragraph may not be less than the interest on the unfunded past service liabilities described in section 412(b)(2)(B) (i) and (iii), determined as of the date 12 months after the date on which section 412 first applies to the plan.

(e) *Reporting requirements.* Each annual report required by section 6058(a) and periodic report of the actuary required by section 6059 must include all additional information relevant to the use of the alternative amortization method as may be required by the applicable forms and the instructions for such forms.

[T.D. 7702, 45 FR 40113, June 13, 1980]

§ 1.412(c)(1)–1 Determinations to be made under funding method—terms defined.

(a) *Actuarial cost method and funding method.* Section 3 (31) of the Employee Retirement Income Security Act of 1974 (''ERISA'') provides certain acceptable (and unacceptable) actuarial cost methods which may (or may not) be used by employee plans. The term ''funding method'' when used in section 412 has the same meaning as the term ''actuarial cost method'' in section 3 (31) of ERISA. For shortfall method for certain collectively bargained plans, see § 1.412(c)(1)–2; for principles applicable to funding methods in general, see regulations under section 412(c)(3).

(b) *Computations included in funding method.* The funding method of a plan includes not only the overall funding method used by the plan but also each specific method of computation used in applying the overall method. However, the choice of which actuarial assumptions are appropriate to the overall method or to the specific method of computation is not a part of the funding method. For example, the decision to use or not to use a mortality factor in the funding method of a plan is not a part of such funding method. Similarly, the specific mortality rate determined to be applicable to a particular plan year is not part of the funding method. See section 412(c)(5) for the requirement of approval to change the funding method used by a plan.

[T.D. 7733, 45 FR 75202, Nov. 14, 1980]

§1.412(c)(1)–2 Shortfall method.

(a) *In general*—(1) *Shortfall method.* The shortfall method is a funding method that adapts a plan's underlying funding method for purposes of section 412. As such, the use of the shortfall method is subject to section 412(c)(3). A plan described in paragraph (a)(2) of this section may elect to determine the charges to the funding standard account required by section 412(b) under the shortfall method. These charges are computed on the basis of an estimated number of units of service or production (for which a certain amount per unit is to be charged). The difference between the net amount charged under this method and the net amount that otherwise would have been charged under section 412 for the same period is a shortfall loss (gain) and is to be amortized over certain subsequent plan years.

(2) *Eligibility for use of shortfall.* No plan may use the shortfall method unless—

(i) The plan is a collectively bargained plan described in section 413(a), and

(ii) Contributions to the plan are made at a rate specified under the terms of a legally binding agreement applicable to the plan.

For purposes of this section, a plan maintained by a labor organization which is exempt from tax under section 501(c)(5) is treated as a collectively bargained plan and the governing rules of the organization (such as its constitution, bylaws, or other document that can be altered only through action of a convention of the organization) are treated as a collectively bargained agreement.

(b) *Computation and effect of net shortfall charge*—(1) *In general.* The ‘‘net shortfall charge’’ to the funding standard account under the shortfall method is the product of (i) the estimated unit charge described in paragraph (c) of this section that applies for a particular plan year, multiplied by (ii) the actual number of base units (for example, units of service or production) which occurred during that plan year. When the shortfall method is used, the net shortfall charge is a substitute for the specific charges and credits to the funding standard account described in section 412 (b)(2) and (3)(B).

(2) *Example.* Paragraph (b)(1) of this section may be illustrated by the following example:

Example. A pension plan uses the calendar year as the plan year and the shortfall method. Its estimated unit charge applicable to 1980 is 80 cents per hour of covered employment. During 1980, there were 125,000 hours of covered employment. The net shortfall charge for the plan year is $100,000 (*i.e.,* 125,000×$.80), regardless of the amount which would be charged and credited to the funding standard account under section 412 (b)(2) and (3)(B) had the shortfall method not applied. The funding standard account for 1980 will be separately credited for the amount considered contributed for the plan year under section 412 (b)(3)(A). The other items which may be credited, if applicable, are a waived funding deficiency and the alternative minimum funding standard credit adjustment under section 412(b)(3)(C) and (D) because these items are not credits under section 412(b)(3)(B).

(3) *Plans with more than one contract, contribution rate, employer, or benefit level*—(i) *General rule.* A single plan with more than one contract, contribution rate, employer, or benefit level may compute a separate net shortfall charge for each contract, contribution rate, each employer, or each benefit level. The sum of these charges is the plan's total net shortfall charge. under §1.412(c)(1)–1(b), the use of separate computations would be a specific method of computation used in applying the

overall funding method. See also paragraph (f)(5) of this section.

(ii) *Single valuation.* Only one actuarial valuation shall be made for the single plan on each actuarial valuation date.

(iii) *Reasonableness test.* The specific method of computation of the net shortfall charge must be reasonable, determined in the light of the facts and circumstances.

(c) *Estimated unit charge.* The estimated unit charge is the annual computation charge described in paragraph (d) of this section divided by the estimated base units of service or production described in paragraph (e) of this section.

(d) *Annual computation charge.* The annual computation charge for a plan year is the sum of the following amounts:

(1) The net charges and credits which, but for using the shortfall method, would be made under section 412 (b)(2) and (b)(3)(B).

(2) The amount described in paragraph (g)(3) of this section, if applicable, for amortization of shortfall gain or loss.

(e) *Estimated base units*—(1) *In general.* The estimated base units are the expected units of service or production for a plan year (hours, days, tons, dollars of compensation, etc.), determined as of the base unit estimation date for that plan year under paragraph (f) of this section. This estimate must be based on the past experience of the plan and the reasonable expectations of the plan for the plan year. The specific type of unit used must be described in the statement of funding method for the plan year. (See paragraph (i)(3) of this section for reporting requirements.)

(2) *Reasonable expectations.* The reasonableness of expectations used under paragraph (e)(1) of this section is determined under the facts and circumstances of the plan for each plan year as of the relevant base unit estimation date. Expectations will be considered unreasonable if, for example, they do not reflect a consistent and substantial decline or growth in actual base units that has occurred over the course of recent years and that is likely to continue beyond the base unit estimation date. This determination of reasonableness is independent of determinations made under section 412(c)(3) of the reasonableness of actuarial assumptions.

(f) *Base unit estimation date*—(1) *In general.* The base unit estimation date for the current plan year is determined under this paragraph (f). This date shall be an actuarial valuation date no earlier than the last actuarial valuation date occurring at least one year before the earliest date any current collectively bargained agreement in existence during the plan year came into effect.

(2) *Four-month rule.* For purposes of this paragraph (f), a current collectively bargained agreement is one in effect during at least four months of the current plan year.

(3) *Effective date of agreement.* For purposes of this paragraph (f), a collectively bargained agreement shall be deemed to have come into effect on the effective date of the agreement containing the currently effective provision for contributions to the plan or the benefits provided under the plan.

(4) *Long-term contract rule.* The effective date of a collectively bargained agreement shall be deemed not to occur prior to the first day of the third plan year preceding the current year.

(5) *Special rule for plans computing separate net shortfall charge.* A plan that computes a separate net shortfall charge for each contract, contribution rate, employer, or benefit level under paragraph (b)(3) of this section shall determine the base unit estimation date for each separate charge without regard to any collectively bargained agreement that does not relate to that contract, contribution rate, employer, or benefit level. If a collective bargaining agreement requiring contributions by a certain employer, or prescribing a certain benefit level, is in effect on December 31, 1980, the preceding sentence shall not apply to the computation of a separate net shortfall charge for that employer or benefit level until the earlier of—

(i) The first plan year beginning after the date on which expires the collective bargaining agreement requiring contributions by that employer (or the last collective bargaining agreement relating to that benefit level), or

(ii) The first plan year beginning after December 31, 1983.

(6) *Example.* The rules contained in paragraph (f) of this section are illustrated by the following table. In the table, ''V'' signifies actuarial valuation date (January 1 in each case shown); ''B'' signifies beginning of a contract; and ''E'' signifies end of a contract. The table shows the resulting earliest base unit estimation date with respect to the following assumed items:

COMPUTATION OF EARLIEST BASE UNIT ESTIMATION DATE

Example	Plan year (calendar year basis)											
	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
Plan A	V			V			V			V		
Contract 1	....	....	E/B	....	....	E/B	....	E/B	....	....	....	E/B
Base unit estimation date [1]				1973	1973	1973	1976	1976	1979	1979	1979	1979
Plan B	V			V			V			V		
Contract 2	[2]	[2]	[2]	B*	....	E/B	....	....	....	E/B*	....	....
Contract 3	E/B	....	....	E/B	....	....	E/B	....	....	E/B	....	....
Base unit estimation date [1]	....	....	....	1973	1973	1973	1976	1976	1976	1976	1979	1979
Plan C	V	V	V	V	V	V	V	V	V	V	V	V
Contract 4	....	....	E/B	....	....	E/B*	....	....	....	E/B*	....	....
Contract 5	....	....	E/B	....	....	E/B*	....	....	....	....	E/B*	....
Base unit estimation date [1]				1974	1974	1977	1977	1977	1977	1978	1979	1981

[1] The base unit estimation date may be on or any time after the actuarial valuation date in the year indicated on this line.
[2] No contract.
* Denotes that a prior contract ends and a new contract begins prior to the fifth month of a plan year.

(g) *Amortization of shortfall gain or loss*—(1) *Definition.* The shortfall gain for a plan is the excess for the plan year of—

(i) The net shortfall charge computed under paragraph (b) of this section over

(ii) The annual computation charge described in paragraph (d) of this section.

The shortfall loss for a plan is the excess for the plan year of the annual computation charge over the net shortfall charge.

(2) *Shortfall amortization period*—(i) *First year.* The plan year in which the amortization of a shortfall gain or loss must begin is the earlier of two years: the fifth plan year following the plan year in which the shortfall gain or loss arose, or the first plan year beginning after the latest scheduled expiration date of a collectively bargained agreement in effect with respect to the plan during the plan year in which the shortfall gain or loss arose. For purposes of this subparagraph, a contract expiring on the last day of a plan year shall be deemed to be renewed on such last day for the same period of years as the contract that succeeds the expiring contract.

(ii) *Last year.* The plan year in which the amortization of a shortfall gain or loss must end is the 15th plan year following the plan year in which the shortfall gain or loss arose. For a multiemployer plan described in section 414(f), the amortization must end with the 20th plan year instead of the 15th.

(3) *Annual amortization amount.* The shortfall gain or loss must be amortized in equal annual installments. The total amount to be amortized must be adjusted for interest at the rate used for determining the plan's normal cost.

(4) *Shortfall gain or loss under spread gain type of funding method*—(i) *In general.* A spread gain type of funding method spreads experience gains and losses over future periods as part of a plan's normal cost. (Examples of spread gain types of funding methods are the aggregate cost method, the frozen initial liability method, and the attained age normal method.) However, a shortfall gain or loss is not an experience gain or loss. Therefore, a plan using a spread gain type of funding method together with the shortfall method must

amortize shortfall gains and losses and otherwise meet the requirements of paragraph (g) of this section.

(ii) *Asset adjustment for aggregate method.* A plan using the shortfall method with the aggregate cost method of funding must adjust its plan assets for a shortfall gain or loss in calculating normal cost. The unamortized portion of any shortfall gain is subtracted from plan assets. The unamortized portion of any shortfall loss is added to plan assets.

(5) *Reconciliation of shortfall gain or loss with funding standard account.* At the beginning of each year, the actual unfunded liability under the method used by the plan must equal the outstanding balance of all amortization bases, including bases for shortfall gains and losses, less the credit balance under the funding standard account at the end of the prior year.

(6) *Example.* This paragraph is illustrated by the following examples:

Example (1). A multiemployer plan described in section 414 (f) is maintained with the calendar year as the plan year and uses the shortfall method. The plan uses the frozen initial liability funding method. A five percent interest assumption is used by the plan, with payments computed as of the first day of each plan year for all items. The expiration dates of contracts in effect during plan years 1976, 1977, and 1978 are such that the amortization of gains or losses for each year must begin in the fifth following plan year. The assumed plan costs and estimated base units for selected years, and the computations under this section which follow from such assumptions are shown in the following table. In the table, ‘‘*’’ denotes an assumed item. The remaining figures have been calculated on the basis of these assumptions.

(A) COMPUTATION OF NET SHORTFALL CHARGE AND SHORTFALL GAIN OR LOSS

Plan year	1976	1977	1978
1. Normal cost* ..	$100,000	$100,000	$100,000
2. Amortization of unfunded liability*	50,000	50,000	50,000
3. Total annual computation charges	$150,000	$150,000	$150,000
4. Estimated base units*	100,000	100,000	100,000
5. Estimated unit charge (line 3÷line 4)	$1.50	$1.50	$1.50
6. Actual units during year*	80,000	90,000	110,000
7. Net shortfall charge for year (line 5×line 6) ..	120,000	135,000	165,000
8. Shortfall (gain) or loss (line 3 − line 7)	30,000	15,000	($15,000)

(B) ANNUAL AMORTIZATION AMOUNT

9. Year of shortfall gain or loss	1976	1977	1978
10. First year of amortization	1981	1982	1983
11. Last year of amortization	1996	1997	1998
12. (Gain) or loss adjusted for interest to year amortization begins (1–1–76 to 1–1–81, etc.)	$38,288	$19,144	($19,144)
13. Annual amortization (16 years)	$3,364	$1,682	($1,682)

(C) COMPUTATION OF NET SHORTFALL CHARGES FOR SELECTED YEARS (INCLUDING SHORTFALL AMORTIZATION)

Plan year	1981	1982	1983
14. Normal cost*	$120,000	$125,000	$130,000
15. Amortization of unfunded liability*	50,000	50,000	50,000
16. Shortfall amortization (see line 13) from:			
1976	3,364	3,364	3,364
1977	....	1,682	1,682
1978	....	....	(1,682)
17. Total annual computation charges	173,364	180,046	183,364
18. Estimated base units*	110,000	110,000	110,000
19. Estimated unit charge (line 17÷line 18)	1.576	1.637	1.667
20. Actual units during year*	105,000	110,000	105,000
21. Net shortfall charge for year (line 19×line 20)	165,480	180,070	175,035
22. Shortfall (gain) loss (line 17 − line 21)	7,884	(24)	8,329

The amounts in line 22 will be amortized beginning 1986, 1987, and 1988, respectively. The $24 gain in 1982 results from rounding the estimated unit charge.

Example (2). Assume the facts in Example (1). Also assume that the plan uses the frozen initial liability funding method, that the unfunded liability as of January 1, 1976 (corresponding to a 40-year charge of $50,000 due at the beginning of the year) is $900,850, and that actual contributions at the rate of $1.75 per unit are paid at mid-year in 1976.

(A) COMPUTATION OF THE UNFUNDED LIABILITY AS OF DECEMBER 31, 1976

1. Unfunded liability as of 1/1/76	$900,850
2. Normal cost (that used in the calculation of the total annual computation charges)	100,000
3. Interest at 5% due on items 1 and 2	50,043
4. Contribution with interest: $1.75×80,000×1.025 (actual contribution rate times acutal base units times interest adjustment from mid-year)	143,500
5. Unfunded liability as of 12/31/76: item 1+item 2+item 3 – item 4	907,393

(B) COMPUTATION OF THE OUTSTANDING BALANCE OF THE BASES AS OF DECEMBER 31, 1976

1. Original base: ($900,850 – $50,000)×1.05	$893,393
2. Shortfall loss $30,000×1.05	31,500
3. Total	924,893

(C) COMPUTATION OF THE CREDIT BALANCE AS OF DECEMBER 31, 1976

1. Net shortfall charge (§ 1.412 (c) (1)–2 (b)) adjusted for interest: $120,000×1.05	$126,000
2. Actual contributions with interest	143,500
3. Credit balance as of 12/31/76: item 2 – item 1	17,500

(D) RECONCILIATION OF COMPUTATIONS

As of January 1, 1977, the unfunded liability ($907,393) equals the outstanding balance of the bases minus the credit balance ($924,893 – $17,500=$907,393).

(h) *Amortization of experience gain or loss*—(1) *General rule.* In the case of a plan using an immediate gain type of funding method, an experience gain or loss shall be amortized pursuant to section 412 (b)(2)(B)(iv) or (b)(3)(B)(ii). (Examples of the immediate gain type of funding method are the unit credit method, the entry age normal cost method, and the individual level premium cost method.) For purposes of this section, a shortfall gain or loss is not an experience gain or loss. The amount of the experience gain or loss must be adjusted for interest at the rate used for determining the plan's normal cost.

(2) *Experience amortization period under shortfall method*—(i) *First year.* The plan year in which the amortization of an experience gain or loss must begin in the case of a plan using the shortfall method is the earlier of two years: the fifth plan year following the plan year in which the experience gain or loss arose, or the first plan year beginning after the last scheduled expiration date of a contract in effect during the plan year in which the experience gain or loss arose. For purposes of this subparagraph a contract expiring on the last day of the plan year shall be deemed to be renewed on such last day for the same period of years as the contract that succeeds the expiring contract.

(ii) *Last year.* The plan year in which the amortization of an experience gain or loss must end in the case of a plan using the shortfall method is the 15th plan year following the plan year in which the experience gain or loss arose. For a multi-employer plan described in section 414 (f), the amortization must end with the 20th plan year instead of the 15th.

(3) *Use of annual computation charge in determining experience gain or loss.* In the case of a plan using an immediate gain type of funding method, an experience gain or loss is the difference between the expected unfunded liability and the actual unfunded liability under the plan. The expected unfunded liability as of the end of a plan year equals the actual unfunded liability as of the beginning of the year plus normal cost, minus contributions, all adjusted for interest. If the plan adopts the shortfall method, the expected unfunded liability is computed by using the normal cost applicable for the plan year in determining the annual computation charge under paragraph (d) of this section. The same normal cost is used in computing the unfunded liability under the frozen initial liability funding method.

(4) *Example.* This paragraph is illustrated by the following example:

Example. Assume the facts in Example (2) from paragraph (g) (6) of this section, except that the entry age normal funding method is used. Also assume that as of December 31, 1976, the actual unfunded liability is $900,000.

(A) COMPUTATION OF EXPECTED UNFUNDED LIABILITY

1. Actual unfunded liability as of 1–1–76	$900,850

(A) COMPUTATION OF EXPECTED UNFUNDED LIABILITY—Continued

2. Normal cost portion of annual computation charge as of 1–1–76	100,000
3. Interest at 5% due on items 1 and 2	50,043
4. Contribution received with interest: $1.75 × 80,000 × 1.025 (actual contribution rate times actual base units times interest adjustment at mid-year)	143,500
5. Expected unfunded liability as of 12–31–76 (item 1 + item 2 + item 3 − item 4)	907,393

(B) COMPUTATION OF GAIN OR LOSS

1. Expected unfunded liability as of 12–31–76	$907,393
2. Actual unfunded liability as of 12–31–76	900,000
3. Gain (or loss) (item 1 − item 2)	7,393

(i) *Election procedure*—(1) *In general.* To elect the shortfall method, a collectively bargained plan must attach a statement to the annual report required under section 6058 (a) for the first plan year to which it is applied. The statement shall state that the shortfall method is adopted, beginning with the plan year covered by such report. Advance approval from the Internal Revenue Service is not required if the shortfall method is first adopted on or before the later of—

(i) The first plan year to which section 412 applies or

(ii) The last plan year commencing before December 31, 1981.

However, approval must be received pursuant to section 412(c)(5) prior to the adoption of the shortfall method at a later time, or the discontinuance of such method, once adopted.

(2) *Use of specific computation method.* A specific method of computation under the shortfall method is described in paragraph (b)(3) of this section, regarding the treatment of more than one contract, employer, or benefit level under the plan. This specific method may be adopted with respect to any plan year to which the shortfall method applies. Approval from the Commissioner must be received under section 412(c)(5) prior to the adoption of this specific computation method for a plan year subsequent to the first plan year to which the shortfall method applies, or prior to the discontinuance of a specific computation method, once adopted.

(3) *Reporting requirements.* Each annual report required by section 6058(a) and periodic report of the actuary required by section 6059 must include all additional information relevant to the use of the shortfall method as may be required by the applicable forms and the instructions for such forms.

(j) *Transitional rule.* In lieu of paragraphs (g)(2) and (h)(2) of this section relating to the amortization period for shortfall and experience gains and losses, for gains and losses arising in plan years beginning before January 1, 1981, a plan may rely on the prior published position of the Internal Revenue Service with respect to the amortization period for shortfall and experience gains and losses.

(k) *Supersession.* This section and § 1.412 (c) (1)–1 supersede §§ 11.412 (c) (1)–1 and (c) (1)–2 of the Temporary Income Tax Regulations Under the Employee Retirement Income Security Act of 1974.

(Secs. 412, 7805, Internal Revenue Code of 1954 (88 Stat. 914 and 68A Stat. 917; (26 U.S.C. 412 and 7805)), and sec. 3 (31) of the Employee Retirement Income Security Act of 1974 (88 Stat. 837; (29 U.S.C. 1002)))

[T.D. 7733, 45 FR 75202, Nov. 14, 1980]

§ 1.412(c)(1)–3 Applying the minimum funding requirements to restored plans.

(a) *In general*—(1) *Restoration method.* The restoration method is a funding method that adapts the underlying funding method of section 412 in the case of certain plans that are or have been terminated and are later restored by the Pension Benefit Guaranty Corporation (PBGC). The normal operation of the funding standard account, and all other provisions of section 412 and the regulations thereunder, are unchanged except as provided in this § 1.412(c)(1)–3. Under the restoration method, the PBGC shall determine a restoration payment schedule, extending over no more than 30 years, that replaces all charges and credits to the funding standard account attributable to pre-restoration amortization bases. The restoration payment schedule is determined on the basis of an actuarial valuation of the accrued liability of the plan on the initial post-restoration valuation date less the actuarial value of the plan assets on that date. The initial post-restoration valuation date is the date of the valuation that falls in the first plan year beginning on or after the date of the restoration order.

(2) *Applicability of restoration method.* A plan must use the restoration method if, and only if—

(i) The plan is being or has been terminated pursuant to section 4041(c) or section 4042 of the Employee Retirement Income Security Act of 1974 (ERISA); and

(ii) The plan has been restored by the PBGC pursuant to its authority under section 4047 of ERISA.

(b) *Computation and effect of the initial restoration amortization base*—(1) *In general.* The initial restoration amortization base is determined under the underlying funding method used by the plan. When the plan uses a spread gain funding method that does not maintain an unfunded liability, the plan must change either to an immediate gain method that directly calculates an accrued liability or to a spread gain method that maintains an unfunded liability. A plan may adopt any cost method that satisfies this requirement and that is acceptable under section 412 and the regulations thereunder, provided that the plan administrator follows the procedures established by the Commissioner for changes in funding methods. The initial restoration amortization base is determined using the valuation for the plan year in which the initial post-restoration valuation date falls. The initial restoration amortization base equals the accrued liability with respect to plan benefit liabilities returned by the PBGC less the value of the plan assets returned by the PBGC. The initial restoration amortization base replaces all prior amortization bases including those under section 412(b)(2) (B), (C), and (D) and under section 412(b)(3)(B). Any base resulting from a change in funding method, including a change required under this paragraph, is treated as a prior amortization base within the meaning of this paragraph (b). Any accumulated funding deficiency or credit balance in the funding standard account is set equal to zero when the initial restoration amortization base is established.

(2) *Example.* The following example illustrates the provisions of this paragraph (b):

Example. A pension plan uses the calendar year as its plan year, makes its annual periodic valuation as of January 1, and uses the unit credit actuarial cost method for funding purposes. The plan is in the process of being terminated. By order of the PBGC the plan is restored as of July 1, 1991. The initial post-restoration valuation date is January 1, 1992, and a restoration payment schedule order is issued on October 31, 1992. If, as of January 1, 1992, the accrued liability of the plan is $1,000,000 and the value of the plan assets is $200,000, the initial restoration amortization base is $800,000.

(c) *Establishment of a restoration payment schedule*—(1) *Certification requirement.* When the PBGC establishes a restoration payment schedule, the Executive Director of the PBGC must certify to the PBGC's Board of Directors, and to the Internal Revenue Service, that the PBGC has reviewed the funding of the plan, the financial condition of the plan sponsor and its controlled group members, the payments required under the restoration payment schedule (taking into account the availability of deferrals authorized under paragraph (c)(4) of this section), and any other factor that the PBGC deems relevant, and, based on that review, determines that it is in the best interests of participants and beneficiaries of the plan and the pension insurance program that the restored plan not be reterminated.

(2) *Requirements for restoration payment schedule*—(i) *Amortization of base over period of no more than 30 years.* The restoration payment schedule must be prescribed in an order requiring the employer to make stated contributions to the plan sufficient to amortize the initial restoration amortization base over a period extending not more than 30 years after the initial post-restoration valuation date (the restoration payment period). Payments included in the restoration payment schedule order are charged to the funding standard account of the plan at the end of each plan year in accordance with paragraph (d) of this section. The restoration payment schedule must provide for total charges that are sufficient to amortize the entire amount of the initial restoration amortization base by the end of the restoration payment period. The scheduled charges need not be in level amounts, but the present value of the

prescribed charges on the initial post-restoration valuation date, computed with interest at the valuation rate, must equal the initial restoration amortization base.

(ii) *Minimum annual charge.* The restoration payment schedule must prescribe annual charges that are sufficient to prevent the outstanding balance of the initial restoration amortization base from exceeding whichever of the following amounts is applicable—

(A) During the first 10 plan years on the restoration payment schedule, the amount of the initial restoration amortization base on the date the base was established; or

(B) During plan years 11 through 20 on the restoration payment schedule, the maximum permitted outstanding balance of the initial restoration amortization base at the end of the tenth plan year, as calculated under paragraph (c)(2)(iii) of this section; or

(C) During plan years 21 through the end of the restoration payment schedule, the maximum permitted outstanding balance of the initial restoration amortization base at the end of the twentieth plan year, as calculated under paragraph (c)(2)(iii) of this section.

(iii) *Interim amortization requirements.* The restoration payment schedule must provide for sufficient periodic charges so that the outstanding balance of the initial restoration amortization base at the end of the tenth plan year and at the end of the twentieth plan year of the restoration payment period will not be larger than the outstanding balance that would have remained at the end of the tenth plan year and at the end of the twentieth plan year, respectively, if the initial restoration amortization base had been amortized in level annual amounts over the restoration payment period at the valuation rate.

(3) *Amendments to the restoration payment schedule.* The order establishing the restoration payment schedule may be amended by the PBGC from time to time with respect to any remaining payments, provided that no amendment may extend the restoration payment period beyond 30 years from the initial post-restoration valuation date, and provided further that the restoration payment schedule, as amended, satisfies the requirements of paragraph (c)(2) of this section.

(4) *Deferral of minimum scheduled annual payment amounts*—(i) *Authority to grant deferral.* Not later than 2½ months following the end of the plan year, the PBGC may grant a deferral of the charges required in the restoration payment schedule for that plan year if the requirements in paragraph (c)(4)(ii) of this section are satisfied. The PBGC may require the plan sponsor and its controlled group members to provide security to the plan as a condition to granting a deferral.

(ii) *Determination of business hardship.* Before granting a deferral under this paragraph (c)(4), the PBGC must make a determination that the granting of the deferral is in the best interests of plan participants and the plan termination insurance system, and that the plan sponsor and its controlled group members are unable to make the scheduled restoration payments without experiencing temporary substantial business hardship. In making these determinations, the factors the PBGC shall consider, include, but are not limited to, the following—

(A) Whether the plan sponsor and its controlled group members are operating at an economic loss;

(B) Whether there is substantial unemployment or underemployment in the trades or businesses of the plan sponsor and its controlled group members;

(C) Whether the sales and profits of the industry or industries are depressed or declining; and

(D) Whether it is reasonable to expect that the plan termination insurance system will suffer a greater loss if the plan is terminated than if it is continued as a restored plan.

(iii) *Amount of deferral.* The amount of the deferral for any particular plan year may not exceed the lesser of the amount that would have been required to be contributed under the restoration payment schedule for that year or interest at the valuation rate on the outstanding balance of the initial restoration amortization base for that year. An amortization payment for a deferral granted for a prior plan year may not be deferred. No deferral may extend the overall restoration payment period beyond 30 years.

(iv) *Modification of payment schedule.* The restoration payment schedule must be adjusted to reflect any deferral granted for a plan year in the manner prescribed in this paragraph (c). The charge otherwise specified in the schedule is reduced by the amount of any deferral. The charges under the restoration payment schedule for the subsequent plan years are increased by the amounts in paragraph (c)(4)(v) of this section.

(v) *Amortization of deferred amount.* The amount of any deferral granted by the PBGC for any plan year must be amortized in level amounts over five years or such shorter period as may be prescribed by the PBGC, at the valuation rate, beginning with the plan year following the year of the deferral.

(vi) *Number of deferrals permitted.* The PBGC may not grant more than five deferrals of the minimum scheduled payments as required by this section during the restoration payment period and no more than three of these deferrals may be granted during the first ten years of that period.

(vii) *Deferrals override minimum annual charges and interim amortization requirements.* In determining the minimum annual charge under paragraph (c)(2)(ii) of this section and in applying the interim amortization requirements of paragraph (c)(2)(iii) of this section, the unamortized balances of any deferrals granted by the PBGC under this paragraph shall be added to the outstanding balance of the initial restoration amortization base otherwise allowable.

(d) *Charging the scheduled restoration payments to the funding standard account.* In addition to any other charges and credits prescribed in the normal operation of the funding standard account under section 412, the amount of each payment specified in the restoration payment schedule shall be charged against the funding standard account of the plan for the plan year to which that payment is attributed in the restoration payment schedule. To the extent that the restoration payment schedule provides for payments before the end of the plan year, the annual charge to the funding standard account attributable to the restoration payment schedule is equal to the sum of the periodic payments for the plan year accumulated with interest at the valuation rate to the last day of the plan year.

(e) *Changes in actuarial assumptions or methods.* The plan administrator must notify the PBGC of any changes in the actuarial assumptions or methods used by the plan. Upon notification of any such change, the PBGC may make any changes to the restoration payment schedule that it deems appropriate.

(f) *Change to restoration method.* A plan that has been restored must use the restoration method until the initial restoration amortization base has been fully amortized. The use of this method does not require prior approval from the Commissioner. A plan using the restoration method must compute the charges to the funding standard account to amortize the initial restoration amortization base in accordance with the order of the PBGC and in accordance with this section.

(g) *Deficit reduction contribution*—(1) *Calculation of deficit reduction contribution.* For any plan using the restoration method, the deficit reduction contribution under section 412(l)(2) is equal to the sum of—

(i) The unfunded section 412(l) restoration liability amount; plus

(ii) The unfunded new liability amount.

(2) *Unfunded section 412(l) restoration liability amount.* The unfunded section 412(l) restoration liability amount is the amount necessary to amortize fully the unfunded section 412(l) restoration liability in installments, as prescribed by the PBGC, over not more than 30 years. The annual amount need not be level, but at all times the present value of the future amortization charges prescribed under the restoration payment schedule, at the current liability interest rate, must equal the outstanding balance of the unfunded section 412(l) restoration liability and the schedule must provide that at the end of no more than 30 years the entire amount of the unfunded section 412(l) restoration liability base will have been fully amortized. The schedule prescribed for amortization of the unfunded section

412(l) restoration liability must comply with the requirements imposed in paragraph (c) of this section on the restoration payment schedule, except as provided in paragraph (g)(7) of this section and except that the maximum permitted outstanding balance of the unfunded section 412(l) restoration liability at the end of the tenth plan year must not be greater than the outstanding balance of the section 412(l) restoration liability that would have remained at the end of the tenth plan year if the unfunded section 412(l) restoration liability had been amortized in level amounts over the restoration payment period at the actual current liability interest rate for each year, increased by the current liability interest rate differential as defined under paragraph (g)(7) of this section. The unfunded section 412(l) restoration liability amount for the tenth plan year otherwise prescribed under the restoration payment schedule is increased by any outstanding current liability interest rate differential. By issuing an appropriate order, the PBGC may permit the outstanding current liability interest rate differential to be amortized over the tenth through the fourteenth plan years. If the PBGC permits the amortization of the outstanding current liability interest rate differential, then the unfunded section 412(l) restoration liability amount for each year to which an amortization payment is attributed under the order shall be increased by such payment. The outstanding balance otherwise required by paragraph (g)(2) of this section is increased by the outstanding balance, if any, of the base resulting from the amortization of the current liability interest rate differential. The PBGC may amend the amortization schedule for the unfunded section 412(l) restoration liability subject to the limits on amendments to the amortization schedule prescribed for the initial restoration amortization base.

(3) *Establishment of unfunded section 412(l) restoration liability.* In the plan year in which the initial post-restoration valuation date falls, the unfunded section 412(l) restoration liability is equal to the unfunded current liability of the plan.

(4) *Unfunded new liability amount.* In the case of a plan using the restoration method, the unfunded new liability amount is the applicable percentage, as defined in section 412(l)(4)(C), of the unfunded new liability determined under paragraph (g)(5) of this section.

(5) *Unfunded new liability.* The unfunded new liability of a plan using the restoration method is the excess, if any, of the unfunded current liability of the plan, within the meaning of section 412(l)(8)(A) for the plan year (determined without taking into account any unpredictable contingent event benefits, even if the event has occurred) over the outstanding balance of the unfunded section 412(l) restoration liability determined under paragraph (g)(3) of this section.

(6) *Offset of amortization charges.* The amounts charged to the funding standard account pursuant to the restoration payment schedule in order to amortize the initial restoration base, as described in paragraph (d) of this section, must be offset against the deficit reduction contribution in paragraph (g)(1) of this section along with any other applicable amounts provided in section 412(l)(1)(A)(ii).

(7) *Interest rate differential.* During the first 10 plan years after the initial post-restoration valuation date, the restoration payment schedule must prescribe an unfunded section 412(l) restoration liability amount for each plan year that is sufficient to prevent the outstanding balance of the unfunded section 412(l) restoration liability from exceeding the initial amount of the unfunded section 412(l) restoration liability increased by the current liability interest rate differential. The current liability interest rate differential at any point during the first ten years of the restoration payment period is the excess, if any, of the outstanding balance of the unfunded section 412(l) restoration liability determined using the actual current liability interest rate for each year, taking into account the charges described in paragraph (d) of this section, over the outstanding balance of the unfunded section 412(l) restoration liability determined using the lowest, for each

year, of the initial current liability interest rate, the current liability interest rate for the computation year, and the valuation interest rate, taking into account the charges described in paragraph (d) of this section.

(h) *Election of the alternative minimum funding standard.* A plan using the restoration method may not elect the alternative minimum funding standard under section 412(g).

(i) *Funding review by the PBGC.* The PBGC must review the funding of any plan using the restoration method at least once in each plan year. As a result of a funding review, the PBGC may amend the restoration payment schedule as provided in paragraph (c)(3) of this section. As part of the funding review, the Executive Director of the PBGC must certify to the PBGC's Board of Directors, and to the Internal Revenue Service, that the PBGC has reviewed the funding of the plan, the financial condition of the plan sponsor and its controlled group members, the payments required under the restoration payment schedule (taking into account the availability of deferrals authorized under paragraph (c)(4) of this section), and any other factor that the PBGC deems relevant, and, based on that review, determines that it is in the best interests of participants and beneficiaries of the plan and the pension insurance program that the restored plan not be reterminated.

[T.D. 8494, 58 FR 54491, Oct. 22, 1993]

§1.412(c)(1)–3T Applying the minimum funding requirements to restored plans (Temporary).

(a) *In general*—(1) *Restoration method.* The restoration method is a funding method that adapts the underlying funding method of section 412 in the case of certain plans that are or have been terminated and are later restored by the Pension Benefit Guaranty Corporation. The normal operation of the funding standard account, and all other provisions of section 412 and the regulations thereunder, are unchanged except as provided in this §1.412(c)(1)–3T. Under the restoration method, the Pension Benefit Guaranty Corporation shall determine a restoration payment schedule, extending over no more than 30 years, that replaces all charges and credits to the funding standard account attributable to pre-restoration amortization bases. The restoration payment schedule is determined on the basis of an actuarial valuation of the accrued liability of the plan on the initial post-restoration valuation date less the actuarial value of the plan assets on that date. The initial post-restoration valuation date is the date of the first valuation that falls in the first plan year beginning on or after the later of October 23, 1990, or the date of the restoration order.

(2) *Applicability of restoration method.* A plan must use the restoration method if, and only if:

(i) The plan is being or has been terminated pursuant to section 4041(c) or section 4042 of the Employee Retirement Income Security Act of 1974 (ERISA), and

(ii) The plan has been restored by the Pension Benefit Guaranty Corporation pursuant to its authority under section 4047 of ERISA.

(b) *Computation and effect of the initial restoration amortization base*—(1) *In general.* The initial restoration amortization base is determined under the underlying funding method used by the plan. When the plan uses a spread gain funding method that does not maintain an unfunded liability, the plan must change either to an immediate gain method that directly calculates an accrued liability or to a spread gain method that maintains an unfunded liability. A plan may adopt any cost method that satisfies this requirement and that is acceptable under section 412 and the regulations thereunder, provided that the plan follows the procedures established by the Commissioner for changes in funding methods. The initial restoration amortization base is determined using the valuation for the plan year in which the initial post-restoration valuation date falls. The initial restoration amortization base equals the accrued liability with respect to plan benefit liabilities returned by the Pension Benefit Guaranty Corporation less the value of the plan assets returned by the Pension Benefit Guaranty Corporation. The initial restoration amortization base replaces all prior amortization bases including those under subparagraphs (B), (C), and (D) of section 412(b)(2) and under subparagraph (B) of section 412(b)(3). Any base resulting from a change in funding method is treated as a prior amortization base within the meaning of this paragraph (b). Any accumulated funding deficiency or credit balance in the funding standard account is set equal to zero when the initial restoration amortization base is established.

(2) *Example.* A pension plan uses the calendar year as its plan year, makes its annual periodic valuation as of January 1, and uses the unit credit actuarial cost method for funding purposes. The plan is in the process of being terminated. By order of the Pension Benefit Guaranty Corporation the plan is restored as of July 1, 1991, and a restoration payment schedule order issued on October 31, 1992. The initial post-restoration valuation date is January l, 1993. If, as of that date, the accrued liability of the plan is $1,000,000 and the value of the plan assets is $200,000, the initial restoration amortization base is $800,000.

(c) *Establishment of a restoration payment schedule*—(1) *Certification requirement.* When the PBGC establishes a restoration payment schedule, the Executive Director of the PBGC must certify to the Corporation's Board of Directors, and to the Internal Revenue Service, that the Corporation has reviewed the funding of the plan, the financial condition of the plan sponsor and its controlled group members, the payments required under the restoration payment schedule (taking into account the availability of deferrals authorized under paragraph (c)(4) of this section), and any other factor that the Corporation deems relevant, and, based on that review, determines that it is in the best interests of participants and beneficiaries of the plan and the pension insurance program that the restored plan not be reterminated.

(2) *Requirements for restoration payment schedule*—(i) *Amortization of base over period of no more than 30 years.* The restoration payment schedule must be prescribed in an order requiring the employer to make stated contributions to the plan sufficient to amortize the initial restoration amortization base over a period extending not more than 30 years after the initial post-restoration valuation date (the restoration payment period). The restoration payment schedule must be sufficient to amortize the entire amount of the initial restoration amortization base by the end of the restoration payment period. The scheduled charges need not be in level amounts, but the present value of the prescribed charges on the initial post-restoration valuation date, computed with interest at the valuation rate, must equal the initial restoration amortization base.

(ii) *Minimum annual charge.* The restoration payment schedule must require annual charges that are sufficient to prevent the outstanding balance of the initial restoration amortization base from exceeding whichever of the following amounts is applicable:

(A) During the first 10 plan years on the restoration payment schedule, the amount of the initial restoration amortization base on the date the base was established, or

(B) During plan years 11 through 20 on the restoration payment schedule, the maximum permitted outstanding balance of the initial restoration amortization base at the end of the tenth plan year, as calculated under paragraph (c)(2)(iii) below, or

(C) During plan years 21 through the end of the restoration payment schedule, the maximum permitted outstanding balance of the initial restoration amortization base at the end of the twentieth plan year, as calculated under paragraph (c)(2)(iii) below.

(iii) *Interim amortization requirements.* The restoration payment schedule must provide for sufficient periodic charges so that the outstanding balance of the initial restoration amortization base at the end of the tenth plan year and at the end of the twentieth plan year of the restoration payment period will not be larger than the outstanding balance that would have remained at the end of the tenth plan year and at the end of the twentieth plan year, respectively, if the initial restoration amortization base had been amortized in level amounts over the restoration payment period at the valuation rate.

(3) *Amendments to the restoration payment schedule.* The order establishing

the restoration payment schedule may be amended by the Pension Benefit Guaranty Corporation from time to time with respect to any remaining payments, provided that no amendment may extend the restoration payment period beyond 30 years from the initial post-restoration valuation date, and provided further that the restoration payment schedule, as amended, satisfies the requirements of paragraph (c)(2) of this section.

(4) *Deferral of minimum scheduled annual payment amounts*—(i) *Authority to grant deferral.* Not later than 2½ months following the end of the plan year, the Pension Benefit Guaranty Corporation may grant a deferral of the charges required in the restoration payment schedule for that plan year if the requirements in paragraph (c)(4)(ii) of this section are satisfied. The Pension Benefit Guaranty Corporation may require the plan sponsor and its controlled group members to provide security to the plan as a condition to granting a deferral.

(ii) *Determination of business hardship.* Before granting a deferral under this paragraph (c)(4), the Pension Benefit Guaranty Corporation must make a determination that the granting of the deferral is in the best interests of plan participants and the plan termination insurance system, and that the plan sponsor and its controlled group members are unable to make the scheduled restoration payments without experiencing temporary substantial business hardship. In making these determinations, the factors the Pension Benefit Guaranty Corporation shall consider, include, but are not limited to, the following:

(A) Whether the plan sponsor and its controlled group members are operating at an economic loss,

(B) Whether there is substantial unemployment or underemployment in the trades or businesses of the plan sponsor and its controlled group members,

(C) Whether the sales and profits of the industry or industries are depressed or declining, and

(D) Whether it is reasonable to expect that the plan termination insurance system will suffer a greater loss if the plan is terminated than if it is continued as a restored plan.

(iii) *Amount of deferral.* The amount of the deferral for any particular plan year may not exceed the lesser of the amount that would have been required to be contributed under the restoration payment schedule for that year or interest on the outstanding balance of the initial restoration amortization base for that year. An amortization payment for a deferral granted for a prior plan year may not be deferred. No deferral may extend the overall restoration payment period beyond 30 years.

(iv) *Modification of payment schedule.* The restoration payment schedule must be adjusted to reflect any deferral granted for a plan year in the manner prescribed in this paragraph (c). The charge otherwise specified in the schedule is reduced by the amount of any deferral. The charges under the restoration payment schedule for the subsequent plan years are increased by the amounts in paragraph (c)(4)(v) of this section.

(v) *Amortization of deferred amount.* The amount of any deferral granted by the Pension Benefit Guaranty Corporation for any plan year must be amortized in level amounts over five years or such shorter period as may be prescribed by the Pension Benefit Guaranty Corporation, at the valuation rate, beginning with the plan year following the year of the deferral.

(vi) *Number of deferrals permitted.* The Pension Benefit Guaranty Corporation may not grant more than five deferrals of the minimum scheduled payments as required by this section during the restoration payment period and no more than three of these deferrals may be granted during the first ten years of that period.

(d) *Charging the scheduled restoration charges to the funding standard account.* In addition to any other charges and credits prescribed in the normal operation of the funding standard account under section 412, the amount of each charge specified in the restoration payment schedule shall be charged against the funding standard account of the plan for the plan year to which that payment is attributed in the restoration payment schedule.

(e) *Changes in actuarial assumptions.* If changes in actuarial assumptions increase or decrease the charges that would be required to amortize the outstanding balance of the initial restoration amortization base over the remaining years of the restoration payment schedule, the plan must notify the Pension Benefit Guaranty Corporation of the changes so that it may make appropriate changes to the restoration payment schedule.

(f) *Change to restoration method.* A plan that has been restored must use the restoration method until the initial restoration amortization base has been fully amortized. The use of this method does not require prior approval from the Commissioner. A plan using the restoration method must compute the charges and credits to the initial restoration amortization base in accordance with the order of the Pension Benefit Guaranty Corporation and in accordance with this section.

(g) *Deficit reduction contribution*—(1) *Calculation of deficit reduction contribution.* For any plan using the restoration method, the deficit reduction contribution under section 412(l)(2) is equal to the sum of—

(i) The unfunded section 412(l) restoration liability amount, plus

(ii) The unfunded new liability amount.

(2) *Unfunded section 412(l) restoration liability amount.* The unfunded section 412(l) restoration liability amount is the amount necessary to amortize fully the unfunded section 412(l) restoration liability in installments, as prescribed by the Pension Benefit Guaranty Corporation, over not more than 30 years. The annual amount need not be level, but at all times the present value of the future amortization charges under the restoration payment schedule, at the current liability interest rate, must equal the outstanding balance of the unfunded section 412(l) restoration liability and the schedule must provide that at the end of no more than 30 years the entire amount of the unfunded section 412(l) restoration liability base will have been fully amortized. The schedule prescribed for amortization of the unfunded section 412(l) restoration liability must comply with the requirements imposed in paragraph (c) of this section on the restoration payment schedule, except as provided in paragraph (g)(7) of this section and except that the maximum permitted outstanding balance of the unfunded section 412(l) restoration liability at the end of the tenth plan year must not be greater than the outstanding balance of the section 412(l) restoration liability that would have remained at the end of the tenth plan year if the unfunded section 412(l) restoration liability had been amortized in level amounts over the restoration payment period at the current liability interest rate, increased by the current liability interest rate differential as defined under paragraph (g)(7) of this section. The Pension Benefit Guaranty Corporation may amend the amortization schedule for the unfunded section 412(l) restoration liability subject to the limits on amendments to the amortization schedule prescribed for the initial restoration amortization base.

(3) *Establishment of unfunded section 412(l) restoration liability.* In the plan year in which the initial post-restoration valuation date falls, the unfunded section 412(l) restoration liability is equal to the unfunded current liability of the plan.

(4) *Unfunded new liability amount.* In the case of a plan using the restoration method, the unfunded new liability amount is the applicable percentage, as defined in section 412(l)(4)(C), of the unfunded new liability determined under paragraph (g)(5) of this section.

(5) *Unfunded new liability.* The unfunded new liability of a plan using the restoration method is the unfunded current liability of the plan for the plan year less the outstanding balance of the unfunded section 412(l) restoration liability determined under paragraph (g)(3) of this section and less any unpredictable contingent event benefit liabilities (without regard to whether or not the event has occurred).

(6) *Offset of amortization charges.* The charges specified in the restoration payment schedule to amortize the initial restoration amortization base, must be offset against the deficit reduction contribution in paragraph (g)(1) of this section along with any other applicab1e amounts provided in section 412 (l)(1)(A)(ii).

(7) *Interest rate differential.* During the first 10 plan years after the initial post-restoration valuation date, the unfunded section 412(l) restoration liability amount for the plan as determined for purposes of this section must be sufficient to prevent the outstanding balance of the unfunded section 412(l) restoration liability from exceeding the initial amount of the unfunded section 412(l) restoration liability increased by the current liability interest rate differential. The current liability interest rate differential at any point during the first ten years of the restoration payment period is the excess if any of the accumulated interest on the unfunded section 412(l) restoration liability computed at the current liability interest rate over the accumulated interest on the unfunded section 412(l) restoration liability computed at the least of the valuation rate, the current liability interest rate and current liability interest rate for the plan year in which the initial post restoration valuation date falls. The current liability interest rate differential is charged to the funding standard account at the end of the tenth plan year, but the Pension Benefit Guaranty Corporation may, as part of the restoration payment schedule order, or a modification to that order, direct that the charging of this amount must be spread over not more than 5 years, beginning with the eleventh plan year.

(h) *Election of the alternative minimum funding standard.* A plan using the restoration method may not elect the alternative minimum funding standard under section 412(g).

(i) *Funding review by the Pension Benefit Guaranty Corporation.* The Pension Benefit Guaranty Corporation must review the funding of any plan using the restoration method at least once in each plan year. As a result of a funding review, the Pension Benefit Guaranty Corporation may amend the restoration payment schedule as provided in paragraph (c)(3) of this section. As part of the funding review, the Executive Director of the PBGC must certify to the Corporation's Board of Directors, and to the Internal Revenue Service, that the Corporation has reviewed the funding of the plan, the financial condition of the plan sponsor and its controlled group members, the payments required under the restoration payment schedule (taking into account the availability of deferrals authorized under paragraph (c)(4) of this section), and any other factor that the Corporation deems relevant, and, based on that review, determines that it is in the best interests of participants and beneficiaries of the plan and the pension insurance program that the restored plan not be reterminated.

[T.D. 8317, 55 FR 42707, Oct. 23, 1990; 56 FR 19038, Apr. 25, 1991]

§1.412(c)(2)–1 Valuation of plan assets; reasonable actuarial valuation methods.

(a) *Introduction*—(1) *In general.* This section prescribes rules for valuing plan assets under an actuarial valuation method which satisfies the requirements of section 412(c)(2)(A). An actuarial valuation method is a funding method within the meaning of section 412(c)(3) and the regulations thereunder. Therefore, certain changes affecting the actuarial valuation method are identified in this section as changes in a plan's funding method.

(2) *Exception for certain bonds, etc.* The rules of this section do not apply to bonds or other evidences of indebtedness for which the election described in section 412(c)(2)(B) has been made, nor are such assets counted in applying paragraphs (b) or (c) of this section. Also, an election under section 412(c)(2)(B) is not a change in funding method within the meaning of section 412(c)(5).

(3) *Money purchase pension plan.* A money purchase pension plan must value assets for the purpose of satisfying the requirements of section 412(c)(2)(A) solely on the basis of their fair market value (under paragraph (c) of this section).

(4) *Defined benefit plans.* (i) To satisfy the requirements of section 412(c)(2)(A), an actuarial method valuing assets of a defined benefit plan must meet the requirements of paragraph (b) of this section.

(ii) In general, the purpose of paragraph (b) of this section is to permit use of reasonble actuarial valuation methods designed to mitigate short-run changes in the fair market value of plan assets. The funding of plan benefits and the charges and credits to the funding standard account required by section 412 are generally based upon the assumption that the defined benefit plan will be continued by the employer. Thus, short-run changes in the value of plan assets presumably will offset one another in the long term. Accordingly, in the determination of the amount required to be contributed under section 412 it is generally not necessary to recognize fully each change in fair market value of the assets in the period in which it occurs.

(iii) The asset valuation rules contained in paragraph (b) produce a ‘‘smoothing’’ effect. Thus, investment performance, including appreciation or depreciation in the market value of the assets occurring in each plan year, may be recognized gradually over several plan years. This ‘‘smoothing’’ is in addition to the ‘‘smoothing’’ effect which results, for example, from amortizing experience losses and gains over 15 or 20 years under section 412(b)(2 (B)(iv) and (3)(B)(ii).

(b) *Asset valuation method requirements*—(1) *Consistent basis.* (i) The actuarial asset valuation method must be applied on a consistent basis. Any change in meeting the requirements of this paragraph (b) is a change in funding method subject to section 412(c)(5).

(ii) A method may satisfy the consistency requirement even though computations are based only on the period elapsed since the adoption of the method or on asset values occurring during that period.

(2) *Statement of plan's method.* The method of determining the actuarial value (but not fair market value) of the assets must be specified in the plan's actuarial report (required under section 6059). The method must be described in sufficient detail so that another actuary employing the method described would arrive at a reasonably similar result. Whether a deviation from the stated actuarial valuation method is a change in funding method is to be determined in accordance with section 412(c)(5) and the regulations thereunder. A deviation to include a type of asset not previously held by the plan would not be a change in funding method.

(3) *Consistent valuation dates.* The same day or days (such as the first or the last day of a plan year) must be used for all purposes to value the plan's assests for each plan year, or portion of plan year, for which a valuation is made. For purposes of this section, each such day is a valuation date. A change in the day or days used is a change in funding method.

(4) *Reflect fair market value.* The valuation method must take into account fair market value by making use of the—

(i) Fair market value (determined under paragraph (c) of this section), or

(ii) Average value (determined under paragraph (b)(7) of this section) of the plan's assets as of the applicable asset valuation date. This is done either directly in the computation of their actuarial value or indirectly in the computation of upper or lower limits placed on that value.

(5) *Results above and below fair market or average value.* A method will not satisfy the requirements of this paragraph (b) if it is designed to produce a result which will be consistently above or below the values described in paragraph (b)(4) (i) and (ii). However, a method designed to produce a result which consistently falls between fair market value and average value will satisfy this requirement. See Example (5) in paragraph (b)(9) of this section for an illustration of a method described in the preceding sentence.

(6) *Corridor limits.* (i) Regardless of how the method reflects fair market value under paragraph (b)(4), the method must result in an actuarial value of the plan's assets which is not less than a minimum amount and not more than a maximum amount. The minimum amount is the lesser of 80 percent of the current fair market value of plan assets as of the applicable asset valuation date or 85 percent of the average value (as described in subparagraph (7)) of plan assets as of that date. The maximum amount is the greater of 120 percent of the current fair market value of plan assets as of the applicable asset valuation date or 115 percent of the average value of plan assets as of that date.

(ii) Under a plan's method, a preliminary computation of the expected actuarial value may fall outside the prescribed corridor. A method meets the requirements of paragraph (b)(6)(i) of this section is such a case only by adjusting the expected actuarial value to the nearest corridor limit applicable under the method. A plan may use an actuarial valuation method with a narrower corridor than the general corridor required under paragraph (b)(6)(i). The adjustment to the nearest corridor limit of such a method for purposes of this subdivision (ii) would be determined by the narrower corridor stated in the description of the plan's method.

(7) *Average value.* the average value of plan assets is computed by—

(i) Determining the fair market value of plan assets at least annually,

(ii) Adding the current fair market value of the assets (as of the applicable valuation date) and their adjusted values (as described in paragraph (b)(8) of this section) for a stated period not to exceed the five most recent plan years (including the current year), and

(iii) Dividing this sum by the number of values (including the current fair market value) considered in computing the sum described in subdivision (ii).

(8) *Adjusted value.* (i) the adjusted value of plan assets for a prior valuation date is their fair market value on that date with certain positive and negative adjustments. These adjustments reflect changes that occur between the prior asset valuation date and the current valuation date. However, no adjustment is made for increases or decreases in the total value of plan assets that result from the purchase, sale, or exchange of plan assets or from the receipt of payment on a debt obligation held by the plan.

(ii) In determining the adjusted value of plan assets for a prior valuation date, there is added to the fair market value of the plan assets of that date the sum of all additions to the plan assets since that date, excluding appreciation in the fair market value of the assets. The additions would include, for example, any contribution to the plan; any interest or dividend paid to the plan; and any asset not taken into account in a prior valuation of assets, but taken into account for the current year, in computing the fair market value of plan assets under paragraph (c) of this section.

(iii) In determining the adjusted value of plan assets for a prior valuation date, there is subtracted from the fair market value of the plan assets on that date the sum of all reductions in plan assets since that date, excluding depreciation in the fair market value of the assets. The reductions would include, for example, any benefit paid from plan assets; any expense paid from plan assets; and any asset taken into account in a prior valuation of assets but not taken into account for the current year, in computing the fair market value of plan assets under paragraph (c) of this section.

(9) *Examples.* This paragraph (b) may be illustrated by the following examples. In each example, assume that the pension plan uses a consistent actuarial method of valuing its assets within the meaning of paragraph (b)(1), (2), and (3) of this section.

Example (1). Plan A considers the value of its assets to be initial cost, increased by an assumed rate of growth of X percent annually. Under the circumstances, the X-percent factor used by the plan is a reasonable assumption. Thus, this method is not designed to produce results consistently above or below fair market value as prohibited by paragraph (b)(5) of this section. Also, the method requires that the actuarial value be adjusted as required to fall within the corridor under paragraph (b) (6) and (7) of this section. Therefore, the method reflects fair market value as required by paragraph (b)(4) of this section.

Example (2). Plan B computes the actuarial value of its assets as follows: It determines the fair market value of the plan assets. Then the fair market value is adjusted to the extent necessary to make the actuarial value fall within a ''5 percent'' corridor. This corridor is plus or minus 5 percent of the following amount: the fair market value of the assets at the beginning of the valuation period plus an assumed annual growth of 4 percent with adjustments for contributions and benefit payments during the period. This method reflects fair market value in a manner prescribed by paragraph (b)(4) of this section. If the 4 percent factor used by the plan is a reasonable assumption, this method is not designed to produce results consistently above or below fair market value, and thus it satisfies paragraph (b)(5). However, this method is unacceptable because in some instances it may result in an actuarial value outside the corridor described in paragraph (b)(6) of this section. This method would be permitted if a second corridor were imposed which would adjust the value of the total plan assets to the corridor limits as required by paragraph (b)(6).

Example (3). Plan C values its assets by multiplying their fair market value by an index number. The use of the index results in the hypothetical average value that plan assets present on the valuation date would have had if they had been held during the current and four preceding years, and had appreciated or depreciated at the actual yield rates including appreciation and depreciation experienced by the plan during that period. However, the method requires an adjustment to the extent necessary to bring the resulting actuarial value of the assets inside the corridor described in the statement of the plan's actuarial valuation method. In this case, the stated corridor is 90 to 110 percent of fair market value, a corridor narrower than that described in paragraph (b)(7) of this section. This method is permitted.

Example (4). Plan D values its assets by multiplying their fair market value by 95 percent. Although the method reflects fair market value and the results of this method will always be within the required corridor, it is not acceptable because it will consistently result in a value less than fair market value.

Example (5). Plan E values its assets by using a five-year average method with appropriate adjustments for the period. Under the particular method used by Plan E, assets are not valued below 80 percent of fair market value or above 100 percent of fair market value. If the average produces a value that exceeds 100 percent of fair market value, the excess between 100 and 120 percent is recorded in a ''value reserve account.'' In years after one in which the average exceeds 100 percent of fair market value, amounts are subtracted from this account and added, to the extent necessary, to raise the value produced by the average for that year to 100 percent of fair market value. This method is permitted because it reflects fair market value under paragraph (b)(4) of this section by appropriately computing an average value, it satisfies paragraph (b)(5) by producing a result that falls consistently between fair market value and average value, and it properly reflects the corridor described in paragraph (b)(7).

Example (6). All assets of Plan F are invested in a trust fund and the plan year is the calendar year. The actuarial value is determined by averaging fair market value over 4 years. An actuarial valuation is performed as of December 31, 1988.

(i) The average value as of December 31, 1988, is computed as follows:

	1986	1986	1987	1987	1988	1988
Fair market value: Jan. 1		$150,000		$196,500		$238,000
Contributions	$65,000		$62,000		$66,000	
Benefit payments	(22,000)		(24,000)		(25,000)	
Expenses	(6,500)		(7,000)		(7,500)	
Interest and dividends	8,000	44,500	7,500	38,500	7,000	240,500
Net realized gains (losses)		(2,000)		6,000		(8,000)
Balancing item [1]		4,000		(3,000)		(42,000)
Fair market value: Dec. 31		196,500		238,000		228,000

[1] This equals the increase (decrease) in unrealized appreciation.

Adjusted values	1985	1986	1987	1988
Fair market value: Dec. 31	$150,000	$196,500	$238,000	$228,000
Net adjustments:				
1988	40,500	40,500	40,500	
1987	38,500	38,500		
1986	44,500			
Total	273,500	275,500	278,500	228,000

Average value: 1988=$273,500 + $275,500 + $278,500 + $228,000 ÷ 4=$263,875

(ii) Plan F properly determines an average value under paragraph (b)(7) of this section for use as an actuarial value. Therefore, the valuation method meets the requirements of this section.

Example (7). Plan G computes the actuarial value of the plan assets as follows: The current fair market value of the plan assets is averaged with the most recent prior adjusted actuarial value. This average value is adjusted up or down toward the current fair market value by 20 percent of the difference between it and the current fair market value of the assets. This value is further adjusted to the extent necessary to fall within the corridor described in the statement of the plan's actuarial valuation method. The lower end of the corridor is the lesser of 80 percent of the fair market value of the plan assets or 85 percent of the average value of the plan assets. The higher end of the corridor is the greater of 120 percent of the fair market value of plan assets or 115 percent of the average value of plan assets. Average value for purposes of the corridor is determined under paragraph (b)(7) of this section. Assuming the numerical data of Example (6), the application of the corridor is as follows. The actuarial asset value as of December 31, 1988, must not be less than $182,400 (80 percent of current fair market value, $228,000) nor greater than $303,456 (115 percent of average value, 263,875). This method is permitted because it reflects fair market value in a manner permitted by paragraph (b)(4) of this section, it produces an actuarial value which is neither consistently above nor consistently below fair market or average value to satisfy paragraph (b)(5), and it is appropriately limited by the corridor described in paragraph (b)(6).

(c) *Fair market value of assets*—(1) *General rules.* Except as otherwise provided in this paragraph (c), the fair market value of a plan's assets for purposes of this section is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

(d) *Methods for taking into account the fair market value of certain agreements.* [Reserved]

(e) *Effective date and transition rules*—(1) *Effective date.* This section applies to plan years to which section 412, or section 302 of the Employee Retirement Income Security Act of 1974, applies.

(2) *Special rule for certain plan years.* For plan years beginning prior to November 12, 1980, the amounts required to be determined under section 412 may be computed on the basis of any reasonable actuarial method of asset valuation which takes into account the fair market value of the plan's assets, even if the method does not meet all of the requirements of paragraphs (a) through (c) of this section.

(3) *Plan years beginning on or after November 12, 1980.* Paragraphs (a) through (c) of this section apply beginning with the first valuation of plan assets made for a plan year to which section 412 applies that begins on or after November 12, 1980. The statement of the plan's actuarial asset valuation method required by paragraph (b)(2) of this section must be included with the plan's actuarial report for that year, in addition to any subsequent reports.

(4) *Effect of change of asset valuation method.* A plan which is required to change its asset valuation method to comply with paragraphs (a) through (c) of this section must make the change no later than the time when the plan is first required to comply with this section under paragraph (e)(3). A method of adjustment must be used to take account of any difference in the actuarial value of the plan's assets based on the old and new valuation methods. The plan may use either—

(i) A method of adjustment described in paragraph (e)(5) or (e)(6) of this section without prior approval by the Commissioner, or

(ii) Any other method of adjustment if the Commissioner gives prior approval under section 412(c)(5).

(5) *Retroactive recomputation method.* (i) Under this method of adjustment, the plan recomputes the balance of the funding standard account as of the beginning of the first plan year for which it uses its new asset valuation method to comply with paragraphs (a) through (c) of this section. This new balance is recomputed by retroactively applying the plan's new method as of the first day of the first plan year to which section 412 applies.

(ii) Beginning with the first plan year for which it uses its new method, the plan computes the normal cost and amortization charges and credits to the funding standard account based on the retroactive application of its new method as of the first day of the first plan year to which section 412 applies.

(iii) If the recomputed aggregate charges exceed the recomputed aggregate credits to the funding standard account as of the end of the first plan year for which the plan uses its new method, an additional contribution to the plan may be necessary to avoid an accumulated funding deficiency in that year. The use of the retroactive recomputation method may also result in an accumulated funding deficiency for years prior to that first year. In such cases, the rules of section 412(c)(10), relating to the time when certain contributions are deemed to have been made, apply.

(6) *Prospective gain or loss adjustment method.* (i) Under this method of adjustment the plan values its assets under its new method no later than the valuation date for the first plan year beginning after [the publication date of this section]

(ii) Regardless of the type of funding method used by a plan, the difference in the value of the assets under the old and the new asset valuation methods may be treated as arising from an experience loss or gain; or alternatively it may be treated as arising from a change in actuarial assumptions.

(iii) The treatment of this difference as an experience gain or loss or as a change in actuarial assumptions must be consistent with the treatment of such gains, losses, or changes under the funding method used by the plan. Thus, if a plan uses a spread gain type funding method other than the aggregate cost method, the difference in the value of assets under the old and the new asset valuation methods may be either amortized or spread over future periods as a part of normal cost. Examples of this type of funding method are the frozen initial liability cost method and the attained age normal cost method. With an aggregate method, the difference in the value of assets under the old and the new asset valuation methods must be spread over future periods as a part of normal cost.

(Secs. 412(c)(2) and 7805 of the Internal Revenue Code of 1954 (88 Stat. 916 and 68A Stat. 917; 26 U.S.C. 412(c)(2) and 7805))

[T.D. 7734, 45 FR 74718, Nov. 12, 1980]

§1.412(c)(3)–1 Reasonable funding methods.

(a) *Introduction*—(1) *In general.* This section prescribes rules for determining whether or not, in the case of an ongoing plan, a funding method is reasonable for purposes of section 412(c)(3). A method is unreasonable only if it is found to be inconsistent with a rule prescribed in this section. The term ''reasonable funding method'' under this section has the same meaning as the term ''acceptable actuarial cost method'' under section 3(31) of the Employee Retirement Income Security Act of 1974 (ERISA).

(2) *Computations included in method.* See §1.412(c)(1)–1(b) for a discussion of matters that are, and are not, included in the funding method of a plan.

(3) *Plans using shortfall.* The shortfall method is a method of determining charges to the funding standard account by adapting the underlying funding method of certain collectively bargained plans in the manner described in §1.412(c)(1)–2. As such, the shortfall method is a funding method. The underlying method of a plan that uses the shortfall method must be a reasonable funding method under this section. The rules contained in this section, relating to cost under a reasonable funding method, apply in the shortfall method to the annual computation charge under §1.412(c)(1)–2(d).

(4) *Scope of funding method.* Except for the shortfall method, a reasonable funding method is applied to the computation of—

(i) The normal cost of a plan for a plan year; and, if applicable,

(ii) The bases established under section 412(b)(2)(B), (C), and (D), and (3)(B) (''amortizable bases'').

(b) *General rules for reasonable funding methods*—(1) *Basic funding formula.* At any time, except as provided by the Commissioner, the present value of future benefits under a reasonable funding method must equal the sum of the following amounts:

(i) The present value of normal costs (taking into account future mandatory employee contributions, within the meaning of section 411(c)(2)(C), in the case of a contributory plan) over the future working lifetime of participants;

(ii) The sum of the unamortized portions of amortizable bases, if any, treating credit bases under section 412(b)(3)(B) as negative numbers; and

(iii) The plan assets, decreased by a credit balance (and increased by a debit balance) in the funding standard account under section 412(b).

(2) *Normal cost.* Normal cost under a reasonable funding method must be expressed as—

(i) A level dollar amount, or a level percentage of pay, that is computed from year to year on either an individual basis or an aggregate basis; or

(ii) An amount equal to the present value of benefits accruing under the method for a particular plan year.

(3) *Application to shortfall.* Paragraph (b)(2) will not fail to be satisfied merely because an amount described in (i) or (ii) is expressed as permitted under the shortfall method.

(c) *Additional requirements*—(1) *Inclusion of all liabilities.* Under a reasonable funding method, all liabilities of the plan for benefits, whether vested or not, must be taken into account.

(2) *Production of experience gains and losses.* If each actuarial assumption is exactly realized under a reasonable funding method, no experience gains or losses are produced.

(3) *Plan population*—(i) *In general.* Under a reasonable funding method, the plan population must include three classes of individuals: participants currently employed in the service of the employer; former participants who either terminated service with the employer, or retired, under the plan; and all other individuals currently entitled to benefits under the plan. See §1.412(c)(3)–1(d)(2) for rules concerning anticipated future participants.

(ii) *Limited exclusion for certain recent participants.* Under a reasonable funding method, certain individuals may be excluded from the first class of individuals described in paragraph (c)(3)(i) of this section unless otherwise provided by the Commissioner. The excludable individuals are participants who would be excluded from participation by the minimum age or service requirement of section 410 but who, under the terms of the plan, participate immediately upon entering the service of the employer.

(iii) *Special exclusion for ''rule of parity'' cases.* Under a reasonable funding method, certain individuals may be excluded from the second class of individuals described in paragraph (c)(3)(i) of this section. The excludable individuals are those former participants who have terminated service with the employer without vested benefits and whose service might be taken into account in future years because the ''rule of parity'' of section 411(a)(6)(D) does not permit that service to be disregarded. However if the plan's experience as to separated employees' returning to service has been such that the exclusion described in this subparagraph would be unreasonable, the exclusion would no longer apply.

(4) *Use of salary scale*—(i) *General acceptability.* The use of a salary scale assumption is not inappropriate merely because of the funding method with which it is used. Therefore, in determining whether actuarial assumptions are reasonable, a salary scale will not be considered to be prohibited merely because a particular funding method is being used.

(ii) *Projection to appropriate salary.* Under a reasonable funding method, salary scales reflected in projected benefits must be the expected salary on which benefits would be based under the plan at the age when the receipt of benefits is expected to begin.

(5) *Treatment of allocable items.* Under a reasonable funding method that allocates assets to individual participants to determine costs, the allocation of assets among participants must be reasonable. An initial allocation of assets among participants will be considered reasonable only if it is in proportion to related liabilities. However, the Commissioner may determine, based on the facts and circumstances, that it is unreasonable to continue to allocate assets on this basis beyond the initial year. Under a reasonable funding method that allocates liabilities among different elements of past and future service, the allocation of liabilities must be reasonable.

(d) *Prohibited considerations under a reasonable funding method*—(1) *Anticipated benefit changes*—(i) *In general.* Except as otherwise provided by the Commissioner, a reasonable funding method does not anticipate changes in plan benefits that become effective, whether or not retroactively, in a future plan year or that become effective after the first day of, but during, a current plan year.

(ii) *Exception for collectively bargained plans.* A collectively bargained plan described in section 413(a) may on a consistent basis anticipate benefit increases scheduled to take effect during the term of the collective-bargaining agreement applicable to the plan. A plan's treatment of benefit increases scheduled in a collective bargaining agreement is part of its funding method. Accordingly, a change in a plan's treatment of such benefit increases (for example, ignoring anticipated increases after taking them into account) is a change of funding method.

(2) *Anticipated future participants.* A reasonable funding method must not anticipate the affiliation with the plan of future participants not employed in the service of the employer on the plan valuation date. However, a reasonable funding method may anticipate the affiliation with the plan of current employees who have not satisfied the participation requirements of the plan.

(e) *Special rules for certain funding methods*—(1) *Applicability of special rules.* Paragraph (e) of this section applies to a funding method that determines normal cost under paragraph (b)(2)(ii) of this section.

(2) *Use of salary scale.* For rules relating to use of a salary scale assumption, see paragraph (c)(4) of this section.

(3) *Allocation of liabilities.* In determining a plan's normal cost and accrued liability for a particular plan year, the projected benefits of the plan must be allocated between past years and future years. Except in the case of a career average pay plan, this allocation must be in proportion to the applicable rates of benefit accrual under the plan. Thus, the allocation to past years is effected by multiplying the projected benefit by a fraction. The numerator of the fraction is the participant's credited years of service. The denominator is the participant's total credited years of service at the anticipated benefit commencement date. Adjustments are made to account for changes in the rate of benefit accrual. An allocation based on compensation is not permitted. In the case of a career average pay plan, an allocation between past and future service benefits must be reasonable.

(f) *Treatment of ancillary benefit costs*—(1) *General rule.* Under a reasonable funding method, except as otherwise provided by this paragraph (f), ancillary benefit costs must be computed by using the same method used to compute retirement benefit costs under a plan.

(2) *Ancillary benefit defined.* For purposes of this paragraph an ancillary benefit is a benefit that is paid as a result of a specified event which—

(i) Occurs not later than a participant's separation from service, and

(ii) Was detrimental to the participant's health.

Thus, for example, benefits payable if a participant dies or becomes disabled prior to separation from service are ancillary benefits because the events giving rise to the benefits are detrimental to the participant's health. However, an early retirement benefit, a social security supplement (as defined in § 1.411(a)–7(c)(4)(ii)), and the vesting of plan benefits (even if more rapid than is required by section 411) are not ancillary benefits because those benefits do not result from an event which is detrimental to the participant's health.

(3) *Exception for certain insurance contracts.* Under a reasonable funding method, regardless of the method used to compute retirement benefit costs, the cost of an ancillary benefit may equal the premium paid for that benefit under an insurance contract if—

(i) The ancillary benefit is provided under the contract, and

(ii) The benefit is guaranteed under the contract.

(4) *Exception for 1-year term funding and other approved methods.* [Reserved]

(5) *Section 401(h) benefits.* Section 412 does not apply to benefits that are described in section 401(h) and for which a separate account is maintained.

(g) *Examples.* The principles of this section are illustrated by the following examples:

Example (1). Assume that a plan, using funding method A, is in its first year. No contributions have been made to the plan, other than a nominal contribution to establish a corpus for the plan's trust. There is no past service liability, and the normal cost is a constant percentage of an annually determined amount. The constant percentage is 99 percent, and the annually determined amount is the excess of the present value of future benefits over plan assets. The present value of future benefits is $10,000. Under paragraph (b)(1) of this section, the present value of future benefits must equal the present value of future normal costs plus plan assets. (No amortizable bases exist, nor are there credit or debit balances.) Under method A, the present value of future normal costs would equal the sum of a series of annually decreasing amounts. Because of the constant percentage factor, the present value of future normal costs over the years can never equal $10,000, the present value of future benefits. In effect, then, assets under method A can never equal the present value of future benefits if all assumptions are exactly realized. Therefore, method A is not a reasonable funding method.

Example (2). Assume that a plan, using funding method B, determines normal cost by computing the present value of benefits expected to be accrued under the plan by the end of 10 years after the valuation date and adding to this the present value of benefits expected to be paid within these 10 years. Plan assets are subtracted from the sum of the two present value amounts. The difference then is divided by the present value of salaries projected over the 10 years. Under paragraph (c)(1) of this section, all liabilities of a plan must be taken into account. Because method B takes into account only benefits paid or accrued by the end of 10 years, it is not a reasonable funding method.

Example (3). Assume that a plan, using funding method C, determines normal cost as a constant percentage of compensation. (This percentage is determined as follows: The excess of projected benefits over accrued benefits is computed. Then the present value of this excess is divided by the present value of future salaries.) However, the accrued liability is computed each year as the present value of accrued benefits. (This computation does not reflect normal cost as a constant percentage of compensation. Thus, normal cost under the plan does not link accrued liabilities under the plan for consecutive years as would be the case, for example, under a unit credit cost method.) In determining gains and losses, method C compares the actual unfunded liability (the accrued liability less assets) with the expected unfunded liability (the sum of the actual unfunded liability in the previous year and the normal cost for the previous year less the contribution made for the previous year, all adjusted for interest). Under paragraph (c)(2) of this section, if actuarial assumptions are exactly realized, experience gains and losses must not be produced. Under method C, the use of a constant percentage in computing normal cost (and the expected unfunded liability) coupled with the manner of computing the accrued liability (and the actual unfunded liability) generally produces gains in the earlier years and losses in the later years if each actuarial assumption is exactly realized. Therefore, method C is not a reasonable funding method.

Example (4). Assume that a plan, using funding method D, bases benefits on final average pay. Under method D, the past service liability on any date equals the present value of the accrued benefit on that date based on compensation as of that date. The normal cost for any year equals the present value of a certain amount. That amount is the excess of the projected accrued benefit as of the end of the year over the actual accrued benefit at the beginning of the year. Accrued benefits, projected as of the end of a year, reflect a 1-year salary projection. Under paragraph (c)(4) of this section, salary scales reflected in projected benefits must project salaries to the salary on which benefits would be based under the plan at the age when the receipt of benefits under the plan is expected to begin. Because the plan is not a career average pay plan and compensation is projected only 1 year, method D is not a reasonable funding method. (Under paragraph (c)(4) of this section, the use of a salary scale assumption could be required with a unit credit method if, without the use of a salary scale, assumptions in the aggregate are unreasonable.)

Example (5). Assume that a plan, using method E, a unit credit funding method, calculates a participant’s accrued benefit according to the following formula: 2 percent of final salary for the first 10 years of service and 1 percent of final salary for the years of service in excess of 10. Under the plan, no employee may be credited with more than 25 years of service. The actuarial assumptions for the valuation include a salary scale of 5 percent per year. For a participant at age 40 with 15 years of service, a current salary of $20,000 and a normal retirement age of 65, the accrued liability for the retirement benefit is the present value of an annuity of $16,932 per year, commencing at age 65. The $16,932 is calculated as follows:

$$\$20{,}000 \times 3.3864 \times 35\% \times \frac{(10 \times 2) + (5 \times 1)}{(10 \times 2) - (15 \times 1) + (15 \times 0)}$$

(3.3864 is 1.05 raised to the 25th power; the 25th power reflects the difference between normal retirement age and attained age (65–40).)

Salary under this method is projected to the age when the receipt of benefits is expected to begin. Therefore, method E meets the requirement of paragraph (c)(4) of this section. Also, the allocation of benefits under method E between past and future years of service meets the requirements of paragraph (e)(3) of this section.

Example (6). Assume that a plan that has two participants and that previously used the unit credit cost method wishes to change the funding method at the beginning of the plan year to funding method F, a modification of the aggregate cost method. The modification involves determining normal cost for each of the two participants under the plan. Therefore, it requires an allocation of assets to each participant for valuation purposes. The actuary proposes to allocate the assets on hand at the beginning of the plan year of the change in funding method in proportion to the accrued liabilities calculated under the unit credit cost method. The relevant results of the calculations are shown below:

	Employees		Totals
	M	N	
Accrued Liabilities (unit credit method):			
Dollar amount	15,670	906	16,576
Per cent of total	94.53	5.47	100.00
Assets:			
Dollar amount	7,835	453	8,288
per cent of total	94.53	5.47	100.00

The proposed allocation in proportion to the accrued liabilities under the unit credit cost method satisfies the requirements of paragraph (c)(5) of this section at the beginning of the first plan year for which the new method is used.

Example (7). The facts are the same as in Example (6). However, the actuary proposes to allocate all the assets to employee M, the older employee. Method F, under these facts, is not an acceptable funding method because the allocation is not in proportion to related liabilities as required under paragraph (c)(5) of this section.

[T.D. 7746, 45 FR 86430, Dec. 31, 1980]

§ 1.412(c)(3)–2 Effective dates and transitional rules relating to reasonable funding methods.

(a) *Introduction.* This section prescribes effective dates for rules relating to reasonable funding methods, under section 412(c)(3) and § 1.412(c)(3)–1. Also, this section sets forth rules concerning adjustments to a plan's funding standard account that are necessitated by a change in funding method, and a provision setting forth procedural requirements for use of an optional phase-in of required changes.

(b) *Effective date*—(1) *General rule.* Except as otherwise provided by subparagraph (2) of this paragraph, § 1.412(c)(3)–1 applies to any valuation of a plan's liabilities (within the meaning of section 412(c)(9)) as of a date after April 30, 1981.

(2) *Exception.* If a collective bargaining agreement which determines contributions to a plan is in effect on April 30, 1981, then § 1.412(c)(3)–1 applies to any valuation of that plan's liabilities as of a date after the earlier of the date on which the last such collective bargaining agreement expires or April 30, 1984.

(3) *Transitional rule.* The reasonableness of a funding method used in making a valuation of a plan's liability as of a date before the effective date determined under subparagraph (1) or (2) of this paragraph is determined on the basis of such published guidance as was available on the date as of which the valuation was made.

(c) *Change of funding method without approval*—(1) *In general.* A plan that is required to change its funding method to comply with § 1.412(c)(3)–1 is not required to submit the change of funding method for approval as otherwise required by section 412(c)(5). However, this change must be described on Form 5500, Schedule B for the plan year with respect to which the change is first effective.

(2) *Amortization base.* An amortization base must be established in the plan year of the change in method equal to the change in the unfunded liability due to the change (where both unfunded liabilities are based on the same actuarial assumptions). Such a base must be amortized over 30 years in determining the charges or credits to the funding standard account, unless the Commissioner upon application permits amortization over a shorter period.

(d) *Phase-in of additional funding required by new method*—(1) *In general.* A plan that is required to change its funding method to comply with § 1.412(c)(3)–1 may elect to charge and credit the funding standard account as provided in this paragraph. An election under this paragraph shall be irrevocable.

(2) *Credit in year of change.* In the plan year of the change in method the funding standard account may be credited with an amount not in excess of 0.8 multiplied by the excess (if any) of—

(i) The normal cost under the new method plus the amortization charge (or minus the amortization credit) computed as described in §1.412(c)(3)–2(c)(2), over

(ii) The normal cost under the prior method, for the plan year of the change in method.

(3) *Credits in the next three years.* In the three years following the year of the change the funding standard account may be credited with an amount not in excess of 0.6, 0.4, and 0.2 respectively in the first, second, and third years, multiplied by either of the following amounts, computed as of the last day of the year of credit—

(i) The excess described in §1.412(c)(3)–2(d)(2) multiplied by a fraction (not greater than 1), the numerator of which is the number of participants in the year of the credit and the denominator of which is the number of participants in the year of the change, or, at the option of the plan,

(ii) The excess (if any) in the year of credit of—

(A) The net charge to the funding standard account based on the new method, over

(B) The net charge to the funding standing account based on the prior method.

(4) *Computational rules.* For purposes of the calculation described in §1.412(c)(3)–2(d)(3)(ii), the net charge is the excess of charges under section 412(b)(2) (A) and (B) over the credits under section 412(b)(3)(B) (including the charge or credit described in §1.412(c)(3)–2(c)) which would be required using the actuarial assumptions and plan benefit structure in effect on the last day of the plan year of change.

(5) *Fifteen-year amortization of credits.* The funding standard account shall be charged with 15-year amortization of each credit described in §1.412(c)(3)–2(d) (2) and (3) beginning in the year following each such credit.

(6) *Manner of election.* An election under this paragraph shall be made by the claiming of the credits described in §1.412(c)(3)–2(d) (2) and (3) on Schedule B to Form 5500 and by filing such other information as may be required by the Commissioner.

(e) *Effect on shortfall method.* The charges and credits described in this section apply in the shortfall method to the annual computation charge described in §1.412(c)(1)–2(d). The amounts described in §1.412(c)(3)–2(d) shall be determined before the application of the shortfall method.

(Sec. 3(31) of the Employee Retirement Income Security Act of 1974 (88 Stat. 837; 29 U.S.C. 1002) and sec. 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7746, 45 FR 86432, Dec. 31, 1980]

§1.412(i)–1 Certain insurance contract plans.

(a) *In general.* Under section 412(h)(2) of the Internal Revenue Code of 1954, as added by section 1013(a) of the Employee Retirement Income Security Act of 1974 (88 Stat. 914) (hereinafter referred to as ‘‘the Act’’), an insurance contract plan described in section 412(i) for a plan year is not subject to the minimum funding requirements of section 412 for that plan year. Consequently, if an individual or group insurance contract plan satisfies all of the requirements of paragraph (b)(2) or (c)(2) of this section, whichever are applicable, for the plan year, the plan is not subject to the requirements of section 412 for that plan year. The effective date for section 412 of the Code is determined under section 1017 of the Act. In general, in the case of a plan which was not in existence on January 1, 1974, this section applies for plan years beginning after September 2, 1974, and in the case of a plan in existence on January 1, 1974, to plan years beginning after December 31, 1975.

(b) *Individual insurance contract plans.* (1) An individual insurance contract plan is described in section 412(i) during a plan year if the plan satisfies the requirements of paragraph (b)(2) of this section for the plan year.

(2) The requirements of this paragraph are:

(i) The plan must be funded exclusively by the purchase from an insurance company or companies (licensed under the law of a State or the District of Columbia to do business with the plan) of individual annuity or individual insurance contracts, or a combination thereof. The purchase may be made either directly by the employer or through the use of a custodial account or trust. A plan shall not be considered to be funded otherwise than exclusively by the purchase of individual annuity or individual insurance contracts merely because the employer makes a payment necessary to comply with the provisions of section 411(c)(2) (relating to accrued benefit from employee contributions).

(ii) The individual annuity or individual insurance contracts issued under the plan must provide for level annual, or more frequent, premium payments to be paid under the plan for the period commencing with the date each individual participating in the plan became a participant and ending not later than the normal retirement age for that individual or, if earlier, the date the individual ceases his participation in the plan. Premium payments may be considered to be level even though items such as experience gains and dividends are applied against premiums. In the case of an increase in benefits, the contracts must provide for level annual payments with respect to such increase to be paid for the period commencing at the time the increase becomes effective. If payment commences on the first payment date under the contract occurring after the date an individual becomes a participant or after the effective date of an increase in benefits, the requirements of this subdivision will be satisfied even though payment does not commence on the date on which the individual's participation commenced or on the effective date of the benefit increase, whichever is applicable. If an individual accrues benefits after his normal retirement age, the requirements of this subdivision are satisfied if payment is made at the time such benefits accrue. If the provisions required by this subdivision are set forth in a separate agreement with the issuer of the individual contracts, they need not be included in the individual contracts.

(iii) The benefits provided by the plan for each individual participant must be equal to the benefits provided under his individual contracts at his normal retirement age under the plan provisions.

(iv) The benefits provided by the plan for each individual participant must be guaranteed by the life insurance company, described in paragraph (b)(2)(i) of this section, issuing the individual contracts to the extent premiums have been paid.

(v) Except as provided in the following sentence, all premiums payable for the plan year, and for all prior plan years, under the insurance or annuity contracts must have been paid before lapse. If the lapse has occurred during the plan year, the requirements of this subdivision will be considered to have been met if reinstatement of the insurance policy, under which the individual insurance contracts are issued, occurs during the year of the lapse and before distribution is made or benefits commence to any participant whose benefits are reduced because of the lapse.

(vi) No rights under the individual contracts may have been subject to a security interest at any time during the plan year. This subdivision shall not apply to contracts which have been distributed to participants if the security interest is created after the date of distribution.

(vii) No policy loans, including loans to individual participants, on any of the individual contracts may be outstanding at any time during the plan year. This subdivision shall not apply to contracts which have been distributed to participants if the loan is made after the date of distribution. An application of funds by the issuer to pay premiums due under the contracts shall be deemed not to be a policy loan if the amount of the funds so applied, and interest thereon, is repaid during the plan year in which the funds are applied and before distribution is made or benefits commence to any participant whose benefits are reduced because of such application.

(c) *Group insurance contract plans.* (1) A group insurance contract plan is described in section 412(i) during a plan year if the plan satisfies the requirements of subparagraph (2) for the plan year.

(2) The requirements of this subparagraph are:

(i) The plan must be funded exclusively by the purchase from an insurance company or companies, described in paragraph (b)(2)(i) of this section, of group annuity or group insurance contracts, or a combination thereof. The purchase may be made either directly by the employer or through the use of a custodial account or trust. A plan shall not be considered to be funded otherwise than exclusively by the purchase of group annuity or group insurance contracts merely because the employer makes a payment necessary to comply with the provisions of section 411 (c)(2) (relating to accrued benefit derived from employee contributions).

(ii) In the case of a plan funded by a group insurance contract or a group annuity contract the requirements of paragraph (b)(2)(ii) of this section must be satisfied by the group contract issued under the plan. Thus, for example, each individual participant's benefits under the group contract must be provided for by level annual, or more frequent, payments equivalent to the payments required to satisfy such paragraph. The requirements of this subdivision will not be satisfied if benefits for any individual are not provided for by level payments made on his behalf under the group contract.

(iii) The group annuity or group insurance contract must satisfy the requirements of clauses (iii), (iv), (v), (vi), and (vii) of paragraph (b)(2). Thus, for example, each participant's benefits provided by the plan must be equal to his benefits provided under the group contract at his normal retirement age.

(iv)(A) If the plan is funded by a group annuity contract, the value of the benefits guaranteed by the insurance company issuing the contract under the plan with respect to each participant under the contract must not be less than the value of such benefits which the cash surrender value would provide for that participant under any individual annuity contract plan satisfying the requirements of paragraph (b) and approved for sale in the State where the principal office of the plan is located.

(B) If the plan is funded by a group insurance contract, the value of the benefits guaranteed by the insurance company issuing the contract under the plan with respect to each participate under the contract must not be less than the value of such benefits which the cash surrender value would provide for that participant under any individual insurance contract plan satisfying the requirements of paragraph (b) and approved for sale in the State where the principal office of the plan is located.

(v) Under the group annuity or group insurance contract, premiums or other consideration received by the insurance company (and, if a custodial account or trust is used, the custodian or trustee thereof) must be allocated to purchase individual benefits for participants under the plan. A plan which maintains unallocated funds in an auxiliary trust fund or which provides that an insurance company will maintain unallocated funds in a separate account, such as a group deposit administration contract, does not satisfy the requirements of this subdivision.

(d) *Combination of plans.* A plan which is funded by a combination of individual contracts and a group contract shall be treated as a plan described in section 412 (i) for the plan year if the combination, in the aggregate, satisfies the requirements of this section for the plan year.

[T.D. 7746, 45 FR 47676, July 16, 1980; 45 FR 50563, July 30, 1980]0

§1.413–1 Special rules for collectively bargained plans.

(a) *Application of section 413(b) to certain collectively bargained plans*—(1) *In general.* Section 413(b) sets forth special rules applicable to certain pension, profit-sharing, and stock bonus plans (and each trust which is a part of such a plan), hereinafter referred to as ''section 413(b) plans'', described in paragraph (a)(2) of this section. Notwithstanding any other provision of the Code, a section 413(b) plan is subject to the special rules of section 413(b) (1) through (8) and paragraphs (b) through (i) of this section.

(2) *Requirements.* Section 413(b) applies to a plan (and each trust which is a part of such plan) if the plan is a single plan which is maintained pursuant to one or more agreements which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers. A plan which provides benefits for employees of more than one employer is considered a single plan subject to the requirements of section 413(b) and this section if the plan is considered a single plan for purposes of applying section 414(l) (see §1.414(l)–

1(b)(1)). For purposes of determining whether one or more plans (or agreements) are a single plan, under sections 413(a) and 414(l), it is irrelevant that there are in form two or more separate plans (or agreements). For example, a single plan will be considered to exist where agreements are entered into separately by a national labor organization (or one or more local units of such organization), on one hand, and individual employers, on the other hand, if the plan is considered a single plan for purposes of applying section 414(*l*).

(3) *Additional rules and effective dates.* (i) If a plan is a section 413(b) plan at a relevant time, the rules of section 413(b) and this section apply, and the rules of section 413(c) and § 1.413–2 do not apply to the plan.

(ii) The qualification of a section 413(b) plan, at any relevant time, under section 401(a), 403(a), or 405(a), as modified by sections 413(b) and this section, is determined with respect to all employers maintaining the plan. Consequently, the failure by one employer maintaining the plan (or by the plan itself) to satisfy an applicable qualification requirement will result in the disqualification of the plan for all employers maintaining the plan.

(iii) Except as otherwise provided, section 413 (a) and (b) and this section apply to a plan for plan years beginning after December 31, 1953.

(b) *Participation.* Section 410 and the regulations thereunder shall be applied as if all employees of each of the employers who are parties to the collective-bargaining agreement and all such employees who are subject to the same benefit computation formula under the plan were employed by a single employer.

(c) *Discrimination, etc.*—(1) *General rule.* Section 401(a)(4) (relating to prohibited discrimination) and section 411(d)(3) (relating to vesting required on termination, partial termination, or discontinuance of contributions) shall be applied as if all the participants in the plan, who are subject to the same benefit computation formula and who are employed by employers who are parties to the collective bargaining agreement, are employed by a single employer.

(2) *Application of discrimination rules.* Under section 401(a)(4) and the regulations thereunder a plan is not qualified unless the contributions or benefits provided under the plan do not discriminate in favor of officers, shareholders or highly compensated employees (hereinafter referred to collectively as ''the prohibited group''). The presence or absence of such discrimination under a plan to which this section applies at any time shall not be determined on an employer-by-employer basis, but rather by testing separately each group of employees who are subject to the same benefit computation formula to determine if there is discrimination within such group. Consequently, discrimination in contributions or benefits among two or more different groups or among employees in different groups covered by the plan may be present without causing the plan to be disqualified. However, the presence of prohibited discrimination within one such group will result in the disqualification of the plan for all groups. Section 401(a)(4) and the regulations thereunder provide rules relating to the determination of which employees are members of the prohibited group and to the determination of discrimination in contributions or benefits which are applicable to a plan to which this section applies. The determination of whether or not an individual employee is a highly compensated employee shall be based on the relationship of the compensation of the employee to the compensation of all the other employees of all employers who are maintaining the plan and have employees covered under the same benefit computation formula, whether or not such other employees are covered by the plan or are covered under the same benefit computation formula, rather than to the compensation of all the other employees of the employer of such individual employee.

(3) *Application of termination, etc. rules.* Section 411(d)(3) and the regulations thereunder (relating to vesting required in the case of a termination, partial termination, or complete discontinuance of contributions) apply to a plan subject to the provisions of this section. The requirements of section

411(d)(3) shall be applied as if all participants in the plan who are subject to the same benefit computation formula and who are employed by employers who are parties to the collective bargaining agreement are employed by a single employer. The determination of whether or not there is a termination, partial termination, or complete discontinuance of contributions shall be made separately for each such group of participants who are treated as employed by a single employer. Consequently, if there are two or more groups of participants, a termination, partial termination, or complete discontinuance can take place under a plan with respect to one group of participants but not with respect to another such group of participants or for the entire plan. See §1.411(d)–2 for rules prescribed under section 411(d)(3).

(4) *Effective dates and transitional rules.* (i) Section 413(b)(2) and this paragraph apply to a plan for plan years beginning after December 31, 1953.

(ii) In applying the rules of this paragraph to a plan for plan years to which section 411 does not apply, section 401(a)(7) (as in effect on September 1, 1974) shall be substituted for section 411(d)(3). See §1.401–6 for rules prescribed under section 401(a)(7) as in effect on September 1, 1974. See §1.411(a)–2 for the effective dates of section 411.

(5) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (*1*). Plan A is a defined benefit plan subject to the provisions of this section and covers two groups of participants, local unions 1 and 2. Each local union has negotiated its own bargaining agreement with employers X, Y, and Z to provide its own benefit computation formula. The following table indicates the composition of the plan A participants:

	Employer X	Employer Y	Employer Z	Total
Local union 1	20	10	70	100
Local union 2	30	70	100	200

Under the rules of subparagraph (2) of this paragraph, the determination of whether contributions or benefits provided under the plan discriminate in favor of the prohibited group is made by applying the rules of section 401(a)(4) separately to participants who are members of local union 1 and local union 2. Thus, plan A will satisfy the qualification requirements of section 401(a)(4) if, within local union 1 and local union 2, respectively, plan benefits do not discriminate in favor of participants who are prohibited group employees within local union 1 and local union 2. Under the rules of subparagraph (2) of this paragraph, the determination under section 401(a)(4) of whether or not any individual employee, included within the 300 participants in plan A, is a highly compensated employee is based on the relationship of the compensation of such individual employee to the compensation of all the employees of Employers X, Y, and Z, whether or not such employees are participants in plan A. Thus, if there are 20 participants who are prohibited group employees within the 100 participants of local union 1, discrimination is determined by comparing the benefits of the 20 prohibited group participants to the benefits of the other 80 participants within local union 1. The same comparison would have to be made for the local union 2 participants between the prohibited group participants and the other participants in local union 2. Discrimination in benefits, if any, between the participants in local union 1 and local union 2, or among the employees of X, Y, or Z, would not affect the qualification of plan A under section 401(a)(4).

Example (2). Assume the same facts as in example (1). Employer X withdraws from the plan. Under subparagraph (3) of this paragraph, whether or not as a result of the withdrawal there is a partial termination under section 411(d)(3) is to be determined by applying the requirements of such section separately to the local union 1 and local union 2 participants. See §1.411(d)–2 for the requirements relating to partial terminations. The application of such requirements raises the following possibilities with respect to the plan: (1) A partial termination as to local union 1, (2) a partial termination as to local union 2, (3) a partial termination as to both local unions 1 and 2, or (4) no partial termination for either local union.

Example (3). Assume the same facts as in example (1). Plan A is amended to cease future benefit accruals under the plan for local union 1 participants. Under subparagraph (3) of the paragraph, whether or not as a result of the cessation there is a partial termination under section 411(d)(3) is to be determined by applying the requirements of such section separately to the local union 1 and local union 2 participants.

Example (4). Plan A is a defined benefit plan that provides for two normal retirement benefits, X and 2X. A participant receives benefit X if the collective bargaining agreement covering his employment provides for a contribution rate, M. If such agreement provides for a contribution rate of N, the participant receives benefit 2X. Benefit X and benefit 2X constitute separate benefit computation formulas.

Example (5). Plan B is a defined benefit plan that provides for a normal retirement benefit, X. Benefit X is provided for all plan participants even though there are two collective bargaining agreements providing for different contribution rates, M and N. Plan B has a single benefit computation formula, even though there are two contribution rates.

(d) *Exclusive benefit.* Under section 401(a), a plan is not qualified unless the plan is for the exclusive benefit of the employees (and their beneficiaries) of the employer establishing and maintaining the plan. Other qualification requirements under section 401(a) require the application of the exclusive benefit rule (for example, section 401(a)(2), which precludes diversion of plan assets). For purposes of applying the requirements of section 401(a) in determining whether a plan subject to this section is, with respect to each employer establishing and maintaining the plan, for the exclusive benefit of its employees (and their beneficiaries), all of the employees participating in the plan shall be treated as employees of each such employer. Thus, for example, contributions by employer A to a plan subject to this section could be allocated to employees of other employers maintaining the plan without violating the requirements of section 401(a)(2), because all the employees participating in the plan are deemed to be employees of A.

(e) *Vesting.* Section 411 (other than section 411(d)(3) relating to termination or partial termination; discontinuance of contributions) and the regulations thereunder shall be applied as if all employers who have been parties to the collective-bargaining agreement constituted a single employer. The application of any rules with respect to breaks in service under section 411 shall be made under regulations prescribed by the Secretary of Labor. Thus, for example, all the hours which an employee worked for each employer in a collectively-bargained plan would be aggregated in computing the employee's hours of service under the plan. See also 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans.)

(f)—(h) [Reserved]

(i) *Employees of labor unions*—(1) *General rule.* For purposes of section 413(b) and this section, employees of employee representatives shall be treated as employees of an employer establishing and maintaining a plan to which section 413(b) and this section apply if, with respect to the employees of such representatives, the plan satisfies the nondiscrimination requirements of section 401(a)(4) (determined without regard to section 413(b)(2)) and the minimum participation and coverage requirements of section 410 (determined without regard to section 413(b)(1)). For purposes of the preceding sentence, the plan and any affiliated employee health or welfare plan shall be deemed to be an employee representative. If employees of employee representatives, the plan, or an affiliated employee health or welfare plan are covered by the plan and are not treated as employees of an employer establishing and maintaining the plan under the provisions of this paragraph, the plan fails to satisfy the qualification requirements of section 401(a). In addition, in order for such a plan to be qualified, the plan must satisfy the requirements of section 413(b) (1) and (2), relating to participation and discrimination, respectively; see paragraphs (b) and (c) of this section. For purposes of this paragraph, an affiliated health or welfare plan is a health or welfare plan that is maintained under the same collective bargaining agreement or agreements, and that covers the same membership.

(2) *Effective dates and transitional rules.* (i) Section 413(b)(8) and this paragraph apply to a plan for plan years beginning after December 31, 1953.

(ii) In applying the rules of this paragraph to a plan for plan years to which section 410 does not apply, section 401(a)(3) (as in effect on September 1, 1974) shall be substituted for section 410. See §1.401–3 for rules prescribed under section 401(a)(3) as in effect on September 1, 1974. See §1.410(a)–2 for the effective dates of section 410.

(3) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). Plan A is a defined benefit plan, maintained pursuant to a collective bargaining agreement between employers, X, Y, and Z and labor union, L, which covers members of L employed by X, Y, and Z. In 1978, plan A is amended to cover, under the same benefit formula, all five employees of L who have satisfied the minimum age and service requirements of the plans (age 25 and 1 year of service). Assume that plan A is subject to section 413(b) and satisfies the requirements of section 413(b) (1) and (2). Assume further that with respect to employees of L, plan A (i) satisfies the nondiscrimination requirements of section 401(a)(4), (ii) meets the minimum participation requirements of section 410(a), and (iii) meets the minimum coverage requirements of section 410(b)(1)(A). Under the rules of subparagraph (1) of this paragraph, because such requirements are all satisfied, the employees of L are treated as employees of an employer establishing and maintaining plan A.

Example (2). Assume the same facts as example (1), except that plan A is amended to cover only one of the five employees of L, none of whom is covered by any other plan. Assume further that, under plan A, L does not satisfy the minimum percentage coverage requirement of section 410(b)(1)(A) with respect to employees of L. Assume further that the compensation of the one L employee who is covered by the plan is such that he is highly compensated relative to the four employees of L not covered by the plan. Consequently, L does not satisfy the minimum coverage requirements of section 410(b)(1)(B), with respect to employees of L. Under the rules of subparagraph (1) of this paragraph, the employees of L cannot be treated as employees of an employer establishing and maintaining the A plan because such coverage requirements are not satisfied by L. Consequently, the A plan fails to satisfy the qualification requirements of section 401(a).

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42340, Aug. 23, 1977, as amended by 42 FR 47198, Sept. 20, 1977; T.D. 7654, 44 FR 65063, Nov. 9, 1979]

§1.413–2 Special rules for plans maintained by more than one employer.

(a) *Application of section 413(c)*—(1) *In general.* Section 413(c) describes certain plans (and each trust which is a part of any such plan) hereinafter referred to as ‘‘section 413(c) plans.’’ A plan (and each trust which is a part of such plan) is deemed to be a section 413(c) plan if it is described in subparagraph (2) of this paragraph. Notwithstanding any other provision of the code (not specifically in conflict with the special rules hereinafter mentioned), a section 413(c) plan is subject to the special rules of section 413(c) (1) through (6) and paragraphs (b) through (g) of this section.

(2) *Section 413(c) plan.* A plan (and each trust which is a part of such plan) is a section 413(c) plan if—

(i) The plan is a single plan, within the meaning of section 413(a) and §1.413–1(a)(2), and

(ii) The plan is maintained by more than one employer.

For purposes of subdivision (ii) of this subparagraph, the number of employers maintaining the plan is determined by treating any employers described in section 414(b) (relating to a controlled group of corporations) or any employers described in section 414(c) (relating to trades or businesses under common control), whichever is applicable, as if such employers are a single employer. See §1.411(a)–5(b)(3) for rules relating to the time when an employer maintains a plan. A master or prototype plan is not a section 413(c) plan unless such a plan is described in this subparagraph. Similarly, the mere fact that a plan, or plans, utilizes a common trust fund or otherwise pools plan assets for investment purposes does not, by itself, result in a particular plan being treated as a section 413(c) plan.

(3) *Additional rules.* (i) If a plan is a collectively bargained plan described in §1.413–1(a), the rules of section 413(c) and this section do not apply, and the rules of section 413(b) and §1.413–1 do apply to the plan.

(ii) The special rules of section 413(b)(1) and §1.413–1(b) relating to the application of section 410, other than the rules of section 410(a), do not apply to a section 413(c) plan. Thus, for example, the minimum coverage requirements of section 410(b) are generally applied to a section 413(c) plan on an employer-by-employer basis, taking into account the generally applicable rules such as section 401(a)(5) and section 414 (b) and (c).

(iii) The special rules of section 413(b)(2) and §1.413–1(c) (relating to (A) section 401(a)(4) and prohibited discrimination, and (B) 411(d)(3) and vesting required on termination, partial termination, or discontinuance of contributions) do not apply to a section 413(c) plan. Thus, for example, the determination of whether or not there is a termination, within the meaning of section 411(d)(3), of a section 413(c) plan is made solely by reference to the rules of sections 411(d)(3) and 413(c)(3).

(iv) The qualification of a section 413(c) plan, at any relevant time, under section 401(a), 403(a) or 405(a), as modified by section 413(c) and this section, is determined with respect to all employers maintaining the section 413(c) plan. Consequently, the failure by one employer maintaining the plan (or by the plan itself) to satisfy an applicable qualification requirement will result in the disqualification of the section 413(c) plan for all employers maintaining the plan.

(4) *Effective dates.* Except as otherwise provided, section 413(c) and this section apply to a plan for plan years beginning after December 31, 1953.

(b) *Participation.* Section 410(a) and the regulations thereunder shall be applied as if all employees of each of the employers who maintain the plan were employed by a single employer.

(c) *Exclusive benefit.* In the case of a plan subject to this section, the exclusive benefit requirements of section 401(a) shall be applied to the plan in the same manner as under section 413(b)(3) and § 1.413–1(d).

(d) *Vesting.* Section 411 and the regulations thereunder shall be applied as if all employers who maintain the plan constituted a single employer. The application of any rules with respect to breaks in service under section 411 shall be made under regulations prescribed by the Secretary of Labor. Thus, for example, all the hours which an employee worked for each employer maintaining the plan would be aggregated in computing the employee's hours of service under the plan. See also 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(Sec. 411 (88 Stat. 901; 26 U.S.C. 411))

[T.D. 7501, 42 FR 42340, Aug. 23, 1977, as amended by 42 FR 47198, Sept. 20, 1977; T.D. 7654, 44 FR 65065, Nov. 9, 1979]

§ 1.414(b)–1 Controlled group of corporations.

(a) *Defintion of controlled group of corporations.* For purposes of this section, the term ''controlled group of corporations'' has the same meaning as is assigned to the term in section 1563(a) and the regulations thereunder, except that (1) the term ''controlled group of corporations'' shall not include an ''insurance group'' described in section 1563(a)(4), and (2) section 1563(e)(3)(C) (relating to stock owned by certain employees' trusts) shall not apply. For purposes of this section, the term ''members of a controlled group'' means two or more corporations connected through stock ownership described in section 1563(a) (1), (2), or (3), whether or not such corporations are ''component members of a controlled group'' within the meaning of section 1563(b). Two or more corporations are members of a controlled group at any time such corporations meet the requirements of section 1563(a) (as modified by this paragraph). For purposes of this section, if a corporation is a member of more than one controlled group of corporations, such corporation shall be treated as a member of each controlled group.

(b) *Single plan adopted by two or more members.* If two or more members of a controlled group of corporations adopt a single plan for a plan year, then the minimum funding standard provided in section 412, the tax imposed by section 4971, and the applicable limitations provided by section 404(a) shall be determined as if such members were a single employer. In such a case, the amount of such items and the allocable portion attributable to each member shall be determined in the manner provided in regulations under sections 412, 4971, and 404(a).

(c) *Cross reference.* For rules relating to the application of sections 401, 408(k), 410, 411, 415, and 416 with respect to two or more trades or businesses which are under common control, see section 414(c) and the regulations thereunder.

[T.D. 8179, 53 FR 6605, Mar. 2, 1988]

§1.414(c)–1 Commonly controlled trades or businesses.

For purposes of applying the provisions of sections 401 (relating to qualified pension, profit-sharing, and stock bonus plans), 408(k) (relating to simplified employee pensions), 410 (relating to minimum participation standards), 411 (relating to minimum vesting standards), 415 (relating to limitations on benefits and contributions under qualified plans), and 416 (relating to top-heavy plans), all employees of two or more trades or businesses under common control within the meaning of §1.414(c)–2 for any period shall be treated as employed by a single employer. See sections 401, 408(k), 410, 411, 415, and 416 and the regulations thereunder for rules relating to employees of trades or businesses which are under common control. See §1.414(c)–5 for effective date.

[T.D. 8179, 53 FR 6606, Mar. 2, 1988]

§1.414(c)–2 Two or more trades or businesses under common control.

(a) *In general.* For purposes of this section, the term ‘‘two or more trades or businesses under common control’’ means any group of trades or businesses which is either a ‘‘parent-subsidiary group of trades or businesses under common control’’ as defined in paragraph (b) of this section, a ‘‘brother-sister group of trades or businesses under common control’’ as defined in paragraph (c) of this section, or a ‘‘combined group of trades or businesses under common control’’ as defined in paragraph (d) of this section. For purposes of this section and §§1.414(c)–3 and 1.414(c)–4, the term ‘‘organization’’ means a sole proprietorship, a partnership (as defined in section 7701(a)(2)), a trust, an estate, or a corporation.

(b) *Parent-subsidiary group of trades or businesses under common control*—(1) *In general.* The term ‘‘parent-subsidiary group of trades or businesses under common control’’ means one or more chains of organizations conducting trades or businesses connected through ownership of a controlling interest with a common parent organization if—

(i) A controlling interest in each of the organizations, except the common parent organization, is owned (directly and with the application of §1.414(c)–4(b)(1), relating to options) by one or more of the other organizations; and

(ii) The common parent organization owns (directly and with the application of §1.414(c)–4(b)(1), relating to options) a controlling interest in at least one of the other organizations, excluding, in computing such controlling interest, any direct ownership interest by such other organizations.

(2) *Controlling interest defined*—(i) *Controlling interest.* For purposes of paragraphs (b) and (c) of this section, the phrase ‘‘controlling interest’’ means:

(A) In the case of an organization which is a corporation, ownership of stock possessing at least 80 percent of total combined voting power of all classes of stock entitled to vote of such corporation or at least 80 percent of the total value of shares of all classes of stock of such corporation;

(B) In the case of an organization which is a trust or estate, ownership of an actuarial interest of at least 80 percent of such trust or estate;

(C) In the case of an organization which is a partnership, ownership of at least 80 percent of the profits interest or capital interest of such partnership; and

(D) In the case of an organization which is a sole proprietorship, ownership of such sole proprietorship.

(ii) *Actuarial interest.* For purposes of this section, the actuarial interest of each beneficiary of trust or estate shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary. The factors and methods prescribed in §20.2031–7 or, for certain prior periods, §20.2031–7A (Estate Tax Regulations) for use in ascertaining the value of an interest in property for estate tax purposes shall be used for purposes of this subdivision in determining a beneficiary’s actuarial interest.

(c) *Brother-sister group of trades or businesses under common control*—(1) *In general.* The term ''brother-sister group of trades or businesses under common control'' means two or more organizations conducting trades or businesses if (i) the same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of § 1.414(c)–4) a controlling interest in each organization, and (ii) taking into account the ownership of each such person only to the extent such ownership is identical with respect to each such organization, such persons are in effective control of each organization. The five or fewer persons whose ownership is considered for purposes of the controlling interest requirement for each organization must be the same persons whose ownership is considered for purposes of the effective control requirement.

(2) *Effective control defined.* For purposes of this paragraph, persons are in ''effective control'' of an organization if—

(i) In the case of an organization which is a corporation, such persons own stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of such corporation;

(ii) In the case of an organization which is a trust or estate, such persons own an aggregate actuarial interest of more than 50 percent of such trust or estate;

(iii) In the case of an organization which is a partnership, such persons own an aggregate of more than 50 percent of the profits interest or capital interest of such partnership; and

(iv) In the case of an organization which is a sole proprietorship, one of such persons owns such sole proprietorship.

(d) *Combined group of trades or businesses under common control.* The term ''combined group of trades or businesses under common control'' means any group of three or more organizations, if (1) each such organization is a member of either a parent-subsidiary group of trades or businesses under common control or a brother-sister group of trades or businesses under common control, and (2) at least one such organization is the common parent organization of a parent-subsidiary group of trades or businesses under common control and is also a member of a brother-sister group of trades or businesses under common control.

(e) *Examples.* The definitions of parent-subsidiary group of trades or businesses under common control, brother-sister group of trades or businesses under common control, and combined group of trades or businesses under common control may be illustrated by the following examples.

Example (1). (a) The ABC partnership owns stock possessing 80 percent of the total combined voting power of all classes of stock entitled to voting of S corporation. ABC partnership is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of the ABC partnership and S Corporation.

(b) Assume the same facts as in (a) and assume further that S owns 80 percent of the profits interest in the DEF Partnership. The ABC Partnership is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of the ABC Partnership, S Corporation, and the DEF Partnership. The result would be the same if the ABC Partnership, rather than S, owned 80 percent of the profits interest in the DEF Partnership.

Example (*2*). L Corporation owns 80 percent of the only class of stock of T Corporation, and T, in turn, owns 40 percent of the capital interest in the GHI Partnership. L also owns 80 percent of the only class of stock of N Corporation and N, in turn, owns 40 percent of the capital interest in the GHI Partnership. L is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of L Corporation, T Corporation, N Corporation, and the GHI Partnership.

Example (*3*). ABC Partnership owns 75 percent of the only class of stock of X and Y Corporations; X owns all the remaining stock of Y, and Y owns all the remaining stock of X. Since interorganization ownership is excluded (that is, treated as not outstanding) for purposes of determining whether ABC owns a controlling interest of at least one of the other organizations, ABC is treated as the owner of stock possessing 100 percent of the voting power and value of all classes of stock of X and of Y for purposes of paragraph (b)(1)(ii) of this section. Therefore, ABC is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of the ABC Partnership, X Corporation, and Y Corporation.

Example (4). Unrelated individuals A, B, C, D, E, and F own an interest in sole proprietorship A, a capital interest in the GHI Partnership, and stock of corporations M, W, X, Y, and Z (each of which has only one class of stock outstanding) in the following proportions:

ORGANIZATIONS

Individuals	A	GHI	M	W	X	Y	Z
A	100%	50%	100%	60%	40%	20%	60%
B	—	40%	—	15%	40%	50%	30%
C	—	—	—	—	10%	10%	10%
D	—	—	—	25%	—	20%	—
E	—	10%	—	—	10%	—	—
	100%	100%	100%	100%	100%	100%	100%

Under these facts the following four brother-sister groups of trades or businesses under common control exist: GHI, X and Z; X, Y and Z; W and Y; A and M. In the case of GHI, X, and Z, for example, A and B together have effective control of each organization because their combined identical ownership of GHI, X and Z is greater than 50%. (A's identical ownership of GHI, X and Z is 40% because A owns at least a 40% interest in each organization. B's identical ownership of GHI, X and Z is 30% because B owns at least a 30% interest in each organization.) A and B (the persons whose ownership is considered for purposes of the effective control requirement) together own a controlling interest in each organization because they own at least 80% of the capital interest of partnership GHI and at least 80% of the total combined voting power of corporations X and Z. Therefore, GHI, X and Z comprise a brother-sister group of trades or businesses under common control. Y is not a member of this group because neither the effective control requirement nor the 80% controlling interest requirement are met. (The effective control requirement is not met because A's and B's combined identical ownership in GHI, X, Y and Z (20% for A and 30% for B) does not exceed 50%. The 80% controlling interest test is not met because A and B together only own 70% of the total combined voting power of the stock of Y.) A and M are not members of this group because B owns no interest in either organization and A's ownership of GHI, X and Z, considered alone, is less than 80%.

Example (5). The outstanding stock of corporations U and V, which have only one class of stock outstanding, is owned by the following unrelated individuals:

CORPORATIONS

Individuals	U	V
	(percent)	(percent)
A	12	12
B	12	12
C	12	12
D	12	12
E	13	13
F	13	13
G	13	13
H	13	13
	100	100

Any group of five of the shareholders will own more than 50 percent of the stock in each corporation, in identical holdings. However, U and V are not members of a brother-sister group of trades or businesses under common control because at least 80 percent of the stock of each corporation is not owned by the same five or fewer persons.

Example (6). A, an individual, owns a controlling interest in ABC Partnership and DEF Partnership. ABC, in turn, owns a controlling interest in X Corporation. Since ABC, DEF, and X are each members of either a parent-subsidiary group or a brother-sister group of trades or businesses under common control, and ABC is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of ABC and X, and also a member of a brother-sister group of trades or businesses under common control consisting of ABC and DEF, ABC Partnership, DEF Partnership, and X Corporation are members of the same combined group of trades or businesses under common control.

[T.D. 8179, 53 FR 6606, Mar. 2, 1988, as amended by T.D. 8540, 59 FR 30102, June 10, 1994]

§1.414(c)–3 Exclusion of certain interests or stock in determining control.

(a) *In general.* For purposes of §1.414(c)–2 (b)(2)(i) and (c)(2), the term ''interest'' and the term ''stock'' do not include an interest which is treated as not outstanding under paragraph (b) of this section in the case of a parent-subsidiary group of trades or businesses under common control or under paragraph (c) of this section in the case of a brother-sister group of trades or businesses under common control. In addition, the term ''stock'' does not include treasury stock or nonvoting stock which is limited and preferred as to dividends. For definitions of certain terms used in this section, see paragraph (d) of this section.

(b) *Parent-subsidiary group of trades or businesses under common control*—(1) *In general.* If an organization (hereinafter in this section referred to as ''parent organization'') owns (within the meaning of paragraph (b)(2) of this section)—

(i) In the case of a corporation, 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of such corporation.

(ii) In the case of a trust or an estate, an actuarial interest (within the meaning of § 1.414(c)–2(b)(2)(ii)) of 50 percent or more of such trust or estate, and

(iii) In the case of a partnership, 50 percent or more of the profits or capital interest of such partnership, then for purposes of determining whether the parent organization or such other organization (hereinafter in this section referred to as ''subsidiary organization'') is a member of a parent-subsidiary group of trades or businesses under common control, an interest in such subsidiary organization excluded under paragraph (b) (3), (4), (5), or (6) of this section shall be treated as not outstanding.

(2) *Ownership.* For purposes of paragraph (b)(1) of this section, a parent organization shall be considered to own an interest in or stock of another organization which it owns directly or indirectly with the application of § 1.414(c)–4(b)(1) and—

(i) In the case of a parent organization which is a partnership, a trust, or an estate, with the application of paragraphs (b) (2), (3), and (4) of § 1.414(c)–4, and

(ii) In the case of a parent organization which is a corporation, with the application of § 1.414(c)–4(b)(4).

(3) *Plan of deferred compensation.* An interest which is an interest in or stock of the subsidiary organization held by a trust which is part of a plan of deferred compensation (within the meaning of section 406(a)(3) and the regulations thereunder) for the benefit of the employees of the parent organization or the subsidiary organization shall be excluded.

(4) *Principal owners, officers, etc.* An interest which is an interest in or stock of the subsidiary organization owned (directly and with the application of § 1.414(c)–4) by an individual who is a principal owner, officer, partner, or fiduciary of the parent organization shall be excluded.

(5) *Employees.* An interest which is an interest in or stock of the subsidiary organization owned (directly and with the application of § 1.414(c)–4) by an employee of the subsidiary organization shall be excluded if such interest or such stock is subject to conditions which substantially restrict or limit the employee's right (or if the employee constructively owns such interest or such stock, the direct or record owner's right) to dispose of such interest or such stock and which run in favor of the parent or subsidiary organization.

(6) *Controlled exempt organization.* An interest which is an interest in or stock of the subsidiary organization shall be excluded if owned (directly and with the application of § 1.414(c)–4) by an organization (other than the parent organization):

(i) To which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies, and

(ii) Which is controlled directly or indirectly (within the meaning of paragraph (d)(7) of this section) by the parent organization or subsidiary organization, by an individual, estate, or trust that is a principal owner of the parent organization, by an officer, partner, or fiduciary of the parent organization, or by any combination thereof.

(c) *Brother-sister group of trades or businesses under common control*—(1) *In general.* If five or fewer persons (hereinafter in this section referred to as ''common owners'') who are individuals, estates, or trusts own (directly and with the application of §1.414(c)–4)—

(i) In the case of a corporation, 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock or such corporation,

(ii) In the case of a trust or an estate, an actuarial interest (within the meaning of §1.414(c)–2(b)(2)(ii)) of 50 percent or more of such trust or estate, and

(iii) In the case of a partnership, 50 percent or more of the profits or capital interest of such partnership, then for purposes of determining whether such organization is a member of a brother-sister group of trades or businesses under common control, an interest in such organization excluded under paragraph (c) (2), (3), or (4) of this section shall be treated as not outstanding.

(2) *Exempt employees' trust.* An interest which is an interest in or stock of such organization held by an employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be excluded if such trust is for the benefit of the employees of such organization.

(3) *Employees.* An interest which is an interest in or stock of such organization owned (directly and with the application of §1.414(c)–4) by an employee of such organization shall be excluded if such interest or stock is subject to conditions which run in favor of a common owner of such organization or in favor of such organization and which substantially restrict or limit the employee's right (or if the employee constructively owns such interest or stock, the direct or record owner's right) to dispose of such interest or stock.

(4) *Controlled exempt organization.* An interest which is an interest in or stock of such organization shall be excluded if owned (directly and with the application of §1.414(c)–4) by an organization:

(i) To which section 501(c)(3) (relating to certain educational and charitable organizations which are exempt from tax) applies, and

(ii) Which is controlled directly or indirectly (within the meaning of paragraph (d)(7) of this section) by such organization, by an individual, estate, or trust that is a principal owner of such organization, by an officer, partner, or fiduciary of such organization, or by any combination thereof.

(d) *Definitions*—(1) *Employee.* For purposes of this section, the term ''employee'' has the same meaning such term is given in section 3306(i) of the Code (relating to definitions for purposes of the Federal Unemployment Tax Act).

(2) *Principal owner.* For purposes of this section, the term ''principal owner'' means a person who owns (directly and with the application of §1.414(c)–4)—

(i) In the case of a corporation, 5 percent or more of the total combined voting power of all classes of stock entitled to vote in such corporation or 5 percent of more of the total value of shares of all classes of stock of such corporation;

(ii) In the case of a trust or estate, an actuarial interest of 5 percent or more of such trust or estate; or

(iii) In the case of a partnership, 5 percent or more of the profits or capital interest of such partnership.

(3) *Officer.* For purposes of this section, the term ''officer'' includes the president, vice-presidents, general manager, treasurer, secretary, and comptroller of a corporation, and any other person who performs duties corresponding to those normally performed by persons occupying such positions.

(4) *Partner.* For purposes of this section, the term ''partner'' means any person defined in section 7701(a)(2) (relating to definitions of partner).

(5) *Fiduciary.* For purposes of this section and §1.414(c)–4, the term ''fiduciary'' has the same meaning as such term is given in section 7701(a)(6) and the regulations thereunder.

(6) *Substantial conditions.* (i) *In general.* For purposes of this section, an interest in or stock of an organization is subject to conditions which substantially restrict or limit the right to dispose of such interest or stock and which run in favor of another person if

the condition extends directly or indirectly to such person preferential rights with respect to the acquisition of the direct owner's (or the record owner's) interest or stock. For a condition to be in favor of another person it is not necessary that such person be extended a discriminatory concession with respect to price. A right of first refusal with respect to an interest or stock in favor of another person is a condition which substantially restricts or limits the direct or record owner's right of disposition which runs in favor of such person. Further, any legally enforceable condition which prohibits the direct or record owner from disposing of his or her interest or stock without the consent of another person will be considered to be a substantial limitation running in favor of such person.

(ii) *Special rule.* For purposes of paragraph (c)(3) of this section only, if a condition which restricts or limits an employee's right (or direct or record owner's right) to dispose of his or her interest or stock also applies to the interest or stock in such organization held by a common owner pursuant to a bonafide reciprocal purchase arrangement, such condition shall not be treated as a substantial limitation or restriction. An example of a reciprocal purchase arrangement is an agreement whereby a common owner and the employee are given a right of first refusal with respect to stock of the employer corporation owned by the other party. If, however, the agreement also provides that the common owner has the right to purchase the stock of the employer corporation owned by the employee in the event the corporation should discharge the employee for reasonable cause, the purchase arrangement would not be reciprocal within the meaning of this subdivision.

(7) *Control.* For purposes of paragraphs (b)(6) and (c)(4) of this section, the term ''control'' means control in fact. The determination of whether there exists control in fact will depend upon all of the facts and circumstances of each case, without regard to whether such control is legally enforceable and irrespective of the method by which such control is exercised or exercisable.

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

Example (1). ABC Partnership owns 70 percent of the capital interest and of the profits interest in the DEF Partnership. The remaining capital interest and profits interest in DEF is owned as follows: 4 percent by A (a general partner in ABC), and 26 percent by D (a limited partner in ABC). ABC satisfies the 50-percent capital interest or profits interest ownership requirement of paragraph (b)(1)(iii) of this section with respect to DEF. Since A and D are partners of ABC, under paragraph (b)(4) of this section the capital and profits interests in DEF owned by A and D are treated as not outstanding for purposes of determining whether ABC and DEF are members of a parent-subsidiary group of trades or businesses under common control under § 1.414 (c)–2(b). Thus, ABC is considered to own 100 percent (70÷70) of the capital interest and profits interest in DEF. Accordingly, ABC and DEF are members of a parent-subsidiary group of trades or businesses under common control.

Example (2). Assume the same facts as in example (1) and assume further that A owns 15 shares of the 100 shares of the only class of stock of S Corporation and DEF Partnership owns 75 shares of such stock. ABC satisfies the 50 percent stock requirement of paragraph (b)(1)(i) of this section with respect to S since ABC is considered as owning 52.5 percent (70 percent×75 percent) of the S stock with the application of § 1.414 (c)–4(b)(2). Since A is a partner of ABC, the S stock owned by A is treated as not outstanding for purposes of determining whether S is a member of a parent-subsidiary group of trades or businesses under common control. Thus, DEF Partnership is considered to own stock possessing 88.2 percent (75÷85) of the voting power and value of the S stock. Accordingly, ABC Partnership, DEF Partnership, and S Corporation are members of a parent-subsidiary group of trades or businesses under common control.

Example (3). ABC Partnership owns 60 percent of the only class of stock of Corporation Y. D, the president of Y, owns the remaining 40 percent of the stock of Y. D has agreed that if she offers her stock in Y for sale she will first offer the stock to ABC at a price equal to the fair market value of the stock on the first date the stock is offered for sale. Since D is an employee of Y within the meaning of section 3306(i) of the Code and her stock in Y is subject to a condition which substantially restricts or limits her right to dispose of such stock and runs in favor of ABC Partnership, under paragraph (b)(5) of this section such stock is treated as not outstanding for purposes of determining whether ABC and Y are members of a parent-subsidiary group of trades or businesses under common control. Thus, ABC Partnership is considered to own stock possessing 100 percent of the voting power and value of the stock of Y. Accordingly, ABC Partnership and Y Corporation are members of a parent-subsidiary group of trades or businesses under common control. The result would be the same if D's husband, instead of D, owned directly the 40 percent stock interest in Y and such stock was subject to a right of first refusal running in favor of ABC Partnership.

(f) *Exception*—(1) *In general.* If an interest in an organization (including stock of a corporation) is owned by a person directly or with the application of the rules of paragraph (b) of §1.414 (c)–4 and such ownership results in the membership of that organization in a group of two or more trades or businesses under common control for any period, then the interest will not be treated as an excluded interest under paragraph (b) or (c) of this section if the result of applying such provisions is that the organization is not a member of a group of two or more trades or businesses under common control for the period.

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

Example. Corporation P owns directly 50 of the 100 shares of the only class of stock of corporation S. A, an officer of P, owns directly 30 shares of S stock which P has an option to acquire. If, under paragraph (b)(4) of this section, the 30 shares owned directly by A are treated as not outstanding, P would be treated as owning stock possessing only 71 percent (50/70) of the total voting power and value of S stock, and S should not be a member of a parent-subsidiary group of trades or businesses under common control. However, because the 30 shares owned by A that P has an option to purchase are considered as owned by P under paragraph (b)(2) of this section, and that ownership plus P's direct ownership of 50 shares result in S's membership in a parent-subsidiary group of trades or businesses under common control for 1985, the provisions of this paragraph apply. Therefore, A's stock is not treated as an excluded interest and S is a member of a parent-subsidiary group consisting of P and S.

[T.D. 8179, 53 FR 6607, Mar. 2, 1988; 53 FR 8302, Mar. 14, 1988]

§1.414(c)–4 Rules for determining ownership.

(a) *In general.* In determining the ownership of an interest in an organization for purposes of §1.414(c)–2 and §1.414(c)–3, the constructive ownership rules of paragraph (b) of this section shall apply, subject to the operating rules contained in paragraph (c). For purposes of this section the term ''interest'' means: in the case of a corporation, stock; in the case of a trust or estate, an actuarial interest; in the case of a partnership, an interest in the profits or capital; and in the case of a sole proprietorship, the proprietorship.

(b) *Constructive ownership*—(1) *Options.* If a person has an option to acquire any outstanding interest in an organization, such interest shall be considered as owned by such person. For this purpose, an option to acquire an option, and each one of a series of such options shall be considered as an option to acquire such interest.

(2) *Attribution from partnerships*—(i) *General.* An interest owned, directly or indirectly, by or for a partnership shall be considered as owned by any partner having an interest of 5 percent or more in either the profits or capital of the partnership in proportion to such partner's interest in the profits or capital, whichever such proportion is greater.

(ii) *Example.* The provisions of paragraph (b)(2)(i) of this section may be illustrated by the following example:

Example. A, B, and C, unrelated individuals, are partners in the ABC Partnership. The partners' interest in the capital and profits of ABC are as follows:

(IN PERCENT)

Partner	Capital	Profits
A	36	25
B	60	71
C	4	4

The ABC Partnership owns the entire outstanding stock (100 shares) of X Corporation. Under paragraph (b)(2)(i) of this section, A is considered to own the stock of X owned by the partnership in proportion to his interest in capital (36 percent) or profits (25 percent), whichever such proportion is greater. Therefore, A is considered to own 36 shares of X stock. Since B has a greater interest in the profits of the partnership than in the capital, B is considered to own X stock in proportion to his interest in such profits. Therefore, B is considered to own 71 shares of X stock. Since C does not have an interest of 5 percent or more in either the capital or profits of ABC, he is not considered to own any shares of X stock.

(3) *Attribution from estates and trusts*—(i) *In general.* An interest in an organization (hereinafter called an ‘‘organization interest’’) owned, directly or indirectly, by or for an estate or trust shall be considered as owned by any beneficiary of such estate or trust who has an actuarial interest of 5 percent or more in such organization interest, to the extent of such actuarial interest. For purposes of this subparagraph, the actuarial interest of each beneficiary shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary and the maximum use of the organization interest to satisfy the beneficiary's rights. A beneficiary of an estate or trust who cannot under any circumstances receive any part of an organization interest held by the estate or trust, including the proceeds from the disposition thereof, or the income therefrom, does not have an actuarial interest in such organization interest. Thus, where stock owned by a decedent's estate has been specifically bequeathed to certain beneficiaries and the remainder of the estate has been specifically bequeathed to other beneficiaries, the stock is attributable only to the beneficiaries to whom it is specifically bequeathed. Similarly a remainderman of a trust who cannot under any circumstances receive any interest in the stock of a corporation which is a part of the corpus of the trust (including any accumulated income therefrom or the proceeds from a disposition thereof) does not have an actuarial interest in such stock. However, an income beneficiary of a trust does have an actuarial interest in stock if he has any right to the income from such stock even though under the terms of the trust instrument such stock can never be distributed to him. The factors and methods prescribed in § 20.2031–7 or, for certain prior periods, § 20.2031–7A (Estate Tax Regulations) for use in ascertaining the value of an interest in property for estate tax purposes shall be used for purposes of this subdivision in determining a beneficiary's actuarial interest in an organization interest owned directly or indirectly by or for an estate or trust.

(ii) *Special rules for estates.* (A) For purposes of this paragraph (b)(3) with respect to an estate, property of a decedent shall be considered as owned by his or her estate if such property is subject to administration by the executor or administrator for the purposes of paying claims against the estate and expenses of administration notwithstanding that, under local law, legal title to such property vests in the decedent's heirs, legatees or devisees immediately upon death.

(B) For purposes of this paragraph (b)(3) with respect to an estate, the term ‘‘beneficiary’’ includes any person entitled to receive property of a decedent pursuant to a will or pursuant to laws of descent and distribution.

(C) For purposes of this paragraph (b)(3) with respect to an estate, a person shall no longer be considered a beneficiary of an estate when all the property to which he or she is entitled has been received by him or her, when he or she no longer has a claim against the estate arising out of having been a beneficiary, and when there is only a remote possibility that it will be necessary for the estate to seek the return of property from him or her or to seek payment from him or her by contribution or otherwise to satisfy claims against the estate or expenses of administration.

(iii) *Grantor trusts, etc.* An interest owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E, part I, subchapter J of the Code (relating to grantors and others treated as substantial owners) is considered as owned by such person.

(4) *Attribution from corporations*—(i) *General.* An interest owned, directly or indirectly, by or for a corporation shall be considered as owned by any person who owns (directly and, in the case of a parent-subsidiary group of trades or businesses under common control, with the application of paragraph (b)(1) of this section, or in the case of a brother-sister group of trades or business under common control, with the application of this section), 5 percent or more in value of the stock in that proportion which the value of the stock which such person so owns bears to the total value of all the stock in such corporation.

(ii) *Example.* The provisions of paragraph (b)(4)(i) of this section may be illustrated by the following example:

Example. B, an individual, owns 60 of the 100 shares of the only class of outstanding stock of corporation P. C, an individual, owns 4 shares of the P stock, and corporation X owns 36 shares of the P stock. Corporation P owns, directly and indirectly, 50 shares of the stock of corporation S. Under this subparagraph, B is considered to own 30 shares of the S stock (60/100×50), and X is considered to own 18 shares of S stock (36/100×50). Since C does not own 5 percent or more in the value of P stock, he is not considered as owning any of the S stock owned by P. If in this example, C's wife had owned directly 1 share of the P stock, C and his wife would each be considered as owning 5 shares of the P stock, and therefore C and his wife would be considered as owning 2.5 shares of the S stock (5/100×50).

(5) *Spouse*—(i) *General rule.* Except as provided in paragraph (b)(5)(ii) of this section, an individual shall be considered to own an interest owned, directly or indirectly, by or for his or her spouse, other than a spouse who is legally separated from the individual under a decree of divorce, whether interlocutory or final, or a decree of separate maintenance.

(ii) *Exception.* An individual shall not be considered to own an interest in an organization owned, directly or indirectly, by or for his or her spouse on any day of a taxable year of such organization, provided that each of the following conditions are satisfied with respect to such taxable year:

(A) Such individual does not, at any time during such taxable year, own directly any interest in such organization;

(B) Such individual is not a member of the board of directors, a fiduciary, or an employee of such organization and does not participate in the management of such organization at any time during such taxable year;

(C) Not more than 50 percent of such organization's gross income for such taxable year was derived from royalties, rents, dividends, interest, and annuities; and

(D) Such interest in such organization is not, at any time during such taxable year, subject to conditions which substantially restrict or limit the spouse's right to dispose of such interest and which run in favor of the individual or the individual's children who have not attained the age of 21 years. The principles of §1.414(c)–3(d)(6)(i) shall apply in determining whether a condition is a condition described in the preceding sentence.

(iii) *Definitions.* For purposes of paragraph (b)(5)(ii)(C) of this section, the gross income of an organization shall be determined under section 61 and the regulations thereunder. The terms ''interest'', ''royalties'', ''rents'', ''dividends'', and ''annuities'' shall have the same meaning such terms are given for purposes of section 1244(c) and §1.1244(c)–1(e)(1).

(6) *Children, grandchildren, parents, and grandparents*—(i) *Children and parents.* An individual shall be considered to own an interest owned, directly or indirectly, by or for the individual's children who have not attained the age of 21 years, and if the individual has not attained the age of 21 years, an interest owned, directly or indirectly, by or for the individual's parents.

(ii) *Children, grandchildren, parents, and grandparents.* If an individual is in effective control (within the meaning of §1.414(c)–2(c)(2)), directly and with the application of the rules of this paragraph without regard to this subdivision, of an organization, then such individual shall be considered to own an interest in such organization owned, directly or indirectly, by or for the individual's parents, grandparents, grandchildren, and children who have attained the age of 21 years.

(iii) *Adopted children.* For purposes of this section, a legally adopted child of an individual shall be treated as a child of such individual.

(iv) *Example.* The provisions of this subparagraph (6) may be illustrated by the following example:

Example—(A) *Facts.* Individual F owns directly 40 percent of the profits interest of the DEF Partnership. His son, M, 20 years of age, owns directly 30 percent of the profits interest of DEF, and his son, A, 30 years of age, owns directly 20 percent of the profits interest of DEF. The 10 percent remaining of the profits interest and 100 percent of the capital interest of DEF is owned by an unrelated person.

(B) *F's ownership.* F owns 40 percent of the profits interest in DEF directly and is considered to own the 30 percent profits interest owned directly by M. Since, for purposes of the effective control test contained in paragraph (b)(6)(ii) of this section, F is treated as owning 70 percent of the profits interest of DEF, F is also considered as owning the 20 percent profits interest of DEF owned by his adult son, A. Accordingly, F is considered as owning a total of 90 percent of the profits interest in DEF.

(C) *M's ownership.* Minor son, M. owns 30 percent of the profits interest in DEF directly, and is considered to own the 40 percent profits interest owned directly by his father, F. However, M is not considered to own the 20 percent profits interest of DEF owned directly by his brother, A, and constructively by F, because an interest constructively owned by F by reason of family attribution is not considered as owned by him for purposes of making another member of his family the constructive owner of such interest. (See paragraph (c)(2) of this section.) Accordingly, M is considered as owning a total of 70 percent of the profits interest of the DEF Partnership.

(D) *A's ownership.* Adult son, A, owns 20 percent of the profits interest in DEF directly. Since, for purposes of determining whether A effectively controls DEF under paragraph (b)(6)(ii) of this section, A is treated as owning only the percentage of profits interest he owns directly, he does not satisfy the condition precedent for the attribution of the DEF profits interest from his father. Accordingly, A is considered as owning only the 20 percent profits interest in DEF which he owns directly.

(c) *Operating rules*—(1) *In general.* Except as provided in paragraph (c)(2) of this section, an interest constructively owned by a person by reason of the application of paragraph (b) (1), (2), (3), (4), (5), or (6) of this section shall, for the purposes of applying such paragraph, be treated as actually owned by such person.

(2) *Members of family.* An interest constructively owned by an individual by reason of the application of paragraph (b) (5) or (6) of this section shall not be treated as owned by such individual for purposes of again applying such subparagraphs in order to make another the constructive owner of such interest.

(3) *Precedence of option attribution.* For purposes of this section, if an interest may be considered as owned under paragraph (b)(1) of this section (relating to option attribution) and under any other subparagraph of paragraph (b) of this section, such interest shall be considered as owned by such person under paragraph (b)(1) of this section.

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

Example (*1*). A, 30 years of age, has a 90 percent interest in the capital and profits of DEF Partnership. DEF owns all the outstanding stock of corporation X and X owns 60 shares of the 100 outstanding shares of corporation Y. Under paragraph (c)(1) of this section, the 60 shares of Y constructively owned by DEF by reason of paragraph (b)(4) of this section are treated as actually owned by DEF for purposes of applying paragraph (b)(2) of this section. Therefore, A is considered as owning 54 shares of the Y stock (90 percent of 60 shares).

Example (2). Assume the same facts as in example (1). Assume further that B, who is 20 years of age and the brother of A, directly owns 40 shares of Y stock. Although the stock of Y owned by B is considered as owned by C (the father of A and B) under paragraph (b)(6)(i) of this section, under paragraph (c)(2) of this section such stock may not be treated as owned by C for purposes of applying paragraph (b)(6)(ii) of this section in order to make A the constructive owner of such stock.

Example (3). Assume the same facts as in example (2), and further assume that C has an option to acquire the 40 shares of Y stock owned by his son, B. The rule contained in paragraph (c)(2) of this section does not prevent the reattribution of such 40 shares to A because, under paragraph (c)(3) of this section, C is considered as owning the 40 shares by reason of option attribution and not by reason of family attribution. Therefore, since A is in effective control of Y under paragraph (b)(6)(ii) of this section, the 40 shares of Y stock constructively owned by C are reattributed to A. A is considered as owning a total of 94 shares of Y stock.

[T.D. 8179, 53 FR 6609, Mar. 2, 1988; 53 FR 8302, Mar. 14, 1988, as amended by T.D. 8540, 59 FR 30102, June 10, 1994]

§ 1.414(c)–5 Effective date.

(a) *General rule.* Except as provided in paragraph (b), (c), (e), or (f) of this section, the provisions of § 1.414(b)–1 and §§ 1.414(c)–1 through 1.414 (c)–4 shall apply for plan years beginning after September 2, 1974.

(b) *Existing plans.* In the case of a plan in existence on January 1, 1974, unless paragraph (c) of this section applies, the provisions of ''§ 1.414 (b)–1 and §§ 1.414(c)–1 through 1.414(c)–4 shall apply for plan years beginning after

December 31, 1975. For definition of the term ‘‘existing plan’’, see §1.410(a)–2(c).

(c) *Existing plans electing new provisions.* In the case of a plan in existence on January 1, 1974, for which the plan administrator makes an election under §1.410 (a)–2(d), the provisions of §1.414(b)–1 and §§1.414 (c)–1 through 1.414(c)–4 shall apply to the plan years elected under §1.410 (a)–2 (d).

(d) *Application.* For purposes of the Employee Retirement Income Security Act of 1974, the provisions of §1.414(b)–1 and §§1.414(c)–1 through 1.414(c)–4 do not apply for any period of time before the plan years described in paragraph (a), (b), or (c) of this section, whichever is applicable.

(e) *Special rule.* Notwithstanding paragraph (a), (b), or (c) of this section, §1.414(c)–3 (f) is effective April 1, 1988.

(f) *Transitional rule*—(1) *In general.* The amendments made by T.D. 8179 apply to the plan years or period described in paragraphs (a), (b), or (c) of this section, whichever is applicable.

(2) *Exception.* In the case of a plan year or period beginning before March 2, 1988, if an organization—

(i) Is a member of a brother-sister group of trades or businesses under common control under §11.414(c)–2(c), as in effect before removal by T.D. 8179 (‘‘old group’’), for such plan year or period, and

(ii) Is not such a member for such plan year or period because of the amendments made by such Treasury decision,

such member (whether or not a corporation) nevertheless will be treated as a member of such old group for purposes of section 414(c) for that plan year or period to the extent provided in §1.1563–1 (d)(2). Also, such member will be treated as a member of an old group for all purposes of the Code for such plan year or period if all the organizations (whether or not corporations) that are members of the old group meet all the requirements of §1.1563–1 (d)(3) with respect to such plan year or period.

[T.D. 8179, 53 FR 6611, Mar. 2, 1988]

§1.414(e)–1 Definition of church plan.

(a) *General rule.* For the purposes of part I of subchapter D of chapter 1 of the Code and the regulations thereunder, the term ‘‘church plan’’ means a plan established and at all times maintained for its employees by a church or by a convention or association of churches (hereinafter included within the term ‘‘church’’) which is exempt from tax under section 501(a), provided that such plan meets the requirements of paragraphs (b) and (if applicable) (c) of this section. If at any time during its existence a plan is not a church plan because of a failure to meet the requirements set forth in this section, it cannot thereafter become a church plan.

(b) *Unrelated businesses*—(1) *In general.* A plan is not a church plan unless it is established and maintained primarily for the benefit of employees (or their beneficiaries) who are not employed in connection with one or more unrelated trades or businesses (within the meaning of section 513).

(2) *Establishment or maintenance of a plan primarily for persons not employed in connection with one or more unrelated trades or businesses.* (i) (A) A plan, other than a plan in existence on September 2, 1974, is established primarily for the benefit of employees (or their beneficiaries) who are not employed in connection with one or more unrelated trades or businesses if on the date the plan is established the number of employees employed in connection with the unrelated trades or businesses eligible to participate in the plan is less than 50 percent of the total number of employees of the church eligible to participate in the plan.

(B) A plan in existence on September 2, 1974, is to be considered established as a plan primarily for the benefit of employees (or their beneficiaries) who are not employed in connection with one or more unrelated trades or businesses if it meets the requirements of both paragraphs (b)(2)(ii) (A) and (B) (if applicable) in either of its first 2 plan years ending after September 2, 1974.

(ii) For plan years ending after September 2, 1974, a plan will be considered maintained primarily for the benefit of employees of a church who are not employed in connection with one or more unrelated trades or businesses if in 4 out of 5 of its most recently completed plan years—

(A) Less than 50 percent of the persons participating in the plan (at any time during the plan year) consist of and in the same year

(B) Less than 50 percent of the total compensation paid by the employer during the plan year (if benefits or contributions are a function of compensation) to employees participating in the plan is paid to,

employees employed in connection with an unrelated trade or business. The determination that the plan is not a church plan will apply to the second year (within a 5 year period) for which the plan fails to meet paragraph (b)(2)(ii) (A) or (B) (if applicable) and to all plan years thereafter unless, taking into consideration all of the facts and circumstances as described in paragraph (b)(2)(iii) of this section, the plan is still considered to be a church plan. A plan that has not completed 5 plan years ending after September 2, 1974, shall be considered maintained primarily for the benefit of employees not employed in connection with an unrelated trade or business unless it fails to meet paragraphs (b)(2)(ii) (A) and (B) in at least 2 such plan years.

(iii) Even though a plan does not meet the provisions of paragraph (b)(2)(ii) of this section, it nonetheless will be considered maintained primarily for the benefit of employees who are not employed in connection with one or more unrelated trades or businesses if the church maintaining the plan can demonstrate that based on all of the facts and circumstances such is the case. Among the facts and circumstances to be considered in evaluating each case are:

(A) The margin by which the plan fails to meet the provisions of paragraph (b)(2)(ii) of this section, and

(B) Whether the failure to meet such provisions was due to a reasonable mistake as to what constituted an unrelated trade or business or whether a particular person or group of persons were employed in connection with one or more unrelated trades or businesses.

(iv) For purposes of this section, an employee will be considered eligible to participate in a plan if such employee is a participant in the plan or could be a participant in the plan upon making mandatory employee contributions to the plan.

(3) *Employment in connection with one or more unrelated trades or businesses.* An employee is employed in connection with one or more unrelated trades or businesses of a church if a majority of such employee's duties and responsibilities in the employ of the church are directly or indirectly related to the carrying on of such trades or businesses. Although an employee's duties and responsibilities may be insignificant with respect to any one unrelated trade or business, such employee will nonetheless be considered as employed in connection with one or more unrelated trades or businesses if such employee's duties and responsibilities with respect to all of the unrelated trades or businesses of the church represent a majority of the total of such person's duties and responsibilities in the employ of the church.

(c) *Plans of two or more employers.* The term ''church plan'' does not include a plan which, during the plan year, is maintained by two or more employers unless—

(1) Each of the employers is a church that is exempt from tax under section 501(a), and

(2) With respect to the employees of each employer, the plan meets the provisions of paragraph (b)(2)(ii) of this section or would be determined to be a church plan based on all the facts and circumstances described in paragraph (b)(2)(iii) of this section.

Thus, if with respect to a single employer the plan fails to meet any provision of this paragraph, the entire plan ceases to be a church plan unless that employer ceases maintaining the plan for all plan years beginning after the plan year in which it receives a final notification from the Internal Revenue Service that it does not meet the provisions of this paragraph. If the employer does cease maintaining the plan in accordance with this paragraph, the fact that the employer formerly did maintain the plan will not prevent the plan from being a church plan for prior years.

(d) *Special rule.* (1) Notwithstanding paragraph (c)(1) of this section, a plan maintained by a church and one or more agencies of such church for the employees of such church and of such agency or agencies, that is in existence on January 1, 1974, shall be treated as a church plan for plan years ending after September 2, 1974, and beginning before January 1, 1983, provided that the plan is described in paragraph (c) of this section without regard to paragraph (c)(1) of this section, and the plan is not maintained by an agency which did not maintain the plan on January 1, 1974.

(2) For the purposes of section 414(e) and this section, an agency of a church means an organization which is exempt from tax under section 501 and which is either controlled by, or associated with, a church. For example, an organization, a majority of whose officers or directors are appointed by a church's governing board or by officials of a church, is controlled by a church within the meaning of this paragraph. An organization is associated with a church if it shares common religious bonds and convictions with that church.

(e) *Religious orders and religious organizations.* For the purpose of this section the term ''church'' includes a religious order or a religious organization if such order or organization (1) is an integral part of a church, and (2) is engaged in carrying out the functions of a church, whether as a civil law corporation or otherwise.

(f) *Separately incorporated fiduciaries.* A plan which otherwise meets the provisions of this section shall not lose its status as a church plan because of the fact that it is administered by a separately incorporated fiduciary such as a pension board or a bank.

(g) *Cross reference.* (1) For rules relating to treatment of church plans, see section 410(c), 411(e), 412(h), 4975(g), and the regulations thereunder.

(2) For rules relating to church plan elections, see section 410(d) and the regulations thereunder.

[T.D. 7688, 45 FR 20797, Mar. 31, 1980]

§1.414(f)–1 Definition of multiemployer plan.

(a) *General rule.* For purposes of part I of subchapter D of chapter 1 of the Code and the regulations thereunder, a plan is a multiemployer plan for a plan year if all of the following requirements are satisfied:

(1) *Number of contributing employers.* More than one employer is required by the plan instrument or other agreement to contribute (or to have contributions made on its behalf) to the plan for the plan year.

(2) *Collective bargaining agreement.* The plan is maintained for the plan year pursuant to one or more collective bargaining agreements between employee representatives and more than one employer.

(3) *Amount of contributions.* Except as provided by paragraph (c) of this section (relating to the special rule for contributions exceeding 50 percent), the amount of contributions made under the plan for the plan year by or on behalf of each employer is less than 50 percent of the total amount of contributions made under the plan for such plan year by or on behalf of all employers.

(4) *Benefits.* The plan provides that the amount of benefits payable with respect to each employee participating in the plan is determined without regard to whether or not his employer continues as a member of the plan. If benefits accrued as a result of the participant's service with his employer during a period before such employer was a member of the plan, this requirement does not apply to the amount of those benefits, except that this requirement does apply to the amount of those benefits (i) which are accrued benefits derived from employee contributions, or (ii) which are accrued under a plan maintained by an employer prior to the time such employer became a member of the plan to which the requirements of this paragraph (a) are applied.

(5) *Other requirements.* The plan satisfies such other requirements as the Secretary of Labor by regulations prescribes under the authority of section 414(f)(1)(E) of the Code and section 3(37) of the Employee Retirement Income Security Act of 1974 (Pub. L. 93–406, 88 Stat. 839). See 29 CFR 2510.3–37.

(b) *Special rules*—(1) *Amount of contributions.* For purposes of paragraphs (a)(3) and (c) of this section, the amount of contributions made under the plan for the plan year by or on behalf of each employer shall be the sum of such contributions made on or before the last day of the plan year. For purposes of determining whether contributions are made on or before the last day of the plan year, the rule of section 412(c)(10) and the regulations thereunder (relating to the treatment of certain contributions made after the last day of the plan year as made on such last day) shall apply.

(2) *Benefits.* (i) For purposes of paragraph (a)(4) of this section, certain benefit amounts are treated as accrued as a result of the participant's service with an employer during a period before such employer was a member of the plan. The amount of such a benefit so treated is the difference (if any) between two calculated amounts. The first calculated amount is the participant's total accrued benefit calculated under the plan as of the date the employer ceased to be a member of the plan. The second calculated amount is the participant's accrued benefit calculated without regard to his service with such employer during the period before such employer was a member of the plan. However, under a special limitation, this difference may not exceed the benefit a participant accrued from service before his employer became a member of the plan. For purposes of this limitation, this benefit is the benefit accrued as of the date the employer ceases to be a member of the plan. An employer shall be deemed to be a member of the plan in a plan year if the employer is required by the plan instrument or other agreement to contribute (or to have contributions made on its behalf) to the plan for such plan year or if an employee of the employer accrues a benefit, on account of service with the employer during such plan year, under the plan for that plan year.

(ii) The provisions of paragraphs (a)(4) and (b)(2)(i) of this section are illustrated by the following example:

Example. On January 1, 1976, employer W became a member of the noncontributory XYZ pension plan which uses the calendar year as the plan year. W did not maintain any plan prior to that date. The plan provided for benefits of $4 per month per year of service (including service with W before January 1, 1976). On January 1, 1980, following adoption of a new collective bargaining agreement, the benefits were increased to $12 per month per year of service for all years of service (including service with W before January 1, 1976). On January 1, 1991, W ceased to be a member of the plan.

A, an employee of W, had 15 years of service before January 1, 1976, 4 years of service between January 1, 1976, and December 31, 1979, and 11 years of service between January 1, 1980, and December 31, 1990. On December 31, 1990, A's accrued benefit was $360 per month ($12 per month x 30). On January 1, 1991, the portion of A's accrued benefit retained and the portion forfeited under the terms of the XYZ pension plan were determined as follows:

Years	Monthly accrued benefit retained	Monthly accrued benefit forfeited
Before Jan. 1, 1976		$12×15 years=$180
Jan. 1, 1976 to Dec. 31, 1979	$4×4 years=$16	$8×4 years=$32
Jan. 1, 1980 to Dec. 31, 1990	$12×11 years=$132	
Total	$148	$212

The XYZ plan does not satisfy the requirements of paragraphs (a)(4) and (b)(2)(i) of this section because no benefit can be forfeited with respect to service after W began participating in the plan. Thus, the maximum accrued benefit that may be forfeited is $180 per month (the accrued benefit with respect to A's service prior to January 1, 1976). Therefore, in order for the plan to meet the requirements of paragraphs (a)(4) and (b)(2)(i) of this section, the plan must provide for A's accrued benefit after W ceased to be a member of the plan to be at least $180 per month ($360 per month total accrued benefit less $180 per month benefit accrued for service prior to W's membership in the plan).

(iii) For purposes of paragraphs (a)(4) and (b)(2) of this section, if an employer for a period employs two or more individuals who, solely by reason of their employment, are participants in the plan and who do not belong to the same collective bargaining unit, the dates on which the employer became and ceased to be a member of the plan shall be determined separately on a class basis for individuals who belong to separate collective bargaining units, as separate classes, and for individuals who do not belong to a collective bargaining unit, as a further single separate class. Thus, such dates shall be determined with respect to individuals as a class who belong to the same collective bargaining unit (or who do not belong to a collective bargaining unit) without consideration of the employment by the employer of, or the participation in the plan by, other individuals (who do not belong to such collective bargaining unit and who may belong to another collective bargaining unit) or whether the employer is a member of the plan with respect to such other individuals. In no event, however, may service not attributable to service with a particular collective bargaining unit be disregarded under paragaphs (a)(4) and (b)(2) of this section merely because the employer ceases to maintain the plan with respect to such unit. Thus, for example, paragraphs (a)(4) and (b)(2) of this section do not permit the disregard of a period of service of an individual belonging to a collective bargaining unit prior to the time the employer became a member of the plan with respect to such unit to the extent that, during such period of service, the individual belonged to another collective bargaining unit with respect to which the employer was a member of the plan.

(3) *Controlled groups.* For purposes of section 414(f) and this section, all corporations which are members of a controlled group of corporations (within the meaning of section 1563(a) and the regulations thereunder, but determined without regard to section 1563(e)(3)(C) and the regulations thereunder) are deemed to be one employer.

(c) *Contributions exceeding 50 percent.* If a plan was a multiemployer plan as defined in this section for any plan year (including plan years ending prior to September 3, 1974), ‘‘75 percent’’ shall be substituted for ‘‘50 percent’’ in applying paragraph (a)(3) of this section for subsequent plan years until the first plan year following a plan year in which the amount contributed by or on behalf of one employer is 75 percent or more of the total amount of contributions made under the plan for that plan year by or on behalf of all of the employers making contributions. In such case ‘‘75 percent’’ shall not again be substituted for ‘‘50 percent’’ until the plan has met the requirements of paragraph (a) of this section (determined without regard to this paragraph) for one plan year.

(d) *Examples.* The application of this section is illustrated by the following examples. For purposes of these examples, assume that the plan meets the requirements of paragraphs (a) (1), (2), (4), and (5) of this section for each plan year.

Example (1). On January 1, 1970, U, V, and W, three employers none of which is a member of a controlled group of corporations with any of the other two employers, establish a plan with a plan year corresponding to the calendar year. U, V, and W each contribute less than one-half of the total contributions made under the plan for each of the years 1970, 1971, and 1972. For the years 1973, 1974, and 1975, U contributes 70 percent and V and W each contribute 15 percent of the total contributions made under the plan for each year. The plan is a multiemployer plan under section 414(f) and this section for 1975 because no employer has contributed 75 percent or more of the total amount contributed for each of the plan years subsequent to 1972.

Example (2). (i) *First plan year.* On January 1, 1975, X, Y, and Z, three employers none of which is a member of a controlled group of corporations with any of the other two employers, establish a plan with a plan year corresponding to the calendar year. X, Y, and Z each contribute less than one-half of the total contributions made under the plan for 1975. The plan is a multiemployer plan for 1975 because it meets the 50 percent contribution requirement of paragraph (a)(3) of this section.

(ii) *Second plan year.* For the second plan year, 1976, X contributes 70 percent and Y and Z each contribute 15 percent of the total contributions made under the plan. The plan is a multiemployer plan for 1976 because it was a multiemployer plan for the preceding plan year and satisfies the 75 percent contribution requirement of paragraph (c) of this section.

(iii) *Third plan year.* For the third plan year, 1977, X contributes 80 percent and Y and Z each contribute 10 percent of the total contributions made under the plan. The plan is not a multiemployer plan for 1977 because it fails to satisfy the 75 percent contribution requirement of paragraph (c) of this section.

(iv) *Fourth plan year.* For the fourth plan year, 1978, Y contributes 60 percent and X and Z each contribute 20 percent of the total contributions made under the plan. The 75 percent contribution requirement of paragraph (c) of this section does not apply. The plan is not a multiemployer plan for 1978 because it fails to satisfy the 50 percent contribution requirement of paragraph (a)(3) of this section.

(v) *Fifth plan year.* For the fifth plan year, 1979, X, Y, and Z each contribute less than one-half of the total contributions made under the plan. The 75 percent contribution requirement of paragraph (c) of this section does not apply. The plan is a multiemployer plan for 1979 because it again meets the 50 percent contribution requirement of paragraph (a)(3) of this section.

(vi) *Sixth plan year.* For the sixth plan year, 1980, the plan will continue to be a multiemployer plan, provided that no employer contributes 75 percent or more of the total amount of contributions made under the plan for the plan year.

(e) *Retention of records.* (1) For plan years ending prior to September 3, 1974, a plan may be required to furnish proof that it met the requirements of section 414(f) and this section for each plan year ending prior to that date to the extent necessary to show the applicability of the 75 percent test provided in paragraph (c) of this section.

(2) For plan years ending after September 2, 1974, a plan may be required to furnish proof that it met the requirements of section 414(f) and this section for 6 immediately preceding plan years.

(Secs. 414(f) and 7805 of the Internal Revenue Code of 1954 (88 Stat. 927, 26 U.S.C. 414(f); 68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7552, 43 FR 29940, July 12, 1978]

§ 1.414(g)–1 Definition of plan administrator.

(a) *In general.* For purposes of part I of subchapter D of chapter 1 of the Code and the regulations thereunder, if the instrument under which the plan is operated for a plan year specifically designates a person or a group of persons as plan administrator, the person or group of persons collectively is the plan administrator for the plan year. The instrument may specifically designate a plan administrator—

(1) By name,

(2) By reference to the person or group of persons holding a named position or positions,

(3) By reference to a procedure established under the terms of the instrument pursuant to which a plan administrator is designated, or

(4) By reference to the person or group of persons charged with specific responsibilities of plan administrator. Consistent with the provisions of section 405 (c) (1) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1105 (c) (1)), a plan may provide for the allocation of specific responsibilities of plan administrator among named persons and for named persons to designate others to carry out such responsibilities. A person or group of persons may be designated as plan administrator in accordance with the rules of this paragraph even though the person or group of persons does not carry the specific title ‘‘plan administrator’’. In the absence of a person or group of persons designated as the plan administrator (individually, collectively, or by designation of different specific administrative responsibilities), the plan administrator for the plan year is the person or group of persons specified in paragraph (b) of this section.

(b) *Plan administrator not specifically designated.* If no person or group of persons is specifically designated as the plan administrator for a plan year by the instrument under which the plan is operated, the plan administrator for such year is the person or group of persons determined under the following rules:

(1) *Single employer.* In the case of a plan maintained by a single employer, the employer is the plan administrator. If the employer is a corporation, the corporation is the plan administrator. However, the corporation’s board of directors may authorize a person or group of persons to fulfill responsibilities of the corporation as plan administrator. In the absence of such authorization, any corporate officer authorized under law, corporate by-laws, or resolution of the board of directors to act on behalf of the corporation with respect to contracts of a value equivalent to the fair market value of the assets of the plan shall be presumed to have authority to fulfill responsibilities of the corporation as plan administrator. For purposes of this paragraph (b) (1), ‘‘employer’’ means the ‘‘employer’’ as defined in section 3 (5)

of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1003 (5)).

(2) *Employee organization.* In the case of a plan maintained by an employee organization, the employee organization is the plan administrator.

(3) *Group representing the parties.* In the case of a plan maintained by two or more employers, or jointly by one or more employers and one or more employee organizations, the association, committee, joint board of trustees, or other similar group of representatives of the parties who maintain the plan, as the case may be, is the plan administrator. For purposes of this subparagraph (3), a plan shall be considered maintained by two or more employers or jointly by one or more employers and one or more employee organizations only if none of the parties has the express power, under the terms of the instrument under which the plan is operated, to terminate the plan unilaterally.

(4) *Person in control of assets.* In any case where a plan administrator may not be determined by application of paragraphs (a) and (b), (1), (2), and (3) of this section, the plan administrator is the person or persons actually responsible, whether or not under the terms of the plan, for the control, disposition, or management of the cash or property received by or contributed to the plan, irrespective of whether such control, disposition, or management is exercised directly by such person or persons or indirectly through an agent or trustee designated by such person or persons.

(Secs. 414(g) and 7805 of the Internal Revenue Code of 1954 (88 Stat. 927, 68A Stat 917; 26 U.S.C. 414(g), 7805))

[T.D. 7618, 44 FR 27657, May 11, 1979]

§1.414(l)–1 Mergers and consolidations of plans or transfers of plan assets.

(a) *In general*—(1) *Scope of the regulations.* Sections 401(a)(12) and 414(l) apply only to plans to which section 411 applies without regard to section 411(e)(2). Thus, for example, these sections do not apply to a governmental plan within the meaning of section 414(d); a church plan, within the meaning of section 414(e), for which there has not been made the election under section 410(d) to have the participation, vesting, funding, etc. requirements apply; or a plan which at no time after September 2, 1974, provided for employer contributions.

(2) *General rule.* Under section 414(l),

(i) A trust which forms a part of a plan will not constitute a qualified trust under section 401, and

(ii) A plan will not be treated as being qualified under section 403 (a) and 405 (a), unless, in the case of a merger or consolidation (as defined in paragraph (b)(2) of this section), or a transfer of assets or liabilities (as defined in paragraph (b)(3) of this section), the following condition is satisfied. This condition requires that each participant receive benefits on a termination basis (as defined in paragraph (b)(5) of this section) from the plan immediately after the merger, consolidation or transfer which are equal to or greater than the benefits the participant would receive on a termination basis immediately before the merger, consolidation, or transfer.

(b) *Definitions.* For purposes of this section:

(1) *Single plan.* A plan is a ‘‘single plan’’ if and only if, on an ongoing basis, all of the plan assets are available to pay benefits to employees who are covered by the plan and their beneficiaries. For purposes of the preceding sentence, all the assets of a plan will not fail to be available to provide all the benefits of a plan merely because the plan is funded in part or in whole with allocated insurance instruments. A plan will not fail to be a single plan merely because of the following:

(i) The plan has several distinct benefit structures which apply either to the same or different participants,

(ii) The plan has several plan documents,

(iii) Several employers, whether or not affiliated, contribute to the plan,

(iv) The assets of the plan are invested in several trusts or annuity contracts, or

(v) Separate accounting is maintained for purposes of cost allocation but not for purposes of providing benefits under the plan.

However, more than one plan will exist if a portion of the plan assets is not available to pay some of the benefits. This will be so even if each plan has the same benefit structure or plan document, or if all or part of the assets are invested in one trust with separate accounting with respect to each plan.

(2) *Merger or consolidation.* The terms ''merger'' or ''consolidation'' means the combining of two or more plans into a single plan. A merger or consolidation will not occur merely because one or more corporations undergo a reorganization (whether or not taxable). Furthermore, a merger or consolidation will not occur if two plans are not combined into a single plan, such as by using one trust which limits the availability of assets of one plan to provide benefits to participants and beneficiaries of only that plan.

(3) *Transfer of assets or liabilities.* A ''transfer of assets or liabilities'' occurs when there is a diminution of assets or liabilities with respect to one plan and the acquisition of these assets or the assumption of these liabilities by another plan. For example, the shifting of assets or liabilities pursuant to a reciprocity agreement between two plans in which one plan assumes liabilities of another plan is a transfer of assets or liabilities. However, the shifting of assets between several funding media used for a single plan (such as between trusts, between annuity contracts, or between trusts and annuity contracts) is not a transfer of assets or liabilities.

(4) *Spinoff.* The term ''spinoff'' means the splitting of a single plan into two or more plans.

(5) *Benefits on a termination basis.* (i) The term ''benefits on a termination basis'' means the benefits that would be provided exclusively by the plan assets pursuant to section 4044 of the Employee Retirement Income Security Act of 1974 (''ERISA'') and the regulations thereunder if the plan terminated. Thus, the term does not include benefits that are guaranteed by the Pension Benefit Guaranty Corporation, but not provided by the plan assets.

(ii) For purposes of determining the benefits on a termination basis, the allocation of assets to various priority categories under section 4044 of ERISA must be made on the basis of reasonable actuarial assumptions. The assumptions used by the Pension Benefit Guaranty Corporation as of the date of the merger or spinoff are deemed reasonable for this purpose.

(iii) If a change in the benefit structure of a plan in conjunction with a merger, consolidation, or transfer of assets or liabilities alters the benefits on a termination basis, the change should be designated, at the time the merger, consolidation, or transfer occurs, to be effective either immediately before or immediately after that occurrence. In the event that no designation is made, the change in the benefit structure will be deemed to occur immediately after the merger, consolidation, or transfer of assets or liabilities.

(6) *Lower funded plan.* (i) The term ''lower funded plan'' generally means the plan which, immediately prior to the merger, would have its assets exhausted in a higher priority category than the other plan.

(ii) Where two plans, immediately prior to the merger, would have their assets exhausted in the same priority category of section 4044 of ERISA in the event of termination, the lower funded plan is the one in which the assets would satisfy a lesser proportion of the liability allocated to that priority category.

(7) *Priority category.* The term ''priority category'' means the category of benefits described in each paragraph of section 4044(a) of ERISA. References to higher or highest priority categories refer to those priority categories which receive the first allocation of asserts, i.e. the lowest paragraph numbers in section 4044(a).

(8) *Separate accounting of assets.* The term ''separate accounting of assets'' means the maintenance of an asset account with respect to a given group of participants which is:

(i) Credited with contributions made to the plan on behalf of the participants and with its allocable share of investment income, if any, and

(ii) Charged with benefits paid to the participants, and with its allocable share of investment losses or expenses.

(9) *Present value of accrued benefit.* For purposes of this section, the present value of an accrued benefit must be determined on the basis of reasonable actuarial assumptions. For this purpose, the assumptions used by

the Pension Benefit Guaranty Corporation as of the date of the merger or spinoff are deemed reasonable.

(10) *Valuation of plan assets.* In determining the value of a plan's assets, the standards set forth in regulations prescribed by the Pension Benefit Guaranty Corporation (29 CFR Part 2611) shall be applied.

(11) *Date of merger or spinoff.* The actual date of a merger or spinoff shall be determined on the basis of the facts and circumstances of the particular situation. For purposes of this determination, the following factors, none of which is necessarily controlling, are relevant:

(i) The date on which the affected employees stop accruing benefits under one plan and begin coverage and benefit accruals under another plan.

(ii) The date as of which the amount of assets to be eventually transferred is calculated.

(iii) If the merger or spinoff agreement provides that interest is to accrue from a certain date to the date of actual transfer, the date from which such interest will accrue.

(c) *Application of section 414(l)*—(1) *Two or more plans.* (i) Section 414(l) does not apply unless more than a single plan is involved. It also does not apply unless at least a single plan assumes liabilities from another plan or obtains assets from another plan (as in a merger or spinoff). For purposes of section 414(l), a transfer of assets or liabilities will not be deemed to occur merely because a defined contribution plan is amended to become a defined benefit plan. This rule will apply even if, under the facts and circumstances of a particular case, a termination of the defined contribution plan will be considered to have occurred for purposes of other provisions of the Code.

(ii) The requirements of this subparagraph may be illustrated as follows:

Example. After acquiring Corporation B, Corporation A amends Corporation B's defined benefit plan (Plan B) to provide the same benefits as Corporation A's defined benefit plan (Plan A). The assets of Plan B are transferred to the trust containing the assets of Plan A in such a manner that the assets of each plan: (1) are separately accounted for, and (2) are not available to pay benefits of the other plan. Because of condition (2) there are still two plans and, therefore, a merger did not occur. As a result, section 414(l) does not apply. If at some later date Corporation A were to sell Corporation B and transfer the assets of Plan B that were separately accounted for to another trust or to an annuity contract solely for the purpose of providing Plan B's benefits, this transfer would also not involve section 414(l). This is so because Plan B was a separate plan before the entire transaction and because no plan assumed liabilities or obtained assets from another plan. If, on the other hand, Corporation A merged Plan A and Plan B at the time of the acquisition of Corporation B by deleting condition (2) above, then section 414(l) would apply both to the merger of Plan A and Plan B and to the spinoff of Plan B from the merged plan. The spinoff would have to satisfy the requirements of paragraph (n) of this section, even if the assets attributable to Plan A and Plan B were separately accounted for in order to allocate funding costs.

(2) *Multiemployer plans.* Except to the extent provided by regulations of the Pension Benefit Guaranty Corporation, section 114(l) does not apply to any transaction to the extent that participants either before or after that transaction are covered under a multiemployer plan within the meaning of section 414(f). Until these regulations are issued, section 414(l) does not apply to any of the following situations:

(i) A multiemployer plan is split into two or more plans, one or more of which are not multiemployer plans, or

(ii) A single employer plan is merged into a multiemployer plan.

Therefore, if some (but not all) of the participants in a single employer plan become participants in a multiemployer plan under an agreement in which the multiemployer plan assumes all the liabilities of the single employer plan with respect to these participants and in which some or all of the assets of the single employer plan are transferred to the multiemployer plan, section 414(l) applies, but only with respect to the participants in the single employer plan who did not transfer to the multiemployer plan.

(d) *Merger of defined contribution plans.* In the case of a merger of two or more defined contribution plans, the requirements of section 414(l) will be satisfied if all of the following conditions are met:

(1) The sum of the account balances in each plan equals the fair market

value (determined as of the date of the merger) of the entire plan assets.

(2) The assets of each plan are combined to form the assets of the plan as merged.

(3) Immediately after the merger, each participant in the plan as merged has an account balance equal to the sum of the account balances the participant had in the plans immediately prior to merger.

(e) *Merger of defined benefit plans*—(1) *General rule.* Section 414(l) compares the benefits on a termination basis before and after the merger. If the sum of the assets of all plans is not less than the sum of the present values of the accrued benefit (whether or not vested) of all plans, the requirements of section 414(l) will be satisfied merely by combining the assets and preserving each participant's accrued benefits. This is so because all the accrued benefits of the plan as merged are provided on a termination basis by the plan as merged. However, if the sum of the assets of all plans is less than the sum of the present values of the accrued benefits (whether or not vested) in all plans, the accrued benefits in the plan as merged are not provided on a termination basis.

(2) *Special schedule of benefits.* Generally, for some participants, the benefits provided on a termination basis for the plan as merged would be different from the benefits provided on a termination basis in the plans prior to merger if the assets were merely combined and if each participant retained his accrued benefit. Some participants would, therefore, receive greater benefits on a termination basis as a result of the merger and some other participants would receive smaller benefits. Accordingly, the requirements of section 414(l) would not be satisfied unless the distribution on termination were modified in some manner to prevent any participant from receiving smaller benefits on a termination basis as a result of the merger. This is accomplished through modifying the application of section 4044 of ERISA by inserting a special schedule of benefits.

(f) *Operational rules for the special schedule.* The application of section 4044 of ERISA as modified by the schedule of benefits is accomplished by the following steps:

(1) Section 4044 is applied in the plan as merged through the priority categories fully satisfied by the assets of the lower funded plan immediately prior to the merger.

(2) The assets in the plan as merged are then allocated to the next priority category as a percentage of the value of the benefits that would otherwise be allocated to that priority category. That percentage is the ratio of (i) the assets allocated to the first priority category not fully satisfied by the lower funded plan immediately prior to the merger to (ii) the assets that would have been allocated had that priority category been fully satisfied.

(3) A schedule of benefits is formed listing participants and scheduled accrued benefits. The scheduled accrued benefit is the excess of the benefits provided on a termination basis with respect to any participant from the plans immediately prior to the merger, over the benefits provided on a termination basis in subparagraphs (1) and (2) of this paragraph immediately after the merger. After allocating the assets in accordance with subparagraph (2) of this paragraph, the assets are allocated to the schedule of benefits as follows:

(i) First the assets are allocated to the scheduled benefits to the extent that the participant would have benefits provided in subparagraph (4) of this paragraph if there were no scheduled benefits.

(ii) Then the assets are allocated to the scheduled benefits to the extent that the participant would have benefits provided pursuant to subparagraph (5) of this paragraph if there were no scheduled benefits.

These assets should be allocated first to those scheduled benefits that are in the highest priority category under section 4044.

(4) The assets are then allocated to those benefits in the priority category described in subparagraph (2) of this paragraph with respect to which assets were not allocated. This allocation is made to the extent that these benefits are not associated with benefits in the schedule.

(5) Finally, the assets are allocated in accordance with section 4044 with respect to priority categories lower than the priority category described in subparagraph (4) of this paragraph. This allocation is made to the extent that these benefits are not associated with benefits in the schedule.

(g) *Successive mergers*—(1) *In general.* In the case of a current merger of a defined benefit plan with another defined benefit plan which as a result of a previous merger has a special schedule, the rules of paragraphs (e) and (f) of this section apply as if the schedule were considered a category described in section 4044 of ERISA. Thus, a second schedule may be formed as a result of the current merger. The second schedule will be inserted in the priority category of section 4044 described in paragraph (f)(2) of this section as of the date of the current merger. This priority category may be higher, lower, or within the schedule of benefits existing on account of a previous merger. If this priority schedule is inserted within a schedule of benefits, a new single schedule of benefits replacing the old schedule of benefits would in effect be created.

(2) *Allocation of assets.* Assets in the new schedule of benefits are allocated as follows:

(i) First to the benefits remaining in the old schedule to the extent that there are assets immediately prior to the second merger to satisfy the original benefits,

(ii) Then to the benefits provided on a termination basis from the plans immediately prior to the second merger to the extent that they are not provided before the schedule after the second merger or in subdivision (i) of this subparagraph,

(iii) Then to benefits remaining in the original schedule not included in subdivision (i) of this subparagraph.

(h) *De minimis rule for merger of defined benefit plan*—(1) *In general.* In the case of a merger of a defined benefit plan (‘‘smaller plan’’) whose liabilities (*i.e.*, the present value of accrued benefits, whether or not vested) are less than 3 percent of the assets of another defined benefit plan (‘‘larger plan’’) as of at least one day in the larger plan's plan year in which the merger of the two plans occurs, section 414(l) will be deemed to be satisfied if the following condition is met. The condition requires that a special schedule of benefits (consisting of all the benefits that would be provided by the smaller plan on a termination basis just prior to the merger) be payable in a priority category higher than the highest priority category in section 4044 of ERISA. Assets will be allocated to that schedule in accordance with the allocation of assets to scheduled benefits in paragraph (f)(3) of this section.

(2) *Application to a series of mergers.* In the case of a series of such mergers in a given plan year of the larger plan, the rule described in subparagraph (1) of this paragraph will apply only if the sum of the liabilities (whether or not vested) assumed by the larger plan are less than 3 percent of the assets of the larger plan as of at least one day in the plan year of the larger plan in which the mergers occurred.

(3) *Application to a merger occurring over more than one plan year.* In the case of a merger of a smaller plan or a portion thereof with a larger plan designed to occur in steps over more than one plan year of the larger plan, the entire transaction will be deemed to occur in the plan year of the larger plan which contains the first of these steps.

(4) *Liabilities of the smaller plan.* For purposes of subparagraphs (2) and (3) of this paragraph, mergers satisfying paragraphs (e), (f) or (g) of this section will be ignored in determining the sum of the liabilities assumed by the larger plan.

(i) *Data maintenance*—(1) *Alternative to the special schedule.* In the case of a merger which would require the creation of a special schedule in order to satisfy section 414(l), the schedule need not be created at the time of the merger if data sufficient to create the schedule is maintained. The schedule would only have to be created in the event of a subsequent plan termination or a subsequent spinoff. In that case the schedule must be determined as of the date of the merger.

(2) *Required data.* The data that must be maintained depends on the plan, and care should be taken to ensure that all necessary data is maintained. Furthermore, in order to take advantage of the

data maintenance alternative provided in this paragraph, an enrolled actuary must certify to the plan administrator that each element of data necessary to determine the schedule as of the date of the merger is maintained. This certification must be based either upon the enrolled actuary's independent examination of the data, or upon his reliance, which under the circumstances of the particular situation must be reasonable, upon a written statement of the plan administrator concerning what data is actually being maintained.

(j) *Five year rule*—(1) *Limitation on the required use of the special schedule.* A plan will not fail to satisfy the requirements of section 414(l) merely because the effects of the special schedule created pursuant to paragraphs (e)(2) or (h) of this section are ignored 5 years after the date of a merger. Furthermore, the date maintained pursuant to paragraph (i) of this section need not be maintained for more than 5 years after the merger, if the plan does not have a spinoff or a termination within 5 years.

(2) *Illustration.* If Plans A and B merge to form Plan AB and if Plan AB merges with Plan C 3 years later to form Plan ABC and if Plan ABC terminates 4 years later, the data relating to the merger of Plans A and B need not be maintained for more than 5 years after the merger of Plans A and B. In addition, after 5 years have elapsed after the merger of Plans A and B, the effect of any special schedule created by the merger of Plans A and B on the schedule created by the merger of Plans AB and C may be ignored in determining the later schedule.

(k) *Examples.* The provisions of paragraphs (e) through (j) of this section may be illustrated by the following examples:

Example (*1*). Plan A, whose assets are $220,000, is to be merged with Plan B, whose assets are $200,000. Plan A has three employees. Plan B has two employees. If Plans A and B were to terminate just prior to the merger, the benefits provided on a termination basis would be as follows:

PLAN A

Priority category of section 4044 of ERISA	(1)—Annual accrued benefits			(2)—Present value of accrued benefits			(3)—Fair market value of assets allocated to priority category	(4)—Benefits on a termination basis		
	EE_1	EE_2	EE_3	EE_1	EE_2	EE_3		EE_1	EE_2	EE_3
3	$10,000			$120,000			$120,000	$10,000		
4	2,000	$4,000		24,000	$44,000		68,000	2,000	$4,000	
5		3,000	$4,000		33,000	$40,000	32,000		[1] 1,315	[2] $1,753
6			1,000			10,000				
Total							220,000	12,000	5,315	1,753

[1] $3,000 × $32,000 ÷ $73,000 i.e. accrued benefit × assets available for priority category 5—Total present value of accrued benefits in category 5.

[2] $4,000 × $32,000 ÷ $73,000.

PLAN B

Priority category of section 4044 of ERISA	(1)—Annual accrued benefits					(2)—Present value of accrued benefits					(3)—Fair market value of assets allocated to priority category	(4)—Benefits on a termination basis				
	EE_1	EE_2	EE_3	EE_4	EE_5	EE_1	EE_2	EE_3	EE_4	EE_5		EE_1	EE_2	EE_3	EE_4	EE_5
3				$15,000					$195,000		$195,000				$15,000	
4					$5,000					$50,000	5,000					[1] $500
5					8,000					80,000						
Total											200,000				15,000	500

[1] $5,000 ÷ $5,000 × $50,000.

Because Plan B's assets are exhausted in a higher priority category than Plan A's assets, Plan B is the lower funded plan. A schedule will, therefore, be inserted in Priority Category 4 of the plan as merged after providing 10% of the benefits provided in category 4, i.e. the ratio of $5,000 assets in Plan B allocated to category 4 to the $50,000 liability in category 4. The schedule would be constructed as follows:

EE	(1)—Benefits on a termination basis before merger	(2)—Benefits provided from priority categories higher than Category 4	(3)—10% of benefits provided in priority Category 4	(4)—Benefits provided before schedule (2) + (3)	(5)—Schedule of benefits (1) − (4)
1	$12,000	$10,000	$200	$10,200	$1,800
2	5,315		400	400	4,915
3	1,753				1,753
4	15,000	15,000		15,000	
5	500		500	500	

Example (2). The facts are the same as in Example (1). The plan, however, terminates one year later. Furthermore, no employee has accrued additional benefits during the year except that the $2,000 benefit for EE$_1$, that was originally in category 4 is now in category 3. The assets would be allocated to the priority categories to the extent that there are assets to cover the following benefits.

Priority termination category	EE$_1$	EE$_2$	EE$_3$	EE$_4$	EE$_5$
3	$12,000			$15,000	
10% of 4		$400			$500
Schedule of benefits included in balance of Category 4		3,600			
Schedule of benefits included in Category 5		1,315	$1,753		
Schedule of benefits included in Category 6					
Balance of Category 4 not included in schedule					4,500
Balance of Category 5 not included in schedule		1,685	2,247		8,000
Balance of Category 6 not included in schedule			1,000		

(l) *Merger of defined benefit and defined contribution plan.* In the case of a merger of a defined benefit plan with a defined contribution plan, one of the plans before the merger should be converted into the other type of plan (*i.e.*, the defined benefit converted into a defined contribution or the defined contribution converted into a defined benefit) and either paragraph (d) or paragraphs (e) through (j) of this section, whichever is appropriate, should be applied.

(m) *Spinoff of a defined contribution plan.* In the case of a spinoff of a defined contribution plan, the requirements of section 414(l) will be satisfied if after the spinoff—

(1) The sum of the account balances for each of the participants in the resulting plans equals the account balance of the participant in the plan before the spinoff, and

(2) The assets in each of the plans immediately after the spinoff equals the sum of the account balances for all participants in that plan.

(n) *Spinoff of a defined benefit plan*—(1) *General rule.* In the case of a spinoff of a defined benefit plan, the requirements of section 414(l) will be satisfied if—

(i) All of the accrued benefits of each participant are allocated to only one of the spun off plans, and

(ii) The value of the assets allocated to each of the spun off plans is not less than the sum of the present value of the benefits on a termination basis in the plan before the spin off for all participants in that spun off plan.

(2) *De minimis rule.* In the case of a spin off the requirements of section 414(l) will be deemed to be satisfied if the value of the assets spun off—

(i) Equals the present value of the accrued benefits spun off (whether or not vested), and

(ii) In conjunction with other assets spun off during the plan year in which the spinoff occurs in accordance with this subparagraph, is less than 3 percent of the assets as of at least one day in that year.

Spinoffs occurring in previous or subsequent plan years are ignored if they are not part of a single spinoff designed to occur in steps over more than one plan year.

(3) *Special temporary rule.* In the case of a defined benefit plan maintained for different groups of employees, which is a single plan (as defined in paragraph (b)(l) of this section) and under which there has been separate accounting of assets for each group, a spinoff of the plan on or before July 1, 1978, into a separate plan for each group will be deemed to satisfy section 414 (l) if—

(i) All the liabilities with respect to each group of employees are allocated to a separate plan for that group of employees, and

(ii) The assets that are separately accounted for with respect to each group of employees are allocated to the separate plan for that group of employees.

For purposes of this subparagraph, a separate accounting of assets will not be considered to have occurred to the extent that the assets allocated to each single plan are determined by an historical re-creation of benefits, contributions, investment gains, etc.

(o) *Transfers of assets or liabilities.* Any transfer of assets or liabilities will for purposes of section 414 (l) be considered as a combination of separate mergers and spinoffs using the rules of paragraphs (d), (e) through (j), (l), (m), or (n) of this section, whichever is appropriate. Thus, for example, if in accordance with the transfer of one or more employees, a block of assets and liabilities are transferred from Plan A to Plan B, each of which is a defined benefit plan, the transaction will be considered as a spinoff from Plan A and a merger of one of the spinoff plans with Plan B. The spinoff and merger described in the previous sentence would be subject to the requirements of paragraphs (n) and (e) through (j) of this section respectively.

[T.D. 7638, 44 FR 48195, Aug. 17, 1979]

§1.414(q)–1 Highly compensated employee.

Q&A–1—Q&A–8: [Reserved] See §1.414(q)–1T, Q&A–1 through Q&A–8 for further guidance.

Q–9: How is the top-paid group determined?

A–9: (a) [Reserved] See §1.414(q)–1T, Q&A–9(a) for further guidance.

(b) *Number of employees in the top-paid group*—(1) *Exclusions.* The number of employees who are in the top-paid group for a year is equal to 20 percent of the total number of active employees of the employer for such year. However, solely for purposes of determining the total number of active employees in the top-paid group for a year, the employees described in §1.414(q)–1T, A–9(b)(1) (i), (ii) and (iii)(B) are disregarded. Paragraph (g) of this A–9 provides rules for determining those employees who are excluded for purposes of applying section 414(r)(2)(A), relating to the 50-employee requirement applicable to a qualified separate line of business.

(i)–(iii) [Reserved] See §1.414(q)–1T, Q&A–9(b)(1) (i) through (iii) for further guidance.

(2) *Alternative exclusion provisions*—(i)–(ii) [Reserved] See §1.414(q)–1T, Q&A–9(b)(2) (i) and (ii) for further guidance.

(iii) *Method of election.* The elections in this paragraph (b)(2) must be provided for in all plans of the employer and must be uniform and consistent with respect to all situations in which the section 414(q) definition is applicable to the employer. Thus, with respect to all plan years beginning in the same calendar year, the employer must apply the test uniformly for purposes of determining its top-paid group with respect to all its qualified plans and employee benefit plans. If either election is changed during the determination year, no recalculation of the lookback year based on the new election is required, provided the change in election does not result in discrimination in operation.

(c)–(f) [Reserved] See §1.414(q)–1T, Q&A–9 (c) through (f) for further guidance.

(g) *Excluded employees under section 414(r)(2)(A)*—(1) *In general.* This paragraph (g) provides the rules for determining which employees are excluded employees for purposes of applying section 414(r)(2)(A), relating to the 50-employee requirement applicable to a qualified separate line of business.

(2) *Excluded employees*—(i) *Age and service exclusion.* All employees are excluded who are described in § 1.414(q)–1T, A–9(b)(1)(i) (relating to exclusions based on age or service). For this purpose, the rules in § 1.414(q)–1T, A–9 (e) and (f) (relating respectively to the 17½-hour rule and the 6-month rule) apply. However, the election in § 1.414(q)–1T, A–9(b)(2)(i) (permitting the employer to elect reduced minimum age or service requirements) does not apply.

(ii) *Nonresident alien exclusion.* All employees are excluded who are described in § 1.414(q)–1T, A–9(b)(1)(ii) (relating to the exclusion of nonresident aliens with no U.S.- source income from the employer).

(iii) *Inclusion of employees covered under a collective bargaining agreement.* All employees are included who are described in § 1.414(q)–1T, A–9(b)(1)(iii)(A) (relating to employees covered under a collective bargaining agreement) and who are not otherwise described in paragraph (g)(2) (i) or (ii) of this A–9. For this purpose, the exclusion in § 1.414(q)–1T, A– 9(b)(1)(iii)(B) and the related election in § 1.414(q)–1T, A–9(b)(2)(ii) do not apply.

(3) *Applicable period.* The determination of which employees are excluded employees is made on the basis of the testing year specified in the regulations under section 414(r) and not on the basis of the determination year or the look-back year under section 414(q).

(h) *Effective date.* The provisions of this A–9 apply to plan years and testing years beginning on or after January 1, 1994.

Q&A–10 through Q&A–15: [Reserved] See § 1.414(q)–1T, Q&A–10 through Q&A–15 for further guidance.

[T.D. 8548, 59 FR 32915, June 27, 1994]

§ 1.414(q)–1T Highly compensated employee (temporary).

The following questions and answers relate to the definition of ‘‘highly compensated employee’’ provided in section 414(q). The definitions and rules provided in these questions and answers are provided solely for purposes of determining the group of highly compensated employees.

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Q–1: To what employee benefit plans and statutory provisions is the definition of highly compensated employee contained in section 414(q) applicable?

A–1: (a) *In general.* This definition is applicable to statutory provisions that incorporate the definition by reference.

(b) *Qualified retirement plans*—(1) *In general.* Generally, this definition is incorporated in many of the nondiscrimination requirements applicable to pension, profit-sharing, and stock bonus plans qualified under section 401(a). *See, e.g.,* the nondiscrimination provisions of sections 401(a) (4) and (5), 401(k)(3), 401(l), 401(m), 406(b), 407(b), 408(k), 410(b) and 411(d)(1). The definition is also incorporated by certain other provisions with respect to such plans, including the aggregation rules of section 414(m) and section 4975 (tax on prohibited transactions).

(2) *Not applicable where not incorporated by reference.* This definition is not applicable to qualified plan provisions that do not incorporate it. *See, e.g.,* section 415 (limitations on contributions and benefits), with the exception of section 415(c)(3)(C) and 415(c)(6) (special rules for permanent and total disability and employee stock ownership plans respectively).

(c) *Other employee benefit plans or arrangements.* This definition is incorporated by various sections relating to employee benefit provisions. *See, e.g.,* section 89 (certain other employee benefit plans), section 106 (accident and health plans), 117(d) (qualified tuition reduction), section 125 (cafeteria plans), section 129 (dependent care assistance programs), section 132 (certain fringe benefits), section 274 (certain entertainment, etc. expenses), section 423(b) (employee stock purchase plan provisions), section 501(c) (17) and (18) (certain exempt trusts providing benefits to employees), and section 505 (certain exempt organizations or trusts providing benefits to individuals). See the respective sections for the applicable effective dates.

(d) *ERISA.* This definition is not determinative with respect to any provisions of Title I of the Employee Retirement Income Security Act of 1974 (ERISA), unless it is explicitly incorporated by reference (e.g., section 408(b)(1)(B)).

Q–2: Who is a highly compensated employee?

A–2: The group of employees (including former employees) who are highly compensated employees consists of both highly compensated active employees (see A–3 of this §1.414(q)–1T) and highly compensated former employees (see A–4 of this §1.414(q)–1T). In many circumstances, highly compensated active employees and highly compensated former employees are considered separately in applying the provisions for which the definition of highly compensated employees in section 414(q) is applicable. Specific rules with respect to the treatment of highly compensated active employees and highly compensated former employees will be provided in the regulations with respect to the sections to which the definition of highly compensated employees is applicable.

Q–3: Who is a highly compensated active employee?

A–3: (a) *General rule.* For purposes of the year for which the determination is being made (the determination year), a highly compensated active employee is any employee who, with respect to the employer, performs services during the determination year and is described in any one or more of the following groups applicable with respect to the look-back year calculation and/or determination year calculation for such determination year. See A–14 for rules relating to the periods for which the look-back year calculation and determination year calculation are to be made.

(1) *Look-back year calculation.*

(i) *5-percent owner.* The employee is a 5-percent owner at any time during the look-back year (i.e., generally, the 12-month period immediately preceding the determination year; see A–14. (See A–8 of this §1.414(q)–1T.)

(ii) *Compensation above $75,000.* The employee receives compensation in excess of $75,000 during the look-back year.

(iii) *Compensation above $50,000 and top-paid group.* The employee receives compensation in excess of $50,000 during the look-back year and is a member of the top-paid group for the look-back year. (See A–9 of this §1.414(q)–1T.)

(iv) *Officer.* The employee is an ‘‘includible officer’’ during the look-back year. (See A–10 of this §1.414(q)–1T.)

(2) *Determination year calculation.*

(i) *5-percent owner.* The employee is a 5-percent owner at any time during the determination year. (See A–8 of this §1.414(q)–1T.)

(ii) *Top-100 employees.* The employee is both (A) described in paragraph (a)(1)(i), (ii) and/or (iv) of this A–3, when such paragraphs are modified to substitute the determination year for the look-back year, and (B) one of the 100 employees who receive the most compensation from the employer during the determination year.

(b) *Rounding and tie-breaking rules.* In making the look-back year and determination year calculations for a determination year, it may be necessary for an employer to adopt a rule for rounding calculations (e.g., in determining the number of employees in the top-paid group). In addition, it may be necessary to adopt a rule breaking ties among two or more employees (e.g., in identifying those particular employees who are in the top-paid group or who are among the 100 most highly compensated employees). In such cases, the employer may adopt any rounding or tie-breaking rules it desires, so long as such rules are reasonable, nondiscriminatory, and uniformly and consistently applied.

(c) *Adjustments to dollar thresholds*—(1) *Indexing of dollar thresholds.* The dollar amounts in paragraph (a)(1) (i) and (ii) of this A–3 are indexed at the same time and in the same manner as the section 415(b)(1)(A) dollar limitation for defined benefit plans.

(2) *Applicable dollar threshold.* The applicable dollar amount for a particular determination year or look-back year is the dollar amount for the calendar year in which such determination year or look-back year begins. Thus, the dollar amount for purposes of determining the highly compensated active employees for a particular look-back year is based on the calendar year in which such look-back year begins, not the calendar year in which such look-back year ends or in which the determination year with respect to such look-back year begins.

(d) *Employees described in more than one group.* An individual who is a highly compensated active employee for a determination year, by reason of being described in one group in paragraph (a) of this A–3, under either the look-back year calculation or the determination year calculation, is not disregarded in determining whether another individual is a highly compensated active employee by reason of being described in another group under paragraph (a). For example, an individual who is a highly compensated active employee for a determination year, by reason of being a 5-percent owner during such year, who receives compensation in excess of $50,000 during both the look-back year and the determination year, is taken into account in determining the group of employees who are highly compensated active employees for such determination year by reason of receiving more than $50,000, and being in the top-paid group under either or both the look-back year calculation or determination year calculation for such determination year.

(e) *Examples.* The following examples, in which the determination year and look-back year are the calendar year, are illustrative of the rules in paragraph (a) of this A–3. For purposes of these examples, the threshold dollar amounts in paragraph (a)(1) (ii) and (iii) of this A–3 are not increased pursuant to paragraph (c) of this A–3.

Example (1). Employee A, who is not at any time a 5-percent owner, an officer, or a member of the top-100 within the meaning of paragraph (a)(1) (i), or (iv), or (a)(2) (i) or (ii), but who was a member of the top-paid group for each year, is included in or excluded from the highly compensated groups as specified below for the following years:

Year	Compensation	Status	Comments
1986	$45,000	N/A	Although prior to 414(q) effective date, 1986 constitutes the look-back year for purposes of determining the highly compensated group for the 1987 determination year.
1987	80,000	Excl	Excluded because A was not an employee described in paragraph (a)(1) (ii) or (iii) of this A–3 for the look-back year (1986).
1988	80,000	Incl	Included because A was an employee described in paragraph (a)(1) (ii) or (iii) of this A–3 for the look-back year (1987).
1989	45,000	Incl	Included because A was an employee described in paragraph (a)(1) (ii) or (iii) of this A–3 for the look-back year (1988).
1990	45,000	Excl	Excluded because A was not an employee described in paragraph (a)(1) (ii) or (iii) of this A–3 for the look-back year (1989).

Example (2). Assuming the same facts as those given in *Example (1),* except that A is a member of the top-100 employees within the meaning of paragraph (a)(2)(ii) of this A–3 for the 1987 year and 1990 year, the results are as follows:

Year	Compensation	Status	Comments
1986	$45,000	N/A	Although prior to 414(q) effective date, 1986 constitutes the look-back year for purposes of determining the highly compensated group for the 1987 determination year.
1987	80,000	Incl	Included because A was an employee described in paragraph (a)(1)(ii) or (iii) of this A–3 for the determination year (1987) and was described in paragraph (a)(2)(ii) of this A–3 in that year.

Year	Compensation	Status	Comments
1988	80,000	Incl	Included because A was an employee described in paragraph (a)(1)(ii) or (iii) of this A–3 for the look-back year (1987).
1989	45,000	Incl	Included because A was an employee described in paragraph (a)(1)(ii) or (iii) of this A–3 for the look-back year (1988).
1990	45,000	Excl	Excluded even though in top-100 employees during 1990 determination year because A was not an employee described in paragraph (a)(1)(ii) or (iii) of this A–3 for the look-back year (1989) or for the determination year (1990).

A–4: Who is a highly compensated former employee?

Q–4: (a) *General rule.* Except to the extent provided in paragraph (d) of this A–4, a highly compensated former employee for a determination year is any former employee who, with respect to the employer, had a separation year (as defined in A–5 of this §1.414(q)–1T) prior to the determination year and was a highly compensated active employee as defined in A–3 of this §1.414(q)–1T for either such employee's separation year or any determination year ending on or after the employee's 55th birthday. Thus, for example, an employee who is a highly compensated active employee for such employee's separation year, by reason of receiving over $75,000 during the look-back year, is a highly compensated former employee for determination years after such employee's separation year.

(b) *Special rule for employees who perform no services for the employer in the determination year.* For purposes of this rule, employees who perform no services for an employer during a determination year are treated as former employees. Thus, for example, an employee who performed no services for the employer during a determination year, by reason of a leave of absence during such year, is treated as a former employee for such year.

(c) *Dollar amounts for pre-1987 determination years.* For determination years beginning before January 1, 1987, the dollar amounts in paragraph (a)(1)(B) and (C) of A–2 of this §1.414(q)–1T are $75,000 and $50,000 respectively.

(d) *Special rule for employees who separated from service before January 1, 1987*—(1) *Election of special rule.* Employers may elect to apply paragraph (d)(2) of this A–4 in lieu of paragraph (a) of this A–4 in determining whether former employees who separated from service prior to January 1, 1987, are highly compensated former employees. If this election is made with respect to any qualified plan, it must be provided for in the plan. If the employer makes this election with respect to any employee benefit plan, such election must be used uniformly for all purposes for which the section 414(q) definition is applicable. The election, once made, cannot be changed without the consent of the Commissioner.

(2) *Special definition of highly compensated former employee.* A highly compensated former employee includes any former employee who separated from service with the employer prior to January 1, 1987, and was described in any one or more of the following groups during either the employee's separation year (or the year preceding such separation year) or any year ending on or after such individual's 55th birthday (or the last year ending before such employee's 55th birthday):

(i) *5-percent owner.* The employee was a 5-percent owner of the employer at any time during the year.

(ii) *Compensation amount.* The employee received compensation is excess of $50,000 during the year.

The determinations provided for in this paragraph (b)(2) may be made on the basis of the calendar year, the plan year, or any other twelve month period selected by the employer and applied on a reasonable and consistent basis.

(e) *Rules with respect to former employees*—(1) *In general.* For specific provisions with respect to the treatment of former employees and of highly compensated former employees, refer to the rules with respect to which the section 414(q) definition of highly compensated employee is applicable.

(2) *Former employees excluded in determining top-paid group, top-100 employees and includible officers.* Former employees are not included in the top-paid group, the group of the top-100 employees, or the group of includible officers for purposes of applying section 414(q)

to active employees. In addition, former employees are not counted as employees for purposes of determining the number of employees in the top-paid group.

Q–5: What is a separation year for purposes of section 414(q)?

A–5: (a) *Separation year*—(1) *In general.* The separation year generally is the determination year during which the employee separates from service with the employer. For purposes of this rule, an employee who performs no services for the employer during a determination year will be treated as having separated from service with the employer in the year in which such employee last performed services for the employer. Thus, for example, an employee who performs no services for the employer by reason of being on a leave of absence throughout the determination year is considered to have separated from service with the employer in the year in which such employee last performed services prior to beginning the leave of absence.

(2) *Deemed separation.* An employee who performs services for the employer during a determination year may be deemed to have separated from service with the employer during such year pursuant to the rules in paragraph (a)(3) of this A–5. Such deemed separation year is relevant for purposes of determining whether such employee is a highly compensated former employee after such employee actually separates from service, not for purposes of identifying such employee as either an active or former employee. Because employees to whom the provisions of paragraph (a)(2) of this A–5 apply are still performing services for the employer during the determination year, they are treated as active employees. Thus, for example, an employee who has a deemed separation year in 1989, a year during which he was a highly compensated employee, who continues to work for the employer until he retires from employment in 1995, is an active employee of the employer until 1995 and is either highly compensated or not highly compensated for any determination year during such period based on the rules with respect to highly compensated active employees. For determination years after the year of such employee's retirement, such employee is a highly compensated former employee because such employee was a highly compensated active employee for the deemed separation year.

(3) *Deemed separation year.* An employee will be deemed to have a separation year if, in a determination year prior to attainment of age 55, the employee receives compensation in an amount less than 50% of the employee's average annual compensation for the three consecutive calendar years preceding such determination year during which the employee received the greatest amount of compensation from the employer (or the total period of the employee's service with the employer, if less).

(4) *Leave of absence.* The deemed separation rules contained in paragraph (a)(2) and (3) of this A–5 apply without regard to whether the reduction in compensation occurs on account of a leave of absence.

(b) *Deemed resumption of employment.* An employee who is treated as having a deemed separation year by reason of the provisions of paragraph (a) of this A–5 will not be treated as a highly compensated former employee (by reason of such deemed separation year) after such employee actually separates from service with the employer if, after such deemed separation year, and before the year of actual separation, such employee's services for and compensation from the employer for a determination year increase significantly so that such employee is treated as having a deemed resumption of employment. The determination of whether an employee who has incurred a deemed separation year has an increase in services and compensation sufficient to result in a deemed resumption of employment will be made on the basis of all the surrounding facts and circumstances pertaining to each individual case. At a minimum, there must be an increase in compensation from the employer to the extent that such compensation would not result in a deemed separation year under the tests in paragraph (a)(2) of this A–5 using the same three-year period taken into account in such paragraph.

(c) *Examples.* Paragraphs (a) and (b) of this A–5 are illustrated by the following examples based on calendar years. For purposes of these examples the threshold dollar amounts in A–5(a) of this §1.414(q)–1T have not been increased pursuant to A–5(b) of this §1.414(q)–1T.

Example (1). Assume that in 1990 A is a highly compensated employee of X by reason of having earned more than $75,000 during the 1989 look-back year. In 1987, 1988 and 1989, A's years of greatest compensation received from X, A received $76,000, $80,000 and $79,000 respectively. In February of 1990, A received $30,000 in compensation. Because A's compensation during the 1990 determination year is less than 50% of A's average annual compensation from X during A's high three prior determination years, A is deemed to have a separation year during the 1990 determination year pursuant to the provisions of paragraph (a) of this A–5. Since A is a highly compensated employee for X in 1990, A's deemed separation year, A will be treated as a highly compensated former employee after A actually separates from service with the employer unless A experiences a deemed resumption of employment within the meaning of paragraph (b) of this A–5.

Example (2). Assume that in 1990 A is a highly compensated employee by reason of having been an officer (with annual compensation in excess of the section 415(c)(1)(A) dollar limitation) during the 1989 look-back year. A's compensation from X during 1990 is $37,000. A's average compensation from X for the three-year period ending with or within January, 1990, was $60,000. A's compensation during the 1990 determination year is not less than 50% of the compensation earned during the test period. Therefore, A is not deemed to have a separation year under paragraph (a)(2)(i) of this A–5.

Example (3). Assume that in 1990 C is 35 and a highly compensated employee of Z for the reasons given in *Example (1)* with the same compensation set forth in that example. During 1990, C leaves C's 40 hour a week position as director of the actuarial division of Z and starts working as an actuary for the same division, producing actuarial reports approximately 15 to 20 hours a week, approximately half of these hours at home. C contemplates returning to full-time employment with Z when C's child enters school. During the 1990 determination year, C's compensation is less than 50% of C's compensation during her high three preceding determination years. Therefore, C has a deemed separation year during the 1990 determination year. In 1991 C commences working 32 hours a week for X at X's place of business and receives compensation in an amount equal to 80 percent of her average annual compensation during her high three prior determination years. The C's increased compensation, considered in conjunction with the reasons for the reduction in service, the nature and extent of the services performed before and after the reduction in services, and the lack of proximity of C's age to age 55 at the time of the reduction are sufficient to establish that C has a deemed resumption of employment within the meaning of paragraph (b) of this A–5. Therefore, when C separates from service with the employer, C will not be treated as a highly compensated former employee by reason of C's deemed separation year in 1990.

Q–6: Who is the employer?

A–6: (a) *Aggregation of certain entities.* The employer is the entity employing the employees and includes all other entities aggregated with such employing entity under the aggregation requirements of section 414(b), (c), (m) and (o). Thus, the following entities must be taken into account as a single employer for purposes of determining the employees who are ''highly compensated employees'' within the meaning of section 414(q):

(1) All corporations that are members of a controlled group of corporations (as defined in section 414(b)) that includes the employing entity.

(2) All trades or businesses (whether or not incorporated) that are under common control (as defined in section 414(c)) which group includes the employing entity.

(3) All organizations (whether or not incorporated) that are members of an affiliated service group (as defined in section 414(m)) that includes the employing entity.

(4) Any other entities required to be aggregated with the employing entity pursuant to section 414(o) and the regulations thereunder.

(b) *Priority of aggregation provisions.* The aggregation requirements of paragraph (a) of this A–6 and of A–7(b) of this section with respect to leased employees are applied before the application of any of the other provisions of section 414(q) and this section.

(c) *Line of business rules.* The section 414(r) rules with respect to separate lines of business are not applicable in determining the group of highly compensated employees.

Q–7: Who is an employee for purposes of section 414(q)?

A–7: (a) *General rule.* Except as provided in paragraph (b) of this A–7, the term ‘‘employee’’ for purposes of section 414(q) refers to individuals who perform services for the employer and are either common-law employees of the employer or self-employed individuals who are treated as employees pursuant to section 401(c)(1). This rule with respect to the inclusion of certain self-employed individuals in the group of highly compensated employees is applicable whether or not such individuals are eligible to participate in the plan or benefit arrangement being tested.

(b) *Leased employees*—(1) *In general.* The term ‘‘employee’’ includes a leased employee who is treated as an employee of the recipient pursuant to the provisions of section 414(n)(2) or 414(o)(2). Employees that an employer treats as leased employees under section 414(n), pursuant to the requirements of section 414(o), are considered to be leased employees for purposes of this rule.

(2) *Safe-harbor exception.* For purposes of qualified retirement plans, if an employee who would be a leased employee within the meaning of section 414(n)(2) is covered in a safe-harbor plan described in section 414(n)(5) (a qualified money purchase pension plan maintained by the leasing organization), and not otherwise covered under a qualified retirement plan of the employer, then such employee is excluded from the term ‘‘employee’’ unless the employer elects to include such employee pursuant to the provisions of paragraph (4) of this paragraph (b).

(3) *Other employee benefit plans.* The exception in paragraph (b)(2) of this A–7 is not applicable to the determination of the highly compensated employee group for purposes of the sections enumerated in section 414(n)(3)(C). Thus, for example, a leased employee covered by a safe-harbor plan is considered to be an employee in applying the nondiscrimination provisions of section 89 to statutory benefit plans. Consequently, an employer with leased employees covered in a safe-harbor plan may have 2 groups of highly compensated employees, one with respect to its retirement plans and another with respect to its statutory benefit plans.

(4) *Election with respect to leased employee exclusion.* An employer may elect to include the employees excepted under the provisions of paragraph (b)(2) of this A–7 in determining the highly compensated group with respect to an employer’s retirement plans. Thus, for example, by electing to forego the exception in paragraph (b)(2) of this A–7, an employer may achieve more uniform highly compensated employee groups for purposes of its retirement plans and welfare benefit plans. The election to include such employees must be made on a reasonable and consistent basis and must be provided for in the plan.

Q–8: Who is a 5-percent owner of the employer?

A–8: An employee is a 5-percent owner of the employer for a particular year if, at any time during such year, such employee is a 5-percent owner as defined in section 416(i)(B)(i) and § 1.416–1 A T–17&18. Thus, if the employer is a corporation, a 5-percent owner is any employee who owns (or is considered as owning within the meaning of section 318) more than 5 percent of the value of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a 5-percent owner is any employee who owns more than 5 percent of the capital or profits interest in the employer. The rules of subsections (b), (c), and (m) of section 414 do not apply for purposes of determining who is a 5-percent owner. Thus, for example, an individual who is a 5-percent owner of a subsidiary corporation that is part of a controlled group of corporations within the meaning of section 414(b) is treated as a 5-percent owner for purposes of these rules.

Q–9: How is the ‘‘top-paid group’’ determined?

A–9: (a) *General rule.* An employee is in the top-paid group of employees for a particular year if such employee is in the group consisting of the top 20 percent of the employer’s employees when ranked on the basis of compensation received from the employer during such year. The identification of the particular employees who are in the top-paid group for a year involves a two-step procedure:

(1) The determination of the number of employees that corresponds to 20 percent of the employer's employees, and

(2) The identification of the particular employees who are among the number of employees who receive the most compensation during this year.

Employees who perform no services for the employer during a year are not included in making either of these determinations for such year.

(b) *Number of employees in the top-paid group*—(1) *Exclusions.* [Reserved] See §1.414(q)–1, Q&A–9(b)(1) for further information.

(i) *Age and service exclusion.* The following employees are excluded on the basis of age or service absent an election by the employer pursuant to the rules in paragraph (b)(2) of this A–9:

(A) Employees who have not completed 6 months of service by the end of such year. For purposes of this paragraph (A), an employee's service in the immediately preceding year is added to service in the current year in determining whether the exclusion is applicable with respect to a particular employee in the current year. For example, given a plan with a calendar determination year, if employee A commences work August 1, 1989, and terminates employment May 31, 1990, A may be excluded under this paragraph (b)(1)(i)(A) in 1989 because A completed only 5 months of service by December 31, 1989. However, A cannot be excluded pursuant to this rule in 1990 because A has completed 10 months of service, for purposes of this rule, by the end of 1990.

(B) Employees who normally work less than 17½ hours per week as defined in paragraph (d) of this A–9 for such year.

(C) Employees who normally work during less than 6 months during any year as defined in paragraph (e) of this A–9 for such year.

(D) Employees who have not had their 21st birthdays by the end of such year.

(ii) *Nonresident alien exclusion.* Employees who are nonresident aliens and who receive no earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3)) are excluded.

(iii) *Collective bargaining exclusion*—(A) *In general.* Except as provided in paragraph (B) of this paragraph (b)(1)(iii), employees who are included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and the employer, which agreement satisfies section 7701(a)(46) and §301.7701–17T (Temporary), are included in determining the number of employees in the top-paid group.

(B) *Percentage exclusion provision.* If 90 percent or more of the employees of the employer are covered under collective bargaining agreements that the Secretary of Labor finds to be collective bargaining agreements between employee representatives and the employer, which agreements satisfy section 7701(a)(46) and §301.7701–17T (Temporary), and the plan being tested covers only employees who are not covered under such agreements, then the employees who are covered under such collective bargaining agreements are not counted in determining the number of noncollective bargaining employees who will be included in the top-paid group for purposes of testing such plan. In addition, such employees are not included in the top-paid group for such purposes. Thus, if the conditions of this paragraph (b)(1)(iii)(B) are satisfied, a separate calculation is required to determine the number and identity of noncollective bargaining employees who will be highly compensated employees by reason of receiving over $50,000 and being in the top-paid group of employees for purposes of testing those plans that cover only noncollective bargaining employees.

(2) *Alternative exclusion provisions*—(i) *Age and service exclusion election.* An employer may elect, on a consistent and uniform basis, to modify the permissible exclusions set forth in paragraph (b)(1)(i) (A), (B), (C), and (D) of this A–9 by substituting any shorter period of service or lower age than that specified in such paragraph. These exclusions may be modified to substitute a zero service or age requirement.

(ii) *Election not to apply percentage exclusion provision.* An employer may elect not to exclude employees under the rules in paragraph (b)(1)(iii)(B) of this A–9.

(iii) *Method of election.* [Reserved] See § 1.414(q)–1, Q&A–9(b)(2)(iii) for further information.

(c) *Identification of top-paid group members.* With the exception of the paragraph (b)(1)(iii) of this A–9 exclusion for certain employees covered by collective bargaining agreements, the exclusions in paragraph (b)(1) of this A–9 are not applicable for purposes of identifying the particular employees in the top-paid group. Thus, for example, even if an employee who normally works for less than 17½ hours is excluded in determining the number of employees in the top-paid group such employee may be a member of the top-paid group. Similarly, if during a determination year, employee A receives over $75,000 and is one of the top-100 employees ranked by compensation, then employee A is a highly compensated active employee for such determination year. This is true even though employee A has worked less than six months and thus may be excluded in determining the number of persons in the top-paid group for the determination year.

(d) *Example.* Paragraphs (b) and (c) of this A–9 are illustrated by the following example:

Example. Employer X has 200 active employees during the 1989 determination year, 100 of whom normally work less than 17½ hours per week during such year and 80 of whom normally work less than 15 hours per week during such year. X elects to exclude all employees who normally work less than 15 hours per week in determining the number of employees in the top-paid group. Thus, X excludes 80 employees in determining the number of employees in the top-paid group. X's top-paid group for the 1989 determination year consists of 20% of 120 or 24 employees. All 200 of X's employees must then be ranked in order by compensation received during the year, and the 24 employees X paid the greatest amount of compensation during the year are top-paid employees with respect to X for the 1989 determination year.

(e) *17½ hour rule*—(1) *In general.* The determination of whether an employee normally works less than 17½ hours per week is made independently for each year based on the rules in paragraph (e)(2) and (3) of this A–9. In making this determination, weeks during which the employee did not work for the employer are not considered. Thus, for example, if an employee normally works twenty hours a week for twenty-five weeks during the fall and winter school quarters, 10 hours a week for the 12 week spring quarter, and does not work for the employer during the three-month summer quarter, such employee is treated as normally working more than 17½ hours per week under the rule of this paragraph (e).

(2) *Deemed above 17½.* An employee who works 17½ hours a week or more, for more than fifty percent of the total weeks worked by such employee during the year, is deemed to normally work more than 17½ hours a week for purposes of this rule.

(3) *Deemed below 17½.* An employee who works less than 17½ hours a week for fifty percent or more of the total weeks worked by such employee during the year is deemed to normally work less than 17½ hours a week for purposes of this rule.

(4) *Application.* The determination provided for in paragraph (e)(1), (2), and (3) of this A–9 may be made separately with respect to each employee, or on the basis of groups of employees who fall within particular job categories as established by the employer on a reasonable basis. For example, under the rule of this paragraph (e)(4) an employer may exclude all office cleaning personnel if, for the year in question, the employees performing this function normally work less than 17½ hours a week. This is true even though one or more employees within this group normally work in excess of 17½ hours. The election to make this determination on the basis of individuals or groups is operational and does not require a plan provision.

(5) *Application based on groups.* (i) Groups of employees who perform the same job are not required to be considered as one category for purposes of the rule in paragraph (e)(4) of this A–9. Thus, for example, an employer supermarket may determine its highly compensated employees by excluding part-time grocery checkers if such personnel normally work less than 17½

hours a week while continuing to include full-time personnel performing this function. In general, 80 percent of the positions within a particular job category must be filled by employees who normally work less than 17½ hours a week before any employees may be excluded under this rule on the basis of their membership in that job category.

(ii) Alternatively, an employer may exclude employees who are members of a particular job category if the median number of hours of service credited to employees in that category during a determination or look-back year is 500 or less.

(f) *6-month rule*—(1) *In general.* The determination of whether employees normally work during not more than 6 months in any year is made on the basis of the facts and circumstances of the particular employer as evidenced by the employer's customary experience in the years preceding the determination year. An employee who works on one day during a month is deemed to have worked during that month.

(2) *Application of prior year experience.* In making the determination under this paragraph (f), the experience for years immediately preceding the determination year will generally be weighed more heavily than that of earlier years. However, this emphasis on more recent years is not appropriate if the data for a particular year reflects unusual circumstances. For example, if fishermen working for employer X worked 9 months in 1987 and 1988, 8 months in 1989, and then, because of abnormal ice conditions, worked only 5 months in 1990, such fishermen could not be excluded under this rule in 1990. Furthermore, the data with respect to 1990 would not be weighed more heavily in making a determination with respect to subsequent years.

(3) *Individual or group basis.* This determination may be made separately with respect to each employee or on the basis of groups of employees who fall within particular job categories in the manner set forth in paragraph (e)(4) of this A–8.

Q–10. For purposes of determining the group of highly compensated employees, which employees are officers and which officers must be included in the highly compensated group?

A–10: (a) *In general.* Subject to the limitations set forth in paragraph (b) of this A–10 and the top-100 employee rule set forth in A–2, an employee is an includible officer for purposes of this section and is a member of the group of highly compensated employees if such employee is an officer of the employer (within the meaning of section 416(i) and §1.416–1 A–T 13 & A–T 15) at any time during the determination year or look-back year and receives compensation during such year that is greater than 150 percent of the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which the determination or look-back year begins. In addition, an officer who does not meet the 415(c)(1)(A) dollar limitation requirement may be an includible officer based on the minimum inclusion rules set forth in paragraph (c) of this A–10.

(b) *Maximum limitation*—(1) *In general.* Nor more than 50 employees (or, if lesser, the greater of 3 employees or 10 percent of the employees without regard to any exclusions) shall be treated as officers for purposes of this provision in determining the group of highly compensated employees for any determination year or look-back year.

(2) *Total number of employees.* The total number of employees for purposes of the limitation in this paragraph (b) is the number of employees the employer has during the particular determination year or look-back year. For purposes of this A–10, employees include only those individuals who perform services for the employer during the determination or look-back year. The exclusions applicable for purposes of determining the number of employees in the top-paid group are not applicable for purposes of the limitations in this paragraph (b).

(3) *Inclusion ranking.* If the number of the employer's officers who satisfy paragraph (a) of this A–10 during either the determination year or the look-back year exceeds the limitation under this paragraph (b), then the officers who will be considered as includible officers for purposes of this rule are those who receive the greatest compensation from the employer during such determination or look-back year.

The definition of compensation in A–13 is to be used for this purpose.

(c) *Minimum inclusion rule.* This paragraph (c) is applicable when no officer of the employer satisfies the compensation requirements of paragraph (a) of this A–10 during either a determination year or look-back year. In such case, the highest paid officer of the employer for such year is treated as a highly compensated employee by reason of being an officer, without regard to the amount of compensation paid to such officer in relation to the section 415(c)(1)(A) dollar amount for the year. This is true whether or not such employee is also a highly compensated employee on any other basis. Thus, for example, if no officer of employer X meets the compensation requirements of paragraph (a) of this A–10 during the 1989 look-back year, and employee A is both the highest paid officer during such year and a 5-percent owner, employee A is treated as an includible officer satisfying the minimum inclusion rules of this paragraph.

(d) *Separate application.* The maximum and minimum officer inclusion rules of paragraphs (b) and (c) of this A–10 apply separately with respect to the determination year calculation and the look-back year calculation. Thus, for example, if no officer of employer X receives compensation above the threshold amount in paragraph (a) of this A–10 during either the determination year or look-back year, application of the minimum inclusion rule would result in the officer of employer X who received the greatest compensation during the look-back year being treated as a highly compensated employee and, in addition, the officer of employer X who receives the most compensation during the determination year would be included in the highly compensated group if such officer is also in the top-100 employees of employer X for such year. Thus, two officers may be treated as highly compensated active employees for a determination year by reason of the provisions of the minimum inclusion rule.

Q–11: To what extent must family members who are employed by the same employer be aggregated for purposes of section 414(q)?

A–11: (a) *Family aggregation*—(1) *In general.* Aggregation is required with respect to an employee who is, during a particular determination year or look-back year, a family member (as defined in A–12) of either (i) a 5-percent owner who is an active or former employee or (ii) a highly compensated employee who is one of the ten most highly compensated employees ranked on the basis of compensation paid by the employer during such year.

(2) *Aggregation of contributions or benefits.* As prescribed in regulations under the provisions to which section 414(q) is applicable, a family member and a 5-percent owner or top-10 highly compensated employee aggregated under this rule are generally treated as a single employee receiving an amount of compensation and a plan contribution or benefit that is based on the compensation, contributions, and benefits of such family member and 5-percent owner or top-10 highly compensated employee.

(b) *Exclusion status irrelevant.* Family members are subject to this aggregation rule whether or not they fall within the categories of employees that may be excluded for purposes of determining the number of employees in the top-paid group and whether or not they are highly compensated employees when considered separately.

(c) *Order of determination*—(1) *Determination of highly compensated employees.* The determination of which employees are highly compensated employees and which highly compensated employees are among the ten most highly compensated employees in making the look-back year calculation or the determination year calculation for a determination year will be made prior to the application of the rules in paragraph (a) of this A–11.

(2) *Determination of top-paid group and top-100 employees.* The determination of the number and identity of employees in the top-paid group under the look-back year calculation or the determination year calculation for a determination year and the identity of individuals in the top-100 employees under the determination year calculation for a determination year is made prior to application of the rules in paragraph (a) of this A–11.

(d) *Determination period.* The rules under paragraph (a) of this A–11 apply separately to the determination year and the look-back year. Thus, assuming there are no 5-percent owners, if employees A, B, C, D, E, F, G, H, I and J are the top 10 highly compensated employees in the 1988 look-back year, and employees F, G, H, I, J, K, L, M, N and O are the top 10 highly compensated employees in the 1989 determination year, then family aggregation would be required with respect to all fifteen of such employees (i.e. employees A, B, C, D, E, F, G, H, I, J, K, L, M, N, and O).

Q–12: Which individuals are family members for purposes of the aggregation rules in section 414(a)(6)(A) and A–11?

A–12: (a) *Definition of family member.* Individuals who are family members for purposes of these provisions include, with respect to any employee or former employee, such employee's or former employee's spouse and lineal ascendants or descendants and the spouses of such lineal ascendants and descendants. In determining whether an individual is a family member with respect to an employee or former employee, legal adoptions shall be taken into account.

(b) *Test period.* If an individual is a family member with respect to an employee or former employee on any day during the year, such individual is treated as a family member for the entire year. Thus, for example, if an individual is a family member with respect to an employee on the first day of a year, such individual continues to be a family member with respect to such employee throughout the year even though their relationship changes as a result of death or divorce.

Q–13: How is ‘‘compensation’’ determined for purposes of determining the group of ‘‘highly compensated employees.’’

A–13: (a) *In general.* For purposes of section 414(q), the term ‘‘compensation’’ means compensation within the meaning of section 415(c)(3) without regard to sections 125, 402(a)(8), and 402(h)(1)(B) and, in the case of employer contributions made pursuant to a salary reduction agreement, without regard to section 403(b). Thus, compensation includes elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement or tax-sheltered annuity.

(b) *Determination period.* For purposes of determining the group of highly compensated employees, compensation must be calculated on the basis of the applicable period for the determination year and look-back year respectively.

(c) *Compensation taken into account.* Only compensation received by an employee during the determination year or during the look-back year is considered in determining whether such employee is a highly compensated active employee under either the look-back year calculation or determination year calculation for such determination year. Thus, compensation is not annualized for purposes of determining an employee' compensation in the determination year or the look-back year in applying the rules of paragraph (a) of this A–13.

Q–14: What periods must be used for determining who is a highly compensated employee for a determination year?

A–14: (a) *Determination year and look-back year*—(1) *In general.* For purposes of determining the group of highly compensated employees for a determination year, the determination year calculation is made on the basis of the applicable year of the plan or other entity for which a determination is being made and the look-back year calculation is made on the basis of the twelve month period immediately preceding such year. Thus, in testing plans X and Y of an employer, if plan X has a calendar year plan year and plan Y has a July 1 to June 30 plan year, the determination year calculation and look-back year calculation for plan X must be made on the basis of the calendar year. Similarly, the determination year calculation and look-back year calculation for plan Y must be made on the basis of the July 1 to June 30 year.

(2) *Applicable year.* For purposes of this A–14, the applicable year is the plan year of the qualified plan or other employee benefit arrangement to which the definition of highly compensated employees is applicable as defined in the written plan document or

otherwise identified in regulations pursuant to sections to which the definition of highly compensated employees is applicable. To the extent that the definition of highly compensated employees is applicable to entities of other arrangements that do not have an otherwise identified plan year, then either the calendar year of the employer's fiscal year may be treated as the plan year.

(3) *Look-back year.* The look-back year is never less than a twelve month period.

(b) *Calendar year calculation election*—(1) *In general.* An employer may elect to make the look-back year calculation for a determination year on the basis of the calendar year ending with or within the applicable determination year (or, in the case of a determination year that is shorter than twelve months, the calendar year ending with or within the twelve-month period ending with the end of the applicable determination year). In such case, the employer must make the determination year calculation for the determination year on the basis of the period (if any) by which the applicable determination year extends beyond such calendar year (i.e., the lag period). If the applicable year for which the determination is being made is the calendar year, the employer still may elect to make the calendar year calculation election under this A–14(b). In such case, the look-back year calculation is made on the basis of the calendar year determination year and, because there is no lag period, a separate determination year calculation under A–3(a)(2) of this § 1.414(q)–1 is not required.

(2) *Lag period calculation.* In making the determination year calculation under A–3(a)(2) of this § 1.414(q)–1 on the basis of the lag period, the dollar amounts applicable under A–3(a)(1) (B) and (C) of this § 1.414(q)–1 are to be adjusted by multiplying such dollar amounts by a fraction, the numerator of which is the number of calendar months that are included in the lag period and the denominator of which is twelve.

(3) *Determination of active employees.* An employee will be considered an active employee for purposes of a determination year for which the calendar year calculation election is in effect so long as such employee performs services for the employer during the applicable year for which the determination is being made. This is the case even if such employee does not perform services for the employer during the lag-period for such determination year.

(4) *Election requirement.* If the employer elects to make the calendar year calculation election with respect to one plan, entity, or arrangement, such election must apply with respect to all plans, entities, and arrangements of the employer. In addition, such election must be provided for in the plan.

(c) *Change in applicable years.* Where there is a change in the applicable year for which a determination is being made with respect to a plan entity, or other arrangement that is not subject to the calendar year calculation election, the look-back year calculation for the short applicable year is to be made on the basis of the twelve month period preceding the short applicable year (i.e., generally, the old applicable year) and the determination year calculation for the short applicable year is to be made on the basis of the short applicable year. In addition, the dollar amounts under A–3(a)(1) (B) and (C) are to be adjusted for such determination year calculation as if the short applicable year were a lag period under paragraph (b)(2) of this A–14.

(d) *Example.* The following examples illustrates the rules of this A–14:

Example 1. Employer X has a single plan (Plan A) with an April 1 to March 31 plan year. Employer X makes no election to use the calendar year for the determination period. Therefore, in determining the group of highly compensated employees for the April 1, 1989 to March 31, 1990 plan year, the determination year is the plan year ending March 31, 1990 and the look-back year is the plan year ending March 31, 1989.

Example 2. Assume the same facts given above. With respect to the plan year beginning in 1990, employer X elects to use the calendar year for the determination period. Therefore, in determining the group of highly compensated employees for the April 1, 1990 to March 31, 1991 plan year, the lag-period determination year is the period from January 1, 1991, through March 31, 1991, and the applicable look-back year is the 1990 calendar year.

Example 3. Employer Y has a single plan (Plan B) with a calendar plan year. With respect to the plan year beginning in 1990, employer Y elects to make the look-back year calculation for the 1990 determination year on the basis of the calendar year ending with or within the 1990 determination year. Because employer Y's determination year is the 1990 calendar year there is no lag period and employer Y determines the group of highly compensated employees for purposes of the 1990 calendar plan year on the basis of such plan year alone.

Q–15: Is there any transition rule in determining the group of highly compensated employees for 1987 and 1988?

A–15: (a) *In general.* Solely for purposes of section 401(k)(3) and (m)(2) and solely for twelve-month plan years beginning in 1987 and 1988, an eligible employer may elect to define the group of highly compensated employees as the group consisting of 5-percent owners of the employer at any time during the plan year and employees who receive compensation in excess of $50,000 during the plan year. This rule would apply in lieu of the look-back year calculation and determination year calculation otherwise applicable under A–3(a) of this §1.44(q)–1. In addition, an eligible employer may elect to make the determinations permitted under this transition rule on the basis of the calendar year ending in the plan year and the period by which such plan year extends beyond such calendar year, in accordance with the rules of A–14(b), in lieu of making the determinations under this transition rule on the basis of the plan year for which the determinations are being made.

(b) *Eligible employers.* An employer is an eligible employer under this A–15 if such employer satisfies both of the following requirements:

(1) The employer does not maintain any top-heavy plan within the meaning of section 416 at any time during 1987 and 1988; and

(2) Under each plan of the employer to which section 401(k)(3) or 401(m)(2) is applicable, the group of eligible employees that comprises the highest 25% of eligible employees ranked on the basis of compensation includes at least one employee whose compensation is $50,000 or below. This requirement must be met separately with respect to each such plan of the employer.

(c) *Uniformity requirement.* An eligible employer may not make the election under paragraph (a) of this A–15 unless the election applies to all of the plans maintained by the employer to which section 401(k)(3) or 401(m)(2) applies.

(d) *Election requirements.* This election is operational and does not require a plan provision.

[T.D. 8173, 53 FR 4967, Feb. 19, 1988, as amended by T.D. 8334, 56 FR 3977, Feb. 1, 1991; T.D. 8548, 59 FR 32916, June 27, 1994]

§1.414(r)–0 Table of contents.

(a) *In general.* Sections 1.414(r)–1 through 1.414(r)–11 provide rules for determining whether an employer is treated as operating qualified separate lines of business under section 414(r) of the Internal Revenue Code of 1986 as added to the Code by section 1115(a) of the Tax Reform Act of 1986 (Pub. L. No. 99–514), as well as rules for applying the requirements of sections 410(b), 401(a)(26), and 129(d)(8) separately with respect to the employees of each qualified separate line of business of an employer. Paragraph (b) of this section contains a listing of the headings of §§1.414(r)–1 through 1.414(r)–11. Paragraph (c) of this section provides a flowchart showing how the major provisions of §§1.414(r)–1 through 1.414(r)–6 are applied.

(b) *Table of contents.* The following is a listing of the headings of §§1.414(r)–1 through 1.414(r)–11.

§1.414(r)–1 Requirements applicable to qualified separate lines of business.

(a) In general.
(b) Conditions under which an employer is treated as operating qualified separate lines of business.
(1) In general.
(2) Qualified separate line of business.
(i) In general.
(ii) Line of business.
(iii) Separate line of business.
(iv) Qualified separate line of business.
(A) In general.
(B) Fifty-employee requirement.
(C) Notice requirement.
(D) Requirement of administrative scrutiny.
(3) Determining the employees of a qualified separate line of business.
(c) Separate application of certain Code requirements to employees of a qualified separate line of business.
(1) In general.
(2) Separate application of section 410(b).

(i) General rule.
(ii) Special rule for employer-wide plans.
(3) Separate application of section 401(a)(26).
(i) General rule.
(ii) Special rule for employer-wide plans.
(4) Separate application of section 129(d)(8) [Reserved]
(5) Separate application of other Code requirements.
(d) Application of requirements.
(1) In general.
(2) Interpretation.
(3) Separate operating units.
(4) Certain mergers and acquisitions.
(5) Governmental and tax-exempt employers.
(i) General rule.
(ii) Additional rules [Reserved].
(6) Testing year basis of application.
(i) Section 414(r).
(ii) Sections 410(b), 401(a)(26), and 129(d)(8).
(7) Averaging rules.
(8) Definitions.
(9) Effective dates.
(i) General rule.
(ii) Reasonable compliance.
(A) In general.
(B) Determination of reasonable compliance.
(C) Effect on other plans.
(e) Additional rules.

§ 1.414(r)–2 Line of business.

(a) General rule.
(b) Employer determination of its lines of business.
(1) In general.
(2) Property and services provided to customers.
(i) In general.
(ii) Timing of provision of property or services.
(3) Employer designation.
(i) In general.
(ii) Ability to combine unrelated types of property or services in a single line of business.
(iii) Ability to separate related types of property or services into two or more lines of business.
(iv) Affiliated service groups.
(c) Examples.
(1) In general.
(2) Examples illustrating employer designation.
(3) Examples illustrating property and services provided to customers.

§ 1.414(r)–3 Separate line of business.

(a) General rule.
(b) Separate organization and operation.
(1) In general.
(2) Separate organizational unit.
(3) Separate financial accountability.
(4) Separate employee workforce.
(5) Separate management.
(c) Supplementary rules.
(1) In general.
(2) Determination of separate employee workforce.
(3) Determination of separate management.
(4) Employees taken into account.
(5) Services taken into account.
(i) Provision of services to a separate line of business.
(ii) Period for which services are provided.
(iii) Optional rule for employees who change status.
(A) In general.
(B) Change in employee's status.
(6) Examples of the separate employee workforce requirement.
(7) Examples of the separate management requirement.
(d) Optional rule for vertically integrated lines of business.
(1) In general.
(2) Requirements.
(3) Optional rule.
(i) Treatment of employees.
(ii) Purposes for which optional rule applies.
(4) Examples.

§ 1.414(r)–4 Qualified separate line of business—fifty-employee and notice requirements.

(a) In general.
(b) Fifty-employee requirement.
(c) Notice requirement.
(1) General rule.
(2) Effect of notice.

§ 1.414(r)–5 Qualified separate line of business—administrative scrutiny requirement—safe harbors.

(a) In general.
(b) Statutory safe harbor.
(1) General rule.
(2) Highly compensated employee percentage ratio.
(3) Employees taken into account.
(4) Ten-percent exception.
(5) Determination based on preceding testing year.
(6) Examples.
(c) Safe harbor for separate lines of business in different industries.
(1) In general.
(2) Optional rule for foreign operations.
(3) Establishment of industry categories.
(4) Examples.
(d) Safe harbor for separate lines of business that are acquired through certain mergers and acquisitions.
(1) General rule.
(2) Employees taken into account.
(3) Transition period.
(4) Examples.
(e) Safe harbor for separate lines of business reported as industry segments.

(1) In general.
(2) Reported as an industry segment in conformity with Form 10–K or Form 20–F.
(3) Timely filing of Form 10–K or 20–F.
(4) Examples.
(f) Safe harbor for separate lines of business that provide same average benefits as other separate lines of business.
(1) General rule.
(2) Separate lines of business benefiting disproportionate number of nonhighly compensated employees.
(i) Applicability of safe harbor.
(ii) Requirement.
(3) Separate lines of business benefiting disproportionate number of highly compensated employees.
(i) Applicability of safe harbor.
(ii) Requirement.
(4) Employees taken into account.
(5) Example.
(g) Safe harbor for separate lines of business that provide minimum or maximum benefits.
(1) In general.
(2) Minimum benefit required.
(i) Applicability.
(ii) Requirement.
(iii) Defined benefit minimum.
(A) In general.
(B) Normal form and equivalent benefits.
(C) Compensation definition.
(D) Average compensation requirement.
(E) Special rules.
(iv) Defined contribution minimum.
(A) In general.
(B) Modified allocation definition for averaging.
(3) Maximum benefit permitted.
(i) Applicability.
(ii) Requirement.
(iii) Defined benefit maximum.
(A) In general.
(B) Determination of defined benefit maximum.
(C) Adjustment for different compensation definitions.
(D) Adjustment for certain subsidies.
(iv) Defined contribution maximum.
(4) Duplication of benefits or contributions.
(i) Plans of the same type.
(ii) Plans of different types.
(iii) Special rule for floor-offset arrangements.
(5) Certain contingency provisions ignored.
(6) Employees taken into account.

§1.414(r)–6 Qualified separate line of business—administrative scrutiny requirement—individual determinations.

(a) In general.
(b) Authority to establish procedures.

§1.414(r)–7 Determination of the employees of an employer's qualified separate lines of business.

(a) Introduction.
(1) In general.
(2) Purposes for which this section applies.
(b) Assignment procedure.
(1) In general.
(2) Assignment for the first testing day.
(3) Assignment of new employees for subsequent testing days.
(4) Special rule for employers using annual option under section 410(b).
(c) Assignment and allocation of residual shared employees.
(1) In general.
(2) Dominant line of business method of allocation.
(i) In general.
(ii) Dominant line of business.
(iii) Employee assignment percentage.
(A) Determination of percentage.
(B) Employees taken into account.
(iv) Option to apply reduced percentage.
(v) Examples.
(3) Pro-rata method of allocation.
(i) In general.
(ii) Allocation procedure.
(iii) Examples.
(4) HCE percentage ratio method of allocation.
(i) In general.
(ii) Highly compensated employee percentage assignment ratio.
(iii) Allocation procedure.
(5) Small group method.
(i) In general.
(ii) Size of group.
(iii) Composition of qualified separate line of business.
(iv) Reasonable allocation.

§1.414(r)–8 Separate application of section 410(b).

(a) General rule.
(b) Rules of separate application.
(1) In general.
(2) Satisfaction of section 410(b)(5)(B) on an employer-wide basis.
(i) General rule.
(ii) Application of facts and circumstances requirements under nondiscriminatory classification test.
(iii) Modification of unsafe harbor percentage for plans satisfying ratio percentage test at 90 percent level.
(A) General Rule.
(B) Facts and circumstances alternative.
(3) Satisfaction of section 410(b) on a qualified-separate-line-of-business basis.
(4) Examples.
(c) Coordination of section 401(a)(4) with section 410(b).
(1) General rule.
(2) Examples.
(d) Supplementary rules.

(1) In general.
(2) Definition of plan.
(3) Employees of a qualified separate line of business.
(4) Consequences of failure.

§ 1.414(r)–9 Separate application of section 401(a)(26).

(a) General rule.
(b) Requirements applicable to a plan.
(c) Supplementary rules.
(1) In general.
(2) Definition of plan.
(3) Employees of a qualified separate line of business.
(4) Consequences of failure.

§ 1.414(r)–10 Separate application of section 129(d)(8). [Reserved]

§ 1.414(r)–11 Definitions and special rules.

(a) In general.
(b) Definitions.
(1) In general.
(2) Substantial-service employee.
(3) Top-paid employee.
(4) Residual shared employee.
(5) Testing year.
(6) Testing day.
(7) First testing day.
(8) Section 401(a)(26) testing day.
(c) Averaging rules.
(1) In general.
(2) Specified provisions.
(3) Averaging of large fluctuations not permitted.
(4) Consistency requirements.

(c) *Flowchart.* The following is a flowchart showing how the major provisions of §§ 1.414(r)–1 through 1.414(r)–6 are applied.

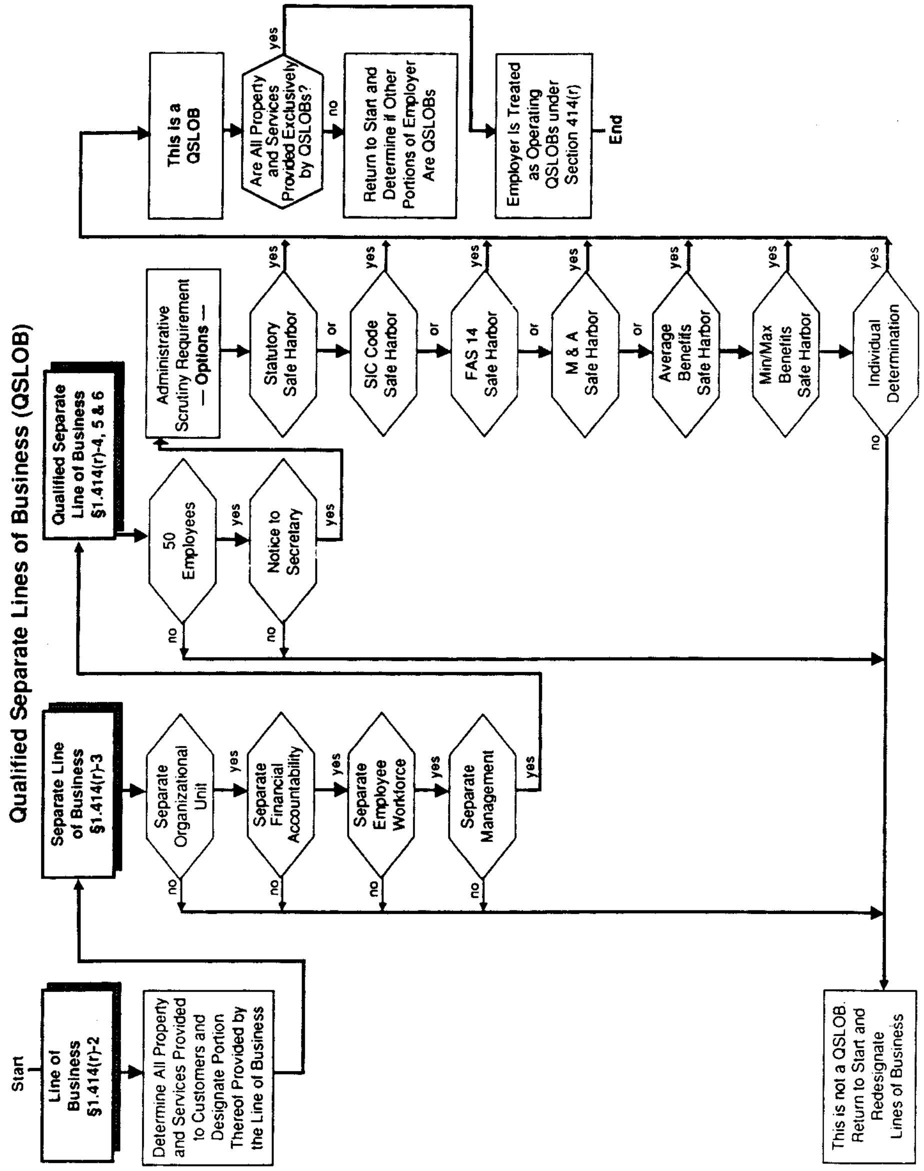
Qualified Separate Lines of Business (QSLOB)
Start
Line of Business §1.414(r)-2
Determine All Property and Services Provided to Customers and Designate Portion Thereof Provided by the Line of Business
Separate Line of Business §1.414(r)-3
Separate Organizational Unit
Separate Financial Accountability
Separate Employee Workforce
Separate Management
yes
no
Qualified Separate Line of Business §1.414(r)-4, 5 & 6
50 Employees
Notice to Secretary
Administrative Scrutiny Requirement — Options —
Statutory Safe Harbor
SIC Code Safe Harbor
FAS 14 Safe Harbor
M & A Safe Harbor
Average Benefits Safe Harbor
Min/Max Benefits Safe Harbor
Individual Determination
or
This is a QSLOB
Are All Property and Services Provided Exclusively by QSLOBs?
Return to Start and Determine if Other Portions of Employer Are QSLOBs
Employer Is Treated as Operating QSLOBs under Section 414(r)
End
This is not a QSLOB. Return to Start and Redesignate Lines of Business

[T.D. 8376, 56 FR 63434, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32916, June 27, 1994]

§1.414(r)–1 Requirements applicable to qualified separate lines of business.

(a) *In general.* Section 414(r) prescribes the conditions under which an employer is treated as operating qualified separate lines of business. If an employer is treated as operating qualified separate lines of business under section 414(r), certain requirements under the Code may be applied separately with respect to the employees of each qualified separate line of business. These requirements are limited to the minimum coverage requirements of section 410(b) (including the nondiscrimination requirements of section 401(a)(4)), the minimum participation requirements of section 401(a)(26), and the 55-percent average benefits test of section 129(d)(8). This section provides the exclusive rules for determining whether an employer is treated as operating qualified separate lines of business under section 414(r), as well as rules for applying the requirements of sections 410(b), 401(a)(26), and 129(d)(8) separately with respect to the employees of a qualified separate line of business.

(b) *Conditions under which an employer is treated as operating qualified separate lines of business*—(1) *In general.* An employer is treated as operating qualified separate lines of business under section 414(r) only if all property and services provided by the employer to its customers are provided exclusively by qualified separate lines of business. Thus, once an employer has determined its qualified separate lines of business under paragraph (b)(2) of this section, no portion of the employer may remain that is not included in a qualified separate line of business. In addition, once the employer has determined the employees of its qualified separate lines of business under paragraph (b)(3) of this section, every employee must be treated as an employee of a qualified separate line of business, and no employee may be treated as an employee of more than one qualified separate line of business.

(2) *Qualified separate line of business*—(i) *In general.* A qualified separate line of business is a portion of the employer that is a line of business within the meaning of paragraph (b)(2)(ii) of this section, that is also a separate line of business within the meaning of paragraph (b)(2)(iii) of this section, and, finally, that satisfies the requirements of section 414(r)(2) in accordance with paragraph (b)(2)(iv) of this section.

(ii) *Line of business.* A line of business is a portion of an employer that is identified by the property or services it provides to customers of the employer. For this purpose, the employer is permitted to determine the lines of business it operates by designating the property and services that each of its lines of business provides to customers of the employer. Rules for determining an employer's lines of business are provided in § 1.414(r)–2.

(iii) *Separate line of business.* A separate line of business is a line of business that is organized and operated separately from the remainder of the employer. The determination of whether a line of business is organized and operated separately from the remainder of the employer is made on the basis of objective criteria. These criteria generally require that the line of business be organized into one or more separate organizational units (e.g., corporations, partnerships, or divisions), that the line of business constitute one or more distinct profit centers within the employer, and that no more than a moderate overlap exist between the employee workforce and management employed by the line of business and those employed by the remainder of the employer. Rules for determining whether a line of business is organized and operated separately from the remainder of the employer and thus constitutes a separate line of business are provided in § 1.414(r)–3. These rules include an optional rule for vertically integrated lines of business.

(iv) *Qualified separate line of business*—(A) *In general.* A qualified separate line of business must satisfy the three statutory requirements in section 414(r)(2). A separate line of business that satisfies these three statutory requirements in accordance with paragraphs (b)(2)(iv)(B) through (b)(2)(iv)(D) of this section constitutes a qualified separate line of business.

(B) *Fifty-employee requirement.* Under section 414(r)(2)(A), a separate line of business must have at least 50 employees. Rules for determining whether this requirement is satisfied are provided in § 1.414(r)–4(b).

(C) *Notice requirement.* Under section 414(r)(2)(B), the employer must notify the Secretary that it treats itself as operating qualified separate lines of business under section 414(r) for purposes of applying the requirements of section 410(b), 401(a)(26), or 129(d)(8) separately with respect to the employees of the separate line of business.

Rules and procedures for complying with this requirement are provided in §1.414(r)–4(c).

(D) *Requirement of administrative scrutiny.* Under section 414(r)(2)(C), a separate line of business must pass administrative scrutiny. A separate line of business may satisfy this requirement in one of two ways. First, a separate line of business that satisfies any of the safe harbors in §1.414(r)–5 satisfies the requirement of administrative scrutiny. These safe harbors implement the statutory safe harbor of section 414(r)(3) as well as the guidelines prescribed under section 414(r)(2)(C). Second, a separate line of business that does not satisfy any of the safe harbors in §1.414(r)–5 nonetheless satisfies the requirement of administrative scrutiny if the employer requests and receives an individual determination from the Commissioner that the separate line of business satisfies the requirement of administrative scrutiny. Rules and procedures applicable to requesting and receiving an individual determination are provided in §1.414(r)–6. A separate line of business is permitted to satisfy the requirement of administrative scrutiny in any manner permitted under this paragraph (b)(2)(iv)(D), regardless of how any other separate line of business of the employer satisfies the requirement.

(3) *Determining the employees of a qualified separate line of business.* In order to apply certain provisions under these regulations, it is necessary to determine the employees of a qualified separate line of business. For these purposes, the employees of a qualified separate line of business consist of all employees who are substantial-service employees with respect to the qualified separate line of business, and all other employees who are assigned to the qualified separate line of business. Rules for making these determinations are provided in §1.414(r)–7. These rules apply solely for the purposes specified in these regulations (see §1.414(r)–7(a)(2) for a comprehensive listing of these purposes). These rules do not apply for any other purpose (e.g., the determination under §1.414(r)–3 of whether a line of business is organized and operated separately from the remainder of the employer).

(c) *Separate application of certain Code requirements to employees of a qualified separate line of business*—(1) *In general.* If an employer is treated as operating qualified separate lines of business under section 414(r) in accordance with paragraph (b) of this section, the requirements of sections 410(b), 401(a)(26), and 129(d)(8) may be applied separately with respect to the employees of each qualified separate line of business. Paragraphs (c)(2) through (c)(4) of this section provide for the separate application of these requirements. In general, the requirements of a Code section are applied separately with respect to the employees of a qualified separate line of business by treating those employees as if they were the only employees of the employer. Paragraph (c)(5) of this section prescribes the limited conditions under which other Code requirements may be applied separately with respect to the employees of a qualified separate line of business.

(2) *Separate application of section 410(b)*—(i) *General rule.* Except as provided in paragraph (c)(2)(ii) of this section, an employer is permitted to apply the requirements of section 410(b) separately with respect to the employees of each qualified separate line of business operated by the employer only if the employer does so with respect to all its plans, all its employees, and all its qualified separate lines of business. For this purpose, the requirements of section 410(b) encompass the requirements of section 401(a)(4) (including, but not limited to, the permitted disparity rules of section 401(*l*), the actual deferral percentage test of section 401(k)(3) and the actual contribution percentage test of section 401(m)(2)). Rules for applying section 410(b) separately with respect to the employees of a qualified separate line of business are provided in §1.414(r)–8. An employer may apply the rules of section 414(r) for purposes of section 410(b) even if it does not apply the rules of section 414(r) for purposes of section 401(a)(26).

(ii) *Special rule for employer-wide plans.* Notwithstanding paragraph (c)(2)(i) of this section, an employer that is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with paragraph (b) of this section may apply the requirements of section 410(b) on an employer-wide rather than a qualified-separate-line-of-business basis with respect to any plan (within the meaning of § 1.414(r)–8(d)(2), but without regard to the mandatory disaggregation rule of § 1.410(b)–7(c)(4) for portions of a plan that benefit employees of different qualified separate lines of business) that benefits a group of employees that satisfies the percentage test of section 410(b)(1)(A) (i.e., benefits at least 70 percent of the employer's nonexcludable nonhighly compensated employees). If section 401(a)(4) requires that a group of employees under the plan described in the preceding sentence satisfy section 410(b) for purposes of satisfying section 401(a)(4), the percentage test of section 410(b)(1)(A) must be satisfied by each such group of employees. See § 1.414(r)–8(c). The rules of this paragraph (c)(2)(ii) are illustrated by the following example.

Example. Employer A maintains a single profit-sharing plan, Plan W, and three pension plans, Plans X, Y and Z, each benefiting employees of a different one of Employer A's three qualified separate lines of business. Contributions to the profit-sharing plan are made pursuant to a cash or deferred arrangement in which all employees of Employer A are eligible to participate. Assume that, as a result, Plan W satisfies the requirements to be tested under this paragraph (c)(2)(ii). None of the pension plans benefits more than 70 percent of the nonexcludable nonhighly compensated employees of Employer A. Employer A is treated as operating qualified separate lines of business for purposes of applying section 410(b) to its qualified plans. The requirements of sections 410(b) and 401(a)(4) must therefore be applied to Plans X, Y and Z separately with respect to the employees of each of the three qualified separate line of business operated by Employer A. Since Plan W benefits at least 70 percent of the nonexcludable nonhighly compensated employees of Employer A, however, the requirements of sections 410(b) and 401(a)(4) (including section 401(k)) may be applied to Plan W on an employer-wide basis.

(3) *Separate application of section 401(a)(26)*—(i) *General rule.* Except as provided in paragraph (c)(3)(ii) of this section, an employer is permitted to apply the requirements of section 401(a)(26) separately with respect to the employees of each qualified separate line of business operated by the employer only if the employer does so with respect to all its plans, all its employees, and all its qualified separate lines of business. Rules for applying the requirements of section 401(a)(26) separately with respect to the employees of a qualified separate line of business are provided in § 1.414(r)–9. An employer may apply the rules of section 414(r) for purposes of section 401(a)(26) even if it does not apply the rules of section 414(r) for purposes of section 410(b).

(ii) *Special rule for employer-wide plans.* Notwithstanding the first sentence of paragraph (c)(3)(i) of this section, an employer that is treated as operating qualified separate lines of business in accordance with paragraph (b) of this section for purposes of both sections 410(b) and 401(a)(26) may apply the requirements of section 401(a)(26) on an employer-wide rather than a qualified-separate-line-of-business basis with respect to any plan (within the meaning of § 1.414(r)–9(c)(2), but without regard to the mandatory disaggregation rule of § 1.401(a)(26)–2(d)(1)(iv) for portions of a plan that benefit employees of different qualified separate lines of business), but only if the special rule for employer-wide plans in paragraph (c)(2)(ii) of this section is applied to the same plan for the same plan year.

(4) *Separate application of section 129(d)(8).* [Reserved]

(5) *Separate application of other Code requirements.* Under no circumstance may the requirements of any section of the Code (other than a section described in paragraphs (c)(2) through (c)(4) of this section) be applied separately with respect to the employees of a qualified separate line of business unless the section specifically cross-references, or is specifically cross-referenced by, section 414(r). The Code sections whose requirements may not be applied separately with respect to the employees of a qualified separate line of business include, but are not limited to, sections 79(d)(3), 105(h), 117(d)(3), 120(c)(2), 125(g)(3), 127(b)(2), 129(d)(3), 132, 195, 401(a)(3) (as in effect on September 1, 1974), 414(q)(4), 501(c)(17)(A)(ii), 501(c)(17)(B)(iii), 501(c)(18)(B), and 505(b)(1)(A).

(d) *Application of requirements*—(1) *In general.* The requirements of paragraphs (b) and (c) of this section must be applied in accordance with the rules in this paragraph (d).

(2) *Interpretation.* The provisions of this section and of §§1.414(r)–2 through 1.414(r)–11 are to be interpreted in a reasonable manner consistent with the purpose of section 414(r) to recognize an employer's operation of qualified separate lines of business for bona fide business reasons and not for reasons of evading the requirements of any section of the Code, including sections 410(b), 401(a)(26), and 129(d)(8). See section 414(r)(1) and (r)(7). Thus, for example, an employer is not permitted to apply these regulations in a manner that may literally comply with the other provisions of this section and of §§1.414(r)–2 through 1.414(r)–11, but that does not reflect the employer's operation of qualified separate lines of business for bona fide business reasons.

(3) *Separate operating units.* No additional requirements beyond those provided in these regulations apply to a separate operating unit. Thus, a separate operating unit that satisfies the requirements of paragraph (b)(2) of this section is deemed to satisfy the geographic separation requirement of section 414(r)(7) and accordingly is treated as a qualified separate line of business for all purposes under this section, including the separate application of section 401(a)(26).

(4) *Certain mergers and acquisitions.* A portion of an employer that is acquired in a transaction described in section 410(b)(6)(C) and §1.410(b)–2(f) (i.e., an asset or stock acquisition, merger, or other similar transaction involving a change in the employer of the employees of a trade or business) is deemed to satisfy the requirements to be a qualified separate line of business, other than the 50-employee requirement and the notice requirement of pararaphs (b)(2)(iv)(R) and (b)(2)(iv)(C) of this section, respectively. In addition, the acquired employees are not taken into account, and the property and services provided by the acquired portion to customers of the employer are disregarded, for purposes of determining whether the employer's remaining lines of business satisfy the requirements of §§1.414(r)–3 through 1.414(r)–6. The rules in this paragraph (d)(4) apply only for those testing years with first testing days that fall within the transition period described in section 410(b)(6)(C). For this purpose, the transition period described in section 410(b)(6)(C) lasts only for so long as the conditions in that section are satisfied. For the definition of ''first testing day,'' see §1.414(r)–11(b)(7). See §1.414(r)–5(d)(4), *Example 1*, for an example of the application of the rule in this paragraph (d)(4). See also §1.414(r)–5(d) for an administrative scrutiny safe harbor applicable to certain separate lines of business acquired in a transaction described in this section.

(5) *Governmental and tax-exempt employers*—(i) *General rule.* Except as provided in paragraph (d)(5)(ii) of this section, the rules of this section are applicable in determining whether section 401(a)(26) is satisfied by a plan maintained by an employer that is exempt from tax under Subtitle A of the Internal Revenue Code (including a governmental plan within the meaning of section 414(d)). Similarly, except as provided in paragraph (d)(5)(ii) of this section, the rules of this section are applicable in determining whether section 410(b) is satisfied by a plan that is subject to section 410(b) (including by virtue of §1410(b)–2(e)) and is maintained by an employer that is exempt from tax under Subtitle A of the Internal Revenue Code (including a governmental plan within the meaning of section 414(d)).

(ii) *Additional rules.* [Reserved]

(6) *Testing year basis of application*—(i) *Section 414(r).* Whether an employer is treated as operating qualified separate lines of business under section 414(r) in accordance with paragraph (b) of this section is determined on a year-by-year basis with respect to the testing year. It is therefore possible for an employer to satisfy paragraph (b) of this section for one testing year and to fail to satisfy it for another testing year. It is also possible for an employer to satisfy paragraph (b) of this section for two testing years but to have designated its lines of business differently in each of those two testing years. In determining whether an employer satisfies paragraph (b) of this section for a testing

year, the requirements of that paragraph are applied solely with respect to the testing year. Thus, all property and services provided by the employer to its customers during the testing year must be provided exclusively by portions of the employer that for the testing year constitute qualified separate lines of business. Furthermore, each employee of the employer must respectively be treated as an employee of one and only one of those qualified separate lines of business for all purposes with respect to the testing year.

(ii) *Sections 410(b), 401(a)(26), and 129(d)(8).* For purposes of paragraph (c) of this section, relating to the separate application of sections 410(b), 401(a)(26), and 129(d)(8) to the employees of a qualified separate line of business, the determination whether an employer operates qualified separate lines of business in accordance with paragraph (b) of this section for a testing year generally applies for all plan years beginning in the testing year. Rules for the separate application of sections 410(b), 401(a)(26), and 129(d)(8) are respectively provided in §§ 1.414(r)–8, 1.414(r)–9, and 1.414(r)–10.

(7) *Averaging rules.* The employer is permitted to apply certain provisions of these regulations on the basis of a consecutive-year average (not to exceed five consecutive years) under the averaging rules of § 1.414(r)–11(c).

(8) *Definitions.* In applying the provisions of this section and of §§ 1.414(r)–2 through 1.414(r)–11, the definitions in §§ 1.414(r)–11(b) and 1.410(b)–9 govern, unless otherwise provided.

(9) *Effective*—(i) *General rule.* The provisions of this section and of §§ 1.414(r)–2 through 1.414(r)–11 apply to plan years and testing years beginning on or after January 1, 1994 (or January 1, 1996, in the case of plans maintained by organizations exempt from income taxation under section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans)).

(ii) *Reasonable compliance*—(A) *In general.* With respect to plan years beginning before the date on which the Commissioner begins issuing determinations under section 414(r)(2)(C), and on or after the first day of the first plan year to which section 414(r) applies under section 1112(a) of the Tax Reform Act of 1986, an employer is treated as operating qualified separate lines of business if the employer reasonably determines that it meets the requirements of section 414(r) (other than the requirement of administrative scrutiny under section 414(r)(2)(C)).

(B) *Determination of reasonable compliance.* Whether an employer reasonably determines that it meets the requirements of section 414(r) generally will be determined on the basis of all relevant facts and circumstances, including the extent to which the employer has resolved unclear issues in its favor. For the period described in paragraph (d)(9)(ii)(A) of this section, the Internal Revenue Service will consider the employer's compliance with the terms of these final regulations (other than the requirement of administrative scrutiny under paragraph (b)(2)(iv)(D) of this section) to constitute a reasonable determination that the employer neets tge reqyurements of section 414(r) (other than the requirement of administrative scrutiny under section 414(r)(2)(C)).

(C) *Effect on other plans.* If an employer sponsors a plan that has a plan year beginning within the period decribed in paragraph (d)(9)(ii)(A) of this section, the employer's reasonable determination of its qualified separate lines of business for the testing year in which that plan year begins, and the allocation of employees to those qualified separate lines of business, must also be used for purposes of applying § 1.414(r)–8 and § 1.414(r)–9 for plan years that begin in that testing year but after the end of the period described in paragraph (d)(9)(ii)(A) of this section.

(e) *Additional rules.* The Commissioner may, in revenue rulings, notices, and other guidance of general applicability, provide any additional rules that may be necessary or appropriate in applying the qualified separate line of business requirements of section 414(r). These additional rules may include, for example, new safe harbors in § 1.414(r)–5.

[T.D. 8376, 56 FR 63437, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32916, June 27, 1994]

§1.414(r)–2 Line of business.

(a) *General rule.* A line of business is a portion of an employer that is identified by the property or services it provides to customers of the employer. For this purpose, an employer is permitted to determine its lines of business by designating the property or services that each of its lines of business provides to customers of the employer. Paragraph (b) of this section explains how an employer determines its lines of business for a testing year. Paragraph (c) of this section provides examples illustrating the application of this section.

(b) *Employer determination of its lines of business*—(1) *In general.* An employer determines its lines of business for a testing year first by identifying all the property and services it provides to its customers during the testing year, and then by designating which portion of the property and services is provided by each of its lines of business.

(2) *Property and services provided to customers*—(i) *In general.* Property, whether real or personal, tangible or intangible, is provided by an employer to a customer if the employer provides the property to or on behalf of the customer for consideration. Similarly, services are provided by an employer to a customer if the employer renders the services to or on behalf of the customer for consideration. An individual item of property or service is taken into account under this paragraph (b)(2) only if the employer provides the item to a person other than the employer in the ordinary course of a trade or business conducted by the employer and the person to whom the employer provides the item is acting in the capacity of a customer of the employer. A type of tangible property is deemed to be provided to customers of the employer for purposes of this section if, with respect to a business that produces or manufactures that type of tangible property, the employer satisfies the special rule in §1.414(r)–3(d)(2)(iii)(B) for vertically integrated businesses.

(ii) *Timing of provision of property or services.* Generally an employer determines its lines of business on the basis of the property and services it provides to its customers for consideration during the testing year. However, it is not necessary both that property or services actually be provided, and that consideration for the property or services actually be paid, during the current testing year. For an employer to be considered to provide property or services to customers for consideration during a testing year under this paragraph (b)(2), it is sufficient that the property or services actually be provided to customers during the testing year, the consideration actually be paid during the testing year, or the employer actually incur significant costs during the testing year associated with the provision of the property or services to a specified customer or specified customers.

(3) *Employer designation*—(i) *In general.* Once the employer has identified all the property and services it provides to its customers during the testing year under paragraph (b)(2) of this section, the employer determines its lines of business for the testing year by designating which portion of those property and services is provided by each of its lines of business. For this purpose, the employer must apportion all the property and services identified under paragraph (b)(2) of this section among its lines of business. An employer generally is not required to designate its lines of business for the testing year in the same manner as it designates its lines of business for any other testing year.

(ii) *Ability to combine unrelated types of property or services in a single line of business.* For purposes of this paragraph (b)(3), there is no requirement that a line of business provide only one type of property or service, or only related types of property or services. Nor is there any requirement that a line of business provide solely property or solely services. Thus, the employer is permitted to combine in a single line of business dissimilar types of property or services that are otherwise unrelated to one another.

(iii) *Ability to separate related types of property or services into two or more lines of business.* For purposes of this paragraph (b)(3), there is no requirement that all property or services of related types or the same type be provided by a single line of business. Thus, the employer is permitted to designate two or more lines of business that provide related types of property or services, or the same type of property or service. An employer might designate two or more lines of business that provide property or services of related types or the same type, for example, where the lines of business manufacture, prepare, or provide the property or services in different geographic areas (e.g., in different regions of the country or the world), or at different levels in the chain of commercial distribution (e.g., wholesale versus retail), or in different types of transactions (e.g, sale versus lease), or for different types of customers (e. g., governmental versus private), or subject to different legal constraints (e. g., regulated versus unregulated), or if the lines of business have developed differently (e.g., one line of business was acquired while another line of business developed internally). Notwithstanding the foregoing, an employer is not permitted to designate two or more lines of business that provide property or services of related types or the same type, if the employer's designation is unreasonable. An employer's designation would be unreasonable, for example, if the designation separated two types of property or services in different lines of business, but the employer did not provide those types of property or services separately from one another to its customers. Similarly, an employer's designation would be unreasonable if it separated two types of property or services in different lines of business, but the provision of one type of property or service was merely ancillary or incidental to, or regularly associated with, the provision of the other type of property or service. See generally § 1.414(r)–1(d)(2) (requiring an employer's operation of qualified separate lines of business to be for bona fide business reasons).

(iv) *Affiliated service groups.* An employer is not permitted to designate its lines of business in a manner that results in separating employees of an affiliated service group (within the meaning of section 414(m)) from other employees of the employer. See section 414(r)(8).

(c) *Examples*—(1) *In general.* Paragraphs (c)(2) and (c)(3) of this section provide examples that illustrate the application of this section.

(2) *Examples illustrating employer designation.* The following examples illustrate the application of paragraph (b)(3) of this section relating to an employer's designation of the property or services provided to customers by each of its lines of business.

Example 1. Employer A is a domestic conglomerate engaged in the manufacture and sale of consumer food and beverage products and the provision of data processing services to private industry. Employer A provides no other property or services to its customers. Pursuant to paragraph (b)(3) of this section, Employer A apportions all the property and services it provides to its customers among three lines of business, one providing all its consumer food products, a second providing all its consumer beverage products, and a third providing all its data processing services. Employer A has three lines of business for purposes of this section.

Example 2. The facts are the same as in *Example 1,* except that Employer A determines that neither the consumer food products line of business nor the consumer beverage products line of business would satisfy the separateness criteria of §1.414(r)–3 for recognition as a separate line of business. Accordingly, pursuant to paragraph (b)(3) of this section, Employer A apportions all the property and services it provides to its customers between only two lines of business, one providing all its consumer food and beverage products, and a second providing all its data processing services. Employer A has two lines of business for purposes of this section.

Example 3. The facts are the same as in *Example 2,* except that Employer A also owns and operates a regional commuter airline, a professional basketball team, a pharmaceutical manufacturer, and a leather tanning company. Pursuant to paragraph (b)(3) of this section, Employer A apportions all the property and services it provides to its customers among three lines of business, one providing all its consumer food and beverage products, a second providing all its data processing services, and a third providing all the other property and services provided to customers through Employer A's regional commuter airline, professional basketball team, pharmaceutical manufacturer, and leather tanning company. Even though the third line of business includes dissimilar types of property and services that are otherwise unrelated to one another, paragraph (b)(3)(ii) of this section permits Employer A to combine these property and services in a single line of business. Employer A has three lines of business for purposes of this section.

Example 4. The facts are the same as in *Example 2,* except that Employer A has recently acquired Corporation L, whose only product is a well-known brand of gourmet ice cream. Although Employer A manufactures and sells other ice cream products, it does not manufacture or market the newly acquired brand of gourmet ice cream except through Corporation L. Pursuant to paragraph (b)(3) of this section, Employer A apportions all the property and services it provides to its customers among three lines of business, one providing only the newly acquired brand of gourmet ice cream, a second providing all its other consumer food and beverage products (including the other ice cream products manufactured and sold by Employer A) and a third providing all its data processing services. Even though the gourmet ice cream line of business provides the same type of property as the consumer food and beverage line of business (i.e., ice cream), paragraph (b)(3)(iii) of this section permits Employer A to separate its ice cream products between two different lines of business. Employer A has three lines of business for purposes of this section.

Example 5. The facts are the same as in *Example 2,* except that Employer A operates the data processing services portion of its business in two separate subsidiaries, one serving customers in the eastern half of the United States and the other serving customers in the western half of the United States. Pursuant to paragraph (b)(3) of this section, Employer A apportions all the property and services it provides to its customers among three lines of business, one providing all its consumer food and beverage products, a second providing data processing services to customers in the eastern half of the United States, and a third providing data processing services to customers in the western half of the United States. Even though the second and third lines of business provide the same type of service (i.e., data processing services), paragraph (b)(3)(iii) of this section permits Employer A to separate its data processing services into two lines of business. Employer A has three lines of business for purposes of this section.

Example 6. Employer B is a diversified engineering firm offering civil, chemical, and aeronautical engineering services to government and private industry. Employer B provides no other property or services to its customers. Employer B operates the aeronautical engineering services portion of its business as two separate divisions, one serving federal government customers and the other serving customers in private industry. Pursuant to paragraph (b)(3) of this section, Employer B apportions all the property and services it provides to its customers among four lines of business, one providing all its civil engineering services, a second providing all its chemical engineering services, a third providing aeronautical engineering services to federal government customers, and a fourth providing aeronautical engineering services to customers in private industry. Even though the third and fourth lines of business include the same type of service (i.e., aeronautical engineering services), paragraph (b)(3)(iii) of this section permits Employer B to separate its aeronautical engineering services into two lines of business. Employer B has four lines of business for purposes of this section.

Example 7. Among its other business activities, Employer C manufacturers industrial diesel generators. At no additional cost to its buyers, Employer C warrants the proper functioning of its diesel generators for a one-year period following sale. Pursuant to its warranty, Employer C provides labor and parts to repair or replace any components that malfunction within the one-year warranty period. Because Employer C does not provide the industrial diesel generators, on the one hand, and the warranty repair services and replacement parts, on the other hand, separately from one another to its customers, under paragraph (b)(3)(iii) of this section it would be unreasonable for Employer C to separate these property and services in different lines of business.

Example 8. Among its other business activities, Employer D leases office photocopying equipment. Employer D also provides photocopying supplies and repair services to its lessees for a separate charge. Employer D generally does not provide such supplies and repair services to persons other than its lessees. Lessees of Employer D's equipment are permitted to use photo-copying supplies and repair services from suppliers other than Employer D. Because the provision of the photo-copying supplies and repair services are merely ancillary or incidental to the provision of the leased photo-copiers, under paragraph (b)(3)(iii) of this section it would be unreasonable for Employer D to separate these property and services in different lines of business.

Example 9. Employer E operates a medical clinic. The employees of the clinic include physicians, nurses, and laboratory technicians, all of whom participate in providing medical and related services to patients of the clinic. Under paragraph (b)(3)(iii) of this section, it would be unreasonable for Employer E to separate the services of the physicians, nurses, and laboratory technicians in different lines of business.

Example 10. Employer F is a law firm. The employees of the firm include lawyers, paralegals, and secretaries, all of whom participate in renderlng legal and related services to clients of the firm. Under paragraph (b)(3)(iii) of this section, it would be unreasonable for Employer F to separate the services of the lawyers, paralegals, and secretaries in different lines of business.

Example 11. Employer G is a management consulting firm. The employees of the firm include management consultants, secretaries, and other support staff personnel, all of whom participate in rendering management consulting and related services to clients of the firm. Under paragraph (b)(3)(iii) of this section, it would be unreasonable for Employer G to separate the services of the management consultants, secretaries, and other support staff personnel in different lines of business.

(3) *Examples illustrating property and services provided to customers.* The following examples illustrate the application of paragraph (b)(2) of this section relating to property and services provided to customers of the employer.

Example 1. Employer H operates several dairy farms and dairy product processing plants. The dairy farms provide part of their output of milk and milk by-products to Employer H's dairy product processing plants and also sell part to retail distributors unrelated to Employer H. The dairy farms' provision of milk and milk by-products to Employer H's dairy product processing plants does not constitute the provision of property or services to customers of Employer H because the milk and milk by-products are not provided to a person other than employer H. However, the dairy farms' provision of milk and milk by-products to independent retail distributors does constitute the provision of property or services to customers of Employer H under paragraph (b)(2) of this section.

Example 2. The facts are the same as in *Example 1,* except that the dairy farms provide their entire output of milk and milk by-products to Employer H's dairy product processing plants. The dairy farms' provision of milk and milk by-products to the dairy product processing plants generally does not constitute the provision of property or services to customers of Employer H because the milk and milk by-products are not provided to a person other than Employer H. However, paragraph (b)(2)(i) of this section provides a special rule for vertically integrated businesses that satisfy § 1.414(r)–3(d)(2)(iii)(B). If § 1.414(r)–3(d)(2)(iii)(B) is satisfied, then, under the special rule of paragraph (b)(2)(i) of this section, the milk and milk by-products are deemed to be provided to customers of Employer H.

Example 3. Among its other business activities, Employer J manufactures automobiles. Employer J operates a cafeteria at one of its automobile manufacturing facilities. The cafeteria is intended primarily for use by employees of Employer J, but nonemployees are not prohibited from using the cafeteria. The cafeteria charges the same prices to employees and non-employees. Under paragraph (b)(2) of this section, the provision of cafeteria services to employees of Employer J does not constitute the provision of property or services to customers of Employer J, because the cafeteria services are provided to the employees in their capacity as employees of Employer J and not as customers of Employer J.

Example 4. Employer K sells books and periodicals to members of the public and provides telecommunications services to private industry. Employer K periodically acquires and disposes of businesses in both asset and stock transactions. In addition, for its own investment purposes, Employer K acquires and disposes of corporate and other securities. Under paragraph (b)(2) of this section, the sale by Employer K of businesses and investment securities does not constitute the provision of property or services to customers of Employer K, because the sales are not made in the ordinary course of a trade or business conducted by Employer K. However, the sale of published materials and the provision of telecommunications services to persons unrelated to Employer K does constitute the provision of property or services to customers of Employer K.

Example 5. Employer L is active in the financial services industry. Subsidiary 1 of Employer L is a brokerage firm that is regulated as a broker-dealer under applicable federal and state law. In its capacity as a dealer, Subsidiary 1 holds in its own inventory securities of unrelated corporations and regularly sells these securities to unrelated persons. Under paragraph (b)(2) of this section, the sale by Subsidiary 1 of the securities to unrelated persons constitutes the provision of property or services to customers of Employer L, because the sales are made in the ordinary course of Subsidiary 1's trade or business as a broker-dealer.

Example 6. The facts are the same as in *Example 5.* Subsidiary 2 of Employer L is an insurance company that is regulated under applicable state insurance laws. In managing its investments, Subsidiary 2 regularly makes use of the brokerage services of Subsidiary 1 (which Subsidiary 1 regularly provides to unrelated persons as well). Under paragraph (b)(2) of this section, Subsidiary 1's provision of brokerage services to Subsidiary 2 does not constitute the provision of property or services to customers of Employer L, because the brokerage services are not provided to a person other than Employer L. However, Subsidiary 1's provision of brokerage services to unrelated persons does constitute the provision of property or services to customers of Employer L.

Example 7. Employer M is a shipbuilder. In a testing year, Employer M enters into a contract with a customer to construct a new cargo ship for delivery two years later. Employer M incurs significant costs designing and planning for the production of the new ship during the testing year, but receives no payments from the customer during that year. Under paragraph (b)(2) of this section, Employer M is treated as providing the cargo ship to the customer during the testing year.

Example 8. The facts are the same as in *Example 7,* except that, pursuant to a request from the customer, Employer M also incurred significant costs developing a prototype and submitting a bid on the new cargo ship in the prior testing year, and that these costs were not reimbursed by the customer. Under paragraph (b)(2) of this section, Employer M is also treated as providing the cargo ship to the customer in the prior testing year.

[T.D. 8376, 56 FR 63439, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32917, June 27, 1994]

§1.414(r)–3 Separate line of business.

(a) *General rule.* A separate line of business is a line of business (as determined under §1.414(r)–2) that is organized and operated separately from the remainder of the employer. Paragraph (b) of this section sets forth the rules for determining whether a line of business is organized and operated separately from the remainder of the employer. Paragraph (c) of this section provides certain supplementary rules necessary to apply the requirements of paragraph (b) of this section, as well as examples illustrating the application of those requirements. Paragraph (d) of this section provides an optional rule for lines of business that are vertically integrated.

(b) *Separate organization and operation*—(1) *In general.* A line of business is organized and operated separately from the remainder of the employer for a testing year only if it satisfies all the requirements of paragraphs (b)(2) through (b)(5) of this section for the testing year.

(2) *Separate organizational unit.* The line of business must be formally organized as a separate organizational unit or group of separate organizational units within the employer. For this purpose, an organizational unit is a corporation, partnership, division, or other unit having a similar degree of organizational formality. This requirement must be satisfied on every day of the testing year.

(3) *Separate financial accountability.* The line of business must be a separate profit center or group of separate profit centers within the employer. This requirement must be satisfied on every day of the testing year. In addition, the employer must maintain books and records that provide separate revenue and expense information that is used for internal planning and control with respect to each profit center comprising the line of business.

(4) *Separate employee workforce.* The line of business must have its own separate employee workforce. A line of business has its own separate workforce only if at least 90 percent of the employees who provide services to the line of business, and who are not substantial-service employees with respect to any other line of business, are substantial-service employees with respect to the line of business. See paragraph (c)(2) of this section to determine how the percentage in the preceding sentence is calculated for the testing year.

(5) *Separate management.* The line of business must have its own separate management. A line of business has its own separate management only if at least 80 percent of the employees who are top-paid employees with respect to the line of business are substantial-service employees with respect to the line of business. See paragraph (c)(3) of this section to determine how the percentage in the preceding sentence is calculated for the testing year.

(c) *Supplementary rules*—(1) *In general.* This paragraph (c) provides certain supplementary rules necessary to apply the requirements of paragraph (b) of this section, as well as examples illustrating the application of those requirements.

(2) *Determination of separate employee workforce.* The percentage in paragraph (b)(4) of this section is the fraction (expressed as a percentage)—

(i) The numerator of which is the number of substantial-service employees with respect to the line of business within the meaning of §1.414(r)–11(b)(2); and

(ii) The denominator of which is the total number of employees who provide services to the line of business within the meaning of paragraph (c)(5) of this section and who are not substantial-service employees with respect to any other line of business.

(3) *Determination of separate management.* The percentage in paragraph

(b)(5) of this section is the fraction (expressed as a percentage)—

(i) The numerator of which is the number of employees who are both top-paid employees and substantial-service employees with respect to the line of business within the meaning of § 1.414(r)–11(b)(3) and (2), respectively; and

(ii) The denominator of which is the total number of top-paid employees with respect to the line of business within the meaning of § 1.414(r)–11(b)(3).

(4) *Employees taken into account.* For purposes of applying this paragraph (c), only employees who are employees on the first testing day are taken into account. For this purpose, there are no excludable employees except nonresident aliens described in section 410(b)(3)(C). Consequently, all other employees who are employees on the first testing day are taken into account, including collectively bargained employees. For the definition of first testing day, see § 1.414(r)–11(b)(7).

(5) *Services taken into account*—(i) *Provision of services to a line of business.* An employee provides services to a line of business if more than a negligible portion of the employee's services contributes to providing the property or services provided by the line of business to customers of the employer. All of the services of each employee who provides services to the employer contribute, whether directly or indirectly, to the provision of property or services to customers of the employer, and therefore each employee who provides services to the employer must be treated as providing more than a negligible portion of the employee's services to one or more lines of business operated by the employer.

(ii) *Period for which services are provided.* Only services performed by an employee during the testing year that contribute to providing the property or services provided by a line of business to customers are taken into account. An employee's services during the testing year are considered to contribute to providing the property or services provided by a line of business to customers of the employer if—

(A) The employee's services during the testing year contribute to providing such property or services to customers of the employer during the testing year; or

(B) It is reasonably anticipated that the employee's services during the testing year will contribute to providing such property and services to customers of the employer after the close of the testing year.

(iii) *Optional rule for employees who change status*—(A) *In general.* Solely for purposes of the separateness rules of this section and the assignment rules of § 1.414(r)–7, if an employee changes status as described in paragraph (c)(5)(iii)(B) of this section, an employer may, for up to three consecutive testing years after the base year (within the meaning of paragraph (c)(5)(iii)(B) (*1*) or (*2*) of this section), treat the employee as providing the same level of service to its lines of business as the employee provided in the base year.

(B) *Change in employee's status.* An employee changes status as described in this paragraph (c)(5)(iii)(B) if—

(*1*) For a testing year (the base year), the employee was a substantial-service employee with respect to a qualified separate line of business of the employer (prior line of business) and, for the immediately succeeding testing year, the employee is not a substantial-service employee with respect to that prior line of business; or

(*2*) For a testing year (the base year), the employee was a residual shared employee and, for the immediately succeeding testing year, the employee is a substantial-service employee with respect to a qualified separate line of business.

(6) *Examples of the separate employee workforce requirement.* The following examples illustrate the application of the separate employee workforce requirement in paragraph (b)(4) of this section and the supplementary rules of this paragraph (c). Unless otherwise specified, it is assumed that the employees and their services described in these examples are taken into account under paragraphs (c) (4) and (5) of this section for the testing year and that the employer does not use the option under § 1.414(r)–11(b)(2) to treat employees who provide less than 75 percent of their services to a line of business as

substantial-service employees with respect to the line of business.

Example 1. Employer A operates three lines of business as determined under §1.414(r)–2. One of Employer A's lines of business manufactures and sells tires and other automotive products. Employee M is a tire press operator in Employer A's tire factory. Employee N is the manager of the tire factory. Under these facts, the services of Employees M and N contribute to providing tires to customers of Employer A. Both employees therefore provide services to Employer A's tire and automotive products line of business within the meaning of paragraph (c)(5) of this section.

Example 2. The facts are the same as in *Example 1.* In addition, none of the services of Employees M and N that contribute to providing property or services to customers contribute to providing any property or service other than tires to customers of Employer A. Under these facts, Employees M and N provide at least 75 percent of their respective services to Employer A's tire and automotive products line of business. Therefore Employees M and N are substantial-service employees with respect to Employer A's tire and automotive products line of business within the meaning of §1.414(r)–11(b)(2), and do not provide any services within the meaning of paragraph (c)(5) of this section to any of Employer A's other lines of business. Moreover, because Employees M and N provide at least 75 percent of their services to Employer A's tire and automotive products line of business and are substantial-service employees with respect to that line, they are disregarded in applying paragraph (b)(4) of this section to any other line of business, even if they provide services to the other line.

Example 3. The facts are the same as in *Example 2.* Employer A's second line of business manufactures and sells construction machinery, and Employer A's third line of business manufactures and sells agricultural equipment. As part of these lines of business, Employer A operates a construction machinery factory and an agricultural equipment factory on the same site as the tire factory described in *Example 2.* Employer A's facilities at the site include a health clinic and a fitness center that serve the employees of the construction machinery factory, the agricultural equipment factory, and the tire factory. Employee O is a nurse in the health clinic, and Employee P is a fitness instructor in the fitness center. Both employees therefore provide services within the meaning of paragraph (c)(5) of this section to Employer A's tire and automotive products line of business, construction machinery line of business, and agricultural equipment line of business. In addition, under these facts, Employer A determines that approximately 33 percent of the services of Employees O and P are provided to each of Employer A's three lines of business. As a result, neither Employee O or P provide at least 75 percent of their respective services to any of Employer A's lines of business. Therefore, Employees O and P are not substantial-service employees with respect to any of Employer A's three lines of business within the meaning of §1.414(r)–11(b)(2).

Example 4. The facts are the same as in *Example 3.* Employee Q is the president and chief executive officer of Employer A and is responsible for reviewing the performance of all Employer A's lines of business. Under these facts, the services of Employee Q contributes to providing property and services to customers of each of Employer A's three lines of business. Employee Q therefore provides services to each of these three lines of business. Employer A determines that Employee Q provides the following percentages of his services to Employer A's three lines of business: tire and automotive products—40 percent; construction machinery—40 percent, and agricultural equipment—20 percent. Employee Q does not provide at least 75 percent of his services to any of Employer A's lines of business. Therefore, Employee Q is not a substantial-service employee with respect to any of Employer A's three lines of business within the meaning of §1.414(r)–11(b)(2).

Example 5. The facts are the same as in *Example 4,* except that Employer A also owns 75 percent of Corporation X. Corporation X is not treated as part of Employer A within the meaning of §1.410(b)–9. Employee R is an accountant in the accounting department of Employer A. Employee R devotes all of his time to maintaining the accounting books and records of the tire and automotive products line of business of Employer A and the accounting books and records of Corporation X. Employer A determines that Employee R provides 40 percent of his services directly to the tire and automotive products line of business. Employer A also determines that Employee R provides the following percentages of the remainder of Employee R's services (i.e., his provision of services of maintaining the accounting books and records of Corporation X) indirectly to Employer A's three lines of business by virtue of the services he provides to Corporation X: tire and automotive products—25 percent; construction machinery—20 percent, and agricultural equipment—15 percent. Therefore, Employee R provides 65 percent of his services to the tire and automotive products line of business of Employer A (i.e., 40 percent directly and 25 percent indirectly). Under the definition of substantial-service employee in §1.414(r)–11(b)(2), Employer A may treat Employee R as a substantial-service employee with respect to the tire and automotive products line of business because Employee R provides at least 50 percent of his services to that line. In that case, Employee R would be disregarded in applying paragraph (b)(4) of this section to the construction machinery and agricultural equipment lines of business.

Example 6. The facts are the same as in *Example 5.* Employee S is a lawyer in the legal department located at the headquarters who devotes all her time to product liability suits filed against the construction machinery line of business. Under these facts, the services of Employee S contribute to providing property and services to customers of Employer A in the construction machinery line of business, and therefore Employee S provides services to that line of business. Because Employee S's services do not contribute to providing property or services in any other of Employer A's lines of business within the meaning of paragraph (c)(5) of this section, Employee S provides more than 75 percent of her services to the construction machinery line of business and therefore is a substantial-service employee with respect to Employer A's construction machinery line of business within the meaning of §1.414(r)–11(b)(2).

Example 7. The facts are the same as in *Example 6.* Employer A also maintains a separate facility that houses a centralized procurement, marketing, and billing operation for all of its lines of business. None of the procurement, marketing, or billing employees specializes in any particular line of business. Under these facts, the services of the procurement, marketing, and billing employees contribute to providing property and services to customers of Employer A in each of Employer A's three lines of business. Employer A determines that each of the procurement, marketing, and billing employees provides approximately an equal proportion of their services to each of Employer A's three lines of business. These employees therefore provide services to all of Employer A's lines of business within the meaning of paragraph (c)(5) of this section. However, none of them provides at least 75 percent of his services to any line of business. Therefore, these employees are not substantial-service employees with respect to any of Employer A's three lines of business within the meaning of §1.414(r)–11(b)(2).

Example 8. The facts are the same as in *Example 7.* Employee T works for the construction machinery line of business. During the testing year, he is temporarily detailed to the agricultural equipment line of business. His temporary detail lasts for one week, after which he returns to his regular duties with the construction machinery line of business. Under these facts, Employee T does not provide more than a negligible portion of his services during the testing year to the agricultural equipment line of business. Accordingly, Employee T does not provide services to the agricultural equipment line of business within the meaning of paragraph (c)(5) of this section. In addition, because Employee T provides at least 75 percent of his services to the construction machinery line of business, Employee T is a substantial-service employee with respect to Employer A's agricultural equipment line of business within the meaning of §1.414(r)–11(b)(2).

Example 9. The facts are the same as in *Example 8,* except that, during the testing year but before the first testing day, Employee T retires from employment with Employer A. Under paragraph (c)(5)(ii) of this section, Employee T is not taken into account in determining whether Employer A's construction machinery line of business has its own separate employee workforce within the meaning of paragraph (b)(4) of this section.

Example 10. Employer B is a multinational controlled group of corporations that engages in the exploration, production, refining, and marketing of petrochemical products. Employer B operates two lines of business as determined under §1.414(r)–2. The first line of business (the ''exploration, production, and refining line of business'') provides lubricating oil, gasoline, and other petrochemical products to wholesale customers of Employer B as well as to the second line of business. The wholesale customers of Employer B include independent jobbers, independent franchisees that operate retail filling stations under Employer B's trademark and tradename, as well as chemical and plastics manufacturers. The second line of business (the ''retail marketing line of business'') provides lubricating oil and gasoline products to retail customers of Employer B through filling stations owned and operated by Employer B. Employee U is an attendant at a filling station owned and operated by Employer B. Employee U performs no other services for Employer B, Under these facts, Employee U provides at least 75 percent of his services to Employer B's retail marketing line of business and therefore is a substantial-service employee with respect to that line of business within the meaning of §1.414(r)–11(b)(2), and does not provide any services within the meaning of paragraph (c)(5) of this section to any of Employer B's other lines of business.

Example 11. The facts are the same as in *Example 10.* Employer B operates a refinery that produces lubricating oil, gasoline, and other petrochemical products. Employee V is an operating engineer at the refinery who is involved at a stage in the refining process before lubricating oil and gasoline products have been separated from other types of petrochemical products. Employee V performs no other services for Employer B. Under these facts, Employee V's services contribute to providing property and services to customers of Employer B in both the exploration, production, and refining line of business and the retail marketing line of business. Employee V therefore provides services to both lines of business within the meaning of paragraph (c)(5) of this section. See paragraph (d) of this section, however, for an optional rule for vertically integrated lines of business.

Example 12. The facts are the same as in *Example 11.* Employee W is a petroleum engineer who conducts geological studies of potential future drilling sites. Although Employee W's services during the testing year will not contribute to providing lubricating oil, gasoline, and other petrochemical products to customers of Employer B during the testing year, it is reasonably anticipated (in accordance with paragraph (c)(5)(ii)(B) of this section) that her services during the testing year will contribute to providing such products to customers of Employer B after the close of the testing year. Under these facts, Employee W provides her services to both of Employer B's lines of business within the meaning of paragraph (c)(5) of this section.

(7) *Examples of the separate management requirement.* The following examples illustrate the application of the separate management requirement in paragraph (b)(5) of this section and the supplementary rules of this paragraph (c). Unless otherwise specified, it is assumed that employees who provide services to a line of business are not substantial-service employees with respect to any other line of business and that, in determining the top-paid employees with respect to a line of business, the employer is using the option under §1.414(r)–11(b)(3) to disregard all employees who provide less than 25 percent of their services to that line of business.

Example 1. (a) Employer C operates three lines of business as determined under §1.414(r)–2. One of its lines of business is the operation of a chain of athletic equipment and apparel stores. Of Employer C's total workforce, 12,000 employees provide more than a negligible amount of the services they provide to Employer C to the athletic equipment and apparel stores line of business, within the meaning of paragraph (c)(5) of this section. Of the 1,200 employees who constitute the top ten percent by compensation of those 12,000 employees, 930 are substantial-service employees with respect to that line of business. Because 930 is 77.5 percent of 1,200, less than 80 percent of the top-paid employees with respect to the line of business are substantial-service employees with respect to that line of business. Therefore, Employer C's athletic equipment and apparel stores line of business does not have its own separate management under paragraph (b)(5) of this section.

(b) Assume that, in determining the top-paid employees with respect to the athletic equipment and apparel stores line of business, Employer C chooses to disregard all employees who provide less than 25 percent of their services to the line of business as permitted under the definition in §1.414(r)–11(b)(3). Of the 12,000 employees who provide more than a negligible amount of their services to the athletic equipment and apparel stores line of business, 10,000 provide at least 25 percent of their services to that line. Of the 1,000 employees who constitute the top ten percent by compensation of those 10,000 employees, 930 are substantial-service employees with respect to the athletic equipment and apparel stores line of business. Because 930 is 93 percent of 1,000, at least 80 percent of the top-paid employees with respect to the line of business are substantial-service employees with respect to that line of business. Therefore, Employer C's athletic equipment and apparel stores line of business has its own separate management and satisfies the requirement of paragraph (b)(5) of this section.

Example 2. The facts are the same as in *Example 1.* Employee X is a vice president of the accounting department located at the headquarters, who devotes all of his time supervising the staff of Employer C's accounting department. Employer C determines that 10 percent of Employee X's services contribute to providing property and services to customers of Employer C's athletic equipment and apparel stores line of business and 45 percent of Employee X's services contribute to providing property and services to customers to each of Employer C's other two lines of business. Because Employee X does not provide at least 25 percent of his services to Employer C's athletic equipment and apparel stores line of business, Employee X is not one of the 10,000 employees described in *Example 1* and therefore cannot be a top-paid employee within the meaning of §1.414(r)–11(b)(3) with respect to the athletic equipment and apparel stores line of business. Therefore, Employee X is not taken into account in determining whether the athletic equipment and apparel stores line of business satisfies the separate management requirement of paragraph (b)(5) of this section.

Example 3. The facts are the same as in *Example 2* except that Employee X provides 60 percent of his services to Employer C's second line of business, an athletic equipment factory, and 30 percent of his service to Employer C's third line of business, a fast-food chain. Because Employee X provides at least 50 percent of his services to the athletic equipment factory line of business, Employer C chooses to treat him as a substantial- service employee with respect to that line of business, as permitted under

§ 1.414(r)–11(b)(2). Thus, Employee X is taken into account as a substantial-service employee with respect to the athletic equipment factory line of business and is disregarded in applying the separate workforce and separate management requirements under paragraphs (b) (4) and (5) to the fast-food chain line of business.

Example 4. Employer D operates four lines of business as determined under § 1.414(r)–2. One of its lines of business is a machine tool shop. Sixty of Employer D's employees provide at least 25 percent of their services to the machine tool shop line of business. Of the six employees who constitute the top 10 percent by compensation of those 60 employees, four are substantial-service employees with respect to the line of business. Because four is 67 percent of six, 80 percent of the top-paid employees with respect to the machine tool shop line of business are not substantial-service employees with respect to that line of business. Therefore the machine tool shop line of business does not satisfy the separate management requirement of paragraph (b)(5) of this section.

Example 5. The facts are the same as in *Example 4,* except that, in addition, another of Employer D's lines of business is an automotive repair shop, and 80 of Employer D's employees provide at least 25 percent of their services to that line of business. Employer D combines the machine shop line of business with the automotive repair shop line of business and treats them as a single line of business. As a result, Employer D has three lines of business as determined under § 1.414(r)–2. Assume that 150 of Employer D's employees provide more than 25 percent of their services to the machine tool shop/automotive repair shop line of business within the meaning of paragraph (c)(5) of this section. Of the 15 employees who constitute the top 10 percent by compensation of these 150 employees, 12 are substantial-service employees with respect to that line of business. Because 12 is 80 percent of 15, at least 80 percent of the top-paid employees with respect to the machine tool shop/automotive repair shop line of business are substantial-service employees with respect to that line of business. Therefore, the machine tool shop/automotive repair shop line of business satisfies the separate management requirement of paragraph (b)(5) of this section.

(d) *Optional rule for vertically integrated lines of business*—(1) *In general.* If two lines of business satisfy the requirements of this paragraph (d) with respect to a type of property or service for a testing year, the employer is permitted to apply the optional rule in this paragraph (d) for the testing year.

(2) *Requirements.* Two lines of business satisfy the requirements of this paragraph (d) with respect to a type of property or service only if—

(i) One of the lines of business (the upstream line of business) provides a type of property or service to the other line of business (the downstream line of business);

(ii) The downstream line of business either—

(A) Uses, consumes, or substantially modifies the property or service in the course of itself providing property or services to customers of the employer; or

(B) Provides the same property or service to customers of the employer at a different level in the chain of commercial distribution from the upstream line of business (e.g., retail versus wholesale); and

(iii) The upstream line of business either—

(A) Provides the same type of property or service to customers of the employer, and at least 25 percent of the total number of units of the same type of property or service provided by the upstream line of business to all persons (including customers of the employer, the downstream line of business, and all other lines of business of the employer) are provided to customers of the employer by the upstream line of business, when measured on a uniform basis; or

(B) Provides to the downstream line of business property consisting primarily of a type of tangible property (i.e., goods, not services) that it produces or manufactures, and some entities outside the employer's controlled group that are engaged in a similar business as the upstream line of business provide the same type of tangible property to unrelated customers (i.e., customers outside those entities' respective controlled groups).

(3) *Optional rule—(* i*) Treatment of employees.* For purposes of determining the lines of business to which an employee provides services under paragraph (c)(5) of this section, an employee is not treated as providing services to the downstream line of business if—

(A) The employee is considered to provide services to the downstream line of business under paragraph (c)(5) of this section (applied without regard to the optional rule in this paragraph (d)); and

(B) The employee is so considered solely because the employee's services contribute to providing the property or service from the upstream line of business to the downstream line of business.

(ii) *Purposes for which optional rule applies.* If an employee applies the optional rule in this paragraph (d), the treatment specified in paragraphs (d)(3)(i) (A) and (B) of this section applies for all the following purposes and only for the following purposes—

(A) The separate employee workforce and separate management requirements of paragraphs (b)(4) and (b)(5) of this section;

(B) The 50-employee requirement of §1.414(r)–4(b); and

(C) The determination of the employees of a qualified separate line of business under §1.414(r)–7.

(4) *Examples.* The following examples illustrate the application of the optional rule in this paragraph (d).

Example 1. Employer E operates two lines of business as determined under §1.414(r)–2, one engaged in upholstery textile manufacturing and the other in furniture manufacturing. During the testing year, the upholstery textile line of business provides its entire output of upholstery textiles to the furniture line of business. The furniture line of business uses the upholstery textiles in the manufacture of upholstered furniture for sale to customers of Employer E. The furniture line of business thus substantially modifies the upholstery textiles provided to it by the upholstery textile line of business in providing upholstered furniture products to customers of Employer E. In addition, although the upholstery textile line of business does not provide upholstery textiles to customers of Employer E, some entities engaged in upholstery textile manufacturing provide upholstery textiles to customers outside their controlled groups. Under these facts, Employer E's two lines of business satisfy the requirements of this paragraph (d) with respect to upholstery textiles for the testing year.

Example 2. Employer B is a multinational controlled group of corporations that engages in the exploration, production, refining, and marketing of petrochemical products. See *Example 10* under paragraph (c)(7) of this section. Employer B operates two lines of business as determined under §1.414(r)–(2). The first line of business (''the exploration, production, and refining line of business'') provides lubricating oil, gasoline, and other petrochemical products to wholesale customers of Employee B as well as the second line of business. The wholesale customers of Employee B include independent jobbers, independent franchisees that operate retail filling stations under Employee B's trademark and tradename, as well as chemical and plastics manufacturers. The second line of business (the ''retail marketing line of business'') provides lubricating oil and gasoline products to retail customers of Employee B through filing stations owned and operated by Employee B. During the testing year, the exploration, production and refining line of business provides 25,000 gallons of lubricating oil, 100,000 gallons of unleaded and 150,000 gallons of leaded gasoline to the retail marketing line of business, and 75,000 gallons of lubricating oil, 500,000 gallons of unleaded gasoline and 15,000 gallons of leaded gasoline to wholesale customers of Employer B. Thus, the exploration, production, and refining line of business provides 75 percent of its output of lubricating oil during the testing year to wholesale customers of Employer B. In addition, because unleaded and leaded gasoline is the same type of property (i.e., gasoline), the exploration, production, and refining line of business provides 67 percent of its output of gasoline products during the testing year to wholesale customers of Employer B. Furthermore, the retail line of business provides lubricating oil and gasoline products to customers of Employer B at different levels in the chain of commercial distribution than the exploration, production, and refining line of business. Under these facts, Employer B's two lines of business satisfy the requirements of this paragraph (d) with respect to both lubricating oil and gasoline products for the testing year.

Example 3. The facts are the same as in *Example 2.* Employer B operates a refinery that produces lubricating oil, gasoline, and other petrochemical products. Employee V is an operating engineer at the refinery who is involved at a stage in the refining process before lubricating oil and gasoline products have been separated from other types of petrochemical products. Employee V performs no other services for Employer B. Absent application of the optional rule in this paragraph (d), Employee V would be considered to provide services to both of Employer B's lines of business. See *Example 11* under paragraph (c)(7) of this section. However, because Employee V's services to the retail marketing line of business contribute solely to providing lubricating oil and gasoline products from the exploration, production, and refining line of business to the retail marketing line of business, under the optional rule in paragraph (d)(3)(i) of this section Employee V is not treated as providing services to the retail marketing line of business.

Example 4. The facts are the same as in *Example 3.* Employee W is a petroleum engineer who conducts geological studies of potential future drilling sites. Employee W performs no other services for Employer B. Absent application of the optional rule in this paragraph (d), Employee W would be considered to provide services to both of Employer B's lines of business. See *Example 12* under paragraph (c)(7) of this Section. However, because Employee W's services to the retail marketing line of business contribute solely to providing lubricating oil and gasoline products from the exploration, production, and refining line of business to the retail marketing line of business, under the optional rule in paragraph (d)(3)(i) of this section Employee W is not treated as providing services to the retail marketing line of business.

Example 5. The facts are the same as in *Example 4.* Employee Y is a vice president in Employer B's home office. As part of his senior management responsibilities, Employee Y helps to set the rate of production at Employer B's refineries in the United States and also helps to set the price charged at the pump at the retail filling stations owned and operated by Employer B in this country. Absent application of the optional rule in this paragraph (d), Employee X would be considered to provide services to both of Employer B's lines of business within the meaning of paragraph (c)(5) of this section for purposes of satisfying the separate workforce requirement of paragraph (b)(4) of this section. Because Employee X helps to set the price charged at the pump by Employer B's retail marketing line of business, Employee X's services to the retail marketing line of business are not limited to contributing solely to providing lubricating oil and gasoline products from the exploration, production, and refining line of business to the retail marketing line of business, as required under paragraph (d)(3)(i)(B) of this section. Accordingly, even though Employer B's two lines of business satisfy the requirements of this paragraph (d) with respect to both lubricating oil and gasoline products for the testing year, and even though Employer B applies the optional rule in this paragraph (d), Employee X is still considered to provide services to both of Employer B's lines of business.

[T.D. 8376, 56 FR 63442, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32917, June 27, 1994]

§ 1.414(r)–4 Qualified separate line of business—fifty-employee and notice requirements.

(a) *In general.* This section sets forth the rules for determining whether a separate line of business (as determined under § 1.414(r)–3) satisfies the 50-employee and notice requirements of § 1.414(r–1(b)(2)(iv) (B) and (C), respectively.

(b) *Fifty-employee requirement.* A separate line of business satisfies the 50-employee requirement of § 1.414(r)–1(b)(2)(iv)(B) for a testing year only if on each day of the testing year there are at least 50 employees who provide services to the separate line of business for the testing year and do not provide services to any other separate line of business of the employer for the testing year within the meaning of § 1.414(r)–3(c)(5). For this purpose, all employees of the employer are taken into account (including collectively bargained employees), except employees described in § 1.414(q)–1, Q&A–9(g)(i.e., the same employees, subject to certain modifications, who are excluded in determining the number of employees in the top-paid group under section 414(q)(4)).

(c) *Notice requirement*—(1) *General rule.* A separate line of business satisfies the notice requirement of § 1.414(r)–1(b)(2)(iv)(C) for a testing year only if the employer notifies the Secretary that it treats itself as operating qualified separate lines of business for the testing year in accordance with § 1.414(r)–1(b). The employer's notice for the testing year must specify each of the qualified separate lines of business operated by the employer and the section or sections of the Code to be applied on a qualified-separate-line-of-business basis. See § 1.414(r)–1(c). The employer's notice must take the form, must be filed at the time and the place, and must contain any additional information prescribed by the Commissioner in revenue procedures, notices, or other guidance of general applicability. No other notice, whether actual or constructive, satisfies the requirement of this paragraph (c).

(2) *Effect of notice.* Once an employer has provided the notice prescribed in this paragraph (c) for a testing year, and the time for filing the notice for the testing year has expired without its being modified, withdrawn, or revoked, the employer is deemed to have irrevocably elected to apply the requirements of the section or sections of the Code specified in the notice separately with respect to the employees of each qualified separate line of business

specified in the notice for all plan years that begin in the testing year. The Commissioner may, in revenue procedures, notices, or other guidance of general applicability, provide for exceptions to the rule in this paragraph (c)(2) as well as for the effect that will be given to the employer's notice for purposes of any future testing year.

[T.D. 8376, 56 FR 63446, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32919, June 27, 1994]

§1.414(r)–5 Qualified separate line of business—administrative scrutiny requirement—safe harbors.

(a) *In general.* A separate line of business (as determined under §1.414(r)–3 satisfies the administrative scrutiny requirement of §1.414(r)–1(b)(2)(iv)(D) for a testing year if the separate line of business satisfies any of the safe harbors in paragraphs (b) through (g) of this section for the testing year. The safe harbor in paragraph (b) of this section implements the statutory safe harbor of section 414(r)(3). The safe harbors in paragraphs (c) through (g) of this section constitute the guidelines provided for under section 414(r)(2)(C). A separate line of business that does not satisfy any of the safe harbors in this section nonetheless satisfies the requirement of administrative scrutiny if the employer requests and receives an individual determination from the Commissioner under §1.414(r)–6 that the separate line of business satisfies the requirement of administrative scrutiny.

(b) *Statutory safe harbor*—(1) *General rule.* A separate line of business satisfies the safe harbor in this paragraph (b) for the testing year only if the highly compensated employee percentage ratio of the separate line of business is—

(i) At least 50 percent; and

(ii) Non more than 200 percent.

(2) *Highly compensated employee percentage ratio.* For purposes of this paragraph (b), the highly compensated employee percentage ratio of a separate line of business is the fraction (expressed as a percentage), the numerator of which is the percentage of the employees of the separate line of business who are highly compensated employees, and the denominator of which is the percentage of all employees of the employer who are highly compensated employees.

(3) *Employees taken into account.* For purposes of this paragraph (b), the employees taken into account are the same employees who are taken into account for purposes of applying section 410(b) with respect to the first testing day. For this purpose, employees described in section 410 (b)(3) and (b)(4) are excluded. However, section 410(b)(4) is applied with reference to the lowest minimum age requirement applicable under any plan of the employer, and with reference to the lowest service requirement applicable under any plan of the employer, as if all the plans were a single plan under §1.410(b)–6(b)(2). The employees of the separate line of business are determined by applying §1.414(r)–7 to the employees taken into account under this paragraph (b)(3). An employee is treated as a highly compensated employee for purposes of this paragraph (b) if the employee is treated as a highly compensated employee for purposes of applying section 410(b) with respect to the first testing day. For the definition of ‘‘first testing day,’’ see §1.414(r)–11(b)(7).

(4) *Ten-percent exception.* A separate line of business is deemed to satisfy paragraph (b)(1)(i) of this section for the testing year if at least 10 percent of all highly compensated employees of the employer provide services to the separate line of business during the testing year and do not provide services to any other separate line of business of the employer during the testing year within the meaning of §1.414(r)–3(c)(5).

(5) *Determination based on preceding testing year.* A separate line of business that satisfied this safe harbor for the immediately preceding testing year (without taking into account the special rule in this paragraph (b)(5)) is deemed to satisfy the safe harbor for the current testing year. The preceding sentence applies to a separate line of business only if the employer designated the same line of business in the immediately preceding testing year as in the current testing year and either—

(i) The highly compensated employee percentage ratio of the separate line of business for the current testing year does not deviate by more than 10 percent (not 10 percentage points) from the highly compensated employee percentage ratio of the separate line of business for the immediately preceding testing year; or

(ii) No more than five percent of the employees of the separate line of business for the current testing year were employees of a different separate line of business for the immediately preceding testing year, and no more than five percent of the employees of the separate line of business for the immediately preceding testing year are employees of a different separate line of business for the current testing year.

(6) *Examples.* The following examples illustrate the application of the safe harbor in this paragraph (b).

Example 1. (i) Employer A operates three separate lines of business as determined under § 1.414(r)–3, that respectively consist of a railroad, an insurance company, and a newspaper. Employer A employs a total of 400 employees, 100 of whom are highly compensated employees. Thus, the percentage of all employees of Employer A who are highly compensated employees in 25 percent. After applying § 1.414(r)–7, the distribution of highly and nonhighly compensated employees among Employer A's separate lines of business is as follows:

	Employer-wide	Railroad	Insurance company	Newspaper
Number of Employees	400	100	150	150
Number of HCEs	100	20	50	30
Number of Non-HCEs	300	80	100	120
HCE Percentage	25%	20%	33%	20%
	(100/400)	(20/100)	(50/150)	(30/150)
HCE Percentage Ratio	N/A	80%	133%	80%
	....	(20%/25%)	(33%/25%)	(20%/25%)

(ii) Because the highly compensated employee percentage ratio of each separate line of business is at least 50 percent and no more than 200 percent, each of Employer A's separate lines of business satisfies the requirements of the safe harbor in this paragraph (b).

Example 2. (i) Employer B operates three separate lines of business as determined under § 1.414(r)–3, that respectively consist of a dairy products manufacturer, a candy manufacturer, and a chain of housewares stores. Employer B employs a total of 1,000 employees, 100 of whom are highly compensated employees. Thus, the percentage of all employees of Employer B who are highly compensated employees is 10 percent. After applying § 1.414(r)–7, the distribution of highly and nonhighly compensated employees among Employer B's separate lines of business is as follows:

	Employer-wide	Dairy products	Candy	Housewares stores
Number of Employees	1,000	200	500	300
Number of HCEs	100	5	50	45
Number of Non-HCEs	900	195	450	255
HCE Percentage	10%	2.5%	10%	15%
	(100/1,000)	(5/200)	(50/500)	(45/300)
HCE Percentage Ratio	N/A	25%	100%	150%
	....	(2.5%/10%)	(10%/10%)	(15%/10%)

(ii) Because the highly compensated employee percentage ratio for the dairy products line of business is less than 50 percent, it does not satisfy the requirements of the statutory safe harbor in this paragraph (b). However, because Employer B's other two separate lines of business (candy manufacturing and housewares stores) each has a highly compensated employee percentage ratio that is no less than 50 percent and no greater than 200 percent, they each satisfy the statutory safe harbor in this paragraph (b).

Example 3. (i) The facts are the same as in *Example 2,* except that Employer B operates only two separate lines of business as determined under § 1.414(r)–3, one consisting of the dairy products manufacturer and the candy manufacturer, and the other consisting of the chain of housewares stores. After applying § 1.414(r)–7, the distribution of highly and nonhighly compensated employees among

Employer B's separate lines of business is as follows:

	Employer-Wide	Candy/Dairy Products	Housewares Stores
Number of Employees	1,000	700	300
Number of HCEs	100	55	45
Number of Non-HCEs	900	645	255
HCE Percentage	10% (100/1,000)	7.9% (55/700)	15% (45/300)
HCE Percentage Ratio	N/A	79% (7.9%/10%)	150% (15%/10%)

(ii) Because the highly compensated employee percentage ratio for both of Employer B's separate lines of business is at least 50 percent and no more than 200 percent, they each satisfy the requirements of the statutory safe harbor in this paragraph (b).

(c) *Safe harbor for separate lines of business in different industries*—(1) *In general.* A separate line of business satisfies the safe harbor in this paragraph (c) for the testing year if it is in a different industry or industries from every other separate line of business of the employer. For this purpose, a separate line of business is in a different industry or industries from every other separate line of business of the employer only if—

(i) The property or services provided to customers of the employer by the separate line of business (as designated by the employer for the testing year under § 1.414(r)–2) fall exclusively within one or more industry categories established by the Commissioner for purposes of this paragraph (c); and

(ii) None of the property or services provided to customers of the employer by any of the employer's other separate lines of business (as designated by the employer for the testing year under § 1.414(r)–2) falls within the same industry category or categories.

(2) *Optional rule for foreign operations.* For purposes of satisfying this paragraph (c), an employer is permitted to disregard any property or services provided to customers of the employer during the testing year by a foreign corporation or foreign partnership (as defined in section 7701(a)(5)), to the extent that income from the provision of the property or services is not effectively connected with the conduct of the trade or business within the United States within the meaning of section 864(c). Thus, for example, an employer is permitted to take into account only property and services provided to customers of the employer by its domestic subsidiaries and property and services provided by its foreign subsidiaries that generate income effectively connected with the conduct of a trade or business within the United States in determining whether the property or services provided to customers of the employer by a separate line of business fall exclusively within one or more industry categories and also whether the property or services provided by any other separate line of business fall within the same industry category or categories.

(3) *Establishment of industry categories.* The Commissioner shall, by revenue procedure or other guidance of general applicability, establish industry categories for purposes of this paragraph (c).

(4) *Examples.* The following examples illustrate the application of the safe harbor in this paragraph (c). For purposes of these examples, it is assumed that, pursuant to paragraph (c)(3) of this section, the Commissioner has established the following industry categories (among others): transportation equipment and services; banking, insurance, and finance; machinery and electronics; and entertainment, sports, and hotels.

Example 1. Among its other business activities, Employer C operates a commercial airline that constitutes a separate line of business under § 1.414(r)–3. In addition, no other separate line of business of Employer C provides to customers of Employer C any property or services in the transportation equipment and services industry category. Under these facts, the separate line of business described in this example satisfies the safe harbor in this paragraph (c).

Example 2. The facts are the same as in *Example 1,* except that Employer C also operates a trucking company that constitutes another separate line of business of Employer C under § 1.414(r)–3. Because the commercial airline and the trucking company both provide to customers of Employer C services in the transportation equipment and services industry category, neither separate line of business satisfies the safe harbor in this paragraph (c).

Example 3. Among its other business activities, Employer D operates a commercial bank and luxury hotel that together constitute a single separate line of business under § 1.414(r)–3. No other separate line of business of employer D provides to customers of Employer D property or services in either the banking, insurance, or financial industry category, or the entertainment, sports, or hotel industry category. Under these facts, the separate line of business described in this example satisfies the safe harbor in this paragraph (c).

Example 4. The facts are the same as in *Example 3,* except that Employer D also manufactures computers in the United States and abroad. Employer D apportions its computer operations by designating these operations between two separate lines of business, one consisting of its domestic operations located in the United States and the second consisting of its foreign operations by a foreign subsidiary. Because both lines of business provide property and services in the machinery and electronics industry category to customers of Employer D, neither separate line of business would satisfy the safe harbor in this paragraph (c). However, pursuant to the optional rule in paragraph (c)(2) of his section, Employer D disregards the property and services provided by its foreign computer subsidiary. As a result, no other separate line of business of Employer D provides to customers of Employer D any property or services in the machinery and electronics industry category. Under these facts, Employer D's domestic computer operations separate line of business satisfies the safe harbor in this paragraph (c).

(d) *Safe harbor for separate lines of business that are acquired through certain mergers and acquisitions*—(1) *General rule.* A portion of the employer that is acquired through a transaction described in section 410(b)(6)(C) and § 1.410(b)–2(f) (i.e., an asset or stock acquisition, merger, or other similar transaction involving a change in the employer of the employees of a trade or business) (the ''acquired line of business'') satisfies the safe harbor in this paragraph (d) for each testing year in the transition period provided in paragraph (d)(3) of this section if each of the following requirements is satisfied—

(i) For each testing year within the transition period the employer designates the acquired line of business as a line of business within the meaning of § 1.414(r)–2;

(ii) On the first testing day in each testing year in the transition period:

(A) The acquired line of business constitutes a separate line of business within the meaning of § 1.414(r)–3 (taking into account § 1.414(r)–1(d)(4));

(B) No more than 10 percent of the employees who are substantial-service employees with respect to the acquired line of business were substantial-service employees with respect to a different separate line of business for the immediately preceding testing year; and

(C) No more than 10 percent of the employees who were substantial-service employees with respect to the acquired line of business for the immediately preceding testing year are substantial-service employees with respect to a different separate line of business in the respective testing year.

(iii) If the transaction described in paragraph (d)(1) of this section occurs after the first testing day in a testing year, the determinations required by paragraphs (d)(1)(ii) (B) and (C) of this section with respect to that testing year are made as of the date of the transaction.

(2) *Employees taken into account.* For purposes of this paragraph (d), the employees taken into account are the same employees who are taken into account for purposes of applying section 410(b) with respect to the first testing day. For this purpose, employees described in section 410(b)(3) and (b)(4) are excluded. However, section 410(b)(4) is applied with reference to the lowest minimum age requirement, and with reference to the lowest service requirement applicable under any plan of the employer that benefits employees of the separate line of business, as if all the plans were a single plan under § 1.410(b)–6(b)(2). The employees of the separate line of business are determined by applying § 1.414(r)–7 to the employees taken into account under this paragraph (d)(2).

(3) *Transition period.* The transition period for purposes of this safe harbor is the period that begins with the first testing year beginning after the date that the transaction described in paragraph (d)(1) of this section occurs. The employer is permitted, but not required, to extend the transition period to include one, two, or three of the testing years immediately succeeding that first testing year.

(4) *Examples.* The following examples illustrate the application of the safe harbor in this paragraph (d).

Example 1. Employer E is treated as operating three qualified separate lines of business pursuant to §1.414(r)–1(b). In 1996, Employer E acquires a company that employs 4,000 employees who manufacture and sell pharmaceutical supplies, and designates that portion as a line of business under §1.414(r)–2. Under §1.414(r)–1(d)(4), the pharmaceutical supplies line of business is deemed to satisfy the requirements to be a qualified separate line of business (other than the 50-employee and notice requirements) for testing year 1996. In addition, the determination of whether Employer E's remaining three lines of business constitute qualified separate lines of business for testing year 1996 is made without taking into account the acquired employees and by disregarding the property and services provided to customers of Employer E by the pharmaceutical supplies line of business.

Example 2. The facts are the same as in *Example 1* except that, by the first testing day in 1997 (Transition Year 1), there are 300 additional substantial-service employees with respect to the pharmaceutical supplies line of business, increasing the total number to 4,300. Of those 300 employees, 250 were substantial-service employees with respect to a different separate line of business for testing year 1996 and 50 are new hires. Assume that, on the first testing day in Transition Year 1, the pharmaceutical supplies line of business satisfies the requirements of §1.414(r)–3 (taking into account §1.414(r)–1(d)(4)) and therefore constitutes a separate line of business. Because 250 is 6 percent of 4,300, no more than ten percent of the employees who are substantial-service employees with respect to the pharmaceutical supplies line of business were substantial- service employees with respect to a different separate line of business for the immediately preceding testing year. The 50 newly hired employees are disregarded in making this determination. Under these facts, the pharmaceutical supplies separate line of business satisfies the safe harbor in this paragraph (d) for Transition Year 1.

Example 3. The facts are the same as in *Example 2,* except that, before the first day of the next testing year (''Transition Year 2''), Employer E permanently transfers 200 of the 4,300 employees who were substantial-service employees with respect to the pharmaceutical line of business on the first testing day in Transition Year 1 to a different line of business and does not hire any additional employees for the pharmaceutical supplies line of business. Therefore, by the first testing day in Transition Year 2, the number of employees who are substantial-service employees with respect to the pharmaceutical line of business of Employer E has decreased from 4,300 to 4,100. Assume that, on that first testing day in Transition Year 2, the pharmaceutical supplies line of business constitutes a separate line of business within the meaning of §1.414(r)–3. Because 200 is approximately 5 percent of 4,300, no more than 10 percent of the employees who were substantial-service employees of the pharmaceutical line of business for Transition Year 1 are not substantial-service employees of the pharmaceutical line of business in Transition Year 2. Under these facts, the pharmaceutical supplies separate line of business continues to satisfy the safe harbor in this paragraph (d) for Transition Year 2.

(e) *Safe harbor for separate lines of business reported as industry segments*—(1) *In general.* A separate line of business satisfies the safe harbor in this paragraph (e) for the testing year if, for the employer's fiscal year ending latest in the testing year, the separate line of business is reported as one or more industry segments on its annual report required to be filed in conformity with either—

(i) Form 10–K, annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (''Form 10–K''); or

(ii) Form 20–F, Annual Report Pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 with Item 18 financials (''Form 20–F''), and the employer timely files either the Form 10–K or Form 20–F with the Securities and Exchange Commission (''SEC'').

(2) *Reported as an industry segment in conformity with Form 10–K or Form 20–F.* For purposes of this paragraph (e), a separate line of business is reported as one or more industry segments in conformity with either Form 10–K or Form 20–F only if—

(i) The separate line of business consists of one or more industry segments within the meaning of paragraphs 10(a), 11(b), and 12 through 14 of the Statement of Financial Accounting Standards No. 14, Financial Reporting for Segments of a Business Enterprise (''FAS 14''); and

(ii) The property or services provided to customers of the employer by the separate line of business (as designated by the employer for the testing year under § 1.414(r)–2) is identical to the property or services provided to customers of the employer by the industry segment or segments (as determined under paragraphs 10(a), 11(b), and 12 through 14 of FAS 14).

(3) *Timely filing of Form 10–K or Form 20–F.* For purposes of this paragraph (e), a Form 10–K of Form 20–F is timely filed with the SEC if it is filed within the required period as provided under 17 CFR 240.12b–25(b)(2)(ii). Therefore, the required period for timely filing of the Form 10–K is the 90-day period after the end of the fiscal year covered by the annual report (including the 15-day extension), and the required period for timely filing of the Form 20–F is the 6-month period after the end of the fiscal year covered by the annual report (including the 15-day extension).

(4) *Examples.* The following examples illustrate the application of the safe harbor in this paragraph (e).

Example 1. Among its other business activities, Employer F operates a bearing manufacturing firm that constitutes a separate line of business under § 1.414(r)–3. Employer F is required to file an annual Form 10–K with the SEC. On its timely filed Form 10–K, Employer F reports its bearing manufacturing operations as an industry segment in accordance of FAS 14 (as determined under paragraphs 10(a), 11(b), and 12 through 14 of FAS 14). The group of bearing products provided by the separate line of business (as designated by Employer F under § 1.414(r)–2) is identical to the group of bearing products provided by the industry segment (as determined under paragraphs 10(a), 11(b), and 12 through 14 of FAS 14). Under these facts, the separate line of business described in this example satisfies the safe harbor in this paragraph (e).

Example 2. The facts are the same as in *Example 1,* except that Employer F has apportioned its bearing manufacturing operations between two separate lines of business as determined under § 1.414(r)–3, one engaged in the manufacture of bearings for use in the automotive industry, and a second engaged in the manufacture of bearings for use in the aerospace industry. Because neither separate line of business provides a group of property or services to customers of Employer F that is identical to the group of bearing products provided by the industry segment reported on Employer F's annual Form 10–K, neither separate line of business described in this example satisfies the safe harbor in this paragraph (e).

(f) *Safe harbor for separate lines of business that provide the same average benefits as other separate lines of business*—(1) *General rule.* A separate line of business satisfies the safe harbor in this paragraph (f) for the testing year only if the level of benefits provided to employees of the separate line of business satisfies paragraph (f)(2) or (f)(3) of this section, whichever is applicable.

(2) *Separate lines of business with a disproportionate number of nonhighly compensated employees*—(i) *Applicability of safe harbor.* This paragraph (f)(2) applies to a separate line of business that for the testing year has a highly compensated employee percentage ratio of less than 50 percent (as determined under paragraph (b)(2) of this section).

(ii) *Requirement.* A separate line of business satisfies this paragraph (f)(2) only if the actual benefit percentage of the group of nonhighly compensated employees of the separate line of business for the testing period that ends with or within the testing year is at least as great as the actual benefit percentage of the group of all other nonhighly compensated employees of the employer for the same testing period. See § 1.410 (b)–5(c) and (d)(3)(ii) for the definitions of actual benefit percentage and testing period, respectively. In determining actual benefit percentages for purposes of this paragraph (f)(2)(ii), the special rule in § 1.410(b)–5(e)(3) (permitting an employer to determine employee benefit percentages separately for defined contribution and defined benefit plans) may not be used.

(3) *Separate lines of business with a disproportionate number of highly compensated employees*—(i) *Applicability of safe harbor.* This paragraph (f)(3) applies to a separate line of business that for the testing year has a highly compensated employee percentage ratio of more than 200 percent (as determined under paragraph (b)(2) of this section).

(ii) *Requirement.* A separate line of business satisfies this paragraph (f)(3) only if the actual benefit percentage of the group of highly compensated employees of the separate line of business for the testing period that ends with or within the testing year is no greater than the actual benefit percentage of the group of all other highly compensated employees of the employer for the same testing period. See §1.410 (b)–5(c) and (d)(3)(ii) for the definitions of actual benefit percentage and testing period, respectively. In determining actual benefit percentages for purposes of this paragraph (f)(3)(ii), the special rule in §1.410(b)–5(e)(3) (permitting an employer to determine employee benefit percentages separately for defined contribution and defined benefit plans) may not be used.

(4) *Employees taken into account.* An employee of a separate line of business (as determined under §1.414(r)–7 is taken into account for a testing period for purposes of this paragraph (f) only if the employee is an employee of the separate line of business on the first testing day, and would not be an excludable employee for purposes of applying the average benefit percentage test of §1.410(b)–5 to a plan for a plan year included in that testing period. In determining whether an employee is an excludable employee for purposes of the average benefit percentage test, the employer is assumed not to be operating qualified separate lines of business under §1.414(r)–1(b). An employee is treated as a highly compensated employee for purposes of this paragraph (f) if the employee is treated as a highly compensated employee for purposes of applying section 410(b) on the first testing day. See §1.414(r)–11(b)(7) for the definition of ‘‘first testing day’’.

(5) *Example.* The rules of this paragraph (f) are illustrated by the following example.

Example. (i) Employer G is treated as operating two separate lines of business, Line 1 and Line 2, in accordance with §1.414(r)–1(b). Employer G maintains three qualified plans. Plan A is a calendar-year profit-sharing plan that benefits all employees of Employer G. Plan B is a defined benefit plan with a plan year ending March 31 that benefits all employees of Line 1. Plan C is a defined benefit plan with a plan year ending November 30 that benefits all employees of Line 2.

(ii) In 1995, Line 1 has a highly compensated employee percentage ratio of 25 percent. Employer G's first testing day is March 31. After applying the rules of §1.414(r)–7, the nonhighly compensated employees of Line 1 and Line 2 on March 31, 1995, are N1–N80 and N81–N100, respectively. N1 is an excludable employee under §1.410(b)–6 for purposes of the average benefit percentage test during the testing period that includes the plan years of Plans A, B, and C that end in 1995 (the ‘‘1995 testing period’’), and would therefore not be taken into account in determining whether any of those plans satisfied the average benefit percentage test of §1.410(b)–5 for plan years included in that testing period, because N1 does not satisfy the minimum age and service conditions under any plan of the employer. All other employees of Line 1 and Line 2 on March 31, 1995 are nonexcludable employees for purposes of the average benefit percentage test during the 1995 testing period.

(iii) In order for Line 1 to satisfy the requirements of this paragraph (f) for 1995, the actual benefit percentage of N2–N80 for the 1995 testing period under Plans A, B and C must be at least as great as the actual benefit percentage of N81–N100 for the same testing period under the same plans. N1 is not taken into account because N1 is an excludable employees for purposes of the average benefit percentage test for the 1995 testing period. Any other employees who were taken into account for purposes of the average benefit percentage test for the 1995 testing period are excluded because they are not employees of Line 1 or Line 2 on March 31, 1995.

(g) *Safe harbor for separate lines of business that provide minimum or maximum benefits.* —(1) *In general.* A separate line of business satisfied the safe harbor in this paragraph (g) for the testing only if the level of benefits provided to employees of the separate line of business satisfies paragraph (g)(2) or (g)(3) of this section, whichever is applicable. For this purpose, the level of benefits is determined with respect to all qualified plans of the employer that benefit employees of the separate line of business for plan years that begin in the testing year.

(2) *Minimum benefit required*—(i) *Applicability*. This paragraph (g)(2) applies to a separate line of business that for the test year has a highly compensated employee percentage ratio of less than 50 percent (as determined under paragraph (b)(2) of this section).

(ii) *Requirement.* A separate line of business satisfies this paragraph (g)(2) only if one of the following requirements is satisfied—

(A) At least 80 percent of all nonhighly compensated employees of the separate line of business either accrue a benefit for the plan year that equals or exceeds the defined benefit minimum in paragraph (g)(2)(iii) of this section, receive all allocation for the plan year that equal or exceeds the defined contribution minimum in paragraph (g)(2)(iv) of this section, or accrue a benefit and receive an allocation that together equal or exceed the combined plan minimum in paragraph (g)(4) of this section. The defined benefit minimum must be provided in a defined plan, and the defined contribution minimum must be provided in a defined contribution plan.

(B) The separate line of business would satisfy the requirements of paragraph (g)(2)(ii)(A) of this section if the 80 percent threshold were reduced to 60 percent, and the average of the accrual rates or allocation rates of all nonhighly compensated employees in the separate line of business equals or exceeds the minimum amount described for each individual employee in paragraph (g)(2)(ii)(A) of this section.

(iii) *Defined benefit minimum*—(A) *In general.* The defined benefit minimum for a plan year is the employer-derived accrual that would result in a normal accrual rate for the plan year equal to 0.75 percent of compensation. For purposes of this paragraph (g)(2)(iii), the normal accrual rate is the percentage (not less than 0) determined by subtracting the employee's normalized accrued benefit as of the end of the prior plan year (expressed as a percentage of average annual compensation as of the end of the prior plan year) from the employee's normalized accrued benefit as of the end of the plan year (expressed as a percentage of average annual compensation as of the end of the plan year).

(B) *Normal form and equivalent benefits.* The benefit that is tested for purposes of this paragraph (g)(2)(iii) is the accrued retirement benefit commencing at normal retirement age. If the normal form of benefit for a plan being tested is other than a straight life annuity beginning at a normal retirement age of 65, the benefit must be normalized (within the meaning of § 1.401(a)(4)–12) to a straight life annuity commencing at age 65. No adjustment is permitted for early retirement benefits or for any ancillary benefit, including disability benefits.

(C) *Compensation definition.* The underlying definition of compensation used for purposes of determining accrual rates under this paragraph (g)(2)(iii) must be a definition of compensation that automatically satisfies section 414(s) without a test for nondiscrimination (see § 1.414(s)–1(c)).

(D) *Average compensation requirement.* For purposes of determining accrual rates, compensation must be average annual compensation within the meaning of § 1.401(a)(4)–3(e)(2) determined using a five-year averaging period. The compensation history to be taken into account are all years beginning with the first year in which the employee benefits under the plan, and ending with the last plan year in which the employee participates in the plan. However, a plan may disregard in a reasonable and consistent manner: years before the effective date of these regulations as set forth in § 1.414(r)–1(d)(9)(i), years more than 10 years preceding the current plan year, and years for which the employer does not use this paragraph (g)(2) to satisfy this safe harbor with respect to the separate line of business. If a plan provides a defined benefit minimum that uses three consecutive years (in lieu of five) for calculating average annual compensation, the 0.75 percent annual accrual in paragraph (g)(2)(iii)(A) of this section is multiplied by 93.3 percent, resulting in a normal accrual rate equal to 0.70 percent. If a plan provides a defined benefit minimum that uses more than five consecutive years for calculating average annual compensation or the plan is an accumulation plan as defined in § 1.401(a)(4)–12, the 0.75 percent annual accrual rate in paragraph (g)(2)(iii)(A) of this section is multiplied by 133.3 percent, resulting in a normal accrual rate equal to 1.0 percent.

(E) *Special rules.* The special rules of § 1.401(a)(4)–3(f) apply for purposes of determining whether a benefit accrual satisfies the minimum benefit requirement. For example, benefits may be determined on other than a plan year basis as permitted by § 1.401(a)(4)–3(f)(6). A plan described in section 412(i) may be used to provide the defined benefit minimum described in this paragraph (g)(2). In such case, the rules in §1.416–1, M–17, apply to such a plan. For purposes of this paragraph (g)(2)(iii) an employee is treated as accruing a benefit equal to the minimum benefit in paragraph (g)(2)(iii)(A) of this section if the reason that the employee does not accrue such a benefit is either—

(*1*) The application of a plan provision that applies uniformly to all employees in the plan and limits the service used for purposes of benefit accrual to a specified maximum no less than 25 years, or

(*2*) The employee has attained normal retirement age and fails to accrue a benefit solely because of the provisions of section 411(b)(1)(H)(iii) regarding adjustments for delayed retirement.

(iv) *Defined contribution minimum*—(A) *In general.* The defined contribution minimum for a plan year is an allocation that results in an allocation rate for the plan year (within the meaning of §1.401(a)(4)–2(c)) equal to three percent of an employee's plan year compensation. Plan year compensation must be based on a definition of compensation that automatically satisfies section 414(s) without a test for nondiscrimination (see §1.414(s)–1(c)). For this purpose, allocations that are taken into account to do not include matching contributions described in §1.401(m)–1(f)(12), elective contributions described in §1.401(k)–1(g)(3), any adjustment in allocation rates permitted under section 401(*l*) or imputed disparity under §1.401(a)(4)–7.

(B) *Modified allocation definition for averaging.* For purposes of determining whether the average allocation rates for all nonhighly compensated employees of the separate line of business satisfy the minimum benefit requirement in paragraph (g)(2)(ii)(B) of this section, matching contributions described in §1.401(m)–1(f)(12) are treated as employer allocations.

(3) *Maximum benefit permitted—(* i*) Applicability*. This paragraph (g)(3) applies to a separate line of business that for the testing year has a highly compensated employee percentage ratio that exceeds 200 percent (as determined under paragraph (b)(2) of this section).

(ii) *Requirement.* A separate line of business satisfies this paragraph (g)(3) only if one of the following requirements is satisfied—

(A) No highly compensated employee of the separate line of business accrues a benefit for the plan year that results in an accrual rate that exceeds the defined benefit maximum in paragraph (g)(3)(iii) of this section, receives an allocation that exceeds the defined contribution maximum in paragraph (g)(3)(iv) of this section, or accrues a benefit and receives an allocation that together exceed the combined plan maximum in paragraph (g)(4) of this section. All benefits provided by qualified defined benefit plans are subject to the defined benefit maximum, and all benefits provided by qualified defined contribution plans are subject to the defined contribution maximum.

(B) The average of the accrual rates or allocation rates of all highly compensated employees of the separate line of business is no more than 80 percent of the maximum amount described for any individual employee in paragraph (g)(3)(ii)(A) of this section.

(iii) *Defined benefit maximum*—(A) *In general.* The defined benefit maximum is the employer-derived accrued benefit that would result from calculating a normal accrual rate equal to 2.5 percent of compensation.

(B) *Determination of defined benefit maximum.* The accrual rate used for the defined benefit maximum is determined in the same manner as the normal accrual rate used for the defined benefit minimum is determined under paragraph (g)(2)(iii) of this section, except as provided below. Thus, a defined benefit plan may provide, in addition to the defined benefit maximum, any benefit the value of which is not taken into account under paragraph (g)(2)(iii) of this section. For example, a plan may provide qualified disability benefits described in section 411(a)(9) or ancillary benefits described in §1.401(a)(4)–4(e)(2).

(C) *Adjustment for different compensation definitions.* If a plan subject to the defined benefit maximum determines accrual rates by using three consecutive years (in lieu of five) for purposes of determining average annual compensation, the 2.5 percent annual accrual rate in paragraph (g)(3)(iii)(B) of this section is multiplied by 93.3 percent, resulting in a maximum accrual rate equal to 2.33 percent. Compensation may be less inclusive than the compensation described in paragraph (g)(2)(iii)(C) of this section. However, no adjustment is made to the maximum normal accrual rate because of the use of a definition of compensation that is less inclusive than the compensation described in paragraph (g)(2)(iii)(C) of this section. In addition, no adjustment is made to the maximum normal accrual rate because the plan uses more than five consecutive years for calculating average annual compensation or the plan is an accumulation plan as defined in § 1.401(a)(4)–12.

(D) *Adjustment for certain subsidies.* If the plan provides subsidized optional forms of benefit, the accrual rate for purposes of this paragraph (g)(3) must be determined by taking those subsidies into account. An optional form of benefit is considered subsidized if the normalized optional form of benefit is larger than the normalized normal retirement benefit under the plan. In the case of a plan with subsidized optional forms, the determination of accrual rate for the plan year under paragraph (g)(2)(iii)(A) of this section is the percentage (not less than 0) determined by subtracting the largest of the sums of the employee's normalized QJSAs and QSUPPs determined for each age under § 1.401(a)(4)–3(d)(1)(ii) as of the end of the prior plan year (expressed as a percentage of average annual compensation as of the end of the prior plan year) from the largest of the sums of the employee's normalized QJSAs and QSUPPs determined for each age under § 1.401(a)(4)–3(d)(1)(ii) as of the end of the plan year (expressed as a percentage of average annual compensation as of the end of the plan year).

(iv) *Defined contribution maximum.* The defined contribution maximum is an allocation that results in an allocation rate for the plan year (within the meaning of § 1.401(a)(4)–2(c)) equal to 10 percent of an employee's plan year compensation. Compensation may be less inclusive than the compensation described in paragraph (g)(2)(iv)(A) of this section. However, no adjustment is made to the defined contribution maximum because of the use of a definition of compensation that is less inclusive than the compensation described in paragraph (g)(2)(iv)(A) of this section. For this purpose, allocations that are taken into account do not include elective contributions described in § 1.401(K)–1(g)(3), any adjustment in allocation rates permitted under section 401(*l*) or imputed disparity under § 1.401(a)(4)–7 but do include employer matching contributions under § 1.401(m)–1(f)(12).

(4) *Duplication of benefits or contributions*—(i) *Plans of the same type.* In the case of an employee who benefits under more than one defined benefit plan, the defined benefit minimum required or the defined benefit maximum permitted under this paragraph (g) is determined by reference to the employee's aggregate employer-provided benefit under all qualified defined benefit plans of the employer. In the case of an employee who benefits under more than one defined contribution plan, the defined contribution minimum required or the defined contribution maximum permitted under this paragraph (g) is determined by reference to the employee's aggregate employer-provided allocations under all qualified defined contribution plans of the employer.

(ii) *Plans of different types.* In the case of an employee who benefits under both a defined benefit plan and a defined contribution plan, a percentage of the minimum benefit required or the maximum benefit permitted under this paragraph (g) may be provided in each type of plan as long as the combined percentage equals at least 100 percent in the case of the minimum benefit required and does not exceed 100 percent in the case of the maximum benefit permitted. Thus, for example, if a highly compensated employee benefits under both types of plans and accrues an aggregate adjusted normal accrual rate equal to 1.25 percent of average annual compensation under all defined benefit plans of the employer (i.e, 50 percent of the defined benefit maximum described in paragraph (g)(3)(iii) of this section), in order to comply with the maximum benefit safe harbor, the employee may not receive an aggregate allocation under all defined contribution plans of the employer in excess of five percent of plan year compensation (i.e., 50 percent of the defined contribution maximum described in paragraph (g)(3)(iv) of this section).

(iii) *Special rule for floor-offset arrangements.* In the case of a floor-offset arrangement (as described in §1.401(a)(4)–8(d)), the minimum or maximum benefit rules are applied to each plan as if the other plan did not exist. Thus, the defined benefit plan must provide at least 100 percent of the defined benefit minimum (or no more than 100 percent of the defined benefit maximum) based on the gross benefit prior to offset, and the defined contribution plan must provide at least 100 percent of the defined contribution minimum (or no more than 100 percent of the defined contribution maximum).

(5) *Certain contingency provisions ignored.* For purposes of this paragraph (g), an employee's accrual or allocation rate is determined without regard to any minimum benefit or any maximum benefit limitation that is applicable to the employee only if the separate line of business fails otherwise to satisfy the requirement of administrative scrutiny.

(6) *Employees taken into account.* For purposes of this paragraph (g), an employee is taken into account if the employee is taken into account for purposes of applying section 410(b) with respect to any testing day for the testing year. For this purpose, employees described in section 410 (b)(3) and (b)(4) are excluded. However, section 410(b)(4) is applied with reference to the lowest minimum age requirement applicable, and with reference to the lowest service requirement applicable under any plan of the employer that benefits employees of the separate line of business, as if all the plans were a single plan under §1.410(b)–6(b)(2). For purposes of the minimum benefit requirement of paragraph (g)(2) of this section, section 410(b)(4) may be applied with reference to the lowest minimum age requirement, and with reference to the lowest minimum service requirement, applicable under any plan of the employer that benefits highly compensated employees of the separate line of business, as if all the plans were a single plan under §1.410(b)–6(b)(2), or, if no plan of the employer benefits highly compensated employees of the separate line of business, with reference to the greatest age and service requirements permitted under section 410(a)(1)(A). The employees of the separate line of business are determined by applying §1.414(r)–7 to the employees taken into account under this paragraph (g)(6). An employee is treated as a highly compensated employee for purposes of this paragraph (g) if the employee is treated as a highly compensated employee for purposes of applying section 410(b) on any testing day for the testing year. For the definition of ''testing day,'' see §1.414(r)–11(b)(6).

[T.D. 8376, 56 FR 63446, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32919, June 27, 1994]

§1.414(r)–6 Qualified separate line of business—administrative scrutiny requirement—individual determinations.

(a) *In general.* A separate line of business (as determined under §1.414(r)–3) that does not satisfy any of the safe harbors in §1.414(r)–5 for a testing year nonetheless satisfies the administrative scrutiny requirement of §1.414(r)–1(b)(2)(iv)(D) if the employer requests and receives from the Commissioner an individual determination under this section that the separate line of business satisfies the requirement of administrative scrutiny for the testing year. This section implements the individual determinations provided for under section 414(r)(2)(C). The Commissioner shall issue such an individual determination only when it is consistent with the purpose of section 414(r), taking into account the nondiscrimination requirements of sections 401(a)(4) and 410(b). Paragraph (b) of this section authorizes the Commissioner to establish procedures for requesting and granting individual determinations.

(b) *Authority to establish procedures.* The Commissioner may, in revenue rulings and procedures, notices, and other guidance, published in the Internal Revenue Bulletin (see

§ 601.601(d)(2)(ii)(b) of this chapter), provide any additional guidance that may be necessary or appropriate for requesting and granting individual determinations under this section. For example, such guidance may specify the circumstances in which an employer may request an individual determination and factors to be taken into account in deciding whether to grant a favorable individual determination. In addition, such guidance may describe situations that automatically fail the administrative scrutiny requirement.

[T.D. 8376, 56 FR 63452, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32920, June 27, 1994]

§ 1.414(r)–7 Determination of the employees of an employer's qualified separate lines of business.

(a) *Introduction*—(1) *In general.* This section provides the rules for determining the employees of each qualified separate line of business operated by an employer. Paragraph (a)(2) of this section lists the specific provisions of the regulations for which these rules apply. Paragraph (b) of this section provides the procedure for assigning the employees of the employer among the qualified separate lines of business of the employer and for determining the day or days on which such assignments must be made. Under this procedure, each employee (i.e., a substantial-service employee or a residual shared employee as defined in § 1.414(r)–11(b)(2) and (4)) is assigned to a single qualified separate line of business in a consistent manner for all purposes listed in paragraph (a)(2) of this section with respect to the testing year and plan years beginning within the testing year. Paragraph (c) of this section provides methods for allocating residual shared employees among qualified separate lines of business.

(2) *Purposes for which this section applies.* This section applies solely for purposes of determining whether—

(i) A separate line of business satisfies the statutory safe harbor of § 1.414(r)–5(b) for a testing year (see § 1.414(r)–5(b)(3) for the employees taken into account for this purpose);

(ii) A separate line of business satisfies the merger and acquisition safe harbor of § 1.414(r)–5(d) for a testing year (see § 1.414(r)–5(d)(2) for the employees taken into account for this purpose);

(iii) A separate line of business satisfies the average benefits safe harbor of § 414(r)–5(f) for a testing year (see § 414(r)–5(f)(4) for the employees taken into account for this purpose);

(iv) A separate line of business satisfies the minimum or maximum benefits safe harbor of § 414(r)–5(g) for a testing year (see § 1.414(r)–5(g)(6) for the employees taken into account for this purpose);

(v) A plan of the employer satisfies sections 410(b) and 401(a)(4) for a plan year (see § 414(r)–8(d)(3) for the employees taken into account for this purpose); or

(vi) A plan of the employer satisfies section 401(a)(26) for a plan year (see § 414(r)–9(c)(3) for the employees taken into account for this purpose).

(b) *Assignment procedure*—(1) *In general.* To apply the provisions listed in paragraph (a)(2) of this section with respect to a testing year or plan year, as the case may be, each of the employees taken into account under that provision must be assigned to a qualified separate line of business of the employer on one or more testing days (or section 401(a)(26) testing days) during the year. The first day for which this assignment procedure is required for a testing year is the first testing day. See § 414(r)–11(b)(6), (7) and (8) (definitions of ''testing day'', ''first testing day'' and ''section 401(a)(26) testing day''). Section § 414(r)–8 may require that the assignment procedure be repeated for testing days that fall after the first testing day (including testing days that fall after the close of the testing year in a plan year that begins in the testing year). Accordingly, new employees may be taken into account for the first time on these later testing days who were not taken into account on the first testing day. Section § 414(r)–9 may have the same effect with respect to section 401(a)(26) testing days that fall after the first testing day.

(2) *Assignment for the first testing day.* The employees taken into account under a provision described in paragraph (a)(2) of this section with respect to the first testing day for a testing

year are assigned among the employer's qualified separate lines of business by applying the following procedure to each of those employees—

(i) An employee who is a substantial-service employee with respect to a qualified separate line of business within the meaning of §414(r)–11(b)(2) must be assigned to that qualified separate line of business;

(ii) An employee who is a residual shared employee within the meaning of §414(r)–11(b)(4) must be assigned to a qualified separate line of business under paragraph (c) of this section.

Each employee assigned to a qualified separate line of business under paragraph (b)(2)(i) of this section or this paragraph (b)(2)(ii) remains assigned to the same qualified separate line of business for all purposes with respect to the testing year listed in paragraph (a)(2) of this section and for all plan years beginning in that testing year. Once an employee is assigned to a qualified separate line of business with respect to a particular testing day or section 401(a)(26) testing day, that employee remains assigned to that qualified separate line of business after the employee terminates employment. However, after the employee terminates employment, that employee will in most cases not be taken into account with respect to a subsequent testing day or section 401(a)(26) testing day for purposes of applying one or more of the provisions in paragraph (a)(2) of this section.

(3) *Assignment of new employees for subsequent testing days.* After the first testing day for the testing year, the employees taken into account under a provision described in paragraph (a)(2) of this section with respect to a subsequent testing day (or a section 401(a)(26) testing day) for the testing year may include one or more employees who previously have not been assigned to a qualified separate line of business for any purpose listed in paragraph (a)(2) of this section with respect to the testing year. An employee may not previously have been assigned to a qualified separate line of business for any purpose with respect to the testing year if, for example, the employee has just been hired or has just become a nonexcludable employee. Previously unassigned employees are assigned among the employer's qualified separate lines of business by applying the procedure in paragraph (b)(2) of this section to those employees. In determining whether an employee who is not employed by the employer during the testing year is a substantial-service or a residual shared employee with respect to a qualified separate line of business, §414(r)–3(c)(5) is applied with reference to services performed by the employee during a period in the immediately succeeding testing year that are reasonably representative of the employee's services for the employer.

(4) *Special rule for employers using annual option under section 410(b).* Notwithstanding the fact that paragraphs (b)(1) through (b)(3) of this section generally only require employees to be assigned on testing days beginning with the first testing day, if a plan is tested under section 410(b) using the annual option of §410(b)–8(a)(4) (including for purposes of the average benefit percentage test), employees must be assigned on every day of the plan year of that plan for purposes of this paragraph (b). Thus, all employees who provide services at any time during the plan year of a plan that is tested using the annual option of §1.410(b)–8(a)(4) must be assigned to a line of business even if they terminate employment before the first testing day within the meaning of §414(r)–11(b)(7) of the testing year in which the plan year begins.

(c) *Assignment and allocation of residual shared employees*—(1)*In general.* All residual shared employees must be allocated among an employer's qualified separate lines of business under one of the allocation methods provided in paragraphs (c)(2) through (5) of this section. An employer is permitted to select which method of allocation to apply for the testing year to residual shared employees. However, the same allocation method must be used for all of the employer's residual shared employees and for all purposes listed in paragraph (a)(2) of this section with respect to the testing year.

(2) *Dominant line of business method of allocation*—(i) *In general.* Under the method of allocation in this paragraph (c)(2), all residual shared employees are allocated to the employer's dominant

line of business. This method does not apply unless the employer has a dominant line of business within the meaning of paragraph (c)(2)(ii) or (c)(2)(iv) of this section. If an employer has more than one dominant line of business under this paragraph (c), the employer must select which qualified separate lines of business is its dominant line of business.

(ii) *Dominant line of business.* An employer's dominant line of business is that qualified separate line of business that has an employee assignment percentage of at least 50 percent.

(iii) *Employee assignment percentage*—(A) *Determination of percentage.* The employee assignment percentage of a qualified separate line of business is the fraction (expressed as a percentage)—

(*1*) The numerator of which is the number of substantial-service employees with respect to the qualified separate line of business who are assigned to that line of business under paragraph (b) of this section; and

(*2*) The denominator of which is the total number of substantial-service employees who are assigned to all qualified separate lines of business of the employer under paragraph (b) of this section.

(B) *Employees taken into account.* The employee assignment percentage is calculated solely with respect to employees who are taken into account for purposes of satisfying section 410(b) with respect to the first testing day. Therefore, this percentage is calculated only once for all purposes with respect to a testing year. The employees described in section 410(b)(3) and (4) are excluded. However, section 410(b)(4) is applied with reference to the lowest minimum age requirement applicable under any plan of the employer, and with reference to the lowest service requirement applicable under any plan of the employer, as if all the plans were a single plan under § 1.410(b)–6(b)(2).

(iv) *Option to apply reduced percentage.* An employer is permitted to determine whether it has a dominant line of business by substituting 25 percent for 50 percent in paragraph (c)(2)(ii) of this section. This option is available for a testing year only if the qualified separate line of business satisfies one of the following requirements:

(A) The qualified separate line of business accounts for at least 60 percent of the employer's gross revenues for the employer's latest fiscal year ending in the testing year.

(B) The employee assignment percentage of the qualified separate line of business would be at least 60 percent if collectively bargained employees were taken into account.

(C) Each qualified separate line of business of the employer satisfies the statutory safe harbor of § 1.414(r)–5(b), the average benefits safe harbor of § 1.414(r)–5(f), or the minimum or maximum benefits safe harbor of § 1.414(r)–5(g). Whether a qualified separate line of business satisfies one of these safe harbors is determined after the application of this section, including the assignment of all residual shared employees under this paragraph (c)(2).

(D) The employee assignment percentage of the qualified separate line of business is at least twice the employee assignment percentages of each of the employer's other qualified separate lines of business.

(v) *Examples.* The following examples illustrate the application of the method of allocation in this paragraph (c)(2).

Example 1. (i) Employer A operates four qualified separate lines of business as determined under § 1.414(r)–1(b) for the testing year, consisting of a software developer, a health food products supplier, a real estate developer, and a ski equipment manufacturer. In applying this section for the first testing day with respect to the testing year, Employer A determines that it has a total of 21,000 employees, of whom 10,000 are substantial-service employees not excludable under section 410(b)(3) or (b)(4). Pursuant to paragraph (b) of this section, these 10,000 employees are assigned among Employer A's qualified separate lines of business as follows:

	Software developer	Health food	Real estate	Ski equipment
Substantial-Service Employees	2,500	1,000	2,500	4,000
Percentage Assigned to QSLOB	25%	10%	25%	40%

(ii) Under these facts, Employer A is not permitted to apply the method of allocation in paragraph (c)(2)(ii) of this section, because none of its qualified separate lines of business satisfies the 50 percent requirement in paragraph (c)(3)(ii) of this section.

Example 2. The facts are the same as in *Example 1,* except that, after allocating all residual shared employees to the ski equipment line of business, the software, ski equipment and health food supplier lines of business each would satisfy the statutory safe harbor of §1.414(r)–5(b), and that the real estate development line of business would satisfy the minimum or maximum benefits safe harbor of §1.414(r)–5(g). Under these facts, Employer A is permitted to apply the method of allocation in this paragraph (c)(2) to allocate all its residual shared employees to the ski equipment line of business, because the employee assignment percentage of the ski equipment line of business exceeds 25 percent and each qualified separate line of business satisfies either the statutory safe harbor of §1.414(r)–5(b) or the minimum or maximum benefits safe harbor of §1.414(r)–5(g).

Example 3. (i) The facts are the same as in *Example 1,* except that, Employer A chooses not to satisfy the minimum or maximum benefits safe harbor of §1.414(r)–5(g). Instead, Employer A combines the real estate developer and ski equipment manufacturer into a single line of business. As a result, Employer A has three qualified separate lines of business as determined under §1.414(r)–1(b). Assume that no residual shared employee becomes a substantial-service employee as a result of the new combination. Employer A's substantial-service employees are assigned among Employer A's qualified separate lines of business as follows:

	Software developer	Health food	Real estate/ ski equipment
Substantial-Service Employees	2,500	1,000	6,500
Percentage Assigned to QSLOB	25%	10%	65%

(ii) Under these facts, Employer A is permitted to apply the method of allocation in this paragraph (c)(2) to allocate all its residual shared employees to the combined real estate development and ski equipment manufacturing line of business, because more than 50 percent of Employer A's substantial-service employees that are taken into account for the first testing day are assigned to that qualified separate line of business.

Example 4. (i) The facts are the same as in *Example 1,* except that, of the remaining 11,000 employees of Employer A, 10,000 employees are substantial-service employees who are collectively bargained employees. Pursuant to paragraph (b) of this section, the 10,000 substantial-service employees and the 10,000 substantial-service employees who are collectively bargained employees are assigned among Employer A's qualified separate lines of business as follows:

	Software developer	Health food	Real estate	Ski equipment
Substantial-Service Employees	2,500	1,000	2,500	4,000
Percentage of total substantial-service employees assigned to QSLOB	25%	10%	25%	40%
Substantial-Service Employees (including collectively bargained employees)	2,500	1,000	2,500	14,000
Percentage of total employees (including collectively bargained employees) assigned to QSLOB	12.5%	5%	12.5%	70%

(ii) Thus, the ski equipment line of business satisfies the 25-percent threshold in paragraph (c)(2)(iv) of this section. In addition, the ski equipment's percentage of substantial-service employees is at least 60 percent when taking into account substantial-service employees who are collectively bargained employees and therefore satisfies the requirement under paragraph (c)(2)(iv)(B) of this section. Under these facts, Employer A is permitted to apply the method of allocation in this paragraph (c)(2) to allocate all its residual shared employees to the ski equipment line of business.

(3) *Pro-rata method of allocation*—(i) *In general.* Under the method of allocation in this paragraph (c)(3), all residual shared employees are allocated among an employer's qualified separate lines of business in proportion to the employee assignment percentage of each qualified separate line of business, as determined under paragraph (c)(2)(iii) of this section.

(ii) *Allocation procedure.* The procedure for allocating residual shared employees under the method in this paragraph (c)(3) is as follows—

(A) The number of highly compensated residual shared employees who are allocated to each qualified separate line of business is equal to the product determined by multiplying the total number of highly compensated residual shared employees of the employer by the employee assignment percentage determined with respect to the qualified separate line of business under paragraph (c)(3)(i) of this section;

(B) The number of nonhighly compensated residual shared employees who are allocated to each qualified separate line of business is equal to the product determined by multiplying the total number of nonhighly compensated residual shared employees of the employer by the employee assignment percentage determined with respect to the qualified separate line of business under paragraph (c)(3)(i) of this section;

(C) For purposes of this procedure, the employer is permitted to determine which highly compensated residual shares employees and which nonhighly compensated residual shared employees are allocated to each qualified separate line of business, provided that the required number of highly and nonhighly compensated residual shared employees are allocated to each qualified separate line of business.

(iii) *Examples.* The following example illustrates the application of the method of allocation in this paragraph (c)(4).

Example 1. The facts that are the same as in *Example 1* under paragraph (c)(2)(v) of this section except that there are no additional residual shared employees after the first testing day. Of Employer A's 1,000 residual shared employees, 800 are highly compensated employees and 200 are nonhighly compensated employees. Employer A applies the pro-rata method of allocation in this paragraph (c)(3). Under these facts, the 1,000 residual shared employees are allocated among Employer A's qualified separate lines of business as follows:

	Software developer	Health food	Real estate	Ski equipment
Substantial-Service Employees	2,500	1,000	2,500	4,000
Percentage Assigned to QSLOB (“employee assignment percentage”)	25%	10%	25%	40%
Residual Shared HCEs	200	80	200	320
Allocated to QSLOB	(25%X800)	(10%X800)	(25%X800)	(40%X200)
Residual Shared NHCEs	50	20	50	80
Allocated to QSLOB	(25%X200)	(10%X200)	(25%X200)	(40%X200)

(4) *HCE percentage ratio method of allocation*—(i) *In general.* Under the method of allocation in this paragraph (c)(4), all residual shared employees are allocated among an employer's qualified separate lines of business according to the highly compensated employee percentage assignment ratio of each qualified separate line of business.

(ii) *Highly compensated employee percentage assignment ratio.* For purposes of this paragraph (c)(4), the highly compensated employee percentage assignment ratio of a qualified separate line of business is the fraction expressed as a percentage)—

(A) The numerator of which is the percentage of all employees who have previously been assigned to the qualified separate line of business under this section with respect to the testing year who are highly compensated employees; and

(B) The denominator of which is the percentage of all employees who have previously been assigned to any qualified separate line of business under this section with respect to the testing year who are highly compensated employees.

Thus, the highly compensated employee percentage assignment ratio of each of the employer's qualified separate lines of business is recalculated each time a residual shared employee is allocated to a qualified separate line of business under this paragraph (c)(5).

(iii) *Allocation procedure.* The procedure for allocating all residual shared employees under the method in this paragraph (c)(4) is as follows—

(A) If there are any qualified separate lines of business with a highly compensated employee percentage assignment ratio of less than 50 percent (as determined immediately before the employee is allocated to a qualified separate line of business), the highly compensated residual shared employee must be allocated to one of these qualified separate lines of business;

(B) If there are any qualified separate lines of business with a highly compensated employee percentage assignment ratio of greater than 200 percent (as determined immediately before the employee is allocated to a qualified separate line of business), the nonhighly compensated residual shared employee must be allocated to one of these qualified separate lines of business;

(C) If there are no qualified separate lines of business with a highly compensated employee percentage assignment ratio less than 50 percent, a highly compensated residual shared employee may be allocated to any qualified separate line of business with a highly compensated employee percentage assignment ratio of no more than 200 percent, provided that the employee's allocation to the qualified separate line of business does not cause its highly compensated employee percentage assignment ratio to exceed 200 percent (as determined immediately after the employee is allocated to the qualified separate line of business);

(D) If there are no qualified separate lines of business with a highly compensated employee percentage assignment ratio greater than 200 percent, a nonhighly compensated residual shared employee may be allocated to any qualified separate line of business with a highly compensated employee percentage assignment ratio of no less than 50 percent, provided that the employee's allocation to the qualified separate line of business does not cause its highly compensated employee percentage assignment ratio to fall below 50 percent (as determined immediately after the employee is allocated to the qualified separate line of business);

(E) For purposes of this procedure, the employer is permitted to determine which highly compensated residual shared employees and which nonhighly compensated residual shared employees are allocated to each qualified separate line of business, provided that the requirements of this paragraph (c)(4)(iii) are satisfied.

(5) *Small group method*—(i) *In general.* Under the method of allocation provided for in this paragraph (c)(5), each residual shared employee is allocated to a qualified separate line of business chosen by the employer. This method does not apply unless all of the requirements of paragraphs (c)(5)(ii), (iii), and (iv) of this section are satisfied.

(ii) *Size of group.* The total number of the employer's residual shared employees allocated under this paragraph (c) must not exceed three percent of all of the employer's employees. For this purpose, the employer's employees include only those employees taken into account under paragraph (c)(2)(iii)(B) of this section.

(iii) *Composition of qualified separate line of business.* The qualified separate line of business to which the residual shared employee is allocated must have an employee assignment percentage under paragraph (c)(2)(iii) of this section of at least ten percent. In addition, the qualified separate line of business to which the residual shared employee is allocated must satisfy the statutory safe harbor under §1.414(r)–5(b) after the employee is so allocated.

(iv) *Reasonable allocation.* The allocation of residual shared employees under the small group method provided for in this paragraph (c)(5) must be reasonable. Reasonable allocations generally include allocations that are based on the level of services that the residual shared employees provide to the employer's qualified separate lines of business, the similar treatment of similarly situated residual shared employees, and other bona fide business criteria; in contrast, an allocation that is designed to maximize benefits for select employees is not considered a reasonable allocation. For example, allocation of all residual shared employees who work in the same department, or at the same location, to the same qualified separate line of business would be an indication of reasonableness. However, allocation of a group of similarly situated residual shared employees to a qualified separate line of business for which they provide minimal services might not be considered reasonable. In addition, the allocation of the professional employees of a department to one qualified separate line of business and the allocation of the support staff of the same department to a different qualified separate line of business would not be reasonable.

[T.D. 8376, 56 FR 63453, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32920, June 27, 1994]

§ 1.414(r)–8 Separate application of section 410(b).

(a) *General rule.* If an employer is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with § 1.414(r)–1(b) for a testing year, the requirements of section 410(b) must be applied in accordance with this section separately with respect to the employees of each qualified separate line of business for purposes of testing all plans of the employer for plan years that begin in the testing year (other than a plan tested under the special rule for employer-wide plans in § 1.414(r)–(c)(2)(ii) for such a plan year). Conversely, if an employer is not treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with § 1.414(r)–1(b) for a testing year, the requirements of section 410(b) must be applied on an employer-wide basis for purposes of testing all plans of the employer for plan years that begin in the testing year. See § 1.414(r)–1(c)(2) and (d)(6). Paragraph (b) of this section explains how the requirements of section 410(b) are applied separately with respect to the employees of a qualified separate line of business for purposes of testing a plan. Paragraph (c) of this section explains the coordination between sections 410(b) and 401(a)(4). Paragraph (d) of this section provides certain supplementary rules necessary for the application of this section.

(b) *Rules of separate application*—(1) *In general.* If the requirements of section 410(b) are applied separately with respect to the employees of each qualified separate line of business operated by the employer for a testing year, a plan (other than a plan that is tested under the special rule for employer-wide plans in § 1.414(r)–1(c)(2)(ii) for a plan year) satisfies the requirements of section 410(b) only if—

(i) The plan satisfies section 410(b)(5)(B) of an employer-wide basis; and

(ii) The plan satisfies section 410(b) on a qualified-separate-line-of-business basis.

(2) *Satisfaction of section 410(b)(5)(B) on an employer-wide basis*—(i) *General rule.* Section 410(b)(5)(B) provides that a plan is not permitted to be tested separately with respect to the employees of a qualified separate line of business unless the plan benefits a classification of employees found by the Secretary to be nondiscriminatory. A plan satisfies this requirement only if the plan satisfies either the ratio percentage test of § 1.410(b)–2(b)(2) or the nondiscriminatory classification test of § 1.410(b)–4 (without regard to the average benefit percentage test of § 1.410(b)–5), taking into account the other applicable provisions of §§ 1.410(b)–1 through 1.410(b)–10. For this purpose, the nonexcludable employees of the employer taken into account in testing the plan under section 410(b) are determined under § 1.410(b)–6, without regard to the exclusion in § 1.410(b)–6(e) for employees of other qualified separate lines of business of the employer. Thus, in testing a plan separately with respect to the employees of one qualified separate line of business under this paragraph (b)(2), the otherwise nonexcludable employees of the employer's other qualified separate lines of business are not treated as excludable employees. However, under the definition of ‘‘plan’’ in paragraph (d)(2) of this section, these employees are not treated as benefiting under the plan for purposes of applying this paragraph (b)(2).

(ii) *Application of facts and circumstances requirements under nondiscriminatory classification test.* The fact that an employer has satisfied the qualified-separate-line-of-business requirements in §§ 1.414(r)–1 through 1.414(r)–7 is taken into account in determining whether a classification of employees benefiting under a plan that falls between the safe and unsafe harbors satisfies § 1.410(b)–4(c)(3) (facts and circumstances requirements). Except in unusual circumstances, this fact will be determinative.

(iii) *Modification of unsafe harbor percentage for plans satisfying ratio percentage test at 90 percent level*—(A) *General rule.* If a plan benefits a group of employees for a plan year that would satisfy the ratio percentage test of §1.410(b)–2(b)(2) on a qualified-separate-line-of-business basis under paragraph (b)(3) of this section if the percentage in §1.410(b)–2(b)(2) were increased to 90 percent, the unsafe harbor percentage in §1.410(b)–4(c)(4)(ii) for the plan is reduced by five percentage points (not five percent) for the plan year and is applied without regard to the requirement that the unsafe harbor percentage not be less than 20 percent. Thus, if the requirements of this paragraph (b)(2)(iii)(A) are satisfied, the unsafe harbor percentage in §1.410(b)–4(c)(4)(ii) is treated as 35 percent, reduced by ¾ of a percentage point for each whole percentage point by which the nonhighly compensated employee concentration percentage exceeds 60 percent.

(B) *Facts and circumstances alternative.* If a plan satisfies the requirements of paragraph (b)(2)(iii)(A) of this section, but has a ratio percentage on an employer-wide basis that falls below the unsafe harbor percentage determined under paragraph (b)(2)(iii)(A) of this section, the plan nonetheless is deemed to satisfy section 410(b)(5)(B) on an employer-wide basis if the Commissioner determines that, on the basis of all of the relevant facts and circumstances, the plan benefits such employees as qualify under a classification of employees that does not discriminate in favor of highly compensated employees.

(3) *Satisfaction of section 410(b) on a qualified-separate-line-of-business basis.* A plan satisfies section 410(b) on a qualified-separate-line-of-business basis only if the plan satisfies either the ratio percentage test of §1.410(b)–2(b)(2) or the average benefit test of §1.410(b)–2(b)(3) (including the nondiscriminatory classification test of §1.410(b)–4 and the average benefit percentage test of §1.410(b)–5), taking into account the other applicable provisions of §§1.410(b)–1 through 1.410(b)–10. For this purpose, the non-excludable employees of the employer taken into account in testing the plan under section 40(b) are determined under §1.410(b)–6, taking into account the exclusion in §1.410(b)–6(e) for employees of other qualified separate lines of business of the employer. Thus, in testing a plan separately with respect to the employees of one qualified separate line of business under this paragraph (b)(3), all employees of the employer's other qualified separate lines of business are treated as excludable employees.

(4) *Examples.* The following examples illustrate the application of this paragraph (b).

Example 1. (i) Employer A is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with §1.414(r)–1(b) for the 1994 testing year with respect to all of its plans. Employer A operates two qualified separate lines of business as determined under §1.414(r)–1(b)(2), Line 1 and Line 2. Employer A maintains only two plans, Plan X which benefits solely employees of Line 1, and Plan Y which benefits solely employees of Line 2. In testing Plan X under section 410(b) with respect to the first testing day for the plan year of Plan X beginning in the 1994 testing year, it is determined that Employer A has 2,100 nonexcludable employees, of whom 100 are highly compensated employees and 2,000 are nonhighly compensated employees. After applying §1.414(r)–7 to these employees, 50 of the highly compensated employees and 100 of the nonhighly compensated employees are treated as employees of Line 2, and the remaining 50 highly compensated employees and the remaining 1,900 nonhighly compensated employees are treated as employees of Line 1.

(ii) All of the highly compensated employees and 1,300 of the nonhighly compensated employees who are treated as employees of Line 1 benefit under Plan X. Thus, on an employer-wide basis, Plan X benefits 50 percent of all Employer A's highly compensated employees (50 out of 100) and 65 percent of all Employer A's nonhighly compensated employees (1,300 out of 2,000). Plan X consequently has a ratio percentage determined on an employer-wide basis of 130 percent (65%÷50%), see §1.410(b)–9, and could satisfy section 410(b) under the ratio percentage test of §1.410(b)–2(b)(2) if that section were applied on an employer-wide basis without regard to the provisions of this paragraph (b). Under paragraph (a) of this section, however, the requirements of section 410(b) must be applied separately with respect to the employees of each qualified separate line of business operated by Employer A for all plans of Employer A for plan years that begin in the 1994 testing year. This rule does not apply to plans tested under the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii). Plan X benefits only 65 percent of the nonhighly compensated employees of Employer A, however, and therefore cannot satisfy the 70 percent requirement necessary to be tested under that rule. As a result, for the plan year of Plan X beginning in the 1994 testing year, Plan X is not permitted to satisfy section 410(b) on an employer-wide basis and, instead, is only permitted to satisfy section 410(b) separately with respect to the employees of each qualified separate line of business operated by Employer A, in accordance with paragraphs (b)(2) and (b)(3) of this section.

Example 2. The facts are the same as in *Example 1.* All of the 50 highly compensated employees treated as employees of Line 2 benefit under Plan Y, and 80 of the 100 nonhighly compensated employees treated as employees of Line 2 benefit under Plan Y. Thus, Plan Y benefits 50 percent of all Employer A's highly compensated employees (50 out of 100) and only 4 percent of all Employer A's nonhighly compensated employees (80 out of 2,000). Thus, while Plan Y has a ratio percentage of 80 percent (80%÷100%) on a qualified-separate-line-of-business basis, it has a ratio percentage of only 8 percent (4%÷50%) on an employer-wide basis. See §1.410(b)–9. Under §1.410(b)–4(c)(4)(iii), the nonhighly compensated employee concentration percentage is 2,000/2,100 or 95 percent. Because 8 percent is less than 20 percent (the unsafe harbor percentage applicable to Employer A under §1.410(b)–4(c)(4)(ii)), Plan Y does not satisfy the nondiscriminatory classification test of §1.410(b)–4 on an employer-wide basis. Nor does Plan Y satisfy the ratio percentage test of §1.410(b)–2(b)(2) on an employer-wide basis, since 8 percent is less than 70 percent. Under these facts, Plan Y does not satisfy section 410(b)(5)(B) on an employer-wide basis in accordance with paragraph (b)(2) of this section for the plan year of Plan Y beginning in the 1994 testing year, and therefore fails to satisfy section 410(b) for that year. This is true even though Plan Y satisfies section 410(b) on a qualified-separate-line-of-business basis in accordance with paragraph (b)(3) of this section.

Example 3. The facts are the same as in *Example 2,* except that all of the employees treated as employees of Line 2 benefit under Plan Y. Thus, Plan Y benefits 50 percent of all of Employer A's highly compensated employees (50 out of 100) and 5 percent of all of Employer A's nonhighly compensated employees (100 out of 2,000). Plan Y therefore has a ratio percentage of 100 percent (100%÷100%) on a qualified-separate-line-of-business basis and a ratio percentage of 10 percent (5%÷50%) on an employer-wide basis. Because Plan Y has a ratio percentage of at least 90 percent on a qualified-separate-line-of-business basis, a reduced unsafe harbor percentage applies to Plan Y under paragraph (b)(2)(iii)(A) of this section. The reduced unsafe harbor percentage applicable to Plan Y is 8.75 percent because Employer A's nonhighly compensated employee concentration percentage is 95 percent. Plan Y's employer-wide ratio percentage of 10 percent therefore exceeds the unsafe harbor percentage. Plan Y thus satisfies section 410(b)(5)(B) on an employer-wide basis in accordance with paragraph (b)(2) of this section for the plan year of Plan Y beginning in the 1994 testing year. Plan Y also satisfies section 410(b) on a qualified-separate-line-of-business basis in accordance with paragraph (b)(3) of this section.

Example 4. The facts are the same as in *Example 3,* except that Employer A's total nonexcludable nonhighly compensated employees are 2,500 (rather than 2,000), of whom 100 are treated as employees of Line 2 and of whom 90 benefit under Plan Y. Plan Y has a ratio percentage of 90 percent (90%÷100%) on a qualified-separate-line-of-business basis, and Employer A's nonhighly compensated employee concentration percentage is 2,500/2,600 or 96 percent. Thus, the reduced unsafe harbor percentage applicable to Plan Y under paragraph (b)(2)(iii)(A) of this section is 8 percent. Plan Y benefits 50 percent of all of Employer A's highly compensated employees (50 out of 100) and 3.6 percent of all of Employer A's nonhighly compensated employees (90 out of 2,500). Plan Y therefore has a ratio percentage of only 7.2 percent (3.6%÷50%) on an employer-wide basis, which falls below the reduced unsafe harbor percentage of 8 percent. Nonetheless, under paragraph (b)(2)(iii)(B) of this section, Plan Y will be deemed to satisfy section 410(b)(5)(B) on an employer-wide basis if the Commissioner determines that, on the basis of all of the relevant facts and circumstances, the plan benefits such employees as qualify under a classification of employees that does not discriminate in favor of highly compensated employees.

Example 5. (i) The facts are the same as in *Example 1,* except that Plan X benefits only 950 of the employees of Line 1. Assume Plan X satisfies the reasonable classification requirement of §1.410(b)–4(b) on an employer-wide basis. Plan X benefits 50 percent of all Employer A's highly compensated employees (50 out 100) and 47.5 percent of all Employer A's nonhighly compensated employees (950 out of 2,000). Plan X consequently has a ratio percentage determined on an employer-wide basis of 95 percent (47.5%÷50%), see §1.410(b)–9, and thus satisfies section 410(b)(5)(B) on an employer-wide basis.

(ii) Plan X has a ratio percentage determined on a qualified-separate-line-of-business basis of 50 percent (50% ÷ 100%). Because 50 percent is less than 70 percent, Plan X must satisfy the nondiscriminatory classification test of §1.410(b)–4 and the average benefit percentage test of §1.410(b)–5 on a qualified-separate-line-of-business basis in order to satisfy the other requirements of section 410(b). Plan X satisfies the nondiscriminatory classification requirement of §1.410(b)–4(c) on a qualified-separate-line-of-business because its ratio percentage determined on a qualified-separate-line-of-business basis is more than 22.25 percent, the safe harbor percentage applicable to Line 1 under §1.410(b)–4(c)(4)(i). Because Plan X satisfies the reasonable classification requirement of §1.410(b)–4(b) on an employer-wide basis, it is also deemed to satisfy this requirement on a qualified-separate-line-of-business basis. See §1.410(b)–7(c)(5). In determining whether Plan X satisfies the average benefit percentage test of §1.410(b)–5, only Plan X and only employees of Line 1 are taken into account. See §§1.410(b)–6(e) and 1.410(b)–7(e).

Example 6. The facts are the same as in *Example 2,* except that, prior to the 1994 testing year, Employer A merges Plan X and Plan Y so that they form a single plan within the meaning of section 414(*l*). Under the definition of ‘‘plan’’ in paragraph (d)(2) of this section, however, the portion of the newly merged plan that benefits employees of Line 2 (former Plan Y) is still treated as a separate plan from the portion of the newly merged plan that benefits employees of Line 1 (former Plan X). The portion of the newly merged plan that benefits employees of Line 2 (former Plan Y) fails to satisfy section 410(b) for the reasons stated in *Example 2.* Under these facts, because the portion of the newly merged plan that benefits employees of Line 2 fails to satisfy section 410(b), the entire newly merged plan fails to satisfy section 410(b) for the plan year of the newly merged plan that begins in the 1994 testing year. See paragraph (d)(5) of this section.

(c) *Coordination of section 401(a)(4) with section 410(b)*—(1) *General rule.* For purposes of these regulations, the requirements of section 410(b) encompass the requirements of section 401(a)(4) (including, but not limited to, the permitted disparity rules of section 401(*l*), the actual deferral percentage test of section 401(k)(3), and the actual contribution percentage test of section 401(m)(2)). Therefore, if the requirements of section 410(b) are applied separately with respect to the employees of each qualified separate line of business of an employer for purposes of testing one or more plans of the employer for plan years that begin in a testing year, the requirements of section 401(a)(4) must also be applied separately with respect to the employees of the same qualified separate lines of business for purposes of testing the same plans for the same plan years. Furthermore, if section 401(a)(4) requires that a group of employees under the plan satisfy section 410(b) for purposes of satisfying section 401(a)(4), section 410(b) must be applied for this purpose in the same manner provided in paragraph (b) of this section. See, for example, §§1.401(a)(4)–2(c)(1) and 1.401(a)(4)–3(c)(1) (requiring each rate group of employees under a plan to satisfy section 410(b)), §1.401(a)(4)–4(b) (requiring the group of employees to whom each benefit, right, or feature is currently available under a plan to satisfy section 410(b)), and §1.401(a)(4)–9(c)(1) (requiring the group of employees included in each component plan into which a plan is restructured to satisfy section 410(b)). Thus, the group of employees must satisfy section 410(b)(5)(B) on an employer-wide basis in accordance with paragraph (b)(2) of this section and also must satisfy section 410(b) on a qualified-separate-line-of-business basis in accordance with paragraph (b)(3) of this section, in both cases as if the group of employees were the only employees benefiting under the plan.

(2) *Examples.* The following examples illustrate the application of the rule in this paragraph (c).

Example 1. Employer B is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with §1.414(r)–1(b) for the 1993 testing year. Employer B operates two qualified separate lines of business as determined under §1.414(r)–1(b)(2), Line 1 and Line 2. Employer B maintains Plan Z, which benefits employees in both Line 1 and Line 2. Under the definition of ‘‘plan’’ in paragraph (d)(2) of this section, the portion of Plan Z that benefits employees of Line 1 is treated as a separate plan from the portion of Plan Z that benefits employees of Line 2. Under this paragraph (c), this result applies for purposes of both section 410(b) and section 401(a)(4).

Example 2. The facts are the same as in *Example 1,* except that Plan Z benefits solely employees of Line 1. In testing Plan Z under section 401(a)(4) for the plan year of Plan Z beginning in the 1993 testing year, Employer B restructures Plan Z into several component plans (within the meaning of §1.401(a)(4)–9(c)). Under §1.401(a)(4)–9(c)(1), each of these component plans is required to satisfy section 410(b). This paragraph (c) requires that each of the component plans be tested separately with respect to the employees of each qualified separate line of business operated by Employer B. This testing must be done in accordance with paragraph (b) of this section. Consequently, each component plan must satisfy section 410(b)(5)(B) on an employer-wide basis in accordance with paragraph (b)(2) of this section and must also satisfy section 410(b) on a qualified-separate-line-of-business basis in accordance with paragraph (b)(3) of this section.

Example 3. The facts are the same as in *Example 1,* except that Plan Z is a profit-sharing plan, and contributions to Plan Z are made pursuant to cash or deferred arrangement in which all employees of Employer B are eligible to participate. Assume that, as a result, Plan Z satisfies the requirements to be tested under the special rule for employer-wide plans in § 1.414(r)–1(c)(2)(ii). Under these facts, the requirements of sections 410(b), 401(a)(4) and 401(k), including the actual deferral percentage test of section 401(k)(3) and § 1.401(k)–1(b), would generally be required to be applied separately to the portions of Plan Z that benefit the employees of Line 1 and Line 2, respectively. However, if Plan Z is tested under the special rule in § 1.414(r)–1(c)(2)(ii), these requirements must be applied on an employer-wide basis.

(d) *Supplementary rules*—(1) *In general.* This paragraph (d) provides certain supplementary rules necessary for the application of this section.

(2) *Definition of plan.* For purposes of this section, the term *plan* means a plan within the meaning of § 1.410(b)–7(a) and (b), after application of the mandatory disaggregation rules of § 1.410(b)–7(c) (including the mandatory disaggregation rule for portions of a plan that benefit employees of different qualified separate lines of business) and the permissive aggregation rules of § 1.410(b)–7(d). Thus, for purposes of this section, the portion of a plan that benefits employees of one qualified separate line of business is treated as a separate plan from the other portions of the same plan that benefit employees of other qualified separate lines of business of the employer, unless the plan is tested under the special rule for employer-wide plans in § 1.414(r)–1(c)(2)(ii) for the plan year.

(3) *Employees of a qualified separate line of business.* For purposes of applying paragraph (b) of this section with respect to a testing day, the employees of each qualified separate line of business of the employer are determined by applying § 1.414(r)–7 to the employees of the employer otherwise taken into account under section 410(b) for the testing day. For purposes of applying paragraph (c) of this section with respect to a testing day, the employees of each qualified separate line of business of the employer are determined by applying § 1.414(r)–7 to the employees of the employer otherwise taken into account under section 410(a)(4) for the testing day. For the definition of *testing day,* see § 1.414(r)–11(b)(6).

(4) *Consequences of failure.* If a plan fails to satisfy either paragraph (b)(2), (b)(3), or (c)(1) of this section, the plan (and any plan of which it constitutes a portion) fails to satisfy section 401(a). However, this failure alone does not cause the employer to fail to be treated as operating qualified separate lines of business in accordance with § 1.414(r)–1(b), unless the employer is relying on benefits provided under the plan to satisfy the minimum benefit portion of the safe harbor in § 1.414(r)–5(g)(2) with respect to at least one of its qualified separate lines of business.

[T.D. 8376, 56 FR 63457, Dec. 4, 1991, as amended by T.D. 8376, 57 FR 52591, Nov. 4, 1992; T.D. 8548, 59 FR 32921, June 27, 1994]

§ 1.414(r)–9 Separate application of section 401(a)(26).

(a) *General rule.* If an employer is treated as operating qualified separate lines of business for purposes of section 401(a)(26) in accordance with § 1.414(r)–1(b) for a testing year, the requirements of section 401(a)(26) must be applied separately with respect to the employees of each qualified separate line of business for purposes of testing all plans of the employer for plan years that begin in the testing year (other than a plan tested under the special rule for employer-wide plans in § 1.414(r)–1(c)(3)(ii) for such a plan year). Conversely, if an employer is not treated as operating qualified separate lines of business for purposes of section 401(a)(26) in accordance with § 1.414(r)–1(b) for a testing year, the requirements of section 401(a)(26) must be applied on an employer-wide basis for purposes of testing all plans of the employer for plan years that begin in the testing years. See §1414(r)–1(c)(3) and (d)(6). Paragraph (b) of this section explains how the requirements of section 401(a)(26) are applied separately with respect to the employees of a qualified separate line of business for purposes of testing a plan. Paragraph (c) of this section provides certain supplementary rules necessary for the application of this section.

(b) *Requirements applicable to a plan*. If the requirements of section 401(a)(26) are applied separately with respect to the employees of a qualified separate line of business for a testing year, a plan (other than a plan that is tested under the special rule for employer-wide plans in §1.414(r)–1(c)(3)(ii) for a plan year) satisfies section 401(a)(26) only if it satisfies the requirements of §§1.401(a)(26)–1 through 1.401(a)(26)–9 on a qualified-separate-line-of-business basis. For this purpose, the nonexcludable employees of the employer taken into account in testing the plan under section 401(a)(26) are determined under §1.401(a)(26)–6(b), taking into account the exclusion in §1.401(a)(26)–6(b)(8) for employees of other qualified separate lines of business of the employer. Thus, in testing a plan separately with respect to the employees of one qualified separate line of business under this paragraph (b), all employees of the employer's other qualified separate lines of business are treated as excludable employees.

(c) *Supplementary rules*—(1) *In general.* This paragraph (c) provides certain supplementary rules necessary for the application of this section.

(2) *Definition of plan*. For purposes of this section, the term *plan* mean a plan within the meaning of §1.401(a)(26)–2(c) and (d), including the mandatory disaggregation rule of §1.401(a)(26)–2(d)(6) for portions of a plan that benefit employees of different qualified separate lines of business. Thus, for purposes of this section, the portion of a plan that benefits employees of one qualified separate line of business is treated as a separate plan from the other portions of the same plan that benefit employees of other qualified separate lines of business of the employer, unless the plan is tested under the special rule for employer-wide plans in §1.414(r)–1(c)(3)(ii) for the plan year.

(3) *Employees of a qualified separate line of business.* For purposes of applying paragraph (b)(2) of this section with respect to a section 401(a)(26) testing day, the employees of each qualified separate line of business of the employer are determined by applying §1.414(r)–7 to the employees of the employer otherwise taken into account under section 401(a)(26) for the section 401(a)(26) testing day. For the definition of *section 401(a)(26) testing day*, see §1.414(r)–11(b)(8).

(4) *Consequences of failure.* If a plan fails to satisfy paragraph (b)(2) of this section, the plan (and any plan of which it constitutes a portion) fails to satisfy section 401(a). However, this failure alone would not cause the employer to fail to be treated as operating qualified separate lines of business in accordance with §1.414(r)–1(b), unless the employer is relying on benefits provided under the plan to satisfy the minimum benefit portion of the safe harbor in §1.414(r)–5(g)(2) with respect to at least one of its qualified separate lines of business.

[T.D. 8376, 56 FR 63459, Dec. 4, 1991]

§1.414(r)–10 Separate application of section 129(d)(8). [Reserved]

§1.414(r)–11 Definitions and special rules.

(a) *In general.* This section contains certain definitions and special rules applicable under these regulations. Paragraph (b) of this section provides certain definitions that apply for purposes of these regulations. Paragraph (c) of this section provides averaging rules under which certain provisions of these regulations may be applied on the basis of a two-year or a three-year average.

(b) *Definitions*—(1) *In general.* In applying the provisions of this section and of §§1.414(r)–1 through 1.414(r)–10, unless otherwise provided, the definitions in this paragraph (b) govern in addition to the definitions in §1.410(b)–9.

(2) *Substantial-service employee.* An employee is a substantial-service employee with respect to a line of business for a testing year if at least 75 percent of the employee's services are provided to that line of business for that testing year within the meaning of § 1.414(r)–3(c)(5). In addition, if an employee provides at least 50% and less than 75% of the employee's services to a line of business for the testing year within the meaning of § 1.414(r)–3(c)(5), the employer may treat that employee as a substantial-service employee with respect to that line of business provided the employee is so treated for all purposes of these regulations. The employer may choose such treatment separately with respect to each employee.

(3) *Top-paid employee.* Generally, an employee is a top-paid employee with respect to a line of business for a testing year if the employee is among the top 10 percent by compensation of those employees who provide services to that line of business for that testing year within the meaning of § 1.414(r)–3(c)(5) and who are not substantial-service employees within the meaning of paragraph (b)(2) of this section with respect to any other line of business. In addition, in determining the group of top-paid employees, the employer may choose to disregard all employees who provide less than 25 percent of their services to the line of business. For purposes of this paragraph (b)(3), an employee's compensation is the compensation used to determine the employee's status as a highly or nonhighly compensated employee under section 414(q) for purposes of applying section 410(b) with respect to the first testing day. For this purpose, only compensation received during the determination year (within the meaning of § 1.414(q)–1T, Q&A–13) is taken into account. See § 1.414(r)–3(c)(7) for examples of the determination of top-paid employee.

(4) *Residual shared employee.* An employee is a residual shared employee for a testing year if the employee is not a substantial-service employee with respect to any line of business for the testing year.

(5) *Testing year.* The term *testing year* means the calendar year.

(6) *Testing day.* The term *testing day* means any day on which § 1.410(b)–8(a)(1) requires any plan (within the meaning of § 1.414(r)–8(d)(2)) of the employer actually to satisfy section 410(b) with respect to plan year that begins in the testing year. Thus, if a plan is required to satisfy section 410(b) on one day within each quarter of the plan year under the quarterly testing option of § 1.410(b)–8(a)(3), each of those four days is a testing day. Similarly, if a plan is required to satisfy section 410(b) on every day of the plan year under the daily testing option of § 1.410(b)–8(a)(2), every day of the plan year is a testing day.

(7) *First testing day.* The term *first testing day* means the testing day that occurs earliest in time of all the testing days under all plans of the employer with respect to the testing year. If a plan is tested under the annual testing option of § 1.410(b)–8(a)(4) (other than for purposes of the average benefit percentage test of § 1.410(b)–5) for a plan year that begins in a testing year, then, solely for purposes of determining the first testing day in a testing year, the employer may treat any day in the plan year as a testing day, provided that the coverage of each plan of the employer on the day selected is reasonably representative of the coverage of the plan over the entire plan year. The first testing day with respect to a testing year must fall within that testing year.

(8) *Section 401(a)(26) testing day.* The term *section 401(a)(26) testing day* means any day on which § 1.401(a)(26)–7(a) or (b) requires any plan of the employer actually to satisfy section 401(a)(26) with respect to a plan year that begins in the testing year. In no event may a section 401(a)(26) testing day with respect to a testing year fall before the first testing day for that testing year. For purposes of this paragraph (b)(8), the term *plan* has the same meaning as in § 1.414(r–9(c)(2).

(c) *Averaging rules*—(1) *In general.* The provisions specified in this paragraph (c) are permitted to be applied based on the average of the percentages for the current testing year and the consecutive testing years (not to exceed four consecutive testing years) immediately preceding the current testing year.

(2) *Specified provisions.* The provisions specified in this paragraph (c) are—

(i) The 90-percent separate employee workforce requirement of §1.414(r)–3(b)(4);

(ii) The 80-percent separate management requirement of §1.414(r)–3(b)(5);

(iii) The 25-percent provision-to-customers requirement of §1.414(r)–3(d)(2)(iii);

(iv) The minimum and maximum highly compensated employee percentage ratios under the statutory safe harbor of §1.414(r)–5(b)(1)(i) and (ii) (50 percent and 200 percent, respectively), but not the 10-percent exception in §1.414(r)–5(b)(4);

(v) The employee assignment percentage applied for purposes of the dominant line of business method of allocating residual shared employees under §1.414(r)–7(c)(2) and the pro-rata method for allocating residual shared employees under §1.414(r)–7(c)(3).

(3) *Averaging of large fluctuations not permitted.* A provision is not permitted to be applied based on an average determined under this paragraph (c) if the percentage for any testing year taken into account in calculating the average falls below a mimimum percentage, or exceeds a maximum percentage, by more than 10 percent (not 10 percentage points) of the respective minimum or maximum percentage. Thus, for example, the statutory safe harbor of §1.414(r)–5(b) is not permitted to be applied based on an average determined under this paragraph (c) if the percentage for any testing year taken into account in calculating the average falls below 45 percent (which is 10 percent below the 50-percent minimum) or exceeds 220 percent (which is 10 percent above the 200-percent maximum).

(4) *Consistency requirements.* A provision is permitted to be applied on an averaging basis under this paragraph (c) regardless of how any other provision is applied, except in the case of the separate employee workforce and separate management requirements of §1.414(r)–3(b)(4) and (5), which each must be applied on the same basis as the other. A provision is also permitted to be applied on an averaging basis under this paragraph (c) for a testing year, regardless of how the provision is applied for any other testing year. However, once a provision is applied on an averaging basis under this paragraph (c) for a testing year, it must be applied on the same basis to all the employer's lines of business to which the provision is applied for the testing year. The percentage for a preceding testing year may be taken into account under this paragraph (c) only if—

(i) The employer calculates the percentage for the preceding testing year in the same manner as the employer calculates the percentage for the current testing year;

(ii) The employer is treated as operating qualified separate lines of business in accordance with §1.414(r)–1(b) for the preceding testing year; and

(iii) The employer designated the same lines of business in the preceding testing year as in the current testing year.

[T.D. 8376, 56 FR 63460, Dec. 4, 1991, as amended by T.D. 8548, 59 FR 32922, June 27, 1994]

§1.414(s)–1 Definition of compensation.

(a) *Introduction*—(1) *In general.* Section 414(s) and this section provide rules for defining compensation for purposes of applying any provision that specifically refers to section 414(s) or this section. For example, section 414(s) is referred to in many of the nondiscrimination provisions applicable to pension, profit-sharing, and stock bonus plans qualified under section 401(a). In accordance with section 414(s)(1), this section defines compensation as compensation within the meaning of section 415(c)(3). It also implements the election provided in section 414(s)(2) to treat certain deferrals as compensation and exercises the authority granted to the Secretary in section 414(s)(3) to prescribe alternative nondiscriminatory definitions of compensation.

(2) *Limitations on scope of section 414(s).* Section 414(s) and this section do not apply unless a provision specifically refers to section 414(s) or this section. For example, even though a definition of compensation permitted under section 414(s) must be used in determining whether the contributions or

benefits under a pension, profit–sharing, or stock bonus plan satisfy a certain applicable provision (such as section 401(a)(4)), except as otherwise specified, the plan is not required to use a definition of compensation that satisfies section 414(s) in calculating the amount of contributions or benefits actually provided under the plan.

(3) *Overview.* Paragraph (b) of this section provides rules of general application that govern a definition of compensation that satisfies section 414(s). Paragraph (c) of this section contains specific definitions of compensation that satisfy section 414(s) without satisfying any additional nondiscrimination requirement under section 414(s). Paragraph (d) of this section provides rules permitting the use of alternative definitions of compensation that satisfy section 414(s) as long as the nondiscrimination requirement and other requirements described in paragraph (d) of this section are satisfied. Paragraph (e) and (f) of this section provide special rules permitting the use of rate of compensation, or prior-employer compensation or imputed compensation, rather than actual compensation, under a definition of compensation that satisfies section 414(s). Paragraph (g) of this section provides other special rules, including a special rule for determining the compensation of a self-employed individual under an alternate definition of compensation. Paragraph (h) of this section provides definitions for certain terms used in this section.

(b) *Rules of general application*—(1) *Use of a definition.* Any definition of compensation that satisfies section 414(s) may be used when a provision explicitly refers to section 414(s) unless the reference or this section specifically indicates otherwise.

(2) *Consistency rule.*—(i) *General rule.* A definition of compensation selected by an employer for use in satisfying an applicable provision must be used consistently to define the compensation of all employees taken into account in satisfying the requirements of the applicable provision for the determination period. For example, although any definition of compensation that satisfies section 414(s) may be used for section 401(a)(4) purposes, the same definition of compensation generally must be used consistently to define the compensation of all employees taken into account in determining whether a plan satisfies section 401(a)(4). Furthermore, a different definition of compensation that satisfies section 414(s) is permitted to be used to determine whether another plan maintained by the same employer separately satisfies the requirements of section 401(a)(4). Although a definition of compensation must be used consistently, an employer may change its definition of compensation for a subsequent determination period with respect to the applicable provision. Rules provided under any applicable provision may modify the consistency requirements of this paragraph (b)(2).

(ii) *Scope of consistency rule.* Compensation will not fail to be defined consistently for a group of employees merely because some employees do not receive one or more of the types of compensation included in the definition. For example, a definition of compensation that includes salary, regular or scheduled pay, overtime, and specified types of bonuses will not fail to define compensation consistently merely because only salaried employees receive salary and these specified types of bonuses and only hourly employees receive regular or scheduled pay and overtime.

(3) *Self-employed individuals.* Notwithstanding paragraph (b)(1) of this section, self-employed individuals' compensation can only be determined under paragraph (c)(2) of this section (with or without the modification permitted by paragraph (c)(4) of this section or a modification permitted by paragraph (c)(5) of this section) or by using an equivalent alternative compensation amount determined in accordance with paragraph (g)(1) of this section. These limitations on self-employed individuals do not affect their common-law employees. Thus, the compensation of common-law employees of a partnership or sole proprietorship may be defined using an alternative definition, provided the definition otherwise satisfies paragraph (c)(3), (d), (e), or (f) of this section. If an alternative definition of compensation under paragraph (c)(3), (d), (e), or

(f) of this section is used for other employees to satisfy an applicable provision, the consistency requirement is only met if paragraph (g) of this section is used for the self-employed individuals.

(c) *Specific definitions of compensation that satisfy section 414(s)*—(1) *General rules.* The definitions of compensation provided in paragraphs (c)(2) and (c)(3) of this section satisfy section 414(s) and need not satisfy any additional requirements under section 414(s). Paragraph (c)(2) of this section describes definitions of compensation within the meaning of section 415(c)(3). Paragraph (c)(3) of this section provides a safe harbor alternative definition that excludes certain additional items of compensation. Paragraph (c)(4) of this section permits any definition provided in paragraph (c)(2) or (c)(3) of this section to include certain types of elective contributions and deferred compensation. Paragraph (c)(5) of this section permits certain modifications to a definition otherwise provided under this paragraph (c).

(2) *Compensation within the meaning of section 415(c)(3).* A definition of compensation that includes all compensation within the meaning of section 415(c)(3) and excludes all other compensation satisfies section 414(s). Sections 1.415–2(d)(2) and (d)(3) provide rules for determining items of compensation included in and excluded from compensation within the meaning of section 415(c)(3). In addition, section 414(s) is satisfied by the safe harbor definitions provided in §1.415–2(d)(10) and (d)(11) and any additional definitions of compensation prescribed by the Commissioner under the authority provided in §1.415–2(d)(13) that are treated as satisfying section 415(c)(3).

(3) *Safe harbor alternative definition.* Under the safe harbor alternative definition in this paragraph (c)(3), compensation is compensation as defined in paragraph (c)(2) of this section, reduced by all of the following items (even if includible in gross income): reimbursements or other expense allowances, fringe benefits (cash and noncash), moving expenses, deferred compensation, and welfare benefits.

(4) *Inclusion of certain deferrals in compensation.* Any definition of compensation provided in paragraph (c)(2) or (c)(3) of this section satisfies section 414(s) even though it is modified to include all of the following types of elective contributions and all of the following types of deferred compensation—

(i) Elective contributions that are made by the employer on behalf of its employees that are not includible in gross income under section 125, section 402(e)(3), section 402(h), and section 403(b);

(ii) Compensation deferred under an eligible deferred compensation plan within the meaning of section 457(b) (deferred compensation plans of state and local governments and tax-exempt organizations); and

(iii) Employee contributions (under governmental plans) described in section 414(h)(2) that are picked up by the employing unit and thus are treated as employer contributions.

(5) *Exclusions applicable solely to highly compensated employees.* Any definition of compensation that satisfies paragraph (c)(2) or (c)(3) of this section, with or without the modification permitted by paragraph (c)(4) of this section, may be modified to exclude any portion of the compensation of some or all of the employer's highly compensated employees (including, for example, any one or more of the types of elective contributions or deferred compensation described in paragraph (c)(4) of this section).

(d) *Alternative definitions of compensation that satisfy section 414(s)*—(1) *General rule.* In addition to the definitions provided in paragraph (c) of this section, any definition of compensation satisfies section 414(s) with respect to employees (other than self-employed individuals treated as employees under section 401(c)(1)) if the definition of compensation does not by design favor highly compensated employees, is reasonable within the meaning of paragraph (d)(2) of this section, and satisfies the nondiscrimination requirement in paragraph (d)(3) of this section.

(2) *Reasonable definition of compensation*—(i) *General rule.* An alternative definition of compensation under this paragraph (d) is reasonable under section 414(s) if it is a definition of compensation provided in paragraph (c) of

this section, modified to exclude all or any portion of one or more of the types of compensation described in paragraph (d)(2)(ii) of this section. See paragraph (e) of this section, however, for special rules that permit definitions of compensation based on employees' rates of compensation and paragraph (f) of this section for special rules that permit definitions of compensation that include prior-employer compensation or imputed compensation.

(ii) *Items that may be excluded.* A reasonable definition of compensation is permitted to exclude, on a consistent basis, all or any portion of irregular or additional compensation, including (but not limited to) one or more of the following: Any type of additional compensation for employees working outside their regularly scheduled tour of duty (such as overtime pay, premiums for shift differential, and call-in premiums), bonuses, or any one or more of the types of compensation excluded under the safe harbor alternative definition in paragraph (c)(3) of this section. Whether a type of compensation is irregular or additional is determined based on all the relevant facts and circumstances. A reasonable definition is also permitted to include, on a consistent basis, all or any portion of the types of elective contributions or deferred compensation described in paragraph (c)(4) of this section and, thus, need not include all those types of elective contributions or deferred compensation as otherwise required under paragraph (c)(4) of this section.

(iii) *Limits on the amount excluded from compensation.* A definition of compensation is not reasonable if it provides that each employee's compensation is a specified portion of the employee's compensation measured for the otherwise applicable determination period under another definition. For example, a definition of compensation that specifically limits each employee's compensation for a determination period to 95 percent of the employee's compensation using a definition provided in paragraph (c) of this section is not reasonable. Similarly, a definition of compensation that limits each employee's compensation used to satisfy an applicable provision with a 12-month determination period to compensation under a definition provided in paragraph (c) of this section for one month is not a reasonable definition of compensation. However, a definition of compensation is not unreasonable merely because it excludes all compensation in excess of a specified dollar amount.

(3) *Nondiscrimination requirement*—(i) *In general.* An alternative definition of compensation under this paragraph (d) is nondiscriminatory under section 414(s) for a determination period if the average percentage of total compensation included under the alternative definition of compensation for an employer's highly compensated employees, as a group for the determination period does not exceed by more than a de minimis amount the average percentage of total compensation included under the alternative definition for the employer's nonhighly compensated employees as a group.

(ii) *Total compensation*—(A) *General rule.* For purposes of this paragraph (d)(3), total compensation must be determined using a definition of compensation provided in paragraph (c)(2) of this section, either with or without the modification permitted by paragraph (c)(4) of this section. Thus, total compensation does not include prior-employer compensation or imputed compensation described in paragraph (f)(1) of this section (including imputed compensation for a period during which an employee performs services for another employer). Total compensation taken into account for each employee (including, if added, the elective contributions and deferred compensation described in paragraph (c)(4) of this section) may not exceed the annual compensation limit of section 401(a)(17).

(B) *Alternative definitions with exclusions applicable solely to highly compensated employees.* If an alternative definition of compensation contains a provision that excludes amounts from compensation and, as described in paragraph (c)(5) of this section, the provision only applies in defining the compensation of some highly compensated employees, then, for purposes of this paragraph (d)(3), the total compensation of any highly compensated employee subject to the provision must be reduced by any amount excluded from the employee's compensation as a result of the provision. However, if the provision applies consistently in defining the compensation of all highly compensated employees, this adjustment to total compensation is not required.

(iii) *Employees taken into account*—(A) *General rule.* In applying the requirement of this paragraph (d)(3), the employees taken into account are the same employees taken into account in satisfying the requirements of the applicable provision for the determination period. For example, in determining whether a plan satisfies section 401(a)(4), an alternative definition must satisfy this paragraph (d)(3) taking into account all employees who benefit under the plan for the plan year (within the meaning of §1.410(b)–3(a)). If an employer is using the same alternative definition of compensation to determine whether more than one separate plan satisfies section 401(a)(4), the employer is permitted to take into account all the employees who benefit under all of those plans for the plan year in determining whether the alternative definition of compensation being used satisfies this paragraph (d)(3).

(B) *Exclusion of self-employed individuals.* In applying the requirement of this paragraph (d)(3), self-employed individuals are disregarded.

(C) *Certain employees disregarded.* If an employee's total compensation for the determination period, determined under paragraph (d)(3)(ii) and (d)(3)(vi)(B) of this section, is zero, the employee is disregarded in determining whether the nondiscrimination requirement of paragraph (d)(3) of this section is satisfied for that determination period. For example, an employee who does not receive any actual compensation during a determination period because the employee is on unpaid leave of absence for the entire period, but who is credited with imputed compensation described in paragraph (f)(1) of this section, is disregarded in determining whether the nondiscrimination requirement of this paragraph (d)(3) is satisfied for that determination period.

(iv) *Calculation of average percentages*—(A) *General rule.* To determine the average percentages described in paragraph (d)(3)(i) of this section, an individual compensation percentage must be calculated for each employee in a group, and then the average of the separately calculated compensation percentages for each employee in the group must be determined. The individual compensation percentage for an employee is calculated by dividing the amount of the employee's compensation that is included under the alternative definition by the amount of the employee's total compensation.

(B) *Other reasonable methods.* Notwithstanding paragraph (d)(3)(iv)(A) of this section, any other reasonable method is permitted to be used to determine the average percentages described in paragraph (d)(3)(i) of this section for either or both of the groups (i.e., highly compensated employees and nonhighly compensated employees), provided that the method cannot reasonably be expected to create a significant variance from the average percentage for that group determined using the individual-percentage method provided in paragraph (d)(3)(iv)(A) of this section. The same method is not required to be used for calculating the two average percentages. For example, to determine the average percentage for nonhighly compensated employees as a group, an employer may calculate an aggregate compensation percentage by dividing the aggregate amount of compensation of nonhighly compensated employees that are included under the alternative definition by the aggregate amount of total compensation of nonhighly compensated employees, provided the resulting percentage is not reasonably expected to vary significantly from the average percentage produced using the individual-percentage method provided in paragraph (d)(3)(iv)(A) of this section because of the extra weight given employees with higher compensation.

(v) *Facts and circumstances determination.* The determination of whether the average percentage of total compensation included for the employer's highly compensated employees as a group for a determination period exceeds by more than a de minimis amount the average percentage of total compensation included for the employer's nonhighly compensated employees as a group is based on all the relevant facts and circumstances. The differences between the percentages for prior determination periods may be considered in determining whether the amount of the difference between the percentages is more than de minimis. In addition, an isolated instance of a more than de minimis difference between the compensation percentages that is due to an extraordinary unforeseeable event (such as overtime payments to employees of a public utility due to a major hurricane) will be disregarded if the amount of the difference in prior determination periods was de minimis.

(vi) *Special rules for definitions of compensation based on rate of compensation or that include prior-employer or imputed compensation*—(A) *Special rule for determining compensation included under an alternative definition.* If an alternative definition uses rate of compensation or includes prior-employer compensation or imputed compensation, the amount of each employee's compensation for a determination period that is treated as included under the alternative definition for purposes of determining the average percentages for the nondiscrimination requirement (i.e. the amount used in the numerator) must not be more than 100 percent of the employee's total compensation for that period, determined under paragraph (d)(3)(ii) and (d)(3)(vi)(B) of this section. This limit on the amount of compensation treated as included under the alternative definition applies even if the amount of compensation actually credited to the employee for the determination period under the definition and, thus, used as compensation within the meaning of section 414(s), exceeds the employee's total compensation for the period.

(B) *Special rule for determining total compensation.* If an alternative definition uses rate of compensation or includes prior-employer compensation or imputed compensation, each employee's total compensation for purposes of determining the average percentages for the nondiscrimination requirement (i.e. the amount used in the denominator) must include all the types of elective contributions and deferred compensation described in paragraph (c)(4) of this section.

(e) *Rate of compensation*—(1) *General rule.* A definition of compensation satisfies section 414(s) as a reasonable definition of compensation even though it defines the amount of each employee's basic or regular compensation using the employee's basic or regular rate of compensation rather than using the employee's actual basic or regular compensation from the employer if the definition satisfies the requirements specified in paragraph (e)(3) of this section and otherwise satisfies the requirements of paragraph (d) of this section, including the nondiscrimination test in paragraph (d)(3) of this section. For this purpose, the employee's rate of compensation must be determined using an hourly pay scale, weekly salary, or similar unit of basic or regular compensation applicable to the employee. A definition will not fail to satisfy the requirements of this paragraph (e) merely because it defines compensation as including each employee's basic or regular compensation, the amount of which is determined using each employee's basic or regular rate of compensation, plus actual amounts of irregular or additional compensation, such as overtime or bonuses. In addition, a definition of compensation will not fail to satisfy section 414(s) merely because it defines compensation for each employee as the greater of the employee's actual compensation, the amount of which is determined using a definition that would otherwise satisfy paragraph (c) or (d)(2) of this section, or the employee's basic or regular compensation, the amount of which is determined using the employee's basic or regular rate of compensation.

(2) *Not applicable to certain contributions.* This paragraph (e) does not apply to a definition of compensation used in determining whether elective deferrals (as defined in section 402(g)(3)), matching contributions (as defined in section 401(m)(4)), or employee contributions subject to section 401(m) satisfy any applicable provision. Thus, for example, a definition of compensation that defines compensation based on each employee's basic or regular rate of compensation may not be used to

measure compensation for purposes of determining if a qualified cash or deferred arrangement satisfies the actual deferral percentage test in section 401(k)(3).

(3) *Requirements for definitions of compensation based on rate of compensation*—(i) *Benefit determination.* The definition of compensation must actually be used to calculate the benefits, contributions, or other amounts, that are subject to the applicable provision. For example, a definition of compensation that defines compensation based on each employee's basic or regular rate of compensation may not be used to determine whether a plan satisfies section 401(a)(4) unless the benefits, contributions, or other amounts for each employee in the plan are determined using that definition of compensation.

(ii) *Period for determining compensation.* The amount of each employee's basic or regular compensation for the determination period must be determined using the employee's basic or regular rate of compensation as of a designated date in the determination period. For example, if the determination period is a calendar year, this requirement would be satisfied if the amount of each employee's basic or regular compensation for the calendar year is determined using the employee's basic or regular rate of compensation as of January 1 of the calendar year. Alternatively, the amount of each employee's basic or regular compensation for a determination period can be the sum of the amounts separately determined for shorter specified periods (e.g., weeks or months) within the determination period provided the amount of each employee's basic or regular compensation for each specified period is determined using the employee's basic or regular rate of compensation as of a designated date within the specified period.

(iii) *Dates for determining rate of compensation.* One or more dates may be used to determine employees' rates of compensation for a determination period or specified period provided that, if the same date is not used for all employees, the dates selected are designed to determine the rates of compensation for that period on a consistent basis for all employees taken into account for the determination period. For example, if annual compensation increases are provided to different groups of employees on different dates during the year, it would be consistent to choose a different date for each group in order to include the annual increase in the employees' rates of compensation for the determination period. In addition, the date or dates selected, by themselves, must not cause the portion of total compensation included to vary significantly among employees.

(iv) *Periods without compensation or with reduced compensation.* An employee's compensation may generally only be determined using the employee's rate of compensation for employment periods during which the employer actually compensates the employee. However, if an employee terminates employment or otherwise stops performing services (such as for a leave of absence, layoff or similar event) either without compensation or with reduced compensation during a determination period, the employer may continue to credit the employee with compensation based on the employee's rate of compensation for a period of up to 31 days after the event, but not beyond the end of the determination period. Paragraph (f) of this section contains special rules for crediting imputed compensation for periods extending beyond 31 days during which an employee is not compensated or an employee's compensation is reduced. See also the definition of *Section 414(s) compensation* in §1.401(a)(4)–12 that, for purposes of satisfying section 401(a)(4), permits adjustments to compensation to reflect the equivalent of full-time compensation to the extent necessary to satisfy the requirements of 29 CFR 2530.204–2(d) (regarding double proration of service and compensation).

(f) *Prior-employer compensation and imputed compensation*—(1) *General rule.* Solely for purposes of determining whether a defined benefit plan, as defined in §1.410(b)–9, satisfies section 401(a)(4) or 410(b), an alternative definition that includes prior-employer compensation or imputed compensation satisfies section 414(s) as a reasonable alternative definition if the definition satisfies the requirements specified in paragraphs (f) (2) and (3) of this section. For this purpose, prior-employer compensation is compensation from an employer other than the employer (determined at the time that the compensation is paid) maintaining the plan that is credited for periods prior to the employee's employment with the employer maintaining the plan and during which the employee performed services for the other employer. For this purpose, imputed compensation is compensation credited for periods after an employee has commenced or recommenced participation in a plan while the employee is not compensated by the employer maintaining the plan or is compensated at a reduced rate by that employer because the employee is not performing services as an employee for the employer (including a period in which the employee performs services for another employer, e.g., a joint venture) or because the employee has a reduced work schedule.

(2) *Requirements for definitions of compensation crediting prior-employer compensation or imputed compensation*—(i) *General requirement.* The definition must otherwise be described in paragraph (c) of this section or must otherwise satisfy the requirements of paragraph (d) or (e) of this section for alternative definitions of compensation, including the nondiscrimination requirement in paragraph (d)(3) of this section.

(ii) *Benefit determination.* A definition of compensation that credits prior-employer compensation or imputed compensation must actually be used to calculate the benefits under the plan. For example, the definition may not be used to determine whether a defined benefit plan satisfies section 401(a)(4) unless the benefits for each employee in the plan are determined using that definition of compensation.

(iii) *Provision applied to all similarly-situated employees.* A provision in a plan's definition of compensation crediting prior-employer compensation or imputed compensation must apply on the same terms to all similarly-situated employees in the plan. The criteria for determining whether employees are similarly situated for this purpose are the same as the criteria for determining whether a plan provision crediting pre-participation or imputed service satisfies the requirements of § 1.401(a)(4)–11(d)(3)(iii)(A).

(iv) *Legitimate business purpose.* There must be a legitimate business purpose, based on all of the relevant facts and circumstances, for crediting prior-employer compensation or imputed compensation to an employee for the period being credited. The standard for determining whether crediting prior-employer compensation or imputed compensation satisfies this requirement is the same as the standard for determining whether crediting pre-participation or imputed service under a plan satisfies the requirements of § 1.401(a)(4)–11(d)(3)(iii)(B) and whether crediting imputed service satisfies the additional requirements of § 1.401(a)(4)–11(d)(3)(iv)(A). However, if the legitimate business reason for crediting imputed compensation relates to the services the employee is performing for another employer and the reason satisfies the standard in § 1.401(a)(4)–11(d)(3)(iii)(B), the additional requirements of § 1.401(a)(4)–11(d)(3)(iv)(A) are deemed to be satisfied. For example, if an employee becomes employed by another employer as a result of a merger, acquisition or similar transaction with the other employer and imputed compensation is credited to the employee while the employee is performing services for the other employer, the crediting of imputed compensation to the employee satisfies the standard in § 1.401(a)(4)–11(d)(3)(iii)(B). Thus, under that example, crediting the imputed compensation to the employee is deemed to satisfy the additional requirements of § 1.401(a)(4)–11(d)(3)(iv)(A), even if the employee is not performing those services under an arrangement that provides an ongoing business benefit to the employer maintaining the plan.

(v) *No significant discrimination.* Based on all of the relevant facts and circumstances, crediting prior-employer compensation or imputed compensation must not by design or in operation discriminate significantly in favor of highly compensated employees. The standard for determining whether crediting prior-employer compensation or imputed compensation satisfies this requirement is the same as the standard for determining whether crediting preparticipation or imputed service satisfies the requirement in § 1.401(a)(4)–11(d)(3)(iii)(C) and whether crediting imputed service satisfies the additional requirement of § 1.401(a)(4)–11(d)(3)(iv)(B).

(3) *Reasonable method*—(i) *General rule.* Any reasonable method may be used to determine the amount of prior-employer compensation or imputed compensation provided that the requirements of paragraph (f)(3) (ii) or (iii) of this section are satisfied, whichever is applicable.

(ii) *Requirements for prior-employer compensation.* Prior-employer compensation credited to an employee for a period that an employee is performing services for another employer must be compensation for the employee from the other employer (or be based on the employee's basic or regular rate of compensation from the other employer) for that period. In addition, prior employer compensation credited to an employee must not exceed the amount of compensation from the other employer that would have been included under the definition of compensation in effect for that period for compensation from the employer maintaining the plan. Reasonable assumptions may be made in determining the amount of compensation received from another employer for a period that would have been included under the definition of compensation in effect for that period for compensation from the employer maintaining the plan.

(iii) *Requirements for imputed compensation*—(A) *General rule.* The amount of imputed compensation credited to an employee during any period, when combined with the amount of any actual compensation being included, must not exceed an amount that, based on all of the relevant facts and circumstances, is reasonably representative of the amount of compensation that the employee would have received and that would have been included under the definition of compensation in effect for the period if the employee had continued to perform services for the employer during that period at the same level as the employee was performing before the employee stopped performing services or changed to a reduced work schedule. The relevant facts and circumstances include the compensation that the employee was receiving immediately before the employee stopped performing services or changed to a reduced work schedule, and, if applicable, the rate of compensation in effect while the employee is not performing services or has a reduced work schedule that is applicable to the employee's specific job grade immediately before the change occurred.

(B) *Imputed compensation from another employer.* Imputed compensation credited for a period that an employee is performing services for another employer is deemed to satisfy paragraph (f)(3)(iii)(A) of this section if the amount of compensation credited satisfies the requirements of paragraph (f)(3)(ii) of this section for prior-employer compensation. Thus, for example, the amount of imputed compensation credited to an employee for a period that the employee is performing services for another employer is deemed to satisfy paragraph (f)(3)(iii)(A) of this section if the amount credited is compensation for the employee from the other employer (or is based on the employee's basic or regular rate of compensation from the other employer) for that period, and the amount credited does not exceed the compensation from the other employer that would be included for the employee under the definition of compensation in effect for that period for compensation from the employer maintaining the plan.

(4) *Special nondiscrimination rule for safe harbor definitions.* If a definition of compensation crediting prior-employer or imputed compensation is otherwise described in paragraph (c) of this section, and the prior-employer compensation or imputed compensation credited satisfies the requirements of paragraphs (f) (1), (2), and (3) of this section, then the definition is deemed to satisfy paragraph (d) of this section (i.e., it is deemed to be nondiscriminatory).

(g) *Special rules*—(1) *Self-employed individuals*—(i) *General rule.* If an alternative definition of compensation under paragraph (c)(3), (d), (e), or (f) of this section is used to satisfy an applicable provision, an equivalent alternative compensation amount must be determined for any self-employed individual who is in the group of employees for whom paragraph (b) of this section requires a single definition of compensation to be used. This equivalent alternative compensation amount is determined by multiplying the self-employed individual's total earned income (as defined in section 401 (c)(2)) for the determination period by the percentage of total compensation (as defined in paragraph (d)(3)(ii) of this section) included under the alternative definition for the employer's nonhighly compensated common-law employees as a group (determined in a manner consistent with the rules in paragraph (d)(3)(iii) of this section and, if applicable, paragraph (d)(3)(vi) of this section). Thus, for purposes of this determination, highly compensated common-law employees must be disregarded. This equivalent alternative compensation amount will be treated as the self-employed individual's compensation under the alternative definition of compensation for the determination period.

(ii) *Inclusion of elective contributions.* If the alternative definition of compensation includes any types of elective contributions described in paragraph (c)(4) of this section, the self-employed individual's earned income for this determination must be increased by the amount of elective contributions made by the employer on behalf of the self-employed individual, and the definition of total compensation for this determination must include all the types of elective contributions described in paragraph (c)(4) of this section made by the employees (other than highly compensated employees.

(iii) *Reductions in equivalent alternative compensation amount applicable only to highly compensated employees.* An alternative definition of compensation may provide that compensation under the alternative definition for some or all self-employed individuals who are highly compensated employees is a specified portion of, rather than equal to, the equivalent compensation amount determined under paragraph (g)(1)(i).

(2) *Leased employees.* [Reserved]

(h) *Definitions.* The following definitions apply for purposes of this section:

(1) *Applicable provision.* Applicable provision means a provision that specifically refers to section 414(s) or this section.

(2) *Determination period.* Determination period means a period during which the amount of compensation is measured for use in determining whether the requirements of an applicable provision are satisfied. If no period is provided under the applicable provision for measuring compensation, the determination period is the period for which the applicable provision must be satisfied. The applicable provision may provide additional rules concerning the determination period to be used for satisfying the nondiscrimination requirement in paragraph (d) of this section.

(3) *Employee.* Employee means employee within the meaning of § 1.410(b)–9.

(4) *Highly compensated employee.* Highly compensated employee means highly compensated employee within the meaning of § 1.410(b)–9.

(5) *Nonhighly compensated employee.* Nonhighly compensated employee means nonhighly compensated employee within the meaning of § 1.410(b)–9.

(6) *Self-employed individual.* Self-employed individual means self-employed individual within the meaning of section 401(c)(1).

(i) *Additional rules.* The Commissioner may in revenue rulings, notices, and other guidance of general applicability provide additional rules for defining compensation within the meaning of section 414(s), including additional definitions of compensation that satisfy section 414(s).

(j) *Effective date and transition rules*—(1) *Statutory effective date.* Section 414(s) applies to years beginning on or after January 1, 1987.

(2) *Regulatory effective date*—(i) *In general.* Except as otherwise provided in paragraph (j)(2)(ii) of this section, § 1.414(s)–1 (a) through (i) apply to years beginning on or after January 1, 1994.

(ii) *Plans of tax-exempt organizations.* In the case of a plan maintained by an organization that is exempt from income taxation pursuant to section 501(a), including plans subject to section 403(b)(12)(A)(i) (nonelective plans),

§1.414(s)–1 (a) through (i) apply to plan years beginning on or after January 1, 1996.

(3) *Compliance during transition period.* For plan years beginning before the effective date of these regulations, as set forth in paragraph (j)(2) of this section, and on or after the statutory effective date as set forth in paragraph (j)(1) of this section, a plan must be operated in accordance with a reasonable, good faith interpretation of section 414(s). Whether a plan is operated in accordance with a reasonable, good faith interpretation of section 414(s) will generally be determined based on all relevant facts and circumstances, including the extent to which an employer has resolved unclear issues in its favor. A plan will be deemed to be operated in accordance with a reasonable, good faith interpretation of section 414(s)(1) and (2) if it is operated in accordance with the terms of §1.414(s)–1 (a) through (i). For years beginning on or after the statutory effective date and before the effective date of these regulations, a definition of compensation is also deemed to satisfy section 414(s) as an alternative method of determining compensation under section 414(s)(3) if the definition satisfies the requirements of §1.414(s)–1 (a) through (i) or if the definition satisfies the prior regulation provisions of §1.414(s)–1T. (See §1.414(s)–1T as contained in the CFR edition revised as of April 1, 1991.) In addition, for those transition years, a definition of compensation is deemed to satisfy section 414(s) as an alternative method of determining compensation under section 414(s)(3) if, based on all the relevant facts and circumstances in effect for the year, use of the definition does not cause discrimination in favor of highly compensated employees.

[T.D. 8361, 56 FR 47662, Sept. 19, 1991; 57 FR 10815, 10953, Mar. 31, 1992, as amended by T.D. 8488, 58 FR 47063, Sept. 7, 1993]

§1.415–1 General rules with respect to limitations on benefits and contributions under qualified plans.

(a) *Trusts.* Under sections 415 and 401(a)(16), a trust which forms part of a pension, profit-sharing or stock bonus plan will not be qualified under section 401(a) if any one of the following conditions exists:

(1) The annual benefits under a defined benefit plan with respect to any participant for any limitation year exceed the limitations of section 415(b) and §1.415–3.

(2) The contributions and other additions credited under a defined contribution plan with respect to any participant for any limitation year exceed the limitations of section 415(c) and §1.415–6.

(3) Where an individual has at any time participated in a defined benefit plan and also has at any time participated in a defined contribution plan maintained by the same employer, the trust has been disqualifed under section 415(g) and §1.415–9.

(b) *Certain annuities and accounts*—(1) *In general.* Except as provided in paragraph (c) of this section, an annuity, account, etc., listed in section 415(a)(2) will not be considered to be described in the otherwise applicable section unless—

(i) It satisfies the requirements of §1.415–3 (relating to limitations on benefits), §1.415–6 (relating to limitations on contributions and other additions) or §1.415–7 (relating to limitations where an individual has at any time participated in a defined contribution plan and also has at any time participated in a defined benefit plan maintained by the same employer), whichever is applicable, and

(ii) It has not been disqualifed under §1.415–9 (relating to disqualification of plans and trusts).

(2) *Special rule for section 403(b) annuity contracts.* (i) With respect to an annuity contract described in section 403(b), the provisions of subparagraph (1) of this paragraph apply only to that portion of the contract which exceeds the limitations of §1.415–3, §1.415–6 and §1.415–7, whichever is applicable.

(ii) In addition, where the amount of the contribution under the section 403(b) annuity contract exceeds the applicable limitation, the exclusion allowance described in section 403(b)(2)(A) is reduced in the manner described in §1.415–6(e)(1)(ii).

(3) *Cross references to additional rules for section 403(b) annuity contracts.* For

additional rules relating to section 403(b) annuity contracts, see—

(i) Section 1.415–1(f)(2) (relating to the plan year for such annuity contracts),

(ii) Section 1.415–2(b)(7) (relating to the limitation year for such annuity contracts),

(iii) Section 1.415–6(e) (relating to the applicability of the alternative limitations described in section 415(c)(4) to such annuity contracts),

(iv) Sections 1.415–7(c)(2) and 1.415–7(h) (relating to rules for such annuity contracts for purposes of computing the defined contribution plan fraction),

(v) Section 1.415–8(d) (relating to rules for such annuity contracts for purposes of combining plans), and

(vi) Section 1.415–9(c) (relating to rules for such annuity contracts for purposes of determining the amount of a disqualified contribution to the annuity contract).

(c) *Certain accounts, annuities and bonds established for non-employed spouse.* Paragraph (b) of this section is not applicable to an account, annuity or bond as described in section 408(a), 408(b) or 409, respectively established for the benefit of the spouse of the individual who contributes to it for any year for which a deduction is allowable for the individual under section 220. For a special effective date with respect to this paragraph, see paragraph (f)(3) of this section.

(d) *Plan provisions*—(1) *In general.* Although no specific plan provision is required under section 415 in order for a plan to establish or maintain its qualification, the plan provisions must preclude the possibility that the limitations imposed by section 415 will be exceeded. For example, a plan may include provisions which automatically freeze or reduce the rate of benefit accrual (in the case of a defined benefit plan) or the annual addition (in the case of a defined contribution plan) to a level necessary to prevent the limitations from being exceeded with respect to any participant. For rules relating to this type of plan provision and the definitely determinable benefit requirement for pension plans, see § 1.401(a)–1(b)(1).

(2) *Special rule for profit-sharing and stock bonus plans.* The use of a plan provision by a profit-sharing or stock bonus plan which automatically freezes or reduces the amount of annual additions to insure that the limitations of section 415 will not be exceeded must comply with the requirement set forth in § 1.401–1(b)(1) (ii) and (iii) that such plans provide a definite predetermined formula for allocating the contributions made to the plan among the participants. Thus, if the operation of this provision involves discretionary action on the part of the employer, the definite predetermined allocation formula requirement will be violated. For example, if two defined contribution plans of one employer otherwise provide for aggregate contributions which may exceed the limits of section 415(c), the plan provisions must specify (without involving employer discretion) which plan will reduce contributions and allocations to prevent an excess annual addition and how the reduction will occur.

(e) *Rules for plans maintained by more than one employer*—(1) *Plans described in section 413(b) or section 413(c).* This subparagraph provides for participants of a plan described in section 413(c) or section 413(b) (other than a plan described in section 414(f)). For purposes of applying the limitations of section 415 with respect to a participant of an employer maintaining the plan, benefits or contributions attributable to such participant from all of the employers maintaining the plan must be taken into account. Furthermore, in applying the limitations of section 415 with respect to such a participant, the total compensation received by the participant from all of the employers maintaining the plan may be taken into account.

(2) *Plans described in section 414(f).* (i) This subparagraph provides rules for participants of a multiemployer plan described in section 414(f). For purposes of applying the limitations of section 415 with respect to a participant of an employer maintaining the plan, only the benefits or contributions provided by the employer of such participant shall be taken into account. The benefits provided by an employer under such a plan shall equal the excess of the plan benefit over the plan benefit

computed as if the participant had no covered service with that employer.

(ii) As an alternative to applying the limitations of section 415 with respect to a participant of an employer maintaining the multiemployer plan in the manner described in subdivision (i) of this subparagaph, the rules described in subparagraph (1) of this paragraph may be used for purposes of applying the section 415 limitations in connection with that participant.

(iii) For rules relating to the limitation year for a multiemployer plan, see §1.415–2(b)(6). See also §1.415–8(e) for a special rule relating to the aggregation of multiemployer plans.

(f) *Rules relating to the effective date of section 415*—(1) *In general.* Except as otherwise provided in this paragraph, §§1.415–1 through 1.415–10 are applicable for plan years beginning after 1975 and for limitation years ending with or within plan years beginning after 1975. However, for all such plan years and limitation years through the plan year beginning before January 7, 1981, a reasonable interpretation of the rules set forth in section 415 of the Code and in Rev. Rul. 75–481, 1975–2 C.B. 188, may be relied upon.

(2) *Plan year for certain annuity contracts and individual retirement plans.* For purposes of section 415 and §§1.415–1 through 1.415–10—

(i) An annuity contract described in section 403(b) shall be considered to have a plan year coinciding with the taxable year of the individual on whose behalf the contract has been purchased, and

(ii) An individual retirement plan (as described in section 7701(a)(37)) shall be considered to have a plan year coinciding with the taxable year of the individual on whose behalf the plan is maintained,

unless the individual demonstrates to the satisfaction of the Commissioner that a different 12 month period should be considered to be the plan year.

(3) *Special effective date for certain accounts, annuities and bonds established for non-employed spouse.* Nothwithstanding subparagraph (1) of this paragraph, the provisions of section 415(a)(3) and paragraph (c) of this section are not applicable until taxable years beginning after December 31, 1976.

(4) *Special rules for certain defined contribution plans with respect to the first limitation year to which section 415 applies.* In the case of a defined contribution plan whose plan year does not coincide with the limitation year, the rules of this subparagraph shall be effective with respect to applying the limitations described in section 415(c) and §1.415–6 for the first limitation year to which section 415 and §§1.415–1 through 1.415–10 apply.

(i) Annual additions (as defined in section 415(c)(2) and §1.415–6(b)) which are allocated under the plan prior to the first day of the first plan year to which section 415 and §§1.415–1 through 1.415–10 are effective do not have to be taken into account.

(ii) The amount of compensation (as defined in §1.415–2(d)) taken into account in applying the limitations may include compensation for the entire limitation year.

(5) *Special effective date for special benefit limitation with respect to certain collectively bargained plans.* Notwithstanding subparagraph (1) of this paragraph, section 415(b)(7) is not applicable until limitation years beginning after December 31, 1978.

(6) *Special effective date for excess contributions to section 403(b) annuity contracts.* (i) Notwithstanding subparagraph (1) of this paragraph, the provisions of §1.415–6(e)(1)(ii) (relating to the manner in which contributions to a section 403(b) annuity contract which exceed the limitations of section 415(c)(1) are treated) are only applicable to taxable years beginning after January 24, 1980.

(ii) For all prior taxable years for which the limitations of section 415 are applicable to section 403(b) annuity contracts, any contribution to the account of an individual under a section 403(b) annuity contract for a taxable year which exceeds the limitations of section 415(c)(1), instead of being treated in the manner described in §1.415–6(e)(1)(ii), shall reduce the exclusion allowance under section 403(b)(2) for such taxable year to the extent of the excess.

(7) *Special effective date for rules relating to change of limitation year.* Notwithstanding subparagraph (1) of this paragraph, the provisions of § 1.415–2(b)(4) (relating to the effect of a change of the limitation year) are required to be applied only for changes in limitation years which occur after January 7, 1981. These provisions may also be used for all prior changes in limitation years. However, if the provisions of § 1.415–2(b)(4) are not used for changes in limitation years which occur prior to January 7, 1981, the requirements of § 2.01(4) of Rev. Rul. 75–481, 1975–2 C.B. 188, shall be applicable with respect to such changes.

(8) *Special effective date for TRASOP's.* The limitations of section 415 apply to an Employee Stock Ownership Plan under section 301(d) of the Tax Reduction Act of 1975 (''TRASOP''). The earliest date on which the first plan year of a TRASOP may begin is January 22, 1974. Therefore, notwithstanding subparagraph (1) of this paragraph, the limitations of section 415 are applicable for TRASOP plan years beginning before 1975 and for limitation years ending with or within plan years beginning before 1975. However, the aggregation rules of § 1.415–8 do not apply to a limitation year of a TRASOP ending with or within a plan year beginning before 1975.

(9) *Transitional rules.* For special transitional rules, see—

(i) Section 1.415–4 (relating to a transitional rule for defined benefit plans),

(ii) Section 1.415–7(b)(2) (relating to the defined benefit plan fraction applicable to certain participants),

(iii) Section 1.415–7(d) (relating to transitional rules for the defined contribution plan fraction), and

(iv) Section 1.415–7(g) (relating to a special rule for certain plans in effect on September 2, 1974).

(g) *Supersession.* Section 11.415(c)(4)–1 (relating to special elections for section 403(b) annuity contracts purchased by educational organizations, hospitals and home health service agencies) of the Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974 is superseded by this section and §§ 1.415–2 through 1.415–10.

[T.D. 7748, 46 FR 1697, Jan. 7, 1981]

§ 1.415–2 Definitions and special rules.

(a) *General application.* Unless otherwise provided in the appropriate section, for purposes of §§ 1.415–1 through 1.415–10, the following definitions and special rules shall apply.

(b) *Limitation year*—(1) *In general.* (i) Unless the election described in subdivision (ii) of this subparagraph is made, the limitation year, with respect to any qualified plan maintained by the employer, is the calendar year.

(ii) Instead of using the calendar year, an employer may elect to use any other consecutive twelve month period as the limitation year. This includes a fiscal year with an annual period varying from 52 to 53 weeks, so long as the fiscal year satisfies the requirements of section 441(f). If the case of a group of employers which constitute either a controlled group of corporations (within the meaning of section 414(b) as modified by section 415(h)) or trades or businesses (whether or not incorporated) which are under common control (within the meaning of section 414(c) as modified by section 45(h)), the election to use a consecutive twelve month period other than the calendar year as the limitation year must be made by all members of the group that maintain a qualified plan.

(2) *Method of election to use a limitation year other than the calendar year or to change limitation year.* (i) The election described in subparagraph (1)(ii) of this paragraph shall be made by the adoption of a written resolution by the employer. This requirement is satisfied if the election is made in connection with the adoption, by the employer, of the plan or any amendments to such plan.

(ii) This resolution will not be considered a change of the limitation year, if it is adopted or modified on or before the later of the adoption date of the first amendment conforming an existing plan to the Employee Retirement Income Security Act of 1974, or December 31, 1976.

(3) *Election of multiple limitation years.* Any employer that maintains more than one qualified plan may elect to use different limitation years for each such plan in accordance with rules determined by the Commissioner. The rule described in this subparagraph

also applies to a controlled group of employers (within the meaning of section 414 (b) or (c), as modified by section 415(h)).

(4) *Effect of change of limitation year.* (i) Once established, the limitation year may be changed only by making the election in the manner described in subparagraph (2) of this paragraph.

(ii) Any change in the limitation year must be a change to a twelve-month period commencing with any day within the current limitation year.

(iii) For purposes of this paragraph, the limitations of section 415 are to be applied in the normal manner to the new limitation year. Moreover, the limitations of section 415 are to be separately applied to a ‘‘limitation period’’ which begins with the first day of the current limitation year and which ends on the day before the first day of the first limitation year for which the change is effective. The dollar limitation with respect to this limitation period is determined by multiplying (A) the applicable dollar limitation for the calendar year in which the limitation period ends by (B) a fraction, the numerator of which is the number of months (including any fractional parts of a month) in the limitation period, and the denominator of which is 12. This adjustment of the dollar limitation only applies to a defined contribution plan.

(iv) For a special effective date with respect to this paragraph, see §1.415–1(f)(7).

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

Example. In 1981, an employer with a qualified defined contribution plan using the calendar year as the limitation year elects to change the limitation year to a period beginning July 1 and ending June 30. Because of this change, the plan must satisfy the limitations of section 415(c) for the limitation period beginning January 1, 1981 and ending June 30 of that year. In applying the limitations of section 415(c) to this limitation period, the amount of compensation taken into account may only include compensation for this period. Furthermore, the dollar limitation for this period is the otherwise applicable dollar limitation for calendar year 1981, multiplied by $\frac{6}{12}$.

(5) *Limitation year for years prior to effective date.* The limitation year for all years prior to the effective date of section 415 is the consecutive twelve-month period which corresponds to the first limitation year of a plan after the effective date of section 415. (See paragraph (b)(1) of this section for rules relating to the determination of a plan’s limitation year.)

(6) *Limitation year for multiemployer plans.* In the case of a multiemployer plan (as defined in section 414(f)), the limitation year is the calendar year unless the plan administrator elects otherwise under paragraph (b)(2) of this section.

(7) *Limitation year for individuals on whose behalf section 403(b) annuity contracts have been purchased.* (i) The limitation year of an individual on whose behalf a section 403(b) annuity contract has been purchased by an employer is determined in the following manner.

(ii) If the individual is not in control (within the meaning of section 414 (b) or (c) as modified by section 415(h)) of any employer, the limitation year is the calendar year. However, the individual may elect to change the limitation year to another twelve-month period. To do this, the individual must attach a statement to his income tax return filed for the taxable year in which the change is made. Any change in the limitation year must comply with the rules set forth in paragraph (b)(4) of this section.

(iii) If the individual is in control (within the meaning of section 414 (b) or (c) as modified by section 415(h)) of an employer, the limitation year is to be the limitation year of that employer.

(8) *Limitation year for individuals on whose behalf individual retirement plans are maintained.* The limitation year of an individual on whose behalf an individual retirement plan (as described in section 7701(a)(37)) is maintained shall be determined in the manner described in paragraph (b)(7) of this section.

(c) *Defined benefit and defined contribution plan*—(1) *Defined benefit plan.* A ‘‘defined benefit plan’’ means a plan described in section 414(j).

(2) *Defined contribution plan.* A ‘‘defined contribution plan’’ means a plan described in section 414(i). It includes a money purchase pension plan (as described in §1.401–1(b)(1)(i)), such as a

target benefit plan (as described in § 1.410(a)–4(a)(1)). A hybrid plan (as defined in section 414(k)) is to be treated as a defined contribution plan to the extent that benefits payable under the plan are based upon the individual account of the participant.

(d) *Compensation*—(1) *General definition.* Except as otherwise provided, compensation within the meaning of section 415(c)(3) includes all remuneration described in paragraph (d)(2) of this section and excludes all other forms of remuneration. Paragraph (d)(3) of this section provides examples of types of remuneration not includible in compensation within the meaning of section 415(c)(3). Paragraphs (d)(4) and (d)(5) of this section provide rules regarding the payment of compensation in the limitation year. Paragraph (d)(6) of this section provides a special rule for determining the compensation of employees of controlled groups or affiliated service groups. Paragraph (d)(7) of this section provides a special rule for applying the limitations of section 415(c) when a section 403(b) annuity is aggregated with a qualified plan of a controlled employer. Paragraphs (d)(8) and (d)(9) of this section are reserved for special rules for leased employees and for permanent and total disability, respectively. Paragraphs (d)(10) and (d)(11) of this section provide additional definitions of compensation that are treated as satisfying section 415(c)(3). Paragraph (d)(12) of this section permits optional use of prior regulations. Paragraph (d)(13) of this section provides authority to the Commissioner to provide further additional definitions of compensation that satisfy section 415(c)(3).

(2) *Items includible as compensation.* For purposes of applying the limitations of section 415, the term ‘‘compensation’’ includes all of the following—

(i) The employee’s wages, salaries, fees for professional services, and other amounts received (without regard to whether or not an amount is paid in cash) for personal services actually rendered in the course of employment with the employer maintaining the plan to the extent that the amounts are includible in gross income (including, but not limited to, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses, fringe benefits, and reimbursements or other expense allowances under a nonaccountable plan (as described in § 1.62–2(c)).

(ii) In the case of an employee who is an employee within the meaning of section 401(c)(1) and the regulations thereunder, the employee’s earned income (as described in section 401(c)(2) and the regulations thereunder).

(iii) Amounts described in sections 104(a)(3), 105(a), and 105(h), but only to the extent that these amounts are includible in the gross income of the employee.

(iv) Amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are not deductible by the employee under section 217.

(v) The value of a non-qualified stock option granted to an employee by the employer, but only to the extent that the value of the option is includible in the gross income of the employee for the taxable year in which granted.

(vi) The amount includible in the gross income of an employee upon making the election described in section 83(b).

Paragraphs (d)(2)(i) and (d)(2)(ii) of this section include foreign earned income (as defined in section 911(b)), whether or not excludable from gross income under section 911. Compensation described in paragraph (d)(2)(i) of this section is to be determined without regard to the exclusions from gross income in sections 931 and 933. Similar principles are to be applied with respect to income subject to sections 931 and 933 in determining compensation described in paragraph (d)(2)(ii) of this section.

(3) *Items not includible as compensation.* The term ‘‘compensation’’ does not include items such as—

(i) Contributions made by the employer to a plan of deferred compensation to the extent that, before the application of the section 415 limitations to that plan, the contributions are not includible in the gross income of the employee for the taxable year in which contributed. In addition, employer contributions made on behalf of an employee to a simplified employee pension described in section 408(k) are not considered as compensation for the taxable year in which contributed. Additionally, any distributions from a plan of deferred compensation are not considered as compensation for section 415 purposes, regardless of whether such amounts are includible in the gross income of the employee when distributed. However, any amounts received by an employee pursuant to an unfunded nonqualified plan is permitted to be considered as compensation for section 415 purposes in the year the amounts are includible in the gross income of the employee.

(ii) Amounts realized from the exercise of a non-qualified stock option, or when restricted stock (or property) held by an employee either becomes freely transferable or is no longer subject to a substantial risk of forfeiture (see section 83 and the regulations thereunder).

(iii) Amounts realized from the sale, exchange or other disposition of stock acquired under a qualified stock option.

(iv) Other amounts which receive special tax benefits, such as premiums for group-term life insurance (but only to the extent that the premiums are not includible in the gross income of the employee), or contributions made by an employer (whether or not under a salary reduction agreement) towards the purchase of an annuity contract described in section 403(b) (whether or not the contributions are excludable from the gross income of the employee).

(4) *Compensation in limitation year.* The compensation (as defined in paragraph (d)(2) of this section) actually paid or made available to an employee within the limitation year is the compensation used for purposes of applying the limitations of section 415.

(5) *Election to use compensation accrued during limitation year*—(i) *Years beginning after December 31, 1991.* For limitation years beginning after December 31, 1991, an employer may not use accrued compensation. Any election previously made to use accrued compensation is not valid for limitation years beginning after December 31, 1991.

(ii) *De minimis accrued compensation.* Notwithstanding paragraph (d)(5)(i) of this section, an employer may include in compensation amounts earned but not paid in a year because of the timing of pay periods and pay days if these amounts are paid during the first few weeks of the next year, the amounts are included on a uniform and consistent basis with respect to all similarly situated employees, and no compensation is included in more than one limitation period. No formal election is required to include the accrued compensation permitted under this de minimis rule. The rule described in this paragraph (d)(5)(ii) does not apply to a section 403(b) annuity contract or to an individual retirement plan (as defined in section 7701(a)(37)).

(iii) *Years beginning before January 1, 1992.* For limitation years beginning before January 1, 1992, instead of using the compensation actually paid or made available to an employee during the limitation year, an employer may elect to use the compensation accrued for an entire limitation year for purposes of applying the limitations of section 415. In the case of a group of employers that constitute either a controlled group of corporations (within the meaning of section 414(b) as modified by section 415(h)) or trades or businesses (whether or not incorporated) that are under common control (within the meaning of section 414(c) as modified by section 415(h)), the election to use accrued compensation must be made by all members of the group that maintain a qualified plan. Once an election is made, it remains in effect until it is revoked by the employer or group of employers. The rule described in this paragraph (d)(5)(iii) does not apply to a section 403(b) annuity contract or to an individual retirement plan (as defined in section 7701(a)(37)). If, in a particular limitation year beginning before January 1, 1992, a previously effective election to use accrued compensation is revoked or an election to use accrued compensation is made, any amounts taken into account for compensation purposes for any preceding limitation year may not be counted again in determining compensation for the particular limitation year.

(6) *Special rule for employees of controlled groups of corporations, etc.* In the case of an employee of two or more corporations which are members of a controlled group of corporations (as defined in section 414(b) as modified by section 415(h)), the term ''compensation'' for such employee includes compensation from all employers that are members of the group, regardless of whether the employee's particular employer has a qualified plan. This special rule is also applicable to an employee of two or more trades or businesses (whether or not incorporated) that are under common control (as defined in section 414(c) as modified by section 415(h)), to an employee of two or more members of an affiliated service group as defined in section 414(m), and to an employee of two or more members of any group of employers who must be aggregated and treated as one employer pursuant to section 414(o).

(7) *Special rule when section 403(b) annuity is aggregated with qualified plan of controlled employer.* If a section 403(b) annuity contract is combined or aggregated with a qualified plan of a controlled employer in accordance with either §1.415–7(h)(2)(i) or §1.415–8(d)(2), the following rules apply:

(i) In applying separately the limitations of section 415 (b) or (c) to the qualified plan and the limitations of section 415(c) and the exclusion allowance of section 403(b)(2)(A) to the section 403(b) annuity, compensation from the controlled employer may not be aggregated with compensation from the employer purchasing the section 403(b) annuity.

(ii) However, in applying the limitations of section 415(c) in connection with the combining of the section 403(b) annuity with a qualified defined contribution plan or section 415(e) in connection with the aggregating of the section 403(b) annuity with a qualified defined benefit plan, the total compensation from both employers may be taken into account.

(8) *Special rules for leased employees.* [Reserved]

(9) *Special rules for permanent and total disability.* [Reserved]

(10) *Safe harbor rule with respect to plan's definition of compensation.* If a plan defines compensation for purposes of applying the limitations of section 415 to include only those items specified in paragraph (d)(2)(i) of this section and to exclude all those items listed in paragraph (d)(3) of this section, if applicable, the plan will automatically be considered to be using a definition of compensation which satisfies section 415(c)(3).

(11) *Alternative definition of compensation.* In lieu of defining compensation in accordance with paragraphs (d)(2) and (d)(3) of this section, for purposes of applying the limitations of section 415 in the case of employees other than self-employed individuals treated as employees within the meaning of section 401(c)(1), a plan may define compensation using either of the following definitions used for wage reporting purposes, as modified herein, and the definition will be considered automatically to satisfy section 415(c)(3):

(i) *Information required to be reported under sections 6041, 6051 and 6052.* Compensation is defined as wages within the meaning of section 3401(a) and all other payments of compensation to an employee by his employer (in the course of the employer's trade or business) for which the employer is required to furnish the employee a written statement under sections 6041(d), 6051(a)(3), and 6052. See §§1.6041–1(a), 1.6041–2(a)(1), 1,6052–1, and 1.6052–2, and also see §31.6051–1(a)(1)(i)(C) of this chapter. This definition of compensation may be modified to exclude amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are deductible by the employee under section 217. Compensation under this paragraph (d)(11)(i) must be determined without regard to any rules under section 3401(a) that limit the remuneration included in wages based on the nature or location of the employment or the services performed (such as the exception for agricultural labor in section 3401(a)(2)).

(ii) *Section 3401(a) wages.* Compensation is defined as wages within the meaning of section 3401(a) (for purposes of income tax withholding at the source) but determined without regard to any rules that limit the remuneration included in wages based on the nature or location of the employment or the services performed (such as the exception for agricultural labor in section 3401(a)(2)).

(12) *Optional use of prior regulations.* For years beginning before September 19, 1991, employers are permitted, in defining compensation for purposes of section 415(c)(3), to comply with either the provisions of this §1.415–2(d) or the prior regulation provisions of §1.415–2(d). See §1.415–2(d) as contained in the CFR edition revised as of April 1, 1991.

(13) *Additional rules.* The Commissioner may in revenue rulings, notices, and other guidance of general applicability provide additional definitions of compensation that are treated as satisfying section 415(c)(3).

[T.D. 7748, 46 FR 1698, Jan. 7, 1981, as amended by T.D. 8361, 56 FR 47667, Sept. 19, 1991; 57 FR 10815, 10953, Mar. 31, 1992]

§1.415–3 Limitations for defined benefit plans.

(a) *General rules*—(1) *Maximum limitations.* Under section 415(b) and this section, to satisfy the provisions of section 415(a) for any limitation year, the annual benefit (as defined in paragraph (b)(1)(i) of this section) to which a participant is entitled at any time under a defined benefit plan may not, during the limitation year, exceed the lesser of—

(i) $75,000, or

(ii) 100 percent of the participant's average compensation for his high 3 years of service.

As required in §1.415–1(d), in order to satisfy the limitations on benefits of this section, the plan provisions must preclude the possibility that any annual benefit exceeding these limitations will be payable at any time. Thus, a plan may fail to satisfy the limitations of this section even though no participant has actually accrued a benefit in excess of these limitations.

(2) *Adjustment to dollar limitation.* The dollar limitation described in section 415(b)(1)(A) and paragraph (a)(1)(i) of this section is adjusted for cost of living increases under section 415(d) and §1.415–5(a). The adjusted figure is effective as of January 1 of each calendar year and is applicable to limitation years that end during that calendar year.

(3) *Average compensation for high 3 years of service.* For purposes of applying the limitation on benefits described in this section, a participant's high 3 years of service is the period of 3 consecutive calendar years (or, the actual number of consecutive years of employment for those employees who are employed for less than 3 consecutive years with the employer) during which the employee had the greatest aggregate compensation (as defined in §1.415–2(d)) from the employer. For purposes of this subparagraph, in determining a participant's high 3 years, the plan may use any 12 month period instead of the calendar year provided that it is uniformly and consistently applied.

(b) *Definitions of terms*—(1) *Annual benefit.* (i) The term ''annual benefit'' means a benefit which is payable annually in the form of a straight life annuity under a plan. Such benefit does not include any benefits attributable to either employee contributions or rollover contributions (as defined in sections 402(a)(5), 403(a)(4), 408(d)(3) and 409(b)(3)(C)). Additionally, in applying the limitations on benefits described in paragraph (a)(1) of this section to the annual benefit of a participant, it is immaterial if the participant works beyond the normal retirement age as determined under the terms of the plan. Thus, for example, if an individual, who is subject to the dollar limitation of section 415(b)(1)(A) ($110,625 for 1980), retires in 1980 after working past the plan's normal retirement age of 65, the plan may only provide such individual with an annual benefit of $110,625 in 1980 and not the actuarial equivalent of the amount the individual would have been entitled to receive at age 65 in order to comply with the section 415(b) limitations.

(ii) If the plan provides for a benefit which is not payable in the form of a straight life annuity, the benefit is adjusted in accordance with paragraph (c) of this section for purposes of applying the limitations on benefits described in paragraph (a)(1) of this section.

(iii) If rollover contributions are made to the plan, the annual benefit attributable to these contributions is determined on the basis of reasonable actuarial assumptions. See paragraph (d) of this section for rules relating to employee contributions.

(iv) For purposes of this paragraph, when there is a transfer of assets or liabilities from one qualified plan to another, the annual benefit attributable to the assets transferred does not have to be taken into account by the transferee plan in applying the limitations of section 415. The annual benefit payable on account of the transfer for any individual that is attributable to the assets transferred will be equal to the annual benefit transferred on behalf of such individual multiple by a fraction, the numerator of which is the total assets transferred and the denominator of which is the total liabilities transferred.

(2) *Retirement benefit.* For purposes of this section, the term ''retirement benefit'' means a benefit provided under the terms of a defined benefit plan which is subject to the limitations of section 415(b) and this section.

(c) *Adjustment where form of benefit is other than straight life annuity*—(1) *In general.* (i) Where a defined benefit plan provides a retirement benefit in any form other than a straight life annuity, the plan benefit is adjusted to a straight life annuity beginning at the same age which is the actuarial equivalent of such benefit in accordance with rules determined by the Commissioner. This adjustment is for purposes of applying the limitations on benefits described in paragraph (a)(1) of this section to the annual benefit of the participant.

(ii) Examples of benefits that are not in the form of a straight life annuity are an annuity which includes a post-retirement death benefit and an annuity providing for a guaranteed number of payments.

(2) *Certain beneifts to which no adjustment is required.* For purposes of the adjustment described in subparagraph (1) of this paragraph, the following values are not taken into account:

(i) The value of a qualified joint and survivor annuity (as defined in section 401(a)(11)(G)(iii) and the regulations thereunder) provided by the plan to the extent that such value exceeds the sum of (A) the value of a straight life annuity beginning on the same date and (B) the value of any post-retirement death benefits which would be payable even if the annuity was not in the form of a joint and survivor annuity.

(ii) The value of benefits that are not directly related to retirement benefits (such as pre-retirement disability and death benefits and post-retirement medical benefits).

(iii) The value of benefits provided by the plan which reflect post-retirement cost of living increases to the extent that such increases are in accordance with section 415(d) and § 1.415–5.

(3) *Examples.* The provisions of subparagraph (2)(i) of this paragraph may be illustrated by the following examples:

Example (1). (i) Corporation ABC maintains a defined benefit plan that provides a benefit in the form of a joint and 100% suvivor annuity with a 10 year certain feature. The value of this benefit is equal to 126% of the value of the same amount payable as a straight life annuity beginning on the same date. If the benefit were payable in the form of a joint and 100% survivor annuity, without a 10 year certain feature, its value would be equal to only 123% of the value of the same amount payable as a straight life annuity beginning on the same date. If the benefit were payable with a 10 year certain feature, but without the joint and 100% survivor aspect, its value would equal 110% of the value of the same amount payable as a straight life annuity beginning on the same date. Thus, the value of the postretirement death benefits which would be payable even if the annuity were not in the form of a joint and survivor annuity is 10%.

(ii) Under subparagraph (2)(i) of this paragraph, the values which may be excluded for purposes of the adjustment required by subparagraph (1) of this paragraph are as follows: The value of the joint and survivor annuity provided by the plan (126%) to the extent that such value exceeds the sum of, the value of the straight life annuity beginning on the same date (100%) and the value of the post-retirement death benefits (10%). Therefore, the value of the joint and survivor annuity provided by the plan exceeds the value of the straight life annuity with the 10 year certain feature by 16% (126%–110%).

(iii) Although 16% of the excess benefit attributable to the annity provided by this plan may, consequently, be ignored (because this represents the value added to the 10 year certain and life annuity benefit by the joint survivor feature), 10% of such excess benefit (the value added to the straight life annuity benefit by the 10 year certain feature) must be taken into account for purposes of adjusting the benefit under the plan to an actuarially equivalent straight life annuity. Thus, for example, if ABC Corporation were to provide a benefit equal to 95% of a participant's compensation for the high three years of service, the limitation of section 415(b)(1)(B) would be exceeded because the benefit under the plan would be the actuarial equivalent of a straight life annuity equal to 105% of a participant's compensation for the high three years.

Example (2). Corporation XYZ maintains a nondiscriminatory defined benefit plan that provides a benefit which is equal to 100% of a participant's compensation for his high 3 years of service. For married participants, the benefit is payable in the form of a joint and 100% survivor annuity. While for participants who are not married, the benefit is payable in the form of a straight life annuity. The plan also provides that married participants can elect to receive their benefits in the form of a lump sum distribution which is the actuarial equivalent of a joint and 100% survivor annuity. The special rule set forth in subparagraph (2)(i) of this paragraph only applies, however, if the benefit is payable in the form of a qualified joint and survivor annuity. Any other forms of optional benefits must be adjusted to a straight life annuity in accordance with subparagraph (1) of this paragraph. Accordingly, because the benefit payable under the plan in the form of a lump sum distribution is the actuarial equivalent of a straight life annuity which is greater than 100% of a participant's compensation for his high 3 years, the limitation of section 415(b)(1)(B) has been exceeded.

(d) *Employee contributions*—(1) *Mandatory contributions.* Where a defined benefit plan provides for mandatory employee contributions (as defined in section 411(c)(2)(C)), the annual benefit attributable to such contributions is not taken into account for purposes of applying the limitations on benefits described in paragraph (a) of this section. The annual benefit attributable to mandatory contributions is determined by using the factors described in section 411(c)(2)(B) and the regulations thereunder, regardless of whether section 411 applies to that plan.

However, the mandatory employee contributions are considered a separate defined contribution plan maintained by the employer that is subject to the limitations on contributions and other additions described in §1.415–6. (See §1.415–7 for provisions relating to the limitations applicable where an employer maintains a defined benefit and defined contribution plan for the same employee.)

(2) *Voluntary contributions.* Where a defined benefit plan provides for voluntary employee contributions, these contributions are considered a separate defined contribution plan maintained by the employer which is subject to the limitations on contributions and other additions described in §1.415–6. (See §1.415–7 for provisions relating to the limitations applicable where an employer maintains a defined benefit and defined contribution plan for the same employee.)

(3) *Example:* The provisions of this paragraph may be illustrated by the following example:

Example. A is a participant in a defined benefit plan maintained by his employer. Under the terms of the plan A must make contributions to the plan in a stated amount to accrue benefits derived from employer contributions. These contributions are mandatory employee contributions within the meaning of section 411(c)(2)(C) and, thus, the annual benefit attributable to these contributions does not have to be taken into account for purposes of testing the annual benefit derived from employer contributions against the applicable limitation on benefits. However, these contributions are considered a separate defined contribution plan maintained by A's employer. Accordingly, with respect to the current limitation year: (1) the limitation on benefits (as described in paragraph (a)(1) of this section) is applicable to the annual benefit attributable to employer contributions to the defined benefit plan; (2) the limitation on contributions and other additions (as described in §1.415–6) is applicable to the defined contribution plan consisting of A's mandatory contributions; and (3) the provisions of §1.415–7 (relating to the limitations where the employer maintains a defined benefit and defined contribution plan for the same employee) are applicable to the defined benefit and defined contribution plan in which A participates. These same limitations would also apply. If, instead of providing for mandatory employee contributions the plan permitted voluntary employee contributions, since both voluntary and mandatory employee contributions are treated as separate defined contribution plans maintained by the employer.

(e) *Adjustment where benefit begins before age 55.* Where a defined benefit plan provides a retirement benefit beginning before age 55, the plan benefit is adjusted to the actuarial equivalent of a benefit beginning at age 55 in accordance with rules determined by the Commissioner. This adjustment is only for purposes of applying the dollar limitation described in section 415(b)(1)(A) to the annual benefit of the participant.

(f) *Total annual benefits not in excess of $10,000*—(1) *In general.* The annual benefit (without regard to the age at which benefits commence) payable with respect to a participant under any defined benefit plan is not considered to exceed the limitations on benefits described in section 415(b)(1) and in paragraph (a)(1) of this section if—

(i) The retirement benefits derived from employer contributions payable with respect to the participant under the plan and all other defined benefit plans of the employer do not in the aggregate exceed $10,000 for the limitation year, or for any prior limitation year, and

(ii) The employer has not at any time, either before or after the effective date of section 415, maintained a defined contribution plan in which the participant participated.

(2) *Special rule with respect to participants in multiemployer plans.* The special $10,000 exception set forth in subparagraph (1) of this paragraph is applicable to a participant in a multiemployer plan described in section 414(f) without regard to whether that participant ever participated in one or more other plans maintained by an employer who also maintains the multiemployer plan, provided that none of such other plans were maintained as a result of collective bargaining involving the same employee representative as the multiemployer plan.

(3) *Special rule with respect to employee contributions.* For purposes of subparagraph (1)(ii) of this paragraph, if a defined benefit plan provides for employee contributions, whether voluntary or mandatory, these contributions will not be considered a separate defined contribution plan maintained by the employer. Thus, a contributory defined benefit plan may utilize the special dollar limitation provided for in this paragraph.

(4) *Computation of $10,000 amount.* For purposes of subparagraph (1)(i) of this paragraph, the value of the retirement benefit payable under the plan is not adjusted upward for early retirement provisions and benefits which are not in the form of a straight life annuity (whether or not directly related to retirement benefits).

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

Example (1). B is a participant in a defined benefit plan maintained by this employer, X Corporation, which provides for a benefit payable in the form of a straight life annuity beginning at age 65. B's compensation for his high 3 years of service is $6,000. The plan does not provide for employee contributions and at no time has B been a participant in a defined contribution plan maintained by X. With respect to the current limitation year, B's retirement benefit under the plan is $9,500. Because B's retirement benefit does not exceed $10,000 and because B has at no time participated in a defined contribution plan maintained by X, the benefits payable under the plan are not considered to exceed the limitation on benefits otherwise applicable to B ($6,000). This result would remain the same, even if, under the terms of the plan, B's normal retirement age were age 50 or if the plan provided for employee contributions.

Example (2). Assume the same facts as in example (1), except that the plan provides for a benefit payable in the form of a life annuity with a 10 year certain feature. Assume that after the adjustment described in paragraph (c) of this section, B's annual benefit under the plan for the current limitation year is $10,500. However, for purposes of applying the special rule provided in this paragraph for total benefits not in excess of $10,000, there is no adjustment required if the retirement benefit payable under the plan is not in the form of a straight life annuity. Therefore, because B's retirement benefit does not exceed $10,000, B may receive the full $9,500 benefit without the otherwise applicable benefit limitations of this section being exceeded.

(g) *Special rule for service of less than 10 years*—(1) *In general.* Where a participant has less than 10 years of service with the employer at the time the participant begins to receive retirement benefits under the plan, the benefit limitations described in section 415(b)(1) and (4) and paragraphs (a)(1) and (f)(1) of this section are to be reduced by multiplying the otherwise applicable limitation by a fraction—

(i) The numerator of which is the number of years of service with the employer as of, and including, the current limitation year, and

(ii) The denominator of which is 10. For purposes of this subparagraph, the term ''year of service'' is to be determined on a reasonable and consistent basis.

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

Example (1). C begins employment with Acme Corporation on January 1, 1977, at the age of 58. Acme maintains only a noncontributory defined benefit plan which provides for a straight life annuity beginning at age 65 and uses the calendar year for the limitation and plan year. Acme has never maintained a defined contribution plan. C becomes a participant in Acme's plan on January 1, 1978 and works through December 31, 1983, when he is age 65. C begins to receive benefits under the plan in 1984. C's average compensation for his high 3 years of service is $20,000. Furthermore, under the terms of Acme's plan, for purposes of computing C's nonforfeitable percentage in his accrued benefit derived from employer contributions, C has only 7 years of service with Acme (1977–1983). Therefore, because C has less than 10 years of service with Acme at the time he begins to receive benefits under the plan, the maximum permissible annual benefit payable with respect to C is only $14,000 ($20,000×7/10).

Example (2). Assume the same facts as in example (1), except that C's average compensation for his high 3 years is $8,000. Because C has less than 10 years of service with Acme at the time he begins to receive benefits, the maximum benefit payable with respect to C would be reduced to $5,600 ($8,000 x 7/10). However, the special rule for total benefits not in excess of $10,000, provided in paragraph (f) of this section, is applicable in this case. Accordingly, C may receive an annual benefit of $7,000 ($10,000 x 7/10) without the benefit limitations of this section being exceeded.

Example (3). ABC corporation maintains a defined benefit plan. Instead of adjusting the benefit limitations in accordance with the method described in subparagraph (1) of this paragraph, the plan provides that the plan administrator may make the necessary adjustment by multiplying the otherwise applicable limitation by a fraction—(1) the numerator of which is the number of completed months of service with the employer, and (2) the denominator of which is 120. The plan further provides that a completed month of service with the employer is any calendar month in which the employee is credited with at least 83 hours of service. Provided that an hour of service is determined in a manner that is reasonable and consistent, the plan may use this alternative rule for making the adjustment required when a participant has less than 10 years of service with the employer at the time he begins to receive benefits under the plan.

(h) *Benefits under certain collectively bargained plans.* For a special rule affecting the compensation limitation described in section 415(b)(1)(B) and paragraph (a)(1)(ii) of this section, see section 415(b)(7). For a special effective date with respect to this rule, see §1.415–1(f)(5).

[T.D. 7748, 46 FR 1700, Jan. 7, 1981]

§1.415–4 Transitional rule for defined benefit plans.

(a) *In general.* If all of the conditions described in paragraph (b) of this section are satisfied, the annual benefit payable to an individual who was a participant in a defined benefit plan at any time before October 3, 1973, will not be considered to exceed the limitations of section 415(b) and §1.415–3(a). In the case of an individual who was a participant in more than one defined benefit plan at any time before October 3, 1973, the annual benefit payable to that individual from each plan will be deemed not to exceed the limitations of section 415(b) and §1.415–3(a) if the benefit from each plan satisfies all of the conditions described in paragraph (b) of this section.

(b) *Conditions for application of transitional rule.* The conditions are—

(1) The annual benefit payable to the participant does not exceed 100 percent of that participant's annual rate of compensation (as defined in paragraph (c) of this section) on October 2, 1973, or, if earlier, as of the date the participant separated from the service of the employer.

(2) The annual benefit payable to the participant does not exceed the annual benefit which would have been payable to the participant at any time if—

(i) All the terms and conditions of the plan which were actually in effect on October 2, 1973 (or if earlier, on the date the participant separated from the service of the employer) had remained in effect, and

(ii) The participant's compensation taken into account for determining benefits under the plan for any period after October 2, 1973, did not exceed his annual rate of compensation (as defined in paragraph (c) of this section) on that date.

(3) The annual benefit payable to a participant who separated from the service of the employer before October 2, 1973, does not exceed the participant's nonforfeitable accrued benefit under the plan as of the date he separated from service.

(c) *Special rules*—(1) *Annual rate of compensation.* For purposes of this section, a participant's annual rate of compensation for a particular calendar year shall be the greater of—

(i) The participant's compensation for that calendar year as determined in accordance with the rules provided in § 1.415–2(d), or

(ii) The compensation which would be used to determine benefits under the plan if the employee separated from the service of the employer on October 2, 1973, or, if earlier, the employee's actual date of separation from the service of the employer.

(2) *Cost-of-living adjustments.* (i) If the plan, as in existence on October 2, 1973, provided for a post-retirement cost of living adjustment to benefits, the adjustment may be taken into account in determining the participant's allowable benefit under paragraph (b) of this section. However, under paragraph (b)(2) of this section, if a plan is amended after October 2, 1973 to provide for cost-of-living benefit increases for retired participants, the transitional rule of this section will not apply to any increased benefit attributable to the amendment.

(ii) Any cost-of-living increase in the dollar limitation described in section 415(b)(1)(A) under section 415(d) and § 1.415–5(a) may be taken advantage of by an individual who is otherwise using the transitional rule set forth in this section. Thus, for example, if, due to cost-of-living increases under section 415(d) and § 1.415–5(a), the dollar limitation for 1981 is greater than $110,625, to the extent allowed under section 415(b), a plan may provide that an individual who is otherwise receiving a benefit of $110,625 per year under the transitional rule of this section, may receive the greater amount in 1981.

(3) *Retirement benefit beginning before age 55.* If a defined benefit plan provides a retirement benefit beginning before age 55, no actuarial adjustment of the benefit which can be provided under the transitional rule of this section is required to be made.

(4) *Retirement benefit payable in a form other than a straight life annuity.* If a defined benefit plan, as in existence on October 2, 1973, provided a retirement benefit in a form other than a straight life annuity, no actuarial adjustment (as otherwise required under § 1.415–3(c)) of the benefit which can be provided under the transitional rule of this section is required to be made. However, if the plan is amended after October 2, 1973, to provide a benefit of greater value than the benefit provided under the plan as of October 2, 1973, the transitional rule of this section will not apply to the increase in the value of the benefit attributable to the amendment. (See paragraph (b)(2)(i) of this section.)

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

Example (1). N, a participant in a noncontributory defined benefit plan maintained by his employer, retired on February 17, 1969, and became eligible to receive benefits under the plan. At that time, N had attained age 65, the normal retirement age under the plan. N's annual rate of compensation on February 17, 1969, was $90,000. Under the terms of the plan, as in effect on February 17, 1969, N was entitled to an annual benefit of $86,000, which was N's accrued nonforfeitable benefit as of that date. Because the annual benefit payable with respect to N (i) does not exceed 100 percent of N's compensation on February 17, 1969, (ii) does not exceed the annual benefit to which N was entitled on retirement, and (iii) did not exceed N's nonforfeitable accrued benefit on retirement, the plan may provide an annual benefit of $86,000 with respect to N for limitation years to which section 415 applies without violating the limitations imposed by section 415(b) and § 1.415–3.

Example (2). Assume the same facts as in example (1) except that on February 17, 1969, when N retired and became eligible to receive benefits under the plan, N had not attained the age of 55. Because the adjustment required under section 415(b)(2)(C) for retirement benefits beginning before age 55 is only applicable to the dollar limitation described in section 415(b)(1)(A), under paragraph (c)(3) of this section, no actuarial adjustment of the annual benefit of $86,000 payable with respect to N is required to be made. Therefore, the plan may pay annual benefits of $86,000 to N, even though N retires and is eligible to receive benefits before age 55.

[T.D. 7748, 46 FR 1703, Jan. 7, 1981]

§1.415–5 Cost of living adjustments for defined benefit plans.

(a) *Dollar limitation*—(1) *In general.* Under section 415(d)(1)(A), the dollar limitation described in section 415(b)(1)(A) applicable to defined benefit plans for limitation years to which section 415 applies is adjusted annually to take into account increases in the cost of living. The adjustment of the dollar limitation is made by multiplying an annual adjustment factor by $75,000. For purposes of this paragraph, the annual adjustment factor is to be determined by the Commissioner.

(2) *Effective date of adjustment.* The adjusted dollar limitation applicable to defined benefit plans is effective as of January 1 of each calendar year and applies with respect to limitation years ending with or within that calendar year.

(3) *Application of adjusted figure.* The adjusted dollar limitation is applicable to employees who are participants in a defined benefit plan and to employees who have retired or otherwise terminated their service under the plan with a nonforfeitable right to accrued benefits, regardless of whether they have actually begun to receive such benefits. However, for purposes of this subparagraph, the annual benefit payable to a terminated participant, which is otherwise limited by the dollar limitation, may only be increased in accordance with cost-of-living adjustments of the dollar limitation if the plan specifically provides for such post-retirement adjustments.

(b) *Average compensation for high 3 years of service limitation*—(1) *In general.* Under section 415(d)(1)(C), with regard to participants who have separated from service with a nonforfeitable right to an accrued benefit, the compensation limitation described in section 415(b)(1)(B) applicable to limitation years to which section 415 applies may be adjusted annually to take into account increases in the cost of living. For any limitation year beginning after the separation occurs, the adjustment of the compensation limitation is made by multiplying the annual adjustment factor (as defined in paragraph (b)(2) of this section) by the compensation limitation applicable to the participant in the limitation year he separated from the service of the employer. In the case of a participant who has separated from service prior to the first limitation year to which section 415 applies, the cost-of-living adjustment of the compensation limitation under this paragraph for all limitation years prior to the effective date of section 415 is to be determined as provided by the Commissioner. For purposes of the adjustment described in this subparagraph, the annual benefit payable to a terminated participant, which is otherwise limited by the compensation limitation, may only be increased in accordance with cost-of-living adjustments of the compensation limitation if the plan specifically provides for such post-retirement adjustments.

(2) *Annual adjustment factor for compensation limitation.* For any limitation year beginning after the separation occurs, the annual adjustment factor is a fraction, the numerator of which is the adjusted dollar limitation for the limitation year in which the compensation limitation is being adjusted and the denominator of which is the adjusted dollar limitation for the limitation year in which the participant separated from service. In determining the adjusted dollar limitation for purposes of computing the annual adjustment factor under this subparagraph, the rule provided in paragraph (a)(2) of this section (relating to the effective date of the adjusted dollar limitation) shall be applicable.

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

Example. X is a participant in a qualified defined benefit plan maintained by his employer. The plan has a calendar year limitation year. Under the terms of the plan, X is entitled to a benefit consisting of a straight life annuity equal to 100 percent of X's compensation for his high 3 years of service. X's average compensation for his high 3 years is

$20,000. X separates from the service of his employer on October 3, 1980, with a nonforfeitable right to his accrued benefit, and begins to receive benefit payments on November 1, 1980. Assume that the adjusted dollar limitation for 1980 is $100,000 and that the adjusted dollar limitation for 1981 is $110,000. For the limitation year beginning January 1, 1981 (the first limitation year beginning after X separates from service), the compensation limitation applicable to X may be adjusted for cost of living increases by multiplying the annual adjustment factor by $20,000. The annual adjustment factor for this limitation year is a fraction, the numerator of which is $110,000 (the adjusted dollar limitation for the limitation year in which the compensation limitation is being adjusted) and the denominator of which is $100,000 (the adjusted dollar limitation for the limitation year in which X separates from service). Thus, for the limitation year beginning January 1, 1981, if the plan provides for post-retirement cost of living adjustments, X's maximum annual benefit could be increased to $22,000 ($110,000/$100,000×$20,000).

(c) *Automatic cost of living adjustments of dollar limitation*—(1) *General rule.* A defined benefit plan may include a provision which provides for an annual automatic cost-of-living adjustment of the dollar limitation described in section 415(b)(1)(A) in accordance with paragraph (a) of this section. However, the provision may only provide for scheduled annual increases in the dollar limitation which become effective no sooner than the date determined in accordance with paragraph (a)(2) of this section.

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

Example. Plan A is a defined benefit plan. Effective January 1, 1976, the plan was amended to limit all participants' annual plan benefits, determined on a straight life annuity basis, to $75,000. The amendment also provides that, ''as of January 1 of each calendar year, the dollar limitation as determined by the Commissioner of Internal Revenue for that calendar year will become effective as the Maximum Permissible Dollar Amount of the plan for that calendar year. The Maximum Permissible Dollar Amount for a calendar year applies to limitation years ending with or within that calendar year.'' The amendment providing for an automatic cost-of-living adjustment of the dollar limitation of Plan A is an example of a provision which satisfies the requirements of subparagraph (1) of this paragraph.

[T.D. 7748, 46 FR 1704, Jan. 7, 1981]

§ 1.415–6 Limitation for defined contribution plans.

(a) *General rules*—(1) *Maximum limitations.* Under section 415(c) and this section, to satisfy the provisions of section 415(a) for any limitation year, the annual additions (as defined in paragraph (b) of this section credited to the account of a participant in a defined contribution plan (as defined in section 414(i))) for the limitation year may not exceed the lesser of—

(i) $25,000, or

(ii) 25 percent of the participant's compensation (as defined in subparagraph (3) of this paragraph) for the limitation year.

(2) *Adjustment to dollar limitation.* The dollar limitation described in section 415(c)(1)(A) and subparagraph (1)(i) of this paragraph is adjusted for cost of living increases under section 415(d) and paragraph (d) of this section. The adjusted figure is effective as of January 1 of each calendar year and applies to limitation years that end during that calendar year.

(3) *Participant's compensation.* For purposes of this section, the term ''participant's compensation'' for any limitation year has the same meaning as set forth in § 1.415–2(d). The term ''participant's compensation'' includes all compensation actually paid or made available to the individual for the entire limitation year even though the individual may not have been a participant for the entire limitation year.

(4) *Section 403(b) annuity contracts.* For special rules with respect to section 403(b) annuity contracts purchased by educational organizations, hospitals and home health service agencies, see paragrpah (e) of this section.

(b) *Annual additions*—(1) *In general*—(i) *Limitation years beginning after December 31, 1986.* For limitation years beginning after December 31, 1986, or such later date provided in paragraph (b)(1)(iii) of this section, the term ''annual addition'' means, for purposes of this section, the sum, credited to a participant's account for any limitation year, of:

(A) Employer contributions;

(B) Employee contributions; and

(C) Forfeitures.

Contributions do not fail to be annual additions merely because they are excess deferrals, excess contributions, or excess aggregate contributions or merely because excess contributions or excess aggregate contributions are corrected through distribution or recharacterization. Excess deferrals that are distributed in accordance with §1.402(g)–1(e) (2) or (3) are not annual additions.

(ii) *Limitation years beginning before January 1, 1987.* For limitation years beginning before January 1, 1987, or such later date provided in paragraph (b)(1)(iii) of this section, the term ''annual addition'' means, for purposes of this section, the sum, credited to a participant's account for any limitation year, of:

(A) Employer contributions;

(B) The lesser of the amount of employee contributions in excess of 6 percent of compensation (as defined in paragraph (a)(3) of this section) for the limitation year, or one-half of the employee contributions for that year; and

(C) Forfeitures.

(iii) *Certain collectively bargained plans.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, for contributions or benefits pursuant to a collective bargaining agreement, the date specified in this paragraph is:

(A) September 31, 1991, in the case of paragraph (b)(1)(i) of this section; and

(B) October 1, 1991, in the case of paragraph (b)(1)(ii) of this section.

(2) *Employer contributions.* (i) For purposes of paragraph (b)(1)(i) of this section, the term ''annual additions'' includes employer contributions which are made under the plan. Furthermore, the Commissioner may in an appropriate case, considering all of the facts and circumstances treat transactions between the plan and the employer or certain allocations to participants' accounts as giving rise to annual additions.

(ii) If, in a particular limitation year, an employer contributes an amount to a participant's account because of an erroneous forfeiture in a prior limitation year, or because of an erroneous failure to allocate amounts in a prior limitation year, the contribution will not be considered an annual addition with respect to the participant for that particular limitation year, but will be considered an annual addition for the limitation year to which it relates. An example of a situation in which an employer contribution might occur under the circumstances described in the preceding sentence is a retroactive crediting of service for an employee under 29 CFR 2530.200(b)–2(a)(3) (regulations promulgated by the Department of Labor) in accordance with an award of back pay. For purposes of this subdivision, if the amount so contributed in the particular limitation year takes into account actual investment gains attributable to the period subsequent to the year to which the contribution relates, the portion of the total contribution which consists of such gains is not considered as an annual addition for any limitation year. The rule described in this subdivision is only applicable for purposes of applying the limitations of section 415.

(iii) The restoration of an employee's accrued benefits by the employer in accordance with section 411(a)(3)(D) or section 411(a)(7)(C) will not be considered an annual addition for the limitation year in which the restoration occurs. (See §1.411(a)–7(d)(6)(iii)(B).)

(iv) The transfer of funds from one qualified plan to another will not be considered an annual addition for the limitation year in which the transfer occurs.

(v) In the case of a defined contribution plan (such as a money purchase pension plan) to which an employer makes a contribution in order to reduce an accumulated funding deficiency (as defined in section 412(a)), the contribution will be considered an annual addition for the limitation year when the contribution was otherwise required to have been made. The special rule provided in the preceding sentence is available however, only if the contribution is allocated to those participants who would have received an addition if the contribution had been timely made. For purposes of determining the amount of the annual addition under this subdivision, any reasonable amount of interest paid by the employer is disregarded. However, any interest paid by the employer that is in excess of a reasonable amount, as determined by the Commissioner, is taken into account as an annual addition for the limitation year when the contribution was otherwise required to have been made.

(vi) In the case of a defined contribution plan (such as a money purchase pension plan) for which there has been a waiver of the minimum funding standard in a prior limitation year in accordance with section 412(d), that portion of an employer contribution in a subsequent limitation year which, if not for the waiver, would have otherwise been required in the prior limitation year under section 412(a) will be considered an annual addition for the prior limitation year. For purposes of determining the amount of such annual addition for the prior limitation year, any reasonable amount of interest paid by the employer in addition to the actual make-up contribution is disregarded. However, any interest paid by the employer that is in excess of a reasonable amount, as determined by the Commissioner, is taken into account as an annual addition for the prior limitation year.

(3) *Employee contributions.* For purposes of paragraph (b)(1)(ii) of this section, the term ''annual additions'' includes, to the extent employee contributions would otherwise be taken into account under this section as an annual addition, mandatory employee contributions (as defined in section 411(c)(2)(C) and the regulations thereunder) as well as voluntary employee contributions. The term ''annual additions'' does not include—

(i) Rollover contributions (as defined in section 402(a)(5), 403(a)(4), 408(d)(3) and 409(b)(3)(C)),

(ii) Repayments of loans made to a participant from the plan,

(iii) Repayments of amounts described in section 411(a)(7)(B) (in accordance with section 411(a)(7)(C)) and section 411(a)(3)(D) (see § 1.411(a)–7(d)(6)(iii)(B)),

The direct transfer of employee contributions from one qualified plan to another.

However, the Commissioner may in an appropriate case, considering all of the facts and circumstances, treat transactions between the plan and the employee or certain allocations to participants' accounts as giving rise to annual additions.

(4) *Contributions other than cash.* For purposes of this paragraph, a contribution by the employer or employee of property other than cash will be considered to be a contribution in an amount equal to the fair market value (as defined in § 20.2031–1 of the Estate Tax Regulations) of the property on the date the contribution is made. The contribution described in this subparagraph may, however, constitute a prohibited transaction within the meaning of section 4975(c)(1).

(5) *Forfeitures.* With respect to a particular limitation year, forfeitures (as well as any income attributable to the forfeiture) will be considered to be an annual addition to the plan if such forfeitures are allocated to the account of the participant as of any day within that limitation year.

(6) *Excess annual additions.* If, as a result of the allocation of forfeitures, a reasonable error in estimating a participant's annual compensation, a reasonable error in determining the amount of elective deferrals (within the meaning of section 402(g)(3)) that may be made with respect to any individual under the limits of section 415, or under other limited facts and circumstances that the Commissioner finds justify the availability of the rules set forth in this paragraph (b)(6), the annual additions under the terms of a plan for a particular participant would cause the limitations of section 415 applicable to that participant for the limitation year to be exceeded, the excess amounts shall not be deemed annual additions in that limitation year if they are treated in accordance with any one of the following:

(i) The excess amounts in the participant's account must be allocated and reallocated to other participants in the plan. However, if the allocation or reallocation of the excess amounts pursuant to the provisions of the plan causes the limitations of section 415 to be exceeded with respect to each plan participant for the limitation year, then these amounts must be held unallocated in a suspense account. If a suspense account is in existence at any time during a particular limitation year, other than the limitation year described in the preceding sentence, all amounts in the suspense account must be allocated and reallocated to participants' accounts (subject to the limitations of section 415) before any employer contributions and employee contributions which would constitute annual additions may be made to the plan for that limitation year.

(ii) The excess amounts in the paticipant's account must be used to reduce employer contributions for the next limitation year (and succeeding limitation years, as necessary) for that participant if that participant is covered by the plan of the employer as of the end of the limitation year. However, if that participant is not covered by the plan of the employer as of the end of the limitation year, then the excess amounts must be held unallocated in a suspense account for the limitation year and allocated and reallocated in the next limitation year to all of the remaining participants in the plan in accordance with the rules set forth in paragraph (b)(6)(i) of this section. Furthermore, the excess amounts must be used to reduce employer contributions for the next limitation year (and succeeding limitation years, as necessary) for all of the remaining participants in the plan. For purposes of this subdivision, excess amounts may not be distributed to participants or former participants.

(iii) The excess amounts in the participant's account must be held unallocated in a suspense account for the limitation year and allocated and reallocated in the next limitation year to all of the participants in the plan in accordance with the rules provided in paragraph (b)(6)(i) of this section. The excess amounts must be used to reduce employer contributions for the next limitation year (and succeeding limitation years, as necessary) for all of the participants in the plan. For purposes of this subdivision, excess amounts may not be distributed to participants or former participants.

(iv) Notwithstanding paragraph (b)(6) (i), (ii), or (iii) of this section, the plan may provide for the distribution of elective deferrals (within the meaning of section 402(g)(3)) or the return of employee contributions (whether voluntary or mandatory), and for the distribution of gains attributable to those elective deferrals and employee contributions, to the extent that the distribution or return would reduce the excess amounts in the participant's account. These distributed or returned amounts are disregarded for purposes of section 402(g), the actual deferral percentage test of section 401(k)(3), and the actual contribution percentage test of section 401(m)(2). However, the return of mandatory employee contributions may result in discrimination in favor of highly compensated employees. If the plan does not provide for the return of gains attributable to the returned employee contributions, such earnings will be considered as an employee contribution for the limitation year in which the returned contribution was made. For limitation years beginning after December 31, 1995, if a plan does not provide for the distribution of gains attributable to the distributed elective deferrals, such earnings will be considered as an employer contribution for the limitation year in which the distributed elective deferral was made. If a suspense account is in existence at any time during the limitation year in accordance with this subparagraph, investment gains and losses and other income may, but need not, be allocated to the suspense account. To the extent that investment gains or other income or investment losses are allocated to the suspense account, the entire amount allocated to participants from the suspense account, including any such gains or other income or less any such losses, is considered as the annual addition. See §1.401(a)–2(b) for provisions relating to the disposition of a suspense account in existence upon termination of a plan.

(7) *Time when annual additions credited.* (i) For purposes of this paragraph, an annual addition is credited to the account of a participant for a particular limitation year if it is allocated to the participant's account under the terms of the plan as of any date within that limitation year. However, an amount is not deemed allocated as of any date within a limitation year if

such allocation is dependent upon participation in the plan as of any date subsequent to such date.

(ii) For purposes of this subparagraph, employer contributions shall not be deemed credited to a participant's account for a particular limitation year, unless the contributions are actually made to the plan no later than 30 days after the end of the period described in section 404(a)(6) applicable to the taxable year with or within which the particular limitation year ends. If, however, contributions are made by an employer exempt from Federal income tax under section 501(a), the contributions must be made to the plan no later than the 15th day of the sixth calendar month following the close of the taxable year (or fiscal year, if no taxable year) with or within which the particular limitation year ends.

(iii) For purposes of this subparagraph, employee contributions, whether voluntary or mandatory, shall not be deemed credited to a participant's account for a particular limitation year, unless the contributions are actually made to the plan no later than 30 days after the close of that limitation year. However, in the case of employee contributions to an employee stock ownership plan which meets the requirements of either section 301(d) of the Tax Reduction Act of 1975 (89 Stat. 38, § 1.46–7) and the regulations thereunder (§ 1.46–8) or section 409A and the regulations thereunder, such contributions shall be deemed credited to a participant's account in the limitation year for which the contribution is allocated to that account under the terms of the plan, provided that the contributions, or pledges to make the contributions, are actually made no later than the period described in section 404(a)(6) applicable to the taxable year with or within which the particular limitation year ends.

(iv) For purposes of this paragraph, amounts contributed to an individual retirement plan (as described in section 7701(a)(37)) are treated as allocated to the individual's account as of the last day of the limitation year ending with or within the taxable year for which the contribution is made.

(c) *Examples.* The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). P is a participant in a qualified profit-sharing plan maintained by his employer, ABC Corporation. The limitation year for the plan is the calendar year. P's compensation (as defined in paragraph (a)(3) of this section) for the current limitation year is $20,000 consisting exclusively of salary. Because the compensation limitation described in section 415(c)(1)(B) applicable to P for the current limitation year is lower than the dollar limitation described in section 415(c)(1)(A) (as adjusted for cost of living increases), the maximum annual addition which can be allocated to P's account for the current limitation year is $5,000 (25 percent of $20,000).

Example (2). Assume the same facts as in Example (1), except that P's compensation for the current limitation year is $140,000. The maximum amount of annual additions that may be allocated to P's account in the current limitation year may not exceed the lesser of $35,000 (25 percent of $140,000) or the dollar limitation as in effect as of January 1 of the calendar year in which the current limitation year ends.

Example (3). Assume the same facts as in Example (1), except that P's compensation for the current limitation year consists of $20,000 salary and a bonus which is paid to P after the end of the current limitation year. Because the bonus was not actually paid or made available to P within the current limitation year, P's compensation for that year, for purposes of computing the compensation limitation described in section 415(c)(1)(B), may not include the bonus. However, if ABC Corporation had elected under § 1.415–2(d)(4) to use the compensation accrued for the current limitation year, then the amount of the bonus which accrued within the current limitation year could have been taken into account.

Example (4). Employer N maintains a qualified profit-sharing plan which uses the calendar year as its plan year and its limitation year. N's taxable year is a fiscal year beginning June 1 and ending May 31. Under the terms of the profit-sharing plan maintained by N, employer contributions are made to the plan two months after the close of N's taxable year and are allocated as of the last day of the plan year ending within the taxable year. Thus, employer contributions for the 1977 calendar year limitation year are made on July 31, 1978 (the date that is two months after the close of N's taxable year ending May 31, 1978) and are allocated as of December 31, 1977. Because the employer contributions are actually made to the plan no later than 30 days after the end of the period described in section 404(a)(6) with respect to

N's taxable year ending May 31, 1978, the contributions will be considered annual additions for the 1977 calendar year limitation year.

Example (5). Assume the same facts as in example (4), except that the plan year for the profit-sharing plan maintained by N is the 12-month period beginning on March 1 and ending on February 28. Under the terms of the plan, an employer contribution which is made to the plan on July 31, 1978, is allocated to participants' accounts as of February 28, 1978. Because the last day of the plan year is in the 1978 calendar year limitation year, and because, under the terms of the plan, employer contributions are allocated to participants' accounts as of the last day of the plan year, the contributions are considered annual additions for the 1978 calendar year limitation year.

Example (6). XYZ Corporation maintains a profit-sharing plan to which a participant may make voluntary employee contributions for any year not to exceed 10 percent of the participant's compensation for the year. The plan permits a participant to make retroactive make-up contributions for any year for which he contributed less than 10 percent of compensation. XYZ uses the calendar year as the plan year and the limitation year. Under the terms of the plan, voluntary employee contributions are credited to a participant's account for a particular limitation year if such contributions are allocated to the participant's account as of any date within that limitation year. Participant A's compensation is as follows:

Limitation year and compensation

1976	$10,000
1977	$12,000
1978	$14,000
1979	$16,000

Participant A makes no voluntary employee contributions during limitation years 1976, 1977 and 1978. On October 1, 1979, participant A makes a voluntary employee contribution of $5,200 (10 percent of A's aggregate compensation for limitation years 1976, 1977, 1978 and 1979 of $52,000). Under the terms of the plan, $1,000 of this 1979 contribution is allocated to A's account as of limitation year 1976; $1,200 is allocated to A's account of limitation year 1977; $1,400 is allocated to A's account as of limitation year 1978, and $1,600 is allocated to A's account as of limitation year 1979. However, under the rule set forth in paragraph (b)(7)(iii) of this section, employee contributions will not be considered credited to a participant's account for a particular limitation year for section 415 purposes unless the contributions are actually made to the plan no later than 30 days after the close of that limitation year. Thus, A's voluntary employee contribution of $5,200 made on October 1, 1979 would be considered as credited to A's account only for the 1979 calendar year limitation year, notwithstanding the plan provisions. (See section 415(c)(2)(B) and paragraph (b)(1)(ii) of this section for provisions relating to the amount of A's contribution that would be considered an annual addition to A's account for the 1979 calendar year limitation year.)

(d) *Cost-of-living adjustment for defined contribution plans*—(1) *In general.* Under section 415(d)(1)(B), the dollar limitation described in section 415(c)(1)(A) applicable to limitation years to which section 415 applies is adjusted annually to take into account increases in the cost of living. See §1.415–5(a) for the procedure for making this adjustment and the effective date of the adjusted dollar limitation.

(2) *Automatic adjustments with respect to dollar limitation.* A defined contribution plan may include a provision which provides for an annual automatic cost of living adjustment of the dollar limitation described in section 415(c)(1)(A).

(e) *Special election for section 403(b) contracts purchased by educational organizations, hospitals and home health service agencies*—(1) *In general.* (i) An annuity contract described in section 403(b) is treated as a defined contribution plan for purposes of the limitations on contributions imposed by section 415. Thus, section 403(b) annuity contracts are subject to the rules regarding the amount of annual additions which may be made to a participant's account for any limitation year under section 415(C)(1) and paragraph (a)(1) of this section. Section 403(b) annuity contracts are also subject to the limitations imposed by section 403(b)(2)(A) with respect to the amount of employer contributions for the purchase of an annuity contract that may be excluded from the gross income of the employee on whose behalf the annuity contract is purchased. Therefore, unless a special election has been made as described in section 415(c)(4) and subparagraph (2) of this paragraph, the excludable amount of a contribution toward the purchase of a section 403(b) annuity contract for a particular taxable year is the lesser of the exclusion allowance computed under section 403(b)(2)(A) for that taxable year or the limitation imposed by section 415(c)(1) for the limitation year ending with or within that taxable year.

(ii) If the amount of contributions for an individual under a section 403(b) annuity contract for a taxable year exceeds the limitation of section 415(c)(1), then for purposes of computing the exclusion allowance under section 403(b)(2)(A) for future taxable years, the excess contribution is considered as an amount contributed by the employer for an annuity contract which was excludable from the employee's gross income for a prior taxable year under section 403(b)(2)(A)(ii). Thus, for future taxable years the exclusion allowance under section 403(b)(2)(A) is reduced by the amount of the excess contribution even though that amount was not excludable from the employee's gross income in the taxable year when it was made. For a special effective date for the rule provided in this subdivision, see § 1.415–1(f)(6).

(iii) For purposes of the limitation imposed by section 415(c)(1), the amount contributed toward the purchase of a section 403(b) annuity contact is treated as allocated to the employee's account as of the last day of the limitation year ending with or within the taxable year during which the contribution is made.

(iv) For rules relating to the limitation year applicable to an individual on whose behalf a section 403(b) annuity contract has been purchased, see § 1.415–2(b)(7).

(2) *Alternative limitations.* (i) Under section 415(c)(4) and this paragraph, a special election is permitted with respect to section 403(b) annuity contracts (including custodial accounts treated as section 403(b) annuity contracts) purchased by educational organizations (as described in section 170(b)(1)(A)(ii)), home health service agencies (as described in paragraph (e)(2)(vi) of this section) and hospitals. Instead of the compensation limitation described in section 415(c)(1)(B) otherwise applicable to the amount of annual additions that may be made to the account of a participant in a defined contribution plan in any limitation year, an individual on whose behalf a section 403(b) annuity contract has been purchased may elect to have substituted for such limitation the amounts described in subparagraph (3) (''(A) election limitation'') or (4) (''(B) election limitation'') of this paragraph. Instead of the exclusion allowance determined under section 403(b)(2)(A) otherwise applicable for the taxable year with or within which the limitation year ends to an individual on whose behalf a section 403(b) annuity contract has been purchased, an individual may elect to have substituted for such exclusion allowance the amount described in paragraph (e)(5) (''(C) election limitation'') of this section. The election shall be made at the time and in the manner prescribed in subparagraph (6) of this paragraph.

(ii) With respect to any limitation or taxable year, an election by an individual to have any one of the alternative limitations described in paragraph (e) (3), (4) or (5) of this section apply to contributions made on his behalf by the employer with respect to any section 403(b) annuity contract precludes an election to have any other of the alternative limitations apply for any future limitation or taxable year with respect to any section 403(b) annuity contract purchased by any employer of such individual.

(iii) With respect to any limitation year, an election by an individual to have paragraph (e)(3) of this section (''(A) election limitation'') apply to contributions made on his behalf by the employer with respect to any section 403(b) annuity contract precludes an election to have any of the alternative limitations apply for any future limitation or taxable year with respect to any section 403(b) annuity contract purchased by any employer of such individual.

(iv) Any election made under this paragraph is irrevocable.

(v) The election made by the individual under this paragraph shall be controlling for all prior taxable years in which, in accordance with § 11.415(c)(4)–1(b), the individual had taken advantage of an alternative limitation, even if inconsistent with the alternative limitation used in determining income tax liability for those taxable years under that section. An individual, who took advantage of an alternative limitation under § 11.415(c)(4)–1(b) which is inconsistent with the one finally elected, may correct this inconsistency for each prior open taxable year in either of two ways. The individual may redetermine income tax liability as though none of the alternative limitations applied for that taxable year. Alternatively, the individual may recompute income tax liability for the particular taxable year in a manner consistent with the alternative limitation elected by the individual under this paragraph rather than the limitation originally used in accordance with §11.415(c)(4)–1(b). Furthermore, if an individual, who had taken advantage of an alternative limitation in prior taxable years under §11.415(c)(4)–1(b), elects under this paragraph not to have any of the alternative limitations apply, the individual, will, nevertheless, be considered to have elected the alternative limitation used under §11.415(c)(4)–1(b). However, the rule described in the preceding sentence is not applicable if the individual recomputes income tax liability for all prior open taxable years in which an alternate limitation was taken advantage of under §11.415(c)(4)–1(b) as though none of the alternative limitations applied for those taxable years. For purposes of section 6654 (relating to the failure of an individual to pay estimated tax), a difference in tax for such years resulting from a difference in these limitations is not treated as an underpayment. This rule only applies to the extent the difference in tax is due to the election of one of the alternative limitations or to a final election not to use one of the alternative limitations.

(vi) For purposes of this paragraph, a home health service agency is an organization described in section 501(c)(3) which is exempt from tax under section 501(a) and which has been determined by the Secretary of Health, Education and Welfare to be a home health service agency under section 1395x(o) of Title 42 of the United States Code.

(3) *''(A) election limitation.''* For the limitation year that ends with or within the taxable year in which an individual eligible to make a special election separates from the service of his employer (and only for that limitation year), the ''(A) election limitation'' is the exclusion allowance computed under section 403(b)(2)(A) for the individual's taxable year in which the separation occurs (without regard to section 415). However, in determining this limitation, there may only be taken into account the individual's years of service for the employer (as defined in section 403(b)(4) and the regulations thereunder) and contributions made by the employer (as described in section 403(b)(2)(A)(ii) and regulations thereunder) during the period of years (not exceeding 10) ending on the date of separation. For purposes of this subparagraph, all service for the employer performed within the period beginning ten years before the date of separation and ending on the separation date must be taken into account. However, the ''(A) election limitation'' may not exceed the dollar limitation described in section 415(c)(1)(A) (as adjusted for cost-of-living increases under section 415(d)(1) and paragraph (d) of this section) applicable to the individual for the limitation year.

(4) *''(B) election limitation.''* For any limitation year with respect to an individual eligible to make a special election, the ''(B) election limitation'' is equal to the least of the following amounts—

(i) $4,000, plus 25 percent of the participant's includible compensation (as defined in section 403(b)(3) and the regulations thereunder) for the taxable year with or within which the limitation year ends.

(ii) The amount of the exclusion allowance determined under section 403(b)(2)(A) and the regulations thereunder for the taxable year with or within which the limitation year ends.

(iii) $15,000.

(5) *''(C) election limitation.''* For any taxable year with respect to an individual eligible to make a special election, the ''(C) election limitation'' is the lesser of the dollar limitation described in section 415(c)(1)(A) (as adjusted for cost-of-living increases under section 415(d)(1) and paragraph (d) of this section) or the compensation limitation described in section 415(c)(1)(B) applicable to the individual for the limitation year ending with or within that taxable year. For purposes of determining the compensation limitation under this subparagraph for a

particular limitation year, the term ''compensation'' has the same meaning as set forth in § 1.415–2(d).

(6) *Time and method of making election.* (i) With respect to any taxable year, an election by an individual to take advantage of any of the alternative limitations described in subparagraphs (3), (4) or (5) of this paragraph is made by determining income tax liability for that taxable year in a way which is consistent with one of the alternative limitations. However, an individual is only considered to have made an election for a taxable year when the use of one of the alternative limitations is necessary to support the exclusion from gross income reflected in the individual's income tax return for that taxable year.

(ii) In the case of an individual who, in accordance with § 11.415(c)(4)–1(b), took advantage of one of the alternative limitations for prior taxable years, the election described in this paragraph to take advantage of an alternative limitation will be effective only if the following two conditions are satisfied. The first condition is that the election must be made (in the manner described in subdivision (i) of this subparagraph) in the individual's income tax return for the taxable year immediately following the taxable year in which final regulations under section 415 are published in the FEDERAL REGISTER. The second condition is that if the individual's election is different from the limitation used under § 11.415(c)(4)–1(b) in determining income tax liability for prior taxable years, the individual must correct this inconsistency by recomputing income tax liability for all such prior open taxable years in accordance with paragraph (e)(2)(v) of this section. See paragraph (e)(2)(v) of this section for rules relating to an individual who had taken advantage of an alternative limitation in prior taxable years under § 11.415(c)(4)–1(b) but does not elect any of the alternative limitations for the taxable year immediately following the taxable yar in which final regulations under section 415 are published in the FEDERAL REGISTER.

(iii) This subdivision provides a special rule for those individuals who, in accordance with § 11.415(c)(4)–1(b), took advantage of one of the alternative limitations for prior taxable years, but who are not participating in a section 403(b) annuity program in the taxable year following the taxable year in which final regulations under section 415 are published in the FEDERAL REGISTER. In such a situation, the election described in this paragraph to take advantage of an alternative limitation (or, alternatively, not to elect any of the alternative limitations) is made by the individual by attaching a statement to the income tax return for the taxable year following the taxable year in which final section 415 regulations are published in the FEDERAL REGISTER. The statement must include the individual's name, address, Social Security number, the name of the section 403(b) annuity program in which the individual participated and a statement indicating the election being made. See paragraph (e)(2)(v) of this section for rules relating to the situation where the individual described in this subdivision chooses not to elect any of the alternative limitations.

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

Example (1). Doctor M is an employee of H Hospital (an organization described in section 501(c)(3) and exempt from taxation under section 501(a)) for the entire 1976 calendar year. M is not in control of any employer within the meaning of section 414 (b) or (c), as modified by section 415(h). M uses the calendar year as the taxable year and limitation year. M has includable compensation (as defined in section 403(b)(3) and the regulations thereunder) and compensation (as defined in paragraph (a)(3) of this section) for taxable year 1976 of $30,000, and M has 4 years of service (as defined in § 1.403(b)–1(f)) with H as of December 31, 1976. During M's prior service with H, H had contributed a total of $12,000 on M's behalf for annuity contracts described in section 403(b), which amount was excludable from M's gross income for such prior years. Thus, for the limitation year ending with or within taxable year 1976, M's exclusion allowance determined under section 403(b)(2)(A) is $12,000 ((.20 × $30,000 4) — $12,000). The limitation imposed by section 415(c)(1) that is applicable to M for limitation year 1976 is the lesser of $26,825 (the amount described in section 415(c)(1)(A) adjusted under section 415(d)(1)(b) for limitation year 1976) or $7,500 (the amount described in section 415(c)(1)(B)). Absent the special elections provided in section

415(c)(4) and this paragraph, $7,500 would be the maximum contribution H could make for annuity contracts described in section 403(b) on M's behalf for limitation year 1976 without increasing M's gross income for taxable year 1976. However, because H is an organization described in section 415(c)(4), M may make a special election with respect to amounts contributed by H on M's behalf for section 403(b) annuity contracts for 1976. Assume that M does not separate from the service of H during 1976 and that, therefore, the ''(A) election limitation'' described in section 415(c)(4)(A) and subparagraph (3) of this paragraph is not available to M. If M elects the ''(B) election limitation'' for 1976, H could contribute $11,500 on M's behalf for annuity contracts described in section 403(b) for that year (the least of $11,500 (the amount described in section 415(c)(4)(B)(i))); $12,000 (the amount described in section 415(c)(4)(B)(ii)); and $15,000 (the amount described in section 415(c)(4)(B)(iii)). If M elects the ''(C) election limitation'' for 1976, H could only contribute up to $7,500 (the lower of the amounts described in section 415(c)(1) (A) or (B)) for section 403(b) annuity contracts on M's behalf for 1976 without increasing M's gross income for that year.

Example (2). Assume the same facts as in example (1) except that H had contributed a total of $18,000 on M's behalf for annuity contracts in prior years, which amount was excludable from M's gross income for such prior years. Accordingly, for 1976, M's exclusion allowance determined under section 403(b)(2)(A) is $6,000 ((.20 × $30,000 × 4)—$18,000). The limitation imposed by section 415(c)(1) applicable to M for 1976 is $7,500 (the lesser of the amount described in section 415(c)(1) (A) or (B)). Absent the special elections provided in section 415(c)(4) and this paragraph, $6,000 would be the maximum amount H could contribute for annuity contracts described in section 403(b) on M's behalf for 1976 without increasing M's gross income for that year. However, if M elects the ''(c) election limitations'' for 1976, H may contribute up to $7,500 without increasing M's gross income for that year.

Example (3). G, a teacher, is an employee of E, an educational organization described in section 170(b)(1)(A)(ii). G uses the calendar year as the taxable year and G uses the 12-month consecutive period beginning July 1 as the limitation year. G has includible compensation (as defined in section 403(b)(3) and the regulations thereunder) for taxable year 1976 of $12,000 and G has compensation (as defined in paragraph (a)(3) of this section) for the limitation year ending with or within taxable year 1976 of $12,000. G has 20 years of service (as defined in § 1.403(b)–1(f)) as of May 30, 1976, the date G separates from the service of E. During G's service with E before taxable year 1976, E had contributed $34,000 toward the purchase of a section 403(b) annuity contract on G's behalf, which amount was excludable from G's gross income for such prior years. Of this amount, $19,000 was so contributed and excluded during the 10 year period ending on May 30, 1976. For the taxable year 1976, G's exclusion allowance determined under section 403(b)(2)(A) is $14,000 ((.20 × $12,000 × 20) — $34,000). Absent the special elections described in section 415(c)(4) and this paragraph, $3,000 (the lesser of G's exclusion allowance for taxable year 1976 or the section 415(c)(1) limitation applicable to G for the limitation year ending with or within such taxable year) would be the maximum excludable contribution E could make for section 403(b) annuity contracts on G's behalf for the limitation year ending with or within taxable year 1976. However, because E is an organization described in section 415(c)(4), G may make a special election with respect to amounts contributed on G's behalf by E for section 403(b) annuity contracts for the limitation year ending with or within taxable year 1976.

Because G has separated from the service of E during such taxable year, G may elect the ''(A) election limitation'' as well as the ''(B) election limitation'' or the ''(C) election limitation.'' If G elects the ''(A) election limitation'' for the limitation year ending with or within taxable year 1976, E could contribute up to $5,000 ((.20 × $12,000 × 10) −$19,000) on G's behalf for section 403(b) annuity contracts for such limitation year without increasing G's gross income for the taxable year with or within which such limtation year ends. If G elects the ''(B) election limitation'' for such limitation year, E could contribute $7,000 (the least of $7,000 (the amount described in section 415(c)(4)(B)(i)); $14,000 (the amount described in section 415(c)(4)(B)(ii)); and $15,000 (the amount described in section 415(c)(4)(B)(iii)). If G elects the ''(C) election limitation'' for taxable year 1976, E could contribute $3,000 (the lesser of the amounts described in section 415(c)(1) (A) or (B)).

(f) *Special rules with respect to the application of section 415(c)(1)(B) with section 404(e)(4).* For special rules relating to the application of the compensation limitation described in section 415(c)(1)(B) with the minimum allowable deduction described in section 404(e)(4) in the case of a plan which provides contributions for employees, some or all of whom are employees within the meaning of section 401(c)(1), see the regulations under section 404(e).

(g) *Special rules for employee stock ownership plans*—(1) *General definitions.* For purposes of this paragraph—(i) An employee stock ownership plan is a plan which meets the requirements of either section 4975(e)(7) and the regulations thereunder, or whichever of the following is applicable: section 301(d) of the Tax Reduction Act of 1975 (89 Stat. 38, 26 CFR 1.46–7) and the regulations thereunder (26 CFR 1.46–8) or section 409A and the regulations thereunder.

(ii) The term ''employer securities'' means, in the case of an employee stock ownership plan within the meaning of section 4975(e)(7) and the regulations thereunder, qualifying employer securities within the meaning of section 4975(e)(8), that are also described in section 301(d)(9)(A) of the Tax Reduction Act of 1975 and the regulations thereunder or section 409A(l) and the regulations thereunder, whichever is applicable. In the case of an employee stock ownership plan described in section 301(d)(2) of the Tax Reductions Act of 1975 or section 409A, whichever is applicable, such term means employer securities within the meaning of section 301(d)(9)(A) of that Act and the regulations thereunder or section 409A(l) and the regulations thereunder, which ever is applicable.

(iii) An individual is considered to own more than 10 percent of the employer's stock if, without regard to stock held under the employee stock ownership plan, the individual owns (after application of section 1563(e), relating to constructive ownership of stock) more than 10 percent of the total combined voting power of all classes of stock entitled to vote or more than 10 percent of the total value of shares of all classes of stock.

(2) *Special dollar limitation.* In the case of an employee stock ownership plan which meets the requirements of paragraph (g)(3) of this section, the applicable dollar limitation for a limitation year equals the sum of—

(i) The dollar amount described in section 415(c)(1)(A) (as so adjusted for that limitation year), and

(ii) The lesser of the amount determined under paragraph (g)(2)(i) of this section or the amount of employer securities within the meaning of paragraph (g)(1)(ii) of this section contributed to the employee stock ownership plan.

(3) *Employee stock ownership plans to which the special dollar limitation applies.* For purposes of this paragraph, the special dollar limitation is only applicable to an employee stock ownership plan for a particular limitation year for which no more than one-third of the employer contributions for the limitation year are allocated to employees who are officers, shareholders owning more than 10 percent of the employer's stock (as determined under subparagraph (1)(iii) of this paragraph), or whose compensation for the limitation year exceeds twice the dollar amount described in section 415(c)(1)(A) (as adjusted for cost-of-living increases under section 415(d)(1) and paragraph (d) of this section).

(4) *Cash contributions treated as contributions of employer securities.* For purposes of the special dollar limitation—

(i) In the case of an employee stock ownership plan in which the employer makes cash contributions which are used in a direct acquisition of employer securities, the cash contributions are treated as a contribution of employer securities for the limitation year, provided that the securities are employer securities within the meaning of paragraph (g)(1)(ii) of this section and are allocated to participants under the terms of the plan as of any date within that limitation year. However, this subdivision is not applicable unless the following two conditions are satisfied. The first condition is that the employer must contribute the cash to the plan no later than 30 days after the end of the period described in section 404(a)(6) applicable to the taxable year with or within which the particular limitation year ends. The second condition is that the employer securities must be purchased no later than 60 days after the end of the period described in the preceding sentence.

(ii) In the case of an employee stock ownership plan to which an exempt loan as described in §54.4975–7(b) has been made, the employer's contribution of both principal and interest used to repay the exempt loan for the limitation year will be treated as a contribution of employer securities for that limitation year, provided that the securities allocated to participants are employer securities within the meaning of paragraph (g)(1)(ii) of this section.

(5) *Amounts considered as annual additions.* For purposes of applying the limitations of section 415(c)(1) and this section and for the special dollar limitation, in the case of an employee stock ownership plan to which an exempt loan as described in §54.4975–7(b) has been made, the amount of employer contributions which is considered an annual addition for the limitation year is calculated with respect to employer contributions of both principal and interest used to repay the exempt loan for that limitation year.

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

Example (1). Employee N is a participant in an employee stock ownership plan maintained by his employer, M Corporation, which meets the requirements of section 4975(e)(7) and the regulations thereunder. The plan also meets the requirements set forth in subparagraph (3) of this paragraph. M does not maintain any other qualified plan. The limitation year for the plan is the calendar year. For 1977, N has compensation (as defined in paragraph (a)(3) of this section) of $160,000. Without the special dollar limitation described in subparagraph (2) of this paragraph, under section 415(c)(1), N could only have annual additions of $28,175 (the lesser of the dollar limitation described in section 415(c)(1)(A) as adjusted for cost of living increases ($28,175) or the compensation limitation described in section 415(c)(1)(B) (25% of $160,000=$40,000)) made to his account for the 1977 limitation year. Under the special dollar limitation, N would be able to have annual additions of $56,350 ($28,175×2) made to his account for the 1977 limitation year, provided that amounts contributed in excess of $28,175 consist solely of employer securities. However, N is also subject to the compensation limitation described in section 415(c)(1)(B). Therefore, even under the special dollar limitation, N may only have annual additions of $40,000 made to his account for the 1977 limitation year: *Provided,* That amounts contributed in excess of $28,175 consist solely of employer securities within the meaning of paragraph (g)(1)(ii) of this section.

Example (2). Assume the same facts as in example (1), except that N's compensation for 1977 is $300,000. Because the compensation limitation (25% of $300,000=$75,000) is greater than the special dollar limitation of $56,350, N can have annual additions of $56,350 made to his account for the 1977 limitation year, provided that amounts contributed in excess of $28,175 consist solely of employer securities.

(h) *Special rules for level premium annuity contracts under plans benefiting owner-employees*—(1) *In general.* The compensation limitation described in section 415(c)(1)(B) will not be less than the contribution described in section 401(e) which is made for the benefit of an owner-employee (within the meaning of section 401(c)(3)) for a limitation year provided that—

(i) The annual additions with respect to such owner-employee for the limitation year consist solely of the contributions described in this paragraph, and

(ii) The owner-employee is not a participant at any time during the limitation year in a defined benefit plan maintained by the employer.

(2) *Application of the non-discrimination rules.* In the case of a plan which provides contributions for employees who are not owner-employees, that plan will not be treated as failing to satisfy the non-discrimination rules of section 401(a)(4) merely because contributions made on behalf of employees who are not owner-employees are not permitted to exceed the compensation limitation described in section 415(c)(1)(B).

(3) *Additional rules.* For additional rules concerning contributions described in section 401(e), see §1.401(e)–4.

[T.D. 7748, 46 FR 1705, Jan. 7, 1981, as amended by T.D. 8357, 56 FR 40549, Aug. 15, 1991; 57 FR 10290, Mar. 25, 1992; T.D. 8581, 59 FR 66181, Dec. 23, 1994]

§1.415–7 Limitation in case of defined benefit and defined contribution plan for same employee.

(a) *Overall limitation*—(1) *In general.* Under section 415(e) and this section, in any case in which an individual has at any time participated in a defined benefit plan and also has at any time participated in a defined contribution plan maintained by the same employer, to satisfy the provisions of section 415(a), the sum of the defined benefit plan fraction (as defined in paragraph (b) of this section) and the defined contribution plan fraction (as defined in paragraph (c) of this section) with respect to that participant for any limitation year may not exceed 1.4.

(2) *Application of overall limitation to employee stock ownership plan.* An employee stock ownership plan which qualifies for, and takes advantage of, the special dollar limitation provided in section 415(c)(6) and § 1.415–6(g) is still subject to the 1.4 limitation of paragraph (a)(1) of this section.

(b) *Defined benefit plan fraction*—(1) *In general.* For purposes of paragraph (a) of this section, the defined benefit plan fraction applicable to a participant for any limitation year is a fraction—

(i) The numerator of which is the projected annual benefit (as defined in subparagraph (3) of this paragraph) of the participant under the plan (determined as of the close of the limitation year), and

(ii) The denominator of which is the projected annual benefit (as defined in subparagraph (3) of this paragraph) of the participant under the plan (determined as of the close of the limitation year) if the plan provided such participant the maximum benefit allowable under § 1.415–3.

In the event a participant has participated in more than one defined benefit plan maintained by the employer, the numerator of the defined benefit plan fraction is the sum of the projected annual benefits under all of the defined benefit plans.

(2) *Participants described in section 2004(d)(2) of the Employee Retirement Income Security Act of 1974.* For purposes of this paragraph, in the case of a participant described in section 2004(d)(2) of the Employee Retirement Income Security Act of 1974 (Pub. L. 93–406, 88 Stat. 987), the defined benefit plan fraction applicable to such participant is deemed not to exceed 1.0 for any limitation year to which section 415 and this section apply.

(3) *Projected annual benefit.* For purposes of this section, a participant's ''projected annual benefit'' is equal to the annual benefit (as defined in § 1.415–3(b)(1)(i)) to which a participant in a defined benefit plan would be entitled under the terms of the plan based upon the following assumptions:

(i) The participant will continue employment until reaching normal retirement age as determined under the terms of the plan (or current age, if that is later).

(ii) The participant's compensation for the limitation year under consideration will remain the same until the date the participant attains the age described in subdivision (i) of this subparagraph.

(iii) All other relevant factors used to determine benefits under the plan for the limitation year under consideration will remain constant for all future limitation years.

(c) *Defined contribution plan fraction*—(1) *In general.* For purposes of paragraph (a) of this section, the defined contribution plan fraction applicable to a participant for any limitation year is a fraction—

(i) The numerator of which is the sum of the annual additions to the participant's account as of the close of the limitation year and for all prior limitation years, and

(ii) The denominator of which is the sum of the maximum amount of annual additions which could have been made under section 415(c) § 1.1415–6(a) (determined without regard to the special dollar limitation provided for employee stock ownership plans under section 415(c)(6) and § 1.415–6(g)) for the limitation year and for each prior limitation year of the participant's service with the employer (regardless of whether a plan was in existence during those years).

For purposes of this paragraph, the term ''annual additions'' has the same meaning as set forth in § 1.415–6(b).

(2) *Special rules for certain annuity contracts and individual retirement plans.* (i) Except as provided in subdivision (ii) of this subparagraph, in computing the defined contribution plan fraction applicable to an individual on whose behalf a section 403(b) annuity contract has been purchased, the amount which is included in the denominator of such fraction for a particular limitation year is the maximum amount which could have been contributed under the limitations of section 415(c) and § 1.415–6(a) applicable to the individual for the particular limitation year. However, if the individual elects an alternative limitation described in either section 415(c)(4)(A) or section 415(c)(4)(B) for a particular limitation year, the denominator of the fraction for such limitation year is the maximum amount

which could have been contributed under the applicable limitations of section 415(c) and §1.415–6(a), as modified by the alternative limitation elected.

(ii) This subdivision provides a rule for computing the defined contribution plan fraction with respect to an individual on whose behalf a section 403(b) annuity has been purchased prior to commencing employment with an employer which the individual controls (within the meaning of section 414 (b) or (c), as modified by section 415(h)) and which maintains a defined benefit plan. In this situation, the controlled employer is considered to be maintaining the section 403(b) annuity contract as a defined contribution plan under the rules of paragraph (h)(2)(i) of this section. However, for all years prior to commencing employment with the controlled employer, the individual does not have any years of service (within the meaning of subparagraph (1)(ii) of this paragraph) with that employer. Thus, for each limitation year in which such individual did not have a year of service with the controlled employer, the denominator of the defined contribution plan fraction applicable to the individual is deemed to equal the numerator of that fraction.

(iii) The rules described in this paragraph also apply to an individual on whose behalf an individual retirement plan (as described in section 7701(a)(37)) has been maintained.

(iv) See paragraph (h)(4) of this section for special rules relating to the aggregation of a section 403(b) annuity contract and a qualified plan.

(d) *Special transitional rules for defined contribution plan fraction.* For purposes of determining the defined contribution plan fraction under paragraph (c) of this section for any limitation year beginning after December 31, 1975, the following rules shall apply with respect to limitation years before the first limitation year to which section 415 and this section apply.

(1) The aggregate amount taken into account under paragraph (c)(1)(i) of this section in determining the numerator of the defined contribution plan fraction is deemed not to exceed the aggregate amount taken into account under paragraph (c)(1)(ii) of this section in determining the denominator of the fraction. Thus, for example, if the aggregate amount of actual annual additions to the plan for all such limitation years is $500,000, while the aggregate amount in the denominator is $250,000, under the rule set forth in this subparagraph, the defined contribution plan fraction is $250,000 divided by $250,000, or 100 percent.

(2) The amount taken into account under section 415(c)(2)(B)(i) for each such limitation year is an amount equal to—

(i) The amount by which the aggregate amount of employee contributions (whether voluntary or mandatory) for all limitation years beginning before January 1, 1976, during which the employee was a participant in the plan exceeds 10 percent of the employee's aggregate compensation from the employer for all such limitation years, divided by

(ii) The number of full limitation years (counting any part of a limitation year as a full limitation year) beginning before January 1, 1976, during which the employee was a participant in the plan. Therefore, for purposes of computing the numerator of a participant's defined contribution plan fraction for limitation years beginning after December 31, 1975, no employee contributions made to the plan before the first limitation year to which section 415 and this section apply are taken into account as annual additions if the aggregate amount of the contributions does not exceed 10 percent of the employee's aggregate compensation from the employer for all limitation years prior to the first such limitation year.

(3) The special transitional rule concerning employee contributions provided for in paragraph (d)(2) of this section does not apply to any employee contributions (whether voluntary or mandatory) made on or after October 2, 1973, to the extent that these contributions exceed the maximum amount of employee contributions permitted under the plan as in effect on October 2, 1973. For purposes of the preceding sentence, plan amendments approved by the Internal Revenue Service before October 2, 1973, and actually put into effect before January 1, 1974, are considered in effect on October 2, 1973.

Therefore, for purposes of computing the numerator of the defined contribution plan fraction for limitation years beginning after December 31, 1975, employee contributions made between October 2, 1973 and prior to the first limitation year to which section 415 and this section apply which exceed the maximum amount the employee was permitted to contribute under the provisions of the plan as in effect on October 2, 1973, are taken into account as annual additions (within the meaning of § 1.415–6(b)(1)(ii)).

(4) For purposes of this paragraph, the participant's aggregate compensation for all years (whichever are applicable under either paragraph (d)(1) or (2) of this section) with the employer before the first limitation year to which section 415 applies equals the product of the participant's compensation during the first limitation year to which section 415 applies times the number of such applicable years. However, this special rule is available only if records necessary for the determination of the participant's aggregate compensation for all such applicable years with the employer before the first limitation year to which section 415 applies are not available.

(e) *Examples.* The provisions of paragraphs (a) through (d) of this section may be illustrated by the following examples:

Example (1). (i) S is an employee of T Corporation and is a participant in both the noncontributory defined benefit plan and noncontributory defined contribution plan maintained by the corporation. S became an employee of T on July 1, 1966. S became a participant in the defined benefit plan maintained by T on January 1, 1968 and he became a participant in the defined contribution plan maintained by T on January 1, 1970. T uses the calendar year as the limitation year for both plans. The current limitation year is 1978. S's compensation (as defined in § 1.415–2(d)) from T is as follows:

Limitation year	Compensation
1966	$3,000
1967	6,000
1968	6,000
1969	8,000
1970	8,000
1971	8,000
1972	9,000
1973	10,000
1974	10,000
1975	11,000
1976	11,000
1977	12,000
1978	12,000

(ii) S's projected annual benefit (as defined in paragraph (b)(3) of this section) as of the close of the current limitation year under the terms of the plan is $9,000. S's compensation for the current limitation year is $12,000. Therefore, the defined benefit plan fraction applicable to S for the current limitation year is .75 or 75 percent (9,000 ÷ 12,000). S's defined contribution compensation limitation (as described in section 415(c)(1)(B)) for the current limitation year is $3,000 (25 percent of $12,000). For all limitation years beginning before January 1, 1978, the maximum aggregate amount of annual additions which could have been allocated to S's account under the defined contribution plan is $25,500 (aggregate compensation of $102,000 for all years of service with T Corporation × 25 percent). Assume that annual additions totaling $11,400 have been allocated to S's account as of the end of the current limitation year. Therefore, S's defined contribution plan fraction as of the end of the current limitation year equals

$$\frac{\$11{,}400}{\$25{,}500+\$3{,}000}=\frac{\$11{,}400}{\$28{,}500}=40 \text{ or } 40 \text{ percent}$$

Because the sum (115 percent) of the defined benefit plan fraction (75 percent) and the defined contribution plan fraction (40 percent) applicable to S for the current limitation year does not exceed 140 percent, the limitations of section 415(e) and this section are not exceeded.

Example (2). Assume the same facts as in example (1) except that the defined contribution plan maintained by T Corporation provides for mandatory employee contributions of 6% of compensation and voluntary employee contributions of 10% of compensation. Assume further that S made the maximum allowable employee contributions under the plan for each limitation year (including the current limitation year) during which he was a participant. For limitation years beginning before January 1, 1976, S made total employee contributions of $8,960. However, because of the special transitional rule applicable to the defined contribution plan fraction with respect to employee contributions for limitation years beginning before January 1, 1976 (as described in paragraph (d)(2) of this section), only $560 of the total employee contributions of $8,960 made by S will be considered an annual addition for each of those limitation years in which S was a participant in the plan total employee contributions for limitation years in which S participated in the plan beginning before January 1, 1976 of $8,960 minus $5,600 (10 percent of total compensation of $56,000 for such years) divided by 6 (the number of such years in which S was a participant in the plan). Thus, in determining the numerator of the defined contribution plan fraction applicable to S, because S was a participant in the plan for 6 limitation years beginning before January 1, 1976, the total amount of employee contributions that must be taken into account as annual additions for such limitation years is $3,360 ($560 × 6). For limitation years beginning after January 1, 1976, S made contributions of $1,760 (for limitation year 1976), $1,920 (for limitation year 1977) and $1,920 (for limitation year 1978, the current limitation year). The amount of annual additions attributable to such contributions under section 415(c)(2)(B) is $880 (for limitation year 1976), $960 (for limitation year 1977) and $960 (for the current limitation year), for a total of $2,800. Thus, the defined contribution plan fraction applicable to S for the current limitation year is

$$\frac{\$3{,}360+\$2{,}800+\$11{,}400}{\$28{,}500}=\frac{\$17{,}560}{\$28{,}500}=62 \text{ or } 62 \text{ percent}$$

Because the sum (137 percent) of the defined benefit plan fraction (75 percent) and the defined contribution plan fraction (62 percent) applicable to S for the current limitation year does not exceed 140 percent, the limitations of section 415(e) and this section are not exceeded.

Example (3). (i) A is an employee of M Corporation and is a participant in both the noncontributory defined benefit plan and noncontributory defined contribution plan maintained by the corporation. A became an employee of M on January 1, 1969 and immediately became a participant in both plans. M uses the calendar year as the limitation year for both plans. The current limitation year is 1978. A's compensation (as defined in §1.415–2(d)) from M is as follows:

Limitation year	Compensation
1969	$100,000
1970	120,000
1971	130,000
1972	160,000
1973	200,000
1974	240,000
1975	280,000
1976	320,000
1977	400,000
1978	460,000

(ii) A is a participant described in section 2004(d)(2) of the Employee Retirement Income Security Act of 1974. A's projected annual benefit (as defined in paragraph (b)(3) of this section) as of the close of the current limitation year under the terms of the defined benefit plan is $100,000. The defined benefit dollar limitation (as described in section 415(b)(1)(A)) applicable to A for the current limitation year is $90,150. Absent the provisions of paragraph (b)(2) of this section, the defined benefit plan fraction applicable to A for the current limitation year would be 1.11 or 111 percent. However, under the provisions of paragraph (b)(2) of this section, for purposes of computing the overall 1.4 limitation imposed by section 415(e) and this section applicable to A for the current limitation year and all future limitation years, A's defined benefit plan fraction is considered to equal 1.0 or 100 percent.

(iii) A's defined contribution dollar limitation (as described in section 415(c)(1)(A)) for the current limitation year is $30,050. For the 9 limitation years ending before January 1, 1978, the maximum amount of annual additions which could have been allocated to A's account under the defined contribution plan is $230,000 ($25,000 × 7, plus $26,825 (adjusted figure for 1976) and $28,175 (adjusted figure for 1977)). Assume that annual additions totaling $60,000 ($10,000 of this amount being attributable to the current limitation year) have been allocated to A's account as of the close of the current limitation year. A's defined contribution plan fraction computed as of the end of the current limitation year is .23 or 23 percent

$$\frac{\$60{,}000}{\$230{,}000+\$30{,}050}=23 \text{ or } 23 \text{ percent}$$

Because the sum (123 percent) of the defined benefit plan fraction (1.0 or 100 percent) and the defined contribution plan fraction (.23 or 23 percent) for the current limitation year does not exceed 1.4 or 140 percent, the limitations of section 415(e) and this section are not violated.

Example (4). (i) J is an employee of M Corporation and is the only participant in the defined contribution plan maintained by the corporation. M uses the calendar year as the limitation year for the plan. The current limitation year is 1980. For all limitation years prior to 1980, the maximum allowable contribution was made to the plan. Thus, J's defined contribution plan fraction as of the end of 1979 is 1.0 or 100 percent. In 1980, before any contributions had been made to the defined contribution plan, the defined contribution plan is converted into a defined benefit plan. The defined benefit plan provides a benefit in the form of a straight life annuity equal to 50% of a participant's compensation for the high 3 years of service, but not less than the amount purchasable by J's account balance. J's average compensation for the high 3 years is $50,000.

(ii) As a result of the conversion of the defined contribution plan into the defined benefit plan, J becomes subject to the 1.4 limitation of section 415(e) and this section because he has at one time participated in a defined contribution plan and has at one time participated in a defined benefit plan maintained by M. Although the defined contribution plan is no longer in existence, J must still take the defined contribution plan fraction into account. A defined contribution plan fraction must continue to be taken into account regardless of whether the plan has been converted into another plan or whether the plan is terminated and distributions are made to participants.

(iii) Even though J is subject to the limitations of section 415(e) and this section, in computing the defined benefit plan fraction, the special rule set forth in § 1.415–3(b)(1)(iv) is applicable based on the facts of this example. That rule provides that when there is a transfer of assets or liabilities from one qualified plan to another, the annual benefit attributable to the assets transferred does not have to be taken into account by the transferee plan in applying the limitations of section 415. (For purposes of section 415, a conversion of a defined contribution plan into a defined benefit plan is considered such a transfer.) Assume that one-half of J's annual benefit under the defined benefit plan is attributable to the assets transferred from the defined contribution plan. This means that by applying the special rule set forth in § 1.415–3(b)(1)(iv), only one-half of J's projected annual benefit must be taken into account in computing J's defined benefit plan fraction. Accordingly, because J's defined benefit plan fraction is only 25 percent (½ of 50% of high 3 years of compensation ($12,500) divided by 100% of high 3 years of compensation ($50,000)) and not 50 percent (which would have been the case absent the special rule of § 1.415–3(b)(1)(iv), the 140 percent limitation of section 415(e) and this section is not violated.

(f) *Special rules where records are not available for past periods*—(1) *In general.* The rules described in paragraph (f) (2) and (3) of this section apply only if the plan is unable to compute the defined contribution plan fraction because of the unavailability of records with respect to limitation years ending before the first limitation year to which section 415 applies to the plan.

(2) *Defined contribution plan fraction for first limitation year to which section 415 applies to a plan.* For purposes of paragraph (c) of this section, the defined contribution plan fraction for the first limitation year to which section 415 and this section apply to a plan equals the following fraction:

(i) The numerator of the fraction is the sum of the participant's account balance as of the valuation date under the plan immediately preceding November 2, 1975, plus any additions to the participant's account made subsequent to that valuation date and through the end of the first limitation year to which section 415 applies to the plan. In determining the participant's account balance as of the valuation date under the plan immediately preceding November 2, 1975, for purposes of this subdivision, one-half of all employee contributions (whether voluntary or mandatory) are not taken into account.

(ii) The denominator of the fraction is the sum of the maximum allowable annual additions under section 415(c) and § 1.415–6 for each limitation year, including the first limitation year to which section 415 applies to the plan, in which the participant had a year of service with the employer (see § 1.415–3(g)(1) for rules relating to the determination of a year of service). In determining the maximum allowable annual additions for purposes of this subdivision, the compensation limitation (as described in section 415(c)(1)(B)) taken into account for all of such limitation years is the applicable compensation limitation for the first limitation year to which section 415 applies to the plan and the dollar limitation taken into account for each such limitation year is the dollar limitation described in section 415(c)(1)(A), as adjusted for cost-of-living increases under section 415(d)(1)(B).

(3) *Defined contribution plan fraction for future limitation years.* For purposes of paragraph (c) of this section, with respect to all limitation years after the first limitation year to which section 415 applies to the plan, the defined contribution plan fraction for the current limitation year equals a fraction. The numerator of the fraction is the amount determined under paragraph (g)(2)(i) of this section, plus any subsequent annual additions made to the participant's account through the end of the current limitation year. The denominator of the fraction equals the sum of—

(i) The amount determined under subparagraph (2)(ii) of this paragraph, plus

(ii) The sum of the maximum allowable annual additions under section 415(c) and §1.415–6 for the current limitation year and all prior limitation years beginning after the end of the first limitation year to which section 415 applies to the plan.

(g) *Special rule for certain plans in effect on date of enactment.* In the case of an individual who, on September 2, 1974, was a participant in a defined benefit and defined contribution plan maintained by the same employer and with respect to whom the sum of the defined benefit plan fraction and the defined contribution plan fraction for the limitation year during which such date falls (determined as of the close of that limitation year) exceeded 140 percent, the sum of such fractions may continue to exceed 140 percent for any particular future limitation year, but only if the conditions set forth in paragraph (g) (1) and (2) of this section are satisfied:

(1) The defined benefit plan fraction of the participant computed as of the close of the particular limitation year does not exceed such fraction computed as of the close of the limitation year during which September 2, 1974, falls.

(2) After September 2, 1974,

(i) No employer contributions are allocated to the participant's account under any defined contribution plan,

(ii) No forfeitures arising under any defined contribution plan are allocated to the participant's account,

(iii) No voluntary employee contributions are made by the participant under any defined contribution or defined benefit plan, and

(iv) No mandatory employee contributions are made by the participant under any defined contribution plan.

(h) *Special rules for section 403(b) annuity contracts*—(1) *In general.* For purposes of section 415, the following rules shall apply:

(i) In the case of an annuity contract described in section 403(b), the participant, on whose behalf the annuity contract is purchased, is considered to have exclusive control of the annuity contract. Accordingly, the participant, and not the participant's employer who purchased the section 403(b) annuity contract, is deemed to maintain the annuity contract.

(ii) Any contributions by the employer for an annuity contract described in this subparagraph are not taken into account in computing the defined contribution plan fraction applicable to the participant for the limitation year.

(2) *Special rules under which the employer is deemed to maintain the annuity contract.* (i) The provisions of this paragraph and not paragraph (h)(1) of this section apply for a particular limitation year with respect to a participant on whose behalf a section 403(b) annuity contract is purchased, if that participant is in control of any employer within the meaning of section 414 (b) or (c), as modified by section 415(h). Under these circumstances, the section 403(b) annuity contract for the benefit of the participant is treated as a defined contribution plan maintained by both the controlled employer and the participant for that limitation year.

(ii) The provisions of this paragraph also apply for a particular limitation year if a participant on whose behalf a section 403(b) annuity contract is purchased has elected, under section 415(c)(4)(D) and §1.415–6(e)(6), to have the provisions of section 415(c)(4)(C) and §1.415–6(e)(5) apply for the taxable year with or within which such limitation year ends. In such a case, the exclusion allowance determined under section 403(b)(2)(A) is not applicable to the annuity contract for the particular limitation year, and the annuity contract is treated as a defined contribution plan maintained by both the employer and the participant for that limitation year.

(iii) For purposes of the limitations of section 415(e) and this section, where a section 403(b) annuity contract is treated as a defined contribution plan maintained by the employer under this subparagraph, any contributions made for the annuity contract for a participant are taken into account in computing the defined contribution plan fraction applicable to that participant for the limitation year. Thus, for example, if a doctor is employed by an educational organization which provides him with a section 403(b) annuity contract and also maintains a private practice as a shareholder owning more than 50 percent of a professional corporation, any qualified defined benefit plan of the professional corporation must be aggregated with the section 403(b) annuity contract for purposes of applying the limitations of section 415(e) and this section.

(3) *Special rule with respect to salary reduction agreements.* The rules provided in this paragraph are applicable whether or not the section 403(b) annuity contract is purchased in connection with a salary reduction agreement between the employer and participant.

(4) *Special rules relating to the aggregation of the annuity contract with a qualified plan.* (i) Where a section 403(b) annuity contract is aggregated with a qualified defined benefit plan in a limitation year because of the application of the rules of paragraph (h)(2) of this section, all contributions made to the annuity contract for a participant in prior limitation years shall be taken into account in computing the participant's defined contribution plan fraction. However, the rule described in the preceding sentence is not applicable if the aggregation is solely attributable to the participant's election to have the provisions of section 415(c)(4)(C) apply. Accordingly, in any case in which aggregation is required as a result of the application of paragraph (h)(2)(ii) of this section, all contributions made to the annuity contract for a participant in prior limitation years in which paragraph (h)(1) of this section was applicable do not have to be taken into account in computing the defined contribution plan fraction applicable to the participant.

(ii) Any contributions made to a section 403(b) annuity contract for a participant in any limitation year in which the rules of paragraph (h)(2)(ii) of this section are applicable shall be taken into account in subsequent limitation years even though the rules of such paragraph are no longer applicable.

(iii) See paragraph (c)(2) of this section for special rules relating to the defined contribution plan fraction for a participant on whose behalf a section 403(b) annuity contract has been purchased.

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

Example (1). A is employed by a hospital which is described in section 501(c)(3) and exempt from tax under section 501(a). The hospital purchases an annuity contract described in section 403(b) on A's behalf for the current limitation year. The hospital also maintains a qualified defined benefit plan during the current limitation year in which A is a participant, but it does not maintain a qualified defined contribution plan during that limitation year. With respect to the annuity contract. A does not elect to have the provisions of section 415(c)(4)(C) apply for the current limitation year. Also, A is not in control of any employer within the meaning of section 414 (b) or (c), as modified by section 415(h). For purposes of section 415, under subparagraph (1) of this paragraph, A is considered to have exclusive control of the annuity contract. Therefore, because A (and not the hospital) is treated as maintaining the annuity contract and because the hospital does not maintain any defined contribution plan, the limitations of section 415(e) and this section are not applicable to A for either the annuity contract or the hospital's defined benefit plan for the current limitation year.

Example (2). Assume the same facts as in example (1), except that the hospital also maintains a qualified defined contribution plan during the limitation year in which A is a participant. Because the hospital is not considered to be maintaining the section 403(b) annuity contract, contributions made to the annuity contract on behalf of A during the current limitation year by the hospital are not taken into account in computing the defined contribution plan fraction applicable to A for the plans maintained by the hospital for that limitation year.

Example (3). Assume the same facts as in example (1), except that A has elected to have the provisions of section 415(c)(4)(C) apply to the annuity contract for the current limitation year. Under the special rules contained in subparagraph (2) of this paragraph, the annuity contract is treated as a defined contribution plan maintained by the hospital as well as a defined contribution plan maintained by A. Accordingly, because the hospital is also maintaining a qualified defined benefit plan, the limitations of section 415(e) and this section are applicable to A for the annuity contract and the defined benefit plan maintained by the hospital in the current limitation year.

Example (4). J is employed by a hospital which is described in section 501(c)(3) and exempt from tax under section 501(a). The hospital purchases an annuity contract described in section 403(b) on J's behalf for the current limitation year. The hospital does not maintain any qualified plans during that limitation year. However, for the limitation year, J is in control (within the meaning of section 414 (b) or (c), as modified by section 415(h)) of employer M. M maintains a qualified defined benefit plan during that limitation year. Under the special rules contained in subparagraph (2) of this paragraph, the annuity contract is treated as a defined contribution plan maintained by M (the controlled employer) as well as a defined contribution plan maintained by J. Therefore, because M is also maintaining a qualified defined benefit plan, the limitations of section 415(e) and this section are applicable to J for the annuity contract and the defined benefit plan maintained by M in the current limitation year.

(i) *Special rules for individual retirement plans.* For purposes of section 415, an individual on whose behalf an individual retirement plan (as described in section 7701(a)(37)) is maintained is considered to have exclusive control of such plan. Therefore, the individual is treated as maintaining such plan. However, if that individual is in control of any employer within the meaning of section 414 (b) or (c), as modified by section 415(h), the individual retirement plan for the benefit of such individual is treated as a defined contribution plan maintained by both the controlled employer and such individual.

[T.D. 7748, 46 FR 1711, Jan. 7, 1981]

§1.415–8 Combining and aggregating plans.

(a) *In general.* Under section 415(f) and this section, for purposes of applying the limitations of section 415 (b), (c), and (e) applicable to a participant for a particular limitation year—

(1) All qualified defined benefit plans (without regard to whether a plan has been terminated) ever maintained by the employer will be treated as one defined benefit plan, and

(2) All qualified defined contribution plans (without regard to whether a plan has been terminated) ever maintained by the employer will be treated as one defined contribution plan.

(b) *Annual compensation taken into account where employer maintains more than one defined benefit plan.* If more than one qualified defined benefit plan is being aggregated under paragraph (a) of this section for a particular limitation year, in applying the defined benefit compensation limitation (as described in section 415(b)(1)(B)) to the annual benefit of a participant under each plan, the participant's high 3 years of compensation is determined in accordance with §1.415–3(a)(3).

(c) *Affiliated employers.* Any qualified defined benefit plan or qualified defined contribution plan maintained by any member of a controlled group of corporations (within the meaning of section 414(b) as modified by section 415(h)) or by any trade or business (whether or not incorporated) under common control (within the meaning of section 414(c) as modified by section 415(h)) is deemed maintained by all such members or such trades or businesses.

(d) *Section 403(b) annuity contracts*—(1) *In general.* In the case of an annuity contract described in section 403(b), except as provided in subparagraph (2) of this paragraph, the participant on whose behalf the annuity contract is purchased is considered to have exclusive control of the annuity contract. Accordingly, the participant, and not the participant's employer who purchased the section 403(b) annuity contract, is deemed to maintain the annuity contract.

(2) *Special rules under which the employer is deemed to maintain the annuity*

contract. If a participant on whose behalf a section 403(b) annuity contract is purchased has elected to have the provisions of section 415(c)(4)(C) and §1.415–6(e)(5) apply for a taxable year, the annuity contract is treated as a defined contribution plan maintained by both the employer that purchased the annuity contract and the participant on whose behalf it was purchased for the limitation year which ends during such taxable year. Even if the election under section 415(c)(4)(C) is not made, where a participant, on whose behalf a section 403(b) annuity contract is purchased, is in control of any employer within the meaning of section 414 (b) or (c) as modified by section 415(h) for a limitation year, the annuity contract for the benefit of the participant is treated as a defined contribution plan maintained by both the controlled employer and the participant for that limitation year. Thus, for example, if a doctor is employed by an educational organization which provides him with a section 403(b) annunity contract and also maintains a private practice as a shareholder owning more than 50 percent of a professional corporation, any qualified defined contribution plan of the professional corporation must be combined with the section 403(b) annuity contract for purposes of applying the limitations of section 415(c) and §1.415–6. For purposes of this paragraph, it is immaterial whether the section 403(b) annuity contract is purchased as a result of a salary reduction agreement between the employer and the participant.

(e) *Multiemployer plans.* Multiemployer plans, as defined in section 414(f), shall not be aggregated with other multiemployer plans. However, where an employer maintains both a plan which is not a multiemployer plan and a multiemployer plan, the plan which is not a multiemployer plan shall be aggregated (based on its limitation year) with the multiemployer plan to the extent that benefits provided under the multiemployer plan are provided by such employer with respect to a common participant. See §1.415–1(e)(2) for a rule relating to the computation of the benefits provided by an employer under a section 414(f) multiemployer plan.

(f) *Special rules for combining certain plans, etc.* If a plan, annuity contract or arrangement is subject to a special limitation in addition to, or instead of, the regular limitations described in section 415 (b) or (c), and is combined under this section with a plan which is subject only to the regular section 415 (b) or (c) limitations, the following rules shall apply:

(1) Each plan, annuity contract or arrangement which is subject to a special limitation must meet its own applicable limitation and each plan subject to the regular limitations of section 415 must meet its applicable limitation.

(2) The combined limitations shall be the larger of the applicable limitations.

(g) *Special priority rule for TRASOP's.* For a special rule concerning allocations to a participant's account under an Employee Stock Ownership Plan under section 301(d) of the Tax Reduction Act of 1975, see §1.46–6(d)(6)(v).

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

Example (1). M is an employee of ABC Corporation and XYZ Corporation. ABC maintains a qualified noncontributory defined benefit plan in which M participates and XYZ maintains a qualified defined contribution plan in which M participates. ABC Corporation and XYZ Corporation are members of a controlled group of corporations within the meaning of section 414(b) as modified by section 415(h). Because ABC Corporation and XYZ Corporation are members of a controlled group of corporations within the meaning of section 414(b) as modified by section 415(h), M is treated as being employed by a single employer. Thus, M's annual benefit under the defined benefit plan maintained by ABC may not exceed the limitations of section 415(b) and §1.415–3; the annual additions to M's account under the defined contribution plan maintained by XYZ may not exceed the limitations of section 415(c) and §1.415–6; and, in addition, the two plans may not exceed the limitations of section 415(e) and §1.415–7.

Example (2). Assume the same facts as in example (1), except that the qualified defined benefit plan maintained by ABC Corporation provides for employee contributions (whether mandatory or voluntary). Under §1.415–3(d), ABC Corporation will be considered to be maintaining a defined contribution plan consisting of M's contributions to the defined benefit plan. For purposes of applying the limitations of section 415(e) and §1.415–7, the qualified defined benefit plan maintained by ABC must be combined with the defined contribution plan which ABC is considered to maintain. In addition, because corporations ABC and XYZ are members of a controlled group of corporations (within the meaning of section 414(b), as modified by section 415(h)), for purposes of applying the limitations of section 415(c) and §1.415–6, the qualified defined contribution plan maintained by XYZ must be combined with the define contribution plan which ABC is considered to be maintaining and the defined contribution plans (as combined) must be aggregated with the qualified defined benefit plan maintained by ABC for purposes of the limitations imposed by section 415(e) and §1.415–7.

[T.D. 7748, 46 FR 1715, Jan. 7, 1981]

§1.415–9 Disqualification of plans and trusts.

(a) *In general.* Under section 415(g) and this section, with respect to a particular limitation year, a plan (and the trust forming part of the plan) is disqualified in accordance with the rules provided in paragraph (b) of this section, if any of the following conditions exist:

(1) Annual additions (as defined in §1.415–6(b)) with respect to the account of any participant in a qualified defined contribution plan maintained by the employer exceed the limitations of section 415(c) and §1.415–6.

(2) The annual benefit (as defined in §1.415–3(b)(1)) of a participant in a qualifed defined benefit plan maintained by the employer exceeds the limitations of section 415(b) and §1.415–3.

(3) The combination of annual additions with respect to the account of any participant in a qualified defined contribution plan and the projected annual benefit payable with respect to such participant in a qualified defined benefit plan maintained by the employer exceeds the limitations of section 415(e) and §1.415–7.

For purposes of this paragraph, the determination of whether a plan or a combination of plans exceeds the limitations imposed by section 415 for a particular limitation year is, except as otherwise provided, made by taking into account the aggregation of plan rules provided in sections 415(f) and 414 (b) and (c) (as modified by section 415(h)).

(b) *Rules for disqualification of plans and trusts*—(1) *In general.* Any plan (including a trust which forms part of such plan) that is disqualified in a particular limitation year under the rules set forth in this paragraph, shall be disqualified as of the first day of the first plan year containing any portion of the particular limitation year.

(2) *Single plan.* In the case of a single qualified defined benefit plan maintained by the employer that provides an annual benefit (as defined in §1.415–3(b)(1)) in excess of the limitations of section 415(b) and §1.415–3 for any particular limitation year, such plan is disqualifed in that limitation year. Similarly, if the employer only maintains a single defined contribution plan under which annual additions (as defined in §1.415–6(b)) allocated to the account of any participant exceed the limitations of section 415(c) and §1.415–6 for any particular limitation year, such plan is also disqualifed in that limitation year.

(3) *More than one plan.* In the event that the limitations of section 415(b) and §1.415–3, or section 415(c) and §1.415–6 are exceeded for a particular limitation year with respect to any participant because of the application of the aggregation rules of section 415(f)(1) or section 414 (b) or (c), as modified by section 415(h), one or more of the plans shall be disqualifed in accordance with the rules set forth in this subparagraph. Similarly, if the limitations of section 415(e) and §1.415–7 are exceeded for a particular limitation year with respect to any participant because of the application of such aggregation rules (although if an individual participates in a defined contribution and defined benefit plan maintained by the same employer, these limitations may be exceeded even without the application of such aggregation rules), one or more of the plans shall be disqualified in accordance with the following rules:

(i) If there are two plans and one of the plans has been terminated at any time including the last day of the particular limitation year, the plan which has not been so terminated (whether or not that plan is a multiemployer plan described in section 414(f)) is disqualified in that limitation year.

(ii) If there are two plans and neither plan has been terminated at any time including the last day of the particular limitation year, and if one of the plans is a multiemployer plan described in section 414(f), the plan which is not a multiemployer plan is disqualified in that limitation year. For purposes of the preceding sentence, the determination of whether a plan is a multiemployer plan described in section 414(f) is made as of the last day of the particular limitation year.

(iii) If there are two plans of an employer and neither plan has either been terminated at any time including the last day of the particular limitation year or determined to be a multiemployer plan described in section 414(f) as of such day, the employer may elect, in a manner determined by the Commissioner, the plan that is disqualified. If the two plans described in this subdivision are involved because of the application of section 414 (b) or (c), as modified by section 415(h), the employers of the controlled group may elect, in a manner determined by the Commissioner, the plan that is disqualified. However, the election described in the preceding sentence is not effective unless made by all of the employers within the controlled group. For purposes of this subdivision, the elected plan is disqualified in the particular limitation year.

(iv) If the election described in subdivision (b)(3)(iii) of this paragraph is not made with respect to the two plans described in such subdivision, the Commissioner, taking into account all of the facts and circumstances, shall have the discretion to determine the plan that is disqualified in the particular limitation year. In making this determination, some of the factors that will be taken into account include, but are not limited to, the number of participants in each plan and the amount of benefits provided on an overall basis by each plan.

(v) If more than two plans are involved, a plan or plans shall be disqualified in the particular limitation year in accordance with the principles contained in this subparagraph.

(4) *Special rules for simplified employee pension.* If there are two or more plans and if one of the plans is a simplified employee pension (as defined in section 408(k)), the simplified employee pension shall not be disqualified until all of the other plans have been disqualified. However, if one of the plans has been terminated, the simplified employee pension shall be disqualified before the terminated plan. For purposes of this subparagraph, the disqualification of a simplified employee pension means that the simplified employee pension is no longer described under section 408(k).

(c) *Special rules concerning section 403(b) annuity contracts*—(1) *In general.* If aggregating or combining a section 403(b) annuity contract and a qualified plan causes the applicable limitations of section 415 to be exceeded, the exclusion allowance under section 403(b)(2) shall be adjusted first to the extent necessary to satisfy such limitations.

(2) *Aggregating section 403(b) annuity contract and qualified defined benefit plan.* In the event that aggregating a section 403(b) annuity contract and a qualified defined benefit plan causes the limitations of section 415(e) and § 1.415–7 to be exceeded with respect to a participant for a particular limitation year, the amount of the contribution to the annuity contract in excess of such limitations is treated as a disqualified contribution and therefore includable in the gross income of the participant for the taxable year with or within which that limitation year ends. Furthermore, for purposes of computing the exclusion allowance under section 403(b)(2)(A) for future taxable years with respect to such participant, the disqualified contribution is treated as an amount contributed by the employer for an annuity contract which was excludable from the participant's gross income under section 403(b)(2)(A)(ii). Thus, for future taxable years, the exclusion allowance will be reduced by the amount of the disqualified contribution even though such amount was not excludable from the participant's gross income in the taxable year when it was made. See § 1.415–7(c)(2) for special rules relating to the defined contribution plan fraction applicable to an individual on whose behalf a section 403(b) annuity contract has been purchased.

(3) *Combining section 403(b) annuity contract and qualified defined contribution plan.* In the event that combining a section 403(b) annuity contract and a qualified defined contribution plan under the provisions of section 415(f)(1)(B) causes the limitations of section 415(c) and §1.415–6 applicable to a participant under the defined contribution plan to be exceeded for a particular limitation year, the excess of the contributions to the annuity contract plus the annual additions to the plan over such limitations is treated as a disqualified contribution to the annuity contract and therefore includable in the gross income of the participant for the taxable year with or within which that limitation year ends. Furthermore, for purposes of computing the exclusion allowance under section 403(b)(2)(A) for future taxable years with respect to such participant, the disqualified contribution is treated as an amount contributed by the employer for an annuity contract which was excludable from the participant's gross income under section 403(b)(2)(A)(ii). Thus, for future taxable years, the exclusion allowance will be reduced by the amount of the disqualified contribution even though such amount was not excludable from the participant's gross income in the taxable year when it was made.

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

Example (1). N is employed by a hospital which purchases an annuity contract described in section 403(b) on N's behalf for the current limitation year. The current limitation year is N's first year of service with the hospital. Solely for the purpose of illustrating the rules set forth in this paragraph, assume that N is in control of the hospital within the meaning of section 414 (b) or (c), as modified by section 415(h). Therefore, under section 415(e)(5), the section 403(b) annuity contract is treated as a defined contribution plan maintained by the hospital and N. The hospital also maintains a qualified defined contribution plan during the current limitation year in which N participates, but it does not maintain any other qualified plan. N's compensation (within the meaning of §1.415–2(d)) from the hospital for the current limitation year is $20,000. N does not elect any of the alternative limitations provided in section 415(c)(4) for the section 403(b) annuity contract. For the current limitation year, the hospital contributes $3,000 for the section 403(b) annuity contract on N's behalf, which is within the limitations applicable to N under the annuity contract (i.e., the lesser of the exclusion allowance under section 403(b)(2)(A) ($4,000) or the limitations of section 415(c)(1) ($5,000)). The hospital also contributes $3,000 to the qualified plan on N's behalf for the current limitation year (which represents the only annual additions allocated to N's account under the plan for such year), which is within the $5,000 limitation of section 415(c)(1) applicable to N under the plan. However, under section 415(f)(1)(B), for purposes of applying the limitations of section 415(c) and §1.415–6, the hospital is considered to maintain only one defined contribution plan and thus, all contributions to the annuity contract and to the regular plan must be combined. Because the total combined contributions ($6,000) exceed the section 415(c) limitation applicable to N under the plan ($5,000), under the special rules contained in this paragraph, $1,000 of the $3,000 contributed to the section 403(b) annuity contract is considered a disqualified contribution and therefore currently includable in N's gross income. Furthermore, in computing N's exclusion allowance for the section 403(b) annuity contract for future taxable years, besides the $3,000 contributed to the qualified plan, the $3,000 contributed for the section 403(b) annuity contract is also considered an amount contributed by the employer and excludable from N's gross income for purposes of section 403(b)(2)(A)(ii), even though only $2,000 of this amount was excludable from N's gross income.

Example (2). Assume the same facts as in example (1), except that instead of the defined contribution plan the hospital maintains a qualified defined benefit plan during the current limitation year in which N participates. Because the hospital is considered to be maintaining a defined contribution plan (in the form of a section 403(b) annuity contract) in addition to its defined benefit plan, the limitations of section 415(e) and §1.415–7 are applicable to N for the current limitation year. If N's defined benefit plan fraction for the current limitation year is 1.0, then to satisfy the limitations of section 415(e) and §1.415–7, N's defined contribution plan fraction may not exceed .4 for the current limitation year. This means that only $2,000 (i.e. 40% of $5,000—the applicable limitation to N for the annuity contract under the special rule set forth in §1.415–7(c)(2)(i)) could have been contributed to the annuity contract on N's behalf for the current limitation year without violating the 1.4 limitation of section 415(e) and §1.415–7. However, because the hospital contributed $3,000 to the section 403(b) annuity contract on N's behalf, under the special rules contained in this paragraph, $1,000 of this amount is considered a disqualified contribution and therefore currently includable in N's gross income. Furthermore, in computing N's exclusion allowance for the section 403(b) annuity contract for future taxable years, the $3,000 contributed to the annuity contract is considered the amount contributed by the employer and excludable from N's gross income for purposes of section 403(b)(2)(A)(ii), even through only $2,000 of this amount was excludable from N's gross income.

[T.D. 1716, 46 FR 1716, Jan. 7, 1981]

§ 1.415–10 Special aggregation rules.

(a) *General rules relating to aggregation of plans during limitation year*—(1) *Scope of aggregation rules.* This section provides rules for those situations in which two or more existing plans, which previously were unaggregated, are aggregated during a particular limitation year on or after the effective date of section 415 and these regulations, and as a result, the limitations of section 415 (b), (c) or (e) are exceeded for that limitation year. The rules described in this section are also applicable with respect to the aggregation of benefits under a multiemployer plan described in section 414(f) that previously were not required to be aggregated.

(2) *Controlling date of aggregation.* For purposes of this section, plans which are not aggregated as of the first day of a limitation year will not be considered aggregated for that limitation year. Notwithstanding the preceding sentence, if a section 403(b) annuity contract is aggregated with a qualified plan because of the election by the individual on whose behalf the annuity contract is purchased to have the provisions of section 415(c)(4)(C) apply for the taxable year, the annuity contract and the plan are deemed to be aggregated as of the first day of the limitation year ending with or within such taxable year.

(3) *Aggregation of additions and benefits.* If plans are aggregated under this section, the following rules shall apply:

(i) All annual additions credited to a participant's account under a defined contribution plan prior to the aggregation of such plan shall be taken into account in computing the participant's defined contribution plan fraction for purposes of applying the limitations of section 415(e) to the aggregated plans.

(ii) The annual benefit or projected annual benefit (whichever is applicable) of a participant under a defined benefit plan prior to the aggregation of such plan shall be taken into account for purposes of applying the limitations of section 415(b) or section 415(e) to the aggregated plans.

(iii) For a special rule relating to the aggregation of contributions to a section 403(b) annuity contract upon the aggregation of the annuity contract with a qualified plan, see § 1.415–7(h)(4)(i).

(b) *Aggregation of defined benefit plans.* In the case of an individual who is a participant in two or more defined benefit plans and with respect to whom the limitations of section 415(b) and § 1.415–3 are exceeded for a particular limitation year because of the aggregation of the plans for that limitation year, the limitations of section 415(b) and § 1.415–3 may be exceeded for that limitation year and for future limitation years provided that there is no increase in the participant's accrued benefit derived from employer contributions during the period within which these limitations are being exceeded.

(c) *Aggregation of defined benefit and defined contribution plan.* In the case of an individual who has at any time participated in a defined benefit plan and also has at any time participated in a defined contribution plan and with respect to whom the limitations of section 415(e) and § 1.415–7 are exceeded for a particular limitation year because of the aggregation of the plans for that limitation year, the limitations of section 415(e) and § 1.415–7 may be exceeded for that limitation year and for future limitation years provided that the following conditions are complied with during that period:

(1) The participant's accrued benefit derived from employer contributions in the defined benefit plan is not increased.

(2) No employer contributions are allocated to the participant's account under any defined contribution plan.

(3) No forfeitures arising under any defined contribution plan are allocated to the participant's account.

(4) No voluntary employee contributions are made by the participant under any defined benefit or defined contribution plan.

(5) No mandatory employee contributions are made by the participant under any defined contribution plan.

(d) *Limitation year for aggregated plans.* If the plans which are aggregated under this section have different limitation years, subparagraph (1) or (2) of this paragraph must be complied with.

(1) The relevant employer or employers must elect the limitation year that is to be controlling. This election shall be made by the adoption of a written resolution by the employer or employers. See §1.415–2(b)(4) for rules relating to a change in the limitation year.

(2) The employer or employers may continue to use different limitation years for each plan in accordance with rules determined by the Commissioner.

If, in accordance with paragraph (d)(1) of this section, one limitation year is elected, and if the plans which are aggregated covered at least one common participant prior to being aggregated, that limitation year shall be applicable for past years for purposes of computing the defined contribution fraction for those years. For special rules relating to the computation of the defined contribution plan fraction where records are not available for past periods, see §1.415–7(f).

(e) The provisions of this section may be illustrated by the following examples:

Example (1). J is an employee of two unrelated corporations, N and M. Each corporation has a qualified defined benefit plan in which J participates. Each plan provides a benefit which is equal to 75 percent of a participant's average compensation for his high 3 years of service and is payable in the form of a straight life annuity beginning at age 65. J's average compensation (within the meaning of §1.415–2(d)) for his high three years of service from each corporation is $80,000. Each plan uses the calendar year for the limitation and plan year. In July, 1978, N Corporation becomes a wholly owned subsidiary of M Corporation, and as a result, J is treated as being employed by a single employer under section 414(b). Therefore, because section 415(f)(1)(A) requires that all defined benefit plans of an employer be treated as one defined benefit plan, the two plans must be aggregated for purposes of applying the limitations of section 415. (Although, under paragraph (a)(2) of this section, since the plans were not aggregated as of the first day of the 1978 limitation year (January 1, 1978), they will not be considered aggregated until the limitation year beginning January 1, 1979.) As a result of such aggregation, J becomes entitled to a combined benefit which is equal to $120,000, which is in excess of the section 415(b) dollar limitation for 1979 of $98,100. However, under paragraph (b) of this section, the limitations of section 415(b) and §1.415–3 applicable to J may be exceeded in this situation without plan disqualification, so long as J's accrued benefit derived from employer contributions is not increased during the period within which the limitations are being exceeded.

Example (2). A, age 30, owns all of the stock of X Corporation and also owns 10 percent of the stock of Z Corporation. F, A's father, directly owns 75 percent of the stock of Z corporation. Both corporations have qualified defined contribution plans in which A participates and both plans use the calendar year for the limitation and plan year. A's compensation (within the meaning of §1.415–6(a)(3)) for 1976 is $40,000 from Z Corporation and $150,000 from X Corporation. During 1976, annual additions of $10,000 are credited to A's account under the plan of Z Corporation, while annual additions of $26,825 are credited to A's account under the plan of X Corporation. In both instances, the amount of annual additions represent the maximum allowable under section 415(c) and §1.415–6. On July 15, 1976, F dies, and A inherits all of F's stock in Z in 1976. Because under section 414(b), A is considered to be in control of X and Z Corporations, the two plans must be aggregated for purposes of applying the limitations of section 415. However, even though A's total annual additions for 1976 are $36,825, the limitations of section 415(c) and §1.415–6 are not violated for 1976, because, under paragraph (a)(2) of this section, the two plans are considered separate plans for that year since they were not aggregated as of the first day of that year.

[T.D. 1718, 46 FR 1718, Jan. 7, 1981]

§1.416–1 Questions and answers on top-heavy plans.

The following questions and answers relate to special rules for top-heavy plans under section 416 of the Internal Revenue Code of 1954, as added by section 240 of the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. 97–248) (TEFRA), and amended by sections 524 and 713(f) of the Tax Reform Act of 1984 (Pub. L. 98–369):

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G. General Provisions

G–1 Q. What requirement plans are subject to the top-heavy rules added to the Code by the Tax Equity and Fiscal Responsibility Act and amended by the Tax Reform Act of 1984?

A. All stock bonus, pension, or profit-sharing plans intended to qualify under section 401(a), annuity contracts described in section 403(a), and simplified employee pensions described in section 408(k) are subject to the new top-heavy rules added to the Code by the Tax Equity and Fiscal Responsibility Act and amended by the Tax Reform Act (''TRA'') of 1984.

G–2 Q. Is a multiple employer plan subject to the top-heavy requirements of section 416?

A. A multiple employer plan is subject to the requirements of section 416, but only with respect to each individual employer. Thus, if twelve employers contribute to a multiple employer plan and the accrued benefits for the key employees of one employer exceed 60 percent of the accrued benefits of all employees for such employer, the plan is top-heavy with respect to that employer. A failure by the multiple employer plan to satisfy section 416 with respect to the employees of such employer means that all employers are maintaining a plan that is not a qualified plan.

G–3 Q. As of what date must plan amendments to comply with top-heavy rules be effective?

A. Amendments required to comply with the top-heavy rules must be effective as of the first day of the first plan year which begins after 1983. See § 1.401(b)–1 for the date by which such amendments must be adopted.

T. Top-Heaviness Determinations

T–1 Q. What factors must be considered in determining whether a plan is top-heavy?

A. (a) In order to determine whether a plan is top-heavy for a plan year, it is necessary to determine which employers will be treated as a single employer for purposes of section 416; what the determination date is for the plan year; which employees are or formerly were key employees; which former employees have not performed any service for the employer maintaining the plan at any time during the five-year period ending on the determination date; which plans of such employers are required or permitted to be aggregated to determine top-heavy status; and the present value of the accrued benefits (including distributions made during the plan year containing the determination date and the four preceding plan years) of key employees, former key employees, and non-key employees.

(b) All employers that are aggregated under section 414 (b), (c), and (m) must be taken into account as a single employer for the plan year in question, and those employees in all plans maintained by the employers that are aggregated must be categorized as key employees, as former key employees, or as non-key employees. See Question and Answer T–12 for the determination of which employees are or were key employees. All plans maintained by the employers in which a key employee participates, and certain other plans, must then be aggregated (the required aggregation group). See Question and Answer T–6 for rules concerning required aggregation. Other plans may in some cases be aggregated with the required aggregation group. See Question and Answer T–7 for rules concerning such permissive aggregation.

(c) Once aggregated, all plans that are required to be aggregated will either be top-heavy or not top-heavy, depending upon whether the aggregation group is top-heavy. A plan or aggregation group will be considered top-heavy if the sum of the present value of the accrued benefits for key employees is more than 60 percent of the sum of the present value of accrued benefits of all employees.

(d) Except as otherwise stated, for purposes of section 416(g), an employee is an individual currently or formerly employed by an employer. Former key employees are non-key employees and are excluded entirely from the calculation to determine top-heaviness. In all cases, the present value of accrued benefits includes distributions made during the plan year containing the determination date and the preceding four plan years. See Questions and Answers T–24 and T–25 for rules concerning the account balances and present value of accrued benefits. For plan years beginning after December 31, 1984, the accrued benefit of an employee who has not performed any sevice for the employer maintaining the plan at any time during the five-year period ending on the determination date is excluded from the calculation to determine top-heaviness. However, if an employee performs no services for five years and then performs sevices, such employee's total accrued benefit is included in the calculation for top-heaviness.

T–2 Q. To what extent are multiemployer plans and multiple employer plans to which an employer makes contributions on behalf of its employees treated as plans of that employer for top-heavy purposes?

A. Multiemployer plans described in section 414(f) and multiple employer plans described in section 413(c) to which an employer makes contributions on behalf of its employees are treated as plans of that employer to the extent that benefits under the plan are provided to employees of the employer because of service with that employer.

T–3 Q. Must a collectively-bargained plan be aggregated with other plans of the employer to determine whether some or all of the employer's plans are top-heavy?

A. A collectively-bargained plan that includes a key employee of an employer must be included in the required aggregation group for that employer. See Question and Answer T–6 for rules concerning required aggregation. A collectively-bargained plan that does not include a key employee may be included in a permissive aggregation group. See Question and Answer T–7 for rules concerning permissive aggregation. However, the special rules in section 416 (b), (c), or (d) applicable to top-heavy plans do not apply with respect to any employee included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective-bargaining agreement between employee representatives and one or more employers if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or employers. In determining whether there is a collective-bargaining agreement between employee representatives and one or more employers, the additional condition of section 7701(a)(46) must be satisfied after March 31, 1984.

T–4 Q. How is a terminated plan treated for purposes of the top-heavy rules?

A. A terminated plan is treated like any other plan for purposes of the top-heavy rules. For purposes of section 416, a terminated plan is one that has been formally terminated, has ceased crediting service for benefit accruals and vesting, and has been or is distributing all plan assets to participants or their beneficiaries as soon as administratively feasible. Such a plan must be aggregated with other plans of the employer if it was maintained within the last five years ending on the determination date for the plan year in question and would, but for the fact that it terminated, be part of a required aggregation group for such plan year. Distributions which have taken place within the five years ending on the determination date must be accounted for in accordance with section 416(g)(3). No additional vesting, benefit accruals or contributions must be provided for participants in a terminated plan.

T–5 Q. How are frozen plans treated for purposes of the top-heavy rules?

A. For purposes of section 416, a frozen plan is one in which benefit accruals have ceased but all assets have not been distributed to participants or their beneficiaries. Such plans are treated, for purposes of the top-heavy rules, as any non-frozen plan. That is, such plans must provide minimum contributions or benefit accruals, limit the amount of compensation which can be taken into account in providing benefits, and provide top-heavy vesting. A frozen defined contribution plan may not be required to provide additional contributions because of the rule in section 416(c)(2)(B).

T–6 Q. What is a required aggregation group?

A. For purposes of determining whether the plans of an employer are top-heavy for a particular plan year, the required aggregation group includes each plan of the employer in which a key employee participates in the plan year containing the determination date, or any of the four preceding plan years. In addition, each other plan of the employer which, during this period, enables any plan in which a key employee participates to meet the requirements of section 401(a)(4) or 410 is part of the required aggregation group. This concept may be illustrated by the following examples:

Example (1). An employer maintains two plans. Key employees participate in one plan, but not in the other. If the plan containing key employees independently satisfies the coverage and non-discrimination rules of sections 410 and 401(a)(4), it may be tested independently to determine whether it is top-heavy. Also, the plan not covering key employees would not be part of a required aggregation group and would not need to be tested to determine whether it is top-heavy. However, if the plan containing key employees satisfies the coverage requirements of section 410(b) or the non-discrimination requirements of section 401(a)(4) only when it is considered together with the other plan in accordance with § 1.410(b)–1(d)(3), the plan not covering key employees would be part of the required aggregation group.

Example (2). A sole proprietor terminated a Keogh plan in 1981. In 1982, the sole proprietor incorporated and established a corporate plan with a calendar-year plan year. For purposes of determining whether the corporate plan is top-heavy for its 1984 plan year, the terminated Keogh plan and the corporate plan would be part of a required aggregation group. The sole proprietor and the corporation would be treated as a single employer under section 414(c). Under Question and Answer T–4, the terminated plan would be aggregated with the corporate plan because it was maintained within the five-year period ending on the determination date for the 1984 plan year and because, but for the fact that it terminated, it would be aggregated with the corporate plan because it covered a key employee.

T–7 Q. What is a permissive aggregation group?

A. A permissive aggregation group consists of plans of the employer that are required to be aggregated, plus one or more plans of the employer that are not part of a required aggregation group but that satisfy the requirements of sections 401(a)(4) and 410 when considered together with the required aggregation group. This concept may be illustrated by the following examples:

Example (1). (a) An employer maintains two plans:

1. Plan A covers key employees and independently satisfies the requirements of sections 410 and 401(a)(4).

2. Plan B covers no key employees. It also independently satisfies the requirements of sections 410 and 401(a)(4).

(b) As indicated in Question and Answer T–6, Plan B is not required to be aggregated with Plan A. Further, if Plan B provided contributions or benefits that were not at least comparable to the contributions or benefits provided under Plan A, then Plan B could not be permissively aggregated with Plan A because the contributions and benefits would discriminate if the two plans were considered as a unit. However, if the benefits or contributions under Plan B were comparable to those under Plan A, the two plans would be permitted to be aggregated to determine whether or not the group consisting of both plans is top-heavy. If Plan A and Plan B are permitted to be aggregated, and if the permissive aggregation group is not top-heavy, then neither Plan A nor Plan B would be considered top-heavy.

Example (2). (a) Employer W maintains two plans.

1. Plan C covers salaried employees and independently satisfies the requirements of sections 410 and 401(a)(4).

2. Plan D covers employees who are included in a unit of employees covered by an agreement which the Secretary of Labor has found to be a collective-bargaining agreement between employee representatives and the employer and retirement benefits were bargained for between employee representatives and the employer.

(b) The fact that Plan D is a collectively-bargained plan does not necessarily mean that it may be permissively aggregated with Plan C. In order to be permissively aggregated with Plan C, Plan D must provide contributions or benefits with respect to service with Employer W that are at least comparable to the contributions or benefits provided under Plan C.

T–8 Q. May an employer permissively aggregate multiemployer plans, multiple employer plans and simplified employee pension plans to which the employer contributes with a plan covering key employees or a required aggregated group?

A. Yes. Multiemployer plans, multiple employer plans and simplified employee pensions to which an employer makes contributions may be permissively aggregated with a plan covering key employees or with a required aggregation group if the contributions or benefits provided under the multiemployer plan, multiple employer plan or simplified employee pension by the employer are comparable to the contributions or benefits provided under the plan covering key employees or the plans in the required aggregation group. In making this determination, only the employer's contribution to the simplified employee pension may be used.

T–9 Q. What plans will be treated as top-heavy if they are part of a required aggregation group that is top-heavy?

A. In the case of plans that are required to be aggregated, each plan in the required aggregation group will be top-heavy if the group is top-heavy. No plan in the required aggregation group will be top-heavy if the group is not top-heavy.

T–10 Q. If a required aggregation group is top-heavy, and one plan of the group satisfies the requirements of sections 416 (b), (c), and (d), may other plans in the group include provisions which do not satisfy sections 416 (b), (c) and (d)?

A. No. Each plan in a required aggregation group is top-heavy if the group is top-heavy. Thus, each plan must contain provisions satisfying the requirements of sections 416 (b) and (d). If all the plans are defined contribution plans, only one plan need satisfy the requirements of section 416(c)(2) with respect to any non-key employee who participates in more than one of the plans. If all the plans are defined benefit plans, only one plan need satisfy the requirements of section 416(c)(1) with respect to any non-key employee who participates in more than one of the plans. However, in the case of non-key employees who do not participate in more than one plan, each plan must separately provide the applicable minimum contribution or benefit with respect to each such employee. See Question and Answer M–12 in the case of employees who are covered under both a defined benefit and a defined contribution plan.

T–11 Q. What plans will be treated as top-heavy if a permissive aggregation group is top-heavy?

A. If a permissive aggregation group is top-heavy, only those plans that are part of the required aggregation group will be subject to the requirements of section 416 (b), (c) and (d). Plans that are not part of the required aggregation group will not be subject to these requirements. Thus, if an employer wishes to demonstrate that the plans maintained by the employer are not top-heavy, the employer need consider only the required aggregation group. If, after considering the required aggregation group, it is determined that the plans are not top-heavy, the requirements of section 416 (b), (c) and (d) will not apply to any of the plans. If, on the other hand, the plans required to be aggregated are top-heavy, the employer may wish to determine whether there are any plans that may be permissively aggregated to demonstrate that the plans are not top-heavy. Assuming that there are plans that are eligible for permissive aggregation, the employer may take these plans into consideration. If, after taking such plans into consideration, the net result is that the entire group is not top-heavy, the top-heavy requirements do not apply to any plan in the group.

T–12 Q. For purposes of determining whether a plan is top-heavy for a plan year, who is a key employee?

A. Under section 416(i)(1), a key employee is any employee (including any deceased employee) who at any time during the plan year containing the determination date for the plan year in question or the four preceding plan years (including plan years before 1984) is:

1. An officer of the employer having annual compensation from the employer for a plan year greater than 150 percent of the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which such plan year ends (see Questions and Answers T–13, T–14, and T–15),

2. One of the ten employees having annual compensation from the employer for a plan year greater than the

dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which such plan year ends and owning (or considered as owning within the meaning of section 318) both more than a ½ percent interest and the largest interests in the employer (see Question and Answer T–19),

3. A 5-percent owner of the employer, or

4. A 1-percent owner of the employer having annual compensation from the employer for a plan year more than $150,000 (see Questions and Answers T–16 and T–21).

An individual may be considered a key employee in a plan year for more than one reason. For example, an individual may be both an officer and one of the ten largest owners. However, in testing whether a plan or group is top-heavy, an individual's accrued benefit is counted only once. The terms key employee, former key employee, and non-key employee include the beneficiaries of such individuals. This Question and Answer is illustrated by the following examples:

Example (1). An employer maintains a calendar-year plan. An individual who was an employee of the employer and a 5-percent owner of the employer in 1986 was neither an employee nor an owner in 1987 or thereafter. Even though the individual is no longer an employee or owner of the employer, the individual would be treated as a key employee for purposes of determining whether the plan is top-heavy for each plan year through the 1991 plan year. However, for purposes of determining whether the plan is top-heavy for the 1992 plan year and for subsequent plan years, the individual would be treated as a former key employee.

Example (2). The facts are the same as in example (1), except that the individual died in early 1987 and his total benefit under the plan was distributed to his beneficiary in 1987. Such distribution would be treated as the accrued benefit of the individual for each year through the 1991 plan year. However, such individual would be treated as a former key employee for purposes of determining whether the plan is top-heavy for the 1992 plan year and for subsequent plan years. The conclusions are not affected by whether the beneficiary of the individual is a non-key employee or a key employee of the employer.

T–13 Q. For purposes of defining a key employee, who is an officer?

A. Whether an individual is an officer shall be determined upon the basis of all the facts, including, for example, the source of his authority, the term for which elected or appointed, and the nature and extent of his duties. Generally, the term officer means an administrative executive who is in regular and continued service. The term officer implies continuity of service and excludes those employed for a special and single transaction. An employee who merely has the title of an officer but not the authority of an officer is not considered an officer for purposes of the key employee test. Similarly, an employee who does not have the title of an officer but has the authority of an officer is an officer for purposes of the key employee test. In the case of one or more employers treated as a single employer under sections 414(b), (c), or (m), whether or not an individual is an officer shall be determined based upon his responsibilities with respect to the employer or employers for which he is directly employed, and not with respect to the controlled group of corporations, employers under common control or affiliated service group. A partner of a partnership will not be treated as an officer for purposes of the key employee test merely because he owns a capital or profits interest in the partnership, exercises his voting rights as a partner, and may, for limited purposes, be authorized and does in fact act as an agent of the partnership.

T–14 Q. For purposes of determining whether a plan is top-heavy for a plan year, how many officers must be taken into account?

A. There is no minimum number of officers that must be taken into account. Only individuals who are in fact officers within the meaning of Question and Answer T–13 must be considered. For example, a corporation with only one officer and two employees would have only one officer for purposes of section 416(i)(1)(A)(i). After aggregating all employees (including leased employees within the meaning of section 414(n)) of employers required to be aggregated under section 414(b), (c) or (m), there is a maximum limit to the number of officers that are to be taken into account as officers for the entire group of employers that are so aggregated. The number of employees an employer (including all employers required to be aggregated under section 414(b), (c), or (m)) has for the plan year containing the determination date is the greatest number of employees it had during that plan year or any of the four preceding plan years. For purposes of this Question and Answer, employees include only those individuals who perform services for the employer during a plan year. If the number of employees (including part-time employees) of all the employers aggregated under section 414(b), (c) or (m) is less than 30 employees, no more than three individuals shall be treated as key employees for the plan year containing the determination date by reason of being officers. If the number of employees of all organizations aggregated under section 414(b), (c) or (m) is greater than 30 but less than 500, no more than 10% of the number of employees will be treated as key employees by reason of being officers. (If 10% of the number of employees is not an integer, the maximum number of individuals to be treated as key employees by reason of being officers shall be increased to the next integer). If the number of employees of employers aggregated under section 414 (b), (c) and (m) exceeds 500, no more than 50 employees are to be considered as key employees by reason of being officers. This limited number of officers is comprised of the individual officers, selected from the group of all individuals who were officers in the plan year containing the determination date or any one of the four preceding plan years, who had annual plan year compensation (in the officer year) in excess of 150 percent of the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which the plan year ends and who had the largest annual plan-year compensation in that five-year period. (The definition of compensation contained in Question and Answer T–21 is to be used for this purpose.) In determining the officers of an employer, an employee who is an officer shall be counted as an officer for key employee purposes without regard to whether the employee is a key employee for any other reason. However, in testing whether the plan(s) is top-heavy, an individual's present value of accrued benefits is counted only once.

Example. A company is testing to see if its plan is top-heavy for the 1985 plan year. In each year from 1980 through 1984 it has more than 500 employees. Assume that (1) because of rapid turnover among officers, the individuals who are officers each year are different from the individuals who are officers in any preceding year, and (2) the annual plan year compensation of each officer exceeds 150 percent of the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which the plan year ends. Under the limitations, only a total of 50 individuals would be considered to be key employees by virtue of being officers in testing for top-heaviness for the 1985 plan year. Further, the 50 individuals considered as key employees under this test would be determined by selecting the 50 out of 250 individuals (50 different officers each year) who had the highest annual plan-year compensation during the 1980–1984 period (while officers).

T–15 Q. For purposes of section 416, do organizations other than corporations have officers?

A. Yes. For purposes of the top-heavy rules, sole proprietorships, partnerships, associations, trusts, and labor organizations may have officers. This rule is effective for purposes of determining whether a plan is top-heavy for plan years which begin after February 28, 1985.

T–16 Q. Who is a 1-percent owner of the employer?

A. (a) If the employer is a corporation, a 1-percent owner is any employee who owns (or is considered as owning within the meaning of section 318) more than 1 percent of the value of the outstanding stock of the corporation or stock possessing more than 1 percent of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a 1-percent owner is any employee who owns more than 1 percent of the capital or profits interest in the employer. The rules of subsections (b), (c), and (m) of section 414 do not apply for purposes of determining who is a 1-percent owner.

(b) For purposes of determining who is a 1-percent owner, 5-percent owner, or top-ten owner, value means fair market value taking into account all facts and circumstances.

T–17 Q. Who is a 5-percent owner of the employer?

A. If the employer is a corporation, a 5-percent owner is any employee who owns (or is considered as owning within the meaning of section 318) more than 5 percent of the value of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a 5-percent owner is any employee who owns more than 5 percent of the capital or profits interest in the employer. The rules of subsections (b), (c), and (m) of section 414 do not apply for purposes of determining who is a 5-percent owner.

T–18 Q. How do the rules of section 318 apply for purposes of determining ownership in an entity other than a corporation?

A. For purposes of determining ownership is an entity other than a corporation, the rules of section 318 apply in a manner similar to the way in which they apply for purposes of determining ownership in a corporation. For non-corporate interests, capital or profits interest must be substituted for stock.

T–19 Q. Which employees will be considered one of the top ten owners?

A. (a) For purposes of determining whether a plan is top-heavy for a plan year, the top ten owners are the ten employees who (1) own (or are considered as owning within the meaning of section 318) during the plan year containing the determination date or any of the four preceding plan years both more than a ½ percent ownership interest in value and the largest percentage ownership interests in value of any of the employers required to be aggregated under section 414(b), (c), or (m), and (2) have during the plan year of ownership annual plan year compensation from the employer more than the limitation in effect under section 415(c)(1)(A) for the calendar year in which such plan year ends. The five years for which the test is made will be referred to as the ‘‘testing period.’’ An employee whose annual plan year compensation exceeds the section 415(c)(1)(A) limit in effect for the calendar year in which a plan year in the testing period ends who has an ownership interest greater than ½ percent in that plan year is considered to be one of the top ten owners unless at least ten other employees own a greater interest in the employer during any year of the testing period and have annual plan year compensation during such plan year of ownership greater than the section 415(c)(1)(A) limit in effect for the calendar year in which such plan year ends. Ownership each plan year is determined on the basis of percentage of ownership interest in total ownership value and not dollar amounts. Thus, an employee whose stock interest is valued at 15 percent of the total stock value of a corporation in year one that was worth $15,000 is ranked higher than an employee whose stock interest is valued at 5 percent of the total stock value of the same corporation in year three which is now worth $50,000.

(b) If an employee’s ownership interest changes during a plan year, his ownership interest for the year is the largest interest owned at any time during the year. If two employees have the same ownership interest in the employer during the testing period, the employee having the largest annual compensation from the employer for the plan year during any part of which that ownership interest existed shall be treated as having a larger interest. Thus, if 25 employees each own 4 percent in value of the employer during the testing period, the 10 employees with the largest single plan year compensation during this period will be considered the top ten owners. For purposes of this Question and Answer, compensation has the meaning set forth in Question and Answer T–21. This Question and Answer is illustrated by the following examples:

Example 1. Corporation K maintains a calendar year defined contribution plan. On January 1, 1986, Corporation K has five owners who owned the following value percentages of K stock: A=50%, B=20%, C=15%, D=10%, and E=5%. On June 30, 1987, the five owners of Corporation K sold all of their shares of stock. The new owners and their respective ownership percentages were: F=40%, G=30%, H=10%, I=10%, and J=10%. Assume that, for 1986, A, B, C, D, and E had annual compensation from Corporation K greater than the section 415(c)(1)(A) limit and that, for 1987, F, G, H, I, and J also had compensation from Corporation K greater than the section 415(c)(1)(A) limit. For purposes of determining whether the plan is top-heavy for the 1991 plan year, the top ten owners will include A, B, C, D, E, F, G, H, I, and J because no 10 individuals during the testing period, 1986–1990, had a greater ownership interest than these individuals.

Example 2. Assume the same facts in *Example 1*, except that on June 1, 1988, F, G, H, I, and J sold their interests to new owners, K, L, M, N, and O. K, L, M, N, and O owned, respectively, 30%, 30%, 30%, 5% and 5% of the value of the shares of X. Assume also that for 1988 K, L, M, N, and O earned more than the section 415(c)(1)(A) limitation. For purposes of determining whether the plan is top-heavy for the 1991 plan year, the top ten owners will include: A, B, F, K, G, L, M, and C because these eight individuals owned the highest value percentages of the Corporation K stock. Since D, H, I, and J owned equal 10% interests in value, the two employees of this group who had the largest annual plan year compensation during the plan years of their ownership will be the last 2 top ten owners.

T–20 Q. For purposes of determining whether an employee is a key employee under section 416(i)(1)(A), what aggregation rules apply?

A. In the case of ownership percentages, each employer that would otherwise be aggregated under section 414 (b), (c) and (m) is treated as a separate employer. (See section 416(i)(1)(C).) However, for purposes of determining whether an individual has compensation of $150,000, or whether an individual is a key employee by reason of being an officer or a top ten owner, compensation from each entity required to be aggregated under sections 414 (b), (c) and (m) is taken into account. These rules may be illustrated by the following example:

Example. An individual owns two percent of the value of a professional corporation, which in turn owns a 1⁄10th of 1 percent interest in a partnership. The entities must be aggregated in accordance with section 414(m). The individual performs services for the professional corporation and for the partnership. The individual receives compensation of $125,000 from the professional corporation and $26,000 from the partnership. The individual is considered to be a key employee with respect to the employer that comprises both the professional corporation and the partnership because he has a two percent interest in the professional corporation and because his combined compensation from both the professional corporation and the partnership is more than $150,000.

T–21 Q. For purposes of testing whether an individual has compensation of more than $150,000, what definition of compensation must be used?

A. The definition of compensation to be used is the definition in §1.415–2(d). In the case of an individual, including a self-employed individual, §1.415–2(d)(2)(i) excludes from compensation amounts contributed to a plan of deferred compensation. Alternatively, compensation that would be stated on an employee's Form W–2 for the calendar year that ends with or within the plan year may be used. A plan must use the same definition of compensation for all top-heavy purposes for which the definition in this Question and Answer must be used.

T–22 Q. In the case of an employer who maintains a single plan, when must the determination whether the plan is top-heavy be made?

A. Whether a plan is top-heavy for a particular plan year is determined as of the determination date for such plan year. The determination date with respect to a plan year is defined in section 416(g)(4)(C) as (1) the last day of the preceding plan year, or (2) in the case of the first plan year, the last day of such plan year. Distributions made and the present value of accrued benefits are generally determined as of the determination date. (See Questions and Answers T–24 and T–25 for more specific rules.)

T–23 Q. In the case of an aggregation group, when must the determination whether the group is top-heavy be made?

A. When two or more plans constitute an aggregation group in accordance with section 416(g)(2), the following procedures are used to determine whether the plans are top-heavy for a particular plan year. First, the present value of the accrued benefits (including distributions for key employees and all employees) is determined separately for each plan as of each plan's determination date. The plans are then aggregated by adding together the results for each plan as of the determination dates for such plans that fall within the same calendar year. The combined results will indicate whether or not the plans so aggregated are top-heavy. These rules may be illustrated by the following example:

Example. An employer maintains Plan A and Plan B, each containing a key employee. Plan A's plan year commences July 1 and ends June 30. Plan B's plan year is the calendar year. For Plan A's plan year commencing July 1, 1984, the determination date is June 30, 1984. For Plan B's plan year in 1985, the determination date is December 31, 1984. These plans are required to be aggregated. For each of these plans as of their respective determination dates, the present value of the accrued benefits for key employees and all employees are separately determined. The two determination dates, June 30, 1984, and December 31, 1984, fall within the same calendar year. Accordingly, the present values of accrued benefits as of each of these determination dates are combined for purposes of determining whether the group is top-heavy. If, after combining the two present values, the total results show that the group is top-heavy, Plan A will be top-heavy for the plan year commencing July 1, 1984, and Plan B will be top-heavy for the 1985 calendar year.

T–24 Q. How is the present value of an accrued benefit determined in a defined contribution plan?

A. The present value of accrued benefits as of the determination date for any individual is the sum of (a) the account balance as of the most recent valuation date occurring within a 12-month period ending on the determination date, and (b) an adjustment for contributions due as of the determination date. In the case of a plan not subject to the minimum funding requirements of section 412, the adjustment in (b) is generally the amount of any contributions actually made after the valuation date but on or before the determination date. However, in the first plan year of the plan, the adjustment in (b) should also reflect the amount of any contributions made after the determination date that are allocated as of a date in that first plan year. In the case of a plan that is subject to the minimum funding requirements, the account balance in (a) should include contributions that would be allocated as of a date not later than the determination date, even though those amounts are not yet required to be contributed. Thus, the account balance will include contributions waived in prior years as reflected in the adjusted account balance and contributions not paid that resulted in a funding deficiency. The adjusted account balance is described in Rev. Rul. 78–223, 1978–1 C.B. 125. Also, the adjustment in (b) should reflect the amount of any contribution actually made (or due to be made) after the valuation date but before the expiration of the extended payment period in section 412(c)(10).

T–25. Q. How is the present value of an accrued benefit determined in a defined benefit plan?

A. The present value of an accrued benefit as of a determination date must be determined as of the most recent valuation date which is within a 12-month period ending on the determination date. In the first plan year of a plan, the accrued benefit for a current employee must be determined either (i) as if the individual terminated service as of the determination date or (ii) as if the individual terminated service as of the valuation date, but taking into account the estimated accrued benefit as of the determination date. For the second plan year of a plan, the accrued benefit taken into account for a current participant must not be less than the accrued benefit taken into account for the first plan year unless the difference is attributable to using an estimate of the accrued benefit as of the determination date for the first plan year and using the actual accrued benefit as of the determination date for the second plan year. For any other plan year, the accrued benefit for a current employee must be determined as if the individual terminated service as of such valuation date. For this purpose, the valuation date must be the same valuation date for computing plan costs for minimum funding, regardless of whether a valuation is performed that year.

T–26. Q. What actuarial assumptions are used for determining the present value of accrued benefits for defined benefit plans?

A. (a) There are no specific prescribed actuarial assumptions that must be used for determining the present value of accrued benefits. The assumptions used must be reasonable and need not relate to the actual plan and investment experience. The assumptions need not be the same as those used for minimum funding purposes or for purposes of determining the actuarial equivalence of optional benefits under the plan. The accrued benefit for each current employee is computed as if the employee voluntarily terminated service as of the valuation date. The present value must be computed using an interest and a post-retirement mortality assumption. Pre-retirement mortality and future increases in cost of living (but not in the maximum dollar amount permitted by section 415) may also be assumed. However, assumptions as to future withdrawals or future salary increases may not be used. In the case of a plan providing a qualified joint and survivor annuity within the meaning of section 401(a)(11) as a normal form of benefit, for purposes of determining the present value of the accrued benefit, the spouse of the participant may be assumed to be the same age as the participant.

(b) Except in the case where the plan provides for a nonproportional subsidy, the present value should reflect a benefit payable commencing at normal retirement age (or attained age, if later). Thus, benefits not relating to retirement benefits, such as pre-retirement death and disability benefits and post-retirement medical benefits, must not be taken into account. Further, subsidized early retirement benefits and subsidized benefit options must not be taken into account unless they are nonproportional subsidies. See Question and Answer
T–27.

(c) Where the plan provides for a nonproportional subsidy, the benefit should be assumed to commence at the age at which the benefit is most valuable. In the case of two or more defined benefit plans which are being tested for determining whether an aggregation group is top-heavy, the actuarial assumptions used for all plans within the group must be the same. Any assumptions which reflect a reasonable mortality experience and an interest rate not less than five percent or greater than six percent will be considered as reasonable. Plans, however, are not required to use an interest rate in this range.

T–27 Q. In determining the present value of accrued benefits in a defined benefit plan, what standards are applied toward determining whether a subsidy is nonproportional?

A. A subsidy is nonproportional unless the subsidy applies to a group of employees that would independently satisfy the requirements of section 410(b). If two or more plans are considered as a unit for comparability purposes under §1.410(b)–1(d)(3), subsidies may be necessary in both plans or else the subsidy may be nonproportional. Thus, for example, in the case of a plan which provides an early retirement benefit after age 55 and 20 years of service equal to the normal retirement benefit without actuarial reduction and if the employees who may conceivably reach age 55 with 20 years of service would, as a group, satisfy the requirements of section 410(b), that subidy is proportional. However, in contrast, consider a plan that provides an early retirement benefit that is the actuarial equivalent of the normal retirement benefit. In determining the early retirement benefit, the plan imposes the section 415 limits only on the early retirement benefit (not on the normal retirement benefit before applying the early retirement reduction factors). In such a plan, a participant with a normal retirement benefit (before limitation by section 415) in excess of the section 415 limits will receive a subsidized early retirement benefit, whereas a participant with a lower normal retirement benefit will not. Thus, such a benefit would be a nonproportional subsidy if the group of individuals who are limited by the limitations under section 415 do not, by themselves, constitute a cross section of employees that could satisfy section 410(b).

T–28 Q. For purposes of determining the present value of accrued benefits in either a defined benefit or defined contribution plan, are the accrued benefits attributable to employee contributions considered to be part of the accrued benefits?

A. The accrued benefits attributable to employee contributions are considered to be part of the accrued benefits without regard to whether such contributions are mandatory or voluntary. However, the amounts attributable to deductible employee contributions (as defined in section 72(o)(5)(A)) are not considered to be part of the accrued benefits.

T–29 Q. How are plans described in section 401(k) treated for purposes of the top-heavy rules?

A. No special top-heavy rules are provided for plans described in section 401(k), except a transitional rule. For plan years beginning after December 31, 1984, amounts which an employee elects to defer are treated as employer contributions for purposes of determining minimum required contributions under section 416(c)(2). However, for plan years beginning prior to January 1, 1985, amounts which an employee elects to have contributed to a plan described in section 401(k) are not treated as employer contributions for these purposes. A plan described in section 401(k) which is top-heavy must provide minimum contributions by the employer and limit the amount of compensation which can be taken into account in providing benefits under the plan.

T–30 Q. What distributions are added to the present value of accrued benefits in determining whether a plan is top-heavy for a particular plan year?

A. Under section 416(g)(3)(A), distributions made within the plan year that includes the determination date and within the four preceding plan years are added to the present value of accrued benefits of key employees and non-key employees in testing for top-heaviness. However, in the case of distributions made after the valuation date and prior to the determination date, such distributions are not included as distributions in section 416(g)(3)(A) to the extent that such distributions are included in the present value of the accrued benefits as of the valuation date. In the case of the distribution of an annuity contract, the amount of such distribution is deemed to be the current actuarial value of the contract, determined on the date of the distribution. Certain distributions that are rolled over by the employee are not included as distributions. See Question and Answer T–32. A distribution will not fail to be considered in determining the present value of accrued benefits merely because it was made before the effective date of section 416. For purposes of this question and answer, distributions mean all distributions made by a plan, including all distributions of employee contributions made during and before the plan year.

T–31 Q. Are benefits paid on account of death treated as distributions for purposes of section 416(g)(3)?

A. Benefits paid on account of death are treated as distributions for purposes of section 416(g)(3) to the extent such benefits do not exceed the present value of accrued benefits existing immediately prior to death; benefits paid on account of death are not treated as distributions for purposes of section 416(g)(3) to the extent such benefits exceed the present value of accrued benefits existing immediately prior to death. The distribution from a defined contribution plan (including the cash value of life insurance policies) of a participant's account balance on account of death will be treated as a distribution for purposes of section 416(g)(3).

T–32 Q. How are rollovers and plan-to-plan transfers treated in testing whether a plan is top-heavy?

A. The rules for handling rollovers and transfers depend upon whether they are unrelated (both initiated by the employee and made from a plan maintained by one employer to a plan maintained by another employer) or related (a rollover or transfer either not initiated by the employee or made to a plan maintained by the same employer). Generally, a rollover or transfer made incident to a merger or consolidation of two or more plans or the division of a single plan into two or more plans will not be treated as being initiated by the employee. The fact that the employer initiated the distribution does not mean that the rollover was not initiated by the employee. For purposes of determining whether two employers are to be treated as the same employer, all employers aggregated under section 414(b), (c) or (m) are treated as the same employer. In the case of unrelated rollovers and transfers, (1) the plan making the distribution or transfer is to count the distribution as a distribution under section 416(g)(3), and (2) the plan accepting the rollover or transfer is not to consider the rollover or transfer as part of the accrued benefit if such rollover or transfer was accepted after December 31, 1983, but is to consider it as part of the accrued benefit if such rollover or transfer was accepted prior to January 1, 1984. In the case of related rollovers and transfers, the plan making the distribution or transfer is not to count the distribution or transfer under section 416(g)(3) and the plan accepting the rollover or transfer counts the rollover or transfer in the present value of the accrued benefits. Rules for related rollovers and transfers do not depend on whether the rollover or transfer was accepted prior to January 1, 1984.

T–33 Q. How are the aggregate defined benefit and defined contribution limits under section 415(e) affected by the top-heavy rules?

A. Section 416(h) modifies the aggregate limits in section 415(e) for super top-heavy plans and for top-heavy plans that are not super top-heavy but do not provide for an additional minimum contribution or benefit. A plan is a super top-heavy plan if the present value of accrued benefits for key employees exceeds 90% of the present value of the accrued benefits for all employees. In the case of a top-heavy aggregation group, the test is applied to all plans in the group as a whole. These present values are computed using the same rules as are used for determining whether the plan is top-heavy. In the case of a super top-heavy plan, in computing the denominators of the defined benefit and defined contribution fractions under section 415(e), a factor of 1.0 is used instead of 1.25 for all employees. In the case of a top-heavy plan that is not super top-heavy, the same rule applies unless each non-key employee who is entitled to a minimum contribution or benefit receives an additional minimum contribution or benefit. In the case of a defined benefit plan, the additional minimum benefit is one percentage point (up to a maximum of ten percentage points) for each year of service described in Question and Answer M–2 of the participant's average compensation for the years described in Question and Answer M–2. In the case of a defined contribution plan, the additional minimum contribution is one percent of the participant's compensation. If a plan does not provide the applicable additional one percent minimum or if a plan is super top-heavy, the factor of 1.25 may be used for an individual only if there are both no further accruals for that individual under any defined benefit plan and no further annual additions for that individual under any defined contribution plan until the combined fraction satisfies the rules of section 415(e) using the 1.0 factor for that individual. The rules contained in this Question and Answer apply for each limitation year that contains any portion of a plan year for which the plan is top-heavy. This Question and Answer may be illustrated by the following example:

Example. A Corporation maintains a profit-sharing plan and a defined benefit plan, and these plans constitute a required aggregation group. Both plans use the calendar year for the plan year and the limitation year under section 415. The plans were determined to be top-heavy for plan year 1986. The plans use the 1.25 factor under section 415(e), and non-key employees covered by both the profit-sharing and the defined benefit plan accrue, under the defined benefit plan, 3% of compensation for each year of service (up to a maximum of 30%). The plans become super top-heavy for the 1990 plan year. In order to satisfy section 415, no further accruals and no further annual additions may take place for any employee covered by both plans until the combined defined benefit-defined contribution fraction for such employee is less than 1.0, using the 1.0 factor in place of 1.25.

T–34 Q. May plans be permissively aggregated to avoid being super top-heavy?

A. Yes, plans may be permissively aggregated to avoid being super top-heavy.

T–35 Q. What provisions must be contained in a plan to comply with the top-heavy requirements?

A. Section 401(a)(10)(B) provides that a plan will qualify only if it contains provisions which will take effect if the plan becomes top-heavy and which meet the requirements of section 416. See Questions and Answers T–39 and T–40 for rules on what provisions must be included. Under section 401(a)(10)(B)(ii), regulations may waive this requirement for some plans. See Question and Answer T–38 for a description of plans that need not include such provisions.

T–36 Q. For an employer who has no employee who has participated or is eligible to participate in both a defined benefit and defined contribution plan (or a simplified employee pension, ''SEP'') of that employer, what provisions must be in the plan(s) to comply with the top-heavy requirements?

A. (a) If the defined benefit plan has no participants who are or could be participants in a defined contribution plan of the employer (or vice versa), the defined benefit plan (or defined contribution plan) need not include provisions describing the defined benefit or defined contribution fractions for purposes of section 415 and, thus, the plan need not contain provisions to determine whether the plan is super top-heavy or to change any plan provisions if the plan becomes super top-heavy. Furthermore, if the plan contains a single benefit structure that satisfies the requirements of section 416 (b), (c), and (d) for each plan year without regard to whether the plan is top-heavy for such year, the plan need not include separate provisions to determine whether the plan is top-heavy or that apply if the plan is top-heavy. If the plan's single benefit structure does not assure that section 416 (b), (c), and (d) will be satisfied in all cases, then the plan must include three types of provisions.

(b) First, the plan must contain provisions describing how to determine whether the plan is top-heavy. These provisions must include (1) the criteria for determining which employees are key employees (or non-key employees), (2) in the case of a defined benefit plan, the actuarial assumptions and benefits considered to determine the present value of accrued benefits, (3) a description of how the top-heavy ratio is computed, (4) a description of what plans (or types of plans) will be aggregated in testing whether the plan is top-heavy, and (5) a definition of the determination date and the valuation date applicable to the determination date. These determinations must be based on standards that are uniformly and consistently applied and that satisfy the rules set forth in section 416 and these Questions and Answers. The provisions in (1) and (3) above may be incorporated in the plan by reference to the applicable sections of the Internal Revenue Code without adversely affecting the qualification of the plan. However, the plan must state the definition of compensation for purposes of determining who is a key employee.

(c) Second, the plan must specifically contain the following provisions that will become effective if the plan becomes top-heavy: vesting that satisfies the minimum vesting requirements of section 416(b), benefits that will not be less than the minimum benefits set forth in section 416(c), and the compensation limitation described in section 416(d). The compensation limitation described in section 416(d) may be incorporated by reference. If a plan always meets the requirements of either section 416(b), (c) or (d), the plan need not include additional provisions to meet any such requirements.

(d) Third, the plan must include provisions insuring that any change in the plan's benefit structure (including vesting schedules) resulting from a change in the plan's top-heavy status will not violate section 411(a)(10). Thus, if a plan ceases being top-heavy, certain restrictions apply with respect to the change in the applicable vesting schedule.

T–37 Q. For an employer who maintains or has maintained both a defined benefit and a defined contribution plan (or a simplified employee pension, ''SEP'') and some participants do or could participate in both types of plan, what provisions must be in the plans to comply with the top-heavy requirements?

A. If an employer maintains (or has maintained) both a defined benefit plan and a defined contribution plan (or SEP), and the plans have or could have participants who participate in both types of plans, then the plans must contain more provisions than those described in Question and Answer T-36. First, the plans may exclude rules to determine whether the plan is top-heavy (or to apply when the plan is top-heavy) only if both plans contain a single benefit structure that satisfies sections 416 (b), (c), and (d) without regard to whether the plans are top-heavy. Second, unless the plans always satisfy the requirements of section 415(e) using the 1.0 factor in the defined benefit and defined contribution fractions as described in section 416(h)(i), the plans must include provisions similar to those in Question and Answer T–36 (for top-heavy) to determine whether the plan is super top-heavy and to satisfy section 416(h) if it is.

T–38 Q. Are any plans exempted from including top-heavy provisions?

A. Section 401(a)(10)(B) exempts governmental plans (as defined in section 414(d)) from the top-heavy requirements and provides that regulations may exempt certain plans from including the top-heavy provisions. A plan need not include any top-heavy provisions if the plan: (1) is not top-heavy, and (2) covers only employees who are included in a unit of employees covered by a collective-bargaining agreement (if retirement benefits were the subject of good faith bargaining) or employees of employee representatives. The requirement set forth in section 7701(a)(46) must be met before an agreement will be considered a collective-bargaining agreement after March 31, 1984.

T–39 Q. Must ratios be computed each year to determine whether a plan is top-heavy?

A. No. In order to administer the plan, the plan administrator must know whether the plan is top-heavy. However, precise top-heavy ratios need not be computed every year. If, on examination, the Internal Revenue Service requests a demonstration as to whether the plan is top-heavy (or super top-heavy; see Question and Answer T–33) the employer must demonstrate to the Service's satisfaction that the plan is not operating in violation of section 401(a)(10)(B). For purposes of any demonstration, the employer may use computations that are not precisely in accordance with this section but which mathematically prove that the plan is not top-heavy. For example, if the employer determined the present value of accrued benefits for key employees in a simplified manner which overstated that value, determined the present value for non-key employees in a simplified manner which understated that value, and the ratio of the key employee present value divided by the sum of the present values was less than 60 percent, the plan would not be considered top-heavy. This would be a sufficient demonstration because the simplified fraction could be shown to be greater than the exact fraction and, thus, the exact fraction must also be less than 60 percent.

Several methods that may be used to simplify the determinations are indicated below.

(1) If the top-heavy ratio, computed considering all the key employees and only some of the non-key employees, is less than 60 percent, then it is not necessary to accumulate employee data on the remaining non-key employees. Inclusion of additional non-key employees would only further decrease the ratio.

(2) If the number of key employees is known but the identity of the key employees is not known (i.e. if the only key employees are officers and the limit on officers is applicable), the numerator may be determined by using a hypothetical ‘‘worst case’’ basis. Thus, in the case of a defined benefit plan, if the numerator of the top-heavy ratio were determined assuming each key employee's present value of accrued benefits were equal to the maximum section 415 benefits at the age that would maximize such present value, that assumption would only overstate the present value of accrued benefits for key employees. Thus, if that ratio is less than 60 percent, the plan is not top-heavy and accurate data on the key employees need not be collected.

(3) If the employer has available present value of accrued benefit computations for key and non-key employees in a defined benefit plan, and these values differ from those that would be produced under Question and Answer T–25 only by inclusion of a withdrawal assumption, the present value for the key employees (but not the non-key employees) may be adjusted to a ‘‘worst case’’ value by dividing by the lowest possible probability of not withdrawing from plan participation before normal retirement age. If the top-heavy ratio based on this inflated key employee value is less than 60 percent, the present value need not be recomputed without the withdrawal assumption. The methods set forth in this answer may also be used to determine whether a plan is super top-heavy by

inserting ''90%'' for ''60%'' in the appropriate places.

T–40 Q. Will a plan fail to qualify if it provides that the $200,000 maximum amount of annual compensation taken into account under section 416(d) for any plan year that the plan is top-heavy may be automatically increased in accordance with regulations under section 416?

A. No.

T–41 Q. If a plan provides benefits based on compensation in excess of $200,000 and the plan becomes top-heavy, must any accrued benefits attributable to this excess compensation be eliminated?

A. No. For any year that a plan is top-heavy, section 416(d) provides that compensation in excess of $200,000 must not be taken into account. However, a top-heavy plan may continue to provide for any benefits attributable to compensation in excess of $200,000 to the extent such benefits were accrued before the plan was top-heavy. Furthermore, section 411(d)(6) will be violated if any individual's pre-top-heavy benefit is reduced by either (1) a plan amendment adding the $200,000 restriction, or (2) an automatic change in the plan benefits structure imposing the $200,000 restriction due to the plan's becoming top-heavy.

T–42 Q. Under a top-heavy defined benefit plan, are the requirements of section 416(d) satisfied if the annual compensation of an employee taken into account to determine plan benefits is limited to the amount currently described in section 416(d) for years during which the plan is top-heavy but higher compensation is taken into account for years before the plan became top-heavy?

A. No. For the top-heavy plan to meet the requrements of section 416(d), compensation for all years, including years before the plan became top-heavy, that is taken into account to determine plan benefits must not exceed the amount currently described in section 416(d). However, if the accrued benefit as of the end of the last plan year before the plan became top-heavy (ignoring any plan amendments after that date) is greater than the accrued benefit determined by limiting compensation in accordance with section 416(d), that higher accrued benefit as of the end of the last plan year before the plan became top-heavy must not be reduced. Providing such higher accrued benefit will not cause the plan to violate section 416(d).

T–43 Q. What happens to an individual who has ceased employment before a plan becomes top-heavy?

A. If an individual has ceased employment before a plan becomes top-heavy, such individual would not be required to receive any additional benefit accruals, contributions, or vesting, unless the individual returned to employment with the employer. See Questions and Answers V–3, M–4, and M–10. In addition, if the individual is receiving benefits based on annual compensation greater than $200,000, such benefits cannot be decreased.

V. VESTING RULES FOR TOP-HEAVY PLANS

V–1 Q. What vesting must be provided under a top-heavy plan?

A. Under section 416(b), the accrued benefits attributable to employer contributions must be nonforfeitable in accordance with one of two statutory standards. Either such accrued benefits must be nonforfeitable after 3 years of service or the nonforfeitable portion of accrued benefits must be at least 20 percent after 2 years of service, 40 percent after 3 years of service, 60 percent after 4 years of service, 80 percent after 5 years of service, and 100 percent after 6 years of service. The accrued benefits attributable to employer contributions has the same meaning as under section 411(c) of the Code. As under section 411(a), the accrued benefits attributable to employee contributions must be nonforfeitable at all times.

V–2 Q. What service must be counted in determining vesting requirements?

A. All service required to be counted under section 411(a) must be counted for these purposes. All service permitted to be disregarded under section 411(a)(4) may similarly be disregarded under the schedules of section 416(b).

V–3 Q. What benefits must be subject to the minimum vesting schedule of section 416(b)?

A. All accrued benefits within the meaning of section 411(a)(7) must be subject to the minimum vesting schedule. These accrued benefits include benefits accrued before the effective date of section 416 and benefits accrued before a plan becomes top-heavy. However, when a plan becomes top-heavy, the accrued benefits of any employee who does not have an hour of service after the plan becomes top-heavy are not required to be subject to the minimum vesting schedule. Accrued benefits which have been forfeited before a plan becomes top-heavy need not vest when a plan becomes top-heavy.

V–4 Q. May a top-heavy plan provide a minimum eligibility requirement of the later of age 21 or the completion of 3 years of service and provide that all benefits are nonforfeitable when accrued?

A. Yes. For plan years which begin after December 31, 1984, a top-heavy plan may provide a minimum eligibility requirement of the later of age 21, or the completion of 3 years of service, and provide that all benefits are nonforfeitable when accrued. For plan years which begin before January 1, 1985, ‘‘25’’ may be substituted for ‘‘21’’ in the preceding sentence.

V–5 Q. What does nonforfeitable mean?

A. In general, nonforfeitable has the same meaning as in section 411(a). However, the minimum benefits required under section 416 (to the extent required to be nonforfeitable under section 416(b)) may not be forfeited under section 411(a)(3) (B) or (D). Thus, if benefits are suspended (ceased) during a period of reemployment, the benefit payable upon the subsequent resumption of payments must be actuarially increased to reflect the nonpayment of benefits during such period of re-employment.

V–6 Q. Will a class-year plan automatically satisfy the minimum vesting requirements in section 416(b) if it provides that contributions with respect to any plan year become nonforfeitable no later than the end of the third plan year following the plan year for which the contribution was made?

A. No. Although this vesting schedule is similar to the 3-year minimum vesting schedule permitted by section 416(b)(1)(A), it does not satisfy that minimum. The 3-year vesting schedule in section 416(b)(1)(A) requires that, after completion of 3 years of service, the entire accrued benefit of a participant be nonforfeitable. Under the class-year vesting schedule described above, a portion of a participant’s accrued benefit (that portion attributable to contributions for the prior 3 years) is forfeitable regardless of the participant’s years of service.

V–7 Q. When a top-heavy plan ceases to be a top-heavy, may the vesting schedule be altered to a vesting schedule permitted without regard to section 416?

A. When a top-heavy plan ceases to be top-heavy, the vesting schedule may be changed to one that would otherwise be permitted. However, in changing the vesting schedule, the rules described in section 411(a)(10) apply. Thus, the nonforfeitable percentage of the accrued benefit before the plan ceased to be top-heavy must not be reduced; also, any employee with five or more years of service must be given the option of remaining under the prior (i.e., top-heavy) vesting schedule.

M. MINIMUM BENEFITS UNDER TOP-HEAVY PLANS

M–1 Q. Which employees must receive minimum contributions or benefits in a top-heavy plan?

A. Generally, every non-key employee who is a participant in a top-heavy plan must receive minimum contributions or benefits under such plan. However, see Questions and Answers M–4 and M–10 for certain exceptions. Different minimums apply for defined benefit and defined contribution plans.

M–2 Q. What is the defined benefit minimum?

A. (a) The defined benefit minimum requires that the accrued benefit at any point in time must equal at least the product of (i) an employee’s average annual compensation for the period of consecutive years (not exceeding five) when the employee had the highest aggregate compensation from the employer and (ii) the lesser of 2% per year of service with the employer or 20%.

(b) For purposes of the defined benefit minimum, years of service with the employer are generally determined under the rules of section 411(a) (4), (5) and (6). However, a plan may disregard any year of service if the plan was not top-heavy for any plan year ending during such year of service, or if the year of service was completed in a plan year beginning before January 1, 1984.

(c) In determining the average annual compensation for a period of consecutive years during which the employee had the largest aggregate compensation, years for which the employee did not earn a year of service under the rules of section 411(a) (4), (5), and (6) are to be disregarded. Thus, if an employee has received compensation from the employer during years one two, and three, and for each of these years the employee earned a year of service, then the employee's average annual compensation is determined by dividing the employee's aggregate compensation for these three years by three. If the employee fails to earn a year of service in the next year, but does earn a year of service in the fifth year, the employee's average annual compensation is calculated by dividing the employee's aggregate compensation for years one, two, three, and five by four. The compensation required to be taken into account is the compensation described in Question and Answer T–21. In addition, compensation received for years ending in plan years beginning before January 1, 1984, and compensation received for years beginning after the close of the last plan year in which the plan is top-heavy may be disregarded.

(d) The defined benefit minimum is expressed as a life annuity (with no ancillary benefits) commencing at normal retirement age. Thus, if post-retirement death benefits are also provided, the 2% minimum annuity benefit may be adjusted. (See Question and Answer M–3.) The 2% minimum annuity benefit may not be adjusted due to the provision of pre-retirement ancillary benefits. Normal retirement age has the same meaning as under section 411(a)(8).

(e) Any accruals of employer-derived benefits, whether or not attributable to years for which the plan is top-heavy, may be used to satisfy the defined benefit minimums. Thus, if a non-key employee had already accrued a benefit of 20 percent of final average pay at the time the plan became top-heavy, no additional minimum accruals are required (although the accrued benefit would increase as final average pay increased). Accrued benefits attributable to employee contributions must be ignored. Accrued benefits attributable to employer and employee contributions have the same meaning as under section 411(c).

M–3 Q. What defined benefit minimum must be received if an employee receives a benefit in a form other than a single life annuity or a benefit other than at normal retirement age?

A. If the form of benefit is other than a single life annuity, the employee must receive an amount that is the actuarial equivalent of the minimum single life annuity benefit. If the benefit commences at a date other than at normal retirement age, the employee must receive at least an amount that is the acturial equivalent of the minimum single life annuity benefit commencing at normal retirement age. Thus, the employee may receive a lower benefit if the benefit commences before the normal retirement age and the employee must receive a higher benefit if the benefit commences after the normal retirement age. No specific actuarial assumptions are mandated providing different actuarial equivalents. However, the assumptions must be reasonable.

M–4 Q. Which employees must accrue a minimum benefit in a top-heavy defined benefit plan?

A. Each non-key employee who is a participant in a top-heavy defined benefit plan and who has at least one thousand hours of service (or equivalent service as determined under Department of Labor regulations, 29 CFR 2530.200b–3) for an accrual computation period must accrue a minimum benefit in a top-heavy defined benefit plan for that accrual computation period. If the accrual computation period does not coincide with the plan year, a minimum benefit must be provided, if required, for both accrual periods within the top-heavy plan year. For a top-heavy plan that does not base accruals on accrual computation periods, minimum benefits must be credited for all periods of service required to be credited for benefit accrual. (See § 1.410(a)–

7). A non-key employee may not fail to accrue a minimum benefit merely because the employee was not employed on a specified date. Similarly, a non-key employee may not fail to accrue a minimum benefit because either (1) an employee is excluded from participation (or accrues no benefit) merely because the employee's compensation is less than a stated amount, or (2) the employee is excluded from participation (or accrues no benefit) merely because of a failure to make mandatory employee contributions.

M–5 Q. Would the defined benefit minimum be satisfied if the plan provides a normal retirement benefit equal to the greater of the plan's projected formula or the projected minimum benefit and if benefits accrue in accordance with the fractional rule described in section 411(b)(1)(C)?

A. No. The fact that this fractional rule would not satisfy the defined benefit minimum may be illustrated by the following example. Consider a non-key employee, age 25, entering a top-heavy plan in which the projected minimum for the employee is greater than the projected benefit under the normal formula. Under the fractional rule, the employee's accrued benefit ten years later at age 35 would be 5% (20% ×(10/40)). Under section 416, the employee's minimum accrued benefit after ten years of service must be at least 20%. Thus, because the 5% benefit is less than the 20% benefit required under section 416, such benefit would not satisfy the required minimum.

M–6 Q. What benefit must an employer provide in a top-heavy defined benefit employee pay-all plan?

A. The defined benefit minimum in an employee pay-all top-heavy plan is the same as that for a plan which has employer contributions. That is, the employer must provide the benefits specified in Question and Answer M–2.

M–7 Q. What is the defined contribution minimum?

A. The sum of the contributions and forfeitures allocated to the account of any non-key employee who is a participant in a top-heavy defined contribution plan must equal at least 3% of such employee's compensation (see Question and Answer T–21 for the definition of compensation) for that plan year or for the calendar year ending within the plan year. However, a lower minimum is permissible where the largest contribution made or required to be made for key employees is less than 3%. The preceding sentence does not apply to any plan required to be included in an aggregation group if such plan enables a defined benefit plan required to be included in such group to meet the requirements of section 401(a)(4) or 410. The contribution made or required to be made on behalf of any key employee is equal to the ratio of the sum of the contributions made or required to be made and forfeitures allocated for such key employee divided by the compensation (not in excess of $200,000) for such key employee. Thus, the defined contribution minimum that must be provided for any non-key employee for a top-heavy plan year is the largest percentage of compensation (not in excess of $200,000) provided on behalf of any key employee for that plan year (if the largest percentage of compensation provided on behalf of any key employee for that plan year is less than 3%).

M–8 Q. If an employer maintains two top-heavy defined contribution plans, must both plans provide the defined contribution minimum for each non-key employee who is a participant in both plans?

A. No. If one of the plans provides the defined contribution minimum for each non-key employee who participates in both plans, the other plan need not provide an additional contribution for such employees. However, the other plan must provide the vesting required by section 416(b) and must limit compensation (based on all compensation from all aggregated employers) in providing benefits as required by section 416(d).

M–9 Q. In the case of the waiver of minimum funding standards of section 412(d), how does section 416 treat the defined contribution minimum?

A. For purposes of determining the contribution that is required to be made on behalf of a key employee, a waiver of the minimum funding requirements is disregarded. Thus, if a defined contribution plan receives a waiver of the minimum funding requirement, and if the minimum contribution required under the plan without regard to the waiver exceeds 3%, the exception described in Question and Answer M–7 does not apply even though no key employee receives a contribution in excess of 3% and even though the amount required to be contributed on behalf of the key employee has been waived. Also, a waiver of the minimum funding requirements will not alter the requirements of section 416. Thus, in the case of the top-heavy defined contribution plan in which the non-key employee must receive an allocation, a waiver of the minimum funding requirements may eliminate a funding violation and such waiver will preclude a violation under section 416 even though the required contribution is not made. However, the adjusted account balance (as described in Rev. Rul. 78–223, 1978–1 C.B. 125) of the non-key employees must reflect the required minimum contribution even though such contribution was not made.

M–10 Q. Which employees must receive the defined contribution minimum?

A. Those non-key employees who are participants in a top-heavy defined contribution plan who have not separated from service by the end of the plan year must receive the defined contribution minimum. Non-key employees who have become participants but who subsequently fail to complete 1,000 hours of service (or the equivalent) for an accrual computation period must receive the defined contribution minimum. A non-key employee may not fail to receive a defined contribution minimum because either (1) the employee is excluded from participation (or accrues no benefit) merely because the employee's compensation is less than a stated amount, or (2) the employee is excluded from participation (or accrues no benefit) merely because of a failure to make mandatory employee contributions or, in the case of a cash or deferred arrangement, elective contributions.

M–11 Q. May either the defined benefit minimum or the defined contribution minimum be integrated with social security?

A. No.

M–12 Q. What minimum contribution or benefit must be received by a non-key employee who participates in a top-heavy plan?

A. In the case of an employer maintaining only one plan, if such plan is a defined benefit plan, each non-key employee covered by that plan must receive the defined benefit minimum. If such plan is a defined contribution plan (including a target benefit plan), each non-key employee covered by the plan must receive the defined contribution minimum. In the case of an employer who maintains more than one plan, employees covered under only the defined benefit plan must receive the defined benefit minimum. Employees covered under only the defined contribution plan must receive the defined contribution minimum. In the case of employees covered under both defined benefit and defined contribution plans, the rules are more complicated. Section 416(f) precludes, in the case of employees covered under both defined benefit and defined contribution plans, either required duplication or inappropriate omission. Therefore, such employees need not receive both the defined benefit and the defined contribution minimums.

There are four safe harbor rules a plan may use in determining which minimum must be provided to a non-key employee who is covered by both defined benefit and defined contribution plans. Since the defined benefit minimums are generally more valuable, if each employee covered under both a top-heavy defined benefit plan and a top-heavy defined contribution plan receives the defined benefit minimum, the defined benefit and defined contribution minimums will be satisfied. Another approach that may be used is a floor offset approach (see Rev. Rul. 76–259, 1976–2 C.B. 111) under which the defined benefit minimum is provided in the defined benefit plan and is offset by the benefits provided under the defined contribution plan. Another approach that may be used in the case of employees covered under both defined benefit and defined contribution plans is to prove, using a comparability analysis (see Rev. Rul. 81–202, 1981–2 C.B. 93) that the plans are providing benefits at least equal to the defined benefit minimum. Finally, in order to preclude the cost of providing the defined benefit minimum alone, the complexity of a floor offset plan and the annual fluctuation of a comparability analysis, a safe haven minimum defined contribution is being provided. If the contributions and forfeitures under the defined contribution plan equal 5% of compensation for each plan year the plan is top-heavy, such minimum will be presumed to satisfy the section 416 minimums.

M–13 Q. An employer maintains a defined benefit plan and a profit-sharing plan. Both plans are top-heavy and are members of a required aggregation group. In order to meet the minimum contribution/minimum benefit requirements, the employer decides to contribute 5% of compensation to the profit-sharing plan. What happens if for a particular plan year there are no profits out of which to make contributions to the profit-sharing plan?

A. In this particular situation, in order to satisfy the requirements of section 416(c), the employer must provide the defined contribution minimum, 5% of compensation. This rule is an exception to the general rule that an employer cannot make a contribution to a profit-sharing plan if there are no profits. Alternatively, the employer may provide the defined benefit minimum for this year.

M–14 Q. What minimum contribution or benefit must be received by a non-key employee when he is covered under both a defined benefit plan and defined contribution plan (both of which are top-heavy) of an employer and the employer desires to use a factor of 1.25 in computing the denominators of the defined benefit and defined contribution fractions under section 415(e)?

A. In this particular situation, the employer may use one of the four rules set forth in Question and Answer M–12, subject to the following modifications. The defined benefit minimum must be increased by one percentage point (up to a maximum of ten percentage points) for each year of service described in Question and Answer M–2 of the participant's average compensation for the years described in Question and Answer M–2. The defined contribution minimum is increased to 7½ percent of compensation. If the floor offset or comparability analysis approach is used, the defined benefit minimum must be increased by one percentage point (up to a maximum of ten percentage points) for each year of service described in Question and Answer M–2 of the participant's average compensation for the years described in Question and Answer M–2.

M–15 Q. May an employer use a different method each year to meet the requirements of Question and Answer M–12 or Question and Answer M–14 without amending the plans each year?

A. No. An employer must set forth in the plan document the method he will use to meet the requirements of Question and Answer M–12 or M–14, as the case may be. If an employer desires to change the method, the plan document must be amended.

M–16 Q. Will target benefit plans be treated as defined benefit or defined contribution plans for purposes of the top-heavy rules?

A. Target benefit plans will be treated as defined contribution plans for purposes of the top-heavy rules.

M–17 Q. Can a plan described in section 412(i) (funded exclusively by level premium insurance contracts) also satisfy the minimum benefit requirements of section 416?

A. The accrued benefits provided for a non-key employee under most level premium insurance contracts might not provide a benefit satisfying the defined benefit minimum because of the lower cash values in early years under most level premium insurance contracts, and because such contracts normally provide for level premiums until normal retirement age. However, a plan will not be considered to violate the requirements of section 412(i) merely because it funds certain benefits through either an auxiliary fund or deferred annuity contracts, if the following conditions are met:

(1) The targeted benefit at normal retirement age under the level premium insurance contract is determined, taking into account the defined benefit minimum that would be required assuming the current top-heavy (or non top-heavy) status of the plan continues until normal retirement age; and

(2) The benefits provided by the auxiliary fund or deferred annuity contracts do not exceed the excess of the defined benefit minimum benefits over the benefits provided by the level premium insurance contract.

If the above conditions are satisfied, then the plan is still exempt from the minimum funding requirements under section 412 and may still utilize the special accrued benefit rule in section 411(b)(1)(F) subject to the following modifications: Although the portion of the plan funded by the level premium annuity contract is exempt from the minimum funding requirements, the portion funded by an auxiliary fund is subject to those requirements. (Thus, a funding standard account must be maintained and a Schedule B must be filed with the annual report). The accrued benefit for any participant may be determined using the rule in section 411(b)(1)(F) but must not be less than the defined benefit minimum.

M–18 Q. May qualified nonelective contributions described in section 401(m)(4)(C) be treated as employer contributions for purposes of the minimum contribution or benefit requirement of section 416?

A. Yes. This is the case even if the qualified nonelective contributions are taken into account under the actual deferral percentage test of § 1.401(k)–1(b)(2) or under the actual contribution percentage test of § 1.401(m)–1(b).

M–19 Q. May matching contributions described in section 40l(m)(4)(A) be treated as employer contributions for purposes of the minimum contribution or benefit requirement of section 416?

A. Matching contributions allocated to key employees are treated as employer contributions for purposes of determining the minimum contribution or benefit under section 416. However, if a plan uses contributions allocated to employees other than key employees on the basis of employee contributions or elective contributions to satisfy the minimum contribution requirement, these contributions are not treated as matching contributions for purposes of applying the requirements of sections 401(k) and 401(m) for plan years beginning after December 31, 1988. Thus these contributions must meet the nondiscrimination requirements of section 401(a)(4) without regard to section 401(m). See § 1.401(m)–1(f)(12)(iii).

M–20 Q. May elective contributions be treated as employer contributions for purposes of satisfying the minimum contribution or benefit requirement of section 416(c)(2)?

A. Elective contributions on behalf of key employees are taken into account in determining the minimum required contribution under section 416(c)(2). However, elective contributions on behalf of employees other than key employees may not be treated as employer contributions for purposes of the minimum contribution or benefit requirement of section 416. See section 401(k)(4)(C) and the regulations thereunder. This Question and Answer is effective for plan years beginning after December 31, 1988.

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§ 1.417(e)–1 Restrictions and valuations of distributions from plans subject to sections 401(a)(11) and 417.

(a) *Scope*—(1) *In general.* A plan does not satisfy the requirements of sections 401(a)(11) and 417 unless it satisfies the consent requirements, the determination of present value requirements and the other requirements set forth in this section. See section 401(a)(11) and § 1.401(a)–20 for other rules regarding the survivor annuity requirements.

(2) *Additional requirements.* See § 1.411(a)–11 for other rules applicable to the consent requirements.

(3) *Accrued benefit.* The definition of ‘‘accrued benefit’’ in §1.411(a)–11 applies when that term is used in this section.

(b) *Consent, etc. requirements*—(1) *General rule.* Generally plans may not commence the distribution of any portion of a participant’s accrued benefit in any form unless the applicable consent requirements are satisfied. No consent of the participant or spouse is needed for distribution of a QJSA or QPSA after the benefit is no longer immediately distributable (after the participant attains (or would have attained if not dead) the later of normal retirement age (as defined in section 411(a)(8)) or age 62). No consent of the spouse is needed for distribution of a QJSA at any time. After the participant's death, a benefit may be paid to a nonspouse beneficiary without the beneficiary's consent. A distribution cannot be made at any time in a form other than a QJSA unless such QJSA has been waived by the participant and such waiver has been consented to by the spouse. A QJSA is an annuity that commences immediately. Thus, for example, a plan may not offer a participant separating from service at age 45 a choice only between a single sum distribution at separation of service and a joint and survivor annuity that satisfies all the requirements of a QJSA except that it commences at normal retirement age rather than immediately. To satisfy this section, the plan must also offer a QJSA (*i.e.*, an annuity that satisfies all the requirements for a QJSA including the requirement that it commences immediately).

(2) *Consent.* (i) Written consent of the participant and, if the participant is married at the annuity starting date and the benefit is to be paid in a form other than a QJSA, the participant's spouse (or, if either the participant or the spouse has died, the survivor) is required before the commencement of the distribution of any part of an accrued benefit if the present value of the nonforfeitable benefit is greater than the cash-out limit in effect under §1.411(a)–11T(c)(3)(ii). No consent is valid unless the participant has received a general description of the material features, and an explanation of the relative values of, the optional forms of benefit available under the plan in a manner which would satisfy the notice requirements of section 417(a)(3). *See* §1.401(a)–20 Q&A 36. No consent is required before the annuity starting date if the present value of the nonforfeitable benefit is not more than the cash-out limit in effect under §1.411(a)–11T(c)(3)(ii). If the present value of the accrued benefit at the time of any distribution exceeds the cash-out limit in effect under §1.411(a)–11T(c)(3)(ii), the present value of the accrued benefit at any subsequent time will be deemed to exceed the cash-out limit in effect under §1.411(a)–11T(c)(3)(ii).

(ii) In determining the present value of any nonforfeitable accrued benefit, a defined benefit plan is limited by the interest rate restriction as set forth in paragraph (d) of this section.

(3) *Time of consent.* (i) Written consent of the participant and the participant's spouse to the distribution must be made not more than 90 days before the annuity starting date.

(ii) A plan must provide participants with the written explanation of the QJSA required by section 417(a)(3) no less than 30 days and no more than 90 days before the annuity starting date (except as otherwise provided by section 417(a)(7) for plan years beginning after December 31, 1996). However, if the participant, after having received the written explanation of the QJSA, affirmatively elects a form of distribution and the spouse consents to that form of distribution (if necessary), a plan will not fail to satisfy the requirements of section 417(a) merely because the annuity starting date is less than 30 days after the written explanation was provided to the participant, provided that the following requirements are met:

(A) The plan administrator provides information to the participant clearly indicating that (in accordance with the first sentence of this paragraph (b)(3)(ii)) the participant has a right to at least 30 days to consider whether to waive the QJSA and consent to a form of distribution other than a QJSA.

(B) The participant is permitted to revoke an affirmative distribution election at least until the annuity starting date, or, if later, at any time prior to the expiration of the 7-day period that begins the day after the explanation of the QJSA is provided to the participant.

(C) The annuity starting date is after the date that the explanation of the QJSA is provided to the participant (except as otherwise provided by section 417(a)(7) for plan years beginning after December 31, 1996). However, the plan may permit the annuity starting date to be before the date that any affirmative distribution election is made by the participant and before the date that the distribution is permitted to commence under paragraph (b)(3)(ii)(D) of this section.

(D) Distribution in accordance with the affirmative election does not commence before the expiration of the 7-day period that begins the day after the explanation of the QJSA is provided to the participant.

(iii) The following example illustrates the provisions of this paragraph (b)(3):

Example. Employee E, a married participant in a defined benefit plan who has terminated employment, is provided with the explanation of the QJSA on November 28.

Employee E elects (with spousal consent) on December 2 to waive the QJSA and receive an immediate distribution in the form of a single life annuity. The plan may permit Employee E to receive payments with an annuity starting date of December 1, provided that the first payment is made no earlier than December 6 and the participant does not revoke the election before that date. The plan can make the remaining monthly payments on the first day of each month thereafter in accordance with its regular payment schedule.

(iv) The additional rules of this paragraph (b)(3) concerning the notice and consent requirements of section 417 apply to distributions on or after September 22, 1995. For distributions before September 22, 1995, the additional rules concerning the notice and consent requirements of section 417 in § 1.417(e)–1(b)(3) in effect prior to September 22, 1995 (see § 1.417(e)–1 (b)(3) in 26 CFR Part 1 revised as of April 1, 1995) apply.

(4) *Delegation to Commissioner.* The Commissioner, in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin, may modify, or provide additional guidance with respect to, the notice and consent requirements of this section. See § 601.601(d)(2)(ii)(*b*) of this chapter.

(c) *Permitted distributions.* A plan may not require that a participant or surviving spouse begin to receive benefits without satisfying paragraph (b) of this section while such benefits are immediately distributable, (see paragraph (b)(1) of this section). Once benefits are no longer immediately distributable, all benefits that the plan requires to begin must be provided in the form of a QJSA and QPSA unless the applicable written explanation, election and consent requirements of section 417 are satisfied.

(d) *Present value requirement*—(1) *General rule.* A defined benefit plan must provide that the present value of any accrued benefit and the amount (subject to sections 411(c)(3) and 415) of any distribution, including a single sum, must not be less than the amount calculated using the applicable interest rate described in paragraph (d)(3) of this section (determined for the month described in paragraph (d)(4) of this section) and the applicable mortality table described in paragraph (d)(2) of this section. The present value of any optional form of benefit cannot be less than the present value of the normal retirement benefit determined in accordance with the preceding sentence. The same rules used for the plan under this paragraph (d) must also be used to compute the present value of the benefit for purposes of determining whether consent for a distribution is required under paragraph (b) of this section.

(2) *Applicable mortality table.* The applicable mortality table is the mortality table based on the prevailing commissioners' standard table (described in section 807(d)(5)(A)) used to determine reserves for group annuity contracts issued on the date as of which present value is being determined (without regard to any other subparagraph of section 807(d)(5)), that is prescribed by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter). The Commissioner may prescribe rules that apply in the case of a change to the prevailing commissioners' standard table (described in section 807(d)(5)(A)) used to determine reserves for group annuity contracts, in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(3) *Applicable interest rate*—(i) *General rule.* The applicable interest rate for a month is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for that month in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(ii) *Example.* This example illustrates the rules of this paragraph (d)(3):

Example. Plan A is a calendar year plan. For its 1995 plan year, Plan A provides that the applicable mortality table is the table described in Rev. Rul. 95–6 (1995–1 C.B. 80), and that the applicable interest rate is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for the first full calendar month preceding the calendar month that contains the annuity starting date. Participant P is age 65 in January 1995, which is the month that contains P's annuity starting date. P has an accrued benefit payable monthly of $1,000 and has elected to receive a distribution in the form of a single sum in January 1995. The annual interest rate on 30-year Treasury securities as published by the Commissioner for December 1994 is 7.87 percent. To satisfy the requirements of section 417(e)(3) and this paragraph (d), the single sum received by P may not be less than $111,351.

(4) *Time for determining interest rate*—(i) *General rule.* Except as provided in paragraph (d)(4)(iv) or (v) of this section, the applicable interest rate to be used for a distribution is the rate determined under paragraph (d)(3) of this section for the applicable lookback month. The applicable lookback month for a distribution is the lookback month (as described in paragraph (d)(4)(iii) of this section) for the month (or other longer stability period described in paragraph (d)(4)(ii) of this section) that contains the annuity starting date for the distribution. The time and method for determining the applicable interest rate for each participant's distribution must be determined in a consistent manner that is applied uniformly to all participants in the plan.

(ii) *Stability period.* A plan must specify the period for which the applicable interest rate remains constant. This stability period may be one calendar month, one plan quarter, one calendar quarter, one plan year, or one calendar year.

(iii) *Lookback month.* A plan must specify the lookback month that is used to determine the applicable interest rate. The lookback month may be the first, second, third, fourth, or fifth full calendar month preceding the first day of the stability period.

(iv) *Permitted average interest rate.* A plan may apply the rules of paragraph (d)(4)(i) of this section by substituting a permitted average interest rate with respect to the plan's stability period for the rate determined under paragraph (d)(3) of this section for the applicable lookback month for the stability period. For this purpose, a permitted average interest rate with respect to a stability period is an interest rate that is computed by averaging the applicable interest rates determined under paragraph (d)(3) of this section for two or more consecutive months from among the first, second, third, fourth, and fifth calendar months preceding the first day of the stability period. For this paragraph (d)(4)(iv) to apply, a plan must specify the manner in which the permitted average interest rate is computed.

(v) *Additional determination dates.* The Commissioner may prescribe, in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*)), other times that a plan may provide for determining the applicable interest rate.

(vi) *Example.* This example illustrates the rules of this paragraph (d)(4):

Example. Employer X maintains Plan A, a calendar year plan. Employer X wishes to amend Plan A so that the applicable interest rate will remain fixed for each plan quarter, and so that the applicable interest rate for distributions made during each plan quarter can be determined approximately 80 days before the beginning of the plan quarter. To comply with the provisions of this paragraph (d)(4), Plan A is amended to provide that the applicable interest rate is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for the fourth calendar month preceding the first day of the plan quarter during which the annuity starting date occurs.

(5) *Use of alternative interest rate and mortality table.* If a plan provides for use of an interest rate or mortality table other than the applicable interest rate or the applicable mortality table, the plan must provide that a participant's benefit must be at least as great as the benefit produced by using the applicable interest rate and the applicable mortality table. For example, if a plan provides for use of an interest rate of 7% and the UP–1984 Mortality Table (see §1.401(a)(4)–12, *Standard mortality table*) in calculating single-sum distributions, the plan must provide that any single-sum distribution is calculated as the greater of the single-sum benefit calculated using 7% and

the UP–1984 Mortality Table and the single-sum benefit calculated using the applicable interest rate and the applicable mortality table.

(6) *Exceptions.* This paragraph (d) (other than the provisions relating to section 411(d)(6) requirements in paragraph (d)(10) of this section) does not apply to the amount of a distribution paid in the form of an annual benefit that—

(i) Does not decrease during the life of the participant, or, in the case of a QPSA, the life of the participant's spouse; or

(ii) Decreases during the life of the participant merely because of—

(A) The death of the survivor annuitant (but only if the reduction is to a level not below 50% of the annual benefit payable before the death of the survivor annuitant); or

(B) The cessation or reduction of Social Security supplements or qualified disability benefits (as defined in section 411(a)(9)).

(7) *Defined contribution plans.* Because the accrued benefit under a defined contribution plan equals the account balance, a defined contribution plan is not subject to the requirements of this paragraph (d), even though it is subject to section 401(a)(11).

(8) *Effective date*—(i) *In general.* This paragraph (d) is effective for distributions with annuity starting dates in plan years beginning after December 31, 1994.

(ii) *Optional delayed effective date of Retirement Protection Act of 1994 (RPA '94)(108 Stat. 5012) rules for plans adopted and in effect before December 8, 1994.* For a plan adopted and in effect before December 8, 1994, the application of the rules relating to the applicable mortality table and applicable interest rate under paragraphs (d)(2) through (4) of this section is delayed to the extent provided in this paragraph (d)(8)(ii), if the plan provisions in effect on December 7, 1994, met the requirements of section 417(e)(3) and §1.417(e)–1(d) as in effect on December 7, 1994 (as contained in 26 CFR part 1 revised April 1, 1995). In the case of a distribution from such a plan with an annuity starting date that precedes the optional delayed effective date described in paragraph (d)(8)(iv) of this section, and that precedes the first day of the first plan year beginning after December 31, 1999, the rules of paragraph (d)(9) of this section (which generally apply to distributions with annuity starting dates in plan years beginning before January 1, 1995) apply in lieu of the rules of paragraphs (d)(2) through (4) of this section. The interest rate under the rules of paragraph (d)(9) of this section is determined under the provisions of the plan as in effect on December 7, 1994, reflecting the interest rate or rates published by the Pension Benefit Guaranty Corporation (PBGC) and the provisions of the plan for determining the date on which the interest rate is fixed. The above described interest rate or rates published by the PBGC are those determined by the PBGC (for the date determined under those plan provisions) pursuant to the methodology under the regulations of the PBGC for determining the present value of a lump sum distribution on plan termination under 29 CFR part 2619 that were in effect on September 1, 1993 (as contained in 29 CFR part 2619 revised July 1, 1994).

(iii) *Optional accelerated effective date of RPA '94 rules.* This paragraph (d) is also effective for a distribution with an annuity starting date after December 7, 1994, during a plan year beginning before January 1, 1995, if the employer elects, on or before the annuity starting date, to make the rules of this paragraph (d) effective with respect to the plan as of the optional accelerated effective date described in paragraph (d)(8)(iv) of this section. An employer is treated as making this election by making the plan amendments described in paragraph (d)(8)(iv) of this section.

(iv) *Determination of delayed or accelerated effective date by plan amendment adopting RPA '94 rules.* The optional delayed effective date of paragraph (d)(8)(ii) of this section, or the optional accelerated effective date of paragraph (d)(8)(iii) of this section, whichever is applicable, is the date plan amendments applying both the applicable mortality table of paragraph (d)(2) of this section and the applicable interest rate of paragraph (d)(3) of this section are adopted or, if later, are made effective.

(9) *Plan years beginning before January 1, 1995*—(i) *Interest rate.* (A) For distributions made in plan years beginning after December 31, 1986, and before January 1, 1995, the following interest rate described in paragraph (d)(9)(i)(A)(*1*) or (*2*) of this section, whichever applies, is substituted for the applicable interest rate for purposes of this section—

(*1*) The rate or rates that would be used by the PBGC for a trusteed single-employer plan to value the participant's (or beneficiary's) vested benefit (PBGC interest rate) if the present value of such benefit does not exceed $25,000; or

(*2*) 120 percent of the PBGC interest rate, as determined in accordance with paragraph (d)(9)(i)(A)(*1*) of this section, if such present value exceeds $25,000. In no event shall the present value determined by use of 120 percent of the PBGC interest rate result in a present value less than $25,000.

(B) The PBGC interest rate may be a series of interest rates for any given date. For example, the PBGC interest rate for immediate annuities for November 1994 is 6%, and the PBGC interest rates for the deferral period for that month are as follows: 5.25% for the first 7 years of the deferral period, 4% for the following 8 years of the deferral period, and 4% for the remainder of the deferral period. For November 1994, 120 percent of the PBGC interest rate is 7.2% (1.2 times 6%) for an immediate annuity, 6.3% (1.2 times 5.25%) for the first 7 years of the deferral period, 4.8% (1.2 times 4%) for the following 8 years of the deferral period, and 4.8% (1.2 times 4%) for the remainder of the deferral period. The PBGC interest rates are the interest rates that would be used (as of the date of the distribution) by the PBGC for purposes of determining the present value of that benefit upon termination of an insufficient trusteed single employer plan. Except as otherwise provided by the Commissioner, the PBGC interest rates are determined by PBGC regulations. See subpart B of 29 CFR part 4044 for the applicable PBGC rates.

(ii) *Time for determining interest rate.* (A) Except as provided in paragraph (d)(9)(ii)(B) of this section, the PBGC interest rate or rates are determined on either the annuity starting date or the first day of the plan year that contains the annuity starting date. The plan must provide which date is applicable.

(B) The plan may provide for the use of any other time for determining the PBGC interest rate or rates provided that such time is not more than 120 days before the annuity starting date if such time is determined in a consistent manner and is applied uniformly to all participants.

(C) The Commissioner may, in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*), prescribe other times for determining the PBGC interest rate or rates.

(iii) *No applicable mortality table.* In the case of a distribution to which this paragraph (d)(9) applies, the rules of this paragraph (d) are applied without regard to the applicable mortality table described in paragraph (d)(2) of this section.

(10) *Relationship with section 411(d)(6)*—(i) *In general.* A plan amendment that changes the interest rate, the time for determining the interest rate, or the mortality assumptions used for the purposes described in paragraph (d)(1) of this section is subject to section 411(d)(6). But see §1.411(d)–4, Q&A–2(b)(2)(v) (regarding plan amendments relating to involuntary distributions). In addition, a plan amendment that changes the interest rate or the mortality assumptions used for the purposes described in paragraph (d)(1) of this section merely to eliminate use of the interest rate described in paragraph (d)(3) or paragraph (d)(9) of this section, or the applicable mortality table, with respect to a distribution form described in paragraph (d)(6) of this section, for distributions with annuity starting dates occurring after a specified date that is after the amendment is adopted, does not violate the requirements of section 411(d)(6) if the amendment is adopted on or before the last day of the last plan year ending before January 1, 2000.

(ii) *Section 411(d)(6) relief for change in time for determining interest rate.* Notwithstanding the general rule of paragraph (d)(10)(i) of this section, if a plan amendment changes the time for determining the applicable interest rate (including an indirect change as a result of a change in plan year), the amendment will not be treated as reducing accrued benefits in violation of section 411(d)(6) merely on account of this change if the conditions of this paragraph (d)(10)(ii) are satisfied. If the plan amendment is effective on or after the adoption date, any distribution for which the annuity starting date occurs in the one-year period commencing at the time the amendment is effective must be determined using the interest rate provided under the plan determined at either the date for determining the interest rate before the amendment or the date for determining the interest rate after the amendment, whichever results in the larger distribution. If the plan amendment is adopted retroactively (that is, the amendment is effective prior to the adoption date), the plan must use the interest rate determination date resulting in the larger distribution for the period beginning with the effective date and ending one year after the adoption date.

(iii) *Section 411(d)(6) relief for plan amendments pursuant to changes to section 417 made by RPA '94 providing for statutory interest rate determination date.* Notwithstanding the general rule of paragraph (d)(10)(i) of this section, except as provided in paragraph (d)(10)(vi)(B) of this section, a participant's accrued benefit is not considered to be reduced in violation of section 411(d)(6) merely because of a plan amendment that changes any interest rate or mortality assumption used to calculate the present value of a participant's benefit under the plan, if the following conditions are satisfied—

(A) The amendment replaces the PBGC interest rate (or an interest rate or rates based on the PBGC interest rate) as the interest rate used under the plan in determining the present value of a participant's benefit under this paragraph (d); and

(B) After the amendment is effective, the present value of a participant's benefit under the plan cannot be less than the amount calculated using the applicable mortality table and the applicable interest rate for the first full calendar month preceding the calendar month that contains the annuity starting date.

(iv) *Section 411(d)(6) relief for plan amendments pursuant to changes to section 417 made by RPA '94 providing for prior determination date or up to two months earlier.* Notwithstanding the general rule of paragraph (d)(10)(i) of this section, except as provided in paragraph (d)(10)(vi)(B) of this section, a participant's accrued benefit is not considered to be reduced in violation of section 411(d)(6) merely because of a plan amendment that changes any interest rate or mortality assumption used to calculate the present value of a participant's benefit under the plan, if the following conditions are satisfied—

(A) The amendment replaces the PBGC interest rate (or an interest rate or rates based on the PBGC interest rate) as the interest rate used under the plan in determining the present value of a participant's benefit under this paragraph (d); and

(B) After the amendment is effective, the present value of a participant's benefit under the plan cannot be less than the amount calculated using the applicable mortality table and the applicable interest rate, but only if the applicable interest rate is the annual interest rate on 30-year Treasury securities for the calendar month that contains the date as of which the PBGC interest rate (or an interest rate or rates based on the PBGC interest rate) was determined immediately before the amendment, or for one of the two calendar months immediately preceding such month.

(v) *Section 411(d)(6) relief for plan amendments pursuant to changes to section 417 made by RPA '94 providing for other interest rate determination date.* Notwithstanding the general rule of paragraph (d)(10)(i) of this section, except as provided in paragraph (d)(10)(vi)(B) of this section, a participant's accrued benefit is not considered to be reduced in violation of section 411(d)(6) merely because of a plan amendment that changes any interest rate or mortality assumption used to calculate the present value of a participant's benefit under the plan, if the following conditions are satisfied—

(A) The amendment replaces the PBGC interest rate (or an interest rate or rates based on the PBGC interest rate) as the interest rate used under the plan in determining the present value of a participant's benefit under this paragraph (d);

(B) After the amendment is effective, the present value of a participant's benefit under the plan cannot be less than the amount calculated using the applicable mortality table and the applicable interest rate; and

(C) The plan amendment satisfies either the condition of paragraph (d)(10)(ii) of this section (determined using the interest rate provided under the terms of the plan after the effective date of the amendment) or the special early transition interest rate rule of paragraph (d)(10)(vi)(C) of this section.

(vi) *Special rules*—(A) *Provision of temporary additional benefits.* A plan amendment described in paragraph (d)(10)(iii), (iv), or (v) of this section is not considered to reduce a participant's accrued benefit in violation of section 411(d)(6) even if the plan amendment provides for temporary additional benefits to accommodate a more gradual transition from the plan's old interest rate to the new rules.

(B) *Replacement of non-PBGC interest rate.* The section 411(d)(6) relief provided in paragraphs (d)(10)(iii) through (v) of this section does not apply to a plan amendment that replaces an interest rate other than the PBGC interest rate (or an interest rate or rates based on the PBGC interest rate) as an interest rate used under the plan in determining the present value of a participant's benefit under this paragraph (d). Thus, the accrued benefit determined using that interest rate and the associated mortality table is protected under section 411(d)(6). For purposes of this paragraph (d), an interest rate is based on the PBGC interest rate if the interest rate is defined as a specified percentage of the PBGC interest rate, the PBGC interest rate minus a specified number of basis points, or an average of such interest rates over a specified period.

(C) *Special early transition interest rate rule for paragraph (d)(10)(v).* A plan amendment satisfies the special rule of this paragraph (d)(10)(vi)(C) if any distribution for which the annuity starting date occurs in the one-year period commencing at the time the plan amendment is effective is determined using whichever of the following two interest rates results in the larger distribution—

(*1*) The interest rate as provided under the terms of the plan after the effective date of the amendment, but determined at a date that is either one month or two months (as specified in the plan) before the date for determining the interest rate used under the terms of the plan before the amendment; or

(*2*) The interest rate as provided under the terms of the plan after the effective date of the amendment, determined at the date for determining the interest rate after the amendment.

(vii) *Examples.* The provisions of this paragraph (d)(10) are illustrated by the following examples:

Example 1. On December 31, 1994, Plan A provided that all single-sum distributions were to be calculated using the UP–1984 Mortality Table and 100% of the PBGC interest rate for the date of distribution. On January 4, 1995, and effective on February 1, 1995, Plan A was amended to provide that all single-sum distributions are calculated using the applicable mortality table and the annual interest rate on 30-year Treasury securities for the first full calendar month preceding the calendar month that contains the annuity starting date. Pursuant to paragraph (d)(10)(iii) of this section, this amendment of Plan A is not considered to reduce the accrued benefit of any participant in violation of section 411(d)(6).

Example 2. On December 31, 1994, Plan B provided that all single-sum distributions were to be calculated using the UP–1984 Mortality Table and an interest rate equal to the lesser of 100% of the PBGC interest rate for the date of distribution, or 6%. On January 4, 1995, and effective on February 1, 1995, Plan B was amended to provide that all single-sum distributions are calculated using the applicable mortality table and the annual interest rate on 30-year Treasury securities for the second full calendar month preceding the calendar month that contains the annuity starting date. Pursuant to paragraph (d)(10)(iv) of this section, this amendment of Plan B is not considered to reduce the accrued benefit of any participant in violation of section 411(d)(6) merely because of the replacement of the PBGC interest rate. However, under paragraph (d)(10)(vi)(B) of this section, the section 411(d)(6) relief provided in paragraphs (d)(10)(iii) through (v) of this section does not apply to a plan amendment that replaces an interest rate other than the PBGC interest rate (or a rate based on the PBGC interest rate). Therefore, pursuant to paragraph (d)(10)(vi)(B) of this section, to satisfy the requirements of section 411(d)(6), the plan must provide that the single-sum distribution payable to any participant must be no less than the single-sum distribution calculated using the UP–1984 Mortality Table and an interest rate of 6%, based on the participant's benefits under the plan accrued through January 31, 1995, and based on the participant's age at the annuity starting date.

Example 3. On December 31, 1994, Plan C, a calendar year plan, provided that all single sum distributions were to be calculated using the UP–1984 Mortality Table and an interest rate equal to the PBGC interest rate for January 1 of the plan year. On March 1, 1995, and effective on July 1, 1995, Plan C was amended to provide that all single-sum distributions are calculated using the applicable mortality table and the annual interest rate on 30-year Treasury securities for August of the year before the plan year that contains the annuity starting date. The plan amendment provides that each distribution with an annuity starting date after June 30, 1995, and before July 1, 1996, is calculated using the 30-year Treasury rate for August of the year before the plan year that contains the annuity starting date, or the 30-year Treasury rate for January of the plan year that contains the annuity starting date, whichever produces the larger benefit. Pursuant to paragraph (d)(10)(v) of this section, the amendment of Plan C is not considered to have reduced the accrued benefit of any participant in violation of section 411(d)(6).

Example 4. (a) Employer X maintains Plan D, a calendar year plan. As of December 7, 1994, Plan D provided for single-sum distributions to be calculated using the PBGC interest rate as of the annuity starting date for distributions not greater than $25,000, and 120% of that interest rate (but not an interest rate producing a present value less than $25,000) for distributions over $25,000. Employer X wishes to delay the effective date of the RPA '94 rules for a year, and to provide for an extended transition from the use of the PBGC interest rate to the new applicable interest rate under section 417(e)(3). On December 1, 1995, and effective on January 1, 1996, Employer X amends Plan D to provide that single-sum distributions are determined as the sum of—

(i) The single-sum distribution calculated based on the applicable mortality table and the annual interest rate on 30-year Treasury securities for the first full calendar month preceding the calendar month that contains the annuity starting date; and

(ii) A transition amount.

(b) The amendment provides that the transition amount for distributions in the years 1996–99 is a transition percentage of the excess, if any, of the amount that the single-sum distribution would have been under the plan provisions in effect prior to this amendment over the amount of the single sum described in paragraph (a)(i) of this *Example 4*. The transition percentages are 80% for 1996, decreasing to 60% for 1997, 40% for 1998 and 20% for 1999. The amendment also provides that the transition amount is zero for plan years beginning on or after the year 2000. Pursuant to paragraphs (d)(10)(iii) and (vi)(A) of this section, the amendment of Plan D is not considered to have reduced the accrued benefit of any participant in violation of section 411(d)(6).

Example 5. On December 31, 1994, Plan E, a calendar year plan, provided that all single-sum distributions were to be calculated using the UP–1984 Mortality Table and an interest rate equal to the PBGC interest rate for January 1 of the plan year. On March 1, 1995, and effective on July 1, 1995, Plan E was amended to provide that all single-sum distributions are calculated using the applicable mortality table and the annual interest rate on 30-year Treasury securities for August of the year before the plan year that contains the annuity starting date. The plan amendment provides that each distribution with an annuity starting date after June 30, 1995, and before July 1, 1996, is calculated using the 30-year Treasury rate for August of the year before the plan year that contains the annuity starting date, or the 30-year Treasury rate for November of the plan year preceding the plan year that contains the annuity starting date, whichever produces the larger benefit. Pursuant to paragraphs (d)(10)(v) and (vi)(C) of this section, the amendment of Plan E is not considered to have reduced the accrued benefit of any participant in violation of section 411(d)(6).

(e) *Special rules for annuity contracts*—(1) *General rule.* Any annuity contract purchased by a plan subject to section 401(a)(11) and distributed to or owned by a participant must provide that benefits under the contract are provided in accordance with the applicable consent, present value, and other requirements of sections 401(a)(11) and 417 applicable to the plan.

(2) [Reserved□

(f) *Effective dates*—(1) *Annuity contracts.* (i) Paragraph (e) of this section does not apply to contracts distributed to or owned by a participant prior to September 17, 1985, unless additional contributions are made under the plan by the employer with respect to such contracts.

(ii) In the case of a contract owned by the employer or distributed to or owned by a participant prior to the first plan year beginning after December 31, 1988, paragraph (e) of this section shall be satisfied if the annuity contracts described therein satisfy the requirements in §§1.401(a)–11T and 1.417(e)–1T. The preceding sentence shall not apply if additional contributions are made under the plan by the employer with respect to such contracts on or after the beginning of the first plan year beginning after December 31, 1988.

(2) *Interest rates.* (i) A plan that uses the PBGC immediate interest rate as required by §1.417(e)–1T(e) for distributions commencing in plan years beginning before January 1, 1987, shall be deemed to satisfy paragraph (d) of this section for such years.

(ii) For a special exception to the requirements of section 411(d)(6) for certain plan amendments that incorporate applicable interest rates, see section 1139(d)(2) of the Tax Reform Act of 1986.

(3) *Other effective dates and transitional rules.* (i) Except as otherwise provided, a plan will be treated as satisfying sections 401(a)(11) and 417 for plan years beginning before the first plan year that the requirements of section 410(b) as amended by TRA 86 apply to such plan, if the plan satisfied the requirements in §§1.401(a)–11T and 1.417(e)–1T.

(ii) See §1.401(a)–20 for other effective dates and transitional rules that apply to plans subject to sections 401(a)(11) and 417.

[T.D. 8219, 53 FR 31854, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988, as amended by T.D. 8591, 60 FR 17219, Apr. 5, 1995; T.D. 8620, 60 FR 49221, Sept. 22, 1995; T.D. 8768, 63 FR 16898, Apr. 7, 1998; T.D. 8796, 63 FR 70011, Dec. 18, 1998; T.D. 8794, 63 FR 70338, Dec. 21, 1998]

§1.417(e)–1T Restrictions and valuations of distributions from plans subject to sections 401(a)(11) and 417. (Temporary)

(a) [Reserved]

(b) *Consent, etc. requirements*—(1) *General rule.* [Reserved]

(2) *Consent.* [Reserved]

(c) [Reserved]

(d) For rules regarding the present value of a participant's accrued benefit and related matters, see §1.417(e)–1(d).

[T.D. 8591, 60 FR 17219, Apr. 5, 1995, as amended by T.D. 8620, 60 FR 49221, Sept. 22, 1995; T.D. 8768, 63 FR 16902, Apr. 7, 1998; T.D. 8796, 63 FR 70012, Dec. 18, 1998]

§1.419–1T Treatment of welfare benefit funds. (Temporary)

Q–1: What does section 419 of the Internal Revenue Code provide?

A–1: Section 419 prescribes limitations upon deductions for contributions paid or accrued with respect to a welfare benefit fund. Under section 419 (a) and (b), an employer's contributions to a welfare benefit fund are not deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for production of income) but, if the requirements of section 162 or 212 are otherwise met, are deductible under section 419 for the taxable year of the employer in which paid to the extent of the welfare benefit fund's qualified cost (within the meaning of section 419(c)(1)) for the taxable year of the fund that relates to such taxable year of the employer. Under section 419(g), section 419 and this section shall also apply to the deduction by a taxpayer of contributions with respect to a fund that would be a welfare benefit fund but for the fact that there is no employer-employee relationship between the person providing the services and the person for whom the services are provided. Contributions paid to a welfare benefit fund after section 419 becomes effective with respect to such contributions are deemed to relate, first, to amounts accrued and deducted (but not paid) by the employer with respect to such fund before section 419 becomes effective with respect to such contributions and thus shall not be treated as satisfying the payment requirement of section 419. See paragraph (b) of Q&A–5 for special deduction limits applicable to employer contributions to welfare benefit funds with excess reserves.

Q–2: When do the deduction rules of section 419, as enacted by the Tax Reform Act of 1984, become effective?

A–2: (a) Section 419 generally applies to contributions paid or accrued with respect to a welfare benefit fund after

December 31, 1985, in taxable years of employers ending after that date. See Q&A–9 of this regulation for special rules relating to the deduction limit for the first taxable year of a fiscal year employer ending after December 31, 1985.

(b) In the case of a welfare benefit fund which is part of a plan maintained pursuant to one or more collective bargaining agreements (1) between employee representatives and one or more employers, and (2) that are in effect on July 1, 1985 (or ratified on or before such date), sections 419 shall not apply to contributions paid or accrued in taxable years beginning before the termination of the last of the collective bargaining agreements pursuant to which the plan is maintained (determined without regard to any extension thereof agreed to after July 1, 1985). For purposes of the preceding sentence, any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added under section 511 of the Tax Reform Act of 1984 (i.e., requirements under sections 419, 419A, 512(a)(3)(E), and 4976) shall not be treated as a termination of such collective bargaining agreement. See § 1.419A–2T for special rules relating to the application of section 419 to collectively bargained welfare benefit funds.

(c) Notwithstanding paragraphs (a) and (b), section 419 applies to any contribution of a facility to a welfare benefit fund (or other contribution, such as cash, which is used to acquire, construct, or improve such a facility) after June 22, 1984, unless such facility is placed in service by the fund before January 1, 1987, and either (1) is acquired or improved by the fund (or contributed to the fund) pursuant to a binding contract in effect on June 22, 1984, and at all times thereafter, or (2) the construction of which was begun by or for the welfare benefit fund before June 22, 1984. See Q&A–11 of this regulation for special rules relating to the application of section 419 to the contribution of a facility to a welfare benefit fund (and to the contribution of other amounts, such as cash, used to acquire, construct, or improve such a facility) before section 419 generally becomes effective with respect to contributions to the fund.

Q–3. What is a ‘‘welfare benefit fund’’ under section 419?

A–3. (a) A ‘‘welfare benefit fund’’ is any fund which is part of a plan, or method or arrangement, of an employer and through which the employer provides welfare benefits to employees or their beneficiaries. For purposes of this section, the term ‘‘welfare benefit’’ includes any benefit other than a benefit with respect to which the employer’s deduction is governed by section 83(h), section 404 (determined without regard to section 404(b)(2)), section 404A, or section 463.

(b) Under section 419(e)(3) (A) and (B), the term ‘‘fund’’ includes any organization described in section 501(c) (7), (9), (17) or (20), and any trust, corporation, or other organization not exempt from tax imposed by chapter 1, subtitle A, of the Internal Revenue Code. Thus, a taxable trust or taxable corporation that is maintained for the purpose of providing welfare benefits to an employer’s employees is a ‘‘welfare benefit fund.’’

(c) Section 419(e)(3)(C) also provides that the term ‘‘fund’’ includes, to the extent provided in regulations, any account held for an employer by any person. Pending the issuance of further guidance, only the following accounts, and arrangements that effectively constitute accounts, as described below, are ‘‘funds’’ within section 419(e)(3)(C).

A retired lives reserve or a premium stabilization reserve maintained by an insurance company is a ‘‘fund,’’ or part of a ‘‘fund,’’ if it is maintained for a particular employer and the employer has the right to have any amount in the reserve applied against its future years’ benefit costs or insurance premiums. Also, if an employer makes a payment to an insurance company under an ‘‘administrative services only’’ arrangement with respect to which the life insurance company maintains a separate account to provide benefits, then the arrangement would be considered to be a ‘‘fund.’’ Finally, an insurance or premium arrangement between an employer and an insurance company is a ‘‘fund’’ if, under the arrangement, the employer has a right to a refund, credit, or additional benefits (including upon termination of the arrangement) based on the benefit or claims experience, administrative cost experience, or investment experience attributable to such employer. However, an arrangement with an insurance company is not a ''fund'' under the previous sentence merely because the employer's premium for a renewal year reflects the employer's own experience for an earlier year if the arrangement is both cancellable by the insurance company and cancellable by the employer as of the end of any policy year and, upon cancellation by either of the parties, neither of the parties can receive a refund or additional amounts or benefits and neither of the parties can incur a residual liability beyond the end of the policy year (other than, in the case of the insurer, to provide benefits with respect to claims incurred before cancellation). The determination whether either of the parties can receive a refund or additional amounts or benefits or can incur a residual liability upon cancellation of an arrangement will be made by examining both the contractual rights and obligations of the parties under the arrangement and the actual practice of the insurance company (and other insurance companies) with respect to other employers upon cancellation of similar arrangements. Similarly, a disability income policy does not constitute a ''fund'' under the preceding provisions merely because, under the policy, an employer pays an annual premium so that employees who became disabled in such year may receive benefit payments for the duration of the disability.

Q–4: For purposes of determining the section 419 limit on the employer's deduction for contributions to the fund for a taxable year of the employer, which taxable year of the welfare benefit fund is related to the taxable year of the employer?

A–4: The amount of an employer's deduction for contributions to a welfare benefit fund for a taxable year of the employer is limited to the ''qualified cost'' of the welfare benefit fund for the taxable year of the fund that is related to such taxable year of the employer. The taxable year of the welfare benefit fund that ends with or within the taxable year of the employer is the taxable year of the fund that is related to the taxable year of the employer. Thus, for example, if an employer has a calendar taxable year and it makes contributions to a fund having a taxable year ending June 30, the ''qualified cost'' of the fund for the taxable year of the fund ending on June 30, 1986, applies to limit the employer's deduction for contributions to the fund in the employer's 1986 taxable year. In the case of employer contributions paid directly to an account or arrangement with an insurance company that is treated as a welfare benefit fund for the purposes of section 419, the policy year will be treated as the taxable year of the fund. See Q&A–7 of this regulation for special section 419 rules relating to the coordination of taxable years for the taxable year of the employer in which a welfare benefit fund is established and for the next following taxable year of the employer.

Q–5: What is the ''qualified cost'' of a welfare benefit fund for a taxable year under section 419?

A–5: (a) Under section 419(c), the ''qualified cost'' of a welfare benefit fund for a taxable year of the fund is the sum of: (1) The ''qualified direct cost'' of such fund for such taxable year of the fund, and (2) the amount that may be added to the qualified asset account for such taxable year of the fund to the extent that such addition does not result in a total amount of such account as of the end of such taxable year of the fund that exceeds the applicable account limit under section 419A(c). However, in calculating the qualified cost of a welfare benefit fund for a taxable year of the fund, this sum is reduced by the fund's ''after-tax income'' (as defined in section 419(c)(4)) for such taxable year of the fund. Also, the qualified cost of a welfare benefit fund is reduced further under the provisions of paragraph (b) of this Q&A.

(b)(1) Pursuant to section 419A(i), notwithstanding section 419 and § 1.419–1T, contributions to a welfare benefit fund during any taxable year of the employer beginning after December 31, 1985, shall not be deductible for such taxable year to the extent that such contributions result in the total amount in the fund as of the end of the last taxable year of the fund ending with or within such taxable year of the employer exceeding the account limit applicable to such taxable year of the fund (as adjusted under section 419A(f)(7)). Solely for purposes of this subparagraph, (i) contributions paid to a welfare benefit fund during the taxable year of the employer but after the end of the last taxable year of the fund that relates to such taxable year of the employer, and (ii) contributions accrued with respect to a welfare benefit fund during the taxable year of the employer or during any prior taxable year of the employer (but not actually paid to such fund on or before the end of a taxable year of the employer) and deducted by the employer for such or any prior taxable year of the employer, shall be treated as an amount in the fund as of the end of the last taxable year of the fund that relates to the taxable year of the employer. Contributions that are not deductible under this subparagraph are in excess of the qualified cost of the welfare benefit fund for the taxable year of the fund that relates to the taxable year of the employer and thus are treated as contributed to the fund on the first day of the employer's next taxable year.

(2) Paragraph (b)(1) of this section shall not apply to contributions with respect to a collectively bargained welfare benefit fund within the meaning of § 1.419A–2T. In addition, paragraph (b)(1) of this section shall not apply to any taxable year of an employer beginning after the end of the earlier of the following taxable years: (i) the first taxable year of the employer beginning after December 31, 1985, for which the employer's deduction limit under section 419 (after the application of paragraph (b)(1) of this section) is at least equal to the qualified direct cost of the fund for the taxable year (or years) of the fund that relates to such first taxable year of the employer, or (ii) the first taxable year of the employer beginning after December 31, 1985, with or within which ends the first taxable year of the fund with respect to which the total amount in the fund as of the end of such taxable year of the fund does not exceed the account limit for such taxable year of the fund (as adjusted under section 419A(f)(7)).

(3) For example, assume an employer with a taxable year ending June 30 and a welfare benefit fund with a taxable year ending January 31. During its taxable year ending June 30, 1987, and on or before January 31, 1987, the employer contributes $250,000 to the fund, and during the remaining portion of its taxable year ending June 30, 1987, the employer contributes $200,000. The qualified direct cost of the fund for its taxable year ending January 31, 1987, is $500,000, the account limit applicable to such taxable year (after the adjustment under section 419A(f)(7)) is $750,000, and the total amount in the fund as of January 31, 1987, is $800,000. Before the application of this paragraph, the employer may deduct the entire $450,000 contribution for its taxable year ending June 30, 1987. However, under this paragraph, the excess of (i) the sum of the total amount in the fund as of January 31, 1987 ($800,000), and employer contributions to the fund after January 31, 1987, and on or before June 30, 1987 ($200,000), over (ii) the account limit applicable to the fund for its taxable year ending January 31, 1987 ($750,000), is $250,000. Thus, under this paragraph, only $200,000 of the $450,000 contribution the employer made during its taxable year ending June 30, 1987, is deductible for such taxable year. If the excess were $450,000 or greater, no portion of the $450,000 contribution would be deductible by the employer for its taxable year ending June 30, 1987. Such nondeductible contributions are in excess of the fund's qualified cost for the taxable year related to the employer's taxable year and thus are deemed to be contributed on the first day of the employer's next taxable year.

(c) See Q&A–7 of this regulation for special rules relating to the calculation of the qualified cost of a welfare benefit fund for an Initial Fund Year and an Overlap Fund Year (as defined in Q&A–7). See Q&A–11 of this regulation for special rules relating to the application of section 419 to the contribution to a welfare benefit fund of a facility (and to the contribution of other amounts, such as cash, used to acquire, construct, or improve a facility) before section 419 generally becomes effective with respect to contributions to the fund. See § 1.419A–2T for special rules relating to certain collectively bargained welfare benefit funds.

Q–6: What is the ‘‘qualified direct cost’’ of a welfare benefit fund under section 419(c)(3)?

A–6: (a) Under section 419(c)(3), the ‘‘qualified direct cost’’ of a welfare benefit fund for any taxable year of the fund is the aggregate amount which would have been allowable as a deduction to the employer for benefits provided by such fund during such year (including insurance coverage for such year) if (1) such benefits were provided directly by the employer and (2) the employer used the cash receipts and disbursements method of accounting and had the same taxable year as the fund. In this regard, a benefit is treated as provided when such benefit would be includible in the gross income of the employee if provided directly by the employer (or would be so includible but for a provision of chapter 1, subtitle A, of the Internal Revenue Code excluding it from gross income). Thus, for example, if a calendar year welfare benefit fund pays an insurance company in July 1986 the full premium for coverage of its current employees under a term health insurance policy for the twelve month period ending June 30, 1987, the insurance coverage will be treated as provided by the fund over such twelve month period. Accordingly, only the portion of the premium for coverage during 1986 will be treated as a ‘‘qualified direct cost’’ of the fund for 1986; the remaining portion of the premium will be treated as a ‘‘qualified direct cost’’ of the fund for 1987. The ‘‘qualified direct cost’’ for a taxable year of the fund includes the administrative expenses incurred by the welfare benefit fund in delivering the benefits for such year.

(b) If, in a taxable year of a welfare benefit fund, the fund holds an asset with a useful life extending substantially beyond the end of the taxable year (e.g., buildings, vehicles, tangible assets, and licenses) and, for such taxable year of the fund, the asset is used in the provision of welfare benefits to employees, the ‘‘qualified direct cost’’ of the fund for such taxable year of the fund includes the amount that would have been allowable to the employer as a deduction under the applicable Code provisions (e.g., sections 168 and 179) with respect to the portion of the asset used in the provision of welfare benefits for such year if the employer had acquired and placed in service the asset at the same time the fund received and placed in service the asset, and the employer had the same taxable year as the fund. This rule applies regardless of whether the fund received the asset through a contribution of the asset by the employer or through an acquisition or the construction by the fund of the asset. For example, assume that in 1986 a calendar year employer contributes recovery property under section 168(c) to a welfare benefit fund with a calendar taxable year to be used in the provision of welfare benefits. The employer will be treated as having sold the property in such year and thus will recognize gain to the extent that the fair market value of the property exceeds the employer’s adjusted basis in the property. In this regard, see section 1239(d). Also, the employer will be treated as having made a contribution to the fund in such year equal to the fair market value of the property. Finally, the qualified direct cost of the welfare benefit fund for 1986 will include the amount that the employer could have deducted in 1986 with respect to the portion of the property used in the provision of welfare benefits if the employer had acquired the property in 1986 and had placed the property in service when the fund actually placed the property in service. Similarly, for example, assume that in 1986 a welfare bendfit fund purchases and places in service a facility to be used in the provision of welfare benefits. The qualified direct cost of the fund for 1986 will include the amount that the employer could have deducted with respect to such facility if the employer had purchased and placed in service the facility at the same time that the fund purchased and placed in service the facility.

(c) The qualified direct cost of a welfare benefit fund does not include expenditures by the fund that would not have been deductible if they had been made directly by the employer. For example, a fund's purchase of land in a year for an employee recreational facility will not be treated as a qualified direct cost because, if made directly by the employer, the purchase would not have been deductible under section 263. See also sections 264 and 274.

(d) Notwithstanding the preceding paragraphs, the qualified direct cost of a welfare benefit fund with respect to that portion of a child care facility used in the provision of welfare benefits for a year will include the amount that would have been allowable to the employer as a deduction for the year under a straight-line depreciation schedule for a period of 60 months beginning with the month in which the facility is placed in service under rules similar to those provided for section 188 property under § 1.188–1(a). For purposes of this section, a ''child care facility'' is tangible property of a character subject to depreciation that is located in the United States and specifically used as an integral part of a ''qualified child care center facility'' within the meaning of § 1.188–1(d)(4).

(e) See Q&A–7 of this regulation for special section 419 rules relating to the calculation of the qualified direct cost of a welfare benefit fund for an Initial Fund Year and an Overlap Fund Year (as defined in Q&A–7). See Q&A–11 of this regulation for special rules relating to the contribution to a welfare benefit fund of a facility (and to the contribution of other amounts, such as cash, used to acquire, construct, or improve a facility) before section 419 generally becomes effective with respect to contributions to the fund.

Q–7: What special rules apply for purposes of determining the section 419 limit on the employer's deduction for contributions to a welfare benefit fund for the taxable year of the employer in which the fund is established and for the next following taxable year of the employer?

A–7: (a) If the taxable year of a welfare benefit fund is the same as the taxable year of the employer, there are no special rules that apply for purposes of determining the section 419 limit on an employer's deduction for contributions to the fund for either the taxable year of the employer in which the fund is established or the next following taxable year of the employer. However, if the taxable year of a welfare benefit fund is different from the taxable year of the employer, the general section 419 rules are modified by the special rules set forth below for purposes of determining the section 419 deduction limit for the taxable year of the employer in which a fund is established and for the next following taxable year of the employer.

(b) If a welfare benefit fund is established after December 31, 1985, during a taxable year of an employer and either (i) the first taxable year of the fund ends after the close of such taxable year of the employer, or (ii) the first taxable year of the fund is six months or less and ends before the close of such taxable year of the employer and the second taxable year of the fund begins before and ends after the close of such taxable year of the employer, the taxable year of the fund that contains the closing day of such taxable year of the employer will be treated as an ''Overlap Fund Year.'' For purposes of determining the limit on the employer's deduction for contributions to a welfare benefit fund for the taxable year of the employer in which the fund was established, the period between the beginning of the fund's Overlap Fund Year and the end of the employer's taxable year in which the Overlap Fund Year began will be treated as a taxable year of the fund (''Initial Fund Year'').

(c) The qualified cost of a welfare benefit fund for its Initial Fund Year will be equal to the qualified direct cost of the fund for such Initial Fund Year. The qualified cost of a fund for its Overlap Fund Year will be determined under the general rules of Q&A–5 of this regulation and section 419(c), with the exception that such qualfied cost will be reduced by the employer contributions made during the Initial Fund Year and deductible by the employer for the taxable year of the employer in which the Overlap Fund Year of the fund begins.

(d) Assume that an employer with a calendar taxable year establishes on July 1, 1986, a welfare benefit fund with a taxable year ending on June 30. The fund's first taxable year from July 1, 1986, to June 30, 1987, is an Overlap

Fund Year. The employer contributes $1,000 to the fund during its taxable year ending December 31, 1986 (i.e., during the period between July 1, 1986, and December 31, 1986, which is also the Initial Fund Year) and another $1,500 to the fund during its taxable year ending December 31, 1987. Assume further that the qualified direct cost of the fund for the Initial Fund Year is $900 and that the qualified cost for the Overlap Fund Year is $2,500 (prior to the reduction required by paragraph (c) of this Q&A). Under the special rules of paragraphs (b) and (c), the employer may deduct $900 for its taxable year ending on December 31, 1986, and $1,600 for its taxable year ending on December 31, 1987. If the qualified direct cost of the fund for the Initial Fund Year had been $1,050 and the qualified cost for the Overlap Fund Year had been $2,500 (prior to the reduction required by paragraph (c) of this Q&A), the employer's deduction for its taxable year ending December 31, 1986, would have been $1,000 and its deduction for its taxable year ending December 31, 1987, would have been $1,500.

(e) Assume that an employer with a calendar taxable year establishes on March 1, 1986, a welfare benefit fund with a taxable year ending June 30. Thus, the fund has a short first taxable year ending June 30, 1986, an Overlap Fund Year from July 1, 1986, until June 30, 1987, and an ongoing June 30 taxable year. The employer contributes $1,750 to the fund during the employer's taxable year ending December 31, 1986—$750 during the short first taxable year of the fund and $1,000 during the Initial Fund Year (i.e., the period between July 1, 1986, and December 31, 1986)—and $1,500 to the fund during its taxable year ending December 31, 1987. Assume that the qualified cost of the fund for the short first taxable year of the fund is $800, the qualified direct cost for the Initial Fund Year is $900, and the qualified cost for the Overlap Fund Year is $2,500 (prior to the reduction required by paragraph (c) of this Q&A). Under the special rules of paragraphs (b) and (c), the employer may deduct $1,700 for its taxable year ending December 31, 1986, and $1,550 for its taxable year ending December 31, 1987.

Q–8: How does section 419 treat an employer's contribution with respect to a welfare benefit fund in excess of the applicable deduction limit for a taxable year of the employer?

A–8: (a) If an employer makes contributions to a welfare benefit fund in a taxable year of the employer and such contributions (when combined with prior contributions that are deemed under the rule of this Q&A and section 419(d) to have been made in such taxable year) exceed the section 419 deduction limit for such taxable year of the employer, the excess amounts are deemed to be contributed to the fund on the first day of the next taxable year of the employer. Such deemed contributions are combined with amounts actually contributed by the employer to the fund during the next taxable year and may be deductible for such year, subject to the otherwise applicable section 419 deduction limit for such year.

(b) Contributions to a welfare benefit fund on or before December 31, 1985, that were not deductible by the employer for any taxable year of the employer ending on or before December 31, 1985, or for the first taxable year of the employer ending after December 31, 1985, as pre-1986 contributions (see Q&A–9 of this regulation) are deemed to be contributed to the fund on January 1, 1986, However, see Q&A–11 of this regulation for special rules relating to the contribution to a welfare benefit fund of amounts (such as cash) used to acquire, construct, or improve a facility before section 419 generally becomes effective with respect to contributions to the fund. Generally, such contributions (to the extent that they were made after June 22, 1984 and on or before December 31, 1985) are treated as nondeductible pre-1986 contributions and are deemed to be contributed in the form of a facility at the same time as when the facility is placed in service by the fund.

Q–9: How does an employer with a fiscal taxable year calculate its deduction limit for contributions with respect to a welfare benefit fund for the first taxable year of the employer ending after December 31, 1985?

A–9: (a) If the first taxable year of an employer ending after December 31, 1985 (or, if applicable under paragraph (b) of Q&A–2 of this section, the first taxable year of an employer beginning after termination of the last of the collective bargaining agreements pursuant to which the fund is maintained) is a fiscal year, the employer's deduction for such taxable year for contributions to a welfare benefit fund that is not a collectively bargained welfare benefit fund under § 1.419A–2T is limited to the greater of the following two amounts: (1) The contributions paid to the fund during such first taxable year up to the qualified cost of the welfare benefit fund for the taxable year of the fund that relates to such taxable year of the employer, and (2) the contributions paid to the fund during the 1985 portion of such first taxable year of the employer (''the pre-1986 contributions'') to the extent that such pre-1986 contributions are deductible under the rules governing the deduction of such contributions before section 419 generally becomes effective (including the rules set forth in Q&A–10 of this regulation, modified for purposes of this Q&A–9 by substituting ''December 31, 1986'' for ''December 31, 1985'' in paragraph (c)). See Q&A–11 of this regulation for special rules relating to the contribution to a welfare benefit fund of a facility (and to the contribution of other amounts, such as cash, used to acquire, construct, or improve such a facility) before section 419 generally becomes effective with respect to contributions to such fund.

(b) For example, assume that an employer with a taxable year ending June 30, contributes to a welfare benefit fund with a taxable year ending January 31. This employer contributes $1,000 to the fund between July 1, 1985, and December 31, 1985, and an additional $500 to the fund between January 1, 1986, and June 30, 1986. Assume further that the qualified direct cost of the fund for the taxable year of the fund ending January 31, 1986, is $500 and that the qualified cost for such taxable year is $800. Under the deduction rule set forth above, the employer's deduction for its taxable year ending June 30, 1986, is the greater of two amounts: (1) The contributions made during such full taxable year ($1,500) up to the qualifed cost of the fund with respect to such taxable year ($800), and (2) the pre-1986 contributions ($1,000) to the extent that such pre-1986 contributions are deductible under the pre-section 419 rules. In determining the extent to which the pre-1986 contributions are deductible under the pre-section 419 rules, the rules contained in Q&A–10 apply as though December 31, 1985, in paragraph (c) were December 31, 1986. Assuming that only $875 is deductible under the pre-section 419 rules, because $875 is greater than $800, this employer may deduct $875 for its first taxable year ending after December 31, 1985. This full $875 deduction for 1985 is deemed to consist entirely of pre-1986 contributions.

Q–10: How do the rules of sections 263, 446(b), 461(a), and 461(h) apply in determining whether contributions with respect to a welfare benefit fund are deductible for a taxable year?

A–10: (a) Both before and after the effective date of section 419 (see Q&A–2 of this regulation), an employer is allowed a deduction for taxable year for contributions paid or accrued with respect to a ''welfare benefit fund'' (as defined in Q&A–3 of this regulation and section 419(e)) only to the extent that such contributions satisfy the requirements of section 162 or 212. These requirements must be satisfied after the effective date of section 419 because 419 requires that (among other requirements) contributions to a welfare benefit fund satisfy the requirements of section 162 or 212.

(b) Except as provided in paragraphs (c) and (d), in determinig the extent to which contributions paid or accrued with respect to welfare benefit fund satisfy the requirements of section 162 or 212 for a taxable year (both before and after section 419 generally becomes effective with respect to such contributions), the rules of sections 263, 446(b), 461(a) (including the rules that relate to the creation of an asset with a useful life extending substantially beyond the close of the taxable year), and 461(h) (to the extent that such section is effective with respect to such contributions) are are generally applicable.

(c) Notwithstanding paragraph (b), under the authority of section 7805(b), the rules of sections 263, 446(b), and

461(a) shall not be applied in determining the extent to which an employer's contribution with respect to a welfare benefit fund is deductible under section 162 or 212 with respect to any taxable year of the employer ending on or before December 31, 1985, to the extent that, for such taxable year, (1) the contribution was made pursuant to a bona fide collective bargaining agreement requiring fixed and determinable contributions to a collectively bargained welfare benefit fund (as defined in §1.419A–2T), or (2) the contribution was not in excess of the amount deductible under the principles of Revenue Rulings 69–382, 1969–2 C.B. 28; 69–478, 1969–2 C.B. 29; and 73–599, 1973–2 C.B. 40, modified as appropriate for benefits for active employees.

(d) Notwithstanding paragraph (b), in determining the extent to which contributions paid or accrued with respect to a welfare benefit fund are deductible under section 419, the rules of sections 263, 446(b), and 461(a) will be treated as having been satisfied to the extent that such contributions satisfy the otherwise applicable rules of section 419. Thus, for example, contributions to a welfare benefit fund will not fail to be deductible under section 419 merely because they create an asset with a useful life extending substantially beyoud the close of the taxable year if such contributions satisfy the otherwise applicable requirements of section 419.

(e) In determining the extent to which contributions with respect to a welfare benefit fund satisfy the requirements of section 461(h) for any taxable year for which section 461(h) is effective, pursuant to the authority under section 461(h)(2), economic performance occurs as contributions to the welfare benefit fund are made. Solely for purposes of section 461(h), in the case of an employer's taxable year ending on or after July 18, 1984, and on or before March 21, 1986, contributions made to the welfare benefit fund after the end of such taxable year and on or before March 21, 1986 shall be deemed to have been made on the last day of such taxable year.

Q–11: What special section 419 rules apply to the payment or accrual with respect to a welfare benefit fund of a facility (and the payment or accrual of other amounts, such as cash, used to acquire, construct, or improve such a facility)?

A–11: (a)(1) In the case of an employer's payment or accrual with respect to a welfare benefit fund after June 22, 1984, and on or before December 31, 1985 (or, if applicable under paragraph (b) of Q&A–2 of this regulation, before section 419 generally becomes effective with respect to contributions to such fund), of a facility, the rules of section 419, §1.419–1T, and §1.419A–2T generally apply to determine the extent to which such contribution is deductible by the employer for its taxable year of contribution. For this purpose, however, the facility is to be treated as the only contribution made to the fund and the qualified cost of the fund for the taxable year of the fund in which the facility was contributed is to be equal to the qualified direct cost directly attributable to the facility (as determined under Q&A–6 of this regulation). Also, for this purpose, the welfare benefit fund to which the facility was contributed may not be aggregated with any other fund. For purposes of this Q&A, ''facility'' means any tangible asset with a useful life extending substantially beyond the end of the taxable year (e.g., vehicles, buildings) and any intangible asset (e.g., licenses) related to a tangible asset, whether or not such asset is used in the provision of welfare benefits. See, however, paragraph (c) of Q&A–2 of this regulation for a binding contract exception.

(2) For example, assume that an employer and a welfare benefit fund each has a calendar taxable year and that, during 1985, the employer contributes to the fund $200,000 in cash and a facility with a fair market value of $100,000. Such facility is used in the provision of welfare benefits under the fund. The employer is treated as having sold the facility in such year and thus will recognize gain to the extent that the fair market value of the facility exceeds the employer's adjusted basis in the facility. In this regard, see section 1239(d). The extent to which the facility contribution is deductible by the employer for its 1985 taxable year is determined as though it were the only contribution made by the employer to the fund during such year and the

qualified cost of the fund for the taxable year of the fund in which the contribution was made (i.e., the 1985 taxable year) were equal to the amount that would have been allowable to the employer as a deduction for such year under the applicable Code provisions with respect to the portion of the facility used in the provision of welfare benefits for such year if the employer had placed in service the facility at the time the fund placed in service the facility and if the employer had the same taxable year as the fund. If, under these assumptions, the employer would have been allowed a $10,000 deduction with respect to the facility for the 1985 taxable year, the fund's qualified cost for its 1985 taxable year would be only $10,000. Thus, only $10,000 of the $100,000 facility contribution would be deductible by the employer for its 1985 taxable year (i.e., the taxable year of the employer with or within which the applicable taxable year of the fund ends). However, in determining the extent to which the $200,000 in cash is deductible by the employer for its 1985 taxable year, the $100,000 facility is not to be disregarded. Thus, if under the applicable pre-section 419 rules the employer is allowed for 1985 a total deduction of only $175,000, the employer would be permitted a deduction for 1985 of $175,000 ($10,000 with respect to the facility and $165,000 of the cash contribution). The nondeductible portion of the cash contribution is to be treated as contributed to the fund on the first day of the next taxable year of the employer. If under the applicable pre-section 419 rules the employer were allowed a total deduction of $300,000 for 1985, the employer would be permitted a deduction for 1985 of only $210,000 ($10,000 with respect to the facility and the full $200,000 cash contribution).

(3) For example, assume that an employer has a June 30 taxable year and maintains a welfare benefit fund with a taxable year ending January 31. During the 1985 portion of its taxable year ending June 30, 1986, the employer contributes $50,000 in cash and a facility with a fair market value of $100,000; and during the 1986 portion of such taxable year, the employer contributes another $75,000 in cash to the fund. The facility is used in the provision of welfare benefits under the fund. Under the rules of Q&A–9 of this regulation, the employer's deduction for its June 30, 1986, taxable year is limited to the greater of the following two amounts: (i) The contributions paid to the fund during such taxable year ($225,000) up to the qualified cost of the fund for the taxable year of the fund ending January 31, 1986, and (ii) the contributions paid to the fund during the 1985 portion of the employer's taxable year ending June 30, 1986 (''the pre-1986 contributions'') ($150,000) to the extent that such pre-1986 contributions are deductible under the rules governing the deduction of such contributions before section 419 is generally effective with respect to the fund. For purposes of this rule, the contribution of the facility on or before December 31, 1985, is to be treated as a pre-1986 contribution and the rules of section 419 and this Q&A are to be treated as rules governing the deduction of such contribution before section 419 generally becomes effective with respect to the fund. Thus, in determining the extent to which the facility is deductible as a pre-1986 contribution under the rules before section 419 generally becomes effective, the facility is treated as the only contribution to the welfare benefit fund and the qualified cost of such fund for the taxable year of the fund in which the facility was contributed is the amount that would have been allowable to the employer as a deduction with respect to the portion of the facility used in the provision of welfare benefits if the employer had placed in service the facility at the same time that the fund placed in service the facility and the employer's taxable year ended on January 31, 1986.

(b)(1) The preceding rules shall also apply for purposes of determining when and the extent to which an employer may deduct contributions or other items and amounts after June 22, 1984 and on or before December 31, 1985 (or, if applicable under paragraph (b) of Q&A–2 of this regulation, before section 419 generally becomes effective with respect to contributions to the fund) that are not facilities (e.g., cash contributions) to a welfare benefit fund that are used by the fund to acquire, construct, or improve a facility. The most recent non-facility contributions made to a welfare benefit fund before the facility in question is placed in service by the fund (up to the fair market value of the facility at such time) are to be treated as used by the fund for the acquisition, construction, or improvement (as the case may be) of such facility. To the extent that contributions before such a facility is placed in service are not at least equal to the value of the facility at such time, contributions after such date (up to the value of the facility at the time it is placed in service) are treated as used for acquisition, construction, or improvement of the facility. Such non-facility contributions, to the extent that they were made after June 22, 1984, and on or before December 31, 1985 (or, if applicable under paragraph (b) of Q&A–2 of this regulation, before section 419 generally becomes effective with respect to contributions to the fund), are not deductible by the employer as non-facility contributions for any year. Instead, the employer is permitted a deduction with respect to such contributions only under the rules of this Q&A as though the employer had contributed a facility to the fund at the same time that the fund placed in service the facility in question and, at such time, the facility had a fair market value equal to the total of such non-facility contributions.

(2) For example, assume that an employer and a welfare benefit fund each has a calendar taxable year and during 1985 the fund acquired and placed in service a facility with a fair market value of $100,000 to be used in the provision of welfare benefits. Further, during July 1984 the employer contributed $150,000 in cash to the fund and, during the portion of 1985, before the facility was placed in service by the fund, the employer contributed another $75,000 in cash to the fund; during the remaining portion of 1985, the employer contributed $125,000 in cash. The facility is used in the provision of welfare benefits under the fund. Because $25,000 of the employer's 1984 contribution is treated under this rule as used for the acquisition of a facility, such $25,000 is not deductible by the employer for 1984. For purposes of determining the employer's deduction for 1985, the employer will be treated as having contributed $125,000 in cash and a facility with a fair market value of $100,000. The employer's deduction for its 1985 taxable year will be determined under the rules relating to the contribution of a facility after June 22, 1984, and on or before December 31, 1985.

(3) For example, assume that an employer and a welfare benefit fund each has a calendar taxable year and during 1986 the fund placed in service a facility with a fair market value of $100,000 to be used in the provision of welfare benefits. During 1985, the employer contributed $125,000 in cash to the fund. During the portion of 1986 before the facility was placed in service, the employer contributed $60,000 in cash, and during the remaining portion of 1986, the employer contributed another $75,000 in cash. The facility is used in the provision of welfare benefits under the fund. Because $40,000 of its 1985 cash contribution is treated under this rule as used for the acquisition of the facility, such $40,000 is not deductible by the employer for 1985. For purposes of determining the employer's deduction for 1986, the employer will be treated as though it had contributed a $40,000 facility to the fund at the time the fund placed the facility in service.

(c) For purposes of calculating the "existing excess reserve amount" under Q&A–1 of § 1.419A–1T and the "existing reserves for post-retirement medical or life insurance benefits" under Q&A–4 of § 1.512(a)–5T (but not the exempt function income under Q&A–3 of § 1.512(a)–5T), the amount set aside as of any applicable date is to be reduced to the extent that contributions originally included in such amount are subsequently treated under this Q&A as used for the acquisition, construction, or improvement of an asset excluded from the calculation of the total amount set aside under paragraph (b) of § 1.512(a)–5T (or would be so treated under this Q&A if it applied to such asset). The reduction required under this paragraph applies for purposes of calculating the "existing excess reserve amount" and the "existing reserves for post-retirement medical or life insurance benefits" for all taxable years of the welfare benefit fund.

[T.D. 8073, 51 FR 4323, Feb. 4, 1986; 51 FR 7262, Mar. 3, 1986; 51 FR 11303, Apr. 2, 1986]

§ 1.419A–1T Qualified asset account limitation of additions to account. (Temporary)

Q–1: What does the transition rule under section 419A(f)(7) provide?

A–1: Section 419A(f)(7) provides that, in the case of a welfare benefit fund that was in existence on July 18, 1984, the account limit (as determined under section 419A(c)) for each of the first four taxable years of the fund that relate to taxable years of the employer ending after December 31, 1985 (or, if applicable under paragraph (b) of Q&A–2 of § 1.419–1T, taxable years of the employer beginning after the termination of the last of the collective bargaining agreements pursuant to which the plan is maintained) shall be increased by the following percentages of the ''existing excess reserve amount'':

	Percent
First taxable year	80
Second taxable year	60
Third taxable year	40
Fourth taxable year	20

For purposes of this section, the ''existing excess reserve amount'' for any taxable year of a fund is the excess of (a) the assets actually set aside for purposes described in section 419A(a) at the close of the first taxable year of the fund ending after July 18, 1984 (calculated in the manner set forth in Q&A–3 of § 1.512(a)–3T, and adjusted under paragraph (c) of Q&A–11 of § 1.419–1T), reduced by employer contributions to the fund before the close of such first taxable year to the extent that such contributions are not deductible for the taxable year of the employer with or within which such taxable year of the fund ends and for any prior taxable year of the employer, over (b) the account limit which would have applied to the taxable year of the fund for which the excess is being computed (without regard to this transition rule). A welfare benefit fund is treated as in existence on July 18, 1984, for purposes of this transition rule only if amounts were actually set aside in such fund on such date to provide welfare benefits enumerated under section 419A.

[T.D. 8073, 51 FR 4329, Feb. 4, 1986, as amended at 51 FR 11303, Apr. 2, 1986]

§ 1.419A–2T Qualified asset account limitation for collectively bargained funds. (Temporary)

Q–1: What account limits apply to welfare benefit funds that are maintained pursuant to a collective bargaining agreement?

A–1: Contributions to a welfare benefit fund maintained pursuant to one or more collective bargaining agreements and the reserves of such a fund generally are subject to the rules of sections 419, 419A, and 512. However, neither contributions to nor reserves of such a collectively bargained welfare benefit fund shall be treated as exceeding the otherwise applicable limits of section 419(b), 419A(b), or 512(a)(3)(E) until the earlier of: (i) The date on which the last of the collective bargaining agreements relating to the fund in effect on, or ratified on or before, the date of issuance of final regulations concerning such limits for collectively bargained welfare benefit funds terminates (determined without regard to any extension thereof agreed to after the date of issuance of such final regulations), or (ii) the date 3 years after the issuance of such final regulations.

Q–2: What is a welfare benefit fund maintained pursuant to a collective bargaining agreement for purposes of Q&A–1?

A–2: (1) For purposes of Q&A–1, a collectively bargained welfare benefit fund is a welfare benefit fund that is maintained pursuant to an agreement which the Secretary of Labor determines to be a collective bargaining agreement and which meets the requirements of the Secretary of the Treasury as set forth in paragraph 2 below.

(2) Notwithstanding a determination by the Secretary of Labor that an agreement is a collective bargaining agreement, a welfare benefit fund is considered to be maintained pursuant to a collective bargaining agreement only if the benefits provided through the fund were the subject of arms-length negotiations between employee

representatives and one or more employers, and if such agreement between employee representatives and one or more employers satisfies section 7701(a)(46) of the Code. Moreover, the circumstances surrounding a collective bargaining agreement must evidence good faith bargaining between adverse parties over the welfare benefits to be provided through the fund. Finally, a welfare benefit fund is not considered to be maintained pursuant to a collective bargaining agreement unless at least 50 percent of the employees eligible to receive benefits under the fund are covered by the collective bargaining agreement.

(3) In the case of a collectively bargained welfare benefit fund, only the portion of the fund (as determined under allocation rules to be provided by the Commissioner) attributable to employees covered by a collective bargaining agreement, and from which benefits for such employees are provided, is considered to be maintained pursuant to a collective bargaining agreement.

(4) Notwithstanding the preceding paragraphs and pending the issuance of regulations setting account limits for collectively bargained welfare benefit funds, a welfare benefit fund will not be treated as a collectively bargained welfare benefit fund for purposes of Q&A–1 if and when, after July 1, 1985, the number of employees who are not covered by a collective bargaining agreement and are eligible to receive benefits under the fund increases by reason of an amendment, merger, or other action of the employer or the fund. In addition, pending the issuance of such regulations, for purposes of applying the 50 percent test of paragraph (2) to a welfare benefit fund that is not in existence on July 1, 1985, ‘‘90 percent’’ shall be substituted for ‘‘50 percent’’.

[T.D. 8034, 50 FR 27428, July 3, 1985]

CERTAIN STOCK OPTIONS

§1.421–1 Effective dates and meaning and use of certain terms.

(a) *Option.* (1) For the purpose of section 421, the term ‘‘option’’ includes the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (d) of this section, such individual being under no obligation to purchase. Such right or privilege, when granted, must be evidenced in writing. The individual who has such right or privilege is referred to as the optionee and the corporation offering to sell stock under such an arrangement is referred to as the optionor. While no particular form of words is necessary, the written option should express, among other things, an offer to sell at the option price and the period of time during which the offer shall remain open.

(2) An option may be granted as part of or in conjunction with an employee stock purchase plan or subscription contract.

(3) An arrangement between a corporation and an employee may involve more than one option. For example, if a corporation on June 1, 1954, grants to an employee the right to purchase 1,000 shares of its stock on or after June 1, 1955, another 1,000 shares on or after June 1, 1956, and a further 1,000 shares on or after June 1, 1957, all shares to be purchased before June 1, 1958, provided the employee at the time of exercise of any of the purchase rights is employed by the corporation, such an arrangement will be construed as the grant to the employee on June 1, 1954, of three options, each for the purchase of 1,000 shares. Similarly, if a corporation grants to an employee on January 1, 1955, the right to purchase 1,000 shares of its stock at $85 per share during 1955, or at $75 per share during 1956, or at $65 per share during 1957, such an arrangement will be construed as the grant to the employee on January 1, 1955, of three alternative options, one option for the purchase of 1,000 shares at $85 per share during 1955, an alternative option for the purchase of 1,000 shares at $75 per share during 1956, and a third alternative option for the purchase of 1,000 shares at $65 per share during 1957.

(b) *Time and date of granting of option.* (1) For the purpose of section 421, the words ‘‘the date of the granting of the option’’ and ‘‘the time such option is granted’’, and similar phrases refer to the date or time when the corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a restricted stock option. Ordinarily, if the corporate action contemplates an immediate offer of stock for sale to an individual or to a class including such individual, or contemplates a particular date on which such offer is to be made, the time or date of the granting of the option is the time or date of such corporate action if the offer is to be made immediately, or the date contemplated as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the individual or to the class will be taken into account as indicating that the corporation contemplated that the offer was to be made at the subsequent date on which such notice is given.

(2) If the corporation imposes conditions on the granting of an option (as distinguished from conditions governing the exercise of the option), such conditions shall be given effect in accordance with the intent of the corporation. A special rule is provided by section 421(d)(5) for options subject to stockholder approval. If the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval. A condition which does not require corporate action, such as the approval of some regulatory or governmental agency, for example, a stock exchange or the Securities and Exchange Commission, is ordinarily considered a condition upon the exercise of the option unless the corporate action clearly indicates that the option is not to be granted until such condition is satisfied. If an option is granted to an individual upon the condition that such individual will become an employee of the corporation granting the option or of its parent or subsidiary corporation, such option is not granted prior to the date the individual becomes such an employee.

(3) In general, conditions imposed upon the exercise of an option will not operate to make ineffective the granting of the option. For example, on June 1, 1954, the A Corporation grants to X, an employee, an option to purchase 5,000 shares of the corporation stock, exercisable by X on or after June 1, 1955, provided he is employed by the corporation on June 1, 1955. Such an option is granted to X on June 1, 1954.

(c) *Stock.* For the purpose of section 421, the term ''stock'' means capital stock of any class, including voting or nonvoting common or preferred stock. The term includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term ''stock'' as used in section 421, provided such stock otherwise possesses the rights and characteristics of capital stock.

(d) *Option price.* (1) For the purpose of section 421, the term ''option price'' or ''price paid under the option'' means the consideration in money or property which, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased.

(2) (i) With respect to its option price, a restricted stock option must, when granted, meet either of the following requirements:

(A) The option price must be fixed or determinable at the time the option is granted; or

(B) In the case of an option exercised during any taxable year of the optionee which begins after December 31, 1953, and ends after August 16, 1954, the option price must be determinable under a variable price option as defined in subdivision (ii) of this subparagraph.

An option which does not meet the requirements of either (A) or (B) of this subdivision when granted will not be treated as a restricted stock option unless it is subsequently changed to meet such requirements. In case of such a change, see paragraph (c)(2) of § 1.421–4.

(ii)(A) The term ''variable price option'' means an option under which the option price is determined by a formula in which the only variable is the fair market value of the stock at any time during a period of six consecutive months which includes the day on which such option is exercised. Except as provided in (*b*) of this subdivision, such formula may provide for determining such price by reference to such value on any particular day in such 6-month period, or by reference to an average value of the stock over either the whole of such 6-month period or over any shorter period included in such 6-month period. Such 6-month period may begin with, end with, or in any other manner span the day on which such option is exercised. Such formula may also depend upon factors other than such value of the stock, but such other factors must not be variable and must be fixed in the option when granted. For example, such formula may provide that the option price shall be 85 percent of the value of the stock on the day the option is exercised, but such price shall not be less than $85, nor more than $110. Another example of a formula which meets the requirements of this subdivision is a provision that the option price shall be 95 percent of the fair market value of the stock on the day the option is exercised but not more than $95. However, the requirements of this subdivision are not met by a formula which provides that if the profits of the employer for the year do not exceed $100,000, the option price shall be $15 under the fair market value of the stock at the time the option is exercised, but if such profits exceed $100,000, the option price shall be $20 under such value of the stock. For an example of how to determine whether an option which contains a formula meeting the requirements of this subdivision also meets the requirement that the option price must be at least 85 percent of the fair market value of the stock at the time the option is granted, see paragraph (a)(1) of §1.421–2.

(B) In the case of an option granted after September 30, 1958, the term ‘‘variable price option’’ does not include any option in which the formula provides for determining the option price by reference to the fair market value of the stock at any time before the option is exercised if such value may be greater than the average fair market value of the stock during the calendar month in which the option is exercised. Whether an option meets the requirement of this subdivision shall be determined solely by reference to the terms of the option, and the circumstances existing at the time the option is granted or exercised are immaterial. Thus, an option, granted after September 30, 1958, and containing a pricing formula which takes into consideration the value of the stock at any time before the option is exercised, is subject to the new limitation and does not meet the requirement of this subdivision, even though the option price is not actually based upon such prior fair market value either at the time the option is exercised or at the time the option price is computed as if it were exercised for the purpose of applying the 85 percent test of section 421(d)(1)(A). For example, a formula which provides that the option price is to be 45 percent of the fair market value of the stock 30 days before the date on which the option is exercised, but not more than $85, will not qualify under this subdivision since under this formula the price may be determinable by reference to a higher prior value. On the other hand, a formula which provides that the option price is to be 90 percent of the average value of the stock during the month the option is exercised or the average value of the stock during the preceding month, whichever is lower, will qualify. In the case of an option granted after September 30, 1958, the only way that a formula which provides for determining the option price by reference to the fair market value of the stock at a time before the option is exercised can come within the requirement of this subdivision is to provide that the option price is to be determined by reference to such fair market value only if such fair market value is not greater than the average fair market value of the stock during the month in which the option is exercised. If under the terms of an option the price is to be determined by reference to the fair market value of the stock at a time before the option is exercised, whether such value is higher or lower than the average fair market value of the stock during the month the option is exercised, such option will not be considered a restricted stock option since the option price may be based upon the prior value of the stock when such value exceeds the average fair market value of the stock during the month the option is exercised. However, if an option provides for determining the option price by reference to a prior fair market value of the stock only when such value is lower than such average value of the stock, such option can qualify as a restricted stock option. The average fair market value of the stock during the month in which the option is exercised means such value during the calendar month the option is exercised and not merely during a 30- or 31-day period including the time the option is exercised. To compute the average fair market value of the stock for the month, it will be necessary to ascertain the fair market value of the stock for each day during the month, including those days which are not business days. In ascertaining the fair market value of the stock for each day, the generally accepted principles for ascertaining such value will be applied.

(e) *Exercise.* For the purpose of section 421, the term ''exercise'', when used in reference to an option, means the act of acceptance by the optionee of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. An agreement or undertaking by the employee to make payments under a stock purchase plan does not constitute the exercise of an option so long as the payments made remain subject to withdrawal by the employee.

(f) *Transfer.* For the purpose of section 421, the term ''transfer'', when used in reference to the transfer to an individual of a share of stock pursuant to his exercise of a restricted stock option, means the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation.

(g) *Effective dates.* Sections 1.421–1 through 1.421–5 are applicable only to options granted after February 26, 1945, and before January 1, 1964, and all references therein to sections of the Code are to the Internal Revenue Code of 1954, before the amendments made by section 221 of the Revenue Act of 1964 (78 Stat. 63). Section 1.421–6 is applicable only to options granted on or after February 26, 1945, and all references to sections of the Code are to the Internal Revenue Code of 1954, as amended. Sections 1.421–7 and 1.421–8 are applicable only to options granted after December 31, 1963, and all references therein to sections of the Code are to the Internal Revenue Code of 1954, as amended.

[T.D. 6500, 25 FR 11692, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 410, Jan. 19, 1961, T.D. 6887, 31 FR 8786, June 24, 1966]

§ 1.421–2 Restricted stock option.

(a) *In general.* (1) A ''restricted stock option'' is an option granted after February 26, 1945, to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but, except in the case of options described in subparagraph (2) of this paragraph, only if—

(i) At the time such option is granted the option price is at least 85 percent of the fair market value at such time of the stock subject to the option; and

(ii) Such option by its terms is not transferable by such individual otherwise than by will or by the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(iii) Such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock either of the employer corporation or of its parent or subsidiary corporation; and

(iv) In the case of options granted after June 21, 1954, such option by its terms is not exercisable after the expiration of ten years from the date on which such option was granted.

For the purpose of applying the rule of subdivision (i) of this subparagraph if the option price is determined by a formula described in paragraph (d)(2)(ii) of § 1.421–1, the option price shall, notwithstanding any provision of the option, be computed as if such option is exercised on the day when it is granted. For example, if on June 15, 1959, an option is granted providing that the option price shall be $10 under the average fair market value of the stock during the month in which the option is exercised or the average fair market value of the stock during the preceding month, whichever is lower, and if on

June 15, 1959, the value of the stock subject to the option is $100 a share, to determine if the option meets the requirement of subdivision (i) of this subparagraph, it is necessary to determine the average fair market value of the stock during the months of May and June 1959. If such lower average fair market value is $95 or more, the option meets the requirement of subdivision (i) of this subparagraph.

(2) Regardless of the extent to which the individual to whom the option is granted owns stock of either the employer corporation, or of its parent or subsidiary corporation, an option is a restricted stock option if—

(i) Such option is granted after February 26, 1945, to such individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations; and

(ii) At the time such option is granted the option price is at least 110 percent of the fair market value at such time of the stock subject to the option; and

(iii) Such option by its terms is not transferable by such individual otherwise than by will or by the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(iv) Such option by its terms is not exercisable after the expiration of five years from the date on which such option was granted, or such option is exercised before August 17, 1955.

(3) At the time the option is granted, the relationship between the individual to whom an option is granted and the corporation granting the option (or a corporation which is a parent or subsidiary thereof) must be the legal and bona fide relationship of employer and employee. For rules applicable to the determination whether the employer-employee relationship exists, see section 3401(c) and the regulations thereunder. An option granted before employment or after termination of employment is not a restricted stock option. As to the granting of an option conditioned upon employment, see paragraph (b)(2) of §1.421–1. The option must be granted for a reason connected with the individual's employment by the corporation or by its parent or subsidiary corporation.

(4) An option may qualify as a restricted stock option only if, under the terms of the option, it is not transferable (other than by will or by the laws of descent and distribution) by the individual to whom it is granted, and is exercisable, during the lifetime of such individual, only by him. Accordingly, an option which is transferable by the individual to whom it is granted during his lifetime, or is exercisable during such individual's lifetime by another person, is not a restricted stock option. However, in case the option contains a provision permitting the individual to whom the option was granted to designate the person who may exercise the option after his death, neither such provision, nor a designation pursuant to such provision, disqualifies the option as a restricted stock option.

(5) Any reasonable valuation methods may be used for the purpose of determining whether at the time the option is granted the option price is at least 85 percent of the fair market value at such time of the stock subject to the option. Such methods include the valuation methods described in §20.2031–2 of this chapter (Estate Tax Regulations).

(b) *Ownership of 10 percent of stock.* In determining the amount of stock owned by an individual, for the purpose of applying the 10 percent test of section 421(d)(1)(C), stock of the employer corporation or of its parent or subsidiary owned (directly or indirectly) by or for such individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants, shall be considered as owned by such individual. Also, for such purpose, if a domestic or foreign corporation, partnership, estate, or trust owns (directly or indirectly) stock of the employer corporation or of its parent or subsidiary, such stock shall be considered as being owned proportionately by or for the shareholders, partners, or beneficiaries of the corporation, partnership, estate, or trust.

[T.D. 6500, 25 FR 11693, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 411, Jan. 19, 1961]

§ 1.421–3 Exercise of restricted stock option.

(a) The special rules of income tax treatment provided in section 421(a) and (b) are applicable only if the following conditions exist with respect to the transfer of a share of stock to an individual:

(1) The share of stock is transferred to the individual pursuant to his exercise after 1949 of a restricted stock option; and

(2) At the time the option is exercised by him, the individual is an employee of the corporation granting such option (or parent or subsidiary thereof), or of a corporation (or parent or subsidiary thereof) which issued or assumed the option under section 421(g) (see paragraph (d) of § 1.421–4), or was an employee of any such corporations within three months before the date the option is exercised.

(b)(1) Section 421 is applicable to the exercise of a restricted stock option only if at the time the individual exercises the option he is a bona fide employee of the corporation granting the option, or of a corporation which is at the time the option is exercised a parent or subsidiary of such corporation, unless the old option has been assumed or a new option has been issued in its place under section 421(g). See paragraph (d) of § 1.421–4. In case of such an assumption of the old option or such issuance of a new option, the individual exercising the option must, at the time he exercises the option, be a bona fide employee of the corporation so assuming or issuing the option, or a parent or subsidiary of such corporation. Section 421 is also applicable if the individual exercising the option was a bona fide employee of any of such corporations within three months before the exercise of the option. For purposes of determining whether an individual meets the requirement of this subparagraph, the term ‘‘employer corporation’’, as used in section 421(d) (2) and (3), shall be read as ‘‘grantor corporation’’ or ‘‘corporation issuing or assuming a stock option in a transaction to which section 421(g) is applicable’’, as the case may be. Therefore, for purposes of the employment requirement, the determination of whether a corporation is a parent corporation or a subsidiary corporation is based upon whether the corporation is a parent or subsidiary of the corporation granting an option or of a corporation which issued or assumed an option under section 421(g).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1954, X Corporation granted a restricted stock option to A, an employee of X Corporation, to purchase a share of X stock. On February 1, 1955, X sold the plant where A was employed to M Corporation, an unrelated corporation, and A was employed by M. If A exercises this restricted stock option on June 1, 1955, section 421 is not applicable to such exercise, because on June 1, 1955, A is not employed by the corporation which granted the option or by a parent or subsidiary of such corporation. Nor was he employed by any of such corporations within three months before June 1, 1955.

Example (2). Assume the facts to be the same as in example (1), except that when A was employed by M Corporation, the option to purchase X stock was terminated, and was replaced by an option to buy M stock in such circumstances that M Corporation is treated as a corporation issuing an option under section 421(g). If A exercises the option to purchase the share of M stock on June 1, 1955, section 421 is applicable for A is then employed by a corporation which issued an option under section 421(g).

Example (3). Assume that P Corporation which owns all of the stock of S Corporation grants a restricted stock option to E, an employee of S Corporation. If E exercises the option, section 421 is applicable since E is employed by a corporation which is a subsidiary of the corporation which granted the restricted stock option.

(c)(1) The determination whether an option ultimately exercised is a restricted stock option is made as of the date such option is granted. An option which is a restricted stock option when granted does not lose its character as such an option by reason of subsequent events, and an option which is not a restricted stock option when granted does not become such an option by reason of subsequent events. See, however, § 1.421–4, relating to modification, extension, or renewal of an option.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). S–1 Corporation is a subsidiary of S Corporation which, in turn, is a subsidiary of P Corporation. On June 1, 1954, P grants to an employee of P a restricted stock option to purchase a share of stock of S–1. On January 1, 1955, S sells a portion of the S–1 stock which it owns to an unrelated corporation and, as of that date, S–1 ceases to be a subsidiary of S. On May 1, 1955, while still employed by P, the employee exercises his option to purchase a share of S–1 stock. The employee has exercised a restricted stock option.

Example (2). Assume P grants an option to an employee under the same facts as in example (1) above, except that on June 1, 1954, S–1 is not a subsidiary of either S or P. Such option is not a restricted stock option on June 1, 1954. On January 1, 1955, S purchases from an unrelated corporation a sufficient number of shares of S–1 stock to make S–1, as of that date, a subsidiary of S. On May 1, 1955, while still employed by P, the employee exercises his option to purchase a share of S–1 stock. The employee has not exercised a restricted stock option.

(d) For the rules applicable to an exercise of a restricted stock option by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by reason of the death of such individual, see paragraph (d) of §1.421–5.

[T.D. 6500, 25 FR 11694, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 411, Jan. 19, 1961]

§1.421–4 Modification, extension, or renewal.

(a) *In general.* Section 421(e) provides the rules for determining whether a share of stock transferred to an individual upon his exercise of an option, after the terms thereof have been modified, extended, or renewed, is transferred pursuant to the exercise of a restricted stock option. Such rules and the rules of this section are applicable to modifications, extensions, or renewals (or to changes which are not treated as modifications) in the case of an exercise of an option in any taxable year of the optionee which begins after December 31, 1953, and ends after August 16, 1954.

(b) *Effect of a modification, extension, or renewal.* (1) Any modification, extension, or renewal of the terms of an option to purchase stock shall be considered as the granting of a new option.

(2) Except as otherwise provided in subparagraph (3) of this paragraph, in case of a modification, extension, or renewal of an option, the highest of the following values shall be considered to be the fair market value of the stock at the time of the granting of such option for the purpose of applying the rule of section 421(d)(1)(A)—

(i) The fair market value on the date of the original granting of the option,

(ii) The fair market value on the date of the making of such modification, extension, or renewal, or

(iii) The fair market value at the time of the making of any intervening modification, extension, or renewal.

(3)(i) The rules of subparagraph (2) of this paragraph do not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months preceding the month in which the modification, extension, or renewal occurs, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest. In such case, any modification, extension, or renewal of the option is treated as the granting of a new option but only the fair market value of the stock subject to the option at the time of the modification, extension, or renewal is considered in determining whether the option is a restricted stock option. In the case of stocks listed on a stock exchange, the average fair market value of the stock for any month may be determined by adding the highest and lowest quoted selling prices during such month and dividing the sum by two. The method used for determining the average fair market value of the stock for any month must be used for all twelve months, except where it is shown that such method cannot be used for any month or does not clearly reflect the average fair market value of the stock for any such month.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On June 1, 1954, a restricted stock option was granted to purchase before July 1, 1955, a share of stock for $85. The fair market value of such stock on June 1, 1954, was $100. On June 15, 1955, when the fair market value of the stock is $60, such option is extended so that it is exercisable at any time before July 1, 1956, at $55 a share. The average fair market value of the stock subject to the option for each of the 12 calendar months preceding June 1955, is as follows:

1954	
June	$100
July	90
August	80
September	70
October	80
November	80
December	90
1955	
January	90
February	80
March	70
April	60
May	60

The aggregate of such values is $950. When this sum is divided by 12, the result is $79.17, which is an amount less than 80 percent of the fair market value of the stock ($100) when the option was granted. Accordingly, when the option is extended on June 15, 1955, the option price could have been reduced as low as $51 (85 percent of the fair market value of the stock on such day) without disqualifying the option as a restricted stock option. If the aggregate fair market values of the stock so ascertained had amounted to $960 or more, the rules of subparagraph (2) of this paragraph would have been applicable with the result that any reduction in the option price would have disqualified the option as a restricted stock option.

(c) *Definition of modification, extension, or renewal.* (1) The time or date when an option is modified, extended, or renewed shall be determined, insofar as applicable, in accordance with the rules governing determination of the time or date of granting an option provided in paragraph (b) of § 1.421–1. For the purpose of section 421, the term ‘‘modification’’ means any change in the terms of the option which gives the optionee additional benefits under the option. For example, a change in the terms of the option, which shortens the period during which the option is exercisable, is not a modification. However, a change, which accelerates the time when the option is first exercisable, or which provides more favorable terms for the payment for the stock purchased under the option, is a modification. A mere change in the terms of the option, with respect to the number or price of the shares of stock subject to the option, to reflect a stock dividend or stock split-up is not a modification of the option. In case there is an assumption or substitution of the option by reason of certain corporate transactions, see paragraph (d) of this section. Where an option is amended solely to increase the number of shares subject to the option, such increase shall not be considered as a modification of the option, but shall be treated as the grant of a new option for the additional shares.

(2) Any change in the terms of an option for the purpose of qualifying the option as a restricted stock option grants additional benefits and, therefore, is a modification. For example, if an option was granted to purchase for $80 a share of stock, the fair market value of which was $100 at such time, and if later the option price is increased to $85 in order to meet the requirement of section 421(d)(1)(A), such change is a modification of the option, although the price is increased. Accordingly, the option, despite the change, is not a restricted stock option if the fair market value of the share is more than $100 when the price is increased. However, if the terms of an option are changed to provide that the optionee cannot transfer the option except by will or by the laws of descent and distribution, such change is not a modification, provided the option is at the same time changed so that it is not exercisable after the expiration of ten years from the date the option was granted.

(3) An extension of an option refers to the granting by the corporation to the optionee of an additional period of time within which to exercise the option beyond the time originally prescribed. A renewal of an option is the granting by the corporation of the same rights or privileges contained in the original option on the same terms and conditions. The rules of this paragraph apply as well to successive modifications, extensions, and renewals.

(d) *Assumption or substitution of restricted stock options in connection with certain corporate transactions.* (1) Where, by reason of a corporate transaction, as defined in this paragraph, an employer corporation, or its parent or subsidiary corporation, assumes an existing option, or issues a new option in place of the old option, such assumption or issuance is not a modification, if—

(i) The excess of the aggregate fair market value of the stock subject to the option immediately after such assumption or issuance over the aggregate option price is not more than the excess of the aggregate fair market value of the stock subject to the option immediately before such assumption or issuance over the aggregate option price, and

(ii) Such assumption of the old option, or issuance of the new option, does not give the optionee additional benefits under the option.

For the purpose of this paragraph, the term ''corporate transaction'' means a corporate merger, consolidation, purchase or acquisition of property or stock, separation, reorganization, or liquidation. Thus, for this purpose, a ''corporate transaction'' includes a taxable transaction (such as, a purchase of stock or property for cash) and any corporate reorganization (whether or not it comes within the definition of such term in section 368) and any corporate liquidation (whether or not section 332 is applicable).

(2)(i) Section 421(g) provides rules under which a new employer, or parent or subsidiary of a new employer, may by reason of a corporate transaction assume a restricted stock option granted by the former employer or parent or subsidiary thereof, or issue a new restricted stock option in place of the option granted by the former employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. For example, section 421(g) may apply where there is a merger of X Corporation into Y Corporation and Y Corporation wishes to employ the employees of X Corporation and to assume restricted stock options which had been granted to them by their former employer, X Corporation. Another example is where X Corporation forms a new subsidiary, Y Corporation, and transfers to it certain assets and employees, and where Y Corporation wishes to grant to such employees a restricted stock option to purchase its stock in place of the restricted stock option which they had to purchase stock of X Corporation.

(ii) Section 421(g) also provides rules under which a new parent or subsidiary corporation of the employer corporation may by reason of a corporate transaction assume a restricted stock option granted by the employer or parent or subsidiary thereof, or issue a new restricted stock option in place of the option granted by the employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. Section 421(g) may apply, for example, where X Corporation acquires a new subsidiary, Y Corporation, by purchase of stock and desires to grant to the employees of Y Corporation a restricted stock option to buy stock of X Corporation in place of the restricted stock option which they have to purchase the stock of Y Corporation.

(iii) Section 421(g) applies only when the assumption or substitution occurs by reason of a corporate -transaction as defined in this paragraph. Thus, section 421(g) may apply where as a result of a corporate transaction a restricted stock option can no longer be exercised, or if exercised, section 421 would not apply (see the first example in subdivision (i) of this subparagraph). Moreover, section 421(g) may apply in any case where the reason for the assumption or substitution grows out of a corporate transaction even though there could have been a valid exercise under section 421 of the original option (see the second example in subdivision (i) of this subparagraph and the example in subdivision (ii) of this subparagraph). However, a corporation which has issued an option may not substitute a new option for such option under section 421(g).

(3) For section 421(g) to apply, it is not necessary to show that the corporation assuming or substituting the option is under any obligation to do so. In fact, section 421(g) may apply where the option which is being assumed or replaced expressly provides that it will terminate upon the occurrence of certain corporate transactions. However, section 421(g) cannot be applied to revive a restricted stock option which, for reasons not related to the corporate

transaction, expires before it can properly be assumed or replaced under section 421(g). For section 421(g) to apply, the assumed or substituted option must qualify as a restricted stock option.

(4) Section 421(g) does not apply if the terms of the assumed or substituted option confer on the employee more favorable benefits than he had under the old option. Thus, section 421(g) would not apply if the old option had just two years to run but the new option has more than two years to run.

(5) For the purpose of applying section 421(g), the assumption or substitution shall be considered to occur at the time that the optionee would, except for section 421(g), be considered to have been granted the option which the employer corporation, or parent or subsidiary thereof, is issuing or assuming. An assumption or substitution which occurs by reason of a corporate transaction may occur before or after the corporate transaction.

(6) In order to have a substitution of an option under section 421(g) the optionee must, in connection with the corporate transaction, lose his rights under the old option. There cannot be a substitution of a new option for an old option within the meaning of section 421(g) if it is contemplated that the optionee may exercise both the old option and the new option. It is not necessary, however, to have a complete substitution of a new option for the old option. For example, assume that X Corporation forms a new corporation, Y Corporation, by a transfer of certain assets and distributes the stock of Y Corporation to the shareholders of X Corporation. Assume further that E, an employee of X Corporation, is thereafter an employee of both X Corporation and Y Corporation. Y Corporation wishes to substitute an option to purchase some of its stock for the restricted stock option which employee E has entitling him to purchase 100 shares of the stock of X Corporation. The option to purchase the stock of X Corporation, at $42.50 a share, was granted when the stock had a fair market value of $50 a share, and the stock was worth $100 a share just before the distribution of the new corporation's stock to the shareholders of X Corporation. The stock of X Corporation and of Y Corporation is worth $50 a share just after such distribution, which also is the time of the substitution. On these facts an option to purchase 200 shares of stock of Y Corporation at $21.25 a share could be given to the employee in complete substitution for the old option. It would also be permissible to give the employee an option to purchase 100 shares of stock of Y Corporation at $21.25 a share in substitution for his right to purchase 50 of the shares covered by the old option.

(7) Any reasonable methods may be used to determine the fair market value of the stock subject to the option immediately before the assumption or substitution and the fair market value of the stock subject to the option immediately after the assumption or substitution. Such methods include the valuation methods described in § 20.2031–2 of this chapter (the Estate Tax Regulations). In the case of stock listed on a stock exchange, the fair market value may be based on the last sale before and the first sale after the assumption or substitution if such sales clearly reflect the fair market value of the stock, or may be based upon an average selling price during a longer period, such as the day or week before, and the day or week after, the assumption or substitution. If the stocks are not listed, or if they are newly issued, it will be reasonable to base the determination on experience over even longer periods. In the case of a merger, consolidation, or other reorganization which is arrived at by arm's length negotiations, the fair market value of the stocks subject to the option before and after the assumption or substitution may be based upon the values assigned to the stock for purposes of the reorganization. For example, if in the case of a merger the parties treat each share of the merged company as being equal in value to a share of the surviving company, it will be reasonable to assume that the stocks are of equal value so that the substituted option may permit the employee to purchase at the same price one share of the surviving company for each share he could have purchased of the merged company.

(8) For the purpose of applying section 421(g), the determination of whether the parent-subsidiary relationship exists shall be based upon circumstances existing immediately after the corporate transaction.

(e) *Effect on qualification.* A restricted stock option may, as a result of a modification, extension, or renewal, thereafter cease to be a restricted stock option, or any option may, by modification, extension, or renewal, thereafter become a restricted stock option.

(f) *Examples.* The rule stated in section 421(e) may be illustrated by the following examples:

Example (1). On June 1, 1954, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at $90 per share, such option to be exercised on or before June 1, 1956. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1955, before the employee exercises the option, X Corporation modifies the option to provide that the price at which the employee may purchase the stock shall be $80 per share. On February 1, 1955, the fair market value of the X Corporation stock is $90 per share. Under section 421(e), the X Corporation is deemed to have granted an option to the employee on February 1, 1955. Unless the value of the stock has substantially declined making paragraph (b)(3) of this section applicable, such option shall be treated as an option to purchase at $80 per share 100 shares of stock having a fair market value of $100 per share, that is, the higher of the fair market value of the stock on June 1, 1954, and on February 1, 1955. The exercise of such option by the employee after February 1, 1955, is not the exercise of a restricted stock option.

Example (2). On June 1, 1954, the X Corporation grants to an employee a restricted stock option to purchase 100 shares of X Corporation stock at $90 per share, exercisable after December 31, 1955, and on or before June 1, 1956. On June 1, 1954, the fair market value of X Corporation's stock is $100 per share. On February 1, 1955, X Corporation modifies the option to provide that the option shall be exercisable on or after February 1, 1955, and on or before June 1, 1956. On February 1, 1955, the fair market value of X Corporation stock is $110 per share. Under section 421(e), X Corporation is deemed to have granted an option to the employee on February 1, 1955, to purchase at $90 per share 100 shares of stock having a fair market value of $110 per share, that is, the higher of the fair market value of the stock on June 1, 1954, and on February 1, 1955. The exercise of such option by the employee is not the exercise of a restricted stock option.

Example (3). The facts are the same as in example (1), except that the employee exercised the option to the extent of 50 shares on January 15, 1955, before the date of the modification of the option. Any exercise of the option after February 1, 1955, the date of the modification, is not the exercise of a restricted stock option. See example (1) in this paragraph. The exercise of the option on January 15, 1955, pursuant to which 50 shares were acquired, is the exercise of a restricted stock option.

Example (4). On June 1, 1954, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at $80 per share, such option to be exercised on or before June 1, 1956. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1955, before the employee exercises the option, the X Corporation modifies the option to provide that the number of shares of stock which the employee may purchase at $80 per share will be 250. On February 1, 1955, the fair market value of the X Corporation stock is $90 per share. Under these facts, the X Corporation has granted two options, one option (not a restricted stock option) with respect to 100 shares having been granted on June 1, 1954, and the other option (a restricted stock option) with respect to the additional 150 shares having been granted on February 1, 1955. In the absence of facts identifying which option is exercised first, the employee will be deemed to have exercised the options in the order in which they were granted.

[T.D. 6500, 25 FR 11694, Nov. 26, 1960]

§1.421–5 Operation of section 421.

(a) *Rules applicable to all restricted stock options*—(1) *In general.* If a share of stock is transferred to an individual pursuant to his timely exercise of a restricted stock option and is not disposed of by him within two years from the date of the granting of the option nor within 1 year (6 months for taxable years before 1977; 9 months for taxable years beginning in 1977) after the transfer of such share to him, then, under section 421(a)—

(i) No income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(ii) No deduction under section 162 shall be allowable at any time to the employer corporation of such individual or its parent or subsidiary corporation, or to a corporation which assumed or issued the option under section 421(g), with respect to the share so transferred; and

(iii) No amount other than the option price shall be considered as received by any of such corporations for the share so transferred.

For the purpose of subdivisions (i), (ii), and (iii) of this subparagraph, each share of stock transferred pursuant to a restricted stock option is treated separately. For example, if an individual, while employed by a corporation granting him a restricted stock option, exercises the option with respect to part of the stock covered by the option, and if such individual exercises the balance of the option more than three months after leaving such employment, the application of section 421 to the stock obtained upon the earlier exercise of the option is not affected by the fact that the income taxes of the employer and the individual with respect to the stock obtained upon the later exercise of the option are not determined under section 421.

(2) *Holding period.* The special rules provided in section 421(a) are not applicable if the individual disposes of the share of stock within two years from the date the option is granted or within six months after the transfer of such share to him. Section 421 is not made inapplicable by a transfer within the 2-year or 1-year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) period if such transfer is not a disposition of the stock as defined in subparagraph (3) of this paragraph, for example, a transfer from the decedent to his estate or a transfer by bequest or inheritance. Similarly, a disposition by the executor, administrator, heir, or legatee is not a disposition by the decedent. In case a restricted stock option is exercised by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by reason of the death of such individual, see paragraph (d) of this section.

(3) *Disposition of stock.* (i) For the purpose of section 421, the term ‘‘disposition’’ includes a sale, exchange, gift, or any transfer of legal title, but does not include—

(a) A transfer from a decedent to his estate or a transfer by bequest or inheritance; or

(b) An exchange which occurs in a taxable year of the optionee beginning after December 31, 1953, and ending after August 16, 1954, and to which is applicable section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) or a corresponding provision of the Internal Revenue Code of 1939; or

(c) A mere pledge or hypothecation. However, a disposition of the stock pursuant to a pledge or hypothecation is a disposition by the individual, even though the making of the pledge or hypothecation is not such a disposition.

(ii) If an individual exercises a restricted stock option, a share of stock acquired pursuant to such exercise is not considered disposed of by the individual if such share is taken in the name of the individual and another person jointly with right of survivorship, or is subsequently transferred into such joint ownership, or is retransferred from such joint ownership to the sole ownership of the individual. However, any termination of such joint ownership is a disposition of such share, except to the extent that the individual reacquires ownership of the share. For example, if such individual and his joint owner transfer such share to another person, the individual has made a disposition of such share. Likewise, if a share of stock held in the joint names of such individual and another person is transferred to the name of such other person, there is a disposition of such share by the individual. If an individual exercises a restricted stock option and a share of stock is transferred to another or is transferred to such individual in his name as trustee for another, the individual has made a disposition of such share.

(4) *Examples.* The rules of section 421(a) may be illustrated by the following examples:

Example (1). On June 1, 1954, the X Corporation grants to E, an employee, a restricted stock option to purchase 100 shares of X Corporation stock at $95 per share. On that date, the fair market value of X Corporation stock is $100 per share. On June 1, 1955, while employed by X Corporation, E exercises the option in full and pays X Corporation $9,500, and on that day X Corporation transfers to E 100 shares of its stock having a fair market value of $12,000. Before June 1, 1956, E makes no disposition of the 100 shares so purchased. E realizes no income on June 1, 1955, with respect to the transfer to him of the 100 shares of X Corporation stock. X Corporation is not entitled to any deduction at any time with respect to its transfer to E of the stock. E's basis for such 100 shares is $9,500.

Example (2). Assume, in example (1), that on August 1, 1956, two years and two months after the granting of the option and one year and two months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for $13,000, which is the fair market value of the stock on that date. For the taxable year in which the sale occurs, E realizes a gain of $3,500 ($13,000 minus E's basis of $9,500), which is treated as long-term capital gain.

Example (3). Assume, in example (2), that on August 1, 1956, E makes a gift of the 100 shares of X Corporation stock to his son. Such disposition results in no realization of gain to E either for the taxable year in which the option is exercised or the taxable year in which the gift is made. E's basis of $9,500 becomes the donee's basis for determining gain or loss.

Example (4). Assume, in example (1), that on May 1, 1956, one year and 11 months after the granting of the option and 11 months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for $13,000. The special rules of section 421(a) are not applicable to the transfer of the stock by X Corporation to E, because disposition of the stock was made by E within two years from the date the option was granted. See paragraph (e) of this section for the effect of a disqualifying disposition.

Example (5). Assume, in example (1), that E dies on September 1, 1955, owning the 100 shares of X Corporation stock acquired by him pursuant to his exercise on June 1, 1955, of the restricted stock option. On the date of death, the fair market value of the stock is $12,500. No income is realized by E by reason of the transfer of the 100 shares to his estate. If the stock is valued as of the date of E's death for estate tax purposes, the basis of the 100 shares in the hands of the executor is $12,500.

(b) *Additional rules applicable where the option price is between 85 percent and 95 percent of the value of the stock*—(1) *In general.* (i) If all the conditions necessary for the application of section 421(a) exist, section 421(b) provides additional rules which are applicable in cases where, at the time the restricted stock option is granted, the option price per share is less than 95 percent (but not less than 85 percent) of the fair market value of such share. In such case, upon the disposition of such share by the individual after the expiration of the 2-year and 1-year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) periods, or upon his death while owning such share (whether occurring before or after the expiration of such periods), there shall be included in the individual's gross income as compensation (and not as gain upon the sale or exchange of a capital asset) an amount determined in the following manner. If the option qualified under section 421(d)(1)(A)(i) (see paragraph (d)(2)(i)*(a)* of §1.421–1), such amount shall be the amount, if any, by which the option price is exceeded by the lesser of the fair market value of the share at the time the option was granted or the fair market value of the share at the time of such disposition or death. However, if the option qualified under section 421(d)(1)(A)(ii) (see paragraph (d)(2)(i)*(b)* of §1.421–1), such amount shall be whichever of the following amounts is lesser:

(a) The excess of the fair market value of the share at the time of such disposition or death over the price paid under the option, or

(b) The excess of the fair market value of the share at the time the option was granted over the option price, computed as if the option had been exercised at such time.

The amount of such compensation shall be included in the individual's gross income for the taxable year in which the disposition occurs or for the taxable year closing with his death, whichever event results in the application of section 421(b).

(ii) The application of the special rules provided in section 421(b) shall not affect the rules provided in section 421(a) with respect to the individual exercising the option, the employer corporation, or its parent or subsidiary corporation. Thus, notwithstanding the inclusion of an amount as compensation in the gross income of an individual, as provided in section 421(b), no income results to the individual at the time the stock is transferred to him, and no deduction under section 162 is allowable at any time to the employer corporation or its parent or subsidiary with respect to such amount.

(iii) If the individual exercises a restricted stock option during his lifetime and dies before the stock is transferred to him pursuant to his exercise of the option, the transfer of such stock to the individual's executor, administrator, heir, or legatee is deemed, for the purpose of section 421, to be a transfer of the stock to the individual exercising the option and a further transfer by reason of death from such individual to his executor, administrator, heir, or legatee.

(2) *Basis.* If the special rules provided in section 421(b) are applicable to the disposition of a share of stock by an individual, the basis of such share in the individual's hands at the time of such disposition, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 421(b). However, in the case of a share of stock acquired by the exercise of a restricted stock option after the death of the employee to whom the option was granted, the basis of such share shall be determined in accordance with the rules of paragraph (d)(4) of this section. If the special rules provided in section 421(b) are applicable to a share of stock upon the death of an individual, the basis of such share in the hands of the estate or the person receiving the stock by bequest or inheritance shall be determined under section 1014, and shall not be increased by reason of the inclusion upon the decedent's death of any amount in his gross income under section 421(b). See example (9) of this paragraph with respect to the determination of basis of the share in the hands of a surviving joint owner.

(3) *Examples.* The operation of section 421(b) may be illustrated by the following examples:

Example (1). On June 1, 1954, the X Corporation grants to E, an employee, a restricted stock option to purchase a share of X Corporation's stock for $85. The fair market value of the X Corporation stock on such date is $100 per share. On June 1, 1955, E exercises the restricted stock option and on that date the X Corporation transfers the share of stock to E. On January 1, 1957, E sells the share for $150, its fair market value on that date. E makes his income tax return on the basis of the calendar year. The income tax consequences to E and X Corporation are as follows: (i) Compensation in the amount of $15 is includible in E's gross income for 1957, the year of the disposition of the share. The $15 represents the difference between the option price ($85) and the fair market value of the share on the date the option was granted ($100), since such value is less than the fair market value of the share on the date of disposition ($150). For the purpose of computing E's gain or loss on the sale of the share, E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100. Since the share was sold for $150, E realizes a gain of $50, which is treated as long-term capital gain; (ii) The X Corporation is entitled to no deduction under section 162 at any time with respect to the share transferred to E.

Example (2). Assume, in example (1), that E sells the share of X Corporation stock on January 1, 1958, for $75, its fair market value on that date. Since $75 is less than the option price ($85), no amount in respect of the sale is includible as compensation in E's gross income for 1958. E's basis for determining gain or loss on the sale is $85. Since E sold the share for $75, E realized a loss of $10 on the sale, which loss is treated as a long-term capital loss.

Example (3). Assume, in example (1), that the option provides that the option price shall be 90 percent of the fair market value of a share of the stock on the day the option is exercised. On June 1, 1955, when the option is exercised, the fair market value of the stock is $120 per share so that E pays $108 for the share of stock. Compensation in the amount of $10 is includible in E's gross income for 1957, the year of the disposition of the share. This is determined in the following manner. The excess of the fair market value of the stock at the time of the disposition ($150) over the price paid for the share ($108) is $42; and the excess of the fair market value of the stock at the time the option was granted ($100) over the option price, computed as if the option had been exercised at such time ($90), is $10. Accordingly, $10 the lesser, is includible in gross income. In this situation, E's cost basis of $108 is increased by $10, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $118. Since the share was sold for $150, E realizes a gain of $32, which is treated as long-term capital gain.

Example (4). Assume, in example (1), that instead of selling the share on January 1, 1957, E makes a gift of the share on that day. In such case, $15 is includible as compensation in E's gross income for 1957. E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100, which becomes the donee's basis, as of the time of the gift, for determining gain or loss.

Example (5). Assume, in example (2), that instead of selling the share on January 1, 1958, E makes a gift of the share on that date. Since the fair market value of the share on that day ($75) is less than the option price ($85), no amount in respect of the disposition by way of gift is includible as compensation in E's gross income for 1958. E's basis for the share is $85, which becomes the donee's basis, as of the time of the gift, for the purpose of determining gain. The donee's basis for the purpose of determining loss, determined under section 1015(a), is $75 (fair market value of the share at the date of gift).

Example (6). Assume, in example (1), that after acquiring the share of stock on June 1, 1955, E dies on August 1, 1956, at which time the share has a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death, such $15 being the difference between the option price ($85) and the fair market value of the share when the option was granted ($100), since such value is less than the fair market value at date of death ($150). The basis of the share in the hands of E's estate is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example (7). Assume, in example (6), that E dies on August 1, 1955, at which time the share has a fair market value of $150. Although E's death occurred within two years from the date of the granting of the option and within six months after the transfer of the share to him, the income tax consequences are the same as in example (6).

Example (8). Assume the same facts as in example (1), except that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and except that E and his wife sold the share on June 15, 1956, for $150, its fair market value on that date. Compensation in the amount of $15 is includible in E's gross income for 1956, the year of the disposition of the share. The basis of the share in the hands of E and his wife for the purpose of determining gain or loss on the sale is $100, that is, the cost of $85 increased by the amount of $15 includible as compensation in E's gross income. The gain of $50 on the sale is treated as long-term capital gain, and is divided equally between E and his wife.

Example (9). Assume the same facts as in example (1), except that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and except that E predeceased his wife on August 1, 1956, at which time the share had a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death. See example (6). The basis of the share in the hands of E's wife as survivor is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example (10). Assume, in example (9), that E's wife predeceased him on July 1, 1956. Section 421(b) does not apply in respect of her death. Upon the subsequent death of E on August 1, 1956, the income tax consequences in respect of E's taxable year closing with the date of his death, and in respect of the basis of the share in the hands of his estate, are the same as in example (6). If E had sold the share on July 15, 1956 (after the death of his wife), for $150, its fair market value at that time, the income tax consequences would be the same as in example (1).

(c) *Acquisition of other stock.* (1) Section 421(c) provides that the special rules stated in section 421 (a) and (b), if applicable with respect to stock transferred to an individual upon his exercise of an option, shall likewise be applicable with respect to stock acquired by a distribution or an exchange to which is applicable section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) or a corresponding provision of the Internal Revenue Code of 1939. Stock so acquired shall, for the purpose of section 421, be considered as having been transferred to the individual upon his exercise of the option. A similar rule shall be applied in the case of a series of such acquisitions. With respect to such acquisitions, section 421(c) does not make inapplicable any of the provisions of section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036). Section 421(c) is applicable only with respect to such acquisitions which occur in any taxable year of the shareholder which begins after December 31, 1953, and ends after August 16, 1954. As to acquisitions occurring in earlier taxable years, see section 130A(c) of the Internal Revenue Code of 1939.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. If, with respect to stock transferred pursuant to the timely exercise of a restricted stock option, there is a distribution of new stock to which section 305(a) is applicable, and if there is a disposition of such new stock within two years after the option was granted, such disposition makes section 421 inapplicable to the transfer of the original stock pursuant to the exercise of the option to the extent that the disposition effects a reduction of the individual's total interest in the old and new stock. However, if the new stock, as well as the old stock, is not disposed of within two years after the option was granted, nor within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of the old stock pursuant to the exercise of the option, section 421 is applicable.

(d) *Exercise after death.* (1) If a restricted stock option is exercised by the estate of the individual to whom the option was granted, or by any person who acquired such option by bequest or inheritance or by reason of the death of such individual, and if such exercise occurs in a taxable year of the estate or of such person beginning after December 31, 1953, and ending after August 16, 1954, section 421 applies to such exercise in the same manner as if such option had been exercised by such deceased individual. Consequently, neither the estate nor such person is required to include any amount in gross income as a result of a transfer of stock pursuant to such exercise of the option. Nor does section 421 become inapplicable if such executor, administrator, or person disposes of the stock so acquired within two years after the granting of such option or within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of the stock pursuant to the exercise of such option. This exception as to the applicability of section 421 does not affect the applicability of section 1222, relating to what constitutes a short-term and long-term capital gain or loss. The executor, administrator, or such person need not exercise the option within three months after the death of the individual to whom the option was granted for section 421 to be applicable. However, the exercise of the option must be pursuant to the terms of the option, and any change in the terms of the option is subject to the rules of § 1.421–4, relating to the modification, extension, or renewal of the option. Section 421 is applicable even though such executor, administrator, or person is not employed by the corporation granting the option, or a parent or subsidiary thereof, either when the option is exercised or at any time. However, section 421 is not applicable to an exercise of the option by the estate or by such person, unless the individual to whom the option was granted met the requirements of paragraph (b) of § 1.421–3, relating to the employment of such individual, either at the time of his death or within three months before such time. If the option is exercised by a person other than the executor or administrator, or other than a person who acquired the option by bequest or inheritance or by reason of the death of such deceased individual, section 421 is not applicable to the exercise. For example, if the option is sold by the estate, section 421 does not apply to an exercise of the option by such buyer; but if the option is distributed by the administrator to an heir as part of the estate, section 421 is applicable to an exercise of the option by such heir.

(2) Any transfer by the estate, whether a sale, a distribution of assets, or otherwise, of the stock acquired by its exercise of the option under this paragraph is a disposition of the stock. Therefore, if section 421(b) is applicable, the estate must include an amount as compensation in its gross income. Similarly, if section 421(b) is applicable in case of an exercise of the option under this paragraph by a person who acquired the option by bequest or inheritance or by reason of the death of the individual to whom the option was granted, there must be included in the gross income of such person an amount as compensation, either when such person disposes of the stock, or when he dies owning the stock.

(3)(i) If under section 421(b) an amount is required to be included in the gross income of the estate or of such person, the estate or such person shall be allowed a deduction as a result of the inclusion of the value of the restricted stock option in the estate of the individual to whom the option was granted. Such deduction shall be computed under section 691(c) by treating the restricted stock option as an item of gross income in respect of a decedent under section 691 and by treating the amount required to be included in gross income under section 421(b) as an amount included in gross income under section 691 in respect of such item of gross income. No such deduction shall be allowable with respect to any amount other than an amount includible under section 421(b). For the rules relating to the computation of a deduction under section 691(c), see §1.691(c)–1.

(ii) The application of subdivision (i) may be illustrated by the following example:

Example. On June 1, 1953, E was granted a restricted stock option to purchase for $85 one share of the stock of his employer. On such day, the fair market value of such stock was $100 a share. E died on February 1, 1954, without having exercised such option. The option was, however, exercisable by his estate, and for purposes of the estate tax was valued at $30. On March 1, 1955, the estate exercised the option, and on March 15, 1955, sold for $150 the share of stock so acquired. For its taxable year including March 15, 1955, the estate is required by section 421(b) to include in its gross income as compensation the amount of $15. During such taxable year, no amounts of income were properly paid, credited, or distributable to the beneficiaries of the estate. However, under section 421(d)(6)(B), the estate is entitled to a deduction determined in the following manner. E's estate includes no other items of income in respect of a decedent referred to in section 691(a), and no deductions referred to in section 691(b), so that the value for estate tax purposes of the restricted stock option, $30, is also the net value of all items of income in respect of the decedent. The estate tax attributable to the inclusion of the restricted stock option in the estate of E is $10. Since $15, the amount includible in gross income by reason of section 421(b), is less than the value for estate tax purposes of the option, only 15⁄30 of the estate tax attributable to the inclusion of the option in the estate is deductible; that is, 15⁄30 of $10, or $5. No deduction under section 421(d)(6)(B) is allowable with respect to any capital gain.

(4)(i) In the case of an employee dying before January 1, 1957, the basis of any share of stock acquired by the exercise of the option under this paragraph, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 421(b). The basis of the share shall not be increased by reason of the inclusion of the value of the restricted stock option in the estate for estate tax purposes.

(ii)*(A)* In the case of an employee dying after December 31, 1956, the basis of any share of stock acquired by the exercise of the option under this paragraph, determined under section 1011, shall be increased by an amount equal to the portion of the basis of the option attributable to such share. For example, if a restricted stock option to acquire 10 shares of stock has a basis of $100, the basis of one share acquired by a partial exercise of the option, determined under section 1011, would be increased by 1⁄10 of $100, or $10. The option acquires a basis, determined under section 1014(a), only if it is exercised in accordance with section 421. Therefore, to the extent the option is so exercised, in whole or in part, it will acquire a basis equal to its fair market value at the date of the employee's death or, if an election is made under section 2032, its value at its applicable valuation date. In certain cases, the basis of the share is subject to the adjustments provided by *(B)* and *(C)* of this subdivision, but such adjustments are only applicable in the case of an option which is subject to section 421(b).

(B) If the amount which would have been includible in gross income under section 421(b) had the employee exercised the option and held the share at the time of his death exceeds the amount which is includible in gross income under section 421(b), the basis of the share, determined under *(A)* of this subdivision, shall be reduced by such excess. For example, if $15 would have been includible in the gross income of the employee had he exercised the option and held such share at the time of his death, and only $10 is includible under section 421(b), the basis of the share, determined under *(A)* of this subdivision, would be reduced by $5. For purposes of determining the amount which would have been includible in gross income under section 421(b) if the employee had exercised the option and held such share at the time of his death, the amount which would have been paid for the share shall be computed as if the option had been exercised on the date the employee died.

(C) If the amount includible in gross income under section 421(b) exceeds the portion of the basis of the option attributable to the share, the basis of the

share, determined under *(A)* of this subdivision, shall be increased by such excess. Thus, if $15 is includible in gross income under section 421(b), and the basis of the option with respect to the share is $10, the basis of the share, determined under *(A)* of this subdivision, will be increased by $5.

(iii) If a restricted stock option is not exercised by the estate of the individual to whom the option was granted, or by the person who acquired such option by bequest or inheritance or by reason of the death of such individual, the option shall be considered to be property which constitutes a right to receive an item of income in respect of a decedent to which the rules of sections 691 and 1014(c) apply.

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

Example (1). On June 1, 1954, the X Corporation granted to E, an employee, a restricted stock option to purchase a share of X Corporation's stock for $85. The fair market value of the X Corporation stock on such date was $100 per share. On June 1, 1955, E died. The fair market value of X Corporation stock on such date exceeded $100 per share and the fair market value of the option on the applicable valuation date was $35. On August 1, 1956, the estate of E exercised the option and sold the share of X Corporation stock at a time when the fair market value of the share was $90. The estate is required by section 421(b) to include $5 in its gross income as compensation. Since E died before January 1, 1957, the basis of the share is $90 (the $85 paid for the stock plus the $5 includible in gross income as compensation), and the basis of the share is not increased by reason of the inclusion of the value of the option in the estate of E (see section 1014(d)). Thus, no gain or loss is realized on the disposition of the share since the basis of the share is equal to the sale price.

Example (2). On June 1, 1956, the X Corporation granted to E, an employee, a restricted stock option to purchase a share of X Corporation stock for $85. The fair market value of X Corporation stock on such date was $100 per share. On June 1, 1957, E died. The fair market value of X Corporation stock on such date exceeded $100 per share and the fair market value of the option on the applicable valuation date was $35. On August 1, 1958, the estate of E exercised the option and sold the share of X Corporation stock at a time when the fair market value of the share was $120. The basis of the share is $120 (the $85 paid for the stock plus the $35 basis of the option). When the share is sold for $120, the estate is required to include $15 in its gross income as compensation. Since $15 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, subdivision (ii)*(B)* of this subparagraph does not apply. Moreover, since the $15 includible in the gross income of the estate does not exceed the basis of the option ($35), subdivision (ii)*(C)* of this subparagraph does not apply. Since the basis of the stock and the sale price are the same, no gain or loss is realized by the estate on the disposition of the share.

Example (3). Assume the same facts as in example (2), except that the fair market value of the share of stock at the time if its sale was $90. The basis of the share, determined under subdivision (ii)*(A)* of this subparagraph, is $120 (the $85 paid for the stock plus the $35 basis of the option). When the share is sold for $90, the estate is required to include $5 in its gross income as compensation. If the employee had exercised the option and held the share at the time of this death, $15 would have been includible in gross income as compensation for the taxable year ending with his death. Since such amount exceeds by $10 the amount which the estate is required to include in its gross income, subdivision (ii)*(B)* of this subparagraph applies, and the basis of the share ($120), determined under subdivision (ii)*(A)* of this subparagraph is reduced by $10. Accordingly, the basis is $110, and a capital loss of $20 is realized on the disposition of the share.

Example (4). Assume the same facts as in example (2), except that the fair market value of the option on the applicable valuation date was $5, and that the fair market value of X Corporation stock on the date the employee died did not exceed $100. The basis of the share, determined under subdivision (ii)*(A)* of this subparagraph, is $90 (the $85 paid for the stock plus the $5 basis of the option). When the share is sold for $120, the estate is required to include $15 in its gross income as compensation. Since such amount exceeds by $10 the basis of the option, subdivision (ii)*(C)* of this subparagraph applies, and the basis of the share ($90), determined under subdivision (ii)*(A)* of this subparagraph, is increased by $10. Accordingly, the basis is $100 and a capital gain of $20 is realized on the disposition of the share.

Example (5). Assume the same facts as in example (2), except that on June 1, 1957, the date the employee died, the fair market value of X Corporation stock was $98, and that on June 1, 1958, the alternate valuation date, the fair market value of the stock had declined substantially, and the fair market value of the option was $5. On August 1, 1958, the estate of E exercised the option and sold the share when its fair market value was $92. The basis of the share, determined under subdivision (ii)*(A)* of this subparagraph, is $90 (the $85) paid for the stock plus the $5 basis of the option). When the share is sold for $92, the estate is required to include $7 in its gross income as compensation. Since $13 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, subdivision (ii)*(B)* of this subparagraph applies, and the basis of the share ($90), determined under subdivision (ii)*(A)* of this subparagraph, is reduced by $6 to $84. Furthermore, since the $7 that the estate is required to include in its gross income when the share is sold for $92 exceeds by $2 the basis of the option, subdivision (ii)*(C)* of this subparagraph applies, and the basis of the share ($84), determined under subdivision (ii)*(A)* and (ii)*(B)* of this subparagraph, is increased by $2. Accordingly, the basis is $86 and a capital gain of $6 is realized on the disposition of the share.

(e) *Disqualifying disposition.* The disposition of a share of stock, acquired by the exercise of a restricted stock option, within two years after the granting of the option or within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of the share pursuant to such exercise makes section 421 inapplicable to such transfer of the share. If such disqualifying disposition occurs in a taxable year of the individual which begins after December 31, 1953, and ends after August 16, 1954, the income attributable to such transfer shall be treated by the individual as income received in the taxable year in which such disposition occurs. Similarly, if such disposition occurs in a taxable year of the employer which begins after December 31, 1953, and ends after August 16, 1954, the deduction attributable to the transfer of the share of stock pursuant to the exercise of the option shall be allowable for the taxable year in which such disposition occurs. In such cases, no amount shall be treated as income, and no amount shall be allowed as a deduction, for any taxable year other than the taxable year in which occurs the disposition. However, if the stock was transferred pursuant to the exercise of the option in a taxable year other than the taxable year of the disposition, the amount of the deduction shall be determinded as if the employee had been paid compensation at the time provided in paragraph (d) of §1.421–6.

[T.D. 6500, 25 FR 11696, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 411, Jan. 19, 1961; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§1.421–6 Options to which section 421 does not apply.

(a) *Scope of section.* (1) If an employer or other person grants to an employee or other person for any reason connected with the employment of such employee an option to purchase stock of the employer or other property, and if section 421 is not applicable, then this section shall apply. This section will apply, for example, when an option is not a qualified or restricted stock option at the time it is granted or an option granted under an employee stock purchase plan, or when an option is modified so that it no longer qualifies as such an option, or when there is a disqualifying disposition of stock acquired by the exercise of such an option so that section 421 does not apply. When an option is granted for any reason connected with the employment of an employee, this section applies, if section 421 does not apply, irrespective of whether the option is granted by the employer, by a parent or subsidiary of the employer, by a stockholder of any of such corporations, or by any other person, and irrespective of whether the option is granted to the employee, to a member of his family, or to any other person, and irrespective of whether the option is to purchase the stock of the employer, the stock of the parent or subsidiary of the employer, the stock of any other corporation, or to purchase any other property. In addition, §1.61–15 makes the rules of this section applicable in determining the time when certain other options result in the realization of income and the amount of such income.

(2) This section is applicable to options granted on or after February 26, 1945, and before July 1, 1969 (and thereafter, to the extent that §1.83–8(b) applies). For rules relating to options granted after June 30, 1969, see §1.83–7. This section, however, is not applicable to—

(i) Property transferred pursuant to an option exercised before September 25, 1959, if the property is transferred subject to a restriction which has a significant effect on its value, or

(ii) Property transferred pursuant to an option granted before September 25, 1959, and exercised on or after such date, if, under the terms of the contract granting such option, the property to be transferred upon the exercise of the option is to be subject to a restriction which has a significant effect on its value and if such property is actually transferred subject to such restriction. However, if an option granted before September 25, 1959, and on or after February 26, 1945, is sold or otherwise disposed of before exercise, the provisions of this section shall be fully applicable to such disposition.

(3) If an option to which this section applies has a readily ascertainable fair market value when granted, no amount is includible in gross income under this section as compensation by reason of the transfer or exercise of such option, irrespective of whether such value was included in income for the taxable year in which the option was granted, and any deduction which is allowable as a result of the granting of such option is allowable only for the taxable year in which the option is granted. Thus, if an option having a readily ascertainable fair market value to which this section applies was granted in a taxable year for which an assessment of deficiency was barred at the time of the adoption of paragraph (c) of this section as a Treasury decision, no amount is includible in gross income under this section as compensation by reason of the transfer or exercise of such option. However, if there is a determination to which the rules of sections 1311–1314 apply, there may be an adjustment for the taxable year in which the option was granted.

(b) *Meaning and use of certain terms.* (1) For the purpose of this section, the term ''option'' includes the right or privilege of a person to purchase property from any person by virtue of an offer continuing for a stated period of time, whether or not irrevocable, to sell such property at a stated price, such person being under no obligation to purchase.

(2) As used in this section, the terms ''employee'', ''employment'', and ''employer'' have reference to the legal and bona fide relationship of employer and employee. For rules applicable to the determination whether the employer employee relationship exists, see section 3401(c) and the regulations thereunder.

(3) For purposes of applying the rules of this section to the options which are made subject to such rules by §1.61–15—

(i) The term ''employee'' includes the person who provided the consideration resulting in the grant of the option, the term ''employer'' includes the person to whom, or for whom, such consideration was provided, and the term ''employment'' includes the providing of such consideration;

(ii) Where a stock option is granted to an underwriter prior to a public offering and such grant is expressly or impliedly conditional upon the successful completion of the underwriting, the date on which the option shall be considered ''granted'' shall be the date of the successful completion of the underwriting.

(c) *Options with a readily ascertainable fair market value.* (1) If there is granted an option to which this section applies and which has a readily ascertainable fair market value (determined in accordance with subparagraphs (2) and (3) of this paragraph) at the time the option is granted, the employee in connection with whose employment such option is granted realizes compensation at such time in an amount equal to the excess, if any, of such fair market value over any amount paid for the option. If an option to which this section applies does not have a readily ascertainable fair market value at the time the option is granted, the time when the compensation is realized and the amount of such compensation shall be determined under paragraph (d) of this section.

(2) Although options may have a value at the time they are granted, that value is ordinarily not readily ascertainable unless the option is actively traded on an established market. If an option is actively traded on an established market, the fair market value of such option is readily ascertainable for purposes of this section by applying the rules of valuation set forth in §20.2031–2 of this chapter (the Estate Tax Regulations).

(3)(i) When an option is not actively traded on an established market, the fair market value of the option is not readily ascertainable unless the fair market value of the option can be measured with reasonable accuracy. For purposes of this section, if an option is not actively traded on an established market, the option does not have a readily ascertainable fair market value when granted unless the taxpayer can show that all of the following conditions exist:

(a) The option is freely transferable by the optionee;

(b) The option is exercisable immediately in full by the optionee;

(c) The option or the property subject to the option is not subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) which has a significant effect upon the fair market value of the option or such property; and

(d) The fair market value of the option privilege is readily ascertainable in accordance with subdivision (ii) of this subparagraph.

(ii) The option privilege in the case of an option to buy is the opportunity to benefit during the option's exercise period from any increase in the value of property subject to the option during such period, without risking any capital. Similarly, the option privilege in the case of an option to sell is the opportunity to benefit during the exercise period from a decrease in the value of the property subject to the option, for example, if at some time during the exercise period of an option to buy, the fair market value of the property subject to the option is greater than the option's exercise price, a profit may be realized by exercising the option and immediately selling the property so acquired for its higher fair market value. Irrespective of whether any such gain may be realized immediately at the time an option is granted, the fair market value of an option includes the value of the right to benefit from any future increase in the value of the property subject to the option (relative to the option exercise period), without risking any capital. Therefore, the fair market value of an option is not merely the difference that may exist at a particular time between the option's exercise price and the value of the property subject to the option, but also includes the value of the option privilege for the remainder of the exercise period. Accordingly, for purposes of this section, in determining whether the fair market value of an option is readily ascertainable, it is necessary to consider whether the value of the entire option privilege can be measured with reasonable accuracy. In determining whether the value of the option privilege is readily ascertainable, and in determining the amount of such value when such value is readily ascertainable, it is necessary to consider—

(*a*) Whether the value of the property subject to the option can be ascertained; and

(*b*) The probability of any ascertainable value of such property increasing or decreasing; and (*c*) The length of the period during which the option can be exercised.

(d) *Options without a readily ascertainable fair market value.* If there is granted an option to which this section applies, and if the option does not have a readily ascertainable fair market value at the time it is granted, the employee in connection with whose employment the option is granted is considered to realize compensation includible in gross income under section 61 at the time and in the amount determined in accordance with the following rules of this paragraph:

(1) Except as provided in subparagraph (2) of this paragraph, if the option is exercised by the person to whom it was granted, the employee realizes compensation at the time an unconditional right to receive the property subject to the option is acquired by such person, and the amount of such compensation is the difference between the amount payable for the property and the fair market value of the property at the time an unconditional right to receive the property is acquired. An individual has an unconditional right to receive the property subject to the option when his right to receive such property is not subject to any conditions, other than conditions that may be performed by him at any time. Thus, if an individual who has exercised an option has a right to make payment for the property at any time and to receive the property immediately after making such payment, such individual realizes compensation

at the time he exercises the option. However, if an individual who has exercised an opinion is prevented by the terms of the option contract from making payment immediately of from receiving an immediate transfer of the property after making payment, such individual does not realize compensation at the time he exercises the option. Such individual will not realize compensation until he does acquire the right to make payment immediately and to receive an immediate transfer of the property. For purposes of this paragraph, an unconditional right to receive the property subject to the option shall not be considered to have been acquired before the date on which the option is exercised.

(2)(i) If the option is exercised by the person to whom it was granted but, at the time an unconditional right to receive the property subject to the option is acquired by such person, such property is subject to a restriction which has a significant effect on its value, the employee realizes compensation at the time such restriction lapses or at the time the property is sold or exchanged, in an arm's length transaction, whichever occurs earlier, and the amount of such compensation is the lesser of—

(a) The difference between the amount paid for the property and the fair market value of the property (determined without regard to the restriction) at the time of its acquisition, or

(b) The difference between the amount paid for the property and either its fair market value at the time the restriction lapses or the consideration received upon the sale or exchange, whichever is applicable.

If the property is sold or exchanged in a transaction which is not at arm's length before the time the employee realizes compensation in accordance with this subdivision, any amount of gain which the employee realizes as a result of such sale or exchange is includible in gross income at the time of such sale or exchange, but the amount includible in gross income under this subdivision at the time of the expiration of the restriction or the sale or exchange at arm's length shall be reduced by the amount of gain includible in gross income as a result of the sale or exchange not at arm's length.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). On November 1, 1959, X Corporation grants to E, an employee, an option to purchase 100 shares of X Corporation stock at $10 per share. Under the terms of the option, E will be subject to a binding commitment to resell the stock to X Corporation at the price he paid for it in the event that his employment terminates within 2 years after he acquires the stock, for any reason except his death. Evidence of this commitment will be stamped on the face of E's stock certificate. E exercises the option and acquires the stock at a time when the stock, determined without regard to the restriction, has a fair market value of $18 per share. Two years after he acquires the stock, at which time the stock has a fair market value of $30 per share, E is still employed by X Corporation. E realizes compensation upon the expiration of the 2-year restriction and the amount of the compensation is $800. The $800 represents the difference between the amount paid for the stock ($1,000) and the fair market value of the stock (determined without regard to the restriction) at the time of its acquisition ($1,800), since such value is less than the fair market value of the stock at the time the restriction lapsed ($3,000).

Example (2). Assume, in example (1), that E dies one year after he acquires the stock, at which time the stock has a fair market value of $25 per share. Since the restriction lapses upon E's death, he realizes compensation of $800 ($1,800 less $1,000) and this amount is includible in E's gross income for the taxable year closing with his death.

Example (3). Assume that, pursuant to the exercise of an option not having a readily ascertainable fair market value to which this section applies, an employee acquires stock subject to the sole condition that, if he desires to dispose of such stock during the period of his employment, he is obligated to offer to sell the stock to his employer at its fair market value at the time of such sale. Since this condition is not a restriction which has a significant effect on value, the employee realizes compensation upon acquisition of the stock.

Example (4). Assume, in example (3), that the employee is obligated to offer to sell the stock to his employer at its book value rather than at its fair market value. Since this condition amounts to a restriction which has a significant effect on value, the employee does not realize compensation upon acquisition of the stock, but he does realize such compensation upon the lapse of the restriction, such as, for example, his death or the termination of his employment.

(3) If the option is not exercised by the person to whom it was granted, but is transferred in an arm's length transaction, the employee realizes compensation in the amount of the gain resulting from such transfer of the option, and such compensation is includible in his gross income in accordance with his method of accounting.

(4) If the option is not exercised by the person to whom it was granted, but is transferred in a transaction which is not at arm's length, the employee realizes compensation in the amount of the gain resulting from such transfer of the option, and such compensation is includible in his gross income in accordance with his method of accounting. Moreover, the employee realizes additional compensation at the time and in the amount determined under subparagraph (1), (2), or (3) of this paragraph, except that the amount of compensation determined under subparagraph (1), (2), or (3) of this paragraph shall be reduced by any amount previously includible in gross income as a result of such transfer of the option. For example, if in 1960 an employee is granted an option not having a readily ascertainable fair market value to buy a share of stock for $50 at a time when the stock has a fair market value of $100, and later in 1960 the employee transfers, in a transaction not at arm's length, the option to his wife for $10, the employee realizes compensation of $10 in 1960. If in 1961 the wife exercises the option at a time when the stock has a fair market value of $120, the employee realizes additional compensation in 1961 in the amount of $60 (the $70 bargain spread less the $10 taxed as compensation in 1960). For the purpose of this subparagraph if a person other than the employee dies holding an unexercised option at a time when the employee is still living, the transfer which results by reason of the death of such person is a transfer in a transaction which is not at arm's length.

(5) If there is granted an option to which this section applies, and the employee dies before realizing the compensation in accordance with the rules of this paragraph, income having the character of compensation is realized at the time and in the amount determined under this paragraph by the person who transfers or exercises the option, or the person who receives the property subject to a restriction which has a significant effect on its value. For example, this subparagraph is applicable:

(i) When an option not having a readily ascertainable fair market value is granted to an employee, and he dies before transferring or exercising the option,

(ii) When an option not having a readily ascertainable fair market value is granted to the employee, and he dies after the transfer of the option in a transaction which is not at arm's length, but before the option is exercised, or

(iii) When an option not having a readily ascertainable fair market value is granted to another person, and the employee dies before realizing all of the compensation which would result from any transfer or exercise of the option. If the option is one which was granted to the employee and he dies before transferring or exercising the option, the option shall be considered a right to receive income in respect of a decedent to which the rules of section 691 apply. In any such case, if the option is transferred, section 691 provides that the amount received for such transfer or the fair market value of the property transferred at the time of transfer, whichever is greater, is income realized at the time of such transfer. Moreover, if a transfer is subject to this rule, it will be treated as a transfer in an arm's length transaction for the purpose of this paragraph.

(6) If an option to which this section applies is exercised in part and transferred in part, the rules of this paragraph shall be applied as if there were two options—one exercised and one transferred.

(7) Notwithstanding the other provisions of this paragraph, if this section is applicable because of a disqualifying disposition of stock acquired by the exercise of a qualified or restricted stock option, or acquired by the exercise of an option granted under an employee stock purchase plan, the taxable year of the employee for which he is required to include in his gross income the compensation resulting from such option is determined under section

421(b) and paragraph (b) of § 1.421–8 (or, in the case of taxable years ending before January 1, 1964, under section 421(f) and paragraph (e) of § 1.421–5) and, in the case of a disqualifying disposition of a share of stock acquired by the exercise of a qualified stock option, the amount of such compensation shall be subject to the limitation provided by section 422(c)(4) and paragraph (b) of § 1.422–1.

(e) *Basis.* (1) If an option to which this section applies is exercised by the person to whom it was granted, such person's basis for the property so acquired shall be increased by any amount that is includible in the gross income of the employee under paragraph (d) of this section. If such person transfers such property to a person whose basis is the same as the transferor's basis, such transferee's basis shall also reflect the adjustment made by this paragraph. However, if such property is transferred by either of such persons at death so that its basis is determined under section 1014, the basis so determined shall not be increased by reason of this paragraph.

(2) If an option to which this section applies is transferred in a transaction which is not at arm's length, the transferee who exercises the option shall increase his basis for the property so acquired by any amount that is includible in the gross income of the employee at the time such transferee acquires the property.

(3) If an option to which this section applies is transferred in a transaction which is at arm's length, the basis of the property acquired by an exercise of the option shall not be increased by reason of any amount that is includible in this gross income of the employee under this section.

(4) If an option to which this section applies has a readily ascertainable fair market value at the time it is granted, the basis of such option includes any amount includible in gross income of the employee under paragraph (c) of this section.

(f) *Deductions.* If the employer grants an option to which this section applies, the employer of the employee in connection with whose employment the option is granted is considered to have paid compensation to such employee at the same time and in the same amount as such employee is considered under paragraph (c) or (d) of this section to have realized compensation. The deductibility of the amount considered so paid is determined under section 162 or other provision of the Code which is applicable to such a payment. Whether such amount may be deducted in the taxable year considered so paid, or whether such amount is a capital expenditure which is not deductible or which may be amortized, depends upon the nature of the transaction involved and the facts and circumstances of each case. If this section is applicable because of a disqualifying disposition of stock acquired by the exercise of a qualified or restricted stock option, or acquired by the exercise of an option granted under an employee stock purchase plan, the employer's taxable year for which such compensation is deductible is determined under section 421(b) and paragraph (b) of § 1.421–8 (or, in the case of taxable years ending before January 1, 1964, under section 421(f) and paragraph (e) of § 1.421–5).

(Secs. 83 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 588; 68A Stat. 917; 26 U.S.C. 83 and 7805))

[T.D. 6540, 26 FR 512, Jan. 20, 1961, as amended by T.D. 6696, 28 FR 13451, Dec. 12, 1963; T.D. 6887, 31 FR 8787, June 24, 1966; T.D. 7554, 43 FR 31926, July 24, 1978]

§ 1.421–7 Meaning and use of certain terms.

(a) *Option.* (1) For purposes of sections 421 through 425, the term ''option'' includes the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (e) of this section, such individual being under no obligation to purchase. Such right or privilege, when granted, must be evidenced in writing. The individual who has such right or privilege is referred to as the optionee and the corporation offering to sell stock under such an arrangement is referred to as the optionor. While no particular form of words is necessary, the written option should express, among other things, an offer to sell at the option price and the period of time during which the offer shall remain open.

(2) An option may be granted as part of or in conjunction with an employee stock purchase plan or subscription contract. See section 423.

(3) An arrangement between a corporation and an employee may involve more than one option. For example, if a corporation on June 1, 1964, grants to an employee the right to purchase 1,000 shares of its stock on or after June 1, 1965, another 1,000 shares on or after June 1, 1966, and a further 1,000 shares on or after June 1, 1967, all shares to be purchased before June 1, 1968, provided the employee at the time of exercise of any of the purchase rights is employed by the corporation, such an arrangement will be construed as the grant to the employee on June 1, 1964, of three options, each for the purchase of 1,000 shares. However, if a corporation grants to an employee on January 1, 1965, the right to purchase 1,000 shares of its stock at $65 per share during 1965, or at $75 per share during 1966, or at $85 per share during 1967, such an arrangement will be construed as the grant to the employee on January 1, 1965, of but one option for the purchase of 1,000 shares, which ceases to be outstanding when fully exercised at the price in effect at the time of exercise.

(b) *Statutory options.* (1) The term ‘‘statutory option’’, used for purposes of convenience hereinafter in this section and in §§1.421–8 through 1.425–1, means a qualified stock option, as defined by section 422(b) and §1.422–2; an option granted under an employee stock purchase plan, as defined by section 423(b) and §1.423–2; and a restricted stock option, as defined in section 424(b) and §1.424–2.

(2) An option may qualify as a statutory option only if the option is not transferable (other than by will or by the laws of descent and distribution) by the individual to whom it is granted, and is exercisable, during the lifetime of such individual, only by him. See sections 422(b)(6), 423(b)(9), and 424(b)(2). Accordingly, an option which is transferable by the individual to whom it is granted during his lifetime, or is exercisable during such individual's lifetime by another person, is not a statutory option. However, in case the option or the plan under which the option was granted contains a provision permitting the individual to whom the option was granted to designate the person who may exercise the option after his death, neither such provision, nor a designation pursuant to such provision, disqualifies the option as a statutory option.

(3)(i) The determination of whether an option is a statutory option is made as of the date such option is granted. An option which is a statutory option when granted does not lose its character as such an option by reason of subsequent events, and an option which is not a statutory option when granted does not become such an option by reason of subsequent events. See, however, paragraph (e) of §1.425–1, relating to modification, extension, or renewal of an option. For rules concerning options that are not statutory options, see §1.83–7.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). S–1 Corporation is a subsidiary of S Corporation which, in turn, is a subsidiary of P Corporation. On June 1, 1964, P grants to an employee of P a statutory option to purchase a share of stock of S–1. On January 1, 1965, S sells a portion of the S–1 stock which it owns to an unrelated corporation and, as of that date, S–1 ceases to be a subsidiary of S. On May 1, 1965, while still employed by P, the employee exercises his option to purchase a share of S–1 stock. Section 421 applies to such exercise.

Example (2). Assume P grants an option to an employee under the same facts as in example (1) above, except that on June 1, 1964, S–1 is not a subsidiary of either S or P. Such option is not a statutory option on June 1, 1964. On January 1, 1965, S purchases from an unrelated corporation a sufficient number of shares of S–1 stock to make S–1, as of that date, a subsidiary of S. On May 1, 1965, while still employed by P, the employee exercises his option to purchase a share of S–1 stock. The employee has not exercised a statutory option.

(c) *Time and date of granting option.* (1) For purposes of sections 421 through 425, the words ‘‘the date of the granting of the option’’ and ‘‘the time such option is granted’’, and similar phrases refer to the date or time when the corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. Ordinarily, if the corporate action contemplates an immediate offer of stock for sale to an individual or to a class including such individual, or contemplates a particular date on which such offer is to be made, the time or date of the granting of the option is the time or date of such corporate action if the offer is to be made immediately, or the date contemplated as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the individual or to the class will be taken into account as indicating that the corporation contemplated that the offer was to be made at the subsequent date on which such notice is given.

(2) If the corporation imposes conditions on the granting of an option (as distinguished from conditions governing the exercise of the option), such conditions shall be given effect in accordance with the intent of the corporation. However, under section 425(i), if the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval. A condition which does not require corporate action, such as the approval of, or registration with, some regulatory or governmental agency, for example, a stock exchange or the Securities and Exchange Commission, is ordinarily considered a condition upon the exercise of the option unless the corporate action clearly indicates that the option is not to be granted until such condition is satisfied. If an option is granted to an individual upon the condition that such individual will become an employee of the corporation granting the option or of a related corporation, such option is not granted prior to the date the individual becomes such an employee.

(3) In general, conditions imposed upon the exercise of an option will not operate to make ineffective the granting of the option. For example, on June 1, 1964, the A Corporation grants to X, an employee, an option to purchase 5,000 shares of the corporation's stock, exercisable by X on or after June 1, 1965, provided he is employed by the corporation on June 1, 1965, and provided that A's profits during the fiscal year preceding the year of exercise exceed $200,000. Such an option is granted to X on June 1, 1964, and will be treated as outstanding as of such date.

(d) *Stock and voting stock.* For purposes of sections 421 through 425, the term ''stock'' means capital stock of any class, including voting or nonvoting common or preferred stock. Except as otherwise provided, the term includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term ''stock'' as used in such sections, provided such stock otherwise possesses the rights and characteristics of capital stock. For purposes of determining what constitutes voting stock in ascertaining whether a plan has been approved by stockholders or whether the limitations pertaining to voting power contained in sections 422(b)(7), 423(b)(3) and 424(b)(3) and the regulations thereunder have been met, stock which does not have voting rights until the happening of an event, such as the default in the payment of dividends on preferred stock, is not voting stock until the happening of the specified event. Moreover, stock which does not possess a general voting power, and may vote only on particular questions, is not voting stock. However, if such stock is entitled to vote on whether a stock option plan is to be adopted, it is voting stock for the purpose of ascertaining whether the plan has been approved by the shareholders.

(e) *Option price.* (1) For purposes of sections 421 through 425, the term ''option price'' or ''price paid under the option'' means the consideration in money or other property which, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased. The term ''option price'' does not include amounts paid as interest under a deferred payment arrangement or treated as unstated interest under section 483 and the regulations thereunder. Thus, for example, section 483 is applicable in determining whether the pricing requirements of section 422(b)(4), 423(b)(6), 424(b)(1), or 424(c) are met and is applicable in determining the basis of any stock acquired pursuant to the exercise of a statutory option. However, with respect to statutory options granted prior to January 1, 1965, the determination of whether the applicable pricing requirements are met shall be made without regard to section 483, but section 483 shall be taken into consideration in determining basis for purposes of determining gain or loss.

(2) In the case of a statutory option, any reasonable valuation method may be used for the purpose of determining whether at the time the option is granted the option price satisfies the pricing requirements of section 442(b)(4) (relating to qualified stock options), section 423(b)(6) (relating to employee stock purchase plans), or section 424(b)(1) (relating to restricted stock options), whichever is applicable, with respect to the stock subject to the option. Such methods include the valuation methods described in §20.2031–2 of this chapter (Estate Tax Regulations).

(f) *Exercise.* For purposes of sections 421 through 425, the term ‘‘exercise’’, when used in reference to an option, means the act of acceptance by the optionee of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. A promise to pay the option price does not constitute an exercise of the option unless the optionee is subject to personal liability on such promise. An agreement or undertaking by the employee to make payments under an employee stock purchase plan does not constitute the exercise of an option so long as the payments made remain subject to withdrawal by the employee.

(g) *Transfer.* For purposes of sections 421 through 425, the term ‘‘transfer’’, when used in reference to the transfer to an individual of a share of stock pursuant to his exercise of a statutory option, means the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation.

(h) *Employment relationship.* (1) Section 421 is applicable to the exercise of a statutory option only if at the time the option is granted, the optionee is an employee of the corporation granting the option, or a related corporation of such corporation, unless the option has been assumed or a new option has been issued in its place under section 425(a). In case of such an assumption or issuance, the optionee must, at the time of such assumption or issuance, be an employee of the corporation so assuming or issuing the option, or a related corporation of such corporation. The determination of whether the optionee is an employee at the time the option is granted (or at the time of the assumption or issuance under section 425(a)) will be made in accordance with the rules contained in section 3401(c) and the regulations thereunder. As to the granting of an option conditioned upon employment, see paragraph (c)(2) of this section. A statutory option must be granted for a reason connected with the individual’s employment by the corporation or by its related corporation.

(2) In order to qualify for the special tax treatment of section 421, in addition to meeting the requirements of subparagraph (1) of this paragraph, an individual exercising a qualified stock option or an option granted under an employee stock purchase plan must, at all times during the period beginning with the date of the granting of such option and ending at the time of such exercise or on the day 3 months before the date of such exercise, be an employee of either the corporation granting such option, a related corporation of such corporation, or a corporation or a related corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies. For this purpose, the employment relationship in respect of an option granted in accordance with the requirements of subparagraph (1) of this paragraph will be treated as continuing intact while the individual is on military, sick leave or other bona fide leave of absence (such as temporary employment by the Government) if the period of such leave does not exceed 90 days, or, if longer, so long as the individual’s right to reemployment with the corporation granting the option (or a related corporation of such corporation, or a corporation, or a related corporation of such corporation issuing or

assuming a stock option in a transaction to which section 425(a) applies) is guaranteed either by statute or by contract. Where the period of leave exceeds 90 days and where the individual's right to reemployment is not guaranteed either by statute or by contract, the employment relationship will be deemed to have terminated on the 91st day of such leave.

(3) For purposes of determining whether an individual meets the requirements of this paragraph, the term ''employer corporation'', as used in section 425 (e) and (f), shall be read as ''grantor corporation'' or ''corporation issuing or assuming a stock option in a transaction to which section 425(a) is applicable'', as the case may be. For purposes of the employment requirement, a corporation employing an optionee is considered a related corporation if it was a parent or subsidiary of the corporation granting or assuming the option during the entire portion of the requisite period of employment during which it was the employer of such optionee.

(4) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, X Corporation granted a statutory option to A, an employee of X Corporation, to purchase a share of X stock. On February 1, 1965, X sold the plant where A was employed to M Corporation, an unrelated corporation, and A was employed by M. If A exercises his statutory option on June 1, 1965, section 421 is not applicable to such exercise, because on June 1, 1965, A is not employed by the corporation which granted the option or by a related corporation of such corporation, nor was he employed by any of such corporations within 3 months before June 1, 1965.

Example (2). Assume the facts to be the same as in example (1), except that when A was employed by M Corporation, the option to purchase X stock was terminated and was replaced by an option to buy M stock in such circumstances that M Corporation is treated as a corporation issuing an option under section 425(a). If A exercises the option to purchase the share of M stock on June 1, 1965, section 421 is applicable for A is then employed by a corporation which issued an option under section 425(a).

Example (3). E is an employee of P Corporation. On June 1, 1964, P grants E a statutory option to purchase a share of P stock. On June 1, 1965, P acquires 100 percent of the stock of S Corporation; on such date S becomes a subsidiary of P. On July 1, 1965, E ceases to be employed by P and becomes employed by S. On October 10, 1965, while still employed by S, E exercises his option to buy P stock. Since E was at all times during the requisite period of employment an employee of either P, the corporation granting the option, or S, a subsidiary of the grantor during the period in which such corporation was E's employer, section 421 is applicable to the exercise of the option.

Example (4). Assume the same facts as in example (3) except assume that at the time E became an employee of S Corporation, S assumed E's option to purchase P stock under section 425(a). Section 421 is applicable to E's exercise of his option to buy P stock.

Example (5). M Corporation grants a qualified stock option to E, an employee of such corporation. E is an officer in a reserve Air Force unit. E goes on military leave with his unit for 3 weeks. Regardless of whether E is an employee of M within the meaning of section 3401(c) and the regulations thereunder during such 3-week period, E's employment relationship with M is treated as uninterrupted during the period of E's military leave.

Example (6). Assume the same facts as in example (5) and assume further that E's active duty status is extended indefinitely, but that E has an employment contract with M which provides that upon the termination of any military duty E may be required to serve, E will be entitled to reemployment with M or a parent or subsidiary of M. E exercises his M option while on active military duty. Irrespective of whether E is an employee of M within the meaning of section 3401(c) and the regulations thereunder at the time of such exercise or within 3 months before such exercise, section 421 can apply to such exercise.

Example (7). X Corporation grants a qualified stock option to A, an employee of X Corporation, whose employment contract provides that in the event of illness, A's right to reemployment with X, or a parent or subsidiary of X, will continue for 1 year after the time A becomes unable to perform his duties for X. A falls ill for 90 days. For purposes of section 422(a)(2), A's employment relationship with X will be treated as uninterrupted during the 90-day period. If A's incapacity extends beyond 90 days, then, for purposes of section 422(a)(2), A's employment relationship with X will be treated as continuing uninterrupted until A's reemployment rights terminate. Under section 422(a)(2), A has 3 months in which to exercise his qualified stock option after his employment relationship with X (and its parent and subsidiary corporation) is terminated.

(i) *Related corporation.* The term ''related corporation'', used for purposes of convenience in this section and §§ 1.421–

8 through 1.425–1, means a corporation which is a parent or subsidiary corporation (as defined by section 425 (e) and (f) and the regulations thereunder).

(Secs. 83 and 7805 of the Internal Rvenue Code of 1954 (83 Stat. 588; 68A Stat. 917; 26 U.S.C. 83 and 7805))

[T.D. 6887, 31 FR 8787, June 24, 1966, as amended by T.D. 6975, 33 FR 14779, Oct. 3, 1968; T.D. 7554, 43 FR 31927, July 24, 1978]

§1.421–8 General rules.

(a) *Effect of qualifying transfer.* (1) If a share of stock is transferred to an individual pursuant to his exercise of a statutory option, and if the requirements of section 422(a) (relating to qualified stock options), section 423(a) (relating to employee stock purchase plans), or section 424(a) (relating to restricted stock option), whichever is applicable, are met, then—

(i) Except as provided in section 422(c)(1) (relating to exercise of option when price is less than value of stock), and paragraph (e)(2) of §1.422–2, no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(ii) No deduction under section 162 or the regulations thereunder (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a related corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 425(a) and paragraph (a) of §1.425–1 (relating to corporate reorganizations, liquidations, etc.) applies, with respect to the share so transferred; and

(iii) No amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.

(2) For the purpose of this paragraph, each share of stock transferred pursuant to a statutory option is treated separately. For example, if an individual, while employed by a corporation granting him a statutory option, exercises the option with respect to part of the stock covered by the option, and if such individual exercises the balance of the option more than three months after leaving such employment, the application of section 421 to the stock obtained upon the earlier exercise of the option is not affected by the fact that the income taxes of the employer and the individual with respect to the stock obtained upon the later exercise of the option are not determined under section 421.

(b) *Effect of disqualifying disposition.* (1) The disposition of a share of stock, acquired by the exercise of a statutory option before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1), makes section 421 inapplicable to the transfer of such share. The income attributable to such transfer shall be treated by the individual as income received in the taxable year in which such disposition occurs. Similarly, a deduction under section 162 attributable to the transfer of the share of stock pursuant to the exercise of the option shall be allowable for the taxable year in which such disposition occurs to the employer corporation, its parent or subsidiary corporation or a corporation issuing or assuming a stock option in a transaction to which section 425(a) applies. In such cases, no amount shall be treated as income, and no amount shall be allowed as a deduction, for any taxable year other than the taxable year in which the disposition occurs. If the stock was transferred pursuant to the exercise of the option in a taxable year other than the taxable year of the disposition, the amount of the deduction shall be determined as if the employee had been paid compensation at the time provided in paragraph (d) of §1.421–6.

(2) Section 421 is not made inapplicable by a transfer before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1), if such transfer is not a disposition of the stock as defined in section 425(c) and paragraph (c) of §1.425–1, for example, a transfer from the decendent to his estate or a transfer by bequest or inheritance. Similarly, a disposition by the executor, administrator, heir, or legatee is not a disposition by the decedent. In case a statutory option is exercised by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by reason of the death of

such individual, see paragraph (c) of this section.

(3) For special rules relating to a disqualifying disposition of a share of stock acquired by the exercise of a qualified stock option, see paragraph (b) of § 1.422–1.

(c) *Exercise by estate.* (1) If a statutory option is exercised by the estate of the individual to whom the option was granted, or by any person who acquired such option by bequest or inheritance or by reason of the death of such individual, section 421(a) applies to such exercise in the same manner as if such option had been exercised by such deceased individual. Consequently, except as provided by section 422(c)(1) and paragraph (e)(2) of § 1.422–2, neither the estate nor such person is required to include any amount in gross income as a result of a transfer of stock pursuant to such exercise of the option. Nor does section 421(a) become inapplicable if such executor, administrator, or person disposes of the stock so acquired before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1). This special rule does not affect the applicability of section 1222, relating to what constitutes a short-term and long-term capital gain or loss. The executor, administrator, or such person need not exercise the option within three months after the death of the individual to whom the option was granted for section 421(a) to be applicable. However, the exercise of the option must be pursuant to the terms of the option, and any change in the terms of the option is subject to the rules of paragraph (e) of § 1.425–1, relating to the modification, extension, or renewal of the option. Section 421(a) is applicable even though such executor, administrator, or person is not employed by the corporation granting the option, or a related corporation, either when the option is exercised or at any time. However, section 421(a) is not applicable to an exercise of the option by the estate or by such person, unless the individual to whom the option was granted met the employment requirements of section 422(a)(2), 423(a)(2), or 424(a)(2), whichever is applicable, either at the time of his death or within three months before such time. If the option is exercised by a person other than the executor or administrator, or other than a person who acquired the option by bequest or inheritance or by reason of the death of such deceased individual, section 421(a) is not applicable to the exercise. For example, if the option is sold by the estate, section 421(a) does not apply to an exercise of the option by such buyer; but if the option is distributed by the administrator to an heir as part of the estate, section 421(a) is applicable to an exercise of the option by such heir.

(2) Any transfer by the estate, whether a sale, a distribution of assets, or otherwise, of the stock acquired by its exercise of the option under this paragraph is a disposition of the stock. Therefore, if section 423(c), or 424(c)(1) is applicable, the estate must include an amount as compensation in its gross income. Similarly, if section 423(c) or 424(c)(1) is applicable in case of an exercise of the option under this paragraph by a person who acquired the option by bequest or inheritance or by reason of the death of the individual to whom the option was granted, there must be included in the gross income of such person an amount as compensation, either when such person disposes of the stock, or when he dies owning the stock.

(3)(i) If, under section 422(c)(1), 423(c), or 424(c)(1), an amount is required to be included in the gross income of the estate or of such person, the estate or such person shall be allowed a deduction as a result of the inclusion of the value of the option in the estate of the individual to whom the option was granted. Such deduction shall be computed under section 691(c) by treating the option as an item of gross income in respect of a decedent under section 691 and by treating the amount required to be included in gross income under section 422(c)(1), 423(c), or 424(c)(1), as an amount included in gross income under section 691 in respect of such item of gross income. No such deduction shall be allowable with respect to any amount other than an amount includible under section 422(c)(1), 423(c), or 424(c)(1). For the rules relating to the computation of a deduction under section 691(c), see § 1.691(c)–1.

(ii) The application of subdivision (i) may be illustrated by the following example:

Example. On June 1, 1964, E was granted an option under an employee stock purchase plan to purchase for $85 one share of the stock of his employer. On such day, the fair market value of such stock was $100 per share. E died on February 1, 1966, without having exercised such option. The option was, however, exercisable by his estate, and for purposes of the estate tax was valued at $30. On March 1, 1966, the estate exercised the option, and on March 15, 1966, sold for $150 the share of stock so acquired. For its taxable year including March 15, 1966, the estate is required by sections 421(c)(1)(B) and 423(c) to include in its gross income as compensation the amount of $15. During such taxable year, no amounts of income were properly paid, credited, or distributable to the beneficiaries of the estate. However, under section 421(c)(2), the estate is entitled to a deduction determined in the following manner. E's estate includes no other items of income in respect of a decedent referred to in section 691(a), and no deductions referred to in section 691(b), so that the value for estate tax purposes of the option, $30, is also the net value of all items of income in respect of the decedent. The estate tax attributable to the inclusion of the option in the estate of E is $10. Since $15, the amount includible in gross income by reason of sections 421(c)(1)(B) and 423(c), is less than the value for estate tax purposes of the option, only 15⁄30 of the estate tax attributable to the inclusion of the option in the estate is deductible; that is, 15⁄30 of $10, or $5. No deduction under section 421(c)(2) is allowable with respect to any capital gain.

(4)(i) In the case of an employee dying before January 1, 1957, the basis of any share of stock acquired by the exercise of a restricted stock option under this paragraph, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 424(c)(1). The basis of the share shall not be increased by reason of the inclusion of the value of the restricted stock option in the estate for estate tax purposes.

(ii)*(a)* In the case of an employee dying after December 31, 1956, the basis of any share of stock acquired by the exercise of an option under this paragraph, determined under section 1011, shall be increased by an amount equal to the portion of the basis of the option attributable to such share. For example, if a statutory option to acquire 10 shares of stock has a basis of $100, the basis of one share acquired by a partial exercise of the option, determined under section 1011, would be increased by 1/10th of $100, or $10. The option acquires a basis, determined under section 1014(a), only if the transfer of the share pursuant to the exercise of such option qualifies for the special tax treatment provided by section 421(a). To the extent the option is so exercised, in whole or in part, it will acquire a basis equal to its fair market value at the date of the employee's death or, if an election is made under section 2032, its value at its applicable valuation date. In certain cases, the basis of the share is subject to the adjustments provided by *(b)* and *(c)* of this subdivision, but such adjustments are only applicable in the case of an option which is subject to section 422(c)(1), 423(c), or 424 (c)(1).

(b) If the amount which would have been includible in gross income under section 422(c)(1), 423(c), or 424(c)(1) had the employee exercised the option on the date of his death and held the share at the time of his death exceeds the amount which is includible in gross income under such section, the basis of the share, determined under *(a)* of this subdivision, shall be reduced by such excess. For example, if $15 would have been includible in the gross income of the employee had he exercised the option and held such share at the time of his death, and only $10 is includible under section 422(c)(1), 423(c), or 424(c)(1), the basis of the share, determined under *(a)* of this subdivision, would be reduced by $5. For purposes of determining the amount which would have been includible in gross income under section 422 (c)(1), 423(c), or 424(c)(1), if the employee had exercised the option and held such share at the time of his death, the amount which would have been paid for the share shall be computed as if the option had been exercised on the date the employee died.

(c) If the amount includible in gross income under section 422(c)(1), 423(c), or 424(c)(1), exceeds the portion of the basis of the option attributable to the share, the basis of the share, determined under *(a)* of this subdivision,

shall be increased by such excess. Thus, if $15 is includible in gross income under such section, and the basis of the option with respect to the share is $10, the basis of the share, determined under *(a)* of this subdivision, will be increased by $5.

(iii) If a statutory option is not exercised by the estate of the individual to whom the option was granted, or by the person who acquired such option by bequest or inheritance or by reason of the death of such individual, the option shall be considered to be property which constitutes a right to receive an item of income in respect of a decedent to which the rules of sections 691 and 1014(c) apply.

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

Example (1). On June 1, 1955, the X Corporation granted to E, an employee, a restricted stock option to purchase a share of X Corporation's stock for $85. The fair market value of the X Corporation stock on such date was $100 per share. On June 1, 1956, E died. The fair market value of the X Corporation stock on such date exceeded $100 per share and the fair market value of the option on the applicable valuation date was $35. On August 1, 1964, the estate of E exercised the option and sold the share of X Corporation stock at a time when the fair market value of the share was $90. The estate is required by section 424(c)(1) to include $5 in its gross income as compensation. Since E died before January 1, 1957, the basis of the share is $90 (the $85 paid for the stock plus the $5 includible in gross income as compensation), and the basis of the share is not increased by reason of the inclusion of the value of the option in the estate of E (see section 1014(d) (as in effect with respect to taxable years ending before January 1, 1957)). Thus, no gain or loss is realized on the disposition of the share since the basis of the share is equal to the sale price.

Example (2). On June 1, 1964, the X Corporation granted to E, an employee, an option under its employee stock purchase plan to purchase a share of X Corporation stock for $85. The fair market value of X Corporation stock on such date was $100 per share. On June 1, 1966, E died. The fair market value of X Corporation stock on such date exceeded $100 per share and the fair market value of the option on the applicable valuation date was $35. On August 1, 1966, the estate of E exercised the option and sold the share of X Corporation stock at a time when the fair market value of the share was $120. The basis of the share is $120 (the $85 paid for the stock plus the $35 basis of the option). When the share is sold for $120, the estate is required to include $15 in its gross income as compensation. Since $15 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, subdivision (ii)*(b)* of this subparagraph does not apply. Moreover, since the $15 includible in the gross income of the estate does not exceed the basis of the option ($35), subdivision (ii)*(c)* of this subparagraph does not apply. Since the basis of the stock and the sale price are the same, no gain or loss is realized by the estate on the disposition of the share.

Example (3). Assume the same facts as in example (2), except that the fair market value of the share of stock at the time of its sale was $90. The basis of the share, determined under subdivision (ii)*(a)* of this subparagraph, is $120 (the $85 paid for the stock plus the $35 basis of the option). When the share is sold for $90, the estate is required to include $5 in its gross income as compensation. If the employee had exercised the option and held the share at the time of his death, $15 would have been includible in gross income as compensation for the taxable year ending with his death. Since such amount exceeds by $10 the amount which the estate is required to include in its gross income, subdivision (ii)*(b)* of this subparagraph applies, and the basis of the share ($120), determined under subdivision (ii)*(a)* of this subparagraph is reduced by $10. Accordingly, the basis is $110, and a capital loss of $20 is realized on the disposition of the share.

Example (4). Assume the same facts as in example (2), except that the fair market value of the option on the applicable valuation date was $5, and that the fair market value of X Corporation stock on the date the employee died did not exceed $100. The basis of the share, determined under subdivision (ii)*(a)* of this subparagraph, is $90 (the $85 paid for the stock plus the $5 basis of the option). When the share is sold for $120, the estate is required to include $15 in its gross income as compensation. Since such amount exceeds by $10 the basis of the option, subdivision (ii)*(c)* of this subparagraph applies, and the basis of the share ($90), determined under subdivision (ii)*(a)* of this subparagraph, is increased by $10. Accordingly, the basis is $100 and a capital gain of $20 is realized on the disposition of the share.

Example (5). Assume the same facts as in example (2), except that on June 1, 1966, the date the employee died, the fair market value of X Corporation stock was $98, and that on June 1, 1967, the alternate valuation date, the fair market value of the stock had declined substantially, and the fair market value of the option was $5. On August 1, 1967, the estate of E exercised the option and sold the share when its fair market value was $92. The basis of the share, determined under subdivision (ii)*(a)* of this subparagraph, is $90 (the $85 paid for the stock plus the $5 basis of the option). When the share is sold for $92, the estate is required to include $7 in its gross income as compensation. Since $13 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, subdivision (ii)*(b)* of this subparagraph applies, and the basis of the share ($90), determined under subdivision (ii)*(a)* of this subparagraph, is reduced by $6 to $84. Furthermore, since the $7 that the estate is required to include in its gross income when the share is sold for $92 exceeds by $2 the basis of the option, subdivision (ii)*(c)* of this subparagraph applies, and the basis of the share ($84), determined under subdivision (ii)*(a)* and (ii)*(b)* of this subparagraph, is increased by $2. Accordingly, the basis is $86 and a capital gain of $6 is realized on the disposition of the share.

(d) *Exercise by deceased employee during lifetime.* If a statutory option is exercised by an individual to whom the option was granted and the individual dies before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1), section 421(a) does not become inapplicable if the executor or administrator of the estate of such individual, or any person who acquired such stock by bequest or inheritance or by reason of the death of such individual, disposes of such stock before the expiration of such applicable holding period. This rule does not affect the applicability of section 1222, relating to what constitutes a short-term and long-term capital gain or loss.

(e) *Incorporation by reference.* Any requirement that an option expressly contain or state a prescribed limitation or term will be considered met if such limitation or term is set forth in a statutory option plan and is incorporated by reference by the option. Thus, if a statutory option plan expressly provides that no option granted thereunder shall be exercisable after five years from the date of grant, and if an option granted thereunder expressly provides that the option is granted subject to the terms and limitations of such plan, the option will be regarded as being, by its terms, not exercisable after the expiration of 5 years from the date such option is granted.

[T.D. 6887, 31 FR 8789, June 24, 1966]

§1.422–4 Qualified stock options (prior law).

Section 422 of the Code, pertaining to qualified stock options, was repealed by section 11801(a)(20) of the Omnibus Budget Reconciliation Act of 1990. In view of the savings provision of section 11821(b) of that act, the regulations under the repealed section 422, which were removed from the Code of Federal Regulations, may be of continuing interest to the public. Those regulations were set forth in 26 CFR 1.422–1 and 1.422–2 as contained in 26 CFR edition revised as of April 1, 1991.

[T.D. 8374, 56 FR 61160, Dec. 2, 1991]

§1.422–5 Stockholder approval of incentive stock option plans.

This section addresses the stockholder approval of incentive stock option plans required by section 422(b)(1) of the Internal Revenue Code. (Section 422 was added to the Code as section 422A by section 251 of the Economic Recovery Tax Act of 1981, and was redesignated as section 422 by section 11801 of the Omnibus Budget Reconciliation Act of 1990.) The approval of stockholders must comply with all applicable provisions of the corporate charter, bylaws, and applicable State law prescribing the method and degree of stockholder approval required for the issuance of corporate stock or options. If the applicable State law does not prescribe a method and degree of stockholder approval in such cases an incentive stock option plan must be approved:

(a) By a majority of the votes cast at a duly held stockholders' meeting at which a quorum representing a majority of all outstanding voting stock is, either in person or by proxy, present and voting on the plan; or

(b) By a method and in a degree that would be treated as adequate under applicable State law in the case of an action requiring stockholder approval (i.e., an action on which stockholders would be entitled to vote if the action were taken at a duly held stockholders' meeting).

[T.D. 8374, 56 FR 61160, Dec. 2, 1991]

§ 1.423–1 Applicability of section 421(a).

(a) *General rule.* Subject to the provisions of section 423(c) and paragraph (k) of this section, the special rules of income tax treatment provided in section 421(a) apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an option granted after December 31, 1963, under an employee stock purchase plan provided that the following conditions are satisfied—

(1) The individual must make no disposition of such share within 2 years from the date of the granting of the option, nor within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of such share to him; and

(2) At all times during the period beginning with the date of the granting of the option and ending on the day three months before the date of such exercise, the individual must be an employee of either the corporation granting the option, a related corporation of such corporation, or a corporation or a related corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies.

(b) *Cross-references.* For rules relating to the employment relationship, see paragraph (h) of § 1.421–7. For rules relating to the effect of a disqualifying disposition, see section 421(b) and paragraph (b) of § 1.421–8. For definition of the term ''disposition'', see section 425(c) and paragraph (c) of § 1.425–1.

[T.D. 6887, 31 FR 8798, June 24, 1966, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.423–2 Employee stock purchase plan defined.

(a) *In general.* (1) The term ''employee stock purchase plan'' means a plan which meets the requirements of paragraphs (1) through (9) of section 423(b). If the terms of the plan do not satisfy the requirements of paragraphs (3) through (9) of section 423(b), such requirements may be satisfied by the terms of an offering made under such plan. However, in such a case, such requirements will be treated as satisfied only with respect to options exercised under such offering.

(2) The determination of whether a particular option is an option granted under an employee stock purchase plan is made at the time such option is granted. If the terms of an option are inconsistent with the terms of the employee stock purchase plan or an offering under such a plan, the option will not be treated as granted under an employee stock purchase plan. If such an option is granted to an employee who is entitled to the grant of an option under the terms of the plan or offering, and such employee is not granted an option under such offering which qualifies as an option granted under an employee stock purchase plan, such offering will not meet the requirements of section 423(b)(4). Accordingly, none of the options granted under such offering will be eligible for the special tax treatment of section 423(b)(4). If such an option is granted to an individual who is not entitled to the grant of an option under the terms of the plan or offering, such option will not be treated as an option granted under an employee stock purchase plan, and the grant of the option will not disqualify the plan or the options granted under such plan or offering. For example, an option granted to an individual who is ineligible to receive an option under an employee stock purchase plan by reason of his ownership of 5 percent or more of the voting power or value of the stock of the grantor corporation (or a related corporation of such corporation), will not be treated as an option granted under an employee stock purchase plan, and the grant of such an option will not disqualify options granted under such plan from the special tax treatment of section 421. If all the options granted under an offering do not give the respective optionees the same rights and privileges, none of the options granted under such offering will be treated as having been granted under an employee stock purchase plan. If, at the time an option is granted, it qualifies as an option granted under an employee stock purchase plan, but the terms of the option are not in fact met, the option will not qualify for the special tax treatment of section 421. However, the failure of

such an option to qualify for the special tax treatment of section 421, will not disqualify other options granted under the plan.

(b) *Options restricted to employees.* An employee stock purchase plan must provide that options are to be granted only to employees of the employer corporation or of its related corporations to purchase stock in any such corporation. If such a provision is not included in the terms of the plan, the plan will not be an employee stock purchase plan and options granted under such plan will not qualify for the special tax treatment of section 421. For rules relating to the employment requirement, see paragraph (h) of §1.421–7.

(c) *Stockholder approval.* (1) An employee stock purchase plan must be approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted. The approval of the stockholders must comply with all applicable provisions of the corporate charter, bylaws and applicable State law prescribing the method and degree of stockholder approval required for the issuance of corporate stock or options. If the applicable State law does not prescribe a method and degree of stockholder approval in such cases an employee stock purchase plan must be approved—

(i) By a majority of the votes cast at a duly held stockholder's meeting at which a quorum representing a majority of all outstanding voting stock is, either in person or by proxy, present and voting on the plan; or

(ii) By a method and in a degree that would be treated as adequate under applicable State law in the case of an action requiring stockholder approval (i.e., an action on which stockholders would be entitled to vote if the action were taken at a duly held stockholders' meeting).

(2) The plan required by section 423 must be approved within 12 months before or after the date the plan is adopted. Ordinarily, a plan is adopted when approved by the board of directors and the date of such board action will be the reference point for determining whether stockholder approval comes within the 12-month period.

(3) The plan as adopted and approved must designate the aggregate number of shares which may be issued under the plan, and the corporations or class of corporations whose employees will be offered options under such plan. A plan which merely provides that the number of shares which may be issued under options shall not exceed a stated percentage of the shares outstanding at the time of each offering or grant under the plan will not satisfy the requirement that the plan state the aggregate number of shares which may be issued under options. However, the maximum number of shares which may be issued under the plan may be stated in terms of a percentage of either the authorized, issued or outstanding shares at the date of the adoption of the plan. The provisions relating to the aggregate number of shares to be issued under the plan and the employees (or class of employees) eligible to receive options under the plan, are the only provisions of a stock option plan which require stockholder approval for purposes of section 423(b)(1).

(4) Any increase in the aggregate number of shares which may be issued under the plan (other than an increase merely reflecting a change in capitalization such as a stock dividend or stock split-up) will be treated as the adoption of a new plan requiring approval of the stockholders within 12 months of such adoption. Similarly, a change in the designation of corporations whose employees may be offered options under the plan will be treated as the adoption of a new plan requiring stockholder approval unless the plan provides that designations of participating corporations may be made from time to time from among a group consisting of the grantor corporation and its parent or subsidiary corporations. The group from among which such changes and designations are permitted without additional stockholder approval may include corporations having become parents or subsidiaries of the grantor after the adoption and approval of the plan. Any other changes in the terms of an employee stock purchase plan may be made without such changes being considered the adoption of a new plan.

(5) A plan which otherwise meets the requirements of section 423(b) and this section may be used as an employee stock purchase plan although the adoption and approval of such plan occurred before January 1, 1964.

(d) *Options granted to certain shareholders.* (1) An employee stock purchase plan must by its terms provide that no employee can be granted an option if such employee, immediately after the option is granted, owns stock possessing 5 percent or more of the total combined voting power or value of all classes of stock of the employer corporation or its parent or subsidiary corporation. In determining whether the stock ownership of an employee equals or exceeds this 5 percent limit, the rules of section 425(d) (relating to attribution of stock ownership) shall apply, and stock which the employee may purchase under outstanding options (whether or not such options qualify for the special tax treatment afforded by section 421(a)) shall be treated as stock owned by the employee. An option is outstanding for purposes of section 423(b)(3) although under its terms it may be exercised only in installments or after the expiration of a fixed period of time. If an option is granted to an individual whose stock ownership (as determined under this paragraph for purposes of section 423(b)(3)) exceeds the limitation of section 423(b)(3), no portion of such option will be treated as having been granted under an employee stock purchase plan.

(2) The determination of the percentage of the total combined voting power or value of all classes of stock of his employer corporation (or a related corporation of such corporation) that is owned by the individual is made by comparing the voting power or value of the shares owned (or treated as owned) by the individual to the aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option to such individual. The aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option does not include the voting power or value of treasury shares or shares authorized for issue under outstanding options held by the individual or any other person.

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

Example (1). E, an employee of M Corporation, owns 6,000 shares of the common stock of M Corporation, the only class of M stock outstanding. M has 100,000 shares of its common stock outstanding. Since E owns 6 percent of the combined voting power or value of all classes of M Corporation stock, M cannot grant an option to E under M's employee stock purchase plan. If E's father and brother each owned 3,000 shares of M stock and E owned no M stock in his own name, the result in this case would be the same, since under section 425(d) a person is treated as owning stock held by his father and his brother. Similarly, the result would be the same if, instead of actually owning 6,000 shares, E merely held an option on 6,000 shares of M stock, irrespective of whether the transfer of stock under such option could qualify for the special tax treatment of section 421, since section 423(b)(3) provides that stock which the employee may purchase under outstanding options shall be treated as stock owned by such employee.

Example (2). Assume the same facts as in example (1) and assume further that M is a subsidiary corporation of P Corporation. Irrespective of whether E owns any P stock, E cannot receive an option from P under P's employee stock purchase plan since he owns 5 percent of the total combined voting power of all classes of stock of a subsidiary of P Corporation, i.e., M Corporation. Thus, an individual who owns (or is treated as owning) stock in excess of the limitation of section 423(b)(3), in any corporation in a group of corporations, consisting of a parent and its subsidiary corporations, cannot receive an option under an employee stock purchase plan from any corporation in the group.

Example (3). F is an employee of R Corporation. R has only one class of stock, of which 100,000 shares are issued and outstanding. Assuming F owns no stock in R or in any parent or subsidiary of R for purposes of section 423(b)(3), R can grant an option to F under its employee stock purchase plan for 4,999 shares, since immediately after the grant of the option, F would not own 5 percent or more of the combined voting power or value of all classes of R stock actually issued and outstanding at such time. The 4,999 shares which F would be treated as owning under section 423(b)(3) would not be added to the 100,000 shares actually issued and outstanding immediately after the grant for purposes of determining whether F's stock ownership exceeds the limitation of section 423(b)(3).

Example (4). Assume the same facts as in example (3) and assume further that on June

1, 1965, R grants F an option, purportedly under its employee stock purchase plan, for 5,000 shares. No portion of this option will be treated as granted under an employee stock purchase plan.

(e) *Employees covered by plan.* (1) Subject to the limitations of section 423(b) (3), (5) and (8), an employee stock purchase plan must, by its terms, provide that options are to be granted to all employees of any corporation which grants options to any of its employees by reason of their employment by such corporation except that one or more of the following categories of employees may be excluded from the coverage of the plan:

(i) Employees who have been employed less than 2 years;

(ii) Employees whose customary employment is 20 hours or less per week;

(iii) Employees whose customary employment is for not more than 5 months in any calendar year;

(iv) Officers;

(v) Persons whose principal duties consist of supervising the work of other employees; and

(vi) Highly compensated employees.

No option granted under a plan or offering which excludes from participation any employees, other than those who may be excluded under section 423(b)(4) and this paragraph, and those barred from participation by reason of section 423(b) (3), (5), and (8) and paragraphs (d), (f) and (i) of this section, can be regarded as having been granted under an employee stock purchase plan. If an option is not granted to any employee who is entitled to the grant of an option under the terms of the plan or offering, none of the options granted under such offering will be treated as having been granted under an employee stock purchase plan. Furthermore, no option will be considered as having been granted under an employee stock purchase plan if the option was granted in connection with an offering made after September 28, 1979 with respect to which employees, otherwise eligible, are denied participation to any extent because of their continuing participation or eligibility for participation in a prior plan or offering (including a prior plan or offering of a related corporation). However, a plan which, by its terms, permits all eligible employees to elect to participate in an offering will not violate the requirements of this paragraph solely because eligible employees who elect not to participate in the offering are not granted options pursuant to such offering.

(2) For purposes of section 423(b)(3) the existence of the employment relationship between an individual and the corporation participating under the plan will be determined under paragraph (h) of §1.421–7 (relating to employment relationship).

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

Example (1). M Corporation has a stock purchase plan which meets all the requirements of section 423(b) except that by its terms, options are not required to be granted to employees whose weekly rate of pay is less than $100. As a matter of corporate practice, M grants options under its plan to all employees, irrespective of their weekly rate of pay. M's plan is not an employee stock purchase plan.

Example (2). Assume the same facts as in example (1) and assume further that the first offering under M's plan provides by its terms that options will be granted to all employees of M Corporation. With respect to options exercised under such offering the terms of such offering will be treated as part of the terms of M's plan. Accordingly, stock transferred pursuant to options exercised under such offering will be treated as stock transferred pursuant to the exercise of options granted under an employee stock purchase plan for purposes of section 421.

(f) *Equal rights and privileges.* (1) An employee stock purchase plan must, by its terms, provide that all employees granted options under such plan shall have the same rights and privileges; however, a plan will not fail to satisfy this requirement merely because the amount of stock which may be purchased by any employee under such plan is determined on the basis of a uniform relationship to the total compensation, or the basic or regular rate of compensation of employees, or because the plan provides that no employee may purchase more than a maximum amount of stock fixed under the plan. Thus, the provisions applying to one option under an offering (such as the provisions relating to the method of payment for the stock and the determination of the purchase price per share) must apply to all other options under such offering in the same manner. If all the options granted under a plan or offering do not, by their terms, give the respective optionees the same rights and privileges, none of such options shall be treated as having been granted under an employee stock purchase plan for purposes of section 421.

(2) The requirements of section 423(b)(5) and this paragraph do not prevent the maximum amount of stock which an employee may purchase from being determined on the basis of a uniform relationship to the total compensation, or the basic or regular rate of compensation, of all employees. For example, if an employee stock purchase plan provides that the maximum amount of stock which each employee may purchase under the offering is one share for each $100 of annual gross pay, options granted under such offering will be treated as meeting the requirement of section 423(b)(5). However, such a provision must not exclude employees from participation under the plan or offering. For example, a plan which provides for the grant of options based on one share for each $100 of annual gross pay in excess of $10,000 will not meet the requirements of section 423(b)(5).

(3)(i) Except as provided in paragraph (f)(3)(ii) of this section, a plan permitting one or more employees to apply sums which were withheld under an earlier plan or offering towards the purchase of additional stock under the current plan or offering will be a violation of equal rights and privileges unless all employees in the current plan or offering are permitted to make payments in an amount not less than that which any employee is allowed to carry over, to be applied to the purchase of shares under the current plan or offering.

(ii) A plan will not fail to satisfy the requirements of this section merely because one or more employees are permitted to apply sums, in an amount representing a fractional share, which were withheld under an earlier plan or offering toward the purchase of additional stock under the current plan or offering.

(4)(i) Section 423(b)(5) does not prohibit the delaying of the grant of an option to any employee who is barred from being granted an option solely by reason of such employee's failing to meet a minimum service requirement until such employee meets such requirement.

(ii) The provision of this paragraph (4) may be illustrated by the following example:

Example. N Corporation has an employee stock purchase plan which provides that options to purchase stock in an amount equal to ten percent of an employee's annual salary at a price equal to 85 percent of the fair market value at the time the option is granted will be granted to all employees other than those who have been employed less than 18 months. In addition, the plan provides that employees who have not yet met the minimum service requirements on the date the options are initially granted will be granted similar options on the date such employment has been attained. Such plan meets the requirements of section 423(b)(5).

(g) *Option price.* (1) An employee stock purchase plan must, by its terms, provide that the option price will not be less than the lesser of—

(i) An amount equal to 85 percent of the fair market value of the stock at the time such option is granted, or

(ii) An amount which under the terms of the option may not be less than 85 percent of the fair market value of the stock at the time such option is exercised.

For definition of the term ''option price'', and general rules relating to such term, see paragraph (e) of § 1.421–7. For rules relating to the determination of when an option is granted, see paragraph (c) of § 1.421–7. Any option which does not meet the minimum pricing requirements of section 423(b)(6) and this paragraph will not be treated as granted under an employee stock purchase plan irrespective of whether the plan itself or the offering satisfies such requirements. If such an option is granted to an employee who is entitled to the grant of an option under the terms of the plan or offering, and such employee is not granted an option under such offering which qualifies as an option granted under an employee stock purchase plan, such offering will not meet the requirements of section 423(b)(4). Accordingly, none of the options granted under such offering will be eligible for the special tax treatment of section 423(b)(4).

(2) The option price may be stated either as a percentage or as a dollar amount. If the option price is stated as a dollar amount, the requirement of section 423(b)(6) and this paragraph can only be met by a plan or offering in which the price is fixed at not less than 85 percent of the fair market value of the stock at the time the option is granted. If the fixed price is less than 85 percent of the fair market value of the stock at grant, the option cannot meet the requirement of section 423(b)(6) even if a decline in the fair market value of the stock results in such fixed price being not less than 85 percent of the fair market value of the stock at the time the option is exercised, since such a result was not certain to occur under the terms of the option.

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

Example (1). M Corporation has an employee stock purchase plan which provides that the option price will be 85 percent of the fair market value of the stock at grant, or 85 percent of the stock at exercise, whichever amount is the lesser. Upon the exercise of an option issued under M's plan, M agrees to accept an amount which is less than the minimum amount allowable under the terms of such plan. Notwithstanding that the option was issued under an employee stock purchase plan, the transfer of stock pursuant to the exercise of such option does not satisfy the requirement of section 423(b)(6) and cannot qualify for the special tax treatment of section 421.

Example (2). Assume the same facts as in example (1) and assume further that at the time of grant, the fair market value of M Corporation stock is $100 per share and that the option price is set at 85 percent of the fair market value of M stock at exercise, but not less than $80 per share. The option satisfies the requirement of section 422(b)(6), and can qualify for the special tax treatment of section 421.

Example (3). Assume the same facts as in example (2), except assume that the option price is set at 85 percent of the fair market value of M stock at exercise, but not more than $80 per share. This option cannot satisfy the requirement of section 423(b)(6) irrespective of whether, at the time the option is exercised, 85 percent of the fair market value of M stock is $80 or less.

(h) *Option period.* An employee stock purchase plan must, by its terms, provide that options granted under such plan cannot be exercised after the expiration of 27 months from the date of grant unless, under the terms of such plan, the option price is to be not less than 85 percent of the fair market value of the stock at the time of the exercise of the option. If the option price is to be not less than 85 percent of the fair market value of the stock at the time the option is exercised, then the option period provided under the plan must not exceed 5 years from the date of grant. If the requirement of section 423(b)(7) is not met by the terms of the plan or offering, options issued under such plan or offering will not be treated as options granted under an employee stock purchase plan irrespective of whether such options, by their terms, are exercisable beyond the period allowable under section 423(b)(7) and this paragraph. An option which provides that the option price is to be not less than 85 percent of the fair market value of the stock at exercise may have an option period of 5 years irrespective of whether the fair market value of the stock at exercise is more or less than the fair market value of such stock at grant. However, if the option provides that the option price is to be 85 percent of the fair market value of the stock at exercise, but not more than some other fixed amount, then irrespective of the price paid on exercise, the option period must not be more than 27 months.

(i) *Restriction on amount of optioned stock.* (1) Under section 423(b)(8), an employee stock purchase plan must, by its terms, provide that no employee may be permitted to purchase stock under all the employee stock purchase plans of his employer corporation and its related corporations at a rate which exceeds $25,000 in fair market value of such stock (determined at the time the option is granted) for each calendar year in which any such option granted to such individual is outstanding at any time. In applying the limitation of section 423(b)(8)—

(i) The right to purchase stock under an option is deemed to accrue when the option (or any portion thereof) first becomes exercisable during the calendar year;

(ii) The right to purchase stock under an option accrues at the rate provided in the option, but in no case may such rate exceed $25,000 of fair market value of such stock (determined at the time such option is granted) for any one calendar year; and

(iii) A right to purchase stock which has accrued under one option granted pursuant to the plan may not be carried over to any other option.

If an option is granted under an employee stock purchase plan which satisfies the requirement of section 423(b)(8), but such option gives the optionee the right to buy stock in excess of the maximum rate allowable under such section and this paragraph, no portion of such option will be treated as having been granted under an employee stock purchase plan. Furthermore, if the option was granted to an employee entitled to the grant of an option under the terms of the plan or offering, and such employee is not granted an option under such offering which qualifies as an option granted under an employee stock purchase plan, such offering will not meet the requirements of section 423(b)(4). Accordingly, none of the options granted under such offering will be eligible for the special tax treatment of section 421.

(2) The limitation of section 423(b)(8) and this paragraph applies only to options granted under employee stock purchase plans and does not limit the amount of stock which an employee may purchase under qualified stock options (as defined in section 422(b)), restricted stock options (as defined in section 424(b)), or any other stock options (except those to which section 423 applies). Stock purchased under options to which section 423 does not apply will not limit the amount which an employee may purchase under an employee stock purchase plan, except for purposes of the 5-percent stock ownership provision of section 423(b)(3).

(3) Under the limitation of section 423(b)(8), an individual may purchase up to $25,000 of stock (based on the fair market value of such stock at the time the option was granted) in each calendar year during which an option granted to such individual under an employee stock purchase plan is outstanding. Alternatively, an individual may purchase more than $25,000 of stock (based on the fair market value of such stock at the time the option was granted) in a calendar year, so long as the total amount of stock which he purchases does not exceed $25,000 in fair market value of such stock (determined at the time the option was granted) for each calendar year in which the option was outstanding. If in any calendar year the individual holds two or more outstanding options granted under employee stock purchase plans of his employer corporation, or a related corporation of such corporation, his purchases of stock attributable to such year under all such options must not exceed $25,000 in fair market value of such stock (determined at the time such options were granted). Under an employee stock purchase plan, an individual may not purchase stock in anticipation that the option will be outstanding for some future year. Thus, the individual may purchase only the amount of stock which does not exceed the limitation of section 423(b)(8) for the year of the purchase and for preceding years during which the option was outstanding. Thus, the amount of stock which may be purchased under an option depends on the number of years in which the option is actually outstanding. The amount of stock which may be purchased under an employee stock purchase plan may not be increased by reason of the failure to grant an option in an earlier year under such plan, or by reason of the failure to exercise an earlier option. For example, if an option is granted to an individual and expires without having been exercised at all, the failure to exercise the option does not increase the amount of stock which such individual may be permitted to purchase under an option granted in a year following the year of such expiration. If an option granted under an employee stock purchase plan is outstanding in more than one calendar year, stock purchased pursuant to the exercise of such an option will be applied first, to the extent allowable under section

423(b)(8) and this paragraph, against the $25,000 limitation for the earliest year in which such option was outstanding, then, against the $25,000 limitation for each succeeding year, in order. For example, if an individual purchases $60,000 in fair market value of stock (determined at the time the option was granted) by the exercise of an option granted under an employee stock purchase plan of his employer corporation, and if such option was outstanding in 3 calendar years, then $25,000 in fair market value of such stock (determined at the time the option was granted) will be attributed to the first calendar year in which such option was outstanding, another $25,000 in fair market value of such stock will be attributed to the second calendar year in which such option was outstanding, and the remaining $10,000 in fair market value of such stock will be attributed to the last calendar year in which such option was outstanding. Thus, the individual may receive a right under another option granted under such employee stock purchase plan (or under an employee stock purchase plan of a parent or subsidiary corporation of his employer corporation) entitling him to purchase another $15,000 in fair market value of such stock (determined as of the date such option is granted) for such last calendar year.

(4) The application of section 423(b)(8) and this paragraph may be illustrated by the following examples:

Example (1). Assume that P Corporation maintains an employee stock purchase plan and that E is employed by P. On June 1, 1964, P grants E an option under the plan to purchase a total of 750 shares of P stock at $85 per share. On such date, the fair market value of P stock is $100 per share. The option provides that it cannot be exercised after May 31, 1966. Under section 423(b)(8), the option must not permit E to purchase more than 250 shares of P stock during the calendar year 1964, since 250 shares are equal to $25,000 in fair market value of P stock determined at the time of grant. During the calendar year 1965, E may purchase under such option an amount of P stock equal to the difference between $50,000 in fair market value of P stock (determined at the time the option was granted) and the fair market value of P stock (determined at the time of grant of the option) purchased during 1964. During the calendar year 1966, E may purchase an amount of P stock equal to the difference between $75,000 in fair market value of such stock (determined at the time of grant of the option) and the total amount of the fair market value of such stock (determined at the time of grant of the option) purchased under such option during the calendar years 1964 and 1965. E may purchase $25,000 of stock for the year 1964 and $25,000 of stock for the year 1966, although the option was outstanding for only a part of each of such years. However, E may not be granted another option under an employee stock purchase plan of P or a related corporation to purchase stock of any of such corporations during the calendar years 1964, 1965, and 1966, so long as the option granted June 1, 1964, is outstanding. If this option permitted E to purchase only $15,000 of P's stock for each year it is outstanding, then E could be granted another option by P, or by a related corporation, in 1964, permitting him to purchase an additional $10,000 of stock for each year it is outstanding.

Example (2). Assume the same facts as in example (1), and assume further that the option granted to E in 1964 is terminated in 1965 without any part of such option having been exercised, and that subsequent to such termination and during 1965, E is granted another option under P's employee stock purchase plan. Under such option, E may be permitted to purchase $25,000 of stock for 1965. On the other hand, if, in 1966, E exercised the option granted to him in 1964 and purchased 600 shares of P stock, 500 shares, the maximum amount of stock which could have been purchased in 1965 under the option, is treated as having been purchased for the years 1964 and 1965. Thus, only 100 shares of the stock are treated as having been purchased for 1966, and E may be permitted under the new option to purchase for 1966 stock having a fair market value of $15,000 at the time the new option is granted.

(j) *Restriction on transferability.* An employee stock purchase plan must, by its terms, provide that options granted under such plan are not transferable by the optionee otherwise than by will or the laws of descent and distribution, and must be exercisable, during his lifetime, only by him. For general rules relating to the restriction on transferability required by section 423(b)(9), see paragraph (b)(2) of § 1.421–7. For a limited exception to the requirement of section 423(b)(9), see section 425(h)(3).

(k) *Special rule where option price is between 85 percent and 100 percent of value of stock.* (1)(i) If all the conditions necessary for the application of section 421(a) exist, section 423(c) provides additional rules which are applicable in cases where, at the time the option is granted, the option price per share is less than 100 percent (but not less than 85 percent) of the fair market value of such share. In such case, upon the disposition of such share by the individual after the expiration of the 2-year and the 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) holding periods, or upon his death while owning such share (whether occurring before or after the expiration of such periods), there shall be included in the individual's gross income as compensation (and not as gain upon the sale or exchange of a capital asset) the lesser of—

(a) The amount, if any, by which the price paid under the option was exceeded by the fair market value of the share at the time the option was granted, or

(b) The amount, if any, by which the price paid under the option was exceeded by the fair market value of the share at the time of such disposition or death.

For purposes of applying the rules of section 423(c) and this paragraph, if the option price is not fixed or determinable at the time the option is granted, the option price will be computed as if the option had been exercised at such time. The amount of compensation resulting from the application of section 423(c) and this paragraph shall be included in the individual's gross income for the taxable year in which the disposition occurs, or for the taxable year closing with his death, whichever event results in the application of section 423(c).

(ii) The application of the special rules provided in section 423(c) shall not affect the rules provided in section 421(a) with respect to the individual exercising the option, the employer corporation, or its parent or subsidiary corporation. Thus, notwithstanding the inclusion of an amount as compensation in the gross income of an individual, as provided in section 423(c), no income results to the individual at the time the stock is transferred to him, and no deduction under section 162 is allowable at any time to the employer corporation or its parent or subsidiary with respect to such amount.

(iii) If, during his lifetime, the individual exercises an option granted under an employee stock purchase plan, but such individual dies before the stock is transferred to him pursuant to his exercise of the option, the transfer of such stock to the individual's executor, administrator, heir, or legatee is deemed, for the purpose of sections 421 and 423, to be a transfer of the stock to the individual exercising the option and a further transfer by reason of death from such individual to his executor, administrator, heir, or legatee.

(2) If the special rules provided in section 423(c) are applicable to the disposition of a share of stock by an individual, the basis of such share in the individual's hands at the time of such disposition, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 423(c). However, the basis of a share of stock acquired after the death of an employee by the exercise of an option granted to such employee under an employee stock purchase plan shall be determined in accordance with the rules of section 421(c) and paragraph (c) of §1.421–8. If the special rules provided in section 423(c) are applicable to a share of stock upon the death of an individual, the basis of such share in the hands of the estate or the person receiving the stock by bequest or inheritance shall be determined under section 1014, and shall not be increased by reason of the inclusion upon the decedent's death of any amount in his gross income under section 423(c). See example (9) of this paragraph with respect to the determination of basis of the share in the hands of a surviving joint owner.

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

Example (1). On June 1, 1964, the X Corporation grants to E, an employee, an option under X's employee stock purchase plan to purchase a share of X Corporation's stock for $85. The fair market value of the X Corporation stock on such date is $100 per share. On June 1, 1965, E exercises the option and on that date the X Corporation transfers the share of stock to E. On January 1, 1967, E sells the share for $150, its fair market value on that date. E makes his income tax return on the basis of the calendar year. The income tax consequences to E and X Corporations are as follows: (i) compensation in the amount of $15 is includible in E's gross income for 1967, the year of the disposition of the share. The $15 represents the difference between the option price ($85) and the fair market value of the share on the date the option was granted ($100), since such value is less than the fair market value of the share on the date of disposition ($150). For the purpose of computing E's gain or loss on the sale of the share, E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100. Since the share was sold for $150, E realizes a gain of $50, which is treated as long-term capital gain; (ii) the X Corporation is entitled to no deduction under section 162 at any time with respect to the share transferred to E.

Example (2). Assume the same facts as in example (1), except assume that E sells the share of X Corporation stock on January 1, 1968, for $75, its fair market value on that date. Since $75 is less than the option price ($85), no amount in respect of the sale is includable as compensation in E's gross income for 1968. E's basis for determining gain or loss on the sale is $85. Since E sold the share for $75, E realized a loss of $10 on the sale, which loss is treated as a long-term capital loss.

Example (3). Assume the same facts as in example (1), except assume that the option provides that the option price shall be 90 percent of the fair market value of the stock on the day the option is exercised. On June 1, 1965, when the option is exercised, the fair market value of the stock is $120 per share so that E pays $108 for the share of the stock. Compensation in the amount of $10 is includible in E's gross income for 1967, the year of the disposition of the share. This is determined in the following manner: The excess of the fair market value of the stock at the time of the disposition ($150) over the price paid for the share ($108) is $42; and the excess of the fair market value of the stock at the time the option was granted ($100) over the option price, computed as if the option had been exercised at such time ($90), is $10. Accordingly, $10, the lesser, is includible in gross income. In this situation, E's cost basis of $108 is increased by $10, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $118. Since the share was sold for $150, E realizes a gain of $32, which is treated as long-term capital gain.

Example (4). Assume the same facts as in example (1), except assume that instead of selling the share on January 1, 1967, E makes a gift of the share on that day. In such case $15 is includible as compensation in E's gross income for 1967. E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100, which becomes the donee's basis, as of the time of the gift, for determining gain or loss.

Example (5). Assume the same facts as in example (2) except assume that instead of selling the share on January 1, 1968, E makes a gift of the share on that date. Since the fair market value of the share on that day ($75) is less than the option price ($85), no amount in respect of the disposition by way of gift is includible as compensation in E's gross income for 1968. E's basis for the share is $85, which becomes the donee's basis, as of the time of the gift, for the purpose of determining gain. The donee's basis for the purpose of determining loss, determined under section 1015(a), is $75 (fair market value of the share at the date of gift).

Example (6). Assume the same facts as in example (1), except assume that after acquiring the share of stock on June 1, 1965, E dies on August 1, 1966, at which time the share has a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death, such $15 being the difference between the option price ($85) and the fair market value of the share when the option was granted ($100), since such value is less than the fair market value at date of death ($150). The basis of the share in the hands of E's estate is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example (7). Assume the same facts as in example (6), except assume that E dies on August 1, 1965, at which time the share has a fair market value of $150. Although E's death occurred within six months after the transfer of the share to him, the income tax consequences are the same as in example (6).

Example (8). Assume the same facts as in example (1), except assume that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and that E and his wife sold the share on June 15, 1966, for $150, its fair market value on that date. Compensation in the amount of $15 is includible in E's gross income for 1966, the year of the disposition of the share. The basis of the share in the hands of E and his wife for the purpose of determining gain or loss on the sale is $100, that is, the cost of $85 increased by the amount of $15 includible as compensation in E's gross income. The gain of $50 on the sale is treated as long-term capital gain, and is divided equally between E and his wife.

Example (9). Assume the same facts as in example (1), except assume that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and that E predeceased his wife on August 1, 1966, at which time the share had a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death. See example (6). The basis of the share in the hands of E's wife as survivor is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example (10). Assume the same facts as in example (9), except assume that E's wife predeceased him on July 1, 1966. Section 423(c) does not apply in respect of her death. Upon the subsequent death of E on August 1, 1966, the income tax consequences in respect of E's taxable year closing with the date of his death, and in respect of the basis of the share in the hands of his estate, are the same as in example (6). If E had sold the share on July 15, 1966 (after the death of his wife), for $150, its fair market value at that time, the income tax consequences would be the same as in example (1).

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§ 1.425–1 Definitions and special rules applicable to statutory options.

(a) *Corporate reorganizations, liquidations, etc.* (1)(i) The term ''issuing or assuming a stock option in a transaction to which section 425(a) applies'' means, for purposes of sections 421 through 425, a substitution of a new option for an old option, or an assumption of such old option, by an employer corporation, or a related corporation of such corporation, by reason of a corporate transaction (as defined by subdivision (ii) of this subparagraph), if—

(a) The excess of the aggregate fair market value of the shares subject to the option immediately after the substitution or assumption over the aggregate option price of such shares is not more than the excess of the aggregate fair market value of all shares subject to the option immediately before such substitution or assumption over the aggregate option price of such shares, and

(b) The new option or the assumption of the old option does not give the employee additional benefits which he did not have under the old option.

(ii) For purposes of this section, the term ''corporate transaction'' means any merger of a corporation into another corporation, any consolidation of two or more corporations into another corporation, any purchase or acquisition of property or stock by any corporation, any separation of a corporation (including a spin-off or other distribution of stock or property by a corporation), any reorganization of a corporation (whether or not such reorganization comes within the definition of such term in section 368), or any partial or complete liquidation by a corporation, if such action by such corporation results in a significant number of employees being transferred to a new employer or discharged, or in the creation or severance of a parent-subsidiary relationship.

(2)(i) A change in the terms of an option attributable to the issuance or assumption of an option by reason of a corporate transaction (as defined under section 425(a) and subparagraph (1)(ii) of this paragraph) is not a modification of such option. See section 425(h)(3) and paragraph (e) of this section. Thus, section 425(a), in effect, provides rules under which a new employer, or a parent or subsidiary of a new employer, may by reason of a corporate transaction assume a statutory option granted by the former employer or parent or subsidiary thereof, or issue a new statutory option in place of the option granted by the former employer or parent or subsidiary thereof, without having such assumption or substitution being considered as a modification of the option. For example, section 425(a) may apply where there is a merger of X Corporation into Y Corporation and Y Corporation wishes to employ the employees of X Corporation and to assume statutory options which had been granted to them by their former employer, X Corporation. Another example is where X Corporation forms a new subsidiary, Y Corporation, and transfers to it certain assets and employees, and where Y Corporation wishes to grant to such employees a statutory option to purchase its stock in place of the statutory option which they had to purchase stock of X Corporation.

(ii) Section 425(a) also provides rules under which a new parent or subsidiary corporation of the employer corporation may by reason of a corporate transaction assume a statutory option granted by the employer or parent or subsidiary thereof, or issue a new statutory option in place of the option granted by the employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. Section 425(a) may apply, for example, where X Corporation acquires a new subsidiary, Y Corporation, by purchase of stock and desires to grant to the employees of Y Corporation a statutory option to buy stock of X Corporation in place of a statutory option which they have to purchase the stock of Y Corporation.

(iii) Section 425(a) applies only when the assumption or substitution occurs by reason of a corporate transaction as defined in this paragraph. Thus, section 425(a) may apply where as a result of a corporate transaction a statutory option can no longer be exercised, or if exercised, section 421 would not apply (see the first example in subdivision (i) of this subparagraph). Moreover, section 425(a) may apply in any case where the reason for the assumption or substitution grows out of a corporate transaction even though there could have been a valid exercise under section 421 of the original option (see the second example in subdivision (i) of this subparagraph and the example in subdivision (ii) of this subparagraph). However, a corporation which has issued an option may not substitute a new option for such option under section 425(a). See, however, paragraph (e) of this section.

(3) For section 425(a) to apply, it is not necessary to show that the corporation assuming or substituting the option is under any obligation to do so. In fact, section 425(a) may apply where the option which is being assumed or replaced expressly provides that it will terminate upon the occurrence of certain corporate transactions. However, section 425(a) cannot be applied to revive a statutory option which, for reasons not related to the corporate transaction, expires before it can properly be assumed or replaced under section 425(a). For section 425(a) to apply, the assumed or substituted option must qualify as a statutory option.

(4)(i) Section 425(a) does not apply if the terms of the assumed or substituted option confer on the employee more favorable benefits than he had under the old option. Section 425(a) can apply to a corporate transaction only if, on a share by share comparison, the ratio of the option price to the fair market value of the stock subject to the option immediately after the substitution or assumption is no more favorable to the optionee than the ratio of the option price to the fair market value of the stock subject to the old option immediately before such substitution or assumption. The number of shares subject to an option issued or assumed may be adjusted to compensate for any change in the aggregate spread between the aggregate option price and the aggregate fair market value of the stock subject to the option immediately after the substitution or assumption as compared to the aggregate spread between the option price and the aggregate fair market value of the stock subject to the option immediately before such substitution or assumption. Such an adjustment will not prevent section 425(a) from applying to such substitution or assumption.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). On June 1, 1965, P Corporation acquires 100 percent of the stock of S Corporation and on such date S becomes a subsidiary of P Corporation. Also on such date, P Corporation substitutes a qualified stock option to purchase P stock for a qualified stock option to purchase S stock held by E, an employee of S. Assume that E's S option had 3 years to run on the date of the substitution. If the P option granted to E in substitution for his S option runs for more than 3 years from the date of the substitution, section 425(a) cannot apply, since the effect of such an option would be to give E an additional benefit which he did not enjoy under his S option.

Example (2). E is an employee of S Corporation. E holds a qualified stock option which was granted to him by S to purchase 60 shares of S stock at $12 per share. On June 1, 1967, S Corporation is merged into P Corporation, and on such date P substitutes a qualified stock option to purchase P stock for E's qualified stock option to purchase S stock. Immediately before the substitution, the fair market value of S stock was $32 per share; immediately after the substitution, the fair market value of P stock is $24 per share. The new option entitles E to buy P stock at $9 per share. Since on a share by share comparison the ratio of the new option price ($9 per share) to the fair market value of P stock immediately after the substitution ($24 per share) is not more favorable to E than the ratio of the old option price ($12 per share) to the fair market value of S stock immediately before the substitution ($32 per share) ($9/24 = 12/32$) the requirement of subparagraph (4)(i) of this paragraph is met. The number of shares subject to E's option to purchase P stock is set at 80. Since the excess of the aggregate fair market value over the aggregate option price of the stock subject to E's new option to purchase P stock, $1,200 (80×$24 minus 80×$9), is not greater than the excess of the aggregate fair market value over the aggregate option price of the stock subject to E's old option to purchase S stock, $1,200 (60×$32 minus 60×$12), the requirement of subparagraph (1)(i)*(a)* of this paragraph is met. Thus, section 425(a) may apply to the substitution.

Example (3). Assume the same facts as in example (2), except assume that the fair market value of S stock immediately before the substitution was $8 per share and that the option price was $10 per share, and that the fair market value of P stock immediately after the substitution is $12 per share. P sets the new option price at $15 per share. Since on a share by share comparison the ratio of the new option price ($15 per share) to the fair market value of P stock immediately after the substitution ($12 per share) is not more favorable to E than the ratio of the old option price ($10 per share) to the fair market value of S stock immediately before the substitution ($8 per share) ($15/12 = 10/8$), the requirement of subparagraph (4)(i) of this paragraph is met. Assume further that the number of shares subject to E's P option is set at 20 as compared to 60 shares under E's old option to buy S stock. Immediately after the substitution, 2 shares of P stock are worth $24, which is what 3 shares of S stock were worth immediately before the substitution (2×$12=3×$8). Thus, to completely replace E's S option, E should have received an option to purchase 40 shares of P stock, *i.e.,* 2 shares of P for each 3 shares of S which E could have purchased under his old option ($2/3 = 40/60$). Since E's new option covers 20 shares of P stock, it is clear that P has replaced only ½ of E's stock option. The portion of E's stock option which was not replaced by P is an outstanding stock option to purchase stock of a predecessor corporation of P Corporation for purposes of section 422(b)(5) and (c)(2).

(5) For the purpose of applying section 425(a), the assumption or substitution shall be considered to occur at the time that the optionee would, except for section 425(a), be considered to have been granted the option which the employer corporation, or parent or subsidiary thereof, is issuing or assuming. An assumption or substitution which occurs by reason of a corporate transaction may occur before or after the corporate transaction.

(6) In order to have a substitution of an option under section 425(a) the optionee must, in connection with the corporate transaction, lose his rights under the old option. There cannot be a substitution of a new option for an old option within the meaning of section 425(a) if it is contemplated that the optionee may exercise both the old option and the new option. It is not necessary, however, to have a complete substitution of a new option for the old option. However, if the old option was a qualified or restricted stock option, any portion of such option which is not substituted or assumed in a transaction to which section 425(a) applies will be treated as an outstanding option to purchase stock of a predecessor corporation of the new employer or grantor corporation. See section 422 (b)(5) and (c)(2) and paragraph (f) of § 1.422–2. For example, assume that X Corporation forms a new corporation, Y Corporation, by a transfer of certain assets and distributes the stock of Y Corporation to the shareholders of X Corporation. Assume further that E, an employee of X Corporation, is thereafter an employee of both X Corporation and Y Corporation. Y Corporation wishes to substitute an option to purchase some of its stock for the statutory option which E has, entitling him to purchase 100 shares of the stock of X Corporation. The option to purchase the stock of X Corporation, at $50 a share, was granted when the stock had a fair market value of $50 a share, and the stock was worth $100 a share just before the distribution of the new corporation's stock to the shareholders of X Corporation. The stock of X Corporation and of Y Corporation is worth $50 a share just after such distribution, which also is the time of the substitution. On these facts an option to purchase 200 shares of stock of Y Corporation at $25 a share could be given to the employee in complete substitution for the old option. It would also be permissible to give the employee an option to purchase 100 shares of stock of Y Corporation at $25 a share in substitution for his right to purchase 50 of the

shares covered by the old option. However, if the option to purchase X stock was a qualified or restricted stock option, then to the extent the old option is not assumed or a new option issued in substitution therefor in a transaction to which section 425(a) applies, such old option will be treated as an outstanding option under section 422(c)(2) for purposes of section 422(b)(5). See paragraph (f) of §1.422–2.

(7) Any reasonable methods may be used to determine the fair market value of the stock subject to the option immediately before the assumption or substitution and the fair market value of the stock subject to the option immediately after the assumption or substitution. Such methods include the valuation methods described in §20.2031–2 of this chapter (the Estate Tax Regulations). In the case of stock listed on a stock exchange, the fair market value may be based on the last sale before and the first sale after the assumption or substitution if such sales clearly reflect the fair market value of the stock, or may be based upon an average selling price during a longer period, such as the day or week before, and the day or week after, the assumption or substitution. If the stocks are not listed, or if they are newly issued, it will be reasonable to base the determination on experience over even longer periods. In the case of a merger, consolidation, or other reorganization which is arrived at by arm's-length negotiations, the fair market value of the stocks subject to the option before and after the assumption or substitution may be based upon the values assigned to the stock for purposes of the reorganization. For example, if in the case of a merger the parties treat each share of the merged company as being equal in value to a share of the surviving company, it will be reasonable to assume that the stocks are of equal value so that the substituted option may permit the employee to purchase at the same price one share of the surviving company for each share he could have purchased of the merged company.

(8) For the purpose of applying section 425(a) and this paragraph, the determination of whether the parent-subsidiary relationship exists shall be based upon circumstances existing immediately after the corporate transaction.

(b) *Acquisition of new stock.* (1) Section 425(b) provides that the rules provided by sections 421 through 425 which are applicable with respect to stock transferred to an individual upon his exercise of an option, shall likewise be applicable with respect to stock acquired by a distribution or an exchange to which section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applies. Stock so acquired shall, for purposes of sections 421 through 425, be considered as having been transferred to the individual upon his exercise of the option. A similar rule shall be applied in the case of a series of such acquisitions. With respect to such acquisitions, section 425(b) does not make inapplicable any of the provisions of section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036).

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

Example. If, with respect to stock transferred pursuant to the timely exercise of a statutory option, there is a distribution of new stock to which section 305(a) is applicable, and if there is a disposition of such new stock before the expiration of the applicable holding period required with respect to the stock originally acquired pursuant to the exercise of such option, such disposition makes section 421 inapplicable to the transfer of the original stock pursuant to the exercise of the option to the extent that the disposition effects a reduction of the individual's total interest in the old and new stock. However, if the new stock, as well as the old stock, is not disposed of before the expiration of the holding period required with respect to the original stock acquired pursuant to the exercise of the option, the special tax treatment provided by section 421 is applicable to both the original shares and the shares acquired by virtue of the distribution to which section 305(a) applies.

(c) *Disposition of stock.* (1) For purposes of sections 421 through 425, the term ''disposition'' includes a sale, exchange, gift, or any transfer of legal title, but does not include—

(i) A transfer from a decedent to his estate or a transfer by bequest or inheritance; or

(ii) An exchange to which is applicable section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036); or

(iii) A mere pledge or hypothecation. However, a disposition of the stock pursuant to a pledge or hypothecation is a disposition by the individual, even though the making of the pledge or hypothecation is not such a disposition.

(2) A share of stock acquired by an individual pursuant to the exercise of a statutory option is not considered disposed of by the individual if such share is taken in the name of the individual and another person jointly with right of survivorship, or is subsequently transferred into such joint ownership, or is retransferred from such joint ownership to the sole ownership of the individual. However, any termination of such joint ownership (other than a termination effected by the death of a joint owner) is a disposition of such share, except to the extent the individual reacquires ownership of the share. For example, if such individual and his joint owner transfer such share to another person, the individual has made a disposition of such share. Likewise, if a share of stock held in the joint names of such individual and another person is transferred to the name of such other person, there is a disposition of such share by the individual. If an individual exercises a statutory option and a share of stock is transferred to another or is transferred to such individual in his name as trustee for another, the individual has made a disposition of such share. However, a termination of joint ownership resulting from the death of one of the owners is not a disposition of such share. For determination of basis in the hands of the survivor where joint ownership is terminated by the death of one of the owners, see section 1014.

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

Example (1). On June 1, 1964, the X Corporation grants to E, an employee, a qualified stock option to purchase 100 shares of X Corporation stock at $100 per share, the fair market value of X Corporation stock on that date. On June 1, 1965, while employed by X Corporation, E exercises the option in full and pays X Corporation $10,000, and on that day X Corporation transfers to E 100 shares of its stock having a fair market value of $12,000. Before June 1, 1968, E makes no disposition of the 100 shares so purchased. E realizes no income on June 1, 1965, with respect to the transfer to him of the 100 shares of X Corporation stock. X Corporation is not entitled to any deduction at any time with respect to its transfer to E of the stock. E's basis for such 100 shares is $10,000.

Example (2). Assume the same facts as in example (1), except assume that on August 1, 1968, three years and two months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for $13,000 which is the fair market value of the stock on that date. For the taxable year in which the sale occurs, E realizes a gain of $3,000 ($13,000 minus E's basis of $10,000), which is treated as long-term capital gain.

Example (3). Assume the same facts as in example (2), except assume that on August 1, 1968, E makes a gift of the 100 shares of Y Corporation stock to his son. Such disposition results in no realization of gain to E either for the taxable year in which the option is exercised or the taxable year in which the gift is made. E's basis of $10,000 becomes the donee's basis for determining gain or loss.

Example (4). Assume the same facts as in example (1), except assume that on May 1, 1968, two years and 11 months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for $13,000. The special rules of section 421(a) are not applicable to the transfer of the stock by X Corporation to E, because disposition of the stock was made by E within three years from the date the shares were transferred to him.

Example (5). Assume the same facts as in example (1), except assume that E dies on September 1, 1965, owning the 100 shares of X Corporation stock acquired by him pursuant to his exercise on June 1, 1965, of the qualified stock option. On the date of death, the fair market value of the stock is $12,500. No income is realized by E by reason of the transfer of the 100 shares to his estate. If the stock is valued as of the date of E's death for estate tax purposes, the basis of the 100 shares in the hands of the executor is $12,500.

Example (6). Assume the same facts as in example (1), except assume that on June 1, 1965, when the option is exercised by E the 100 shares are transferred by X to E and his wife W, as joint owners with right of survivorship, and that E dies on July 1, 1965. Neither the transfer into joint ownership nor the termination of such joint ownership by E's death is a disposition. Because E has made no disqualifying disposition of the shares, section 421(a) is applicable and E realizes no income at death with respect to the shares even though he held the stock less than 3 years after the transfer of the shares to him pursuant to his exercise of a qualified stock option. See paragraph (b)(2) of § 1.421–8.

(d) *Attribution of stock ownership.* Section 425(d) provides that in determining the amount of stock owned by an individual for purposes of applying the percentage limitations of section 422(b)(7), 423(b)(3), and 424(b)(3), stock of the employer corporation or of a related corporation which is owned (directly or indirectly) by or for such individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants, shall be considered as owned by such individual. Also, for such purpose, if a domestic or foreign corporation, partnership, estate, or trust owns (directly or indirectly) stock of the employer corporation or of its parent or subsidiary, such stock shall be considered as being owned proportionately by or for the shareholders, partners, or beneficiaries of the corporation, partnership, estate, or trust.

(e) *Modification, extension, or renewal of option.* (1) Section 425(h) provides the rules for determining whether a share of stock transferred to an individual upon his exercise of an option, after the terms thereof have been modified, extended, or renewed, is transferred pursuant to the exercise of a statutory option. Such rules and the rules of this section are applicable to modifications, extensions, or renewals (or to changes which are not treated as modifications) of an option in any taxable year of the optionee which begins after December 31, 1963, except that section 425(h)(1) and this paragraph shall not apply to any change made before January 1, 1965, in the terms of an option granted after December 31, 1963, to permit such option to meet the requirements of section 422(b) (3), (4), or (5), and the regulations thereunder. See paragraphs (d), (e), and (f), of §1.422–2, relating to period for exercising options, option price, and prior outstanding options, respectively, in the case of qualified stock options.

(2) Any modification, extension, or renewal of the terms of an option to purchase stock shall be considered as the granting of a new option.

(3) Except as otherwise provided in subparagraph (4) of this paragraph, in case of a modification, extension, or renewal of an option, the highest of the following values shall be considered to be the fair market value of the stock at the time of the granting of such option for purposes of applying the rules of sections 423(b)(6), and 424(b)(1)—

(i) The fair market value on the date of the original granting of the option,

(ii) The fair market value on the date of the making of such modification, extension, or renewal, or

(iii) The fair market value at the time of the making of any intervening modification, extension, or renewal.

(4)(i) In the case of a modification, extension, or renewal of a restricted stock option before January 1, 1964 (or after December 31, 1963, if made pursuant to a binding written contract entered into before January 1, 1964), the rules of subparagraph (3) of this paragraph do not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months preceding the month in which the modification, extension, or renewal occurs, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest. In such case, any modification, extension, or renewal of the option is treated as the granting of a new option but only the fair market value of the stock subject to the option at the time of the modification, extension, or renewal is considered in determining whether the option is a restricted stock option. In the case of stocks listed on a stock exchange, the average fair market value of the stock for any month may be determined by adding the highest and lowest quoted selling prices during such month and dividing the sum by two. The method used for determining the average fair market value of the stock for any month must be used for all twelve months, except where it is shown that such method cannot be used for any month or does not clearly reflect the average fair market value of the stock for any such month.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On June 1, 1962, a restricted stock option was granted to purchase before July

1, 1965, a share of stock for $85. The fair market value of such stock on June 1, 1962, was $100. On June 15, 1963, when the fair market value of the stock is $60, such option is extended so that it is exercisable at any time before July 1, 1966, at $55 a share. The average fair market value of the stock subject to the option for each of the 12 calendar months preceding June 1963, is as follows:

1962	
June	$100
July	90
August	80
September	70
October	$80
November	80
December	90
1963	
January	90
February	80
March	70
April	60
May	60

The aggregate of such values is $950. When this sum is divided by 12, the result is $79.17, which is an amount less than 80 percent of the fair market value of the stock ($100) when the option was granted. Accordingly, when the option is extended on June 15, 1963, the option price could have been reduced as low as $51 (85 percent of the fair market value of the stock on such day) without disqualifying the option as a restricted stock option. If the aggregate fair market values of the stock so ascertained had amounted to $960 or more, the rules of subparagraph (3) of this paragraph would have been applicable with the result that any reduction in the option price would have disqualified the option as a restricted stock option.

(5)(i) The time or date when an option is modified, extended, or renewed shall be determined, insofar as applicable, in accordance with the rules governing determination of the time or date of granting an option provided in paragraph (c) of § 1.421–7. For purposes of sections 421 through 425, the term ‘‘modification’’ means any change in the terms of the option which gives the optionee additional benefits under the option. For example, a change in the terms of the option, which shortens the period during which the option is exercisable, is not a modification. However, a change which provides more favorable terms for the payment for the stock purchased under the option, is a modification. Where an option is amended solely to increase the number of shares subject to the option, such increase shall not be considered as a modification of the option, but shall be treated as the grant of a new option for the additional shares.

(ii)*(a)* A change in the number or price of the shares of stock subject to an option merely to reflect a stock dividend, or stock split-up, is not a modification of the option.

(b) A change in the number or price of the shares of stock subject to an option to reflect a corporate transaction (as defined by paragraph (a)(1) (ii) of this section) is not a modification of the option provided that the excess of the aggregate fair market value (determined immediately after such corporate transaction) of the shares subject to the option immediately after such change over the aggregate new option price of such shares is not more than the excess of the aggregate fair market value of the shares subject to the option immediately before the transaction over the aggregate former option price of such shares, and provided that the option after such change does not give the employee additional benefits which he did not have before such change. The ratio of the option price immediately after the change to the fair market value of the stock subject to the option immediately after the corporate transaction must not be more favorable to the optionee on a share by share comparison than the ratio of the old option price to the fair market value of the stock subject to the option immediately before such a transaction. A reduction in the option price of an option, other than as specifically provided for in this section, is a modification of such option.

(c) The application of *(b)* of this subdivision may be illustrated by the following example:

Example. E, an employee of P Corporation, holds a qualified stock option granted to him by P to buy 90 shares of P stock at $36 per share. P Corporation is a party to a corporate transaction (as defined by paragraph (a)(1)(ii) of this section) which results in a decline in the fair market value of P stock. Immediately before such transaction the fair market value of P stock was $64 per share. Immediately after such transaction, the fair market value of P stock is $48 per share. Two weeks after such transaction, P proposes to amend E's option in order to reflect the decline in the fair market value of P stock attributable to the transaction. At such time, the fair market value of P stock is $50 per share. However, since the change was not made at the time of the transaction, the fair market value of P stock at the time of the change is irrelevant for purposes of determining whether the change comes under the rule of *(b)* of this subdivision. P changes the terms of E’s option to lower the option price to $27 per share and to increase the number of shares subject to the option to 120. No other terms of the option are changed. The aggregate fair market value (determined immediately after the corporate transaction) of the shares subject to the option immediately after the change is $5,760 ($48 × 120). The aggregate option price of the shares subject to the option immediately after the change is $3,240 ($27 × 120). Thus, the excess of such fair market value over such option price is $2,520 ($5,760 − $3,240). The aggregate fair market value of the stock subject to the option immediately before the corporate transaction is $5,760 ($64 × 90). The aggregate option price for the stock subject to the option immediately before the change is $3,240 ($36 × 90). Thus, the excess of such fair market value over such option price is $2,520 ($5,760 − $3,240). Accordingly, the excess after the change does not exceed the excess before the corporate transaction. Moreover, the ratio of the option price immediately after the change ($27 per share) to the fair market value of P stock immediately after the transaction ($48 per share) is not more favorable to E on a share by share comparison than the ratio of the old option price ($36 per share) to the fair market value of P stock immediately before the transaction ($64) ($\frac{27}{48} = \frac{36}{64}$). For purposes of section 425(h), the changes made do not confer additional benefits on E which he did not have before the change. Accordingly, the changes do not constitute a modification of E’s option.

(iii) Any change in the terms of an option for the purpose of qualifying the option as a statutory option grants additional benefits and, therefore, is a modification. However, if the terms of an option are changed to provide that the optionee cannot transfer the option except by will or by the laws of descent and distribution in order to meet the requirements of section 422(b)(6), 423(b)(9), or 424(b)(2), such change is not a modification, provided that in any case where the purpose of the change is to meet the requirements of section 424(b)(2) the option is at the same time changed so that it is not exercisable after the expiration of ten years from the date the option was granted. Where an option is not immediately exercisable in full, a change in the terms of such option to accelerate the time at which the option (or any portion thereof) may be exercised is not a modification for purposes of section 425(h) and this section. A modification results where an option is revised to insert the language required by section 422(c)(6)(B).

(iv) An extension of an option refers to the granting by the corporation to the optionee of an additional period of time within which to exercise the option beyond the time originally prescribed. A renewal of an option is the granting by the corporation of the same rights or privileges contained in the original option on the same terms and conditions. The rules of this paragraph apply as well to successive modifications, extensions, and renewals.

(6) A statutory option may, as a result of a modification, extension, or renewal, thereafter cease to be a statutory option, or any option may, by modification, extension, or renewal, thereafter become a statutory option. Moreover, a qualified option after a modification may not be exercisable in accordance with its terms because of the requirements of section 422(b)(5) and section 422(c)(6). See paragraph (f)(3)(i) of §1.422–2 and examples (8) and (9) of paragraph (f)(4) of §1.422–2.

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

Example (1). On June 1, 1964, the X Corporation grants to an employee an option under X’s employee stock purchase plan to purchase 100 shares of the stock of X Corporation at $90 per share, such option to be exercised on or before June 1, 1966. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1965, before the employee exercises the option, X Corporation modifies the option to provide that the price at which the employee may purchase the stock shall be $80 per share. On February 1, 1965, the fair market value of the X Corporation stock is $90 per share. Under section 425(h), the X Corporation is deemed to have granted an option to the employee on February 1, 1965. Such option shall be treated as an option to purchase at $80 per share 100 shares of stock having a fair market value of $100 per share, that is, the higher of the fair market value of the stock on June 1, 1964, or on February 1, 1965. The exercise of such option by the employee after February 1, 1965, is not the exercise of a statutory option.

Example (2). On June 1, 1964, the X Corporation grants to an employee an option under

X's employee stock purchase plan to purchase 100 shares of X Corporation stock at $90 per share, exercisable after December 31, 1965, and on or before June 1, 1966. On June 1, 1964, the fair market value of X Corporation's stock is $100 per share. On February 1, 1965, X Corporation modifies the option to provide that the option shall be exercisable on or before September 1, 1966. On February 1, 1965, the fair market value of X Corporation stock is $110 per share. Under section 425(h), X Corporation is deemed to have granted an option to the employee on February 1, 1965, to purchase at $90 per share 100 shares of stock having a fair market value of $110 per share, that is, the higher of the fair market value of the stock on June 1, 1964, or on February 1, 1965. The exercise of such option by the employee is not the exercise of a statutory option.

Example (3). The facts are the same as in example (1), except that the employee exercised the option to the extent of 50 shares on January 15, 1965, before the date of the modification of the option. Any exercise of the option after February 1, 1965, the date of the modification, is not the exercise of a statutory option. See example (1) in this subparagraph. The exercise of the option on January 15, 1965, pursuant to which 50 shares were acquired, is the exercise of a statutory option.

Example (4). On June 1, 1964, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at $80 per share, such option to be exercised on or before June 1, 1966. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1965, before the employee exercises the option, the X Corporation modifies the option to provide that the number of shares of stock which the employee may purchase at $80 per share will be 250. On February 1, 1965, the fair market value of X Corporation stock is $80 per share. Under these facts, the X Corporation has granted two options, one option (not a statutory option) with respect to 100 shares having been granted on June 1, 1964, and the other option (a qualified stock option) with respect to the additional 150 shares having been granted on February 1, 1965. In the absence of facts identifying which option is exercised first, the employee will be deemed to have exercised the options in the order in which they were granted.

[T.D. 6887, 31 FR 8808, June 24, 1966]

SUBCHAPTER A—INCOME TAX (Continued)

PART 1—INCOME TAXES (Continued)

Normal Taxes and Surtaxes (Continued)

DEFERRED COMPENSATION, ETC.

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1.482–2A Determination of taxable income in specific situations.

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Accounting Periods and Methods of Accounting

ACCOUNTING PERIODS

§ 1.441–1T Period for computation of taxable income (temporary).

(a) *Computation of taxable income.* Taxable income shall be computed and a return shall be made for a period known as the ''taxable year.'' For rules relating to methods of accounting, the taxable year for which items of gross income are included and deductions are taken, inventories, and adjustments, see parts II and III (section 446 and following), subchapter E, chapter 1 of the Code, and the regulations thereunder.

(b) *Taxable year*—(1) *Definition of taxable year*—(i) *In general.* Except as otherwise provided in this paragraph (b)(1), the term ''taxable year'' means—

(A) The taxpayer's annual accounting period if it is a calendar year or a fiscal year; or

(B) The calendar year if section 441(g) (relating to taxpayers who keep no books or have no accounting period) applies. Except as provided in administrative provisions of the Internal Revenue laws, a taxable year may not cover a period of more than 12 calendar months. If a return is made under section 443 for a period of less than 12 months (a ''short period''), the taxable year is the short period for which the return is made.

(ii) *Special rules for certain entities.* The general rule provided in paragraph (b)(1)(i) of this section may be modified by the Internal Revenue laws or regulations. For example, special rules are provided for the following taxpayers—

(A) In the case of personal service corporations, the applicable rules are contained in § 1.441–4T.

(B) In the case of partnerships, the applicable rules are contained in § 1.706–1T.

(C) In the case of S corporations, the applicable rules are contained in section 1378.

(D) In the case of members of an affiliated group which makes a consolidated return, the applicable rules are contained in § 1.1502–76 and paragraph (d) of § 1.442–1.

(E) In the case of trusts, the applicable rules are contained in section 645.

(F) In the case of real estate investment trusts, the applicable rules are contained in section 859.

(G) In the case of real estate mortgage investment conduits, the applicable rules are contained in section 860D(a)(5).

(H) In the case of FSCs or DISCs, the applicable rules are contained in section 441(h).

(2) *Adoption of taxable year.* A new taxpayer adopts a taxable year on or before the time prescribed by law (not including extensions) for the filing of the taxpayer's first return and may adopt, without prior approval, any taxable year that satisfies the requirements of section 441 and this section.

(3) *Change in taxable year*—(i) *General rule.* After a taxpayer has adopted a taxable year, such year must be used in computing taxable income and making returns for all subsequent years unless prior approval is obtained from the Commissioner to make a change or unless a change is otherwise permitted or required under the Internal Revenue laws or regulations. See section 442 and § 1.442–1. Also see paragraph (b)(4) of this section.

(ii) *Change in taxable year required by the Tax Reform Act of 1986.* Procedures for entities (certain personal service corporations, partnerships and S corporations) required to change their taxable year under section 806 of the Tax Reform Act of 1986, Pub. L. 99–514, 100 Stat. 2362, are provided in Rev. Proc. 87–32, 1987–28 I.R.B. 14, or successor revenue procedures.

(4) *Retention of taxable year*—(i) *In general.* In certain cases, taxpayers will be required under the Internal Revenue laws or regulations to change their taxable year unless they establish a business purpose for retaining their current taxable year. For example, corporations electing to be S corporations. corporations that are personal service corporations for the first time, and certain partnerships with new partners may be required to change their taxable year unless they establish a business purpose for retaining their current taxable year.

(ii) *Section 806 of the Tax Reform Act of 1986.* Rev. Proc. 87–32 provides (and any successor revenue procedure would provide) procedures for certain entities (i.e., personal service corporations, partnerships and S corporations) requesting the Commissioner's approval to retain a fiscal year when such entity would otherwise be required to change its taxable year under section 806 of the Tax Reform Act of 1986. In addition, personal service corporations should see Announcement 87–82, 1987–37 I.R.B. 30, for modifications to Rev. Proc. 87–32 extending the due date for personal service corporations requesting the Commissioner's approval to establish a business purpose.

(c) *Annual accounting period.* The term ''annual accounting period'' means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes his income in keeping his books.

(d) *Calendar year.* The term ''calendar year'' means a period of 12 months ending on December 31. A taxpayer who has not established a fiscal year must make his return on the basis of a calendar year.

(e) *Fiscal year.* (1) The term ''fiscal year'' means—

(i) A period of 12 months ending on the last day of any month other than December, or

(ii) The 52–53-week annual accounting period, if such period has been elected by the taxpayer.

(2) A fiscal year will be recognized only if it is established as the annual accounting period of the taxpayer and only if the books of the taxpayer are kept in accordance with such fiscal year.

(f) *Election of year consisting of 52–53 weeks.* For rules relating to the 52–53-week taxable year, see §§1.441–2T, 1.441–3T, and 1.441–4T.

(g) *No books kept; no accounting period.* Except as otherwise provided in the Internal Revenue laws or regulations, the taxpayer's taxable year shall be the calendar year if—

(1) The taxpayer keeps no books;

(2) The taxpayer does not have an annual accounting period (as defined in section 441(c) and paragraph (c) of this section); or

(3) The taxpayer has an annual accounting period, but such period does not qualify as a fiscal year (as defined in section 441(e) and paragraph (e) of this section).

For the purposes of paragraph (g)(1) of this section, the keeping of books does not require that records be bound. Records which are sufficient to reflect income adequately and clearly on the basis of an annual accounting period will be regarded as the keeping of books. A taxpayer whose taxable year is required to be a calendar year under section 441(g) and this paragraph (g) may not adopt a fiscal year without obtaining prior approval from the Commissioner. See section 442 and §1.442–1T(a)(2).

(h) *Effective date.* This section is effective for taxable years beginning after December 31, 1986. See 26 CFR 1.441–1 (revised as of April 1, 1987) for rules applicable to taxable years beginning before January 1, 1987.

(Secs. 860(e), (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)); and sec. 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11701, Nov. 26, 1960. Redesignated and amended by T.D. 8167, 52 FR 48526, Dec. 23, 1987]

§1.441–2T Election of year consisting of 52–53 weeks (temporary).

(a) *General rule.* Section 441(f) provides, in general, that a taxpayer may elect to compute his taxable income on the basis of a fiscal year which—

(1) Varies from 52 to 53 weeks,

(2) Ends always on the same day of the week, and

(3) Ends always on—

(i) Whatever date this same day of the week last occurs in a calendar month, or

(ii) Whatever date this same day of the week falls which is nearest to the last day of the calendar month.

For example, if the taxpayer elects a taxable year ending always on the last Saturday in November, then for the year 1956, the taxable year would end on November 24, 1956. On the other hand, if the taxpayer had elected a taxable year ending always on the Saturday nearest to the end of November, then for the year 1956, the taxable year would end on December 1, 1956. Thus, in the case of a taxable year described in subparagraph (3)(i) of this paragraph, the year will always end within the month and may end on the last day of the month, or as many as six days before the end of the month. In the case of a taxable year described in subparagraph (3)(ii) of this paragraph, the year may end on the last day of the month, or as many as three days before or three days after the last day of the month.

(b) *Application of effective dates.* (1) For purposes of determining the effective date or the applicability of any provision of this title which is expressed in terms of taxable years beginning, including, or ending with reference to the first or last day of a specified calendar month, a 52–53-week taxable year is deemed to begin on the first day of the calendar month beginning nearest to the first day of the 52–53-week taxable year, and is deemed to end or close on the last day of the calendar month ending nearest to the last day of the 52–53-week taxable year, as the case may be. Examples of provisions of this title the applicability of which is expressed in terms referred to in the preceding sentence include the provisions of this title the applicability of which is expressed in terms referred to in the preceding sentence include the provisions relating to the time for filing returns and other documents, paying tax, or performing other acts, and the provisions of part II (section 1561 and following), subchapter B, chapter 6, relating to surtax exemptions of certain controlled corporations. The provisions of this subparagraph do not apply to the computation of the tax if subparagraph (2) of this paragraph, relating to the computation under section 21 of the effect of changes in rates of tax during a taxable year, applies. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Assume that an income tax provision is applicable to taxable years beginning on or after January 1, 1957. For that purpose, a 52–53-week taxable year beginning on any day within the period December 26, 1956, to January 4, 1957, inclusive, shall be treated as beginning on January 1, 1957.

Example (2). Assume that an income tax provision requires that a return must be filed on or before the 15th day of the third month following the close of the taxable year. For that purpose, a 52–53-week taxable year ending on any day during the period May 25 to June 3, inclusive, shall be treated as ending on May 31, the last day of the month ending nearest to the last day of the taxable year, and the return, therefore, must be made on or before August 15.

Example (3). X, a corporation created on January 1, 1966, elects a 52–53-week taxable year ending on the Friday nearest the end of December. Thus, X's first taxable year begins on Saturday, January 1, 1966, and ends on Friday, December 30, 1966; its next taxable year begins on Saturday, December 31, 1966, and ends on Friday, December 29, 1967; and its next taxable year begins on Saturday, December 30, 1967, and ends on Friday, January 3, 1969. For purposes of applying the provisions of Part II, subchapter B, chapter 6 of the Code, X's first taxable year is deemed to begin on January 1, 1966, and end on December 31, 1966; its next taxable year is deemed to begin on January 1, 1967, and end on December 31, 1967; and its next taxable year is deemed to begin on January 1, 1968, and end on December 31, 1968. Accordingly, each such taxable year is treated as including one and only one December 31st.

(2) If a change in the rate of tax is effective during a 52–53-week taxable year (other than on the first day of such year as determined under subparagraph (1) of this paragraph), the tax for the 52–53-week taxable year shall be computed in accordance with section 21, regulating to effect of changes, and the regulations thereunder. For the purpose of the computation under section 21, the determination of the number of days in the period before the change, and in the period on and after the change, is to be made without regard to the provisions of subparagraph (1) of this paragraph. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Assume a change in the rate of tax is effective for taxable years beginning after June 30, 1956. For a 52–53-week taxable year beginning on Wednesday, November 2, 1955, the tax must be computed on the basis of the old rates for the actual number of days, from November 2, 1955, to June 30, 1956, inclusive, and on the basis of the new rates for the actual number of days from July 1, 1956, to Tuesday, October 30, 1956, inclusive.

Example (2). Assume a change in the rate of tax for taxable years beginning after June 30. For this purpose, a 52–53-week taxable year beginning on any of the days from June 25 to July 4, inclusive, is treated as beginning on July 1. Therefore, no computation under section 21 will be required for such year because of the change in rate.

(c) *Adoption of or change to or from 52–53-week taxable year.* (1) A new taxpayer may adopt the 52–53-week taxable year for his first taxable year if he keeps his books and computes his income on that basis, or if he conforms his books accordingly in closing them. The taxpayer must thereafter keep his books and report his income on the basis of the 52–53-week taxable year so adopted unless prior approval for a change is obtained from the Commissioner. See subparagraph (4) of this paragraph. The taxpayer shall file with his return for his first taxable year a statement containing the information required in subparagraph (3) of this paragraph. A newly-formed partnership may adopt a 52–53-week taxable year without the permission of the Commissioner only if such a year ends either with reference to the same month in which the taxable years of all its principal partners end or with reference to the month of December. See paragraph (b)(1) of §1.706–1.

(2) A taxpayer, including a partnership, may change to a 52–53-week taxable year without the permission of the Commissioner if the 52–53-week taxable year ends with reference to the end of the same calendar month as that in which the former taxable year ended, and if the taxpayer keeps his books and computes his income for the year of change on the basis of such 52–53-week taxable year, or if he conforms his books accordingly in closing them. The taxpayer must continue to keep his books and compute his income on the basis of such 52–53-week taxable year unless prior approval for a change is obtained. See subparagraph (4) of this paragraph. The taxpayer shall indicate his election to change to such 52–53-week taxable year by a statement filed with his return for the first taxable year for which the election is made. This statement shall contain the information required in subparagraph (3) of this paragraph.

(3) The statement referred to in subparagraphs (1) and (2) of this paragraph shall contain the following information:

(i) The calendar month with reference to which the new 52–53-week taxable year ends;

(ii) The day of the week on which the 52–53-week taxable year always will end; and

(iii) Whether the 52–53-week taxable year will always end on *(a)* the date on which such day of the week falls in the calendar month, or *(b)* on the date on which such day of the week last occurs which is nearest to the last day of such calendar month.

(4) Where a taxpayer wishes to change to a 52–53-week taxable year and, in addition, wishes to change the month with reference to which the taxable year ends, or where a taxpayer wishes to change from a 52–53-week taxable year, he must obtain prior approval from the Commissioner, as provided in section 442 and §1.442–1.

(5) If a change from or to a 52–53-week taxable year results in a short period (within the meaning of section 443) of 359 days or more, or six days or less, the tax computation under section 443(b) shall not apply. If the short period is 359 days or more, it shall be treated as a full taxable year. If the short period is six days or less, such short period is not a separate taxable year but shall be added to and deemed a part of the following taxable year. (In the case of a change from or to a 52–53-week taxable year not involving a change of the month with reference to which the taxable year ends, the tax computation under section 443(b) does not apply since the short period will always be 359 days or more, or six days or less.) In the case of a short period which is more than six days, but less than 359 days, taxable income for the short period shall be placed on an annual basis for the purpose of section 443(b) by multiplying such income by 365 and dividing the result by the number of days in the short period. In such case, the tax for the short period shall be the same part of the tax computed on such income placed on an annual basis as the number of days in the short period is of 365 days (unless section 443(b)(2) and paragraph (b)(2) of §1.443–1, relating to the alternative tax computation, apply). For adjustment in deduction for personal exemption, see section 443(c) and paragraph (b)(1)(v) of §1.443–1.

(6) The provisions of subparagraph (5) of this paragraph are illustrated by the following examples:

Example (1). A taxpayer having a fiscal year ending April 30 elects for years beginning after April 30, 1955, a 52–53-week taxable year ending on the last Saturday in April. This election involves a short period of 364 days, from May 1, 1955, to April 28, 1956, inclusive. Since this short period is 359 days or more, it is not placed on an annual basis and is treated as a full taxable year.

Example (2). Assume the same conditions as in example (1), except that the taxpayer elects for years beginning after April 30, 1955, a taxable year ending on the Tuesday nearest to April 30. This election involves a short period of three days, from May 1 to May 3, 1955. Since this short period is less than seven days, tax is not separately computed for it. This short period is added to and deemed part of the following 52-week taxable year which would otherwise begin on May 4, 1955, and end on May 1, 1956. Thus, that taxable year is deemed to begin on May 1, 1955, and end on May 1, 1956.

(d) *Computation of taxable income.* The principles of section 451, relating to the taxable year for inclusion of items of gross income, and section 461, relating to the taxable year for taking deductions, are generally applicable to 52–53-week taxable years. Thus, items of income and deductions are determined on the basis of a 52–53-week taxable year, except that such items may be determined as though the 52–53-week taxable year were a taxable year consisting of 12 calendar months if such practice is consistently followed by the taxpayer and if income is clearly reflected thereby. In the case of depreciation, unless some other practice is consistently followed, the allowance shall be determined as though the 52–53-week year were a taxable year consisting of 12 calendar months. Amortization deductions for the taxable year shall be determined as though the 52–53-week year were a taxable year consisting of 12 calendar months.

(e) *Partnerships, S corporations, and personal service corporations*—(1) *In general.* Paragraph (e) of this section applies if a partnership, partner, S corporation, S corporation shareholder, personal service corporation (within the meaning of § 1.441–4T(d)), or employee-owner (within the meaning of § 1.441–4T(h)) uses a 52–53-week taxable year.

(2) *Treatment of taxable years ending with reference to the same calendar month*—(i) *Timing of partners taking into account partnership items.* If the taxable year of a partnership and a partner end with reference to the same ca!endar month, then for purposes of determining the taxable year in which a partner takes into account—

(A) Items described in section 702, and

(B) Items that are deductible by the partnership (including items described in section 707(c)) and includible in the income of the partner, the partner's taxable year will be deemed to end on the last day of the partnership's taxable year.

(ii) *Timing of S shareholders taking into account S corporation items.* If the taxable year of an S corporation and a shareholder end with reference to the same calendar month, then for purposes of determining the taxable year in which a shareholder takes into account—

(A) Items described in section 1366(a), and

(B) Items that are deductible by the S corporation and includible in the income of the shareholder, the shareholder's taxable year will be deemed to end on the last day of the S corporation's taxable year.

(iii) *Personal service corporations and employee-owners.* If the taxable year of a personal service corporation and an employee-owner end with reference to the same calendar month, then for purposes of determining the taxable year in which an employee-owner takes into account items that are deductible by the personal service corporation and includible in the income of the employee-owner, the employee-owner's taxable year will be deemed to end on the last day of the personal service corporation's taxable year.

(3) *Automatic approval for partnerships and S corporations.* If a partnership or S corporation is required to use a taxable year ending with respect to the last day of a particular month and the partnership or S corporation desires to use a 52–53-week taxable year with reference to such month, the partnership or S corporation is granted automatic approval to use such 52–53-week taxable year. See § 1.441–4T(b)(2)(ii) for a similar rule for personal service corporations.

(4) *Examples.* The provisions of paragraph (e)(2) of this section may be illustrated by the following examples.

Example (1). ABC Partnership uses a 52–53-week taxable year that ends on the Sunday nearest to December 31, and its partners, A, B, and C, are individual calendar year taxpayers. Assume that, for ABC's taxable year ending January 3, 1988, each partner's distributive share of ABC's taxable income is $10,000. Under section 706(a) and paragraph (e)(2)(i) of this section, for the taxable year ending December 31, 1987, A, B, and C each must include $10,000 in income with respect to the ABC year ending January 3, 1988. Similarly, if ABC makes a guaranteed payment to A on January 2, 1988, A must include the payment in income for his or her taxable year ending December 31, 1987.

Example (2). X, a personal service corporation, uses a 52–53-week taxable year that ends on the Sunday nearest to December 31, and all of the employee-owners of X are individual calendar year taxpayers. Assume that, for its taxable year ending January 3, 1988, X pays a bonus of $10,000 to each employee-owner. Under paragraph (e)(2)(iii) of this section, each employee-owner must include the bonus in income for the taxable year ending December 31, 1987.

(5) *Effective date.* Paragraph (e) of this section applies to taxable years beginning after December 31, 1986.

(f) *Special rules for 1986 and subsequent years.* For special rules relating to certain adoptions of, or changes to or from, a 52–53-week taxable year ending in 1986 or 1987, see §1.441–3T. For special rules relating to a 52–53-week taxable year beginning after December 31, 1986, see §1.441–2T(e).

[T.D. 6500, 25 FR 11702, Nov. 26, 1960, as amended by T.D. 6845, 30 FR 9739, Aug. 5, 1965. Redesignated and amended by T.D. 8167, 52 FR 48527, Dec. 23, 1987]

§1.441–3T Special rules for certain adoptions of, retentions of, or changes to or from a 52–53-week taxable year (temporary).

(a) *Applicability.* This section applies to any partnership, partner, S corporation, S corporation shareholder, personal service corporation, or employee-owner that wishes to adopt or change to or from a 52–53-week taxable year. This section also applies to a corporation seeking S status that wishes to adopt, retain, or change to or from a 52–53-week taxable year. This section applies in the case of a change to or from a 52–53-week taxable year whether or not the taxpayer also wishes to change the month with reference to which its taxable year ends. Paragraph (c)(2) of this section applies to any taxpayer (including, for example, a corporation that is not seeking S status) that wishes to adopt or change to or from a 52–53-week taxable year.

(b) *Definitions*—(1) *Personal service corporation.* For purposes of this section only, the term ''personal service corporation'' means any corporation (other than an S corporation) if—

(i) The principal activity of that corporation is the performance of personal services, and

(ii) Such services are substantially performed by employee-owners.

A corporation shall not be treated as a personal service corporation, however, unless more than 10 percent of the fair market value of the outstanding stock of the corporation is held by employee-owners.

(2) *Employee-owner.* For purposes of this section, the term ''employee-owner'' means an employee who owns, on any day of the corporation's taxable year, any outstanding stock of the personal service corporation. Section 318 will apply to determine stock ownership for purposes of this paragraph (b), except that ''any'' is to be substituted for ''50 percent or more in value'' in section 318(a)(2)(C).

(3) *Performance of a substantial portion of services.* For purposes of paragraph (b)(1) of this section, personal services are substantially performed by employee-owners if the total time spent by employee-owners in performing those services is 10 percent or more of the total time spent by all employees (including employee-owners) in performing those services. In determining time spent in performing personal services of a corporation, time spent on matters that do not relate directly and intrinsically to the performance of services for or on behalf of clients or customers of the corporation shall not be taken into account. Thus, for example, in the case of a corporation performing accounting services, time spent in performing secretarial services, managerial work of a purely administrative nature, or janitorial services shall not be taken into account in

determining either the time spent by employee-owners in performing accounting services or the total time spent by all employees in performing accounting services. Managerial time shall be taken into account, however, to the extent that it consists of the supervision of accounting services performed by employees for or on behalf of clients or customers of the corporation.

(c) *General rule*—(1) *Satisfaction of applicable conditions.* A taxpayer to which this section applies may not adopt, retain, or change to or from a 52–53-week taxable year under § 1.441–2(c) (1) or (2), § 1.442–1, or 26 CFR 18.1378–1 unless each of the applicable conditions set forth in paragraph (d) of this section is satisfied with respect to the taxpayer seeking the adoption, retention, or change. For additional requirements applicable to certain taxpayers that wish to adopt, retain, or change to or from a 52–53-week taxable year, see §§ 1.442–2T and 1.442–3T.

(2) *Evasion or avoidance of tax*—(i) *General rule.* A taxpayer may not adopt or change to or from a 52–53-week taxable year if the principal purpose for such action is the evasion or avoidance of Federal income tax.

(ii) *Example.* The provisions of this paragraph (c)(2) may be illustrated by the following example.

Example. Assume that X, a calendar year corporation, wishes to elect, for taxable years beginning after December 31, 1985, a 52–53-week taxable year that ends on the Tuesday nearest to December 31. Assume that such election allows the corporation to sell a substantial portion of its assets on Wednesday, December 31, 1986, and to report the income from such sale in the taxable year beginning on December 31, 1986, and ending on December 29, 1987. By electing the 52–53-week taxable year, the corporation obtains the advantages of the lower Federal income tax rates applicable for the period beginning December 31, 1986. Moreover, the sale of the assets on December 31 allows the buyer of the assets, a calendar year taxpayer, to obtain certain Federal income tax advantages that are not available with respect to purchases of assets in 1987 and later years. Given the above facts, it is presumed that the principal purpose for such action is the evasion or avoidance of Federal income tax. Thus, X may not adopt a 52–53-week taxable year.

(d) *Conditions applicable to certain taxpayers*—(1) *Conditions.* (i) If the taxpayer seeking the adoption or change is a partnership, all of the partners (determined at the close of the first taxable year of the partnership for which the election to use the 52–53-week taxable year is made or, if applicable, the short period involved in the change) must agree to treat the current and all subsequent 52–53-week years of the partnership (and of any partner) as ending on the last day of the calendar month that ends nearest to the last day of the 52–53-week year for purposes of determining the taxable year in which the inclusions required by sections 702 and 707(c) are taken into account.

(ii) If the taxpayer seeking the adoption or change is a partner, the partner must agree to treat the current and all subsequent 52–53-week years of the partner (and the 52–53-week years of any partnership in which such taxpayer is a partner) as ending on the last day of the calendar month that ends nearest to the last day of the 52–53-week year for purposes of determining the taxable year in which the inclusions required by sections 702 and 707(c) are taken into account.

(iii) If the taxpayer seeking the adoption, retention, or change is an S corporation or a corporation seeking S status, all of the shareholders (determined at the close of the first taxable year of the S corporation for which the election to use or retain the 52–53-week year is made or, if applicable, the short period involved in the change) must agree to treat the current and all subsequent 52–53-week taxable years of the corporation (and of any shareholder) as ending on the last day of the calendar month that ends nearest to the last day of the 52–53-week year for purposes of determining the taxable year in which the inclusions required by section 1366 are taken into account.

(iv) If the taxpayer seeking the adoption or change is an S corporation shareholder, the shareholder must agree to treat the current and all subsequent 52–53-week taxable years of the shareholder (and the 52–53-week years of any S corporation in which such taxpayer is a shareholder) as ending on the last day of the calendar month that ends nearest to the last day of the 52–

53-week year for purposes of determining the taxable year in which the inclusions required by section 1366 are taken into account.

(v) If the taxpayer seeking the adoption or change is a personal service corporation, all of the employee-owners (determined at the close of the first taxable year of the corporation for which the election to use the 52–53-week taxable year is made or, if applicable, the short period involved in the change) must agree to treat the current and all subsequent taxable years of an employee-owner and the corporation that end with or with reference to the same calendar month as if both such taxable years ended on the last day of the taxable year of the corporation for purposes of determining the taxable year in which payments (whether or not in cash) that are deductible by the corporation are taken into account by the employee-owner.

(vi) If the taxpayer seeking the adoption or change is an employee-owner of a personal service corporation, the employee-owner must agree to treat the current and all subsequent taxable years of the employee-owner and the corporation that end with or with reference to the same calendar month as if both such taxable years ended on the last day of the taxable year of the corporation for purposes of determining the taxable year in which payments (whether or not in cash) that are deductible by the corporation are taken into account by the employee-owner.

(2) *Examples.* The provisions of paragraph (d)(1) of this section may be illustrated by the following examples.

Example (1). Assume that ABC, a calendar year partnership, wishes to elect, for taxable years beginning after December 31, 1985, a 52–53-week taxable year that ends on the Friday nearest to December 31. Assume that A, B, and C, who are individual calendar year taxpayers, are equal partners in ABC. Assume also that A, B, and C agree to treat each of the 52–53-week taxable years of ABC as ending on December 31 for purposes of determining the taxable year in which guaranteed payments and their distributive shares of income, gains, losses, deductions, and credits are taken into account. Assume that, for its taxable year ending January 2, 1987, ABC has net income of $30,000, and that ABC has no other items of income, gain, loss, deduction, or credit for that taxable year. Under paragraph (d)(1)(i) of this section, A, B, and C each must include $10,000 in income for their taxable years ending on December 31, 1986. Similarly, if ABC makes a guaranteed payment to A on January 2, 1987, A must include the payment in income for the taxable year ending December 31, 1986.

Example (2). Assume that X, a calendar year personal service corporation, wishes to elect, for taxable years beginning after December 31, 1985, a 52–53-week taxable year that ends on the Friday nearest to December 31. Assume that all of the employer-owners of X are individual calendar year taxpayers. Assume further that all of the employee-owners agree to treat their taxable year as ending on the last day of X's taxable year for purposes of determining the year in which payments by X are taken into income. Assume that on January 2, 1987, X makes a payment of bonuses of $10,000 to each employee-owner. Under paragraph (d)(1)(v) of this section, each employee-owner must include $10,000 in income for the taxable year ending December 31, 1986.

(e) *Procedural requirements.* In the case of an adoption of or change to a 52–53-week taxable year under § 1.441–2(c) (1) or (2), a taxpayer to which any condition in paragraph (d) of this section applies must indicate on the statement required under § 1.441–2(c) (1) or (2), or on a separate statement that is attached to the income tax return for the year of adoption or change, that all of the applicable conditions are satisfied. If the due date for that return is before March 9, 1987, the statement required under § 1.441–2(c) (1) or (2) (or an amended statement) indicating that the applicable conditions are satisfied must be filed by the later of March 9, 1987 or the due date for the return (determined with regard to extensions). If § 1.442–2T or § 1.442–3T applies to an adoption of, retention of, or change to or from a 52–53-week taxable year, the procedures set forth in § 1.442–2T or § 1.442–3T (whichever is applicable) must be followed and the rules set forth in § 1.442–2T(f)(3) or § 1.442–3T(d) shall apply.

(f) *Effective date*—(1) *In general.* This section shall apply to adoptions of, retentions of, or changes to or from a 52–53-week taxable year if—

(i) The income tax return for the first taxable year for which the election to use or retain the 52–53-week year is made (or, if applicable, the income tax return for the short period involved in the change) is filed after September 29, 1986, and

(ii) The first taxable year for which the election to use or retain the 52–53-week year is made (or the short period involved in the change) ends before January 5, 1987.

(2) *Exceptions.* This section shall not apply if the application required to effect or request the adoption, retention, or change was timely filed before September 30, 1986. In the case of an adoption or change that is effected by filing an income tax return for the first taxable year for which the election is made, this section shall not apply if an application for extension of time for filing that return was filed before September 30, 1986, the application clearly stated the taxpayer's intention to adopt or change to a 52–53-week taxable year, and the income tax return for that taxable year is timely filed (determined with regard to extensions).

[T.D. 8123, 52 FR 3617, Feb. 5, 1987]

§ 1.441–4T Taxable year of a personal service corporation (temporary).

(a) *Taxable year.* The taxable year of a personal service corporation (as defined in paragraph (d) of this section) is—

(1) The calendar year, or a ''short period'' (as provided in § 1.441–1T(b)(1)(i)) ending December 31; or

(2) A fiscal year, or a short period (other than a short period provided in paragraph (a)(1) of this section), if the corporation obtains the approval of the Commissioner (in accordance with paragraph (c) of this section) for using such fiscal year.

(b) *Change in taxable year required*—(1) *In general.* For any taxable year beginning after December 31, 1986, a taxpayer that is a personal service corporation for such taxable year must—

(i) Use a taxable year described in paragraph (a) of this section; or

(ii) Change to such a taxable year by using a short taxable year that ends on the last day of a taxable year described in paragraph (a) of this section.

(2) *Approval not required for change to a calendar year*—(i) *In general.* A personal service corporation may change its taxable year to the calendar year without the approval of the Commissioner. In such cases, however, the taxpayer should notify the Internal Revenue Service of the change in accordance with the provisions of the applicable revenue procedure. See, for example, section 5.02(1) of Rev. Proc. 87–32, 1987–28 I.R.B. 14.

(ii) *Special rule for 52–53-week taxable year ending with reference to the month of December.* For purposes of this section, a 52–53-week taxable year of a personal service corporation ending with reference to the month of December shall be treated as the calendar year. In order to assist in the processing of the retention or change in taxable year, taxpayers should refer to this special rule by either typing or legibly printing the following statement at the top of page 1 of the income tax return: ''FILED UNDER § 1.441–4T(b)(2)(ii).'' See § 1.441–2T(e) for special rules regarding 52–53-week taxable years for personal service corporations.

(3) *Examples.* The provisions of paragraph (b) of this section may be illustrated by the following examples.

Example (1). X corporation's last taxable year beginning before January 1, 1987, ends on January 31, 1987. In addition, X is a personal service corporation for its taxable year beginning February 1, 1987, and does not obtain the approval of the Commissioner for using a fiscal year. Thus, under paragraph (b)(1) of this section, X is required to change its taxable year to the calendar year by using a short taxable year that begins on February 1, 1987, and ends on December 31, 1987. Under paragraph (b)(2)(i) of this section, X may change its taxable year without the consent of the Commissioner, but should notify the Internal Revenue Service of the change in accordance with section 5.02(1) of Rev. Proc. 87–32.

Example (2). Assume the same facts as in example (1), except that for its taxable year beginning February 1, 1987, X obtains the approval of the Commissioner to change its annual accounting period to a fiscal year ending September 30. Under paragraph (b)(1) of this section, X must file a tax return for the short period from February 1, 1987, through September 30, 1987.

Example (3). Assume the same facts as in example (1), except that the first taxable year for which X is a personal service corporation is the taxable year that begins on February 1, 1990. Thus, for taxable years ending before that date, this section does not apply with respect to X. For its taxable year beginning on February 1, 1990, however, X will be required to comply with paragraph (b) of this section. If X does not obtain the approval of the Commissioner to use a fiscal year, X will be required to change its taxable year to the calendar year by using a short taxable year that ends on December 31, 1990.

Example (4). Assume the same facts as in example (1), except that X desires to change to a 52–53-week taxable year ending with reference to the month of December. Pursuant to paragraphs (b)(2)(i) and (b)(2)(ii) of this section, X may change its taxable year to a 52–53-week taxable year ending with reference to the month of December without the consent of the Commissioner, but should notify the Internal Revenue Service of the change in accordance with paragraph (b)(2)(ii) of this section.

(c) *Approval of a fiscal year.* A personal service corporation must establish to the satisfaction of the Commissioner a business purpose for using a fiscal year under paragraph (a)(2) of this section. Business purpose is established to the satisfaction of the Commissioner in the case of a personal service corporation that—

(1) Requests to use, or is using, a fiscal year that coincides with its natural business year, as defined in section 4.01(1) of Rev. Proc. 87–32, or successor revenue procedures, or

(2) Receives permission from the Commissioner to use the fiscal year by establishing a business purpose for the fiscal year under section 6.01 of Rev. Proc. 87–32, or successor revenue procedures. See also Rev. Rul. 87–57, 1987–28 I.R.B. 7. See Announcement 87–82 for modifications to Rev. Proc. 87–32 regarding due dates for personal service corporations filing applications and income tax returns for certain short taxable years beginning after December 31, 1986.

(d) *Personal service corporation for a taxable year*—(1) *In general.* For purposes of this section, a taxpayer is a personal service corporation for a taxable year only if—

(i) The taxpayer is a C corporation (as defined in section 1361(a)(2)) for the taxable year;

(ii) The principal activity of the taxpayer during the testing period for the taxable year is the performance of personal services;

(iii) During the testing period for the taxable year, such services are substantially performed by employee-owners; and

(iv) Employee-owners, as defined in paragraph (h) of this section, own (as determined under the attribution rules of section 318, except that ‘‘any’’ shall be substituted for ‘‘50 percent’’ in section 318(a)(2)(C)) more than 10 percent of the fair market value of the outstanding stock in the taxpayer on the last day of the testing period for the taxable year.

(2) *Testing period*—(i) *In general.* Except as otherwise provided in paragraph (d)(2)(ii) of this section, the testing period for a taxable year is the taxable year preceding such taxable year.

(ii) *New corporations.* The testing period for a taxpayer's first taxable year is the period beginning on the first day of such taxable year and ending on the earlier of—

(A) The last day of such taxable year; or

(B) The last day of the calendar year in which such taxable year begins.

(3) *Examples.* The provisions of paragraph (d)(2) of this section may be illustrated by the following examples.

Example (1). Corporation A has been in existence since 1980 and has used a January 31 taxable year for all taxable years beginning before 1987. For purposes of determining whether A is a personal service corporation for the taxable year beginning February 1, 1987, A's testing period under paragraph (d)(2)(i) of this section is the taxable year ending January 31, 1987.

Example (2). B corporation's first taxable year begins on June 1, 1987, and B desires to use a September 30 taxable year. However, if B is a personal service corporation, it must obtain the Commissioner's approval to use a September 30 taxable year. Pursuant to paragraph (d)(2)(ii) of this section, B's testing period for its first taxable year beginning June 1, 1987, is the period June 1, 1987 through September 30, 1987. Thus, if, based upon such testing period, B is a personal service corporation, B must obtain the Commissioner's permission to use a September 30 taxable year.

Example (3). The facts are the same as in Example (2), except that B desires to use a March 31 taxable year. Pursuant to paragraph (d)(2)(ii) of this section, B's testing period for its first taxable year beginning June 1, 1987, is the period June 1, 1987, through December 31, 1987. Thus, if, based upon such testing period, B is a personal service corporation, B must obtain the Commissioner's permission to use a March 31 fiscal year.

(e) *Determination of whether an activity during the testing period is treated as the performance of personal services*—(1) *Activities described in section 448(d)(2)(A).*

For purposes of this section, any activity of the taxpayer described in section 448(d)(2)(A) or the regulations thereunder will be treated as the performance of personal services. Therefore, any activity of the taxpayer that involves the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (as such fields are defined in the regulations interpreting section 448) will be treated as the performance of personal services for purposes of this section.

(2) *Activities not described in section 448(d)(2)(A).* For purposes of this section, any activity of the taxpayer not described in section 448(d)(2)(A) or the regulations thereunder will not be treated as the performance of personal services.

(f) *Principal activity*—(1) *General rule.* For purposes of this section, the principal activity of a corporation for any testing period will be considered to be the performance of personal services if the cost of the corporation's compensation (the ''compensation cost'') for such testing period that is attributable to its activities that are treated as the performance of personal services under paragraph (e) of this section exceeds 50 percent of the corporation's total compensation cost for such testing period.

(2) *Compensation cost.* For purposes of this section, the compensation cost of a corporation for a taxable year is equal to the sum of the following amounts allowable as a deduction, allocated to a long-term contract, or otherwise chargeable to a capital account by the corporation during such taxable year—

(i) Wages and salaries, and

(ii) Any other amounts attributable to services performed for or on behalf of the corporation by a person who is an employee of the corporation (including an owner of the corporation who is treated as an employee under paragraph (h)(2) of this section) during the testing period. Such amounts include, but are not limited to, amounts attributable to deferred compensation, commissions, bonuses, compensation includible in income under section 83, compensation for services based on a percentage of profits, and the cost of providing fringe benefits that are includible in income.

However, for purposes of this section, compensation cost does not include amounts attributable to a plan qualified under section 401(a) or 403(a), or to a simplified employee pension plan defined in section 408(k).

(3) *Attribution of compensation cost to personal service activity*—(i) *Employees involved only in the performance of personal services.* The compensation cost for employees involved only in the performance of activities that are treated as personal services under paragraph (e) of this section, or employees involved only in supporting the work of such employees, shall be considered to be attributable to the corporation's personal service activity.

(ii) *Employees involved only in activities that are not treated as the performance of personal services.* The compensation cost for employees involved only in the performance of activities that are not treated as personal services under paragraph (e) of this section, or for employees involved only in supporting the work of such employees, shall not be considered to be attributable to the corporation's personal service activity.

(iii) *Other employees.* The compensation cost for any employee who is not described in either paragraph (f)(3)(i) or paragraph (f)(3)(ii) of this section (''a mixed activity employee'') shall be allocated as follows—

(A) *Compensation cost attributable to personal service activity.* That portion of the compensation cost for a mixed activity employee that is attributable to the corporation's personal service activity equals the compensation cost for such employee multiplied by the percentage of the total time worked for the corporation by such employee during the year that is attributable to activities of the corporation that are treated as the performance of personal services under paragraph (e) of this section. Such percentage shall be determined by the taxpayer in any reasonable and consistent manner. Time logs are not required unless maintained for other purposes;

(B) *Compensation cost not attributable to personal service activity.* That portion of the compensation cost for a mixed activity employee that shall not be considered to be attributable to the corporation's personal service activity is the compensation cost for such employee less the amount determined in paragraph (f)(3)(iii)(A) of this section.

(g) *Services substantially performed by employee-owners*—(1) *General rule.* Personal services are substantially performed during the testing period by employee-owners of the corporation if more than 20 percent of the corporation's compensation cost for such period attributable to its activities that are treated as the performance of personal services (within the meaning of paragraph (e) of this section), is attributable to personal services performed by employee-owners.

(2) *Compensation cost attributable to personal services.* For purposes of paragraph (g)(1) of this section—

(i) The corporation's compensation cost attributable to its activities that are treated as the performance of personal services shall be determined under paragraph (f)(3) of this section; and

(ii) The portion of the amount determined under paragraph (g)(2)(i) of this section that is attributable to personal services performed by employee-owners shall be determined by the taxpayer in any reasonable and consistent manner.

(3) *Examples.* The provisions of paragraph (g) of this section may be illustrated by the following examples.

Example (1). For its taxable year beginning February 1, 1987, Corporation A's testing period is the taxable year ending January 31, 1987. During such testing period, A's only activity was the performance of personal services. The total compensation cost of A (including compensation cost attributable to employee-owners) for the testing period was $1,000,000. The total compensation cost attributable to employee-owners of A for the testing period was $210,000. Pursuant to paragraph (g)(1) of this section, the employee-owners of A substantially performed the personal services of A during the testing period because the compensation cost of A's employee-owners was more than 20 percent of the total compensation cost for all of A's employees (including employee-owners).

Example (2). Corporation B has the same facts as corporation A in example (1), except that during the taxable year ending January 31, 1987, B also participated in an activity that would not be characterized as the performance of personal services under this section. The total compensation cost of B (including compensation cost attributable to employee-owners) for the testing period was $1,500,000 ($1,000,000 attributable to B's personal service activity and $500,000 attributable to B's other activity). The total compensation cost attributable to employee-owners of B for the testing period was $250,000 ($210,000 attributable to B's personal service activity and $40,000 attributable to B's other activity). Pursuant to paragraph (g)(1) of this section, the employee-owners of B substantially performed the personal services of B during the testing period because more than 20 percent of B's compensation cost during the testing period attributable to its personal service activities was attributable to personal services performed by employee-owners ($210,000).

(h) *Employee-owner defined*—(1) *General rule.* For purposes of this section, a person is an employee-owner of a corporation for a testing period if—

(i) The person is an employee of the corporation on any day of the testing period, and

(ii) The person owns any outstanding stock of the corporation on any day of the testing period.

(2) *Special rule for independent contractors who are owners.* Any person who is an owner of the corporation within the meaning of paragraph (h)(1)(ii) of this section and who performs personal services for or on behalf of the corporation shall be treated as an employee for purposes of this section, even if the legal form of that person's relationship to the corporation is such that he or she would be considered an independent contractor for other purposes.

(i) *Special rules for affiliated group filing consolidated return*—(1) *In general.* For purposes of applying this section to the members of an affiliated group of corporations filing a consolidated return for the taxable year—

(i) The members of the affiliated group shall be treated as a single corporation;

(ii) The employees of the members of the affiliated group shall be treated as employees of such single corporation; and

(iii) All of the stock, of the members of the affiliated group, that is not owned by any other member of the affiliated group shall be treated as the outstanding stock of such corporation.

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

Example (1). The affiliated group AB, consisting of corporation A and its wholly owned subsidiary B, filed a consolidated Federal income tax return for the taxable year ending January 31, 1987, and AB is attempting to determine whether it is affected by this section for its taxable year beginning February 1, 1987. During the testing period (i.e., the taxable year ending January 31, l987), A did not perform personal services while B's only activity was the performance of personal services. On the last day of the testing period, employees of A did not own any stock in A while some of B's employees own stock in A. In the aggregate, B's employees own 9 percent of A's stock on the last day of the testing period. Pursuant to paragraph (i)(1) of this section, this section is effectively applied on a consolidated basis to members of an affiliated group filing a consolidated Federal income tax return. Since the only employee-owners of AB are the employees of B and since B's employees do not own more than 10 percent of AB on the last day of the testing period, AB is not subject to the provisions of this section. Thus, AB is not required to determine on a consolidated basis whether, during the testing period, (a) its principal activity is the providing of personal services, or (b) the personal services are substantially performed by employee-owners.

Example (2). The facts are the same as in example (1), except that on the last day of the testing period A owns only 80 percent of B. The remaining 20 percent of B is owned by employees of B. The fair market value of A, including its 80 percent interest in B, as of the last day of the testing period, is $1,000,000. In addition, the fair market value of the 20 percent interest in B owned by B's employees is $5,000 as of the last day of the testing period. Pursuant to paragraph (d)(1)(iv) and paragraph (i)(1) of this section, AB must determine whether the employee-owners of A and B (*i.e.,* B's employees) own more than 10 percent of the fair market value of A and B as of the last day of the testing period. Since the $14,000 [($100,000.09)+ $5,000] fair market value of the stock held by B's employees is greater than 10 percent of the $105,000 ($100,000+$5,000) aggregate fair market value of A and B as of the last day of the testing period, AB may be subject to this section if, on a consolidated basis during the testing period, (a) the principal activity of AB is the performance of personal services and (b) the personal services are substantially performed by employee-owners.

(j) *Effective date.* This section applies to taxable years beginning after December 31, 1986.

[T.D. 8167, 52 FR 48528, Dec. 23, 1987]

§ 1.442–1 Change of annual accounting period.

(a) *Manner of effecting such change*—(1) *In general.* If a taxpayer wishes to change his annual accounting period (as defined in section 441(c)) and adopt a new taxable year (as defined in section 441(b)), he must obtain prior approval from the Commissioner by application, as provided in paragraph (b) of this section, or the change must be authorized under the Income Tax Regulations. A new taxpayer who adopts an annual accounting period as provided in section 441 and §§ 1.441–1 or 1.441–2 need not secure the permission of the Commissioner under section 442 and this section. However, see subparagraph (2) of this paragraph. For adoption of and changes to or from a 52–53-week taxable year, see section 441(f) and § 1.441–2; for adoption of and changes in the taxable years of partners and partnerships, see paragraph (b)(2) of this section, section 706(b) and paragraph (b) of § 1.706–1; for special rules relating to certain corporations, subsidiary corporations, and newly married couples, see paragraphs (c), (d), and (e), respectively, of this section. For special rules relating to real estate investment trusts, see section 859.

(2) *Taxpayers to whom section 441(g) applies.* Section 441(g) provides that if a taxpayer keeps no books, does not have an annual accounting period, or has an accounting period which does not meet the requirements for a fiscal year, his taxable year shall be the calendar year. If section 441(g) applies to a taxpayer, the adoption of a fiscal year will be treated as a change in his annual accounting period under section 442. Therefore, such fiscal year can become the taxpayer's taxable year only with the approval of the Commissioner. Approval of any such change will be denied unless the taxpayer agrees in his application to establish and maintain accurate records of his taxable income for the short period involved in the change and for the fiscal year proposed.

The keeping of records which adequately and clearly reflect income for the taxable year constitutes the keeping of books within the meaning of section 441(g) and paragraph (g) of §1.441–1.

(b) *Prior approval of the Commissioner*—(1) *In general.* In order to secure prior approval of a change of a taxpayer's annual accounting period, the taxpayer must file an application on Form 1128 with the Commissioner of Internal Revenue, Washington, D.C. 20224, to effect the change of accounting period. If the short period involved in the change ends after December 31, 1973, such form shall be filed on or before the 15th day of the second calendar month following the close of such short period; if such short period ends before January 1, 1974, such form shall be filed on or before the last day of the first calendar month following the close of such short period. Approval will not be granted unless the taxpayer and the Commissioner agree to the terms, conditions, and adjustments under which the change will be effected. In general, a change of annual accounting period will be approved where the taxpayer established a substantial business purpose for making the change. In determining whether a taxpayer has established a substantial business purpose for making the change, consideration will be given to all the facts and circumstances relating to the change, including the tax consequences resulting therefrom. Among the nontax factors that will be considered in determining whether a substantial business purpose has been established is the effect of the change on the taxpayer's annual cycle of business activity. The agreement between the taxpayer and the Commissioner under which the change will be effected shall, in appropriate cases, provide terms, conditions, and adjustments necessary to prevent a substantial distortion of income which otherwise would result from the change. The following are examples of effects of the change which would substantially distort income:

(i) Deferral of a substantial portion of the taxpayer's income, or shifting of a substantial portion of deductions, from one year to another so as to reduce substantially the taxpayer's tax liability;

(ii) Causing a similar deferral or shifting in the case of any other person, such as a partner, a beneficiary, or a shareholder in an electing small business corporation as defined in selection 1371(b); or

(iii) Creating a short period in which there is either *(a)* a substantial net operating loss, or *(b)* in the case of an electing small business corporation, a substantial portion of amounts treated as long-term capital gain.

Even though a substantial business purpose is not established, the Commissioner in appropriate cases may permit a husband or wife to change his or her taxable year in order to secure the benefits of section 1(a) (relating to tax in case of a joint return). See paragraph (e) of this section for special rule for newly married couples.

(2) *Partnerships and partners.* (i) A newly-formed partnership may adopt a taxable year which is the same as the taxable year of all its principal partners (or is the same taxable year to which its principal partners who do not have such taxable year concurrently change) without securing prior approval from the Commissioner. If all its principal partners are not on the same taxable year, a newly-formed partnership may adopt a calendar year without securing prior approval from the Commissioner. If a newly-formed partnership wishes to adopt a taxable year that does not qualify under the preceding two sentences, the adoption of such year requires the prior approval of the Commissioner in accordance with section 706(b)(1) and paragraph (b) of §1.706–1. An existing partnership may change its taxable year without securing prior approval from the Commissioner if all its principal partners have the same taxable year to which the partnership changes, or if all its principal partners who do not have such a taxable year concurrently change to such taxable year. In any other case, an existing partnership may not change its taxable year unless it secures the prior approval of the Commissioner in accordance with paragraph (b)(1) of this section and section 706(b)(1) and paragraph (b) of §1.706–1.

(ii) A partner may change his taxable year only if he secures the prior approval of the Commissioner in accordance with paragraph (b)(1) of this section.

(3) *Certain foreign corporations.* Application for approval to change such taxable year of either a controlled foreign corporation (as defined in section 957 or a foreign corporation that meets the stock ownership requirements of a foreign personel holding company (as defined in section 552) shall be made by filing an application in accordance with paragraph (b)(1) of this section. The application shall be made by one or more of such controlled foreign corporation's United States shareholders (as defined in section 951(b)), by one or more individuals who comprise a foreign corporation's ''United States group''(as defined in section 552(a)(2)), or by the respective corporations. In general, a change of such a taxable year will be approved if the annual accounting period of such controlled foreign corporation or foreign corporation meeting the stock ownership requirements of a foreign personal holding company is changed to conform to the requirements of foreign law or because bona fide foreign business reasons make such a change necessary or desirable and the other applicable provisions of paragraph (b)(1) of this section are satisfied.

(c) *Special rule for certain corporations.* (1) Except as otherwise provided in paragraph (c)(4) and (5) of this section and under section 859, a corporation may change its annual accounting period without the prior approval of the commissioner if all the conditions in subparagraph (2) of this paragraph are met, and if the corporation files a statement with the district director with whom the returns of the corporation are filed at or before the time (including extension) for filing the return for the short period required by such change. This statement shall indicate that the corporation is changing its annual accounting period under paragraph (c) of this section and shall contain information indicating that all of the conditions in subparagraph (2) of this paragraph have been met.

(2) The provisions of this paragraph do not apply unless all of the following conditions are met:

(i) The corporation has not changed its annual accounting period at any time within the ten calendar years ending with the calendar year which includes the beginning of the short period required to effect the change of annual accounting period;

(ii) The short period required to effect the change of annual accounting period is not a taxable year in which the corporation has a net operating loss as defined in section 172;

(iii) The taxable income of the corporation for the short period required to effect the change of annual accounting period is, if placed on an annual basis (see paragraph (b)(1) (i) and (ii) of § 1.443–1), 80 percent or more of the taxable income of the corporation for the taxable year immediately preceding such short period;

(iv) If a corporation had a special status either for the short period or for the taxable year immediately preceding such short period, it must have the same special status for both the short period and such taxable year (for the purpose of this subdivision, special status includes only: a personal holding company, a corporation that is an exempt organization, a foreign corporation not engaged in a trade or business within the United States, a Western Hemisphere trade corporation, and a China Trade Act corporation); and

(v) The corporation does not attempt to make an election under section 1372(a) that purports to initially become effective with respect to a taxable year which *(a)* would immediately follow the short period required to effect the change of annual accounting period, and *(b)* would begin after August 23, 1972.

(3) If the Commissioner finds upon examination of the returns that the corporation, because of subsequent adjustments in establishing tax liability, did not in fact meet all the conditions in subparagraph (2) of this paragraph, the statement filed under subparagraph (1) of this paragraph shall be considered as a timely application for permission to change the corporation's annual accounting period to the taxable year indicated in the statement.

(4) A corporation which is an electing small business corporation (as defined in section 1371(b)) or a DISC (as defined in section 992(a)(1)) during the short period required to effect the change of annual accounting period may change its taxable year only if it secures the prior approval of the Commissioner in accordance with paragraph (b)(1) of this section. This subparagraph shall apply only if such short period ends after February 28, 1959. See subparagraphs (3)(ii) and (4) of §1.991–1(b) for special rules relating to the change of a DISC's annual accounting period during 1972.

(5) A controlled foreign corporation (as defined in section 957) or a foreign corporation that meets the stock ownership requirements of a foreign personal holding company (as defined in section 552) may change its taxable year only if it secures the prior approval of the Commissioner in accordance with paragraph (b) (1) and (3) of this section. A controlled foreign corporation or a foreign corporation that meets the stock ownership requirements of a foreign personal holding company that is not subject to United States income tax shall be treated for the purposes of this section as a taxpayer within the meaning of section 7701(a)(14).

(d) *Special rule for change of annual accounting period by subsidiary corporation.* A subsidiary corporation which is required to change its annual accounting period under §1.1502–76, relating to the taxable year of members of an affiliated group which file a consolidated return, need not file an application on Form 1128 with respect to such change.

(e) *Special rule for newly married couples.* (1) A newly married husband or wife may change his or her annual accounting period in order to adopt the annual accounting period of the other spouse so that a joint return may be filed for the first or second taxable year of such spouse ending after the date of marriage, provided that the newly married husband or wife adopting the annual accounting period of the other spouse files a return for the short period required by such change on or before the 15th day of the 4th month following the close of such short period. See section 443 and the regulations thereunder. (If the due date for any such short-period return occurs before the date of marriage, the first taxable year of the other spouse ending after the date of marriage cannot be adopted under this paragraph.) The short-period return shall contain a statement that it is filed under authority of this paragraph. For a change of annual accounting period by a husband or wife which does not qualify under this subparagraph, see paragraph (b) of this section.

(2) The provisions of this paragraph may be illustrated by the following example:

Example. H & W marry on September 25, 1956. H is on a fiscal year ending June 30, and W is on a calendar year. H wishes to change to a calendar year in order to file joint returns with W. W's first taxable year after marriage ends on December 31, 1956. H may not change to a calendar year for 1956 since, under paragraph (e) of §1.442–1, he would have had to file a return for the short period from July 1 to December 31, 1955, by April 15, 1956. Since the date of marriage occurred subsequent to this due date, the return could not be filed under paragraph (e) of §1.442–1. Therefore, H cannot change to a calendar year for 1956. However, H may change to a calendar year for 1957 by filing a return under paragraph (e) of §1.442–1 by April 15, 1957, for the short period from July 1 to December 31, 1956. If H files such a return, H and W may file a joint return for calendar year 1957 (which is W's second taxable year ending after the date of marriage).

(f) *Effective date.* The provisions of this section (other than paragraphs (c)(4) and (e) thereof) are effective for any change of annual accounting period where the last day of the short period required to effect the change ends on or after March 1, 1957. For special rules applicable to certain changes of annual accounting period that result in a short period ending in 1986 or 1987, see §1.442–2T. For special rules applicable to certain adoptions and retentions of a taxable year ending in 1986 or 1987, see § 1.442–3T.

(Secs. 860(e), (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)); and sec. 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11703, Nov. 26, 1960, as amended by T.D. 6614, 27 FR 10098, Oct. 13, 1962; T.D. 7235, 37 FR 28624, Dec. 28, 1972; T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7286, 38 FR 26911, Sept. 27, 1973; T.D. 7323, 39 FR 34409, Sept. 25, 1974; T.D. 7470, 42 FR 12178, Mar 3, 1977; T.D. 7767, 46 FR 11265, Feb. 6, 1981; T.D. 7936, 49 FR 2106, Jan. 18, 1984; T.D. 8123, 52 FR 3619, Feb. 5, 1987]

§ 1.442–2T Special limitations on certain changes of annual accounting period (temporary).

(a) *Applicability.* This section applies to any taxpayer that wishes to change its annual accounting period, or that wishes to adopt an annual accounting period described in paragraph (h) of this section. This section shall not apply, however, to:

(1) Any taxpayer to which the provisions of § 1.1502–76 apply (other than a taxpayer to which the provisions of paragraph (h) of this section apply);

(2) Any taxpayer to which the provisions of § 1.442–1(e) apply;

(3) Any taxpayer that wishes to change its annual accounting period to a calendar year (including a change under 26 CFR 18.1378–1(b)) or to a 52–53-week taxable year that ends with reference to the month of December (see, however, § 1.441–3T);

(4) Any partnership that wishes to change its annual accounting period under § 1.706–1(b)(1) to the same taxable year as that of all of its principal partners or to which all of its principal partners are concurrently changing;

(5) Any corporation seeking S status that wishes to change its annual accounting period under section 4.02 of Rev. Proc. 83–25, 1983–1 C.B. 689, to the same taxable year as that of shareholders holding more than 50 percent of the shares of stock of the corporation or to which such shareholders are concurrently changing;

(6) Any corporation seeking S status that wishes to change its annual accounting period under section 4.04 of Rev. Proc. 83–25, 1983–1 C.B. 689;

(7) Any taxpayer that wishes to change to a 52–53-week taxable year that ends with reference to the same calendar month as that in which the former taxable year ended (see, however, § 1.441–3T); or

(8) Any organization exempt under section 501(a), and any plan meeting the requirements for qualification under section 401(a) and which is exempt under section 501 (a), except those organizations and plans required to file a Form 990–T for the short period involved in the change of annual accounting period.

(b) *General rule.* A taxpayer to which this section applies may not change its annual accounting period under the provisions of—

(1) Paragraph (c) of § 1.442–1,

(2) Paragraph (b) of § 1.706–1,

(3) 26 CFR 18.1378–1(b),

(4) Rev. Proc. 72–51, 1972–2 C.B. 832, or

(5) Any revenue procedure issued before September 18, 1986, that, without regard to this section, would permit a taxpayer to change its taxable year either under a procedure that does not require the prior approval of the Commissioner or under expedited procedures for obtaining that approval.

Examples of procedures suspended by paragraph (b)(5) of this section include Rev. Proc. 84–34, 1984–1 C.B. 508, and those portions of Rev. Proc. 83–25, 1983–1 C.B. 689, that apply to changes of annual accounting period. In addition, the Commission will not consider a request by a taxpayer to which this section applies for approval of a change of annual accounting period under § 1.442–1(b)(1) unless the requirements of paragraph (e) of this section are satisfied. A taxpayer to which this section applies may, however, change its annual accounting period without securing the prior approval of the Commissioner if the taxpayer can establish a substantial business purpose for the change under paragraph (c) of this section and agrees to all of the applicable conditions set forth in paragraph (d) of this section.

(c) *Substantial business purpose*—(1) *General rule.* Except as provided in paragraph (c)(4) of this section, a taxpayer generally can establish a substantial business purpose under this paragraph (c) for a change of annual accounting period to any taxable year that meets the requirements of paragraph (c)(2) of this section. If more than one taxable year meets the requirements of paragraph (c)(2), however, a taxpayer can establish a substantial business purpose under this paragraph (c) only for a change to the year that yields the highest percentage when the percentages (rounded to the nearest 1/100 of a percent) obtained under paragraph (c)(2) of this section are averaged.

(2) *Mechanical test.* A taxable year meets the requirements of this paragraph (c)(2) only if, for the most recent 12-month period (determined at the time the statement or application required to effect or request the change is filed) ending with the last month of the requested taxable year and for each of the two preceding 12-month periods ending with the corresponding month—

(i) The gross receipts from sales or services for the last two months of such 12-month period equal or exceed 25 percent of—

(ii) The gross receipts from sales or services for such 12-month period.

(3) *Special rules*—(i) *Gross receipts.* For purposes of this section, gross receipts from sales or services shall be determined using the taxpayer's method of accounting.

(ii) *52–53-week taxable year.* If the requested year is a 52–53-week taxable year, the calendar month ending nearest to the last day of the 52–53-week taxable year shall be treated for purposes of paragraph (c)(2) of this section as the last month of the requested year.

(iii) *Taxpayers not in existence for three 12-month periods.* If a taxpayer has not been in existence for the three 12-month periods described in paragraph (c)(2) of this section, the requirements of paragraph (c)(2) of this section may be satisfied by taking into account the gross receipts from sales and services of a predecessor organization (within the meaning of section 4.04 of Rev. Proc. 83–25) that was actively engaged in a trade or business at all times during the portion of the three applicable 12-month periods prior to the inception of the taxpayer. Thus, a taxpayer in existence for only the most recent applicable 12-month period may use the gross receipts of a predecessor organization for the two preceding 12-month periods.

(4) *Exceptions.* The following taxpayers cannot establish a substantial business purpose for a change of annual accounting period under this section solely by satisfying the requirements of this paragraph (c), and, thus, must secure the prior approval of the Commissioner to the change:

(i) A partner of a partnership;

(ii) A partnership in which any partner is a partnership or S corporation;

(iii) A beneficiary of a trust or estate;

(iv) A United States shareholder of a controlled foreign corporation; and

(v) A shareholder of a DISC or former DISC.

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

Example (1). Assume that X, a calendar year corporation that is not described in paragraph (c)(4) of this section, wishes to change its annual accounting period to a fiscal year that ends on November 30. If the change is permitted under this section, the short period involved in the change would end on November 30, 1986. Under paragraph (f) of this section, X must attach a statement to its income tax return for the short period ending November 30, 1986, in order to effect the change. For purposes of paragraph (c)(2) of this section, the most recent 12-month period ending with the last month of the requested taxable year (November), determined as of the time the statement required to effect the change is filed, is the period that begins on December 1, 1985, and ends on November 30, 1986. The two preceding 12-month periods ending with the corresponding month are the periods from December 1, 1984, through November 30, 1985, and from December 1, 1983, through November 30, 1984.

Example (2). Assume that X, a calendar year corporation that is not described in paragraph (c)(4) of this section, wishes to change its annual accounting period to a fiscal year that ends on September 30. Assume that the most recent 12-month period determined under paragraph (c)(2) of this section is the period from October 1, 1985, through September 30, 1986, and that the two preceding 12-month periods are the periods from October 1, 1984, through September 30, 1985, and from October 1, 1983, through September 30, 1984.

Assume that the gross receipts from sales or services for the last two months of the 12-month periods ending on September 30, 1986, September 30, 1985, and September 30, 1984, are $3,500, $3,125, and $2,500, respectively. Assume further that the total gross receipts for the 12-month periods ending on September

30, 1986, September 30, 1985, and September 30, 1984, are $12,500, $12,000, and $10,000, respectively. The following percentages are obtained for the 12-month periods ending on September 30, 1986, September 30, 1985, and September 30, 1984, when the gross receipts for the last two months of each period are divided by the total gross receipts for that 12-month period: 28.00% ($3,500/$12,500), 26.04% ($3,125/$12,000), and 25.00% ($2,500/$10,000). Thus, the requirements of paragraph (c)(2) of this section are satisfied since each of those percentages equals or exceeds 25%.

Example (3). Assume the same facts as in example (2) except that X wishes to change its annual accounting period to a fiscal year that ends on July 31. In addition, assume that the percentages obtained for purposes of paragraph (c)(2) of this section with respect to a fiscal year that ends on July 31 are 26.00%, 25.00%, and 25.00%. Under paragraph (c)(1) of this section, X can establish a substantial business purpose only for a fiscal year that ends on September 30 since the average of the percentages obtained under paragraph (c)(2) of this section with respect to that year (26.35%) exceeds the average of the percentages obtained with respect to a fiscal year that ends on July 31 (25.33%).

(d) *Conditions.* The requirements of this section are in addition to any applicable conditions under sections 441, 442, 443, 706, and 1378. Thus, for example, a taxpayer must annualize income for the short period involved in a change of annual accounting period to which this section applies if required to do so under section 443(b). The following additional conditions apply under this section to any change of annual accounting period made by a corporation (other than an S corporation) without the prior approval of the Commissioner:

(1) If the taxpayer has a net operating loss as defined in section 172 for the short period involved in the change, that net operating loss must be deducted ratably over a six-year period beginning with the first taxable year after the short period unless—

(i) The net operating loss resulting from the short period is $10,000 or less, or

(ii) The net operating loss results from a short period of nine months or longer and is less than the net operating loss for a full 12-month period beginning with the first day of the short period.

(2) If the taxpayer has an unused credit for the short period, the taxpayer must carry the unused credit forward. Unused credits from the short period may not be carried back.

(3) The taxpayer may not make an election to be treated as an S corporation that would be effective for the taxable year immediately following the short period.

(e) *Prior approval of the Commissioner*—(1) *In general.* The Commissioner will not consider a request for approval to a change of annual accounting period under this section unless—

(i) The taxpayer is described in paragraph (c)(4) of this section and the taxable year to which the taxpayer wishes to change meets the requirements of paragraph (c)(1) of this section, or

(ii) The taxpayer has experienced a substantial acquisition or diverstiture, as defined in paragraph (e)(2) of this section.

(2) *Substantial acquisition or diverstiture*—(i) *In general.* For purposes of this paragraph (e), a taxpayer has not experienced a substantial acquisition or diverstiture unless—

(A) The taxpayer has acquired or disposed of a block of assets on or after the first day of the taxable year immediately preceeding the short period involved in the change of annual accounting period,

(B) At all times during the applicable 12-month periods (as defined in paragraph (e)(2)(iii) of this section), including any period during which the assets were not held by the taxpayer, the assets were segregated, whether in a separate branch or division or otherwise, so that the gross receipts attributable to those assets can be identified, and

(C) The requirements of paragraph (e)(2)(ii) of this section are satisfied.

If a taxpayer has experienced a substantial acquisition or diverstiture it is anticipated that the Commissioner will usually approve a change of annual accounting period to a taxable year that would meet the requirements of paragraph (c)(1) of this section if pro-forma gross receipts (*i.e.*, gross receipts that would have resulted if the acquistion or diverstiture had taken place at the beginning of the earliest applicable 12-month period) were substituted for the gross receipts described in paragraph (c)(2) of this section. The failure of a requested taxable year to meet the requirements of paragraph (c)(1) when pro-forma gross receipts are used, however, will not prevent the Commissioner from approving the change.

(ii) *Mechanical test.* A taxpayer has experienced a substantial acquisition or diverstiture for purposes of this paragraph (e) only if—

(A) The aggregate of the gross receipts from sales and services (within the meaning of paragraph (c)(3)(i) of this section) for the applicable 12-month periods attributable to the acquired or divested assets (including receipts for any period during which the assets were not held by the taxpayer), exceeds 80 percent of—

(B) The aggregate of the gross receipts from sales and services (within the meaning of paragraph (c)(3)(i) of this section) of the taxpayer for the applicable 12-month periods, determined without taking into account the gross receipts from sales and services attributable to the acquired or divested assets.

(iii) *Applicable 12-month periods.* For purposes of this paragraph (e)(2), the term ''applicable 12-month periods'' means—

(A) In the case of an acquisition, the 12-month periods described in paragraph (c)(2) of the section; and

(B) In the case of divestiture, the 12-month periods described in paragraph (c)(2) of this section that end before the date of the divestiture.

(iv) *Example.* The provisions of this paragraph (e) may be illustrated by the following example.

Example. Assume that X, a calendar year corporation, wishes to change its annual accounting period to a fiscal year ending October 31, 1986. Assume that on January 1, 1986, X acquired from corporation Y a block of assets that Y held in a separate division and that X also holds in a separate division. Assume that the most recent 12-month period described in paragraph (c)(2) of this section is the period that begins on November 1, 1985, and ends on October 31, 1986, and that the two preceding 12-month periods are the periods from November 1, 1984 through October 31, 1985, and from November 1, 1983, through October 31, 1984. Assume that the gross receipts attributable to the assets acquired from Y for the 12-month period ending October 31, 1986 (including the receipts attributable to the period from November 1, 1985, through December 31, 1985, when the assets were held by Y, and the receipts attributable to the period from January 1, 1986, through October 31, 1986, when the assets were held by X), are $8,000. In addition, assume that the gross receipts attributable to the assets acquired from Y for the 12-month periods ending October 31, 1985, and October 31, 1984, when the assets were held by Y, are $7,500, and $7,000, respectively. Assume further that X's gross receipts from sales and services for the 12-month period ending October 31, 1986, October 31, 1985, and October 31, 1984, without taking into account gross receipts attributable to the assets acquired from Y, are $10,000, $9,000, and $8,000, respectively. The requirements of paragraph (e)(2)(ii) of this section are satisfied since $22,500 ($8,000 + $7,500 + $7,000) exceeds 80 percent of $27,000 ($10,00 + $9,000 + $8,000). Thus, the Commissioner will consider X's request to change its taxable year to a fiscal year ending October 31, 1986.

(f) *Procedures*—(1) *Changes not requiring the prior approval of the Commissioner.* In order to effect a change that does not require the prior approval of the Commissioner under this section, a taxpayer must indicate that the requirements of this section are satisfied in a statement setting forth the computations required to establish a substantial business purpose under paragraph (c) of this section. The statement also must indicate that the taxpayer has agreed to all of the applicable conditions to the change, including any applicable conditions contained in § 1.441–3T. A taxpayer (other than a corporation seeking S status) must attach the statement to the income tax return for the short period involved in the change and, in addition, must type or legibly print the following caption at the top of page 1 of the return; ''FILED UNDER § 1.442–2T (f)(1).'' In the case of a corporation seeking S status, the statement must be attached to Form 2553 and the caption ''FILED UNDER § 1.442–2T (f)(1)'' must be typed or printed legibly at the top of page 1 of Form 2553.

(2) *Changes requiring the prior approval of the Commissioner.* In the case of a change of annual accounting period that requires the prior approval of the Commissioner under this section, a taxpayer must file Form 1128 or Form 2553, whichever is applicable. (See paragraph (e)(1) of this section for situations in which a request for approval will be considered.) The taxpayer must

indicate that the application is filed under this paragraph (f)(2) by typing or printing legibly the following caption at the top of page 1 of the Form 1128 or Form 2553: ‘‘FILED UNDER § 1.442–2T (f)(2).’’ The taxpayer also must attach a statement to the applicable form setting forth the computations described in paragraph (c) of this section. In addition, a taxpayer described in paragraph (e)(1)(ii) of this section must attach a statement setting forth the computations described in paragraph (e)(2) of this section.

(3) *Time for filing.* (i) Except as otherwise provided in paragraph (f)(3)(ii) of this section, a taxpayer cannot change its annual accounting period under this section unless the return or form required to effect or request the change is filed by its due date (with extensions if the change is effected by filing an income tax return for the short period involved in the change).

(ii) A taxpayer may change its annual accounting period under this section if the due date (without regard to extensions) for the return or form required to effect or request the change is on or after September 30, 1986, and before March 9, 1987 and the return or form is filed before March 9, 1987 (or, in the case of a change effected by filing an income tax return for the short period involved in the change, if an application for extension is filed before March 9, 1987. This paragraph only extends the time for changing an annual accounting period and does not extend the time for making an S election. An S election that is timely filed before March 9, 1987, however, will not be denied or rendered ineffective solely by reason of the need for the taxpayer to submit the information required by paragraph (f)(1) or (f)(2) of this section.

(iii) In the case of a change of annual accounting period under this section that is effected by filing an income tax return for the short period involved in the change, any failure to file a return or to pay tax on or before the due date for the return or the date prescribed for payment will be treated as due to reasonable cause and will not give rise to any addition to tax under section 6651 if—

(A) The due date for the return (without regard to extensions) or the date prescribed for payment is on or after September 30, 1986, and before March 9, 1987, and

(B) The return (or application for extension) is filed and the tax is paid before March 9, 1987.

(g) *Effective date*—(1) *In general.* This section shall apply to a change of annual accounting period (other than a change described in paragraph (g)(2) of this section) if—

(i) The income tax return for the short period involved in the change is filed after September 29, 1986, and

(ii) The short period involved in the change ends before January 5, 1987.

(2) *Exceptions.* This section shall not apply to a change of annual accounting period if the application required to effect or request the change was timely filed before September 30, 1986. In the case of a change that is effected by filing an income tax return for the short period involved in the change, this section shall not apply if an application for extension to file that return was filed before September 30, 1986, the application clearly stated the year to which the taxpayer intended to change, and the income tax return for the short period is timely filed (determined with regard to extensions).

(3) *Hardship rule.* A taxpayer can request a waiver from the provisions of this section if the taxpayer can demonstrate, to the satisfaction of the Commissioner, that the taxpayer would sustain a substantial hardship from the application of this section, and if the short period involved in the change ends on or before October 5, 1986. A waiver ordinarily will not be granted unless the taxpayer can show that, by October 5, 1986, the taxpayer had closed its books in a manner that indicates that the period in question was intended to be the end of the short period, taken a physical inventory (if applicable), and incurred substantial costs in modifying its accounting systems (including, for example, costs of reprogramming applicable computer systems) in order to change its year. A request for a waiver under this paragraph (g)(3) must be filed with the Commissioner of Internal Revenue, 1111 Constitution Avenue, NW, Room 5040, Washington, DC 20224 by March 9, 1987. Any information submitted with the

request for waiver shall be submitted under penalties of perjury.

(h) *Anti-abuse rule*—(1) *In general.* A taxpayer may not adopt any taxable year that has the effect of circumventing the provisions of this section. The provisions of this section are deemed to be circumvented if, for example, a taxpayer that is unable to change its taxable year under this section transfers a substantial portion of its net assets to a related person and the related person purportedly adopts the desired taxable year. In that case, purported adoption of the desired taxable year will not be given effect and the related person must adopt the same taxable year as that of the taxpayer that is unable to change its taxable year under this section. For this purpose, the term ''related person'' has the same meaning as in section 168(e)(4)(D) (as in effect prior to the enactment of the Tax Reform Act of 1986), except that the second sentence thereof (relating to the substitution of 10 percent for 50 percent in applying sections 267(b) and 707(b)(1)) shall be disregarded.

(2) *Example.* The provisions of paragraph (h)(1) of this section may be illustrated with the following example.

Example. Assume that X, a calendar year corporation, is subject to the restrictions on changes in annual accounting period under this section. Assume that X wishes to change its taxable year to a fiscal year ending November 30, 1986, but cannot do so because it does not meet the requirements of this section. Assume further that X creates corporation Y, a wholly-owned subsidiary of X, which purportedly adopts a taxable year ending November 30, 1986. In addition, assume that X transfers a substantial portion of its net assets to Y before November 30, 1986, in a transaction described in section 351 or 368. Under these facts, Y may not adopt a November 30 taxable year and instead must adopt a taxable year that ends on December 31, which is the taxable year of X.

[T.D. 8123, 52 FR 3619, Feb. 5, 1987]

§ 1.442–3T Special limitations on certain adoptions and retentions of a taxable year (temporary).

(a) *Applicability.* This section generally applies to—

(1) Any partnership that wishes to adopt a taxable year other than the calendar year, the taxable year of its principal partners, or the taxable year to which all of its principal partners are concurrently changing, and

(2) Any corporation seeking S status that wishes to adopt or retain a taxable year other than the calender year or a taxable year that meets the requirements of section 4.02 or 4.04 of Rev. Proc. 83–25, 1983–1 C.B. 689.

(b) *General rule.* A taxpayer to which this section applies may not adopt or retain a taxable year that results in any deferral of income to its partners or shareholders unless the taxpayer—

(1) Secures the prior approval of the Commissioner by establishing a substantial business purpose under paragraph (c)(2) of this section for the adoption or retention, or

(2) Is permitted to adopt or retain the taxable year without securing the prior approval of the Commissioner under paragraph (c)(1) of this section.

Thus, a taxpayer to which this section applies may not adopt or retain a taxable year that results in a deferral of income to its partners or shareholders under Rev. Proc. 72–51, 1972–2 C.B. 832, or section 4.03 of Rev. Proc. 83–25, 1983–1 C.B. 689.

(c) *Substantial business purpose*—(1) *Prior approval of the Commissioner not needed.* Notwithstanding § 1.706–1(b), § 1.442–1(b)(2), and 26 CFR 18.1378–1(a), a taxpayer to which this section applies may adopt or retain a taxable year that results in a deferral of income to its partners or shareholders without the prior approval of the Commissioner if the taxpayer can establish a substantial business purpose under § 1.442–2T(c). Thus, a taxpayer described in § 1.442–2T(c)(4) must secure the prior approval of the Commissioner to the adoption or retention even if the requirements of § 1.442–2T(c)(1) are satisfied. A taxpayer shall effect an adoption or retention permitted under this paragraph (c)(1) in the manner prescribed by § 1.442–2T(f)(1), except that the taxpayer's first income tax return shall be treated as the return for the short period involved in a change of annual accounting period.

(2) *Prior approval of the Commissioner.* In any case where the taxpayer was in existence for the three 12-month periods described in § 1.442–2T(c)(2), or where a predecessor organization (within the meaning of § 4.04 of Rev.

Proc. 83–25) was actively engaged in a trade or business at all times during the portion of those three 12-month periods prior to the inception of the taxpayer, the Commissioner will consider a request for prior approval of an adoption or retention of a taxable year that results in a deferral of income to its partners or shareholders only if the taxpayer is described in § 1.442–2T(e). In such a case, the application for approval shall be filed in the manner prescribed by § 1.442–2T(f)(2). In any other case, the taxpayer must establish a substantial business purpose in order to obtain the prior approval of the Commissioner, and must file an application for approval in accordance with § 1.706–1(b) or 26 CFR 18.1378–1(a) (whichever is applicable) and § 1.442–1T(b)(1). For this purpose, the following factors generally will not be sufficient to establish a substantial business purpose:

(i) The use of a particular year for regulatory or financial accounting purposes;

(ii) The hiring patterns of a particular business (e.g., the fact that a firm typically hires staff during certain times of the year);

(iii) The use of a particular year for administrative purposes, such as for the admission or retirement of partners or shareholders, promotion of staff, and compensation or retirement arrangements with staff, partners, or shareholders; and

(iv) The fact that a particular business involves the use of price lists, model year, or other items that change on an annual basis.

(d) *Time for filing.* (1) Except as otherwise provided in paragraph (d)(2) of this section, a taxpayer cannot adopt or retain a taxable year under this section unless the return or form required to effect or request the adoption or retention is filed by its due date (with extensions if the adoption is effected by filing an income tax return for the taxpayer's first taxable year).

(2) A taxpayer may adopt or retain a taxable year under this section if the due date (without regard to extensions) for the return or form required to effect or request the adoption or retention is on or after November 6, 1986, and before March 9, 1987, and the return or form is filed before March 9, 1987 (or, in the case of an adoption effected by filing an income tax return for the taxpayer's first taxable year, if an application for extension is filed before March 9, 1987). This paragraph (d)(2) only extends the time for adopting or retaining a taxable year and does not extend the time for making an S election. An S election that is timely filed before March 9, 1987, however, will not be denied or rendered ineffective solely by reason of the need for the taxpayer to submit the information required by paragraph (c) of this section.

(3) In the case of an adoption or retention of a taxable year under this section that is effected by filing an income tax return for the taxpayer's first taxable year, any failure to file a return or to pay tax on or before the due date for the return or the date prescribed for payment will be treated as due to reasonable cause and will not give rise to any addition to tax under section 6651 if—

(i) The due date for the return (without regard to extensions) or the date prescribed for payment is on or after November 6, 1986, and before March 9, 1987, and

(ii) The return (or application for extension) is filed and the tax is paid before March 9, 1987.

(e) *Effective date.* This section generally applies if the first taxable year of the partnership or the first taxable year for which the election to be an S corporation is effective begins before January 1, 1987, unless the application necessary to effect or request the adoption or retention was timely filed before November 6, 1986. This section shall not apply, however, to an adoption by a partnership of a taxable year that begins before January 1, 1986.

[T.D. 8123, 52 FR 3622, Feb. 5, 1987]

§ 1.443–1 Returns for periods of less than 12 months.

(a) *Returns for short period.* A return for a short period, that is, for a taxable year consisting of a period of less than 12 months, shall be made under any of the following circumstances:

(1) *Change of annual accounting period.* In the case of a change in the annual accounting period of a taxpayer, a separate return must be filed for the

short period of less than 12 months beginning with the day following the close of the old taxable year and ending with the day preceding the first day of the new taxable year. However, such a return is not required for a short period of six days or less, or 359 days or more, resulting from a change from or to a 52–53-week taxable year. See section 441(f) and §1.441–2. The computation of the tax for a short period required to effect a change of annual accounting period is described in paragraph (b) of this section. In general, a return for a short period resulting from a change of annual accounting period shall be filed and the tax paid within the time prescribed for filing a return for a taxday of the short period. For rules applicable to a subsidiary corporation which becomes a member of an affiliated group which files a consolidated return, see §1.1502–76.

(2) *Taxpayer not in existence for entire taxable year.* If a taxpayer is not in existence for the entire taxable year, a return is required for the short period during which the taxpayer was in existence. For example, a corporation organized on August 1 and adopting the calendar year as its annual accounting period is required to file a return for the short period from August 1 to December 31, and returns for each calendar year thereafter. Similarly, a dissolving corporation which files its returns for the calendar year is required to file a return for the short period from January 1 to the date it goes out of existence. Income for the short period is not required to be annualized if the taxpayer is not in existence for the entire taxable year, and, in the case of a taxpayer other than a corporation, the deduction under section 151 for personal exemptions (or deductions in lieu thereof) need not be reduced under section 443(c). In general, the requirements with respect to the filing of returns and the payment of tax for a short period where the taxpayer has not been in existence for the entire taxable year are the same as for the filing of a return and the payment of tax for a taxable year of 12 months ending on the last day of the short period. Although the return of a decedent is a return for the short period beginning with the first day of his last taxable year and ending with the date of his death, the filing of a return and the payment of tax for a decedent may be made as though the decedent had lived throughout his last taxable year.

(b) *Computation of tax for short period on change of annual accounting period*—(1) *General rule.* (i) If a return is made for a short period resulting from a change of annual accounting period, the taxable income for the short period shall be placed on an annual basis by multiplying such income by 12 and dividing the result by the number of months in the short period. Unless section 443(b)(2) and subparagraph (2) of this paragraph apply, the tax for the short period shall be the same part of the tax computed on the annual basis as the number of months in the short period is of 12 months.

(ii) If a return is made for a short period of more than 6 days, but less than 359 days, resulting from a change from or to a 52–53-week taxable year, the taxable income for the short period shall be annualized and the tax computed on a daily basis, as provided in section 441(f)(2)(B)(iii) and paragraph (c)(5) of §1.441–2.

(iii) For method of computation of income for a short period in the case of a subsidiary corporation required to change its annual accounting period to conform to that of its parent, see §1.1502–76(b).

(iv) An individual taxpayer making a return for a short period resulting from a change of annual accounting period is not allowed to take the standard deduction provided in section 141 in computing his taxable income for the short period. See section 142(b)(3).

(v) In computing the taxable income of a taxpayer other than a corporation for a short period (which income is to be annualized in order to determine the tax under section 443(b)(1)) the personal exemptions allowed individuals under section 151 (and any deductions allowed other taxpayers in lieu thereof, such as the deduction under section 642(b)) shall be reduced to an amount which bears the same ratio to the full amount of the exemptions as the number of months in the short period bears to 12. In the case of the taxable income for a short period resulting from a change from or to a 52–53-week taxable year to which section 441(f)(2)(B)(iii) applies, the computation required by the preceding sentence shall be made on a daily basis, that is, the deduction for personal exemptions (or any deduction in lieu thereof) shall be reduced to an amount which bears the same ratio to the full deduction as the number of days in the short period bears to 365.

(vi) If the amount of a credit against the tax (for example, the credits allowable under section 34 (for dividends received on or before December 31, 1964), and 35 (for partially tax-exempt interest)) is dependent upon the amount of any item of income or deduction, such credit shall be computed upon the amount of the item annualized separately in accordance with the foregoing rules. The credit so computed shall be treated as a credit against the tax computed on the basis of the annualized taxable income. In any case in which a limitation on the amount of a credit is based upon taxable income, taxable income shall mean the taxable income computed on the annualized basis.

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

Example (1). A taxpayer with one dependent who has been granted permission under section 442 to change his annual accounting period files a return for the short period of 10 months ending October 31, 1956. He has income and deductions as follows:

Income			
Interest income			$10,000.00
Partially tax-exempt interest with respect to which a credit is allowable under section 35			500.00
Dividends to which sections 34 and 116 are applicable			750.00
			11,250.00
Deductions			
Real estate taxes			200.00
2 personal exemptions at $600 on an annual basis			1,200.00
The tax for the 10-month period is computed as follows:			
Total income as above			11,250.00
Less:			
Exclusion for dividends received		$50.00	
2 personal exemptions ($1,200×10/12)		1,000.00	
Real estate taxes		200.00	
			1,250.00
Taxable income for 10-month period before annualizing			10,000.00
Taxable income annualized (10,000×12/10)			12,000.00
Tax on $12,000 before credits			3,400.00
Deduct credits:			
Dividends received for 10-month period	$750.00		
Less: Excluded portion	50.00		
Included in gross income	700.00		
Dividend income annualized ($700×12/10)	840.00		
Credit (4 percent of $840)		33.60	
Partially tax-exempt interest included in gross income for 10-month period	500.00		
Partially tax-exempt interest (annualized) ($500×12/10)	600.00		
Credit (3 percent of $600)		18.00	
			51.60
Tax on $12,000 (after credits)			3,348.40
Tax for 10-month period ($3,348.40×10/12)			2,790.33

Example (2). The X Corporation makes a return for the one-month period ending September 30, 1956, because of a change in annual accounting period permitted under section 442. Income and expenses for the short period are as follows:

Gross operating income		$126,000
Business expenses		130,000
Net loss from operations		(4,000)
Dividends received from taxable domestic corporations		30,000
Gross income for short period before annualizing		26,000
Dividends received deduction (85 percent of $30,000, but not in excess of 85 percent of $26,000)		22,100
Taxable income for short period before annualizing		3,900
Taxable income annualized ($8,900×12)		46,800
Tax on annual basis:		
$46,800 at 52 percent	$24,336	
Less surtax exemption	5,500	
		$18,836
Tax for 1-month period ($18,836×1/12)		1,570

Example (3). The Y Corporation makes a return for the six-month period ending June 30, 1957, because of a change in annual accounting period permitted under section 442. Income for the short period is as follows:

Taxable income exclusive of net long-term capital gain		$40,000
Net long-term capital gain		10,000
Taxable income for short period before annualizing		50,000
Taxable income annualized ($50,000×12⁄6)		100,000
Regular tax computation		
Taxable income annualized		100,000
Tax on annual basis:		
$100,000 at 52 percent	$52,000	
Less surtax exemption	5,500	
	46,500	
Tax for 6-month period ($46,500×6⁄12)		23,250
Alternative tax computation		
Taxable income annualized		100,000
Less annualized capital gain ($10,000×12⁄6)		20,000
Annualized taxable income subject to partial tax		80,000
Partial tax on annual basis		
$60,000 at 52 percent	$41,600	
Less surtax exemption	5,500	
		36,100
25 percent of annualized capital gain ($20,000)		5,000
Alternative tax on annual basis		41,100
Alternative tax for 6-month period ($41,100×6⁄12)		20,550

Since the alternative tax of $20,550 is less than the tax computed in the regular manner ($23,250), the corporation's tax for the 6-month short period is $20,550.

(2) *Exception: computation based on 12-month period.* (i) A taxpayer whose tax would otherwise be computed under section 443(b)(1) (or section 441(f)(2)(B)(iii) in the case of certain changes from or to a 52–53-week taxable year) for the short period resulting from a change of annual accounting period may apply to the district director to have his tax computed under the provisions of section 443(b)(2) and this subparagraph. If such application is made, as provided in subdivision (v) of this subparagraph, and if the taxpayer establishes the amount of his taxable income for the 12-month period described in subdivision (ii) of this subparagraph, then the tax for the short period shall be the greater of the following—

(a) An amount which bears the same ratio to the tax computed on the taxable income which the taxpayer has established for the 12-month period as the taxable income computed on the basis of the short period bears to the taxable income for such 12-month period; or

(b) The tax computed on the taxable income for the short period without placing the taxable income on an annual basis.

However, if the tax computed under section 443(b)(2) and this subparagraph is not less than the tax for the short period computed under section 443(b)(1) (or section 441(f)(2)(B)(iii) in the case of certain changes from or to a 52–53-week taxable year), then section 443(b)(2) and this subparagraph do not apply.

(ii) The term ''12-month period'' referred to in subdivision (i) of this subparagraph means the 12-month period beginning on the first day of the short period. However, if the taxpayer is not in existence at the end of such 12-month period, or if the taxpayer is a corporation which has disposed of substantially all of its assets before the end of such 12-month period, the term ''12-month period'' means the 12-month period ending at the close of the last day of the short period. For the purposes of the preceding sentence, a corporation which has ceased business and distributed so much of the assets used in its business that it cannot resume its customary operations with the remaining assets, will be considered to have disposed of substantially all of its assets. In the case of a change from a 52–53-week taxable year, the term ''12-month period'' means the period of 52 or 53 weeks (depending on the taxpayer's 52–53-week taxable year) beginning on the first day of the short period.

(iii)*(a)* The taxable income for the 12-month period is computed under the same provisions of law as are applicable to the short period and is computed as if the 12-month period were an actual annual accounting period of the taxpayer. All items which fall in such 12-month period must be included even if they are extraordinary in amount or of an unusual nature. If the taxpayer is a member of a partnership, his taxable income for the 12-month period shall include his distributive share of partnership income for any taxable year of the partnership ending within or with such 12-month period, but no amount shall be included with respect to a taxable year of the partnership ending before or after such 12-month period. If any other item partially applicable to such 12-month period can be determined only at the end of a taxable year which includes only part of the 12-month period, the taxpayer, subject to review by the Commissioner, shall apportion such item to the 12-month period in such manner as will most clearly reflect income for the 12-month period.

(b) In the case of a taxpayer permitted or required to use inventories, the cost of goods sold during a part of the 12-month period included in a taxable year shall be considered, unless a more exact determination is available, as such part of the cost of goods sold during the entire taxable year as the gross receipts from sales for such part of the 12-month period is of the gross receipts from sales for the entire taxable year. For example, the 12-month period of a corporation engaged in the sale of merchandise, which has a short period from January 1, 1956, to September 30, 1956, is the calendar year 1956. The three-month period, October 1, 1956, to December 31, 1956, is part of the taxpayer's taxable year ending September 30, 1957. The cost of goods sold during the three-month period, October 1, 1956, to December 31, 1956, is such part of the cost of goods sold during the entire fiscal year ending September 30, 1957, as the gross receipts from sales for such three-month period are of the gross receipts from sales for the entire fiscal year.

(c) The Commissioner may, in granting permission to a taxpayer to change his annual accounting period, require, as a condition to permitting the change, that the taxpayer must take a closing inventory upon the last day of the 12-month period if he wishes to obtain the benefits of section 443(b)(2). Such closing inventory will be used only for the purposes of section 443(b)(2), and the taxpayer will not be required to use such inventory in computing the taxable income for the taxable year in which such inventory is taken.

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

Example (1). The taxpayer in example (1) under paragraph (b)(1)(vii) of this section establishes his taxable income for the 12-month period from January 1, 1956, to December 31, 1956. The taxpayer has a short period of 10 months, from January 1, 1956, to October 31, 1956. The taxpayer files an application in accordance with subdivision (v) of this subparagraph to compute his tax under section 443(b)(2). The taxpayer's income and deductions for the 12-month period, as so established, follow:

Income

Interest income		$11,000
Partially tax-exempt interest with respect to which a credit is allowable under section 35		600
Dividends to which sections 34 and 116 are applicable		850
		12,450

Deductions

Real estate taxes		200
2 personal exemptions at $600		1,200

Tax computation for short period under section 443(b)(2)(A)(i)

Total income as above		$12,450
Less:		
Exclusion for dividends received	$50	
Personal exemptions	1,200	
Deduction for taxes	200	
		1,450
Taxable income for 12-month period		11,000
Tax before credits		3,020
Credit for partially tax-exempt interest (3 percent of $600)	18	
Credit for dividends received (4 percent of ($850 − 50))	32	
		50
Tax under section 443(b)(2)(A)(i) for 12-month period		2,970
Taxable income for 10-month short period from example (1) of paragraph (b)(1)(vii) of this section before annualizing		10,000
Tax for short period under section 443(b)(2)(A)(i) ($2,970×$10,000 (taxable income for short period)/$11,000 (taxable income for 12-month period))		2,700

Tax computation for short period under section 443(b)(2)(A)(ii)

Total income for 10-month short period		11,250
Less:		
Exclusion for dividends received	50	
2 personal exemptions	1,200	
Real estate taxes	200	
		1,450
Taxable income for short period without annualizing and without proration of personal exemptions		9,800
Tax before credits		2,572
Less credits:		
Partially tax-exempt interest (3 percent of $500)	15	
Dividends received (4 percent of ($750 − 50))	28	
		43
Tax for short period under section 443(b)(2)(A)(ii)		2,529

The tax of $2,700 computed under section 443(b)(2)(A)(i) is greater than the tax of $2,529, computed under section 443(b)(2)(A)(ii), and is, therefore, the tax under section 443(b)(2). Since the tax of $2,700 (computed under section 443(b)(2)) is less than the tax of $2,790.33 (computed under section 443(b)(1)) on the annualized income of the short period (see example (1) of paragraph (b)(1)(vii) of this section), the taxpayer's tax for the 10-month short period is $2,700.

Example (2). Assume the same facts as in example (1) of this subdivision, except that, during the month of November 1956, the taxpayer suffered a casualty loss of $5,000. The tax computation for the short period under section 443(b)(2) would be as follows:

Tax computation for short period under section 443(b)(2)(A)(i)

Taxable income for 12-month period from example (1)		$11,000
Less: Casualty loss		5,000
Taxable income for 12-month period		6,000
Tax before credits	$1,360	
Credits from example (1)	50	
Tax under section 443(b)(2)(A)(i) for 12-month period	1,310	
Tax for short period ($1,310× $10,000/ $6,000) under section 443(b)(2)(A)(i)	2,183	

Tax computation for short period under section 443(b)(2)(A)(ii)

Total income for the short period	11,250	
Less:		
Exclusion for dividends received	50	
2 personal exemptions	1,200	
Real estate taxes	200	
		1,450
Taxable income for short period without annualizing and without proration of personal exemptions		9,800
Tax before credits		2,572
Less credits:		
Partially tax-exempt interest (3 percent of $500)	15	
Dividends received (4 percent of $750 − 50))	28	
		43
Tax for short period under section 443(b)(2)(A)(ii)		2,529

The tax of $2,529, computed under section 443(b)(2)(A)(ii) is greater than the tax of $2,183 computed under section 443(b)(2)- (A)(i) and is, therefore, the tax under section 443(b)(2). Since this tax is less than the tax of $2,790.33, computed under section 443(b)(1) (see example (1) of paragraph (b)(1)(vii) of this section), the taxpayer's tax for the 10-month short period is $2,529.

(v)*(a)* A taxpayer who wishes to compute his tax for a short period resulting from a change of annual accounting period under section 443(b)(2) must make an application therefor. Except as provided in *(b)* of this subdivision, the taxpayer shall first file his return for the short period and compute his tax under section 443(b)(1). The application for the benefits of section 443(b)(2) shall subsequently be made in the form of a claim for credit or refund. The claim shall set forth the computation of the taxable income and the tax thereon for the 12-month period and must be filed not later than the time (including extensions) prescribed for filing the return for the taxpayer's first taxable year which ends on or after the day which is 12 months after the beginning of the short period. For example, assume that a taxpayer changes his annual accounting period from the calendar year to a fiscal year ending September 30, and files a return for the short period from January 1, 1956, to September 30, 1956. His application for the benefits of section 443(b)(2) must be filed not later than the time prescribed for filing his return for his first taxable year which ends on or after the last day of December 1956, the twelfth month after the beginning of the short period. Thus, the taxpayer must file his application not later than the time prescribed for filing the return for his fiscal year ending September 30, 1957. If he obtains an extension of time for filing the return for such fiscal year, he may file his application during the period of such extension. If the district director determines that the taxpayer has established the amount of his taxable income for the 12-month period, any excess of the tax paid for the short period over the tax computed under section 443(b)(2) will be credited or refunded to the taxpayer in the same manner as in the case of an overpayment.

(b) If at the time the return for the short period is filed, the taxpayer is able to determine that the 12-month period ending with the close of the short period (see section 443(b)(2)-(B)(ii) and subparagraph (2)(ii) of this paragraph) will be used in the computations under section 443(b)(2), then the tax on the return for the short period may be determined under the provisions of section 443(b)(2). In such case, a return covering the 12-month

period shall be attached to the return for the short period as a part thereof, and the return and attachment will then be considered as an application for the benefits of section 443(b)(2).

(c) *Adjustment in deduction for personal exemption.* For adjustment in the deduction for personal exemptions in computing the tax for a short period resulting from a change of annual accounting period under section 443(b)(1) (or under section 441(f)(2)(B)(iii) in the case of certain changes from or to a 52–53-week taxable year), see paragraph (b)(1)(v) of this section.

(d) *Adjustments in exclusion of computing minimum tax for tax preferences.* (1) If a return is made for a short period on account of any of the reasons specified in subsection (a) of section 443, the $30,000 amount specified in section 56 (relating to minimum tax for tax preferences), modified as provided by section 58 and the regulations thereunder, shall be reduced to the amount which bears the same ratio to such specified amount as the number of days in the short period bears to 365.

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

Example. A taxpayer who is an unmarried individual has been granted permission under section 442 to change his annual accounting period files a return for the short period of 4 months ending April 30, 1970. The $30,000 amount specified in section 56 is reduced as follows:

$(120/365)\times\$30,000=\$9,835.89.$

(e) *Cross references.* For inapplicability of section 443(b) and paragraph (b) of this section in computing—

(1) Accumulated earnings tax, see section 536 and the regulations thereunder;

(2) Personal holding company tax, see section 546 and the regulations thereunder;

(3) Undistributed foreign personal holding company income, see section 557 and the regulations thereunder;

(4) The taxable income of a regulated investment company, see section 852(b)(2)(E) and the regulations thereunder; and

(5) The taxable income of a real estate investment trust, see section 857(b)(2)(C) and the regulations thereunder.

[T.D. 6500, 25 F.R. 11705, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4093, Apr. 28, 1962; T.D. 6777, 29 FR 17808, Dec. 16, 1964; T.D. 7244, 37 FR 28897, Dec. 30, 1972, T.D. 7564, 43 FR 40494, Sept. 12, 1978; T.D. 7575, 43 FR 58816, Dec. 18, 1978; T.D. 7767, 465 FR 11265, Feb. 6, 1981]

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[T.D. 8205, 53 FR 19693, May 27, 1988]

§1.444–1T Election to use a taxable year other than the required taxable year (temporary).

(a) *General rules*—(1) *Year other than required year.* Except as otherwise provided in this section and §1.444–2T, a partnership, S corporation, or personal service corporation (as defined in §1.441–4T(d)) may make or continue an election (a ‘‘section 444 election’’) to have a taxable year other than its required taxable year. See paragraph (b) of this section for limitations on the taxable year that may be elected. See §1.444–2T for rules that generally prohibit a partnership, S corporation, or personal service corporation that is a member of a tiered structure from making or continuing a section 444 election. See §1.444–3T for rules explaining how and when to make a section 444 election.

(2) *Effect of section 444 election*—(i) *In general.* A partnership or S corporation that makes or continues a section 444 election shall file returns and make payments as required by §§1.7519–1T

and 1.7519–2T. A personal service corporation that makes or continues a section 444 election is subject to the deduction limitation of § 1.280H–1T.

(ii) *Duration of section 444 election.* A section 444 election shall remain in effect until the election is terminated pursuant to paragraph (a)(5) of this section.

(3) *Section 444 election not required for certain years.* A partnership, S corporation, or personal service corporation is not required to make a section 444 election to use—

(i) A taxable year for which such entity establishes a business purpose to the satisfaction of the Commissioner (*i.e.*, approved under section 4 or 6 of Rev. Proc. 87–32, 1987–28 I.R.B. 14, or any successor revenue ruling or revenue procedure), or

(ii) A taxable year that is a ''grandfathered fiscal year,'' within the meaning of section 5.01(2) of Rev. Proc. 87–32 or any successor revenue ruling or revenue procedure.

Although a partnership, S corporation or personal service corporation qualifies to use a taxable year described in paragraph (a)(3) (i) or (ii) of this section, such entity may, if otherwise qualified, make a section 444 election to use a different taxable year. Thus, for example, assume that a personal service corporation that historically used a January 31 taxable year established to the satisfaction of the Commissioner, under section 6 of Rev. Proc. 87–32, a business purpose to use a September 30 taxable year for its taxable year beginning February 1, 1987. Pursuant to this paragraph (a)(3), such personal service corporation may use a September 30 taxable year without making a section 444 election. However, the corporation may, if otherwise qualified, make a section 444 election to use a year ending other than September 30 for its taxable year beginning February 1, 1987.

(4) *Required taxable year.* For purposes of this section, the term ''required taxable year'' means the taxable year determined under section 706(b), 1378, or 441(i) without taking into account any taxable year which is allowable either—

(i) By reason of business purpose (*i.e.*, approved under section 4 or 6 of Rev. Proc. 87–32 or any successor revenue ruling or procedure), or

(ii) As a ''grandfathered fiscal year'' within the meaning of section 5.01(2) of Rev. Proc. 87–32, or any successor revenue ruling or procedure.

(5) *Termination of section 444 election*—(i) *In general.* A section 444 election is terminated when—

(A) A partnership, S corporation, or personal service corporation changes to its required taxable year; or

(B) A partnership, S corporation, or personal service corporation liquidates (including a deemed liquidation of a partnership under § 1.708–1 (b)(1)(iv)); or

(C) A partnership, S corporation, or personal service corporation willfully fails to comply with the requirements of section 7519 or 280H, whichever is applicable; or

(D) A partnership, S corporation, or personal service corporation becomes a member of a tiered structure (within the meaning of § 1.444–2T), unless it is a partnership or S corporation that meets the same taxable year exception under § 1.444–2T (e); or

(E) An S corporation's S election is terminated; or

(F) A personal service corporation ceases to be a personal service corporation.

However, if a personal service corporation, that has a section 444 election in effect, elects to be an S corporation, the S corporation may continue the section 444 election of the personal service corporation. Similarly, if an S corporation that has a section 444 election in effect terminates its S election and immediately becomes a personal service corporation, the personal service corporation may continue the section 444 election of the S corporation. If a section 444 election is terminated under this paragraph (a)(5), the partnership, S corporation, or personal service corporation may not make another section 444 election for any taxable year.

(ii) *Effective date of termination.* A termination of a section 444 election shall be effective—

(A) In the case of a change to the required year, on the first day of the short year caused by the change;

(B) In the case of a liquidating entity, on the date the liquidation is completed for tax purposes;

(C) In the case of willful failure to comply, on the first day of the taxable year (determined as if a section 444 election had never been made) determined in the discretion of the District Director;

(D) In the case of membership in a tiered structure, on the first day of the taxable year in which the entity is considered to be a member of a tiered structure, or such other taxable year determined in the discretion of the District Director;

(E) In the case of termination of S status, on the first day of the taxable year for which S status no longer exists;

(F) In the case of a personal service corporation that changes status, on the first day of the taxable year, for which the entity is no longer a personal service corporation.

In the case of a termination under this paragraph (a)(5) that results in a short taxable year, an income tax return is required for the short period. In order to allow the Service to process the affected income tax return in an efficient manner, a partnership, S corporation, or personal service corporation that files such a short period return should type or legibly print at the top of the first page of the income tax return for the short taxable year—''SECTION 444 ELECTION TERMINATED.'' In addition, a personal service corporation that changes its taxable year to the required taxable year is required to annualize its income for the short period.

(iii) *Example.* The provisions of paragraph (a)(5)(ii) of this section may be illustrated by the following example.

Example. Assume a partnership that is 100 percent owned, at all times, by calendar year individuals has historically used a June 30 taxable year. Also assume the partnership makes a valid section 444 election to retain a year ending June 30 for its taxable year beginning July 1, 1987. However, for its taxable year beginning July 1, 1988, the partnership changes to a calendar year, its required year. Based on these facts, the partnership's section 444 election is terminated on July 1, 1988, and the partnership must file a short period return for the period July 1, 1988–December 31, 1988. Furthermore, pursuant to § 1.702–3T(a)(1), the partners in such partnership are not entitled to a 4-year spread with respect to partnership items of income and expense for the taxable year beginning July 1, 1988 and ending December 31, 1988.

(iv) *Special rule for entity that liquidates or is sold prior to making a section 444 election, required return, or required payment.* A partnership, S corporation, or personal service corporation that is liquidated or sold for tax purposes before a section 444 election, required return, or required payment is made for a particular year may, nevertheless, make or continue a section 444 election, if otherwise qualified. (See §§ 1.7519–2T (a)(2) and 1.7519–1T (a)(3), respectively, for a description of the required return and a definition of the term ''required payment.'') However, the partnership, S corporation, or personal service corporation (or a trustee or agent thereof) must comply with the requirements for making or continuing a section 444 election. Thus, if applicable, required payments must be made and a subsequent claim for refund must be made in accordance with § 1.7519–2T(a)(6). The following examples illustrate the application of this paragraph (a)(5)(iv).

Example (1). Assume an existing S corporation historically used a June 30 taxable year and desires to make a section 444 election for its taxable year beginning July 1, 1987. Assume further that the S corporation is liquidated for tax purposes on February 15, 1988. If otherwise qualified, the S corporation (or a trustee or agent thereof) may make a section 444 election to have a taxable year beginning July 1, 1987, and ending February 15, 1988. However, if the S corporation makes a section 444 election, it must comply with the requirements for making a section 444 election, including making required payments.

Example (2). The facts are the same as in example (1), except that instead of liquidating on February 15, 1988, the shareholders of the S corporation sell their stock to a corporation on February 15, 1988. Thus, the corporation's S election is terminated on February 15, 1988. If otherwise qualified, the corporation may make a section 444 election to have a taxable year beginning July 1, 1987, and ending February 14, 1988.

Example (3). The facts are the same as in example (2), except that the new shareholders are individuals. Furthermore, the corporation's S election is not terminated. Based on these facts, the S corporation, if otherwise qualified, may make a section 444 election to retain a year ending June 30 for its taxable year beginning July 1, 1987. Furthermore, the S corporation may, if otherwise qualified, continue its section 444 election for subsequent taxable years.

(6) *Re-activating certain S elections*—(i) *Certain corporations electing S status that did not make a back-up calendar year request.* If a corporation that timely filed Form 2553, Election by a Small Business Corporation, effective for its first taxable year beginning in 1987—

(A) Requested a fiscal year based on business purpose,

(B) Did not agree to use a calendar year in the event its business purpose request was denied, and

(C) Such business purpose request is denied or withdrawn,

such corporation may retroactively re-activate its S election by making a valid section 444 election for its first taxable year beginning in 1987 and complying with the procedures in paragraph (a)(6)(iii) of this section.

(ii) *Certain corporations that revoked their S status.* If a corporation that used a fiscal year revoked its S election (pursuant to section 1362(d)(1)) for its first taxable year beginning in 1987, such corporation may retroactively re-activate its S election (*i.e.* rescind its revocation) by making a valid section 444 election for its first taxable year beginning in 1987 and complying with the procedures in paragraph (a)(6)(iii) of this section.

(iii) *Procedures for re-activating an S election.* A corporation re-activating its S election pursuant to paragraph (a)(6) (i) or (ii) of this section must—

(A) Obtain the consents of all shareholders who have owned stock in the corporation since the first day of the first taxable year of the corporation beginning after December 31, 1986,

(B) Include the following statement at the top of the first page of the corporation's Form 1120S for its first taxable year beginning in 1987—''SECTION 444 ELECTION—RE-ACTIVATES S STATUS,'' and

(C) Include the following statement with Form 1120S—''RE-ACTIVATION CONSENTED TO BY ALL SHAREHOLDERS WHO HAVE OWNED STOCK AT ANY TIME SINCE THE FIRST DAY OF THE FIRST TAXABLE YEAR OF THIS CORPORATION BEGINNING AFTER DECEMBER 31, 1986.''

(iv) *Examples.* The provisions of this paragraph (a)(6) may be illustrated by the following examples.

Example (1). Assume a corporation historically used a June 30 taxable year and such corporation timely filed Form 2553, Election by a Small Business Corporation, to be effective for its taxable year beginning July 1, 1987. On its Form 2553, the corporation requested permission to retain its June 30 taxable year based on business purpose. However, the corporation did not agree to use a calendar year in the event its business purpose request was denied. On April 1, 1988, the Internal Revenue Service notified the corporation that its business purpose request was denied and therefore the corporation's S election was not effective. Pursuant to paragraph (a)(6)(i) of this section, the corporation may re-activate its S election by making a valid section 444 election and complying with the procedures in paragraph (a)(6)(iii) of this section.

Example (2). The facts are the same as in example (1), except that as of July 26, 1988, the Internal Revenue Service has not yet determined whether the corporation has a valid business purpose to retain a June 30 taxable year. Based on these facts, the corporation may, if otherwise qualified, make a back-up section 444 election as provided in § 1.444–3T(b)(4). If the corporation's business purpose request is subsequently denied, the corporation should follow the procedures in §1.444–3T(b)(4)(iii) for activating a back-up section 444 election rather than the procedures provided in this paragraph (a)(6 for re-activating an S election.

Example (3). Assume a corporation has historically been an S corporation with a March 31 taxable year. However, for its taxable year beginning April 1, 1987, the corporation revoked its S election pursuant to section 1362 (d)(1). Pursuant to paragraph (a)(6)(ii) of this section, such corporation may retroactively rescind its S election revocation by making a valid section 444 election for its taxable year beginning April 1, 1987, and complying with the procedures provided in paragraph (a)(6)(iii) of this section. If the corporation retroactively rescinds its S revocation, the corporation shall file a Form 1120S for its taxable year beginning April 1, 1987.

(b) *Limitation on taxable years that may be elected*—(1) *General rule.* Except as provided in paragraphs (b)(2) and (3) of this section, a section 444 election may be made only if the deferral period (as defined in paragraph (b)(4) of this section) of the taxable year to be elected is not longer than three months.

(2) *Changes in taxable year*—(i) *In general.* In the case of a partnership, S corporation, or personal service corporation changing its taxable year, such entity may make a section 444 election only if the deferral period of the taxable year to be elected is not longer than the shorter of—

(A) Three months, or

(B) The deferral period of the taxable year that is being changed, as defined in paragraph (b)(2)(iii) of this section.

(ii) *Special rule for certain existing corporations electing S status.* If a corporation with a taxable year other than the calendar year—

(A) Elected after September 18, 1986, and before January 1, 1988, under section 1362 of the Code to be an S corporation, and

(B) Elected to have the calendar year as the taxable year of the S corporation,

then, for taxable years beginning before 1989, paragraph (b)(2)(i) of this section shall be applied by taking into account the deferral period of the last taxable year of the corporation prior to electing to be an S corporation, rather than the deferral period of the taxable year that is being changed. Thus, the provisions of the preceding sentence do not apply to a corporation that elected to be an S corporation for its first taxable year.

(iii) *Deferral period of the taxable year that is being changed.* For purposes of paragraph (b)(2)(i)(B) of this section, the phrase ‘‘deferral period of the taxable year that is being changed’’ means the deferral period of the taxable year immediately preceding the taxable year for which the taxpayer desires to make a section 444 election. Furthermore, the deferral period of such year will be determined by using the required taxable year of the taxable year for which the taxpayer desires to make a section 444 election. For example, assume P, a partnership that has historically used a March 31 taxable year, desires to change to a September 30 taxable year by making a section 444 election for its taxable year beginning April 1, 1987. Furthermore, assume that pursuant to paragraph (a)(4) of this section, P’s required taxable year for the taxable year beginning April 1, 1987 is a year ending December 31. Based on these facts the deferral period of the taxable year being changed is nine months (the period from March 31 to December 31).

(iv) *Examples.* See paragraph (d)(1) of this section for examples that illustrate the provisions of this paragraph (b)(2).

(3) *Special rule for entities retaining 1986 taxable year.* Notwithstanding paragraph (b)(2) of this section, a partnership, S corporation, or personal service corporation may, for its first taxable year beginning after December 31, 1986, if otherwise qualified, make a section 444 election to have a taxable year that is the same as the entity’s last taxable year beginning in 1986. See paragraph (d)(2) of this section for examples that illustrate the provisions of this paragraph (b)(3).

(4) *Deferral period*—(i) *Retentions of taxable year.* For a partnership, S corporation, or personal service corporation that desires to retain its taxable year by making a section 444 election, the term ‘‘deferral period’’ means the months between the beginning of such year and the close of the first required taxable year (as defined in paragraph (a)(4) of this section). The following example illustrates the application of this paragraph (b)(4)(i).

Example. AB partnership has historically used a taxable year ending July 31. AB desires to retain its July 31 taxable year by making a section 444 election for its taxable year beginning August 1, 1987. Calendar year individuals, A and B, each own 50 percent of the profits and capital of AB; thus, under paragraph (a)(4) of this section AB’s required taxable year is the year ending December 31. Pursuant to this paragraph (b)(4)(i), if AB desires to retain its year ending July 31, the deferral period is five months (the months between July 31 and December 31).

(ii) *Adoptions of and changes in taxable year*—(A) *In general.* For a partnership, S corporation, or personal service corporation that desires to adopt or change its taxable year by making a section 444 election, the term ‘‘deferral period’’ means the months that occur after the end of the taxable year desired under section 444 and before the close of the required taxable year.

(B) *Special rule.* If a partnership, S corporation or personal service corporation is using the required taxable year as its taxable year, the deferral period is deemed to be zero.

(C) *Examples.* The provisions of this paragraph (b)(4)(ii) may be illustrated by the following examples.

Example (1). Assume that CD partnership has historically used the calendar year and that CD's required taxable year is the calendar year. Under the special rule provided in paragraph (b)(4)(ii)(B) of this section, CD's deferral period is zero. See paragraph (b)(2)(i) of this section for rules that preclude CD from making a section 444 election to change its taxable year.

Example (2). E, a newly formed partnership, began operations on December 1, 1987, and is owned by calendar year individuals. E desires to make a section 444 election to adopt a September 30 taxable year. E's required taxable year is December 31. Pursuant to paragraph (b)(4)(ii)(A) of this section E's deferral period for the taxable year beginning December 1, 1987, is three months (the number of months between September 30 and December 31).

Example (3). Assume that F, a personal service corporation, has historically used a June 30 taxable year. F desires to make a section 444 election to change to an August 31 taxable year, effective for its taxable year beginning July 1, 1987. For purposes of determining the availability of a section 444 election for changing to the taxable year ending August 31, the deferral period of an August 31 taxable year is four months (the number of months between August 31 and December 31). The deferral period for F's existing June 30 taxable year is six months (the number of months between June 30 and December 31). Pursuant to §1.444–1T(b)(2)(i), F may not make a section 444 election to change to an August 31 taxable year.

(5) *Miscellaneous rules*—(i) *Special rule for determining the taxable year of a corporation electing S status.* For purposes of this section, and only for purposes of this section, a corporation that elected to be an S corporation for a taxable year beginning in 1987 or 1988 and which elected to be an S corporation prior to September 26, 1988, will not be considered to have adopted or changed its taxable year by virtue of information included on Form 2553, Election by a Small Business Corporation. See example (8) in paragraph (d) of this section.

(ii) *Special procedure for cases where an income tax return is superseded*—(A) *In general.* In the case of a partnership, S corporation, or personal service corporation that filed an income tax return for its first taxable year beginning after December 31, 1986, but subsequently makes a section 444 election that would result in a different year end for such taxable year, the income tax return filed pursuant to the section 444 election will supersede the original return. However, any payments of income tax made with respect to such superseded return will be credited to the taxpayer's superseding return and the taxpayer may file a claim for refund for such payments. See examples (5) and (7) in paragraph (d)(2) of this section.

(B) *Procedure for superseding return.* In order to allow the Service to process the affected income tax returns in an efficient manner, a partnership, S corporation, or personal service corporation that desires to supersede an income tax return in accordance with paragraph (b)(5)(ii)(A) of this section, should type or legibly print at the top of the first page of the income tax return for the taxable year elected—''SECTION 444 ELECTION—SUPERSEDES PRIOR RETURN.''

(iii) *Anti-abuse rule*— If an existing partnership, S corporation or personal service corporation (''predecessor entities''), or the owners thereof, transfer assets to a related party and the principal purpose of such transfer is to—

(A) Create a deferral period greater than the deferral period of the predecessor entity's taxable year, or

(B) Make a section 444 election following the termination of the predecessor entity's section 444 election,

then such transfer will be disregarded for purposes of section 444 and this section, even if the deferral created by such change is effectively eliminated by a required payment (within the meaning of section 7519) or deferral of a deduction (to a personal service corporation under section 280H). The following example illustrates the application of this paragraph (b)(5)(iii).

Example. Assume that P1 is a partnership that historically used the calendar year and is owned by calendar year partners. Assume that P1 desires to make a section 444 election to change to a September year for the taxable year beginning January 1, 1988. P1 may not make a section 444 election to change taxable years under section 444(b)(2) because its current deferral period is zero.

Assume further that P1 transfers a substantial portion of its assets to a newly-formed partnership (P2), which is owned by the partners of P1. Absent paragraph (b)(5)(iii) of this section, P2 could, if otherwise qualified, make a section 444 election under paragraph (b)(1) of this section to use a taxable year with a three month or less deferral period (*i.e.*, a September 30, October 31, or November 30 taxable year). However, if the principal purpose of the asset transfer was to create a one-, two-, or three-month deferral period by P2 making a section 444 election, the section 444 election shall not be given effect, even if the deferral would be effectively eliminated by P2 making a required payment under section 7519.

(iv) *Special rules for partial months and 52–53-week taxable years.* Except as otherwise provided in § 1.280H–1T(c)(2)(i)(A), for purposes of this section and §§ 1.7519–1T, 1.7519–2T and 1.280H–1T—

(A) A month of less than 16 days is disregarded, and a month of more than 15 days is treated as a full month; and

(B) A 52–53-week taxable year with reference to the end of a particular month will be considered to be the same as a taxable year ending with reference to the last day of such month.

(c) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

(d) *Examples*—(1) *Changes in taxable year.* The following examples illustrate the provisions of paragraph (b)(2) of this section.

Example (1). A is a personal service corporation that historically used a June 30 taxable year. A desires to make a section 444 election to change to an August 31 taxable year, effective with its taxable year beginning July 1, 1987. Under paragraph (b)(4)(ii) of this section, the deferred period of the taxable year to be elected is four months (the number of months between August 31 and December 31). Furthermore, the deferral period of the taxable year that is being changed is six months (the number of months between June 30 and December 31). Pursuant to paragraph (b)(2)(i) of this section, a taxpayer may, if otherwise qualified, make a section 444 election to change to a taxable year only if the deferral period of the taxable year to be elected is not longer than the shorter of three months or the deferred period of the taxable year being changed. Since the deferral period of the taxable year to be elected (August 31) is greater than three months, A may not make a section 444 election to change to the taxable year ending August 31, However, since the deferral period of the taxable year that is being changed is three months or more, A may, if otherwise qualified, make a section 444 election to change to a year ending September 30, 1987 (three-month deferral period), a year ending October 31, 1987 (two-month deferral period), or a year ending November 30, 1987 (one-month deferral period). In addition, instead of making a section 444 election to change its taxable year, A could, if otherwise qualified, make a section 444 election to retain its June end, pursuant to paragraph (b)(3) of this section.

Example (2). B, a corporation that historically used an August 31 taxable year, elected on November 1, 1986 to be an S corporation for its taxable year beginning September 1, 1986. As a condition to having the S election accepted, B agreed on Form 2553 to use calendar year. Pursuant to the general effective date provided in paragraph (c) of this section, B may not make a section 444 election for its taxable year beginning in 1986. Thus, B must file a short period income tax return for the period September 1 to December 31, 1986.

Example (3). The facts are the same as in example (2), except that B desires to make a section 444 election for its taxable year beginning January 1, 1987. Absent paragraph (b)(2)(ii) of this section, B would not be allowed to change its taxable year because the deferral period of the taxable year being changed (*i.e.*, the calendar year) is zero. However, pursuant to the special rule provided in paragraph (b)(2)(ii) of this section, B shall apply paragraph (b)(2)(i) of this section by taking into account the deferral period of the last taxable year of B prior to B's election to be an S corporation (four months), rather than the deferral period of B's taxable year that is being changed (zero months). Thus, if otherwise qualified, B may make a section 444 election to change to a taxable year ending September 30, October 31, or November 30, for its taxable year beginning January 1, 1987.

Example (4). The facts are the same as in example (3), except that B files a calendar year income tax return for 1987 rather than making a section 444 election. However, for its taxable year beginning January 1, 1988, B desires to change its taxable year by making a section 444 election. Given that the special rule provided in paragraph (b)(2)(ii) of this section applies to section 444 elections made in taxable years beginning before 1989, B may, if otherwise qualified, make a section 444 election to change to a taxable year ending September 30, October 31, or November 30 for its taxable year beginning January 1, 1988.

Example (5). C, a corporation that historically used a June 30 taxable year, elected on December 15, 1986 to be an S corporation for its taxable year beginning July 1, 1987. As a condition to having the S election accepted, C agreed on Form 2553 to use a calendar year. Although pursuant to paragraph (b)(3) of this section, C would, if otherwise qualified, be allowed to retain its June 30 taxable year, C desires to change to a September 30 taxable year by making a section 444 election. Pursuant to paragraph (b)(2) of this section, a taxpayer may, if otherwise qualified, make a section 444 election to change to a taxable year only if the deferral period of the taxable year to be elected is not longer than the shorter of three months or the deferral period of the taxable year being changed. Given these facts, the deferral period of the taxable year to be elected is 3 months (September 30 to December 31) while the deferral period of the taxable year being changed is 6 months (June 30 to December 31). Thus, C may, if otherwise qualified, change to a September 30 taxable year for its taxable year beginning July 1, 1987, by making a section 444 election. The fact that C agreed on Form 2553 to use a calendar year is not relevant.

Example (6). D, a corporation that historically used a March 31 taxable year, elects on June 1, 1988 to be an S corporation for its taxable year beginning April 1, 1988. D desires to change to a June 30 taxable year by making a section 444 election for its taxable year beginning April 1, 1988. Pursuant to paragraph (b)(2)(i) of this section, D may not change to a June 30 taxable year because such year would have a deferral period greater than 3 months. However, if otherwise qualified, D may make a section 444 election to change to a taxable year ending September 30, October 31, or November 30 for its taxable year beginning April 1, 1988.

Example (7). E, a corporation that began operations on November 1, 1986, elected to be an S corporation on December 15, 1986, for its taxable year beginning November 1, 1986. E filed a short period income tax return for the period November 1 to December 31, 1986. E desires to change to a September 30 taxable year by making a section 444 election for its taxable year beginning January 1, 1987. Although E elected to be an S corporation after September 18, 1986, and before January 1, 1988, paragraph (b)(2)(ii) of this section does not apply to E since E was not a C corporation prior to electing S status. Thus, E may not change its taxable year for the taxable year beginning January 1, 1987, by making a section 444 election.

Example (8). The facts are the same as in example (7), except that E began operations on April 15, 1987, and elected to be an S corporation on June 1, 1987, for its taxable year beginning April 15, 1987. As a condition to being an S corporation, E agreed on Form 2553 to use a calendar year. E desires to make a section 444 election to use a year ending September 30 for its taxable year beginning April 15, 1987. Pursuant to paragraph (b)(5)(i) of this section, E's agreement to use a calendar year on Form 2553 does not mean that E has adopted a calendar year. Thus, E's desire to make a section 444 election to use a September 30 taxable year will not be considered a change in taxable year and thus paragraph (b)(2) of this section will not apply. Instead, E will be subject to paragraph (b)(1) of this section. Since a September 30 taxable year would result in only a three-month deferral period (September 30 to December 31), E may, if otherwise qualified, make a section 444 election to use a year ending September 30 for its taxable year beginning April 15, 1987.

(2) *Special rule for entities retaining their 1986 taxable year.* The following examples illustrate the provisions of paragraph (b)(3) of this section.

Example (1). F, an S corporation that elected to be an S corporation several years ago, has historically used a June 30 taxable year. F desires to retain its June 30 taxable year by making a section 444 election for its taxable year beginning July 1, 1987. Pursuant to paragraph (b)(4)(i) of this section, the deferral period of the taxable year being retained is 6 months (June 30 to December 31, F's required taxable year). Absent the special rule provided in paragraph (b)(3) of this section, F would be subject to the general rule provided in paragraph (b)(1) of this section which limits the deferral period of the taxable year elected to three months or less. However, pursuant to paragraph (b)(3) of this section, F may, if otherwise qualified, make a section 444 election to retain its year ending June 30 for its taxable year beginning July 1, 1987.

Example (2). The facts are the same as in example (1), except that F received permission from the Commissioner to change its taxable year to the calendar year, and filed a short period income tax return for the period July 1 to December 31, 1986. F desires to make a section 444 election to use a year ending June 30 for its taxable year beginning January 1, 1987. Given that F had a December 31 taxable year for its last taxable year beginning in 1986, the special rule provided in paragraph (b)(3) of this section does not allow F to use a June 30 taxable year for its taxable year beginning January 1, 1987. Furthermore, pursuant to paragraph (b)(2)(i) of this section, F is not allowed to change its taxable year from December 31 to June 30 because the deferral period of the taxable year being changed is zero months.

Example (3). G, a corporation that historically used an August 31 taxable year, elected be an S corporation on November 15, 1986, for its taxable year beginning September 1, 1986. As a condition to obtaining S status, G agreed to use a calendar year. Thus, G filed its first S corporation return for the period September 1 to December 31, 1986. G desires to make a section 444 election to use a year ending August 31 for its taxable year beginning January 1, 1987. Since G's last taxable year beginning in 1986 was a calendar year, G cannot use paragraph (b)(3) of this section, relating to retentions of taxable years, to elect an August 31 taxable year. Thus, G is subject to paragraph (b)(2)(i) of this section, relating to changes in taxable year. Although G, if otherwise qualified, may use the special rule provided in paragraph (b)(2)(ii) of this section, G may only change from its current taxable year (*i.e.*, the calendar year) to a taxable year that has no more than a three-month deferral period (*i.e.*, September 30, October 31, or November 30).

Example (4). The facts are the same as in example (3), except that G elected to be an S corporation for its taxable year beginning September 1, 1987, rather than its taxable year beginning September 1, 1986. As a condition to making its S election, G agreed, on Form 2553, to use the calendar year. However, G has not yet filed a short period income tax return for the period September 1 to December 31, 1987. Given these facts, paragraph (b)(3) of this section would allow G, if otherwise qualified, to make a section 444 election to retain an August 31 taxable year for its taxable year beginning September 1, 1987.

Example (5). The facts are the same as in example (4), except that G has already filed a short period income tax return for the period September 1 to December 31, 1987. Pursuant to paragraph (b)(5)(ii)(A) of this section, G may supersede the return it filed for the period September 1 to December 31, 1987. Thus, pursuant to paragraph (b)(3) of this section, G may, if otherwise qualified, make a section 444 election to retain an August 31 taxable year for the taxable year beginning September 1, 1987. In addition, G should follow the special procedures set forth in paragraph (b)(5)(ii)(B) of this section.

Example (6). H, a corporation that historically used a May 31 taxable year, elects to be an S corporation on June 15, 1988 for its taxable year beginning June 1, 1988. H desires to make a section 444 election to use a taxable year other than the calendar year. Since the taxable year in issue is not H's first taxable year beginning after December 31, 1986, H may not use the special rule provided in paragraph (b)(3)(i) and thus may not retain its May 31 year. However, H may, if otherwise qualified, make a section 444 election under paragraph (b)(2)(i) of this section, to change to a taxable year that has no more than a three-month deferral period (*i.e.*, September 30, October 31, or November 30) for its taxable year beginning June 1, 1988.

Example (7). I is a partnership that has historically used a calendar year. Sixty percent of the profits and capital of I are owned by Q, a corporation (that is neither an S corporation nor a personal service corporation) that has a June 30 taxable year, and 40 percent of the profits and capital are owned by R, a calendar year individual. Since the partner that has more than a fifty percent interest in I has a June 30 taxable year, I's required taxable year is June 30. Accordingly, I filed an income tax return for the period January 1 to June 30, 1987. Based on these facts, I may, pursuant to paragraph (b)(5)(ii)(A) of this section, disregard the income tax return filed for the period January 1 to June 30, 1987. Thus, if otherwise qualified, I may make a section 444 election under paragraph (b)(2)(i) of this section to use a calendar year for its taxable year beginning January 1, 1987. If I makes such a section 444 election, I should follow the special procedures set forth in paragraph (b)(5)(ii)(B) of this section.

[T.D. 8205, 53 FR 19694, May 27, 1988]

§ 1.444–2T Tiered structure (temporary).

(a) *General rule.* Except as provided in paragraph (e) of this section, no section 444 election shall be made or continued with respect to a partnership, S corporation, or personal service corporation that is a member of a tiered structure on the date specified in paragraph (d) of this section. For purposes of this section, the term ''personal service corporation'' means a personal service corporation as defined in § 1.441–4T (d).

(b) *Definition of a member of a tiered structure*— (1) *In general.* A partnership, S corporation, or personal service corporation is considered a member of a tiered structure if—

(i) The partnership, S corporation, or personal service corporation directly owns any portion of a deferral entity, or

(ii) A deferral entity directly owns any portion of the partnership, S corporation, or personal service corporation.

However, see paragraph (c) of this section for certain de minimis rules, and see paragraph (b)(3) of this section for an anti-abuse rule. In addition, for purposes of this section, a beneficiary of a trust shall be considered to own an interest in the trust.

(2) *Deferral entity*—(i) *In general.* For purposes of this section, the term ''deferral entity'' means an entity that is a partnership, S corporation, personal service corporation, or trust. In the case of an affiliated group of corporations filing a consolidated income tax return that is treated as a personal

service corporation pursuant to §1.441–4T (i), such affiliated group is considered to be a single deferral entity.

(ii) *Grantor trusts.* The term ‘‘deferral entity’’ does not include a trust (or a portion of a trust) which is treated as owned by the grantor or beneficiary under Subpart E, part I, subchapter J, chapter 1, of the Code (relating to grantor trusts), including a trust that is treated as a grantor trust pursuant to section 1361(d)(1)(A) of the Code (relating to qualified subchapter S trusts). Thus, any taxpayer treated under subpart E as owning a portion of a trust shall be treated as owning the assets of the trust attributable to that ownership. The following examples illustrate the provisions of this paragraph (b)(2)(ii).

Example (1). A, an individual, is the sole beneficiary of T. T is a trust that owns 50 percent of the profits and capital of X, a partnership that desires to make a section 444 election. Furthermore, pursuant to Subpart E, Part I, subchapter J, chapter 1 of the Code, A is treated as an owner of X. Based upon these facts, T is not a deferral entity and 50 percent of X is considered to be directly owned by A.

Example (2). The facts are the same as in example (1), except that A is a personal service corporation rather than an individual. Given these facts, 50 percent of X is considered to be directly owned by A, a deferral entity. Thus, X is considered to be a member of a tiered structure.

(3) *Anti-abuse rule.* Notwithstanding paragraph (b)(1) of this section, a partnership, S corporation, or personal service corporation is considered a member of a tiered structure if the partnership, S corporation, personal service corporation, or related taxpayers have organized or reorganized their ownership structure or operations for the principal purpose of obtaining a significant unintended tax benefit from making or continuing a section 444 election. For purposes of the preceding sentence, a significant unintended tax benefit results when a partnership, S corporation, or personal service corporation makes a section 444 election and, as a result, a taxpayer (not limited to the entity making the election) obtains a significant deferral of income substantially all of which is not eliminated by a required payment under section 7519. See examples (15) through (19) in paragraph (f) of this section.

(c) *De minimis rules*—(1) *In general.* For rules relating to a de minimis exception to paragraph (b)(1)(i) of this section (the ‘‘downstream de minimis rule’’), see paragraph (c)(2) of this section. For rules relating to a de minimis exception to paragraph (b)(1)(ii) of this section (the ‘‘upstream de minimis rule’’), see paragraph (c)(3) of this section. For rules relating to the interaction of the de minimis rules provided in this paragraph (c) and the ‘‘same taxable year exception’’ provided in paragraph (e) of this section, see paragraph (e)(5) of this section.

(2) *Downstream de minimis rule*—(i) *General rule.* If a partnership, S corporation, or personal service corporation directly owns any portion of one or more deferral entities as of the date specified in paragraph (d) of this section, such ownership is disregarded for purposes of paragraph (b)(1)(i) of this section if, in the aggregate, all such deferral entities accounted for—

(A) Not more than 5 percent of the partnership's, S corporation's, or personal service corporation's adjusted taxable income for the testing period (‘‘5 percent adjusted taxable income test’’), or

(B) Not more than 2 percent of the partnership's, S corporation's, or personal service corporation's gross income for the testing period (‘‘2 percent gross income test’’). See section 702 (c) for rules relating to the determination of gross income of a partner in a partnership.

See examples (3) through (5) in paragraph (f) of this section.

(ii) *Definition of testing period.* For purposes of this paragraph (c)(2), the term ‘‘testing period’’ means the taxable year that ends immediately prior to the taxable year for which the partnership, S corporation, or personal service corporation desires to make or continue a section 444 election. However, see the special rules provided in paragraph (c)(2)(iv) of this section for certain special cases (*e.g.*, the partnership, S corporation, personal service corporation or deferral entity was not in existence during the entire testing period). The following example illustrates the application of this paragraph (c)(2)(ii).

Example. A partnership desires to make a section 444 election for its taxable year beginning November 1, 1987. The testing period for purposes of determining whether deferral entities owned by such partnership are de minimis under paragraph (c)(2) of this section is the taxable year ending October 31, 1987. If either the partnership or the deferral entities were not in existence for the entire taxable year ending October 1, 1987, see the special rules provided in paragraph (c)(2)(iv) of this section.

(iii) *Definition of adjusted taxable income*—(A) *Partnership.* In the case of a partnership, adjusted taxable income for purposes of paragraph (c)(2) of this section is an amount equal to the sum of the—

(*1*) Aggregate amount of the partnership items described in section 702(a) (other than credits and tax-exempt income),

(*2*) Applicable payments defined in section 7519(d)(3) that are deducted in determining the amount described in paragraph (c)(2)(iii)(A)(*1*) of this section, and

(*3*) Guaranteed payments defined in section 707(c) that are deducted in determining the amount described in paragraph (c)(2)(iii)(A)(*1*) of this section and are not otherwise included in paragraph (c)(2)(iii)(A)(*2*) of this section. For purposes of determining the aggregate amount of partnership items under paragraph (c)(2)(iii)(A)(*1*) of this section, deductions and losses are treated as negative income. Thus, for example, if under section 702(a) a partnership has $1,000 of ordinary taxable income, $500 of specially allocated deductions, and $300 of capital loss, the partnership's aggregate amount of partnership items under paragraph (c)(2)(iii)(A)(*1*) of this section is $200 ($1,000–$500–$300).

(B) *S corporation.* In the case of an S corporation, adjusted taxable income for purposes of paragraph (c)(2) of this section is an amount equal to the sum of the—

(*1*) Aggregate amount of the S corporation items described in section 1366(a) (other than credits and tax-exempt income), and

(*2*) Applicable payments defined in section 7519(d)(3) that are deducted in determining the amount described in paragraph (c)(2)(iii)(B)(*1*) of this section.

For purposes of determining the aggregate amount of S corporation items under paragraph (c)(2)(iii)(B)(*1*) of this section, deductions and losses are treated as negative income. Thus, for example, if under section 1366(a) an S corporation has $2,000 of ordinary taxable income, $1,000 of deductions described in section 1366(a)(1)(A) of the Code, and $500 of capital loss, the S corporation's aggregate amount of S corporation items under paragraph (c)(2)(iii)(B)(*1*) of this section is $500 ($2,000–$1,000–$500).

(C) *Personal service corporation.* In the case of a personal service corporation, adjusted taxable income for purposes of paragraph (c)(2) of this section is an amount equal to the sum of the—

(*1*) Taxable income of the personal service corporation, and

(*2*) Applicable amounts defined in section 280H(f)(1) that are deducted in determining the amount described in paragraph (c)(2)(iii)(C)(*1*) of this section.

(iv) *Special rules*—(A) *Pro-forma rule.* Except as provided in paragraph (c)(iv)(C)(*2*) of this section, if a partnership, S corporation, or personal service corporation directly owns any interest in a deferral entity as of the date specified in paragraph (d) of this section and such ownership interest is different in amount from the partnership's, S corporation's, or personal service corporation's interest on any day during the testing period, the 5 percent adjusted taxable income test and the 2 percent gross income test must be applied on a pro-forma basis (*i.e.,* adjusted taxable income and gross income must be calculated for the testing period assuming that the partnership, S corporation, or personal service corporation owned the same interest in the deferral entity that it owned as of the date specified in paragraph (d) of this section). The following example illustrates the application of this paragraph (c)(2)(iv)(A).

Example. A personal service corporation desiring to make a section 444 election for its taxable year beginning October 1, 1987, acquires a 25 percent ownership interest in a partnership on or after October 1, 1987. Furthermore, the partnership has been in existence for several years. The personal service corporation must modify its calculations of the 5 percent adjusted taxable income test and the 2 percent gross income test for the testing period ended September 30, 1987, by assuming that the personal service corporation owned 25 percent of the partnership during such testing period and the personal service corporation's adjusted taxable income and gross income were correspondingly adjusted.

(B) *Reasonable estimates allowed.* If the information necessary to complete the pro-forma calculation described in paragraph (c)(2)(iv)(A) of this section is not readily available, the partnership, S corporation, or personal service corporation may make a reasonable estimate of such information.

(C) *Newly formed entities*—(*1*) *Newly formed deferral entities.* If a partnership, S corporation, or personal service corporation owns any portion of a deferral entity on the date specified in paragraph (d) of this section and such deferral entity was not in existence during the entire testing period (hereinafter referred to as a ''newly formed deferral entity''), both the 5 percent adjusted taxable income test and the 2 percent gross income test are modified as follows. First, the partnership, S corporation, or personal service corporation shall calculate the percentage of its adjusted taxable income or gross income that is attributable to deferral entities, excluding newly formed deferral entities. Second, the partnership, S corporation, or personal service corporation shall calculate (on the date specified in paragraph (d) of this section) the percentage of the tax basis of its assets that are attributable to its tax basis with respect to its ownership interests in all newly formed deferral entities. If the sum of the two percentages is 5 percent or less, the deferral entities are considered de minimis and are disregarded for purposes of paragraph (b)(1)(i) of this section. If the sum of the two percentages is greater than 5 percent, the deferral entities do not qualify for the de minimis rule provided in paragraph (c)(2) of this section and thus the partnership, S corporation, or personal service corporation is considered to be a member of a tiered structure for purposes of this section.

(*2*) *Newly formed partnership, S corporation, or personal service corporation desiring to make a section 444 election.* If a partnership, S corporation, or personal service corporation desires to make a section 444 election for the first taxable year of its existence, the 5 percent adjusted taxable income test and the 2 percent gross income test are replaced by a 5 percent of assets test. Thus, if on the date specified in paragraph (d) of this section, 5 percent or less of the assets (measured by reference to the tax basis of the assets) of the newly formed partnership, S corporation, or personal service corporation are attributable to the tax basis with respect to its ownership interests in the deferral entities, the deferral entities will be considered de minimis and will be disregarded for purposes of paragraph (b)(1)(i) of this section.

(*3*) *Upstream de minimis rule.* If a partnership, S corporation, or personal service corporation is directly owned by one or more deferral entities as of the date specified in paragraph (d) of this section, such ownership is disregarded for purposes of paragraph (b)(1)(ii) of this section if on the date specified in paragraph (d) of this section the deferral entities directly own, in the aggregate, 5 percent or less of—

(*i*) An interest in the current profits of the partnership, or

(*ii*) The stock (measured by value) of the S corporation or personal service corporation.

See examples (6) and (7) in paragraph (f) of this section.

(d) *Date for determining the existence of a tiered structure*—(1) *General rule.* For purposes of paragraph (a) of this section, a partnership, S corporation, or personal service corporation will be considered a member of a tiered structure for a particular taxable year if the partnership, S corporation, or personal service corporation is a member of a tiered structure on the last day of the required taxable year (as defined in section 444 (e) of the Code) ending within such year. If a particular taxable year does not include the last day of the required taxable year for such year, the partnership, S corporation, or personal service corporation will not be considered a member of a tiered structure for such year. The following examples illustrate the application of this paragraph (d)(1).

Example (1). Assume that a newly formed partnership whose first taxable year begins November 1, 1988, desires to adopt a September 30 taxable year by making a section 444 election. Furthermore, assume that for its taxable year beginning November 1, 1988, the partnership's required taxable year is December 31. If the partnership is a member of a tiered structure on December 31, 1988, it will not be eligible to make a section 444 election for a taxable year beginning November 1, 1988, and ending September 30, 1989.

Example (2). Assume an S corporation that historically used a June 30 taxable year desires to make a section 444 election to change to a year ending September 30 for its taxable year beginning July 1, 1987. If the S corporation can make the section 444 election, it will have a short taxable year beginning July 1, 1987, and ending September 30, 1987. Given these facts, the short taxable year beginning July 1, 1987, does not include the last day of the S corporation's required taxable year for such year (*i.e.*, December 31, 1987). Thus, pursuant to paragraph (d)(1) of this section, the S corporation will not be considered a member of a tiered structure for its taxable year beginning July 1, 1987, and ending September 30, 1987.

(2) *Special rule for taxable years beginning in 1987.* For purposes of paragraph (a) of this section, a partnership, S corporation, or personal service corporation will not be considered a member of a tiered structure for a taxable year beginning in 1987 if the partnership, S corporation, or personal service corporation is not a member of a tiered structure on the day the partnership, S corporation, or personal service corporation timely files its section 444 election for such year. The following examples illustrate the application of this paragraph (d)(2).

Example (1). Assume that a partnership desires to retain a June 30 taxable year by making a section 444 election for its taxable year beginning July 1, 1987. Furthermore, assume that the partnership's required taxable year for such year is December 31 and that the partnership was a member of a tiered structure on such date. Also assume that the partnership was not a member of a tiered structure as of the date it timely filed its section 444 election for its taxable year beginning July 1, 1987. Based upon the special rule provided in this paragraph (d)(2), the partnership will not be considered a member of a tiered structure for its taxable year beginning July 1, 1987.

Example (2). Assume the same facts as in example (1), except that the partnership was a member of a tiered structure on the date it filed its section 444 election for its taxable year beginning July 1, 1987, but was not a member of a tiered structure on December 31, 1987. Paragraph (d)(1) of this section would still apply and thus the partnership would not be considered part of a tiered structure for its taxable year beginning July 1, 1987. However, the partnership would be considered a member of a tiered structure for its taxable year beginning July 1, 1988, if the partnership was a member of a tiered structure on December 31, 1988.

(e) *Same taxable year exception*—(1) *In general.* Although a partnership or S corporation is a member of a tiered structure as of the date specified in paragraph (d) of this section, the partnership, S corporation may make or continue a section 444 election if the tiered structure (as defined in paragraph (e)(2) of this section) consists entirely of partnerships or S corporations (or both), all of which have the same taxable year as determined under paragraph (e)(3) of this section. However, see paragraph (e)(5) of this section for the interaction of the de minimis rules provided in paragraph (c) of this section with the same taxable year exception. For purposes of this paragraph (e), two or more entities are considered to have the same taxable year if their taxable years end on the same day, even though they begin on different days. See examples (8) through (14) in paragraph (f) of this section.

(2) *Definition of tiered structure*—(i) *General rule.* For purposes of the same taxable year exception, the members of a tiered structure are defined to include the following entities—

(A) The partnership or S corporation that desires to qualify for the same taxable year exception,

(B) A deferral entity (or entities) directly owned (in whole or in part) by the partnership or S corporation that desires to qualify for the same taxable year exception,

(C) A deferral entity (or entities) directly owning any portion of the partnership or S corporation that desires to qualify for the same taxable year exception, and

(D) A deferral entity (or entities) directly owned (in whole or in part) by a ''downstream controlled partnership,'' as defined in paragraph (e)(2)(ii) of this section.

(ii) *Special flow-through rule for downstream controlled partnerships.* If more than 50 percent of a partnership's profits and capital are owned by a partnership or S corporation that desires to qualify for the same taxable year exception, such owned partnership is considered a downstream controlled partnership for purposes of paragraph (e)(2)(i) of this section. Furthermore, if more than 50 percent of a partnership's profits and capital are owned by a downstream controlled partnership, such owned partnership is considered a downstream controlled partnership for purposes of paragraph (e)(2)(i) of this section.

(3) *Determining the taxable year of a partnership or S corporation.* The taxable year of a partnership or S corporation to be taken into account for purposes of paragraph (e)(1) of this section is the taxable year ending with or prior to the date specified in paragraph (d) of this section. Furthermore, the determination of such taxable year will take into consideration any section 444 elections made by the partnership or S corporation. See examples (10) and (11) in paragraph (f) of this section.

(4) *Special rule for 52–53-week taxable years.* For purposes of this paragraph (e), a 52–53-week taxable year with reference to the end of a particular month will be considered to be the same as a taxable year ending with reference to the last day of such month.

(5) *Interaction with de minimis rules*—(i) *Downstream de minimis rule*—(A) *In general.* If a partnership or S corporation that desires to make or continue a section 444 election is a member of a tiered structure (as defined in paragraph (e)(2) of this section) and directly owns any member (or members) of the tiered structure with a taxable year different from the taxable year of the partnership or S corporation, such ownership is disregarded for purposes of the same taxable year exception of paragraph (e)(1) of this section provided that, in the aggregate, the de minimis rule of paragraph (c)(2) of this section is satisfied with respect to such owned member (or members). The following example illustrates the application of this paragraph (e)(5)(i)(A).

Example. P, a partnership with a June 30 taxable year, owns 60 percent of P1, another partnership with a June 30 taxable year. P also owns 1 percent of P2 and P3, calendar year partnerships. If, in the aggregate, P's ownership interests in P2 and P3 are considered de minimis under paragraph (c)(2) of this section, P meets the same taxable year exception and may make a section 444 election to retain its June 30 taxable year.

(B) *Special rule for members of a tiered structure directly owned by a downstream controlled partnership.* For purposes of paragraph (e)(5)(i)(A) of this section, a partnership or S corporation desiring to make or continue a section 444 election is considered to directly own any member of the tiered structure (as defined in paragraph (e)(2) of this section) directly owned by a downstream controlled partnership (as defined in paragraph (e)(2)(ii) of this section). The adjusted taxable income or gross income of the partnership or S corporation that is attributable to a member of a tiered structure directly owned by a downstream controlled partnership equals the adjusted taxable income or gross income of such member multiplied by the partnership's or S corporation's indirect ownership percentage of such member. The following example illustrates the application of this paragraph (e)(5)(i)(B).

Example. P, a partnership, desires to retain its June 30 taxable year by making a section 444 election. However, as of the date specified in paragraph (d) of this section, P owns 75 percent of P1, a June 30 partnership, and P1 owns 40 percent of P2, a calendar year partnership. P also owns 25 percent of P3, a calendar year partnership. Pursuant to paragraphs (e)(5)(i) (A) and (B) of this section, P may only qualify to use the same taxable year exception if, in the aggregate, P2 and P3 are de minimis with respect to P. Pursuant to paragraph (e)(5)(i)(B) of this section, P's adjusted taxable income or gross income attributable to P2 equals 30 percent (75 percent times 40 percent) of P2's adjusted taxable income or gross income.

(ii) *Upstream de minimis rule.* If a partnership or S corporation that desires to make or continue a section 444 election is a member of a tiered structure (as defined in paragraph (e)(2) of this section) and is owned directly by a member (or members) of the tiered structure with taxable years different from the taxable year of the partnership or S corporation, such ownership is disregarded for purposes of the same taxable year exception of paragraph (e)(1) of this section provided that, in the aggregate, the de minimis rule of paragraph (c)(3) of this section is satisfied with respect to such owning member (or members). See example (12) of paragraph (f) of this section.

(f) *Examples.* The provisions of this section may be illustrated by the following examples.

Example (1). A, a partnership, desires to make or continue a section 444 election. However, on the date specified in paragraph (d) of this section, A is owned by a combination of individuals and S corporations. The S corporations are deferral entities, as defined in paragraph (b)(2) of this section. Thus, pursuant to paragraph (b)(1)(ii) of this section, A will be a member of a tiered structure unless under paragraph (c)(3) of this section, the S corporations, in the aggregate, own a de minimis portion of A. If the S corporations' ownership in A is not considered de minimis under paragraph (c)(3) of this section, A is a member of a tiered structure and will be allowed to make or continue a section 444 election only if it meets the same taxable year exception provided in paragraph (e) of this section.

Example (2). B, a partnership, desires to make or continue a section 444 election. However, on the date specified in paragraph (d) of this section, B is a partner in two partnerships, B1 and B2. B1 and B2 are deferral entities, as defined in paragraph (b)(2) of this section. Thus, under paragraph (b)(1)(i) of this section, B will be a member of a tiered structure unless B's aggregate ownership interests in B1 and B2 are considered de minimis under paragraph (c)(2) of this section. If B is a member of a tiered structure on the date specified in paragraph (d) of this section, B will be allowed to make or continue a section 444 election only if it meets the same taxable year exception provided in paragraph (e) of this section.

Example (3). C, a partnership with a September 30 taxable year, is 100 percent owned by calendar year individuals. C desires to make a section 444 election for its taxable year beginning October 1, 1987. However, on the date specified in paragraph (d) of this section, C owns a 1 percent interest in C1, a partnership. C does not own any other interest in a deferral entity. For the taxable year ended September 30, 1987, 10 percent of C's adjusted taxable income (as defined in paragraph (c)(2)(iii) of this section) was attributable to C's partnership interest in C1. Furthermore, 4 percent of C's gross income for the taxable year ended September 30, 1987, was attributable to C's partnership interest in C1. Under paragraph (c)(2) of this section, C's partnership interest in C1 is not de minimis because during the testing period more than 5 percent of C's adjusted taxable income is attributable to C1 and more than 2 percent of C's gross income is attributable to C1. Thus, C is a member of a tiered structure for its taxable year beginning October 1, 1987.

Example (4). The facts are the same as example (3), except that for the taxable year ended September 30, 1987, only 2 percent of C's adjusted taxable income was attributable to C1. Under paragraph (c)(2) of this section, C's partnership interest in C1 is considered de minimis for purposes of determining whether C is a member of a tiered structure because not more than 5 percent of C's adjusted taxable income during the testing period is attributable to C1. Thus, C is not a member of a tiered structure for its taxable year beginning October 1, 1987.

Example (5). The facts are the same as example (4), except that in addition to owning C1, C also owns 15 percent of C2, another partnership. For the taxable year ended September 30, 1987, 2 percent of C's adjusted taxable income is attributable to C1 and an additional 4 percent is attributable to C2. Furthermore, for the taxable year ended September 30, 1987, 4 percent of C's gross income is attributable to C1 while 3 percent is attributable to C2. Under paragraph (c)(2) of this section, C1 and C2 must be aggregated for purposes of determining whether C meets either the 5 percent adjusted taxable income test or the 2 percent gross income test. Since C's adjusted taxable income attributable to C1 and C2 is 6 percent (2 percent + 4 percent) and C's gross income attributable to C1 and C2 is 7 percent (4 percent + 3 percent), C does not meet the downstream de minimis rule provided in paragraph (c)(2) of this section. Thus, C is a member of a tiered structure for its taxable year beginning October 1, 1987.

Example (6). The facts are the same as example (3), except that instead of determining whether C is part of a tiered structure, the issue is whether C1 is part of a tiered structure. In addition, assume that on the date specified in paragraph (d) of this section, the remaining 99 percent of C1 is owned by calendar year individuals and C1 does not own an interest in any deferral entity. Although C in Example (3) was considered to be a part of a tiered structure by virtue of its ownership interest in C1, C1 must be tested separately to determine whether it is part of a tiered structure. Since C's interest in C1 is 5 percent or less, C's interest in C1 is de minimis with respect to C1. See paragraph (c)(3) of this section. Thus, based upon these facts, C1 is not part of a tiered structure.

Example (7). The facts are the same as example (6), except that the remaining 99 percent of C1 is owned 94 percent by calendar year individuals and 5 percent by C3, another partnership. Thus, deferral entities own 6 percent of C1 (1 percent owned by C and 5 percent owned by C3). Under paragraph (c)(3) of this section, deferral entities own more than a de minimis interest (*i.e.*, 5 percent) of C1, and thus C1 is part of a tiered structure.

Example (8). D, a partnership with a September 30 taxable year, desires to make a section 444 election for its taxable year beginning October 1, 1987. On December 31, 1987, and the date D plans to file its section 444 election, D is 10 percent owned by D1, a personal service corporation with a September 30 taxable year, and 90 percent owned by calendar year individuals. Furthermore, D1 will retain its September 30 taxable year because it previously established a business purpose for such year. Since D is owned in part by D1, a personal service corporation, and the ownership interest is not de minimis under paragraph (c)(3) of this section, D is considered a member of a tiered structure for its taxable year beginning October 1, 1987. Furthermore, although D and D1 have the same taxable year, D does not qualify for the same taxable year exception provided in paragraph (e) of this section because D1 is a personal service corporation rather than a partnership or S corporation. Thus, pursuant to paragraph (a) of this section, D may not make a section 444 election for its taxable year beginning October 1, 1987.

Example (9). The facts are the same as example (8), except that D1 is a partnership rather than a personal service corporation. Based upon these facts, D qualifies for the same taxable year exception provided in paragraph (e) of this section. Thus, D may make a section 444 election for its taxable year beginning October 1, 1987.

Example (10). The facts are the same as example (9), except that D1 has not established a business purpose for a September 30 taxable year. In addition, D1 does not desire to make a section 444 election and, under section 706(b), D1 will be required to change to a calendar year for its taxable year beginning October 1, 1987. Pursuant to paragraph (e)(3) of this section, D and D1 do not have the same taxable year for purposes of the same taxable year exception provided in paragraph (e) of this section. Thus, D may not make a section 444 election for its taxable year beginning October 1, 1987.

Example (11). The facts are the same as example (8), except that D1 is a partnership with a March 31 taxable year. Furthermore, for its taxable year beginning April 1, 1987, D1 will change to a September 30 taxable year by making a section 444 election. Pursuant to paragraph (e)(3) of this section, D1 is considered to have a September 30 taxable year for purposes of determining whether D qualifies for the same taxable year exception provided in paragraph (e) of this section. Since both D and D1 will have the same taxable year as of the date specified in paragraph (d) of this section, D may make a section 444 election for its taxable year beginning October 1, 1987.

Example (12). The facts are the same as example (11), except that instead of the remaining 90 percent of D being owned by calendar year individuals, it is owned 86 percent by individuals and 4 percent by D2, a calendar year partnership. Thus, D, a September 30 partnership, is 10 percent owned by D1, a September 30 partnership, 86 percent owned by calendar year individuals, and 4 percent owned by D2, a calendar year partnership. Under paragraph (e)(5)(ii) of this section, D2’s ownership interest in D is considered de minimis for purposes of the same taxable year exception. Since D2’s ownership interest in D is considered de minimis, it is disregarded for purposes of determining whether D qualifies for the same taxable year exception provided in paragraph (e) of this section. Thus, since both D and D1 will have the same taxable year as of the date specified in paragraph (d) of this section, D may make a section 444 election for its taxable year beginning October 1, 1987.

Example (13). E, a partnership with a June 30 taxable year, desires to make a section 444 election for its taxable year beginning July 1, 1987. On the date specified in paragraph (d) of this section, E is 100 percent owned by calendar year individuals; E owns 99 percent of the profits and capital of E1, a partnership with a June 30 taxable year; and E1 owns 30 percent of the profits and capital of E2, a partnership with a September 30 taxable year. E owns no other deferral entities. Pursuant to paragraph (b)(1)(i) of this section, E is considered to be a member of a tiered structure. Furthermore, pursuant to paragraph (e) of this section, E does not qualify for the same taxable year exception because E2 does not have the same taxable year as E and E1.

Example (14). The facts are the same as example (13), except that E owns only 49 percent (rather than 99 percent) of the profits and capital of E1. Pursuant to paragraph (e) of this section, E qualifies for the same taxable year exception because E and E1 have the same taxable year. Pursuant to paragraph (e) of this section, E1’s ownership interest in E2 is disregarded since E does not own more than 50 percent of E1’s profits and capital.

Example (15). Prior to consideration of the anti-abuse rule provided in paragraph (b)(3) of this section, H, a partnership that commenced operations on October 1, 1987, is eligible to make a section 444 election for its taxable year beginning October 1, 1987. Although H may obtain a significant deferral of income substantially all of which is not eliminated by a required payment under section 7519 (since there will be no required payment for H's first taxable year), the anti-abuse rule of paragraph (b)(3) will not apply unless the principal purpose of organizing H was the attainment of a significant deferral of income that would result from making a section 444 election.

Example (16). F, a partnership with a January 31 taxable year, desires to make a section 444 election to retain its January 31 taxable year for the taxable year beginning February 1, 1987. F is 100 percent owned by calendar year individuals. Prior to the date specified in paragraph (d) of this section, F contributes substantially all of its assets to F1, a partnership, in exchange for a 51 percent interest in F1. The remaining 49 percent of F1 is owned by the calendar year individuals owning 100 percent of F. If F is allowed to make a section 444 election to retain its January 31 taxable year, F1's required taxable year will be January 31 since a majority of F1's partners use a January 31 taxable year (see § 1.706–3T). F's principal purpose for creating F1 and contributing its assets to F1 is to obtain an 11-month deferral on 49 percent of the income previously earned by F and now earned by F1. Pursuant to paragraph (b)(3) of this section, F is not allowed to make a section 444 election for its taxable year beginning February 1, 1987.

Example (17). The facts are the same as in example (16), except that F does not create F1 and contribute its assets to F1 until immediately after F makes its section 444 election for the taxable year beginning February 1, 1987. Thus, F is allowed to make a section 444 election for its taxable year beginning February 1, 1987. However, pursuant to paragraph (b)(3) of this section, F will have its section 444 election terminated for subsequent years unless the tax deferral inherent in the structure is eliminated (*e.g.,* F1 is liquidated or the individual owners of F contribute their interests in F1 to F) prior to the date specified in paragraph (d) of this section for subsequent taxable years beginning on or after February 1, 1988.

Example (18). The facts are the same as in example (16), except that F1 is 99 percent owned by F and none of the individual owners of F own any portion of F1. Furthermore, F obtained no tax benefit from creating and contributing assets to F1. Given these facts paragraph (b)(3) of this section does not apply and thus, F may make a section 444 election for its taxable year beginning February 1, 1987.

Example (19). G, a partnership with an October 31 taxable year, desires to retain its October 31 taxable year for its taxable year beginning November 1, 1987. However, as of December 31, 1987, G owns a 30 percent interest in G1, a calendar year partnership. G owns no other deferral entity, and G is 100 percent owned by calendar year individuals. Furthermore, G's interest in G1 does not meet the de minimis rule provided in paragraph (c)(3) of this section. Thus, in order to avoid being a tiered structure, G sells its interest in G1 to an unrelated third party prior to the date G timely makes it section 444 election for its taxable year beginning November 1, 1987. Although the sale of G1 allows G to qualify to make a section 444 election, and therefore to obtain a significant tax benefit, such benefit is not unintended. Thus, paragraph (b)(3) of this section does not apply, and G may make a section 444 election for its taxable year beginning November 1, 1987.

(g) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

[T.D. 8205, 53 FR 19698, May 27, 1988]

§ 1.444–3T Manner and time of making section 444 election (temporary).

(a) *In general.* A section 444 election shall be made in the manner and at the time provided in this section.

(b) *Manner and time of making election*—(1) *General rule.* A section 444 election shall be made by filing a properly prepared Form 8716, ''Election to Have a Tax Year Other Than a Required Tax Year,'' with the Service Center indicated by the instructions to Form 8716. Except as provided in paragraphs (b) (2) and (4) of this section, Form 8716 must be filed by the earlier of—

(i) The 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective, or

(ii) The due date (without regard to extensions) of the income tax return resulting from the section 444 election.

In addition, a copy of Form 8716 must be attached to Form 1065 or Form 1120 series form, whichever is applicable, for the first taxable year for which the section 444 election is made. Form 8716 shall be signed by any person who is authorized to sign Form 1065 or Form 1120 series form, whichever is applicable. (See sections 6062 and 6063, relating to the signing of returns.) The provisions of this paragraph (b)(1) may be illustrated by the following examples.

Example (1). A, a partnership that began operations on September 10, 1988, is qualified to make a section 444 election to use a September 30 taxable year for its taxable year beginning September 10, 1988. Pursuant to paragraph (b)(1) of this section, A must file Form 8716 by the earlier of the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective (*i.e.*, February 15, 1989) or the due date (without regard to extensions) of the partnership's tax return for the period September 10, 1988 to September 30, 1988 (*i.e.*, January 15, 1989). Thus, A must file Form 8716 by January 15, 1989.

Example (2). The facts are the same as in example (1), except that A began operations on October 20, 1988. Based upon these facts, A must file Form 8716 by March 15, 1989, the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective.

Example (3). B is a corporation that first becomes a personal service corporation for its taxable year beginning September 1, 1988. B qualifies to make a section 444 election to use a September 30 taxable year for its taxable year beginning September 1, 1988. Pursuant to this paragraph (b)(1), B must file Form 8716 by December 15, 1988, the due date of the income tax return for the short period September 1 to September 30, 1988.

(2) *Special extension of time for making an election.* If, pursuant to paragraph (b)(1) of this section, the due date for filing Form 8716 is prior to July 26, 1988, such date is extended to July 26, 1988. The provisions of this paragraph (b)(2) may be illustrated by the following examples.

Example (1). B, a partnership that historically used a June 30 taxable year, is qualified to make a section 444 election to retain a June 30 taxable year for its taxable year beginning July 1, 1987. Absent paragraph (b)(2) of this section, B would be required to file Form 8716 by December 15, 1987. However, pursuant to paragraph (b)(2) of this section, B's due date for filing Form 8716 is extended to July 26, 1988.

Example (2). C, a partnership that began operations on January 20, 1988, is qualified to make a section 444 election to use a year ending September 30 for its taxable year beginning January 20, 1988. Absent paragraph (b)(2) of this section, C is required to file Form 8716 by June 15, 1988 (the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective). However, pursuant to paragraph (b)(2) of this section, the due date for filing Form 8716 is July 26, 1988.

(3) *Corporation electing to be an S corporation*—(i) *In general.* A corporation electing to be an S corporation is subject to the same time and manner rules for filing Form 8716 as any other taxpayer making a section 444 election. Thus, a corporation electing to be an S corporation that desires to make a section 444 election is not required to file Form 8716 with its Form 2553, ''Election by a Small Business Corporation.'' However, a corporation electing to be an S corporation after September 26, 1988, is required to state on Form 2553 its intention to—

(A) Make a section 444 election, if qualified, or

(B) Make a ''back-up section 444 election'' as described in paragraph (b)(4) of this section.

If a corporation electing to be an S corporation fails to state either of the above intentions, the District Director may, at his discretion, disregard any section 444 election for such taxpayer.

(ii) *Examples.* The provisions of this paragraph (b)(3) may be illustrated by the following examples.

Example (1). D is a corporation that commences operations on October 1, 1988, and elects to be an S corporation for its taxable year beginning October 1, 1988. All of D's shareholders use the calendar year as their taxable year. D desires to adopt a September 30 taxable year. D does not believe it has a business purpose for a September 30 taxable year and thus it must make a section 444 election to use such year. Based on these facts, D must, pursuant to the instructions to Form 2553, state on Form 2553 that, if qualified, it will make a section 444 election to adopt a year ending September 30 for its taxable year beginning October 1, 1988. If D is qualified (*i.e.*, D is not a member of a tiered structure on December 31, 1988) to make a section 444 election for its taxable year beginning October 1, 1988, D must file Form 8716 by March 15, 1989. If D ultimately is not qualified to make a section 444 election for its taxable year beginning October 1, 1988, D's election to be an S corporation will not be effective unless, pursuant to the instructions to Form 2553, D made a back-up calendar year election (*i.e.*, an election to adopt the calendar year in the event D ultimately is not qualified to make a section 444 election for such year).

Example (2). The facts are the same as in example (1), except that D believes it can establish, to the satisfaction of the Commissioner, a business purpose for adopting a September 30 taxable year. However, D desires to make a ''back-up section 444 election'' (see paragraph (b)(4) of this section) in the event that the Commissioner does not grant permission to adopt a September 30 taxable year based upon business purpose.

Based on these facts, D must, pursuant to the instructions to Form 2553, state on Form 2553 its intention, if qualified, to make a back-up section 444 election to adopt a September 30 taxable year. If, by March 15, 1989, D has not received permission to adopt a September 30 taxable year and D is qualified to make a section 444 election, D must make a back-up election in accordance with paragraph (b)(4) of this section.

(4) *Back-up section 444 election*—(i) *General rule.* A taxpayer that has requested (or is planning to request) permission to use a particular taxable year based upon business purpose, may, if otherwise qualified, file a section 444 election (referred to as a ''back-up section 444 election''). If the Commissioner subsequently denies the business purpose request, the taxpayer will, if otherwise qualified, be required to activate the back-up section 444 election. See examples (1) and (2) in paragraph (b)(4)(iv) of this section.

(ii) *Procedures for making a back-up section 444 election.* In addition to following the general rules provided in this section, a taxpayer making a back-up section 444 election should, in order to allow the Service to process the affected returns in an efficient manner, type or legibly print the words ''BACK-UP ELECTION'' at the top of Form 8716, ''Election to Have a Tax Year Other Than a Required Tax Year.'' However, if such Form 8716 is filed on or after the date a Form 1128, Application for Change in Accounting Period, is filed with respect to a period that begins on the same date, the words ''FORM 1128 BACK-UP ELECTION'' should be typed or legibly printed at the top of Form 8716.

(iii) *Procedures for activating a back-up section 444 election*—(A) *Partnerships and S corporations*—(*1*) *In general.* A back-up section 444 election made by a partnership or S corporation is activated by filing the return required in § 1.7519–2T (a)(2)(i) and making the payment required in § 1.7519–1T. The due date for filing such return and payment will be the later of—

(*i*) The due dates provided in § 1.7519–2T, or

(*ii*) 60 days from the date the Commissioner denies the business purpose request.

However, interest will be assessed (at the rate provided in section 6621 (a)(2)) on any required payment made after the due date (without regard to any extension for a back-up election) provided in § 1.7519–2T (a)(4)(i) or (a)(4)(ii), whichever is applicable, for such payment. Interest will be calculated from such due date to the date such amount is actually paid. Interest assessed under this paragraph will be separate from any required payments. Thus, interest will not be subject to refund under § 1.7519–2T.

(*2*) *Special rule if Form 720 used to satisfy return requirement.* If, pursuant to § 1.7519–2T (a)(3), a partnership or S corporation must use Form 720, ''Quarterly Federal Excise Tax Return,'' to satisfy the return requirement of § 1.7519–2T (a)(2), then in addition to following the general rules provided in § 1.7519–2T, the partnership or S corporation must type or legibly print the words ''ACTIVATING BACK-UP ELECTION'' on the top of Form 720. A partnership or S corporation that would otherwise file a Form 720 on or before the date specified in paragraph (b)(4)(iii)(A)(*1*) of this section may satisfy the return requirement by including the necessary information on such Form 720. Alternatively, such partnership or S corporation may file an additional Form 720 (*i.e.*, a Form 720 separate from the Form 720 it would otherwise file). Thus, for example, if the due date for activating an S corporation's back-up election is November 15, 1988, and the S corporation must file a Form 720 by October 31, 1988, to report manufacturers excise tax for the third quarter of 1988, the S corporation may use that Form 720 to activate its back-up election. Alternatively, the S corporation may file its regular Form 720 that is due October 31, 1988, and file an additional Form 720 by November 15, 1988, activating its back-up election.

(B) *Personal service corporations.* A back-up section 444 election made by a personal service corporation is activated by filing Form 8716 with the personal service corporation's original or amended income tax return for the taxable year in which the election is first effective, and typing or legibly printing the words—''ACTIVATING BACK-

UP ELECTION'' on the top of such income tax return.

(iv) *Examples.* The provisions of this paragraph (b)(4) may be illustrated by the following examples. Also see example (2) in paragraph (b)(3) of this section.

Example (1). E, a partnership that historically used a June 30 taxable year, requested (pursuant to section 6 of Rev. Proc. 87–32, 1987–28 I.R.B. 14) permission from the Commissioner to retain a June 30 taxable year for its taxable year beginning July 1, 1987. Furthermore, E is qualified to make a section 444 election to retain a June 30 taxable year for its taxable year beginning July 1, 1987. However, as of the date specified in paragraph (b)(2) of this section, the Commissioner has not determined whether E has a valid business purpose for retaining its June 30 taxable year. Based on these facts, E may, by the date specified in paragraph (b)(2) of this section, make a back-up section 444 election to retain its June 30 taxable year.

Example (2). The facts are the same as in example (1). In addition, on August 12, 1988, the Internal Revenue Service notifies E that its business purpose request is denied. E asks for reconsideration of the Service's decision, and the Service sustains the original denial on September 30, 1988. Based on these facts, E must activate its back-up section 444 election within 60 days after September 30, 1988.

Example (3). The facts are the same as in example (1), except that E desires to make a section 444 election to use a year ending September 30 for its taxable year beginning July 1, 1987. Although E qualifies to make a section 444 election to retain its June 30 taxable year, E may make a back-up section 444 election for a September 30 taxable year.

(c) *Administrative relief*—(1) *Extension of time to file income tax returns*—(i) *Automatic extension.* If a partnership, S corporation, or personal service corporation makes a section 444 election (or does not make a section 444 election, either because it is ineligible or because it decides not to make the election, and therefore changes to its required taxable year) for its first taxable year beginning after December 31, 1986, the due date for filing its income tax return for such year shall be the later of—

(A) The due date established under—

(*1*) Section 6072, in the case of Form 1065,

(*2*) § 1.6037–1 (b), in the case of Form 1120S,

(*3*) Section 6072 (b), in the case of other Form 1120 series form; or

(B) August 15, 1988.

The words ''SECTION 444 RETURN'' should, in order to allow the Service to process the affected returns in an efficient manner, be typed or legibly printed at the top of the Form 1065 or Form 1120 series form, whichever is applicable, filed under this paragraph (c)(1)(i).

(ii) *Additional extensions.* If the due date of the income tax return for the first taxable year beginning after December 31, 1986, extended as provided in paragraph (c)(1)(i)(B) of this section, occurs before the date that is 6 months after the date specified in paragraph (c)(1)(i)(A) of this section, the partnership, S corporation, or personal service corporation may request an additional extension or extensions of time (up to 6 months after the date specified in paragraph (c)(1)(i)(A) of this section) to file its income tax return for such first taxable year. The request must be made by the later of the date specified in paragraph (c)(1)(i)(A) or (c)(1)(i)(B) of this section and must be made on Form 7004, ''Application for Automatic Extension of Time To File Corporation Income Tax Return'', or Form 2758, ''Application for Extension of Time to File U.S. Partnership, Fiduciary, and Certain Other Returns,'' whichever is applicable, in accordance with the form and its instructions. In addition, the following words should be typed or legibly printed at the top of the form—''SECTION 444 REQUEST FOR ADDITIONAL EXTENSION.''

(iii) *Examples.* The provisions of paragraph (c)(1) of this section may be illustrated by the following examples.

Example (1). G, a partnership that historically used a January 31 taxable year, makes a section 444 election to retain such year for its taxable year beginning February 1, 1987. Absent paragraph (c)(1)(i) of this section, G's Form 1065 for the taxable year ending January 31, 1988, is due on or before May 15, 1988. However, if G types or legibly prints ''SECTION 444 RETURN'' at the top of Form 1065 for such year, paragraph (c)(1)(i) of this section automatically extends the due date of such return to August 15, 1988.

Example (2). The facts are the same as in example (1), except that G desires to extend the due date of its income tax return for the year ending January 31, 1988, to a date beyond August 15, 1988. Pursuant to paragraph (c)(1)(ii) of this section, G may extend such return to November 15, 1988 (*i.e.*, the date that is up to 6 months after May 15, 1988, the normal due date of the return). However, in order to obtain this additional extension, G must file Form 2758 pursuant to paragraph (c)(1)(i) of this section on or before August 15, 1988.

Example (3). H, a partnership that historically used a May 31 taxable year, makes a section 444 election to use a year ending September 30 for its taxable year beginning on June 1, 1987. Absent paragraph (c)(1)(i) of this section, H's Form 1065 for the taxable year beginning June 1, 1987, and ending September 30, 1987, is due on or before January 15, 1988. However, if H types or legibly prints ''SECTION 444 RETURN'' at the top of Form 1065 for such year, paragraph (c)(1)(i) of this section automatically extends the due date of such return to August 15, 1988.

Example (4). The facts are the same as in example (3), except H desires to further extend (*i.e.,* extend beyond August 15, 1988) the due date of its income tax return for its taxable year beginning June 1, 1987, and ending September 30, 1987. Since August 15, 1988, is 6 months or more after the due date (without extensions) of such return, paragraph (c)(1)(ii) of this section prevents H from further extending the time for filing such return.

Example (5). I, a partnership that historically used a June 30 taxable year, considered making a section 44 election to retain such taxable year, but eventually decided to change to a December 31, taxable year (I's required taxable year). Absent paragraph (c)(1)(i) of this section, I's Form 1065 for the taxable year beginning July 1, 1987, and ending December 31, 1987, is due on or before April 15, 1988. Pursuant to paragraph (c)(1)(i) of this section, if I types or legibly prints ''SECTION 444 RETURN'' at the top of Form 1065 for such year, paragraph (c)(1)(i) of this section automatically extends the due date of such return to August 15, 1988. In addition, I may further extend such return pursuant to paragraph (c)(1)(ii) of this section.

(2) *No penalty for certain late payments*—(i) *In general.* In the case of a personal service corporation or S corporation described in paragraph (c)(1)(i) of this section, no penalty under section 6651 (a)(2) will be imposed for failure to pay income tax (if any) for the first taxable year beginning after December 31, 1986, but only for the period beginning with the last date for payment and ending with the later of the date specified in paragraph (c)(1)(i) or paragraph (c)(1)(ii) of this section.

(ii) *Example.* The provisions of paragraph (c)(2)(i) of this section may be illustrated by the following example.

Example. J, a personal service corporation that historically used a January 31 taxable year, makes a section 444 election to retain such year for its taxable year beginning February 1, 1987. The last date (without extension) for payment of J's income tax (if any) for its taxable year beginning February 1, 1987, is April 15, 1988. However, under paragraph (c)(2)(i) of this section, no penalty under section 6651(a)(2) will be imposed on any underpayment of income tax for the period beginning April 15, 1988 and ending August 15, 1988.

(d) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

[T.D. 8205, 53 FR 19703, May 27, 1988]

METHODS OF ACCOUNTING

METHODS OF ACCOUNTING IN GENERAL

§1.446–1 General rule for methods of accounting.

(a) *General rule.* (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term ''method of accounting'' includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are,

in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461, and the regulations thereunder.

(4) Each taxpayer is required to make a return of his taxable income for each taxable year and must maintain such accounting records as will enable him to file a correct return. See section 6001 and the regulations thereunder. Accounting records include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return, as for example, a reconciliation of any differences between such books and his return. The following are among the essential features that must be considered in maintaining such records:

(i) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in process, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. (For rules relating to computation of inventories, see section 263A, 471, and 472 and the regulations thereunder.)

(ii) Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account.

(iii) In any case in which there is allowable with respect to an asset a deduction for depreciation, amortization, or depletion, any expenditures (other than ordinary repairs) made to restore the asset or prolong its useful life shall be added to the asset account or charged against the appropriate reserve.

(b) *Exceptions.* (1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

(2) A taxpayer whose sole source of income is wages need not keep formal books in order to have an accounting method. Tax returns, copies thereof, or other records may be sufficient to establish the use of the method of accounting used in the preparation of the taxpayer's income tax returns.

(c) *Permissible methods*—(1) In general. Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

(i) *Cash receipts and disbursements method.* Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipt, see § 1.451–2. For treatment of an expenditure attributable to more than one taxable year, see section 461(a) and paragraph (a)(1) of § 1.461–1.

(ii) *Accrual method.* (A) Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. (See paragraph (a)(2)(iii)(A) of §1.461–1 for examples of liabilities that may not be taken into account until after the taxable year incurred, and see §§1.461–4 through 1.461–6 for rules relating to economic performance.) Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. For example, section 162 provides that a deductible liability generally is taken into account in the taxable year incurred through a deduction from gross income. As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of §1.263A–1(c)(3)) and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Internal Revenue Code sections and related guidance.

(B) The term ''liability'' includes any item allowable as a deduction, cost, or expense for Federal income tax purposes. In addition to allowable deductions, the term includes any amount otherwise allowable as a capitalized cost, as a cost taken into account in computing cost of goods sold, as a cost allocable to a long-term contract, or as any other cost or expense. Thus, for example, an amount that a taxpayer expends or will expend for capital improvements to property must be incurred before the taxpayer may take the amount into account in computing its basis in the property. The term ''liability'' is not limited to items for which a legal obligation to pay exists at the time of payment. Thus, for example, amounts prepaid for goods or services and amounts paid without a legal obligation to do so may not be taken into account by an accrual basis taxpayer any earlier than the taxable year in which those amounts are incurred.

(C) No method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. The method used by the taxpayer in determining when income is to be accounted for will generally be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations. For example, a taxpayer engaged in a manufacturing business may account for sales of the taxpayer's product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customers, whether or not billed, depending on the method regularly employed in keeping the taxpayer's books.

(iii) *Other permissible methods.* Special methods of accounting are described elsewhere in chapter 1 of the Code and the regulations thereunder. For example, see the following sections and the regulations thereunder: Sections 61 and 162, relating to the crop method of accounting; section 453, relating to the installment method; section 451, relating to the long-term contract methods. In addition, special methods of accounting for particular items of income and expense are provided under other sections of chapter 1. For example, see section 174, relating to research and experimental expenditures, and section 175, relating to soil and water conservation expenditures.

(iv) *Combinations of the foregoing methods. (a)* In accordance with the following rules, any combination of the foregoing methods of accounting will be permitted in connection with a trade or business if such combination clearly reflects income and is consistently used. Where a combination of methods of accounting includes any special methods, such as those referred to in subdivision (iii) of this subparagraph, the taxpayer must comply with the requirements relating to such special methods. A taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash method in computing all other items of income and expense. However, a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method of accounting in computing business expenses shall use an accrual method in computing items affecting gross income from his trade or business.

(b) A taxpayer using one method of accounting in computing items of income and deductions of his trade or business may compute other items of income and deductions not connected with his trade or business under a different method of accounting.

(2) *Special rules.* (i) In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

(ii) No method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year. The Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in the regulations in this part if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the regulations in this part, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. See section 446(a) and paragraph (a) of this section, which require that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books, and section 446(e) and paragraph (e) of this section, which require the prior approval of the Commissioner in the case of changes in accounting method.

(d) *Taxpayer engaged in more than one business.* (1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

(e) *Requirement respecting the adoption or change of accounting method.* (1) A taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. See section 446(c) and paragraph (c) of this section for permissible methods. Moreover, a taxpayer may adopt any permissible method of accounting in connection with each separate and distinct trade or business, the income from which is reported for the first time. See section 446(d) and paragraph (d) of this section. See also section 446(a) and paragraph (a) of this section.

(2)(i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.

(ii)*(a)* A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder), a change from the cash or accrual method to a long-term contract method, or vice versa (see §1.451–3), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a change where the Internal Revenue Code and regulations thereunder specifically require that the consent of the Commissioner must be obtained before adopting such a change.

(b) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction which does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but which are in fact payments of dividends, and of items that are deducted as business expenses, but which are in fact personal expenses, are not changes in method of accounting. In addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts or an adjustment in the useful life of a depreciable asset. Although such adjustments may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustments in the current and future years. For the treatment of the adjustment of the addition to a bad debt reserve, see the regulations under section 166 of the Code; for the treatment of a change in the useful life of a depreciable asset, see the regulations under section 167(b) of the Code. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. On the other hand, for example, a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which has been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item, and is to be treated as a change in method of accounting.

(c) A change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting.

(iii) A change in the method of accounting may be illustrated by the following examples:

Example (1). Although the sale of merchandise is an income producing factor, and therefore inventories are required, a taxpayer in the retail jewelry business reports his income on the cash receipts and disbursements method of accounting. A change from the cash receipts and disbursements method of accounting to the accrual method of accounting is a change in the overall plan of accounting and thus is a change in method of accounting.

Example (2). A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis except for real estate taxes which have been reported on the cash receipts and disbursements method of accounting. A change in the treatment of real estate taxes from the cash receipts and disbursements method to the accrual method is a change in method of accounting because such change is a change in the treatment of a material item within his overall accounting practice.

Example (3). A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis. Vacation pay has been deducted in the year in which paid because the taxpayer did not have a completely vested vacation pay plan, and, therefore, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make the payment now arises. The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed.

Example (4). From 1968 through 1970, a taxpayer has fairly allocated indirect overhead costs to the value of inventories on a fixed percentage of direct costs. If the ratio of indirect overhead costs to direct costs increases in 1971, a change in the underlying facts has occurred. Accordingly, an increase in the percentage in 1971 to fairly reflect the increase in the relative level of indirect overhead costs is not a change in method of accounting but is a change in treatment resulting from a change in the underlying facts.

Example (5). A taxpayer values inventories at cost. A change in the basis for valuation of inventories from cost to the lower of cost or market is a change in an overall practice of valuing items in inventory. The change, therefore, is a change of method of accounting for inventories.

Example (6). A taxpayer in the manufacturing business has for many taxable years valued its inventories at cost. However, cost has been improperly computed since no overhead costs have been included in valuing the inventories at cost. The failure to allocate an appropriate portion of overhead to the value of inventories is contrary to the requirement of the Internal Revenue Code and the regulations thereunder. A change requiring appropriate allocation of overhead is a change in method of accounting because it involves a change in the treatment of a material item used in the overall practice of identifying or valuing items in inventory.

Example (7). A taxpayer has for many taxable years valued certain inventories by a method which provides for deducting 20 percent of the cost of the inventory items in determining the final inventory valuation. The 20 percent adjustment is taken as a ‘‘reserve for price changes.’’ Although this method is not a proper method of valuing inventories under the Internal Revenue Code or the regulations thereunder, it involves the treatment of a material item used in the overall practice of valuing inventory. A change in such practice or procedure is a change of method of accounting for inventories.

Example (8). A taxpayer has always used a base stock system of accounting for inventories. Under this system a constant price is applied to an assumed constant normal quantity of goods in stock. The base stock system is an overall plan of accounting for inventories which is not recognized as a proper method of accounting for inventories under the regulations. A change in this practice is, nevertheless, a change of method of accounting for inventories.

(3)(i) Except as otherwise provided under the authority of paragraph (e)(3)(ii) of this section, to secure the Commissioner’s consent to a taxpayer’s change in method of accounting the taxpayer must file an application on Form 3115 with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting. To the extent applicable, the taxpayer must furnish all information requested on the Form 3115. This information includes all classes of items that will be treated differently under the new method of accounting, any amounts that will be duplicated or omitted as a result of the proposed change, and the taxpayer’s computation of any adjustments necessary to prevent such duplications or omissions. The Commissioner may require such other information as may be necessary to determine whether the proposed change will be permitted. Permission to change a taxpayer’s method of accounting will not be granted unless the taxpayer agrees to the Commissioner’s prescribed terms and conditions for effecting the change, including the taxable year or years in which any adjustment necessary to prevent amounts from being duplicated or omitted is to be taken into account. See section 481 and the regulations thereunder, relating to certain adjustments resulting from accounting method changes, and section 472 and the regulations thereunder, relating to adjustments for changes to and from the last-in, first-out inventory method. For any Form 3115 filed on or after May 15, 1997, see § 1.446–1T(e)(3)(i)(B).

(ii) Notwithstanding the provisions of paragraph (e)(3)(i) of this section, the

Commissioner may prescribe administrative procedures under which taxpayers will be permitted to change their method of accounting. The administrative procedures shall prescribe those terms and conditions necessary to obtain the Commissioner's consent to effect the change and to prevent amounts from being duplicated or omitted. The terms and conditions that may be prescribed by the Commissioner may include terms and conditions that require the change in method of accounting to be effected on a cut-off basis or by an adjustment under section 481(a) to be taken into account in the taxable year or years prescribed by the Commissioner.

(iii) This paragraph (e)(3) applies to Forms 3115 filed on or after December 31, 1997. For other Forms 3115, see §1.446–1(e)(3) in effect prior to December 31, 1997 (§1.446–1(e)(3) as contained in the 26 CFR part 1 edition revised as of April 1, 1997).

[T.D. 6500, 25 FR 11708, Nov. 26, 1960, as amended by T.D. 7073, 35 FR 17710, Nov. 18, 1970; T.D. 7285, 38 FR 26184, Sept. 19, 1973; T.D. 8067, 51 FR 378, Jan. 6, 1986; T.D. 8131, 52 FR 10084, Mar. 30, 1987; T.D. 8408, 57 FR 12419, Apr. 10, 1992; T.D. 8482, 58 FR 42233, Aug. 9, 1993; T.D. 8608, 60 FR 40078, Aug. 7, 1995; T.D. 8719, 62 FR 26741, May 15, 1997; T.D. 8742, 62 FR 68169, Dec. 31, 1997]

§1.446–2 Method of accounting for interest.

(a) *Applicability*—(1) *In general.* This section provides rules for determining the amount of interest that accrues during an accrual period (other than interest described in paragraph (a)(2) of this section) and for determining the portion of a payment that consists of accrued interest. For purposes of this section, interest includes original issue discount and amounts treated as interest (whether stated or unstated) in any lending or deferred payment transaction. Accrued interest determined under this section is taken into account by a taxpayer under the taxpayer's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method). Application of an exception described in paragraph (a)(2) of this section to one party to a transaction does not affect the application of this section to any other party to the transaction.

(2) *Exceptions*—(i) *Interest included or deducted under certain other provisions.* This section does not apply to interest that is taken into account under—

(A) Sections 1272(a), 1275, and 163(e) (income and deductions relating to original issue discount);

(B) Section 467(a)(2) (certain payments for the use of property or services);

(C) Sections 1276 through 1278 (market discount);

(D) Sections 1281 through 1283 (discount on certain short-term obligations);

(E) Section 7872(a) (certain loans with below-market interest rates); or

(F) Section 1.1272–3 (an election by a holder to treat all interest on a debt instrument as original issue discount).

(ii) *De minimis original issue discount.* This section does not apply to de minimis original issue discount (other than de minimis original issue discount treated as qualified stated interest) as determined under §1.1273–1(d). See §1.163–7 for the treatment of de minimis original issue discount by the issuer and §§1.1273–1(d) and 1.1272–3 for the treatment of de minimis original issue discount by the holder.

(b) *Accrual of qualified stated interest.* Qualified stated interest (as defined in §1.1273–1(c)) accrues ratably over the accrual period (or periods) to which it is attributable and accrues at the stated rate for the period (or periods).

(c) *Accrual of interest other than qualified stated interest.* Subject to the modifications in paragraph (d) of this section, the amount of interest (other than qualified stated interest) that accrues for any accrual period is determined under rules similar to those in the regulations under sections 1272 and 1275 for the accrual of original issue discount. The preceding sentence applies regardless of any contrary formula agreed to by the parties.

(d) *Modifications*—(1) *Issue price.* The issue price of the loan or contract is equal to—

(i) In the case of a contract for the sale or exchange of property to which section 483 applies, the amount described in §1.483–2(a)(1)(i) or (ii), whichever is applicable;

(ii) In the case of a contract for the sale or exchange of property to which section 483 does not apply, the stated principal amount; or

(iii) In any other case, the amount loaned.

(2) *Principal payments that are not deferred payments.* In the case of a contract to which section 483 applies, principal payments that are not deferred payments are ignored for purposes of determining yield and adjusted issue price.

(e) *Allocation of interest to payments*—(1) *In general.* Except as provided in paragraphs (e)(2), (e)(3), and (e)(4) of this section, each payment under a loan (other than payments of additional interest or similar charges provided with respect to amounts that are not paid when due) is treated as a payment of interest to the extent of the accrued and unpaid interest determined under paragraphs (b) and (c) of this section as of the date the payment becomes due.

(2) *Special rule for points deductible under section 461(g)(2).* If a payment of points is deductible by the borrower under section 461(g)(2), the payment is treated by the borrower as a payment of interest.

(3) *Allocation respected in certain small transactions.* [Reserved]

(4) *Pro rata prepayments.* Accrued but unpaid interest is allocated to a pro rata prepayment under rules similar to those for allocating accrued but unpaid original issue discount to a pro rata prepayment under § 1.1275–2(f). For purposes of the preceding sentence, a pro rata prepayment is a payment that is made prior to maturity that—

(i) Is not made pursuant to the contract's payment schedule; and

(ii) Results in a substantially pro rata reduction of each payment remaining to be paid on the contract.

(f) *Aggregation rule.* For purposes of this section, all contracts calling for deferred payments arising from the same transaction (or a series of related transactions) are treated as a single contract. This rule, however, generally only applies to contracts involving a single borrower and a single lender.

(g) *Debt instruments denominated in a currency other than the U.S. dollar.* This section applies to a debt instrument that provides for all payments denominated in, or determined by reference to, the functional currency of the taxpayer or qualified business unit of the taxpayer (even if that currency is other than the U.S. dollar). See § 1.988–2(b) to determine interest income or expense for debt instruments that provide for payments denominated in, or determined by reference to, a nonfunctional currency.

(h) *Example.* The following example illustrates the rules of this section.

Example. Allocation of unstated interest to deferred payments—(i) *Facts.* On July 1, 1996, A sells his personal residence to B for a stated purchase price of $1,297,143.66. The property is not personal use property (within the meaning of section 1275(b)(3)) in the hands of B. Under the loan agreement, B is required to make two installment payments of $648,571.83 each, the first due on June 30, 1998, and the second due on June 30, 2000. Both A and B use the cash receipts and disbursements method of accounting and use a calendar year for their taxable year.

(ii) *Amount of unstated interest.* Under section 483, the agreement does not provide for adequate stated interest. Thus, the loan's yield is the test rate of interest determined under § 1.483–3. Assume that both A and B use annual accrual periods and that the test rate of interest is 9.2 percent, compounded annually. Under § 1.483–2, the present value of the deferred payments is $1,000,000. Thus, the agreement has unstated interest of $297,143.66.

(iii) *First two accrual periods.* Under paragraph (d)(1) of this section, the issue price at the beginning of the first accrual period is $1,000,000 (the amount described in § 1.483–2(a)(1)(i)). Under paragraph (c) of this section, the amount of interest that accrues for the first accrual period is $92,000 ($1,000,000×.092) and the amount of interest that accrues for the second accrual period is $100,464 ($1,092,000×.092). Thus, $192,464 of interest has accrued as of the end of the second accrual period. Under paragraph (e)(1) of this section, the $648,571.83 payment made on June 30, 1998, is treated first as a payment of interest to the extent of $192,464. The remainder of the payment ($456,107.83) is treated as a payment of principal. Both A and B take the payment of interest ($192,464) into account in 1998.

(iv) *Second two accrual periods.* The adjusted issue price at the beginning of the third accrual period is $543,892.17 ($1,092,000+$100,464–$648,571.83). The amount of interest that accrues for the third accrual period is $50,038.08 ($543,892.17×.092) and the amount of interest that accrues for the final accrual period is $54,641.58, the excess of the amount payable at maturity ($648,571.83), over the adjusted issue price at the beginning of the accrual period ($593,930.25). As of the date the second payment becomes due, $104,679.66 of interest has accrued. Thus, of the $648,571.83 payment made on June 30, 2000, $104,679.66 is treated as interest and $543,892.17 is treated as principal. Both A and B take the payment of interest ($104,679.66) into account in 2000.

(i) [Reserved]

(j) *Effective date.* This section applies to debt instruments issued on or after April 4, 1994, and to lending transactions, sales, and exchanges that occur on or after April 4, 1994. Taxpayers, however, may rely on this section for debt instruments issued after December 21, 1992, and before April 4, 1994, and for lending transactions, sales, and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4804, Feb. 2, 1994]

§1.446–3 Notional principal contracts.

(a) *Table of contents.* This paragraph (a) lists captioned paragraphs contained in §1.446–3.

§1.446–3 Notional principal contracts.

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(b) *Purpose.* The purpose of this section is to enable the clear reflection of the income and deductions from notional principal contracts by prescribing accounting methods that reflect the economic substance of such contracts.

(c) *Definitions and scope*—(1) *Notional principal contract*—(i) *In general.* A notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract because a taxpayer cannot enter into a contract with itself. Notional principal contracts governed by this section include interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, and similar agreements. A collar is not itself a notional principal contract, but certain caps and floors that comprise a collar may be treated as a single notional principal contract under paragraph (f)(2)(v)(C) of this section. A contract may be a notional principal contract governed by this section even though the term of the contract is subject to termination or extension. Each confirmation under a master agreement to enter into agreements governed by this section is treated as a separate notional principal contract.

(ii) *Excluded contracts.* A contract described in section 1256(b), a futures contract, a forward contract, and an option are not notional principal contracts. An instrument or contract that constitutes indebtedness under general principles of Federal income tax law is not a notional principal contract. An option or forward contract that entitles or obligates a person to enter into a notional principal contract is not a notional principal contract, but payments made under such an option or forward contract may be governed by paragraph (g)(3) of this section.

(iii) *Transactions within section 475.* To the extent that the rules provided in paragraphs (e) and (f) of this section are inconsistent with the rules that apply to any notional principal contract that is governed by section 475 and regulations thereunder, the rules of section 475 and the regulations thereunder govern.

(iv) *Transactions within section 988.* To the extent that the rules provided in this section are inconsistent with the rules that apply to any notional principal contract that is also a section 988 transaction or that is integrated with other property or debt pursuant to section 988(d), the rules of section 988 and the regulations thereunder govern.

(2) *Specified index.* A specified index is—

(i) A fixed rate, price, or amount;

(ii) A fixed rate, price, or amount applicable in one or more specified periods followed by one or more different fixed rates, prices, or amounts applicable in other periods;

(iii) An index that is based on objective financial information (as defined in paragraph (c)(4)(ii) of this section); and

(iv) An interest rate index that is regularly used in normal lending transactions between a party to the contract and unrelated persons.

(3) *Notional principal amount.* For purposes of this section, a notional principal amount is any specified amount of money or property that, when multiplied by a specified index, measures a party's rights and obligations under the contract, but is not borrowed or loaned between the parties as part of the contract. The notional principal amount may vary over the term of the contract, provided that it is set in advance or varies based on objective financial information (as defined in paragraph (c)(4)(ii) of this section).

(4) *Special definitions*—(i) *Related person and party to the contract.* A related person is a person related (within the meaning of section 267(b) or 707(b)(1)) to one of the parties to the notional principal contract or a member of the same consolidated group (as defined in §1.1502–1(h)) as one of the parties to the contract. For purposes of this paragraph (c), a related person is considered to be a party to the contract.

(ii) *Objective financial information.* For purposes of this paragraph (c), objective financial information is any current, objectively determinable financial or economic information that is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances (such as one party's dividends, profits, or the value of its stock). Thus, for example, a notional principal amount may be based on a broadly-based equity index or the outstanding balance of a pool of mortgages, but not on the value of a party's stock.

(iii) *Dealer in notional principal contracts.* A dealer in notional principal contracts is a person who regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in notional principal contracts with customers in the ordinary course of a trade or business.

(d) *Taxable year of inclusion and deduction.* For all purposes of the Code, the net income or net deduction from a notional principal contract for a taxable year is included in or deducted from gross income for that taxable year. The net income or net deduction from a notional principal contract for a taxable year equals the total of all of the periodic payments that are recognized from that contract for the taxable year under paragraph (e) of this section and all of the nonperiodic payments that are recognized from that contract for the taxable year under paragraph (f) of this section.

(e) *Periodic payments*—(1) *Definition.* Periodic payments are payments made or received pursuant to a notional principal contract that are payable at intervals of one year or less during the entire term of the contract (including any extension periods provided for in the contract), that are based on a specified index described in paragraph (c)(2)(i), (iii), or (iv) of this section (appropriately adjusted for the length of the interval), and that are based on either a single notional principal amount or a notional principal amount that varies over the term of the contract in the same proportion as the notional principal amount that measures the other party's payments. Payments to purchase or sell a cap or a floor, however, are not periodic payments.

(2) *Recognition rules*—(i) *In general.* All taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a periodic payment for the taxable year to which that portion relates.

(ii) *Rate set in arrears.* If the amount of a periodic payment is not determinable at the end of a taxable year because the value of the specified index is not fixed until a date that occurs after the end of the taxable year, the ratable daily portion of a periodic payment that relates to that taxable year is generally based on the specified index that would have applied if the specified index were fixed as of the last day of the taxable year. If a taxpayer determines that the value of the specified index as of the last day of the taxable year does not provide a reasonable estimate of the specified index that will apply when the payment is fixed, the taxpayer may use a reasonable estimate of the specified index each year, provided that the taxpayer (and any related person that is a party to the contract) uses the same method to make the estimate consistently from year to year and uses the same estimate for purposes of all financial reports to equity holders and creditors. The taxpayer's treatment of notional principal contracts with substantially similar specified indices will be considered in determining whether the taxpayer's estimate of the specified index is reasonable. Any difference between the amount that is recognized under this paragraph (e)(2)(ii) and the corresponding portion of the actual payment that becomes fixed under the contract is taken into account as an adjustment to the net income or net deduction from the notional principal contract for the taxable year during which the payment becomes fixed.

(iii) *Notional principal amount set in arrears.* Rules similar to the rules of paragraph (e)(2)(ii) of this section apply if the amount of a periodic payment is not determinable at the end of a taxable year because the notional principal amount is not fixed until a date that occurs after the end of the taxable year.

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

Example 1. Accrual of periodic swap payments. (a) On April 1, 1995, *A* enters into a contract with unrelated counterparty *B* under which, for a term of five years, *A* is obligated to make a payment to *B* each April 1, beginning April 1, 1996, in an amount equal to the London Interbank Offered Rate (LIBOR), as determined on the immediately preceding April 1, multiplied by a notional principal amount of $100 million. Under the contract, *B* is obligated to make a payment to *A* each April 1, beginning April 1, 1996, in an amount equal to 8% multiplied by the same notional principal amount. *A* and *B* are calendar year taxpayers that use the accrual method of accounting. On April 1, 1995, LIBOR is 7.80%.

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section, and both LIBOR and a fixed interest rate of 8% are specified indices under paragraph (c)(2) of this section. All of the payments to be made by *A* and *B* are periodic payments under paragraph (e)(1) of this section because each party's payments are based on a specified index described in paragraphs (c)(2)(iii) and (c)(2)(i) of this section, respectively, are payable at periodic intervals of one year or less throughout the term of the contract, and are based on a single notional principal amount.

(c) Under the terms of the swap agreement, on April 1, 1996, *B* is obligated to make a payment to *A* of $8,000,000 (8% x $100,000,000) and *A* is obligated to make a payment to *B* of

$7,800,000 (7.80% x $100,000,000). Under paragraph (e)(2)(i) of this section, the ratable daily portions for 1995 are the amounts of these periodic payments that are attributable to *A*'s and *B*'s taxable year ending December 31, 1995. The ratable daily portion of the 8% fixed leg is $6,010,929 (275 days/366 days x $8,000,000), and the ratable daily portion of the floating leg is $5,860,656 (275 days/366 days x $7,800,000). The net amount for the taxable year is the difference between the ratable daily portions of the two periodic payments, or $150,273 ($6,010,929—$5,860,656). Accordingly, *A* has net income of $150,273 from this swap for 1995, and *B* has a corresponding net deduction of $150,273.

(d) The $49,727 unrecognized balance of the $200,000 net periodic payment that is made on April 1, 1996, is included in *A*'s and *B*'s net income or net deduction from the contract for 1996.

(e) If the parties had entered into the contract on February 1, 1995, the result would not change because no portion of either party's obligation to make a payment under the swap relates to the period prior to April 1, 1995. Consequently, under paragraph (e)(2) of this section, neither party would accrue any income or deduction from the swap for the period from February 1, 1995, through March 31, 1995.

Example 2. Accrual of periodic swap payments by cash method taxpayer. (a) On April 1, 1995, *C* enters into a contract with unrelated counterparty *D* under which, for a period of five years, *C* is obligated to make a fixed payment to *D* each April 1, beginning April 1, 1996, in an amount equal to 8% multiplied by a notional principal amount of $100 million. *D* is obligated to make semi-annual payments to *C* each April 1 and October 1, beginning October 1, 1995, in an amount equal to one-half of the LIBOR amount as of the first day of the preceding 6-month period multiplied by the notional principal amount. The payments are to be calculated using a 30/360 day convention. *C* is a calendar year taxpayer that uses the accrual method of accounting. *D* is a calendar year taxpayer that uses the cash receipts and disbursements method of accounting. LIBOR is 7.80% on April 1, 1995, and 7.46% on October 1, 1995.

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section, and LIBOR and the fixed interest rate of 8% are each specified indices under paragraph (c)(2) of this section. All of the payments to be made by *C* and *D* are periodic payments under paragraph (e)(1) of this section because they are each based on appropriate specified indices, are payable at periodic intervals of one year or less throughout the term of the contract, and are based on a single notional principal amount.

(c) Under the terms of the swap agreement, *D* pays *C* $3,900,000 (0.5 x 7.8% x $100,000,000) on October 1, 1995. In addition, *D* is obligated to pay *C* $3,730,000 (0.5 x 7.46% x $100,000,000) on April 1, 1996. *C* is obligated to pay *D* $8,000,000 on April 1, 1996. Under paragraph (e)(2)(i) of this section, *C*'s and *D*'s ratable daily portions for 1995 are the amounts of the periodic payments that are attributable to their taxable year ending December 31, 1995. The ratable daily portion of the 8% fixed leg is $6,000,000 (270 days/360 days x $8,000,000), and the ratable daily portion of the floating leg is $5,765,000 ($3,900,000 + (90 days/180 days x $3,730,000)). Thus, *C*'s net deduction from the contract for 1995 is $235,000 ($6,000,000—$5,765,000) and *D* reports $235,000 of net income from the contract for 1995.

(d) The net unrecognized balance of $135,000 ($2,000,000 balance of the fixed leg—$1,865,000 balance of the floating leg) is included in *C*'s and *D*'s net income or net deduction from the contract for 1996.

Example 3. Accrual of swap payments on index set in arrears. (a) The facts are the same as in *Example 1*, except that *A*'s obligation to make payments based upon LIBOR is determined by reference to LIBOR on the day each payment is due. LIBOR is 8.25% on December 31, 1995, and 8.16% on April 1, 1996.

(b) On December 31, 1995, the amount that *A* is obligated to pay *B* is not known because it will not become fixed until April 1, 1996. Under paragraph (e)(2)(ii) of this section, the ratable daily portion of the periodic payment from *A* to *B* for 1995 is based on the value of LIBOR on December 31, 1995 (unless *A* or *B* determines that the value of LIBOR on that day does not reasonably estimate the value of the specified index). Thus, the ratable daily portion of the floating leg is $6,198,770 (275 days/366 days x 8.25% x $100,000,000), while the ratable daily portion of the fixed leg is $6,010,929 (275 days/366 days x $8,000,000). The net amount for 1995 on this swap is $187,841 ($6,198,770—$6,010,929). Accordingly, *B* has $187,841 of net income from the swap in 1995, and *A* has a net deduction of $187,841.

(c) On April 1, 1996, *A* makes a net payment to *B* of $160,000 ($8,160,000 payment on the floating leg—$8,000,000 payment on the fixed leg). For purposes of determining their net income or net deduction from this contract for the year ended December 31, 1996, *B* and *A* must adjust the net income and net deduction they recognized in 1995 by $67,623 (275 days/366 days x ($8,250,000 presumed payment on the floating leg—$8,160,000 actual payment on the floating leg)).

(f) *Nonperiodic payments*—(1) *Definition.* A nonperiodic payment is any payment made or received with respect to a notional principal contract that is not a periodic payment (as defined in paragraph (e)(1) of this section) or a termination payment (as defined in paragraph (h) of this section). Examples of nonperiodic payments are the premium for a cap or floor agreement (even if it is paid in installments), the payment for an off-market swap agreement, the prepayment of part or all of one leg of a swap, and the premium for an option to enter into a swap if and when the option is exercised.

(2) *Recognition rules*—(i) *In general.* All taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a nonperiodic payment for the taxable year to which that portion relates. Generally, a nonperiodic payment must be recognized over the term of a notional principal contract in a manner that reflects the economic substance of the contract.

(ii) *General rule for swaps.* A nonperiodic payment that relates to a swap must be recognized over the term of the contract by allocating it in accordance with the forward rates (or, in the case of a commodity, the forward prices) of a series of cash-settled forward contracts that reflect the specified index and the notional principal amount. For purposes of this allocation, the forward rates or prices used to determine the amount of the nonperiodic payment will be respected, if reasonable. See paragraph (f)(4) *Example 7* of this section.

(iii) *Alternative methods for swaps.* Solely for purposes of determining the timing of income and deductions, a nonperiodic payment made or received with respect to a swap may be allocated to each period of the swap contract using one of the methods described in this paragraph (f)(2)(iii). The alternative methods may not be used by a dealer in notional principal contracts (as defined in paragraph (c)(4)(iii) of this section) for swaps entered into or acquired in its capacity as a dealer.

(A) *Prepaid swaps.* An upfront payment on a swap may be amortized by assuming that the nonperiodic payment represents the present value of a series of equal payments made throughout the term of the swap contract (the level payment method), adjusted as appropriate to take account of increases or decreases in the notional principal amount. The discount rate used in this calculation must be the rate (or rates) used by the parties to determine the amount of the nonperiodic payment. If that rate is not readily ascertainable, the discount rate used must be a rate that is reasonable under the circumstances. Under this method, an upfront payment is allocated by dividing each equal payment into its principal recovery and time value components. The principal recovery components of the equal payments are treated as periodic payments that are deemed to be made on each of the dates that the swap contract provides for periodic payments by the payor of the nonperiodic payment or, if none, on each of the dates that the swap contract provides for periodic payments by the recipient of the nonperiodic payment. The time value component is needed to compute the amortization of the nonperiodic payment, but is otherwise disregarded. See paragraph (f)(4) *Example 5* of this section.

(B) *Other nonperiodic swap payments.* Nonperiodic payments on a swap other than an upfront payment may be amortized by treating the contract as if it provided for a single upfront payment (equal to the present value of the nonperiodic payments) and a loan between the parties. The discount rate (or rates) used in determining the deemed upfront payment and the time value component of the deemed loan is the same as the rate (or rates) used in the level payment method. The single upfront payment is then amortized under the level payment method described in paragraph (f)(2)(iii)(A) of this section. The time value component of the loan is not treated as interest, but, together with the amortized amount of the deemed upfront payment, is recognized as a periodic payment. See paragraph (f)(4) *Example 6* of this section. If both parties make nonperiodic payments, this calculation is done separately for the nonperiodic payments made by each party.

(iv) *General rule for caps and floors.* A payment to purchase or sell a cap or floor must be recognized over the term of the agreement by allocating it in accordance with the prices of a series of cash-settled option contracts that reflect the specified index and the notional principal amount. For purposes of this allocation, the option pricing used by the parties to determine the total amount paid for the cap or floor will be respected, if reasonable. Only the portion of the purchase price that is allocable to the option contract or contracts that expire during a particular period is recognized for that period. Thus, under this paragraph (f)(2)(iv), straight-line or accelerated amortization of a cap premium is generally not permitted. See paragraph (f)(4) *Examples 1* and *2* of this section.

(v) *Alternative methods for caps and floors that hedge debt instruments.* Solely for purposes of determining the timing of income and deductions, if a cap or floor is entered into primarily to reduce risk with respect to a specific debt instrument or group of debt instruments held or issued by the taxpayer, the taxpayer may amortize a payment to purchase or sell the cap or floor using the methods described in this paragraph (f)(2)(v), adjusted as appropriate to take account of increases or decreases in the notional principal amount. The alternative methods may not be used by a dealer in notional principal contracts (as defined in paragraph (c)(4)(iii) of this section) for caps or floors entered into or acquired in its capacity as a dealer.

(A) *Prepaid caps and floors.* A premium paid upfront for a cap or a floor may be amortized using the ‘‘level payment method’’ described in paragraph (f)(2)(iii)(A) of this section. See paragraph (f)(4) *Example 3* of this section.

(B) *Other caps and floors.* Nonperiodic payments on a cap or floor other than an upfront payment are amortized by treating the contract as if it provided for a single upfront payment (equal to the present value of the nonperiodic payments) and a loan between the parties as described in paragraph (f)(2)(iii)(B) of this section. Under the level payment method, a cap or floor premium paid in level annual installments over the term of the contract is effectively included or deducted from income ratably, in accordance with the level payments. See paragraph (f)(4) *Example 4* of this section.

(C) *Special method for collars.* A taxpayer may also treat a cap and a floor that comprise a collar as a single notional principal contract and may amortize the net nonperiodic payment to enter into the cap and floor over the term of the collar in accordance with the methods prescribed in this paragraph (f)(2)(v).

(vi) *Additional methods.* The Commissioner may, by a revenue ruling or a revenue procedure published in the Internal Revenue Bulletin, provide alternative methods for allocating nonperiodic payments that relate to a notional principal contract to each year of the contract. See § 601.601(d)(2)(ii)(*b*) of this chapter.

(3) *Term of extendible or terminable contracts.* For purposes of this paragraph (f), the term of a notional principal contract that is subject to extension or termination is the reasonably expected term of the contract.

(4) *Examples.* The following examples illustrate the application of paragraph (f) of this section.

Example 1. Cap premium amortized using general rule. (a) On January 1, 1995, when LIBOR is 8%, *F* pays unrelated party *E* $600,000 for a contract that obligates *E* to make a payment to *F* each quarter equal to one-quarter of the excess, if any, of three-month LIBOR over 9% with respect to a notional principal amount of $25 million. Both *E* and *F* are calendar year taxpayers. *E* provides *F* with a schedule of allocable premium amounts indicating that the cap was priced according to a reasonable variation of the Black-Scholes option pricing formula and that the total premium is allocable to the following periods:

	Pricing allocation
1995	$55,000
1996	225,000
1997	320,000
	$600,000

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section, and LIBOR is a specified index under paragraph (c)(2)(iii) of this section. Any payments made by *E* to *F* are periodic payments under paragraph (e)(1) of this section because they are payable at periodic intervals of one year or less throughout the term of the contract, are based on an appropriate specified index, and are based on a single notional principal amount. The $600,000 cap premium paid by *F* to *E* is a nonperiodic payment as defined in paragraph (f)(1) of this section.

(c) The Black-Scholes model is recognized in the financial industry as a standard technique for pricing interest rate cap agreements. Therefore, because *E* has used a reasonable option pricing model, the schedule generated by *E* is consistent with the economic substance of the cap, and may be used by both *E* and *F* for calculating their ratable daily portions of the cap premium. Under paragraph (f)(2)(iv) of this section, *E* recognizes the ratable daily portion of the cap premium as income, and *F* recognizes the ratable daily portion of the cap premium as a deduction based on the pricing schedule. Thus, *E* and *F* account for the contract as follows:

	Ratable daily portion
1995	$55,000
1996	225,000
1997	320,000
	$600,000

(d) Any periodic payments under the cap agreement (that is, payments that *E* makes to *F* because LIBOR exceeds 9%) are included in the parties' net income or net deduction from the contract in accordance with paragraph (e)(2) of this section.

Example 2. Cap premium allocated to proper period. (a) The facts are the same as in *Example 1,* except that the cap is purchased by *F* on November 1, 1994. The first determination date under the cap agreement is January 31, 1995 (the last day of the first quarter to which the contract relates). LIBOR is 9.1% on December 31, 1994, and is 9.15% on January 31, 1995.

(b) *E* and *F* recognize $9,192 (61 days/365 days x $55,000) as the ratable daily portion of the nonperiodic payment for 1994, and include that amount in their net income or net deduction from the contract for 1994. If *E*'s pricing model allocated the cap premium to each quarter covered by the contract, the ratable daily portion would be 61 days/92 days times the premium allocated to the first quarter.

(c) Under paragraph (e)(2)(ii) of this section, *E* and *F* calculate the payments using LIBOR as of December 31, 1994. *F* recognizes as income the ratable daily portion of the presumed payment, or $4,144 (61 days/92 days x .25 x .001 x $25,000,000). Thus, *E* reports $5,048 of net income from the contract for 1994 ($9,192–$4,144), and *F* reports a net deduction from the contract of $5,048.

(d) On January 31, 1995, *E* pays *F* $9,375 (.25 x .0015 x $25,000,000) under the terms of the cap agreement. For purposes of determining their net income or net deduction from this contract for the year ended December 31, 1995, *E* and *F* must adjust their respective net income and net deduction from the cap by $2,072 (61 days/92 days x ($9,375 actual payment under the cap on January 31, 1995—$6,250 presumed payment under the cap on December 31, 1994)).

Example 3. Cap premium amortized using alternative method. (a) The facts are the same as in *Example 1,* except that the cap provides for annual payments by *E* and is entered into by F primarily to reduce risk with respect to a debt instrument issued by *F. F* elects to amortize the cap premium using the alternative level payment method provided under paragraph (f)(2)(v)(A) of this section. Under that method, *F* amortizes the cap premium by assuming that the $600,000 is repaid in 3 equal annual payments of $241,269, assuming a discount rate of 10%. Each payment is divided into a time value component and a principal component, which are set out below.

	Level payment	Time value component	Principal component
1995	$241,269	$60,000	$181,269
1996	241,269	41,873	199,396
1997	241,269	21,934	219,335
	$723,807	$123,807	$600,000

(b) The net of the ratable daily portions of the principal component and the payments, if any, received from *E* comprise *F*'s annual net income or net deduction from the cap. The time value components are needed only to compute the ratable daily portions of the cap premium, and are otherwise disregarded.

Example 4. Cap premium paid in level installments and amortized using alternative method. (a) The facts are the same as in *Example 3,* except that *F* agrees to pay for the cap in three level installments of $241,269 (a total of $723,807) on December 31, 1995, 1996, and 1997. The present value of three payments of $241,269, discounted at 10%, is $600,000. For purposes of amortizing the cap premium under the alternative method provided in paragraph (f)(2)(v)(B) of this section, *F* is treated as paying $600,000 for the cap on January 1, 1995, and borrowing $600,000 from *E* that will be repaid in three annual installments of $241,269. The time value component of the loan is computed as follows:

	Loan balance	Time value component	Principal component
1995	$600,000	$60,000	$181,269
1996	418,731	41,873	199,396
1997	219,335	21,934	219,335
		$123,807	$600,000

(b) *F* is treated as making periodic payments equal to the amortized principal components from a $600,000 cap paid in advance (as described in *Example 3*), increased by the time value components of the $600,000 loan, which totals $241,269 each year. The time value components of the $600,000 loan are included in the periodic payments made by *F*, but are not characterized as interest income or expense. The effect of the alternative method in this situation is to allow *F* to amortize the cap premium in level installments, the same way it is paid. The net of the ratable daily portions of *F*'s deemed periodic payments and the payments, if any, received from *E* comprise *F*'s annual net income or net deduction from the cap.

Example 5. Upfront interest rate swap payment amortized using alternative method. (a) On January 1, 1995, *G* enters into an interest rate swap agreement with unrelated counterparty *H* under which, for a term of five years, *G* is obligated to make annual payments at 11% and H is obligated to make annual payments at LIBOR on a notional principal amount of $100 million. At the time *G* and *H* enter into this swap agreement, the rate for similar on-market swaps is LIBOR to 10%. To compensate for this difference, on January 1, 1995, *H* pays *G* a yield adjustment fee of $3,790,786. *G* provides *H* with information that indicates that the amount of the yield adjustment fee was determined as the present value, at 10% compounded annually, of five annual payments of $1,000,000 (1% x $100,000,000). *G* and *H* are calendar year taxpayers.

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section. The yield adjustment fee is a nonperiodic payment as defined in paragraph (f)(1) of this section.

(c) Under the alternative method described in paragraph (f)(2)(iii)(A) of this section, the yield adjustment fee is recognized over the life of the agreement by assuming that the $3,790,786 is repaid in five level payments. Assuming a constant yield to maturity and annual compounding at 10%, the ratable daily portions are computed as follows:

	Level payment	Time value component	Principal component
1995	$1,000,000	$379,079	$620,921
1996	1,000,000	316,987	683,013
1997	1,000,000	248,685	751,315
1998	1,000,000	173,554	826,446
1999	1,000,000	90,909	909,091
	$5,000,000	$1,209,214	$3,790,786

(d) *G* also makes swap payments to *H* at 11%, while *H* makes swap payments to *G* based on LIBOR. The net of the ratable daily portions of the 11% payments by *G*, the LIBOR payments by *H*, and the principal component of the yield adjustment fee paid by *H* determines the annual net income or net deduction from the contract for both *G* and *H*. The time value components are needed only to compute the ratable daily portions of the yield adjustment fee paid by *H*, and are otherwise disregarded.

Example 6. Backloaded interest rate swap payment amortized using alternative method. (a) The facts are the same as in *Example 5*, but *H* agrees to pay *G* a yield adjustment fee of $6,105,100 on December 31, 1999. Under the alternative method in paragraph (f)(2)(iii)(B) of this section, *H* is treated as paying a yield adjustment fee of $3,790,786 (the present value of $6,105,100, discounted at a 10% rate with annual compounding) on January 1, 1995. Solely for timing purposes, *H* is treated as borrowing $3,790,786 from *G*. Assuming annual compounding at 10%, the time value component is computed as follows:

	Loan balance	Time value component	Principal component
1995	$3,790,786	$379,079	0
1996	4,169,865	416,987	0

	Loan balance	Time value component	Principal component
1997	4,586,852	458,685	0
1998	5,045,537	504,554	0
1999	5,550,091	555,009	6,105,100

(b) The amortization of *H*'s yield adjustment fee is equal to the amortization of a yield adjustment fee of $3,790,786 paid in advance (as described in *Example 5*), increased by the time value component of the $3,790,786 deemed loan from *G* to *H*. Thus, the amount of *H*'s yield adjustment fee that is allocated to 1995 is $1,000,000 ($620,921 + $379,079). The time value components of the $3,790,786 loan are included in the periodic payments paid by *H*, but are not characterized as interest income or expense. The net of the ratable daily portions of the 11% swap payments by *G*, and the LIBOR payments by H, added to the principal components from *Example 5* and the time value components from this *Example 6*, determines the annual net income or net deduction from the contract for both *G* and *H*.

Example 7. Nonperiodic payment on a commodity swap amortized under general rule. (a) On January 1, 1995, *I* enters into a commodity swap agreement with unrelated counterparty *J* under which, for a term of three years, *I* is obligated to make annual payments based on a fixed price of $2.35 per bushel times a notional amount of 100,000 bushels of corn and *J* is obligated to make annual payments equal to the spot price times the same notional amount. Assume that on January 1, 1995, the price of a one year forward for corn is $2.40 per bushel, of a two year forward $2.55 per bushel, and of a 3 year forward $2.75 per bushel. To compensate for the below-market fixed price provided in the swap agreement, *I* pays *J* $53,530 for entering into the swap. *I* and *J* are calendar year taxpayers.

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section, and $2.35 and the spot price of corn are specified indices under paragraphs (c)(2)(i) and (iii) of this section, respectively. The $53,530 payment is a nonperiodic payment as defined by paragraph (f)(1) of this section.

(c) Assuming that *I* does not use the alternative methods provided under paragraph (f)(2)(iii) of this section, paragraph (f)(2)(ii) of this section requires that *I* recognize the nonperiodic payment over the term of the agreement by allocating the payment to each forward contract in accordance with the forward price of corn. Solely for timing purposes, *I* treats the $53,530 nonperiodic payment as a loan that *J* will repay in three installments of $5,000, $20,000, and $40,000, the expected payouts on the in-the-money forward contracts. With annual compounding at 8%, the ratable daily portions are computed as follows:

	Expected forward payment	Time value component	Principal component
1995	$5,000	$4,282	$718
1996	20,000	4,225	15,775
1997	40,000	2,963	37,037
	$65,000	$11,470	$53,530

(d) The ratable daily portion of the principal component is added to *I*'s periodic payments in computing its net income or net deduction from the notional principal contract for each taxable year. The time value components are needed only to compute the principal components, and are otherwise disregarded.

(g) *Special rules*—(1) *Disguised notional principal contracts.* The Commissioner may recharacterize all or part of a transaction (or series of transactions) if the effect of the transaction (or series of transactions) is to avoid the application of this section.

(2) *Hedged notional principal contracts.* If a taxpayer, either directly or through a related person (as defined in paragraph (c)(4)(i) of this section), reduces risk with respect to a notional principal contract by purchasing, selling, or otherwise entering into other notional principal contracts, futures, forwards, options, or other financial contracts (other than debt instruments), the taxpayer may not use the alternative methods provided in paragraphs (f)(2)(iii) and (v) of this section. Moreover, where such positions are entered into to avoid the appropriate

timing or character of income from the contracts taken together, the Commissioner may require that amounts paid to or received by the taxpayer under the notional principal contract be treated in a manner that is consistent with the economic substance of the transaction as a whole.

(3) *Options and forwards to enter into notional principal contracts.* An option or forward contract that entitles or obligates a person to enter into a notional principal contract is subject to the general rules of taxation for options or forward contracts. Any payment with respect to the option or forward contract is treated as a nonperiodic payment for the underlying notional principal contract under the rules of paragraphs (f) and (g)(4) or (g)(5) of this section if and when the underlying notional principal contract is entered into.

(4) *Swaps with significant nonperiodic payments.* A swap with significant nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and a loan. The loan must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan is not included in the net income or net deduction from the swap under paragraph (d) of this section, but is recognized as interest for all purposes of the Internal Revenue Code. See paragraph (g)(6) *Example* 3 of this section. For purposes of section 956, the Commissioner may treat any nonperiodic swap payment, whether or not it is significant, as one or more loans.

(5) *Caps and floors that are significantly in-the-money.* [Reserved]

(6) *Examples.* The following examples illustrate the application of paragraph (g) of this section.

Example 1. Cap hedged with options.(a) On January 1, 1995, *K* sells to unrelated counterparty *L* three cash settlement European-style put options on Eurodollar time deposits with a strike rate of 9%. The options have exercise dates of January 1, 1996, January 1, 1997, and January 1, 1998, respectively. If LIBOR exceeds 9% on any of the exercise dates, *L* will be entitled, by exercising the relevant option, to receive from *K* an amount that corresponds to the excess of LIBOR over 9% times $25 million. *L* pays *K* $650,000 for the three options. Furthermore, *K* is related to *F*, the cap purchaser in paragraph (f)(4) *Example 1* of this section.

(b) *K*'s option agreements with *L* reduce risk with respect to *F*'s cap agreement with *E*. Accordingly, under paragraph (g)(2) of this section, *F* cannot use the alternative methods provided in paragraph (f)(2)(v) of this section to amortize the premium paid under the cap agreement. *F* must amortize the cap premium it paid in accordance with paragraph (f)(2)(iv) of this section.

(c) The method that *E* may use to account for its agreement with *F* is not affected by the application of paragraph (g)(2) of this section to *F*.

Example 2. Nonperiodic payment that is not significant. (a) On January 1, 1995, *G* enters into an interest rate swap agreement with unrelated counterparty *H* under which, for a term of five years, *G* is obligated to make annual payments at 11% and *H* is obligated to make annual payments at LIBOR on a notional principal amount of $100 million. At the time *G* and *H* enter into this swap agreement, the rate for similar on-market swaps is LIBOR to 10%. To compensate for this difference, on January 1, 1995, *H* pays *G* a yield adjustment fee of $3,790,786. *G* provides *H* with information that indicates that the amount of the yield adjustment fee was determined as the present value, at 10% compounded annually, of five annual payments of $1,000,000 (1% x $100,000,000). *G* and *H* are calendar year taxpayers. (These facts are the same as in paragraph (f)(4) *Example 5* of this section.)

(b) In this situation, the yield adjustment fee of $3,790,786 is not a significant nonperiodic payment within the meaning of paragraph (g)(4) of this section, in light of the amount of the fee in proportion to the present value of the total amount of fixed payments due under the contract. Accordingly, no portion of the swap is recharacterized as a loan for purposes of this section.

Example 3. Significant nonperiodic payment. (a) On January 1, 1995, unrelated parties *M* and *N* enter into an interest rate swap contract. Under the terms of the contract, *N* agrees to make five annual payments to *M* equal to LIBOR times a notional principal amount of $100 million. In return, *M* agrees to pay *N* 6% of $100 million annually, plus $15,163,147 on January 1, 1995. At the time *M* and *N* enter into this swap agreement the rate for similar on- market swaps is LIBOR to 10%, and *N* provides *M* with information that the amount of the initial payment was determined as the present value, at 10% compounded annually, of five annual payments from *M* to *N* of $4,000,000 (4% of $100,000,000).

(b) Although the parties have characterized this transaction as an interest rate swap, the $15,163,147 payment from *M* to *N* is significant when compared to the present value of the total fixed payments due under the contract. Accordingly, under paragraph (g)(4) of this section, the transaction is recharacterized as consisting of both a $15,163,147 loan from *M* to *N* that *N* repays in installments over the term of the agreement, and an interest rate swap between *M* and *N* in which *M* immediately pays the installment payments on the loan back to *N* as part of its fixed payments on the swap in exchange for the LIBOR payments by *N*.

(c) The yield adjustment fee is recognized over the life of the agreement by treating the $15,163,147 as a loan that will be repaid with level payments over five years. Assuming a constant yield to maturity and annual compounding at 10%, *M* and *N* account for the principal and interest on the loan as follows:

	Level payment	Interest component	Principal component
1995	$4,000,000	$1,516,315	$2,483,685
1996	4,000,000	1,267,946	2,732,054
1997	4,000,000	994,741	3,005,259
1998	4,000,000	694,215	3,305,785
1999	4,000,000	363,636	3,636,364
	$20,000,000	$4,836,853	$15,163,147

(d) *M* recognizes interest income, and *N* claims an interest deduction, each taxable year equal to the interest component of the deemed installment payments on the loan. These interest amounts are not included in the parties' net income or net deduction from the swap contract under paragraph (d) of this section. The principal components are needed only to compute the interest component of the level payment for the following period, and do not otherwise affect the parties' net income or net deduction from this contract.

(e) *N* also makes swap payments to *M* based on LIBOR, and receives swap payments from *M* at a fixed rate that is equal to the sum of the stated fixed rate and the rate calculated by dividing the deemed level annual payments on the loan by the notional principal amount. Thus, the fixed rate on this swap is 10%, which is the sum of the stated rate of 6% and the rate calculated by dividing the annual loan payment of $4,000,000 by the notional principal amount of $100,000,000, or 4%. Using the methods provided in paragraph (e)(2) of this section, the swap payments from *M* to *N* of $10,000,000 (10% of $100,000,000) and the LIBOR swap payments from *N* to *M* are included in the parties' net income or net deduction from the contract for each taxable year.

Example 4. Swaps recharacterized as a loan. (a) The facts are the same as in *Example 3,* except that on January 1, 1995, *N* also enters into an interest rate swap agreement with unrelated counterparty *O* under which, for a term of five years, *N* is obligated to make annual payments at 12% and *O* is obligated to make annual payments at LIBOR on a notional principal amount of $100 million. At the time *N* and *O* enter into this swap agreement, the rate for similar on-market swaps is LIBOR to 10%. To compensate for this difference, *O* pays *N* an upfront yield adjustment fee of $7,581,574. This yield adjustment fee equals the present value, at 10% compounded annually, of five annual payments of $2,000,000 (2% of $100,000,000).

(b) In substance, these two interest rate swaps are the equivalent of a fixed rate borrowing by *N* of $22,744,721 ($15,163,147 from *M* plus $7,581,574 from *O*). Under paragraph (g)(2) of this section, if these positions were entered into to avoid interest character on a net loan position, the Commissioner may recharacterize the swaps as a loan which *N* will repay with interest in five annual installments of $6,000,000 each (the difference between the 12% *N* pays under the swap with *O* and the 6% *N* receives under the swap with *M*, multiplied by the $100,000,000 notional principal amount).

(c) *N* recognizes no net income or net deduction from these contracts under paragraph (d) of this section because, as to *N*, there is no notional principal contract income or expense. However, the recharacterization of *N*'s separate transactions as a loan has no effect on the way *M* and *O* must each account for their notional principal contracts under paragraphs (d) through (g) of this section.

(h) *Termination payments*—(1) *Definition.* A payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under a notional principal contract is a termination payment to the party making the termination payment and the party receiving the payment. A termination payment includes a payment made between the original parties to the contract (an extinguishment), a payment made between one party to the contract and a third party (an assignment), and any gain or loss realized on the exchange of one notional principal contract for another. Where one party assigns its remaining rights and obligations to a third party, the original nonassigning counterparty realizes gain or loss if the assignment results in a deemed exchange of contracts and a realization event under section 1001.

(2) *Taxable year of inclusion and deduction by original parties.* Except as otherwise provided (for example, in section 453, section 1092, or § 1.446–4), a party to a notional principal contract recognizes a termination payment in the year the contract is extinguished, assigned, or exchanged. When the termination payment is recognized, the party also recognizes any other payments that have been made or received pursuant to the notional principal contract, but that have not been recognized under paragraph (d) of this section. If only a proportionate part of a party's rights and obligations is extinguished, assigned, or exchanged, then only that proportion of the unrecognized payments is recognized under the previous sentence.

(3) *Taxable year of inclusion and deduction by assignees.* A termination payment made or received by an assignee pursuant to an assignment of a notional principal contract is recognized by the assignee under the rules of paragraphs (f) and (g)(4) or (g)(5) of this section as a nonperiodic payment for the notional principal contract that is in effect after the assignment.

(4) *Special rules*—(i) *Assignment of one leg of a contract.* A payment is not a termination payment if it is made or received by a party in exchange for assigning all or a portion of one leg of a notional principal contract at a time when a substantially proportionate amount of the other leg remains unperformed and unassigned. The payment is either an amount loaned, an amount borrowed, or a nonperiodic payment, depending on the economic substance of the transaction to each party. This paragraph (h)(4)(i) applies whether or not the original notional principal contract is terminated as a result of the assignment.

(ii) *Substance over form.* Any economic benefit that is given or received by a taxpayer in lieu of a termination payment is a termination payment.

(5) *Examples.* The following examples illustrate the application of this paragraph (h). The contracts in the examples are not hedging transactions as defined in § 1.1221–2(b), and all of the examples assume that no loss-deferral rules apply.

Example 1. Termination by extinguishment. (a) On January 1, 1995, *P* enters into an interest rate swap agreement with unrelated counterparty *Q* under which, for a term of seven years, *P* is obligated to make annual payments based on 10% and *Q* is obligated to make semi-annual payments based on LIBOR and a notional principal amount of $100 million. *P* and *Q* are both calendar year taxpayers. On January 1, 1997, when the fixed rate on a comparable LIBOR swap has fallen to 9.5%, *P* pays *Q* $1,895,393 to terminate the swap.

(b) The payment from *P* to *Q* extinguishes the swap contract and is a termination payment, as defined in paragraph (h)(1) of this section, for both parties. Accordingly, under paragraph (h)(2) of this section, *P* recognizes a loss of $1,895,393 in 1997 and *Q* recognizes $1,895,393 of gain in 1997.

Example 2. Termination by assignment. (a) The facts are the same as in *Example 1,* except that on January 1, 1997, *P* pays unrelated party *R* $1,895,393 to assume all of *P*'s rights and obligations under the swap with *Q*. In return for this payment, *R* agrees to pay 10% of $100 million annually to *Q* and to receive LIBOR payments from *Q* for the remaining five years of the swap.

(b) The payment from *P* to *R* terminates *P*'s interest in the swap contract with *Q* and is a termination payment, as defined in paragraph (h)(1) of this section, for *P*. Under paragraph (h)(2) of this section, *P* recognizes a loss of $1,895,393 in 1997. Whether *Q* also has a termination payment with respect to the payment from *P* to *R* is determined under section 1001.

(c) Under paragraph (h)(3) of this section, the assignment payment that *R* receives from *P* is a nonperiodic payment for an interest rate swap. Because the assignment payment is not a significant nonperiodic payment within the meaning of paragraph (g)(1) of this section, *R* amortizes the $1,895,393 over the five year term of the swap agreement under paragraph (f)(2) of this section.

Example 3. Assignment of swap with yield adjustment fee. (a) The facts are the same as in *Example 2,* except that on January 1, 1995, *Q* paid *P* a yield adjustment fee to enter into the seven year interest rate swap. In accordance with paragraph (f)(2) of this section, *P* and *Q* included the ratable daily portions of that nonperiodic payment in their net income or net deduction from the contract for 1995 and 1996. On January 1, 1997, $300,000 of the nonperiodic payment has not yet been recognized by *P* and *Q*.

(b) Under paragraph (h)(2) of this section, *P* recognizes a loss of $1,595,393 ($1,895,393–$300,000) in 1997. *R* accounts for the termination payment in the same way it did in *Example 2*; the existence of an unamortized payment with respect to the original swap has no effect on *R*.

Example 4. Assignment of one leg of a swap. (a) On January 1, 1995, *S* enters into an interest rate swap agreement with unrelated counterparty *T* under which, for a term of five years, *S* will make annual payments at 10% and *T* will make annual payments at LIBOR on a notional principal amount of $50 million. On January 1, 1996, unrelated party U pays *T* $15,849,327 for the right to receive the four remaining $5,000,000 payments from *S*. Under the terms of the agreement between *S* and *T*, *S* is notified of this assignment, and *S* is contractually bound thereafter to make its payments to *U* on the appropriate payment dates. *S*'s obligation to pay *U* is conditioned on *T* making its LIBOR payment to *S* on the appropriate payment dates.

(b) Because *T* has assigned to *U* its rights to the fixed rate payments, but not its floating rate obligations under the notional principal contract, *U*'s payment to *T* is not a termination payment as defined in paragraph (h)(1) of this section, but is covered by paragraph (h)(4)(i) of this section. The economic substance of the transaction between *T* and *U* is a loan that does not affect the way that *S* and *T* account for the notional principal contract under this section.

(i) *Anti-abuse rule.* If a taxpayer enters into a transaction with a principal purpose of applying the rules of this section to produce a material distortion of income, the Commissioner may depart from the rules of this section as necessary to reflect the appropriate timing of income and deductions from the transaction.

(j) *Effective date.* These regulations are effective for notional principal contracts entered into on or after December 13, 1993.

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§1.446–4 Hedging transactions.

(a) *In general.* Except as provided in this paragraph (a), a hedging transaction as defined in §1.1221–2(b) (whether or not the character of gain or loss from the transaction is determined under §1.1221–2) must be accounted for under the rules of this section. To the extent that provisions of any other regulations governing the timing of income, deductions, gain, or loss are inconsistent with the rules of this section, the rules of this section control.

(1) *Trades or businesses excepted.* A taxpayer is not required to account for hedging transactions under the rules of this section for any trade or business in which the cash receipts and disbursements method of accounting is used or in which §1.471–6 is used for inventory valuations if, for all prior taxable years ending on or after September 30, 1993, the taxpayer met the $5,000,000 gross receipts test of section 448(c) (or would have met that test if the taxpayer were a corporation or partnership). A taxpayer not required to use the rules of this section may nonetheless use a method of accounting that is consistent with these rules.

(2) *Coordination with other sections.* This section does not apply to—

(i) Any position to which section 475(a) applies;

(ii) An integrated transaction subject to §1.1275–6;

(iii) Any section 988 hedging transaction if the transaction is integrated under §1.988–5 or if other regulations issued under section 988(d) (or an advance ruling described in 1.988–5(e)) govern when gain or loss from the transaction is taken into account; or

(iv) The determination of the issuer's yield on an issue of tax-exempt bonds for purposes of the arbitrage restrictions to which §1.148–4(h) applies.

(b) *Clear reflection of income.* The method of accounting used by a taxpayer for a hedging transaction must clearly reflect income. To clearly reflect income, the method used must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged. Taking gains and losses into account in the period in which they are realized may clearly reflect income in the case of certain hedging transactions. For example, where a hedge and the item being hedged are disposed of in the same taxable year, taking realized gain or loss into account on both items in that taxable year may clearly reflect income. In the case of many hedging transactions, however, taking gains and losses into account as they are realized does not result in the matching required by this section.

(c) *Choice of method and consistency.* For any given type of hedging transaction, there may be more than one method of accounting that satisfies the clear reflection requirement of paragraph (b) of this section. A taxpayer is generally permitted to adopt a method of accounting for a particular type of hedging transaction that clearly reflects the taxpayer's income from that type of transaction. See paragraph (e) of this section for requirements and limitations on the taxpayer's choice of method. Different methods of accounting may be used for different types of hedging transactions and for transactions that hedge different types of items. Once a taxpayer adopts a method of accounting, however, that method must be applied consistently and can only be changed with the consent of the Commissioner, as provided by section 446(e) and the regulations and procedures thereunder.

(d) *Recordkeeping requirements*—(1) *In general.* The books and records maintained by a taxpayer must contain a description of the accounting method used for each type of hedging transaction. The description of the method or methods used must be sufficient to show how the clear reflection requirement of paragraph (b) of this section is satisfied.

(2) *Additional identification.* In addition to the identification required by § 1.1221–2(e), the books and records maintained by a taxpayer must contain whatever more specific identification with respect to a transaction is necessary to verify the application of the method of accounting used by the taxpayer for the transaction. This additional identification may relate to the hedging transaction or to the item, items, or aggregate risk being hedged. The additional identification must be made at the time specified in § 1.1221–2(e)(2) and must be made on, and retained as part of, the taxpayer's books and records.

(3) *Transactions in which character of gain or loss is not determined under § 1.1221–2.* A section 988 transaction, as defined in section 988(c)(1), or a qualified fund, as defined in section 988(c)(1)(E)(iii), is subject to the identification and recordkeeping requirements of § 1.1221–2(e). See § 1.1221–2(a)(4)(i).

(e) *Requirements and limitations with respect to hedges of certain assets and liabilities.* In the case of certain hedging transactions, this paragraph (e) provides guidance in determining whether a taxpayer's method of accounting satisfies the clear reflection requirement of paragraph (b) of this section. Even if these rules are satisfied, however, the taxpayer's method, as actually applied to the taxpayer's hedging transactions, must clearly reflect income by meeting the matching requirement of paragraph (b) of this section.

(1) *Hedges of aggregate risk*—(i) *In general.* The method of accounting used for hedges of aggregate risk must comply with the matching requirements of paragraph (b) of this section. Even though a taxpayer may not be able to associate the hedging transaction with any particular item being hedged, the timing of income, deduction, gain, or loss from the hedging transaction must be matched with the timing of the aggregate income, deduction, gain, or loss from the items being hedged. For example, if a notional principal contract hedges a taxpayer's aggregate risk, taking into account income, deduction, gain, or loss under the provisions of § 1.446–3 may clearly reflect income. See paragraph (e)(5) of this section.

(ii) *Mark-and-spread method.* The following method may be appropriate for taking into account income, deduction, gain, or loss from hedges of aggregate risk:

(A) The hedging transactions are marked to market at regular intervals for which the taxpayer has the necessary data, but no less frequently than quarterly; and

(B) The income, deduction, gain, or loss attributable to the realization or periodic marking to market of hedging transactions is taken into account over the period for which the hedging transactions are intended to reduce risk. Although the period over which the hedging transactions are intended to reduce risk may change, the period must be reasonable and consistent with the taxpayer's hedging policies and strategies.

(2) *Hedges of items marked to market.* In the case of a transaction that hedges an item that is marked to market under the taxpayer's method of accounting, marking the hedge to market clearly reflects income.

(3) *Hedges of inventory*—(i) *In general.* If a hedging transaction hedges purchases of inventory, gain or loss on the hedging transaction may be taken into account in the same period that it would be taken into account if the gain or loss were treated as an element of the cost of inventory. Similarly, if a hedging transaction hedges sales of inventory, gain or loss on the hedging transaction may be taken into account in the same period that it would be taken into account if the gain or loss were treated as an element of sales proceeds. If a hedge is associated with a particular purchase or sales transaction, the gain or loss on the hedge may be taken into account when it would be taken into account if it were an element of cost incurred in, or sales proceeds from, that transaction. As with hedges of aggregate risk, however, a taxpayer may not be able to associate hedges of inventory purchases or sales with particular purchase or sales transactions. In order to match the timing of income, deduction, gain, or loss from the hedge with the timing of aggregate income, deduction, gain, or loss from the hedged purchases or sales, it may be appropriate for a taxpayer to account for its hedging transactions in the manner described in paragraph (e)(1)(ii) of this section, except that the gain or loss that is spread to each period is taken into account when it would be if it were an element of cost incurred (purchase hedges), or an element of proceeds from sales made (sales hedges), during that period.

(ii) *Alternative methods for certain inventory hedges.* In lieu of the method described in paragraph (e)(3)(i) of this section, other simpler, less precise methods may be used in appropriate cases where the clear reflection requirement of paragraph (b) of this section is satisfied. For example:

(A) Taking into account realized gains and losses on both hedges of inventory purchases and hedges of inventory sales when they would be taken into account if the gains and losses were elements of inventory cost in the period realized may clearly reflect income in some situations, but does not clearly reflect income for a taxpayer that uses the last-in, first-out method of accounting for the inventory; and

(B) Marking hedging transactions to market with resulting gain or loss taken into account immediately may clearly reflect income even though the inventory that is being hedged is not marked to market, but only if the inventory is not accounted for under either the last-in, first-out method or the lower-of-cost-or-market method and only if items are held in inventory for short periods of time.

(4) *Hedges of debt instruments.* Gain or loss from a transaction that hedges a debt instrument issued or to be issued by a taxpayer, or a debt instrument held or to be held by a taxpayer, must be accounted for by reference to the terms of the debt instrument and the period or periods to which the hedge relates. A hedge of an instrument that provides for interest to be paid at a fixed rate or a qualified floating rate, for example, generally is accounted for using constant yield principles. Thus, assuming that a fixed rate or qualified floating rate instrument remains outstanding, hedging gain or loss is taken into account in the same periods in which it would be taken into account if it adjusted the yield of the instrument over the term to which the hedge relates. For example, gain or loss realized on a transaction that hedged an anticipated fixed rate borrowing for its entire term is accounted for, solely for purposes of this section, as if it decreased or increased the issue price of the debt instrument. Similarly, gain or loss realized on a transaction that hedges a contingent payment on a debt instrument subject to §1.1275–4(c) (a contingent payment debt instrument issued for nonpublicly traded property) is taken into account when the contingent payment is taken into account under §1.1275–4(c).

(5) *Notional principal contracts.* The rules of §1.446–3 govern the timing of income and deductions with respect to a notional principal contract unless, because the notional principal contract is part of a hedging transaction, the

application of those rules would not result in the matching that is needed to satisfy the clear reflection requirement of paragraph (b) and, as applicable, (e)(4) of this section. For example, if a notional principal contract hedges a debt instrument, the method of accounting for periodic payments described in § 1.446–3(e) and the methods of accounting for nonperiodic payments described in § 1.446–3(f)(2)(iii) and (v) generally clearly reflect the taxpayer's income. The methods described in § 1.446–3(f)(2)(ii) and (iv), however, generally do not clearly reflect the taxpayer's income in that situation.

(6) *Disposition of hedged asset or liability.* If a taxpayer hedges an item and disposes of, or terminates its interest in, the item but does not dispose of or terminate the hedging transaction, the taxpayer must appropriately match the built-in gain or loss on the hedging transaction to the gain or loss on the disposed item. To meet this requirement, the taxpayer may mark the hedge to market on the date it disposes of the hedged item. If the taxpayer intends to dispose of the hedging transaction within a reasonable period, however, it may be appropriate to match the realized gain or loss on the hedging transaction with the gain or loss on the disposed item. If the taxpayer intends to dispose of the hedging transaction within a reasonable period and the hedging transaction is not actually disposed of within that period, the taxpayer must match the gain or loss on the hedge at the end of the reasonable period with the gain or loss on the disposed item. For purposes of this paragraph (e)(6), a reasonable period is generally 7 days.

(7) *Recycled hedges.* If a taxpayer enters into a hedging transaction by recycling a hedge of a particular hedged item to serve as a hedge of a different item, as described in § 1.1221–2(c)(2), the taxpayer must match the built-in gain or loss at the time of the recycling to the gain or loss on the original hedged item, items, or aggregate risk. Income, deduction, gain, or loss attributable to the period after the recycling must be matched to the new hedged item, items, or aggregate risk under the principles of paragraph (b) of this section.

(8) *Unfulfilled anticipatory transactions*—(i) *In general.* If a taxpayer enters into a hedging transaction to reduce risk with respect to an anticipated asset acquisition, debt issuance, or obligation, and the anticipated transaction is not consummated, any income, deduction, gain, or loss from the hedging transaction is taken into account when realized.

(ii) *Consummation of anticipated transaction.* A taxpayer consummates a transaction for purposes of paragraph (e)(8)(i) of this section upon the occurrence (within a reasonable interval around the expected time of the anticipated transaction) of either the anticipated transaction or a different but similar transaction for which the hedge serves to reasonably reduce risk.

(9) *Hedging by members of a consolidated group*—(i) *General rule: single-entity approach.* In general, a member of a consolidated group must account for its hedging transactions as if all of the members were separate divisions of a single corporation. Thus, the timing of the income, deduction, gain, or loss on a hedging transaction must match the timing of income, deduction, gain, or loss from the item or items being hedged. Because all of the members are treated as if they were divisions of a single corporation, intercompany transactions are neither hedging transactions nor hedged items for these purposes.

(ii) *Separate-entity election.* If a consolidated group makes an election under § 1.1221–2(d)(2), then paragraph (e)(9)(i) of this section does not apply. Thus, in that case, each member of the consolidated group must account for its hedging transactions in a manner that meets the requirements of paragraph (b) of this section. For example, the income, deduction, gain, or loss from intercompany hedging transactions (as defined in § 1.1221–2(d)(2)(ii)) is taken into account under the timing rules of § 1.446–4 rather than under the timing rules of § 1.1502–13.

(iii) *Definitions.* For definitions of consolidated group, divisions of a single corporation, intercompany transaction, and member, see section 1502 and the regulations thereunder.

(iv) *Effective date.* This paragraph (e)(9) applies to transactions entered into on or after March 8, 1996.

(f) *Type or character of income and deduction.* The rules of this section govern the timing of income, deduction, gain, or loss on hedging transactions but do not affect the type or character of income, deduction, gain, or loss produced by the transaction. Thus, for example, the rules of paragraph (e)(3) of this section do not affect the computation of cost of goods sold or sales proceeds for a taxpayer that hedges inventory purchases or sales. Similarly, the rules of paragraph (e)(4) of this section do not increase or decrease the interest income or expense of a taxpayer that hedges a debt instrument or a liability.

(g) *Effective date.* This section applies to hedging transactions entered into on or after October 1, 1994.

(h) *Consent to change methods of accounting.* The Commissioner grants consent for a taxpayer to change its methods of accounting for transactions that are entered into on or after October 1, 1994, and that are described in paragraph (a) of this section. This consent is granted only for changes for the taxable year containing October 1, 1994. The taxpayer must describe its new methods of accounting in a statement that is included in its Federal income tax return for that taxable year.

[T.D. 8554, 59 FR 36358, July 18, 1994, as amended by T.D. 8653, 61 FR 519, Jan. 8, 1996; T.D. 8674, 61 FR 30138, June 14, 1996]

§1.448–1 Limitation on the use of the cash receipts and disbursements method of accounting.

(a)–(f) [Reserved]

(g) *Treatment of accounting method change and timing rules for section 481(a) adjustment*—(1) *Treatment of change in accounting method.* Notwithstanding any other procedure published prior to January 7, 1991, concerning changes from the cash method, any taxpayer to whom section 448 applies must change its method of accounting in accordance with the provisions of this paragraph (g) and paragraph (h) of this section. In the case of any taxpayer required by this section to change its method of accounting for any taxable year, the change shall be treated as a change initiated by the taxpayer. The adjustments required under section 481(a) with respect to the change in method of accounting of such a taxpayer shall not be reduced by amounts attributable to taxable years preceding the Internal Revenue Code of 1954. Paragraph (h)(2) of this section provides procedures under which a taxpayer may change to an overall accrual method of accounting for the first taxable year the taxpayer is subject to this section (‘‘first section 448 year’’). If the taxpayer complies with the provisions of paragraph (h)(2) of this section for its first section 448 year, the change shall be treated as made with the consent of the Commissioner. Paragraph (h)(3) of this section provides procedures under which a taxpayer may change to other than an overall accrual method of accounting for its first section 448 year. Unless the taxpayer complies with the provisions of paragraph (h)(2) or (h)(3) of this section for its first section 448 year, the taxpayer must comply with the provisions of paragraph (h)(4) of this section. See paragraph (h) of this section for rules to effect a change in method of accounting.

(2) *Timing rules for section 481(a) adjustment*—(i) *In general.* Except as otherwise provided in paragraphs (g)(2)(ii) and (g)(3) of this section, a taxpayer required by this section to change from the cash method must take the section 481(a) adjustment into account ratably (beginning with the year of change) over the shorter of—

(A) The number of taxable years the taxpayer used the cash method, or

(B) 4 taxable years,

provided the taxpayer complies with the provisions of paragraph (h)(2) or (h)(3) of this section for its first section 448 year.

(ii) *Hospital timing rules*—(A) *In general.* In the case of a hospital that is required by this section to change from the cash method, the section 481(a) adjustment shall be taken into account ratably (beginning with the year of change) over 10 years, provided the taxpayer complies with the provisions of paragraph (h)(2) or (h)(3) of this section for its first section 448 year.

(B) *Definition of hospital.* For purposes of paragraph (g) of this section, a hospital is an institution—

(*1*) Accredited by the Joint Commission on Accreditation of Healthcare Organizations or its predecessor (the JCAHO) (or accredited or approved by a program of the qualified governmental unit in which such institution is located if the Secretary of Health and Human Services has found that the accreditation or comparable approval standards of such qualified governmental unit are essentially equivalent to those of the JCAHO);

(*2*) Used primarily to provide, by or under the supervision of physicians, to inpatients diagnostic services and therapeutic services for medical diagnosis, treatment, and care of injured, disabled, or sick persons;

(*3*) Requiring every patient to be under the care and supervision of a physician; and

(*4*) Providing 24-hour nursing services rendered or supervised by a registered professional nurse and having a licensed practical nurse or registered nurse on duty at all times.

For purposes of this section, an entity need not be owned by or on behalf of a governmental unit or by a section 501(c)(3) organization, or operated by a section 501(c)(3) organization, in order to be considered a hospital. In addition, for purposes of this section, a hospital does not include a rest or nursing home, continuing care facility, daycare center, medical school facility, research laboratory, or ambulatory care facility.

(C) *Dual function facilities.* With respect to any taxpayer whose operations consist both of a hospital, and other facilities not qualifying as a hospital, the portion of the adjustment required by section 481(a) that is attributable to the hospital shall be taken into account in accordance with the rules of paragraph (g)(2) of this section relating to hospitals. The portion of the adjustment required by section 481(a) that is not attributable to the hospital shall be taken into account in accordance with the rules of paragraph (g)(2) of this section not relating to hospitals.

(iii) *Untimely change in method of accounting to comply with this section.* Unless a taxpayer (including a hospital and a cooperative) required by this section to change from the cash method complies with the provisions of paragraph (h)(2) or (h)(3) of this section for its first section 448 year within the time prescribed by those paragraphs, the taxpayer must take the section 481 (a) adjustment into account under the provisions of any applicable administrative procedure that is prescribed by the Commissioner after January 7, 1991, specifically for purposes of complying with this section. Absent such an administrative procedure, a taxpayer must request a change under § 1.446–1(e)(3) and shall be subject to any terms and conditions (including the year of change) as may be imposed by the Commissioner.

(3) *Special timing rules for section 481(a) adjustment*—(i) *One-third rule.* If, during the period the section 481(a) adjustment is to be taken into account, the balance of the taxpayer's accounts receivable as of the last day of each of two consecutive taxable years is less than 66⅔ percent of the taxpayer's accounts receivable balance at the beginning of the first year of the section 481(a) adjustment, the balance of the section 481(a) adjustment (relating to accounts receivable) not previously taken into account shall be included in income in the second taxable year. This paragraph (g)(3)(i) shall not apply to any hospital (within the meaning of paragraph (g)(2)(ii) of this section).

(ii) *Cooperatives.* Notwithstanding paragraph (g)(2)(i) of this section, in the case of a cooperative (within the meaning of section 1381(a)) that is required by this section to change from the cash method, the entire section 481(a) adjustment may, at the cooperative's option, be taken into account in the year of change, provided the cooperative complies with the provisions of paragraph (h)(2) or (h)(3) of this section for its first section 448 year.

(iii) *Cessation of trade or business.* If the taxpayer ceases to engage in the trade or business to which the section 481(a) adjustment relates, or if the taxpayer operating the trade or business terminates existence, and such cessation or termination occurs prior to the expiration of the adjustment period described in paragraph (g)(2) (i) or (ii) of this section, the taxpayer must take into account, in the taxable year of such cessation or termination, the balance of the adjustment not previously taken into account in computing taxable income. For purposes of this paragraph (g)(3)(iii), the determination as to whether a taxpayer has ceased to engage in the trade or business to which the section 481(a) adjustment relates, or has terminated its existence, is to be made under the principles of §1.446–1(e)(3)(ii) and its underlying administrative procedures.

(iv) *De minimis rule for a taxpayer other than a cooperative.* Notwithstanding paragraph (g)(2)(i) and (ii) of this section, a taxpayer other than a cooperative (within the meaning of section 1381(a)) that is required to change from the cash method by this section may elect to use, in lieu of the adjustment period described in paragraph (g)(2)(i) and (ii) of this section, the adjustment period for de minimis section 481(a) adjustments provided in the applicable administrative procedure issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method. A taxpayer may make an election under this paragraph (g)(3)(iv) only if—

(A) The taxpayer's entire net section 481(a) adjustment (whether positive or negative) is a de minimis amount as determined under the applicable administrative procedure issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method,

(B) The taxpayer complies with the provisions of paragraph (h)(2) or (3) of this section for its first section 448 year,

(C) The return for such year is due (determined with regard to extensions) after December 27, 1993, and

(D) The taxpayer complies with any applicable instructions to Form 3115 that specify the manner of electing the adjustment period for de minimis section 481(a) adjustments.

(4) *Additional rules relating to section 481(a) adjustment.* In addition to the rules set forth in paragraph (g) (2) and (3) of this section, the following rules shall apply in taking the section 481(a) adjustment into account—

(i) Any net operating loss and tax credit carryforwards will be allowed to offset any positive section 481(a) adjustment,

(ii) Any net operating loss arising in the year of change or in any subsequent year that is attributable to a negative section 481(a) adjustment may be carried back to earlier taxable years in accordance with section 172, and

(iii) For purposes of determining estimated income tax payments under sections 6654 and 6655, the section 481(a) adjustment will be recognized in taxable income ratably throughout a taxable year.

(5) *Outstanding section 481(a) adjustment from previous change in method of accounting.* If a taxpayer changed its method of accounting to the cash method for a taxable year prior to the year the taxpayer was required by this section to change from the cash method (the section 448 year), any section 481(a) adjustment from such prior change in method of accounting that is outstanding as of the section 448 year shall be taken into account in accordance with the provisions of this paragraph (g)(5). A taxpayer shall account for any remaining portion of the prior section 481(a) adjustment outstanding as of the section 448 year by continuing to take such remaining portion into account under the provisions and conditions of the prior change in method of accounting, or, at the taxpayer's option, combining or netting the remaining portion of the prior section 481(a) adjustment with the section 481(a) adjustment required under this section, and taking into account under the provisions of this section the resulting net amount of the adjustment. Any taxpayer choosing to combine or net the section 481(a) adjustments as described in the preceding sentence shall indicate such choice on the Form 3115 required to be filed by such taxpayer under the provisions of paragraph (h) of this section.

(6) *Examples.* The following examples illustrate the provisions of paragraph (g) of this section.

Example (1). Y is required by this section to change from the cash method of accounting for its taxable year beginning January 1, 1987. Y changes to an overall accrual method. The adjustment required by section 481(a) to effect the change is $10,000. Y has been using the cash method for the 10-year period preceding the year of change. Y is required by paragraph (g)(2)(i) of this section to include the section 481(a) adjustment in taxable income ratably over four consecutive taxable years, beginning with 1987, i.e., $2,500 of the section 481(a) adjustment should be included in income for each of the four years.

Example (2). The facts are the same as in example (1), except that Y is required to change from the cash method and changes to an overall accrual method of accounting for its taxable year beginning January 1, 1989. The result is the same as in example (1), except that the four-year period for ratably taking the section 481(a) adjustment into account begins with the 1989 taxable year.

Example (3). Assume that X is required by this section to change from the cash method and that it changes to an overall accrual method for its taxable year beginning January 1, 1987. The adjustment required by section 481 (a) to effect the change is $10,000. X was formed on January 1, 1986, and began business operations during that year. Since X only used the cash method for one year, X is required by paragraph (g)(2)(i) of this section to include all ($10,000) of the section 481(a) adjustment in taxable income for the 1987 taxable year.

Example (4). The facts are the same as in example (1). In addition, Y previously changed from an accrual method of accounting to the cash method for its taxable year beginning January 1, 1983. As a result of that prior change, Y was required to take into account a $5,000 negative section 481(a) adjustment ratably over a ten-year period, beginning with the 1983 taxable year.

As of the beginning of the 1987 taxable year $3,000 of that adjustment had not been taken into account. Y may continue to take the remaining negative $3,000 section 481(a) adjustment into account ratably over the remaining adjustment period for the prior change in method of accounting (*i.e.,* six remaining years). Alternatively, Y may combine or net the negative $3,000 adjustment with the positive $10,000 section 481(a) adjustment required by this section, and include the resulting $7,000 amount in taxable income ratably over four consecutive taxable years, beginning with 1987. Y is not allowed to take the entire unamortized amount of the prior section 481(a) adjustment into account for its 1987 taxable year.

(h) *Procedures for change in method of accounting*—(1) *Applicability.* Paragraph (h) of this section applies to taxpayers who change from the cash method as required by this section. Paragraph (h) of this section does not apply to a change in accounting method required by any Code section (or regulations thereunder) other than this section.

(2) *Automatic rule for changes to an overall accrual method*—(i) *Timely changes in method of accounting.* Notwithstanding any other available procedures to change to the accrual method of accounting, a taxpayer to whom paragraph (h) of this section applies who desires to make a change to an overall accrual method for its first section 448 year must make that change under the provisions of this paragraph (h)(2). A taxpayer changing to an overall accrual method under this paragraph (h)(2) must file a current Form 3115 by the time prescribed in paragraph (h)(2)(ii). In addition, the taxpayer must set forth on a statement accompanying the Form 3115 the period over which the section 481(a) adjustment will be taken into account and the basis for such conclusion. Moreover, the taxpayer must type or legibly print the following statement at the top of page 1 of the Form 3115: ''Automatic Change to Accrual Method—Section 448.'' The consent of the Commissioner to the change in method of accounting is granted to taxpayers who change to an overall accrual method under this paragraph (h)(2). See paragraph (g)(2)(i), (g)(2)(ii), or (g)(3) of this section, whichever is applicable, for rules to account for the section 481(a) adjustment.

(ii) *Time and manner for filing Form 3115*—(A) *In general.* Except as provided in paragraph (h)(2)(ii)(B) of this section, the Form 3115 required by paragraph (h)(2)(i) must be filed no later than the due date (determined with regard to extensions) of the taxpayer's federal income tax return for the first section 448 year and must be attached to that return.

(B) *Extension of filing deadline.* Notwithstanding paragraph (h)(2)(ii)(A) of this section, the filing of the Form 3115 required by paragraph (h)(2)(i) shall not be considered late if such Form 3115 is attached to a timely filed amended income tax return for the first section 448 year, provided that—

(*1*) The taxpayer's first section 448 year is a taxable year that begins (or, pursuant to § 1.441–2T (b)(1), is deemed to begin) in 1987, 1988, 1989, or 1990,

(*2*) The taxpayer has not been contacted for examination, is not before appeals, and is not before a federal court with respect to an income tax issue (each as defined in applicable administrative pronouncements), unless the taxpayer also complies with any requirements for approval in those applicable administrative pronouncements, and

(*3*) Any amended return required by this paragraph (h)(2)(ii)(B) is filed on or before July 8, 1991.

Filing an amended return under this paragraph (h)(2)(ii)(B) does not extend the time for making any other election. Thus, for example, taxpayers that comply with this section by filing an amended return pursuant to this paragraph (h)(2)(ii)(B) may not elect out of section 448 pursuant to paragraph (i)(2) of this section.

(3) *Changes to a method other than overall accrual method*—(i) *In general.* A taxpayer to whom paragraph (h) of this section applies who desires to change to a special method of accounting must make that change under the provisions of this paragraph (h)(3), except to the extent other special procedures have been promulgated regarding the special method of accounting. Such a taxpayer includes taxpayers who change to both an accrual method of accounting and a special method of accounting such as a long-term contract method. In order to change an accounting method under this paragraph (h)(3), a taxpayer must submit an application for change in accounting method under the applicable administrative procedures in effect at the time of change, including the applicable procedures regarding the time and place of filing the application for change in method. Moreover, a taxpayer who changes an accounting method under this paragraph (h)(3) must type or legibly print the following statement on the top of page 1 of Form 3115: ‘‘Change to a Special Method of Accounting—Section 448.’’ The filing of a Form 3115 by any taxpayer requesting a change of method of accounting under this paragraph (h)(3) for its taxable year beginning in 1987 will not be considered late if the form is filed with the appropriate office of the Internal Revenue Service on or before the later of: the date that is the 180th day of the taxable year of change; or September 14, 1987. If the Commissioner approves the taxpayer's application for change in method of accounting, the timing of the adjustment required under section 481 (a), if applicable, will be determined under the provisions of paragraph (g)(2)(i), (g)(2)(ii), or (g)(3) of this section, whichever is applicable. If the Commissioner denies the taxpayer's application for change in accounting method, or if the taxpayer's application is untimely, the taxpayer must change to an overall accrual method of accounting under the provisions of either paragraph (h)(2) or (h)(4) of this section, whichever is applicable.

(ii) *Extension of filing deadline.* Notwithstanding paragraph (h)(3)(i) of this section, if the events or circumstances which under section 448 disqualify a taxpayer from using the cash method occur after the time prescribed under applicable procedures for filing the Form 3115, the filing of such form shall not be considered late if such form is filed on or before 30 days after the close of the taxable year.

(4) *Untimely change in method of accounting to comply with this section.* Unless a taxpayer to whom paragraph (h) of this section applies complies with the provisions of paragraph (h)(2) or (h)(3) of this section for its first section 448 year, the taxpayer must comply with the requirements of §1.446–1 (e)(3) (including any applicable administrative procedure that is prescribed thereunder after January 7, 1991 specifically for purposes of complying with this section) in order to secure the consent of the Commissioner to change to a method of accounting that is in compliance with the provisions of this section. The taxpayer shall be subject to any terms and conditions (including the year of change) as may be imposed by the Commissioner.

(i) *Effective date*—(1) *In general.* Except as provided in paragraph (i)(2), (3), and (4) of this section, this section applies to any taxable year beginning after December 31, 1986.

(2) *Election out of section 448*—(i) *In general.* A taxpayer may elect not to have this section apply to any (A) transaction with a related party (within the meaning of section 267(b) of the Internal Revenue Code of 1954, as in effect on October 21, 1986), (B) loan, or (C) lease, if such transaction, loan, or lease was entered into on or before September 25, 1985. Any such election described in the preceding sentence may

be made separately with respect to each transaction, loan, or lease. For rules relating to the making of such election, see §301.9100–7T (temporary regulations relating to elections under the Tax Reform Act of 1986). Notwithstanding the provisions of this paragraph (i)(2), the gross receipts attributable to a transaction, loan, or lease described in this paragraph (i)(2) shall be taken into account for purposes of the $5,000,000 gross receipts test described in paragraph (f) of this section.

(ii) *Special rules for loans.* If the taxpayer makes an election under paragraph (i)(2)(i) of this section with respect to a loan entered into on or before September 25, 1985, the election shall apply only with respect to amounts that are attributable to the loan balance outstanding on September 25, 1985. The election shall not apply to any amounts advanced or lent after September 25, 1985, regardless of whether the loan agreement was entered into on or before such date. Moreover, any payments made on outstanding loan balances after September 25, 1985, shall be deemed to first extinguish loan balances outstanding on September 25, 1985, regardless of any contrary treatment of such loan payments by the borrower and lender.

(3) *Certain contracts entered into before September 25, 1985.* This section does not apply to a contract for the acquisition or transfer of real property or a contract for services related to the acquisition or development of real property if—

(i) The contract was entered into before September 25, 1985; and

(ii) The sole element of the contract which was not performed as of September 25, 1985, was payment for such property or services.

(4) *Transitional rule for paragraphs (g) and (h) of this section.* To the extent the provisions of paragraphs (g) and (h) of this section were not reflected in paragraphs (g) and (h) of §1.448–1T (as set forth in 26 CFR part 1 as revised on April 1, 1993), paragraphs (g) and (h) of this section will not be adversely applied to a taxpayer with respect to transactions entered into before December 27, 1993.

[T.D. 8514, 58 FR 68299, Dec. 27, 1993]

§1.448–1T Limitation on the use of the cash receipts and disbursements method of accounting (temporary).

(a) *Limitation on accounting method*—(1) *In general.* This section prescribes regulations under section 448 relating to the limitation on the use of the cash receipts and disbursements method of accounting (the cash method) by certain taxpayers.

(2) *Limitation rule.* Except as otherwise provided in this section, the computation of taxable income using the cash method is prohibited in the case of a—

(i) C corporation,

(ii) Partnership with a C corporation as a partner, or

(iii) Tax shelter.

A partnership is described in paragraph (a)(2)(ii) of this section, if the partnership has a C corporation as a partner at any time during the partnership's taxable year beginning after December 31, 1986.

(3) *Meaning of C corporation.* For purposes of this section, the term ‘‘C corporation’’ includes any corporation that is not an S corporation. For example, a regulated investment company (as defined in section 851) or a real estate investment trust (as defined in section 856) is a C corporation for purposes of this section. In addition, a trust subject to tax under section 511 (b) shall be treated, for purposes of this section, as a C corporation, but only with respect to the portion of its activities that constitute an unrelated trade or business. Similarly, for purposes of this section, a corporation that is exempt from federal income taxes under section 501 (a) shall be treated as a C corporation only with respect to the portion of its activities that constitute an unrelated trade or business. Moreover, for purposes of determining whether a partnership has a C corporation as a partner, any partnership described in paragraph (a)(2)(ii) of this section is treated as a C corporation. Thus, if partnership ABC has a partner that is a partnership with a C corporation, then, for purposes of this section, partnership ABC is treated as a partnership with a C corporation partner.

(4) *Treatment of a combination of methods.* For purposes of this section, the

use of a method of accounting that records some, but not all, items on the cash method shall be considered the use of the cash method. Thus, a C corporation that uses a combination of accounting methods including the use of the cash method is subject to this section.

(b) *Tax shelter defined*—(1) *In general.* For purposes of this section, the term ''tax shelter'' means any—

(i) Enterprise (other than a C corporation) if at any time (including taxable years beginning before January 1, 1987) interests in such enterprise have been offered for sale in any offering required to be registered with any federal or state agency having the authority to regulate the offering of securities for sale,

(ii) Syndicate (within the meaning of paragraph (b)(3) of this section), or

(iii) Tax shelter within the meaning of section 6661 (b)(2)(C)(ii) (relating to (A) a partnership or other entity, (B) any investment plan or arrangement, or (C) any other plan or arrangement, whose principal purpose is the avoidance or evasion of Federal income tax).

(2) *Requirement of registration.* For purposes of paragraph (b)(1)(i) of this section, an offering is required to be registered with a federal or state agency if, under the applicable federal or state law, failure to register the offering would result in a violation of the applicable federal or state law (regardless of whether the offering is in fact registered). In addition, an offering is required to be registered with a federal or state agency if, under the applicable federal or state law, failure to file a notice of exemption from registration would result in a violation of the applicable federal or state law (regardless of whether the notice is in fact filed).

(3) *Meaning of syndicate.* For purposes of paragraph (b)(1)(ii) of this section, the term ''syndicate'' means a partnership or other entity (other than a C corporation) if more than 35 percent of the losses of such entity during the taxable year (for taxable years beginning after December 31, 1986) are allocated to limited partners or limited entrepreneurs. For purposes of this paragraph (b)(3), the term ''limited entrepreneur'' has the same meaning given such term in section 464 (e)(2). In addition, in determining whether an interest in a partnership is held by a limited partner, or an interest in an entity or enterprise is held by a limited entrepreneur, section 464 (c)(2) shall apply in the case of the trade or business of farming (as defined in paragraph (d)(2) of this section), and section 1256 (e)(3)(C) shall apply in any other case. Moreover, for purposes of this paragraph (b)(3), the losses of a partnership, entity, or enterprise (the enterprise) means the excess of the deductions allowable to the enterprise over the amount of income recognized by such enterprise under the enterprise's method of accounting used for federal income tax purposes (determined without regard to this section). For this purpose, gains or losses from the sale of capital assets or section 1221 (2) assets are not taken into account.

(4) *Presumed tax avoidance.* For purposes of paragraph (b)(1)(iii) of this section, marketed arrangements in which persons carrying on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance if such persons use borrowed funds to prepay a substantial portion of their farming expenses (*e.g.*, payment for farm supplies that will not be used or consumed until a taxable year subsequent to the taxable year of payment).

(5) *Taxable year tax shelter must change accounting method.* A partnership, entity, or enterprise that is a tax shelter must change from the cash method for the later of (i) the first taxable year beginning after December 31, 1986, or (ii) the taxable year that such partnership, entity, or enterprise becomes a tax shelter.

(c) *Effect of section 448 on other provisions.* Nothing in section 448 shall have any effect on the application of any other provision of law that would otherwise limit the use of the cash method, and no inference shall be drawn from section 448 with respect to the application of any such provision. For example, nothing in section 448 affects the requirement of section 447 that certain corporations must use an accrual method of accounting in computing taxable income from farming, or the requirement of § 1.446–1(c)(2) that an accrual method be used with regard to purchases and sales of inventory. Similarly, nothing in section 448 affects the authority of the Commissioner under section 446(b) to require the use of an accounting method that clearly reflects income, or the requirement under section 446(e) that a taxpayer secure the consent of the Commissioner before changing its method of accounting. For example, a taxpayer using the cash method may be required to change to an accrual method of accounting under section 446(b) because such method clearly reflects that taxpayer's income, even though the taxpayer is not prohibited by section 448 from using the cash method. Similarly, a taxpayer using an accrual method of accounting that is not prohibited by section 448 from using the cash method may not change to the cash method unless the taxpayer secures the consent of the Commissioner under section 446(e), and, in the opinion of the Commissioner, the use of the cash method clearly reflects that taxpayer's income under section 446(b).

(d) *Exception for farming business*—(1) *In general.* Except in the case of a tax shelter, this section shall not apply to any farming business. A taxpayer engaged in a farming business and a separate nonfarming business is not prohibited by this section from using the cash method with respect to the farming business, even though the taxpayer may be prohibited by this section from using the cash method with respect to the nonfarming business.

(2) *Meaning of farming business.* For purposes of paragraph (d) of this section, the term ''farming business'' means—

(i) The trade or business of farming as defined in section 263A(e)(4) (including the operation of a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees), or

(ii) The raising, harvesting , or growing of trees described in section 263A(c)(5) (relating to trees raised, harvested, or grown by the taxpayer other than trees described in paragraph (d)(2)(i) of this section).

Thus, for purposes of this section, the term ''farming business'' includes the raising of timber. For purposes of this section, the term ''farming business'' does not include the processing of commodities or products beyond those activities normally incident to the growing, raising or harvesting of such products. For example, assume that a C corporation taxpayer is in the business of growing and harvesting wheat and other grains. The taxpayer processes the harvested grains to produce breads, cereals, and similar food products which it sells to customers in the course of its business. Although the taxpayer is in the farming business with respect to the growing and harvesting of grain, the taxpayer is not in the farming business with respect to the processing of such grains to produce food products which the taxpayer sells to customers. Similarly, assume that a taxpayer is in the business of raising poultry or other livestock. The taxpayer uses the livestock in a meat processing operation in which the livestock are slaughtered, processed, and packaged or canned for sale to customers. Although the taxpayer is in the farming business with respect to the raising of livestock, the taxpayer is not in the farming business with respect to the meat processing operation. However, under this section the term ''farming business'' does include processing activities which are normally incident to the growing, raising or harvesting of agricultural products. For example, assume a taxpayer is in the business of growing fruits and vegetables. When the fruits and vegetables are ready to be harvested, the taxpayer picks, washes, inspects, and packages the fruits and vegetables for sale. Such activities are normally incident to the raising of these crops by farmers. The taxpayer will be considered to be in the business of farming with respect to the growing of fruits and vegetables, and the processing activities incident to the harvest.

(e) *Exception for qualified personal service corporation*—(1) *In general.* Except in the case of a tax shelter, this section does not apply to a qualified personal service corporation.

(2) *Certain treatment for qualified personal service corporation.* For purposes of paragraph (a)(2)(ii) of this section (relating to whether a partnership has

a C corporation as a partner), a qualified personal service corporation shall be treated as an individual.

(3) *Meaning of qualified personal service corporation.* For purposes of this section, the term ''qualified personal service corporation'' means any corporation that meets—

(i) The function test paragraph (e)(4) of this section, and

(ii) The ownership test of paragraph (e)(5) of this section.

(4) *Function test*—(i) *In general.* A corporation meets the function test if substantially all the corporation's activities for a taxable year involve the performance of services in one or more of the following fields—

(A) Health,
(B) Law,
(C) Engineering (including surveying and mapping),
(D) Architecture,
(E) Accounting,
(F) Actuarial science,
(G) Performing arts, or
(H) Consulting.

Substantially all of the activities of a corporation are involved in the performance of services in any field described in the preceding sentence (a qualifying field), only if 95 percent or more of the time spent by employees of the corporation, serving in their capacity as such, is devoted to the performance of services in a qualifying field. For purposes of determining whether this 95 percent test is satisfied, the performance of any activity incident to the actual performance of services in a qualifying field is considered the performance of services in that field. Activities incident to the performance of services in a qualifying field include the supervision of employees engaged in directly providing services to clients, and the performance of administrative and support services incident to such activities.

(ii) *Meaning of services performed in the field of health.* For purposes of paragraph (e)(4)(i)(A) of this section, the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers.

(iii) *Meaning of services performed in the field of performing arts.* For purposes of paragraph (e)(4)(i)(G) of this section, the performance of services in the field of the performing arts means the provision of services by actors, actresses, singers, musicians, entertainers, and similar artists in their capacity as such. The performance of services in the field of the performing arts does not include the provision of services by persons who themselves are not performing artists (*e.g.*, persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts). Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate the performances of such artists to members of the public (*e.g.*, employees of a radio station that broadcasts the performances of musicians and singers). Finally, the performance of services in the field of the performing arts does not include the provision of services by athletes.

(iv) *Meaning of services performed in the field of consulting*—(A) *In general.* For purposes of paragraph (e)(4)(i)(H) of this section, the performance of services in the field of consulting means the provision of advice and counsel. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or brokerage services, or economically similar services. For purposes of the preceding sentence, the determination of whether a person's services are sales or brokerage services, or economically similar services, shall be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided (*e.g.*, whether the compensation for the services is contingent upon the consummation of the transaction that the services were intended to effect).

(B) *Examples.* The following examples illustrate the provisions of paragraph (e)(4)(iv)(A) of this section. The examples do not address all types of services that may or may not qualify as consulting. The determination of whether activities not specifically addressed in the examples qualify as consulting shall be made by comparing the service activities in question to the types of service activities discussed in the examples. With respect to a corporation which performs services which qualify as consulting under this section, and other services which do not qualify as consulting, see paragraph (e)(4)(i) of this section which requires that substantially all of the corporation's activities involve the performance of services in a qualifying field.

Example (1). A taxpayer is in the business of providing economic analyses and forecasts of business prospects for its clients. Based on these analyses and forecasts, the taxpayer advises its clients on their business activities. For example, the taxpayer may analyze the economic conditions and outlook for a particular industry which a client is considering entering. The taxpayer will then make recommendations and advise the client on the prospects of entering the industry, as well as on other matters regarding the client's activities in such industry. The taxpayer provides similar services to other clients, involving, for example, economic analyses and evaluations of business prospects in different areas of the United States or in other countries, or economic analyses of overall economic trends and the provision of advice based on these analyses and evaluations. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example (2). A taxpayer is in the business of providing services that consist of determining a client's electronic data processing needs. The taxpayer will study and examine the client's business, focusing on the types of data and information relevant to the client and the needs of the client's employees for access to this information. The taxpayer will then make recommendations regarding the design and implementation of data processing systems intended to meet the needs of the client. The taxpayer does not, however, provide the client with additional computer programming services distinct from the recommendations made by the taxpayer with respect to the design and implementation of the client's data processing systems. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example (3). A taxpayer is in the business of providing services that consist of determining a client's management and business structure needs. The taxpayer will study the client's organization, including, for example, the departments assigned to perform specific functions, lines of authority in the managerial hierarchy, personnel hiring, job responsibility, and personnel evaluations and compensation. Based on the study, the taxpayer will then advise the client on changes in the client's management and business structure, including, for example, the restructuring of the client's departmental systems or its lines of managerial authority. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example (4). A taxpayer is in the business of providing financial planning services. The taxpayer will study a particular client's financial situation, including, for example, the client's present income, savings and investments, and anticipated future economic and financial needs. Based on this study, the taxpayer will then assist the client in making decisions and plans regarding the client's financial activities. Such financial planning includes the design of a personal budget to assist the client in monitoring the client's financial situation, the adoption of investment strategies tailored to the client's needs, and other similar services. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example (5). A taxpayer is in the business of executing transactions for customers involving various types of securities or commodities generally traded through organized exchanges or other similar networks. The taxpayer provides its clients with economic analyses and forecasts of conditions in various industries and businesses. Based on these analyses, the taxpayer makes recommendations regarding transactions in securities and commodities. Clients place orders with the taxpayer to trade securities or commodities based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the trade orders. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in brokerage services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the execution of trade orders for its clients).

Example (6). A taxpayer is in the business of studying a client's needs regarding its data processing facilities and making recommendations to the client regarding the design and implementation of data processing systems. The client will then order computers and other data processing equipment through the taxpayer based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the equipment orders made by the clients. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in the performance of sales services. Relevant to this determination is the fact that the compensation of the taxpayer for its services it contingent upon the consummation of the transaction the services were intended to effect (i.e., the execution of equipment orders for its clients).

Example (7). A taxpayer is in the business of assisting businesses in meeting their personnel requirements by referring job applicants to employers with hiring needs in a particular area. The taxpayer may be informed by potential employers of their need for job applicants, or, alternatively, the taxpayer may become aware of the client's personnel requirements after the taxpayer studies and examines the client's management and business structure. The taxpayer's compensation for its services is typically based on the job applicants, referred by the taxpayer to the clients, who accept employment positions with the clients. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is involved in the performance of services economically similar to brokerage services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the hiring of a job applicant by the client).

Example (8). The facts are the same as in example (7), except that the taxpayer's clients are individuals who use the services of the taxpayer to obtain employment positions. The taxpayer is typically compensated by its clients who obtain employment as a result of the taxpayer's services. For the reasons set forth in example (7), the taxpayer is not considered to be engaged in the performance of services in the field of consulting.

Example (9). A taxpayer is in the business of assisting clients in placing advertisements for their goods and services. The taxpayer analyzes the conditions and trends in the client's particular industry, and then makes recommendations to the client regarding the types of advertisements which should be placed by the client and the various types of advertising media (e.g., radio, television, magazines, etc.) which should be used by the client. The client will then purchase, through the taxpayer, advertisements in various media based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the particular orders for advertisements which the client makes. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in the performance of services economically similar to brokerage services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the placing of advertisements by clients).

Example (10). A taxpayer is in the business of selling insurance (including life and casualty insurance), annuities, and other similar insurance products to various individual and business clients. The taxpayer will study the particular client's financial situation, including, for example, the client's present income, savings and investments, business and personal insurance risks, and anticipated future economic and financial needs. Based on this study, the taxpayer will then make recommendations to the client regarding the desirability of various insurance products. The client will then purchase these various insurance products through the taxpayer. The taxpayer's compensation for its services is typically based on the purchases made by the clients. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in the performance of brokerage or sales services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the purchase of insurance products by its clients).

(5) *Ownership test*—(i) *In general.* A corporation meets the ownership test, if at all times during the taxable year, substantially all the corporation's stock, by value, is held, directly or indirectly, by—

(A) Employees performing services for such corporation in connection with activities involving a field referred to in paragraph (e)(4) of this section,

(B) Retired employees who had performed such services for such corporation,

(C) The estate of any individual described in paragraph (e)(5)(i) (A) or (B) of this section, or

(D) Any other person who acquired such stock by reason of the death of an individual described in paragraph (e)(5)(i) (A) or (B) of this section, but only for the 2-year period beginning on the date of the death of such individual.

For purposes of this paragraph (e)(5) of this section, the term ‘‘substantially all’’ means an amount equal to or greater than 95 percent.

(ii) *Definition of employee.* For purposes of the ownership test of this paragraph (e)(5) of this section, a person shall not be considered an employee of a corporation unless the services performed by that person for such corporation, based on the facts and circumstances, are more than de minimis. In addition, a person who is an employee of a corporation shall not be treated as an employee of another corporation merely by reason of the employer corporation and the other corporation being members of the same affiliated group or otherwise related.

(iii) *Attribution rules.* For purposes of this paragraph (e)(5) of this section, a corporation’s stock is considered held indirectly by a person if, and to the extent, such person owns a proportionate interest in a partnership, S corporation, or qualified personal service corporation that owns such stock. No other arrangement or type of ownership shall constitute indirect ownership of a corporation’s stock for purposes of this paragraph (e)(5) of this section. Moreover, stock of a corporation held by a trust is considered held by a person if, and to the extent, such person is treated under subpart E, part I, subchapter J, chapter 1 of the Code as the owner of the portion of the trust that consists of such stock.

(iv) *Disregard of community property laws.* For purposes of this paragraph (e)(5) of this section, community property laws shall be disregarded. Thus, in determining the stock ownership of a corporation, stock owned by a spouse solely by reason of community property laws shall be treated as owned by the other spouse.

(v) *Treatment of certain stock plans.* For purposes of this paragraph (e)(5) of this section, stock held by a plan described in section 401 (a) that is exempt from tax under section 501 (a) shall be treated as held by an employee described in paragraph (e)(5)(i)(A) of this section.

(vi) *Special election for certain affiliated groups.* For purposes of determining whether the stock ownership test of this paragraph (e)(5) of this section has been met, at the election of the common parent of an affiliated group (within the meaning of section 1504 (a)), all members of such group shall be treated as one taxpayer if substantially all (within the meaning of paragraph (e)(4)(i) of this section) the activities of all such members (in the aggregate) are in the same field described in paragraph (e)(4)(i)(A)–(H) of this section. For rules relating to the making of the election, see 26 CFR 5h.5 (temporary regulations relating to elections under the Tax Reform Act of 1986).

(vii) *Examples.* The following examples illustrate the provisions of paragraph (e) of this section:

Example (1). (i) X, a Corporation, is engaged in the business of providing accounting services to its clients. These services consist of the preparation of audit and financial statements and the preparation of tax returns. For purposes of section 448, such services consist of the performance of services in the field of accounting. In addition, for purposes of section 448, the supervision of employees directly preparing the statements and returns, and the performance of all administrative and support services incident to such activities (including secretarial, janitorial, purchasing, personnel, security, and payroll services) are the performance of services in the field of accounting.

(ii) In addition, X owns and leases a portion of an office building. For purposes of this section, the following types of activities undertaken by the employees of X shall be considered as the performance of services in a field other than the field of accounting: (A) services directly relating to the leasing activities, e.g., time spent in leasing and maintaining the leased portion of the building; (B) supervision of employees engaged in directly providing services in the leasing activity; and (C) all administrative and support services incurred incident to services described in (A) and (B). The leasing activities of X are considered the performance of services in a field other than the field of accounting, regardless of whether such leasing activities constitute a trade or business under the Code. If the employees of X spend 95% or more of their time in the performance of services in the field of accounting, X satisfies the function test of paragraph (e)(4) of this section.

Example (2). Assume that Y, a C corporation, meets the function test of paragraph (e)(4) of this section. Assume further that all the employees of Y are performing services for Y in a qualifying field as defined in paragraph (e)(4) of this section. P, a partnership, owns 40%, by value, of the stock of Y. The remaining 60% of the stock of Y is owned directly by employees of Y. Employees of Y have an aggregate interest of 90% in the capital and profits of P. This, 96% of the stock of Y is held directly, or indirectly, by employees of Y performing services in a qualifying field. Accordingly, Y meets the ownership test of paragraph (e)(5) of this section and is a qualified personal service corporation.

Example (3). The facts are the same as in example (2), except that 40% of the stock of Y is owned by Z, a C corporation. The remaining 60% of the stock is owned directly by the employees of Y. Employees of Y own 90% of the stock, by value, of Z. Assume that Z independently qualifies as a personal service corporation. The result is the same as in example (2), i.e., 96% of the stock of Y is held, directly or indirectly, by employees of Y performing services in a qualifying field. Thus, Y is a qualified personal service corporation.

Example (4). The facts are the same as in example (3), except that Z does not independently qualify as a personal service corporation. Because Z is not a qualified personal service corporation, the Y stock owned by Z is not treated as being held indirectly by the Z shareholders. Consequently, only 60% of the stock of Y is held, directly or indirectly, by employees of Y. Thus, Y does not meet the ownership test of paragraph (e)(5) of this section, and is not a qualified personal service corporation.

Example (5). Assume that W, a C corporation, meets the function test of paragraph (e)(4) of this section. In addition, assume that all the employees of W are performing services for W in a qualifying field. Nominal legal title to 100% of the stock of W is held by employees of W. However, due solely to the operation of community property laws, 20% of the stock of W is held by spouses of such employees who themselves are not employees of W. In determining the ownership of the stock, community property laws are disregarded. Thus, Y meets the ownership test of paragraph (e)(5) of this section, and is a qualified personal service corporation.

Example (6). Assume that 90% of the stock of T, a C corporation, is directly owned by the employees of T. Spouses of T's employees directly own 5% of the stock of T. The spouses are not employees of T, and their ownership does not occur solely by operation of community property laws. In addition, 5% of the stock of T is held by trusts (other than a trust described in section 401(a) that is exempt from tax under section 501(a)), the sole beneficiaries of which are employees of T. The employees are not treated as owners of the trusts under subpart E, part I, subchapter J, chapter 1 of the Code. Since a person is not treated as owning the stock of a corporation owned by that person's spouse, or by any portion of a trust that is not treated as owned by such person under subpart E, only 90% of the stock of T is treated as held, directly or indirectly, by employees of T. Thus, T does not meet the ownership test of paragraph (e)(5) of this section, and is not a qualified personal service corporation.

Example (7). Assume that Y, a C corporation, directly owns all the stock of three subsidiaries, F, G, and H. Y is a common parent of an affiliated group within the meaning of section 1504(a) consisting of Y, F, G, and H. Y is not engaged in the performance of services in a qualifying field. Instead, Y is a holding company whose activities consist of its ownership and investment in its operating subsidiaries. Substantially all the activities of F involve the performance of services in the field of engineering. In addition, a majority of (but not substantially all) the activities of G involve the performance of services in the field of engineering; the remainder of G's services involve the performance of services in a nonqualifying field. Moreover, a majority of (but not substantially all) the activities of H involve the performance of services in the field of engineering; the remainder of H's activities involve the performance of services in the field of architecture. Nevertheless, substantially all the activities of the group consisting of Y, F, G, and H, in the aggregate, involve the performance of services in the field of engineering. Accordingly, Y elects under paragraph (e)(5)(vi) of this section to be treated as one taxpayer for determining the ownership test of paragraph (e)(5) of this section. Assume that substantially all the stock of Y (by value) is held by employees of F, G, or H who perform services in connection with a qualifying field (engineering or architecture). Thus, for purposes of determining whether any member corporation is a qualified personal service corporation, the ownership test of paragraph (e)(5) of this section has been satisfied. Since F and H satisfy the function test of paragraph (e)(4) of this section, F and H are qualified personal service corporations. However, since Y and G each fail the function test of paragraph (e)(4) of this section, neither corporation is a qualified personal service corporation.

Example (8). The facts are the same as in example (7), except that less than substantially all the activities of the group consisting of Y, F, G, and H, in the aggregate, are performed in the field of engineering. Substantially all the activities of the group consisting of Y, F, G, and H, are, in the aggregate, performed in two fields, the fields of engineering and architecture. Y may not elect to have the affiliated group treated as one taxpayer for purposes of determining whether group members meet the ownership test of paragraph (e)(5) of this section. The election is available only if substantially all the activities of the group, in the aggregate, involve the performance of services in only one qualifying field. Moreover, none of the group members are qualified personal service corporations. Y fails the function test of paragraph (e)(4) of this section because less than substantially all the activities of Y are performed in a qualifying field. In addition, F, G, and H fail the ownershp test of paragraph (e)(5) of this section because substantially all their stock is owned by Y and not by their employees. The owners of Y are not deemed to indirectly own the stock owned by Y because Y is not a qualified personal service corporation.

Example (9). (i) The facts are the same as in example (8), except Y itself satisfies the function tests of paragraph (e)(4) of this section because substantially all the activities of Y involve the performance of services in the field of engineering. In addition, assume that all employees of Y are involved in the performance of services in the field of engineering, and that all such employees own 100% of Y's stock. Moreover, assume that one-third of all the employees of Y are separately employed by F. Similarly, another one-third of the employees of Y are separately employed by G and H, respectively. None of the employees of Y are employed by more than one of Y's subsidiaries. Also, no other persons except the employees of Y are employed by any of the subsidiaries.

(ii) Y is a personal service corporation under section 448 because Y satisfies both the function and the ownership test of paragraphs (e) (4) and (5) of this section. As in example (8), Y is unable to make the election to have the affiliated group treated as one taxpayer for purposes of determining whether group members meet the ownership test of paragraph (e)(5) of this section because less than substantially all the activities, in the aggregate, of the group members are performed in one of the qualifying fields. However, because Y is a personal service corporation, the stock owned by Y is treated as indirectly owned, proportionately, by the owners of Y. Thus, the employees of F are collectively treated as owning one-third of the stock of F, G, and H. The employees of G and H are similarly treated as owning one-third of each subsidiary's stock.

(iii) F, G, and H each fail the ownership test of paragraph (e)(5) of this section because less than substantially all of each corporation's stock is owned by the employees of the respective corporation. Only one-third of each corporation's stock is owned by employees of that corporation. Thus, F, G, and H are not qualified personal service corporations.

Example (10). (i) Assume that Y, a C corporation, directly owns all the stock of three subsidiaries, F, G, and Z. Y is a common parent of an affiliated group within the meaning of section 1504(a) consisting of Y, F, and G. Z is a foreign corporation and is excluded from the affiliated group under section 1504. Assume that Y is a holding company whose activities consist of its ownership and investment in its operating subsidiaries. Substantially all the activities of F, G, and Z involve the performance of services in the field of engineering. Assume that employees of Z own one-third of the stock of Y and that none of these employees are also employees of Y, F, or G. In addition, assume that Y elects to be treated as one taxpayer for determining whether group members meet the ownership tests of paragraph (e)(5) of this section. Thus, Y, F, and G are treated as one taxpayer for purposes of the ownership test.

(ii) None of the members of the group are qualified personal service corporations. Y, F, and G fail the ownership test of paragraph (e)(5) of this section because less than substantially all the stock of Y is owned by employees of either Y, F, or G. Moreover, Z fails the ownership test of paragraph (e)(5) of this section because substantially all its stock is owned by Y and not by its employees.

(6) *Application of function and ownership tests.* A corporation that fails the function test of paragraph (e)(4) of this section for any taxable year, or that fails the ownership test of paragraph (e)(5) of this section at any time during any taxable year, shall change from the cash method effective for the year in which the corporation fails to meet the function test or the ownership test. For example, if a personal service corporation fails the function test for taxable year 1987, such corporation must change from the cash method effective for taxable year 1987. A corporation that fails the function or ownership test for a taxable year shall not be treated as a qualified personal service corporation for any part of that taxable year.

(f) *Exception for entities with gross receipts of not more than $5 million*—(1) *In general.* Except in the case of a tax shelter, this section shall not apply to any C corporation or partnership with a C corporation as a partner for any taxable year if, for all prior taxable years beginning after December 31, 1985, such corporation or partnership (or any predecessor thereof) meets the $5,000,000 gross receipts test of paragraph (f)(2) of this section.

(2) *The $5,000,000 gross receipts test*—(i) *In general.* A corporation meets the $5,000,000 gross receipts test of this paragraph (f)(2) for any prior taxable

year if the average annual gross receipts of such corporation for the 3 taxable years (or, if shorter, the taxable years during which such corporation was in existence) ending with such prior taxable year does not exceed $5,000,000. In the case of a C corporation exempt from federal income taxes under section 501(a), or a trust subject to tax under section 511(b) that is treated as a C corporation under paragraph (a)(3) of this section, only gross receipts from the activities of such corporation or trust that constitute unrelated trades or businesses are taken into account in determining whether the $5,000,000 gross receipts test is satisfied. A partnership with a C corporation as a partner meets the $5,000,000 gross receipts test of this paragraph (f)(2) for any prior taxable year if the average annual gross receipts of such partnership for the 3 taxable years (or, if shorter, the taxable years during which such partnership was in existence) ending with such prior year does not exceed $5,000,000. The gross receipts of the corporate partner are not taken into account in determining whether the partnership meets the $5,000,000 gross receipts test.

(ii) *Aggregation of gross receipts.* For purposes of determining whether the $5,000,000 gross receipts test has been satisfied, all persons treated as a single employer under section 52 (a) or (b), or section 414 (m) or (o) (or who would be treated as a single employer under such sections if they had employees) shall be treated as one person. Gross receipts attributable to transactions between persons who are treated as a common employer under this paragraph shall not be taken into account in determining whether the $5,000,000 gross receipts test is satisified.

(iii) *Treatment of short taxable year.* In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts shall be annualized by (A) multiplying the gross receipts for the short period by 12 and (B) dividing the result by the number of months in the short period.

(iv) *Determination of gross receipts*—(A) *In general.* The term ‘‘gross receipts’’ means gross receipts of the taxable year in which such receipts are properly recognized under the taxpayer's accounting method used in that taxable year (determined without regard to this section) for federal income tax purposes. For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments, and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103), dividends, rents, royalties, and annuities, regardless of whether such amounts are derived in the ordinary course of the taxpayer's trade of business. Gross receipts are not reduced by cost of goods sold or by the cost of property sold if such property is described in section 1221 (1), (3), (4) or (5). With respect to sales of capital assets as defined in section 1221, or sales of property described in 1221 (2) (relating to property used in a trade or business), gross receipts shall be reduced by the taxpayer's adjusted basis in such property. Gross receipts do not include the repayment of a loan or similar instrument (*e.g.*, a repayment of the principal amount of a loan held by a commercial lender). Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts shall include the amounts received that are allocable to the payment of such tax.

(3) *Examples.* The following examples illustrate the provisions of paragraph (f) of this section:

Example (1). X, a calendar year C corporation, was formed on January 1, 1986. Assume that in 1986 X has gross receipts of $15 million. For taxable year 1987, this section applies to X because in 1986, the period during which X was in existence, X has average annual gross receipts of more than $5 million.

Example (2). Y, a calendar year C corporation that is not a qualified personal service corporation, has gross receipts of $10 million, $9 million, and $4 million for taxable years 1984, 1985, and 1986, respectively. In taxable year 1986, X has average annual gross receipts for the 3-taxable-year period ending with 1986 of $7.67 million ($10 million + 9 million + 4 million ÷3). Thus, for taxable year 1987, this section applies and Y must change from the cash method for such year.

Example (3). Z, a C corporation which is not a qualified personal service corporation, has a 5% partnership interest in ZAB partnership, a calendar year cash method taxpayer. All other partners of ZAB partnership are individuals. Z corporation has average annual gross receipts of $100,000 for the 3-taxable-year period ending with 1986 (*i.e.,* 1984, 1985 and 1986). The ZAB partnership has average annual gross receipts of $6 million for the same 3-taxable-year period. Since ZAB fails to meet the $5,000,000 gross receipts test for 1986, this section applies to ZAB for its taxable year beginning January 1, 1987. Accordingly, ZAB must change from the cash method for its 1987 taxable year. The gross receipts of Z corporation are not relevant in determining whether ZAB is subject to this section.

Example (4). The facts are the same as in example (3), except that during the 1987 taxable year of ZAB, the Z corporation transfers its partnership interest in ZAB to an individual. Under paragraph (a)(1) of this section, ZAB is treated as a partnership with a C corporation as a partner. Thus, this section requires ZAB to change from the cash method effective for its taxable year 1987. If ZAB later desires to change its method of accounting to the cash method for its taxable year beginning January 1, 1988 (or later), ZAB must comply with all requirements of law, including sections 446(b), 446(e), and 481, to effect the change.

Example (5). X, a C corporation that is not a qualified personal service corporation, was formed on January 1, 1986, in a transaction described in section 351. In the transaction, A, an individual, contributed all of the assets and liabilities of B, a trade or business, to X, in return for the receipt of all the outstanding stock of X. Assume that in 1986 X has gross receipts of $4 million. In 1984 and 1985, the gross receipts of B, the trade or business, were $10 million and $7 million respectively. The gross receipts test is applied for the period during which X and its predecessor trade or business were in existence. X has average annual gross receipts for the 3-taxable-year period ending with 1986 of $7 million ($10 million + $7 million + $4 million÷3). Thus, for taxable year 1987, this section applies and X must change from the cash method for such year.

[T.D. 8143, 52 FR 22766, June 16, 1987, as amended by T.D. 8329, 56 FR 485, Jan. 7, 1991; T.D. 8514, 58 FR 68299, Dec. 27, 1993]

§ 1.448–2T Nonaccrual of certain amounts by service providers (temporary).

(a) *In general.* Except as otherwise provided, this section applies to any person using an accrual method of accounting with respect to amounts to be received from the performance of services by such person. This section applies to such persons regardless of whether such persons changed their method of accounting from the cash method under section 448. For example, this section applies to a taxpayer who used an overall accrual method of accounting in taxable years prior to 1987.

(b) *Nonaccrual-experience method; treatment as method of accounting.* Any person to whom this section applies is not required to accrue any portion of amounts to be received from the performance of services which, on the basis of experience, will not be collected. This nonaccrual of amounts to be received for the performance of services shall be treated as a method of accounting under the Code (the nonaccrual-experience method).

(c) *Method not available if interest charged on amounts due*—(1) *In general.* The nonaccrual-experience method of accounting may not be used with respect to amounts due for which interest is required to be paid, or for which there is any penalty for failure to timely pay any amounts due. For this purpose, interest or penalties for late payment will be deemed to be charged by a taxpayer if such treatment is in accordance with the economic substance of a transaction, regardless of the characterization of the transaction by the parties, or the treatment of the transaction under state or local law. However, the offering of a discount for early payment of an amount due will not be regarded as the charging of interest or penalties for late payment under this section, if (i) the full amount due is otherwise accrued as gross income by the taxpayer at the time the services are provided, and (ii) the discount for early payment is treated as an adjustment to gross income in the year of payment, if payment is received within the time required for allowance of such discount.

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

Example. X uses an accrual method of accounting for amounts to be received from the provision of services. For such amounts, X has two billing methods. Under one method, for amounts that are more than 90 days past due, X charges interest at a market rate until such amounts (together with interest) are paid. Under the other billing method, X charges no interest for amounts past due. X cannot use the nonaccrual-experience method of accounting with respect to any of the amounts billed under the method that charges interest on amounts that are more than 90 days past due. X may, however, use the nonaccrual-experience method with respect to the amounts billed under the method that does not charge interest for amounts past due.

(d) *Method not available for certain receivables.* The nonaccrual-experience method of accounting may be used only with respect to amounts earned by the taxpayer and otherwise recognized in income (an account receivable) through the performance of services by such taxpayer. For example, the nonaccrual-experience method may not be used with respect to amounts owed to the taxpayer by reason of the taxpayer's activities with respect to (1) lending money; (2) selling goods; or (3) acquiring receivables or other rights to receive payment from other persons (including persons related to the taxpayer) regardless of whether those other persons earned such amounts through the provision of services.

(e) *Use of experience to estimate uncollectible amounts*—(1) *In general.* In determining the portion of any amount due which, on the basis of experience, will not be collected, the formula prescribed by paragraph (e)(2) of this section shall be used by the taxpayer with respect to each separate trade or business of the taxpayer. No other method or formula may be used by a taxpayer in determining the uncollectible amounts under this section.

(2) *Six-year moving average*—(i) *General rule.* For any taxable year the uncollectible amount of a receivable is the amount of that receivable which bears the same ratio to the account receivable outstanding at the close of the taxable year as (A) the total bad debts (with respect to accounts receivable) sustained throughout the period consisting of the taxable year and the five preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period, bears to (B) the sum of the accounts receivable earned throughout the entire six (or fewer) taxable year period (i.e., the total amount of sales resulting in accounts receivable) throughout the period. Accounts receivable described in paragraphs (c) and (d) of this section are not taken into account in computing the ratio.

(ii) *Period of less than six years.* A period shorter than six years generally will be appropriate only if there is a change in the type of a substantial portion of the outstanding accounts receivable such that the risk of loss is substantially increased. A decline in the general economic conditions in the area, which substantially increases the risk of loss, is a relevant factor in determining whether a shorter period is appropriate. However, approval to use a shorter period will not be granted unless the taxpayer supplies specific evidence that the loans outstanding at the close of the taxable years for the shorter period requested are not comparable in nature and risk to loans outstanding at the close of the six taxable years. A substantial increase in a taxpayer's bad debt experience, is not, by itself, sufficient to justify the use of a shorter period. If approval is granted to use a shorter period, the experience for the excluded taxable years shall not be used for any subsequent year. A request for approval to exclude the experience of a prior taxable year shall be made in accordance with the applicable procedures for requesting a letter ruling and shall include a statement of the reasons such experience should be excluded. A request will not be considered unless it is sent to the Commissioner at least 30 days before the close of the first taxable year for which such approval is requested.

(iii) *Special rule for new taxpayers.* In the case of any current taxable year which is preceded by less than 5 taxable years, paragraph (e)(2)(i) of this section shall be applied by using the experience of the current year and the actual number of preceding taxable years. However, for this purpose, experience from preceding taxable years of a predecessor trade or business may be used in applying paragraph (e)(2)(i) of this section.

(3) *Mechanics of nonaccrual-experience method.* The nonaccrual-experience method shall be applied with respect to each account receivable of the taxpayer which is eligible for such method. With respect to a particular account receivable, the taxpayer will determine, in the manner prescribed in paragraph (e) of this section, the amount of such account receivable that is not expected to be collected. Such determination shall be made only once with respect to each account receivable, regardless of the term of such receivable. The estimated uncollectible amount shall not be recognized as gross income. Thus, the amount recognized as gross income shall be the amount that would otherwise be recognized as gross income with respect to the account receivable, less the amount which is not expected to be collected. Upon the collection of the account receivable, additional gross income shall be recognized with respect to the collection of any amount not initially expected to be collected. Similarly, no bad debt deduction under section 166 for a wholly or partially worthless account receivable shall be allowed for any amount not previously taken into income under the nonaccrual-experience method.

(4) *Examples.* The following examples illustrate the provisions of paragraph (e) of this section:

Example (1). X is a calendar year service provider that uses an accrual method of accounting with respect to the amounts (accounts receivable) to be received from the provision of services. X does not require the payment of interest or penalties with respect to past due accounts receivable. Assume that under this section, X adopts for taxable year 1987 the nonaccrual-experience method of accounting with respect to its accounts receivable. Further, assume that X's total accounts receivable and bad debt experience for the current and five preceding taxable years is as follows:

Years	Total accounts receivable	Bad debts adjusted for recoveries
1982	$30,000	$5,700
1983	40,000	7,200
1984	50,000	11,000
1985	60,000	10,200
1986	70,000	14,000
1987	80,000	16,800
	330,000	64,900

Thus, the ratio of the bad debts (adjusted for recoveries) for the current and five preceding taxable years to the total accounts receivable over the same period is 19.67% ($64,900/$330,000). Assume that $49,300 of the total $80,000 of accounts receivable earned throughout the taxable year 1987 are outstanding as of the close of such year. Assume further that the $49,300 of the accounts receivable outstanding as of the close of the tax year 1987 consist of 10 separate accounts receivable. The uncollectible amount of each receivable is 19.67%. The amount of these accounts receivable and the uncollectible amount of each is as follows:

	Accounts receivable	Applicable ratio	Uncollectible amount
1.	$5,200	.1967	$1,022.84
2.	7,300	.1967	1,435.91
3.	3,200	.1967	629.44
4.	4,300	.1967	845.81
5.	1,700	.1967	334.39
6.	4,000	.1967	786.80
7.	6,300	.1967	1,239.21
8.	8,000	.1967	1,573.60
9.	3,200	.1967	629.44
10.	6,100	.1967	1,199.87
	49,300		9,697.31

For taxable year 1987, X will not accrue as income $9,697.31 of its accounts receivable of $49,300 outstanding as of the close of the year.

Example (2). The facts are the same as in example (1). In 1988 the entire amount of account receivable number 8 becomes wholly worthless. Since in 1987 X did not accrue as income under the nonaccrual-experience method $1,573.60 of that account receivable, no deduction under section 166 is allowable with respect to that amount of the account receivable; a deduction of $6,426.40 under section 166 is allowable for 1988.

Example (3). The facts are the same as in example (1). In 1988 X collects, in full, account receivable number 5. Accordingly, in 1988 X must recognize additional gross income of $334.39, the amount of the account receivable that was initially considered uncollectible.

(5) *Special rule for estimated tax.* For purposes of section 6654 or 6655 only (relating to the addition to tax for underpayment of estimated tax), a taxpayer's income does not include eligible income attributable to the period

before May 16, 1988. A taxpayer's eligible income is the excess (if any) of—

(i) Income (including the amount of any adjustment required under section 481(a)) computed with a bad debt experience ratio using accounts receivable earned throughout the period ending at the close of the six-year period (or other shorter period) described in paragraph (e)(2)(i) of this section, over

(ii) Income (including the amount of any adjustment required under section 481(a)) computed with a bad debt experience ratio using the year-end balances of accounts receivable over such six-year (or other shorter) period.

(f) [Reserved]

(g) *Coordination of change in accounting method with section 481*—(1) *Taxpayers required to change their method of accounting under section 448.* The provisions of this paragraph (g)(1) apply to taxpayers who under § 1.448–1T(h) change from the cash method as required by section 448 and who also change under paragraph (h) of this section to a method of accounting that includes the nonaccrual-experience method. With respect to such taxpayers, the section 481(a) adjustment resulting from the change in method of accounting to the nonaccrual-experience method shall be combined or netted with the section 481(a) adjustment applicable to the change in method of accounting required under section 448. The resulting amount shall then be taken into account in accordance with the provisions of § 1.448–1T(g) applicable to the change in method of accounting required by section 448.

(2) *Taxpayers not required to change their method of accounting under section 448.* The provisions of this paragraph (g)(2) apply to taxpayers who are not required by section 448 to change their method of accounting (*e.g.*, taxpayers who were using an accrual method of accounting for taxable years preceding 1987) and who change to the nonaccrual-experience method under paragraph (h)(3) of this section. With respect to such taxpayers, the section 481(a) adjustment resulting from the change in method of accounting to the nonaccrual-experience method shall be taken into account ratably over four taxable years. The provisions of this paragraph (g)(2) shall apply to any taxpayer regardless of whether such taxpayer was required to change its method of accounting for bad debts under section 805 of the Tax Reform Act of 1986.

(h) *Changes in method of accounting to nonaccrual-experience method*—(1) *Automatic changes to overall accrual method.* The provisions of this paragraph (h)(1) apply to taxpayers who change from the cash method as required by section 448, and change to an overall accrual method of accounting under the automatic change provisions of § 1.448–1T(h)(2). Taxpayers to whom this paragraph (h)(1) applies may automatically change their method of accounting to the nonaccrual-experience method under this paragraph (h)(1), if they otherwise qualify under this section for the use of such method. Taxpayers changing to the nonaccrual-experience method under this paragraph (h)(1) shall comply with the provisions of § 1.448–1T(h)(2). Moreover, such taxpayers shall type or legibly print the following statement at the top of page 1 of Form 315: ''Automatic Change to Nonaccrual Experience Method—Section 448.'' The consent of the Commissioner to the change in method of accounting is granted to taxpayers changing to the nonaccrual-experience method under this paragraph (h)(1).

(2) *Changes to a method other than overall accrual method.* The provisions of this paragraph (h)(2) apply to taxpayers who change from the cash method as required by section 448 and who also change to a permissible special method of accounting under § 1.448–1T(h)(3). Taxpayers to whom this paragraph (h)(2) applies may change their method of accounting to the nonaccrual-experience method under this paragraph (h)(2). Taxpayers changing to the nonaccrual-experience method under this paragraph (h)(2) shall comply with the provisions of § 1.448–1T(h)(3). Moreover, such taxpayers shall type or legibly print the following statement on the top of page 1 of Form 3115: ''Change to Nonaccrual-Experience Method and Special Method of Accounting-Section 448.'' The consent of the Commissioner to the change in method of accounting is granted to taxpayers changing to the nonaccrual-

experience method under this paragraph (h)(2).

(3) *Taxpayers not required to change their method of accounting under section 448.* The provisions of this paragraph (h)(3) apply to taxpayers who are not required by section 448 to change their method of accounting for the taxable year in which such taxpayers desire to adopt the nonaccrual-experience method (*e.g.*, taxpayers who were using an accrual method of accounting for taxable years preceding 1987). Such taxpayers may automatically change their method of accounting to the nonaccrual-experience method under the provisions of this paragraph (h)(3), for their taxable year beginning in 1987, if they otherwise qualify under the provisions of this section for the use of such method. Taxpayers changing to the nonaccrual-experience method for their taxable year beginning in 1987 shall complete and file a current Form 3115. The Form 3115 shall be filed no later than the due date (including extension) of the taxpayer's federal income tax return for the year of change and shall be attached to that return, Moreover, the taxpayer shall type or legibly print the following statement at the top of page 1 of Form 3115: ''Automatic Change to Nonaccrual Experience Method—Taxpayer not Required to Change Method of Accounting Under Section 448.'' The consent of the Commissioner to the change in method of accounting is granted to taxpayers changing to the nonaccrual-experience method for their taxable year beginning in 1987 under this paragraph (h)(3). With respect to taxpayers described in this paragraph (h)(3) who desire to change to the nonaccrual-experience method for a taxable year beginning after December 31, 1987, such taxpayers shall submit an application for change in accounting method under the administrative procedures applicable to taxpayers at the time of change, including the applicable procedures regarding the time and place of filing the application for change in method. Taxpayers described in the preceding sentence include taxpayers who were required to change their method of accounting under section 448 for an earlier taxable year, but who did not change to the nonaccrual-experience method at that time.

(i) *Effective date.* This section applies to any taxable year beginning after December 31, 1986.

[T.D. 8143, 52 FR 22774, June 16, 1987, as amended by T.D. 8194, 53 FR 12513, Apr. 15, 1988]

TAXABLE YEAR FOR WHICH ITEMS OF GROSS INCOME INCLUDED

§ 1.451–1 General rule for taxable year of inclusion.

(a) *General rule.* Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and paragraph (a) of §1.706–1. If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom.

(b) *Special rule in case of death.* (1) A taxpayer's taxable year ends on the date of his death. See section 443(a)(2) and paragraph (a)(2) of §1.443–1. In computing taxable income for such year, there shall be included only amounts properly includible under the method of accounting used by the taxpayer. However, if the taxpayer used an accrual method of accounting, amounts accrued only by reason of his death shall not be included in computing taxable income for such year. If the taxpayer uses no regular accounting method, only amounts actually or constructively received during such year shall be included. (For rules relating to the inclusion of partnership income in the return of a decedent partner, see subchapter K, chapter 1 of the Code, and the regulations thereunder.)

(2) If the decedent owned an installment obligation the income from which was taxable to him under section 453, no income is required to be reported in the return of the decedent by reason of the transmission at death of such obligation. See section 453(d)(3). For the treatment of installment obligations acquired by the decedent's estate or by any person by bequest, devise, or inheritance from the decedent, see section 691(a)(4) and the regulations thereunder.

(c) *Special rule for employee tips.* Tips reported by an employee to his employer in a written statement furnished to the employer pursuant to section 6053(a) shall be included in gross income of the employee for the taxable year in which the written statement is furnished the employer. For provisions relating to the reporting of tips by an employee to his employer, see section 6053 and §31.6053–1 of this chapter (Employment Tax Regulations).

(d) *Special rule for ratable inclusion of original issue discount.* For ratable inclusion of original issue discount in respect of certain corporate obligations issued after May 27, 1969, see section 1232(a)(3).

(e) *Special rule for inclusion of qualified tax refund effected by allocation.* For rules relating to the inclusion in income of an amount paid by a taxpayer in respect of his liability for a qualified State individual income tax and allocated or reallocated in such a manner as to apply it toward the taxpayer's liability for the Federal income tax, see paragraph (f)(1) of §301.6361–1 of this chapter (Regulations on Procedure and Administration).

(f) *Timing of income from notional principal contracts.* For the timing of income with respect to notional principal contracts, see §1.446–3.

[T.D. 6500, 25 FR 11709, Nov. 26, 1960, as amended by T.D. 7001, 34 FR 997, Jan. 23, 1969; T.D. 7154, 36 FR 24996, Dec. 28, 1971; 43 FR 59357, Dec. 20, 1978; T.D. 8491, 58 FR 53135, Oct. 14, 1993]

§1.451–2 Constructive receipt of income.

(a) *General rule.* Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt. In the case of interest, dividends, or other earnings (whether or not credited) payable in respect of any deposit or account in a bank, building and loan association, savings and loan association, or similar institution, the following are not substantial limitations or restrictions on the taxpayer's control over the receipt of such earnings:

(1) A requirement that the deposit or account, and the earnings thereon, must be withdrawn in multiples of even amounts;

(2) The fact that the taxpayer would, by withdrawing the earnings during the taxable year, receive earnings that are not substantially less in comparison with the earnings for the corresponding period to which the taxpayer would be entitled had he left the account on deposit until a later date (for example, if an amount equal to three months' interest must be forfeited upon withdrawal or redemption before maturity of a one year or less certificate of deposit, time deposit, bonus plan, or other deposit arrangement then the earnings payable on premature withdrawal or redemption would be substantially less when compared with the earnings available at maturity);

(3) A requirement that the earnings may be withdrawn only upon a withdrawal of all or part of the deposit or account. However, the mere fact that such institutions may pay earnings on withdrawals, total or partial, made during the last three business days of any calendar month ending a regular quarterly or semiannual earnings period at the applicable rate calculated to the end of such calendar month shall not constitute constructive receipt of income by any depositor or account holder in any such institution who has not made a withdrawal during such period;

(4) A requirement that a notice of intention to withdraw must be given in advance of the withdrawal. In any case when the rate of earnings payable in respect of such a deposit or account depends on the amount of notice of intention to withdraw that is given, earnings at the maximum rate are constructively received during the taxable year regardless of how long the deposit or account was held during the year or whether, in fact, any notice of intention to withdraw is given during the year. However, if in the taxable year of withdrawal the depositor or account holder receives a lower rate of earnings because he failed to give the required notice of intention to withdraw, he shall be allowed an ordinary loss in such taxable year in an amount equal to the difference between the amount of earnings previously included in gross income and the amount of earnings actually received. See section 165 and the regulations thereunder.

(b) *Examples of constructive receipt.* Amounts payable with respect to interest coupons which have matured and are payable but which have not been cashed are constructively received in the taxable year during which the coupons mature, unless it can be shown that there are no funds available for payment of the interest during such year. Dividends on corporate stock are constructively received when unqualifiedly made subject to the demand of the shareholder. However, if a dividend is declared payable on December 31 and the corporation followed its usual practice of paying the dividends by checks mailed so that the shareholders would not receive them until January of the following year, such dividends are not considered to have been constructively received in December. Generally, the amount of dividends or interest credited on savings bank deposits or to shareholders of organizations such as building and loan associations or cooperative banks is income to the depositors or shareholders for the taxable year when credited. However, if any portion of such dividends or interest is not subject to withdrawal at the time credited, such portion is not constructively received and does not constitute income to the depositor or shareholder until the taxable year in which the portion first may be withdrawn. Accordingly, if, under a bonus or forfeiture plan, a portion of the dividends or interest is accumulated and may not be withdrawn until the maturity of the plan, the crediting of such portion to the account of the shareholder or depositor does not constitute constructive receipt. In this case, such credited portion is income to the depositor or shareholder in the year in which the plan matures. However, in the case of certain deposits made after December 31, 1970, in banks, domestic building and loan associations, and similar financial institutions, the ratable inclusion rules of section 1232(a)(3) apply. See §1.1232–3A. Accrued interest on unwithdrawn insurance policy dividends is gross income to the taxpayer for the first taxable year during which such interest may be withdrawn by him.

[T.D. 6723, 29 FR 5342, Apr. 21, 1964; as amended by T.D. 7154, 36 FR 24997, Dec. 28, 1971; T.D. 7663, 44 FR 76782, Dec. 28, 1979]

§1.451–3 Long-term contracts.

(a) *Introduction and effective date*—(1) *In general.* Income from a long-term contract (as defined in paragraph (b)(1) of this section) may be included in gross income in accordance with one of the two long-term contract methods, namely, the percentage of completion method (as described in paragraph (c) of this section) or the completed contract method (as described in paragraph (d) of this section), or any other method. Whichever method is chosen must, in the opinion of the Commissioner, clearly reflect income. See §1.446–1(a)(2) and (c). In addition, it must be applied consistently to all long-term contracts within the same trade or business except that a taxpayer who has long-term contracts of substantial duration and long-term contracts of less than substantial duration in the same trade or business may report the income from all the contracts of substantial duration on the same long-term contract method and report the income from the contracts of less than substantial duration pursuant to another proper method of accounting. For example, if a manufacturer of heavy machinery has special-order contracts of a type that generally take 15 months to complete and also has contracts of a type that generally take 3 months to complete, the manufacturer may use a long-term contract method for the 15-month contracts and a proper inventory method pursuant to section 471 and the regulations thereunder for the 3-month contracts. Similarly, if a construction contractor has construction contracts of a type that generally take 15 calendar months to complete and other construction contracts that take only 5 months to complete but that are long-term contracts because they are not completed in the taxable years in which they are entered into (pursuant to paragraph (b)(1)(i) of this section), such contractor may either use a long-term contract method for all the contracts of both types or use a long-term contract method for the 15-month contracts and another proper method of accounting for the 5-month contracts. If a taxpayer distinguishes between contracts of substantial duration and other long-term contracts of less than substantial duration, he must adhere to a consistently applied standard for determining substantial duration.

(2) *Reporting requirement.* When a taxpayer reports income under the percentage of completion method or the completed contract method, a statement to that effect shall be attached to his income tax return.

(3) *Allocation among activities required.* The percentage of completion method and the completed contract method apply only to the accounting for income and expenses attributable to long-term contracts. The term ‘‘expenses attributable to long term contracts’’ means all direct labor costs and direct material costs (within the meaning of paragraph (d)(5)(i) or (6)(i) of this section), and all indirect costs except those described in paragraph (d)(5)(iii) or, in the case of extended period long-term contracts, paragraph (d)(6)(iii). Other income and expense items, such as investment income, expenses not attributable to such contracts, and costs incurred with respect to any guarantee, warranty, maintenance, or other service agreement relating to the subject matter of such contracts, shall be acounted for under a proper method of accounting. See section 446(c) and §1.446–1(c).

(4) *Severing and aggregating contracts.* In the case of income attributable to a long-term contract, whether or not a long-term contract method is used, for the purpose of clearly reflecting income it may be necessary in some instances for the Commissioner either to treat one agreement as several contracts or to treat several agreements as one contract. The rules of paragraph (e)(1) of this section shall apply to determine whether an agreement should be so severed or several agreements so aggregated.

(5) *Certain taxpayers not using a long-term contract method.* In the case of a taxpayer using a method of accounting that uses inventories (other than a long-term contract method) for any extended period long-term contract entered into after December 31, 1982, see paragraphs (d)(6)(v) and (g) of this section.

(6) *Use of inventory methods in connection with the long-term contract method.* Effective for taxable years beginning after December 31, 1982, the taxpayer may use an inventory method to determine the costs attributable to a long-term contract accounted for under a long-term contract method only in accordance with paragraph (d)(8) of this section.

(7) *Effective date.* Except as otherwise provided, this section is effective for taxable years ending after December 31, 1982. For taxable years ending before January 1, 1983, see CFR §1.451–3, revised as of 4/1/85.

(8) *Incurred.* For purposes of this section, the term ''incurred'' has the same meaning as in §1.446–1(c)(1)(ii).

(b) *Definitions, and special rules relating to certain contracts*—(1) *Long-term contract*—(i) *In general.* Except as provided in paragraph (b)(1)(ii) of this section, the term ''long-term contract'' means a building, installation, construction or manufacturing contract which is not completed within the taxable year in which it is entered into.

(ii) *Manufacturing contracts.* Notwithstanding paragraph (b)(1)(i) of this section, a manufacturing contract is a ''long-term contract'' only if such contract involves the manufacture of (A) unique items of a type which is not normally carried in the finished goods inventory of the taxpayer, or (B) items which normally require more than 12 calendar months to complete (regardless of the duration of the actual contract). Thus, for example, a contract to manufacture a unit of industrial machinery specifically designed for the needs of a customer and not normally carried in the taxpayer's inventory or a contract to manufacture machinery which will require more than 12 calendar months to complete are long term contracts[.] However, a contract to manufacture 15,000 folding chairs which take 3 days each to manufacture is not a long-term contract even though it takes more than 12 calendar months to manufacture all 15,000 chairs and the contract is not completed within the taxable year it is entered into.

(2) *Completion*—(i) *Final completion and acceptance*—(A) *General rule.* Except as otherwise provided in this paragraph (b)(2), and in paragraph (d) (2), (3), and (4) of this section (relating to disputes), a long-term contract shall not be considered ''completed'' until final completion and acceptance have occurred. Nevertheless, a taxpayer may not delay the completion of a contract for the principal purpose of deferring Federal income tax.

(B) *Completion determined on basis of all facts and circumstances.* Final completion and acceptance of a contract for Federal income tax purposes is determined from an analysis of all the relevant facts and circumstances, including the manner in which the parties to the contract deal with each other and with the subject matter of the contract, the physical condition and state of readiness of the subject matter of the contract, and the nature of any work or costs remaining to be performed or incurred on the contract. In considering the manner in which the parties deal with the subject matter of the contract, any use of the primary subject matter of the contract by the purchaser (except for testing purposes that produce no gross revenue, cost savings, or other substantial benefits for the purchaser) will be considered.

(C) *Examples.* The principles of paragraph (b)(2)(i) of this section are illustrated by the following examples:

Example (1). In 1982, A, a calendar year contractor, contracts with B to construct a building. The initial completion date specified in the contract is October 1984. In November 1984, the building is completed in every respect necessary for the use for which the building is intended. Later in November 1984, B occupies the building and notifies A that certain minor deficiencies should be corrected. A agrees to correct the deficiencies. Under these circumstances, the contract is considered completed for Federal income tax purposes in A's taxable year ending December 31, 1984, without regard to when A corrects the deficiencies. The contract is considered completed because the parties have dealt with each other and with the subject matter of the contract in a manner that indicates that final completion and acceptance have occurred.

Example (2). Assume the same facts as in example 1, except that there are no deficiencies in the building that require correction or repair. In addition, assume that the contract between A and B provides that none of the retainage under the contract may be released to A until A obtains an architect's certificate that the building has been completed according to the specifications of the contract. A obtains this certificate in February, 1985. Under these circumstances, the contract is considered completed for Federal income tax purposes in A's taxable year ending December 31, 1984, without regard to when A obtains the required architect's certificate, and without regard to when the retainage is released to A, because the parties have dealt with each other and with the subject matter of the contract in a manner that indicates that final completion and acceptance have occurred.

Example (3). In 1982, X, a calendar year taxpayer who manufactures industrial machinery, contracts with F to build and install one large item of industrial machinery to be delivered in August 1983 and to be installed and tested by X in F's factory. The contract provides that the machinery will be accepted by F when the tests performed by X demonstrate that the machinery will perform within certain environmental standards required by a government agency, regardless of whether an operating permit has been obtained. Because of technical problems the machinery is not ready for delivery until December 1983. F accepts delivery of the machinery in December 1983 subject to installation and testing to determine if the assembled machinery meets the environmental standards. The machinery is installed and tested during December 1983 through February 1984, and F accepts the machinery in February 1984. An operating permit required to operate the machinery under the environmental standards is issued by the governmental agency in February, 1985. Under these circumstances final completion and acceptance of the machinery for Federal income tax purposes occurs in February, 1984.

Example (4). In 1983, D, a calendar year taxpayer, contracts with E to construct a shopping center and related parking areas. The shopping center is completed in October 1985. In December 1985, the shopping center and three-fourths of the parking area are opened to the general public. At that time, the entire parking area of the shopping center has been graded and three-fourths has been paved, but the final asphalt coating has not been laid due to general weather conditions. Under these circumstances, the contract to construct the shopping center and parking area is considered completed for Federal income tax purposes in December 1985, because the shopping center and a major portion of the parking area were ready to be used and were used at that time.

(ii) *Contracts with more than one subject matter*—(A) *General rule.* In the case of a long-term contract (which, after the application of the rules provided in paragraph (e) of this section, is treated as a single long-term contract for Federal income tax purposes) for one or more units (such as an aircraft or an item of industrial machinery) that represent the primary subject matter of the contract, and for other items (such as training manuals, or spare or replacement parts or components) that do not represent the primary subject matter of the contract, ‘‘final completion and acceptance’’ shall be determined without regard to the contractor's obligation to supply the other items that do not represent the primary subject matter of the contract. If at the end of the taxable year in which the long-term contract is completed there remain any other items that do not represent the primary subject matter of the contract and that have not been finally completed and accepted then the costs that have been incurred prior to the end of such year and that are properly allocable to such other items (determined pursuant to paragraph (d) (5) or (6) (as the case may be) of this section), and a portion of the gross contract price (if any) reasonably allocable to such other items shall be separated from the long-term contract, and such costs and such portion of the gross contract price shall be accounted for under a proper method of accounting. Such proper method of accounting includes a long-term contract method only if a separate contract for such other items would be a long-term contract (as defined in paragraph (b)(1) of this section).

(B) *Example.* The principles of paragraph (b)(2)(ii)(A) of this section may be illustrated by the following example:

Example. In 1982, X contracts with the Y Government to manufacture five aircraft and to manufacture 12 spare and replacement parts for the five aircraft and for certain other aircraft supplied to Y under prior contracts. Assume that under all the facts and circumstances it is determined that the portion of the contract relating to the 12 spare and replacement parts does not have to be severed from the portion of the contract relating to the five aircraft. Assume also that under all the facts and circumstances it is determined that the five aircraft represent the primary subject matter of the contract, and that the spare and replacement parts do not represent the primary subject matter of the contract. In 1984, X tenders the five aircraft and seven of the spare and replacement parts to Y. Y accepts the aircraft and the parts subject to X's delivery of the balance of the spare and replacement parts. For Federal income tax purposes the contract is deemed to have been completed in 1984. Accordingly, X must include in gross income in 1984 the entire contract price, less the portion of the gross contract price reasonably allocable (if any) to the parts not delivered in 1984. X must deduct from gross income in 1984 the entire costs properly allocable to the contract, less the entire costs incurred that are properly allocable to the parts not delivered in 1984. X will account for the income and costs allocable to the parts not delivered in 1984 under a proper method of accounting.

(iii) *Contingent compensation.* In the case of a long-term contract, ''final completion and acceptance'' shall be determined without regard to any term of the contract providing for additional compensation contingent upon the continued successful performance of the subject matter of the contract after the subject matter of the contract has been accepted by the purchaser (such as an incentive fee payable if a satellite remains in operation after it is placed in orbit). Such contingent compensation shall be included in gross income in the appropriate taxable year determined under the taxpayer's method of accounting other than a long-term contract method.

(iv) *Certain supervision of installation.* In the case of a long-term contract, ''final completion and acceptance'' shall be determined without regard to any obligation on the part of the contractor to assist or to supervise installation or assembly of the subject matter of the contract where such installation or assembly is to be performed by the purchaser and, under applicable contract law, the subject matter of the contract may be accepted by the purchaser prior to such installation or assembly. If the preceding sentence applies to a contract, ''final completion and acceptance'' shall be determined without regard to such obligation [.] In addition, the entire gross contract price less the portion of the gross contract price (if any) reasonably allocable to such obligation, shall be included in gross income in the taxable year in which the contract is completed[.] Further, all costs properly allocable to the contract and which have been incurred prior to the end of the taxable year in which such contract is completed shall be deducted in such year[.] Finally, all other costs properly allocable to such contract and the portion of the gross contract price reasonably allocable to the obligation to assist or to supervise installation shall be accounted for under a proper method of accounting other than a long-term contract method.

(v) *Subcontractors.* In the case of a subcontractor who completes work on a long-term contract prior to the completion of the entire contract, ''final completion and acceptance'' of the contract with respect to such subcontractor shall be deemed to have occurred when the subcontractor's work has been completed and has been accepted by the party with whom the subcontractor has contracted.

(vi) *Disputes.* Completion of a long-term contract is determined without regard to whether a dispute exists at the time the taxpayer tenders the subject matter of the contract to the party with whom the taxpayer has contracted. See paragraphs (d)(2), (3) and (4) of this section.

(3) *Extended period long-term contract*—(i) *General Rule.* This paragraph (b)(3) does not apply to contracts accounted for under the percentage of completion method. Except as provided in paragraph (b)(3)(ii) of this section, the term ''extended period long-term contract'' means any long-term contract that the taxpayer estimates (at the time such contract is entered into) will not be completed (as defined in paragraph (b)(2) of this section) within the 2-year period beginning on the first date (hereinafter, ''the contract commencement date'') that the taxpayer incurs any costs (other than costs such as bidding expenses, or expenses incurred in connection with negotiating the contract) allocable to such contract (under the cost allocation rules of paragraph (d)(6) of this section). The preceding sentence shall be applied without regard to when costs allocable

to a contract are recorded under the cost accounting procedures used by the taxpayer. In general, the contract commencement date will be the first date that any of the following activities occur; the taxpayer incurs design or engineering costs allocable to the contract other than design or engineering costs incurred solely for purposes of bidding for the contract; materials or equipment are shipped to the jobsite; or workers whose labor costs is treated as direct labor are sent to the jobsite. If the first date when any cost allocable to a contract are incurred is not determinable, the contract commencement date of a contract shall be the date such contract is entered into, unless the taxpayer establishes to the satisfaction of the district director that another date is a more appropriate contract commencement date. The contract commencement date shall not be earlier than the date the contract is entered into, unless the taxpayer delayed entering into the contract for a principal purpose of avoiding the rules of this section.

(ii) *Certain construction contracts.* The term ''extended period long-term contract'' does not include any construction contract entered into by a taxpayer—

(A) Who estimates (at the time such contract is entered into) that such contract will be completed within the 3-year period beginning on the contract commencement date of such contract, or

(B) Whose average annual gross receipts (determined under paragraph (b)(3)(iii) of the this section) over the 3 taxable years preceding the taxable year the contract is entered into (or, if less, the number of preceding taxable years the taxpayer has been in existence) do not exceed $25 million.

For purposes of this paragraph (b)(3)(ii), the term ''construction contract'' means any contract for the building, construction, or erection of, or the installation of any integral component to, improvements to real property. For purposes of the preceding sentence, construction includes reconstruction and rehabilitation. An improvement to real property includes buildings or other structures intended to be permanently affixed to real property, roadways, dams, or bridges, but does not include such items as vessels or offshore drilling platforms. An integral component to an improvement to real property includes property not produced at the site of the real property but intended to be permanently affixed to an improvement to real property, for example, elevators and central heating and cooling systems. In the case of a contract that provides for the manufacture and the installation of an integral component to an improvement to real property (such as the pollution control equipment for a power plant), only the part of the overall gross contract price and the costs properly allocable to the work of installing the finished component is a construction contract. For example, in the case of a contract both to manufacture and to install an elevator in an office building, only the portion of the gross contract price and only the costs properly allocable to installing the elevator is a construction contract. However, in determining whether the installation portion of a contract is expected to be completed within three years, the time expected to complete both the manufacture and the installation of the contract subject matter must be taken into account. Similarly, in determining whether the manufacturing portion of a contract is expected to be completed within two years, the time expected to complete both the manufacture and the installation of the contract subject matter must be taken into account. Alternatively, the taxpayer may consistently account for the manufacturing portion and the installation portion of all such agreements as separate contracts if there is an appropriate allocation of the gross contract price between the manufacturing portion and the installation portion of the agreement. The preceding sentence applies without regard to paragraph (e)(1) of this section.

(iii) *Determination of gross receipts*—(A) *Aggregation and attribution of gross receipts.* The following rules shall apply in determining the gross receipts of the taxpayer for purposes of paragraph (b)(3)(ii)(B) of this section, that is, for determining if the average annual gross receipts of the taxpayer over the 3 taxable years preceding the taxable year in which a construction contract is entered into (or, if less, the number of preceding taxable years the taxpayer has been in existence) exceed $25 million. Under paragraph (b)(3)(iii)(B) of this section, the average annual gross receipts of all trades or businesses (regardless of the nature of such trades or businesses) under common control with the taxpayer who enters into the construction contract are combined. Under paragraph (b)(3)(iii)(C), a portion of the average annual gross receipts from building, installation or construction contracts (hereinafter ‘‘construction gross receipts’’) of trades or businesses not under common control with the taxpayer who enters into the contract, but which are related to the taxpayer through a chain of attribution (using indirect and constructive ownership), are attributed to the taxpayer who enters into the contract. Except as provided in paragraph (b)(3)(iii)(C)(*4*)(*i*), the rules of paragraph (b)(3)(iii) (B) and (C) are both applied. For purposes of paragraph (b)(3) of this section, ‘‘gross receipts’’ include the gross receipts realized from the active conduct of any trade or business, (*e.g.*,— sales revenue), and shall be the gross receipts of the taxable year in which such receipts are recognized properly under the tax accounting method of the taxpayer. For this purpose ‘‘gross receipts’’ shall not include amounts that, under Federal income tax law, are interest, dividends, rents, royalties, annuities or the amount realized from the sale or exchange of property used in the trade or business or held for the production of income. Gross receipts of a contract includes the gross contract price (whether the contract is a general contract or a subcontract, and whether or not the contract is a long-term contract). If the taxpayer enters into a contract which provides that any direct materials (as described in paragraph (d)(5)(i) of this section) will be supplied by the party for whom the contract is being performed (and thus the cost of which is not represented in the gross contract price), gross receipts do not include the cost of such direct materials unless the contractual arrangement was entered into for a principal purpose of reducing the contractor’s gross receipts.

(B) *Aggregation of all gross receipts of trades or businesses under common control.* If, at any time during the calendar year in which the taxpayer enters into a construction contract, such taxpayer and any other trades or businesses (whether or not incorporated) are under common control, then the average annual gross receipts of each such trade or business (for the 3 taxable years of such trade or business preceding the taxable year of such trade or business in which the construction contract is entered into or, if less, the number of preceding taxable years such trade or business has been in existence) shall be combined with the average annual gross receipts of the taxpayer for taxpayer’s 3 taxable years preceding the taxable year of the taxpayer in which the construction contract is entered into (or, if less, the number of preceding taxable years the taxpayer has been in existence). Gross receipts attributable to transactions between trades or businesses under common control shall be eliminated. For purposes of paragraph (b)(3) of this section, the term ‘‘trades or businesses under common control’’ means any group of trades or businesses that is either—

(*1*) A ‘‘parent-subsidiary group under common control’’ as defined in § 1.52–1(c),

(*2*) A ‘‘brother-sister group under common control’’ as defined in § 1.52–1(d), or

(*3*) A ‘‘combined group under common control’’ as defined in § 1.52–1(e).

(C) *Attribution of construction gross receipts to or from individuals, proprietorships, corporations, partnerships, trusts and estates not under common control—(1) Attribution of construction gross receipts to the contractor from persons owning an interest in the contractor.* For purposes of paragraph (b)(3) of this section, if a 5 percent or greater interest in the person who enters into a construction contract (hereinafter, ‘‘the contractor’’) is owned (at any time during the calendar year in which the construction contract is entered into), directly, or indirectly through the application of this paragraph (b)(3)(iii)(C), by or for any person, the average annual gross receipts of the contractor for the contractor’s 3 taxable years preceding the taxable year of the contractor in which the contract was entered into (or, if less, the number of preceding taxable years the contractor has been in existence) shall include the average annual construction gross receipts of such person (for the 3 taxable years of such person preceding the taxable year of such person in which the contract was entered into or, if less, the number of preceding taxable years in which such person has been in existence) in proportion to the interest of such person in the contractor. If an interest is not owned for the entire calendar year, or if an interest varies during the calendar year, the amount of such interest for such year shall be the weighted average based on the number of days each interest is owned during such calendar year.

(*2*) *Attribution of construction gross receipts to the contractor from persons in which the contractor owns an interest.* For purposes of paragraph (b)(3) of this section, if (at any time during the calendar year in which the contractor enters into a construction contract) a 5 percent or greater interest in any person is owned, directly, or indirectly through the application of this paragraph (b)(3)(iii)(C), by or for the contractor, the average annual gross receipts of the contractor for the contractor's 3 taxable years preceding the taxable year of the contractor in which the contract was entered into (or, if less, the number of preceding taxable years the taxpayer has been in existence) shall include the average annual construction gross receipts of such person (for the 3 taxable years of such person preceding the taxable year of such person in which the contract was entered into or, if less, the number of preceding taxable years such person has been in existence) in proportion to the interest of the contractor in such person. If an interest is not owned for the entire calendar year, or if an interest varies during the calendar year, the amount of such interest for such year shall be the weighted average based on the number of days each interest is owned during such calendar year.

(*3*) *Rules for determining ownership*—(*i*) *In general.* In determining the ownership of an interest in any person for purposes of paragraph (b)(3)(iii)(C) of this section, the indirect and constructive ownership rules of this paragraph (b)(3)(iii)(C)(*3*) shall apply, subject to the operating rules contained in paragraph (b)(3)(iii)(C)(*4*). For purposes of paragraph (b)(3)(iii)(C), an ''interest'' means: in the case of a corporation, stock; in the case of a trust or estate, an actuarial interest; in the case of a partnership, an interest in capital or profits; and in the case of a sole proprietorship, the proprietorship.

(*ii*) *Members of a family.* An individual shall be considered as owning any interest in any person owned, directly or indirectly, by or for—

(*A*) Such individual's spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance, whether final or interlocutory), and

(*B*) Such individual's children, grandchildren, parents and grandparents. A legally adopted child of an individual shall be treated as the child of such individual.

(*iii*) *Attribution from partnerships, estates, trusts and corporations*—(*A*) *From partnerships.* An interest in any person owned, directly or indirectly, by or for a partnership shall be considered as owned by any partner having a 5 percent or greater interest in either the profits or capital of the partnership, in proportion to such partner's interest in profits or capital, whichever is greater.

(*B*) *From estate and trusts.* An interest in any person (hereinafter an ''organization interest'') owned, directly or indirectly, by or for an estate or trust shall be considered as owned by any beneficiary of such estate or trust who has an actuarial interest of 5 percent or greater in such organization interest, to the extent of such actuarial interest, as determined under §11.414(c)–4(b)(3).

An interest in any person owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners) shall be considered as owned by such person.

(*C*) *From corporations.* An interest in any person owned, directly or indirectly, by or for a corporation shall be considered as owned by any shareholder who owns (directly, and indirectly through the application of paragraph (b)(3)(iii)(C) of this section) 5 percent or more in value of such corporation's stock, in proportion to the value of the stock owned by such shareholder to the total value of all the outstanding stock in such corporation.

(*iv*) *Attribution to partnerships, estates, trusts and corporations*—(*A*) *To partnerships.* An interest in any person owned, directly or indirectly, by or for a partner having a 5 percent or greater interest in partnership profits or capital shall be considered as owned by the partnership in proportion to the partner's interest in profits or capital, whichever is greater.

(*B*) *To estates and trusts.* An interest in any person owned, directly or indirectly, by or for a beneficiary having an actuarial interest of 5 percent or greater in the value of property of an estate or trust shall be considered as owned by such estate or trust in proportion to the beneficiary's actuarial interest in the assets of the estate or trust. For purposes of this paragraph (b)(3) (iii)(C)(*3*)(*iv*)(*B*) the actuarial interest of a beneficiary shall be determined under the maximum exercise of discretion by the executor or trustee in favor of such beneficiary.

An interest in any person owned, directly or indirectly, by or for a person who is considered the owner of any portion of a trust under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners) shall be considered as owned by such trust.

(*C*) *To corporations.* An interest in any person owned, directly or indirectly, by or for a shareholder who owns (directly and indirectly through the application of paragraph (b)(3)(iii)(C) of this section) 5 percent or more in value of the stock in a corporation shall be considered as owned by such corporation in proportion to the value of the stock owned by such shareholder to the total value of all the outstanding stock in such corporation.

(*v*) *Options.* If a person has an option to acquire any outstanding interest in any organization, such interest shall be considered as owned by such person. An option to acquire an option, and each one of a series of such options, shall be considered as an option to acquire such an interest.

(4) Operating rules—(i) Common control. Paragraph (b)(3)(iii)(C) of this section shall not apply between two persons both of whom, under paragraph (b)(3)(iii)(B), are members of the group of trades or businesses under common control that includes the contractor. However, in applying paragraph (b)(3)(iii)(C) between two persons where one or both of such persons are not members of the group of trades or businesses under common control that includes the contractor, paragraph (b)(3)(iii)(C) shall be applied without regard to paragraph (b)(3)(iii)(B).

(*ii*) *Reattribution.* Except as provided in paragraph (b)(3)(iii)(C)(*4*)(*iii*) (relating to no double family attribution) or (iv) (relating to no reattribution to certain co-owners), in applying paragraphs (b)(3)(iii)(C)(*3*) (*ii*), (*iii*), (*iv*), or (*v*), an interest constructively owned by a person shall, in applying paragraphs (b)(3)(iii)(C)(*3*), (*ii*), (*iii*), (*iv*) or (*v*), be considered as actually owned by such person, and such interest may be reattributed to another person.

(*iii*) *No double family attribution.* An interest constructively owned by an individual by reason of paragraph (b)(3)(iii)(C)(*3*)(*ii*) shall not be considered as owned by such individual for purposes of again applying such paragraph to make another the constructive owner of such interest.

(iv) No reattribution to certain co-owners. An interest constructively owned by a person by reason of paragraph (b)(3)(iii)(C)(*3*)(*iv*) shall not be considered as owned by such person for purposes of applying paragraph (b)(3)(iii)(C)(*3*)(*iii*) in order to make another person the constructive owner of such interest.

(v) Option rule in lieu of family rule. If an interest may be considered as owned by an individual under paragraphs (b)(3)(iii)(C)(*3*) (*ii*) or (*v*), it shall be considered as owned by such individual under paragraph (b)(3)(iii)(C)(*3*)(*v*).

(vi) Limitation. In applying paragraph (b)(3)(iii)(C)(*3*) to determine the ownership of an interest by any person for any one purpose—

(*A*) A corporation shall not be considered to own its own stock by reason of paragraph (b)(3)(iii)(C)(*3*)(*iv*)(*C*), and

(*B*) If an interest owned by any person may be included in the computation more than one time, such interest shall be included only once, in the manner that will impute to the person concerned the largest total interest.

(D) *Short taxable years.* For any taxpayer required to determine its average annual gross receipts over the three taxable year period of such person preceding the taxable year in which a construction contract is entered into, if such period includes a taxable year of less than 12 full months, the taxpayer shall place the gross receipts of such taxable year on an annual basis by dividing the gross receipts of such taxable year by the number of full calendar months in such taxable year and multiplying the result by 12.

(iv) *Classification of contracts*—(A) *Initial classification by taxpayer.* The taxpayer shall determine whether a contract is an extended period long-term contract at the time such contract is entered into. In estimating the time required to perform any contract, the taxpayer shall anticipate and provide a reasonable allowance for delay, rework, change orders, technology or design problems, and other problems. If the taxpayer determines that a contract is an extended period long-term contract, the cost allocation rules of paragraph (d)(6) of this section shall apply, and such contract shall be treated as an extended period long-term contract even if such contract is actually completed within the 2-year period (3 years in the case of certain construction contracts) beginning on the contract commencement date of such contract. Except as provided in paragraph (b)(3)(iv)(B) of this section, a long-term contract that is not completed within the 2-year period (3 years in the case of certain construction contracts) beginning on the actual contract commencement date of such contract and which the taxpayer did not classify and account for as an extended period long-term contract will not be required to be reclassified (for any taxable year) and accounted for as an extended period long-term contract if, at the time the contract was entered into, the taxpayer reasonably could have expected the contract to be completed within that time. The taxpayer shall maintain contemporaneous written records setting forth the basis for classifying each contract, and such records shall be in sufficient detail to enable the district director readily to determine whether the taxpayer's estimate of the time required to complete a contract was made on a reasonable basis. A contract term specifying an expected completion or delivery date may be considered evidence that the parties expected completion or delivery to occur on or about the date specified, especially if there are actual bona fide penalties for not meeting the specified date. The taxpayer's estimate will not be considered unreasonable if a contract was not completed within the expected time primarily because of unforeseeable factors not within the control of the taxpayer. For purposes of the preceding sentence, ‘‘unforeseeable factors’’ are abnormal factors, such as prolonged third-party litigation, abnormal weather (considering the season and the jobsite), prolonged strikes, and prolonged delays in securing required permits or licenses, that could not reasonably be anticipated considering the nature of the contract and prior experience.

(B) *Exception for unreasonable classification, amended returns.* If under all the facts and circumstances it is determined that a contract which the taxpayer did not classify and account for as an extended period long-term contract reasonably should have been so classified and accounted for, the taxpayer shall reclassify and account for such contract as an extended period long-term contract for the current taxable year and all subsequent taxable years. In addition, the taxpayer should file an amended return for each prior taxable year (assuming that the period for assessment has not run for such year) in which costs were incurred with respect to such contract, and such amended returns should reflect an allocation to the contract of costs incurred in such prior years using the cost allocation rules provided in paragraph (d)(6) of this section. If a contract is not an extended period long-term contract by reason of the $25 million gross receipts test of paragraph (b)(3)(ii)(B) of this section, such contract shall not be reclassified regardless of the taxpayer's gross receipts for any subsequent year and regardless of the time required to complete such contract.

(v) *Special rule for contract commencement date in case of components or subassemblies produced by the taxpayer.* If the cost of components or subassemblies produced by the taxpayer represents a significant amount of the total costs allocable to a contract, the contract commencement date of such contract shall be the first date the taxpayer incurs any costs allocable either to (1) such type or category of components or subassemblies, or (2) any other subject matter of the contract. The contract commencement date shall not be earlier than the date the contract is entered into, unless the taxpayer delayed entering into the contract for a principal purpose of avoiding the rules for this section. For example, assume an airplane manufacturer who also manufactures a type of engine that represents a significant amount of the total costs of the airplanes produced enters into one or more contracts to manufacture airplanes containing such type of engine. For purposes of determining the contract commencement date with respect to each contract, the first date the manufacturer incurs any cost allocable to any of the engines is the first date that the taxpayer incurs any cost allocable to such type of engine, even if the manufacturer has not yet produced enough engines to satisfy all contracts.

See § 1.451–3(d)(6)(iv) for the cost allocation rules required in the case of certain components or subassemblies.

(c) *Percentage of completion method.* (1) Under the percentage of completion method, the portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year must be included in gross income for such taxable year.

(2) The determination of the percentage of completion of a contract generally may be made on either of the following methods:

(i) By comparing, as of the end of the taxable year, the costs incurred with respect to the contract with the estimated total contract costs, or

(ii) By comparing, as of the end of the taxable year, the work performed on the contract with the estimated total work to be performed.

In determining the percentage of completion pursuant to subdivision (i) of this subparagraph with respect to a long-term contract, a taxpayer may use any method of cost comparisons (such as comparisons of total direct and indirect costs incurred to date to estimated total direct and indirect costs, of total direct costs incurred to date to estimated total direct costs, or of direct labor costs incurred to date to estimated total direct labor costs) so long as such method is used consistently with respect to such contract and such method clearly reflects income. In determining the percentage of completion pursuant to subdivision (ii) of this subparagraph, the criteria used to compare the work performed on a contract as of the end of the taxable year with the estimated total work to be performed must clearly reflect the earning of income with respect to the contract. Thus, for example, in the case of a roadbuilder, a standard of completion based solely upon miles of roadway completed in a case where the terrain is substantially different with respect to roadway completed during one taxable year as compared with roadway completed during another taxable year may not clearly reflect the earning of income with respect to the contract. If the method described in subdivision (i) of this subparagraph is used and the taxpayer revises the estimated total costs as of the end of a taxable year, certificates of architects or engineers or other appropriate documentation showing the basis for such revision must be available at the principal place of business of the taxpayer for inspection in connection with an examination of the income tax return. If the method described in subdivision (ii) of this subparagraph is used, certificates of architects or engineers or other appropriate documentation showing the percentage of completion of each contract during the taxable year must be available at the principal place of business of the taxpayer for inspection in connection with an examination of the income tax return.

(3) Under the percentage of completion method, all costs incurred during the taxable year with respect to a long-term contract (account being taken of the material and supplies on hand at the beginning and the end of the taxable year for use in the contract) must be deducted. ‘‘Costs incurred during the taxable year with respect to a long-term contract’’ do not include costs incurred with respect to any guarantee, warranty, maintenance, or other service agreement relating to the subject matter of the long-term contract. See paragraph (a)(3) of this section.

(d) *Completed contract method*—(1) *In general.* Except as otherwise provided in paragraphs (d) (2), (3) or (4) (relating to disputes) of this section, under the completed contract method, gross income derived from long-term contracts must be reported by including the gross contract price of each contract in gross income for the taxable year in which such contract is completed (as defined in paragraph (b)(2) of this section). All costs properly allocable to a long-term contract (determined pursuant to paragraph (d) (5) or (6) of this section) must be deducted from gross income for the taxable year in which the contract is completed. In addition, account must be taken of any material and supplies charged to the contract but remaining on hand at the time of completion.

(2) *Contracts with disputes from buyer claims.* (i) This subparagraph applies in any case where, on or after a taxpayer tenders the subject matter of a long-term contract to the party with whom he is contracting, there exists an amount reasonably in dispute because such party wishes to have the original contract price reduced or to have additional work performed on the contract. Any item of income or deduction with respect to an amount reasonably in dispute shall be taken into account in the taxable year in which such dispute is resolved. In addition, any item of income or deduction which is properly allocable to such contract and which is not included in or deducted from gross income in a prior taxable year pursuant to subdivisions (ii), (iii), (iv), or (v) of this subparagraph and which is not taken into account under the preceding sentence shall be included in or deducted from gross income in the taxable year in which the final dispute is resolved.

(ii) If the amount reasonably in dispute affects so much of the contract price that it is not possible to determine whether a profit (an excess of the gross contract price over the costs properly allocable to such contract) or loss (an excess of the costs properly allocable to the long-term contract over the gross contract price) will ultimately be realized on such contract, then no item of income or deduction which is properly allocable to such contract shall be included in or deducted from gross income in the taxable year in which such contract is completed (without regard to such dispute).

(iii) In all other cases, the entire amount of the gross contract price reduced (but not below zero) by an amount equal to the amount reasonably in dispute shall be included in gross income in the taxable year in which such contract is completed (without regard to the dispute).

(iv) If the taxpayer is assured of a profit on such contract regardless of the outcome of the dispute, then all costs which are properly allocable to such contract and which have been incurred prior to the end of the taxable year in which such contract is completed (without regard to the dispute) shall be deducted in such year.

(v) If the taxpayer is assured of a loss on such contract regardless of the outcome of the dispute, then there shall be deducted in the taxable year in which such contract is completed (without regard to the dispute) the total amount of costs properly allocable to such contract which are incurred prior to the end of such year reduced by the amount by which the gross contract price was reduced pursuant to subdivision (iii) of this subparagraph. All other costs which are properly allocable to such contract shall be deducted in the taxable year in which incurred.

(vi) For purposes of this paragraph, where there is additional work to be performed with respect to a contract in dispute, the term ‘‘taxable year in which the dispute is resolved’’ means the taxable year in which such work is completed rather than the taxable year in which the outcome of the dispute is determined by agreement, decision, or otherwise.

(vii) The application of this subparagraph may be illustrated by the following examples:

Example (1). X, a calendar year taxpayer utilizing the completed contract method of accounting, constructs a building for Y pursuant to a long-term contract. According to the terms of the contract, the gross contract price is $2,000,000. X finishes construction of the building in 1972 at a cost of $1,900,000. Y examines the building and is dissatisfied with the construction. He demands either alterations or a reduction in the gross contract. The amount reasonably in dispute is $500,000. This dispute affects so much of the contract price that X is unable to determine whether a profit or a loss will ultimately be realized on such contract. Accordingly, pursuant to this subparagraph, X does not include any portion of the gross contract price in gross income and does not deduct any costs which are properly allocable to the contract until the taxable year in which the dispute is resolved.

Example (2). A, a calendar year taxpayer utilizing the completed contract method of accounting, constructs a bridge for B pursuant to a long-term contract. The terms of the contract provide for a $10,000,000 gross contract price. A finishes construction of the bridge in 1972 at a cost of $9,500,000. When B examines the bridge, he insists that either certain girders be repainted or that the contract price be reduced. The amount reasonably in dispute is $100,000. Since under the terms of the contract, A would be assured of a profit of at least $400,000 ($10,000,000—[$9,500,000+$100,000]) even if the dispute were resolved unfavorable to A, $9,900,000 ($10,000,000 − $100,000 in dispute) of the gross contract price must be included in A's gross income in 1972 and $9,500,000 of costs must be deducted from A's gross income in 1972 pursuant to this subparagraph. In 1973 A and B resolve the dispute, A repaints certain girders at a cost to A of $60,000, and A and B agree that the contract price is not to be reduced. In 1973 A must include $100,000 ($10,000,000 − $9,000,000) in gross income and must deduct $60,000 from gross income.

Example (3). M, a calendar year taxpayer utilizing the completed contract method of accounting, constructs a plant for N pursuant to a long-term contract. Under the terms of the contract M is entitled to receive $1,000,000 upon completion of the plant. M finishes construction of the plant in 1973 at a cost of $1,200,000. N examines the plant and determines that an elevator operates unsatisfactorily and insists that M either replace the elevator or that the contract price be reduced. The amount reasonably in dispute is $100,000. Under the terms of the contract M would be assured of a loss of at least $200,000 ($1,200,000 − $1,000,000) even if the dispute were resolved in favor of M. Pursuant to this subparagraph M must include $900,000 ($1,000,000 − $100,000) in gross income for 1973 and must deduct $1,100,000 ($1,200,000 − $100,000) from gross income in 1973. In 1974 the dispute is resolved, and M replaces certain components of the elevator at a cost of $50,000. M must include $100,000 ($1,000,000 − $900,000) in gross income for 1974, and must deduct $150,000 ($100,000 of previously undeducted costs plus $50,000 of additional costs) from gross income in 1974.

Example (4). Assume the same facts as in Example (3) except that N is insisting that the contract price be reduced because an elevator has insufficient capacity and that in 1974 the dispute is resolved by a reduction in the gross contract price of $40,000 (from $1,000,000 to $960,000). By the end of 1973, M is assured of a loss of at least $200,000 ($1,200,000 − $1,000,000) under the terms of the contract even if the dispute were resolved in favor of M. Pursuant to this subparagraph, M must include in gross income for 1973 $900,000 ($1,000,000 − $100,000) and must deduct from gross income in such year $1,100,000 ($1,200,000 − $100,000). In 1974, when the dispute is resolved, M must include $60,000 ($960,000 − $900,000) in gross income and must deduct $100,000 ($1,200,000 − $1,100,000) from gross income.

Example (5). Assume the same facts as in Example (3) except that N is also insisting that the contract price be reduced by an additional amount because an underground storage facility has insufficient capacity. M determines that the total amount reasonably in dispute is $160,000, $100,000 attributable to the elevator plus $60,000 attributable to the underground storage facility. Under the terms of the contract, M would be assured of a loss of at least $200,000 ($1,200,000 − $1,000,000) even if both disputes were resolved in favor of M. Pursuant to this subparagraph, M must include $840,000 ($1,000,000 − $160,000) in gross income for 1973 and must deduct $1,040,000 (1,200,000 − $160,000) from gross income in 1973. In 1974 the dispute relating to the elevator is resolved, and M replaces certain components of the elevator at a cost of $50,000. M must include $100,000 (the amount of the gross contract price not included in gross income in 1973 by reason of the elevator dispute) in gross income for 1974 and must deduct $150,000 ($100,000 of previously undeducted costs plus $50,000 of additional costs) from gross income in 1974. In 1975, the dispute relating to the underground storage facility is resolved by a reduction in the gross contract price of $20,000 (from $1,000,000 to $980,000). In 1975 M must include $40,000 ($60,000 − $20,000) in gross income and must deduct $60,000 (his previously undeducted costs) from gross income.

(3) *Contracts with disputes from taxpayer claims.* (i) This subparagraph applies in any case where, on or after a taxpayer tenders the subject matter of a long-term contract to the party with whom he is contracting, a dispute exists because the taxpayer is requesting that the amount to be paid to him under such contract be increased.

(ii) Except as provided in subparagraph (2) of this paragraph, in all cases described in subdivision (i) of this subparagraph, the entire amount of the gross contract price shall be included in gross income in the taxable year the contract is completed (without regard to the dispute), and all costs which are properly allocable to such contract and which have been incurred prior to the end of the taxable year in which such contract is completed (without regard to the dispute) shall be deducted in such year.

(iii) Any item of income which is properly allocable to such contract and which is not included in gross income in a prior taxable year pursuant to subdivision (ii) of this subparagraph shall be included in gross income in the taxable year in which any such dispute (or part thereof) is resolved. Any item of deduction which is properly allocable to such contract and which is incurred in a taxable year subsequent to the year such contract is completed (without regard to the dispute) shall be deducted from gross income in the taxable year in which such item of deduction is incurred.

(iv) For purposes of this paragraph, the term ‘‘gross contract price’’ means the original stated price of the contract with any modifications to which the parties have agreed as of the end of the taxable year. Thus, for example, such term includes any amount which the taxpayer is claiming by virtue of changes in the specifications of the contract which the other parties to the contract have agreed is proper, but it does not include any amount which the contractor is claiming which is disputed by the other parties to the contract. However, no amount is excluded from the term, ‘‘gross contract price’’ solely because a party refuses to pay such amount when due. Thus, for example, if the parties to a contract agree that the gross contract price is $100,000, but a party refuses to pay $60,000 of such amount when due, such refusal does not prevent the gross contract price from being $100,000.

(v) The application of this subparagraph may be illustrated by the following examples:

Example (1). S, a calendar year taxpayer utilizing the completed contract method of accounting, constructs a building for T pursuant to a long-term contract. Under the terms of the contract, S is entitled to receive $100,000 upon completion of the building. S finishes construction of the building in 1974 at a cost of $105,000. T examines the building in 1974 and agrees that it meets his specifications; however, as of the end of 1974, S and T are unable to agree as to the merits of S’s claim for an additional $10,000 for certain items which S alleges are changes in contract specifications and T alleges are within the scope of the contract’s original specifications. Under these circumstances, S must include in income in 1974 the gross contract price of $100,000 and must deduct from gross income in such year the $105,000 of costs. In 1975 the dispute is resolved by a payment to S of $2,000 with respect to his claim. S must include this $2,000 in gross income in 1975.

Example (2). Assume the same facts as in Example (1) except that S’s claim for an additional $10,000 relates to two items which S alleges are changes in contract specifications, namely $7,000 for changes in the heating system and $3,000 for changes in the electrical system. In 1975 the dispute with respect to the electrical system is resolved by a payment to S of $750, and in 1976 the dispute with respect to the heating system is resolved by a payment to S of $1,250 and by S’s performance of additional work at a cost of $250. S must include the $750 in gross income for 1975 and the $1,250 in gross income for 1976, and S must deduct the $250 from gross income in 1976.

(4) *Contracts with disputes from both buyer and taxpayer claims.* (i) This subparagraph applies in any case where, on or after a taxpayer tenders the subject matter of a long-term contract, a dispute exists involving both claims by the taxpayer for an increase in the contract price and claims by the other party to the contract either for a reduction in the contract price or for the performance of additional work under the contract. In any case described in the preceding sentence, principles similar to the principles of subparagraphs (2) and (3) of this paragraph shall be applied.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). W, a calendar year taxpayer utilizing the completed contract method of accounting, constructs a factory for Z pursuant to a long-term contract. Under the terms of the contract, Z agrees to pay W a total of $100,000 for construction of the factory. W finishes construction of the factory in December 1974 at a cost of $110,000. When Z examines the factory in December 1974, Z is dissatisfied with the location and workmanship of certain heating ducts. As of the end of 1974, W contends that the heating ducts as constructed are in accordance with contract specifications. The amount reasonably in dispute with respect to the heating ducts is $6,000. As of this time, W is claiming $14,000 in addition to the original contract price for certain changes in contract specifications which W alleges have increased his costs. Z denies that such changes have increased W's costs. In 1975 the disputes between W and Z are resolved by performance of additional work by W at a cost of $1,000 and by an agreement that the contract price would be revised downward to $96,000. Under these circumstances, W must include in his gross income for 1974, $94,000 (the gross contract price less the amount reasonably in dispute because of Z's claim, or $100,000−$6,000). In 1974, W must also deduct $104,000 (his costs incurred of $110,000 less $6,000, an amount equal to the amount in dispute). In 1975, W must include in gross income an additional $2,000 ($96,000−$94,000) and must deduct $7,000 (the $1,000 of costs W incurs in such year plus the $6,000 of previously undeducted costs).

Example (2). R, a calendar year taxpayer utilizing the completed contract method of accounting, agrees to construct an office building for X for a total contract price of $10,000,000. R begins construction in 1973 and tenders the building to X in November 1975. As of November 1975, R has incurred $15,000,000 of costs which are allocable to the contract. When X examines the building, X is dissatisfied with certain aspects of the construction and demands that a substantial amount of additional work be done. The amount reasonably in dispute with respect to X's demand is $4,000,000. R is claiming an additional $2,000,000 for certain changes in contract specifications which have allegedly increased his costs. As of the end of 1975, neither dispute has been resolved. In 1976, the dispute relating to X's claim is resolved by R's performance of additional work at a cost of $3,500,000 and X's agreement to pay R an additional $400,000. In 1977, the dispute relating to R's claim is resolved by X's agreement to increase the contract price by $1,800,000. Under these circumstances R must include in his gross income for 1975 $6,000,000 ($10,000,000− $4,000,000) and must deduct from gross income $11,000,000 ($15,000,000−$4,000,000). In 1976, when the dispute relating to X's claim is resolved, R must include in gross income $4,400,000 (the $4,000,000 of the gross contract price which was excluded from gross income in 1975 by reason of X's claim plus the $400,000 by which the contract price was increased) and must deduct $7,500,000 (the previously undeducted costs of $4,000,000 plus the costs of the work performed to resolve the dispute of $3,500,000). In 1977, when the dispute relating to R's claim is resolved, R must include in gross income the $1,800,000 by which the contract price was increased in settlement of R's claim.

(5) *General rule for allocation of costs to long-term contracts.* The following rules shall apply in determining what costs are properly allocable to a long-term contract (other than an extended period long-term contract to which the rules of paragraph (d)(6) of this section apply) in the case of a taxpayer using the completed contract method of accounting for tax purposes:

(i) *Direct costs.* Direct material costs and direct labor costs must be treated as costs properly allocable to a long-term contract ''Direct material costs'' include the costs of those materials which become an integral part of the subject matter of the long-term contract and those materials which are consumed in the ordinary course of building, constructing, installing, or manufacturing the subject matter of a long-term contract. See §1.471–3(b) for the elements of direct material costs. ''Direct labor costs'' include the cost of labor which can be identified or associated with a particular long-term contract. The elements of direct labor costs include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor.

(ii) *Indirect costs allocated to long-term contracts.* The term ''indirect costs'' includes all costs (other than direct material costs and direct labor costs) which are incident to and necessary for the performance of particular long-term contracts. Indirect costs which must be allocated to long-term contracts include:

(A) Repair expenses of equipment or facilities used in the performance of particular long-term contracts,

(B) Maintenance of equipment or facilities used in the performance of particular long-term contracts,

(C) Utilities, such as heat, light, and power, relating to equipment or facilities used in the performance of particular long-term contracts,

(D) Rent of equipment or facilities used in the performance of particular long-term contracts,

(E) Indirect labor and contract supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay, (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential payroll taxes and contributions to a supplemental unemployment benefit plan incurred in the performance of particular long-term contracts.

(F) Indirect materials and supplies used in the performance of particular long-term contract,

(G) Tools and equipment not capitalized used in the performance of particular long-term contracts,

(H) Costs of quality control and inspection incurred in the performance of particular long-term contracts,

(I) Taxes otherwise allowable as a deduction under section 164 (other than State and local, and foreign income taxes) to the extent such taxes are attributable to labor, materials, supplies, equipment or facilities used in the performance of particular long-term contracts,

(J) Depreciation, amortization and cost recovery allowances reported for the taxable year for financial purposes on equipment and facilities used in the performance of particular long-term contracts (but not in excess of the depreciation, amortization or cost recovery allowance allowable for the taxable year under Chapter I of the Code with respect to any item of equipment or facility).

(K) Cost depletion incurred in the performance of particular long-term contracts,

(L) Administrative costs incurred in the performance of particular long-term contracts (but not including any costs of selling or any return on capital),

(M) Compensation paid to officers attributable to services performed on particular long-term contracts (other than incidental or occasional services). and

(N) Cost of insurance incurred in the performance of particular long-term contracts, such as insurance on machinery and equipment used in the construction of the subject matter of a long-term contract.

(iii) *Costs not allocated to long-term contracts.* Costs which are not required to be included in costs attributable to a long-term contract include:

(A) Marketing and selling expenses, including bidding expenses,

(B) Advertising expenses,

(C) Other distribution expenses,

(D) Interest,

(E) General and administrative expenses attributable to the performance of services which benefit the long-term contractor’s activities as a whole (such as payroll expenses, legal and accounting expenses, etc.),

(F) Research and experimental expenses (described in section 174 and the regulations thereunder),

(G) Losses under section 165 and the regulations thereunder,

(H) Percentage of depletion in excess of cost depletion,

(I) Depreciation, amortization and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle (for this purpose, an asset is not considered to be temporarily idle on non-working days, and an asset used in construction is considered to be idle when it is not enroute to or not located at a job-site), and depreciation, amortization and cost recovery allowances under Chapter I of the Code in excess of depreciation, amortization and cost recovery allowances reported by the taxpayer in the taxpayer’s financial reports,

(J) Income taxes attributable to income received from long-term contracts,

(K) Contributions paid to or under a stock bonus, pension, profit-sharing or annuity plan or other plan deferring the receipt of compensation whether or not the plan qualifies under section 401(a), and other employee benefit expenses paid or accrued on behalf of labor, to the extent such contributions or expenses are otherwise allowable as deductions under chapter 1 of the Code. ''Other employee benefit expenses'' include (but are not limited to): worker's compensation; amounts deductible or for whose payment reduction in earnings and profits is allowed under section 404A and the regulations thereunder; payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983; amounts includible in the gross income of employees under a method or arrangement of employer contributions or compensation which has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or other plan deferring the receipt of compensation or providing deferred benefits; premiums on life and health insurance; and miscellaneous benefits provided for employees such as safety, medical treatment, recreational and eating facilities, membership dues, etc.

(L) Cost attributable to strikes, rework labor, scrap and spoilage, and

(M) Compensation paid to officers attributable to the performance of services which benefit the long-term contractor's activities as a whole.

(6) *Allocation of costs to extended period long-term contracts.* Except as provided in paragraph (g) of this section, this paragraph (d)(6) applies to taxable years beginning after December 31, 1982. The following rules shall apply in determining what costs are properly allocable to an extended period long-term contract (as defined in paragraph (b)(3) of this section) in the case of a taxpayer using the completed contract method of accounting for long-term contracts for tax purposes. These rules may also apply to certain extended period long-term contracts accounted for under a method of accounting that uses inventories (other than a long-term contract method). See paragraph (d)(6)(v) of this section.

(i) *Direct costs.* Direct material costs and direct labor costs must be treated as costs properly allocable to an extended period long-term contract. ''Direct material costs'' include the costs of those materials which become an integral part of the subject matter of the extended period long-term contract and those materials which are consumed in the ordinary course of building, constructing, installing or manufacturing the subject matter of an extended period long-term contract. See § 1.471–3(b) for the elements of direct material costs. ''Direct labor costs'' include the cost of labor which can be identified or associated with a particular extended period long-term contract. The elements of direct labor costs include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor.

(ii) *Indirect costs allocated to extended period long-term contracts.* The term ''indirect costs'' include all costs other than direct material costs and direct labor costs. In determining what indirect costs are properly allocable to an extended period long-term contract, all such costs that directly benefit the performance of extended period long-term contracts, or are incurred by reason of the performance of extended period long-term contracts must be allocated to extended period long-term contracts unless otherwise provided in paragraph (d)(6)(iii) of this section. Certain types of costs may directly benefit, or be incurred by reason of the performance of extended period long-term contracts of the taxpayer even though the same type of costs also benefits other activities of the taxpayer. Accordingly, such costs require a reasonable allocation between the portion of such costs that are attributable to extended period long-term contracts and the portion attributable to the other activities of the taxpayer. Indirect costs that must be allocated to extended period long-term contracts include:

(A) Repair expenses of equipment or facilities used in the performance of particular extended period long-term contracts,

(B) Maintenance of equipment or facilities used in the performance of particular extended period long-term contracts,

(C) Utilities, such as heat, light, and power, relating to equipment or facilities used in the performance of particular extended period long-term contracts,

(D) Rent of equipment or facilities used in the performance of particular extended period long-term contracts,

(E) Indirect labor and contract supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes and contributions to a supplemental unemployment benefit plan incurred in the performance of particular extended period long-term contracts,

(F) Indirect materials and supplies used in the performance of particular extended period long-term contracts,

(G) Tools and equipment not capitalized used in the performance of particular extended period long-term contracts,

(H) Costs of quality control and inspection incurred in the performance of particular extended period long-term contracts,

(I) Taxes otherwise allowable as a deduction under section 164 (other than State and local[,] and foreign income taxes) to the extent such taxes are attributable to labor, materials, supplies, equipment or facilities used in the performance of particular extended period long-term contracts,

(J) Depreciation, amortization and cost recovery allowances on equipment and facilities (to the extent allowable as deductions under Chapter I of the Code) used in the performance of particular extended period long-term contracts,

(K) Depletion (whether or not in excess of cost) incurred in the performance of particular extended period long-term contracts,

(L) Administrative costs (whether or not performed on a job-site) directly attributable to the performance of particular extended period long-term contracts (but not including any cost of selling, or any return on capital),

(M) Direct and indirect costs incurred by any administrative, service, or support function or department to the extent such costs are allocable to particular extended period long-term contracts pursuant to paragraph (d)(9) of this section.

(N) Compensation paid to officers attributable to services performed on particular extended period long-term contracts (but not including any cost of selling),

(O) Costs of insurance incurred in the performance of particular extended period long-term contracts, such as insurance on machinery and equipment used in the construction of the subject matter of an extended period long-term contract.

(P) Contributions paid to or under a stock bonus, pension, profit-sharing or annuity plan or other plan deferring the receipt of compensation whether or not the plan qualifies under section 401(a) (except for amounts described in paragraph (d)(6)(iii)(I) of this section), and other employees benefit expenses paid or accrued on behalf of labor, to the extent such contributions or expenses are otherwise allowable as deductions under chapter 1 of the Code. ‘‘Other employee benefit expenses’’ include (but are not limited to): worker’s compensation; amounts deductible or for whose payment reduction in earnings of profits is allowed under section 404A and the regulations thereunder; payments pursuant to a wage contribution plan under section 105(d) as it existed prior to its repeal in 1983; amounts includible in the gross income of employees under a method or arrangement of employer contributions or compensation which has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or other plan deferring the receipt of compensation or providing deferred benefits; premiums on life and health insurance; and miscellaneous benefits provided for employees such as safety, medical treatment, recreational and eating facilities, membership dues, etc.,

(Q) Research and experimental expenses (described in section 174 and the regulations thereunder) directly attributable to particular extended period long-term contracts in existence at the time such expenses are incurred, or incurred under an agreement to perform research or experimentation,

(R) Rework labor, scrap and spoilage to the extent incurred in the performance of particular extended period long-term contracts, and

(S) Bidding expenses incurred in the solicitation of particular extended period long-term contracts ultimately awarded to the taxpayer. For purposes of this section, the term ''bidding expenses'' does not include any research and experimental expenses described in section 174 and the regulations thereunder. The taxpayer shall defer all bidding expenses paid or incurred in the solicitation of a particular extended period long-term contract until the contract is awarded. If the contract is awarded to the taxpayer, the bidding costs become part of the indirect costs assigned to the contract. If the contract is not awarded to the taxpayer, bidding costs become deductible in the taxable year the contract is awarded, or the taxable year the taxpayer is notified in writing that no contract will be awarded and that the contract (or similar or related contract) will not be re-bid, or in the taxable year that the taxpayer abandons its bid or proposal, whichever occurs first. Abandoning a bid does not include modifying, supplementing, or changing the original bid or proposal. If the taxpayer is awarded only part of the bid (for example, the taxpayer submitted one bid to build each of two different types of bridges and the taxpayer was awarded a contract to build only one of the two bridges), the taxpayer shall deduct the portion of the bidding expenses related to the portion of the bid not awarded to the taxpayer; in the case of a bid or proposal for a multi-unit contract, however, all the bidding expenses shall be allocated to a contract awarded to the taxpayer to produce any or such units (for example, where the taxpayer submitted one bid to produce three similar turbines and the taxpayer was awarded a contract to produce only two of the three turbines).

(iii) *Costs not allocated to extended period long-term contracts.* Costs which are not required to be included in costs attributable to an extended period long-term contract include:

(A) Marketing, selling and advertising expenses;

(B) Bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer (see paragraph (d)(6)(ii)(S) of this section),

(C) Interest,

(D) General and administrative expenses (but not including any cost described in paragraph (d)(6)(ii) (L) or (M) of this section) and compensation paid to officers attributable to the performance of services that do not directly benefit or are not incurred by reason of any extended period long-term contracts,

(E) Research and experimental expenses (described in section 174 and the regulations thereunder) neither directly attributable to particular extended period long-term contracts in existence at the time such expenses are incurred nor incurred under any agreement to perform research or experimentation,

(F) Losses under section 165 and the regulations thereunder,

(G) Depreciation, amortization and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle (for this purpose, an asset is not considered to be temporarily idle on non-working days, and an asset used in construction is considered to be idle when it is not en route to or not located at a job-site),

(H) Income taxes attributable to income received from extended period long-term contracts,

(I) Contributions paid to or under a pension or annuity plan allowable as a deduction under section 404 (and section 404A if applicable) to the extent such contributions represent past service costs, and

(J) Costs attributable to strikes.

(iv) *Special rule for component parts or subassemblies produced by the taxpayer.* In the case of any type of component or subassembly produced by the taxpayer, the taxpayer shall use the cost allocation rules prescribed in paragraph (d) (6) and (8) of this section to determine the unit cost of the components or subassemblies that reasonably can be expected to be incorporated into the subject matter of extended period long-term contracts of the taxpayer. The taxpayer may use other proper cost allocation rules (see §1.471–11) to determine the unit cost of the components or subassemblies other than those described in the preceding sentence. For each taxable year, the taxpayer's estimate of the number of components or subassemblies that can be expected to be incorporated into the subject matter of extended period long-term contracts shall be considered reasonable if the estimate is based upon facts known at the beginning of the taxable year.

(v) *Taxpayers not using a long-term contract method.* Taxpayers who use a method of accounting that uses inventories (other than a long-term contract method) must use the cost allocation rules provided in paragraph (d)(6) of this section (rather than the cost allocation rules provided in §1.471–11) for any extended period long-term contract unless the taxpayer reasonably expects that:

(A) 40% of the gross income from such contract will be recognized no later than the taxable year after the taxable year in which the contract is entered into;

(B) 70% of the gross income from such contract will be recognized no later than the second taxable year after the taxable year in which the contract is entered into; and

(C) 100% of the gross income from such contract will be recognized no later than the third taxable year after the taxable year in which the contract is entered into.

In determining whether the taxpayer meets the ''reasonably expected'' test of this paragraph (d)(6)(v), rules consistent with the rules of paragraph (b)(3)(iv) of this section will apply.

(7) *Guarantees, warranties, maintenance costs, etc.* ''Costs which are properly allocable to a long-term contract'' do not include costs incurred with respect to any guarantee, warranty, maintenance, or other service agreement relating to the subject matter of the long-term contract. See paragraph (a)(3) of this section.

(8) *Separate accounts; annual cost allocation; use of inventory methods in connection with the completed contract method*—(i) *General rule.* This paragraph (d)(8) is effective for taxable years beginning after December 31, 1982. For taxable years beginning before January 1, 1983, see 26 CFR 1.451–3(d)(6) (revised as of April 1, 1985). The taxpayer shall maintain separate accounts for each long-term contract, and both the direct costs (as described in paragraph (d)(5)(i) or (d)(6)(i) of this section) and the indirect costs (as described in paragraph (d)(5)(ii) or (d)(6)(ii) of this section) incurred during the taxable year attributable to long-term contracts shall be allocated to particular long-term contracts for the taxable year such costs are incurred. Any change in the taxpayer's method of accounting for costs attributable to long-term contracts required by this paragraph (d)(8) is a change in method of accounting to which section 446(e) and the regulations and procedures thereunder apply.

(ii) *Direct labor.* Direct labor costs incurred during the taxable year shall be allocated to particular long-term contracts using a specific identification (or ''tracing'') method. However, if direct labor costs attributable to more than one long-term contract are intermingled so that it is impractical to specifically identify (or ''trace'') such costs to a particular long-term contract, such costs shall be allocated to particular long-term contracts using any reasonable method, provided that the method employed reasonably allocates direct labor costs among long-term contracts completed during the taxable year and long-term contracts that have not been completed as of the end of the taxable year. For the purpose of allocating elements of direct labor cost other than basic compensation to particular long-term contracts, all such cost elements may be grouped together and then allocated to particular long-term contracts in proportion to the charge for basic compensation.

(iii) *Direct materials*—(A) *General rule.* The cost of direct materials that are dedicated to a long-term contract in a taxable year shall be allocated to that long-term contract for that year. The cost that is allocated to the particular contract for the year of dedication shall be determined using the taxpayer's method of accounting for inventories (e.g., specific identification, FIFO, LIFO, etc.) of the material whose cost is being allocated. The costing rule in the preceding sentence applies both when materials are purchased specifically for a contract and when materials previously held by the taxpayer are dedicated to the contract. Examples of dedication of materials to a long-term contract include the following:

(*1*) Delivery of materials to a job site (if only one contract is being performed at that site);

(*2*) Association of materials with a specific contract (for example, by purchase order, entry on books and records, shipping instructions, etc.); and, if not previously assigned, the physical incorporation of the material into the subject matter of the contract or the consumption of the material in the production of the subject matter of the contract.

(B) *Alternative rule for taxable years beginning after December 31, 1982 and before January 1, 1986.* For taxable years beginning after December 31, 1982, and before January 1, 1986, taxpayers may, in lieu of applying the general rule of paragraph (d)(8)(iii)(A) of this section, allocate direct costs incurred during the taxable year to particular long-term contracts using the specific identification (or ''tracing'') method, and if direct costs attributable to more than one long-term contract are intermingled so that such costs cannot be identified (or ''traced'') specifically to a particular long-term contract, such costs shall be allocated to particular long-term contracts using any reasonable method, provided that the method employed reasonably allocates direct costs among long-term contracts completed during the taxable year and long-term contracts that have not been completed as of the end of the taxable year. However, taxpayers utilizing the rule of this paragraph (d)(8)(iii)(B) may not use any LIFO or lower of cost or market method of identifying or allocating direct costs to any long-term contract.

(iv) *Indirect costs.* The indirect costs required to be allocated to a long-term contract under paragraph (d)(5)(ii) or (d)(6)(ii) of this section shall be allocated to particular contracts for the year such costs are incurred using either—

(A) A specific identification (or ''tracing'') method, or

(B) A method using burden rates, such as ratios based on direct costs, hours, or other items, or similar formulas, so long as the method employed for such allocation reasonably allocates indirect costs among long-term contracts completed during the taxable year and long-term contracts that have not been completed as of the end of the taxable year. Indirect costs may ordinarily be allocated to long-term contracts on the basis of direct labor and material costs, direct labor hours, or any other basis which results in a reasonable allocation of such indirect costs.

(9) *Allocation of administrative, service, or support costs to extended period long-term contracts*—(i) *Introduction.* (A) If a function or department of the taxpayer incurs costs that directly benefit or are incurred by reason of the extended period long-term contract activities of the taxpayer, the costs of such function or department are allocable to such extended period long-term contracts. See paragraph (d)(6)(ii)(M) of this section. However, if a function or department incurs costs that do not directly benefit and are not incurred by reason of the taxpayer's extended period long-term contracts, but rather, for example, benefit only the overall management or policy guidance functions of the taxpayer, the costs incurred by such function or department are not allocable to any extended period long-term contract. In some cases, the costs incurred by a function or department may directly benefit or be incurred by reason of the taxpayer's extended period long-term contract activities as well as the taxpayer's overall management or policy guidance function. In such cases, the taxpayer shall reasonably allocate the costs of such function or department between the taxpayer's extended period long-term contract activities and the taxpayer's overall management or policy guidance functions. Paragraph (d)(9) of

this section provides guidance in making these allocations.

(B) If the methods of allocation used by the taxpayer, or the taxpayer's selection of specific types of costs to be allocated differs from the allocation methods or the specific types of costs to be allocated described in this paragraph (d)(9), the taxpayer's allocation methods and selection of specific types of costs to be allocated shall generally not be changed if, with respect to the taxpayer's extended period long-term contracts taken as a whole—

(*1*) The total amount of costs incurred during the taxable year of a type described in this paragraph (d)(9) that the taxpayer allocated to such contracts does not differ significantly from the total amount of costs that would be allocated to such contracts under this paragraph (d)(9); and

(*2*) The taxpayer's selection of cost allocation methods and specific types of costs to be allocated are applied consistently and do not result in any disproportionate allocation of costs to contracts expected to be completed in the near future.

(ii) *General rule.* The total amount of administrative, service, or support costs that directly benefit or are incurred by reason of only a particular extended period long-term contract shall be directly assigned to such contract. The direct and indirect cost (hereinafter ‘‘service costs’’) of administrative, service or support functions or departments (hereinafter ‘‘service departments’’) that directly benefit or are incurred by reason of more than one activity shall be allocated to particular extended period long-term contracts on the basis of a factor or relationship that reasonably relates the incurring of the service cost to the benefits received by the extended period long-term contract. In general, the direct costs of a service department include costs that can be identified specifically with the services provided by the department, and the indirect costs of a service department include costs not identified specifically with the services provided by the function or department, but incurred by reason of the direct costs of the function or department. Such direct and indirect costs include, but are not limited to, compensation (including compensation described in paragraph (d)(6)(ii) (E) and (P) of this section) of employees directly engaged in performing the services provided by the department, travel, materials and supplies consumed by the department, supervisory and clerical compensation, occupancy costs (rents or an allocable share of depreciation and property taxes), depreciation or rent of office machines, utilities, telephone, and other department overhead. The types of activities that are administrative, service or support functions or departments are not predetermined, but depend upon the facts and circumstances of each contractor's activities and business organization. In a decentralized business organization, all costs incurred at higher levels, for example, at a parent corporation or organization, or at the headquarters of a subsidiary corporation or division, are not necessarily general and administrative expenses (as described in paragraph (d)(5)(iii)(D) of this section) with respect to an extended period long-term contract.

(iii) *Rules for allocation of service costs.* The taxpayer shall allocate the total direct and indirect costs of a service department to extended period long-term contracts by applying consistently any reasonable method of cost allocation authorized by cost accounting principles. Reasonable methods include:

(A) The direct reallocation method, whereby the total costs (direct and indirect) of all service departments are allocated only to production departments, and then from the production departments to particular extended period long-term contracts and to other production activities that are not extended period long-term contracts. The service costs allocable to such other production activities shall be accounted for under a proper method of accounting. This direct reallocation method ignores benefits provided by one service department for other service departments, and also excludes such other service departments from the base used to make the allocation;

(B) The step-allocation method, whereby a sequence of allocations is made beginning with the allocation to other service departments and to production departments of the total costs (direct and indirect) of the service department that provides benefits to the greatest number of other service departments, and ending with the allocation of the total costs (including the costs allocated to it from the other service departments) of the service department that provides benefits to the least number of other service departments. Under this allocation method, the cost of service departments allocated properly to functions or departments that are not service departments or production departments (for example, payroll costs allocated to a financial planning function or department) are not reallocated to any other service department or production department. The taxpayer shall then allocate the costs of the production departments (including the reallocated service department costs) to extended period long-term contracts and to other production activities that are not extended period long-term contracts. The service costs allocable to such other production activities shall be accounted for under a proper method of accounting, or

(C) Other methods of cost allocation authorized by cost accounting principles. However, a reasonable method does not include allocating service department costs to other service departments without taking such allocation into account in allocating the costs of such other service departments.

(iv) *Relationship of service costs to benefits received.* Factors or relationships that relate the incurring of service costs to the benefits received by an extended period long-term contract include measures based upon the total output of the service department (for example, the approximate number of service hours or the approximate number or the dollar volume of transactions provided to an extended period long-term contract as a fraction of the total number of service hours or the total number or the total dollar volume of transactions provided by the department), or measures based upon the relative size of the extended period long-term contract to the size of the taxpayer's other production activities (for example, the number of direct labor employees or direct labor hours or direct labor costs (as described in paragraph (d)(6)(i) of this section) incurred on an extended period long-term contract as a fraction of the total number of direct labor employees, direct labor hours, or direct labor costs incurred by the taxpayer in all production activities). In general, allocation methods prescribed in regulations of the Cost Accounting Standards Board, 4 CFR Chapter III, Subchapter G, as well as other allocation methods consistent with the principles or paragraph (d)(g) of this section are acceptable allocation methods, provided that the taxpayer applies such methods consistently.

(v) *Additional requirements.* (A) If, pursuant to section 482 and the regulations thereunder, the district director makes an allocation of income or deductions between members of a group of controlled entities to reflect the performance of services or the provision of equipment or facilities at other than an arm's length charge, any taxpayer that has extended period long-term contracts and is affected by such allocation is required to take such allocation into account in making the taxpayer's allocation to extended period long-term contracts of the cost of administrative, service or support functions or departments.

(B) If the taxpayer establishes to the satisfaction of the district director that all of a particular type of administrative, service or support function is performed only at the jobsite (that is, at the offices of a production plant or at a construction site), then all the direct and indirect costs of such function incurred at the jobsite shall be directly allocated to each particular extended period long-term contract and any other activities performed at that jobsite, and no further allocation of that type of cost shall be required .

(C) For each taxable year that the taxpayer allocates costs service to an extended period long-term contract, the taxpayer shall maintain the records used to make such allocation so that the allocations may be readily examined and verified by the district director. The taxpayer shall also maintain records describing the types of costs that the taxpayer has deducted currently under paragraph (d)(6)(iii)(D) (general and administrative expenses), so that the amount, nature and allocation of such costs may be verified readily by the district director. A change in the method or base used in allocating such service costs (such as changing from an allocation base using direct labor cost to a base using direct labor hours), or a change in the taxpayer's determination of what functions or departments of the taxpayer are required or not required to be allocated to extended period long-term contracts is a change in method of accounting to which section 446(e) and the regulations and procedures thereunder apply. See §1.446–1(e).

(vi) *Illustration of types of activities with respect to which costs ordinarily are required to be allocated.* Costs incurred by the following types of functions or departments ordinarily are required to be allocated to extended period long-term contracts:

(A) The administration and coordination of manufacturing or construction projects (wherever performed in the business organization of the taxpayer);

(B) Personnel operations, including the cost of recruiting, hiring, relocating, assigning, and maintaining personnel records of employees whose labor cost is allocable to extended period long-term contracts;

(C) Purchasing operations, including purchasing materials and equipment, scheduling and coordinating delivery and return of materials and equipment to or from factories or jobsites, and expediting and follow-up;

(D) Materials handling and warehousing operations;

(E) Accounting and data services operations related to contract activities, including cost accounting, accounts payable, disbursements, billing, accounts receivable and payroll;

(F) Data processing;

(G) Security services; and

(H) Legal departments that provide legal services to contracts.

(vii) *Illustration of types of activities with respect to which costs ordinarily are not required to be allocated.* Costs incurred by the following types of functions or departments ordinarily are not required to be allocated to extended period long-term contracts:

(A) Functions or departments responsible for overall management of the taxpayer, or for setting overall policy for all of the taxpayer's activities or trades or businesses (such as, the board of directors (including their immediate staff), and the chief executive, financial, accounting and legal officers (including their immediate staffs) of the taxpayer, provided that no substantial part of the costs of such departments or functions directly benefit extended period long-term contracts);

(B) General business planning;

(C) Financial accounting (including the accounting services required to prepare consolidated reports, but not including any accounting for particular contracts);

(D) General financial planning (including general budgeting) and financial management (including bank relations and cash management);

(E) General economic analysis and forecasting;

(F) Internal audit;

(G) Shareholder, public and industrial relations;

(H) Tax department; and

(I) Other departments or functions that are not responsible for day-to-day operations but are instead responsible for setting policy and establishing procedures to be used by all of the taxpayer's activities or trades or businesses.

(viii) *Policy and overall management services.* Examples of such functions or departments that are responsible for setting policy and establishing procedures applicable to all of the taxpayer's activities or trades or businesses (see paragraph (d)(9)(vii)(I) of this section) are:

(A) Purchasing policy (such as maintaining lists of approved suppliers, developing purchasing manuals and policy directives of general application, developing general quality standards for purchased materials and components, general auditing and review of purchasing activities to assure compliance with the taxpayer's purchasing policy and compliance with government purchasing requirements, and management of small business participation),

(B) Personnel policy (such as establishing and managing personnel policy in general, developing general wage, salary and benefit policies, developing employee training programs unrelated to particular contracts, negotiations with labor unions and relations with retired workers),

(C) Quality control policy,

(D) Safety engineering policy,

(E) Insurance or risk management policy (but not including bid or performance bonds or insurance related to particular contracts), and

(F) Environmental management policy. However, the cost of establishing any system or procedure that will only benefit a particular extended period long-term contract shall be directly allocated to such contract.

(ix) *Costs not described.* The costs of any administrative, service or support function or department of the taxpayer not described in paragraph (d)(9) (iv) or (vii) of this section are required to be allocated to extended period long-term contracts to the extent that the nature of the benefits provided by such function or department is more like the type of benefits described in paragraph (d)(9)(vi) than the type of benefits described in paragraph (d)(9)(vii).

(x) *Illustrations of the allocations required by this paragraph (d)(9).* The following illustrate the types of considerations that are to be taken into account in making the allocations required by paragraph (d)(9) of this section. The taxpayer need not use the same method to allocate a particular type of administrative, service or support cost as the method described in these illustrations provided that the method used by the taxpayer is reasonable. See paragraph (d)(9)(iii) of this section. The allocation methods illustrated may be used to allocate other types of service costs not illustrated.

(A) *Security services.* The cost of security or protection services benefits all areas covered by the service and should be allocated to each physical area that receives the service in proportion either to the size of the physical area, number of employees in the area, or in proportion to the relative fair market value of assets located in the area, or in any other reasonable basis applied consistently. That part of the total cost allocable to a factory or jobsite where the only work being performed is an extended period long-term contract shall be directly allocated to that contract. The treatment of the cost of security services allocable to other service departments depends upon the method of allocation adopted by the taxpayer under paragraph (d)(9)(iii) of this section.

(B) *Legal services.* The cost of a legal department includes rent (or an allocation of building depreciation and occupancy costs), travel, office machines, supplies, telephone, library, and other overhead and the compensation of the attorneys and other employees assigned to the department. For this purpose compensation includes compensation described in paragraphs (d)(6)(ii) (E) and (P) of this section. These costs only benefit activities of the taxpayer requiring legal services. These costs are generally allocable directly to an extended period long-term contract on the basis of the approximate number of hours of legal services (including research) performed in connection with the contract, including bidding, negotiating, drafting, or reviewing the contract (including subcontracts and supply contracts), obtaining necessary licenses and permits, and in resolving contract disputes, termination claims or disputes arising from the performance of the contract. Different hourly rates may be appropriate for different services. In determining the number of hours allocable to any contract, approximations are appropriate, detailed time records need not be kept, and insubstantial amounts of services provided to a contract by senior legal staff as administrators or as reviewers may be ignored. The taxpayer shall also allocate directly to a contract the cost of any outside legal services provided to the contract. Instead of an allocation based upon total hours of legal services provided to an activity, the taxpayer may choose to allocate the costs of a legal department to an extended period long-term contract and to other production activities on the basis of total direct costs (as described in paragraph (d)(6)(i) of this section) incurred on an extended period long-term contract as a fraction of the total direct costs incurred on all production activities. Legal costs may also be allocable to long-term contracts of the taxpayer that are not extended period long-term contracts under paragraph (d)(5)(ii) of this section. Legal activities relating to general corporate functions, financing, securities law compliance, antitrust law compliance, tax compliance, industrial relations, compliance with laws and regulations not related to particular contracts, after the fact review of contracts to insure compliance with company policies, patents and licensing unrelated to particular contracts, and similar general legal functions are not required to be allocated to long-term contracts.

(C) *Centralized payroll department.* The cost of a payroll department includes rent (or an allocation of building depreciation and occupancy costs), office machines, supplies, telephones and other overhead and compensation of employees assigned to the department. The department cost may also include the cost of data processing and file maintenance, or these costs may be incurred by a separate data processing or records department and allocated to the payroll department. Payroll service costs benefit any production department or other service department incurring labor costs. The cost of a payroll department is generally allocated on the basis of the gross amount of payroll processed.

(D) *Centralized data processing.* The cost of a data processing department includes rent or depreciation of data processing machines, supplies, rent (or an allocation of building depreciation and occupancy costs), power, telephone and other overhead, and the compensation of employees assigned to the department. These costs benefit all production departments and all other service departments that require data processing services. Data processing costs are generally allocated based upon the number of data processing hours supplied. Other reasonable bases, such as an allocation based upon total direct costs, may also be used. The costs of data processing systems developed for particular long-term contract shall be directly allocated to such contract.

(E) *Engineering and design services.* The cost of an engineering or design department includes rent (or an allocation of building depreciation and occupancy costs), travel, office machines, supplies, telephones, library, and other overhead, and compensation of employees assigned to the department. Unless the engineering and design services are properly accounted for separately, the cost of engineering or design service departments generally is directly allocable to a long-term contract (whether or not the contract is an extended period long-term contract) on the basis of the approximate number of hours of work performed on the contract as a fraction of the total hours of engineering or design work performed for all activities. Different services may be allocated at different hourly rates. Engineering and design services may also be treated as direct costs of the contract, provided that the taxpayer also treats all engineering and design overhead as a direct or indirect cost of the contract.

(F) *Safety engineering.* The cost of a safety engineering department includes the compensation paid to employees assigned to the department, rent (or an allocation of building depreciation and occupancy costs), travel, office machines, supplies, telephones, library, and other overhead. These costs benefit all the production activities of the taxpayer and should be allocated to an extended period long-term contract on the basis of the approximate number of safety inspections made on the contract as a fraction of total inspections, or on the basis of the number of employees assigned to the contract as a fraction of total production employees or on the basis of total labor hours worked on the contract as a fraction of total production hours, whichever is most reasonable. The cost of a safety engineering department reponsible only for setting safety policy and establishing safety procedures to be used in all of the taxpayer's production activities or trades or businesses is not required to be allocated to extended period long-term contracts and other production activities. However, in determining the total costs of a safety engineering department to be allocated, costs attributable to providing a safety program only for a particular long-term contract shall be directly assigned to the contract.

(e) *Severing and aggregating contracts*—(1) *In general.* (i)(A) For the purpose of clearly reflecting income (*e.g.*, to prevent the unreasonable deferral of recognition of income or the premature recognition of loss), it may be necessary in some instances for the Commissioner either to treat one agreement as several contracts or to treat several agreements as one contract.

(B) However, in the case of long-term contracts since the factors described in this paragraph are different from the factors for determining whether certain elements of an agreement are eligible for long-term contract treatment, the factors described in this paragraph do not apply in determining which elements of an agreement that are ineligible for long-term contract treatment must be separated from those elements that are eligible for long-term contract treatment.

(C) In general only the Commissioner (and not the taxpayer) may take action under this paragraph. Thus, for example, if the taxpayer enters into one agreement, the taxpayer may not treat that agreement as several contracts for purposes of this section unless and until that agreement is changed into several agreements. See examples 3 and 5 for instances when one agreement is changed into several agreements.

(ii) Whether an agreement should be so severed or several agreements so aggregated will depend on all the facts and circumstances. Such facts and circumstances may include whether there is separate delivery or separate acceptance of units representing a portion of the subject matter of the contract, whether such units are independently priced, whether there is no business purpose for one agreement rather than several agreements or several agreements rather than one agreement, and such other factors as customary commercial practice, the dealings between parties to the contract, the nature of the subject matter of the contract, the total number of units to be constructed, manufactured, or installed under the contract, and the contemplated time between the completion of each unit.

(iii) Generally, one agreement will not be treated as several contracts unless such agreement contemplates separate delivery or separate acceptance of portions of the subject matter of the contract. However, separate delivery or separate acceptance of portions of the subject matter of a contract does not necessarily require severing of an agreement (see example (4) of paragraph (e)(2) of this section).

(iv) One agreement may be severed, or several agreements may be aggregated, based upon the pricing formula of such agreements. For example, in the case of a multi-unit agreement for several similar items, if the price to be paid for similar units is determined under different terms or formulas (for example, if some units are priced under a cost-plus incentive fee arrangement, and later units are to be priced under a fixed-price arrangement), then the difference in the pricing terms or formulas may indicate that the agreement should be treated as several contracts.

(v) An agreement generally will be treated as several contracts where there is no business purpose for entering into one agreement rather than several agreements.

A factor which may evidence that no such business purpose exists is that the agreement covers two or more subject matters, none of which readily can be determined to be the primary subject matter of the contract (within the meaning of paragraph (b)(2)(ii) of this section); such factor must be considered along with other factors indicating the presence or absence of business purpose.

(vi) Several agreements generally will not be aggregated unless there is no business purpose for entering into several agreements rather than one agreement.

(vii) An example of a factor which is evidence that two agreements entered into between the same parties should be aggregated is that (without regard to the order in which the agreements were entered into or performed, and without regard to whether one of the agreements could actually be performed without the prior or contemporaneous performance of the other agreement) a reasonable business-person would not have entered into one of the agreement for the terms agreed upon but for entering into the other agreement in such other agreement for the terms agreed upon (or for more favorable terms). See example (2) of paragraph (e)(2) of this section. An example of a factor which is not evidence that two agreements entered into between the same parties should be aggregated is that one of the agreements would not have been entered into containing the terms agreed upon but for the expectation that the parties would enter into the other agreement.

(viii) If the number of items to be supplied is increased (as by the exercise of an option or the issuance of a ''change order''), the supplying of such additional items generally results in the agreement being changed into several agreements. See paragraph §1.451–3(e)(1)(i).

(ix) See paragraph (b)(2)(ii) of this section for special rules relating to the time for completion of certain contracts having more than one subject matter.

(2) *Examples.* The application of paragraph (e) of this section may be illustrated by the following examples.

Example (1). X, a calendar year taxpayer engaged in the construction business and using a long-term contract method, enters into one agreement in 1972 with A, a real estate developer, to build three houses of different designs in three different suburbs of a large city. The houses are to be completed, accepted, and put into service in 1973, 1974, and 1975, respectively. The portion of the total contract price attributable to each house can reasonably be determined. In these circumstances it may be necessary for the Commissioner to sever and treat the agreement as separate contracts to build each house for purposes of applying X's long-term contract method.

Example (2). Y, a calendar year shipbuilder using a long-term contract method, enters into two agreements at about the same time during 1982 with M. These agreements are the product of a single negotiation. Under each agreement the taxpayer is to construct for M a submarine of the same class. Although the specifications for each submarine are similar, it is anticipated that, since the taxpayer has never constructed this class of submarine before, the costs incurred in constructing the first submarine (to be delivered in 1983) will be substantially greater than the costs incurred in constructing the second submarine (to be delivered in 1984.) If the agreements are treated as separate contracts, it is estimated that the first contract could result in little or no gain, while the second contract would result in substantial profits. A reasonable business person would not have entered into the agreement to construct the first submarine for the price specified without entering into the agreement to construct the second submarine. In these circumstances, it may be necessary for the Commissioner to aggregate the two agreements for purposes of applying Y's long-term contract method.

Example (3). Assume the same facts as in example (2) with the addition of the following facts: In 1983, M issues a ''change order'' providing for a third submarine of the same class to be constructed by Y and delivered to M in 1985. The portion of the total contract price attributable to the ''change order'' providing for the third submarine can reasonably be determined. A reasonable business person would have entered into the agreements to construct the first two submarines for the price specified without regard to whether M would issue the ''change order'' for the third submarine. In these circumstances the ''change order'' providing for the third submarine must be treated as a separate contract for purposes of applying Y's long-term contract method.

Example (4). Z, a calendar year taxpayer engaged in the construction business and using a long-term contract method, enters into an agreement in 1983 to build a ten story office building for the Y Bank. In 1984, the structure is completed and the first three floors of the building are completed and accepted, and Y occupies these floors and uses them for the conduct of its banking business. Construction, however, continues on the remaining seven floors, which are completed and accepted in 1985. In these circumstances, it is clear that even though separate acceptance of portions of the subject matter of the agreement has occurred, the subject matter of the agreement was essentially a single unit, namely a building, and that there was a business purpose for entering into one contract rather than several contracts. Consequently, the agreement ordinarily will not be severed into separate contracts for purposes of applying Z's long-term contract method.

Example (5). The facts are the same as in example (4), except that due to a change in business conditions, Y will not require (either for its own use or for rental) the remaining seven floors for at least two years and, pursuant to a separate agreement entered into in 1984 between the parties, substantially all work on completing the remaining seven floors is stopped. In these circumstances, due to the change in business conditions and the actions of the parties, the original agreement (as modified by the second agreement) is changed into two agreements, each of which is treated as a separate contract for purposes of this section, one contract (entered into in 1983) for the construction of a ten story building with the first three floors completed for occupancy, and a separate contract (or contracts) to finish work on the remaining seven floors on an ‘‘as requested’’ basis.

Example (6). T, a calendar year taxpayer engaged in the business of manufacturing aircraft and related equipment, enters into an agreement in 1982 with the B government to manufacture 10 military aircraft for delivery in 1984. It is anticipated at the time the agreement is entered into that B may enter into an agreement with T for the production and sale of as many as 300 of these aircraft over the next 20 years. In negotiating the price for the agreement, B and T take into account the expected total cost of manufacturing the 10 aircraft, the risks and the opportunities associated with the agreement and all other factors that the parties consider relevant, in such a manner that T would have entered into the agreement with the terms agreed upon whether or not T would actually enter into one or more additional production agreements. However, it is unlikely that T would have entered into the agreements but for the expectation that T and B would enter into additional production agreements. In 1984, the 10 aircraft are completed by T and accepted by B. In 1984, T also enters into an agreement with B to manufacture 20 aircraft of the same type for delivery in 1986. In negotiating the price for these 20 aircraft, B and T take into account the fact that the expected unit costs for this production of 20 will be different than the unit costs of the 10 aircraft completed in 1984, but also that the expected unit costs of this production of 20 will be substantially higher than the costs of future production. Because the price awarded for each of the two agreements takes into account the expected total costs and the risks expected for each agreement standing alone, the terms agreed upon for any one of the agreements are independent of the terms agreed upon for the other agreements. Under the facts of this example, the two agreements may not be aggregated into one contract for purposes of applying T’s long-term contract method.

Example (7). R, a calendar year taxpayer engaged in the manufacture of industrial machinery, enters into one agreement in 1982 with Z to manufacture five specialized machines and to manufacture spare and replacement parts for the machines. The machines are to be delivered in 1982 and 1983, and the spare and replacement parts are to be delivered in 1983 through 1985. The portion of the total contract price attributable to the five machines and to the spare and replacement parts reasonably can be determined. The portion of the total contract price reasonably attributable to the spare and replacement parts is more than an insignificant amount of the total contract price. Assume that, under all the facts and circumstance, it is determined that the portion of the agreement attributable to the five machines need not be severed as between the machines. In these circumstances, because the agreement contemplates separate delivery of the machines and the parts, because more than an insignificant amount of the total contract price is allocable to the spare and replacement parts, and because spare or replacement parts are items different than an entire machine, it may be necessary for the Commissioner to sever the agreement, treating the agreement to manufacture the five machines as a separate contract and the agreement to manufacture the spare and replacement parts as another separate contract (or as several separate contracts depending on the facts and circumstances) for purposes of applying R’s long-term contract method.

(3) *Cross reference.* See § 1.6001–1 (a) regarding the duty of taxpayers to keep such records as are sufficient to establish the amount of gross income, deductions, etc.

(f) *Changing to or from a long-term method of accounting.* A taxpayer may change to or from the percentage of completion method or the completed contract method only with the consent of the Commissioner. See section 446(e) and § 1.446–1(e).

(g) *Effective date and transition to 1983 cost allocation rules; special rules*—(1) *In general.* In the case of a taxpayer using the completed contract method or a method of accounting that uses inventories (other than a long-term contract method), the cost allocation rules prescribed in paragraph (d)(6) of this section (hereinafter ‘‘the 1983 cost allocation method’’) shall apply (with the phase-in described in paragraph (g)(2) of this section) to costs incurred by the taxpayer in taxable years beginning after December 31, 1982, but only with respect to extended period long-term contracts (as defined in paragraph (b)(3) of this section) entered into after December 31, 1982. No costs incurred with respect to any contract entered into before January 1, 1983 are required to be accounted for under the 1983 cost allocation method. Such costs shall be accounted for under the cost allocation method prescribed in paragraph (d)(5) of this section. Because the transition to the 1983 cost allocation method is to be applied on a ‘‘cut-off’’ basis, sections 446(e) and 481 do not apply to the transition to the 1983 cost allocation method.

(2) *Phase-in.* For costs required to be allocated to an extended period long-term contract under the 1983 cost allocation method that are not required to be allocated to the contract under the cost allocation method prescribed in paragraph (d)(5) of this section (or in paragraph (c) of §1.471–11 in the case of a taxpayer accounting for extended period long-term contracts under a method of accounting that uses inventories (other than a long-term contract method)), in lieu of allocating the full amount of such costs to the extended period long-term contract, the taxpayer shall allocate to the contract only the applicable percentage of such costs incurred in taxable years beginning after December 31, 1982 and before January 1, 1986, with respect to extending period long-term contracts entered into after December 31, 1982. The applicable percentage shall be determined as follows:

For taxable years beginning in calendar year—	The applicable percentage is—
1983	33½
1984	66⅔
1985 or thereafter	100

In the case of a taxpayer whose taxable year does not begin on January 1, costs incurred with respect to extended period long-term contracts entered into after December 31, 1982, shall be accounted for under the cost allocation method prescribed in paragraph (d)(5) of this section (or paragraph (c) of §1.471–11 in the case of a taxpayer using an inventory method) in the case of costs incurred in taxable years begininng before January 1, 1983, and under the 1983 cost allocation method (with the application of paragraph (g) of this section) in the case of taxable years beginning after December 31, 1982.

(3) *Special rule for completion of certain contracts in taxable years ending before January 1, 1983.* Any contract that would (but for this paragraph (g)(3)) be considered to be completed in a taxable year ending before January 1, 1983, solely by reason of the application of paragraphs (b)(2)(i)(B), (ii), (iii), or (iv) of this section, shall be considered to be completed on the first day of the taxpayer's first taxable year ending after December 31, 1982. The application of this paragraph (g)(3) shall not be considered to be a change in method of accounting to which section 481 applies.

(4) *Special rule for severing and aggregating certain contracts in taxable years ending before January 1, 1983.* Any contract of a taxpayer that would (but for this paragraph (g)(4)) be considered completed in a taxable year ending before January 1, 1983—

(i) Solely by reason of the application of those provisions of paragraph (e)(1) of this section expressly made applicable to taxable years ending after December 31, 1982 (hereinafter, the "severing/aggregating modifications") or,

(ii) Solely by reason of the application of both the severing/aggregating modifications and the application of paragraphs (b)(2)(i)(B), (ii), (iii) or (iv) of this section (hereinafter, the "completion modifications"), shall be treated as having been completed on the first day after December 31, 1982, on which any contract that was severed from such contract (by reason of the severing/aggregating modifications) is completed (determined with application of the completion modifications). The application of this paragraph (g)(4) shall not be considered to be a change in method of accounting to which section 481 applies.

(5) *Special rule for estimated tax payments.* For purposes of the addition to the tax for underpayment of estimated tax under section 6654 (relating to individuals) and section 6655 (relating to corporations), the gross income realized in the taxpayer's first taxable year ending after December 31, 1982, attributable to long-term contracts deemed to be completed in such taxable years solely by the application of paragraphs (b)(2)(i)(B), (ii), (iii), or (iv), (g)(3) or (g)(4) of this section or those portions of paragraph (e)(1) of this section made applicable to taxable years ending after December 31, 1982, shall be considered to be taxable income for such taxable year, but only with respect to installments of estimated tax required to be paid on or after April 13, 1983.

(6) *Taxpayer changing from a method more inclusive of indirect costs.* Except as

provided in paragraphs (g)(1) and (2) of this section, if a taxpayer wishes to change to a method of accounting for indirect costs prescribed under this section (or under § 1.471–11 (c) in the case of a taxpayer using an inventory method of accounting for long-term contracts) from a method of accounting for indirect costs that is more inclusive of indirect costs, the taxpayer must secure the consent of the Commissioner prior to making the change in accordance with the regulations and procedures established under section 446(e).

[T.D. 7397, 41 FR 2637, Jan. 19, 1976, as amended by T.D. 8067, 51 FR 378, Jan. 6, 1986; 51 FR 6520, Feb. 25, 1986; 51 FR 6914, Feb. 27, 1986; 51 FR 16021, Apr. 30, 1986; T.D. 8408, 57 FR 12420, Apr. 10, 1992]

§ 1.451–4 Accounting for redemption of trading stamps and coupons.

(a) *In general*—(1) *Subtraction from receipts.* If an accrual method taxpayer issues trading stamps or premium coupons with sales, or an accrual method taxpayer is engaged in the business of selling trading stamps or premium coupons, and such stamps or coupons are redeemable by such taxpayer in merchandise, cash, or other property, the taxpayer should, in computing the income from such sales, subtract from gross receipts with respect to sales of such stamps or coupons (or from gross receipts with respect to sales with which trading stamps or coupons are issued) an amount equal to—

(i) The cost to the taxpayer of merchandise, cash, and other property used for redemptions in the taxable year,

(ii) Plus the net addition to the provision for future redemptions during the taxable year (or less the net subtraction from the provision for future redemptions during the taxable year).

(2) *Trading stamp companies.* For purposes of this section, a taxpayer will be considered as being in the business of selling trading stamps or premium coupons if—

(i) The trading stamps or premium coupons sold by him are issued by purchasers to promote the sale of their merchandise or services,

(ii) The principal activity of the trade or business is the sale of such stamps or coupons,

(iii) Such stamps or coupons are redeemable by the taxpayer for a period of at least 1 year from the date of sale, and

(iv) Based on his overall experience, it is estimated that not more than two-thirds of the stamps or coupons sold which it is estimated, pursuant to paragraph (c) of this section, will be ultimately redeemed, will be redeemed within 6 months of the date of sale.

(b) *Computation of the net addition to or subtraction from the provision for future redemptions*—(1) *Determination of the provision for future redemptions.* (i) The provision for future redemptions as of the end of a taxable year is computed by multiplying ‘‘estimated future redemptions’’ (as defined in subdivision (ii) of this subparagraph) by the estimated average cost of redeeming each trading stamp or coupon (computed in accordance with subdivision (iii) of this subparagraph).

(ii) For purposes of this section, the term ‘‘estimated future redemptions’’ as of the end of a taxable year means the number of trading stamps or coupons outstanding as of the end of such year that it is reasonably estimated will ultimately be presented for redemption. Such estimate shall be determined in accordance with the rules contained in paragraph (c) of this section.

(iii) For purposes of this section, the estimated average cost of redeeming each trading stamp or coupon shall be computed by including only the costs to the taxpayer of acquiring the merchandise, cash, or other property needed to redeem such stamps or coupons. The term ‘‘the costs to the taxpayer of acquiring the merchandise, cash, or other property needed to redeem such stamps or coupons’’ includes only the price charged by the seller (less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer provided a consistent course is followed) plus transportation or other necessary charges in acquiring possession of the goods. Items such as the costs of advertising, catalogs, operating redemption centers, transporting merchandise or other property from a central warehouse to a branch warehouse (or from a warehouse to a redemption center), and storing the merchandise or other property used to redeem stamps or coupons should not be included in costs of redeeming stamps or premium coupons, but rather should be accounted for in accordance with the provisions of sections 162 and 263.

(2) *Changes in provision for future redemptions.* For purposes of this section, a ‘‘net addition to’’ or ‘‘net subtraction from’’ the provision for future redemptions for a taxable year is computed as follows:

(i) Carry over the provision for future redemptions (if any) as of the end of the preceding taxable year,

(ii) Compute the provision for future redemptions as of the end of the taxable year in accordance with subparagraph (1) of this paragraph, and

(iii) If the amount referred to in subdivision (ii) of this subparagraph exceeds the amount referred to in subdivision (i) of this subparagraph, such excess is the net addition to the provision for future redemptions for the taxable year. On the other hand, if the amount referred to in such subdivision (i) exceeds the amount referred to in such subdivision (ii), such excess is the net subtraction from the provision for future redemptions for the taxable year.

(3) *Example.* The provisions of this paragraph and paragraph (a)(1) of this section may be illustrated by the following example:

Example. (a) X Company, a calendar year accrual method taxpayer, is engaged in the business of selling trading stamps to merchants. In 1971, its first year of operation, X sells 10 million stamps at $5 per 1,000; it redeems 3 million stamps for merchandise and cash of an average value of $3 per 1,000 stamps. At the end of 1971 it is estimated (pursuant to paragraph (c) of this section) that a total of 9 million stamps of the 10 million stamps issued in 1971 will eventually be presented for redemption. At this time it is estimated that the average cost of redeeming stamps (as described in subparagraph (1)(iii) of this paragraph) would continue to be $3 per 1,000 stamps. Under these circumstances, X computes its gross income from sales of trading stamps as follows:

Gross receipts from sales (10 million stamps at $5 per 1,000)		$50,000
Less:		
Cost of actual redemptions (3 million stamps at $3 per 1,000)	$9,000	
Provision for future redemptions on December 31, 1971 (9 million stamps — 3 million stamps × $3 per 1,000)	18,000	
		27,000
1971 gross income from sales of stamps		23,000

(b) In 1972, X also sells 10 million stamps at $5 per 1,000 stamps. During 1972 X redeems 7 million stamps at an average cost of $3.01 per 1,000 stamps. At the end of 1972 it is determined that the estimated future redemptions (within the meaning of subparagraph (1)(ii) of this paragraph) is 8 million. It is further determined that the estimated average cost of redeeming stamps would continue to be $3.01 per 1,000 stamps. X thus computes its gross income from sales of trading stamps for 1972 as follows:

Gross receipts from sales (10 million stamps at $5 per 1,000)		$50,000
Less:		
Cost of actual redemptions (7 million stamps at $3.01 per 1,000)	$21,070	
Plus:		
Provision for future redemptions on Dec. 31, 1972 (8 million stamps at $3.01 per 1,000)	24,080	
Minus provision for future redemptions on Dec. 31, 1971	18,000	
Addition to provision for future redemptions	6,080	
Total cost of redemptions		27,150
1972 Gross income from sales of stamps		22,850

(c) *Estimated future redemptions*—(1) *In general.* A taxpayer may use any method of determining the estimated future redemptions as of the end of a year so long as—

(i) Such method results in a reasonably accurate estimate of the stamps or coupons outstanding at the end of such year that will ultimately be presented for redemption,

(ii) Such method is used consistently, and

(iii) Such taxpayer complies with the requirements of this paragraph and paragraphs (d) and (e) of this section.

(2) *Utilization of prior redemption experience.* Normally, the estimated future redemptions of a taxpayer shall be determined on the basis of such taxpayer’s prior redemption experience. However, if the taxpayer does not have sufficient redemption experience to make a reasonable determination of his ‘‘estimated future redemptions,’’ or if because of a change in his mode of operation or other relevant factors the

determination cannot reasonably be made completely on the basis of the taxpayer's own experience, the experiences of similarly situated taxpayers may be used to establish an experience factor.

(3) *One method of determining estimated future redemptions.* One permissible method of determining the estimated future redemptions as of the end of the current taxable year is as follows:

(i) Estimate for each preceding taxable year and the current taxable year the number of trading stamps or coupons issued for each such year which will ultimately be presented for redemption.

(ii) Determine the sum of the estimates under subdivision (i) of this subparagraph for each taxable year prior to and including the current taxable year.

(iii) The difference between the sum determined under subdivision (ii) of this subparagraph and the total number of trading stamps or coupons which have already been presented for redemption is the estimated future redemptions as of the end of the current taxable year.

(4) *Determination of an ''estimated redemption percentage.''* For purposes of applying subparagraph (3)(i) of this paragraph, one permissible method of estimating the number of trading stamps or coupons issued for a taxable year that will ultimately be presented for redemption is to multiply such number of stamps issued for such year by an ''estimated redemption percentage.'' For purposes of this section the term ''estimated redemption percentage'' for a taxable year means a fraction, the numerator of which is the number of trading stamps or coupons issued during a taxable year that it is reasonably estimated will ultimately be redeemed, and the denominator of which is the number of trading stamps or coupons issued during such year. Consequently, the product of such percentage and the number of stamps issued for such year equals the number of trading stamps or coupons issued for such year that it is estimated will ultimately be redeemed.

(5) *Five-year rule.* (i) One permissible method of determining the ''estimated redemption percentage'' for a taxable year is to—

(a) Determine the percentage which the total number of stamps or coupons redeemed in the taxable year and the 4 preceding taxable years is of the total number of stamps or coupons issued or sold in such 5 years; and

(b) Multiply such percentage by an appropriate growth factor as determined pursuant to guidelines published by the Commissioner.

(ii) If a taxpayer uses the method described in subdivision (i) of this subparagraph for a taxable year, it will normally be presumed that such taxpayer's ''estimated redemption percentage'' is reasonably accurate.

(6) *Other methods of determining estimated future redemptions.* (i) If a taxpayer uses a method of determining his ''estimated future redemptions'' (other than a method which applies the 5-year rule as described in subparagraph (5)(i) of this paragraph) such as a probability sampling technique, the appropriateness of the method (including the appropriateness of the sampling technique, if any) and the accuracy and reliability of the results obtained must, if requested, be demonstrated to the satisfaction of the district director.

(ii) No inference shall be drawn from subdivision (i) of this subparagraph that the use of any method to which such subdivision applies is less acceptable than the method described in subparagraph (5)(i) of this paragraph. Therefore, certain probability sampling techniques used in determining estimated future redemptions may result in reasonably accurate and reliable estimates. Such a sampling technique will be considered appropriate if the sample is—

(a) Taken in accordance with sound statistical sampling principles,

(b) In accordance with such principles, sufficiently broad to produce a reasonably accurate result, and

(c) Taken with sufficient frequency as to produce a reasonably accurate result.

In addition, if the sampling technique is appropriate, the results obtained therefrom in determining estimated future redemptions will be considered accurate and reliable if the evaluation of such results is consistent with sound statistical principles. Ordinarily, samplings and recomputations of the estimated future redemptions will be required annually. However, the facts and circumstances in a particular case may justify such a recomputation being taken less frequently than annually. In addition, the Commissioner may prescribe procedures indicating that samples made to update the results of a sample of stamps redeemed in a prior year need not be the same size as the sample of such prior year.

(d) *Consistency with financial reporting*—(1) *Estimated future redemptions.* For taxable years beginning after August 22, 1972, the estimated future redemptions must be no greater than the estimate that the taxpayer uses for purposes of all reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes.

(2) *Average cost of redeeming stamps.* For taxable years beginning after August 22, 1972, the estimated average cost of redeeming each stamp or coupon must be no greater than the average cost of redeeming each stamp or coupon (computed in accordance with paragraph (b)(1)(iii) of this section) that the taxpayer uses for purposes of all reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes.

(e) *Information to be furnished with return*—(1) *In general.* For taxable years beginning after August 22, 1972, a taxpayer described in paragraph (a) of this section who uses a method of determining the ‘‘estimated future redemptions’’ other than that described in paragraph (c)(5)(i) of this section shall file a statement with his return showing such information as is necessary to establish the correctness of the amount subtracted from gross receipts in the taxable year.

(2) *Taxpayers using the 5-year rule.* If a taxpayer uses the method of determining estimated future redemptions described in paragraph (c)(5)(i) of this section, he shall file a statement with his return showing, with respect to the taxable year and the 4 preceding taxable years—

(i) The total number of stamps or coupons issued or sold during each year, and

(ii) The total number of stamps or coupons redeemed in each such year.

(3) *Trading stamp companies.* In addition to the information required by subparagraph (1) or (2) of this paragraph, a taxpayer engaged in the trade or business of selling trading stamps or premium coupons shall include with the statement described in subparagraph (1) or (2) of this paragraph such information as may be necessary to satisfy the requirements of paragraph (a)(2)(iv) of this section.

[T.D. 7201, 37 FR 16911, Aug. 23, 1972, as amended by T.D. 7201, 37 FR 18617, Sept. 14, 1972]

§1.451–5 Advance payments for goods and long-term contracts.

(a) *Advance payment defined.* (1) For purposes of this section, the term ‘‘advance payment’’ means any amount which is received in a taxable year by a taxpayer using an accrual method of accounting for purchases and sales or a long-term contract method of accounting (described in §1.451–3), pursuant to, and to be applied against, an agreement:

(i) For the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(ii) For the building, installing, constructing or manufacturing by the taxpayer of items where the agreement is not completed within such taxable year.

(2) For purposes of subparagraph (1) of this paragraph:

(i) The term ‘‘agreement’’ includes *(a)* a gift certificate that can be redeemed for goods, and *(b)* an agreement which obligates a taxpayer to perform activities described in subparagraph (1)(i) or (ii) of this paragraph and which also contains an obligation to perform services that are to be performed as an integral part of such activities; and

(ii) Amounts due and payable are considered ‘‘received’’.

(3) If a taypayer (described in subparagraph (1) of this paragraph) receives an amount pursuant to, and to be applied against, an agreement that

not only obligates the taxpayer to perform the activities described in subparagraph (1) (i) and (ii) of this paragraph, but also obligates the taxpayer to perform services that are not to be performed as an integral part of such activities, such amount will be treated as an ''advance payment'' (as defined in subparagraph (1) of this paragraph) only to the extent such amount is properly allocable to the obligation to perform the activities described in subparagraph (1) (i) and (ii) of this paragraph. The portion of the amount not so allocable will not be considered an ''advance payment'' to which this section applies. If, however, the amount not so allocable is less than 5 percent of the total contract price, such amount will be treated as so allocable except that such treatment cannot result in delaying the time at which the taxpayer would otherwise accrue the amounts attributable to the activities described in subparagraph (1) (i) and (ii) of this paragraph.

(b) *Taxable year of inclusion*—(1) *In general.* Advance payments must be included in income either—

(i) In the taxable year of receipt; or

(ii) Except as provided in paragraph (c) of this section.

(*a*) In the taxable year in which properly accruable under the taxpayer's method of accounting for tax purposes if such method results in including advance payments in gross receipts no later than the time such advance payments are included in gross receipts for purposes of all of his reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes, or

(*b*) If the taxpayer's method of accounting for purposes of such reports results in advance payments (or any portion of such payments) being included in gross receipts earlier than for tax purposes, in the taxable year in which includible in gross receipts pursuant to his method of accounting for purposes of such reports.

(2) *Examples.* This paragraph may be illustrated by the following examples:

Example (1). S, a retailer who uses for tax purposes and for purposes of the reports referred to in subparagraph (1)(ii)(a) of this paragraph, an accrual method of accounting under which it accounts for its sales of goods when the goods are shipped, receives advance payments for such goods. Such advance payments must be included in gross receipts for tax purposes either in the taxable year the payments are received or in the taxable year such goods are shipped (except as provided in paragraph (c) of this section).

Example (2). T, a manufacturer of household furniture, is a calendar year taxpayer who uses an accrual method of accounting pursuant to which income is accrued when furniture is shipped for purposes of its financial reports (referred to in subparagraph (1)(ii)(*a*) of this paragraph) and an accrual method of accounting pursuant to which the income is accrued when furniture is delivered and accepted for tax purposes. See § 1.446–1(c)(1)(ii). In 1974, T receives an advance payment of $8,000 from X with respect to an order of furniture to be manufactured for X for a total price of $20,000. The furniture is shipped to X in December 1974, but it is not delivered to and accepted by X until January 1975. As a result of this contract, T must include the entire advance payment in its gross income for tax purposes in 1974 pursuant to subparagraph (1)(ii)(*b*) of this paragraph. T must include the remaining $12,000 of the gross contract price in its gross income in 1975 for tax purposes.

(3) *Long-term contracts.* In the case of a taxpayer accounting for advance payments for tax purposes pursuant to a long-term contract method of accounting under § 1.451–3, or of a taxpayer accounting for advance payments with respect to a long-term contract pursuant to an accrual method of accounting referred to in the succeeding sentence, advance payments shall be included in income in the taxable year in which properly included in gross receipts pursuant to such method of accounting (without regard to the financial reporting requirement contained in subparagraph (1)(ii) (*a*) or (*b*) of this paragraph). An accrual method of accounting to which the preceding sentence applies shall consist of any method of accounting under which the income is accrued when, and costs are accumulated until, the subject matter of the contract (or, if the subject matter of the contract consists of more than one item, an item) is shipped, delivered, or accepted.

(4) *Installment method.* The financial reporting requirement of subparagraph (1)(ii) (*a*) or (*b*) of this paragraph shall not be construed to prevent the use of

the installment method under section 453. See §1.446–1(c)(1)(ii).

(c) *Exception for inventoriable goods.* (1)(i) If a taxpayer receives an advance payment in a taxable year with respect to an agreement for the sale of goods properly includible in his inventory, or with respect to an agreement (such as a gift certificate) which can be satisfied with goods or a type of goods that cannot be identified in such taxable year, and on the last day of such taxable year the taxpayer—

(a) Is accounting for advance payments pursuant to a method described in paragraph (b)(1)(ii) of this section for tax purposes,

(b) Has received ''substantial advance payments'' (as defined in subparagraph (3) of this paragraph) with respect to such agreement, and

(c) Has on hand (or available to him in such year through his normal source of supply) goods of substantially similar kind and in sufficient quantity to satisfy the agreement in such year,

then all advance payments received with respect to such agreement by the last day of the second taxable year following the year in which such substantial advance payments are received, and not previously included in income in accordance with the taxpayer's accrual method of accounting, must be included in income in such second taxable year.

(ii) If advance payments are required to be included in income in a taxable year solely by reason of subdivision (i) of this subparagraph, the taxpayer must take into account in such taxable year the costs and expenditures included in inventory at the end of such year with respect to such goods (or substantially similar goods) on hand or, if no such goods are on hand by the last day of such second taxable year, the estimated cost of goods necessary to satisfy the agreement.

(iii) Subdivision (ii) of this subparagraph does not apply if the goods or type of goods with respect to which the advance payment is received are not identifiable in the year the advance payments are required to be included in income by reason of subdivision (i) of this subparagraph (for example, where an amount is received for a gift certificate).

(2) If subparagraph (1)(i) of this paragraph is applicable to advance payments received with respect to an agreement, any advance payments received with respect to such agreement subsequent to such second taxable year must be included in gross income in the taxable year of receipt. To the extent estimated costs of goods are taken into account in a taxable year pursuant to subparagraph (1)(ii) of this paragraph, such costs may not again be taken into account in another year. In addition, any variances between the costs or estimated costs taken into account pursuant to subparagraph (1)(ii) of this paragraph and the costs actually incurred in fulfilling the taxpayer's obligations under the agreement must be taken into account as an adjustment to the cost of goods sold in the year the taxpayer completes his obligations under such agreement.

(3) For purposes of subparagraph (1) of this paragraph, a taxpayer will be considered to have received ''substantial advance payments'' with respect to an agreement by the last day of a taxable year if the advance payments received with respect to such agreement during such taxable year plus the advance payments received prior to such taxable year pursuant to such agreement, equal or exceed the total costs and expenditures reasonably estimated as includible in inventory with respect to such agreement. Advance payments received in a taxable year with respect to an agreement (such as a gift certificate) under which the goods or type of goods to be sold are not identifiable in such year shall be treated as ''substantial advance payments'' when received.

(4) The application of this paragraph is illustrated by the following example:

Example. In 1971, X, a calendar year accrual method taxpayer, enters into a contract for the sale of goods (properly includible in X's inventory) with a total contract price of $100. X estimates that his total inventoriable costs and expenditures for the goods will be $50. X receives the following advance payments with respect to the contract:

1971	$35
1972	20
1973	15
1974	10
1975	10
1976	10

The goods are delivered pursuant to the customer's request in 1977. X's closing inventory for 1972 of the type of goods involved in the contract is sufficient to satisfy the contract. Since advance payments received by the end of 1972 exceed the inventoriable costs X estimates that he will incur, such payments constitute ''substantial advance payments''. Accordingly, all payments received by the end of 1974, the end of the second taxable year following the taxable year during which ''substantial advance payments'' are received, are includible in gross income for 1974. Therefore, for taxable year 1974 X must include $80 in his gross income. X must include in his cost of goods sold for 1974 the cost of such goods (or similar goods) on hand or, if no such goods are on hand, the estimated inventoriable costs necessary to satisfy the contract. Since no further deferral is allowable for such contract, X must include in his gross income for the remaining years of the contract, the advance payment received each year. Any variance between estimated costs and the costs actually incurred in fulfilling the contract is to be taken into account in 1977, when the goods are delivered. See paragraph (c)(2) of this section.

(d) *Information schedule.* If a taxpayer accounts for advance payments pursuant to paragraph (b)(1)(ii) of this section, he must attach to his income tax return for each taxable year to which such provision applies an annual information schedule reflecting the total amount of advance payments received in the taxable year, the total amount of advance payments received in prior taxable years which has not been included in gross income before the current taxable year, and the total amount of such payments received in prior taxable years which has been included in gross income for the current taxable year.

(e) *Adoption of method.* (1) For taxable years ending on or after December 31, 1969, and before January 1, 1971, a taxpayer (even if he has already filed an income tax return for a taxable year ending within such period) may secure the consent of the Commissioner to change his method of accounting for such year to a method prescribed in paragraph (b)(1)(ii) of this section in the manner prescribed in section 446 and the regulations thereunder, if an application to secure such consent is filed on Form 3115 within 180 days after March 23, 1971.

(2) A taxpayer who is already reporting his income in accordance with a method prescribed in paragraph (b)(1)(ii)*(a)* of this section need not secure the consent of the Commissioner to continue to utilize this method. However, such a taxpayer, for all taxable years ending after March 23, 1971, must comply with the requirements of paragraphs (b)(1)(ii)*(a)* (including the financial reporting requirement) and (d) (relating to an annual information schedule) of this section.

(f) *Cessation of taxpayer's liability.* If a taxpayer has adopted a method prescribed in paragraph (b)(1)(ii) of this section, and if in a taxable year the taxpayer dies, ceases to exist in a transaction other than one to which section 381(a) applies, or his liability under the agreement otherwise ends, then so much of the advance payment as was not includible in his gross income in preceding taxable years shall be included in his gross income for such taxable year.

(g) *Special rule for certain transactions concerning natural resources.* A transaction which is treated as creating a mortgage loan pursuant to section 636 and the regulations thereunder rather than as a sale shall not be considered a ''sale or other disposition'' within the meaning of paragraph (a)(1) of this section. Consequently, any payment received pursuant to such a transaction, which payment would otherwise qualify as an ''advance payment'', will not be treated as an ''advance payment'' for purposes of this section.

[T.D. 7103, 36 FR 5495, Mar. 24, 1971, as amended by T.D. 7397, 41 FR 2641, Jan. 19, 1976; T.D. 8067, 51 FR 393, Jan. 6, 1986]

§ 1.451–6 Election to include crop insurance proceeds in gross income in the taxable year following the taxable year of destruction or damage.

(a) *In general.* (1) For taxable years ending after December 30, 1969, a taxpayer reporting gross income on the cash receipts and disbursements method of accounting may elect to include insurance proceeds received as a result of the destruction of, or damage to, crops in gross income for the taxable year following the taxable year of the destruction or damage, if the taxpayer establishes that, under the taxpayer's normal business practice, the income from those crops would have been included in gross income for any taxable year following the taxable year of the destruction or damage. However, if the taxpayer receives the insurance proceeds in the taxable year following the taxable year of the destruction or damage, the taxpayer shall include the proceeds in gross income for the taxable year of receipt without having to make an election under section 451(d) and this section. For the purposes of this section only, federal payments received as a result of destruction or damage to crops caused by drought, flood, or any other natural disaster, or the inability to plant crops because of such a natural disaster, shall be treated as insurance proceeds received as a result of destruction or damage to crops. The preceding sentence shall apply to payments that are received by the taxpayer after December 31, 1973.

(2) In the case of a taxpayer who receives insurance proceeds as a result of the destruction of, or damage to, two or more specific crops, if such proceeds may, under section 451(d) and this section, be included in gross income for the taxable year following the taxable year of such destruction or damage, and if such taxpayer makes an election under section 451(d) and this section with respect to any portion of such proceeds, then such election will be deemed to cover all of such proceeds which are attributable to crops representing a single trade or business under section 446(d). A separate election must be made with respect to insurance proceeds attributable to each crop which represents a separate trade or business under section 446(d).

(b)(1) *Time and manner of making election.* The election to include in gross income insurance proceeds received as a result of destruction of, or damage to, the taxpayer's crops in the taxable year following the taxable year of such destruction or damage shall be made by means of a statement attached to the taxpayer's return (or an amended return) for the taxable year of destruction or damage. The statement shall include the name and address of the taxpayer (or his duly authorized representative), and shall set forth the following information:

(i) A declaration that the taxpayer is making an election under section 451(d) and this section;

(ii) Identification of the specific crop or crops destroyed or damaged;

(iii) A declaration that under the taxpayer's normal business practice the income derived from the crops which were destroyed or damaged would have been included in this gross income for a taxable year following the taxable year of such destruction or damage;

(iv) The cause of destruction or damage of crops and the date or dates on which such destruction or damage occurred;

(v) The total amount of payments received from insurance carriers, itemized with respect to each specific crop and with respect to the date each payment was received;

(vi) The name(s) of the insurance carrier or carriers from whom payments were received.

(2) *Scope of election.* Once made, an election under section 451(d) is binding for the taxable year for which made unless the district director consents to a revocation of such election. Requests for consent to revoke an election under section 451(d) shall be made by means of a letter to the district director for the district in which the taxpayer is required to file his return, setting forth the taxpayer's name, address, and identification number, the year for which it is desired to revoke the election, and the reasons therefor.

[T.D. 7097, 36 FR 5215, Mar. 18, 1971, as amended by T.D. 7526, 42 FR 64624, Dec. 27, 1977; T.D. 8429, 57 FR 38595, Aug. 26, 1992]

§1.451–7 Election relating to livestock sold on account of drought.

(a) *In general.* Section 451(e) provides that for taxable years beginning after December 31, 1975, a taxpayer whose principal trade or business is farming (within the meaning of §6420 (c)(3)) and who reports taxable income on the cash receipts and disbursements method of accounting may elect to defer for one year a certain portion of income. The income which may be deferred is the amount of gain realized during the taxable year from the sale or exchange of that number of livestock sold or exchanged solely on account of a drought which caused an area to be designated as eligible for assistance by the Federal Government (regardless of whether the designation is made by the President or by an agency or department of the Federal Government). That number is equal to the excess of the number of livestock sold or exchanged over the number which would have been sold or exchanged had the taxpayer followed its usual business practices in the absence of such drought. For example, if in the past it has been a taxpayer's practice to sell or exchange annually 400 head of beef cattle but due to qualifying drought conditions 550 head were sold in a given taxable year, only income from the sale of 150 head may qualify for deferral under this section. The election is not available with respect to livestock described in section 1231(b)(3) (relating to cattle, horses (and other livestock) held by the taxpayer for 24 months (12 months) and used for draft, breeding, dairy, or sporting purposes).

(b) *Usual business.* The determination of the number of animals which a taxpayer would have sold if it had followed its usual business practice in the absence of drought will be made in light of all facts and circumstances. In the case of taxpayers who have not established a usual business practice, reliance will be placed upon the usual business practice of similarly situated taxpayers in the same general region as the taxpayer.

(c) *Special rules*—(1) *Connection with drought area.* To qualify under section 451(e) and this section, the livestock need not be raised, and the sale or exchange need not take place, in a drought area. However, the sale or exchange of the livestock must occur solely on account of drought conditions, the existence of which affected the water, grazing, or other requirements of the livestock so as to necessitate their sale or exchange.

(2) *Sale prior to designation of area as eligible for Federal assistance.* The provisions of this section will apply regardless of whether all or a portion of the excess number of animals were sold or exchanged before an area becomes eligible for Federal assistance, so long as the drought which caused such dispositions also caused the area to be designated as eligible for Federal assistance.

(d) *Classifications of livestock with respect to which the election may be made.* The election to have the provisions of section 451(e) apply must be made separately for each broad generic classification of animals (e.g., hogs, sheep, cattle) for which the taxpayer wishes the provisions to apply. Separate elections shall not be made solely by reason of the animals' age, sex, or breed.

(e) *Computation*—(1) *Determination of amount deferred.* The amount of income which may be deferred for a classification of livestock pursuant to this section shall be determined in the following manner. The total amount of income realized from the sale or exchange of all livestock in the classification during the taxable year shall be divided by the total number of all such livestock sold. The resulting quotient shall then be multiplied by the excess number of such livestock sold on account of drought.

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

Example. A, a calendar year taxpayer, normally sells 100 head of beef cattle a year. As the result of drought conditions existing during 1976, A sells 135 head during that year. A realizes $35,100 of income from the sale of the 135 head. On August 9, 1976, as a result of the drought, the affected area was declared a disaster area thereby eligible for Federal assistance. The amount of income which A may defer until 1977, presuming the other provisions of this section are met, is determined as follows:

$35,100 (total income from sales of beef cattle)/135 (total number of beef cattle sold)×35 (excess number of beef cattle sold, i.e. 135−100)=$9,100 (amount which A may defer until 1977)

(f) *Successive elections.* If a taxpayer makes an election under section 451(e) for successive years, the amount deferred from one year to the next year shall not be deemed to have been received from the sale or exchange of livestock during the later year. In addition, in determining the taxpayer's normal business practice for the later year, earlier years for which an election under section 451(e) was made shall not be considered.

(g) *Time and manner of making election.* The election provided for in this section must be made by the later of (1) the due date for filing the income tax return (determined with regard to any extensions of time granted the taxpayer for filing such return) for the taxable year in which the early sale of livestock occurs, or (2) (the 90th day after the date these regulations are published as a Treasury decision in the FEDERAL REGISTER). The election must be made separately for each taxable year to which it is to apply. It must be made by attaching a statement to the return or an amended return for such taxable year. The statement shall include the name and address of the taxpayer and shall set forth the following information for each classification of livestock for which the election is made:

(1) A declaration that the taxpayer is making an election under section 451(e);

(2) Evidence of the existence of the drought conditions which forced the early sale or exchange of the livestock and the date, if known, on which an area was designated as eligible for assistance by the Federal Government as a result of the drought conditions.

(3) A statement explaining the relationship of the drought area to the taxpayer's early sale or exchange of the livestock;

(4) The total number of animals sold in each of the three preceding years;

(5) The number of animals which would have been sold in the taxable year had the taxpayer followed its normal business practice in the absence of drought;

(6) The total number of animals sold, and the number sold on account of drought, during the taxable year; and

(7) A computation, pursuant to paragraph (e) of this section, of the amount of income to be deferred for each such classification.

(h) *Revocation of election.* Once an election under this section is made for a taxable year, it may be revoked only with the approval of the Commissioner.

(i) *Cross reference.* For provisions relating to the involuntary conversion of livestock sold on account of drought see section 1033(e) and the regulations thereunder.

[T.D. 7526, 42 FR 64624, Dec. 27, 1977]

§§1.453–1—1.453–2 [Reserved]

§1.453–3 Purchaser evidences of indebtedness payable on demand or readily tradable.

(a) *In general.* A bond or other evidence of indebtedness (hereinafter in this section referred to as an obligation) issued by any person and payable on demand shall not be treated as an evidence of indebtedness of the purchaser in applying section 453(b) to a sale or other disposition of real property or to a casual sale or other casual disposition of personal property. In addition, an obligation issued by a corporation or a government or political subdivision thereof—

(1) With interest coupons attached (whether or not the obligation is readily tradable in an established securities market),

(2) In registered form (other than an obligation issued in registered form which the taxpayer establishes will not be readily tradable in an established securities market), or

(3) In any other form designed to render such obligation readily tradable in an established securities market shall not be treated as an evidence of indebtedness of the purchaser in applying section 453(b) to a sale or other disposition of real property or to a casual sale or other casual disposition of personal property. For purposes of this section, an obligation is to be considered in registered form if it is registered as to principal, interest, or both and if its transfer must be effected by the surrender of the old instrument and either the reissuance by the corporation of the old instrument to the new holder or the issuance by the corporation of a new instrument to the new holder.

(b) *Treatment as payment.* If under section 453(b)(3) an obligation is not treated as an evidence of indebtedness of the purchaser, then—

(1) For purposes of determining whether the payments received in the taxable year of the sale or disposition exceed 30 percent of the selling price, and

(2) For purposes of returning income on the installment method during the taxable year of the sale or disposition

or in a subsequent taxable year, the receipt by the seller of such obligation shall be treated as a payment. The rules stated in this paragraph may be illustrated by the following examples:

$$\frac{\text{\$250,000 payment (i.e., 250 of corporation Y's registered bonds each with a principal amount and fair market value of \$1,000)}}{\text{\$1 million selling price (i.e., \$250,000 of corporation Y's registered bonds plus promissory note of \$750,000)}} = \text{25 percent}$$

Example (1). On July 1, 1970, A, an individual on the cash method of accounting reporting on a calendar year basis, transferred all of his stock in corporation X (traded on an established securities market and having a fair market value of $1 million) to corporation Y in exchange for 250 of corporation Y's registered bonds (which are traded in an over-the-counter bond market) each with a principal amount and fair market value of $1,000 (with interest payable at the rate of 8 percent per year), and Y's unsecured promissory note, with a principal amount of $750,000. At the time of such exchange A's basis in the corporation X stock is $900,000. The promissory note is payable at the rate of $75,000 annually, due on July 1, of each year following 1970, until the principal balance is paid. The note provides for the payment of interest at the rate of 10 percent per year also payable on July 1 of each year. Under the rule stated in subparagraph (1) of this paragraph, the 250 registered bonds of corporation Y are treated as a payment for purposes of the 30 percent test described in section 453(b)(2)(A)(ii). The payment on account of the bonds equals 25 percent of the selling price determined as follows:

Since the payments received in the taxable year of the sale do not exceed 30 percent of the selling price and the sales price exceeds $1,000, A may report the income received on the sale of his corporation X stock on the installment method. A elects to report the income on the installment method. The gross profit to be realized when the corporation X stock is fully paid for is 10 percent of the total contract price, computed as follows: $100,000 gross profit (i.e., $1 million contract price less $900,000 basis in corporation X stock) over $1 million contract price. However, since subparagraph (2) of this paragraph also treats the 250 corporation Y registered bonds as a payment for purposes of reporting income, A must include $25,000 (i.e., 10 percent times $250,000) in his gross income for calendar year 1970, the taxable year of sale.

Example (2). Assume the same facts as in example (1). Assume further that on July 1, 1971, corporation Y makes its first installment payment to A under the terms of the unsecured promissory note with 75 more of its $1,000 registered bonds. A must include $7,500 (i.e., 10 percent gross profit percentage times $75,000) in his gross income for calendar year 1971. In addition, A includes the interest payment made by corporation Y on July 1, in his gross income for 1971.

(c) *Payable on demand.* Under section 453(b)(3), an obligation shall be treated as payable on demand only if the obligation is treated as payable on demand under applicable state or local law.

(d) *Designed to be readily tradable in an established securities market*—(1) *In general.* Obligations issued by a corporation or government or political subdivision thereof will be deemed to be in a form designed to render such obligations readily tradable in an established securities market if—

(i) Steps necessary to create a market for them are taken at the time of issuance (or later, if taken pursuant to an expressed or implied agreement or understanding which existed at the time of issuance),

(ii) If they are treated as readily tradable in an established securities market under subparagraph (2) of this paragraph, or

(iii) If they are convertible obligations to which paragraph (e) of this section applies.

(2) *Readily tradable in an established securities market.* An obligation will be treated as readily tradable in an established securities market if—

(i) The obligation is part of an issue or series of issues which are readily tradable in an established securities market, or

(ii) The corporation issuing the obligation has other obligations of a comparable character which are described in subdivision (i) of this subparagraph.

For purposes of subdivision (ii) of this subparagraph, the determination as to whether there exist obligations of a comparable character depends upon the particular facts and circumstances. Factors to be considered in making such determination include, but are not limited to, substantial similarity with respect to the presence and nature of security for the obligation, the number of obligations issued (or to be issued), the number of holders of such obligation, the principal amount of the obligation, and other relevant factors.

(3) *Readily tradable.* For purposes of subparagraph (2)(i) of this paragraph, an obligation shall be treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such obligation or is part of an issue a portion of which is in fact traded in an established securities market.

(4) *Established securities market.* For purposes of this paragraph, the term established securities market includes (i) a national securities exchange which is registered under section 6 of the Securities and Exchange Act of 1934 (15 U.S.C. 78f), (ii) an exchange which is exempted from registration under section 5 of the Securities Exchange Act of 1935 (15 U.S.C. 78e) because of its limited volume of transactions, and (iii) any over-the-counter market. For purposes of this subparagraph, an over-the-counter market is reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of obligations by identified brokers or dealers, other than a quotation sheet prepared and distributed by a broker or dealer in the regular course of his business and containing only quotations of such broker or dealer.

(5) *Examples.* The rules stated in this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1971, 25 individuals owning equal interests in a tract of land with a fair market value of $1 million sell the land to corporation Y. The $1 million sales price is represented by 25 bonds issued by corporation Y each having a face value of $40,000. The bonds are not in registered form and do not have interest coupons attached, and, in addition, are payable in 120 equal installments each due on the first business day of each month. In addition, the bonds are negotiable and may be assigned by the holder to any other person. However, the bonds are not quoted by any brokers or dealers who deal in corporate bonds, and, furthermore, there are no comparable obligations of corporation Y (determined with reference to the characteristics set forth in subparagraph (2) of this paragraph) which are so quoted. Therefore, the bonds are not treated as readily tradable in an established securities market. In addition, under the particular facts and circumstances stated, the bonds will not be considered to be in a form designed to render them readily tradeable in an established securities market. Since the bonds are not in registered form, do not have coupons attached, are not in a form designed to render them readily tradable in an established securities market, the receipt of such bonds by the holder is not treated as a payment for purposes of section 453(b), notwithstanding that they are freely assignable.

Example (2). On April 1, 1972, corporation M purchases in a casual sale of personal property a fleet of trucks from corporation N in exchange for corporation M's negotiable notes, not in registered form and without coupons attached. The corporation M notes are comparable to earlier notes issued by corporation M, which notes are quoted in the Eastern Bond section of the National daily quotation sheet, which is an interdealer quotation system. Both issues of notes are unsecured, held by more than 100 holders, have a maturity date of more than 5 years, and were issued for a comparable principal amount. On the basis of these similar characteristics it appears that the latest notes will also be readily tradable. Since an interdealer system reflects an over-the-counter market, the earlier notes are treated as readily tradable in an established securities market. Since the later notes are obligations comparable to the earlier ones, which are treated as readily tradable in an established securities market, the later notes are also treated as readily tradable in an established securities market (whether or not such notes are actually traded).

(e) *Special rule for convertible securities*—(1) *General rule.* For purposes of paragraph (d)(1) of this section, if an obligation contains a right whereby the holder of such obligation may convert it directly or indirectly into another obligation which would be treated as a payment under paragraph (b) of this section or may convert it directly or indirectly into stock which would be treated as readily tradable or designed to be readily tradable in an established securities market under paragraph (d) of this section, the convertible obligation shall be considered to be in a form designed to render such obligation readily tradable in an established securities market unless such obligation is convertible only at a substantial discount. In determining whether the stock or obligation, into which an obligation is convertible, is readily tradable or designed to be readily tradable in an established securities market, the rules stated in paragraph (d) of this section shall apply, and for purposes of such paragraph (d) if such obligation is convertible into stock then the term ‘‘stock’’ shall be substituted for the term ‘‘obligation’’ wherever it appears in such paragraph (d).

(2) *Substantial discount rule.* Whether an obligation is convertible at a substantial discount depends upon the particular facts and circumstances. A substantial discount shall be considered to exist if at the time the convertible obligation is issued, the fair market value of the stock or obligation into which the obligation is convertible is less than 80 percent of the fair market value of the obligation (determined by taking into account all relevant factors, including proper discount to reflect the fact that the convertible obligation is not readily tradable in an established securities market and any additional consideration required to be paid by the taxpayer). Also, if a privilege to convert an obligation into stock or an obligation which is readily tradable in an established securities market may not be exercised within a period of 1 year from the date the obligation is issued, a substantial discount shall be considered to exist.

(f) *Effective date.* The provisions of this section shall apply to sales or other dispositions occurring after May 27, 1969, which are not made pursuant to a binding written contract entered into on or before such date. No inference shall be drawn from this section as to any question of law concerning the application of section 453 to sales or other dispositions occurring on or before May 27, 1969.

[T.D. 7197, 37 FR 13532, July 11, 1972]

§ 1.453–4 Sale of real property involving deferred periodic payments.

(a) *In general.* Sales of real property involving deferred payments include (1) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid, and (2) sales in which there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments.

(b) *Classes of sales.* Such sales, under either paragraph (a) (1) or (2) of this section, fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of real property which may be accounted for on the installment method, that is, sales of real property in which (i) there are no payments during the taxable year of the sale or (ii) the payments in such taxable year (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price, or

(2) Deferred-payment sales of real property in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed 30 percent of the selling price.

(c) *Determination of ‘‘selling price’’.* In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall, for the purpose of determining whether a sale is on the installment plan, be included as a part of the ‘‘selling price’’; and for the purpose of determining the payments and the total contract price as those terms are used in section 453, and §§ 1.453–1 through 1.453–7, the amount of such mortgage shall be included only to the extent that it exceeds the basis of the property. The term ‘‘payments’’ does not include amounts received by the vendor in the year of sale from the disposition to a third person of notes given by the vendee as part of the purchase price which are due and payable in subsequent years. Commissions and other selling expenses paid or incurred by the vendor shall not reduce the amount of the payments, the total contract price, or the selling price.

[T.D. 6500, 25 FR 11715, Nov. 26, 1960]

§ 1.453–5 Sale of real property treated on installment method.

(a) *In general.* In any transaction described in paragraph (b)(1) of § 1.453–4, that is, sales of real property in which there are no payments during the year of sale or the payments in that year do not exceed 30 percent of the selling price, the vendor may return as income from each such transaction in any taxable year that proportion of the installment payments actually received in that year which the gross profit (as described in paragraph (b) of §1.453–1) realized or to be realized when the property is paid for bears to the total contract price. In any case, the sale of each lot or parcel of a subdivided tract must be treated as a separate transaction and gain or loss computed accordingly. (See paragraph (a) of §1.61–6.)

(b) *Defaults and repossessions*—(1) *Effective date.* This paragraph shall apply only with respect to taxable years beginning before September 3, 1964, in respect of which an election has not been properly made to have the provisions of section 1038 apply. For rules applicable to taxable years beginning after September 2, 1964, and for taxable years beginning after December 31, 1957, to which such an election applies, see section 1038, and §§1.1038–1 through 1.1038–3.

(2) *Gain or loss on reacquisition of property.* If the purchaser of real property on the installment plan defaults in any of his payments, and the vendor returning income on the installment method reacquires the property sold, whether title thereto had been retained by the vendor or transferred to the purchaser, gain or loss for the year in which the reacquisition occurs is to be computed upon any installment obligations of the purchaser which are satisfied or discharged upon the reacquisition or are applied by the vendor to the purchase or bid price of the property. Such gain or loss is to be measured by the difference between the fair market value at the date of reacquisition of the property reacquired (including the fair market value of any fixed improvements placed on the property by the purchaser) and the basis in the hands of the vendor of the obligations of the purchaser which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the reacquisition.

(3) *Fair market value of reacquired property.* If the property reacquired is bid in by the vendor at a foreclosure sale, the fair market value of the property shall be presumed to be the purchase or bid price thereof in the absence of clear and convincing proof to the contrary.

(4) *Basis of obligations.* The basis in the hands of the vendor of the obligations of the purchaser satisfied, discharged, or applied upon the reacquisition of the property will be the excess of the face value of such obligations over an amount equal to the income which would be returnable were the obligations paid in full. For definition of the basis of an installment obligation, see section 453(d)(2) and paragraph (b)(2) of §1.453–9.

(5) *Bad debt deduction.* No deduction for a bad debt shall in any case be taken on account of any portion of the obligations of the purchaser which are treated by the vendor as not having been satisfied, discharged, or applied upon the reacquisition of the property, unless it is clearly shown that after the property was reacquired the purchaser remained liable for such portion; and in no event shall the amount of the deduction exceed the basis in the hands of the vendor of the portion of the obligations with respect to which the purchaser remained liable after the reacquisition. See section 166 and the regulations thereunder.

(6) *Basis of reacquired property.* If the property reacquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition, including the fair market value of any fixed improvements placed on the property by the purchaser.

[T.D. 6500, 25 FR 11716, Nov. 26, 1960, as amended by T.D. 6916, 32 FR 5923, Apr. 13, 1967]

§1.453–6 Deferred payment sale of real property not on installment method.

(a) *Value of obligations.* (1) In transactions included in paragraph (b)(2) of §1.453–4, that is, sales of real property involving deferred payments in which the payments received during the year of sale exceed 30 percent of the selling price, the obligations of the purchaser received by the vendor are to be considered as an amount realized to the extent of their fair market value in ascertaining the profit or loss from the transaction. Such obligations, however, are not considered in determining whether the payments during the year of sale exceed 30 percent of the selling price.

(2) If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount thereof being the difference between the reduced basis as provided in the preceding sentence and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value.

(b) *Repossession of property where title is retained by vendor*—(1) *Gain or loss on repossession.* If the vendor in sales referred to in paragraph (a) of this section has retained title to the property and the purchaser defaults in any of his payments, and the vendor repossesses the property, the difference between—

(i) The entire amount of the payments actually received on the contract and retained by the vendor plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser, and

(ii) The sum of the profits previously returned as income in connection therewith and an amount representing what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the purchaser had the sale not been made, will constitute gain or loss, as the case may be, to the vendor for the year in which the property is repossessed.

(2) *Basis of repossessed property.* The basis of the property described in subparagraph (1) of this paragraph in the hands of the vendor will be the original basis at the time of the sale plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser, except that, with respect to repossessions occurring after September 18, 1958, the basis of the property shall be reduced by what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the purchaser if the sale had not been made.

(c) *Reacquisition of property where title is transferred to purchaser*—(1) *Gain or loss on reacquisition.* If the vendor in sales described in paragraph (a) of this section has previously transferred title to the purchaser, and the purchaser defaults in any of his payments, and the vendor accepts a voluntary reconveyance of the property, in partial or full satisfaction of the unpaid portion of the purchase price, the receipt of the property so reacquired, to the extent of its fair market value at that time, including the fair market value of fixed improvements placed on the property by the purchaser, shall be considered as the receipt of payment on the obligations satisfied. If the fair market value of the property is greater than the basis of the obligations of the purchaser so satisfied (generally, such basis being the fair market value of such obligations previously recognized in computing income), the excess constitutes ordinary income. If the value of such property is less than the basis of such obligations, the difference may be deducted as a bad debt if uncollectible, except that, if the obligations satisfied are securities (as defined in section 165(g)(2)(C)), any gain or loss resulting from the transaction is a capital gain or loss subject to the provisions of sections 1201 through 1241.

(2) *Basis of reacquired property.* If the reacquired property described in subparagraph (1) of this paragraph is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition, including the fair market value of the fixed improvements placed on the property by the purchaser. See section 166 and the regulations thereunder with respect to property reacquired by the vendor in a foreclosure proceeding.

(d) *Effective date.* Paragraphs (b) and (c) of this section shall apply only with respect to taxable years beginning before September 3, 1964, in respect of which an election has not been properly made to have the provisions of section 1038 apply. For rules applicable to taxable years beginning after September 2, 1964, and for taxable years beginning after December 31, 1957, to which such an election applies, see section 1038, and §§ 1.1038–1 through 1.1038–3.

[T.D. 6500, 25 FR 11716, Nov. 26, 1960, as amended by T.D. 6916, 32 FR 5923, Apr. 13, 1967]

§§ 1.453–7—1.453–8 [Reserved]

§ 1.453–9 Gain or loss on disposition of installment obligations.

(a) *In general.* Subject to the exceptions contained in section 453(d)(4) and paragraph (c) of this section, the entire amount of gain or loss resulting from any disposition or satisfaction of installment obligations, computed in accordance with section 453(d), is recognized in the taxable year of such disposition or satisfaction and shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received by the taxpayer.

(b) *Computation of gain or loss.* (1) The amount of gain or loss resulting under paragraph (a) of this section is the difference between the basis of the obligation and (i) the amount realized, in the case of satisfaction at other than face value or in the case of a sale or exchange, or (ii) the fair market value of the obligation at the time of disposition, if such disposition is other than by sale or exchange.

(2) The basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

(3) The application of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example (1). In 1960 the M Corporation sold a piece of unimproved real estate to B for $20,000. The company acquired the property in 1948 at a cost of $10,000. During 1960 the company received $5,000 cash and vendee's notes for the remainder of the selling price, or $15,000, payable in subsequent years. In 1962, before the vendee made any further payments, the company sold the notes for $13,000 in cash. The corporation makes its returns on the calendar year basis. The income to be reported for 1962 is $5,500, computed as follows:

Proceeds of sale of notes		$13,000
Selling price of property	$20,000	
Cost of property	10,000	
Total profit	10,000	
Total contract price	20,000	
Percent of profit, or proportion of each payment returnable as income, $10,000 divided by $20,000, 50 percent.		
Face value of notes	15,000	
Amount of income returnable were the notes satisfied in full, 50 percent of $15,000	7,500	
Basis of obligation—excess of face value of notes over amount of income returnable were the notes satisfied in full	7,500	
Taxable income to be reported for 1962		5,500

Example (2). Suppose in example (1) the M Corporation, instead of selling the notes, distributed them in 1962 to its shareholders as a dividend, and at the time of such distribution, the fair market value of the notes was $14,000. The income to be reported for 1962 is $6,500, computed as follows:

Fair market value of notes	$14,000
Basis of obligation—excess of face value of notes over amount of income returnable were the notes satisfied in full (computed as in example (1))	7,500
Taxable income to be reported for 1962	6,500

(c) *Disposition from which no gain or loss is recognized.* (1)(i) Under section 453(d)(4)(A), no gain or loss shall be recognized to a distributing corporation with respect to the distribution made after November 13, 1966, of installment obligations if *(a)* the distribution is made pursuant to a plan for the complete liquidation of a subsidiary under section 332, and *(b)* the basis of the such obligations in the hands of the distributee is determined under section 334(b)(1).

(ii) Under section 453(d)(4)(B), no gain or loss shall be recognized to a distributing corporation with respect to the distribution of installment obligations if the distribution is made, pursuant to a plan for the complete liquidation of a corporation which meets the requirements of section 337, under conditions whereby no gain or loss would have been recognized to the corporation had such installment obligations been sold or exchanged on the day of the distribution. The preceding sentence shall not apply to the extent that under section 453(d)(1) gain to the distributing corporation would be considered as gain to which section 341(f)(2), 617(d)(1), 1245(a)(1), 1250(a)(1), 1251(c)(1), 1252(a)(1), or 1254(a)(1) applies, computed under the principles of the regulations under such provisions. See paragraph (d) of § 1.1245–6, paragraph (c)(6) of § 1.1250–1, paragraph (e)(6) of § 1.1251–1, paragraph (d)(3) of § 1.1252–1, and paragraph (d) of § 1.1254–1.

(2) Where the Code provides for exceptions to the recognition of gain or loss in the case of certain dispositions, no gain or loss shall result under section 453(d) in the case of a disposition of an installment obligation. Such exceptions include: Certain transfers to corporations under sections 351 and 361; contributions of property to a partnership by a partner under section 721; and distributions by a partnership to a partner under section 731 (except as provided by section 736 and section 751).

(3) Any amount received by a person in payment or settlement of an installment obligation acquired in a transaction described in subparagraphs (1) or (2) of this paragraph (other than an amount received by a stockholder with respect to an installment obligation distributed to him pursuant to section 337) shall be considered to have the character it would have had in the hands of the person from whom such installment obligation was acquired.

(d) *Carryover of installment method.* For the treatment of income derived from installment obligations received in transactions to which section 381 (a) is applicable, see section 381(c)(8) and the regulations thereunder.

(e) *Installment obligations transmitted at death.* Where installment obligations are transmitted at death, see section 691(a)(4) and the regulations thereunder for the treatment of amounts considered income in respect of a decedent.

(f) *Losses.* See subchapter P (section 1201 and following), chapter 1 of the Code, as to the limitation on capital losses sustained by corporations and the limitation as to both capital gains and capital losses of individuals.

(g) *Disposition of installment obligations to life insurance companies.* (1) Notwithstanding the provisions of section 453(d)(4) and paragraph (c) of this section or any provision of subtitle A relating to the nonrecognition of gain, the entire amount of any gain realized on the disposition of an installment obligation by any person, other than a life insurance company (as defined in section 801(a) and paragraph (b) of § 1.801–3), to a life insurance company or to a partnership of which a life insurance company is a partner shall be recognized and treated in accordance with section 453(d)(1) and paragraphs (a) and (b) of this section. If a corporation which is a life insurance company for the taxable year was a corporation which was not a life insurance company for the preceding taxable year, such corporation shall be treated, for purposes of section 453(d)(1) and this paragraph, as having transferred to a life insurance company, on the last day of the preceding taxable year, all installment obligations which it held on such last day. The gain, if any, realized by reason of the installment obligations being so transferred shall be recognized and treated in accordance with section 453(d)(1) and paragraphs (a) and (b) of this section. Similarly, a partnership of which a life insurance company becomes a partner shall be treated, for purposes of section 453(d)(1) and this paragraph, as having transferred to a life insurance company, on the last day of the preceding taxable year of such partnership, all installment obligations which it holds at the time such life insurance company becomes a partner. The gain, if any, realized by reason of the installment obligations being so transferred shall be recognized and treated in accordance with section 453(d)(1) and paragraphs (a) and (b) of this section.

(2) The provisions of section 453(d)(5) and subparagraph (1) of this paragraph shall not apply to losses sustained in connection with the disposition of installment obligations to a life insurance company.

(3) For the effective date of the provisions of section 453(d)(5) and this paragraph, see paragraph (f) of § 1.453–10.

(4) Application of the provisions of this paragraph may be illustrated by the following examples:

Example (1). A, an individual, in a transaction to which section 351 applies, transfers in 1961 certain assets, including installment obligations, to a new corporation, X, which qualifies as a life insurance company (as defined in section 801(a)) for the year 1961. A makes his return on the calendar year basis. Section 453(d)(5) provides that the nonrecognition provisions of section 351 will not apply to the installment obligations transferred by A to X Corporation. Therefore, the entire amount of any gain realized by A on the transfer of the installment obligations shall be recognized in 1961, with the amount of any such gain computed in accordance with the provisions of section 453(d)(1) and paragraph (b) of this section.

Example (2). The M Corporation did not qualify as a life insurance company (as defined in section 801(a)) for the taxable year 1958. On December 31, 1958, it held $60,000 of installment obligations. The M Corporation qualified as a life insurance company for the taxable year 1959. Accordingly, the M Corporation is treated as having transferred to a life insurance company, on December 31, 1958, the $60,000 of installment obligations it held on such date. The gain, if any, realized by M by reason of such installment obligations being so transferred shall be recognized in the taxable year 1958, with the amount of any such gain computed in accordance with the provisions of section 453(d)(1) and paragraph (b) of this section.

Example (3). During its taxable year 1958, none of the partners of the N partnership qualified as a life insurance company (as defined in section 801(a)). The N partnership held $30,000 of installment obligations on December 31, 1958. On July 30, 1959, the O Corporation, a life insurance company (as defined in section 801(a)), became a partner in the partnership. The N partnership held $50,000 of installment obligations on July 30, 1959. Pursuant to section 453(d)(5), the N partnership is treated as having transferred to a life insurance company, on December 31, 1958, the $50,000 of installment obligations it held on July 30, 1959. The gain, if any, realized by the N partnership by reason of such installment obligations being so transferred shall be recognized in the taxable year 1958, with the amount of any such gain computed in accordance with the provisions of section 453(d)(1) and paragraph (b) of this section.

Example (4). In 1960, the P Corporation, in a reorganization qualifying under section 368(a), transferred certain assets (including installment obligations) to the R Corporation, a life insurance company as defined in section 801(a). P realized a loss upon the transfer of the installment obligations, which was not recognized under section 361. Pursuant to subparagraph (2) of paragraph (c) of this section, no loss with respect to the transfer of these obligations will be recognized to P under section 453(d)(1).

[T.D. 6500, 25 FR 11718, Nov. 26, 1960, as amended by T.D. 6590, 27 FR 1319, Feb. 13, 1962; T.D. 7084, 36 FR 267, Jan. 8, 1971; T.D. 7418, 41 FR 18812, May 7, 1976; T.D. 8586, 60 FR 2500, Jan. 10, 1995]

§1.453–10 Effective date.

(a) Except as provided in this section, the provisions of section 453 and §§1.453–1 through 1.453–9 shall apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

(b) The provisions of paragraphs (a) (2) and (3), (b), and (c) of §1.453–8 shall apply to taxable years ending after December 17, 1958.

(c) Under the provisions of sections 453(b) and 7851(a)(1)(C), section 453(b)(1) and the regulations with respect thereto shall also apply—

(1) To a sale or other disposition during a taxable year beginning before January 1, 1954, only if the income was returnable (by reason of section 44(b) of the Internal Revenue Code of 1939) on the basis and in the manner prescribed in section 44(a) of such code.

(2) To a sale or other disposition during a taxable year beginning after December 31, 1953, and ending before August 17, 1954, though such taxable year is subject to the provisions of the Internal Revenue Code of 1939.

(d) Under the provisions of sections 453(c)(1)(B) and 7851(a)(1)(C) section 453(c) and the regulations with respect thereto shall also apply to taxable years beginning after December 31, 1953, and ending before August 17, 1954, though such taxable years are subject to the provisions of the Internal Revenue Code of 1939.

(e) The provisions of paragraph (b)(3) of §1.453–6 shall apply to repossessions occurring after December 18, 1958.

(f) The provisions of section 453(d)(5) and paragraph (g) of §1.453–9 shall apply to taxable years ending after December 31, 1957, but only as to transfers or other dispositions of installment obligations occurring after such date.

[T.D. 6500, 25 FR 11718, Nov. 26, 1960, as amended by T.D. 6590, 27 FR 1320, Feb. 13, 1962; T.D. 6682, 28 FR 11177, Oct. 18, 1963]

§ 1.453–11 Installment obligations received from a liquidating corporation.

(a) *In general*—(1) *Overview.* Except as provided in section 453(h)(1)(C) (relating to installment sales of depreciable property to certain closely related persons), a qualifying shareholder (as defined in paragraph (b) of this section) who receives a qualifying installment obligation (as defined in paragraph (c) of this section) in a liquidation that satisfies section 453(h)(1)(A) treats the receipt of payments in respect of the obligation, rather than the receipt of the obligation itself, as a receipt of payment for the shareholder's stock. The shareholder reports the payments received on the installment method unless the shareholder elects otherwise in accordance with § 15a.453–1(d) of this chapter.

(2) *Coordination with other provisions*—(i) *Deemed sale of stock for installment obligation.* Except as specifically provided in section 453(h)(1)(C), a qualifying shareholder treats a qualifying installment obligation, for all purposes of the Internal Revenue Code, as if the obligation is received by the shareholder from the person issuing the obligation in exchange for the shareholder's stock in the liquidating corporation. For example, if the stock of a corporation that is liquidating is traded on an established securities market, an installment obligation distributed to a shareholder of the corporation in exchange for the shareholder's stock does not qualify for installment reporting pursuant to section 453(k)(2).

(ii) *Special rules to account for the qualifying installment obligation*—(A) *Issue price.* A qualifying installment obligation is treated by a qualifying shareholder as newly issued on the date of the distribution. The issue price of the qualifying installment obligation on that date is equal to the sum of the adjusted issue price of the obligation on the date of the distribution (as determined under § 1.1275–1(b)) and the amount of any qualified stated interest (as defined in § 1.1273–1(c)) that has accrued prior to the distribution but that is not payable until after the distribution. For purposes of the preceding sentence, if the qualifying installment obligation is subject to § 1.446–2 (e.g., a debt instrument that has unstated interest under section 483), the adjusted issue price of the obligation is determined under § 1.446–2(c) and (d).

(B) *Variable rate debt instrument.* If the qualifying installment obligation is a variable rate debt instrument (as defined in § 1.1275–5), the shareholder uses the equivalent fixed rate debt instrument (within the meaning of § 1.1275–5(e)(3)(ii)) constructed for the qualifying installment obligation as of the date the obligation was issued to the liquidating corporation to determine the accruals of original issue discount, if any, and interest on the obligation.

(3) *Liquidating distributions treated as selling price.* All amounts distributed or treated as distributed to a qualifying shareholder incident to the liquidation, including cash, the issue price of qualifying installment obligations as determined under paragraph (a)(2)(ii)(A) of this section, and the fair market value of other property (including obligations that are not qualifying installment obligations) are considered as having been received by the shareholder as the selling price (as defined in § 15a.453–1(b)(2)(ii) of this chapter) for the shareholder's stock in the liquidating corporation. For the proper method of reporting liquidating distributions received in more than one taxable year of a shareholder, see paragraph (d) of this section. An election not to report on the installment method an installment obligation received in the liquidation applies to all distributions received in the liquidation.

(4) *Assumption of corporate liability by shareholders.* For purposes of this section, if in the course of a liquidation a shareholder assumes secured or unsecured liabilities of the liquidating corporation, or receives property from the corporation subject to such liabilities (including any tax liabilities incurred by the corporation on the distribution), the amount of the liabilities is added to the shareholder's basis in the stock of the liquidating corporation. These additions to basis do not affect the shareholder's holding period for the stock. These liabilities do not reduce the amounts received in computing the selling price.

(5) *Examples.* The provisions of this paragraph (a) are illustrated by the following examples. Except as otherwise provided, assume in each example that A, an individual who is a calendar-year taxpayer, owns all of the stock of T corporation. A's adjusted tax basis in that stock is $100,000. On February 1, 1998, T, an accrual method taxpayer, adopts a plan of complete liquidation that satisfies section 453(h)(1)(A) and immediately sells all of its assets to unrelated B corporation in a single transaction. The examples are as follows:

Example 1. (i) The stated purchase price for T's assets is $3,500,000. In consideration for the sale, B makes a down payment of $500,000 and issues a 10-year installment obligation with a stated principal amount of $3,000,000. The obligation provides for interest payments of $150,000 on January 31 of each year, with the total principal amount due at maturity.

(ii) Assume that for purposes of section 1274, the test rate on February 1, 1998, is 8 percent, compounded semi-annually. Also assume that a semi-annual accrual period is used. Under §1.1274–2, the issue price of the obligation on February 1, 1998, is $2,368,450. Accordingly, the obligation has $631,550 of original issue discount ($3,000,000–$2,368,450). Between February 1 and July 31, $19,738 of original issue discount and $75,000 of qualified stated interest accrue with respect to the obligation and are taken into account by T.

(iii) On July 31, 1998, T distributes the installment obligation to A in exchange for A's stock. No other property is ever distributed to A. On January 31, 1999, A receives the first annual payment of $150,000 from B.

(iv) When the obligation is distributed to A on July 31, 1998, it is treated as if the obligation is received by A in an installment sale of shares directly to B on that date. Under §1.1275–1(b), the adjusted issue price of the obligation on that date is $2,388,188 (original issue price of $2,368,450 plus accrued original issue discount of $19,738). Accordingly, the issue price of the obligation under paragraph (a)(2)(ii)(A) of this section is $2,463,188, the sum of the adjusted issue price of the obligation on that date ($2,388,188) and the amount of accrued but unpaid qualified stated interest ($75,000).

(v) The selling price and contract price of A's stock in T is $2,463,188, and the gross profit is $2,363,188 ($2,463,188 selling price less A's adjusted tax basis of $100,000). A's gross profit ratio is thus 96 percent (gross profit of $2,363,188 divided by total contract price of $2,463,188).

(vi) Under §§1.446–2(e)(1) and 1.1275–2(a), $98,527 of the $150,000 payment is treated as a payment of the interest and original issue discount that accrued on the obligation from July 31, 1998, to January 31, 1999 ($75,000 of qualified stated interest and $23,527 of original issue discount). The balance of the payment ($51,473) is treated as a payment of principal. A's gain recognized in 1999 is $49,414 (96 percent of $51,473).

Example 2. (i) T owns Blackacre, unimproved real property, with an adjusted tax basis of $700,000. Blackacre is subject to a mortgage (underlying mortgage) of $1,100,000. A is not personally liable on the underlying mortgage and the T shares held by A are not encumbered by the underlying mortgage. The other assets of T consist of $400,000 of cash and $600,000 of accounts receivable attributable to sales of inventory in the ordinary course of business. The unsecured liabilities of T total $900,000.

(ii) On February 1, 1998, T adopts a plan of complete liquidation complying with section 453(h)(1)(A), and promptly sells Blackacre to B for a 4-year mortgage note (bearing adequate stated interest and otherwise meeting all of the requirements of section 453) in the face amount of $4 million. Under the agreement between T and B, T (or its successor) is to continue to make principal and interest payments on the underlying mortgage. Immediately thereafter, T completes its liquidation by distributing to A its remaining cash of $400,000 (after payment of T's tax liabilities), accounts receivable of $600,000, and the $4 million B note. A assumes T's $900,000 of unsecured liabilities and receives the distributed property subject to the obligation to make payments on the $1,100,000 underlying mortgage. A receives no payments from B on the B note during 1998.

(iii) Unless A elects otherwise, the transaction is reported by A on the installment method. The selling price is $5 million (cash of $400,000, accounts receivable of $600,000, and the B note of $4 million). The total contract price also is $5 million. A's adjusted tax basis in the T shares, initially $100,000, is increased by the $900,000 of unsecured T liabilities assumed by A and by the obligation (subject to which A takes the distributed property) to make payments on the $1,100,000 underlying mortgage on Blackacre, for an aggregate adjusted tax basis of $2,100,000. Accordingly, the gross profit is $2,900,000 (selling price of $5 million less aggregate adjusted tax basis of $2,100,000). The gross profit ratio is 58 percent (gross profit of $2,900,000 divided by the total contract price of $5 million). The 1998 payments to A are $1 million ($400,000 cash plus $600,000 receivables) and A recognizes gain in 1998 of $580,000 (58 percent of $1 million).

(iv) In 1999, A receives payment from B on the B note of $1 million (exclusive of interest). A's gain recognized in 1999 is $580,000 (58 percent of $1 million).

(b) *Qualifying shareholder.* For purposes of this section, *qualifying shareholder* means a shareholder to which, with respect to the liquidating distribution, section 331 applies. For example, a creditor that receives a distribution from a liquidating corporation, in exchange for the creditor's claim, is not a qualifying shareholder as a result of that distribution regardless of whether the liquidation satisfies section 453(h)(1)(A).

(c) *Qualifying installment obligation*—(1) *In general.* For purposes of this section, *qualifying installment obligation* means an installment obligation (other than an evidence of indebtedness described in § 15a.453–1(e) of this chapter, relating to obligations that are payable on demand or are readily tradable) acquired in a sale or exchange of corporate assets by a liquidating corporation during the 12-month period beginning on the date the plan of liquidation is adopted. See paragraph (c)(4) of this section for an exception for installment obligations acquired in respect of certain sales of inventory. Also see paragraph (c)(5) of this section for an exception for installment obligations attributable to sales of certain property that do not generally qualify for installment method treatment.

(2) *Corporate assets.* Except as provided in section 453(h)(1)(C), in paragraph (c)(4) of this section (relating to certain sales of inventory), and in paragraph (c)(5) of this section (relating to certain tax avoidance transactions), the nature of the assets sold by, and the tax consequences to, the selling corporation do not affect whether an installment obligation is a qualifying installment obligation. Thus, for example, the fact that the fair market value of an asset is less than the adjusted basis of that asset in the hands of the corporation; or that the sale of an asset will subject the corporation to depreciation recapture (e.g., under section 1245 or section 1250); or that the assets of a trade or business sold by the corporation for an installment obligation include depreciable property, certain marketable securities, accounts receivable, installment obligations, or cash; or that the distribution of assets to the shareholder is or is not taxable to the corporation under sections 336 and 453B, does not affect whether installment obligations received in exchange for those assets are treated as qualifying installment obligations by the shareholder. However, an obligation received by the corporation in exchange for cash, in a transaction unrelated to a sale or exchange of noncash assets by the corporation, is not treated as a qualifying installment obligation.

(3) *Installment obligations distributed in liquidations described in section 453(h)(1)(E)*—(i) *In general.* In the case of a liquidation to which section 453(h)(1)(E) (relating to certain liquidating subsidiary corporations) applies, a qualifying installment obligation acquired in respect of a sale or exchange by the liquidating subsidiary corporation will be treated as a qualifying installment obligation if distributed by a controlling corporate shareholder (within the meaning of section 368(c)) to a qualifying shareholder. The preceding sentence is applied successively to each controlling corporate shareholder, if any, above the first controlling corporate shareholder.

(ii) *Examples.* The provisions of this paragraph (c)(3) are illustrated by the following examples:

Example 1. (i) A, an individual, owns all of the stock of T corporation, a C corporation. T has an operating division and three wholly-owned subsidiaries, X, Y, and Z. On February 1, 1998, T, Y, and Z all adopt plans of complete liquidation.

(ii) On March 1, 1998, the following sales are made to unrelated purchasers: T sells the assets of its operating division to B for cash and an installment obligation. T sells the stock of X to C for an installment obligation. Y sells all of its assets to D for an installment obligation. Z sells all of its assets to E for cash. The B, C, and D installment obligations bear adequate stated interest and meet the requirements of section 453.

(iii) In June 1998, Y and Z completely liquidate, distributing their respective assets (the D installment obligation and cash) to T. In July 1998, T completely liquidates, distributing to A cash and the installment obligations respectively issued by B, C, and D. The liquidation of T is a liquidation to which section 453(h) applies and the liquidations of Y and Z into T are liquidations to which section 332 applies.

(iv) Because T is in control of Y (within the meaning of section 368(c)), the D obligation acquired by Y is treated as acquired by T pursuant to section 453(h)(1)(E). A is a qualifying shareholder and the installment obligations issued by B, C, and D are qualifying installment obligations. Unless A elects otherwise, A reports the transaction on the installment method as if the cash and installment obligations had been received in an installment sale of the stock of T corporation. Under section 453B(d), no gain or loss is recognized by Y on the distribution of the D installment obligation to T. Under sections 453B(a) and 336, T recognizes gain or loss on the distribution of the B, C, and D installment obligations to A in exchange for A's stock.

Example 2. (i) A, a cash-method individual taxpayer, owns all of the stock of P corporation, a C corporation. P owns 30 percent of the stock of Q corporation. The balance of the Q stock is owned by unrelated individuals. On February 1, 1998, P adopts a plan of complete liquidation and sells all of its property, other than its Q stock, to B, an unrelated purchaser for cash and an installment obligation bearing adequate stated interest. On March 1, 1998, Q adopts a plan of complete liquidation and sells all of its property to an unrelated purchaser, C, for cash and installment obligations. Q immediately distributes the cash and installment obligations to its shareholders in completion of its liquidation. Promptly thereafter, P liquidates, distributing to A cash, the B installment obligation, and a C installment obligation that P received in the liquidation of Q.

(ii) In the hands of A, the B installment obligation is a qualifying installment obligation. In the hands of P, the C installment obligation was a qualifying installment obligation. However, in the hands of A, the C installment obligation is not treated as a qualifying installment obligation because P owned only 30 percent of the stock of Q. Because P did not own the requisite 80 percent stock interest in Q, P was not a controlling corporate shareholder of Q (within the meaning of section 368(c)) immediately before the liquidation. Therefore, section 453(h)(1)(E) does not apply. Thus, in the hands of A, the C obligation is considered to be a third-party note (not a purchaser's evidence of indebtedness) and is treated as a payment to A in the year of distribution. Accordingly, for 1998, A reports as payment the cash and the fair market value of the C obligation distributed to A in the liquidation of P.

(iii) Because P held 30 percent of the stock of Q, section 453B(d) is inapplicable to P. Under sections 453B(a) and 336, accordingly, Q recognizes gain or loss on the distribution of the C obligation. P also recognizes gain or loss on the distribution of the B and C installment obligations to A in exchange for A's stock. See sections 453B and 336.

(4) *Installment obligations attributable to certain sales of inventory*—(i) *In general.* An installment obligation acquired by a corporation in a liquidation that satisfies section 453(h)(1)(A) in respect of a broken lot of inventory is not a qualifying installment obligation. If an installment obligation is acquired in respect of a broken lot of inventory and other assets, only the portion of the installment obligation acquired in respect of the broken lot of inventory is not a qualifying installment obligation. The portion of the installment obligation attributable to other assets is a qualifying installment obligation. For purposes of this section, the term *broken lot of inventory* means inventory property that is sold or exchanged other than in bulk to one person in one transaction involving substantially all of the inventory property attributable to a trade or business of the corporation. See paragraph (c)(4)(ii) of this section for rules for determining what portion of an installment obligation is not a qualifying installment obligation and paragraph (c)(4)(iii) of this section for rules determining the application of payments on an installment obligation only a portion of which is a qualifying installment obligation.

(ii) *Rules for determining nonqualifying portion of an installment obligation.* If a broken lot of inventory is sold to a purchaser together with other corporate assets for consideration consisting of an installment obligation and either cash, other property, the assumption of (or taking property subject to) corporate liabilities by the purchaser, or some combination thereof, the installment obligation is treated as having been acquired in respect of a broken lot of inventory only to the extent that the fair market value of the broken lot of inventory exceeds the sum of unsecured liabilities assumed by the purchaser, secured liabilities which encumber the broken lot of inventory and are assumed by the purchaser or to which the broken lot of inventory is subject, and the sum of the cash and fair market value of other property received. This rule applies solely for the purpose of determining the portion of the installment obligation (if any) that is attributable to the broken lot of inventory.

(iii) *Application of payments.* If, by reason of the application of paragraph (c)(4)(ii) of this section, a portion of an installment obligation is not a qualifying installment obligation, then for purposes of determining the amount of gain to be reported by the shareholder under section 453, payments on the obligation (other than payments of qualified stated interest) shall be applied first to the portion of the obligation that is not a qualifying installment obligation.

(iv) *Example.* The following example illustrates the provisions of this paragraph (c)(4). In this example, assume that all obligations bear adequate stated interest within the meaning of section 1274(c)(2) and that the fair market value of each nonqualifying installment obligation equals its face amount. The example is as follows:

Example. (i) P corporation has three operating divisions, X, Y, and Z, each engaged in a separate trade or business, and a minor amount of investment assets. On July 1, 1998, P adopts a plan of complete liquidation that meets the criteria of section 453(h)(1)(A). The following sales are promptly made to purchasers unrelated to P: P sells all of the assets of the X division (including all of the inventory property) to B for $30,000 cash and installment obligations totalling $200,000. P sells substantially all of the inventory property of the Y division to C for a $100,000 installment obligation, and sells all of the other assets of the Y division (excluding cash but including installment receivables previously acquired in the ordinary course of the business of the Y division) to D for a $170,000 installment obligation. P sells ⅓ of the inventory property of the Z division to E for $100,000 cash, ⅓ of the inventory property of the Z division to F for a $100,000 installment obligation, and all of the other assets of the Z division (including the remaining ⅓ of the inventory property worth $100,000) to G for $60,000 cash, a $240,000 installment obligation, and the assumption by G of the liabilities of the Z division. The liabilities assumed by G, which are unsecured liabilities and liabilities encumbering the inventory property acquired by G, aggregate $30,000. Thus, the total purchase price G pays is $330,000.

(ii) P immediately completes its liquidation, distributing the cash and installment obligations, which otherwise meet the requirements of section 453, to A, an individual cash-method taxpayer who is its sole shareholder. In 1999, G makes a payment to A of $100,000 (exclusive of interest) on the $240,000 installment obligation.

(iii) In the hands of A, the installment obligations issued by B, C, and D are qualifying installment obligations because they were timely acquired by P in a sale or exchange of its assets. In addition, the installment obligation issued by C is a qualifying installment obligation because it arose from a sale to one person in one transaction of substantially all of the inventory property of the trade or business engaged in by the Y division.

(iv) The installment obligation issued by F is not a qualifying installment obligation because it is in respect of a broken lot of inventory. A portion of the installment obligation issued by G is a qualifying installment obligation and a portion is not a qualifying installment obligation, determined as follows: G purchased part of the inventory property (with a fair market value of $100,000) and all of the other assets of the Z division by paying cash ($60,000), issuing an installment obligation ($240,000), and assuming liabilities of the Z division ($30,000). The assumed liabilities ($30,000) and cash ($60,000) are attributed first to the inventory property. Therefore, only $10,000 of the $240,000 installment obligation is attributed to inventory property. Accordingly, in the hands of A, the G installment obligation is a qualifying installment obligation to the extent of $230,000, but is not a qualifying installment obligation to the extent of the $10,000 attributable to the inventory property.

(v) In the 1998 liquidation of P, A receives a liquidating distribution as follows:

Item	Qualifying installment obligations	Cash and other property
Cash	....	$190,000
B note	$200,000	....
C note	$100,000	....
D note	$170,000	....
F note	....	$100,000
G note[1]	$230,000	$ 10,000
Total	$700,000	$300,000

[1] Face amount $240,000.

(vi) Assume that A's adjusted tax basis in the stock of P is $100,000. Under the installment method, A's selling price and the contract price are both $1 million, the gross profit is $900,000 (selling price of $1 million less adjusted tax basis of $100,000), and the gross profit ratio is 90 percent (gross profit of $900,000 divided by the contract price of $1 million). Accordingly, in 1998, A reports gain of $270,000 (90 percent of $300,000 payment in cash and other property). A's adjusted tax basis in each of the qualifying installment obligations is an amount equal to 10 percent of the obligation's respective face amount.

A's adjusted tax basis in the F note, a nonqualifying installment obligation, is $100,000, i.e., the fair market value of the note when received by A. A's adjusted tax basis in the G note, a mixed obligation, is $33,000 (10 percent of the $230,000 qualifying installment obligation portion of the note, plus the $10,000 nonqualifying portion of the note).

(vii) With respect to the $100,000 payment received from G in 1999, $10,000 is treated as the recovery of the adjusted tax basis of the nonqualifying portion of the G installment obligation and $9,000 (10 percent of $90,000) is treated as the recovery of the adjusted tax basis of the portion of the note that is a qualifying installment obligation. The remaining $81,000 (90 percent of $90,000) is reported as gain from the sale of A's stock. See paragraph (c)(4)(iii) of this section.

(5) *Installment obligations attributable to sales of certain property*—(i) *In general.* An installment obligation acquired by a liquidating corporation, to the extent attributable to the sale of property described in paragraph (c)(5)(ii) of this section, is not a qualifying obligation if the corporation is formed or availed of for a principal purpose of avoiding section 453(b)(2) (relating to dealer dispositions and certain other dispositions of personal property), section 453(i) (relating to sales of property subject to recapture), or section 453(k) (relating to dispositions under a revolving credit plan and sales of stock or securities traded on an established securities market) through the use of a party bearing a relationship, either directly or indirectly, described in section 267(b) to any shareholder of the corporation.

(ii) *Covered property.* Property is described in this paragraph (c)(5)(ii) if, within 12 months before or after the adoption of the plan of liquidation, the property was owned by any shareholder and—

(A) The shareholder regularly sold or otherwise disposed of personal property of the same type on the installment plan or the property is real property that the shareholder held for sale to customers in the ordinary course of a trade or business (provided the property is not described in section 453(l)(2) (relating to certain exceptions to the definition of dealer dispositions));

(B) The sale of the property by the shareholder would result in recapture income (within the meaning of section 453(i)(2)), but only if the amount of the recapture income is equal to or greater than 50 percent of the property's fair market value on the date of the sale by the corporation;

(C) The property is stock or securities that are traded on an established securities market; or

(D) The sale of the property by the shareholder would have been under a revolving credit plan.

(iii) *Safe harbor.* Paragraph (c)(5)(i) of this section will not apply to the liquidation of a corporation if, on the date the plan of complete liquidation is adopted and thereafter, less than 15 percent of the fair market value of the corporation's assets is attributable to property described in paragraph (c)(5)(ii) of this section.

(iv) *Example.* The provisions of this paragraph (c)(5) are illustrated by the following example:

Example. Ten percent of the fair market value of the assets of T is attributable to stock and securities traded on an established securities market. T owns no other assets described in paragraph (c)(5)(ii) of this section. T, after adopting a plan of complete liquidation, sells all of its stock and securities holdings to C corporation in exchange for an installment obligation bearing adequate stated interest, sells all of its other assets to B corporation for cash, and distributes the cash and installment obligation to its sole shareholder, A, in a complete liquidation that satisfies section 453(h)(1)(A). Because the C installment obligation arose from a sale of publicly traded stock and securities, T cannot report the gain on the sale under the installment method pursuant to section 453(k)(2). In the hands of A, however, the C installment obligation is treated as having arisen out of a sale of the stock of T corporation. In addition, the general rule of paragraph (c)(5)(i) of this section does not apply, even if a principal purpose of the liquidation was the avoidance of section 453(k)(2), because the fair market value of the publicly traded stock and securities is less than 15 percent of the total fair market value of T's assets. Accordingly, section 453(k)(2) does not apply to A, and A may use the installment method to report the gain recognized on the payments it receives in respect of the obligation.

(d) *Liquidating distributions received in more than one taxable year.* If a qualifying shareholder receives liquidating distributions to which this section applies in more than one taxable year, the shareholder must reasonably estimate the gain attributable to distributions received in each taxable year. In allocating basis to calculate the gain for a taxable year, the shareholder must reasonably estimate the anticipated aggregate distributions. For this purpose, the shareholder must take into account distributions and other relevant events or information that the shareholder knows or reasonably could know up to the date on which the federal income tax return for that year is filed. If the gain for a taxable year is properly taken into account on the basis of a reasonable estimate and the exact amount is subsequently determined the difference, if any, must be taken into account for the taxable year in which the subsequent determination is made. However, the shareholder may file an amended return for the earlier year in lieu of taking the difference into account for the subsequent taxable year.

(e) *Effective date.* This section is applicable to distributions of qualifying installment obligations made on or after January 28, 1998.

[T.D. 8762, 63 FR 4170, Jan. 28, 1998]

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[T.D. 8270, 54 FR 46376, Nov. 3, 1989]

§ 1.453A–1 Installment method of reporting income by dealers on personal property.

(a) *In general.* A dealer (as defined in paragraph (c)(1) of this section) may elect to return the income from the sale of personal property on the installment method if such sale is a sale on the installment plan (as defined in paragraphs (c)(3) and (d) of this section). Under the installment method of accounting, a taxpayer may return as income from installment sales in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when the property is paid for bears to the total contract price. For this purpose, gross profit means sales less cost of goods sold. See paragraph (d) of this section for additional rules relating to the computation of income under the installment method of accounting. In addition, see § 1.453A–2 for rules treating revolving credit plans as installment plans for taxable years beginning on or before December 31, 1986.

(b) *Effect of security.* A dealer may adopt (but is not required to do so) one of the following four ways of protecting against loss in case of default by the purchaser:

(1) An agreement that title is to remain in the vendor until performance of the purchaser's part of the transaction is completed;

(2) A form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the selling price;

(3) A present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the vendor; or

(4) A conveyance to a trustee pending performance of the contract and subject to its provisions.

(c) *Definitions of dealer, sale, and sale on the installment plan.* For purposes of the regulations under section 453A—

(1) The term ''dealer'' means a person who regularly sells or otherwise disposes of personal property on the installment plan;

(2) The term ''sale'' includes sales and other dispositions; and

(3) Except as provided in paragraph (d)(2) of this section, the term ''sale on the installment plan'' means—

(i) A sale of personal property by the taxpayer under any plan for the sale of personal property, which plan, by its terms and conditions, contemplates that each sale under the plan will be paid for in two or more payments; or

(ii) A sale of personal property by the taxpayer under any plan for the sale of personal property—

(A) Which plan, by its terms and conditions, contemplates that such sale will be paid for in two or more payments; and

(B) Which sale is in fact paid for in two or more payments.

(d) *Installment plans*—(1) *Traditional installment plans.* A traditional installment plan usually has the following characteristics:

(i) The execution of a separate installment contract for each sale or disposition of personal property; and

(ii) The retention by the dealer of some type of security interest in such property.

Normally, a sale under a traditional installment plan meets the requirements of paragraph (c)(3)(i) of this section.

(2) *Revolving credit plans.* Sales under a revolving credit plan (within the meaning of §1.453A–2(c)(1))—

(i) Are treated, for taxable years beginning on or before December 31, 1986, as sales on the installment plan to the extent provided in §1.453A–2, which provides for the application of the requirements of paragraph (c)(3)(ii) of this section to sales under revolving credit plans; and

(ii) Are not treated as sales on the installment plan for taxable years beginning after December 31, 1986.

(e) *Installment income of dealers in personal property*—(1) *In general.* The income from sales on the installment plan of a dealer may be ascertained by treating as income that proportion of the total payments received in the taxable year from sales on the installment plan (such payments being allocated to the year against the sales of which they apply) which the gross profit realized or to be realized on the total sales on the installment plan made during each year bears to the total contract price of all such sales made during that respective year. However, if the dealer demonstrates to the satisfaction of the district director that income from sales on the installment plan is clearly reflected, the income from such sales may be ascertained by treating as income that proportion of the total payments received in the taxable year from sales on the installment plan (such payments being allocated to the year against the sales of which they apply) which either:

(i) The gross profit realized or to be realized on the total credit sales made during each year bears to the total contract price of all credit sales during that respective year, or

(ii) The gross profit realized or to be realized on all sales made during each year bears to the total contract price of all sales made during that respective year.

A dealer who desires to compute income by the installment method shall maintain accounting records in such a manner as to enable an accurate computation to be made by such method in accordance with the provisions of this section, section 446, and §1.446–1.

(2) *Gross profit and total contract price.* For purposes of paragraph (e)(1) of this section, in computing the gross profit realized or to be realized on the total sales on the installment plan, there shall be included in the total selling price and, thus, in the total contract price of all such sales.

(i) The amount of carrying charges or interest which is determined at the time of each sale and is added to the established cash selling price of such property and is treated as part of the selling price for customer billing purposes, and

(ii) In the case of sales made in taxable years beginning on or after January 1, 1960, the amount of carrying charges or interest determined with respect to such sales which are added contemporaneously with the sale on the books of account of the seller but are treated as periodic service charges for customer billing purposes.

Any change in the amount of the carrying charges or interest in a year subsequent to the sale will not affect the computation of the gross profit for the year of sale but will be taken into account at the time the carrying charges or interest are adjusted. The application of this paragraph (e)(2) to carrying charges or interest described in paragraph (e)(2)(ii) of this section may be illustrated by the following example:

Example. X Corporation makes sales on the traditional installment plan. The customer's order specifies that the total price consists of a cash price plus a ''time price differential'' of 1½ percent per month on the outstanding balance in the customer's account, and the customer is billed in this manner. On its books and for purposes of reporting to stockholders, X Corporation consistently makes the following entries each month when it records its sales. A debit entry is make to accounts receivable (for the total price) and balancing credit entries are made to sales (for the established selling price) and to a reserve account for collection expense (for the amount of the time price differential). In computing the gross profit realized or to be realized on the total sales on the installment plan, the total selling price and, thus, the total contract price for purposes of this paragraph (e) would, with respect to sales made in taxable years beginning on or after January 1, 1960, include the time price differential.

(3) *Carrying charges not included in total contract price.* In the case of sales by dealers in personal property made during taxable years beginning after December 31, 1963, the income from which is returned on the installment method, if the carrying charges or interest with respect to such sales is not included in the total contract price, payments received with respect to such sales shall be treated as applying first against such carrying charges or interest.

(f) Other accounting methods. If the vendor chooses as a matter of consistent practice to return the income from installment sales on an accrual method (,) such a course is permissible.

(g) Records. In adopting the installment method of accounting the seller must maintain such records as are necessary to clearly reflect income in accordance with this section, section 446 and § 1.446–1.

(h) *Effective date.* This section applies for taxable years beginning after December 31, 1953, and ending after August 16, 1954, but generally does not apply to sales made after December 31, 1987, in taxable years ending after such date. For sales made after December 31, 1987, sales made by a dealer in personal or real property shall not be treated as sales on the installment plan. (However, see section 453(l)(2) for exceptions to this rule.)

[T.D. 8270, 54 FR 46377, Nov. 3, 1989]

§ 1.453A–2 Treatment of revolving credit plans; taxable years beginning on or before December 31, 1986.

(a) *In general.* If a dealer sells or otherwise disposes of personal property under a revolving credit plan—

(1) Such sales will be treated as sales on the installment plan to the extent provided in paragraph (c) of this section;

(2) Income from sales treated as sales on the installment plan under paragraph (c) of this section may be returned on the installment method; and

(3) Income returned on the installment method is computed in accordance with § 1.453A–1, except that—

(i) The gross profit on such sales is computed without regard to § 1.453A– 1 (e)(2);

(ii) Under the circumstances described in paragraph (c)(6)(vi) of this section, the taxpayer may, in computing income for a taxable year, treat all such sales as sales made in such taxable year for purposes of applying the gross profit percentage; and

(iii) The rule contained in § 1.453A– 1 (e)(3) is applied in accordance with paragraph (c)(6)(v) of this section.

(b) *Coordination with traditional installment plan.* A dealer who makes sales of personal property under both a revolving credit plan and a traditional installment plan (1) may elect to report only sales under the traditional installment plan on the installment method, (2) may elect to report only sales under the revolving credit plan on the installment method, or (3) may elect to report both sales under the revolving credit plan and the traditional installment plan on the installment method.

(c) *Revolving credit plans.* (1) To the extent provided in this paragraph (c) sales under a revolving credit plan will be treated as sales on the installment plan. The term ''revolving credit plan'' includes cycle budget accounts, flexible budget accounts, continuous budget accounts, and other similar plans or arrangements for the sale of personal property under which the customer agrees to pay each billing-month (as defined in paragraph (c)(6)(iii) of this section) a part of the outstanding balance of the customer's account. Sales under a revolving credit plan do not constitute sales on the installment plan merely by reason of the fact that the total debt at the end of a billing-month is paid in installments. The terms and conditions of a revolving credit plan do not contemplate that each sale under the plan will be paid for in two or more payments and thus do not meet the requirements of §1.453A–1(c)(3)(i). In addition, since under a revolving credit plan payments are not generally applied to liquidate any particular sale, and since the terms and conditions of such plan contemplate that account balances may be paid in full or in installments, it is generally impossible to determine that a particular sale under a revolving credit plan is to be or is in fact paid for in installments so as to meet the requirements of §1.453A–1 (c)(3)(ii). However, paragraphs (c) (2) and (3) of this section provides rules under which a certain percentage of charges under a revolving credit plan will be treated as sales on the installment plan. For purposes of arriving at this percentage, these rules, in general, treat as sales on the plan those sales under a revolving installment credit plan:

(i) Which are of the type which the terms and conditions of the plan contemplate will be paid for in two or more installments and

(ii) Which are charged to accounts on which subsequent payments indicate that such sales are being paid for in two or more installments.

(2)(i) The percentage of charges under a revolving credit plan which will be treated as sales on the installment plan shall be computed by making an actual segregation of charges in a probability sample of the revolving credit accounts and by applying the rules contained in paragraph (c)(3) of this section to determine what percentage of charges in the sample is to be treated as sales on the installment plan. (See paragraph (c)(5) of this section for rules to be used if some of the sales under a revolving credit plan are nonpersonal property sales (as defined in paragraph (c)(6)(iv) of this section).) Such segregation shall be made of charges which make up the balances in the sample accounts as of the end of each customer's last billing-month ending within the taxable year. (See paragraph (c)(6)(v) of this section for rules to be used in determining which charges make up the balance of an account.) However, in making such segregation, any account to which a sale is charged during the taxable year on which no payment is credited after the billing-month within which the sale is made (hereinafter called the ''billing-month of sale'') and on or before the end of the first billing-month ending in the taxpayer's next taxable year shall be disregarded and not taken into account in the determination of what percentage of charges in the sample is to be treated as sales on the installment plan. In order to obtain a probability sample, the accounts shall be selected in accordance with generally accepted probability sampling techniques. The appropriateness of the sampling technique and the accuracy and reliability of the results obtained must, if requested, be demonstrated to the satisfaction of the district director. If the district director is not satisfied that the taxpayer's sample is appropriate or that the results obtained are accurate and reliable, the taxpayer shall recompute the sample percentage or make appropriate adjustments to the original computations in a manner satisfactory to the district director. The taxpayer shall maintain records in sufficient detail to show the method of computing and applying the sample.

(ii) For taxable years ending before January 31, 1964, a taxpayer who has reported for income tax purposes all or a portion of sales under a revolving credit plan as sales on the installment method may apply the percentage obtained for the first taxable year ending on or after such date in determining the percentage of charges under a revolving credit plan for such prior taxable year (or years) which will be treated as sales on the installment plan. However, in computing the percentage to be applied in determining the percentage of charges under a revolving credit plan which will be treated as sales on the installment plan for such prior taxable year (or years), the rule stated in § 1.453A–1(e)(3) shall not apply. See paragraph (c)(6)(v) of this section for rules relating to the application of payments to finance charges for such prior taxable years.

(3) For the purpose of determining the percentage described in paragraph (c)(2) of this section, a charge under a revolving credit plan will be treated as a sale on the installment plan only if such charge is a sale (as defined in paragraph (c)(6) of this section) and meets the following requirements:

(i) The sale must be of the type which the terms and conditions of the plan contemplate will be paid for in two or more installments. If the aggregate of sales charged during a billing-month to an account under a revolving credit plan exceeds the required monthly payment, then all sales during such billing-month shall be considered to be of the type which the terms and conditions of such plan contemplate will be paid for in two or more installments. The required monthly payment shall be the amount of the payment which the terms and conditions of the revolving credit contract require the customer to make with respect to a billing-month. If the amount of such payment is not fixed at the date the contract is entered into, but is dependent upon the balance of the account, then such amount shall be the amount that the customer is required to pay (but not including any past-due payments) as shown on the statement either:

(A) For the last billing-month ending within the taxpayer's taxable year or

(B) For the billing-month of sale, whichever method the taxpayer adopts for all accounts. A taxpayer shall not change such method of determining the required monthly payment based upon the balance of the account without obtaining the consent of the district director. In any case where the required monthly payment is not set in accordance with a consistent method used during the entire taxable year, the district director may determine the required monthly payment in accordance with the method used during the major portion of such taxable year if the use of such method is necessary in order to reflect properly the income from sales under a revolving credit plan. The requirements stated in this paragraph (c)(3)(i) may be illustrated by the following examples:

Example (1). Under the terms of a revolving credit plan the required monthly payment to be made by customer A is $20. During the billing-month ending in December, sales aggregating $80 are charged to customer A's account, and during the next billing-month, ending in January, sales aggregating $19.95 and finance charges of $.60 are charged to A's account. Since the aggregate of sales charged to customer A's account during the billing-month ending in December ($80) exceeds the required monthly payment ($20), the terms and conditions of the plan contemplate that the sales charged during such billing-month are of the type which will be paid for in two or more installments. Since the aggregate of sales charged to customer A's account during the billing-month ending in January ($19.95) does not exceed the required monthly payment, the sales making up the aggregate of sales in such billing-month are not of the type which the terms and conditions of the plan contemplate will be paid for in two or more installments.

Example (2). The terms of a revolving credit plan require a payment of 20 percent of the balance of the customer's account as of the end of the billing-month for which the statement is rendered. A customer makes purchases aggregating $25 in the customer's next to the last billing-month ending within the taxpayer's taxable year, and the balance at the end of that month is $150. At the end of the customer's last billing-month ending within the taxpayer's taxable year, the balance of the account has decreased to $110. If the taxpayer determines the required monthly payment by reference to the payment required on the statement for the last billing-month ending within the taxable year and applies such method consistently to all accounts, then the sales making up the $25 aggregate of sales are of the type which the terms and conditions of the plan contemplate will be paid for in two or more installments. Although such aggregate was less than the $30 payment (20%×$150) required on the statement rendered for the billing-month of sales. It was more than the $22 (20%×$110) that the customer was required to pay on the statement rendered for his last billing-month ending within the taxable year, and thus meets the requirements of this paragraph (c)(3)(i). If, however, the taxpayer determines the required monthly payment by reference to the payment required on the statement for the billing-month of sale, then the sales making up the aggregate of sales during such billing-month do not meet the requirements of this paragraph (c)(3)(i) because such aggregate was less than the $30 payment required on the statement rendered for such month.

(ii) The sale must be charged to an account on which the first payment after the billing-month of sale indicates that the sale is being paid in installments. The first payment after the billing-month of sale indicates that the sale is being paid in installments if, and only if, such payment is an amount which is less than the balance of the account as of the close of the billing-month of sale. For purposes of this paragraph (c)(3)(ii), such balance shall be reduced by any return or allowance credited to the account after the close of the billing-month of sale and before the close of the billing-month within which the first payment after the billing-month of sale is credited to the account, unless the taxpayer demonstrates that the return or allowance was attributable to a charge made in a month subsequent to the billing-month of sale. The requirements stated in this paragraph (c)(3)(ii) may be illustrated by the following examples, in which it is assumed that the taxpayer's annual accounting period ends on January 31.

Example (1). Customer A's revolving credit account shows the following sales and payments:

Month ending	Aggregate sales in month	Payments	Balance
December 20	$150	0	$150
January 20	75	$30	195
February 20	0	195	0

All sales made in the billing-month ending December 20 meet the requirements of this paragraph (c)(3)(ii) because the first payment on the account after such billing-month ($30) was less than the balance of the account as of the close of such billing-month ($150); and none of the sales made in the billing-month ending January 20 meets the requirements of this paragraph (c)(3)(ii) because the balance of the account as of the end of such billing-month was liquidated in one payment. By application of the rules of paragraph (c)(6)(v) of this section, the balance in the account as of the last billing-month ending in the taxable year ($195) consists of $120 of the $150 of sales made in the billing-month ending December 20 and all of the $75 of sales made in the billing-month ending January 20. Therefore, $120 of the account balance meets the requirements of this paragraph (c)(3)(ii) and $75 does not.

Example (*2*). Customer B's revolving credit account shows the following sales and payments:

Month ending	Aggregate sales in month	Payments	Balance
December 20	$ 50	0	$ 50
January 20	100	0	150
February 20	0	$50	100

None of the sales made in the billing-month ending December 20 meets the requirements of this paragraph (c)(3)(ii) because the first payment credited to the account after such billing-month ($50) is not less than the balance of the account as of the close of such month ($50). All of the sales made in the billing-month ending January 20 meet the requirements of this paragraph (c)(3)(ii) because the first payment after such billing-month ($50) is less than the balance of the account as of the close of such month ($150).

Example (3). Customer C's revolving credit account shows the following purchases and credits:

Month ending	Item	Charges	Credits	Balance
January 20	Coat	$55		
	Dress	40		
	Shirt	5		$100
February 20	Return		$5	
	Payments		95	0

None of the sales made in the billing-month ending January 20 meets the requirements of this paragraph (c)(3)(ii) because the first payment credited to the account after such billing-month ($95) was equal to the balance of the account as of the end of such billing-month, $95. For this purpose, the balance of $100 is reduced by the $5 return which was credited to the account after the close of the billing-month of sale and before the close of the billing-month within which the first payment after the billing-month of sale is credited.

(4) The provisions of paragraphs (c) (2) and (3) of this section may be illustrated by the following examples in which it is assumed that the taxpayer is a dealer whose annual accounting period ends on January 31.

Example (1). Customer A's revolving credit ledger account shows the following:

Month ending	Aggregate sales in month[1]	Returns and allowances	Payments	Finance charges	Balance
January 20	$15.00	0	0	0	$15.00
February 20	0	0	0	$0.15	15.15

[1] Including sales of personal property and nonpersonal property sales.

For purposes of the segregation provided for in paragraph (c)(2)(i) of this section, customer A's account will be disregarded and not taken into account in the determination of what percentage of charges in the sample is to be treated as sales on the installment plan because no payment was credited to that account after the billing-month of sale and on or before February 20.

Example (2). This example is applicable with respect to sales made during taxable years beginning before January 1, 1964. Under the terms of corporation X's revolving credit plan, payments are required in accordance with the following schedule:

	Required monthly payment
Unpaid balance:	
0 to $99.99	$20
$100 to $199.99	40
$200 to $299.99	60

Customer B's revolving credit ledger account for the period beginning on September 21, 1963, and ending February 20, 1964, shows the following:

Month ending	Aggregate sales in month[1]	Returns and allowances	Payments	Finance charges	Balances
October 20	$55.00	0	0	0	$55.00
November 20	45.00	0	$20.00	$0.35	80.35
December 20	20.00	0	20.00	.60	80.95
January 20	26.00	$5.00	20.00	.61	82.56
February 20	0	10.00	72.56	0	0

[1] Including sales of personal property and nonpersonal property sales.

The three $20 payments and the $5 return or allowance made in the billing-months ending in the taxable year are applied under the rules in paragraph (c)(6)(v) of this section to liquidate the earliest outstanding charges, first to the $55 aggregate of sales in the billing-month ending October 20 and next to $10 of the aggregate of sales made in the billing-month ending November 20. Thus, the balance of the account as of the close of the billing-month ending January 20, $82.56, is made up as follows:

Remainder of sales in billing-month ending Nov. 20 ($45 − $10)	$35.00
Finance charges for billing-month ending Nov. 20	0.35
Sales for billing-month ending Dec. 20	20.00
Finance charge for billing-month ending Dec. 20	0.60
Sales for billing-month ending Jan. 20	26.00
Finance charge for billing-month ending Jan. 20	0.61
Total	82.56

The sales of $35 remaining from the aggregate of sales for the billing-month ending November 20 meet the requirements of paragraph (c)(3)(i) of this section because the aggregate of sales charged during such billing-month ($45) exceeds the required monthly payment ($20), and such sales meet the requirements of paragraph (c)(3)(ii) of this section because the first payment after the billing-month of sale ($20) is an amount less than the balance of the account as of the close of such month ($80.35). Therefore, $35 of sales will be treated as sales on the installment plan. The $20 aggregate of sales charged during the billing-month ending December 20 does not meet the requirements of paragraph (c)(3)(i) of this section because it is in an amount which does not exceed the required monthly payment ($20). (The finance charge of $0.60 added in the billing-month does not enter into the determination of the aggregate of sales for the month because the term ‘‘sales’’ (as defined in paragraph (c)(6)(i) of this section does not include finance charges). The $26 aggregate of sales for the billing-month ending January 20 does not meet the requirements of paragraph (c)(3)(ii) of this section because the first payment after such billing-month ($72.56) was equal to the balance of the account as of the close of such billing-month ($72.56). For this purpose, the balance of $82.56 is reduced by the $10 return or allowance which was credited after the billing-month of sale and before February 20. Thus, of the $82.56 balance of B’s account as of the close of the last billing-month ending within corporation X’s taxable year, $35 will be treated as sales on the installment plan for purposes of determining the percentage provided for paragraph (c)(2) of this section.

Example (3). This example is applicable with respect to sales made during taxable years beginning after December 31, 1963. Assume the facts in example (2), except that Customer B’s revolving credit ledger account is for the period beginning on September 21, 1964 and ending February 20, 1965. Since payments received are first used to liquidate any outstanding finance charges under the rule in paragraph (c)(6)(v) of this section, the $20 payment in December liquidated the $0.35 finance charge accrued at the end of the November billing-month and the $20 payment in January liquidated the $0.60 finance charge accrued at the end of the December billing-month. The balance of the three $20 payments ($59.05) and the $5 return or allowance are applied (under the rules in paragraph (c)(6)(v) of this section) to liquidate the earliest outstanding sales, first to the $55 aggregate of sales in the billing-month ending October 20 and next to $9.05 of the aggregate of sales made in the billing-month ending November 20. Thus, the balance of the account as of the close of the billing-month ending January 20, $82.56, is made up as follows:

Remainder of sales in billing-month ending Nov. 20 ($45-$9.05)	$35.95
Sales for billing-month ending Dec. 20	20.00
Sales for billing-month ending Jan. 20	26.00
Finance charge for billing-month ending Jan. 20	0.61
Total	82.56

The sales of $35.95 remaining from the aggregate of sales for the billing-month ending November 20 meet the requirements of paragraph (c)(3)(i) of this section because the aggregate of sales charged during such billing-month ($45) exceeds the required monthly payment ($20), and such sales meet the requirements of paragraph (c)(3)(ii) of this section because the first payment after the billing-month of sale ($20) is an amount less than the balance of the account as of the close of such month ($80.35). Therefore, $35.95 of sales will be treated as sales on the installment plan. The $20 aggregate of sales charged during the billing-month ending December 20 does not meet the requirements of paragraph (c)(3)(i) of this section because it is in an amount which does not exceed the required monthly payment ($20). The $26 aggregate of sales for the billing-month ending January 20 does not meet the requirements of paragraph (c)(3)(ii) of this section because the first payment after such billing-month ($72.56) was equal to the balance of the account as of the close of such billing-month ($72.56). For this purpose, the balance of $82.56 is reduced by the $10 return or allowance which was credited after the billing-month of sale and before February 20. Thus, of the $82.56 balance of B’s account as of the close of the last billing-month ending within corporation X’s taxable year $35.95 will be treated as sales on the installment plan for purposes of determining the percentage provided for in paragraph (c)(2) of this section.

(5) Sales under a revolving credit plan which are nonpersonal property sales (as defined in paragraph (c)(6)(iv) of this section) do not constitute sales on the installment plan. Therefore, the charges under a revolving credit plan must be reduced by the nonpersonal property sales, if any, under such plan, before application of the sample percentage as provided for in paragraph (c)(2)(i) of this section. The taxpayer may treat as the nonpersonal property sales under the plan for the taxable year an amount which bears the same ratio to the total sales under the revolving credit plan made in the taxable year as the total nonpersonal property sales made in such year bears to the total sales made in such year.

(6) For purposes of this paragraph (c)—

(i) The term ‘‘sales’’ includes sales of services, such as a charge for watch repair, as well as sales of property, but does not include finance or service charges.

(ii) The term ‘‘charges’’ includes sales of services and property as well as finance or service charges.

(iii) A billing-month is that period of time for which a periodic statement of charges and credits is rendered to a customer.

(iv) The term ''nonpersonal property sales'' means all sales which are not sales of personal property made by the taxpayer. Thus, sales of a department leased by the taxpayer to another are nonpersonal property sales. Likewise, charges for services rendered by the taxpayer are nonpersonal property sales unless such services are incidental to and rendered contemporaneously with the sale of personal property, in which case such charges shall be considered as constituting part of the selling price of such property.

(v) Except as otherwise provided in this paragraph (c)(6)(v), each payment received from a customer under a revolving credit plan before the close of the last billing-month ending in the taxable year shall be applied to liquidate the earliest outstanding charges under such plan, notwithstanding any rule of law or contract provision to the contrary. For purposes of determining which charges remain in the balance of an account at the end of the last billing-month ending in the taxable year, the taxpayer may apply returns and allowances which are credited before the close of the last billing-month ending in the taxable year either (A) to liquidate or reduce the charge for the specific item so returned or for which an allowance is permitted, or (B) to liquidate or reduce the earliest outstanding charges. The method so selected for applying returns and allowances shall be followed on a consistent basis from year to year unless the district director consents to a change. Additionally, finance or service charges which are computed on the basis of the balance of the account at the end of the previous billing-month (usually reduced by payments during the current billing-month) are accrued at the end of the current billing-month and are therefore considered, for purposes of determining the earliest outstanding charges, as charged to the account after any sales made during the current billing month. However, for purposes of determining which charges remain in the balance of an account at the end of the last billing-month ending in a taxable year which began after December 31, 1963, payments received during such year shall be applied first against any finance or service charges which were outstanding at the time such payment was received. The preceding sentence shall not apply with respect to a computation made for purposes of applying the rule described in paragraph (c)(2)(ii) of this section.

(vi) The taxpayer shall allocate those sales under a revolving credit plan which are treated as sales on the installment plan to the proper year of sale in order to apply the appropriate gross profit percentage as provided for in § 1.453A–1(e). This allocation shall be made on the basis of the percentages of charges treated as sales on the installment plan which are attributable to each taxable year as determined in the sample of accounts described in paragraph (c)(2) of this section. However, if the taxpayer demonstrates to the satisfaction of the district director that income from sales on the installment plan is clearly reflected, all sales may be considered as being made in the taxable year for purposes of applying the gross profit percentage.

(7) The provisions of this paragraph (c) may be illustrated by the following example:

Example. Corporation X is a dealer and has elected to report on the installment method those sales under its revolving credit plan which may be treated as sales on the installment plan. Corporation X's taxable year ends on January 31, and the total balance of all its revolving credit accounts as of January 31, 1964, is $2,000,000. The total sales made in the taxable year are $10,000,000 of which $500,000 are nonpersonal property sales. The gross profit percentage realized or to be realized on all sales made in the taxable year is 40 percent. The amount of the gross profit contained in the year-end balance of $2,000,000 which may be deferred to succeeding years is computed as follows:

(i) In order to reduce the charges appearing in the year-end balance of revolving credit accounts receivable by the nonpersonal property sales contained therein, corporation X determines the amount of such nonpersonal property sales under the method permitted in paragraph (c)(5) of this section. Corporation X first determines the ratio which total nonpersonal property sales made during the year ($500,000) bears to total sales made during the year ($10,000,000), and then applies the percentage (5 percent) thus obtained to the year-end balance of revolving credit accounts receivable ($2,000,000). The nonpersonal property sales thus determined ($100,000) is subtracted from such year-end balance to obtain the charges under the revolving credit plan appearing in the year-end balance ($1,900,000) to which the sample percentage is to be applied.

(ii) In accordance with generally accepted sampling techniques, the taxpayer selects a probability sample of all revolving credit accounts having balances for billing-months ending in January 1964. The technique employed results in a random selection of accounts with total balances of $100,000.

(iii) Analysis of these sample accounts discloses that of the $100,000 of balances, $10,000 of balances are in accounts on which no payment was credited after a billing-month of sale and on or before the end of the first billing-month ending in the taxable year beginning February 1, 1964. These balances are, therefore, disregarded and not taken into account in the determination of what percentage of sales in the sample is to be treated as sales on the installment plan. Of the remaining $90,000 of balances, the taxpayer determines, by analyzing the ledger cards in the sample, that $63,000 of balances are composed of sales which meet the requirements of paragraphs (c)(3) (i) and (ii) of this section and are thus treated as sales on the installment plan. The remaining $27,000 of balances either did not meet the requirements of paragraphs (c)(3) (i) and (ii) of this section or were not sales (as defined in paragraph (c)(6)(i) of this section). The percentage of charges in the sample treated as sales on the installment plan is, therefore, 70 percent ($63,000 ÷ $90,000).

(iv) The charges in the year-end balance which are to be treated as sales on the installment plan, $1,330,000, are computed by multiplying the charges to which the sample percentage is applied ($1,900,000) by the sample percentage (70 percent).

(v) The deferred gross profit attributable to sales under the revolving credit plan for the taxable year, $532,000, is determined by multiplying the amount treated as sales on the installment plan ($1,330,000), by the gross profit percentage (40 percent). (Corporation X will be able to demonstrate to the satisfaction of the district director that (A) since the gross profit percentage for all sales does not vary materially from the gross profit percentage for all sales made under the revolving credit plan, (B) since only an insubstantial amount of sales included in year-end account balances was made prior to the taxable year, and (C) since the prior year's gross profit percentage does not vary materially from the gross profit percentage for the taxable year, income from sales on the installment plan will be clearly reflected by applying the current year's gross profit percentage for all sales under the revolving credit plan treated as sales on the installment plan.)

(d) *Effective date.* This section applies for taxable years beginning after December 31, 1953, and ending after August 16, 1954, but does not apply for any taxable year beginning after December 31, 1986. For taxable years beginning after December 31, 1986, sales under a revolving credit plan shall not be treated as sales on the installment plan.

[T.D. 8269, 54 FR 46375, Nov. 3, 1989]

§1.453A–3 Requirements for adoption of or change to installment method by dealers in personal property.

(a) *In general.* A dealer (within the meaning of §1.453A–1(c)(1)) may adopt or change to the installment method for a type or types of sales on the installment plan (within the meaning of §1.453A–1(c)(3) and (d)) in the manner prescribed in this section. This section applies only to dealers and only with respect to their sales on the installment plan.

(b) *Time and manner of electing installment method reporting*—(1) *Time for election.* An election to adopt or change to the installment method for a type or types of sales must be made on an income tax return for the taxable year of the election, filed on or before the time specified (including extensions thereof) for filing such return.

(2) *Adoption of installment method.* A taxpayer who adopts the installment method for the first taxable year in which sales are made on an installment plan of any kind must indicate in the income tax return for that taxable year that the installment method of accounting is being adopted and specify the type or types of sales included within the election. If a taxpayer in the year of the initial election made only one type of sale on the installment plan, but during a subsequent taxable year makes another type of sale on the installment plan and adopts the installment method for that other type of sale, the taxpayer must indicate in the income tax return for the subsequent year that an election is being made to adopt the installment method of accounting for the additional type of sale.

(3) *Change to installment method.* A taxpayer who changes to the installment method for a particular type or types of sales on the installment plan in acordance with this section must, for each type of sale on the installment plan for which the installment method is to be used, attach a separate statement to the income tax return for the taxable year with respect to which the change is made. Each statement must show the method of accounting used in computing taxable income before the change and the type of sale on the installment plan for which the installment method is being elected.

(4) *Deemed elections.* A dealer (including a person who is a dealer as a result of the recharacterization of transactions as sales) is deemed to have elected the installment method if the dealer treats a sale on the installment plan as a transaction other than a sale and fails to report the full amount of gain in the year of the sale. For example, if a transaction treated by a dealer as a lease is recharacterized by the Internal Revenue Service as a sale on the installment plan, the dealer will be deemed to have elected the installment method assuming the dealer failed to report the full amount of gain in the year of the transaction.

(c) *Consent.* A dealer may adopt or change to the installment method for sales on the installment plan without the consent of the Commissioner. However, a dealer may not change from the installment method to the accrual method of accounting or to any other method of accounting without the consent of the Commissioner.

(d) *Cut-off method for amounts previously accrued.* An election to change to the installment method for a type of sale applies only with respect to sales made on or after the first day of the taxable year of change. Thus, payments received in the taxable year of the change, or in subsequent years, in respect of an installment obligation which arose in a taxable year prior to the taxable year of change are not taken into account on the installment method, but rather must be accounted for under the taxpayer's method of accounting in use in the prior year.

(e) *Effective date.* This section applies to sales by dealers in taxable years ending after October 19, 1980, but generally does not apply to sales made after December 31, 1987. For sales made after December 31, 1987, sales by a dealer in personal or real property shall not be treated as sales on the installment plan. (However, see section 453(l)(2) for certain exceptions to this rule.) For rules relating to sales by dealers in taxable years ending before October 20, 1980, see 26 CFR 1.453–7 and 1.453–8 (rev. as of April 1, 1987).

[T.D. 8269, 54 FR 46375, Nov. 3, 1989]

§ 1.454–1 Obligations issued at discount.

(a) *Certain non-interest-bearing obligations issued at discount*—(1) *Election to include increase in income currently.* If a taxpayer owns—

(i) A non-interest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals (other than an obligation issued by a corporation after May 27, 1969, as to which ratable inclusion of original issue discount is required under section 1232(a)(3)), or

(ii) An obligation of the United States, other than a current income obligation, in which he retains his investment in a matured series E U.S. savings bond, or

(iii) A nontransferable obligation (whether or not a current income obligation) of the United States for which a series E U.S. savings bond was exchanged (whether or not at final maturity) in an exchange upon which gain is not recognized because of section 1037(a) (or so much of section 1031(b) as relates to section 1037),

and if the increase, if any, in redemption price of such obligation described in subdivision (i), (ii), or (iii) of this subparagraph during the taxable year (as described in subparagraph (2) of this paragraph) does not constitute income for such year under the method of accounting used in computing his taxable income, then the taxpayer may, at his election, treat the increase as constituting income for the year in which such increase occurs. If the election is not made and section 1037 (or so much of section 1031 as relates to section 1037) does not apply, the taxpayer shall treat the increase as constituting income for the year in which the obligation is redeemed or disposed of, or finally matures, whichever is earlier. Any such election must be made in the taxpayer's return and may be made for any taxable year. If an election is made with respect to any such obligation described in subdivision (i), (ii), or (iii) of this subparagraph, it shall apply also to all other obligations of the type described in such subdivisions owned by the taxpayer at the beginning of the first taxable year to which the election applies, and to those thereafter acquired by him, and shall be binding for the taxable year for which the return is filed and for all subsequent taxable years, unless the Commissioner permits the taxpayer to change to a different method of reporting income from such obligations. See section 446(e) and paragraph (e) of §1.446–1, relating to requirement respecting a change of accounting method. Although the election once made is binding upon the taxpayer, it does not apply to a transferee of the taxpayer.

(2) *Amount of increase in case of non-interest-bearing obligations.* In any case in which an election is made under section 454, the amount which accrues in any taxable year to which the election applies is measured by the actual increase in the redemption price occurring in that year. This amount does not accrue ratably between the dates on which the redemption price changes. For example, if two dates on which the redemption price increases (February 1 and August 1) fall within a taxable year and if the redemption price increases in the amount of 50 cents on each such date, the amount accruing in that year would be $1 ($0.50 on February 1 and $0.50 on August 1). If the taxpayer owns a non-interest-bearing obligation of the character described in subdivision (i), (ii), or (iii) of subparagraph (1) of this paragraph acquired prior to the first taxable year to which his election applies, he must also include in gross income for such first taxable year (i) the increase in the redemption price of such obligation occurring between the date of acquisition of the obligation and the first day of such first taxable year and (ii), in a case where a series E bond was exchanged for such obligation, the increase in the redemption price of such series E bond occurring between the date of acquisition of such series E bond and the date of the exchange.

(3) *Amount of increase in case of current income obligations.* If an election is made under section 454 and the taxpayer owns, at the beginning of the first taxable year to which the election applies, a current income obligation of the character described in subparagraph (1)(iii) of this paragraph acquired prior to such taxable year, he must also include in gross income for such first taxable year the increase in the redemption price of the series E bond which was surrendered to the United States in exchange for such current income obligation; the amount of the increase is that occurring between the date of acquisition of the series E bond and the date of the exchange.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). Throughout the calendar year 1954, a taxpayer who uses the cash receipts and disbursements method of accounting holds series E U.S. savings bonds having a maturity value of $5,000 and a redemption value at the beginning of the year 1954 of $4,050 and at the end of the year 1954 of $4,150. He purchased the bonds on January 1, 1949, for $3,750, and holds no other obligation of the type described in this section. If the taxpayer exercises the election in his return for the calendar year 1954, he is required to include $400 in taxable income with respect to such bonds. Of this amount, $300 represents the increase in the redemption price before 1954 and $100 represents the increase in the redemption price in 1954. The increases in redemption value occurring in subsequent taxable years are includible in gross income for such taxable years.

Example (2). In 1958 B, a taxpayer who uses the cash receipts and disbursements method of accounting and the calendar year as his taxable year, purchased for $7,500 a series E United States savings bond with a face value of $10,000. In 1965, when the stated redemption value of the series E bond is $9,760, B surrenders it to the United States in exchange solely for a $10,000 series H U.S. current income savings bond in an exchange qualifying under section 1037(a), after paying $240 additional consideration. On the exchange of the series E bond for the series H bond in 1965, B realizes a gain of $2,260 ($9,760 less $7,500), none of which is recognized for that year by reason of section 1037(a). B retains the series H bond and redeems it at maturity in 1975 for $10,000, but in 1966 he exercises the election under section 454(a) in his return for that year with respect to five series E bonds he purchased in 1960. B is required to include in gross income for 1966 the increase in redemption price occurring before 1966 and in 1966 with respect to the series E bonds purchased in 1960; he is also required to include in gross income for 1966 the $2,260 increase in redemption price of the series E bond which was exchanged in 1965 for the series H bond.

(b) *Short-term obligations issued on a discount basis.* In the case of obligations of the United States or any of its possessions, or of a State, or Territory, or any political subdivision thereof, or of the District of Columbia, issued on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation originally sold does not accrue until the date on which such obligation is redeemed, sold, or otherwise disposed of. This rule applies regardless of the method of accounting used by the taxpayer. For examples illustrating rules for computation of income from sale or other disposition of certain obligations of the type described in this paragraph, see section 1221 and the regulations thereunder.

(c) *Matured U.S. savings bonds*—(1) *Inclusion of increase in income upon redemption or final maturity.* If a taxpayer (other than a corporation) holds—

(i) A matured series E U.S. savings bond,

(ii) An obligation of the United States, other than a current income obligation, in which he retains his investment in a matured series E U.S. savings bond, or

(iii) A nontransferable obligation (whether or not a current income obligation) of the United States for which a series E U.S. savings bond was exchanged (whether or not at final maturity) in an exchange upon which gain is not recognized because of section 1037(a) (or so much of section 1031(b) as relates to section 1037(a)),

the increase in redemption price of the series E bond in excess of the amount paid for such series E bond shall be included in the gross income of such taxpayer for the taxable year in which the obligation described in subdivision (i), (ii), or (iii) of this subparagraph is redeemed or disposed of, or finally matures, whichever is earlier, but only to the extent such increase has not previously been includible in the gross income of such taxpayer or any other taxpayer. If such obligation is partially redeemed before final maturity, or partially disposed of by being partially reissued to another owner, such increase in redemption price shall be included in the gross income of such taxpayer for such taxable year on a basis proportional to the total denomination of obligations redeemed or disposed of. The provisions of section 454 (c) and of this subparagraph shall not apply in the case of any taxable year for which the taxpayer's taxable income is computed under an accrual method of accounting or for a taxable year for which an election made by the taxpayer under section 454(a) and paragraph (a) of this section applies. For rules respecting the character of the gain realized upon the disposition or redemption of an obligation described in subdivision (iii) of this subparagraph, see paragraph (b) of § 1.1037–1.

(2) *Illustrations.* The application of this paragraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and the calendar year as his taxable year:

Example (1). On June 1, 1941, A purchased for $375 a series E U.S. savings bond which was redeemable at maturity (10 years from issue date) for $500. At maturity of the bond, A exercised the option of retaining the matured series E bond for the 10-year extended maturity period. On June 2, 1961, A redeemed the series E bond, at which time the stated redemption value was $674.60. A never elected under section 454(a) to include the annual increase in redemption price in gross income currently. Under section 454(c), A is required to include $299.60 ($674.60 less $375) in gross income for 1961 by reason of his redemption of the bond.

Example (2). The facts are the same as in example (2) in paragraph (a)(4) of this section. On redemption of the series H bond received in the exchange qualifying under section 1037(a), B realizes a gain of $2,260, determined as provided in example (5) in paragraph (b)(4) of § 1.1037–1. None of this amount is includible in B's gross income for 1975, such amount having already been includible in his gross income for 1966 because of his election under section 454(a).

Example (3). C, who had elected under section 454(a) to include the annual increase in the redemption price of his non-interest-bearing obligations in gross income currently, owned a $1,000 series E U.S. savings bond, which was purchased on October 1, 1949, for $750, C died on February 1, 1955, when the redemption value of the bond was $820. The bond was immediately reissued to D, his only heir, who has not made an election under section 454(a). On January 15, 1960, when the redemption value of the bond is $1,000, D surrenders it to the United States in exchange solely for a $1,000 series H U.S. savings bond in an exchange qualifying under the provisions of section 1037(a). For 1960 D properly does not return any income from the exchange of bonds, although he returns the interest payments on the series H bond for the taxable years in which they are received. On September 1, 1964, prior to maturity of the series H bond, D redeems it for $1,000. For 1964, D must include $180 in gross income under section 454(c) from the redemption of the series H bond, that is, the amount of the increase in the redemption price of the series E bond ($1,000 less $820) occurring between February 1, 1955, and January 15, 1960, the period during which he owned the series E bond.

[T.D. 6500, 25 FR 11719, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15820, Nov. 17, 1967; T.D. 7154, 36 FR 24997, Dec. 28, 1971]

§1.455–1 Treatment of prepaid subscription income.

Effective with respect to taxable years beginning after December 31, 1957, section 455 permits certain taxpayers to elect with respect to a trade or business in connection with which prepaid subscription income is received, to include such income in gross income for the taxable years during which a liability exists to furnish or deliver a newspaper, magazine, or other periodical. If a taxpayer does not elect to treat prepaid subscription income under the provisions of section 455, such income is includible in gross income for the taxable year in which received by the taxpayer, unless under the method or practice of accounting used in computing taxable income such amount is to be properly accounted for as of a different period.

[T.D. 6591, 27 FR 1798, Feb. 27, 1962]

§1.455–2 Scope of election under section 455.

(a) If a taxpayer makes an election under section 455 and §1.455–6 with respect to a trade or business, all prepaid subscription income from such trade or business shall be included in gross income for the taxable years during which the liability exists to furnish or deliver a newspaper, magazine, or other periodical. Such election shall be applicable to all prepaid subscription income received in connection with the trade or business for which the election is made; except that the taxpayer may further elect to include in gross income for the taxable year of receipt (as described in section 455(d)(3) and paragraph (c) of §1.455–5) the entire amount of any prepaid subscription income if the liability from which it arose is to end within 12 months after the date of receipt, hereinafter sometimes referred to as ‘‘within 12 months’’ election.

(b) If the taxpayer is engaged in more than one trade or business in which a liability is incurred to furnish or deliver a newspaper, magazine, or other periodical, a separate election 455 with respect to each such trade or business. In addition, a taxpayer may make a separate ‘‘within 12 months’’ election for each separate trade or business for which it has made an election under section 455.

(c) An election made under section 455 shall be binding for the first taxable year for which the election is made and for all subsequent taxable years, unless the taxpayer secures the consent of the Commissioner to the revocation of such election. Thus, in any case where the taxpayer has elected a method prescribed by section 455 for the inclusion of prepaid subscription income in gross income, such method of reporting income may not be changed without the prior approval of the Commissioner. In order to secure the Commissioner's consent to the revocation of such election, an application must be filed with the Commissioner in accordance with section 446(e) and the regulations thereunder. For purposes of subtitle A of the Code, the computation of taxable income under an election made under section 455 shall be treated as a method of accounting. For adjustments required by changes in method of accounting, see section 481 and the regulations thereunder.

(d) An election made under section 455 shall not apply to any prepaid subscription income received before the first taxable year to which the election applies. For example, Corporation M, which computes its taxable income under an accrual method of accounting and files its income tax returns on the calendar year basis, publishes a monthly magazine and customarily sells subscriptions on a 3-year basis. In 1958 it received $135,000 of 3-year prepaid subscription income for subscriptions beginning during 1958, and in 1959 it received $142,000 of prepaid subscription income for subscriptions beginning after December 31, 1958. In February 1959 it elected, with the consent of the Commissioner, to report its prepaid subscription income under the provisions of section 455 for the year 1959 and subsequent taxable years. The $135,000 received in 1958 from prepaid subscriptions must be included in gross income in full in that year, and no part of such 1958 income shall be allocated to the years 1959, 1960, and 1961 during which M was under a liability to deliver its magazine. The $142,000 received in 1959 from prepaid subscriptions shall be allocated to the years 1959, 1960, 1961, and 1962.

(e) No election may be made under section 455 with respect to a trade or business if, in computing taxable income, the cash receipts and disbursements method of accounting is used with respect to such trade or business. However, if the taxpayer is on a ‘‘combination’’ method of accounting under section 446(c)(4) and the regulations thereunder, it may elect the benefits of section 455 if it uses an accrual method of accounting for subscription income

[T.D. 6591, 27 FR 1798, Feb. 27, 1962]

§ 1.455–3 Method of allocation.

(a) Prepaid subscription income to which section 455 applies shall be included in gross income for the taxable years during which the liability to which the income relates is discharged or is deemed to be discharged on the basis of the taxpayer’s experience.

(b) For purposes of determining the period or periods over which the liability of the taxpayer extends, and for purposes of allocating prepaid subscription income to such periods, the taxpayer may aggregate similar transactions during the taxable year in any reasonable manner, provided the method of aggregation and allocation is consistently followed.

[T.D. 6591, 27 FR 1798, Feb. 27, 1962]

§ 1.455–4 Cessation of taxpayer’s liability.

(a) If a taxpayer has elected to apply the provisions of section 455 to a trade or business in connection with which prepaid subscription income is received, and if its liability to furnish or deliver a newspaper, magazine, or other periodical ends for any reason, then so much of the prepaid subscription income attributable to such liability as was not includible in its gross income under section 455 for preceding taxable years shall be included in its gross income for the taxable year in which such liability ends. A taxpayer’s liability may end, for example, because of the cancellation of a subscription. See section 381(c)(4) and the regulations thereunder for the treatment of prepaid subscription income in a transaction to which section 381(a) applies.

(b) If a taxpayer who has elected to apply the provisions of section 455 to a trade or business dies or ceases to exist, then so much of the prepaid subscription income attributable to such trade or business which was not includible in its gross income under section 455 for preceding taxable years shall be included in its gross income for the taxable year in which such death or cessation of existence occurs. See section 381(c)(4) and the regulations thereunder for the treatment of prepaid subscription income in a transaction to which section 381(a) applies.

[T.D. 6591, 27 FR 1799, Feb. 27, 1962]

§ 1.455–5 Definitions and other rules.

(a) *Prepaid subscription income.* (1) The term ‘‘prepaid subscription income’’ means any amount includible in gross income which is received in connection with, and is directly attributable to, a liability of the taxpayer which extends beyond the close of the taxable year in which such amount is received and which is income from a newspaper, magazine, or other periodical. For example where Corporation X, a publisher of newspapers, magazines, and other periodicals makes sales on a subscription basis and the purchaser pays the subscription price in advance, prepaid subscription income would include the amounts actually received by X in connection with its liability to furnish or deliver the newspaper, magazine, or other periodical.

(2) For purposes of section 455, prepaid subscription income does not include amounts received by a taxpayer in connection with sales of subscriptions on a prepaid basis where such taxpayer does not have the liability to furnish or deliver a newspaper, magazine, or other periodical. The provisions of this subparagraph may be illustrated by the following example. Corporation D has a contract with each of several large publishers which grants it the right to sell subscriptions to their periodicals. Corporation D collects the subscription price from the subscribers, retains a portion thereof as its commission and remits the balance to the publishers. The amount retained by Corporation D represents commissions on the sale of subscriptions, and is not prepaid subscription income for purposes of section 455 since the commissions represent compensation for services rendered and are not directly attributable to a liability of Corporation D to furnish or deliver a newspaper, magazine, or other periodical.

(b) *Liability.* The term ''liability'' means a liability of the taxpayer to furnish or deliver a newspaper, magazine, or other periodical.

(c) *Receipt of prepaid subscription income.* For purposes of section 455, prepaid subscription income shall be treated as received during the taxable year for which it is includible in gross income under section 451, relating to general rule for taxable year of inclusion, without regard to section 455.

(d) *Treatment of prepaid subscription income under an established accounting method.* Notwithstanding the provisions of section 455 and §1.455–1, any taxpayer who, for taxable years beginning before January 1, 1958, has reported prepaid subscription income for income tax purposes under an established and consistent method or practice of deferring such income may continue to report such income in accordance with such method or practice for all subsequent taxable years to which section 455 applies without making an election under section 455.

[T.D. 6591, 27 FR 1799, Feb. 27, 1962]

§1.455–6 Time and manner of making election.

(a) *Election without consent.* (1) A taxpayer may, without consent, elect to treat prepaid subscription income of a trade or business under section 455 for the first taxable year—

(i) Which begins after December 31, 1957, and

(ii) In which there is received prepaid subscription income from the trade or business for which the election is made. Such an election shall be made not later than the time prescribed by law for filing the income tax return for such year (including extensions thereof), and shall be made by means of a statement attached to such return.

(2) The statement shall indicate that the taxpayer is electing to apply the provisions of section 455 to his trade or business, and shall contain the following information:

(i) The name and a description of the taxpayer's trade or business to which the election is to apply;

(ii) The method of accounting used in such trade or business;

(iii) The total amount of prepaid subscription income from such trade or business for the taxable year;

(iv) The period or periods over which the liability of the taxpayer to furnish or deliver a newspaper, magazine, or other periodical extends;

(v) The amount of prepaid subscription income applicable to each such period; and

(vi) A description of the method used in allocating the prepaid subscription income to each such period.

In any case in which prepaid subscription income is received from more than one trade or business, the statement shall set forth the required information with respect to each trade or business subject to the election.

(3) See paragraph (c) of this section for additional information required to be submitted with the statement if the taxpayer also elects to include in gross income for the taxable year of receipt the entire amount of prepaid subscription income attributable to a liability which is to end within 12 months after the date of receipt.

(b) *Election with consent.* A taxpayer may, with the consent of the Commissioner, elect at any time to apply the provisions of section 455 to any trade or business in which it receives prepaid subscription income. The request for such consent shall be in writing, signed by the taxpayer or its authorized representative, and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R:C, Washington, D.C. 20224. The request must be filed on or before the later of the following dates:

(1) 90 days after the beginning of the first taxable year to which the election is to apply or

(2) May 28, 1962, and must contain the information described in paragraph (a)(2) of this section.

See paragraph (c) of this section for additional information required to be submitted with the request if the taxpayer also elects to include in gross income for the taxable year of receipt the entire amount of prepaid subscription income attributable to a liability which is to end within 12 months after the date of receipt.

(c) *''Within 12 months'' election.* (1) A taxpayer who elects to apply the provisions of section 455 to any trade or business may also elect to include in gross income for the taxable year of receipt (as described in section 455(d)(3) and paragraph (c) of § 1.455–5) the entire amount of any prepaid subscription income from such trade or business if the liability from which it arose is to end within 12 months after the date of receipt. Any such election is binding for the first taxable year for which it is effective and for all subsequent taxable years, unless the taxpayer secures permission from the Commissioner to treat such income differently. Application to revoke or change a ''within 12 months'' election shall be made in accordance with the provisions of section 446(e) and the regulations thereunder.

(2) The ''within 12 months'' election shall be made by including in the statement required by paragraph (a) of this section or the request described in paragraph (b) of this section, whichever is applicable, a declaration that the taxpayer elects to include such income in gross income in the taxable year of receipt, and the amount of such income. If the taxpayer is engaged in more than one trade or business for which the election under section 455 is made, it must include, in such statement or request, a declaration for each trade or business for which it makes the ''within 12 months'' election. See also paragraph (e) of § 1.455–2.

(3) If the taxpayer does not make the ''within 12 months'' election for its trade or business at the time prescribed for making the election to include prepaid subscription income in gross income for the taxable years during which its liability to furnish or deliver a newspaper, magazine, or other periodical exists for such trade or business, but later wishes to make such election, it must apply for permission from the Commissioner. Such application shall be made in accordance with the provisions of section 446(e) and the regulations thereunder.

[T.D. 6591, 27 FR 1799, Feb. 27, 1962]

§ 1.456–1 Treatment of prepaid dues income.

Effective for taxable years beginning after December 31, 1960, a taxpayer which is a membership organization (as described in paragraph (c) of § 1.456–5) and which receives prepaid dues income as described in paragraph (a) of § 1.456–5 in connection with its trade or business of rendering services or making available membership privileges may elect under section 456 to include such income in gross income ratably over the taxable years during which its liability (as described in paragraph (b) of § 1.456–5) to render such services or extend such privileges exists, if such liability does not extend over a period of time in excess of 36 months. If the taxpayer does not elect to treat prepaid dues income under section 456, or if such income may not be reported under section 456, as for example, where the income relates to a liability to render services or make available membership privileges which extends beyond 36 months, then such income is includible in gross income for the taxable year in which it is received (as described in paragraph (d) of §1.456–5).

[T.D. 6937, 32 FR 16394, Nov. 30, 1967]

§1.456–2 Scope of election under section 456.

(a) An election made under section 456 and §1.456–6, shall be applicable to all prepaid dues income received in connection with the trade or business for which the election is made. However, the taxpayer may further elect to include in gross income for the taxable year of receipt the entire amount of any prepaid dues income attributable to a liability extending beyond the close of the taxable year but ending within 12 months after the date of receipt, hereinafter referred to as the ‘‘within 12 months’’ election.

(b) If the taxpayer is engaged in more than one trade or business in connection with which prepaid dues income is received, a separate election may be made under section 456 with respect to each such trade or business. In addition, a taxpayer may make a separate ‘‘within 12 months’’ election for each separate trade or business for which it has made an election under section 456.

(c) A section 456 election and a ‘‘within 12 months’’ election shall be binding for the first taxable year for which the election is made and for all subsequent taxable years, unless the taxpayer secures the consent of the Commissioner to the revocation of either election. In order to secure the Commissioner’s consent to the revocation of the section 456 election or the ‘‘within 12 months’’ election, an application must be filed with the Commissioner in accordance with section 446(e) and the regulations thereunder. However, an application for consent to revoke the section 456 election or the ‘‘within 12 months’’ election in the case of all taxable years which end before November 30, 1967 must be filed on or before February 28, 1968. For purposes of Subtitle A of the Code, the computation of taxable income under an election made under section 456 or under the ‘‘within 12 months’’ election shall be treated as a method of accounting. For adjustments required by changes in method of accounting, see section 481 and the regulations thereunder.

(d) Except as provided in section 456(d) and §1.456–7, an election made under section 456 shall not apply to any prepaid dues income received before the first taxable year to which the election applies. For example, Corporation X, a membership organization which files its income tax returns on a calendar year basis, customarily sells 3-year memberships, payable in advance. In 1961 it received $160,000 of prepaid dues income for 3-year memberships beginning during 1961, and in 1962 it received $185,000 of prepaid dues income for 3-year memberships beginning on January 1, 1962. In March 1962 it elected, with the consent of the Commissioner, to report its prepaid dues income under the provisions of section 456 for the year 1962 and subsequent taxable years. The $160,000 received in 1961 from prepaid dues must be included in gross income in full in that year, and except as provided in section 456(d) and §1.456–7, no part of such income shall be allocated to the taxable years 1962, 1963, and 1964 during which X was under a liability to make available its membership privileges. The $185,000 received in 1962 from prepaid dues income shall be allocated to the years 1962, 1963, and 1964.

(e) No election may be made under section 456 with respect to a trade or business if, in computing taxable income, the cash receipts and disbursements method (or a hybrid thereof) of accounting is used with respect to such trade or business, unless the combination of the section 456 election and the taxpayer’s hybrid method of accounting does not result in a material distortion of income.

[T.D. 6937, 32 FR 16394, Nov. 30, 1967; 32 FR 17479, Dec. 6, 1967]

§1.456–3 Method of allocation.

(a) Prepaid dues income for which an election has been made under section 456 shall be included in gross income over the period of time during which the liability to render services or make available membership privileges exists. The liability to render the services or make available the membership privileges shall be deemed to exist ratably over the period of time such services are required to be rendered, or such membership privileges are required to be made available. Thus, the prepaid dues income shall be included in gross income ratably over the period of the membership contract. For example, Corporation X, a membership organization, which files its income tax returns on a calendar year basis, elects, for its taxable year beginning January 1, 1961, to report its prepaid dues income in accordance with the provisions of section 456. On March 31, 1961, it sells a 2-year membership for $48 payable in advance, the membership to extend from May 1, 1961, to April 30, 1963. X shall include in its gross income for the taxable year 1961 8⁄24 of the $48, or $16, and for the taxable year 1962 12⁄24 of the $48, or $24, and for the taxable year 1963 4⁄24 of the $48, or $8.

(b) For purposes of determining the period or periods over which the liability of the taxpayer exists, and for purposes of allocating prepaid dues income to such periods, the taxpayer may aggregate similar transactions during the taxable year in any reasonable manner, provided the method of aggregation and allocation is consistently followed.

[T.D. 6937, 32 FR 16395, Nov. 30, 1967]

§ 1.456–4 Cessation of liability or existence.

(a) If a taxpayer has elected to apply the provisions of section 456 to a trade or business in connection with which prepaid dues income is received, and if the taxpayer's liability to render services or make available membership privileges ends for any reason, as for example, because of the cancellation of a membership then so much of the prepaid dues income attributable to such liability as was not includible in the taxpayer's gross income under section 456 for preceding taxable years shall be included in gross income for the taxable year in which such liability ends. This paragraph shall not apply to amounts includible in gross income under § 1.456–7.

(b) If a taxpayer which has elected to apply the provisions of section 456 ceases to exist, then the prepaid dues income which was not includible in gross income under section 456 for preceding taxable years shall be included in the taxpayer's gross income for the taxable year in which such cessation of existence occurs. This paragraph shall not apply to amounts includible in gross income under § 1.456–7.

(c) If a taxpayer is a party to a transaction to which section 381(a) applies and the taxpayer's method of accounting with respect to prepaid dues income is used by the acquiring corporation under the provisions of section 381(c)(4), then neither the liability nor the existence of the taxpayer shall be deemed to have ended or ceased. In such cases see section 381(c)(4) and the regulations thereunder for the treatment of the portion of prepaid dues income which was not included in gross income under section 456 for preceding taxable years.

[T.D. 6937, 32 FR 16395, Nov. 30, 1967]

§ 1.456–5 Definitions and other rules.

(a) *Prepaid dues income.* (1) The term ''prepaid dues income'' means any amount for membership dues includible in gross income which is received by a membership organization in connection with, and is directly attributable to, a liability of the taxpayer to render services or make available membership privileges over a period of time which extends beyond the close of the taxable year in which such amount is received.

(2) For purposes of section 456, prepaid dues income does not include amounts received by a taxpayer in connection with sales of memberships on a prepaid basis where the taxpayer does not have the liability to furnish the services or make available the membership privileges. For example, where a taxpayer has a contract with several membership organizations to sell memberships in such organizations and retains a portion of the amounts received from the sale of such memberships and remits the balance to the membership organizations, the amounts retained by such taxpayer represent commissions and do not constitute prepaid dues income for purposes of section 456.

(b) *Liability.* The term ''liability'' means a liability of the taxpayer to render services or make available membership privileges over a period of time which does not exceed 36 months. Thus, if during the taxable year a taxpayer sells memberships for more than

36 months and also memberships for 36 months or less, section 456 does not apply to the income from the sale of memberships for more than 36 months. For the purpose of determining the duration of a liability, a bona fide renewal of a membership shall not be considered to be a part of the existing membership.

(c) *Membership organization.* (1) The term ''membership organization'' means a corporation, association, federation, or other similar organization meeting the following requirements:

(i) It is organized without capital stock of any kind.

(ii) Its charter, bylaws, or other written agreement or contract expressly prohibits the distribution of any part of the net earnings directly or indirectly, in money, property, or services, to any member, and

(iii) No part of the net earnings of which is in fact distributed to any member either directly or indirectly, in money, property, or services.

(2) For purposes of this paragraph an increase in services or reduction in dues to all members shall generally not be considered distributions of net earnings.

(3) If a corporation, association, federation, or other similar organization subsequent to the time it elects to report its prepaid dues income in accordance with the provisions of section 456, (i) issues any kind of capital stock either to any member or nonmember, (ii) amends its charter, bylaws, or other written agreement or contract to permit distributions of its net earnings to any member or, (iii) in fact, distributes any part of its net earnings either in money, property, or services to any member, then immediately after such event the organization shall not be considered a membership organization within the meaning of section 456(e)(3).

(d) *Receipt of prepaid dues income.* For purposes of section 456, prepaid dues income shall be treated as received during the taxable year for which it is includible in gross income under section 451, relating to the general rule for taxable year of inclusion, without regard to section 456.

[T.D. 6937, 32 FR 16395, Nov. 30, 1967]

§1.456–6 Time and manner of making election.

(a) *Election without consent.* A taxpayer may make an election under section 456 without the consent of the Commissioner for the first taxable year beginning after December 31, 1960, in which it receives prepaid dues income in the trade or business for which such election is made. The election must be made not later than the time prescribed by law for filing the income tax return for such year (including extensions thereof). The election must be made by means of a statement attached to such return. In addition, there should be attached a copy of a typical membership contract used by the organization and a copy of its charter, bylaws, or other written agreement or contract of organization or association. The statement shall indicate that the taxpayer is electing to apply the provisions of section 456 to the trade or business, and shall contain the following information:

(1) The taxpayer's name and a description of the trade or business to which the election is to apply.

(2) The method of accounting used for prepaid dues income in the trade or business during the first taxable year for which the election is to be effective and during each of 3 preceding taxable years, and if there was a change in the method of accounting for prepaid dues income during such 3-year period, a detailed explanation of such change including the adjustments necessary to prevent duplications or omissions of income.

(3) Whether any type of deferral method for prepaid dues income has been used during any of the 3 taxable years preceding the first taxable year for which the election is effective. Where any type of such deferral method has been used during this period, an explanation of the method and a schedule showing the amounts received in each such year and the amounts deferred to each succeeding year.

(4) A schedule with appropriate explanations showing:

(i) The total amount of prepaid dues income received in the trade or business in the first taxable year for which the election is effective and the amount of such income to be included in each taxable year in accordance with the election,

(ii) The total amount, if any, of prepayments of dues received in the first taxable year for which the election is effective which are directly attributable to a liability of the taxpayer to render services or make available membership privileges over a period of time in excess of 36 months, and

(iii) The total amount, if any, of prepaid dues income received in the trade or business in—

(a) The taxable year preceding the first taxable year for which the election is effective if all memberships sold by the taxpayer are for periods of 1 year or less,

(b) Each of the 2 taxable years preceding the first taxable year for which the election is effective if any memberships are sold for periods in excess of 1 year but none are sold for periods in excess of 2 years, or

(c) Each of the 3 taxable years preceding the first taxable year for which the election is effective if any memberships are sold for periods in excess of 2 years.

In each case there shall be set forth the amount of such income which would have been includible in each taxable year had the election been effective for the years for which the information is required.

In any case in which prepaid dues income is received from more than one trade or business, the statement shall set forth separately the required information with respect to each trade or business for which the election is made. See paragraph (c) of this section for additional information required to be submitted with the statement if the taxpayer also elects to include in gross income for the taxable year of receipt the entire amount of prepaid dues income attributable to a liability which is to end within 12 months after the date of receipt.

(b) *Election with consent.* A taxpayer may elect with the consent of the Commissioner, to apply the provisions of section 456 to any trade or business in which it receives prepaid dues income. The request for such consent shall be in writing, signed by the taxpayer or its authorized representative, and shall be addressed to the Commissioner of Internal Revenue, Washington, D.C. 20224. The request must be filed on or before the later of the following dates:

(1) 90 days after the beginning of the first taxable year to which the election is to apply, or

(2) February 28, 1968 and should contain the information described in paragraph (a) of this section.

See paragraph (c) of this section for additional information required to be submitted with the request if the taxpayer also elects to include in gross income for the taxable year of receipt the entire amount of prepaid dues income attributable to a liability which is to end within 12 months after the date of receipt.

(c) *''Within 12 months'' election.* (1) The ''within 12 months'' election shall be made by including in the statement required by paragraph (a) of this section or the request described in paragraph (b) of this section, whichever is applicable, a declaration that the taxpayer elects to include such income in gross income in the taxable year of receipt, and the amount of such income for each taxable year to which the election is to apply which has ended prior to the time such statement or request is filed. If the taxpayer is engaged in more than one trade or business for which the election under section 456 is made, it must include, in such statement or request, a declaration for each trade or business for which it wishes to make the ''within 12 months'' election.

(2) If the taxpayer does not make the ''within 12 months'' election for a trade or business at the time it makes the election under paragraph (a) or (b) of this section, but later wishes to make such election, it must apply for permission from the Commissioner. Such application shall be made in accordance with the provisions of section 446(e).

[T.D. 6937, 32 FR 16395, Nov. 30, 1967; 32 FR 17479, Dec. 6, 1967]

§ 1.456–7 Transitional rule.

(a) Under section 456(d)(1), a taxpayer making an election under section 456 shall include in its gross income for the first taxable year to which the election applies and for each of the 2 succeeding taxable years not only that portion of prepaid dues income which is includible in gross income for each such taxable year under section 456(a), but also an additional amount equal to that portion of the total prepaid dues income received in each of the 3 taxable years preceding the first taxable year to which the election applies which would have been includible in gross income for such first taxable year and such 2 succeeding taxable years had the election under section 456 been effective during such 3 preceding taxable years. In computing such additional amounts—

(1) In the case of taxpayers who did not include in gross income for the taxable year preceding the first taxable year for which the election is effective, that portion of the prepaid dues income received in such year attributable to a liability which is to end within 12 months after the date of receipt, no effect shall be given to a ''within 12 months'' election made under paragraph (c) of § 1.456–6, and

(2) There shall be taken into account only prepaid dues income arising from a trade or business with respect to which an election is made under section 456 and § 1.456–6.

Section 481 and the regulations thereunder shall have no application to the additional amounts includible in gross income under section 456(d) and this section, but section 481 and the regulations thereunder shall apply to prevent other amounts from being duplicated or omitted.

(b) A taxpayer who makes an election with respect to prepaid dues income, and who includes in gross income for any taxable year to which the election applies an additional amount computed under section 456(d)(1) and paragraph (a) of this section, shall be permitted under section 456(d)(2) to deduct for such taxable year and for each of the 4 succeeding taxable years an amount equal to one-fifth of such additional amount, but only to the extent that such additional amount was also included in the taxpayer's gross income for any of the 3 taxable years preceding the first taxable year to which such election applies. The taxpayer shall maintain books and records in sufficient detail to enable the district director to determine upon audit that the additional amounts were included in the taxpayer's gross income for any of the 3 taxable years preceding such first taxable year. If, however, the taxpayer ceases to exist, as described in paragraph (b) of § 1.456–4, and there is included in gross income, under such paragraph, of the year of cessation the entire portion of prepaid dues income not previously includible in gross income under section 456 for preceding taxable years (other than for amounts received prior to the first year for which an election was made), all the amounts not previously deducted under this paragraph shall be permitted as a deduction in the year of cessation of existence.

(c) The provisions of this section may be illustrated by the following example:

Example. (1) Assume that X Corporation, a membership organization qualified to make the election under section 456, elects to report its prepaid dues income in accordance with the provisions of section 456 for its taxable year ending December 31, 1961. Assume further that X Corporation receives in the middle of each taxable year $3,000 of prepaid dues income in connection with a liability to render services over a 3-year period beginning with the date of receipt. Under section 456(a), X Corporation will report income received in 1961 and subsequent years as follows:

Year of receipt	Total receipts	1961	1962	1963	1964	1965	1966	1967	1968
1961	$3,000	$500	$1,000	$1,000	$500	....	....	....	....
1962	3,000	....	500	1,000	1,000	$500	....	....	....
1963	3,000	....	....	500	1,000	1,000	$500	....	....
1964	3,000	....	....	....	500	1,000	1,000	$500	....
1965	3,000	....	....	....	....	500	1,000	1,000	$500
1966	3,000	....	....	....	....	....	500	1,000	1,000
1967	3,000	....	....	....	....	....	....	500	1,000
1968	3,000	....	....	....	....	....	....	....	500
Total reportable under section 456(a)		500	1,500	2,500	3,000	3,000	3,000	3,000	3,000

(2) Under section 456(d) (1), X Corporation must include in its gross income for the first taxable year to which the election applies and for each of the 2 succeeding taxable years, the amounts which would have been included in those years had the election been effective 3 years earlier. If the election had been effective in 1958, the following amounts received in 1958, 1959, and 1960 would have been reported in 1961 and subsequent years:

Year of receipt	Amount received	Years of including additional amounts		
		1961	1962	1963
1958	$3,000	$500	....	....
1959	3,000	1,000	$500	....
1960	3,000	1,000	1,000	$500
Total additional amounts to be included under section 456(d)(1)	2,500	1,500	500	

(3) Having included the additional amounts as required by section 456(d)(1), and assuming such amounts were actually included in gross income in the 3 taxable years preceding the first taxable year for which the election is effective, X Corporation is entitled to deduct under section 456(d)(2) in the year of inclusion and in each of the succeeding 4 years an amount equal to one-fifth of the amounts included, as follows:

Year of inclusion	Amount	Years of deduction						
		1961	1962	1963	1964	1965	1966	1967
1961	$2,500	$500	$500	$500	$500	$500	....	....
1962	1,500	....	300	300	300	300	$300	....
1963	500	....	....	100	100	100	100	$10
Total amount deductible under section 456(d)(2)	500	800	900	900	900	400	100	

(4) The net result of the inclusions under section 456(d)(1) and the deductions under section 456(d)(2) may be summarized as follows:

	1961	1962	1963	1964	1965	1966	1967	1968
Amount includible under section 456(a)	$500	$1,500	$2,500	$3,000	$3,000	$3,000	$3,000	$3,000
Amount includible under section 456(d)(1)	2,500	1,500	500	....	....	....	....	....
Total	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
Amount deductible under section 456(d)(2)	500	800	900	900	900	400	100	....
Net amount reportable under section 456	2,500	2,200	2,100	2,100	2,100	2,600	2,900	3,000

[T.D. 6937, 32 FR 16396, Nov. 30. 1967]

§ 1.457–1 Compensation deferred under eligible State deferred compensation plans.

(a) *Year of inclusion in gross income*—(1) *In general.* For taxable years beginning after December 31, 1978, section 457(a) provides that amounts deferred (within the meaning of § 1.457–1(d)(3)) under an eligible State deferred compensation plan that satisfies the requirements of § 1.457–2 (an ‘‘eligible plan’’) are includible in gross income only for the taxable year in which paid or otherwise made available to the participant or beneficiary under the plan.

(2) *Maximum deferral; in general.* Under section 457(c)(1), the exclusion from gross income described in this paragraph (a) does not apply to compensation deferred under one or more eligible plans to the extent that the compensation so deferred during a participant's taxable year exceeds the greater of—

(i) $7,500, or,

(ii) As applicable, the sum of the plan ceilings determined under § 1.457–2(f), to the extent such sum does not exceed $15,000.

(3) *Maximum deferral; exclusions under section 403(b) taken into account.* Under

section 457(c)(2), for a participant's taxable year for which an amount is contributed to an annuity contract described in section 403(b) (including a custodial account described in section 403(b)(7)) on behalf of the participant, subparagraph (2) of this paragraph (a) is applied by substituting—

(i) For $7,500, an amount equal to $7,500, less the amount excludable from the participant's gross income under section 403(b) for the taxable year,

(ii) For the sum of the plan ceilings determined under §1.457–2(f), an amount equal to the sum of the plan ceilings determined under §1.457–2(f), less the amount excludable from the participant's gross income under section 403(b) for the taxable year, if such amount is not taken into account under such §1.457–2(f), and

(iii) For $15,000, an amount equal to $15,000, less the amount excludable from the participant's gross income under section 403(b) for the taxable year.

(b) *Amounts made available to participant or beneficiary*—(1) *In general.* For purposes of section 457(a) and this section, amounts deferred under an eligible plan will not be considered made available to the participant or beneficiary if under the plan the participant or beneficiary may irrevocably elect, prior to the time any such amounts become payable, to defer payment of some or all of such amounts to a fixed or determinable future time. In addition, amounts deferred (including amounts previously deferred) under an eligible plan will not be considered made available to the participant solely because the participant is permitted to choose among various investment modes under the plan for the investment of such amounts whether before or after payments have commenced under the plan.

(2) *Examples.* Further examples of when amounts deferred will or will not be considered as being made available to the participant or beneficiary are provided below:

Example (1). (i) C, an individual, is a participant in an eligible State deferred compensation plan that provides the following:

(A) The total of the amounts deferred under the plan is payable to the participant in 120 substantially equal monthly installments commencing on the date 30 days after the participant attains normal retirement age under the plan (age 65), unless the participant elects, within the 90 day period ending on the date the participant attains normal retirement age, to receive a single sum payment of the deferred amounts. The single sum payment is payable to a participant on the date the first of the monthly payment would otherwise be payable to the participant.

(B) If a participant separates from the service of the State before attaining normal retirement age, the total of the amounts deferred under the plan is payable to the participant in a single sum payment on the date 90 days after the date of the separation, unless, before the date 30 days after the separation, the participant elects not to receive the single sum payment. The election is irrevocable. If the participant makes the election, the total of the amounts deferred under the plan is payable to the participant as described in (A), either in monthly installments or, at the election of the participant, in a single sum payment.

(ii) On June 6, 1982, C, a calendar year taxpayer aged 59, separates from the service of the State. On June 18, 1982, C elects not to receive the single sum payment payable on account of the separation. Because of C's election, no amount deferred under the plan is considered made available in 1982 by reason of C's right to receive the single sum payment.

(iii) On February 6, 1988, C attains age 65. C did not, within the 90 day period elect the single sum payment that is payable in lieu of the monthly installments. Amounts deferred under the plan are includible in C's gross income as they are paid to C in the monthly installments. No amount is considered made available by reason of C's right to elect the single sum payment.

Example (2). Assume the same facts as in example (1), except that the plan provides that notwithstanding that monthly installments have commenced under the plan, as described in (i)(A), the participant may, without restriction, elect to receive all or any portion of the amount remaining payable to the participant. The total of the amounts deferred under the plan is considered made available in 1988.

Example (3). Assume the same facts as in example (1), except that the plan provides that once monthly installment payments have commenced under the plan, as described in (i)(A), the participant may accelerate the payment of the amount remaining payable to the participant upon the occurrence of an unforeseeable emergency as described in §1.457–2(h)(4) in an amount not exceeding that described in §1.457–2(h)(5). No amount is considered made available to C on account of C's right to accelerate payments upon the occurrence of an unforeseeable emergency.

Example (4). Under an eligible plan of which individual D is a participant, normal retirement age is age 65 at which time payments must begin. Payments may begin earlier upon a separation from the service. Under the plan, a participant who separates from the service before age 65 or the participant's beneficiary (if the separation is due to the participant's death) may elect to defer the distribution of the amounts deferred until the year in which the participant attains or would have attained age 65. This election may be made only prior to the time any payments commence and once made may not be revoked. If such an election is made, the participant, former participant, or beneficary need not elect the method of payment, or if one is elected may change the method elected, until the date 30 days preceding the date upon which payments are to commence. No amount is considered made available by reason of D's right to defer the distribution of the amounts deferred until age 65, nor on account of D's right to delay the election of the method of payout. Similarly, if D dies at age 60, no amount is considered made available to D's beneficiary by reason of the beneficiary's right to defer the distribution of the amounts deferred until the year in which D would have attained age 65, nor on account of the beneficiary's right to delay the election of the method of payout.

Example (5). Under an eligible plan of which individual E is a participant, the maximum that may be deferred in any taxable year is 33⅓% of includible compensation, not to exceed $7,500. The plan does not provide for a catch-up deferral under section 457(b)(3). In one taxable year, E elects to have amounts deferred in excess of the limitation provided for under the plan. The amounts deferred in excess of the limitation will be considered to have been made available to E in the taxable year in which deferred.

Example (6). Assume the same facts as in example (5), except that E's employer also contributes amounts for the purchase of an annuity contract under section 403(b). In one taxable year, E has amounts contributed for the annuity within the limitations of section 403(b)(2), and also has amounts deferred under the eligible plan for the same year. The aggregate of the amounts contributed for the annuity contract and the amounts deferred under the plan exceed the deferral limitations under the plan. The excess deferrals will be considered made available to E in the year in which the amounts were deferred.

Example (7). Under an eligible plan of which F is a participant, amounts deferred have been invested in a money market investment fund. The plan then transfers the amounts deferred to a life insurance company for the purchase of life insurance contracts as an investment medium. However, the entity sponsoring the plan (1) retains all of the incidents of ownership of the contracts, (2) is the sole beneficiary under the contracts, and (3) is under no obligation to transfer the contracts or to pass through the proceeds of the contracts to any participant or a beneficiary of any participant. The movement of the amounts deferred to the life insurance company (whether or not made at the request of any plan participant) will not be considered to make the amounts available to the plan's participants. The cost of current life insurance protection under the life insurance contracts will not be considered made available to the plan's participants.

(c) *Life insurance proceeds and death benefits paid under eligible plan.* No amount received or made available under an eligible plan is excludable from gross income under section 101(a) (relating to life insurance contracts) or section 101(b) (relating to employees' death benefits).

(d) *Definitions.* For purposes of §§ 1.457–1 through 1.457–4:

(1) *Participant.* ''Participant'' means an individual who is eligible under § 1.457–2(d) to defer compensation under the plan.

(2) *Beneficiary.* ''Beneficiary'' means a beneficiary of a participant, a participant's estate, or any other person whose interest in the plan is derived from the participant.

(3) *Amounts deferred.* ''Amount(s) deferred'' under an eligible plan means compensation deferred under the plan, plus income attributable to compensation so deferred. Income attributable to compensation deferred under an eligible plan includes gain from the disposition of property. The term ''amounts deferred'' includes amounts deferred in taxable years beginning before January 1, 1979, if such amounts were deferred under a plan described in § 1.457–2(b), and such amounts were made a part of an eligible plan.

[T.D. 7836, 47 FR 42337, Sept. 27, 1982]

§ 1.457–2 Eligible State deferred compensation plan defined.

(a) *In general.* For purposes of §§ 1.457–1 through 1.457–4, an ''eligible State deferred compensation plan'' (sometimes referred to as ''eligible plan'') is a plan satisfying the requirements of paragraphs (c) through (k) of this section.

(b) *Plan.* For purposes of this section and §1.457–3, the term ‘‘plan’’ includes any agreement or arrangement between a State (within the meaning of paragraph (c) of this section) and a participant or participants, under which the payment of compensation is deferred, but only if such agreement or arrangement is not described in §1.457–3(b).

(c) *State.* The plan must be established and maintained by a State. For this purpose, the term ‘‘State’’ includes:

(1) The 50 states of the United States and the District of Columbia;

(2) A political subdivision of a State;

(3) Any agency or instrumentality of a State or political subdivision of a State;

(4) An organization that is exempt from tax under section 501(a) and engaged primarily in providing electrical service on a mutual or cooperative basis; and

(5) An organization that is described in section 501(c)(4) or (6) and exempt from tax under section 501(a) and at least 80% of the members of which are organizations described in subparagraph (4).

Where it appears in this §1.457–2, the term ‘‘State’’ means the entity described in this paragraph (c) that sponsors the plan.

(d) *Participants.* The plan must provide that only individuals who perform services for the State, either as an employee of the State or as an independent contractor, may defer compensation under the plan.

(e) *Maximum deferrals*—(1) *In general.* The plan must provide that the amount of compensation that may be deferred under the plan for a taxable year of a participant shall not exceed an amount specifed in the plan (the ‘‘plan ceiling’’). Except as described in paragraph (f) of this section, a plan ceiling shall not exceed the lesser of:

(i) $7,500, or

(ii) 33⅓% of the participant’s includible compensation for the taxable year, reduced by any amount excludable from the participant’s gross income for the taxable year under section 403(b) on account of contributions made by the State.

(2) *Includible compensation.* For purposes of this section, a participant’s includible compensation for a taxable year includes only compensation from the State that is attributable to services performed for the State and that is includible in the participant’s gross income for the taxable year. Accordingly, a participant’s includible compensation for a taxable year does not include an amount payable by the State that is excludable from the employee’s gross income under section 457(a) and §1.457–1 or under section 403(b) (relating to annuity contracts purchased by section 501(c)(3) organizations or public schools), section 105(d) (relating to wage continuation plans) or section 911 (relating to citizens or residents of the United States living abroad). A participant’s includible compensation for a taxable year is determined without regard to any community property laws.

(3) *Compensation taken into account at its present value.* For purposes of subparagraph (1) of this paragraph, compensation deferred under a plan shall be taken into account at its value in the plan year in which deferred. However, if the compensation deferred is subject to a substantial risk of forfeiture (as defined in section 457(e)(3)), such compensation shall be taken into account at its value in the plan year in which such compensation is no longer subject to a substantial risk of forfeiture.

(f) *Limited catch-up*—(1) *In general.* The plan may provide that, for 1 or more of the participant’s last 3 taxable years ending before the participant attains normal retirement age, the plan ceiling is an amount not in excess of the lesser of:

(i) $15,000, reduced by any amount excludable from the participant’s gross income for the taxable year under section 403(b) on account of contributions made by the State, or

(ii) The amount determined under subparagraph (2) of this paragraph.

(2) *Underutilized limitations.* The amount determined under this subparagraph (2) is the sum of:

(i) The plan ceiling established under paragraph (e)(1) of this section for the taxable year, plus

(ii) The plan ceiling established under paragraph (e)(1) of this section for any prior taxable year or years, less the amount of compensation deferred under the plan for such prior taxable year or years.

A prior taxable year shall be taken into account under subdivision (ii) of this subparagraph (2) only if (A) it begins after December 31, 1978, (B) the participant was eligible to participate in the plan during all or any portion of the taxable year, and (C) compensation deferred (if any) under the plan during the taxable year was subject to a plan ceiling established under paragraph (e)(1) of this section. A participant will be considered eligible to participate in the plan for a taxable year if the participant is described in paragraph (d) of this section for any part of that taxable year. A prior taxable year includes a taxable year in which the participant was eligible to participate in an eligible plan sponsored by a different entity, provided that the entities sponsoring the plans are located within the same State as that term is used in § 1.457–2(c)(1).

(3) *Restriction on limited catch-up.* The plan shall not provide that a participant may elect to have the limited catch-up provision of this paragraph (f) apply more than once, whether or not the limited catch-up is utilized in less than all of the three taxable years ending before the participant attains normal retirement age, and whether or not the participant or former participant rejoins the plan or participates in another eligible plan after retirement. For example, if the participant elects to utilize the limited catch-up only for the one taxable year ending before normal retirement age, and, after retirement at that age, the participant renders services for the State as an independent contractor or otherwise, the plan may not provide that the participant may utilize the limited catch-up for any of the taxable years subsequent to retirement.

(4) *Normal retirement age.* For purposes of this paragraph (f), normal retirement age may be specified in the plan. If no normal retirement age is specified in the plan, then the normal retirement age is the later of the latest normal retirement age specified in the basic pension plan of the State, or age 65. A plan may define normal retirement age as any range of ages ending no later than age 70½ and beginning no earlier than the earliest age at which the participant has the right to retire under the State's basic pension plan without consent of the State and to receive immediate retirement benefits without actuarial or similar reduction because of retirement before some later specified age in the State's basic pension plan. The plan may further provide that in the case of a participant who continues to work beyond the ages specified in the preceding two sentences, the normal retirement age shall be that date or age designated by the participant, but such date or age shall not be later than the mandatory retirement age provided by the State, or the date or age at which the participant separates from the service with the State.

(g) *Agreement for deferral.* The plan must provide that, in general, compensation is to be deferred for any calendar month only if an agreement providing for such deferral has been entered into before the first day of the month. However, a plan may provide that, with respect to a new employee, compensation is to be deferred for the calendar month during which the participant first becomes an employee, if an agreement providing for such deferral is entered into on or before the first day on which the participant becomes an employee.

(h) *Payments under the plan*—(1) *In general.* The plan may not provide that amounts payable under the plan will be paid or made available to a participant or beneficiary before the participant separates from service with the State, or, if the plan provides for payment in the case of an unforeseeable emergency, before the participant incurs an unforeseeable emergency.

(2) *Separation from service; general rule.* An employee is separated from service with the State if there is a separation from the service within the meaning of section 402(e)(4)(A)(iii), relating to lump sum distributions, and on account of the participant's death or retirement.

(3) *Separation from service; independent contractor*—(i) *In general.* An independent contractor is considered separated from service with the State upon

the expiration of the contract (or in the case of more than one contract, all contracts) under which services are performed for the State, if the expiration constitutes a good-faith and complete termination of the contractual relationship. An expiration will not constitute a good faith and complete termination of the contractual relationship if the State anticipates a renewal of a contractual relationship or the independent contractor becoming an employee. For this purpose, a State is considered to anticipate the renewal of the contractual relationship with an independent contractor if it intends to again contract for the services provided under the expired contract, and neither the State nor the independent contractor has eliminated the independent contractor as a possible provider of services under any such new contract. Further, a State is considered to intend to again contract for the services provided under an expired contract, if the State's doing so is conditioned only upon the State's incurring a need for the services, or the availability of funds or both.

(ii) *Special rule.* Notwithstanding subdivision (i), if, with respect to amounts payable to a participant who is an independent contractor, a plan provides that—

(A) No amount shall be paid to the participant before a date at least 12 months after the day on which the contract expires under which services are performed for the State (or, in the case of more than one contract, all such contracts expire), and

(B) No amount payable to the participant on that date shall be paid to the participant if, after the expiration of the contract (or contracts) and before that date, the participant performs services for the State as an independent contractor or an employee,

the plan is considered to satisfy the requirement described in subparagraph (1) that no amounts payable under the plan will be paid or made available to the participant before the participant separates from service with the State.

(4) *Unforeseeable emergency.* For purposes of this paragraph (h), an unforeseeable emergency is, and if the plan provides for payment in the case of an unforeseeable emergency must be defined in the plan as, severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant or of a dependent (as defined in section 152(a)) of the participant, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. The circumstances that will constitute an unforeseeable emergency will depend upon the facts of each case, but, in any case, payment may not be made to the extent that such hardship is or may be relieved—

(i) Through reimbursement or compensation by insurance or otherwise,

(ii) By liquidation of the participant's assets, to the extent the liquidation of such assets would not itself cause severe financial hardship, or

(iii) By cessation of deferrals under the plan.

Examples of what are not considered to be unforeseeable emergencies include the need to send a participant's child to college or the desire to purchase a home.

(5) *Emergency withdrawals.* Withdrawals of amounts because of an unforeseeable emergency must only be permitted to the extent reasonably needed to satisfy the emergency need.

(i) *Distributions of deferrals*—(1) *Commencement of distributions.* A plan is not an eligible plan unless under the plan the payment of amounts deferred will commence not later than the later of—

(i) 60 days after the close of the plan year in which the participant or former participant attains (or would have attained) normal retirement age (within the meaning of §1.457–2(f)(4)), or

(ii) 60 days after the close of the plan year in which the participant separates from service (within the meaning of §§1.457–2(h) (2) and (3)) with the State.

A plan is not other than an eligible plan merely because, prior to October 27, 1982, the distribution of amounts deferred under the plan may commence no later than the close of the participant's taxable year in which the participant attains age 70½.

(2) *Limitations on distributions.* Distributions must be made primarily for the benefit of participants (or former

participants). Thus, the schedule selected by the participant for payments of benefits under the plan must be such that benefits payable to a beneficiary are not more than incidental. For example, if provision is made for payment of a portion of the amounts deferred to a beneficiary, the amounts payable to the participant or former participant (as determined by use of the expected return multiples in § 1.72–9, or, in the case of payments under a contract issued by an insurance company, by use of the mortality tables of such company), must exceed one-half of the maximum that could have been payable to the participant if no provision were made for payment to a beneficiary.

(3) *Distributions to beneficiaries.* A plan is not an eligible plan unless the plan provides that, if the participant dies before the entire amount deferred is paid to the participant, the entire amount deferred (or the remaining part of such deferrals if payment thereof has commenced) must be paid to a beneficiary over—

(i) The life of the beneficiary (or any shorter period), if the beneficiary is the participant's surviving spouse, or

(ii) A period not in excess of 15 years, if the beneficiary is not the participant's surviving spouse.

(j) *Administration of plan.* A plan is not an eligible plan unless all amounts deferred under the plan, all property and rights to property (including rights as a beneficiary of a contract providing life insurance protection) purchased with the amounts, and all income attributable to the amounts, property, or rights to property, remain (until paid or made available to the participant or beneficiary under the plan) solely the property and rights of the State (without being restricted to the benefits under the plan) subject to the claims of the general creditors of the State only. However, nothing in this paragraph (j) prohibits a plan's permitting participants to direct, from among different modes under the plan, the investment of the above amounts (see § 1.457–1(b)).

(k) *Plan-to-plan transfers.* The plan may provide for the transfer of amounts deferred by a former participant to another eligible plan of which the former participant has become a participant if the following conditions are met—

(1) The entities sponsoring the plans are located within the same State (as that term is used in § 1.457–2(c)(1)),

(2) The plan receiving such amounts provides for the acceptance of the amounts, and

(3) The plan provides that if the participant separates from service in order to accept employment with another such entity, payout will not commence upon separation from service, regardless of any other provision of the plan, and amounts previously deferred will automatically be transferred.

(l) *Effect on plan when not administered in accordance with paragraphs (c) through (k).* A plan that is administered in a manner which is inconsistent with one or more of the requirements of paragraphs (c) through (k) of this section ceases to be an eligible plan on the first day of the first plan year beginning more than 180 days after the date of written notification by the Internal Revenue Service that the requirements are not satisfied, unless the inconsistency is corrected before the first day of that plan year.

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

Example 1. A, born on June 1, 1917, is a participant in an eligible State deferred compensation plan providing a normal retirement age of 65. The plan provides limitations on deferrals up to the maximum permitted under § 1.457–2 (e) and (f).

For 1979, A, who will be 62, is scheduled to receive a salary of $20,000 from the State. A desires to defer the maximun amount possible in 1979. The maximum amount that A may defer under the plan is the lesser of $7,500, or 33⅓% of A's includible compensation (generally the equivalent of 25 percent of gross compensation). Accordingly, the maximum that A may defer for 1979 is $5,000 [$5,000=$20,000×.25]. Although A's taxable year 1979 is one of A's last 3 taxable years before the year in which A attains normal retirement age under the plan, A is not able to utilize the catch-up provisions of § 1.457–2(f) in 1979 because only taxable years beginning after December 31, 1978, may be taken into account under those provisions.

Example 2. Assume the same facts as in example 1. In A's taxable year 1980, A receives a salary of $20,000, and elects to defer only $1,000 under the plan. In A's taxable year 1981, A again receives a salary of $20,000 and elects to defer the maximum amount permissible under the plan's catch-up provisions prescribed under §1.457–2(f). The applicable limit on deferrals under the catch-up provision is the lesser of $15,000 or the sum of the normal plan ceiling for 1981, plus any underutilized deferrals for any taxable year before 1981. Thus, the maximum amount that A may defer in 1981 is $9,000, the normal plan ceiling for 1981, $5,000, plus the under-utilized deferrals for 1980, $4,000.

Example 3. Assume the same facts as in examples 1 and 2. In A's taxable year 1982, the year in which A will attain age 65, normal retirement age under the plan, A desires to defer the maximum amount possible under the plan. For 1982 the normal limitations of §1.457–2(e) are applicable, and the maximum amount that A may defer is $5,000, assuming that A's salary for 1982 was again $20,000. The plan's catch-up provisions prescribed under §1.457–2(f) are not applicable because 1982 is not a year ending before the year in which A attains normal retirement age.

[T.D. 7836, 47 FR 42338, Sept. 27, 1982]

§1.457–3 Tax treatment of participants where plan is not an eligible plan.

(a) *In general.* If a State (within the meaning of §1.457–2(c)) provides for a deferral of compensation (after the effective date described in paragraph (c)) under any agreement or arrangement described in §1.457–2(b) that is not an eligible plan within the meaning of §1.457–2—

(1) Compensation deferred under the agreement or arrangement shall be includible in the gross income of the participant of beneficiary for the first taxable year in which there is no substantial risk of forfeiture (within the meaning of section 457(e)(3)) of the rights to such compensation,

(2) Earnings credited on the compensation deferred under the agreement of arrangement shall be includible in the gross income of the participant or beneficiary only when paid or made available, provided that the interest of the participant or beneficiary in the assets (including amounts deferred under the plan) of the entity sponsoring the plan is not senior to the entity's general creditors, and

(3) Amounts paid or made available under the plan to a participant or beneficiary shall be taxable to the participant or beneficiary under section 72, relating to annuities.

(b) *Exceptions.* Paragraph (a) does not apply with respect to—

(1) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a),

(2) An annuity plan or contract described in section 403,

(3) A qualified bond purchase plan described in section 405(a),

(4) That portion of any plan which consists of a transfer of property described in section 83, and

(5) That portion of any plan which consists of a trust to which section 402(b) applies.

(c) *Effective date.* This section is effective for taxable years beginning after December 31, 1981. For rules applicable in taxable years beginning after December 31, 1978, and before January 1, 1982, see §1.457–4.

[T.D. 7836, 47 FR 42341, Sept. 27, 1982; 47 FR 46497, Oct. 19, 1982]

§1.457–4 Transitional rules.

(a) *In general.* Subject to the limitations described in paragraphs (b) and (c) of this section, amounts deferred (within the meaning of §1.457–1(d)(3)) in taxable years beginning after December 31, 1978, and before January 1, 1982 under a plan described in §1.457–2(b) (including an eligible plan within the meaning of §1.457–2, but not including a plan described in section 457(e)(2) and §1.457–3(b)) shall be includible in gross income only for the taxable year in which paid or otherwise made available to the participant or other beneficiary.

(b) *General limitation.* Except as described in paragraph (c) of this section, and excluding amounts deferred in taxable years beginning before January 1, 1979, compensation deferred under one or more plans described in paragraph (a) of this section is excludable from a participant's gross income under this section for a taxable year only to the extent it does not exceed the lesser of—

(1) $7,500, or

(2) 33⅓% of the participant's includible compensation (within the meaning of §1.457–2(e)(2)) for the taxable year, reduced by any amount excludable from the participant's gross income for the taxable year under section 403(b) on account of contributions made by the State (within the meaning of §1.457–2(c)). For purposes of this paragraph, compensation deferred under a plan shall be taken into account at its value

in the plan year in which deferred. However, if the compensation deferred is subject to a substantial risk of forfeiture (as defined in section 457(e)(3)), such compensation shall be taken into account at its value in the plan year in which such compensation is no longer subject to a substantial risk of forfeiture.

(c) *Limited catch-up.* This paragraph (c) applies if all plans described in paragraph (a) of this section in which an individual is a participant are eligible plans within the meaning of § 1.457–2, and the participant's taxable year is a taxable year described in section 457(b)(3) and § 1.457–2(f). In such a case, compensation deferred under the plans for the taxable year is excluded from gross income under paragraph (a) of this section to the extent it does not exceed the amount determined under § 1.457–1(a)(2) or, as applicable, § 1.457–1(a)(3).

(d) *Example.* The provisions of this section may be illustrated by the following example:

Example. A is a participant in a State deferred compensation plan that is not an eligible plan within the meaning of § 1.457–2. The plan provides no limitations on the amount of compensation that may be deferred during any taxable year. For the taxable years 1979, 1980, and 1981 A has includible compensation of $40,000. In each of those years, A has deferred $10,000 of compensation. Under the transitional rules described in this section, $7,500 of A's deferrals in each year will be includible in gross income in the taxable year in which paid or made available to A or A's beneficiary. The remaining $2,500 of each year's deferrals ($10,000 – $7,500) are includible in A's gross income for the deferral year. Thus, $2,500 is includible in A's gross income for each of the taxable years 1979, 1980, and 1981. The tax treatment of amounts deferred by A in taxable years after 1981 is described in § 1.457–3.

[T.D. 7836, 47 FR 42341, Sept. 27, 1982]

§ 1.458–1 Exclusion for certain returned magazines, paperbacks, or records.

(a) *In general*—(1) *Introduction.* For taxable years beginning after September 30, 1979, section 458 allows accrual basis taxpayers to elect to use a method of accounting that excludes from gross income some or all of the income attributable to qualified sales during the taxable year of magazines, paperbacks, or records, that are returned before the close of the applicable merchandise return period for that taxable year. Any amount so excluded cannot be excluded or deducted from gross income for the taxable year in which the merchandise is returned to the taxpayer. For the taxable year in which the taxpayer first uses this method of accounting, the taxpayer is not allowed to exclude from gross income amounts attributable to merchandise returns received during the taxable year that would have been excluded from gross income for the prior taxable year had the taxpayer used this method of accounting for that prior year. (See paragraph (e) of this section for rules describing how this amount should be taken into account.) The election to use this method of accounting shall be made in accordance with the rules contained in section 458(c) and in § 1.458–2 and this section. A taxpayer that does not elect to use this method of accounting can reduce income for returned merchandise only for the taxable year in which the merchandise is actually returned unsold by the purchaser.

(2) *Effective date.* While this section is generally effective only for taxable years beginning after August 31, 1984, taxpayers may rely on the provisions of paragraphs (a) through (f) of this section in taxable years beginning after September 30, 1979.

(b) *Definitions*—(1) *Magazine.* ''Magazine'' means a publication, usually paper-backed and sometimes illustrated, that is issued at regular intervals and contains stories, poems, articles, features, etc. This term includes periodicals, but does not include newspapers or volumes of a single publication issued at various intervals. However, volumes of a single publication that are issued at least annually, are related by title or subject matter to a magazine, and would otherwise qualify as a magazine, will be treated as a magazine.

(2) *Paperback.* ''Paperback'' means a paperback book other than a magazine. Unlike a hardback book, which usually has stiff front and back covers that enclose pages bound to a separate spine, a paperback book is characterized by a

flexible outer cover to which the pages of the book are directly affixed.

(3) *Record.* ‘‘Record’’ means a disc, tape, or similar item on which music, spoken or other sounds are recorded. However, the term does not include blank records, tapes, etc., on which it is expected the ultimate purchaser will record. The following items, provided they carry pre-recorded sound, are examples of ‘‘records’’: audio and video cassettes, eight-track tapes, reel-to-reel tapes, cylinders, and flat, compact, and laser discs.

(4) *Qualified sale.* In order for a sale to be considered a qualified sale, both of the following conditions must be met:

(i) The taxpayer must be under a legal obligation (as determined by applicable State law), at the time of sale, to adjust the sales price of the magazine, paperback, or record on account of the purchaser’s failure to resell it; and

(ii) The taxpayer must actually adjust the sales price of the magazine, paperback, or record to reflect the purchaser’s failure to resell the merchandise. The following are examples of adjustments to the sales price of unsold merchandise: Cash refunds, credits to the account of the purchaser, and repurchases of the merchandise. The adjustment need not be equal to the full amount of the sales price of the item. However, a markdown of the sales price under an agreement whereby the purchaser continues to hold the merchandise for sale or other disposition (other than solely for scrap) does not constitute an adjustment resulting from a failure to resell.

(5) *Merchandise return period*—(i) *In general.* Unless the taxpayer elects a shorter period, the ‘‘merchandise return period’’ is the period that ends 2 months and 15 days after the close of the taxable year for sales of magazines and 4 months and 15 days after the close of the taxable year for sales of paperbacks and records.

(ii) *Election to use shorter period.* The taxpayer may select a shorter merchandise return period than the applicable period set forth in paragraph (b)(5)(i) of this section.

(iii) *Change in merchandise return period.* Any change in the merchandise return period after its initial establishment will be treated as a change in method of accounting.

(c) *Amount of the exclusion*—(1) *In general.* Except as otherwise provided in paragraph (g) of this section, the amount of the gross income exclusion with respect to any qualified sale is equal to the lesser of—

(i) The amount covered by the legal obligation referred to in paragraph (b)(4)(i) of this section; or

(ii) The amount of the adjustment agreed to by the taxpayer before the close of the merchandise return period.

(2) *Price adjustment in excess of legal obligation.* The excess, if any, of the amount described in paragraph (c)(1)(ii) of this section over the amount described in paragraph (c)(1)(i) of this section should be excluded in the taxable year in which it is properly accruable under section 461.

(d) *Return of the merchandise*—(1) *In general.* (i) The exclusion from gross income allowed by section 458 applies with respect to a qualified sale of merchandise only if the seller receives, before the close of the merchandise return period, either—

(A) The physical return of the merchandise; or

(B) Satisfactory evidence that the merchandise has not been and will not be resold (as defined in paragraph (d)(2) of this section).

(ii) For purposes of this paragraph (d), evidence of a return received by an agent of the seller (other than the purchaser who purchased the merchandise from the seller) will be considered to be received by the seller at the time the agent receives the merchandise or evidence.

(2) *Satisfactory evidence.* Evidence that merchandise has not been and will not be resold is satisfactory only if the seller receives—

(i) Physical return of some portion of the merchandise (e.g., covers) provided under either the agreement between the seller and the purchaser or industry practice (such return evidencing the fact that the purchaser has not and will not resell the merchandise); or

(ii) A written statement from the purchaser specifying the quantities of each title not resold, provided either—

(A) The statement contains a representation that the items specified will not be resold by the purchaser; or

(B) The past dealings, if any, between the parties and industry practice indicate that such statement constitutes a promise by the purchaser not to resell the items.

(3) *Retention of evidence.* In the case of a return of merchandise (described in paragraph (d)(1)(i)(A) of this section) or portion thereof (described in paragraph (d)(2)(i) of this section), the seller has no obligation to retain physical evidence of the returned merchandise or portion thereof, provided the seller maintains documentary evidence that describes the quantity of physical items returned to the seller and indicates that the items were returned before the close of the merchandise return period.

(e) *Transitional adjustment*—(1) *In general.* An election to change from some other method of accounting for the return of magazines, paperbacks, or records to the method of accounting described in section 458 is a change in method of accounting that requires a transitional adjustment. Section 458 provides special rules for transitional adjustments that must be taken into account as a result of this change. See paragraph (e)(2) of this section for special rules applicable to magazines and paragraphs (e) (3) and (4) of this section for special rules applicable to paperbacks and records.

(2) *Magazines: 5-year spread of decrease in taxable income.* For taxpayers who have elected to use the method of accounting described in section 458 to account for returned magazines for a taxable year, section 458(d) and this paragraph (e)(2) provide a special rule for taking into account any decrease in taxable income resulting from the adjustment required by section 481(a)(2). Under these provisions, one-fifth of the transitional adjustment must be taken into account in the taxable year of the change and in each of the 4 succeeding taxable years. For example, if the application of section 481(a)(2) would produce a decrease in taxable income of $50 for 1980, the year of change, then $10 (one-fifth of $50) must be taken into account as a decrease in taxable income for 1980, 1981, 1982, 1983, and 1984.

(3) *Suspense account for paperbacks and records*—(i) *In general.* For taxpayers who have elected to use the method of accounting described in section 458 to account for returned paperbacks and records for a taxable year, section 458(e) provides that, in lieu of applying section 481, an electing taxpayer must establish a separate suspense account for its paperback business and its record business. The initial opening balance of the suspense account is described in paragraph (e)(3)(ii)(A) of this section. An initial adjustment to gross income for the year of election is described in paragraph (e)(3)(ii)(B) of this section. Annual adjustments to the suspense account are described in paragraph (e)(3)(iii)(A) of this section. Gross income adjustments are described in paragraph (e)(3)(iii)(B) of this section. Examples are provided in paragraph (e)(4) of this section. The effect of the suspense account is to defer all, or some part, of the deduction of the transitional adjustment until the taxpayer is no longer engaged in the trade or business of selling paperbacks or records, whichever is applicable.

(ii) *Establishing a suspense account*—(A) *Initial opening balance.* To compute the initial opening balance of the suspense account for the first taxable year for which an election is effective, the taxpayer must determine the section 458 amount (as defined in paragraph (e)(3)(ii)(C) of this section) for each of the three preceding taxable years. The initial opening balance of the account is the largest of the section 458 amounts.

(B) *Initial year adjustment.* If the initial opening balance in the suspense account exceeds the section 458 amount (as defined in paragraph (e)(3)(ii)(C) of this section) for the taxable year immediately preceding the year of election, the excess is included in the taxpayer's gross income for the first taxable year for which the election was made.

(C) *Section 458 amount.* For purposes of paragraph (e)(3)(ii) of this section, the section 458 amount for a taxable year is the dollar amount of merchandise returns that would have been excluded from gross income under section

458(a) for that taxable year if the section 458 election had been in effect for that taxable year.

(iii) *Annual adjustments*—(A) *Adjustment to the suspense account.* Adjustments are made to the suspense account each year to account for fluctuations in merchandise returns. To compute the annual adjustment, the taxpayer must determine the amount to be excluded under the election from gross income under section 458(a) for the taxable year. If the amount is less than the opening balance in the suspense account for the taxable year, the balance in the suspense account is reduced by the difference. Conversely, if the amount is greater than the opening balance in the suspense account for the taxable year, the account is increased by the difference, but not to an amount in excess of the initial opening balance described in paragraph (e)(3)(ii)(A) of this section. Therefore, the balance in the suspense account will never be greater than the initial opening balance in the suspense account determined in paragraph (e)(3)(ii)(A) of this section. However, the balance in the suspense account after adjustments may be less than this initial opening balance in the suspense account.

(B) *Gross income adjustments.* Adjustments to the suspense account for years subsequent to the year of election also produce adjustments in the taxpayer's gross income. Adjustments which reduce the balance in the suspense account reduce gross income for the year in which the adjustment to the suspense account is made. Adjustments which increase the balance in the suspense account increase gross income for the year in which the adjustment to the suspense account is made.

(4) *Example.* The provisions of paragraph (e)(3) of this section may be illustrated by the following example:

Example: (i) X corporation, a paperback distributor, makes a timely section 458 election for its taxable year ending December 31, 1980. If the election had been in effect for the taxable years ending on December 31, 1977, 1978, and 1979, the dollar amounts of the qualifying returns would have been $5, $8, and $6, respectively. The initial opening balance of X's suspense account on January 1, 1980, is $8, the largest of these amounts. Since the initial opening balance ($8), is larger than the qualifying returns for 1979 ($6), the initial adjustment to gross income for 1980 is $2 ($8–$6).

(ii) X has $5 in qualifying returns for its taxable year ending December 31, 1980. X must reduce its suspense account by $3, which is the excess of the opening balance ($8) over the amount of qualifying returns for the 1980 taxable year ($5). X also reduces its gross income for 1980 by $3. Thus, the net amount excludable from gross income for the 1980 taxable year after taking into account the qualifying returns, the gross income adjustment, and the initial year adjustment is $6 ($3+$5 − $2).

(iii) X has qualifying returns of $7 for its taxable year ending December 31, 1981. X must increase its suspense account balance by $2, which is the excess of the amount of qualifying returns for 1981 ($7) over X's opening balance in the suspense account ($5). X must also increase its gross income by $2. Thus, the net income excludable from gross income for the 1981 taxable year after taking into account the qualifying returns and the gross income adjustment is $5 ($7–$2).

(iv) X has qualifying returns of $10 for its taxable year ending December 31, 1982. The opening balance in X's suspense account of $7 will not be increased in excess of the initial opening balance ($8). X must also increase gross income by $1. Thus, the net amount excludable from gross income for the 1982 taxable year is $9 ($10–$1).

(v) This example is summarized by the following table:

	Years Ending December 31					
	1977	1978	1979	1980 [1]	1981	1982
Facts:						
Qualifying returns during merchandise return period for the taxable year	$5	$8	$6	$5	$7	$10
Adjustment to suspense account:						
Opening balance				$8	$5	$7
Addition to account [2]					2	1
Reduction to account [3]				(3)		
Opening balance for next year				$5	$7	$8

	Years Ending December 31					
	1977	1978	1979	1980[1]	1981	1982
Amount excludable from income:						
Initial year adjustment				$(2)		
Amount excludable as qualifying returns in merchandise return period				5	$7	$10
Adjustment for increase in suspense account					(2)	(1)
Adjustment for decrease in suspense account				3		
Net amount excludable for the year				$6	$5	$9

[1] Year of Change.
[2] Applies when qualifying returns during the merchandise return period exceed the opening balance; the addition is not to cause the suspense account to exceed the initial opening balance.
[3] Applies when qualifying returns during the merchandise return period are less than the opening balance.

(f) *Subchapter C transactions*—(1) *General rule.* If a transfer of substantially all the assets of a trade or business in which paperbacks or records are sold is made to an acquiring corporation, and if the acquiring corporation determines its basis in these assets, in whole or part, with reference to the basis of these assets in the hands of the transferor, then for the purposes of section 458(e) the principles of section 381 and § 1.381(c)(4)–1 will apply. The application of this rule is not limited to the transactions described in section 381(a). Thus, the rule also applies, for example, to transactions described in section 351.

(2) *Special rules.* If, in the case of a transaction described in paragraph (f)(1) of this section, an acquiring corporation acquires assets that were used in a trade or business that was not subject to a section 458 election from a transferor that is owned or controlled directly (or indirectly through a chain of corporations) by the same interests, and if the acquiring corporation uses the acquired assets in a trade or business for which the acquiring corporation later makes an election to use section 458, then the acquiring corporation must establish a suspense account by taking into account not only its own experience but also the transferor's experience when the transferor held the assets in its trade or business. Furthermore, the transferor is not allowed a deduction or exclusion for merchandise returned after the date of the transfer attributable to sales made by the transferor before the date of the transfer. Such returns shall be considered to be received by the acquiring corporation.

(3) *Example.* The provisions of paragraph (f)(2) of this section may be illustrated by the following example.

Example. Corporation S, a calendar year taxpayer, is a wholly owned subsidiary of Corporation P, a calendar year taxpayer. On December 31, 1982, S acquires from P substantially all of the assets used in a trade or business in which records are sold. P had not made an election under section 458 with respect to the qualified sale of records made in connection with that trade or business. S makes an election to use section 458 for its taxable year ending December 31, 1983, for the trade or business in which the acquired assets are used. P's qualified record returns within the 4 month and 15 day merchandise return period following the 1980 and 1981 taxable years were $150 and $170, respectively. S's qualified record returns during the merchandise return period following 1982 were $160. S must establish a suspense account by taking into account both P's and S's experience for the 3 immediately preceding taxable years. Thus, the initial opening balance of S's suspense account is $170. S must also make an initial year adjustment of $10 ($170—$160), which S must include in income for S's taxable year ending December 31, 1983. P is not entitled to a deduction or exclusion for merchandise received after the date of the transfer (December 31, 1982) attributable to sales made by the transferor before the date of transfer. Thus, P is not entitled to a deduction or exclusion for the $160 of merchandise received by S during the first 4 months and 15 days of 1983.

(g) *Adjustment to inventory and cost of goods sold.* (1) If a taxpayer makes adjustments to gross receipts for a taxable year under the method of accounting described in section 458, the taxpayer, in determining excludable gross income, is also required to make appropriate correlative adjustments to purchases or closing inventory and to cost of goods sold for the same taxable year. Adjustments are appropriate, for example, where the taxpayer holds the merchandise returned for resale or where the taxpayer is entitled to receive a price adjustment from the person or entity that sold the merchandise to the taxpayer. Cost of goods sold must be properly adjusted in accordance with the provisions of §1.61–3 which provides, in pertinent part, that gross income derived from a manufacturing or merchandising business equals total sales less cost of goods sold.

(2) The provisions of this paragraph (g) may be illustrated by the following examples. These examples do not, however, reflect any required adjustments under paragraph (e)(3) of this section.

Example 1. (i) In 1986, P, a publisher, properly elects under section 458 of the Code not to include in its gross income in the year of sale, income attributable to qualified sales of paperback books returned within the specified statutory merchandise return period of 4 months and 15 days. P and D, a distributor, agree that P shall provide D with a full refund for paperback books that D purchases from P and is unable to resell, provided the merchandise is returned to P within four months following the original sale. The agreement constitutes a legal obligation. The agreement provides that D's return of the covers of paperback books within the first four months following their sale constitutes satisfactory evidence that D has not resold and will not resell the paperback books. During P's 1989 taxable year, pursuant to the agreement, P sells D 500 paperback books for $1 each. In 1990, during the merchandise return period, D returns covers from 100 unsold paperback books representing $100 of P's 1989 sales of paperback books. P's cost attributable to the returned books is $25. No adjustment to cost of goods sold is required under paragraph (g)(1) of this section because P is not holding returned merchandise for resale. P's proper amount excluded from its 1989 gross income under section 458 is $100.

(ii) If D returns the paperback books, rather than the covers, to P and these same books are then held by P for resale to other customers, paragraph (g)(1) of this section applies. Under paragraph (g)(1), P is required to decrease its cost of goods sold by $25, the amount of P's cost attributable to the returned merchandise. The proper amount excluded from P's 1989 gross income under section 458 is $75, resulting from adjustments to sales and cost of sales [(100×$1)—$25].

Example 2. (i) In 1986, D, a distributor, properly elects under section 458 of the Code not to include in its gross income in the year of sale, income attributable to qualified sales of paperback books returned within the specified statutory merchandise return period of four months and 15 days. D and R, a retailer, agree that D shall provide a full refund for paperback books that R purchases from it and is unable to resell. D and R also have agreed that the merchandise must be returned to D within four months following the original sale. The agreement constitutes a legal obligation. D is similarly entitled to a full refund from P, the publisher, for the same paperback books. In 1990, during the merchandise return period, R returns paperback books to D representing $100 of 1989 sales. D's cost relating to these sales is $50. Under paragraph (g)(1) of this section, D must decrease its costs of goods sold by $50. D's proper amount excluded from its 1989 gross income under section 458 is $50 resulting from adjustments to sales and costs of sales ($100—$50).

(ii) If D is instead only entitled to a 50 percent refund from P, D is required under paragraph (g)(1) of this section to decrease its costs of goods sold by $25, the amount of refund from P. D's proper amount excluded from its 1989 gross income under section 458 is $75, resulting from adjustments to sales and cost of sales ($100—$25).

[T.D. 8426, 57 FR 38596, Aug. 26, 1992; 57 FR 45879, Oct. 5, 1992]

§1.458–2 Manner of and time for making election.

(a) *Scope.* For taxable years beginning after September 30, 1979, section 458 provides a special method of accounting for taxpayers who account for sales of magazines, paperbacks, or records using an accrual method of accounting. In order to use the special method of accounting under section 458, a taxpayer must make an election in the manner prescribed in this section. The election does not require the prior consent of the Internal Revenue Service. The election is effective for the taxable year for which it is made and for all subsequent taxable years, unless the taxpayer secures the prior consent of the Internal Revenue Service to revoke such election.

(b) *Separate election for each trade or business.* An election is made with respect to each trade or business of a taxpayer in connection with which qualified sales (as defined in section 458(b)(5)) of a category of merchandise were made. Magazines, paperbacks, and records are each treated as a separate category of merchandise. If qualified sales of two or more categories of merchandise are made in connection with the same trade or business, then solely for purposes of section 458, each category is treated as a separate trade or business. For example, if a taxpayer makes qualified sales of both magazines and paperbacks in the same trade or business, then solely for purposes of section 458, the qualified sales relating to magazines are considered one trade or business and the qualified sales relating to paperbacks are considered a separate trade or business. Thus, if the taxpayer wishes to account under section 458 for the qualified sales of both magazines and paperbacks, such taxpayer must make a separate election for each category.

(c) *Manner of, and time for, making election.* An election is made under section 458 and this section by filing a statement of election containing the information described in paragraph (d) of this section with the taxpayer's income tax return for first taxable year for which the election is made. The election must be made no later than the time prescribed by law (including extensions) for filing the income tax return for the first taxable year for which the election is made. Thus, the election may not be filed with an amended income tax return after the prescribed date (including extensions) for filing the original return for such year.

(d) *Required information.* The statement of election required by paragraph (c) of this section must indicate that an election is being made under section 458(c) and must set forth the following information:

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

(2) A description of each trade or business for which an election is made;

(3) The first taxable year for which an election is made for each trade or business;

(4) The merchandise return period (as defined in section 458(b)(7)) for each trade or business for which an election is made;

(5) With respect to an election that applies to magazines, the amount of the adjustment computed under section 481(a) resulting from the change to the method of accounting described in section 458; and

(6) With respect to an election that applies to paperbacks or records, the initial opening balance (computed in accordance with section 458(e)) in the suspense account for each trade or business for which an election is made.

The statement of election should be made on a Form 3115 which need contain no information other than that required by this paragraph.

[T.D. 7628, 44 FR 33398, June 11, 1979. Redesignated by T.D. 8426, 57 FR 38599, Aug. 26, 1992]

§ 1.460–0 Outline of regulations under section 460.

This section lists the paragraphs contained in §§ 1.460–1 through 1.460–8.

§ 1.460–1 Accounting for long-term contracts in general. [Reserved]

§ 1.460–2 Definition of long-term contract. [Reserved]

§ 1.460–3 Percentage of completion method. [Reserved]

§ 1.460–4 Methods of accounting for long-term contracts.

(a)–(i) [Reserved]
(j) Consolidated groups and controlled groups.
(1) Intercompany transactions.
(i) In general.
(ii) Definitions and nomenclature.
(2) Example.
(3) Effective dates.
(i) In general.
(ii) Prior law.
(4) Consent to change method of accounting.

§ 1.460–5 Cost allocation rules. [Reserved]

§ 1.460–6 Look-back method.

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(j) Election not to apply look-back method in de minimis cases.

§1.460–7 Exempt long-term contracts. [Reserved]

§1.460–8 Changes in method of accounting. [Reserved]

[T.D. 9315, 55 FR 41670, Oct. 15, 1990, as amended by T.D. 8597, 60 FR 36683, July 18, 1995; T.D. 8756, 63 FR 1918, Jan. 13, 1998; T.D. 8775, 63 FR 36181, July 2, 1998]

§1.460–1 Accounting for long-term contracts in general. [Reserved]

§1.460–2 Definition of long-term contract. [Reserved]

§1.460–3 Percentage of completion method. [Reserved]

§1.460–4 Methods of accounting for long-term contracts.

(a)–(i) [Reserved]

(j) *Consolidated groups and controlled groups*—(1) *Intercompany transactions*—(i) *In general.* Section 1.1502–13 does not apply to the income, gain, deduction, or loss from an intercompany transaction between members of a consolidated group, and section 267(f) does not apply to these items from an intercompany sale between members of a controlled group, to the extent—

(A) The transaction or sale directly or indirectly benefits, or is intended to benefit, another member's long-term contract with a nonmember;

(B) The selling member is required under section 460 to determine any part of its gross income from the transaction or sale under the percentage-of-completion method (PCM); and

(C) The member with the long-term contract is required under section 460 to determine any part of its gross income from the long-term contract under the PCM.

(ii) *Definitions and nomenclature.* The definitions and nomenclature under § 1.1502–13 and § 1.267(f)–1 apply for purposes of this paragraph (j).

(2) *Example.* The following example illustrates the principles of paragraph (j)(1) of this section.

Example. Corporations P, S, and B file consolidated returns on a calendar-year basis. In 1996, B enters into a long-term contract with X, a nonmember, to manufacture 5 airplanes for $500 million, with delivery scheduled for 1999. Section 460 requires B to determine the gross income from its contract with X under the PCM. S enters into a contract with B to manufacture for $50 million the engines that B will install on X's airplanes. Section 460 requires S to determine the gross income from its contract with B under the PCM. S estimates that it will incur $40 million of total contract costs during 1997 and 1998 to manufacture the engines. S incurs $10 million of contract costs in 1997 and $30 million in 1998. Under paragraph (j) of this section, S determines its gross income from the long-term contract under the PCM rather than taking its income or loss into account under section 267(f) or § 1.1502–13. Thus, S includes $12.5 million of gross receipts and $10 million of contract costs in gross income in 1997 and includes $37.5 million of gross receipts and $30 million of contract costs in gross income in 1998.

(3) *Effective dates*—(i) *In general.* This paragraph (j) applies with respect to transactions and sales occurring pursuant to contracts entered into in years beginning on or after July 12, 1995.

(ii) *Prior law.* For transactions and sales occurring pursuant to contracts entered into in years beginning before July 12, 1995, see the applicable regulations issued under sections 267(f) and 1502, including §§ 1.267(f)–1T, 1.267(f)–2T, and 1.1502–13(n) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

(4) *Consent to change method of accounting.* For transactions and sales to which this paragraph (j) applies, the Commissioner's consent under section 446(e) is hereby granted to the extent any changes in method of accounting are necessary solely to comply with this section, provided the changes are made in the first taxable year of the taxpayer to which the rules of this paragraph (j) apply. Changes in method of accounting for these transactions are to be effected on a cut-off basis.

[T.D. 8597, 60 FR 36684, July 18, 1995]

§ 1.460–5 Cost allocation rules. [Reserved]

§ 1.460–6 Look-back method.

(a) *In general*—(1) *Introduction.* With respect to income from any long-term contract reported under the percentage of completion method, a taxpayer is required to pay or is entitled to receive interest under section 460(b) on the amount of tax liability that is deferred or accelerated as a result of overestimating or underestimating total contract price or contract costs. Under this look-back method, taxpayers are required to pay interest for any deferral of tax liability resulting from the underestimation of the total contract price or the overestimation of total contract costs. Conversely, if the total contract price is overestimated or the total contract costs are underestimated, taxpayers are entitled to receive interest for any resulting acceleration of tax liability. The computation of the amount of deferred or accelerated tax liability under the look-back method is hypothetical; application of the look-back method does not result in an adjustment to the taxpayer's tax liability as originally reported, as reported on an amended return, or as adjusted on examination. Thus, the look-back method does not correct for differences in tax liability that result from over- or under-estimation of contract price and costs and that are permanent because, for example, tax rates change during the term of the contract.

(2) *Overview.* Paragraph (b) explains which situations require application of the look-back method to income from

a long-term contract. Paragraph (c) explains the operation of the three computational steps for applying the look-back method. Paragraph (d) provides guidance concerning the simplified marginal impact method. Paragraph (e) provides an elective method to minimize the number of times the look-back method must be reapplied to a single long-term contract. Paragraph (f) describes the reporting requirements for the look-back method and the tax treatment of look-back interest. Paragraph (g) provides rules for applying the look-back method when there is a transaction that changes the taxpayer that reports income from a long-term contract prior to the completion of a contract. Paragraph (h) provides examples illustrating the three computational steps for applying the look-back method.

(b) *Scope of look-back method*—(1) *In general.* The look-back method applies to any income from a long-term contract within the meaning of section 460(f) that is required to be reported under the percentage of completion method (as modified by section 460) for regular income tax purposes or for alternative minimum tax purposes. If a taxpayer uses the percentage of completion-capitalized cost method for long-term contracts, the look-back method applies for regular tax purposes only to the portion (40, 70, or 90 percent, whichever applies) of the income from the contract that is reported under the percentage of completion method. The requirements of section 460 also apply to income and expenses attributable to activities that benefit any long-term contract entered into by a party related to the taxpayer within the meaning of section 707(b) or 267(b), determined without regard to section 267(f)(1)(A) and by substituting ‘‘80 percent’’ for ‘‘50 percent’’ with regard to the ownership of the stock of a C corporation. Therefore, to the extent that the percentage of completion method is required to be used with respect to income and expenses that are attributable to activities that benefit a related party’s long-term contract, the look-back method also applies to these amounts, even if those activities are not performed under a contract entered into directly by the taxpayer.

(2) *Exceptions from section 460.* The look-back method generally does not apply to the regular taxable income from any long-term construction contract within the meaning of section 460(e)(4) that:

(i) Is a home construction contract within the meaning of section 460(e)(1)(A), or

(ii) Is not a home construction contract but is estimated to be completed within a 2-year period by a taxpayer whose average annual gross receipts for the 3 tax years preceding the tax year the contract is entered into do not exceed $10,000,000 (as provided in section 460(e)(1)(B)). These contracts are not subject to the look-back method for regular tax purposes, even if the taxpayer uses a version of the percentage of completion method permitted under §1.451–3, unless the taxpayer has properly changed its method of accounting for these contracts to the percentage of completion method as modified by section 460(b). The look-back method, however, applies to the alternative minimum taxable income from a contract of this type, unless it is exempt from the required use of the percentage of completion method under section 56(a)(3).

(3) *De minimis exception.* Notwithstanding that the percentage of completion method is otherwise required to be used, the look-back method does not apply to any long-term contract that:

(i) Is completed within 2 years of the contract commencement date, and

(ii) Has a gross contract price (as of the completion of the contract) that does not exceed the lesser of $1,000,000 or 1 percent of the average annual gross receipts of the taxpayer for the 3 tax years preceding the tax year in which the contract is completed.

This de minimis exception is mandatory and, therefore, precludes application of the look-back method to any contract that meets the requirements of the exception. The de minimis exception applies for purposes of computing both regular taxable income and alternative minimum taxable income. Solely for this purpose, the determination of whether a long-term contract meets the gross receipts test for both alternative minimum tax and regular tax purposes is made based only on the taxpayer's regular taxable income.

(4) *Alternative minimum tax.* For purposes of computing alternative minimum taxable income, section 56(a)(3) generally requires long-term contracts within the meaning of section 460(f) (generally without regard to the exceptions in section 460(e)) to be accounted for using only the percentage of completion method as defined in section 460(b), including the look-back method of section 460(b), with respect to tax years beginning after December 31, 1986. However, section 56(a)(3) (and thus the look-back method) does not apply to any long-term contract entered into after June 20, 1988, and before the beginning of the first tax year that begins after September 30, 1990, that meets the conditions of both section 460(e)(1)(A) and clauses (i) and (ii) of section 460(e)(1)(B), and does not apply to any long-term contract entered into in a tax year that begins after September 30, 1990, that meets the conditions of section 460(e)(1)(A). A taxpayer that applies the percentage of completion method (and thus the look-back method) to income from a long-term contract only for purposes of determining alternative minimum taxable income, and not regular taxable income, must apply the look-back method to the alternative minimum taxable income in the year of contract completion and other filing years whether or not the taxpayer was liable for the alternative minimum tax for the filing year or for any prior year. Interest is computed under the look-back method to the extent that the taxpayer's total tax liability (including the alternative minimum tax liability) would have differed if the percentage of completion method had been applied using actual, rather than estimated, contract price and contract costs.

(5) *Effective date.* The look-back method, including the de minimis exception, applies to long-term contracts entered into after February 28, 1986. With respect to activities that are subject to section 460 solely because they benefit a long-term contract of a related party, the look-back method generally applies only if the related party's long-term contract was entered into after June 20, 1988, unless a principal purpose of the related-party arrangement is to avoid the requirements of section 460.

(c) *Operation of the look-back method*—(1) *Overview*—(i) *In general.* The amount of interest charged or credited to a taxpayer under the look-back method is computed in three steps. This paragraph (c) describes the three steps for applying the look-back method. These steps are illustrated by the examples in paragraph (h). The first step is to hypothetically reapply the percentage of completion method to all long-term contracts that are completed or adjusted in the current year (the ''filing year''), using the actual, rather than estimated, total contract price and contract costs. Based on this reapplication, the taxpayer determines the amount of taxable income (and alternative minimum taxable income) that would have been reported for each year prior to the filing year that is affected by contracts completed or adjusted in the filing year if the actual, rather than estimated, total contract price and costs had been used in applying the percentage of completion method to these contracts, and to any other contracts completed or adjusted in a year preceding the filing year. If the percentage of completion method only applies to alternative minimum taxable income for contracts completed or adjusted in the filing year, only alternative minimum taxable income is recomputed in the first step. The second step is to compare what the tax liability would have been under the percentage of completion method (as reapplied in the first step) for each tax year for which the tax liability is affected by income from contracts completed or adjusted in the filing year (a ''redetermination year'') with the most recent determination of tax liability for that year to produce a hypothetical underpayments or overpayment of tax. The third step is to apply the rate of interest on overpayments designated under section 6621 of the Code, compounded daily, to the hypothetical underpayment or overpayment of tax for each redetermination year to compute interest that runs, generally, from the due date (determined without regard to extensions) of the return for the redetermination year to the due date (determined without regard to extensions) of the return for the filing year. The net amount of interest computed under the third step is paid by or credited to the taxpayer for the filing year. Paragraph (d) provides a simplified marginal impact method that simplifies the second step—the computation of hypothetical underpayments or overpayments of tax liability for redetermination years—and, in some cases, the third step—the determination of the time period for computing interest.

(ii) *Post-completion revenue and expenses*—(A) *In general.* The look-back method is applied upon the completion of any long-term contract and (unless the taxpayer elects the delayed reapplication method of this section) is applied in any subsequent tax year for which there are taken into account any increases or decreases in either total contract price or total contract costs allocable to the contract under section 460(c) (''allocable contract costs'') to the extent those increases or decreases were not previously taken into account under the percentage of completion method. Any year in which the look-back method must be reapplied is treated as a filing year. See Example (3) of paragraph (h)(4) for an illustration of how the look-back method is applied to post-completion adjustments.

(B) *Completion.* A contract is considered to be completed for purposes of the look-back method no later than the year in which final completion and acceptance within the meaning of §1.451–3(b)(2) have occurred. Accordingly, determination of the completion year for any long-term contract is based on an analysis of all the relevant facts and circumstances, including the manner in which the parties to the contract deal with each other and with the subject matter of the contract and the nature of any work or costs remaining to be performed or incurred on the contract. Therefore, the first application of the look-back method must occur no later than the tax year in which the subject matter of the contract has been delivered and is available for use by the customer, even if the taxpayer reasonably expects at that time to incur additional allocable contract costs.

(C) *Discounting of contract price and contract cost adjustments subsequent to completion; election not to discount*—(*1*) *General rule.* The amount of any post-completion adjustment to the total contract price or contract costs is discounted, solely for purposes of applying the look-back method, from its value at the time the amount is taken into account in computing taxable income to its value at the completion of the contract. The discount rate for this purpose is the Federal mid-term rate under section 1274(d) in effect at the time the amount is properly taken into account. For purposes of applying the look-back method for the completion year, no amounts are discounted, even if they are received after the completion year.

(*2*) *Election not to discount.* Notwithstanding the general requirement to discount post-completion adjustments, a taxpayer may elect not to discount contract price and contract cost adjustments with respect to any contract. The election not to discount is to be made on a contract-by-contract basis and is binding with respect to all post-completion adjustments that arise with respect to a contract for which an election has been made. An election not to discount with respect to any contract is made by stating that an election is being made on the taxpayer's timely filed Federal income tax return (determined with regard to extensions) for the first tax year after completion in which the taxpayer takes into account (i.e., includes in income or deducts) any adjustment to the contract price or contract costs. See §5h.6.

(*3*) *Year-end discounting convention.* In the absence of an election not to discount, any revisions to the contract price and contract costs must be discounted to their value as of the completion of the contract in reapplying the look-back method. For this purpose, the period of discounting is the period between the completion date of the contract and the date that any adjustment is taken into account in computing taxable income. Although taxpayers may use the period between the months in which these two events actually occur, in many cases, these dates may not be readily identifiable. Therefore, for administrative convenience, taxpayers are permitted to use the period between the end of the tax years in which these events occur as the period of discounting provided that the convention is used consistently with respect to all post-completion adjustments for all contracts of the taxpayer the adjustments to which are discounted. In that case, the taxpayer must use as the discount rate the Federal mid-term rate under section 1274(d) as of the end of the tax year in which any revision is taken into account in computing taxable income.

(D) *Revenue acceleration rule.* Section 460(b)(1) imposes a special rule that requires a taxpayer to include in gross income, for the tax year immediately following the year of completion, any previously unreported portion of the total contract price (including amounts that the taxpayer expects to receive in the future) determined as of that year, even if the percentage of completion ratio is less than 100 percent because the taxpayer expects to incur additional allocable contract costs in a later year. At the time any remaining portion of the contract price is includible in income under this rule, no offset against this income is permitted for estimated future contract costs. To achieve the requirement to report all remaining contract revenue without regard to additional estimated costs, a taxpayer must include only costs actually incurred through the end of the tax year in the denominator of the percentage of completion ratio in applying the percentage of completion method for any tax years after the year of completion. The look-back method also must be reapplied for the year immediately following the year of completion if any portion of the contract price is includible in income in that year by reason of section 460(b)(1). For purposes of reapplying the look-back method as a result of this inclusion in income, the taxpayer must only include in the denominator of the percentage of completion ratio the actual contract costs incurred as of the end of the year, even if the taxpayer reasonably expects to incur additional allocable contract costs. To the extent that costs are incurred in a subsequent tax year, the look-back method is reapplied in that year (or a later year if the delayed reapplication method is used), and the taxpayer is entitled to receive interest for the post-completion adjustment to contract costs. Because this reapplication occurs subsequent to the completion year, only the cumulative costs incurred as of the end of the reapplication year are includible in the denominator of the percentage of completion ratio.

(2) *Look-back Step One*—(i) *Hypothetical reallocation of income among prior tax years.* For each filing year, a taxpayer must allocate total contract income among prior tax years, by hypothetically applying the percentage of completion method to all contracts that are completed or adjusted in the filing year using the rules of this paragraph (c)(2). The taxpayer must reallocate income from those contracts among all years preceding the filing year that are affected by those contracts using the total contract price and contract costs, as determined as of the end of the filing year (‘‘actual contract price and costs’’), rather than the estimated contract price and contract costs. The taxpayer then must determine the amount of taxable income and the amount of alternative minimum taxable income that would have been reported for each affected tax year preceding the filing year if the percentage of completion method had been applied on the basis of actual contract price and contract costs in reporting income from all contracts completed or adjusted in the filing year and in any preceding year. If the percentage of completion method only applies to alternative minimum taxable income from the contract, only alternative minimum taxable income is recomputed in the first step. For purposes of reallocating income (and costs if the 10-percent year changes for a taxpayer using the 10-percent method of section 460(b)(5)) under the look-back method, the method of computing the percentage of completion ratio is the same method used to report income from the contract on the taxpayer's return. (Thus, an election to use the 10-percent method or the simplified cost-

to-cost method is taken into account). See Example (1) of paragraph (h)(2) for an illustration of Step One.

(ii) *Treatment of estimated future costs in year of completion.* If a taxpayer reasonably expects to incur additional allocable contract costs in a tax year subsequent to the year in which the contract is completed, the taxpayer includes the actual costs incurred as of the end of the completion year plus the additional allocable contract costs that are reasonably expected to be incurred (to the extent includible under the taxpayer's percentage of completion method) in the denominator of the percentage of completion ratio. The completion year is the only filing year for which the taxpayer may include additional estimated costs in the denominator of the percentage of completion ratio in applying the look-back method. If the look-back method is reapplied in any year after the completion year, only the cumulative costs incurred as of the end of the year of reapplication are includible in the denominator of the percentage of completion ratio in reapplying the look-back method.

(iii) *Interim reestimates not considered.* The look-back method cannot be applied to a contract before it is completed. Accordingly, for purposes of applying Step One, the actual total contract price and contract costs are substituted for the previous estimates of total contract price and contract costs only with respect to contracts that have been completed in the filing year and in a tax year preceding the filing year. No adjustments are made under Step One for contracts that have not been completed prior to the end of the current filing year, even if, as of the end of this year, the estimated total contract price or contract costs for these uncompleted contracts is different from the estimated amount that was used during any tax year for which taxable income is recomputed with respect to completed contracts under the look-back method for the current filing year.

(iv) *Tax years in which income is affected.* In general, because income under the percentage of completion method is generally reported as costs are incurred, the taxable income and alternative minimum taxable income are recomputed only for each year in which allocable contract costs were incurred. However, there will be exceptions to this general rule. For example, a taxpayer may be required to cumulatively adjust the income from a contract in a year in which no allocable contract costs are incurred if the estimated total contract price or contract costs was revised in that year. However, in applying the look-back method, no contract income is allocated to that year. Thus, there may be a difference between the amount of contract income originally reported for that year and the amount of contract income as reallocated. Similarly, because of the revenue acceleration rule of section 460(b)(1), income may be reported in the year immediately following the completion year even though no costs were incurred during that year and, in applying the look-back method in that year or another year, if additional costs are incurred or the contract price is adjusted in a later year, no income is allocated to the year immediately following the completion year.

(v) *Costs incurred prior to contract execution; 10-percent method*—(A) *General rule.* There are two situations in which allocable contract costs may be incurred without causing contract income to be reported under the percentage of completion method. First, allocable contract costs that are incurred in tax years prior to the tax year the contract is entered into are deductible in the tax year the contract is entered into, and no contract income is required to be reported in any of these prior tax years. The look-back method does not require allocation of contract income to tax years before the contract was entered into. Costs incurred prior to the year a contract is entered into are similarly first taken into account in the numerator of the percentage of completion ratio in the year the contract is entered into. Second, under the elective 10-percent method of section 460(b)(5), a taxpayer takes no contract revenues or contract costs into account until the tax year as of the close of which at least 10 percent of the total estimated contract costs are incurred (the 10-percent year). Instead, contract costs incurred in a tax year preceding the 10-percent year are deferred until the 10-percent year, at which time they are included in the numerator of the percentage of completion ratio and deducted from gross income. A taxpayer using the 10-percent method must also use the 10-percent method in applying the look-back method, using actual total contract costs to determine the 10-percent year. Thus, contract income is never reallocated to a year before the 10-percent year as determined on the basis of actual contract costs. If the 10-percent year is earlier as a result of applying Step One of the look-back method, contract costs incurred up to and including the new 10-percent year (as determined based on actual contract costs), are reallocated from the original 10-percent year to the new 10-percent, and costs incurred in later years but before the old 10-percent year are reallocated to those years. If the 10-percent year is later as a result of applying Step One of the look-back method, contract costs incurred up to and including the new 10-percent year are reallocated from all prior years to the new 10-percent year. This is the only case in which costs are reallocated under the look-back method.

(B) *Example.* The application of the look-back method by a taxpayer using the 10-percent method is illustrated by the following example:

Example. Z elected to use the 10-percent method of section 460(b)(5) for reporting income under the percentage of completion method. Z entered into a contract in 1990 for a fixed price of $1,000*x*. During 1990, Z incurred allocable contract costs of $80*x* and estimated that it would incur a total of $900*x* for the entire contract. Since $80*x* is less than 10 percent of total estimated contract costs, Z reported no revenue from the contract in 1990 and deferred the $80*x* of costs incurred. In 1991, Z incurred an additional $620*x* of contract costs, and completed the contract. Accordingly, in its 1991 return, Z reported the entire contract price of $1,000*x*, and deducted the $620*x* of costs incurred in 1991 and the $80*x* of costs incurred in 1990.

Under section 460(b)(5), the 10-percent method applies both for reporting contract income and the look-back method. Under the look-back method, since the costs incurred in 1990 ($80*x*) exceed 10 percent of the actual total contract costs ($700*x*), Z is required to allocate $114*x* of contract revenue ($80*x*/$700*x* x $1,000*x*) and the $80*x* of costs incurred to 1990. Thus, application of the 1ook-back method results in a net increase in taxable income for 1990 of $34*x*, solely for purposes of the look-back method.

(vi) *Amount treated as contract price*—(A) *General rule.* The amount that is treated as total contract price for purposes of applying the percentage of completion method and reapplying the percentage of completion method under the look-back method under Step One includes all amounts that the taxpayer expects to receive from the customer. Thus, amounts are treated as part of the contract price as soon as it is reasonably estimated that they will be received, even if the all-events test has not yet been met.

(B) *Contingencies.* Any amounts related to contingent rights or obligations, such as incentive fees or amounts in dispute, are not separated from the contract and accounted for under a non-long-term contract method of accounting, notwithstanding any provision in § 1.451–3(b)(2) (ii), (iii), (iv), and § 1.451–3(d) (2), (3), and (4), to the contrary. Instead, those amounts are treated as part of the total contract price in applying the percentage of completion method and the look-back method. For example, if an incentive fee under a contract to manufacture a satellite is payable to the taxpayer after a specified period of successful performance, the incentive fee is includible in the total contract price at the time and to the extent that it can reasonably be predicted that the performance objectives will be met, for purposes of both the percentage of completion method and the look-back method. Similarly, a portion of the contract price that is in dispute is included in the total contract price at the time and to the extent that the taxpayer can reasonably expect the dispute will be resolved in the taxpayer's favor (without regard to when the taxpayer receives payment for the amount in dispute or when the dispute is finally resolved).

(C) *Change orders.* In applying the look-back method, a change order with respect to a contract is not treated as a separate contract unless the change order would be treated as a separate contract under the rules for severing and aggregating contracts provided in § 1.451–3(e). Thus, if a change order is not treated as a separate contract, the contract price and contract costs attributable to the change order must be taken into account in allocating contract income to all tax years affected by the underlying contract.

(3) *Look-back Step Two: Computation of hypothetical overpayment or underpayment of tax*—(i) *In general.* Step Two involves the computation of a hypothetical overpayment or underpayment of tax for each year in which the tax liability is affected by income from contracts that are completed or adjusted in the filing year (a ‘‘redetermination year’’). The application of Step Two depends on whether the taxpayer uses the simplified marginal impact method contained in paragraph (d) or the actual method described in this paragraph (c)(3). The remainder of this paragraph (c)(3) does not apply if a taxpayer uses the simplified marginal impact method.

(ii) *Redetermination of tax liability.* Under the method described in this paragraph (c)(3) (the ‘‘actual method’’), a taxpayer, first, must determine what its regular and alternative minimum tax liability would have been for each redetermination year if the amounts of contract income allocated in Step One for all contracts completed or adjusted in the filing year and in any prior year were substituted for the amounts of contract income reported under the percentage of completion method on the taxpayer’s original return (or as subsequently adjusted on examination, or by amended return). See Example (2) of paragraph (h)(3) for an illustration of Step Two.

(iii) *Hypothetical underpayment or overpayment.* After redetermining the income tax liability for each tax year affected by the reallocation of contract income, the taxpayer then determines the amount, if any, of the hypothetical underpayment or overpayment of tax for each of these redetermination years. The hypothetical underpayment or overpayment for each affected year is the difference between the tax liability as redetermined under the look-back method for that year and the amount of tax liability determined as of the latest of the following:

(A) The original return date;

(B) The date of a subsequently amended or adjusted return (if, however, the amended return is due to a carryback described in section 6611(f), see paragraph (c)(4)(iii)); or,

(C) The last previous application of the look-back method (in which case, the previous hypothetical tax liability is used).

(iv) *Cumulative determination of tax liability.* The redetermination of tax liability resulting from previous applications of the look-back method is cumulative. Thus, for example, in computing the amount of a hypothetical overpayment or underpayment of tax for a redetermination year, the current hypothetical tax liability is compared to the hypothetical tax liability for that year determined as of the last previous application of the look-back method.

(v) *Years affected by look-back only.* A redetermination of income tax liability under Step Two is required for every tax year for which the tax liability would have been affected by a change in the amount of income or loss for any other year for which a redetermination is required. For example, if the allocation of contract income under Step One changed the amount of a net operating loss that was carried back to a year preceding the year the taxpayer entered into the contract, the tax liability for the earlier year must be redetermined.

(vi) *Definition of tax liability.* For purposes of Step Two, the income tax liability must be redetermined by taking into account all applicable additions to tax, credits, and net operating loss carrybacks and carryovers. Thus, the tax, if any, imposed under section 55 (relating to alternative minimum tax) must be taken into account. For example, if the taxpayer did not pay alternative minimum tax, but would have paid alternative minimum tax for that year if actual rather than estimated contract price and costs had been used in determining contract income for the year, the amount of any hypothetical overpayment or underpayment of tax must be determined by comparing the hypothetical total tax liability (including hypothetical alternative minimum tax liability) with the actual tax liability for that year. The effect of taking these items into account in applying the look-back method is illustrated in Examples (4) through (7) of paragraphs (h)(5) through (h)(8) below.

(4) *Look-back Step Three: Calculation of interest on underpayment or overpayment*—(i) *In general.* After determining a hypothetical underpayment or overpayment of tax for each redetermination year, the taxpayer must determine the interest charged or credited on each of these amounts. Interest on the amount determined under Step Two is determined by applying the overpayment rate designated under section 6621, compounded daily. In general, the time period over which interest is charged on hypothetical underpayments or credited on hypothetical overpayments begins at the due date (not including extensions) of the return for the redetermination year for which the hypothetical underpayment or overpayment determined in Step Two is computed. This time period generally ends on the earlier of:

(A) The due date (not including extensions) of the return for the filing year, and

(B) The date both

(*1*) The income tax return for the filing year is filed, and

(*2*) The tax for that year has been paid in full. If a taxpayer uses the simplified marginal impact method contained in paragraph (d), the remainder of this paragraph (c)(4) does not apply.

(ii) *Changes in the amount of a loss or credit carryback or carryover.* The time period for determining interest may be different in cases involving loss or credit carrybacks or carryovers in order to properly reflect the time period during which the taxpayer (in the case of an underpayment) or the Government (in the case of an overpayment) had the use of the amount determined to be a hypothetical underpayment or overpayment. Thus, if a reallocation of contract income under Step One results in an increase or decrease to a net operating loss carryback (but not a carryforward), the interest due or to be refunded must be computed on the increase or decrease in tax attributable to the change to the carryback only from the due date (not including extensions) of the return for the redetermination year that generated the carryback and not from the due date of the return for the redetermination year in which the carryback was absorbed. In the case of a change in the amount of a carryover as a result of applying the lookback method, interest is computed from the due date of the return for the year in which the carryover was absorbed. See Examples (8) and (9) of paragraph (h)(9) for an illustration of these rules.

(iii) *Changes in the amount of tax liability that generated a subsequent refund.* If the amount of tax liability for a redetermination year (as reported on the taxpayer's original return, as subsequently adjusted on examination, as adjusted by amended return, or as redetermined by the last previous application of the look-back method) is decreased by the application of the look-back method, and any portion of the redetermination year tax liability was absorbed by a loss or credit carryback arising in a year subsequent to the redetermination year, the look-back method applies as follows to properly reflect the time period of the use of the tax overpayment. To the extent the amount of tax absorbed because of the carryback exceeds the total hypothetical tax liability for the year (as redetermined under the look-back method) the taxpayer is entitled to receive interest only until the due date (not including extensions) of the return for the year in which the carryback arose.

Example. Upon the completion of a long-term contract in 1990, the taxpayer redetermines its tax liability for 1988 under the look-back method. This redetermination results in a hypothetical reduction of tax liability from $1,500*x* (actual liability originally reported) to $1,200*x* (hypothetical liability). In addition, the taxpayer had already received a refund of some or all of the actual 1988 tax by carrying back a net operating loss (NOL) that arose in 1989. The time period over which interest would be computed on the hypothetical overpayment of $300*x* for 1988 would depend on the amount of the refund generated by the carryback, as illustrated by the following three alternative situations:

(A) If the amount refunded because of the NOL is $1,500*x:* interest is credited to the taxpayer on the entire hypothetical overpayment of $300*x* from the due date of the 1988 return, when the hypothetical overpayment occurred, until the due date of the 1989 return, when the taxpayer received a refund for the entire amount of the 1988 tax, including the hypothetical overpayment.

(B) If the amount refunded because of the NOL is $1,000*x:* interest is credited to the taxpayer on the entire amount of the hypothetical overpayment of $300*x* from the due date of the 1988 return, when the hypothetical overpayment occurred, until the due date of the 1990 return. In this situation interest is credited until the due date of the return for the completion year of the contract, rather than the due date of the return for the year in which the carryback arose, because the amount refunded was less than the redetermined tax liability. Therefore, no portion of the hypothetical overpayment is treated as having been refunded to the taxpayer before the filing year.

(C) If the amount refunded because of the NOL is $1,300*x*−*:* interest is credited to the taxpayer on $100*x* ($1,300*x*-$1,200*x*) from the due date of the 1988 return until the due date of the 1989 return because only this portion of the total hypothetical overpayment is treated as having been refunded to the taxpayer before the filing year. However, the taxpayer did not receive a refund for the remaining $200*x* of the overpayment at that time and, therefore, is credited with interest on $200*x* through the due date of the tax return for 1990, the filing year. See Examples (10) and (11) of paragraph (h)(9) for a further illustration of this rule.

(iv) *Additional interest due on interest only after tax liability due.* For each filing year, taxpayers are required to file a Form 8697 (Interest Computation Under the Look-back Method for Completed Long-term Contracts) at the time the return for that filing year is filed to report the interest due or to be refunded under the look-back method. Even if the taxpayer has received an extension to file its income tax return for the filing year, look-back interest is computed with respect to the hypothetical increase (or decrease) in the tax liability determined under the look-back method only until the initial due date of that return (without regard to the extension). Interest is charged, unless the taxpayer otherwise has a refund that fully offsets the amount of interest due, (or credited) with respect to the amount of look-back interest due (or to be refunded) under the look-back method from the initial due date of the return through the date the return is filed. No interest is charged (or credited) after the due date of the return with respect to the amount of the hypothetical increases (or decreases) in tax liability determined under the look-back method.

(d) *Simplified marginal impact method*—(1) *Introduction.* This paragraph (d) provides a simplified method for calculating look-back interest. Any taxpayer may elect this simplified marginal impact method, except that pass-through entities described in paragraph (d)(4) of this section are required to apply the simplified marginal impact method at the entity level with respect to domestic contracts and the owners of those entities do not apply the look-back method to those contracts. Under the simplified marginal impact method, a taxpayer calculates the hypothetical underpayments or overpayments of tax for a prior year based on an assumed marginal tax rate. A taxpayer electing to use the simplified marginal impact method must use the method for each long-term contract for which it reports income (except with respect to domestic contracts if the taxpayer is an owner in a widely held pass-through entity that is required to use the simplified marginal impact method at the entity level for those contracts).

(2) *Operation*—(i) *In general.* Under the simplified marginal impact method, income from those contracts that are completed or adjusted in the filing year is first reallocated in accordance with the procedures of Step One contained in paragraph (c)(2) of this section. Step Two is modified in the following manner. The hypothetical underpayment or overpayment of tax for each year of the contract (a ‘‘redetermination year’’) is determined by multiplying the applicable regular tax rate (as defined in paragraph (d)(2)(iii)) by the increase or decrease in regular taxable income (or, if it produces a greater amount, by multiplying the applicable alternative minimum tax rate by the increase or decrease in alternative minimum taxable income, whether or not the taxpayer would have been subject to the alternative minimum tax) that results from reallocating income to the tax year under Step One. Generally, the product of the alternative minimum tax rate and the increase or decrease in alternative minimum taxable income will be the greater of the two amounts described in the preceding

sentence only with respect to contracts for which a taxpayer uses the full percentage of completion method only for alternative minimum tax purposes and uses the completed contract method, or the percentage of completion-capitalized cost method, for regular tax purposes. Step Three is then applied. Interest is credited to the taxpayer on the net overpayment and is charged to the taxpayer on the net underpayment for each redetermination year from the due date (determined without regard to extensions) of the return for the redetermination year until the earlier of

(A) The due date (determined without regard to extensions) of the return for the filing year, and

(B) The first date by which both the return is filed and the tax is fully paid.

(ii) *Applicable tax rate.* For purposes of determining hypothetical underpayments or overpayments of tax under the simplified marginal impact method, the applicable regular tax rate is the highest rate of tax in effect for the redetermination year under section 1 in the case of an individual and under section 11 in the case of a corporation. The applicable alternative minimum tax rate is the rate of tax in effect for the taxpayer under section 55(b)(1). The highest rate is determined without regard to the taxpayer's actual rate bracket and without regard to any additional surtax imposed for the purpose of phasing out multiple tax brackets or exemptions.

(iii) *Overpayment ceiling.* The net hypothetical overpayment of tax for any redetermination year is limited to the taxpayer's total federal income tax liability for the redetermination year reduced by the cumulative amount of net hypothetical overpayments of tax for that redetermination year resulting from earlier applications of the look-back method. If the reallocation of contract income results in a net overpayment of tax and this amount exceeds the actual tax liability (as of the filing year) for the redetermination year, as adjusted for past applications of the look-back method and taking into account net operating loss, capital loss, or credit carryovers and carrybacks to that year, the actual tax so adjusted is treated as the overpayment for the redetermination year. This overpayment ceiling does not apply when the simplified marginal impact method is applied at the entity level by a widely held pass-through entity in accordance with paragraph (d)(4) of this section.

(iv) *Example.* The application of the simplified marginal impact method is illustrated by the following example:

Example. Corporation X, a calendar-year taxpayer, reports income from long-term contracts and elected the simplified marginal impact method when it filed its income tax return for 1989. X uses only the percentage of completion method for both regular taxable income and alternative minimum taxable income. X completed contracts A, B, and C in 1989 and, therefore, was required to apply the look-back method in 1989. Income was actually reported for these contracts in 1987, 1988, and 1989. X's applicable tax rate, as determined under section 11, for the redetermination years 1987 and 1988 was 40 percent and 34 percent, respectively. The amount of contract income originally reported and reallocated for contracts A, B, and C, and the net overpayments and underpayments for the redetermination years are as follows:

	1987	1988
Contract A:		
Originally reported	$5,000*x*	$4,000*x*
Reallocated	3,000*x*	5,000*x*
Increase/(Decrease)	(2,000*x*)	1,000*x*
Contract B:		
Originally reported	6,000*x*	2,000*x*
Reallocated	7,000*x*	1,500*x*
Increase/(Decrease)	1,000*x*	(500*x*)
Contract C:		
Originally reported	8,000*x*	5,000*x*
Reallocated	4,000*x*	7,000*x*
Increase/(Decrease)	(4,000*x*)	2,000*x*
Net Increase/(Decrease)	(5,000*x*)	2,500*x*
Tentative (Underpayment)/Overpayment:		
@ .40	2,000*x*	....
@ .34	....	(850*x*)
Ceiling:		
Actual Tax Liability (After Carryovers and Carrybacks)	1,500*x*	500*x*
Final (Underpayment)/Overpayment	1,500*x*	(850*x*)

Under the simplified marginal impact method, X determined a tentative hypothetical net overpayment for 1987 and a net underpayment for 1988. X determined these amounts by first aggregating the difference for contracts A, B, and C between the amount of contract price originally reported and the amount of contract price as reallocated and, then, applying the highest regular tax rate to the aggregate decrease in income for 1987 and the aggregate increase in income for 1988.

However, X's overpayment for 1987 is subject to a ceiling based on X's total tax liability. Because the tentative net overpayment of tax for 1987 exceeds the actual tax liability for that year after taking into account carryovers and carrybacks to that year, the final overpayment under the simplified marginal impact method is the amount of tax liability paid instead of the tentative net overpayment. Since application of the look-back method for 1988 results in a tentative underpayment of tax, it is not subject to a ceiling. If the look-back method is applied in 1991, the ceiling amount for 1987 will be zero and the ceiling amount for 1988 will be $1,350.

X is entitled to receive interest on the hypothetical overpayment from March 15, 1988, to March 15, 1990. X is required to pay interest on the underpayment from March 15, 1989, to March 15, 1990.

(3) *Anti-abuse rule.* If the simplified marginal impact method is used with respect to any long-term contract (including a contract of a widely held pass-through entity), the district director may recompute interest for the contract (including domestic contracts of widely held pass-through entities) under the look-back method using the actual method (and without regard to the simplified marginal impact method). The district director may make such a recomputation only if the amount of income originally reported with respect to the contract for any redetermination year exceeds the amount of income reallocated under the look-back method with respect to that contract for that year (using actual contract price and contract costs) by the lesser of $1,000,000 or 20 percent of the amount of income as reallocated (*i.e.*, based on actual contract price and contract costs) under the look-back method with respect to that contract for that year. In determining whether to exercise this authority upon examination of the Form 8697, the district director may take into account whether the taxpayer overreported income for a purpose of receiving interest under the look-back method on a hypothetical overpayment determined at the applicable tax rate. The district director also may take into account whether the taxpayer underreported income for the year in question with respect to other contracts. Notwithstanding the look-back method, the district director may require an adjustment to the tax liability for any open tax year if the taxpayer did not apply the percentage of completion method properly on its original return.

(4) *Application*—(i) *Required use by certain pass-through entities*—(A) *General rule.* The simplified marginal impact method is required to be used with respect to income reported from domestic contracts by a pass-through entity that is either a partnership, an S corporation, or a trust, and that is not closely held. With respect to contracts described in the preceding sentence, the simplified marginal impact method is applied by the pass-through entity at the entity level. For determining the amount of any hypothetical underpayment or overpayment, the applicable regular and alternative minimum tax rates, respectively, are generally the highest rates of tax in effect for corporations under section 11 and section 55 (b)(1). However, the applicable regular and alternative minimum tax rates are the highest rates of tax imposed on individuals under section 1 and section 55 (b)(1) if, at all times during the redetermination year involved (*i.e.*, the year in which the hypothetical increase or decrease in income arises), more than 50 percent of the interests in the entity were held by individuals directly or through 1 or more pass-through entities.

(B) *Closely held.* A pass-through entity is closely held if, at any time during any redetermination year, 50 percent of more (by value) of the beneficial interests in that entity are held (directly or indirectly) by or for 5 or fewer persons. For this purpose, the term ''person'' has the same meaning as in section 7701(a)(1), except that a pass-through entity is not treated as a person. In addition, the constructive ownership rules of section 1563(e) apply by substituting the term ''beneficial interest'' for the term ''stock'' and by substituting the term ''pass-through entity'' for the term, ''corporation'' used in that section, as appropriate, for purposes of determining whether a beneficial interest in a pass-through entity is indirectly owned by any person.

(C) *Examples.* The following examples illustrate the application of the rules of paragraph (d)(4)(i):

Example (1). P, a partnership, began a long-term contract on March 1, 1986, and completed this contract in its tax year ending December 31, 1989. P used the percentage of completion method for all contract income. Substantially all of the income from the contract arose from U.S. sources. At all times during all of the years for which income was required to be reported under the contract, exactly 25 percent of the value of P's interests was owned by Corporation M. The remaining 75 percent of the value of P's interests was owned in equal shares by 15 unrelated individuals, who are also unrelated to Corporation M. M's ownership of P represents less than 50 percent of the value of the beneficial interests in P, and, therefore, viewed alone, is insufficient to make P a closely held partnership. In addition, because no 4 of the individual owners together own 25 percent or more of the remaining value of P's beneficial interests, there is no group of 5 owners that together own, directly or indirectly, 50 percent or more by value of the beneficial interests in P. Therefore, P is not closely held pass-through entity.

Because P is not a closely held pass-through entity, and because P completed the contract after the effective date of section 460(b)(4), P is required to use the simplified marginal impact method. Any interest computed under the look-back method will be paid to, or collected from, P, rather than its partners, and must be reported to each of the partners on Form 1065 as interest income or expense. Further, assume that, for the redetermination years, Corporation M is subject to alternative minimum tax at the rate of 20 percent and 3 of the individuals who own interests in P are subject to the highest marginal tax rate of 33 percent in 1988. Regardless of the actual marginal tax rates of its partners, P is required to determine the underpayment or overpayment of tax for each redetermination year at the entity level by applying a single rate to the increase or decrease in income resulting from the reallocation of contract income under the look-back method. Because more than 50 percent of the interests in P are held by individuals, P must use the highest rate specified in section 1 for each redetermination year. Thus, the rate applied by P is 50 percent for 1986, 38.5 percent for 1987, and 28 percent for 1988.

Example (2). Assume the same facts as in Example (1), except that one of the individuals, Individual I, who directly owns 5 percent of the value of the interests of P, also owns 100 percent of the stock of Corporation M. Section 1563(e)(4) of the Code provides that stock owned directly or indirectly by or for a corporation is considered to be owned by any person who owns 5 percent or more in value of its stock in that proportion which the value of the stock which that person so owns bears to the value of all the stock in that corporation. Because section 460(b)(4)(C)(iii) and this paragraph (d)(4) provide that rules similar to the constructive ownership rules of section 1563(e) apply in determining whether a pass-through entity is closely held, all of M's interest in P is attributed to I because I owns 100 percent of the value of the stock in M. Accordingly, because I's direct 5 percent and constructive 25 percent ownership of P, plus the interests owned by any 4 other individual partners, equals 50 percent or more of the value of the beneficial interests of P, P is a closely held pass-through entity within the meaning of section 460(b)(4)(C)(iii). Therefore, P cannot use the simplified marginal impact method at the entity level. Accordingly, each of the partners of P must separately apply the look-back method to their respective interests in the income and expenses attributable to the contract, but each partner may elect to use the simplified marginal impact method with respect to the partner's share of income from the contract.

(D) *Domestic contracts*—(*1*) *General rule.* A domestic contract is any contract substantially all of the income of which is from sources in the United States. For this purpose, ''substantially all'' of the income from a long-term contract is considered to be from United States sources if 95 percent or more of the gross income from the contract is from sources within the United States as determined under the rules in sections 861 through 865.

(*2*) *Portion of contract income sourced.* In determining whether substantially all of the gross income from a long-term contract is from United States sources, taxpayers must apply the allocation and apportionment principles of sections 861 through 865 only to the portion of the contract accounted for under the percentage of completion method. Under the percentage of completion method, gross income from a long-term contract includes all payments to be received under the contract (*i.e.*, any amounts treated as contract price). Similarly, all costs taken into account in the computation of taxable income under the percentage of completion method are deducted from gross income rather than added to a cost of goods sold account that reduces gross income. Therefore, allocable contract costs are not considered in determining whether a long-term contract is a domestic contract or a foreign contract, even if, under the taxpayer's facts, the allocation of contract costs to any portion of a contract not accounted for under the percentage of completion method would affect the relative percentages of United States and foreign source gross income from the entire contract if this portion of the contract were taken into account in applying the 95-percent test.

(E) *Application to foreign contracts.* If a widely held pass-through entity has some foreign contracts and some domestic contracts, the owners of the pass-through entity each apply the look-back method (using, if they elect, the simplified marginal impact method) to their respective share of the income and expense from foreign contracts. Moreover, in applying the look-back method to foreign contracts at the owner level, the owners do not take into account their share of increases or decreases in contract income resulting from the application of the simplified marginal impact method with respect to domestic contracts at the entity level.

(F) *Effective date.* The simplified marginal impact method must be applied to pass-through entities described in paragraph (d)(4)(i) of this section with respect to domestic contracts completed or adjusted in tax years for which the due date of the return (determined with regard to extensions) of the pass-through entity is after November 9, 1988.

(ii) *Elective use*—(A) *General rule.* As provided in paragraph (d)(4)(i) of this section, the simplified marginal impact method must be used by certain pass-through entities with respect to domestic contracts. C corporations, individuals, and owners of closely held pass-through entities may elect the simplified marginal impact method. Owners of other pass-through entities may also elect the simplified marginal impact method with respect to all contracts other than those for which the simplified marginal impact method is required to be applied at the entity level. This rule applies to foreign contracts of widely held pass-through entities. In the case of an electing owner in a pass-through entity, the simplified marginal impact method is applied at the owner level, instead of at the entity level, with respect to the owner's share of the long-term contract income and expense reported by the pass-through entity.

(B) *Election requirements.* A taxpayer elects the simplified marginal impact method by stating that the election is being made on a timely filed income tax return (determined with regard to extensions) for the first tax year the election is to apply. An election to use the simplified marginal impact method applies to all applications of the look-back method to all eligible long-term contracts for the tax year for which the election is made and for any subsequent tax year. The election may not be revoked without the consent of the Commissioner.

(C) *Consolidated group consistency rule.* In the case of a consolidated group of corporations within the meaning of section 1504(a), an election to use the simplified marginal impact method is made by the common parent of the group. The election is binding on all other affected members of the group (including members that join the group after the election is made with respect to all applications of the look-back method after joining). If a member subsequently leaves the group, the election remains binding as to that member unless the Commissioner consents to a revocation of the election. If a corporation using the simplified marginal impact method joins a group that does not use the method, the election is automatically revoked with respect to all applications of the look-back method after it joins the group.

(e) *Delayed reapplication method*—(1) *In general.* For purposes of reapplying the look-back method after the year of contract completion, a taxpayer may elect the delayed reapplication method to minimize the number of required reapplications of the look-back method. Under this method, the look-back method is reapplied after the year of completion of a contract (or after a subsequent application of the look-back method) only when the first one of the following conditions is met with respect to the contract:

(i) The net undiscounted value of increases or decreases in the contract price occurring since the time of the last application of the look-back method exceeds the lesser of $1,000,000 or 10 percent of the total contract price as of that time,

(ii) The net undiscounted value of increases or decreases in the contract costs occurring since the time of the last application of the look-back method exceeds the lesser of $1,000,000 or 10 percent of the total contract price as of that time,

(iii) The taxpayer goes out of existence,

(iv) The taxpayer reasonably believes the contract is finally settled and closed, or

(v) Neither condition (e)(1) (i), (ii), (iii), nor (iv) above is met by the end of the fifth tax year that begins after the last previous application of the look-back method.

(2) *Time and manner of making election.* An election to use the delayed reapplication method may be made for any filing year for which the due date of the return (determined with regard to extensions) is after June 12, 1990. The election is made by a statement to that effect on the taxpayer's timely filed Federal income tax return (determined with regard to extensions) for the first tax year the election is to be effective. An election to use the delayed reapplication method is binding with respect to all long-term contracts for which the look-back method would be reapplied without regard to the election in the year of election and any subsequent year unless the Commissioner consents to a revocation of the election. In the case of a consolidated group of corporations within the meaning of section 1504(a), an election to use the delayed reapplication method is made by the common parent of the group. The election is binding on all other affected members of the group (including members that join the group after the election is made with respect to contracts adjusted after joining). If a member subsequently leaves the group, the election remains binding as to that member unless the Commissioner consents to a revocation of the election. If a corporation that has made the election joins a consolidated group that has not made the election, the election is treated as revoked with respect to contracts adjusted after joining.

(3) *Examples.* The operation of this delayed reapplication method is illustrated by the following examples:

Example (1). X completes a contract in 1987, and applies the look-back method when its return for 1987 is filed. X properly uses $600,000 as the actual contract price in applying the look-back method. In 1990, as a result of the settlement of a dispute with its customer, X redetermines total contract price to be $640,000, and includes $40,000 in gross income. On its return for 1990, X states it is electing the delayed reapplication method. X is not required to reapply the look-back method at that time, because $40,000 does not exceed the lesser of $1,000,000 or 10 percent of the unadjusted contract price of $600,000, and 5 years have not passed since the last application of the look-back method.

Example (2). Assume the same facts as in Example (1), except that at the end of 1992, the fifth year after completion of the contract, no other adjustments to contract price or contract costs have occurred. X is required to reapply the look-back method in 1992 and, accordingly, redetermine its tax liability for each redetermination year. After redetermining the underpayment of tax for those years, X must compute the amount of interest charged on the underpayments. Although 1992 is the filing year, interest is due on the amount of each underpayment resulting from the adjustment only from the due date of the return for each redetermination year to the due date of the return for 1990 because the tax liability for the adjustment was fully paid in 1990. However, from the due of the 1990 return until the due date of the 1992 return, when the look-back method is reapplied for the adjustment, interest is due on the amount of interest attributable to the underpayments.

(f) *Look-back reporting*—(1) *Procedure.* The amount of any interest due or to be refunded as a result of applying the look-back method is computed and reported on Form 8697 for any filing year. In general, the look-back method is applied by and Form 8697 is filed by the taxpayer that reports income from a long-term contract. See paragraph (g) of this section to determine who is responsible for applying the look-back method when, prior to the completion of a long-term contract, there is a transaction that changes the taxpayer that reports income from the contract.

(2) *Treatment of interest on return*—(i) *General rule.* The amount of interest required to be paid by a taxpayer is treated as an income tax under subtitle A, but only for purposes of subtitle F of the Code (other than sections 6654 and

6655), which addresses tax procedures and administration.

Thus, a taxpayer that fails to file Form 8697 with respect to interest required to be paid or that fails to pay the amount of interest due is subject to any applicable penalties under subtitle F, including, for example, a penalty for failing to file Form 8697. However, interest required to be paid under the look-back method is treated as interest expense for purposes of computing taxable income under subtitle A, even though it is treated as income tax liability for penalty purposes. Interest received under the look-back method is treated as taxable interest income for all purposes, and is not treated as a reduction in tax liability. The determination of whether or not interest computed under the look-back method is treated as tax is determined on a ‘‘net’’ basis for each filing year. Thus, if a taxpayer computes for the current filing year both hypothetical overpayments and hypothetical underpayments for prior years, the taxpayer has an increase in tax only if the interest computed on the underpayments for all those prior years exceeds the interest computed on the overpayments for all those prior years, for all contracts completed or adjusted for the year.

(ii) *Timing of look-back interest.* For purposes of determining taxable income under subtitle A of the Code, any amount of interest refunded to the taxpayer under the look-back method is includible in gross income as interest income in the tax year it is properly taken into account under the taxpayer's method of accounting for interest income. Any amount of interest required to be paid is taken into account as interest expense arising from an underpayment of income tax in the tax year it is properly taken into account under the taxpayer's method of accounting for interest expense. Thus, look-back interest required to be paid by an individual, or by a pass-through entity on behalf of an individual owner (or beneficiary) under the simplified marginal impact method, is personal interest and, therefore, is disallowed in accordance with §1.163–9T(b)(2). Interest determined at the entity level under the simplified marginal impact method is allocated among the owners (or beneficiaries) for reporting purposes in the same manner that interest income and interest expense are allocated to owners (or beneficiaries) and subject to the requirements of section 704 and any other applicable rules.

(g) *Mid-contract change in taxpayer.* [Reserved]

(h) *Examples*—(1) *Overview.* This paragraph provides computational examples of the rules of this section. Except as otherwise noted, the examples involve calendar-year taxpayers and involve long-term contracts subject to section 460 that are accounted for using the percentage of completion method, rather than the percentage of completion-capitalized cost method. If the percentage of completion-capitalized cost method were used by a taxpayer described in the examples, the amounts of contract income and expenses shown in the examples would be reduced, for purposes of determining regular taxable income, to the appropriate fraction (40, 70, or 90 percent) of contract items accounted for under the percentage of completion method. Tens of thousands of dollars ($ 00,000's) are omitted from the figures in the examples. The contracts described in the examples are assumed to be the taxpayers' only contracts that are subject to the look-back method of section 460. Except as otherwise stated, the examples assume that the taxpayer has no adjustments and preferences for purposes of section 55, so that alternative minimum taxable income is the same as taxable income, and no alternative minimum tax is imposed for the years involved. The examples assume that the taxpayer does not elect the 10-percent method, the simplified marginal impact method, or the delayed reapplication method.

(2) *Step One.* The following example illustrates the application of paragraph (c)(2):

Example (1). In 1989, W completes three long-term contracts, A, B, and C, entered into on January 1 of 1986, 1987, and 1988, respectively. For Contract A, W used the completed contract method of accounting. For Contract B, W used the percentage of completion-capitalized cost method of accounting, taking into account 60 percent of contract income under W's normal method of accounting, which was the completed contract method. For Contract C, W used the percentage of completion method of accounting. The total price for each contract was $1,000. In computing alternative minimum taxable income, W is required to use the percentage of completion method for Contracts B and C. W used regular tax costs for purposes of determining the degree of contract completion under the alternative minimum tax.

Contract A is not taken into account for purposes of applying the look-back method, because it is subject to neither section 460 nor section 56(a)(3). Thus, even if W had used the percentage of completion method as permitted under § 1.451–3, instead of the completed contract method, the look-back method would not be applicable because the Contract A was entered into before the effective date of section 460.

The actual costs allocated to Contracts B and C under section 460(c) and incurred in each year of the contract were as follows:

Contract	1987	1988	1989	Total
B	$200	$400	$200	$800
C	100	300	400	800

In applying the look-back method, the first step is to allocate the contract price among tax years preceding and including the completion year. That allocation would produce the following amounts of gross income for purposes of the regular tax. Note that no income from Contract C is allocated to 1987, the year before the contract was entered into, even though contract costs were incurred in 1987:

Contract	1987	1988	1989
B	$100 (40%X$200/$800X$1000)	$200 ((40%X$600/$800X$1000)–$100)	$700 ....
C	0	500 ($400/$800X$1000)	500 ....

Because the percentage of completion-capitalized cost method may not be used for alternative minimum tax purposes, the allocation of contract income would produce the following amounts of gross income for purposes of computing alternative minimum taxable income:

Contract	1987	1988	1989
B	$250 ($200/$800X$1000)	$500 (($600/$800X$1000)–$250)	$250 ....
C	0	500	500

(3) *Step Two.* The following example illustrates the application of paragraph (c)(3):

Example (2). (i) X enters into two long-term contracts (D and E) in 1988. X determines its tax liability for 1988 as follows:

e=estimate
a=amount originally reported (actual)
h=hypothetical

	1988		Total
	D	E	
1988 contract costs	$3,000a	$2,000a	....
Total contract costs	8,000e	8,000e	....
Total contract price	10,000e	10,000e	....
1988 completion %	37.5e	25e	....
1988 gross income	3,750a	2,500a	....
Less, 1988 costs	(3,000a)	(2,000a)	....
1988 net contract income	750a	500a	$1,250a
Other 1988 net income (loss)	....	....	(2,000a)
Taxable income (NOL)	....	....	(750a)
Tax	....	....	0a
Refund from NOL carryback fully absorbed in 1985, at 46%	....	....	345a

(ii) X completes Contract D during 1989. X determines its taxable income for 1989 as follows:

	1989		Total
	D	E	
1989 contract costs	$3,000a	0a	
Total contract costs	6,000a	$9,000e	
Total contract price	10,000a	10,000e	
1989 completion %	100a	22.2e	
1989 gross income/(loss)	6,250a	(278a)	
Less, 1989 costs	(3,000a)	0a	
1989 net contract income	3,250a	(278a)	$2,972a
Other 1989 net income (loss)			0a
Taxable income (NOL)			2,972a
Tax at 34%			1,011a

(iii) For purposes of the look-back method, X must reallocate the actual total contract D price between 1988 and 1989 based on the actual total contract D costs. This results in the following hypothetical underpayment of tax for 1988 for purposes of the look-back method. Note that X does not reallocate the contract E price in applying the look-back method in 1989 because contract E has not been completed, even though X's estimate of contract E costs has changed. The following computation is only for purposes of applying the look-back method, and does not result in the assessment of a tax deficiency.

	1988		Total
	D	E	
1988 contract costs	$3,000a	$2,000a	
Total contract costs	6,000a	8,000e	
Total contract price	10,000a	10,000e	
1988 completion %	50a	25e	
1988 gross income	5,000h	2,500a	
Less, 1988 costs	(3,000a)	(2,000a)	
1988 net contract income	2,000h	500a	$2,500h
Other 1988 net income (loss)			(2,000a)
Taxable income (NOL)			500h
Tax at 34%			170h
Less, previously computed tax			−0a
Underpayment of 1988 tax			170h
Underpayment of 1985 tax from NOL carryback refund in 1988			345h
Total underpayment of tax			515h

For purposes of any subsequent application of the look-back method for which 1989 is a redetermination year, because the reallocation of contract income and redetermination of tax liability are cumulative, X will use for 1989 the amount of contract D income and the amount of tax liability that would have been reported in 1989 if X had used actual contract costs instead of the amounts that were originally reported using the estimate of $8,000. Assuming no subsequent revisions (due to, for example, adjustments to contract D price and costs determined after the end of 1989), this amount would be determined as follows:

	1989		Total
	D	E	
1989 contract costs	$3,000a	0a	
Total contract costs	6,000a	$9,000e	
Total contract price	10,000a	10,000e	
1989 completion %	100a	22.2e	
1989 gross income	5,000h	(278a)	
Less, 1989 costs	(3,000a)	0a	
1989 net contract income	2,000h	(278a)	$1,722h
Other 1989 net income (loss)			0a
Taxable income (NOL)			1,722h
Tax at 34%			585h

(iv) X completes contract E during 1990. X determines its taxable income for 1990 as follows:

	1990		Total
	D	E	
1990 contract costs		$7,000a	
Total contract costs		9,000a	
Total contract price		10,000a	
1990 completion %		100a	
1990 gross income		7,778a	
Less, 1990 costs		(7,000a)	
1990 net contract income		778a	$778a
Other 1990 net income (loss)			0a
Taxable income (NOL)			778a
Tax at 34%			265a

(v) For purposes of the look-back method, X must reallocate the actual total contract E price between the 1988, 1989, and 1990, based on the actual total contract E costs.

This results in the following hypothetical overpayment of tax for 1988. Note that X uses the amount of income for contract D determined in the last previous application of the look-back method, and not the amount of income actually reported:

	1988		Total
	D	E	
1988 contract costs	$3,000a	$2,000a	
Total contract costs	$6,000a	$9,000a	
Total contract price	$10,000a	$10,000a	
1988 completion (%)	50a	22.2a	
1988 gross income	$5,000h	$2,222h	
Less, 1988 costs	($3,000a)	($2,000a)	
1988 net contract income	$2,000h	$222h	$2,222h
Other 1988 net income (loss)			($2,000a)
Taxable income (NOL)			$222h
Tax at 34%			$75h
Less, previously computed tax (based on most recent application of the look-back method)			$170h
Overpayment of 1988 tax			($95h)

In applying the look-back method to 1989, X again uses the amounts substituted as of the last previous application of the look-back method with respect to contract D. Thus, X computes its hypothetical underpayment for 1989 as follows:

	1989		Total
	D	E	
1989 contract costs	$3,000a	0a	
Total contract costs	$6,000a	$9,000a	
Total contract price	$10,000a	$10,000a	
1989 completion (%)	100a	22.2a	
1989 gross income	$5,000h	$0h	
Less, 1989 costs	($3,000a)	($0a)	
1989 net contract income	$2,000h	0a	$2,000h
Other 1989 net income (loss)			($0a)
Taxable income (NOL)			$2,000h
Tax at 34%			$680h
Less, previously computed tax			$585h
Underpayment of 1989 tax			$95h

For purposes of any subsequent application of the look-back method for which 1990 is a redetermination year, X will use for 1990 the amount of Contract E income, and the amount of tax liability, that was originally reported in 1990 because X's estimate of the total contract costs from $8,000 to $9,000 did not change after 1989. Without regard to any subsequent revisions, these amounts are the same as in the table in paragraph (h)(3)(iv) above.

(4) *Post-completion adjustments.* The following example illustrates the application of paragraph (c)(1)(ii):

Example (3). The facts are the same as in Example (2). In 1991, X settles a lawsuit against its customer in Contract E. The customer pays X an additional $3,000, without interest, in 1991. Applying the Federal mid-term rate then in effect, this $3,000 has a discounted value at the time of contract completion in 1990 of $2,700. X is required to apply the look-back method for 1991 even though no contract was completed in 1991. X must include the full $3,000 adjustment (which was not previously includible in total contract price) in gross income for 1991. X does not elect not to discount adjustments to the contract price or costs. Thus, X adjusts the contract price by the discounted amount of the adjustment and, therefore, uses $12,700 (not $13,000) for total Contract E price, rather than $10,000, which was used when the look-back method was first applied with respect to Contract E.

For purposes of the look-back method, X must allocate the revised total Contract E price of $12,700 between 1988, 1989 and 1990 based on the actual total Contract E costs, and compare the resulting revised tax liability with the tax liability determined for the last previous application of the look-back method involving those years. This results in the following hypothetical underpayments of tax for purposes of the look-back method:

r=revised

	1988		Total
	D	E	
1988 contract costs	$3,000a	$2,000a	
Total contract costs	$6,000a	$9,000a	
Total contract price	$10,000a	$12,700r	
1988 completion (%)	50a	22.2a	
1988 gross income	$5,000h	$2,822rh	
Less, 1988 costs	($3,000a)	($2,000a)	
1988 net contract income	$2,000h	822rh	$2,222rh
Other 1988 net income (loss)			($2,000a)
Taxable income			$822rh
Tax at 34%			$279rh
Less, previously computed tax			$75h
Underpayment of 1988 tax			$204rh

No Contract E costs were incurred in 1989, and there is no hypothetical underpayment for 1989.

	1990		
	D	E	Total
1990 contract costs		$7,000a	
Total contract costs		$9,000a	
Total contract price		$12,700r	
1990 completion (%)		100a	
1990 gross income		$9,878rh	
Less 1990 costs		(*$7,000a*)	
1990 net contract income		$2,878rh	$2,878rh
Other 1990 net income (loss)			0a
Taxable income (NOL)			$2,878rh
Tax at 34%			$978rh
Less, previously computed tax			$265h
Underpayment of 1990 tax			$713rh

In 1992, X incurs an additional cost of $1,000 allocable to the contract, which was not previously includible in total contract costs. Applying the Federal mid-term rate then in effect, the $1,000 has a discounted value at the time of contract completion of $800. X deducts this additional $1,000 in expenses in 1992. Based on this increase to contract costs, X reapplies the look-back method, and determines the following hypothetical underpayments for 1988, 1989 and 1990 for purposes of the look-back method:

	1988		Total
	D	E	
1988 contract costs	$3,000a	$2,000a	
Total contract costs	$6,000a	$9,800r	
Total contract price	$10,000a	$12,700r	
1988 completion (%)	50a	20.4r	
1988 gross income	$5,000h	$2,592rh	
Less, 1988 costs	(*$3,000a*)	(*$2,000a*)	
1988 net contract income	$2,000h	592rh	$2,592rh
Other 1988 net income (loss)			(*$2,000a)*
Taxable income (NOL)			$592rh
Tax at 34%			$201rh
Less, previously computed tax			$279rh
Overpayment of 1988 tax			($78rh)

No Contract E costs were incured in 1989, and there is no hypothetical underpayment for 1989.

	1990		Total
	D	E	
1990 contract costs			$7,000a
Total contract costs		9,800r	
Total contract price		12,700r	
1990 completion (%)		92a	
1990 gross income		9,071rh	
Less, 1990 costs		(*7,000a*)	
1990 Net contract income		2,071rh	$2,071rh
Other 1990 net income (loss)			*0a*
Taxable income (NOL)			2,071rh
Tax at 34%			704rh
Less, previously computed tax			978rh
Overpayment of 1990 tax			(274rh)

(5) *Alternative minimum tax.* The operation of the look-back method in the case of a taxpayer liable for the alternative minimum tax as provided in paragraph (c)(3)(vi) is illustrated by the following examples:

Example (4). Y enters into a long-term contract in 1988 that is completed in 1989. Y used regular tax costs for purposes of determining the degree of contract completion under the alternative minimum tax.

(i) Y determines its tax liability for 1988 as follows:

1988 contract costs	$4,000a
Total contract costs	$8,000e
Total contract price	$20,000e
1988 completion (%)	50e
1988 gross income	$10,000a
Less, 1988 contract costs	(*$4,000a*
1988 net contract income	$6,000a
Other 1988 net income/(loss)	($3,400a)
Taxable income	$2,600a
Regular tax at 34%	884a
Adjustments and preferences to produce alternative minimum taxable income	$600a
Alternative minimum taxable income	$3,200a
Tentative minimum tax at 20%	640a
Tax liability	$884a

In 1989, Y determines the following amounts:

1989 contract costs	$6,000a
Total contract costs	$10,000a
Total contract price	$20,000a

(ii) For purposes of applying the look-back method, Y redetermines its tax liability for 1988, which results in a hypothetical overpayment of tax. This hypothetical overpayment is determined by comparing Y's original regular tax liability for 1988 with the hypothetical total tax liability (including alternative minimum tax liability) for that year because Y would have paid the alternative minimum tax if Y had used its actual contract costs to report income:

1988 contract costs	$4,000a
Total contract costs	$10,000a
Total contract price	$20,000a

1988 completion(%)	40a
1988 gross income	$8,000h
less, 1988 contract costs	($4,000a)
1988 net contract income	$4,000h
Other 1988 net income/(loss)	($3,400a)
Taxable income	$600h
Regular tax at 34%	$204h
Adjustments and preferences to produce alternative minimum taxable income	$600a
Alternative minimum taxable income	$1,200h
Tentative minimum tax at 20%	240h
Alternative minimum tax	$36h
Total tax liability	$240h
less, previously computed tax	$884a
Underpayment/(overpayment)	($644h)

(6) *Credit carryovers.* The operation of the look-back method in the case of credit carryovers as provided in paragraph (c)(3)(v) is illustrated by the following example:

Example (5). Z enters into a contract in 1986 that is completed in 1987. Z determines its tax liability for 1986 as follows:

1986 contract costs	$400a
Total contract costs	$1,000e
Total contract price	$2,000e
1986 completion (%)	40e
1986 gross income	$800a
Less, 1986 costs	($400a)
1986 net contract income	$400a
Other 1986 net income	$0a
Taxable income	$400a
Tax at 46%	$184a
Unused tax credits carried forward from 1985 allowable in 1986	$350a
Net tax due	$0a

Z determines the following amounts for 1987:

1987 contract costs	$400a
Total contract price	$2,000a
Total contract costs	$800a

If Z had used actual rather than estimated contract costs in determining gross income for 1986, Z would have reported tax liability of $276 (46%x$600) rather than $184. However, Z would have paid no additional tax for 1986 because its unused tax credits carried forward from 1985 would have been sufficient to offset this increased tax liability. Therefore, there is no hypothetical underpayment for 1986 for purposes of the look-back method. However, this hypothetical earlier use of the credit may increase the hypothetical tax liability for 1987 (or another subsequent year) for purposes of subsequent applications of the look-back method.

(7) *Net operating losses.* The operation of the look-back method in the case of net operating loss (‘‘NOL’’) carryovers as provided in paragraph (c)(3)(v) is illustrated by the following example:

Example (6). A entered into a long-term contract in 1986, which was completed in 1987. A determined its tax liability for 1986 as follows:

1986 contract costs	$400a
Total contract costs	$1,000e
Total contract price	$2,000e
1986 completion (%)	40e
1986 gross income	$800a
Less, 1986 costs	($400a)
1986 net contract income	$400a
Other 1986 net income/(loss)	($1,000a)
Taxable income/(NOL)	($600a)
Tax	$0a

A elected to carry this loss forward to 1987 pursuant to section 172(b)(3)(C).

For 1987, A determined the following amounts:

1987 contract costs	$400a
Total contract costs	$800a
Total contract price	$2,000a

If actual rather than estimated contract costs had been used in determining gross income for 1986, A would have reported $1,000 of gross income from the contract rather than $800, and thus would have reported a loss of $400 rather than $600. However, since A would have paid no tax for 1986 regardless of whether actual or estimated contract costs had been used, A does not have an underpayment for 1986 for purposes of the look-back method. If A had, instead, carried back the 1986 NOL, and this NOL had been absorbed in the tax years 1983 through 1985, it would have resulted in refunds of tax for those years in 1986. When A applies the look-back method, a hypothetical underpayment of tax would have resulted for those years due to a hypothetical reduction in the amount that would have been refunded if income had been reported on the basis of actual contract costs. See Example (2)(iii).

(8) *Alternative minimum tax credit.* The following example illustrates the application of the look-back method if affected by the alternative minimum tax credit as provided in paragraph (c)(3)(vi):

(i) Example (4), above illustrates that the reallocation of contract income under the look-back method can result in a hypothetical underpayment or overpayment determined using the alternative minimum tax rate, even though the taxpayer actually paid only the regular tax for that year. However, application of the look-back method had no effect on the difference between the amount of alternative minimum taxable income and the amount of regular taxable income taken into account in that year because the taxpayer was required to use the percentage of completion method for both regular and alternative minimum tax purposes and used the same version of the percentage of completion method for both regular and alternative minimum tax purposes (*i.e.*, the taxpayer had made an election to use regular tax costs in determining the percentage of completion for purposes of computing alternative minimum taxable income).

(ii) The following example illustrates the application of the look-back method in the case of a taxpayer that does not use the percentage of completion method of accounting for long-term contracts in computing taxable income for regular tax purposes and thus must make an adjustment to taxable income to determine alternative minimum taxable income. The example also shows how interest is computed under the look-back method when the taxpayer is entitled to a credit under section 53 for minimum tax paid because of this adjustment.

Example (7). X is a taxpayer engaged in the construction of real property under contracts that are completed within a 24-month period and whose average annual gross receipts do not exceed $10,000,000. As permitted by section 460(e)(1)(B), X uses the completed contract method (''CCM'') for regular tax purposes. However, X is engaged in the construction of commercial real property and, therefore, is required to use the percentage of completion method (''PCM'') for alternative minimum tax (''AMT'') purposes.

Assume that for 1988, 1989, and 1990, X has only one long-term contract, which is entered into in 1988 and completed in 1990. Assume further that X estimates gross income from the contract to be $2,000, total contract costs to be $1,000, and that the contract is 25 percent complete in 1988 and 75 percent complete in 1989. In 1990, the year of completion, the percentage of completion does not change but, upon completion, gross income from the contract is actually $3,000, instead of $2,000, and costs are actually $1,000.

For 1988, 1989, and 1990, X's income and tax liability using estimated contract price and costs are as follows:

Estimates	1988	1989	1990
Regular tax:			
Long-term:			
Contract-CCM	0	0	$2,000
Other Income	0	$5,000	0
Total Income	0	$5,000	$2,000
Tax @ 34%	0	$1,700	$680
AMT			
Gross Income	$500	$1,000	$1,500
Deductions	$(250)	$(500)	$(250)
Total long-term:			
Contract-PCM	$250	$500	$1,250
Other Income	0	$5,000	0
Total Income	$250	$5,500	$1,250
Tax @ 20%	$50	$1,100	$250
Tentative Minimum Tax	$50	$1,100	$250
Regular Tax	0	$1,700	$680
Minimum Tax Credit	0	$(50)	0
Net Tax Liability	$50	$1,650	$680

When X files its tax return for 1990, X applies the look-back method to the contract. For 1988, 1989, and 1990, X's income and tax liability using actual contract price and costs are as follows:

Actual	1988	1989	1990
Regular tax:			
Long-term:			
Contract-CCM	0	0	$2,000
Other Income	0	$5,000	0
Total Income	0	$5,000	$2,000
Tax @ 34%	0	$1,700	$680
AMT			
Gross Income	$750	$1,500	$750
Deductions	$(250)	$(500)	$(250)
Total long-term:			
Contract-PCM	$500	$1,000	$500
Other Income	0	$5,000	0
Total Income	$500	$6,000	$500
Tax @ 20%	$100	$1,200	$100
Tentative Minimum Tax	$100	$1,200	$100

Actual	1988	1989	1990
Regular Tax	0	$1,700	$680
Minimum Tax Credit	0	$(100)	0
Net Tax Liability	$100	$1,600	$680
Underpayment	$50		
Overpayment		$50	

As shown above, application of the look-back method results in a hypothetical underpayment of $50 for 1988 because X was subject to the alternative minimum tax for that year. Interest is charged to X on this $50 underpayment from the due date of X's 1988 return until the due date of X's 1990 return.

In 1989, although X was required to compute alternative minimum taxable income using the percentage of completion method, X was not required to pay alternative minimum tax. Nevertheless, the look-back method must be applied to 1989 because use of actual rather than estimated contract price in computing alternative minimum taxable income for 1988 would have changed the amount of the alternative minimum tax credit carried to 1989. Interest is paid to X on the resulting $50 overpayment from the due date of X's 1989 return until the due date of X's 1990 return.

(9) *Period for interest.* The following Examples (8) through (11) illustrate how to determine the period for computing interest as provided in paragraph (c)(4):

Example (8). The facts are the same as in Example (6), except that the contract is completed in 1988, and A determined the following amounts for 1987 and 1988:

For 1987:	
1987 contract costs	0
Total contract costs	$1,000e
Total contract price	$2,000e
1987 completion (%)	$40e
1987 gross income	0a
Less, 1987 costs	0a
Other 1987 net income	$600a
Net operating loss carryforward from 1986	$(600a)
Taxable income	0a
Tax	0a
For 1988:	
1988 contract costs	$400a
Total contract costs	$800a
Total contract price	$2,000a

If actual rather than estimated contract costs had been used in determining gross income for 1986, A would have reported $1,000 of gross income from the contract for 1986 rather than $800, and would have reported a net operating loss carryforward to 1987 of $400 rather than $600. Therefore, A would have reported taxable income of $200, and would have paid tax of $80 (*i.e.,* $200 × 40%) for 1987. The due date for filing A's Federal income tax return for its 1988 taxable year is March 15. A obtains an extension and files its 1988 return on September 15, 1989. Under the look-back method, A is required to pay interest on the amount of this hypothetical underpayment ($80) computed from the due date (determined without regard to extensions) for A's return for 1987 (not 1986, even though 1986 was the year in which the net operating loss arose) until March 15 (not September 15), the due date (without regard to extensions) of A's return for 1988. A is required to pay additional interest from March 15 until September 15 on the amount of interest outstanding as of March 15 with respect to the hypothetical underpayment of $80.

Example (9). The facts are the same as in Example (6), except that A carries the net operating loss of $600 back to 1983 rather than forward to 1987, and receives a refund of $276 ($600 reduction in 1983 taxable income × 46% rate in effect in 1983). As in Example (6), if actual contract costs had been used, A would have reported a loss for 1986 of $400 rather than $600. Thus, A would have received a refund of 1983 tax of $184 ($400 × 46%) rather than $276. Under the look-back method A is required to pay interest on the difference in these two amounts ($92) computed from the due date (determined without regard to extensions) of A's return for 1986 (the year in which the carryback arose rather than 1983, the year in which it was used) until the due date of A's return for 1988.

Example (10). B enters into a long-term contract in 1986 that is completed in 1988. B determines its 1986 tax liability as follows:

1986 contract costs	$400a
Total contract costs	$1,000e
Total contract price	$2,000e
1986 completion (%)	40e
1986 gross income	$800a
Less, 1986 costs	($400a)
1986 net contract income	$400a
Other 1986 net income	$2,000a
Taxable income	$2,400a
Tax at 46%	$1,104a

B determines its tax liability for 1987 as follows:

1987 contract costs	$400a
Total contract costs	$1,600e
Total contract price	$2,000e
1987 completion (%)	50e
1987 gross income	$200a
(=(50% × $2,000)—$800 previously reported) less, 1987 costs	($400a)
1987 net contract income	($200a)

Other 1987 net income/(loss)	($2,200a)
Taxable income (NOL)	($2,400a)
Tax	0a

Assume that B had no taxable income in either 1984 or 1985, so that the entire amount of the $2,400 net operating loss is carried back to 1986, and B receives a refund, with interest from the due date of B's 1987 return, of the entire $1,104 in tax that it paid for 1986.

In 1988, B determines the following amounts:

1988 contract costs	$800a
Total contract costs	$1,600a
Total contract price	$2,000a

If B had used actual contract costs rather than estimated costs in determining its gross income for 1986, B would have had gross income from the contract of $500 rather than $800, and thus would have had taxable income of $2,100 rather than $2,400, and would have paid tax of $966 rather than $1,104. B is entitled to receive interest on the difference between these two amounts, the hypothetical overpayment of tax of $138. Interest is computed from the due date (without regard to extensions) of B's return for 1986 until the due date for B's return for 1987. Interest stops running at this date, because B's hypothetical overpayment of tax ended when B filed its original 1987 return and received a refund for the carryback to 1986, and interest on this refund began to run only from the due date of B's 1987 return. See section 6611(f).

Example (11). C enters into a long-term contract in 1986, its first year in business, which is completed in 1988. C determines its tax liability for 1986 as follows:

1986 contract costs	$400a
Total contract costs	$1,000e
Total contract price	$2,000e
1986 completion (%)	40e
1986 gross income	$800a
less, 1986 costs	($400a)
1986 net contract income	$400a
Other 1986 net income	$2,000a
Taxable income (NOL)	$2,400a
Tax at 46%	$1,104a

C determines its tax liability for 1987 as follows:

1987 contract costs	$400a
Total contract costs	$1,066e
Total contract price	$2,000e
1987 completion (%)	75e
1987 gross income	$700a
Less, 1987 costs	($400a)
1987 net contract income	$300a
Other 1987 net income	($2,450a)
Taxable income (NOL)	($2,150a)
Tax	$10a

C carries back the net operating loss to 1986, and files an amended return for 1986, showing taxable income of $250, and receives a refund of $989 (46% x $2,150). Interest on this refund begins to run only as of the due date of C's 1987 return. See section 6611(f).

In 1988, when the contract is completed, C determines the following amounts:

1988 contract costs	$800a
Total contract costs	$1,600a
Total contract price	$2,000a

If C had used actual contract price and contract costs in determining gross income for 1986, it would have reported gross income from the contract of $500 rather than $800, taxable income of $2,100 rather than $2,400, and tax liability of $966 rather than $1,104.

If C had used actual contract price and contract costs in determining gross income for 1987, it would have reported gross income from the contract of $500 rather than $700, and would have reported a net operating loss of $2,350, rather than $2,150, which would have been carried back to 1986.

Under the look-back method, C receives interest with respect to a total 1986 hypothetical overpayment of $138 ($1,104 minus $966). C is credited with interest on $23 of this amount only from the due date of C's 1986 return until the due date of C's 1987 tax return, because this portion of C's total hypothetical overpayment for 1986 was refunded to C with interest computed from the due date of C's 1987 return and, therefore, was no longer held by the government. However, because the remainder of the total hypothetical overpayment of $115 was not refunded to C, C is credited with interest on this amount from the due date of C's 1986 return until the due date of C's 1988 tax return.

Under the look-back method, C receives no interest with respect to 1987, because C had no tax liability for 1987 using either estimated or actual contract price and costs.

(i) [Reserved].

(j) *Election not to apply look-back method in de minimis cases.* Section 460(b)(6) provides taxpayers with an election not to apply the look-back method to long-term contracts in de minimis cases, effective for contracts completed in taxable years ending after August 5, 1997. To make an election, a taxpayer must attach a statement to its timely filed original federal income tax return (including extensions) for the taxable year the election is to become effective or to an amended return for that year, provided the amended return is filed on or before March 31, 998. This statement must have the legend ''NOTIFICATION OF ELECTION UNDER SECTION 460(b)(6)''; provide the taxpayer's name and identifying number and the effective date of the election; and identify the trades or businesses that involve long-term contracts. An election applies to all long-term contracts completed during and after the taxable year for which the election is effective. An election may not be revoked without the Commissioner's consent. For taxpayers who elected to use the delayed reapplication method under paragraph (e) of this section, an election under this paragraph (j) automatically revokes the election to use the delayed reapplication method for contracts subject to section 460(b)(6). A consolidated group of corporations, as defined in §1.1502–1(h), is subject to consistency rules analogous to those in paragraph (e)(2) of this section and in paragraph (d)(4)(ii)(C) of this section (concerning election to use simplified marginal impact method).

[T.D. 9315, 55 FR 41670, Oct. 15, 1990, as amended by T.D. 8775, 63 FR 36181, July 2, 1998]

§1.460–7 Exempt long-term contracts. [Reserved]

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TAXABLE YEAR FOR WHICH DEDUCTIONS TAKEN

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(h) Liabilities arising under the Nuclear Waste Policy Act of 1982.

(i) [Reserved]

(j) Contingent liabilities. [Reserved]

(k) Special effective dates.

(1) In general.

(2) Long-term contracts.

(3) Payment liabilities.

(l) [Reserved]

(m) Change in method of accounting required by this section.

(1) In general.

(2) Change in method of accounting for long-term contracts and payment liabilities.

§ 1.461–5 Recurring item exception.

(a) In general.

(b) Requirements for use of the exception.

(1) General rule.

(2) Amended returns.

(3) Liabilities that are recurring in nature.

(4) Materiality requirement.

(5) Matching requirement.

(c) Types of liabilities not eligible for treatment under the recurring item exception.

(d) Time and manner of adopting the recurring item exception.

(1) In general.

(2) Change to the recurring item exception method for the first taxable year beginning after December 31, 1991.

(3) Retroactive change to the recurring item exception method.

(e) Examples.

§ 1.461–6 Economic performance when certain liabilities are assigned or are extinguished by the establishment of a fund.

(a) Qualified assignments of certain personal injury liabilities under section 130.

(b) Section 468B.

(c) Payments to other funds or persons that constitute economic performance. [Reserved]

(d) Effective dates.

[T.D. 8408, 57 FR 12420, Apr. 10, 1992, as amended by T.D. 8593, 60 FR 18743, Apr. 13, 1995]

§ 1.461–1 General rule for taxable year of deduction.

(a) *General rule*—(1) *Taxpayer using cash receipts and disbursements method.* Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in determining whether the useful life of the improvements exceeds the remaining term of the lease where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make. See section 263 and the regulations thereunder for rules relating to capital expenditures.

(2) *Taxpayer using an accrual method*—(i) *In general.* Under an accrual method of accounting, a liability (as defined in § 1.446–1(c)(1)(ii)(B)) is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. (See paragraph (a)(2)(iii)(A) of this section for examples of liabilities that may not be taken into account until a taxable year subsequent to the taxable year incurred, and see §§ 1.461–4 through

1.461–6 for rules relating to economic performance.) Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. For example, section 162 provides that the deductible liability generally is taken into account in the taxable year incurred through a deduction from gross income. As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of §1.263A–1(c)(3)), and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Internal Revenue Code sections and guidance published by the Secretary. The principles of this paragraph (a)(2) also apply in the calculation of earnings and profits and accumulated earnings and profits.

(ii) *Uncertainty as to the amount of a liability.* While no liability shall be taken into account before economic performance and all of the events that fix the liability have occurred, the fact that the exact amount of the liability cannot be determined does not prevent a taxpayer from taking into account that portion of the amount of the liability which can be computed with reasonable accuracy within the taxable year. For example, A renders services to B during the taxable year for which A charges $10,000. B admits a liability to A for $6,000 but contests the remainder. B may take into account only $6,000 as an expense for the taxable year in which the services were rendered.

(iii) *Alternative timing rules.* (A) If any provision of the Code requires a liability to be taken into account in a taxable year later than the taxable year provided in paragraph (a)(2)(i) of this section, the liability is taken into account as prescribed in that Code provision. See, for example, section 267 (transactions between related parties) and section 464 (farming syndicates).

(B) If the liability of a taxpayer is subject to section 170 (charitable contributions), section 192 (black lung benefit trusts), section 194A (employer liability trusts), section 468 (mining and solid waste disposal reclamation and closing costs), or section 468A (certain nuclear decommissioning costs), the liability is taken into account as determined under that section and not under section 461 or the regulations thereunder. For special rules relating to certain loss deductions, see sections 165(e), 165(i), and 165(l), relating to theft losses, disaster losses, and losses from certain deposits in qualified financial institutions.

(C) Section 461 and the regulations thereunder do not apply to any amount allowable under a provision of the Code as a deduction for a reserve for estimated expenses.

(D) Except as otherwise provided in any Internal Revenue regulations, revenue procedure, or revenue ruling, the economic performance requirement of section 461(h) and the regulations thereunder is satisfied to the extent that any amount is otherwise deductible under section 404 (employer contributions to a plan of deferred compensation), section 404A (certain foreign deferred compensation plans), or section 419 (welfare benefit funds). See §1.461–4(d)(2)(iii).

(3) *Effect in current taxable year of improperly accounting for a liability in a prior taxable year.* Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year generally cannot be used to reduce the income of a subsequent year. A taxpayer may not take into account in a return for a subsequent taxable year liabilities that, under the taxpayer's method of accounting, should have been taken into account in a prior taxable year. If a taxpayer ascertains that a liability should have been taken into account in a prior taxable year, the taxpayer should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arising

therefrom. Similarly, if a taxpayer ascertains that a liability was improperly taken into account in a prior taxable year, the taxpayer should, if within the period of limitation, file an amended return and pay any additional tax due. However, except as provided in section 905(c) and the regulations thereunder, if a liability is properly taken into account in an amount based on a computation made with reasonable accuracy and the exact amount of the liability is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year.

(4) *Deductions attributable to certain foreign income.* In any case in which, owing to monetary, exchange, or other restrictions imposed by a foreign country, an amount otherwise constituting gross income for the taxable year from sources without the United States is not includible in gross income of the taxpayer for that year, the deductions and credits properly chargeable against the amount so restricted shall not be deductible in such year but shall be deductible proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income. See paragraph (b) of § 1.905–1 for rules relating to credit for foreign income taxes when foreign income is subject to exchange controls.

(b) *Special rule in case of death.* A taxpayer's taxable year ends on the date of his death. See section 443(a)(2) and paragraph (a)(2) of § 1.443–1. In computing taxable income for such year, there shall be deducted only amounts properly deductible under the method of accounting used by the taxpayer. However, if the taxpayer used an accrual method of accounting, no deduction shall be allowed for amounts accrued only by reason of his death. For rules relating to the inclusion of items of partnership deduction, loss, or credit in the return of a decedent partner, see subchapter K, chapter 1 of the Code, and the regulations thereunder.

(c) *Accrual of real property taxes*— (1) *In general.* If the accrual of real property taxes is proper in connection with one of the methods of accounting described in section 446(c), any taxpayer using such a method of accounting may elect to accrue any real property tax, which is related to a definite period of time, ratably over that period in the manner described in this paragraph. For example, assume that such an election is made by a calendar-year taxpayer whose real property taxes, applicable to the period from July 1, 1955, to June 30, 1956, amount to $1,200. Under section 461(c), $600 of such taxes accrue in the calendar year 1955, and the balance accrues in 1956. For special rule in the case of certain contested real property taxes in respect of which the taxpayer transfers money or other property to provide for the satisfaction of the contested tax, see § 1.461–2. For general rules relating to deductions for taxes, see section 164 and the regulations thereunder.

(2) *Special rules*—(i) *Effective date.* Section 461(c) and this paragraph do not apply to any real property tax allowable as a deduction under the Internal Revenue Code of 1939 for any taxable year beginning before January 1, 1954.

(ii) If real property taxes which relate to a period prior to the taxpayer's first taxable year beginning on or after January 1, 1954, would, but for section 461(c), be deductible in such first taxable year, the portion of such taxes which applies to the prior period is deductible in such first taxable year (in addition to the amount allowable under section 461(c)(1)).

(3) *When election may be made*—(i) *Without consent.* A taxpayer may elect to accrue real property taxes ratably in accordance with section 461(c) and this paragraph without the consent of the Commissioner for his first taxable year beginning after December 31, 1953, and ending after August 16, 1954, in which the taxpayer incurs real property taxes. Such election must be made not later than the time prescribed by law for filing the return for such year (including extensions thereof). An election may be made by the taxpayer for each separate trade or business (and for nonbusiness activities, if accounted for separately). Such an election shall apply to all real property taxes of the trade, business, or nonbusiness activity for which the election is made. The election shall be made in a statement submitted with the taxpayer's return

for the first taxable year to which the election is applicable. The statement should set forth:

(a) The trades or businesses, or nonbusiness activity, to which the election is to apply, and the method of accounting used therein;

(b) The period of time to which the taxes are related; and

(c) The computation of the deduction for real property taxes for the first year of the election (or a summary of such computation).

(ii) *With consent.* A taxpayer may elect with the consent of the Commissioner to accrue real property taxes ratably in accordance with section 461 (c) and this paragraph. A written request for permission to make such an election shall be submitted to the Commissioner of Internal Revenue, Washington, D.C. 20224, within 90 days after the beginning of the taxable year to which the election is first applicable, or before March 26, 1958, whichever date is later. The request for permission shall state:

(a) The name and address of the taxpayer;

(b) The trades or businesses, or nonbusiness activity, to which the election is to apply, and the method of accounting used therein;

(c) The taxable year to which the election first applies;

(d) The period to which the real property tax relate;

(e) The computation of the deduction for real property taxes for the first year of election (or a summary of such computation); and

(f) An adequate description of the manner in which all real property taxes were deducted in the year prior to the year of election.

(4) *Binding effect of election.* An election to accrue real property taxes ratably under section 461(c) is binding upon the taxpayer unless the consent of the Commissioner is obtained under section 446(e) and paragraph (e) of §1.446–1 to change such method of deducting real property taxes. If the last day prescribed by law for filing a return for any taxable year (including extensions thereof) to which section 461(c) is applicable falls before March 25, 1958, consent is hereby given for the taxpayer to revoke an election previously made to accrue real property taxes in the manner prescribed by section 461(c). If the taxpayer revokes his election under the preceding sentence, he must, on or before March 25, 1958, notify the district director for the district in which the return was filed of such revocation. For any taxable year for which such revocation is applicable, an amended return reflecting such revocation shall be filed on or before March 25, 1958.

(5) *Apportionment of taxes on real property between seller and purchaser.* For apportionment of taxes on real property between seller and purchaser, see section 164(d) and the regulations thereunder.

(6) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). A taxpayer on an accrual method reports his taxable income for the taxable year ending June 30. He elects to accrue real property taxes ratably for the taxable year ending June 30, 1955 (which is his first taxable year beginning on or after January 1, 1954). In the absence of an election under section 461(c), such taxes would accrue on January 1 of the calendar year to which they are related. The real property taxes are $1,200 for 1954; $1,600 for 1955; and $1,800 for 1956. Deductions for such taxes for the fiscal years ending June 30, 1955, and June 30, 1956, are computed as follows:

Fiscal year ending June 30, 1955

July through December 1954	[1]None
January through June 1955 (6⁄12 of $1,600)	$800
Deduction for fiscal year ending June 30, 1955	800

[1] The taxes for 1954 were deductible in the fiscal year ending June 30, 1954, since such taxes accrued on January 1, 1954.

Fiscal year ending June 30, 1956

July through December 1955 (6⁄12 of $1,600)	$800
January through June 1956 (6⁄12 of $1,800)	900
Deduction for fiscal year ending June 30, 1956	1,700

Example (2). A calendar-year taxpayer on an accrual method elects to accrue real property taxes ratably for 1954. In the absence of an election under section 461(c), such taxes would accrue on July 1 and are assessed for the 12-month period beginning on that date. The real property taxes assessed for the year ending June 30, 1954, are $1,200; $1,600 for the year ending June 30, 1955; and $1,800 for the year ending June 30, 1956. Deductions for such taxes for the calendar years 1954 and 1955 are computed as follows:

Year ending December 31, 1954

January through June 1954	[1]None

Year ending December 31, 1954—Continued

July through December 1954 (6⁄12 of $1,600)	$800
Deduction for year ending December 31, 1954	800

[1] The entire tax of $1,200 for the year ended June 30, 1954, was deductible in the return for 1953, since such tax accrued on July 1, 1953.

Year ending December 31, 1955

January through June 1955 (6⁄12 of $1,600)	$800
July through December 1955 (6⁄12 of $1,800)	900
Deduction for year ending December 31, 1955	1,700

Example (3). A calendar-year taxpayer on an accrual method elects to accrue real property taxes ratably for 1954. In the absence of an election under section 461(c), such taxes, which relate to the calendar year 1954, are accruable on December 1 of the preceding calendar year. No deduction for real property taxes is allowable for the taxable year 1954 since such taxes accrued in the taxable year 1953 under section 23(c) of the Internal Revenue Code of 1939.

Example (4). A taxpayer on an accrual method reports his taxable income for the taxable year ending March 31. He elects to accrue real property taxes ratably for the taxable year ending March 31, 1955. In the absence of an election under section 461(c), such taxes are accruable on June 1 of the calendar year to which they relate. The real property taxes are $1,200 for 1954; $1,600 for 1955; and $1,800 for 1956. Deductions for such taxes for the taxable years ending March 31, 1955, and March 31, 1956, are computed as follows:

Fiscal year ending March 31, 1955

April through December 1954 (9⁄12 of $1,200)	$900
January through March 1955 (3⁄12 of $1,600)	400
Taxes accrued ratably in fiscal year ending March 31, 1955	1,800
Tax relating to period January through March 1954, paid in June 1954, and not deductible in prior taxable year (9⁄12 of $1,200)	300
Deduction for fiscal year ending March 31, 1955	1,600

Fiscal year ending March 31, 1956

April through December 1955 (9⁄12 of $1,600)	$1,200
January through March 1956 (3⁄12 of $1,800)	450
Deduction for fiscal year ending March 31, 1956	1,650

Example (5). The facts are the same as in example (4) except that in June 1955, when the taxpayer pays his $1,600 real property taxes for 1955, he pays $400 of such amount under protest. Deductions for taxes for the taxable years ending March 31, 1955, and March 31, 1956, are computed as follows:

Fiscal year ending March 31, 1955

April through December 1954 (9⁄12 of $1,200)	$900
January through March 1955 (3⁄12 of $1,200, that is, $1,600 minus $400 (the contested portion which is not properly accruable))	300
Taxes accrued ratably in fiscal year ending March 31, 1955	1,200
Tax relating to period January through March 1954, paid in June 1954, and not deductible in prior taxable years (3⁄12 of $1,200)	300
Deduction for fiscal year ending March 31, 1955	1,500

Fiscal year ending March 31, 1956

April through December 1955 (9⁄12 of $1,200)	$900
January through March 1956 (3⁄12 of $1,800)	450
Taxes accrued ratably in fiscal year ending March 31, 1956	1,350
Contested portion of tax relating to period January through December 1955, paid in June 1955, and deductible, under section 461(f), for taxpayer's fiscal year ending March 31, 1956	400
Deduction for fiscal year ending March 31, 1956	1,750

(d) *Limitation on acceleration of accrual of taxes.* (1) Section 461(d)(1) provides that, in the case of a taxpayer whose taxable income is computed under an accrual method of accounting, to the extent that the time for accruing taxes is earlier than it would be but for any action of any taxing jurisdiction taken after December 31, 1960, such taxes are to be treated as accruing at the time they would have accrued but for such action. Any such action which, but for the provisions of section 461(d) and this paragraph, would accelerate the time for accruing a tax is to be disregarded in determining the time for accruing such tax for purposes of the deduction allowed for such tax. Such action is to be disregarded not only with respect to a taxpayer (whose taxable income is computed under an accrual method of accounting) upon whom the tax is imposed at the time of the action, but also with respect to such a taxpayer upon whom the tax is imposed at any time subsequent to such action. Thus, in the case of a tax imposed on property, the acceleration of the time for accruing taxes is to be disregarded not only with respect to the taxpayer who owned the property at the time of such acceleration, but also with respect to any subsequent owner of the property whose taxable income is computed under an accrual method of accounting. Similarly, such action is to be disregarded with respect to all property subject to such tax, even if such property is acquired after the action. Whenever the time for accruing taxes is to be disregarded in accordance with the provisions of this paragraph, the taxpayer shall accrue the tax at the time (original accrual date) the tax would have accrued but for such action, and shall, in the absence of any action of the taxing jurisdiction placing the time for accruing such tax at a time subsequent to the original accrual date, continue to accrue the tax as of the original accrual date for all future taxable years.

(2) For purposes of this paragraph—

(i) The term ‘‘a taxpayer whose taxable income is computed under an accrual method of accounting’’ means a taxpayer who, for Federal income tax purposes, accounts for any tax which is the subject of ‘‘any action’’ (as defined in subdivision (iii) of this subparagraph) under an accrual method of accounting. See section 446 and the regulations thereunder. If a taxpayer uses an accrual method as his overall method of accounting, it shall be presumed that he is ‘‘a taxpayer whose taxable income is computed under an accrual method of accounting.’’ However, if the taxpayer establishes to the satisfaction of the district director that he has, for Federal income tax purposes, consistently accounted for such tax under the cash method of accounting, he shall be considered not to be ‘‘a taxpayer whose taxable income is computed under an accrual method of accounting.’’

(ii) The time for accruing taxes shall be determined under section 461 and the regulations in this section.

(iii) The term ‘‘any action’’ includes the enactment or reenactment of legislation, the adoption of an ordinance, the exercise of any taxing or administrative authority, or the taking of any other step, the result of which is an acceleration of the accrual event of any tax. The term also applies to the substitution of a substantially similar tax by either the original taxing jurisdiction or a substitute jurisdiction. However, the term does not include either a judicial interpretation, or an administrative determination by the Internal Revenue Service, as to the event which fixes the accrual date for the tax.

(iv) The term ‘‘any taxing jurisdiction’’ includes the District of Columbia, any State, possession of the United States, city, county, municipality, school district, or other political subdivision or authority, other than the United States, which imposes, assesses, or collects a tax.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example (1). State X imposes a tax on intangible and tangible personal property used in a trade or business conducted in the State. The tax is assessed as of July 1, and becomes a lien as of that date. As a result of administrative and judicial decisions, July 1 is recognized as the proper date on which accrual method taxpayers may accrue their personal property tax for Federal income tax purposes. In 1961 State X, by legislative action, changes the assessment and lien dates from July 1, 1962, to December 31, 1961, for the property tax year 1962. The action taken by State X is considered to be ‘‘any action’’ of a taxing jurisdiction which results in the time for accruing taxes being earlier than it would have been but for that action. Therefore, for purposes of the deduction allowed for such tax, the personal property tax imposed by State X, for the property tax year 1962, shall be treated as though it accrued on July 1, 1962.

Example (2). Assume the same facts as in example (1) except that State X repeals the personal property tax and in lieu thereof enacts a franchise tax which is imposed on the privilege of conducting a trade or business within State X, and is based on the value of intangible and tangible personal property used in the trade or business. The franchise tax is to be assessed and will become a lien as of December 31, 1961, for the franchise tax year 1962, and on December 31 for all subsequent franchise tax years. Since the franchise tax is substantially similar to the former personal property tax and since the enactment of the franchise tax has the effect of accelerating the accrual date of the personal property tax from July 1, 1962, to December 31, 1961, the action taken by State X is considered to be ‘‘any action’’ of a taxing jurisdiction which results in the time for accruing taxes being earlier than it would have been but for that action. Therefore, for purposes of the deduction allowed for such tax, the franchise tax imposed by State X shall be treated as though it accrued on July 1, 1962, for the franchise tax year 1962, and on July 1 for all subsequent franchise tax years.

Example (3). Assume the same facts as in example (1) except that State X repealed the personal property tax and empowered the counties within the State to impose a personal property tax. Assuming the counties in State X subsequently imposed a personal property tax and chose December 31 of the preceding year as the assessment and lien date, the action of each of the counties would be considered to be ‘‘any action’’ of a taxing jurisdiction which results in the time for accruing taxes being earlier than it would have been but for that action since it is immaterial whether the original taxing jurisdiction or a substitute jurisdiction took the action.

(4) Section 461(d)(1) shall not be applicable to the extent that it would prevent the taxpayer and all other persons, including successors in interest, from ever taking into account, for Federal income tax purposes, any tax to which that section would otherwise apply. For example, assume that State Y imposes a personal property tax on tangible personal property used in a trade or business conducted in the State during a calendar year. The tax is assessed as of February 1 of the year following the personal property tax year, and becomes a lien as of that date. As a result of administrative and judicial decisions, February 1 of the following year is recognized as the proper date on which accrual method taxpayers may accrue the personal property tax for Federal income tax purposes. In 1962 State Y, by legislative action, changes the assessment and lien dates for the personal property tax year 1962 from February 1, 1963, to December 1, 1962, and to December 1 of the personal property tax year for all subsequent years. Corporation A, an accrual method taxpayer which uses the calendar year as its taxable year, pays the tax for 1962 on December 10, 1962. On December 15, 1962, the property which was taxed is completely destroyed and, on December 20, 1962, corporation A transfers all of its remaining assets to its shareholders, and is dissolved. Since corporation A is not in existence in 1963, and therefore could not take the personal property tax into account in computing its 1963 Federal income tax if February 1, 1963, is considered to be the time for accruing the tax, and no other person could ever take such tax into account in computing his Federal income tax, such tax shall be treated as accruing as of December 1, 1962. To the extent that any person other than the taxpayer may at any time take such tax into account in computing his taxable income, the provisions of section 461(d)(1) shall apply. Thus, upon the dissolution of a corporation or the termination of a partnership between the time which, but for the provisions of section 461(d)(1) and this paragraph, would be the time for accruing any tax which was the subject of ‘‘any action’’ (as defined in subdivision (iii) of subparagraph (2)), and the original accrual date, the corporation or the partnership would be entitled to a deduction for only that portion, if any, of such tax with respect to which it can establish, to the satisfaction of the district director, that no other taxpayer can properly take into account in computing his taxable income. However, to the extent that the corporation or partnership cannot establish, at the time of its dissolution or termination, as the case may be, that no other taxpayer would be entitled to take such tax into account in computing his taxable income, and it is subsequently determined that no other taxpayer is entitled to take such tax into account in computing his taxable income, the corporation or partnership may file a claim for refund for the year of its dissolution or termination (subject to the limitations prescribed in section 6511) and claim as a deduction therein the portion of such tax determined to be not deductible by any other taxpayer.

(5) Section 461(d) and this paragraph shall apply to taxable years ending after December 31, 1960.

(e) *Dividends or interest paid by certain savings institutions on certain deposits or withdrawable accounts*—(1) *Deduction not allowable*—(i) *In general.* Except as otherwise provided in this paragraph, pursuant to section 461(e) amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts (if such amounts paid or credited are withdrawable on demand subject only to customary notice to withdraw) by a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank shall not be allowed as a deduction for the taxable year to the extent such amounts are paid or credited for periods representing more than 12 months. The provisions of section 461(e) are applicable with respect to taxable years ending after December 31, 1962. Whether amounts are paid or credited for periods representing more than 12 months depends upon all the facts and circumstances in each case. For example, payments or credits which under all the facts and circumstances are in the nature of bona fide bonus interest or dividends paid or credited because a shareholder or depositor maintained a certain balance for more than 12 months, will not be considered made for more than 12 months, providing the regular payments or credits represent a period of 12 months or less. The nonallowance of a deduction to the taxpayer under section 461(e) and this subparagraph has no effect either on the proper time for reporting dividends or interest by a depositor or holder of a withdrawable account, or on the obligation of the taxpayer to make a return setting forth, among other things, the aggregate amounts paid to a depositor or shareholder under section 6049 (relating to returns regarding payments of interest) and the regulations thereunder. With respect to a short period (a taxable year consisting of a period of less than 12 months), amounts of dividends or interest paid or credited shall not be allowed as a deduction to the extent that such amounts are paid or credited for a period representing more than the number of months in such short period. In such a case, the rules contained in section 461(e) and this paragraph apply to the short period in a manner consistent with the application of such rules to a 12-month taxable year. Subparagraph (2) of this paragraph provides rules for computing amounts not allowed in the taxable year and subparagraph (3) provides rules for determining when such amounts are allowed. See section 7701(a) (19) and (32) and the regulations thereunder for the definitions of domestic building and loan association and cooperative bank.

(ii) *Exceptions.* The rule of nonallowance set forth in subdivision (i) of this subparagraph is not applicable to a taxpayer in the year in which it liquidates (other than following, or as part of, an acquisition of its assets in which the acquiring corporation, pursuant to section 381(a), takes into account certain items of the taxpayer, which for purposes of this paragraph shall be referred to as an acquisition described in section 381(a)). In addition, such rule of nonallowance is not applicable to a taxpayer which pays or credits grace interest or dividends to terminating depositors or shareholders, provided the total amount of the grace interest or dividends paid or credited during the payment or crediting period (for example, a quarterly or semiannual period) does not exceed 10 percent of the total amount of the interest or dividends paid or credited during such period, computed without regard to the grace interest or dividends. For example, providing the 10 percent limitation is met, the rule of nonallowance does not apply in a case in which a calendar year taxpayer, with regular interest payment dates of January 1, April 1, July 1, and October 1, pays grace interest for the period beginning October 1 to a depositor who terminates his account on December 10.

(2) *Computation of amounts not allowed as a deduction*—(i) *Method of computation.* The amount of the dividends or interest to which subparagraph (1) of this paragraph applies, which is not allowed as a deduction, shall be computed under the rules of this subparagraph. The amount which is not allowed as a deduction is the difference between the total amount of dividends or interest paid or credited to that class of accounts with respect to which a deduction is not allowed under subparagraph (1) of this paragraph during the taxable year (or short period, if applicable) and an amount which bears the same ratio to such total as the number 12 (or number of months in the short period) bears to the number of months with respect to which such amounts of dividends or interest are paid or credited.

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

Example (1). X Association, a domestic building and loan association filing its return on the basis of a calendar year, regularly credits dividends on its withdrawable accounts quarterly on the first day of the quarter following the quarter with respect to which they are earned. X changes the time of crediting dividends commencing with the credit for the fourth quarter of 1964. Such credit and all subsequent credits are made on the last day of the quarter with respect to which they are earned. As a result of this change X's credits for the year 1964 are as follows:

Period with respect to which earned	Date credited in 1964	Amt.
4th quarter, 1963	Jan. 1	$250,000
1st quarter, 1964	Apr. 1	300,000
2d quarter, 1964	July 1	300,000
3d quarter, 1964	Oct. 1	300,000
4th quarter, 1964	Dec. 31	350,000
Total dividends credited		1,500,000

Since the change in the time of crediting dividends results in the crediting in 1964 of amounts of dividends representing periods totaling 15 months (October 1963 through December 1964), amounts shall not be allowed as a deduction in 1964 which are in excess of $1,200,000, which is the amount which bears the same ratio to the amounts of dividends credited during the year ($1,500,000) as the number 12 bears to the number of months (15) with respect to which such dividends are credited. Thus, $300,000 ($1,500,000 minus $1,200,000) is not allowed as a deduction in 1964.

Example (2). Y Association, a domestic building and loan association filing its return on the basis of a calendar year, regularly credits dividends on its withdrawable accounts on the basis of a semiannual period on March 31 and September 30 of each year. Y changes the period with respect to which credits are made from the semiannual period to the quarterly basis, commencing with the last quarter in 1964. The credit for this last quarter and all subsequent credits are made on the last day of the quarter with respect to which they are earned. As a result of this change, Y's credits for the year 1964 are as follows:

Period with respect to which earned	Date credited in 1964	Amt.
6-month period ending Mar. 31, 1964.	Mar. 31	$300,000
6-month period ending Sept. 30, 1964.	Sept. 30	400,000
4th quarter, 1964	Dec. 31	200,000
Total dividends credited		900,000

Since the change in the basis of crediting dividends results in a crediting in 1964 of dividends representing periods totaling 15 months (October 1963 through December 1964), amounts shall not be allowed as a deduction in 1964 which are in excess of $720,000, which is the amount which bears the same ratio to the amounts of dividends credited during the year ($900,000) as the number 12 bears to the number of months (15) with respect to which such dividends are credited. Thus, $180,000 ($900,000 minus $720,000) is not allowed as a deduction in 1964.

Example (3). Z Association, a domestic building and loan association regularly files its return on the basis of a fiscal year ending on the last day of February and regularly credits dividends on its withdrawable accounts quarterly on the last day of the quarter with respect to which they are earned. Z receives approval from the Commissioner of Internal Revenue to change its accounting period to a calendar year and effects the change by filing a return for a short period ending on December 31, 1964. Dividend credits for the short period beginning on March 1 and ending on December 31, 1964, are as follows:

Period with respect to which earned	Date credited in 1964	Amt.
January–March 1964	Mar. 31	$250,000
April–June 1964	June 30	300,000
July–September 1964	Sept. 30	300,000
October–December 1964	Dec. 31	350,000
Total dividends credited		1,200,000

Since the change of accounting period results in amounts of dividends credited ($1,200,000) representing periods totaling 12 months (January through December 1964), and such periods represent more than the number of months (10) in the short period, an amount shall not be allowed as a deduction in such short period which is in excess of $1,000,000, which is the amount which bears the same ratio to the amount of dividends credited in the short period ($1,200,000) as the number of months (10) in the short period bears to the number of months (12) with respect to which such dividends are credited. Thus, $200,000 ($1,200,000 minus $1,000,000) is not allowed as a deduction in the short period.

(3) *When amounts allowable.* The amount of dividends or interest not allowed as a deduction under subparagraph (1) of this paragraph shall be allowed as follows (subject to the limitation that the total of the amounts so allowed shall not exceed the amount not allowed under subparagraph (1)):

(i) Such amount shall be allowed as a deduction in a later taxable year or years subject to the limitation that, when taken together with the deductions otherwise allowable in the later taxable year or years, it does not bring the deductions for any later taxable year to a total representing a period of more than 12 months (or number of months in the short period, if applicable). However, in any event, an amount otherwise allowable under subdivision (ii) of this subparagraph shall be allowed notwithstanding the fact that it may bring the deductions allowable to a total representing a period of more than 12 months (or number of months in the short period, if applicable).

(ii) In any case in which it is established to the satisfaction of the Commissioner that the taxpayer does not intend to avoid taxes, one-tenth of such amount shall be allowed as a deduction in each of the 10 succeeding taxable years—

(a) Commencing with the taxable year for which such amount is not allowed as a deduction under subparagraph (1), or

(b) In the case of such amount not allowed for a taxable year ending before July 1, 1964, commencing with either the first or second taxable year after the taxable year for which such amount is not allowed as a deduction under subparagraph (1) if the taxpayer has not taken a deduction on his return, or filed a claim for credit or refund, in respect of such amount under *(a)*.

Normally, if the deduction not allowed under subparagraph (1) is a result of a change, not requested by the taxpayer, in the taxpayer's annual accounting period or dividend or interest payment or crediting dates solely as a consequence of a requirement of a Federal or State regulatory authority, or if the deduction is not allowed solely as a result of the taxpayer being a party to an acquisition to which section 381(a) applies, the Commissioner will permit the allowance of the amount not allowed in the manner provided in this subdivision. Nothing set forth in this subdivision shall be construed as permitting the allowance of a credit or refund for any year which is barred by the limitations on credit or refund provided by section 6511.

(iii) If the total of the amounts, if any, allowed under subdivisions (i) and (ii) of this subparagraph before the taxable year in which the taxpayer liquidates or otherwise ceases to engage in trade or business is less than the amount not allowed under subparagraph (1), there shall be allowed a deduction in such taxable year for the difference between the amount not allowed under subparagraph (1) and the amounts allowed, if any, as deductions under subdivisions (i) and (ii) unless the circumstances under which the taxpayer ceased to do business constitute an acquisition described in section 381(a) (relating to carryovers in certain corporate acquisitions). If the circumstances under which the taxpayer ceased to do business constitute an acquisition described in section 381(a), the acquiring corporation shall succeed to and take into account the balance of the amounts not allowed on the same basis as the taxpayer, had it not ceased to engage in business.

[T.D. 6500, 25 FR 11720, Nov. 26, 1960, as amended by T.D. 6520, 25 FR 13692, Dec. 24, 1960; T.D. 6710, 29 FR 3473, Mar. 18, 1964; T.D. 6735, 29 FR 6494, May 19, 1964; T.D. 6772, 29 FR 15753, Nov. 24, 1964; T.D. 6917, 32 FR 6682, May 2, 1967; T.D. 8408, 57 FR 12420, Apr. 10, 1992; T.D. 8482, 58 FR 42233, Aug. 9, 1993; T.D. 8554, 59 FR 36360, July 18, 1994]

§1.461–2 Contested liabilities.

(a) *General rule*—(1) *Taxable year of deduction.* If—

(i) The taxpayer contests an asserted liability,

(ii) The taxpayer transfers money or other property to provide for the satisfaction of the asserted liability,

(iii) The contest with respect to the asserted liability exists after the time of the transfer, and

(iv) But for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or, in the case of an accrual method taxpayer, for an earlier taxable year for which such amount would be accruable),

then the deduction with respect to the contested amount shall be allowed for the taxable year of the transfer.

(2) *Exception.* Subparagraph (1) of this paragraph shall not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or

possession of the United States, including a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.

(3) *Refunds includible in gross income.* If any portion of the contested amount which is deducted under subparagraph (1) of this paragraph for the taxable year of transfer is refunded when the contest is settled, such portion is includible in gross income except as provided in § 1.111–1, relating to recovery of certain items previously deducted or credited. Such refunded amount is includible in gross income for the taxable year of receipt, or for an earlier taxable year if properly accruable for such earlier year.

(4) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). X Corporation, which uses an accrual method of accounting, in 1964 contests $20 of a $100 asserted real property tax liability but pays the entire $100 to the taxing authority. In 1968, the contest is settled and X receives a refund of $5. X deducts $100 for the taxable year 1964, and includes $5 in gross income for the taxable year 1968 (assuming § 1.111–1 does not apply to such amount). If in 1964 X pays only $80 to the taxing authority, X deducts only $80 for 1964. The result would be the same if X Corporation used the cash method of accounting.

Example (2). Y Corporation makes its return on the basis of a calendar year and uses an accrual method of accounting. Y's real property taxes are assessed and become a lien on December 1, but are not payable until March 1 of the following year. On December 10, 1964, Y contests $20 of the $100 asserted real property tax which was assessed and became a lien on December 1, 1964. On March 1, 1965, Y pays the entire $100 to the taxing authority. In 1968, the contest is settled and Y receives a refund of $5. Y deducts $80 for the taxable year 1964, deducts $20 for the taxable year 1965, and includes $5 in gross income for the taxable year 1968 (assuming § 1.111–1 does not apply to such amount).

(5) *Liabilities described in paragraph (g) of § 1.461–4.* [Reserved]

(b) *Production costs*—(1) *In general; asserted liability.* For purposes of paragraph (a)(1) of this section, the term ''asserted liability'' means an item with respect to which, but for the existence of any contest in respect of such item, a deduction would be allowable under an accrual method of accounting. For example, a notice of a local real estate tax assessment and a bill received for services may represent asserted liabilities.

(2) *Definition of the term ''contest''.* Any contest which would prevent accrual of a liability under section 461(a) shall be considered to be a contest in determining whether the taxpayer satisfies paragraph (a)(1)(i) of this section. A contest arises when there is a bona fide dispute as to the proper evaluation of the law or the facts necessary to determine the existence or correctness of the amount of an asserted liability. It is not necessary to institute suit in a court of law in order to contest an asserted liability. An affirmative act denying the validity or accuracy, or both, of an asserted liability to the person who is asserting such liability, such as including a written protest with payment of the asserted liability, is sufficient to commence a contest. Thus, lodging a protest in accordance with local law is sufficient to contest an asserted liability for taxes. It is not necessary that the affirmative act denying the validity or accuracy, or both, of an asserted liability be in writing if, upon examination of all the facts and circumstances, it can be established to the satisfaction of the Commissioner that a liability has been asserted and contested.

(3) *Example.* The provisions of this paragraph are illustrated by the following example:

Example: O Corporation makes its return on the basis of a calendar year and uses an accrual method of accounting. O receives a large shipment of typewriter ribbons from S Company on January 30, 1964, which O pays for in full on February 10, 1964. Subsequent to their receipt, several of the ribbons prove defective because of inferior materials used by the manufacturer. On August 9, 1964, O orally notifies S and demands refund of the full purchase price of the ribbons. After negotiations prove futile and a written demand is rejected by S, O institutes an action for the full purchase price. For purposes of paragraph (a)(1)(i) of this section, S has asserted a liability against O which O contests on August 9, 1964. O deducts the contested amount for 1964.

(c) *Transfer to provide for the satisfaction of an asserted liability*—(1) *In general.* A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control (i) to the person who is asserting the liability, (ii) to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest, or (iii) to an escrowee or trustee pursuant to an order of the United States, any State or political subdivision thereof, or any agency or instrumentality of the foregoing, or a court that the money or other property be delivered in accordance with the settlement of the contest. A taxpayer may also provide for the satisfaction of an asserted liability by transferring money or other property beyond his control to a court with jurisdiction over the contest. Purchasing a bond to guarantee payment of the asserted liability, an entry on the taxpayer's books of account, and a transfer to an account which is within the control of the taxpayer are not transfers to provide for the satisfaction of an asserted liability. In order for money or other property to be beyond the control of a taxpayer, the taxpayer must relinquish all authority over such money or other property.

(2) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). M Corporation contests a $5,000 liability asserted against it by L Company for services rendered. To provide for the contingency that it might have to pay the liability, M establishes a separate bank account in its own name. M then transfers $5,000 from its general account to such separate account. Such transfer does not qualify as a transfer to provide for the satisfaction of an asserted liability because M has not transferred the money beyond its control.

Example (2). M Corporation contests a $5,000 liability asserted against it by L Company for services rendered. To provide for the contingency that it might have to pay the liability, M transfers $5,000 to an irrevocable trust pursuant to a written agreement among the trustee, M (the taxpayer), and L (the person who is asserting the liability) that the money shall be held until the contest is settled and then disbursed in accordance with the settlement. Such transfer qualifies as a transfer to provide for the satisfaction of an asserted liability.

(d) *Contest exists after transfer.* In order for a contest with respect to an asserted liability to exist after the time of transfer, such contest must be pursued subsequent to such time. Thus, the contest must have been neither settled nor abandoned at the time of the transfer. A contest may be settled by a decision, judgment, decree, or other order of any court of competent jurisdiction which has become final, or by written or oral agreement between the parties. For example, Z Corporation, which uses an accrual method of accounting, in 1964 contests a $100 asserted liability. In 1967 the contested liability is settled as being $80 which Z accrues and deducts for such year. In 1968 Z pays the $80. Section 461(f) does not apply to Z with respect to the transfer because a contest did not exist after the time of such transfer.

(e) *Deduction otherwise allowed*—(1) *In general.* The existence of the contest with respect to an asserted liability must prevent (without regard to section 461(f)) and be the only factor preventing a deduction for the taxable year of the transfer (or, in the case of an accrual method taxpayer, for an earlier taxable year for which such amount would be accruable) to provide for the satisfaction of such liability. Nothing in section 461(f) or this section shall be construed to give rise to a deduction since section 461(f) and this section relate only to the timing of deductions which are otherwise allowable under the Code.

(2) *Example.* The provisions of this paragraph are illustrated by the following example:

Example. A, an individual, makes a gift of certain property to B, an individual. A pays the entire amount of gift tax assessed against him but contests his liability for such tax. Section 275(a)(3) provides that gift taxes are not deductible. A does not satisfy the requirement of paragraph (a)(1)(iv) of this section since a deduction would not be allowed for the taxable year of the transfer even if A did not contest his liability for such tax.

(f) *Treatment of money or property transferred to an escrowee, trustee, or court and treatment of any income attributable thereto.* [Reserved]

(g) *Effective dates.* Paragraphs (a) through (e) of this section apply to transfers of money or property made in taxable years beginning after December 31, 1953, and ending after August 16, 1954.

[T.D. 6772, 29 FR 15753, Nov. 24, 1964, as amended by T.D. 8408, 57 FR 12421, Apr. 10, 1992]

§ 1.461–3 Prepaid interest. [Reserved]

§ 1.461–4 Economic performance.

(a) *Introduction*—(1) *In general.* For purposes of determining whether an accrual basis taxpayer can treat the amount of any liability (as defined in § 1.446–1(c)(1)(ii)(B)) as incurred, the all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability.

(2) *Overview.* Paragraph (b) of this section lists exceptions to the economic performance requirement. Paragraph (c) of this section provides cross-references to the definitions of certain terms for purposes of section 461 (h) and the regulations thereunder. Paragraphs (d) through (m) of this section and § 1.461–6 provide rules for determining when economic performance occurs. Section 1.461–5 provides rules relating to an exception under which certain recurring items may be incurred for the taxable year before the year during which economic performance occurs.

(b) *Exceptions to the economic performance requirement.* Paragraph (a)(2)(iii)(B) of § 1.461–1 provides examples of liabilities that are taken into account under rules that operate without regard to the all events test (including economic performance).

(c) *Definitions.* The following cross-references identify certain terms defined for purposes of section 461(h) and the regulations thereunder:

(1) *Liability.* See paragraph (c)(1)(ii)(B)d of § 1.446–1 for the definition of ‘‘liability.’’

(2) *Payment.* See paragraph (g)(1)(ii) of this section for the definition of ‘‘payment.’’

(d) *Liabilities arising out of the provision of services, property, or the use of property*—(1) *In general.* The principles of this paragraph (d) determine when economic performance occurs with respect to liabilities arising out of the performance of services, the transfer of property, or the use of property. This paragraph (d) does not apply to liabilities described in paragraph (e) (relating to interest expense) or paragraph (g) (relating to breach of contract, workers compensation, tort, etc.) of this section. In addition, except as otherwise provided in Internal Revenue regulations, revenue procedures, or revenue rulings this paragraph (d) does not apply to amounts paid pursuant to a notional principal contract. The Commissioner may provide additional rules in regulations, revenue procedures, or revenue rulings concerning the time at which economic performance occurs for items described in this paragraph (d).

(2) *Services or property provided to the Taxpayer*—(i) *In general.* Except as otherwise provided in paragraph (d)(5) of this section, if the liability of a taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as the services or property is provided.

(ii) *Long-term contracts.* In the case of any liability of a taxpayer described in paragraph (d)(2)(i) of this section that is an expense attributable to a long-term contract with respect to which the taxpayer uses the percentage of completion method, economic performance occurs—

(A) As the services or property is provided; or, if earlier,

(B) As the taxpayer makes payment (as defined in paragraph (g)(1)(ii) of this section) in satisfaction of the liability to the person providing the services or property. See paragraph (k)(2) of this section for the effective date of this paragraph (d)(2)(ii).

(iii) *Employee benefits*—(A) *In general.* Except as otherwise provided in any Internal Revenue regulation, revenue procedure, or revenue ruling, the economic performance requirement is satisfied to the extent that any amount is otherwise deductible under section 404 (employer contributions to a plan of deferred compensation), section 404A (certain foreign deferred compensation plans), and section 419 (welfare benefit funds). See § 1.461–1(a)(2)(iii)(D).

(B) *Property transferred in connection with performance of services.* [Reserved]

(iv) *Cross-references.* See *Examples 4* through *6* of paragraph (d)(7) of this section. See paragraph (d)(6) of this section for rules relating to when a taxpayer may treat services or property as provided to the taxpayer.

(3) *Use of property provided to the taxpayer*—(i) *In general.* Except as otherwise provided in this paragraph (d)(3)d and paragraph (d)(5) of this section, if the liability of a taxpayer arises out of the use of property by the taxpayer, economic performance occurs ratably over the period of time the taxpayer is entitled to the use of the property (taking into account any reasonably expected renewal periods when necessary to carry out the purposes of section 461(h)). See *Examples 6* through *9* of paragraph (d)(7) of this section.

(ii) *Exceptions.* If the liability of a taxpayer arises out of the use of property by the taxpayer and all or a portion of the liability is determined by reference to the frequency or volume of use of the property or the income from the property, economic performance occurs for the portion of the liability determined by reference to the frequency or volume of use of the property or the income from the property as the taxpayer uses the property or includes income from the property. See *Examples 8* and *9* of paragraph (d)(7) of this section. This paragraph (d)(3)(ii) shall not apply if the District Director determines, that based on the substance of the transaction, the liability of the taxpayer for use of the property is more appropriately measured ratably over the period of time the taxpayer is entitled to the use of the property.

(4) *Services or property provided by the taxpayer*—(i) *In general.* Except as otherwise provided in paragraph (d)(5) of this section, if the liability of a taxpayer requires the taxpayer to provide services for property to another person, economic performance occurs as the taxpayer incurs costs (within the meaning of §1.446–1(c)(1)(ii)) in connection with the satisfaction of the liability. See *Examples 1* through *3* of paragraph (d)(7) of this section.

(ii) *Barter transactions.* If the liability of a taxpayer requires the taxpayer to provide services, property, or the use of property, and arises out of the use of property by the taxpayer, or out of the provision of services or property to the taxpayer by another person, economic performance occurs to the extent of the lesser of—

(A) The cumulative extent to which the taxpayer incurs costs (within the meaning of §1.446–1(c)(1)(ii)) in connection with its liability to provide the services of property; or

(B) The cumulative extent to which the services or property is provided to the taxpayer.

(5) *Liabilities that are assumed in connection with the sale of a trade or business*—(i) *In general.* If, in connection with the sale or exchange of a trade or business by a taxpayer, the purchaser expressly assumes a liability arising out of the trade or business that the taxpayer but for the economic performance requirement would have been entitled to incur as of the date of the sale, economic performance with respect to that liability occurs as the amount of the liability is properly included in the amount realized on the transaction by the taxpayer. See §1.1001–2 for rules relating to the inclusion in amount realized from a discharge of liabilities resulting from a sale or exchange.

(ii) *Trade or business.* For purposes of this paragraph (d)(5), a trade or business is a specific group of activities carried on by the taxpayer for the purpose of earning income or profit if every operation that is necessary to the process of earning income or profit is included in the group. Thus, for example, the group of activities generally must include the collection of income and the payment of expenses.

(iii) *Tax avoidance.* This paragraph (d)(5) does not apply if the District Director determines that tax avoidance is one of the taxpayer's principal purposes for the sale or exchange.

(6) *Rules relating to the provision of services or property to a taxpayer.* The following rules apply for purposes of this paragraph (d):

(i) Services or property provided to a taxpayer include services or property provided to another person at the direction of the taxpayer.

(ii) A taxpayer is permitted to treat services or property as provided to the taxpayer as the taxpayer makes payment to the person providing the services or property (as defined in paragraph (g)(1)(ii) of this section), if the taxpayer can reasonably expect the person to provide the services or property within 3½ months after the date of payment.

(iii) A taxpayer is permitted to treat property as provided to the taxpayer when the property is delivered or accepted, or when title to the property passes. The method used by the taxpayer to determine when property is provided is a method of accounting that must comply with the rules of § 1.446–1(e). Thus, the method of determining when property is provided must be used consistently from year to year, and cannot be changed without the consent of the Commissioner.

(iv) If different services or items of property are required to be provided to a taxpayer under a single contract or agreement, economic performance generally occurs over the time each service is provided and as each item of property is provided. However, if a service or item of property to be provided to the taxpayer is incidental to other services or property to be provided under a contract or agreement, the taxpayer is not required to allocate any portion of the total contract price to the incidental service or property. For purposes of this paragraph (d)(6)(iv), services or property is treated as incidental only if—

(A) The cost of the services or property is treated on the taxpayer's books and records as part of the cost of the other services or property provided under the contract; and

(B) The aggregate cost of the services or property does not exceed 10 percent of the total contract price.

(7) *Examples.* The following examples illustrate the principles of this paragraph (d). For purposes of these examples, it is assumed that the requirements of the all events test other than economic performance have been met, and that the recurring item exception is not used.

Example 1. Services or property provided by the taxpayer. (i) X corporation, a calendar year, accrual method taxpayer, is an oil company. During March 1990, X enters into an oil and gas lease with Y. In November 1990, X installs a platform and commences drilling. The lease obligates X to remove its offshore platform and well fixtures upon abandonment of the well or termination of the lease. During 1998, X removes the platform and well fixtures at a cost of $200,000.

(ii) Under paragraph (d)(4)(i) of this section, economic performance with respect to X's liability to remove the offshore platform and well fixtures occurs as X incurs costs in connection with that liability. X incurs these costs in 1998 as, for example, X's employees provide X with removal services (see paragraph (d)(2) of this section). Consequently, X incurs $200,000 for the 1998 taxable year. Alternatively, assume that during 1990 X pays Z $130,000 to remove the platform and fixtures, and that Z performs these removal services in 1998. Under paragraph (d)(2) of this section, X does not incur this cost until Z performs the services. Thus, economic performance with respect to the $130,000 X pays Z occurs in 1998.

Example 2. Services or property provided by the taxpayer. (i) W corporation, a calendar year, accrual method taxpayer, sells tractors under a three-year warranty that obligates W to make any reasonable repairs to each tractor it sells. During 1990, W sells ten tractors. In 1992 W repairs, at a cost of $5,000, two tractors sold during 1990.

(ii) Under paragraph (d)(4)(i) of this section, economic performance with respect to W's liability to perform services under the warranty occurs as W incurs costs in connection with that liability. W incurs these costs in 1992 as, for example, replacement parts are provided to W (see paragraph (d)(2) of this section). Consequently, $5,000 is incurred by W for the 1992 taxable year.

Example 3. Services or property provided by the taxpayer; Long-term contracts. (i) W corporation, a calendar year, accrual method taxpayer, manufactures machine tool equipment. In November 1992, W contracts to provide X corporation with certain equipment. The contract is not a long-term contract under section 460 or § 1.451–3. In 1992, W pays Z corporation $50,000 to lease from Z, for the one-year period beginning on January 1, 1993, testing equipment to perform quality control tests required by the agreement with X. In 1992, pursuant to the terms of a contract, W pays Y corporation $100,000 for certain parts necessary to manufacture the equipment. The parts are provided to W in 1993. W's employees provide W with services necessary to manufacture the equipment during 1993, for which W pays $150,000 in 1993.

(ii) Under paragraph (d)(4) of this section, economic performance with respect to W's liability to provide the equipment to X occurs as W incurs costs in connection with that liability. W incurs these costs during 1993, as services, property, and the use of property necessary to manufacture the equipment are provided to W (see paragraphs (d)(2) and (d)(3) of this section). Thus, $300,000 is incurred by W for the 1993 taxable year. See section 263A and the regulations thereunder for rules relating to the capitalization and inclusion in inventory of these incurred costs.

(iii) Alternatively, assume that the agreement with X is a long-term contract as defined in section 460(f), and that W takes into account all items with respect to such contracts under the percentage of completion method as described in section 460(b)(1). Under paragraph (d)(2)(ii) of this section, the $100,000 W pays in 1992 for parts is incurred for the 1992 taxable year, for purposes of determining the percentage of completion under section 460(b)(1)(A). W's other costs under the agreement are incurred for the 1993 taxable year for this purpose.

Example 4. Services or property provided to the taxpayers. (i) LP1, a calendar year, accrual method limited partnership, owns the working interest in a parcel of property containing oil and gas. During December 1990, LP1 enters into a turnkey contract with Z corporation pursuant to which LP1 pays Z $200,000 and Z is required to provide a completed well by the close of 1992. In May 1992, Z commences drilling the well, and, in December 1992, the well is completed.

(ii) Under paragraph (d)(2) of this section, economic performance with respect to LP1's liability for drilling and development services provided to LP1 by Z occurs as the services are provided. Consequently, $200,000 is incurred by LP1 for the 1992 taxable year.

Example 5. Services or property provided to the taxpayer. (i) X corporation, a calendar year, accrual method taxpayer, is an automobile dealer. On Jaunary 15, 1990, X agrees to pay an additional $10 to Y, the manufacturer of the automobiles, for each automobile purchased by X from Y. Y agrees to provide advertising and promotional activities to X.

(ii) During 1990, X purchases from Y 1,000 new automobiles and pays to Y an additional $10,000 as provided in the agreement. Y, in turn, uses this $10,000 to provide advertising and promotional activities during 1992.

(iii) Under paragraph (d)(2) of this section, economic performance with respect to X's liability for advertising and promotional services provided to X by Y occurs as the services are provided. Consequently, $10,000 is incurred by X for the 1992 taxable year.

Example 6. Use of property provided to the taxpayer; services or property provided to the taxpayer. (i) V corporation, a calendar year, accrual method taxpayer, charters aircrafts. On December 20, 1990, V leases a jet aircraft from L for the four-year period that begins on January 1, 1991. The lease obligates V to pay L a base rental of $500,000 per year. In addition, the lease requires V to pay $25 to an escrow account for each hour that the aircraft is flown. The escrow account funds are held by V and are to be used by L to make necessary repairs to the aircraft. Any amount remaining in the escrow account upon termination of the lease is payable to V. During 1991, the aircraft is flown 1,000 hours and V pays $25,000 to the escrow account. The aircraft is repaired by L in 1993. In 1994, $20,000 is released from the escrow account to pay L for the repairs.

(ii) Under paragraph (d)(3)(i) of this section, economic performance with respect to V's base rental liability occurs ratably over the period of time V is entitled to use the jet aircraft. Consequently, the $500,000 rent is incurred by V for the 1991 taxable year and for each of the next three taxable years. Under paragraph (d)(2) of this section, economic performance with respect to the liability to place amounts in escrow occurs as the aircraft is repaired. Consequently, V incurs $20,00 for the 1993 taxable year.

Example 7. Use of property provided to the taxpayer. (i) X corporation, a calendar year, accrual method taxpayer, manufactures and sells electronic circuitry. On November 15, 1990, X enters into a contract with Y that entitles X to the exclusive use of a product owned by Y for the five-year period beginning on January 1, 1991. Pursuant to the contract, X pays Y $100,000 on December 30, 1990.

(ii) Under paragraph (d)(3)(i) of this section, economic performance with respect to X's liability for the use of property occurs ratably over the period of time X is entitled to use the product. Consequently, $20,000 is incurred by X for 1991 and for each of the succeeding four taxable years.

Example 8. Use of property provided to the taxpayer. (i) Y corporation, a calendar year, accrual method taxpayer, enters into a five-year lease with Z for the use of a copy machine on July 1, 1991. Y also receives elivery of the copy machine on July 1, 1991. The lease obligates Y to pay Z a base rental payment of $6,000 per year at the beginning of each lease year and an additional charge of 5 cents per copy 30 days after the end of each lease year. The machine is used to make 50,000 copies during the first lease year: 20,000 copies in 1991 and 30,000 copies from January 1, 1992, to July 1, 1992. Y pays the $6,000 base rental payment to Z on July 1, 1991, and the $2,500 variable use payment on July 30, 1992.

(ii) under paragraph (d)(3)(i) of this section, economic performance with respect to Y's base rental liability occurs ratably over the period of time Y is entitled to use the copy machine. Consequently, $3,000 rent is incurred by Y for the 1991 taxable year. Under paragraph (d)(3)(ii) of this section, economic performance with respect to Y's variable use portion of the liability occurs as Y uses the machine. Thus, the $1,000 of the $2,500 variable-use liability that relates to the 20,000 copies made in 1991 is incurred by Y for the 1991 taxable year.

Example 9. Use of property provided to the taxpayer. (i) X corporation, a calendar year, accrual method taxpayer, enters into a five-year product distribution agreement with Y, on January 1, 1992. The agreement provides for a payment of $100,000 on January 1, 1992, plus 10 percent of the gross profits earned by X from distribution of the product. The variable income portion of X's liability is payable on April 1 of each subsequent year. On January 1, 1992, X pays Y $100,000. On April 1, 1993, X pays Y $3 million representing 10 percent of X's gross profits from January 1 through December 31, 1992.

(ii) Under paragraph (d)(3)(i) of this section, economic performance with respect to X's $100,000 payment occurs ratably over the period of time X is entitled to use the product. Consequently, $20,000 is incurred by X for each year of the agreement beginning with 1992. Under paragraph (d)(3)(ii) of this section, economic performance with respect to X's variable income portion of the liability occurs as the income is earned by X. Thus, the $3 million variable-income liability is incurred by X for the 1992 taxable year.

(e) *Interest.* In the case of interest, economic performance occurs as the interest cost economically accrues, in accordance with the principles of relevant provisions of the Code.

(f) *Timing of deductions from notional principal contracts.* Economic performance on a notional principal contract occurs as provided under § 1.446–3.

(g) *Certain liabilities for which payment is economic perforance* —(1) *In general* —(i) *Person to which payment must be made.* In the case of liabilities described in paragraphs (g) (2) through (7) of this section, economic performance occurs when, and to the extent that, payment is made to the person to which the liability is owed. Thus, except as otherwise provided in paragraph (g)(1)(iv) of this section and § 1.461–6, economic performance does not occur as a taxpayer makes payments in connection with such a liability to any other person, including a trust, escrow account, court-administered fund, or any similar arrangement, unless the payments constitute payment to the person to which the liability is owed under paragraph (g)(1)(ii)(B) of this section. Instead, economic performance occurs as payments are made from that other person or fund to the person to which the liability is owed. The amount of economic performance that occurs as payment is made from the other person or fund to the person to which the liability is owed may not exceed the amount the taxpayer transferred to the other person or fund. For special rules relating to the taxation of amounts transferred to ''qualified settlement funds,'' see section 468B and the regulations thereunder. The Commissioner may provide additional rules in regulations, revenue procedures, and revenue rulings concerning the time at which economic performance occurs for items described in this paragraph (g).

(ii) *Payment to person to which liability is owed.* Paragraph (d)(6) of this section provides that for purposes of paragraph (d) of this section (relating to the provision of services or property to the taxpayer) in certain cases a taxpayer may treat services or property as provided to the taxpayer as the taxpayer makes payments to the person providing the services or property. In addition, this paragraph (g) provides that in the case of certain liabilities of a taxpayer, economic performance occurs as the taxpayer makes payment to persons specified therein. For these and all other purposes of section 461(h) and the regulations thereunder:

(A) *Payment.* The term *payment* has the same meaning as is used when determining whether a taxpayer using the cash receipts and disbursements method of accounting has made a payment. Thus, for example, payment includes the furnishing of cash or cash equivalents and the netting of offsetting accounts. Payment does not include the furnishing of a note or other evidence of indebtedness of the taxpayer, whether or not the evidence is guaranteed by any other instrument (including a standby letter of credit) or by any third party (including a government agency). As a further example, payment does not include a promise of the taxpayer to provide services or property in the future (whether or not the promise is evidenced by a contract or other witten agreement). In addition, payment does not include an amount transferred as a loan, refundable deposit, or contingent payment.

(B) *Person to which payment is made.* Payment to a particular person is accomplished if paragraph (g)(1)(ii)(A) of this section is satisfied and a cash basis taxpayer in the position of that person would be treated as having actually or constructively received the amount of the payment as gross income under the principles of section 451 (without regard to section 104(a) or any other provision that specifically excludes the amount from gross income). Thus, for example, the purchase of an annuity contract or any other asset generally does not constitute payment to the person to which a liability is owed unless the ownership of the contract or other asset is transferred to that person.

(C) *Liabilities that are assumed in connection with the sale of a trade or business.* Paragraph (d)(5) of this section provides rules that determine when economic performance occurs in the case of liabilities that are assumed in connection with the sale of a trade or business. The provisions of paragraph (d)(5) of this section also apply to any liability described in paragraph (g) (2) through (7) of this section that the purchaser expressly assumes in connection with the sale or exchange of a trade or business by a taxpayer, provided the taxpayer (but for the economic performance requirement) would have been entitled to incur the liability as of the date of the sale.

(iii) *Person.* For purposes of this paragraph (g), ‘‘person’’ has the same meaning as in section 7701(a)(1), except that it also includes any foreign state, the United States, any State or political subdivision thereof, any possession of the United States, and any agency or instrumentality of any of the foregoing.

(iv) *Assignments.* If a person that has a right to receive payment in satisfaction of a liability described in paragraphs (g) (2) through (7) of this section makes a valid assignment of that right to a second person, or if the right is assigned to the second person through operation of law, then payment to the second person in satisfaction of that liability constitutes payment to the person to which the liability is owed.

(2) *Liabilities arising under a workers compensation act or out of any tort, breach of contract, or violation of law.* If the liability of a taxpayer requires a payment or series of payments to another person and arises under any workers compensation act or out of any tort, breach of contract, or violation of law, economic performance occurs as payment is made to the person to which the liability is owed. See *Example 1* of paragraph (g)(8) of this section. For purposes of this paragraph (g)(2)—

(i) A liability to make payments for services, property, or other consideration provided under a contract is not a liability arising out of a breach of that contract unless the payments are in the nature of incidental, consequential, or liquidated damages; and

(ii) A liability arising out of a tort, breach of contract, or violation of law includes a liability arising out of the settlement of a dispute in which a tort, breach of contract, or violation of law, respectively, is alleged.

(3) *Rebates and refunds.* If the liability of a taxpayer is to pay a rebate, refund, or similar payment to another person (whether paid in property, money, or as a reduction in the price of goods or services to be provided in the future by the taxpayer), economic performance occurs as payment is made to the person to which the liability is owed. This paragraph (g)(3) applies to all rebates, refunds, and payments or transfers in the nature of a rebate or refund regardless of whether they are characterized as a deduction from gross income, an adjustment to gross receipts or total sales, or an adjustment or addition to cost of goods sold. In the case of a rebate or refund made as a reduction in the price of goods or services to be provided in the future by the taxpayer, ‘‘payment’’ is deemed to occur as the taxpayer would otherwise be required to recognize income resulting from a disposition at an unreduced price. See *Example 2* of paragraph (g)(8) of this section. For purposes of determining whether the recurring item exception of §1.461–5 applies, a liability that arises out of a tort, breach of contract, or violation of law is not considered a rebate or refund.

(4) *Awards, prizes, and jackpots.* If the liability of a taxpayer is to provide an award, prize, jackpot, or other similar payment to another person, economic performance occurs as payment is made to the person to which the liability is owed. See *Examples 3* and *4* of paragraph (g)(8) of this section.

(5) *Insurance, warranty, and service contracts.* If the liability of a taxpayer arises out of the provision to the taxpayer of insurance, or a warranty or service contract, economic performance occurs as payment is made to the person to which the liability is owed. See *Examples 5* through *7* of paragraph (g)(8) of this section. For purposes of this paragraph (g)(5)—

(i) A warranty or service contract is a contract that a taxpayer enters into in connection with property bought or leased by the taxpayer, pursuant to which the other party to the contract promises to replace or repair the property under specified circumstances.

(ii) The term ''insurance'' has the same meaning as is used when determining the deductibility of amounts paid or incurred for insurance under section 162.

(6) *Taxes*—(i) *In general.* Except as otherwise provided in this paragraph (g)(6), if the liability of a taxpayer is to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed the tax. For purposes of this paragraph (g)(6), payment includes payments of estimated income tax and payments of tax where the taxpayer subsequently files a claim for credit or refund. In addition, for purposes of this paragraph (g)(6), a tax does not include a charge collected by a governmental authority for specific extraordinary services or property provided to a taxpayer by the governmental authority. Examples of such a charge include the purchase price of a parcel of land sold to a taxpayer by a governmental authority and a charge for labor engaged in by government employees to improve that parcel. In certain cases, a liability to pay a tax is permitted to be taken into account in the taxable year before the taxable year during which economic performance occurs under the recurring item exception of § 1.461–5. See *Example 8* of paragraph (g)(8) of this section.

(ii) *Licensing fees.* If the liability of a taxpayer is to pay a licensing or permit fee required by a governmental authority, economic performance occurs as the fee is paid to the governmental authority, or as payment is made to any other person at the direction of the governmental authority.

(iii) *Exceptions*—(A) *Real property taxes.* If a taxpayer has made a valid election under section 461 (c), the taxpayer's accrual for real property taxes is determined under section 461 (c). Otherwise, economic performance with respect to a property tax liability occurs as the tax is paid, as specified in paragraph (g)(6)(i) of this section.

(B) *Certain foreign taxes.* If the liability of a taxpayer is to pay an income, war profits, or excess profits tax that is imposed by the authority of any foreign country or possession of the United States and is creditable under section 901 (including a creditable tax described in section 903 that is paid in lieu of such a tax), economic performance occurs when the requirements of the all events test (as described in § 1.446–1 (c)(1)(ii)) other than economic performance are met, whether or not the taxpayer elects to credit such taxes under section 901 (a).

(7) *Other liabilities.* In the case of a taxpayer's liability for which economic perfomance rules are not provided elsewhere in this section or in any other Internal Revenue regulation, revenue ruling or revenue procedure, economic performance occurs as the taxpayer makes payments in satisfaction of the liability to the person to which the liability is owed. This paragraph (g)(7) applies only if the liability cannot properly be characterized as a liability covered by rules provided elsewhere in this section. If a liability may properly be characterized as, for example, a liability arising from the provision of services or property to, or by, a taxpayer, the determination as to when economic performance occurs with respect to that liability is made under paragraph (d) of this section and not under this paragraph (g)(7).

(8) *Examples.* The following examples illustrate the principles of this paragraph (g). For purposes of these examples, it is assumed that the requirements of the all events test other than economic performance have been met and, except as otherwise provided, that the recurring item exception is not used.

Example 1. Liabilities arising out of a tort. (i) During the period 1970 through 1975, Z corporation, a calendar year, accrual method taxpayer, manufactured and distributed industrial products that contained carcinogenic substances. In 1992, a number of lawsuits are filed against Z alleging damages due to exposure to these products. In settlement of a lawsuit maintained by A, Z agrees to purchase an annuity contract that will provide annual payments to A of $50,000 for a period of 25 years. On December 15, 1992, Z pays W, an unrelated life insurance company, $491,129 for such an annuity contract. Z retains ownership of the annuity contract.

(ii) Under paragraph (g)(2) of this section, economic performance with respect to Z's liability to A occurs as each payment is made to A. Consequently, $50,000 is incurred by Z for each taxable year that a payment is made to A under the annuity contract. (Z must also include in income a portion of amounts paid under the annuity, pursuant to section 72.) The result is the same if in 1992 Z secures its obligation with a standby letter of credit.

(iii) If Z later transfers ownership of the annuity contract to A, an amount equal to the fair market value of the annuity on the date of transfer is incurred by Z in the taxable year of the transfer (see paragraph (g)(1)(ii)(B) of this section). In addition, the transfer constitutes a transaction to which section 1001 applies.

Example 2. Rebates and refunds. (i) X corporation, a calendar year, accrual method taxpayer, manufactures and sells hardware products. X enters into agreements that entitle each of its distributors to a rebate (or discount on future purchases) from X based on the amount of purchases made by the distributor from X during any calendar year. During the 1992 calendar year, X becomes liable to pay a $2,000 rebate to distributor A. X pays A $1,200 of the rebate on January 15, 1993, and the remaining $800 on October 15, 1993. Assume the rebate is deductible (or allowable as an adjustment to gross receipts or cost of goods sold) when incurred.

(ii) If X does not adopt the recurring item exception described in §1.461–5 with respect to rebates and refunds, then under paragraph (g)(3) of this section, economic performance with respect to the $2,000 rebate liability occurs in 1993. However, if X has made a proper election under §1.461–5, and as of December 31, 1992, all events have occurred that determine the fact of the rebate liability, X incurs $1,200 for the 1992 taxable year. Because economic performance (payment) with respect to the remaining $800 does not occur until October 15, 1993 (more than 8½ months after the end of 1992), X cannot use the recurring item exception for this portion of the liability (see §1.461–5). Thus, the $800 is not incurred by X until the 1993 taxable year. If, instead of making the cash payments to A during 1993, X adjusts the price of hardware purchased by A that is delivered to A during 1993, X's ‘‘payment'' occurs as X would otherwise be required to recognize income resulting from a disposition at an unreduced price.

Example 3. Awards, prizes, and jackpots. (i) W corporation, a calendar year, accrual method taxpayer, produces and sells breakfast cereal. W conducts a contest pursuant to which the winner is entitled to $10,000 per year for a period of 20 years. On December 1, 1992, A is declared the winner of the contest and is paid $10,000 by W. In addition, on December 1 of each of the next nineteen years, W pays $10,000 to A.

(ii) Under paragraph (g)(4) of this section, economic performance with respect to the $200,000 contest liability occurs as each of the $10,000 payments is made by W to A. Consequently, $10,000 is incurred by W for the 1992 taxable year and for each of the succeeding nineteen taxable years.

Example 4. Awards, prizes, and jackpots. (i) Y corporation, a calendar year, accrual method taxpayer, owns a casino that contains progressive slot machines. A progressive slot machine provides a guaranteed jackpot amount that increases as money is gambled through the machine until the jackpot is won or until a maximum predetermined amount is reached. On July 1, 1993, the guaranteed jackpot amount on one of Y's slot machines reaches the maximum predetermined amount of $50,000. On October 1, 1994, the $50,000 jackpot is paid to B.

(ii) Under paragraph (g)(4) of this section, economic performance with respect to the $50,000 jackpot liability occurs on the date the jackpot is paid to B. Consequently, $50,000 is incurred by Y for the 1994 taxable year.

Example 5. Insurance, warranty, and service contracts. (i) V corporation, a calendar year, accrual method taxpayer, manufactures toys. V enters into a contract with W, an unrelated insurance company, on December 15, 1992. The contract obligates V to pay W a premium of $500,000 before the end of 1995. The contract obligates W to satisfy any liability of V resulting from claims made during 1993 or 1994 against V by any third party for damages attributable to defects in toys manufactured by V. Pursuant to the contract, V pays W a premium of $500,000 on October 1, 1995.

(ii) Assuming the arrangement constitutes insurance, under paragraph (g)(5) of this section economic performance occurs as the premium is paid. Thus, $500,000 is incurred by V for the 1995 taxable year.

Example 6. Insurance, warranty, and service contracts. (i) Y corporation, a calendar year, accrual method taxpayer, is a common carrier. On December 15, 1992, Y enters into a contract with Z, an unrelated insurance company, under which Z must satisfy any liability of Y that arises during the succeeding 5 years for damages under a workers compensation act or out of any tort, provided the event that causes the damages occurs during

1993 or 1994. Under the contract, Y pays $360,000 to Z on December 31, 1993.

(ii) Assuming the arrangement constitutes insurance, under paragraph (g)(5) of this section economic performance occurs as the premium is paid. Consequently, $360,000 is incurred by Y for the 1993 taxable year. The period for which the $360,000 amount is permitted to be taken into account is determined under the capitalization rules because the insurance contract is an asset having a useful life extending substantially beyond the close of the taxable year.

Example 7. Insurance, warranty, and service contracts. Assume the same facts as in *Example 6,* except that Y is obligated to pay the first $5,000 of any damages covered by the arrangement with Z. Y is, in effect, self-insured to the extent of this $5,000 ''deductible.'' Thus, under paragraph (g)(2) of this section, economic performance with respect to the $5,000 liability does not occur until the amount is paid to the person to which the tort or workers compensation liability is owed.

Example 8. Taxes. (i) The laws of State A provide that every person owning personal property located in State A on the first day of January shall be liable for tax thereon and that a lien for the tax shall attach as of that date. In addition, the laws of State A provide that 60% of the tax is due on the first day of December following the lien date and the remaining 40% is due on the first day of July of the succeeding year. On January 1, 1992, X corporation, a calendar year, accrual method taxpayer, owns personal property located in State A. State A imposes a $10,000 tax on S with respect to that property on January 1, 1992. X pays State A $6,000 of the tax on December 1, 1992, and the remaining $4,000 on July 1, 1993.

(ii) Under paragraph (g)(6) of this section, economic performance with respect to $6,000 of the tax liability occurs on December 1, 1992. Consequently, $6,000 is incurred by X for the 1992 taxable year. Economic performance with respect to the remaining $4,000 of the tax liability occurs on July 1, 1993. If X has adopted the recurring item exception described in § 1.461–5 as a method of accounting for taxes, and as of December 31, 1992, all events have occurred that determine the liability of X for the remaining $4,000, X also incurs $4,000 for the 1992 taxable year. If X does not adopt the recurring item exception method, the $4,000 is not incurred by X until the 1993 taxable year.

(h) *Liabilities arising under the Nuclear Waste Policy Act of 1982.* Notwithstanding the principles of paragraph (d) of this section, economic performance with respect to the liability of an owner or generator of nuclear waste to make payments to the Department of Energy (''DOE'') pursuant to a contract required by the Nuclear Waste Policy Act of 1982 (Pub. L. 97–425, 42 U.S.C. 10101–10226 (1982)) occurs as each payment under the contract is made to DOE and not when DOE satisfies its obligations under the contract. This rule applies to the continuing fee required by 42 U.S.C. 10222(a)(2) (1982), as well as the one-time fee required by 42 U.S.C. 10222 (a)(3) (1982). For rules relating to when economic performance occurs with respect to interest, see paragraph (e) of this section.

(i) [Reserved]

(j) *Contingent liabilities.* [Reserved]

(k) *Special effective dates*—(1) *In general.* Except as otherwise provided in this paragraph (k), section 461(h) and this section apply to liabilities that would, under the law in effect before the enactment of section 461(h), be allowable as a deduction or otherwise incurred after July 18, 1984. For example, the economic performance requirement applies to all liabilities arising under a workers compensation act or out of any tort that would, under the law in effect before the enactment of section 461(h), be incurred after July 18, 1984. For taxable years ending before April 7, 1995, see Q&A–2 of § 1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995), which provides an election to make this change in method of accounting applicable to either the portion of the first taxable year that occurs after July 18, 1984 (part-year change method), or the entire first taxable year ending after July 18, 1984 (full-year change method). With respect to the effective date rules for interest, section 461(h) applies to interest accruing under any obligation (whether or not evidenced by a debt instrument) if the obligation is incurred in any transaction occurring after June 8, 1984, and is not incurred under a written contract which was binding on March 1, 1984, and at all times thereafter until the obligation is incurred. Interest accruing under an obligation described in the preceding sentence is subject to section 461(h) even if the interest accrues before July 19, 1984. Similarly, interest accruing under any obligation incurred in a transaction occurring before June 9, 1984, (or under a written contract which was binding on

March 1, 1984, and at all times thereafter until the obligation is incurred) is not subject to section 461(h) even to the extent the interest accrues after July 18, 1984.

(2) *Long-term contracts.* Except as otherwise provided in paragraph (M)(2) of this section, in the case of liabilities described in paragraph (d)(2)(ii) of this section (relating to long-term contracts), paragraph (d)(2)(ii) of this section applies to liabilities that would, but for the enactment of section 461(h), be allowable as a deduction or otherwise incurred for taxable years beginning after December 31, 1991.

(3) *Payment liabilities.* Except as otherwise provided in paragraph (m)(2) of this section, in the case of liabilities described in paragraph (g) of this section (other than liabilities arising under a workers compensation act or out of any tort described in paragraph (g)(2) of this section), paragraph (g) of this section applies to liabilities that would, but for the enactment of section 461(h), be allowable as a deduction or otherwise incurred for taxable years beginning after December 31, 1991.

(l) [Reserved]

(m) *Change in method of accounting required by this section*—(1) *In general.* For the first taxable year ending after July 18, 1984, a taxpayer is granted the consent of the Commissioner to change its method of accounting for liabilities to comply with the provisions of this section pursuant to any of the following procedures:

(i) For taxable years ending before April 7, 1995, the part-year change in method election described in Q&A–2 through Q&A–6 and Q&A–8 through Q&A–10 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995);

(ii) For taxable years ending before April 7, 1995, the full-year change in method election described in Q&A–2 through Q&A–6 and Q&A–8 through Q&A–10 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995); or

(iii) For taxable years ending before April 7, 1995, if no election is made, the cut-off method described in Q&A–1 and Q&A–11 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995).

(2) *Change in method of accounting for long-term contracts and payment liabilities*—(i) *First taxable year beginning after December 31, 1991.* For the first taxable year beginning after December 31, 1991, a taxpayer is granted the consent of the Commissioner to change its method of accounting for long-term contract liabilities described in paragraph (D)(2)(ii) of this section and payment liabilities described in paragraph (g) of this section (other than liabilities arising under a workers compensation act or out of any tort described in paragraph (g)(2) of this section) to comply with the provisions of this section. The change must be made in accordance with paragraph (m)(1)(ii) or (m)(1)(iii) of this section, except the effective date is the first day of the first taxable year beginning December 31, 1991.

(ii) *Retroactive change in method of accounting for long-term contracts and payment liabilities.* For the first taxable year beginning after December 31, 1989, or the first taxable year beginning after December 31, 1990, a taxpayer is granted the consent of the Commissioner to change its method of accounting for long-term contract liabilities described in paragraph (d)(2)(ii) of this section and payment liabilities described in paragraph (g) of this section (other than liabilities arising under a workers compensation act or out of any tort described in paragraph (g)(2) of this section) to comply with the provisions of this section. The change must be made in accordance with paragraph (m)(1)(ii) or (m)(1)(iii) of this section, except the effective date is the first day of the first taxable year beginning after December 31, 1989, or the first day of the first taxable year beginning after December 31, 1990. For taxable years ending before April 7, 1995, the taxpayer may make the change in method of accounting, including a full-year change in method election under paragraph (m)(1)(ii) of this section and Q&A–5 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995), by filing an amended return for such year, provided the amended return is filed on or before October 7, 1992.

[T.D. 8408, 57 FR 12421, Apr. 10, 1992, as amended by T.D. 8491, 58 FR 53135, Oct. 14, 1993; T.D. 8593, 60 FR 18743, Apr. 13, 1995]

§ 1.461–5 Recurring item exception.

(a) *In general.* Except as otherwise provided in paragraph (c) of this section, a taxpayer using an accrual method of accounting may adopt the recurring item exception described in paragraph (b) of this section as method of accounting for one or more types of recurring items incurred by the taxpayer. In the case of the ''other payment liabilities'' described in § 1.461–4(g)(7), the Commissioner may provide for the application of the recurring item exception by regulation, revenue procedure or revenue ruling.

(b) *Requirements for use of the exception*—(1) *General rule.* Under the recurring item exception, a liability is treated as incurred for a taxable year if—

(i) As of the end of that taxable year, all events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy;

(ii) Economic performance with respect to the liability occurs on or before the earlier of—

(A) The date the taxpayer files a timely (including extensions) return for that taxable year; or

(B) The 15th day of the 9th calendar month after the close of that taxable year;

(iii) The liability is recurring in nature; and

(iv) Either—

(A) The amount of the liability is not material; or

(B) The accrual of the liability for that taxable year results in a better matching of the liability with the income to which it relates than would result from accruing the liability for the taxable year in which economic performance occurs.

(2) *Amended returns.* A taxpayer may file an amended return treating a liability as incurred under the recurring item exception for a taxable year if economic performance with respect to the liability occurs after the taxpayer files a return for that year, but within 8½ months after the close of that year.

(3) *Liabilities that are recurring in nature.* A liability is recurring if it can generally be expected to be incurred from one taxable year to the next. However, a taxpayer may treat such a liability as recurring in nature even if it is not incurred by the taxpayer in each taxable year. In addition, a liability that has never previously been incurred by a taxpayer may be treated as recurring if it is reasonable to expect that the liability will be incurred on a recurring basis in the future.

(4) *Materiality requirement.* For purposes of this paragraph (b):

(i) In determining whether a liability is material, consideration shall be given to the amount of the liability in absolute terms and in relation to the amount of other items of income and expense attributable to the same activity.

(ii) A liability is material if it is material for financial statement purposes under generally acepted accounting principles.

(iii) A liability that is immaterial for financial statement purposes under generally accepted accounting principles may be material for purposes of this paragraph (b).

(5) *Matching requirement.* (i) In determining whether the matching requirement of paragraph (b)(1)(iv)(B) of this section is satisfied, generally accepted accounting principles are an important factor, but are not dispositive.

(ii) In the case of a liability described in paragraph (g)(3) (rebates and refunds), paragraph (g)(4) (awards, prizes, and jackpots), paragraph (g)(5) (insurance, warranty, and service contracts), paragraph (g)(6) (taxes), or paragraph (h) (continuing fees under the Nuclear Waste Policy Act of 1982) of § 1.461–4, the matching requirement of paragraph (b)(1)(iv)(B) of this section shall be deemed satisfied.

(c) *Types of liabilities not eligible for treatment under the recurring item exception.* The recurring item exception does not apply to any liability of a taxpayer described in paragraph (e) (interest), paragraph (g)(2) (workers compensation, tort, breach of contract, and violation of law), or paragraph (g)(7) (other liabilities) of § 1.461–4. Moreover, the recurring item exception does not apply to any liability incurred by a tax shelter, as defined in section 461(i) and § 1.448–1T(b).

(d) *Time and manner of adopting the recurring item exception*—(1) *In general.* The recurring item exception is a method of accounting that must be consistently applied with respect to a type of item, or for all items, from one taxable year to the next in order to clearly reflect income. A taxpayer is permitted to adopt the recurring item exception as part of its method of accounting for any type of item for the first taxable year in which that type of item is incurred. Except as otherwise provided, the rules of section 446(e) and §1.446–1(e) apply to changes to or from the recurring item exception as a method of accounting. For taxable years ending before April 7, 1995, see Q&A–7 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995) for rules concerning the time and manner of adopting the recurring item exception for taxable years that include July 19,1984. For purposes of this section, items are to be classified by type in a manner that results in classifications that are no less inclusive than the classifications of production costs provided in the full-absorption regulations of §1.471–11(b) and(c), whether or not the taxpayer is required to maintain inventories.

(2) *Change to the recurring item exception method for the first taxable year beginning after December 31, 1991*—(i) *In general.* For the first taxable year beginning after December 31, 1991, a taxpayer is granted the consent of the Commissioner to change to the recurring item exception method of accounting. A taxpayer is also granted the consent of the Commissioner to expand or modify its use of the recurring item exception method for the first taxable year beginning after December 31, 1991. For each trade or business for which a taxpayer elects to use the recurring item exception method, the taxpayer must use the same method of change (cut-off or full-year change) it is using for that trade or business under §1.461–4(m). For taxable year sending before April 7, 1995, see Q&A–11 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995) for an explanation of how amounts are taken into account under the cut-off method (except that, for purposes of this paragraph (d)(2), the change applies to all amounts otherwise incurred on or after the first day of the first taxable year beginning after December 31, 1991). For taxable years ending before April 7, 1995, see Q&A–6 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995) for an explanation of how amounts are taken into account under the full-year change method (except that the change in method occurs on the first day of the first taxable year beginning after December 31, 1991). For taxable years ending before April 7, 1995, the full-year change in method may result in a section 481(a) adjustment that must be taken into account in the manner described in Q&A–8 and Q&A–9 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995) (except that the taxable year of change is the first taxable year beginning after December 31, 1991).

(ii) *Manner of changing to the recurring item exception method.* For the first taxable year beginning after December 31, 1991, a taxpayer may change to the recurring item exception method by accounting for the item on its timely filed original return for such taxable year (including extensions). For taxable years ending before April 7, 1995, the automatic consent of the Commissioner is limited to those items accounted for under the recurring item exception method on the timely filed return, unless the taxpayer indicates a wider scope of change by filing the statement provided in Q&A–7(b)(2) of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995).

(3) *Retroactive change to the recurring item exception method.* For the first taxable year beginning after December 31, 1989, or December 31, 1990, a taxpayer is granted consent of the Commissioner to change to the recurring item exception method of accounting, provided the taxpayer complies with paragraph (d)(2) of this section on either the original return for such year or on an amended return for such year filed on or before October 7, 1991. For this purpose the effective date is the first day of the first taxable year beginning after December 31, 1989, or the first day of the first taxable year beginning after December 31, 1990. A taxpayer is also granted the consent of the Commissioner to expand or modify its use of the recurring item exception method for the first taxable year beginning

after December 31, 1989, December 31, 1990, or December 31, 1991.

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

Example 1. Requirements for use of the recurring item exception. (i) Y corporation, a calendar year, accrual method taxpayer, manufactures and distributes video cassette recorders. Y timely files its federal income tax return for each taxable year on the extended due date for the return (September 15, of the following taxable year). Y offers to refund the price of a recorder to an purchaser not satisfied with the recorder. During 1992, 100 purchasers request a refund of the $500 purchase price. Y refunds $30,000 on or before September 15, 1993, and the remaining $20,000 after such date but before the end of 1993.

(ii) Under paragraph (g)(3) of § 1.461–4, economic performance with respect to $30,000 of the refund liability occurs on September 15, 1993. Assume the refund is deductible (or allowable as an adjustment to gross receipts or cost of goods sold) when incurred. If Y does not adopt the recurring item exception with respect to rebates and refunds, the $30,000 refund is incurred by Y for the 1993 taxable year. However, if Y has properly adopted the recurring item exception method of accounting under this section, and as of December 31, 1992, all events have occurred that determine the fact of the liability for the $30,000 refund, Y incurs that amount for the 1992 taxable year. Because economic performance (payment) with respect to the remaining $20,000 occurs after September 15, 1993 (more than 8½ months after the end of 1992), that amount is not eligible for recurring item treatment under this section. Thus, the $20,000 amount is not incurred by Y until the 1993 taxable year.

Example 2. Requirements for use of the recurring item exception; amended returns. The facts are the same as in *Example 2*, except that Y files its income tax return for 1992 on March 15, 1993, and Y does not refund the price of any recorder before that date. Under paragraph (b)(1) of this section, the refund liability is not eligible for the recurring item exception because economic performance with respect to the refund does not occur before Y files a return for the taxable year for which the item would have been incurred under the exception. However, since economic performance occurs within 8½ months after 1992, Y may file an amended return claiming the $30,000 as incurred for its 1992 taxable year (see paragraph (b)(2) of this section).

[T.D. 8408, 57 FR 12427, Apr. 10, 1992, as amended by T.D. 8593, 60 FR 18743, Apr. 13, 1995]

§ 1.461–6 Economic performance when certain liabilities are assigned or are extinguished by the establishment of a fund.

(a) *Qualified assignments of certain personal injury liabilities under section 130.* In the case of a qualified assignment (within the meaning of section 130(c)), economic performance occurs as a taxpayer-assignor makes payments that are excludible from the income of the assignee under section 130(a).

(b) *Section 468B.* Economic performance occurs as a taxpayer makes qualified payments to a designated settlement fund under section 468B, relating to special rules for designated settlement funds.

(c) *Payments to other funds or persons that constitute economic performance.* [Reserved]

(d) *Effective dates.* The rules in paragraph (a) of this section apply to payments after July 18, 1984.

[T.D. 8408, 57 FR 12428, Apr. 10, 1992]

§ 1.463–1T Transitional rule for vested accrued vacation pay (temporary).

(a) *Introduction.* Section 91(i) of the Tax Reform Act of 1984 provides a transitional rule for the election under section 463, relating to accrual of vacation pay. Section 91(i) applies only in the case of taxpayers with respect to which a deduction was allowable (other than under section 463) for vested accrued vacation pay for the last taxable year ending or or before July 18, 1984.

(b) *Election under transitional rule.* A taxpayer described in paragraph (a) of this section that makes an election under section 463 for the first taxable year ending after July 18, 1984, shall compute the opening balance of the account described in section 463(a)(1) (‘‘accrual account’’) with respect to such vacation pay under the rules provided in paragraph (e)(3) of this section.

(c) *Multiple vacation pay accounts within a single trade or business.* (1) An election under section 463 must be made with respect to all vacation pay accounts maintained by the taxpayer within a single trade or business whether the liability is for vested accrued vacation pay or for vacation pay that is contingent.

(2) If a taxpayer has elected, in a taxable year ending on or before July 18, 1984, to treat contingent vacation pay with respect to a single trade or business under section 463, the taxpayer may elect, under the provisions of section 91(i) of the Tax Reform Act of 1984, to treat vested accrued vacation pay with respect to the same trade or business under section 463. However, no election may be made with respect to vacation pay for which a prior section 463 election was made and that is accounted for under section 463.

(d) *Time for making election.* A taxpayer described in paragraph (a) of this section that makes an election under section 463 for the first taxable year ending after July 18, 1984, must make the election on or before the due date (determined with regard to extensions) for filing the taxpayer's income tax return for such taxable year. However, if the taxpayer's income tax return was filed for the first taxable year ending after July 18, 1984, prior to March 6, 1986, the taxpayer must make the election by the later of the due date (determined with regard to extensions) for filing the taxpayer's income tax return, or May 5, 1986. In this case, the election must be made by filing an amended return (showing adjustments, if any) for such year and attaching the statement required by paragraph (e) of this section on or before the later of the due date (determined with regard to extensions) for filing the taxpayer's income tax return, or May 5, 1986.

(e) *Manner of making election.* A taxpayer must make the election described in paragraph (b) of this section by attaching a statement to the taxpayer's income tax return for the first taxable year ending after July 18, 1984. The statement must indicate that the taxpayer is electing to apply the provisions of section 463 with respect to vested accrued vacation pay for the taxpayer's first taxable year ending after July 18, 1984. The statement must contain the following information:

(1) The taxpayer's name and a description of the vacation pay plans to which the election applies.

(2) If a taxpayer has more than one trade or business and is not making the election with respect to all trades or businesses, a description of the trades or businesses to which the election applies.

(3) The opening balance in the taxpayer's accrual account. This balance equals the amount determined as if the taxpayer had maintained an account for the last taxable year ending on or before July 18, 1984, representing the taxpayer's liability for vested accrued vacation pay earned by employees before the close of the last taxable year ending on or before July 18, 1984, and payable during that taxable year or within 12 months following the close of that taxable year. If the taxpayer's liability for vacation pay includes both vested accrued vacation pay and vacation pay the liability for which is contingent, the amount in the opening balance of the accrual account that represents the taxpayer's liability for contingent vacation pay is to be determined under the rules provided in section 463(b)(2).

(4) The opening balance in the taxpayer's suspense account. This balance equals the amount determined under paragraph (e)(3) of this section less the portion allowed as deductions under section 162 for prior taxable years for vacation pay earned but not paid at the close of the last taxable year ending on or before July 18, 1984.

(f) *Vested accrued vacation pay.* For purposes of paragraphs (a) through (e) of this section, ''vested accrued vacation pay'' means any amount allowable as a deduction under section 162(a) for a taxable year with respect to vacation pay of employees of the taxpayer (determined without regard to section 463). For purposes of this section, vacation pay will be considered vested accrued vacation pay even though there is a limit or ceiling on the amount of vacation pay an employee is entitled to as of the close of any plan year.

For example, if under a vacation pay plan an employee may accumulate no more than 40 days of vacation leave by the end of any plan year and any unused days in excess of 40 days are forfeited, the taxpayer is considered to have vested accrued vacation pay (even though the plan is not fully vested) and may make an election under the transitional rule.

[T.D. 8073, 51 FR 4329, Feb. 4, 1986, as amended at 51 FR 11303, Apr. 2, 1986]

§ 1.465–1T Aggregation of certain activities (temporary).

(a) *General rule.* A partner in a partnership or an S corporation shareholder may aggregate and treat as a single activity—

(1) The holding, production, or distribution of more than one motion picture film or video tape by the partnership or S corporation,

(2) The farming (as defined in section 464 (e)) of more than one farm by the partnership or S corporation,

(3) The exploration for, or exploitation of, oil and gas resources with respect to more than one oil and gas property by the partnership or S corporation, or

(4) The exploration for, or exploitation of, geothermal deposits (within the meaning of section 613(e)(3)) with respect to more than one geothermal property by the partnership or S corporation.

Thus, for example, if a partnership or S corporation is engaged in the activity of exploring for, or exploiting, oil and gas resources with respect to 10 oil and gas properties, a partner or S corporation shareholder may aggregate those properties and treat the aggregated oil and gas activities as a single activity. If that partnership or S corporation also is engaged in the activity of farming with respect to two farms, the partner or shareholder may aggregate the farms and treat the aggregated farming activities as a single separate activity. Except as provided in section 465(c)(2)(B)(ii), the partner or shareholder cannot aggregate the farming activity with the oil and gas activity.

(b) *Effective date.* This section shall apply to taxable years beginning after December 31, 1983 and before January 1, 1985.

(Secs. 465(c)(2)(B) and 7805 of the Internal Revenue Code of 1954 (98 Stat. 814, 68A Stat. 917; 26 U.S.C. 465(c)(2)(B) and 7805))

[T.D. 8012, 50 FR 9614, Mar. 11, 1985]

§ 1.465–27 Qualified nonrecourse financing.

(a) *In general.* Notwithstanding any provision of section 465(b) or the regulations under section 465(b), for an activity of holding real property, a taxpayer is considered at risk for the taxpayer's share of any qualified nonrecourse financing which is secured by real property used in such activity.

(b) *Qualified nonrecourse financing secured by real property*—(1) *In general.* For purposes of section 465(b)(6) and this section, the term *qualified nonrecourse financing* means any financing—

(i) Which is borrowed by the taxpayer with respect to the activity of holding real property;

(ii) Which is borrowed by the taxpayer from a qualified person or represents a loan from any federal, state, or local government or instrumentality thereof, or is guaranteed by any federal, state, or local government;

(iii) For which no person is personally liable for repayment, taking into account paragraphs (b)(3), (4), and (5) of this section; and

(iv) Which is not convertible debt.

(2) *Security for qualified nonrecourse financing*—(i) *Types of property.* For a taxpayer to be considered at risk under section 465(b)(6), qualified nonrecourse financing must be secured only by real property used in the activity of holding real property. For this purpose, however, property that is incidental to the activity of holding real property will be disregarded. In addition, for this purpose, property that is neither real property used in the activity of holding real property nor incidental property will be disregarded if the aggregate gross fair market value of such property is less than 10 percent of the aggregate gross fair market value of all the property securing the financing.

(ii) *Look-through rule for partnerships.* For purposes of paragraph (b)(2)(i) of this section, a borrower shall be treated as owning directly its proportional share of the assets in a partnership in which the borrower owns (directly or indirectly through a chain of partnerships) an equity interest.

(3) *Personal liability; partial liability.* If one or more persons are personally liable for repayment of a portion of a financing, the portion of the financing for which no person is personally liable may qualify as qualified nonrecourse financing.

(4) *Partnership liability.* For purposes of section 465(b)(6) and this paragraph

(b), the personal liability of any partnership for repayment of a financing is disregarded and, provided the requirements contained in paragraphs (b)(1)(i), (ii), and (iv) of this section are satisfied, the financing will be treated as qualified nonrecourse financing secured by real property if—

(i) The only persons personally liable to repay the financing are partnerships;

(ii) Each partnership with personal liability holds only property described in paragraph (b)(2)(i) of this section (applying the principles of paragraph (b)(2)(ii) of this section in determining the property held by each partnership); and

(iii) In exercising its remedies to collect on the financing in a default or default-like situation, the lender may proceed only against property that is described in paragraph (b)(2)(i) of this section and that is held by the partnership or partnerships (applying the principles of paragraph (b)(2)(ii) of this section in determining the property held by the partnership or partnerships).

(5) *Disregarded entities.* Principles similar to those described in paragraph (b)(4) of this section shall apply in determining whether a financing of an entity that is disregarded for federal tax purposes under § 301.7701–3 of this chapter is treated as qualified nonrecourse financing secured by real property.

(6) *Examples.* The following examples illustrate the rules of this section:

Example 1. Personal liability of a partnership; incidental property. (i) X is a limited liability company that is classified as a partnership for federal tax purposes. X engages only in the activity of holding real property. In addition to real property used in the activity of holding real property, X owns office equipment, a truck, and maintenance equipment that it uses to support the activity of holding real property. X borrows $500 to use in the activity. X is personally liable on the financing, but no member of X and no other person is liable for repayment of the financing under local law. The lender may proceed against all of X's assets if X defaults on the financing.

(ii) Under paragraph (b)(2)(i) of this section, the personal property is disregarded as incidental property used in the activity of holding real property. Under paragraph (b)(4) of this section, the personal liability of X for repayment of the financing is disregarded and, provided the requirements contained in paragraphs (b)(1)(i), (ii), and (iv) of this section are satisfied, the financing will be treated as qualified nonrecourse financing secured by real property.

Example 2. Bifurcation of a financing. The facts are the same as in *Example 1,* except that A, a member of X, is personally liable for repayment of $100 of the financing. If the requirements contained in paragraphs (b)(1)(i), (ii), and (iv) of this section are satisfied, then under paragraph (b)(3) of this section, the portion of the financing for which A is not personally liable for repayment ($400) will be treated as qualified nonrecourse financing secured by real property.

Example 3. Personal liability; tiered partnerships. (i) UTP1 and UTP2, both limited liability companies classified as partnerships, are the only general partners in Y, a limited partnership. Y borrows $500 with respect to the activity of holding real property. The financing is a general obligation of Y. UTP1 and UTP2, therefore, are personally liable to repay the financing. Under section 752, UTP1's share of the financing is $300, and UTP2's share is $200. No person other than Y, UTP1, and UTP2 is personally liable to repay the financing. Y, UTP1, and UTP2 each hold only real property.

(ii) Under paragraph (b)(4) of this section, the personal liability of Y, UTP1, and UTP2 to repay the financing is disregarded and, provided the requirements of paragraphs (b)(1)(i), (ii), and (iv) of this section are satisfied, UTP1's $300 share of the financing and UTP2's $200 share of the financing will be treated as qualified nonrecourse financing secured by real property.

Example 4. Personal liability; tiered partnerships. The facts are the same as in *Example 3,* except that Y's general partners are UTP1 and B, an individual. Because B, an individual, is also personally liable to repay the $500 financing, the entire financing fails to satisfy the requirement in paragraph (b)(1)(iii) of this section. Accordingly, UTP1's $300 share of the financing will not be treated as qualified nonrecourse financing secured by real property.

Example 5. Personal liability; tiered partnerships. The facts are the same as in *Example 3,* except that Y is a limited liability company and UTP1 and UTP2 are not personally liable for the debt. However, UTP1 and UTP2 each pledge property as security for the loan that is other than real property used in the activity of holding real property and other than property that is incidental to the activity of holding real property. The fair market value of the property pledged by UTP1 and UTP2 is greater than 10 percent of the sum of the aggregate gross fair market value of the property held by Y and the aggregate gross fair market value of the property pledged by UTP1 and UTP2. Accordingly, the financing fails to satisfy the requirement in paragraph (b)(1)(iii) of this section by virtue of its failure to satisfy paragraph (b)(4)(iii) of this section. Therefore, the financing is not qualified nonrecourse financing secured by real property.

Example 6. Personal liability; Disregarded entity. (i) X is a single member limited liability company that is disregarded as an entity separate from its owner for federal tax purposes under § 301.7701–3 of this chapter. X owns certain real property and property that is incidental to the activity of holding the real property. X does not own any other property. For federal tax purposes, A, the sole member of X, is considered to own all of the property held by X and is engaged in the activity of holding real property through X. X borrows $500 and uses the proceeds to purchase additional real property that is used in the activity of holding real property. X is personally liable to repay the financing, but A is not personally liable for repayment of the financing under local law. The lender may proceed against all of X's assets if X defaults on the financing.

(ii) X is disregarded so that the assets and liabilities of X are treated as the assets and liabilities of A. However, A is not personally liable for the $500 liability. Provided that the requirements contained in paragraphs (b)(1)(i), (ii), and (iv) of this section are satisfied, the financing will be treated as qualified nonrecourse financing secured by real property with respect to A.

(c) *Effective date.* This section is effective for any financing incurred on or after August 4, 1998. Taxpayers, however, may apply this section retroactively for financing incurred before August 4, 1998.

[T.D. 8777, 63 FR 41421, Aug. 4, 1998]

§ 1.466–1 Method of accounting for the redemption cost of qualified discount coupons.

(a) *Introduction.* Section 466 permits taxpayers who elect to use the method of accounting description in section 466 to deduct the redemption cost (as defined in paragraph (b) of this section) of qualified discount coupons (as defined in paragraph (c) of this section) outstanding at the end of the taxable year and redeemed during the redemption period (within the meaning of paragraph (d)(2) of this section) in addition to the redemption cost of qualified discount coupons redeemed during the taxable year which were not deducted for a prior taxable year. For the taxable year in which the taxpayer first uses this method of accounting, the taxpayer is not allowed to deduct the redemption costs of qualified discount coupons redeemed during the taxable year that would have been deductible for the prior taxable year had the taxpayer used this method of accounting for such prior year. (See paragraph (e) of this section for rules describing how this amount should be taken into account.) A taxpayer must use the accrual method of accounting for any trade or business for which an election is made under section 466. Furthermore, the taxpayer must make an election in accordance with the rules in section 466(d) and § 1.466–3 for that trade or business. The method of accounting in section 466 is applicable only to the taxpayer's redemption of qualified discount coupons. Section 466 does not apply to trading stamps or premium coupons, which are subject to the method of accounting in § 1.451–4, or to discount coupons that are not qualified discount coupons.

(b) *Redemption costs*—(1) *Costs deductible under section 466.* The deduction allowed by section 466 applies only to the redemption cost of qualified discount coupons. The term ''redemption cost'' means an amount equal to:

(i) The lesser of:

(A) The amount of the discount stated on the coupon, or

(B) The cost incurred by the taxpayer for paying the discount; plus

(ii) The amount payable to the retailer (or other person redeeming the coupon from the person receiving the price discount) for services in redeeming the coupon.

The amount payable to the retailer or other person for services in redeeming the coupon is allowed only if the amount payable is stated on the coupon.

(2) *Costs not deductible under section 466.* The term ''redemption cost'' includes only the amounts stated in paragraph (b)(1) of this section. Amounts other than those mentioned in paragraph (b)(1) of this section cannot be deducted under the method of accounting described in section 466 even though such amounts are incurred

in relation to the redemption of qualified discount coupons. Therefore, those amounts must be taken into account as if section 466 did not apply. Examples of such amounts are fees paid to the redemption center or clearinghouse and amounts payable to the retailer in excess of the amount stated on the coupon.

(c) *Qualified discount coupons*—(1) *General rule.* In order for a discount coupon (as defined in paragraph (c)(2)(i) of this section) to be considered a qualified discount coupon, all of the following requirements must be met:

(i) The coupon must have been issued by and must be redeemable by the taxpayer;

(ii) The coupon must allow a discount on the purchase price of merchandise or other tangible personal property;

(iii) The face amount of the coupon must not exceed five dollars;

(iv) The coupon, by its terms, may not be used with other coupons to bring about a price discount reimbursable by the issuer of more than five dollars with respect to any item; and

(v) There must exist a redemption chain (as defined in paragraph (c)(2)(ii) of this section) with respect to the coupon.

(2) *Definitions*—(i) *Discount coupon.* A discount coupon is a sales promotion device used to encourage the purchase of a specific product by allowing a purchaser of that product to receive a discount on its purchase price. The term ‘‘discount coupon’’ does not include trading stamps or premium coupons, which are subject to the method of accounting in §1.451–4. A discount coupon may or may not be issued as part of a prior purchase. A discount coupon normally entitles its holders to receive nothing more than a reduction in the sales price of one of the issuer's products. The discount may be stated in terms of a cash amount, a percentage or fraction of the purchase price, a ‘‘two for the price of one’’ deal, or any other similar provision. A discount coupon need not be printed on paper in the form usually associated with coupons; it may be a token or other object so long as it functions as a coupon.

(ii) *Redemption chain.* A redemption chain exists when the issuer redeems the coupon from some person other than the customer who used the coupon to receive the price discount. Thus, in order to be treated as a qualified discount coupon, the coupon must not be issued by the person that initially redeems the coupon from the customer. For purposes of determining whether a redemption chain exists, corporations that are members of the same controlled group of corporations (as defined in section 1563(a)) as the issuer of the coupon shall be treated as the issuer. Thus, if the issuer of the coupon and the retailer that initially redeems the coupon from the customer are members of the same controlled group of corporations, the coupon shall not be treated as a qualified discount coupon.

(d) *Deduction for coupons redeemed during the redemption period*—(1) *General rule.* Two special conditions must be met before the cost of redeeming qualified discount coupons during the redemption period can be deducted from the taxpayer's gross income for the taxable year preceding the redemption period. First, the qualified discount coupons must have been outstanding at the close of such taxable year. Second, the qualified discount coupons must have been received by the taxpayer before the close of the redemption period for that taxable year.

(2) *Redemption period.* The taxpayer can select any redemption period so long as the period does not extend longer than 6 months after the close of the taxapayer's taxable year. A change in the redemption period so selected shall be treated as a change in method of accounting.

(3) *Coupons received.* The deduction provided for in section 466(a)(1) is limited to the redemption costs associated with coupons that are actually received by the taxpayer within the redemption period. For purposes of this paragraph, if the issuer uses a redemption agent or clearinghouse to group, count, and verify coupons after they have been redeemed by a retailer, the coupons received by the redemption agent or clearinghouse will be considered to have been received by the issuer. Nothing in section 466, however, allows deductions to be made on the

basis of estimated redemptions, whether such estimates are made by either the issuer or some other party.

(e) *Transitional adjustment*—(1) *In general.* An election to change from some other method of accounting for the redemption of discount coupons to the method of accounting described in section 466 is a change in method of accounting that requires a transitional adjustment. Unless the taxpayer can qualify for a waiver of the suspense account requirement as provided for in section 373(c) of the Revenue Act of 1978 (92 Stat. 2865), the taxpayer should compute the transitional adjustment described in section 481(a)(2) according to the rules contained in this section. This adjustment should be taken into account according to the special rules in subsections (e) and (f) of section 466.

(2) *Net increase in taxable income.* In the case of a transitional adjustment that would result in a net increase in taxable income under section 481(a)(2) for the year of change, that increase should be taken into income over a ten-year period consisting of the year of change and the immediately succeeding nine taxable years. For example, assume that A, a calendar year taxpayer, makes an election to use the method of accounting described in section 466 for the year 1980 and for subsequent years. Assume further that the amount of the transitional adjustment computed under section 481(a)(2) would result in a net increase in taxable income of $100 for 1980. Under these facts, A should increase taxable income for 1980 and each of the next nine taxable years by $10.

(3) *Suspense account*—(i) *In general.* In the case of a transitional adjustment that would result in a net decrease in taxable income under section 481(a)(2) for the year of change, in lieu of applying section 481, the taxpayer must establish a separate suspense account for each trade or business for which the taxpayer has made an election to use section 466. The computation of the initial opening balance in the suspense account is described in paragraph (e)(3)(ii)(A) of this section. An initial adjustment to gross income for the year of election is described in paragaph (e)(3)(ii)(B) of this section. Annual adjustments to the suspense account are described in paragraph (e)(3)(iii)(A) of this section, and gross income adjustments are described in paragraph (e)(3)(iii)(B) of this section. Examples are provided in paragraph (e)(4) of this section. The effect of the suspense account is to defer some part of, or all of, the deduction of the transitional adjustment until the taxpayer no longer redeems discount coupons in connection with the trade or business to which the suspense account relates.

(ii) *Establishing a suspense account*—(A) *Initial opening balance.* To compute the initial opening balance of the suspense account for the first taxable year for which the election to use section 466 is effective, the taxpayer must determine the dollar amount of the deduction that would have been allowed for qualified discount coupon redemption costs during the redemption period for each of the three immediately preceding taxable years had the election to use section 466 been in effect for those years. The initial opening balance of the suspense account is the largest such dollar amount reduced by the sum of the adjustments attributable to the change in method of accounting that increase income for the year of change.

(B) *Initial year adjustment.* If, in computing the initial opening balance, the largest dollar amount of deduction that would have been allowed in any of the three prior years exceeds the actual cost of redeeming qualified discount coupons received during the redemption period following the close of the year immediately preceding the year of election, the excess is included in income in the year of election. Section 481(b) does not apply to this increase in gross income.

(iii) *Annual adjustments*—(A) *Adjustment to the suspense account.* Adjustments are made to the suspense account each year to account for fluctuations in coupon redemptions. To compute the annual adjustment, the taxpayer must determine the amount to be deducted under section 466(a)(1) for the taxable year. If the amount is less than the opening balance in the suspense account for the taxable year, the balance in the suspense account is reduced by the difference. Conversely, if such amount is greater than the opening balance in the suspense account for the taxable year, the account is increased by the difference (but not to an amount in excess of the initial opening balance described in paragraph (e)(3)(ii) of this section). Therefore, the balance in the suspense account will never be greater than the initial opening balance in the suspense account determined in paragraph (e)(3)(ii) of this section. However, the balance in the suspense account after adjustments may be less than this initial opening balance in the suspense account.

(B) *Gross income adjustments.* Adjustments to the suspense account for years subsequent to the year of the election also produce adjustments in the taxpayer's gross income. Adjustments which reduce the balance in the suspense account reduce gross income for the year in which the adjustment to the suspense account is made. Adjustments which increase the balance in the suspense account increase gross income for the year in which the adjustment to the suspense account is made.

(4) *Examples.* (i) The provisions of paragraph (e)(3) of this section may be illustrated by the following examples:

Example (1). Assume that the issuer of qualified discount coupons makes a timely election under section 466 for its taxable year ending December 31, 1979, and does not select a coupon redemption period shorter than the statutory period of 6 months. Assume further that the taxpayer's qualified discount coupon redemption costs in the first 6 months of 1977, 1978, and 1979 were $7, $13, and $8 respectively, and that the accounting change adjustments that increase income for 1979 are $10. Since the accounting change adjustment that increases income for 1979, ($10), is greater than the taxpayer's discount coupon redemptions during the first 6 months of 1979 ($8), the net section 481(a)(2) adjustment for the year of change results in a positive adjustment. Because of this, a suspense account is not required. The taxpayer should instead follow the rules in section 466(f) and in paragraph (e)(2) of this section in order to take this positive transitional adjustment into account.

Example (2). Assume the same facts as in example (1), except that the sum of the accounting change adjustments that increase income for 1979 is equal to $2. Under these facts the initial opening balance in the suspense account on January 1, 1979 would be $11 (that is, the largest dollar amount of qualified coupon redemption costs in the pertinent years ($13), reduced by the sum of the accounting change adjustments that increase income in the year of change ($2)). Since the coupon redemption costs taken into account in determining the initial opening balance ($13 in 1979) exceed the actual redemption costs in the first 6 months of the taxable year for which the election is first effective ($8 in 1979), the excess of $5 is added to gross income for the year of election (1979).

Example (3). Assume, in addition to the facts of example (2), that coupon redemption costs during the redemption period for the 1979 taxable year are $7. Since the qualifying redemption costs ($7) during the redemption period for the taxable year are less than the opening balance in the suspense account ($11) the taxpayer must reduce the suspense account balance by the difference ($4). The taxpayer is also allowed to take a deduction equal to the amount of this adjustment to the suspense account. Thus, the net amount deductible for the 1979 taxable year after taking into account the coupon redemptions during the redemption period, the amount deductible because of the decrease in the suspense account, and the initial year adjustment determined in example (2) is $6 ($7+$4−$5).

Example (4). Assume, in addition to the facts of example (3), that coupon redemption costs during the redemption period for the 1980 taxable year are $10. Since the qualifying redemption costs during the redemption period for the taxable year ($10) exceed the opening balance of the suspense account at the beginning of the taxable year ($7), the suspense account must be increased by the difference ($3). The taxpayer must also include $3 in gross income for the taxable year. Thus, the net amount deductible for the 1980 taxable year is $7 ($10−$3).

Example (5). Assume, in addition to the facts of example (4), that coupon redemption costs during the redemption period for the 1981 taxable year are $12. Since the qualifying redemption costs for the 1961 taxable year ($12) exceed the opening balance of the suspense account at the beginning of the taxable year ($10), the suspense account must be increased by the difference ($2) but not above the initial opening balance ($11). Thus, the taxpayer will increase the balance by $1. The taxpayer must also include $1 in gross income for the taxable year. Thus, the net amount deductible for the 1981 taxable year is $11 ($12−$1).

(ii) The following table summarizes examples (2) through (5):

	Years ending Dec. 31—					
	1977	1978	1979	1980	1981	1982
Facts:						
Actual coupon redemption costs in first six months	$7	$13	$8	$7	$10	$12
Accounting change adjustments that increase income in year of change	....	....	2	....	....	....
Net adjustment decreasing income in year of change under sec. 481(a)(2)	....	....	6	....	....	....
Adjustment to suspense account:						
Opening balance	....	....	11	7	10	11
Addition to account	....	....	....	3	1	....
Reduction to account	....	....	(4)	....	....	....
Opening balance for next year	....	....	7	10	11	....
Amount deductible:						
Initial year adjustment	....	....	(5)	....	....	....
Amount of deductible as actual coupon redemptions during redemption period	....	....	7	10	12	....
Adjustment for increase in suspense account	....	....	....	(3)	(1)	....
Adjustment for decrease in suspense account	....	....	4	....	....	....
Net amount deductible for the year for coupons redeemed during the redemption period	....	....	6	7	11	....

(f) *Subchapter C transactions*—(1) *General rule.* If a transfer of substantially all the assets of a trade or business in which discount coupons are redeemed is made to an acquiring corporation, and if the acquiring corporation determines its bases in these assets, in whole or part, with reference to the basis of these assets in the hands of the transferor, then for the purposes of section 466(e) the principles of section 381 and § 1.381(c)(4)–1 will apply. The application of this rule is not limited to the transactions described in section 381(a). Thus, the rule also applies, for example, to transactions described in section 351.

(2) *Special rules.* If, in the case of a transaction described in paragraph (f)(1) of this section, an acquiring corporation acquires assets that were used in a trade or business that was not subject to a section 466 election from a transferor that is owned or controlled directly (or indirectly through a chain of corporations) by the same interests, and if the acquiring corporation uses the acquired assets in a trade or business for which the acquiring corporation later makes an election to use section 466, then the acquiring corporation must establish a suspense account by taking into account not only its own experience but also the transferor's experience when the transferor held the assets in its trade or business. Furthermore, the transferor is not allowed a deduction for qualified discount coupons redeemed after the date of the transfer attributable to discount coupons issued by the transferor before the date of the transfer. Such redemptions shall be considered to be made by the acquiring corporation.

(3) *Example.* The provisions of paragraph (f)(2) of this section may be illustrated by the following example:

Example. Corporation S, a calendar year taxpayer, is a wholly owned subsidiary of Corporation P, a calendar year taxpayer. On December 31, 1982, S acquires from P sustantially all of the assets used in a trade or business in which qualified disount coupons are redeemed. P had not made an election under section 466 with respect to the redemption costs of the qualified discount coupons issued in connection with that trade or business. S makes an election to use section 466 for its taxable year ending December 31, 1983, for the trade or business in which the acquired assets are used, and selects a redemption period of 6 months. Assume that P's qualified discount coupon redemption costs in the first 6 months of 1981 and 1982 were $120 and $140 respectively. Assume further that S's qualified discount coupon redemption costs in the first 6 months of 1983 were $130, and that there are no accounting change adjustments that increase income with respect to the election. S must establish a suspense account by taking into account the largest dollar amount of deductions that would have been allowed under section 466(a)(1) for the 3 immediately preceding taxable years of P, including both P's and S's experience with respect to costs actually incurred during the redemption periods relating to those years. Thus, the initial opening balance of S's suspense account is $140. S must also make an initial year adjustment of $10 ($140–$130), which S must include in income for S's taxable year ending December 31, 1983. P may not take a deduction for the qualified coupon redemptions made after December 31, 1982, that are attributable to coupons issued by P before December 31, 1982. Thus, none of the $130 qualified discount coupon redemption costs incurred by S during the first six months of 1983 may be deducted by P.

[T.D. 8022, 50 FR 18474, May 1, 1985, as amended at 50 FR 21046, May 22, 1985]

§1.466–2 Special protective election for certain taxpayers.

(a) *General rule.* Section 373(c) of the Revenue Act of 1978 (92 Stat. 2865) allows certain taxpayers, who in prior years have accounted for discount coupons under a method of accounting reasonably similar to the method described in §1.451–4, to elect to treat that method of accounting as a proper one for those prior years. There are several differences between this protective election and the section 466(d) election. First, the protective election applies only to a single continuous period of taxable years the last year of which ends before January 1, 1979. Second, an otherwise qualifying protective election may apply to coupons which are discount coupons but which would not be treated as qualified discount coupons under Code section 466. Third, certain expenses such as the cost of redemption center service fees, and amounts that are payable to the retailer (or other person redeeming the coupons from the person receiving the price discount) for services in redeeming the coupons but that are not stated on the coupon, can be subtracted from gross receipts for prior years covered by a protective election (if treated as deductible under the accounting method for such years), even though such expenses would not be deductible under Code section 466.

(b) *Requirements.* In order to qualify for this special protective election, the following conditions must be met:

(1) For a continuous period of one or more prior taxable years, (the last year of which ends before Jan. 1, 1979), the taxpayer must have used a method of accounting for discount coupons that is reasonably similar to the method provided in §1.451–4 or its predecessors under the Internal Revenue Code of 1954;

(2) The taxpayer must make an election under section 466 of the Internal Revenue Code of 1954 according to the rules contained in §1.466–3 for its first taxable year ending after December 31, 1978; and

(3) The taxpayer must make an election under section 373(c) of the Revenue Act of 1978 according to the rules contained in §1.466–4 for its first taxable year ending after December 31, 1978.

(c) *Amount to be subtracted from gross receipts.* The amount the taxpayer may subtract under this section for the redemption costs of coupons shall include only:

(1) Costs of the type permitted by §1.451–4 to be included in the estimated average cost of redeeming coupons, plus

(2) Any amount designated or referred to on the coupon payable by the taxpayer to the person who allowed the discount on a sale by such person to the user of the coupon.

Nothing in this paragraph shall allow an item to be deducted more than once.

(d) *Right to amend prior tax returns.* This paragraph applies only to those taxpayers who have agreed in a prior year to discontinue the use of the method of accounting described in §1.451–4 for discount coupon redemptions. If the taxpayer used such method of accounting on the original return filed for the prior taxable year, and if any such year is not closed under the statute of limitations or by reason of a closing agreement with the Internal Revenue Service, a taxpayer who has made a protective election may file an amended return and a claim for refund for such years. In this amended return, the taxpayer should account for its discount coupon redemptions, according to the method of accounting described in §1.451–4. This is not to be construed, however, to abrogate in any way the rules regarding the close of taxable years due to the statute of limitations or a binding closing agreement between the Internal Revenue Service and the taxpayer.

(e) *Suspense account not required.* If the following three conditions are satisfied, the taxpayer need not establish the suspense account otherwise required by section 466(e). First, the taxpayer must make a timely election under these rules to protect prior years. Second, the method of accounting used in those years must have been used for all discount coupons issued by the taxpayer in those years in all the taxpayer's separate trades or businesses in which coupons were issued. Third, either before or after an amendment to the taxpayer's tax returns as described in paragraph (d) of this section, a method of accounting reasonably similar to the method of accounting described in §1.451–4 must have been used for the taxable year ending on or before December 31, 1978. If these conditions are met, the taxpayer will treat the election of the method under section 466 as a change in method of accounting to which the rules in section 481 and the regulations thereunder apply.

(f) *Definition: reasonably similar.* For purposes of paragraphs (b)(1) and (e) of this section, a taxpayer will be considered to have used a method of accounting for discount coupons that is ''reasonably similar'' to the method of accounting provided in §1.451–4 if the taxpayer followed the method of accounting described in §1.451–4 as if that method were a valid method of accounting for discount coupon redemptions.

[T.D. 8022, 50 FR 18476, May 1, 1985]

§1.466–3 Manner of and time for making election under section 466.

(a) *In general.* Section 466 provides a special method of accounting for accrual basis taxpayers who issue qualified discount coupons (as defined in section 466(b)). In order to use the special method under section 466, a taxpayer must make an election with respect to the trade or business in connection with which the qualified discount coupons are issued. If a taxpayer issues qualified discount coupons in connection with more than one trade or business, the taxpayer may use the special method of accounting under section 466 only with respect to the qualified discount coupons issued in connection with a trade or business for which an election is made. The election must be made in the manner prescribed in this section. The election does not require the prior consent of the Internal Revenue Service. An election under section 466 is effective for the taxable year for which it is made and for all subsequent taxable years, unless the taxpayer secures the prior consent of the Internal Revenue Service to revoke such election.

(b) *Manner of and time for making election*—(1) *General rule.* Except as provided in paragraph (b)(2) of this section, an election is made under section 466 and this section by filing a statement of election containing the information described in paragraph (c) of this section with the taxpayer's income tax return for the taxpayer's first taxable year for which the election is made. The election must be made not later than the time prescribed by law (including extensions thereof) for filing the income tax return for the first taxable year for which the election is made. Thus, the election may not be made for a taxable year by filing an amended income tax return after the time prescribed (including extensions) for filing the original return for such year.

(2) *Transitional rule.* If the last day of the time prescribed by law (including extensions thereof) for filing a taxpayer's income tax return for the taxpayer's first taxable year ending after December 31, 1978, falls before December 3, 1979, and the taxpayer does not make an election under section 466 with respect to such taxable year in the manner prescribed by paragraph (b)(1) of this section, an election is made under section 466 and this section with respect to such taxable year if—

(i) Within the time prescribed by law (including extensions thereof) for filing the taxpayer's income tax return for such taxable year, the taxpayer has made a reasonable effort to notify the Commissioner of the taxpayer's intent to make an election under section 466 with respect to such taxable year, and

(ii) Before January 2, 1980, the taxpayer files a statement of election containing the information described in paragraph (c) of this section to be associated with the taxpayer's income tax return for such taxable year.

For purposes of paragraph (b)(2)(i) of this section, a reasonable effort to notify the Commissioner of an intent to make an election under section 466 with respect to a taxable year includes the timely filing of an income tax return for such taxable year if the taxable income reported on the return reflects a deduction for the redemption costs of qualified discount coupons as determined under section 466(a).

(c) *Required information.* The statement of election required by paragraph (b) of this section must indicate that the taxpayer (identified by name, address, and taxpayer identification number) is making an election under section 466 and must set forth the following information:

(1) A description of each trade or business for which the election is made;

(2) The first taxable year for which the election is made;

(3) The redemption period (as defined in section 466(c)(2)) for each trade or business for which the election is made;

(4) If the taxpayer is required to establish a suspense account under section 466(e) for a trade or business for which the election is made, the initial opening balance of such account (as defined in section 466(e)(2)) for each such trade or business; and

(5) In the case of an election under section 466 that results in a net increase in taxable income under section 481(a)(2), the amount of such net increase.

The statement of election should be made on a Form 3115, which need contain no information other than that required by this paragraph or paragraph (c) of §1.466–4.

[T.D. 8022, 50 FR 18477, May 1, 1985]

§1.466–4 Manner of and time for making election under section 373(c) of the Revenue Act of 1978.

(a) *In general.* Section 373(c)(2) of the Revenue Act of 1978 (92 Stat. 2865) provides an election for taxpayers who satisfy the requirements of section 373(c)(2)(A) (i) and (ii) of the Act. The election is made with respect to a method of accounting for the redemption costs of discount coupons used by the electing taxpayer in a continuous period of one or more taxable years ending before January 1, 1979. The election must be made in the manner prescribed by this section. The election does not require the prior consent of the Internal Revenue Service.

(b) *Manner of and time for making election*—(1) *General rule.* Except as provided in paragraph (b)(2) of this section, the election under section 373(c) of the Revenue Act of 1978 is made by filing a statement of election containing the information described in paragraph (c) of this section with the taxpayer's income tax return for the taxpayer's first taxable year ending after December 31, 1978. The election must be made not later than the time prescribed by law (including extensions thereof) for filing the income tax return for the taxpayer's first taxable year ending after December 31, 1978. Thus, the election may not be made with an amended income tax return for such year filed after the time prescribed (including extensions) for filing the original return.

(2) *Transitional rule.* If the last day of the time prescribed by law (including extensions thereof) for filing a taxpayer's income tax return for the taxpayer's first taxable year ending after December 31, 1978, falls before December 3, 1979, and the taxpayer does not make an election in the manner prescribed by paragraph (b)(1) of this section, an election is made under section 373(c) of the Act and this section with respect to a continuous period if—

(i) Within the time prescribed by law (including extensions thereof) for filing the taxpayer's income tax return for the taxpayer's first taxable year ending after December 31, 1978, the taxpayer has made a reasonable effort to notify the Commissioner of the taxpayer's intent to make election under section 373(c) of the Act with respect to the continuous period, and

(ii) Before January 2, 1980, the taxpayer files a statement of election containing the information described in paragraph (c) of this section to be associated with the taxpayer's income tax return for the taxpayer's first taxable year ending after December 31, 1978.

(c) *Required information.* The statement of election required by paragraph (b) of this section must indicate that the taxpayer (identified by name, address, and taxpayer identification number) is making an election under section 373(c) of the Revenue Act of 1978 and must set forth the taxable years in the continuous period for which the election is made. The statement of election should be made on the same form 3115 on which the taxpayer has made a statement of election under section 466. The Form 3115 need contain no information other than that required by this paragraph or paragraph (c) of § 1466–3.

[T.D. 8022, 50 FR 18478, May 1, 1985]

§ 1.468A–0 Nuclear decommissioning costs; table of contents.

This section lists the paragraphs contained in §§ 1.468A–1 through 1.468A–8.

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[T.D. 8184, 53 FR 6804, Mar. 3, 1988, as amended by T.D. 8461, 57 FR 62199, Dec. 30, 1992; T.D. 8580, 59 FR 66473, Dec. 27, 1994]

§1.468A–1 Nuclear decommissioning costs; general rules.

(a) *Introduction.* Section 468A provides an elective method for taking into account nuclear decommissioning costs for Federal income tax purposes. In general, an eligible taxpayer that elects the application of section 468A pursuant to the rules contained in §1.468A–7 is allowed a deduction (as determined under §1.468A–2) for the taxable year in which the taxpayer makes a cash payment to a nuclear decommissioning fund. Taxpayers using an accrual method of accounting that do not elect the application of section 468A are not allowed a deduction for nuclear decommissioning costs prior to the taxable year in which economic performance occurs with respect to such costs (see section 461(h)).

(b) *Definitions.* The following terms are defined for purposes of section 468A and the regulations thereunder:

(1) The term *eligible taxpayer* means any taxpayer that possesses a qualifying interest in a nuclear power plant (including a nuclear power plant that is under construction).

(2) The term *qualifying interest* means—

(i) A direct ownership interest; and

(ii) A leasehold interest in any portion of a nuclear power plant if—

(A) The holder of the leasehold interest is subject to the jurisdiction of a public utility commission with respect to such portion of the nuclear power plant;

(B) The holder of the leasehold interest is primarily liable under Federal or State law for decommissioning such portion of the nuclear power plant; and

(C) No other person establishes a nuclear decommissioning fund with respect to such portion of the nuclear power plant.

A direct ownership interest includes an interest held as a tenant in common or joint tenant, but does not include stock in a corporation that owns a nuclear power plant or an interest in a partnership that owns a nuclear power plant. Thus, in the case of a partnership that owns a nuclear power plant, the election under section 468A must be made by the partnership and not by the partners. In the case of an unincorporated organization described in § 1.761–2(a)(3) that elects under section 761(a) to be excluded from the application of subchapter K, each taxpayer that is a co-owner of the nuclear power plant is eligible to make a separate election under section 468A.

(3) The terms *nuclear decommissioning fund* and *qualified nuclear decommissioning fund* mean a fund that satisfies the requirements of § 1.468A–5. The term *nonqualified decommissioning fund* means a fund that does not satisfy those requirements.

(4) The term *nuclear power plant* means any nuclear power reactor that is used predominantly in the trade or business of the furnishing or sale of electric energy, if the rates for the furnishing or sale, as the case may be, either have been established or approved by a public utility commission or are under the jurisdiction of the Rural Electrification Administration. Each unit (i.e., nuclear reactor) located on a multi-unit site is a separate nuclear power plant. The term *nuclear power plant* also includes the portion of the common facilities of a multi-unit site allocable to a unit on that site.

(5) The term *nuclear decommissioning costs* or *decommissioning costs* means all otherwise deductible expenses to be incurred in connection with the entombment, decontamination, dismantlement, removal and disposal of the structures, systems and components of a nuclear power plant that has permanently ceased the production of electric energy. Such term includes all otherwise deductible expenses to be incurred in connection with the preparation for decommissioning, such as engineering and other planning expenses, and all otherwise deductible expenses to be incurred with respect to the plant after the actual decommissioning occurs, such as physical security and radiation monitoring expenses. Such term does not include otherwise deductible expenses to be incurred in connection with the disposal of spent nuclear fuel under the Nuclear Waste Policy Act of 1982 (Pub. L. 97–425). An expense is otherwise deductible for purposes of this paragraph (b)(5) if it would be deductible under chapter 1 of the Internal Revenue Code without regard to section 280B.

(6) The term *public utility commission* means any State or political subdivision thereof, any agency, instrumentality or judicial body of the United States, or any judicial body, commission or other similar body of the District of Columbia or of any State or any political subdivision thereof that establishes or approves rates for the furnishing or sale of electric energy.

(7) The term *ratemaking proceeding* means any proceeding before a public utility commission in which rates for the furnishing or sale of electric energy are established or approved. Such term includes a generic proceeding that applies to two or more taxpayers that are subject to the jurisdiction of a single public utility commission.

(c) *Special rules applicable to certain experimental nuclear facilities.* (1) The owner of a qualifying interest in an experimental nuclear facility possesses a qualifying interest in a nuclear power plant for purposes of paragraph (b) of this section if—

(i) Such person is engaged in the trade or business of the furnishing or sale of electric energy;

(ii) The rates charged for electric energy furnished or sold by such person are established or approved by a public utility commission; and

(iii) The cost of decommissioning the facility is included in the cost of service of such person.

(2) An owner of stock in a corporation that owns an experimental nuclear facility possesses a qualifying interest in a nuclear power plant for purposes of paragraph (b)(1) of this section if—

(i) Such stockholder satisfies the conditions of paragraph (c)(1) (i) through (iii) of this section; and

(ii) The corporation that directly owns the facility is not engaged in the trade or business of the furnishing or sale of electric energy.

(3) For purposes of this paragraph (c), an experimental nuclear facility is a nuclear power reactor that is used predominantly for the purpose of conducting experimentation and research.

(d) *Special rules for electing taxpayers whose rates are under the jurisdiction of the Rural Electrification Administration.* Notwithstanding any other provision of the regulations under section 468A, a schedule of ruling amounts may be provided to a taxpayer with respect to a nuclear power plant if the rates for the furnishing or sale of the plant's electricity are under the jurisdiction of the Rural Electrification Administration. This schedule will be determined on the basis of all facts and circumstances in a manner consistent with section 468A. No taxpayer will be provided a schedule of ruling amounts under section 468A for any taxable year unless the portion of the rates attributable to the decommissioning costs of that taxpayer with respect to such taxable year are treated by the taxpayer as though they were subject to section 88.

[T.D. 8184, 53 FR 6805, Mar. 3, 1988, as amended by T.D. 8461, 57 FR 62199, Dec. 30, 1992; T.D. 8580, 59 FR 66473, Dec. 27, 1994]

§1.468A–2 Treatment of electing taxpayer.

(a) *In general.* An eligible taxpayer that elects the application of section 468A pursuant to the rules contained in §1.468A–7 (an ‘‘electing taxpayer’’) is allowed a deduction for the taxable year in which the taxpayer makes a cash payment (or is deemed to make a cash payment as provided in paragraph (c) of this section) to a nuclear decommissioning fund. The amount of the deduction for any taxable year equals the total amount of cash payments made (or deemed made) by the electing taxpayer to a nuclear decommissioning fund (or nuclear decommissioning funds) during such taxable year. A payment may not be made (or deemed made) to a nuclear decommissioning fund before the first taxable year in which all of the following conditions are satisfied:

(1) The construction of the nuclear power plant to which the nuclear decommissioning fund relates has commenced.

(2) Nuclear decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates are included in the taxpayer's cost of service for ratemaking purposes (see paragraph (b) of this section).

(3) A ruling amount is applicable to the nuclear decommissioning fund (see §1.468A–3).

(b) *Limitation on payments to a nuclear decommissioning fund*—(1) *In general.* For purposes of paragraph (a) of this section, the maximum amount of cash payments made (or deemed made) to a nuclear decommissioning fund during any taxable year shall not exceed the lesser of:

(i) The cost of service amount applicable to the nuclear decommissioning fund for such taxable year (as defined in paragraph (b)(2) of this section); or

(ii) The ruling amount applicable to the nuclear decommissioning fund for such taxable year (as determined under §1.468A–3).

If the amount of cash payments made (or deemed made) to a nuclear decommissioning fund during any taxable year exceeds the limitation of this paragraph (b)(1), the excess is not deductible by the electing taxpayer. In addition, see paragraph (c) of §1.468A–5 for rules which provide that the Internal Revenue Service may disqualify a nuclear decommissioning fund if the amount of cash payments made (or deemed made) to a nuclear decommissioning fund during any taxable year exceeds the limitation of this paragraph (b)(1).

(2) *Cost of service amount.* (i) For purposes of section 468A and the regulations thereunder, the ‘‘cost of service amount applicable to a nuclear decommissioning fund for a taxable year’’ is the amount of decommissioning costs included in the electing taxpayer's cost of service for ratemaking purposes for such taxable year. Decommissioning costs are included in cost of service for a taxable year only to the extent such costs are directly or indirectly charged to customers of the taxpayer by reason of electric energy consumed during such taxable year or are otherwise required to be included in the taxpayer's income under section 88 and the regulations thereunder.

(ii) Except as otherwise provided in paragraph (b)(4)(i) of §1.468A–8 (relating to a special transitional rule), decommissioning costs shall generally not be considered included in cost of service for purposes of this section unless—

(A) The order or opinion of the applicable public utility commission identifies the amount of decommissioning costs that is included in cost of service for ratemaking purposes; or

(B) The written records of the ratemaking proceeding clearly and unambiguously indicate the amount of decommissioning costs that is included in cost of service for ratemaking purposes.

(iii) Except as otherwise provided in paragraph (f)(2) of this section (relating to a special rule that applies to certain retroactive adjustments to interim rate orders), orders or opinions of a public utility commission that are issued after the close of any taxable year shall not be considered in determining the amount of decommissioning costs included in cost of service for such taxable year.

(iv) If a taxpayer possesses a qualifying interest in two or more nuclear power plants that are the subject of a single ratemaking proceeding, the amount of decommissioning costs included in cost of service pursuant to such ratemaking proceeding must be allocated among such nuclear power plants. Such allocation must be reasonable and consistent, and must take into account the assumptions and determinations, if any, used by the public utility commission in establishing or approving the amount of decommissioning costs included in cost of service.

(c) *Deemed payment rules.* (1) The amount of any cash payment made by an electing taxpayer to a nuclear decommissioning fund on or before the 15th day of the third calendar month after the close of any taxable year (the ‘‘deemed payment deadline date’’) shall be deemed made during such taxable year if the electing taxpayer irrevocably designates the amount as relating to such taxable year on its timely filed Federal income tax return for such taxable year (see paragraph (b)(4)(iv) of § 1.468A–7 for rules relating to such designation).

(2) The amount of any cash payment made by a customer of an electing taxpayer to a nuclear decommissioning fund of such electing taxpayer shall be deemed made by the electing taxpayer if the amount is included in the gross income of the electing taxpayer in the manner prescribed by section 88 and § 1.88–1.

(d) *Treatment of distributions*—(1) *In general.* Except as otherwise provided in paragraph (d)(2) of this section, the amount of any actual or deemed distribution from a nuclear decommissioning fund shall be included in the gross income of the electing taxpayer for the taxable year in which the distribution occurs. The amount of any distribution of property equals the fair market value of the property on the date of the distribution. A distribution from a nuclear decommissioning fund shall include an expenditure from the fund or the use of the fund's assets—

(i) To satisfy, in whole or in part, the liability of the electing taxpayer for decommissioning costs of the nuclear power plant to which the fund relates; and

(ii) To pay administrative costs and other incidental expenses of the fund.

See paragraphs (c) and (d) of § 1.468A–5 for rules relating to the deemed distribution of the assets of a nuclear decommissioning fund in the case of a disqualification or termination of the fund.

(2) *Exceptions to inclusion in gross income*—(i) *Payment of administrative costs and incidental expenses.* The amount of any payment by a nuclear decommissioning fund for administrative costs or other incidental expenses of such fund (as defined in paragraph (a)(3)(ii) of § 1.468A–5) shall not be included in the gross income of the electing taxpayer unless such amount is paid to the electing taxpayer (in which case the amount of the payment is included in the gross income of the electing taxpayer under section 61).

(ii) *Withdrawals of excess contributions.* The amount of a withdrawal of an excess contribution (as defined in paragraph (c)(2)(ii) of § 1.468A–5) by an electing taxpayer pursuant to the rules of paragraph (c)(2) of § 1.468A–5 shall not be included in the gross income of the electing taxpayer. See paragraph (b)(1) of this section, which provides that the payment of such amount to the nuclear decommissioning fund is not deductible by the electing taxpayer.

(iii) *Actual distributions of amounts included in gross income as deemed distributions.* If the amount of a deemed distribution is included in the gross income of the electing taxpayer for the taxable year in which the deemed distribution occurs, no further amount is required to be included in gross income when the amount of the deemed distribution is actually distributed by the nuclear decommissioning fund. The amount of a deemed distribution is actually distributed by a nuclear decommissioning fund as the first actual distributions are made by the nuclear decommissioning fund on or after the date of the deemed distribution.

(e) *Deduction when economic performance occurs.* An electing taxpayer using an accrual method of accounting is allowed a deduction for nuclear decommissioning costs no earlier than the taxable year in which economic performance occurs with respect to such costs (see section 461 (h)(2)). The amount of nuclear decommissioning costs that is deductible under this paragraph (e) is determined without regard to section 280B (see paragraph (b)(5) of §1.468A–1). A deduction is allowed under this paragraph (e) whether or not a deduction was allowed with respect to such costs under section 468A(a) and paragraph (a) of this section for an earlier taxable year (see paragraph (a)(2) of §1.468A–8, however, for the effective date applicable to this paragraph (e)).

(f) *Effect of interim rate orders and retroactive adjustments to such orders*—(1) *In general.* (i) The amount of decommissioning costs included in cost of service for any taxable year that ends before the date of a retroactive adjustment to an interim rate order or interim determination of a public utility commission shall include amounts authorized pursuant to such interim rate order or interim determination unless a taxpayer elects the application of paragraph (f)(2) of this section for such taxable year. For purposes of this paragraph (f), a retroactive adjustment occurs on the effective date of the revised rate schedule that implements the retroactive adjustment.

(ii) If a retroactive adjustment to an interim rate order or interim determination reduces the amount of decommissioning costs included in cost of service for one or more taxable years ending before the date of the adjustment, the amount of such reduction must be subtracted from the amount of decommissioning costs included in cost of service (as determined under paragraph (b)(2) of this section) for one or more taxable years ending on or after the date of the adjustment. For this purpose, the amount of such reduction must be taken into account in the following manner:

(A) If the retroactive adjustment reduces the amount of decommissioning costs included in cost of service for one taxable year ending before the date of the adjustment, the total amount of the reduction must be taken into account for the taxable year that includes the date of the adjustment.

(B) If the retroactive adjustment reduces the amount of decommissioning costs included in cost of service for two taxable years ending before the date of the adjustment, at least one-half of the total amount of the reduction must be taken into account for the first taxable year ending on or after the date of the adjustment and the total amount of the reduction must be taken into account over the first two taxable years ending on or after the date of the adjustment.

(C) If the retroactive adjustment reduces the amount of decommissioning costs included in cost of service for three or more taxable years ending before the date of the adjustment, at least one-third of the total amount of the reduction must be taken into account for the first taxable year ending on or after the date of the adjustment, at least two-thirds of the total amount of the reduction must be taken into account over the first two taxable years ending on or after the date of the adjustment, and the total amount of the reduction must be taken into account over the first three taxable years ending on or after the date of the adjustment.

(2) *Special rule permitting withdrawal of excess contribution that results from retroactive adjustment to interim rate order.* (i) If a retroactive adjustment that reduces the amount of decommissioning costs included in cost of service for a taxable year occurs on or before

the date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for such taxable year, a taxpayer may elect the application of this paragraph (f)(2) for such taxable year by—

(A) Including in the amount of decommissioning costs included in cost of service for such taxable year only the amount of decommissioning costs authorized for such taxable year under the retroactive adjustment; and

(B) Withdrawing any excess contribution that results from such treatment in accordance with the rules of paragraph (c)(2) of § 1.468A–5.

(ii) If a taxpayer elects the application of this paragraph (f)(2) for any taxable year, the retroactive adjustment shall not be treated for purposes of paragraph (f)(1)(ii) of this section as a reduction in the amount of decommissioning costs included in cost of service for such taxable year.

(3) *Revised schedule of ruling amounts.* (i) If the rules provided in this paragraph (f) result in a cost of service amount applicable to a nuclear decommissioning fund for any taxable year that is less than the cost of service amount applicable to the nuclear decommissioning fund for the immediately preceding taxable year, the taxpayer must request a revised schedule of ruling amounts on or before the deemed payment deadline date for the taxable year in which the retroactive adjustment occurs. The first taxable year to which the revised schedule of ruling amount applies shall be the taxable year in which the retroactive adjustment occurs.

(ii) The requirement of this paragraph (f)(3) does not apply if the taxpayer determines its schedule of ruling amounts under a formula or method obtained under § 1.468A–3(a)(4) and the cost of service amount is a variable element of that formula or method.

(4) *Example.* The following example illustrates the application of the principles of this paragraph (f):

Example. (i) X corporation is a calendar year, accrual method taxpayer engaged in the sale of electric energy generated by a nuclear power plant owned by X. During 1989, X is authorized pursuant to an interim rate order issued by the public utility commission of State A to collect nuclear decommissioning costs of $500,000 per year beginning on January 1, 1990. On May 1, 1992, the public utility commission of State A issues a final rate order that is effective on July 1, 1992. The final rate order authorizes X to collect decommissioning costs of $400,000 per year and requires X to refund to the ratepayers of State A excess decommissioning costs of $250,000 collected between January 1, 1990, and July 1, 1992.

(ii) If X elects the application of paragraph (f)(2) of this section for the 1991 taxable year, the amount of decommissioning costs included in cost of service for such taxable year is $400,000. If X made a contribution of $500,000 to a nuclear decommissioning fund for the 1991 taxable year, X must withdraw $100,000 from the nuclear decommissioning fund on or before the date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for the 1991 taxable year (see paragraph (c)(2) of § 1.468A–5).

(iii) In addition, under paragraph (f)(1)(i) of this section, the amount of decommissioning costs included in cost of service for the 1990 taxable year is $500,000, and, under paragraph (f)(1)(ii) of this section, the amount of decommissioning costs included in cost of service for the 1992 taxable year is $300,000. Because the cost of service amount for the 1991 taxable year ($400,000) is less than the cost of service amount for the 1990 taxable year ($500,000), paragraph (f)(3) of this section applies and X must file a request for a revised schedule of ruling amounts for the period beginning with the 1992 taxable year on or before March 15, 1993.

(iv) Alternatively, if X does not elect the application of paragraph (f)(2) section, the amount of decommissioning costs included in cost of service for the 1990 and 1991 taxable years is $500,000, and, under paragraph (f)(1)(ii) of this section, the amount of decommissioning costs included in cost of service for the 1992 taxable year may not exceed $300,000. Because the cost of service amount for the 1992 taxable year is less than the cost of service amount for the 1991 taxable year, paragraph (f)(3) of this section applies and X must file a request for a revised schedule of ruling amounts for the period beginning with the 1992 taxable year on or before March 15, 1993.

[T.D. 8184, 53 FR 6806, Mar. 3, 1988, as amended by T.D. 8461, 57 FR 62199, Dec. 30, 1992; T.D. 8758, 63 FR 2894, Jan. 20, 1998]

§ 1.468A–3 Ruling amount.

(a) *In general.* (1) Except as otherwise provided in paragraph (j) of this section, an electing taxpayer is allowed a deduction under section 468A(a) for the taxable year in which the taxpayer makes a cash payment (or is deemed to make a cash payment) to a nuclear decommissioning fund only if the taxpayer has received a schedule of ruling amounts for the nuclear decommissioning fund that includes a ruling amount for such taxable year. Except as provided in paragraph (a) (4) or (5) of this section, a schedule of ruling amounts for a nuclear decommissioning fund (''schedule of ruling amounts'') is a ruling (within the meaning of paragraph (a)(2) of §601.201) specifying the annual payments (''ruling amounts'') that, over the taxable years remaining in the ''funding period'' as of the date the schedule first applies, will result in a projected balance of the nuclear decommissioning fund as of the last day of the funding period equal to (and in no event greater than) the ''amount of decommissioning costs allocable to the fund.'' The projected balance of a nuclear decommissioning fund as of the last day of the funding period shall be calculated by taking into account the fair market value of the assets of the fund as of the first day of the first taxable year to which the schedule of ruling amounts applies and the estimated rate of return to be earned by the assets of the fund after payment of the estimated administrative costs and incidental expenses to be incurred by the fund (as defined in paragraph (a)(3)(ii) of §1.468A–5), including all Federal, State and local income taxes to be incurred by the fund (the ''after-tax rate of return''). See paragraph (c) of this section for a definition of funding period and paragraph (d) of this section for guidance with respect to the amount of decommissioning costs allocable to a fund.

(2) To the extent consistent with the principles and provisions of this section, each schedule of ruling amounts shall be based on the reasonable assumptions and determinations used by the applicable public utility commission(s) in establishing or approving the amount of decommissioning costs to be included in cost of service for ratemaking purposes, taking into account amounts that are otherwise required to be included in the taxpayer's income under section 88 and the regulations thereunder. Thus, for example, each schedule of ruling amounts shall be based on the public utility commission's reasonable assumptions concerning—

(i) The after-tax rate of return to be earned by the amounts collected for decommissioning;

(ii) The total estimated cost of decommissioning the nuclear power plant (see paragraph (d)(2) of this section); and

(iii) The frequency of contributions to a nuclear decommissioning fund for a taxable year (*e.g.,* monthly, quarterly, semi-annual or annual contributions).

(3) The Internal Revenue Service shall provide a schedule of ruling amounts that is identical to the schedule of ruling amounts proposed by the taxpayer in connection with the taxpayer's request for a schedule of ruling amounts (see paragraph (h)(2)(viii) of this section), but no schedule of ruling amounts shall be provided unless the taxpayer's proposed schedule of ruling amounts is consistent with the principles and provisions of this section. If a proposed schedule of ruling amounts is not consistent with the principles and provisions of this section, the taxpayer may propose an amended schedule of ruling amounts that is consistent with such principles and provisions.

(4) The Internal Revenue Service will approve, at the request of the taxpayer, a formula or method for determining a schedule of ruling amounts (rather than a schedule specifying a dollar amount for each taxable year) that is consistent with the principles and provisions of this section. See paragraph (i)(1)(ii) of this section for a special rule relating to the mandatory review of ruling amounts that are determined pursuant to a formula or method.

(5) The Internal Revenue Service may, in its discretion, provide a schedule of ruling amounts that is determined on a basis other than the rules of paragraphs (a) through (g) of this section if—

(i) In connection with its request for a schedule of ruling amounts, the taxpayer explains the need for special treatment and sets forth an alternative basis for determining the schedule of ruling amounts; and

(ii) The Internal Revenue Service determines that special treatment is consistent with the purpose of section 468A.

(b) *Level funding limitation.* (1) Except as otherwise provided in paragraph (b)(4) of this section and paragraph (b)(6) of § 1.468A–8 (relating to a special transitional rule), the ruling amount specified in a schedule of ruling amounts for any taxable year in the level funding limitation period shall not be less than the ruling amount specified in such schedule for any earlier taxable year.

(2) For purposes of this section, the level funding limitation period for a nuclear decommissioning fund is the period that—

(i) Begins on the first day of the first taxable year for which a deductible payment is made (or deemed made) to such nuclear decommissioning fund (see paragraph (a) of § 1.468A–2 for rules relating to the first taxable year for which a payment may be made (or deemed made) to a nuclear decommissioning fund); and

(ii) Ends on the last day of the taxable year that includes the estimated date on which the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base for ratemaking purposes (see paragraphs (e) (2) and (4) of this section).

(3) The ruling amount specified in a schedule of ruling amounts for a taxable year after the end of the level funding limitation period may be less than the ruling amount specified in such schedule for an earlier taxable year.

(4) The ruling amount specified in a schedule of ruling amounts for the last taxable year in the level funding limitation period may be less than the ruling amount specified in such schedule for any earlier taxable year if the applicable public utility commission assumes for cost of service purposes that decommissioning costs will be included in cost of service for only a portion of the last taxable year in the level funding limitation period. The ruling amount for the last taxable year in the level funding limitation period, however, may not be less than the amount that bears the same relationship to the ruling amount for the preceding taxable year as the period for which decommissioning costs will be included in cost of service for such last taxable year bears to one year.

(c) *Funding period*—(1) *General rule.* For purposes of this section, the funding period for a nuclear decommissioning fund is the period that—

(i) Begins on the first day of the first taxable year for which a deductible payment is made (or deemed made) to such nuclear decommissioning fund (see paragraph (a)(1) § 1.468A–2 for rules relating to the first taxable year for which a payment may be made (or deemed made) to a nuclear decommissioning fund); and

(ii) Ends on the later of—

(A) The last day of the taxable year that includes the estimated date on which decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's cost of service for ratemaking purposes (see paragraph (e)(1) of this section); or

(B) The last day of the taxable year that includes the estimated date on which the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base for ratemaking purposes (see paragraph (e)(2) of this section).

(2) *Examples.* The following examples illustrate the application of the principles of paragraphs (a), (b) and (c) of this section:

Example (1). (i) X corporation is a calendar year, accrual method taxpayer engaged in the sale of electric energy generated by power plants owned by X. On March 15, 1995, X commences the construction of a nuclear power plant in State A. On May 15, 1995, the public utility commission of State A issues a final rate order for the four-year period beginning on January 1, 1995, that authorizes X to collect decommissioning costs from ratepayers residing in State A. For the 1995 taxable year, X is authorized to collect decommissioning costs of $500,000, and, for each taxable year during the remainder of the period to which the rate order applies, X is authorized to collect decommissioning costs in an amount equal to 105 percent of the amount authorized to be collected for the preceding taxable year.

(ii) In determining the amount of decommissioning costs to be collected from ratepayers residing in State A, the public utility commission assumes that (A) decommissioning costs will be included in cost of service for each taxable year in the period that begins with 1995 and ends with 2025 and (B) decommissioning costs collected pursuant to subsequent rate orders will increase in the same manner as amounts collected pursuant to the rate order issued on May 15, 1995. In addition, in determining the rate of return to be earned by X with respect to the nuclear power plant, the public utility commission assumes that the nuclear power plant will be included in rate base for each year in the period that begins with 2000 and ends with 2025.

(iii) X requests a schedule of ruling amounts in accordance with the rules of paragraph (h) of this section for the period beginning with the 1995 taxable year. In determining the level funding limitation period and the funding period, the Internal Revenue Service shall assume that a deductible payment will be made to a nuclear decommissioning fund for the 1995 taxable year. Thus, under paragraph (b) of this section, the level funding limitation period begins on January 1, 1995, and ends on December 31, 2025. Under paragraph (c)(1) of this section, the funding period begins on January 1, 1995, and ends on December 31, 2025.

(iv) In its request for a schedule or ruling amounts, X proposes a ruling amount for each taxable year in the funding period that corresponds to the projected cost of service amount for such taxable year. If (A) the assumptions and determinations used by the public utility commission in establishing the amount of decommissioning costs to be included in cost of service are reasonable and (B) the amounts collected pursuant to the proposed schedule, combined with the after-tax earnings on such amounts, will result in a projected balance of the nuclear decommissioning fund as of December 31, 2025, equal to the amount of decommissioning costs allocable to the fund, then, under paragraph (a)(3) of this section, each ruling amount in the initial schedule of ruling amounts shall equal the ruling amount proposed by X in connection with its request for a schedule of ruling amounts. Thus, the ruling amount for the 1995 taxable year would be $500,000, and the ruling amount for each subsequent taxable year would be 105 percent of the ruling amount for the preceding taxable year.

Example (2). (i) Assume the same facts as in Example (1), except that on May 15, 1995, the public utility commission of State A issues a final rate order for the four-year period beginning on January 1, 1995, that authorizes X to collect decommissioning costs of $600,000 per year from ratepayers residing in State A. In determining the amount of decommissioning costs to be collected from ratepayers residing in State A, the public utility commission assumes that decommissioning costs of $600,000 will be collected for each taxable year in the period that begins with 1995 and ends with 2004 and that decommissioning costs of $200,000 will be collected for each taxable year in the period that begins with 2005 and ends with 2025.

(ii) X requests a schedule of ruling amounts in accordance with the rules of paragraph (h) of this section for the period beginning with the 1995 taxable year. In determining the level funding limitation period and the funding period, the Internal Revenue Service shall assume that a deductible payment will be made to a nuclear decommissioning fund for the 1995 taxable year. Thus, under paragraph (b) of this section, the level funding limitation period begins on January 1, 1995, and ends on December 31, 2025. Under paragraph (c)(1) of this section, the funding period begins on January 1, 1995, and ends on December 31, 2025.

(iii) In its request for a schedule of ruling amounts, X proposes a ruling amount for each taxable year in the funding period that corresponds to the projected cost of service amount for such taxable year. A schedule of ruling amounts based on the projected cost of service amount would be inconsistent with the level funding limitation of paragraph (b) of this section because the projected cost of service amount for 2005 is less than the projected cost of service amount for 2004. Consequently, under paragraph (a)(3) of this section, no schedule of ruling amounts shall be provided to X unless X proposes an amended schedule of ruling amounts that is consistent with the level funding limitation and the other principles and provisions of this section.

(iv) Assume that X proposes an amended schedule of ruling amounts that provides for ruling amounts of $400,000 for each taxable year in the funding period. If (A) the schedule of ruling amounts proposed by X is based on the reasonable assumptions and determinations used by the public utility commission in establishing the amount of decommissioning costs to be included in cost of service and (B) the amounts collected pursuant to the proposed schedule, combined with the after-tax earnings on such amounts, will result in a projected balance of the nuclear decommissioning fund as of December 31, 2025, equal to the amount of decommissioning costs allocable to the fund, then, under paragraph (a)(3) of this section, each ruling amount in the initial schedule of ruling amounts shall equal the ruling amount proposed by X in connection with its request for a schedule of ruling amounts. Thus, the ruling amount for the 1995 taxable year and for each subsequent taxable year through 2025 would be $400,000.

(v) Under section 468A(b) and paragraph (b)(1) of §1.468A–2, the maximum amount of cash payments that X can make to a nuclear decommissioning fund for any taxable year shall not exceed the lesser of (A) the cost of service amount for such taxable year or (B) the ruling amount for such taxable year. If the projected cost of service amount that was assumed in determining rates under the rate order that was issued on May 15, 1995, is the actual cost of service amount for each taxable year in the funding period and the ruling amounts provided in the initial schedule of ruling amounts are not changed by a subsequent schedule of ruling amounts, then X would be allowed to make a deductible contribution of $400,000 to a nuclear decommissioning fund for each taxable year in the period that begins with 1995 and ends with 2004 and to make a deductible contribution of $200,000 to such nuclear decommissioning fund for each taxable year in the period that begins with 2005 and ends with 2025.

Example (3). (i) Y corporation is a calendar year, accrual method taxpayer engaged in the sale of electric energy generated by power plants owned by Y. On June 1, 1990, a nuclear power plant owned by Y began commercial operations in State B. In the first ratemaking proceeding in which the nuclear power plant was included in rate base, the public utility commission of State B assumed that the nuclear power plant would be included in rate base for each year in the period that began with 1990 and ended with 2020. In addition, for each taxable year in the period that began with 1990 and ended with 2017, Y made a deductible contribution of $750,000 to a nuclear decommissioning fund established by Y. The $750,000 contribution equalled the cost of service amount and the ruling amount for each taxable year in the 28-year period.

(ii) On August 30, 2017, the public utility commission of State B issues a final rate order for the six-year period beginning on January 1, 2018, that authorizes Y to collect decommissioning costs of: (A) $500,000 for 2018, 2019 and 2020; (B) $1,500,000 for 2021; (C) $1,000,000 for 2022; and (D) $750,000 for 2023. In determining the amount of decommissioning costs to be collected from ratepayers residing in State B, the public utility commission assumes that decommissioning costs will no longer be included in cost of service after 2023. In addition, in determining the rate of return to be earned by Y with respect to the nuclear power plant, the public utility commission assumes that the nuclear power plant will no longer be included in rate base after 2020.

(iii) Under paragraph (i)(1)(iii) of this section, Y is required to request a revised schedule of ruling amounts on or before March 15, 2019. Assume that Y makes a timely request for a revised schedule of ruling amounts in accordance with the rules of paragraph (h) of this section. In its request, Y proposes a ruling amount for each taxable year in the period that begins with 2018 and ends with 2023 that corresponds to the amount of decommissioning costs to be included in cost of service under the rate order of August 30, 2017.

(iv) Under paragraph (b) of this section, the level funding limitation period begins on January 1, 1990, and ends on December 31, 2020. Under paragraph (c)(1) of this section, the funding period begins on January 1, 1990, and ends on December 31, 2023.

(v) If (A) the assumptions and determinations used by the public utility commission in establishing the amount of decommissioning costs to be included in cost of service are reasonable and (B) the projected balance of the nuclear decommissioning fund as of December 31, 2023 (taking into account the fair market value of the assets of the fund as of January 1, 2018, and the estimated after-tax rate of return to be earned by the assets of the fund) will equal the amount of decommissioning costs allocable to the fund, then, under paragraph (a)(3) of this section, each ruling amount in the revised schedule of ruling amounts shall equal the ruling amount proposed by Y in connection with its request for a schedule of ruling amounts. Thus, the ruling amount for 2018, 2019 and 2020 would be $500,000, the ruling amount for 2021 would be $1,500,000, the ruling amount for 2022 would be $1,000,000 and the ruling amount for 2023 would be $750,000.

(vi) Although the ruling amount specified in the revised schedule of ruling amounts for 2018, 2019 and 2020 is less than a ruling amount specified in a prior schedule of ruling amounts for years prior to 2018, the revised schedule of ruling amounts is consistent with the level funding limitation. Under paragraph (i)(3) of this section, a ruling amount specified in a revised schedule of ruling amounts for any taxable year in level funding limitation period may be less than one or more ruling amounts specified in a prior schedule of ruling amounts for a prior taxable year. In addition, although the ruling amount specified in the revised schedule of ruling amounts for 2022 and 2023 is less than a ruling amount specified in such schedule for a prior taxable year, the revised schedule of ruling amounts is consistent with the level funding limitation because the level funding limitation period ends on December 31, 2020.

(d) *Decommissioning costs allocable to a fund.* The amount of decommissioning costs allocable to a nuclear decommissioning fund is determined for purposes of this section by applying the following rules and definitions:

(1) *General rule.* The amount of decommissioning costs allocable to a nuclear decommissioning fund is the taxpayer's share of the total estimated cost of decommissioning the nuclear

power plant to which the fund relates, multiplied by the qualifying percentage.

(2) *Total estimated cost of decommissioning.* (i) Except as otherwise provided in paragraph (d)(2)(ii) of this section, the total estimated cost of decommissioning a nuclear power plant is the reasonably estimated cost of decommissioning used by the applicable public utility commission in establishing or approving the amount of decommissioning costs to be included in cost of service for ratemaking purposes. If, in establishing or approving the amount of decommissioning costs to be included in cost of service, the public utility commission uses an estimated cost of decommissioning that is equal to a generic estimate of the cost of decommissioning as determined by the Nuclear Regulatory Commission (or an estimated cost that is based on the generic estimate adjusted for inflation), the Internal Revenue Service may, at its discretion, accept such amount as a reasonable estimate of the cost of decommissioning. In addition, if the estimated costs used by the applicable public utility commission are expected to be paid in any taxable year other than the taxable year that includes the last day of the funding period or the immediately succeeding taxable year, such costs must be adjusted (increased or decreased, as the case may be) by discounting or compounding such costs at the after-tax rate of return from the date such costs are expected to be paid to the last day of the funding period.

(ii) If, in establishing or approving the amount of decommissioning costs to be included in cost of service, the applicable public utility commission assumes a projected balance of amounts set aside for decommissioning (whether or not such amounts are provided by a nuclear decommissioning fund) that is less than the total estimated cost of decommissioning assumed by the public utility commission, the total estimated cost of decommissioning for purposes of determining the schedule of ruling amounts shall equal the projected balance of amounts set aside for decommissioning that was assumed by the public utility commission.

(3) *Taxpayer's share.* The taxpayer's share of the total estimated cost of decommissioning a nuclear power plant equals the total estimated cost of decommissioning such nuclear power plant multiplied by the percentage of such nuclear power plant that the qualifying interest of the taxpayer represents (see paragraph (b)(2) of §1.468A–1 for circumstances in which a taxpayer possesses a qualifying interest in a nuclear power plant).

(4) *Qualifying percentage.* (i) Except as otherwise provided in paragraph (b)(7)(iii) of §1.468A–8 (relating to a special transitional rule), the qualifying percentage for any nuclear decommissioning fund is equal to the fraction, the numerator of which is the number of taxable years in the estimated period for which the nuclear decommissioning fund is to be in effect and the denominator of which is the number of taxable years in the estimated useful life of the applicable nuclear power plant.

(ii) Except as otherwise provided in paragraph (b)(7) (i) of (ii) of §1.468A–8 (relating to special transitional rules), the estimated period for which a nuclear decommissioning fund is to be in effect—

(A) Begins on the later of—

(*1*) The first day of the first taxable year for which a deductible payment is made (or deemed made) to such nuclear decommissioning fund; or

(*2*) The first day of the taxable year that includes the date the nuclear power plant to which such nuclear decommissioning fund relates begins commercial operations; and

(B) Ends on the last day of the taxable year that includes the estimated date on which the nuclear power plant to which such nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base for ratemaking purposes (see paragraph (e) (3) and (4) of this section).

(iii) Except as otherwise provided in paragraph (b)(7)(ii) of §1.468A–8 (relating to a special transitional rule), the estimated useful life of a nuclear power plant.

(A) Begins on the first day of the taxable year that includes the date that the nuclear power plant begins commercial operations; and

(B) Ends on the last day of the taxable year that includes the estimated date on which the nuclear power plant will no longer be included in the taxpayer's rate base for ratemaking purposes (see paragraph (e) (3) and (4) of this section).

(e) *Determination of estimated dates.* (1) For purposes of paragraph (c)(1)(ii)(A) of this section (relating to the funding period), the estimated date on which decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's cost of service for ratemaking purposes is determined under the ratemaking assumptions that were used to determine the last rates (whether interim or final) that were established or approved by the applicable public utility commission prior to the filing of the current request for a schedule of ruling amounts.

(2) For purposes of paragraphs (b)(2)(ii) and (c)(1)(ii)(B) of this section (relating to the level funding limitation period and the funding period), the estimated date on which the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base for ratemaking purposes is determined under the ratemaking assumptions that were used to determine the last rates (whether interim or final) that were established or approved by the applicable public utility commission prior to the filing of the current request for a schedule of ruling amounts.

(3) For purposes of paragraph (d)(4)(ii)(B) and (iii)(B) of this section (relating to the qualifying percentage), the estimated date on which the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base for ratemaking purposes is determined under the ratemaking assumptions used by the applicable public utility commission in establishing or approving rates during the first ratemaking proceeding in which the nuclear power plant was included in the taxpayer's rate base.

(4) For purposes of this section, in the case of a taxpayer whose interest in the nuclear power plant is described in paragraph (b)(2)(ii) of § 1.468A–1, the date corresponding to ‘‘the estimated date on which the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base’’ will be determined upon the basis of all the facts and circumstances in a manner consistent with the provisions of this section and section 468A of the Code.

(5) A formula or method obtained under paragraph (a)(4) of this section may provide for changes in an estimated date described in paragraph (e)(1) or (2) of this section to reflect changes in the ratemaking assumptions used to determine rates (whether interim or final) that are established or approved by the applicable public utility commission after the filing of the request for approval of a formula or method.

(f) *Special rules in the case of rates established or approved by two or more public utility commissions.* If two or more public utility commissions establish or approve rates for electric energy generated by a single nuclear power plant, the following rules shall apply in determining the schedule of ruling amounts for the nuclear decommissioning fund that relates to such nuclear power plant.

(1) A schedule of ruling amounts shall be separately determined pursuant to the rules of paragraphs (a) through (e) of this section for each public utility commission that has determined the amount of decommissioning costs to be included in cost of service for ratemaking purposes with respect to such nuclear power plant (see paragraph (g) of this section).

(2) The separate determination with respect to a public utility commission shall be based on the reasonable assumptions and determinations used by such public utility commission and shall take into account only that portion of the total estimated cost of decommissioning the nuclear power plant that is properly allocable to the ratepayers whose rates are established or approved by such public utility commission.

(3) The ruling amount applicable to the nuclear decommissioning fund for

any taxable year is the sum of the ruling amounts for such taxable year determined under the separate schedules of ruling amounts.

(4) The schedule of ruling amounts for the nuclear decommissioning fund is the schedule of the ruling amounts determined under paragraph (f)(3) of this section.

(g) *Requirement of determination by public utility commission of decommissioning costs to be included in cost of service.* The Internal Revenue Service shall not provide a taxpayer with a schedule of ruling amounts for any nuclear decommissioning fund unless a public utility commission that establishes or approves rates for electric energy generated by the nuclear power plant to which the nuclear decommissioning fund relates has—

(1) Determined the amount of decommissioning costs of such nuclear power plant to be included in the taxpayer's cost of service for ratemaking purposes; and

(2) Disclosed the after-tax return and any other assumption and determinations used in establshing or approving such amount for any taxable year beginning on or after January 1, 1987.

(h) *Manner of requesting schedule of ruling amounts*—(1) *In general.* (i) In order to receive a ruling amount for any taxable year, a taxpayer must file a request for a schedule of ruling amounts that complies with the requirements of this paragraph (h), the applicable procedural rules set forth in paragraph (e) of §601.201 (Statement of Procedural Rules) and the requirements of any applicable revenue procedure that is in effect on the date the request is filed.

(ii) A separate request for a schedule of ruling amounts is required for each nuclear decommissioning fund established by a taxpayer (see paragraph (a) of §1.468A–5 for rules relating to the number of nuclear decommissioning funds that a taxpayer can establish).

(iii) Except as provided by §1.468A–5 (a)(1)(iv) (relating to certain unincorporated organizations that may be taxable as corporations), a request for a schedule of ruling amounts must not contain a request for a ruling on any other issue, whether the issue involves section 468A or another section of the Internal Revenue Code.

(iv) In the case of an affiliated group of corporations that join in the filing of a consolidated return, the common parent of the group may request a schedule of ruling amounts for each member of the group that possesses a qualifying interest in the same nuclear power plant by filing a single submission with the Internal Revenue Service.

(v) Except as otherwise provided in paragraph (b)(1) of §1.468A–8, the Internal Revenue Service shall not provide or revise a ruling amount applicable to a taxable year in response to a request for a schedule of ruling amounts that is filed after the deemed payment deadline date (as defined in paragraph (c)(1) of §1.468A–2) for such taxable year. In determining the date when a request is filed, the principles of sections 7502 and 7503 shall apply.

(vi) Except as provided in paragraph (h)(1)(vii) of this section, a request for a schedule of ruling amounts shall be considered filed only if such request complies substantially with the requirements of this paragraph (h).

(vii)(A) If a request does not comply substantially with the requirements of this paragraph (h), the Internal Revenue Service will notify the taxpayer of that fact. If the information or materials necessary to comply substantially with the requirements of this paragraph (h) are provided to the Internal Revenue Service within 30 days after this notification, the request will be considered filed on the date of the original submission. If the information or materials necessary to comply substantially with the requirements of this paragraph (h) are not provided within 30 days after this notification, the request will be considered filed on the date that all information or materials necessary to comply with the requirements of this paragraph (h) are provided.

(B) The Internal Revenue Service may waive the requirements of paragraph (h)(1)(vii)(A) of this section if the Service determines that the electing taxpayer is making a good faith effort to comply with the deadline and if the waiver is consistent with the purposes of section 468A.

(2) *Information required.* A request for a schedule of ruling amounts must contain the following information:

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

(ii) Whether the request is for an initial schedule of ruling amounts, a mandatory review of the schedule of ruling amounts (see paragraph (i)(1) of this section) or an elective review of the schedule of ruling amounts (see paragraph (i)(2) of this section).

(iii) The name and location of the nuclear power plant with respect to which a schedule of ruling amounts is requested.

(iv) A description of the taxpayer's qualifying interest in the nuclear power plant and the percentage of such nuclear power plant that the qualifying interest of the taxpayer represents.

(v) An identification of each public utility commission that establishes or approves rates for the furnishing or sale by the taxpayer of electric energy generated by the nuclear power plant, and, for each public utility commission identified—

(A) Whether the public utility commission has determined the amount of decommissioning costs to be included in the taxpayer's cost of service for ratemaking purposes; and

(B) Whether a proceeding is pending before the public utility commission that may result in an increase or decrease in the amount of decommissioning costs to be included in cost of service.

(vi) For each public utility commission that has determined the amount of decommissioning costs to be included in the taxpayer's cost of service for ratemaking purposes—

(A) The amount of decommissioning costs that are to be included in the taxpayer's cost of service for each taxable year under the current determination and amounts that otherwise are required to be included in the taxpayer's income under section 88 and the regulations thereunder;

(B) A description of the assumptions, estimates and other factors that were used in determining the amounts described in paragraph (h)(2)(vi)(A) of this section, including each of the following if applicable—

(*1*) A description of the proposed method of decommissioning the nuclear power plant (for example, prompt removal/dismantlement, safe storage entombment with delayed dismantlement, or safe storage mothballing with delayed dismantlement);

(*2*) The estimated year in which substantial decommissioning costs will first be incurred;

(*3*) The estimated year in which the decommissioning of the nuclear power plant will be substantially complete (see paragraph (d)(2) of § 1.468A–5 for a definition of substantial completion of decommissioning);

(*4*) The total estimated cost of decommissioning expressed in current dollars (*i.e.,* based on price levels in effect at the time of the current determination);

(*5*) The total estimated cost of decommissioning expressed in future dollars (*i.e.,* based on anticipated price levels when expenses are expected to be paid);

(*6*) For each taxable year in the period that begins with the year specified in paragraph (h)(2)(vi)(B)(*2*) of this section (‘‘the estimated year in which substantial decommissioning costs will first be incurred’’) and ends with the year specified in paragraph (h)(2)(vi)(B)(*3*) of this section (‘‘the estimated year in which the estimated year in which the decommissioning of the nuclear power plant will be substantially complete’’), the estimated cost of decommissioning expressed in future dollars;

(*7*) A description of the methodology used in converting the estimated cost of decommissioning expressed in current dollars to the estimated cost of decommissioning expressed in future dollars;

(*8*) The assumed after-tax rate of return to be earned by the amounts collected for decommissioning (if two or more after-tax rates of return are assumed by the public utility commission, each assumed after-tax rate of return and the amounts collected for decommissioning to which each assumed after-tax rate of return applies);

(*9*) The proposed period over which decommissioning costs will be included in the cost of service of the taxpayer and the projected amount that will be included in cost of service for each taxable year in the proposed period;

(*10*) The estimated date on which the nuclear power plant will no longer be included in the taxpayer's rate base for ratemaking purposes as determined under the ratemaking assumptions that were used to determine the last rates (whether interim or final) that were established or approved by the applicable public utility commission prior to the filing of the current request for a schedule of ruling amounts (or a corresponding date in the case of a taxpayer whose interest in the nuclear power plant is described in paragraph (b)(2)(ii) of §1.468A–1; see paragraph (e)(4) of this section); and

(*11*) The estimated date on which the nuclear power plant will no longer be included in the taxpayer's rate base for ratemaking purposes as determined under the ratemaking assumptions that were used by the applicable public utility commission in establishing or approving rates during the first ratemaking proceeding in which the nuclear power plant was included in the taxpayer's rate base (or a corresponding date in the case of a taxpayer whose interest in the nuclear power plant is described in paragraph (b)(2)(ii) of §1.468A–1; see paragraph (e)(4) of this section);

(C) A copy of such portions of any order or opinion of the public utility commission as pertain to the commission's most recent determination of the amount of decommissioning costs to be included in cost of service; and

(D) A copy of each engineering or cost study that was relied on or used by the taxpayer or the public utility commission in determining the amount of decommissioning costs to be included in the taxpayer's cost of service under the current determination.

(vii) For each proceeding pending before a public utility commission that may result in an increase or decrease in the amount of decommissioning costs to be included in the taxpayer's cost of service—

(A) A description of the stage of the proceeding;

(B) The amount of decommissioning costs that are proposed to be included in the taxpayer's cost of service for each taxable year;

(C) A description of the assumptions, estimates and other factors that were used in determining the amount of decommissioning costs that are proposed to be included in the taxpayer's cost of service for each taxable year, including each of the items described in paragraph (h)(2)(vi)(B) of this section if applicable; and

(D) A copy of each engineering or cost study that was relied on or used by the taxpayer or the public utility commission in determining the amount of decommissioning costs that are proposed to be included in the taxpayer's cost of service.

(viii) A proposed schedule of ruling amounts for each taxable year remaining in the funding period as of the date the schedule of ruling amounts will first apply.

(ix) A description of the assumptions, estimates and other factors that were used in determining the proposed schedule of ruling amounts, including each of the following if applicable—

(A) The level funding limitation period (as such term is defined in paragraph (b)(2) of this section);

(B) The funding period (as such term is defined in paragraph (c) of this section);

(C) The assumed after-tax rate of return to be earned by the assets of the nuclear decommissioning fund;

(D) The fair market value of the assets (if any) of the nuclear decommissioning fund as of the first day of the first taxable year to which the schedule of ruling amounts will apply;

(E) The amount expected to be earned by the assets of the nuclear decommissioning fund (based on the after-tax rate of return applicable to the fund) over the period that begins on the first day of the first taxable year to which the schedule of ruling amounts will apply and ends on the last day of the funding period;

(F) The amount of decommissioning costs allocable to the nuclear decommissioning fund (as determined under paragraph (d) of this section);

(G) The total estimated cost of decommissioning (as such term is defined in paragraph (d)(2) of this section);

(H) The taxpayer's share of the total estimated cost of decommissioning (as such term is defined in paragraph (d)(3) of this section);

(I) The qualifying percentage (as such term is defined in paragraph (d)(4)(i) of this section);

(J) The estimated period for which the nuclear decommissioning fund is to be in effect (as such term is defined in paragraph (d)(4)(ii) of this section); and

(K) The estimated useful life of the nuclear power plant (as such term is defined in paragraph (d)(4)(iii) of this section).

(x) If the request is for a revised schedule of ruling amounts, the after-tax rate of return earned by the assets of the nuclear decommissioning fund for each taxable year in the period that begins with the date of the inital contribution to the fund and ends with the first day of the first taxable year to which the revised schedule of ruling amounts applies.

(xi) If applicable, an explanation of the need for a schedule of ruling amounts determined on a basis other than the rules of paragraphs (a) through (g) of this section and a description of an alternative basis for determining a schedule of ruling amounts (see paragraph (a)(5) of this section).

(xii) A chart or table, based upon the assumed after-tax rate of return to be earned by the assets of the nuclear decommissioning fund, setting forth the years the fund will be in existence, the annual contribution to the fund, the estimated annual earnings of the fund and the cumulative total balance in the fund.

(xiii) If the request is for a revised schedule of ruling amounts, a copy of the most recently issued schedule of ruling amounts for the nuclear power plant to which the request relates that has been issued to the taxpayer (or a predecessor in interest) making the request.

(xiv) If the request for a schedule of ruling amounts contains a request, pursuant to § 1.468A–5 (a)(1)(iv), that the Service rule whether an unincorporated organization through which the assets of the fund are invested is an association taxable as a corporation for federal tax purposes, a copy of the legal documents establishing or otherwise governing the organization.

(xv) Any other information required by the Internal Revenue Service that may be necessary or useful in determining the schedule of ruling amounts.

(3) *Administrative procedures.* The Internal Revenue Service may prescribe administrative procedures that supplement the provisions of paragraph (h) (1) and (2) of this section. In addition, the Internal Revenue Service may, in its discretion, waive the requirements of paragraph (h) (1) and (2) of this section under appropriate circumstances.

(i) *Review and revision of schedule of ruling amounts*—(1) *Mandatory review.* (i) Any taxpayer that has obtained a schedule of ruling amounts pursuant to paragraph (h) of this section must file a request for a revised schedule of ruling amounts on or before the deemed payment deadline date for the 10th taxable year that begins after the taxable year in which the most recent schedule of ruling amounts was received. The first taxable year to which the revised schedule of ruling amounts applies shall be the 10th taxable year that begins after the taxable year in which the most recent schedule of ruling amounts was received.

(ii)(A) Any taxpayer that has obtained a formula or method for determining a schedule of ruling amounts for any taxable year under paragraph (a)(4) of this section must file a request for a revised schedule on or before the earlier of the deemed payment deadline for the fifth taxable year that begins after its taxable year in which the most recent formula or method was approved or the deemed payment deadline for the first taxable year that begins after a taxable year in which there is a substantial variation in the ruling amount determined under the most recent formula or method. There is a substantial variation in the ruling amount determined under the formula or method in effect for a taxable year if the ruling amount for the year and the ruling amount for any earlier year since the most recent formula or method was approved differ by more than 50 percent of the smaller amount.

(B) Any taxpayer that has determined its ruling amount for any taxable year under a formula prescribed by § 1.468A–6 (which prescribes ruling amounts for the taxable year in which there is a disposition of a qualifying interest in a nuclear power plant) must file a request for a revised schedule of ruling amounts on or before the deemed payment deadline for its first taxable year that begins after the disposition.

(iii) A taxpayer is required to request a revised schedule of ruling amounts for a nuclear decommissioning fund if—

(A) Any public utility commission that establishes or approves rates for the furnishing or sale of electric energy generated by a nuclear power plant to which the nuclear decommissioning fund relates—

(*1*) Increases the proposed period over which decommissioning costs of such nuclear power plant will be included in cost of service for ratemaking purposes;

(*2*) Adjusts the estimated date on which such nuclear power plant will no longer be included in the taxpayer's rate base for ratemaking purposes; or

(*3*) Reduces the amount of decommissioning costs to be included in cost of service for any taxable year;

(B) The taxpayer's most recent request for a schedule of ruling amounts did not provide notice to the Internal Revenue Service of such action by the public utility commission; and

(C) In the case of a taxpayer that determines its schedule of ruling amounts under a formula or method obtained under paragraph (a)(4) of this section, the item increased, adjusted, or reduced is a fixed (rather than a variable) element of that formula or method.

(iv) If a taxpayer is required to request a revised schedule of ruling amounts by reason of an action described in paragraph (i)(1)(iii) of this section, the taxpayer must file the request for a revised schedule of ruling amounts on or before the deemed payment deadline date for the first taxable year in which rates that reflect such action become effective. The first taxable year to which the revised schedule of ruling amounts applies shall be the first taxable year in which such rates become effective.

(v) A request for a schedule of ruling amounts required by this paragraph (i)(1) must be made in accordance with the rules of paragraph (h) of this section. If a taxpayer does not properly file a request for a revised schedule of ruling amounts by the date provided in paragraph (i)(1) (i), (ii) or (iv) of this section (whichever is applicable), the taxpayer's ruling amount for the first taxable year to which the revised schedule of ruling amounts would have applied and for all succeeding taxable years until a new schedule is obtained shall be zero, unless, in its discretion, the Internal Revenue Service provides otherwise in such new schedule of ruling amounts.

(vi) See paragraph (f)(3) of §1.468A–2 for the application of the rules in paragraph (i)(1) (iii), (iv), and (v) of this section in the case of certain retroactive adjustments to interim rate orders.

(2) *Elective review.* Any taxpayer that has obtained a schedule of ruling amounts pursuant to paragraph (h) of this section can request a revised schedule of ruling amounts. Such a request must be made in accordance with the rules of paragraph (h) of this section; thus, the Internal Revenue Service shall not provide a revised ruling amount applicable to a taxable year in response to a request for a schedule of ruling amounts that is filed after the deemed payment deadline date for such taxable year (see paragraph (h)(1)(vi) of this section).

(3) *Determination of revised schedule of ruling amounts.* A revised schedule of ruling amounts for a nuclear decommissioning fund shall be determined under this section without regard to any schedule of ruling amounts for such nuclear decommissioning fund that was issued prior to such revised schedule. Thus, a ruling amount specified in a revised schedule of ruling amounts for any taxable year in the level funding limitation period can be less than one or more ruling amounts specified in a prior schedule of ruling amounts for a prior taxable year.

(j) *Special rule permitting payments to a nuclear decommissioning fund before receipt of an initial or revised ruling amount applicable to a taxable year.* (1) If an electing taxpayer has filed a timely request for an initial or revised ruling amount for a taxable year beginning on or after January 1, 1987, and does not receive the ruling amount on or before the deemed payment deadline date for such taxable year, the taxpayer may make a payment to a nuclear decommissioning fund on the basis of the ruling amount proposed in the taxpayer's request. Thus, under the preceding sentence, an electing taxpayer may make a payment to a nuclear decommissioning fund for such taxable year that does not exceed the lesser of—

(i) The cost of service amount applicable to the nuclear decommissioning fund for such taxable year; or

(ii) The ruling amount proposed by the taxpayer for such taxable year in a timely filed request for a schedule of ruling amounts.

(2) If an electing taxpayer makes a payment to a nuclear decommissioning fund for any taxable year pursuant to paragraph (j)(1) of this section and the ruling amount that is provided by the Internal Revenue Service is greater than the ruling amount proposed by the taxpayer for such taxable year, the taxpayer is not allowed to make an additional payment to the fund for such taxable year after the deemed payment deadline date for such taxable year.

(3) If—(i) An electing taxpayer makes a payment to a nuclear decommissioning fund for any taxable year pursuant to paragraph (j)(1) of this section,

(ii) The ruling amount that is provided by the Internal Revenue Service is less than the ruling amount proposed by the taxpayer for such taxable year, and

(iii) As a result, there is an excess contribution (as defined in paragraph (c)(2)(ii) of §1.468A–5) for such taxable year,

Then the amount of the excess contribution is not deductible (see paragraph (b)(1) of §1.468A–2) and must be withdrawn by the taxpayer pursuant to the rules of paragraph (c)(2)(i) of §1.468A–5. Thus, an electing taxpayer that files a return based on a payment made pursuant to paragraph (j)(1) of this section should file an amended return if an excess contribution results when the ruling amount is issued for such taxable year.

[T.D. 8184, 53 FR 6808, Mar. 3, 1988, as amended by T.D. 8461, 57 FR 62199, Dec. 30, 1992; T.D. 8580, 59 FR 66474, Dec. 27, 1994; 60 FR 8932, Feb. 16, 1995; T.D. 8758, 63 FR 2894, Jan. 20, 1998]

§1.468A–4 Treatment of nuclear decommissioning fund.

(a) *In general.* A nuclear decommissioning fund is subject to tax on all of its modified gross income (as defined in paragraph (b) of this section). The rate of tax is 22 percent for taxable years beginning in calendar year 1994 or 1995, 20 percent for taxable years beginning after December 31, 1995, and the highest rate of tax specified by section 11(b) for other years. This tax is in lieu of any other tax that may be imposed under subtitle A of the Internal Revenue Code on the income earned by the assets of the nuclear decommissioning fund.

(b) *Modified gross income.* For purposes of this section, the term ''modified gross income'' means gross income as defined under section 61 computed with the following modifications:

(1) The amount of any payment to the nuclear decommissioning fund with respect to which a deduction is allowed under section 468A(a) is excluded from gross income.

(2) A deduction is allowed for the amount of administrative costs and other incidental expenses of the nuclear decommissioning fund (including taxes, legal expenses, accounting expenses, actuarial expenses and trustee expenses, but not including decommissioning costs) that are otherwise deductible and that are paid by the nuclear decommissioning fund to any person other than the electing taxpayer. An expense is otherwise deductible for purposes of this paragraph (b)(2) if it would be deductible under chapter 1 of the Internal Revenue Code in determining the taxable income of a corporation. For example, because Federal income taxes are not deductible under chapter 1 of the Internal Revenue Code in determining the taxable income of a

corporation, the tax imposed by section 468A(e)(2) and paragraph (a) of this section is not deductible in determining the modified gross income of a nuclear decommissioning fund. Similarly, because certain expenses allocable to tax-exempt interest income are not deductible under section 265 of the Internal Revenue Code in determining the taxable income of a corporation, such expenses are not deductible in determining the modified gross income of a nuclear decommissioning fund.

(3) A deduction is allowed for the amount of an otherwise deductible loss that is sustained by the nuclear decommissioning fund in connection with the sale, exchange or worthlessness of any investment. A loss is otherwise deductible for purposes of this paragraph (b)(3) if such loss would be deductible by a corporation under section 165 (f) or (g) and sections 1211(a) and 1212(a).

(4) A deduction is allowed for the amount of an otherwise deductible net operating loss of the nuclear decommissioning fund. For purposes of this paragraph (b), the net operating loss of a nuclear decommissioning fund for a taxable year is the amount by which the deductions allowable under paragraph (b) (2) and (3) of this section exceed the gross income of the nuclear decommissioning fund computed with the modification described in paragraph (b)(1) of this section. A net operating loss is otherwise deductible for purposes of this paragraph (b)(4) if such a net operating loss would be deductible by a corporation under section 172(a).

(c) *Special rules*—(1) *Period for computation of modified gross income.* The modified gross income of a nuclear decommissioning fund must be computed on the basis of the taxable year of the electing taxpayer. If an electing taxpayer changes its taxable year, each nuclear decommissioning fund of the electing taxpayer must change to the new taxable year. See section 442 and §1.442–1 for rules relating to the change to a new taxable year.

(2) *Gain or loss upon distribution of property by a fund.* A distribution of property by a nuclear decommissioning fund (whether an actual distribution or a deemed distribution) shall be considered a disposition of property by the nuclear decommissioning fund for purposes of section 1001. In determining the amount of gain or loss from such disposition, the amount realized by the nuclear decommissioning fund shall be the fair market value of the property on the date of disposition.

(3) *Denial of credits against tax.* The tax imposed on the modified gross income of a nuclear decommissioning fund under paragraph (a) of this section is not to be reduced or offset by any credits against tax provided by part IV of subchapter A of chapter 1 of the Internal Revenue Code other than the credit provided by section 31(c) for amounts withheld under section 3406 (back-up withholding).

(4) *Other corporate taxes inapplicable.* Although the modified gross income of a nuclear decommissioning fund is subject to tax at the rate specified by section 468A(e)(2) and paragraph (a) of this section, a nuclear decommissioning fund is not subject to the other taxes imposed on corporations under subtitle A of the Internal Revenue Code. For example, a nuclear decommissioning fund is not subject to the alternative minimum tax imposed by section 55, the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, and the alternative tax imposed on a corporation under section 1201(a).

(d) *Treatment as corporation for purposes of subtitle F.* For purposes of subtitle F of the Internal Revenue Code and the regulations thereunder, a nuclear decommissioning fund is to be treated as if it were a corporation and the tax imposed by section 468A(e)(2) and paragraph (a) of this section is to be treated as a tax imposed by section 11. Thus, for example, the following rules apply:

(1) A nuclear decommissioning fund must file a return with respect to the tax imposed by section 468A(e)(2) and paragraph (a) of this section for each taxable year (or portion thereof) that the fund is in existence even though no amount is included in the gross income of the fund for such taxable year. The return is to be made on Form 1120–ND in accordance with the instructions relating to such form. For purposes of

this paragraph (d)(1), a nuclear decommissioning fund is in existence for the period that—

(i) Begins on the date that the first deductible payment is actually made to such nuclear decommissioning fund; and

(ii) Ends on the date of termination (see paragraph (d) of § 1.468A–5), the date that the entire fund is disqualified (see paragraph (c) of § 1.468A–5), or the date that the electing taxpayer disposes of its entire qualifying interest in the nuclear power plant to which the nuclear decommissioning fund relates, whichever is applicable.

(2) For each taxable year of the nuclear decommissioning fund, the return described in paragraph (d)(1) of this section must be filed on or before the 15th day of the third month following the close of such taxable year unless the nuclear decommissioning fund is granted an extension of time for filing under section 6081. If such an extension is granted for any taxable year, the return for such taxable year must be filed on or before the extended due date for such taxable year. In no event will the filing of the initial return of a nuclear decommissioning fund be required before January 6, 1987.

(3) A nuclear decommissioning fund must provide its employer identification number on returns, statements and other documents as required by the forms and instructions relating thereto. The employer identification number is obtained by filing a Form SS–4 in accordance with the instructions relating thereto.

(4) A nuclear decommissioning fund must deposit all payments of tax imposed by section 468A(e)(2) and paragraph (a) of this section (including any payments of estimated tax) with an authorized government depositary in accordance with § 1.6302–1.

(5) A nuclear decommissioning fund is subject to the addition to tax imposed by section 6655 in case of a failure to pay estimated income tax. For purposes of section 6655 and this section—

(i) The tax with respect to which the amount of the underpayment is computed in the case of a nuclear decommissioning fund is the tax imposed by section 468A(e)(2) and paragraph (a) of this section; and

(ii) The taxable income with respect to which the nuclear decommissioning fund's status as a ''large corporation'' is measured is ''modified gross income'' (as defined by paragraph (b) of this section).

[T.D. 8184, 53 FR 6814, Mar. 3, 1988, as amended by T.D. 8461, 57 FR 62199, Dec. 30, 1992]

§ 1.468A–5 Nuclear decommissioning fund qualification requirements; prohibitions against self-dealing; disqualification of nuclear decommissioning fund; termination of fund upon substantial completion of decommissioning.

(a) *Qualification requirements*—(1) *In general.* (i) A nuclear decommissioning fund must be established and maintained at all times in the United States pursuant to an arrangement that qualifies as a trust under State law. Such trust must be established for the exclusive purpose of providing funds for the decommissioning of one or more nuclear power plants, but a single trust agreement may establish multiple funds for such purpose. Thus—

(A) Two or more nuclear decommissioning funds can be established and maintained pursuant to a single trust agreement; and

(B) One or more funds that are to be used for the decommissioning of a nuclear power plant and that do not qualify as nuclear decommissioning funds under this paragraph (a) can be established and maintained pursuant to a trust agreement that governs one or more nuclear decommissioning funds.

(ii) A separate nuclear decommissioning fund is required for each electing taxpayer and for each nuclear power plant with respect to which an electing taxpayer possesses a qualifying interest. The Internal Revenue Service shall issue a separate schedule of ruling amounts with respect to each nuclear decommissioning fund and each nuclear decommissioning fund must file a separate income tax return even if other nuclear decommissioning funds or nonqualified decommissioning funds are established and maintained pursuant to the trust agreement governing such fund or the assets of other nuclear decommissioning funds or nonqualified decommissioning funds are pooled with the assets of such fund.

(iii) An electing taxpayer can maintain only one nuclear decommissioning fund for each nuclear power plant with respect to which the taxpayer elects the application of section 468A. If a nuclear power plant is subject to the ratemaking jurisdiction of two or more public utility commissions and any such public utility commission requires a separate fund to be maintained for the benefit of ratepayers whose rates are established or approved by the public utility commission, the separate funds maintained for such plant (whether or not established and maintained pursuant to a single trust agreement) shall be considered a single nuclear decommissioning fund for purposes of section 468A and §§1.468A–1 through 1.468A–5, 1.468A–7 and 1.468A–8. Thus, for example, the Internal Revenue Service shall issue one schedule of ruling amounts with respect to such nuclear power plant (see paragraph (f) of §1.468A–3), the nuclear decommissioning fund must file a single income tax return (see paragraph (d)(1) of §1.468A–4), and, if the Internal Revenue Service disqualifies the nuclear decommissioning fund, the assets of each separate fund are treated as distributed on the date of disqualification (see paragraph (c)(3) of this section).

(iv) If assets of a nuclear decommissioning fund are (or will be) invested through an unincorporated organization, within the meaning of §301.7701–2 of this chapter, the Internal Revenue Service will rule, if requested, whether the organization is an association taxable as a corporation for federal tax purposes. A request for a ruling may be made by the electing taxpayer as part of its request for a schedule of ruling amounts.

(2) *Limitation on contributions.* Except as otherwise provided in paragraph (b)(2)(ii) of §1.468A–8 (relating to a special transitional rule), a nuclear decommissioning fund is not permitted to accept any contributions in cash or property other than cash payments with respect to which a deduction is allowed under section 468A(a) and paragraph (a) of §1.468A–2. Thus, for example, unless the exception contained in paragraph (b)(2)(ii) of §1.468A–8 applies, securities may not be contributed to a nuclear decommissioning fund even if the taxpayer or a fund established by the taxpayer previously held such securities for the purpose of providing funds for the decommissioning of a nuclear power plant.

(3) *Limitation on use of fund*—(i) *In general.* The assets of a nuclear decommissioning fund are to be used exclusively—

(A) To satisfy, in whole or in part, the liability of the electing taxpayer for decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates;

(B) To pay administrative costs and other incidental expenses of the nuclear decommissioning fund; and

(C) To the extent that the assets of the nuclear decommissioning fund are not currently required for the purposes described in paragraph (a)(3)(i) (A) or (B) of this section, to make investments.

(ii) *Definition of administrative costs and expenses.* For purposes of paragraph (a)(3)(i) of this section, the term ‘‘administrative costs and other incidental expenses of a nuclear decommissioning fund’’ means all ordinary and necessary expenses incurred in connection with the operation of the nuclear decommissioning fund. Such term includes the tax imposed by section 468A(e)(2) and §1.468A–4(a), any State or local tax imposed on the income or the assets of the fund, legal expenses, accounting expenses, actuarial expenses and trustee expenses. Such term does not include decommissioning costs. Such term also does not include the excise tax imposed on the trustee or other disqualified person under section 4951 or the reimbursement of any expenses incurred in connection with the assertion of such tax unless such expenses are considered reasonable and necessary under section 4951(d)(2)(C) and it is determined that the trustee or other disqualified person is not liable for the excise tax.

(4) *Trust provisions.* By December 31, 1996, each qualified nuclear decommissioning fund trust agreement must provide that assets in the fund must be used as authorized by section 468A and the regulations thereunder and that

the agreement may not be amended so as to violate section 468A or the regulations thereunder.

(b) *Prohibitions against self-dealing*—(1) *In general.* Except as otherwise provided in this paragraph (b), the excise taxes imposed by section 4951 shall apply to each act of self-dealing between a disqualified person and a nuclear decommissioning fund.

(2) *Self-dealing defined.* For purposes of this paragraph (b), the term ''self-dealing'' means any act described in section 4951(d), except—

(i) A payment by a nuclear decommissioning fund for the purpose of satisfying, in whole or in part, the liability of the electing taxpayer for decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates;

(ii) A withdrawal of an excess contribution by the electing taxpayer pursuant to the rules of paragraph (c)(2) of this section;

(iii) A withdrawal by the electing taxpayer of amounts that have been treated as distributed under paragraph (c)(3) of this section;

(iv) A payment of amounts remaining in a nuclear decommissioning fund to the electing taxpayer after the termination of such fund (as determined under paragraph (d) of this section);

(v) Any act described in section 4951(d)(2) (B) or (C);

(vi) Any act described in § 53.4951–1(c) of this chapter only if undertaken to facilitate the temporary investment of assets or the payment of reasonable administrative expenses of the nuclear decommissioning fund; or

(vii) A payment by a nuclear decommissioning fund for the performance of trust functions and certain general banking services by a bank or trust company which is a disqualified person, where the banking services are reasonable and necessary to carry out the purposes of the fund, if the compensation paid to the bank or trust company, taking into account the fair interest rate for the use of the funds by the bank or trust company, for such services is not excessive. The general banking services allowed by this paragraph (b)(2)(vii) are—

(A) Checking accounts, as long as the bank does not charge interest on any overwithdrawals,

(B) Savings accounts, as long as the fund may withdraw its funds on no more than 30 days' notice without subjecting itself to a loss of interest on its money for the time during which the money was on deposit, and

(C) Safekeeping activities. (See example 3 of § 53.4941(d)–3(c)(2).)

(3) *Disqualified person defined.* For purposes of this paragraph (b), the term ''disqualified person'' includes each person described in section 4951(e)(4) and paragraph (d) of § 53.4951–1.

(c) *Disqualification of nuclear decommissioning fund*—(1) *In general.* Except as otherwise provided in paragraph (c)(2) of this section, if at any time during a taxable year of a nuclear decommissioning fund—

(i) The nuclear decommissioning fund does not satisfy the requirements of paragraph (a) of this section, or

(ii) The nuclear decommissioning fund and a disqualified person engage in an act of self-dealing (as defined in paragraph (b)(2) of this section), the Internal Revenue Service may, in its discretion, disqualify all or any portion of the fund as of the date that the fund does not satisfy the requirements of paragraph (a) of this section or the date on which the act of self-dealing occurs, whichever is applicable, or as of any subsequent date (''date of disqualification''). The Internal Revenue Service shall notify the electing taxpayer of the disqualification of a nuclear decommissioning fund and the date of disqualification by registered or certified mail to the last known address of the electing taxpayer (the ''notice of disqualification'').

(2) *Exception to disqualification*—(i) *In general.* A nuclear decommissioning fund will not be disqualified under paragraph (c)(1) of this section by reason of an excess contribution or the withdrawal of such excess contribution by an electing taxpayer if the amount of the excess contribution is withdrawn by the electing taxpayer on or before the date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for the

taxable year to which the excess contribution relates. In the case of an excess contribution that is the result of a payment made pursuant to paragraph (j)(1) of §1.468A–3, a nuclear decommissioning fund will not be disqualified under paragraph (c)(1) of this section if the amount of the excess contribution is withdrawn by the electing taxpayer on or before the later of—

(A) The date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for the taxable year to which the excess contribution relates; or

(B) The date that is 30 days after the date that the taxpayer receives the ruling amount for such taxable year.

(ii) *Excess contribution defined.* For purposes of this section, an excess contribution is the amount by which cash payments made (or deemed made) to a nuclear decommissioning fund during any taxable year exceed the payment limitation contained in section 468A(b) and paragraph (b) of §1.468A–2.

(iii) *Taxation of income attributable to an excess contribution.* The income of a nuclear decommissioning fund attributable to an excess contribution is required to be included in the gross income of the nuclear decommissioning fund under paragraph (b) of §1.468A–4.

(3) *Effect of disqualification.* If all or any portion of a nuclear decommissioning fund is disqualified under paragraph (c)(1) of this section, the portion of the nuclear decommissioning fund that is disqualified is treated as distributed to the electing taxpayer on the date of disqualification. Such a distribution shall be treated for purposes of section 1001 as a disposition of property held by the nuclear decommissioning fund (see paragraph (c)(2) of §1.468A–4). In addition, the electing taxpayer must include in gross income for the taxable year that includes the date of disqualification an amount equal to the product of—

(i) The fair market value of the assets of the fund determined as of the date of disqualification, reduced by—

(A) The amount of any excess contribution that was not withdrawn before the date of disqualification if no deduction was allowed with respect to such excess contribution;

(B) The amount of any deemed distribution that was not actually distributed before the date of disqualification (as determined under paragraph (d)(2)(iii) of §1.468A–2) if the amount of the deemed distribution was included in the gross income of the electing taxpayer for the taxable year in which the deemed distribution occurred; and

(C) The amount of any tax that—

(*1*) Is imposed on the income of the fund;

(*2*) Is attributable to income taken into account before the date of disqualification or as a result of the disqualification; and

(*3*) Has not been paid as of the date of disqualification; and

(ii) The fraction of the nuclear decommissioning fund that was disqualified under paragraph (c)(1) of this section.

Contributions made to a disqualified fund after the date of disqualification are not deductible under section 468A(a) and paragraph (a) of §1.468A–2, or, if the fund is disqualified only in part, are deductible only to the extent provided in the notice of disqualification. In addition, if any assets of the fund that are deemed distributed under this paragraph (c)(3) are held by the fund after the date of disqualification (or if additional assets are acquired with nondeductible contributions made to the fund after the date of disqualification), the income earned by such assets after the date of disqualification must be included in the gross income of the electing taxpayer (see section 671) to the extent that such income is otherwise includible under chapter 1 of the Internal Revenue Code. An electing taxpayer can establish a nuclear decommissioning fund to replace a fund that has been disqualified in its entirety only if the Internal Revenue Service specifically consents to the establishment of a replacement fund in connection with the issuance of an initial schedule of ruling amounts for such replacement fund.

(d) *Termination of nuclear decommissioning fund upon substantial completion of decommissioning*—(1) *In general.* Upon substantial completion of the decommissioning of a nuclear power plant to which a nuclear decommissioning fund relates, such nuclear decommissioning fund shall be considered terminated and treated as having distributed all of its assets on the date the termination occurs. Such a distribution shall be treated for purposes of section 1001 as a disposition of property held by the nuclear decommissioning fund (see paragraph (c)(2) of § 1.468A–4). In addition, the electing taxpayer shall include in gross income for the taxable year in which the termination occurs an amount equal to the fair market value of the assets of the fund determined as of the date of termination, reduced by—

(i) The amount of any deemed distribution that was not actually distributed before the date of termination if the amount of the deemed distribution was included in the gross income of the electing taxpayer for the taxable year in which the deemed distribution occurred; and

(ii) The amount of any tax that—

(A) Is imposed on the income of the fund;

(B) Is attributable to income taken into account before the date the termination occurs or as a result of the termination; and

(C) Has not been paid as of the date the termination occurs.

Contributions made to a nuclear decommissioning fund after the termination date are not deductible under section 468A(a) and paragraph (a) of § 1.468A–2. In addition, if any assets are held by the fund after the termination date, the income earned by such assets after the termination date must be included in the gross income of the electing taxpayer (see section 671) to the extent that such income is otherwise includible under chapter 1 of the Internal Revenue Code. Finally, an electing taxpayer using an accrual method of accounting is allowed a deduction for nuclear decommissioning costs that are incurred during any taxable year (see paragraph (e) of § 1.468A–2) even if such costs are incurred after substantial completion of decommissioning (*e.g.*, expenses incurred to monitor or safeguard the plant site).

(2) *Substantial completion of decommissioning defined.* (i) Except as otherwise provided in paragraph (d)(2)(ii) of this section, the substantial completion of the decommissioning of a nuclear power plant occurs on the date that the maximum acceptable radioactivity levels mandated by the Nuclear Regulatory Commission with respect to a decommissioned nuclear power plant are satisfied (the ‘‘substantial completion date’’).

(ii) If a significant portion of the total estimated decommissioning costs with respect to a nuclear power plant are not incurred on or before the substantial completion date, an electing taxpayer may request, and the Internal Revenue Service shall issue, a ruling that designates the date on which substantial completion of decommissioning occurs. The date designated in the ruling shall not be later than the last day of the third taxable year after the taxable year that includes the substantial completion date. The request for a ruling under this paragraph (d)(2)(ii) must be filed during the taxable year that includes the substantial completion date and must comply with the procedural rules in effect at the time of the request.

[T.D. 8184, 53 FR 6815, Mar. 3, 1988, as amended by T.D. 8461, 57 FR 62200, Dec. 30, 1992; T.D. 8580, 59 FR 66474, Dec. 27, 1994; 60 FR 8932, Feb. 16, 1995]

§ 1.468A–6 Disposition of an interest in a nuclear power plant.

(a) *In general.* This section describes the federal income tax consequences of a transfer of the assets of a nuclear decommissioning fund (Fund) within the meaning of § 1.468A–1(b)(3) in connection with a sale, exchange, or other disposition by a taxpayer (transferor) of all or a portion of its qualifying interest in a nuclear power plant to another taxpayer (transferee). This section also explains how a schedule of ruling amounts will be determined for the transferor and transferee.

(b) *Requirements.* This section applies if—

(1) Immediately before the disposition, the transferor maintained a Fund with respect to the interest disposed of; and

(2) Immediately after the disposition—

(i) The transferee maintains a Fund with respect to the interest acquired;

(ii) The interest acquired is a qualifying interest of the transferee in the nuclear power plant;

(iii) Either a proportionate amount (which could include all) of the assets of the transferor's Fund is transferred to a Fund of the transferee, or the transferor's entire Fund is transferred to the transferee, provided in the latter case (or if the transferee receives all of the assets in the transferor's Fund, but not the transferor's Fund) that the transferee acquires the transferor's entire qualifying interest in the plant; and

(iv) The transferee continues to satisfy the requirements of §1.468A–5(a)(iii), which permits an electing taxpayer to maintain only one Fund for each plant.

(c) *Tax consequences.* A disposition that satisfies the requirements of paragraph (b) of this section will have the following tax consequences at the time it occurs:

(1) *The transferor and its Fund.* Neither the transferor nor the transferor's Fund will recognize gain or loss or otherwise take any income or deduction into account by reason of the transfer of a proportionate amount of the assets of the transferor's Fund to the transferee's Fund (or by reason of the transfer of the transferor's entire Fund to the transferee). For purposes of the regulations under section 468A, this transfer (or the transfer of the transferor's Fund) will not be considered a distribution of assets by the transferor's Fund.

(2) *The transferee and its Fund.* Neither the transferee nor the transferee's Fund will recognize gain or loss or otherwise take any income or deduction into account by reason of the transfer of a proportionate amount of the assets of the transferor's Fund to the transferee's Fund (or by reason of the transfer of the transferor's Fund to the transferee). For purposes of the regulations under section 468A, this transfer (or the transfer of the transferor's Fund) will not constitute a payment or a contribution of assets by the transferee to its Fund.

(3) *Basis.* Transfers of assets of a Fund to which this section applies do not affect basis. Thus, the transferee's Fund will have a basis in the assets received from the transferor's Fund that is the same as the basis of those assets in the transferor's Fund immediately before the disposition.

(d) *Determination of proportionate amount.* For purposes of this section, a transferor of a qualifying interest in a nuclear power plant is considered to transfer a proportionate amount of the assets of its Fund to a Fund of a transferee of the interest if, on the date of the transfer of the interest, the percentage of the fair market value of the Fund's assets that are transferred equals the percentage of the transferor's qualifying interest that is transferred.

(e) *Calculation of schedule of ruling amounts for dispositions described in this section*—(1) *Transferor.* If a transferor disposes of all or a portion of its qualifying interest in a nuclear power plant in accordance with this section, the transferor's schedule of ruling amounts with respect to the interests disposed of and retained (if any) will be determined in accordance with paragraphs (e)(1) (i) and (ii) of this section.

(i) *Taxable year of disposition.* If a transferor does not file a request for a revised schedule of ruling amounts on or before the deemed payment deadline for the taxable year of the transferor in which the disposition of its interest in the nuclear power plant occurs (that is, the date that is two and one-half months after the close of that year), the transferor's ruling amount with respect to that plant for that year will equal the sum of—

(A) The ruling amount contained in the transferor's current schedule of ruling amounts with respect to that plant for that taxable year multiplied by the portion of the qualifying interest that is retained (if any); and

(B) The ruling amount contained in the transferor's current schedule of ruling amounts with respect to that plant for that taxable year multiplied by the product of—

(*1*) The portion of the transferor's qualifying interest that is disposed of; and

(*2*) A fraction, the numerator of which is the number of days in that taxable year that precede the date of disposition, and the denominator of which is the number of days in that taxable year.

(ii) *Taxable years after the year of disposition.* A transferor that retains a qualifying interest in a nuclear power plant must file a request for a revised schedule of ruling amounts with respect to that interest on or before the deemed payment deadline for the first taxable year of the transferor beginning after the disposition. See § 1.468A–3(i)(1)(ii)(B). If the transferor does not timely file such a request, the transferor's ruling amount with respect to that interest for the affected year or years will be zero, unless the Internal Revenue Service waives the application of this paragraph (e)(1)(ii) upon a showing of good cause for the delay.

(2) *Transferee.* If a transferee acquires all or a portion of a transferor's qualifying interest in a nuclear power plant under this section, the transferee's schedule of ruling amounts with respect to the interest acquired will be determined under paragraphs (e)(2) (i) and (ii) of this section.

(i) *Taxable year of disposition.* If a transferee does not file a request for a schedule of ruling amounts on or before the deemed payment deadline for the taxable year of the transferee in which the disposition occurs (that is, the date that is two and one-half months after the close of that year), the transferee's ruling amount with respect to the interest acquired in the nuclear power plant for that year is the amount described in the following sentence. This amount is the amount contained in the transferor's current schedule of ruling amounts for that plant for the taxable year of the transferor in which the disposition occurred, multiplied by the product of—

(A) The portion of the transferor's qualifying interest that is transferred; and

(B) A fraction, the numerator of which is the number of days in the taxable year of the transferor including and following the date of disposition, and the denominator of which is the number of days in that taxable year.

(ii) *Taxable years after the year of disposition.* A transferee of a qualifying interest in a nuclear power plant must file a request for a revised schedule of ruling amounts with respect to that interest on or before the deemed payment deadline for the first taxable year of the transferee beginning after the disposition. See § 1.468A–3(i)(1)(ii)(B). If the transferee does not timely file such a request, the transferee's ruling amount with respect to that interest for the affected year or years will be zero, unless the Internal Revenue Service waives the application of this paragraph (e)(2)(ii) upon a showing of good cause for the delay.

(3) *Example.* The following example illustrates the provisions of this paragraph (e).

Example. (i) *X* Corporation is a calendar year taxpayer engaged in the sale of electric energy generated by a nuclear power plant. The plant is owned entirely by *X*. On May 27, 1995, *X* transfers a 60 percent qualifying interest in the plant to *Y* Corporation, a calendar year taxpayer. Before the transfer, *X* had received a schedule of ruling amounts containing an annual ruling amount of $10 million for the taxable years 1993 through 2013. For 1995, neither *X* nor *Y* files a request for a revised schedule of ruling amounts.

(ii) Under paragraph (e)(1)(i) of this section, *X*'s ruling amount for 1995 is calculated as follows: ($10,000,000×40%) + ($10,000,000×60%×146/365)=$6,400,000. Under paragraph (e)(2)(i) of this section, Y's ruling amount for 1995 is calculated as follows: $10,000,000×60%×219/365=$3,600,000. Under paragraphs (e)(1)(ii) and (e)(2)(ii) of this section, *X* and *Y* must file requests for revised schedules of ruling amounts by March 15, 1997.

(f) *Calculation of the qualifying percentage after dispositions described in this section*—(1) *In general.* If a transferee acquires an interest in a nuclear power plant in a transaction that satisfies the requirements of this section, the transferee's qualifying percentage (within the meaning of § 1.468A–3(d)(4)) for the interest acquired is the transferor's qualifying percentage for that interest immediately before the disposition. If the Internal Revenue Service has not approved a qualifying percentage for the transferor with respect to the interest transferred, the qualifying percentage for that interest is determined under § 1.468A–3(d)(4).

(2) *Special rule.* The Internal Revenue Service may, in its discretion, determine a qualifying percentage for an interest in a nuclear power plant acquired by a transferee on a basis other than the rule set forth in paragraph (f)(1) of this section if—

(i) In connection with its first request for a schedule of ruling amounts after the disposition, the transferee requests special treatment, explains the need for such treatment, and sets forth an alternative basis for determining the qualifying percentage; and

(ii) The Internal Revenue Service determines that the special treatment is consistent with the purposes of section 468A.

(g) *Other*—(1) *Anti-abuse provision.* The Internal Revenue Service may treat a disposition occurring on or after December 27, 1994 as satisfying the requirements of this section if the Internal Revenue Service determines that this treatment is necessary or appropriate to carry out the purposes of section 468A and the regulations thereunder.

(2) *Relief provision.* Upon request of the electing taxpayer, the Internal Revenue Service may treat a disposition occurring after July 17, 1984, and before December 27, 1994 as satisfying the requirements of this section if the Internal Revenue Service determines that this treatment is necessary or appropriate to carry out the purposes of section 468A and the regulations thereunder.

(h) *Effective date.* Section 1.468A–6 is effective for a disposition of an interest in a nuclear power plant on or after December 27, 1994.

[T.D. 8580, 59 FR 66474, Dec. 27, 1994]

§1.468A–7 Manner of and time for making election.

(a) *In general.* An eligible taxpayer is allowed a deduction for the taxable year in which the taxpayer makes a cash payment (or is deemed to make a cash payment) to a nuclear decommissioning fund only if the taxpayer elects the application of section 468A. A separate election is required for each nuclear decommissioning fund and for each taxable year with respect to which payments are to be deducted under section 468A. In the case of an affiliated group of corporations that join in the filing of a consolidated return for a taxable year, the common parent must make a separate election on behalf of each member whose payments to a nuclear decommissioning fund during such taxable year are to be deducted under section 468A. The election under section 468A for any taxable year is irrevocable and must be made by attaching a statement (‘‘Election Statement’’) and a copy of the schedule of ruling amounts provided pursuant to the rules of §1.468A–3 to the taxpayer’s Federal income tax return (or, in the case of an affiliated group of corporations that join in the filing of a consolidated return, the consolidated return) for such taxable year. Except as otherwise provided in paragraph (b)(3) of §1.468A–8, the return to which the Election Statement and a copy of the schedule of ruling amounts is attached must be filed on or before the time prescribed by law (including extensions) for filing the return for the taxable year with respect to which payments are to be deducted under section 468A.

(b) *Required information.* The Election Statement must include the following information:

(1) The legend ‘‘Election Under Section 468A’’ typed or legibly printed at the top of the first page.

(2) The electing taxpayer’s name, address and taxpayer identification number (or, in the case of an affiliated group of corporations that join in the filing of a consolidated return, the name, address and taxpayer identification number of each electing taxpayer).

(3) The taxable year for which the election is made.

(4) For each nuclear decommissioning fund for which an election is made—

(i) The name and location of the nuclear power plant to which the fund relates;

(ii) The name and employer identification number of the nuclear decommissioning fund;

(iii) The total amount of actual cash payments made to the nuclear decommissioning fund during the taxable year that were not treated as deemed cash payments under paragraph (c)(1) of §1.468A–2 for a prior taxable year;

(iv) The total amount of cash payments deemed made to the nuclear decommissioning fund under paragraph (c)(1) of §1.468A–2 for the taxable year; and

(v) The cost of service amount for the taxable year (see paragraph (b)(2) of § 1.468A–2).

[T.D. 8184, 53 FR 6818, Mar. 3, 1988]

§ 1.468A–8 Effective date and transitional rules.

(a) *Effective date*—(1) *In general.* Section 468A and §§ 1.468A–1 through 1.468A–5, 1.468A–7 and 1.468A–8 are effective on July 18, 1984, and apply with respect to taxable years ending on or after such date.

(2) *Cut-off method applicable to electing taxpayers.* Any amount of nuclear decommissioning costs taken into account before July 18, 1984, for a taxable year beginning before such date, is not allowable as a deduction after July 17, 1984, under section 468A(c)(2) and paragraph (e) of § 1.468A–2.

(b) *Transitional rules*—(1) *Time for filing request for schedule of ruling amounts.* The Internal Revenue Service shall provide a ruling amount for any taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, if—

(i) Paragraph (g) of § 1.468A–3 is satisfied for the taxable year; and

(ii) The taxpayer files a request for a schedule of ruling amounts that includes a proposed ruling amount for the taxable year on or before June 1, 1988.

(2) *Manner of and time for making contributions to a nuclear decommissioning fund.* (i) The amount of any contribution (including a contribution of property allowed under paragraph (b)(2)(ii) of this section) to a nuclear decommissioning fund that relates to a taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, shall be deemed made during such taxable year if—

(A) The taxpayer makes such contribution on or before the 30th day after the date the taxpayer receives a ruling amount applicable to such taxable year; and

(B) The taxpayer irrevocably designates the amount of such contribution as relating to such taxable year on the Election Statement attached to its Federal income tax return (or amended return) for such taxable year.

(ii)(A) An electing taxpayer may contribute property to a nuclear decommissioning fund if the property—

(*1*) Is described in paragraph (a)(3)(i)(C) of § 1.468–5;

(*2*) Was acquired after July 18, 1984, and before March 3, 1988; and

(*3*) Is contributed for any taxable year ending after July 18, 1984, and beginning before March 3, 1988.

(B) If a taxpayer contributes property to a nuclear decommissioning fund under this paragraph (b)(2)(ii)—

(*1*) The amount of the contribution (and the basis of the property to the nuclear decommissioning fund) shall equal the fair market value of the property on the date the property is contributed to the nuclear decommissioning fund;

(*2*) The contribution of the property to the nuclear decommissioning fund shall be considered a sale or exchange of the property by the taxpayer for purposes of section 1001; and

(*3*) For purposes of section 1001, the amount realized by the taxpayer shall be the fair market value of the property on the date the property was contributed to the nuclear decommissioning fund.

(iii) A fund established by a taxpayer for the purpose of paying the decommissioning costs of a nuclear power plant is not treated as a nuclear decommissioning fund before the earlier of—

(A) The date the taxpayer receives an initial schedule of ruling amounts with respect to the fund, or

(B) The first day of the first taxable year of the taxpayer that begins on or after January 1, 1987,

even if the taxpayer elects the application of section 468A for a taxable year that begins before such date. Any income earned before such date by the assets of a fund that satisfies the requirements of § 1.468A–5 must be included in the gross income of the taxpayer treated under section 671 as the owner of such assets.

(iv) If a fund is first treated as a nuclear decommissioning fund on the date described in paragraph (b)(2)(iii) of this section—

(A) The assets held in the fund on such date shall be treated for purposes of this paragraph (b)(2) as assets contributed to the nuclear decommissioning fund on such date; and

(B) The withdrawal of any such assets on or before the date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for the taxable year that includes such date shall be treated in the same manner as the withdrawal of an excess contribution (see paragraph (c)(2) of §1.468A–5).

(3) *Manner of and time for making election.* A taxpayer may elect the application of section 468A for a taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, by attaching the Election Statement and a copy of the schedule of ruling amounts to—

(i) A return that is filed on or before the time prescribed by law (including extensions) for filing to return for such taxable year; or

(ii) An amended return for such taxable year that is filed on or before the 90th day after the date that the taxpayer receives a ruling amount for such table year.

(4) *Determination of cost of service limitation.* (i) For purposes of section 468A(b)(1) and paragraph (b)(2)(ii) of §1.468A–2, decommissioning costs included in cost of service for any taxable year beginning before January 1, 1987, shall include decommissioning costs that can be accurately determined from information contained in the regulated books of account or other written records of the taxpayer.

(ii) For purposes of section 468A(b)(1) and paragraph (b)(2) of §1.468A–2, the cost of service amount applicable to a nuclear decommissioning fund for the taxable year that includes July 18, 1984, is the amount determined under paragraph (b)(2) of §1.468A–2 multiplied by a fraction, the numerator of which is the amount of nuclear decommissioning costs that is directly or indirectly charged to customers in such taxable year and that is included in the taxable income of the taxpayer for such taxable year and the denominator of which is the amount of nuclear decommissioning costs that is directly or indirectly charged to customers in such taxable year and that would have been included in the gross income of the taxpayer if such costs were taken into account by the taxpayer in the same manner as amounts charged for electric energy (see §1.88–1). Under the preceding sentence, an amount of decommissioning costs is included in the taxable income of a taxpayer for the taxable year that includes July 18, 1984, if the amount is included in gross income for such taxable year and no deduction (other than a deduction allowed under section 468A(a) and paragraph (a) of §1.468A–2) is claimed with respect to such amount for such taxable year.

(5) *Assumptions and determinations to be used in determining ruling amounts.* (i) To the extent consistent with the principles and provisions of §1.468A–3, a ruling amount for any taxable year beginning before January 1, 1987, shall be based on the reasonable assumptions and determinations used by the applicable public utility commission(s) in establishing or approving the amount of decommissioning costs included in cost of service for ratemaking purposes for such taxable year.

(ii) If the applicable public utility commission(s) did not disclose the after-tax rate of return used in establishing or approving the amount of decommissioning costs included in cost of service for any period during a taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, the after-tax rate of return during such period is equal to 54 percent of the overpayment rate in effect under section 6621 during such period.

(iii) If the applicable public utility commission(s) did not disclose the other assumptions and determinations used in establishing or approving the amount of decommissioning costs included in cost of service for any taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, ruling amount for each such taxable year shall be determined by taking into account—

(A) The amount of decommissioning costs included in cost of service for such taxable year;

(B) The qualifying percentage (as determined under paragraph (d)(4) of §1.468A–3 and paragraph (b)(7) of this section); and

(C) The amount of decommissioning costs included in cost of service for any earlier taxable year.

(6) *Exception to level funding limitation.* Notwithstanding paragraph (b) of § 1.468A–3, the Internal Revenue Service may, in its discretion, provide a schedule of ruling amounts specifying a ruling amount for a taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, that is greater than the ruling amount specified in such scedule for a later taxable year.

(7) *Determination of qualifying percentage.* (i)(A) The qualifying percentage shall be determined under this paragraph (b)(7)(i) if a nuclear power plant began commercial operations on or before July 10, 1986, and a taxpayer—

(*1*) Files a request for a schedule of ruling amounts for the nuclear decommissioning fund maintained with respect to such nuclear power plant on or before June 1, 1988; and

(*2*) Elects the application of this paragraph (b)(7)(i) in its request for a schedule of ruling amounts.

(B) If the qualifying percentage is determined under this paragraph (b)(7)(i), the estimated period for which the nuclear decommissioning fund is to be in effect for purposes of paragraph (d)(4)(ii) of § 1.468A–3 begins on the later of—

(*1*) The first day of the taxable year that includes the date that the nuclear power plant began commercial operations; or

(*2*) The first day of the taxable year that includes July 18, 1984.

(ii)(A) The qualifying percentage shall be determined under this paragraph (b)(7)(ii) if a nuclear power plant began commercial operations before July 18, 1984, and a taxpayer—

(*1*) Files a request for a schedule of ruling amounts for the nuclear decommissioning fund maintained with respect to such nuclear power plant on or before June 1, 1988; and

(*2*) Elects the application of this paragraph (b)(7)(ii) in its request for a schedule of ruling amounts.

(B) If the qualifying percentage is determined under this paragraph (b)(7)(ii), the estimated period for which the nuclear decommissioning fund is to be in effect for purposes of paragraph (d)(4)(ii) of § 1.468A–3 and the estimated useful life of the nuclear power plant for purposes of paragraph (d)(4)(iii) of § 1.468A–3 shall end on the earlier of—

(*1*) The last day of the taxable year in which it is estimated that decommissioning will begin; or

(*2*) The last day of the taxable year that includes the expiration date of the Nuclear Regulatory Commission operating license as in effect on July 18, 1984, without regard to any extensions or amendments thereto.

(iii) In the case of a nuclear power plant that began commercial operations before July 18, 1984, and whose estimated useful life for ratemaking purposes was adjusted by a public utility commission before July 18, 1984, a taxpayer may elect in its request for a schedule of ruling amounts to compute the qualifying percentage in accordance with the following rules:

(A) If the taxpayer files a request for a schedule of ruling amounts for the nuclear decommissioning fund maintained with respect to such nuclear power plant on or before June 1, 1988, the qualifying percentage equals the percentage of original depreciation costs (determined without regard to capitalized decommissioning costs) with respect to the nuclear power plant that remains to be recovered for ratemaking purposes as of the first day of the taxable year that includes July 18, 1984.

(B) If a taxpayer does not file a request for a schedule of ruling amounts for the nuclear decommissioning fund maintained with respect to such nuclear power plant on or before June 1, 1988, the qualifying percentage equals the percentage of original depreciation costs (determined without regard to capitalized decommissioning costs) with respect to the nuclear power plant that remains to be recovered for ratemaking purposes as of the first day of the first taxable year for which a deductible payment is made to the nuclear decommissioning fund that relates to such nuclear power plant.

(C) For purposes of this paragraph (b)(7)(iii), original depreciation costs with respect to a nuclear power plant include only those costs that were taken into account in determining the amount of depreciation with respect to such plant in the first ratemaking proceeding in which such depreciation was treated as a cost of service.

(8) *Limitation on payments to a nuclear decommissioning fund*—(i) The limitation on payments to a nuclear decommissioning fund (see section 468A(b) and paragraph (b) of §1.468A–2) for a taxable year that ends on or after July 18, 1984, and begin before January 1, 1987, shall be determined under paragraph (b)(8)(ii) of this section if—

(A) The electing taxpayer receives a ruling amount applicable to such taxable year after the deemed payment deadline date for such taxable year; and

(B) The requirements of paragraph (b)(8)(iii) of this section are satisfied.

(ii) If the limitation on payments to a nuclear decommissioning fund for a taxable year is determined under this paragraph (b)(8)(ii), the maximum amount of payments made (or deemed made) to the nuclear decommissioning fund during such taxable year shall not exceed the sum of—

(A) The amount determined under section 468A(b) and paragraph (b) of §1.468A–2 (*i.e.*, the lesser of the cost of service amount or the ruling amount) after application of the transitional rules contained in paragraph (b)(4), (5), (6) and (7) of this section; and

(B) The amount of after-tax earnings that would have accumulated to the date of actual payment to the nuclear decommissioning fund if the amount described in paragraph (b)(8)(ii)(A) of this section had been contributed to the nuclear decommissioning fund on the deemed payment deadline date for such taxable year.

In determining the after-tax earnings that would have accumulated to the date of payment, an electing taxpayer must use the after-tax rate of return of the nuclear decommissioning fund that was used in determining the initial schedule of ruling amounts.

(iii) In order to compute the payment limitation under paragraph (b)(8)(ii) of this section for any taxable year, an electing taxpayer must—

(A) Indicate on the Election Statement for the taxable year that the amount of the deductible payment is greater than the amount determined under section 468A(b) and paragraph (b) of §1.468A–2 because paragraph (b)(8) of §1.468A–8 applies;

(B) Not have claimed a deduction for the taxable year under section 468A(a) or paragraph (a) of §1.468A–2 on any return that is filed before the date that a ruling amount is received for the taxable year;

(C) Not have taken a deduction under section 468A (a) or paragraph (a) of §1.468A–2 into account in determining the amount properly estimated as tax for the taxable year under section 6081 (b) (relating to the automatic extension for filing corporate income tax returns); and

(D) Not take the deduction allowed with respect to such payment into account in determining the amount of any overpayment of tax (within the meaning of section 6611) or underpayment of tax (within the meaning of section 6601) for the period ending on the date of such payment (see paragraph (b)(9) of this section).

(iv) The following example illustrates the application of the principles of paragraph (b)(8) of this section:

Example. X corporation is a calendar year, accrual method taxpayer engaged in the sale of electric energy generated by a nuclear power plant owned by X. On September 15, 1987, X receives a schedule of ruling amounts from the Internal Revenue Service that includes a ruling amount of $1,000,000 for the 1986 taxable year. For purposes of this example, assume that the cost of service amount applicable to the nuclear decommissioning fund for the 1986 taxable year is also $1,000,000 and that the after-tax rate of return of the nuclear decommissioning fund that was used in determining the schedule of ruling amounts is 10 percent compounded semi-annually. On September 15, 1987, X makes a contribution of $1,050,000 to a nuclear decommissioning fund established by X. Under paragraph (b)(8)(ii) of this section, this contribution does not exceed the limitation on payments for the 1986 taxable year and the entire amount of the contribution is deductible for such year. The additional $50,000 deductible payment that is allowed under this paragraph (b)(8) reflects the foregone earnings of the fund for the six-month period beginning on the deemed payment deadline date for the 1986 taxable year (March 15, 1987) and ending on the date of the contribution (September 15, 1987).

(9) *Denial of interest on overpayment.* If a deduction is allowed by reason of paragraph (b)(2) of this section for the

amount of any payment made after the 15th day of the third calendar month after the close of the taxable year to which such payment relates, such deduction shall not be taken into account in determining the amount of any overpayment of tax (within the meaning of section 6611) or underpayment of tax (within the meaning of section 6601) for the period ending on the date of such payment.

(10) *Determination of addition to tax for failure to pay estimated tax.* In the case of any taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, the tax shown on the return for such taxable year for purposes of section 6655(b) shall equal the tax that would be shown on the return if a deduction were allowed for the lesser of—

(i) The amount of the payment made to the nuclear decommissioning fund for such taxable year; or

(ii) The amount determined under section 468A(b) and paragraph (b) of § 1.468A–2 (*i.e.*, the lesser of the cost of service amount or the ruling amount) after application of the transitional rules contained in paragraph (b)(4), (5), (6) and (7) of this section but without regard to the transitional rule contained in paragraph (b)(8) of this section.

(11) *Nuclear decommissioning fund qualification requirements.* For tax years beginning prior to January 1, 1995, the Service will not assert that an unincorporated organization referred to in § 1.468A–5(a)(1)(iv), established prior to January 1, 1993, through which the assets of a nuclear decommissioning fund are invested, is an association taxable as a corporation for federal tax purposes.

(12) *Use of formula or method.* Section 1.468A–2(f)(3)(ii) and § 1.468A–3(a)(4) (to the extent it permits a formula or method when the applicable public utility commission estimates the cost of decommissioning in future dollars), (e)(5), (i)(1)(ii)(A) (to the extent it requires the taxpayer to file a request for a revised schedule because of a substantial variation in ruling amounts), and (i)(1)(iii)(C) apply only to requests for a formula or method submitted on or after January 20, 1998 and to formulas and methods obtained in response to those requests.

[T.D. 8184, 53 FR 6818, Mar. 3, 1988; 53 FR 9276, Mar. 24, 1988, as amended by T.D. 8461, 57 FR 62200, Dec. 30, 1992; T.D. 8758, 63 FR 2894, Jan. 20, 1998]

§ 1.468B Designated settlement funds.

A designated settlement fund, as defined in section 468B(d)(2), is taxed in the manner described in § 1.468B–2. The rules for transferors to a qualified settlement fund described in § 1.468B–3 apply to transferors to a designated settlement fund. Similarly, the rules for claimants of a qualified settlement fund described in § 1.468B–4 apply to claimants of a designated settlement fund. A fund, account, or trust that does not qualify as a designated settlement fund is, however, a qualified settlement fund if it meets the requirements of a qualified settlement fund described in § 1.468B–1.

[T.D. 8459, 57 FR 60988, Dec. 23, 1992]

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[T.D. 8459, 57 FR 60988, Dec. 23, 1992, as amended by T.D. 8495, 58 FR 58787, Nov. 4, 1993]

§1.468B–1 Qualified settlement funds.

(a) *In general.* A qualified settlement fund is a fund, account, or trust that satisfies the requirements of paragraph (c) of this section.

(b) *Coordination with other entity classifications.* If a fund, account, or trust that is a qualified settlement fund could be classified as a trust within the meaning of §301.7701–4 of this chapter, it is classified as a qualified settlement fund for all purposes of the Internal Revenue Code (Code). If a fund, account, or trust, organized as a trust under applicable state law, is a qualified settlement fund, and could be classified as either an association (within the meaning of §301.7701–2 of this chapter) or a partnership (within the meaning of §301.7701–3 of this chapter), it is classified as a qualified settlement fund for all purposes of the Code. If a fund, account, or trust, established for contested liabilities pursuant to §1.461–2(c)(1) is a qualified settlement fund, it is classified as a qualified settlement fund for all purposes of the Code.

(c) *Requirements.* A fund, account, or trust satisfies the requirements of this paragraph (c) if—

(1) It is established pursuant to an order of, or is approved by, the United

States, any state (including the District of Columbia), territory, possession, or political subdivision thereof, or any agency or instrumentality (including a court of law) of any of the foregoing and is subject to the continuing jurisdiction of that governmental authority;

(2) It is established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability—

(i) Under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (hereinafter referred to as CERCLA), as amended, 42 U.S.C. 9601 *et seq.*; or

(ii) Arising out of a tort, breach of contract, or violation of law; or

(iii) Designated by the Commissioner in a revenue ruling or revenue procedure; and

(3) The fund, account, or trust is a trust under applicable state law, or its assets are otherwise segregated from other assets of the transferor (and related persons).

(d) *Definitions.* For purposes of this section—

(1) *Transferor.* A ‘‘transferor’’ is a person that transfers (or on behalf of whom an insurer or other person transfers) money or property to a qualified settlement fund to resolve or satisfy claims described in paragraph (c)(2) of this section against that person.

(2) *Related person.* A ‘‘related person’’ is any person who is related to the transferor within the meaning of sections 267(b) or 707(b)(1).

(e) *Governmental order or approval requirement*—(1) *In general.* A fund, account, or trust is ‘‘ordered by’’ or ‘‘approved by’’ a governmental authority described in paragraph (c)(1) of this section when the authority issues its initial or preliminary order to establish, or grants its initial or preliminary approval of, the fund, account, or trust, even if that order or approval may be subject to review or revision. Except as otherwise provided in paragraph (j)(2) of this section, the governmental authority’s order or approval has no retroactive effect and does not permit a fund, account, or trust to be a qualified settlement fund prior to the date the order is issued or the approval is granted.

(2) *Arbitration panels.* An arbitration award that orders the establishment of, or approves, a fund, account, or trust is an order or approval of a governmental authority described in paragraph (c)(1) of this section if—

(i) The arbitration award is judicially enforceable;

(ii) The arbitration award is issued pursuant to a bona fide arbitration proceeding in accordance with rules that are approved by a governmental authority described in paragraph (c)(1) of this section (such as self-regulatory organization-administered arbitration proceedings in the securities industry); and

(iii) The fund, account, or trust is subject to the continuing jurisdiction of the arbitration panel, the court of law that has jurisdiction to enforce the arbitration award, or the governmental authority that approved the rules of the arbitration proceeding.

(f) *Resolve or satisfy requirement*—(1) *Liabilities to provide services or property.* Except as otherwise provided in paragraph (f)(2) of this section, a liability is not described in paragraph (c)(2) of this section if it is a liability for the provision of services or property, unless the transferor’s obligation to provide services or property is extinguished by a transfer or transfers to the fund, account, or trust.

(2) *CERCLA liabilities.* A transferor’s liability under CERCLA to provide services or property is described in paragraph (c)(2) of this section if following its transfer to a fund, account, or trust the transferor’s only remaining liability to the Environmental Protection Agency (if any) is a remote, future obligation to provide services or property.

(g) *Excluded liabilities.* A liability is not described in paragraph (c)(2) of this section if it—

(1) Arises under a workers compensation act or a self-insured health plan;

(2) Is an obligation to refund the purchase price of, or to repair or replace, products regularly sold in the ordinary course of the transferor’s trade or business;

(3) Is an obligation of the transferor to make payments to its general trade creditors or debtholders that relates to a title 11 or similar case (as defined in section 368(a)(3)(A)), or a workout; or

(4) Is designated by the Commissioner in a revenue ruling or a revenue procedure (see §601.601(d)(2)(ii)(*b*) of this chapter).

(h) *Segregation requirement*—(1) *In general.* If it is not a trust under applicable state law, a fund, account, or trust satisfies the requirements of paragraph (c)(3) of this section if its assets are physically segregated from other assets of the transferor (and related persons). For example, cash held by a transferor in a separate bank account satisfies the segregation requirement of paragraph (c)(3) of this section.

(2) *Classification of fund established to resolve or satisfy allowable and non-allowable claims.* If a fund, account, or trust is established to resolve or satisfy claims described in paragraph (c)(2) of this section as well as other types of claims (*i.e.*, non-allowable claims) arising from the same event or related series of events, the fund is a qualified settlement fund. However, under §1.468B–3(c), economic performance does not occur with respect to transfers to the qualified settlement fund for non-allowable claims.

(i) [Reserved]

(j) *Classification of fund prior to satisfaction of requirements in paragraph (c) of this section*—(1) *In general.* If a fund, account, or trust is established to resolve or satisfy claims described in paragraph (c)(2) of this section, the assets of the fund, account, or trust are treated as owned by the transferor of those assets until the fund, account, or trust also meets the requirements of paragraphs (c) (1) and (3) of this section. On the date the fund, account, or trust satisfies all the requirements of paragraph (c) of this section, the transferor is treated as transferring the assets to a qualified settlement fund.

(2) *Relation-back rule*—(i) *In general.* If a fund, account, or trust meets the requirements of paragraphs (c)(2) and (c)(3) of this section prior to the time it meets the requirements of paragraph (c)(1) of this section, the transferor and administrator (as defined in §1.468B–2(k)(3)) may jointly elect (a relation-back election) to treat the fund, account, or trust as coming into existence as a qualified settlement fund on the later of the date the fund, account, or trust meets the requirements of paragraphs (c)(2) and (c)(3) of this section or January 1 of the calendar year in which all the requirements of paragraph (c) of this section are met. If a relation-back election is made, the assets held by the fund, account, or trust on the date the qualified settlement fund is treated as coming into existence are treated as transferred to the qualified settlement fund on that date.

(ii) *Relation-back election.* A relation-back election is made by attaching a copy of the election statement, signed by each transferor and the administrator, to (and as part of) the timely filed income tax return (including extensions) of the qualified settlement fund for the taxable year in which the fund is treated as coming into existence. A copy of the election statement must also be attached to (and as part of) the timely filed income tax return (including extensions), or an amended return that is consistent with the requirements of §§1.468B–1 through 1.468B–4, of each transferor for the taxable year of the transferor that includes the date on which the qualified settlement fund is treated as coming into existence. The election statement must contain—

(A) A legend, ‘‘§1.468B–1 Relation-Back Election’’, at the top of the first page;

(B) Each transferor’s name, address, and taxpayer identification number;

(C) The qualified settlement fund’s name, address, and employer identification number;

(D) The date as of which the qualified settlement fund is treated as coming into existence; and

(E) A schedule describing each asset treated as transferred to the qualified settlement fund on the date the fund is treated as coming into existence. The schedule of assets does not have to identify the amount of cash or the property treated as transferred by a particular transferor. If the schedule does not identify the transferor of each asset, however, each transferor must include with the copy of the election statement that is attached to its income tax return (or amended return) a schedule describing each asset the transferor is treated as transferring to the qualified settlement fund.

(k) *Examples.* The following examples illustrate the rules of this section:

Example 1. In a class action brought in a United States federal district court, the court holds that the defendant, Corporation X, violated certain securities laws and must pay damages in the amount of $150 million. Pursuant to an order of the court, Corporation X transfers $50 million in cash and transfers property with a fair market value of $75 million to a state law trust. The trust will liquidate the property and distribute the cash proceeds to the plaintiffs in the class action. The trust is a qualified settlement fund because it was established pursuant to the order of a federal district court to resolve or satisfy claims against Corporation X for securities law violations that have occurred.

Example 2. (i) Assume the same facts as in *Example 1,* except that Corporation X and the class of plaintiffs reach an out-of-court settlement that requires Corporation X to establish and fund a state law trust before the settlement agreement is submitted to the court for approval.

(ii) The trust is not a qualified settlement fund because it neither is established pursuant to an order of, nor has it been approved by, a governmental authority described in paragraph (c)(1) of this section.

Example 3. On June 1, 1994, Corporation Y establishes a fund to resolve or satisfy claims against it arising from the violation of certain securities laws. On that date, Corporation Y transfers $10 million to a segregated account. On December 1, 1994, a federal district court approves the fund. Assuming Corporation Y and the administrator of the qualified settlement fund do not make a relation-back election, Corporation Y is treated as the owner of the $10 million, and is taxable on any income earned on that money, from June 1 through November 30, 1994. The fund is a qualified settlement fund beginning on December 1, 1994.

Example 4. (i) On September 1, 1993, Corporation X, which has a taxable year ending on October 31, enters into a settlement agreement with a plaintiff class for asserted tort liabilities. Under the settlement agreement, Corporation X makes two $50 million payments into a segregated fund, one on September 1, 1993, and one on October 1, 1993, to resolve or satisfy the tort liabilities. A federal district court approves the settlement agreement on November 1, 1993.

(ii) The administrator of the fund and Corporation X elect to treat the fund as a qualified settlement fund prior to governmental approval under the relation-back rule of paragraph (j)(2) of this section. The administrator must attach the relation-back election statement to the fund's income tax return for calendar year 1993, and Corporation X must attach the election to its original or amended income tax return for its taxable year ending October 31, 1993.

(iii) Pursuant to the relation-back election, the fund begins its existence as a qualified settlement fund on September 1, 1993, and Corporation X is treated as transferring $50 million to the qualified settlement fund on September 1, 1993, and $50 million on October 1, 1993.

(iv) With respect to these transfers, Corporation X must provide the statement described in § 1.468B–3(e) to the administrator of the qualified settlement fund by February 15, 1994, and must attach a copy of this statement to its original or amended income tax return for its taxable year ending October 31, 1993.

Example 5. Assume the same facts as in *Example 4,* except that the court approves the settlement on May 1, 1994. The administrator must attach the relation-back election statement to the fund's income tax return for calendar year 1994, and Corporation X must attach the election statement to its original or amended income tax return for its taxable year ending October 31, 1994. Pursuant to this election, the fund begins its existence as a qualified settlement fund on January 1, 1994. In addition, Corporation X is treated as transferring to the qualified settlement fund all amounts held in the fund on January 1, 1994. With respect to the transfer, Corporation X must provide the statement described in § 1.468B–3(e) to the administrator of the qualified settlement fund by February 15, 1995, and must attach a copy of this statement to its income tax return for its taxable year ending October 31, 1994.

Example 6. Corporation Z establishes a fund that meets all the requirements of section 468B(d)(2) for a designated settlement fund, except that Corporation Z does not make the election under section 468B(d)(2)(F). Although the fund does not qualify as a designated settlement fund, it is a qualified settlement fund because the fund meets the requirements of paragraph (c) of this section.

Example 7. Corporation X owns and operates a landfill in State A. State A requires Corporation X to transfer money to a trust annually based on the total tonnage of material placed in the landfill during the year. Under the laws of State A, Corporation X will be required to perform (either itself or through contractors) specified closure activities when the landfill is full, and the trust assets will be used to reimburse Corporation X for those closure costs. The trust is not a qualified settlement fund because it is established to secure the liability of Corporation X to perform the closure activities.

[T.D. 8459, 57 FR 60989, Dec. 23, 1992; 58 FR 7865, Feb. 10, 1993]

§ 1.468B–2 Taxation of qualified settlement funds and related administrative requirements.

(a) *In general.* A qualified settlement fund is a United States person and is subject to tax on its modified gross income for any taxable year at a rate equal to the maximum rate in effect for that taxable year under section 1(e).

(b) *Modified gross income.* The ''modified gross income'' of a qualified settlement fund is its gross income, as defined in section 61, computed with the following modifications—

(1) In general, amounts transferred to the qualified settlement fund by, or on behalf of, a transferor to resolve or satisfy a liability for which the fund is established are excluded from gross income. However, dividends on stock of a transferor (or a related person), interest on debt of a transferor (or a related person), and payments in compensation for late or delayed transfers, are not excluded from gross income.

(2) A deduction is allowed for administrative costs and other incidental expenses incurred in connection with the operation of the qualified settlement fund that would be deductible under chapter 1 of the Internal Revenue Code in determining the taxable income of a corporation. Administrative costs and other incidental expenses include state and local taxes, legal, accounting, and actuarial fees relating to the operation of the qualified settlement fund, and expenses arising from the notification of claimants and the processing of their claims. Administrative costs and other incidental expenses do not include legal fees incurred by, or on behalf of, claimants.

(3) A deduction is allowed for losses sustained by the qualified settlement fund in connection with the sale, exchange, or worthlessness of property held by the fund to the extent the losses would be deductible in determining the taxable income of a corporation under section 165 (f) or (g), and sections 1211(a) and 1212(a).

(4) A deduction is allowed for the amount of a net operating loss of the qualified settlement fund to the extent the loss would be deductible in determining the taxable income of a corporation under section 172(a). For purposes of this paragraph (b)(4), the net operating loss of a qualified settlement fund for a taxable year is the amount by which the deductions allowed under paragraphs (b)(2) and (b)(3) of this section exceed the gross income of the fund computed with the modification described in paragraph (b)(1) of this section.

(c) *Partnership interests held by a qualified settlement fund on February 14, 1992*—(1) *In general.* For taxable years ending prior to January 1, 2003, a qualified settlement fund that holds a partnership interest it acquired prior to February 15, 1992, is allowed a deduction for its distributive share of that partnership's items of loss, deduction, or credit described in section 702(a) that would be deductible in determining the taxable income (or in the case of a credit, the income tax liability) of a corporation to the extent of the fund's distributive share of that partnership's items of income and gain described in section 702(a) for the same taxable year. For purposes of this paragraph (c)(1), a distributive share of a partnership credit is treated as a deduction in an amount equal to the amount of the credit divided by the rate described in paragraph (a) of this section.

(2) *Limitation on changes in partnership agreements and capital contributions.* For purposes of paragraph (c)(1) of this section, changes in a qualified settlement fund's distributive share of items of income, gain, loss, deduction, or credit are disregarded if—

(i) They result from a change in the terms of the partnership agreement on or after December 18, 1992, or a capital contribution to the partnership on or after December 18, 1992, unless the partnership agreement as in effect prior to December 18, 1992, requires the contribution; and

(ii) A principal purpose of the change in the terms of the partnership agreement or the capital contribution is to circumvent the limitation described in paragraph (c)(1) of this section.

(d) *Distributions to transferors and claimants.* Amounts that are distributed by a qualified settlement fund to, or on behalf of, a transferor or a claimant are not deductible by the fund.

(e) *Basis of property transferred to a qualified settlement fund.* A qualified settlement fund's initial basis in property it receives from a transferor (or from an insurer or other person on behalf of a transferor) is the fair market value of that property on the date of transfer to the fund.

(f) *Distribution of property.* A qualified settlement fund must treat a distribution of property as a sale or exchange of that property for purposes of section 1001(a). In computing gain or loss, the amount realized by the qualified settlement fund is the fair market value of the property on the date of distribution.

(g) *Other taxes.* The tax imposed under paragraph (a) of this section is in lieu of any other taxation of the income of a qualified settlement fund under subtitle A of the Internal Revenue Code. Thus, a qualified settlement fund is not subject to the alternative minimum tax of section 55, the accumulated earnings tax of section 531, the personal holding company tax of section 541, or the maximum capital gains rate of section 1(h). A qualified settlement fund is, however, subject to taxes that are not imposed on the income of a taxpayer, such as the tax on transfers of property to foreign entities under section 1491.

(h) *Denial of credits against tax.* The tax imposed on the modified gross income of a qualified settlement fund under paragraph (a) of this section may not be reduced or offset by any credits against tax provided by part IV of subchapter A of chapter 1 of the Internal Revenue Code.

(i) [Reserved]

(j) *Taxable year and accounting method.* The taxable year of a qualified settlement fund is the calendar year. A qualified settlement fund must use an accrual method of accounting within the meaning of section 446(c).

(k) *Treatment as corporation for purposes of subtitle F.* Except as otherwise provided in § 1.468B–5(b), for purposes of subtitle F of the Internal Revenue Code, a qualified settlement fund is treated as a corporation and any tax imposed under paragraph (a) of this section is treated as a tax imposed by section 11. Subtitle F rules that apply to qualified settlement funds include, but are not limited to—

(1) A qualified settlement fund must file an income tax return with respect to the tax imposed under paragraph (a) of this section for each taxable year that the fund is in existence, whether or not the fund has gross income for that taxable year.

(2) A qualified settlement fund is in existence for the period that—

(i) Begins on the first date on which the fund is treated as a qualified settlement fund under § 1.468B–1; and

(ii) Ends on the earlier of the date the fund—

(A) No longer satisfies the requirements of § 1.468B–1; or

(B) No longer has any assets and will not receive any more transfers. (See paragraph (m) of this section for procedures for the prompt assessment of tax.)

(3) The income tax return of the qualified settlement fund must be filed on or before March 15 of the year following the close of the taxable year of the qualified settlement fund unless the fund is granted an extension of time for filing under section 6081. The return must be made by the administrator of the qualified settlement fund. The ‘‘administrator’’ (which may include a trustee if the qualified settlement fund is a trust) of a qualified settlement fund is, in order of priority—

(i) The person designated, or approved, by the governmental authority that ordered or approved the fund for purposes of § 1.468B–1(c)(1);

(ii) The person designated in the escrow agreement, settlement agreement, or other similar agreement governing the fund;

(iii) The escrow agent, custodian, or other person in possession or control of the fund's assets; or

(iv) The transferor or, if there are multiple transferors, all the transferors, unless an agreement signed by all the transferors designates a single transferor as the administrator.

(4) The administrator of a qualified settlement fund must obtain an employer identification number for the fund.

(5) A qualified settlement fund must deposit all payments of tax imposed under paragraph (a) of this section (including any payments of estimated tax) with an authorized government depositary in accordance with §1.6302–1.

(6) A qualified settlement fund is subject to the addition to tax imposed by section 6655 in the case of an underpayment of estimated tax computed with respect to the tax imposed under paragraph (a) of this section. For purposes of section 6655(g)(2), a qualified settlement fund's taxable income is its modified gross income and a transferor is not considered a predecessor of a qualified settlement fund.

(l) *Information reporting and withholding requirements*—(1) *Payments to a qualified settlement fund.* Payments to a qualified settlement fund are treated as payments to a corporation for purposes of the information reporting requirements of part III of subchapter A of chapter 61 of the Internal Revenue Code.

(2) *Payments and distributions by a qualified settlement fund*—(i) *In general.* Payments and distributions by a qualified settlement fund are subject to the information reporting requirements of part III of subchapter A of chapter 61 of the Internal Revenue Code (Code), and the withholding requirements of subchapter A of chapter 3 of subtitle A and subtitle C of the Code.

(ii) *Special rules.* The following rules apply with respect to payments and distributions by a qualified settlement fund—

(A) A qualified settlement fund must make a return for, or must withhold tax on, a distribution to a claimant if one or more transferors would have been required to make a return or withhold tax had that transferor made the distribution directly to the claimant;

(B) For purposes of sections 6041(a) and 6041A, if a qualified settlement fund makes a payment or distribution to a transferor, the fund is deemed to make the payment or distribution to the transferor in the course of a trade or business;

(C) For purposes of sections 6041(a) and 6041A, if a qualified settlement fund makes a payment or distribution on behalf of a transferor or a claimant, the fund is deemed to make the payment or distribution to the recipient of that payment or distribution in the course of a trade or business;

(D) With respect to a distribution or payment described in paragraph (l)(2)(ii)(C) of this section and the information reporting requirements of part III of subchapter A of chapter 61 of the Internal Revenue Code, the qualified settlement fund is also deemed to have made the distribution or payment to the transferor or claimant.

(m) *Request for prompt assessment.* A qualified settlement fund is eligible to request the prompt assessment of tax under section 6501(d). For purposes of section 6501(d), a qualified settlement fund is treated as dissolving on the date the fund no longer has any assets (other than a reasonable reserve for potential tax liabilities and related professional fees) and will not receive any more transfers.

(n) *Examples.* The following examples illustrate the rules of this section:

Example 1. On June 30, 1993, a United States federal district court approves the settlement of a lawsuit under which Corporation X must transfer $10,833,000 to a qualified settlement fund on August 1, 1993. The $10,833,000 includes $10 million of damages incurred by plaintiffs on October 1, 1992, and $833,000 of interest calculated at 10 percent annually from October 1, 1992, to August 1, 1993. The $833,000 of interest is not a payment to the qualified settlement fund in compensation for a late or delayed transfer to the fund within the meaning of paragraph (b)(1) of this section because the payment of $10,833,000 to the fund is not due until August 1, 1993.

Example 2. Assume the same facts as in *Example 1* except that the settlement agreement also provides for interest to accrue at a rate of 12 percent annually on any amount not transferred to the qualified settlement fund on August 1, 1993, and the only transfer Corporation X makes to the fund is $11,374,650 on January 1, 1994. The additional payment of $541,650 ($11,374,650 paid on January 1, 1994, less $10,833,000 due on August 1, 1993) is a payment to the qualified settlement fund in compensation for a late or delayed transfer to the fund within the meaning of paragraph (b)(1) of this section.

[T.D. 8459, 57 FR 60991, Dec. 23, 1992; 58 FR 7865, Feb. 10, 1993]

§ 1.468B–3 Rules applicable to the transferor.

(a) *Transfer of property*—(1) *In general.* A transferor must treat a transfer of property to a qualified settlement fund as a sale or exchange of that property for purposes of section 1001(a). In computing the gain or loss, the amount realized by the transferor is the fair market value of the property on the date the transfer is made (or is treated as made under § 1.468B–1(g)) to the qualified settlement fund. Because the issuance of a transferor's debt, obligation to provide services or property in the future, or obligation to make a payment described in § 1.461–4(g), is generally not a transfer of property by the transferor, it generally does not result in gain or loss to the transferor under this paragraph (a)(1). If a person other than the transferor transfers property to a qualified settlement fund, there may be other tax consequences as determined under general federal income tax principles.

(2) *Anti-abuse rule.* The Commissioner may disallow a loss resulting from the transfer of property to a qualified settlement fund if the Commissioner determines that a principal purpose for the transfer was to claim the loss and—

(i) The transferor places significant restrictions on the fund's ability to use or dispose of the property; or

(ii) The property (or substantially similar property) is distributed to the transferor (or a related person).

(b) *Qualified appraisal requirement for transfers of certain property*—(1) *In general.* A transferor must obtain a qualified appraisal to support a loss or deduction it claims with respect to a transfer to a qualified settlement fund of the following types of property—

(i) Nonpublicly traded securities (as defined in § 1.170A–13(c)(7)(ix)) issued by the transferor (or a related person); and

(ii) Interests in the transferor (if the transferor is a partnership) and in a partnership in which the transferor (or a related person) is a direct or indirect partner.

(2) *Provision of copies.* The transferor must provide a copy of the qualified appraisal to the administrator of the qualified settlement fund no later than February 15 of the year following the calendar year in which the property is transferred. The transferor also must attach a copy of the qualified appraisal to (and as part of) its timely filed income tax return (including extensions) for the taxable year of the transferor in which the transfer is made.

(3) *Qualified appraisal.* A ''qualified appraisal'' is a written appraisal that—

(i) Is made within 60 days before or after the date the property is transferred to the qualified settlement fund;

(ii) Is prepared, signed, and dated by an individual who is a qualified appraiser within the meaning of § 1.170A–13(c)(5);

(iii) Includes the information required by paragraph (b)(4) of this section; and

(iv) Does not involve an appraisal fee of the type prohibited by § 1.170A–13(c)(6).

(4) *Information included in a qualified appraisal.* A qualified appraisal must include the following information—

(i) A description of the appraised property;

(ii) The date (or expected date) of the property's transfer to the qualified settlement fund;

(iii) The appraised fair market value of the property on the date (or expected date) of transfer;

(iv) The method of valuing the property, such as the comparable sales approach;

(v) The specific basis for the valuation, such as specific comparable sales or statistical sampling, including a justification for using comparable sales or statistical sampling and an explanation of the procedure employed;

(vi) The terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the transferor (or a related person) or the qualified settlement fund that relates to the use, sale, or other disposition of the transferred property, including, for example, the terms of any agreement or understanding that temporarily or permanently—

(A) Restricts the qualified settlement fund's right to use or dispose of the property; or

(B) Reserves to, or confers upon, any person other than the qualified settlement fund any right (including designating another person as having the right) to income from the property, to possess the property (including the right to purchase or otherwise acquire the property), or to exercise any voting rights with respect to the property;

(vii) The name, address, and taxpayer identification number of the qualified appraiser; and if the qualified appraiser is acting in his or her capacity as a partner in a partnership, an employee of any person, or an independent contractor engaged by a person other than the transferor, the name, address, and taxpayer identification number of the partnership or the person who employs or engages the qualified appraiser;

(viii) The qualifications of the qualified appraiser, including the appraiser's background, experience, education, and membership, if any, in professional appraisal associations; and

(ix) A statement that the appraisal was prepared for income tax purposes.

(5) *Effect of signature of the qualified appraiser.* Any appraiser who falsely or fraudulently overstates the value of the transferred property referred to in a qualified appraisal may be subject to a civil penalty under section 6701 for aiding and abetting an understatement of tax liability and may have appraisals disregarded pursuant to 31 U.S.C. 330(c).

(c) *Economic performance*—(1) *In general.* Except as otherwise provided in this paragraph (c), for purposes of section 461(h), economic performance occurs with respect to a liability described in §1.468B–1(c)(2) (determined with regard to §1.468B–1(f) and (g)) to the extent the transferor makes a transfer to a qualified settlement fund to resolve or satisfy the liability.

(2) *Right to a refund or reversion*—(i) *In general.* Economic performance does not occur to the extent—

(A) The transferor (or a related person) has a right to a refund or reversion of a transfer if that right is exercisable currently and without the agreement of an unrelated person that is independent or has an adverse interest (e.g., the court or agency that approved the fund, or the fund claimants); or

(B) Money or property is transferred under conditions that allow its refund or reversion by reason of the occurrence of an event that is certain to occur, such as the passage of time, or if restrictions on its refund or reversion are illusory.

(ii) *Right extinguished.* With respect to a transfer described in paragraph (c)(2)(i) of this section, economic performance is deemed to occur on the date, and to the extent, the transferor's right to a refund or reversion is extinguished.

(3) *Obligations of a transferor.* Economic performance does not occur when a transferor transfers to a qualified settlement fund its debt (or the debt of a related person). Instead, economic performance occurs as the transferor (or related person) makes principal payments on the debt. Similarly, economic performance does not occur when a transferor transfers to a qualified settlement fund its obligation (or the obligation of a related person) to provide services or property in the future, or to make a payment described in §1.461–4(g). Instead, economic performance with respect to such an obligation occurs as services, property or payments are provided or made to the qualified settlement fund or a claimant.

(d) *Payment of insurance amounts.* No deduction is allowed to a transferor for a transfer to a qualified settlement fund to the extent the transferred amounts represent amounts received from the settlement of an insurance claim and are excludable from gross income. If the settlement of an insurance claim occurs after a transferor makes a transfer to a qualified settlement fund for which a deduction has been taken, the transferor must include in income the amounts received from the settlement of the insurance claim to the extent of the deduction.

(e) *Statement to the qualified settlement fund and the Internal Revenue Service*—(1) *In general.* A transferor must provide the statement described in paragraph (e)(2) of this section to the administrator of a qualified settlement fund no later than February 15 of the year following each calendar year in which the transferor (or an insurer or other person on behalf of the transferor) makes a transfer to the fund. The transferor must attach a copy of the statement to (and as part of) its timely filed income tax return (including extensions) for the taxable year of the transferor in which the transfer is made.

(2) *Required statement*—(i) *In general.* The statement required by this paragraph (e) must provide the following information—

(A) A legend, ''§ 1.468B–3 Statement'', at the top of the first page;

(B) The transferor's name, address, and taxpayer identification number;

(C) The qualified settlement fund's name, address, and employer identification number;

(D) The date of each transfer;

(E) The amount of cash transferred; and

(F) A description of property transferred and its fair market value on the date of transfer.

(ii) *Combined statements.* If a qualified settlement fund has more than one transferor, any two or more of the transferors may provide a combined statement to the administrator that does not identify the amount of cash or the property transferred by a particular transferor. If a combined statement is used, however, each transferor must include with its copy of the statement that is attached to its income tax return a schedule describing each asset that the transferor transferred to the qualified settlement fund.

(f) *Distributions to transferors*—(1) *In general.* A transferor must include in gross income any distribution (including a deemed distribution described in paragraph (f)(2) of this section) it receives from a qualified settlement fund. If property is distributed, the amount includible in gross income and the basis in that property, is the fair market value of the property on the date of the distribution.

(2) *Deemed distributions*—(i) *Other liabilities.* If a qualified settlement fund makes a distribution on behalf of a transferor to a person that is not a claimant, or to a claimant to resolve or satisfy a liability of the transferor (or a related person) other than a liability described in § 1.468B–1(c)(2) for which the fund was established, the distribution is deemed made by the fund to the transferor. The transferor, in turn, is deemed to have made a payment to the actual recipient.

(ii) *Constructive receipt.* To the extent a transferor acquires a right to a refund or reversion described in paragraph (c)(2) of this section of all or a portion of the assets of a qualified settlement fund subsequent to the transfer of those assets to the fund, the fund is deemed to distribute those assets to the transferor on the date the right is acquired.

(3) *Tax benefit rule.* A distribution described in paragraph (f)(1) or (f)(2) of this section is excluded from the gross income of a transferor to the extent provided by section 111(a).

(g) *Example.* The following example illustrates the rules of this section:

Example. On March 1, 1993, Individual A transfers $1 million to a qualified settlement fund to resolve or satisfy claims against him resulting from certain violations of securities laws. Individual A uses the cash receipts and disbursements method of accounting. Since Individual A does not use the accrual method of accounting, the economic performance rules of paragraph (c) of this section are not applicable. Therefore, whether, when, and to what extent Individual A can deduct the transfer is determined under applicable provisions of the Internal Revenue Code, such as sections 162 and 461.

[T.D. 8459, 57 FR 60992, Dec. 23, 1992]

§ 1.468B–4 Taxability of distributions to claimants.

Whether a distribution to a claimant is includible in the claimant's gross income is generally determined by reference to the claim in respect of which the distribution is made and as if the distribution were made directly by the transferor. For example, to the extent a distribution is in satisfaction of damages on account of personal injury or sickness, the distribution may be excludable from gross income under section 104(a)(2). Similarly, to the extent a distribution is in satisfaction of a claim for foregone taxable interest, the distribution is includible in the claimant's gross income under section 61(a)(4).

[T.D. 8459, 57 FR 60994, Dec. 23, 1992]

§ 1.468B–5 Effective dates and transition rules.

(a) *In general.* Section 468B, including section 468B(g), is effective as provided in the Tax Reform Act of 1986 and the

Technical and Miscellaneous Revenue Act of 1988. Except as otherwise provided in this section, §§1.468B–1 through 1.468–4 are effective on January 1, 1993. Thus, the regulations apply to income of a qualified settlement fund earned after December 31, 1992, transfers to a fund after December 31, 1992, and distributions from a fund after December 31, 1992. For purposes of §1.468B–3(c) (relating to economic performance), previously transferred assets held by a qualified settlement fund on the date these regulations first apply to the fund (i.e., January 1, 1993, or the earlier date provided under paragraph (b)(2) of this section) are treated as transferred to the fund on that date, to the extent no taxpayer has previously claimed a deduction for the transfer.

(b) *Taxation of certain pre-1996 fund income*—(1) *Reasonable method*—(i) *In general.* With respect to a fund, account, or trust established after August 16, 1986, but prior to February 15, 1992, that satisfies (or, if it no longer exists, would have satisfied) the requirements of §1.468B–1(c), the Internal Revenue Service will not challenge a reasonable, consistently applied method of taxation for transfers to the fund, income earned by the fund, and distributions made by the fund after August 16, 1986, but prior to January 1, 1996. A method is generally considered reasonable if, depending on the facts and circumstances, all transferors and the administrator of the fund have consistently treated transfers to the fund, income earned by the fund, and distributions made by the fund after August 16, 1986, as if the fund were—

(A) A grantor trust and the transferors are the grantors;

(B) A complex trust and the transferors are the grantors; or

(C) A designated settlement fund.

(ii) *Qualified settlement funds established after February 14, 1992, but before January 1, 1993.* With respect to a fund, account, or trust established after February 14, 1992, but prior to January 1, 1993, that satisfies the requirements of §1.468B–1(c), the Internal Revenue Service will not challenge a reasonable, consistently applied method of taxation as described in paragraph (b)(1)(i) of this section for transfers to, income earned by, and distributions made by the fund prior to January 1, 1993. However, pursuant to paragraph (a) of this section, sections 1.468B–1 through 1.468B–4 apply to transfers to, income earned by, and distributions made by the qualified settlement fund after 1992.

(iii) *Use of cash method of accounting.* For purposes of paragraphs (b)(i) and (b)(ii) of this section, for taxable years beginning prior to January 1, 1996, the Internal Revenue Service will not challenge the use of the cash receipts and disbursement method of accounting by a fund, account, or trust.

(iv) *Unreasonable position.* In no event is it a reasonable position to assert, pursuant to Rev. Rul. 71–119 (see §601.601(d)(2)(ii)(*b*) of this chapter), that there is no current taxation of the income of a fund established after August 16, 1986.

(v) *Waiver of penalties.* For taxable years beginning prior to January 1, 1993, if a fund, account or trust is subject to section 468B(g) and the Internal Revenue Service does not challenge the method of taxation for transfers to, income earned by, and distributions made by, the fund pursuant to paragraph (b)(1)(i) or (b)(1)(ii) of this section, penalties will not be imposed in connection with the use of such method. For example, the penalties under section 6655 for failure to pay estimated tax, section 6651(a)(1) for failure to file a return, section 6651(a)(2) for failure to pay tax, section 6656 for failure to make deposit of taxes, and section 6662 for accuracy-related underpayments will generally not be imposed.

(2) *Election to apply qualified settlement fund rules*—(i) *In general.* The person that will be the administrator of a qualified settlement fund may elect to apply §§1.468B–1 through 1.468B–4 to transfers to, income earned by, and distributions made by, the fund in taxable years ending after August 16, 1986. The election is effective beginning on the first day of the earliest open taxable year of the qualified settlement fund. For purposes of this paragraph (b)(2), a taxable year is considered open if the period for assessment and collection of tax has not expired pursuant to the rules of section 6501. The election

statement must provide the information described in paragraph (b)(2)(ii) of this section and must be signed by the person that will be the administrator. Such person must also provide each transferor of the qualified settlement fund with a copy of the election statement on or before March 15, 1993.

(ii) *Election statement.* The election statement must provide the following information—

(A) A legend, ''§ 1.468B–5(b)(2) Election'', at the top of the first page;

(B) Each transferor's name, address, and taxpayer identification number;

(C) The qualified settlement fund's name, address, and employer identification number; and

(D) The date the qualified settlement fund was established within the meaning of § 1.468B–1(j).

(iii) *Due date of returns and amended returns.* The election statement described in paragraph (b)(2)(ii) of this section must be filed with, and as part of, the qualified settlement fund's timely filed tax return for the taxable year ended December 31, 1992. In addition, the qualified settlement fund must file an amended return that is consistent with the requirements of §§ 1.468B–1 through 1.468B–4 for any taxable year to which the election applies in which the fund took a position inconsistent with those requirements. Any such amended return must be filed no later than March 15, 1993, and must include a copy of the election statement described in paragraph (b)(2)(ii) of this section.

(iv) *Computation of interest and waiver of penalties.* For purposes of section 6601 and section 6611, the income tax return for each taxable year of the qualified settlement fund to which the election applies is due on March 15 of the year following the taxable year of the fund. For taxable years of a qualified settlement fund ending prior to January 1, 1993, the income earned by the fund is deemed to have been earned on December 31 of each taxable year for purposes of section 6655. Thus, the addition to tax for failure to pay estimated tax under section 6655 will not be imposed. The penalty for failure to file a return under section 6651(a)(1), the penalty for failure to pay tax under section 6651(a)(2), the penalty for failure to make deposit of taxes under section 6656, and the accuracy-related penalty under section 6662 will not be imposed on a qualified settlement fund if the fund files its tax returns for taxable years ending prior to January 1, 1993, and pays any tax due for those taxable years, on or before March 15, 1993.

[T.D. 8459, 57 FR 60994, Dec. 23, 1992]

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(h)(1) In general.
(2) Definitions.
(3) [Reserved]
(4) Status and participation of members.
(i) Determination by reference to status and participation of group.
(ii) Determination of status and participation of consolidated group.
(5) [Reserved]
(6) Intercompany transactions.
(i) In general.
(ii) Example.
(iii) Effective dates.
(h)(7)–(k) [Reserved]

§1.469–1T General rules (temporary).

(a) Passive activity loss and credit disallowed.

(1) In general.

(2) Exceptions.

(b) Taxpayers to whom these rules apply.

(c) Cross references.

(1) Definition of passive activity.

(2) Passive activity loss.

(3) Passive activity credit.

(4) Effect of rules for other purposes.

(5) Special rule for oil and gas working interests.

(6) Treatment of disallowed losses and credits.

(7) Corporations subject to section 469.

(8) [Reserved]

(9) Joint returns.

(10) Material participation.

(11) Effective date and transition rules.

(12) Future regulations.

(d) Effect of section 469 and the regulations thereunder for other purposes.

(1) Treatment of items of passive activity income and gain.

(2) Coordination with sections 613A(d) and 1211. [Reserved]

(3) Treatment of passive activity losses.

(e) Definition of ‘‘passive activity.’’

(1) In general.

(2) Trade or business activity. [Reserved]

(3) Rental Activity.

(i) In general.

(ii) Exceptions.

(iii) Average period of customer use. [Reserved]

(A) In general. [Reserved]

(B) Average use factor. [Reserved]

(C) Average period of customer use for class of property. [Reserved]

(D) Period of Customer use. [Reserved]

(E) Class of property. [Reserved]

(F) Gross rental income and daily rent. [Reserved]

(iv) Significant personal services.

(A) In general.

(B) Excluded services.

(v) Extraordinary personal services.

(vi) Rental of property incidental to a nonrental activity of the taxpayer.

(A) In general.

(B) Property held for investment.

(C) Property used in a trade or business.

(D) Lodging rented for convenience of employer. [Reserved]

(E) Unadjusted basis. [Reserved]

(vii) Property made available for use in a nonrental activity conducted by a partnership, S corporation or joint venture in which the taxpayer owns an interest.

(viii) Examples.

(4) Special rules for oil and gas working interests.

(i) In general.

(ii) Exception for deductions attributable to a period during which liability is limited.

(A) In general.

(B) Coordination with rules governing the identification of disallowed passive activity deductions.

(C) Meaning of certain terms.

(*1*) Allocable deductions.

(*2*) Disqualified deductions.

(*3*) Net loss.

(*4*) Ratable portion.

(iii) Examples.

(iv) Definition of ‘‘working interest.’’ [Reserved]

(v) Entities that limit liability.

(A) General rule.

(B) Other limitations disregarded.

(C) Examples.

(vi) Cross reference to special rule for income from certain oil or gas properties.

(5) Rental of dwelling unit. [Reserved]

(6) Activity of trading personal property.

(i) In general.

(ii) Personal property.

(iii) Example.

(f) Treatment of disallowed passive activity losses and credits.

(1) Scope of this paragraph.

(2) Identification of disallowed passive activity deductions.

(i) Allocation of disallowed passive activity deductions.

(A) General rule.

(B) Loss from an activity.

(C) Significant participation passive activities.

(D) Examples.

(ii) Allocation with loss activities.

(A) In general.

(B) Excluded deductions.

(iii) Separately identified deductions.

(3) Identification of disallowed credits from passive activities.

(i) General rule.

(ii) Coordination rule.

(iii) Separately identified credits.

(4) Carryover of disallowed deductions and credits. [Reserved]

(i) In general.

(ii) Operations continued through C corporations or similar entities.

(iii) Examples.

(g) Application of these rules to C corporations.

(1) In general.

(2) Definitions.

(3) Participation of corporations.

(i) Material participation.

(ii) Significant participation.

(iii) Participation of individual.

(4) Modified computation of passive activity loss in the case of closely held corporations.

(i) In general.

(ii) Net active income.

(iii) Examples.

(5) Allowance of passive activity credit of closely held corporations to extent of net active income tax liability.

(i) In general.

(ii) Net active income tax liability.

(h) Special rules for affiliated group filing consolidated return.

(1)–(2) [Reserved]

(3) Disallowance of consolidated group's passive activity loss or credit.

(4) Status and participation of members. [Reserved]

(i) Determination by reference to status and participation of group. [Reserved]

(ii) Determination of status and participation of consolidated group. [Reserved]

(5) Modification of rules for identifying disallowed passive activity deductions and credits.

(i) Identification of disallowed deductions.

(ii) Ratable portion of disallowed passive activity losses.

(iii) Identification of disallowed credits.

(6) [Reserved]

(7) Disposition of stock of a member of an affiliated group.

(8) Dispositions of property used in multiple activities.

(i) [Reserved]

(j) Spouses filing joint returns.

(1) In general.

(2) Exceptions of treatment as one taxpayer.

(i) Identification of disallowed deductions and credits.

(ii) Treatment of deductions disallowed under sections 704(d), 1366(d) and 465.

(iii) Treatment of losses from working interests.

(3) Joint return no longer filed.

(4) Participation of spouses.

(k) Former passive activities and changes in status of corporations. [Reserved]

§ 1.469–2 Passive activity loss.

(a)–(c)(2)(ii) [Reserved]

(iii) Disposition of substantially appreciated property formerly used in a nonpassive activity.

(A) In general.

(B) Date of disposition.

(C) Substantially appreciated property.

(D) Investment property.

(E) Coordination with § 1.469–2T(c)(2)(ii).

(F) Coordination with section 163(d).

(G) Examples.

(iv) Taxable acquisitions.

(v) Property held for sale to customers.

(A) Sale incidental to another activity.

(*1*) Applicability.

(*i*) In general.

(*ii*) Principal purpose.

(*2*) Dealing activity not taken into account.

(B) Use in a nondealing activity incidental to sale.

(C) Examples.

(c)(3)–(c)(5) [Reserved]

(6) Gross income from certain oil or gas properties.

(i) In general.

(ii) Gross and net passive income from the property.

(iii) Property.

(iv) Examples 1 and 2.

(c)(6)(iv) Example 3–(c)(7)(iii) [Reserved]

(c)(7)(iv) through (vi) (no paragraph headings)

(d)(1)–(d)(2)(viii) [Reserved]

(d)(2)(ix) through (d)(2)(xii) (no paragraph headings)

(d)(3)–(d)(5)(ii) [Reserved]

(d)(5)(iii)(A) Applicability of rules in § 1.469–2T(c)(2).

(d)(5)(iii)(B)–(d)(6)(v)(D) [Reserved]

(d)(6)(v)(E) (no paragraph heading)

(d)(6)(v)(F)–(d)(7) [Reserved]

(8) Taxable year in which item arises.

(e)(1)–(e)(2)(i) [Reserved]

(ii) Section 707(c).

(iii) Payments in liquidation of a partner's interest in partnership property.

(A) In general.

(B) Payments in liquidation of a partner's interest in unrealized receivables and goodwill under section 736(a).

(e)(3)(i)–(iii)(A) [Reserved]

(e)(3)(iii)(B) (no paragraph heading)

(e)(3)(iii)(C)–(f)(4) [Reserved]

(5) Net income from certain property rented incidental to development activity.

(i) In general.

(ii) Commencement of use.

(iii) Services performed for the purpose of enhancing the value of property.

(iv) Examples.

(6) Property rented to a nonpassive activity.

(f)(7)–(f)(9)(ii) [Reserved]

(f)(9)(iii) through (f)(9)(iv) (no paragraph heading).

(10) Coordination with section 163(d).

(f)(11) [Reserved]

§ 1.469–2T Passive activity loss (temporary).

(a) Scope of this section.

(b) Definition of passive activity loss.

(1) In general.

(2) Cross reference.

(c) Passive activity group income.

(1) In general.

(2) Treatment of gain from disposition of an interest in an activity or an interest in property used in an activity.

(i) In general.

(A) Treatment of gain.

(B) Dispositions of partnership interest and S corporation stock.

(C) Interest in property.

(D) Examples.

(ii) Disposition of property used in more than one activity in 12-month period preceding disposition.

(iii) Disposition of substantially appreciated property used in nonpassive activity. [Reserved]

(A) In general. [Reserved]

(B) Date of disposition. [Reserved]

(C) Substantially appreciated property. [Reserved]

(D) Investment property. [Reserved]

(E) Coordination with paragraph (c)(2)(ii) of this section. [Reserved]

(F) Coordination with section 163(d). [Reserved]

(G) Examples. [Reserved]

(iv) Taxable acquisitions. [Reserved]

(v) Property held for sale to customers. [Reserved]

(A) Sale incidental to another activity. [Reserved]

(*1*) Applicability. [Reserved]

(*i*) In general. [Reserved]

(*ii*) Principal purpose. [Reserved]

(*2*) Dealing activity not taken into account. [Reserved]

(B) Use in a nondealing activity incidental to sale. [Reserved]

(C) Examples. [Reserved]

(3) Items of portfolio income specifically excluded.

(i) In general.

(ii) Gross income derived in the ordinary course of a trade or business.

(iii) Special rules.

(A) Income from property held for investment by dealer.

(B) Royalties derived in the ordinary course of the trade or business of licensing intangible property.

(*1*) In general.

(*2*) Substantial services or costs.

(*i*) In general.

(*ii*) Exception.

(*iii*) Expenditures taken into account.

(*3*) Passthrough entities.

(*4*) Cross reference.

(C) Mineral production payments.

(iv) Examples.

(4) Items of personal service income specifically excluded.

(i) In general.

(ii) Example.

(5) Income from section 481 adjustments.

(i) In general.

(ii) Positive section 481 adjustments.

(iii) Ratable portion.

(6) Gross income from certain oil or gas properties. [Reserved]

(i) In general. [Reserved]

(ii) Gross and net passive income from the properties. [Reserved]

(iii) Property. [Reserved]

(iv) Examples.

(7) Other items specifically excluded.

(d) Passive activity deductions.

(1) In general.

(2) Exceptions.

(3) Interest expense.

(4) Clearly and directly allocable expenses.

(5) Treatment of loss from disposition.

(i) In general.

(ii) Disposition of property used in more than one activity in 12-month period preceding disposition.

(iii) Other applicable rules.

(A) Applicability or rules in paragraph (c)(2).

(B) Dispositions of partnership interest and S corporation stock.

(6) Coordination with other limitations on deductions that apply before section 469.

(i) In general.

(ii) Proration of deductions disallowed under basis limitations.

(A) Deductions disallowed under section 704(d).

(B) Deductions disallowed under section 1366(d).

(iii) Proration of deductions disallowed under at-risk limitations.

(iv) Coordination of basis and at-risk limitations.

(v) Separately identified items of deduction and loss.

(7) Deductions from section 481 adjustment.

(i) In general.

(ii) Negative section 481 adjustment.

(iii) Ratable portion.

(8) Taxable year in which item arises.

(e) Special rules for partners and S corporation shareholders.

(1) In general.

(2) Payments under sections 707(a), 707(c), and 736(b).

(i) Section 707(a).

(ii) Section 707(c).

(iii) Payments in liquidation of a partner's interest in partnership property.

(A) In general.

(B) Payments in liquidation of a partner's interest of a partnership property.

(3) Sale or exchange of interest in passthrough entity.

(i) Application of this paragraph (e)(3).

(ii) General rule.

(A) Allocation among activities.

(B) Ratable portions.

(1) Disposition on which gain is recognized.

(2) Disposition on which loss is recognized.

(C) Default rule.

(D) Special rules.

(*1*) Applicable valuation date.

(*i*) In general.

(*ii*) Exception.

(*2*) Basis adjustment.

(*3*) Tiered passthrough entities.

(E) Meaning of certain terms.

(iii) Treatment of gain allocated to certain passive activities as not from a passive activity.

(iv) Dispositions occurring in taxable years beginning before February 19, 1988.

(A) In general.

(B) Exceptions.

(v) Treatment of portfolio assets.

(vi) Definitions.

(vii) Examples.

(f) Recharacterization of passive income in certain situations.

(1) In general.

(2) Special rule for significant participation.

(i) In general.

(ii) Significant participation passive activity.

(iii) Example.

(3) Rental of nondepreciable property.

(4) Net interest income from passive equity-financed lending activity.

(i) In general.

(ii) Equity-financed lending activity.

(A) In general.

(B) Certain liabilities not taken into account.

(iii) Equity-financed interest income.

(iv) Net interest income.

(v) Interest-bearing assets.

(vi) Liabilities incurred in the activity.

(vii) Average outstanding balance.

(viii) Example.

(5) Net income from certain property rented incidental to development activity.

(i) In general. [Reserved]

(ii) Commencement of use. [Reserved]

(iii) Services performed for the purpose of enhancing the value of property. [Reserved]

(iv) Examples. [Reserved]

(6) Property rented to a nonpassive activity.

(7) Special rules applicable to the acquisition of an interest of a passthrough entity engaged in the trade or business of licensing intangible property.

(i) In general.

(ii) Royalty income from property.

(iii) Exceptions.

(iv) Capital expenditures.

(v) Example.

(8) Limitation on recharacterized income.

(9) Meaning of certain terms.

(10) Coordination with section 163(d).

(11) Effective date.

§1.469–3 Passive activity credit.

(a)–(d) [Reserved]

(e) Coordination with section 38(b).

(f) Coordination with section 50.

(g) [Reserved]

§1.469–3T Passive activity credit (temporary).

(a) Computation of passive activity credit.

(b) Credits subject to section 469.

(1) In general.

(2) Treatment of credits attributed to qualified progress expenditures.

(3) Special rule for partners and S corporations shareholders.

(4) Exception for pre-1987 credits.

(c) Taxable year to which credit is attributable.

(d) Regular tax liability allocable to passive activities.

(1) In general.

(2) Regular tax liability.

(e) Coordination with section 38(b). [Reserved]

(f) Coordination with section 47. [Reserved]

(g) Examples.

§1.469–4 Definition of activity.

(a) Scope and purpose.

(b) Definitions.

(1) Trade or business activities.

(2) Rental activities.

(c) General rules for grouping activities.

(1) Appropriate economic unit.

(2) Facts and circumstances test.

(3) Examples.

(d) Limitation on grouping certain activities.

(1) Grouping rental activities with other trade or business activities.

(i) Rule.

(ii) Examples.

(2) Grouping real property rentals and personal property rentals prohibited.

(3) Certain activities of limited partners and limited entrepreneurs.

(i) In general.

(ii) Example.

(4) Other activities identified by the Commissioner.

(5) Activities conducted through section 469 entities.

(i) In general.

(ii) Cross reference.

(e) Disclosure and consistency requirements.

(1) Original groupings.

(2) Regroupings.

(f) Grouping by Commissioner to prevent tax avoidance.

(1) Rule.

(2) Example.

(g) Treatment of partial dispositions.

(h) Rules for grouping rental real estate activities for taxpayers qualifying under section 469(c)(7).

§1.469–5 Material participation.

(a)–(e) [Reserved]

(f) Participation.

(1) In general.

(f)(2)–(h)(2) [Reserved]

(3) Coordination with rules governing the treatment of passthroughs entities.

(i) [Reserved]

(j) Material participation for preceding taxable years.

(1) In general.

(2) Material participation test for taxable years beginning before January 1, 1987

(k) Examples (1)–(4). [Reserved]

(k) Example (5).

(k) Examples (6)–(8). [Reserved]

§1.469–5T Material participation (temporary).

(a) In general.

(b) Facts and circumstances.

(1) In general. [Reserved]

(2) Certain participation insufficient to constitute material participation under this paragraph (b).

(i) Participation satisfying standards not contained in section 469.

(ii) Certain management activities.

(iii) Participation less than 100 hours.

(c) Significant participation activity.

(1) In general.

(2) Significant participation.

(d) Personal service activity.

(e) Treatment of limited partners.

(1) General rule.

(2) Exceptions.

(3) Limited partnership interest.

(i) In general.

(ii) Limited partner holding general partner interest.

(f) Participation. [Reserved]

(1) In general. [Reserved]

(2) Exceptions.

(i) Certain work not customarily done by owners.

(ii) participation as an investor.

(A) In general.

(B) Work done in individual's capacity as an investor.

(3) Participation of spouses.

(4) Methods of proof.

(g) Material participation of trust and estates. [Reserved]

(h) Miscellaneous rules.

(1) Participation of corporations.

(2) Treatment of certain retired farmers and surviving spouses of retired or disabled farmers.

(3) Coordination with rules governing the treatment of passthroughs entities. [Reserved]

(i) [Reserved]

(j) Material participation for preceding taxable years. [Reserved]

(1) In general. [Reserved]

(2) Material participation for taxable years beginning before January 1, 1987. [Reserved]

(k) Examples.

§1.469–6 Treatment of losses upon certain dispositions. [Reserved]

§1.469–7 Treatment of self-charged items of income and expense. [Reserved]

§1.469–8 Application of section 469 to trust, estates, and their beneficiaries. [Reserved]

§1.469–9 Rules for certain rental real estate activities.

(a) Scope and purpose.

(b) Definitions.

(1) Trade or business.

(2) Real property trade or business.

(3) Rental real estate.

(4) Personal services.

(5) Material participation.

(6) Qualifying taxpayer.

(c) Requirements for qualifying taxpayers.

(1) In general.

(2) Closely held C corporations.

(3) Requirement of material participation in the real property trades or businesses.

(4) Treatment of spouses.

(5) Employees in real property trades or businesses.

(d) General rule for determining real property trades or businesses.

(1) Facts and circumstances.

(2) Consistency requirement.

(e) Treatment of rental real estate activities of a qualifying taxpayer.

(1) In general.

(2) Treatment as a former passive activity.

(3) Grouping rental real estate activities with other activities.

(i) In general.

(ii) Special rule for certain management activities.

(4) Example.

(f) Limited partnership interests in rental real estate activities.

(1) In general.

(2) De minimis exception.

(g) Election to treat all interests in rental real estate as a single rental real estate activity.

(1) In general.

(2) Certain changes not material.

(3) Filing a statement to make or revoke the election.

(h) Interests in rental real estate held by certain passthrough entities.

(1) General rule.

(2) Special rule if a qualifying taxpayer holds a fifty-percent or greater interest in a passthrough entity.

(3) Special rule for interests held in tiered passthrough entities.

(i) [Reserved]

(j) $25,000 offset for rental real estate activities of qualifying taxpayers.

(1) In general.

(2) Example.

§1.469–10 Application of section 469 to publicly traded partnerships. [Reserved]

§1.469–11 Effective date and transition rules.

(a) Generally applicable effective dates.

(b) Additional effective dates.

(1) Application of 1992 amendments for taxable years beginning before October 4, 1994.

(2) Additional transition rule for 1992 amendments.

(3) Fresh starts under consistency rules.

(i) Regrouping when tax liability is first determined under Project PS–1–89.

(ii) Regrouping when tax liability is first determined under §1.469–4.

(iii) Regrouping when taxpayer is first subject to section 469(c)(7).

(4) Certain investment credit property.

(c) Special rules.

(1) Applicability of certain income recharacterization rules.

(i) in general.

(ii) Property rented to a nonpassive activity.

(2) Qualified low-income housing projects.

(3) Effect of events occurring in years prior to 1987.

(d) Examples.

[T.D. 8417, 57 FR 20748, May 15, 1992, as amended by T.D. 8477, 58 FR 11538, Feb. 26, 1993; T.D. 8495, 58 FR 58787, Nov. 4, 1993; T.D. 8565, 59 FR 50487, Oct. 4, 1994; T.D. 8597, 60 FR 36684, July 18, 1995; T.D. 8645, 60 FR 66498, Dec. 22, 1995]

§ 1.469–1 General rules.

(a)–(c)(7) [Reserved]

(c)(8) *Consolidated groups.* Rules relating to the application of section 469 to consolidated groups are contained in paragraph (h) of this section.

(c)(9)–(d)(1) [Reserved]

(d)(2) *Coordination with sections 613A (d) and 1211.* A passive activity deduction that is not disallowed for the taxable year under section 469 and the regulations thereunder may nonetheless be disallowed for the taxable year under section 613A(d) or 1211. The following example illustrates the application of this paragraph (d)(2):

Example. In 1993, an individual derives $10,000 of ordinary income from passive activity X, no gains from the sale or exchange of capital assets or assets used in a trade or business, $12,000 of capital loss from passive activity Y, and no income, gain, deductions, or losses from any other passive activity. The capital loss from activity Y is a passive activity deduction (within the meaning of § 1.469–2T(d)). Under section 469 and the regulations thereunder, the taxpayer is allowed $10,000 of the $12,000 passive activity deduction and has a $2,000 passive activity loss for the taxable year. Since the $10,000 passive activity deduction allowed under section 469 is a capital loss, such deduction is allowable for the taxable year only to the extent provided under section 1211. Therefore, the taxpayer is allowed $3,000 of the $10,000 capital loss under section 1211 and has a $7,000 capital loss carryover (within the meaning of section 1212(b)) to the succeeding taxable year.

(d)(3)–(e)(1) [Reserved]

(e)(2) *Trade or business activities. Trade or business activities* are activities that constitute trade or business activities within the meaning of § 1.469–4(b)(1).

(e)(3)(i)–(e)(3)(ii) [Reserved]

(e)(3)(iii) *Average period of customer use*—(A) *In general.* For purposes of this paragraph (e)(3), the average period of customer use for property held in connection with an activity (the *activity's average period of customer use)* is the sum of the average use factors for each class of property held in connection with the activity.

(B) *Average use factor.* The average use factor for a class of property held in connection with an activity is the average period of customer use for that class of property multiplied by the fraction obtained by dividing—

(*1*) The activity's gross rental income attributable to that class of property; by

(*2*) The activity's gross rental income.

(C) *Average period of customer use for class of property.* In determining an activity's average period of customer use for a taxable year, the average period of customer use for a class of property held in connection with an activity is determined by dividing—

(*1*) The aggregate number of days in all periods of customer use for property in the class (taking into account only periods that end during the taxable year or that include the last day of the taxable year); by

(*2*) The number of those periods of customer use.

(D) *Period of customer use.* Each period during which a customer has a continuous or recurring right to use an item of property held in connection with the activity (without regard to whether the customer uses the property for the entire period or whether the right to use the property is pursuant to a single agreement or to renewals thereof) is treated for purposes of this paragraph (e)(3)(iii) as a separate period of customer use. The duration of a period of customer use that includes the last day of a taxable year may be determined on the basis of reasonable estimates.

(E) *Class of property.* Taxpayers may organize property into classes for purposes of this paragraph (e)(3)(iii) using any method under which items of property for which the amount of the daily rent differs significantly are not included in the same class.

(F) *Gross rental income and daily rent.* In determining an activity's average period of customer use for a taxable year—

(*1*) The activity's gross rental income is the gross income from the activity for the taxable year taking into account only income that is attributable to amounts paid for the use of property;

(*2*) The activity's gross rental income attributable to a class of property is the gross income from the activity for the taxable year taking into account only income that is attributable to amounts paid for the use of property in that class; and

(*3*) The daily rent for items of property may be determined on any basis that reasonably reflects differences during the taxable year in the amounts ordinarily paid for one day's use of those items of property.

(e)(3)(iv)–(e)(3)(vi)(C) [Reserved]

(e)(3)(vi)(D) *Lodging rented for convenience of employer.* The provision of lodging to an employee or to an employee's spouse or dependents is treated as incidental to the activity (or activities) of the taxpayer in which the employee performs services if the lodging is furnished for the taxpayer's convenience (within the meaning of section 119).

(E) *Unadjusted basis.* For purposes of this paragraph (e)(3)(vi), the term *unadjusted basis* means adjusted basis determined without regard to any adjustment described in section 1016 that decreases basis.

(e)(3)(vii)–(e)(4)(iii) [Reserved]

(e)(4)(iv) *Definition of ''working interest.''* For purposes of section 469 and the regulations thereunder, the term *working interest* means a working or operating mineral interest in any tract or parcel of land (within the meaning of §1.612–4(a)).

(e)(4)(v)–(f)(3) [Reserved]

(f)(4) *Carryover of disallowed deductions and credits*—

(i) *In general.* In the case of an activity of a taxpayer with respect to which any deductions or credits are disallowed for a taxable year under §1.469–1T (f)(2) or (f)(3) (the loss activity)—

(A) The disallowed deductions or credits is allocated among the taxpayer's activities for the succeeding taxable year in a manner that reasonably reflects the extent to which each activity continues the loss activity; and

(B) The disallowed deductions or credits allocated to an activity under paragraph (f)(4)(i)(A) of this section shall be treated as deductions or credits from the activity for the succeeding taxable year.

(ii) *Business continued through C corporations or similar entities.* If a taxpayer continues part or all of a loss activity through a C corporation or similar entity (C corporation entity), the taxpayer's interest in the C corporation entity shall be treated for purposes of this paragraph (f)(4) as an interest in a passive activity that continues that loss activity in whole or part. An entity is similar to a C corporation for this purpose if the owners of interests in the entity derive only portfolio income (within the meaning of §1.469–2T(c)(3)(i)) from the interests.

(iii) *Examples.* The following examples illustrate the application of this paragraph (f)(4). In each example, the taxpayer is an individual whose taxable year is the calendar year.

Example 1. (i) The taxpayer owns interests in a convenience store and an apartment building. In each taxable year, the taxpayer's interests in the convenience store and the apartment building are treated under §1.469–4 as interests in two separate passive activities of the taxpayer. A $5,000 loss from the convenience-store activity and a $3,000 loss from the apartment-building activity are disallowed under §1.469–1T(f)(2) for 1993. Under §1.469–1T(f)(2), the $5,000 loss from the convenience-store activity is allocated among the passive activity deductions from that activity for 1993, and the $3,000 loss from the apartment-building activity is treated similarly.

(ii) In 1994, the convenience store is continued in a single activity, and the section 469 activities that constituted the apartment building is similarly continued in a separate activity. Thus, the disallowed deductions from the convenience-store activity for 1993 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's convenience-store activity in 1994. Similarly, the disallowed deductions from the apartment-building activity for 1993 must be allocated to the taxpayer's apartment-building activity in 1994. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the convenience-store activity in 1994 are treated as deductions from that activity for 1994, and the disallowed deductions allocated to the apartment-building activity for 1994 are treated as deductions from the apartment-building activity for 1994.

Example 2. (i) In 1993, the taxpayer acquires a restaurant and a catering business. Assume that in 1993 and 1994 the restaurant and the catering business are treated under § 1.469–4 as an interest in a single passive activity of the taxpayer (the restaurant and catering activity). A $10,000 loss from the activity is disallowed under § 1.469–1T(f)(2) for 1994. Assume that in 1995, the taxpayer's interests in the restaurant and the catering business are treated under § 1.469–4 as interests in two separate passive activities of the taxpayer.

(ii) Under § 1.469–1T(f)(2), the $10,000 loss from the restaurant and catering activity is allocated among the passive activity deductions from that activity for 1994. In 1995, the businesses that constituted the restaurant and catering activity are continued, but are treated as two separate activities under § 1.469–4. Thus, the disallowed deductions from the restaurant and catering activity for 1994 must be allocated under paragraph (f)(4)(i)(A) of this section between the restaurant activity and the catering activity in 1995 in a manner that reasonably reflects the extent to which each of the activities continues the single restaurant and catering activity. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the restaurant activity in 1995 are treated as deductions from the restaurant activity for 1995, and the disallowed deductions allocated to the catering activity in 1995 are treated as deductions from the catering activity for 1995.

Example 3. (i) In 1993, the taxpayer acquires a restaurant and a catering business. Assume that in 1993 and 1994 the restaurant and the catering business are treated under§ 1.469–4 as an interest in a single passive activity of the taxpayer (the restaurant and catering activity). A $10,000 loss from the activity is disallowed under § 1.469–1T(f)(2) for 1994. Assume that in 1995, the taxpayer's interests in the restaurant and the catering business are treated under § 1.469–4 as interestes in two separate passive activities of the taxpayer. In addition, a $20,000 loss from the activity was disallowed under § 1.469–1T(f)(2) for 1993, and the gross income and deductions (including deductions that were disallowed for 1993 under § 1.469–1T(f)(2)) from the restaurant and catering business for 1993 and 1994 are as follows:

	Restaurant	Catering business
1993:		
Gross income	$20,000	$60,000
Deductions	40,000	60,000
Net income (loss)	(20,000)	....
1994:		
Gross income	40,000	50,000
Deductions	[1]30,000	[2]70,000
Net income (loss)	10,000	(20,000)

[1] Includes $8,000 of deductions that were disallowed for 1993 ($20,000 x $40,000/$100,000).

[2] Includes $12,000 of deductions that were disallowed for 1993 ($20,000 x $60,000/$100,000).

(ii) Under paragraph (f)(4)(i)(A) of this section, the disallowed deductions from the restaurant and catering activity must be allocated among the taxpayer's activities for the succeeding year in a manner that reasonably reflects the extent to which those activities continue the restaurant and catering activity. The remainder of this example describes a number of allocation methods that will ordinarily satisfy the requirement of paragraph (f)(4)(i)(A) of this section. The description of specific allocation methods in this example does not preclude the use of other reasonable allocation methods for purposes of paragraph (f)(4)(i)(A) of this section.

(iii) Ordinarily, an allocation of disallowed deductions from the restaurant to the restaurant activity and disallowed deductions from the catering business to the catering activity would satisfy the requirement of paragraph (f)(4)(i)(A) of this section. Under § 1.469–1T (f)(2)(ii), a ratable portion of each deduction from the restaurant and catering activity is disallowed for 1994. Thus, $3,000 of the 1994 deductions from the restaurant are disallowed ($10,000 x $30,000/$100,000), and $7,000 of the 1994 deductions from the catering business are disallowed ($10,000 x $70,000/ $100,000). Thus, the taxpayer can ordinarily treat $3,000 of the disallowed deductions as deductions from the restaurant activity for 1995, and $7,000 of the disallowed deductions as deductions from the catering activity for 1995.

(iv) Ordinarily, an allocation of disallowed deductions between the restaurant activity and catering activity in proportion to the losses from the restaurant and from the catering business for 1994 would also satisfy the requirement of paragraph (f)(4)(i)(A) of this section. If the restaurant and the catering business had been treated as separate activities in 1994, the restaurant activity would have had net income of $10,000 and the catering activity would have had a $20,000 loss. Thus, the taxpayer can ordinarily treat all $10,000 of disallowed deductions as deductions from the catering activity for 1995.

(v) Ordinarily, an allocation of disallowed deductions between the restaurant activity and catering activity in proportion to the losses from the restaurant and from the catering business for 1994 (determined as if the restaurant and the catering business had been separate activities for all taxable years) would also satisfy the requirement of paragraph (f)(4)(i)(A) of this section. If the restaurant and the catering business had been treated as separate activities for all taxable years, the entire $20,000 loss from the restaurant in 1993 would have been allocated to the restaurant activity in 1994, and the gross income and deductions from the separate activities for 1994 would be as follows:

	Restaurant	Catering business
Gross income	$40,000	$50,000
Deductions	42,000	58,000
Net income (loss)	(2,000)	(8,000)

Thus, the taxpayer can ordinarily treat $2,000 of the disallowed deductions as deductions from the restaurant activity for 1995, and $8,000 of the disallowed deductions as deductions from the catering activity for 1995.

Example 4. (i) The taxpayer is a partner in a law partnership that acquires a building in December 1993 for use in the partnership's law practice. In taxable year 1993, four floors that are not needed in the law practice are leased to tenants; in taxable year 1994, two floors are leased to tenants; in taxable years after 1994, only one floor is leased to tenants and the rental operations are insubstantial. Assume that under §1.469–4, the law practice and the rental property are treated as a trade or business activity and a separate rental activity for taxable years 1993 and 1994. Assume further that the law practice and the rental operations are a single trade or business activity for taxable years after 1994 under §1.469–4. The trade or business activity is not a passive activity of the taxpayer. The rental activity, however, is a passive activity. Under §1.469–T(f)(2), a $12,000 loss from the rental activity is disallowed for 1993 and a $9,000 loss from the rental activity is disallowed for 1994.

(ii) Under §1.469–1T(f)(2), the $12,000 loss from the rental activity for 1993 is allocated among the passive activity deductions from that activity for 1993. In 1994, the business of the rental activity is continued in two separate activities. Only two floors of the building remain in the rental activity, and the other two floors (*i.e.*, the floors that were leased to tenants in 1993, but not in 1994) are used in the taxpayer's law-practice activity. Thus, the disallowed deductions from the rental activity for 1993 must be allocated under paragraph (f)(4)(i)(A) of this section between the rental activity and the law-practice activity in a manner that reasonably reflects the extent to which each of the activities continues business on the four floors that were leased to tenants in 1993. In these circumstances, the requirement of paragraph (f)(4)(i)(A) of this section would ordinarily be satisfied by any of the allocation methods illustrated in Example 3 or by an allocation of 50 percent of the disallowed deductions to each activity. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the rental activity in 1994 are treated as deductions from the rental activity for 1994, and the disallowed deductions ($6,000) allocated to the law-practice activity in 1994 are treated as deductions from the law-practice activity for 1994.

(iii) Under §1.469–1T(f)(2), the $9,000 loss from the rental activity for 1994 is allocated among the passive activity deductions from that activity for 1994. In 1995, the rental activity is continued in the taxpayer's law-practice activity. Thus, the disallowed deductions from the rental activity for 1994 must be allocated under paragraph (f)(4)(ii) of this section to the taxpayer's law-practice activity in 1995. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the law-practice activity are treated as deductions from the law-practice activity for 1995.

(iv) Rules relating to former passive activities will be contained in paragraph (k) of this section. Under those rules, any disallowed deductions from the rental activity that are treated as deductions from the law-practice activity will be treated as unused deductions that are allocable to a former passive activity.

Example 5. (i) The taxpayer owns stock in a corporation that is an S corporation for the taxpayer's 1993 taxable year and a C coporation thereafter. The only activity of the corporation is a rental activity. For 1993, the taxpayer's pro rata share of the corporation's loss from the rental activity is $5,000, and the entire loss is disallowed under §1.469–1T(f)(2) of this section.

(ii) Under §1.469–1T(f)(2), the taxpayer's $5,000 loss from the rental activity is allocated among the taxpayer's deductions from that activity for 1993. In 1994, the rental activity is continued through a C corporation, and the taxpayer's interest in the C corporation is treated under paragraph (f)(4)(ii) of this section as a passive activity that continues the rental activity (the C corporation activity) for purposes of allocating the previously disallowed loss. Thus, the disallowed deductions from the rental activity for 1993 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's C corporation activity in 1994, and are treated under paragraph (f)(4)(i)(B) of this section as deductions from the C corporation activity for 1994.

(iii) Treating the taxpayer's interest in the C corporation as an interest in a passive activity that continues the business of the rental activity does not change the character of the taxpayer's dividend income from the C corporation. Thus, the taxpayer's dividend income is portfolio income (within the meaning of §1.469–2T(c)(3)(i)) and is not included in passive activity gross income. Accordingly, the taxpayer's loss from the C corporation activity for 1994 is $5,000.

Example 6. (i) The taxpayer owns stock in a corporation that is an S corporation for the taxpayer's 1993 taxable year and a C corporation thereafter. The only activity of the corporation is a rental activity. For 1993, the taxpayer's pro rata share of the corporation's loss from the rental activity is $5,000, and the entire loss is disallowed under § 1.469–1T(f)(2). The taxpayer has $2,000 in income from other passive activities for 1994, and as a result, only 60% of the taxpayer's loss from the C corporation activity ($3,000) is disallowed for 1994 under § 1.469–1T(f)(2).

(ii) Under § 1.469–1T(f)(2), the $3,000 disallowed loss from the C corporation activity is allocated among the passive activity deductions from that activity for 1994. In effect, therefore, 60 percent of each disallowed deduction from the rental activity for 1993 is again disallowed for 1994.

(iii) Under paragraph (f)(4) of this section, the taxpayer's interest in the C corporation is treated as a loss activity and as an interest in a passive activity that continues the business of that loss activity for 1995. Thus, the disallowed deductions from the C corporation activity for 1994 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's C corporation activity in 1995, and are treated under paragraph (f)(4)(i)(B) of this section as deductions from that activity for 1995.

(g)(1)–(g)(4)(ii)(B) [Reserved]

(g)(4)(ii)(C) Portfolio income (within the meaning of § 1.469–2T(c)(3)(i)), including any gross income that is treated as portfolio income under any other provision of the regulations (See, e.g., § 1.469–2(c)(2)(iii)(F) (relating to gain from the disposition of substantially appreciated property formerly held for investment) and § 1.469–2(f)(10) (relating to certain recharacterized passive activity gross income))

(5) [Reserved]

(h)(1) *In general.* This paragraph (h) provides rules for applying section 469 in computing a consolidated group's consolidated taxable income and consolidated tax liability (and the separate taxable income and tax liability of each member).

(2) *Definitions.* The definitions and nomenclature in the regulations under section 1502 apply for purposes of this paragraph (h). See, e.g., §§ 1.1502–1 (definitions of group, consolidated group, member, subsidiary, and consolidated return year), 1.1502–2 (consolidated tax liability), 1.1502–11 (consolidated taxable income), 1.1502–12 (separate taxable income), 1.1502–13 (intercompany transactions), 1.1502–21T (net operating losses (temporary)), and 1.1502–22T (consolidated net capital gain and loss (temporary)).

(3) [Reserved]

(4) *Status and participation of members*—(i) *Determination by reference to status and participation of group.* For purposes of section 469 and the regulations thereunder—

(A) Each member of a consolidated group shall be treated as a closely held corporation or personal service corporation, respectively, for the taxable year, if and only if the consolidated group is treated (under the rules of paragraph (h)(4)(ii) of this section) as a closely held corporation or personal service corporation for that year; and

(B) The determination of whether a trade or business activity (within the meaning of paragraph (e)(2) of this section) conducted by one or more members of a consolidated group is a passive activity of the members is made by reference to the consolidated group's participation in the activity.

(ii) *Determination of status and participation of consolidated group.* For purposes of determining under § 1.469–1T(g)(2) whether a consolidated group is treated as a closely held corporation or a personal service corporation, and determining under § 1.469–1T(g)(3) whether the consolidated group materially or significantly participates in any activity conducted by one or more members of the group—

(A) The members of the consolidated group shall be treated as one corporation;

(B) Only the outstanding stock of the common parent shall be treated as outstanding stock of the corporation;

(C) An employee of any member of the group shall be treated as an employee of the corporation; and

(D) An activity is treated as the principal activity of the corporation if and only if it is the principal activity (within the meaning of § 1.441–4T(f)) of the consolidated group.

(5) [Reserved]

(6) *Intercompany transactions*—(i) *In general.* Section 1.1502–13 applies to determine the treatment under section 469 of intercompany items and corresponding items from intercompany transactions between members of a consolidated group. For example, the matching rule of § 1.1502–13(c) treats

the selling member (S) and the buying member (B) as divisions of a single corporation for purposes of determining whether S's intercompany items and B's corresponding items are from a passive activity. Thus, for purposes of applying §1.469–2(c)(2)(iii) and §1.469–2T(d)(5)(ii) to property sold by S to B in an intercompany transaction—

(A) S and B are treated as divisions of a single corporation for determining the uses of the property during the 12-month period preceding its disposition to a nonmember, and generally have an aggregate holding period for the property; and

(B) §1.469–2(c)(2)(iv) does not apply.

(ii) *Example.* The following example illustrates the application of this paragraph (h)(6).

Example. (i) P, a closely held corporation, is the common parent of the P consolidated group. P owns all of the stock of S and B. X is a person unrelated to any member of the P group. S owns and operates equipment that is not used in a passive activity. On January 1 of Year 1, S sells the equipment to B at a gain. B uses the equipment in a passive activity and does not dispose of the equipment before it has been fully depreciated.

(ii) Under the matching rule of §1.1502–13(c), S's gain taken into account as a result of B's depreciation is treated as gain from a passive activity even though S used the equipment in a nonpassive activity.

(iii) The facts are the same as in paragraph (a) of this Example, except that B sells the equipment to X on December 1 of Year 3 at a further gain. Assume that if S and B were divisions of a single corporation, gain from the sale to X would be passive income attributable to a passive activity. To the extent of B's depreciation before the sale, the results are the same as in paragraph (ii) of this Example. B's gain and S's remaining gain taken into account as a result of B's sale are treated as attributable to a passive activity.

(iv) The facts are the same as in paragraph (iii) of this Example, except that B recognizes a loss on the sale to X. B's loss and S's gain taken into account as a result of B's sale are treated as attributable to a passive activity.

(iii) *Effective dates.* This paragraph (h)(6) applies with respect to transactions occurring in years beginning on or after July 12, 1995. For transactions occurring in years beginning before July 12, 1995, see §1.469–1T(h)(6) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

(h)(7)–(k) [Reserved]

[T.D. 8417, 57 FR 20750, May 15, 1992; 57 FR 28612, June 26, 1992, as amended by T.D. 8417, 59 FR 45623, Sept. 2, 1994; T.D. 8597, 60 FR 36684, July 18, 1995; T.D. 8677, 61 FR 33322, June 27, 1996]

§1.469–1T General rules (temporary).

(a) *Passive activity loss and credit disallowed*—(1) *In general.* Except as otherwise provided in paragraph (a)(2) of this section—

(i) The passive activity loss for the taxable year shall not be allowed as a deduction; and

(ii) The passive activity credit for the taxable year shall not be allowed.

(2) *Exceptions.* Paragraph (a)(1) of this section shall not apply to the passive activity loss or the passive activity credit for the taxable year to the extent provided in—

(i) Section 469(i) and the rules to be contained in §1.469–9T (relating to losses and credits attributable to certain rental real estate activities); and

(ii) Section 1.469–11T (relating to losses and credits attributable to certain pre-enactment interests in activities).

(b) *Taxpayers to whom these rules apply.* The rules of section 469 and the regulations thereunder generally apply to—

(1) Individuals;

(2) Trusts (other than trusts (or portions of trusts) described in section 671);

(3) Estates;

(4) Personal service corporations (within the meaning of paragraph (g)(2)(i) of this section); and

(5) Closely held corporations (within the meaning of paragraph (g)(2)(ii) of this section).

(c) *Cross references*—(1) *Definition of ''passive activity.''* Rules relating to the definition of the term ''passive activity'' are contained in paragraph (e) of this section.

(2) *Passive activity loss.* Rules relating to the computation of the passive activity loss for the taxable year are contained in §1.469–2T.

(3) *Passive activity credit.* Rules relating to the computation of the passive activity credit for the taxable year are contained in §1.469–3T.

(4) *Effect of rules for other purposes.* Rules relating to the effect of section 469 and the regulations thereunder for other purposes under the Code are contained in paragraph (d) of this section.

(5) *Special rule for oil and gas working interests.* Rules relating to the treatment of losses and credits from certain interests in oil and gas wells are contained in paragraph (e)(4) of this section

(6) *Treatment of disallowed losses and credits.* Paragraph (f) of this section contains rules relating to—

(i) The treatment of deductions from passive activities in taxable years in which the passive activity loss is disallowed in whole or in part under paragraph (a)(1)(i) of this section; and

(ii) The treatment of credits from passive activities in taxable years in which the passive activity credit is disallowed in whole or in part under paragraph (a)(1)(ii) of this section.

(7) *Corporation subject to section 469.* Rules relating to the application of section 469 and regulations thereunder to C corporations are contained in paragraph (g) of this section.

(8) [Reserved]

(9) *Joint returns.* Rules relating to the application of section 469 and the regulations thereunder to spouses filing a joint return for the taxable year are contained in paragraph (j) of this section.

(10) *Material participation*. Rules defining the term ''material participation'' are contained in § 1.469–5T.

(11) *Effective date and transition rules.* Rules relating to the effective date of section 469 and the regulations thereunder and transition rules applicable to pre-enactment interests in activities are contained in § 1.469–11T.

(12) *Future regulations.* (i) Rules relating to former passive activities and changes in corporate status will be contained in paragraph (k) of this section.

(ii) Rules relating to the definition of ''activity'' will be contained in § 1.469–4T.

(iii) Rules relating to the treatment of deductions from activities that are disposed of in certain transactions will be contained in § 1.469–6T.

(iv) Rules relating to the treatment of self-charged items of income and expense will be contained in § 1.469–7T.

(v) Rules relating to the application of section 469 and the regulations thereunder to trusts, estates, and their beneficiaries will be contained in § 1.469–8T.

(vi) Rules relating to the treatment of income, deductions, and credits from certain rental real estate activities of individuals and certain estates will be contained in § 1.469–9T.

(vii) Rules relating to the application of section 469 to publicly traded partnerships will be contained in § 1.469–10T.

(d) *Effect of section 469 and the regulations thereunder for other purposes*—(1) *Treatment of items of passive activity income and gain.* Neither the provisions of section 469 (a)(1) and paragraph (a)(1) of this section nor the characterization of items of income or deduction as passive activity gross income (within the meaning of § 1.469–2T (c)) or passive activity deductions (within the meaning of § 1.469–2T (d)) affects the treatment of any item of income or gain under any provision of the Internal Revenue Code other than section 469. The following example illustrates the application of this paragraph (d)(1):

Example. (i) In 1991, an individual's only income and loss from passive activities are a $10,000 capital gain from passive activity × and a $12,000 ordinary loss from passive activity Y. The taxpayer also has a $10,000 capital loss that is not derived from a passive activity.

(ii) Under § 1.469–2T (b), the taxpayer has a $2,000 passive activity loss for the taxable year. The only effect of section 469 and the regulations thereunder is to disallow a deduction for the taxpayer's $2,000 passive activity loss for the taxable year. Thus, the taxpayer's capital loss for the taxable year is allowed because the $10,000 capital gain from passive activity × is taken into account under section 1211 (b) in computing the taxpayer's allowable capital loss for the year.

(2) *Coordination with sections 613A(d) and 1211.* [Reserved] See § 1.469–1(d)(2) for rules relating to this paragraph.

(3) *Treatment of passive activity losses.* Except as otherwise provided by regulations, a deduction that is disallowed for a taxable year under section 469 and the regulations thereunder is not taken

into account as a deduction that is allowed for the taxable year in computing the amount subject to any tax imposed by subtitle A of the Internal Revenue Code. The following example illustrates the application of this paragraph (d)(3):

Example. An individual has a $5,000 passive activity loss for a taxable year, all of which is disallowed under paragraph (a)(1) of this section. All of the disallowed loss is allocated under paragraph (f) of this section to activities that are trades or businesses (within the meaning of section 1402(c)). Such loss is not taken into account for the taxable year in computing the taxpayer's taxable income subject to tax under section 1. In addition, under this paragraph (d)(3), such loss is not taken into account for the taxable year in computing the taxpayer's net earnings from self-employment subject to tax under section 1401.

(e) *Definition of ''passive activity''*—(1) *In general.* Except as otherwise provided in this paragraph (e), an activity is a passive activity of the taxpayer for a taxable year if and only if the activity—

(i) Is a trade or business activity (within the meaning of paragraph (e)(2) of this section) in which the taxpayer does not materially participate for such taxable year; or

(ii) Is a rental activity (within the meaning of paragraph (e)(3) of this section), without regard to whether or to what extent the taxpayer participates in such activity.

(2) *Trade or business activity.* [Reserved] See § 1.469–1(e)(2) for rules relating to this paragraph.

(3) *Rental activity*—(i) *In general.* Except as otherwise provided in this paragraph (e)(3), an activity is a rental activity for a taxable year if—

(A) During such taxable year, tangible property held in connection with the activity is used by customers or held for use by customers; and

(B) The gross income attributable to the conduct of the activity during such taxable year represents (or, in the case of an activity in which property is held for use by customers, the expected gross income from the conduct of the activity will represent) amounts paid or to be paid principally for the use of such tangible property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

(ii) *Exceptions.* For purposes of this paragraph (e)(3), an activity involving the use of tangible property is not a rental activity for a taxable year if for such taxable year—

(A) The average period of customer use for such property is seven days or less;

(B) The average period of customer use for such property is 30 days or less, and significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) are provided by or on behalf of the owner of the property in connection with making the property available for use by customers;

(C) Extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use);

(D) The rental of such property is treated as incidental to a nonrental activity of the taxpayer under paragraph (e)(3)(vi) of this section;

(E) The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers; or

(F) The provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest is not a rental activity under paragraph (e)(3)(vii) of this section.

(iii) *Average period of customer use.* [Reserved] See § 1.469–1(e)(3)(iii) for rules relating to this paragraph.

(iv) *Significant personal services*—(A) *In general.* For purposes of paragraph (e)(3)(ii)(B) of this section, personal services include only services performed by individuals, and do not include excluded services (within the meaning of paragraph (e)(3)(iv)(B) of this section). In determining whether personal services provided in connection with making property available for use by customers are significant, all of the relevant facts and circumstances shall be taken into account. Relevant facts and circumstances include the frequency with which such services are provided, the type and amount of labor required to perform such services, and the value of such services relative to the amount charged for the use of the property.

(B) *Excluded services.* For purposes of paragraph (e)(3)(iv)(A) of this section, the term ''excluded services'' means, with respect to any property made available for use by customers—

(*1*) Services necessary to permit the lawful use of the property;

(*2*) Services performed in connection with the construction of improvements to the property, or in connection with the performance of repairs that extend the property's useful life for a period substantially longer than the average period for which such property is used by customers; and

(*3*) Services, provided in connection with the use of any improved real property, that are similar to those commonly provided in connection with long-term rentals of high-grade commercial or residential real property (e.g., cleaning and maintenance of common areas, routine repairs, trash collection, elevator service, and security at entrances or perimeters).

(v) *Extraordinary personal services.* For purposes of paragraph (e)(3)(ii)(C) of this section, extraordinary personal services are provided in connection with making property available for use by customers only if the services provided in connection with the use of the property are performed by individuals, and the use by customers of the property is incidental to their receipt of such services. For example, the use by patients of a hospital's boarding facilities generally is incidental to their receipt of the personal services provided by the hospital's medical and nursing staff. Similarly, the use by students of a boarding school's dormitories generally is incidental to their receipt of the personal services provided by the school's teaching staff.

(vi) *Rental of property incidental to a nonrental activity of the taxpayer*—(A) *In general.* For purposes of paragraph (e)(3)(ii)(D) of this section, the rental of property shall be treated as incidental to a nonrental activity of the taxpayer only to the extent provided in this paragraph (e)(3)(vi).

(B) *Property held for investment.* The rental of property during a taxable year shall be treated as incidental to an activity of holding such property for investment if and only if—

(*1*) The principal purpose for holding the property during such taxable year is to realize gain from the appreciation of the property (without regard to whether it is expected that such gain will be realized from the sale or exchange of the property in its current state of development); and

(*2*) The gross rental income from the property for such taxable year is less than two percent of the lesser of—

(*i*) The unadjusted basis of such property; and

(*ii*) The fair market value of such property.

(C) *Property used in a trade or business.* The rental of property during a taxable year shall be treated as incidental to a trade or business activity (within the meaning of paragraph (e)(2) of this section) if and only if—

(*1*) The taxpayer owns an interest in such trade or business activity during the taxable year;

(*2*) The property was predominantly used in such trade or business activity during the taxable year or during at least two of the five taxable years that immediately precede the taxable year; and

(*3*) The gross rental income from such property for the taxable year is less than two percent of the lesser of—

(*i*) The unadjusted basis of such property; and

(*ii*) The fair market value of such property.

(D) *Lodging for convenience of employer.* [Reserved] See § 1.469–1(e)(3)(vi)(D) for rules relating to this paragraph.

(E) *Unadjusted basis.* [Reserved] See § 1.469–1(e)(3)(vi)(E) for rules relating to this paragraph.

(vii) *Property made available for use in a nonrental activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.* If the taxpayer owns an interest in a partnership, S corporation, or joint venture conducting an activity other than a rental activity, and the taxpayer provides property for use in the activity in the taxpayer's capacity as an owner of an interest in such partnership, S corporation, or joint venture, the provision of such property is not a rental activity. Thus, if a partner contributes the use of property to a partnership, none of the partner's distributive share of partnership income is income from a rental activity unless the partnership is engaged in a rental activity. In addition, a partner's gross income attributable to a payment described in section 707(c) is not income from a rental activity under any circumstances (see § 1.469–2T (e)(2)). The determination of whether property used in an activity is provided by the taxpayer in the taxpayer's capacity as an owner of an interest in a partnership, S corporation, or joint venture shall be made on the basis of all of the facts and circumstances.

(viii) *Examples.* The following examples illustrate the application of this paragraph (e)(3):

Example (1). The taxpayer is engaged in an activity of leasing photocopying equipment. The average period of customer use for the equipment exceeds 30 days. Pursuant to the lease agreements, skilled technicians employed by the taxpayer maintain the equipment and service malfunctioning equipment for no additional charge. Service calls occur frequently (three times per week on average) and require substantial labor. The value of the maintenance and repair services (measured by the cost to the taxpayer of employees performing these services) exceeds 50 percent of the amount charged for the use of the equipment. Under these facts, services performed by individuals are provided in connection with the use of the photocopying equipment, but the customers' use of the photocopying equipment is not incidental to their receipt of the services. Therefore, extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are not provided in connection with making the photocopying equipment available for use by customers, and the activity is a rental activity.

Example (2). The facts are the same as in example (1), except that the average period of customer use for the photocopying equipment exceeds seven days but does not exceed 30 days. Under these facts, significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) are provided in connection with making the photocopying equipment available for use by customers and, under paragraph (e)(3)(ii)(B) of this section, the activity is not a rental activity.

Example (3). The taxpayer is engaged in an activity of transporting goods for customers. In conducting the activity, the taxpayer provides tractor-trailers to transport goods for customers pursuant to arrangements under which the tractor-trailers are selected by the taxpayer, may be replaced at the sole option of the taxpayer, and are operated and maintained by drivers and mechanics employed by the taxpayer. The average period of customer use for the tractor-trailers exceeds 30 days. Under these facts, the use of tractor-trailers by the taxpayer's customers is incidental to their receipt of personal services provided by the taxpayer. Accordingly, the services performed in the activity are extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) and, under paragraph (e)(3)(ii)(C) of this section, the activity is not a rental activity.

Example (4). The taxpayer is engaged in an activity of owning and operating a residential apartment hotel. For the taxable year, the average period of customer use for apartments exceeds seven days but does not exceed 30 days. In addition to cleaning public entrances, exists, stairways, and lobbies, and collecting and removing trash, the taxpayer provides a daily maid and linen service at no additional charge. All of the services other than maid and linen service are excluded services (within the meaning of paragraph (e)(3)(iv)(B) of this section), because such services are similar to those commonly provided in connection with long-term rentals of high-grade residential real property. The value of the maid and linen services (measured by the cost to the taxpayer of employees performing such services) is less than 10 percent of the amount charged to tenants for occupancy of apartments. Under these facts, neither significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) nor extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are provided in connection with making apartments available for use by customers. Accordingly, the activity is a rental activity.

Example (5). The taxpayer owns 1,000 acres of unimproved land with a fair market value of $350,000 and an unadjusted basis of $210,000. The taxpayer holds the land for the principal purpose of realizing gain from appreciation. In order to defray the cost of carrying the land, the taxpayer leases the land to a rancher, who uses the land to graze cattle and pays rent of $4,000 per year. Thus, the gross rental income from the land is less than two percent of the lesser of the fair market value and the unadjusted basis of the land (.02× $210,000=$4,200). Accordingly, under paragraph (e)(3)(ii)(D) of this section, the rental of the land is not a rental activity because the rental is treated under paragraph (e)(3)(vi)(B) of this section as incidental to an activity of holding the property for investment.

Example (6). (i) A calendar year taxpayer owns an interest in a farming activity which is a trade or business activity (within the meaning of paragraph (e)(2) of this section) and owns farmland which was used in the farming activity in 1985 and 1986. The fair market value of the farmland is $350,000 and its unadjusted basis is $210,000. In 1987, 1988, and 1989, the taxpayer continues to own an interest in the farming activity but does not use the land in the activity. In 1987, the taxpayer leases the land for $4,000 to a rancher, who uses the land to graze cattle. In 1988, the taxpayer leases the land for $10,000 to a film production company, which uses the land to film scenes for a movie. In 1989, the taxpayer again leases the land for $4,000 to the rancher.

(ii) For 1987 and 1989, the taxpayer owns an interest in a trade or business activity, and the farmland which the taxpayer leases to the rancher was used in such activity for two out of the five immediately preceding taxable years. In addition, the gross rental income from the land ($4,000) is less than two percent of the lesser of the fair market value and the unadjusted basis of the land (.02x$210,000=$4,200). Accordingly, the taxpayer's rental of the land is treated under paragraph (e)(3)(vi)(C) of this section as incidental to the taxpayer's farming activity, and is not a rental activity.

(iii) Because the taxpayer's gross rental income from the land for 1988 ($10,000) is not less than two percent of the lesser of the fair market value and the unadjusted basis of the land, the requirement of paragraph (e)(3)(vi)(C)(*3*) of this section is not met. Therefore, the taxpayer's rental of the land in 1988 is not treated as incidental to the taxpayer's farming activity and is a rental activity.

Example (7). (i) In 1988, the taxpayer acquires vacant land for the purpose of constructing a shopping mall. Before commencing construction, the taxpayer leases the land under a one-year lease to an automobile dealer, who uses the land to park cars held in its inventory. The taxpayer commences construction of the shopping mall in 1989.

(ii) The taxpayer acquired the land for the principal purpose of constructing the shopping mall, not for the principal purpose of realizing gain from the appreciation of the property. Therefore, the rental of the property in 1988 is not treated under paragraph (e)(3)(vi)(B) of this section as incidental to an activity of holding the property for investment.

(iii) The land has not been used in any taxable year in any trade or business of the taxpayer. Therefore, the rental of the property in 1988 is not treated under paragraph (e)(3)(vi)(C) of this section as incidental to a trade or business activity.

(iv) Since the rental of the land in 1988 is not treated under paragraph (e)(3)(vi) of this section as incidental to a nonrental activity of the taxpayer, the rental of the land in 1988 is a rental activity. See § 1.469–2T(f)(3) for a special rule relating to the treatment of gross income from the rental of nondepreciable property.

Example (8). The taxpayer makes farmland available to a tenant farmer pursuant to an arrangement designated a ‘‘crop-share lease.’’ Under the arrangement, the tenant is required to use the tenant's best efforts to farm the land and produce marketable crops. The taxpayer is obligated to pay 50 percent of the costs incurred in the activity (without regard to whether any crops are successfully produced or marketed), and is entitled to 50 percent of the crops produced (or 50 percent of the proceeds from marketing the crops). For purposes of paragraph (e)(3)(vii) of this section, the taxpayer is treated as providing the farmland for use in a farming activity conducted by a joint venture in the taxpayer's capacity as an owner of an interest in the joint venture. Accordingly, under paragraph (e)(3)(ii)(F) of this section, the taxpayer is not engaged in a rental activity, without regard to whether the taxpayer performs any services in the farming activity.

Example (9). The taxpayer owns a taxicab which the taxpayer operates during the day and leases to another driver for use at night under a one-year lease. Under the terms of the lease, the other driver is charged a fixed rental for use of the taxicab. Assume that, under the rules to be contained in § 1.469–4T, the taxpayer is engaged in two separate activities, an activity of operating the taxicab and an activity of making the taxicab available for use by the other driver. Under these facts, the period for which the other driver uses the taxicab exceeds 30 days, and the taxpayer does not provide extraordinary personal services in connection with making the taxicab available to the other driver. Accordingly, the lease of the taxicab is a rental activity.

Example (10). The taxpayer operates a golf course. Some customers of the golf course pay green fees upon each use of the golf course, while other customers purchase weekly, monthly, or annual passes. The golf course is open to all customers from sunrise to sunset every day of the year except certain holidays and days on which the taxpayer determines that the course is too wet for play. The taxpayer thus makes the golf course available during prescribed hours for nonexclusive use by various customers. Accordingly, under paragraph (e)(3)(ii)(E) of this section, the taxpayer is not engaged in a rental activity, without regard to the average period of customer use for the golf course.

(4) *Special rule for oil and gas working interests*—(i) *In general.* Except as otherwise provided in paragraph (e)(4)(ii) of this section, an interest in an oil or gas well drilled or operated pursuant to a working interest (within the meaning of paragraph (e)(4)(iv) of this section) of a taxpayer is not an interest in a passive activity for the taxpayer's taxable year (without regard to whether the taxpayer materially participates in such activity) if at any time during such taxable year the taxpayer holds such working interest either—

(A) Directly; or

(B) Through an entity that does not limit the liability of the taxpayer with respect to the drilling or operation of such well pursuant to such working interest.

(ii) *Exception for deductions attributable to a period during which liability is limited*—(A) *In general.* If paragraph (e)(4)(i) of this section applies for a taxable year to the taxpayer's interest in an oil or gas well that would, but for the application of paragraph (e)(4)(i) of this section, by an interest in a passive activity for the taxable year, and the taxpayer has a net loss (within the meaning of paragraph (e)(4)(ii)(C)(*3*) of this section) from the well for the taxable year—

(*1*) The taxpayer's disqualified deductions (within the meaning of paragraph (e)(4)(ii)(C)(*2*) of this section) from such oil or gas well for such year shall be treated as passive activity deductions for such year (within the meaning of § 1.469–2T(d)); and

(*2*) A ratable portion (within the meaning of paragraph (e)(4)(ii)(C)(*4*) of this section) of the taxpayer's gross income from such oil or gas well for such year shall be treated as passive activity gross income for such year (within the meaning of § 1.469–2T(c)).

(B) *Coordination with rules governing the identification of disallowed passive activity deductions.* If gross income and deductions from an activity for a taxable year are treated as passive activity gross income and passive activity deductions under paragraph (e)(4)(ii)(A) of this section, such activity shall be treated as a passive activity for such year for purposes of applying paragraph (f) (2) and (4) of this section.

(C) *Meaning of certain terms.* For purposes of this paragraph (e)(4)(ii), the following terms shall have the meanings set forth below:

(*1*) *Allocable deductions.* The deductions allocable to a taxable year are any deductions that arise in such year (within the meaning of § 1.469–2T (d)(8)) and any deductions that are treated as deductions for such year under paragraph (f)(4) of this section.

(*2*) *Disqualified deductions.* The taxpayer's ‘‘disqualified deductions'' from an oil or gas well for a taxable year are the taxpayer's deductions—

(*i*) That are attributable to such well and allocable to the taxable year; and

(*ii*) With respect to which economic performance (within the meaning of section 461(h), without regard to section 461 (h)(3) or (i)(2)) occurs at a time during which the taxpayer's only interest in the working interest is held through an entity that limits the taxpayer's liability with respect to the drilling or operation of such well.

(*3*) *Net loss.* The ‘‘net loss'' of a taxpayer from an oil or gas well for a taxable year equals the amount by which the taxpayer's deductions that are attributable to such oil or gas well and allocable to such year exceeds the gross income of the taxpayer from such well for such year.

(*4*) *Ratable portion.* The ‘‘ratable portion'' of the taxpayer's gross income from an oil or gas well for a taxable year equals the total amount of such gross income multiplied by the fraction obtained by dividing—

(*i*) The disqualified deductions from such oil or gas well for the taxable year; by

(*ii*) The total amount of the deductions that are attributable to such oil or gas well and allocable to the taxable year.

(iii) *Examples.* The following examples illustrate the application of paragraphs (e)(4) (i) and (ii) of this section:

Example (1). (i) A, a calendar year individual, acquires on January 1, 1987, a general partnership interest in P, a calendar year partnership that holds a working interest in an oil or gas property. Pursuant to the partnership agreement, A is entitled to convert the general partnership interest into a limited partnership interest at any time. On December 1, 1987, pursuant to a contract with D, an independent drilling contractor, P commences drilling a single well pursuant to the working interest. Under the drilling contract, P pays D for the drilling only as the work is performed. All drilling costs are deducted by P in the year in which they are paid. At the end of 1987, A converts the general partnership interest into a limited partnership interest, effective immediately. The drilling of the well is completed on February 28, 1988. A's interest in the well would but for this paragraph (e)(4) be an interest in a passive activity.

(ii) Throughout 1987, A holds the working interest through an entity that does not limit A's liability with respect to the drilling of the well pursuant to the working interest. In 1988, however, A holds the working interest through an entity that limits A's liability with respect to the drilling and operation of the well throughout such year. Accordingly, under paragraph (e)(4)(i) of this section, A's interest in P's well is not an interest in a passive activity for 1987 but is an interest in a passive activity for 1988. Moreover, since economic performance occurs in 1987 with respect to all items of deduction for drilling costs that are allocable to 1987, A has no disqualified deductions for 1987.

Example (2). The facts are the same as in example (1), except that all costs of drilling under the contract with D (including costs of drilling performed after 1987) are paid before the end of 1987 and A has a net loss for 1987. In addition, A has $15,000 of total deductions that are attributable to the well and allocable to 1987, but economic performance (as that term is used in paragraph (e)(4)(ii)(C)(*2*)(*ii*) of this section) does not occur with respect to $5,000 of those deductions until 1988. Under paragraph (e)(4)(ii) of this section, the $5,000 of deductions with respect to which economic performance occurs in 1988 are disqualified deductions and are treated as passive activity deductions for 1987. In addition, one-third ($5,000/$15,000) of A's gross income from the well for 1987 is treated as passive activity gross income.

(iv) *Definition of ''working interest.''* [Reserved] See § 1.469–1(e)(4)(iv) for rules relating to this paragraph.

(v) *Entities that limit liability*—(A) *General rule.* For purposes of paragraph (e)(4)(i)(B) of this section, an entity limits the liability of the taxpayer with respect to the drilling or operation of a well pursuant to a working interest held through such entity if the taxpayer's interest in the entity is in the form of—

(*1*) A limited partnership interest in a partnership in which the taxpayer is not a general partner;

(*2*) Stock in a corporation; or

(*3*) An interest in any entity (other than a limited partnership or corporation) that, under applicable State law, limits the potential liability of a holder of such an interest for all obligations of the entity to a determinable fixed amount (for example, the sum of the taxpayer's capital contributions).

(B) *Other limitations disregarded.* For purposes of this paragraph (e)(4), protection against loss through any of the following is not taken into account in determining whether a taxpayer holds a working interest through an entity that limits the taxpayer's liability:

(*1*) An indemnification agreement;

(*2*) A stop loss arrangement;

(*3*) Insurance;

(*4*) Any similar arrangement; or

(*5*) Any combination of the foregoing.

(C) *Examples.* The following examples illustrate the application of this paragraph (e)(4)(v):

Example (1). A owns a 20 percent interest as a general partner in the capital and profits of P, a partnership which owns oil or gas working interests. The other partners of P agree to indemnify A against liability in excess of A's capital contribution for any of P's costs and expenses with respect to P's working interests. As a general partner, however, A is jointly and severally liable for all of P's liabilities and, under paragraph (e)(4)(v)(B)(*1*) of this section, the indemnification agreement is not taken into account in determining whether A holds the working interests through an entity that limits A's liability. Accordingly, the partnership does not limit A's liability with respect to the drilling or operation of wells pursuant to the working interests.

Example (2). B owns a 10 percent interest in X, an entity (other than a limited partnership or corporation) created under applicable State law to hold working interests in oil or gas properties. Under applicable State law, B is liable without limitation for 10 percent of X's costs and expenses with respect to X's working interests but is not liable for the remaining 90 percent of such costs and expenses. Since B's liability for the obligations of X is not limited to a determinable fixed amount (within the meaning of paragraph (e)(4)(v)(A)(*3*) of this section), the entity does not limit B's liability with respect to the drilling or operation of wells pursuant to the working interests.

Example (3). C is both a general partner and a limited partner in a partnership that owns a working interest in oil or gas property. Because C owns an interest as a general partner in each well drilled pursuant to the working interest, C's entire interest in each well drilled pursuant to the working interest is treated under paragraph (e)(4)(i) of this section as an interest in an activity that is not a passive activity (without regard to whether C materially participates in such activity).

(vi) *Cross reference to special rule for income from certain oil or gas properties.* A special rule relating to the treatment of income from certain interests in oil or gas properties is contained in § 1.469–2T(c)(6).

(5) *Rental of dwelling unit.* [Reserved] See § 1.469–2(d)(2)(xii) for rules relating to this paragraph.

(6) *Activity of trading personal property*—(i) *In general.* An activity of trading personal property for the account of owners of interests in the activity is not a passive activity (without regard to whether such activity is a trade or business activity (within the meaning of paragraph (e)(2) of this section)).

(ii) *Personal property.* For purposes of this paragraph (e)(6), the term ''personal property'' means personal property (within the meaning of section 1092(d), without regard to paragraph (3) thereof).

(iii) *Example.* The following example illustrates the application of this paragraph (e)(6):

Example. A partnership is a trader of stocks, bonds, and other securities (within the meaning of section 1236(c)). The capital employed by the partnership in the trading activity consists of amounts contributed by the partners in exchange for their partnership interests, and funds borrowed by the partnership. The partnership derives gross income from the activity in the form of interest, dividends, and capital gains. Under these facts, the partnership is treated as conducting an activity of trading personal property for the account of its partners. Accordingly, under this paragraph (e)(6), the activity is not a passive activity.

(f) *Treatment of disallowed passive activity losses and credits*—(1) *Scope of this paragraph.* The rules in this paragraph (f)—

(i) Identify the passive activity deductions that are disallowed for any taxable year in which all or a portion of the taxpayer's passive activity loss is disallowed under paragraph (a)(1)(i) of this section;

(ii) Identify the credits from passive activities that are disallowed for any taxable year in which all or a portion of the taxpayer's passive activity credit is disallowed under paragraph (a)(1)(i) of this section; and

(iii) Provide for the carryover of disallowed deductions and credits.

(2) *Identification of disallowed passive activity deductions*—(i) *Allocation of disallowed passive activity loss among activities*—(A) *General rule.* If all or any portion of the taxpayer's passive activity loss is disallowed for the taxable year under paragraph (a)(1)(i) of this section, a ratable portion of the loss (if any) from each passive activity of the taxpayer is disallowed. For purposes of the preceding sentence, the ratable portion of a loss from an activity is computed by multiplying the passive activity loss that is disallowed for the taxable year by the fraction obtained by dividing—

(*1*) The loss from the activity for the taxable year; by

(*2*) The sum of the losses for the taxable year from all activities having losses for such year.

(B) *Loss from an activity.* For purposes of this paragraph (f)(2)(i), the term ''loss from an activity'' means—

(*1*) The amount by which the passive activity deductions from the activity for the taxable year (within the meaning of § 1.469–2T(d)) exceed the passive activity gross income from the activity for the taxable year (within the meaning of § 1.469–2T(c)); reduced by

(*2*) Any part of such amount that is allowed under section 469(i) and the rules to be contained in § 1.469–9T (relating to the $25,000 allowance for certain rental real estate activities).

(C) *Significant participation passive activities.* If the taxpayer's passive activity gross income from significant participation passive activities (within the meaning of § 1.469–2T(f)(2)(ii)) for the taxable year (determined without regard to § 1.469–2T(f)(2) through (4)) exceeds the taxpayer's passive activity deductions from such activities for the taxable year, such activities shall be treated, solely for purposes of applying this paragraph (f)(2)(i) for the taxable year, as a single activity that does not have a loss for such taxable year.

(D) *Examples.* The following examples illustrate the application of this paragraph (f)(2)(i):

Example (1). An individual holds interests in three passive activities, A, B, and C. The gross income and deductions from these activities for the taxable year are as follows:

	A	B	C	Total
Gross income	$7,000	$4,000	$12,000	$23,000
Deductions	(16,000)	(20,000)	(8,000)	(44,000)
Net income (loss)	($9,000)	($16,000)	$4,000	($21,000)

The taxpayer's $21,000 passive activity loss for the taxable year is disallowed under paragraph (a)(1)(i) of this section. Therefore, a ratable portion of the losses from activities A and B is disallowed. The disallowed portion of each loss is determined as follows:

A: $21,000 × $9,000/$25,000	$7,560
B: $21,000 × $16,000/$25,000	$13,440
Total	$21,000

Example (2). An individual holds interests in four passive activities, A, B, C, and D. The results of operations of these activities for the taxable year are as follows:

	A	B	C	D	Total
Gross income	15,000	5,000	10,000	10,000	40,000
Deductions	(5,000)	(10,000)	(20,000)	(8,000)	(43,000)
Net income (loss)	10,000	(5,000)	(10,000)	2,000	(3,000)

Activities A and B are significant participation passive activities (within the meaning of § 1.469–2T(f)(2)(ii)). The gross income from these activities for the taxable year ($20,000) exceeds the passive activity deductions from those activities for the taxable year ($15,000) by $5,000 and, under § 1.469–2T(f)(2), $5,000 of gross income from those activities is treated as not from a passive activity. Therefore, solely for purposes of applying this paragraph (f)(2)(i) for the taxable year, activities A and B are treated as a single activity that does not have a loss for the taxable year. Under § 1.469–2T(b), the taxpayer's passive activity loss for the taxable year is $8,000 ($43,000 of passive activity deductions minus $35,000 of passive activity gross income). The results of treating activities A and B as a single activity that does not have a loss for the taxable year is that none of the $8,000 passive activity loss is allocated under this paragraph (f)(2)(i) to activity B for the taxable year, even though the taxpayer incurred a loss in that activity for the taxable year.

(ii) *Allocation within loss activities*—(A) *In general.* If all or any portion of a taxpayer's loss from an activity is disallowed under paragraph (f)(2)(i) of this section for the taxable year, a ratable portion of each passive activity deduction (other than an excluded deduction (within the meaning of paragraph (f)(2)(ii)(B) of this section)) of the taxpayer from such activity is disallowed. For purposes of the preceding sentence, the ratable portion of a passive activity deduction of a taxpayer is the amount of the disallowed portion of the taxpayer's loss from the activity (within the meaning of paragraph (f)(2)(i)(B) of this section) for the taxable year multiplied by the fraction obtained by dividing—

(*1*) The amount of such deduction; by

(*2*) The sum of all passive activity deductions (other than excluded deductions (within the meaning of paragraph (f)(2)(ii)(B) of this section)) of the taxpayer from such activity from the taxable year.

(B) *Excluded deductions.* The term ''excluded deduction'' means any passive activity deduction of a taxpayer that is taken into account in computing the taxpayer's net income from an item of property for a taxable year in which an amount of the taxpayer's gross income from such item of property is treated as not from a passive activity under § 1.469–2T(c)(6) or § 1.469–2T(f) (5), (6), or (7).

(iii) *Separately identified deductions.* In identifying the deductions from an activity that are disallowed under this paragraph (f)(2), the taxpayer need not account separately for a deduction unless such deduction may, if separately taken into account, result in an income tax liability for any taxable year different from that which would result were such deduction not taken into account separately. For related rules applicable to partnerships and S corporations, see § 1.702–1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Deductions that must be accounted for separately include (but are not limited to) deductions that—

(A) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469–9T) in taxable years in which the taxpayer actively participates (within the meaning of section 469(i) and the rules to be contained in § 1.469–9T) in such activity;

(B) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469–9T) in taxable years in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in § 1.469–9T) in such activity; or

(C) Are taken into account under section 1211 (relating to the limitation on capital losses) or section 1231 (relating to property used in a trade or business and involuntary conversions).

(3) *Identification of disallowed credits from passive activities*—(i) *General rule.* If all or any portion of the taxpayer's passive activity credit is disallowed for the taxable year under paragraph (a)(1)(ii) of this section, a ratable portion of each credit from each passive activity of the taxpayer is disallowed. For purposes of the preceding sentence, the ratable portion of a credit of a taxpayer is computed by multiplying the portion of the taxpayer's passive activity credit that is disallowed for the taxable year by the fraction obtained by dividing—

(A) The amount of the credit; by

(B) The sum of all of the taxpayer's credits from passive activities for the taxable year.

(ii) *Coordination rule.* For purposes of paragraph (f)(3)(i) of this section, the credits from a passive activity do not include any credit or portion of a credit that—

(A) Is allowed for the taxable year under section 469(i) and the rules to be contained in § 1.469–9T (relating to the $25,000 allowance for certain rental real estate activities); or

(B) Increases the basis of property during the taxable year under section 469(j)(9) and the rules to be contained in § 1.469–6T (relating to the election to increase the basis of certain property by disallowed credits).

(iii) *Separately identified credits.* In identifying the credits from an activity that are disallowed under this paragraph (f)(3), the taxpayer need not account separately for any credit unless such credit may, if separately taken into account, result in an income tax liability for any taxable year different from that which would result were such credit not taken into account separately. For related rules applicable to partnerships and S corporations, see § 1.702–1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Credits that must be accounted for separately include (but are not limited to)—

(A) Credits (other than the low-income housing and rehabilitation investment credits) from a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469–9T) that arise in a taxable year in which the taxpayer actively participates (within the meaning of section 469(i) and the rules to be contained in § 1.469–9T) in such activity;

(B) Credits (other than the low-income housing and rehabilitation investment credits) from a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469–9T) that arise in a taxable year in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in § 1.469–9T) in such activity;

(C) Low-income housing and rehabilitation investment credits from a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469–9T); and

(D) Any credit that is subject to the limitations of sections 26(a), 28(d)(2), 29(b)(5), or 38(c) in a manner that differs from the manner in which any other credit is subject to such limitations.

(4) *Carryover of disallowed deductions and credits.* [Reserved] See § 1.469–1(f)(4) for rules relating to this paragraph.

(g) *Application of these rules to C corporations*—(1) *In general.* Except as otherwise provided in the rules to be contained in paragraph (k) of this section, section 469 and the regulations thereunder do not apply to any corporation that is not a personal service corporation or a closely held corporation for the taxable year. See paragraphs (g) (4) and (5) of this section for special rules for computing the passive activity loss and passive activity credit, respectively, of a closely held corporation.

(2) *Definitions.* For purposes of section 469 and the regulations thereunder—

(i) The term *personal service corporation* means a C corporation that is a personal service corporation for the taxable year (within the meaning of § 1.441–4T(d)); and

(ii) The term *closely held corporation* means a C corporation that meets the stock ownership requirements of section 542(a)(2) (taking into account the modifications in section 465(a)(3)) for the taxable year and is not a personal service corporation for such year.

(3) *Participation of corporations*—(i) *Material participation.* For purposes of section 469 and the regulations thereunder, a corporation described in paragraph (g)(2) of this section shall be treated as materially participating in an activity for a taxable year if and only if—

(A) One or more individuals, each of whom is treated under paragraph (g)(3)(iii) of this section as materially participating in such activity for the taxable year, directly or indirectly hold (in the aggregate) more than 50 percent (by value) of the outstanding stock of such corporation; or

(B) In the case of a closely held corporation (within the meaning of paragraph (g)(2)(ii) of this section), the requirements of section 465(c)(7)(C) (without regard to clause (iv) thereof and taking into account section 465(c)(7)(D)) are met with respect to such activity.

(ii) *Significant participation.* For purposes of § 1.469–2T(f)(2), an activity of a corporation described in paragraph (g)(2) of this section shall be treated as a significant participation passive activity for a taxable year if and only if—

(A) The corporation is not treated as materially participating in such activity for the taxable year; and

(B) One or more individuals, each of whom is treated under paragraph (g)(3)(iii) of this section as significantly participating in such activity, directly or indirectly hold (in the aggregate) more than 50 percent (by value) of the outstanding stock of such corporation.

(iii) *Participation of individual.* Whether an individual is treated for purposes of this paragraph (g)(3) as materially participating or significantly participating in an activity of a corporation shall be determined under the rules of § 1.469–5T, except that in applying such rules—

(A) All activities of the corporation shall be treated as activities in which the individual holds an interest in determining whether the individual participates (within the meaning of § 1.469–5T(f)) in an activity of the corporation; and

(B) The individual's participation in all activities other than activities of the corporation shall be disregarded in determining whether the individual's participation in an activity of the corporation is treated as material participation under § 1.469–5T(a)(4) (relating to material participation in significant participation activities).

(4) *Modified computation of passive activity loss in the case of closely held corporations.*—(i) *In general.* A closely held corporation's passive activity loss for the taxable year is the amount, if any, by which the corporation's passive activity deductions for the taxable year (within the meaning of § 1.469–2T(d)) exceed the sum of—

(A) The corporation's passive activity gross income for the taxable year (within the meaning of § 1.469–2T(c)); and

(B) The corporation's net active income for the taxable year.

(ii) *Net active income.* For purposes of this paragraph (g)(4), a corporation's net active income for the taxable year is such corporation's taxable income for the taxable year, determined without regard to the following items for the year:

(A) Passive activity gross income;

(B) Passive activity deductions;

(C) [Reserved] See § 1.469–1(g)(4)(ii)(C) for rules relating to this paragraph.

(D) Gross income that is treated under § 1.469–2T(c)(6) (relating to gross income from certain oil or gas properties) as not from a passive activity;

(E) Gross income and deductions from any trade or business activity (within the meaning of paragraph (e)(2) of this section) that is described in paragraph (e)(6) of this section (relating to certain activities of trading personal property) but only if the corporation did not materially participate in such activity for the taxable year;

(F) Deductions described in § 1.469–2T(d)(2)(i), (ii), and (iv) (relating to certain deductions attributable to portfolio income); and

(G) Interest expense allocated under § 1.163–8T to a portfolio expenditure (within the meaning of § 1.163–8T(b)(6)).

(iii) *Examples.* The following examples illustrate the application of this paragraph (g)(4):

Example (1). (i) For 1987, X, a closely held corporation, is engaged in two activities, a trade or business activity in which X materially participates for 1987 and a rental activity. X also holds portfolio investments. For 1987, X has the following gross income and deductions:

Gross income:	
Rents	$60,000
Gross income from business	100,000
Portfolio income	35,000
Total	$195,000
Deductions:	
Rental deductions	($100,000)
Business deductions (80,000).	
Interest expense allocable to portfolio expenditures under § 1.163–8T	(10,000)
Deductions (other than interest expense) clearly and directly allocable to portfolio income	(5,000)
Total	($195,000)

(ii) The corporation's net active income for 1987 is $20,000, computed as follows:

Gross income		$195,000	
Amounts not taken into account in computing net active income:			
Rents (see paragraph (g)(4)(ii)(A) of this section)	$60,000		
Portfolio income (see paragraph (g)(4)(ii)(C) of this section)	$35,000		
	$95,000	($95,000)	
Gross income taken into account in computing net active income		$100,000	$100,000
Deductions		($195,000)	
Amounts not taken into account in computing net active income:			
Rental deductions (see paragraph (g)(4)(ii)(B) of this section)	($100,000)		
Interest expense allocated to portfolio expenditures (see paragraph (g)(4)(ii)(G) of this section)	($10,000)		
Other deductions clearly and directly allocable to portfolio income (see paragraph (g)(4)(ii)(F) of this section)	($5,000)		
	($115,000)	$115,000	
Deductions taken into account in computing net active income		($80,000)	($80,000)
Net active income			$20,000

(iii) Under paragraph(g)(4)(i) of this section, X's passive activity loss for 1987 is $20,000, the amount by which the passive activity deductions for the taxable year ($100,000) exceed the sum of (a) the passive activity gross income for the taxable year ($60,000) and (b) the net active income for the taxable year ($20,000). Under paragraph (f)(4) of this section, the $20,000 of deductions from X's rental activity that are disallowed for

1987 are treated as deductions from the rental activity for 1988. If computed without regard to the net active income for the taxable year, X's passive activity loss would be $40,000 ($100,000 of rental deductions minus $60,000 of rental income). Thus, the effect of the rule in paragraph (g)(4)(i) of this section is to reduce the corporation's passive activity loss for the taxable year by the amount of the corporation's net active income for such year.

(iv) Under these facts, X's taxable income for 1987 is $20,000, computed as follows:

Gross income		$195,000
Deductions:		
Total deductions	($195,000)	
Passive activity loss	$20,000	
Allowable deductions	($175,000)	($175,000)
Taxable income		$20,000

Example (2). (i) The facts are the same as in example (1), except that, in 1988, X has a loss from the trade or business activity, and a net operating loss (''NOL'') of $15,000 that is carried back under section 172(b) to 1987. Since NOL carrybacks are taken into account in computing net active income, X's net active income for 1987 must be recomputed as follows:

Net active income before NOL carryback	$20,000
NOL carryback	($15,000)
Net active income	$5,000

(ii) Under these facts, X's disallowed passive activity loss for 1987 is $35,000, the amount by which the passive activity deductions for the taxable year ($100,000) exceed the sum of (a) the passive activity gross income for the taxable year ($60,000) and (b) the net active income for the taxable year ($5,000).

(iii) Under paragraph (f)(4) of this section, the $35,000 of deductions from X's rental activity that are disallowed for 1987 are treated as deductions from the rental activity for 1988. X's taxable income for 1987 is $20,000, computed as follows:

Gross income		$195,000
Deductions:		
Total deductions	($210,000)	
Passive activity loss	$35,000	
Allowable deductions	($175,000)	($175,000)
Taxable income		$20,000

Thus, taking the NOL carryback into account in computing net active income for 1987 does not affect X's taxable income for 1987, but increases the deductions treated under paragraph (f)(4) as deductions from X's rental activity for 1988 and decreases X's NOL carryover to years other than 1987.

(5) *Allowance of passive activity credit of closely held corporations to extent of net active income tax liability*—(i) *In general.* Solely for purposes of determining the amount disallowed under paragraph (a)(1)(ii) of this section, a closely held corporation's passive activity credit for the taxable year shall be reduced by such corporation's net active income tax liability for such year.

(ii) *Net active income tax liability.* For purposes of paragraph (g)(5)(i) of this section, a corporation's net active income tax liability for a taxable year is the amount (if any) by which—

(A) The corporation's regular tax liability (within the meaning of section 26(b)) for the taxable year, determined by reducing the corporation's taxable income for such year by an amount equal to the excess (if any) of the corporation's passive activity gross income for such year over the corporation's passive activity deductions for such year; exceeds

(B) The sum of—

(*1*) The corporation's regular tax liability for the taxable year, determined by reducing the corporation's taxable income for such year by an amount equal to the excess (if any) of the sum of the corporation's net active income (within the meaning of paragraph (g)(4)(ii) of this section) and passive activity gross income for such year over the corporation's passive activity deductions for such year; and

(*2*) The corporation's credits (other than credits from passive activities) that are allowable for the taxable year (without regard to the limitations contained in sections 26(a), 28(d)(2), 29(b)(5), 38(c), and 469).

(h) *Special rules for affiliated group filing consolidated return.*

(1)–(2) [Reserved]

(3) *Disallowance of consolidated group's passive activity loss or credit.* A consolidated group's passive activity loss or passive activity credit for the taxable year shall be disallowed to the extent provided in paragraph (a) of this section. For purposes of the preceding sentence, a consolidated group's passive

activity loss and passive activity credit shall be determined by taking into account the following items of each member of such group:

(i) Passive activity gross income;

(ii) Passive activity deductions;

(iii) Net active income (in the case of a consolidated group treated as a closely held corporation under paragraph (h)(4)(ii) of this section); and

(iv) Credits from passive activities.

(4) [Reserved] See § 1.469–1(h)(4) for rules relating to this paragraph.

(5) *Modification of rules for identifying disallowed passive activity deductions and credits*—(i) *Identification of disallowed deductions.* In applying paragraphs (f)(2) and (4) of this section to a consolidated group for purposes of identifying the passive activity deductions of such consolidated group and of each member of such consolidated group that are disallowed for the taxable year and treated as deductions from activities for the succeeding taxable year, the following rules shall apply:

(A) A ratable portion (within the meaning of paragraph (h)(5)(ii) of this section) of the passive activity loss of the consolidated group that is disallowed for the taxable year shall be allocated to each member of the group;

(B) Pararaph (f)(2) of this section shall then be applied to each member of the group as if—

(*1*) Such member were a separate taxpayer; and

(*2*) The amount allocated to such member under paragraph (h)(5)(i)(A) of this section were the amount of such member's passive activity loss that is disallowed for the taxable year; and

(C) Paragraph (f)(4) of this section shall be applied to each member of the group as if it were a separate taxpayer.

(ii) *Ratable portion of disallowed passive activity loss.* For purposes of paragraph (h)(5)(i)(A) of this section, a member's ratable portion of the disallowed passive activity loss of the consolidated group is the amount of such disallowed loss multiplied by the fraction obtained by dividing—

(A) The amount of the passive activity loss of such member of the consolidated group that would be disallowed for the taxable year if the items of gross income and deduction of such member were the only items of the group for such year; by

(B) The sum of the amounts described in paragraph (h)(5)(ii)(A) of this section for all members of the group.

(iii) *Identification of disallowed credits.* In applying paragraph (f)(3) of this section to a consolidated group for purposes of identifying the credits from passive activities of members of such consolidated group that are disallowed for the taxable year, the consolidated group shall be treated as one taxpayer. Thus, a ratable portion of each of the group's credits from passive activities is disallowed.

(6) [Reserved]

(7) *Disposition of stock of a member of an affiliated group.* Any gain recognized by a member on the disposition of stock of a subsidiary (including income resulting from the recognition of an excess loss account under § 1.1502–19) shall be treated as portfolio income (within the meaning of § 1.469–2T (c)(3)(i)).

(8) *Dispositions of property used in multiple activities.* The determination of whether § 1.469–2T(c)(2)(ii) or (iii) or (d)(5)(ii) applies to a disposition (including a deemed disposition described in paragraph (h)(6)(iii)(C)(*1*) of this section) of property by a member of a consolidated group shall be made by treating such member as having held the property for the entire period that the group has owned such property and as having used the property in all of the activities in which the group has used such property

(i) [Reserved]

(j) *Spouses filing joint return*—(1) *In general.* Except as otherwise provided in the regulations under section 469, spouses filing a joint return for a taxable year shall be treated for such year as one taxpayer for purposes of section 469 and the regulations thereunder Thus, for example, spouses filing a joint return are treated as one taxpayer for purposes of—

(i) Section 1.469–2T (relating generally to the computation of such taxpayer's passive activity loss); and

(ii) Paragraph (f) of this section (relating to the allocation of such taxpayer's disallowed passive activity loss and passive activity credit among activities and the identification of disallowed passive activity deductions and credits from passive activities).

(2) *Exceptions to treatment as one taxpayer*—(i) *Identification of disallowed deductions and credits.* For purposes of paragraphs (f)(2)(iii) and (3)(iii) of this section, spouses filing a joint return for the taxable year must account separately for the deductions and credits attributable to the interests of each spouse in any activity.

(ii) *Treatment of deductions disallowed under sections 704(d), 1366(d), and 465.* Notwithstanding any other provision of this section or § 1.469–2T, this paragraph (j) shall not affect the application of section 704(d), section 1366(d), or section 465 to taxpayers filing a joint return for the taxable year.

(iii) *Treatment of losses from working interests.* Paragraph (e)(4) of this section (relating to losses and credits from certain interests in oil and gas wells) shall be applied by treating a husband and wife (whether or not filing a joint return) as separate taxpayers.

(3) *Joint return no longer filed.* If an individual—

(A) Does not file a joint return for the taxable years; and

(B) Filed a joint return for the immediately preceding taxable year;

then the passive activity deductions and credits allocable to such individual's activities for the taxable year under paragraph (f)(4) of this section shall be determined by taking into account the items of deduction and credit attributable to such individual's interests in passive activities for the immediately preceding taxable year. See paragraph (j)(2)(i) of this section.

(4) *Participation of spouses.* Rules treating an individual's participation in an activity as participation of such individual's spouse in such activity (without regard to whether the spouses file a joint return) are contained in § 1.469–5T(f)(3).

(k) *Former passive activities and changes in status of corporations.* [Reserved]

[T.D. 8175, 53 FR 5700, Feb. 25, 1988, as amended by T.D. 8253, 54 FR 20535, May 12, 1989; T.D. 8319, 55 FR 49038, Nov. 26, 1990; T.D. 8417, 57 FR 20753, May 15, 1992; 58 FR 29536, May 21, 1993; 58 FR 45059, Aug. 26, 1993; 59 FR 17478, Apr. 13, 1994; T.D. 8560, 59 FR 41674, Aug. 15, 1994; T.D. 8597, 60 FR 36685, July 18, 1995]

§ 1.469–2 Passive activity loss.

(a)–(c)(2)(ii) [Reserved]

(c)(2)(iii) *Disposition of substantially appreciated property formerly used in nonpassive activity*—(A) *In general.* If an interest in property used in an activity is substantially appreciated at the time of its disposition, any gain from the disposition shall be treated as not from a passive activity unless the interest in property was used in a passive activity for either—

(*1*) 20 percent of the period during which the taxpayer held the interest in property; or

(*2*) The entire 24-month period ending on the date of the disposition.

(B) *Date of disposition.* For purposes of this paragraph (c)(2)(iii), a disposition of an interest in property is deemed to occur on the date that the interest in property becomes subject to an oral or written agreement that either requires the owner or gives the owner an option to transfer the interest in property for consideration that is fixed or otherwise determinable on that date.

(C) *Substantially appreciated property.* For purposes of this paragraph (c)(2)(iii), an interest in property is substantially appreciated if the fair market value of the interest in property exceeds 120 percent of the adjusted basis of the interest.

(D) *Investment property.* For purposes of this paragraph (c)(2)(iii), an interest in property is treated as an interest in property used in an activity other than a passive activity and as an interest in property held for investment for any period during which the interest is held through a C corporation or similar entity. An entity is similar to a C corporation for this purpose if the owners of interests in the entity derive only portfolio income (within the meaning of § 1.469–2T) from the interests.

(E) *Coordination with § 1.469–2T(c)(2)(ii).* If § 1.469–2T(c)(2)(ii) applies to the disposition of an interest in property, this paragraph (c)(2)(iii) applies only to that portion of the gain from the disposition of the interest in property that is characterized as gain from a passive activity after the application of § 1.469–2T(c)(2)(ii).

(F) *Coordination with section 163(d).* Gain that is treated as not from a passive activity under this paragraph (c)(2)(iii) is treated as income described in section 469(e)(1)(A) and § 1.469–2T(c)(3)(i) if and only if the gain is from the disposition of an interest in property that was held for investment for more than 50 percent of the period during which the taxpayer held that interest in property in activities other than passive activities.

(G) *Examples.* The following examples illustrate the application of this paragraph (c)(2)(iii):

Example 1. A acquires a building on January 1, 1993, and uses the building in a trade or business activity in which A materially participates until March 31, 2004. On April 1, 2004, A leases the building to B. On December 31, 2005, A sells the building. At the time of the sale, A's interest in the building is substantially appreciated (within the meaning of paragraph (c)(2)(iii)(C) of this section). Assuming A's lease of the building to B constitutes a rental activity (within the meaning of § 1.469–1T(e)(3)), the building is used in a passive activity for 21 months (April 1, 2004, through December 31, 2005). Thus, the building was not used in a passive activity for the entire 24-month period ending on the date of the sale. In addition, the 21-month period during which the building was used in a passive activity is less than 20 percent of A's holding period for the building (13 years). Therefore, the gain from the sale is treated under this paragraph (c)(2)(iii) as not from a passive activity.

Example 2. (i) A, an individual, is a stockholder of corporation X. X is a C corporation until December 31, 1993, and is an S corporation thereafter. X acquires a building on January 1, 1993, and sells the building on March 1, 1994. At the time of the sale, A's interest in the building held through X is substantially appreciated (within the meaning of paragraph (c)(2)(iii)(C) of this section). The building is leased to various tenants at all times during the period in which it is held by X. Assume that the lease of the building would constitute a rental activity (within the meaning of § 1.469–1T(e)(3)) with respect to a person that holds the building directly or through an S corporation.

(ii) Paragraph (c)(2)(iii)(D) of this section provides that an interest in property is treated for purposes of this paragraph (c)(2)(iii) as used in an activity other than a passive activity and as held for investment for any period during which the interest is held through a C corporation. Thus, for purposes of determining the character of A's gain from the sale of the building, A's interest in the building is treated as an interest in property held for investment for the period from January 1, 1993, to December 31, 1993, and as an interest in property used in a passive activity for the period from January 1, 1994, to February 28, 1994.

(iii) A's interest in the building was not used in a passive activity for the entire 24-month period ending on the date of the sale. In addition, the 2-month period during which A's interest in the building was used in a passive activity is less than 20 percent of the period during which A held an interest in the building (14 months). Therefore, the gain from the sale is treated under this paragraph (c)(2)(iii) as not from a passive activity.

(iv) Under paragraph (c)(2)(iii)(F) of this section, gain that is treated as nonpassive under this paragraph (c)(2)(iii) is treated as portfolio income (within the meaning of § 1.469–2T(c)(3)(i)) if the gain is from the disposition of an interest in property that was held for investment for more than 50 percent of the period during which the taxpayer held the interest in activities other than passive activities. In this case, A's interest in the building was treated as held for investment for the entire period during which it was used in activities other than passive activities (*i.e.,* the 12-month period from January 1, 1993, to December 31, 1993). Accordingly, A's gain from the sale is treated under this paragraph (c)(2)(iii) as portfolio income.

(iv) *Taxable acquisitions.* If a taxpayer acquires an interest in property in a transaction other than a nonrecognition transaction (within the meaning of section 7701(a)(45)), the ownership and use of the interest in property before the transaction is not taken into account for purposes of applying this paragraph (c)(2) to any subsequent disposition of the interest in property by the taxpayer.

(v) *Property held for sale to customers*—(A) *Sale incidental to another activity*—(*1*) *Applicability*—(*i*) *In general.* This paragraph (c)(2)(v)(A) applies to the disposition of a taxpayer's interest in property if and only if—

(*A*) At the time of the disposition, the taxpayer holds the interest in property in an activity that, for purposes of section 1221(1), involves holding the property or similar property primarily for sale to customers in the ordinary course of a trade or business (a dealing activity);

(*B*) One or more other activities of the taxpayer do not involve holding similar property for sale to customers in the ordinary course of a trade or business (nondealing activities) and the interest in property was used in the nondealing activity or activities for more than 80 percent of the period during which the taxpayer held the interest in property; and

(*C*) The interest in property was not acquired and held by the taxpayer for the principal purpose of selling the interest to customers in the ordinary course of a trade or business.

(*ii*) *Principal purpose.* For purposes of this paragraph (c)(2)(v)(A), a taxpayer is rebuttably presumed to have acquired and held an interest in property for the principal purpose of selling the interest to customers in the ordinary course of a trade or business if—

(*A*) The period during which the interest in property was used in nondealing activities of the taxpayer does not exceed the lesser of 24 months or 20 percent of the recovery period (within the meaning of section 168) applicable to the property; or

(*B*) The interest in property was simultaneously offered for sale to customers and used in a nondealing activity of the taxpayer for more than 25 percent of the period during which the interest in property was used in nondealing activities of the taxpayer.

For purposes of the preceding sentence, an interest in property is not considered to be offered for sale to customers solely because a lessee of the property has been granted an option to purchase the property.

(*2*) *Dealing activity not taken into account.* If paragraph (c)(2)(v)(A) applies to the disposition of a taxpayer's interest in property, holding the interest in the dealing activity is treated, for purposes of § 1.469–2T(c)(2), as the use of the interest in the last nondealing activity of the taxpayer in which the interest in property was used prior to its disposition.

(B) *Use in a nondealing activity incidental to sale.* If paragraph (c)(2)(v)(A) of this section does not apply to the disposition of a taxpayer's interest in property that is held in a dealing activity of the taxpayer at the time of disposition, the use of the interest in property in a nondealing activity of the taxpayer for any period during which the interest in property is also offered for sale to customers is treated, for purposes of § 1.469–2T(c)(2), as the use of the interest in property in the dealing activity of the taxpayer.

(C) *Examples.* The following examples illustrate the application of this paragraph (c)(2)(v):

Example 1. (i) The taxpayer acquires a residential apartment building on January 1, 1993, and uses the building in a rental activity. In January 1996, the taxpayer converts the apartments into condominium units. After the conversion, the taxpayer holds the condominium units for sale to customers in the ordinary course of a trade or business of dealing in condominium units. (Assume that these are dealing operations treated as separate activities under § 1.469–4, and that the taxpayer materially participates in the activity.) In addition, the taxpayer continues to use the units in the rental activity until they are sold. The units are first held for sale on January 1, 1996, and the last unit is sold on December 31, 1996.

(ii) This paragraph (c)(2)(v) provides that holding an interest in property in a dealing activity (the marketing of the property) is treated for purposes of § 1.469–2T(c)(2) as the use of the interest in a nondealing activity if the marketing of the property is incidental to the nondealing use. Under paragraph (c)(2)(v)(A)(*2*) of this section, the interests in property are treated as used in the last nondealing activity in which they were used prior to their disposition. In addition, paragraph (c)(2)(v)(A)(*1*) of this section provides rules for determining whether the marketing of the property is incidental to the use of an interest in property in a nondealing activity. Under these rules, the marketing of the property is treated as incidental to the use in a nondealing activity if the interest in property was used in nondealing activities for more than 80 percent of the taxpayer's holding period in the property (the holding period requirement) and the taxpayer did not acquire and hold the interest in property for the principal purpose of selling it to customers in the ordinary course of a trade or business (a dealing purpose).

(iii) In this case, the apartments were used in a rental activity for the entire period during which they were held by the taxpayer. Thus, the apartments were used in a nondealing activity for more than 80 percent of the taxpayer's holding period in the property, and the marketing of the property satisfies the holding period requirement.

(iv) Paragraph (c)(2)(v)(A)(*1*)(*ii*) of this section provides that a taxpayer is rebuttably presumed to have a dealing purpose unless the interest in property was used in nondealing activities for more than 24 months or 20 percent of the property's recovery period (whichever is less). The same presumption applies if the interest in property was offered for sale to customers during more than 25 percent of the period in which the interest was held in nondealing activities. In this case, the taxpayer used each apartment in a nondealing activity (the rental activity) for a period of 36 to 48 months (*i.e.*, from January 1, 1993, to the date of sale in the period from January through December 1996). Thus, the apartments were used in nondealing activities for more than 24 months, and the first of the rebuttable presumptions described above does not apply. In addition, the apartments were offered for sale to customers for up to 12 months (depending on the month in which the apartment was sold) during the period in which the apartments were used in a nondealing activity. The percentage obtained by dividing the period during which an apartment was held for sale to customers by the period during which the apartment was used in nondealing activities ranges from zero in the case of apartments sold on January 1, 1996, to 25 percent (*i.e.*, 12 months/48 months) in the case of apartments sold on December 31, 1996. Thus, no apartment was offered for sale to customers during more than 25 percent of the period in which it was used in nondealing activities, and the second rebuttable presumption does not apply.

(v) Because neither of the rebuttable presumptions in paragraph (c)(2)(v)(A)(*1*)((*ii*) of this section applies in this case, the taxpayer will not be treated as having a dealing purpose unless other facts and circumstances establish that the taxpayer acquired and held the apartments for the principal purpose of selling the apartments to customers in the ordinary course of a trade or business. Assume that none of the facts and circumstances suggest that the taxpayer had such a purpose. If that is the case, the taxpayer does not have a dealing purpose.

(vi) The marketing of the property satisfies the holding period requirement, and the taxpayer does not have a dealing purpose. Thus, holding the apartments in the taxpayer's dealing activity is treated for purposes of this paragraph (c)(2) as the use of the apartments in a nondealing activity. In this case, the rental activity is the only nondealing activity in which the apartments were used prior to their disposition. Thus, the apartments are treated under paragraph (c)(2)(v)(A)(*2*) of this section as interests in property that were used only in the rental activity for the entire period during which the taxpayer held the interests. Accordingly, the rules in §1.469–2T(c)(2)(ii) and paragraph (c)(2)(iii) of this section do not apply, and all gain from the sale of the apartments is treated as passive activity gross income.

Example 2. (i) The taxpayer acquires a residential apartment building on January 1, 1993, and uses the building in a rental activity. The taxpayer converts the apartments into condominium units on July 1, 1993. After the conversion, the taxpayer holds the condominium units for sale to customers in the ordinary course of a trade or business of dealing in condominium units. (Assume that these are dealing operations treated as separate activities under §1.469–4, and that the taxpayer materially participates in the activities.) In addition, the taxpayer continues to use the units in the rental activity until they are sold. The first unit is sold on January 1, 1994, and the last unit is sold on December 31, 1996.

(ii) In this case, all of the apartments were simultaneously offered for sale to customers and used in a nondealing activity of the taxpayer for more than 25 percent of the period during which the apartments were used in nondealing activities. Thus, the taxpayer is rebuttably presumed to have acquired the apartments (including apartments that are used in the rental activity for at least 24 months) for the principal purpose of selling them to customers in the ordinary course of a trade or business. Assume that the facts and circumstances do not rebut this presumption. If that is the case, the taxpayer has a dealing purpose, and paragraph (c)(2)(v)(A) of this section does not apply to the disposition of the apartments.

(iii) Paragraph (c)(2)(v)(B) of this section provides that if paragraph (c)(2)(v)(A) of this section does not apply to the disposition of a taxpayer's interest in property that is held in a dealing activity of the taxpayer at the time of the disposition, the use of the interest in property in any nondealing activity of the taxpayer for any period during which the interest is also offered for sale to customers is treated as incidental to the use of the interest in the dealing activity. Accordingly, for purposes of applying the rules of §1.469–2T(c)(2) to the disposition of the apartments, the rental of the apartments after July 1, 1993, is treated as the use of the apartments in the taxpayer's dealing activity.

Example 3. (i) The taxpayer acquires a residential apartment building on January 1, 1993, and uses the building in a rental activity. In January 1996, the taxpayer converts the apartments into condominium units. After the conversion, the taxpayer holds the condominium units for sale to customers in the ordinary course of a trade or business of dealing in condominium units. (Assume that these are dealing operations treated as separate activities under § 1.469–4, and that the taxpayer materially participates in the activities.) In addition, the taxpayer continues to use the units in the rental activity until they are sold. The units are first held for sale on January 1, 1996, and the last unit is sold in 1997.

(ii) The treatment of apartments sold in 1996 is the same as in Example 1. The apartments sold in 1997, however, were simultaneously offered for sale to customers and used in a nondealing activity for more than 25 percent of the period during which the apartments were used in nondealing activities. (For example, an apartment that is sold on January 31, 1997, has been offered for sale for 13 months or 26.1 percent of the 49-month period during which it was used in nondealing activities.) Thus, the taxpayer is rebuttably presumed to have acquired the apartments sold in 1997 for the principal purpose of selling them to customers in the ordinary course of a trade of business. Assume that the facts and circumstances do not rebut this presumption. In that case, the marketing of the apartments sold in 1997 does not satisfy the principal purpose requirement, and paragraph (c)(2)(v)(A) of this section does not apply to the disposition of those apartments. Accordingly, for purposes of applying the rules of § 1.469–2T(c)(2) to the disposition of the apartments sold in 1997, the rental of the apartments after January 1, 1996, is treated, under paragraph (c)(2)(v)(B) of this section, as the use of the apartments in the taxpayer's dealing activity.

(c)(3)–(c)(5) [Reserved]

(c)(6) *Gross income from certain oil or gas properties*—(i) *In general.* Notwithstanding any other provision of the regulations under section 469, passive activity gross income for any taxable year does not include an amount of the taxpayer's gross passive income for the year from a property described in this paragraph (c)(6)(i) equal to the taxpayer's net passive income from the property for the year. Property is described in this paragraph (c)(6)(i) if the property is—

(A) An oil or gas property that includes an oil or gas well if, for any prior taxable year beginning after December 31, 1986, any of the taxpayer's loss from the well was treated, solely by reason of § 1.469–1T(e)(4) (relating to a special rule for losses from oil and gas working interests), and not by reason of the taxpayer's material participation in the activity, as a loss that is not from a passive activity; or

(B) Any property the basis of which is determined in whole or in part by reference to the basis of property described in paragraph (c)(6)(i)(A) of this section.

(ii) *Gross and net passive income from the property.* For purposes of this paragraph (c)(6)—

(A) The taxpayer's gross passive income for any taxable year from any property described in paragraph (c)(6)(i) of this section is any passive activity gross income for the year (determined without regard to this paragraph (c)(6) and § 1.469–2T(f)) from the property;

(B) The taxpayer's net passive income for any taxable year from any property described in paragraph (c)(6)(i) of this section is the excess, if any, of—

(*1*) The taxpayer's gross passive income for the taxable year from the property; over

(*2*) Any passive activity deductions for the taxable year (including any deduction treated as a deduction for the year under § 1.469–1T(f)(4)) that are reasonably allocable to the income; and

(C) if any oil or gas well or other item of property (the item) is included in two or more properties described in paragraph (c)(6)(i) of this section (the properties), the taxpayer must allocate the passive activity gross income (determined without regard to this paragraph (c)(6) and § 1.469–2T(f) from the item and the passive activity deductions reasonably allocable to the item among the properties.

(iii) *Property.* For purposes of paragraph (c)(6)(i)(A) of this section, the term ''property'' does not have the meaning given the term by section 614(a) or the regulations thereunder, and an oil or gas property that includes an oil or gas well is—

(A) The well; and

(B) Any other item of property (including any oil or gas well) the value of which is directly enhanced by any drilling, logging, seismic testing, or other activities the costs of which were taken into account in determining the amount of the taxpayer's income or loss from the well.

(iv) *Examples.* The following examples illustrate the application of this paragraph (c)(6):

Example 1. A is a general partner in partnership P and a limited partner in partnership R. P and R own oil and gas working interests in two separate tracts of land acquired from two separate landowners. In 1993, P drills a well on its tract, and A's distributive share of P's losses from drilling the well are treated under §1.469–1T(e)(4) as not from a passive activity. In the course of selecting the drilling site and drilling the well, P develops information indicating that the reservior in which the well was drilled underlies R's tract as well as P's. Under these facts, P's and R's tracts are treated as one property for purposes of this paragraph (c)(6), even if A's interests in the mineral deposits in the tracts are treated as separate properties under section 614(a). Accordingly, in 1994 and subsequent years, A's distributive share of both P's and R's income and expenses from their respective tracts is taken into account in computing A's net passive income from the property for purposes of this paragraph (c)(6).

Example 2. B is a general partner in partnership S. S owns an oil and gas working interest in a single tract of land. In 1993, S drills a well, and B's distributive share of S's losses from drilling the well is treated under §1.469–1T(e)(4) as not from a passive activity. In the course of drilling the well, S discovers two oil-bearing formations, one underlying the other. On December 1, 1993, S completes the well in the underlying formation. On January 1, 1994, B converts B's entire general partnership interest in S into a limited partnership interest. In 1994, S completes in, and commences production from, the shallow formation. Under these facts, the two mineral deposits in S's tract are treated as one property for purposes of this paragraph (c)(6), even if they are treated as separate properties under section 614(a). Accordingly, B's distributive share of S's income and expenses from both the underlying formation and from recompletion in and production from the shallow formation is taken into account in computing B's net passive income from the property for purposes of this paragraph (c)(6).

(c)(6)(iv) *Example 3*—(c)(7)(iii) [Reserved]

(c)(7)(iv) Gross income of an individual from a covenant by such individual not to compete;

(v) Gross income that is treated as not from a passive activity under any provision of the regulations under section 469, including but not limited to §1.469–1T(h)(6) (relating to income from intercompany transactions of members of an affiliated group of corporations filing a consolidated return) and §1.469–2T(f) and paragraph (f) of this section (relating to recharacterized passive income);

(vi) Gross income attributable to the reimbursement of a loss from fire, storm, shipwreck, or other casualty, or from theft (as such terms are used in section 165(c)(3)) if—

(A) The reimbursement is included in gross income under §1.165–1(d)(2)(iii) (relating to reimbursements of losses that the taxpayer deducted in a prior taxable year); and

(B) The deduction for the loss was not a passive activity deduction; and

(c)(7)(vii) Gross income or gain allocable to business or rental use of a dwelling unit for any taxable year in which section 280A(c)(5) applies to such business or rental use.

(d)(1)–(d)(2)(viii) [Reserved]

(ix) An item of loss or deduction that is carried to the taxable year under section 172(a), section 613A(d), section 1212(a)(1) (in the case of corporations), or section 1212(b) (in the case of taxpayers other than corporations);

(x) An item of loss or deduction that would have been allowed for a taxable year beginning before January 1, 1987, but for section 704(d), 1366, or 465;

(xi) A deduction for a loss from fire, storm, shipwreck, or other casualty, or from theft (as such terms are used in section 165(c)(3)) if losses that are similar in cause and severity do not recur regularly in the conduct of the activity; and

(xii) A deduction or loss allocable to business or rental use of a dwelling unit for any taxable year in which section 280A(c)(5) applies to such business or rental use.

(d)(3)–(d)(5)(ii) [Reserved]

(d)(5)(iii) *Other applicable rules*—(A) *Applicability of rules in §1.469–2T(c)(2).* For purposes of this paragraph (d)(5), a taxpayer's interests in property used in an activity and the amounts allocated to the interests shall be determined under §1.469–2T(c)(2)(i)(C). In addition, the rules contained in paragraph (c)(2)(iv) and (v) of this section apply in determining for purposes of this paragraph (d)(5) the activity (or activities) in which an interest in property is used at the time of its disposition and during the 12-month period ending on the date of its disposition.

(d)(5)(iii)(B)–(d)(6)(v)(D) [Reserved]

(d)(6)(v)(E) Are taken into account under section 613A(d) (relating to limitations on certain depletion deductions), section 1211 (relating to the limitation on capital losses), or section 1231 (relating to property used in a trade or business and involuntary conversions); or

(d)(6)(v)(F)–(d)(7) [Reserved]

(d)(8) *Taxable year in which item arises.* For purposes of § 1.469–2T(d), an item of deduction arises in the taxable year in which the item would be allowable as a deduction under the taxpayer's method of accounting if taxable income for all taxable years were determined without regard to sections 469, 613A(d) and 1211.

(e)(1)–(e)(2)(i) [Reserved]

(e)(2)(ii) *Section 707(c).* Except as provided in paragraph (e)(2)(iii)(B) of this section, any payment to a partner for services or the use of capital that is described in section 707(c), including any payment described in section 736(a)(2) (relating to guaranteed payments made in liquidation of the interest of a retiring or deceased partner), is characterized as a payment for services or as the payment of interest, respectively, and not as a distributive share of partnership income.

(iii) *Payments in liquidation of a partner's interest in partnership property*—(A) *In general.* If any gain or loss is taken into account by a retiring partner (or any other person that owns (directly or indirectly) an interest in the partner if the partner is a passthrough entity) or a deceased partner's successor in interest as a result of a payment to which section 736(b) (relating to payments made in exchange for a retired or deceased partner's interest in partnership property) applies, the gain or loss is treated as passive activity gross income or a passive activity deduction only to the extent that the gain or loss would have been passive activity gross income or a passive activity deduction of the retiring or deceased partner (or the other person) if it had been recognized at the time the liquidation of the partner's interest commenced.

(B) *Payments in liquidation of a partner's interest in unrealized receivables and goodwill under section 736(a).* (*1*) If a payment is made in liquidation of a retiring or deceased partner's interest, the payment is described in section 736(a), and any income—

(*i*) Is taken into account by the retiring partner (or any other person that owns (directly or indirectly) an interest in the partner if the partner is a passthrough entity) or the deceased partner's successor in interest as a result of the payment; and

(*ii*) Is attributable to the portion (if any) of the payment that is allocable to the unrealized receivables (within the meaning of section 751(c)) and goodwill of the partnership;

the percentage of the income that is treated as passive activity gross income shall not exceed the percentage of passive activity gross income that would be included in the gross income that the retiring or deceased partner (or the other person) would have recognized if the unrealized receivables and goodwill had been sold at the time that the liquidation of the partner's interest commenced.

(*2*) For purposes of this paragarph (e)(2)(iii)(B), the portion (if any) of a payment under section 736(a) that is allocable to unrealized receivables and goodwill of a partnership shall be determined in accordance with the principles employed under § 1.736–1(b) for determining the portion of a payment made under section 736 that is treated as a distribution under section 736(b).

(e)(3)(i)–(iii)(A) [Reserved]

(B) An amount of gain that would have been treated as gain that is not from a passive activity under paragraph (c)(2)(iii) of this section (relating to substantially appreciated property formerly used in a nonpassive activity), paragraph (c)(6) of this section (relating to certain oil or gas properties), § 1.469–2T(f)(5) (relating to certain property rented incidental to development), paragraph (f)(6) of this section (relating to property rented to a nonpassive activity), or § 1.469–2T(f)(7) (relating to certain interests in a passthrough entity engaged in the trade or business of licensing intangible property) would have been allocated to the holder (or such other person) with respect to the interest if all of the property used in the passive activity had been sold immediately prior to the disposition for its fair market value on the applicable valuation date (within the meaning of §1.469–2T(e)(3)(ii)(D)(*1*)); and

(e)(3)(iii)(C)–(f)(4) [Reserved]

(f)(5) *Net income from certain property rented incidental to development activity*—(i) *In general.* An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from the item of property shall be treated as not from a passive activity if—

(A) Any gain from the sale, exchange, or other disposition of the item of property is included in the taxpayer's income for the taxable year;

(B) The taxpayer's use of the item of property in an activity involving the rental of the property commenced less than 12 months before the date of the disposition (within the meaning of paragraph (c)(2)(iii)(B) of this section) of such property; and

(C) The taxpayer materially participated (within the meaning of §1.469–5T) or significantly participated (within the meaning of §1.469–5T(c)(2)) for any taxable year in an activity that involved for such year the performance of services for the purpose of enhancing the value of such item of property (or any other item of property if the basis of the item of property that is sold, exchanged, or otherwise disposed of is determined in whole or in part by reference to the basis of such other item of property).

(ii) *Commencement of use*—(A) *In general.* For purposes of paragraph (f)(5)(i)(B) of this section, a taxpayer's use of an item of property in an activity involving the rental of the property commences on the first date on which—

(*1*) The taxpayer owns an interest in the property;

(*2*) Substantially all of the property is rented (or is held out for rent and is in a state of readiness for rental); and

(*3*) No significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed.

(B) *Value-enhancing services.* For purposes of this paragraph (f)(5)(ii), the term value-enhancing services means the services described in paragraphs (f)(5) (i)(C) and (iii) of this section, except that the term does not include lease-up. Thus, in cases in which this paragraph (f)(5) applies solely because substantial lease-up remains to be performed (see paragraph (f)(5)(iii)(C) of this section), the twelve month period described in paragraph (f)(5)(i)(B) of this section will begin when the taxpayer acquires an interest in the property if substantially all of the property is held out for rent and is in a state of readiness for rental on that date.

(iii) *Services performed for the purpose of enhancing the value of property.* For purposes of paragraph (f)(5)(i)(C) of this section, services that are treated as performed for the purpose of enhancing the value of an item of property include but are not limited to—

(A) Construction;

(B) Renovation; and

(C) Lease-up (unless more than 50 percent of the property is leased on the date that the taxpayer acquires an interest in the property).

(iv) *Examples.* The following examples illustrate the application of this paragraph (f)(5):

Example 1. (i) A, a calendar year individual, is a partner in P, a calendar year partnership, which develops real estate. In 1993, P acquires an interest in undeveloped land and arranges for the financing and construction of an office building on the land. Construction is completed in February 1995, and substantially all of the building is either rented or held out for rent and in a state of readiness for rental beginning on March 1, 1995. Twenty percent of the building is leased as of March 1, 1995.

(ii) P rents the building (or holds it out for rent) for the remainder of 1995 and all of 1996, and sells the building on February 1, 1997, pursuant to a contract entered into on January 15, 1996. P did not hold the building (or any other buildings) for sale to customers in the ordinary course of P's trade or business (see paragraph (c)(2)(v) of this section). A's distributive share of P's taxable losses from the rental of the building is $50,000 for 1995 and $30,000 for 1996. All of A's losses from the rental of the building are disallowed under 1.469–1(a)(1)(i) (relating to the disallowance of the passive activity loss for the taxable year). A's distributive share of P's gain from the sale of the building is $150,000. A has no other gross income or deductions from the activity of renting the building.

(iii) The real estate development activity that A holds through P in 1993, 1994, and 1995 involves the performance of services (e.g., construction) for the purpose of enhancing the value of the building. Accordingly, an amount equal to A's net rental activity income from the building may be treated as gross income that is not from a passive activity if A's use of the building in an activity involving the rental of the building commenced less that 12 months before the date of the disposition of the building. In this case, the date of the disposition of the building is January 15, 1996, the date of the binding contract for its sale.

(iv)(A) A taxpayer's use of an item of property in an activity involving the rental of the property commences on the first date on which—

(*1*) The taxpayer owns an interest in the item of property;

(*2*) Substantially all of the property is rented (or is held out for rent and is in a state of readiness for rental); and

(*3*) No significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed.

(B) In this case, A's use of the building in an activity involving the rental of the building commenced on March 1, 1995, less than 12 months before January 15, 1996, the date of disposition. Accordingly, if A materially (or significantly) participated in the real estate development activity in 1993, 1994, or 1995 (without regard to whether A materially participated in the activity in more than one of those years), an amount of A's gross rental activity income from the building for 1997 equal to A's net rental activity income from the building for 1997 is treated under this paragraph (f)(5) as gross income that is not from a passive activity. Under paragraph (f)(9)(iv) of this section, A's net rental activity income from the building for 1997 is $70,000 ($150,000 distributive share of gain from the disposition of the building minus $80,000 of reasonably allocable passive activity deductions).

Example 2. (i) X, a calendar year taxpayer subject to section 469, acquires a building on February 1, 1994, when the building is 25 percent leased. During 1994, X rents the building (or holds it out for rent) and materially participates in an activity that involves the lease-up of the building. X's activities do not otherwise involve the performance of construction or other services for the purpose of enhancing the value of the building, and X does not hold the building (or any other building) for sale to customers in the ordinary course of X's trade or business. X sells the building on December 1, 1994.

(ii)(A) Under paragraph (f)(5)(iii)(C) of this section, lease-up is considered a service performed for the purpose of enhancing the value of property unless more than 50 percent of the property is leased on the date the taxpayer acquires an interest in the property. Under paragraph (f)(5)(ii)(B) of this section, however, lease-up is not considered a value-enhancing service for purposes of determining when the taxpayer commences using an item of property in an activity involving the rental of the property. Accordingly, X's acquisition of the building constitutes a commencement of X's use of the building in a rental activity, because February 1, 1994, is the first date on which—

(*1*) The taxpayer owns an interest in the item of property;

(*2*) Substantially all of the property is held out for rent; and

(*3*) No significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed.

(B) In this case, X disposes of the property within 12 months of the date X commenced using the building in a rental activity. Accordingly, an amount of X's gross rental activity income for 1994 equal to X's net rental activity income from the building for 1994 is treated under this paragraph (f)(5) as gain that is not from a passive activity.

Example 3. The facts are the same as in Example 2, except that at the time X acquires the building it is 60 percent leased. Under paragraph (f)(5)(iii)(C) of this section, lease-up is not considered a service performed for the purpose of enhancing the value of property if more than 50 percent of the property is leased on the date the taxpayer acquires an interest in the property. Therefore, additional lease-up performed by X is not taken into account under this paragraph (f)(5). Since X's activities do not otherwise involve the performance of services for the purpose of enhancing the value of the building, none of X's gross rental activity income from the building will be treated as income that is not from a passive activity under this paragraph (f)(5).

(f)(6) *Property rented to a nonpassive activity.* An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as not from a passive activity if the property—

(i) Is rented for use in a trade or business activity (within the meaning of paragraph (e)(2) of this section) in which the taxpayer materially participates (within the meaning of § 1.469–5T) for the taxable year; and

(ii) Is not described in § 1.469–2T(f)(5).

(f)(7)–(f)(9)(ii) [Reserved]

(f)(9)(iii) The gross rental activity income for a taxable year from an item of property is any passive activity gross income (determined without regard to § 1.469–2T(f)(2) through (f)(6)) that—

(A) Is income for the year from the rental or disposition of such item of property; and

(B) In the case of income from the disposition of such item of property, is income from an activity that involved the rental of such item of property during the 12-month period ending on the date of the disposition (see §1.469–2T(c)(2)(ii)); and

(iv) The net rental activity income from an item of property for the taxable year is the excess, if any, of—

(A) The gross rental activity income from the item of property for the taxable year; over

(B) Any passive activity deductions for the taxable year (including any deduction treated as a deduction for the year under §1.469–1(f)(4)) that are reasonably allocable to the income.

(10) *Coordination with section 163(d).* Gross income that is treated as not from a passive activity under §1.469–2T(f)(3), (4), or (7) is treated as income described in section 469(e)(1)(A) and §1.469–2T(c)(3)(i) except in determining whether—

(i) Any property is treated for purposes of section 469(e)(1)(A)(ii)(I) and §1.469–2T(c)(3)(i)(C) as property that produces income of a type described in §1.469–2T(c)(3)(i)(A);

(ii) Any property is treated for purposes of section 469(e)(1)(A)(ii)(II) and §1.469–2T(c)(3)(i)(D) as property held for investment;

(iii) An expense (other than interest expense) is treated for purposes of section 469(e)(1)(A)(i)(II) and §1.469–2T(d)(4) as clearly and directly allocable to portfolio income (within the meaning of §1.469–2T(c)(3)(i); and

(iv) Interest expense is allocated under §1.163–8T to an investment expenditure (within the meaning of §1.163–8T(b)(3)) or to a passive activity expenditure (within the meaning of §1.163–8T(b)(4)).

(11) [Reserved]

[T.D. 8417, 57 FR 20754, May 15, 1992, as amended by T.D. 8477, 58 FR 11538, Feb. 26, 1993; 58 FR 13706, Mar. 15, 1993; 58 FR 29536, May 21, 1993; T.D. 8495, 58 FR 58787, Nov. 4, 1993; T.D. 8417, 59 FR 45623, Sept. 2, 1994]

§1.469–2T Passive activity loss (temporary).

(a) *Scope of this section.* This section contains rules for determining the amount of the taxpayer's passive activity loss for the taxable year for purposes of section 469 and the regulations thereunder. The rules contained in this section—

(1) Provide general guidance for identifying items of income and deduction that are taken into account in determining the amount of the passive activity loss for the taxable year;

(2) Specify particular items of income and deduction that are not taken into account in determining the amount of the passive activity loss for the taxable year; and

(3) Specify the manner in which provisions of the Internal Revenue Code and the regulations, other than section 469 and the regulations thereunder, are applied for purposes of determining the extent to which items of deduction are taken into account for a taxable year in computing the amount of the passive activity loss for such year.

(b) *Definition of passive activity loss*—(1) *In general.* In the case of a taxpayer other than a closely held corporation (within the meaning of §1.469–1T(g)(2)(ii)), the passive activity loss for the taxable year is the amount, if any, by which the passive activity deductions for the taxable year exceed the passive activity gross income for the taxable year.

(2) *Cross references.* See paragraph (c) of this section for the definition of ''passive activity gross income,'' paragraph (d) of this section for the definition of ''passive activity deduction,'' and §1.469–1T(g)(4) for the computation of the passive activity loss of a closely held corporation.

(c) *Passive activity gross income*—(1) *In general.* Except as otherwise provided in the regulations under section 469, passive activity gross income for a taxable year includes an item of gross income if and only if such income is from a passive activity.

(2) *Treatment of gain from disposition of an interest in an activity or an interest in property used in an activity*—(i) *In general*—(A) *Treatment of gain.* Except as otherwise provided in the regulations under section 469, any gain recognized

upon the sale, exchange or other disposition (a ‘‘disposition’’) of an interest in property used in an activity at the time of the disposition or of an interest in an activity held through a partnership or S corporation is treated in the following manner:

(*1*) The gain is treated as gross income from such activity for the taxable year or years in which it is recognized;

(*2*) If the activity is a passive activity of the taxpayer for the taxable year of the disposition, the gain is treated as passive activity gross income for the taxable year or years in which it is recognized; and

(*3*) If the activity is not a passive activity of the taxpayer for the taxable year of the disposition, the gain is treated as not from a passive activity.

(B) *Dispositions of partnership interests and S corporation stock.* A partnership interest or S corporation stock is not property used in an activity for purposes of this paragraph (c)(2). See paragraph (e)(3) of this section for rules treating the gain recognized upon the disposition of a partnership interest or S corporation stock as gain from the disposition of interests in the activities in which the partnership or S corporation has an interest.

(C) *Interest in property.* For purposes of applying this paragraph (c)(2) to a disposition of property—

(*1*) Any material portion of the property that was used, at any time before the disposition, in any activity at a time when the remainder of the property was not used in such activity shall be treated as a separate interest in property; and

(*2*) The amount realized from the disposition and the adjusted basis of the property must be allocated among the separate interests in a reasonable manner.

(D) *Examples.* The following examples illustrate the application of this paragraph (c)(2)(i):

Example (1). A owns an interest in a trade or business activity in which A has never materially partcipated. In 1987, A sells equipment that was used exclusively in the activity and realizes a gain on the sale. Under paragraph (c)(2)(i)(A)(*2*) of this section, the gain is passive activity gross income.

Example (2). B owns an interest in a trade or business activity in which B materially participates for 1987. In 1987, B sells a building used in the activity in an installment sale and realizes a gain on the sale. B does not materially participate in the activity for 1988 or any subsequent year. Under paragraph (c)(2)(i)(A)(*3*) of this section, none of B’s gain from the sale (including gain taken into account after 1987) is passive activity gross income.

Example (3). C enters into a contract to acquire property used by the seller in a rental activity. Before acquiring the property pursuant to the contract, C sells all rights under the contract and realizes a gain on the sale. Since C’s rights under the contract are not property used in a rental activity, the gain is not income from a rental activity. The result would be the same if C owned an option to acquire the property and sold the option.

Example (4). D sells a ten-floor office building. D owned the building for three years preceding the sale and at all times during that period used seven floors of the building in a trade or business activity and three floors in a rental activity. The fair market value per square foot is substantially the same throughout the building, and D did not maintain a separate adjusted basis for any part of the building. Under paragraph (c)(2)(i)(C)(*1*) of this section, the seven floors used in the trade or business activity and the three floors used in the rental activity are treated as separate interests in property. Under paragraph (c)(2)(i)(C)(*2*) of this section, the amount realized and the adjusted basis of the building must be allocated between the separate interests in a reasonable manner. Under these facts, an allocation based on the square footage of the parts of the building used in each activity would be reasonable.

Example (5). The facts are the same as in example (4), except that two of the seven floors used in the trade or business activity were used in the rental activity until five months before the sale. Under paragraph (c)(2)(i)(C)(*1*) of this section, the five floors used exclusively in the trade or business activity and the two floors used first in the rental activity and then in the trade or business activity are treated as separate interests in property. See paragraph (c)(2)(ii) of this section for rules for allocating amount realized and adjusted basis upon a disposition of an interest in property used in more than one activity during the 12-month period ending on the date of the disposition.

(ii) *Disposition of property used in more than one activity in 12-month period preceding disposition.* In the case of a disposition of an interest in property that is used in more than one activity during the 12-month period ending on the date of the disposition, the amount realized from the disposition and the adjusted basis of such interest must be allocated among such activities on a basis that reasonably reflects the use of such interest in property during such 12-month period. For purposes of this paragraph (c)(2)(ii), an allocation of the amount realized and adjusted basis solely to the activity in which an iterest in property is predominantly used during the 12-month period ending on the date of the disposition reasonably reflects the use of such interest in property if the fair market value of such interest does not exceed the lesser of—

(A) $10,000; and

(B) 10 percent of the sum of the fair market value of such interest and the fair market value of all other property used in such activity immediately before the disposition.

The following examples illustrate the application of this paragraph (c)(2)(ii):

Example (1). The facts are the same as in example (5) of paragraph (c)(2)(i)(D) of this section. Under paragraph (c)(2)(i)(C)(*2*) of this section, D allocates the amount realized and adjusted basis of the building 30 percent to the three floors used exclusively in the rental activity, 50 percent to the five floors used exclusively in the trade or business activity, and 20 percent to the two floors used first in the rental activity and then in the trade or business activity. Under this paragraph (c)(2)(ii), the amount realized and adjusted basis allocated to the two floors that were used in both activities during the 12-month period ending on the date of the disposition must also be allocated between such activities. Under these facts, an allocation of 7/12 of such amounts to the rental activity and 5/12 of such amounts to the trade or business activity would reasonably reflect the use of the two floors during the 12-month period ending on the date of the disposition.

Example (2). B is a limited partner in a partnership that sells a tractor-trailer. During the 12-month period ending on the date of the sale, the tractor-trailer was used in several activities, and the partnership allocates the amount realized from the disposition and the adjusted basis of the tractor-trailer among the activities based on the number of days during the 12-month period that the partnership used the tractor-trailer in each activity. Under these facts, the partnership's allocation reasonably reflects the use of the tractor-trailer during the 12-month period ending on the date of the sale.

Example (3). C sells a personal computer for $8,000. During the 12-month period ending on the date of the sale, 70 percent of C's use of the computer was in a passive activity. Immediately before the sale, the fair market value of all property used in the passive activity (including the personal computer) was $200,000. Under these facts, the computer was predominatly used in the passive activity during the 12-month period ending on the date of the sale, and the value of the computer, as measured by its sale price ($8,000), does not exceed the lesser of (a) $10,000, and (b) 10 percent of the value of all property used in the activity immediately before the sale ($20,000). C allocates the amount realized and the adjusted basis solely to the passive activity. Under this paragraph (c)(2)(ii), C's allocation reasonably reflects the use of the computer during the 12-month period ending on the date of the sale.

(iii) *Disposition of substantially appreciated property formerly used in nonpassive activity.* [Reserved] See § 1.469–4(c)(2)(iii) for rules relating to this paragraph.

(iv) *Taxable acquisitions.* [Reserved] See § 1.469–2(c)(iv) for rules relating to this paragraph.

(v) *Property held for sale to customers.* [Reserved] See § 1.469–2(c)(v) for rules relating to this paragraph.

(3) *Items of portfolio income specifically excluded*—(i) *In general.* Passive activity gross income does not include portfolio income. For purposes of the preceding sentence, portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business (within the meaning of paragraph (c)(3)(ii) of this section), that is attributable to—

(A) Interest (including amounts treated as interest under paragraph (e)(2)(ii) of this section, relating to certain payments to partners for the use of capital); annuities; royalties (including fees and other payments for the use of intangible property); dividends on C corporation stock; and income (including dividends) from a real estate investment trust (within the meaning of section 856), regulated investment company (within the meaning of section 851), real estate mortgage investment conduit (within the meaning of section 860D), common trust fund (within the meaning of section 584), controlled foreign corporation (within the meaning of section 957), qualified electing fund (within the meaning of section 1295(a)), or cooperative (within the meaning of section 1381(a));

(B) Dividends on S corporation stock (within the meaning of section 1368(c)(2);

(C) The disposition of property that produces income of a type described in paragraph (c)(3)(i)(A) of this section; and

(D) The disposition of property held for investment (within the meaning of section 163 (d)).

(ii) *Gross income derived in the ordinary course of a trade or business.* Solely for purposes of paragraph (c)(3)(i) of this section, gross income derived in the ordinary course of a trade or business includes only—

(A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;

(B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;

(C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;

(D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);

(E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);

(F) Amount included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and

(G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

(iii) *Special rules*—(A) *Income from property held for investment by dealer.* For purposes of paragraph (c)(3)(i) of this section, a dealer's income or gain from an item of property is not dervied by the dealer in the ordinary course of a trade or business of dealing in such property if the dealer held the property for investment at any time before such income or gain is recognized.

(B) *Royalties derived in the ordinary course of the trade or business of licensing intangible property*—(*1*) *In general.* Royalties received by any person with respect to a license or other transfer of any rights in intangible property shall be considered to be derived in the ordinary course of the trade or business of licensing such property only if such person—

(*i*) Created such property; or

(*ii*) Performed substantial services or incurred substantial costs with respect to the development or marketing of such property.

(*2*) *Substantial services or costs*—(*i*) *In general.* Except as provided in paragraph (c)(3)(iii)(B)(*2*)(*ii*) of this section, the determination of whether a person has performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property shall be made on the basis of all the facts and circumstances.

(*ii*) *Exception.* A person has performed substantial services or incurred substantial costs for a taxable year with respect to the development or marketing of an item of intangible property if—

(*a*) The expenditures reasonably incurred by such person in such taxable year with respect to the development or marketing of the property exceed 50 percent of the gross royalties from licensing such property that are includible in such person's gross income for the taxable year; or

(*b*) The expenditures reasonably incurred by such person in such taxable year and all prior taxable years with respect to the development or marketing of the property exceed 25 percent of the aggregate capital expenditures (without any adjustment of amortization) made by such person with respect to the property in all such taxable years.

(*iii) Expenditures taken into account.* For purposes of paragraph (c)(3)(iii)(B)(*2*)(*ii*) of this section, expenditures in a taxable year include amounts chargeable to capital account for such year without regard to the year or years (if any) in which any deduction for such expenditure is allowed.

(*3*) *Passthrough entities.* For purposes of this paragraph (c)(3)(iii)(B), in the case of any intangible property held by a partnership, S corporation, estate, or trust, the determination of whether royalties from such property are derived in the ordinary course of a trade or business shall be made by applying the rules of this paragraph (c)(3)(iii)(B) to such entity and not to any holder of an interest in such entity.

(*4*) *Cross reference.* For special rules applicable to certain gross income from a trade or business of licensing intangible property, see paragraph (f)(7) of this section.

(C) *Mineral production payments.* For purposes of section 469 and the regulations thereunder—

(*1*) If a mineral production payment is treated as a loan under section 636, the portion of any payment in discharge of the production payment that is the equivalent of interest shall be treated as interest; and

(*2*) If a mineral production payment is not treated as a loan under section 636, payments in discharge of the production payment shall be treated as royalties.

(iv) *Examples.* The following examples illustrate the application of this paragraph (c)(3):

Example (1). A, an individual engaged in the trade or business of farming, disposes of farmland in an installment sale. A is not engaged in a trade or business of selling farmland. Therefore, A's interest income from the installment note is not gross income derived in the ordinary course of a trade or business.

Example (2). P, a partnership, operates a rental apartment building for low-income tenants in City Y. Under Y's laws relating to the operation of low-income housing, P is required to maintain a reserve fund to pay for the maintenance and repair of the building. P invests the reserve fund in short-term interest-bearing deposits. Because P's interest income from the investment of the reserve fund is not interest income described in paragraph (c)(3)(ii) of this section, such income is not treated as derived in the ordinary course of a trade or business. Accordingly, P's interest income from the deposits is portfolio income (within the meaning of paragraph (c)(3)(i) of this section).

Example (3). (i) B is a partner in a partnership that is engaged in an activity involving the conduct of a trade or business of dealing in securities. On February 1, the partnership acquires certain securities for investment (within the meaning of section 163(d)). On February 2, before recognizing any income with respect to the securities, the partnership determines that it would be advisable to hold the securities primarily for sale to customers and subsequently sells them to customers in the ordinary course of its business.

(ii) Under paragraph (c)(3)(iii)(A) of this section, income or gain from any security (including any security acquired pursuant to an investment of working capital) held by a dealer for investment at any time before such income or gain is recognized is not treated for purposes of paragraph (c)(3)(i) of this section as derived by the dealer in the ordinary course of its trade or business of dealing in securities. Accordingly, B's distributive share of the partnership's interest, dividends, or gains from the securities acquired by the partnership for investment on February 1 is portfolio income of B, notwithstanding that such securities were held by the partnership, subsequent to February 1, primarily for sale to customers in the ordinary course of the partnership's trade or business of dealing in securities.

Example (4). C is a partner in a partnership that is engaged in an activity of trading or dealing in royalty interests in mineral properties. The partnership derives royalty income from royalty interests held in the activity. If the activity is a trade or business activity, C's distributive share of the partnership's royalty income from such royalty interests is treated under paragraph (c)(3)(ii)(D) of this section as derived in the ordinary course of the partnership's trade or business.

Example (5). (i) D, a calendar year individual, is a partner in a calendar year partnership that is engaged in an activity of developing and marketing a design for a system that reduces air pollution in office buildings. D has a 10 percent distributive share of all items of partnership income, gain, loss, deduction, and credit. In 1987, the partnership acquired the rights to the design for $100,000. In 1987, 1988, and 1989, the partnership incurs expenditures with respect to the development and marketing of the design, and derives gross royalties from licensing the design, in the amounts set forth in the table below. The expenditures incurred in 1987 and 1988 are currently deductible expenses. The expenditures incurred in 1989 are capitalized and may be deducted only in subsequent taxable years.

Year	Gross royalties	Expenditures	Cumulative capital expenditures
1987	$20,000	$8,000	$100,000
1988	20,000	12,000	100,000
1989	60,000	15,000	115,000
1990	120,000	0	115,000

(ii) Under paragraph (c)(3)(iii)(B)(*3*) of this section, the determination of whether royalties from intangible property are derived in the ordinary course of a trade or business of a partnership is made by applying the rules of paragraph (c)(3)(iii)(B) of this section to the partnership rather than the partners. The expenditures reasonably incurred by the partnership in 1987 with respect to the development or marketing of the design ($8,000) do not exceed 50 percent of the partnership's gross royalties for such year from licensing the design ($20,000). In addition, the sum of such expenditures incurred in 1987 and all prior taxable years ($8,000) does not exceed 25 percent of the aggregate capital expenditures made by the partnership in all such taxable years with respect to the design ($100,000). Accordingly, for 1987, the partnership is not treated under paragraph (c)(3)(iii)(B)(*2*)(*ii*) of this section as performing substantial services or incurring substantial costs with respect to the development or marketing of the design. Therefore, unless all of the facts and circumstances indicate that the partnership performed substantial services or incurred substantial costs with respect to the development or marketing of the design, D's distributive share of the partnership's royalty income for 1987 is portfolio income.

(iii) As of the end of 1988, the sum of the expenditures reasonably incurred by the partnership during such taxable year and all prior taxable years with respect to the development or marketing of the design ($20,000) does not exceed 25 percent of the aggregate capital expenditures made by the partnership in all such years with respect to the design ($100,000). However, the amount of such expenditures incurred by the partnership in 1988 ($12,000) exceeds 50 percent of the partnership's gross royalties for such year from licensing the design ($20,000). Accordingly, for 1988, under paragraph (c)(3)(iii)(B)(*2*)(*ii*)(*a*) of this section, the partnership is treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design, and D's distributive share of the partnership's royalty income for 1988 is considered for purposes of paragraph (c)(3)(i) of this section to be derived in the ordinary course of a trade or business and therefore is not portfolio income.

(iv) The expenditures reasonably incurred by the partnership in 1989 with respect to the development or marketing of the design ($15,000) do not exceed 50 percent of the partnership's gross royalties for such year from licensing the design ($60,000). However, the sum of such expenditures incurred by the partnership in 1989 and all prior taxable years ($35,000) exceeds 25 percent of the partnership's aggregate capital expenditures made in all such years with respect to the design ($115,000). Accordingly, for 1989, under paragraph (c)(3)(iii)(B)(*2*)(*ii*)(*b*) of this section, the partnership is treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design, and D's distributive share of the partnership's royalty income in 1989 is considered for purposes of paragraph (c)(3)(i) of this section to be derived in the ordinary course of a trade or business and therefore is not portfolio income.

(v) The result for 1990 is the same as for 1989, notwithstanding that the partnership incurs no expenditures in 1990 with respect to the development or marketing of the design.

Example (6). The facts are the same as in example (5), except that, for 1987, D's distributive share of the partnership's development and marketing costs is 15 percent, while D's distributive share of the partnership's gross royalties is 10 percent. Although D's distributive share of the expenditures reasonably incurred by the partnership during 1987 with respect to the development and marketing of the design ($1,200) is more than 50 percent of D's distributive share of the partnership's gross royalties from licensing the design ($2,000), D is not treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design for 1987 under paragraph (c)(3)(iii)(B)(*2*)(*ii*)(*a*) of this section. This is because, under paragraph (c)(3)(iii)(B)(*3*) of this section, the determination of whether the royalties are derived in the ordinary course of a trade or business is made by applying paragraph (c)(3)(iii)(B) of this section to the partnership, and not to D.

(4) *Items of personal service income specifically excluded*—(i) *In general.* Passive activity gross income does not include compensation paid to or on behalf of an individual for personal services performed or to be performed by such individual at any time. For purposes of this paragraph (c)(4), compensation for personal services includes only—

(A) Earned income (within the meaning of section 911(d)(2)(A)), including gross income from a payment described in paragraph (e)(2) of this section that represents compensation for the performance of services by a partner;

(B) Amounts includible in gross income under section 83;

(C) Amounts includible in gross income under sections 402 and 403;

(D) Amounts (other than amounts described in paragraph (c)(4)(i)(C) of this section) paid pursuant to retirement, pension, and other arrangements for deferred compensation for services;

(E) Social security benefits (within the meaning of section 86(d)) includible in gross income under section 86; and

(F) Other income identified by the Commissioner as income derived by the taxpayer from personal services;

provided, however, that no portion of a partner's distributive share of partnership income (within the meaning of section 704(b)) or a shareholder's pro rata share of income from an S corporation (within the meaning of section 1377(a)) shall be treated as compensation for personal services.

(ii) *Example.* The following example illustrates the application of this paragraph (c)(4):

Example. C owns 50 percent of the stock of X, an S corporation. X owns rental real estate, which it manages. X pays C a salary for services performed by C on behalf of X in connection with the management of X's rental properties. Under this paragraph (c)(4), although C's pro rata share of X's gross rental income is passive activity gross income (even if the salary paid to C is less than the fair market value of C's services), the salary paid to C does not constitute passive activity gross income.

(5) *Income from section 481 adjustment*—(i) *In general.* If a change in accounting method results in a positive section 481 adjustment with respect to an activity, a ratable portion (within the meaning of paragraph (c)(5)(iii) of this section) of the amount taken into account for a taxable year as a net positive section 481 adjustment by reason of such change shall be treated as gross income from the activity for such taxable year, and such gross income shall be treated as passive activity gross income if and only if such activity is a passive activity for the year of the change (within the meaning of section 481(a)).

(ii) *Positive section 481 adjustments.* For purposes of applying this paragraph (c)(5)—

(A) The term ''net positive section 481 adjustment'' means the increase (if any) in taxable income taken into account under section 481(a) to prevent amounts from being duplicated or omitted by reason of a change in accounting method; and

(B) The term ''positive section 481 adjustment with respect to an activity'' means the increase (if any) in taxable income that would be taken into account under section 481(a) to prevent only the duplication or omission of amounts from such activity by reason of the change in accounting method.

(iii) *Ratable portion.* The ratable portion of the amount taken into account as a net positive section 481 adjustment for a taxable year by reason of a change in accounting method is determined with respect to an activity by multiplying such amount by the fraction obtained by dividing—

(A) The positive section 481 adjustment with respect to the activity; by

(B) The sum of the positive section 481 adjustments with respect to all of the activities of the taxpayer.

(6) *Gross income from certain oil or gas properties*—(i) *In general.* [Reserved] See § 1.469–2(c)(6)(i) for rules relating to this paragraph.

(ii) *Gross and net passive income from the property.* [Reserved] See § 1.469–2(c)(6)(ii) for rules relating to this paragraph.

(iii) *Property.* [Reserved] See 1.469–2(c)(6)(iii) for rules relating to this paragraph.

(iv) *Examples.* The following examples illustrate the application of this (c)(6):

Example 1. [Reserved] See § 1.469–2(c)(6)(iv) *Example 1.*

Example 2. [Reserved] See § 1.469–2(c)(6)(iv) *Example 2.*

Example (3). C is a general partner in partnership T and a limited partner in partnership U. T and U both own oil and gas working interests in tracts of land in County X. In 1987, T drills a well, and C's distributive share of T's losses from drilling the well is treated under § 1.469–1T(e)(4) as not from a passive activity. In the course of selecting the drilling site and drilling the well, T develops information indicating a significant probability that substantial oil and gas reserves underlie most portions of County X. As a result, the value of all oil and gas properties in County X is enhanced. The information developed by T does not, however, indicate that the reservoir in which T's well is drilled underlies U's tract. Under these facts, T's and U's tracts are not treated as one property for purposes of this paragraph (c)(6), because the value of U's tract is not directly enhanced by T's activities.

(7) *Other items specifically excluded.* Notwithstanding any other provision of the regulations under section 469, passive activity gross income does not include the following:

(i) Gross income of an individual from intangible property, such as a patent, copyright, or literary, musical, or artistic composition, if the taxpayer's personal efforts significantly contributed to the creation of such property;

(ii) Gross income from a qualified low-income housing project (within the meaning of section 502 of the Tax Reform Act of 1986) for any taxable year in the relief period (within the meaning of section 502(b) of such Act;

(iii) Gross income attributable to a refund of any state, local, or foreign income, war profits, or excess profits tax;

(iv) [Reserved] See § 1.469–2(c)(7)(iv) for rules relating to this paragraph (c)(7)(iv).

(v) [Reserved] See § 1.469–2(c)(7)(v) for rules relating to this paragraph (c)(7)(v).

(vi) [Reserved] See § 1.469–2(c)(7)(vi) for rules relating to this paragraph (c)(7)(vi).

(d) *Passive activity deductions*—(1) *In general.* Except as otherwise provided in section 469 and the regulations thereunder, a deduction is a passive activity deduction for a taxable year if and only if such deduction—

(i) Arises (within the meaning of paragraph (d)(8) of this section) in connection with the conduct of a activity that is a passive activity for the taxable year; or

(ii) Is treated as a deduction from an activity under § 1.469–1T(f)(4) for the taxable year.

The following example illustrates the application of this paragraph (d)(1):

Example. (i) In 1987, A, a calendar year individual, acquires a partnership interest in R, a calendar year partnership. R's only activity is a trade or business activity in which A materially participates for 1987. R incurs a loss in 1987. A's distributive share of R's 1987 loss is $1,000. However, A's basis in the partnership interest at the end of 1987 (without regard to A's distributive share of partnership loss) is $600; accordingly, section 704(d) disallows any deduction in 1987 for $400 of A's distributive share of R's loss. The remainder of A's distributive share of R's loss would be allowed as a deduction for 1987 if taxable income for all taxable years were determined without regard to sections 469, 613A(d), and 1211. See paragraph (d)(8) of this section.

(ii) A does not materially participate in R's activity for 1988. In 1988, R again incurs a loss, and A's distributive share of the loss is again $1,000. At the end of 1988, A's basis in the partnership interest (without regard to A's distributive share of partnership loss) is $2,000; accordingly, in 1988 section 704(d) does not limit A's deduction for either A's $1,000 distributive share of R's 1988 loss or the $400 loss carried over from 1987 under the second sentence of section 704(d). These losses would be allowed as a deduction for 1988 if taxable income for all taxable years were determined without regard to sections 469, 613A(d) and 1211. See paragraph (d)(8) of this section.

(iii) Under these facts, only $400 of A's distributive share of R's deductions from the activity are disallowed under section 704(d) in 1987. A's remaining deductions from the activity are treated as deductions that arise in connection with the activity for 1987 under paragraph (d)(8) of this section. Because A materially participates in the activity for 1987, the activity is not a passive activity (within the meaning of § 1.469–1T(e)(1)) of A for such year. Accordingly, the deductions that are not disallowed in 1987 are not passive activity deductions.

(iv) A does not materially participate in R's activity for 1988. Accordingly, the activity is a passive activity of A for such year. No portion of A's distributive share of R's deductions from the activity is disallowed under section 704(d) in 1988. Accordingly, A's distributive share of R's deductions for 1988 and the $400 of deductions carried over from 1987 are both treated under paragraph (d)(8) of this section as deductions that arise in 1988. Since the activity is a passive activity for 1988, such deductions are passive activity deductions.

(2) *Exceptions.* Passive activity deductions do not include—

(i) A deduction for an item of expense (other than interest) that is clearly and directly allocable (within the meaning of paragraph (d)(4) of this section) to portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(ii) A deduction allowed under section 243, 244, or 245 with respect to any dividend that is not included in passive activity gross income;

(iii) Interest expense (other than interest expense described in paragraph (d)(3) of this section);

(iv) A deduction for a loss from the disposition of property of a type that produces portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(v) A deduction that, under section 469(g) and §1.469–6T (relating to the allowance of passive activity losses upon certain dispositions of interests in passive activities), is treated as a deduction that is not a passive activity deduction;

(vi) A deduction for any state, local, or foreign income, war profits, or excess profits tax;

(vii) A miscellaneous itemized deduction (within the meaning of section 67(b)) that is subject to disallowance in whole or in part under section 67(a) (without regard to whether any amount of such deduction is disallowed under section 67);

(viii) A deduction allowed under section 170 for a charitable contribution;

(ix) [Reserved] See §1.469–2(d)(2)(ix) for rules relating to this paragraph.

(x) [Reserved] See §1.469–2(d)(2)(x) for rules relating to this paragraph (d)(2)(x).

(xi) [Reserved] See §1.469–2(d)(2)(xi) for rules relating to this paragraph (d)(2)(xi).

(xii) [Reserved] See §1.469–2(d)(2)(xii) for rules relating to this paragraph (d)(2)(xii).

(3) *Interest expense.* Except as otherwise provided in the regulations under section 469, interest expense is taken into account as a passive activity deduction if and only if such interest expense—

(i) Is allocated under §1.163–8T to a passive activity expenditure (within the meaning of §1.163–8T(b)(4)); and

(ii) Is not—

(A) Qualified residence interest (within the meaning of §1.163–10T); or

(B) Capitalized pursuant to a capitalization provision (within the meaning of §1.163–8T(m)(7)(i)).

(4) *Clearly and directly allocable expenses.* For purposes of section 469 and the regulations thereunder, an expense (other than interest expense) is clearly and directly allocable to portfolio income (within the meaning of paragraph (c)(3)(i) of this section) if and only if such expense is incurred as a result of, or incident to, an activity in which such gross income is derived or in connection with property from which such gross income is derived. For example, general and administrative expenses and compensation paid to officers attributable to the performance of services that do not directly benefit or are not incurred by reason of a particular activity or particular property are not clearly and directly allocable to portfolio income (within the meaning of paragraph (c)(3)(i) of this section).

(5) *Treatment of loss from disposition*—(i) *In general.* Except as otherwise provided in the regulations under section 469—

(A) Any loss recognized in any year upon the sale, exchange, or other disposition (a ‘‘disposition’’) of an interest in property used in an activity at the time of the disposition or of an interest in an activity held through a partnership or S corporation and any deduction allowed on account of the abandonment or worthlessness of such an interest is treated as a deduction from such activity; and

(B) Any such deduction is a passive activity deduction if and only if the activity is a passive activity of the taxpayer for the taxable year of the disposition (or other event giving rise to the deduction).

(ii) *Disposition of property used in more than one activity in 12-month period preceding disposition.* In the case of a disposition of an interest in property that is used in more than one activity during the 12-month period ending on the date of the disposition, the amount realized from the disposition and the adjusted basis of such interest must be allocated among such activities in the manner described in paragraph (c)(2)(ii) of this section.

(iii) *Other applicable rules*—

(A) *Applicability of rules in paragraph (c)(2).* [Reserved] See §1.469–2(d)(5)(iii)(A) for rules relating to this paragraph.

(B) *Dispositions of partnership interests and S corporation stock.* A partnership interest or S corporation stock is not property used in an activity for purposes of this paragraph (d)(5). See paragraph (e)(3) of this section for rules treating the loss recognized upon the disposition of a partnership interest or S corporation stock as loss from the disposition of interests in the activities in which the partnership or S corporation has an interest.

(6) *Coordination with other limitations on deductions that apply before section 469*—(i) *In general.* An item of deduction from a passive activity that is disallowed for a taxable year under section 704(d), 1366(d), or 465 is not a passive activity deduction for the taxable year. Paragraphs (d)(6) (ii) and (iii) of this section provide rules for determining the extent to which items of deduction from a passive activity are disallowed for a taxable year under sections 704(d), 1366(d), and 465.

(ii) *Proration of deductions disallowed under basis limitations*—(A) *Deductions disallowed under section 704(d).* If any amount of a partner's distributive share of a partnership's loss for the taxable year is disallowed under section 704(d), a ratable portion of the partner's distributive share of each item of deduction or loss of the partnership is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing—

(*1*) The amount of the partner's distributive share of partnership loss that is disallowed for the taxable year; by

(*2*) The sum of the partner's distributive shares of all items of deduction and loss of the partnership for the taxable year.

(B) *Deductions disallowed under section 1366(d).* If any amount of an S corporation shareholder's pro rata share of an S corporation's loss for the taxable year is disallowed under section 1366(d), a ratable portion of the taxpayer's pro rata share of each item of deduction or loss of the S corporation is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing—

(*1*) The amount of the shareholder's pro rata share of S corporation loss that is disallowed for the taxable year; by

(*2*) The sum of the shareholder's pro rata shares of all items of deduction and loss of the corporation for the taxable year.

(iii) *Proration of deductions disallowed under at-risk limitation.* If any amount of the taxpayer's loss from an activity (within the meaning of section 465(c)) is disallowed under section 465 for the taxable year, a ratable portion of each item of deduction or loss from the activity is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing—

(*1*) The amount of the loss from the activity that is disallowed for the taxable year; by

(*2*) The sum of all deductions from the activity for the taxable year.

(iv) *Coordination of basis and at-risk limitations.* The portion of any item of deduction or loss that is disallowed for the taxable year under section 704(d) or 1366(d) is not taken into account for the taxable year in determining the loss from an activity (within the meaning of section 465(c)) for purposes of applying section 465.

(v) *Separately identified items of deduction and loss.* In identifying the items of deduction and loss from an activity that are not disallowed under sections 704(d), 1366(d), and 465 (and that therefore may be treated as passive activity deductions), the taxpayer need not account separately for any item of deduction or loss unless such item may, if separately taken into account, result in an income tax liability different from that which would result were such item of deduction or loss taken into account separately. For related rules applicable to partnerships and S corporations, see § 1.702–1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Items of deduction or loss that must be accounted for separately include (but are not limited to) items of deduction or loss that—

(A) Are attributable to separate activities (within the meaning of the rules to be contained in § 1.469–4T);

(B) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469–9T) in taxable years in which the taxpayer activity participates (within the meaning of section 469(i) and the rules to be contained in § 1.469–9T) in such activity;

(C) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in §1.469–9T) in taxable years in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in §1.469–9T) in such activity;

(D) Arose in a taxable year beginning before 1987 and were not allowed for such taxable year under section 704(d), 1366(d), or 465(a)(2);

(E) [Reserved] See §1.469–2(d)(6)(v)(E) for rules relating to this paragraph.

(F) Are attributable to pre-enactment interests in activities (within the meaning of §1.469–11T(c)).

(7) *Deductions from section 481 adjustment*—(i) *In general.* If a change in accounting method results in a negative section 481 adjustment with respect to an activity, a ratable portion (within the meaning of paragraph (d)(7)(iii) of this section) of the amount taken into account for a taxable year as a net negative section 481 adjustment by reason of such change shall be treated as a deduction from the activity for such taxable year, and such deduction shall be treated as a passive activity deduction if and only if such activity is a passive activity for the year of the change (within the meaning of section 481(a)). See the rules to be contained in §1.469–1T(k) for the treatment of passive activity deductions from an activity in taxable years in which the activity is a former passive activity.

(ii) *Negative section 481 adjustments.* For purposes of applying this paragraph (d)(7)—

(A) The term ‘‘net negative section 481 adjustment’’ means the decrease (if any) in taxable income taken into account under section 481(a) to prevent amounts from being duplicated or omitted by reason of a change in accounting method; and

(B) The term ‘‘negative section 481 adjustment with respect to an activity’’ means the decrease (if any) in taxable income that would be taken into account under section 481(a) to prevent only the duplication or omission of amounts from such activity by reason of the change in accounting method.

(iii) *Ratable portion.* The ratable portion of the amount taken into account as a net negative section 481 adjustments for a taxable year by reason of a change in accounting method is determined with respect to an activity by multiplying such amount by the fraction obtained by dividing—

(A) The negative section 481 adjustment with respect to the activity; by

(B) The sum of the negative section 481 adjustments with respect to all of the activities of the taxpayer.

(8) *Taxable year in which item arises.* [Reserved] See §1.469–2(d)(8) for rules relating to this paragraph.

(e) *Special rules for partners and S corporation shareholders*—(1) *In general.* For purposes of section 469 and the regulations thereunder, the character (as an item of passive activity gross income or passive activity deduction) of each item of gross income and deduction allocated to a taxpayer from a partnership or S corporation (a ‘‘passthrough entity’’) shall be determined, in any case in which participation is relevant, by reference to the participation of the taxpayer in the activity (or activities) that generated such item. Such participation is determined for the taxable year of the passthrough entity (and not the taxable year of the taxpayer). The following example illustrates the application of this paragraph (e)(1):

Example. A, a calendar year individual, is a partner in a partnership that has a taxable year ending January 31. During its taxable year ending on January 31, 1988, the partnership engages in a single trade or business activity. For the period from February 1, 1987, through January 31, 1988, A does not materially participate in this activity. In A’s calendar year 1988 return, A’s distributive share of the partnership’s gross income and deductions from the activity must be treated as passive activity gross income and passive activity deductions, without regard to A’s participation in the activity from February 1, 1988, through December 31, 1988. See also §1.469–11T(a)(4) (relating to the effective date of, and transition rules under, section 469 and the regulations thereunder).

(2) *Payments under sections 707(a), 707(c), and 736(b).* Items of gross income and deduction attributable to a transaction described in section 707(a), 707(c), or 736(b) shall be characterized for purposes of section 469 and the regulations thereunder in accordance with the following rules:

(i) *Section 707(a).* Any item of gross income or deduction attributable to a transaction that is treated under section 707(a) as a transaction between a partnership and a partner acting in a capacity other than as a member of such partnership shall be characterized for purposes of section 469 and the regulations thereunder in a manner that is consistent with the treatment of such transaction under section 707(a).

(ii) *Section 707(c).* [Reserved] See § 1.469–2(e)(ii) for rules relating to this paragraph.

(iii) *Payments in liquidation of a partner's interest in partnership property.* [Reserved] See § 1.469–2(e)(iii) for rules relating to this paragraph.

(3) *Sale or exchange of interest in passthrough entity*—(i) *Application of this paragraph (e)(3).* In the case of the sale, exchange, or other disposition (a ‘‘disposition'') of an interest in a passthrough entity, the amount of the seller's gain or loss from each activity in which such entity has an interest is determined, for purposes of section 469 and the regulations thereunder, under this paragraph (e)(3). In the case of any such disposition, except as otherwise provided in paragraph (e)(3)(iii) or (iv) of this section, paragraph (e)(3)(ii) of this section shall apply. See paragraphs (c)(2) and (d)(5) of this section for rules for determining the character of gain or loss, respectively, recognized upon a disposition of an interest in an activity held through a passthrough entity.

(ii) *General rule*—(A) *Allocation among activities.* Except as otherwise provided in this paragraph (e)(3)(ii) or in paragraph (e)(3) (iii) or (iv) of this section, if a holder of an interest in a passthrough entity disposes of such interest, a ratable portion (within the meaning of paragraph (e)(3)(ii)(B) of this section) of any gain or loss from such disposition shall be treated as gain or loss from the disposition of an interest in each trade or business, rental, or investment activity in which such passthrough entity owns an interest on the applicable valuation date.

(B) *Ratable portion*—(*1*) *Dispositions on which gain is recognized.* The ratable portion of any gain from the disposition of an interest in a passthrough entity that is allocable to an activity described in paragraph (e)(3)(ii)(A) of this section is determined by multiplying the amount of such gain by the fraction obtained by dividing—

(*i*) The amount of net gain (within the meaning of paragraph (e)(3)(ii)(E)(*3*) of this section) that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date; by

(*ii*) The sum of the amounts of net gain that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in each appreciated activity (within the meaning of paragraph (e)(3)(ii)(E)(*1*) of this section) described in paragraph (e)(3)(ii)(A) of this section for the fair market value of each such activity on the applicable valuation date.

(*2*) *Dispositions on which loss is recognized.* The ratable portion of any loss from the disposition of an interest in a passthrough entity that is allocable to an activity described in paragraph (e)(3)(ii)(A) of this section is determined by multiplying the amount of such loss by the fraction obtained by dividing—

(*i*) The amount of net loss (within the meaning of paragraph (e)(3)(ii)(E)(*4*) of this section) that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date; by

(*ii*) The sum of the amounts of net loss that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in each depreciated activity (within the meaning of paragraph (e)(3)(ii)(E)(*2*) of this section) described in paragraph (e)(3)(ii)(A) of this section for the fair market value of each such activity on the applicable valuation date.

(C) *Default rule.* If the gain or loss recognized upon the disposition of an interest in a passthrough entity cannot be allocated under paragraph (e)(3)(ii)(A) of this section, such gain or loss shall be allocated among the activities described in paragraph (e)(3)(ii)(A) of this section in proportion to the respective fair market values of the passthrough entity's interests in such activities at the applicable valuation date, and the gain or loss allocated to each activity of the passthrough entity shall be treated as gain or loss from the disposition of an interest in such activity.

(D) *Special rules.* For purposes of this paragraph (e)(3)(ii), the following rules shall apply:

(*1*) *Applicable valuation date*—(*i*) *In general.* Except as otherwise provided in paragraph (e)(3)(ii)(D)(*1*)(*ii*) of this section, the applicable valuation date with respect to any disposition of an interest in a passthrough entity is whichever one of the following dates is selected by the passthrough entity:

(*a*) The beginning of the taxable year of the passthrough entity in which such disposition occurs; or

(*b*) The date on which such disposition occurs.

(*ii*) *Exception.* If, after the beginning of a passthrough entity's taxable year in which a holder's disposition of an interest in such passthrough entity occurs and before the time of such disposition—

(*a*) The passthrough entity disposes of more than 10 percent of its interest (by value as of the beginning of such taxable year) in any activity;

(*b*) More than 10 percent of the property (by value as of the beginning of such taxable year) used in any activity of the passthrough entity is disposed of; or

(*c*) The holder of such interest contributes to the passthrough entity substantially appreciated property or substantially depreciated property with a total fair market value or adjusted basis, respectively, which exceeds 10 percent of the total fair market value of the holder's interest in the passthrough entity as of the beginning of such taxable year;

then the applicable valuation date shall be the date immediately preceding the date on which such disposition occurs.

(*2*) *Basis adjustments.* Any adjustment to the basis of partnership property under section 743(b) made with respect to the holder of an interest in a partnership shall be taken into account in computing the net gain or net loss that would have been allocated to the holder with respect to such interest if the partnership had sold its entire interest in an activity.

(*3*) *Tiered passthrough entities.* In the case of a disposition of an interest in a passthrough entity (the ''subsidiary passthrough entity'') by a holder that is also a passthrough entity, any gain or loss from such disposition that is taken into account by any person that owns (directly or indirectly) an interest in such holder shall be allocated among the activities of the subsidiary passthrough entity by applying the rules of this paragraph (e)(3)(ii) to the person taking such gain or loss into account as if such person has been the holder of an interest in such subsidiary passthrough entity and had recognized such gain or loss as a result of a disposition of such interest.

(E) *Meaning of certain terms.* For purposes of this paragraph (e)(3)(ii)—

(*1*) An activity is an appreciated activity with respect to a holder that has disposed of an interest in a passthrough entity if a net gain would have been allocated to the holder with respect to such interest if the passthrough entity has sold its entire interest in such activity for its fair market value on the applicable valuation date;

(*2*) An activity is a depreciated activity with respect to a holder that has disposed of an interest in a passthrough entity if a net loss would have been allocated to the holder with respect to such interest if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date;

(*3*) The term ''net gain'' means, with respect to the sale of a passthrough entity's entire interest in an activity, the amount by which the gains from the sale of all of the property used by (or representing the interest of) the passthrough entity in such activity exceed the losses (if any) from such sale;

(*4*) The term ''net loss'' means, with respect to the sale of a passthrough entity's entire interest in an activity, the amount by which the losses from the sale of all of the property used by (or representing the interest of) the passthrough entity in such activity exceed the gains (if any) from such sale.

(iii) *Treatment of gain allocated to certain passive activities as not from a passive activity.* If, in the case of a disposition of an interest in a passthrough entity—

(A) An amount of gain recognized on account of such disposition by the holder of such interest (or any other person that owns (directly or indirectly) an interest in such holder if such holder is a passthrough entity) is allocated to a passive activity of such holder (or such other person) under paragraph (e)(3)(ii) of this section;

(B) [Reserved] See § 1.469–2(e)(3)(iii)(B) for rules relating to this paragraph.

(C) The amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(B) of this section exceeds 10 percent of the amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(A) of this section;

then the gain of the holder (or such other person) that is described in paragraph (e)(3)(iii)(A) of this section shall be treated as gain that is not from a passive activity to the extent that such gain does not exceed the amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(B) of this section. For purposes of applying the preceding sentence to the disposition of an interest in a partnership, the amount of gain that would have been allocated to the holder (or such other person) if all of the property used in an activity had been sold shall be determined by taking into account any adjustment to the basis of partnership property made with respect to such holder (or such other person) under section 743(b).

(iv) *Dispositions occurring in taxable years beginning before February 19, 1988*—(A) *In general.* Except as otherwise provided in this paragraph (e)(3)(iv), if the holder of an interest in a passthrough entity sells, exchanges, or otherwise disposes of all or part of such interest during a taxable year of such entity beginning prior to February 19, 1988, any gain or loss recognized from such disposition shall be allocated among the activities of the passthrough entity under any reasonable method selected by the passthrough entity, and the gain or loss allocated to each activity of the passthrough entity shall be treated as gain or loss from the disposition of an interest in such activity. For purposes of the preceding sentence, a reasonable method shall include the method prescribed by paragraph (e)(3)(ii) of this section. In addition, a method that allocates gain or loss among the passthrough entity's activities on the basis of the fair market value, cost, or adjusted basis of the property used in such activities shall generally be considered a reasonable method for purposes of this paragraph (e)(3)(iv).

(B) *Exceptions.* This paragraph (e)(3)(iv) shall not apply to any disposition of an interest in a passthrough entity occurring after February 19, 1988, if after such date, but before the holder's disposition of such interest, the holder (or any other person that owns (directly or indirectly) an interest in such holder if such holder is a passthrough entity) contributes to the passthrough entity substantially appreciated portfolio assets or any other substantially appreciated property that was used in any trade or business activity (within the meaning of § 1.469–1T(e)) of the holder (or such other person) during—

(*1*) The taxable year of such person in which such contribution occurs; or

(*2*) The immediately preceding taxable year of such person;

but only if such person materially participated (within the meaning of § 1.469–5T) in the activity for such year.

(v) *Treatment of portfolio assets.* For purposes of the paragraph (e)(3), all portfolio assets owned by a passthrough entity shall be treated as held in a single investment activity.

(vi) *Definitions.* For purposes of this paragraph (e)(3)—

(A) The term ''portfolio asset'' means any property of a type that produces portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(B) The term ''substantially appreciated property'' means property with a fair market value that exceeds 120 percent of its adjusted basis; and

(C) The term ''substantially depreciated property'' means property with an adjusted basis that exceeds 120 percent of its fair market value.

(vii) *Examples*. The following examples illustrate the application of this paragraph (e)(3):

Example (1). (i) A owns a one-half interest in P, a calendar year partnership. In 1993, A sells 50 percent of such interest for $50,000. A's adjusted basis for the interest sold is $30,000. Thus, A recognizes $20,000 of gain from the sale. P is engaged in three trade or business activities, X, Y, and Z, and owns marketable securities that are portfolio assets. For 1993, A materially participates in activity Z, but does not participate in activities X and Y. Paragraph (c)(2)(iii) of this section would not have applied to any of the gain that A would have been allocated if, immediately before A's sale, P had disposed of all of the property used in its trade or business activities. During the portion of 1993 preceding A's sale, P did not sell any of the property used in its activities, and A did not contribute any property to P.

(ii) Under paragraph (e)(3)(ii) of this section, a ratable portion of A's $20,000 gain is allocated to each appreciated activity in which P owned an interest on the applicable valuation date (within the meaning of paragraph (e)(3)(ii)(D)(*1*) of this section). For this purpose, paragraph (e)(3)(v) of this section treats the marketable securities owned by P as a single investment activity.

(iii) P selects the beginning of 1993 as the applicable valuation date pursuant to paragraph (e)(3)(ii)(D)(*1*)(*i*) of this section. P is not required to use the date of A's sale as the applicable valuation date under paragraph (e)(3)(ii)(D)(*1*)(*ii*) of this section because during the portion of 1993 preceding A's sale, P did not sell any of its property and A did not contribute any property to P. At the beginning of 1993, the fair market value and adjusted basis of the property used in P's activities are as follows:

	Adjusted basis	Fair market value
X	$68,000	$48,000
Y	30,000	62,000
Z	20,000	80,000
Marketable securities	2,000	10,000
Total	120,000	200,000

(iv) Under paragraph (e)(3)(ii)(B) of this section, the portion of A's $20,000 gain that is allocated to an appreciated activity of P (i.e., activities Y and Z and the marketable securities) is the amount of such gain multiplied by the fraction obtained by dividing (a) the net gain that would have been allocated to A with respect to the interest sold by A if P had sold its entire interest in such activity at the beginning of 1993 by (b) the sum of the amounts of net gain that would have been allocated to A with respect to the interest sold by A if P had sold its entire interest in each appreciated activity at the beginning of 1993.

(v) If P had sold its entire interest in activities Y and Z and the marketable securities at the beginning of 1993, A would have been allocated the following amounts of net gain with respect to the interest in P that A sold in 1993:

Activity	Net gain
Y	$8,000
Z	15,000
Marketable securities	2,000
Total	25,000

(vi) Accordingly, under paragraph (e)(3)(ii) of this section, $6,400 of A's $20,000 gain ($20,000 × $8,000/$25,000) is allocated to activity Y, $12,000 of A's $20,000 gain ($20,000 × $15,000/$25,000) is allocated to activity Z, and $1,600 of A's $20,000 gain ($20,000 × $2,000/ $25,000) is allocated to the marketable securities. The gain allocated to activity Y is passive activity gross income. None of that gain is treated as gain that is not from a passive activity under paragraph (e)(3)(iii) of this section because paragraph (c)(2)(iii) of this section would not have applied to any of the gain that A would have been allocated if P had sold all of the property used in activity Y immediately prior to A's sale.

Example (2). (i) B and C, calendar year individuals, are equal partners in calendar year partnership R, which they formed on January 1, 2005, with contributions of property and money. The only item of property (other than money) contributed by B was a building that B had used for 12 years preceding the contribution in an activity that was not a passive activity during such period. At the time of its contribution, the building had an adjusted basis of $40,000 and a fair market value of $66,000. R is engaged in a single activity: the sale of equipment to customers in the ordinary course of the business of dealing in such property. R uses the building contributed by B in the dealership activity. B did not materially participate in the dealership activity during 2005. On July 1, 2005, D purchases one-half of B's interest in R for $37,500 in cash. At the time of the sale, the balance sheet of R, which uses the accrual method of accounting, is as follows:

	Adjusted basis per books	Fair market value
ASSETS		
Cash	$30,000	$30,000
Accounts receivable:		
Dealership	20,000	18,000
Inventory:		
Dealership	52,000	66,000
Building	40,000	66,000

	Adjusted basis per books	Fair market value
Total	142,000	180,000
LIABILITIES AND CAPITAL		
Liabilities	$30,000	$30,000
Capital:		
B	47,000	75,000
C	65,000	75,000
Total	142,000	180,000

Thus, B's gain from the sale is $14,000 ($45,000 amount realized from the sale (consisting of $37,500 of cash and $7,500 of liabilities assumed by the purchaser) minus B's $31,000 adjusted basis for the interest sold (one-half of B's total adjusted basis of $62,000)).

(ii) Under paragraph (e)(3)(ii) of this section, all $14,000 of B's gain from the sale is allocated to R's dealership activity, which is a passive activity of B for 2005. If, however, R had sold its interest in the building immediately prior to B's sale for its fair market value on the applicable valuation date (the valuation date selected by R is irrelevant since the building had a fair market value of $66,000 at the beginning of 2005 and at the time of the sale), B would have been allocated $13,000 of gain under section 704(c) with respect to the interest in R that B sold to D. This gain would have been treated as gain that is not from a passive activity under paragraph (c)(2)(iii) of this section and would have exceeded 10 percent of the total amount of B's gain that is allocated to the dealership activity under paragraph (e)(3)(ii) of this section. Accordingly, under paragraph (e)(3)(iii) of this section, B's gain from the sale ($14,000) is treated as gain that is not from a passive activity to the extent that such gain does not exceed the amount of gain subject to paragraph (c)(2)(iii) of this section that B would have been allocated with respect to the interest sold to D if R had sold all of the property used in the dealership activity immediately prior to B's sale ($13,000). Thus, $13,000 of B's gain from the sale is treated as gain that is not from a passive activity.

(f) *Recharacterization of passive income in certain situations*—(1) *In general.* This paragraph (f) sets forth rules that require income from certain passive activities to be treated as income that is not from a passive activity (regardless of whether such income is treated as passive activity gross income under section 469 or any other provision of the regulations thereunder). For definitions of certain terms used in this paragraph (f), see paragraph (f)(9) of this section.

(2) *Special rule for significant participation*—(i) *In general.* An amount of the taxpayer's gross income from each significant participation passive activity for the taxable year equal to a ratable portion of the taxpayer's net passive income from such activity for the taxable year shall be treated as not from a passive activity if the taxpayer's passive activity gross income from all significant participation passive activities for the taxable year (determined without regard to paragraphs (f) (2) through (4) of this section) exceeds the taxpayer's passive activity deductions from all such activities for such year. For purposes of this paragraph (f)(2), the ratable portion of the net passive income from an activity is determined by multiplying the amount of such income by the fraction obtained by dividing—

(A) The amount of the excess described in the preceding sentence; by

(B) The amount of the excess described in the preceding sentence taking into account only significant participation passive activities from which the taxpayer has net passive income for the taxable year.

(ii) *Significant participation passive activity.* For purposes of this paragraph (f)(2), the term ''significant participation passive activity'' means any trade or business activity (within the meaning of § 1.469–1T(e)(2)) in which the taxpayer significantly participates (within the meaning of § 1.469–5T(c)(2)) for the taxable year but in which the taxpayer does not materially participate (within the meaning of § 1.469–5T) for such year.

(iii) *Example.* The following example illustrates the application of this paragraph (f)(2):

Example. (i) A owns interests in three trade or business activities, X, Y, and Z. A does not materially participate in any of these activities for the taxable year, but participates in activity X for 110 hours, in activity Y for 160 hours, and in activity Z for 125 hours. A owns no interest in any other trade or business activity in which A does not materially participate for the taxable year but in which A participates for more than 100 hours during the taxable year. A's net passive income (or loss) for the taxable year from activities X, Y, and Z is as follows:

	X	Y	Z
Passive activity gross income	$600	$700	$900

	X	Y	Z
Passive activity deductions	(200)	(1,000)	(300)
Net passive income	400	(300)	600

(ii) Under paragraph (f)(2)(ii) of this section, activities X, Y, and Z are A's only significant participation passive activities for the taxable year. A's passive activity gross income from significant participation passive activities ($2,200) exceeds A's passive activity deductions from significant participation passive activities ($1,500) by $700 for such year. Therefore, under paragraph (f)(2)(i) of this section, a ratable portion of A's gross income from activities X and Z (A's significant participation passive activities with net passive income for the taxable year) is treated as gross income that is not from a passive activity. The ratable portion is determined by dividing (a) the amount by which A's passive activity gross income from significant participation passive activities exceeds A's passive activity deductions from significant participation passive activities for the taxable year ($700) by (b) such excess taking into account only A's significant participation passive activities having net passive income for the taxable year ($1,000). Accordingly, $280 of gross income from activity X ($400 x 700/1000) and $420 of gross income from activity Z ($600 x 700/1000) is treated as gross income that is not from a passive activity.

(3) *Rental of nondepreciable property.* If less than 30 percent of the unadjusted basis of the property used or held for use by customers in a rental activity (within the meaning of § 1.469–1T(e)(3)) during the taxable year is subject to the allowance for depreciation under section 167, an amount of the taxpayer's gross income from the activity equal to the taxpayer's net passive income from the activity shall be treated as not from a passive activity. For purposes of this paragraph (f)(3), the term ''unadjusted basis'' means adjusted basis determined without regard to any adjustment described in section 1016 that decreases basis. The following example illustrates the application of this paragraph (f)(3):

Example. C is a limited partner in a partnership. The partnership acquires vacant land for $300,000, constructs improvements on the land at a cost of $100,000, and leases the land and improvements to a tenant. The partnership then sells the land and improvements for $600,000, thereby realizing a gain on the disposition. The unadjusted basis of the improvements ($100,000) equals 25 percent of the unadjusted basis of all property ($400,000) used in the rental activity. Therefore, under this paragraph (f)(3), an amount of C's gross income from the activity equal to the net passive income from the activity (which is computed by taking into account the gain from the disposition, including gain allocable to the improvements) is treated as not from a passive activity.

(4) *Net interest income from passive equity-financed lending activity*—(i) *In general.* An amount of the taxpayer's gross income for the taxable year from any equity-financed lending activity equal to the lesser of—

(A) The taxpayer's equity-financed interest income from the activity for such year; and

(B) The taxpayer's net passive income from the activity for such year

shall be treated as not from a passive activity.

(ii) *Equity-financed lending activity*—(A) *In general.* For purposes of this paragraph (f)(4), an activity is an equity-financed lending activity for a taxable year if—

(*1*) The activity involves a trade or business of lending money; and

(*2*) The average outstanding balance of the liabilities incurred in the activity for the taxable year does not exceed 80 percent of the average outstanding balance of the interest-bearing assets held in the activity for such year.

(B) *Certain liabilities not taken into account.* For purposes of paragraph (f)(4)(ii)(A)(*2*) of this section, liabilities incurred principally for the purpose of increasing the percentage described in paragraph (f)(4)(ii)(A)(*2*) of this section shall not be taken into account in computing such percentage.

(iii) *Equity-financed interest income.* For purposes of this paragraph (f)(4), the taxpayer's equity-financed interest income from an activity for a taxable year is the amount of the taxpayer's net interest income from the activity for such year multiplied by the fraction obtained by dividing—

(A) The excess of the average outstanding balance for such year of the interest-bearing assets held in the activity over the average outstanding balance for such year of the liabilities incurred in the activity; by

(B) The average outstanding balance for such year of the interest-bearing assets held in the activity.

(iv) *Net interest income.* For purposes of this paragraph (f)(4), the net interest income from an activity for a taxable year is—

(A) The gross interest income from the activity for such year; reduced by

(B) Expenses from the activity (other than interest on liabilities described in paragraph (f)(4)(vi) of this section) for such year that are reasonably allocable to such gross interest income.

(v) *Interest-bearing assets.* For purposes of this paragraph (f)(4), the interest-bearing assets held in an activity include all assets that produce interest income, including loans to customers.

(vi) *Liabilities incurred in the activity.* For purposes of this paragraph (f)(4), liabilities incurred in an activity include all fixed and determinable liabilities incurred in the activity that bear interest or are issued with original issue discount other than debts secured by tangible property used in the activity. In the case of an activity conducted by an entity in which the taxpayer owns a interest, liabilities incurred in an activity include only liabilities with respect to which the entity is the borrower.

(vii) *Average outstanding balance.* For purposes of this paragraph (f)(4), the average outstanding balance of liabilities incurred in an activity or of the interest-bearing assets held in an activity may be computed on a daily, monthly, or quarterly basis at the option of the taxpayer.

(viii) *Example.* The following example illustrates the application of this paragraph (f)(4):

Example: (i) A, a calendar year individual, acquires on January 1, 1988, a limited partnership interest in P, a calendar year partnership. Under the partnership agreement, A has a one percent share of each item of income, gain, loss, deduction, and credit of P. A acquires the partnership interest for $90,000, using $50,000 of unborrowed funds and $40,000 of proceeds of a loan bearing interest at an annual rate of 10 percent. A pays $4,000 of interest on the loan in 1988.

(ii) P's sole activity is a trade or business of lending money. A does not materially participate in the activity for 1988. During 1988, the average outstanding balance of P's interest-bearing assets (including loans to customers, temporary deposits with other lending institutions, and government and corporate securities) is $20 million. P incurs numerous interest-bearing liabilities in connection with its lending activity, including liabilities for deposits taken from customers, unsecured short-term and long-term loans from other lending institutions, and a mortgage loan secured by the building, owned by P, in which P conducts its business. For 1988, the average outstanding balance of all of these liabilities (other than the mortgage loan) is $11 million. None of these liabilities was incurred by P principally for the purpose of increasing the percentage described in paragraph (f)(4)(ii)(A)(*2*) of this section.

(iii) The interest income derived by P for 1988 from its interest-bearing assets is $2.2 million. The interest expense paid by P for 1988 with respect to the liabilities incurred in connection with its lending activity (other than the mortgage loan) is $990,000. P's other expenses for 1988 that are reasonably allocable to P's gross interest income (including expenses for advertising, loan processing and servicing, and insurance, and depreciation on P's building) total $250,000. P's interest expense for 1988 on the mortgage loan secured by the building used in P's lending activity is $50,000. All of the interest expense paid or incurred by P for 1988 is allocated under § 1.63–8T to expeditures in connection with P's lending activity.

(iv) Under paragraph (f)(4)(ii) of this section, P's activity is an equity-financed lending activity for 1988, since, for 1988, the activity involves a trade or business of lending money and the average outstanding balance of the liabilities incurred in the activity ($11 million) does not exceed 80 percent of the average outstanding balance of the interest-bearing assets held in the activity ($20 million). Accordingly, under paragraph (f)(4)(i) of this section, an amount of A's gross income from the activity equal to the lesser of (a) A's equity-financed interest income from the activity for 1988, or (b) A's net passive income from the activity for 1988, is treated as income that is not from a passive activity.

(v) Under paragraph (f)(4)(iii) of this section, A's equity-financed interest income from the activity for 1988 is determined by multiplying A's net interest income from the activity for 1988 by the fraction obtained by dividing $9 million (the excess of the average interest-bearing assets for 1988 over the average interest-bearing liabilities for 1988) by $20 million (the average interest-bearing assets for 1988). Under paragraph (f)(4)(iv) of this section, A's net interest income from the activity for 1988 is $19,000 (A's distributive share of $2.2 million of gross interest income less A's distributive share of $300,000 of expenses described in paragraph (f)(4)(iv)(B) of this section, including interest expense on the mortgage loan). A's distributive share of P's other interest expense ($990,000) is not taken into account in computing A's net interest income for 1988. Accordingly, A's equity-financed interest income from the activity for 1988 is $8,550 ($19,000 x $9 million/$20 million).

(vi) Under paragraph (f)(9)(i) of this section, A's net passive income from the activity for 1988 is determined by taking into account A's distributive share of P's gross income and deductions from the activity for 1988, as well as any interest expense incurred by A individually that is taken into account under § 1.163–8T in determining A's income or loss from the activity for 1988. Assuming that for 1988 all $4,000 of interest expense on the loan that A used to finance the acquisition of A's interest in P is allocated under § 1.163–8T to expenditures of A in connection with the lending activity for 1988, A's net passive income from the activity for 1988 is $5,100, computed as set forth in the following table:

Gross income:	
Interest income	$22,000
Deductions:	
Distributive share of P's expenses from the activity	(12,900)
Interest expense on A's acquisition debt	(4,000)
Net passive income	5,100

(vii) A's net passive income from the activity for 1988 ($5,100) is less than A's equity-financed income from the activity for 1988 ($8,550). Accordingly, under this paragraph (f)(4), $5,100 of A's gross income from the activity for 1988 is treated as not from a passive activity.

(5) *Net income from certain property rented incidental to development activity*—

(i) *In general.* [Reserved] See § 1.469–2(f)(5)(i) for rules relating to this paragraph.

(ii) *Commencement.* [Reserved] See § 1.469–2(f)(5)(ii) for rules relating to this paragraph (f)(5)(ii).

(iii) *Services performed for the purpose of enhancing the value of property.* [Reserved] See § 1.469–2(f)(5)(iii) for rules relating to this paragraph (f)(5)(iii).

(iv) *Examples.* [Reserved] See § 1.469–2(f)(5)(iv) for examples relating to this paragraph (f)(5)(iv).

(6) *Property rented to a nonpassive activity.* [Reserved] See § 1.469–2(f)(6) for rules relating to this paragraph.

(7) *Special rules applicable to the acquisition of an interest in a passthrough entity engaged in the trade or business of licensing intangible property*—(i) *In general.* If a taxpayer acquires an interest in an entity described in paragraph (c)(3)(iii)(B)(*3*) of this section (the ''development entity'') after the development entity has created an item of intangible property or performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property, an amount of the taxpayer's gross royalty income for the taxable year from such item of property equal to the taxpayer's net royalty income for the year from such item of property shall be treated as not from a passive activity.

(ii) *Royalty income from property.* For purposes of this paragraph (f)(7)—

(A) A taxpayer's gross royalty income for a taxable year from an item of property is the taxpayer's share of passive activity gross income for such year (determined without regard to paragraphs (f)(2) through (7) of this section) from the licensing or transfer of any right in such property; and

(B) A taxpayer's net royalty income for a taxable year from an item of property is the excess, if any, of—

(*1*) The taxpayer's gross royalty income for the taxable year from such item of property; over

(*2*) Any passive activity deductions for such taxable year (including any deduction treated as a deduction for such year under § 1.469–1T (f)(4)) that are reasonably allocable to such item of property.

(iii) *Exceptions.* Paragraph (f)(7)(i) of this section shall not apply to a taxpayer's gross royalty income for a taxable year from the licensing of an item of intangible property if—

(A) The expenditures reasonably incurred by the development entity for the taxable year of the entity ending with or within the taxpayer's taxable year with respect to the development or marketing of such property satisfy paragraph (c)(3)(iii)(B)(*2*)(*ii*) (*a*) of this section; or

(B) The taxpayer's share of the expenditures reasonably incurred by the development entity with respect to the development or marketing of such property for all taxable years of the entity beginning with the taxable year of the entity in which the taxpayer acquired the interest in the entity and ending with the taxable year of the entity ending with or within the taxpayer's current taxable year exceeds 25 percent of the fair market value of the taxpayer's interest in such property at the time the taxpayer acquired the interest in the entity.

(iv) *Capital expenditures.* For purposes of paragraph (f)(7)(iii)(B) of this section, a capital expenditure shall be taken into account for the taxable year of the entity in which such expenditure is chargeable to capital account, and the taxpayer's share of such expenditure shall be determined as though such expenditure were allowed as a deduction for such year.

(v) *Example.* The following example illustrates the application of this paragraph (f)(7):

Example. (i) The facts are the same as in example (5) in paragraph (c)(3)(iv) of this section, except that, in 1988, D's 10 percent partnership interest is sold to F for $13,000, all of which is attributable to the design licensed by the partnership.

(ii) For 1988, the expenditures reasonably incurred by the partnership with respect to the development or marketing of the design satisfy paragraph (c)(3)(iii)(B)(*2*)(*ii*)(*a*) of this section. Accordingly, under paragraph (f)(7)(iii)(A) of this section, paragraph (f)(7)(i) of this section does not apply to F's distributive share of the partnership's gross income from licensing the design.

(iii) For 1989, the expenditures reasonably incurred by the partnership with respect to the development or marketing of the design do not satisfy paragraph (c)(3)(iii)(B)(*2*)(*ii*)(*a*) of this section. Moreover, F's distributive share of such expenditures reasonably incurred by the partnership for 1988 and 1989 ($27,000 x .10 = $2,700) does not exceed 25 percent of the fair market value of F's interest in the design at the time F acquired the partnership interest ($13,000). Accordingly, neither of the exceptions provided in paragraph (f)(7)(iii) of this section applies for 1989 and, under paragraph (f)(7)(i) of this section, an amount of F's gross royalty income from the design equal to F's net royalty income from the design is treated as not from a passive activity.

(8) *Limitation on recharacterized income.* The amount of gross income from an activity that is treated as not from a passive activity for the taxable year under subparagraphs (f) (2) through (4) of this paragraph (f) shall not exceed the greatest amount of gross income treated as not from a passive activity under any one of such subparagraphs.

(9) *Meaning of certain terms.* For purposes of this paragraph (f), the terms set forth below shall have the following meanings:

(i) The net passive income from an activity for a taxable year is the amount by which the taxpayer's passive activity gross income from the activity for the taxable year (determined without regard to paragraphs (f) (2) through (4) of this section) exceeds the taxpayer's passive activity deductions from the activity for such year;

(ii) The net passive loss from an activity for a taxable year is the amount by which the taxpayer's passive activity deductions from the activity for the taxable year exceeds the taxpayer's passive activity gross income from the activity for such year (determined without regard to paragraphs (f) (2) through (4) of this section).

(iii) [Reserved] See § 1.469–2(f)(9)(iii) for rules relating to this paragraph.

(iv) [Reserved] See § 1.469–2(f)(9)(iv) for rules relating to this paragraph.

(10) *Coordination with section 163(d).* [Reserved] See paragraph 1.469–2(f)(10) for rules relating to this paragraph.

(11) *Effective date.* For the effective date of the rules in this paragraph (f), see § 1.469–11T (relating to effective date and transition rules).

[T.D. 8175, 53 FR 5711, Feb. 25, 1988; 53 FR 15494, Apr. 29, 1988; as amended by T.D. 8253, 54 FR 20538, May 12, 1989; T.D. 8290, 55 FR 6981, Feb. 28, 1990; T.D. 8318, 55 FR 48108, Nov. 19, 1990; 55 FR 51688, Dec. 17, 1990; T.D. 8417, 57 FR 20758, May 15, 1992; T.D. 8477, 58 FR 11538, Feb. 26, 1993; T.D. 8495, 58 FR 58788, Nov. 4, 1993]

§ 1.469–3 Passive activity credit.

(a)–(d) [Reserved]

(e) *Coordination with section 38(b).* Any credit described in section 38(b) (1) through (5) is taken into account in computing the current year business credit for the first taxable year in which the credit is subject to section 469 and is not disallowed by section 469 and the regulations thereunder.

(f) *Coordination with section 50.* In the case of any cessation described in section 50(a) (1) or (2), the credits allocable to the taxpayer's activities under § 1.469–1(f)(4) shall be adjusted by reason of the cessation.

(g) [Reserved]

[T.D. 8417, 57 FR 20758, May 15, 1992]

§1.469–3T Passive activity credit (temporary).

(a) *Computation of passive activity credit.* The taxpayer's passive activity credit for the taxable year is the amount (if any) by which—

(1) The sum of all of the taxpayer's credits that are subject to section 469 for such year; exceeds

(2) The taxpayer's regular tax liability allocable to all passive activities for such year.

(b) *Credits subject to section 469*—(1) *In general.* Except as otherwise provided in this paragraph (b), a credit is subject to section 469 for a taxable year if and only if—

(i) Such credit—

(A) Is attributable to such taxable year and arises in connection with the conduct of an activity that is a passive activity for such taxable year; and

(B) Is described in—

(*1*) Section 38(b) (1) through (5) (relating to general business credits);

(*2*) Section 27(b) (relating to corporations described in section 936);

(*3*) Section 28 (relating to clinical testing of certain drugs); or

(*4*) Section 29 (relating to fuel from nonconventional sources); or

(ii) Such credit is allocable to an activity for such taxable year under §1.469–1T(f)(4).

(2) *Treatment of credits attributable to qualified progress expenditures.* Any credit attributable to an increase in qualified investment under section 46(d)(1)(A) (relating to qualified progress expenditures) with respect to progress expenditure property (as defined in section 46(d)(2)) is subject to section 469 for a taxable year if—

(i) Such credit is attributable to such taxable year;

(ii) Such credit is described in paragraph (b)(1)(i)(B) of this section; and

(iii) It is reasonable to believe that such progress expenditure property will be used in a passive activity of the taxpayer when it is placed in service.

(3) *Special rule for partners and S corporation shareholders.* The character of a credit of a taxpayer arising in connection with an activity conducted by a partnership or S corporation (as a credit subject to section 469) shall be determined, in any case in which participation is relevant, by reference to the participation of the taxpayer in such activity. Such participation is determined for the taxable year of the partnership or S corporation (and not the taxable year of the taxpayer). See §1.469–2T(e)(1).

(4) *Exception for pre-1987 credits.* A credit is not subject to section 469 if it is attributable to a taxable year of the taxpayer beginning prior to January 1, 1987.

(c) *Taxable year to which credit is attributable.* A credit is attributable to the taxable year in which such credit would be (or would have been) allowed if the credits regard to the limitations contained in sections 26(a), 28(d)(2), 29(b)(5), 38(c), and 469.

(d) *Regular tax liability allocable to passive activities*—(1) *In general.* For purposes of paragraph (a)(2) of this section, the taxpayer's regular tax liability allocable to all passive activities for the taxable year is the excess (if any) of—

(i) The taxpayer's regular tax liability for such taxable year; over

(ii) The amount of such regular tax liability determined by reducing the taxpayer's taxable income for such year by the excess (if any) of the taxpayer's passive activity gross income for such year over the taxpayer's passive activity deductions for such year.

(2) *Regular tax liability.* For purposes of this section, the term ''regularly tax liability'' has the meaning given such term in section 26(b).

(e) *Coordination with section 38(b).* [Reserved] See §1.469–3(e) for rules relating to this paragraph.

(f) *Coordination with section 50.* [Reserved] See §1.469–3(f) for rules relating to this paragraph.

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

Example (1). (i) A, a calendar year individual, is a general partner in calendar year partnership P. P purchases a building in 1987 and, in 1987, 1988, and 1989, incurs rehabilitation costs with respect to the building. The building is placed in service in the rental activity in 1989. P's rehabilitation costs are qualified rehabilitation expenditures (within the meaning of section 48(g)(2)) and are taken into account in determining the amount of the investment credit for rehabilitation expenditures. P's qualified rehabilitation expenditures are not qualified progress expenditures (within the meaning of section 46(d)).

(ii) Because, under section 46(c)(1), the credit is allowable for the taxable year in which the rehabilitated property is placed in service, the credit allowable for P's qualified rehabilitation expenditures arises in connection with the activity in which the property is placed in service. In addition, the credit is attributable to 1989, the year in which the property is placed in service, because it would be allowed for such year if A's credits allowed for all taxable years were determined without regard to the limitations contained in sections 26(a), 28(d)(2), 29(b)(5), 38(c), and 469. Accordingly, under paragraph (b)(1) of this section, A's distributive share of the credit is subject to section 469 for 1989 because the credit arises in connection with a rental activity for such year.

Example (2). The facts are the same as in example (1), except that the rehabilitation costs are incurred in anticipation of placing the building in service in a rental activity, the qualified rehabilitation expenditures in 1987 and 1988 are qualified progress expenditures (''QPEs'') (within the meaning of section 46(d)(3)), the improvements resulting from the expenditures are progress expenditure property (within the meaning of paragraph (d)(2) of this section), and it is reasonable to expect that such property will be transition property (within the meaning of section 49(e)) when the property is placed in service. Therefore, under section 46(d)(1)(A), the qualified investment for 1987 and 1988 is increased by an amount equal to the aggregate of the applicable percentage of the qualified rehabilitation expenditures incurred in such years. The credits that are based on these expenditures are attributable (under paragraph (c) of this section) to 1987 and 1988, respectively. It is reasonable to believe in 1987 and 1988 that the progress expenditure property will be used in a rental activity when it is placed in service. Accordingly, under paragraph (b)(2) of this section, A's distributive share of the credit for 1987 and 1988 is subject to section 469. Under paragraph (b)(1) of this section (as in example (1)), A's distributive share of the credit for 1989 is also subject to section 469.

Example (3). (i) B, a single individual, acquires an interest in a partnership that, in 1988, rehabilitates a building and places it in service in a trade or business activity in which B does not materially participate. For 1988, B has the following items of gross income, deduction, and credit:

Gross income:		
Income other than passive activity gross income	$110,000	
Passive activity gross income	20,000	$130,000
Deductions:		
Deductions other than passive activity deductions	23,950	
Passive activity deductions	18,000	(41,950)
Taxable income	....	88,050
Credits:		
Rehabilitation credit from the passive activity	....	8,000

(ii) For 1988, the amount by which B's passive activity gross income exceeds B's passive activity deductions (B's net passive income) is $2,000. Under paragraph (d) of this section, B's regular tax liability allocable to passive activities for 1988 is determined as follows:

(A) Taxable income	$88,050	
(B) Regular tax liability	....	$24,578.50
(C) Taxable income minus net passive income	86,050	
(D) Regular tax liability for taxable income of $86,050.00	....	23,918.50
(E) Regular tax liability allocable to passive activities ((B) minus (D))	....	$660.00

(iii) Under paragraph (a) of this section, B's passive activity credit for 1988 is the amount by which B's credits that are subject to section 469 for 1988 ($8,000) exceed B's regular tax liability allocable to passive activities for 1988 ($660.00). Accordingly, B's passive activity credit for 1988 is $7,340.

Example (4). (i) The facts are the same as in example (3) except that, in 1988, B also has additional deductions of $100,000 from a trade or business activity in which B materially participates for 1988. Thus, B has a taxable loss for 1988 of $11,950, determined as follows:

Gross income:		
Income other than passive activity gross income	$110,000	
Passive activity gross income	20,000	$130,000
Deductions:		
Deductions other than passive activity deductions	123,950	
Passive activity deductions	18,000	(141,950)
Taxable income	....	(11,950)

(ii) Under section 26(b) and paragraph (d)(2) of this section, the regular tax liability for a taxable year cannot exceed the tax imposed by chapter 1 of subtitle A of the Internal Revenue Code for the taxable year. Therefore, under paragraph (d)(1) of this section, B's regular tax liability allocable to passive activities for 1988 is zero. Although B's net operating loss for the taxable year is reduced by B's net passive income, and B's regular tax liability for other taxable years may increase as a result of the reduction, such an increase does not change B's regular tax liability allocable to passive activities for 1988. Accordingly, B's passive activity credit for 1988 is $8,000.

[T.D. 8175, 53 FR 5724, Feb. 25, 1988; 53 FR 15494, Apr. 29, 1988; T.D. 8253, 54 FR 20542, May 12, 1989; T.D. 8417, 57 FR 20758, May 15, 1992]

§1.469–4 Definition of activity.

(a) *Scope and purpose.* This section sets forth the rules for grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of section 469. A taxpayer's activities include those conducted through C corporations that are subject to section 469, S corporations, and partnerships.

(b) *Definitions.* The following definitions apply for purposes of this section—

(1) *Trade or business activities. Trade or business activities* are activities, other than rental activities or activities that are treated under §1.469–1T(e)(3)(vi)(B) as incidental to an activity of holding property for investment, that—

(i) Involve the conduct of a trade or business (within the meaning of section 162);

(ii) Are conducted in anticipation of the commencement of a trade or business; or

(iii) Involve research or experimental expenditures that are deductible under section 174 (or would be deductible if the taxpayer adopted the method described in section 174(a)).

(2) *Rental activities. Rental activities* are activities that constitute rental activities within the meaning of §1.469–1T(e)(3).

(c) *General rules for grouping activities*—(1) *Appropriate economic unit.* One or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469.

(2) *Facts and circumstances test.* Except as otherwise provided in this section, whether activities constitute an appropriate economic unit and, therefore, may be treated as a single activity depends upon all the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities. The factors listed below, not all of which are necessary for a taxpayer to treat more than one activity as a single activity, are given the greatest weight in determining whether activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469—

(i) Similarities and differences in types of trades or businesses;

(ii) The extent of common control;

(iii) The extent of common ownership;

(iv) Geographical location; and

(v) Interdependencies between or among the activities (for example, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

(3) *Examples.* The following examples illustrate the application of this paragraph (c).

Example 1. Taxpayer *C* has a significant ownership interest in a bakery and a movie theater at a shopping mall in Baltimore and in a bakery and a movie theater in Philadelphia. In this case, after taking into account all the relevant facts and circumstances, there may be more than one reasonable method for grouping *C*'s activities. For instance, depending on the relevant facts and circumstances, the following groupings may or may not be permissible: a single activity; a movie theater activity and a bakery activity; a Baltimore activity and a Philadelphia activity; or four separate activities. Moreover, once *C* groups these activities into appropriate economic units, paragraph (e) of this section requires *C* to continue using that grouping in subsequent taxable years unless a material change in the facts and circumstances makes it clearly inappropriate.

Example 2. Taxpayer *B*, an individual, is a partner in a business that sells non-food items to grocery stores (partnership *L*). *B* also is a partner in a partnership that owns and operates a trucking business (partnership *Q*). The two partnerships are under common control. The predominant portion of *Q*'s business is transporting goods for *L*, and *Q* is the only trucking business in which *B* is involved. Under this section, *B* appropriately treats *L*'s wholesale activity and *Q*'s trucking activity as a single activity.

(d) *Limitation on grouping certain activities.* The grouping of activities under this section is subject to the following limitations:

(1) *Grouping rental activities with other trade or business activities*—(i) *Rule.* A rental activity may not be grouped with a trade or business activity unless the activities being grouped together constitute an appropriate economic unit under paragraph (c) of this section and—

(A) The rental activity is insubstantial in relation to the trade or business activity;

(B) The trade or business activity is insubstantial in relation to the rental activity; or

(C) Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.

(ii) *Examples.* The following examples illustrate the application of paragraph (d)(1)(i) of this section:

Example 1. (i) *H* and *W* are married and file a joint return. *H* is the sole shareholder of an S corporation that conducts a grocery store trade or business activity. *W* is the sole shareholder of an S corporation that owns and rents out a building. Part of the building is rented to *H*'s grocery store trade or business activity (the grocery store rental). The grocery store rental and the grocery store trade or business are not insubstantial in relation to each other.

(ii) Because they file a joint return, *H* and *W* are treated as one taxpayer for purposes of section 469. See § 1.469–1T(j). Therefore, the sole owner of the trade or business activity (taxpayer *H–W*) is also the sole owner of the rental activity. Consequently, each owner of the trade or business activity has the same proportionate ownership interest in the rental activity. Accordingly, the grocery store rental and the grocery store trade or business activity may be grouped together (under paragraph (d)(1)(i) of this section) into a single trade or business activity, if the grouping is appropriate under paragraph (c) of this section.

Example 2. Attorney *D* is a sole practitioner in town *X*. *D* also wholly owns residential real estate in town *X* that *D* rents to third parties. *D*'s law practice is a trade or business activity within the meaning of paragraph (b)(1) of this section. The residential real estate is a rental activity within the meaning of § 1.469–1T(e)(3) and is insubstantial in relation to *D*'s law practice. Under the facts and circumstances, the law practice and the residential real estate do not constitute an appropriate economic unit under paragraph (c) of this section. Therefore, *D* may not treat the law practice and the residential real estate as a single activity.

(2) *Grouping real property rentals and personal property rentals prohibited.* An activity involving the rental of real property and an activity involving the rental of personal property (other than personal property provided in connection with the real property or real property provided in connection with the personal property) may not be treated as a single activity.

(3) *Certain activities of limited partners and limited entrepreneurs*—(i) *In general.* Except as provided in this paragraph, a taxpayer that owns an interest, as a limited partner or a limited entrepreneur (as defined in section 464(e)(2)), in an activity described in section 465(c)(1), may not group that activity with any other activity. A taxpayer that owns an interest as a limited partner or a limited entrepreneur in an activity described in the preceding sentence may group that activity with another activity in the same type of business if the grouping is appropriate under the provisions of paragraph (c) of this section.

(ii) *Example.* The following example illustrates the application of this paragraph (d)(3):

Example. (i) Taxpayer *A*, an individual, owns and operates a farm. *A* is also a member of *M*, a limited liability company that conducts a cattle-feeding business. *A* does not actively participate in the management of *M* (within the meaning of section 464(e)(2)(B)). In addition, *A* is a limited partner in *N*, a limited partnership engaged in oil and gas production.

(ii) Because *A* does not actively participate in the management of *M*, *A* is a limited entrepreneur in *M*'s activity. *M*'s cattle-feeding business is described in section 465(c)(1)(B) (relating to farming) and may not be grouped with any other activity that does not involve farming. Moreover, *A*'s farm may not be grouped with the cattle-feeding activity unless the grouping constitutes an appropriate economic unit for the measurement of gain or loss for purposes of section 469.

(iii) Because *A* is a limited partner in *N* and *N*'s activity is described in section 465(c)(1)(D) (relating to exploring for, or exploiting, oil and gas resources), *A* may not group *N*'s oil and gas activity with any other activity that does not involve exploring for, or exploiting, oil and gas resources. Thus, *N*'s activity may not be grouped with *A*'s farm or with *M*'s cattle-feeding business.

(4) *Other activities identified by the Commissioner.* A taxpayer that owns an interest in an activity identified in guidance issued by the Commissioner as an activity covered by this paragraph (d)(4) may not group that activity with any other activity, except as provided in the guidance issued by the Commissioner.

(5) *Activities conducted through section 469 entities*—(i) *In general.* A C corporation subject to section 469, an S corporation, or a partnership (a section 469 entity) must group its activities under the rules of this section. Once the section 469 entity groups its activities, a shareholder or partner may group those activities with each other, with activities conducted directly by the shareholder or partner, and with activities conducted through other section 469 entities, in accordance with the rules of this section. A shareholder or partner may not treat activities grouped together by a section 469 entity as separate activities.

(ii) *Cross reference.* An activity that a taxpayer conducts through a C corporation subject to section 469 may be grouped with another activity of the taxpayer, but only for purposes of determining whether the taxpayer materially or significantly participates in the other activity. See §1.469–2T(c)(3)(i)(A) and (c)(4)(i) for the rules regarding dividends on C corporation stock and compensation paid for personal services.

(e) *Disclosure and consistency requirements*—(1) *Original groupings.* Except as provided in paragraph (e)(2) of this section and §1.469–11, once a taxpayer has grouped activities under this section, the taxpayer may not regroup those activities in subsequent taxable years. Taxpayers must comply with disclosure requirements that the Commissioner may prescribe with respect to both their original groupings and the addition and disposition of specific activities within those chosen groupings in subsequent taxable years.

(2) *Regroupings.* If it is determined that a taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities and must comply with disclosure requirements that the Commissioner may prescribe.

(f) *Grouping by Commissioner to prevent tax avoidance*—(1) *Rule.* The Commissioner may regroup a taxpayer's activities if any of the activities resulting from the taxpayer's grouping is not an appropriate economic unit and a principal purpose of the taxpayer's grouping (or failure to regroup under paragraph (e) of this section) is to circumvent the underlying purposes of section 469.

(2) *Example.* The following example illustrates the application of this paragraph (f):

Example. (i) Taxpayers *D*, *E*, *F*, *G*, and *H* are doctors who operate separate medical practices. *D* invested in a tax shelter several years ago that generates passive losses and the other doctors intend to invest in real estate that will generate passive losses. The taxpayers form a partnership to engage in the trade or business of acquiring and operating X-ray equipment. In exchange for equipment contributed to the partnership, the taxpayers receive limited partnership interests. The partnership is managed by a general partner selected by the taxpayers; the taxpayers do not materially participate in its operations. Substantially all of the partnership's services are provided to the taxpayers or their patients, roughly in proportion to the doctors' interests in the partnership. Fees for the partnership's services are set at a level equal to the amounts that would be charged if the partnership were dealing with the taxpayers at arm's length and are expected to assure the partnership a profit. The taxpayers treat the partnership's services as a separate activity from their medical practices and offset the income generated by the partnership against their passive losses.

(ii) For each of the taxpayers, the taxpayer's own medical practice and the services provided by the partnership constitute an appropriate economic unit, but the services provided by the partnership do not separately constitute an appropriate economic unit. Moreover, a principal purpose of treating the medical practices and the partnership's services as separate activities is to circumvent the underlying purposes of section 469. Accordingly, the Commissioner may require the taxpayers to treat their medical practices and their interests in the partnership as a single activity, regardless of whether the separate medical practices are conducted through C corporations subject to section 469, S corporations, partnerships, or sole proprietorships. The Commissioner may assert penalties under section 6662 against the taxpayers in appropriate circumstances.

(g) *Treatment of partial dispositions.* A taxpayer may, for the taxable year in which there is a disposition of substantially all of an activity, treat the part disposed of as a separate activity, but only if the taxpayer can establish with reasonable certainty—

(1) The amount of deductions and credits allocable to that part of the activity for the taxable year under § 1.469–1(f)(4) (relating to carryover of disallowed deductions and credits); and

(2) The amount of gross income and of any other deductions and credits allocable to that part of the activity for the taxable year.

(h) *Rules for grouping rental real estate activities for taxpayers qualifying under section 469(c)(7).* See § 1.469–9 for rules for certain rental real estate activities.

[T.D. 8565, 59 FR 50487, Oct. 4, 1994, as amended by T.D. 8645, 60 FR 66499, Dec. 22, 1995]

§ 1.469–4T Definition of activity (temporary).

(a) *Overview*—(1) *Purpose and effect of overview.* This paragraph (a) contains a general description of the rules contained in this section and is intended solely as an aid to readers. The provisions of this paragraph (a) are not a substitute for the more detailed rules contained in the remainder of this section and cannot be relied upon in cases in which those rules qualify the general description contained in this paragraph (a).

(2) *Scope and structure of § 1.469–4T.* This section provides rules under which a taxpayer's business and rental operations are treated as one or more activities for purposes of section 469 and the regulations thereunder. (See paragraph (b)(2)(ii) of this section for the definition of business and rental operations.) In general, these rules are divided into three groups:

(i) Rules that identify the business and rental operations that constitute an undertaking (the undertaking rules).

(ii) Rules that identify the undertaking or undertakings that constitute an activity (the activity rules).

(iii) Rules that apply only under certain special circumstances (the special rules).

(3) *Undertaking rules*—(i) *In general.* The undertaking is generally the smallest unit that can constitute an activity. (See paragraph (b)(1) of this section for the general rule and paragraph (k)(2)(iii) of this section for a special rule that permits taxpayers to treat a single rental real estate undertaking as multiple activities.) An undertaking may include diverse business and rental operations.

(ii) *Basic undertaking rule.* The basic undertaking rule identifies the business and rental operations that constitute an undertaking by reference to their location and ownership. Under this rule, business and rental operations that are conducted at the same location and are owned by the same person are generally treated as part of the same undertaking. Conversely, business and rental operations generally constitute separate undertakings to the extent that they are conducted at different locations or are not owned by the same person. (See paragraph (c)(2)(i) of this section.)

(iii) *Circumstances in which location is disregarded.* In some circumstances, the undertaking in which business and rental operations are included does not depend on the location at which the operations are conducted. Operations that are not conducted at any fixed place of business or that are conducted at the customer's place of business are treated as part of the undertaking with which the operations are most closely associated (see paragraph (c)(2)(iii)(C) of this section). In addition, operations that are conducted at a location but do not relate to the production of property at that location or to the transaction of business with customers at that location are treated, in effect, as part of the undertaking or undertakings that the operations support (see paragraph (c)(2)(ii) of this section).

(iv) *Rental undertakings.* The basic undertaking rule is also modified if the undertaking determined under that rule includes both rental and nonrental operations. In such cases, the rental operations and the nonrental operations generally must be treated as separate undertakings (see paragraph (d)(1) of this section). This rule does not apply if more than 80 percent of the income of the undertaking determined under the basic rule is attributable to one class of operations (*i.e.*, rental or nonrental) or if the rental operations would not be treated as part of a rental activity because of the exceptions contained in § 1.469–1T(e)(3)(ii) (see paragraph (d)(2) of this section). In applying the rental undertaking rules, short-term rentals of real property (*e.g.*, hotel-room rentals) are generally treated as nonrental operations (see paragraph (d)(3)(ii) of this section).

(v) *Oil and gas wells.* Another exception to the basic undertaking rule treats oil and gas wells that are subject to the working-interest exception in § 1.469–1T(e)(4) as separate undertakings (see paragraph (e) of this section).

(4) *Activity rules*—(i) *In general.* The basic activity rule treats each undertaking in which a taxpayer owns an interest as a separate activity of the taxpayer (see paragraph (b)(1) of this section). In the case of trade or business undertakings, professional service undertakings, and rental real estate undertakings, additional rules may either require or permit the aggregation of two or more undertakings into a single activity.

(ii) *Aggregation of trade or business undertakings*—(A) *Trade or business undertakings.* Trade or business undertakings include all nonrental undertakings other than oil and gas undertakings described in paragraph (a)(3)(v) of this section and professional service undertakings described in paragraph (a)(4)(iii) of this section (see paragraph (f)(1)(ii) of this section).

(B) *Similar, commonly-controlled undertakings treated as a single activity.* An aggregation rule treats trade or business undertakings that are both similar and controlled by the same interests as part of the same activity. This rule is, however, generally inapplicable to small interests held by passive investors in such undertakings, except to the extent such interests are held through the same passthrough entity. (See paragraph (f)(2) of this section.) Undertakings are similar for purposes of this rule if more than half (by value) of their operations are in the same line of business (as defined in a revenue procedure issued pursuant to paragraph (f)(4)(iv) of this section) or if the undertakings are vertically integrated (see paragraph (f)(4)(iii) of this section). All the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests for purposes of the aggregation rule (see paragraph (j)(1) of this section). If, however, each member of a group of five or fewer persons owns a substantial interest in each of the undertakings, the undertakings may be rebuttably presumed to be controlled by the same interests (see paragraph (j)(2) and (3) of this section).

(C) *Integrated businesses treated as a single activity.* Trade or business undertakings (including undertakings that have been aggregated because of their similarity and common control) are subject to a second aggregation rule. Under this rule undertakings that constitute an integrated business and are controlled by the same interests must be treated as part of the same activity. (See paragraph (g) of this section.)

(iii) *Aggregation of professional service undertakings.* Professional service undertakings are nonrental undertakings that predominantly involve the provision of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (see paragraph (h)(1)(ii) of this section). In general, professional service undertakings that are either similar, related, or controlled by the same interests must be treated as part of the same activity (see paragraph (h)(2) of this section). The rules for determining whether trade or business undertakings are controlled by the same interests also apply with respect to professional service undertakings. Professional service undertakings are similar, however, if more than 20 percent (by value) of their operations are in the same field, and two professional service undertakings are related if one of the undertakings derives more than 20 percent of its gross income from persons who are customers of the other undertaking (see paragraph (h)(3) of this section).

(iv) *Rules for rental real estate*—(A) *Taxpayers permitted to determine rental real estate activities.* The rules for aggregating rental real estate undertakings are generally elective. They permit taxpayers to treat any combination of rental real estate undertakings as a single activity. Taxpayers may also divide their rental real estate undertakings and then treat portions of the undertakings as separate activities or recombine the portions into activities that include parts of different undertakings. (See paragraph (k)(2) (i) and (iii) of this section.)

(B) *Limitations on fragmentation and aggregation of rental real estate.* Taxpayers may not fragment their rental real estate in a manner that is inconsistent with their treatment of such property in prior taxable years or with the treatment of such property by the passthrough entity through which it is held (see paragraph (k) (2)(ii) and (3) of this section). There are no comparable limitations on the aggregation of rental real estate into a single activity. If however, the income or gain from a rental real estate undertaking is subject to recharacterization under § 1.469–2T(f)(3) (relating to the rental of nondepreciable property), a coordination rule provides that the undertaking must be treated as a separate activity (see paragraph (k)(6) of this section.)

(v) *Election to treat nonrental undertakings as separate activities.* Another elective rule permits taxpayers to treat a nonrental undertaking as a separate activity even if the undertaking would be treated as part of a larger activity under the aggregation rules applicable to the undertaking (see paragraph (o)(2) of this section). This elective rule is limited by consistency requirements similar to those that apply to rental real estate operations (see paragraph (o) (3) and (4) of this section). Moreover, in cases in which a taxpayer elects to treat a nonrental undertaking as a separate activity, the taxpayer's level of participation (*i.e.,* material, significant, or otherwise) in the separate activity is the same as the taxpayer's level of participation in the larger activity in which the undertaking would be included but for the election (see paragraph (o)(6) of this section).

(5) *Special rules*—(i) *Consolidated groups and publicly traded partnerships.* Special rules apply to the business and rental operations of consolidated groups of corporations and publicly traded partnerships. Under these rules, a consolidated group is treated as one taxpayer in determining its activities and those of its members (see paragraph (m) of this section), and business and rental operations owned through a publicly traded partnership cannot be aggregated with operations that are not owned through the partnership (see paragraph (n) of this section).

(ii) *Transitional rule.* A special rule applies for taxable years ending before August 10, 1989. In those years, taxpayers may organize business and rental operations into activities under any reasonable method (see paragraph (p)(1) of this section). A taxpayer will also be permitted to use any reasonable method to allocate disallowed deductions and credits among activities for the first taxable year in which the taxpayer's activities are determined under the general rules of § 1.469–4T (see paragraph (p)(3) of this section).

(b) *General rule and definitions of general application*—(1) *General rule.* Except as otherwise provided in this section, each undertaking in which a taxpayer owns an interest shall be treated as a separate activity of the taxpayer. See paragraphs (f), (g), and (h) of this section for rules requiring certain nonrental undertakings to be treated as part of the same activity and paragraph (k) of this section for rules identifying the rental real estate undertakings (or portions thereof) that are included in an activity.

(2) *Definitions of general application*. The following definitions set forth the meaning of certain terms for purposes of this section:

(i) *Passthrough entity.* The term ''passthrough entity'' means a partnership, S corporation, estate, or trust.

(ii) *Business and rental operations*—(A) *In general.* Except as provided in paragraph (b)(2)(ii)(B) of this section, the term ‘‘business and rental operations’’ means all endeavors that are engaged in for profit or the production of income and satisfy one or more of the following conditions for the taxable year:

(*1*) Such endeavors involve the conduct of a trade or business (within the meaning of section 162) or are conducted in anticipation of such endeavors becoming a trade or business;

(*2*) Such endeavors involve making tangible property available for use by customers; or

(*3*) Research or experimental expenditures paid or incurred with respect to such endeavors are deductible under section 174 (or would be deductible if the taxpayer adopted the method described in section 174(a)).

(B) *Operations conducted through non-passthrough entities.* For purposes of applying section 469 and the regulations thereunder, a taxpayer's activities do not include operations that a taxpayer conducts through one or more entities (other than passthrough entities). The following example illustrates the operation of this paragraph (b)(2)(ii)(B):

Example. (i) A, an individual, owns stock of X, a closely held corporation (within the meaning of §1.469–1T(g)(2)(ii) that is directly engaged in the conduct of a real estate development business. A participates in X's real estate development business, but does not own any interest in the business other than through ownership of the stock of X.

(ii) X is subject to section 469 (see §1.469–1T(b)(5)) and does not hold the real estate development business through another entity. Accordingly, for purposes of section 469 and the regulations thereunder, the operations of X's real estate development business are treated as part of X's activities.

(iii) A is also subject to section 469 (see §1.469–1T(b)(1)), but A's only interest in the real estate development business is held through X. X is a C corporation and therefore is not a passthrough entity. Thus, for purposes of section 469 and the regulations thereunder, A's activities do not include the operations of X's real estate development business. Accordingly, A's participation in X's busines is not participation in an activity of A, and is not taken into account in determining whether A materially participates (within the meaning of §1.469–5T) or significantly participates (within the meaning of §1.469–1T(c)(2)) in any activity. (See, however, §1.469–1T(g)(3) for rules under which a shareholder's participation is taken into account for purposes of determining whether a corporation materially or significantly participates in an activity.

(c) *Undertaking*—(1) *In general.* Except as otherwise provided in paragraphs (d), (e), and (k)(2)(iii) of this section, business and rental operations that constitute a separate source of income production shall be treated as a single undertaking that is separate from other undertakings.

(2) *Operations treated as a separate source of income production*—(i) *In general.* Except as otherwise provided in this paragraph (c)(2), business and rental operations shall be treated for purposes of this paragraph (c) as a separate source of income production if and only if—

(A) Such operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (within the meaning of paragraph (c)(2)(v) of this section); and

(B) Income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) owned by such person are conducted at such location.

(ii) *Treatment of support operations*—(A) *In general.* For purposes of section 469 and the regulations thereunder—

(*1*) The support operations conducted at a location shall not be treated as part of an undertaking under paragraph (c)(2)(i) of this section; and

(*2*) The income and expenses that are attributable to such operations and are reasonably allocable to an undertaking conducted at a different location shall be taken into account in determining the income or loss from the activity or activities that include such undertaking.

(B) *Support operations.* For purposes of this paragraph (c)(2), the business and rental operations conducted at a location are treated as support operations to the extent that—

(*1*) Such operations and an undertaking that is conducted at a different location are owned by the same person (within the meaning of paragraph (c)(2)(v) of this section);

(*2*) Such operations involve the provision of property or services to such undertaking; and

(*3*) Such operations are not income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section).

(iii) *Location.* For purposes of this paragraph (c)(2)—

(A) The term ''location'' means, with respect to any business and rental operations, a fixed place of business at which such operations are regularly conducted;

(B) Business and rental operations are conducted at the same location if they are conducted in the same physical structure or within close proximity of one another;

(C) Business and rental operations that are not conducted at a fixed place of business or that are conducted on the customer's premises shall be treated as operations that are conducted at the location (other than the customer's premises) with which they are most closely associated;

(D) All the facts and circumstances (including, in particular, the factors listed in paragraph (c)(3) of this section) are taken into account in determining the location with which business and rental operations are most closely associated; and

(E) Oil and gas operations that are conducted for the development of a common reservoir are conducted within close proximity of one another.

(iv) *Income-producing operations.* For purposes of this paragraph (c)(2), the term ''income-producing operations'' means business and rental operations that are conducted at a location and relate to (or are conducted in reasonable anticipation of)—

(A) The production of property at such location;

(B) The sale of property to customers at such location;

(C) The performance of services for customers at such location;

(D) Transactions in which customers take physical possession at such location of property that is made available for their use; or

(E) Any other transactions that involve the presence of customers at such location.

(v) *Ownership by the same person.* For purposes of this paragraph (c)(2), business and rental operations are owned by the same person if and only if one person (within the meaning of section 7701(a)(1)) is the direct owner of such operations.

(3) *Facts and circumstances determinations.* In determining whether a location is the location with which business and rental operations are most closely associated for purposes of paragraph (c)(2)(iii)(D) of this section, the following relationships between operations that are conducted at such location and other operations are generally the most significant:

(i) The extent to which other persons conduct similar operations at one location;

(ii) Whether such operations are treated as a unit in the primary accounting records reflecting the results of such operations;

(iii) The extent to which other persons treat similar operations as a unit in the primary accounting records reflecting the results of such similar operations;

(iv) The extent to which such operations involve products or services that are commonly provided together;

(v) The extent to which such operations serve the same customers;

(vi) The extent to which the same personnel, facilities, or equipment are used to conduct such operations;

(vii) The extent to which such operations are conducted in coordination with or reliance upon each other;

(viii) The extent to which the conduct of any such operations is incidental to the conduct of the remainder of such operations;

(ix) The extent to which such operations depend on each other for their economic success; and

(x) Whether such operations are conducted under the same trade name.

(4) *Examples.* The following examples illustrate the application of this paragraph (c). In each example that does not state otherwise, the taxpayer is an individual and the facts, analysis, and conclusion relate to a single taxable year.

Example (1). The taxpayer is the sole owner of a department store and a restaurant and conducts both businesses in the same building. Thus, the department store and restaurant operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, property is sold to customers and services are performed for customers on the premises of the department store). Accordingly, the department store and restaurant operations are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section).

Example (2). (i) The facts are the same as in example (1), except that the taxpayer is also the sole owner of an automotive center that services automobiles and sells tires, batteries, motor oil, and accessories. The taxpayer operates the automotive center in a separate structure in the shopping mall in which the department store is located. Although the automotive center operations and the department store and restaurant operations are not conducted in the same physical structure, they are conducted within close proximity (within the meaning of paragraph (c)(2)(iii)(B) of this section) of one another. Thus, the department store, restaurant, and automotive center operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section).

(ii) As in example (1), the operations conducted at the same location are owned by the same person, and the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location. Accordingly, the department store, restaurant, and automotive center operations are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section).

Example (3). (i) The facts are the same as in example (2), except that the automotive center is located several blocks from the shopping mall. As in example (1), the department store and restaurant operations are treating as a single undertaking that is separate from other undertakings. Because, however, the automotive center operations are not conducted within close proximity (within the meaning of paragraph (c)(2)(iii)(B) of this section) of the department store and restaurant operations, all of the taxpayer's operations are not conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section).

(ii) All of the automotive center operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, property is sold to customers and services are performed for customers on the premises of the automotive center). Accordingly, the automotive center operations are also treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See, however, paragraph (g) of this section for rules under which certain trade or business activities are treated as a single activity.

Example (4). The taxpayer is the sole owner of a building and rents residential, office, and retail space in the building to various tenants. The taxpayer manages these rental operations from an office located in the building. The rental operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, customers take physical possession in the building of property made available for their use). Accordingly, the rental operations are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See paragraph (d) of this section for rules for determining whether this undertaking is a rental undertaking and paragraph (k) of this section for rules for identifying rental real estate activities.

Example (5). (i) The facts are the same as in example (4), except that the taxpayer also uses the rental office in the building (''Building #1'') to manage rental operations in another building (''Building #2'') that the taxpayer owns. The rental operations conducted in Building #2 are treated as a separate source of income production under paragraph (c)(2) of this section and as a single undertaking that is separate from other undertakings (the ''Building #2 undertaking'') under paragraph (c)(1) of this section.

(ii) The operations conducted at the rental office in Building #1 and the Building #2 undertaking are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the operations conducted at the rental office with respect to the Building #2 undertaking relate to transactions in which customers take physical possession at another location of property that is made available for their use (*i.e.*, the operations are not income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section)). Thus, to the extent the operations conducted at the rental office involve the management of the Building #2 undertaking, they are support operations (within the meaning of paragraph (c)(2)(ii)(B) of this section) with respect to the Building #2 undertaking.

(iii) Paragraph (c)(2)(ii)(A)(*1*) of this section provides that support operations are not treated as part of an undertaking under paragraph (c)(2)(i) of this section. Therefore, the support operations conducted at the rental office are not treated as part of the undertaking that consists of the rental operations conducted in Building #1 (the ‘‘Building #1 undertaking’’). Paragraph (c)(2)(ii)(A)(*2*) of this section provides that the income and expenses that are attributable to support operations and are reasonably allocable to an undertaking conducted at a different location shall be taken into account in determining the income or loss from the activity that includes such undertaking. Accordingly, the income and expenses of the rental office that are reasonably allocable to the Building #2 undertaking are taken into account in determining the income or loss from the activity or activities that include the Building #2 undertaking. See paragraph (k) of this section for rules for identifying rental real estate activities.

(iv) Rental office operations that involve the management of rental operations conducted in Building #1 are not support operations (within the meaning of paragraph (c)(2)(ii)(B) of this section) because they relate to an undertaking that is conducted at the same location (the ‘‘Building #1 undertaking’’). Thus, the rules for support operations in paragraph (c)(2)(ii)(A) of this section do not apply to such operations, and they are treated as part of the Building #1 undertaking.

Example (6). (i) The taxpayer conducts business and rental operations at eleven different locations (within the meaning of paragraph (c)(2)(iii) of this section). At ten of the locations the taxpayer owns grocery stores, and at the eleventh location the taxpayer owns a warehouse that receives goods and supplies them to the taxpayer’s stores. The operations of each store are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at each location (*i.e.*, property is sold to customers on the store premises, and customers take physical possession on the store premises of property made available for their use). Accordingly, the operations of each of the ten grocery stores are treated as a separate source of income production (see paragraph (c)(2) of this section), and each store is treated as a single undertaking (a ‘‘grocery store undertaking’’) that is separate from other undertakings (see paragraph (c)(1) of this section). The operations conducted at the warehouse, however, do not include any income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section). Accordingly, the warehouse operations do not satisfy the requirements of paragraph (c)(2)(i) of this section and are not treated as a separate undertaking under paragraph (c)(1) of this section.

(ii) The warehouse operations and the grocery store undertakings are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations), the operations conducted at the warehouse involve the provision of property to the grocery store undertakings, and the warehouse operations are not income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section). Thus, the warehouse operations are support operations (within the meaning of paragraph (c)(2)(ii)(B) of this section) with respect to the grocery store undertakings. Paragraph (c)(2)(ii)(A)(*2*) of this section provides that the income and expenses that are attributable to support operations and are reasonably allocable to an undertaking conducted at a different location shall be taken into account in determining the income or loss from the activity or activities that include such undertaking. Accordingly, the income and expenses of the warehouse operations that are reasonably allocable to a grocery store undertaking are taken into account in determining the income or loss from the activity or activities that include such undertaking. See paragraph (f) of this section for rules under which certain similar, commonly-controlled undertakings are treated as a single activity.

Example (7). (i) The facts are the same as in example (6), except that the warehouse operations also include the sale of goods to grocery stores that the taxpayer does not own (‘‘other grocery stores’’). Because of these sales, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the warehouse. The warehouse operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). Accordingly, prior to the application of the rules for support operations in paragraph (c)(2)(ii) of this section, the warehouse operations are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking (the ‘‘separate warehouse undertaking’’) that is separate from other undertakings (see paragraph (c)(1) of this section).

(ii) As in example (6), the warehouse operations that involve supplying goods to the taxpayer’s grocery store undertakings are support operations with respect to those undertakings. Therefore, those operations are not treated as part of the separate warehouse undertaking (see paragraph (c)(2)(ii)(A)(*1*) of this section), and the income and expenses of such operations are taken into account, as in example (6), in determining the income or loss from the activity or activities that include the taxpayer's grocery store undertakings.

Example (8). (i) A partnership is formed to acquire real property and construct a building on the property. The partnership hires brokers to locate a suitable parcel of land, lawyers to negotiate zoning variances, easements, and building permits, and architects and engineers to design the improvements. After the architects and engineers have designed the improvements and other preliminaries have been completed, the partnership hires a general contractor who hires subcontractors and oversees construction. During the construction process and after construction has been completed, the partnership leases out space in the building. The partnership then operates the building as a rental property. The operations of acquiring the real property, negotiating contracts, overseeing the designing and construction of the improvements, leasing up the building, and operating the building are conducted at an office (the ''management office'') that is not at the same location (within the meaning of paragraph (c)(2)(iii) of this section) as the building.

(ii) The operations conducted at the building site (*e.g.*, excavating the land, pouring the concrete for the foundation, erecting the frame of the building, completing the exterior of the building, and building out the interior of the building) are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the partnership is the direct owner of the operations). In addition, the partnership conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, during the construction period property (the building) is produced at the building site, and during the rental period customers take physical possession in the building of property made available for their use). Accordingly, the operations conducted at the building site are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section).

(iii) The operations conducted at the management office and the undertaking conducted at the building site are owned by the same person (*i.e.*, the partnership is the direct owner of the operations). In addition, the operations conducted at the management office relate to transactions in which customers take physical possession at another location of property that is made available for their use (*i.e.*, the operations are not income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section)). Thus, to the extent the operations conducted at the management office involve the provision of services to the undertaking conducted at the building site, they are support operations (within the meaning of paragraph (c)(2)(ii)(B) of this section) with respect to such undertaking.

(iv) Paragraph (c)(2)(ii)(A)(*2*) of this section provides that the income and expenses of support operations that are reasonably allocable to an undertaking conducted at a different location shall be taken into account in determining the income or loss from the activity that includes such undertaking. Accordingly, the income and expenses of the management office that are reasonably allocable to the undertaking conducted at the building site are taken into account in determining the income or loss from the activity or activities that include such undertaking.

(v) Until the building is first held out for rent and is in a state of readiness for rental, the undertaking conducted at the building site is a trade or business undertaking (within the meaning of paragraph (f)(1)(ii) of this section). See paragraph (d) of this section for rules for determining whether the undertaking is a rental undertaking for periods after the building is first held out for rent and is in a state of readiness for rental and paragraph (k) of this section for rules for identifying rental real estate activities.

Example (9). The taxpayer owns 15 oil wells pursuant to a single working interest (within the meaning of § 1.469–1T (e)(4)(iv). All of the wells are drilled and operated for the development of a common reservoir. Thus, all of the wells are at the same location (see paragraph (c)(2)(iii)(E) of this section). All of the wells are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations), and the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, oil wells are drilled in reasonable anticipation of producing oil at the location). Accordingly, the operations of the wells are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See paragraph (e) of this section for rules under which certain oil and gas operations are treated as multiple undertakings even if they would be part of the same undertaking under the rules of this paragraph (c).

Example (10). (i) Partnership X owns an automobile dealership and partnership Y owns an automobile repair shop. The dealership and repair shop operations are conducted in the same physical structure. Individuals A, B, and C are the only partners in partnerships X and Y, and each of the partners owns a one-third interest in both partnerships.

(ii) The dealership operations and the repair-shop operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section), but are owned by different persons (*i.e.,* X is the direct owner of the dealership operations, and Y is the direct owner of the repair-shop operations). Moreover, indirect ownership of the operations is not taken into account under paragraph (c)(2)(v) of this section. Thus, it is irrelevant that the two partnerships are owned by the same persons in identical proportions. Accordingly, the dealership and repair-shop operations are not treated as part of the same source of income production (see paragraph (c)(2) of this section) or as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See, however, paragraph (g) of this section for rules under which certain trade or business activities are treated as a single activity.

Example (11). (i) The taxpayer owns and operates a delivery service. The business consists of a central office, retail establishments, and messengers who transport packages from one place to another. Customers may bring their packages to a retail establishment for delivery elsewhere or, by calling the central office, may have packages picked up at their homes or offices. The central office dispatches messengers and coordinates all pickups and deliveries. Customers may pay for deliveries when they drop off or pick up packages at a retail establishment, or the central office will bill the customer for services rendered. In addition, many packages are routed through the central office.

(ii) The operations conducted at the central office are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.,* the taxpayer is the direct owner of the operations). The operations actually conducted at the central office, however, do not include any income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section).

(iii) Under paragraph (c)(2)(iii) (C) and (D) of this section, business and rental operations that are not conducted at a fixed place of business or that are conducted on the customer's premises are treated as operations that are conducted at the location (other than the customer's premises) with which they are most closely associated, and all the facts and circumstances are taken into account in determining the location with which business and rental operations are most closely associated. The facts and circumstances in this case (including the facts that the central office dispatches messengers, coordinates all pickups and deliveries, and is the transshipment point for many packages) establish that the operations of delivering packages from one location to another are most closely associated with the central office. Thus, the delivery operations are treated as operations that are conducted at the central office, and the deliveries are treated as income-producing operations (*i.e.,* the performance of services for customers) that the taxpayer conducts at the central office. Accordingly, the operations conducted at the central office are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section).

(iv) The operations conducted at each retail establishment are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.,* the taxpayer is the direct owner of the operations). At each retail establishment, the taxpayer's operations include transactions that involve the presence of customers at the establishment. Thus, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv)(E) of this section) at the retail establishments. Accordingly, the operations of each retail establishment are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See, however, paragraph (f) of this section for rules under which certain similar, commonly-controlled undertakings are treated as a single activity.

Example (12). (i) The taxpayer is the sole owner of a saw mill and a lumber yard. The taxpayer's business operations consist of converting timber into lumber and other wood products and selling the resulting products. The timber is processed at the saw mill, and the resulting products are transported to the lumber yard where they are sold. The saw mill and the lumber yard are at different locations (within the meaning of paragraph (c)(2)(iii) of this section). The transportation operations are managed at the saw mill.

(ii) The operations conducted at the saw mill are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.,* the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.,* lumber is produced at the mill). Similarly, the selling operations at the lumber yard are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.,* the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, lumber is sold to customers at the lumber yard). Thus, the milling operations and the selling operations are treated as separate sources of income production (see paragraph (c)(2) of this section) and as separate undertakings (see paragraph (c)(1) of this section).

(iii) The operations conducted at the mill involve the provision of property to the lumber-yard undertaking. Nonetheless, the milling operations are income-producing operations because they relate to the production of property at the mill, and an undertaking's income-producing operations are not treated as support operations (see paragraph (c)(2)(ii)(B)(*3*) of this section). Accordingly, the milling operations are not support operations with respect to the lumber-yard undertaking. See, however, paragraph (f) of this section for rules under which certain vertically-integrated undertakings are treated as part of the same activity.

(iv) The operations of transporting finished products from the saw mill to the lumber yard are not conducted at a fixed location. Under paragraphs (c)(2)(iii) (C) and (D) of this section, business and rental operations that are not conducted at a fixed place of business or that are conducted on the customer's premises are treated as operations that are conducted at the location (other than the customer's premises) with which they are most closely associated, and all the facts and circumstances are taken into account in determining the location with which business and rental operations are most closely associated. The facts and circumstances in this case (including the fact that the transportation operations are managed at the saw mill) establish that the transportation operations are most closely associated with the saw mill. Thus, the transportation operations are treated as operations that are conducted at the mill and as part of the undertaking that consists of the milling operations.

(d) *Rental undertaking*—(1) *In general.* This paragraph (d) applies to operations that are treated, under paragraph (c) of this section and before the application of paragraph (d)(1)(i) of this section, as a single undertaking that is separate from other undertakings (a ''paragraph (c) undertaking''). For purposes of this section—

(i) A paragraph (c) undertaking's rental operations and its operations other than rental operations shall be treated, except as otherwise provided in paragraph (d)(2) of this section, as two separate undertakings;

(ii) The income and expenses that are reasonably allocable to an undertaking (determined after the application of paragraph (d)(1)(i) of this section) shall be taken into account in determining the income or loss from the activity or activities that include such undertaking; and

(iii) An undertaking (determined after the application of paragraph (d)(1)(i) of this section) shall be treated as a rental undertaking if and only if such undertaking, considered as a separate activity, would constitute a rental activity (within the meaning of § 1.469–1T(e)(3)).

(2) *Exceptions.* Paragraph (d)(1)(i) of this section shall not apply to a paragraph (c) undertaking for any taxable year in which—

(i) The rental operations of the paragraph (c) undertaking, considered as a separate activity, would not constitute a rental activity (within the meaning of § 1.469–1T(e)(3));

(ii) Less than 20 percent of the gross income of the paragraph (c) undertaking is attributable to rental operations; or

(iii) Less than 20 percent of the gross income of the paragraph (c) undertaking is attributable to operations other than rental operations.

(3) *Rental operations.* For purposes of this paragraph (d), a paragraph (c) undertaking's rental operations are determined under the following rules:

(i) *General rule.* Except as otherwise provided in paragraph (d)(3) (ii) or (iii) of this section, a paragraph (c) undertaking's rental operations are all of the undertaking's business and rental operations that involve making tangible property available for use by customers and the provision of property and services in connection therewith.

(ii) *Real property provided for short-term use.* A paragraph (c) undertaking's operations that involve making short-term real property available for use by customers and the provision of property and services in connection therewith shall not be treated as rental operations if such operations, considered as a separate activity, would not constitute a rental activity. An item of property is treated as short-term real property for this purpose if and only if such item is real property that the paragraph (c) undertaking makes available for use by customers and the average period of customer use (within the meaning of § 1.469–1T(e)(3)(iii)) for all of the paragraph (c) undertaking's real property of the same type as such item is 30 days or less.

(iii) *Property made available to licensees.* A paragraph (c) undertaking's operations that involve making tangible property available during defined business hours for nonexclusive use by various customers shall not be treated as rental operations. (See § 1.469–1T(e)(3)(ii)(E).)

(4) *Examples.* The following examples illustrate the application of this paragraph (d). In each example that does not state otherwise, the taxpayer is an individual and the facts, analysis, and conclusions relate to a single taxable year.

Example (1) . (i) The taxpayer owns a building in which the taxpayer rents office space to tenants and operates a parking garage that is used by tenants and other persons. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) The taxpayer's tenants typically occupy an office for at least one year, and the services provided to tenants are those customarily provided in office buildings. Some persons (including tenants) rent spaces in the parking garage on a monthly or annual basis. In general, however, spaces are rented on an hourly or daily basis, and the average period for which all customers (including tenants) use the parking garage is less than 24 hours. The paragraph (c) undertaking derives 75 percent of its gross income from office-space rentals and 25 percent of its gross income from the parking garage. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of § 1.469–1T(e)(3)(vi)).

(ii) The parking spaces are real property and the average period of customer use (within the meaning of § 1.469–1T(e)(3)(iii)) for the parking spaces is 30 days or less. Thus, the parking spaces are short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section). (For this purpose, individual parking spaces that are rented on a monthly or annual basis are, nevertheless, short-term real properties because all the parking spaces are property of the same type, and the average rental period taking all parking spaces into account is 30 days or less.) In addition, the parking-garage operations involve making short-term real properties available for use by customers and the provision of property and services in connection therewith.

(iii) Paragraph (d)(3) (i) and (ii) of this section provides, in effect, that a paragraph (c) undertaking's operations that involve making short-term real properties available for use by customers and the provision of property and services in connection therewith are treated as rental operations if and only if the operations, considered as a separate activity, would constitute a rental activity (within the meaning of § 1.469–1T(e)(3)). In this case, the parking-garage operations, if considered as a separate activity, would not constitute a rental activity because the average period of customer use for the parking spaces is seven days or less (see § 1.469–1T(e)(3)(ii)(A)). Accordingly, the parking-garage operations are not treated as rental operations.

(iv) The paragraph (c) undertaking's remaining operations involve the provision of tangible property (the office spaces) for use by customers and the provision of property and services in connection therewith. The average period of customer use for the office spaces exceeds 30 days. Thus, the office spaces are not short-term real properties, and the undertaking's operations involving the rental of office spaces are rental operations.

(v) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, at least 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (the office-space operations) and at least 20 percent is attributable to operations other than rental operations (the parking-garage operations). Thus, the exceptions in paragraph (d)(2) (ii) and (iii) of this section do not apply. In addition, the average period of customer use for the office spaces exceeds 30 days, extraordinary personal services (within the meaning of § 1.469–1T(e)(3)(v)) are not provided, and the rental of the office spaces is not treated as incidental to a nonrental activity under § 1.469–1T(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Thus, the rental operations, if considered as a separate activity, would constitute a rental activity, and the exception in paragraph (d)(2)(i) of this section does not apply. Accordingly, the rental operations and the parking-garage operations are treated as two separate undertakings (the ''office-space undertaking'' and the ''parking-garage undertaking'').

(vi) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the office-space undertaking, if considered as a separate activity, would constitute a rental activity (see (v) above), and the parking-garage undertaking, if considered as a separate activity, would not constitute a rental activity (see (iii) above). Accordingly, the office-space undertaking is treated as a rental undertaking, and the parking-garage undertaking is not.

Example (2). (i) The taxpayer owns a building in which the taxpayer rents apartments to tenants and operates a restaurant. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) The taxpayer's tenants typically occupy an apartment for at least one year, and the services provided to tenants are those customarily provided in residential apartment buildings. The paragraph (c) undertaking derives 85 percent of its gross income from apartment rentals and 15 percent of its gross income from the restaurant. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469–1T(e)(3)(vi)).

(ii) The operations with respect to apartments (the ‘‘apartment operations’’) involve the provision of tangible property (the apartments) for use by customers and the provision of property and services in connection therewith. In addition, the apartments are not short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section) because the average period of customer use (within the meaning of §1.469–1T(e)(3)(iii)) for the apartments exceeds 30 days. Accordingly, the apartment operations are rental operations (within the meaning of paragraph (d)(3) of this section). The restaurant operations do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Thus, the restaurant operations are not rental operations.

(iii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the exception in paragraph (d)(2)(iii) of this section applies because less than 20 percent of the paragraph (c) undertaking's gross income is attributable to operations other than rental operations (the restaurant operations). Accordingly, the rental operations and the restaurant operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(iv) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the undertaking (determined after the application of paragraph (d)(1)(i) of this section) includes both the apartment operations and the restaurant operations, and the gross income of this undertaking represents amounts paid principally for the use of tangible property (the apartments). Moreover, the average period of customer use for the apartments exceeds 30 days, extraordinary personal services (within the meaning of §1.469–1T(e)(3)(v)) are not provided, and the rental of the apartments is not treated as incidental to a nonrental activity under §1.469–1T(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Thus, the undertaking, if considered as a separate activity, would constitute a rental activity. Accordingly, the undertaking is treated as a rental undertaking.

Example (3). (i) The taxpayer owns a building in which the taxpayer rents hotel rooms, meeting rooms, and parking spaces to customers, rents space to various retailers, and operates a restaurant and health club. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) Although some customers occupy hotel rooms for extended periods (including some customers who reside in the hotel), customers use hotel rooms for an average period of two days and meeting rooms for an average period of one day. The services provided to persons using the hotel rooms and meeting rooms are those customarily provided in hotels (including wake-up calls, valet services, and delivery of food and beverages to rooms). Some customers rent spaces in the parking garage on a monthly or annual basis. In general, however, parking spaces are rented on an hourly or daily basis, and the average period for which customers use the parking garage is less than 24 hours. Retail tenants typically occupy their space for at least one year, and the services provided to retail tenants are those customarily provided in commercial buildings. The paragraph (c) undertaking derives 45 percent of its gross income from renting hotel rooms, meeting rooms, and parking spaces, 35 percent of its gross income from renting retail space, and 20 percent of its gross income from the restaurant and health club. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469–1T(e)(3)(vi)).

(ii) The parking spaces, hotel rooms, and meeting rooms are real property of three different types, but the average period of customer use (within the meaning of §1.469–1T (e)(3)(iii)) for property of each type is 30 days or less. Thus, the parking spaces, hotel rooms, and meeting rooms are short-term real properties. (For this purpose, individual parking spaces or hotel rooms that are rented for extended periods are, nevertheless, short-term real properties if the average rental period for all parking spaces is 30 days or less and the average rental period for all hotel rooms is 30 days or less.) In addition, the parking garage operations, the operations with respect to hotel rooms (the ''hotel-room operations''), and the operations with respect to meeting rooms (the ''meeting-room operations'') involve making short-term real properties available for use by customers and the provision of property and services in connection therewith.

(iii) Paragraph (d)(3) (i) and (ii) of this section provides, in effect, that a paragraph (c) undertaking's operations that involve making short-term real properties available for use by customers and the provision of property and services in connection therewith are treated as rental operations if and only if the operations, considered as a separate activity, would constitute a rental activity (within the meaning of § 1.469–1T (e)(3)). In this case the parking-garage, hotel-room and meeting-room operations, if considered as separate activities, would not constitute rental activities because the average period of customer use for parking spaces, hotel rooms, and meeting rooms does not exceed seven days (see § 1.469–1T (e)(3)(ii)(A)). Accordingly, the parking-garage, hotel-room, and meeting-room operations are not treated as rental operations.

(iv) The operations with respect to retail space in the building (the ''retail-space operations'') involve the provision of tangible property (the retail spaces) for use by customers and the provision of property and services in connection therewith. In addition, the retail spaces are not short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section) because the average period of customer use (within the meaning of § 1.469–1T (e)(3)(iii)) for the retail spaces exceeds 30 days. Accordingly, the retail-space operations are rental operations.

(v) The health-club operations involve making tangible property available for use by customers, but the property is customarily made available during defined business hours for nonexclusive use by various customers. Accordingly, the health-club operations are not rental operations (see paragraph (d)(3)(iii) of this seciton). The restaurant operations do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Accordingly, the restaurant operations also are not rental operations.

(vi) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, at least 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (35 percent of the paragraph (c) undertaking's gross income is from the retail-space operations) and at least 20 percent is attributable to operations other than rental operations (45 percent from the hotel-room, meeting-room and parking-garage operations and 20 percent from the restaurant and health-club operations). Thus, the exceptions in paragraph (d)(2) (ii) and (iii) of this section do not apply. In addition, the average period of customer use for the retail space exceeds 30 days, extraordinary personal services (within the meaning of § 1.469–1T (e)(3)(v)) are not provided, and the rental of the retail space is not treated as incidental to a nonrental activity under § 1.469–1T (e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Thus, the retail-space operations, if considered as a separate activity, would constitute a rental activity, and the exception in paragraph (d)(2)(i) of this section does not apply. Accordingly, the retail-space operations are treated as an undertaking (the ''retail-space undertaking'') and all the other operations conducted in the building (*i.e.*, renting hotel and meeting rooms and parking spaces and operating the restaurant and health club) are treated as a separate undertaking (the ''hotel undertaking'').

(vii) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the retail-space undertaking, if considered as a separate activity, would constitute a rental activity (see (iv) above). Accordingly, the retail-space undertaking is treated as a rental undertaking. The hotel undertaking, if considered as a separate activity, would not constitute a rental activity because all tangible property provided for the use of customers in the hotel undertaking is either property for which the average period of customer use is seven days or less (see § 1.469–1T (e)(3)(ii)(A)) or property customarily made available during defined business hours for nonexclusive use by various customers (see § 1.469–1T (e)(3)(ii)(E)). Accordingly, the hotel undertaking is not treated as a rental undertaking.

Example (4). (i) A law partnership owns a ten-story building. The partnership uses eight floors of the building in its law practice and leases two floors to one or more tenants. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) Tenants typically occupy space on the two rented floors for at least one year, and the services provided to tenants are those customarily provided in office buildings. The paragraph (c) undertaking derives 90 percent of its gross income from rendering legal services and 10 percent of its gross income from renting space. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469–1T (e)(3)(vi)).

(ii) The operations with respect to the office space leased to tenants (the ‘‘office-space operations’’) involve the provision of tangible property (the office space) for use by customers and the provision of property and services in connection therewith. In addition, the office spaces are not short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section) because the average period of customer use (within the meaning of §1.469–1T(e)(3)(iii)) for the office space exceeds 30 days. Accordingly, the office-space operations are rental operations (within the meaning of paragraph (d)(3) of this section).

(iii) The operations that involve the performance of legal services (the ‘‘law-practice operations’’) do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Accordingly, the law-practice operations are not rental operations.

(iv) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking’s rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the exception in paragraph (d)(2)(ii) of this section applies because less than 20 percent of the paragraph (c) undertaking’s gross income is attributable to rental operations (the office-space operations). Accordingly, the law-practice operations and the office-space operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(v) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the undertaking (determined after the application of paragraph (d)(1)(i) of this section) includes both the law-practice operations and the office-space operations, and the gross income of this undertaking does not represent amounts paid principally for the use of tangible property. Thus, the undertaking, if considered as a separate activity, would not constitute a rental activity. Accordingly, the undertaking is not treated as a rental undertaking.

Example (5). (i) The facts are the same as in example (4), except that the building is owned by a separate partnership (the ‘‘real estate partnership’’), which leases eight floors of the building to the law partnership for use in its law practice and two floors to one or more other tenants. The law partnership and real estate partnership are owned by the same individuals in identical proportions.

(ii) The operations conducted in the building are owned by two different persons (*i.e.*, the law partnership and the real estate partnership). (See paragraph (c)(2)(v) of this section.) Thus, the operations conducted in the building are not treated as a single undertaking under paragraph (c)(1) of this section. Instead, each partnership’s share of such operations is treated as a separate paragraph (c) undertaking (the ‘‘law-practice undertaking’’ and the ‘‘office-space undertaking’’).

(iii) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the office-space undertaking, if considered as a separate activity, would constitute a rental activity because all of the undertaking’s gross income (including rents paid by the law partnership) represents amounts paid principally for the use of tangible property (the office space), the average period of customer use for the office space exceeds 30 days, extraordinary personal services (within the meaning of §1.469–1T(e)(3)(v)) are not provided, and the rental of the office space is not treated as incidental to a nonrental activity under §1.469–1T(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Accordingly, the office-space undertaking is treated as a rental undertaking. See, however, §1.469–2T(f)(6) (relating to certain rentals of property to a trade or business activity in which the taxpayer materially participates).

(iv) The law-practice undertaking, if considered as a separate activity, would not constitute a rental activity because none of the undertaking’s gross income represents amounts paid principally for the use of tangible property. Accordingly, the law-practice undertaking is not treated as a rental undertaking.

Example (6). (i) The taxpayer owns a building in which the taxpayer operates a nursing home and a medical clinic. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) The nursing-home operations consist of renting apartments in the nursing home to elderly and handicapped persons and providing medical care, meals, and social activities. (Assume that these services are extraordinary personal services (within the meaning of §1.469–1T(e)(3)(v)). The medical clinic provides medical care to nursing-home residents and other individuals. Nursing-home residents typically occupy an apartment for at least one year. The paragraph (c) undertaking derives 55 percent of its gross income from nursing-home operations (including the provision of medical services to nursing-home residents) and 45 percent of its gross income from medical-clinic operations. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of § 1.469–1T(e)(3)(vi)).

(ii) The paragraph (c) undertaking's nursing-home operations involve the provision of tangible property (the apartments) for use by customers and the provision of property and services in connection therewith. In addition, the apartments are not short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section) because the average period of customer use (within the meaning of § 1.469–1T(e)(3)(iii)) for the apartments exceeds 30 days. Accordingly, the nursing-home operations are rental operations (within the meaning of paragraph (d)(3) of this section). The medical-clinic operations do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Thus, the medical-clinic operations are not rental operations.

(iii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the nursing-home operations, if considered as a separate activity, would not constitute a rental activity because extraordinary personal services are provided in connection with making nursing-home apartments available for use by customers (see § 1.469–T(e)(3)(ii)(C)). Thus, the exception in paragraph (d)(2)(i) of this section applies, and the nursing-home operations and the medical-clinic operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(iv) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the nursing-home operations, if considered as a separate activity, would not constitute a rental activity (see (iii) above). Thus, an undertaking that includes no rental operations other than the nursing-home operations would not, if considered as a separate activity, constitute a rental activity. Accordingly, the undertaking is not treated as a rental undertaking.

Example (7). (i) The taxpayer rents and sells videocassettes. (Assumes that, under paragraph (c)(1) of this section, the videocassette operations are treated as a single paragraph (c) undertaking.) Renters of videocassettes typically keep the videocassettes for one or two days, and do not receive any other property or services in connection with videocassette rentals. The paragraph (c) undertaking derives 70 percent of its gross income from renting videocassettes and 30 percent of its gross income from selling videocassettes. The videocassette operations are not incidental to any other activity of the taxpayer (within the meaning of § 1.469–1T(e)(3)(vi)).

(ii) The rental of videocassettes involves the provision of tangible property (the videocassettes) for use by customers. In addition, the special rules for short-term real properties contained in paragraph (d)(3)(ii) of this section do not apply in this case because the videocassettes are not real property. Thus, the operations that involve videocassette rentals are rental operations (within the meaning of paragraph (d)(3) of this section). The sale of videocassettes does not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Thus, the operations that involve videocassette sales are not rental operations.

(iii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the rental operations, if considered as a separate activity, would not constitute a rental activity because the average period of customer use for rented videocassettes does not exceed seven days (see § 1.469–1T(e)(3)(ii)(A)). Accordingly, the exception in paragraph (d)(2)(i) of this section applies, and the videocassette-rental operations and videocassette-sales operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(iv) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the videocassette-rental operations, if considered as a separate activity, would not constitute a rental activity (see (iii) above). Thus, an undertaking that includes no rental operations other than the videocassette-rental operations would not, if considered as a separate activity, constitute a rental activity. Accordingly, the undertaking is not treated as a rental undertaking.

Example (8). (i) The taxpayer owns a building in which the taxpayer sells, leases, and services automobiles. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) The minimum lease term for any leased automobile is 31 days, and the services provided to lessees (including periodic oil changes, lubrication, and routine services and repairs) are those customarily provided in long-term automobile leases. The paragraph (c) undertaking derives 75 percent of its gross income from selling automobiles, 15 percent of its gross income from servicing automobiles other than leased automobiles, and 10 percent of its gross income from leasing automobiles. The taxpayer's automobile operations are not incidental to any other activity of the taxpayer (within the meaning of §1.469–1T(e)(3)(vi)).

(ii) The paragraph (c) undertaking's automobile-leasing operations involve the provision of tangible property (the automobiles) for use by customers and the provision of services in connection therewith. In addition, the special rules for short-term real properties contained in paragraph (d)(3)(ii) of this section do not apply in this case because the automobiles are not real property. Accordingly, the automobile-leasing operations are rental operations (within the meaning of paragraph (d)(3) of this section). The paragraph (c) undertaking's automobile-sales operations and servicing operations for automobiles other than leased automobiles (the ''selling-and-servicing operations'') do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Thus, the selling-and-servicing operations are not rental operations.

(iii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the exception in paragraph (d)(2)(ii) of this section applies because less than 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (the ''automobile-leasing operations''). Accordingly, the rental operations and the selling-and-servicing operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(iv) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the undertaking (determined after the application of paragraph (d)(1)(i) of this section) includes both the selling-and-servicing operations and the automobile-leasing operations, and the gross income of the undertaking does not represent amounts paid principally for the use of tangible property. Thus, the undertaking, if considered as a separate activity, would not constitute a rental activity. Accordingly, the undertaking is not treated as a rental undertaking.

Example (9). (i) The facts are the same as in example (8), except that the paragraph (c) undertaking derives 60 percent of its gross income from selling automobiles, 15 percent of its gross income from servicing automobiles other than leased automobiles, and 25 percent of its gross income from leasing automobiles.

(ii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, more than 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (the automobile-leasing operations), and more than 20 percent is attributable to operations other than rental operations (the selling-and-servicing operations). Thus, the exceptions in paragraph (d)(2) (ii) and (iii) of this section do not apply. In addition, the average period of customer use for leased automobiles exceeds 30 days, extraordinary personal services (within the meaning of §1.469–1T(e)(3)(v)) are not provided, and the leasing of the automobiles is not treated as incidental to a nonrental activity under §1.469–1T(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Thus, the leasing operations, if considered as a separate activity, would constitute a rental activity, and the exception in paragraph (d)(2)(i) of this section does not apply. Accordingly, the rental operations and the selling-and-servicing operations are treated as two separate undertakings (the ''automobile-leasing undertaking'' and the ''automobile selling-and-servicing undertaking'').

(iii) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the automobile-leasing undertaking would, if considered as a separate activity, constitute a rental activity, and the automobile selling-and-servicing undertaking would not, if considered as a separate activity, constitute a rental activity (see example (8) and (ii) above). Accordingly, the automobile-leasing undertaking is treated as a rental undertaking, and the automobile selling-and-servicing undertaking is not.

(e) *Special rules for certain oil and gas operations*—(1) *Wells treated as nonpassive under §1.469–1T(e)(4)(i).* An oil or gas well shall be treated as an undertaking that is separate from other undertakings in determining the activities of a taxpayer for a taxable year if the following conditions are satisfied:

(i) The well is drilled or operated pursuant to a working interest (within the meaning of § 1.469–1T(e)(4)(iv)) and at any time during such taxable year the taxpayer holds such working interest either—

(A) Directly; or

(B) Through an entity that does not limit the liability of the taxpayer with respect to the drilling or operation of such well pursuant to such working interest; and

(ii) The taxpayer would not be treated as materially participating (within the meaning of § 1.469–5T) for the taxable year in the activity in which such well would be included if the taxpayer's activities were determined without regard to this paragraph (e).

(2) *Business and rental operations that constitute an undertaking.* In any case in which an oil or gas well is treated under this paragraph (e) as an undertaking that is separate from other undertakings, the business and rental operations that constitute such undertaking are the business and rental operations that are attributable to such well.

(3) *Examples.* The following examples illustrate the application of this paragraph (e). In each example, the taxpayer is an individual whose taxable year is the calendar year.

Example (1). During 1989, A directly owns an undivided interest in a working interest (within the meaning of § 1.469–1T(e)(4)(iv)) in two oil wells. A does not participate in the activity in which the wells would be included if A's activities were determined without regard to this paragraph (e). Under paragraph (e)(1) of this section, each well is treated as a separate undertaking in determining A's activities for 1989 because A holds the working interest directly and would not be treated as materially participating for 1989 in the activity in which the wells would be included if A's activities were determined without regard to this paragraph (e). The aggregation rules in paragraph (f) of this section do not apply to these undertakings (see paragraph (f)(1)(ii)(B) of this section). Thus, each of the undertakings is treated as a separate activity under paragraph (b)(1) of this section. The result is the same even if A has net income from one or both wells for 1989 and even if the wells would otherwise be treated as part of the same undertaking under paragraph (c) of this section. The result would also be the same if A held the working interest through an entity, such as a general partnership, that does not limit A's liability with respect to the drilling or operation of the wells pursuant to the working interest.

Example (2). (i) During 1989, B is a general partner in a partnership that owns a working interest (within the meaning of § 1.469–1T(e)(4)(iv)) in an oil well. B does not own any interest in the well other than through the partnership. At the end of 1989, however, B's partnership interest is converted into a limited partnership interest, and during 1990 B holds the working interest only as a limited partner. B does not participate in the activity in which the well would be included if B's activities were determined without regard to this paragraph (e).

(ii) Under paragraph (e)(1) of this section, the well is treated as a separate undertaking in determining B's activities for 1989 because B holds the working interest during 1989 through an entity that does not limit B's liability with respect to the drilling or operation of the well pursuant to the working interest, and B would not be treated as materially participating for 1989 in the activity in which the well would be included if B's activities were determined without regard to this paragraph (e). Throughout 1990, however, B's liability with respect to the drilling and operation of the well is limited by the entity through which B holds the working interest (*i.e.*, the limited partnership). Accordingly, paragraph (e)(1) of this section does not apply to the well in 1990, and the well may be included under paragraph (c) of this section in an undertaking that includes other operations.

Example (3). The facts are the same as in example (2), except that B's partnership interest is converted into a limited partnership interest at the end of November 1989. An oil or gas well may be treated as a separate undertaking under paragraph (e)(1) of this section if at any time during the taxable year the taxpayer holds a working interest in the well directly or through an entity that does not limit the taxpayer's liability with respect to the drilling or operation of the well pursuant to the working interest (see § 1.469–1T(e)(4)(i)). Thus, although B's liability with respect to the drilling and operation of the well is limited during December 1989, the result in both 1989 and 1990 is the same as in example (2). In 1989, however, disqualified deductions and a ratable portion of the gross income from the well may be treated under § 1.469–1T(e)(4)(ii) as passive activity deductions and passive activity gross income, respectively.

(f) *Certain trade or business undertakings treated as part of the same activity*—(1) *Applicability*—(i) *In general.* This paragraph (f) applies to a taxpayer's interests in trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section).

(ii) *Trade or business undertaking.* For purposes of this paragraph (f), the term ''trade or business undertaking'' means any undertaking in which a taxpayer has an interest, other than—

(A) A rental undertaking (within the meaning of paragraph (d) of this section);

(B) An oil or gas well treated as an undertaking that is separate from other undertakings under paragraph (e) of this section; or

(C) A professional service undertaking (within the meaning of paragraph (h) of this section).

(2) *Treatment as part of the same activity.* A taxpayer's interests in two or more trade or business undertakings that are similar (within the meaning of paragraph (f)(4) of this section) and controlled by the same interests (within the meaning of paragraph (j) of this section) shall be treated as part of the same activity of the taxpayer for any taxable year in which the taxpayer—

(i) Owns interests in each such undertaking through the same passthrough entity;

(ii) Owns a direct or substantial indirect interest (within the meaning of paragraph (f)(3) of this section) in each such undertaking; or

(iii) Materially or significantly participates (within the meaning of § 1.469–5T) in the activity that would result if such undertakings were treated as part of the same activity.

(3) *Substantial indirect interest*—(i) *In general.* For purposes of this paragraph (f), a taxpayer owns a substantial indirect interest in an undertaking for a taxable year if at any time during such taxable year the taxpayer's ownership percentage (determined in accordance with paragraph (j)(3) of this section) in a passthrough entity that directly owns such undertaking exceeds ten percent.

(ii) *Coordination rule.* A taxpayer shall be treated for purposes of this paragraph (f) as owning a substantial indirect interest in each of two or more undertakings for any taxable year in which—

(A) Such undertakings are treated as part of the same activity of the taxpayer under paragraph (f)(2)(i) of this section; and

(B) The taxpayer owns a substantial indirect interest (within the meaning of paragraph (f)(3)(i) of this section) in any such undertaking.

(4) *Similar undertakings*—(i) *In general.* Except as provided in paragraph (f)(4)(iii) of this section, two undertakings are similar for purposes of this paragraph (f) if and only if—

(A) There are predominant operations in each such undertaking; and

(B) The predominant operations of both undertakings are in the same line of business.

(ii) *Predominant operations.* For purposes of paragraph (f)(4)(i)(A) of this section, there are predominant operations in an undertaking if more than 50 percent of the undertaking's gross income is attributable to operations in a single line of business.

(iii) *Vertically-integrated undertakings.* If an undertaking (the ''supplier undertaking'') provides property or services to other undertakings (the ''recipient undertakings''), the following rules apply for purposes of this paragraph (f):

(A) *Supplier undertaking similar to recipient undertaking.* If the supplier undertaking predominantly involves the provision of property and services to a recipient undertaking that is controlled by the same interests (within the meaning of paragraph (j) of this section), the supplier undertaking shall be treated as similar to the recipient undertaking. For purposes of applying the preceding sentence—

(*1*) If a supplier undertaking and two or more recipient undertakings that are similar (within the meaning of paragraph (f)(4)(i) of this section) are controlled by the same interests, such recipient undertakings shall be treated as a single undertaking; and

(*2*) A supplier undertaking predominantly involves the provision of property and services to a recipient undertaking for any taxable year in which such recipient undertaking obtains more than 50 percent (by value) of all property and services provided by the supplier undertaking.

(B) *Recipient undertaking similar to supplier undertaking.* If the supplier undertaking is the predominant provider of property and services to a recipient undertaking that is controlled by the same interests (within the meaning of paragraph (j) of this section), the recipient undertaking shall be treated, except as otherwise provided in paragraph (f)(4)(iii)(C) of this section, as similar to the supplier undertaking. For purposes of the preceding sentence, a supplier undertaking is the predominant provider of property and services to a recipient undertaking for any taxable year in which the supplier undertaking provides more than 50 percent (by value) of all property and services obtained by the recipient undertaking.

(C) *Coordination rules.* (*1*) Paragraph (f)(4)(iii)(B) of this section does not apply if, under paragraph (f)(4)(iii)(A) of this section—

(*i*) The supplier undertaking is treated as an undertaking that is similar to any recipient undertaking;

(*ii*) The recipient undertaking is treated as a supplier undertaking that is similar to another recipient undertaking; or

(*iii*) Another supplier undertaking is treated as an undertaking that is similar to the recipient undertaking.

(*2*) If paragraph (f)(4)(iii)(A) of this section applies to a supplier undertaking, the supplier undertaking shall be treated as similar to undertakings that are similar to the recipient undertaking and shall not otherwise be treated as similar to undertakings to which the supplier undertaking would be similar without regard to paragraph (f)(4)(iii) of this section.

(*3*) If paragraph (f)(4)(iii)(B) of this section applies to a recipient undertaking, the recipient undertaking shall be treated as similar to undertakings that are similar to the supplier undertaking and shall not otherwise be treated as similar to undertakings to which the recipient undertaking would be similar without regard to paragraph (f)(4)(iii) of this section.

(iv) *Lines of business.* The Commissioner shall establish, by revenue procedure, lines of business for purposes of this paragraph (f)(4). Business and rental operations that are not included in the lines of business established by the Commissioner shall nonetheless be included in a line of business for purposes of this paragraph (f)(4). Such operations shall be included in a single line of business or in multiple lines of business on a basis that reasonably reflects—

(A) Similarities and differences in the property or services provided pursuant to such operations and in the markets to which such property or services are offered; and

(B) The treatment within the lines of business established by the Commissioner of operations that are comparable in their similarities and differences.

(5) *Examples.* The following examples illustrate the application of this paragraph (f). In each example that does not state otherwise, the taxpayer is an individual and the facts, analysis, and conclusions relate to a single taxable year.

Example (1). (i) The taxpayer is a partner in partnerships A, B, C, and D and owns a five-percent interest in each partnership. Each partnership owns a single undertaking (undertakings A, B, C, and D), and the undertakings are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that are controlled by the same interests (within the meaning of paragraph (j) of this section). In addition, undertakings A, B, and D are similar (within the meaning of paragraph (f)(4) of this section). The taxpayer is not related to any of the other partners, and does not participate in any of the undertakings.

(ii) In general, each undertaking in which a taxpayer owns an interest is treated as a single activity that is separate from other activities of the taxpayer (see paragraph (b)(1) of this section). This paragraph (f) provides aggregation rules for trade or business undertakings that are similar and controlled by the same interests. These aggregation rules do not apply, however, unless the taxpayer owns interests in the undertakings through the same passthrough entity, owns direct or substantial indirect interests in the undertakings, or materially or significantly participates in the undertakings. In this case, the taxpayer does not satisfy any of these conditions, and the aggregation rules in this paragraph (f) do not apply. Accordingly, except as otherwise provided in paragraph (g) of this section (relating to an aggregation rule for integrated businesses), undertakings A, B, C, and D are treated as separate activities of the taxpayer under paragraph (b)(1) of this section.

Example (2). (i) The facts are the same as in example (1), except that the taxpayer owns a 25-percent interest in partnership A, a 15-percent interest in partnership B, and a 40-percent interest in partnership C.

(ii) Paragraph (f)(2)(ii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns a direct or substantial indirect interest in each such undertaking. In this case, the taxpayer owns more than ten percent of partnerships A, B, and C, and these partnerships directly own undertakings A, B, and C. Thus, the taxpayer owns a substantial indirect interest in undertakings A, B, and C (see paragraph (f)(3)(i) of this section). Of these undertakings, only undertakings A and B are both similar and controlled by the same interests. Accordingly, the taxpayer's interests in undertakings A and B are treated as part of the same activity. As in example (1), the aggregation rules in this paragraph (f) do not apply to undertakings C and D, and except as otherwise provided in paragraph (g) of this section, undertakings C and D are treated as separate activities.

Example (3). (i) The facts are the same as in example (1), except that the taxpayer participates (within the meaning of § 1.469–5T(f)) for 60 hours in undertaking A and for 60 hours in undertaking B.

(ii) Paragraph (f)(2)(iii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer materially or significantly participates (within the meaning of § 1.469–5T) in the activity that would result from the treatment of similar, commonly-controlled undertakings as part of the same activity. In this case, the activity that would result from treating the similar, commonly-controlled undertakings as part of the same activity consists of undertakings A, B, and D, and the taxpayer participates for 120 hours in the activity that results from this treatment. Accordingly, undertakings A, B, and D are treated as part of the same activity because the taxpayer significantly participates (within the meaning of § 1.469–5T(c)(2)) in the activity that results from this treatment. The result is the same whether the taxpayer participates in one, two, or all three of the similar, commonly-controlled undertakings, so long as the taxpayer's aggregate participation in undertakings A, B, and D exceeds 100 hours. As in example (1), the aggregation rules in this paragraph (f) do not apply to undertaking C, and except as otherwise provided in paragraph (g) of this section, undertaking C is treated as a separate activity.

Example (4). (i) The taxpayer owns a 5-percent interest in partnership A. Partnership A owns interests in partnerships B and C, each of which owns a single undertaking (undertakings B and C). In addition, the taxpayer is a partner in partnerships C and D and directly owns a 15-percent interest in each partnership. Partnership D also owns a single undertaking (undertaking D). Undertakings B, C, and D are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that are similar (within the meaning of paragraph (f)(4) of this section) and controlled by the same interests (within the meaning of paragraph (j) of this section). The taxpayer does not participate in undertaking B, C, or D.

(ii) Paragraph (f)(2)(i) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns interests in the undertakings through the same passthrough entity. In this case, the taxpayer owns interests in undertakings B and C through partnership A. Thus, the taxpayer's interests in undertakings B and C are treated as part of the same activity.

(iii) Paragraph (f)(2)(ii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns a direct or substantial indirect interest in each such undertaking. In this case, the taxpayer owns more than ten percent of partnerships C and D, and these partnerships directly own undertakings C and D. Thus, the taxpayer owns a substantial indirect interest in undertakings C and D (see paragraph (f)(3)(i) of this section).

(iv) The coordination rule in paragraph (f)(3)(ii) of this section applies to undertakings B and C because they are treated as part of the same activity under paragraph (f)(2)(i) of this section, and the taxpayer owns a substantial indirect interest in undertaking C. Under the coordination rule, the taxpayer is treated as owning a substantial indirect interest in undertaking B as well as undertaking C. Accordingly, the taxpayer's interests in undertakings B, C, and D are treated as part of the same activity.

Example (5). (i) Undertakings A, B, C, and D are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section), each of which involves the operation of a department store, restaurants, and movie theaters. The following table shows, for each undertaking, the percentages of gross income attributable to the various operations of the undertaking.

	Department store	Restaurants	Movie Theaters
Undertaking A	70%	20%	10%
Undertaking B	60%	20%	20%
Undertaking C	35%	35%	30%

	Department store	Restaurants	Movie Theaters
Undertaking D	35%	10%	55%

(ii) Paragraph (f)(4)(i) of this section provides that two undertakings are similar for purposes of this paragraph (f) if and only if there are predominant operations in each undertaking and the predominant operations of the two undertakings are in the same line of business. (Assume that the applicable revenue procedure provides that ‘‘general merchandise stores,’’ ‘‘eating and drinking places,’’ and ‘‘motion picture services’’ are three separate lines of business.)

(iii) Undertaking A and undertaking B each derives more than 50 percent of its gross income from department-store operations, which are in the general-merchandise-store line of business. Thus, there are predominant operations in undertaking A and undertaking B, and the predominant operations of the two undertakings are in the same line of business. Accordingly, undertakings A and B are similar.

(iv) Undertaking C does not derive more than 50 percent of its gross income from operations in any single line of business. Thus, there are no predominant operations in undertaking C, and undertaking C is not similar to any of the other undertakings.

(v) Undertaking D derives more than 50 percent of its gross income from movie-theater operations, which are in the motion-picture-services line of business. Thus, there are predominant operations in undertaking D. The predominant operations of undertaking D, however, are not in the same line of business as those of undertakings A and B. Accordingly, undertaking D is not similar to undertakings A and B.

Example (6). (i) Undertakings A and B are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that derive all of their gross income from the sale of automobiles. Undertakings C and D derive all of their gross income from the rental of automobiles. Undertaking C is not a rental undertaking (within the meaning of paragraph (d)(1)(iii) of this section) because the average period of customer use (within the meaning of § 1.469–1T(e)(3)(iii)) for its automobiles does not exceed seven days (see § 1.469–1T(e)(3)(ii)(A)). Undertaking D, on the other hand, leases automobiles for periods of one year or more and is a rental undertaking.

(ii) Paragraph (f)(4)(i) of this section provides that two undertakings are similar for purposes of this paragraph (f) if and only if there are predominant operations in each undertaking and the predominant operations of the two undertakings are in the same line of business. (Assume that the applicable revenue procedure provides that (a) ‘‘automotive dealers and service stations’’ (automotive retail) and (b) ‘‘auto repair, services (including rentals), and parking’’ (automotive services) are two separate lines of business.)

(iii) Undertakings A and B both derive more than 50 percent of their gross income from operations in the automotive-retail line of business (the automobile-sales operations). Similarly, undertakings C and D both derive more than 50 percent of their gross income from operations in the automotive-services line of business (the automobile-rental operations). Thus, there are predominant operations in each undertaking, the predominant operations of undertakings A and B are in the same line of business, and the predominant operations of undertakings C and D are in the same line of business. Accordingly, undertakings A and B are similar, undertakings C and D are similar, and undertakings A and B are not similar to undertakings C and D.

(iv) Paragraph (f)(1) of this section provides that this paragraph (f) applies only to trade or business undertakings and that a rental undertaking is not a trade or business undertaking. Accordingly, this paragraph (f) does not apply to undertaking D, and undertakings C and D, although similar, are not treated, under this paragraph (f), as part of the same activity.

Example (7). (i) Undertakings A, B, and C are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that involve real estate operations. Undertaking A derives all of its gross income from the development of real property, undertaking B derives all of its gross income from the management of real property and the performance of services as a leasing agent with respect to real property, and undertaking C derives all of its gross income from buying, selling, or arranging purchases and sales of real property. Undertaking D derives all of its gross income from the rental of residential apartments and is a rental undertaking (within the meaning of paragraph (d)(1)(iii) of this section).

(ii) Paragraph (f)(4)(i) of this section provides that two undertakings are similar for purposes of this paragraph (f) if there are predominant operations in each undertaking and the predominant operations of the two undertakings are in the same line of business. (Assume that the applicable revenue procedure provides that real estate development and services (including the development and management of real property, dealing in real property, and the performance of services as a leasing agent with respect to real property) is a single line of business (the ‘‘real-estate’’ line of business).)

(iii) Undertakings A, B, and C all derive more than 50 percent of their gross income from operations in the real-estate line of business. Thus, there are predominant operations in undertakings A, B, and C, and the predominant operations of the three undertakings are in the same line of business. Accordingly, undertakings A, B, and C are similar.

(iv) Undertaking D also derives more than 50 percent of its gross income from operations in the real-estate line of business. Thus, there are predominant operations in undertaking D, and the predominant operations of undertaking D are in the same line of business as those of undertakings A, B, and C. Paragraph (f)(1) of this section provides, however, that this paragraph (f) applies only to trade or business undertakings and that a rental undertaking is not a trade or business undertaking. Accordingly, this paragraph (f) does not apply to undertaking D, and undertaking D, although similar to undertakings A, B, and C, is not treated, under this paragraph (f), as part an activity that includes undertaking A, B, or C.

Example (8). (i) Undertakings A and B are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section), both of which involve the provision of moving services. Undertaking A derives its gross income principally from local moves, and undertaking B derives its gross income principally from long-distance moves.

(ii) Paragraph (f)(4)(i) of this section provides that two undertakings are similar for purposes of this paragraph (f) if there are predominant operations in each undertaking and the predominant operations of the two undertakings are in the same line of business. Under paragraph (f)(4)(iv) of this section, operations that are not in the lines of business established by the applicable revenue procedure are nonetheless included in a line of business. In addition, such operations are included in a single line of business or in multiple lines of business on a basis that reasonably reflects (a) similarities and differences in the property or services provided pursuant to such operations and in the markets to which such property or services are offered, and (b) the treatment within the lines of business established by the Commissioner of operations that are comparable in their similarities and differences. (Assume that the provision of moving services is not in any line of business established by the Commissioner and that within the lines of business established by the Commissioner services that differ only in the distance over which they are performed (*e.g.*, local and long-distance telephone services) are generally treated as part of the same line of business.)

(iii) Undertakings A and B provide the same types of services to similar customers, and the only significant difference in the services provided is the distance over which they are performed. Thus, treating local and long-distance moving services as a single line of business (the ‘‘moving-services’’ line of business) reasonably reflects the treatment within the lines of business established by the Commissioner of operations that are comparable in their similarities and differences.

(iv) Each undertaking derives more than 50 percent of its gross income from operations in the moving-services line of business. Thus, there are predominant operations in each undertaking, and the predominant operations of the two undertakings are in the same line of business. Accordingly, undertakings A and B are similar.

Example (9). (i) Undertakings A, B, C, D, and E are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) and are controlled by the same interests (within the meaning of paragraph (j) of this section). Undertakings A, B, and C derive all of their gross income from retail sales of dairy products, and undertakings D and E derive all of their gross income from the processing of dairy products. Undertakings D and E sell less than ten percent of their dairy products to undertakings A, B, and C, and sell the remainder to unrelated undertakings. Undertakings A, B, and C purchase less than ten percent of their inventory from undertakings D and E and purchase the remainder from unrelated undertakings.

(ii) Paragraph (f)(4)(i) of this section provides that, except as provided in paragraph (f)(4)(iii) of this section, undertakings are similar for purposes of this paragraph (f) if and only if there are predominant operations in each undertaking and the predominant operations of the undertakings are in the same line of business. (Assume that the applicable revenue procedure provides that (a) ‘‘food stores’’ and (b) ‘‘manufacturing—food and kindred products’’ are two separate lines of business.)

(iii) Undertakings A, B, and C all derive more than 50 percent of their gross income from operations in the food-store line of business (the dairy-sales operations). Thus, there are predominant operations in undertakings A, B, and C, and the predominant operations of the three undertakings are in the same line of business. Accordingly, undertakings A, B, and C are similar.

(iv) Undertakings D and E both derive more than 50 percent of their gross income from operations in the food-manufacturing line of business (the dairy-processing operations). Thus, there are predominant operations in undertakings D and E, and the predominant operations of the two undertakings are in the same line of business. Accordingly, undertakings D and E are similar. The predominant operations of undertakings D and E are not in the same line of business as those of undertakings A, B, and C. Accordingly, undertakings D and E are not similar to undertakings A, B, and C.

(v) Paragraph (f)(4)(iii) of this section provides rules under which certain undertakings whose operations are not in the same line of business nevertheless are similar to one another if one of the undertakings (the ''supplier undertaking'') provides property or services to the other undertaking (the ''recipient undertaking''), and the undertakings are controlled by the same interests. These rules apply, however, only if the supplier undertaking predominantly involves the provision of property and services to the recipient undertaking (see paragraph (f)(4)(iii)(A) of this section), or the supplier undertaking is the predominant provider of property and services to the recipient undertaking (see paragraph (f)(4)(iii)(B) of this section). In this case, undertakings D and E are supplier undertakings, and undertakings A, B, and C are recipient undertakings. Undertakings D and E, however, sell less than ten percent of their dairy products to undertakings A, B, and C and thus do not predominantly involve the provision of property and services to recipient undertakings. Similarly, undertakings D and E are not the predominant providers of property and services to undertakings A, B, and C. Thus, the rules for vertically-integrated undertakings in paragraph (f)(4)(iii) of this section do not apply in this case.

Example (10). (i) The facts are the same as in example (9), except that undertaking D sells 75 percent of its dairy products to undertakings A, B, and C.

(ii) Paragraph (f)(4)(iii)(A) of this section applies if a supplier undertaking predominantly involves the provision of property to a recipient undertaking that is controlled by the same interests. Paragraph (f)(4)(iii)(A)(*2*) of this section provides that a supplier undertaking predominantly involves the provision of property to a recipient undertaking if the supplier undertaking provides more than 50 percent of its property to such recipient undertaking. In addition, paragraph (f)(4)(iii)(A)(*1*) of this section provides that if a supplier undertaking and two or more similar recipient undertakings are controlled by the same interests, the recipient undertakings are treated as a single undertaking for purposes of applying paragraph (f)(4)(iii)(A) of this section. Undertakings D and E both provide dairy products to undertakings A, B, and C. Thus, for purposes of paragraph (f)(4)(iii) of this section, undertakings D and E are supplier undertakings and undertakings A, B, and C are recipient undertakings. Undertaking D predominantly involves the provision of property to undertakings A, B, and C. Moreover, undertakings A, B, and C are treated as a single undertaking under paragraph (f)(4)(iii)(A)(*1*) of this section because undertakings A, B, and C are similar to one another under paragraph (f)(4)(i) of this section, and undertakings A, B, C, and D are controlled by the same interests. Accordingly, paragraph (f)(4)(iii)(A) of this section applies to undertakings A, B, C, and D.

(iii) If paragraph (f)(4)(iii)(A) of this section applies to supplier and recipient undertakings, the supplier undertaking is treated under paragraph (f)(4)(iii) (A) and (C)(*2*) of this section as an undertaking that is similar to the recipient undertakings and to undertakings to which the recipient undertakings are similar. Accordingly, undertaking D is similar, for purposes of this paragraph (f), to undertakings A, B, and C.

(iv) Undertaking E does not predominantly involve the provision of property to undertakings A, B, and C, or to any other related undertakings. Thus, paragraph (f)(4)(iii)(A) of this section does not apply to undertaking E, and undertaking E is not similar to undertakings A, B, and C. Moreover, undertakings D and E are not similar because, under paragraph (f)(4)(iii)(C)(*2*) of this section, undertaking D is not similar to any undertaking that is not similar to undertakings A, B, and C.

Example (11). (i) The facts are the same as in example (10), except that 75 percent of undertaking D's dairy products are sold to undertakings A and B, and none are sold to undertaking C.

(ii) In this case, undertaking D is a supplier undertaking only with respect to undertakings A and B. Accordingly, paragraph (f)(4)(iii)(A) applies only to undertakings A, B, and D. As in example (10), undertaking D is similar to undertakings A and B, and is not similar to undertaking E. In addition, if paragraph (f)(4)(iii)(A) of this section applies to supplier and recipient undertakings, the supplier undertaking is treated under paragraph (f)(4)(iii)(C)(*2*) of this section as an undertaking that is similar to the recipient undertakings and undertakings to which the recipient undertakings are similar. Accordingly, even though undertaking D does not provide any property or services to undertaking C, undertaking D is similar to undertaking C because undertaking C is similar to undertakings A and B.

Example (12). (i) The facts are the same as in example (9), except that undertakings A and B purchase 80 percent of their inventory from undertaking D.

(ii) Paragraph (f)(4)(iii)(B) of this section applies, except as provided in paragraph (f)(4)(iii)(C) of this section, if a supplier undertaking is the predominant provider of property to a recipient undertaking that is controlled by the same interests. Undertakings D and E both provide dairy products to undertakings A, B, and C. Thus, for purposes of paragraph (f)(4)(iii) of this section, undertakings D and E are supplier undertakings, and undertakings A, B, and C are recipient undertakings. In addition, undertaking D is the predominant provider of property and services to undertakings A and

B, and undertakings A, B and D are controlled by the same interests. Thus, except as provided in paragraph (f)(4)(iii)(C) of this section, paragraph (f)(4)(iii)(B) of this section applies to undertakings A, B, and D.

(iii) The coordination rules in paragraph (f)(4)(iii)(C)(*1*) of this section provide that paragraph (f)(4)(iii)(B) of this section does not apply in certain cases to which paragraph (f)(4)(iii)(A) of this section applies. These coordination rules would apply if undertaking D or E (or any other undertaking that is controlled by the interests that control undertakings A, B, and C) predominantly involved the provision of property and services to undertakings A, B, and C. The coordination rules in paragraph (f)(4)(iii)(C)(*1*) of this section would also apply if undertaking A, B, or D predominantly involved the provision of property or services to a recipient undertaking that is controlled by the same interests. Assume that these coordination rules do not apply in this case.

(iv) If paragraph (f)(4)(iii)(B) of this section applies to supplier and recipient undertakings, the recipient undertakings are treated under paragraph (f)(4)(iii) (B) and (C)(*3*) of this section as undertakings that are similar to the supplier undertaking and to undertakings to which the supplier undertaking is similar. Accordingly, undertakings A and B are similar, for purposes of this paragraph (f), to undertaking D and, because undertakings D and E are similar, to undertaking E.

(v) The principal providers of property and services to undertaking C are unrelated undertakings. Thus, paragraph (f)(4)(iii)(B) of this section does not apply to undertaking C, and undertaking C is not similar to undertakings D and E. Moreover, undertaking C is not similar to undertakings A and B because, under paragraph (f)(4)(iii)(C)(*3*) of this section, undertakings A and B are not similar to any undertaking that is not similar to undertaking D.

Example (13). (i) Undertakings A through Z are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) and are controlled by the same interests (within the meaning of paragraph (j) of this section). Undertaking A derives all of its gross income from the manufacture and sale of men's and women's clothing, undertaking B derives all of its gross income from sales of men's and women's clothing to retail stores, and undertakings C through Z derive all of their gross income from retail sales of men's and women's clothing. Undertaking A sells clothing exclusively to undertaking B. Undertaking B sells 75 percent of its clothing to undertakings C through Z, and sells the remainder to unrelated retail stores. Undertaking B purchases 80 percent of its inventory from undertaking A, and undertakings C through Z purchase 60 to 90 percent of their inventory from undertaking B.

(ii) Paragraph (f)(4)(iii)(A) of this section applies if a supplier undertaking predominantly involves the provision of property to a recipient undertaking that is controlled by the same interests. In addition, paragraph (f)(4)(iii)(A)(*1*) of this section provides that if a supplier undertaking and two or more similar recipient undertakings are controlled by the same interests, the recipient undertaking are treated as a single undertaking for this purpose. Undertaking B provides men's and women's clothing to undertaking C through Z. Thus, for purposes of paragraph (f)(4)(iii) of this section, undertaking B is a supplier undertaking and undertakings C through Z are recipient undertakings. In addition, undertaking B predominantly involves the provision of property to undertakings C through Z, and undertakings C through Z are treated as a single undertaking for purposes of paragraph (f)(4)(iii)(A) of this section. Accordingly, paragraph (f)(4)(iii)(A) of this section applies to undertakings B and C through Z.

(iii) If paragraph (f)(4)(iii)(A) of this section applies to supplier and recipient undertakings, the supplier undertaking is treated under paragraph (f)(4)(iii)(A) of this section as an undertaking that is similar to the recipient undertakings. Accordingly, undertaking B is similar, for purposes of this paragraph (f), to undertakings C through Z.

(iv) Undertaking A provides men's and women's clothing to undertaking B. Thus, for purposes of paragraph (f)(4)(iii) of this section, undertaking A is a supplier undertaking and undertaking B is a recipient undertaking. In addition, undertaking A predominantly involves the provision of property to undertaking B, and undertakings A and B are controlled by the same interests. Accordingly, paragraph (f)(4)(iii)(A) of this section applies to undertakings A and B, and undertaking A is similar to undertaking B.

(v) If paragraph (f)(4)(iii)(A) of this section applies to supplier and recipient undertakings, the supplier undertaking is treated under paragraph (f)(4)(iii)(C)(*2*) of this section as an undertaking that is similar to undertakings to which the recipient undertakings are similar. Accordingly, undertaking A is also similar, for purposes of this paragraph (f), to undertakings C through Z.

(vi) The coordination rule in paragraph (f)(4)(iii)(C)(*1*)(*i*) of this section provides that paragraph (f)(4)(iii)(B) of this section does not apply if, as described above, the supplier undertaking predominantly involves the provision of property to recipient undertakings and is treated under paragraph (f)(4)(iii)(A) of this section as an undertaking that is similar to such recipient undertakings. Accordingly, paragraph (f)(4)(iii)(B) of this section does not apply to undertakings B through Z, even though undertaking B is the predominant provider of property and services to undertakings C through Z, and undertakings B through Z are controlled by the same interests. For the same reason, paragraph (f)(4)(iii)(B) of this section does not apply to undertaking A and B. (Paragraph (f)(4)(iii)(B) of this section is also inapplicable to undertakings A and B because the coordination rule in paragraph (f)(4)(iii)(C)(*1*)(*ii*) of this section applies if the recipient undertaking (undertaking B) is itself a supplier undertaking that is treated under paragraph (f)(4)(iii)(A) of this section as an undertaking that is similar to its recipient undertakings (undertakings C through Z).)

(g) *Integrated businesses*—(1) *Applicability*—(i) *In general.* This paragraph (g) applies to a taxpayer's interests in trade or business activities (within the meaning of paragraph (g)(1)(ii) of this section).

(ii) *Trade or business activity.* For purposes of this paragraph (g), the term ''trade or business activity'' means any activity (determined without regard to this paragraph (g)) that consists of interests in one or more trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section).

(2) *Treatment as a single activity.* A taxpayer's interests in two or more trade or business activities shall be treated as a single activity if and only if—

(i) The operations of such trade or business activities constitute a single integrated business, activities constitute a single integrated business; and

(ii) Such activities are controlled by the same interests (within the meaning of paragraph (j) of this section).

(3) *Facts and circumstances test.* In determining whether the operations of two or more trade or business activities constitute a single integrated business for purposes of this paragraph (g), all the facts and circumstances are taken into account, and the following factors are generally the most significant:

(i) Whether such operations are conducted at the same location;

(ii) The extent to which other persons conduct similar operations at one location;

(iii) Whether such operations are treated as a unit in the primary accounting records reflecting the results of such operations;

(iv) The extent to which other persons treat similar operations as a unit in the primary accounting records reflecting the results of such similar operations;

(v) Whether such operations are owned by the same person (within the meaning of paragraph (c)(2)(v) of this section);

(vi) The extent to which such operations involve products or services that are commonly provided together;

(vii) The extent to which such operations serve the same customers;

(viii) The extent to which the same personnel, facilities, or equipment are used to conduct such operations;

(ix) The extent to which such operations are conducted in coordination with or reliance upon each other;

(x) The extent to which the conduct of any such operations is incidental to the conduct of the remainder of such operations;

(xi) The extent to which such operations depend on each other for their economic success; and

(xii) Whether such operations are conducted under the same trade name.

(4) *Examples.* The following examples illustrate the application of this paragraph (g). The facts, analysis, and conclusion in each example relate to a single taxable year, and the trade or business activities described in each example are controlled by the same interests (within the meaning of paragraph (j) of this section).

Example (1). (i) The taxpayer owns a number of department stores and auto-supply stores. Some of the taxpayer's department stores include auto-supply departments. In other cases, the taxpayer operates a department store and an auto-supply store at the same location (within the meaning of paragraph (c)(2)(iii) of this section), or at different locations from which the same group of customers can be served. In cases in which a department store and an auto-supply store are operated at the same location, the department-store operations are the predominant operations (within the meaning of paragraph (f)(4)(ii) of this section), and the undertaking that includes the stores is treated as a department-store undertaking for purposes of paragraph (f) of this section. Under paragraph (f) of this section, the department-store undertakings are all treated as part of the same activity of the taxpayer (the ''department-store activity''). Similarly, the auto-supply undertakings (*i.e.*, the auto-supply stores that are not operated at a department-store location) are all treated as part of the same activity (the ‘‘auto-supply activity’’). (Assume that department-store undertakings and auto-supply undertakings are not similar and are not treated as part of the same activity under paragraph (f) of this section.)

(ii) The department stores and auto-supply stores use a common trade name and coordinate their marketing activities (*e.g.*, the stores advertise in the same catalog and the same newspaper supplements, honor the same credit cards (including credit cards issued by the department stores), and jointly conduct sales and other promotional activities). Although sales personnel generally work only in a particular store or in a particular department within a store, other employees (*e.g.*, cashiers, janitorial and maintenance workers, and clerical staff) may work in or perform services for various stores, including both department and auto-supply stores. In addition, the management of store operations is organized on a geographical basis, and managers above the level of the individual store generally supervise operations in both types of store. A central office provides payroll, financial, and other support services to all stores and establishes pricing and other business policies. Most inventory for both types of stores is acquired through a central purchasing department and inventory for all stores in an area is stored in a common warehouse.

(iii) Based on the foregoing facts and circumstances, the operations of the department-store activity and the auto-supply activity constitute an integrated business. Paragraph (g)(3) of this section provides that the factors relevant to this determination include the conduct of department-store and auto-supply operations at the same location, the location of department and auto-supply stores at sites where the same group of customers can be served, the treatment of all such operations as a unit in the taxpayer’s financial statements, the taxpayer’s ownership and the common management of all such operations, the use of the same personnel, facilities, and equipment to conduct and support the operations, the use of a common trade name, and the coordination (as evidenced by the coordinated marketing activities) of department-store and auto-supply operations.

(iv) Paragraph (g)(2) of this section provides that a taxpayer’s interests in two or more trade or business activities (within the meaning of paragraph (g)(1)(ii) of this section) are treated as a single activity of the taxpayer if the operations of such activities constitute an integrated business and the activities are controlled by the same interests. The department-store activity and the auto-supply activity consist of trade or business undertakings and, thus, are trade or business activities. In addition, the activities are controlled by the same interests (the taxpayer), and the operations of the activities constitute an integrated business. Accordingly, the department-store activity and the auto-supply activity are treated as a single activity of the taxpayer.

Example (2). (i) The taxpayer owns a number of stores that sell stereo equipment and a repair shop that services stereo equipment. Under paragraph (f) of this section, the stores are all treated as part of the same activity of the taxpayer (the ‘‘store activity’’). The repair shop does not sell stereo equipment, does not predominantly involve the provision of services to the taxpayer’s stores, and is treated as a separate activity (the ‘‘repair-shop activity’’). (Assume that stereo-sales undertakings and stereo-repair undertakings are not similar and are not treated as part of the same activity under paragraph (f) of this section.)

(ii) The stores sell stereo equipment produced by manufacturers for which the stores are an authorized distributor. The repair shop’s operations principally involve the servicing of stereo equipment produced by the same manufacturers. These operations include repairs on equipment under warranty for which reimbursement is received from the manufacturer and reconditioning of equipment taken as trade-ins by the taxpayer’s stores. The majority of the operations, however, involve repairs that are performed for customers and are not covered by a warranty. The taxpayer’s distribution agreements with manufacturers generally require the taxpayer to repair and service equipment produced by the manufacturer both during and after the warranty period. In some cases, the distribution agreements require that the taxpayer’s repair facility meet the manufacturer’s standards and provide for periodic inspections to ensure that these standards are met.

(iii) The stores and the repair shop use a common trade name. Sales personnel generally work only in a particular store and stereo technicians work only in the repair shop. The stores and the repair shop are, however, managed from a central office, which supervises both store and repair-shop operations, provides payroll, financial, and other support services to the stores and the repair shop, and establishes pricing and other business policies. In addition, inventory for the stores and supplies for the repair shop are acquired through a central purchasing department and are stored in a single warehouse.

(iv) Based on the foregoing facts and circumstances, the operations of the store activity and the repair-shop activity constitute an integrated business. Paragraph (g)(3) of this section provides that the factors relevant to this determination include the treatment of all such operations as a unit in the taxpayer's financial statements, the taxpayer's ownership and the common management of all such operations, the use of the same personnel and facilities to support the operations, the use of a common trade name, the extent to which the same customers patronize both the stores and the repair shop, the similarity of the products (*i.e.*, stereo equipment) involved in both store and repair-shop operations, and the extent to which the provision of repair services contributes to the taxpayer's ability to obtain the stereo equipment sold in store operations.

(v) Paragraph (g)(2) of this section provides that a taxpayer's interests in two or more trade or business activities (within the meaning of paragraph (g)(1)(ii) of this section) are treated as a single activity of the taxpayer if the operations of such activities constitute an integrated business and the activities are controlled by the same interests. The store activity and repair-shop activity consist of trade or business undertakings and thus are trade or business activities. In addition, the activities are controlled by the same interests (the taxpayer), and the operations of the activities constitute an integrated business. Accordingly, the store activity and the repair-shop activity are treated as a single activity of the taxpayer.

Example (3). (i) The taxpayer owns interests in three partnerships. One partnership owns a television station, the second owns a professional sports franchise, and the third owns a motion-picture production company. The operations of the partnerships are treated as three separate undertakings. Although other persons own interests in the partnerships, all three undertakings are controlled (within the meaning of paragraph (j) of this section) by the taxpayer. The operations of the partnerships are treated as three separate activities (the ''television activity,'' the ''sports activity,'' and the ''motion-picture activity''). (Assume that the undertakings are not similar and are not treated as part of the same activity under paragraph (f) of this section.)

(ii) Each partnership prepares financial statements that reflect only the results of that partnership's operations, and each of the activities is conducted under its own trade name. The taxpayer participates extensively in the management of each partnership and makes the major business decisions for all three partnerships. Each partnership, however, employs separate management and other personnel who conduct its operations on a day-to-day basis. The taxpayer generally arranges the partnerships' financing and often obtains loans for two, or all three, partnerships from the same source. Although the assets of one partnership are not used as security for loans to another partnership, the taxpayer's interest in a partnership may secure loans to the other partnerships. The television station broadcasts the sports franchise's games, and the motion-picture production company occasionally prepares programming for the television station. In addition, support staff of one partnership may, during periods of peak activity or in the case of emergency, be made available to another partnership on a temporary basis. There are no other significant transactions between the partnerships. Moreover, all transactions between the partnerships involve essentially the same terms as would be provided in transactions between unrelated persons.

(iii) Based on the foregoing facts and circumstances, the television activity, the sports activity, and the motion-picture activity constitute three separate businesses. Paragraph (g)(3) of this section provides that the factors relevant to this determination include the treatment of the activities as separate units in the partnerships' financial statements, the use of a different trade name for each activity, the separate day-to-day management of the activities, and the limited extent to which the activities contribute to or depend on each other (as evidenced by the small number of significant transactions between the partnerships and the arm's length nature of those transactions). The taxpayer's participation in management and financing are taken into account in this determination, as are the transactions between the partnerships, but these factors do not of themselves support a determination that the activities constitute an integrated business.

(iv) Paragraph (g)(2) of this section provides that a taxpayer's interests in two or more trade or business activities (within the meaning of paragraph (g)(1)(ii) of this section) are treated as a single activity of the taxpayer only if the operations of such activities constitute an integrated business and the activities are controlled by the same interests. In this case, the taxpayer's activities do not constitute an integrated business, and the aggregation rule in paragraph (g)(2) of this section does not apply. Accordingly, the television activity, the sports activity, and the motion-picture activity are treated as three separate activities of the taxpayer.

(h) *Certain professional service undertakings treated as a single activity*—(1) *Applicability*—(i) *In general.* This paragraph (h) applies to a taxpayer's interests in professional service undertakings (within the meaning of paragraph (h)(1)(ii) of this section).

(ii) *Professional service undertaking.* For purposes of this paragraph (h), an undertaking is treated as a professional service undertaking for any taxable year in which the undertaking derives more than 50 percent of its gross income from the provision of services that are treated, for purposes of section 448 (d)(2)(A) and the regulations thereunder, as services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

(2) *Treatment as a single activity*—(i) *Undertakings controlled by the same interest.* A taxpayer's interests in two or more professional service undertakings that are controlled by the same interests (within the meaning of paragraph (j) of this section) shall be treated as part of the same activity of the taxpayer.

(ii) *Undertakings involving significant similar or significant related services.* A taxpayer's interests in two or more professional service undertakings that involve the provision of significant similar services or significant related services shall be treated as part of the same activity of the taxpayer.

(iii) *Coordination rule.* (A) Except as provided in paragraph (h)(2)(iii)(B) of this section, a taxpayer's interests in two or more undertakings (the ‘‘original undertakings'') that are treated as part of the same activity of the taxpayer under the provisions of paragraph (h)(2) (i) or (ii) of this section shall be treated as interests in a single professional service undertaking (the ‘‘aggregated undertaking'') for purposes of reapplying such provisions.

(B) If any original undertaking included in an aggregated undertaking and any other undertaking that is not included in such aggregated undertaking involve the provision of significant similar or related services, the aggregated undertaking and such other undertaking shall be treated as undertakings that involve the provision of significant similar or related services for purposes of reapplying the provisions of paragraph (h)(2)(ii) of this section.

(3) *Significant similar or significant related services.* For purposes of this paragraph (h)—

(i) Services (other than consulting services) in any field described in paragraph (h)(1)(ii) of this section are similar to all other services in the same field;

(ii) All the facts and circumstances are taken into account in determining whether consulting services are similar;

(iii) Two professional service undertakings involve the provision of significant similar services if and only if—

(A) Each such undertaking provides significant professional services; and

(B) Significant professional services provided by one such undertaking are similar to significant professional services provided by the other such undertaking;

(iv) Services are significant professional services if and only if such services are in a field described in paragraph (h)(1)(ii) of this section and more than 20 percent of the undertaking's gross income is attributable to services in such field (or, in the case of consulting services, to similar services in such field); and

(v) Two professional service undertakings involve the provision of significant related services if and only if more than 20 percent of the gross income of one such undertaking is derived from customers that are also customers of the other such undertaking.

(4) *Examples.* The following examples illustrate the application of this paragraph (h). In each example that does not state otherwise, the taxpayer is an individual, and the facts, analysis, and conclusions relate to a single taxable year.

Example (1). (i) The taxpayer is a partner in a law partnership that has offices in various cities. Some of the partnership's offices provide a full range of legal services. Other offices, however, specialize in a particular area or areas of the law (*e.g.*, litigation, tax law, corporate law, *etc.*). In either case, substantially all of the office's gross income is derived from the provision of legal services. Under paragraph (c)(1) of this section, each of the law partnership's offices is treated as a single undertaking that is separate from other undertakings (a ‘‘law-office undertaking'').

(ii) Each law-office undertaking derives more than 50 percent of its gross income from the provision of services in the field law. Thus, each such undertaking is treated as a professional service undertaking (within the meaning of paragraph (h)(1)(ii) of this section).

(iii) Each law-office undertaking derives more than 20 percent of its gross income from services in the field of law. Thus, each such undertaking involves significant professional services (within the meaning of paragraph (h)(3)(iv) of this section) in the field of law. In addition, all services in the field of law are treated as similar services under paragraph (h)(3)(i) of this section. Thus, the law-office undertakings involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section).

(iv) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interest in professional service undertakings that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. Accordingly, the taxpayer's interests in the law-office undertakings are treated as part of the same activity of the taxpayer under paragraph (h)(2)(ii) of this section even if the undertakings are not controlled by the same interests (within the meaning of paragraph (j) of this section).

Example (2). (i) The taxpayer is a partner in medical partnerships A and B. Both partnerships derive all of their gross income from the provision of medical services, but partnership A specializes in internal medicine and partnership B operates a radiology laboratory. Under paragraph (c)(1) of this section, the medical-service business of each partnership is treated as a single undertaking that is separate from other undertakings (a ''medical-service undertaking''). Partnerships A and B are not controlled by the same interests (within the meaning of paragraph (j) of this section).

(ii) Each partnership's medical-service undertaking derives more than 50 percent of its gross income from the provision of services in the field of health. Thus, each partnership's medical-service undertaking is treated as a professional service undertaking (within the meaning of paragraph (h)(1)(ii) of this section).

(iii) Each partnership's medical-service undertaking derives more than 20 percent of its gross income from services in the field of health. Thus, each such undertaking involves significant professional services (within the meaning of paragraph (h)(3)(iv) of this section) in the field of health. In addition, all services in the field of health are treated as similar services under paragraph (h)(3)(i) of this section. Thus, the medical-services undertakings of partnerships A and B involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section).

(iv) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. Accordingly, the taxpayer's interests in the medical-service undertakings of partnerships A and B are treated as part of the same activity of the taxpayer under paragraph (h)(2)(ii) of this section even though the undertakings are not controlled by the same interests.

Example (3). (i) The facts are the same as in example (2), except that the taxpayer withdraws from partnership A in 1989 and becomes a partner in partnership B in 1990. In addition, the taxpayer was a full-time participant in the operations of partnership A from 1970 through 1989, but does not participate in the operations of partnership B.

(ii) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. This rule is not limited to cases in which the taxpayer holds such interests simultaneously. Thus, as in example (2), the taxpayer's interests in the medical-service undertakings of partnerships A and B are treated as part of the same activity of the taxpayer.

(iii) The activity that includes the taxpayer's interests in the medical-service undertakings of partnerships A and B is a personal service activity (within the meaning of § 1.469–5T(d)) because it involves the performance of personal services in the field of health. In addition, the taxpayer materially participated in the activity for three or more taxable years preceding 1990 (see § 1.469–5T(j)(1)). Thus, even if the taxpayer does not work in the activity after 1989, the taxpayer is treated, under § 1.469–5T(a)(6), as materially participating in the activity for 1990 and subsequent taxable years.

Example (4). (i) The taxpayer is a partner in an accounting partnership that has offices in various cities (partnership A) and in a management-consulting partnership that has a single office (partnership B). Each of partnership A's offices derives substantially all of its gross income from services in the field of accounting, and partnership B derives substantially all of its gross income from services in the field of consulting. Under paragraph (c)(1) of this section, partnership B's consulting business is treated as a single undertaking that is separate from other undertakings (the ''consulting undertaking'') and each of partnership A's offices is similarly treated (the ''accounting undertakings''). The accounting undertakings are controlled by the same interests, but partnerships A and B are not controlled by the same interests (within the meaning of paragraph (j) of this section). Partnership B's consulting business derives 50 percent of its gross income from customers of partnership A's accounting undertakings, but does not derive more than 20 percent of its gross income from the customers of any single accounting undertaking.

(ii) Each accounting undertaking derives more than 50 percent of its gross income from the provision of services in the field of accounting, and the consulting undertaking derives more than 50 percent of its gross income from the provision of services in the field of consulting. Thus, each accounting undertaking is treated as a professional service undertaking (within the meaning of paragraph (h)(1)(ii) of this section), and the consulting undertaking is also treated as a professional service undertaking.

(iii) Each accounting undertaking derives more than 20 percent of its gross income from services in the field of accounting. Thus, each such undertaking involves significant professional services (within the meaning of paragraph (h)(3)(iv) of this section) in the field of accounting. In addition, all services in the field of accounting are treated as similar services under paragraph (h)(3)(i) of this section. Thus, the accounting undertakings involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section).

(iv) Paragraph (h)(2) (i) and (ii) of this section provides that a taxpayer's interests in professional service undertakings that are controlled by the same interests or that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. The accounting undertakings are controlled by the same interests (see (i) above) and involve the provision of significant similar services (see (iii) above). Accordingly, the taxpayer's interests in the accounting undertakings are treated as part of the same activity under paragraph (h)(2) (i) and (ii) of this section.

(v) The consulting undertaking derives more than 20 percent of its gross income from services in the field of consulting. If, based on all the facts and circumstances, these services are determined to be similar consulting services under paragraph (h)(3)(ii) of this section, the consulting undertaking involves significant professional services (within the meaning of paragraph (h)(3)(iv) of this section). In this case, however, the consulting undertaking and the accounting undertakings do not involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section) because consulting services and accounting services are not treated as similar services under paragraph (h)(3)(i) of this section.

(vi) The consulting undertaking does not derive more than 20 percent of its gross income from the customers of any single accounting undertaking of partnership A. If, however, partnership A's accounting undertakings are aggregated, the consulting undertaking derives more than 20 percent of its gross income from customers of the aggregated undertakings. Paragraph (h)(3)(v) of this section provides that two professional service undertakings involve the provision of significant related services if more than 20 percent of the gross income of one undertaking is derived from customers of the other undertaking. For purposes of applying this rule, partnership A's accounting undertakings are treated as a single undertaking under paragraph (h)(2)(iii) of this section because the accounting undertakings are treated as part of the same activity under paragraph (h)(2)(i) and (ii) of this section. Thus, the consulting undertaking and the accounting undertakings involve the provision of significant related services.

(vii) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant related services are treated as part of the same activity of the taxpayer. Accordingly, the taxpayer's interests in the consulting undertaking and the accounting undertakings are treated as part of the same activity of the taxpayer under paragraph (h)(2)(ii) of this section.

Example (5). (i) The facts are the same as in example (4), except that partnership B's consulting business derives only 15 percent of its gross income from customers of partnership A's accounting undertakings.

(ii) As in example (4), the taxpayer's interests in the accounting undertakings are treated as part of the same activity under paragraph (h)(2)(i) and (ii) of this section and are treated under paragraph (h)(2)(iii) of this section as a single undertaking for purposes of reapplying those provisions. In this case, however, the consulting undertaking does not derive more than 20 percent of its gross income from the customers of partnership A's accounting undertakings. Thus, the consulting undertaking and the accounting undertakings do not involve the provision of significant related services. Accordingly, the accounting undertakings and the consulting undertaking are not treated as part of the same activity under paragraph (h)(2)(i) or (ii) of this section because they are not controlled by the same interests and do not involve the provision of significant similar or related services.

Example (6). (i) The taxpayer is a partner in partnerships A, B, and C. Partnership A derives substantially all of its gross income from the provision of engineering services, partnership B derives substantially all of its gross income from the provision of architectural services, and partnership C derives 40 percent of its gross income from the provision of engineering services and the remainder from the provision of architectural services. Under paragraph (c)(1) of this section, each partnership's service business is treated as a single undertaking that is separate from other undertakings. Partnerships A, B, and C are not controlled by the same interests (within the meaning of paragraph (j) of this section).

(ii) Each partnership's undertaking derives more than 50 percent of its gross income from the provision of services in the fields of architecture and engineering. Thus, each such undertaking is treated as a professional service undertaking (within the meaning of paragraph (h)(1)(ii) of this section).

(iii) Partnership A's undertaking (''undertaking A'') derives more than 20 percent of its gross income from services in the field of engineering, partnership B's undertaking (''undertaking B'') derives more than 20 percent of its gross income from services in the field of architecture, and partnership C's undertaking (''undertaking C'') derives more than 20 percent of its gross income from services in the field of engineering and more than 20 percent of its gross income from services in the field of architecture. Thus, undertaking A involves significant services in the field of engineering, undertaking B involves significant services in the field of architecture, and undertaking C involves significant services in both fields. Under paragraph (h)(3)(i) of this section, all services within each field are treated as similar services, but engineering services and architectural services are not treated as similar services. Thus, undertakings A and C, and undertakings B and C, involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section).

(iv) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. Accordingly, the taxpayer's interests in undertakings A and C are treated as part of the same activity of the taxpayer.

(v) Under paragraph (h)(2)(iii)(A) of this section, undertakings A and C are also treated as a single undertaking for purposes of determining whether undertaking B involves the provision of significant similar services. Paragraph (h)(2)(iii)(B) of this section in effect provides that treating undertakings A and C as a single undertaking does not affect the conclusion that the architectural services provided by undertakings B and C are significant similar services. Thus, undertaking B and the single undertaking in which undertakings A and C are included under paragraph (h)(3)(iii) of this section involve the provision of significant similar services, and the taxpayer's interests in undertakings A, B, and C are treated as part of the same activity of the taxpayer under paragraph (h)(2)(ii) of this section.

(i) [Reserved]

(j) *Control by the same interests and ownership percentage*—(1) *In general.* Except as otherwise provided in paragraph (j)(2) of this section, all the facts and circumstances are taken into account in determining, for purposes of this section, whether undertakings are controlled by the same interests. For this purpose, control includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of control that is determinative, and not its form or mode of exercise.

(2) *Presumption*—(i) *In general.* Undertakings are rebuttably presumed to be controlled by the same interests if such undertakings are part of the same common-ownership group.

(ii) *Common-ownership group.* Except as provided in paragraph (j)(2)(iii) of this section, two or more undertakings of a taxpayer are part of the same common-ownership group for purposes of this paragraph (j)(2) if and only if the sum of the common-ownership percentages of any five or fewer persons (within the meaning of section 7701(a)(1), but not including passthrough entities) with respect to such undertakings exceeds 50 percent. For this purpose, the common-ownership percentage of a person with respect to such undertakings is the person's smallest ownership percentage (determined in accordance with paragraph (j)(3) of this section) in any such undertaking.

(iii) *Special aggregation rule.* If, without regard to this paragraph (j)(2)(iii), an undertaking of a taxpayer is part of two or more common-ownership groups, any undertakings of the taxpayer that are part of any such common-ownership group shall be treated for purposes of this paragraph (j)(2) as part of a single common-ownership group in determining the activities of such taxpayer.

(3) *Ownership percentage*—(i) *In general.* For purposes of this section, a person's ownership percentage in an undertaking or in a passthrough entity shall include any interest in such undertaking or passthrough entity that the person holds directly and the person's share of any interest in such undertaking or passthrough entity that is held through one or more passthrough entities.

(ii) *Passthrough entities.* The following rules apply for purposes of applying paragraph (j)(3)(i) of this section:

(A) A partner's interest in a partnership and share of any interest in a passthrough entity or undertaking held through a partnership shall be determined on the basis of the greater of such partner's percentage interest in the capital (by value) of such partnership or such partner's largest distributive share of any item of income or gain (disregarding guaranteed payments under section 707(c)) of such partnership.

(B) A shareholder's interest in an S corporation and share of any interest in a passthrough entity or undertaking held through an S corporation shall be determined on the basis of such shareholder's stock ownership.

(C) A beneficiary's interest in a trust or estate and share of any interest in a passthrough entity or undertaking held through a trust or estate shall not be taken into account.

(iii) *Attribution rules*—(A) *In general.* Except as otherwise provided in paragraph (j)(3)(iii)(B) of this section, a person's ownership percentage in a passthrough entity or in an undertaking shall be determined by treating such person as the owner of any interest that a person related to such person owns (determined without regard to this paragraph (j)(3)(iii)) in such passthrough entity or in such undertaking.

(B) *Determination of common-ownership percentage.* The common-ownership percentage of five or fewer persons with respect to two or more undertakings shall be determined, in any case in which, after the application of paragraph (j)(3)(iii)(A) of this section, two or more such persons own the same interest in any such undertaking (the ''related-party owners'') by treating as the only owner of such interest (or portion thereof) the related-party owner whose ownership of such interest (or a portion thereof) would result in the highest common-ownership percentage.

(C) *Related person.* A person is related to another person for purposes of this paragraph (j)(3)(iii) if the relationship of such persons is described in section 267(b) or 707(b)(1).

(4) *Special rule for trade or business activities.* In determining whether two or more trade or business activities are controlled by the same interests for purposes of paragraph (g) of this section, each such activity shall be treated as a separate undertaking in applying this paragraph (j).

(5) *Examples.* The following examples illustrate the application of this paragraph (j):

Example (1). (i) Partnership X is the sole owner of an undertaking (undertaking X), and partnership Y is the sole owner of another undertaking (undertaking Y). Individuals A, B, C, D, and E are the only partners in partnerships X and Y, and the partnership agreements of both X and Y provide that no action may be taken or decision made on behalf of the partnership without the unanimous consent of the partners. Moreover, each partner actually participates in, and agrees to, all major decisions that affect the operations of either partnership. The ownership percentages (within the meaning of paragraph (j)(3) of this section) of A, B, C, D, and E in each partnership (and in the undertaking owned by the partnership) are as follows:

Partner	PARTNERSHIP/UNDERTAKING	
	X (percent)	Y (percent)
A	15	5
B	10	60
C	10	20
D	77	12
E	8	20
	120	117

The sum of the ownership percentages exceeds 100 percent for both X and Y because, under paragraph (j)(3)(ii)(A) of this section, each partner's ownership percentage is determined on the basis of the greater of the partner's percentage interest in the capital of the partnership or the partner's largest distributive share of any item of income or gain of the partnership.

(ii) Paragraph (j)(2)(ii) of this section provides that a person's common-ownership percentage with respect to any two or more undertakings is the person's smallest ownership percentage in any such undertaking. Thus, the common-ownership percentages of A, B, C, D, and E with respect to undertakings X and Y are as follows:

Partner	Common-ownership percentage
A	5
B	10
C	10
D	12
E	8
	45

(iii) Paragraph (j)(2)(i) of this section provides that undertakings are rebuttably presumed to be controlled by the same interests if the undertakings are part of the same common-ownership group. In general, undertakings are part of a common-ownership group only if the sum of the common-ownership percentages of any five or fewer persons with respect to such undertakings exceeds 50 percent. In this case, the sum of the partners' common-ownership percentages with respect to undertakings X and Y is only 45 percent. Thus, undertakings X and Y are not part of the same common-ownership group.

(iv) If the presumption in paragraph (j)(2)(i) of this section does not apply, all the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests (see paragraph (j)(1) of this section). In this case, all actions and decisions in both undertakings require the unanimous consent of the same persons and each of those persons actually participates in, and agrees to, all major decisions. Accordingly, undertakings X and Y are controlled by the same interests (*i.e.*, A, B, C, D, and E).

Example (2). (i) Partnerships W, X, Y, and Z are each the sole owner of an undertaking (undertakings W, X, Y, and Z). Individuals A, B, and C are partners in each of the four partnerships, and the remaining interests in each partnership are owned by a number of unrelated individuals, none of whom owns more than a one-percent interest in any of the partnerships. The ownership percentages (within the meaning of paragraph (j)(3) of this section) of A, B, and C in each partnership (and in the undertaking owned by the partnership) are as follows:

Partnership/Undertaking	Partner		
	A	B	C
W	23%	21%	40%
X	19%	30%	22%
Y	25%	25%	20%
Z	8%	4%	2%

(ii) Paragraph (j)(2)(ii) of this section provides that a person's common-ownership percentage with respect to any two or more undertakings is the person's smallest ownership percentage in any such undertaking. Thus, the common-ownership percentages of A, B, and C in undertakings W, X, Y, and Z are as follows:

Partner	Common-ownership percentage
A	8
B	4
C	2
	14

(iii) The sum of the common-ownership percentages of A, B, and C with respect to undertakings W, X, Y, and Z is 14 percent, and no other person owns more than a one-percent interest in any of the undertakings. Thus, the sum of the common-ownership percentages of any five or fewer persons with respect to all four undertakings cannot exceed 50 percent. Accordingly, undertakings W, X, Y, and Z are not part of the same common-ownership group (see paragraph (j)(2)(ii) of this section) and are not rebuttably presumed to be controlled by the same interests (see paragraph (j)(2)(i) of this section).

(iv) The common-ownership percentages of A, B, and C in undertakings W, X, and Y are as follows:

Partner	Common ownership percentage
A	19
B	21
C	20
	60

(v) The sum of the common-ownership percentages of A, B, and C, taking into account only undertakings W, X, and Y, is 60 percent. Because the sum of the common-ownership percentages exceeds 50 percent, undertakings W, X, and Y are part of the same common-ownership group (see paragraph (j)(2)(ii) of this section and are rebuttably presumed to be controlled by the same interests (see paragraph (j)(2)(i) of this section).

Example (3). (i) Corporation X, an S corporation, is the sole owner of an undertaking (undertaking X), and corporation Y, another S corporation, is the sole owner of another undertaking (undertaking Y). Individuals A, B, and C are shareholders in corporations X and Y. Both A and B are related (within the meaning of paragraph (j)(3)(iii)(C) of this section) to C, but not to each other. A, B, and C are not related to any other person that owns an interest in either corporation X or corporation Y. The ownership percentages (determined without regard to the attribution rules of paragraph (j)(3)(iii) of this section) of A, B, and C in each corporation (and in the undertaking owned by the corporation) are as follows:

CORPORATION/UNDERTAKING

Shareholder	X (percent)	Y (percent)
A	20	
B		20
C	5	5

(ii) In general, a person's ownership percentage is determined by treating the person as the owner of interests that are actually owned by related persons (see paragraph (j)(3)(iii)(A) of this section). If A, B, and C are treated as owning interests that are actually owned by related persons, their ownership percentages are as follows:

CORPORATION/UNDERTAKING

Shareholder	X (percent)	Y (percent)
A	25	5
B	5	25
C	25	25

(iii) Paragraph (j)(3)(iii)(B) of this section provides that, in determining the sum of the common-ownership percentages of any five or fewer persons with respect to any undertakings, each interest in such undertakings is counted only once. If two or more persons are treated as owners of the same interest under paragraph (j)(3)(iii)(A) of this section, the person whose ownership would result in the highest sum is treated as the only owner of the interest. In this case, C's common-ownership percentage with respect to undertakings X and Y, determined by treating C as the owner of the interests actually owned by A and B, is 25 percent. If, however, A and B are treated as the owners of the interests actually owned by C, each has a common-ownership percentage of only five percent. Thus, in determining the sum of common-ownership percentages with respect to undertakings X and Y, C is treated as the owner of the interests actually owned by A and B because this treatment results in the highest sum of common-ownership percentages with respect to such undertakings.

Example (4). (i) The ownership percentages of individuals A, B, and C in undertakings X, Y, and Z are as follows:

UNDERTAKING

Individual	X	Y	Z
A	30%	30%	30%
B	30%	30%	30%
C	....	30%	30%

No other person owns an interest in more than one of the undertakings.

(ii) Paragraph (j)(2)(ii) of this section provides that a person's common ownership percentage with respect to any two or more undertakings is the person's smallest ownership percentage in any such undertaking. Thus, A's common-ownership percentage with respect to undertakings X, Y, and Z is 30 percent, and the common-ownership percentages of B and C (and all other persons owning interests in such undertakings) with respect to such undertakings is zero. Accordingly, the sum of the common ownership percentages with respect to undertakings X, Y, and Z is only 30 percent, and undertakings X, Y, and Z are not treated as part of the same common-ownership group under paragraph (j)(2)(ii) of this section.

(iii) B's common-ownership percentage with respect to undertakings X and Y is 30 percent, and the sum of A's and B's common-ownership percentages with respect to such undertakings is 60 percent. Thus, undertakings X and Y are treated as part of the same common-ownership group under paragraph (j)(2)(ii) of this section. Similarly, C's common-ownership percentage with respect to undertakings Y and Z is 30 percent, and the sum of A's and C's common-ownership percentages with respect to such undertakings is 60 percent. Thus, undertakings Y and Z are also treated as part of the same common-ownership group under paragraph (j)(2)(ii) of this section.

(iv) Paragraph (j)(2)(iii) of this section requires the aggregation of common-ownership groups that include the same undertaking. In this case, undertaking Y is treated as part of the common-ownership group XY and as part of the common-ownership group YZ. Accordingly, undertakings X, Y, and Z are treated as part of a single common-ownership group and are rebuttably presumed to be controlled by the same interests (see paragraph (j)(2)(i) of this section) even though B does not own an interest in undertaking Z and C does not own an interest in undertaking X. The fact that B and C are not common owners with respect to undertakings X and Z is taken into account, however, in determining whether this presumption is rebutted.

(k) *Identification of rental real estate activities*—(1) *Applicability*—(i) *In general.* Except as otherwise provided in paragraph (k)(6) of this section, this paragraph (k) applies to a taxpayer's interests in rental real estate undertakings (within the meaning of paragraph (k)(1)(ii) of this section).

(ii) *Rental real estate undertaking.* For purposes of this paragraph (k), a rental real estate undertaking is a rental undertaking (within the meaning of paragraph (d) of this section) in which at least 85 percent of the unadjusted basis (within the meaning of § 1.469–2T(f)(3)) of the property made available for use by customers is real property. For this purpose the term ''real property'' means any tangible property other than tangible personal property (within the meaning of § 1.48–1(c)).

(2) *Identification of activities*—(i) *Multiple undertakings treated as a single activity or multiple activities by taxpayer.* Except as otherwise provided in this paragraph (k), a taxpayer may treat two or more rental real estate undertakings (determined after the application of paragraph (k)(2) (ii) and (iii) of this section) as a single activity or may treat such undertakings as separate activities.

(ii) *Multiple undertakings treated as a single activity by passthrough entity.* A taxpayer must treat two or more rental real estate undertakings as a single rental real estate undertaking for a taxable year if any passthrough entity through which the taxpayer holds such undertakings treats such undertakings as a single activity on the applicable return of the passthrough entity for the taxable year of the taxpayer.

(iii) *Single undertaking treated as multiple undertakings.* Notwithstanding that a taxpayer's interest in leased property would, but for the application of this paragraph (k)(2)(iii), be treated as used in a single rental real estate undertaking, the taxpayer may, except as otherwise provided in paragraph (k)(3) of this section, treat a portion of the leased property (including a ratable portion of any common areas or facilities) as a rental real estate undertaking that is separate from the undertaking or undertakings in which the remaining portion of the property is treated as used. This paragraph (k)(2)(iii) shall apply for a taxable year if and only if—

(A) Such portion of the leased property can be separately conveyed under applicable State and local law (taking into account the limitations, if any, imposed by any special rules or procedures, such as condominium conversion laws, restricting the separate conveyance of parts of the same structure); and

(B) The taxpayer holds such leased property directly or through one or more passthrough entities, each of which treats such portion of the leased property as a separate activity on the applicable return of the passthrough entity for the taxable year of the taxpayer.

(3) *Treatment in succeeding taxable years.* All rental real estate undertakings or portions of such undertakings that are treated, under this paragraph (k), as part of the same activity for a taxable year ending after August 9, 1989 must be treated as part of the same activity in each succeeding taxable year.

(4) *Applicable return of passthrough entity.* For purposes of this paragraph (k), the applicable return of a passthrough entity for a taxable year of a taxpayer is the return reporting the passthrough entity's income, gain, loss, deductions, and credits taken into account by the taxpayer for such taxable year.

(5) *Evidence of treatment required.* For purposes of this paragraph (k), a person (including a passthrough entity) does not treat a rental real estate undertaking as multiple undertakings for a taxable year or, except as otherwise provided in paragraph (k) (2)(ii) or (3) of this section, treat multiple rental real estate undertakings as a single undertaking for a taxable year unless such treatment is reflected on a schedule attached to the person's return for the taxable year.

(6) *Coordination rule for rental of nondepreciable property.* This paragraph (k) shall not apply to a rental real estate undertaking if less than 30 percent of the unadjusted basis (within the meaning of §1.469–2T(f)(3)) of property used or held for use by customers in such undertaking during the taxable year is subject to the allowance for depreciation under section 167.

(7) *Coordination rule for rental of dwelling unit.* For any taxable year in which section 280A(c)(5) applies to a taxpayer's use of a dwelling unit—

(i) Paragraph (k) (2) and (3) of this section shall not apply to the taxpayer's interest in such dwelling unit; and

(ii) The taxpayer's interest in such dwelling unit shall be treated as a separate activity of the taxpayer.

(8) *Examples.* The following examples illustrate the application of this paragraph (k). In each example, the taxpayer is an individual whose taxable year is the calendar year.

Example (1). (i) In 1989, the taxpayer directly owns five condominium units (units A, B, C, D, and E) in three different buildings. Units A, B, and C are in one of the buildings and constitute a single rental real estate undertaking (within the meaning of paragraph (k)(1)(ii) of this section). Units D and E are in the other two buildings, and each of these units constitutes a separate rental real estate undertaking. Each of the units can be separately conveyed under applicable State and local law.

(ii) Paragraph (k)(2)(iii) of this section permits a taxpayer to treat a portion of the property included in a rental real estate undertaking as a separate rental real estate undertaking if the property can be separately conveyed under applicable State and local law and the taxpayer owns the property directly. Thus, the taxpayer can treat units A, B, and C as three separate undertakings. Alternatively, the taxpayer could treat two of those units (*e.g.*, units A and C) as an undertaking and the remaining unit as a separate undertaking, or could treat units A, B, and C as a single undertaking.

(iii) Paragraph (k)(2)(i) of this section permits a taxpayer to treat two or more rental real estate undertakings as a single activity, or to treat such undertakings as separate activities. Thus, the taxpayer, by combining undertakings, can treat all five units as a single activity. Alternatively, the taxpayer could treat each undertaking as a separate activity, or could combine some, but not all, undertakings. Thus, for example, the taxpayer could treat units A, B, C, and D as an activity and unit E as a separate activity.

(iv) For purposes of paragraph (k)(2)(i) of this section, a taxpayer's rental real estate undertakings are determined after the application of paragraph (k)(2)(iii) of this section. Thus, the taxpayer, by treating units as separate undertakings under paragraph (k)(2)(iii) of this section and combining them with other units under paragraph (k)(2)(i) of this section, can treat any combination of units as a single activity. For example, the taxpayer could treat units A and B as a separate rental real estate undertaking, and then treat units A, B, and D as a single activity. In that case, the taxpayer could treat units C and E either as a single activity or as two separate activities.

Example (2). (i) The facts are the same as in example (1). In addition, the taxpayer treats all five units as a single activity for 1989 and sells unit E in 1990. (See paragraph (k)(5) of this section for a rule providing that the units are treated as a single activity only if such treatment is reflected on a schedule attached to the taxpayer's return.)

(ii) Under paragraph (k)(3) of this section, rental real estate undertakings that are treated as part of the same activity for a taxable year must be treated as part of the same activity in each succeeding year. In this case, all five units were treated as part of the same activity for 1989 and must therefore be treated as part of the same activity for 1990. Accordingly, the taxpayer's sale of unit E in 1990 cannot be treated as a disposition of the taxpayer's entire interest in an activity for purposes of section 469(g) and the rules to be contained in § 1.469–6T (relating to the treatment of losses upon certain dispositions of passive and former passive activities).

Example (3). (i) The facts are the same as in example (1), except that the taxpayer is a partner in a partnership that is the direct owner of the five condominium units. In its return for its taxable year ending on November 30, 1989, the partnership treats the five units as a single activity. (See paragraph (k)(5) of this section for a rule providing that the units are treated as a single activity only if such treatment is reflected on a schedule attached to the partnership's return.) The partnership sells unit E on November 1, 1990.

(ii) Paragraph (k)(2)(ii) of this section provides that a taxpayer who holds rental real estate undertakings through a passthrough entity must treat those undertakings as a single rental real estate undertaking if they are treated as a single activity on the applicable return of the passthrough entity. Under paragraph (k)(4) of this section, the applicable return of the partnership for the taxpayer's 1989 taxable year is the partnership's return for its taxable year ending on November 30, 1989. Accordingly, the taxpayer must treat the five condominium units as a single rental real estate undertaking (and thus as part of the same activity) for 1989 because they are treated as a single activity on the partnership's return for its taxable year ending in 1989.

(iii) Under paragraph (k)(3) of this section, the taxpayer must continue treating the condominium units as part of the same activity for taxable years after 1989. Accordingly, as in example (2), the five condominium units are treated as part of the same activity for 1990, and the sale of unit E in 1990 cannot be treated as a disposition of the taxpayer's interest in an activity for purposes of section 469(g) and the rules to be contained in § 1.469–6T.

Example (4). (i) The taxpayer owns a shopping center and a vacant lot that are separate rental real estate undertakings (within the meaning of paragraph (k)(1)(ii) of this section). The taxpayer rents space in the shopping center to various tenants and rents the vacant lot to a parking lot operator. Most of the unadjusted basis of the property used in the shopping-center undertaking (taking into account the land on which the shopping center is built) is subject to the allowance for depreciation, but no depreciable property is used in the parking-lot undertaking.

(ii) This paragraph (k) provides rules for identifying rental real estate activities (including the rule in paragraph (k)(2)(i) of this section that permits a taxpayer to treat two or more rental real estate undertakings as a single activity). Paragraph (k)(6) of this section provides, however, that these rules do not apply to a rental real estate undertaking if less than 30 percent of the unadjusted basis of the property used in the undertaking is subject to the allowance for depreciation. Thus, the taxpayer may not combine the parking-lot undertaking, which includes no depreciable property, with the shopping-center undertaking or any other rental real estate undertaking under paragraph (k)(2)(i) of this section. Accordingly, the parking lot undertaking is treated as a separate activity under paragraph (b)(1) of this section.

Example (5). (i) The facts are the same as in example (4), except that the shopping center and the vacant lot are at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are part of the same rental real estate undertaking (within the meaning of paragraph (k)(1)(ii) of this section). Taking into account the property used in the shopping center operations (including the land on which the shopping center is built) and the vacant lot, 50 percent of the unadjusted basis of the property used in the undertaking is subject to the allowance for depreciation.

(ii) In this case, the vacant lot is used in a rental real estate undertaking in which depreciable property is also used. Moreover, the exception in paragraph (k)(6) of this section does not apply to the undertaking consisting of the shopping center and the parking lot because at least 30 percent of unadjusted basis of the property used in the undertaking is subject to the allowance for depreciation. Accordingly, the taxpayer may combine the undertaking with other rental real estate undertakings and treat the combined undertakings as a single activity under paragraph (k)(2)(i) of this section.

(l) [Reserved.]

(m) *Consolidated groups*—(1) *In general.* The activities of a consolidated group (within the meaning of § 1.469–1T(h)(2)(ii)) and of each member of such group shall be determined under this section as if the consolidated group were one taxpayer.

(2) *Examples.* The following examples illustrate the application of this paragraph (m). In each example, the facts, analysis, and conclusions relate to a single taxable year.

Example (1) . (i) Corporations M, N, and O are the members of a consolidated group (within the meaning of § 1.469–1T(h)(2)(ii)). Under § 1.469–1T(h)(4)(i)(A) and (ii), the consolidated group and its members are treated as closely held corporations (within the meaning of § 1.469–1T(g)(2)(ii)). Each member of the consolidated group owns a two-percent interest in partnership X and a two-percent interest in partnership Y, and owns interests in a number of trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) through the partnerships. Each of these undertakings is directly owned by partnership X or Y, and all the undertakings of partnerships X and Y are controlled by the same interests (within the meaning of paragraph (j) of this section) and are similar (within the meaning of paragraph (f)(4) of this section). The employees of the consolidated group and the shareholders of its common parent do not participate in the undertakings that the member corporations own through the partnerships.

(ii) Paragraph (f)(2)(i) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns interests in the undertakings through the same passthrough entity. In this case, the member corporations own interests in similar, commonly-controlled undertakings through both partnerships, and such interests are treated under this paragraph (m) as interests owned by one taxpayer (the consolidated group). Accordingly, the member corporations' interests in the undertakings owned through partnership X are treated as part of the same activity of the consolidated group, and their interests in the undertakings owned through partnership Y are treated similarly.

Example (2) . (i) The facts are the same as in example (1), except that each member of the consolidated group owns a five-percent interest in partnership X and a five-percent interest in partnership Y.

(ii) Paragraph (f)(2)(ii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns a direct or substantial indirect interest in each such undertaking. In this case, the member corporations own, in the aggregate, a 15-percent interest in partnership X and a 15-percent interest in partnership Y, and such interests are treated under this paragraph (m) as interests owned by one taxpayer (the consolidated group). Thus, the consolidated group owns a substantial indirect interest in the similar, commonly-controlled undertakings owned by partnerships X and Y (see paragraph (f)(3)(i) of this section). Accordingly, the member corporations' interests in the undertakings owned through partnerships X and Y are treated as part of the same activity of the consolidated group.

(n) *Publicly traded partnerships.* The rules of this section shall apply to a taxpayer's interest in business and rental operations held through a publicly traded partnership (within the meaning of section 469(k)(2)) as if the taxpayer had no interest in any other business and rental operations. The following example illustrates the application of this paragraph (n):

Example. (i) The taxpayer, an individual, owns a 20-percent interest in partnership X and a 15-percent interest in partnership Y. Partnership X directly owns a hotel (''hotel 1'') and a commercial office building (''building 1''). Partnership Y directly owns two hotels (''hotels 2 and 3'') and two commercial office buildings (''buildings 2 and 3''). Each of the three hotels is a separate trade or business undertaking (within the meaning of paragraph (f)(1)(ii) of this section), and each of the three office buildings is a separate rental real estate undertaking (within the meaning of paragraph (k)(1)(ii) of this section). The three hotel undertakings are similar (within the meaning of paragraph (f)(4) of this section) and are controlled by the same interests (within the meaning of paragraph (j) of this section). Partnership X is not a publicly traded partnership (within the meaning of section 469(k)(2)). Partnership Y, however, is a publicly traded partnership and is not treated as a corporation under section 7704.

(ii) This paragraph (n) provides that the rules of this section apply to a taxpayer's interest in business and rental operations held through a publicly traded partnership as if the taxpayer had no interest in any other business and rental operations. Thus, undertakings owned through partnership Y may be treated as part of the same activity under the rules of this section, but an undertaking owned through partnership Y and an undertaking that is not owned through partnership Y may not be treated as part of the same activity.

(iii) Paragraph (f)(2)(i) of this section provides that a taxpayer's interests in two or more trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity if the taxpayer owns interests in each undertaking through the same passthrough entity. Partnership Y's hotel undertakings (*i.e.,* hotels 2 and 3) are similar and are controlled by the same interests. In addition, the taxpayer owns interests in both undertakings through the same partnership. Accordingly, the taxpayer's interests in partnership Y's hotel undertakings are treated as part of the same activity.

(iv) The hotel undertaking owned through partnership X (*i.e.,* hotel 1) and the hotel undertakings owned through partnership Y are similar and controlled by the same interests, and the taxpayer owns a substantial indirect interest in each of the undertakings (see paragraph (f)(3)(i) of this section). Thus, the three undertakings would ordinarily be treated as part of the same activity under paragraph (f)(2)(ii) of this section. Under this paragraph (n), however, undertakings that are owned through a publicly traded partnership cannot be treated as part of the same activity as any undertaking not owned through that partnership. Accordingly, the hotel undertaking that the taxpayer owns through partnership X and the hotel undertakings that the taxpayer owns through partnership Y are treated as two separate activities.

(v) Paragraph (k)(2)(i) of this section provides that, with certain exceptions, a taxpayer may treat two or more rental real estate undertakings as a single activity or as separate activities. Thus, the taxpayer's interests in the rental real estate undertakings owned through partnership Y (*i.e.,* buildings 2 and 3) may be treated as a single activity or as separate activities. Under this paragraph (n), however, undertakings that are owned through a publicly traded partnership cannot be treated as part of the same activity as any undertaking not owned through that partnership. Accordingly, the taxpayer's interest in the rental real estate undertaking owned through partnership X (building 1) cannot be treated as part of an activity that includes any rental real estate undertaking owned through partnership Y.

(o) *Elective treatment of undertakings as separate activities*—(1) *Applicability.* This paragraph applies to a taxpayer's interest in any undertaking (other than a rental real estate undertaking (within the meaning of paragraph (k)(1)(ii) of this section)) that would otherwise be treated under this section as part of an activity that includes the taxpayer's interest in any other undertaking.

(2) *Undertakings treated as separate activities.* Except as otherwise provided in this paragraph (o), a person (including a passthrough entity) shall treat an undertaking to which this paragraph (o) applies as an activity separate from the remainder of the activity in which such undertaking would otherwise be included for a taxable year if and only if, for such taxable year or any preceding taxable year, such person made an election with respect to such undertaking under this paragraph (o).

(3) *Multiple undertakings treated as a single activity by passthrough entity.* A person (including a passthrough entity) must treat interests in two or more undertakings as part of the same activity for a taxable year if any passthrough entity through which the person holds such undertakings treats such undertakings as part of the same activity on the applicable return of the passthrough entity for the taxable year of such person.

(4) *Multiple undertakings treated as a single activity for a preceding taxable year.* If a person (including a passthrough entity) treats undertakings as part of the same activity on such person's return for a taxable year ending after August 9, 1989, such person may not treat such undertakings as part of different activities under this paragraph (o) for any subsequent taxable year.

(5) *Applicable return of passthrough entity.* For purposes of this paragraph (o), the applicable return of a passthrough entity for a taxable year of a taxpayer is the return reporting the passthrough entity's income, gain, loss, deductions, and credits taken into account by the taxpayer for such taxable year.

(6) *Participation.* The following rules apply to multiple activities (the ''separate activities'') that would be treated as a single activity (the ''original activity'') if the taxpayer's activities were determined without regard to this paragraph (o):

(i) The taxpayer shall be treated as materially participating (within the meaning of § 1.469–5T) for the taxable year in the separate activities if and only if the taxpayer would, but for the application of this paragraph (o), be treated as materially participating for the taxable year in the original activity.

(ii) The taxpayer shall be treated as significantly participating (within the meaning of § 1.469–5T(c)(2)) for the taxable year in the separate activities if and only if the taxpayer would, but for the application of this paragraph (o), be treated as significantly participating for the taxable year in the original activity.

(7) *Election*—(i) *In general.* A person makes an election with respect to an undertaking under this paragraph (o) by attaching the written statement described in paragraph (o)(7)(ii) of this section to such person's return for the taxable year for which the election is made (see paragraph (o)(2) of this section).

(ii) *Written statement.* The written statement required by paragraph (o)(7)(i) of this section must—

(A) State the name, address, and taxpayer identification number of the person making the election;

(B) Contain a declaration that an election is being made under § 1.469–4T(o);

(C) Identify the undertaking with respect to which such election is being made; and

(D) Identify the remainder of the activity in which such undertaking would otherwise be included.

(8) *Examples.* The following examples illustrate the application of this paragraph (o):

Example (1). (i) During 1989, the taxpayer, an individual whose taxable year is the calendar year, acquires and is the direct owner of ten grocery stores. The operations of each grocery store are treated under paragraph (c)(1) of this section as a single undertaking that is separate from other undertakings (a ''grocery-store undertaking''), and the taxpayer's interests in the grocery-store undertakings would be treated as part of the same activity of the taxpayer under paragraph (f)(2) of this section.

(ii) Paragraph (o)(2) of this section provides that, with certain exceptions, undertakings that would be treated as part of the same activity under other rules in this section may, at the election of the taxpayer, be treated as separate activities. Thus, the taxpayer may elect to treat each grocery-store undertaking as a separate activity for 1989. Alternatively, the taxpayer may combine grocery-store undertakings in any manner and treat each combination of undertakings (and each uncombined undertaking) as a separate activity for 1989. In either case, the election must be made by attaching the written statement described in paragraph (o)(7)(ii) of this section to the taxpayer's 1989 return.

Example (2). (i) The facts are the same as in example (1). In addition, the taxpayer, in 1989, elects to treat each grocery-store undertaking as a separate activity and participates for 15 hours in each of the grocery-store undertakings.

(ii) The taxpayer's interest in each grocery-store undertaking is treated, under paragraph (o)(2) of this section, as a separate activity of the taxpayer for 1989 (a ''grocery-store activity''). In 1989, however, the taxpayer participates for more than 100 hours in the activity in which the undertakings would be included (but for the election to treat the grocery-store undertakings as separate activities) and would be treated under § 1.469–5T(c)(2) as significantly participating in such activity. Accordingly, the taxpayer is treated under paragraph (o)(6)(ii) of this section as significantly participating in each of the grocery-store activities for 1989.

Example (3). (i) The facts are the same as in example (1). In addition, the taxpayer, in 1989, elects to treat each grocery-store undertaking as a separate activity. The taxpayer does not participate in any of the grocery-store undertakings in 1989 or 1990, and sells one of the grocery stores in 1990.

(ii) As in example (2), the taxpayer's interests in each grocery-store undertaking is treated, under paragraph (o)(2) of this section, as a separate activity of the taxpayer for 1989. Because the taxpayer elected to treat the undertakings as separate activities for a preceding taxable year (1989), each grocery-store undertaking is also treated, under paragraph (o)(2) of this section, as a separate activity of the taxpayer for 1990. In addition, each of the taxpayer's grocery-store activities is a passive activity for 1989 and 1990 because the taxpayer does not participate in any of the grocery store undertakings for 1989 and 1990. Accordingly, the taxpayer's sale of the grocery store will generally be treated as a disposition of the taxpayer's entire interest in a passive activity for purposes of section 469(g) and the rules to be contained in § 1.469–6T (relating to the treatment of losses upon certain dispositions of passive and former passive activities).

Example (4). (i) The facts are the same as in example (3), except that the taxpayer elects to treat the grocery-store undertakings as two separate activities. One of the activities includes three grocery-store undertakings, and the store sold in 1990 is part of this activity. The other activity includes the seven remaining grocery-store undertakings.

(ii) Paragraph (o)(4) of this section provides that a person who treats undertakings as part of the same activity for a taxable year ending after August 9, 1989, may not elect to treat those undertakings as separate activities for a subsequent taxable year. The grocery store sold in 1990 was treated for 1989 as part of an activity that includes two other grocery stores. Thus, those three stores must be treated as part of the same activity for 1990. Accordingly, the taxpayer's sale of the grocery store cannot be treated as a disposition of the taxpayer's entire interest in a passive activity for purposes of section 469(g) and the rules to be contained in § 1.469–6T.

Example (5). (i) The facts are the same as in example (1), except that the taxpayer is a partner in a partnership that acquires and is the direct owner of the ten grocery stores. The taxable year of the partnership ends on November 30, and the partnership acquires the grocery stores in its taxable year ending on November 30, 1989. In its return for that taxable year, the partnership treats the grocery-store undertakings as a single activity.

(ii) Paragraph (o)(3) of this section provides that a person who holds undertakings through a passthrough entity may not elect to treat those undertakings as separate activities if they are treated as part of the same activity on the applicable return of the passthrough entity. Under paragraph (o)(5) of this section, the applicable return of the partnership for the taxpayer's 1989 taxable year is the partnership's return for its taxable year ending on November 30, 1989. Accordingly, the taxpayer must treat the grocery-store undertakings as a single activity for 1989 because those undertakings are treated as a single activity on the partnership's return for its taxable year ending in 1989.

(iii) Under paragraph (o)(4) of this section, the taxpayer must continue treating the grocery-store undertakings as part of the same activity for taxable years after 1989. This rule applies even if the partnership subsequently distributes its interest in the grocery stores to the taxpayer, and the taxpayer becomes the direct owner of the grocery-store undertakings.

(p) Special rule for taxable years ending before August 10, 1989—(1) *In general.* For purposes of applying section 469 and the regulations thereunder for a taxable year ending before August 10, 1989, a taxpayer's business and rental operations may be organized into activities under the rules or paragraphs (b) through (n) of this section or under any other reasonable method. For example, for such taxable years a taxpayer may treat each of the taxpayer's undertakings as a separate activity, or a taxpayer may treat undertakings that involve the provision of similar goods or services as a single activity.

(2) *Unreasonable methods.* A method of organizing business and rental operations into activities is not reasonable if such method—

(i) Treats rental operations (within the meaning of paragraph (d)(3) of this section) that are not ancillary to a trade or business activity (within the meaning of § 1.469–1T(e)(2)) as part of a trade or business activity;

(ii) Treats operations that are not rental operations and are not ancillary to a rental activity (within the meaning of § 1.469–1T(e)(3)) as part of a rental activity;

(iii) Includes in a passive activity of a taxpayer any oil or gas well that would be treated, under paragraph (e)(1) of this section, as a separate undertaking in determining the taxpayer's activities;

(iv) Includes in a passive activity of a taxpayer any interest in a dwelling unit that would be treated, under paragraph (K)(7) of this section, as a separate activity of the taxpayer; or

(v) Is inconsistent with the taxpayer's method of organizing business and rental operations into activities for the taxpayer's first taxable year beginning after December 31, 1986.

(3) *Allocation of dissallowed deductions in succeeding taxable year.* If any of the taxpayer's passive activity deductions or the taxpayer's credits from passive

activities are disallowed under § 1.469–1T for the last taxable year of the taxpayer ending before August 10, 1989, such disallowed deductions or credits shall be allocated among the taxpayer's activities for the first taxable year of the taxpayer ending after August 9, 1989, using any reasonable method. See § 1.469–1T(f)(4).

[T.D. 8253, 54 FR 20542, May 12, 1989]

§ 1.469–5 Material participation.

(a)–(e) [Reserved]

(f) *Participation*—(1) *In general.* Except as otherwise provided in this paragraph (f), any work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done shall be treated for purposes of this section as participation of the individual in the activity.

(f)(2)–(h)(2) [Reserved]

(h)(3) *Coordination with rules governing the treatment of passthrough entities.* If a taxpayer takes into account for a taxable year of the taxpayer any item of gross income or deduction from a partnership or S corporation that is characterized as an item of gross income or deduction from an activity in which the taxpayer materially participated under § 1.469–2T(e)(1), the taxpayer is treated as materially participating in the activity for the taxable year for purposes of applying § 1.469–5T(a)(5) and (6) to any succeeding taxable year of the taxpayer.

(i) [Reserved]

(j) *Material participation for preceding taxable years*—(1) *In general.* For purposes of § 1.469–5T(a)(5) and (6), a taxpayer has materially participated in an activity for a preceding taxable year if the activity includes significant section 469 activities that are substantially the same as significant section 469 activities that were included in an activity in which the taxpayer materially participated (determined without regard to § 1.469–5T(a)(5)) for the preceding taxable year.

(2) *Material participation for taxable years beginning before January 1, 1987.* In any case in which it is necessary to determine whether an individual materially participated in any activity for a taxable year beginning before January 1, 1987 (other than a taxable year of a partnership, S corporation, estate, or trust ending after December 31, 1986), the determination shall be made without regard to paragraphs (a)(2) through (7) of this section.

(k) *Examples.* Example (1)—Example (4) [Reserved]

Example (5). In 1993, D, an individual, acquires stock in an S corporation engaged in a trade or business activity (within the meaning of § 1.469–1(e)(2)). For every taxable year from 1993 through 1997, D is treated as materially participating (without regard to § 1.469–5T(a)(5)) in the activity. D retires from the activity at the beginning of 1998, and would not be treated as materially participating in the activity for 1998 and subsequent taxable years if material participation of those years were determined without regard to § 1.469–5T(a)(5). Under § 1.469–5T(a)(5) of this section, however, D is treated as materially participating in the activity for taxable years 1998 through 2003 because D materially participated in the activity (determined without regard to § 1.469–5T(a)(5) for five taxable years during the ten taxable years that immediately precede each of those years. D is not treated under § 1.469–5T(a)(5) as materially participating in the activity for taxable years beginning after 2003 because for those years D has not materially participated in the activity (determined without regard to § 1.469–5T(a)(5) for five of the last ten immediately preceding taxable years.

[T.D. 8417, 57 FR 20758, May 15, 1992]

§ 1.469–5T Material participation (temporary).

(a) *In general.* Except as provided in paragraphs (e) and (h)(2) of this section, an individual shall be treated, for purposes of section 469 and the regulations thereunder, as materially participating in an activity for the taxable year if and only if—

(1) The individual participates in the activity for more than 500 hours during such year;

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the

taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;

(4) The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;

(5) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

(6) The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or

(7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

(b) *Facts and circumstances*—(1) *In general.* [Reserved]

(2) *Certain participation insufficient to constitute material participation under this paragraph (b)* —(i) *Participation satisfying standards not contained in section 469.* Except as provided in section 469(h)(3) and paragraph (h)(2) of this section (relating to certain retired individuals and surviving spouses in the case of farming activities), the fact that an individual satisfies the requirements of any participation standard (whether or not referred to as ''material participation'') under any provision (including sections 1402 and 2032A and the regulations thereunder) other than section 469 and the regulations thereunder shall not be taken into account in determining whether such individual materially participates in any activity for any taxable year for purposes of section 469 and the regulations thereunder.

(ii) *Certain management activities.* An individual's services performed in the management of an activity shall not be taken into account in determining whether such individual is treated as materially participating in such activity for the taxable year under paragraph (a)(7) of this section unless, for such taxable year—

(A) No person (other than such individual) who performs services in connection with the management of the activity receives compensation described in section 911(d)(2)(A) in consideration for such services; and

(B) No individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by such individual.

(iii) *Participation less than 100 hours.* If an individual participates in an activity for 100 hours or less during the taxable year, such individual shall not be treated as materially participating in such activity for the taxable year under paragraph (a)(7) of this section.

(c) *Significant participation activity* —(1) *In general.* For purposes of paragraph (a)(4) of this section, an activity is a significant participation activity of an individual if and only if such activity—

(i) Is a trade or business activity (within the meaning of §1.469–1T(e)(2)) in which the individual significantly participates for the taxable year; and

(ii) Would be an activity in which the individual does not materially participate for the taxable year if material participation for such year were determined without regard to paragraph (a)(4) of this section.

(2) *Significant participation.* An individual is treated as significantly participating in an activity for a taxable year if and only if the individual participates in the activity for more than 100 hours during such year.

(d) *Personal service activity.* An activity constitutes a personal service activity for purposes of paragraph (a)(6) of this section if such activity involves the performance of personal services in—

(1) The fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or

(2) Any other trade or business in which capital is not a material income-producing factor.

(e) *Treatment of limited partners*—(1) *General rule.* Except as otherwise provided in this paragraph (e), an individual shall not be treated as materially participating in any activity of a limited partnership for purposes of applying section 469 and the regulations thereunder to—

(i) The individual's share of any income, gain, loss, deduction, or credit from such activity that is attributable to a limited partnership interest in the partnership; and

(ii) Any gain or loss from such activity recognized upon a sale or exchange of such an interest.

(2) *Exceptions.* Paragraph (e)(1) of this section shall not apply to an individual's share of income, gain, loss, deduction, and credit for a taxable year from any activity in which the individual would be treated as materially participating for the taxable year under paragraph (a)(1), (5), or (6) of this section if the individual were not a limited partner for such taxable year.

(3) *Limited partnership interest*—(i) *In general.* Except as provided in paragraph (e)(3)(ii) of this section, for purposes of section 469(h)(2) and this paragraph (e), a partnership interest shall be treated as a limited partnership interest if—

(A) Such interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law; or

(B) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractural obligations to make additional capital contributions to the partnership).

(ii) *Limited partner holding general partner interest.* A partnership interest of an individual shall not be treated as a limited partnership interest for the individual's taxable year if the individual is a general partner in the partnership at all times during the partnership's taxable year ending with or within the individual's taxable year (or the portion of the partnership's taxable year during which the individual (directly or indirectly) owns such limited partnership interest).

(f) *Participation*—(1) [Reserved] See §1.469–5(f)(1) for rules relating to this paragraph.

(2) *Exceptions*—(i) *Certain work not customarily done by owners.* Work done in connection with an activity shall not be treated as participation in the activity for purposes of this section if—

(A) Such work is not of a type that is customarily done by an owner of such an activity; and

(B) One of the principal purposes for the performance of such work is to avoid the disallowance, under section 469 and the regulations thereunder, of any loss or credit from such activity.

(ii) *Participation as an investor*—(A) *In general.* Work done by an individual in the individual's capacity as an investor in an activity shall not be treated as participation in the activity for purposes of this section unless the individual is directly involved in the day-to-day management or operations of the activity.

(B) *Work done in individual's capacity as an investor.* For purposes of this paragraph (f)(2)(ii), work done by an individual in the individual's capacity as an investor in an activity includes—

(*1*) Studying and reviewing financial statements or reports on operations of the activity;

(*2*) Preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use; and

(*3*) Monitoring the finances or operations of the activity in a non-managerial capacity.

(3) *Participation of spouse.* In the case of any person who is a married individual (within the meaning of section 7703) for the taxable year, any participation by such person's spouse in the activity during the taxable year (without regard to whether the spouse owns an interest in the activity and without regard to whether the spouses file a joint return for the taxable year) shall be treated, for purposes of applying section 469 and the regulations thereunder to such person, as participation

by such person in the activity during the taxable year.

(4) *Methods of proof.* The extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.

(g) *Material participation of trusts and estates.* [Reserved]

(h) *Miscellaneous rules*—(1) *Participation of corporations.* For rules relating to the participation in an activity of a personal service corporation (within the meaning of § 1.468–1T(g)(2)(i)) or a closely held corporation (within the meaning of § 1.469–1T(g)(2)(ii)), see § 1.469–1T(g)(3).

(2) *Treatment of certain retired farmers and surviving spouses of retired or disabled farmers.* An individual shall be treated as materially participating for a taxable year in any trade or business activity of farming if paragraph (4) or (5) of section 2032A(b) would cause the requirements of section 2032A(b)(1)(C)(ii) to be met with respect to real property used in such activity had the individual died during such taxable year.

(3) *Coordination with rules governing the treatment of passthrough entities.* [Reserved] See § 1.469–5(h)(3) for rules relating to this paragraph.

(i) [Reserved]

(j) *Material participation for preceding taxable years.* [Reserved] See § 1.469–5(j) for rules relating to this paragraph.

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

Example 1. A, a calendar year individual, owns all of the stock of X, a C corporation. X is the general partner, and A is the limited partner, in P, a calendar year partnership. P has a single activity, a restaurant, which is a trade or business activity (within the meaning of § 1.469–1T(e)(2)). During the taxable year, A works for an average of 30 hours per week in connection with P's restaurant activity. Under paragraphs (a)(1) and (e)(2) of this section, A is treated as materially participating in the activity for the taxable year because A participates in the restaurant activity during such year for more than 500 hours. In addition, under § 1.469–1T(g)(3)(i), A's participation will cause X to be treated as materially participating in the restaurant activity.

Example 2. The facts are the same as in example (1), except that the partnership agreement provides that P's restaurant activity is to be managed by X, and A's work in the activity is performed pursuant to an employment contract between A and X. Under paragraph (f)(1) of this section, work done by A in connection with the activity in any capacity is treated as participation in the activity by A. Accordingly, the conclusion is the same as in example (1). The conclusion would be the same if A owned no stock in X at any time, although in that case A's participation would not be taken into account in determining whether X materially participates in the restaurant activity.

Example 3. B, an individual, is employed fulltime as a carpenter. B also owns an interest in a partnership which is engaged in a van conversion activity, which is a trade or business activity (within the meaning of § 1.469–1T(e)(2)). B and C, the other partner, are the only participants in the activity for the taxable year. The activity is conducted entirely on Saturdays. Each Saturday throughout the taxable year, B and C work for eight hours in the activity. Although B does not participate in the activity for more than 500 hours during the taxable year, under paragraph (a)(3) of this section, B is treated for such year as materially participating in the activity because B participates in the activity for more than 100 hours during the taxable year, and B's participation in the activity for such year is not less than the participation of any other person in the activity for such year.

Example 4. C, an individual, is employed full-time as an accountant. C also owns interests in a restaurant and a shoe store. The restaurant and shoe store are trade or business activities (within the meaning of § 1.469–1T(e)(2)) that are treated as separate activities under the rules to be contained in § 1.469–4T. Each activity has several full-time employees. During the taxable year, C works in the restaurant activity for 400 hours and in the shoe store activity for 150 hours. Under paragraph (c) of this section, both the restaurant and shoe store activities are significant participation activities of C for the taxable year. Accordingly, since C's aggregate participation in the restaurant and shoe store activities during the taxable year exceeds 500 hours, C is treated under paragraph (a)(4) of this section as materially participating in both activities.

Example 5. [Reserved] See § 1.469–5(k) *Example 5* for this example.

Example 6. The facts are the same as in example (5), except that D does not acquire any stock in the S corporation until 1994. Under paragraph (f)(1) of this section, D is not treated as participating in the activity for any taxable year prior to 1994 because D does not own as interest in the activity for any such taxable year. Accordingly, D materially participates in the activity for only one taxable year prior to 1995, and D is not treated under paragraph (a)(5) of this section as materially participating in the activity for 1995 or subsequent taxable years.

Example 7. (i) E, a married individual filing a separate return for the taxable year, is employed full-time as an attorney. E also owns an interest in a professional football team that is a trade or business activity (within the meaning of § 1.469–1T(e)(2)). E does no work in connection with this activity. E anticipates that, for the taxable year, E's deductions from the activity will exceed E's gross income from the activity and that, if E does not materially participate in the activity for the taxable year, part or all of F's passive activity loss for the taxable year will be disallowed under § 1.469–1T(a)(1)(i). Accordingly, E pays E's spouse to work as an office receptionist in connection with the activity for an average of 15 hours per week during the taxable year.

(ii) Under paragraph (f)(3) of this section any participation in the activity by E's spouse is treated as participation in the activity by E. However, under paragraph (f)(2)(i) of this section, the work done by E's spouse is not treated as participation in the activity because work as an office receptionist is not work of a type customarily done by an owner of a football team, and one of E's principal purposes for paying E's spouse to do this work is to avoid the disallowance under § 1.469–1T(a)(1)(i) of E's passive activity loss. Accordingly, E is not treated as participating in the activity for the taxable year.

Example 8. (i) F, an individual, owns an interest in a partnership that feeds and sells cattle. The general partner of the partnership periodically mails F a letter setting forth certain proposed actions and decisions with respect to the cattle-feeding operation. Such actions and decisions include, for example, what kind of feed to purchase, how much to purchase, and when to purchase it, how often to feed cattle, and when to sell cattle. The letters explain the proposed actions and decisions, emphasize that taking or not taking a particular action or decision is solely within the discretion of F and other partners, and ask F to indicate a decision with respect to each proposed action by answering certain questions. The general partner receives a fee that constitutes earned income (within the meaning of section 911 (d)(2)(A)) for managing the cattle-feeding operation. F is not treated as materially participating in the cattle-feeding operation under paragraph (a) (1) through (6) of this section.

(ii) F's only participation in the cattle-feeding operation is to make certain managerial decisions. Under paragraph (b)(2)(ii) of this section, such management services are not taken into account in determining whether the taxpayer is treated as materially participating in the activity for a taxable year under paragraph (a)(7) of this section, if any other person performs services in connection with the management of the activity and receives compensation described in section 911(d)(2)(A) for such services. Therefore, F is not treated as materially participating for the taxable year in the cattle-feeding operation.

[T.D. 8175, 53 FR 5725, Feb. 25, 1988; 53 FR 15494, Apr. 29, 1988, as amended by T.D. 8253, 54 FR 20565, May 12, 1989; T.D. 8417, 57 FR 20759, May 15, 1992; 61 FR 14247, Apr. 1, 1996]

§ 1.469–6 Treatment of losses upon certain dispositions. [Reserved]

§ 1.469–7 Treatment of self-charged items of income and expense. [Reserved]

§ 1.469–8 Application of section 469 to trust, estates, and their beneficiaries. [Reserved]

§ 1.469–9 Rules for certain rental real estate activities.

(a) *Scope and purpose.* This section provides guidance to taxpayers engaged in certain real property trades or businesses on applying section 469(c)(7) to their rental real estate activities.

(b) *Definitions.* The following definitions apply for purposes of this section:

(1) *Trade or business.* A *trade or business* is any trade or business determined by treating the types of activities in § 1.469–4(b)(1) as if they involved the conduct of a trade or business, and any interest in rental real estate, including any interest in rental real estate that gives rise to deductions under section 212.

(2) *Real property trade or business. Real property trade or business* is defined in section 469(c)(7)(C).

(3) *Rental real estate. Rental real estate* is any real property used by customers or held for use by customers in a rental activity within the meaning of § 1.469–1T(e)(3). However, any rental real estate that the taxpayer grouped with a

trade or business activity under §1.469–4(d)(1)(i)(A) or (C) is not an interest in rental real estate for purposes of this section.

(4) *Personal services. Personal services* means any work performed by an individual in connection with a trade or business. However, personal services do not include any work performed by an individual in the individual's capacity as an investor as described in §1.469–5T(f)(2)(ii).

(5) *Material participation. Material participation* has the same meaning as under §1.469–5T. Paragraph (f) of this section contains rules applicable to limited partnership interests in rental real estate that a qualifying taxpayer elects to aggregate with other interests in rental real estate of that taxpayer.

(6) *Qualifying taxpayer.* A *qualifying taxpayer* is a taxpayer that owns at least one interest in rental real estate and meets the requirements of paragraph (c) of this section.

(c) *Requirements for qualifying taxpayers*—(1) *In general.* A qualifying taxpayer must meet the requirements of section 469(c)(7)(B).

(2) *Closely held C corporations.* A closely held C corporation meets the requirements of paragraph (c)(1) of this section by satisfying the requirements of section 469(c)(7)(D)(i). For purposes of section 469(c)(7)(D)(i), gross receipts do not include items of portfolio income within the meaning of §1.469–2T(c)(3).

(3) *Requirement of material participation in the real property trades or businesses.* A taxpayer must materially participate in a real property trade or business in order for the personal services provided by the taxpayer in that real property trade or business to count towards meeting the requirements of paragraph (c)(1) of this section.

(4) *Treatment of spouses.* Spouses filing a joint return are qualifying taxpayers only if one spouse separately satisfies both requirements of section 469(c)(7)(B). In determining the real property trades or businesses in which a married taxpayer materially participates (but not for any other purpose under this paragraph (c)), work performed by the taxpayer's spouse in a trade or business is treated as work performed by the taxpayer under §1.469–5T(f)(3), regardless of whether the spouses file a joint return for the year.

(5) *Employees in real property trades or businesses.* For purposes of paragraph (c)(1) of this section, personal services performed during a taxable year as an employee generally will be treated as performed in a trade or business but will not be treated as performed in a real property trade or business, unless the taxpayer is a five-percent owner (within the meaning of section 416(i)(1)(B)) in the employer. If an employee is not a five-percent owner in the employer at all times during the taxable year, only the personal services performed by the employee during the period the employee is a five-percent owner in the employer will be treated as performed in a real property trade or business.

(d) *General rule for determining real property trades or businesses*—(1) *Facts and circumstances.* The determination of a taxpayer's real property trades or businesses for purposes of paragraph (c) of this section is based on all of the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the facts and circumstances in determining the real property trades or businesses in which the taxpayer provides personal services. Depending on the facts and circumstances, a real property trade or business consists either of one or more than one trade or business specifically described in section 469(c)(7)(C). A taxpayer's grouping of activities under §1.469–4 does not control the determination of the taxpayer's real property trades or businesses under this paragraph (d).

(2) *Consistency requirement.* Once a taxpayer determines the real property trades or businesses in which personal services are provided for purposes of paragraph (c) of this section, the taxpayer may not redetermine those real property trades or businesses in subsequent taxable years unless the original determination was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original determination clearly inappropriate.

(e) *Treatment of rental real estate activities of a qualifying taxpayer*—(1) *In general.* Section 469(c)(2) does not apply to any rental real estate activity of a taxpayer for a taxable year in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section. Instead, a rental real estate activity of a qualifying taxpayer is a passive activity under section 469 for the taxable year unless the taxpayer materially participates in the activity. Each interest in rental real estate of a qualifying taxpayer will be treated as a separate rental real estate activity, unless the taxpayer makes an election under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity. Each separate rental real estate activity, or the single combined rental real estate activity if the taxpayer makes an election under paragraph (g), will be an activity of the taxpayer for all purposes of section 469, including the former passive activity rules under section 469(f) and the disposition rules under section 469(g). However, section 469 will continue to be applied separately with respect to each publicly traded partnership, as required under section 469(k), notwithstanding the rules of this section.

(2) *Treatment as a former passive activity.* For any taxable year in which a qualifying taxpayer materially participates in a rental real estate activity, that rental real estate activity will be treated as a former passive activity under section 469(f) if disallowed deductions or credits are allocated to the activity under § 1.469–1(f)(4).

(3) *Grouping rental real estate activities with other activities*—(i) *In general.* For purposes of this section, a qualifying taxpayer may not group a rental real estate activity with any other activity of the taxpayer. For example, if a qualifying taxpayer develops real property, constructs buildings, and owns an interest in rental real estate, the taxpayer's interest in rental real estate may not be grouped with the taxpayer's development activity or construction activity. Thus, only the participation of the taxpayer with respect to the rental real estate may be used to determine if the taxpayer materially participates in the rental real estate activity under § 1.469–5T.

(ii) *Special rule for certain management activities.* A qualifying taxpayer may participate in a rental real estate activity through participation, within the meaning of §§ 1.469–5(f) and 5T(f), in an activity involving the management of rental real estate (even if this management activity is conducted through a separate entity). In determining whether the taxpayer materially participates in the rental real estate activity, however, work the taxpayer performs in the management activity is taken into account only to the extent it is performed in managing the taxpayer's own rental real estate interests.

(4) *Example.* The following example illustrates the application of this paragraph (e).

Example. (i) Taxpayer *B* owns interests in three rental buildings, *U, V* and *W*. In 1995, *B* has $30,000 of disallowed passive losses allocable to Building *U* and $10,000 of disallowed passive losses allocable to Building *V* under § 1.469–1(f)(4). In 1996, *B* has $5,000 of net income from Building *U*, $5,000 of net losses from Building *V*, and $10,000 of net income from Building *W*. Also in 1996, *B* is a qualifying taxpayer within the meaning of paragraph (c) of this section. Each building is treated as a separate activity of *B* under paragraph (e)(1) of this section, unless *B* makes the election under paragraph (g) to treat the three buildings as a single rental real estate activity. If the buildings are treated as separate activities, material participation is determined separately with respect to each building. If *B* makes the election under paragraph (g) to treat the buildings as a single activity, all participation relating to the buildings is aggregated in determining whether *B* materially participates in the combined activity.

(ii) Effective beginning in 1996, *B* makes the election under paragraph (g) to treat the three buildings as a single rental real estate activity. *B* works full-time managing the three buildings and thus materially participates in the combined activity in 1996 (even if *B* conducts this management function through a separate entity, including a closely held C corporation). Accordingly, the combined activity is not a passive activity of *B* in 1996. Moreover, as a result of the election under paragraph (g), disallowed passive losses of $40,000 ($30,000+$10,000) are allocated to the combined activity. B's net income from the activity for 1996 is $10,000 ($5,000 − $5,000+$10,000). This net income is nonpassive income for purposes of section

469. However, under section 469(f), the net income from a former passive activity may be offset with the disallowed passive losses from the same activity. Because Buildings *U, V* and *W* are treated as one activity for all purposes of section 469 due to the election under paragraph (g), and this activity is a former passive activity under section 469(f), *B* may offset the $10,000 of net income from the buildings with an equal amount of disallowed passive losses allocable to the buildings, regardless of which buildings produced the income or losses. As a result, *B* has $30,000 ($40,000 − $10,000) of disallowed passive losses remaining from the buildings after 1996.

(f) *Limited partnership interests in rental real estate activities*—(1) *In general.* If a taxpayer elects under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity, and at least one interest in rental real estate is held by the taxpayer as a limited partnership interest (within the meaning of §1.469–5T(e)(3)), the combined rental real estate activity will be treated as a limited partnership interest of the taxpayer for purposes of determining material participation. Accordingly, the taxpayer will not be treated under this section as materially participating in the combined rental real estate activity unless the taxpayer materially participates in the activity under the tests listed in §1.469–5T(e)(2) (dealing with the tests for determining the material participation of a limited partner).

(2) *De minimis exception.* If a qualifying taxpayer elects under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity, and the taxpayer's share of gross rental income from all of the taxpayer's limited partnership interests in rental real estate is less than ten percent of the taxpayer's share of gross rental income from all of the taxpayer's interests in rental real estate for the taxable year, paragraph (f)(1) of this section does not apply. Thus the taxpayer may determine material participation under any of the tests listed in §1.469–5T(a) that apply to rental real estate activities.

(g) *Election to treat all interests in rental real estate as a single rental real estate activity*—(1) *In general.* A qualifying taxpayer may make an election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. This election is binding for the taxable year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section, even if there are intervening years in which the taxpayer is not a qualifying taxpayer. The election may be made in any year in which the taxpayer is a qualifying taxpayer, and the failure to make the election in one year does not preclude the taxpayer from making the election in a subsequent year. In years in which the taxpayer is not a qualifying taxpayer, the election will not have effect and the taxpayer's activities will be those determined under §1.469–4. If there is a material change in the taxpayer's facts and circumstances, the taxpayer may revoke the election using the procedure described in paragraph (g)(3) of this section.

(2) *Certain changes not material.* The fact that an election is less advantageous to the taxpayer in a particular taxable year is not, of itself, a material change in the taxpayer's facts and circumstances. Similarly, a break in the taxpayer's status as a qualifying taxpayer is not, of itself, a material change in the taxpayer's facts and circumstances.

(3) *Filing a statement to make or revoke the election.* A qualifying taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity by filing a statement with the taxpayer's original income tax return for the taxable year. This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to section 469(c)(7)(A). The taxpayer may make this election for any taxable year in which section 469(c)(7) is applicable. A taxpayer may revoke the election only in the taxable year in which a material change in the taxpayer's facts and circumstances occurs or in a subsequent year in which the facts and circumstances remain materially changed from those in the taxable year for which the election was made. To revoke the election, the taxpayer must file a statement with the taxpayer's original income tax return for the year of revocation. This statement must

contain a declaration that the taxpayer is revoking the election under section 469(c)(7)(A) and an explanation of the nature of the material change.

(h) *Interests in rental real estate held by certain passthrough entities*—(1) *General rule.* Except as provided in paragraph (h)(2) of this section, a qualifying taxpayer's interest in rental real estate held by a partnership or an S corporation (passthrough entity) is treated as a single interest in rental real estate if the passthrough entity grouped its rental real estate as one rental activity under § 1.469–4(d)(5). If the passthrough entity grouped its rental real estate into separate rental activities under § 1.469–4(d)(5), each rental real estate activity of the passthrough entity will be treated as a separate interest in rental real estate of the qualifying taxpayer. However, the qualifying taxpayer may elect under paragraph (g) of this section to treat all interests in rental real estate, including the rental real estate interests held through passthrough entities, as a single rental real estate activity.

(2) *Special rule if a qualifying taxpayer holds a fifty-percent or greater interest in a passthrough entity.* If a qualifying taxpayer owns, directly or indirectly, a fifty-percent or greater interest in the capital, profits, or losses of a passthrough entity for a taxable year, each interest in rental real estate held by the passthrough entity will be treated as a separate interest in rental real estate of the qualifying taxpayer, regardless of the passthrough entity's grouping of activities under § 1.469–4(d)(5). However, the qualifying taxpayer may elect under paragraph (g) of this section to treat all interests in rental real estate, including the rental real estate interests held through passthrough entities, as a single rental real estate activity.

(3) *Special rule for interests held in tiered passthrough entities.* If a passthrough entity owns a fifty-percent or greater interest in the capital, profits, or losses of another passthrough entity for a taxable year, each interest in rental real estate held by the lower-tier entity will be treated as a separate interest in rental real estate of the upper-tier entity, regardless of the lower-tier entity's grouping of activities under § 1.469–4(d)(5).

(i) [Reserved]

(j) *$25,000 offset for rental real estate activities of qualifying taxpayers*—(1) *In general.* A qualifying taxpayer's passive losses and credits from rental real estate activities (including prior-year disallowed passive activity losses and credits from rental real estate activities in which the taxpayer materially participates) are allowed to the extent permitted under section 469(i). The amount of losses or credits allowable under section 469(i) is determined after the rules of this section are applied. However, losses allowable by reason of this section are not taken into account in determining adjusted gross income for purposes of section 469(i)(3).

(2) *Example.* The following example illustrates the application of this paragraph (j).

Example (i) Taxpayer *A* owns building *X* and building *Y*, both interests in rental real estate. In 1995, *A* is a qualifying taxpayer within the meaning of paragraph (c) of this section. *A* does not elect to treat *X* and *Y* as one activity under section 469(c)(7)(A) and paragraph (g) of this section. As a result, *X* and *Y* are treated as separate activities pursuant to section 469(c)(7)(A)(ii). *A* materially participates in *X* which has $100,000 of passive losses disallowed from prior years and produces $20,000 of losses in 1995. *A* does not materially participate in *Y* which produces $40,000 of income in 1995. *A* also has $50,000 of income from other nonpassive sources in 1995. *A* otherwise meets the requirements of section 469(i).

(ii) Because *X* is not a passive activity in 1995, the $20,000 of losses produced by *X* in 1995 are nonpassive losses that may be used by *A* to offset part of the $50,000 of nonpassive income. Accordingly, *A* is left with $30,000 ($50,000–$20,000) of nonpassive income. In addition, A may use the prior year disallowed passive losses of *X* to offset any income from *X* and passive income from other sources. Therefore, *A* may offset the $40,000 of passive income from *Y* with $40,000 of passive losses from *X*.

(iii) Because *A* has $60,000 ($100,000–$40,000) of passive losses remaining from *X* and meets all of the requirements of section 469(i), *A* may offset up to $25,000 of nonpassive income with passive losses from *X* pursuant to section 469(i). As a result, *A* has $5,000 ($30,000–$25,000) of nonpassive income remaining and disallowed passive losses from *X* of $35,000 ($60,000–$25,000) in 1995.

[T.D. 8645, 60 FR 66499, Dec. 22, 1995]

§1.469–10 Application of section 469 to publicly traded partnerships.

(a) [Reserved].

(b) *Publicly traded partnership*—(1) *In general.* For purposes of section 469(k), a partnership is a publicly traded partnership only if the partnership is a publicly traded partnership as defined in §1.7704–1.

(2) *Effective date.* This section applies for taxable years of a partnership beginning on or after December 17, 1998.

[T.D. 8799, 63 FR 69553, Dec. 17, 1998]

§1.469–11 Effective date and transition rules.

(a) *Generally applicable effective dates.* Except as otherwise provided in this section—

(1) The rules contained in §§1.469–1, 1.469–1T, 1.469–2, 1.469–2T, 1.469–3, 1.469–3T, 1.469–4, 1.469–5, and 1.469–5T apply for taxable years ending after May 10, 1992.

(2) The rules contained in 26 CFR 1.469–1T, 1.469–2T, 1.469–3T, 1.469–4T, 1.469–5T, 1.469–11T (b) and (c) (as contained in the CFR edition revised as of April 1, 1992) apply for taxable years beginning after December 31, 1986, and ending on or before May 10, 1992;

(3) The rules contained in §1.469–9 apply for taxable years beginning on or after January 1, 1995, and to elections made under §1.469–9(g) with returns filed on or after January 1, 1995; and

(4) This section applies for taxable years beginning after December 31, 1986.

(b) *Additional effective dates.*—(1) *Application of 1992 amendments for taxable years beginning before October 4, 1994.* Except as provided in paragraph (b)(2) of this section, for taxable years that end after May 10, 1992, and begin before October 4, 1994, a taxpayer may determine tax liability in accordance with Project PS–1–89 published at 1992–1 C.B. 1219 (see §601.601(d)(2)(ii)(b) of this chapter).

(2) *Additional transition rule for 1992 amendments.* If a taxpayer's first taxable year ending after May 10, 1992, begins on or before that date, the taxpayer may treat the taxable year, for purposes of paragraph (a) of this section, as a taxable year ending on or before May 10, 1992.

(3) *Fresh starts under consistency rules*—(i) *Regrouping when tax liability is first determined under Project PS–1–89.* For the first taxable year in which a taxpayer determines its tax liability under Project PS–1–89, the taxpayer may regroup its activities without regard to the manner in which the activities were grouped in the preceding taxable year and must regroup its activities if the grouping in the preceding taxable year is inconsistent with the rules of Project PS–1–89.

(ii) *Regrouping when tax liability is first determined under §1.469–4.* For the first taxable year in which a taxpayer determines its tax liability under §1.469–4, rather than under the rules of Project PS–1–89, the taxpayer may regroup its activities without regard to the manner in which the activities were grouped in the preceding taxable year and must regroup its activities if the grouping in the preceding taxable year is inconsistent with the rules of §1.469–4.

(iii) *Regrouping when taxpayer is first subject to section 469(c)(7).* For the first taxable year beginning after December 31, 1993, a taxpayer may regroup its activities to the extent necessary or appropriate to avail itself of the provisions of section 469(c)(7) and without regard to the manner in which the activities were grouped in the preceding taxable year.

(4) *Certain investment credit property.* (i) The rules contained in §1.469–3(f) apply with respect to property placed in service after December 31, 1990 (other than property described in section 11813 (c)(2) of the Omnibus Reconciliation Act of 1990 (P.L. 101–508)).

(ii) The rules contained in 26 CFR 1.469–3T(f) (as contained in the CFR edition revised as of April 1, 1992) apply with respect to property placed in service on or before December 31, 1990, and property described in section 11813(c)(2) of the Omnibus Reconcilation Act of 1990.

(c) *Special rules*—(1) *Application of certain income recharacterization rules*—(i) *In general.* No amount of gross income shall be treated under §1.469–2T(f)(3) through (7) as income that is not from a passive activity for any taxable year of the taxpayer beginning before January 1, 1988.

(ii) *Property rented to a nonpassive activity.* In applying § 1.469–2(f)(6) or § 1.469–2T(f)(6) to a taxpayer's rental of an item of property, the taxpayer's net rental activity income (within the meaning of § 1.469–2(f)(9)(iv) or § 1.469–2T(f)(9)(iv)) from the property for any taxable year beginning after December 31, 1987, does not include the portion of the income (if any) that is attributable to the rental of that item of property pursuant to a written binding contract entered into before February 19, 1988.

(2) *Qualified low-income housing projects.* For a transitional rule concerning the application of section 469 to losses from qualified low-income housing projects, see section 502 of the Tax Reform Act of 1986.

(3) *Effect of events occurring in years prior to 1987.* The treatment for a taxable year beginning after December 31, 1986, of any item of income, gain, loss, deduction, or credit as an item of passive activity gross income, passive activity deduction, or credit from a passive activity, is determined as if section 469 and the regulations thereunder had been in effect for taxable years beginning before January 1, 1987, but without regard to any passive activity loss or passive activity credit that would have been disallowed for any taxable year beginning before January 1, 1987, if section 469 and the regulations thereunder had been in effect for that year. For example, in determining whether a taxpayer materially participates in an activity under § 1.469–5T(a)(5) (relating to taxpayers who have materially participated in an activity for five of the ten immediately preceding taxable years) for any taxable year beginning after December 31, 1986, the taxpayer's participation in the activity for all prior taxable years (including taxable years beginning before 1987) is taken into account. See § 1.469–5(j) (relating to the determination of material participation for taxable years beginning before January 1, 1987).

(d) *Examples.* The following examples illustrate the application of paragraph (c) of this section:

Example 1. A, a calendar year individual, is a partner in a partnership with a taxable year ending on January 31. During its taxable year ending January 31, 1987, the partnership was engaged in a single activity involving the conduct of a trade or business. In applying section 469 and the regulations thereunder to A for calendar year 1987, A's distributive share of partnership items for the partnership's taxable year ending January 31, 1987, is taken into account. Therefore, under § 1.469–2T(e)(1) and paragraph (c)(3) of this section, A's participation in the activity throughout the partnership's taxable year beginning February 1, 1986, and ending January 31, 1987, is taken into account for purposes of determining the character under section 469 of the items of gross income, deduction, and credit allocated to A for the partnership's taxable year ending January 31, 1987.

Example 2. B, a calendar year individual, is a beneficiary of a trust described in section 651 that has a taxable year ending January 31. The trust conducts a rental activity (within the meaning of § 1.469–1T(e)(3)). Because the trust's taxable year ending January 31, 1987, began before January 1, 1987, section 469 and the regulations thereunder do not applying to the trust for that year. Section 469 and the regulations thereunder do apply, however, to B for B's calender year 1987. Therefore, income of the trust from the rental activity for the trust's taxable year ending January 31, 1987, that is included in B's gross income for 1987 is taken into account in apply section 469 to B for 1987.

[T.D. 8417, 57 FR 20759, May 15, 1992, as amended by T.D. 8417, 59 FR 45623, Sept. 2, 1994; T.D. 8565, 59 FR 50489, Oct. 4, 1994; T.D. 8645, 60 FR 66501, Dec. 22, 1995]

INVENTORIES

§ 1.471–1 Need for inventories.

In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected. (But see §1.472–1.)

[T.D. 6500, 25 FR 11724, Nov. 26, 1960]

§1.471–2 Valuation of inventories.

(a) Section 471 provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

(b) It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is in accord with §§1.471–1 through 1.471–11.

(c) The bases of valuation most commonly used by business concerns and which meet the requirements of section 471 are (1) cost and (2) cost or market, whichever is lower. (For inventories by dealers in securities, see §1.471–5.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether subparagraph (1) or (2) of this paragraph is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

(d) In respect of normal goods, whichever method is adopted must be applied with reasonable consistency to the entire inventory of the taxpayer's trade or business except as to those goods inventoried under the last-in, first-out method authorized by section 472 or to animals inventoried under the elective unit, livestock-price-method authorized by §1.471–6. See paragraph (d) of §1.446–1 for rules permitting the use of different methods of accounting if the taxpayer has more than one trade or business. Where the taxpayer is engaged in more than one trade or business the Commissioner may require that the method of valuing inventories with respect to goods in one trade or business also be used with respect to similar goods in other trades or businesses if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essential to a clear reflection of income. Taxpayers were given an option to adopt the basis of either (1) cost or (2) cost or market, whichever is lower, for their 1920 inventories. The basis properly adopted for that year or any subsequent year is controlling, and a change can now be made only after permission is secured from the Commissioner. Application for permission to change the basis of valuing inventories shall be made in writing and filed with the Commissioner as provided in paragraph (e) of §1.446–1. Goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will be deemed to be the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired. But see section 472 as to last-in, first-out inventories. Where the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of goods used, transferred, or sold, calculated upon the basis of the actual cost of the goods acquired during the taxable year (including the inventory at the beginning of the year), the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balances shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

(e) Inventories should be recorded in a legible manner, properly computed and summarized, and should be preserved as a part of the accounting records of the taxpayer. The inventories of taxpayers on whatever basis taken will be subject to investigation by the district director, and the taxpayer must satisfy the district director of the correctness of the prices adopted.

(f) The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with the regulations in this part:

(1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.

(2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

(3) Omitting portions of the stock on hand.

(4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock.

(5) Including stock in transit, shipped either to or from the taxpayer, the title to which is not vested in the taxpayer.

(6) Segregating indirect production costs into fixed and variable production cost classifications (as defined in § 1.471–11(b)(3)(ii)) and allocating only the variable costs to the cost of goods produced while treating fixed costs as period costs which are currently deductible. This method is commonly referred to as the ''direct cost'' method.

(7) Treating all or substantially all indirect production costs (whether classified as fixed or variable) as period costs which are currently deductible. This method is generally referred to as the ''prime cost'' method.

[T.D. 6500, 25 FR 11724, Nov. 26, 1960, as amended by T.D. 7285, 38 FR 26185, Sept. 19, 1973]

§ 1.471–3 Inventories at cost.

Cost means:

(a) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(b) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods. For taxpayers acquiring merchandise for resale that are subject to the provisions of section 263A, see §§ 1.263A–1 and 1.263A–3 for additional amounts that must be included in inventory costs.

(c) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to and necessary for the production of the particular article, including in such indirect production costs an appropriate portion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit. See §§ 1.263A–1 and 1.263A–2 for more specific rules regarding the treatment of production costs.

(d) In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry. Among such cases are:

(1) Farmers and raisers of livestock (see §1.471–6);

(2) Miners and manufacturers who by a single process or uniform series of processes derive a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike (see §1.471–7); and

(3) Retail merchants who use what is known as the ''retail method'' in ascertaining approximate cost (see §1.471–8).

Notwithstanding the other rules of this section, cost shall not include an amount which is of a type for which a deduction would be disallowed under section 162 (c), (f), or (g) and the regulations thereunder in the case of a business expense.

[T.D. 6500, 25 FR 11725, Nov. 26, 1960, as amended by T.D. 7285, 38 FR 26185, Sept. 19, 1973; T.D. 7345, 40 FR 7439, Feb. 20, 1975; T.D. 8131, 52 FR 10084, Mar. 30, 1987; T.D. 8482, 58 FR 42233, Aug. 9, 1993]

§1.471–4 Inventories at cost or market, whichever is lower.

(a) *In general*—(1) *Market definition.* Under ordinary circumstances and for normal goods in an inventory, *market* means the aggregate of the current bid prices prevailing at the date of the inventory of the basic elements of cost reflected in inventories of goods purchased and on hand, goods in process of manufacture, and finished manufactured goods on hand. The basic elements of cost include direct materials, direct labor, and indirect costs required to be included in inventories by the taxpayer (e.g., under section 263A and its underlying regulations for taxpayers subject to that section). For taxpayers to which section 263A applies, for example, the basic elements of cost must reflect all direct costs and all indirect costs properly allocable to goods on hand at the inventory date at the current bid price of those costs, including but not limited to the cost of purchasing, handling, and storage activities conducted by the taxpayer, both prior to and subsequent to acquisition or production of the goods. The determination of the current bid price of the basic elements of costs reflected in goods on hand at the inventory date must be based on the usual volume of particular cost elements purchased (or incurred) by the taxpayer.

(2) *Fixed price contracts.* Paragraph (a)(1) of this section does not apply to any goods on hand or in process of manufacture for delivery upon firm sales contracts (i.e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, under which the taxpayer is protected against actual loss. Any such goods must be inventoried at cost.

(3) *Examples.* The valuation principles in paragraph (a)(1) of this section are illustrated by the following examples:

Example 1. (i) Taxpayer A manufactures tractors. A values its inventory using cost or market, whichever is lower, under paragraph (a)(1) of this section. At the end of 1994, the cost of one of A's tractors on hand is determined as follows:

Direct materials	$3,000
Direct labor	4,000
Indirect costs under section 263A	3,000
Total section 263A costs (cost)	$10,000

(ii) A determines that the aggregate of the current bid prices of the materials, labor, and overhead required to reproduce the tractor at the end of 1994 are as follows:

Direct materials	$3,100
Direct labor	4,100
Indirect costs under section 263A	3,100
Total section 263A costs (market)	$10,300

(iii) In determining the lower of cost or market value of the tractor, A compares the cost of the tractor, $10,000, with the market value of the tractor, $10,300, in accordance with paragraph (c) of this section. Thus, under this section, A values the tractor at $10,000.

Example 2. (i) Taxpayer B purchases and resells several lines of shoes and is subject to section 263A. B values its inventory using cost or market, whichever is lower, under paragraph (a)(1) of this section. At the end of 1994, the cost of one pair of shoes on hand is determined as follows:

Acquisition cost	$200
Indirect costs under section 263A	10
Total section 263A costs (cost)	$210

(ii) B determines the aggregate current bid prices prevailing at the end of 1994 for the elements of cost (both direct costs and indirect costs incurred prior and subsequent to acquisition of the shoes) based on the volume of the elements usually purchased (or incurred) by B as follows:

Acquisition cost	$178
Indirect costs under section 263A	12
Total § 263A costs (market)	$190

(iii) In determining the lower of cost or market value of the shoes, B compares the cost of the pair of shoes, $210, with the market value of the shoes, $190, in accordance with paragraph (c) of this section. Thus, under this section, B values the shoes at $190.

(b) *Inactive markets.* Where no open market exists or where quotations are nominal, due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.

(c) *Comparison of cost and market.* Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.

(d) *Effective date.* This section applies to inventory valuations for taxable years beginning after December 31, 1993. For taxable years beginning before January 1, 1994, taxpayers must take reasonable positions on their federal income tax returns with respect to the application of section 263A, and must have otherwise complied with § 1.471–4 (as contained in the 26 CFR part 1 edition revised April 1, 1993). For purposes of this paragraph (d), a reasonable position as to the application of section 263A is a position consistent with the temporary regulations, revenue rulings, revenue procedures, notices, and announcements concerning section 263A applicable in taxable years beginning before January 1, 1994. (See § 601.601(d)(2)(ii)(*b*) of this chapter.)

[T.D. 6500, 25 FR 11725, Nov. 26, 1960, as amended by T.D. 8482, 58 FR 42233, Aug. 9, 1993]

§ 1.471–5 Inventories by dealers in securities.

A dealer in securities who in his books of account regularly inventories unsold securities on hand either—

(a) At cost,

(b) At cost or market, whichever is lower, or

(c) At market value,

may make his return upon the basis upon which his accounts are kept, provided that a description of the method employed is included in or attached to the return, that all the securities are inventoried by the same method, and that such method is adhered to in subsequent years, unless another method is authorized by the Commissioner pursuant to a written application therefor filed as provided in paragraph (e) of § 1.446–1. A dealer in securities in whose books of account separate computations of the gain or loss from the sale of the various lots of securities sold are made on the basis of the cost of each lot shall be regarded, for the purposes of this section, as regularly inventorying his securities at cost. For the purposes of this section, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as provided in this section may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this section. See §§1.263A–1 and 1.263A–3 for rules regarding the treatment of costs with respect to property acquired for resale.

[T.D. 6500, 25 FR 11725, Nov. 26, 1960, as amended by T.D. 8131, 52 FR 10084, Mar 30, 1987; T.D. 8482, 58 FR 42234, Aug. 9, 1993]

§1.471–6 Inventories of livestock raisers and other farmers.

(a) A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in paragraph (e) of §1.446–1.

(b) In any change of accounting method from the cash receipts and disbursements method to an inventory method, adjustments shall be made as provided in section 481 (relating to adjustments required by change in method of accounting) and the regulations thereunder.

(c) Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory method may value their inventories according to the ‘‘farm-price method’’, and farmers raising livestock may value their inventories of animals according to either the ‘‘farm-price method’’ or the ‘‘unit-livestock-price method’’. In addition, these inventory methods may be used to account for the costs of property produced in a farming business that are required to be capitalized under section 263A regardless of whether the property being produced is otherwise treated as inventory by the taxpayer, and regardless of whether the taxpayer is otherwise using the cash or an accrual method of accounting. Thus, for example, the unit livestock method may be utilized by a taxpayer in accounting under section 263A for the costs of raising animals that will be used for draft, breeding, or dairy purposes.

(d) The ‘‘farm-price method’’ provides for the valuation of inventories at market price less direct cost of disposition. If this method of valuation is used, it generally must be applied to all property produced by the taxpayer in the trade or business of farming, except as to livestock accounted for, at the taxpayer’s election, under the unit livestock method of accounting. However, see §1.263A–4T(c)(3) for an exception to this rule. If the use of the ‘‘farm-price method’’ of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in paragraph (e) of §1.446–1.

(e) The ‘‘unit-livestock-price method’’ provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuing his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: Calves, $15; yearlings, $22.50; 2-year olds, $30; mature animals, $37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several classes, are subject to approval by the district director upon examination of the taxpayer’s return.

(f) A taxpayer who elects to use the ‘‘unit-livestock-price method’’ must apply it to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. Except as otherwise provided in this paragraph, once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent taxable years.

For taxable years beginning after August 22, 1997, a taxpayer using the unit livestock method must, however, annually reevaluate the unit livestock prices and must adjust the prices upward to reflect increases in the costs of raising livestock. The consent of the Commissioner is not required to make such upward adjustments. No other changes in the classification of animals or unit prices shall be made without the consent of the Commissioner. See § 1.263A–4T for rules regarding the computation of costs for purposes of the unit livestock method.

(g) A livestock raiser who uses the ''unit-livestock-price method'' must include in his inventory at cost any livestock purchased, except that animals purchased for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each taxable year in accordance with the established unit prices, except that no increase is to be made in the taxable year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in, first-out method of valuing inventories must be applied.

(h) If a taxpayer using the ''farm-price method'' desires to adopt the ''unit-livestock-price method'' in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in paragraph (e) of § 1.446–1. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market whichever is lower, may adopt the ''unit-livestock-price method'' for valuing his inventories of livestock without formal application for permission, but the classifications and unit prices selected are subject to approval by the district director upon examination of the taxpayer's return. A livestock raiser who has adopted a constant unit-price method of valuing livestock inventories and filed returns on that basis will be considered as having elected the ''unit-livestock-price method''.

(i) If returns have been made in which the taxable income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding taxable year. In this statement such adjustments shall be made as are necessary to bring the closing inventory for the preceding taxable year into agreement with the opening complete inventory for the current taxable year. If necessary clearly to reflect income, similar adjustments may be made as at the beginning of the preceding year or years, and the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such year or years.

[T.D. 6500, 25 FR 11726, Nov. 26, 1960, as amended by T.D. 8131, 52 FR 10084, Mar. 30, 1987; T.D. 8729, 62 FR 44551, Aug. 22, 1997]

§ 1.471–7 Inventories of miners and manufacturers.

A taxpayer engaged in mining or manufacturing who by a single process or uniform series of processes derives a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike, and who in conformity to a recognized trade practice allocates an amount of cost to each kind, size, or grade of product, which in the aggregate will absorb the total cost of production, may, with the consent of the Commissioner, use such allocated cost as a basis for pricing inventories, provided such allocation bears a reasonable relation to the respective selling values of the different kinds, sizes, or grades of product. See section 472 as to last-in, first-out inventories.

[T.D. 6500, 25 FR 11726, Nov. 26, 1960]

§ 1.471–8 Inventories of retail merchants.

(a) Retail merchants who employ what is known as the ''retail method'' of pricing inventories may make their returns upon that method, provided that the use of such method is designated upon the return, that accurate accounts are kept, and that such method is consistently adhered to unless a change is authorized by the Commissioner as provided in paragraph (e) of §1.446–1. Under the retail method the total of the retail selling prices of the goods on hand at the end of the year in each department or of each class of goods is reduced to approximate cost by deducting therefrom an amount which bears the same ratio to such total as—

(1) The total of the retail selling prices of the goods included in the opening inventory plus the retail selling prices of the goods purchased during the year, with proper adjustment to such selling prices for all mark-ups and mark-downs, less

(2) The cost of the goods included in the opening inventory plus the cost of the goods purchased during the year, bears to (1).

The result should represent as accurately as may be the amounts added to the cost price of the goods to cover selling and other expenses of doing business and for the margin of profit. See §§1.263A–1 and 1.263A–3 for rules regarding the computation of costs with respect to property acquired for resale.

(b) For further adjustments to be made in the case of a retail merchant using the last-in, first-out inventory method authorized by section 472, see paragraph (k) of §1.472–1.

(c) A taxpayer maintaining more than one department in his store or dealing in classes of goods carrying different percentages of gross profit should not use a percentage of profit based upon an average of his entire business, but should compute and use in valuing his inventory the proper percentages for the respective departments or classes of goods.

(d) A taxpayer (other than one using the last-in, first-out inventory method) who previously has determined inventories in accordance with the retail method, except that, to obtain a basis of approximate cost or market, whichever is lower, has consistently and uniformly followed the practice of adjusting the retail selling prices of the goods included in the opening inventory and purchased during the taxable year for mark-ups but not for mark-downs, may continue such practice subject to the conditions prescribed in this section. The adjustments must be bona fide and consistent and uniform. Where mark-downs are not included in the adjustments, mark-ups made to cancel or correct mark-downs shall not be included; and the mark-ups included must be reduced by the mark-downs made to cancel or correct such mark-ups.

(e) In no event shall mark-downs not based on actual reduction of retail sale prices, such as mark-downs based on depreciation and obsolescence, be recognized in determining the retail selling prices of the goods on hand at the end of the taxable year.

(f) A taxpayer (other than one using the last-in, first-out inventory method) who previously has determined inventories without following the practice of eliminating mark-downs in making adjustments to retail selling prices may adopt such practice, provided permission to do so is obtained in accordance with, and subject to the terms provided by, paragraph (e) of §1.446–1. A taxpayer filing a first return of income may adopt such practice subject to approval by the district director upon examination of the return.

(g) A taxpayer using the last-in, first-out inventory method in conjunction with retail computations must adjust retail selling prices for mark-downs as well as mark-ups, in order that there may be reflected the approximate cost of the goods on hand at the end of the taxable year regardless of market values.

[T.D. 6500, 25 FR 11726, Nov. 26, 1960, as amended by T.D. 8131, 52 FR 10084, Mar. 30, 1987; T.D. 8482, 58 FR 42234, Aug. 9, 1993]

§1.471–9 Inventories of acquiring corporations.

For additional rules in the case of certain corporate acquisitions specified in section 381(a), see section 381(c)(5) and the regulations thereunder.

[T.D. 6500, 25 FR 11727, Nov. 26, 1960]

§1.471–10 Applicability of long-term contract methods.

See §1.451–3 for rules providing for the application of the long-term contract methods to certain manufacturing contracts.

[T.D. 8067, 51 FR 393, Jan. 6, 1986]

§ 1.471–11 Inventories of manufacturers.

(a) *Use of full absorption method of inventory costing.* In order to conform as nearly as may be possible to the best accounting practices and to clearly reflect income (as required by section 471 of the Code), both direct and indirect production costs must be taken into account in the computation of inventoriable costs in accordance with the ''full absorption'' method of inventory costing. Under the full absorption method of inventory costing production costs must be allocated to goods produced during the taxable year, whether sold during the taxable year or in inventory at the close of the taxable year determined in accordance with the taxpayer's method of identifying goods in inventory. Thus, the taxpayer must include as inventoriable costs all direct production costs and, to the extent provided by paragraphs (c) and (d) of this section, all indirect production costs. For purposes of this section, the term ''financial reports'' means financial reports (including consolidated financial statements) to shareholders, partners, beneficiaries or other proprietors and for credit purposes. See also § 1.263A–1T with respect to the treatment of production costs incurred in taxable years beginning after December 31, 1986, and before January 1, 1994. See also §§ 1.263A–1 and 1.263A–2 with respect to the treatment of production costs incurred in taxable years beginning after December 31, 1993.

(b) *Production costs*—(1) *In general.* Costs are considered to be production costs to the extent that they are incident to and necessary for production or manufacturing operations or processes. Production costs include direct production costs and fixed and variable indirect production costs.

(2) *Direct production costs.* (i) Costs classified as ''direct production costs'' are generally those costs which are incident to and necessary for production or manufacturing operations or processes and are components of the cost of either direct material or direct labor. Direct material costs include the cost of those materials which become an integral part of the specific product and those materials which are consumed in the ordinary course of manufacturing and can be identified or associated with particular units or groups of units of that product. See § 1.471–3 for the elements of direct material costs. Direct labor costs include the cost of labor which can be identified or associated with particular units or groups of units of a specific product. The elements of direct labor costs include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d)), shift differential, payroll taxes and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor. For the treatment of rework labor, scrap, spoilage costs, and any other costs not specifically described as direct production costs see § 1.471–11(c)(2).

(ii) Under the full absorption method, a taxpayer must take into account all items of direct production cost in his inventoriable costs. Nevertheless, a taxpayer will not be treated as using an incorrect method of inventory costing if he treats any direct production costs as indirect production costs, provided such costs are allocated to the taxpayer's ending inventory to the extent provided by paragraph (d) of this section. Thus, for example, a taxpayer may treat direct labor costs as part of indirect production costs (for example, by use of the conversion cost method), provided all such costs are allocated to ending inventory to the extent provided by paragraph (d) of this section.

(3) *Indirect production costs*—(i) *In general.* The term ''indirect production costs'' includes all costs which are incident to and necessary for production or manufacturing operations or processes other than direct production costs (as defined in subparagraph (2) of this paragraph). Indirect production costs may be classified as to kind or type in accordance with acceptable accounting principles so as to enable convenient identification with various production or manufacturing activities or functions and to facilitate reasonable groupings of such costs for purposes of determining unit product costs.

(ii) *Fixed and variable classifications.* For purposes of this section, fixed indirect production costs are generally those costs which do not vary significantly with changes in the amount of goods produced at any given level of production capacity. These fixed costs may include, among other costs, rent and property taxes on buildings and machinery incident to and necessary for manufacturing operations or processes. On the other hand, variable indirect production costs are generally those costs which do vary significantly with changes in the amount of goods produced at any given level of production capacity. These variable costs may include, among other costs, indirect materials, factory janitorial supplies, and utilities. Where a particular cost contains both fixed and variable elements, these elements should be segregated into fixed and variable classifications to the extent necessary under the taxpayer's method of allocation, such as for the application of the practical capacity concept (as described in paragraph (d) (4) of this section).

(c) *Certain indirect and production costs*—(1) *General rule.* Except as provided in paragraph (c)(3) of this section and in paragraph (d)(6)(v) of §1.451–3, in order to determine whether indirect production costs referred to in paragraph (b) of this section must be included in a taxpayer's computation of the amount of inventoriable costs, three categories of costs have been provided in subparagraph (2) of this paragraph. Costs described in subparagraph (2)(i) of this paragraph must be included in the taxpayer's computation of the amount of inventoriable costs, regardless of their treatment by the taxpayer in his financial reports. Costs described in subparagraph (2)(ii) of this paragraph need not enter into the taxpayer's computation of the amount of inventoriable costs, regardless of their treatment by the taxpayer in his financial reports. Costs described in subparagraph (2)(iii) of this paragraph must be included in or excluded from the taxpayer's computation of the amount inventoriable costs in accordance with the treatment of such costs by the taxpayer in his financial reports and generally accepted accounting principles. For the treatment of indirect production costs described in subparagraph (2) of this paragraph in the case of a taxpayer who is not using comparable methods of accounting for such costs for tax and financial reporting see paragraph (c)(3) of this section. For contracts entered into after December 31, 1982, notwithstanding this section, taxpayers who use an inventory method of accounting for extended period long-term contracts (as defined in paragraph (b)(3) of §1.451–3) for tax purposes may be required to use the cost allocation rules provided in paragraph (d)(6) of §1.451–3 rather than the cost allocation rules provided in this section. See paragraph (d)(6)(v) of §1.451–3. After a taxpayer has determined which costs must be treated as indirect production costs includible in the computation of the amount of inventoriable costs, such costs must be allocated to a taxpayer's ending inventory in a manner prescribed by paragraph (d) of this section.

(2) *Includibility of certain indirect production costs*—(i) *Indirect production* costs included in inventoriable costs. Indirect production costs which must enter into the computation of the amount of inventoriable costs (regardless of their treatment by a taxpayer in his financial reports) include:

(a) Repair expenses,

(b) Maintenance,

(c) Utilities, such as heat, power and light,

(d) Rent,

(e) Indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d), shift differential, payroll taxes and contributions to a supplemental unemployment benefit plan,

(f) Indirect materials and supplies,

(g) Tools and equipment not capitalized, and

(h) Costs of quality control and inspection,

to the extent, and only to the extent, such costs are incident to and necessary for production or manufacturing operations or processes.

(ii) *Costs not included in inventoriable costs.* Costs which are not required to be included for tax purposes in the computation of the amount of inventoriable costs (regardless of their treatment by a taxpayer in his financial reports) include:

(a) Marketing expenses,

(b) Advertising expenses,

(c) Selling expenses,

(d) Other distribution expenses,

(e) Interest,

(f) Research and experimental expenses including engineering and product development expenses,

(g) Losses under section 165 and the regulations thereunder,

(h) Percentage depletion in excess of cost depletion,

(i) Depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported by the taxpayer in his financial reports,

(j) Income taxes attributable to income received on the sale of inventory,

(k) Pension contributions to the extent that they represent past services cost,

(l) General and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes, and

(m) Salaries paid to officers attributable to the performance of services which are incident to and necessary for the taxpayer's activities taken as a whole rather than to production or manufacturing operations or processes.

Notwithstanding the preceding sentence, if a taxpayer consistently includes in his computation of the amount of inventoriable costs any of the costs described in the preceding sentence, a change in such method of inclusion shall be considered a change in method of accounting within the meaning of sections 446, 481, and paragraph (e)(4) of this section.

(iii) *Indirect production costs includible in inventoriable costs depending upon treatment in taxpayer's financial reports.* In the case of costs listed in this subdivision, the inclusion or exclusion of such costs from the amount of inventoriable costs for purposes of a taxpayer's financial reports shall determine whether such costs must be included in or excluded from the computation of inventoriable costs for tax purposes, but only if such treatment is not inconsistent with generally accepted accounting principles. In the case of costs which are not included in subdivision (i) or (ii) of this subparagraph, nor listed in this subdivision, whether such costs must be included in or excluded from the computation of inventoriable costs for tax purposes depends upon the extent to which such costs are similar to costs included in subdivision (i) or (ii), and if such costs are dissimilar to costs in subdivision (i) or (ii), such costs shall be treated as included in or excludable from the amount of inventoriable costs in accordance with this subdivision. The costs listed in this subdivision are:

(a) Taxes. Taxes otherwise allowable as a deduction under section 164 (other than State and local and foreign income taxes) attributable to assets incident to and necessary for production or manufacturing operations or processes. Thus, for example, the cost of State and local property taxes imposed on a factory or other production facility and any State and local taxes imposed on inventory must be included in or excluded from the computation of the amount of inventoriable costs for tax purposes depending upon their treatment by a taxpayer in his financial reports.

(b) Depreciation and depletion. Depreciation reported in financial reports and cost depletion on assets incident to and necessary for production or manufacturing operations or processes. In computing cost depletion under this section, the adjusted basis of such assets shall be reduced by cost depletion and not by percentage depletion taken thereon.

(c) Employee benefits. Pension and profit-sharing contributions representing current service costs otherwise allowable as a deduction under section 404, and other employee benefits incurred on behalf of labor incident to and necessary for production or manufacturing operations or processes. These other benefits include workmen's compensation expenses, payments under a wage continuation plan described in section 105(d), amounts of a type which would be includible in the gross income of employees under nonqualified pension, profit-sharing and stock bonus plans, premiums on life and health insurance and miscellaneous benefits provided for employees

such as safety, medical treatment, cafeteria, recreational facilities, membership dues, etc., which are otherwise allowable as deductions under chapter 1 of the Code.

(d) Costs attributable to strikes, rework labor, scrap and spoilage. Costs attributable to rework labor, scrap and spoilage which are incident to and necessary for production or manufacturing operations or processes and costs attributable to strikes incident to production or manufacturing operation or processes.

(e) Factory administrative expenses. Administrative costs of production (but not including any cost of selling or any return on capital) incident to and necessary for production or manufacturing operations or processes.

(f) Officers' salaries. Salaries paid to officers attributable to services performed incident to and necessary for production or manufacturing operations or processes.

(g) Insurance costs. Insurance costs incident to and necessary for production or manufacturing operations or processes such as insurance on production machinery and equipment. A change in the taxpayer's treatment in his financial reports of costs described in this subdivision which results in a change in treatment of such costs for tax purposes shall constitute a change in method of accounting within the meaning of sections 446 and 481 to which paragraph (e) applies.

(3) *Exception.* Except as provided in paragraph (d)(6) of §1.451–3, in the case of a taxpayer whose method of accounting for production costs in his financial reports is not comparable to his method of accounting for such costs for tax purposes (such as a taxpayer using the prime cost method for purposes of financial reports), the following rules apply:

(i) *Indirect production costs included in inventoriable costs.* Indirect production costs which must enter into the computation of the amount of inventoriable costs (to the extent, and only to the extent, such costs are incident to and necessary for production or manufacturing operations or processes) include:

(a) Repair expenses,

(b) Maintenance,

(c) Utilities, such as heat, power and light,

(d) Rent,

(e) Indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d)), shift differential, payroll taxes and contributions to a supplemental unemployment benefit plan,

(f) Indirect materials and supplies,

(g) Tools and equipment not capitalized,

(h) Costs of quality control and inspection,

(i) Taxes otherwise allowable as a deduction under section 164 (other than State and local and foreign income taxes),

(j) Depreciation and amortization reported for financial purposes and cost depletion,

(k) Administrative costs of production (but not including any cost of selling or any return on capital) incident to and necessary for production or manufacturing operations or processes,

(l) Salaries paid to officers attributable to services performed incident to and necessary for production or manufacturing operations or processes, and

(m) Insurance costs incident to and necessary for production or manufacturing operations or processes such as insurance on production machinery and equipment.

(ii) *Costs not included in inventoriable costs.* Costs which are not required to be included in the computation of the amount of inventoriable costs include:

(a) Marketing expenses,

(b) Advertising expenses,

(c) Selling expenses,

(d) Other distribution expenses,

(e) Interest,

(f) Research and experimental expenses including engineering and product development expenses,

(g) Losses under section 165 and the regulations thereunder,

(h) Percentage depletion in excess of cost depletion,

(i) Depreciation reported for Federal income tax purposes in excess of depreciation reported by the taxpayer in his financial reports,

(j) Income taxes attributable to income received on the sale of inventory,

(k) Pension and profit-sharing contributions representing either past service costs or representing current service costs otherwise allowable as a deduction under section 404, and other employee benefits incurred on behalf of labor. These other benefits include workmen's compensation expenses, payments under a wage continuation plan described in section 105(d), amounts of a type which would be includible in the gross income of employees under nonqualified pension, profit-sharing and stock bonus plans, premiums on life and health insurance and miscellaneous benefits provided for employees such as safety, medical treatment, cafeteria, recreational facilities, membership dues, etc., which are otherwise allowable as deductions under chapter 1 of the Code,

(l) Cost attributable to strikes, rework labor, scrap and spoilage,

(m) General and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes, and

(n) Salaries paid to officers attributable to the performance of services which are incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes.

(d) *Allocation methods*—(1) *In general.* Indirect production costs required to be included in the computation of the amount of inventoriable costs pursuant to paragraphs (b) and (c) of this paragraph must be allocated to goods in a taxpayer's ending inventory (determined in accordance with the taxpayer's method of identification) by the use of a method of allocation which fairly apportions such costs among the various items produced. Acceptable methods for allocating indirect production costs to the cost of goods in the ending inventory include the manufacturing burden rate method and the standard cost method. In addition, the practical capacity concept can be used in conjunction with either the manufacturing burden rate or standard cost method.

(2) *Manufacturing burden rate method*—(i) *In general.* Manufacturing burden rates may be developed in accordance with acceptable accounting principles and applied in a reasonable manner. In developing a manufacturing burden rate, the factors described in paragraph (d)(2)(ii) of this section may be taken into account. Furthermore, if the taxpayer chooses, he may allocate different indirect production costs on the basis of different manufacturing burden rates. Thus, for example, the taxpayer may use one burden rate for allocating rent and another burden rate for allocating utilities. The method used by the taxpayer in allocating such costs in his financial reports shall be given great weight in determining whether the taxpayer's method employed for tax purposes fairly allocates indirect production costs to the ending inventory. Any change in a manufacturing burden rate which is merely a periodic adjustment to reflect current operating conditions, such as increases in automation or changes in operation, does not constitute a change in method of accounting under section 446. However, a change in the concept upon which such rates are developed does constitute a change in method of accounting requiring the consent of the Commissioner. The taxpayer shall maintain adequate records and working papers to support all manufacturing burden rate calculations.

(ii) *Development of manufacturing burden rate.* The following factors, among others, may be taken into account in developing manufacturing burden rates:

(a) The selection of an appropriate level of activity and period of time upon which to base the calculation of rates which will reflect operating conditions for purposes of the unit costs being determined;

(b) The selection of an appropriate statistical base such as direct labor hours, direct labor dollars, or machine hours, or a combination thereof, upon which to apply the overhead rate to determine production costs; and

(c) The appropriate budgeting, classification and analysis of expenses (for example, the analysis of fixed and variable costs).

(iii) *Operation of the manufacturing burden rate method. (a)* The purpose of the manufacturing burden rate method used in conjunction with the full absorption method of inventory costing is to allocate an appropriate amount of indirect production costs to a taxpayer's goods in ending inventory by the use of predetermined rates intended to approximate the actual amount of indirect production costs incurred. Accordingly, the proper use of the manufacturing burden rate method under this section requires that any net negative or net positive difference between the total predetermined amount of indirect production costs allocated to the goods in ending inventory and the total amount of indirect production costs actually incurred and required to be allocated to such goods (i.e., the under or over-applied burden) must be treated as an adjustment to the taxpayer's ending inventory in the taxable year in which such difference arises. However, if such adjustment is not significant in amount in relation to the taxpayer's total actual indirect production costs for the year then such adjustment need not be allocated to the taxpayer's goods in ending inventory unless such allocation is made in the taxpayer's financial reports. The taxpayer must treat both positive and negative adjustments consistently.

(b) Notwithstanding subdivision *(a),* the practical capacity concept may be used to determine the total amount of fixed indirect production costs which must be allocated to goods in ending inventory. See subparagraph (4) of this paragraph.

(3) *Standard cost method*—(i) *In general.* A taxpayer may use the so-called ''standard cost'' method of allocating inventoriable costs to the goods in ending inventory, provided he treats variances in accordance with the procedures prescribed in paragraph (d)(3)(ii) of this section. The method used by the taxpayer in allocating such costs in his financial reports shall be given great weight in determining whether the taxpayer's method employed for tax purposes fairly allocates indirect production costs to the ending inventory. For purposes of this subparagraph, a ''net positive overhead variance'' shall mean the excess of total standard (or estimated) indirect production costs over total actual indirect production costs and a ''net negative overhead variance'' shall mean the excess of total actual indirect production costs over total standard (or estimated) indirect production costs.

(ii) *Treatment of variances. (a)* The proper use of the standard cost method pursuant to this subparagraph requires that a taxpayer must reallocate to the goods in ending inventory a pro rata portion of any net negative or net positive overhead variances and any net negative or net positive direct production cost variances. The taxpayer must apportion such variances among his various items in ending inventory. However, if such variances are not significant in amount in relation to the taxpayer's total actual indirect production costs for the year then such variances need not be allocated to the taxpayer's goods in ending inventory unless such allocation is made in the taxpayer's financial reports. The taxpayer must treat both positive and negative variances consistently.

(b) Notwithstanding subdivision *(a),* the practical capacity concept may be used to determine the total amount of fixed indirect production costs which must be allocated to goods in ending inventory. See subparagraph (4) of this paragraph.

(4) *Practical capacity concept*—(i) *In general.* Under the practical capacity concept, the percentage of practical capacity represented by actual production (not greater than 100 percent), as calculated under subdivision (ii) of this subparagraph, is used to determine the total amount of fixed indirect production costs which must be included in the taxpayer's computation of the amount of inventoriable costs. The portion of such costs to be included in the taxpayer's computation of the amount of inventoriable costs is then combined with variable indirect production costs and both are allocated to the goods in ending inventory in accordance with this paragraph. See the example in subdivision (ii)*(d)* of this subparagraph. The difference (if any) between the amount of all fixed indirect production costs and the fixed indirect production costs which are included in the computation of the amount of inventoriable costs under the practical

capacity concept is allowable as a deduction for the taxable year in which such difference occurs.

(ii) *Calculation of practical capacity—(a) In general.* Practical capacity and theoretical capacity (as described in *(c)* of this subdivision) may be computed in terms of tons, pounds, yards, labor hours, machine hours, or any other unit of production appropriate to the cost accounting system used by a particular taxpayer. The determination of practical capacity and theoretical capacity should be modified from time to time to reflect a change in underlying facts and conditions such as increased output due to automation or other changes in plant operation. Such a change does not constitute a change in method of accounting under sections 446 and 481.

(b) Based upon taxpayer's experience. In selecting an appropriate level of production activity upon which to base the calculation of practical capacity, the taxpayer shall establish the production operating conditions expected during the period for which the costs are being determined, assuming that the utilization of production facilities during operations will be approximately at capacity. This level of production activity is frequently described as practical capacity for the period and is ordinarily based upon the historical experience of the taxpayer. For example, a taxpayer operating on a 5-day, 8-hour basis may have a ''normal'' production of 100,000 units a year based upon three years of experience.

(c) Based upon theoretical capacity. Practical capacity may also be established by the use of ''theoretical'' capacity, adjusted for allowances for estimated inability to achieve maximum production, such as machine breakdown, idle time, and other normal work stoppages. Theoretical capacity is the level of production the manufacturer could reach if all machines and departments were operated continously at peak efficiency.

(d) Example. The provisions of *(c)* of this subdivision may be illustrated by the following example:

Corporation X operates a stamping plant with a theoretical capacity of 50 units per hour. The plant actually operates 1960 hours per year based on an 8-hour day, 5 day week basis and 15 shutdown days for vacations and holidays. A reasonable allowance for down time (the time allowed for ordinary and necessary repairs and maintenance) is 5 percent of practical capacity before reduction for down time. Assuming no loss of production during starting up, closing down, or employee work breaks, under these facts and circumstances X may properly make a practical capacity computation as follows:

Practical capacity without allowance for down time based on theoretical capacity per hour is (1960×50)	98,000
Reduction for down time (98,000×5 percent)	4,900
Practical capacity	93,100

The 93,100 unit level of activity (*i.e.*, practical capacity) would, therefore, constitute an appropriate base for calculating the amount of fixed indirect production costs to be included in the computation of the amount of inventoriable costs for the period under review. On this basis if only 76,000 units were produced for the period, the effect would be that approximately 81.6 percent (76,000, the actual number of units produced, divided by 93,100, the maximum number of units producible at practical capacity) of the fixed indirect production costs would be included in the computation of the amount of inventoriable costs during the year. The portion of the fixed indirect production costs not so included in the computation of the amount of inventoriable costs would be deductible in the year in which paid or incurred. Assume further that 7,600 units were on hand at the end of the taxable year and the 7,600 units were in the same proportion to the total units produced. Thus, 10 percent (7,600 units in inventory at the end of the taxable year, divided by 76,000, the actual number of units produced) of the fixed indirect production costs included in the computation of the amount of inventoriable costs (the above-mentioned 81.6 percent) and 10 percent of the variable indirect production costs would be included in the cost of the goods in the ending inventory, in accordance with a method of allocation provided by this paragraph.

(e) *Transition to full absorption method of inventory costing*—(1) *In general*—(i) *Mandatory requirement.* A taxpayer not using the full absorption method of inventory costing, as prescribed by paragraph (a) of this section, must change to that method. Any change to the full absorption method must be made by the taxpayer with respect to all trades or businesses of the taxpayer to which this section applies. A taxpayer not using the full absorption method of inventory costing, as prescribed by paragraph (a) of this section, who makes the special election provided in subdivision (ii) of this subparagraph during the transition period described in subdivision (ii) of this subparagraph need not change to the full absorption method of inventory costing for taxable years prior to the year for which such election is made. In determining whether the taxpayer is changing to a more or less inclusive method of inventory costing, all positive and negative adjustments for all items and all trades or businesses of the taxpayer shall be aggregated. If the net adjustment is positive, paragraph (e)(3) shall apply, and if the net adjustment is negative, paragraph (e)(4) shall apply to the change. The rules otherwise prescribed in sections 446 and 481 and the regulations thereunder shall apply to any taxpayer who fails to make the special election in subdivision (ii) of this subparagraph. The transition rules of this paragraph are available only to those taxpayers who change their method of inventory costing.

(ii) *Special election during two-year-transition period.* If a taxpayer elects to change to the full absorption method of inventory costing during the transition period provided herein, he may elect on Form 3115 to change to such full absorption method of inventory costing and, in so doing, employ the transition procedures and adopt any of the transition methods prescribed in subparagraph (3) of this paragraph. Such election shall be made during the first 180 days of any taxable year beginning on or after September 19, 1973 and before September 19, 1975 (i.e., the ‘‘transition period’’) and the change in inventory costing method shall be made for the taxable year in which the election is made. Notwithstanding the preceding sentence if the taxpayer’s prior returns have been examined by the Service prior to Sept. 19, 1973, and there is a pending issue involving the taxpayer’s method of inventory costing, the taxpayer may request the application of this regulation by agreeing and filing a letter to that effect with the district director, within 90 days after September 19, 1973 to change to the full absorption method for the first taxable year of the taxpayer beginning after Sept. 19, 1973 and subsequently filing Form 3115 within the first 180 days of such taxable year of change.

(iii) *Change initiated by the Commissioner.* A taxpayer who properly makes an election under subdivision (ii) of this subparagraph shall be considered to have made a change in method of accounting not initiated by the taxpayer, notwithstanding the provisions of §1.481–1(c)(5). Thus, any of the taxpayer’s ‘‘pre-1954 inventory balances’’ with respect to such inventory shall not be taken into account as an adjustment under section 481. For purposes of this paragraph, a ‘‘pre-1954 inventory balance’’ is the net amount of the adjustments which would have been required if the taxpayer had made such change in his method of accounting with respect to his inventory in his first taxable year which began after December 31, 1953, and ended after August 16, 1954. See section 481(a)(2) and §1.481–3.

(2) *Procedural rules for change.* If a taxpayer makes an election pursuant to subparagraph (1)(ii) of this paragraph, the Commissioner’s consent will be evidenced by a letter of consent to the taxpayer, setting forth the values of inventory, as provided by the taxpayer, determined under the full absorption method of inventory costing, except to the extent that no determination of such values is necessary under subparagraph (3)(ii)(B) of this paragraph (the cut off method), the amount of the adjustments (if any) required to be taken into account by section 481, and the treatment to be accorded to any such adjustments. Such full absorption values shall be subject to verification on examination by the district director. The taxpayer shall preserve at his principal place of business all records, data, and other evidence relating to the full absorption values of inventory.

(3) *Transition methods.* In the case of a taxpayer who properly makes an election under subparagraph (1)(ii) of this paragraph during the transition period—

(i) *10-year adjustment period.* Such taxpayer may elect to take any adjustment required by section 481 with respect to any inventory being revalued under the full absorption method into account ratably over a period designated by the taxpayer at the time of such election, not to exceed the lesser of 10 taxable years commencing with the year of transition or the number of years the taxpayer has been on the inventory method from which he is changing. If the taxpayer dies or ceases to exist in a transaction other than one to which section 381(a) of the Code applies or if the taxpayer's inventory (determined under the full absorption method) on the last day of any taxable year is reduced (by other than a strike or involuntary conversion) by more than an amount equal to 33⅓ percent of the taxpayer's inventory (determined under the full absorption method) as of the beginning of the year of change, the entire amount of the section 481 adjustment not previously taken into account in computing income shall be taken into account in computing income for the taxable year in which such taxpayer so ceases to exist or such taxpayer's inventory is so reduced.

(ii) *Additional rules for LIFO taxpayers.* A taxpayer who uses the LIFO method of inventory identification may either—

(a) Employ the special transition rules described in subdivision (i) of this subparagraph. Accordingly, all LIFO layers must be revalued under the full absorption method and the section 481 adjustment must be computed for all items in all layers in inventory, but no pre-1954 inventory balances shall be taken into account as adjustments under section 481; or

(b)(1) Employ a cut-off method whereby the full absorption method is only applied in costing layers of inventory acquired during all taxable years beginning with the year for which an election is made under subparagraph (e)(1)(ii).

(2) In the case of a taxpayer using dollar value LIFO, employ a cut-off method whereby the taxpayer must use, for the year of change, the full absorption method in computing the base year cost and current cost of a dollar value inventory pool for the beginning of such year. The taxpayer shall not be required to recompute his LIFO inventories based on the full absorption method for a taxable year beginning prior to the year of change to the full absorption method. The base cost and layers of increment previously computed shall be retained and treated as if such base cost and layers of increment had been computed under the method authorized by this section. The taxpayer shall use the year of change as the base year in applying the double extension method or other method approved by the Commissioner, instead of the earliest year for which he adopted the LIFO method for any items in the pool.

(4) *Transition to full absorption method of inventory costing from a method more* inclusive of indirect production costs—(i) *Taxpayer has not previously changed to his present method pursuant to subparagraphs (1), (2), and (3) of this paragraph.* If a taxpayer wishes to change to the full absorption method of inventory costing (as prescribed by paragraph (a) of this section) from a method of inventory costing which is more inclusive of indirect production costs and he has not previously changed to his present method by use of the special transition rules provided by subparagraphs (1), (2) and (3) of this paragraph, he may elect on Form 3115 to change to the full absorption method of inventory costing and, in so doing, take into account any resulting section 481 adjustment generally over 10 taxable years commencing with the year of transition. The Commissioner's consent to such election will be evidenced by a letter of consent to the taxpayer setting forth the values of inventory, as provided by the taxpayer determined under the full absorption method of inventory costing, except to the extent that no determination of such values is necessary under subparagraph (3)(ii)*(b)* of this paragraph, the amount of the adjustments (if any) required to be taken into account by section 481, and the treatment to be accorded such adjustments, subject to terms and conditions specified by the Commissioner to prevent distortions of income. Such election must be made within the transition period described in subparagraph (1)(ii) of this paragraph. A change pursuant to this subparagraph shall be a change initiated by the taxpayer as provided by § 1.481–1(c)(5). Thus, any of the taxpayers ''pre-1954 inventory

balances'' will be taken into account as an adjustment under section 481.

(ii) *Taxpayer has previously changed to his present method pursuant to subparagraph (1), (2), and (3) of this paragraph or would satisfy all the requirements of subdivision (i) of this subparagraph but fails to elect within the transition period.* If a taxpayer wishes to change to the full absorption method of inventory costing (as prescribed by paragraph (a) of this section) from a method of inventory costing which is more inclusive of indirect production costs and he has previously changed to his present method pursuant to subparagraphs (1), (2), and (3) of this paragraph or he would satisfy the requirements of subdivision (i) of this subparagraph but he fails to elect within the transition period, he must secure the consent of the Commissioner prior to making such change.

[T.D. 7285, 38 FR 26185, Sept. 19, 1973, as amended by T.D. 8067, 51 FR 393, Jan. 6, 1986; T.D. 8131, 52 FR 10084, Mar. 30, 1987; T.D. 8482, 58 FR 42234, Aug. 9, 1993]

§1.472–1 Last-in, first-out inventories.

(a) Any taxpayer permitted or required to take inventories pursuant to the provisions of section 471, and pursuant to the provisions of §§1.471–1 to 1.471–9, inclusive, may elect with respect to those goods specified in his application and properly subject to inventory to compute his opening and closing inventories in accordance with the method provided by section 472, this section, and §1.472–2. Under this last-in, first-out (LIFO) inventory method, the taxpayer is permitted to treat those goods remaining on hand at the close of the taxable year as being:

(1) Those included in the opening inventory of the taxable year, in the order of acquisition and to the extent thereof, and

(2) Those acquired during the taxable year.

The LIFO inventory method is not dependent upon the character of the business in which the taxpayer is engaged, or upon the identity or want of identity through commingling of any of the goods on hand, and may be adopted by the taxpayer as of the close of any taxable year.

(b) If the LIFO inventory method is used by a taxpayer who regularly and consistently, in a manner similar to hedging on a futures market, matches purchases with sales, then firm purchases and sales contracts (i.e., those not legally subject to cancellation by either party) entered into at fixed prices on or before the date of the inventory may be included in purchases or sales, as the case may be, for the purpose of determining the cost of goods sold and the resulting profit or loss, provided that this practice is regularly and consistently adhered to by the taxpayer and provided that, in the opinion of the Commissioner, income is clearly reflected thereby.

(c) A manufacturer or processor who has adopted the LIFO inventory method as to a class of goods may elect to have such method apply to the raw materials only (including those included in goods in process and in finished goods) expressed in terms of appropriate units. If such method is adopted, the adjustments are confined to costs of the raw material in the inventory and the cost of the raw material in goods in process and in finished goods produced by such manufacturer or processor and reflected in the inventory. The provisions of this paragraph may be illustrated by the following examples:

Example (1). Assume that the opening inventory had 10 units of raw material, 10 units of goods in process, and 10 units of finished goods, and that the raw material cost was 6 cents a unit, the processing cost 2 cents a unit, and overhead cost 1 cent a unit. For the purposes of this example, it is assumed that the entire amount of goods in process was 50 percent processed.

OPENING INVENTORY

	Raw material	Goods in process	Finished goods
Raw material	$0.60	$0.60	$0.60
Processing cost	....	.10	.20
Overhead	....	.05	.10

In the closing inventory there are 20 units of raw material, 6 units of goods in process, and 8 units of finished goods and the costs were: Raw material 10 cents, processing cost 4 cents, and overhead 1 cent.

CLOSING INVENTORY

[Based on cost and prior to adjustment]

	Raw material	Goods in process	Finished goods
Raw material	$2.00	$0.60	$0.80
Processing costs		.12	.32
Overhead		.03	.08
Total	2.00	.75	1.20

There were 30 units of raw material in the opening inventory and 34 units in the closing inventory. The adjustment to the closing inventory would be as follows:

CLOSING INVENTORY AS ADJUSTED

	Raw material	Goods in process	Finished goods
Raw material:			
20 at 6 cents	$1.20		
6 at 6 cents		$0.36	
4 at 6 cents			$0.24
4 at 10 cents [1]			.40
Processing costs		.12	.32
Overhead		.03	.08
Total	1.20	.51	1.04

[1] This excess is subject to determination of price under section 472(b)(1) and § 1.472–2. If the excess falls in goods in process, the same adjustment is applicable.

The only adjustment to the closing inventory is the cost of the raw material; the processing costs and overhead cost are not changed.

Example (2). Assume that the opening inventory had 5 units of raw material, 10 units of goods in process, and 20 units of finished goods, with the same prices as in example (1), and that the closing inventory had 20 units of raw material, 20 units of goods in process, and 10 units of finished goods, with raw material costs as in the closing inventory in example (1). The adjusted closing inventory would be as follows in so far as the raw material is concerned:

Raw material, 20 at 6 cents	$1.20
Goods in process:	
15 at 6 cents	.90
5 at 10 cents [1]	.50
Finished goods:	
None at 6 cents	0.00
10 at 10 cents [1]	1.00

[1] This excess is subject to determination of price under section 472(b)(1) and § 1.472–2.

The 20 units of raw material in the raw state plus 15 units of raw material in goods in process make up the 35 units of raw material that were contained in the opening inventory.

(d) For the purposes of this section, raw material in the opening inventory must be compared with similar raw material in the closing inventory. There may be several types of raw materials, depending upon the character, quality, or price, and each type of raw material in the opening inventory must be compared with a similar type in the closing inventory.

(e) In the cotton textile industry there may be different raw materials depending upon marked differences in length of staple, in color or grade of the cotton. But where different staple lengths or grades of cotton are being used at different times in the same mill to produce the same class of goods, such differences would not necessarily require the classification into different raw materials.

(f) As to the pork packing industry a live hog is considered as being composed of various raw materials, different cuts of a hog varying markedly in price and use. Generally a hog is processed into approximately 10 primal cuts and several miscellaneous articles. However, due to similarity in price and use, these may be grouped into fewer classifications, each group being classed as one raw material.

(g) When the finished product contains two or more different raw materials as in the case of cotton and rayon mixtures, each raw material is treated separately and adjustments made accordingly.

(h) Upon written notice addressed to the Commissioner of Internal Revenue, Attention T:R, Washington, D.C. 20224 by the taxpayer, a taxpayer who has heretofore adopted the LIFO inventory method in respect of any goods may adopt the method authorized in this section and limit the election to the raw material including raw materials entering into goods in process and in finished goods. If this method is adopted as to any specific goods, it must be used exclusively for such goods for any prior taxable year (not closed by agreement) to which the prior election applies and for all subsequent taxable years, unless permission to change is granted by the Commissioner.

(i) The election may also be limited to that phase in the manufacturing process where a product is produced that is recognized generally as a salable product as, for example, in the textile industry where one phase of the process is the production of yarn. Since yarn is generally recognized as a salable product, the election may be limited to that portion of the process when yarn is produced. In the case of copper and brass processors, the election may be limited to the production of bars, plates, sheets, etc., although these may be further processed into other products.

(j) The election may also apply to any one raw material, when two or more raw materials enter into the composition of the finished product; for example, in the case of cotton and rayon yarn, the taxpayer may elect to inventory the cotton only. However, a taxpayer who has previously made an election to use the LIFO inventory method may not later elect to exclude any raw materials that were covered by such previous election.

(k) If a taxpayer using the retail method of pricing inventories, authorized by §1.471–8, elects to use in connection therewith the LIFO inventory method authorized by section 472 and this section, the apparent cost of the goods on hand at the end of the year, determined pursuant to §1.471–8, shall be adjusted to the extent of price changes therein taking place after the close of the preceding taxable year. The amount of any apparent inventory increase or decrease to be eliminated in this adjustment shall be determined by reference to acceptable price indexes established to the satisfaction of the Commissioner. Price indexes prepared by the United States Bureau of Labor Statistics which are applicable to the goods in question will be considered acceptable to the Commissioner. Price indexes which are based upon inadequate records, or which are not subject to complete and detailed audit within the Internal Revenue Service, will not be approved.

(l) If a taxpayer uses consistently the so-called ‘‘dollar-value’’ method of pricing inventories, or any other method of computation established to the satisfaction of the Commissioner as reasonably adaptable to the purpose and intent of section 472 and this section, and if such taxpayer elects under section 472 to use the LIFO inventory method authorized by such section, the taxpayer’s opening and closing inventories shall be determined under section 472 by the use of the appropriate adaptation. See §1.472–8 for rules relating to the use of the dollar-value method.

[T.D. 6500, 25 FR 11727, Nov. 26, 1960, as amended by T.D. 6539, 26 FR 518, Jan. 20, 1961]

§1.472–2 Requirements incident to adoption and use of LIFO inventory method.

Except as otherwise provided in §1.472–1 with respect to raw material computations, with respect to retail inventory computations, and with respect to other methods of computation established to the satisfaction of the Commissioner as reasonably adapted to the purpose and intent of section 472, and in §1.472–8 with respect to the ‘‘dollar-value’’ method, the adoption and use of the LIFO inventory method is subject to the following requirements:

(a) The taxpayer shall file an application to use such method specifying with particularity the goods to which it is to be applied.

(b) The inventory shall be taken at cost regardless of market value.

(c) Goods of the specified type included in the opening inventory of the taxable year for which the method is first used shall be considered as having been acquired at the same time and at a unit cost equal to the actual cost of the aggregate divided by the number of units on hand. The actual cost of the aggregate shall be determined pursuant to the inventory method employed by the taxpayer under the regulations applicable to the prior taxable year with the exception that restoration shall be made with respect to any writedown to market values resulting from the pricing of former inventories.

(d) Goods of the specified type on hand as of the close of the taxable year in excess of what were on hand as of the beginning of the taxable year shall be included in the closing inventory, regardless of identification with specific invoices and regardless of specific cost accounting records, at costs determined pursuant to the provisions of subparagraph (1) or (2) of this paragraph, dependent upon the character of the transactions in which the taxpayer is engaged:

(1)(i) In the case of a taxpayer engaged in the purchase and sale of merchandise, such as a retail grocer or druggist, or engaged in the initial production of merchandise and its sale without processing, such as a miner selling his ore output without smelting or refining, such costs shall be determined—

(a) By reference to the actual cost of the goods most recently purchased or produced;

(b) By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition;

(c) By application of an average unit cost equal to the aggregate cost of all of the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced, the goods reflected in such inventory increase being considered for the purposes of section 472 as having been acquired all at the same time; or

(d) Pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.

(ii) Whichever of the several methods of valuing the inventory increase is adopted by the taxpayer and approved by the Commissioner shall be consistently adhered to in all subsequent taxable years so long as the LIFO inventory method is used by the taxpayer.

(iii) The application of subdivisions (i) and (ii) of this subparagraph may be illustrated by the following examples:

Example (1). Suppose that the taxpayer adopts the LIFO inventory method for the taxable year 1957 with an opening inventory of 10 units at 10 cents per unit, that it makes 1957 purchases of 10 units as follows:

January	1 at	$0.11=	$0.11
April	2 at	.12=	.24
July	3 at	.13=	.39
October	4 at	.14=	.56
Totals	10		1.30

and that it has a 1957 closing inventory of 15 units. This closing inventory, depending upon the taxpayer's method of valuing inventory increases, will be computed as follows:

(a) Most recent purchases—

	10 at	$0.10	$1.00
October	4 at	.14	.56
July	1 at	.13	.13
Totals	15		1.69

(*b*) In order of acquisitions—

	10 at	$0.10	$1.00
January	1 at	.11	.11
April	2 at	.12	.24
July	2 at	.13	.26
Totals	15		1.61

or

(c) At an annual average—

	10 at	$0.10	$1.00
(130/10)	5 at	.13	.65
Totals	15		1.65

Example (2). Suppose that the taxpayer's closing inventory for 1958, the year following that involved in example (1) of this subdivision, reflects an inventory decrease for the year, and not an increase; suppose that there is, accordingly, a 1958 closing inventory of 13 units. Inasmuch as the decreased closing inventory will be determined wholly by reference to the 15 units reflected in the opening inventory for the year, and will be taken ''in the order of acquisition'' pursuant to section 472 (b) (1), and inasmuch as the character of the taxpayer's opening inventory for 1958 will be dependent upon its method of valuing its 5-unit inventory increase for 1957, the closing inventory for 1958 will be computed as follows:

(a) In case the increase for 1957 was taken by reference to the most recent purchases—

From 1956	10 at	$0.10	$1.00
July 1957	1 at	.13	.13
October 1957	2 at	.14	.28
Totals	13		1.41

or

(b) In case the increase for 1957 was taken in the order of acquisition—

From 1956	10 at	$0.10	$1.00
January 1957	51 at	.11	.11
April 1957	2 at	.12	.24
Totals	13		1.35

or

(c) In case the increase for 1957 was taken on the basis of an average—

From 1956	10 at	$0.10	$1.00
From 1957	3 at	.13	.39
Totals	13		1.39

(2) In the case of a taxpayer engaged in manufacturing, fabricating, processing, or otherwise producing merchandise, such costs shall be determined:

(i) In the case of raw materials purchased or initially produced by the taxpayer, in the manner elected by the taxpayer under subparagraph (1) of this paragraph to the same extent as if the taxpayer were engaged in purchase and sale transactions; and

(ii) In the case of goods in process, regardless of the stage to which the manufacture, fabricating, or processing may have advanced, and in the case of finished goods, pursuant to any proper method which, in the opinion of the Commissioner, clearly reflects income.

(e) *LIFO conformity requirement*—(1) *In general.* The taxpayer must establish to the satisfaction of the Commissioner that the taxpayer, in ascertaining the income, profit, or loss for the taxable year for which the LIFO inventory method is first used, or for any subsequent taxable year, for credit purposes or for purposes of reports to shareholders, partners, or other proprietors, or to beneficiaries, has not used any inventory method other than that referred to in §1.472–1 or at variance with the requirement referred to in §1.472–2(c). See paragraph (e)(2) of this section for rules relating to the meaning of the term ''taxable year'' as used in this paragraph. The following are not considered at variance with the requirement of this paragraph:

(i) The taxpayer's use of an inventory method other than LIFO for purposes of ascertaining information reported as a supplement to or explanation of the taxpayer's primary presentation of the taxpayer's income, profit, or loss for a taxable year in credit statements or financial reports (including preliminary and unaudited financial reports). See paragraph (e)(3) of this section for rules relating to the reporting of supplemental and explanatory information ascertained by the use of an inventory method other than LIFO.

(ii) The taxpayer's use of an inventory method other than LIFO to ascertain the value of the taxpayer's inventory of goods on hand for purposes of reporting the value of such inventories as assets. See paragraph (e)(4) of this section for rules relating to such disclosures.

(iii) The taxpayer's use of an inventory method other than LIFO for purposes of ascertaining information reported in internal management reports. See paragraph (e)(5) of this section for rules relating to such reports.

(iv) The taxpayer's use of an inventory method other than LIFO for purposes of issuing reports or credit statements covering a period of operations that is less than the whole of a taxable year for which the LIFO method is used for Federal income tax purposes. See paragraph (e)(6) of this section for rules relating to series of interim reports.

(v) The taxpayer's use of the lower of LIFO cost or market method to value LIFO inventories for purposes of financial reports and credit statements. However, except as provided in paragraph (e)(7) of this section, a taxpayer may not use market value in lieu of cost to value inventories for purposes of financial reports or credit statements.

(vi) The taxpayer's use of a costing method or accounting method to ascertain income, profit, or loss for credit purposes or for purposes of financial reports if such costing method or accounting method is neither inconsistent with the inventory method referred to in §1.472–1 nor at variance with the requirement referred to in §1.472–2(c), regardless of whether such costing method or accounting method is used by the taxpayer for Federal income tax purposes. See paragraph (e)(8) of this section for examples of such costing methods and accounting methods.

(vii) For credit purposes or for purposes of financial reports, the taxpayer's treatment of inventories, after such inventories have been acquired in a transaction to which section 351 applies from a transferor that used the LIFO method with respect to such inventories, as if such inventories had the same acquisition dates and costs as in the hands of the transferor.

(viii) For credit purposes or for purposes of financial reports relating to a taxable year, the taxpayer's determination of income, profit, or loss for the taxable year by valuing inventories in accordance with the procedures described in section 472(b) (1) and (3), notwithstanding that such valuation differs from the valuation of inventories for Federal income tax purposes because the taxpayer either—

(A) Adopted such procedures for credit or financial reporting purposes beginning with an accounting period other than the taxable year for which the LIFO method was first used by the taxpayer for Federal income tax purposes, or

(B) With respect to such inventories treated a business combination for credit or financial reporting purposes in a manner different from the treatment of the business combination for Federal income tax purposes.

(2) *One-year periods other than a taxable year.* The rules of this paragraph relating to the determination of income, profit, or loss for a taxable year and credit statements or financial reports that cover a taxable year also apply to the determination of income, profit, or loss for a one-year period other than a taxable year and credit statements or financial reports that cover a one-year period other than a taxable year, but only if the one-year period both begins and ends in a taxable year or years for which the taxpayer uses the LIFO method for Federal income tax purposes. For example, the requirements of paragraph (e)(1) of this section apply to a taxpayer's determination of income for purposes of a credit statement that covers a 52-week fiscal year beginning and ending in a taxable year for which the taxpayer uses the LIFO method for Federal income tax purposes. Similarly, in the case of a calendar year taxpayer, the requirements of paragraph (e)(1) of this section apply to the taxpayer's determination of income for purposes of a credit statement that covers the period October 1, 1981, through September 30, 1982, if the taxpayer uses the LIFO method for Federal income tax purposes in taxable years 1981 and 1982. However, the Commissioner will waive any violation of the requirements of this paragraph in the case of a credit statement or financial report that covers a one-year period other than a taxable year if the report was issued before January 22, 1981.

(3) *Supplemental and explanatory information*—(i) *Face of the income statement.* Information reported on the face of a taxpayer's financial income statement for a taxable year is not considered a supplement to or explanation of the taxpayer's primary presentation of the taxpayer's income, profit, or loss for the taxable year in credit statements or financial reports. For purposes of paragraph (e)(3) of this section, the face of an income statement does not include notes to the income statement presented on the same page as the income statement, but only if all notes to the financial income statement are presented together.

(ii) *Notes to the income statement.* Information reported in notes to a taxpayer's financial income statement is considered a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss for the period covered by the income statement if all notes to the financial income statement are presented together and if they accompany the income statement in a single report. If notes to an income statement are issued in a report that does not include the income statement, the question of whether the information reported therein is supplemental or explanatory is determined under the rules in paragraph (e)(3)(iv) of this section.

(iii) *Appendices and supplements to the income statement.* Information reported in an appendix or supplement to a taxpayer's financial income statement is considered a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss for the period covered by the income statement if the appendix or supplement accompanies the income statement in a single report and the information reported in the appendix or supplement is clearly identified as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's income statement. If an appendix or supplement to an income statement is issued in a report that does not include the income statement, the question of whether the information reported therein is supplemental or explanatory is determined under the rules in paragraph (e)(3)(iv) of this section. For purposes of paragraph (e)(3)(iii) of this section, an appendix or supplement to an income statement includes written statements, schedules, and reports that are labelled supplements or appendices to the income statement. However, sections of an annual report such as those labelled ''President's Letter'', ''Management's Analysis'', ''Statement of Changes in Financial Position'', ''Summary of Key

Figures'', and similar sections are reports described in paragraph (e)(3)(iv) of this section and are not considered ''supplements or appendices to an income statement'' within the meaning of paragraph (e)(3)(iii) of this section, regardless of whether such sections are also labelled as supplements or appendices. For purposes of paragraph (e)(3)(iii) of this section, information is considered to be clearly identified as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's income statement if the information either—

(A) Is reported in an appendix or supplement that contains a general statement identifying all such supplemental or explanatory information;

(B) Is identified specifically as supplemental or explanatory by a statement immediately preceding or following the disclosure of the information;

(C) Is disclosed in the context of making a comparison to corresponding information disclosed both on the face of the taxpayer's income statement and in the supplement or appendix; or

(D) Is a disclosure of the effect on an item reported on the face of the taxpayer's income statement of having used the LIFO method.

For example, a restatement of cost of goods sold based on an inventory method other than LIFO is considered to be clearly identified as supplemental or explanatory information if the supplement or appendix containing the restatement contains a general statement that all information based on such inventory method is reported in the appendix or supplement as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's income statement.

(iv) *Other reports; in general.* The rules of paragraph (e)(3) (iv), (v), and (vi) of this section apply to the following types of reports: news releases; letters to shareholders, partners, or other proprietors or beneficiaries; oral statements at press conferences, shareholders' meetings or securities analysts' meetings; sections of an annual report such as those labelled ''President's Letter'', ''Management's Analysis'', ''Statement of Changes in Financial Position'', ''Summary of Key Figures'', and similar sections; and reports other than a taxpayer's income statement or accompanying notes, appendices, or supplements. Information disclosed in such a report is considered a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss for the period covered by an income statement if the supplemental or explanatory information is clearly identified as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's income statement and the specific item of information being explained or supplemented, such as the cost of goods sold, net income, or earnings per share ascertained using the LIFO method, is also reported in the other report.

(v) *Other reports; disclosure of non-LIFO income.* For purposes of paragraph (e)(3)(iv) of this section, supplemental or explanatory information is considered to have been clearly identified as such if it would be considered to have been clearly identified as such under the rules of paragraph (e)(3)(iii) of this section, relating to information reported in supplements or appendices to an income statement. For example, if at a securities analysts' meeting the following question is asked, ''What would the reported earnings per share for the year have been if the FIFO method had been used to value inventories?'', it would be permissible to respond ''Reported earnings per share for the year were $6.00. If the company had used the FIFO method to value inventories this year and had computed earnings based upon the following assumptions, earnings per share would have been $8.20. FIFO earnings are based on the following assumptions:

''(A) The use of the same effective tax rate as used in computing LIFO earnings, and

''(B) All other conditions and assumptions remain the same, including—

''(*1*) The use of the LIFO method for Federal income tax purposes and

''(*2*) The investment of the tax savings resulting from such use of the

LIFO method, the income from which is included in both LIFO and FIFO ‘‘earnings.’’ ’’

(vi) *Other reports; disclosure of effect on income.* For purposes of paragraph (e)(3)(iv) of this section, if the only supplement to or explanation of a specific item is the effect on the item of having used LIFO instead of a method other than LIFO to value inventories, it is not necessary to also report the specific item. For example, if at a shareholders’ meeting the question is asked, ‘‘What was the effect on reported earnings per share of not having used FIFO to value inventories?’’, it would be permissible to respond ‘‘If earnings would have been computed on the basis of the following assumptions, the use of LIFO instead of FIFO to value inventories would have decreased reported earnings per share by $2.20. FIFO earnings are based on the following assumptions:

‘‘(A) The use of the same effective tax rate as used in computing LIFO earnings, and

‘‘(B) All other conditions and assumptions remain the same, including—

‘‘(*1*) The use of the LIFO method for Federal income tax purposes and

‘‘(*2*) The investment of the tax savings resulting from such use of the LIFO method, the income from which is included in both LIFO and FIFO earnings.’’

(4) *Inventory asset value disclosures.* Under paragraph (e)(1)(ii) of this section, the use of an inventory method other than LIFO to ascertain the value of the taxpayer’s inventories for purposes of reporting the value of the inventories as assets is not considered the ascertainment of income, profit, or loss and therefore is not considered at variance with the requirement of paragraph (e)(1) of this section. Therefore, a taxpayer may disclose the value of inventories on a balance sheet using a method other than LIFO to identify the inventories, and such a disclosure will not be considered at variance with the requirement of paragraph (e)(1) of this section. However, the disclosure of income, profit, or loss for a taxable year on a balance sheet issued to creditors, shareholders, partners, other proprietors, or beneficiaries is considered at variance with the requirement of paragraph (e)(1) of this section if such income information is ascertained using an inventory method other than LIFO and such income information is for a taxable year for which the LIFO method is used for Federal income tax purposes. Therefore, a balance sheet that discloses the net worth of a taxpayer, determined as if income had been ascertained using an inventory method other than LIFO, may be at variance with the requirement of paragraph (e)(1) of this section if the disclosure of net worth is made in a manner that also discloses income, profit, or loss for a taxable year.

However, a disclosure of income, profit, or loss using an inventory method other than LIFO is not considered at variance with the requirement of paragraph (e)(1) of this section if the disclosure is made in the form of either a footnote to the balance sheet or a parenthetical disclosure on the face of the balance sheet. In addition, an income disclosure is not considered at variance with the requirement of paragraph (e)(1) of this section if the disclosure is made on the face of a supplemental balance sheet labelled as a supplement to the taxpayer’s primary presentation of financial position, but only if, consistent with the rules of paragraph (e)(3) of this section, such a disclosure is clearly identified as a supplement to or explanation of the taxpayer’s primary presentation of financial income as reported on the face of the taxpayer’s income statement.

(5) *Internal management reports.* [Reserved]

(6) *Series of interim reports.* For purposes of paragraph (e)(1)(iv) of this section, a series of credit statements or financial reports is considered a single statement or report covering a period of operations if the statements or reports in the series are prepared using a single inventory method and can be combined to disclose the income, profit, or loss for the period. However, the Commissioner will waive any violation of the requirement of this paragraph in the case of a series of interim reports issued before February 6, 1978, that cover a taxable year, or a series of interim reports issued before January 22,

1981 that cover a one-year period other than a taxable year.

(7) *Market value.* The Commissioner will waive any violation of the requirement of this paragraph in the case of a taxpayer's use of market value in lieu of cost for a credit statement or financial report issued before January 22, 1981. However, the special rule of this (7) applies only to a taxpayer's use of market value in lieu of cost and does not apply to the use of a method of valuation such as market value in lieu of cost but not more than FIFO cost.

(8) *Use of different methods.* The following are examples of costing methods and accounting methods that are neither inconsistent with the inventory method referred to in §1.472–1 nor at variance with the requirement of §1.472–2(c) and which, under paragraph (e)(1)(vi) of this section, may be used to ascertain income, profit, or loss for credit purposes or for purposes of financial reports regardless of whether such method is also used by the taxpayer for Federal income tax purposes:

(i) Any method relating to the determination of which costs are includible in the computation of the cost of inventory under the full absorption inventory method.

(ii) Any method of establishing pools for inventory under the dollar-value LIFO inventory method.

(iii) Any method of determining the LIFO value of a dollar-value inventory pool, such as the double-extension method, the index method, and the link chain method.

(iv) Any method of determining or selecting a price index to be used with the index or link chain method of valuing inventory pools under the dollar-value LIFO inventory method.

(v) Any method permitted under §1.472–8 for determining the current-year cost of closing inventory for purposes of using the dollar-value LIFO inventory method.

(vi) Any method permitted under §1.472–2(d) for determining the cost of goods in excess of goods on hand at the beginning of the year for purposes of using a LIFO method other than the dollar-value LIFO method.

(vii) Any method relating to the classification of an item as inventory or a capital asset.

(viii) The use of an accounting period other than the period used for Federal income tax purposes.

(ix) The use of cost estimates.

(x) The use of actual cost of cut timber or the cost determined under section 631(a).

(xi) The use of inventory costs unreduced by any adjustment required by the application of section 108 and section 1017, relating to discharge of indebtedness.

(xii) The determination of the time when sales or purchases are accrued.

(xiii) The use of a method to allocate basis in the case of a business combination other than the method used for Federal income tax purposes.

(xiv) The treatment of transfers of inventory between affiliated corporations in a manner different from that required by §1.1502–13.

(9) *Reconciliation of LIFO inventory values.* A taxpayer may be required to reconcile differences between the value of inventories maintained for credit or financial reporting purposes and for Federal income tax purposes in order to show that the taxpayer has satisfied the requirements of this paragraph.

(f) Goods of the specified type on hand as of the close of the taxable year preceding the taxable year for which this inventory method is first used shall be included in the taxpayer's closing inventory for such preceding taxable year at cost determined in the manner prescribed in paragraph (c) of this section.

(g) The LIFO inventory method, once adopted by the taxpayer with the approval of the Commissioner, shall be adhered to in all subsequent taxable years unless—

(1) A change to a different method is approved by the Commissioner; or

(2) The Commissioner determines that the taxpayer, in ascertaining income, profit, or loss for the whole of any taxable year subsequent to his adoption of the LIFO inventory method, for credit purposes or for the purpose of reports to shareholders, partners, or other proprietors, or to beneficiaries, has used any inventory method at variance with that referred to in §1.472–1 and requires of the taxpayer a change to a different method for such

subsequent taxable year or any taxable year thereafter.

(h) The records and accounts employed by the taxpayer in keeping his books shall be maintained in conformity with the inventory method referred to in § 1.472–1; and such supplemental and detailed inventory records shall be maintained as will enable the district director readily to verify the taxpayer's inventory computations as well as his compliance with the requirements of section 472 and §§ 1.472–1 through 1.472–7.

(i) Where the taxpayer is engaged in more than one trade or business, the Commissioner may require that if the LIFO method of valuing inventories is used with respect to goods in one trade or business the same method shall also be used with respect to similar goods in the other trades or businesses if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essential to a clear reflection of income.

[T.D. 6500, 25 FR 11728, Nov. 26, 1960, as amended by T.D. 6539, 26 FR 518, Jan. 20, 1961; T.D. 7756, 46 FR 6920, Jan. 22, 1981; T.D 7756, 46 FR 15685, Mar. 9, 1981]

§ 1.472–3 Time and manner of making election.

(a) The LIFO inventory method may be adopted and used only if the taxpayer files with his income tax return for the taxable year as of the close of which the method is first to be used a statement of his election to use such inventory method. The statement shall be made on Form 970 pursuant to the instructions printed with respect thereto and to the requirements of this section, or in such other manner as may be acceptable to the Commissioner. Such statement shall be accompanied by an analysis of all inventories of the taxpayer as of the beginning and as of the end of the taxable year for which the LIFO inventory method is proposed first to be used, and also as of the beginning of the prior taxable year. In the case of a manufacturer, this analysis shall show in detail the manner in which costs are computed with respect to raw materials, goods in process, and finished goods, segregating the products (whether in process or finished goods) into natural groups on the basis of either (1) similarity in factory processes through which they pass, or (2) similarity of raw materials used, or (3) similarity in style, shape, or use of finished products. Each group of products shall be clearly described.

(b) The taxpayer shall submit for the consideration of the Commissioner in connection with the taxpayer's adoption or use of the LIFO inventory method such other detailed information with respect to his business or accounting system as may be at any time requested by the Commissioner.

(c) As a condition to the taxpayer's use of the LIFO inventory method, the Commissioner may require that the method be used with respect to goods other than those specified in the taxpayer's statement of election if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essential to a clear reflection of income.

(d) Whether or not the taxpayer's application for the adoption and use of the LIFO inventory method should be approved, and whether or not such method, once adopted, may be continued, and the propriety of all computations incidental to the use of such method, will be determined by the Commissioner in connection with the examination of the taxpayer's income tax returns.

[T.D. 6500, 25 FR 11729, Nov. 26, 1960, as amended by T.D. 7295, 38 FR 34203, Dec. 12, 1973]

§ 1.472–4 Adjustments to be made by taxpayer.

A taxpayer may not change to the LIFO method of taking inventories unless, at the time he files his application for the adoption of such method, he agrees to such adjustments incident to the change to or from such method, or incident to the use of such method, in the inventories of prior taxable years or otherwise, as the district director upon the examination of the taxpayer's returns may deem necessary in order that the true income of the taxpayer will be clearly reflected for the years involved.

[T.D. 6500, 25 FR 11730, Nov. 26, 1960]

§1.472–5 Revocation of election.

An election made to adopt and use the LIFO inventory method is irrevocable, and the method once adopted shall be used in all subsequent taxable years, unless the use of another method is required by the Commissioner, or authorized by him pursuant to a written application therefor filed as provided in paragraph (e) of §1.446–1.

[T.D. 6500, 25 FR 11730, Nov. 26, 1960]

§1.472–6 Change from LIFO inventory method.

If the taxpayer is granted permission by the Commissioner to discontinue the use of LIFO method of taking inventories, and thereafter to use some other method, or if the taxpayer is required by the Commissioner to discontinue the use of the LIFO method by reason of the taxpayer's failure to conform to the requirements detailed in §1.472–2, the inventory of the specified goods for the first taxable year affected by the change and for each taxable year thereafter shall be taken—

(a) In conformity with the method used by the taxpayer under section 471 in inventorying goods not included in his LIFO inventory computations; or

(b) If the LIFO inventory method was used by the taxpayer with respect to all of his goods subject to inventory, then in conformity with the inventory method used by the taxpayer prior to his adoption of the LIFO inventory method; or

(c) If the taxpayer had not used inventories prior to his adoption of the LIFO inventory method and had no goods currently subject to inventory by a method other than the LIFO inventory method, then in conformity with such inventory method as may be selected by the taxpayer and approved by the Commissioner as resulting in a clear reflection of income; or

(d) In any event, in conformity with any inventory method to which the taxpayer may change pursuant to application approved by the Commissioner.

[T.D. 6500, 25 FR 11730, Nov. 26, 1960]

§1.472–7 Inventories of acquiring corporations.

For additional rules in the case of certain corporate acquisitions specified in section 381(a), see section 381(c)(5) and the regulations thereunder.

[T.D. 6500, 25 FR 11730, Nov. 26, 1960]

§1.472–8 Dollar-value method of pricing LIFO inventories.

(a) *Election to use dollar-value method.* Any taxpayer may elect to determine the cost of his LIFO inventories under the so-called ''dollar-value'' LIFO method, provided such method is used consistently and clearly reflects the income of the taxpayer in accordance with the rules of this section. The dollar-value method of valuing LIFO inventories is a method of determining cost by using ''base-year'' cost expressed in terms of total dollars rather than the quantity and price of specific goods as the unit of measurement. Under such method the goods contained in the inventory are grouped into a pool or pools as described in paragraphs (b) and (c) of this section. The term ''base-year cost'' is the aggregate of the cost (determined as of the beginning of the taxable year for which the LIFO method is first adopted, i.e., the base date) of all items in a pool. The taxable year for which the LIFO method is first adopted with respect to any item in the pool is the ''base year'' for that pool, except as provided in paragraph (g)(3) of this section. Liquidations and increments of items contained in the pool shall be reflected only in terms of a net liquidation or increment for the pool as a whole. Fluctuations may occur in quantities of various items within the pool, new items which properly fall within the pool may be added, and old items may disappear from the pool, all without necessarily effecting a change in the dollar value of the pool as a whole. An increment in the LIFO inventory occurs when the end of the year inventory for any pool expressed in terms of base-year cost is in excess of the beginning of the year inventory for that pool expressed in terms of base-year cost. In determining the inventory value for a pool, the increment, if any, is adjusted for changing unit costs or values by reference to a percentage, relative to base-year-cost, determined for the pool as a whole. See paragraph (e) of this section. See also paragraph (f) of this section for rules relating to the change to the dollar-value LIFO method from another LIFO method.

(b) *Principles for establishing pools of manufacturers and processors*—(1) *Natural business unit pools.* A pool shall consist of all items entering into the entire inventory investment for a natural business unit of a business enterprise, unless the taxpayer elects to use the multiple pooling method provided in subparagraph (3) of this paragraph. Thus, if a business enterprise is composed of only one natural business unit, one pool shall be used for all of its inventories, including raw materials, goods in process, and finished goods. If, however, a business enterprise is actually composed of more than one natural business unit, more than one pool is required. Where similar types of goods are inventoried in two or more natural business units of the taxpayer, the Commissioner may apportion or allocate such goods among the various natural business units, if he determines that such apportionment or allocation is necessary in order to clearly reflect the income of such taxpayer. Where a manufacturer or processor is also engaged in the wholesaling or retailing of goods purchased from others, any pooling of the LIFO inventory of such purchased goods for the wholesaling or retailing operations shall be determined in accordance with the rules of paragraph (c) of this section.

(2) *Definition of natural business unit.* (i) Whether an enterprise is composed of more than one natural business unit is a matter of fact to be determined from all the circumstances. The natural business divisions adopted by the taxpayer for internal management purposes, the existence of separate and distinct production facilities and processes, and the maintenance of separate profit and loss records with respect to separate operations are important considerations in determining what is a business unit, unless such divisions, facilities, or accounting records are set up merely because of differences in geographical location. In the case of a manufacturer or processor, a natural business unit ordinarily consists of the entire productive activity of the enterprise within one product line or within two or more related product lines including (to the extent engaged in by the enterprise) the obtaining of materials, the processing of materials, and the selling of manufactured or processed goods. Thus, in the case of a manufacturer or processor, the maintenance and operation of a raw material warehouse does not generally constitute, of itself, a natural business unit. If the taxpayer maintains and operates a supplier unit the production of which is both sold to others and transferred to a different unit of the taxpayer to be used as a component part of another product, the supplier unit will ordinarily constitute a separate and distinct natural business unit. Ordinarily, a processing plant would not in itself be considered a natural business unit if the production of the plant, although saleable at this stage, is not sold to others, but is transferred to another plant of the enterprise, not operated as a separate division, for further processing or incorporation into another product. On the other hand, if the production of a manufacturing or processing plant is transferred to a separate and distinct division of the taxpayer, which constitutes a natural business unit, the supplier unit itself will ordinarily be considered a natural business unit. However, the mere fact that a portion of the production of a manufacturing or processing plant may be sold to others at a certain stage of processing with the remainder of the production being further processed or incorporated into another product will not of itself be determinative that the activities devoted to the production of the portion sold constitute a separate business unit. Where a manufacturer or processor is also engaged in the wholesaling or retailing of goods purchased from others, the wholesaling or retailing operations with respect to such purchased goods shall not be considered a part of any manufacturing or processing unit.

(ii) The rules of this subparagraph may be illustrated by the following examples:

Example (1). A corporation manufactures, in one division, automatic clothes washers and driers of both commercial and domestic grade as well as electric ranges, mangles, and dishwashers. The corporation manufactures, in another division, radios and television sets. The manufacturing facilities and processes used in manufacturing the radios and television sets are distinct from those used in manufacturing the automatic clothes washers, etc. Under these circumstances, the enterprise would consist of two business units and two pools would be appropriate, one consisting of all of the LIFO inventories entering into the manufacture of clothes washers and driers, electric ranges, mangles, and dishwashers and the other consisting of all of the LIFO inventories entering into the production of radio and television sets.

Example (2). A taxpayer produces plastics in one of its plants. Substantial amounts of the production are sold as plastics. The remainder of the production is shipped to a second plant of the taxpayer for the production of plastic toys which are sold to customers. The taxpayer operates his plastics plant and toy plant as separate divisions. Because of the different product lines and the separate divisions the taxpayer has two natural business units.

Example (3). A taxpayer is engaged in the manufacture of paper. At one stage of processing, uncoated paper is produced. Substantial amounts of uncoated paper are sold at this stage of processing. The remainder of the uncoated paper is transferred to the taxpayer's finishing mill where coated paper is produced and sold. This taxpayer has only one natural business unit since coated and uncoated paper are within the same product line.

(3) *Multiple pools*—(i) *Principles for establishing multiple pools. (a)* A taxpayer may elect to establish multiple pools for inventory items which are not within a natural business unit as to which the taxpayer has adopted the natural business unit method of pooling as provided in subparagraph (1) of this paragraph. Each such pool shall ordinarily consist of a group of inventory items which are substantially similar. In determining whether such similarity exists, consideration shall be given to all the facts and circumstances. The formulation of detailed rules for selection of pools applicable to all taxpayers is not feasible. Important considerations to be taken into account include, for example, whether there is substantial similarity in the types of raw materials used or in the processing operations applied; whether the raw materials used are readily interchangeable; whether there is similarity in the use of the products; whether the groupings are consistently followed for purposes of internal accounting and management; and whether the groupings follow customary business practice in the taxpayer's industry. The selection of pools in each case must also take into consideration such factors as the nature of the inventory items subject to the dollar-value LIFO method and the significance of such items to the taxpayer's business operations. Where similar types of goods are inventoried in natural business units and multiple pools of the taxpayer, the Commissioner may apportion or allocate such goods among the natural business units and the multiple pools, if he determines that such apportionment or allocation is necessary in order to clearly reflect the income of the taxpayer.

(b) Raw materials which are substantially similar shall be pooled together in accordance with the principles of this subparagraph. However, inventories of raw or unprocessed materials of an unlike nature may not be placed into one pool, even though such materials become part of otherwise identical finished products.

(c) Finished goods and goods-in-process in the inventory shall be placed into pools classified by major classes or types of goods. The same class or type of finished goods and goods-in-process shall ordinarily be included in the same pool. Where the material content of a class of finished goods and goods-in-process included in a pool has been changed, for example, to conform with current trends in an industry, a separate pool of finished goods and goods-in-process will not ordinarily be required unless the change in material content results in a substantial change in the finished goods.

(d) The requirement that pools be established by major types of materials or major classes of goods is not to be construed so as to preclude the establishment of a miscellaneous pool. Since a taxpayer may elect the dollar-value LIFO method with respect to all or any designated goods in his inventory, there may be a number of such inventory items covered in the election. A

miscellaneous pool shall consist only of items which are relatively insignificant in dollar value by comparison with other inventory items in the particular trade or business and which are not properly includible as part of another pool.

(ii) *Raw materials content pools.* The dollar-value method of pricing LIFO inventories may be used in conjunction with the raw materials content method authorized in § 1.472–1. Raw materials (including the raw material content of finished goods and goods-in-process) which are substantially similar shall be pooled together in accordance with the principles of subdivision (i) of this subparagraph. However, inventories of materials of an unlike nature may not be placed into one pool, even though such materials become part of otherwise identical finished products.

(c) *Principles for establishing pools for wholesalers, retailers, etc.* Items of inventory in the hands of wholesalers, retailers, jobbers, and distributors shall be placed into pools by major lines, types, or classes of goods. In determining such groupings, customary business classifications of the particular trade in which the taxpayer is engaged is an important consideration. An example of such customary business classification is the department in the department store. In such case, practices are relatively uniform throughout the trade, and departmental grouping is peculiarly adapted to the customs and needs of the business. However, in appropriate cases, the principles set forth in paragraphs (b) (1) and (2) of this section, relating to pooling by natural business units, may be used, with permission of the Commissioner, by wholesalers, retailers, jobbers, or distributors. Where a wholesaler or retailer is also engaged in the manufacturing or processing of goods, the pooling of the LIFO inventory for the manufacturing or processing operations shall be determined in accordance with the rules of paragraph (b) of this section.

(d) *Determination of appropriateness of pools.* Whether the number and the composition of the pools used by the taxpayer is appropriate, as well as the propriety of all computations incidental to the use of such pools, will be determined in connection with the examination of the taxpayer's income tax returns. Adequate records must be maintained to support the base-year unit cost as well as the current-year unit cost for all items priced on the dollar-value LIFO inventory method, regardless of the method authorized by paragraph (e) of this section which is used in computing the LIFO value of the dollar-value pool. The pool or pools selected must be used for the year of adoption and for all subsequent taxable years unless a change is required by the Commissioner in order to clearly reflect income, or unless permission to change is granted by the Commissioner as provided in paragraph (e) of § 1.446–1. However, see paragraph (h) of this section for authorization to change the method of pooling in certain specified cases.

(e) *Methods of computation of the LIFO value of a dollar-value pool*—(1) *Methods authorized.* A taxpayer may ordinarily use only the so-called ''double-extension'' method for computing the base-year and current-year cost of a dollar-value inventory pool. Where the use of the double-extension method is impractical, because of technological changes, the extensive variety of items, or extreme fluctuations in the variety of the items, in a dollar-value pool, the taxpayer may use an index method for computing all or part of the LIFO value of the pool. An index may be computed by double-extending a representative portion of the inventory in a pool or by the use of other sound and consistent statistical methods. The index used must be appropriate to the inventory pool to which it is to be applied. The appropriateness of the method of computing the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns. The use of any so-called ''link-chain'' method will be approved for taxable years beginning after December 31, 1960, only in those cases where the taxpayer can demonstrate to the satisfaction of the district director that the use of either an index method or the double-extension method would be impractical or unsuitable in view of the nature of the pool. A taxpayer using either an index or link-chain method shall attach to his income tax return for the first taxable year beginning after December 31, 1960, for which the index or link-chain method is used, a statement describing the particular link-chain method or the method used in computing the index. The statement shall be in sufficient detail to facilitate the determination as to whether the method used meets the standards set forth in this subparagraph. In addition, a copy of the statement shall be filed with the Commissioner of Internal Revenue, Attention: T:R, Washington, D.C. 20224. The taxpayer shall submit such other information as may be requested with respect to such index or link-chain method. Adequate records must be maintained by the taxpayer to support the appropriateness, accuracy, and reliability of an index or link-chain method. A taxpayer may request the Commissioner to approve the appropriateness of an index or link-chain method for the first taxable year beginning after December 31, 1960, for which it is used. Such request must be submitted within 90 days after the beginning of the first taxable year beginning after December 31, 1960, in which the taxpayer desires to use the index or link-chain method, or on or before May 1, 1961, whichever is later. A taxpayer entitled to use the retail method of pricing LIFO inventories authorized by paragraph (k) of §1.472–1 may use retail price indexes prepared by the United States Bureau of Labor Statistics. Any method of computing the LIFO value of a dollar-value pool must be used for the year of adoption and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner in accordance with paragraph (e) of §1.446–1 to use a different method.

(2) *Double-extension method.* (i) Under the double-extension method the quantity of each item in the inventory pool at the close of the taxable year is extended at both base-year unit cost and current-year unit cost. The respective extensions at the two costs are then each totaled. The first total gives the amount of the current inventory in terms of base-year cost and the second total gives the amount of such inventory in terms of current-year cost.

(ii) The total current-year cost of items making up a pool may be determined—

(a) By reference to the actual cost of the goods most recently purchased or produced;

(b) By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition;

(c) By application of an average unit cost equal to the aggregate cost of all of the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced; or

(d) Pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.

(iii) Under the double-extension method a base-year unit cost must be ascertained for each item entering a pool for the first time subsequent to the beginning of the base year. In such a case, the base-year unit cost of the entering item shall be the current-year cost of that item unless the taxpayer is able to reconstruct or otherwise establish a different cost. If the entering item is a product or raw material not in existence on the base date, its cost may be reconstructed, that is, the taxpayer using reasonable means may determine what the cost of the item would have been had it been in existence in the base year. If the item was in existence on the base date but not stocked by the taxpayer, he may establish, by using available data or records, what the cost of the item would have been to the taxpayer had he stocked the item. If the base-year unit cost of the entering item is either reconstructed or otherwise established to the satisfaction of the Commissioner, such cost may be used as the base-year unit cost in applying the double-extension method. If the taxpayer does not reconstruct or establish to the satisfaction of the Commissioner a base-year unit cost, but does reconstruct or establish to the satisfaction of the Commissioner the cost of the item at some year subsequent to the base year, he may use the earliest cost which he does reconstruct or establish as the base-year unit cost.

(iv) To determine whether there is an increment or liquidation in a pool for a particular taxable year, the end of the year inventory of the pool expressed in terms of base-year cost is compared with the beginning of the year inventory of the pool expressed in terms of base-year cost. When the end of the year inventory of the pool is in excess of the beginning of the year inventory of the pool an increment occurs in the pool for that year. If there is an increment for the taxable year, the ratio of the total current-year cost of the pool to the total base-year cost of the pool must be computed. This ratio when multiplied by the amount of the increment measured in terms of base-year cost gives the LIFO value of such increment. The LIFO value of each such increment is hereinafter referred to in this section as the ‘‘layer of increment’’ and must be separately accounted for and a record thereof maintained as a separate layer of the pool, and may not be combined with a layer of increment occurring in a different year. On the other hand, when the end of the year inventory of the pool is less than the beginning of the year inventory of the pool, a liquidation occurs in the pool for that year. Such liquidation is to be reflected by reducing the most recent layer of increment by the excess of the beginning of the year inventory over the end of the year inventory of the pool. However, if the amount of the liquidation exceeds the amount of the most recent layer of increment, the preceding layers of increment in reverse chronological order are to be successively reduced by the amount of such excess until all the excess is absorbed. The base-year inventory is to be reduced by liquidation only to the extent that the aggregate of all liquidation exceeds the aggregate of all layers of increment.

(v) The following examples illustrate inventories under the double-extension the computation of the LIFO value of method.

Example (1). (a) A taxpayer elects, beginning with the calendar year 1961, to compute his inventories by use of the LIFO inventory method under section 472 and further elects to use the dollar-value method in pricing such inventories as provided in paragraph (a) of this section. He creates Pool No. 1 for items A, B, and C. The composition of the inventory for Pool No. 1 at the base date, January 1, 1961, is as follows:

Items	Units	Unit cost	Total cost
A	1,000	$5	$5,000
B	2,000	4	8,000
C	500	2	1,000
Total base-year cost at Jan. 1, 1961	....	....	14,000

(b) The closing inventory of Pool No. 1 at December 31, 1961, contains 3,000 units of A, 1,000 units of B, and 500 units of C. The taxpayer computes the current-year cost of the items making up the pool by reference to the actual cost of goods most recently purchased. The most recent purchases of items A, B, and C are as follows:

Item	Purchase date	Quantity purchased	Unit cost
A	Dec. 15, 1961	3,500	$6.00
B	Dec. 10, 1961	2,000	5.00
C	Nov. 1, 1961	500	2.50

(c) The inventory of Pool No. 1 at December 31, 1961, shown at base-year and current-year cost is as follows:

Item	Quantity	Dec. 31, 1961, inventory at Jan. 1, 1961, base-year cost		Dec. 31, 1961, inventory at current-year cost	
		Unit cost	Amount	Unit cost	Amount
A	3,000	$5.00	$15,000	$6.00	$18,000
B	1,000	4.00	4,000	5.00	5,000
C	500	2.00	1,000	2.50	1,250
Total	....	....	20,000	....	24,250

(d) If the amount of the December 31, 1961, inventory at base-year cost were equal to, or less than, the base-year cost of $14,000 at January 1, 1961, such amount would be the closing LIFO inventory at December 31, 1961. However, since the base-year cost of the closing LIFO inventory at December 31, 1961, amounts to $20,000, and is in excess of the $14,000 base-year cost of the opening inventory for that year, there is a $6,000 increment in Pool No. 1 during the year. This increment must be valued at current-year cost, i.e., the ratio of 24,250/20,000, or 121.25 percent. The LIFO value of the inventory at December 31, 1961, is $21,275, computed as follows:

POOL NO. 1

	Dec. 31, 1961, inventory at Jan. 1, 1961, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1961, inventory at LIFO value
Jan. 1, 1961, base cost	14,000	100.00	$14,000

POOL NO. 1—Continued

	Dec. 31, 1961, inventory at Jan. 1, 1961, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1961, inventory at LIFO value
Dec. 31, 1961, increment	6,000	121.25	7,275
Total	20,000	....	21,275

Example (2). (a) Assume the taxpayer in example (1) during the year 1962 completely disposes of item C and purchases item D. Assume further that item D is properly includible in Pool No. 1 under the provisions of this section. The closing inventory on December 31, 1962, consists of quantities at current-year unit cost, as follows:

Items	Units	Current-year unit cost Dec. 31, 1962
A	2,000	$6.50
B	1,500	6.00
D	1,000	5.00

(b) The taxpayer establishes that the cost of item D, had he acquired it on January 1, 1961, would have been $2.00 per unit. Such cost shall be used as the base-year unit cost for item D, and the LIFO computations at December 31, 1962, are made as follows:

Item	Quantity	Dec. 31, 1962, inventory at Jan. 1, 1961, base-year cost		Dec. 31, 1962, inventory at current-year cost	
		Unit cost	Amount	Unit cost	Amount
A	2,000	$5.00	$10,000	$6.50	$13,000
B	1,500	4.00	6,000	6.00	9,000
D	1,000	2.00	2,000	5.00	5,000
Total	....	....	18,000	....	27,000

(c) Since the closing inventory at base-year cost, $18,000, is less than the 1962 opening inventory at base-year cost, $20,000, a liquidation of $2,000 has occurred during 1962. This liquidation is to be reflected by reducing the most recent layer of increment. The LIFO value of the inventory at December 31, 1962, is $18,850, and is summarized as follows:

POOL NO. 1

	Dec. 31, 1962, inventory at Jan. 1, 1961, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1962, inventory at LIFO value
Jan. 1, 1961, base cost	14,000	100.00	$14,000
Dec. 31, 1961, increment	4,000	121.25	4,850
Total	18,000	....	18,850

(3) *Use of inventory price index computed with reference to consumer or producer price indexes*—(i) *In general.* For purposes of paragraph (e)(1) of this section, for taxable years beginning after December 31, 1981, an inventory price index computed in the manner provided by paragraph (e)(3) will be accepted by the Commissioner as an appropriate method of computing an index, and the use of such inventory price index to compute the LIFO value of a dollar-value inventory pool will be accepted as accurate, reliable, and suitable. A taxpayer using the inventory price index computation method provided by paragraph (e)(3) must use such method in determing the value of all goods for which the taxpayer has elected to use the LIFO method. However, the inventory price index computation method provided by paragraph (e)(3) may not be used by a taxpayer eligible to use inventory price indexes prepared by the United States Bureau of Labor Statistics for the purpose of valuing the LIFO inventories of a specific industry. Thus, a taxpayer eligible to use the retail price indexes prepared by the Bureau of Labor Statistics and published in *Department Store Inventory Price Indexes* may not use the inventory price index computation method provided by paragraph (e)(3). An inventory price index computed as provided by paragraph (e)(3) is computed in the manner provided by paragraph (e)(3)(ii) with reference to consumer or producer price indexes selected in the manner provided by paragraph (e)(3)(iii). Special rules for establishing inventory

pools to be valued by an inventory price index computed in the manner provided by paragraph (e)(3) are in paragraph (e)(3)(iv). Rules relating to the adoption of, or change to, the method of computing an inventory price index in the manner provided by paragraph (e)(3) are in paragraph (e)(3) (v) and (vi).

(ii) *Computation of index.* An inventory price index computed in the manner provided by this (ii) shall be a stated percentage of the percent change in the selected consumer or producer price index or indexes for a specific category or categories of goods. The stated percentage for a taxpayer in a taxable year in which it is an eligible small business, as defined by section 474(b) of the Code, shall be 100 percent of the percent change in the selected price indexes. The stated percentage for all other taxpayers shall be 80 percent of the percent change in the selected price indexes.

See paragraph (e)(3)(iii) of this section for rules relating to the selection of appropriate consumer or producer price indexes. Thus, if the selected consumer or producer price index for a specific category of goods increased 10 percent for the period December 1981 to December 1982, an inventory price index computed in the manner provided by this (ii) with reference to such consumer or producer price index will reflect an increase of either 10 percent for an eligible small business or 8 percent (80 percent of 10 percent) for all other taxpayers. If the selected consumer or producer price index for a specific category of goods increased 10 percent per year for the period December 1981 to December 1983, an inventory price index computed in the manner provided by this (ii) with reference to such consumer or producer price index will reflect an increase of either 21 percent for an eligible small business or 16.8 percent (80 percent of 21 percent) for all other taxpayers. If under paragraph (e)(3)(iii) it is necessary to select more than one specific consumer or producer price index for an inventory pool, the stated percentage of the percent change in such indexes is the stated percentage of the weighted average percent change for such indexes. Such weighted average is computed with reference to the relative amounts of costs in the inventory pool for each index category of goods. The costs to be used in computing such weighted average must be the relative current-year costs in ending inventory.

(iii) *Selection of consumer or producer price indexes*—(A) *In general.* An inventory price index computed as provided by paragraph (e)(3) of this section is computed with reference to the consumer or producer price indexes for specific categories of inventory items in the *CPI Detailed Report* or *Producer Prices and Price Indexes* published by the United States Bureau of Labor Statistics.

(B) *Selection of indexes by category of inventory items.* The selection of consumer or producer price indexes for an inventory pool is accomplished via a two-step process. First, the inventory items in each pool should be classified according to the detailed listings in the appropriate tables of the *CPI Detailed Report* or in *Producer Prices and Price Indexes* and assigned an index category. Second, an appropriate consumer or producer price index must be determined for each index category to which inventory items have been assigned. The assignment of index categories to the taxpayer's inventory items is accomplished by a process of elimination as follows:

(*1*) Whenever a specific inventory item in the taxpayer's inventory comprises 10 percent or more of total inventory value, such an inventory item must be placed in it's own, separate index category. The index category selected must be the most detailed index category which includes that specific inventory item. In addition, any other inventory item that is included in such most detailed index category must also be included in such index category.

(*2*) If there are inventory items still remaining in the pool that have not been included in an index category, the taxpayer, beginning with the most detailed index categories for such remaining inventory items, must investigate successively less detailed index category levels and select the first index category that contains remaining inventory items which in the aggregate comprise 10 percent or more of total inventory value. The index category so selected must be the separate index category for the included inventory items. This procedure must be repeated either until all inventory items in the pool have been included in an index category, or until the remaining inventory items in the aggregate comprise less than 10 percent of total inventory value, or until it has been determined that no appropriate index category exists for the aggregate of such remaining inventory items.

(*3*) If there are inventory items remaining in the pool that comprise less than 10 percent of total inventory value, the index category to be selected for these inventory items must be the most detailed index category that includes such inventory items. If it has been determined that no appropriate index category exists for such remaining inventory items, such remaining inventory items must be combined in a miscellaneous index category created by the taxpayer.

In no event shall an index category be selected that is less detailed than either the 11 general categories of consumer goods described in Tables 3 and 5 of the *CPI Detailed Report* (see paragraph (e)(3)(iv) of this section), or the 15 general categories of producer goods described in Table 6 of the *Producer Prices and Price Indexes.* The determination of the appropriate index for an index category is accomplished as follows:

(*4*) Whenever an index category has been selected pursuant to paragraph (e)(3)(iii)(B)(*1*) of this section the appropriate index must be the published index for that index category.

(*5*) Whenever an index category has been selected pursuant to paragraph (e)(3)(iii)(B) (*2*) or (*3*) of this section, the appropriate index must be a weighted average of the published indexes of the index category items actually present in the taxpayer's inventory, excluding any index category items that have been placed in any other separate index category, weighted according to the weights used by BLS. Thus, if a taxpayer's inventory contains every inventory item that comprises the selected index category and none of these inventory items have been placed in any other separate index category, the appropriate index must be the published index for that index category. In the case of a miscellaneous index category created by the taxpayer, the appropriate index must be a weighted average of the published indexes for the index category items, weighted according to the weights used by BLS.

The use of BLS weights is limited only to the determination of the appropriate index for an index category. In computing the index for a pool, the taxpayer will weight the appropriate indexes for the separate index categories comprising the pool according to the taxpayer's actual inventory weights for such separate index categories. Whether the selection of the consumer or producer price indexes to be used to compute an inventory price index is appropriate, and the propriety of all computations incidental to the use of such consumer or producer price indexes, will be determined in connection with the examination of the taxpayer's income tax return. The selection of a consumer or producer price index for a specific good to compute an inventory price index under paragraph (e)(3) is a method of accounting. A taxpayer desiring to change the selection of such a consumer or producer price index must secure the consent of the Commissioner as provided in §1.446–1(e). In the case of such a change, any layers of inventory increments previously determined and the LIFO value of such increments shall be retained. Instead of using the earliest taxable year for which the taxpayer adopted the LIFO method for any items in the inventory pool, the year of such change shall be used as the base year in determining the LIFO value of the inventory pool for the year of change and later taxable years. The base year costs of layers of increments in the pool at the beginning of the year of change shall be restated in terms of new base year costs using the year of change as the new base year.

(C) *Other selection requirements.* Manufacturers, processors, wholesalers, jobbers, and distributors may select indexes from only *Producer Prices and*

Price Indexes. Retailers may select indexes from either the *CPI Detailed Report* or *Producer Prices and Price Indexes,* but if equally appropriate indexes could be selected from either publication, a retailer using the retail inventory method must select the index from the *CPI Detailed Report* and a retailer not using the retail inventory method must select the index from *Producer Prices and Price Indexes.* If a retailer using the retail inventory method selects a price index from *Producer Prices and Price Indexes,* the selected index must be converted into a retail price index. If a retailer not using the retail inventory method selects an index from the *CPI Detailed Report,* the selected index must be converted into a cost price index. Manufacturers, processors, wholesalers, jobbers, and distributors, must convert selected indexes into cost price indexes. In the case of the *CPI Detailed Report,* indexes may be selected only from Table 3 (Consumer Price Index for All Urban Consumers: Food expenditure categories, U.S. city average) and Table 5 (Consumer Price Index for All Urban Consumers: Nonfood expenditure categories, U.S. city average). In the case of the *Producer Prices and Price Indexes,* indexes may be selected only from Table 6 (Producer prices and price indexes for commodity groupings and individual items), unless the taxpayer can demonstrate that the selection of an index from another *Producer Prices and Price Indexes* table would be more appropriate. In the case of a taxpayer using the retail inventory method, the selected index must be the index as of the last month of the taxpayer's taxable year. Taxpayers that do not use the retail inventory method must select indexes as of the month or months most appropriate to the taxpayer's method of determining the current-year cost of the inventory pool under paragraph (e)(2)(ii) of this section, or make a one-time binding election of an appropriate representative month during the taxable year. The election must be clearly set forth on Form 970 (see paragraph (e)(3)(v) of this section).

(iv) *Special rules for pools.* A retailer, wholesaler, jobber, or distributor computing an inventory price index in the manner provided by paragraph (e)(3) of this section may, at the option of the taxpayer, establish an inventory pool for any group of goods included within one of eleven general categories of consumer goods described in the *CPI Detailed Report.* The eleven categories are food and beverages, housing maintenance and repair commodities, fuels (other than gasoline), house furnishings and housekeeping supplies, apparel commodities, private transportation (including gasoline), medical care commodities, entertainment commodities, tobacco products, toilet goods and personal care appliances, and school books and supplies. Inventory pools that comprise less than 5 percent of inventory value may be combined to form a single miscellaneous inventory pool. If the resulting miscellaneous inventory pool itself comprises less than 5 percent of inventory value, such pool may be combined only with the largest inventory pool. See paragraphs (b), (c) and (d) of this section for additional rules relating to the establishment of pools. See also section 474 of the Code for rules relating to the use of a single pool by an eligible small business. Except as provided in paragraph (e)(3)(v) of this section, relating to the adoption or change of method of computing an inventory price index, the rules of paragraph (g)(1) and (2) of this section apply to a change in method of pooling.

(v) *Adoption or change of method.* The use of an inventory price index computed in the manner provided by paragraph (e)(3) of this section is considered a method of accounting. A taxpayer permitted to adopt or change to the dollar-value LIFO inventory method without first securing the consent of the Commissioner may also adopt the inventory price index computation method prescribed by paragraph (e)(3) incident to such adoption or change without first securing the consent of the Commissioner. In all other cases, a taxpayer may adopt or change to the inventory price index computation method prescribed by paragraph (e)(3) only after first securing the consent of the Commissioner as provided in § 1.446–1(e). However, in the case of a taxpayer not using the inventory price index computation method prescribed by paragraph (e)(3), the taxpayer may adopt or change to such method for the taxpayer's first or second taxable year beginning after December 31, 1981, without requesting the Commissioner's consent to such adoption or change. In addition, in such a case the taxpayer is not required to request the Commissioner's consent to a change in method of pooling incident to such adoption or change if the taxpayer is changing to a method of pooling authorized by paragraph (e)(3)(iv). In this case the rules of §1.472–8(g) will apply. The inventory price index computation method provided by paragraph (e)(3) may be adopted and used only if the taxpayer indicates on a Form 970, or in such other manner as may be acceptable to the Commissioner, a listing of each inventory pool, the type of goods included in each pool, and the consumer or producer price index or indexes selected for each inventory pool. In the case of a taxpayer permitted to adopt or change to the inventory price index computation method without requesting the Commissioner's consent, the Form 970 shall be attached to the taxpayer's income tax return for the taxable year of such adoption or change. In other cases, the Form 970 shall be attached to a Form 3115 filed in accordance with §1.446–1(e). Taxpayers must maintain adequate books and records of the use and computation of the inventory price index method in order to satisfy the requirements of §1.472–2(h). Notwithstanding the rules in paragraph (e)(1) of this section, a taxpayer adopting or changing to the use of an inventory price index computed in the manner provided by paragraph (e)(3) is not required to demonstrate that the use of the double-extension method is impractical.

(vi) *Requirement incident to change.* In the case of a taxpayer using a method other than an inventory price index computed as prescribed by paragraph (e)(3) of this section to determine the LIFO value of a dollar-value inventory pool, any layers of inventory increments previously determined by such method and the LIFO value of such layers shall be retained if the taxpayer changes to the use of a price index computed as prescribed by paragraph (e)(3). Instead of using the earliest taxable year for which the taxpayer adopted the LIFO method for any items in the pool, the year of such change shall be used as the base year in determining the LIFO value of the inventory pool for the year of change and later taxable years. The base year costs of layers of increments in the pool at the beginning of the year of change shall be restated in terms of new base year cost, using the year of change as the new base year. See paragraph (f)(2) of this section for rules relating to a change to the dollar-value method from another method of pricing LIFO inventories.

(f) *Change to dollar-value method from another method of pricing LIFO inventories*—(1) *Consent required.* Except as provided in §1.472–3 in the case of a taxpayer electing to use a LIFO inventory method for the first time, or in the case of a taxpayer changing to the dollar-value method and continuing to use the same pools as were used under another LIFO method, a taxpayer using another LIFO method of pricing inventories may not change to the dollar-value method of pricing such inventories unless he first secures the consent of the Commissioner in accordance with paragraph (e) of §1.446–1.

(2) *Method of converting inventory.* Where the taxpayer changes from one method of pricing LIFO inventories to the dollar-value method, the ending LIFO inventory for the taxable year immediately preceding the year of change shall be converted to the dollar-value LIFO method. This is done to establish the base-year cost for subsequent calculations. Thus, if the taxpayer was previously valuing LIFO inventories on the specific goods method, these separate values shall be combined into appropriate pools. For this purpose, the base year for the pool shall be the earliest taxable year for which the LIFO inventory method had been adopted for any item in that pool. No change will be made in the overall LIFO value of the opening inventory for the year of change as a result of the conversion, and that inventory will merely be restated in the manner used under the dollar-value method. All layers of increment for such inventory must be retained, except that all layers of increment which occurred in the same taxable year must be combined. The following examples illustrate the provisions of this subparagraph:

Example (1). (i) Assume that the taxpayer has used another LIFO method for finished goods since 1954 and has complied with all the requirements prerequisite for a change to the dollar-value method. Items A, B, and C, which have previously been inventoried under the specific goods LIFO method, may properly be included in a single dollar-value LIFO pool. The LIFO inventory value of items A, B, and C at December 31, 1960, is $12,200, computed as follows:

Year	Base quantity and yearly increments	Unit cost	Dec. 31, 1960, inventory at LIFO value
Item A			
1954 (base year)	100	$1	$100
1955	200	2	400
1956	100	4	400
1960	100	6	600
Total	500	....	1,500
Item B			
1954 (base year)	300	6	1,800
1955	100	8	800
1960	50	10	500
Total	450	....	3,100
Item C			
1954 (base year)	1,000	4	4,000
1955	200	6	1,200
1956	300	8	2,400
Total	1,500	....	7,600
LIFO value of items A, B, and C at Dec. 31, 1960	....	....	12,200

There were no increments in the years 1957, 1958, or 1959.

(ii) The computation of the ratio of the total current-year cost to the total base-year cost for the base year and each layer of increment in Pool No. 1 is shown as follows:

Item	1954 base-year unit cost	Year 1954	Increments		
			1955	1956	1960
A					
Base-year cost	$1.00	$100	$200	$100	$100
LIFO value	....	100	400	400	600
B					
Base-year cost	6.00	1,800	600	....	300
LIFO value	....	1,800	800	....	500
C					
Base-year cost	4.00	4,000	800	1,200	....
LIFO value	....	4,000	1,200	2,400	....
Total—Base-year cost	5,900	1,600	1,300	400	
Total—LIFO value	5,900	2,400	2,800	1,100	
Ratio of total current-year cost to total base-year cost (percent)	....	100.00	150.00	215.38	275.00

(iii) On the basis of the foregoing computations, the LIFO inventory of Pool No. 1, at December 31, 1960, is restated as follows:

	Dec. 31, 1960, inventory at base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
1954 base cost	$5,900	100.00	$5,900
1955 increment	1,600	150.00	2,400
1956 increment	1,300	215.38	2,800
1960 increment	400	275.00	1,100
Total	9,200	....	12,200

Example (2). Assume the same facts as in example (1) and assume further that the base-year cost of Pool No. 1 at December 31, 1961, is $8,350. Since the closing inventory for the taxable year 1961 at base-year cost is less than the opening inventory for that year at base-year cost, a liquidation has occurred during 1961. This liquidation absorbs all of the 1960 layer of increment and part of the 1956 layer of increment. The December 31, 1961, inventory is $10,131, computed as follows:

	Dec. 31, 1961, inventory at base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1961, inventory at LIFO value
1954 base cost	$5,900	100.00	$5,900

	Dec. 31, 1961, inventory at base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1961, inventory at LIFO value
1955 increment	1,600	150.00	2,400
1956 increment	850	215.38	1,831
Total	8,350	....	10,131

(g) *Transitional rules*—(1) *Change in method of pooling.* Any method of pooling authorized by this section and used by the taxpayer in computing his LIFO inventories under the dollar-value method shall be treated as a method of accounting. Any method of pooling which is authorized by this section shall be used for the year of adoption and for all subsequent taxable years unless a change is required by the Commissioner in order to clearly reflect income, or unless permission to change is granted by the Commissioner as provided in paragraph (e) of §1.446–1. Where the taxpayer changes from one method of pooling to another method of pooling permitted by this section, the ending LIFO inventory for the taxable year preceding the year of change shall be restated under the new method of pooling.

(2) *Manner of combining or separating dollar-value pools.* (i) A taxpayer who has been using the dollar-value LIFO method and who is permitted or required to change his method of pooling, shall combine or separate the LIFO value of his inventory for the base year and each yearly layer of increment in order to conform to the new pool or pools. Each yearly layer of increment in the new pool or pools must be separately accounted for and a record thereof maintained, and any liquidation occurring in the new pool or pools subsequent to the formation thereof shall be treated in the same manner as if the new pool or pools had existed from the date the taxpayer first adopted the LIFO inventory method. The combination or separation of the LIFO value of his inventory for the base year and each yearly layer of increment shall be made in accordance with the appropriate method set forth in this subparagraph, unless the use of a different method is approved by the Commissioner.

(ii) Where the taxpayer is permitted or required to separate a pool into more than one pool, the separation shall be made in the following manner: First, each item in the former pool shall be placed in an appropriate new pool. Every item in each new pool is then extended at its base-year unit cost and the extensions are totaled. Each total is the amount of inventory for each new pool expressed in terms of base-year cost. Then a ratio of the total base-year cost of each new pool to the base-year cost of the former pool is computed. The resulting ratio is applied to the amount of inventory for the base year and each yearly layer of increment of the former pool to obtain an allocation to each new pool of the base-year inventory of the former pool and subsequent layers of increment thereof. The foregoing may be illustrated by the following example of a change for the taxable year 1961:

Example. (a) Assume that items A, B, C, and D are all grouped together in one pool prior to December 31, 1960. The LIFO inventory value at December 31, 1960, is computed as follows:

	Pool ABCD		
	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Jan. 1, 1956, base cost	$10,000	100	$10,000
Dec. 31, 1956, increment	1,000	110	1,100
Dec. 31, 1958, increment	5,000	120	6,000
Dec. 31, 1960, increment	4,000	125	5,000
Total	20,000	....	22,100

(b) The extension of the quantity of items A, B, C, and D at respective base-year unit costs is as follows:

Item	Quantity	Base-year unit cost	Amount
A	2,000	$2	$4,000
B	1,000	3	3,000
C	1,000	5	5,000
D	4,000	2	8,000
Total	....	....	20,000

(c) Under the provisions of this section the taxpayer separates former Pool ABCD into

two pools, Pool AB and Pool CD. The computation of the ratio of total base-year cost for each of the new pools to the base-year cost of the former pool is as follows:

Item	Total base-year cost	Ratio
Pool AB:		
A	$4,000	....
B	3,000	....
	7,000	7,000/20,000
Pool CD:		
C	5,000	....
D	8,000	....
	13,000	13,000/20,000
Total for pool ABCD	20,000	....

(d) The ratio of the base-year cost of new Pools AB and CD to the base-year cost of former Pool ABCD is 7,000/20,000 and 13,000/20,000, respectively. The allocation of the January 1, 1956 base cost and subsequent yearly layers of increment of former Pool ABCD to new Pools AB and CD is as follows:

	Base-year cost to be allocated	Pool	
		AB	CD
Jan. 1, 1956, base cost	$10,000	$3,500	$6,500
Dec. 31, 1956, increment	1,000	350	650
Dec. 31, 1958, increment	5,000	1,750	3,250
Dec. 31, 1960, increment ..	4,000	1,400	2,600
Total	20,000	7,000	13,000

(e) The LIFO value of new Pools AB and CD at December 31, 1960, as allocated, is as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Pool AB			
Jan. 1, 1956, base cost	$3,500	100	$3,500
Dec. 31, 1956, increment	350	110	385
Dec. 31, 1958, increment	1,750	20	2,100
Dec. 31, 1960, increment	1,400	125	1,750
Total	7,000	....	7,735
Pool CD			
Jan. 1, 1956, base cost	6,500	100	6,500
Dec. 31, 1956, increment	650	110	715
Dec. 31, 1958, increment	3,250	120	3,900
Dec. 31, 1960, increment	2,600	125	3,250
Total	13,000	....	14,365

(iii) Where the taxpayer is permitted or required to combine two or more pools having the same base year, they shall be combined into one pool in the following manner: The LIFO value of the base-year inventory of each of the former pools is combined to obtain a LIFO value of the base-year inventory for the new pool. Then, any layers of increment in the various pools which occurred in the same taxable year are combined into one total layer of increment for that taxable year. However, layers of increment which occurred in different taxable years may not be combined. In combining the layers of increment a new ratio of current-year cost to base-year cost is computed for each of the combined layers of increment. The foregoing may be illustrated by the following example:

Example. (a) Assume the taxpayer has two pools at December 31, 1960. Under the provisions of this section the taxpayer combines these pools into a single pool as of January 1, 1961. The LIFO inventory value of each pool at December 31, 1960, is shown as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1957, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Pool No. 1			
Jan. 1, 1956, base cost	$10,000	100	$10,000
Dec. 31, 1957, increment	2,000	110	2,200
Dec. 31, 1960, increment	1,000	120	1,200
Total	13,000	....	13,400
Pool No. 2			
Jan. 1, 1957, base cost	5,000	100	5,000
Dec. 31, 1960, increment	3,000	140	4,200
Total	8,000	....	9,200

(b) The computation of the ratio of the total current-year cost to the total base-year cost for the base year and each yearly layer of increment in the new pool is as follows:

Pool	Base year 1957	Increments	
		Dec. 31, 1957	Dec. 31, 1960
No. 1:			
Base-year cost	$10,000	$2,000	$1,000
LIFO value	10,000	2,200	1,200
No. 2:			
Base-year cost	5,000	....	3,000
LIFO value	5,000	....	4,200
Total, base-year cost	15,000	2,000	4,000
Total, LIFO value	15,000	2,200	5,400
Ratio of total current-year cost to total base-year cost (percent)	100	110	135

(c) On the basis of the foregoing computations, the LIFO inventory of the new pool at December 31, 1960, is restated as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1957, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Jan. 1, 1957, base cost	$15,000	100	$15,000
Dec. 31, 1957, increment	2,000	110	2,200
Dec. 31, 1960, increment	4,000	135	5,400
Total	21,000	....	22,600

(iv) In combining pools having different base years, the principles set forth in subdivision (iii) of this subparagraph are to be applied, except that all base years subsequent to the earliest base year shall be treated as increments, and the base-year costs for all pools having a base year subsequent to the earliest base year of any pool shall be redetermined in terms of the base cost for the earliest base year. The foregoing may be illustrated by the following example:

Example. (a) Assume that the taxpayer has two pools at December 31, 1960. Under the provisions of this section the taxpayer combines these pools into a single pool as of January 1, 1961. The LIFO inventory value of each pool at December 31, 1960, is shown as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current rent-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Pool No. 1			
Jan. 1, 1956, base cost	$7,000	100	$7,000
Dec. 31, 1956, increment	1,000	105	1,050
Dec. 31, 1957, increment	500	110	550
Dec. 31, 1958, increment	500	110	550
Dec. 31, 1960, increment	1,000	120	1,200
Total	10,000	....	10,350
Pool No. 2			
Jan. 1, 1958, base cost	3,500	100	3,500
Dec. 31, 1958, increment	1,000	110	1,100
Dec. 31, 1959, increment	500	115	575
Total	5,000	....	5,175

(b) The next step is to redetermine the 1958 base-year cost for Pool No. 2 in terms of 1956 base-year cost. January 1, 1956 base-year unit cost must be reconstructed or established in accordance with paragraph (e)(2) of this section for each item in Pool No. 2. Such costs are assumed to be $9.00 for item A, $20.00 for item B, and $1.80 for item C. A ratio of the 1958 total base-year cost to the 1956 total base-year cost for Pool No. 2 is computed as follows:

Item	Quantity	Jan. 1, 1956, base-year unit cost	Jan. 1, 1956, base-year cost
A	250	$9.00	$2,250
B	75	20.00	1,500
C	500	1.80	900
Total	....	....	4,650
A	250	10.00	2,500
B	75	20.00	1,500
C	500	2.00	1,000
Total	....	....	5,000

(c) The ratio of the 1956 total base-year cost to the 1958 total base-year cost for Pool No. 2 is 4,650/5,000 or 93 percent. The January 1, 1958 base cost and each yearly layer of increment at 1958 base-year cost is multiplied

by this ratio. Such computation is as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1958, base-year cost	Ratio (percent)	Dec. 31, 1960, inventory restated at Jan. 1, 1956, base-year cost
Jan. 1, 1958, base cost	$3,500	93	$3,255
Dec. 31, 1958, increment	1,000	93	930
Dec. 31, 1959, increment	500	93	465
Total			4,650

(d) The computation of the ratio of the total current-year cost to the total base-year cost for the base year (1956) and each yearly layer of increment in the new pool is as follows:

Pool	Base year 1956	Increments				
		Dec. 31, 1956	Dec. 31, 1957	Dec. 31, 1958	Dec. 31, 1959	Dec. 31, 1960
No. 1:						
Base-year cost	$7,000	$1,000	$500	$500		$1,000
LIFO value	7,000	1,050	550	550		1,200
No. 2:						
Base-year cost as restated			3,255	930	$465	
LIFO value			3,500	1,100	575	
Total, base-year cost	7,000	1,000	3,755	1,430	465	1,000
Total, LIFO value	7,000	1,050	4,050	1,650	575	1,200
Ratio of total current-year cost to total base-year cost (percent)	100.00	105.00	107.86	115.38	133.66	120.00

(e) On the basis of the foregoing computation, the LIFO inventory of the new pool at December 31, 1960, is restated as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Jan. 1, 1956, base cost	$7,000	100.00	$7,000
Dec. 31, 1956, increment	1,000	105.00	1,050
Dec. 31, 1957, increment	3,755	107.86	4,050
Dec. 31, 1958, increment	1,430	115.38	1,650
Dec. 31, 1959, increment	465	123.66	575
Dec. 31, 1960, increment	1,000	120.00	1,200
Total	14,650		15,525

(3) *Change in methods of computation at the LIFO value of a dollar-value pool.* For the first taxable year beginning after December 31, 1960, the taxpayer must use a method authorized by paragraph (e)(1) of this section in computing the base-year cost and current-year cost of a dollar-value inventory pool for the end of such year. If the taxpayer had previously used any methods other than one authorized by paragraph (e)(1) of this section, he shall not be required to recompute his LIFO inventories for taxable years beginning on or before December 31, 1960, under a method authorized by such paragraph. The base cost and layers of increment previously computed by such other method shall be retained and treated as if such base cost and layers of increment had been computed under a method authorized by paragraph (e)(1) of this section. The taxpayer shall use the year of change as the base year in applying the double-extension method or other method approved by the Commissioner, instead of the earliest year for which he adopted the LIFO method for any items in the pool.

(h) *Change without consent in method of pooling*—(1) *Authorization.* Notwithstanding the provisions of paragraph (g) of this section, a taxpayer, for his first taxable year ending after April 15, 1961, may change from one method of pooling authorized by this section to any other method of pooling authorized by this section provided the requirements of subparagraph (2) of this paragraph are met. Also, for such year, if a taxpayer is currently using only a method of pooling authorized by this section, or a method of pooling which would be authorized by this section if additional items were included in the pool, and could change to the natural business unit method, except for the fact he has not inventoried all items entering into the inventory investment for such natural business unit on the LIFO method, he may change to the natural business unit method if he elects under the provisions of §1.472–3 to extend the LIFO election to all items entering into the entire inventory investment for such natural business unit, provided the requirements of subparagraph (2) of this paragraph are met. The method of pooling adopted shall be used for the year of change and for all subsequent taxable years unless a change is required by the Commissioner in order to clearly reflect income, or unless permission to change is granted by the Commission as provided in paragraph (e) of §1.446–1.

(2) *Requirements.* A statement shall be attached to the income tax return for the year of change referred to in subparagraph (1) of this paragraph setting forth, in summary form, the following information:

(i) A description of the new pool or pools,

(ii) The basis for selection of the new pool or pools,

(iii) A schedule showing the computation of the LIFO value of the former pool or pools, and,

(iv) A schedule showing the transition from the former pool or pools to the new pool or pools.

In addition, a copy of the statement shall be filed with the Commissioner of Internal Revenue, Attention: T:R, Washington, DC 20024. The taxpayer shall submit such other information with respect to the change in method of pooling as may be requested.

[T.D. 6539, 26 FR 518, Jan. 20, 1961, as amended by T.D. 7814, 47 FR 11272, Mar. 16, 1982]

§1.475–0 Table of contents.

This section lists the major captions in §§1.475(a)–3, 1.475(b)–1, 1.475(b)–2, 1.475(b)–4, 1.475(c)–1, 1.475(c)–2, 1.475(d)–1, and 1.475(e)–1.

§§1.475(a)–1—1.475(a)–2 [Reserved]

§1.475(a)–3 Acquisition by a dealer of a security with a substituted basis.

(a) Scope.
(b) Rules.

§1.475(b)–1 Scope of exemptions from mark-to-market requirement.

(a) Securities held for investment or not held for sale.
(b) Securities deemed identified as held for investment.
(1) In general.
(2) Relationships.
(i) General rule.
(ii) Attribution.
(iii) Trusts treated as partnerships.
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(1) [Reserved].

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(1) Description.

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§ 1.475(d)–1 Character of gain or loss.

(a) Securities never held in connection with the taxpayer's activities as a dealer in securities.

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[T.D. 8700, 61 FR 67719, Dec. 24, 1996]

§ 1.475(a)–1—1.475(a)–2 [Reserved]

§ 1.475(a)–3 Acquisition by a dealer of a security with a substituted basis.

(a) *Scope.* This section applies if—

(1) A dealer in securities acquires a security that is subject to section 475(a) and the dealer's basis in the security is determined, in whole or in part, by reference to the basis of that security in the hands of the person from whom the security was acquired; or

(2) A dealer in securities acquires a security that is subject to section 475(a) and the dealer's basis in the security is determined, in whole or in part, by reference to other property held at any time by the dealer.

(b) *Rules.* If this section applies to a security—

(1) Section 475(a) applies only to changes in value of the security occurring after the acquisition; and

(2) Any built-in gain or loss with respect to the security (based on the difference between the fair market value of the security on the date the dealer acquired it and its basis to the dealer on that date) is taken into account at the time, and has the character, provided by the sections of the Internal Revenue Code that would apply to the built-in gain or loss if section 475(a) did not apply to the security.

[T.D. 8700, 61 FR 67720, Dec. 24, 1996]

§ 1.475(b)–1 Scope of exemptions from mark-to-market requirement.

(a) *Securities held for investment or not held for sale.* Except as otherwise provided by this section and subject to the identification requirements of section 475(b)(2), a security is held for investment (within the meaning of section 475(b)(1)(A)) or not held for sale (within the meaning of section 475(b)(1)(B)) if it is not held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(b) *Securities deemed identified as held for investment*—(1) *In general.* The following items held by a dealer in securities are per se held for investment within the meaning of section 475(b)(1)(A) and are deemed to be properly identified as such for purposes of section 475(b)(2)—

(i) Except as provided in paragraph (b)(3) of this section, stock in a corporation, or a partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, to which the taxpayer has a relationship specified in paragraph (b)(2) of this section; or

(ii) A contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract (see sections 72, 817, and 7702).

(2) *Relationships*—(i) *General rule.* The relationships specified in this paragraph (b)(2) are—

(A) Those described in section 267(b) (2), (3), (10), (11), or (12); or

(B) Those described in section 707(b)(1)(A) or (B).

(ii) *Attribution.* The relationships described in paragraph (b)(2)(i) of this section are determined taking into account sections 267(c) and 707(b)(3), as appropriate.

(iii) *Trusts treated as partnerships.* For purposes of this paragraph (b)(2), the phrase partnership or trust is substituted for the word *partnership* in sections 707(b) (1) and (3), and a reference to beneficial ownership interest is added to each reference to capital interest or profits interest in those sections.

(3) *Securities traded on certain established financial markets.* Paragraph (b)(1)(i) of this section does not apply to a security if—

(i) The security is actively traded within the meaning of §1.1092(d)–1(a) taking into account only established financial markets identified in §1.1092(d)–1(b)(1) (i) or (ii) (describing national securities exchanges and interdealer quotation systems);

(ii) Less than 15 percent of all of the outstanding shares or interests in the same class are held by the taxpayer and all persons having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section; and

(iii) If the security was acquired (e.g., on original issue) from a person having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section, then, after the time the security was acquired—

(A) At least one full business day has passed; and

(B) There has been significant trading involving persons not having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section.

(4) *Changes in status*—(i) *Onset of prohibition against marking.* (A) Once paragraph (b)(1) of this section begins to apply to the security and for so long as it continues to apply, section 475(a) does not apply to the security in the hands of the taxpayer.

(B) If a security has not been timely identified under section 475(b)(2) and, after the last day on which such an identification would have been timely, paragraph (b)(1) of this section begins to apply to the security, then the dealer must recognize gain or loss on the security as if it were sold for its fair market value as of the close of business of the last day before paragraph (b)(1) of this section begins to apply to the security, and gain or loss is taken into account at that time.

(ii) *Termination of prohibition against marking.* If a taxpayer did not timely identify a security under section 475(b)(2), and paragraph (b)(1) of this section applies to the security on the last day on which such an identification would have been timely but thereafter ceases to apply—

(A) An identification of the security under section 475(b)(2) is timely if made on or before the close of the day paragraph (b)(1) of this section ceases to apply; and

(B) Unless the taxpayer timely identifies the security under section 475(b)(2) (taking into account the additional time for identification that is provided by paragraph (b)(4)(ii)(A) of this section), section 475(a) applies to changes in value of the security after the cessation in the same manner as under section 475(b)(3).

(iii) *Examples.* These examples illustrate this paragraph (b)(4):

Example 1. Onset of prohibition against marking—(A) *Facts.* Corporation *H* owns 75 percent of the stock of corporation *D,* a dealer in securities within the meaning of section 475(c)(1). On December 1, 1995, *D* acquired less than half of the stock in corporation *X*. *D* did not identify the stock for purposes of section 475(b)(2). On July 17, 1996, *H* acquired from other persons 70 percent of the stock of *X*. As a result, *D* and *X* became related within the meaning of paragraph (b)(2)(i) of this section. The stock of *X* is not described in paragraph (b)(3) of this section (concerning some securities traded on certain established financial markets).

(B) *Holding.* Under paragraph (b)(4)(i) of this section, *D* recognizes gain or loss on its *X* stock as if the stock were sold for its fair market value at the close of business on July 16, 1996, and the gain or loss is taken into account at that time. As with any application of section 475(a), proper adjustment is made in the amount of any gain or loss subsequently realized. After July 16, 1996, section 475(a) does not apply to D's *X* stock while paragraph (b)(1)(i) of this section (concerning the relationship between *X* and *D*) continues to apply.

Example 2. Termination of prohibition against marking; retained securities identified as held for investment—(A) *Facts.* On July 1, 1996, corporation *H* owned 60 percent of the stock of corporation *Y* and all of the stock of corporation *D*, a dealer in securities within the meaning of section 475(c)(1). Thus, *D* and *Y* are related within the meaning of paragraph (b)(2)(i) of this section. Also on July 1, 1996, *D* acquired, as an investment, 10 percent of the stock of *Y*. The stock of *Y* is not described in paragraph (b)(3) of this section (concerning some securities traded on certain established financial markets). When *D* acquired its shares of *Y* stock, it did not identify them for purposes of section 475(b)(2). On December 24, 1996, *D* identified its shares of *Y* stock as held for investment under section 475(b)(2). On December 30, 1996, *H* sold all of its shares of stock in *Y* to an unrelated party. As a result, *D* and *Y* ceased to be related within the meaning of paragraph (b)(2)(i) of this section.

(B) *Holding.* Under paragraph (b)(4)(ii)(A) of this section, identification of the *Y* shares is timely if done on or before the close of December 30, 1996. Because *D* timely identified its *Y* shares under section 475(b)(2), it continues after December 30, 1996, to refrain from marking to market its *Y* stock.

Example 3. Termination of prohibition against marking; retained securities not identified as held for investment— (A) *Facts.* The facts are the same as in *Example 2* above, except that *D* did not identify its stock in *Y* for purposes of section 475(b)(2) on or before December 30, 1996. Thus, *D* did not timely identify these securities under section 475(b)(2) (taking into account the additional time for identification provided in paragraph (b)(4)(ii)(A) of this section).

(B) *Holding.* Under paragraph (b)(4)(ii)(B) of this section, section 475(a) applies to changes in value of *D*'s *Y* stock after December 30, 1996, in the same manner as under section 475(b)(3).

Thus, any appreciation or depreciation that occurred while the securities were prohibited from being marked to market is suspended. Further, section 475(a) applies only to those changes occurring after December 30, 1996.

Example 4. Acquisition of actively traded stock from related party—(A) *Facts.* Corporation *P* is the parent of a consolidated group whose taxable year is the calendar year, and corporation *M*, a member of that group, is a dealer in securities within the meaning of section 475(c)(1). Corporation *M* regularly acts as a market maker with respect to common and preferred stock of corporation *P*. Corporation *P* has outstanding 2,000,000 shares of series *X* preferred stock, which are traded on a national securities exchange. During the business day on December 29, 1997, corporation *P* sold 100,000 shares of series *X* preferred stock to corporation *M* for $100 per share. Subsequently, also on December 29, 1997, persons not related to corporation *M* engaged in significant trading of the series *X* preferred stock. At the close of business on December 30, 1997, the fair market value of series *X* stock was $99 per share. At the close of business on December 31, 1997, the fair market value of series *X* stock was $98.50 per share. Corporation *M* sold the series *X* stock on the exchange on January 2, 1998. At all relevant times, corporation *M* and all persons related to *M* owned less than 15% of the outstanding series *X* preferred stock.

(B) *Holding.* The 100,000 shares of series *X* preferred stock held by corporation *M* are not subject to mark-to-market treatment under section 475(a) on December 29, 1997, because at that time the stock was held for less than one full business day and is therefore treated as properly identified as held for investment. At the close of business on December 30, 1997, that prohibition on marking ceases to apply, and section 475(b)(3) begins to apply. The built-in loss is suspended, and subsequent appreciation and depreciation are subject to section 475(a). Accordingly, when corporation *M* marks the series *X* stock to market at the close of business on December 31, 1997, under section 475(a) it recognizes and takes into account a loss of $.50 per share. Under section 475(b)(3), when corporation *M* sells the series *X* stock on January 2, 1998, it takes into account the suspended loss, that is, the difference between the $100 per share it paid corporation *P* for that stock and the $99-per-share fair market value when section 475(b)(1) ceased to be applied to the stock. No deduction, however, is allowed for that loss. (See §1.1502–13(f)(6), under which no deduction is allowed to a member of a consolidated group for a loss with respect to a share of stock of the parent of that consolidated group, if the member does not take the gain or loss into account pursuant to section 475(a).)

(c) *Securities deemed not held for investment; dealers in notional principal contracts and derivatives.* (1) Except as otherwise determined by the Commissioner in a revenue ruling, revenue procedure, or letter ruling, section 475(b)(1)(A) (exempting from mark-to-market accounting certain securities that are held for investment) does not apply to a security if—

(i) The security is described in section 475(c)(2) (D) or (E) (describing certain notional principal contracts and derivative securities); and

(ii) The taxpayer is a dealer in such securities.

(2) See §1.475(d)–1(b) for a rule concerning the character of gain or loss on securities described in this paragraph (c).

(d) *Special rule for hedges of another member's risk.* A taxpayer may identify under section 475(b)(1)(C) (exempting certain hedges from mark-to-market accounting) a security that hedges a position of another member of the taxpayer's consolidated group if the security meets the following requirements—

(1) The security is a hedging transaction within the meaning of §1.1221–2(b);

(2) The security is timely identified as a hedging transaction under §1.1221–2(e) (including identification of the hedged item); and

(3) The security hedges a position that is not marked to market under section 475(a).

(e) *Transitional rules*—(1) *Stock, partnership, and beneficial ownership interests in certain controlled corporations, partnerships, and trusts before January 23, 1997*—(i) *In general.* The following items held by a dealer in securities are per se held for investment within the meaning of section 475(b)(1)(A) and are deemed to be properly identified as such for purposes of section 475(b)(2)—

(A) Stock in a corporation that the taxpayer controls (within the meaning of paragraph (e)(1)(ii) of this section); or

(B) A partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust that the taxpayer controls (within the meaning of paragraph (e)(1)(ii) of this section).

(ii) *Control defined.* Control means the ownership, directly or indirectly through persons described in section 267(b) (taking into account section 267(c)), of—

(A) 50 percent or more of the total combined voting power of all classes of stock entitled to vote; or

(B) 50 percent or more of the capital interest, the profits interest, or the beneficial ownership interest in the widely held or publicly traded partnership or trust.

(iii) *Applicability.* The rules of this paragraph (e)(1) apply only before January 23, 1997.

(2) *Dealers in notional principal contracts and derivatives acquired before January 23, 1997*—(i) *General rule.* Section 475(b)(1)(A) (exempting certain securities from mark-to-market accounting) does not apply to a security if—

(A) The security is described in section 475(c)(2) (D) or (E) (describing certain notional principal contracts and derivative securities); and

(B) The taxpayer is a dealer in such securities.

(ii) *Exception for securities not acquired in dealer capacity.* This paragraph (e)(2) does not apply if the taxpayer establishes unambiguously that the security was not acquired in the taxpayer's capacity as a dealer in such securities.

(iii) *Applicability.* The rules of paragraph (e)(2) apply only to securities acquired before January 23, 1997.

[T.D. 8700, 61 FR 67720, Dec. 24, 1996]

§1.475(b)–2 Exemptions—identification requirements.

(a) *Identification of the basis for exemption.* An identification of a security as exempt from mark to market does not satisfy section 475(b)(2) if it fails to state whether the security is described in—

(1) Either of the first two subparagraphs of section 475(b)(1) (identifying a security as held for investment or not held for sale); or

(2) The third subparagraph thereof (identifying a security as a hedge).

(b) *Time for identifying a security with a substituted basis.* For purposes of determining the timeliness of an identification under section 475(b)(2), the date that a dealer acquires a security is not affected by whether the dealer's basis in the security is determined, in whole or in part, either by reference to the basis of the security in the hands of the person from whom the security was acquired or by reference to other property held at any time by the dealer. See § 1.475(a)–3 for rules governing how the dealer accounts for such a security if this identification is not made.

(c) *Integrated transactions under § 1.1275–6*—(1) *Definitions.* The following terms are used in this paragraph (c) with the meanings that are given to them by § 1.1275–6: integrated transaction, legging into, legging out, qualifying debt instrument, § 1.1275–6 hedge, and synthetic debt instrument.

(2) *Synthetic debt held by a taxpayer as a result of legging in.* If a taxpayer is treated as the holder of a synthetic debt instrument as the result of legging into an integrated transaction, then, for purposes of the timeliness of an identification under section 475(b)(2), the synthetic debt instrument is treated as having the same acquisition date as the qualifying debt instrument. A pre-leg-in identification of the qualifying debt instrument under section 475(b)(2) applies to the integrated transaction as well.

(3) *Securities held after legging out.* If a taxpayer legs out of an integrated transaction, then, for purposes of the timeliness of an identification under section 475(b)(2), the qualifying debt instrument, or the § 1.1275–6 hedge, that remains in the taxpayer's hands is generally treated as having been acquired, originated, or entered into, as the case may be, immediately after the leg-out. If any loss or deduction determined under § 1.1275–6(d)(2)(ii)(B) is disallowed by § 1.1275–6(d)(2)(ii)(D) (which disallows deductions when a taxpayer legs out of an integrated transaction within 30 days of legging in), then, for purposes of this section and section 475(b)(2), the qualifying debt instrument that remains in the taxpayer's hands is treated as having been acquired on the same date that the synthetic debt instrument was treated as having been acquired.

[T.D. 8700, 61 FR 67722, Dec. 24, 1996]

§ 1.475(b)–3 [Reserved]

§ 1.475(b)–4 Exemptions—transitional issues.

(a) *Transitional identification*—(1) *Certain securities previously identified under section 1236.* If, as of the close of the last taxable year ending before December 31, 1993, a security was identified under section 1236 as a security held for investment, the security is treated as being identified as held for investment for purposes of section 475(b).

(2) *Consistency requirement for other securities.* In the case of a security (including a security described in section 475(c)(2)(F)) that is not described in paragraph (a)(1) of this section and that was held by the taxpayer as of the close of the last taxable year ending before December 31, 1993, the security is treated as having been properly identified under section 475(b)(2) or 475(c)(2)(F)(iii) if the information contained in the dealer's books and records as of the close of that year supports the identification. If there is any ambiguity in those records, the taxpayer must, no later than January 31, 1994, place in its records a statement resolving this ambiguity and indicating unambiguously which securities are to be treated as properly identified. Any information that supports treating a security as having been properly identified under section 475(b)(2) or (c)(2)(F)(iii) must be applied consistently from one security to another.

(b) *Corrections on or before January 31, 1994*—(1) *Purpose.* This paragraph (b) allows a taxpayer to add or remove certain identifications covered by § 1.475(b)–1.

(2) *To conform to § 1.475(b)–1(a)*—(i) *Added identifications.* To the extent permitted by paragraph (b)(2)(ii) of this section, a taxpayer may identify as being described in section 475(b)(1) (A) or (B)—

(A) A security that was held for immediate sale but was not held primarily for sale to customers in the ordinary course of the taxpayer's trade or business (for example, a trading security); or

(B) An evidence of indebtedness that was not held for sale to customers in the ordinary course of the taxpayer's trade or business and that the taxpayer intended to hold for less than one year.

(ii) *Limitations.* An identification described in paragraph (b)(2)(i) of this section is permitted only if—

(A) Prior to December 28, 1993, the taxpayer did not identify as being described in section 475(b)(1) (A) or (B) any of the securities described in paragraph (b)(2)(i) of this section;

(B) The taxpayer identifies every security described in paragraph (b)(2)(i) of this section for which a timely identification of the security under section 475(b)(2) cannot be made after the date on which the taxpayer makes these added identifications; and

(C) The identification is made on or before January 31, 1994.

(3) *To conform to §1.475(b)–1(c).* On or before January 31, 1994, a taxpayer described in §1.475(b)–1(e)(2)(i)(B) may remove an identification under section 475(b)(1)(A) of a security described in §1.475(b)–1(e)(2)(i)(A).

(c) *Effect of corrections.* An identification added under paragraph (a)(2) or (b)(2) of this section is timely for purposes of section 475(b)(2) or (c)(2)(F)(iii). An identification removed under paragraph (a)(2) or (b)(3) of this section does not subject the taxpayer to the provisions of section 475(d)(2).

[T.D. 8700, 61 FR 67722, Dec. 24, 1996]

§1.475(c)–1 Definitions—dealer in securities.

(a) *Dealer-customer relationship.* Whether a taxpayer is transacting business with customers is determined on the basis of all of the facts and circumstances.

(1) [Reserved]

(2) *Transactions described in section 475(c)(1)(B)*—(i) *In general.* For purposes of section 475(c)(1)(B), the term *dealer in securities* includes, but is not limited to, a taxpayer that, in the ordinary course of the taxpayer's trade or business, regularly holds itself out as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B).

(ii) *Examples.* The following examples illustrate the rules of this paragraph (a)(2). In the following examples, B is a bank and is not a member of a consolidated group:

Example 1. B regularly offers to enter into interest rate swaps with other persons in the ordinary course of its trade or business. B is willing to enter into interest rate swaps under which it either pays a fixed interest rate and receives a floating rate or pays a floating rate and receives a fixed rate. B is a dealer in securities under section 475(c)(1)(B), and the counterparties are its customers.

Example 2. B, in the ordinary course of its trade or business, regularly holds itself out as being willing and able to enter into either side of positions in a foreign currency with other banks in the interbank market. B's activities in the foreign currency make it a dealer in securities under section 475(c)(1)(B), and the other banks in the interbank market are its customers.

Example 3. B engages in frequent transactions in a foreign currency in the interbank market. Unlike the facts in *Example 2,* however, B does not regularly hold itself out as being willing and able to enter into either side of positions in the foreign currency, and all of B's transactions are driven by its internal need to adjust its position in the currency. No other circumstances are present to suggest that B is a dealer in securities for purposes of section 475(c)(1)(B). B's activity in the foreign currency does not qualify it as a dealer in securities for purposes of section 475(c)(1)(B), and its transactions in the interbank market are not transactions with customers.

(3) *Related parties*—(i) *General rule.* Except as provided in paragraph (a)(3)(ii) of this section (concerning transactions between members of a consolidated group, as defined in §1.1502–1(h)), a taxpayer's transactions with related persons may be transactions with customers for purposes of section 475. For example, if a taxpayer, in the ordinary course of the taxpayer's trade or business, regularly holds itself out to its foreign subsidiaries or other related persons as being willing and able to enter into either side of transactions enumerated in section 475(c)(1)(B), the taxpayer is a dealer in securities within the meaning of section 475(c)(1), even if it engages in no other transactions with customers.

(ii) *Special rule for members of a consolidated group.* Solely for purposes of paragraph (c)(1) of section 475 (concerning the definition of dealer in securities) and except as provided in paragraph (a)(3)(iii) of this section, a taxpayer's transactions with other members of its consolidated group are not with customers. Accordingly, notwithstanding paragraph (a)(2) of this section, the fact that a taxpayer regularly holds itself out to other members of its consolidated group as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B) does not cause the taxpayer to be a dealer in securities within the meaning of section 475(c)(1)(B).

(iii) *The intragroup-customer election*—(A) *Effect of election.* If a consolidated group makes the intragroup-customer election, paragraph (a)(3)(ii) of this section (special rule for members of a consolidated group) does not apply to the members of the group. Thus, a member of a group that has made this election may be a dealer in securities within the meaning of section 475(c)(1) even if its only customer transactions are with other members of its consolidated group.

(B) *Making and revoking the election.* Unless the Commissioner otherwise prescribes, the intragroup-customer election is made by filing a statement that says, ''[Insert name and employer identification number of common parent] hereby makes the Intragroup-Customer Election (as described in § 1.475(c)–1(a)(3)(iii) of the income tax regulations) for the taxable year ending [describe the last day of the year] and for subsequent taxable years.'' The statement must be signed by the common parent and attached to the timely filed federal income tax return for the consolidated group for that taxable year. The election applies for that year and continues in effect for subsequent years until revoked. The election may be revoked only with the consent of the Commissioner.

(iv) *Examples.* The following examples illustrate this paragraph (a)(3):

General Facts. HC, a hedging center, provides interest rate hedges to all of the members of its affiliated group (as defined in section 1504(a)(1)). Because of the efficiencies created by having a centralized risk manager, group policy prohibits members other than *HC* from entering into derivative interest rate positions with outside parties. *HC* regularly holds itself out as being willing and able to, and in fact does, enter into either side of interest rate swaps with its fellow members. *HC* periodically computes its aggregate position and hedges the net risk with an unrelated party. *HC* does not otherwise enter into interest rate positions with persons that are not members of the affiliated group. *HC* attempts to operate at cost, and the terms of its swaps do not factor in any risk of default by the affiliate. Thus, *HC*'s affiliates receive somewhat more favorable terms then they would receive from an unrelated swaps dealer (a fact that may subject *HC* and its fellow members to reallocation of income under section 482). No other circumstances are present to suggest that *HC* is a dealer in securities for purposes of section 475(c)(1)(B).

Example 1. General rule for related persons. In addition to the *General Facts* stated above, assume that *HC*'s affiliated group has not elected under section 1501 to file a consolidated return. Under paragraph (a)(3)(i) of this section, *HC*'s transactions with its affiliates can be transactions with customers for purposes of section 475(c)(1). Thus, under paragraph (a)(2)(i) of this section, *HC* is a dealer in securities within the meaning of section 475(c)(1)(B), and the members of the group with which it does business are its customers.

Example 2. Special rule for members of a consolidated group. In addition to the *General Facts* stated above, assume that *HC*'s affiliated group has elected to file consolidated returns and has not made the intragroup-customer election. Under paragraph (a)(3)(ii) of this section, *HC*'s interest rate swap transactions with the members of its consolidated group are not transactions with customers for purposes of determining whether *HC* is a dealer in securities within the meaning of section 475(c)(1). Further, the fact that *HC* regularly holds itself out to members of its consolidated group as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B) does not cause *HC* to be a dealer in securities within the meaning of section 475(c)(1)(B). Because no other circumstances are present to suggest that *HC* is a dealer in securities for purposes of section 475(c)(1)(B), *HC* is not a dealer in securities.

Example 3. Intragroup-customer election. In addition to the *General Facts* stated above, assume that *HC*'s affiliated group has elected to file a consolidated return but has also made the intragroup-customer election under paragraph (a)(3)(iii) of this section. Thus, the analysis and result are the same as in *Example 1.*

(b) *Sellers of nonfinancial goods and services*—(1) *Purchases and sales of customer paper.* Except as provided in paragraph (b)(3) of this section, if a taxpayer would not be a dealer in securities within the meaning of section 475(c)(1) but for its purchases and sales of debt instruments that, at the time of purchase or sale, are customer paper with respect to either the taxpayer or a corporation that is a member of the same consolidated group (as defined in §1.1502–1(h)) as the taxpayer, then for purposes of section 475 the taxpayer is not a dealer in securities.

(2) *Definition of customer paper.* A debt instrument is customer paper with respect to a person at a point in time if—

(i) The person's principal activity is selling nonfinancial goods or providing nonfinancial services;

(ii) The debt instrument was issued by a purchaser of the goods or services at the time of the purchase of those goods or services in order to finance the purchase; and

(iii) At all times since the debt instrument was issued, it has been held either by the person selling those goods or services or by a corporation that is a member of the same consolidated group as that person.

(3) *Exceptions.* Paragraph (b)(1) of this section does not apply if—

(i) For purposes of section 471, the taxpayer accounts for any security (as defined in section 475(c)(2)) as inventory;

(ii) The taxpayer is subject to an election under paragraph (b)(4) of this section; or

(iii) The taxpayer is not described in paragraph (b)(2)(i) of this section and one or more debt instruments that are customer paper with respect to a corporation that is a member of the same consolidated group as the taxpayer are accounted for by the taxpayer, or by a corporation that is a member of the same consolidated group as the taxpayer, in a manner that allows recognition of unrealized gains or losses or deductions for additions to a reserve for bad debts.

(4) *Election not to be governed by the exception for sellers of nonfinancial goods or services*—(i) *Method of making the election.* Unless the Commissioner otherwise prescribes, an election under this paragraph (b)(4) must be made in the manner, and at the time, prescribed in this paragraph (b)(4)(i). The taxpayer must file with the Internal Revenue Service a statement that says, ‘‘[Insert name and taxpayer identification number of the taxpayer] hereby elects not to be governed by §1.475(c)–1(b)(1) of the income tax regulations for the taxable year ending [describe the last day of the year] and for subsequent taxable years.’’

(A) *Taxable years ending after December 24, 1996.* If the first taxable year subject to an election under this paragraph (b)(4) ends after December 24, 1996, the statement must be attached to a timely filed federal income tax return for that taxable year.

(B) *Taxable years ending on or before December 24, 1996.* If the first taxable year subject to an election under this paragraph (b)(4) ends on or before December 24, 1996 and the election changes the taxpayer's taxable income for any taxable year the federal income tax return for which was filed before February 24, 1997, the statement must be attached to an amended return for the earliest such year that is so affected, and that amended return (and an amended return for any other such year that is so affected) must be filed not later than June 23, 1997. If the first taxable year subject to an election under this paragraph (b)(4) ends on or before December 24, 1996 but the taxpayer is not described in the preceding sentence, the statement must be attached to the first federal income tax return that is for a taxable year subject to the election and that is filed on or after February 24, 1997.

(ii) *Continued applicability of an election.* An election under this paragraph (b)(4) continues in effect for subsequent taxable years until revoked. The election may be revoked only with the consent of the Commissioner.

(c) *Taxpayers that purchase securities from customers but engage in no more than negligible sales of the securities*—(1) *Exemption from dealer status*—(i) *General rule.* A taxpayer that regularly purchases securities from customers in the ordinary course of a trade or business (including regularly making loans to customers in the ordinary course of a trade or business of making loans) but engages in no more than negligible sales of the securities so acquired is not a dealer in securities within the meaning of section 475(c)(1) unless the taxpayer elects to be so treated or, for purposes of section 471, the taxpayer accounts for any security (as defined in section 475(c)(2)) as inventory.

(ii) *Election to be treated as a dealer.* A taxpayer described in paragraph (c)(1)(i) of this section elects to be treated as a dealer in securities by filing a federal income tax return reflecting the application of section 475(a) in computing its taxable income.

(2) *Negligible sales.* Solely for purposes of paragraph (c)(1) of this section, a taxpayer engages in negligible sales of debt instruments that it regularly purchases from customers in the ordinary course of its business if, and only if, during the taxable year, either—

(i) The taxpayer sells all or part of fewer than 60 debt instruments, regardless how acquired; or

(ii) The total adjusted basis of the debt instruments (or parts of debt instruments), regardless how acquired, that the taxpayer sells is less than 5 percent of the total basis, immediately after acquisition, of the debt instruments that it acquires in that year.

(3) *Special rules for members of a consolidated group*—(i) *Intragroup-customer election in effect.* If a taxpayer is a member of a consolidated group that has made the intragroup-customer election (described in paragraph (a)(3)(iii) of this section), the negligible sales test in paragraph (c)(2) of this section takes into account all of the taxpayer's sales of debt instruments to other group members.

(ii) *Intragroup-customer election not in effect.* If a taxpayer is a member of a consolidated group that has not made the intragroup-customer election (described in paragraph (a)(3)(iii) of this section), the taxpayer satisfies the negligible sales test in paragraph (c)(2) of this section if either—

(A) The test is satisfied by the taxpayer, taking into account sales of debt instruments to other group members (as in paragraph (c)(3)(i) of this section); or

(B) The test is satisfied by the group, treating the members of the group as if they were divisions of a single corporation.

(4) *Special rules.* Whether sales of securities are negligible is determined without regard to—

(i) Sales of securities that are necessitated by exceptional circumstances and that are not undertaken as recurring business activities;

(ii) Sales of debt instruments that decline in quality while in the taxpayer's hands and that are sold pursuant to an established policy of the taxpayer to dispose of debt instruments below a certain quality; or

(iii) Acquisitions and sales of debt instruments that are qualitatively different from all debt instruments that the taxpayer purchases from customers in the ordinary course of its business.

(5) *Example.* The following example illustrates paragraph (c)(4)(iii) of this section:

Example. I, an insurance company, regularly makes policy loans to its customers but does not sell them. *I*, however, actively trades Treasury securities. No other circumstances are present to suggest that *I* is a dealer in securities for purposes of section 475(c)(1). Since the Treasuries are qualitatively different from the policy loans that *I* originates, under paragraph (c)(4)(iii) of this section, *I* disregards the purchases and sales of Treasuries in applying the negligible sales test in paragraph (c)(2) of this section.

(d) *Issuance of life insurance products.* A life insurance company that is not otherwise a dealer in securities within the meaning of section 475(c)(1) does not become a dealer in securities solely because it regularly issues life insurance products to its customers in the ordinary course of a trade or business. For purposes of the preceding sentence, the term *life insurance product* means a contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract. See sections 72, 817, and 7702.

[T.D. 8700, 61 FR 67723, Dec. 24, 1996]

§ 1.475(c)–2 Definitions—security.

(a) *Items that are not securities.* The following items are not securities within the meaning of section 475(c)(2) with respect to a taxpayer and, therefore, are not subject to section 475—

(1) A security (determined without regard to this paragraph (a)) if section

1032 prevents the taxpayer from recognizing gain or loss with respect to that security;

(2) A debt instrument issued by the taxpayer (including a synthetic debt instrument, within the meaning of §1.1275–6(b)(4), that §1.1275–6(b) treats the taxpayer as having issued); or

(3) A REMIC residual interest, or an interest or arrangement that is determined by the Commissioner to have substantially the same economic effect, if the residual interest or the interest or arrangement is acquired on or after January 4, 1995.

(b) *Synthetic debt that §1.1275–6(b) treats the taxpayer as holding.* If §1.1275–6 treats a taxpayer as the holder of a synthetic debt instrument (within the meaning of §1.1275–6(b)(4)), the synthetic debt instrument is a security held by the taxpayer within the meaning of section 475(c)(2)(C).

(c) *Negative value REMIC residuals acquired before January 4, 1995.* A REMIC residual interest that is described in paragraph (c)(1) of this section or an interest or arrangement that is determined by the Commissioner to have substantially the same economic effect is not a security within the meaning of section 475(c)(2).

(1) *Description.* A residual interest in a REMIC is described in this paragraph (c)(1) if, on the date the taxpayer acquires the residual interest, the present value of the anticipated tax liabilities associated with holding the interest exceeds the sum of—

(i) The present value of the expected future distributions on the interest; and

(ii) The present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.

(2) *Special rules applicable to negative value REMIC residuals acquired before January 4, 1995.* Solely for purposes of this paragraph (c)—

(i) If a transferee taxpayer acquires a residual interest with a basis determined by reference to the transferor's basis, then the transferee is deemed to acquire the interest on the date the transferor acquired it (or is deemed to acquire it under this paragraph (c)(2)(i)).

(ii) Anticipated tax liabilities, expected future distributions, and anticipated tax savings are determined under the rules in §1.860E–2(a)(3) and without regard to the operation of section 475.

(iii) Present values are determined under the rules in §1.860E–2(a)(4).

[T.D. 8700, 61 FR 67725, Dec. 24, 1996]

§1.475(d)–1 Character of gain or loss.

(a) *Securities never held in connection with the taxpayer's activities as a dealer in securities.* If a security is never held in connection with the taxpayer's activities as a dealer in securities, section 475(d)(3)(A) does not affect the character of gain or loss from the security, even if the taxpayer fails to identify the security under section 475(b)(2).

(b) *Ordinary treatment for notional principal contracts and derivatives held by dealers in notional principal contracts and derivatives.* Section 475(d)(3)(B)(ii) (concerning the character of gain or loss with respect to a security held by a person other than in connection with its activities as a dealer in securities) does not apply to a security if §1.475(b)–1(c) and the absence of a determination by the Commissioner prevent section 475(b)(1)(A) from applying to the security.

[T.D. 8700, 61 FR 67725, Dec. 24, 1996]

§1.475(e)–1 Effective dates.

(a)–(b) [Reserved]

(c) Section 1.475(a)–3 (concerning acquisition by a dealer of a security with a substituted basis) applies to securities acquired, originated, or entered into on or after January 4, 1995.

(d) Except as provided elsewhere in this paragraph (d), §1.475(b)–1 (concerning the scope of exemptions from the mark-to-market requirement) applies to taxable years ending on or after December 31, 1993.

(1) Section 1.475(b)–1(b) applies as follows:

(i) Section 1.475(b)–1(b)(1)(i) (concerning equity interests issued by a related person) applies beginning June 19, 1996. If, on June 18, 1996, a security is subject to mark-to-market accounting and, on June 19, 1996, §1.475(b)–1(b)(1) begins to apply to the security solely because of the effective dates in this paragraph (d) (rather than because of a change in facts), then the rules of § 1.475(b)–1(b)(4)(i)(A) (concerning the prohibition against marking) apply, but § 1.475(b)–1(b)(4)(i)(B) (imposing a mark-to-market on the day before the onset of the prohibition) does not apply.

(ii) Section 1.475(b)–1(b)(2) (concerning relevant relationships for purposes of determining whether equity interests in related persons are prohibited from being marked to market) applies beginning June 19, 1996.

(iii) Section 1.475(b)–1(b)(3) (concerning certain actively traded securities) applies beginning June 19, 1996, to securities held on or after that date, except for securities described in § 1.475(b)–1(e)(1)(i) (concerning equity interests issued by controlled entities). If a security is described in § 1.475(b)–1(e)(1)(i), § 1.475(b)–1(b)(3) applies only on or after January 23, 1997 if the security is held on or after that date. If § 1.475(b)–1(b)(1) ceases to apply to a security by virtue of the operation of this paragraph (d)(1)(iii), the rules of § 1.475(b)–1(b)(4)(ii) apply to the cessation.

(iv) Except to the extent provided in paragraph (d)(1) of this section, § 1.475(b)–1(b)(4) (concerning changes in status) applies beginning June 19, 1996.

(2) Section 1.475(b)–1(c) (concerning securities deemed not held for investment by dealers in notional principal contracts and derivatives) applies to securities acquired on or after January 23, 1997.

(3) Section 1.475(b)–1(d) (concerning the special rule for hedges of another member's risk) is effective for securities acquired, originated, or entered into on or after January 23, 1997.

(e) Section 1.475(b)–2 (concerning identification of securities that are exempt from mark-to-market treatment) applies as follows:

(1) Section 1.475(b)–2(a) (concerning the general rules for identification of basis for exemption from mark to market treatment) applies to identifications made on or after July 1, 1997.

(2) Section 1.475(b)–2(b) (concerning time for identifying a security with a substituted basis) applies to securities acquired, originated, or entered into on or after January 4, 1995.

(3) Section 1.475(b)–2(c) (concerning identification in the context of integrated transactions under § 1.1275–6) applies on and after August 13, 1996 (the effective date of § 1.1275–6).

(f) [Reserved]

(g) Section 1.475(b)–4 (concerning transitional issues relating to exemptions) applies to taxable years ending on or after December 31, 1993.

(h) Section 1.475(c)–1 applies as follows:

(1) Except as otherwise provided in this paragraph (h)(1), § 1.475(c)–1(a) (concerning the dealer-customer relationship) applies to taxable years beginning on or after January 1, 1995.

(i) [Reserved]

(ii) Section 1.475(c)–1(a)(2)(ii) (illustrating rules concerning the dealer-customer relationship) applies to taxable years beginning on or after June 20, 1996.

(iii)(A) Section 1.475(c)–1(a)(3) applies to taxable years beginning on or after June 20, 1996, except for transactions between members of the same consolidated group.

(B) For transactions between members of the same consolidated group, paragraph § 1.475(c)–1(a)(3) applies to taxable years beginning on or after December 24, 1996.

(2) Section 1.475(c)–1(b) (concerning sellers of nonfinancial goods and services) applies to taxable years ending on or after December 31, 1993.

(3) Except as otherwise provided in this paragraph (h)(3), section 1.475(c)–1(c) (concerning taxpayers that purchase securities but engage in no more than negligible sales of the securities) applies to taxable years ending on or after December 31, 1993.

(i) Section 1.475(c)–1(c)(3) (special rules for members of a consolidated group) is effective for taxable years beginning on or after December 24, 1996.

(ii) A taxpayer may rely on the rules set out in § 1.475(c)–1T(b) (as contained in 26 CFR part 1 revised April 1, 1996) for taxable years beginning before January 23, 1997, provided the taxpayer applies that paragraph reasonably and consistently.

(4) Section 1.475(c)–1(d) (concerning the issuance of life insurance products) applies to taxable years beginning on or after January 1, 1995.

(i) Section 1.475(c)–2 (concerning the definition of security) applies to taxable years ending on or after December 31, 1993. By its terms, however, §1.475(c)–2(a)(3) applies only to residual interests or to interests or arrangements that are acquired on or after January 4, 1995; and the integrated transactions that are referred to in §§1.475(c)–2(a)(2) and 1.475(c)–2(b) exist only after August 13, 1996 (the effective date of §1.1275–6).

(j) Section 1.475(d)–1 (concerning the character of gain or loss) applies to taxable years ending on or after December 31, 1993.

[T.D. 8700, 61 FR 67725, Dec. 24, 1996]

ADJUSTMENTS

§1.481–1 Adjustments in general.

(a)(1) Section 481 prescribes the rules to be followed in computing taxable income in cases where the taxable income of the taxpayer is computed under a method of accounting different from that under which the taxable income was previously computed. A change in method of accounting to which section 481 applies includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. For rules relating to changes in methods of accounting, see section 446(e) and paragraph (e) of §1.446–1. In computing taxable income for the taxable year of the change, there shall be taken into account those adjustments which are determined to be necessary solely by reason of such change in order to prevent amounts from being duplicated or omitted. The ‘‘year of the change’’ is the taxable year for which the taxable income of the taxpayer is computed under a method of accounting different from that used for the preceding taxable year.

(2) Unless the adjustments are attributable to a change in method of accounting initiated by the taxpayer, no part of the adjustments required by subparagraph (1) of this paragraph shall be based on amounts which were taken into account in computing income (or which should have been taken into account had the new method of accounting been used) for taxable years beginning before January 1, 1954, or ending before August 17, 1954 (hereinafter referred to as pre-1954 years).

(b) The adjustments specified in section 481(a) and this section shall take into account inventories, accounts receivable, accounts payable, and any other item determined to be necessary in order to prevent amounts from being duplicated or omitted.

(c)(1) The term ‘‘adjustments’’, as used in section 481, has reference to the net amount of the adjustments required by section 481(a) and paragraph (b) of this section. In the case of a change in the over-all method of accounting, such as from the cash receipts and disbursements method to an accrual method, the term ‘‘net amount of the adjustments’’ means the consolidation of adjustments (whether the amounts thereof represent increases or decreases in items of income or deductions) arising with respect to balances in various accounts, such as inventory, accounts receivable, and accounts payable, at the beginning of the taxable year of the change in method of accounting. With respect to the portion of the adjustments attributable to pre-1954 years, it is immaterial that the same items or class of items with respect to which adjustments would have to be made (for the first taxable year to which section 481 applies) do not exist at the time the actual change in method of accounting occurs. For purposes of section 481, only the net dollar balance is to be taken into account. In the case of a change in the treatment of a single material item, the amount of the adjustment shall be determined with reference only to the net dollar balances in that particular account.

(2) If a change in method of accounting is voluntary (i.e., initiated by the taxpayer), the entire amount of the adjustments required by section 481(a) is generally taken into account in computing taxable income in the taxable year of the change, regardless of whether the adjustments increase or decrease taxable income. See, however, §§1.446–1(e)(3) and 1.481–4 which provide that the Commissioner may prescribe the taxable year or years in which the adjustments are taken into account.

(3) If the change in method of accounting is involuntary (i.e., not initiated by the taxpayer), then only the amount of the adjustments required by section 481(a) that is attributable to taxable years beginning after December 31, 1953, and ending after August 16, 1954, (hereinafter referred to as post-1953 years) is taken into account. This amount is generally taken into account in computing taxable income in the taxable year of the change, regardless of whether the adjustments increase or decrease taxable income. See, however, §§ 1.446–1(e)(3) and 1.481–4 which provide that the Commissioner may prescribe the taxable year or years in which the adjustments are taken into account. See also § 1.481–3 for rules relating to adjustments attributable to pre-1954 years.

(4) For any adjustments attributable to post-1953 years that are taken into account entirely in the year of change and that increase taxable income by more than $3,000, the limitations on tax provided in section 481(b) (1) or (2) apply. See § 1.481–2 for rules relating to the limitations on tax provided by sections 481(b) (1) and (2).

(5) A change in the method of accounting initiated by the taxpayer includes not only a change which he originates by securing the consent of the Commissioner, but also a change from one method of accounting to another made without the advance approval of the Commissioner. A change in the taxpayer's method of accounting required as a result of an examination of the taxpayer's income tax return will not be considered as initiated by the taxpayer. On the other hand, a taxpayer who, on his own initiative, changes his method of accounting in order to conform to the requirements of any Federal income tax regulation or ruling shall not, merely because of such fact, be considered to have made an involuntary change.

(d) Any adjustments required under section 481(a) that are taken into account during a taxable year must be properly taken into account for purposes of computing gross income, adjusted gross income, or taxable income in determining the amount of any item of gain, loss, deduction, or credit that depends on gross income, adjusted gross income, or taxable income.

[T.D. 6500, 25 FR 11731, Nov. 26, 1960, as amended by T.D. 8608, 60 FR 40078, Aug. 7, 1995]

§ 1.481–2 Limitation on tax.

(a) *Three-year allocation.* Section 481(b)(1) provides a limitation on the tax under chapter 1 of the Internal Revenue Code for the taxable year of change that is attributable to the adjustments required under section 481(a) and § 1.481–1 if the entire amount of the adjustments is taken into account in the year of change. If such adjustments increase the taxpayer's taxable income for the taxable year of the change by more than $3,000, then the tax for such taxable year that is attributable to the adjustments shall not exceed the lesser of the tax attributable to taking such adjustments into account in computing taxable income for the taxable year of the change under section 481(a) and § 1.481–1, or the aggregate of the increases in tax that would result if the adjustments were included ratably in the taxable year of the change and the two preceding taxable years. For the purpose of computing the limitation on tax under section 481(b)(1), the adjustments shall be allocated ratably to the taxable year of the change and the two preceding taxable years, whether or not the adjustments are in fact attributable in whole or in part to such years. The limitation on the tax provided in this paragraph shall be applicable only if the taxpayer used the method of accounting from which the change was made in computing taxable income for the two taxable years preceding the taxable year of the change.

(b) *Allocation under new method of accounting.* Section 481(b)(2) provides a second alternative limitation on the tax for the taxable year of change under chapter 1 of the Internal Revenue Code that is attributable to the adjustments required under section 481(a) and § 1.481–1 where such adjustments increase taxable income for the taxable year of change by more than $3,000. If the taxpayer establishes from his books of account and other records what his taxable income would have been under the new method of accounting for one or more consecutive taxable years immediately preceding the taxable year of the change, and if the taxpayer in computing taxable income for such years used the method of accounting from which the change was made, then the tax attributable to the adjustments shall not exceed the smallest of the following amounts:

(1) The tax attributable to taking the adjustments into account in computing taxable income for the taxable year of the change under section 481(a) and §1.481–1;

(2) The tax attributable to such adjustments computed under the 3-year allocation provided in section 481(b)(1), if applicable; or

(3) The net increase in the taxes under chapter 1 (or under corresponding provisions of prior revenue laws) which would result from allocating that portion of the adjustments to the one or more consecutive preceding taxable years to which properly allocable under the new method of accounting and from allocating the balance thereof to the taxable year of the change.

(c) *Rules for computation of tax.* (1) The first step in determining whether either of the limitations described in section 481(b) (1) or (2) applies is to compute the increase in tax for the taxable year of the change that is attributable to the increase in taxable income for such year resulting solely from the adjustments required under section 481(a) and §1.481–1. This increase in tax is the excess of the tax for the taxable year computed by taking into account such adjustments under section 481(a) over the tax computed for such year without taking the adjustments into account.

(2) The next step is to compute under section 481(b)(1) the tax attributable to the adjustments referred to in paragraph (c)(1) of this section for the taxable year of the change and the two preceding taxable years as if an amount equal to one-third of the net amount of such adjustments had been received or accrued in each of such taxable years. The increase in tax attributable to the adjustments for each such taxable year is the excess of the tax for such year computed with the allocation of one-third of the net adjustments to such taxable year over the tax computed without the allocation of any part of the adjustments to such year. For the purpose of computing the aggregate increase in taxes for such taxable years, there shall be taken into account the increase or decrease in tax for any taxable year preceding the taxable year of the change to which no adjustment is allocated under section 481(b)(1) but which is affected by a net operating loss under section 172 or by a capital loss carryback or carryover under section 1212, determined with reference to taxable years with respect to which adjustments under section 481(b)(1) are allocated.

(3) In the event that the taxpayer satisfies the conditions set forth in section 481(b)(2), the next step is to determine the amount of the net increase in tax attributable to the adjustments referred to in paragraph (c)(1) of this section for:

(i) The taxable year of the change,

(ii) The consecutive taxable year or years immediately preceding the taxable year of the change for which the taxpayer can establish his taxable income under the new method of accounting, and

(iii) Any taxable year preceding the taxable year of the change to which no adjustment is allocated under section 481(b)(2), but which is affected by a net operating loss or by a capital loss carryback or carryover determined with reference to taxable years with respect to which such adjustments are allocated.

The net increase in tax for the taxable years specified in subdivisions (i), (ii), and (iii) of this subparagraph shall be computed as if the amount of the adjustments for the prior taxable years to which properly allocable in accordance with section 481(b)(2) had been received or accrued, or paid or incurred, as the case may be, in such prior years and the balance of the adjustments in the taxable year of the change. The amount of tax attributable to such adjustments for the taxable years specified in subdivisions (i), (ii), and (iii) of this subparagraph is the aggregate of the differences (increases and decreases) between the tax for each such year computed by taking into account the allocable portion of the adjustments in computing taxable income and the tax computed without taking into account any portion of the adjustments in computing taxable income. Generally, where there is an increase in taxable income for a preceding consecutive taxable year established under the new method of accounting, computed without regard to adjustments attributable to any preceding taxable year, the amount of the adjustments to be allocated to each such year shall be an amount equal to such increase. However, where the amount of the adjustments to be allocated to a prior taxable year is less than the increase in taxable income for such year established under the new method of accounting, the amount of the increase in such taxable income for purposes of determining the increase in tax under section 481(b)(2) for such year shall be considered to be the amount so allocated. For example, if the amount of the adjustments required by section 481(a) for 1958 (the taxable year of the change) is $60,000, and the increase in taxable income is determined by the taxpayer to be $40,000, $5,000, and $35,000, computed under the new method of accounting, for the taxable years 1957, 1956, and 1955, respectively, then the amount of the adjustments to be allocated to 1955 will be the balance of the adjustments, or $15,000.

(4) The tax for the taxable year of the change shall be the tax for such year, computed without taking any of the adjustments referred to in paragraph (c)(1) of this section into account, increased by the smallest of the following amounts—

(i) The amount of tax for the taxable year of the change attributable solely to taking into account the entire amount of the adjustments required by section 481(a) and § 1.481–1;

(ii) The sum of the increases in tax liability for the taxable year of the change and the two immediately preceding taxable years that would have resulted solely from taking into account one-third of the amount of such adjustments required for each of such years as though such amounts had been properly attributable to such years (computed in accordance with paragraph (c)(2) of this section); or

(iii) The net increase in tax attributable to allocating such adjustments under the new method of accounting (computed in accordance with paragraph (c)(3) of this section).

(5)(i) In the case of a change in method of accounting by a partnership, the adjustments required by section 481 shall be made with respect to the taxable income of the partnership but the limitations on tax under section 481(b) shall apply to the individual partners. Each partner shall take into account his distributive share of the partnership items, as so adjusted, for the taxable year of the change. Section 481(b) applies to a partner whose taxable income is so increased by more than $3,000 as a result of such adjustments to the partnership taxable income. It is not necessary for the partner to have been a member of the partnership for the two taxable years immediately preceding the taxable year of the change of the partnership's accounting method in order to have the limitation provided by section 481(b)(1) apply. Further, a partner may apply section 481(b)(2) even though he was not a member of the partnership for all the taxable years affected by the computation thereunder.

(ii) In the case of a change in method of accounting by an electing small business corporation under subchapter S, chapter 1 of the Code, the adjustments required by section 481 shall be made with respect to the taxable income of such electing corporation in the year of the change, but the limitations on tax under section 481(b) shall apply to the individual shareholders. Section 481(b) applies to a shareholder of an electing small business corporation whose taxable income is so increased by more than $3,000 as a result of such adjustments to such corporation's taxable income. It is not necessary for the shareholder to have been a member of the electing small business corporation, or for such corporation to have been an electing small business corporation, for the two taxable years immediately preceding the taxable year of the change of the corporation's accounting method in order to have the limitation provided by section 481(b)(1) apply. Further, a shareholder may apply section 481(b)(2), even though he was not a shareholder, or the corporation was not an electing small business corporation, for all the taxable years affected by the computation thereunder.

(6) For the purpose of the successive computations of the limitations on tax under section 481(b) (1) or (2), if the treatment of any item under the provisions of the Internal Revenue Code of 1986 (or corresponding provisions of prior internal revenue laws) depends upon the amount of gross income, adjusted gross income, or taxable income (for example, medical expenses, charitable contributions, or credits against the tax), such item shall be determined for the purpose of each such computation by taking into account the proper portion of the amount of any adjustments required to be taken into account under section 481 in each such computation.

(7) The increase or decrease in the tax for any taxable year for which an assessment of any deficiency, or a credit or refund of any overpayment, is prevented by any law or rule of law, shall be determined by reference to the tax previously determined (within the meaning section 1314(a) for such year.

(8) In applying section 7807(b)(1), the provisions of chapter 1 (other than subchapter E, relating to tax on self-employment income) and chapter 2 of the Internal Revenue Code of 1939 shall be treated as the corresponding provisions of the Internal Revenue Code of 1939.

(d) *Examples.* The application of section 481(b) (1) and (2) may be illustrated by the following examples. Although the examples in this paragraph are based upon adjustments required in the case of a change in the over-all method of accounting, the principles illustrated would be equally applicable to adjustments required in the case of a change in method of accounting for a particular material item, provided the treatment of such adjustments is not specifically subject to some other provision of the Internal Revenue Code of 1986.

Example (1). An unmarried individual taxpayer using the cash receipts and disbursements method of accounting for the calendar year is required by the Commissioner to change to an accrual method effective with the year 1958. As of January 1, 1958, he had an opening inventory of $11,000. On December 31, 1958, he had a closing inventory of $12,500. Merchandise purchases during the year amounted to $22,500, and net sales were $32,000. Total deductible business expenses were $5,000. There were no receivables or payables at January 1, 1958. The computation of taxable income for 1958, assuming no other adjustments, using the new method of accounting follows:

Net sales		$32,000
Opening inventory	$11,000	
Purchases	22,500	
Total	33,500	
Less closing inventory	12,500	
Cost of goods sold		21,000
Gross profit		11,000
Business expenses		5,000
Business income		6,000
Personal exemption and itemized deductions		1,600
Taxable income		4,400

Under the cash receipts and disbursements method of accounting, only $9,000 of the $11,000 opening inventory had been included in the cost of goods sold and claimed as a deduction for the taxable years 1954 through 1957; the remaining $2,000 had been so accounted for in pre-1954 years. In order to prevent the same item from reducing taxable income twice, an adjustment of $9,000 must be made to the taxable income of 1958 under the provisions of section 481(a) and §1.481–1. Since the change in method of accounting was not initiated by the taxpayer, the $2,000 of opening inventory which had been included in cost of goods sold in pre-1954 years is not taken into account. Taxable income for 1958 is accordingly increased by $9,000 under section 481(a) to $13,400. Assuming that the tax on $13,400 is $4,002 and that the tax on $4,400 (income without the adjustment) is $944, the increase in tax attributable to the adjustment, if taken into account for the taxable year of the change, would be the difference between the two, or $3,058. Since the adjustment required by section 481(a) and §1.481–1 ($9,000) increases taxable income by more than $3,000, the increase in tax for the taxable year 1958 attributable to the adjustment of $9,000 (i.e., $3,058) may be limited under the provisions of section 481(b) (1) or (2). See examples (2) and (3).

Example (2). Assume that the taxpayer in example (1) used the cash receipts and disbursements method of accounting in computing taxable income for the years 1956 and 1957 and that the taxable income for these years determined under such method was $4,000 and $6,000, respectively. The section 481(b)(1) limitation on tax with a pro rata three-year allocation of the $9,000 adjustment is computed as follows:

Taxable year	Taxable income before adjustment	Taxable income with adjustment	Assume total tax	Assumed tax before adjustment	Increase in tax attributable to adjustment
1956	$4,000	$7,000	$1,660	$840	$820
1957	6,000	9,000	2,300	1,360	940
1958	4,400	7,400	1,780	944	836
Total	....	....	....	....	2,596

Since this increase in tax of $2,596 is less than the increase in tax attributable to the inclusion of the entire adjustment in the income for the taxable year of the change ($3,058), the limitation provided by section 481(b)(1) applies, and the total tax for 1958, the taxable year of the change, if section 481(b)(2) does not apply, is determined as follows:

Tax without any portion of adjustment	$944
Increase in tax attributable to adjustment computed under section 481(b)(1)	2,596
Total tax for taxable year of the change	3,540

Example (3). (i) Assume the same facts as in example (1) and, in addition, assume that the taxpayer used the cash receipts and disbursements method of accounting in computing taxable income for the years 1953 through 1957; that he established his taxable income under the new method for the taxable years 1953, 1954, and 1957, but did not have sufficient records to establish his taxable income under such method for the taxable years 1955 and 1956. The original taxable income and taxable income as redetermined are as follows:

Taxable year	Taxable income		Increase or (decrease) in taxable income
	Determined under cash receipts and disbursements method	Established under new method	
1953	$5,000	$7,000	$2,000
1954	6,000	7,000	1,000
1955	5,500	[1]	....
1956	4,000	[1]	....
1957	6,000	10,000	4,000

[1] Undetermined.

As in examples (1) and (2), the total adjustment under section 481(a) is $9,000. Of the $9,000 adjustment, $4,000 may be allocated to 1957, which is the only year consecutively preceding the taxable year of the change for which the taxpayer was able to establish his income under the new method. Since the income cannot be established under the new method for 1956 and 1955, no allocation may be made to 1954 or 1953, even though the taxpayer has established his income for those years under the new method of accounting. The balance of $5,000 ($9,000 minus $4,000) must be allocated to 1958.

(ii) The limitation provided by section 481(b)(2) is computed as follows: The tax for 1957, based on taxable income of $6,000, is assumed to be $1,360. Under the new method, based on taxable income of $10,000, the tax for 1957 is assumed to be $2,640, the increase attributable to $4,000 of the $9,000 section 481(a) adjustment being $1,280, ($2,640 minus $1,360). The tax for 1958, computed on the basis of taxable income of $4,400 (determined under the new method), is assumed to be $944. The tax computed for 1958 on taxable income of $9,400 ($4,400 plus the $5,000 adjustment allocated to 1958) is assumed to be $2,436, leaving a difference of $1,492 ($2,436 minus $944) attributable to the inclusion in 1958 of the portion of the total adjustment to be taken into account which could not be properly allocated to the taxable year or years consecutively preceding 1958.

(iii) The tax attributable to the adjustment is determined by selecting the smallest of the three following amounts:

Increase in tax attributable to adjustment computed under section 481(b)(2) ($1,280+$1,492)	$2,772
Increase in tax attributable to adjustment computed under section 481(b)(1) (example (2))	2,596
Increase in tax if the entire adjustment is taken into account in the taxable year of the change (example (1))	3,058

The final tax for 1958 is then $3,540 computed as follows:

Tax before inclusion of any adjustment	$944
Increase in tax attributable to adjustments (smallest of $2,772, $2,596 or $3,058)	2,596
Total tax for 1958 (limited in accordance with section 481(b)(1))	3,540

Example (4). Assume that X Corporation has maintained its books of account and filed its income tax returns using the cash receipts and disbursements method of accounting for the years 1953 through 1957. The corporation secures permission to change to an accrual method of accounting for the calendar year 1958. The following tabulation presents the data with respect to the taxpayer's income for the years involved:

Year	Taxable income under the cash receipts and disbursements method		Taxable income established under accrual method	Increase or (decrease) attributable to change	Changes in taxable income due to changes in net loss carryback
	Before application of net operating loss carryback	After application of net operating loss carryback			
1953	$2,000	0	[1]		$2,000
1954	4,000	$1,000	[1]		3,000
1955	(5,000)		$1,000	$6,000	
1956	80,000	80,000	77,000	(3,000)	
1957	90,000	90,000	96,000	6,000	
1958			100,000		

[1] Not established.

As indicated above, taxable income for 1953 and 1954, as determined under the cash receipts and disbursements method of accounting, was $2,000 and $4,000, respectively, and after application of the net operating loss carryback from 1955, the taxable income was reduced to zero in 1953 and to $1,000 in 1954. The taxpayer was unable to establish taxable income for these years under an accrual method of accounting; however, under section 481(b)(3)(A), increases or decreases in the tax for taxable years to which no adjustment is allocated must, nevertheless, be taken into account to the extent the tax for such years would be affected by a net operating loss determined with reference to taxable years to which adjustments are allocated. The total amount of the adjustments required under section 481(a) and attributable to the taxable years 1953 through 1957 in this example is assumed to be $10,000. The redetermination of taxable income established by the taxpayer for the taxable years 1955, 1956, and 1957 appears under the heading ''Taxable income established under accrual method'' in the above tabulation. The tabulation assumes that the taxpayer has been able to recompute the income for those years so as to establish a net adjustment of $9,000, which leaves a balance of $1,000 unaccounted for. In accordance with the requirements of section 481(b)(2), the $1,000 amount is allocated to 1958, the taxable year of the change. The following computations are necessary in order to determine the tax attributable to the adjustments under section 481(a):

Increase in tax attributable to inclusion in 1958 of the entire $10,000 adjustment

Tax on income of 1958 increased by entire amount of adjustment ($100,000+$10,000)	$51,700
Tax on income of 1958 without adjustment ($100,000)	46,500
Increase in tax attributable to inclusion of entire adjustment in year of the change	5,200

Increase in tax attributed to adjustment computed under section 481(b)(1)

Year	Amount of adjustment	Tax before adjustment	Tax after adjustment	Increase in tax liability attributable to adjustment
1958	$3,334	$46,500	$48,234	$1,734
1957	3,333	41,300	43,033	1,733
1956	3,333	36,100	37,833	1,733
Increase in tax attributable to adjustment computed under section 481(b)(1)				5,200

Increase in tax attributed to adjustment computed under section 481(b)(2)

Year	Amount of adjustment	Tax before adjustment	Tax after adjustment	Increase in tax liability attributable to adjustment
1953	[1] $2,000	0	[1] $600	$600
1954	[1] 3,000	$300	[1] 1,200	900
1955	6,000	0	300	300
1956	(3,000)	36,100	34,540	(1,560)
1957	96,000	41,300	44,420	3,120
1958	[2] 1,000	46,500	[2] 47,020	520
Increase in tax attributable to the adjustment computed under section 481(b)(2)				3,880

[1] Attributable to recomputations of net operating loss carrybacks determined with reference to net operating loss in 1955.

[2] Attributable to the inclusion of $1,000 in the year of the change which represents the portion of the $10,000 adjustment not allocated to taxable years prior to the year of the change for which taxable income is established under the new method.

Since the limitation under section 481(b)(2) ($3,880) on the amount of tax attributable to the adjustments is applicable, the final tax for the taxable year of the change is computed by adding such amount to the tax for that year computed without the inclusion of any amount attributable to the adjustments, that is, $46,500 plus $3,880, or $50,380.

[T.D. 6500, 25 FR 11732, Nov. 26, 1960, as amended by T.D. 6490, 25 FR 8374, Sept. 1, 1960; T.D. 7301, 39 FR 963, Jan. 4, 1974; T.D. 8608, 60 FR 40078, Aug. 7, 1995]

§ 1.481–3 Adjustments attributable to pre-1954 years where change was not initiated by taxpayer.

If the adjustments required by section 481(a) and § 1.481–1 are attributable to a change in method of accounting which was not initiated by the taxpayer, no portion of any adjustments which is attributable to pre-1954 years shall be taken into account in computing taxable income. For example, if the total adjustments in the case of a change in method of accounting which is not initiated by the taxpayer amount to $10,000, of which $4,000 is attributable to pre-1954 years, only $6,000 of the $10,000 total adjustments is required to be taken into account under section 481 in computing taxable income. The portion of the adjustments which is attributable to pre-1954 years is the net amount of the adjustments which would have been required if the taxpayer had changed his method of accounting in his first taxable year which began after December 31, 1953, and ended after August 16, 1954.

[T.D. 6500, 25 FR 11735, Nov. 26, 1960, as amended by T.D. 8608, 60 FR 40079, Aug. 7, 1995]

§ 1.481–4 Adjustments taken into account with consent.

(a) In addition to the terms and conditions prescribed by the Commissioner under § 1.446–1(e)(3) for effecting a change in method of accounting, including the taxable year or years in which the amount of the adjustments required by section 481(a) is to be taken into account, or the methods of allocation described in section 481(b), a taxpayer may request approval of an alternative method of allocating the amount of the adjustments under section 481. See section 481(c). Requests for approval of an alternative method of allocation shall set forth in detail the facts and circumstances upon which the taxpayer bases its request. Permission will be granted only if the taxpayer and the Commissioner agree to the terms and conditions under which the allocation is to be effected. See § 1.446–1(e) for the rules regarding how to secure the Commissioner's consent to a change in method of accounting.

(b) An agreement to the terms and conditions of a change in method of accounting under § 1.446–1(e)(3), including the taxable year or years prescribed by the Commissioner under that section (or an alternative method described in paragraph (a) of this section) for taking the amount of the adjustments under section 481(a) into account, shall be in writing and shall be signed by the Commissioner and the taxpayer. It shall set forth the items to be adjusted, the amount of the adjustments, the taxable year or years for which the adjustments are to be taken into account, and the amount of the adjustments allocable to each year. The agreement shall be binding on the parties except upon a showing of fraud, malfeasance, or misrepresentation of material fact.

[T.D. 8608, 60 FR 40079, Aug. 7, 1995]

§ 1.481–5 Effective dates.

Sections 1.481–1, 1.481–2, 1.481–3, and 1.481–4 are effective for Consent Agreements signed on or after December 27, 1994. For Consent Agreements signed before December 27, 1994, see §§ 1.481–1, 1.481–2, 1.481–3, 1.481–4, and 1.481–5 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

[T.D. 8608, 60 FR 40079, Aug. 7, 1995]

§ 1.482–0 Outline of regulations under 482.

This section contains major captions for §§ 1.482–1 through 1.482–8.

§ 1.482–1 Allocation of income and deductions among taxpayers.

(a) In general.
(1) Purpose and scope.
(2) Authority to make allocations.
(3) Taxpayer's use of section 482.
(b) Arm's length standard.
(1) In general.
(2) Arm's length methods.

(i) Methods.

(ii) Selection of category of method applicable to transaction.

(c) Best method rule.

(1) In general.

(2) Determining the best method.

(i) Comparability.

(ii) Data and assumptions.

(A) Completeness and accuracy of data.

(B) Reliability of assumptions.

(C) Sensitivity of results to deficiencies in data and assumptions.

(iii) Confirmation of results by another method.

(d) Comparability.

(1) In general.

(2) Standard of comparability.

(3) Factors for determining comparability.

(i) Functional analysis.

(ii) Contractual terms.

(A) In general.

(B) Identifying contractual terms.

(*1*) Written agreement.

(*2*) No written agreement.

(C) Examples.

(iii) Risk.

(A) In general.

(B) Identification of party that bears risk.

(C) Examples.

(iv) Economic conditions.

(v) Property or services.

(4) Special circumstances.

(i) Market share strategy.

(ii) Different geographic markets.

(A) In general.

(B) Example.

(C) Location savings.

(D) Example.

(iii) Transactions ordinarily not accepted as comparables.

(A) In general.

(B) Examples.

(e) Arm's length range.

(1) In general.

(2) Determination of arm's length range.

(i) Single method.

(ii) Selection of comparables.

(iii) Comparables included in arm's length range.

(A) In general.

(B) Adjustment of range to increase reliability.

(C) Interquartile range.

(3) Adjustment if taxpayer's results are outside arm's length range.

(4) Arm's length range not prerequisite to allocation.

(5) Examples.

(f) Scope of review.

(1) In general.

(i) Intent to evade or avoid tax not a prerequisite.

(ii) Realization of income not a prerequisite.

(A) In general.

(B) Example.

(iii) Nonrecognition provisions may not bar allocation.

(A) In general.

(B) Example.

(iv) Consolidated returns.

(2) Rules relating to determination of true taxable income.

(i) Aggregation of transactions.

(A) In general.

(B) Examples.

(ii) Allocation based on taxpayer's actual transactions.

(A) In general.

(B) Example.

(iii) Multiple year data.

(A) In general.

(B) Circumstances warranting consideration of multiple year data.

(C) Comparable effect over comparable period.

(D) Applications of methods using multiple year averages.

(E) Examples.

(iv) Product lines and statistical techniques.

(v) Allocations apply to results, not methods.

(A) In general.

(B) Example.

(g) Collateral adjustments with respect to allocations under section 482.

(1) In general.

(2) Correlative allocations.

(i) In general.

(ii) Manner of carrying out correlative allocation.

(iii) Events triggering correlative allocation.

(iv) Examples.

(3) Adjustments to conform accounts to reflect section 482 allocations.

(i) In general.

(ii) Example.

(4) Setoffs.

(i) In general.

(ii) Requirements.

(iii) Examples.

(h) Special rules.

(1) Small taxpayer safe harbor. [Reserved]

(2) Effect of foreign legal restrictions.

(i) In general.

(ii) Applicable legal restrictions.

(iii) Requirement for electing the deferred income method of accounting.

(iv) Deferred income method of accounting.

(v) Examples.

(3) Coordination with section 936.

(i) Cost sharing under section 936.

(ii) Use of terms.

(i) Definitions.

(j) Effective dates.

§1.482–2 Determination of taxable income in specific situations.

(a) Loans or advances.

(1) Interest on bona fide indebtedness.

(i) In general.

(ii) Application of paragraph (a) of this section.

(A) Interest on bona fide indebtedness.

(B) Alleged indebtedness.

(iii) Period for which interest shall be charged.

(A) General rule.

(B) Exception for certain intercompany transactions in the ordinary course of business.

(C) Exception for trade or business of debtor member located outside the United States.

(D) Exception for regular trade practice of creditor member or others in creditor's industry.

(E) Exception for property purchased for resale in a foreign country.

(*1*) General rule.

(*2*) Interest-free period.

(*3*) Average collection period.

(*4*) Illustration.

(iv) Payment; book entries.

(2) Arm's length interest rate.

(i) In general.

(ii) Funds obtained at situs of borrower.

(iii) Safe haven interest rates for certain loans and advances made after May 8, 1986.

(A) Applicability.

(*1*) General rule.

(*2*) Grandfather rule for existing loans.

(B) Safe haven interest rate based on applicable Federal rate.

(C) Applicable Federal rate.

(D) Lender in business of making loans.

(E) Foreign currency loans.

(3) Coordination with interest adjustments required under certain other Internal Revenue Code sections.

(4) Examples.

(b) Performance of services for another.

(1) General rule.

(2) Benefit test.

(3) Arm's length charge.

(4) Costs or deductions to be taken into account.

(5) Costs and deductions not to be taken into account.

(6) Methods.

(7) Certain services.

(8) Services rendered in connection with the transfer of property.

(c) Use of tangible property.

(1) General rule.

(2) Arm's length charge.

(i) In general.

(ii) Safe haven rental charge.

(iii) Subleases.

(d) Transfer of property.

§ 1.482–3 Methods to determine taxable income in connection with a transfer of tangible property.

(a) In general.

(b) Comparable uncontrolled price method.

(1) In general.

(2) Comparability and reliability considerations.

(i) In general.

(ii) Comparability.

(A) In general.

(B) Adjustments for differences between controlled and uncontrolled transactions.

(iii) Data and assumptions.

(3) Arm's length range.

(4) Examples.

(5) Indirect evidence of comparable uncontrolled transactions.

(i) In general.

(ii) Limitations.

(iii) Examples.

(c) Resale price method.

(1) In general.

(2) Determination of arm's length price.

(i) In general.

(ii) Applicable resale price.

(iii) Appropriate gross profit.

(iv) Arm's length range.

(3) Comparability and reliability considerations.

(i) In general.

(ii) Comparability.

(A) Functional comparability.

(B) Other comparability factors.

(C) Adjustments for differences between controlled and uncontrolled transactions.

(D) Sales agent.

(iii) Data and assumptions.

(A) In general.

(B) Consistency in accounting.

(4) Examples.

(d) Cost plus method.

(1) In general.

(2) Determination of arm's length price.

(i) In general.

(ii) Appropriate gross profit.

(iii) Arm's length range.

(3) Comparability and reliability considerations.

(i) In general.

(ii) Comparability.

(A) Functional comparability.

(B) Other comparability factors.

(C) Adjustments for differences between controlled and uncontrolled transactions.

(D) Purchasing agent.

(iii) Data and assumptions.

(A) In general.

(B) Consistency in accounting.

(4) Examples.

(e) Unspecified methods.

(1) In general.

(2) Example.

(f) Coordination with intangible property rules.

§ 1.482–4 Methods to determine taxable income in connection with a transfer of intangible property.

(a) In general.

(b) Definition of intangible.

(c) Comparable uncontrolled transaction method.

(1) In general.

(2) Comparability and reliability considerations.

(i) In general.

(ii) Reliability.

(iii) Comparability.

(A) In general.

(B) Factors to be considered in determining comparability.

(*1*) Comparable intangible property.

(*2*) Comparable circumstances.

(iv) Data and assumptions.

(3) Arm's length range.

(4) Examples.

(d) Unspecified methods.

(1) In general.

(2) Example.

(e) Coordination with tangible property rules.

(f) Special rules for transfers of intangible property.

(1) Form of consideration.

(2) Periodic adjustments.

(i) General rule.

(ii) Exceptions.

(A) Transactions involving the same intangible.

(B) Transactions involving comparable intangible.

(C) Methods other than comparable uncontrolled transaction.

(D) Extraordinary events.

(E) Five-year period.

(iii) Examples.

(3) Ownership of intangible property.

(i) In general.

(ii) Identification of the owner.

(A) Legally protected intangible property.

(B) Intangible property that is not legally protected.

(iii) Allocations with respect to assistance provided to the owner.

(iv) Examples.

(4) Consideration not artificially limited.

(5) Lump sum payments.

(i) In general.

(ii) Exceptions.

(iii) Example.

§1.482–5 Comparable profits method.

(a) In general.

(b) Determination of arm's length result.

(1) In general.

(2) Tested party.

(i) In general.

(ii) Adjustments for tested party.

(3) Arm's length range.

(4) Profit level indicators.

(i) Rate of return on capital employed.

(ii) Financial ratios.

(iii) Other profit level indicators.

(c) Comparability and reliability considerations.

(1) In general.

(2) Comparability.

(i) In general.

(ii) Functional, risk and resource comparability.

(iii) Other comparability factors.

(iv) Adjustments for differences between tested party and the uncontrolled taxpayers.

(3) Data and assumptions.

(i) In general.

(ii) Consistency in accounting.

(iii) Allocations between the relevant business activity and other activities.

(d) Definitions.

(e) Examples.

§1.482–6 Profit split method.

(a) In general.

(b) Appropriate share of profits and losses.

(c) Application.

(1) In general.

(2) Comparable profit split.

(i) In general.

(ii) Comparability and reliability considerations.

(A) In general.

(B) Comparability.

(*1*) In general.

(*2*) Adjustments for differences between the controlled and uncontrolled taxpayers.

(C) Data and assumptions.

(D) Other factors affecting reliability.

(3) Residual profit split.

(i) In general.

(A) Allocate income to routine contributions.

(B) Allocate residual profit.

(ii) Comparability and reliability considerations.

(A) In general.

(B) Comparability.

(C) Data and assumptions.

(D) Other factors affecting reliability.

(iii) Example.

§1.482–7 Sharing of costs.

(a) In general.

(1) Scope and application of the rules in this section.

(2) Limitation on allocations.

(3) Cross references.

(b) Qualified cost sharing arrangement.

(c) Participant.

(1) In general.

(2) Treatment of a controlled taxpayer that is not a controlled participant.

(i) In general.

(ii) Example.

(3) Treatment of consolidated group.

(d) Costs.

(1) Intangible development costs.

(2) Examples.

(e) Anticipated benefits.

(1) Benefits.

(2) Reasonably anticipated benefits.

(f) Cost allocations.

(1) In general.

(2) Share of intangible development costs.

(i) In general.

(ii) Example.
(3) Share of reasonably anticipated benefits.
(i) In general.
(ii) Measure of benefits.
(iii) Indirect bases for measuring anticipated benefits.
(A) Units used, produced or sold.
(B) Sales.
(C) Operating profit.
(D) Other bases for measuring anticipated benefits.
(E) Examples.
(iv) Projections used to estimate anticipated benefits.
(A) In general.
(B) Unreliable projections.
(C) Foreign-to-foreign adjustments.
(D) Examples.
(4) Timing of allocations.
(g) Allocations of income, deductions or other tax items to reflect transfers of intangibles (buy-in).
(1) In general.
(2) Pre-existing intangibles.
(3) New controlled participant.
(4) Controlled participant relinquishes interests.
(5) Conduct inconsistent with the terms of a cost sharing arrangement.
(6)Failure to assign interests under a qualified cost sharing arrangement.
(7) Form of consideration.
(i) Lump sum payments.
(ii) Installment payments.
(iii) Royalties.
(8) Examples.
(h) Character of payments made pursuant to a qualified cost sharing arrangement.
(1) In general.
(2) Examples.
(i) Accounting requirements.
(j) Administrative requirements.
(1) In general.
(2) Documentation.
(i) Requirements.
(ii) Coordination with penalty regulation.
(3) Reporting requirements.
(k) Effective date.
(l) Transition rule.

§ 1.482–8 Examples of the best method rule.

(a) In general.
(b) Examples.

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§ 1.482–1 Allocation of income and deductions among taxpayers.

(a) *In general*—(1) *Purpose and scope.* The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. This § 1.482–1 sets forth general principles and guidelines to be followed under section 482. Section 1.482–2 provides rules for the determination of the true taxable income of controlled taxpayers in specific situations, including controlled transactions involving loans or advances, services, and property. Sections 1.482–3 through 1.482–6 elaborate on the rules that apply to controlled transactions involving property. Section 1.482–7T sets forth the cost sharing provisions. Finally, § 1.482–8 provides examples illustrating the application of the best method rule.

(2) *Authority to make allocations.* The district director may make allocations between or among the members of a controlled group if a controlled taxpayer has not reported its true taxable income. In such case, the district director may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income (referred to as allocations). The appropriate allocation may take the form of an increase or decrease in any relevant amount.

(3) *Taxpayer's use of section 482.* If necessary to reflect an arm's length result, a controlled taxpayer may report on a timely filed U.S. income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged. Except as provided in this paragraph, section 482 grants no other right to a controlled taxpayer to apply the provisions of section 482 at will or to compel the district director to apply such provisions. Therefore, no untimely or amended returns will be permitted to decrease taxable income based on allocations or other adjustments with respect to controlled transactions. See § 1.6662–6T(a)(2) or successor regulations.

(b) *Arm's length standard*—(1) *In general.* In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.

A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances. See §1.482–1(d)(2) (Standard of comparability). Evaluation of whether a controlled transaction produces an arm's length result is made pursuant to a method selected under the best method rule described in §1.482–1(c).

(2) *Arm's length methods*—(i) *Methods.* Sections 1.482–2 through 1.482–6 provide specific methods to be used to evaluate whether transactions between or among members of the controlled group satisfy the arm's length standard, and if they do not, to determine the arm's length result.

(ii) *Selection of category of method applicable to transaction.* The methods listed in §1.482–2 apply to different types of transactions, such as transfers of property, services, loans or advances, and rentals. Accordingly, the method or methods most appropriate to the calculation of arm's length results for controlled transactions must be selected, and different methods may be applied to interrelated transactions if such transactions are most reliably evaluated on a separate basis. For example, if services are provided in connection with the transfer of property, it may be appropriate to separately apply the methods applicable to services and property in order to determine an arm's length result. But see §1.482–1(f)(2)(i) (Aggregation of transactions). In addition, other applicable provisions of the Code may affect the characterization of a transaction, and therefore affect the methods applicable under section 482. See for example section 467.

(c) *Best method rule*—(1) *In general.* The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result. See §1.482–8 for examples of the application of the best method rule.

(2) *Determining the best method.* Data based on the results of transactions between unrelated parties provides the most objective basis for determining whether the results of a controlled transaction are arm's length. Thus, in determining which of two or more available methods (or applications of a single method) provides the most reliable measure of an arm's length result, the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis. In addition, in certain circumstances, it also may be relevant to consider whether the results of an analysis are consistent with the results of an analysis under another method. These factors are explained in paragraphs (c)(2)(i), (ii), and (iii) of this section.

(i) *Comparability.* The relative reliability of a method based on the results of transactions between unrelated parties depends on the degree of comparability between the controlled transaction or taxpayers and the uncontrolled comparables, taking into account the factors described in §1.482–1(d)(3) (Factors for determining comparability), and after making adjustments for differences, as described in §1.482–1(d)(2) (Standard of comparability). As the degree of comparability increases, the number and extent of potential differences that could render the analysis inaccurate is reduced. In addition, if adjustments are made to increase the degree of comparability, the number, magnitude, and reliability of those adjustments will affect the reliability of the results of the analysis. Thus, an analysis under the comparable uncontrolled price method will generally be more reliable than analyses obtained under other methods if the analysis is based on closely comparable uncontrolled transactions, because such an analysis can be expected to achieve a higher degree of comparability and be susceptible to fewer differences than analyses under other methods. See § 1.482–3(b)(2)(ii)(A). An analysis will be relatively less reliable, however, as the uncontrolled transactions become less comparable to the controlled transaction.

(ii) *Data and assumptions.* Whether a method provides the most reliable measure of an arm's length result also depends upon the completeness and accuracy of the underlying data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions. Such factors are particularly relevant in evaluating the degree of comparability between the controlled and uncontrolled transactions. These factors are discussed in paragraphs (c)(2)(ii) (A), (B), and (C) of this section.

(A) *Completeness and accuracy of data.* The completeness and accuracy of the data affects the ability to identify and quantify those factors that would affect the result under any particular method. For example, the completeness and accuracy of data will determine the extent to which it is possible to identify differences between the controlled and uncontrolled transactions, and the reliability of adjustments that are made to account for such differences. An analysis will be relatively more reliable as the completeness and accuracy of the data increases.

(B) *Reliability of assumptions.* All methods rely on certain assumptions. The reliability of the results derived from a method depends on the soundness of such assumptions. Some assumptions are relatively reliable. For example, adjustments for differences in payment terms between controlled and uncontrolled transactions may be based on the assumption that at arm's length such differences would lead to price differences that reflect the time value of money. Although selection of the appropriate interest rate to use in making such adjustments involves some judgement, the economic analysis on which the assumption is based is relatively sound. Other assumptions may be less reliable. For example, the residual profit split method may be based on the assumption that capitalized intangible development expenses reflect the relative value of the intangible property contributed by each party. Because the costs of developing an intangible may not be related to its market value, the soundness of this assumption will affect the reliability of the results derived from this method.

(C) *Sensitivity of results to deficiencies in data and assumptions.* Deficiencies in the data used or assumptions made may have a greater effect on some methods than others. In particular, the reliability of some methods is heavily dependent on the similarity of property or services involved in the controlled and uncontrolled transaction. For certain other methods, such as the resale price method, the analysis of the extent to which controlled and uncontrolled taxpayers undertake the same or similar functions, employ similar resources, and bear similar risks is particularly important. Finally, under other methods, such as the profit split method, defining the relevant business activity and appropriate allocation of costs, income, and assets may be of particular importance. Therefore, a difference between the controlled and uncontrolled transactions for which an accurate adjustment cannot be made may have a greater effect on the reliability of the results derived under one method than the results derived under another method. For example, differences in management efficiency may have a greater effect on a comparable profits method analysis than on a comparable uncontrolled price method analysis, while differences in product characteristics will ordinarily have a greater effect on a comparable uncontrolled price method analysis than on a comparable profits method analysis.

(iii) *Confirmation of results by another method.* If two or more methods produce inconsistent results, the best method rule will be applied to select the method that provides the most reliable measure of an arm's length result. If the best method rule does not clearly indicate which method should be selected, an additional factor that may be taken into account in selecting a method is whether any of the competing methods produce results that are consistent with the results obtained from the appropriate application of another method. Further, in evaluating different applications of the same method, the fact that a second method (or another application of the first method) produces results that are consistent with one of the competing applications may be taken into account.

(d) *Comparability*—(1) *In general.* Whether a controlled transaction produces an arm's length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances. For this purpose, the comparability of transactions and circumstances must be evaluated considering all factors that could affect prices or profits in arm's length dealings (comparability factors). While a specific comparability factor may be of particular importance in applying a method, each method requires analysis of all of the factors that affect comparability under that method. Such factors include the following—

(i) Functions;

(ii) Contractual terms;

(iii) Risks;

(iv) Economic conditions; and

(v) Property or services.

(2) *Standard of comparability.* In order to be considered comparable to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm's length result. If there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results. For purposes of this section, a material difference is one that would materially affect the measure of an arm's length result under the method being applied. If adjustments for material differences cannot be made, the uncontrolled transaction may be used as a measure of an arm's length result, but the reliability of the analysis will be reduced. Generally, such adjustments must be made to the results of the uncontrolled comparable and must be based on commercial practices, economic principles, or statistical analyses. The extent and reliability of any adjustments will affect the relative reliability of the analysis. See §1.482–1(c)(1) (Best method rule). In any event, unadjusted industry average returns themselves cannot establish arm's length results.

(3) *Factors for determining comparability.* The comparability factors listed in §1.482–1(d)(1) are discussed in this section. Each of these factors must be considered in determining the degree of comparability between transactions or taxpayers and the extent to which comparability adjustments may be necessary. In addition, in certain cases involving special circumstances, the rules under paragraph (d)(4) of this section must be considered.

(i) *Functional analysis.* Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the functions performed, and associated resources employed, by the taxpayers in each transaction. This comparison is based on a functional analysis that identifies and compares the economically significant activities undertaken, or to be undertaken, by the taxpayers in both controlled and uncontrolled transactions. A functional analysis should also include consideration of the resources that are employed, or to be employed, in conjunction with the activities undertaken, including consideration of the type of assets used, such as plant and equipment, or the use of valuable intangibles. A functional analysis is not a pricing method and does not itself determine the arm's length result for the controlled transaction under review. Functions that may need to be accounted for in determining the comparability of two transactions include—

(A) Research and development;

(B) Product design and engineering;

(C) Manufacturing, production and process engineering;

(D) Product fabrication, extraction, and assembly;

(E) Purchasing and materials management;

(F) Marketing and distribution functions, including inventory management, warranty administration, and advertising activities;

(G) Transportation and warehousing; and

(H) Managerial, legal, accounting and finance, credit and collection, training, and personnel management services.

(ii) *Contractual terms*—(A) *In general.* Determining the degree of comparability between the controlled and uncontrolled transactions requires a comparison of the significant contractual terms that could affect the results of the two transactions. These terms include—

(*1*) The form of consideration charged or paid;

(*2*) Sales or purchase volume;

(*3*) The scope and terms of warranties provided;

(*4*) Rights to updates, revisions or modifications;

(*5*) The duration of relevant license, contract or other agreements, and termination or renegotiation rights;

(*6*) Collateral transactions or ongoing business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services; and

(*7*) Extension of credit and payment terms. Thus, for example, if the time for payment of the amount charged in a controlled transaction differs from the time for payment of the amount charged in an uncontrolled transaction, an adjustment to reflect the difference in payment terms should be made if such difference would have a material effect on price. Such comparability adjustment is required even if no interest would be allocated or imputed under § 1.482–2(a) or other applicable provisions of the Internal Revenue Code or regulations.

(B) *Identifying contractual terms*—(*1*) *Written agreement.* The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties (see, for example, § 1.482–4(f)(3) (Ownership of intangible property)). If the contractual terms are inconsistent with the economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

(*2*) *No written agreement.* In the absence of a written agreement, the district director may impute a contractual agreement between the controlled taxpayers consistent with the economic substance of the transaction. In determining the economic substance of the transaction, greatest weight will be given to the actual conduct of the parties and their respective legal rights (see, for example, § 1.482–4(f)(3) (Ownership of intangible property)). For example, if, without a written agreement, a controlled taxpayer operates at full capacity and regularly sells all of its output to another member of its controlled group, the district director may impute a purchasing contract from the course of conduct of the controlled taxpayers, and determine that the producer bears little risk that the buyer will fail to purchase its full output. Further, if an established industry convention or usage of trade assigns a risk or resolves an issue, that convention or usage will be followed if the conduct of the taxpayers is consistent with it. See UCC 1–205. For example, unless otherwise agreed, payment generally is due at the time and place at which the buyer is to receive goods. See UCC 2–310.

(C) *Examples.* The following examples illustrate this paragraph (d)(3)(ii).

Example 1—Differences in volume. USP, a United States agricultural exporter, regularly buys transportation services from FSub, its foreign subsidiary, to ship its products from the United States to overseas markets. Although FSub occasionally provides transportation services to URA, an unrelated domestic corporation, URA accounts for only 10% of the gross revenues of FSub, and the remaining 90% of FSub's gross revenues are attributable to FSub's transactions with USP. In determining the degree of comparability between FSub's uncontrolled transaction with URA and its controlled transaction with USP, the difference in volumes involved in the two transactions and the regularity with which these services are provided must be taken into account if such difference would have a material effect on the price charged. Inability to make reliable adjustments for these differences would affect the reliability of the results derived from the uncontrolled transaction as a measure of the arm's length result.

Example 2— Reliability of adjustment for differences in volume. (i) FS manufactures product XX and sells that product to its parent corporation, P. FS also sells product XX to uncontrolled taxpayers at a price of $100 per unit. Except for the volume of each transaction, the sales to P and to uncontrolled taxpayers take place under substantially the same economic conditions and contractual terms. In uncontrolled transactions, FS offers a 2% discount for quantities of 20 per order, and a 5% discount for quantities of 100 per order. If P purchases product XX in quantities of 60 per order, in the absence of other reliable information, it may reasonably be concluded that the arm's length price to P would be $100, less a discount of 3.5%.

(ii) If P purchases product XX in quantities of 1,000 per order, a reliable estimate of the appropriate volume discount must be based on proper economic or statistical analysis, not necessarily a linear extrapolation from the 2% and 5% catalog discounts applicable to sales of 20 and 100 units, respectively.

Example 3— Contractual term imputed from economic substance. (i) USD, a United States corporation, is the exclusive distributor of products manufactured by FP, its foreign parent. The FP products are sold under a tradename that is not known in the United States. USD does not have an agreement with FP for the use of FP's tradename. For Years 1 through 6, USD bears marketing expenses promoting FP's tradename in the United States that are substantially above the level of such expenses incurred by comparable distributors in uncontrolled transactions. FP does not directly or indirectly reimburse USD for its marketing expenses. By Year 7, the FP tradename has become very well known in the market and commands a price premium. At this time, USD becomes a commission agent for FP.

(ii) In determining USD's arm's length result for Year 7, the district director considers the economic substance of the arrangements between USD and FP throughout the course of their relationship. It is unlikely that at arm's length, USD would incur these above-normal expenses without some assurance it could derive a benefit from these expenses. In this case, these expenditures indicate a course of conduct that is consistent with an agreement under which USD received a long-term right to use the FP tradename in the United States. Such conduct is inconsistent with the contractual arrangements between FP and USD under which USD was merely a distributor, and later a commission agent, for FP. Therefore, the district director may impute an agreement between USD and FP under which USD will retain an appropriate portion of the price premium attributable to the FP tradename.

(iii) *Risk*—(A) *Comparability*. Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant risks that could affect the prices that would be charged or paid, or the profit that would be earned, in the two transactions. Relevant risks to consider include—

(*1*) Market risks, including fluctuations in cost, demand, pricing, and inventory levels;

(*2*) Risks associated with the success or failure of research and development activities;

(*3*) Financial risks, including fluctuations in foreign currency rates of exchange and interest rates;

(*4*) Credit and collection risks;

(*5*) Product liability risks; and

(*6*) General business risks related to the ownership of property, plant, and equipment.

(B) *Identification of taxpayer that bears risk*. In general, the determination of which controlled taxpayer bears a particular risk will be made in accordance with the provisions of §1.482–1(d)(3)(ii)(B) (Identifying contractual terms). Thus, the allocation of risks specified or implied by the taxpayer's contractual terms will generally be respected if it is consistent with the economic substance of the transaction. An allocation of risk between controlled taxpayers after the outcome of such risk is known or reasonably knowable lacks economic substance. In considering the economic substance of the transaction, the following facts are relevant—

(*1*) Whether the pattern of the controlled taxpayer's conduct over time is consistent with the purported allocation of risk between the controlled taxpayers; or where the pattern is changed, whether the relevant contractual arrangements have been modified accordingly;

(*2*) Whether a controlled taxpayer has the financial capacity to fund losses that might be expected to occur as the result of the assumption of a risk, or whether, at arm's length, another party to the controlled transaction would ultimately suffer the consequences of such losses; and

(*3*) The extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized. In arm's length dealings, parties ordinarily bear a greater share of those risks over which they have relatively more control.

(C) *Examples.* The following examples illustrate this paragraph (d)(3)(iii).

Example 1. FD, the wholly-owned foreign distributor of USM, a U.S. manufacturer, buys widgets from USM under a written contract. Widgets are a generic electronic appliance. Under the terms of the contract, FD must buy and take title to 20,000 widgets for each of the five years of the contract at a price of $10 per widget. The widgets will be sold under FD's label, and FD must finance any marketing strategies to promote sales in the foreign market. There are no rebate or buy back provisions. FD has adequate financial capacity to fund its obligations under the contract under any circumstances that could reasonably be expected to arise. In Years 1, 2 and 3, FD sold only 10,000 widgets at a price of $11 per unit. In Year 4, FD sold its entire inventory of widgets at a price of $25 per unit. Since the contractual terms allocating market risk were agreed to before the outcome of such risk was known or reasonably knowable, FD had the financial capacity to bear the market risk that it would be unable to sell all of the widgets it purchased currently, and its conduct was consistent over time, FD will be deemed to bear the risk.

Example 2. The facts are the same as in *Example 1,* except that in Year 1 FD had only $100,000 in total capital, including loans. In subsequent years USM makes no additional contributions to the capital of FD, and FD is unable to obtain any capital through loans from an unrelated party. Nonetheless, USM continues to sell 20,000 widgets annually to FD under the terms of the contract, and USM extends credit to FD to enable it to finance the purchase. FD does not have the financial capacity in Years 1, 2 and 3 to finance the purchase of the widgets given that it could not sell most of the widgets it purchased during those years. Thus, notwithstanding the terms of the contract, USM and not FD assumed the market risk that a substantial portion of the widgets could not be sold, since in that event FD would not be able to pay USM for all of the widgets it purchased.

Example 3. S, a Country X corporation, manufactures small motors that it sells to P, its U.S. parent. P incorporates the motors into various products and sells those products to uncontrolled customers in the United States. The contract price for the motors is expressed in U.S. dollars, effectively allocating the currency risk for these transactions to S for any currency fluctuations between the time the contract is signed and payment is made. As long as S has adequate financial capacity to bear this currency risk (including by hedging all or part of the risk) and the conduct of S and P is consistent with the terms of the contract (i.e., the contract price is not adjusted to reflect exchange rate movements), the agreement of the parties to allocate the exchange risk to S will be respected.

Example 4. USSub is the wholly-owned U.S. subsidiary of FP, a foreign manufacturer. USSub acts as a distributor of goods manufactured by FP. FP and USSub execute an agreement providing that FP will bear any ordinary product liability costs arising from defects in the goods manufactured by FP. In practice, however, when ordinary product liability claims are sustained against USSub and FP, USSub pays the resulting damages. Therefore, the district director disregards the contractual arrangement regarding product liability costs between FP and USSub, and treats the risk as having been assumed by USSub.

(iv) *Economic conditions.* Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant economic conditions that could affect the prices that would be charged or paid, or the profit that would be earned in each of the transactions. These factors include—

(A) The similarity of geographic markets;

(B) The relative size of each market, and the extent of the overall economic development in each market;

(C) The level of the market (e.g., wholesale, retail, etc.);

(D) The relevant market shares for the products, properties, or services transferred or provided;

(E) The location-specific costs of the factors of production and distribution;

(F) The extent of competition in each market with regard to the property or services under review;

(G) The economic condition of the particular industry, including whether the market is in contraction or expansion; and

(H) The alternatives realistically available to the buyer and seller.

(v) *Property or services.* Evaluating the degree of comparability between controlled and uncontrolled transactions requires a comparison of the property or services transferred in the transactions. This comparison may include any intangibles that are embedded in tangible property or services being transferred. The comparability of the embedded intangibles will be analyzed using the factors listed in §1.482–4(c)(2)(iii)(B)(*1*) (Comparable intangible property). The relevance of product comparability in evaluating the relative reliability of the results will depend on the method applied. For guidance concerning the specific comparability considerations applicable to transfers of tangible and intangible property, see §§1.482–3 through 1.482–6; see also §1.482–3(f), dealing with the coordination of the intangible and tangible property rules.

(4) *Special circumstances*—(i) *Market share strategy.* In certain circumstances, taxpayers may adopt strategies to enter new markets or to increase a product's share of an existing market (market share strategy). Such a strategy would be reflected by temporarily increased market development expenses or resale prices that are temporarily lower than the prices charged for comparable products in the same market. Whether or not the strategy is reflected in the transfer price depends on which party to the controlled transaction bears the costs of the pricing strategy. In any case, the effect of a market share strategy on a controlled transaction will be taken into account only if it can be shown that an uncontrolled taxpayer engaged in a comparable strategy under comparable circumstances for a comparable period of time, and the taxpayer provides documentation that substantiates the following—

(A) The costs incurred to implement the market share strategy are borne by the controlled taxpayer that would obtain the future profits that result from the strategy, and there is a reasonable likelihood that the strategy will result in future profits that reflect an appropriate return in relation to the costs incurred to implement it;

(B) The market share strategy is pursued only for a period of time that is reasonable, taking into consideration the industry and product in question; and

(C) The market share strategy, the related costs and expected returns, and any agreement between the controlled taxpayers to share the related costs, were established before the strategy was implemented.

(ii) *Different geographic markets*—(A) *In general.* Uncontrolled comparables ordinarily should be derived from the geographic market in which the controlled taxpayer operates, because there may be significant differences in economic conditions in different markets. If information from the same market is not available, an uncontrolled comparable derived from a different geographic market may be considered if adjustments are made to account for differences between the two markets. If information permitting adjustments for such differences is not available, then information derived from uncontrolled comparables in the most similar market for which reliable data is available may be used, but the extent of such differences may affect the reliability of the method for purposes of the best method rule. For this purpose, a geographic market is any geographic area in which the economic conditions for the relevant product or service are substantially the same, and may include multiple countries, depending on the economic conditions.

(B) *Example.* The following example illustrates this paragraph (d)(4)(ii).

Example. Manuco, a wholly-owned foreign subsidiary of P, a U.S. corporation, manufactures products in Country Z for sale to P. No uncontrolled transactions are located that would provide a reliable measure of the arm's length result under the comparable uncontrolled price method. The district director considers applying the cost plus method or the comparable profits method. Information on uncontrolled taxpayers performing comparable functions under comparable circumstances in the same geographic market is not available. Therefore, adjusted data from uncontrolled manufacturers in other markets may be considered in order to apply the cost plus method. In this case, comparable uncontrolled manufacturers are found in the United States. Accordingly, data from the comparable U.S. uncontrolled manufacturers, as adjusted to account for differences between the United States and Country Z's geographic market, is used to test the arm's length price paid by P to Manuco. However, the use of such data may affect the reliability of the results for purposes of the best method rule. See § 1.482–1(c).

(C) *Location savings.* If an uncontrolled taxpayer operates in a different geographic market than the controlled taxpayer, adjustments may be necessary to account for significant differences in costs attributable to the geographic markets. These adjustments must be based on the effect such differences would have on the consideration charged or paid in the controlled transaction given the relative competitive positions of buyers and sellers in each market. Thus, for example, the fact that the total costs of operating in a controlled manufacturer's geographic market are less than the total costs of operating in other markets ordinarily justifies higher profits to the manufacturer only if the cost differences would increase the profits of comparable uncontrolled manufacturers operating at arm's length, given the competitive positions of buyers and sellers in that market.

(D) *Example.* The following example illustrates the principles of this paragraph (d)(4)(ii)(C).

Example. Couture, a U.S. apparel design corporation, contracts with Sewco, its wholly owned Country Y subsidiary, to manufacture its clothes. Costs of operating in Country Y are significantly lower than the operating costs in the United States. Although clothes with the Couture label sell for a premium price, the actual production of the clothes does not require significant specialized knowledge that could not be acquired by actual or potential competitors to Sewco at reasonable cost. Thus, Sewco's functions could be performed by several actual or potential competitors to Sewco in geographic markets that are similar to Country Y. Thus, the fact that production is less costly in Country Y will not, in and of itself, justify additional profits derived from lower operating costs in Country Y inuring to Sewco, because the competitive positions of the other actual or potential producers in similar geographic markets capable of performing the same functions at the same low costs indicate that at arm's length such profits would not be retained by Sewco.

(iii) *Transactions ordinarily not accepted as comparables*— (A) *In general.* Transactions ordinarily will not constitute reliable measures of an arm's length result for purposes of this section if—

(*1*) They are not made in the ordinary course of business; or

(*2*) One of the principal purposes of the uncontrolled transaction was to establish an arm's length result with respect to the controlled transaction.

(B) *Examples.* The following examples illustrate the principle of this paragraph (d)(4)(iii).

Example 1 Not in the ordinary course of business. USP, a United States manufacturer of computer software, sells its products to FSub, its foreign distributor in country X. Compco, a United States competitor of USP, also sells its products in X through unrelated distributors. However, in the year under review, Compco is forced into bankruptcy, and Compco liquidates its inventory by selling all of its products to unrelated distributors in X for a liquidation price. Because the sale of its entire inventory was not a sale in the ordinary course of business, Compco's sale cannot be used as an uncontrolled comparable to determine USP's arm's length result from its controlled transaction.

Example 2 Principal purpose of establishing an arm's length result. USP, a United States manufacturer of farm machinery, sells its products to FSub, its wholly-owned distributor in Country Y. USP, operating at nearly full capacity, sells 95% of its inventory to FSub. To make use of its excess capacity, and also to establish a comparable uncontrolled price for its transfer price to FSub, USP increases its production to full capacity. USP sells its excess inventory to Compco, an unrelated foreign distributor in Country X. Country X has approximately the same economic conditions as that of Country Y. Because one of the principal purposes of selling to Compco was to establish an arm's length price for its controlled transactions with FSub, USP's sale to Compco cannot be used as an uncontrolled comparable to determine USP's arm's length result from its controlled transaction.

(e) *Arm's length range*—(1) *In general.* In some cases, application of a pricing method will produce a single result that is the most reliable measure of an arm's length result. In other cases, application of a method may produce a number of results from which a range of reliable results may be derived. A taxpayer will not be subject to adjustment if its results fall within such range (arm's length range).

(2) *Determination of arm's length range*—(i) *Single method.* The arm's length range is ordinarily determined by applying a single pricing method selected under the best method rule to two or more uncontrolled transactions of similar comparability and reliability. Use of more than one method may be appropriate for the purposes described in paragraph (c)(2)(iii) of this section (Best method rule).

(ii) *Selection of comparables.* Uncontrolled comparables must be selected based upon the comparability criteria relevant to the method applied and must be sufficiently similar to the controlled transaction that they provide a reliable measure of an arm's length result. If material differences exist between the controlled and uncontrolled transactions, adjustments must be made to the results of the uncontrolled transaction if the effect of such differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results. See §1.482–1(d)(2) (Standard of comparability). The arm's length range will be derived only from those uncontrolled comparables that have, or through adjustments can be brought to, a similar level of comparability and reliability, and uncontrolled comparables that have a significantly lower level of comparability and reliability will not be used in establishing the arm's length range.

(iii) *Comparables included in arm's length range*—(A) *In general.* The arm's length range will consist of the results of all of the uncontrolled comparables that meet the following conditions: the information on the controlled transaction and the uncontrolled comparables is sufficiently complete that it is likely that all material differences have been identified, each such difference has a definite and reasonably ascertainable effect on price or profit, and an adjustment is made to eliminate the effect of each such difference.

(B) *Adjustment of range to increase reliability.* If there are no uncontrolled comparables described in paragraph (e)(2)(iii)(A) of this section, the arm's length range is derived from the results of all the uncontrolled comparables, selected pursuant to paragraph (e)(2)(ii) of this section, that achieve a similar level of comparability and reliability. In such cases the reliability of the analysis must be increased, where it is possible to do so, by adjusting the range through application of a valid statistical method to the results of all of the uncontrolled comparables so selected. The reliability of the analysis is increased when statistical methods are used to establish a range of results in which the limits of the range will be determined such that there is a 75 percent probability of a result falling above the lower end of the range and a 75 percent probability of a result falling below the upper end of the range. The interquartile range ordinarily provides an acceptable measure of this range; however a different statistical method may be applied if it provides a more reliable measure.

(C) *Interquartile range.* For purposes of this section, the interquartile range is the range from the 25th to the 75th percentile of the results derived from the uncontrolled comparables. For this purpose, the 25th percentile is the lowest result derived from an uncontrolled comparable such that at least 25 percent of the results are at or below the value of that result. However, if exactly 25 percent of the results are at or below a result, then the 25th percentile is equal to the average of that result and the next higher result derived from the uncontrolled comparables. The 75th percentile is determined analogously.

(3) *Adjustment if taxpayer's results are outside arm's length range.* If the results of a controlled transaction fall outside the arm's length range, the district director may make allocations that adjust the controlled taxpayer's result to any point within the arm's length range. If the interquartile range is used to determine the arm's length range, such adjustment will ordinarily be to

the median of all the results. The median is the 50th percentile of the results, which is determined in a manner analogous to that described in paragraph (e)(2)(iii)(C) of this section (Interquartile range). In other cases, an adjustment normally will be made to the arithmetic mean of all the results. See §1.482–1(f)(2)(iii)(D) for determination of an adjustment when a controlled taxpayer's result for a multiple year period falls outside an arm's length range consisting of the average results of uncontrolled comparables over the same period.

(4) *Arm's length range not prerequisite to allocation.* The rules of this paragraph (e) do not require that the district director establish an arm's length range prior to making an allocation under section 482. Thus, for example, the district director may properly propose an allocation on the basis of a single comparable uncontrolled price if the comparable uncontrolled price method, as described in §1.482–3(b), has been properly applied. However, if the taxpayer subsequently demonstrates that the results claimed on its income tax return are within the range established by additional equally reliable comparable uncontrolled prices in a manner consistent with the requirements set forth in §1.482–1(e)(2)(iii), then no allocation will be made.

(5) *Examples.* The following examples illustrate the principles of this paragraph (e).

Example 1 Selection of comparables. (i) To evaluate the arm's length result of a controlled transaction between USSub, the United States taxpayer under review, and FP, its foreign parent, the district director considers applying the resale price method. The district director identifies ten potential uncontrolled transactions. The distributors in all ten uncontrolled transactions purchase and resell similar products and perform similar functions to those of USSub.

(ii) Data with respect to three of the uncontrolled transactions is very limited, and although some material differences can be identified and adjusted for, the level of comparability of these three uncontrolled comparables is significantly lower than that of the other seven. Further, of those seven, adjustments for the identified material differences can be reliably made for only four of the uncontrolled transactions. Therefore, pursuant to §1.482–1(e)(2)(ii) only these four uncontrolled comparables may be used to establish an arm's length range.

Example 2 Arm's length range consists of all the results. (i) The facts are the same as in *Example 1.* Applying the resale price method to the four uncontrolled comparables, and making adjustments to the uncontrolled comparables pursuant to §1.482- 1(d)(2), the district director derives the following results:

Comparable	Result (price)
1	$44.00
2	45.00
3	45.00
4	45.50

(ii) The district director determines that data regarding the four uncontrolled transactions is sufficiently complete and accurate so that it is likely that all material differences between the controlled and uncontrolled transactions have been identified, such differences have a definite and reasonably ascertainable effect, and appropriate adjustments were made for such differences. Accordingly, if the resale price method is determined to be the best method pursuant to §1.482–1(c), the arm's length range for the controlled transaction will consist of the results of all of the uncontrolled comparables, pursuant to paragraph (e)(2)(iii)(A) of this section. Thus, the arm's length range in this case would be the range from $44 to $45.50.

Example 3 Arm's length range limited to interquartile range. (i) The facts are the same as in *Example 2,* except in this case there are some product and functional differences between the four uncontrolled comparables and USSub. However, the data is insufficiently complete to determine the effect of the differences. Applying the resale price method to the four uncontrolled comparables, and making adjustments to the uncontrolled comparables pursuant to §1.482–1(d)(2), the district director derives the following results:

Uncontrolled comparable	Result (price)
1	$42.00
2	44.00
3	45.00
4	47.50

(ii) It cannot be established in this case that all material differences are likely to have been identified and reliable adjustments made for those differences. Accordingly, if the resale price method is determined to be the best method pursuant to §1.482–1(c), the arm's length range for the controlled transaction must be established pursuant to paragraph (e)(2)(iii)(B) of this section. In this case, the district director uses the interquartile range to determine the arm's length range, which is the range from $43 to $46.25. If USSub's price falls outside this range, the district director may make an allocation. In this case that allocation would be to the median of the results, or $44.50.

Example 4 Arm's length range limited to interquartile range. (i) To evaluate the arm's length result of controlled transactions between USP, a United States manufacturing company, and FSub, its foreign subsidiary, the district director considers applying the comparable profits method. The district director identifies 50 uncontrolled taxpayers within the same industry that potentially could be used to apply the method.

(ii) Further review indicates that only 20 of the uncontrolled manufacturers engage in activities requiring similar capital investments and technical know-how. Data with respect to five of the uncontrolled manufacturers is very limited, and although some material differences can be identified and adjusted for, the level of comparability of these five uncontrolled comparables is significantly lower than that of the other 15. In addition, for those five uncontrolled comparables it is not possible to accurately allocate costs between the business activity associated with the relevant transactions and other business activities. Therefore, pursuant to §1.482–1(e)(2)(ii) only the other fifteen uncontrolled comparables may be used to establish an arm's length range.

(iii) Although the data for the fifteen remaining uncontrolled comparables is relatively complete and accurate, there is a significant possibility that some material differences may remain. The district director has determined, for example, that it is likely that there are material differences in the level of technical expertise or in management efficiency. Accordingly, if the comparable profits method is determined to be the best method pursuant to §1.482–1(c), the arm's length range for the controlled transaction may be established only pursuant to paragraph (e)(2)(iii)(B) of this section.

(f) *Scope of review*—(1) *In general.* The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer is other than it would have been had the taxpayer, in the conduct of its affairs, been dealing at arm's length with an uncontrolled taxpayer.

(i) *Intent to evade or avoid tax not a prerequisite.* In making allocations under section 482, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances.

(ii) *Realization of income not a prerequisite*—(A) *In general.* The district director may make an allocation under section 482 even if the income ultimately anticipated from a series of transactions has not been or is never realized. For example, if a controlled taxpayer sells a product at less than an arm's length price to a related taxpayer in one taxable year and the second controlled taxpayer resells the product to an unrelated party in the next taxable year, the district director may make an appropriate allocation to reflect an arm's length price for the sale of the product in the first taxable year, even though the second controlled taxpayer had not realized any gross income from the resale of the product in the first year. Similarly, if a controlled taxpayer lends money to a related taxpayer in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second controlled taxpayer does not realize income during such year. Finally, even if two controlled taxpayers realize an overall loss that is attributable to a particular controlled transaction, an allocation under section 482 is not precluded.

(B) *Example.* The following example illustrates this paragraph (f)(1)(ii).

Example. USSub is a U.S. subsidiary of FP, a foreign corporation. Parent manufactures product X and sells it to USSub. USSub functions as a distributor of product X to unrelated customers in the United States. The fact that FP may incur a loss on the manufacture and sale of product X does not by itself establish that USSub, dealing with FP at arm's length, also would incur a loss. An independent distributor acting at arm's length with its supplier would in many circumstances be expected to earn a profit without regard to the level of profit earned by the supplier.

(iii) *Nonrecognition provisions may not bar allocation*—(A) *In general.* If necessary to prevent the avoidance of taxes or to clearly reflect income, the district director may make an allocation under section 482 with respect to transactions that otherwise qualify for nonrecognition of gain or loss under applicable provisions of the Internal Revenue Code (such as section 351 or 1031).

(B) *Example.* The following example illustrates this paragraph (f)(1)(iii).

Example. (i) In Year 1 USP, a United States corporation, bought 100 shares of UR, an unrelated corporation, for $100,000. In Year 2, when the value of the UR stock had decreased to $40,000, USP contributed all 100 shares of UR stock to its wholly-owned subsidiary in exchange for subsidiary's capital stock. In Year 3, the subsidiary sold all of the UR stock for $40,000 to an unrelated buyer, and on its U.S. income tax return, claimed a loss of $60,000 attributable to the sale of the UR stock. USP and its subsidiary do not file a consolidated return.

(ii) In determining the true taxable income of the subsidiary, the district director may disallow the loss of $60,000 on the ground that the loss was incurred by USP. *National Securities Corp. v Commissioner,* 137 F.2d 600 (3rd Cir. 1943), cert. denied, 320 U.S. 794 (1943).

(iv) *Consolidated returns.* Section 482 and the regulations thereunder apply to all controlled taxpayers, whether the controlled taxpayer files a separate or consolidated U.S. income tax return. If a controlled taxpayer files a separate return, its true separate taxable income will be determined. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer must be determined consistently with the principles of a consolidated return.

(2) *Rules relating to determination of true taxable income.* The following rules must be taken into account in determining the true taxable income of a controlled taxpayer.

(i) *Aggregation of transactions*—(A) *In general.* The combined effect of two or more separate transactions (whether before, during, or after the taxable year under review) may be considered, if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions. Generally, transactions will be aggregated only when they involve related products or services, as defined in § 1.6038A–3(c)(7)(vii).

(B) *Examples.* The following examples illustrate this paragraph (f)(2)(i).

Example 1. P enters into a license agreement with S1, its subsidiary, that permits S1 to use a proprietary manufacturing process and to sell the output from this process throughout a specified region. S1 uses the manufacturing process and sells its output to S2, another subsidiary of P, which in turn resells the output to uncontrolled parties in the specified region. In evaluating the arm's length character of the royalty paid by S1 to P, it may be appropriate to consider the arm's length character of the transfer prices charged by S1 to S2 and the aggregate profits earned by S1 and S2 from the use of the manufacturing process and the sale to uncontrolled parties of the products produced by S1.

Example 2. S1, S2, and S3 are Country Z subsidiaries of U.S. manufacturer P. S1 is the exclusive Country Z distributor of computers manufactured by P. S2 provides marketing services in connection with sales of P computers in Country Z, and in this regard uses significant marketing intangibles provided by P. S3 administers the warranty program with respect to P computers in Country Z, including maintenance and repair services. In evaluating the arm's length character of the transfer price paid by S1 to P, of the fees paid by S2 to P for the use of P marketing intangibles, and of the service fees earned by S2 and S3, it may be appropriate to consider the combined effects of these separate transactions because they are so interrelated that they are most reliably analyzed on an aggregated basis.

Example 3. The facts are the same as in *Example 2.* In addition, U1, U2, and U3 are uncontrolled taxpayers that carry out functions comparable to those of S1, S2, and S3, respectively, with respect to computers produced by unrelated manufacturers. R1, R2, and R3 are a controlled group of taxpayers (unrelated to the P controlled group) that also carry out functions comparable to those of S1, S2, and S3 with respect to computers produced by their common parent. Prices charged to uncontrolled customers of the R group differ from the prices charged to customers of U1, U2, and U3. In determining whether the transactions of U1, U2, and U3, or the transactions of R1, R2, and R3 would provide a more reliable measure of the arm's length result, it is determined that the interrelated R group transactions are more reliable than the wholly independent transactions of U1, U2, and U3, given the interrelationship of the P group transactions.

Example 4. P enters into a license agreement with S1 that permits S1 to use a propriety process for manufacturing product X and to sell product X to uncontrolled parties throughout a specified region. P also sells to S1 product Y which is manufactured by P in the United States, and which is unrelated to product X. Product Y is resold by S1 to uncontrolled parties in the specified region. In evaluating the arm's length character of the royalty paid by S1 to P for the use of the manufacturing process for product X, and the transfer prices charged for unrelated product Y, it would not be appropriate to consider the combined effects of these separate and unrelated transactions.

(ii) *Allocation based on taxpayer's actual transactions*—(A) *In general.* The district director will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the district director may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. In such cases the district director may adjust the consideration charged in the controlled transaction based on the cost or profit of an alternative as adjusted to account for material differences between the alternative and the controlled transaction, but will not restructure the transaction as if the alternative had been adopted by the taxpayer. See §1.482–1(d)(3) (Factors for determining comparability, Contractual terms and Risk); §§1.482–3(e) and 1.482–4(d) (Unspecified methods).

(B) *Example.* The following example illustrates this paragraph (f)(2)(ii).

Example. P and S are controlled taxpayers. P enters into a license agreement with S that permits S to use a proprietary process for manufacturing product X. Using its sales and marketing employees, S sells product X to related and unrelated customers outside the United States. If the license agreement between P and S has economic substance, the district director ordinarily will not restructure the taxpayer's transaction to treat P as if it had elected to exploit directly the manufacturing process. However, the fact that P could have manufactured product X may be taken into account under §1.482–4(d) in determining the arm's length consideration for the controlled transaction. For an example of such an analysis, see *Example* in §1.482–4(d)(2).

(iii) *Multiple year data*—(A) *In general.* The results of a controlled transaction ordinarily will be compared with the results of uncontrolled comparables occurring in the taxable year under review. It may be appropriate, however, to consider data relating to the uncontrolled comparables or the controlled taxpayer for one or more years before or after the year under review. If data relating to uncontrolled comparables from multiple years is used, data relating to the controlled taxpayer for the same years ordinarily must be considered. However, if such data is not available, reliable data from other years, as adjusted under paragraph (d)(2) (Standard of comparability) of this section may be used.

(B) *Circumstances warranting consideration of multiple year data.* The extent to which it is appropriate to consider multiple-year data depends on the method being applied and the issue being addressed. Circumstances that may warrant consideration of data from multiple years include the extent to which complete and accurate data is available for the taxable year under review, the effect of business cycles in the controlled taxpayer's industry, or the effects of life cycles of the product or intangible being examined. Data from one or more years before or after the taxable year under review must ordinarily be considered for purposes of applying the provisions of §1.482–1(d)(3)(iii) (Risk), §1.482–1(d)(4)(i) (Market share strategy), §1.482–4(f)(2) (Periodic adjustments), and §1.482–5 (Comparable profits method). On the other hand, multiple-year data ordinarily will not be considered for purposes of applying the comparable uncontrolled price method (except to the extent that risk or market share strategy issues are present).

(C) *Comparable effect over comparable period.* Data from multiple years may be considered to determine whether the same economic conditions that caused the controlled taxpayer's results had a comparable effect over a comparable period of time on the uncontrolled comparables that establish the arm's length range. For example, given that uncontrolled taxpayers enter into transactions with the ultimate expectation of earning a profit, persistent losses among controlled taxpayers may be an indication of non-arm's length dealings. Thus, if a controlled taxpayer that realizes a loss with respect to a controlled transaction seeks to demonstrate that the loss is within the arm's length range, the district director may take into account data from taxable years other than the taxable year of the transaction to determine whether the loss was attributable to arm's length dealings. The rule of this paragraph (f)(2)(iii)(C) is illustrated by *Example 3* of paragraph (f)(2)(iii)(E) of this section.

(D) *Applications of methods using multiple year averages.* If a comparison of a controlled taxpayer's average result over a multiple year period with the average results of uncontrolled comparables over the same period would reduce the effect of short-term variations that may be unrelated to transfer pricing, it may be appropriate to establish a range derived from the average results of uncontrolled comparables over a multiple year period to determine if an adjustment should be made. In such a case the district director may make an adjustment if the controlled taxpayer's average result for the multiple year period is not within such range. Such a range must be determined in accordance with §1.482–1(e) (Arm's length range). An adjustment in such a case ordinarily will be equal to the difference, if any, between the controlled taxpayer's result for the taxable year and the mid-point of the uncontrolled comparables' results for that year. If the interquartile range is used to determine the range of average results for the multiple year period, such adjustment will ordinarily be made to the median of all the results of the uncontrolled comparables for the taxable year. See *Example 2* of §1.482–5(e). In other cases, the adjustment normally will be made to the arithmetic mean of all the results of the uncontrolled comparables for the taxable year. However, an adjustment will be made only to the extent that it would move the controlled taxpayer's multiple year average closer to the arm's length range for the multiple year period or to any point within such range. In determining a controlled taxpayer's average result for a multiple year period, adjustments made under this section for prior years will be taken into account only if such adjustments have been finally determined, as described in §1.482–1(g)(2)(iii). See *Example 3* of §1.482–5(e).

(E) *Examples.* The following examples, in which S and P are controlled taxpayers, illustrate this paragraph (f)(2)(iii). *Examples 1* and *4* also illustrate the principle of the arm's length range of paragraph (e) of this section.

Example 1. P sold product Z to S for $60 per unit in 1995. Applying the resale price method to data from uncontrolled comparables for the same year establishes an arm's length range of prices for the controlled transaction from $52 to $59 per unit. Since the price charged in the controlled transaction falls outside the range, the district director would ordinarily make an allocation under section 482. However, in this case there are cyclical factors that affect the results of the uncontrolled comparables (and that of the controlled transaction) that cannot be adequately accounted for by specific adjustments to the data for 1995. Therefore, the district director considers results over multiple years to account for these factors. Under these circumstances, it is appropriate to average the results of the uncontrolled comparables over the years 1993, 1994, and 1995 to determine an arm's length range. The averaged results establish an arm's length range of $56 to $58 per unit. For consistency, the results of the controlled taxpayers must also be averaged over the same years. The average price in the controlled transaction over the three years is $57. Because the controlled transfer price of product Z falls within the arm's length range, the district director makes no allocation.

Example 2. (i) FP, a Country X corporation, designs and manufactures machinery in Country X. FP's costs are incurred in Country X currency. USSub is the exclusive distributor of FP's machinery in the United States. The price of the machinery sold by FP to USSub is expressed in Country X currency. Thus, USSub bears all of the currency risk associated with fluctuations in the exchange rate between the time the contract is signed and the payment is made. The prices charged by FP to USSub for 1995 are under examination. In that year, the value of the dollar depreciated against the currency of Country X, and as a result, USSub's gross margin was only 8%.

(ii) UD is an uncontrolled distributor of similar machinery that performs distribution functions substantially the same as those performed by USSub, except that UD purchases and resells machinery in transactions where both the purchase and resale prices are denominated in U.S. dollars. Thus, UD had no currency exchange risk. UD's gross margin in 1995 was 10%. UD's average gross margin for the period 1990 to 1998 has been 12%.

(iii) In determining whether the price charged by FP to USSub in 1995 was arm's length, the district director may consider USSub's average gross margin for an appropriate period before and after 1995 to determine whether USSub's average gross margin during the period was sufficiently greater than UD's average gross margin during the same period such that USSub was sufficiently compensated for the currency risk it bore throughout the period. See §1.482-1(d)(3)(iii) (Risk).

Example 3. FP manufactures product X in Country M and sells it to USSub, which distributes X in the United States. USSub realizes losses with respect to the controlled transactions in each of five consecutive taxable years. In each of the five consecutive years a different uncontrolled comparable realized a loss with respect to comparable transactions equal to or greater than USSub's loss. Pursuant to paragraph (f)(3)(iii)(C) of this section, the district director examines whether the uncontrolled comparables realized similar losses over a comparable period of time, and finds that each of the five comparables realized losses in only one of the five years, and their average result over the five-year period was a profit. Based on this data, the district director may conclude that the controlled taxpayer's results are not within the arm's length range over the five year period, since the economic conditions that resulted in the controlled taxpayer's loss did not have a comparable effect over a comparable period of time on the uncontrolled comparables.

Example 4. (i) USP, a U.S. corporation, manufactures product Y in the United States and sells it to FSub, which acts as USP's exclusive distributor of product Y in Country N. The resale price method described in §1.482–3(c) is used to evaluate whether the transfer price charged by USP to FSub for the 1994 taxable year for product Y was arm's length. For the period 1992 through 1994, FSub had a gross profit margin for each year of 13%. A, B, C and D are uncontrolled distributors of products that compete directly with product Y in country N. After making appropriate adjustments in accordance with §§1.482–1(d)(2) and 1.482–3(c), the gross profit margins for A, B, C, and D are as follows:

	1992	1993	1994	Average
A	13	3	8	8.00
B	11	13	2	8.67
7C	4	7	13	8.00
7D	7	9	6	7.33

(ii) Applying the provisions of §1.482–1(e), the district director determines that the arm's length range of the average gross profit margins is between 7.33 and 8.67. The district director concludes that FSub's average gross margin of 13% is not within the arm's length range, despite the fact that C's gross profit margin for 1994 was also 13%, since the economic conditions that caused S's result did not have a comparable effect over a comparable period of time on the results of C or the other uncontrolled comparables. In this case, the district director makes an allocation equivalent to adjusting FSub's gross profit margin for 1994 from 13% to the mean of the uncontrolled comparables' results for 1994 (7.25%).

(iv) *Product lines and statistical techniques.* The methods described in §§1.482–2 through 1.482–6 are generally stated in terms of individual transactions. However, because a taxpayer may have controlled transactions involving many different products, or many separate transactions involving the same product, it may be impractical to analyze every individual transaction to determine its arm's length price. In such cases, it is permissible to evaluate the arm's length results by applying the appropriate methods to the overall results for product lines or other groupings. In addition, the arm's length results of all related party transactions entered into by a controlled taxpayer may be evaluated by employing sampling and other valid statistical techniques.

(v) *Allocations apply to results, not methods*—(A) *In general.* In evaluating whether the result of a controlled transaction is arm's length, it is not necessary for the district director to determine whether the method or procedure that a controlled taxpayer employs to set the terms for its controlled transactions corresponds to the method or procedure that might have been used by a taxpayer dealing at arm's length with an uncontrolled taxpayer. Rather, the district director will evaluate the result achieved rather than the method the taxpayer used to determine its prices.

(B) *Example.* The following example illustrates this paragraph (f)(2)(v).

Example. (i) FS is a foreign subsidiary of P, a U.S. corporation. P manufactures and sells household appliances. FS operates as P's exclusive distributor in Europe. P annually establishes the price for each of its appliances sold to FS as part of its annual budgeting, production allocation and scheduling, and performance evaluation processes. FS's aggregate gross margin earned in its distribution business is 18%.

(ii) ED is an uncontrolled European distributor of competing household appliances. After adjusting for minor differences in the level of inventory, volume of sales, and warranty programs conducted by FS and ED, ED's aggregate gross margin is also 18%. Thus, the district director may conclude that the aggregate prices charged by P for its appliances sold to FS are arm's length, without determining whether the budgeting, production, and performance evaluation processes of P are similar to such processes used by ED.

(g) *Collateral adjustments with respect to allocations under section 482*—(1) *In general.* The district director will take into account appropriate collateral adjustments with respect to allocations under section 482. Appropriate collateral adjustments may include correlative allocations, conforming adjustments, and setoffs, as described in this paragraph (g).

(2) *Correlative allocations*—(i) *In general.* When the district director makes an allocation under section 482 (referred to in this paragraph (g)(2) as the primary allocation), appropriate correlative allocations will also be made with respect to any other member of the group affected by the allocation. Thus, if the district director makes an allocation of income, the district director will not only increase the income of one member of the group, but correspondingly decrease the income of the other member. In addition, where appropriate, the district director may make such further correlative allocations as may be required by the initial correlative allocation.

(ii) *Manner of carrying out correlative allocation.* The district director will furnish to the taxpayer with respect to which the primary allocation is made a written statement of the amount and nature of the correlative allocation. The correlative allocation must be reflected in the documentation of the other member of the group that is maintained for U.S. tax purposes, without regard to whether it affects the U.S. income tax liability of the other member for any open year. In some circumstances the allocation will have an immediate U.S. tax effect, by changing the taxable income computation of the other member (or the taxable income computation of a shareholder of the other member, for example, under the provisions of subpart F of the Internal Revenue Code). Alternatively, the correlative allocation may not be reflected on any U.S. tax return until a later year, for example when a dividend is paid.

(iii) *Events triggering correlative allocation.* For purposes of this paragraph (g)(2), a primary allocation will not be considered to have been made (and therefore, correlative allocations are not required to be made) until the date of a final determination with respect to the allocation under section 482. For this purpose, a final determination includes—

(A) Assessment of tax following execution by the taxpayer of a Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment) with respect to such allocation;

(B) Acceptance of a Form 870–AD (Offer of Waiver of Restriction on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment);

(C) Payment of the deficiency;

(D) Stipulation in the Tax Court of the United States; or

(E) Final determination of tax liability by offer-in-compromise, closing agreement, or final resolution (determined under the principles of section 7481) of a judicial proceeding.

(iv) *Examples.* The following examples illustrate this paragraph (g)(2). In each example, X and Y are members of the same group of controlled taxpayers and each regularly computes its income on a calendar year basis.

Example 1. (i) In 1996, Y, a U.S. corporation, rents a building owned by X, also a U.S. corporation. In 1998 the district director determines that Y did not pay an arm's length rental charge. The district director proposes to increase X's income to reflect an arm's length rental charge. X consents to the assessment reflecting such adjustment by executing Form 870, a Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment. The assessment of the tax with respect to the adjustment is made in 1998. Thus, the primary allocation, as defined in paragraph (g)(2)(i) of this section, is considered to have been made in 1998.

(ii) The adjustment made to X's income under section 482 requires a correlative allocation with respect to Y's income. The district director notifies X in writing of the amount and nature of the adjustment made with respect to Y. Y had net operating losses in 1993, 1994, 1995, 1996, and 1997. Although a correlative adjustment will not have an effect on Y's U.S. income tax liability for 1996, an adjustment increasing Y's net operating loss for 1996 will be made for purposes of determining Y's U.S. income tax liability for 1998 or a later taxable year to which the increased net operating loss may be carried.

Example 2. (i) In 1995, X, a U.S. construction company, provided engineering services to Y, a U.S. corporation, in the construction of Y's factory. In 1997, the district director determines that the fees paid by Y to X for its services were not arm's length and proposes to make an adjustment to the income of X. X consents to an assessment reflecting such adjustment by executing Form 870. An assessment of the tax with respect to such adjustment is made in 1997. The district director notifies X in writing of the amount and nature of the adjustment to be made with respect to Y.

(ii) The fees paid by Y for X's engineering services properly constitute a capital expenditure. Y does not place the factory into service until 1998. Therefore, a correlative adjustment increasing Y's basis in the factory does not affect Y's U.S. income tax liability for 1997. However, the correlative adjustment must be made in the books and records maintained by Y for its U.S. income tax purposes and such adjustment will be taken into account in computing Y's allowable depreciation or gain or loss on a subsequent disposition of the factory.

Example 3. In 1995, X, a U.S. corporation, makes a loan to Y, its foreign subsidiary not engaged in a U.S. trade or business. In 1997, the district director, upon determining that the interest charged on the loan was not arm's length, proposes to adjust X's income to reflect an arm's length interest rate. X consents to an assessment reflecting such allocation by executing Form 870, and an assessment of the tax with respect to the section 482 allocation is made in 1997. The district director notifies X in writing of the amount and nature of the correlative allocation to be made with respect to Y. Although the correlative adjustment does not have an effect on Y's U.S. income tax liability, the adjustment must be reflected in the documentation of Y that is maintained for U.S. tax purposes. Thus, the adjustment must be reflected in the determination of the amount of Y's earnings and profits for 1995 and subsequent years, and the adjustment must be made to the extent it has an effect on any person's U.S. income tax liability for any taxable year.

(3) *Adjustments to conform accounts to reflect section 482 allocations*—(i) *In general.* Appropriate adjustments must be made to conform a taxpayer's accounts to reflect allocations made under section 482. Such adjustments may include the treatment of an allocated amount as a dividend or a capital contribution (as appropriate), or, in appropriate cases, pursuant to such applicable revenue procedures as may be provided by the Commissioner (see §601.601(d)(2) of this chapter), repayment of the allocated amount without further income tax consequences.

(ii) *Example.* The following example illustrates the principles of this paragraph (g)(3).

Example Conforming cash accounts. (i) USD, a United States corporation, buys Product from its foreign parent, FP. In reviewing USD's income tax return, the district director determines that the arm's length price would have increased USD's taxable income by $5 million. The district director accordingly adjusts USD's income to reflect its true taxable income.

(ii) To conform its cash accounts to reflect the section 482 allocation made by the district director, USD applies for relief under Rev. Proc. 65–17, 1965–1 C.B. 833 (see §601.601(d)(2)(ii)(*b*) of this chapter), to treat the $5 million adjustment as an account receivable from FP, due as of the last day of the year of the transaction, with interest accruing therefrom.

(4) *Setoffs*—(i) *In general.* If an allocation is made under section 482 with respect to a transaction between controlled taxpayers, the district director will also take into account the effect of any other non-arm's length transaction between the same controlled taxpayers in the same taxable year which will result in a setoff against the original section 482 allocation. Such setoff, however, will be taken into account only if the requirements of §1.482–1(g)(4)(ii) are satisfied. If the effect of the setoff is to change the characterization or source of the income or deductions, or otherwise distort taxable income, in such a manner as to affect the U.S. tax liability of any member, adjustments will be made to reflect the correct amount of each category of income or deductions. For purposes of this setoff provision, the term arm's length refers to the amount defined in paragraph (b) (Arm's length standard) of this section, without regard to the rules in §1.482–2 under which certain charges are deemed to be equal to arm's length.

(ii) *Requirements.* The district director will take a setoff into account only if the taxpayer—

(A) Establishes that the transaction that is the basis of the setoff was not at arm's length and the amount of the appropriate arm's length charge;

(B) Documents, pursuant to paragraph (g)(2) of this section, all correlative adjustments resulting from the proposed setoff; and

(C) Notifies the district director of the basis of any claimed setoff within 30 days after the earlier of the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments or the date of the issuance of the notice of deficiency.

(iii) *Examples.* The following examples illustrate this paragraph (g)(4).

Example 1. P, a U.S. corporation, renders services to S, its foreign subsidiary in Country Y, in connection with the construction of S's factory. An arm's length charge for such services determined under § 1.482–2(b) would be $100,000. During the same taxable year P makes available to S the use of a machine to be used in the construction of the factory, and the arm's length rental value of the machine is $25,000. P bills S $125,000 for the services, but does not charge S for the use of the machine. No allocation will be made with respect to the undercharge for the machine if P notifies the district director of the basis of the claimed setoff within 30 days after the date of the letter from the district director transmitting the examination report notifying P of the proposed adjustment, establishes that the excess amount charged for services was equal to an arm's length charge for the use of the machine and that the taxable income and income tax liabilities of P are not distorted, and documents the correlative allocations resulting from the proposed setoff.

Example 2. The facts are the same as in *Example 1,* except that, if P had reported $25,000 as rental income and $25,000 less as service income, it would have been subject to the tax on personal holding companies. Allocations will be made to reflect the correct amounts of rental income and service income.

(h) *Special rules*—(1) *Small taxpayer safe harbor.* [Reserved]

(2) *Effect of foreign legal restrictions*—(i) *In general.* The district director will take into account the effect of a foreign legal restriction to the extent that such restriction affects the results of transactions at arm's length. Thus, a foreign legal restriction will be taken into account only to the extent that it is shown that the restriction affected an uncontrolled taxpayer under comparable circumstances for a comparable period of time. In the absence of evidence indicating the effect of the foreign legal restriction on uncontrolled taxpayers, the restriction will be taken into account only to the extent provided in paragraphs (h)(2) (iii) and (iv) of this section (Deferred income method of accounting).

(ii) *Applicable legal restrictions.* Foreign legal restrictions (whether temporary or permanent) will be taken into account for purposes of this paragraph (h)(2) only if, and so long as, the conditions set forth in paragraphs (h)(2)(ii) (A) through (D) of this section are met.

(A) The restrictions are publicly promulgated, generally applicable to all similarly situated persons (both controlled and uncontrolled), and not imposed as part of a commercial transaction between the taxpayer and the foreign sovereign;

(B) The taxpayer (or other member of the controlled group with respect to which the restrictions apply) has exhausted all remedies prescribed by foreign law or practice for obtaining a waiver of such restrictions (other than remedies that would have a negligible prospect of success if pursued);

(C) The restrictions expressly prevented the payment or receipt, in any form, of part or all of the arm's length amount that would otherwise be required under section 482 (for example, a restriction that applies only to the deductibility of an expense for tax purposes is not a restriction on payment or receipt for this purpose); and

(D) The related parties subject to the restriction did not engage in any arrangement with controlled or uncontrolled parties that had the effect of circumventing the restriction, and have not otherwise violated the restriction in any material respect.

(iii) *Requirement for electing the deferred income method of accounting.* If a foreign legal restriction prevents the payment or receipt of part or all of the arm's length amount that is due with respect to a controlled transaction, the restricted amount may be treated as deferrable if the following requirements are met—

(A) The controlled taxpayer establishes to the satisfaction of the district director that the payment or receipt of the arm's length amount was prevented because of a foreign legal restriction and circumstances described in paragraph (h)(2)(ii) of this section; and

(B) The controlled taxpayer whose U.S. tax liability may be affected by the foreign legal restriction elects the deferred income method of accounting, as described in paragraph (h)(2)(iv) of this section, on a written statement attached to a timely U.S. income tax return (or an amended return) filed before the IRS first contacts any member of the controlled group concerning an examination of the return for the taxable year to which the foreign legal restriction applies. A written statement furnished by a taxpayer subject to the Coordinated Examination Program will be considered an amended return for purposes of this paragraph (h)(2)(iii)(B) if it satisfies the requirements of a qualified amended return for purposes of §1.6664–2(c)(3) as set forth in those regulations or as the Commissioner may prescribe by applicable revenue procedures. The election statement must identify the affected transactions, the parties to the transactions, and the applicable foreign legal restrictions.

(iv) *Deferred income method of accounting.* If the requirements of paragraph (h)(2)(ii) of this section are satisfied, any portion of the arm's length amount, the payment or receipt of which is prevented because of applicable foreign legal restrictions, will be treated as deferrable until payment or receipt of the relevant item ceases to be prevented by the foreign legal restriction. For purposes of the deferred income method of accounting under this paragraph (h)(2)(iv), deductions (including the cost or other basis of inventory and other assets sold or exchanged) and credits properly chargeable against any amount so deferred, are subject to deferral under the provisions of §1.461- 1(a)(4). In addition, income is deferrable under this deferred income method of accounting only to the extent that it exceeds the related deductions already claimed in open taxable years to which the foreign legal restriction applied.

(v) *Examples.* The following examples, in which Sub is a Country FC subsidiary of U.S. corporation, Parent, illustrate this paragraph (h)(2).

Example 1. Parent licenses an intangible to Sub. FC law generally prohibits payments by any person within FC to recipients outside the country. The FC law meets the requirements of paragraph (h)(2)(ii) of this section. There is no evidence of unrelated parties entering into transactions under comparable circumstances for a comparable period of time, and the foreign legal restrictions will not be taken into account in determining the arm's length amount. The arm's length royalty rate for the use of the intangible property in the absence of the foreign restriction is 10% of Sub's sales in country FC. However, because the requirements of paragraph (h)(2)(ii) of this section are satisfied, Parent can elect the deferred income method of accounting by attaching to its timely filed U.S. income tax return a written statement that satisfies the requirements of paragraph (h)(2)(iii)(B) of this section.

Example 2. (i) The facts are the same as in *Example 1,* except that Sub, although it makes no royalty payment to Parent, arranges with an unrelated intermediary to make payments equal to an arm's length amount on its behalf to Parent.

(ii) The district director makes an allocation of royalty income to Parent, based on the arm's length royalty rate of 10%. Further, the district director determines that because the arrangement with the third party had the effect of circumventing the FC law, the requirements of paragraph (h)(2)(ii)(D) of this section are not satisfied. Thus, Parent could not validly elect the deferred income method of accounting, and the allocation of royalty income cannot be treated as deferrable. In appropriate circumstances, the district director may permit the amount of the distribution to be treated as payment by Sub of the royalty allocated to Parent, under the provisions of §1.482–1(g) (Collateral adjustments).

Example 3. The facts are the same as in *Example 1,* except that the laws of FC do not prevent distributions from corporations to their shareholders. Sub distributes an amount equal to 8% of its sales in country FC. Because the laws of FC did not expressly prevent all forms of payment from Sub to Parent, Parent cannot validly elect the deferred income method of accounting with respect to any of the arm's length royalty amount. In appropriate circumstances, the district director may permit the 8% that was distributed to be treated as payment by Sub of the royalty allocated to Parent, under the provisions of § 1.482–1(g) (Collateral adjustments).

Example 4. The facts are the same as in *Example 1,* except that Country FC law permits the payment of a royalty, but limits the amount to 5% of sales, and Sub pays the 5% royalty to Parent. Parent demonstrates the existence of a comparable uncontrolled transaction for purposes of the comparable uncontrolled transaction method in which an uncontrolled party accepted a royalty rate of 5%. Given the evidence of the comparable uncontrolled transaction, the 5% royalty rate is determined to be the arm's length royalty rate.

(3) *Coordination with section 936*—(i) *Cost sharing under section 936.* If a possessions corporation makes an election under section 936(h)(5)(C)(i)(I), the corporation must make a section 936 cost sharing payment that is at least equal to the payment that would be required under section 482 if the electing corporation were a foreign corporation. In determining the payment that would be required under section 482 for this purpose, the provisions of §§ 1.482–1 and 1.482–4 will be applied, and to the extent relevant to the valuation of intangibles, §§ 1.482–5 and 1.482–6 will be applied. The provisions of section 936(h)(5)(C)(i)(II) (Effect of Election—electing corporation treated as owner of intangible property) do not apply until the payment that would be required under section 482 has been determined.

(ii) *Use of terms.* A cost sharing payment, for the purposes of section 936(h)(5)(C)(i)(I), is calculated using the provisions of section 936 and the regulations thereunder and the provisions of this paragraph (h)(3). The provisions relating to cost sharing under section 482 do not apply to payments made pursuant to an election under section 936(h)(5)(C)(i)(I). Similarly, a profit split payment, for the purposes of section 936(h)(5)(C)(ii)(I), is calculated using the provisions of section 936 and the regulations thereunder, not section 482 and the regulations thereunder.

(i) *Definitions.* The definitions set forth in paragraphs (i) (1) through (10) of this section apply to §§ 1.482–1 through 1.482–8.

(1) *Organization* includes an organization of any kind, whether a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation (as each is defined or understood in the Internal Revenue Code or the regulations thereunder), irrespective of the place of organization, operation, or conduct of the trade or business, and regardless of whether it is a domestic or foreign organization, whether it is an exempt organization, or whether it is a member of an affiliated group that files a consolidated U.S. income tax return, or a member of an affiliated group that does not file a consolidated U.S. income tax return.

(2) *Trade* or *business* includes a trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place of operation. Employment for compensation will constitute a separate trade or business from the employing trade or business.

(3) *Taxpayer* means any person, organization, trade or business, whether or not subject to any internal revenue tax.

(4) *Controlled* includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(5) *Controlled taxpayer* means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers. *Uncontrolled taxpayer* means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests.

(6) *Group, controlled group,* and *group of controlled taxpayers* mean the taxpayers owned or controlled directly or indirectly by the same interests.

(7) *Transaction* means any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money, however such transaction is effected, and

whether or not the terms of such transaction are formally documented. A transaction also includes the performance of any services for the benefit of, or on behalf of, another taxpayer.

(8) *Controlled transaction* or *controlled transfer* means any transaction or transfer between two or more members of the same group of controlled taxpayers. The term *uncontrolled transaction* means any transaction between two or more taxpayers that are not members of the same group of controlled taxpayers.

(9) *True taxable income* means, in the case of a controlled taxpayer, the taxable income that would have resulted had it dealt with the other member or members of the group at arm's length. It does not mean the taxable income resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement the controlled taxpayer chose to make (even though such contract, transaction, or arrangement is legally binding upon the parties thereto).

(10) *Uncontrolled comparable* means the uncontrolled transaction or uncontrolled taxpayer that is compared with a controlled transaction or taxpayer under any applicable pricing methodology. Thus, for example, under the comparable profits method, an uncontrolled comparable is any uncontrolled taxpayer from which data is used to establish a comparable operating profit.

(j) *Effective dates*—(1) The regulations in this are generally effective for taxable years beginning after October 6, 1994.

(2) Taxpayers may elect to apply retroactively all of the provisions of these regulations for any open taxable year. Such election will be effective for the year of the election and all subsequent taxable years.

(3) Although these regulations are generally effective for taxable years as stated, the final sentence of section 482 (requiring that the income with respect to transfers or licenses of intangible property be commensurate with the income attributable to the intangible) is generally effective for taxable years beginning after December 31, 1986. For the period prior to the effective date of these regulations, the final sentence of section 482 must be applied using any reasonable method not inconsistent with the statute. The IRS considers a method that applies these regulations or their general principles to be a reasonable method.

(4) These regulations will not apply with respect to transfers made or licenses granted to foreign persons before November 17, 1985, or before August 17, 1986, for transfers or licenses to others. Nevertheless, they will apply with respect to transfers or licenses before such dates if, with respect to property transferred pursuant to an earlier and continuing transfer agreement, such property was not in existence or owned by the taxpayer on such date.

[T.D. 8552, 59 FR 34990, July 8, 1994]

§1.482–2 Determination of taxable income in specific situations.

(a) *Loans or advances*—(1) *Interest on bona fide indebtedness*—(i) *In general.* Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest (as defined in paragraph (a)(2) of this section) with respect to such loan or advance, the district director may make appropriate allocations to reflect an arm's length rate of interest for the use of such loan or advance.

(ii) *Application of paragraph (a) of this section*—(A) *Interest on bona fide indebtedness.* Paragraph (a) of this section applies only to determine the appropriateness of the rate of interest charged on the principal amount of a bona fide indebtedness between members of a group of controlled entities, including—

(*1*) Loans or advances of money or other consideration (whether or not evidenced by a written instrument); and

(*2*) Indebtedness arising in the ordinary course of business from sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit.

(B) *Alleged indebtedness.* This paragraph (a) does not apply to so much of an alleged indebtedness which is not in fact a bona fide indebtedness, even if the stated rate of interest thereon would be within the safe haven rates prescribed in paragraph (a)(2)(iii) of this section. For example, paragraph (a) of this section does not apply to payments with respect to all or a portion of such alleged indebtedness where in fact all or a portion of an alleged indebtedness is a contribution to the capital of a corporation or a distribution by a corporation with respect to its shares. Similarly, this paragraph (a) does not apply to payments with respect to an alleged purchase-money debt instrument given in consideration for an alleged sale of property between two controlled entities where in fact the transaction constitutes a lease of the property. Payments made with respect to alleged indebtedness (including alleged stated interest thereon) shall be treated according to their substance. See § 1.482–2(a)(3)(i).

(iii) *Period for which interest shall be charged*—(A) *General rule.* This paragraph (a)(1)(iii) is effective for indebtedness arising after June 30, 1988. See § 1.482–2(a)(3) (26 CFR Part 1 edition revised as of April 1, 1988) for indebtedness arising before July 1, 1988. Except as otherwise provided in paragraphs (a)(1)(iii)(B) through (E) of this section, the period for which interest shall be charged with respect to a bona fide indebtedness between controlled entities begins on the day after the day the indebtedness arises and ends on the day the indebtedness is satisfied (whether by payment, offset, cancellation, or otherwise). Paragraphs (a)(1)(iii)(B) through (E) of this section provide certain alternative periods during which interest is not required to be charged on certain indebtedness. These exceptions apply only to indebtedness described in paragraph (a)(1)(ii)(A)(2) of this section (relating to indebtedness incurred in the ordinary course of business from sales, services, etc., between members of the group) and not evidenced by a written instrument requiring the payment of interest. Such amounts are hereinafter referred to as intercompany trade receivables. The period for which interest is not required to be charged on intercompany trade receivables under this paragraph (a)(1)(iii) is called the interest-free period. In general, an intercompany trade receivable arises at the time economic performance occurs (within the meaning of section 461(h) and the regulations thereunder) with respect to the underlying transaction between controlled entities. For purposes of this paragraph (a)(1)(iii), the term United States includes any possession of the United States, and the term foreign country excludes any possession of the United States.

(B) *Exception for certain intercompany transactions in the ordinary course of business.* Interest is not required to be charged on an intercompany trade receivable until the first day of the third calendar month following the month in which the intercompany trade receivable arises.

(C) *Exception for trade or business of debtor member located outside the United States.* In the case of an intercompany trade receivable arising from a transaction in the ordinary course of a trade or business which is actively conducted outside the United States by the debtor member, interest is not required to be charged until the first day of the fourth calendar month following the month in which such intercompany trade receivable arises.

(D) *Exception for regular trade practice of creditor member or others in creditor's industry*. If the creditor member or unrelated persons in the creditor member's industry, as a regular trade practice, allow unrelated parties a longer period without charging interest than that described in paragraph (a)(1)(iii)(B) or (C) of this section (whichever is applicable) with respect to transactions which are similar to transactions that give rise to intercompany trade receivables, such longer interest-free period shall be allowed with respect to a comparable amount of intercompany trade receivables.

(E) *Exception for property purchased for resale in a foreign country—(1) General rule.* If in the ordinary course of business one member of the group (related purchaser) purchases property from another member of the group (related seller) for resale to unrelated persons located in a particular foreign country, the related purchaser and the related seller may use as the interest-free period for the intercompany trade receivables arising during the related seller's taxable year from the purchase of such property within the same product group an interest-free period equal the sum of—

(*i*) The number of days in the related purchaser's average collection period (as determined under paragraph (a)(1)(iii)(E)(*2*) of this section) for sales of property within the same product group sold in the ordinary course of business to unrelated persons located in the same foreign country; plus

(*ii*) Ten (10) calendar days.

(*2*) *Interest-free period.* The interest-free period under this paragraph (a)(1)(iii)(E), however, shall in no event exceed 183 days. The related purchaser does not have to conduct business outside the United States in order to be eligible to use the interest-free period of this paragraph (a)(1)(iii)(E). The interest-free period under this paragraph (a)(1)(iii)(E) shall not apply to intercompany trade receivables attributable to property which is manufactured, produced, or constructed (within the meaning of §1.954–3(a)(4)) by the related purchaser. For purposes of this paragraph (a)(1)(iii)(E) a product group includes all products within the same three-digit Standard Industrial Classification (SIC) Code (as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.)

(*3*) *Average collection period.* An average collection period for purposes of this paragraph (a)(1)(iii)(E) is determined as follows—

(*i*) *Step 1.* Determine total sales (less returns and allowances) by the related purchaser in the product group to unrelated persons located in the same foreign country during the related purchaser's last taxable year ending on or before the first day of the related seller's taxable year in which the intercompany trade receivable arises.

(*ii*) *Step 2.* Determine the related purchaser's average month-end accounts receivable balance with respect to sales described in paragraph (a)(1)(iii)(E)(*2*)(*i*) of this section for the related purchaser's last taxable year ending on or before the first day of the related seller's taxable year in which the intercompany trade receivable arises.

(*iii*) *Step 3.* Compute a receivables turnover rate by dividing the total sales amount described in paragraph (a)(1)(iii)(E)(*2*)(*i*) of this section by the average receivables balance described in paragraph (a)(1)(iii)(E)(*2*)(*ii*) of this section.

(*iv*) *Step 4.* Divide the receivables turnover rate determined under paragraph (a)(1)(iii)(E)(*2*)(*iii*) of this section into 365, and round the result to the nearest whole number to determine the number of days in the average collection period.

(*v*) *Other considerations.* If the related purchaser makes sales in more than one foreign country, or sells property in more than one product group in any foreign country, separate computations of an average collection period, by product group within each country, are required. If the related purchaser resells fungible property in more than one foreign country and the intercompany trade receivables arising from the related party purchase of such fungible property cannot reasonably be identified with resales in particular foreign countries, then solely for the purpose of assigning an interest-free period to such intercompany trade receivables under this paragraph (a)(1)(iii)(E), an amount of each such intercompany trade receivable shall be treated as allocable to a particular foreign country in the same proportion that the related purchaser's sales of such fungible property in such foreign country during the period described in paragraph (a)(1)(iii)(E)(2)(i) of this section bears to the related purchaser's sales of all such fungible property in all such foreign countries during such period. An interest-free period under this paragraph (a)(1)(iii)(E) shall not apply to any intercompany trade receivables arising in a taxable year of the related seller if the related purchaser made no sales described in paragraph (a)(1)(iii)(E)(2)(i) of this section from which the appropriate interest-free period may be determined.

(*4*) *Illustration*. The interest-free period provided under paragraph (a)(1)(iii)(E) of this section may be illustrated by the following example:

Example—(i) Facts. X and Y use the calendar year as the taxable year and are members of the same group of controlled entities within the meaning of section 482. For Y's 1988 calendar taxable year X and Y intend to use the interest-free period determined under this paragraph (a)(1)(iii)(E) for intercompany trade receivables attributable to X's purchases of certain products from Y for resale by X in the ordinary course of business to unrelated persons in country Z. For its 1987 calendar taxable year all of X's sales in country Z were of products within a single product group based upon a three-digit SIC code, were not manufactured, produced, or constructed (within the meaning of § 1.954–3(a)(4)) by X, and were sold in the ordinary course of X's trade or business to unrelated persons located only in country Z. These sales and the month-end accounts receivable balances (for such sales and for such sales uncollected from prior months) are as follows:

Month	Sales	Accounts receivable
Jan. 1987	$500,000	$2,835,850
Feb.	600,000	2,840,300
Mar.	450,000	2,850,670
Apr.	550,000	2,825,700
May.	650,000	2,809,360
June	525,000	2,803,200
July	400,000	2,825,850
Aug.	425,000	2,796,240
Sept.	475,000	2,839,390
Oct.	525,000	2,650,550
Nov.	450,000	2,775,450
Dec. 1987	650,000	2,812,600
Totals	6,200,000	33,665,160

(ii) *Average collection period.* X's total sales within the same product group to unrelated persons within country Z for the period are $6,200,000. The average receivables balance for the period is $2,805,430 ($33,665,160/12). The average collection period in whole days is determined as follows:

$$\text{Receivables Turnover Rate} = \frac{\$6{,}200{,}000}{\$2{,}805{,}430} = 2.21$$

$$\begin{array}{c}\text{Average Collection}\\ \text{Period}\end{array} = \frac{365}{2.21} = \begin{array}{c}\text{165.16 days, rounded to the}\\ \text{nearest whole day} = 165\text{ days.}\end{array}$$

(iii) *Interest-free period.* Accordingly, for intercompany trade receivables incurred by X during Y's 1988 calendar taxable year attributable to the purchase of property from Y for resale to unrelated persons located in country Z and included in the product group, X may use an interest-free period of 175 days (165 days in the average collection period plus 10 days, but not in excess of a maximum of 183 days). All other intercompany trade receivables incurred by X are subject to the interest-free periods described in paragraphs (a)(1)(iii) (B), (C), or (D), whichever are applicable. If X makes sales in other foreign countries in addition to country Z or makes sales of property in more than one product group in any foreign country, separate computations of X's average collection period, by product group within each country, are required in order for X and Y to determine an interest-free period for such product groups in such foreign countries under this paragraph (a)(1)(iii)(E).

(iv) *Payment; book entries*—(A) Except as otherwise provided in this paragraph (a)(1)(iv), in determining the period of time for which an amount owed by one member of the group to another member is outstanding, payments or other credits to an account are considered to be applied against the earliest amount outstanding, that is, payments or credits are applied against amounts in a first-in, first-out (FIFO) order. Thus, tracing payments to individual intercompany trade receivables is generally not required in order to determine whether a particular intercompany trade receivable has been paid within the applicable interest-free period determined under paragraph (a)(1)(iii) of this section. The application of this paragraph (a)(1)(iv)(A) may be illustrated by the following example:

Example—(i) Facts. X and Y are members of a group of controlled entities within the meaning of section 482. Assume that the balance of intercompany trade receivables owed by X to Y on June 1 is $100, and that all of the $100 balance represents amounts incurred by X to Y during the month of May. During the month of June X incurs an additional $200 of intercompany trade receivables to Y. Assume that on July 15, $60 is properly credited against X's intercompany account to Y, and that $240 is properly credited against the intercompany account on August 31. Assume that under paragraph (a)(1)(iii)(B) of this section interest must be charged on X's intercompany trade receivables to Y beginning with the first day of the third calendar month following the month the intercompany trade receivables arise, and that no alternative interest-free period applies. Thus, the interest-free period for intercompany trade receivables incurred during the month of May ends on July 31, and the interest-free period for intercompany trade receivables incurred during the month of June ends on August 31.

(ii) *Application of payments.* Using a FIFO payment order, the aggregate payments of $300 are applied first to the opening June balance, and then to the additional amounts incurred during the month of June. With respect to X's June opening balance of $100, no interest is required to be accrued on $60 of such balance paid by X on July 15, because such portion was paid within its interest-free period. Interest for 31 days, from August 1 to August 31 inclusive, is required to be accrued on the $40 portion of the opening balance not paid until August 31. No interest is required to be accrued on the $200 of intercompany trade receivables X incurred to Y during June because the $240 credited on August 31, after eliminating the $40 of indebtedness remaining from periods before June, also eliminated the $200 incurred by X during June prior to the end of the interest-free period for that amount. The amount of interest incurred by X to Y on the $40 amount during August creates bona fide indebtedness between controlled entities and is subject to the provisions of paragraph (a)(1)(iii)(A) of this section without regard to any of the exceptions contained in paragraphs (a)(1)(iii)(B) through (E).

(B) Notwithstanding the first-in, first-out payment application rule described in paragraph (a)(1)(iv)(A) of this section, the taxpayer may apply payments or credits against amounts owed in some other order on its books in accordance with an agreement or understanding of the related parties if the taxpayer can demonstrate that either it or others in its industry, as a regular trade practice, enter into such agreements or understandings in the case of similar balances with unrelated parties.

(2) *Arm's length interest rate*—(i) *In general.* For purposes of section 482 and paragraph (a) of this section, an arm's length rate of interest shall be a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. All relevant factors shall be considered, including the principal amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties.

(ii) *Funds obtained at situs of borrower.* Notwithstanding the other provisions of paragraph (a)(2) of this section, if the loan or advance represents the proceeds of a loan obtained by the lender at the situs of the borrower, the arm's length rate for any taxable year shall be equal to the rate actually paid by the lender increased by an amount which reflects the costs or deductions incurred by the lender in borrowing such amounts and making such loans, unless the taxpayer establishes a more appropriate rate under the standards set forth in paragraph (a)(2)(i) of this section.

(iii) *Safe haven interest rates for certain loans and advances made after May 8, 1986*—(A) *Applicability*—(*1*) *General rule.* Except as otherwise provided in paragraph (a)(2) of this section, paragraph (a)(2)(iii)(B) applies with respect to the rate of interest charged and to the amount of interest paid or accrued in any taxable year—

(*i*) Under a term loan or advance between members of a group of controlled entities where (except as provided in paragraph (a)(2)(iii)(A)(*2*)(*ii*) of this section) the loan or advance is entered into after May 8, 1986; and

(*ii*) After May 8, 1986 under a demand loan or advance between such controlled entities.

(*2*) *Grandfather rule for existing loans.* The safe haven rates prescribed in paragraph (a)(2)(iii)(B) of this section shall not apply, and the safe haven rates prescribed in §1.482–2(a)(2)(iii) (26 CFR part 1 edition revised as of April 1, 1985), shall apply to—

(*i*) Term loans or advances made before May 9, 1986; and

(*ii*) Term loans or advances made before August 7, 1986, pursuant to a binding written contract entered into before May 9, 1986.

(B) *Safe haven interest rate based on applicable Federal rate.* Except as otherwise provided in this paragraph (a)(2), in the case of a loan or advance between members of a group of controlled entities, an arm's length rate of interest referred to in paragraph (a)(2)(i) of this section shall be for purposes of chapter 1 of the Internal Revenue Code—

(*1*) The rate of interest actually charged if that rate is—

(*i*) Not less than 100 percent of the applicable Federal rate (lower limit); and

(*ii*) Not greater than 130 percent of the applicable Federal rate (upper limit); or

(*2*) If either no interest is charged or if the rate of interest charged is less than the lower limit, then an arm's length rate of interest shall be equal to the lower limit, compounded semiannually; or

(*3*) If the rate of interest charged is greater than the upper limit, then an arm's length rate of interest shall be equal to the upper limit, compounded semiannually, unless the taxpayer establishes a more appropriate compound rate of interest under paragraph (a)(2)(i) of this section. However, if the compound rate of interest actually charged is greater than the upper limit and less than the rate determined under paragraph (a)(2)(i) of this section, or if the compound rate actually charged is less than the lower limit and greater than the rate determined under paragraph (a)(2)(i) of this section, then the compound rate actually charged shall be deemed to be an arm's length rate under paragraph (a)(2)(i). In the case of any sale-leaseback described in section 1274(e), the lower limit shall be 110 percent of the applicable Federal rate, compounded semiannually.

(C) *Applicable Federal rate.* For purposes of paragraph (a)(2)(iii)(B) of this section, the term applicable Federal rate means, in the case of a loan or advance to which this section applies and having a term of—

(*1*) Not over 3 years, the Federal short-term rate;

(*2*) Over 3 years but not over 9 years, the Federal mid-term rate; or

(*3*) Over 9 years, the Federal long-term rate, as determined under section 1274(d) in effect on the date such loan or advance is made. In the case of any sale or exchange between controlled entities, the lower limit shall be the lowest of the applicable Federal rates in effect for any month in the 3-calendar- month period ending with the first calendar month in which there is a binding written contract in effect for such sale or exchange (lowest 3-month rate, as defined in section 1274(d)(2)). In the case of a demand loan or advance to which this section applies, the applicable Federal rate means the Federal short-term rate determined under section 1274(d) (determined without regard to the lowest 3-month short term rate determined under section 1274(d)(2)) in effect for each day on which any amount of such loan or advance (including unpaid accrued interest determined under paragraph (a)(2) of this section) is outstanding.

(D) *Lender in business of making loans.* If the lender in a loan or advance transaction to which paragraph (a)(2) of this section applies is regularly engaged in the trade or business of making loans or advances to unrelated parties, the safe haven rates prescribed in paragraph (a)(2)(iii)(B) of this section shall not apply, and the arm's length interest rate to be used shall be determined under the standards described in paragraph (a)(2)(i) of this section, including reference to the interest rates charged in such trade or business by the lender on loans or advances of a similar type made to unrelated parties at and about the time the loan or advance to which paragraph (a)(2) of this section applies was made.

(E) *Foreign currency loans.* The safe haven interest rates prescribed in paragraph (a)(2)(iii)(B) of this section do not apply to any loan or advance the principal or interest of which is expressed in a currency other than U.S. dollars.

(3) *Coordination with interest adjustments required under certain other Code sections.* If the stated rate of interest on the stated principal amount of a loan or advance between controlled entities is subject to adjustment under section 482 and is also subject to adjustment under any other section of

the Internal Revenue Code (for example, section 467, 483, 1274 or 7872), section 482 and paragraph (a) of this section may be applied to such loan or advance in addition to such other Internal Revenue Code section. After the enactment of the Tax Reform Act of 1964, Pub. L. 98–369, and the enactment of Pub. L. 99–121, such other Internal Revenue Code sections include sections 467, 483, 1274 and 7872. The order in which the different provisions shall be applied is as follows—

(i) First, the substance of the transaction shall be determined; for this purpose, all the relevant facts and circumstances shall be considered and any law or rule of law (assignment of income, step transaction, etc.) may apply. Only the rate of interest with respect to the stated principal amount of the bona fide indebtedness (within the meaning of paragraph (a)(1) of this section), if any, shall be subject to adjustment under section 482, paragraph (a) of this section, and any other Internal Revenue Code section.

(ii) Second, the other Internal Revenue Code section shall be applied to the loan or advance to determine whether any amount other than stated interest is to be treated as interest, and if so, to determine such amount according to the provisions of such other Internal Revenue Code section.

(iii) Third, whether or not the other Internal Revenue Code section applies to adjust the amounts treated as interest under such loan or advance, section 482 and paragraph (a) of this section may then be applied by the district director to determine whether the rate of interest charged on the loan or advance, as adjusted by any other Code section, is greater or less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.

(iv) Fourth, section 482 and paragraphs (b) through (d) of this section and §§1.482–3 through 1.482–7, if applicable, may be applied by the district director to make any appropriate allocations, other than an interest rate adjustment, to reflect an arm's length transaction based upon the principal amount of the loan or advance and the interest rate as adjusted under paragraph (a)(3) (i), (ii) or (iii) of this section. For example, assume that two commonly controlled taxpayers enter into a deferred payment sale of tangible property and no interest is provided, and assume also that section 483 is applied to treat a portion of the stated sales price as interest, thereby reducing the stated sales price. If after this recharacterization of a portion of the stated sales price as interest, the recomputed sales price does not reflect an arm's length sales price under the principles of §1.482–3, the district director may make other appropriate allocations (other than an interest rate adjustment) to reflect an arm's length sales price.

(4) *Examples.* The principles of paragraph (a)(3) of this section may be illustrated by the following examples:

Example 1. An individual, A, transfers $20,000 to a corporation controlled by A in exchange for the corporation's note which bears adequate stated interest. The district director recharacterizes the transaction as a contribution to the capital of the corporation in exchange for preferred stock. Under paragraph (a)(3)(i) of this section, section 1.482–2(a) does not apply to the transaction because there is no bona fide indebtedness.

Example 2. B, an individual, is an employee of Z corporation, and is also the controlling shareholder of Z. Z makes a term loan of $15,000 to B at a rate of interest that is less than the applicable Federal rate. In this instance the other operative Code section is section 7872. Under section 7872(b), the difference between the amount loaned and the present value of all payments due under the loan using a discount rate equal to 100 percent of the applicable Federal rate is treated as an amount of cash transferred from the corporation to B and the loan is treated as having original issue discount equal to such amount. Under paragraph (a)(3)(iii) of this section, section 482 and paragraph (a) of this section may also be applied by the district director to determine if the rate of interest charged on this $15,000 loan (100 percent of the AFR, compounded semiannually, as adjusted by section 7872) is an arm's length rate of interest. Because the rate of interest on the loan, as adjusted by section 7872, is within the safe haven range of 100–130 percent of the AFR, compounded semiannually, no further interest rate adjustments under section 482 and paragraph (a) of this section will be made to this loan.

Example 3. The facts are the same as in Example 2 except that the amount lent by Z to B is $9,000, and that amount is the aggregate outstanding amount of loans between Z and B. Under the $10,000 de minimis exception of section 7872(c)(3), no adjustment for interest will be made to this $9,000 loan under section 7872. Under paragraph (a)(3)(iii) of this section, the district director may apply section 482 and paragraph (a) of this section to this $9,000 loan to determine whether the rate of interest charged is less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.

Example 4. X and Y are commonly controlled taxpayers. At a time when the applicable Federal rate is 12 percent, compounded semiannually, X sells property to Y in exchange for a note with a stated rate of interest of 18 percent, compounded semiannually. Assume that the other applicable Code section to the transaction is section 483. Section 483 does not apply to this transaction because, under section 483(d), there is no total unstated interest under the contract using the test rate of interest equal to 100 percent of the applicable Federal rate. Under paragraph (a)(3)(iii) of this section, section 482 and paragraph (a) of this section may be applied by the district director to determine whether the rate of interest under the note is excessive, that is, to determine whether the 18 percent stated interest rate under the note exceeds an arm's length rate of interest.

Example 5. Assume that A and B are commonly controlled taxpayers and that the applicable Federal rate is 10 percent, compounded semiannually. On June 30, 1986, A sells property to B and receives in exchange B's purchase-money note in the amount of $2,000,000. The stated interest rate on the note is 9%, compounded semiannually, and the stated redemption price at maturity on the note is $2,000,000. Assume that the other applicable Code section to this transaction is section 1274. As provided in section 1274A(a) and (b), the discount rate for purposes of section 1274 will be nine percent, compounded semiannually, because the stated principal amount of B's note does not exceed $2,800,000. Section 1274 does not apply to this transaction because there is adequate stated interest on the debt instrument using a discount rate equal to 9%, compounded semiannually, and the stated redemption price at maturity does not exceed the stated principal amount. Under paragraph (a)(3)(iii) of this section, the district director may apply section 482 and paragraph (a) of this section to this $2,000,000 note to determine whether the 9% rate of interest charged is less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.

(b) *Performance of services for another*—(1) *General rule.* Where one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit of, or on behalf of another member of the group without charge, or at a charge which is not equal to an arm's length charge as defined in paragraph (b)(3) of this section, the district director may make appropriate allocations to reflect an arm's length charge for such services.

(2) *Benefit test*—(i) Allocations may be made to reflect arm's length charges with respect to services undertaken for the joint benefit of the members of a group of controlled entities, as well as with respect to services performed by one member of the group exclusively for the benefit of another member of the group. Any allocations made shall be consistent with the relative benefits intended from the services, based upon the facts known at the time the services were rendered, and shall be made even if the potential benefits anticipated are not realized. No allocations shall be made if the probable benefits to the other members were so indirect or remote that unrelated parties would not have charged for such services. In general, allocations may be made if the service, at the time it was performed, related to the carrying on of an activity by another member or was intended to benefit another member, either in the member's overall operations or in its day-to-day activities. The principles of this paragraph (b)(2)(i) may be illustrated by the following examples in each of which it is assumed that X and Y are corporate members of the same group of controlled entities:

Example 1. X's International Division engages in a wide range of sales promotion activities. Although most of these activities are undertaken exclusively for the benefit of X's international operations, some are intended to jointly benefit both X and Y and others are undertaken exclusively for the benefit of Y. The district director may make an allocation to reflect an arm's length charge with respect to the activities undertaken for the joint benefit of X and Y consistent with the relative benefits intended as well as with respect to the services performed exclusively for the benefit of Y.

Example 2. X operates an international airline, and Y owns and operates hotels in several cities which are serviced by X. X, in conjunction with its advertising of the airline, often pictures Y's hotels and mentions Y's name. Although such advertising was primarily intended to benefit X's airline operations, it was reasonable to anticipate that there would be substantial benefits to Y resulting from patronage by travelers who responded to X's advertising. Since an unrelated hotel operator would have been charged for such advertising, the district director may make an appropriate allocation to reflect an arm's length charge consistent with the relative benefits intended.

Example 3. Assume the same facts as in Example 2 except that X's advertising neither mentions nor pictures Y's hotels. Although it is reasonable to anticipate that increased air travel attributable to X's advertising will result in some benefit to Y due to increased patronage by air travelers, the district director will not make an allocation with respect to such advertising since the probable benefit to Y was so indirect and remote that an unrelated hotel operator would not have been charged for such advertising.

(ii) Allocations will generally not be made if the service is merely a duplication of a service which the related party has independently performed or is performing for itself. In this connection, the ability to independently perform the service (in terms of qualification and availability of personnel) shall be taken into account. The principles of this paragraph (b)(2)(ii) may be illustrated by the following examples, in each of which it is assumed that X and Y are corporate members of the same group of controlled entities:

Example 1. At the request of Y, the financial staff of X makes an analysis to determine the amount and source of the borrowing needs of Y. Y does not have personnel qualified to make the analysis, and it does not undertake the same analysis. The district director may make an appropriate allocation to reflect an arm's length charge for such analysis.

Example 2. Y, which has a qualified financial staff, makes an analysis to determine the amount and source of its borrowing needs. Its report, recommending a loan from a bank, is submitted to X. X's financial staff reviews the analysis to determine whether X should advise Y to reconsider its plan. No allocation should be made with respect to X's review.

(3) *Arm's length charge.* For the purpose of this paragraph an arm's length charge for services rendered shall be the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts. However, except in the case of services which are an integral part of the business activity of either the member rendering the services or the member receiving the benefit of the services (as described in paragraph (b)(7) of this section) the arm's length charge shall be deemed equal to the costs or deductions incurred with respect to such services by the member or members rendering such services unless the taxpayer establishes a more appropriate charge under the standards set forth in the first sentence of this subparagraph. Where costs or deductions are a factor in applying the provisions of this paragraph adequate books and records must be maintained by taxpayers to permit verification of such costs or deductions by the Internal Revenue Service.

(4) *Costs or deductions to be taken into account*—(i) Where the amount of an arm's length charge for services is determined with reference to the costs or deductions incurred with respect to such services, it is necessary to take into account on some reasonable basis all the costs or deductions which are directly or indirectly related to the service performed.

(ii) Direct costs or deductions are those identified specifically with a particular service. These include, but are not limited to, costs or deductions for compensation, bonuses, and travel expenses attributable to employees directly engaged in performing such services, for material and supplies directly consumed in rendering such services, and for other costs such as the cost of overseas cables in connection with such services.

(iii) Indirect costs or deductions are those which are not specifically identified with a particular activity or service but which relate to the direct costs referred to in paragraph (b)(4)(ii) of this section. Indirect costs or deductions generally include costs or deductions with respect to utilities, occupancy, supervisory and clerical compensation, and other overhead burden of the department incurring the direct costs or deductions referred to in paragraph (b)(4)(ii) of this section. Indirect costs or deductions also generally include an appropriate share of the costs or deductions relating to supporting departments and other applicable general and administrative expenses to the extent reasonably allocable to a particular service or activity. Thus, for example, if a domestic corporation's advertising department performs services for the direct benefit of a foreign subsidiary, in addition to direct costs of such department, such as salaries of employees and fees paid to advertising agencies or consultants, which are attributable to such foreign advertising, indirect costs must be taken into account on some reasonable basis in determining the amount of costs or deductions with respect to which the arm's length charge to the foreign subsidiary is to be determined. These generally include depreciation, rent, property taxes, other costs of occupancy, and other overhead costs of the advertising department itself, and allocations of costs from other departments which service the advertising department, such as the personnel, accounting, payroll, and maintenance departments, and other applicable general and administrative expenses including compensation of top management.

(5) *Costs and deductions not to be taken into account.* Costs or deductions of the member rendering the services which are not to be taken into account in determining the amount of an arm's length charge for services include—

(i) Interest expense on indebtedness not incurred specifically for the benefit of another member of the group;

(ii) Expenses associated with the issuance of stock and maintenance of shareholder relations; and

(iii) Expenses of compliance with regulations or policies imposed upon the member rendering the services by its government which are not directly related to the service in question.

(6) *Methods*—(i) Where an arm's length charge for services rendered is determined with reference to costs or deductions, and a member has allocated and apportioned costs or deductions to reflect arm's length charges by employing in a consistent manner a method of allocation and apportionment which is reasonable and in keeping with sound accounting practice, such method will not be disturbed. If the member has not employed a method of allocation and apportionment which is reasonable and in keeping with sound accounting practice, the method of allocating and apportioning costs or deductions for the purpose of determining the amount of arm's length charges shall be based on the particular circumstances involved.

(ii) The methods of allocation and apportionment referred to in this paragraph (b)(6) are applicable both in allocating and apportioning indirect costs to a particular activity or service (see paragraph (b)(4)(iii) of this section) and in allocating and apportioning the total costs (direct and indirect) of a particular activity or service where such activity or service is undertaken for the joint benefit of two or more members of a group (see paragraph (b)(2)(i) of this section). While the use of one or more bases may be appropriate under the circumstances, in establishing the method of allocation and apportionment, appropriate consideration should be given to all bases and factors, including, for example, total expenses, asset size, sales, manufacturing expenses, payroll, space utilized, and time spent. The costs incurred by supporting departments may be apportioned to other departments on the basis of reasonable overall estimates, or such costs may be reflected in the other departments' costs by means of application of reasonable departmental overhead rates Allocations and apportionments of costs or deductions must be made on the basis of the full cost as opposed to the incremental cost. Thus, if an electronic data processing machine, which is rented by the taxpayer, is used for the joint benefit of itself and other members of a controlled group, the determination of the arm's length charge to each member must be made with reference to the full rent and cost of operating the machine by each member, even if the additional use of the machine for the benefit of the other members did not increase the cost to the taxpayer.

(iii) Practices actually employed to apportion costs or expenses in connection with the preparation of statements and analyses for the use of management, creditors, minority shareholders, joint venturers, clients, customers, potential investors, or other parties or agencies in interest shall be considered by the district director. Similarly, in determining the extent to which allocations are to be made to or from foreign members of a controlled group, practices employed by the domestic members of a controlled group in apportioning costs between themselves shall also be considered if the relationships with the foreign members of the group are comparable to the relationships between the domestic members of the group. For example, if, for purposes of reporting to public stockholders or to a governmental agency, a corporation apportions the costs attributable to its executive officers among the domestic members of a controlled group on a reasonable and consistent basis, and such officers exercise comparable control over foreign members of such group, such domestic apportionment practice will be taken into consideration in determining the amount of allocations to be made to the foreign members.

(7) *Certain services.* An arm's length charge shall not be deemed equal to costs or deductions with respect to services which are an integral part of the business activity of either the member rendering the services (referred to in this paragraph (b) as the renderer) or the member receiving the benefit of the services (referred to in this paragraph (b) as the recipient). Paragraphs (b)(7)(i) through (b)(7)(iv) of this section describe those situations in which services shall be considered an integral part of the business activity of a member of a group of controlled entities.

(i) Services are an integral part of the business activity of a member of a controlled group where either the renderer or the recipient is engaged in the trade or business of rendering similar services to one or more unrelated parties.

(ii) (A) Services are an integral part of the business activity of a member of a controlled group where the renderer renders services to one or more related parties as one of its principal activities. Except in the case of services which constitute a manufacturing, production, extraction, or construction activity, it will be presumed that the renderer does not render services to related parties as one of its principal activities if the cost of services of the renderer attributable to the rendition of services for the taxable year to related parties does not exceed 25 percent of the total costs or deductions of the renderer for the taxable year. Where the cost of services rendered to related parties is in excess of 25 percent of the total costs or deductions of the renderer for the taxable year or where the 25-percent test does not apply, the determination of whether the rendition of such services is one of the principal activities of the renderer will be based on the facts and circumstances of each particular case. Such facts and circumstances may include the time devoted to the rendition of the services, the relative cost of the services, the regularity with which the services are rendered, the amount of capital investment, the risk of loss involved, and whether the services are in the nature of supporting services or independent of the other activities of the renderer.

(B) For purposes of the 25-percent test provided in this paragraph (b)(7)(ii), the cost of services rendered to related parties shall include all costs or deductions directly or indirectly related to the rendition of such services including the cost of services which constitute a manufacturing, production, extraction, or construction activity; and the total costs or deductions of the renderer for the taxable year shall exclude amounts properly reflected in the cost of goods sold of the renderer. Where any of the costs or deductions of the renderer do not reflect arm's length consideration and no adjustment is made under any provision of the Internal Revenue Code to reflect arm's length consideration, the 25-percent test will not apply if, had an arm's length charge been made, the costs or deductions attributable to the renderer's rendition of services to related entities would exceed 25 percent of the total costs or deductions of the renderer for the taxable year.

(C) For purposes of the 25-percent test in this paragraph (b)(7)(ii), a consolidated group (as defined in this paragraph (b)(7)(ii)(C)) may, at the option of the taxpayer, be considered as the renderer where one or more members of the consolidated group render services for the benefit of or on behalf of a related party which is not a member of the consolidated group. In such case, the cost of services rendered by members of the consolidated group to any related parties not members of the consolidated group, as well as the total costs or deductions of the members of the consolidated group, shall be considered in the aggregate to determine if such services constitute a principal activity of the renderer. Where a consolidated group is considered the renderer in accordance with this paragraph (b)(7)(ii)(C), the costs or deductions referred to in this paragraph (b)(7)(ii) shall not include costs or deductions paid or accrued to any member of the consolidated group. In addition to the preceding provisions of this paragraph (b)(7)(ii)(C), if part or all of the services rendered by a member of a consolidated group to any related party not a member of the consolidated group are similar to services rendered by any other member of the consolidated group to unrelated parties as part of a trade or business, the 25-percent test in this paragraph (b)(7)(ii) shall be applied with respect to such similar services without regard to this paragraph (b)(7)(ii)(C). For purposes of this paragraph (b)(7)(ii)(C), the term consolidated group means all members of a group of controlled entities created or organized within a single country and subjected to an income tax by such country on the basis of their combined income.

(iii) Services are an integral part of the business activity of a member of a controlled group where the renderer is peculiarly capable of rendering the services and such services are a principal element in the operations of the recipient. The renderer is peculiarly capable of rendering the services where the renderer, in connection with the rendition of such services, makes use of a particularly advantageous situation or circumstance such as by utilization of special skills and reputation, utilization of an influential relationship with customers, or utilization of its intangible property (as defined in § 1.482–4(b)). However, the renderer will not be considered peculiarly capable of rendering services unless the value of the services is substantially in excess of the costs or deductions of the renderer attributable to such services.

(iv) Services are an integral part of the business activity of a member of a controlled group where the recipient has received the benefit of a substantial amount of services from one or more related parties during its taxable year. For purposes of this paragraph (b)(7)(iv), services rendered by one or more related parties shall be considered substantial in amount if the total costs or deductions of the related party or parties rendering services to the recipient during its taxable year which are directly or indirectly related to such services exceed an amount equal to 25 percent of the total costs or deductions of the recipient during its taxable year. For purposes of the preceding sentence, the total costs or deductions of the recipient shall include the renderers' costs or deductions directly or indirectly related to the rendition of such services and shall exclude any amounts paid or accrued to the renderers by the recipient for such services and shall also exclude any amounts paid or accrued for materials the cost of which is properly reflected in the cost of goods sold of the recipient. At the option of the taxpayer, where the taxpayer establishes that the amount of the total costs or deductions of a recipient for the recipient's taxable year are abnormally low due to the commencement or cessation of an operation by the recipient, or other unusual circumstances of a nonrecurring nature, the costs or deductions referred to in the preceding two sentences shall be the total of such amount for the 3-year period immediately preceding the close of the taxable year of the recipient (or for the first 3 years of operation of the recipient if the recipient had been in operation for less than 3 years as of the close of the taxable year in which the services in issue were rendered).

(v) The principles of paragraphs (b)(7)(i) through (iv) of this section may be illustrated by the following examples:

Example 1. Y is engaged in the business of selling merchandise and X, an entity related to Y, is a printing company regularly engaged in printing and mailing advertising literature for unrelated parties. X also prints circulars advertising Y's products, mails the circulars to potential customers of Y, and in addition, performs the art work involved in the preparation of the circulars. Since the printing, mailing, and art work services rendered by X to Y are similar to the printing and mailing services rendered by X as X's trade or business, the services rendered to Y are an integral part of the business activity of X as described in paragraph (b)(7)(i) of this section.

Example 2. V, W, X, and Y are members of the same group of controlled entities. Each member of the group files a separate income tax return. X renders wrecking services to V, W, and Y, and, in addition, sells building materials to unrelated parties. The total costs or deductions incurred by X for the taxable year (exclusive of amounts properly reflected in the cost of goods sold of X) are $4 million. The total costs or deductions of X for the taxable year which are directly or indirectly related to the services rendered to V, W, and Y are $650,000. Since $650,000 is less than 25 percent of the total costs or deductions of X (exclusive of amounts properly reflected in the cost of goods sold of X) for the taxable year ($4,000,000 * 25% = $1,000,000), the services rendered by X to V, W, and Y will not be considered one of X's principal activities within the meaning of paragraph (b)(7)(ii) of this section.

Example 3. Assume the same facts as in *Example 2,* except that the total costs or deductions of X for the taxable year which are directly or indirectly related to the services rendered to V, W, and Y are $1,800,000. Assume in addition, that there is a high risk of loss involved in the rendition of the wrecking services by X, that X has a large investment in the wrecking equipment, and that a substantial amount of X's time is devoted to the rendition of wrecking services to V, W, and Y. Since $1,800,000 is greater than 25 percent of the total costs or deductions of X for the taxable year (exclusive of amounts properly reflected in the cost of goods sold of X), i.e., $1 million, the services rendered by X to V, W, and Y will not be automatically excluded from classification as one of the principal activities of X as in *Example 2,* and consideration must be given to the facts and circumstances of the particular case. Based on the facts and circumstances in this case, X would be considered to render wrecking services to related parties as one of its principal activities. Thus, the wrecking services are an integral part of the business activity of X as described in paragraph (b)(7)(ii) of this section.

Example 4. Z is a domestic corporation and has several foreign subsidiaries. Z and X, a domestic subsidiary of Z, have exercised the privilege granted under section 1501 to file a consolidated return and, therefore, constitute a *consolidated group* within the meaning of paragraph (b)(7)(ii)(C) of this section. Pursuant to paragraph (b)(7)(ii)(C) of this section, the taxpayer treats X and Z as the renderer. The sole function of X is to provide accounting, billing, communication, and travel services to the foreign subsidiaries of Z. Z also provides some other services for the benefit of its foreign subsidiaries. The total costs or deductions of X and Z related to the services rendered for the benefit of the foreign subsidiaries is $750,000. Of that amount, $710,000 represents the costs of X, which are X's total operating costs. The total costs or deductions of X and Z for the taxable year with respect to their operations (exclusive of amounts properly reflected in the cost of goods sold of X and Z) is $6,500,000. Since the total costs or deductions related to the services rendered to the foreign subsidiaries ($750,000) is less than 25 percent of the total costs or deductions of X and Z (exclusive of amounts properly reflected in the costs of goods sold of X or Z) in the aggregate ($6,500,000 * 25% = $1,625,000), the services rendered by X and Z to the foreign subsidiaries will not be considered one of the principal activities of X and Z within the meaning of paragraph (b)(7)(ii) of this section.

Example 5. Assume the same facts as in *Example 4,* except that all the communication services rendered for the benefit of the foreign subsidiaries are rendered by X and that Z renders communication services to unrelated parties as part of its trade or business. X is regularly engaged in rendering communication services to foreign subsidiaries and devotes a substantial amount of its time to this activity. The costs or deductions of X related to the rendition of the communication services to the foreign subsidiaries are $355,000. By application of the paragraph (b)(7)(ii)(C) of this section, the services provided by X and Z to related entities other than the communication services will not be considered one of the principal activities of X and Z. However, since Z renders communication services to unrelated parties as a part of its trade or business, the communication services rendered by X to the foreign subsidiaries will be subject to the provisions of paragraph (b)(7)(ii) of this section without regard to paragraph (b)(7)(ii)(C) of this section. Since the costs or deductions of X related to the rendition of the communication services ($355,000) are in excess of 25 percent of the total costs or deductions of X (exclusive of amounts properly reflected in the cost of goods sold of X) for the taxable year ($710,000 * 25% = $177,500), the determination of whether X renders the communication services as one of its principal activities will depend on the particular facts and circumstances. The given facts and circumstances indicate that X renders the communication services as one of its principal activities.

Example 6. X and Y are members of the same group of controlled entities. Y produces and sells product D. As a part of the production process, Y sends materials to X who converts the materials into component parts. This conversion activity constitutes only a portion of X's operations. X then ships the component parts back to Y who assembles them (along with other components) into the finished product for sale to unrelated parties. Since the services rendered by X to Y constitute a manufacturing activity, the 25-percent test in paragraph (b)(7)(ii) of this section does not apply.

Example 7. X and Y are members of the same group of controlled entities. X manufactures product D for distribution and sale in the United States, Canada, and Mexico. Y manufactures product D for distribution and sale in South and Central America. Due to a breakdown of machinery, Y is forced to cease its manufacturing operations for a 1-month period. In order to meet demand for product D during the shutdown period, Y sends partially finished goods to X. X, for that period, completes the manufacture of product D for Y and ships the finished product back to Y. The costs or deductions of X related to the manufacturing services rendered to Y are $750,000. The total costs or deductions of X are $24,000,000. Since the services in issue constitute a manufacturing activity, the 25-percent test in paragraph (b)(7)(ii) of this section does not apply. However, under these facts and circumstances, i.e., the insubstantiality of the services rendered to Y in relation to X's total operations, the lack of regularity with which the services are rendered, and the short duration for which the services are rendered, X's rendition of manufacturing services to Y is not considered one of X's principal activities within the meaning of paragraph (b)(7)(ii) of this section.

Example 8. Assume the same facts as in *Example 7,* except that, instead of temporarily ceasing operations, Y requests assistance from X in correcting the defects in the manufacturing equipment. In response, X sends a team of engineers to discover and correct the defects without the necessity of a shutdown. Although the services performed by the engineers were related to a manufacturing activity, the services are essentially supporting in nature and, therefore, do not constitute a manufacturing, production, extraction, or construction activity. Thus, the 25-percent test in paragraph (b)(7)(ii) of this section applies.

Example 9. X is a domestic manufacturing corporation. Y, a foreign subsidiary of X, has decided to construct a plant in Country A. In connection with the construction of Y's plant, X draws up the architectural plans for the plant, arranges the financing of the construction, negotiates with various Government authorities in Country A, invites bids from unrelated parties for several phases of construction, and negotiates, on Y's behalf, the contracts with unrelated parties who are retained to carry out certain phases of the construction. Although the unrelated parties retained by X for Y perform the physical construction, the aggregate services performed by X for Y are such that they, in themselves, constitute a construction activity. Thus, the 25-percent test in paragraph (b)(7)(ii) of this section does not apply with respect to such services.

Example 10. X and Y are members of the same group of controlled entities. X is a finance company engaged in financing automobile loans. In connection with such loans it requires the borrower to have life insurance in the amount of the loan. Although X's borrowers are not required to take out life insurance from any particular insurance company, at the same time that the loan agreement is being finalized, X's employees suggest that the borrower take out life insurance from Y, which is an agency for life insurance companies. Since there would be a delay in the processing of the loan if some other company were selected by the borrower, almost all of X's borrowers take out life insurance through Y. Because of this utilization of its influential relationship with its borrowers, X is peculiarly capable of rendering selling services to Y and, since a substantial amount of Y's business is derived from X's borrowers, such selling services are a principal element in the operation of Y's insurance business. In addition, the value of the services is substantially in excess of the costs incurred by X. Thus, the selling services rendered by X to Y are an integral part of the business activity of a member of the controlled group as described in paragraph (b)(7)(iii) of this section.

Example 11. X and Y are members of the same group of controlled entities. Y is a manufacturer of product E. In past years product E has not always operated properly because of imperfections present in the finished product. X owns an exclusive patented process by which such imperfections can be detected and removed prior to sale of the product, thereby greatly increasing the marketability of the product. In connection with its manufacturing operations Y sends its products to X for inspection which involves utilization of the patented process. The inspection of Y's products by X is not one of the principal activities of X. However, X is peculiarly capable of rendering the inspection services to Y because of its utilization of the patented process. Since this inspection greatly increases the marketability of product E it is extremely valuable. Such value is substantially in excess of the cost incurred by X in rendition of such services. Because of the impact of the inspection on sales, such services are a principal element in the operations of Y. Thus, the inspection services rendered by X to Y are an integral part of the business activity of a member of the controlled group as described in paragraph (b)(7)(iii) of this section.

Example 12. Assume the same facts as in *Example 11* except that Y owns the patented process for detecting the imperfections. Y, however, does not have the facilities to implement the inspection process. Therefore, Y sends its products to X for inspection which involves utilization of the patented process owned by Y. Since Y owns the patent, X is not peculiarly capable of rendering the inspection services to Y within the meaning of paragraph (b)(7)(iii) of this section.

Example 13. Assume the same facts as in *Example 12* except that X and Y both own interests in the patented process as a result of having developed the process pursuant to a bona fide cost sharing plan (within the meaning of §1.482–7T). Since Y owns the requisite interest in the patent, X is not peculiarly capable of rendering the inspection services to Y within the meaning of paragraph (b)(7)(iii) of this section.

Example 14. X and Y are members of the same group of controlled entities. X is a large manufacturing concern. X's accounting department has, for many years, maintained the financial records of Y, a distributor of X's products. Although X is able to render these accounting services more efficiently than others due to its thorough familiarity with the operations of Y, X is not peculiarly capable of rendering the accounting services to Y because such familiarity does not, in and of itself, constitute a particularly advantageous situation or circumstance within the meaning of paragraph (b)(7)(iii) of this section. Furthermore, under these circumstances, the accounting services are supporting in nature and, therefore, do not constitute a principal element in the operations of Y. Thus, the accounting services rendered by X to Y are not an integral part of the business activity of either X or Y within the meaning of paragraph (b)(7)(iii) of this section.

Example 15. (i) Corporations X, Y, and Z are members of the same group of controlled entities. X is a manufacturer, and Y and Z are distributors of X's products. X provides a variety of services to Y including billing, shipping, accounting, and other general and administrative services. During Y's taxable year, on several occasions, Z renders selling and other promotional services to Y. None of the services rendered to Y constitute one of the principal activities of any of the renderers within the meaning of paragraph (b)(7)(ii) of this section. Y's total costs and deductions for Y's taxable year (exclusive of amounts paid to X and Z for services rendered and amounts paid for goods purchased for resale) are $1,600,000. The total direct and indirect costs of X and Z for services rendered to Y during Y's taxable year are as follows:

Services provided by X:	
Billing	$50,000
Shipping	250,000
Accounting	150,000
Other	200,000
Services provided by Z:	
Selling	500,000
Total Costs	1,150,000

(ii) Since the total costs or deductions of X and Z related to the rendition of services to Y exceed the amount equal to 25 percent of the total costs or deductions of Y (exclusive of amounts paid to X and Z for the services rendered and amounts paid for goods purchased for resale) plus the total costs or deductions of X and Z related to the rendition of services to Y ($1,150,000 ÷ [$1,600,000 + $1,150,000] = 41.8%), the services rendered by X and Z to Y are substantial within the meaning of paragraph (b)(7)(iv) of this section. Thus, the services rendered by X and Z to Y are an integral part of the business activity of Y as described in paragraph (b)(7)(iv) of this section.

Example 16. Assume the same facts as in *Example 15*, except that the taxpayer establishes that, due to a major change in the operations of Y, Y's total costs or deductions for Y's taxable year were abnormally low. Y has always used the calendar year as its taxable year. Y's total costs and deductions for the 2 years immediately preceding the taxable year in issue (exclusive of amounts paid to X and Z for services rendered and amounts paid for goods purchased for resale) were $6 million and $6,200,000 respectively. The total direct and indirect costs of X and Z for services rendered to Y were $1,150,000 for each of the 3 years. Applying the same formula to the costs or deductions for the 3 years immediately preceding the close of the taxable year in issue, the costs or deductions of X and Z related to the rendition of services to Y (3 * $1,150,000=$3,450,000) amount to 20 percent of the sum of the total costs or deductions of Y (exclusive of amounts paid to X and Z for the services rendered and amounts paid for goods purchased for resale) plus the total costs or deductions of X and Z related to the rendition of services to Y ($3,450,000 $1,600,000 + $6,000,000 + $6,200,000 + $3,450,000=20%). If the taxpayer chooses to use the 3-year period, the services rendered by X and Z to Y are not substantial within the meaning of paragraph (b)(7)(iv) of this section. Thus, the services will not be an integral part of the business activity of a member of the controlled group as described in paragraph (b)(7)(iv) of this section.

(8) *Services rendered in connection with the transfer of property.* Where tangible or intangible property is transferred, sold, assigned, loaned, leased, or otherwise made available in any manner by one member of a group to another member of the group and services are rendered by the transferor to the transferee in connection with the transfer, the amount of any allocation that may

be appropriate with respect to such transfer shall be determined in accordance with the rules of paragraph (c) of this section, or §§ 1.482–3 or 1.482–4, whichever is appropriate and a separate allocation with respect to such services under this paragraph shall not be made. Services are rendered in connection with the transfer of property where such services are merely ancillary and subsidiary to the transfer of the property or to the commencement of effective use of the property by the transferee. Whether or not services are merely ancillary and subsidiary to a property transfer is a question of fact. Ancillary and subsidiary services could be performed, for example, in promoting the transaction by demonstrating and explaining the use of the property, or by assisting in the effective starting-up of the property transferred, or by performing under a guarantee relating to such effective starting-up. Thus, where an employee of one member of a group, acting under the instructions of his employer, reveals a valuable secret process owned by his employer to a related entity, and at the same time supervises the integration of such process into the manufacturing operation of the related entity, such services could be considered to be rendered in connection with the transfer, and, if so considered, shall not be the basis for a separate allocation. However, if the employee continues to render services to the related entity by supervising the manufacturing operation after the secret process has been effectively integrated into such operation, a separate allocation with respect to such additional services may be made in accordance with the rules of this paragraph.

(c) *Use of tangible property*—(1) *General rule.* Where possession, use, or occupancy of tangible property owned or leased by one member of a group of controlled entities (referred to in this paragraph as the owner) is transferred by lease or other arrangement to another member of such group (referred to in this paragraph as the user) without charge or at a charge which is not equal to an arm's length rental charge (as defined in paragraph (c)(2)(i) of this section) the district director may make appropriate allocations to properly reflect such arm's length charge. Where possession, use, or occupancy of only a portion of such property is transferred, the determination of the arm's length charge and the allocation shall be made with reference to the portion transferred.

(2) *Arm's length charge*—(i) *In general.* For purposes of paragraph (c) of this section, an arm's length rental charge shall be the amount of rent which was charged, or would have been charged for the use of the same or similar property, during the time it was in use, in independent transactions with or between unrelated parties under similar circumstances considering the period and location of the use, the owner's investment in the property or rent paid for the property, expenses of maintaining the property, the type of property involved, its condition, and all other relevant facts.

(ii) *Safe haven rental charge.* See § 1.482–2(c)(2)(ii) (26 CFR Part 1 revised as of April 1, 1985), for the determination of safe haven rental charges in the case of certain leases entered into before May 9, 1986, and for leases entered into before August 7, 1986, pursuant to a binding written contract entered into before May 9, 1986.

(iii) *Subleases*—(A) Except as provided in paragraph (c)(2)(iii)(B) of this section, where possession, use, or occupancy of tangible property, which is leased by the owner (lessee) from an unrelated party is transferred by sublease or other arrangement to the user, an arm's length rental charge shall be considered to be equal to all the deductions claimed by the owner (lessee) which are attributable to the property for the period such property is used by the user. Where only a portion of such property was transferred, any allocations shall be made with reference to the portion transferred. The deductions to be considered include the rent paid or accrued by the owner (lessee) during the period of use and all other deductions directly and indirectly connected with the property paid or accrued by the owner (lessee) during such period. Such deductions include deductions for maintenance and repair, utilities, management and other similar deductions.

(B) The provisions of paragraph (c)(2)(iii)(A) of this section shall not apply if either—

(*1*) The taxpayer establishes a more appropriate rental charge under the general rule set forth in paragraph (c)(2)(i) of this section; or

(*2*) During the taxable year, the owner (lessee) or the user was regularly engaged in the trade or business of renting property of the same general type as the property in question to unrelated persons.

(d) *Transfer of property.* For rules governing allocations under section 482 to reflect an arm's length consideration for controlled transactions involving the transfer of property, see §§1.482–3 through 1.482–6.

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§1.482–3 Methods to determine taxable income in connection with a transfer of tangible property.

(a) *In general.* The arm's length amount charged in a controlled transfer of tangible property must be determined under one of the six methods listed in this paragraph (a). Each of the methods must be applied in accordance with all of the provisions of §1.482–1, including the best method rule of §1.482–1(c), the comparability analysis of §1.482–1(d), and the arm's length range of §1.482–1(e). The methods are—

(1) The comparable uncontrolled price method, described in paragraph (b) of this section;

(2) The resale price method, described in paragraph (c) of this section;

(3) The cost plus method, described in paragraph (d) of this section;

(4) The comparable profits method, described in §1.482–5;

(5) The profit split method, described in §1.482–6; and

(6) Unspecified methods, described in paragraph (e) of this section.

(b) *Comparable uncontrolled price method*—(1) *In general.* The comparable uncontrolled price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction.

(2) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from applications of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in §1.482–1(c). The application of these factors under the comparable uncontrolled price method is discussed in paragraph (b)(2)(ii) and (iii) of this section.

(ii) *Comparability*—(A) *In general.* The degree of comparability between controlled and uncontrolled transactions is determined by applying the provisions of §1.482–1(d). Although all of the factors described in §1.482–1(d)(3) must be considered, similarity of products generally will have the greatest effect on comparability under this method. In addition, because even minor differences in contractual terms or economic conditions could materially affect the amount charged in an uncontrolled transaction, comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences. The results derived from applying the comparable uncontrolled price method generally will be the most direct and reliable measure of an arm's length price for the controlled transaction if an uncontrolled transaction has no differences with the controlled transaction that would affect the price, or if there are only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made. If such adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled transactions, the comparable uncontrolled price method may be used, but the reliability of the results as a measure of the arm's length price will be reduced. Further, if there are material product differences for which reliable adjustments cannot be made, this method ordinarily will not provide a reliable measure of an arm's length result.

(B) *Adjustments for differences between controlled and uncontrolled transactions.* If there are differences between the controlled and uncontrolled transactions that would affect price, adjustments should be made to the price of the uncontrolled transaction according to the comparability provisions of §1.482–1(d)(2). Specific examples of the factors that may be particularly relevant to this method include—

(*1*) Quality of the product;

(*2*) Contractual terms (e.g., scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms);

(*3*) Level of the market (i.e., wholesale, retail, etc.);

(*4*) Geographic market in which the transaction takes place;

(*5*) Date of the transaction;

(*6*) Intangible property associated with the sale;

(*7*) Foreign currency risks; and

(*8*) Alternatives realistically available to the buyer and seller.

(iii) *Data and assumptions.* The reliability of the results derived from the comparable uncontrolled price method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply the method. See § 1.482–1(c) (Best method rule).

(3) *Arm's length range.* See § 1.482–1(e)(2) for the determination of an arm's length range.

(4) *Examples.* The principles of this paragraph (b) are illustrated by the following examples.

Example 1 Comparable Sales of Same Product. USM, a U.S. manufacturer, sells the same product to both controlled and uncontrolled distributors. The circumstances surrounding the controlled and uncontrolled transactions are substantially the same, except that the controlled sales price is a delivered price and the uncontrolled sales are made f.o.b. USM's factory. Differences in the contractual terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, and adjustments are made to the results of the uncontrolled transaction to account for such differences. No other material difference has been identified between the controlled and uncontrolled transactions. Because USM sells in both the controlled and uncontrolled transactions, it is likely that all material differences between the two transactions have been identified. In addition, because the comparable uncontrolled price method is applied to an uncontrolled comparable with no product differences, and there are only minor contractual differences that have a definite and reasonably ascertainable effect on price, the results of this application of the comparable uncontrolled price method will provide the most direct and reliable measure of an arm's length result. See § 1.482–3(b)(2)(ii)(A).

Example 2 Effect of Trademark. The facts are the same as in *Example 1,* except that USM affixes its valuable trademark to the property sold in the controlled transactions, but does not affix its trademark to the property sold in the uncontrolled transactions. Under the facts of this case, the effect on price of the trademark is material and cannot be reliably estimated. Because there are material product differences for which reliable adjustments cannot be made, the comparable uncontrolled price method is unlikely to provide a reliable measure of the arm's length result. See § 1.482–3(b)(2)(ii)(A).

Example 3 Minor Product Differences. The facts are the same as in *Example 1,* except that USM, which manufactures business machines, makes minor modifications to the physical properties of the machines to satisfy specific requirements of a customer in controlled sales, but does not make these modifications in uncontrolled sales. If the minor physical differences in the product have a material effect on prices, adjustments to account for these differences must be made to the results of the uncontrolled transactions according to the provisions of § 1.482- 1(d)(2), and such adjusted results may be used as a measure of the arm's length result.

Example 4 Effect of Geographic Differences. FM, a foreign specialty radio manufacturer, sells its radios to a controlled U.S. distributor, AM, that serves the West Coast of the United States. FM sells its radios to uncontrolled distributors to serve other regions in the United States. The product in the controlled and uncontrolled transactions is the same, and all other circumstances surrounding the controlled and uncontrolled transactions are substantially the same, other than the geographic differences. If the geographic differences are unlikely to have a material effect on price, or they have definite and reasonably ascertainable effects for which adjustments are made, then the adjusted results of the uncontrolled sales may be used under the comparable uncontrolled price method to establish an arm's length range pursuant to § 1.482–1(e)(2)(iii)(A). If the effects of the geographic differences would be material but cannot be reliably ascertained, then the reliability of the results will be diminished. However, the comparable uncontrolled price method may still provide the most reliable measure of an arm's length result, pursuant to the best method rule of § 1.482–1(c), and, if so, an arm's length range may be established pursuant to § 1.482–1(e)(2)(iii)(B).

(5) *Indirect evidence of comparable uncontrolled transactions*—(i) *In general.* A comparable uncontrolled price may be

derived from data from public exchanges or quotation media, but only if the following requirements are met—

(A) The data is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled sales;

(B) The data derived from public exchanges or quotation media is used to set prices in the controlled transaction in the same way it is used by uncontrolled taxpayers in the industry; and

(C) The amount charged in the controlled transaction is adjusted to reflect differences in product quality and quantity, contractual terms, transportation costs, market conditions, risks borne, and other factors that affect the price that would be agreed to by uncontrolled taxpayers.

(ii) *Limitation.* Use of data from public exchanges or quotation media may not be appropriate under extraordinary market conditions.

(iii) *Examples.* The following examples illustrate this paragraph (b)(5).

Example 1 Use of Quotation Medium. (i) On June 1, USOil, a United States corporation, enters into a contract to purchase crude oil from its foreign subsidiary, FS, in Country Z. USOil and FS agree to base their sales price on the average of the prices published for that crude in a quotation medium in the five days before August 1, the date set for delivery. USOil and FS agree to adjust the price for the particular circumstances of their transactions, including the quantity of the crude sold, contractual terms, transportation costs, risks borne, and other factors that affect the price.

(ii) The quotation medium used by USOil and FS is widely and routinely used in the ordinary course of business in the industry to establish prices for uncontrolled sales. Because USOil and FS use the data to set their sales price in the same way that unrelated parties use the data from the quotation medium to set their sales prices, and appropriate adjustments were made to account for differences, the price derived from the quotation medium used by USOil and FS to set their transfer prices will be considered evidence of a comparable uncontrolled price.

Example 2 Extraordinary Market Conditions. The facts are the same as in *Example 1,* except that before USOil and FS enter into their contract, war breaks out in Countries X and Y, major oil producing countries, causing significant instability in world petroleum markets. As a result, given the significant instability in the price of oil, the prices listed on the quotation medium may not reflect a reliable measure of an arm's length result. See §1.482–3(b)(5)(ii).

(c) *Resale price method*—(1) *In general.* The resale price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. The resale price method measures the value of functions performed, and is ordinarily used in cases involving the purchase and resale of tangible property in which the reseller has not added substantial value to the tangible goods by physically altering the goods before resale. For this purpose, packaging, repackaging, labelling, or minor assembly do not ordinarily constitute physical alteration. Further the resale price method is not ordinarily used in cases where the controlled taxpayer uses its intangible property to add substantial value to the tangible goods.

(2) *Determination of arm's length price*—(i) *In general.* The resale price method measures an arm's length price by subtracting the appropriate gross profit from the applicable resale price for the property involved in the controlled transaction under review.

(ii) *Applicable resale price.* The applicable resale price is equal to either the resale price of the particular item of property involved or the price at which contemporaneous resales of the same property are made. If the property purchased in the controlled sale is resold to one or more related parties in a series of controlled sales before being resold in an uncontrolled sale, the applicable resale price is the price at which the property is resold to an uncontrolled party, or the price at which contemporaneous resales of the same property are made. In such case, the determination of the appropriate gross profit will take into account the functions of all members of the group participating in the series of controlled sales and final uncontrolled resales, as well as any other relevant factors described in §1.482–1(d)(3).

(iii) *Appropriate gross profit.* The appropriate gross profit is computed by multiplying the applicable resale price by the gross profit margin (expressed as a percentage of total revenue derived from sales) earned in comparable uncontrolled transactions.

(iv) *Arm's length range.* See § 1.482–1(e)(2) for determination of the arm's length range.

(3) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from applications of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in § 1.482–1(c). The application of these factors under the resale price method is discussed in paragraphs (c)(3) (ii) and (iii) of this section.

(ii) *Comparability*—(A) *Functional comparability.* The degree of comparability between an uncontrolled transaction and a controlled transaction is determined by applying the comparability provisions of § 1.482–1(d). A reseller's gross profit provides compensation for the performance of resale functions related to the product or products under review, including an operating profit in return for the reseller's investment of capital and the assumption of risks. Therefore, although all of the factors described in § 1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on similarity of functions performed, risks borne, and contractual terms, or adjustments to account for the effects of any such differences. If possible, appropriate gross profit margins should be derived from comparable uncontrolled purchases and resales of the reseller involved in the controlled sale, because similar characteristics are more likely to be found among different resales of property made by the same reseller than among sales made by other resellers. In the absence of comparable uncontrolled transactions involving the same reseller, an appropriate gross profit margin may be derived from comparable uncontrolled transactions of other resellers.

(B) *Other comparability factors.* Comparability under this method is less dependent on close physical similarity between the products transferred than under the comparable uncontrolled price method. For example, distributors of a wide variety of consumer durables might perform comparable distribution functions without regard to the specific durable goods distributed. Substantial differences in the products may, however, indicate significant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions would involve the distribution of products of the same general type (e.g., consumer electronics). Furthermore, significant differences in the value of the distributed goods due, for example, to the value of a trademark, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross profit may be adversely affected by factors that have less effect on prices. For example, gross profit may be affected by a variety of other factors, including cost structures (as reflected, for example, in the age of plant and equipment), business experience (such as whether the business is in a start-up phase or is mature), or management efficiency (as indicated, for example, by expanding or contracting sales or executive compensation over time). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) *Adjustments for differences between controlled and uncontrolled transactions.* If there are material differences between the controlled and uncontrolled transactions that would affect the gross profit margin, adjustments should be made to the gross profit margin earned with respect to the uncontrolled transaction according to the comparability provisions of § 1.482–1(d)(2). For this purpose, consideration of operating expenses associated with functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses. If there are differences in functions performed, however, the effect on gross profit of such differences is not necessarily equal to the differences in the amount of related operating expenses. Specific examples of the factors that may be particularly relevant to this method include—

(*1*) Inventory levels and turnover rates, and corresponding risks, including any price protection programs offered by the manufacturer;

(*2*) Contractual terms (e.g., scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms);

(*3*) Sales, marketing, advertising programs and services, (including promotional programs, rebates, and co-op advertising);

(*4*) The level of the market (e.g., wholesale, retail, etc.); and

(*5*) Foreign currency risks.

(D) *Sales agent.* If the controlled taxpayer is comparable to a sales agent that does not take title to goods or otherwise assume risks with respect to ownership of such goods, the commission earned by such sales agent, expressed as a percentage of the uncontrolled sales price of the goods involved, may be used as the comparable gross profit margin.

(iii) *Data and assumptions*—(A) *In general.* The reliability of the results derived from the resale price method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See §1.482–1(c) (Best method rule).

(B) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross profit margin affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect the gross profit margin, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, the controlled transaction and the uncontrolled comparable should be consistent in the reporting of items (such as discounts, returns and allowances, rebates, transportation costs, insurance, and packaging) between cost of goods sold and operating expenses.

(4) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. A controlled taxpayer sells property to another member of its controlled group that resells the property in uncontrolled sales. There are no changes in the beginning and ending inventory for the year under review. Information regarding an uncontrolled comparable is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. If the applicable resale price of the property involved in the controlled sale is $100 and the appropriate gross profit margin is 20%, then an arm's length result of the controlled sale is a price of $80 ($100 minus (20%×$100)).

Example 2. (i) S, a U.S. corporation, is the exclusive distributor for FP, its foreign parent. There are no changes in the beginning and ending inventory for the year under review. S's total reported cost of goods sold is $800, consisting of $600 for property purchased from FP and $200 of other costs of goods sold incurred to unrelated parties. S's applicable resale price and reported gross profit are as follows:

Applicable resale price	$1000
Cost of goods sold:	
Cost of purchases from FP ...	600
Costs incurred to unrelated parties	200
Reported gross profit	200

(ii) The district director determines that the appropriate gross profit margin is 25%. Therefore, S's appropriate gross profit is $250 (i.e., 25% of the applicable resale price of $1000). Because S is incurring costs of sales to unrelated parties, an arm's length price for property purchased from FP must be determined under a two-step process. First, the appropriate gross profit ($250) is subtracted from the applicable resale price ($1000). The resulting amount ($750) is then reduced by the costs of sales incurred to unrelated parties ($200). Therefore, an arm's length price for S's cost of sales of FP's product in this case equals $550 (i.e., $750 minus $200).

Example 3. FP, a foreign manufacturer, sells Product to USSub, its U.S. subsidiary, which in turn sells Product to its domestic affiliate Sister. Sister sells Product to unrelated buyers. In this case, the applicable resale price is the price at which Sister sells Product in uncontrolled transactions. The determination of the appropriate gross profit margin for the sale from FP to USSub will take into account the functions performed by USSub and Sister, as well as other relevant factors described in §1.482–1(d)(3).

Example 4. USSub, a U.S. corporation, is the exclusive distributor of widgets for its foreign parent. To determine whether the gross profit margin of 25% earned by USSub is an arm's length result, the district director considers applying the resale price method. There are several uncontrolled distributors that perform similar functions under similar circumstances in uncontrolled transactions. However, the uncontrolled distributors treat certain costs such as discounts and insurance as cost of goods sold, while USSub treats such costs as operating expenses. In such cases, accounting reclassifications, pursuant to § 1.482–3(c)(3)(iii)(B), must be made to ensure consistent treatment of such material items. Inability to make such accounting reclassifications will decrease the reliability of the results of the uncontrolled transactions.

Example 5. (i) USP, a U.S. corporation, manufactures Product X, an unbranded widget, and sells it to FSub, its wholly owned foreign subsidiary. FSub acts as a distributor of Product X in country M, and sells it to uncontrolled parties in that country. Uncontrolled distributors A, B, C, D, and E distribute competing products of approximately similar value in country M. All such products are unbranded.

(ii) Relatively complete data is available regarding the functions performed and risks borne by the uncontrolled distributors and the contractual terms under which they operate in the uncontrolled transactions. In addition, data is available to ensure accounting consistency between all of the uncontrolled distributors and FSub. Because the available data is sufficiently complete and accurate to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified, such differences have a definite and reasonably ascertainable effect, and reliable adjustments are made to account for such differences, the results of each of the uncontrolled distributors may be used to establish an arm's length range pursuant to § 1.482–1(e)(2)(iii)(A).

Example 6. The facts are the same as *Example 5,* except that sufficient data is not available to determine whether any of the uncontrolled distributors provide warranties or to determine the payment terms of the contracts. Because differences in these contractual terms could materially affect price or profits, the inability to determine whether these differences exist between the controlled and uncontrolled transactions diminishes the reliability of the results of the uncontrolled comparables. However, the reliability of the results may be enhanced by the application of a statistical method when establishing an arm's length range pursuant to § 1.482–1(e)(2)(iii)(B).

Example 7. The facts are the same as in *Example 5,* except that Product X is branded with a valuable trademark that is owned by P. A, B, and C distribute unbranded competing products, while D and E distribute products branded with other trademarks. D and E do not own any rights in the trademarks under which their products are sold. The value of the products that A, B, and C sold are not similar to the value of the products sold by S. The value of products sold by D and E, however, is similar to that of Product X. Although close product similarity is not as important for a reliable application of the resale price method as for the comparable uncontrolled price method, significant differences in the value of the products involved in the controlled and uncontrolled transactions may affect the reliability of the results. In addition, because in this case it is difficult to determine the effect the trademark will have on price or profits, reliable adjustments for the differences cannot be made. Because D and E have a higher level of comparability than A, B, and C with respect to S, pursuant to § 1.482–1(e)(2)(ii), only D and E may be included in an arm's length range.

(d) *Cost plus method*—(1) *In general.* The cost plus method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit markup realized in comparable uncontrolled transactions. The cost plus method is ordinarily used in cases involving the manufacture, assembly, or other production of goods that are sold to related parties.

(2) *Determination of arm's length price*—(i) *In general.* The cost plus method measures an arm's length price by adding the appropriate gross profit to the controlled taxpayer's costs of producing the property involved in the controlled transaction.

(ii) *Appropriate gross profit.* The appropriate gross profit is computed by multiplying the controlled taxpayer's cost of producing the transferred property by the gross profit markup, expressed as a percentage of cost, earned in comparable uncontrolled transactions.

(iii) *Arm's length range.* See § 1.482–1(e)(2) for determination of an arm's length range.

(3) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from the application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in § 1.482–1(c).

(ii) *Comparability*—(A) *Functional comparability.* The degree of comparability between controlled and uncontrolled transactions is determined by applying the comparability provisions of § 1.482–1(d). A producer's gross profit provides compensation for the performance of the production functions related to the product or products under review, including an operating profit for the producer's investment of capital and assumption of risks. Therefore, although all of the factors described in §1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on similarity of functions performed, risks borne, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross profit markup should be derived from comparable uncontrolled transactions of the taxpayer involved in the controlled sale, because similar characteristics are more likely to be found among sales of property by the same producer than among sales by other producers. In the absence of such sales, an appropriate gross profit markup may be derived from comparable uncontrolled sales of other producers whether or not such producers are members of the same controlled group.

(B) *Other comparability factors.* Comparability under this method is less dependent on close physical similarity between the products transferred than under the comparable uncontrolled price method. Substantial differences in the products may, however, indicate significant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions involve the production of goods within the same product categories. Furthermore, significant differences in the value of the products due, for example, to the value of a trademark, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross profit may be adversely affected by factors that have less effect on prices. For example, gross profit may be affected by a variety of other factors, including cost structures (as reflected, for example, in the age of plant and equipment), business experience (such as whether the business is in a start-up phase or is mature), or management efficiency (as indicated, for example, by expanding or contracting sales or executive compensation over time). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) *Adjustments for differences between controlled and uncontrolled transactions.* If there are material differences between the controlled and uncontrolled transactions that would affect the gross profit markup, adjustments should be made to the gross profit markup earned in the comparable uncontrolled transaction according to the provisions of §1.482–1(d)(2). For this purpose, consideration of the operating expenses associated with the functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses. If there are differences in functions performed, however, the effect on gross profit of such differences is not necessarily equal to the differences in the amount of related operating expenses. Specific examples of the factors that may be particularly relevant to this method include—

(*1*) The complexity of manufacturing or assembly;

(*2*) Manufacturing, production, and process engineering;

(*3*) Procurement, purchasing, and inventory control activities;

(*4*) Testing functions;

(*5*) Selling, general, and administrative expenses;

(*6*) Foreign currency risks; and

(*7*) Contractual terms (e.g., scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms).

(D) *Purchasing agent.* If a controlled taxpayer is comparable to a purchasing agent that does not take title to property or otherwise assume risks with respect to ownership of such goods, the commission earned by such purchasing agent, expressed as a percentage of the purchase price of the goods, may be used as the appropriate gross profit markup.

(iii) *Data and assumptions*—(A) *In general.* The reliability of the results derived from the cost plus method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See §1.482–1(c) (Best method rule).

(B) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross profit markup affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect the gross profit markup, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, the controlled transaction and the comparable uncontrolled transaction should be consistent in the reporting of costs between cost of goods sold and operating expenses. The term *cost of producing* includes the cost of acquiring property that is held for resale.

(4) *Examples.* The following examples illustrate the principles of this paragraph (d).

Example 1. (i) USP, a domestic manufacturer of computer components, sells its products to FS, its foreign distributor. UT1, UT2, and UT3 are domestic computer component manufacturers that sell to uncontrolled foreign purchasers.

(ii) Relatively complete data is available regarding the functions performed and risks borne by UT1, UT2, and UT3, and the contractual terms in the uncontrolled transactions. In addition, data is available to ensure accounting consistency between all of the uncontrolled manufacturers and USP. Because the available data is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified, the effect of the differences are definite and reasonably ascertainable, and reliable adjustments are made to account for the differences, an arm's length range can be established pursuant to § 1.482–1(e)(2)(iii)(A).

Example 2. The facts are the same as in *Example 1,* except that USP accounts for supervisory, general, and administrative costs as operating expenses, which are not allocated to its sales to FS. The gross profit markups of UT1, UT2, and UT3, however, reflect supervisory, general, and administrative expenses because they are accounted for as costs of goods sold. Accordingly, the gross profit markups of UT1, UT2, and UT3 must be adjusted as provided in paragraph (d)(3)(iii)(B) of this section to provide accounting consistency. If data is not sufficient to determine whether such accounting differences exist between the controlled and uncontrolled transactions, the reliability of the results will be decreased.

Example 3. The facts are the same as in *Example 1,* except that under its contract with FS, USP uses materials consigned by FS. UT1, UT2, and UT3, on the other hand, purchase their own materials, and their gross profit markups are determined by including the costs of materials. The fact that USP does not carry an inventory risk by purchasing its own materials while the uncontrolled producers carry inventory is a significant difference that may require an adjustment if the difference has a material effect on the gross profit markups of the uncontrolled producers. Inability to reasonably ascertain the effect of the difference on the gross profit markups will affect the reliability of the results of UT1, UT2, and UT3.

Example 4. (i) FS, a foreign corporation, produces apparel for USP, its U.S. parent corporation. FS purchases its materials from unrelated suppliers and produces the apparel according to designs provided by USP. The district director identifies 10 uncontrolled foreign apparel producers that operate in the same geographic market and are similar in many respect to FS.

(ii) Relatively complete data is available regarding the functions performed and risks borne by the uncontrolled producers. In addition, data is sufficiently detailed to permit adjustments for differences in accounting practices. However, sufficient data is not available to determine whether it is likely that all material differences in contractual terms have been identified. For example, it is not possible to determine which parties in the uncontrolled transactions bear currency risks. Because differences in these contractual terms could materially affect price or profits, the inability to determine whether differences exist between the controlled and uncontrolled transactions will diminish the reliability of these results. Therefore, the reliability of the results of the uncontrolled transactions must be enhanced by the application of a statistical method in establishing an arm's length range pursuant to § 1.482–1(e)(2)(iii)(B).

(e) *Unspecified methods*—(1) *In general.* Methods not specified in paragraphs (a)(1), (2), (3), (4), and (5) of this section may be used to evaluate whether the amount charged in a controlled transaction is arm's length. Any method used under this paragraph (e) must be applied in accordance with the provisions of § 1.482–1. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. For example, the comparable uncontrolled price method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price to which the parties would have agreed had they resorted directly to a market alternative to the controlled transaction. Therefore, in establishing whether a controlled transaction achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See §1.482–1(c). Therefore, in accordance with §1.482–1(d) (Comparability), to the extent that a method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

(2) *Example.* The following example illustrates an application of the principle of this paragraph (e).

Example. Amcan, a U.S. company, produces unique vessels for storing and transporting toxic waste, toxicans, at its U.S. production facility. Amcan agrees by contract to supply its Canadian subsidiary, Cancan, with 4000 toxicans per year to serve the Canadian market for toxicans. Prior to entering into the contract with Cancan, Amcan had received a bona fide offer from an independent Canadian waste disposal company, Cando, to serve as the Canadian distributor for toxicans and to purchase a similar number of toxicans at a price of $5,000 each. If the circumstances and terms of the Cancan supply contract are sufficiently similar to those of the Cando offer, or sufficiently reliable adjustments can be made for differences between them, then the Cando offer price of $5,000 may provide reliable information indicating that an arm's length consideration under the Cancan contract will not be less than $5,000 per toxican.

(f) *Coordination with intangible property rules.* The value of an item of tangible property may be affected by the value of intangible property, such as a trademark affixed to the tangible property (embedded intangible). Ordinarily, the transfer of tangible property with an embedded intangible will not be considered a transfer of such intangible if the controlled purchaser does not acquire any rights to exploit the intangible property other than rights relating to the resale of the tangible property under normal commercial practices. Pursuant to §1.482–1(d)(3)(v), however, the embedded intangible must be accounted for in evaluating the comparability of the controlled transaction and uncontrolled comparables. For example, because product comparability has the greatest effect on an application of the comparable uncontrolled price method, trademarked tangible property may be insufficiently comparable to unbranded tangible property to permit a reliable application of the comparable uncontrolled price method. The effect of embedded intangibles on comparability will be determined under the principles of §1.482–4. If the transfer of tangible property conveys to the recipient a right to exploit an embedded intangible (other than in connection with the resale of that item of tangible property), it may be necessary to determine the arm's length consideration for such intangible separately from the tangible property, applying methods appropriate to determining the arm's length result for a transfer of intangible property under §1.482–4. For example, if the transfer of a machine conveys the right to exploit a manufacturing process incorporated in the machine, then the arm's length consideration for the transfer of that right must be determined separately under §1.482–4.

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§1.482–4 Methods to determine taxable income in connection with a transfer of intangible property.

(a) *In general.* The arm's length amount charged in a controlled transfer of intangible property must be determined under one of the four methods listed in this paragraph (a). Each of the methods must be applied in accordance with all of the provisions of §1.482–1, including the best method rule of § 1.482–1(c), the comparability analysis of § 1.482–1(d), and the arm's length range of § 1.482–1(e). The arm's length consideration for the transfer of an intangible determined under this section must be commensurate with the income attributable to the intangible. See § 1.482–4(f)(2) (Periodic adjustments). The available methods are—

(1) The comparable uncontrolled transaction method, described in paragraph (c) of this section;

(2) The comparable profits method, described in § 1.482–5;

(3) The profit split method, described in § 1.482–6; and

(4) Unspecified methods described in paragraph (d) of this section.

(b) *Definition of intangible.* For purposes of section 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual—

(1) Patents, inventions, formulae, processes, designs, patterns, or know-how;

(2) Copyrights and literary, musical, or artistic compositions;

(3) Trademarks, trade names, or brand names;

(4) Franchises, licenses, or contracts;

(5) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and

(6) Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.

(c) *Comparable uncontrolled transaction method*—(1) *In general.* The comparable uncontrolled transaction method evaluates whether the amount charged for a controlled transfer of intangible property was arm's length by reference to the amount charged in a comparable uncontrolled transaction. The amount determined under this method may be adjusted as required by paragraph (f)(2) of this section (Periodic adjustments).

(2) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from applications of this method are the most reliable measure of an arm's length result is determined using the factors described under the best method rule in § 1.482–1(c). The application of these factors under the comparable uncontrolled transaction method is discussed in paragraphs (c)(2)(ii), (iii), and (iv) of this section.

(ii) *Reliability.* If an uncontrolled transaction involves the transfer of the same intangible under the same, or substantially the same, circumstances as the controlled transaction, the results derived from applying the comparable uncontrolled transaction method will generally be the most direct and reliable measure of the arm's length result for the controlled transfer of an intangible. Circumstances between the controlled and uncontrolled transactions will be considered substantially the same if there are at most only minor differences that have a definite and reasonably ascertainable effect on the amount charged and for which appropriate adjustments are made. If such uncontrolled transactions cannot be identified, uncontrolled transactions that involve the transfer of comparable intangibles under comparable circumstances may be used to apply this method, but the reliability of the analysis will be reduced.

(iii) *Comparability*—(A) *In general.* The degree of comparability between controlled and uncontrolled transactions is determined by applying the comparability provisions of § 1.482–1(d). Although all of the factors described in § 1.482–1(d)(3) must be considered, specific factors may be particularly relevant to this method. In particular, the application of this method requires that the controlled and uncontrolled transactions involve either the same intangible property or comparable intangible property, as defined in paragraph (c)(2)(iii)(B)(*1*) of this section. In addition, because differences in contractual terms, or the economic conditions in which transactions take place, could materially affect the amount charged, comparability under this method also depends on similarity with respect to these factors, or adjustments to account for material differences in such circumstances.

(B) *Factors to be considered in determining comparability*—(*1*) *Comparable intangible property*. In order for the intangible property involved in an uncontrolled transaction to be considered comparable to the intangible property involved in the controlled transaction, both intangibles must—

(*i*) Be used in connection with similar products or processes within the same general industry or market; and

(*ii*) Have similar profit potential. The profit potential of an intangible is most reliably measured by directly calculating the net present value of the benefits to be realized (based on prospective profits to be realized or costs to be saved) through the use or subsequent transfer of the intangible, considering the capital investment and start-up expenses required, the risks to be assumed, and other relevant considerations. The need to reliably measure profit potential increases in relation to both the total amount of potential profits and the potential rate of return on investment necessary to exploit the intangible. If the information necessary to directly calculate net present value of the benefits to be realized is unavailable, and the need to reliably measure profit potential is reduced because the potential profits are relatively small in terms of total amount and rate of return, comparison of profit potential may be based upon the factors referred to in paragraph (c)(2)(iii)(B)(*2*) of this section. See *Example 3* of §1.482–4(c)(4). Finally, the reliability of a measure of profit potential is affected by the extent to which the profit attributable to the intangible can be isolated from the profit attributable to other factors, such as functions performed and other resources employed.

(*2*) *Comparable circumstances*. In evaluating the comparability of the circumstances of the controlled and uncontrolled transactions, although all of the factors described in §1.482–1(d)(3) must be considered, specific factors that may be particularly relevant to this method include the following—

(*i*) The terms of the transfer, including the exploitation rights granted in the intangible, the exclusive or nonexclusive character of any rights granted, any restrictions on use, or any limitations on the geographic area in which the rights may be exploited;

(*ii*) The stage of development of the intangible (including, where appropriate, necessary governmental approvals, authorizations, or licenses) in the market in which the intangible is to be used;

(*iii*) Rights to receive updates, revisions, or modifications of the intangible;

(*iv*) The uniqueness of the property and the period for which it remains unique, including the degree and duration of protection afforded to the property under the laws of the relevant countries;

(*v*) The duration of the license, contract, or other agreement, and any termination or renegotiation rights;

(*vi*) Any economic and product liability risks to be assumed by the transferee;

(*vii*) The existence and extent of any collateral transactions or ongoing business relationships between the transferee and transferor; and

(*viii*) The functions to be performed by the transferor and transferee, including any ancillary or subsidiary services.

(iv) *Data and assumptions*. The reliability of the results derived from the comparable uncontrolled transaction method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See §1.482–1(c) (Best method rule).

(3) *Arm's length range*. See §1.482–1(e)(2) for the determination of an arm's length range.

(4) *Examples*. The following examples illustrate the principles of this paragraph (c).

Example 1. (i) USpharm, a U.S. pharmaceutical company, develops a new drug Z that is a safe and effective treatment for the disease zeezee. USpharm has obtained patents covering drug Z in the United States and in various foreign countries. USpharm has also obtained the regulatory authorizations necessary to market drug Z in the United States and in foreign countries.

(ii) USpharm licenses its subsidiary in country X, Xpharm, to produce and sell drug Z in country X. At the same time, it licenses an unrelated company, Ydrug, to produce and sell drug Z in country Y, a neighboring country. Prior to licensing the drug, USpharm had obtained patent protection and regulatory approvals in both countries and both countries provide similar protection for intellectual property rights. Country X and country Y are similar countries in terms of population, per capita income and the incidence of disease zeezee. Consequently, drug Z is expected to sell in similar quantities and at similar prices in both countries. In addition, costs of producing and marketing drug Z in each country are expected to be approximately the same.

(iii) USpharm and Xpharm establish terms for the license of drug Z that are identical in every material respect, including royalty rate, to the terms established between USpharm and Ydrug. In this case the district director determines that the royalty rate established in the Ydrug license agreement is a reliable measure of the arm's length royalty rate for the Xpharm license agreement.

Example 2. The facts are the same as in *Example 1,* except that the incidence of the disease zeezee in Country Y is much higher than in Country X. In this case, the profit potential from exploitation of the right to make and sell drug Z is likely to be much higher in country Y than it is in Country X. Consequently, the Ydrug license agreement is unlikely to provide a reliable measure of the arm's length royalty rate for the Xpharm license.

Example 3. (i) FP, is a foreign company that designs, manufactures and sells industrial equipment. FP has developed proprietary components that are incorporated in its products. These components are important in the operation of FP's equipment and some of them have distinctive features, but other companies produce similar components and none of these components by itself accounts for a substantial part of the value of FP's products.

(ii) FP licenses its U.S. subsidiary, USSub, exclusive North American rights to use the patented technology for producing component X, a heat exchanger used for cooling operating mechanisms in industrial equipment. Component X incorporates proven technology that makes it somewhat more efficient than the heat exchangers commonly used in industrial equipment. FP also agrees to provide technical support to help adapt component X to USSub's products and to assist with initial production. Under the terms of the license agreement USSub pays FP a royalty equal to 3 percent of sales of USSub equipment incorporating component X.

(iii) FP does not license unrelated parties to use component X, but many similar components are transferred between uncontrolled taxpayers. Consequently, the district director decides to apply the comparable uncontrolled transaction method to evaluate whether the 3 percent royalty for component X is an arm's length royalty.

(iv) The district director uses a database of company documents filed with the Securities and Exchange Commission (SEC) to identify potentially comparable license agreements between uncontrolled taxpayers that are on file with the SEC. The district director identifies 40 license agreements that were entered into in the same year as the controlled transfer or in the prior or following year, and that relate to transfers of technology associated with industrial equipment that has similar applications to USSub's products. Further review of these uncontrolled agreements indicates that 25 of them involved components that have a similar level of technical sophistication as component X and could be expected to play a similar role in contributing to the total value of the final product.

(v) The district director makes a detailed review of the terms of each of the 25 uncontrolled agreements and finds that 15 of them are similar to the controlled agreement in that they all involve—

(A) The transfer of exclusive rights for the North American market;

(B) Products for which the market could be expected to be of a similar size to the market for the products into which USSub incorporates component X;

(C) The transfer of patented technology;

(D) Continuing technical support;

(E) Access to technical improvements;

(F) Technology of a similar age; and

(G) A similar duration of the agreement.

(vi) Based on these factors and the fact that none of the components to which these license agreements relate accounts for a substantial part of the value of the final products, the district director concludes that these fifteen intangibles have similar profit potential to the component X technology.

(vii) The 15 uncontrolled comparables produce the following royalty rates:

License	Royalty rate (percent)
1	1.0
2	1.0
3	1.25
4	1.25
5	1.5
6	1.5
7	1.75
8	2.0
9	2.0
10	2.0
11	2.25
12	2.5
13	2.5
14	2.75
15	3.0

(viii) Although the uncontrolled comparables are clearly similar to the controlled transaction, it is likely that unidentified material differences exist between the uncontrolled comparables and the controlled transaction. Therefore, an appropriate statistical technique must be used to establish the arm's length range. In this case the district director uses the interquartile range to determine the arm's length range. Therefore, the arm's length range covers royalty rates from 1.25 to 2.5 percent, and an adjustment is warranted to the 3 percent royalty charged in the controlled transfer. The district director determines that the appropriate adjustment corresponds to a reduction in the royalty rate to 2.0 percent, which is the median of the uncontrolled comparables.

Example 4. (i) USdrug, a U.S. pharmaceutical company, has developed a new drug, Nosplit, that is useful in treating migraine headaches and produces no significant side effects. Nosplit replaces another drug, Lessplit, that USdrug had previously produced and marketed as a treatment for migraine headaches. A number of other drugs for treating migraine headaches are already on the market, but Nosplit can be expected rapidly to dominate the worldwide market for such treatments and to command a premium price since all other treatments produce side effects. Thus, USdrug projects that extraordinary profits will be derived from Nosplit in the U.S. market and other markets.

(ii) USdrug licenses its newly established European subsidiary, Eurodrug, the rights to produce and market Nosplit in the European market. In setting the royalty rate for this license, USdrug considers the royalty that it established previously when it licensed the right to produce and market Lessplit in the European market to an unrelated European pharmaceutical company. In many respects the two license agreements are closely comparable. The drugs were licensed at the same stage in their development and the agreements conveyed identical rights to the licensees. Moreover, there appear to have been no significant changes in the European market for migraine headache treatments since Lessplit was licensed. However, at the time that Lessplit was licensed there were several other similar drugs already on the market to which Lessplit was not in all cases superior. Consequently, the projected and actual Lessplit profits were substantially less than the projected Nosplit profits. Thus, USdrug concludes that the profit potential of Lessplit is not similar to the profit potential of Nosplit, and the Lessplit license agreement consequently is not a comparable uncontrolled transaction for purposes of this paragraph (c) in spite of the other indicia of comparability between the two intangibles.

(d) *Unspecified methods*—(1) *In general.* Methods not specified in paragraphs (a)(1), (2), and (3) of this section may be used to evaluate whether the amount charged in a controlled transaction is arm's length. Any method used under this paragraph (d) must be applied in accordance with the provisions of §1.482–1. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. For example, the comparable uncontrolled transaction method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price the parties would have agreed to had they resorted directly to a market alternative to the controlled transaction. Therefore, in establishing whether a controlled transaction achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See §1.482–1(c). Therefore, in accordance with §1.482–1(d) (Comparability), to the extent that a method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

(2) *Example.* The following example illustrates an application of the principle of this paragraph (d).

Example (i) USbond is a U.S. company that licenses to its foreign subsidiary, Eurobond, a proprietary process that permits the manufacture of Longbond, a long-lasting industrial adhesive, at a substantially lower cost than otherwise would be possible. Using the proprietary process, Eurobond manufactures Longbond and sells it to related and unrelated parties for the market price of $550 per ton. Under the terms of the license agreement, Eurobond pays USbond a royalty of $100 per ton of Longbond sold. USbond also manufactures and markets Longbond in the United States.

(ii) In evaluating whether the consideration paid for the transfer of the proprietary process to Eurobond was arm's length, the district director may consider, subject to the best method rule of § 1.482–1(c), USbond's alternative of producing and selling Longbond itself. Reasonably reliable estimates indicate that if USbond directly supplied Longbond to the European market, a selling price of $300 per ton would cover its costs and provide a reasonable profit for its functions, risks and investment of capital associated with the production of Longbond for the European market. Given that the market price of Longbond was $550 per ton, by licensing the proprietary process to Eurobond, USbond forgoes $250 per ton of profit over the profit that would be necessary to compensate it for the functions, risks and investment involved in supplying Longbond to the European market itself. Based on these facts, the district director concludes that a royalty of $100 for the proprietary process is not arm's length.

(e) *Coordination with tangible property rules.* See § 1.482–3(f) for the provisions regarding the coordination between the tangible property and intangible property rules.

(f) *Special rules for transfers of intangible property*—(1) *Form of consideration.* If a transferee of an intangible pays nominal or no consideration and the transferor has retained a substantial interest in the property, the arm's length consideration shall be in the form of a royalty, unless a different form is demonstrably more appropriate.

(2) *Periodic adjustments*—(i) General rule. If an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible. Adjustments made pursuant to this paragraph (f)(2) shall be consistent with the arm's length standard and the provisions of § 1.482–1. In determining whether to make such adjustments in the taxable year under examination, the district director may consider all relevant facts and circumstances throughout the period the intangible is used. The determination in an earlier year that the amount charged for an intangible was an arm's length amount will not preclude the district director in a subsequent taxable year from making an adjustment to the amount charged for the intangible in the subsequent year. A periodic adjustment under the commensurate with income requirement of section 482 may be made in a subsequent taxable year without regard to whether the taxable year of the original transfer remains open for statute of limitation purposes. For exceptions to this rule see paragraph (f)(2)(ii) of this section.

(ii) *Exceptions*—(A) *Transactions involving the same intangible.* If the same intangible was transferred to an uncontrolled taxpayer under substantially the same circumstances as those of the controlled transaction; this transaction serves as the basis for the application of the comparable uncontrolled transaction method in the first taxable year in which substantial periodic consideration was required to be paid; and the amount paid in that year was an arm's length amount, then no allocation in a subsequent year will be made under paragraph (f)(2)(i) of this paragraph for a controlled transfer of intangible property.

(B) *Transactions involving comparable intangible.* If the arm's length result is derived from the application of the comparable uncontrolled transaction method based on the transfer of a comparable intangible under comparable circumstances to those of the controlled transaction, no allocation will be made under paragraph (f)(2)(i) of this section if each of the following facts is established—

(*1*) The controlled taxpayers entered into a written agreement (controlled agreement) that provided for an amount of consideration with respect to each taxable year subject to such agreement, such consideration was an arm's length amount for the first taxable year in which substantial periodic consideration was required to be paid under the agreement, and such agreement remained in effect for the taxable year under review;

(*2*) There is a written agreement setting forth the terms of the comparable uncontrolled transaction relied upon to establish the arm's length consideration (uncontrolled agreement), which contains no provisions that would permit any change to the amount of consideration, a renegotiation, or a termination of the agreement, in circumstances comparable to those of the controlled transaction in the taxable year under review (or that contains provisions permitting only specified, non-contingent, periodic changes to the amount of consideration);

(*3*) The controlled agreement is substantially similar to the uncontrolled agreement, with respect to the time period for which it is effective and the provisions described in paragraph (f)(2)(ii)(B)(*2*) of this section;

(*4*) The controlled agreement limits use of the intangible to a specified field or purpose in a manner that is consistent with industry practice and any such limitation in the uncontrolled agreement;

(*5*) There were no substantial changes in the functions performed by the controlled transferee after the controlled agreement was executed, except changes required by events that were not foreseeable; and

(*6*) The aggregate profits actually earned or the aggregate cost savings actually realized by the controlled taxpayer from the exploitation of the intangible in the year under examination, and all past years, are not less than 80% nor more than 120% of the prospective profits or cost savings that were foreseeable when the comparability of the uncontrolled agreement was established under paragraph (c)(2) of this section.

(C) *Methods other than comparable uncontrolled transaction.* If the arm's length amount was determined under any method other than the comparable uncontrolled transaction method, no allocation will be made under paragraph (f)(2)(i) of this section if each of the following facts is established—

(*1*) The controlled taxpayers entered into a written agreement (controlled agreement) that provided for an amount of consideration with respect to each taxable year subject to such agreement, and such agreement remained in effect for the taxable year under review;

(*2*) The consideration called for in the controlled agreement was an arm's length amount for the first taxable year in which substantial periodic consideration was required to be paid, and relevant supporting documentation was prepared contemporaneously with the execution of the controlled agreement;

(*3*) There have been no substantial changes in the functions performed by the transferee since the controlled agreement was executed, except changes required by events that were not foreseeable; and

(*4*) The total profits actually earned or the total cost savings realized by the controlled transferee from the exploitation of the intangible in the year under examination, and all past years, are not less than 80% nor more than 120% of the prospective profits or cost savings that were foreseeable when the controlled agreement was entered into.

(D) *Extraordinary events.* No allocation will be made under paragraph (f)(2)(i) of this section if the following requirements are met—

(*1*) Due to extraordinary events that were beyond the control of the controlled taxpayers and that could not reasonably have been anticipated at the time the controlled agreement was entered into, the aggregate actual profits or aggregate cost savings realized by the taxpayer are less than 80% or more than 120% of the prospective profits or cost savings; and

(*2*) All of the requirements of paragraph (f)(2)(ii) (B) or (C) of this section are otherwise satisfied.

(E) *Five-year period.* If the requirements of §1.482–4 (f)(2)(ii)(B) or (f)(2)(ii)(C) are met for each year of the five-year period beginning with the first year in which substantial periodic consideration was required to be paid, then no periodic adjustment will be made under paragraph (f)(2)(i) of this section in any subsequent year.

(iii) *Examples.* The following examples illustrate this paragraph (f)(2).

Example 1. (i) USdrug, a U.S. pharmaceutical company, has developed a new drug, Nosplit, that is useful in treating migraine headaches and produces no significant side effects. A number of other drugs for treating migraine headaches are already on the market, but Nosplit can be expected rapidly to dominate the worldwide market for such treatments and to command a premium price since all other treatments produce side effects. Thus, USdrug projects that extraordinary profits will be derived from Nosplit in the U.S. and European markets.

(ii) USdrug licenses its newly established European subsidiary, Eurodrug, the rights to produce and market Nosplit for the European market for 5 years. In setting the royalty rate for this license, USdrug makes projections of the annual sales revenue and the annual profits to be derived from the exploitation of Nosplit by Eurodrug. Based on the projections, a royalty rate of 3.9% is established for the term of the license.

(iii) In Year 1, USdrug evaluates the royalty rate it received from Eurodrug. Given the high profit potential of Nosplit, USdrug is unable to locate any uncontrolled transactions dealing with licenses of comparable intangible property. USdrug therefore determines that the comparable uncontrolled transaction method will not provide a reliable measure of an arm's length royalty. However, applying the comparable profits method to Eurodrug, USdrug determines that a royalty rate of 3.9% will result in Eurodrug earning an arm's length return for its manufacturing and marketing functions.

(iv) In Year 5, the U.S. income tax return for USdrug is examined, and the district director must determine whether the royalty rate between USdrug and Eurodrug is commensurate with the income attributable to Nosplit. In making this determination, the district director considers whether any of the exceptions in § 1.482–4(f)(2)(ii) are applicable. In particular, the district director compares the profit projections attributable to Nosplit made by USdrug against the actual profits realized by Eurodrug. The projected and actual profits are as follows:

	Profit projections	Actual profits
Year 1	200	250
Year 2	250	300
Year 3	500	600
Year 4	350	200
Year 5	100	100
Total	1400	1450

(v) The total profits earned through Year 5 were not less than 80% nor more than 120% of the profits that were projected when the license was entered into. If the district director determines that the other requirements of § 1.482–4(f)(2)(ii)(C) were met, no adjustment will be made to the royalty rate between USdrug and Eurodrug for the license of Nosplit.

Example 2. (i) The facts are the same as in *Example 1,* except that Eurodrug's actual profits earned were much higher than the projected profits, as follows:

	Profit projections	Actual profits
Year 1	200	250
Year 2	250	500
Year 3	500	800
Year 4	350	700
Year 5	100	600
Total	1400	2850

(ii) In examining USdrug's tax return for Year 5, the district director considers the actual profits realized by Eurodrug in Year 5, and all past years. Accordingly, although Years 1 through 4 may be closed under the statute of limitations, for purposes of determining whether an adjustment should be made with respect to the royalty rate in Year 5 with respect to Nosplit, the district director aggregates the actual profits from those years with the profits of Year 5. However, the district director will make an adjustment, if any, only with respect to Year 5.

Example 3. (i) FP, a foreign corporation, licenses to USS, its U.S. subsidiary, a new air-filtering process that permits manufacturing plants to meet new environmental standards. The license runs for a 10-year period, and the profit derived from the new process is projected to be $15 million per year, for an aggregate profit of $150 million.

(ii) The royalty rate for the license is based on a comparable uncontrolled transaction involving a comparable intangible under comparable circumstances. The requirements of paragraphs (f)(2)(ii)(B)(*1*) through (*5*) of this section have been met. Specifically, FP and USS have entered into a written agreement that provides for a royalty in each year of the license, the royalty rate is considered arm's length for the first taxable year in which a substantial royalty was required to be paid, the license limited the use of the process to a specified field, consistent with industry practice, and there are no substantial changes in the functions performed by USS after the license was entered into.

(iii) In examining Year 4 of the license, the district director determines that the aggregate actual profits earned by USS through Year 4 are $30 million, less than 80% of the projected profits of $60 million. However, USS establishes to the satisfaction of the district director that the aggregate actual profits from the process are less than 80% of the projected profits in Year 3 because an earthquake severely damaged USS's manufacturing plant. Because the difference between the projected profits and actual profits was due to an extraordinary event that was beyond the control of USS, and could not reasonably have been anticipated at the time the license was entered into, the requirement under § 1.482–4(f)(2)(ii)(D) has been met, and no adjustment under this section is made.

(3) *Ownership of intangible property*—(i) *In general.* If the owner of the rights to exploit an intangible transfers such rights to a controlled taxpayer, the owner must receive an amount of consideration with respect to such transfer that is determined in accordance with the provisions of this section. If another controlled taxpayer provides assistance to the owner in connection

with the development or enhancement of an intangible, such person may be entitled to receive consideration with respect to such assistance. See §1.482–4(f)(3)(iii) (Allocations with respect to assistance provided to the owner). Because the right to exploit an intangible can be subdivided in various ways, a single intangible may have multiple owners for purposes of this paragraph (3)(i). Thus, for example, the owner of a trademark may license to another person the exclusive right to use that trademark in a specified geographic area for a specified period of time (while otherwise retaining the right to use the intangible). In such a case, both the licensee and the licensor will be considered owners for purposes of this paragraph (f)(3)(i), with respect to their respective exploitation rights.

(ii) *Identification of owner*—(A) *Legally protected intangible property.* The legal owner of a right to exploit an intangible ordinarily will be considered the owner for purposes of this section. Legal ownership may be acquired by operation of law or by contract under which the legal owner transfers all or part of its rights to another. Further, the district director may impute an agreement to convey legal ownership if the conduct of the controlled taxpayers indicates the existence in substance of such an agreement. See §1.482–1(d)(3)(ii)(B) (Identifying contractual terms).

(B) *Intangible property that is not legally protected.* In the case of intangible property that is not legally protected, the developer of the intangible will be considered the owner. Except as provided in §1.482–7T, if two or more controlled taxpayers jointly develop an intangible, for purposes of section 482, only one of the controlled taxpayers will be regarded as the developer and owner of the intangible, and the other participating members will be regarded as assisters. Ordinarily, the developer is the controlled taxpayer that bore the largest portion of the direct and indirect costs of developing the intangible, including the provision, without adequate compensation, of property or services likely to contribute substantially to developing the intangible. A controlled taxpayer will be presumed not to have borne the costs of development if, pursuant to an agreement entered into before the success of the project is known, another person is obligated to reimburse the controlled taxpayer for its costs. If it cannot be determined which controlled taxpayer bore the largest portion of the costs of development, all other facts and circumstances will be taken into consideration, including the location of the development activities, the capability of each controlled taxpayer to carry on the project independently, the extent to which each controlled taxpayer controls the project, and the conduct of the controlled taxpayers.

(iii) *Allocations with respect to assistance provided to the owner.* Allocations may be made to reflect an arm's length consideration for assistance provided to the owner of an intangible in connection with the development or enhancement of the intangible. Such assistance may include loans, services, or the use of tangible or intangible property. Assistance does not, however, include expenditures of a routine nature that an unrelated party dealing at arm's length would be expected to incur under circumstances similar to those of the controlled taxpayer. The amount of any allocation required with respect to that assistance must be determined in accordance with the applicable rules under section 482.

(iv) *Examples.* The principles of this paragraph are illustrated by the following examples.

Example 1. A, a member of a controlled group, allows B, another member of the controlled group and the owner of an intangible, to use tangible property, such as laboratory equipment, in connection with the development of the intangible. Any allocations with respect to the owner's use of the property will be determined under §1.482–2(c).

Example 2. FP, a foreign producer of cheese, markets the cheese in countries other than the United States under the tradename Fromage Frere. FP owns all the worldwide rights to this name. The name is widely known and is valuable outside the United States but is not known within the United States. In 1995, FP decides to enter the United States market and incorporates U.S. subsidiary, USSub, to be its U.S. distributor and to supervise the advertising and other marketing efforts that will be required to develop the name Fromage Frere in the United States. USSub incurs expenses that are not reimbursed by FP for developing the U.S.

market for Fromage Frere. These expenses are comparable to the levels of expense incurred by independent distributors in the U.S. cheese industry when introducing a product in the U.S. market under a brand name owned by a foreign manufacturer. Since USSub would have been expected to incur these expenses if it were unrelated to FP, no allocation to USSub is made with respect to the market development activities performed by USSub.

Example 3. The facts are the same as in *Example 2,* except that the expenses incurred by USSub are significantly larger than the expenses incurred by independent distributors under similar circumstances. FP does not reimburse USSub for its expenses. The district director concludes based on this evidence that an unrelated party dealing at arm's length under similar circumstances would not have engaged in the same level of activity relating to the development of FP's marketing intangibles. The expenditures in excess of the level incurred by the independent distributors therefore are considered to be a service provided to FP that adds to the value of FP's trademark for Fromage Frere. Accordingly, the district director makes an allocation under section 482 for the fair market value of the services that USSub is considered to have performed for FP.

Example 4. The facts are the same as in *Example 3,* except that FP and USSub conclude a long term agreement under which USSub receives the exclusive right to distribute cheese in the United States under FP's trademark. USSub purchases cheese from FP at an arm's length price. Since USSub is the owner of the trademark under paragraph (f)(3)(ii)(A) of this section, and its conduct is consistent with that status, its activities related to the development of the trademark are not considered to be a service performed for the benefit of FP, and no allocation is made with respect to such activities.

(4) *Consideration not artificially limited.* The arm's length consideration for the controlled transfer of an intangible is not limited by the consideration paid in any uncontrolled transactions that do not meet the requirements of the comparable uncontrolled transaction method described in paragraph (c) of this section. Similarly, the arm's length consideration for an intangible is not limited by the prevailing rates of consideration paid for the use or transfer of intangibles within the same or similar industry.

(5) *Lump sum payments*—(i) *In general.* If an intangible is transferred in a controlled transaction for a lump sum, that amount must be commensurate with the income attributable to the intangible. A lump sum is commensurate with income in a taxable year if the equivalent royalty amount for that taxable year is equal to an arm's length royalty. The equivalent royalty amount for a taxable year is the amount determined by treating the lump sum as an advance payment of a stream of royalties over the useful life of the intangible (or the period covered by an agreement, if shorter), taking into account the projected sales of the licensee as of the date of the transfer. Thus, determining the equivalent royalty amount requires a present value calculation based on the lump sum, an appropriate discount rate, and the projected sales over the relevant period. The equivalent royalty amount is subject to periodic adjustments under § 1.482–4(f)(2)(i) to the same extent as an actual royalty payment pursuant to a license agreement.

(ii) *Exceptions.* No periodic adjustment will be made under paragraph (f)(2)(i) of this section if any of the exceptions to periodic adjustments provided in paragraph (f)(2)(ii) of this section apply.

(iii) *Example.* The following example illustrates the principle of this paragraph (f)(5).

Example. Calculation of the equivalent royalty amount. (i) FSub is the foreign subsidiary of USP, a U.S. company. USP licenses FSub the right to produce and sell the whopperchopper, a patented new kitchen appliance, for the foreign market. The license is for a period of five years, and payment takes the form of a single lump-sum charge of $500,000 that is paid at the beginning of the period.

(ii) The equivalent royalty amount for this license is determined by deriving an equivalent royalty rate equal to the lump-sum payment divided by the present discounted value of FSub's projected sales of whopperchoppers over the life of the license. Based on the riskiness of the whopperchopper business, an appropriate discount rate is determined to be 10 percent. Projected sales of whopperchoppers for each year of the license are as follows:

Year	Projected sales
1	$2,500,000
2	2,600,000
3	2,700,000
4	2,700,000
5	2,750,000

(iii) Based on this information, the present discounted value of the projected whopperchopper sales is approximately $10 million, yielding an equivalent royalty rate of approximately 5%. Thus, the equivalent royalty amounts for each year are as follows:

Year	Projected sales	Equivalent royalty amount
1	$2,500,000	$125,000
2	2,600,000	130,000
3	2,700,000	135,000
4	2,700,000	135,000
5	2,750,000	137,500

(iv) If in any of the five taxable years the equivalent royalty amount is determined not to be an arm's length amount, a periodic adjustment may be made pursuant to §1.482–4(f)(2)(i). The adjustment in such case would be equal to the difference between the equivalent royalty amount and the arm's length royalty in that taxable year.

[T.D. 8552, 59 FR 35016, July 8, 1994]

§1.482–5 Comparable profits method.

(a) *In general.* The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.

(b) *Determination of arm's length result*—(1) *In general.* Under the comparable profits method, the determination of an arm's length result is based on the amount of operating profit that the tested party would have earned on related party transactions if its profit level indicator were equal to that of an uncontrolled comparable (comparable operating profit). Comparable operating profit is calculated by determining a profit level indicator for an uncontrolled comparable, and applying the profit level indicator to the financial data related to the tested party's most narrowly identifiable business activity for which data incorporating the controlled transaction is available (relevant business activity). To the extent possible, profit level indicators should be applied solely to the tested party's financial data that is related to controlled transactions. The tested party's reported operating profit is compared to the comparable operating profits derived from the profit level indicators of uncontrolled comparables to determine whether the reported operating profit represents an arm's length result.

(2) *Tested party*—(i) *In general.* For purposes of this section, the tested party will be the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located. Consequently, in most cases the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.

(ii) *Adjustments for tested party.* The tested party's operating profit must first be adjusted to reflect all other allocations under section 482, other than adjustments pursuant to this section.

(3) *Arm's length range.* See §1.482–1(e)(2) for the determination of the arm's length range. For purposes of the comparable profits method, the arm's length range will be established using comparable operating profits derived from a single profit level indicator.

(4) *Profit level indicators.* Profit level indicators are ratios that measure relationships between profits and costs incurred or resources employed. A variety of profit level indicators can be calculated in any given case. Whether use of a particular profit level indicator is appropriate depends upon a number of factors, including the nature of the activities of the tested party, the reliability of the available data with respect to uncontrolled comparables, and the extent to which the profit level indicator is likely to produce a reliable measure of the income that the tested party would have earned had it dealt with controlled taxpayers at arm's length, taking into account all of the facts and circumstances. The profit level indicators should be derived from a sufficient number of years of data to reasonably measure returns that accrue to uncontrolled comparables. Generally, such a period should encompass at least the taxable year under review and the preceding two taxable years. This analysis must be applied in accordance with §1.482–1(f)(2)(iii)(D).

Profit level indicators that may provide a reliable basis for comparing operating profits of the tested party and uncontrolled comparables include the following—

(i) *Rate of return on capital employed.* The rate of return on capital employed is the ratio of operating profit to operating assets. The reliability of this profit level indicator increases as operating assets play a greater role in generating operating profits for both the tested party and the uncontrolled comparable. In addition, reliability under this profit level indicator depends on the extent to which the composition of the tested party's assets is similar to that of the uncontrolled comparable. Finally, difficulties in properly valuing operating assets will diminish the reliability of this profit level indicator.

(ii) *Financial ratios.* Financial ratios measure relationships between profit and costs or sales revenue. Since functional differences generally have a greater effect on the relationship between profit and costs or sales revenue than the relationship between profit and operating assets, financial ratios are more sensitive to functional differences than the rate of return on capital employed. Therefore, closer functional comparability normally is required under a financial ratio than under the rate of return on capital employed to achieve a similarly reliable measure of an arm's length result. Financial ratios that may be appropriate include the following—

(A) Ratio of operating profit to sales; and

(B) Ratio of gross profit to operating expenses. Reliability under this profit level indicator also depends on the extent to which the composition of the tested party's operating expenses is similar to that of the uncontrolled comparables.

(iii) *Other profit level indicators.* Other profit level indicators not described in this paragraph (b)(4) may be used if they provide reliable measures of the income that the tested party would have earned had it dealt with controlled taxpayers at arm's length. However, profit level indicators based solely on internal data may not be used under this paragraph (b)(4) because they are not objective measures of profitability derived from operations of uncontrolled taxpayers engaged in similar business activities under similar circumstances.

(c) *Comparability and reliability considerations*—(1) *In general.* Whether results derived from application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in § 1.482–1(c).

(2) *Comparability*—(i) *In general.* The degree of comparability between an uncontrolled taxpayer and the tested party is determined by applying the provisions of § 1.482–1(d)(2). The comparable profits method compares the profitability of the tested party, measured by a profit level indicator (generally based on operating profit), to the profitability of uncontrolled taxpayers in similar circumstances. As with all methods that rely on external market benchmarks, the greater the degree of comparability between the tested party and the uncontrolled taxpayer, the more reliable will be the results derived from the application of this method. The determination of the degree of comparability between the tested party and the uncontrolled taxpayer depends upon all the relevant facts and circumstances, including the relevant lines of business, the product or service markets involved, the asset composition employed (including the nature and quantity of tangible assets, intangible assets and working capital), the size and scope of operations, and the stage in a business or product cycle.

(ii) *Functional, risk and resource comparability.* An operating profit represents a return for the investment of resources and assumption of risks. Therefore, although all of the factors described in § 1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on resources employed and risks assumed. Moreover, because resources and risks usually are directly related to functions performed, it is also important to consider functions performed in determining the degree of comparability between the tested party and an uncontrolled taxpayer. The degree of functional comparability required to obtain a reliable result under the comparable profits method, however, is generally less than that required under the resale price or cost plus methods. For example, because differences in functions performed often are reflected in operating expenses, taxpayers performing different functions may have very different gross profit margins but earn similar levels of operating profit.

(iii) *Other comparability factors.* Other factors listed in §1.482–1(d)(3) also may be particularly relevant under the comparable profits method. Because operating profit usually is less sensitive than gross profit to product differences, reliability under the comparable profits method is not as dependent on product similarity as the resale price or cost plus method. However, the reliability of profitability measures based on operating profit may be adversely affected by factors that have less effect on results under the comparable uncontrolled price, resale price, and cost plus methods. For example, operating profit may be affected by varying cost structures (as reflected, for example, in the age of plant and equipment), differences in business experience (such as whether the business is in a start-up phase or is mature), or differences in management efficiency (as indicated, for example, by objective evidence such as expanding or contracting sales or executive compensation over time). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(iv) *Adjustments for the differences between the tested party and the uncontrolled taxpayers.* If there are differences between the tested party and an uncontrolled comparable that would materially affect the profits determined under the relevant profit level indicator, adjustments should be made according to the comparability provisions of §1.482–1(d)(2). In some cases, the assets of an uncontrolled comparable may need to be adjusted to achieve greater comparability between the tested party and the uncontrolled comparable. In such cases, the uncontrolled comparable's operating income attributable to those assets must also be adjusted before computing a profit level indicator in order to reflect the income and expense attributable to the adjusted assets. In certain cases it may also be appropriate to adjust the operating profit of the tested party and comparable parties. For example, where there are material differences in accounts payable among the comparable parties and the tested party, it will generally be appropriate to adjust the operating profit of each party by increasing it to reflect an imputed interest charge on each party's accounts payable.

(3) *Data and assumptions*—(i) *In general.* The reliability of the results derived from the comparable profits method is affected by the quality of the data and assumptions used to apply this method.

(ii) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect operating profit affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect operating profit, the ability to make reliable adjustments for such differences would affect the reliability of the results.

(iii) *Allocations between the relevant business activity and other activities.* The reliability of the allocation of costs, income, and assets between the relevant business activity and other activities of the tested party or an uncontrolled comparable will affect the reliability of the determination of operating profit and profit level indicators. If it is not possible to allocate costs, income, and assets directly based on factual relationships, a reasonable allocation formula may be used. To the extent direct allocations are not made, the reliability of the results derived from the application of this method is reduced relative to the results of a method that requires fewer allocations of costs, income, and assets. Similarly, the reliability of the results derived from the application of this method is affected by the extent to which it is possible to apply the profit level indicator to the tested party's financial data that is related solely to the controlled transactions. For example, if the relevant business activity is the assembly of components purchased from both controlled and uncontrolled suppliers, it may not be possible to apply the profit level indicator solely to financial data related to the controlled transactions. In such a case, the reliability of the results derived from the application of this method will be reduced.

(d) *Definitions.* The definitions set forth in paragraphs (d)(1) through (6) of this section apply for purposes of this section.

(1) *Sales revenue* means the amount of the total receipts from sale of goods and provision of services, less returns and allowances. Accounting principles and conventions that are generally accepted in the trade or industry of the controlled taxpayer under review must be used.

(2) *Gross profit* means sales revenue less cost of goods sold.

(3) *Operating expenses* includes all expenses not included in cost of goods sold except for interest expense, foreign income taxes (as defined in § 1.901–2(a)), domestic income taxes, and any other expenses not related to the operation of the relevant business activity. Operating expenses ordinarily include expenses associated with advertising, promotion, sales, marketing, warehousing and distribution, administration, and a reasonable allowance for depreciation and amortization.

(4) *Operating profit* means gross profit less operating expenses. Operating profit includes all income derived from the business activity being evaluated by the comparable profits method, but does not include interest and dividends, income derived from activities not being tested by this method, or extraordinary gains and losses that do not relate to the continuing operations of the tested party.

(5) *Reported operating profit* means the operating profit of the tested party reflected on a timely filed U.S. income tax return. If the tested party files a U.S. income tax return, its operating profit is considered reflected on a U.S. income tax return if the calculation of taxable income on its return for the taxable year takes into account the income attributable to the controlled transaction under review. If the tested party does not file a U.S. income tax return, its operating profit is considered reflected on a U.S. income tax return in any taxable year for which income attributable to the controlled transaction under review affects the calculation of the U.S. taxable income of any other member of the same controlled group. If the comparable operating profit of the tested party is determined from profit level indicators derived from financial statements or other accounting records and reports of comparable parties, adjustments may be made to the reported operating profit of the tested party in order to account for material differences between the tested party's operating profit reported for U.S income tax purposes and the tested party's operating profit for financial statement purposes. In addition, in accordance with § 1.482–1(f)(2)(iii)(D), adjustments under section 482 that are finally determined may be taken into account in determining reported operating profit.

(6) *Operating assets.* The term operating assets means the value of all assets used in the relevant business activity of the tested party, including fixed assets and current assets (such as cash, cash equivalents, accounts receivable, and inventories).

The term does not include investments in subsidiaries, excess cash, and portfolio investments. Operating assets may be measured by their net book value or by their fair market value, provided that the same method is consistently applied to the tested party and the comparable parties, and consistently applied from year to year. In addition, it may be necessary to take into account recent acquisitions, leased assets, intangibles, currency fluctuations, and other items that may not be explicitly recorded in the financial statements of the tested party or uncontrolled comparable. Finally, operating assets must be measured by the average of the values for the beginning of the year and the end of the year, unless substantial fluctuations in the value of operating assets during the year make this an inaccurate measure of the average value over the year. In such a case, a more accurate measure of the average value of operating assets must be applied.

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

Example 1 Transfer of tangible property resulting in no adjustment. (i) FP is a publicly traded foreign corporation with a U.S. subsidiary, USSub, that is under audit for its 1996 taxable year. FP manufactures a consumer product for worldwide distribution. USSub imports the assembled product and distributes it within the United States at the wholesale level under the FP name.

(ii) FP does not allow uncontrolled taxpayers to distribute the product. Similar products are produced by other companies but none of them is sold to uncontrolled taxpayers or to uncontrolled distributors.

(iii) Based on all the facts and circumstances, the district director determines that the comparable profits method will provide the most reliable measure of an arm's length result. USSub is selected as the tested party because it engages in activities that are less complex than those undertaken by FP.

There is data from a number of independent operators of wholesale distribution businesses. These potential comparables are further narrowed to select companies in the same industry segment that perform similar functions and bear similar risks to USSub. An analysis of the information available on these taxpayers shows that the ratio of operating profit to sales is the most appropriate profit level indicator, and this ratio is relatively stable where at least three years are included in the average. For the taxable years 1994 through 1996, USSub shows the following results:

	1994	1995	1996	Average
Sales	$500,000	$560,000	$500,000	$520,000
Cost of Goods Sold	393,000	412,400	400,000	401,800
Operating Expenses	80,000	110,000	104,600	98,200
Operating Profit	27,000	37,600	(4,600)	20,000

(iv) After adjustments have been made to account for identified material differences between USSub and the uncontrolled distributors, the average ratio of operating profit to sales is calculated for each of the uncontrolled distributors. Applying each ratio to USSub would lead to the following comparable operating profit (COP) for USSub:

Uncontrolled distributor	OP/S (percent)	USSub COP
A	1.7	$8,840
B	3.1	16,120
C	3.8	19,760
D	4.5	23,400
E	4.7	24,440
F	4.8	24,960
G	4.9	25,480
H	6.7	34,840
I	9.9	51,480
J	10.5	54,600

(v) The data is not sufficiently complete to conclude that it is likely that all material differences between USSub and the uncontrolled distributors have been identified. Therefore, an arm's length range can be established only pursuant to §1.482-1(e)(2)(iii)(B). The district director measures the arm's length range by the interquartile range of results, which consists of the results ranging from $19,760 to $34,840. Although USSub's operating income for 1996 shows a loss of $4,600, the district director determines that no allocation should be made, because USSub's average reported operating profit of $20,000 is within this range.

Example 2 —Transfer of tangible property resulting in adjustment. (i) The facts are the same as in *Example 1* except that USSub reported the following income and expenses:

	1994	1995	1996	Average
Sales	$500,000	$560,000	$500,000	$520,000
Cost of Good Sold	370,000	460,000	400,000	410,000
Operating Expenses	110,000	110,000	110,000	110,000
Operating Profit	20,000	(10,000)	(10,000)	0

(ii) The interquartile range of comparable operating profits remains the same as derived in *Example 1:* $19,760 to $34,840. USSub's average operating profit for the years 1994 through 1996 ($0) falls outside this range. Therefore, the district director determines that an allocation may be appropriate.

(iii) To determine the amount, if any, of the allocation, the district director compares USSub's reported operating profit for 1996 to comparable operating profits derived from the uncontrolled distributors' results for 1996. The ratio of operating profit to sales in 1996 is calculated for each of the uncontrolled comparables and applied to USSub's 1996 sales to derive the following results:

Uncontrolled distributor	OP/S (percent)	USSub COP
C	0.5	$2,500
D	1.5	7,500
E	2.0	10,000
A	1.6	13,000
F	2.8	14,000
B	2.9	14,500
J	3.0	15,000
I	4.4	22,000
H	6.9	34,500
G	7.4	37,000

(iv) Based on these results, the median of the comparable operating profits for 1996 is $14,250. Therefore, USSub's income for 1996 is increased by $24,250, the difference between USSub's reported operating profit for 1996 and the median of the comparable operating profits for 1996.

Example 3 —Multiple year analysis. (i) The facts are the same as in *Example 2.* In addition, the district director examines the taxpayer's results for the 1997 taxable year. As in *Example 2*, the district director increases USSub's income for the 1996 taxable year by $24,250. The results for the 1997 taxable year, together with the 1995 and 1996 taxable years, are as follows:

	1995	1996	1997	Average
Sales	$560,000	$500,000	$530,000	$530,000
Cost of Good Sold	460,000	400,000	430,000	430,000
Operating Expenses	110,000	110,000	110,000	110,000
Operating Profit	(10,000)	(10,000)	(10,000)	(10,000)

(ii) The interquartile range of comparable operating profits, based on average results from the uncontrolled comparables and average sales for USSub for the years 1995 through 1997, ranges from $15,500 to $30,000. In determining whether an allocation for the 1997 taxable year may be made, the district director compares USSub's average reported operating profit for the years 1995 through 1997 to the interquartile range of average comparable operating profits over this period. USSub's average reported operating profit is determined without regard to the adjustment made with respect to the 1996 taxable year. See § 1.482–1(f)(2)(iii)(D). Therefore, USSub's average reported operating profit for the years 1995 through 1997 is ($10,000). Because this amount of income falls outside the interquartile range, the district director determines that an allocation may be appropriate.

(iii) To determine the amount, if any, of the allocation for the 1997 taxable year, the district director compares USSub's reported operating profit for 1997 to the median of the comparable operating profits derived from the uncontrolled distributors' results for 1997. The median of the comparable operating profits derived from the uncontrolled comparables results for the 1997 taxable year is $12,000. Based on this comparison, the district director increases USSub's 1997 taxable income by $22,000, the difference between the median of the comparable operating profits for the 1997 taxable year and USSub's reported operating profit of ($10,000) for the 1997 taxable year.

Example 4—Transfer of intangible to offshore manufacturer. (i) DevCo is a U.S. developer, producer and marketer of widgets. DevCo develops a new ‘‘high tech widget'' (htw) that is manufactured by its foreign subsidiary ManuCo located in Country H. ManuCo sells the htw to MarkCo (a U.S. subsidiary of DevCo) for distribution and marketing in the United States. The taxable year 1996 is under audit, and the district director examines whether the royalty rate of 5 percent paid by ManuCo to DevCo is an arm's length consideration for the htw technology.

(ii) Based on all the facts and circumstances, the district director determines that the comparable profits method will provide the most reliable measure of an arm's length result. ManuCo is selected as the tested party because it engages in relatively routine manufacturing activities, while DevCo engages in a variety of complex activities using unique and valuable intangibles. Finally, because ManuCo engages in manufacturing activities, it is determined that the ratio of operating profit to operating assets is an appropriate profit level indicator.

(iii) Uncontrolled taxpayers performing similar functions cannot be found in country H. It is determined that data available in countries M and N provides the best match of companies in a similar market performing similar functions and bearing similar risks. Such data is sufficiently complete to identify many of the material differences between ManuCo and the uncontrolled comparables, and to make adjustments to account for such differences. However, data is not sufficiently complete so that it is likely that no material differences remain. In particular, the differences in geographic markets might have materially affected the results of the various companies.

(iv) In a separate analysis, it is determined that the price that ManuCo charged to MarkCo for the htw's is an arm's length price under §1.482–3(b). Therefore, ManuCo's financial data derived from its sales to MarkCo are reliable. ManuCo's financial data from 1994–1996 is as follows:

	1994	1995	1996	Average
Assets	$24,000	$25,000	$26,000	$25,000
Sales to MarkCo	25,000	30,000	35,000	30,000
Cost of Goods Sold	6,250	7,500	8,750	7,500
Royalty to DevCo (5%)	1,250	1,500	1,750	1,500
Other	5,000	6,000	7,000	6,000
Operating Expenses	1,000	1,000	1,000	1,000
Operating Profit	17,750	21,500	25,250	21,500

(v) Applying the ratios of average operating profit to operating assets for the 1994 through 1996 taxable years derived from a group of similar uncontrolled comparables located in country M and N to ManuCo's average operating assets for the same period provides a set of comparable operating profits. The interquartile range for these average comparable operating profits is $3,000 to $4,500. ManuCo's average reported operating profit for the years 1994 through 1996 ($21,500) falls outside this range. Therefore, the district director determines that an allocation may be appropriate for the 1996 taxable year.

(vi) To determine the amount, if any, of the allocation for the 1996 taxable year, the district director compares ManuCo's reported operating profit for 1996 to the median of the comparable operating profits derived from the uncontrolled distributors' results for 1996. The median result for the uncontrolled comparables for 1996 is $3,750. Based on this comparison, the district director increases royalties that ManuCo paid by $21,500 (the difference between $25,250 and the median of the comparable operating profits, $3,750).

Example 5 Adjusting operating assets and operating profit for differences in accounts receivable. (i) USM is a U.S. company that manufactures parts for industrial equipment and sells them to its foreign parent corporation. For purposes of applying the comparable profits method, 15 uncontrolled manufacturers that are similar to USM have been identified.

(ii) USM has a significantly lower level of accounts receivable than the uncontrolled manufacturers. Since the rate of return on capital employed is to be used as the profit level indicator, both operating assets and operating profits must be adjusted to account for this difference. Each uncontrolled comparable's operating assets is reduced by the amount (relative to sales) by which they exceed USM's accounts receivable. Each uncontrolled comparable's operating profit is adjusted by deducting imputed interest income on the excess accounts receivable. This imputed interest income is calculated by multiplying the uncontrolled comparable's excess accounts receivable by an interest rate appropriate for short-term debt.

Example 6 Adjusting operating profit for differences in accounts payable. (i) USD is the U.S. subsidiary of a foreign corporation. USD purchases goods from its foreign parent and sells them in the U.S. market. For purposes of applying the comparable profits method, 10 uncontrolled distributors that are similar to USD have been identified.

(ii) There are significant differences in the level of accounts payable among the uncontrolled distributors and USD. To adjust for these differences, the district director increases the operating profit of the uncontrolled distributors and USD to reflect interest expense imputed to the accounts payable. The imputed interest expense for each company is calculated by multiplying the company's accounts payable by an interest rate appropriate for its short-term debt.

[T.D. 8552, 59 FR 35021, July 8, 1994; 60 FR 16703, Mar. 31, 1995]

§1.482–6 Profit split method.

(a) *In general.* The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most narrowly identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions (relevant business activity).

(b) *Appropriate share of profits and losses.* The relative value of each controlled taxpayer's contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the relevant business activity, consistent with the comparability provisions of § 1.482–1(d)(3). Such an allocation is intended to correspond to the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions similar to those of the various controlled taxpayers engaged in the relevant business activity. The profit allocated to any particular member of a controlled group is not necessarily limited to the total operating profit of the group from the relevant business activity. For example, in a given year, one member of the group may earn a profit while another member incurs a loss. In addition, it may not be assumed that the combined operating profit or loss from the relevant business activity should be shared equally, or in any other arbitrary proportion. The specific method of allocation must be determined under paragraph (c) of this section.

(c) *Application*—(1) *In general.* The allocation of profit or loss under the profit split method must be made in accordance with one of the following allocation methods—(i) The comparable profit split, described in paragraph (c)(2) of this section; or

(ii) The residual profit split, described in paragraph (c)(3) of this section.

(2) *Comparable profit split*—(i) *In general.* A comparable profit split is derived from the combined operating profit of uncontrolled taxpayers whose transactions and activities are similar to those of the controlled taxpayers in the relevant business activity. Under this method, each uncontrolled taxpayer's percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity.

(ii) *Comparability and reliability considerations—(A) In general.* Whether results derived from application of this method are the most reliable measure of the arm's length result is determined using the factors described under the best method rule in § 1.482–1(c).

(B) *Comparability*—(*1*) *In general.* The degree of comparability between the controlled and uncontrolled taxpayers is determined by applying the comparability provisions of § 1.482–1(d). The comparable profit split compares the division of operating profits among the controlled taxpayers to the division of operating profits among uncontrolled taxpayers engaged in similar activities under similar circumstances. Although all of the factors described in § 1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on the considerations described under the comparable profits method in § 1.482–5(c)(2), because this method is based on a comparison of the operating profit of the controlled and uncontrolled taxpayers. In addition, because the contractual terms of the relationship among the participants in the relevant business activity will be a principal determinant of the allocation of functions and risks among them, comparability under this method also depends particularly on the degree of similarity of the contractual terms of the controlled and uncontrolled taxpayers. Finally, the comparable profit split may not be used if the combined operating profit (as a percentage of the combined assets) of the uncontrolled comparables varies significantly from that earned by the controlled taxpayers.

(*2*) *Adjustments for differences between the controlled and uncontrolled taxpayers.* If there are differences between the controlled and uncontrolled taxpayers that would materially affect the division of operating profit, adjustments must be made according to the provisions of § 1.482–1(d)(2).

(C) *Data and assumptions.* The reliability of the results derived from the comparable profit split is affected by the quality of the data and assumptions used to apply this method. In particular, the following factors must be considered—

(*1*) The reliability of the allocation of costs, income, and assets between the relevant business activity and the participants' other activities will affect the accuracy of the determination of combined operating profit and its allocation among the participants. If it is not possible to allocate costs, income, and assets directly based on factual relationships, a reasonable allocation formula may be used. To the extent direct allocations are not made, the reliability of the results derived from the application of this method is reduced relative to the results of a method that requires fewer allocations of costs, income, and assets. Similarly, the reliability of the results derived from the application of this method is affected by the extent to which it is possible to apply the method to the parties' financial data that is related solely to the controlled transactions. For example, if the relevant business activity is the assembly of components purchased from both controlled and uncontrolled suppliers, it may not be possible to apply the method solely to financial data related to the controlled transactions. In such a case, the reliability of the results derived from the application of this method will be reduced.

(*2*) The degree of consistency between the controlled and uncontrolled taxpayers in accounting practices that materially affect the items that determine the amount and allocation of operating profit affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect operating profit, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, accounting consistency among the participants in the controlled transaction is required to ensure that the items determining the amount and allocation of operating profit are measured on a consistent basis.

(D) *Other factors affecting reliability.* Like the methods described in §§1.482–3, 1.482–4, and 1.482–5, the comparable profit split relies exclusively on external market benchmarks. As indicated in §1.482–1(c)(2)(i), as the degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, the reliability of the analysis under this method may be enhanced by the fact that all parties to the controlled transaction are evaluated under the comparable profit split. However, the reliability of the results of an analysis based on information from all parties to a transaction is affected by the reliability of the data and the assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(3) *Residual profit split*—(i) *In general.* Under this method, the combined operating profit or loss from the relevant business activity is allocated between the controlled taxpayers following the two-step process set forth in paragraphs (c)(3)(i)(A) and (B) of this section.

(A) *Allocate income to routine contributions.* The first step allocates operating income to each party to the controlled transactions to provide a market return for its routine contributions to the relevant business activity. Routine contributions are contributions of the same or a similar kind to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns. Routine contributions ordinarily include contributions of tangible property, services and intangibles that are generally owned by uncontrolled taxpayers engaged in similar activities. A functional analysis is required to identify these contributions according to the functions performed, risks assumed, and resources employed by each of the controlled taxpayers. Market returns for the routine contributions should be determined by reference to the returns achieved by uncontrolled taxpayers engaged in similar activities, consistent with the methods described in §§1.482–3, 1.482–4 and 1.482–5.

(B) *Allocate residual profit.* The allocation of income to the controlled taxpayers' routine contributions will not reflect profits attributable to the controlled group's valuable intangible property where similar property is not owned by the uncontrolled taxpayers from which the market returns are derived. Thus, in cases where such intangibles are present there normally will be an unallocated residual profit after the allocation of income described in paragraph (c)(3)(i)(A) of this section. Under this second step, the residual profit generally should be divided among the controlled taxpayers based upon the relative value of their contributions of intangible property to the relevant business activity that was not accounted for as a routine contribution. The relative value of the intangible property contributed by each taxpayer may be measured by external market benchmarks that reflect the fair market value of such intangible property. Alternatively, the relative value of intangible contributions may be estimated by the capitalized cost of developing the intangibles and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible. Finally, if the intangible development expenditures of the parties are relatively constant over time and the useful life of the intangible property of all parties is approximately the same, the amount of actual expenditures in recent years may be used to estimate the relative value of intangible contributions. If the intangible property contributed by one of the controlled taxpayers is also used in other business activities (such as transactions with other controlled taxpayers), an appropriate allocation of the value of the intangibles must be made among all the business activities in which it is used.

(ii) *Comparability and reliability considerations*—(A) *In general.* Whether results derived from this method are the most reliable measure of the arm's length result is determined using the factors described under the best method rule in § 1.482–1(c). Thus, comparability and the quality of data and assumptions must be considered in determining whether this method provides the most reliable measure of an arm's length result. The application of these factors to the residual profit split is discussed in paragraph (c)(3)(ii)(B), (C), and (D) of this section.

(B) *Comparability.* The first step of the residual profit split relies on market benchmarks of profitability. Thus, the comparability considerations that are relevant for the first step of the residual profit split are those that are relevant for the methods that are used to determine market returns for the routine contributions. The second step of the residual profit split, however, may not rely so directly on market benchmarks. Thus, the reliability of the results under this method is reduced to the extent that the allocation of profits in the second step does not rely on market benchmarks.

(C) *Data and assumptions.* The reliability of the results derived from the residual profit split is affected by the quality of the data and assumptions used to apply this method. In particular, the following factors must be considered—

(*1*) The reliability of the allocation of costs, income, and assets as described in paragraph (c)(2)(ii)(C)(*1*) of this section;

(*2*) Accounting consistency as described in paragraph (c)(2)(ii)(C)(*2*) of this section;

(*3*) The reliability of the data used and the assumptions made in valuing the intangible property contributed by the participants. In particular, if capitalized costs of development are used to estimate the value of intangible property, the reliability of the results is reduced relative to the reliability of other methods that do not require such an estimate, for the following reasons. First, in any given case, the costs of developing the intangible may not be related to its market value. Second, the calculation of the capitalized costs of development may require the allocation of indirect costs between the relevant business activity and the controlled taxpayer's other activities, which may affect the reliability of the analysis. Finally, the calculation of costs may require assumptions regarding the useful life of the intangible property.

(D) *Other factors affecting reliability.* Like the methods described in §§ 1.482–3, 1.482–4, and 1.482–5, the first step of the residual profit split relies exclusively on external market benchmarks. As indicated in § 1.482–1(c)(2)(i), as the degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, to the extent the allocation of profits in the second step is not based on external market benchmarks, the reliability of the analysis will be decreased in relation to an analysis under a method that relies on market benchmarks. Finally, the reliability of the analysis under this method may be enhanced by the fact that all parties to the controlled transaction are evaluated under the residual profit split. However, the reliability of the results of an analysis based on information from all parties to a transaction is affected by the reliability of the data and the assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(iii) *Example.* The provisions of this paragraph (c)(3) are illustrated by the following example.

Example—Application of Residual Profit Split. (i) XYZ is a U.S. corporation that develops, manufactures and markets a line of products for police use in the United States. XYZ's research unit developed a bulletproof material for use in protective clothing and headgear (Nulon). XYZ obtains patent protection for the chemical formula for Nulon. Since its introduction in the U.S., Nulon has captured a substantial share of the U.S. market for bulletproof material.

(ii) XYZ licensed its European subsidiary, XYZ-Europe, to manufacture and market Nulon in Europe. XYZ-Europe is a well- established company that manufactures and markets XYZ products in Europe. XYZ-Europe has a research unit that adapts XYZ products for the defense market, as well as a well-developed marketing network that employs brand names that it developed.

(iii) XYZ-Europe's research unit alters Nulon to adapt it to military specifications and develops a high-intensity marketing campaign directed at the defense industry in several European countries. Beginning with the 1995 taxable year, XYZ-Europe manufactures and sells Nulon in Europe through its marketing network under one of its brand names.

(iv) For the 1995 taxable year, XYZ has no direct expenses associated with the license of Nulon to XYZ-Europe and incurs no expenses related to the marketing of Nulon in Europe. For the 1995 taxable year, XYZ-Europe's Nulon sales and pre-royalty expenses are $500 million and $300 million, respectively, resulting in net pre-royalty profit of $200 million related to the Nulon business. The operating assets employed in XYZ-Europe's Nulon business are $200 million. Given the facts and circumstances, the district director determines under the best method rule that a residual profit split will provide the most reliable measure of an arm's length result. Based on an examination of a sample of European companies performing functions similar to those of XYZ-Europe, the district director determines that an average market return on XYZ-Europe's operating assets in the Nulon business is 10 percent, resulting in a market return of $20 million (10% X $200 million) for XYZ- Europe's Nulon business, and a residual profit of $180 million.

(v) Since the first stage of the residual profit split allocated profits to XYZ-Europe's contributions other than those attributable to highly valuable intangible property, it is assumed that the residual profit of $180 million is attributable to the valuable intangibles related to Nulon, i.e., the European brand name for Nulon and the Nulon formula (including XYZ-Europe's modifications). To estimate the relative values of these intangibles, the district director compares the ratios of the capitalized value of expenditures as of 1995 on Nulon-related research and development and marketing over the 1995 sales related to such expenditures.

(vi) Because XYZ's protective product research and development expenses support the worldwide protective product sales of the XYZ group, it is necessary to allocate such expenses among the worldwide business activities to which they relate. The district director determines that it is reasonable to allocate the value of these expenses based on worldwide protective product sales. Using information on the average useful life of its investments in protective product research and development, the district director capitalizes and amortizes XYZ's protective product research and development expenses. This analysis indicates that the capitalized research and development expenditures have a value of $0.20 per dollar of global protective product sales in 1995.

(vii) XYZ-Europe's expenditures on Nulon research and development and marketing support only its sales in Europe. Using information on the average useful life of XYZ-Europe's investments in marketing and research and development, the district director capitalizes and amortizes XYZ-Europe's expenditures and determines that they have a value in 1995 of $0.40 per dollar of XYZ-Europe's Nulon sales.

(viii) Thus, XYZ and XYZ-Europe together contributed $0.60 in capitalized intangible development expenses for each dollar of XYZ-Europe's protective product sales for 1995, of which XYZ contributed one-third (or $0.20 per dollar of sales). Accordingly, the district director determines that an arm's length royalty for the Nulon license for the 1995 taxable year is $60 million, i.e., one-third of XYZ-Europe's $180 million in residual Nulon profit.

[T.D. 8552, 59 FR 35025, July 8, 1994; 60 FR 16382, Mar. 30, 1995]

§ 1.482–7 Sharing of costs.

(a) *In general*—(1) *Scope and application of the rules in this section.* A cost sharing arrangement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement. A taxpayer may claim that a cost sharing arrangement is a qualified cost sharing arrangement only if the agreement meets the requirements of paragraph (b) of this section. Consistent with the rules of § 1.482–1(d)(3)(ii)(B) (Identifying contractual terms), the district director may apply the rules of this section to any arrangement that in substance constitutes a cost sharing arrangement, notwithstanding a failure to comply with any requirement of this section. A qualified cost sharing arrangement, or an arrangement to which the district director applies the rules of this section, will not be treated as a partnership to which the rules of subchapter K apply. See § 301.7701–3(e) of this chapter. Furthermore, a participant that is a foreign corporation or nonresident alien individual will not be treated as engaged in trade or business within the United States solely by reason of its participation in such an arrangement. See generally § 1.864–2(a).

(2) *Limitation on allocations.* The district director shall not make allocations with respect to a qualified cost sharing arrangement except to the extent necessary to make each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equal to its share of reasonably anticipated benefits attributable to such development, under the rules of this section. If a controlled taxpayer acquires an interest in intangible property from another controlled taxpayer (other than in consideration for bearing a share of the costs of the intangible's development), then the district director may make appropriate allocations to reflect an arm's length consideration for the acquisition of the interest in such intangible under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6. See paragraph (g) of this section. An interest in an intangible includes any commercially transferable interest, the benefits of which are susceptible of valuation. See § 1.482–4(b) for the definition of an intangible.

(3) *Cross references.* Paragraph (c) of this section defines participant. Paragraph (d) of this section defines the costs of intangible development. Paragraph (e) of this section defines the anticipated benefits of intangible development. Paragraph (f) of this section provides rules governing cost allocations. Paragraph (g) of this section provides rules governing transfers of intangibles other than in consideration for bearing a share of the costs of the intangible's development. Rules governing the character of payments made pursuant to a qualified cost sharing arrangement are provided in paragraph (h) of this section. Paragraph (i) of this section provides accounting requirements. Paragraph (j) of this section provides administrative requirements. Paragraph (k) of this section provides an effective date. Paragraph (l) provides a transition rule.

(b) *Qualified cost sharing arrangement.* A qualified cost sharing arrangement must—

(1) Include two or more participants;

(2) Provide a method to calculate each controlled participant's share of intangible development costs, based on factors that can reasonably be expected to reflect that participant's share of anticipated benefits;

(3) Provide for adjustment to the controlled participants' shares of intangible development costs to account for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the arrangement; and

(4) Be recorded in a document that is contemporaneous with the formation (and any revision) of the cost sharing arrangement and that includes—

(i) A list of the arrangement's participants, and any other member of the controlled group that will benefit from the use of intangibles developed under the cost sharing arrangement;

(ii) The information described in paragraphs (b)(2) and (b)(3) of this section;

(iii) A description of the scope of the research and development to be undertaken, including the intangible or class of intangibles intended to be developed;

(iv) A description of each participant's interest in any covered intangibles. A covered intangible is any intangible property that is developed as a result of the research and development undertaken under the cost sharing arrangement (intangible development area);

(v) The duration of the arrangement; and

(vi) The conditions under which the arrangement may be modified or terminated and the consequences of such modification or termination, such as the interest that each participant will receive in any covered intangibles.

(c) *Participant*—(1) *In general.* For purposes of this section, a participant is a controlled taxpayer that meets the requirements of this paragraph (c)(1) (controlled participant) or an uncontrolled taxpayer that is a party to the cost sharing arrangement (uncontrolled participant). See §1.482–1(i)(5) for the definitions of controlled and uncontrolled taxpayers. A controlled taxpayer may be a controlled participant only if it—

(i) Reasonably anticipates that it will derive benefits from the use of covered intangibles;

(ii) Substantially complies with the accounting requirements described in paragraph (i) of this section; and

(iii) Substantially complies with the administrative requirements described in paragraph (j) of this section.

(iv) The following example illustrates paragraph (c)(1)(i) of this section:

Example. Foreign Parent (FP) is a foreign corporation engaged in the extraction of a natural resource. FP has a U.S. subsidiary (USS) to which FP sells supplies of this resource for sale in the United States. FP enters into a cost sharing arrangement with USS to develop a new machine to extract the natural resource. The machine uses a new extraction process that will be patented in the United States and in other countries. The cost sharing arrangement provides that USS will receive the rights to use the machine in the extraction of the natural resource in the United States, and FP will receive the rights in the rest of the world. This resource does not, however, exist in the United States. Despite the fact that USS has received the right to use this process in the United States, USS is not a qualified participant because it will not derive a benefit from the use of the intangible developed under the cost sharing arrangement.

(2) *Treatment of a controlled taxpayer that is not a controlled participant*—(i) *In general.* If a controlled taxpayer that is not a controlled participant (within the meaning of this paragraph (c)) provides assistance in relation to the research and development undertaken in the intangible development area, it must receive consideration from the controlled participants under the rules of §1.482–4(f)(3)(iii) (Allocations with respect to assistance provided to the owner). For purposes of paragraph (d) of this section, such consideration is treated as an operating expense and each controlled participant must be treated as incurring a share of such consideration equal to its share of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section).

(ii) *Example.* The following example illustrates this paragraph (c)(2):

Example. (i) U.S. Parent (USP), one foreign subsidiary (FS), and a second foreign subsidiary constituting the group's research arm (R+D) enter into a cost sharing agreement to develop manufacturing intangibles for a new product line A. USP and FS are assigned the exclusive rights to exploit the intangibles respectively in the United States and the rest of the world, where each presently manufactures and sells various existing product lines. R+D is not assigned any rights to exploit the intangibles. R+D's activity consists solely in carrying out research for the group. It is reliably projected that the shares of reasonably anticipated benefits of USP and FS will be 66⅔% and 33⅓, respectively, and the parties' agreement provides that USP and FS will reimburse 66⅔% and 33⅓%, respectively, of the intangible development costs incurred by R+D with respect to the new intangible.

(ii) R+D does not qualify as a controlled participant within the meaning of paragraph (c) of this section, because it will not derive any benefits from the use of covered intangibles. Therefore, R+D is treated as a service provider for purposes of this section and must receive arm's length consideration for the assistance it is deemed to provide to USP and FS, under the rules of §1.482–4(f)(3)(iii). Such consideration must be treated as intangible development costs incurred by USP and

FS in proportion to their shares of reasonably anticipated benefits (i.e., 66⅔% and 33⅓%, respectively). R+D will not be considered to bear any share of the intangible development costs under the arrangement.

(3) *Treatment of consolidated group.* For purposes of this section, all members of the same affiliated group (within the meaning of section 1504(a)) that join in the filing of a consolidated return for the taxable year under section 1501 shall be treated as one taxpayer.

(d) *Costs*—(1) *Intangible development costs.* For purposes of this section, a controlled participant's costs of developing intangibles for a taxable year mean all of the costs incurred by that participant related to the intangible development area, plus all of the cost sharing payments it makes to other controlled and uncontrolled participants, minus all of the cost sharing payments it receives from other controlled and uncontrolled participants. Costs incurred related to the intangible development area consist of the following items: operating expenses as defined in § 1.482–5(d)(3), other than depreciation or amortization expense, plus (to the extent not included in such operating expenses, as defined in § 1.482–5(d)(3)) the charge for the use of any tangible property made available to the qualified cost sharing arrangement. If tangible property is made available to the qualified cost sharing arrangement by a controlled participant, the determination of the appropriate charge will be governed by the rules of § 1.482–2(c) (Use of tangible property). Intangible development costs do not include the consideration for the use of any intangible property made available to the qualified cost sharing arrangement. See paragraph (g)(2) of this section. If a particular cost contributes to the intangible development area and other areas or other business activities, the cost must be allocated between the intangible development area and the other areas or business activities on a reasonable basis. In such a case, it is necessary to estimate the total benefits attributable to the cost incurred. The share of such cost allocated to the intangible development area must correspond to covered intangibles' share of the total benefits. Costs that do not contribute to the intangible development area are not taken into account.

(2) *Examples.* The following examples illustrate this paragraph (d):

Example 1. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a qualified cost sharing arrangement to develop a better mousetrap. USS and FP share the costs of FP's research and development facility that will be exclusively dedicated to this research, the salaries of the researchers, and reasonable overhead costs attributable to the project. They also share the cost of a conference facility that is at the disposal of the senior executive management of each company but does not contribute to the research and development activities in any measurable way. In this case, the cost of the conference facility must be excluded from the amount of intangible development costs.

Example 2. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a qualified cost sharing arrangement to develop a new device. USP and FS share the costs of a research and development facility, the salaries of researchers, and reasonable overhead costs attributable to the project. USP also incurs costs related to field testing of the device, but does not include them in the amount of intangible development costs of the cost sharing arrangement. The district director may determine that the field testing costs are intangible development costs that must be shared.

(e) *Anticipated benefits*—(1) *Benefits.* Benefits are additional income generated or costs saved by the use of covered intangibles.

(2) *Reasonably anticipated benefits.* For purposes of this section, a controlled participant's reasonably anticipated benefits are the aggregate benefits that it reasonably anticipates that it will derive from covered intangibles.

(f) *Cost allocations*—(1) *In general.* For purposes of determining whether a cost allocation authorized by paragraph (a)(2) of this section is appropriate for a taxable year, a controlled participant's share of intangible development costs for the taxable year under a qualified cost sharing arrangement must be compared to its share of reasonably anticipated benefits under the arrangement. A controlled participant's share of intangible development costs is determined under paragraph (f)(2) of this section. A controlled participant's share of reasonably anticipated benefits under the arrangement is determined under paragraph (f)(3) of this section. In determining whether benefits were reasonably anticipated, it may be appropriate to compare actual benefits to anticipated benefits, as described in paragraph (f)(3)(iv) of this section.

(2) *Share of intangible development costs*—(i) *In general.* A controlled participant's share of intangible development costs for a taxable year is equal to its intangible development costs for the taxable year (as defined in paragraph (d) of this section), divided by the sum of the intangible development costs for the taxable year (as defined in paragraph (d) of this section) of all the controlled participants.

(ii) *Example.* The following example illustrates this paragraph (f)(2):

Example (i) U.S. Parent (USP), Foreign Subsidiary (FS), and Unrelated Third Party (UTP) enter into a cost sharing arrangement to develop new audio technology. In the first year of the arrangement, the controlled participants incur $2,250,000 in the intangible development area, all of which is incurred directly by USP. In the first year, UTP makes a $250,000 cost sharing payment to USP, and FS makes a $800,000 cost sharing payment to USP, under the terms of the arrangement. For that year, the intangible development costs borne by USP are $1,200,000 (its $2,250,000 intangible development costs directly incurred, minus the cost sharing payments it receives of $250,000 from UTP and $800,000 from FS); the intangible development costs borne by FS are $800,000 (its cost sharing payment); and the intangible development costs borne by all of the controlled participants are $2,000,000 (the sum of the intangible development costs borne by USP and FS of $1,200,000 and $800,000, respectively). Thus, for the first year, USP's share of intangible development costs is 60% ($1,200,000 divided by $2,000,000), and FS's share of intangible development costs is 40% ($800,000 divided by $2,000,000).

(ii) For purposes of determining whether a cost allocation authorized by paragraph §1.482–7(a)(2) is appropriate for the first year, the district director must compare USP's and FS's shares of intangible development costs for that year to their shares of reasonably anticipated benefits. See paragraph (f)(3) of this section.

(3) *Share of reasonably anticipated benefits*—(i) *In general.* A controlled participant's share of reasonably anticipated benefits under a qualified cost sharing arrangement is equal to its reasonably anticipated benefits (as defined in paragraph (e)(2) of this section), divided by the sum of the reasonably anticipated benefits (as defined in paragraph (e)(2) of this section) of all the controlled participants. The anticipated benefits of an uncontrolled participant will not be included for purposes of determining each controlled participant's share of anticipated benefits. A controlled participant's share of reasonably anticipated benefits will be determined using the most reliable estimate of reasonably anticipated benefits. In determining which of two or more available estimates is most reliable, the quality of the data and assumptions used in the analysis must be taken into account, consistent with §1.482–1(c)(2)(ii) (Data and assumptions). Thus, the reliability of an estimate will depend largely on the completeness and accuracy of the data, the soundness of the assumptions, and the relative effects of particular deficiencies in data or assumptions on different estimates. If two estimates are equally reliable, no adjustment should be made based on differences in the results. The following factors will be particularly relevant in determining the reliability of an estimate of anticipated benefits—

(A) The reliability of the basis used for measuring benefits, as described in paragraph (f)(3)(ii) of this section; and

(B) The reliability of the projections used to estimate benefits, as described in paragraph (f)(3)(iv) of this section.

(ii) *Measure of benefits.* In order to estimate a controlled participant's share of anticipated benefits from covered intangibles, the amount of benefits that each of the controlled participants is reasonably anticipated to derive from covered intangibles must be measured on a basis that is consistent for all such participants. See paragraph (f)(3)(iii)(E), *Example 8,* of this section. If a controlled participant transfers covered intangibles to another controlled taxpayer, such participant's benefits from the transferred intangibles must be measured by reference to the transferee's benefits, disregarding any consideration paid by the transferee to the controlled participant (such as a royalty pursuant to a license agreement). Anticipated benefits are measured either on a direct basis, by reference to estimated additional income to be generated or costs to be saved by the use of covered intangibles, or on an indirect basis, by reference to certain measurements that reasonably can be assumed to be related to income generated or costs saved. Such indirect bases of measurement of anticipated benefits are described in paragraph (f)(3)(iii) of this section. A controlled participant's anticipated benefits must be measured on the most reliable basis, whether direct or indirect. In determining which of two bases of measurement of reasonably anticipated benefits is most reliable, the factors set forth in § 1.482–1(c)(2)(ii) (Data and assumptions) must be taken into account. It normally will be expected that the basis that provided the most reliable estimate for a particular year will continue to provide the most reliable estimate in subsequent years, absent a material change in the factors that affect the reliability of the estimate. Regardless of whether a direct or indirect basis of measurement is used, adjustments may be required to account for material differences in the activities that controlled participants undertake to exploit their interests in covered intangibles. See *Example 6* of paragraph (f)(3)(iii)(E) of this section.

(iii) *Indirect bases for measuring anticipated benefits.* Indirect bases for measuring anticipated benefits from participation in a qualified cost sharing arrangement include the following:

(A) *Units used, produced or sold.* Units of items used, produced or sold by each controlled participant in the business activities in which covered intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will be more reliable to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to the covered intangibles per unit of the item or items used, produced or sold. This circumstance is most likely to arise when the covered intangibles are exploited by the controlled participants in the use, production or sale of substantially uniform items under similar economic conditions.

(B) *Sales.* Sales by each controlled participant in the business activities in which covered intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will be more reliable to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to covered intangibles per dollar of sales. This circumstance is most likely to arise if the costs of exploiting covered intangibles are not substantial relative to the revenues generated, or if the principal effect of using covered intangibles is to increase the controlled participants' revenues (e.g., through a price premium on the products they sell) without affecting their costs substantially. Sales by each controlled participant are unlikely to provide a reliable basis for measuring benefits unless each controlled participant operates at the same market level (e.g., manufacturing, distribution, etc.).

(C) *Operating profit.* Operating profit of each controlled participant from the activities in which covered intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will be more reliable to the extent that such profit is largely attributable to the use of covered intangibles, or if the share of profits attributable to the use of covered intangibles is expected to be similar for each controlled participant. This circumstance is most likely to arise when covered intangibles are integral to the activity that generates the profit and the activity could not be carried on or would generate little profit without use of those intangibles.

(D) *Other bases for measuring anticipated benefits.* Other bases for measuring anticipated benefits may, in some circumstances, be appropriate, but only to the extent that there is expected to be a reasonably identifiable relationship between the basis of measurement used and additional income generated or costs saved by the use of covered intangibles. For example, a division of costs based on employee compensation would be considered unreliable unless there were a relationship between the amount of compensation and the expected income of the controlled participants from the use of covered intangibles.

(E) *Examples.* The following examples illustrate this paragraph (f)(3)(iii):

Example 1. Foreign Parent (FP) and U.S. Subsidiary (USS) both produce a feedstock for the manufacture of various high-performance plastic products. Producing the feedstock requires large amounts of electricity, which accounts for a significant portion of its production cost. FP and USS enter into a cost sharing arrangement to develop a new process that will reduce the amount of electricity required to produce a unit of the feedstock. FP and USS currently both incur an electricity cost of X% of its other production costs and rates for each are expected to remain similar in the future. How much the new process, if it is successful, will reduce the amount of electricity required to produce a unit of the feedstock is uncertain, but it will be about the same amount for both companies. Therefore, the cost savings each company is expected to achieve after implementing the new process are similar relative to the total amount of the feedstock produced. Under the cost sharing arrangement FP and USS divide the costs of developing the new process based on the units of the feedstock each is anticipated to produce in the future. In this case, units produced is the most reliable basis for measuring benefits and dividing the intangible development costs because each participant is expected to have a similar decrease in costs per unit of the feedstock produced.

Example 2. The facts are the same as in *Example 1,* except that USS pays X% of its other production costs for electricity while FP pays 2X% of its other production costs. In this case, units produced is not the most reliable basis for measuring benefits and dividing the intangible development costs because the participants do not expect to have a similar decrease in costs per unit of the feedstock produced. The district director determines that the most reliable measure of benefit shares may be based on units of the feedstock produced if FP's units are weighted relative to USS' units by a factor of 2. This reflects the fact that FP pays twice as much as USS as a percentage of its other production costs for electricity and, therefore, FP's savings per unit of the feedstock would be twice USS's savings from any new process eventually developed.

Example 3. The facts are the same as in *Example 2,* except that to supply the particular needs of the U.S. market USS manufactures the feedstock with somewhat different properties than FP's feedstock. This requires USS to employ a somewhat different production process than does FP. Because of this difference, it will be more costly for USS to adopt any new process that may be developed under the cost sharing agreement. In this case, units produced is not the most reliable basis for measuring benefit shares. In order to reliably determine benefit shares, the district director offsets the reasonably anticipated costs of adopting the new process against the reasonably anticipated total savings in electricity costs.

Example 4. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a cost sharing arrangement to develop new anesthetic drugs. USP obtains the right to use any resulting patent in the U.S. market, and FS obtains the right to use the patent in the European market. USP and FS divide costs on the basis of anticipated operating profit from each patent under development. USP anticipates that it will receive a much higher profit than FS per unit sold because drug prices are uncontrolled in the U.S., whereas drug prices are regulated in many European countries. In this case, the controlled taxpayers' basis for measuring benefits is the most reliable.

Example 5. (i) Foreign Parent (FP) and U.S. Subsidiary (USS) both manufacture and sell fertilizers. They enter into a cost sharing arrangement to develop a new pellet form of a common agricultural fertilizer that is currently available only in powder form. Under the cost sharing arrangement, USS obtains the rights to produce and sell the new form of fertilizer for the U.S. market while FP obtains the rights to produce and sell the fertilizer for the rest of the world. The costs of developing the new form of fertilizer are divided on the basis of the anticipated sales of fertilizer in the participants' respective markets.

(ii) If the research and development is successful the pellet form will deliver the fertilizer more efficiently to crops and less fertilizer will be required to achieve the same effect on crop growth. The pellet form of fertilizer can be expected to sell at a price premium over the powder form of fertilizer based on the savings in the amount of fertilizer that needs to be used. If the research and development is successful, the costs of producing pellet fertilizer are expected to be approximately the same as the costs of producing powder fertilizer and the same for both FP and USS. Both FP and USS operate at approximately the same market levels, selling their fertilizers largely to independent distributors.

(iii) In this case, the controlled taxpayers' basis for measuring benefits is the most reliable.

Example 6. The facts are the same as in *Example 5,* except that FP distributes its fertilizers directly while USS sells to independent distributors. In this case, sales of USS and FP are not the most reliable basis for measuring benefits unless adjustments are made to account for the difference in market levels at which the sales occur.

Example 7. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement to develop materials that will be used to train all new entry-level employees. FP and USS determine that the new materials will save approximately ten hours of training time per employee. Because their entry-level employees are paid on differing wage scales, FP and USS decide that they should not divide costs based on the number of entry-level employees hired by each. Rather, they divide costs based on compensation paid to the entry-level employees hired by each. In this case, the basis used for measuring benefits is the most reliable because there is a direct relationship between compensation paid to new entry-level employees and costs saved by FP and USS from the use of the new training materials.

Example 8. U.S. Parent (USP), Foreign Subsidiary 1 (FS1) and Foreign Subsidiary 2 (FS2) enter into a cost sharing arrangement to develop computer software that each will market and install on customers' computer systems. The participants divide costs on the basis of projected sales by USP, FS1, and FS2 of the software in their respective geographic areas. However, FS1 plans not only to sell but also to license the software to unrelated customers, and FS1's licensing income (which is a percentage of the licensees' sales) is not counted in the projected benefits. In this case, the basis used for measuring the benefits of each participant is not the most reliable because all of the benefits received by participants are not taken into account. In order to reliably determine benefit shares, FS1's projected benefits from licensing must be included in the measurement on a basis that is the same as that used to measure its own and the other participants' projected benefits from sales (e.g., all participants might measure their benefits on the basis of operating profit).

(iv) *Projections used to estimate anticipated benefits*—(A) *In general.* The reliability of an estimate of anticipated benefits also depends upon the reliability of projections used in making the estimate. Projections required for this purpose generally include a determination of the time period between the inception of the research and development and the receipt of benefits, a projection of the time over which benefits will be received, and a projection of the benefits anticipated for each year in which it is anticipated that the intangible will generate benefits. A projection of the relevant basis for measuring anticipated benefits may require a projection of the factors that underlie it. For example, a projection of operating profits may require a projection of sales, cost of sales, operating expenses, and other factors that affect operating profits. If it is anticipated that there will be significant variation among controlled participants in the timing of their receipt of benefits, and consequently benefit shares are expected to vary significantly over the years in which benefits will be received, it may be necessary to use the present discounted value of the projected benefits to reliably determine each controlled participant's share of those benefits. If it is not anticipated that benefit shares will significantly change over time, current annual benefit shares may provide a reliable projection of anticipated benefit shares. This circumstance is most likely to occur when the cost sharing arrangement is a long-term arrangement, the arrangement covers a wide variety of intangibles, the composition of the covered intangibles is unlikely to change, the covered intangibles are unlikely to generate unusual profits, and each controlled participant's share of the market is stable.

(B) *Unreliable projections.* A significant divergence between projected benefit shares and actual benefit shares may indicate that the projections were not reliable. In such a case, the district director may use actual benefits as the most reliable measure of anticipated benefits. If benefits are projected over a period of years, and the projections for initial years of the period prove to be unreliable, this may indicate that the projections for the remaining years of the period are also unreliable and thus should be adjusted. Projections will not be considered unreliable based on a divergence between a controlled participant's projected benefit share and actual benefit share if the amount of such divergence for every controlled participant is less than or equal to 20% of the participant's projected benefit share. Further, the district director will not make an allocation based on such divergence if the difference is due to an extraordinary event, beyond the control of the participants, that could not reasonably have been anticipated at the time that costs were shared. For purposes of this paragraph, all controlled participants that are not U.S. persons will be treated as a single controlled participant. Therefore, an adjustment based on an unreliable projection will be made to the cost shares of foreign controlled participants only if there is a matching adjustment to the cost shares of controlled participants that are U.S. persons. Nothing in this paragraph (f)(3)(iv)(B) will prevent the district director from making an allocation if the taxpayer did not use the most reliable basis for measuring anticipated benefits. For example, if the taxpayer measures anticipated benefits based on units sold, and the district director determines that another basis is more reliable for measuring anticipated benefits, then the fact that actual units sold were within 20% of the projected unit sales will not preclude an allocation under this section.

(C) *Foreign-to-foreign adjustments.* Notwithstanding the limitations on adjustments provided in paragraph (f)(3)(iv)(B) of this section, adjustments to cost shares based on an unreliable projection also may be made solely among foreign controlled participants if the variation between actual and projected benefits has the effect of substantially reducing U.S. tax.

(D) *Examples.* The following examples illustrate this paragraph (f)(3)(iv):

Example 1. (i) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement to develop a new car model. The participants plan to spend four years developing the new model and four years producing and selling the new model. USS and FP project total sales of $4 billion and $2 billion, respectively, over the planned four years of exploitation of the new model. Cost shares are divided for each year based on projected total sales. Therefore, USS bears 66⅔% of each year's intangible development costs and FP bears 33⅓% of such costs.

(ii) USS typically begins producing and selling new car models a year after FP begins producing and selling new car models. The district director determines that in order to reflect USS' one-year lag in introducing new car models, a more reliable projection of each participant's share of benefits would be based on a projection of all four years of sales for each participant, discounted to present value.

Example 2. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a cost sharing arrangement to develop new and improved household cleaning products. Both participants have sold household cleaning products for many years and have stable market shares. The products under development are unlikely to produce unusual profits for either participant. The participants divide costs on the basis of each participant's current sales of household cleaning products. In this case, the participants' future benefit shares are reliably projected by current sales of cleaning products.

Example 3. The facts are the same as in *Example 2,* except that FS's market share is rapidly expanding because of the business failure of a competitor in its geographic area. The district director determines that the participants' future benefit shares are not reliably projected by current sales of cleaning products and that FS's benefit projections should take into account its growth in sales.

Example 4. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement to develop synthetic fertilizers and insecticides. FP and USS share costs on the basis of each participant's current sales of fertilizers and insecticides. The market shares of the participants have been stable for fertilizers, but FP's market share for insecticides has been expanding. The district director determines that the participants' projections of benefit shares are reliable with regard to fertilizers, but not reliable with regard to insecticides; a more reliable projection of benefit shares would take into account the expanding market share for insecticides.

Example 5. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a cost sharing arrangement to develop new food products, dividing costs on the basis of projected sales two years in the future. In year 1, USP and FS project that their sales in year 3 will be equal, and they divide costs accordingly. In year 3, the district director examines the participants' method for dividing costs. USP and FS actually accounted for 42% and 58% of total sales, respectively. The district director agrees that sales two years in the future provide a reliable basis for estimating benefit shares. Because the differences between USP's and FS's actual and projected benefit shares are less than 20% of their projected benefit shares, the projection of future benefits for year 3 is reliable.

Example 6. The facts are the same as in *Example 5,* except that the in year 3 USP and FS actually accounted for 35% and 65% of total sales, respectively. The divergence between USP's projected and actual benefit shares is greater than 20% of USP's projected benefit share and is not due to an extraordinary event beyond the control of the participants. The district director concludes that the projection of anticipated benefit shares was unreliable, and uses actual benefits as the basis for an adjustment to the cost shares borne by USP and FS.

Example 7. U.S. Parent (USP), a U.S. corporation, and its foreign subsidiary (FS) enter a cost sharing arrangement in year 1. They project that they will begin to receive benefits from covered intangibles in years 4 through 6, and that USP will receive 60% of total benefits and FS 40% of total benefits. In years 4 through 6, USP and FS actually receive 50% each of the total benefits. In evaluating the reliability of the participants' projections, the district director compares these actual benefit shares to the projected benefit shares. Although USP's actual benefit share (50%) is within 20% of its projected benefit share (60%), FS's actual benefit share (50%) is not within 20% of its projected benefit share (40%). Based on this discrepancy, the district director may conclude that the participants' projections were not reliable and may use actual benefit shares as the basis for an adjustment to the cost shares borne by USP and FS.

Example 8. Three controlled taxpayers, USP, FS1 and FS2 enter into a cost sharing arrangement. FS1 and FS2 are foreign. USP is a United States corporation that controls all the stock of FS1 and FS2. The participants project that they will share the total benefits of the covered intangibles in the following percentages: USP 50%; FS1 30%; and FS2 20%. Actual benefit shares are as follows: USP 45%; FS1 25%; and FS2 30%. In evaluating the reliability of the participants' projections, the district director compares these actual benefit shares to the projected benefit shares. For this purpose, FS1 and FS2 are treated as a single participant. The actual benefit share received by USP (45%) is within 20% of its projected benefit share (50%). In addition, the non-US participants' actual benefit share (55%) is also within 20% of their projected benefit share (50%). Therefore, the district director concludes that the participants' projections of future benefits were reliable, despite the fact that FS2's actual benefit share (30%) is not within 20% of its projected benefit share (20%).

Example 9. The facts are the same as in *Example 8.* In addition, the district director determines that FS2 has significant operating losses and has no earnings and profits, and that FS1 is profitable and has earnings and profits. Based on all the evidence, the district director concludes that the participants arranged that FS1 would bear a larger cost share than appropriate in order to reduce FS1's earnings and profits and thereby reduce inclusions USP otherwise would be deemed to have on account of FS1 under subpart F. Pursuant to §1.482–7 (f)(3)(iv)(C), the district director may make an adjustment solely to the cost shares borne by FS1 and FS2 because FS2's projection of future benefits was unreliable and the variation between actual and projected benefits had the effect of substantially reducing USP's U.S. income tax liability (on account of FS1 subpart F income).

Example 10. (i)(A) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement in 1996 to develop a new treatment for baldness. USS's interest in any treatment developed is the right to produce and sell the treatment in the U.S. market while FP retains rights to produce and sell the treatment in the rest of the world. USS and FP measure their anticipated benefits from the cost sharing arrangement based on their respective projected future sales of the baldness treatment. The following sales projections are used:

SALES

[In millions of dollars]

Year	USS	FP
1997	5	10
1998	20	20
1999	30	30
2000	40	40
2001	40	40
2002	40	40
2003	40	40
2004	20	20
2005	10	10
2006	5	5

(B) In 1997, the first year of sales, USS is projected to have lower sales than FP due to lags in U.S. regulatory approval for the baldness treatment. In each subsequent year USS and FP are projected to have equal sales. Sales are projected to build over the first three years of the period, level off for several years, and then decline over the final years of the period as new and improved baldness treatments reach the market.

(ii) To account for USS's lag in sales in the first year, the present discounted value of sales over the period is used as the basis for measuring benefits. Based on the risk associated with this venture, a discount rate of 10 percent is selected. The present discounted value of projected sales is determined to be approximately $154.4 million for USS and $158.9 million for FP. On this basis USS and FP are projected to obtain approximately 49.3% and 50.7% of the benefit, respectively, and the costs of developing the baldness treatment are shared accordingly.

(iii) (A) In the year 2002 the district director examines the cost sharing arrangement. USS and FP have obtained the following sales results through the year 2001:

SALES

[In millions of dollars]

Year	USS	FP
1997	0	17
1998	17	35
1999	25	41
2000	38	41
2001	39	41

(B) USS's sales initially grew more slowly than projected while FP's sales grew more quickly. In each of the first three years of the period the share of total sales of at least one of the parties diverged by over 20% from its projected share of sales. However, by the year 2001 both parties' sales had leveled off at approximately their projected values. Taking into account this leveling off of sales and all the facts and circumstances, the district director determines that it is appropriate to use the original projections for the remaining years of sales. Combining the actual results through the year 2001 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately $141.6 million for USS and $187.3 million for FP. This result implies that USS and FP obtain approximately 43.1% and 56.9%, respectively, of the anticipated benefits from the baldness treatment. Because these benefit shares are within 20% of the benefit shares calculated based on the original sales projections, the district director determines that, based on the difference between actual and projected benefit shares, the original projections were not unreliable. No adjustment is made based on the difference between actual and projected benefit shares.

Example 11. (i) The facts are the same as in *Example 10,* except that the actual sales results through the year 2001 are as follows:

SALES

[In millions of dollars]

Year	USS	FP
1997	0	17
1998	17	35
1999	25	44
2000	34	54
2001	36	55

(ii) Based on the discrepancy between the projections and the actual results and on consideration of all the facts, the district director determines that for the remaining years the following sales projections are more reliable than the original projections:

SALES

[In millions of dollars]

Year	USS	FP
2002	36	55
2003	36	55
2004	18	28
2005	9	14
2006	4.5	7

(iii) Combining the actual results through the year 2001 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately $131.2 million for USS and $229.4 million for FP. This result implies that USS and FP obtain approximately 35.4% and 63.6%, respectively, of the anticipated benefits from the baldness treatment. These benefit shares diverge by greater than 20% from the benefit shares calculated based on the original sales projections, and the district director determines that, based on the difference between actual and projected benefit shares, the original projections were unreliable. The district director adjusts costs shares for each of the taxable years under examination to conform them to the recalculated shares of anticipated benefits.

(4) *Timing of allocations.* If the district director reallocates costs under the provisions of this paragraph (f), the allocation must be reflected for tax purposes in the year in which the costs were incurred. When a cost sharing payment is owed by one member of a qualified cost sharing arrangement to another member, the district director may make appropriate allocations to reflect an arm's length rate of interest for the time value of money, consistent with the provisions of § 1.482–2(a) (Loans or advances).

(g) *Allocations of income, deductions or other tax items to reflect transfers of intangibles (buy-in)*—(1) *In general.* A controlled participant that makes intangible property available to a qualified cost sharing arrangement will be treated as having transferred interests in such property to the other controlled participants, and such other controlled participants must make buy-in payments to it, as provided in paragraph (g)(2) of this section. If the other controlled participants fail to make such payments, the district director may make appropriate allocations, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, to reflect an arm's length consideration for the transferred intangible property. Further, if a group of controlled taxpayers participates in a qualified cost sharing arrangement, any change in the controlled participants' interests in covered intangibles, whether by reason of entry of a new participant or otherwise by reason of transfers (including deemed transfers) of interests among existing participants, is a transfer of intangible property, and the district director may make appropriate allocations, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, to reflect an arm's length consideration for the transfer. See paragraphs (g) (3), (4), and (5) of this section. Paragraph (g)(6) of this section provides rules for assigning unassigned interests under a qualified cost sharing arrangement.

(2) *Pre-existing intangibles.* If a controlled participant makes pre-existing intangible property in which it owns an interest available to other controlled participants for purposes of research in the intangible development area under a qualified cost sharing arrangement, then each such other controlled participant must make a buy-in payment to the owner. The buy-in payment by each such other controlled participant is the arm's length charge for the use of the intangible under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6, multiplied by the controlled participant's share of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section). A controlled participant's payment required under this paragraph (g)(2) is deemed to be reduced to the extent of any payments owed to it under this paragraph (g)(2) from other controlled participants. Each payment received by a payee will be treated as coming pro rata out of payments made by all payors. See paragraph (g)(8), *Example 4,* of this section. Such payments will be treated as consideration for a transfer of an interest in the intangible property made available to the qualified cost sharing arrangement by the payee. Any payment to or from an uncontrolled participant in consideration for intangible property made available to the qualified cost sharing arrangement will be shared by the controlled participants in accordance with their shares of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section). A controlled participant's payment required under this paragraph (g)(2) is deemed to be reduced by such a share of payments owed from an uncontrolled participant to the same extent as by any payments owed from other controlled participants under this paragraph (g)(2). See paragraph (g)(8), *Example 5,* of this section.

(3) *New controlled participant.* If a new controlled participant enters a qualified cost sharing arrangement and acquires any interest in the covered intangibles, then the new participant must pay an arm's length consideration, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, for such interest to each controlled participant from whom such interest was acquired.

(4) *Controlled participant relinquishes interests.* A controlled participant in a qualified cost sharing arrangement may be deemed to have acquired an interest in one or more covered intangibles if another controlled participant transfers, abandons, or otherwise relinquishes an interest under the arrangement, to the benefit of the first participant. If such a relinquishment occurs, the participant relinquishing the interest must receive an arm's length consideration, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, for its interest. If the controlled participant that has relinquished its interest subsequently uses that interest, then that participant must pay an arm's length consideration, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, to the controlled participant that acquired the interest.

(5) *Conduct inconsistent with the terms of a cost sharing arrangement.* If, after any cost allocations authorized by paragraph (a)(2) of this section, a controlled participant bears costs of intangible development that over a period of years are consistently and materially greater or lesser than its share of reasonably anticipated benefits, then the district director may conclude that the economic substance of the arrangement between the controlled participants is inconsistent with the terms of the cost sharing arrangement. In such a case, the district director may disregard such terms and impute an agreement consistent with the controlled participants' course of conduct, under which a controlled participant that bore a disproportionately greater share of costs received additional interests in covered intangibles. See § 1.482–1(d)(3)(ii)(B) (Identifying contractual terms) and § 1.482- 4(f)(3)(ii) (Identification of owner). Accordingly, that participant must receive an arm's length payment from any controlled participant whose share of the intangible development costs is less than its share of reasonably anticipated benefits over time, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6.

(6) *Failure to assign interests under a qualified cost sharing arrangement.* If a qualified cost sharing arrangement fails to assign an interest in a covered

intangible, then each controlled participant will be deemed to hold a share in such interest equal to its share of the costs of developing such intangible. For this purpose, if cost shares have varied materially over the period during which such intangible was developed, then the costs of developing the intangible must be measured by their present discounted value as of the date when the first such costs were incurred.

(7) *Form of consideration.* The consideration for an acquisition described in this paragraph (g) may take any of the following forms:

(i) *Lump sum payments.* For the treatment of lump sum payments, see § 1.482–4(f)(5) (Lump sum payments);

(ii) *Installment payments.* Installment payments spread over the period of use of the intangible by the transferee, with interest calculated in accordance with § 1.482–2(a) (Loans or advances); and

(iii) *Royalties.* Royalties or other payments contingent on the use of the intangible by the transferee.

(8) *Examples.* The following examples illustrate allocations described in this paragraph (g):

Example 1. In year one, four members of a controlled group enter into a cost sharing arrangement to develop a commercially feasible process for capturing energy from nuclear fusion. Based on a reliable projection of their future benefits, each cost sharing participant bears an equal share of the costs. The cost of developing intangibles for each participant with respect to the project is approximately $1 million per year. In year ten, a fifth member of the controlled group joins the cost sharing group and agrees to bear one-fifth of the future costs in exchange for part of the fourth member's territory reasonably anticipated to yield benefits amounting to one-fifth of the total benefits. The fair market value of intangible property within the arrangement at the time the fifth company joins the arrangement is $45 million. The new member must pay one-fifth of that amount (that is, $9 million total) to the fourth member from whom it acquired its interest in covered intangibles.

Example 2. U.S. Subsidiary (USS), Foreign Subsidiary (FS) and Foreign Parent (FP) enter into a cost sharing arrangement to develop new products within the Group X product line. USS manufactures and sells Group X products in North America, FS manufactures and sells Group X products in South America, and FP manufactures and sells Group X products in the rest of the world. USS, FS and FP project that each will manufacture and sell a third of the Group X products under development, and they share costs on the basis of projected sales of manufactured products. When the new Group X products are developed, however, USS ceases to manufacture Group X products, and FP sells its Group X products to USS for resale in the North American market. USS earns a return on its resale activity that is appropriate given its function as a distributor, but does not earn a return attributable to exploiting covered intangibles. The district director determines that USS' share of the costs (one-third) was greater than its share of reasonably anticipated benefits (zero) and that it has transferred an interest in the intangibles for which it should receive a payment from FP, whose share of the intangible development costs (one-third) was less than its share of reasonably anticipated benefits over time (two-thirds). An allocation is made under §§ 1.482–1 and 1.482–4 through 1.482–6 from FP to USS to recognize USS' one-third interest in the intangibles. No allocation is made from FS to USS because FS did not exploit USS' interest in covered intangibles.

Example 3. U.S. Parent (USP), Foreign Subsidiary 1 (FS1), and Foreign Subsidiary 2 (FS2) enter into a cost sharing arrangement to develop a cure for the common cold. Costs are shared USP–50%, FS1–40% and FS2–10% on the basis of projected units of cold medicine to be produced by each. After ten years of research and development, FS1 withdraws from the arrangement, transferring its interests in the intangibles under development to USP in exchange for a lump sum payment of $10 million. The district director may review this lump sum payment, under the provisions of § 1.482–4(f)(5), to ensure that the amount is commensurate with the income attributable to the intangibles.

Example 4. (i) Four members A, B, C, and D of a controlled group form a cost sharing arrangement to develop the next generation technology for their business. Based on a reliable projection of their future benefits, the participants agree to bear shares of the costs incurred during the term of the agreement in the following percentages: A 40%; B 15%; C 25%; and D 20%. The arm's length charges, under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6, for the use of the existing intangible property they respectively make available to the cost sharing arrangement are in the following amounts for the taxable year: A 80X; B 40X; C 30X; and D 30X. The provisional (before offsets) and final buy-in payments/receipts among A, B, C, and D are shown in the table as follows:

[All amounts stated in X's]

	A	B	C	D
Payments	<40>	<21>	<37.5>	<30>
Receipts	48	34	22.5	24
Final	8	13	<15>	<6>

(ii) The first row/first column shows A's provisional buy-in payment equal to the product of 100X (sum of 40X, 30X, and 30X) and A's share of anticipated benefits of 40%. The second row/first column shows A's provisional buy-in receipts equal to the sum of the products of 80X and B's, C's, and D's anticipated benefits shares (15%, 25%, and 20%, respectively). The other entries in the first two rows of the table are similarly computed. The last row shows the final buy-in receipts/payments after offsets. Thus, for the taxable year, A and B are treated as receiving the 8X and 13X, respectively, pro rata out of payments by C and D of 15X and 6X, respectively.

Example 5. A and B, two members of a controlled group form a cost sharing arrangement with an unrelated third party C to develop a new technology useable in their respective businesses. Based on a reliable projection of their future benefits, A and B agree to bear shares of 60% and 40%, respectively, of the costs incurred during the term of the agreement. A also makes available its existing technology for purposes of the research to be undertaken. The arm's length charge, under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6, for the use of the existing technology is 100X for the taxable year. Under its agreement with A and B, C must make a specified cost sharing payment as well as a payment of 50X for the taxable year on account of the pre- existing intangible property made available to the cost sharing arrangement. B's provisional buy-in payment (before offsets) to A for the taxable year is 40X (the product of 100X and B's anticipated benefits share of 40%). C's payment of 50X is shared provisionally between A and B in accordance with their shares of reasonably anticipated benefits, 30X (50X times 60%) to A and 20X (50X times 40%) to B. B's final buy-in payment (after offsets) is 20X (40X less 20X). A is treated as receiving the 70X total provisional payments (40X plus 30X) pro rata out of the final payments by B and C of 20X and 50X, respectively.

(h) *Character of payments made pursuant to a qualified cost sharing arrangement*—(1) *In general.* Payments made pursuant to a qualified cost sharing arrangement (other than payments described in paragraph (g) of this section) generally will be considered costs of developing intangibles of the payor and reimbursements of the same kind of costs of developing intangibles of the payee. For purposes of this paragraph (h), a controlled participant's payment required under a qualified cost sharing arrangement is deemed to be reduced to the extent of any payments owed to it under the arrangement from other controlled or uncontrolled participants. Each payment received by a payee will be treated as coming pro rata out of payments made by all payors. Such payments will be applied pro rata against deductions for the taxable year that the payee is allowed in connection with the qualified cost sharing arrangement. Payments received in excess of such deductions will be treated as in consideration for use of the tangible property made available to the qualified cost sharing arrangement by the payee. For purposes of the research credit determined under section 41, cost sharing payments among controlled participants will be treated as provided for intra-group transactions in § 1.41–8(e). Any payment made or received by a taxpayer pursuant to an arrangement that the district director determines not to be a qualified cost sharing arrangement, or a payment made or received pursuant to paragraph (g) of this section, will be subject to the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6. Any payment that in substance constitutes a cost sharing payment will be treated as such for purposes of this section, regardless of its characterization under foreign law.

(2) *Examples.* The following examples illustrate this paragraph (h):

Example 1. U.S. Parent (USP) and its wholly owned Foreign Subsidiary (FS) form a cost sharing arrangement to develop a miniature widget, the Small R. Based on a reliable projection of their future benefits, USP agrees to bear 40% and FS to bear 60% of the costs incurred during the term of the agreement. The principal costs in the intangible development area are operating expenses incurred by FS in Country Z of 100X annually, and operating expenses incurred by USP in the United States also of 100X annually. Of the total costs of 200X, USP's share is 80X and FS's share is 120X, so that FS must make a payment to USP of 20X. This payment will be treated as a reimbursement of 20X of USP's operating expenses in the United States. Accordingly, USP's Form 1120 will reflect an 80X deduction on account of activities performed in the United States for purposes of allocation and apportionment of the deduction to source. The Form 5471 for FS will reflect a 100X deduction on account of activities performed in Country Z, and a 20X deduction on account of activities performed in the United States.

Example 2. The facts are the same as in *Example 1,* except that the 100X of costs borne by USP consist of 5X of operating expenses incurred by USP in the United States and 95X of fair market value rental cost for a facility in the United States. The depreciation deduction attributable to the U.S. facility is 7X. The 20X net payment by FS to USP will first be applied in reduction pro rata of the 5X deduction for operating expenses and the 7X depreciation deduction attributable to the U.S. facility. The 8X remainder will be treated as rent for the U.S. facility.

(i) *Accounting requirements.* The accounting requirements of this paragraph are that the controlled participants in a qualified cost sharing arrangement must use a consistent method of accounting to measure costs and benefits, and must translate foreign currencies on a consistent basis.

(j) *Administrative requirements*—(1) *In general.* The administrative requirements of this paragraph consist of the documentation requirements of paragraph (j)(2) of this section and the reporting requirements of paragraph (j)(3) of this section.

(2) *Documentation*—(i) *Requirements.* A controlled participant must maintain sufficient documentation to establish that the requirements of paragraphs (b)(4) and (c)(1) of this section have been met, as well as the additional documentation specified in this paragraph (j)(2)(i), and must provide any such documentation to the Internal Revenue Service within 30 days of a request (unless an extension is granted by the district director). Documents necessary to establish the following must also be maintained—

(A) The total amount of costs incurred pursuant to the arrangement;

(B) The costs borne by each controlled participant;

(C) A description of the method used to determine each controlled participant's share of the intangible development costs, including the projections used to estimate benefits, and an explanation of why that method was selected;

(D) The accounting method used to determine the costs and benefits of the intangible development (including the method used to translate foreign currencies), and, to the extent that the method materially differs from U.S. generally accepted accounting principles, an explanation of such material differences; and

(E) Prior research, if any, undertaken in the intangible development area, any tangible or intangible property made available for use in the arrangement, by each controlled participant, and any information used to establish the value of pre-existing and covered intangibles.

(ii) *Coordination with penalty regulation.* The documents described in paragraph (j)(2)(i) of this section will satisfy the principal documents requirement under §1.6662–6(d)(2)(iii)(B) with respect to a qualified cost sharing arrangement.

(3) *Reporting requirements.* A controlled participant must attach to its U.S. income tax return a statement indicating that it is a participant in a qualified cost sharing arrangement, and listing the other controlled participants in the arrangement. A controlled participant that is not required to file a U.S. income tax return must ensure that such a statement is attached to Schedule M of any Form 5471 or to any Form 5472 filed with respect to that participant.

(k) *Effective date.* This section is effective for taxable years beginning on or after January 1, 1996.

(l) *Transition rule.* A cost sharing arrangement will be considered a qualified cost sharing arrangement, within the meaning of this section, if, prior to January 1, 1996, the arrangement was a bona fide cost sharing arrangement under the provisions of §1.482–7T (as contained in the 26 CFR part 1 edition revised as of April 1, 1995), but only if the arrangement is amended, if necessary, to conform with the provisions of this section by December 31, 1996.

[T.D. 8632, 60 FR 65557, Dec. 20, 1995, as amended by T.D. 8670, 61 FR 21956, May 13, 1996; 61 FR 33656, June 28, 1996]

§ 1.482–8 Examples of the best method rule.

In accordance with the best method rule of § 1.482–1(c), a method may be applied in a particular case only if the comparability, quality of data, and reliability of assumptions under that method make it more reliable than any other available measure of the arm's length result. The following examples illustrate the comparative analysis required to apply this rule. As with all of the examples in these regulations, these examples are based on simplified facts, are provided solely for purposes of illustrating the type of analysis required under the relevant rule, and do not provide rules of general application. Thus, conclusions reached in these examples as to the relative reliability of methods are based on the assumed facts of the examples, and are not general conclusions concerning the relative reliability of any method.

Example 1 Preference for comparable uncontrolled price method. Company A is the U.S. distribution subsidiary of Company B, a foreign manufacturer of consumer electrical appliances. Company A purchases toaster ovens from Company B for resale in the U.S. market. To exploit other outlets for its toaster ovens, Company B also sells its toaster ovens to Company C, an unrelated U.S. distributor of toaster ovens. The products sold to Company A and Company C are identical in every respect and there are no material differences between the transactions. In this case application of the CUP method, using the sales of toaster ovens to Company C, generally will provide a more reliable measure of an arm's length result for the controlled sale of toaster ovens to Company A than the application of any other method. See §§ 1.482–1(c)(2)(i) and –3(b)(2)(ii)(A).

Example 2 Resale price method preferred to comparable uncontrolled price method. The facts are the same as in Example 1, except that the toaster ovens sold to Company A are of substantially higher quality than those sold to Company C and the effect on price of such quality differences cannot be accurately determined. In addition, in order to round out its line of consumer appliances Company A purchases blenders from unrelated parties for resale in the United States. The blenders are resold to substantially the same customers as the toaster ovens, have a similar resale value to the toaster ovens, and are purchased under similar terms and in similar volumes. The distribution functions performed by Company A appear to be similar for toaster ovens and blenders. Given the product differences between the toaster ovens, application of the resale price method using the purchases and resales of blenders as the uncontrolled comparables is likely to provide a more reliable measure of an arm's length result than application of the comparable uncontrolled price method using Company B's sales of toaster ovens to Company C.

Example 3 Resale price method preferred to comparable profits method. (i) The facts are the same as in *Example 2* except that Company A purchases all its products from Company B and Company B makes no uncontrolled sales into the United States. However, six uncontrolled U.S. distributors are identified that purchase a similar line of products from unrelated parties. The uncontrolled distributors purchase toaster ovens from unrelated parties, but there are significant differences in the characteristics of the toaster ovens, including the brandnames under which they are sold.

(ii) Under the facts of this case, reliable adjustments for the effect of the different brandnames cannot be made. Except for some differences in payment terms and inventory levels, the purchases and resales of toaster ovens by the three uncontrolled distributors are closely similar to the controlled purchases in terms of the markets in which they occur, the volume of the transactions, the marketing activities undertaken by the distributor, inventory levels, warranties, allocation of currency risk, and other relevant functions and risks. Reliable adjustments can be made for the differences in payment terms and inventory levels. In addition, sufficiently detailed accounting information is available to permit adjustments to be made for differences in accounting methods or in reporting of costs between cost of goods sold and operating expenses. There are no other material differences between the controlled and uncontrolled transactions.

(iii) Because reliable adjustments for the differences between the toaster ovens, including the trademarks under which they are sold, cannot be made, these uncontrolled transactions will not serve as reliable measures of an arm's length result under the comparable uncontrolled price method. There is, however, close functional similarity between the controlled and uncontrolled transactions and reliable adjustments have been made for material differences that would be likely to affect gross profit. Under these circumstances, the gross profit margins derived under the resale price method are less likely to be susceptible to any unidentified differences than the operating profit measures used under the comparable profits method. Therefore, given the close functional comparability between the controlled and uncontrolled transactions, and the high quality of the data, the resale price method achieves a higher degree of comparability and will provide a more reliable measure of an arm's length result. See §1.482–1(c) (Best method rule).

Example 4 Comparable profits method preferred to resale price method. The facts are the same as in *Example 3,* except that the accounting information available for the uncontrolled comparables is not sufficiently detailed to ensure consistent reporting between cost of goods sold and operating expenses of material items such as discounts, insurance, warranty costs, and supervisory, general and administrative expenses. These expenses are significant in amount. Therefore, whether these expenses are treated as costs of goods sold or operating expenses would have a significant effect on gross margins. Because in this case reliable adjustments can not be made for such accounting differences, the reliability of the resale price method is significantly reduced. There is, however, close functional similarity between the controlled and uncontrolled transactions and reliable adjustments have been made for all material differences other than the potential accounting differences. Because the comparable profits method is not adversely affected by the potential accounting differences, under these circumstances the comparable profits method is likely to produce a more reliable measure of an arm's length result than the resale price method. See §1.482–1(c) (Best method rule).

Example 5 Cost plus method preferred to comparable profits method. (i) USS is a U.S. company that manufactures machine tool parts and sells them to its foreign parent corporation, FP. Four U.S. companies are identified that also manufacture various types of machine tool parts but sell them to uncontrolled purchasers.

(ii) Except for some differences in payment terms, the manufacture and sales of machine tool parts by the four uncontrolled companies are closely similar to the controlled transactions in terms of the functions performed and risks assumed. Reliable adjustments can be made for the differences in payment terms. In addition, sufficiently detailed accounting information is available to permit adjustments to be made for differences between the controlled transaction and the uncontrolled comparables in accounting methods and in the reporting of costs between cost of goods sold and operating expenses.

(iii) There is close functional similarity between the controlled and uncontrolled transactions and reliable adjustments can be made for material differences that would be likely to affect gross profit. Under these circumstances, the gross profit markups derived under the cost plus method are less likely to be susceptible to any unidentified differences than the operating profit measures used under the comparable profits method. Therefore, given the close functional comparability between the controlled and uncontrolled transactions, and the high quality of the data, the cost plus method achieves a higher degree of comparability and will provide a more reliable measure of an arm's length result. See §1.482–1(c) (Best method rule).

Example 6 Comparable profits method preferred to cost plus method. The facts are the same as in *Example 5,* except that there are significant differences between the controlled and uncontrolled transactions in terms of the types of parts and components manufactured and the complexity of the manufacturing process. The resulting functional differences are likely to materially affect gross profit margins, but it is not possible to identify the specific differences and reliably adjust for their effect on gross profit. Because these functional differences would be reflected in differences in operating expenses, the operating profit measures used under the comparable profits method implicitly reflect to some extent these functional differences. Therefore, because in this case the comparable profits method is less sensitive than the cost plus method to the potentially significant functional differences between the controlled and uncontrolled transactions, the comparable profits method is likely to produce a more reliable measure of an arm's length result than the cost plus method. See §1.482–1(c) (Best method rule).

Example 7 Preference for comparable uncontrolled transaction method. (i) USpharm, a U.S. pharmaceutical company, develops a new drug Z that is a safe and effective treatment for the disease zeezee. USpharm has obtained patents covering drug Z in the United States and in various foreign countries. USpharm has also obtained the regulatory authorizations necessary to market drug Z in the United States and in foreign countries.

(ii) USpharm licenses its subsidiary in country X, Xpharm, to produce and sell drug Z in country X. At the same time, it licenses an unrelated company, Ydrug, to produce and sell drug Z in country Y, a neighboring country. Prior to licensing the drug, USpharm had obtained patent protection and regulatory approvals in both countries and both countries provide similar protection for intellectual property rights. Country X and country Y are similar countries in terms of population, per capita income and the incidence of disease zeezee. Consequently, drug Z is expected to sell in similar quantities and at similar prices in both countries. In addition, costs of producing drug Z in each country are expected to be approximately the same.

(iii) USpharm and Xpharm establish terms for the license of drug Z that are identical in every material respect, including royalty rate, to the terms established between USpharm and Ydrug. In this case the district director determines that the royalty rate established in the Ydrug license agreement is a reliable measure of the arm's length royalty rate for the Xpharm license agreement. Given that the same property is transferred in the controlled and uncontrolled transactions, and that the circumstances under which the transactions occurred are substantially the same, in this case the comparable uncontrolled transaction method is likely to provide a more reliable measure of an arm's length result than any other method. See § 1.482–4(c)(2)(ii).

Example 8 Residual profit split method preferred to other methods. (i) USC is a U.S. company that develops, manufactures and sells communications equipment. EC is the European subsidiary of USC. EC is an established company that carries out extensive research and development activities and develops, manufactures and sells communications equipment in Europe. There are extensive transactions between USC and EC. USC licenses valuable technology it has developed to EC for use in the European market but EC also licenses valuable technology it has developed to USC. Each company uses components manufactured by the other in some of its products and purchases products from the other for resale in its own market.

(ii) Detailed accounting information is available for both USC and EC and adjustments can be made to achieve a high degree of consistency in accounting practices between them. Relatively reliable allocations of costs, income and assets can be made between the business activities that are related to the controlled transactions and those that are not. Relevant marketing and research and development expenditures can be identified and reasonable estimates of the useful life of the related intangibles are available so that the capitalized value of the intangible development expenses of USC and EC can be calculated. In this case there is no reason to believe that the relative value of these capitalized expenses is substantially different from the relative value of the intangible property of USC and EC. Furthermore, comparables are identified that could be used to estimate a market return for the routine contributions of USC and EC. Based on these facts, the residual profit split could provide a reliable measure of an arm's length result.

(iii) There are no uncontrolled transactions involving property that is sufficiently comparable to much of the tangible and intangible property transferred between USC and EC to permit use of the comparable uncontrolled price method or the comparable uncontrolled transaction method. Uncontrolled companies are identified in Europe and the United States that perform somewhat similar activities to USC and EC; however, the activities of none of these companies are as complex as those of USC and EC and they do not use similar levels of highly valuable intangible property that they have developed themselves. Under these circumstances, the uncontrolled companies may be useful in determining a market return for the routine contributions of USC and EC, but that return would not reflect the value of the intangible property employed by USC and EC. Thus, none of the uncontrolled companies is sufficiently similar so that reliable results would be obtained using the resale price, cost plus, or comparable profits methods. Moreover, no uncontrolled companies can be identified that engaged in sufficiently similar activities and transactions with each other to employ the comparable profit split method.

(iv) Given the difficulties in applying the other methods, the reliability of the internal data on USC and EC, and the fact that acceptable comparables are available for deriving a market return for the routine contributions of USC and EC, the residual profit split method is likely to provide the most reliable measure of an arm's length result in this case.

Example 9 Comparable profits method preferred to profit split. (i) Company X is a large, complex U.S. company that carries out extensive research and development activities and manufactures and markets a variety of products. Company X has developed a new process by which compact disks can be fabricated at a fraction of the cost previously required. The process is expected to prove highly profitable, since there is a large market for compact disks. Company X establishes a new foreign subsidiary, Company Y, and licenses it the rights to use the process to fabricate compact disks for the foreign market as well as continuing technical support and improvements to the process. Company Y uses the process to fabricate compact disks which it supplies to related and unrelated parties.

(ii) The process licensed to Company Y is unique and highly valuable and no uncontrolled transfers of intangible property can be found that are sufficiently comparable to permit reliable application of the comparable uncontrolled transaction method. Company X is a large, complex company engaged in a variety of activities that owns unique and highly valuable intangible property. Consequently, no uncontrolled companies can be found that are similar to Company X. Furthermore, application of the profit split method in this case would involve the difficult and problematic tasks of allocating Company X's costs and assets between the relevant business activity and other activities and assigning a value to Company X's intangible contributions. On the other hand, Company Y performs relatively routine manufacturing and marketing activities and there are a number of similar uncontrolled companies. Thus, application of the comparable profits method using Company Y as the tested party is likely to produce a more reliable measure of an arm's length result than a profit split in this case.

[T.D. 8552, 59 FR 35028, July 8, 1994]

§1.483–1 Interest on certain deferred payments.

(a) *Amount constituting interest in certain deferred payment transactions*—(1) *In general.* Except as provided in paragraph (c) of this section, section 483 applies to a contract for the sale or exchange of property if the contract provides for one or more payments due more than 1 year after the date of the sale or exchange, and the contract does not provide for adequate stated interest. In general, a contract has adequate stated interest if the contract provides for a stated rate of interest that is at least equal to the test rate (determined under §1.483–3) and the interest is paid or compounded at least annually. Section 483 may apply to a contract whether the contract is express (written or oral) or implied. For purposes of section 483, a sale or exchange is any transaction treated as a sale or exchange for tax purposes. In addition, for purposes of section 483, property includes debt instruments and investment units, but does not include money, services, or the right to use property. For the treatment of certain obligations given in exchange for services or the use of property, see sections 404 and 467. For purposes of this paragraph (a), money includes functional currency and, in certain circumstances, nonfunctional currency. See §1.988–2(b)(2) for circumstances when nonfunctional currency is treated as money rather than as property.

(2) *Treatment of contracts to which section 483 applies*—(i) *Treatment of unstated interest.* If section 483 applies to a contract, unstated interest under the contract is treated as interest for tax purposes. Thus, for example, unstated interest is not treated as part of the amount realized from the sale or exchange of property (in the case of the seller), and is not included in the purchaser's basis in the property acquired in the sale or exchange.

(ii) *Method of accounting for interest on contracts subject to section 483.* Any stated or unstated interest on a contract subject to section 483 is taken into account by a taxpayer under the taxpayer's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method). See §§1.446–1, 1.451–1, and 1.461–1. For purposes of the preceding sentence, the amount of interest (including unstated interest) allocable to a payment under a contract to which section 483 applies is determined under §1.446–2(e).

(b) *Definitions*—(1) *Deferred payments.* For purposes of the regulations under section 483, a deferred payment means any payment that constitutes all or a part of the sales price (as defined in paragraph (b)(2) of this section), and that is due more than 6 months after the date of the sale or exchange. Except as provided in section 483(c)(2) (relating to the treatment of a debt instrument of the purchaser), a payment may be made in the form of cash, stock or securities, or other property.

(2) *Sales price.* For purposes of section 483, the sales price for any sale or exchange is the sum of the amount due under the contract (other than stated interest) and the amount of any liability included in the amount realized from the sale or exchange. See §1.1001–2. Thus, the sales price for any sale or exchange includes any amount of unstated interest under the contract.

(c) *Exceptions to and limitations on the application of section 483*—(1) *In general.* Sections 483(d), 1274(c)(4), and 1275(b) contain exceptions to and limitations on the application of section 483.

(2) *Sales price of $3,000 or less.* Section 483(d)(2) applies only if it can be determined at the time of the sale or exchange that the sales price cannot exceed $3,000, regardless of whether the sales price eventually paid for the property is less than $3,000.

(3) *Other exceptions and limitations*—(i) *Certain transfers subject to section 1041.* Section 483 does not apply to any transfer of property subject to section

1041 (relating to transfers of property between spouses or incident to divorce).

(ii) *Treatment of certain obligees.* Section 483 does not apply to an obligee under a contract for the sale or exchange of personal use property (within the meaning of section 1275(b)(3)) in the hands of the obligor and that evidences a below-market loan described in section 7872(c)(1).

(iii) *Transactions involving certain demand loans.* Section 483 does not apply to any payment under a contract that evidences a demand loan that is a below-market loan described in section 7872(c)(1).

(iv) *Transactions involving certain annuity contracts.* Section 483 does not apply to any payment under an annuity contract described in section 1275(a)(1)(B) (relating to annuity contracts excluded from the definition of debt instrument).

(v) *Options.* Section 483 does not apply to any payment under an option to buy or sell property.

(d) *Assumptions.* If a debt instrument is assumed, or property is taken subject to a debt instrument, in connection with a sale or exchange of property, the debt instrument is treated for purposes of section 483 in a manner consistent with the rules of § 1.1274–5.

(e) *Aggregation rule.* For purposes of section 483, all sales or exchanges that are part of the same transaction (or a series of related transactions) are treated as a single sale or exchange, and all contracts calling for deferred payments arising from the same transaction (or a series of related transactions) are treated as a single contract. This rule, however, generally only applies to contracts and to sales or exchanges involving a single buyer and a single seller.

(f) *Effective date.* This section applies to sales and exchanges that occur on or after April 4, 1994. Taxpayers, however, may rely on this section for sales and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4805, Feb. 2, 1994]

§ 1.483–2 Unstated interest.

(a) *In general*—(1) *Adequate stated interest.* For purposes of section 483, a contract has unstated interest if the contract does not provide for adequate stated interest. A contract does not provide for adequate stated interest if the sum of the deferred payments exceeds—

(i) The sum of the present values of the deferred payments and the present values of any stated interest payments due under the contract; or

(ii) In the case of a cash method debt instrument (within the meaning of section 1274A(c)(2)) received in exchange for property in a potentially abusive situation (as defined in § 1.1274–3), the fair market value of the property reduced by the fair market value of any consideration other than the debt instrument, and reduced by the sum of all principal payments that are not deferred payments.

(2) *Amount of unstated interest.* For purposes of section 483, unstated interest means an amount equal to the excess of the sum of the deferred payments over the amount described in paragraph (a)(1)(i) or (a)(1)(ii) of this section, whichever is applicable.

(b) *Operational rules*—(1) *In general.* For purposes of paragraph (a) of this section, rules similar to those in § 1.1274–2 apply to determine whether a contract has adequate stated interest and the amount of unstated interest, if any, on the contract.

(2) *Present value.* For purposes of paragraph (a) of this section, the present value of any deferred payment or interest payment is determined by discounting the payment from the date it becomes due to the date of the sale or exchange at the test rate of interest applicable to the contract in accordance with § 1.483–3.

(c) *Examples.* The following examples illustrate the rules of this section.

Example 1. Contract that does not have adequate stated interest. On January 1, 1995, A sells B nonpublicly traded property under a contract that calls for a $100,000 payment of principal on January 1, 2005, and 10 annual interest payments of $9,000 on January 1 of each year, beginning on January 1, 1996. Assume that the test rate of interest is 9.2 percent, compounded annually. The contract does not provide for adequate stated interest because it does not provide for interest equal to 9.2 percent, compounded annually. The present value of the deferred payments is $98,727.69. As a result, the contract has unstated interest of $1,272.31 ($100,000 − $98,727.69).

Example 2. Contract that does not have adequate stated interest; no interest for initial short period. On May 1, 1996, A sells B nonpublicly traded property under a contract that calls for B to make a principal payment of $200,000 on December 31, 1998, and semiannual interest payments of $9,000, payable on June 30 and December 31 of each year, beginning on December 31, 1996. Assume that the test rate of interest is 9 percent, compounded semiannually. Even though the contract calls for a stated rate of interest no lower than the test rate of interest, the contract does not provide for adequate stated interest because the stated rate of interest does not apply for the short period from May 1, 1996, through June 30, 1996.

Example 3. Potentially abusive situation—(i) *Facts.* In a potentially abusive situation, a contract for the sale of nonpublicly traded personal property calls for the issuance of a cash method debt instrument (as defined in section 1274A(c)(2)) with a stated principal amount of $700,000, payable in 5 years. No other consideration is given. The debt instrument calls for annual payments of interest over its entire term at a rate of 9.2 percent, compounded annually (the test rate of interest applicable to the debt instrument). Thus, the present value of the deferred payment and the interest payments is $700,000. Assume that the fair market value of the property is $500,000.

(ii) *Amount of unstated interest.* A cash method debt instrument received in exchange for property in a potentially abusive situation provides for adequate stated interest only if the sum of the deferred payments under the instrument does not exceed the fair market value of the property. Because the deferred payment ($700,000) exceeds the fair market value of the property ($500,000), the debt instrument does not provide for adequate stated interest. Therefore, the debt instrument has unstated interest of $200,000.

Example 4. Variable rate debt instrument with adequate stated interest; variable rate as of the issue date greater than the test rate—(i) *Facts.* A contract for the sale of nonpublicly traded property calls for the issuance of a debt instrument in the principal amount of $75,000 due in 10 years. The debt instrument calls for interest payable semiannually at a rate of 3 percentage points above the yield on 6-month Treasury bills at the mid-point of the semiannual period immediately preceding each interest payment date. Assume that the interest rate is a qualified floating rate and that the debt instrument is a variable rate debt instrument within the meaning of § 1.1275–5.

(ii) *Adequate stated interest.* Under paragraph (b)(1) of this section, rules similar to those in § 1.1274–2(f) apply to determine whether the debt instrument has adequate stated interest. Assume that the test rate of interest applicable to the debt instrument is 9 percent, compounded semiannually. Assume also that the yield on 6-month Treasury bills on the date of the sale is 8.89 percent, which is greater than the yield on 6-month Treasury bills on the first date on which there is a binding written contract that substantially sets forth the terms under which the sale is consummated. Under § 1.1274–2(f), the debt instrument is tested for adequate stated interest as if it provided for a stated rate of interest of 11.89 percent (3 percent plus 8.89 percent), compounded semiannually, payable over its entire term. Because the test rate of interest is 9 percent, compounded semiannually, and the debt instrument is treated as providing for stated interest of 11.89 percent, compounded semiannually, the debt instrument provides for adequate stated interest.

(d) *Effective date.* This section applies to sales and exchanges that occur on or after April 4, 1994. Taxpayers, however, may rely on this section for sales and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4806, Feb. 2, 1994]

§ 1.483–3 Test rate of interest applicable to a contract.

(a) *General rule.* For purposes of section 483, the test rate of interest for a contract is the same as the test rate that would apply under § 1.1274–4 if the contract were a debt instrument. Paragraph (b) of this section, however, provides for a lower test rate in the case of certain sales or exchanges of land between related individuals.

(b) *Lower rate for certain sales or exchanges of land between related individuals*—(1) *Test rate.* In the case of a qualified sale or exchange of land between related individuals (described in section 483(e)), the test rate is not greater than 6 percent, compounded semiannually, or an equivalent rate based on an appropriate compounding period.

(2) *Special rules.* The following rules and definitions apply in determining whether a sale or exchange is a qualified sale under section 483(e):

(i) *Definition of family members.* The members of an individual's family are determined as of the date of the sale or exchange. The members of an individual's family include those individuals described in section 267(c)(4) and the spouses of those individuals. In addition, for purposes of section 267(c)(4), full effect is given to a legal adoption, ancestor means parents and grandparents, and lineal descendants means children and grandchildren.

(ii) *$500,000 limitation.* Section 483(e) does not apply to the extent that the stated principal amount of the debt instrument issued in the sale or exchange, when added to the aggregate stated principal amount of any other debt instruments to which section 483(e) applies that were issued in prior qualified sales between the same two individuals during the same calendar year, exceeds $500,000. See *Example 3* of paragraph (b)(3) of this section.

(iii) *Other limitations.* Section 483(e) does not apply if the parties to a contract include persons other than the related individuals and the parties enter into the contract with an intent to circumvent the purposes of section 483(e). In addition, if the property sold or exchanged includes any property other than land, section 483(e) applies only to the extent that the stated principal amount of the debt instrument issued in the sale or exchange is attributable to the land (based on the relative fair market values of the land and the other property).

(3) *Examples.* The following examples illustrate the rules of this paragraph (b).

Example 1. On January 1, 1995, A sells land to B, A's child, for $650,000. The contract for sale calls for B to make a $250,000 down payment and issue a debt instrument with a stated principal amount of $400,000. Because the stated principal amount of the debt instrument is less than $500,000, the sale is a qualified sale and section 483(e) applies to the debt instrument.

Example 2. The facts are the same as in *Example 1* of paragraph (b)(3) of this section, except that on June 1, 1995, A sells additional land to B under a contract that calls for B to issue a debt instrument with a stated principal amount of $100,000. The stated principal amount of this debt instrument ($100,000) when added to the stated principal amount of the prior debt instrument ($400,000) does not exceed $500,000. Thus, section 483(e) applies to both debt instruments.

Example 3. The facts are the same as in *Example 1* of paragraph (b)(3) of this section, except that on June 1, 1995, A sells additional land to B under a contract that calls for B to issue a debt instrument with a stated principal amount of $150,000. The stated principal amount of this debt instrument when added to the stated principal amount of the prior debt instrument ($400,000) exceeds $500,000. Thus, for purposes of section 483(e), the debt instrument issued in the sale of June 1, 1995, is treated as two separate debt instruments: a $100,000 debt instrument (to which section 483(e) applies) and a $50,000 debt instrument (to which section 1274, if otherwise applicable, applies).

(c) *Effective date.* This section applies to sales and exchanges that occur on or after April 4, 1994. Taxpayers, however, may rely on this section for sales and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4807, Feb. 2, 1994]

§ 1.483–4 Contingent payments.

(a) *In general.* This section applies to a contract for the sale or exchange of property (the overall contract) if the contract provides for one or more contingent payments and the contract is subject to section 483. This section applies even if the contract provides for adequate stated interest under § 1.483–2. If this section applies to a contract, interest under the contract is generally computed and accounted for using rules similar to those that would apply if the contract were a debt instrument subject to § 1.1275–4(c). Consequently, all noncontingent payments under the overall contract are treated as if made under a separate contract, and interest accruals on this separate contract are computed under rules similar to those contained in § 1.1275–4(c)(3). Each contingent payment under the overall contract is characterized as principal and interest under rules similar to those contained in § 1.1275–4(c)(4). However, any interest, or amount treated as interest, on a contract subject to this section is taken into account by a taxpayer under the taxpayer's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method).

(b) *Examples.* The following examples illustrate the provisions of paragraph (a) of this section:

Example 1. Deferred payment sale with contingent interest—(i) *Facts.* On December 31, 1996, A sells depreciable personal property to B. As consideration for the sale, B issues to A a debt instrument with a maturity date of December 31, 2001. The debt instrument provides for a principal payment of $200,000 on the maturity date, and a payment of interest on December 31 of each year, beginning in 1997, equal to a percentage of the total gross income derived from the property in that year. However, the total interest payable on the debt instrument over its entire term is limited to a maximum of $50,000. Assume that on December 31, 1996, the short-term applicable Federal rate is 4 percent, compounded annually, and the mid-term applicable Federal rate is 5 percent, compounded annually.

(ii) *Treatment of noncontingent payment as separate contract.* Each payment of interest is a contingent payment. Accordingly, under paragraph (a) of this section, for purposes of applying section 483 to the debt instrument, the right to the noncontingent payment of $200,000 is treated as a separate contract. The amount of unstated interest on this separate contract is equal to $43,295, which is the amount by which the payment ($200,000) exceeds the present value of the payment ($156,705), calculated using the test rate of 5 percent, compounded annually. The $200,000 payment is thus treated as consisting of a payment of interest of $43,295 and a payment of principal of $156,705. The interest is includible in A's gross income, and deductible by B, under their respective methods of accounting.

(iii) *Treatment of contingent payments.* Assume that the amount of the contingent payment that is paid on December 31, 1997, is $20,000. Under paragraph (a) of this section, the $20,000 payment is treated as a payment of principal of $19,231 (the present value, as of the date of sale, of the $20,000 payment, calculated using a test rate equal to 4 percent, compounded annually) and a payment of interest of $769. The $769 interest payment is includible in A's gross income, and deductible by B, in their respective taxable years in which the payment occurs. The amount treated as principal gives B additional basis in the property on December 31, 1997. The remaining contingent payments on the debt instrument are accounted for similarly, using a test rate of 4 percent, compounded annually, for the payments made on December 31, 1998, and December 31, 1999, and a test rate of 5 percent, compounded annually, for the payments made on December 31, 2000, and December 31, 2001.

Example 2. Contingent stock payout—(i) *Facts.* M Corporation and N Corporation each owns one-half of the stock of O Corporation. On December 31, 1996, pursuant to a reorganization qualifying under section 368(a)(1)(B), M acquires the one-half interest of O held by N in exchange for 30,000 shares of M voting stock and a non-assignable right to receive up to 10,000 additional shares of M's voting stock during the next 3 years, provided the net profits of O exceed certain amounts specified in the contract. No interest is provided for in the contract. No additional shares are received in 1997 or in 1998. In 1999, the annual earnings of O exceed the specified amount, and, on December 31, 1999, an additional 3,000 M voting shares are transferred to N. The fair market value of the 3,000 shares on December 31, 1999, is $300,000. Assume that on December 31, 1996, the short-term applicable Federal rate is 4 percent, compounded annually. M and N are calendar year taxpayers.

(ii) *Allocation of interest.* Section 1274 does not apply to the right to receive the additional shares because the right is not a debt instrument for federal income tax purposes. As a result, the transfer of the 3,000 M voting shares to N is a deferred payment subject to section 483 and a portion of the shares is treated as unstated interest under that section. The amount of interest allocable to the shares is equal to the excess of $300,000 (the fair market value of the shares on December 31, 1999) over $266,699 (the present value of $300,000, determined by discounting the payment at the test rate of 4 percent, compounded annually, from December 31, 1999, to December 31, 1996). As a result, the amount of interest allocable to the payment of the shares is $33,301 ($300,000–$266,699). Both M and N take the interest into account in 1999.

(c) *Effective date.* This section applies to sales and exchanges that occur on or after August 13, 1996.

[T.D. 8674, 61 FR 30138, June 14, 1996]

REGULATIONS APPLICABLE FOR TAXABLE YEARS BEGINNING ON OR BEFORE APRIL 21, 1993

§1.482–1A Allocation of income and deductions among taxpayers.

(a) *Definitions.* When used in this section and in §1.482–2—

(1) The term "organization" includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation (as each is defined or understood in the Internal Revenue Code or the regulations thereunder), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The term "trade" or "business" includes any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

(3) The term ‘‘controlled’’ includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term ‘‘controlled taxpayer’’ means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms ‘‘group’’ and ‘‘group of controlled taxpayers’’ mean the organizations, trades, or businesses owned or controlled by the same interests.

(6) The term ‘‘true taxable income’’ means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm’s length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.* (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer.

(2) Section 482 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate taxable income. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

(3) Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions. It is not intended (except in the case of the computation of consolidated taxable income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income, deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated taxable income under subchapter A, chapter 6 of the Code.

(c) *Application.* Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(d) *Method of allocation.* (1) The method of allocating, apportioning, or distributing income, deductions, credits, and allowances to be used by the district director in any case, including the form of the adjustments and the character and source of amounts allocated, shall be determined with reference to the substance of the particular transactions or arrangements which result in the avoidance of taxes or the failure to clearly reflect income. The appropriate adjustments may take the form of an increase or decrease in gross income, increase or decrease in deductions (including depreciation), increase or decrease in basis of assets (including inventory), or any other adjustment which may be appropriate under the circumstances. See §1.482–2 for specific rules relating to methods of allocation in the case of several types of business transactions.

(2) Whenever the district director makes adjustments to the income of one member of a group of controlled taxpayers (such adjustments being referred to in this paragraph as ''primary'' adjustments) he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation. The correlative adjustment shall actually be made if the U.S. income tax liability of the other member would be affected for any pending taxable year. Thus, if the district director makes an allocation of income, he shall not only increase the income of one member of the group, but shall decrease the income of the other member if such adjustment would have an effect on the U.S. income tax liability of the other member for any pending taxable year. For the purposes of this subparagraph, a ''pending taxable year'' is any taxable year with respect to which the U.S. income tax return of the other member has been filed by the time the allocation is made, and with respect to which a credit or refund is not barred by the operation of any law or rule of law. If a correlative adjustment is not actually made because it would have no effect on the U.S. income tax liability of the other member involved in the allocation for any pending taxable year, such adjustment shall nevertheless be deemed to have been made for the purpose of determining the U.S. income tax liability of such member for a later taxable year, or for the purposes of determining the U.S. income tax liability of any person for any taxable year. The district director shall furnish to the taxpayer with respect to which the primary adjustment is made a written statement of the amount and nature of the correlative adjustment which is deemed to have been made. For purposes of this subparagraph, a primary adjustment shall not be considered to have been made (and therefore a correlative adjustment is not required to be made) until the first occurring of the following events with respect to the primary adjustment:

(i) The date of assessment of the tax following execution by the taxpayer of a Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment) with respect to such adjustment,

(ii) Acceptance of a Form 870–AD (Offer of Waiver of Restriction on Assessment and Collection Deficiency in Tax and Acceptance of Overassessment),

(iii) Payment of the deficiency,

(iv) Stipulation in the Tax Court of the United States, or

(v) Final determination of tax liability by offer-in-compromise, closing agreement, or court action.

The principles of this subparagraph may be illustrated by the following examples in each of which it is assumed that X and Y are members of the same group of controlled entities and that they regularly compute their incomes on the basis of a calendar year:

Example (1). Assume that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length rental charge for Y's use of X's tangible property in

1966; that X consents to an assessment reflecting such adjustment by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. The primary adjustment is therefore considered to have been made in 1968. Assume further that both X and Y are United States corporations and that Y had net operating losses in 1963, 1964, 1965, 1966, and 1967. Although a correlative adjustment would not have an effect on Y's U.S. income tax liability for any pending taxable year, an adjustment increasing Y's net operating loss for 1966 shall be deemed to have been made for the purposes of determining Y's U.S. income tax liability for 1968 or a later taxable year to which the increased operating loss may be carried. The district director shall notify X in writing of the amount and nature of the adjustment which is deemed to have been made to Y.

Example (2). Assume that X and Y are United States corporations; that X is in the business of rendering engineering services; that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length fee for the rendition of engineering services by X in 1966 relating to the construction of Y's factory; that X consents to an assessment reflecting such adjustment by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. Assume further that fees for such services would properly constitute a capital expenditure by Y, and that Y does not place the factory in service until 1969. Although a correlative adjustment (increase in basis) would not have an effect on Y's U.S. income tax liability for a pending taxable year, an adjustment increasing the basis of Y's assets for 1966 shall be deemed to have been made in 1968 for the purpose of computing allowable depreciation or gain or loss on disposition for 1969 and any future taxable year. The district director shall notify X in writing of the amount and nature of the adjustment which is deemed to have been made to Y.

Example (3). Assume that X is a U.S. taxpayer and Y is a foreign taxpayer not engaged in a trade or business in the United States; that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length interest charge on a loan made to Y; that X consents to an assessment reflecting such allocation by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. Although a correlative adjustment would not have an effect on Y's U.S. income tax liability, an adjustment in Y's income for 1966 shall be deemed to have been made in 1968 for the purposes of determining the amount of Y's earnings and profits for 1966 and subsequent years, and of any other effect it may have on any person's U.S. income tax liability for any taxable year. The district director shall notify X in writing of the amount and nature of the allocation which is deemed to have been made to Y.

(3) In making distributions, apportionments, or allocations between two members of a group of controlled entities with respect to particular transactions, the district director shall consider the effect upon such members of an arrangement between them for reimbursement within a reasonable period before or after the taxable year if the taxpayer can establish that such an arrangement in fact existed during the taxable year under consideration. The district director shall also consider the effect of any other nonarm's length transaction between them in the taxable year which, if taken into account, would result in a setoff against any allocation which would otherwise be made, provided the taxpayer is able to establish with reasonable specificity that the transaction was not at arm's length and the amount of the appropriate arm's length charge. For purposes of the preceding sentence, the term arm's length refers to the amount which was charged or would have been charged in independent transactions with unrelated parties under the same or similar circumstances considering all the relevant facts and without regard to the rules found in § 1.482–2 by which certain charges are deemed to be equal to arm's length. For example, assume that one member of a group performs services which benefit a second member, which would in itself require an allocation to reflect an arm's length charge for the performance of such services. Assume further that the first member can establish that during the same taxable year the second member engages in other nonarm's length transactions which benefit the first member, such as by selling products to the first member at a discount, or purchasing products from the first member at a premium, or paying royalties to the first member in an excessive amount. In such case, the value of the benefits received by the first member as a result of the other activities will be set-off against the allocation which would otherwise be made. If the effect of the set-off is to change the characterization or source of the income or

deductions, or otherwise distort taxable income, in such a manner as to affect the United States tax liability of any member, allocations will be made to reflect the correct amount of each category of income or deductions. In order to establish that a set-off to the adjustments proposed by the district director is appropriate, the taxpayer must notify the district director of the basis of any claimed set-off at any time before the expiration of the period ending 30 days after the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments or before July 16, 1968, whichever is later. The principles of this subparagraph may be illustrated by the following examples, in each of which it is assumed that P and S are calendar year corporations and are both members of the same group of controlled entities:

Example (1). P performs services in 1966 for the benefit of S in connection with S's manufacture and sale of a product. S does not pay P for such services in 1966, but in consideration for such services, agrees in 1966 to pay P a percentage of the amount of sales of the product in 1966 through 1970. In 1966 it appeared this agreement would provide adequate consideration for the services. No allocation will be made with respect to the services performed by P.

Example (2). P renders services to S in connection with the construction of S's factory. An arm's length charge for such services, determined under paragraph (b) of §1.482–2, would be $100,000. During the same taxable year P makes available to S a machine to be used in such construction. P bills S $125,000 for the services, but does not bill for the use of the machine. No allocation will be made with respect to the excessive charge for services or the undercharge for the machine if P can establish that the excessive charge for services was equal to an arm's length charge for the use of the machine, and if the taxable income and income tax liabilities of P and S are not distorted.

Example (3). Assume the same facts as in example (2), except that, if P had reported $25,000 as rental income and $25,000 less service income, it would have been subject to the tax on personal holding companies. Allocations will be made to reflect the correct amounts of rental income and service income.

(4) If the members of a group of controlled taxpayers engage in transactions with one another, the district director may distribute, apportion, or allocate income, deductions, credits, or allowances to reflect the true taxable income of the individual members under the standards set forth in this section and in §1.482–2 notwithstanding the fact that the ultimate income anticipated from a series of transactions may not be realized or is realized during a later period. For example, if one member of a controlled group sells a product at less than an arm's length price to a second member of the group in one taxable year and the second member resells the product to an unrelated party in the next taxable year, the district director may make an appropriate allocation to reflect an arm's length price for the sale of the product in the first taxable year, notwithstanding that the second member of the group had not realized any gross income from the resale of the product in the first year. Similarly, if one member of a group lends money to a second member of the group in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second member does not realize income during such year. The provisions of this subparagraph apply even if the gross income contemplated from a series of transactions is never, in fact, realized by the other members.

(5) Section 482 may, when necessary to prevent the avoidance of taxes or to clearly reflect income, be applied in circumstances described in sections of the Code (such as section 351) providing for nonrecognition of gain or loss. See, for example, ''National Securities Corporation v. Commissioner of Internal Revenue'', 137 F. 2d 600 (3d Cir. 1943), cert. denied 320 U.S. 794 (1943).

(6) If payment or reimbursement for the sale, exchange, or use of property, the rendition of services, or the advance of other consideration among members of a group of controlled entities was prevented, or would have been prevented, at the time of the transaction because of currency or other restrictions imposed under the laws of any foreign country, any distributions, apportionments, or allocations which may be made under section 482 with respect to such transactions may be

treated as deferrable income or deductions, providing the taxpayer has, for the year to which the distributions, apportionments, or allocations relate, elected to use a method of accounting in which the reporting of deferrable income is deferred until the income ceases to be deferrable income. Under such method of accounting, referred to in this section as the deferred income method of accounting, any payments or reimbursements which were prevented or would have been prevented, and any deductions attributable directly or indirectly to such payments or reimbursements, shall be deferred until they cease to be deferrable under such method of accounting. If such method of accounting has not been elected with respect to the taxable year to which the allocations under section 482 relate, the taxpayer may elect such method with respect to such allocations (but not with respect to other deferrable income) at any time before the first occurring of the following events with respect to the allocations:

(i) Execution by the taxpayer of Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment);

(ii) Expiration of the period ending 30 days after the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments reflecting such allocations or before July 16, 1968, whichever is later; or

(iii) Execution of a closing agreement or offer-in-compromise.

The principles of this subparagraph may be illustrated by the following example in which it is assumed that X, a domestic corporation, and Y, a foreign corporation, are members of the same group of controlled entities:

Example. X, which is in the business of rendering a certain type of service to unrelated parties, renders such services for the benefit of Y in 1965. The direct and indirect costs allocable to such services are $60,000, and an arm's length charge for such services is $100,000. Assume that the district director proposes to increase X's income by $100,000, but that the country in which Y is located would have blocked payment in 1965 for such services. If, prior to the first occurring of the events described in subdivisions (i), (ii), or (iii) of this subparagraph, X elects to use the deferred income method of accounting with respect to such allocation, the $100,000 allocation and the $60,000 of costs are deferrable until such amounts cease to be deferrable under X's method of accounting.

[T.D. 6595, 27 FR 3598, Apr. 14, 1962, as amended by T.D. 6952, 33 FR 5848, Apr. 16, 1968. Redesignated by T.D. 8470, 58 FR 5271, Jan. 21, 1993]

§ 1.482–2A Determination of taxable income in specific situations.

(a)–(c) For applicable rules, see § 1.482–2T (a) through (c).

(d) *Transfer or use of intangible property*—(1) *In general.* (i) Except as otherwise provided in subparagraph (4) of this paragraph, where intangible property or an interest therein is transferred, sold, assigned, loaned, or otherwise made available in any manner by one member of a group of controlled entities (referred to in this paragraph as the transferor) to another member of the group (referred to in this paragraph as the transferee) for other than an arm's length consideration, the district director may make appropriate allocations to reflect an arm's length consideration for such property or its use. Subparagraph (2) of this paragraph provides rules for determining the form an amount of an appropriate allocation, subparagraph (3) of this paragraph provides a definition of ''intangible property'', and subparagraph (4) of this paragraph provides rules with respect to certain cost-sharing arrangements in connection with the development of intangible property. For purposes of this paragraph, an interest in intangible property may take the form of the right to use such property.

(ii)*(a)* In the absence of a bona fide cost-sharing arrangement (as defined in subparagraph (4) of this paragraph), where one member of a group of related entities undertakes the development of intangible property as a developer within the meaning of *(c)* of this subdivision, no allocation with respect to such development activity shall be made under the rules of this paragraph or any other paragraph of this section (except as provided in *(b)* of this subdivision) until such time as any property developed, or any interest therein, is or is deemed to be transferred, sold, assigned, loaned, or otherwise made available in any manner by the developer to a related entity in a transfer subject to the rules of this paragraph. Where a member of the group other than the developer acquires an interest in the property developed by virtue of obtaining a patent or copyright, or by any other means, the developer shall be deemed to have transferred such interest in such property to the acquiring member in a transaction subject to the rules of this paragraph. For example, if one member of a group (the developer) undertakes to develop a new patentable product and the costs of development are incurred by that entity over a period of 3 years, no allocation with respect to that entity's activity shall be made during such period. The amount of any allocation that may be appropriate at the expiration of such development period when, for example, the patent on the product is transferred, or deemed transferred, to a related entity for other than an arm's length consideration, shall be determined in accordance with the rules of this paragraph.

(b) Where one member of a group renders assistance in the form of loans, services, or the use of tangible or intangible property to a developer in connection with an attempt to develop intangible property, the amount of any allocation that may be appropriate with respect to such assistance shall be determined in accordance with the rules of the appropriate paragraph or paragraphs of this section. Thus, where one entity allows a related entity, which is the developer, to use tangible property, such as laboratory equipment, in connection with the development of intangible property, the amount of any allocation that may be appropriate with respect to such use shall be determined in accordance with the rules of paragraph *(c)* of this section. In the event that the district director does not exercise his discretion to make allocations with respect to the assistance rendered to the developer, the value of the assistance shall be allowed as a set-off against any allocation that the district director may make under this paragraph as a result of the transfer of the intangible property to the entity rendering the assistance.

(c) The determination as to which member of a group of related entities is a developer and which members of the group are rendering assistance to the developer in connection with its development activities shall be based upon all the facts and circumstances of the individual case. Of all the facts and circumstances to be taken into account in making this determination, greatest weight shall be given to the relative amounts of all the direct and indirect costs of development and the corresponding risks of development borne by the various members of the group, and the relative values of the use of any intangible property of members of the group which is made available without adequate consideration for use in connection with the development activity, which property is likely to contribute to a substantial extent in the production of intangible property. For this purpose, the risk to be borne with respect to development activity is the possibility that such activity will not result in the production of intangible property or that the intangible property produced will not be of sufficient value to allow for the recovery of the costs of developing it. A member will not be considered to have borne the costs and corresponding risks of development unless such member is committed to bearing such costs in advance of, or contemporaneously with, their incurrence and without regard to the success of the project. Other factors that may be relevant in determining which member of the group is the developer include the location of the development activity, the capabilities of the various members to carry on the project independently, and the degree of control over the project exercised by the various members.

(d) The principles of this subdivision (ii) may be illustrated by the following examples in which it is assumed that X and Y are corporate members of the same group:

Example (1). X, at the request of Y, undertakes to develop a new machine which will function effectively in the climate in which Y's factory is located. Y agrees to bear all the direct and indirect costs of the project whether or not X successfully develops the machine. Assume that X does not make any of its own intangible property available for use in connection with the project. The machine is successfully developed and Y obtains possession of the intangible property necessary to produce such machine. Based on the facts and circumstances as stated, Y shall be considered to be the developer of the intangible property and, therefore, Y shall not be treated as having obtained the property in a transfer subject to the rules of this paragraph. Any amount which may be allocable with respect to the assistance rendered by X shall be determined in accordance with the rules of *(b)* of this subdivision.

Example (2). Assume the same facts as in example (1) except that Y agrees to reimburse X for its costs only in the event that the property is successfully developed. In such case X is the developer and Y is deemed to have received the property in a transfer subject to the rules of this paragraph. Therefore, the district director may make an allocation to reflect an arm's length consideration for such property.

Example (3). In 1967 X undertakes to develop product M in its research and development department. X incurs direct and indirect costs of $1 million per year in connection with the project in 1967, 1968, and 1969. In connection with the project, X employs the formula for compound N, which it owns, and which is likely to contribute substantially to the success of the project. The value of the use of the formula for compound N in connection with this project is $750,000. In 1968, 4 chemists employed by Y spend 6 months working on the project in X's laboratory. The salary and other expenses connected with the chemists' employment for that period ($100,000) are paid by Y, for which no charge is made to X. In 1969, product M is perfected and Y obtains patents thereon. X is considered to be the developer of product M since, among other things, it bore the greatest relative share of the costs and risks incurred in connection with this project and made available intangible property (formula for compound N) which was likely to contribute substantially in the development of product M. Accordingly, no allocation with respect to X's development activity should be made before 1969. The property is deemed to have been transferred to Y at that time by virtue of the fact that Y obtained the patent rights to product M. In such case the district director may make an allocation to reflect an arm's length consideration for such transfer. In the event that the district director makes such an allocation and he has not made or does not make an allocation for 1968 with respect to the services of the chemists in accordance with the principles of paragraph (b) of this section, the value of the assistance shall be allowed as a set-off against the amount of the allocation reflecting an arm's length consideration for the transfer of the intangible property.

(2) *Arm's length consideration.* (i) An arm's length consideration shall be in a form which is consistent with the form which would be adopted in transactions between unrelated parties under the same circumstances. To the extent appropriate, an arm's length consideration may take any one or more of the following forms:

(a) Royalties based on the transferee's output, sales, profits, or any other measure;

(b) Lump-sum payments; or

(c) Any other form, including reciprocal licensing rights, which might reasonably have been adopted by unrelated parties under the circumstances, provided that the parties can establish that such form was adopted pursuant to an arrangement which in fact existed between them.

However, where the transferee pays nominal or no consideration for the property or interest therein and where the transferor has retained a substantial interest in the property, an allocation shall be presumed not to take the form of a lump-sum payment.

(ii) In determining the amount of an arm's length consideration, the standard to be applied is the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances. Where there have been transfers by the transferor to unrelated parties involving the same or similar intangible property under the same or similar circumstances the amount of the consideration for such transfers shall generally be the best indication of an arm's length consideration.

(iii) Where a sufficiently similar transaction involving an unrelated party cannot be found, the following factors, to the extent appropriate (depending upon the type of intangible property and the form of the transfer), may be considered in arriving at the amount of the arm's length consideration:

(a) The prevailing rates in the same industry or for similar property,

(b) The offers of competing transferors or the bids of competing transferees,

(c) The terms of the transfer, including limitations on the geographic area

covered and the exclusive or nonexclusive character of any rights granted,

(d) The uniqueness of the property and the period for which it is likely to remain unique,

(e) The degree and duration of protection afforded to the property under the laws of the relevant countries.

(f) Value of services rendered by the transferor to the transferee in connection with the transfer within the meaning of paragraph (b)(8) of this section,

(g) Prospective profits to be realized or costs to be saved by the transferee through its use or subsequent transfer of the property,

(h) The capital investment and starting up expenses required of the transferee,

(i) The next subdivision is *(j),*

(j) The availability of substitutes for the property transferred,

(k) The arm's length rates and prices paid by unrelated parties where the property is resold or sublicensed to such parties,

(l) The costs incurred by the transferor in developing the property, and

(m) Any other fact or circumstance which unrelated parties would have been likely to consider in determining the amount of an arm's length consideration for the property.

(3) *Definition of intangible property.* (i) Solely for the purposes of this section, intangible property shall consist of the items described in subdivision (ii) of this subparagraph, provided that such items have substantial value independent of the services of individual persons.

(ii) The items referred to in subdivision (i) of this subparagraph are as follows:

(a) Patents, inventions, formulas, processes, designs, patterns, and other similar items;

(b) Copyrights, literary, musical, or artistic compositions, and other similar items;

(c) Trademarks, trade names, brand names, and other similar items;

(d) Franchises, licenses, contracts, and other similar items;

(e) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data, and other similar items.

(4) *Sharing of costs and risks.* Where a member of a group of controlled entities acquires an interest in intangible property as a participating party in a bona fide cost sharing arrangement with respect to the development of such intangible property, the district director shall not make allocations with respect to such acquisition except as may be appropriate to reflect each participant's arm's length share of the costs and risks of developing the property. A bona fide cost sharing arrangement is an agreement, in writing, between two or more members of a group of controlled entities providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced. In order for the arrangement to qualify as a bona fide arrangement, it must reflect an effort in good faith by the participating members to bear their respective shares of all the costs and risks of development on an arm's length basis. In order for the sharing of costs and risk to be considered on an arm's length basis, the terms and conditions must be comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement. If an oral cost sharing arrangement, entered into prior to April 16, 1968, and continued in effect after that date, is otherwise in compliance with the standards prescribed in this subparagraph, it shall constitute a bona fide cost sharing arrangement if it is reduced to writing prior to January 1, 1969.

(e) *Sales of tangible property*—(1) *In general.* (i) Where one member of a group of controlled entities (referred to in this paragraph as the ''seller'') sells or otherwise disposes of tangible property to another member of such group (referred to in this paragraph as the ''buyer'') at other than an arm's length price (such a sale being referred to in this paragraph as a ''controlled sale''), the district director may make appropriate allocations between the seller and the buyer to reflect an arm's length price for such sale or disposition. An arm's length price is the price that an unrelated party would have paid under the same circumstances for the property involved in the controlled sale. Since unrelated parties normally sell products at a profit, an arm's length price normally involves a profit to the seller.

(ii) Subparagraphs (2), (3), and (4) of this paragraph describe three methods of determining an arm's-length price and the standards for applying each method. They are, respectively, the comparable uncontrolled price method, the resale price method, and the cost-plus method. In addition, a special rule is provided in subdivision (v) of this subparagraph for use (notwithstanding any other provision of this subdivision) in determining an arm's-length price for an ore or mineral. If there are comparable uncontrolled sales as defined in subparagraph (2) of this paragraph, the comparable uncontrolled price method must be utilized because it is the method likely to result in the most accurate estimate of an arm's-length price (for the reason that it is based upon the price actually paid by unrelated parties for the same or similar products). If there are no comparable uncontrolled sales, then the resale price method must be utilized if the standards for its application are met because it is the method likely to result in the next most accurate estimate in such instances (for the reason that, in such instances, the arm's-length price determined under such method is based more directly upon actual arm's-length transactions than is the cost-plus method). A typical situation where the resale price method may be required is where a manufacturer sells products to a related distributor which, without further processing, resells the products in uncontrolled transactions. If all the standards for the mandatory application of the resale price method are not satisfied, then, as provided in subparagraph (3)(iii) of this paragraph, either that method or the cost-plus method may be used, depending upon which method is more feasible and is likely to result in a more accurate estimate of an arm's-length price. A typical situation where the cost-plus method may be appropriate is where a manufacturer sells products to a related entity which performs substantial manufacturing, assembly, or other processing of the product or adds significant value by reason of its utilization of its intangible property prior to resale in uncontrolled transactions.

(iii) Where the standards for applying one of the three methods of pricing described in subdivision (ii) of this subparagraph are met, such method must, for the purposes of this paragraph, be utilized unless the taxpayer can establish that, considering all the facts and circumstances, some method of pricing other than those described in subdivision (ii) of this subparagraph is clearly more appropriate. Where none of the three methods of pricing described in subdivision (ii) of this subparagraph can reasonably be applied under the facts and circumstances as they exist in a particular case, some appropriate method of pricing other than those described in subdivision (ii) of this subparagraph, or variations on such methods, can be used.

(iv) The methods of determining arm's length prices described in this section are stated in terms of their application to individual sales of property. However, because of the possibility that a taxpayer may make controlled sales of many different products, or many separate sales of the same product, it may be impractical to analyze every sale for the purposes of determining the arm's length price. It is therefore permissible to determine or verify arm's length prices by applying the appropriate methods of pricing to product lines or other groupings where it is impractical to ascertain an arm's length price for each product or sale. In addition, the district director may determine or verify the arm's length price of all sales to a related entity by employing reasonable statistical sampling techniques.

(v) The price for a mineral product which is sold at the stage at which mining or extraction ends shall be determined under the provisions of §§ 1.613–3 and 1.613–4.

(2) *Comparable uncontrolled price method.* (i) Under the method of pricing described as the ''comparable uncontrolled price method'', the arm's length price of a controlled sale is equal to the price paid in comparable uncontrolled sales, adjusted as provided in subdivision (ii) of this subparagraph.

(ii) ''Uncontrolled sales'' are sales in which the seller and the buyer are not members of the same controlled group. These include *(a)* sales made by a member of the controlled group to an unrelated party, *(b)* sales made to a member of the controlled group by an unrelated party, and *(c)* sales made in which the parties are not members of the controlled group and are not related to each other. However, uncontrolled sales do not include sales at unrealistic prices, as for example where a member makes uncontrolled sales in small quantities at a price designed to justify a nonarm's length price on a large volume of controlled sales. Uncontrolled sales are considered comparable to controlled sales if the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in the controlled sales, or if such properties and circumstances are so nearly identical that any differences either have no effect on price, or such differences can be reflected by a reasonable number of adjustments to the price of uncontrolled sales. For this purpose, differences can be reflected by adjusting prices only where such differences have a definite and reasonably ascertainable effect on price. If the differences can be reflected by such adjustment, then the price of the uncontrolled sale as adjusted constitutes the comparable uncontrolled sale price. Some of the differences which may affect the price of property are differences in the quality of the product, terms of sale, intangible property associated with the sale, time of sale, and the level of the market and the geographic market in which the sale takes place. Whether and to what extent differences in the various properties and circumstances affect price, and whether differences render sales noncomparable, depends upon the particular circumstances and property involved. The principles of this subdivision may be illustrated by the following examples, in each of which it is assumed that X makes both controlled and uncontrolled sales of the identical property:

Example (1). Assume that the circumstances surrounding the controlled and the uncontrolled sales are identical, except for the fact that the controlled sales price is a delivered price and the uncontrolled sales are made f.o.b. X's factory. Since differences in terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, such differences do not normally render the uncontrolled sales noncomparable to the controlled sales.

Example (2). Assume that the circumstances surrounding the controlled and uncontrolled sales are identical, except for the fact that X affixes its valuable trademark in the controlled sales, and does not affix its trademark in uncontrolled sales. Since the effects on price of differences in intangible property associated with the sale of tangible property, such as trademarks, are normally not reasonably ascertainable, such differences would normally render the uncontrolled sales noncomparable.

Example (3). Assume that the circumstances surrounding the controlled and uncontrolled sales are identical, except for the fact that X, a manufacturer of business machines, makes certain minor modifications in the physical properties of the machines to satisfy safety specifications or other specific requirements of a customer in controlled sales, and does not make these modifications in uncontrolled sales. Since minor physical differences in the product generally have a definite and reasonably ascertainable effect on prices, such differences do not normally render the uncontrolled sales noncomparable to the controlled sales.

(iii) Where there are two or more comparable uncontrolled sales susceptible of adjustment as defined in subdivision (ii) of this subparagraph, the comparable uncontrolled sale or sales requiring the fewest and simplest adjustments provided in subdivision (ii) of this subparagraph should generally be selected. Thus, for example, if a taxpayer makes comparable uncontrolled sales of a particular product which differ from the controlled sale only with respect to the terms of delivery, and makes other comparable uncontrolled sales of the product which differ from the controlled sale with respect to both terms of delivery and terms of payment, the comparable uncontrolled sales differing only with respect to terms of delivery should be selected as the comparable uncontrolled sale.

(iv) One of the circumstances which may affect the price of property is the fact that the seller may desire to make sales at less than a normal profit for the primary purpose of establishing or maintaining a market for his products. Thus, a seller may be willing to reduce the price of a product, for a time, in order to introduce his product into an area or in order to meet competition. However, controlled sales may be priced in such a manner only if such price would have been charged in an uncontrolled sale under comparable circumstances. Such fact may be demonstrated by showing that the buyer in the controlled sale made corresponding reductions in the resale price to uncontrolled purchasers, or that such buyer engaged in substantially greater sales promotion activities with respect to the product involved in the controlled sale than with respect to other products. For example, assume X, a manufacturer of batteries, commences to sell car batteries to Y, a subsidiary of X, for resale in a new market. In its existing markets X's batteries sell to independent retailers at $20 per unit, and X sells them to wholesalers at $17 per unit. Y also sells X's batteries to independent retailers at $20 per unit. X's batteries are not known in the new market in which Y is operating. In order to engage competitively in the new market Y incurs selling and advertising costs substantially higher than those incurred for its sales of other products. Under these circumstances X may sell to Y, for a time, at less than $17 to take into account the increased selling and advertising activities of Y in penetrating and establishing the new market. This may be done even though it may result in a transfer price from X to Y which is below X's full costs of manufacturing the product.

(3) *Resale price method.* (i) Under the pricing method described as the ''resale price method'', the arm's length price of a controlled sale is equal to the applicable resale price (as defined in subdivision (iv) or (v) of this subparagraph), reduced by an appropriate markup, and adjusted as provided in subdivision (ix) of this subparagraph. An appropriate markup is computed by multiplying the applicable resale price by the appropriate markup percentage as defined in subdivision (vi) of this subparagraph. Thus, where one member of a group of controlled entities sells property to another member which resells the property in uncontrolled sales, if the applicable resale price of the property involved in the uncontrolled sale is $100 and the appropriate markup percentage for resales by the buyer is 20 percent, the arm's length price of the controlled sale is $80 ($100 minus 20 percent × $100), adjusted as provided in subdivision (ix) of this subparagraph.

(ii) The resale price method must be used to compute an arm's length price of a controlled sale if all the following circumstances exist:

(a) There are no comparable uncontrolled sales as defined in subparagraph (2) of this paragraph.

(b) An applicable resale price, as defined in subdivision (iv) or (v) of this subparagraph, is available with respect to resales made within a reasonable time before or after the time of the controlled sale.

(c) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by physically altering the product before resale. For this purpose packaging, repacking, labeling, or minor assembly of property does not constitute physical alteration.

(d) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by the use of intangible property. See § 1.482–2(d)(3) for the definition of intangible property.

(iii) Notwithstanding the fact that one or both of the requirements of subdivision (ii) *(c)* or *(d)* of this subparagraph may not be met, the resale price method may be used if such method is more feasible and is likely to result in a more accurate determination of an arm's length price than the use of the cost plus method. Thus, even though one of the requirements of such subdivision is not satisfied, the resale price method may nevertheless be more appropriate than the cost plus method because the computations and evaluations required under the former method may be fewer and easier to make than under the latter method. In general, the resale price method is more appropriate when the functions performed by the seller are more extensive and more difficult to evaluate than the functions performed by the buyer (reseller). The principle of this subdivision may be illustrated by the following examples in each of which it is assumed that corporation X developed a valuable patent covering product M which it manufactures and sells to corporation Y in a controlled sale, and for which there is no comparable uncontrolled sale:

Example (1). Corporation Y adds a component to product M and resells the assembled product in an uncontrolled sale within a reasonable time after the controlled sale of product M. Assume further that the addition of the component added more than an insubstantial amount to the value of product M, but that Y's function in purchasing the component and assembling the product prior to sale was subject to reasonably precise valuation. Although the controlled sale and resale does not meet the requirements of subdivision (ii)*(c)* of this subparagraph, the resale price method may be used under the circumstances because that method involves computations and evaluations which are fewer and easier to make than under the cost plus method. This is because X's use of a patent may be more difficult to evaluate in determining an appropriate gross profit percentage under the cost plus method, than is evaluation of Y's assembling function in determining the appropriate markup percentage under the resale price method.

Example (2). Corporation Y resells product M in an uncontrolled sale within a reasonable time after the controlled sale after attaching its valuable trademark to it. Assume further that it can be demonstrated through comparison with other uncontrolled sales of Y that the addition of Y's trademark to a product usually adds 25 percent to the markup on its sales. On the other hand, the effect of X's use of its patent is difficult to evaluate in applying the cost plus method because no reasonable standard of comparison is available. Although the controlled sale and resale does not meet the requirements of subdivision (ii)*(d)* of this subparagraph, the resale price method may be used because that method involves computations and evaluation which are fewer and easier to make than under the cost plus method. That is because, under the circumstances, X's use of a patent is more difficult to evaluate in determining an appropriate gross profit percentage under the cost plus method, than is evaluation of the use of Y's trademark in determining the appropriate markup percentage under the resale price method.

(iv) For the purposes of this subparagraph the ‘‘applicable resale price’’ is the price at which it is anticipated that property purchased in the controlled sale will be resold by the buyer in an uncontrolled sale. The ‘‘applicable resale price’’ will generally be equal to either the price at which current resales of the same property are being made or the resale price of the particular item of property involved.

(v) Where the property purchased in the controlled sale is resold in another controlled sale, the ‘‘applicable resale price’’ is the price at which such property is finally resold in an uncontrolled sale, providing that the series of sales as a whole meets all the requirements of subdivision (ii) of this subparagraph or that the resale price method is used pursuant to subdivision (iii) of this subparagraph. In such case, the determination of the appropriate markup percentage shall take into account the function or functions performed by all members of the group participating in the series of sales and resales. Thus, if X sells a product to Y in a controlled sale, Y sells the product to Z in a controlled sale, and Z sells the product in an uncontrolled sale, the resale price method must be used if Y and Z together have not added more than an insubstantial amount to the value of the product through physical alteration or the application of intangible property, and the final resale occurs within a reasonable time of the sale from X to Y. In such case, the applicable resale price is the price at which Z sells the product in the uncontrolled sale, and the appropriate markup percentage shall take into account the functions performed by both Y and Z.

(vi) For the purposes of this subparagraph, the appropriate markup percentage is equal to the percentage of gross profit (expressed as a percentage of sales) earned by the buyer (reseller) or another party on the resale of property which is both purchased and resold in an uncontrolled transaction, which resale is most similar to the applicable resale of the property involved in the controlled sale. The following are the most important characteristics to be considered in determining the similarity of resales:

(a) The type of property involved in the sales. For example: machine tools, men's furnishings, small household appliances.

(b) The functions performed by the reseller with respect to the property. For example: packaging, labeling, delivering, maintenance of inventory, minor assembly, advertising, selling at

wholesale, selling at retail, billing, maintenance of accounts receivable, and servicing.

(c) The effect on price of any intangible property utilized by the reseller in connection with the property resold. For example: patents, trademarks, trade names.

(d) The geographic market in which the functions are performed by the reseller.

In general, the similarity to be sought relates to the probable effect upon the markup percentage of any differences in such characteristics between the uncontrolled purchases and resales on the one hand and the controlled purchases and resales on the other hand. Thus, close physical similarity of the property involved in the sales compared is not required under the resale price method since a lack of close physical similarity is not necessarily indicative of dissimilar markup percentages.

(vii) Whenever possible, markup percentages should be derived from uncontrolled purchases and resales of the buyer (reseller) involved in the controlled sale, because similar characteristics are more likely to be found among different resales of property made by the same reseller than among sales made by other resellers. In the absence of resales by the same buyer (reseller) which meet the standards of subdivision (vi) of this subparagraph, evidence of an appropriate markup percentage may be derived from resales by other resellers selling in the same or a similar market in which the controlled buyer (reseller) is selling providing such resellers perform comparable functions. Where the function performed by the reseller is similar to the function performed by a sales agent which does not take title, such sales agent will be considered a reseller for the purpose of determining an appropriate markup percentage under this subparagraph and the commission earned by such sales agent, expressed as a percentage of the sales price of the goods, may constitute the appropriate markup percentage. If the controlled buyer (reseller) is located in a foreign country and information on resales by other resellers in the same foreign market is not available, then markup percentages earned by United States resellers performing comparable functions may be used. In the absence of data on markup percentages of particular sales or groups of sales, the prevailing markup percentage in the particular industry involved may be appropriate.

(viii) In calculating the markup percentage earned on uncontrolled purchases and resales, and in applying such percentage to the applicable resale price to determine the appropriate markup, the same elements which enter into the computation of the sales price and the costs of goods sold of the property involved in the comparable uncontrolled purchases and resales should enter into such computation in the case of the property involved in the controlled purchases and resales. Thus, if freight-in and packaging expense are elements of the cost of goods sold in comparable uncontrolled purchases, then such elements should also be taken into account in computing the cost of goods sold of the controlled purchase. Similarly, if the comparable markup percentage is based upon net sales (after reduction for returns and allowances) of uncontrolled resellers, such percentage must be applied to net sales of the buyer (reseller).

(ix) In determining an arm's length price appropriate adjustment must be made to reflect any material differences between the uncontrolled purchases and resales used as the basis for the calculation of the appropriate markup percentage and the resales of property involved in the controlled sale. The differences referred to in this subdivision are those differences in functions or circumstances which have a definite and reasonably ascertainable effect on price. The principles of this subdivision may be illustrated by the following example:

Example. Assume that X and Y are members of the same group of controlled entities and that Y purchases electric mixers from X and electric toasters from uncontrolled entities. Y performs substantially similar functions with respect to resales of both the mixers and the toasters, except that it does not warrant the toasters, but does provide a 90-day warranty for the mixers. Y normally earns a gross profit on toasters of 20 percent of gross selling price. The 20-percent gross profit on the resale of toasters is an appropriate markup percentage, but the price of the controlled sale computed with reference to such rate must be adjusted to reflect the difference in terms (the warranty).

(4) *Cost plus method.* (i) Under the pricing method described as the ‘‘cost plus method’’, the arm’s length price of a controlled sale of property shall be computed by adding to the cost of producing such property (as computed in subdivision (ii) of this subparagraph), an amount which is equal to such cost multiplied by the appropriate gross profit percentage (as computed in subdivision (iii) of this subparagraph), plus or minus any adjustments as provided in subdivision (v) of this subparagraph.

(ii) For the purposes of this subparagraph, the cost of producing the property involved in the controlled sale, and the costs which enter into the computation of the appropriate gross profit percentage shall be computed in a consistent manner in accordance with sound accounting practices for allocating or apportioning costs, which neither favors nor burdens controlled sales in comparison with uncontrolled sales. Thus, if the costs used in computing the appropriate gross profit percentage are comprised of the full cost of goods sold, including direct and indirect costs, then the cost of producing the property involved in the controlled sales must be comprised of the full cost of goods sold, including direct and indirect costs. On the other hand, if the costs used in computing the appropriate gross profit percentage are comprised only of direct costs, the cost of producing the property involved in the controlled sale must be comprised only of direct costs. The term ‘‘cost of producing’’, as used in this subparagraph, includes the cost of acquiring property which is held for resale.

(iii) For the purposes of this subparagraph, the appropriate gross profit percentage is equal to the gross profit percentage (expressed as a percentage of cost) earned by the seller or another party on the uncontrolled sale or sales of property which are most similar to the controlled sale in question. The following are the most important characteristics to be considered in determining the similarity of the uncontrolled sale or sales:

(a) The type of property involved in the sales. For example: machine tools, men’s furnishings, small household appliances.

(b) The functions performed by the seller with respect to the property sold. For example: contract manufacturing, product assembly, selling activity, processing, servicing, delivering.

(c) The effect of any intangible property used by the seller in connection with the property sold. For example: patents, trademarks, trade names.

(d) The geographic market in which the functions are performed by the seller. In general, the similarity to be sought relates to the probable effect upon the margin of gross profit of any differences in such characteristics between the uncontrolled sales and the controlled sale. Thus, close physical similarity of the property involved in the sales compared is not required under the cost plus method since a lack of close physical similarity is not necessarily indicative of dissimilar profit margins. See subparagraph (2)(iv) of this paragraph, relating to sales made at less than a normal profit for the primary purpose of establishing or maintaining a market.

(iv) Whenever possible, gross profit percentages should be derived from uncontrolled sales made by the seller involved in the controlled sale, because similar characteristics are more likely to be found among sales of property made by the same seller than among sales made by other sellers. In the absence of such sales, evidence of an appropriate gross profit percentage may be derived from similar uncontrolled sales by other sellers whether or not such sellers are members of the controlled group. Where the function performed by the seller is similar to the function performed by a purchasing agent which does not take title, such purchasing agent will be considered a seller for the purpose of determining an appropriate gross profit percentage under this subparagraph and the commission earned by such purchasing agent, expressed as a percentage of the purchase price of the goods, may constitute the appropriate gross profit percentage. In the absence of data on gross profit percentages of particular sales or groups of sales which are similar to the controlled sale, the prevailing gross profit percentages in the particular industry involved may be appropriate.

(v) Where the most similar sale or sales from which the appropriate gross profit percentage is derived differ in any material respect from the controlled sale, the arm's length price which is computed by applying such percentage must be adjusted to reflect such differences to the extent such differences would warrant an adjustment of price in uncontrolled transactions. The differences referred to in this subdivision are those differences which have a definite and reasonably ascertainable effect on price.

(Sec. 385 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 613 and 68A Stat. 917; 26 U.S.C. 385 and 7805))

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EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.482–2A, see the List of CFR Sections Affected in the Finding Aids section of this volume.

SUBCHAPTER A—INCOME TAX (Continued)

PART 1—INCOME TAXES (Continued)

Normal Taxes and Surtaxes (Continued)

EXEMPT ORGANIZATIONS

GENERAL RULE

Sec.
1.501(a)–1 Exemption from taxation.
1.501(c)(2)–1 Corporations organized to hold title to property for exempt organizations.
1.501(c)(3)–1 Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.
1.501(c)(4)–1 Civic organizations and local associations of employees.
1.501(c)(5)–1 Labor, agricultural, and horticultural organizations.
1.501(c)(6)–1 Business leagues, chambers of commerce, real estate boards, and boards of trade.
1.501(c)(7)–1 Social clubs.
1.501(c)(8)–1 Fraternal beneficiary societies.
1.501(c)(9)–1 Voluntary employees' beneficiary associations, in general.
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1.501(c)(9)–3 Voluntary employees' beneficiary associations; life, sick, accident, or other benefits.
1.501(c)(9)–4 Voluntary employees' beneficiary associations; inurement.
1.501(c)(9)–5 Voluntary employees' beneficiary associations; recordkeeping requirements.
1.501(c)(9)–6 Voluntary employees' beneficiary associations; benefits includible in gross income.
1.501(c)(9)–7 Voluntary employees' beneficiary associations; section 3(4) of ERISA.
1.501(c)(9)–8 Voluntary employees' beneficiary associations; effective date.
1.501(c)(10)–1 Certain fraternal beneficiary societies.
1.501(c)(12)–1 Local benevolent life insurance associations, mutual irrigation and telephone companies, and like organizations.
1.501(c)(13)–1 Cemetery companies and crematoria.
1.501(c)(14)–1 Credit unions and mutual insurance funds.
1.501(c)(15)–1 Mutual insurance companies or associations.
1.501(c)(16)–1 Corporations organized to finance crop operations.
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1.501(c)(17)–2 General rules.
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1.502–1 Feeder organizations.
1.503(a)–1 Denial of exemption to certain organizations engaged in prohibited transactions.
1.503(b)–1 Prohibited transactions.
1.503(c)–1 Future status of organizations denied exemption.
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1.503(e)–4 Disallowance of charitable deductions for certain gifts made before January 1, 1970.
1.503(f)–1 Loans by employers who are prohibited from pledging assets.
1.504–1 Attempts to influence legislation; certain organizations formerly described in section 501(c)(3) denied exemption.
1.504–2 Certain transfers made to avoid section 504(a).
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Sec. 1.527–9 also issued under 26 U.S.C. 527(h)(2)(B)(i).
Sec. 1.585–5 through 1.585–8 also issued under 26 U.S.C. 585(b)(3).
Sec. 1.597–1 through 1.597–7 also issued under 26 U.S.C. 597 and 1502.
Sec. 1.597–8 also issued under 26 U.S.C. 597.

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EXEMPT ORGANIZATIONS

GENERAL RULE

§1.501(a)–1 Exemption from taxation.

(a) *In general; proof of exemption.* (1) Section 501(a) provides an exemption from income taxes for organizations which are described in section 501 (c) or (d) and section 401(a), unless such organization is a *feeder organization* (see section 502), or unless it engages in a transaction described in section 503. However, the exemption does not extend to *unrelated business taxable income* of such an organization (see part III (Section 511 and following), subchapter F, chapter 1 of the Code).

(2) An organization, other than an employees' trust described in section 401(a), is not exempt from tax merely because it is not organized and operated for profit. In order to establish its exemption, it is necessary that every such organization claiming exemption file an application form as set forth below with the district director for the internal revenue district in which is located the principal place of business or principal office of the organization. Subject only to the Commissioner's inherent power to revoke rulings because of a change in the law or regulations or for other good cause, an organization that has been determined by the Commissioner or the district director to be exempt under section 501(a) or the corresponding provision of prior law may rely upon such determination so long as there are no substantial changes in the organization's character, purposes, or methods of operation. An organization which has been determined to be exempt under the provisions of the Internal Revenue Code of 1939 or prior law is not required to secure a new determination of exemption merely because of the enactment of the Internal Revenue Code of 1954 unless affected by

substantive changes in law made by such Code.

(3) An organization claiming exemption under section 501(a) and described in any paragraph of section 501(c) (other than section 501(c)(1) shall file the form of application prescribed by the Commissioner and shall include thereon such information as required by such form and the instructions issued with respect thereto. For rules relating to the obtaining of a determination of exempt status by an employees' trust described in section 401(a), see the regulations under section 401.

(b) *Additional proof by particular classes of organizations.* (1) Organizations mentioned below shall submit with and as a part of their applications the following information:

(i) Mutual insurance companies shall submit copies of the policies or certificates of membership issued by them.

(ii) In the case of title holding companies described in section 501(c)(2), if the organization for which title is held has not been specifically notified in writing by the Internal Revenue Service that it is held to be exempt under section 501(a), the title holding company shall submit the information indicated herein as necessary for a determination of the status of the organization for which title is held.

(iii) An organization described in section 501(c)(3) shall submit with, and as a part of, an application filed after July 26, 1959, a detailed statement of its proposed activities.

(2) In addition to the information specifically called for by this section, the Commissioner may require any additional information deemed necessary for a proper determination of whether a particular organization is exempt under section 501(a), and when deemed advisable in the interest of an efficient administration of the internal revenue laws, he may in the cases of particular types of organizations prescribe the form in which the proof of exemption shall be furnished.

(3) An organization claiming to be specifically exempted by section 6033(a) from filing annual returns shall submit with and as a part of its application a statement of all the facts on which it bases its claim.

(c) *Private shareholder or individual defined.* The words *private shareholder or individual* in section 501 refer to persons having a personal and private interest in the activities of the organization.

(d) *Requirement of annual returns.* For the annual return requirements of organizations exempt under section 501(a), see section 6033 and §1.6033–1.

(e) *Certain Puerto Rican pension, etc., trusts.* Effective for taxable years beginning after December 31, 1973, section 1022(i)(1) of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 942) provides that trusts under certain Puerto Rican pension, etc., plans (as defined under P.R. Laws Ann. tit. 13, section 3165, and the articles thereunder), all of the participants of which are residents of the Commonwealth of Puerto Rico, are to be treated only for purposes of section 501(a) as trusts described in section 401(a). The practical effect of section 1022(i)(1) is to exempt these trusts from U.S. income tax on income from their U.S. investments. For purposes of section 1022(i)(1), the term *residents of the Commonwealth of Puerto Rico* means bona fide residents of Puerto Rico, and persons who perform labor or services primarily within the Commonwealth of Puerto Rico, regardless of residence for other purposes, and the term *participants* is restricted to current employees who are not excluded under the eligibility provisions of the plan.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7428, 41 FR 34619, Aug. 16, 1976; T.D. 7859, 47 FR 54298, Dec. 2, 1982]

§1.501(c)(2)–1 Corporations organized to hold title to property for exempt organizations.

(a) A corporation described in section 501(c)(2) and otherwise exempt from tax under section 501(a) is taxable upon its unrelated business taxable income. For taxable years beginning before January 1, 1970, see §1.511–2(c)(4). Since a corporation described in section 501(c)(2) cannot be exempt under section 501(a) if it engages in any business other than that of holding title to property and collecting income therefrom, it cannot have unrelated business taxable income as defined in section 512 other than income which is treated as unrelated business taxable income solely because of the applicability of section 512(a)(3)(C); or debt financed income which is treated as unrelated business taxable income solely because of section 514; or certain interest, annuities, royalties, or rents which are treated as unrelated business taxable income solely because of section 512(b)(3)(B)(ii) or (13). Similarly, exempt status under section 501(c)(2) shall not be affected where certain rents from personal property leased with real property are treated as unrelated business taxable income under section 512(b)(3)(A)(ii) solely because such rents attributable to such personal property are more than incidental when compared to the total rents received or accrued under the lease, or under section 512(b)(3)(B)(i) solely because such rents attributable to such personal property exceed 50 percent of the total rents received or accrued under the lease.

(b) A corporation described in section 501(c)(2) cannot accumulate income and retain its exemption, but it must turn over the entire amount of such income, less expenses, to an organization which is itself exempt from tax under section 501(a).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7658, 45 FR 33972, May 21, 1980]

§1.501(c)(3)–1 Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

(a) *Organizational and operational tests.* (1) In order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

(2) The term *exempt purpose or purposes*, as used in this section, means any purpose or purposes specified in section 501(c)(3), as defined and elaborated in paragraph (d) of this section.

(b) *Organizational test*—(1) *In general.* (i) An organization is organized exclusively for one or more exempt purposes only if its articles of organization (referred to in this section as its *articles*) as defined in subparagraph (2) of this paragraph:

(a) Limit the purposes of such organization to one or more exempt purposes; and

(b) Do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.

(ii) In meeting the organizational test, the organization’s purposes, as stated in its articles, may be as broad as, or more specific than, the purposes stated in section 501(c)(3). Therefore, an organization which, by the terms of its articles, is formed *for literary and scientific purposes within the meaning of section 501(c)(3) of the Code* shall, if it otherwise meets the requirements in this paragraph, be considered to have met the organizational test. Similarly, articles stating that the organization is created solely *to receive contributions and pay them over to organizations which are described in section 501(c)(3) and exempt from taxation under section 501(a)* are sufficient for purposes of the organizational test. Moreover, it is sufficient if the articles set for the purpose of the organization to be the operation of a school for adult education and describe in detail the manner of the operation of such school. In addition, if the articles state that the organization is formed for *charitable purposes*, such articles ordinarily shall be sufficient for purposes of the organizational test (see subparagraph (5) of this paragraph for rules relating to construction of terms).

(iii) An organization is not organized exclusively for one or more exempt purposes if its articles expressly empower it to carry on, otherwise than as an insubstantial part of its activities, activities which are not in furtherance of one or more exempt purposes, even though such organization is, by the terms of such articles, created for a purpose that is no broader than the purposes specified in section 501(c)(3).

Thus, an organization that is empowered by its articles *to engage in a manufacturing business,* or *to engage in the operation of a social club* does not meet the organizational test regardless of the fact that its articles may state that such organization is created *for charitable purposes within the meaning of section 501(c)(3) of the Code.*

(iv) In no case shall an organization be considered to be organized exclusively for one or more exempt purposes, if, by the terms of its articles, the purposes for which such organization is created are broader than the purposes specified in section 501(c)(3). The fact that the actual operations of such an organization have been exclusively in furtherance of one or more exempt purposes shall not be sufficient to permit the organization to meet the organizational test. Similarly, such an organization will not meet the organizational test as a result of statements or other evidence that the members thereof intend to operate only in furtherance of one or more exempt purposes.

(v) An organization must, in order to establish its exemption, submit a detailed statement of its proposed activities with and as a part of its application for exemption (see paragraph (b) of § 1.501(a)–1).

(2) *Articles of organization.* For purposes of this section, the term *articles of organization* or *articles* includes the trust instrument, the corporate charter, the articles of association, or any other written instrument by which an organization is created.

(3) *Authorization of legislative or political activities.* An organization is not organized exclusively for one or more exempt purposes if its articles expressly empower it:

(i) To devote more than an insubstantial part of its activities to attempting to influence legislation by propaganda or otherwise; or

(ii) Directly or indirectly to participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office; or

(iii) To have objectives and to engage in activities which characterize it as an *action* organization as defined in paragraph (c)(3) of this section.

The terms used in subdivisions (i), (ii), and (iii) of this subparagraph shall have the meanings provided in paragraph (c)(3) of this section. An organization's articles will not violate the provisions of paragraph (b)(3)(i) of this section even though the organization's articles expressly empower it to make the election provided for in section 501(h) with respect to influencing legislation and, only if it so elects, to make lobbying or grass roots expenditures that do not normally exceed the ceiling amounts prescribed by section 501(h)(2)(B) and (D).

(4) *Distribution of assets on dissolution.* An organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose. An organization's assets will be considered dedicated to an exempt purpose, for example, if, upon dissolution, such assets would, by reason of a provision in the organization's articles or by operation of law, be distributed for one or more exempt purposes, or to the Federal Government, or to a State or local government, for a public purpose, or would be distributed by a court to another organization to be used in such manner as in the judgment of the court will best accomplish the general purposes for which the dissolved organization was organized. However, an organization does not meet the organizational test if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders.

(5) *Construction of terms.* The law of the State in which an organization is created shall be controlling in construing the terms of its articles. However, any organization which contends that such terms have under State law a different meaning from their generally accepted meaning must establish such special meaning by clear and convincing reference to relevant court decisions, opinions of the State attorney-general, or other evidence of applicable State law.

(6) *Applicability of the organizational test.* A determination by the Commissioner or a district director that an organization is described in section

501(c)(3) and exempt under section 501(a) will not be granted after July 26, 1959 (regardless of when the application is filed), unless such organization meets the organizational test prescribed by this paragraph. If, before July 27, 1959, an organization has been determined by the Commissioner or district director to be exempt as an organization described in section 501(c)(3) or in a corresponding provision of prior law and such determination has not been revoked before such date, the fact that such organization does not meet the organizational test prescribed by this paragraph shall not be a basis for revoking such determination. Accordingly, an organization which has been determined to be exempt before July 27, 1959, and which does not seek a new determination of exemption is not required to amend its articles of organization to conform to the rules of this paragraph, but any organization which seeks a determination of exemption after July 26, 1959, must have articles of organization which meet the rules of this paragraph. For the rules relating to whether an organization determined to be exempt before July 27, 1959, is organized exclusively for one or more exempt purposes, see 26 CFR (1939) 39.101(6)–1 (Regulations 118) as made applicable to the Code by Treasury Decision 6091, approved August 16, 1954 (19 FR 5167; C.B. 1954–2, 47).

(c) *Operational test*—(1) *Primary activities.* An organization will be regarded as *operated exclusively* for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

(2) *Distribution of earnings.* An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. For the definition of the words *private shareholder or individual,* see paragraph (c) of §1.501(a)–1.

(3) *Action organizations.* (i) An organization is not operated exclusively for one or more exempt purposes if it is an *action* organization as defined in subdivisions (ii), (iii), or (iv) of this subparagraph.

(ii) An organization is an *action* organization if a substantial part of its activities is attempting to influence legislation by propaganda or otherwise. For this purpose, an organization will be regarded as attempting to influence legislation if the organization:

(a) Contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation; or

(b) Advocates the adoption or rejection of legislation.

The term *legislation,* as used in this subdivision, includes action by the Congress, by any State legislature, by any local council or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure. An organization will not fail to meet the operational test merely because it advocates, as an insubstantial part of its activities, the adoption or rejection of legislation. An organization for which the expenditure test election of section 501(h) is in effect for a taxable year will not be considered an *action* organization by reason of this paragraph (c)(3)(ii) for that year if it is not denied exemption from taxation under section 501(a) by reason of section 501(h).

(iii) An organization is an *action* organization if it participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office.

The term *candidate for public office* means an individual who offers himself, or is proposed by others, as a contestant for an elective public office, whether such office be national, State, or local. Activities which constitute participation or intervention in a political campaign on behalf of or in opposition to a candidate include, but are not limited to, the publication or distribution of written or printed statements or the making of oral statements on behalf of or in opposition to such a candidate.

(iv) An organization is an *action* organization if it has the following two characteristics: *(a)* Its main or primary objective or objectives (as distinguished from its incidental or secondary objectives) may be attained only by legislation or a defeat of proposed legislation; and *(b)* it advocates, or campaigns for, the attainment of such main or primary objective or objectives as distinguished from engaging in nonpartisan analysis, study, or research and making the results thereof available to the public. In determining whether an organization has such characteristics, all the surrounding facts and circumstances, including the articles and all activities of the organization, are to be considered.

(v) An *action* organization, described in subdivisions (ii) or (iv) of this subparagraph, though it cannot qualify under section 501(c)(3), may nevertheless qualify as a social welfare organization under section 501(c)(4) if it meets the requirements set out in paragraph (a) of § 1.501(c)(4)–1.

(d) *Exempt purposes*—(1) *In general.* (i) An organization may be exempt as an organization described in section 501(c)(3) if it is organized and operated exclusively for one or more of the following purposes:

(a) Religious,

(b) Charitable,

(c) Scientific,

(d) Testing for public safety,

(e) Literary,

(f) Educational, or

(g) Prevention of cruelty to children or animals.

(ii) An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

(iii) Since each of the purposes specified in subdivision (i) of this subparagraph is an exempt purpose in itself, an organization may be exempt if it is organized and operated exclusively for any one or more of such purposes. If, in fact, an organization is organized and operated exclusively for an exempt purpose or purposes, exemption will be granted to such an organization regardless of the purpose or purposes specified in its application for exemption. For example, if an organization claims exemption on the ground that it is *educational*, exemption will not be denied if, in fact, it is *charitable.*

(2) *Charitable defined.* The term *charitable* is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of *charity* as developed by judicial decisions. Such term includes: Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency. The fact that an organization which is organized and operated for the relief of indigent persons may receive voluntary contributions from the persons intended to be relieved will not necessarily prevent such organization from being exempt as an organization organized and operated exclusively for charitable purposes. The fact that an organization, in carrying out its primary purpose, advocates social or civic changes or presents opinion on controversial issues with the intention of molding public opinion or creating public sentiment to an acceptance of its views does not preclude such organization from qualifying under section 501(c)(3) so long as it is not an *action* organization of any one of the types described in paragraph (c)(3) of this section.

(3) *Educational defined*—(i) *In general.* The term *educational*, as used in section 501(c)(3), relates to:

(a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or

(b) The instruction of the public on subjects useful to the individual and beneficial to the community.

An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.

(ii) *Examples of educational organizations.* The following are examples of organizations which, if they otherwise meet the requirements of this section, are educational:

Example 1. An organization, such as a primary or secondary school, a college, or a professional or trade school, which has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on.

Example 2. An organization whose activities consist of presenting public discussion groups, forums, panels, lectures, or other similar programs. Such programs may be on radio or television.

Example 3. An organization which presents a course of instruction by means of correspondence or through the utilization of television or radio.

Example 4. Museums, zoos, planetariums, symphony orchestras, and other similar organizations.

(4) *Testing for public safety defined.* The term *testing for public safety*, as used in section 501(c)(3), includes the testing of consumer products, such as electrical products, to determine whether they are safe for use by the general public.

(5) *Scientific defined.* (i) Since an organization may meet the requirements of section 501(c)(3) only if it serves a public rather than a private interest, a *scientific* organization must be organized and operated in the public interest (see subparagraph (1)(ii) of this paragraph). Therefore, the term *scientific*, as used in section 501(c)(3), includes the carrying on of scientific research in the public interest. Research when taken alone is a word with various meanings; it is not synonymous with *scientific*; and the nature of particular research depends upon the purpose which it serves. For research to be *scientific*, within the meaning of section 501(c)(3), it must be carried on in furtherance of a *scientific* purpose. The determination as to whether research is *scientific* does not depend on whether such research is classified as *fundamental* or *basic* as contrasted with *applied* or *practical*. On the other hand, for purposes of the exclusion from unrelated business taxable income provided by section 512(b)(9), it is necessary to determine whether the organization is operated primarily for purposes of carrying on *fundamental*, as contrasted with *applied*, research.

(ii) Scientific research does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, as, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc.

(iii) Scientific research will be regarded as carried on in the public interest:

(a) If the results of such research (including any patents, copyrights, processes, or formulae resulting from such research) are made available to the public on a nondiscriminatory basis;

(b) If such research is performed for the United States, or any of its agencies or instrumentalities, or for a State or political subdivision thereof; or

(c) If such research is directed toward benefiting the public. The following are examples of scientific research which will be considered as directed toward benefiting the public, and, therefore, which will be regarded as carried on in the public interest: *(1)* Scientific research carried on for the purpose of aiding in the scientific education of college or university students; *(2)* scientific research carried on for the purpose of obtaining scientific information, which is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public; *(3)* scientific research carried on for the purpose of discovering a cure for a disease; or *(4)* scientific research carried on for the purpose of aiding a community or geographical area by attracting new industry to the community or area or by encouraging the development of, or retention of, an

industry in the community or area. Scientific research described in this subdivision will be regarded as carried on in the public interest even though such research is performed pursuant to a contract or agreement under which the sponsor or sponsors of the research have the right to obtain ownership or control of any patents, copyrights, processes, or formulae resulting from such research.

(iv) An organization will not be regarded as organized and operated for the purpose of carrying on scientific research in the public interest and, consequently, will not qualify under section 501(c)(3) as a *scientific* organization, if:

(a) Such organization will perform research only for persons which are (directly or indirectly) its creators and which are not described in section 501(c)(3), or

(b) Such organization retains (directly or indirectly) the ownership or control of more than an insubstantial portion of the patents, copyrights, processes, or formulae resulting from its research and does not make such patents, copyrights, processes, or formulae available to the public. For purposes of this subdivision, a patent, copyright, process, or formula shall be considered as made available to the public if such patent, copyright, process, or formula is made available to the public on a nondiscriminatory basis. In addition, although one person is granted the exclusive right to the use of a patent, copyright, process, or formula, such patent, copyright, process, or formula shall be considered as made available to the public if the granting of such exclusive right is the only practicable manner in which the patent, copyright, process, or formula can be utilized to benefit the public. In such a case, however, the research from which the patent, copyright, process, or formula resulted will be regarded as carried on in the public interest (within the meaning of subdivision (iii) of this subparagraph) only if it is carried on for a person described in subdivision (iii)*(b)* of this subparagraph or if it is scientific research described in subdivision (iii)*(c)* of this subparagraph.

(v) The fact that any organization (including a college, university, or hospital) carries on research which is not in furtherance of an exempt purpose described in section 501(c)(3) will not preclude such organization from meeting the requirements of section 501(c)(3) so long as the organization meets the organizational test and is not operated for the primary purpose of carrying on such research (see paragraph (e) of this section, relating to organizations carrying on a trade or business). See paragraph (a)(5) of §1.513–2, with respect to research which constitutes an unrelated trade or business, and section 512(b) (7), (8), and (9), with respect to income derived from research which is excludable from the tax on unrelated business income.

(vi) The regulations in this subparagraph are applicable with respect to taxable years beginning after December 31, 1960.

(e) *Organizations carrying on trade or business*—(1) *In general.* An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes. An organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under section 501(c)(3) even though it has certain religious purposes, its property is held in common, and its profits do not inure to the benefit of individual members of the organization. See, however, section 501(d) and §1.501(d)–1, relating to religious and apostolic organizations.

(2) *Taxation of unrelated business income.* For provisions relating to the taxation of unrelated business income of certain organizations described in section 501(c)(3), see sections 511 to 515, inclusive, and the regulations thereunder.

(f) *Applicability of regulations in this section.* The regulations in this section are, except as otherwise expressly provided, applicable with respect to taxable years beginning after July 26, 1959. For the rules applicable with respect to taxable years beginning before July 27, 1959, see 26 CFR (1939) 39.101(6)–1 (Regulations 118) as made applicable to the Code by Treasury Decision 6091, approved August 16, 1954 (19 FR 5167; C.B. 1954–2, 47).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6525, 26 FR 189, Jan. 11, 1961; T.D. 6939, 32 FR 17661, Dec. 12, 1967; T.D. 7428, 41 FR 34620, Aug. 16, 1976; T.D. 8308, 55 FR 35587, Aug. 31, 1990]

§1.501(c)(4)–1 Civic organizations and local associations of employees.

(a) *Civic organizations*—(1) *In general.* A civic league or organization may be exempt as an organization described in section 501(c)(4) if—

(i) It is not organized or operated for profit; and

(ii) It is operated exclusively for the promotion of social welfare.

(2) *Promotion of social welfare*—(i) *In general.* An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterments and social improvements. A *social welfare* organization will qualify for exemption as a charitable organization if it falls within the definition of *charitable* set forth in paragraph (d)(2) of §1.501(c)(3)–1 and is not an *action* organization as set forth in paragraph (c)(3) of §1.501(c)(3)–1.

(ii) *Political or social activities.* The promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office. Nor is an organization operated primarily for the promotion of social welfare if its primary activity is operating a social club for the benefit, pleasure, or recreation of its members, or is carrying on a business with the general public in a manner similar to organizations which are operated for profit. See, however, section 501(c)(6) and §1.501(c)(6)–1, relating to business leagues and similar organizations. A social welfare organization that is not, at any time after October 4, 1976, exempt from taxation as an organization described in section 501(c)(3) may qualify under section 501(c)(4) even though it is an *action* organization described in §1.501(c)(3)–1(c)(3)(ii) or (iv), if it otherwise qualifies under this section. For rules relating to an organization that is, after October 4, 1976, exempt from taxation as an organization described in section 501(c)(3), see section 504 and §1.504–1.

(b) *Local associations of employees.* Local associations of employees described in section 501(c)(4) are expressly entitled to exemption under section 501(a). As conditions to exemption, it is required (1) that the membership of such an association be limited to the employees of a designated person or persons in a particular municipality, and (2) that the net earnings of the association be devoted exclusively to charitable, educational, or recreational purposes. The word *local* is defined in paragraph (b) of §1.501(c)(12)–1. See paragraph (d) (2) and (3) of §1.501(c)(3)–1 with reference to the meaning of *charitable* and *educational* as used in this section.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8308, 55 FR 35588, Aug. 31, 1990]

§1.501(c)(5)–1 Labor, agricultural, and horticultural organizations.

(a) The organizations contemplated by section 501(c)(5) as entitled to exemption from income taxation are those which:

(1) Have no net earnings inuring to the benefit of any member, and

(2) Have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.

(b)(1) *General rule.* An organization is not an organization described in section 501(c)(5) if the principal activity of the organization is to receive, hold, invest, disburse or otherwise manage funds associated with savings or investment plans or programs, including pension or other retirement savings plans or programs.

(2) *Exception*. Paragraph (b)(1) of this section shall not apply to an organization which—

(i) Is established and maintained by another labor organization described in section 501(c)(5) (determined without regard to this paragraph (b)(2));

(ii) Is not directly or indirectly established or maintained in whole or in part by one or more—

(A) Employers;

(B) Governments or agencies or instrumentalities thereof; or

(C) Government controlled entities;

(iii) Is funded by membership dues from members of the labor organization described in this paragraph (b)(2) and earnings thereon; and

(iv) Has not at any time after September 2, 1974 (the date of enactment of the Employee Retirement Income Security Act of 1974, Pub. L. 93–406, 88 Stat. 829) provided for, permitted or accepted employer contributions.

(3) *Example*. The principles of this paragraph (b) are illustrated by the following example:

Example. Trust A is organized in accordance with a collective bargaining agreement between labor union K and multiple employers. Trust A forms part of a plan that is established and maintained pursuant to the agreement and which covers employees of the signatory employers who are members of K. Representatives of both the employers and K serve as trustees. A receives contributions from the employers who are subject to the agreement. Retirement benefits paid to K's members as specified in the agreement are funded exclusively by the employers' contributions and accumulated earnings. A also provides information to union members about their retirement benefits and assists them with administrative tasks associated with the benefits. Most of A's activities are devoted to these functions. From time to time, A also participates in the renegotiation of the collective bargaining agreement. A's principal activity is to receive, hold, invest, disburse, or otherwise manage funds associated with a retirement savings plan. In addition, A does not satisfy all the requirements of the exception described in paragraph (b)(2) of this section. (For example, A accepts contributions from employers.) Therefore, A is not a labor organization described in section 501(c)(5).

(c) Organizations described in section 501(c)(5) and otherwise exempt from tax under section 501(a) are taxable upon their unrelated business taxable income. See part II (section 511 and following), subchapter F, chapter 1 of the Code, and the regulations thereunder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8726, 62 FR 40449, July 29, 1997]

§ 1.501(c)(6)–1 Business leagues, chambers of commerce, real estate boards, and boards of trade.

A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus, its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit, even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league. An association engaged in furnishing information to prospective investors, to enable them to make sound investments, is not a business league, since its activities do not further any common business interest, even though all of its income is devoted to the purpose stated. A stock or commodity exchange is not a business league, a chamber of commerce, or a board of trade within the meaning of section 501(c)(6) and is not exempt from tax. Organizations otherwise exempt from tax under this section are taxable upon their unrelated business taxable income. See part II (section 511 and following), subchapter F, chapter 1 of the Code, and the regulations thereunder.

§ 1.501(c)(7)–1 Social clubs.

(a) The exemption provided by section 501(a) for organizations described in section 501(c)(7) applies only to clubs which are organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, but does not apply to any club if any part of its net earnings inures to the benefit of any private shareholder. In general, this exemption extends to social and recreation clubs which are supported solely by membership fees, dues, and assessments. However, a club otherwise entitled to exemption will not be disqualified because it raises revenue from members through the use of club facilities or in connection with club activities.

(b) A club which engages in business, such as making its social and recreational facilities available to the general public or by selling real estate, timber, or other products, is not organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, and is not exempt under section 501(a). Solicitation by advertisement or otherwise for public patronage of its facilities is prima facie evidence that the club is engaging in business and is not being operated exclusively for pleasure, recreation, or social purposes. However, an incidental sale of property will not deprive a club of its exemption.

§1.501(c)(8)–1 Fraternal beneficiary societies.

(a) A fraternal beneficiary society is exempt from tax only if operated under the *lodge system* or for the exclusive benefit of the members so operating. *Operating under the lodge system* means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like. In order to be exempt it is also necessary that the society have an established system for the payment to its members or their dependents of life, sick, accident, or other benefits.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7061, 35 FR 14770, Sept. 23, 1970]

§1.501(c)(9)–1 Voluntary employees' beneficiary associations, in general.

To be described in section 501(c)(9) an organization must meet all of the following requirements:

(a) The organization is an employees' association,

(b) Membership in the association is voluntary,

(c) The organization provides for the payment of life, sick, accident, or other benefits to its members or their dependents or designated beneficiaries, and substantially all of its operations are in furtherance of providing such benefits, and

(d) No part of the net earnings of the organization inures, other than by payment of the benefits referred to in paragraph (c) of this section, to the benefit of any private shareholder or individual.

[T.D. 7750, 45 FR 1721, Jan. 7, 1981]

§1.501(c)(9)–2 Membership in a voluntary employees' beneficiary association; employees; voluntary association of employees.

(a) *Membership*—(1) *In general.* The membership of an organization described in section 501(c)(9) must consist of individuals who become entitled to participate by reason of their being employees and whose eligibility for membership is defined by reference to objective standards that constitute an employment-related common bond among such individuals. Typically, those eligible for membership in an organization described in section 501(c)(9) are defined by reference to a common employer (or affiliated employers), to coverage under one or more collective bargaining agreements (with respect to benefits provided by reason of such agreement(s)), to membership in a labor union, or to membership in one or more locals of a national or international labor union. For example, membership in an association might be open to all employees of a particular employer, or to employees in specified job classifications working for certain employers at specified locations and who are entitled to benefits by reason of one or more collective bargaining agreements. In addition, employees of one or more employers engaged in the same line of business in the same geographic locale will be considered to share an employment-related bond for purposes of an organization through which their employers provide benefits. Employees of a labor union also will be considered to share an employment-related common bond with members of the union, and employees of an association will be considered to share an employment-related common bond with members of the association. Whether a group of individuals is defined by reference to a permissible standard or standards is a question to be determined with regard to all the facts and circumstances, taking into account the guidelines set forth in this paragraph. Exemption will not be denied merely because the membership of an association includes some individuals who are not employees (within the meaning of paragraph (b) of this section), provided that such individuals share an employment-related bond with the employee-members. Such individuals may include, for example, the proprietor of a business whose employees are members of the association. For purposes of the preceding two sentences, an association will be considered to be composed of employees if 90 percent of the total membership of the association on one day of each quarter of the association's taxable year consists of employees (within the meaning of paragraph (b) of this section).

(2) *Restrictions*—(i) *In general.* Eligibility for membership may be restricted by geographic proximity, or by objective conditions or limitations reasonably related to employment, such as a limitation to a reasonable classification of workers, a limitation based on a reasonable minimum period of service, a limitation based on maximum compensation, or a requirement that a member be employed on a full-time basis. Similarly, eligibility for benefits may be restricted by objective conditions relating to the type or amount of benefits offered. Any objective criteria used to restrict eligibility for membership or benefits may not, however, be selected or administered in a manner that limits membership or benefits to officers, shareholders, or highly compensated employees of an employer contributing to or otherwise funding the employees' association. Similarly, eligibility for benefits may not be subject to conditions or limitations that have the effect of entitling officers, shareholders, or highly compensated employees of an employer contributing to or otherwise funding the employees' association to benefits that are disproportionate in relation to benefits to which other members of the association are entitled. See § 1.501(c)(9)–4(b). Whether the selection or administration of objective conditions has the effect of providing disproportionate benefits to officers, shareholders, or highly compensated employees generally is to be determined on the basis of all the facts and circumstances.

(ii) *Generally permissible restrictions or conditions.* In general the following restrictions will not be considered to be inconsistent with § 1.501(c)(9)–2(a)(2)(i) or § 1.501(c)(9)–4(b):

(A) In the case of an employer-funded organization, a provision that excludes or has the effect of excluding from membership in the organization or participation in a particular benefit plan employees who are members of another organization or covered by a different plan, funded or contributed to by the employer, to the extent that such other organization or plan offers similar benefits on comparable terms to the excluded employees.

(B) In the case of an employer funded-organization, a provision that excludes from membership, or limits the type or amount of benefits provided to, individuals who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that the benefit or benefits provided by the organization were the subject of good faith bargaining between such employee representatives and such employer or employers.

(C) Restrictions or conditions on eligibility for membership or benefits that are determined through collective bargaining, by trustees designated pursuant to a collective bargaining agreement, or by the collective bargaining agents of the members of an association or trustees named by such agent or agents.

(D) The allowance of benefits only on condition that a member or recipient contribute to the cost of such benefits, or the allowance of different benefits based solely on differences in contributions, provided that those making equal contributions are entitled to comparable benefits.

(E) A requirement that a member (or a member's dependents) meet a reasonable health standard related to eligibility for a particular benefit.

(F) The provision of life benefits in amounts that are a uniform percentage of the compensation received by the individual whose life is covered.

(G) The provision of benefits in the nature of wage replacement in the event of disability in amounts that are a uniform percentage of the compensation of the covered individuals (either before or after taking into account any disability benefits provided through social security or any similar plan providing for wage replacement in the event of disability).

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

Example 1. Pursuant to a collective bargaining agreement entered into by X Corporation and W, a labor union which represents all of X Corporation's hourly-paid employees, the X Corporation Union Benefit Plan is established to provide life insurance benefits to employees of X represented by W. The Plan is funded by contributions from X, and is jointly administered by X and W. In order to provide its non-unionized employees with comparable life insurance benefits, X also establishes and funds the X Corporation Life Insurance Trust. The Trust will not be ineligible for exemption as an organization described in section 501(c)(9) solely because membership is restricted to those employees of X who are not members of W.

Example 2. The facts are the same as in Example 1 except that the life insurance benefit provided to the non-unionized employees of X differs from the life insurance benefit provided to the unionized employees of X pursuant to the collective bargaining agreement. The trust will not be ineligible for exemption as an organization described in section 501(c)(9) solely because the life insurance benefit provided to X's nonunionized employees is not same as the life insurance benefit provided to X's unionized employees.

Example 3. S corporation established a plan to provide health benefits to all its employees. In accordance with the provisions of the plan each employee may secure insurance coverage by making an election under which the employee agrees to contribute periodically to the plan an amount which is determined solely by whether the employee elects a high option coverage or a low option coverage and on whether the employee is unmarried or has a family. As an alternative, the employee may elect high or low options, self only or self and family, coverage through a local prepaid group medical plan. The contributions required of those electing the prepaid group medical plan also vary with the type of coverage selected, and differ from those required of employees electing insurance. The difference between the amount contributed by employees electing the various coverages and the actual cost of purchasing the coverage is made up through contributions by S to the plan, and under the plan, S provides approximately the same proportion of the cost for each coverage. To fund the plan, S established an arrangement in the nature of a trust under applicable local law and contributes all employee contributions, and all amounts which by the terms of the plan it is required to contribute, to the trust. The terms of the plan do not provide for disproportionate benefits to the employees of S and will not be considered inconsistent with §1.501(c)(9)–2(a)(2)(i).

Example 4. The facts are the same as in Example 3 except that, for those employees or former employees covered by Medicare, the plan provides a distinct coverage which supplements Medicare benefits. Eligibility for Medicare is an objective condition relating to a type of benefit offered, and the provision of separate coverage for those eligible for Medicare will not be considered inconsistent with §1.501(c)(9)–2(a)(2)(i).

(b) *Meaning of employee.* Whether an individual is an *employee* is determined by reference to the legal and bona fide relationship of employer and employee. The term *employee* includes the following:

(1) An individual who is considered an employee:

(i) For employment tax purposes under subtitle C of the Internal Revenue Code and the regulations thereunder, or

(ii) For purposes of a collective bargaining agreement,

whether or not the individual could qualify as an employee under applicable common law rules. This would include any person who is considered an employee for purposes of the Labor Management Relations Act of 1947, 61 Stat. 136, *as amended,* 29 U.S.C. 141 (1979).

(2) An individual who became entitled to membership in the association by reason of being or having been an employee. Thus, an individual who would otherwise qualify under this paragraph will continue to qualify as

an employee even though such individual is on leave of absence, works temporarily for another employer or as an independent contractor, or has been terminated by reason of retirement, disability or layoff. For example, an individual who in the normal course of employment is employed intermittently by more than one employer in an industry characterized by short-term employment by several different employers will not, by reason of temporary unemployment, cease to be an employee within the meaning of this paragraph.

(3) The surviving spouse and dependents of an employee (if, for purposes of the 90-percent test of § 1.501(c)(9)–2(a)(1) they are considered to be members of the association).

(c) *Description of voluntary association of employees*—(1) *Association.* To be described in section 501(c)(9) and this section there must be an entity, such as a corporation or trust established under applicable local law, having an existence independent of the member-employees or their employer.

(2) *Voluntary.* Generally, membership in an association is voluntary if an affirmative act is required on the part of an employee to become a member rather than the designation as a member due to employee status. However, an association shall be considered voluntary although membership is required of all employees, provided that the employees do not incur a detriment (for example, in the form of deductions from pay) as the result of membership in the association. An employer is not deemed to have imposed involuntary membership on the employee if membership is required as the result of a collective bargaining agreement or as an incident of membership in a labor organization.

(3) *Of employees.* To be described in this section, an organization must be controlled—

(i) By its membership,

(ii) By independent trustee(s) (such as a bank), or

(iii) By trustees or other fiduciaries at least some of whom are designated by, or on behalf of, the membership. Whether control by or on behalf of the membership exists is a question to be determined with regard to all of the facts and circumstances, but generally such control will be deemed to be present when the membership (either directly or through its representative) elects, appoints or otherwise designates a person or persons to serve as chief operating officer(s), administrator(s), or trustee(s) of the organization. For purposes of this paragraph an organization will be considered to be controlled by independent trustees if it is an *employee welfare benefit plan,* as defined in section 3(1) of the Employee Retirement Income Security Act of 1974 (ERISA), and, as such, is subject to the requirements of parts 1 and 4 of subtitle B, title I of ERISA. Similarly, a plan will be considered to be controlled by its membership if it is controlled by one or more trustees designated pursuant to a collective bargaining agreement (whether or not the bargaining agent of the represented employees bargained for and obtained the right to participate in selecting the trustees).

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

Example 1. X, a labor union, represents all the hourly-paid employees of Y Corporation. A health insurance benefit plan was established by X and Y as the result of a collective bargaining agreement entered into by them. The plan established the terms and conditions of membership in, and the benefits to be provided by, the plan. In accordance with the terms of the agreement, Y Corporation is obligated to establish a trust fund and make contributions thereto at specified rates. The trustees, some of whom are designated by X and some by Y, are authorized to hold and invest the assets of the trust and to make payments on instructions issued by Y Corporation in accordance with the conditions contained in the plan. The interdependent benefit plan agreement and trust indenture together create a voluntary employees' beneficiary association over which the employees posses the requisite control through the trustees designated by their representative, X.

Example 2. Z Corporation unilaterally established an educational benefit plan for its employees. The purpose of the plan is to provide payments for job-related educational or training courses, such as apprenticeship training programs, for Z Corporation employees, according to objective criteria set forth in the plan. Z establishes a separate bank account which it uses to fund payments to the plan. Contributions to the account are to be made at the discretion of and solely by Z Corporation, which also administers the plan and retains control over the assets in the fund. Z Corporation's educational benefit plan and the related account do not constitute an association having an existence independent of Z Corporation and therefore do not constitute a voluntary employees' beneficiary association.

Example 3. A, an individual, is the incorporator and chief operating officer of Lawyers' Beneficiary Association (LBA). LBA is engaged in the business of providing medical benefits to members of the Association and their families. Membership is open only to practicing lawyers located in a particular metropolitan area who are neither self-employed nor partners in a law firm. Membership in LBA is solicited by insurance agents under the control of X Corporation (owned by A) which, by contract with LBA, is the exclusive sales agent. Medical benefits are paid from a trust account containing periodic *contributions* paid by the members, together with proceeds from the investment of those contributions. Contribution and benefit levels are set by LBA. The *members* of LBA do not hold meetings, have no right to elect officers or directors of the Association, and no right to replace trustees. Collectively, the subscribers for medical benefits from LBA cannot be said to control the association and membership is neither more than nor different from the purchase of an insurance policy from a stock insurance company. LBA is not a voluntary employees' beneficiary association.

Example 4. U corporation unilaterally established a plan to provide benefits to its employees. In accordance with the provisions of the plan, each employee may secure insurance or benefit coverage by making an election under which the employee agrees to contribute to the plan an amount which is determined solely by whether the employee elects a high option coverage or a low option coverage and on whether the employee elects self only or self and family coverage. The difference between the amount contributed by employees electing the various coverages and the actual cost of the coverage is made up through contributions by U to the plan. To fund the plan, U established an arrangement in the nature of a trust under applicable local law and contributed all employee contributions, and all amounts which by the term of the plan it was required to provide to the plan, to the trust. The trust constitutes an *employee welfare benefit plan* within the meaning of, and subject to relevant requirements of, ERISA. It will be considered to meet the requirements of §1.501(c)(9)–2(c)(3).

[T.D. 7750, 46 FR 1723, Jan. 7, 1981]

§1.501(c)(9)–3 Voluntary employees' beneficiary associations; life, sick, accident, or other benefits.

(a) *In general.* The life, sick, accident, or other benefits provided by a voluntary employees' beneficiary association must be payable to its members, their dependents, or their designated beneficiaries. For purposes of section 501(c)(9), *dependent* means the member's spouse; any child of the member or the member's spouse who is a minor or a student (within the meaning of section 151(e)(4)); any other minor child residing with the member; and any other individual who an association, relying on information furnished to it by a member, in good faith believes is a person described in section 152(a). Life, sick, accident, or other benefits may take the form of cash or noncash benefits. A voluntary employees' beneficiary association is not operated for the purpose of providing life, sick, accident, or other benefits unless substantially all of its operations are in furtherance of the provision of such benefits. Further, an organization is not described in this section if it systematically and knowingly provides benefits (of more than a *de minimis* amount) that are not permitted by paragraphs (b), (c), (d), or (e) of this section.

(b) *Life benefits.* The term *life benefits* means a benefit (including a burial benefit or a wreath) payable by reason of the death of a member or dependent. A *life benefit* may be provided directly or through insurance. It generally must consist of current protection, but also may include a right to convert to individual coverage on termination of eligibility for coverage through the association, or a permanent benefit as defined in, and subject to the conditions in, the regulations under section 79. A *life benefit* also includes the benefit provided under any life insurance contract purchased directly from an employee-funded association by a member or provided by such an association to a member. The term *life benefit* does not include a pension, annuity or similar benefit, except that a benefit payable by reason of the death of an insured may be settled in the form of an annuity to the beneficiary in lieu of a lump-sum death benefit (whether or not the contract provides for settlement in a lump sum).

(c) *Sick and accident benefits.* The term *sick and accident benefits* means amounts furnished to or on behalf of a member or a member's dependents in the event of illness or personal injury to a member or dependent. Such benefits may be provided through reimbursement to a member or a member's dependents for amounts expended because of illness or personal injury, or through the payment of premiums to a medical benefit or health insurance program. Similarly, a sick and accident benefit includes an amount paid to a member in lieu of income during a period in which the member is unable to work due to sickness or injury. Sick benefits also include benefits designed to safeguard or improve the health of members and their dependents. Sick and accident benefits may be provided directly by an association to or on behalf of members and their dependents, or may be provided indirectly by an association through the payment of premiums or fees to an insurance company, medical clinic, or other program under which members and their dependents are entitled to medical services or to other sick and accident benefits. Sick and accident benefits may also be furnished in noncash form, such as, for example, benefits in the nature of clinical care services by visiting nurses, and transportation furnished for medical care.

(d) *Other benefits.* The term *other benefits* includes only benefits that are similar to life, sick, or accident benefits. A benefit is similar to a life, sick, or accident benefit if:

(1) It is intended to safeguard or improve the health of a member or a member's dependents, or

(2) It protects against a contingency that interrupts or impairs a member's earning power.

(e) *Examples of other benefits.* Paying vacation benefits, providing vacation facilities, reimbursing vacation expenses, and subsidizing recreational activities such as athletic leagues are considered *other benefits.* The provision of child-care facilities for preschool and school-age dependents are also considered *other benefits.* The provision of job readjustment allowances, income maintenance payments in the event of economic dislocation, temporary living expense loans and grants at times of disaster (such as fire or flood), supplemental unemployment compensation benefits (as defined in section 501(c)(17)(D)(i) of the Code), severance benefits (under a severance pay plan within the meaning of 29 CFR 2510.3–2(b)) and education or training benefits or courses (such as apprentice training programs) for members, are considered *other benefits* because they protect against a contingency that interrupts earning power. Personal legal service benefits which consist of payments or credits to one or more organizations or trusts described in section 501(c)(20) are considered *other benefits.* Except to the extent otherwise provided in these regulations, as amended from time to time, *other benefits* also include any benefit provided in the manner permitted by paragraphs (5) *et seq.* of section 302(c) of the Labor Management Relations Act of 1947, 61 Stat. 136, *as amended,* 29 U.S.C. 186(c) (1979).

(f) *Examples of nonqualifying benefits.* Benefits that are not described in paragraphs (d) or (e) of this section are not *other benefits.* Thus, *other benefits* do not include the payment of commuting expenses, such as bridge tolls or train fares, the provision of accident or homeowner's insurance benefits for damage to property, the provision of malpractice insurance, or the provision of loans to members except in times of distress (as permitted by § 1.501(c)(9)–3(e)). *Other benefits* also do not include the provision of savings facilities for members. The term *other benefits* does not include any benefit that is similar to a pension or annuity payable at the time of mandatory or voluntary retirement, or a benefit that is similar to the benefit provided under a stock bonus or profit-sharing plan. For purposes of section 501(c)(9) and these regulations, a benefit will be considered similar to that provided under a pension, annuity, stock bonus or profit-sharing plan if it provides for deferred compensation that becomes payable by reason of the passage of time, rather than as the result of an unanticipated event. Thus, for example, supplemental unemployment benefits, which generally become payable by reason of unanticipated layoff, are not, for purposes of these regulations, considered similar to the benefit provided under a pension, annuity, stock bonus or profit-sharing plan.

(g) *Examples.* The provisions of this section may be further illustrated by the following examples:

Example 1. V was organized in connection with a vacation plan created pursuant to a collective bargaining agreement between M, a labor union, which represents certain hourly paid employees of T corporation, and T. The agreement calls for the payment by T to V of a specified sum per hour worked by T employees who are covered by the collective bargaining agreement. T includes the amounts in the covered employees' wages and withholds income and FICA taxes. The amounts are paid by T to V to provide vacation benefits provided under the collective bargaining agreement. Generally, each covered employee receives a check in payment of his or her vacation benefit during the year following the year in which contributions were made by T to V. The amount of the vacation benefit is determined by reference to the contributions during the prior year to V by T on behalf of each employee, and is distributed in cash to each such employee. If the earnings on investments by V during the year preceding distribution are sufficient after deducting the expenses of administering the plan, each recipient of a vacation benefit is paid an amount, in addition to the contributions on his or her behalf, equal to his/her ratable share of the net earnings of V during such year. The plan provides a vacation benefit that constitutes an eligible *other benefit* described in section 501(c)(9) and §1.501(c)(9)–3(e).

Example 2. The facts are the same as in Example 1, except that each covered employee of T is entitled, at his or her discretion, to contribute up to an additional $1,000 each year to V, which agrees in respect of such sum to pay interest at a stated rate from the time of contribution until the time at which the contributing employee's vacation benefit is distributed. In addition, each employee may elect to leave all or a portion of his/her distributable benefit on deposit past the time of distribution, in which case interest will continue to accrue. Because the plan more closely resembles a savings arrangement than a vacation plan, the benefit payable to the covered employees of T is not a *vacation benefit* and is not an eligible *other benefit* described in section 501(c)(9) and §1.501(c)(9)–3 (d) or (e).

[T.D. 7750, 46 FR 1724, Jan. 7, 1981]

§1.501(c)(9)–4 Voluntary employees' beneficiary associations; inurement.

(a) *General rule.* No part of the net earnings of an employees' association may inure to the benefit of any private shareholder or individual other than through the payment of benefits permitted by §1.501(c)(9)–3. The disposition of property to, or the performance of services for, a person for less than the greater of fair market value or cost (including indirect costs) to the association, other than as a life, sick, accident or other permissible benefit, constitutes prohibited inurement. Generally, the payment of unreasonable compensation to the trustees or employees of the association, or the purchase of insurance or services for amounts in excess of their fair market value from a company in which one or more of the association's trustees, officers or fiduciaries has an interest, will constitute prohibited inurement. Whether prohibited inurement has occurred is a question to be determined with regard to all of the facts and circumstances, taking into account the guidelines set forth in this section. The guidelines and examples contained in this section are not an exhaustive list of the activities that may constitute prohibited inurement, or the persons to whom the association's earnings could impermissibly inure. See §1.501(a)–1(c).

(b) *Disproportionate benefits.* For purposes of subsection (a), the payment to any member of disproportionate benefits, where such payment is not pursuant to objective and nondiscriminatory standards, will not be considered a benefit within the meaning of §1.501(c)(9)–3 even though the benefit otherwise is one of the type permitted by that section. For example, the payment to highly compensated personnel of benefits that are disproportionate in relation to benefits received by other members of the association will constitute prohibited inurement. Also, the payment to similarly situated employees of benefits that differ in kind or amount will constitute prohibited inurement unless the difference can be justified on the basis of objective and reasonable standards adopted by the association or on the basis of standards adopted pursuant to the terms of a collective bargaining agreement. In general, benefits paid pursuant to standards or subject to conditions that do not provide for disproportionate benefits to officers, shareholders, or highly compensated employees will not be considered disproportionate. See §1.501(c)(9)–2(a) (2) and (3).

(c) *Rebates.* The rebate of excess insurance premiums, based on the mortality or morbidity experience of the insurer to which the premiums were paid, to the person or persons whose contributions were applied to such premiums, does not constitute prohibited inurement. A voluntary employees' beneficiary association may also make administrative adjustments strictly incidental to the provision of benefits to its members.

(d) *Termination of plan or dissolution of association.* It will not constitute prohibited inurement if, on termination of a plan established by an employer and funded through an association described in section 501(c)(9), any assets remaining in the association, after satisfaction of all liabilities to existing beneficiaries of the plan, are applied to provide, either directly or through the purchase of insurance, life, sick, accident or other benefits within the meaning of §1.501(c)(9)–3 pursuant to criteria that do not provide for disproportionate benefits to officers, shareholders, or highly compensated employees of the employer. See §1.501(c)(9)–2(a)(2). Similarly, a distribution to members upon the dissolution of the association will not constitute prohibited inurement if the amount distributed to members are determined pursuant to to the terms of a collective bargaining agreement or on the basis of objective and reasonable standards which do not result in either unequal payments to similarly situated members or in disproportionate payments to officers, shareholders, or highly compensated employees of an employer contributing to or otherwise funding the employees' association. Except as otherwise provided in the first sentence of this paragraph, if the association's corporate charter, articles of association, trust instrument, or other written instrument by which the association was created, as amended from time to time, provides that on dissolution its assets will be distributed to its members' contributing employers, or if in the absence of such provision the law of the state in which the association was created provides for such distribution to the contributing employers, the association is not described in section 501(c)(9).

(e) *Example.* The provisions of this section may be illustrated by the following example:

Example. Employees A, B and C, members of the X voluntary employees' beneficiary association, are unemployed. They receive unemployment benefits from X. Those to A include an amount in addition to those provided to B and C, to provide for A's retraining. B has been found pursuant to objective and reasonable standards not to qualify for the retraining program. C, although eligible for retraining benefits has declined. X's additional payment to A for retraining does not constitute prohibited inurement.

[T.D. 7750, 46 FR 1725, Jan. 7, 1981]

§1.501(c)(9)–5 Voluntary employees' beneficiary associations; recordkeeping requirements.

(a) *Records.* In addition to such other records which may be required (for example, by section 512(a)(3) and the regulations thereunder), every organization described in section 501(c)(9) must maintain records indicating the amount contributed by each member and contributing employer, and the amount and type of benefits paid by the organization to or on behalf of each member.

(b) *Cross reference.* For provisions relating to annual information returns with respect to payments, see section 6041 and the regulations thereunder.

[T.D. 7750, 46 FR 1725, Jan. 7, 1981]

§1.501(c)(9)–6 Voluntary employees' beneficiary associations; benefits includible in gross income.

(a) *In general.* Cash and noncash benefits realized by a person on account of the activities of an organization described in section 501(c)(9) shall be included in gross income to the extent provided in the Internal Revenue Code of 1954, including, but not limited to, sections 61, 72, 101, 104 and 105 of the Code and regulations thereunder.

(b) *Availability of statutory exclusions from gross income.* The availability of any statutory exclusion from gross income with respect to contributions to, or the payment of benefits from, an organization described in section 501(c)(9) is determined by the statutory provision conferring the exclusion, and the regulations and rulings thereunder, not by whether an individual is eligible for membership in the organization or by the permissibility of the benefit paid. Thus, for example, if a benefit is paid by an employer-funded organization described in section 501(c)(9) to a member who is not an *employee*, a statutory exclusion from gross income that is available only for *employees* would be unavailable in the case of a benefit paid to such individual. Similarly, the fact that, for example, under some circumstances educational benefits constitute *other benefits* does not of itself mean that such benefits are eligible for the exclusion of either section 117 or section 127 of the Code.

[T.D. 7750, 46 FR 1725, Jan. 7, 1981]

§1.501(c)(9)–7 Voluntary employees' beneficiary associations; section 3(4) of ERISA.

The term *voluntary employees' beneficiary association* in section 501(c)(9) of the Internal Revenue Code is not necessarily coextensive with the term *employees' beneficiary association* as used in section 3(4) of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1002(4), and the requirements which an organization must meet to be an *employees' beneficiary association* within the meaning of section 3(4) of ERISA are not necessarily identical to the requirements that an organization must meet in order to be a *voluntary employees' beneficiary association* within the meaning of section 501(c)(9) of the Code.

[T.D. 7750, 46 FR 1725, Jan. 7, 1981]

§1.501(c)(9)–8 Voluntary employees' beneficiary associations; effective date.

(a) *General rule.* Except as otherwise provided in this section, the provisions of §§1.501(c)(9)–1 through 1.501(c)(9)–7 shall apply with respect to taxable years beginning after December 31, 1954.

(b) *Pre-1970 taxable years.* For taxable years beginning before January 1, 1970, section 501(c)(9)(B) (relating to the requirement that 85 percent or more of the association's income consist of amounts collected from members and contributed by employers), as in effect for such years, shall apply.

(c) *Existing associations.* Except as otherwise provided in paragraph (d), the provisions of §1.501(c)(9)–2(a)(1) and (c)(3) shall apply with respect to taxable years beginning after December 31, 1980.

(d) *Collectively-bargained plans.* In the case of a voluntary employees' beneficiary association which receives contributions from one or more employers pursuant to one or more collective bargaining agreements in effect on December 31, 1980, the provisions of §§1.501(c)(9)–1 through 1.501(c)(9)–5 shall apply with respect to taxable years beginning after the date on which the agreement terminates (determined without regard to any extension thereof agreed to after December 31, 1980).

(e) *Election.* Notwithstanding paragraphs (c) and (d) of this section, an organization may choose to be subject to all or a portion of one or more of the provisions of these regulations for any taxable year beginning after December 31, 1954.

[T.D. 7750, 46 FR 1725, Jan. 7, 1981; 46 FR 11971, Feb. 12, 1981]

§1.501(c)(10)–1 Certain fraternal beneficiary societies.

(a) For taxable years beginning after December 31, 1969, an organization will qualify for exemption under section 501(c)(10) if it:

(1) Is a domestic fraternal beneficiary society order, or association, described in section 501(c)(8) and the regulations thereunder except that it does not provide for the payment of life, sick, accident, or other benefits to its members, and

(2) Devotes its net earnings exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes.

Any organization described in section 501(c)(7), such as, for example, a national college fraternity, is not described in section 501(c)(10) and this section.

[T.D. 7172, 37 FR 5618, Mar. 17, 1972]

§ 1.501(c)(12)–1 Local benevolent life insurance associations, mutual irrigation and telephone companies, and like organizations.

(a) An organization described in section 501(c)(12) must receive at least 85 percent of its income from amounts collected from members for the sole purpose of meeting losses and expenses. If an organization issues policies for stipulated cash premiums, or if it requires advance deposits to cover the cost of the insurance and maintains investments from which more than 15 percent of its income is derived, it is not entitled to exemption. On the other hand, an organization may be entitled to exemption, although it makes advance assessments for the sole purpose of meeting future losses and expenses, provided that the balance of such assessments remaining on hand at the end of the year is retained to meet losses and expenses or is returned to members.

(b) The phrase *of a purely local character* applies to benevolent life insurance associations, and not to the other organizations specified in section 501(c)(12). It also applies to any organization seeking exemption on the ground that it is an organization similar to a benevolent life insurance association. An organization of a purely local character is one whose business activities are confined to a particular community, place, or district, irrespective, however, of political subdivisions. If the activities of an organization are limited only by the borders of a State it cannot be considered to be purely local in character.

(c) For taxable years of a mutual or cooperative telephone company beginning after December 31, 1974, the 85 percent member-income test described in paragraph (a) of this section is applied without taking into account income received or accrued from another telephone company for the performance of communication services involving the completion of long distance calls to, from, or between members of the mutual or cooperative telephone company. For example, if, in one year, a cooperative telephone company receives $85x from its members for telephone calls, $15x as interest income, and $20x as credits under long distance interconnection agreements with other telephone companies for the performance of communication services involving the completion of long distance calls to, from, or between the cooperative's members (whether or not the credits may be offset, in whole or in part, by amounts due the other companies under the interconnection agreements), the member-income fraction is calculated without taking into account, either in the numerator or denominator, the $20x credits received from the other telephone companies. In this example, the 85 percent member-income test is satisfied because at least 85 percent

$$\frac{\text{member income}}{\text{total income}} = \frac{85x}{85x+15x} = \frac{85}{100} = 85\%$$

of the cooperative's total income is derived from member income.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended at 44 FR 59523, Oct. 16, 1979]

§ 1.501(c)(13)–1 Cemetery companies and crematoria.

(a) *Nonprofit mutual cemetery companies.* A nonprofit cemetery company may be entitled to exemption if it is owned by and operated exclusively for the benefit of its lot owners who hold such lots for bona fide burial purposes and not for the purpose of fesale. A mutual cemetery company which also engages in charitable activities, such as burial of paupers, will be regarded as operating in conformity with this standard. Further, the fact that a mutual cemetery company limits its membership to a particular class of individuals, such as members of a family, will not affect its status as mutual so long as all the other requirements of section 501(c)(13) are met.

(b) *Nonprofit cemetery companies and crematoria.* Any nonprofit corporation, chartered solely for the purpose of the burial, or (for taxable years beginning after December 31, 1970) the cremation of bodies, and not permitted by its charter to engage in any business not necessarily incident to that purpose, is exempt from income tax, provided that no part of its net earnings inures to the benefit of any private shareholder or individual.

(c) *Preferred stock*—(1) *In general.* Except as provided in subparagraph (3) of this paragraph, a cemetery company or crematorium is not described in section 501(c)(13) if it issues preferred stock on or after November 28, 1978.

(2) *Transitional rule for preferred stock issued prior to November 28, 1978.* In the case of preferred stock issued prior to November 28, 1978, a cemetery company or crematorium which issued such stock shall not fail to be exempt from income tax solely because it issued preferred stock which entitled the holders to dividends at a fixed rate, not exceeding the legal rage of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, if its articles of incorporation require:

(i) That the preferred stock be retired at par as rapidly as funds therefor become available from operations, and

(ii) That all funds not required for the payment of dividends upon or for the retirement of preferred stock be used by the company for the care and inprovement of the cemetery property. The term *legal rate of interest* shall mean the rate of interest prescribed by law in the State of incorporation which prevails in the absence of an agreement between contracting parties fixing a rate.

(3) *Transitional rule for preferred stock issued on or after November 28, 1978.* In the case of preferred stok issued on or after November 28, 1978, a cemetery company or crematorium shall not fail to be exempt from income tax if its articles of incorporation and the preferred stock meet the requirements of paragraph (c)(2) and if such stock is issued pursuant to a plan which has been reduced to writing and adopted prior to November 28, 1978. The adoption of the plan must be shown by the acts of the duly constituted responsible officers and appear upon the official records of the cemetery company or crematorium.

(d) *Sales to exempt cemetery companies and crematoria.* Except as provided in paragraph (c)(2) or (c)(3) of this section (relating to transitional rules for preferred stock), no person may have any interest in the net earnings of a tax-exempt cemetery company or crematorium. Thus, a cemetery company or crematorium is not exempt from tax if property is transferred to such organization in exchange for an interest in the net earnings of the organization so long as such interest remains outstanding. An interest in a cemetery company or crematorium that constitutes an equity interest within the meaning of section 385 will be considered an interest in the net earnings of the cemetery. However, an interest in a cemetery company or crematorium that does not constitute an equity interest within the meaning of section 385 may nevertheless constitute an interest in the net earning of the organization. Thus, for example, a bond or other evidence of indebtedness issued by a cemetery company or crematorium which provides for a fixed rate of interest but which, in addition, provides for additional interest payments contingent upon the revenues or income of the organization is considered an interest in the net earnings of the organization. Similarly, a convertible debt obligation issued by a cemetery company or crematorium after July 7, 1975, is considered an interest in the net earnings of the organization.

[T.D. 7698, 45 FR 33972, May 21, 1980]

§1.501(c)(14)–1 Credit unions and mutual insurance funds.

Credit unions (other than Federal credit unions described in section 501(c)(1)) without capital stock, organized and operated for mutual purposes and without profit, are exempt from tax under section 501(a). Corporations or associations without capital stock organized before September 1, 1951 and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of, shares or deposits in:

(a) Domestic building and loan associations as defined in section 7701(a)(19),

(b) Cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

(c) Mutual savings banks not having capital stock represented by shares,

are also exempt from tax under section 501(a). In addition, corporations or associations of the type described in the preceding sentence which were organized on or after September 1, 1951, but before September 1, 1957, are exempt from tax under section 501(a) for taxable years beginning after December 31, 1959.

[T.D. 6493, 25 FR 9219, Sept. 27, 1960]

§ 1.501(c)(15)–1 Mutual insurance companies or associations.

(a) *Taxable years beginning after December 31, 1962.* An insurance company or association described in section 501(c)(15) is exempt under section 501(a) if it is a mutual company or association (other than life or marine) or if it is a mutual interinsurer or reciprocal underwriter (other than life or marine) and if the gross amount received during the taxable year from the sum of the following items does not exceed $150,000:

(1) The gross amount of income during the taxable year from:

(i) Interest (including tax-exempt interest and partially tax-exempt interest), as described in § 1.61–7. Interest shall be adjusted for amortization of premium and accrual of discount in accordance with the rules prescribed in section 822(d)(2) and the regulations thereunder.

(ii) Dividends, as described in § 1.61–9.

(iii) Rents and royalties, as described in § 1.61–8.

(iv) The entering into of any lease, mortgage, or other instrument or agreement from which the company may derive interest, rents, or royalties.

(v) The alteration or termination of any instrument or agreement described in subdivision (iv) of this subparagraph.

(2) The gross income from any trade or business (other than an insurance business) carried on by the company or association, or by a partnership of which the company or association is a partner.

(3) Premiums (including deposits and assessments).

(b) *Taxable years beginning after December 31, 1954, and before January 1, 1963.* An insurance company or association described in section 501(c)(15) and paragraph (a) of this section is exempt under section 501(a) if the gross amount received during the taxable year from the sum of the items described in paragraph (a) (1), (2), and (3) of this section does not exceed $75,000.

(c) *No double inclusion of income.* In computing the gross income from any trade or business (other than an insurance business) carried on by the company or association, or by a partnership of which the company or association is a partner, any item described in section 822(b)(1) (A), (B), or (C) and paragraph (a)(1) of this section shall not be considered as gross income arising from the conduct of such trade or business, but shall be taken into account under section 822(b)(1) (A), (B), or (C) and paragraph (a)(1) of this section.

(d) *Taxable years beginning after December 31, 1953, and before January 1, 1955.* An insurance company or association described in section 501(c)(15) is exempt under section 501(a) if it is a mutual company or association (other than life or marine) or if it is a mutual interinsurer or reciprocal underwriter (other than life or marine) and if the gross amount received during the taxable year from the sum of the following items does not exceed $75,000:

(1) The gross amount of income during the taxable year from—

(i) Interest (including tax-exempt interest and partially tax-exempt interest), as described in § 1.61–7. Interest shall be adjusted for amortization of premium and accrual of discount in accordance with the rules prescribed in section 822(d)(2) and § 1.822–3.

(ii) Dividends, as described in § 1.61–9.

(iii) Rents (but excluding royalties), as described in § 1.61–8.

(2) Premiums (including deposits and assessments).

(e) *Exclusion of capital gains.* Gains from sales or exchanges of capital assets to the extent provided in subchapter P (section 1201 and following, relating to capital gains and losses), chapter 1 of the Code, shall be excluded from the amounts described in this section.

[T.D. 6662, 28 FR 6972, July 29, 1963]

§1.501(c)(16)–1 Corporations organized to finance crop operations.

A corporation organized by a farmers' cooperative marketing or purchasing association, or the members thereof, for the purpose of financing the ordinary crop operations of such members or other producers is exempt, provided the marketing or purchasing association is exempt under section 521 and the financing corporation is operated in conjunction with the marketing or purchasing association. The provisions of §1.521–1 relating to a reserve or surplus and to capital stock shall also apply to corporations coming under this section.

§1.501(c)(17)–1 Supplemental unemployment benefit trusts.

(a) *Requirements for qualification.* (1) A supplemental unemployment benefit trust may be exempt as an organization described in section 501(c)(17) if the requirements of subparagraphs (2) through (6) of this paragraph are satisfied.

(2) The trust is a valid, existing trust under local law and is evidenced by an executed written document.

(3) The trust is part of a written plan established and maintained by an employer, his employees, or both the employer and his employees, solely for the purpose of providing supplemental unemployment compensation benefits (as defined in section 501(c)(17)(D) and paragraph (b)(1) of §1.501(c)(17)–1).

(4) The trust is part of a plan which provides that the corpus and income of the trust cannot (in the taxable year, and at any time thereafter, before the satisfaction of all liabilities to employees covered by the plan) be used for, or diverted to, any purpose other than the providing of supplemental unemployment compensation benefits. Thus, if the plan provides for the payment of any benefits other than supplemental unemployment compensation benefits as defined in paragraph (b) of this section, the trust will not be entitled to exemption as an organization described in section 501(c)(17). However, the payment of any necessary or appropriate expenses in connection with the administration of a plan providing supplemental unemployment compensation benefits shall be considered a payment to provide such benefits and shall not affect the qualification of the trust.

(5) The trust is part of a plan whose eligibility conditions and benefits do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees. See sections 401(a)(3)(B) and 401(a)(4) and §§1.401–3 and 1.401–4. However, a plan is not discriminatory within the meaning of section 501(c)(17)(A)(iii), relating to the requirement that the benefits paid under the plan be nondiscriminatory, merely because the benefits received under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered by the plan. Accordingly, the benefits provided for highly paid employees may be greater than the benefits provided for lower paid employees if the benefits are determined by reference to their compensation; but, in such a case, the plan will not qualify if the benefits paid to the higher paid employees bear a larger ratio to their compensation than the benefits paid to the lower paid employees bear to their compensation. In addition, section 501(c)(17)(B) sets forth certain other instances in which a plan will not be considered discriminatory (see paragraph (c) of §1.501(c)(17)–2).

(6) The trust is part of a plan which requires that benefits are to be determined according to objective standards. Thus, a plan may provide similarly situated employees with benefits which differ in kind and amount, but may not permit such benefits to be determined solely in the discretion of the trustees.

(b) *Meaning of terms.* The following terms are defined for purposes of section 501(c)(17):

(1) *Supplemental unemployment compensation benefits.* The term *supplemental unemployment compensation benefits* means only:

(i) Benefits paid to an employee because of his involuntary separation from the employment of the employer, whether or not such separation is temporary, but only when such separation is one resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions; and

(ii) Sick and accident benefits subordinate to the benefits described in subdivision (i) of this subparagraph.

(2) *Employee.* The term *employee* means an individual whose status is that of an employee under the usual common-law rules applicable in determining the employer-employee relationship. The term *employee* also includes an individual who qualifies as an *employee* under the State or Federal unemployment compensation law covering his employment, whether or not such an individual could qualify as an employee under such common-law rules.

(3) *Involuntary separation from the employment of the employer.* Whether a *separation from the employment of the employer* occurs is a question to be decided with regard to all the facts and circumstances. However, for purposes of section 501(c)(17), the term *separation* includes both a temporary separation and a permanent severance of the employment relationship. Thus, for example, an employee may be separated from the employment of his employer even though at the time of separation it is believed that he will be reemployed by the same employer. Whether or not an employee is *involuntarily* separated from the employment of the employer is a question of fact. However, normally, an employee will not be deemed to have separated himself voluntarily from the employment of his employer merely because his collective bargaining agreement provides for the termination of his services upon the happening of a condition subsequent and that condition does in fact occur. For example, if the collective bargaining agreement provides that the employer may automate a given department and thereby dislocate several employees, the fact that the employees' collective bargaining agent has consented to such a condition will not render any employee's subsequent unemployment for such cause voluntary.

(4) *Other similar conditions.* Involuntary separation directly resulting from *other similar conditions* includes, for example, involuntary separation from the employment of the employer resulting from cyclical, seasonal, or technological causes. Some causes of involuntary separation from the employment of the employer which are not similar to those enumerated in section 501(c)(17)(D)(i) are separation for disciplinary reasons or separation because of age.

(5) *Subordinate sick and accident benefits.* In general, a sick and accident benefit payment is an amount paid to an employee in the event of his illness or personal injury (whether or not such illness or injury results in the employee's separation from the service of his employer). In addition, the phrase *sick and accident benefits* includes amounts provided under the plan to reimburse an employee for amounts he expends because of the illness or injury of his spouse or a dependent (as defined in section 152). Sick and accident benefits may be paid by a trust described in section 501(c)(17) only if such benefits are subordinate to the separation payments provided under the plan of which the trust forms a part. Whether the sick and accident benefits provided under a supplemental unemployment compensation benefit plan are subordinate to the separation benefits provided under such plan is a question to be decided with regard to all the facts and circumstances.

[T.D. 6972, 33 FR 12900, Sept. 12, 1968]

§ 1.501(c)(17)–2 General rules.

(a) *Supplemental unemployment compensation benefits.* Supplemental unemployment compensation benefits as defined in section 501(c)(17)(D) and paragraph (b)(1) of § 1.501(c)(17)–1 may be paid in a lump sum or installments. Such benefits may be paid to an employee who has, subsequent to his separation from the employment of the employer, obtained other part-time, temporary, or permanent employment. Furthermore, such payments may be made in cash, services, or property. Thus, supplemental unemployment compensation benefits provided to involuntarily separated employees may include, for example, the following: Furnishing of medical care at an established clinic, furnishing of food, job training and schooling, and job counseling. If such benefits are furnished in services or property, the fair market value of the benefits must satisfy the requirements of section 501(c)(17)(A)(iii), relating to nondiscrimination as to benefits. However, supplemental unemployment compensation benefits may be provided only to an employee and only under circumstances described in paragraph (b)(1) of §1.501(c)(17)–1. Thus, a trust described in section 501(c)(17) may not provide, for example, for the payment of a death, vacation, or retirement benefit.

(b) *Sick and accident benefits.* If a trust described in section 501(c)(17) provides for the payment of sick and accident benefits, such benefits may only be provided for employees who are eligible for receipt of separation benefits under the plan of which the trust is a part. However, the sick and accident benefits need not be provided for all the employees who are eligible for receipt of separation benefits, so long as the plan does not discriminate in favor of persons with respect to whom discrimination is proscribed in section 501(c)(17)(A) (ii) and (iii). Furthermore, the portion of the plan which provides for the payment of sick and accident benefits must satisfy the nondiscrimination requirements of section 501(c)(17)(A) (ii) and (iii) without regard to the portion of the plan which provides for the payment of benefits because of involuntary separation.

(c) *Correlation with other plans.* (1) In determining whether a plan meets the requirements of section 501(c)(17)(A) (ii) and (iii), any benefits provided under any other plan shall not be taken into consideration except in the particular instances enumerated in section 501(c)(17)(B) (i), (ii), and (iii). In general, these three exceptions permit a plan providing for the payment of supplemental unemployment compensation benefits to satisfy the nondiscrimination requirements in section 501(c)(17)(A) (ii) and (iii) if the plan is able to satisfy such requirements when it is correlated with one or more of the plans described in section 501(c)(17)(B).

(2) Under section 501(c)(17)(B)(i), a plan will not be considered discriminatory merely because the benefits under the plan which are first determined in a nondiscriminatory manner (within the meaning of section 501(c)(17)(A)) are then reduced by any sick, accident, or unemployment compensation benefits received under State or Federal law, or are reduced by a portion of these benefits if determined in a nondiscriminatory manner. Under this exception, a plan may, for example, satisfy the requirements of section 501(c)(17)(A)(iii) if it provides for the payment of an unemployment benefit and the amount of such benefit is determined as a percentage of the employee’s compensation which is then reduced by any unemployment benefit which the employee receives under a State plan. In addition, a plan could provide for the reduction of such a plan benefit by a percentage of the State benefit. Furthermore, a plan may also satisfy the requirements of section 501(c)(17)(A) if it provides for the payment to an employee of an amount which when added to any State unemployment benefit equals a percentage of the employee’s compensation.

(3) Under section 501(c)(17)(B)(ii), a plan will not be considered discriminatory merely because the plan provides benefits only for employees who are not eligible to receive sick, accident, or unemployment compensation benefits under State or Federal law. In such a case, however, the benefits provided under the plan seeking to satisfy the requirements of section 501(c)(17) must be the same benefits, or a portion of the same benefits if determined in a nondiscriminatory manner, which such ineligible employees would receive under State or Federal law if they were eligible for such benefits. Under this exception, for example, an employer may establish a plan only for employees who have exhausted their benefits under the State law, and, if the plan provides for such employees the same benefits which they would receive under the State plan, the State plan and the plan of the employer will be considered as one plan in determining whether the requirements relating to nondiscrimination in section 501(c)(17)(A) are satisfied. Furthermore, such a plan could also qualify even though it does not provide all of the benefits provided under the State plan. Thus, a plan could provide for the payment of a reduced amount of the benefits, or for the payment of only certain of the types of benefits, provided by the

State plan. For example, if the State plan provides for the payment of sick, accident, and separation benefits, the plan of the employer may provide for the payment of only separation benefits, or for the payment of an amount equal to only one-half of the State provided benefit. However, if a plan provides benefits for employees who are not eligible to receive the benefits provided under a State plan and such benefits are greater or of a different type than those under the State plan, the plan of the employer must satisfy the requirements of section 501(c)(17)(A) without regard to the benefits and coverage provided by the State plan.

(4) Under section 501(c)(17)(B)(iii), a plan is not considered discriminatory merely because the plan provides benefits only for employees who are not eligible to receive benefits under another plan which satisfies the requirements of section 501(c)(17)(A) and which is funded solely by contributions of the employer. In such a case, the plan seeking to qualify under section 501(c)(17) must provide the same benefits, or a portion of such benefits if determined in a nondiscriminatory manner, as are provided for the employees under the plan funded solely by employer contributions. Furthermore, this exception only applies if the employees eligible to receive benefits under both plans would satisfy the requirements in section 501(c)(17)(A)(ii), relating to nondiscrimination as to coverage. The plan of the employer which is being correlated with the plan seeking to satisfy the requirements of section 501(c)(17) may be a plan which forms part of a voluntary employees' beneficiary association described in section 501(c)(9), if such plan satisfies all the requirements of section 501(c)(17)(A). Under this exception, for example, if an employer has established a plan providing for the payment of supplemental unemployment compensation benefits for his hourly wage employees and such plan satisfies the requirements of section 501(c)(17)(A) (even though the plan forms part of a voluntary employees' beneficiary association described in section 501(c)(9)), the salaried employees of such employee may establish a plan for themselves, and, if such plan provides for the same benefits as the plan covering hourly-wage employees, both plans may be considered as one plan in determining whether the plan covering the salaried employees satisfies the requirement that is be nondiscriminatory as to coverage. The foregoing example would also be applicable if the benefits provided for the salaried employees were funded solely or in part by employer contributions.

(d) *Permanency of the plan.* A plan providing for the payment of supplemental unemployment compensation benefits contemplates a permanent as distinguished from a temporary program. Thus, although there may be reserved the right to change or terminate the plan, and to discontinue contributions thereunder, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the purpose of providing supplemental unemployment compensation benefits to employees. Whether or not a particular plan constitutes a permanent arrangement will be determined by all of the surrounding facts and circumstances. However, merely because a collective bargaining agreement provides that a plan may be modified at the termination of such agreement, or that particular provisions of the plan are subject to renegotiation during the duration of such agreement, does not necessarily imply that the plan is not a permanent arrangement. Moreover, the fact that the plan provides that the assets remaining in the trust after the satisfaction of all liabilities (including contingent liabilities) under the plan may be returned to the employer does not imply that the plan is not a permanent arrangement nor preclude the trust from qualifying under section 501(c)(17).

(e) *Portions of years.* A plan must satisfy the requirements of section 501(c)(17) throughout the entire taxable year of the trust in order for the trust to be exempt for such year. However, section 501(c)(17)(C) provides that a plan will satisfy the nondiscrimination as to classification requirements of section 501(c)(17)(A) if on at least one day in each quarter of the taxable year of the trust it satisfies such requirements.

(f) *Several trusts constituting one plan.* Several trusts may be designated as constituting part of one plan which is intended to satisfy the requirements of section 501(c)(17), in which case all of such trusts taken as a whole must meet the requirements of such section. The fact that a combination of trusts fails to satisfy the requirements of section 501(c)(17) as one plan does not prevent such of the trusts as satisfy the requirements of section 501(c)(17) from qualifying for exemption under that section.

(g) *Plan of several employers.* A trust forming part of a plan of several employers, or the employees of several employers, will be a supplemental unemployment benefit trust described in section 501(c)(17) if all the requirements of that section are otherwise satisfied.

(h) *Investment of trust funds.* No specific limitations are provided in section 501(c)(17) with respect to investments which may be made by the trustees of a trust qualifying under that section. Generally, the contributions may be used by the trustees to purchase any investments permitted by the trust agreement to the extent allowed by local law. However, the tax-exempt status of the trust will be forfeited if the investments made by the trustees constitute *prohibited transactions* within the meaning of section 503. See section 503 and the regulations thereunder. In addition, such a trust will be subject to tax under section 511 with respect to any *unrelated business taxable income* (as defined in section 512) realized by it from its investments. See sections 511 to 515, inclusive, and the regulations thereunder.

(i) *Allocations.* If a plan which provides sick and accident benefits is financed solely by employer contributions to the trust, and such sick and accident benefits are funded by payment of premiums on an accident or health insurance policy (whether on a group or individual basis) or by contributions to a separate fund which pays such sick and accident benefits, the plan must specify that portion of the contributions to be used to fund such benefits. If a plan which is financed in whole or in part by employee contributions provides sick and accident benefits, the plan must specify the portion, if any, of employee contributions allocated to the cost of funding such benefits, and must allocate the cost of funding such benefits between employer contributions and employee contributions.

(j) *Required records and returns.* Every trust described in section 501(c)(17) must maintain records indicating the amount of separation benefits and sick and accident benefits which have been provided to each employee. If a plan is financed, in whole or in part, by employee contributions to the trust, the trust must maintain records indicating the amount of each employee's total contributions allocable to separation benefits. In addition, every trust described in section 501(c)(17) which makes one or more payments totaling $600 or more in 1 year to an individual must file an annual information return in the manner described in paragraph (b)(1) of §1.6041–2. However, if the payments from such trust are subject to income tax withholding under section 3402(o) and the regulations thereunder, the trust must file, in lieu of such annual information return, the returns of income tax withheld from wages required by section 6011 and the regulations thereunder. In such circumstances, the trust must also furnish the statements to the recipients of trust distributions required by section 6051 and the regulations thereunder.

[T.D. 6972, 33 FR 12901, Sept. 12, 1968, as amended by T.D. 7068, 35 FR 17328, Nov. 11, 1970]

§1.501(c)(17)–3 Relation to other sections of the Code.

(a) *Taxability of benefit distributions*—(1) *Separation benefits.* If the separation benefits described in section 501(c)(17)(D)(i) are funded entirely by employer contributions, then the full amount of any separation benefit payment received by an employee is includible in his gross income under section 61(a). If any such separation benefit is funded by both employer and employee contributions, or solely by employee contributions, the amount of any separation benefit payment which is includible in the gross income of the employee is the amount by which such distribution and any prior distributions of such separation payments exceeds the employee's total contributions to fund such separation benefits.

(2) *Sick and accident benefits.* Any benefit payment received from the trust under the part of the plan, if any, which provides for the payment of sick and accident benefits must be included in gross income under section 61(a), unless specifically excluded under section 104 or 105 and the regulations thereunder. See section 105(b) and § 1.105–2 for benefit payments expended for medical care, benefit payments in excess of actual medical expenses, and benefit payments which an employee is entitled to receive irrespective of whether or not he incurs expenses for medical care. See section 213 and § 1.213–1(g) for benefit payments representing reimbursement for medical expenses paid in prior years. See § 1.501(c)(17)–2(i) for the requirement that a trust described in section 501(c)(17) which receives employee contributions must be part of a written plan which provides for the allocation of the cost of funding sick and accident benefits.

(b) *Exemption as a voluntary employees' beneficiary association.* Section 501(c)(17)(E) contemplates that a trust forming part of a plan providing for the payment of supplemental unemployment compensation benefits may, if it qualifies, apply for exemption from income tax under section 501(a) either as a voluntary employees' beneficiary association described in section 501(c)(9) or as a trust described in section 501(c)(17).

(c) *Returns.* A trust which is described in section 501(c)(17) and which is exempt from tax under section 501(a) must file a return in accordance with section 6033 and the regulations thereunder. If such a trust realizes any unrelated business taxable income, as defined in section 512, the trust is also required to file a return with respect to such income.

(d) *Effective date.* Section 501(c)(17) shall apply to taxable years beginning after December 31, 1959, and shall apply to supplemental unemployment benefit trusts regardless of when created or organized.

[T.D. 6972, 33 FR 12902, Sept. 12, 1968]

§ 1.501(c)(18)–1 Certain funded pension trusts.

(a) *In general.* Organizations described in section 501(c)(18) are trusts created before June 25, 1959, forming part of a plan for the payment of benefits under a pension plan funded only by contributions of employees. In order to be exempt, such trusts must also meet the requirements set forth in section 501(c)(18) (A), (B), and (C), and in paragraph (b) of this section.

(b) *Requirements for qualification.* A trust described in section 501(c)(18) must meet the following requirements:

(1) *Local law.* The trust must be a valid, existing trust under local law, and must be evidenced by an executed written document.

(2) *Funding.* The trust must be funded solely from contributions of employees who are members of the plan. For purposes of this section, the term *contributions of employees* shall include earnings on, and gains derived from, the assets of the trust which were contributed by employees.

(3) *Creation before June 25, 1959*—(i) *In general.* The trust must have been created before June 25, 1959. A trust created before June 25, 1959 is described in section 501(c)(18) and this section even though changes in the makeup of the trust have occurred since that time so long as these are not fundamental changes in the character of the trust or in the character of the beneficiaries of the trust. Increases in the beneficiaries of the trust by the addition of employees in the same or related industries, whether such additions are of individuals or of units (such as local units of a union) will generally not be considered a fundamental change in the character of the trust. A merger of a trust created after June 25, 1959 into a trust created before such date is not in itself a fundamental change in the character of the latter trust if the two trusts are for the benefit of employees of the same or related industries.

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

Example 1. Assume that trust C, for the benefit of members of participating locals of National Union X, was established in 1950 and adopted by 29 locals before June 25, 1959.

The subsequent adoption of trust C by additional locals of National Union X in 1962 will not constitute a fundamental change in the character of trust C, since such subsequent adoption is by employees in a related industry.

Example 2. Assume the facts as stated in example 1, except that in 1965 National Union X merged with National Union Y, whose members are engaged in trades related to those engaged in by X's members. Assume further that trust D, the employee funded pension plan and fund for employees of Y, was subsequently merged into trust C. The merger of trust D into trust C would not in itself constitute a fundamental change in the character of trust C, since both C and D are for the benefit of employees of related industries.

(4) *Payment of benefits.* The trust must provide solely for the payment of pension or retirement benefits to its beneficiaries. For purposes of this section, the term *retirement benefits* is intended to include customary and incidental benefits, such as death benefits within the limits permissible under section 401.

(5) *Diversion.* The trust must be part of a plan which provides that, before the satisfaction of all liabilities to employees covered by the plan, the corpus and income of the trust cannot (within the taxable year and at any time thereafter) be used for, or diverted to, any purpose other than the providing of pension or retirement benefits. Payment of expenses in connection with the administration of a plan providing pension or retirement benefits shall be considered a payment to provide such benefits and shall not affect the qualification of the trust.

(6) *Discrimination.* The trust must be part of a plan whose eligibility conditions and benefits do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees. See sections 401(a)(3)(B) and 401(a)(4) and §§1.401–3 and 1.401–4. However, a plan is not discriminatory within the meaning of section 501(c)(18) merely because the benefits received under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered by the plan. Accordingly, the benefits provided for highly paid employees may be greater than the benefits provided for lower paid employees if the benefits are determined by reference to their compensation; but, in such a case, the plan will not qualify if the benefits paid to the higher paid employees are a larger portion of compensation than the benefits paid to lower paid employees.

(7) *Objective standards.* The trust must be part of a plan which requires that benefits be determined according to objective standards. Thus, while a plan may provide similarly situated employees with benefits which differ in kind and amount, these benefits may not be determined solely in the discretion of the trustees.

(c) *Effective date.* The provisions of section 501(c)(18) and this section shall apply with respect to taxable years beginning after December 31, 1969.

[T.D. 7172, 37 FR 5618, Mar. 17, 1972]

§1.501(c)(19)–1 War veterans organizations.

(a) *In general.* (1) For taxable years beginning after December 31, 1969, a veterans post or organization which is organized in the United States or any of its possessions may be exempt as an organization described in section 501(c)(19) if the requirements of paragraphs (b) and (c) of this section are met and if no part of its net earnings inures to the benefit of any private shareholder or individual. Paragraph (b) of this section contains the membership requirements such a post or organization must meet in order to qualify under section 501(c)(19). Paragraph (c) of this section outlines the purposes, at least one of which such a post or organization must have in order to so qualify.

(2) In addition, an auxiliary unit or society described in paragraph (d) of this section of such a veterans post or organization and a trust or foundation described in paragraph (e) of this section for such post or organization may be exempt as an organization described in section 501(c)(19).

(b) *Membership requirements.* (1) In order to be described in section 501(c)(19) under paragraph (a)(1) of this section, an organization must meet the membership requirements of section 501(c)(19)(B) and this paragraph. There are two requirements that must be met under this paragraph. The first requirement is that at least 75 percent of the members of the organization must be war veterans. For purposes of this section the term *war veterans* means persons, whether or not present members of the United States Armed Forces, who have served in the Armed Forces of the United States during a period of war (including the Korean and Vietnam conflicts).

(2) The second requirement of this paragraph is that at least 97.5 percent of all members of the organization must be described in one or more of the following categories:

(i) War veterans,

(ii) Present or former members of the United States Armed Forces,

(iii) Cadets (including only students in college or university ROTC programs or at Armed Services academies), or

(iv) Spouses, widows, or widowers of individuals referred to in paragraph (b)(2) (i), (ii) or (iii) of this section.

(c) *Exempt purposes.* In addition to the requirements of paragraphs (a)(1) and (b) of this section, in order to be described in section 501(c)(19) under paragraph (a)(1) of this section an organization must be operated exclusively for one or more of the following purposes:

(1) To promote the social welfare of the community as defined in § 1.501(c)(4)–1(a)(2).

(2) To assist disabled and needy war veterans and members of the United States Armed Forces and their dependents, and the widows and orphans of deceased veterans,

(3) To provide entertainment, care, and assistance to hospitalized veterans or members of the Armed Forces of the United States,

(4) To carry on programs to perpetuate the memory of deceased veterans and members of the Armed Forces and to comfort their survivors,

(5) To conduct programs for religious, charitable, scientific, literary, or educational purposes,

(6) To sponsor or participate in activities of a patriotic nature,

(7) To provide insurance benefits for their members or dependents of their members or both, or

(8) To provide social and recreational activities for their members.

(d) *Auxiliary units or societies for war veterans organizations.* A unit or society may be exempt as an organization described in section 501(c)(19) and paragraph (a)(2) of this section if it is an auxiliary unit or society of a post or organization of war veterans described in paragraph (a)(1) of this section. A unit or society is an auxiliary unit or society or such a post or organization if it meets the following requirements:

(1) It is affiliated with, and organized in accordance with, the bylaws and regulations formulated by an organization described in paragraph (a)(1) of this section,

(2) At least 75 percent of its members are either war veterans, or spouses of war veterans, or are related to a war veteran within two degrees of consanguinity (i.e., grandparent, brother, sister, grandchild, represent the most distant allowable relationships),

(3) All of its members are either members of an organization described in paragraph (a)(1) of this section, or spouses of a member of such an organization or are related to a member of such an organization, within two degrees of consanguinity, and

(4) No part of its net earnings inures to the benefit of any private shareholder or individual.

(e) *Trusts or foundations.* A trust or foundation may be exempt as an organization described in section 501(c)(19) and paragraph (a)(2) of this section if it is a trust or foundation for a post or organization of war veterans described in paragraph (a)(1) of this section. A trust or foundation is a trust or foundation for such a post or organization if it meets the following requirements:

(1) The trust or foundation is in existence under local law and, if organized for charitable purposes, has a dissolution provision described in § 1.501(c)(3)–1(b)(4).

(2) The corpus or income cannot be diverted or used other than for the funding of a post or organization of war veterans described in paragraph (a)(1) of this section, for section 170(c)(4) purposes, or as an insurance set aside (as defined in § 1.512(a)–4(b)).

(3) The trust income is not unreasonably accumulated and, if the trust or

foundation is not an insurance set aside, a substantial portion of the income is in fact distributed to such post or organization or for section 170(c)(4) charitable purposes, and

(4) It is organized exclusively for one or more of those purposes enumerated in paragraph (c) of this section.

[T.D. 7438, 41 FR 44392, Oct. 8, 1976]

§1.501(c)(21)–1 Black lung trusts—certain terms.

(a) *Created or organized in the United States.* A trust is not *created or organized in the United States* unless it is maintained at all times as a domestic trust in the United States. For this purpose, section 7701(a)(9) limits the term *United States* to the District of Columbia and States of the United States.

(b) *Insurance company.* The term *insurance company* means an insurance, surety, bonding or other company whose liability for the kinds of claims to which section 501(c)(21)(A)(i) applies is as an insurer or guarantor of the liabilities of another.

(c) *Black Lung Acts.* The term *Black Lung Acts* includes any State law providing compensation for disability or death due to pneumoconiosis even though the State law compensates for other kinds of injuries. In such a case, section 501(c)(21) applies only to the extent that the liability is attributable to disability or death due to pneumoconiosis. For this purpose, the term *pneumoconiosis* has the same meaning as it has under federal law. See 30 U.S.C. 902.

(d) *Insurance exclusively covering such liability.* The term *insurance exclusively covering such liability* includes insurance that covers risk for liabilities in addition to the liabilities to which section 501(c)(21)(A)(i) applies. In such a case, payment for premiums may be made from the trust only to the extent of that portion of the premiums that has been separately allocated and stated by the insurer as attributable solely to coverage of the liabilities to which section 501(c)(21)(A)(i) applies.

(e) *Administrative and other incidental expenses.* The term *administrative and other incidental expenses* means expenditures that are appropriate and helpful to the trust making them in carrying out the purposes for which its assets may be used under section 501(c)(21)(B). The term includes any exicse tax imposed on the trust under section 4952 (relating to taxes on taxable expenditures) and reasonable expenses, such as legal expenses, incurred by the trust in connection with an assertion against the trust of liability for a taxable expenditure. The term does not include an excise tax imposed on the trustee or on other disqualified persons under section 4951 (relating to taxes on self-dealing) or under section 4953 (relating to tax on excess contributions to black lung benefit trusts) or any expenses incurred in connection with the assertion of these taxes other than expenses that are treated as part of reasonable compensation under section 4951(d)(2)(C). See §§53.4941 (d)–2(f)(3) and (d)–3(c) for interpretations of similar provisions under section 4941(d)(2)(E), relating to reasonable compensation for private foundation disqualified persons.

(f) *Public debt securities of the United States.* The term *public debt securities of the United States* means obligations that are taken into consideration for purposes of the public debt limit. See, for example 31 U.S.C. 757b.

(g) *Obligations of a State or local government.* The term *obligations of a State or local government* means the obligations of a State or local governmental unit the interest on which is exempt from tax under section 103(a). See §1.103–1(a).

(h) *Time or demand deposits.* The term *time or demand deposits* includes checking accounts, savings accounts, certificates of deposit or other time or demand deposits. The term does not include common or collective trust funds such as a common trust fund as defined in section 584.

[44 FR 52197, Sept. 7, 1979]

§1.501(c)(21)–2 Same—trust instrument.

As trust does not meet the requirements of section 501(c)(21) if it is not established and maintained pursuant to a written instrument. The trust instrument must definitely and affirmatively prohibit a diversion or use of trust assets that is not permitted under section 501(c)(21)(B) or section

4953(c), whether by operation or natural termination of the trust, by power of revocation or amendment by the happening of a contingency by collateral arrangement, or by any other means. No particular form for the trust instrument is required. A trust may meet the requirements of section 501(c)921) although the trust instrument fails to contain provisions the effects of which are to prohibit acts that are subject to section 4951 (relating to taxes on self-dealing), section 4952 (relating to taxes on taxable expenditures) or the retention of contributions subject to section 4953 (relating to tax on excess contributions to black lung benefit trusts).

[44 FR 52197, Sept. 7, 1979]

§ 1.501(d)–1 Religious and apostolic associations or corporations.

(a) Religious or apostolic associations or corporations are described in section 501(d) and are exempt from taxation under section 501(a) if they have a common treasury or community treasury, even though they engage in business for the common benefit of the members, provided each of the members includes (at the time of filing his return) in his gross income his entire pro rata share, whether distributed or not, of the net income of the association or corporation for the taxable year of the association or corporation ending with or during his taxable year. Any amount so included in the gross income of a member shall be treated as a dividend received.

(b) For annual return requirements of organizations described in section 501(d), see section 6033 and paragraph (a)(5) of § 1.6033–1.

§ 1.501(e)–1 Cooperative hospital service organizations.

(a) *General rule.* Section 501(e) is the exclusive and controlling section under which a cooperative hospital service organization can qualify as a charitable organization. A cooperative hospital service organization which meets the requirements of section 501(e) and this section shall be treated as an organization described in section 501(c)(3), exempt from taxation under section 501(a), and referred to in section 170(b)(1)(A) (iii) (relating to percentage limitations on charitable contributions). In order to qualify for tax exempt status, a cooperative hospital service organization must—

(1) Be organized and operated on a cooperative basis,

(2) Perform, on a centralized basis, only one or more specifically enumerated services which, if performed directly by a tax exempt hospital, would constitute activities in the exercise or performance of the purpose or function constituting the basis for its exemption, and

(3) Perform such service or services solely for two or more patron-hospitals as described in paragraph (d) of this section.

(b) *Organized and operated on a cooperative basis*—(1) *In general.* In order to meet the requirements of section 501(e), the organization must be organized and operated on a cooperative basis (whether or not under a specific statute on cooperatives) and must allocate or pay all of its net earnings within 8½ months after the close of the taxable year to its patron-hospitals on the basis of the percentage of its services performed for each patron. To *allocate* its net earnings to its patron-hospitals, the organization must make appropriate bookkeeping entries and provide timely written notice to each patron-hospital disclosing to the patron-hospital the amount allocated to it on the books of the organization. For the recordkeeping requirements of a section 501(e) organization, see § 1.521–1(a)(1).

(2) *Percentage of services defined.* The percentage of services performed for each patron-hospital may be determined on the basis of either the value or the quantity of the services provided by the organization to the patron-hospital, provided such basis is realistic in terms of the actual cost of the services to the organization.

(3) *Retention of net earnings.* Exemption will not be denied a cooperative hospital service organization solely because the organization, instead of paying all net earnings to its patron-hospitals, retains an amount for such purposes as retiring indebtedness, expanding the services of the organization, or for any other necessary purpose and allocates such amounts to its patrons.

However, such funds may not be accumulated beyond the reasonably anticipated needs of the organization. See, §1.537–1(b). Whether there is an improper accumulation of funds depends upon the particular circumstances of each case. Moreover, where an organization retains net earnings for necessary purposes, the organization's records must show each patron's rights and interests in the funds retained. For purposes of this paragraph, the term *net earnings* does not include capital contributions to the organization and such contributions need not satisfy the allocation or payment requirements.

(4) *Nonpatronage and other income.* An organization described in section 501(e) may, in addition to net earnings, receive membership dues and related membership assessment fees, gifts, grants and income from nonpatronage sources such as investment of retained earnings. However, such an organization cannot be exempt if it engages in any business other than that of providing the specified services, described in paragraph (c), for the specified patron-hospitals, described in paragraph (d). Thus, an organization described in section 501(e) generally cannot have unrelated business taxable income as defined in section 512, although it may earn certain interest, annuities, royalties, and rents which are excluded from unrelated business taxable income because of the modifications contained in sections 512(b) (1), (2) or (3). An organization described in section 501(e) may, however, have debt-financed income which is treated as unrelated business taxable income solely because of the applicability of section 514. In addition, exempt status under section 501(e) will not be affected where rent from personal property leased with real property is treated as unrelated business taxable income under section 512(b)(3)(A)(ii) solely because the rent attributable to the personal property is more than incidental or under section 512(b)(3)(B)(i) solely because the rent attributable to the personal property exceeds 50 percent of the total rent received or accrued under the lease. Exemption will not be affected solely because the determination of the amount of rent depends in whole or in part on the income or profits derived from the property leased. See, section 512(b)(3)(B)(ii). An organization described in section 501(e) may also derive nonpatronage income from sources that are incidental to the conduct of its exempt purposes or functions. For example, income derived from the operation of a cafeteria or vending machines primarily for the convenience of its employees or the disposition of by-products in substantially the same state they were in on completion of the exempt function (e.g., the sale of silver waste produced in the processing of x-ray film) will not be considered unrelated business taxable income. See, section 513(a)(2) and §1.513–1(d)(4)(ii). The nonpatronage and other income permitted under this subparagraph (4) must be allocated or paid as provided in subparagraph (1) or retained as provided in subparagraph (3).

(5) *Stock ownership*—(i) *Capital stock of organization.* An organization does not meet the requirements of section 501(e) unless all of the organization's outstanding capital stock, if there is such stock, is held solely by its patron-hospitals. However, no amount may be paid as dividends on the capital stock of the organization. For purposes of the preceding sentence, the term *capital stock* includes common stock (whether voting or nonvoting), preferred stock, or any other form evidencing a proprietary interest in the organization.

(ii) *Stock ownership as a condition for obtaining credit.* If by statutory requirement a cooperative hospital service organization must be a shareholder in a United States or state chartered corporation as a condition for obtaining credit from that corporate-lender, the ownership of shares and the payment of dividends thereon will not for such reason be a basis for the denial of exemption to the organization. See, e.g., National Consumer Cooperative Bank, 12 U.S.C. 3001 *et seq.*

(c) *Scope of services*—(1) *Permissible services.* An organization meets the requirements of section 501(e) only if the organization performs, on a centralized basis, one or more of the following services and only such services: data processing, purchasing (including the purchasing and dispensing of drugs and pharmaceuticals to patron-hospitals), warehousing, billing and collection, food, clinical (including radiology), industrial engineering (including the installation, maintenance and repair of biomedical and similar equipment), laboratory, printing, communications, record center, and personnel (including recruitment, selection, testing, training, education and placement of personnel) services. An organization is not described in section 501(e) if, in addition to or instead of one or more of these specified services, the organization performs any other service (other than services referred to under paragraph (b)(4) that are incidental to the conduct of exempt purposes or functions).

(2) *Illustration.* The provisions of this subparagraph may be illustrated by the following example.

Example. An organization performs industrial engineering services on a cooperative basis solely for patron-hospitals each of which is an organization described in section 501(c)(3) and exempt from taxation under section 501(a). However, in addition to this service, the organization operates laundry services for its patron-hospitals. This cooperative organization does not meet the requirements of this paragraph because it performs laundry services not specified in this paragraph.

(d) *Patron-hospitals*—(1) *Defined.* Section 501(e) only applies if the organization performs its services solely for two or more patron-hospitals each of which is—

(i) An organization described in section 501(c)(3) which is exempt from taxation under section 501(a),

(ii) A constituent part of an organization described in section 501(c)(3) which is exempt from taxation under section 501(a) and which, if organized and operated as a separate entity, would constitute an organization described in section 501(c)(3), or

(iii) Owned and operated by the United States, a State, the District of Columbia, or a possession of the United States, or a political subdivision or an agency or instrumentality of any of the foregoing.

(2) *Business with nonvoting patron-hospitals.* Exemption will not be denied a cooperative hospital service organization solely because the organization (whether organized on a stock or membership basis) transacts business with patron-hospitals which do not have voting rights in the organization and therefore do not participate in the decisions affecting the operation of the organization. Where the organization has both patron-hospitals with voting rights and patron-hospitals without such rights, the organization must provide at least 50 percent of its services to patron-hospitals with voting rights in the organization. Thus, the percentage of services provided to nonvoting patrons may not exceed the percentage of such services provided to voting patrons. A patron-hospital will be deemed to have voting rights in the cooperative hospital service organization if the patron-hospital may vote directly on matters affecting the operation of the organization or if the patron-hospital may vote in the election of cooperative board members. Notwithstanding that an organization may have both voting and nonvoting patron-hospitals, patronage refunds must nevertheless be allocated or paid to all patron-hospitals solely on the basis specified in paragraph (b) of this section.

(3) *Services to other organizations.* An organization does not meet the requirements of section 501(e) if, in addition to performing services for patron-hospitals (entities described in subdivisions (i), (ii) or (iii) of subparagraph (1)), the organization performs any service for any other organization. For example, a cooperative hospital service organization is not exempt if it performs services for convalescent homes for children or the aged, vocational training facilities for the handicapped, educational institutions which do not provide hospital care in their facilities, and proprietary hospitals. However, the provision of the specified services between or among cooperative hospital service organizations meeting the requirements of section 501(e) and this section is permissible. Also permissible is the provision of the specified services to entities which are not patron-hospitals, but only if such services are de minimis and are mandated by a governmental unit as, for example, a condition for licensing.

(e) *Effective dates.* An organization, other than an organization performing clinical services, may meet the requirements of section 501(e) and be a tax exempt organization for taxable years ending after June 28, 1968. An organization performing clinical services may meet the requirements of section 501(e) and be a tax exempt organization for taxable years ending after December 31, 1976. However, pursuant to the authority contained in section 7805(b) of the Internal Revenue Code, these regulations shall not become effective with respect to an organization which has received a ruling or determination letter from the Internal Revenue Service recognizing its exemption under section 501(e) until January 2, 1987.

[T.D. 8100, 51 FR 31615, Sept. 4, 1986; 51 FR 33593, Sept. 22, 1986]

§1.501(h)–1 Application of the expenditure test to expenditures to influence legislation; introduction.

(a) *Scope.* (1) There are certain requirements an organization must meet in order to be a *charity* described in section 501(c)(3). Among other things, section 501(c)(3) states that ‘‘no substantial part of the activities of [a charity may consist of] carrying on propaganda, or otherwise attempting to influence legislation, (except as otherwise provided in subsection (h)).’’ This requirement is called the *substantial part test.*

(2) Under section 501(h), many public charities may elect the *expenditure test* as a substitute for the substantial part test. The expenditure test is described in section 501(h) and this §1.501(h). A public charity is any charity that is not a private foundation under section 509(a). (Unlike a public charity, a private foundation may not make any lobbying expenditures: If a private foundation does make a lobbying expenditure, it is subject to an excise tax under section 4945). Section 1.501(h)–2 lists which public charities are eligible to make the expenditure test election. Section 1.501(h)–2 also provides information about how a public charity makes and revokes the election to be covered by the expenditure test.

(3) A public charity that makes the election may make lobbying expenditures within specified dollar limits. If an electing public charity’s lobbying expenditures are within the dollar limits determined under section 4911(c), the electing public charity will not owe tax under section 4911 nor will it lose its tax exempt status as a charity by virtue of section 501(h). If, however, that electing public charity’s lobbying expenditures exceed its section 4911 lobbying limit, the organization is subject to an excise tax on the excess lobbying expenditures. Further, under section 501(h), if an electing public charity’s lobbying expenditures normally are more than 150 percent of its section 4911 lobbying limit, the organization will cease to be a charity described in section 501(c)(3).

(4) A public charity that elects the expenditure test may nevertheless lose its tax exempt status if it is an action organization under §1.501(c)(3)–1(c)(3)(iii) or (iv). A public charity that does not elect the expenditure test remains subject to the substantial part test. The substantial part test is applied without regard to the provisions of section 501(h) and 4911 and the related regulations.

(b) *Effective date.* The provisions of §1.501(h)–1 through §1.501(h)–3, are effective for taxable years beginning after August 31, 1990. An election made before August 31, 1990, under the provisions of §7.0(c)(4) or the instructions to Form 5768, will be effective under these regulations without again filing Form 5768.

[T.D. 8308, 55 FR 35588, Aug. 31, 1990]

§1.501(h)–2 Electing the expenditure test.

(a) *In general.* The election to be governed by section 501(h) may be made by an eligible organization (as described in paragraph (b) of this section) for any taxable year of the organization beginning after December 31, 1976, other than the first taxable year for which a voluntary revocation of the election is effective (see paragraph (d) of this section). The election is made by filing a completed Form 5768, Election/Revocation of Election by an Eligible Section 501(c)(3) Organization to Make Expenditures to Influence Legislation, with the appropriate Internal Revenue Service Center listed on that form. Under section 501(h)(6), the election is effective with the beginning of the taxable year in which the form is filed. For example, if an eligible organization whose taxable year is the calendar year files Form 5768 on December 31, 1979, the organization is governed by section 501(h) for its taxable year beginning January 1, 1979. Once made, the expenditure test election is effective (without again filing Form 5768) for each succeeding taxable year for which the organization is an eligible organization and which begins before a notice of revocation is filed under paragraph (d) of this section.

(b) *Organizations eligible to elect the expenditure test*—(1) *In general.* For purposes of section 501(h) and the regulations thereunder, an organization is an eligible organization for a taxable year if, for that taxable year, it is—

(i) Described in section 501(c)(3) (determined, in any year for which an election is in effect, without regard to the substantial part test of section 501(c)(3)),

(ii) Described in section 501(h)(4) and paragraph (b)(2) of this section, and

(iii) Not a disqualified organization described in section 501(h)(5) and paragraph (b)(3) of this section.

(2) *Certain organizations listed.* An organization is described in section 501(h)(4) and this paragraph (b)(2) if it is an organization described in—

(i) Section 170(b)(1)(A)(ii) (relating to educational institutions),

(ii) Section 170(b)(1)(A)(iii) (relating to hospitals and medical research organizations),

(iii) Section 170(b)(1)(A)(iv) (relating to organizations supporting government schools),

(iv) Section 170(b)(1)(A)(vi) (relating to organizations publicly supported by charitable contributions),

(v) Section 509(a)(2) (relating to organizations publicly supported by admissions, sales, etc.), or

(vi) Section 509(a)(3) (relating to organizations supporting public charities), except that for purposes of this paragraph (b)(2), section 509(a)(3) shall be applied without regard to the last sentence of section 509(a).

(3) *Disqualified organizations.* An organization is a disqualified organization described in section 501(h)(5) and this paragraph (b)(3) if the organization is—

(i) Described in section 170(b)(1)(A)(i) (relating to churches),

(ii) An integrated auxiliary of a church or of a convention or association of churches see (§ 1.6033–2(g)(5)), or

(iii) Described in section 501(c)(3) and affiliated (within the meaning of § 56.4911–7) with one or more organizations described in paragraph (b)(3) (i) or (ii) of this section.

(4) *Other organizations ineligible to elect.* Under section 501(h)(4), certain organizations, although not disqualified organizations, are not eligible to elect the expenditure test. For example, organizations described in section 509(a)(4) are not listed in section 501(h)(4) and therefore are not eligible to elect. Similarly, private foundations (within the meaning of section 509(a)) are not eligible to elect. For the treatment of expenditures by a private foundation for the purpose of carrying on propaganda, or otherwise attempting, to influence legislation, see § 53.4945–2.

(c) *New organizations.* A newly created organization may submit Form 5768 to elect the expenditure test under section 501(h) before it is determined to be an eligible organization and may submit Form 5768 at the time it submits its application for recognition of exemption (Form 1023). If the newly created organization is determined to be an eligible organization, the election will be effective under the provisions of paragraph (a) of this section, that is, with the beginning of the taxable year in which the Form 5768 is filed by the eligible organization. However, if a newly created organization is determined by the Service not to be an eligible organization, the organization's election will not be effective and the substantial part test will apply from the effective date of its section 501(c)(3) classification.

(d) *Voluntary revocation of expenditure test election*—(1) *Revocation effective.* An organization may voluntarily revoke an expenditure test election by filing a notice of voluntary revocation with the appropriate Internal Revenue Service Center listed on Form 5768. Under section 501(h)(6)(B), a voluntary revocation is effective with the beginning of the first taxable year after the taxable year in which the notice is filed. If an organization voluntarily revokes its election, the substantial part test of section 501(c)(3) will apply with respect to the organization's activities in attempting to influence legislation beginning with the taxable year for which the voluntary revocation is effective.

(2) *Re-election of expenditure test.* If an organization's expenditure test election is voluntarily revoked, the organization may again make the expenditure test election, effective no earlier than for the taxable year following the first taxable year for which the revocation is effective.

(3) *Example.* X, an organization whose taxable year is the calendar year, plans to voluntarily revoke its expenditure test election effective beginning with its taxable year 1985. X must file its notice of voluntary revocation on Form 5768 after December 31, 1983, and before January 1, 1985. If X files a notice of voluntary revocation on December 31, 1984, the revocation is effective beginning with its taxable year 1985. The organization may again elect the expenditure test by filing Form 5768. Under paragraph (d)(2) of this section, the election may not be made for taxable year 1985. Under paragraph (a) of this section, a new expenditure test election will be effective for taxable years beginning with taxable year 1986, if the Form 5768 is filed after December 31, 1985, and before January 1, 1987.

(e) *Involuntary revocation of expenditure test election.* If, while an election by an eligible organization is in effect, the organization ceases to be an eligible organization, its election is automatically revoked. The revocation is effective with the beginning of the first full taxable year for which it is determined that the organization is not an eligible organization. If an organization's expenditure test election is involuntarily revoked under this paragraph (e) but the organization continues to be described in section 501(c)(3), the substantial part test of section 501(c)(3) will apply with respect to the organization's activities in attempting to influence legislation beginning with the first taxable year for which the involuntary revocation is effective.

(f) *Supersession.* This section supersedes §7.0(c)(4) of the Temporary Income Tax Regulations under the Tax Reform Act of 1976, effective August 31, 1990.

[T.D. 8308, 55 FR 35588, Aug. 31, 1990]

§1.501(h)–3 Lobbying or grass roots expenditures normally in excess of ceiling amount.

(a) *Scope.* This section provides rules under section 501(h) for determining whether an organization that has elected the expenditure test and that is not a member of an affiliated group of organizations (as defined in §56.4911–7(e)) either normally makes lobbying expenditures in excess of its lobbying ceiling amount or normally makes grass roots expenditures in excess of its grass roots ceiling amount. Under section 501(h) and this section, an organization that has elected the expenditure test and that normally makes expenditures in excess of the corresponding ceiling amount will cease to be exempt from tax under section 501(a) as an organization described in section 501(c)(3). For similar rules relating to members of an affiliated group of organizations, see §56.4911–9.

(b) *Loss of exemption*—(1) *In general.* Under section 501(h)(1), an organization that has elected the expenditure test shall be denied exemption from taxation under section 501(a) as an organization described in section 501(c)(3) for the taxable year following a determination year if—

(i) The sum of the organization's lobbying expenditures for the base years exceeds 150 percent of the sum of its lobbying nontaxable amounts for the base years, or (ii) The sum of the organization's grass roots expenditures for its base years exceeds 150 percent of the sum of its grass roots nontaxable amounts for the base years.

The organization thereafter shall not be exempt from tax under section 501(a) as an organization described in section 501(c)(3) unless, pursuant to paragraph (d) of this section, the organization reapplies for recognition of exemption and is recognized as exempt.

(2) *Special exception for organization's first election.* For the first, second, or third consecutive determination year for which an organization's first expenditure test election is in effect, no determination is required under paragraph (b)(1) of this section, and the organization will not be denied exemption from tax by reason of section 501(h) and this section if, taking into account as base years only those years

for which the expenditure test election is in effect—

(i) The sum of the organization's lobbying expenditures for such base years does not exceed 150 percent of the sum of its lobbying nontaxable amounts for the same base years, and

(ii) The sum of the organization's grass roots expenditure for those base years does not exceed 150 percent of the sum of its grass roots nontaxable amounts for such base years. If an organization does not satisfy the requirements of this paragraph (b)(2), paragraph (b)(1) of this section will apply.

(c) *Definitions.* For purposes of this section—

(1) The term *lobbying expenditures* means lobbying expenditures as defined in section 4911(c)(1) or section 4911(f)(4)(A) and § 56.4911–2(a).

(2) The term *lobbying nontaxable amount* is defined in § 56.4911–1(c)(1).

(3) An organization's *lobbying ceiling amount* is 150 percent of the organization's lobbying nontaxable amount for a taxable year.

(4) The term *grass roots expenditures* means expenditures for grass roots lobbying communications as defined in section 4911(c)(3) or section 4911(f)(4)(A) and §§ 56.4911–2 and 56.4911–3.

(5) The term *grass roots nontaxable amount* is defined in § 56.4911–1(c)(2).

(6) An organization's *grass roots ceiling amount* is 150 percent of the organization's grass roots nontaxable amount for a taxable year.

(7) In general, the term *base years* means the determination year and the three taxable years immediately preceding the determination year. The base years, however, do not include any taxable year preceding the taxable year for which the organization is first treated as described in section 501(c)(3).

(8) A taxable year is a *determination year* if it is a year for which the expenditure test election is in effect, other than the taxable year for which the organization is first treated as described in section 501(c)(3).

(d) *Reapplication for recognition of exemption*—(1) *Time of application.* An organization that is denied exemption from taxation under section 501(a) by reason of section 501(h) and this section may apply on Form 1023 for recognition of exemption as an organization described in section 501(c)(3) for any taxable year following the first taxable year for which exemption is so denied. See paragraphs (d)(2) and (d)(3) of this section for material to be included with an application described in the preceding sentence.

(2) *Section 501(h) calculation.* An application described in paragraph (d)(1) of this section must demonstrate that the organization would not be denied exemption from taxation under section 501(a) by reason of section 501(h) if the expenditure test election has been in effect for all of its last taxable year ending before the application is made by providing the calculations, described either in paragraphs (b)(1) (i) and (ii) of this section or in § 56.4911–9(b), that would have applied to the organization for that year.

(3) *Operations not disqualifying.* An application described in paragraph (d)(1) of this section must include information that demonstrates to the satisfaction of the Commissioner that the organization will not knowingly operate in a manner that would disqualify the organization for tax exemption under section 501(c)(3) by reason of attempting to influence legislation.

(4) *Reelection of expenditure test.* If an organization is denied exemption from tax for a taxable year by reason of section 501(h) and this section, and thereafter is again recognized as an organization described in section 501(c)(3) pursuant to this paragraph (d), it may again elect the expenditure test under section 501(h) in accordance with § 1.501(h)–2(a).

(e) *Examples.* The provisions of this section are illustrated by the following examples, which also illustrate the operation of the tax imposed by section 4911.

Example 1. (1) The following table contains information used in this example concerning organization X.

Year	Exempt purpose expenditures (EPE)	Calculation	Lobbying	
			Nontaxable amount (LNTA)	Lobbying expenditures (LE)
1979	$400,000	(20% of $400,000=)	$80,000	$100,000
1980	300,000	(20% of $300,000=)	60,000	100,000
1981	600,000	(20% of $500,000+15% of $100,000=)	115,000	120,000
1982	500,000	(20% of $500,000=)	100,000	100,000
Totals	1,800,000		355,000	420,000

(2) Organization X, whose taxable year is the calendar year, was organized in 1971. X first made the expenditure test election under section 501(h) effective for taxable years beginning with 1979 and has not revoked the election. None of X's lobbying expenditures for its taxable years 1979 through 1982 are grass roots expenditures. Under section 4911(a) and § 56.4911–1(a), X must determine for each year for which the expenditure test election is effective whether it is liable for the 25 percent excise tax imposed by section 4911(a) on excess lobbying expenditures. X is liable for this tax for each of its taxable years 1979, 1980, and 1981, because in each year its lobbying expenditures exceeded its lobbying nontaxable amount for the year. For 1979, the tax imposed by section 4911(a) is $5,000 {25%×($100,000−$80,000)=$5,000}. For 1980, the tax is $10,000. For 1981, the tax is $1,250.

(3) The taxable years 1979 through 1981 are all determination years under paragraph (c)(8) of this section. On its annual return for determination year 1979, the first year of its first election, X can demonstrate, under paragraph (b)(2) of this section, that its lobbying expenditures during 1979 ($100,000) do not exceed 150 percent of its lobbying nontaxable amount for 1979 ($120,000). For determination year 1980, under paragraph (b)(2), X can demonstrate that the sum of its lobbying expenditures for 1979 and 1980 ($200,000) does not exceed 150 percent of the sum of its lobbying nontaxable amounts for 1979 and 1980 ($210,000). For 1981, under paragraph (b)(2), X can demonstrate that the sum of its lobbying expenditures for 1979, 1980, and 1981 ($320,000) does not exceed 150 percent of the sum of its lobbying nontaxable amounts for 1979, 1980, and 1981 ($382,500). For each of the determination years 1979, 1980, and 1981, the first three years of its first election, X satisfies the requirements of paragraph (b)(2). Accordingly, no determination under paragraph (b)(1) of this section is required for those years, and X is not denied tax exemption by reason of section 501(h).

(4) Under paragraph (b)(1) of this section, X must determine for its determination year 1982 whether it has normally made lobbying expenditures in excess of the lobbying ceiling amount. This determination takes into account expenditures in base years 1979 through 1982. The sum of X's lobbying expenditures for the base years ($420,000) does not exceed 150 percent of the sum of the lobbying nontaxable amounts for the base years (150%×$355,000=$532,500). Accordingly, X is not denied tax exemption by reason of section 501(h).

Example 2. (1) The following table contains information used in this example concerning W.

Year	Exempt purpose expenditures (EPE) (dollars)	Calculation	Lobbying nontaxable amount (LNTA) (dollars)	Lobbying expenditures (LE) (dollars)	Grass roots nontaxable amount (25 percent of LNTA) (dollars)	Grass roots expenditures (dollars)
1979	700,000	(20% of $500,000+15% of $200,000=).	130,000	120,000	32,500	30,000
1980	800,000	(20% of $500,000+15% of $300,000=).	145,000	100,000	36,250	60,000
1981	800,000	(20% of $500,000+15% of $300,000=).	145,000	100,000	36,250	65,000
1982	900,000	(20% of $500,000+15% of $400,000=).	160,000	150,000	40,000	65,000
Total	3,200,000		580,000	470,000	145,000	220,000

(2) Organization W, whose taxable year is the calendar year, made the expenditure test election under section 501(h) effective for taxable years beginning with 1979 and has not revoked the election. W has been treated as an organization described in section 501(c)(3) for each of its taxable years beginning within its taxable year 1974.

(3) Under section 4911(a) and § 56.4911–1(a), W must determine for each year for which the expenditure test election is effective whether it is liable for the 25 percent excise tax imposed by section 4911(a) on excess lobbying expenditures. In 1980, 1981, and 1982, W has excess lobbying expenditures because its grass roots expenditures in each of those years exceeded its grass roots nontaxable amount for the year. Therefore, W is liable for the excise tax under section 4911(a) for those years. The tax imposed by section 4911(a) for 1980 is $5,937.50 {25%×($60,000−$36,250)= $5,937.50}. For 1981, the tax is $7,187.50. For 1982, the tax is $6,250.

(4) On its annual return for its determination years 1979, 1980, and 1981, the first three years of its first election, W demonstrates that it satisfies the requirements of paragraph (b)(2) of this section. Accordingly, no determination under paragraph (b)(1) of this section is required for those years, and W is not denied tax exemption by reason of section 501(h).

(5) On its annual return for its determination year 1982, W must determine under paragraph (b)(1) whether it has normally made lobbying expenditures or grass roots expenditures in excess of the corresponding ceiling amount. This determination takes into account expenditures in base years 1979 through 1982. The sum of W's lobbying expenditures for the base years ($470,000) does not exceed 150% of the sum of W's lobbying nontaxable amounts for those years (150%×$580,000=$870,000). However, the sum of W's grass roots expenditures for the base years ($220,000) does exceed 150% of the sum of W's grass roots nontaxable amonts for those years (150%×$145,000=$217,500). Under section 501(h), W is denied tax exemption under section 501(a) as an organization described in section 501(c)(3) for its taxable year 1983. For its taxable year 1984 and any taxable year thereafter, W is exempt from tax as an organization described in section 501(c)(3) only if W applies for recognition of its exempt status under paragraph (d) of this section and is recognized as exempt from tax.

Example 3. (1) The following table contains information used in this example concerning organization Y.

Taxable Year	Exempt purpose expenditures (EPE) (dollars)	Calculation	Lobbying nontaxable amount (LNTA) (dollars)	Lobbying expenditures (LE)(dollars)	Grass roots nontaxable amount (25 percent of LNTA)(dollars)	Grass roots expenditures (dollars)
1977	700,000	(20% of $500,000+15% of $200,000=).	130,000	182,000	32,500	30,000
1978	800,000	(20% of $500,000+15% of $300,000=).	145,000	224,750	36,250	35,000
Subtotal	1,500,000		275,000	406,750	68,750	65,000
1979	900,000	(20% of $500,000+15% of $400,000=).	160,000	264,000	40,000	50,000
Totals:	2,400,000		435,000	670,750	108,750	115,000

(2) Organization Y, whose taxable year is the calendar year, was first treated as an organization described in section 501(c)(3) on February 1, 1977. Y made the expenditure test election under section 501(h) effective for taxable years beginning with 1977 and has not revoked the election.

(3) For 1977, Y has excess lobbying expenditures of $52,000 because its lobbying expenditures ($182,000) exceed its lobbying nontaxable amount ($130,000) for the taxable year. Accordingly, Y is liable for the 25 percent excise tax imposed by section 4911(a). The amount of the tax is $13,000 [25%×($182,000−$130,000)=$13,000].

(4) For 1978, Y again has excess lobbying expenditures and is again liable for the 25 percent excise tax imposed by section 4911(a). The amount of the tax is $19,937.50 [25%×($224,750−$145,000)=$19,937.50].

(5) For 1979, Y's lobbying expenditures ($264,000) exceed its lobbying nontaxable amount ($160,000) by $104,000, and its grass roots expenditures ($50,000) exceed its grass roots nontaxable amount ($40,000) by $10,000. Under § 56.4911–1(b), Y's excess lobbying expenditures are the greater of $104,000 or $10,000. The amount of the tax, therefore, is $26,000 [25%×$104,000=$26,000].

(6) Under paragraph (c)(8) of this section, 1977 is not a determination year because it is

the first year for which the organization is treated as described in section 501(c)(3). For 1977, Y need not determine whether it has normally made lobbying expenditures or grass roots expenditures in excess of the corresponding ceiling amount for purposes of determining whether it is denied exemption under section 501(h) for its taxable year 1978.

(7) For determination year 1978, Y must determine whether it has normally made lobbying or grass roots expenditures in excess of the corresponding ceiling amount, taking into account expenditures for the base years 1977 and 1978. For Y, the determination under paragraph (b)(2) of this section considers the same base years as the determination under paragraph (b)(1) of this section and is, therefore, redundant. Accordingly, Y proceeds to determine, under (b)(1), whether it is denied exemption. Y's grass roots expenditures for 1977 and 1978 ($65,000) did not exceed 150 percent of the sum of its grass roots nontaxable amounts for those years ($103,125). Y's lobbying expenditures for 1977 and 1978 ($406,750) did not exceed 150% of its lobbying nontaxable amount for those years (150%×$275,000=$412,500). Therefore, Y is not denied tax exemption under section 501(h) for its taxable year 1979.

(8) For determination year 1979, the sum of Y's grass roots expenditures in base years 1977, 1978, and 1979 does not exceed 150 percent of its grass roots nontaxable amount (calculation omitted). However, the sum of Y's lobbying expenditures for the base years ($670,750) does exceed 150% of the sum of the lobbying nontaxable amounts for those years (150%×$435,000=$652,500). Since Y was not described in section 501(c)(3) prior to 1977, only the years 1977, 1978, and 1979 may be considered in determining whether Y has normally made lobbying expenditures in excess of its lobbying ceiling. Therefore, Y determines that it has normally made lobbying expenditures in excess of its lobbying ceiling. Under section 501(h), Y is denied tax exemption under section 501(a) as an organization described in section 501(c)(3) for its taxable year 1980. For its taxable year 1981, and any taxable year thereafter, Y is exempt from tax as an organization described in section 501(c)(3) only if Y applies for recognition of its exempt status under paragraph (d) of this section and is recognized as exempt from tax.

Example 4. Organization M made the expenditure test election under section 501(h) effective for taxable years beginning with 1977 and has not revoked the election. M has $500,000 of exempt purpose expenditures during each of the years 1981 through 1984. In addition, during each of those years, M spends $75,000 for direct lobbying and $25,000 for grass roots lobbying. Since the amount expended for M's lobbying (both total lobbying and grass roots lobbying) is within the respective nontaxable expenditure limitations, M is not liable for the 25 percent excise tax imposed under section 4911(a) upon excess lobbying expenditures, nor is M denied tax-exempt status by reason of section 501 (h).

Example 5. Assume the same facts as in Example 4, except that, on behalf of M, numerous unpaid volunteers conduct substantial lobbying activities with no reimbursement. Since the substantial lobbying activities of the unpaid volunteers are not counted towards the expenditure limitations and the amount expended for M's lobbying is within the respective nontaxable expenditure limitations, M is not liable for the 25 percent excise tax under section 4911, nor is M denied tax-exempt status by reason of section 501(h).

[T.D. 8308, 55 FR 35589, Aug. 31, 1990]

§1.501(k)–1 Communist-controlled organizations.

Under section 11(b) of the Internal Security Act of 1950 (50 U.S.C. 790(b)), as amended, which is made applicable to the Code by section 7852(b) of that Code, no organization is entitled to exemption under sections 501(a) or 521(a) for any taxable year if at any time during such year such organization is registered under section 7 of such Act or if there is in effect a final order of the Subversive Activities Control Board established by section 12 of such Act requiring such organization to register under section 7 of such Act, or determining that it is a Communist-infiltrated organization.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; redesignated by T.D. 8100, 51 FR 31615, Sept. 4, 1986]

§1.502–1 Feeder organizations.

(a) In the case of an organization operated for the primary purpose of carrying on a trade or business for profit, exemption is not allowed under section 501 on the ground that all the profits of such organization are payable to one or more organizations exempt from taxation under section 501. In determining the primary purpose of an organization, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of those activities of such organization which are specified in the applicable paragraph of section 501.

(b) If a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with its parent organization, for example, a subsidiary organization which is operated for the sole purpose of furnishing electric power used by its parent organization, a tax-exempt educational organization, in carrying on its educational activities. However, the subsidiary organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization. For example, if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations), it is not exempt since such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations. For purposes of this paragraph, organizations are related only if they consist of:

(1) A parent organization and one or more of its subsidiary organizations; or

(2) Subsidiary organizations having a common parent organization.

An exempt organization is not related to another exempt organization merely because they both engage in the same type of exempt activities.

(c) In certain cases an organization which carries on a trade or business for profit but is not operated for the primary purpose of carrying on such trade or business is subject to the tax imposed under section 511 on its unrelated business taxable income.

(d) *Exception*—(1) *Taxable years beginning before January 1, 1970.* For purposes of section 502 and this section, for taxable years beginning before January 1, 1970, the term *trade or business* does not include the rental by an organization of its real property (including personal property leased with the real property).

(2) *Taxable years beginning after December 31, 1969.* For purposes of section 502 and this section, for taxable years beginning after December 31, 1969, the term *trade or business* does not include:

(i) The deriving of rents described in section 512(b)(3)(A),

(ii) Any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation, or

(iii) Any trade or business (such as a *thrift shop*) which consists of the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

For purposes of the exception described in subdivision (i) of this subparagraph, if the rents derived by an organization would not be excluded from unrelated business income pursuant to section 512(b)(3) and the regulations thereunder, the deriving of such rents shall be considered a *trade or business.*

(3) *Cross references and special rules.* (i) For determination of when rents are excluded from the tax on unrelated business income see section 512(b)(3) and the regulations thereunder.

(ii) The rules contained in § 1.513–1(e)(1) shall apply in determining whether a trade or business is described in section 502(b)(2) and subparagraph (2)(ii) of this paragraph.

(iii) The rules contained in § 1.513–1(e)(3) shall apply in determining whether a trade or business is described in section 502(b)(3) and subparagraph (2)(iii) of this paragraph.

[T.D. 6500, 25 FR 11737, No. 26, 1960, as amended by T.D. 6662, 28 FR 6973, July 29, 1963; T.D. 7033, 35 FR 19997, Dec. 31, 1970]

§ 1.503(a)–1 Denial of exemption to certain organizations engaged in prohibited transactions.

(a)(1) Prior to January 1, 1970, section 503 applies to those organizations described in sections 501(c)(3), 501(c)(17), and section 401(a) except:(i) A religious organization (other than a trust);

(ii) An educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on;

(iii) An organization which normally receives a substantial part of its support (exclusive or income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a)) from the United States or any State or political subdivision thereof or from direct of indirect contributions from the general public,

(iv) An organization which is operated, supervised, controlled or principally supported by a religious organization (other than a trust) which is itself not subject to the provisions of this section; and

(v) An organization the principal purposes or functions of which are the providing of medical or hospital care or medical education or medical research or agricultural research.

(2) Effective January 1, 1907, and prior to January 1, 1975, section 503 shall apply only to organizations described in section 501(c) (17) or (18) or section 401(a).

(3) Effective January 1, 1975, section 503 shall apply only to organization described in section 501(c) (17) or (18) or described in section 401(a) and referred to in section 4975(g) (2) or (3).

(b) The prohibited transactions enumerated in section 503(b) are in addition to and not in limitation of the restrictions contained in section 501(c) (3), (17), or (18) or section 401(a). Even though an organization has not engaged in any of the prohibited transactions referred to in section 503(b), it still may not qualify for tax exemptions in view of the general provisions of section 501(c) (3), (17), or (18) or section 401(a). Thus, if a trustee or other fiduciary of the organization (whether or not he is also a creater or such organization) enters into a transaction with the organization, such transaction will be closely scrutinized in the light of the fiduciary principle requiring undivided loyalty to ascertain whether the organization is in fact being operated for the stated exempt purpose.

(c) An organization—(1) Described in section 501(c)(3) which after July 1, 1950, but before January 1, 1970, has engaged in any prohibited transaction as defined in section 503(b), unless it is excepted by the provisions of paragraph (a)(1) of this section;

(2) Described in section 401(a) and referred to in section 4975(g) (2) or (3) which after March 1, 1954, has engaged in any prohibited transaction as defined in section 503(b);

(3) Described in section 401(a) and not referred to in section 4975(g) (2) or (3) which after March 1, 1954, but before January 1, 1975, has engaged in any prohibited transaction as defined in section 503(b) or which after December 31, 1962, but before January 1, 1975, has engaged in any prohibited transaction as defined in section 503(g) prior to its repeal by section 2003(b)(5) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978);

(4) Described in section 501(c)(17) which after December 31, 1959, has engaged in any prohibited transaction as defined in section 503(b); or

(5) Described in section 501(c)(18) which after December 31, 1969, has engaged in any prohibited transaction described in section 503(b);

Shall not be exempt from taxation under section 501(a) for any taxable year subsequent to the taxable year in which there is mailed to it a notice in writing by the Commissioner that it has engaged in such prohibited transactions. Such notification by the Commissioner shall be by registered or certified mail to the last known name and address of the organization. However, notwithstanding the requirement of notification by the Commissioner, the exemption shall be denied with respect to any taxable year if such organization during or prior to such taxable year commenced the prohibited transaction with the purpose of diverting income or corpus from its exempt purposes and such transaction involved a substantial party of the income or corpus of such organization. For the purpose of this section, the term *taxable year* means the established annual accounting period of the organization; or, if the organization has no such established annual accounting period, the *taxable year* of the organizations means a calendar year. See 26 CFR §1.503(j)–1 (rev. as of Apr. 1, 1974) for provisions relating to the definition of prohibited transactions in the case of trusts benefitting certain owner-employees after December 31, 1962, but prior to January 1, 1975. See also section 2003 (c)(1)(B) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978) in the case of an organization described in section 401(a) with respect to which a disqualified person elects to pay a tax in the amount and manner provided with respect to the tax imposed by section 4975 of the Code so that the organization may avoid denial of exemption under section 503.

(d) The application of section 503(b) may be illustrated by the following examples:

Example 1. A creates a foundation in 1954 ostensibly for educational purposes. B, a trustee, accumulates the foundation's income from 1957 until 1959 and then uses a substantial part of this accumulated income to send A's children to college. The foundation would lose its exemption for the taxable years 1957 through 1959 and for subsequent taxable years until it regains its exempt status.

Example 2. If under the facts in Example 1 such private benefit was the purpose of the foundation from its inception, such foundation is not exempt by reason of the general provisions of section 501(c)(3), without regard to the provisions of section 503, for all years since its inception, that is, for the taxable years 1954 through 1959 and subsequent taxable years, since under section 501(c)(3) the organization must be organized and operated exclusively for exempt purposes. See §1.501(c)(3)–1.

[T.D. 7428, 41 FR 34621, Aug. 16, 1976]

§1.503(b)–1 Prohibited transactions.

(a) *In general.* The term *prohibited transaction* means any transaction set forth in section 503(b) engaged in by any organization described in paragraph (a) of §1.503(a)–1. Whether a transaction is a prohibited transaction depends on the facts and circumstances of the particular case. This section is intended to deny tax-exempt status to such organizations which engage in certain transactions which inure to the private advantage of (1) the creator of such organization (if it is a trust); (2) any substantial contributor to such organization; (3) a member of the family (as defined in section 267(c)(4) of an individual who is such creator of or such substantial contributor to such organization; or (4) a corporation controlled, as set forth in section 503(b), by such creator or substantial contributor.

(b) *Loans as prohibited transactions under section 503(b)(1)*—(1) *Adequate security.* For the purposes of section 503(b)(1), which treats as prohibited transactions certain loans by an organization without receipt of adequate security and a reasonable rate of interest, the term *adequate security* means something in addition to and supporting a promise to pay, which is so pledged to the organization that it may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, the value and liquidity of which security is such that it may reasonably be anticipated that loss of principal or interest will not result from the loan. Mortgages or liens on property, accommodation endorsements of those financially capable of meeting the indebtedness, and stock or securities issued by corporations other than the borrower may constitute security for a loan to the persons or organizations described in section 503(b). Stock of a borrowing corporation does not constitute adequate security. A borrower's evidence of indebtedness, irrespective of its name, is not security for a loan, whether or not it was issued directly to the exempt organization. However, if any such evidence of indebtedness provides for security that may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, there may be adequate security for such loan. If an organization subject to section 503(b) purchases debentures issued by a person specified in section 503(b), the purchase is considered, for purposes of section 503(b)(1), as a loan made by the purchaser to the issuer on the date of such purchase. For example, if an exempt organization subject to section 503(b) makes a purchase through a registered security exchange of debentures issued by a person described in section 503(b), and owned by an unknown third party, the purchase will be considered as a loan to the issuer by the purchaser. For rules relating to loan of funds to, or investment of funds in stock or securities of, persons described in section 503(b) by an organization described in section 401(a), see paragraph (b)(5) of §1.401–1.

(2) *Effective dates.* The effective dates for the application of the definition of adequate security in paragraph (b)(1) of this paragraph are:

(i) March 15, 1956, for loans (other than debentures) made after March 15, 1956;

(ii) January 31, 1957, for loans (other than debentures) made before March 16, 1956, and continued after January 31, 1957;

(iii) November 8, 1956, for debentures which were purchased after November 8, 1956;

(iv) December 1, 1958, for debentures which were purchased before November 9, 1956, and held after December 1, 1958;

(v) If an employees' pension, stock bonus, or profit-sharing trust described in section 401(a) made a loan before March 1, 1954, repayable by its terms after December 31, 1955, and which would constitute a prohibited transaction if made on or after March 1, 1954, the loan shall not constitute a prohibited transaction if held until maturity (determined without regard to any extension or renewal thereof);

(vi) January 1, 1960, for loans (including the purchase of debentures) made by supplemental unemployment benefit trusts, described in section 501 (c)(17);

(vii) January 1, 1970, for loans (including the purchase of debentures) made by employees' contribution pension plan trusts described in section 501(c)(18).

(3) *Certain exceptions to section 503(b)(1).* See section 503(e) and §1.503(e)–1, 1.503(e)–2, and 1.503(e)–3 for special rules providing that certain obligations acquired by trusts described in section 401(a) or section 501(c) (17) or (18) shall not be treated as loans made without the receipt of adequate security for purposes of section 503(b)(1). See section 503(f) and §1.503(f)–1 for an exception to the application of sections 503(b)(1) for certain loans made by employees' trusts described in section 401(a).

(c) *Examples.* The principles of this section are illustrated by the following examples: (Assume that section 503 (e) and (f) are not applicable.)

Example 1. A, creator of an exempt trust subject to section 503, borrows $100,000 from such trust in 1960, giving his unsecured promissory note. The net worth of A is $1,000,000. The net worth of A is not *security* for such loan and the transaction is a prohibited transaction. If, however, the note is secured by a mortgage on property of sufficient value, or is accompanied by acceptable collateral of sufficient value, or carries with it the secondary promise of repayment by an accommodation endorser financially capable of meeting the indebtedness, it may be adequately secured. However, subordinated debentures bonds of a partnership which are guaranteed by the general partners are not adequately secured since the general partners are liable for the firm's debt and their guaranty adds no additional security.

Example 2. Assume the same facts as in example 1 except that A's promissory note in the amount of $100,000 to the trust is secured by property which has a fair market value of $75,000. A's promissory note secured to the extent of $75,000 is not adequately secured within the meaning of section 503(b)(1) since the security at the time of the transaction must be sufficient to repay the indebtedness, interest, and charges which may pertain thereto.

Example 3. Corporation M, a substantial contributor to an exempt organization subject to section 503, borrows $150,000 from such organization in 1960, giving its promissory note accompanied by stock of the borrowing corporation with a fair market value of $200,000. Since promissory notes and debentures have priority over stock in the event of liquidation of the corporation, stock of a borrowing corporation is not adequate security. Likewise, debenture bonds which are convertible on default into voting stock of the issuing corporation do not constitute *adequate security* under section 503(b)(1).

Example 4. B, creator of an exempt trust subject to section 503, borrows $100,000 from such trust in 1960, giving his secured promissory note at the rate of 3 percent interest. The prevailing rate of interest charged by financial institutions in the community where the transaction takes place is 5 percent for a loan of the same duration and similarly secured. The loan by the trust to the grantor is a prohibited transaction since section 503(b)(1) requires both adequate security and a reasonable rate of interest. Further, a promise to repay the loan plus a percentage of future profits which may be greater than the prevailing rate of interest does not meet the reasonable rate of interest requirement.

Example 5. N Corporation, a substantial contributor to an exempt organization subject to section 503 borrows $50,000 on or after March 16, 1956, from the organization. If the loan is not adequately secured, the organization has committed a prohibited transaction at the time the loan was made. If the loan had been made on or before March 15, 1956, and is continued after January 31, 1957, it must be adequately secured on February 1, 1957, or it will be considered a prohibited transaction on that date. However, if the exempt organization were an employees' trust, described in section 401(a), and the loan were made before March 1, 1954, repayable by its terms after December 31, 1955, it would not have to be adequately secured on February 1, 1957. Moreover, if the exempt organization were a supplemental unemployment benefit trust, described in section 501(c)(17), and the loan were made before January 1, 1960, repayable by its terms after December 31, 1959, it would not have to be adequately secured on January 1, 1960.

Example 6. An exempt organization subject to section 503 purchases a debenture issued by O Corporation, which is a substantial contributor to the organization. The organization purchases the debenture in an arm's length transaction from a third person on or after November 9, 1956. The purchase is considered as a loan by the organization to O Corporation. The loan must be adequately secured when it is made, or it is considered as a prohibited transaction at that time. If the organization purchased the debenture before November 9, 1956, and holds it after December 1, 1958, the debenture must be adequately secured on December 2, 1958, or it will then be considered as a prohibited transaction. However, if the organization were an employees' trust described in section 401(a), and if the debenture were purchased before March 1, 1954, and its maturity date is after December 31, 1955, the debenture does not have to be adequately secured. Moreover, if the organization were an employees' contribution pension plan trust described in section 501(c)(18), and if the debenture were purchased before January 1, 1970, and its maturity date is after December 31, 1969, the debenture does not have to be adequately secured.

[T.D. 7428, 41 FR 34621, Aug. 16, 1976]

§ 1.503(c)–1 Future status of organizations denied exemption.

(a) Any organization described in section 501(c) (3), (17), or (18), or an employees' trust described in section 401(a), which is denied exemption under section 501(a) by reason of the provisions of section 503(a), may file, in any taxable year following the taxable year in which notice of denial was issued, a claim for exemption. In the case of organizations described in section 501(c) (3), (17), or (18), the appropriate exemption application shall be used for this purpose, and shall be filed with the district director. In the case of an enmployees' trust described in section 401(a), the information described in § 1.404(a)–2 shall be submitted with a letter claiming exemption. All employees' trust described in section 401(a) shall submit this information to the district director with whom a request for a determination as to its qualification under section 401 and exemption under section 501 may be submitted under paragraph (s) of § 601.201 of this chapter (Statement of Procedural Rules). A claim for exemption must contain or have attached to it, in addition to the information generally required of such an organization claiming exemption as an organization described in section 501(c) (17), or (18), or section 401(a) (or section 501(c)(3) prior to January 1, 1970), a written declaration made under the penalities of perjury by principal officer of such organization authorized to make such declaration that the organization will not knowingly again engage in a prohibited transaction, (as defined in section 503(b) (or 4975(c) if such section applies to such organization)). In the case of section 501(c)(3) organizations which have lost their exemption after December 31, 1969, pursuant to section 503, a claim for exemption must contain or have attached to it a written agreement made under penalities of perjury by a principal officer of such organization authorized to make such agreement that the organization will not violate the provisions of chapter 42. In addition, such organization must comply with the rules for governing instruments as prescribed in § 1.508–3. See § 1.501(a)–1 for proof of exemption requirements in general.

(b) If the Commissioner is satisfied that such organization will not knowingly again engage in a prohibited transaction (as defined under section 503(b) or 4975(c), as applicable to such organization) or in the case of a section 501(c)(3) organization, will not violate the provisions of chapter 42, and the organization also satisfied all the other requirements under section 501(c) (3), (17), or (18), or section 401(a), the organization will be so notified in writing. In such case the organization will be exempt (subject to the provisions of section 501(c)(3), or sections 501(c) (17), (18) or 401(a), and 503, and 504 when applicable) with respect to the taxable years subsequent to the taxable year in which the claim described in section 503(c) is filed. Section 503 contemplates that an organization denied exemption because of the terms of such section will be subject to taxation for at least one full taxable year. For the purpose of this section, the term *taxable year* means the established annual accounting period of the organization; or, if the organization has no such established annual accounting period, the *taxable year* of the organization means the calendar year.

(c) For taxable years beginning after December 31, 1969, the denial of an exemption pursuant to this section, for a taxable year prior to January 1, 1970, of an organization described in section 501(c)(3) shall not cause such organization to cease to be described in section 501(c)(3) for purposes of part II of subchapter F, chapter 1 and for purposes of the application of chapter 42 taxes.

(d) In the case of an organization described in section 501(c)(3), which has lost its exemption pursuant to section 503, and which has not notified the Commissioner that it is applying for recognition of its exempt status under section 508(a) and this section, no gift or contribution made after December 31, 1969, which would otherwise be deductible under section 170, 642(c), or 545(b)(2) shall be allowed as a deduction. For rules relating to the denial of deductions with respect to gifts or contributions made before January 1, 1970, see, §1.503(e)–4.

[T.D. 7428, 41 FR 34622, Aug. 16, 1976, as amended by T.D. 7896, 48 FR 23817, May 27, 1983]

§1.503(d)–1 Cross references.

For provisions relating to loans described in section 503(b)(1) by a trust described in section 401(a), see §1.503(b)–1 and section 503 (e) and (f) and the regulations thereunder.

[T.D. 7428, 41 FR 34623, Aug. 16, 1976]

§1.503(e)–1 Special rules.

(a) *In general.* (1) Section 503(e) provides that for purposes of section 503(b)(1) (relating to loans made without the receipt of adequate security and a reasonable rate of interest) the acquisition of a bond, debenture, note, or certificate or other evidence of indebtedness shall not be treated as a loan made without the receipt of adequate security if certain requirements are met. Those requirements are described in §1.503(e)–2.

(2) Section 503(e) does not affect the requirement in section 503(b)(1) of a reasonable rate of interest. Thus, although the acquistion of a certificate of indebtedness which meets all of the requirements of section 503(e) and of §1.503(e)–2 will not be considered as a loan made without the receipt of adequate security, the acquisition of such an indebtedness does consitute a prohibited transaction if the indebtedness does not bear a reasonable rate of interest.

(3) The provisions of section 503(e) do not limit the effect of section 401(a) and §1.401–2, section 501(c)(17)(A)(i), or section 501(c)(18)(A), all relating to the use of diversion of corpus or incopme of the respective employee trusts. Furthermore, the provisions of section 503(e) do not limit the effect of any of the provisions of section 503 other than section 503(b)(1). Thus, for example, although a loan made by employees' trust described in section 503(a)(1)(B) meets all the requirements of section 503(e) and therefore is not treated as a loan made without the receipt of adequate security, such an employees' trust making such a loan will lose its exempt status if the loan is not considered as made for the exclusive benefit of the employees or their beneficiaries. Similarly, a loan which meets the requirements of section 503(e) will constitute a prohibited transaction within the meaning of section 503(b)(6) if it results in a substantial diversion of the trust's income or corpus to a person described in section 503(b).

(b) *Definitions.* For purposes of section 503(e):

(1) The term *obligation* means bond, debenture, note, or certificate or other evidence of indebtedness.

(2) The term *issuer* includes any person described in section 503(b) who issues an obligation.

(3)(i) The term *person independent of the issuer* means a person who is not related to the issuer by blood, by marriage, or by reason of any substantial business interests. Persons who will be considered not to be independent of the issuer include but are not limited to:

(a) The spouse, ancestor, lineal descendant, or brother or sister (whether by whole or half blood) of an individual who is the issuer of an obligation;

(b) A corporation controlled directly or indirectly by an individual who is the issuer, or directly or indirectly by the spouse, ancestor, lineal descendant, or brother or sister (whether by whole or half blood) of an individual who is the issuer;

(c) A corporation which directly or indirectly controls, or is controlled by, a corporate issuer;

(d) A controlling shareholder of a corporation which is the issuer, or which controls the issuer;

(e) An officer, director, or other employee of the issuer, of a corporation controlled by the issuer, or of a corporation which controls the issuer;

(f) A fiduciary of any trust created by the issuer, by a corporation which controls the issuer, or by a corporation which is controlled by the issuer; or

(g) A corporation controlled by a person who controls a corporate issuer.

(ii) For purposes of paragraph (b)(3)(i) of this section, the term *control* means, with respect to a corporation, direct or indirect ownership of 50 percent or more of the total combined voting power of all voting stock or 50 percent or more of the total value of shares of all classes of stock. If the aggregate amount of stock in a corporation owned by an individual and by the spouse, ancestors, lineal descendants, brothers and sisters (whether by whole of half blood) of the individual is 50 percent or more of the total combined voting power of all voting stock or is 50 percent or more of the total value of all classes of stock, then each of these persons shall be considered as the controlling shareholder of the corporation.

(iii) In determining family relationships for purposes of paragraph (b)(3)(i) of this section, a legally adopted child of an individual shall be treated as a child of such individual by blood.

(4) The term *issue* means all the obligations of a issuer which are offered for sale on substantially the same terms. Obligations shall be considered offered for sale on substantially the same terms if such obligation would, at the same time and under the same circumstances, be traded on the market at the same price. On the other hand, if the terms on which obligations are offered for sale differ in such manner as would cause such obligations to be traded on the market at different prices, then such obligations are not part of the same issue. The following are examples of terms which, if different, would cause obligations to be traded on the market at different prices: (i) Interest rate; (ii) Maturity date; (iii) Collateral; and (iv) Conversion provisions.

The fact that obligations are offered for sale on different dates will not preclude such obligations from being part of the same issue if they all mature on the same date and if the terms on which they are offered for sale are otherwise the same, since such obligations would, at the same time and under the same conditions, be traded on the market at the same price. Obligations shall not be considered part of the same issue merely because they are part of the same authorization or because they are registered as part of the same issue with the Securities and Exchange Commission.

[T.D. 7428, 41 FR 34623, Aug. 16, 1976]

§ 1.503(e)–2 Requirements.

(a) *In general.* The requirements which must be met under section 503(e) for an obligation not to be treated as a loan made without the receipt of adequate security for purposes of section 503(b)(1) are described in paragraphs (b), (c), and (d) of this section. For purposes of this section, the term *employee trust* shall mean any of the three kinds of organizations described in section 503(a)(1).

(b) *Methods of acquisition*—(1) *In general.* The employee trust must acquire the obligation of the market, by purchase from an underwriter, or by purchase from the issuer, in the manner described in subparagraph (2), (3), or (4) of this paragraph.

(2) *On the market.* (i) An obligation is acquired on the market when it is purchased through a national securities exchange which is registered with the Securities and Exchange Commission, or when it is purchased in an over-the-counter transaction. For purposes of the preceding sentence, securities purchased through an exchange which is not a national securities exchange registered with the Securities and Exchange Commission shall be treated as securities purchased in an over-the-counter transaction.

(ii)*(a)* If the obligation is listed on a national securities exchange registered with the Securities and Exchange Commission, it must be purchased through such an exchange or in an over-the-counter transaction at a price not greater than the price of the obligation prevailing on such an exchange at the time of the purchase by the employee trust.

(b) For purposes of section 503(e), the price of the obligation prevailing at the time of the purchase means the price which accurately reflects the market value of the obligation. In the case of an obligation purchased through a national securities exchange which is registered with the Securities and Exchange Commission, the price paid for the obligation will be considered the prevailing price of the obligation. In the case of an obligation purchased in an over-the-counter transaction, the prevailing price may be the price at which the last sale of the obligation was affected on such national securities exchange immediately before the employee trust's purchase of such obligation on the same day or may be the mean between the highest and lowest prices at which sales were effected on such exchange on the same day or on the immediately preceding day or on the last day during which there were sales of such obligation or may be a price determined by any other method which accurately reflects the market value of the obligation.

(iii)*(a)* If the obligation is not listed on a national securities exchange which is registered with the Securities and Exchange Commission, it must be purchased in an over-the-counter transaction at a price not greater than the offering price for the obligation as established by current bid and asked prices quoted by persons independent of the issuer.

(b) For purposes of section 503(e) the offering price for the obligation at the time of the purchase means the price which accurately reflects the market value of the obligation. The offering price may be the price at which the last sale of the obligation to a person independent of the issuer was effected immediately before the employee trust's purchase of such obligation on the same day or may be the mean between the highest and lowest prices at which sales to persons independent of the issuer were effected on the same day or on the last day during which they were sales of such obligation or may be a price determinated by any other method which accurately reflects the market value of the obligation. The offering price for an obligation must be a valid price for the amount of the obligations which the trust is purchasing. For example, if an employees' trust described in section 503(a)(1)(B) purchases 1,000 bonds of the employer corporation at the offering price established by current prices for a lot of 10 such bonds, such offering price may not be a valid price for 1,000 bonds and the purchase may therefore not meet the requirements of this subdivision. For a purchase of an obligation to qualify under this subdivision, there must be sufficient current prices quoted by persons independent of the issuer to establish accurately the current value of the obligation. Thus, if there are no current prices quoted by persons independent of the issuer, an over-the-counter transaction will not qualify under this subparagraph even though the obligation was purchased in an arms's length transaction from a person independent of the issuer.

(iv) For purposes of this section, an over-the-counter transaction is one not executed on a national securities exchange which is registered with the Securities and Exchange Commission. An over-the-counter transaction may be made through a dealer or an exchange which is not such a national securities exchange or may be made directly from the seller to the purchaser.

(3) *From an underwriter.* An obligation may be purchased from an underwriter if it is purchased at a price not greater than:

(i) The public offering price for the obligation as set forth in a prospectus or offering circular filed with the Securities and Exchange Commission, or

(ii) The price at which a substantial portion of the issue including such obligation is acquired by persons independent of the issuer,

whichever is the lesser price. For purposes of this subparagraph, a portion of the issue will be considered substantial if the purchasers of such portion by persons independent of the issuer are sufficient to establish that fair market value of the obligations included in such issue. In determining whether the purchases are sufficient to establish the fair market value, all the surrounding facts and circumstances will be considered, including the number of independent purchasers, the aggregate amount purchased by each such independent purchaser, and the number of transactions. In the case of a large issue, purchases of a small percentage of the outstanding obligations may be considered purchases of a substantial portion of the issue; whereas, in the case of a small issue, purchases of a larger percentage of the outstanding obligations will ordinarily be required. The requirement in paragraph (b)(3)(ii) of this section contemplates purchase of the obligations by persons independent of the issuer contemporaneously with the purchase by the employee trust. If a substantial portion has been purchased at different prices, the price of the portion may be based on the average of such prices, and if several substantial portions have been sold to persons independent of the issuer, the price of any of the substantial portions may be used for pusposes of this subparagraph.

(4) *From the issuer.* An obligation may be purchased directly from the issuer at a price not greater than the price paid currently for a substantial portion of the same issue by persons independent of the issuer. This requirement contemplates purchase of a substantial portion of the same issue by persons independent of the issuer contemporaneously with the purchase by the employee trust. For purposes of this subparagraph, a portion of the issue will be considered substantial if the purchases of such portion by persons independent of the issuer are sufficient to establish the fair market value of the obligations included in such issue. In determining whether the purchases are sufficient to establish the fair market value, all the surrounding facts and circumstances will be considered, including the number of independent purchasers, the aggregage amount purchased by each such independent purchaser, and the number of transactions. In the case of a large issue, purchases of a small percentage of the outstanding obligations may be considered purchases of a substantial portion of the issue; whereas, in the case of a small issue, purchases of a larger percentage of the outstanding obligations will ordinarily be required. The price paid for a substantial portion of the issue may be determined in the manner privided in paragraph (b)(3) of this section.

(c) *Limitations on holdings of obligations.* (1) Immediately following acquisition of the obligation by the employee trust:

(i) Not more than 25 percent of the aggregate amount of the obligations issued in such issue and outstanding immediately after acquisition by the trust may be held by the trust, and

(ii) At least 50 percent of such aggregate amount must be held by persons independent of the issuer.

(2)(i) For purposes of paragraph (c)(1) of this section, an obligation is not considered as outstanding if it is held by the issuer. For example, if an obligation which has been issued and outstanding is repurchased and held by the issuer, without cancellation or retirement, such an obligation is not considered outstanding.

(ii) For purposes of paragraph (c)(1) of this section, the amounts of the obligations held by the trust and by persons independent of the issuer shall be computed on the basis of the face amount of the obligations.

(d) *Limitation on amount invested in obligations.* (1)(i) Immediately following acquisition of the obligation, not more 25 percent of the assets of the employee trust may be invested in all obligations of all persons described in section 503(b). For purposes of determining the amount of the trust's assets which are invested in obligations of persons described in section 503(b) immediately following acquisition of the obligation, those obligations shall be valued as follows:

(a) Those obligations included in the acquisition in respect of which the percentage test in the first sentence of this subdivision is being applied shall be valued at their adjusted basis, as provided in section 1011, relating to adjusted basis for determining gain or loss; and

(b) All other obligations of persons described in section 503(b) which were part of the trust's assets immediately before the acquisition of the obligations described in (d)(1)(i)*(a)* of this section shall be valued at their fair market value on the day that the obligations described in (d)(1)(i)*(a)* of this section were acquired. For purposes of determining the total amount of the assets of the trust (including obligations of persons described in section 503(b)), there shall be used the fair market value of those assets on the day the obligation is acquired.

(ii) The application of the rules in paragraph (d)(1)(i) of this section may be illustrated by the following example:

Example. On February 1, 1960, an exempt employees' trust described in section 401(a) purchases unsecured debentures issued by the employer corporation for $1,000. At the time of this purchase, such debentures have a fair market value of $1,200. Immediately after the purchase of such unsecured debentures, the assets of the trust consist of the following:

	Cost	Fair market value on Feb. 1, 1960
(a) Assets other than obligations of persons described in sec. 503(b)	$5,000	$7,800
(b) Obligations of persons described in sec. 503(b) acquired before Feb. 1, 1960	500	1,000
(c) Unsecured debentures of employer purchased on Feb. 1, 1960	1,000	1,200

Immediately following acquisition of the unsecured debentures by the trust, the percent of the assets of the trust that are invested in all obligations of all persons described in section 503(b) is computed as follows:

(1) Obligations of persons described in section 503(b) acquired before Feb. 1, 1960 (valued at fair market value)	$1,000
(2) Unsecured debentures of employer purchased on Feb. 1, 1960 (valued at cost)	1,000
(3) Total amount of trust's assets invested in obligations of persons described in section 503(b) ((1) plus (2))	2,000
(4) Assets of the trust other than obligations of persons described in section 503(b) (valued at fair market value on Feb. 1, 1960)	7,800
(5) Obligations of persons described in section 503(b) acquired before Feb. 1, 1960 (valued at fair market value on Feb. 1, 1960)	1,000
(6) Unsecured debentures of employer purchased on Feb. 1, 1960 (valued at fair market value on Feb. 1, 1960)	$1,200
(7) Total assets of the trust valued at fair market value on Feb. 1, 1960 (sum of (4), (5), and (6))	10,000
(8) Percent of assets of the trust invested in all obligations of all persons described in section 503(b) immediately following purchase of unsecured debentures on Feb. 1, 1960 ((3)÷(7), that is, $2,000÷$10,000)	20%

(2) In determining for purposes of subparagraph (1) of this paragraph the amount invested in obligations of persons described in section 503(b), there shall be included amounts invested in any obligations issued by any such person, irrespective of whether the obligation is secured, and irrespective of whether the obligation meets the conditions of section 503(e) or section 503(f). Obligations of persons described in section 503(b) other than the issuer of the obligation to which section 503(e) applies are also included within the 25 percent limitation. For example, if on February 19, 1959, an exempt employees' trust described in section 401(a) purchases unsecured debentures issued by the employer corporation in a transaction effected on the New York Stock Exchange, and if immediately after the purchase 10 percent of the trust's assets is invested in such debentures and 20 percent of its assets is invested in a loan made with adequate security on January 12, 1959, to the wholly-owned subsidiary of the employer corporation, then the purchase of the employer's debentures will not qualify under section 503(e), since 30 percent of the trust's assets are then invested in obligations of persons described in section 503(b).

(e) *Change of terms of an obligation.* A change in terms of an obligation is considered as the acquisition of a new obligation. If such new obligation is not adequately secured, the requirements of section 503(e) must be met at the time the terms of the obligation are changed for such section to be applicable to such new loan.

[T.D. 7428, 41 FR 34624, Aug 16, 1976]

§ 1.503(e)–3 Effective dates.

(a) Section 503(e) and §§ 1.503(e)–1 and 1.503(e)–3 are effective in the case of an employees' trust described in section 401(a) for taxable years ending after March 15, 1956. Thus, if during a taxable year ending before March 16, 1956, an employees' trust made a loan which meets the requirements of section 503(e), such loan will not be treated as made without the receipt of adequate security and will not cause the loss of exemption for taxable years ending after March 15, 1956, although such loan was not considered adequately secured when made. (However, section 503 does not apply to organizations described in section 401(a) not referred to in section 4975(g) (2) or (3) for transactions occurring after December 31, 1974.)

(b)(1) In the case of obligations acquired by an employees' trust described in section 401(a) before September 2, 1958, which were held on that date, the requirements described in paragraphs (c) and (d) of § 1.503(e)–2 which were not satisfied immediately following the acquisition shall be treated as satisfied at that time if those requirements would have been satisfied had the obligations been acquired on September 2, 1958. For example, on January 3, 1955, an employees' trust described in section 401(a) purchased through the New York Stock Exchange unsecured debentures issued by the employer corporation. Under section 503(e) the acquisition of such debentures by the trust will not be treated for taxable years ending after March 15, 1956, as a loan made without the receipt of adequate security if the debentures were held by the employees' trust on September 2, 1958, and if the requirements of paragraphs (c) and (d) of § 1.503(e)–2 which were not met on January 3, 1955, were met on September 2, 1958, as if that date were the date of acquisition.

(2) In the case of obligations acquired before September 2, 1958, which were not held by the employees' trust described in section 401(a) on that date, only the requirements described in paragraph (b) of § 1.503(e)–2 must be satisfied for section 503(e) to be applicable to such acquisition. For example, if on December 5, 1956, an employees' trust lent money to the employer corporation by purchasing a debenture issued by the employer and if the trust sold the debenture on August 1, 1958, such loan would not be treated as made without the receipt of adequate security if the requirement described in paragraph (b) of § 1.503(e)–2 was met on December 5, 1956.

(c) Section 503(e) and §§ 1.503(e)–1 and 1.503(e)–2 are effective in the case of trusts described in section 501(c)(17) with respect to loans made, renewed, or, in the case of demand loans, continued after December 31, 1959, and in the case of trusts described in section 501(c)(18) with respect to loans made, renewed or, in the case of demand loans, continued after December 31, 1969.

(d) See paragraph (b)(2) of § 1.503(b)–1 for the effective dates for the application of the definition of adequate security.

[T.D. 7428, 41 FR 34626, Aug. 16, 1976]

§ 1.503(e)–4 Disallowance of charitable deductions for certain gifts made before January 1, 1970.

Paragraphs (a), (b), and (c) of this section shall apply only to gifts or contributions made before January 1, 1970, to an organization described in section 501(c)(3). For rules relating to the denial of deductions with respect to gifts or contributions made after December 31, 1969, see § 1.503(c)–1(d).

(a) No gift or contribution which would otherwise be allowable as a charitable or other deductions under section 170, 642(c), or 545(b)(2) shall be allowed as a deduction if made to an organization described in section 501(c)(3) which at the time the gift or contribution is made is not exempt under section 501(a) by reason of the provisions of section 503.

(b) If an organization which is described in section 501(c)(3) is not exempt because it engaged in a prohibited transaction involving a substantial part of its income of corpus with the purpose of diverting its income or corpus from its exempt purposes, and if the organization receives a gift or contribution during, or prior to, its taxable year in which such prohibited transaction occurred, then a deduction by the donor with respect to the gift or contribution shall not be disallowed under section 503(b) unless the donor (or any member of his family if the donor is an individual) is a party to such prohibited transaction. For the purpose of the preceding sentence *family* is defined in section 267(c)(4) and includes brothers and sisters, whether by whole or half blood, spouse, ancestors, and lineal descendants. See the regulations under section 267(c).

(c) The application of §1.503(e)–4 may be illustrated by the following example:

Example. In 1954, Corporation M, which files its income tax returns on the calendar year basis, creates a foundation purportedly for charitable purposes and deducts from its gross income for that year the amount of the gift to the foundation. Corporation M makes additional gifts to this foundation in 1955, 1956, and 1957, and takes charitable deductions for such years. B, an individual, also contributes to the foundation in 1955, 1956, and 1957, and takes charitable deductions for such years. In 1955, the foundation commences purposely to divert its corpus to the benefit of Corporation M, and a substantial amount of such corpus is so diverted by the close of the taxable year 1956. For 1955 and subsequent taxable years, the exemption allowed the foundation as an organization described in section 501(c)(3) is denied by reason of the provisions of section 503(a). Both Corporation M and individual B would be disallowed any deduction for the contributions made during 1957 to the foundation. Moreover, the charitable deductions taken by Corporation M for contributions to the foundation in the years 1955 and 1956 would also be disallowed since Corporation M was a party to the prohibited transactions. If the facts and surrounding cuircumstances indicate that the contribution in 1954 by Corporation M was for the purpose of the prohibited transaction, then the charitable deduction for the year 1954 shall also be disallowed with respect to Corporation M, since the prohibited transaction would then have commenced with the making of such contribution and the exemption allowed the foundation would then be denied for 1954 by reason of the provisions of §1.503(e)–4. B's deductions for his contributions for the years 1955 and 1956 will not be disallowed since he was not a party to the prohibited transaction.

[T.D. 7428, 41 FR 34626, Aug. 16, 1976]

§1.503(f)–1 Loans by employers who are prohibited from pledging assets.

(a) *In general.* (1) Section 503(f) provides that section 503(b)(1) shall not apply to a loan made to the employer by an employees' trust described in section 401(a) if the loan bears a reasonable rate of interest and certain conditions are met. Section 503(f) also applies to the renewal of loans to the employer and, in the case of demand loans, to the continuation of such loans.

(2) The provisions of section 503(f) do not limit the effect of section 401(a) and §1.401–2, relating to use or diversion of corpus or income of an employees' trust, or the effect of any of the provisions of section 503 other than section 503(b)(1). Consequently, although a loan made by an employees' trust described in section 503(a)(1)(B) meets all the requirements of section 503(f) and therefore is not treated as a loan made without the receipt of adequate security, an employees' trust making such a loan will lose its exempt status if the loan is not considered as made for the exclusive benefit of the employees or their beneficiaries. Similarly, a loan which meets the requirements of section 503(f) will constitute a prohibited transaction within the meaning of section 503(b)(6) if it results in a substantial diversion of the trust's income or corpus to a person described in section 503(b).

(b) *Conditions.* (1) Section 503(f) applies to a loan only if, with respect to the making or renewal of the loan, the conditions described in paragraphs (b)(2), (3), and (4) of this section are met. For purpose of this paragraph, the mere continuance of a demand loan is not considered as the making or renewal of such a loan.

(2) The employer must be prohibited (at the time of the making or renewal of the loan) by any law of the United States or regulations thereunder from directly or indirectly pledging, as security for such a loan, a particular class

or classes of his assets the value of which (at such time) represents more than one-half of the value of all his assets. If a loan is made or renewed when the employer is prohibited by a law of the United States (or the regulations thereunder) from pledging a class of his assets, the qualification of such a loan under section 503(f) will not be affected by a subsequent change in such law or regulations permitting the employer to pledge such assets, unless such loan is renewed after such change. See section 8(a) of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78h(a)), which prohibits certain persons from pledging a class of assets as security for loans, and 12 CFR 220.5(a) (credit by brokers, dealers, and members of national securities exchanges).

(3) The making or renewal, as the case may be, must be approved in writing as an investment which is consistent with the exempt purposes of the trust by a trustee who is independent of the employer, and such written approval must not have been previously refused by any other such trustee. A trustee is independent of the employer, for purposes of this subparagraph, if he is entirely free of influence or controlled by the employer. For example, if the employer is a partnership, then a partner in such partnership, or a member of a partner's family would not be considered independent of the employer. Similarly, an employee of the employer would not be considered independent of the employer. For purposes of this subparagraph, the term *trustee* means, with respect to any trust for which there are two trustees who are independent of the employer, both of such trustees and, with respect to any trust for which there are more than two such independent trustees, a majority of the trustees independent of the employer.

(4)(i) Immediately following the making or renewal, as the case may be, the aggregate amount lent by the trust to the employer, without the receipt of adequate security must not exceed 25 percent of the value of all the assets of the trust.

(ii) For purposes of paragraph (b)(4)(i) of this section, the determination as to whether any amount lent by the trust to the employer is a loan made without the receipt of adequate security shall be made without regard to section 503(e). Thus, if an employees' trust makes a loan on January 2, 1959, to the employer without adequate security (but which loan is not considered as made without adquate security under section 503(e)), and if immediately after making such loan 10 percent of the value of all its assets is invested in such loan, then the trust may on that day invest not more than an additional 15 percent of its assets in a loan which would be considered made without adequate security if it were not for the provisions of section 503(f).

(iii) For purposes of paragraph (b)(4)(i) of this section, in determining the value of all the assets of the trust, there shall be used the fair market value of those assets on the day of the making or renewal.

(c) *Reasonable rate of interest.* Section 503(f) only applies if, in addition to meeting the conditions described in paragraph (b) of this section, the loan bears a reasonable rate of interest when it is made, renewed, or, in the case of demand loans, during the period of its existence.

(d) *Change of terms of loan.* A change in the terms of a loan (including a reduction in the security for a loan) is considered as the making of a new loan. If such a new loan is not adequately secured, the requirements of section 503(f) must be met at the time the terms of the loan are changed for such section to be applicable to such new loan.

(e) *Effective date.* (1) This section and section 503(f) are effective for taxable years ending after September 2, 1958, but only with respect to periods after such date. Thus, if a loan was made on or before September 2, 1958, without the receipt of adequate security and if, when such loan was made, it met all of the requirements of section 503(f) and this section, then the loan is not subject to section 503(b)(1) after September 2, 1958, and would not consitite a prohibited transaction after that date because of a lack of adequate security.

(2) See paragraph (b)(2) of § 1.503(b)–1 for the effective dates for application of the definition of adequate security.

[T.D. 7428, 41 FR 34626, Aug. 16, 1976]

§1.504–1 Attempts to influence legislation; certain organizations formerly described in section 501(c)(3) denied exemption.

Section 504(a) and this section apply to an organization that is exempt from taxation at any time after October 4, 1976, as an organization described in section 501(c)(3), and that ceases to be described in that section because it—

(a) Is an *action* organization within the meaning of §1.501(c)(3)–1(c)(3)(ii) or (iv), on account of activities occurring after October 4, 1976, or

(b) Is denied exemption under the provisions of section 501(h) (see §1.501(h)–3 or §56.4911–9).

This section does not apply, however, to an organization that was described in section 501(h)(5) and §1.501(h)–2(b)(3) (relating generally to churches) for its taxable year immediately preceding the first taxable year for which it is no longer an organization described in section 501(c)(3). An organization to which section 504(a) and this section apply shall not be treated as described in section 501(c)(4) at any time after the organization ceases to be described in section 501(c)(3). Further, an organization denied treatment as an organization described in section 501(c)(4) under this section may not be treated as an organization described in section 501(c) other than as an organization described in section 501(c)(3). For rules relating to recognition of exemption after exemption is denied under section 501(h), §1.501(h)–3(d).

[T.D. 8308, 55 FR 35592, Aug. 31, 1990]

§1.504–2 Certain transfers made to avoid section 504(a).

(a) *Scope.* Under section 504(b), a transfer described in paragraph (b) or (c) of this section to an organization exempt from tax under section 501(a) may result in loss of exemption by the transferee unless the Commissioner determines, under paragraph (e) of this section, that the original transfer did not effect an avoidance of section 504(a). For purposes of this section, the term *transfer* includes any use by, or for the benefit of, the recipient of the transfer, but does not include any transfer made for adequate and full consideration.

(b) *Transferor and transferee commonly controlled*—(1) *Loss of exemption.* A transfer is described in this paragraph (b) if it is described in paragraphs (b)(2) through (b)(6). The transferee of a transfer described in this paragraph will cease to be exempt from tax under section 501(a), unless the provisions of paragraph (e) of this section apply.

(2) *Transferor organization.* A transfer is described in this paragraph (b)(2) only if it is from an organization that—

(i) Is or was described in section 501(c)(3), but not in section 501(h)(5), and

(ii) Is determined to be an ‘‘action’’ organization (as defined in §1.501(c)(3)–1(c)(3)(ii) or (iv)), or is denied exemption from tax by reason of section 501(h) and either §1.501(h)–3 or §56.4911–9.

(3) *Transferor and transferee commonly controlled.* A transfer is described in this paragraph (b)(3) only if, at the time of the transfer or at any time during the transferee's ten taxable years following the year in which the transfer was made, the transferee is controlled (directly or indirectly), as defined in paragraph (f) of this section, by the same person or persons who control the transferor.

(4) *Time of transfer.* A transfer is described in this paragraph (b)(4) only if the transfer is made—

(i) After the date that is 24 months before the earliest of the effective date of the determination under section 501(h) that the transferor is not exempt, the effective date of the Commissioner's determination that the transferor is an ‘‘action’’ organization (as defined in §1.501(c)(3)(ii) or (iv)), or the date on which the Commissioner proposes to treat it as no longer described in section 501(c)(3), and

(ii) Before the transferor again is recognized as an organization described in section 501(c)(3).

(5) *Transferee.* A transfer is described in this paragraph (b)(5) only if the transferee is exempt from tax under section 501(a) but the transferee is neither—

(i) An organization described in section 501(c)(3), nor

(ii) An organization described in section 401(a) to which the transferor contributes as an employer.

(6) *Amount of transfer.* A transfer is described in this paragraph (b)(6) only if the amount of the transfer exceeds the lesser of 30 percent of the net fair market value of the transferor's assets or 50 percent of the net fair market value of the transferee's assets, computed immediately before the transfer. For purposes of this paragraph (b)(6)—

(i) The amount of a transfer by a transferor is the sum of the amounts transferred to any number of transferees in any number of transfers, all of which are described in paragraphs (b)(2) through (b)(5) of this section, and the time of the transfer is the time of the first transfer so taken into account; and

(ii) The amount of a transfer to a transferee is the sum of the amounts transferred by a transferor to the transferee in any number of transfers, all of which are described in paragraphs (b)(2) through (b)(5) of this section, and the time of the transfer is the time of the first transfer so taken into account.

(c) *Other transfers*—(1) *Transfers included.* A transfer is described in this paragraph (c) if it would be described in paragraph (b) of this section except that either—

(i) The amount of the transfer is less than the amount determined in paragraph (b)(6) of this section, or

(ii) The transferor and transferee are not commonly controlled as described in paragraph (b)(3) of this section, or

(iii) The transferee is an organization described in sections 501(c)(3) and 501(h)(4).

(2) *Loss of exemption.* The transferee of a transfer described in this paragraph (c) will cease to be exempt under section 501(a) if the Commissioner determines on all the facts and circumstances that the transfer effected an avoidance of section 504(a). In determining whether a transfer effected an avoidance of section 504(a), the Commissioner may consider whether the transferee engages, or has engaged, in attempts to influence legislation and may also consider any factors enumerated in paragraph (e) of this section.

(d) *Date of loss of exempt status.* A transferee of a transfer described in paragraph (b), (c)(1)(ii), or (c)(1)(iii) of this section will cease to be exempt from tax under section 501(a) on the date that all requirements of paragraph (b), (c)(1)(ii), or (c)(1)(iii) (other than the determination by the Commissioner) are satisfied. A transferee of a transfer described in paragraph (c)(1)(i) of this section will cease to be exempt from tax under section 501(a) on the date of the last transfer preceding notification of the transferee that the Commissioner proposes to treat the transferee as other than an exempt organization.

(e) *Transfers not in avoidance of section 504(a).* Notwithstanding paragraph (b) of this section, if, based on all the facts and circumstances, the Commissioner determines that a transfer described in paragraph (b) did not effect an avoidance of section 504(a), the transferee will not be denied exemption from tax by reason of section 504(b) and this section. In making the determination called for in the preceding sentence, the Commissioner may consider all relevant factors including:

(1) Whether enforceable and effective conditions on the transfer preclude use of any of the transferred assets for any purpose that, if it were a substantial part of an organization's activities, would be inconsistent with exemption as an organization described in section 501(c)(3);

(2) In the absence of conditions described in paragraph (e)(1) of this section, whether the transferred assets are used exclusively for purposes that are consistent with the transferor's exemption as an organization described in section 501(c)(3);

(3) Whether the assets transferred would be describe in § 53.4942(a)(–2(c)(3) before, as well as after, the transfer if both the transferor and transferee were private foundations;

(4) Whether and to what extent the transfer would satisfy the provisions of § 1.507–2(a) (7) and (8) if the transferor were a private foundation;

(5) Whether all of the transferred assets have been expended during a period when the transferee was not controlled (directly or indirectly) by the

same person or persons who controlled the transferor; and

(6) Whether the entire amount of the transferred assets were in turn transferred, before the close of the transferee's taxable year following the taxable year in which the transferred assets were received, to one or more organizations described in section 507(b)(1)(A) none of which are controlled (directly or indirectly) by the same persons who control either the original transferor or transferee.

(f) *Control.* For purposes of section 504 and the regulations thereunder—

(1) The transferor will be presumed to control any organization with which it is affiliated within the meaning of §56.4911–7(a), or would be if both organizations were described in section 501(c)(3), and

(2) The transferee will be treated as controlled (directly of indirectly) by the same person or persons who control the transferor if the transferee would be treated as controlled under §53.4942(a)–3(a)(3), for which purpose the transferor shall be treated as a private foundation.

[T.D. 8308, 55 FR 35592, Aug. 31, 1990]

§1.505(c)–1T Questions and answers relating to the notification requirement for recognition of exemption under paragraphs (9), (17) and (20) of Section 501(c) (temporary).

Q–1: What does section 505(c) of the Internal Revenue Code provide?

A–1: Section 505(c) provides that an organization will not be recognized as exempt under section 501(c)(9) as a voluntary employees' beneficiary association, under section 501(c)(17) as a trust forming part of a plan providing for the payment of supplemental unemployment compensation benefits, or under section 501(c)(20) as a trust forming part of a qualified group legal services plan unless notification is given to the Internal Revenue Service. The notification required of a trust created pursuant to section 501(c)(20) and forming part of a qualified group legal services plan is set forth in Q&A–2. The notification required of an organization organized after July 18, 1984, and applying for exempt status as an organization described in section 501(c) (9) or (17) is set forth in Q&A–3 through Q&A–8. The notification required of an organization organized on or before July 18, 1984, and claiming exemption as an organization described in section 501(c) (9) or (17) is set forth in Q&A–9 through Q&A–11. However, an organization that has previously notified the Internal Revenue Service of its claim to exemption under section 501(c) (9), (17), or (20) or its claim to exemption under those sections pursuant to another provision of the Code, is not required, under section 505(c), to submit a renotification (See Q&A–2 and Q&A–12).

Section 501(c)(20) Trusts

Q–2: What is the notice required of a trust created pursuant to section 501(c)(20) and forming part of a qualified group legal services plan under section 120?

A–2: (a) A trust claiming exemption as an organization described in section 501(c)(20) will be recognized as exempt if the exclusive function of the trust is to form part of a qualified group legal services plan or plans. Exemption of the trust under section 501(c)(20) will generally be dependent upon and coextensive with recognition of the plan as a qualified group legal services plan. Therefore, a trust organized pursuant to section 501(c)(20) after July 18, 1984, need not file a separate notice with the Internal Revenue Service of its claim to exemption because the notice required by section 120(c)(4) will suffice for purposes of section 505(c), provided a copy of the trust instrument is filed with the Form 1024 submitted by the group legal services plan. If the trust instrument has not been filed with the Form 1024 submitted by the group legal services plan, the trust must comply with (and exemption will be dependent upon) the filing applicable to a trust organized on or before July 18, 1984. For the notice required and effective dates of exemption of a qualified group legal services plan under section 120, see §1.120–3.

(b) A trust organized on or before July 18, 1984, that claims exempt status as a trust described in section 501(c)(20) and that forms part of a qualified group legal services plan which has been recognized as exempt under section 120, must file a copy of its trust instrument with the Internal Revenue Service before February 4, 1987. If a copy of the trust instrument is filed within the time provided, the trust's exemption will be recognized retroactively to the date the qualified group legal services plan was recognized as exempt under section 120. However, if a copy of the trust instrument is filed after the time provided, exemption will be recognized only for the period after the copy of the trust instrument is filed with the Internal Revenue Service. See Q&A–7 for a further discussion of *date of filing.* A trust that has previously filed a copy of its trust instrument with the Service need not refile that document.

Section 501(c) (9) and (17) Organizations Organized After July 18, 1984

Q–3: What is the notice required of an organization or trust, organized after July 18, 1984, that is applying for recognition of tax exempt status under section 501(c) (9) or (17)?

A–3: An organization or trust that is organized after July 18, 1984, will not be treated as described in paragraphs (9) or (17) of section 501(c), unless the organization notifies the Internal Revenue Service that it is applying for recognition of exemption. In addition, unless the required notice is given in the manner and within the time prescribed by these regulations, an organization will not be treated as exempt for any period before the giving of the required notice. The notice is filed by submitting a properly completed and executed Form 1024, ''Application for Recognition of Exemption Under Section 501(a) or for Determination Under Section 120'' together with the additional information required under Q&A–4 and Q&A–5. The notice is filed with the district director for the key district in which the organization's principal place of business or principal office is located.

The notice may be filed by either the plan administrator (as defined in section 414(g)) or the trustee. The Internal Revenue Service will not accept a Form 1024 for any organization or trust before such entity has been organized.

Q–4: What information, in addition to the information required by Form 1024, must be submitted by an organization or trust seeking recognition of exemption under section 501(c) (9) or (17)?

A–4: A notice will not be considered complete unless, in addition to a properly completed and executed Form 1024, the organization or trust submits a full description of the benefits available to participants under section 501(c) (9) or (17). Moreover, both the terms and conditions of eligibility for membership and the terms and conditions of eligibility for benefits must be set forth. This information may be contained in a separate document, such as a *plan document,* or it may be contained in the creating document of the entity (e.g., the articles of incorporation or association, or a trust indenture). For benefits provided through a policy or policies of insurance, all such policies must be included with the notice. Where individual policies of insurance are provided to the participants, single exemplar copies, typical of policies generally issued to participants, are acceptable, provided they adequately describe all forms of insurance available to participants. In providing a full description of the benefits available, the benefits provided must be sufficiently described so that each benefit is definitely determinable. A benefit is definitely determinable if the amount of the benefit, its duration, and the persons eligible to receive it are ascertainable from the plan document or other instrument. Thus, a benefit is not definitely determinable if the rules governing either its amount, its duration, or its recipients are not ascertainable from the plan document or other instrument but are instead subject to the discretion of a person or committee. Likewise, a benefit is not definitely determinable if the amount for any individual is based upon a percentage share of any item that is within the discretion of the employer. However, a disability benefit will not fail to be considered definitely determinable merely because the determination of whether an individual is disabled is made under established guidelines by an authorized person or committee.

Q–5: What is the notice required of collectively bargained plans?

A–5: If an organization or trust claiming exemption under section 501(c) (9) or (17) is organized and maintained pursuant to a collective bargaining agreement between employee representatives and one or more employer, only one Form 1024 is required to be filed for the organization or trust, regardless of the number of employers originally participating in the agreement. Moreover, once a Form 1024 is filed pursuant to a collective bargaining areement, an additional Form 1024 is not required to be filed by an employer who thereafter participates in that agreement. When benefits are provided pursuant to a collective bargaining agreement, the notice will not be considered complete unless, in addition to a properly completed and executed Form 1024, a copy of the collective bargaining agreement is also submitted together with the additional information delineated in Q&A–4.

Q–6: When must the required notice be filed by an organization or trust, organized after July 18, 1984, that seeks recognition of exemption under section 501(c) (9) or (17)?

A–6: An organization or trust applying for exemption must file the required notice by the later of February 4, 1987 or 15 months from the end of the month in which the organization or trust was organized. An extension of time for filing the required notice may be granted by the district director if the request is submitted before the end of the applicable period and it is demonstrated that additional time is needed.

Q–7: What is the effective date of exemption for a new organization or trust, organized after July 18, 1984, that has submitted the required notice?

A–7: If the required notice is filed within the time provided by these regulations, the organization's exemption will be recognized retroactively to the date the organization was organized, provided its purpose, organization and operation (including compliance with the applicable nondiscrimination requirements) during the period prior to the date of the determination letter are in accordance with the applicable law. However, if the required notice is filed after the time provided by these regulations, exemption will be recognized only for the period after the application is filed with the Internal

Revenue Service. The date of filing is the date of the United States postmark on the cover in which an exemption application is mailed or, if no postmark appears on the cover, the date the application is stamped as received by the Service. If an extension for filing the required notice has been granted to the organization, a notice filed on or before the last day specified in the extension will be considered timely and not the otherwise applicable date under Q&A–6.

Q–8: What is the effect on exemption of the filing of an incomplete notice?

A–8: Although a properly completed and executed Form 1024 together with the required additional information (See Q&A–4 and Q&A–5) must be submitted to satisfy the notice required by section 505(c), the failure to file, within the time specified, all of the information necessary to complete such notice will not alone be sufficient to deny recognition of exemption from the date of organization to the date the completed information is submitted to the Service. If the notice which is filed with the Service within the required time is substantially complete, and the organization supplies the necessary additional information requested by the Service within the additional time allowed, the original notice will be considered timely. However, if the notice is not substantially complete or the additional information is not provided within the additional time allowed, exemption will be recognized only from the date of filing of the additional information.

SECTION 501(C) (9) AND (17) ORGANIZATIONS ORGANIZED ON OR BEFORE JULY 18, 1984

Q–9: What is the notice required of an organization or trust organized on or before July 18, 1984, that claims exempt status as an organization described in section 501(c) (9) or (17)?

A–9: Section 505(c) provides a special rule for existing organizations and trusts organized on or before July 18, 1984. Such an organization or trust will not be treated as described in paragraphs (9) or (17) of section 501(c) unless the organization or trust notifies the Internal Revenue Service in the manner and within the time prescribed in these regulations that it is claiming exemption under the particular section. The type of notice, the manner for filing that notice, and the additional information required is the same as that set forth in Q&A–3 through Q&A–5 for new organizations.

Q–10: When must the required notice be filed by an organization or trust organized on or before July 18, 1984?

A–10: An organization or trust organized on or before July 18, 1984, that claims exempt status as an organization described in section 501(c) (9) or (17), must file the required notice before February 4, 1987. An extension of time for filing the required notice may be granted by the district director if the request is submitted before the due date of the notice and it is demonstrated that additional time is needed.

Q–11: What is the effective date of exemption for an organization or trust organized on or before July 18, 1984, that has submitted the required notice?

A–11: If the required notice is filed within the time provided by these regulations, the organization's exemption will be recognized retroactively to the date the organization was organized, provided its purpose, organization and operation (including compliance with the applicable nondiscrimination requirements) during the period prior to the date of the determination letter are in accordance with the applicable law. If, on the other hand, the required notice is filed after the time provided by these regulations, exemption will be recognized only for the period after the notice is received by the Internal Revenue Service. See Q&A–7 for a further discussion of *date of filing.* See also Q&A–8 for the effect on exemption of a notice that has been timely filed but is incomplete.

EXCEPTIONS TO NOTICE REQUIREMENT

Q–12: Are any organizations or trusts claiming recognition of exemption as an organization described in section 501(c) (9) or (17) excepted from the notice requirement of section 505(c)?

A–12: An organization or trust that has previously notified the Internal Revenue Service of its claim to exemption by filing Form 1024 is not required, under section 505(c), to renotify the Service. Thus, an organization that has filed a Form 1024 that is pending with the Service need not refile that form. Also, an organization that has received a ruling or determination letter from the Service recognizing its exemption from taxation need not submit the notification required by section 505(c).

[T.D. 8073, 51 FR 4330, Feb. 4, 1986]

EXEMPT ORGANIZATIONS

PRIVATE FOUNDATIONS

§1.507–1 General rule.

(a) *In general.* Except as provided in §1.507–2, the status of any organization as a private foundation shall be terminated only if:

(1) Such organization notifies the district director of its intent to accomplish such termination, or

(2)(i) With respect to such organization, there have been either willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act), giving rise to liability for tax under chapter 42, and

(ii) The Commissioner notifies such organization that, by reason of subdivision (i) of this subparagraph, such organization is liable for the tax imposed by section 507(c),

and either such organization pays the tax imposed by section 507(c) (or any portion not abated under section 507(g)) or the entire amount of such tax is abated under section 507(g).

(b) *Termination under section 507(a)(1).* (1) In order to terminate its private foundation status under paragraph (a)(1) of this section, an organization must submit a statement to the district director of its intent to terminate its private foundation status under section 507(a)(1). Such statement must set forth in detail the computation and amount of tax imposed under section 507(c). Unless the organization requests abatement of such tax pursuant to section 507(g), full payment of such tax must be made at the time the statement is filed under section 507(a)(1). An organization may request the abatement of all of the tax imposed under section 507(c), or may pay any part thereof and request abatement of the unpaid portion of the amount of tax assessed. If the organization requests abatement of the tax imposed under section 507(c) and such request is denied, the organization must pay such tax in full upon notification by the Internal Revenue Service that such tax will not be abated. For purposes of subtitle F of the Code, the statement described in this subparagraph, once filed, shall be treated as a return.

(2) Termination of private foundation status under section 507(a)(1) does not relieve a private foundation, or any disqualified person with respect thereto, of liability for tax under chapter 42 with respect to acts or failures to act prior to termination or for any additional taxes imposed for failure to correct such acts or failures to act. See subparagraph (8) of this paragraph as to the possible imposition of transferee liability in cases not involving termination of private foundation status.

(3) In the case of an organization which has terminated its private foundation status under section 507(a) and continues in operation thereafter, if such organization wishes to be treated as described in section 501(c)(3), then pursuant to section 509(c) and § 1.509(c)–1 such organization must apply for recognition of exemption as an organization described in section 501(c)(3) in accordance with the provisions of section 508(a).

(4) See § 53.4947–1(c)(7) of this chapter as to the application of section 507(a) to certain split-interest trusts.

(5) For purposes of section 508(d)(1), the Internal Revenue Service shall make notice to the public (such as by publication in the Internal Revenue Bulletin) of any notice received from a private foundation pursuant to section 507(a)(1) or of any notice given to a private foundation pursuant to section 507(a)(2).

(6) If a private foundation transfers all or part of its assets to one or more other private foundations (or one or more private foundations and one or more section 509(a) (1), (2), (3), or (4) organizations) pursuant to a transfer described in section 507(b)(2) and § 1.507–3(c), such transferor foundation will not have terminated its private foundation status under section 507(a)(1). See § 1.507–3, however, for the special rules applicable to private foundations participating in section 507(b)(2) transfers.

(7) Neither a transfer of all of the assets of a private foundation nor a significant disposition of assets (as defined in § 1.507–3(c)(2)) by a private foundation (whether or not any portion of such significant disposition of assets is made to another private foundation) shall be deemed to result in a termination of the transferor private foundation under section 507(a) unless the transferor private foundation elects to terminate pursuant to section 507(a)(1) or section 507(a)(2) is applicable. Thus, if a private foundation transfers all of its assets to one or more persons, but less than all of its net assets to one or more organizations described in section 509(a)(1) which have been in existence and so described for a continuous period of 60 calendar months, for purposes of this paragraph such transferor foundation will not be deemed by reason of such transfer to have terminated its private foundation status under section 507 (a) or (b) unless section 507(a)(2) is applicable. Such foundation

will continue to be treated as a private foundation for all purposes. For example, if a private foundation transfers all of its net assets to a section 509(a)(2) organization in 1971 and receives a bequest in 1973, the bequest will be regarded as having been made to a private foundation and the foundation will be subject to the provisions of chapter 42 with respect to such funds. If a private foundation makes a transfer of all of its net assets to a section 509(a) (2) or (3) organization, for example, it must retain sufficient income or assets to pay the tax imposed under section 4940 for that portion of its taxable year prior to such transfer. For additional rules applicable to a transfer by a private foundation of all of its net assets to a section 509(a)(1) organization which has not been in existence and so described for a continuous period of 60 calendar months, see §1.507–3(e).

(8) If a private foundation makes a transfer described in subparagraph (7) of this paragraph and prior to, or in connection with, such transfer, liability for any tax under chapter 42 is incurred by the transferor foundation, transferee liability may be applied against the transferee organization for payment of such taxes. For purposes of this subparagraph, liability for any tax imposed under chapter 42 for failure to correct any act or failure to act shall be deemed incurred on the date on which the act or failure to act giving rise to the initial tax liability occurred.

(9) A private foundation which transfers all of its net assets is required to file the annual information return required by section 6033, and the foundation managers are required to file the annual report of a private foundation required by section 6056, for the taxable year in which such transfer occurs. However, neither such foundation nor its foundation managers will be required to file such returns for any taxable year following the taxable year in which the last of any such transfers occurred, if at no time during the subsequent taxable years in question the foundation has either legal or equitable title to any assets or engages in any activity.

(c) *Involuntary termination under section 507(a)(2).* (1) For purposes of section 507(a)(2)(A), the term *willful repeated acts (or failures to act)* means at least two acts or failures to act both of which are voluntary, conscious, and intentional.

(2) For purposes of section 507(a)(2)(A), a *willful and flagrant act (or failure to act)* is one which is voluntarily, consciously, and knowingly committed in violation of any provision of chapter 42 (other than section 4940 or 4948(a)) and which appears to a reasonable man to be a gross violation of any such provision.

(3) An act (or failure to act) may be treated as an act (or failure to act) by the private foundation for purposes of section 507(a)(2) even though tax is imposed upon one or more foundation managers rather than upon the foundation itself.

(4) For purposes of section 507(a)(2), the failure to correct the act or acts (or failure or failures to act) which gave rise to liability for tax under any section of chapter 42 by the close of the correction period for such section may be a willful and flagrant act (or failure to act).

(5) No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make an act (or failure to act) willful. However, a foundation's act (or failure to act) is not willful if the foundation (or a foundation manager, if applicable) does not know that it is an act of self-dealing, a taxable expenditure, or other act (or failure to act) to which chapter 42 applies. Rules similar to the regulations under chapter 42 (see, for example, §53.4945–1(a)(2)(iii) of this chapter) shall apply in determining whether a foundation or a foundation manager *knows* that an act (or failure to act) is an act of self-dealing a taxable expenditure or other such act (or failure to act).

[T.D. 7233, 37 FR 28157, Dec. 21, 1972, as amended by T.D. 7290, 38 FR 31833, Nov. 19, 1973]

§1.507–2 Special rules; transfer to, or operation as, public charity.

(a) *Transfer to public charities*—(1) *General rule.* Under section 507(b)(1)(A) a private foundation, with respect to which there have not been either willful repeated acts (or failures to act) or a willful and flagrant act (or failure to act) giving rise to liability for tax under chapter 42, may terminate its private foundation status by distributing all of its net assets to one or more organizations described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)) each of which has been in existence and so described for a continuous period of at least 60 calendar months immediately preceding such distribution. Since section 507(a) does not apply to such a termination, a private foundation which makes such a termination is not required to give the notification described in section 507(a)(1). A private foundation which terminates its private foundation status under section 507(b)(1)(A) does not incur tax under section 507(c) and, therefore, no abatement of such tax under section 507(g) is required.

(2) *Effect of current ruling*—(i) *Distributions before final regulations.* With respect to distributions made before (insert day after the date these regulations are filed by the Office of the Federal Register), an organization to which a distribution of net assets is made will qualify as an organization *described in section 170(b)(1)(A) (other than clauses (vii) and (viii))* for purposes of meeting the requirements of section 507(b)(1)(A) without a further showing if such distributee organization:

(A) Has been in existence for a continuous period of at least 60 calendar months preceding the distribution described in subparagraph (1) of this paragraph;

(B) Has received a ruling or determination letter that it is an organization described in clause (i), (ii), (iii), (iv), (v), or (vi) of section 170(b)(1) (A);

(C) The facts and circumstances forming the basis for the issuance of the ruling have not substantially changed during the 60-month period referred to in (A) of this subdivision; and

(D) The ruling or determination letter referred to in (B) of this subdivision has not been revoked expressly or by a subsequent change of the law or regulations under which the ruling was issued.

(ii) *Distributions after final regulations.* With respect to distributions made after December 29, 1972, a private foundation seeking to terminate its private foundation status pursuant to section 507(b)(1)(A) may rely on a ruling or determination letter issued to a potential distributee organization that such distributee organization is an organization described in clause (i), (ii), (iii), (iv), (v), or (vi) of section 170(b)(1)(A) in accordance with the provisions of § 1.509(a)–7.

(3) *Organizations described in more than one clause of section 170(b)(1)(A).* For purposes of this paragraph and section 507(b)(1)(A), the parenthetical term *other than in clauses (vii) and (viii)* shall refer only to an organization which is described only in section 170(b)(1)(A) (vii) or (viii). Thus, an organization described in clause (i), (ii), (iii), (iv), (v), or (vi) of section 170(b)(1)(A) will not be precluded from being a distributee described in section 507(b)(1)(A) merely because it also appears to meet the description of an organization described in section 170(b)(1)(A) (vii) or (viii).

(4) *Applicability of chapter 42 to foundations terminating under section 507(b)(1)(A).* Except as provided in subparagraph (5) of this paragraph, an organization which terminates its private foundation status pursuant to section 507(b)(1)(A) will remain subject to the provisions of chapter 42 until the distribution of all of its net assets to distributee organizations described in section 507(b)(1)(A) has been completed.

(5) *Special transitional rule.* (i) Section 4940(a) imposes a tax upon private foundations with respect to the carrying on of activities for each taxable year. For purposes of section 4940, an organization which terminates its private foundation status under section 507(b)(1)(A) by the end of the period described in subdivision (ii) of this subparagraph will not be considered as carrying on activities within the meaning of section 4940 during such period. Such organization will therefore not be subject to the tax imposed under section 4940(a) for such period.

(ii) The period referred to in subdivision (i) of this subparagraph is the 12-month period beginning with the first day of the organization's first taxable year which begins after December 31, 1969, but such period shall not be treated as ending before February 20, 1973. In the case of a private foundation distributing assets pursuant to section 507(b)(1)(A) to a medical research organization or a community trust (or in the case of a private foundation seeking to terminate into such an organization or trust pursuant to section 507(b)(1)(B)), the period described in this subdivision shall not be treated as ending before:

(A) In the case of a distribution to a medical research organization, March 29, 1976; or

(B) In the case of a community trust, May 11, 1977.

(iii) If the period described in subdivision (ii) of this subparagraph has not expired prior to the due date for the organization's annual return required to be filed by section 6033 or 6012 (determined with regard to any extension of time for filing the return) for its first taxable year which begins after December 31, 1969 (or for any other taxable year ending before the expiration of the period referred to in subdivision (ii) of this subparagraph), and if the organization has not terminated its private foundation status under section 507(b)(1)(A) by such date, then notwithstanding the provisions of subdivision (ii) of this subparagraph, the organization must take either of the following courses of action:

(A) Complete and file its annual return, including the line relating to excise taxes on investment income, by such date, and pay the tax on investment income imposed under section 4940 at the time it files its annual return. If such organization subsequently terminates its private foundation status under section 507(b)(1)(A) within the period specified in subdivision (ii) of this subparagraph, it may file a claim for refund of the tax paid under section 4940; or

(B) Complete and file its annual return, except for the line relating to excise taxes on investment income, by such date, and, in lieu of paying the tax on investment income imposed under section 4940, file a statement with its annual return which establishes that the organization has taken affirmative action by such date to terminate its private foundation status under section 507(b)(1)(A). Such statement must indicate the type of affirmative action taken and explain how such action will result in the termination of its private foundation status under section 507(b)(1)(A). Such affirmative action may include making application to the appropriate State court for approval of the distribution of all net assets pursuant to section 507(b)(1)(A) in the case of a charitable trust, or the passage of a resolution by the organization's governing body directing the distribution of all net assets pursuant to section 507(b)(1)(A) in the case of a not-for-profit corporation. A written commitment or letter of agreement by the trustee or governing body to one or more section 509(a)(1) distributees indicating an intent to distribute all of the organization's net assets to such distributees will also constitute appropriate affirmative action for purposes of this subdivision. An organization may take such affirmative action and may terminate its private foundation status under section 507(b)(1)(A) in reliance upon 26 CFR 13.12 (rev. as of Jan. 1, 1972) and upon the provisions of the notices of proposed rule making under sections 170(b)(1)(A), 507(b)(1), and 509. Thus, if a distributee organization meets the requirements of the provisions of the notices of proposed rule- making under sections 170(b)(1)(A), 507, or 509 as a distributee under section 507(b)(1)(A), the distributor organization may terminate its private foundation status under section 507(b)(1)(A) in reliance upon such provisions prior to the expiration of the period described in subdivision (ii) of this subparagraph. If such organization, however, fails to terminate its private foundation status under section 507(b)(1)(A) within the period specified in subdivision (ii) of this subparagraph by failing to meet the requirements of either the notices of proposed rulemaking under section 170(b)(1)(A), 507(b)(1), or 509 or the final regulations published under these Code sections, the tax imposed under section 4940 shall be treated as if due from the due date for its annual return (determined without regard to any extension of time for filing its return).

(6) *Return required from organizations terminating private foundation status*

under section 507(b)(1)(A). (i) An organization which terminates its private foundation status under section 507(b)(1)(A) is required to file a return under the provisions of section 6043(b), rather than under the provisions of section 6050.

(ii) An organization which terminates its private foundation status under section 507(b)(1)(A) is not required to comply with section 6104(d) for the taxable year in which such termination occurs. For purposes of this subdivision, the term *taxable year* shall include the period described in subparagraph (5)(ii) of this paragraph.

(7) *Distribution of net assets.* A private foundation will meet the requirement that it *distribute all of its net assets* within the meaning of section 507(b)(1)(A) only if it transfers all of its right, title, and interest in and to all of its net assets to one or more organizations referred to in section 507(b)(1)(A).

(8) *Effect of restrictions and conditions upon distributions of net assets*— (i) *In general.* In order to effectuate a transfer of *all of its right title and interest in and to all of its net assets* within the meaning of paragraph (a)(7) of this section, a transferor private foundation may not impose any material restriction or condition that prevents the transferee organization referred to in section 507(b)(1)(A) (herein sometimes referred to as the *public charity*) from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes. Whether or not a particular condition or restriction imposed upon a transfer of assets is *material* (within the meaning of paragraph (a)(8) of this section) must be determined from all of the facts and circumstances of the transfer. Some of the more significant facts and circumstances to be considered in making such a determination are:

(A) Whether the public charity (including a participating trustee, custodian, or agent in the case of a community trust) is the owner in fee of the assets it receives from the private foundation;

(B) Whether such assets are to be held and administered by the public charity in a manner consistent with one or more of its exempt purposes;

(C) Whether the governing body of the public charity has the ultimate authority and control over such assets, and the income derived therefrom; and

(D) Whether, and to what extent, the governing body of the public charity is organized and operated so as to be independent from the transferor.

(ii) *Independent governing body.* As provided in paragraph (a)(8)(i)(D) of this section, one of the more significant facts and circumstances to be considered in making the determination whether a particular condition or restriction imposed upon a transfer of assets is *material* within the meaning of paragraph (a)(8) of this section is whether, and the extent to which, the governing body is organized and operated so as to be independent from the transferor. In turn, the determination as to such factor must be determined from all of the facts and circumstances. Some of the more significant facts and circumstances to be considered in making such a determination are:

(A) Whether, and to what extent, members of the governing body are comprised of persons selected by the transferor private foundation or disqualified persons with respect thereto, or are themselves such disqualified persons;

(B) Whether, and to what extent, members of the governing body are selected by public officials acting in their capacities as such; and

(C) How long a period of time each member of the governing body may serve as such. In the case of a transfer that is a community trust, the community trust shall meet paragraph (a)(8)(ii)(C) of this section if it meets the requirements of § 1.170A–9(e)(13)(iv) (other than § 1.170A–9(e)(13)(iv) (C) or (D)), relating to rules for governing body.

(iii) *Factors not adversely affecting determination.* The presence of some or all of the following factors will not be considered as preventing the transferee *from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes* (within the meaning of paragraph (a)(8)(i) of this section):

(A) *Name.* The fund is given a name or other designation which is the same as or similar to that of the transferor private foundation or otherwise memorializes the creator of the foundation or his family.

(B) *Purpose.* The income and assets of the fund are to be used for a designated purpose or for one or more particular section 509(a) (1), (2), or (3) organizations, and such use is consistent with the charitable, educational, or other basis for the exempt status of the public charity under section 501(c)(3).

(C) *Administration.* The transferred assets are administered in an identifiable or separate fund, some or all of the principal of which is not to be distributed for a specified period, if the public charity (including a participating trustee, custodian, or agent in the case of a community trust) is the legal and equitable owner of the fund and the governing body exercises ultimate and direct authority and control over such fund, as, for example, a fund to endow a chair at a university or a medical research fund at a hospital. In the case of a community trust, the transferred assets must be administered in or as a component part of the community trust within the meaning of §1.170A–9(e)(11).

(D) *Restrictions on disposition.* The transferor private foundation transfers property the continued retention of which by the transferee is required by the transferor if such retention is important to the achievement of charitable or other similar purposes in the community because of the peculiar features of such property, as, for example, where a private foundation transfers a woodland preserve which is to be maintained by the public charity as an arboretum for the benefit of the community. Such a restriction does not include a restriction on the disposition of an investment asset or the distribution of income.

(iv) *Adverse factors.* The presence of any of the following factors will be considered as preventing the transferee *from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes* (within the meaning of paragraph (a)(8)(i) of this section):

(A) *Distributions. (1)* With respect to distributions made after April 19, 1977, the transferor private foundation, a disqualified person with respect thereto, or any person or committee designated by, or pursuant to the terms of an agreement with, such a person (hereinafter referred to as *donor*), reserves the right, directly or indirectly, to name (other than by designation in the instrument of transfer of particular section 509(a) (1), (2), or (3) organizations) the persons to which the transferee public charity must distribute, or to direct the timing of such distributions (other than by direction in the instrument of transfer that some or all of the principal, as opposed to specific assets, not be distributed for a specified period) as, for example, by a power of appointment. The Internal Revenue Service will examine carefully whether the seeking of advice by the transferee from, or the giving of advice by, any donor after the assets have been transferred to the transferee constitutes an indirect reservation of a right to direct such distributions. In any such case, the reservation of such a right will be considered to exist where the only criterion considered by the public charity in making a distribution of income or principal from a donor's fund is advice offered by the donor. Whether there is a reservation of such a right will be determined from all of the facts and circumstances, including, but not limited to, the facts contained in paragraph (a)(8)(iv)(A) (*2*) and (*3*) of this section.

(*2*) The presence of some or all of the following factors will indicate that the reservation of such a right does not exist:

(*i*) There has been an independent investigation by the staff of the public charity evaluating whether the donor's advice is consistent with specific charitable needs most deserving of support by the public charity (as determined by the public charity);

(*ii*) The public charity has promulgated guidelines enumerating specific charitable needs consistent with the charitable purposes of the public charity and the donor's advice is consistent with such guidelines;

(*iii*) The public charity has instituted an educational program publicizing to donors and other persons the guidelines enumerating specific charitable needs consistent with the charitable purposes of the public charity;

(*iv*) The public charity distributes funds in excess of amounts distributed from the donor's fund to the same or similar types of organizations or charitable needs as those recommended by the donor; and

(*v*) The public charity's solicitations (written or oral) for funds specifically state that such public charity will not be bound by advice offered by the donor.

(*3*) The presence of some or all of the following factors will indicate the reservation of such a right does exist:

(*i*) The solicitations (written or oral) of funds by the public charity state or imply, or a pattern of conduct on the part of the public charity creates an expectation, that the donor's advice will be followed;

(*ii*) The advice of a donor (whether or not restricted to a distribution of income or principal from the donor's trust or fund) is limited to distributions of amounts from the donor's fund, and the factors described in paragraph (a)(8)(iv)(A)(2) or (*i*) or (*ii*) of this section are not present;

(*iii*) Only the advice of the donor as to distributions of such donor's fund is solicited by the public charity and no procedure is provided for considering advice from persons other than the donor with respect to such fund; and

(*iv*) For the taxable year and all prior taxable years the public charity follows the advice of all donors with respect to their funds substantially all of the time.

(B) *Other action or withholding of action.* The terms of the transfer agreement, or any expressed or implied understanding, required the public charity to take or withhold action with respect to the transferred assets which is not designed to further one or more of the exempt purposes of the public charity, and such action or withholding of action would, if performed by the transferor private foundation with respect to such assets, have subjected the transferor to tax under chapter 42 (other than with respect to the minimum investment return requirement of section 4942(e)).

(C) *Assumption of leases, etc.* The public charity assumes leases, contractural obligations, or liabilities of the transferor private foundation, or takes the assets thereof subject to such liabilities (including obligations under commitments or pledges to donees of the transferor private foundation), for purposes inconsistent with the purposes or best interests of the public charity, other than the payment of the transferor's chapter 42 taxes incurred prior to the transfer to the public charity to the extent of the value of the assets transferred.

(D) *Retention of investment assets.* The transferee public charity is required by any restriction or agreement (other than a restriction or agreement imposed or required by law or regulatory authority), express or implied, to retain any securities or other investment assets transferred to it by the private foundation. In a case where such transferred assets consistently produce a low annual return of income, the Internal Revenue Service will examine carefully whether the transferee is required by any such restriction or agreement to retain such assets.

(E) *Right of first refusal.* An agreement is entered into in connection with the transfer of securities or other property which grants directly or indirectly to the transferor private foundation or any disqualified person with respect thereto a right of first refusal with respect to the transferred securities or other property when and if disposed of by the public charity, unless such securities or other property was acquired by the transferor private foundation subject to such right of first refusal prior to October 9, 1969.

(F) *Relationships.* An agreement is entered into between the transferor private foundation and the transferee public charity which establishes irrevocable relationships with respect to the maintenance or management of assets transferred to the public charity, such as continuing relationships with banks, brokerage firms, investment counselors, or other advisors with regard to the investments or other property transferred to the public charity (other than a relationship with a trustee, custodian, or agent for a community trust acting as such). The transfer of property to a public charity subject to contractual obligations which were established prior to November 11, 1976 between the transferor private foundation and persons other than disqualified persons with respect to such foundation will not be treated as prohibited under the preceding sentence, but only if such contractual obligations were not entered into pursuant to a plan to terminate the private foundation status of the transferor under section 507(b)(1)(A) and if the continuation of such contractual obligations is in the best interests of the public charity.

(G) *Other conditions.* Any other condition is imposed on action by the public charity which prevents it from exercising ultimate control over the assets received from the transferor private foundation for purposes consistent with its exempt purposes.

(v) *Examples.* The provisions of paragraph (a)(8) of this sectiom may be illustrated by the following examples:

Example 1. The M Private Foundation transferred all of its net assets to the V Cancer Institute, a public charity described in section 170(b)(1)(A)(iii). Prior to the transfer, M's activities consisted of making grants to hospitals and universities to further research into the causes of cancer. Under the terms of the transfer, V is required to keep M's assets in a separate fund and use the income and principal to further cancer research. Although the assets may be used only for a limited purpose, this purpose is consistent with and in furtherance of V's exempt purposes, and does not prevent the transfer from being a distribution for purposes of section 507(b)(1)(A).

Example 2. The N Private Foundation transferred all of its net assets to W University, a public charity described in section 170(b)(1)(A)(ii). Under the terms of the transfer, W is required to use the income and principal to endow a chair at the university to be known as the ''John J. Doe Memorial Professorship'', named after N's creator. Although the transferred assets are to be used for a specified purpose by W, this purpose is in furtherance of W's exempt educational purposes, and there are no conditions on investment or reinvestment of the principal or income. The use of the name of the foundation's creator for the chair is not a restriction which would prevent the transfer from being a distribution for purposes of section 507(b)(1)(A).

Example 3. The O Private Foundation transferred all of its net assets to X Bank as trustee for the P Community Trust, a community trust which is a public charity described in section 170(b)(1)(A)(vi). Under the terms of the transfer, X is to hold the assets in trust for P and is directed to distribute the income annually to the Y Church, a public charity described in Section 170(b)(1)(A)(i). The distribution of income to Y Church is consistent with P's exempt purposes. If the trust created by this transfer otherwise meets the requirements of §1.170A–9(e)(11) as a component part of P Community Trust, and assets transferred by O to X will be treated as distributed to one or more public charities within the meaning of section 507(b)(1)(A). The direction to distribute the income to Y Church meets the conditions of paragraph (a)(8)(iii)(B) of this section and will therefore not disqualify the transfer under section 507(b)(1)(A).

Example 4. The U Private Foundation transferred all of its net assets to Z Bank as trustee for the R Community Trust, a community trust which is a public charity described in section 170(b)(1)(A)(vi). Under the terms of the transfer, Z is to hold the assets in trust for R and distribute the income to those public charities described in section 170(b)(1)(A) (i) through (vi) that are designated by B, the creator of U. R's governing body has no authority during B's lifetime to vary B's direction. Under the terms of the transfer, it is intended that Z retain the transferred assets in their present form for a period of 20 years, or until the date of B's death if it occurs before the expiration of such period. Upon the death of B, R will have the power to distribute the income to such public charities as it selects and may dispose of the corpus as it sees fit.

Under paragraph (a)(8)(iv) (A) or (D) of this section, as a result of the restrictions imposed with respect to the transferred assets, there has been no distribution of all U's net assets within the meaning of section 507(b)(1)(A) at the time of the transfer. In addition, U has not transferred its net assets to a component part of R Community Trust, but rather to a separate trust described in §1.170A–9(e)(14).

(vi) *Transitional rule.* If the governing instrument of the public charity (or an instrument of transfer) lacks the factors described in paragraph (a)(8)(i)(D) or (ii) of this section, but with respect to gifts or bequests acquired before January 1, 1982, the public charity changes its governing instrument (or instrument of transfer) by the later of November 11, 1977, or one year after the gift or bequest is acquired, in order to conform such instrument to such provisions, then such an instrument shall be treated as consistent with such provisions for taxable years beginning prior to the date of change. In addition, if prior to the later of such dates, the organization has instituted court proceedings in order to conform such an instrument, then it may apply (prior to the later of such dates) for an extension of the period to conform such instrument to such provisions. Such application shall be made to the Commissioner of Internal Revenue, Attention E:EO, Washington, DC 20224. The Commissioner, at the Commissioner's discretion, may grant such an extension, if in the Commissioner's opinion such a change will conform the instrument to such provisions, and the change will be made within a reasonable time.

(b) *Operation as a public charity*— (1) *In general.* Under section 507(b)(1)(B) an organization can terminate its private foundation status if the organization:

(i) Meets the requirements of section 509(a) (1), (2), or (3) by the end of the 12-month period (as extended by paragraph (c)(3)(i) of this section) beginning with its first taxable year which begins after December 31, 1969, or for a continuous period of 60 calendar months beginning with the first day of any taxable year which begins after December 31, 1969;

(ii) In compliance with section 507(b)(1)(B)(ii) and subparagraph (3) of this paragraph, properly notifies the district director before the commencement of such 12-month or 60-month period or before March 29, 1973 that it is terminating its private foundation status; and

(iii) Properly establishes immediately after the expiration of such 12-month or 60-month period that such organization has complied with the requirements of section 509(a) (1), (2), or (3) by the end of the 12-month period or during the 60-month period, as the case may be, in the manner described in subparagraph (4) of this paragraph.

(2) *Relationship of section 507(b)(1)(B) to section 507 (a), (c), and (g).* Since section 507(a) does not apply to a termination described in section 507(b)(1)(B), a private foundation's notification that it is commencing a termination pursuant to section 507(b)(1)(B) will not be treated as a notification described in section 507(a) even if the private foundation does not successfully terminate its private foundation status pursuant to section 507(b)(1)(B). A private foundation which terminates its private foundation status under section 507(b)(1)(B) does not incur tax under section 507(c) and, therefore, no abatement of such tax under section 507(g) is required.

(3) *Notification of termination.* In order to comply with the requirements under section 507(b)(1)(B)(ii), an organization shall before the commencement of the 12-month or 60-month period under section 507(b)(1)(B)(i) (or before March 29, 1973) or, in the case of the 12-month period for a community trust, before May 11, 1977, notify the district director of its intention to terminate its private foundation status.

Such notification shall contain the following information:

(i) The name and address of the private foundation;

(ii) Its intention to terminate its private foundation status;

(iii) Whether the 12-month or 60-month period shall apply;

(iv) The Code section under which it seeks classification (section 509(a) (1), (2), or (3));

(v) If section 509(a)(1) is applicable, the clause of section 170(b)(1)(A) involved;

(vi) The date its regular taxable year begins; and

(vii) The date of commencement of the 12-month or 60-month period.

(4) *Establishment of termination.* In order to comply with the requirements under section 507(b)(1)(B)(iii), an organization shall within 90 days after the expiration of the 12-month or 60-month period, file such information with the district director as is necessary to make a determination as to the organization's status as an organization described under section 509(a) (1), (2), or (3) and the regulations thereunder. See paragraphs (c) and (d) of this section as to the information required to be submitted under this subparagraph.

(5) *Incomplete information; 12- and 60-month terminations.* The failure to supply, within the required time, all of the information required by subparagraph (3) or (4) of this paragraph is not alone sufficient to constitute a failure to satisfy the requirements of section 507(b)(1)(B). If the information which is submitted within the required time is

incomplete and the organization supplies the necessary additional information at the request of the Commissioner within the additional time period allowed by him, the original submission will be considered timely.

(6) *Application of special rules and filing requirements.* An organization which has terminated its private foundation status under section 507(b)(1)(B) is not required to comply with the special rules set forth in section 508 (a) and (b). Such organization is also not required to file a return under the provisions of section 6043(b) or 6050 by reason of termination of its private foundation status under the provisions of section 507(b)(1)(B).

(7) *Extension of time to assess deficiencies.* If a private foundation files a notification (described in subparagraph (3) of this paragraph) that it intends to begin a 60-month termination pursuant to section 507(b)(1)(B) and does not file a request for an advance ruling pursuant to paragraph (e) of this section, such private foundation may file with the notification described in subparagraph (3) of this paragraph a consent under section 6501(c)(4) to the effect that the period of limitation upon assessment under section 4940 for any taxable year within the 60-month termination period shall not expire prior to 1 year after the date of the expiration of the time prescribed by law for the assessment of a deficiency for the last taxable year within the 60-month period. Such consents, if filed, will ordinarily be accepted by the Commissioner. See paragraph (f)(3) of this section for an illustration of the procedure required to obtain a refund of the tax imposed by section 4940 in a case where such a consent is not in effect.

(c) *Twelve-month terminations*—(1) *Method of determining normal sources of support*—(i) *In general.* The 12-month termination provisions of section 507(b)(1)(B) permit a private foundation to terminate its private foundation status by changing its organizational structure, its operations, the sources of its support, or any combination thereof, in order to conform to the requirements of section 509(a) (1), (2), or (3) by the end of the 12-month period.

(ii) *Support requirements for 12-month termination under section 170(b)(1)(A)(vi).* A private foundation attempting to meet the requirements of section 509(a)(1) as an organization described in section 170(b)(1)(A)(vi) will be considered *normally* to receive a substantial part of its support from governmental units or direct or indirect contributions from the general public if it can establish that it has changed the sources of its support before the close of the 12-month period to those of an organization described in section 170(b)(1)(A)(vi) and it can reasonably be expected to maintain its publicly supported status for subsequent years. In order to establish these facts, an organization shall submit all information sufficient to make a determination under §1.170A–9(e) as if such provisions applied, including a description of all organizational and operational changes which have occurred during the 12-month period. It shall also submit detailed information with respect to its sources of support for the 12-month period, as well as for the four taxable years immediately preceding the 12-month period. In applying the tests contained in §1.170A–9(e), however, data from periods preceding the 12-month period shall be disregarded except for purposes of determining whether the organization has effectively changed its sources of support and whether it can reasonably be expected to maintain such publicly supported status for subsequent years. Thus, for example, in applying the mathematical tests of §1.170A–9(e) only data for the 12-month period may enter into the computation.

(iii) *Support requirements for 12-month terminations under section 170(b)(1)(A)(iv).* Section 170(b)(1) (A)(iv) describes an organization which *normally* receives a substantial part of its support (exclusive of income from related activities) from the United States or any State or political subdivision thereof, or from the general public, and which is organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of certain colleges or universities. For purposes of the 12-month termination period, the rule set forth in subdivision (ii) of this subparagraph with respect to section 170(b)(1)(A)(vi) organizations shall be applicable in determining whether an organization *normally* receives a substantial part of its support from the sources required under section 170(b)(1)(A)(iv).

(iv) *Support requirements for 12-month terminations under section 509(a)(2).* An organization attempting to terminate its private foundation status under section 507(b)(1)(B) by meeting the requirements of section 509(a)(2) by the end of the 12-month period will be considered as *normally* receiving its support in compliance with the one-third support requirements of section 509(a)(2) if:

(A) For the 12-month period under section 507(b)(1)(B), the organization receives more than one-third of its support from gifts, grants, contributions, membership fees, and gross receipts from related activities (as limited by section 509(a)(2)(A)(ii)) and not more than one-third of its support from items described in section 509 (a)(2)(B), and

(B) The organization can establish that it can reasonably be expected to maintain its continued public support for subsequent years. In order to establish a reasonable expectation of continued public support, an organization shall submit a detailed statement describing its past and current operations, any organizational or operational changes and when such changes have occurred, and any changes in its foundation managers (as defined in section 4946(b)(1)). Duplicate copies of its governing instrument and bylaws, with an indication of any amendments made, and detailed information with respect to its sources of support for the 4 taxable years immediately preceding the 12-month period shall also be submitted as part of the evidence that the organization can reasonably be expected to maintain its publicly supported status.

(2) *Organizational and operational tests*—(i) *Section 509(a)(3) organizations*—(A) *In general.* An organization attempting to terminate its private foundation status under section 507(b)(1)(B) by meeting the requirements of section 509(a)(3) by the end of the 12-month period is required to meet the organizational and operational test of section 509(a)(3)(A), in addition to the requirements of section 509(a)(3) (B) and (C), by the end of the 12-month period beginning with its first taxable year which begins after December 31, 1969. An organization may qualify under section 509(a)(3)(A) even though its original governing instrument did not limit its purposes to those set forth in section 509(a)(3)(A) and even though it operated for some other purpose before the end of the 12-month period, if it has amended its governing instrument and changed its operations to conform to the requirements of section 509(a)(3) by the end of the 12-month period.

(B) *Proof of changed status.* In order to establish that an organization described in (A) of this subdivision will continue to be operated exclusively for the required purposes in years subsequent to the end of the 12-month period, such organization shall submit a detailed statement describing its past and current operations, any organizational or operational changes and when such changes have occurred, any changes in foundation managers (as defined in section 4946(b)(1)), and duplicate copies of its governing instrument and bylaws, with an indication of any amendments made. A detailed statement of the relationship between such organization and the specified organizations described in section 509(a) (1) or (2) (as required by section 509(a)(3) (A) and (B)) and all pertinent information to establish that the organization does not violate the control requirements of section 509(a)(3)(C) shall also be submitted.

(ii) *Section 509(a)(1) organizations other than those described in section 170(b)(1)(A)(vi)*—

(A) *In general.* An organization attempting to terminate its private foundation status under section 507(b)(1)(B) by meeting the requirements of section 170(b)(1)(A) (i), (ii), (iii), (iv), or (v) by the end of the 12-month period is required to be operated as an organization described in clauses (i), (ii), (iii), (iv), or (v) of section 170(b)(1)(A) by the end of the 12-month period beginning with its first taxable year which begins after December 31, 1969.

(B) *Proof of changed status.* In order to establish that it will continue to be operated as an organization described in section 509(a)(1) in years subsequent to the end of the 12-month period, the organization shall submit a detailed statement describing its past and current operations, any organizational or operational changes and when such changes have occurred, and any changes in its foundation managers (as defined in section 4946(b)(1)). Duplicate copies of its governing instrument and bylaws, with an indication of any amendments made, and its financial statements for the 4-taxable years immediately preceding the 12-month period shall also be submitted as evidence that the organization can reasonably be expected to maintain its status as an organization described in section 170(b)(1)(A)(i), (ii), (iii), (iv), or (v).

(3) *Extensions of the 12-month period.* (i) For purposes of this section, an organization may accomplish a 12-month termination if it meets the requirements of section 507(b)(1)(B) and this paragraph for such a termination with respect to any of the following periods:

(A) The 12-month period beginning with the organization's first taxable year which begins after December 31, 1969;

(B) The period described in paragraph (a)(5)(ii) of this section; or

(C) Any period consisting of two or more taxable years beginning with the organization's first taxable year beginning after December 31, 1969, and ending with any taxable year ending before the end of the period described in paragraph (a)(5)(ii) of this section.

(ii) An organization will be considered as ''normally'' meeting the requirements of section 170(b)(1)(A) (iv) or (vi) or 509(a)(2), as the case may be, if it meets the requirements of such provision with respect to any period described in subdivision (i) (A), (B), or (C) of this subparagraph. Thus, for example, an organization on a calendar year basis which seeks to convert to a section 509(a)(2) organization under section 507(b)(1)(B) may meet the one-third support requirement based on the aggregate support received during a period described in subdivision (i) (A), (B), or (C) of this subparagraph, for purposes of subparagraph (1)(iv) of this paragraph.

(4) *Status of organization subsequent to the 12-month period.* For purposes of sections 507 through 509, an organization, the status of which as a private foundation is terminated under section 507(b)(1), shall (except as provided in paragraph (b)(6) of this section) be treated as an organization created on the day after the date of such termination. However, termination of private foundation status under the provisions of section 507(b)(1)(B) is based upon an organization's submission of information establishing compliance by the end of the 12-month period with the requirements of subparagraph (1) or (2) of this paragraph. Therefore, if in the 4 taxable years immediately following the end of the 12-month period, the sources of support or the methods of operation of the organization are materially different from the facts and circumstances presented during the 12-month period upon which the determination under section 507(b)(1)(B)(iii) was made (and such material difference adversely affects such determination), the organization will be deemed not to have satisfied the requirements of section 507(b)(1)(B). Under such circumstances, section 509(c) will not apply and the organization will continue to remain subject to the provisions of section 507. However, the status of grants and contributions under sections 170, 4942, and 4945 will not be affected until the Internal Revenue Service makes notice to the public (such as by publication in the Internal Revenue Bulletin) that the organization has been deleted from classification as an organization described in section 509(a) (1), (2), or (3) unless the donor (1) was in part responsible for, or was aware of, the act or failure to act that resulted in the organization's inability to satisfy the requirements of section 507(b) (1)(B), or (2) had knowledge that such organization would be deleted from classification as an organization described in section 509(a) (1), (2), or (3). Prior to the making of any grant or contribution which allegedly will not result in the grantee's loss of classification under section 509(a) (1), (2), or (3), a potential grantee organization may request a ruling whether such grant or contribution may be made without such loss of classification. A request for such ruling may be filed by

the grantee organization with the district director. The issuance of such ruling will be at the sole discretion of the Commissioner.

(d) *Sixty-month terminations*—(1) *Method of determining normal sources of support.* (i) In order to meet the requirement of section 507(b)(1)(B) for the 60-month termination period as a section 509(a) (1) or (2) organization, an organization must meet the requirements of section 509(a) (1) or (2), as the case may be, for a continuous period of at least 60 calendar months. In determining whether an organization seeking status under section 509(a)(1) as an organization described in section 170(b)(1)(A) (iv) or (vi) or under section 509(a)(2) ''normally'' meets the requirements set forth under such sections, support received in taxable years prior to the commencement of the 60-month period shall not be taken into consideration, except as otherwise provided in this section. Therefore, in such cases rules similar to the rules applicable to new organizations would apply.

(ii) For purposes of section 507(b)(1)(B), an organization will be considered to be a section 509(a)(1) organization described in section 170(b)(1)(A)(vi) for a continuous period of 60 calendar months only if the organization satisfies the provisions of § 1.170A–9(e) based upon aggregate data for such entire period, rather than for any shorter period set forth in § 1.170A–9(e). Except for the substitution of such 60-month period for the periods described in § 1.170A–9(e), all other provisions of such regulations pertinent to determining an organization's normal sources of support shall remain applicable.

(iii) For purposes of section 507(b)(1)(B), an organization will be considered to be a section 509(a)(2) organization only if such organization meets the support requirements set forth in section 509(a)(2) (A) and (B) for the continuous period of 60 calendar months prescribed under section 507(b)(1)(B), rather than for any shorter period set forth in the regulations under section 509(a)(2). Except for the substitution of such 60-month period for the periods described in the regulations under section 509(a)(2), all other provisions of such regulations pertinent to determining an organization's normal sources of support shall remain applicable.

(2) *Organizational and operational tests.* In order to meet the requirements of section 507(b)(1)(B) for the 60-month termination period as an organization described in section 170(b)(1)(A) (i), (ii), (iii), (iv), or (v) or section 509(a)(3), as the case may be, an organization must meet the requirements of the applicable provision for a continuous period of at least 60 calendar months. For purposes of section 507(b)(1)(B), an organization will be considered to be such an organization only if it satisfies the requirements of the applicable provision (including with respect to section 509(a)(3), the organizational and operational test set forth in subparagraph (A) thereof) at the commencement of such 60-month period and continuously thereafter during such period.

(e) *Advance rulings for 60-month terminations*—(1) *In general.* An organization which files the notification required by section 507(b)(1)(B)(ii) that it is commencing a 60-month termination may obtain an advance ruling from the Commissioner that it can be expected to satisfy the requirements of section 507(b)(1)(B)(i) during the 60-month period. Such an advance ruling may be issued if the organization can reasonably be expected to meet the requirements of section 507(b)(1)(B)(i) during the 60-month period. The issuance of a ruling will be discretionary with the Commissioner.

(2) *Basic consideration.* In determining whether an organization can reasonably be expected (within the meaning of subparagraph (1) of this paragraph) to meet the requirements of section 507(b)(1)(B)(i) for the 60-month period, the basic consideration is whether its organizational structure (taking into account any revisions made prior to the beginning of the 60-month period), proposed programs or activities, intended method of operation, and projected sources of support are such as to indicate that the organization is likely to satisfy the requirements of section 509(a) (1), (2), or (3) and paragraph (d) of this section during the 60-month period. In making such a determination, all pertinent facts and circumstances shall be considered.

(3) *Reliance by grantors and contributors.* For purposes of sections 170, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522, grants or contributions to an organization which has obtained a ruling referred to in this paragraph will be treated as made to an organization described in section 509(a) (1), (2), or (3), as the case may be, until notice that such advance ruling is being revoked is made to the public (such as by publication in the Internal Revenue Bulletin). The preceding sentence shall not apply, however, if the grantor or contributor was responsible for, or aware of, the act or failure to act that resulted in the organization's failure to meet the requirements of section 509(a) (1), (2), or (3), or acquired knowledge that the Internal Revenue Service had given notice to such organization that its advance ruling would be revoked. Prior to the making of any grant or contribution which allegedly will not result in the grantee's failure to meet the requirements of section 509(a) (1), (2), or (3), a potential grantee organization may request a ruling whether such grant or contribution may be made without such failure. A request for such ruling may be filed by the grantee organization with the district director. The issuance of such ruling will be at the sole discretion of the Commissioner. The organization must submit all information necessary to make a determination on the factors referred to in subparagraph (2) of this paragraph. If a favorable ruling is issued, such ruling may be relied upon by the grantor or contributor of the particular contribution in question for purposes of sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522.

(4) *Reliance by organization.* An organization obtaining an advance ruling pursuant to this paragraph cannot rely on such a ruling. Consequently, if the organization does not pay the tax imposed by section 4940 for any taxable year or years during the 60-month period, and it is subsequently determined that such tax is due for such year or years (because the organization did not in fact complete a successful termination pursuant to section 507(b)(1)(B) and was not treated as an organization described in section 509(a) (1), (2), or (3) for such year or years), the organization is liable for interest in accordance with section 6601 if any amount of tax under section 4940 has not been paid on or before the last date prescribed for payment. However, since any failure to pay such tax during the 60-month period (or prior to the revocation of such ruling) is due to reasonable cause, the penalty under section 6651 with respect to the tax imposed by section 4940 shall not apply.

(5) *Extension of time to assess deficiencies.* The advance ruling described in subparagraph (1) of this paragraph shall be issued only if such organization's request for an advance ruling is filed with a consent under section 6501(c)(4) to the effect that the period of limitation upon assessment under section 4940 for any taxable year within the advance ruling period shall not expire prior to 1 year after the date of the expiration of the time prescribed by law for the assessment of a deficiency for the last taxable year within the 60-month period.

(f) *Effect on grantors or contributors and on the organization itself*—(1) *Effect of satisfaction of requirements for termination*—(i) *Treatment during the termination period.* In the event that an organization satisfies the requirements of section 507(b)(1)(B) for termination of its private foundation status by the end of the 12-month period or during the continuous 60-month period, such organization shall be treated for such entire 12-month or 60-month period in the same manner as an organization described in section 509(a) (1), (2), or (3).

(ii) *Twelve-month terminations by fiscal year organizations.* In the case of an organization which operates on a fiscal year basis and terminates its private foundation status by the end of the 12-month period beginning with its first taxable year which begins after December 31, 1969, such 12-month period shall, for purposes of this paragraph, be treated as including the period between January 1, 1970, and the last day of the taxable year immediately preceding its first taxable year which begins after December 31, 1969, so long as the requirements of section 507(b)(1)(B) and paragraph (c) of this section are met by the end of the 12-month period (including such additional period).

(2) *Failure to meet termination requirements*—(i) *In general.* Except as otherwise provided in subdivision (ii) of this subparagraph and paragraph (e) of this section, any organization which fails to satisfy the requirements of section 507(b)(1)(B) for termination of its private foundation status by the end of the 12-month period or during the continuous 60-month period shall be treated as a private foundation for the entire 12-month or 60-month period, for purposes of sections 507 through 509 and chapter 42, and grants or contributions to such an organization shall be treated as made to a private foundation for purposes of sections 170, 507(b)(1)(A), 4942, and 4945.

(ii) *Certain 60-month terminations.* Notwithstanding subdivision (i) of this subparagraph, if an organization fails to satisfy the requirements of section 509(a) (1), (2), or (3) for the continuous 60-month period but does satisfy the requirements of section 509(a) (1), (2), or (3), as the case may be, for any taxable year or years during such 60-month period, the organization shall be treated as a section 509(a) (1), (2), or (3) organization for such taxable year or years and grants or contributions made during such taxable year or years shall be treated as made to an organization described in section 509(a) (1), (2), or (3). In addition, sections 507 through 509 and chapter 42 shall not apply to such organization for any taxable year within such 60-month period for which it does meet such requirements. For purposes of determining whether an organization satisfies the requirements of section 509(a) (1), (2), or (3) for any taxable year in the 60-month period, the organization shall be treated as if it were a new organization with its first taxable year beginning on the date of the commencement of the 60-month period. Thus, for example, if an organization were attempting to terminate its private foundation status under section 507(b)(1)(B) by meeting the requirements of section 170(b)(1)(A)(vi), the rules under § 1.170A–9(e) relating to the initial determination of status of a new organization would apply.

(iii) *Aggregate tax benefit.* For purposes of section 507(d), the organization's aggregate tax benefit resulting from the organization's section 501(c)(3) status shall continue to be computed from the date from which such computation would have been made, but for the notice filed under section 507(b)(1)(B)(ii), except that any taxable year within such 60-month period for which such organization meets the requirements of section 509(a) (1), (2), or (3) shall be excluded from such computations.

(iv) *Excess business holdings.* See section 4943 and the regulations thereunder for rules relating to decreases in a private foundation's holdings in a business enterprise which are caused by the foundation's failure to terminate its private foundation status after giving the notification for termination under section 507(b)(1)(B)(ii).

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

Example. Y, a calendar year private foundation, notifies the district director that it intends to terminate its private foundation status by converting into a publicly supported organization described in section 170(b)(1)(A)(vi) and that its 60-month termination period will commence on January 1, 1974. Y does not obtain a ruling described in paragraph (e) of this section. Based upon its support for 1974 Y does not qualify as a publicly supported organization within the meaning of § 1.170A–9(e) and this paragraph. Consequently, in order to avoid the risks of penalties and interest if Y fails to terminate within the 60-month period, Y files its return as a private foundation and pays the tax imposed by section 4940. Similarly, based upon its support for the period 1974 through 1975, fails to qualify as such a publicly supported organization and files its return and pays the tax imposed by section 4940 for both 1975 and 1976. Since a consent (described in paragraph (b)(7) of this section) which would prevent the period of limitation from expiring is not in effect, in order to be able to file a claim for refund, Y and the district director agree to extend the period of limitation for all taxes imposed under chapter 42. However, based upon its support for the period 1974 through 1976 Y does qualify as a publicly supported organization, and therefore shall not be treated as a private foundation for either 1977 or 1978 even if it fails to terminate within the 60-month period. However, based upon the aggregate data for the entire 60-month period (1974 through 1978), Y does qualify as an organization described in section 170(b)(1)(A)(vi). Consequently, pursuant to this paragraph, Y is treated as if it had been a publicly supported organization for the entire 60-month period. Y files claim for refund for the taxes paid under section 4940 for the years 1974, 1975, and 1976, and such taxes are refunded.

(g) *Special transitional rules for organizations operating as public charities.* Section 4940 imposes a tax upon private foundations with respect to the carrying on of activities for each taxable year. For purposes of section 4940, an organization which terminates its private foundation status under section 507(b)(1)(B) by the end of the period described in paragraph (a)(5)(ii) of this section will not be considered as carrying on activities within the meaning of section 4940 during such period. Such organization will therefore not be subject to the tax imposed under section 4940 for such period. Consequently, in the case of an organization seeking to terminate its private foundation status under section 507(b)(1)(B) if the period described in paragraph (a)(5)(ii) of this section has not expired prior to the due date for the organization's annual return required to be filed under section 6033 or 6012 (determined with regard to any extension of time for filing the return) for its first taxable year which begins after December 31, 1969 (or any other taxable year ending before the expiration of the period described in paragraph (a)(5)(ii) of this paragraph) and if the organization has not terminated its private foundation status under section 507(b)(1)(B) by such date, then notwithstanding the provisions of paragraph (f) of this section, the organization must take either of the following courses of action:

(1) Complete and file its annual return including the line relating to excise taxes on investment income, by such date, and pay the tax on investment income imposed under section 4940 at the time it files its annual return. If such organization subsequently terminates its private foundation status under section 507(b)(1)(B) within a period specified in paragraph (c)(3)(i) of this section, it may file a claim for refund of the tax paid under section 4940; or

(2) Complete and file its annual return, except for the line relating to excise taxes on investment income, by such date, and in lieu of paying the tax on investment income imposed under section 4940, file a statement with its annual return which establishes that the organization has taken affirmative action by such date to terminate its private foundation status under section 507(b)(1)(B). Such statement must indicate the type of affirmative action taken and explain how such action will result in the termination of its private foundation status under section 507(b)(1)(B). Such affirmative action may include making application to the appropriate State court for approval to amend the provisions of the organization's trust instrument to limit payments to specified section 509(a) (1) or (2) beneficiaries pursuant to section 509(a)(3) in the case of a charitable trust; commencing a fund-raising drive among the general public in the case of an organization seeking to become a section 170(b)(1)(A)(vi) or 509(a)(2) organization; or the passage of a resolution by the organization's governing body or the filing of an amendment to the organization's articles of incorporation permitting a change in the operations of the organization to enable it to conform to the provisions of section 509(a) (1), (2), or (3) in the case of a not-for-profit corporation. An organization may take such affirmative action and may terminate its private foundation status under section 507(b)(1)(B) in reliance upon 26 CFR 13.12 (rev. as of Jan. 1, 1972) and upon the provisions of the notices of proposed rulemaking under sections 170(b)(1)(A), 507(b)(1), and 509. Thus, if an organization meets the requirement of the provisions of the notice of proposed rulemaking as a section 509(a)(3) organization, such organization may terminate its private foundation status under section 507(b)(1)(B) in reliance upon such provisions prior to the expiration of the period described in paragraph (a)(5)(ii) of this section. If such organization, however, fails to terminate its private foundation status under section 507(b)(1)(B) within the period specified in paragraph (a)(5)(ii) of this section by failing to meet the requirements of either the notices of proposed rulemaking under section 170(b)(1)(A), 507(b)(1), or 509 or the final regulations published under these Code sections, the tax imposed under section 4940 shall be treated as if due from the due date for its annual return (determined without regard to

any extension of time, for filing its return).

[T.D. 7248, 38 FR 861, Jan. 5, 1973; 38 FR 3598, Feb. 8, 1973; 38 FR 4259, Feb. 12, 1973, as amended by T.D. 7290, 38 FR 31833, Nov. 19, 1973; T.D. 7440, 41 FR 50654, Nov. 17, 1976; 41 FR 52454, Nov. 30, 1976; T.D. 7465, 42 FR 4437, Jan. 25, 1977; T.D. 7784, 46 FR 37889, July 23, 1981]

§ 1.507–3 Special rules; transferee foundations.

(a) *General rule.* (1) For purposes of part II, subchapter F, chapter 1 of the Code, in the case of a transfer of assets of any private foundation to another private foundation pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization, the transferee organization shall not be treated as a newly created organization. Thus, in the case of a significant disposition of assets to one or more private foundations within the meaning of paragraph (c) of this section, the transferee organization shall not be treated as a newly created organization. A transferee organization to which this paragraph applies shall be treated as possessing those attributes and characteristics of the transferor organization which are described in subparagraphs (2), (3), and (4) of this paragraph.

(2)(i) A transferee organization to which this paragraph applies shall succeed to the aggregate tax benefit of the transferor organization in an amount determined as follows: Such amount shall be an amount equal to the amount of such aggregate tax benefit multiplied by a fraction the numerator of which is the fair market value of the assets (less encumbrances) transferred to such transferee and the denominator of which is the fair market value of the assets of the transferor (less encumbrances) immediately before the transfer. Fair market value shall be determined as of the time of the transfer.

(ii) Notwithstanding subdivision (i) of this subparagraph, a transferee organization which is not effectively controlled (within the meaning of § 1.482–1(a)(3)), directly or indirectly, by the same person or persons who effectively control the transferor organization shall not succeed to an aggregate tax benefit in excess of the fair market value of the assets transferred at the time of the transfer.

(iii) This subparagraph may be illustrated by the following examples:

Example 1. Pursuant to a transfer described in section 507(b)(2), F, a private foundation, transfers to G, a private foundation, all of its assets, which have a fair market value of $400,000. Immediately before the transfer F's aggregate tax benefit was $200,000, and G's aggregate tax benefit was $300,000. After the transfer G's aggregate tax benefit is $500,000 ($200,000+$300,000).

Example 2. Pursuant to a transfer described in section 507(b)(2), M, a private foundation, transfers all of its assets, which immediately prior to the transfer have a fair market value of $100,000. The assets were transferred to the following organizations at the following fair market values (determined at the time of transfer) $40,000 to N, a private foundation, $30,000 to O, a private foundation, and $30,000 to P, an organization described in section 170(b)(1)(A)(vi). Immediately before the transfer M's aggregate tax benefit was $50,000. Therefore, N succeeds to M's aggregate tax benefit to the extent of $20,000 ($50,000×$40,000/$100,000) and O succeeds to M's aggregate tax benefit to the extent of $15,000 ($50,000×$30,000/$100,000). The remaining $15,000 of M's aggregate tax benefit is retained by M as M has not terminated under section 507.

Example 3. Assume the same facts as in Example 2 except that the transfers were made as follows: M transferred $30,000 to N on January 1, 1972, $40,000 to P on July 1, 1972, and $30,000 to O on December 31, 1972. Further, assume that the fair market value of the assets and the aggregate tax benefit do not change during 1972 and that O is not effectively controlled (directly or indirectly) by the same person or persons who effectively control M. N succeeds to M's aggregate tax benefit to the extent of $15,000 ($50,000×$30,000/$100,000). However, since $40,000 of the remaining $70,000 ($100,000−$30,000) of assets of M was transferred to P on July 1, 1972, immediately before the transfer to O, the fair market value of the assets held by M is $30,000 ($70,000−$40,000). On the other hand, because P is not a private foundation, M's aggregate tax benefit immediately before the transfer to O remains $35,000 ($50,000−$15,000). Therefore, before applying subdivision (ii) of this subparagraph, O would succeed to $35,000 ($35,000×$30,000/$30,000) of M's aggregate tax benefit. However, applying subdivision (ii) of this subparagraph since M transferred only $30,000 to O, O shall succeed to only $30,000 of M's aggregate tax benefit. The remaining $5,000 ($35,000−$30,000) of M's aggregate tax benefit is retained by M as M has not terminated under section 507.

(3) For purposes of section 507(d)(2), in the event of a transfer of assets described in section 507(b)(2), any person who is a *substantial contributor* (within the meaning of section 507(d)(2)) with respect to the transferor foundation shall be treated as a *substantial contributor* with respect to the transferee foundation, regardless of whether such person meets the $5,000-two percent test with respect to the transferee organization at any time. If a private foundation makes a transfer described in section 507(b)(2) to two or more transferee private foundations, any person who is a *substantial contributor* with respect to the transferor foundation prior to such transfer shall be considered a *substantial contributor* with respect to each transferee private foundation.

(4) If a private foundation incurs liability for one or more of the taxes imposed under chapter 42 (or any penalty resulting therefrom) prior to, or as a result of, making a transfer of assets described in section 507(b)(2) to one or more private foundations, in any case where transferee liability applies each transferee foundation shall be treated as receiving the transferred assets subject to such liability to the extent that the transferor foundation does not satisfy such liability.

(5) Except as provided in subparagraph (9) of this paragraph, a private foundation is required to meet the distribution requirements of section 4942 for any taxable year in which it makes a section 507(b)(2) transfer of all or part of its net assets to another private foundation. Such transfer shall itself be counted toward satisfaction of such requirements to the extent the amount transferred meets the requirements of section 4942(g). However, where the transferor has disposed of all of its assets, the recordkeeping requirements of section 4942(g)(3)(B) shall not apply during any period in which it has no assets. Such requirements are applicable for any taxable year other than a taxable year during which the transferor has no assets.

(6) For purposes of section 4943(c) (4), (5), and (6), whenever a private foundation makes a section 507(b)(2) transfer of all or part of its net assets to another private foundation, the applicable period of time described in section 4943(c) (4), (5), or (6) shall include both the period during which the transferor foundation held such assets and the period during which the transferee foundation holds such assets.

(7) Except as provided in subparagraph (9) of this paragraph, where the transferor has disposed of all of its assets, during any period in which the transferor has no assets, section 4945 (d)(4) and (h) shall not apply to the transferee or the transferor with respect to any *expenditure responsibility* grants made by the transferor. However, the exception contained in this subparagraph shall not apply with respect to any information reporting requirements imposed by section 4945 and the regulations thereunder for any year in which any such transfer is made.

(8)(i) Except as provided in subdivision (ii) of this subparagraph or subparagraph (6) or (9) of this paragraph or whenever a private foundation makes a transfer of assets described in section 507(b)(2) to one or more private foundations, the transferee foundation:

(a) Will not be treated as being in existence prior to January 1, 1970, with respect to any transferred assets;

(b) Will not be treated as holding the transferred assets prior to January 1, 1970; and

(c) Will not be treated as having engaged in, or become subject to, any transaction, lease, contract, or other obligation with respect to the transferred assets prior to January 1, 1970.

(ii) Notwithstanding subdivision (i) of this subparagraph, the provisions enumerated in *(a)* through *(g)* of this subdivision shall apply to the transferee foundation with respect to the assets transferred to the same extent and in the same manner that they would have applied to the transferor foundation had the transfer described in section 507(b)(2) not been effected:

(a) Section 4940(c)(4)(B) and the regulations thereunder with respect to basis of property,

(b) Section 4942(f)(4) and the regulations thereunder with respect to distributions of income,

(c) Section 101(l)(2) of the Tax Reform Act of 1969 (83 Stat. 533), as amended by

sections 1301 and 1309 of the Tax Reform Act of 1976 (90 Stat. 1713, 1729), with respect to the provisions of section 4941,

(d) Section 101*(l)*(3)(A) of the Tax Reform Act of 1969 (83 Stat. 534) with respect to the provisions of section 4942, but only if the transferor qualified for the application of such section immediately before the transfer, and at least 85 percent of the fair market value of the net assets of the transferee immediately after the transfer was received pursuant to the transfer,

(e) Section 101*(l)*(3) (B) through (E) of the Tax Reform Act of 1969 (83 Stat. 534) with respect to the provisions of section 4942,

(f) Section 101(l)(5) of the Tax Reform Act of 1969 (83 Stat. 535) with respect to the provisions of section 4945, and

(g) Section 101*(l)*(6) of the Tax Reform Act of 1969 (83 Stat. 535) with respect to the provisions of section 508(e).

(9) (i) If a private foundation transfers all of its net assets to one or more private foundations which are effectively controlled (within the meaning of § 1.482–1(a)(3)), directly or indirectly, by the same person or persons which effectively controlled the transferor private foundation, for purposes of chapter 42 (section 4940 *et seq.*) and part II of subchapter F of chapter 1 of the Code (sections 507 through 509) such a transferee private foundation shall be treated as if it were the transferor. However, where proportionality is appropriate, such a transferee private foundation shall be treated as if it were the transferor in the proportion which the fair market value of the assets (less encumbrances) transferred to such transferee bears to the fair market value of the assets (less encumbrances) of the transferor immediately before the transfer.

(ii) Subdivision (i) of this subparagraph shall not apply to the requirements under sections 6033, 6056, and 6104 which must be complied with by the transferor private foundation, nor to the requirement under section 6043 that the transferor file a return with respect to its liquidation, dissolution, or termination.

(iii) This subparagraph may be illustrated by the following examples:

Example 1. The trustees of X charitable trust, a private foundation, form the Y charitable corporation, also a private foundation, in order to facilitate the conduct of their activities. The trustees of X are also the directors of Y. Y has the same charitable purposes as X. All of the assets of X are transferred to Y, and Y continues to carry on X's charitable activities. Under such circumstances, Y shall be treated as if it were X for the purposes of subdivision (i) of this subparagraph. Thus, for example, Y will be permitted to take advantage of any special rules or savings provisions with respect to chapter 42 to the same extent as X could have if X had continued in existence.

Example 2. A and B are the trustees of the P charitable trust, a private foundation, and are the only substantial contributors to P. On July 1, 1973, in order to facilitate accomplishment of diverse charitable purposes, A and B create and control the R Foundation, the S Foundation and the T Foundation and transfer the net assets of P to R, S, and T. As of the end of 1973, P has an outstanding grant to Foundation W and has been required to exercise expenditure responsibility with respect to this grant under sections 4945 (d)(4) and (h). Under these circumstances, R, S, and T shall each be treated as if they are P in the proportion the fair market value of the assets transferred to each bears to the fair market value of the assets of P immediately before the transfer. Since R, S, and T are treated as P, absent a specific provision for exercising expenditure responsibility with respect to the grant to W, each of them is required to exercise expenditure responsibility with respect to such grant. If, as a part of the transfer to R, P assigned, and R assumed, P's duties with respect to the expenditure responsibility grant to W, only R would be required to exercise expenditure responsibility with respect to the grant to W. Since R, S, and T are treated as P rather than as recipients of *expenditure responsibility* grants, there are no expenditure responsibility requirements which must be exercised under sections 4945 (d)(4) and (h) with respect to the transfers of assets to R, S, and T.

(10) For certain rules relating to filing requirements where a private foundation has transferred all its net assets, see § 1.507–1(b)(9).

(b) *Status of transferee organization under section 507(b)(2).* Since a transfer of assets pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization or reorganization to an organization not described in section 501(c)(3) (other than an organization described in section 509(a)(4)) or 4947 is a taxable expenditure under section 4945(d)(5), in order for such a transfer of assets not to be a taxable expenditure, it must be to an organization described in section 501(c)(3) (other than an organization described in section 509(a)(4)) or treated as described in section 501(c)(3) under section 4947. See §53.4945–6(c)(3) of this chapter. Consequently, unless such a transferee is an organization described in section 509(a) (1), (2), or (3), the transferee is a private foundation and the rules of section 507(b)(2) and paragraph (a) of this section apply. On the other hand, if such a transfer of assets is made to a transferee organization which is not described in either section 501(c)(3) (other than an organization described in section 509(a)(4)) or 4947, and in order to correct the making of a taxable expenditure, such assets are transferred to a private foundation, section 507(b)(2) and paragraph (a) of this section shall apply as if the transfer of assets had been made directly to such private foundation.

(c) *Section 507(b)(2) transfers.* (1) A transfer of assets is described in section 507(b)(2) if it is made by a private foundation to another private foundation pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization. This shall include any organization or reorganization described in subchapter C of chapter 1. For purposes of section 507(b)(2), the terms *other adjustment, organization, or reorganization* shall include any partial liquidation or any other significant disposition of assets to one or more private foundations, other than transfers for full and adequate consideration or distributions out of current income. For purposes of this paragraph, a distribution out of current income shall include any distribution described in section 4942(h)(1) (A) and (B).

(2) The term *significant disposition of assets to one or more private foundations* shall include any disposition for a taxable year where the aggregate of:

(i) The dispositions to one or more private foundations for the taxable year, and

(ii) Where any disposition to one or more private foundations for the taxable year is part of a series of related dispositions made during prior taxable years, the total of the related dispositions made during such prior taxable years, is 25 percent or more of the fair market value of the net assets of the foundation at the beginning of the taxable year (in the case of subdivision (i) of this subparagraph) or at the beginning of the first taxable year in which any of the series of related dispositions was made (in the case of subdivision (ii) of this subparagraph). A *significant disposition of assets* may occur in a single taxable year (as in subdivision (i) of this subparagraph) or over the course of two or more taxable years (as in subdivision (ii) of this subparagraph). The determination whether a significant disposition has occurred through a series of related distributions (within the meaning of subdivision (ii) of this subparagraph) will be made on the basis of all the facts and circumstances of the particular case. However, if one or more persons who are disqualified persons (within the meaning of section 4946) with respect to the transferor private foundation are also disqualified persons with respect to any of the transferee private foundations, such fact shall be evidence that the transfer is part of a series of related dispositions (within the meaning of subdivision (ii) of this subparagraph). In the case of a series of related dispositions described in subdivision (ii) of this subparagraph, each transferee private foundation shall (on any date) be subject to the provisions of section 507(b)(2) (with respect to all such dispositions made to it on or before such date) to the extent described in paragraphs (a) and (b) of this section.

(3) A private foundation which fails to meet the requirements of section 507(b)(1)(A) for a taxable year may be required to file a return under section 6043(b) by reason of a transfer of assets to one or more sections 509(a) (1), (2), or (3) organizations. Hence, such filing does not necessarily mean that a section 507(b)(2) transfer has occurred. See §1.6043–3(f)(1).

(4) This paragraph applies to any section 507(b)(2) transfer made by a private foundation referred to in section 170(b)(1)(E) (i), (ii), or (iii).

(5) The provisions of this paragraph may be illustrated by the following examples:

Example 1. M is a private foundation on the calendar year basis. It has net assets worth $100,000 as of January 1, 1971. In 1971, in addition to distributions out of current income, M transfers $10,000 to N, $10,000 to O, and $10,000 to P. N, O, and P are all private foundations. Under subparagraph (2)(i) of this paragraph, M has made a significant disposition of its assets in 1971 since M has disposed of more than 25 percent of its net assets (with respect to the fair market value of such assets as of January 1, 1971). M has therefore made section 507(b)(2) transfers within the meaning of this paragraph, and section 507(b)(2) applies to the transfers made to N, O, and P.

Example 2. U, a tax-exempt private foundation on the calendar year basis, has net assets worth $100,000 as of January 1, 1971. As part of a series of related dispositions in 1971 and 1972, U transfers in 1971, in addition to distributions out of current income, $10,000 to private foundation X and $10,000 to private foundation Y, and in 1972, in addition to distributions out of current income, U transfers $10,000 to private foundation Z. Under subparagraph (2)(ii) of this paragraph, U is treated as having made a series of related dispositions in 1971 and 1972. The aggregate of the 1972 disposition (under subparagraph (2)(i) of this paragraph) and the series of related dispositions (under subparagraph (2)(ii) of this paragraph) is $30,000, which is more than 25 percent of the fair market value of U's net assets as of the beginning of 1971 ($100,000), the first year in which any such disposition was made. Thus, U has made a significant disposition of its assets and has made transfers described in section 507(b)(2). The provisions of paragraphs (a) and (b) of this section apply to each of the transferees as of the date on which it received assets from U.

(d) *Inapplicability of section 507(a) to section 507(b)(2) transfers.* Unless a private foundation voluntarily gives notice pursuant to section 507(a)(1), a transfer of assets described in section 507(b)(2) will not constitute a termination of the transferor's private foundation status under section 507(a)(1). Such transfer must, nevertheless, satisfy the requirements of any pertinent provisions of chapter 42. See subparagraphs (5) through (7) of paragraph (a) of this section. However, if such transfer constitutes an act or failure to act which is described in section 507(a)(2)(A), then such transfer will be subject to the provisions of section 507(a)(2) rather than section 507(b)(2). For example, X, a private nonoperating foundation, transfers all of its net assets to Y, a private operating foundation, in 1971. X does not file the notice referred to in section 507(a)(1) and the transfer does not constitute either a willful and flagrant act (or failure to act), or one of a series of willful repeated acts (or failures to act), giving rise to liability for tax under chapter 42. Under these circumstances, the transfer is described in section 507(b)(2) and the provisions of paragraph (a) of this section apply with respect to Y. The private foundation status of X has not been terminated under section 507(a).

(e) *Transfers to certain section 509(a) (1), (2), or (3) organizations.* If a private foundation transfers all or part of its assets to one or more organizations described in section 509(a) (1), (2), or (3) and, within a period of 3 years from the date of such transfers, one or more of the transferee organizations lose their section 509(a) (1), (2), or (3) status and become private foundations, then for purposes of this section, a transfer of assets within the meaning of paragraph (c) of this section to such an organization which becomes a private foundation will be treated as a transfer described in section 507(b)(2), and the provisions of paragraph (a) of this section shall be treated as applying to such a transferee organization from the date on which any such transfer was made to it.

(f) *Certain transfers made during section 507(b)(1)(B) terminations.* If:

(1) During the course of the 12-month or 60-month period described in section 507(b)(1)(B), a private foundation makes one or more transfers to one or more private foundations;

(2) Such transfers are described in §1.507–3(c)(1); and

(3) Even though the transferor foundation thereafter meets the requirements of section 507(b)(1)(B),

then for purposes of this section, the provisions of §1.507–2(e) shall not apply with respect to such transfers, and such transfers will be treated as transfers described in section 507(b)(2) and §1.507–3 rather than as transfers from an organization described in section 509(a) (1), (2), or (3).

[T.D. 7233, 37 FR 28158, Dec. 21, 1972; 38 FR 3189, Feb. 2, 1973, as amended by T.D. 7678, 45 FR 12415, Feb. 26, 1980]

§1.507–4 Imposition of tax.

(a) *General rule.* Section 507(c) imposes on each organization the private foundation status of which is terminated under section 507(a) a tax equal to the lower of:

(1) The amount which such organization substantiates by adequate records (or other corroborating evidence which may be required by the Commissioner) as the aggregate tax benefit (as defined in section 507(d)) resulting from the section 501(c)(3) status of such organization, or

(2) The value of the net assets of such organization.

(b) *Transfers not subject to section 507(c).* Private foundations which make transfers described in section 507(b)(1)(A) or (2) are not subject to the tax imposed under section 507(c) with respect to such transfers unless the provisions of section 507(a) become applicable. See §§1.507–1(b), 1.507–2(a)(6) and 1.507–3(d).

[T.D. 7233, 37 FR 28161, Dec. 21, 1972]

§1.507–5 Aggregate tax benefit; in general.

(a) *General rule.* For purposes of section 507(c)(1), the aggregate tax benefit resulting from the section 501(c)(3) status of any private foundation is the sum of:

(1) The aggregate increases in tax under chapters 1, 11, and 12 (or the corresponding provisions of prior law) which would have been imposed with respect to all substantial contributors to the foundation if deductions for all contributions made by such contributors to the foundation after February 28, 1913, had been disallowed,

(2) The aggregate increases in tax under chapter 1 (or the corresponding provisions of prior law) which would have been imposed with respect to the income of the private foundation for taxable years beginning after December 31, 1912, if (i) it had not been exempt from tax under section 501(a) (or the corresponding provisions of prior law), and (ii) in the case of a trust, deductions under section 642(c) (or the corresponding provisions of prior law) had been limited to 20 percent of the taxable income of the trust (computed without the benefit of section 642(c) but with the benefit of section 170(b)(1)(A)),

(3) The amount succeeded to from transferors under §1.507–3(a) and section 507(b)(2), and

(4) Interest on the increases in tax determined under subparagraphs (1), (2), and (3) of this paragraph from the first date on which each such increase would have been due and payable to the date on which the organization ceases to be a private foundation.

(b) *Contributions.* In computing the amount of the aggregate increases in tax under subparagraph (1) of this paragraph, all deductions attributable to a particular contribution shall be included. For example, if a substantial contributor has taken deductions under sections 170 and 2522 (or the corresponding provisions of prior law) with respect to the same contribution, the amount of each deduction shall be included in the computations under section 507(d)(1)(A). Accordingly, the aggregate tax benefit may exceed the fair market value of the property transferred.

[T.D. 7233, 37 FR 28161, Dec. 21, 1972]

§1.507–6 Substantial contributor defined.

(a) *Definition*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the term *substantial contributor* means, with respect to a private foundation, any person (within the meaning of section 7701(a)(1)), whether or not exempt from taxation under section 501(a), who contributed or bequeathed an aggregate amount of more than $5,000 to the private foundation, if such amount is more than 2 percent of the total contributions and bequests received by the private foundation before the close of the taxable year of the private foundation in which a contribution or bequest is received by the foundation from such person. In the case of a trust, the term *substantial contributor* also means the creator of the trust. Such term does not include a governmental unit described in section 170(c)(1).

(2) *Special rules.* For purposes of sections 170(b)(1)(E)(iii), 507(d)(1), 508(d), 509(a) (1) and (3), and chapter 42, the term *substantial contributor* shall not

include an organization which is described in section 509(a) (1), (2), or (3) or any other organization which is wholly owned by such section 509(a) (1), (2), or (3) organization. Furthermore, taking section 4941 (relating to taxes on self-dealing) in context, it would unduly restrict the activities of private foundations if the term *substantial contributor* were to include any section 501(c)(3) organizations. It was not intended, for example, that a large grant for charitable purposes from one private foundation to another world forever preclude the latter from making any grants to, or otherwise dealing with, the former. Accordingly, for purposes of section 4941 only, the term *substantial contributor* shall not only include any organization which is described in section 501(c)(3) (other than an organization described in section 509(a)(4)).

(b) *Determination of substantial contributor*—(1) *In general.* In determining under paragraph (a) of this section whether the aggregate of contributions and bequests from a person exceeds 2 percent of the total contributions and bequests received by a private foundation, both the total of such amounts received by the private foundation, and the aggregate of such amounts contributed and bequeathed by such person, shall be determined as of the last day of each taxable year commencing with the first taxable year ending after October 9, 1969. Generally, under section 507(d)(2) and this section, except for purposes of valuation under section 507(d)(2)(B)(i), all contributions and bequests made before October 9, 1969, are deemed to have been made on October 9, 1969. For purposes of section 509(a)(2) and the support test described in § 1.509(a)–3(c), contributions and bequests before October 9, 1969, will be taken into account in the year when actually made. For example, in the case of a contribution or bequest of $6,000 in 1967, such contribution or bequest shall be treated as made by a substantial contributor in 1967 for purposes of section 509(a)(2) and § 1.509(a)–3(c) if such person met the $5,000—2 percent test as of December 31, 1967, and December 31, 1969 (in the case of a calendar year accounting period). Although the determination of the percentage of total contributions and bequests represented by a given donor's contributions and bequests is not made until the end of the foundation's taxable year, a donor is a substantial contributor as of the first date when the foundation received from him an amount sufficient to make him a substantial contributor. Except as otherwise provided in this subparagraph, such amount is treated for all purposes as made by a substantial contributor. Thus, the total contributions and bequests received by the private foundation from all persons, and the aggregate contributions and bequests made by a particular person, are to be determined as of December 31, 1969 (in the case of a calendar year organization which was in existence on that date), and the amounts included in each respective total would be all contributions and bequests received by the organization on or before that date, and all contributions and bequests made by the person on or before that date. Thereafter, a similar determination is to be made with respect to such private foundation as of the end of each of its succeeding taxable years. Status as a substantial contributor, however, will date from the time when the donor first met the $5,000 and 2 percent test. Once a person is a substantial contributor with respect to a private foundation, he remains a substantial contributor even though he might not be so classified if a determination were first made at some later date. For instance, even though the aggregate contributions and bequests of a person become less than 2 percent of the total received by a private foundation (for example, because of subsequent contributions and bequests by other persons), such person remains a substantial contributor with respect to the foundation.

(2) *Examples.* The provisions of paragraph (a) of this section and this paragraph (b) may be illustrated by the following examples:

Example 1. On January 1, 1968, A, an individual, gave $4,500 to M, a private foundation on a calendar year basis. On June 1, 1969, A gave M the further sum of $1,500. Throughout its existence, through December 31, 1969, M has received $250,000 in contributions and bequests from all sources. As of June 1, 1969, A is a substantial contributor to M for purposes of section 509(a)(2).

Example 2. On September 9, 1966, B, an individual, gave $3,500 to N, a private foundation on a calendar year basis. On March 15, 1970, B gave N the further sum of $3,500. Throughout its existence, through December 31, 1970, N has received $200,000 in contributions and bequests from all sources. B is a substantial contributor to N as of March 15, 1970, since that is the first date on which his contributions met the 2 percent-$5,000 test.

Example 3. On July 21, 1964, X, a corporation, gave $2,000 to O, a private foundation on a calendar year basis. As of December 31, 1969, O had received $150,000 from all sources. On September 17, 1970, X gave O the further sum of $3,100. Through September 17, 1970, O had received $245,000 from all sources as total contributions and bequests. Between September 17, 1970, and December 31, 1970, however, O received $50,000 in contributions and bequests from others. X is not a substantial contributor to O, since X's contributions to O were not more than 2 percent of the total contributions and bequests received by O by December 31, 1970, the end of O's taxable year, even though X's contributions met that test at one point during the year.

Example 4. On September 16, 1970, C, an individual, gave $10,000 to P, a private foundation on a calendar year basis. Throughout its existence, and through December 31, 1970, the close of its taxable year, P had received a total of $100,000 in contributions and bequests. On January 3, 1971, P received a bequest of $1 million. C is a substantial contributor to P since he was a substantial contributor as of September 16, 1970, and therefore remains one even though he no longer meets the 2-percent test on a later date after the end of the taxable year of the foundation in which he first became a substantial contributor.

(c) *Special rules*—(1) *Contributions defined.* The term *contribution* shall, for purposes of section 507(d)(2), have the same meaning as such term has under section 170(c) and also include bequests, legacies, devises, and transfers within the meaning of section 2055 or 2106(a)(2). Thus, for purposes of section 507(d)(2), any payment of money or transfer of property without adequate consideration shall be considered a *contribution*. Where payment is made or property transferred as consideration for admissions, sales of merchandise, performance of services, or furnishing of facilities to the donor, the qualification of all or any part of such payment or transfer as a contribution under section 170(c) shall determine whether and to what extent such payment or transfer constitutes a *contribution* under section 507(d)(2).

(2) *Valuation of contributions and bequests.* Each contribution or bequest to a private foundation shall be valued at fair market value when actually received by the private foundation.

(3) *Contributions and bequests by a spouse.* An individual shall be considered, for purposes of this section, to have made all contributions and bequests made by his spouse during the period of their marriage. Thus, for example, where W contributed $500,000 to P, a private foundation, in 1941 and that amount exceeded 2 percent of the total contributions received by P as of the end of P's first taxable year ending after October 9, 1969, H (W's spouse at the time of the 1941 gift) is considered to have made such contribution (even if W died prior to October 9, 1969, or their marriage was otherwise terminated prior to such date). Similarly, any bequest or devise shall be treated as having been made by the decedent's surviving spouse.

[T.D. 7241, 37 FR 28743, Dec. 29, 1972; 38 FR 24206, Sept. 6, 1973]

§1.507–7 Value of assets.

(a) *In general.* For purposes of section 507(c), the value of the net assets shall be determined at whichever time such value is higher:

(1) The first day on which action is taken by the organization which culminates in its ceasing to be a private foundation, or

(2) The date on which it ceases to be a private foundation.

(b) *Valuation dates.* (1) In the case of a termination under section 507(a)(1), the date referred to in paragraph (a)(1) of this section shall be the date on which the terminating foundation gives the notification described in section 507(a)(1).

(2) In the case of a termination under section 507(a)(2), the date referred to in paragraph (a)(1) of this section shall be the date of occurrence of the willful and flagrant act (or failure to act) or the first of the series of willful repeated acts (or failures to act) giving rise to liability for tax under chapter 42 and the imposition of tax under section 507(a)(2).

(c) *Fair market value.* For purposes of this section, fair market value shall be determined pursuant to the provisions of § 53.4942(a)–2(c)(4) of this chapter.

(d) *Net assets.* For purposes of section 507 and the regulations thereunder, the term *net assets* shall mean the gross assets of a private foundation reduced by all liabilities of the foundation, including appropriate estimated and contingent liabilities. Thus, a determination of net assets may reflect reductions for any liability or contingent liability for tax imposed upon the private foundation under chapter 42 with respect to acts or failures to act prior to termination, for any liability or contingent liability for failures to correct such acts or failures to act, or for any liability or estimated or contingent liability with respect to expenses associated with winding up the organization. If a private foundation's determination of net assets reflects any reduction for any estimated or contingent liability, such private foundation must establish, to the satisfaction of the Commissioner, the reasonableness of such reduction. If the amount of net assets reflects a reduction for any estimated or contingent liability, at the earlier of the final determination of the contingency or the termination of a reasonable time, any excess of the amount by which the gross assets was reduced over the amount of the liability shall be treated in the same manner as if such excess had been considered part of the net assets.

[T.D. 7233, 37 FR 28161, Dec. 21, 1972]

§ 1.507–8 Liability in case of transfers.

For purposes of determining liability for the tax imposed under section 507(c) in the case of assets transferred by the private foundation, such tax shall be deemed to have been imposed on the first day on which action is taken by the organization which culminates in its ceasing to be a private foundation. If an organization's private foundation status is terminated under section 507(a)(2), the first day on which action is taken which culminates in its ceasing to be a private foundation (within the meaning of section 507(f)) shall be the date described in § 1.507–7(b)(2). If an organization terminates its private foundation status under section 507(a)(1), the first day on which action is taken which culminates in its ceasing to be a private foundation (within the meaning of section 507(f)) shall be the date described in § 1.507–7(b)(1).

[T.D. 7233, 37 FR 28161, Dec. 21, 1972]

§ 1.507–9 Abatement of taxes.

(a) *General rule.* The Commissioner may at his discretion abate the unpaid portion of the assessment of any tax imposed by section 507(c), or any liability in respect thereof, if:

(1) The private foundation distributes all of its net assets to one or more organizations described in section 170(b)(1)(A) (other than in clauses (vii) or (viii)) each of which has been in existence and so described for a continuous period of at least 60 calendar months, or

(2) Effective assurance is given to the Commissioner in accordance with paragraphs (b) and (c) of this section that the assets of the organization which are dedicated to charitable purposes will, in fact, be used for charitable purposes.

The provisions of § 1.507–2(a) (2), (3), and (7) shall apply to distributions under subparagraph (1) of this paragraph. Since section 507(g) provides only for the abatement of tax imposed under section 507(c), no tax imposed under any provision of chapter 42 shall be abated under section 507(g). Where the taxpayer files a petition with the Tax Court with respect to a notice of deficiency regarding any tax under section 507(c), such tax shall be treated as having been assessed for the purposes of abatement of such tax under section 507(g) and the regulations thereunder.

(b) *State proceedings.* (1) The Commissioner may at his discretion abate the unpaid portion of the assessment of any tax imposed by section 507(c), or any liability in respect thereof, under the procedures outlined in subparagraphs (2) and (3) of this paragraph. Such tax may not be abated by the Commissioner unless he determines that corrective action as defined in paragraph (c) of this section has been taken. The Commissioner may not abate by reason of section 507(g) any amount of such tax which has already been collected since only the unpaid portion thereof can be abated.

(2) The appropriate State officer shall have 1 year from the date of notification prescribed in section 6104(c) that a notice of deficiency of tax imposed under section 507(c) has been issued with respect to a foundation, to advise the Commissioner that corrective action has been initiated pursuant to State law as may be ordered or approved by a court of competent jurisdiction. Corrective action may be initiated either by the appropriate State officer or by an organization described in section 509(a) (1), (2), or (3) which is a beneficiary of the private foundation and has enforceable rights against such foundation under State law. Copies of all pleadings and other documents filed with the court at the initial stages of the proceedings shall be attached to the notification made by the State officer to the Commissioner. Prior to notification by the appropriate State officer that corrective action has been initiated, the Commissioner shall follow those procedures which would apply with respect to the assessment and collection of the tax imposed under section 507(c) without regard to section 507(g)(2). Subsequent to notification by the appropriate State officer that corrective action has been initiated, the Commissioner shall suspend action with respect to the assessment or collection of tax imposed under section 507(c) until notified of the final determination of such corrective action, as long as any such resulting delay does not jeopardize the collection of such tax and does not cause collection to be barred by operation of law or any rule of law. In any case where collection of such tax is about to be barred by operation of section 6502 and the Commissioner has not been advised of the final determination of corrective action, the Commissioner should make every effort to obtain appropriate agreements with the foundation subject to such tax to extend the period of limitations under section 6502(a)(2). Where such agreements are obtained, action with respect to the assessment and collection of such tax may be suspended to the extent not inconsistent with this subparagraph.

(3) Upon receipt of certification from the appropriate State officer that action has been ordered or approved by a court of competent jurisdiction, the Commissioner may abate the unpaid portion of the assessment of tax imposed by section 507(c), or any liability in respect thereof, if in his judgment such action is corrective action within the meaning of paragraph (c) of this section. In the event that such action is not corrective action, the Commissioner may in his discretion again suspend action on the assessment and collection of such tax until corrective action is obtained, or if in his judgment corrective action cannot be obtained, he may resume the assessment and collection of such tax.

(c) *Corrective action*. The term *corrective action* referred to in paragraph (b) of this section means vigorous enforcement of State laws sufficient to assure implementation of the provisions of chapter 42 and insure that the assets of such private foundation are preserved for such charitable or other purposes specified in section 501(c)(3). Except where assets of the terminated private foundation are transferred to an organization described in section 509(a) (1) through (4) the State is required to take such action to assure that the provisions of section 508(e)(1) (A) and (B) are applicable to the terminated foundation (or any transferee) with respect to such assets as if such organization were a private foundation. Thus, the governing instrument of such organization must include provisions with respect to such assets:

(1) Requiring its income therefrom for each taxable year to be distributed at such time and in such manner as not to subject such organization to tax under section 4942 (as if the organization were a private foundation),

(2) Prohibiting such organization from engaging in any act of self-dealing (as defined in section 4941(d) as if the organization were a private foundation),

(3) Prohibiting such organization from retaining any excess business holdings (as defined in section 4943(c) as if the organization were a private foundation),

(4) Prohibiting such organization from making any investments in such

manner as to subject such organization to tax under section 4944 (as if the organization were a private foundation), and

(5) Prohibiting such organization from making any taxable expenditures (as defined in section 4945(d) as if the organization were a private foundation). Consequently, in cases where the preceding sentence applies, although the private foundation status of an organization is terminated for tax purposes, it is contemplated that its status under State law would remain unchanged, because the tax under section 507(c) has been abated solely because the Commissioner has been given effective assurance that there is vigorous enforcement of State laws sufficient to assure implementation of the provisions of chapter 42. Therefore, in such a case while chapter 42 will not apply to acts occurring subsequent to termination which previously would have resulted in the imposition of tax under chapter 42, it is contemplated that there will be vigorous enforcement of State laws (including laws made applicable by the provisions in the governing instrument) with respect to such acts. Notwithstanding the preceding three sentences, no amendment to the organization's governing instrument is necessary where there are provisions of State law which have the effect of requiring a terminated private foundation to which the rules of subparagraphs (1) through (5) of this paragraph apply to be subject to such rules whether or not there are such provisions in such terminated private foundation's governing instrument.

[T.D. 7233, 37 FR 28161, Dec. 21, 1972]

§ 1.508–1 Notices.

(a) *New organizations must notify the Commissioner that they are applying for recognition of section 501(c)(3) status*—(1) *In general.* Except as provided in subparagraph (3) of this paragraph, an organization that is organized after October 9, 1969, will not be treated as described in section 501(c)(3):

(i) Unless such organization has given the Commissioner notice in the manner prescribed in subparagraph (2) of this paragraph; or

(ii) For any period before the giving of such notice, unless such notice is given in the manner and within the time prescribed in subparagraph (2) of this paragraph.

No organization shall be exempt from taxation under section 501(a) by reason of being described in section 501(c)(3) whenever such organization is not treated as described in section 501(c)(3) by reason of section 508(a) and this paragraph. See section 508(d)(2)(B) and § 1.508–2(b) regarding the deductibility of charitable contributions to an organization during the period such organization is not exempt under section 501(a) as an organization described in section 501(c)(3) by reason of failing to file a notice under section 508(a) and this subparagraph. See also § 1.508–2(b)(1)(viii) regarding the deductibility of charitable contributions to trusts described in section 4947(a)(1).

(2) *Filing of notice.* (i) For purposes of subparagraph (1) of this paragraph, except as provided in subparagraph (3) of this paragraph, an organization seeking exemption under section 501(c)(3) must file the notice described in section 508(a) within 15 months from the end of the month in which the organization was organized, or before March 22, 1973, whichever comes later. Such notice is filed by submitting a properly completed and executed Form 1023, exemption application. Notice should be filed with the district director. A request for extension of time for the filing of such notice should be submitted to such district director. Such request may be granted if it demonstrates that additional time is required.

(ii) Although the information required by Form 1023 must be submitted to satisfy the notice required by this section, the failure to supply, within the required time, all of the information required to complete such form is not alone sufficient to deny exemption from the date of organization to the date such complete information is submitted by the organization. If the information which is submitted within the required time is incomplete, and the organization supplies the necessary additional information at the request of the Commissioner within the additional time period allowed by him, the original notice will be considered timely.

(iii) For purposes of subdivision (i) of this subparagraph and paragraph (b)(2)(i) of this section, an organization shall be considered *organized* on the date it becomes an organization described in section 501(c)(3) (determined without regard to section 508(a)).

(iv) Since a trust described in section 4947(a)(2) is not an organization described in section 501(c)(3), it is not required to file a notice described in section 508(a).

(v) For the treatment of community trusts, and the trusts or funds comprising them, under section 508, see the special rules under §1.170A–9(e).

(vi) A foreign organization shall, for purposes of section 508, be treated in the same manner as a domestic organization, except that section 508 shall not apply to a foreign organization which is described in section 4948(b).

(3) *Exceptions from notice.* (i) Paragraphs (a) (1) and (2) of this section are inapplicable to the following organizations:

(*a*) Churches, interchurch organizations of local units of a church, conventions or associations of churches, or integrated auxiliaries of a church. See §1.6033–2(h) regarding the definition of integrated auxiliary of a church;

(b) Any organization which is not a private foundation (as defined in section 509(a)) and the gross receipts of which in each taxable year are normally not more than $5,000 (as described in subdivision (ii) of this subparagraph);

(c) Subordinate organizations (other than private foundations) covered by a group exemption letter;

(d) Solely for purposes of sections 507, 508(d)(1), 508(d)(2)(A) and 508(d)(3), 508(e), 509 and chapter 42, a trust described in section 4947(a)(1). (However, a trust described in section 501(c)(3) which was organized after October 9, 1969, shall be exempt under section 501(a) by reason of being described in section 501(c)(3) only if it files such notice); and

(e) Any other class of organization that the Commissioner from time to time excludes from the requirement of filing notice under section 508(a).

(ii) For purposes of subdivision (i) *(b)* of this subparagraph and paragraph (b)(7)(ii) of this section, the gross receipts (as defined in subdivision (iii) of this subparagraph) of an organization are normally not more than $5,000 if:

(a) During the first taxable year of the organization the organization has received gross receipts of $7,500 or less;

(b) During its first 2 taxable years the aggregate gross receipts received by the organization are $12,000 or less; and

(c) In the case of an organization which has been in existence for at least 3 taxable years, the aggregate gross receipts received by the organization during the immediately preceding 2 taxable years, plus the current year are $15,000 or less.

If an organization fails to meet the requirements of *(a), (b),* or *(c)* of this subdivision, then with respect to the organization, such organization shall be required to file the notices described in section 508 (a) and (b) within 90 days after the end of the period described in *(a), (b),* or *(c)* of this subdivision or before March 22, 1973, whichever is later, in lieu of the period prescribed in subparagraph (2)(i) of this paragraph. Thus, for example, if an organization meets the $7,500 requirement of *(a)* of this subdivision for its first taxable year, but fails to meet the $12,000 requirement of *(b)* of this subdivision for the period ending with its second taxable year, then such organization shall meet the notification requirements of section 508(a)(1) and 508(b) and subparagraph (2)(i) of this paragraph if it files such notification within 90 days after the close of its second taxable year. If an organization which has been in existence at least 3 taxable years meets the requirements of *(a), (b),* and *(c)* with respect to all prior taxable years, but fails to meet the requirements of *(c)* of this subdivision with respect to the current taxable year, then even if the organization fails to make such notification within 90 days after the close of the current taxable year, section 508(a)(1) and 508(b) shall not apply with respect to its prior years. In such a case, the organization shall not be treated as described in section 501(c)(3) for a period beginning with such current taxable year and ending when such notice is given under section 508(a)(2).

(iii) For a definition of *gross receipts* for purposes of subdivision (i)(*b*) of this subparagraph and paragraph (b)(7)(ii) of this section, see § 1.6033–2(g)(4).

(4) *Voluntary filings by new organizations excepted from filing notice.* Any organization excepted from the requirement of filing notice under section 508(a) will be exempt from taxation under section 501(c)(3) if it meets the requirements of that section, whether or not it files such notice. However, in order to establish its exemption with the Internal Revenue Service and receive a ruling or determination letter recognizing its exempt status, an organization excepted from the notice requirement by reason of subparagraph (3) of this paragraph should file proof of its exemption in the manner prescribed in § 1.501(a)–1.

(b) *Presumption that old and new organizations are private foundations*—(1) *In general.* Except as provided in subparagraph (7) of this paragraph, any organization (including an organization in existence on October 9, 1969) which is described in section 501(c)(3), and which does not notify the Commissioner within the time and in the manner prescribed in subparagraph (2) that it is not a private foundation, will be presumed to be a private foundation.

(2) *Filing of notice.* (i) Except as provided in subparagraph (7) of this paragraph, an organization must file the notice described in section 508(b) and subparagraph (1) of this paragraph within 15 months from the end of the month in which such organization was organized, or before March 22, 1973, whichever comes later. See paragraph (a)(2)(iii) of this section, for rules pertaining to when an organization is *organized*.

(ii) Any organization filing notice under this paragraph that has received a ruling or determination letter from the Internal Revenue Service dated on or before July 13, 1970, recognizing its exemption from taxation under section 501(c)(3) (or the corresponding provisions of prior law), shall file the notice described in section 508(b) by submitting a properly completed and executed Form 4653, Notification Concerning Foundation Status.

(iii) The financial schedule on Form 4653 need be completed only if the organization is, or thinks it might be, described in section 170(b)(1)(A) (iv) or (vi) or section 509(a)(2).

(iv) Any organization filing notice under this paragraph that has not received a ruling or determination letter from the Internal Revenue Service dated on or before July 13, 1970, recognizing its exemption from taxation under section 501(c)(3) (or the corresponding provisions of prior law), shall file its notice by submitting a properly completed and executed Form 1023 and providing information that it is not a private foundation. The organization shall also submit all information required by the regulations under section 170 or 509 (whichever is applicable) necessary to establish recognition of its classification as an organization described in section 509(a) (1), (2), (3), or (4). A Form 1023 submitted prior to July 14, 1970, will satisfy this requirement if the organization submits an additional statement that it is not a private foundation together with all pertinent additional information required. Any statement filed under this subdivision shall be accompanied by a written declaration by the principal officer, manager or authorized trustee that there is a reasonable basis in law and in fact for the statement that the organization so filing is not a private foundation, and that to the best of the knowledge and belief of such officer, manager or trustee, the information submitted is complete and correct.

(v) The notice filed under subdivision (ii) of this subparagraph should be filed in accordance with the instructions applicable to Form 4653. The notice required by subdivision (iv) of this subparagraph should be filed with the district director. An extension of time for the filing of such notice may be granted by the Director of the Internal Revenue Service Center or district director upon timely request by the organization to such person, if the organization demonstrates that additional time is required.

(3) *Effect of notice upon the filing organization.* (i) The notice filed under this paragraph may not be relied upon by the organization so filing unless and until the Internal Revenue Service notifies the organization that it is an organization described in paragraph (1),

(2), (3), or (4), of section 509(a). For purposes of the preceding sentence, an organization that has filed notice under section 508(b), and has previously received a ruling that it is an organization described in section 170(b)(1)(A) (other than clauses (vii) and (viii) thereof), will be considered to have been notified by the Internal Revenue Service that it is an organization described in paragraph (1) of section 509(a) if *(a)* the facts and circumstances forming the basis for the issuance of such ruling have not substantially changed, and *(b)* the ruling issued under that section has not been revoked expressly or by a subsequent change of the law or regulations under which the ruling was issued.

(ii) If an organization has filed a notice under section 508(b) stating that it is not a private foundation and designating only one paragraph of section 509(a) under which it claims recognition of its classification (such as an organization described in section 509(a)(2)), and if it has received a ruling or determination letter which recognizes that it is not a private foundation but which fails to designate the paragraph under section 509(a) in which it is described, then such organization will be treated as described under the paragraph designated by it, until such ruling or determination letter is modified or revoked. The rule in the preceding sentence shall not apply to an organization which indicated that it does not know its status under section 509(a) or which claimed recognition of its status under more than one paragraph of section 509(a).

(4) *Effect of notice upon grantors or contributors to the filing organization.* In the case of grants, contributions, or distributions made prior to:

(i) In the case of community trusts, 6 months after the date on which corrective and clarifying regulations designated as §1.170A–9(e)(10) become final;

(ii) In the case of medical research organizations, 6 months after the date on which corrective and clarifying regulations designated as §1.170A–9(b)(2), become final, and

(iii) In all other cases, January 1, 1976, any organization which has properly filed the notice described in section 508(b) prior to March 22, 1973 will not be treated as a private foundation for purposes of making any determination under the internal revenue laws with respect to a grantor, contributor or distributor (as for example, a private foundation distributing all of its net assets pursuant to a section 507(b)(1)(A) termination) thereto, unless the organization is controlled directly or indirectly by such grantor, contributor or distributor, if by the 30th day after the day on which such notice is filed, the organization has not been notified by the Commissioner that the notice filed by such organization has failed to establish that such organization is not a private foundation. See subparagraph (6) of this paragraph for the effect of an adverse notice by the Internal Revenue Service. For purposes of this subparagraph, an organization which has properly filed notice described in section 508(b) prior to March 22, 1973, and which has claimed recognition of its status under only one paragraph of section 509(a) in such notice, will be treated only for purposes of grantors, contributors or distributors as having the classification claimed in the notice if the provisions of this subparagraph are otherwise satisfied.

(5) *Statement that old and new organizations are operating foundations.* (i) Any organization (including an organization in existence on October 9, 1969) which is described in section 501(c)(3) may submit a statement, in the form and manner provided for notice in subparagraph (2) of this paragraph, that it is an operating foundation (as defined in section 4942(j)(3)) and include in such statement:

(a) Necessary supporting information as required by the regulations under section 4942(j)(3) to confirm such determination (including a statement identifying the clause of section 4942(j)(3)(B) that is applicable); and

(b) A written declaration by the principal officer, manager, or authorized trustee that there is a reasonable basis in law and in fact that the organization so filing is an operating foundation, and that to the best of the knowledge and belief of such officer, manager or trustee, the information submitted is complete and correct.

(ii) The statement filed under this subparagraph may not be relied upon by the organization so filing unless and until the Internal Revenue Service notifies the organization that it is an operating foundation described in section 4942(j)(3).

(iii) In the case of grants, contributions, or distributions made prior to March 22, 1973, any organization which has properly filed the statement described in this subparagraph prior to such date will be treated as an operating foundation for purposes of making any determination under the internal revenue laws with respect to a grantor, contributor, or distributor thereto, unless the organization is controlled directly or indirectly by such grantor, contributor, or distributor, if by the 30th day after the day on which such statement is filed, the organization has not been notified by the Commissioner or his delegate that its statement has failed to establish that such organization is an operating foundation. See subparagraph (6) of this paragraph for the effect of an adverse notice by the Internal Revenue Service.

(6) *Effect of notice by Internal Revenue Service concerning organization's notice or statement.* Subparagraph (4) and subdivision (iii) of subparagrph (5) of this paragraph shall have no effect:

(i) With respect to a grantor, contributor, or distributor to any organization for any period after the date on which the Internal Revenue Service makes notice to the public (such as by publication in the Internal Revenue Bulletin) that a grantor, contributor, or distributor to such organization can no longer rely upon the notice or statement submitted by such organization; and

(ii) Upon any grant, contribution, or distribution made to an organization on or after the date on which a grantor, contributor, or distributor acquired knowledge that the Internal Revenue Service has given notice to such organization that its notice or statement has failed to establish that such organization either is not a private foundation, or is an operating foundation, as the case may be.

(7) *Exceptions from notice.* Subparagraphs (1) and (2) of this paragraph are inapplicable to the following organizations:

(i) Churches, interchurch organizations of local units of a church, conventions or associations of churches, or integrated auxiliaries of a church, such as a men's or women's organization, religious school, mission society, or youth group;

(ii) Any organization which is not a private foundation (as defined in section 509(a)) and the gross receipts of which in each taxable year are normally not more than $5,000 (as determined under paragraph (a)(3)(ii) of this section);

(iii) Subordinate organizations (other than private foundations) covered by a group exemption letter but only if the parent or supervisory organization submits a notice covering the subordinates;

(iv) Trusts described in section 4947(a)(1); and

(v) Any other class of organization that the Commissioner from time to time excludes from the notification requirements of section 508(b).

(8) *Voluntary filings by organizations excepted from filing notice.* Any organization excepted from the requirement of filing notice under section 508(b) by reason of subdivisions (i), (ii), and (v) of subparagraph (7) of this paragraph may receive the benefits of subparagraph (4) of this paragraph by filing such notice.

(Secs. 508 and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7232, 37 FR 28289, Dec. 22, 1972, as amended by T.D. 7342, 40 FR 1237, Jan. 7, 1975; T.D. 7395, 41 FR 1063, Jan. 6, 1976; T.D. 8640, 60 FR 65552, Dec. 20, 1995]

§ 1.508–2 Disallowance of certain charitable, etc., deductions.

(a) *Gift or bequest to organizations subject to section 507(c) tax*—(1) *General rule.* No gift or bequest made to an organization upon which the tax provided by section 507(c) has been imposed shall be allowed as a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, if such gift or bequest is made:

(i) By any person after notification has been made by the organization under section 507(a)(1) or after notification has been made by the Commissioner under section 507(a)(2)(B), or

(ii) By a substantial contributor (as defined in section 507(d)(2)) in his taxable year which includes the first day on which action is taken by such organization which culminates in the imposition of tax under section 507(c) and any subsequent taxable year.

For purposes of subdivision (ii) of this subparagraph, the first day on which action is taken by an organization which culminates in the imposition of tax under section 507(c) shall be determined under the rules set forth in §1.507–7(b) (1) and (2).

(2) *Exception.* Subparagraph (1) of this paragraph shall not apply if the entire amount of the unpaid portion of the tax imposed by section 507(c) is abated by the Commissioner under section 507(g).

(b) *Gift or bequest to taxable private foundation, section 4947 trust, etc.*—(1) *General rule.* (i) Except as provided in subparagraph (2) of this paragraph, no gift or bequest made to an organization shall be allowed as a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, if such gift or bequest is made:

(a) To a private foundation or a trust described in section 4947(a)(2) in a taxable year for which it fails to meet the requirements of section 508(e) (determined without regard to section 508(e)(2) (B) and (C), or

(b) To any organization in a period for which it is not treated as an organization described in section 501(c)(3) by reason of section 508(a).

(ii) For purposes of subdivision (i)*(a)* of this subparagraph the term *taxable year* refers to the taxable year of the donee or beneficiary organization. In the event a bequest is made to a private foundation or trust described in section 4947(a)(2) which is not in existence at the date of the testator's death (but which is created under the terms of the testator's will), the term *taxable year* shall mean the first taxable year of the private foundation or trust.

(iii) For purposes of subdivision (i)*(a)* of this subparagraph, an organization does not fail to meet the requirements of section 508(e) for a taxable year, unless it fails to meet such requirements for the entire year. Therefore, even if a donee organization fails to meet the requirements of section 508(e) on the date it receives a grant from a donor, the donor's grant will not be disallowed by operation of section 508(d)(2)(A) and subdivision (i)*(a)* of this subparagraph, if the organization meets the requirements of section 508(e) (determined without regard to section 508(e)(2) (B) or (C)) by the end of its taxable year.

(iv) No deduction will be disallowed under section 508(d)(2)(A) with respect to a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 if during the taxable year in question, the private foundation or trust described in section 4947(a)(2) has instituted a judicial proceeding which is necessary to reform its governing instrument or other instrument in order to meet the requirements of section 508(e)(1). This subdivision shall not apply unless within a reasonable time such judicial proceedings succeed in so reforming such instrument.

(v) No deduction will be disallowed under section 508(d)(2)(A) and subdivision (i)*(a)* of this subparagraph for any taxable year beginning before January 1, 1972, with respect to a private foundation or trust described in section 4947 organized before January 1, 1970. See also §1.508–3(g) regarding transitional rules for extending compliance with section 508(e)(1).

(vi)*(a)* In the case of a contribution or bequest to a trust described in section 4947(a)(2) other than to a trust to which subdivision (vii) of this subparagraph applies, no deduction shall be disallowed by reason of section 508(d)(2)(A) on the grounds that such trust's governing instrument contains no provisions with respect to section 4942. Similarly, if for a taxable year such trust is also a trust described in section 4947(b)(3), no deduction for such year shall be so disallowed on the grounds that the governing instrument contains no provision with respect to section 4943 or 4944.

(b) This subdivision may be illustrated by the following example:

Example. H executes a will on January 1, 1977, establishing a charitable remainder trust (as described in section 664) with income payable to W, his wife, for life, remainder to X university, an organization described in section 170(b)(1)(A)(ii). The will provides that the trust is prohibited from engaging in activities which would subject itself, its foundation manager or a disqualified person to taxes under section 4941 or 4945 of the Code. The will is silent as to sections 4942, 4943, and 4944. H dies February 12, 1978. Section 508(d)(2)(A) will not operate to disallow any deduction to H's estate under section 2055 with respect to such trust.

(vii)*(a)* In the case of a trust described in section 4947(a)(2) which by its terms will become a trust described in section 4947(a)(1) and the governing instrument of which is executed after March 22, 1973, the governing instrument shall not meet the requirements of section 508(e)(1) if it does not contain provisions to the effect that the trust must comply with the provisions of section 4942, or sections 4942, 4943, and 4944 (as the case may be) to the extent such section or sections shall become applicable to such trust.

(b) This subdivision may be illustrated by the following example:

Example. H executes a will on January 1, 1977, establishing a charitable remainder trust (as described in section 664) with income payable to W, his wife, for life, remainder in trust in perpetuity for the benefit of an organization described in section 170(c). By its terms the trust will become a trust described in section 4947(a)(1), and will become a private foundation. The will provides that the trust is prohibited from engaging in activities which would subject itself, its foundation manager or a disqualified person to taxes under sections 4941 or 4945 of the Code. The will is silent as to sections 4942, 4943, and 4944. H dies February 12, 1978. Unless the trust's governing instrument is amended prior to the end of the trust's first taxable year, or judicial proceedings have been instituted under subdivision (iv) of this subparagraph, section 508(d)(2)(A) will operate to disallow any deduction to H's estate under section 2055 with respect to such trust.

(viii) Since a charitable trust described in section 4947(a)(1) is not required to file a notice under section 508(a), section 508(d)(2)(B) and subdivision (i)*(b)* of this subparagraph are not applicable to such a trust.

(2) *Transitional rules.* Any deduction which would otherwise be allowable under section 642(c)(2), 2106(a)(2), or 2055 shall not be disallowed under section 508(d)(2)(A) if such deduction is attributable to:

(i) Property passing under the terms of a will executed on or before October 9, 1969,

(a) If the decedent dies after October 9, 1969, but before October 9, 1972, without having amended any dispositive provision of the will after October 9, 1969, by codicil or otherwise,

(b) If the decedent dies after October 9, 1969, and at no time after that date had the right to change the portions of the will which pertains to the passing of property to, or for the use of, an organization described in section 170(c)(2)(B) or 2055(a), or

(c) If no dispositive provision of the will is amended by the decedent, by codicil or otherwise, before October 9, 1972, and the decedent is on October 9, 1972, and at all times thereafter under a mental disability (as defined in § 1.642(c)–2(b)(3)(ii)) to amend the will by codicil or otherwise, or

(ii) Property transferred in trust on or before October 9, 1969,

(a) If the grantor dies after October 9, 1969, but before October 9, 1972, without having amended, after October 9, 1969, any dispositive provision of the instrument governing the disposition of the property,

(b) If the property transferred was an irrevocable interest to, or for the use of, an organization described in section 170(c)(2)(B) or 2055(a),

(c) In the case of a deduction under section 2106(a)(2) or 2055; if no dispositive provision of the instrument governing the disposition of the property is amended by the grantor before October 9, 1972, and the grantor is on October 9, 1972, and at all times thereafter under a mental disability (as defined in § 1.642(c)–2(b)(3)(ii)) to change the disposition of the property, or

(d) In the case of a deduction under section 642(c)(2)(A), if the grantor is at all times after October 9, 1969, and up to, and including, the last day of the taxable year for which the deduction under such section is claimed, under a mental disability (as defined in § 1.642(c)–2(b)(3)(ii)) to change the terms of the trust.

See also § 1.508–3(g) regarding the extension of time for compliance with section 508(e), § 1.664–1(f)(3) (ii) and (g) regarding the special transitional rules for charitable remainder annuity and unitrusts described in section 664 which were created prior to December 31, 1972, and §20.2055–2(e)(4) of this chapter regarding the rules for determining if the dispositive provisions have been amended.

[T.D. 7232, 37 FR 28291, Dec. 22, 1972]

§1.508–3 Governing instruments.

(a) *General rule.* A private foundation shall not be exempt from taxation under section 501(a) for a taxable year unless by the end of such taxable year its governing instrument includes provisions the effects of which are:

(1) To require distributions at such times and in such manner as not to subject the foundation to tax under section 4942, and

(2) To prohibit the foundation from engaging in any act of self-dealing (as defined in section 4941(d)), from retaining any excess business holdings (as defined in section 4943(c)), from making any investments in such manner as to subject the foundation to tax under section 4944, and from making any taxable expenditures (as defined in section 4945(d)).

(b) *Effect and nature of governing instrument*—(1) *In general.* Except as provided in paragraph (d) of this section, the provisions of a foundation's governing instrument must require or prohibit, as the case may be, the foundation to act or refrain from acting so that the foundation, and any foundation managers or other disqualified persons with respect thereto, shall not be liable for any of the taxes imposed by sections 4941, 4942, 4943, 4944, and 4945 of the Code or, in the case of a split-interest trust described in section 4947(a)(2), any of the taxes imposed by those sections of chapter 42 made applicable under section 4947. Specific reference to these sections of the Code will generally be required to be included in the governing instrument, unless equivalent language is used which is deemed by the Commissioner to have the same full force and effect. However, a governing instrument which contains only language sufficient to satisfy the requirements of the organizational test under §1.501(c)(3)–1(b) will not be considered as meeting the requirements of this subparagraph, regardless of the interpretation placed on such language as a matter of law by a State court in a particular jurisdiction, unless the requirements of paragraph (d) of this section are satisfied.

(2) *Corpus.* A governing instrument does not meet the requirements of paragraph (a)(1) of this section if it expressly prohibits the distribution of capital or corpus.

(3) *Savings provisions.* For purposes of sections 508(d)(2) (A) and (e), a governing instrument need not include any provision which is inconsistent with section 101(l) (2), (3), (4), or (5) of the Tax Reform Act of 1969 (83 Stat. 533), as amended by sections 1301 and 1309 of the Tax Reform Act of 1976 (90 Stat. 1713, 1729), with respect to the organization. Accordingly, a governing instrument complying with the requirements of subparagraph (1) of this paragraph may incorporate any savings provision contained in section 101(l) (2), (3), (4), or (5) of the Tax Reform Act of 1969, as amended by sections 1301 and 1309 of the Tax Reform Act of 1976, as a specific exception to the general provisions of paragraph (a) of this section. In addition, in the absence of any express provisions to the contrary, the exceptions contained in such savings provisions will generally be regarded as contained in a governing instrument meeting the requirements of subparagraph (1) of this paragraph.

(4) *Excess holdings.* For purposes of paragraph (a)(2) of this section, the prohibition against *retaining any excess business holdings (as defined in section 4943(c))* shall be deemed only to prohibit the foundation from retaining any excess business holdings when such holdings would subject the foundation to tax under section 4943(a).

(5) *Revoked ruling on status.* In the case of an organization which:

(i) Has been classified as an organization described in section 509(a) (1), (2), (3), or (4), and

(ii) Subsequently receives a ruling or determination letter stating that it is no longer described in section 509(a) (1), (2), (3), or (4), but is a private foundation within the meaning of section 509, such organization shall have 1 year from the date of receipt of such ruling or determination letter, or the final ruling or determination letter if a protest is filed to an earlier one, to meet the requirements of section 508(e). Section 508(d)(2)(A) shall not be applicable with respect to gifts and bequests made during this 1-year period if such requirements are met within the 1-year period.

(6) *Judicial proceeding.* For purposes of paragraphs (a), (b)(5), (d)(2), and (e)(3) of this section, an organization shall be deemed to have met the requirements of section 508(e) within a year, if a judicial proceeding which is necessary to reform its governing instrument or other instrument is instituted within the year and within a reasonable time the organization, in fact, meets the requirements of section 508(e). For purposes only of paragraphs (b)(5), (d)(2), and (e)(3) of this section, if an organization organized before January 1, 1970, institutes such a judicial proceeding within such 1-year period, section 508 (e)(2)(C) shall be applied as if such proceeding had been instituted prior to January 1, 1972.

(c) *Meaning of governing instrument.* For purposes of section 508(e), the term *governing instrument* shall have the same meaning as the term *articles of organization* under §1.501(c)(3)–1(b)(2). The bylaws of an organization shall not constitute its governing instrument for purposes of section 508(e).

(d) *Effect of State law*—(1) *In general.* A private foundation's governing instrument shall be deemed to conform with the requirements of paragraph (a) of this section if valid provisions of State law have been enacted which:

(i) Require it to act or refrain from acting so as not to subject the foundation to the taxes imposed by section 4941 (relating to taxes on self-dealing), 4942 (relating to taxes on failure to distribute income), 4943 (relating to taxes on excess business holdings), 4944 (relating to taxes on investments which jeopardize charitable purpose), and 4945 (relating to taxable expenditures); or

(ii) Treat the required provisions as contained in the foundation's governing instrument.

(2) *Validity.* (i) Any provision of State law described in subparagraph (1) of this paragraph shall be presumed valid as enacted, and in the absence of State provisions to the contrary, to apply with respect to any foundation that does not specifically disclaim coverage under State law (either by notification to the appropriate State official or by commencement of judicial proceedings) except as provided in subdivisions (ii) and (iii) of this subparagraph.

(ii) If such provision is declared invalid or inapplicable with respect to a class of foundations by the highest appellate court of the State or by the Supreme Court of the United States, the foundations covered by the determination must meet the requirements of section 508(e) within 1 year from the date on which the time for perfecting an application for review by the Supreme Court expires. If such application is filed, the requirements of section 508(e) must be met within a year from the date on which the Supreme Court disposes of the case, whether by denial of the application for review or decision on the merits.

(iii) In addition, if such provision of State law is declared invalid or inapplicable with respect to a class of foundations by any court of competent jurisdiction which decision is not reviewed by a court referred to in subdivision (ii) of this subparagraph, and the Commissioner makes notice to the general public (such as by publication in the Internal Revenue Bulletin) that such provision has been so declared invalid or inapplicable, then all foundations in such State must meet the requirements of section 508(e), without reliance upon such statute to the extent declared invalid or inapplicable by such decision, within 1 year from the date such notice is made public.

(iv) This subparagraph shall not apply to any foundation that is subject to a final judgment entered by a court of competent jurisdiction, holding the law invalid or inapplicable with respect to such foundation. See paragraph (b)(6) of this section for the effect of certain judicial proceedings that are brought within 1 year.

(3) *Conflicting instrument.* For taxable years beginning after March 22, 1973 in order for a private foundation or trust described in section 4947(a)(2) to receive the benefit of coverage under any State statute which makes applicable the requirements of section 508(e)(1) (A) and (B), where the statute by its

terms does not apply to a governing instrument which contains a mandatory direction conflicting with any of such requirements, such organization must indicate on its annual return required to be filed under section 6033 (or section 6012 in the case of a trust described in section 4947(a)) that its governing instrument contains no mandatory directions which conflict with the requirements of section 508(e)(1) (A) or (B), as incorporated by the State statute. General language in a governing instrument empowering the trustee to make investments without being limited to those investments authorized by law will not be regarded as a mandatory conflicting direction.

(4) *Exclusion from statute.* (i) For any taxable year beginning after March 22, 1973 in the case of a private foundation or trust described in section 4947(a)(2) subject to a State statute which makes applicable the requirements of section 508(e)(1) (A) and (B) to the governing instruments of such organizations, other than those which take action to be excluded therefrom (such as by filing a notice of exclusion or by instituting appropriate judicial proceedings), an organization will receive the benefit of such State statute only if it indicates on its annual return required to be filed under section 6033 (or section 6012 in the case of a trust described in section 4947(a)) that it has not so taken action to be excluded.

(ii) This paragraph permits certain organizations that are subject to the provisions of such a State law, to avoid changing their governing instruments in order to meet the requirements of section 508(e)(1). Since an organization which avoids the application of a provision or provisions of State law, such as by filing a notice of exclusion, is not entitled to the benefits of this paragraph, such an organization must meet the requirements of section 508(e)(1) without regard to this paragraph and except as provided in section 508(e)(2)(C) or paragraph (g)(1)(iii) of this section must change its governing instrument to the extent inconsistent with section 508(e)(1).

(5) *Treatment of prevailing conflicting clause.* If provisions of State law are inapplicable to a clause in a governing instrument which is contrary to the provisions of section 508(e)(1), the requirements of section 508(e)(2)(C) and paragraph (g)(1)(iii) of this section are not satisfied by a provision of State law which purports to eliminate the need for litigation under such circumstances. Therefore, except as otherwise provided in this section unless the governing instrument is changed or litigation is commenced pursuant to section 508(e)(2)(B) by an organization organized before January 1, 1970, or pursuant to paragraph (g)(1)(ii) of this section, to amend the nonconforming provision to meet the requirements of section 508(e)(1) (A) and (B), then pursuant to section 508(e), such organization will not be exempt from taxation.

(6) *Retroactive application to grants or bequests.* If valid provisions of such a State law apply retroactively to a taxable year within which an organization has received a grant or request, section 508(d)(2)(A) shall not apply so as to disallow such grant or bequest, but only if such valid provisions of State law are enacted within 2 years of such grant or bequest.

(e) *Effect of section 508(e) upon section 4947 trusts*—(1) *Section 4947(a)(1) trusts.* A charitable trust described in section 4947(a)(1) (unless also described in a paragraph of section 509(a)) is subject to all the provisions of paragraph (a) of this section.

(2) *Section 4947(a)(2) trusts.* A split-interest trust described in section 4947(a)(2), as long as it is so described, is subject to the provisions of paragraph (a)(2) of this section, except to the extent that section 4947 makes any such provisions inapplicable to certain trusts and certain amounts in trust. The governing instrument of a trust described in section 4947(a)(2) may except amounts described in section 4947(a)(2) (A), (B), and (C) from the requirements of paragraph (a)(2) of this section. In the case of a trust having amounts transferred to it both before May 27, 1969, and after May 26, 1969, its governing instrument may except from the provisions of paragraph (a)(2) of this section only those segregated amounts excluded from the application of section 4947(a)(2) by reason of section 4947(a)(2)(C) and the regulations thereunder. Also, the governing instrument of such a trust may exclude the

application of sections 4943 and 4944 for any period during which such trust is described in section 4947(b)(3) (A) or (B). See § 53.4947–1(c) of this chapter for rules relating to the applicability of section 4947 to split-interest trusts and § 1.508–2(b)(1) (vi) and (vii) for rules relating to the deductibility of grants or bequests to such trusts.

(3) *A section 4947(a)(2) trust becoming a section 4947(a)(1) trust.* If the governing instrument of a trust described in section 4947(a)(2) meets the applicable requirements of paragraph (a)(2) of this section and such trust ceases to be so described and becomes instead a trust described in section 4947(a)(1), then such governing instrument must meet, prior to the end of 12 months from the date such trust first becomes described in section 4947(a)(1) (except as otherwise provided in this section) all the requirements of paragraph (a) of this section in order to comply with section 508(e).

(f) *Special rules for existing private foundations.* (1) Pursuant to section 508(e)(2), section 508(e)(1) and paragraph (a) of this section shall not apply in the case of any organization whose governing instrument was executed before January 1, 1970:

(i) To any taxable year beginning before January 1, 1972;

(ii) To any period after December 31, 1971, during the pendency of any judicial proceeding begun before January 1, 1972, by the private foundation which is necessary to reform, or to excuse such foundation from compliance with, its governing instrument or any other instrument in order to meet the requirements of section 508(e)(1); and

(iii) To any period after the termination of any judicial proceeding described in subdivision (ii) of this subparagraph during which its governing instrument or any other instrument does not permit it to meet the requirements of section 508(e)(1).

(2) For purposes of subparagraph (1) of this paragraph, and § 1.508–2(b)(1)(vi)*(a)*, a governing instrument will not be treated as executed before the applicable date, if, after such date the dispositive provisions of the instrument are amended (determined under rules similar to the rules set forth in § 20.2055–2(e)(4) of this chapter).

(3) For purposes of subparagraph (1) (ii) and (iii) of this paragraph, a private foundation will be treated as meeting the requirements of section 508(e)(2) (B) and (C) if it has commenced a necessary and timely proceeding in an appropriate court of original jurisdiction and such court has ruled that the foundation's governing instrument or any other instrument does not permit it to meet the requirements of section 508(e)(1). Such foundation is not required to commence proceedings in any court of appellate jurisdiction in order to comply with section 508(e)(2)(C). See also § 1.508–2(b)(2).

(g) *Extension of time for compliance with section 508(e).* (1) Except as provided in subparagraph (2) of this paragraph, section 508(e)(1) shall not apply to any private foundation (regardless of when organized) with respect:

(i) To any taxable year beginning before the transitional date,

(ii) To any period on or after the transitional date during the pendency of any judicial proceeding begun before the transitional date by the private foundation which is necessary to reform, or to excuse such foundation from compliance with, its governing instrument or any other instrument in order to meet the requirements of section 508(e)(1), and

(iii) To any period after the termination of any judicial proceeding described in subdivision (ii) of this subparagraph during which its governing instrument or any other instrument does not permit it to meet the requirements of section 508(e)(1).

(2) Subparagraph (1) of this paragraph shall apply only to gifts or bequests referred to in section 508(d)(2)(A) that are made before the transitional date.

(3) For purposes of this paragraph the term *transitional dates* means the earlier of the following dates:

(i) In the case of a medical research organization, May 21, 1976 or in the case of a community trust February 10, 1977, or

(ii) The 91st day after the date an organization receives a final ruling or determination letter that it is a private foundation under section 509(a).

[T.D. 7232, 37 FR 28292, Dec. 22, 1972, as amended by T.D. 7440, 41 FR 50656, Nov. 17, 1976; T.D. 7678, 45 FR 12415, Feb. 26, 1980]

§1.508–4 Effective date.

Except as otherwise provided, §§1.508–1 through 1.508–3 shall take effect on January 1, 1970.

(Sec. 7805 of the Internal Revenue Code of 1954, 68A Stat. 917; 26 U.S.C. 7805)

[T.D. 7232, 37 FR 28294, Dec. 22, 1972]

§1.509(a)–1 Definition of private foundation.

In general. Section 509(a) defines the term *private foundation* to mean any domestic or foreign organization described in section 501(c)(3) other than an organization described in section 509(a) (1), (2), (3), or (4). Organizations which fall into the categories excluded from the definition of *private foundation* are generally those which either have broad public support or actively function in a supporting relationship to such organizations. Organizations which test for public safety are also excluded.

[T.D. 7212, 37 FR 21907, Oct. 17, 1972]

§1.509(a)–2 Exclusion for certain organizations described in section 170(b)(1)(A).

(a) *General rule.* Organizations described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)) are excluded from the definition of *private foundation* by section 509(a)(1). For the requirements to be met by organizations described in section 170(b)(1)(A) (i) through (vi), see §1.170A–9 (a) through (e) and paragraph (b) of this section. For purposes of this section, the parenthetical language *other than in clauses (vii) and (viii)* used in section 509(a)(1) means *other than an organization which is described only in clause (vii) or (viii).* For purposes of this section, an organization may qualify as a section 509(a)(1) organization regardless of the fact that it does not satisfy section 170(c)(2) because:

(1) Its funds are not used within the United States or its possessions, or

(2) It was created or organized other than in, or under the law of, the United States, any State or territory, the District of Columbia, or any possession of the United States.

(b) *Medical research organizations.* In order to qualify under section 509(a)(1) as a medical research organization described in section 170(b)(1)(A)(iii), an organization must meet the requirements of section 170(b)(1)(A)(iii) and §1.170A–9(c)(2), except that, solely for purposes of classification as a section 509(a)(1) organization, such organization need not be committed to spend every contribution for medical research before January 1 of the fifth calendar year which begins after the date such contribution is made.

[T.D. 7212, 37 FR 21907, Oct. 17, 1972]

§1.509(a)–3 Broadly, publicly supported organizations.

(a) *In general*—(1) *General rule.* Section 509(a)(2) excludes certain types of broadly, publicly supported organizations from private foundation status. An organization will be excluded under section 509(a)(2) if it meets the one-third support test under section 509(a)(2)(A) and the not–more–than–one–third support test under section 509(a)(2)(B).

(2) *One–third support test.* An organization will meet the one-third support test if it normally (within the meaning of paragraph (c), (d), or (e) of this section) receives more than one-third of its support in each taxable year from any combination of:

(i) Gifts, grants, contributions, or membership fees, and

(ii) Gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity which is not an unrelated trade or business (within the meaning of section 513), subject to certain limitations described in paragraph (b) of this section,

from permitted sources. For purposes of this section, governmental units, organizations described in section 509(a)(1) and persons other than disqualified persons with respect to the organization shall be referred to as permitted sources. For purposes of this section, the amount of support received from the sources described in subdivisions (i) and (ii) of this subparagraph (subject to the limitations referred to in this subparagraph) will be referred to as the numerator of the one-third support total amount of support received (as defined in section 509(d)) will be referred to as the denominator of the one-third support fraction. For purposes of section 509(a)(2), paragraph (f) of this section distinguishes gifts and contributions from gross receipts; paragraph (g) of this section distinguishes grants from gross receipts; paragraph (h) of this section defines membership fees; paragraph (i) of this section defines *any bureau or similar agency of a governmental unit*; paragraph (j) of this section describes the treatment of certain indirect forms of support; paragraph (k) of this section describes the method of accounting for support; paragraph (l) of this section describes the treatment of gross receipts from section 513(a) (1), (2), or (3) activities; and paragraph (m) of this section distinguishes gross receipts from gross investment income.

(3) *Not-more-than-one-third support test*—(i) *In general.* An organization will meet the not-more-than-one-third support test under section 509(a)(2)(B) if it normally (within the meaning of paragraph (c), (d), or (e) of this section) receives not more than one-third of its support in each taxable year from the sum of its gross investment income (as defined in section 509(e)) and the excess (if any) of the amount of its unrelated business taxable income (as defined in section 512) derived from trades or businesses which were acquired by the organization after June 30, 1975, over the amount of tax imposed on such income by section 511. For purposes of this section the amount of support received from items described in section 509(a)(2)(B) will be referred to as the numerator of the not-more-than-one-third support fraction, and the total amount of support (as defined in section 509(d)) will be referred to as the denominator of the not-more-than-one-third support fraction. For purposes of section 509(a)(2), paragraph (m) of this section distinguishes gross receipts from gross investment income. For purposes of section 509(e), gross investment income includes the items of investment income described in § 1.512(b)–1(a).

(ii) *Trade or business.* For purposes of section 509(a)(2)(B)(ii), a trade or business acquired after June 30, 1975, by an organization shall include, in addition to other trades or businesses:

(A) A trade or business acquired after such date from, or as a result of the liquidation of, an organization's subsidiary which is described in section 502 whether or not the subsidiary was held on June 30, 1975.

(B) A new trade or business commenced by an organization after such date.

(iii) *Allocation of deductions between businesses acquired before, and businesses acquired after, June 30, 1975.* Deductions which are allowable under section 512 but are not directly connected to a particular trade or business, such as deductions referred to in paragraphs (10) and (12) of section 512(b), shall be allocated in the proportion that the unrelated trade or business taxable income derived from trades or businesses acquired after June 30, 1975, bears to the organization's total unrelated business taxable income, both amounts being determined without regard to such deductions.

(iv) *Allocation of tax.* The tax imposed by section 511 shall be allocated in the same proportion as in paragraph (a)(3)(iii) of this section.

(4) *Purposes.* The one-third support test and the not–more–than–one–third support test are designed to insure that an organization which is excluded from private foundation status under section 509(a)(2) is responsive to the general public, rather than to the private interests of a limited number of donors or other persons.

(b) *Limitation on gross receipts*—(1) *General rule.* In computing the amount of support received from gross receipts under section 509(a)(2)(A)(ii) for purposes of the one-third support test of section 509(a)(2)(A), gross receipts from related activities received from any person, or from any bureau or similar agency of a governmental unit, are includible in any taxable year only to the extent that such receipts do not exceed the greater of $5,000 or 1 percent of the organization's support in such taxable year.

(2) *Examples.* The application of this paragraph may be illustrated by the examples set forth below. For purposes of these examples, the term *general public* is defined as persons other than disqualified persons and other than persons from whom the foundation receives gross receipts in excess of the greater of $5,000 or 1 percent of its support in any taxable year, and the term *gross receipts* is limited to receipts from activities which are not unrelated trade or business (within the meaning of section 513).

Example 1. For the taxable year 1970, X, an organization described in section 501(c)(3), received support of $10,000 from the following sources:

Bureau M (a governmental bureau from which X received gross receipts for services rendered)	$25,000
Bureau N (a governmental bureau from which X received gross receipts for services rendered)	25,000
General public (gross receipts for services rendered)	20,000
Gross investment income	15,000
Contributions from individual substantial contributors (defined as disqualified persons under section 4946(a)(2))	15,000
Total support	100,000

Since the $25,000 received from each bureau amounts to more than the greater of $5,000 or 1 percent of X's support for 1970 (1% of $100,000=$1,000) under section 509(a)(2)(A)(ii), each amount is includible in the numerator of the one-third support fraction only to the extent of $5,000. Thus, for the taxable year 1970, X received support from sources which are taken into account in meeting the one-third support test of section 509(a)(2)(A) computed as follows:

Bureau M	$5,000
Bureau N	5,000
General public	20,000
Total	30,000

Therefore, in making the computations required under paragraph (c), (d), or (e) of this section, only $30,000 is includible in the aggregate numerator and $100,000 is includible in the aggregate denominator of the support fraction.

Example 2. For the taxable year 1970, Y, an organization described in section 501(c)(3), received support of $600,000 from the following sources:

Bureau O (gross receipts for services rendered)	$10,000
Bureau P (gross receipts for services rendered)	10,000
General public (gross receipts for services rendered)	150,000
General public (contributions)	40,000
Gross investment income	150,000
Contributions from substantial contributors	240,000
Total support	600,000

Since the $10,000 received from each bureau amounts to more than the greater of $5,000 or 1 percent of Y's support for 1970 (1% of $600,000=$6,000), each amount is includible in the numerator of the one-third support fraction only to the extent of $6,000. Thus, for the taxable year 1970, Y received support from sources required to meet the one-third support test of section 509(a)(2)(A) computed as follows:

Bureau O	$6,000
Bureau P	6,000
General public (gross receipts)	150,000
General public (contributions)	40,000
Total	202,000

Therefore, in making the computations required under paragraph (c), (d), or (e) of this section, $202,000 is includible in the aggregate numerator and $600,000 is includible in the aggregate denominator of the support fraction.

(c) *Normally—(*1) *In general—(* i) *Definition.* The support tests set forth in section 509(a)(2) are to be computed on the basis of the nature of the organization's *normal* sources of support. An organization will be considered as *normally* receiving one-third of its support from any combination of gifts, grants, contributions, membership fees, and gross receipts from permitted sources (subject to the limitations described in paragraph (b) of this section) and not more than one-third of its support from items described in section 509(a)(2)(B) for its current taxable year and the taxable year immediately succeeding its current year, if, for the 4 taxable years immediately preceding the current taxable year, the aggregate amount of the support received during the applicable period from gifts, grants, contributions, membership fees, and gross receipts from permitted sources (subject to the limitations described in paragraph (b) of this section) is more than one-third, and the aggregate amount of the support received from items described in section 509(a)(2)(B) is not more than one-third of the total support of the organization for such 4-year period.

(ii) *Exception for material changes in sources of support.* If for the current taxable year there are substantial and material changes in an organization's sources of support other than changes arising from unusual grants excluded under subparagraph (3) of this paragraph, then in applying subdivision (i) of this subparagraph, neither the 4-year computation period, applicable to such year as an immediately succeeding taxable year, not the 4-year computation period, applicable to such year as a current taxable year shall apply, and in lieu of such computation periods there shall be applied a computation period consisting of the taxable year of substantial and material changes and the 4 taxable years immediately preceding such year. Thus, for example, if there are substantial and material changes in an organization's sources of support for taxable year 1976, then even though such organization meets the requirements of subdivision (i) of this subparagraph based on a computation period of taxable years 1971 through 1974 or 1972 through 1975, such an organization will not meet the requirements of section 509(a)(2) unless it meets the requirements of subdivision (i) of this subparagraph for a computation period of the taxable years 1972 through 1976. See example 3 in subparagraph (6) of this paragraph for an illustration of this subdivision. An example of a substantial and material change is the receipt of an unusually large contribution or bequest which does not qualify as an unusual grant under subparagraph (3) of this paragraph. See subparagraph (5)(ii) of this paragraph as to the procedure for obtaining a ruling whether an unusually large grant may be excluded as an unusual grant.

(iii) *Status of grantors and contributors. (a)* If as a result of subdivision (ii) of this subparagraph, an organization is not able to meet the requirements of either the one-third support test described in paragraph (a)(2) of this section or the not–more–than–one–third support test described in paragraph (a)(3) of this section for its current taxable year, its status (with respect to a grantor or contributor under sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522) will not be affected until notice of change of status under section 509(a)(2) is made to the public (such as by publication in the Internal Revenue Bulletin). The preceding sentence shall not apply, however, if the grantor or contributor was responsible for, or was aware of, the substantial and material change referred to in subdivision (ii) of this subparagraph, or acquired knowledge that the Internal Revenue Service had given notice to such organization that it would be deleted from classification as section 509(a)(2) organization.

(b) A grantor or contributor other than one of the organization's founders, creators, or foundation managers (within the meaning of section 4946(b)) will not be considered to be responsible for, or aware of, the substantial and material change referred to in subdivision (ii) of this subparagraph if such grantor or contributor has made such grant or contribution in reliance upon a written statement by the grantee organization that such grant or contribution will not result in the loss of such organization's classification as not a private foundation under section 509(a). Such statement must be signed by a responsible officer of the grantee organization and must set forth sufficient information, including a summary of the pertinent financial data for the 4 preceding years, to assure a reasonably prudent man that his grant or contribution will not result in the loss of the grantee organization's classification as not a private foundation under section 509(a). If a reasonable doubt exists as to the effect of such grant or contribution, or if the grantor or contributor is one of the organization's founders, creators, or foundation managers, the procedure set forth in subparagraph (5)(ii) of this paragraph may be followed by the grantee organization for the protection of the grantor or contributor.

(iv) *Special rule for new organizations.* If an organization has been in existence for at least 1 taxable year consisting of at least 8 months, but for fewer than 5 taxable years, the number of years for which the organization has been in existence immediately preceeding each current taxable year being tested will be substituted for the 4-year period described in subdivision (i) of this subparagraph to determine whether the organization *normally* meets the requirements of paragraph (a) of this section. However, if subdivision (ii) of this subparagraph applies, then the period consisting of the number of years for which the organization has been in existence (up to and including the current year) will be substituted for the 4-year period described in subdivision (i) of this subparagraph. An organization which has been in existence for at least 1 taxable year, consisting of 8 or more months, may be issued a ruling or determination letter if it *normally* meets the requirements of paragraph (a) of this section for the number of years described in this subdivision. Such an organization may apply for a ruling or determination letter under the provisions of this paragraph, rather than under the provisions of paragraph (d) of this section. The issuance of a ruling or determination letter will be discretionary with the Commissioner. See paragraph (e)(4) of this section as to the initial determination of the status of a newly created organization. This subdivision shall not apply to those organizations receiving an extended advance ruling under paragraph (d)(4) of this section.

(2) *Terminations under section 507(b)(1)(B).* For the special rules applicable to the term *normally* as applied to private foundations which elect to terminate their private foundation status pursuant to the 12-month or 60-month procedure provided in section 507(b)(1)(B), see the regulations under such section.

(3) *Exclusion of unusual grants.* For purposes of applying the 4-year aggregation test for support set forth in subparagraph (1) of this paragraph, one or more contributions (including contributions made prior to Jan. 1, 1970) may be excluded from the numerator of the one-third support fraction and from the denominator of both the one-third support and not–more–than–one–third support fractions only if such a contribution meets the requirements of this subparagraph. The exclusion provided by this subparagraph is generally intended to apply to substantial contributions and bequests from disinterested parties, which contributions or bequests:

(i) Are attracted by reason of the publicly supported nature of the organization;

(ii) Are unusual or unexpected with respect to the amount thereof; and

(iii) Would by reason of their size, adversely affect the status of the organization as normally meeting the one-third support test for any of the applicable periods described in paragraph (c), (d), or (e) of this section.

In the case of a grant (as defined in paragraph (g) of this section) which meets the requirements of this subparagraph, if the terms of the granting instrument (whether executed before or after 1969) require that the funds be paid to the recipient organization over a period of years, the amount received by the organization each year pursuant to the terms of such grant may be excluded for such year. However, no item described in section 509(a)(2)(B) may be excluded under this subparagraph. The provisions of this subparagraph shall apply to exclude unusual grants made during any of the applicable periods described in paragraph (c), (d), or (e) of this section. See subparagraph (5)(ii) of this paragraph as to reliance by a grantee organization upon an unusual grant ruling under this subparagraph.

(4) *Determining factor.* In determining whether a particular contribution may be excluded under subparagraph (3) of this paragraph, all pertinent facts and circumstances will be taken into consideration. No single factor will necessarily be determinative. Among the factors to be considered are:

(i) Whether the contribution was made by any person (or persons standing in a relationship to such person which is described in section 4946(a)(1)(C) through (G)) who created the organization, previously contributed a substantial part of its support or endowment, or stood in a position of authority, such as a foundation manager (within the meaning of section 4946(b)), with respect to the organization. A contribution made by a person other than those persons described in this subdivision will ordinarily be given more favorable consideration than a contribution made by a person described in this subdivision.

(ii) Whether the contribution was a bequest or an inter vivos transfer. A bequest will ordinarily be given more favorable consideration than an inter vivos transfer.

(iii) Whether the contribution was in the form of cash, readily marketable securities, or assets which further the exempt purposes of the organization, such as a gift of a painting to a museum.

(iv) Except in the case of a new organization, whether, prior to the receipt of the particular contribution, the organization *(a)* has carried on an actual program of public solicitation and exempt activities and *(b)* has been able to attract a significant amount of public support.

(v) Whether the organization may reasonably be expected to attract a significant amount of public support subsequent to the particular contribution. In this connection, continued reliance on unusual grants to fund an organization's current operating expenses (as opposed to providing new endowment funds) may be evidence that the organization cannot reasonably be expected to attract future support from the general public.

(vi) Whether, prior to the year in which the particular contribution was received, the organization met the one-third support test described in subparagraph (1) of this paragraph without the benefit of any exclusions of unusual grants pursuant to subparagraph (3) of this paragraph;

(vii) Whether neither the contributor nor any person standing in a relationship to such contributor which is described in section 4946(a)(1) (C) through (G) continues directly or indirectly to exercise control over the organization;

(viii) Whether the organization has a representative governing body as described in § 1.509(a)–3(d)(3)(i); and

(ix) Whether material restrictions or conditions (within the meaning of § 1.507–2(a)(8)) have been imposed by the transferor upon the transferee in connection with such transfer.

(5) *Grantors and contributors.* (i) As to the status of grants and contributions which result in substantial and material changes in the organization (as described in subparagraph (1)(ii) of this paragraph) and which fail to meet the requirements for exclusion under subparagraph (3) of this paragraph, see the rules prescribed in subparagraph (1)(iii) of this paragraph.

(ii) Prior to the making of any grant or contribution which will allegedly meet the requirements for exclusion under subparagraph (3) of this paragraph, a potential grantee organization may request a ruling whether such grant or contribution may be so excluded. Requests for such ruling may be filed by the grantee organization with the district director. The issuance of such ruling will be at the sole discretion of the Commissioner. The organization must submit all information necessary to make a determination of the applicability of subparagraph (3) of this paragraph, including all information relating to the factors described in subparagraph (4) of this paragraph. If a favorable ruling is issued, such ruling may be relied upon by the grantor or contributor of the particular contribution in question for purposes of sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522 and by the grantee organization for purposes of subparagraph (3) of this paragraph.

(6) *Examples.* The application of the principles set forth in this paragraph is illustrated by the examples set forth below. For purposes of these examples, the term *general public* is defined as persons other than disqualified persons and other than persons from whom the foundation received gross receipts in excess of the greater of $5,000 or 1 percent of its support in any taxable year, the term *gross investment income* is as defined in section 509(e), and the term *gross receipts* is limited to receipts from activities which are not unrelated trade or business (within the meaning of section 513).

Example 1. For the years 1970 through 1973, X, an organization exempt under section 501(c)(3) which makes scholarship grants to needy students of a particular city, received support from the following sources:

1970	
Gross receipts (general public)	$35,000
Contributions (substantial contributors)	36,000
Gross investment income	29,000
Total support	100,000
1971	
Gross receipts (general public)	34,000
Contributions (substantial contributors)	35,000
Gross investment income	31,000
Total support	100,000
1972	
Gross receipts (general public)	35,000

Contributions (substantial contributors)	30,000
Gross investment income	35,000
Total support	100,000
1973	
Gross receipts (general public)	30,000
Contributions (substantial contributors)	39,000
Gross investment income	31,000
Total support	100,000

In applying section 509(a)(2) to the taxable year 1974 on the basis of subparagraph (1)(i) of this paragraph, the total amount of support from gross receipts from the general public ($134,000) for the period 1970 through 1973 was more than one-third, and the total amount of support from gross investment income ($126,000) was less than one-third, of its total support for the same period ($400,000). For the taxable years 1974 and 1975, X is therefore considered *normally* to receive more than one-third of its support from the public sources described in section 509(a)(2)(A) and less than one-third of its support from items described in section 509(a)(2)(B) since due to the pattern of X's support, there are no substantial and material changes in the sources of the organization's support in these years. The fact that X received less than one-third of its support from section 509(a)(2)(A) sources in 1973 and more than one-third of its support from items described in section 509(a)(2)(B) in 1972 does not affect its status since it met the *normally* test over a 4-year period.

Example 2. Assume the same facts as in example 1 except that in 1973 X also received an unexpected bequest of $50,000 from A, an elderly widow who was interested in encouraging the work of X, but had no other relationship to it. Solely by reason of the bequest, A became a disqualified person. X used the bequest to create five new scholarships. Its operations otherwise remained the same. Under these circumstances X could not meet the 4-year support test since the total amount received from gross receipts from the general public ($134,000) would not be more than one-third of its total support for the 4-year period ($450,000). Since A is a disqualified person, her bequest cannot be included in the numerator of the one-third support test under section 509(a)(2)(A). However, based on the factors set forth in subparagraph (4) of this paragraph, A's bequest may be excluded as an unusual grant under subparagraph (3) of this paragraph. Therefore, X will be considered to have met the support test for the taxable years 1974 and 1975.

Example 3. In 1970, Y, an organization described in section 501(c)(3), was created by A, the holder of all the common stock in M corporation, B, A's wife, and C, A's business associate. Each of the three creators made small cash contributions to Y to enable it to begin operations. The purpose of Y was to sponsor and equip athletic teams for underprivileged children in the community. Between 1970 and 1973, Y was able to raise small amounts of contributions through fund raising drives and selling admission to some of the sponsored sporting events. For its first year of operations, it was determined that Y was excluded from the definition of *private foundation* under the provisions of section 509(a)(2). A made small contributions to Y from time to time. At all times, the operations of Y were carried out on a small scale, usually being restricted to the sponsorship of two to four baseball teams of underprivileged children. In 1974, M recapitalized and created a first and second class of 6 percent nonvoting preferred stock, most of which was held by A and B. A then contributed 49 percent of his common stock in M to Y. A, B, and C continued to be active participants in the affairs of Y from its creation through 1974. A's contribution of M's common stock was substantial and constituted 90 percent of Y's total support for 1974. Although Y could satisfy the one-third support test on the basis of the four taxable years prior to 1974, a combination of the facts and circumstances described in subparagraph (4) of this paragraph preclude A's contribution of M's common stock in 1974 from being excluded as an unusual grant under subparagraph (3) of this paragraph. A's contribution in 1974 constituted a substantial and material change in Y's sources of support within the meaning of subparagraph (1)(ii) of this paragraph and on the basis of the 5-year period prescribed in subparagraph (1)(ii) of this paragraph (1970 to 1974), Y would not be considered as *normally* meeting the one-third support test described in paragraph (a)(2) of this section for the taxable years 1974 (the current taxable year) and 1975 (the immediately succeeding taxable year).

Example 4. M, an organization described in section 501(c)(3), was organized in 1971 to promote the appreciation of ballet in a particular region of the United States. Its principal activities will consist of erecting a theater for the performance of ballet and the organization and operation of a ballet company. The governing body of M consists of 9 prominent unrelated citizens residing in the region who have either an expertise in ballet or a strong interest in encouraging appreciation of the art form. In order to provide sufficient capital for M to commence its activities, X, a private foundation, makes a grant of $500,000 in cash to M. Although A, the creator of X, is one of the nine members of M's governing body, was one of M's original founders, and continues to lend his prestige to M's activities and fund raising efforts, A does not, directly or indirectly, exercise any control over M. By the close of its first taxable year, M has also received a significant amount of support from a number of smaller contributions and pledges from other members of the general public. Upon the opening of its first season of ballet performances, M expects to charge admission to the general public. Under the above circumstances, the grant by X to M may be excluded as an unusual grant under subparagraph (3) of this paragraph for purposes of determining whether M meets the one-third support test under section 509(a)(2). Although A was a founder and member of the governing body of M, X's grant may be excluded.

Example 5. Assume the same facts as Example 4. In 1974, during M's third season of operations, B, a widow, passed away and bequeathed $4 million to M. During 1971 through 1973, B had made small contributions to M, none exceeding $10,000 in any year. During 1971 through 1974, M had received approximately $550,000 from receipts for admissions and contributions from the general public. At the time of B's death, no person standing in a relationship to B described in section 4946(a)(1) (C) through (G) was a member of M's governing body. B's bequest was in the form of cash and readily marketable securities. The only condition placed upon the bequest was that it be used by M to advance the art of ballet. Under the above circumstances, the bequest of B to M may be excluded as an unusual grant under subparagraph (3) of this paragraph for purposes of determining whether M meets the one-third support test under section 509(a)(2).

Example 6. O is a research organization described in section 501(c)(3). O was created by A in 1971 for the purpose of carrying on economic studies primarily through persons receiving grants from O and engaging in the sale of economic publications. O's five-member governing body consists of A, A's sons, B, and C, and two unrelated economists. In 1971, A made a contribution to O of $100,000 to help establish the organization. During 1971 through 1974 A made annual contributions to O averaging $20,000 a year. During the same period, O received annual contributions from members of the general public averaging $15,000 per year and receipts from the sale of its publications averaging $50,000 per year. In 1974, B made an inter vivos contribution to O of $600,000 in cash and readily marketable securities. Undera majority vote, the governing body decided to retain the Y stock for a period of at least 5 years. Under the above circumstances, A's contribution of the Y stock cannot be excluded as an unusual grant under subparagraph (3) of this paragraph for purposes of determining whether P meets the one-third support test.

(d) *Advance rulings to newly created organizations*—(1) *In general.* A ruling or determination letter that an organization is described in section 509(a)(2) will not be issued to a newly created organization prior to the close of its first taxable year consisting of at least 8 months. However, such organization may request a ruling or determination letter that it will be treated as a section 509(a)(2) organization for its first 2 taxable years (or its first 3 taxable years, if its first taxable year consists of less than 8 months). For purposes of this section such 2- or 3-year period, whichever is applicable, shall be referred to as the advance ruling period. Such an advance ruling or determination letter may be issued if the organization can reasonably be expected to meet the requirements of paragraph (a) of this section during the advance ruling period. The issuance of a ruling or determination letter will be discretionary with the Commissioner.

(2) *Basic consideration.* In determinating whether an organization *can reasonably be expected* (within the meaning of subparagraph (1) of this paragraph) to meet the one-third support test under section 509(a)(2)(A) and the not–more–than–one–third support test under section 509(a)(2)(B) described in paragraph (a) of this section for its advance ruling period or extended advance ruling period as provided in subparagraph (4) of this paragraph, if applicable, the basic consideration is whether its organizational structure, proposed programs or activities, and intended method of operation are such as to attract the type of broadly based support from the general public, public charities, and governmental units which is necessary to meet such tests. While the factors which are relevant to this determination, and the weight accorded to each of them, may differ from case to case, depending on the nature and functions of the organization, a favorable determination will not be made where the facts indicate that an organization is likely during its advance or extended advance ruling period to receive less than one-third of its support from permitted sources (subject to the limitations of paragraph (b) of this section) or to receive more than one-third of its support from items described in section 509(a)(2)(B).

(3) *Factors taken into account.* All pertinent facts and circumstances shall be taken into account under subparagraph (2) of this paragraph in determining whether the organizational structure, programs or activities, and method of

operation of an organization are such as to enable it to meet the tests under section 509(a)(2) for its advance or extended advance ruling period. Some of the pertinent factors are:

(i) Whether the organization has or will have a governing body which is comprised of public officials, or individuals chosen by public officials acting in their capacity as such, of persons having special knowledge in the particular field or discipline in which the organization is operating, of community leaders, such as elected officials, clergymen, and educators, or, in the case of a membership organization, of individuals elected pursuant to the organization's governing instrument or bylaws by a broadly based membership. This characteristic does not exist if the membership of the organization's governing body is such as to indicate that it represents the personal or private interests of disqualified persons, rather than the interests of the community or the general public.

(ii) Whether a substantial portion of the organization's initial funding is to be provided by the general public, by public charities, or by government grants, rather than by a limited number of grantors or contributors who are disqualified persons with respect to the organization. The fact that the organization plans to limit its activities to a particular community or region or to a special field which can be expected to appeal to a limited number of persons will be taken into consideration in determining whether those persons providing the initial support for the organization are representative of the general public. On the other hand, the subsequent sources of funding which the organization can reasonably expect to receive after it has become established and fully operational will also be taken into account.

(iii) Whether a substantial proportion of the organization's initial funds are placed, or will remain, in an endowment, and whether the investment of such funds is unlikely to result in more than one-third of its total support being received from items described in section 509(a)(2)(B).

(iv) In the case of an organization which carries on fund-raising activities, whether the organization has developed a concrete plan for solicitation of funds from the general public on a community or area-wide basis; whether any steps have been taken to implement such plan; whether any firm commitments of financial or other support have been made to the organization by civic, religious, charitable, or similar groups within the community; and whether the organization has made any commitments to, or established any working relationships with, those organizations or classes of persons intended as the future recipients of its funds.

(v) In the case of an organization which carries on community services, such as slum clearance and employment opportunities, whether the organization has a concrete program to carry out its work in the community; whether any steps have been taken to implement that program; whether it will receive any part of its funds from a public charity or governmental agency to which it is in some way held accountable as a condition of the grant or contribution; and whether it has enlisted the sponsorship or support of other civic or community leaders involved in community service programs similar to those of the organization.

(vi) In the case of an organization which carries on educational or other exempt activities for, or on behalf of, members, whether the solicitation for dues-paying members is designed to enroll a substantial number of persons in the community, area, profession, or field of special interest (depending on the size of the area and the nature of the organization's activities); whether membership dues for individual (rather than institutional) members have been fixed at rates designed to make membership available to a broad cross-section of the public rather than to restrict membership to a limited number of persons; and whether the activities of the organization will be likely to appeal to persons having some broad common interest or purpose, such as educational activities in the case of alumni associations, musical activities in the case of symphony societies, or civic affairs in the case of parent-teacher associations.

(vii) In the case of an organization which provides goods, services, or facilities, whether the organization is or will be required to make its services, facilities, performances, or products available (regardless of whether a fee is charged) to the general public, public charities, or governmental units, rather than to a limited number of persons or organizations; whether the organization will avoid executing contracts to perform services for a limited number of firms or governmental agencies or bureaus; and whether the service to be provided is one which can be expected to meet a special or general need among a substantial portion of the general public.

(4) *Extension of advance ruling period.* (i) The advance ruling period described in subparagraph (1) of this paragraph shall be extended for a period of 3 taxable years after the close of the unextended advance ruling period if the organization so requests, but only if such organization's request accompanies its request for an advance ruling and is filed with a consent under section 6501(c)(4) to the effect that the period of limitation upon assessment under section 4940 for any taxable year within the extended advance ruling period shall not expire prior to 1 year after the date of the expiration of the time prescribed by law for the assessment of a deficiency for the last taxable year within the extended advance ruling period. An organization's extended advance ruling period is 5 taxable years if its first taxable year consists of at least 8 months, or is 6 taxable years if its first taxable year is less than 8 months.

(ii) Notwithstanding subdivision (i) of this subparagraph, an organization which has received or applied for an advance ruling prior to October 16, 1972, may file its request for the 3-year extension within 90 days from such date, but only if it files the consents required in this section.

(iii) See paragraph (e)(4)(i)(*d*) of this section for the effect upon the initial determination of status of an organization which receives an advance ruling for an extended advance ruling period.

(e) *Status of newly created organizations*—(1) *Advance or extended advance ruling.* This subparagraph shall apply to a newly created organization which has received a ruling or determination letter under paragraph (d) of this section that it be treated as a section 509(a)(2) organization for its advance or extended advance ruling period. So long as such an organization's ruling or determination letter has not been terminated by the Commissioner before the expiration of the advance or extended advance ruling period, then whether or not such organization has satisfied the requirements of paragraph (a) of this section during such advance or extended advance ruling period, such an organization will be treated as an organization described in section 509(a)(2) in accordance with subparagraphs (2) and (3) of this paragraph, both for purposes of the organization and any grantor or contributor to such organization.

(2) *Reliance period.* Except as provided in subparagraphs (1) and (3) of this paragraph, an organization described in subparagraph (1) of this paragraph will be treated as an organization described in section 509(a)(2) for all purposes other than section 507(d) and 4940 for the period beginning with its inception and ending 90 days after its advance or extended advance ruling period. Such period will be extended until a final determination is made of such an organization's status only if the organization submits, within the 90-day period, information needed to determine whether it meets the requirements of paragraph (a) of this section for its advance or extended advance ruling period (even if such organization fails to meet the requirements of such paragraph (a)). However, since this subparagraph does not apply to section 4940, if it is subsequently determined that the organization was a private foundation from its inception, then the tax imposed by section 4940 shall be due without regard to the advance ruling or determination letter. Consequently, if any amount of tax under section 4940 in such a case is not paid on or before the last date prescribed for payment, the organization is liable for interest in accordance with section 6601. However, since any failure to pay such tax during the period referred to in this subparagraph is due to reasonable cause, the penalty under section 6651 with respect to the tax imposed by section 4940 shall not apply.

(3) *Grantors or contributors.* If a ruling or determination letter is terminated

by the Commissioner prior to the expiration of the period described in subparagraph (2) of this paragraph, for purposes of sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522 the status of grants or contributions with respect to grantors or contributors to such organizations will not be affected until notice of change of status of such organization is made to the public (such as by publication of the Internal Revenue Bulletin). The preceding sentence shall not apply, however, if the grantor or contributor was responsible for, or aware of, the act or failure to act that resulted in the organization's loss of classification under section 509(a)(2) or acquired knowledge that the Internal Revenue Service had given notice to such organization that it would be deleted from such classification. See, however, §1.509(a)–3(c)(5)(ii) for the procedures to be followed to protect the grantor or contributor from being considered responsible for, or aware of, the act or failure to act resulting in the grantee's loss of classification under section 509(a)(2).

(4) *Initial determination of status*— (i) *New organizations. (a)* The initial determination of status of a newly created organization is the first determination (other than by issuance of an advance ruling or determination letter under paragraph (d) of this section) that the organization will be considered as *normally* meeting the requirements of paragraph (a) of this section for a period beginning with its first taxable year.

(b) In the case of a new organization whose first taxable year is at least 8 months, except as provided for in subdivision (i)*(d)* of this subparagraph, the initial determination of status shall be based on a computation period of either the first taxable year or the first and second taxable years.

(c) In the case of a new organization whose first taxable year is less than 8 taxable months, except as provided for in subdivision (i)*(d)* of this subparagraph, the initial determination of status shall be based on a computation period of either the first and second taxable years or the first, second and third taxable years.

(d) In the case of an organization which has received a ruling or determination letter for an extended advance ruling period under paragraph (d)(4) of this section, the initial determination of status shall be based on a computation period of all of the taxable years in the extended advance ruling period. However, where the ruling or determination letter for an extended advance ruling period under paragraph (d)(4) of this section is terminated by the Commissioner prior to the expiration of the period described in subparagraph (2) of this paragraph, the initial determination of status shall be based on a computation period of the period provided for in *(b)* or *(c)* of this subdivision or, if greater, the number of years to which the advance ruling applies.

(e) An initial determination that an organization will be considered as *normally* meeting the requirements of paragraph (a) of this section shall be effective for each taxable year in the computation period plus (except as provided by paragraph (c)(1)(ii) of this section relating to material changes in sources of support) the two taxable years immediately succeeding the computation period. Therefore, in the case of an organization referred to in *(b)* of this subdivision to which paragraph (c)(1)(ii) of this section does not apply, with respect to its first, second, and third taxable years, such an organization shall be described in section 509(a)(2) if it meets the requirements of paragraph (a) of this section for either its first taxable year or for its first and second taxable years on an aggregate basis. In addition, if it meets the requirements of paragraph (a) of this section for its first and second taxable years it shall be described in section 509(a)(2) for its fourth taxable year. Once an organization is considered as *normally* meeting the requirements of paragraph (a) for a period specified under this subdivision, paragraph (c)(1) (i), (ii), or (iv) of this section shall apply.

(f) The provisions of this subdivision may be illustrated by the following examples:

Example 1. X, a calendar year organization described in section 501(c)(3), is created in February 1972 for the purpose of displaying African art. The support X received from the public in 1972 satisfies the one-third support and not–more–than–one–third support tests described in section 509(a)(2) for its first taxable year, 1972. X may therefore get an initial determination that it meets the requirements of paragraph (a) of this section for its first taxable year beginning in February 1972 and ending on December 31, 1972. This determination will be effective for taxable years 1972, 1973, and 1974.

Example 2. Assume the same facts as in example 1 except that X also receives a substantial contribution from one individual in 1972 which is not excluded from the denominator of the one-third support fraction described in section 509(a)(2) by reason of the unusual grant provision of subparagraph (c)(3) of this section. Because of this substantial contribution, X fails to satisfy the one-third support test over its first taxable year, 1972. However, the support received from the public over X's first and second taxable years in the aggregate satisfies the one-third support and not–more–than–one–third support tests. X may therefore get an initial determination that it meets the requirements of paragraph (a) of this section for its first and second taxable years in the aggregate beginning in February 1972 and ending on December 31, 1973. This determination will be effective for taxable years 1972, 1973, 1974, and 1975.

Example 3. Y, a calendar year organization described in section 501(c)(3), is created in July 1972 for the encouragement of the musical arts. Y requests and receives an extended advance ruling period of five full taxable years plus its initial short taxable year of 6 months under subparagraph (d)(4) of this section. The extended advance ruling period begins in July 1972 and ends on December 31, 1977. The support received from the public over Y's first through sixth taxable years in the aggregate will satisfy the one-third support and not–more–than–one–third support tests described in section 509(a)(2). Therefore, Y in 1978 may get an initial determination that it meets the requirements of paragraph (a) of this section in the aggregate over all the taxable years in its extended advance ruling period beginning in July 1972 and ending on December 31, 1977. This determination will be effective for taxable years 1972 through 1979.

Example 4. Assume the same facts as in examples 3 except that the ruling for the extended advance ruling period is terminated prospectively at the end of 1975, so that Y may not rely upon such ruling for 1976 or any succeeding year. The support received from the public over Y's first through fourth taxable years (1972 through 1975) will not satisfy the one-third support and not–more–than–one–third support tests described in section 509(a)(2). Because the ruling was terminated, the computation period for Y's initial determination of status is the period 1972 through 1975. Since Y has not met the requirements of paragraph (a) of this section for such computation period, Y is not described in section 509(a)(2) for purposes of its initial determination of status. If Y is not described in section 509(a) (1), (3), or (4), then Y is a private foundation. As of 1976, Y shall be treated as a private foundation for all purposes (except as provided in subparagraph (3) of this paragraph with respect to grantors and contributors), and as of July 1972 for purposes of the tax imposed by section 4940 and for purposes of section 507(d) (relating to aggregate tax benefit).

(ii) *Advance rulings.* Unless a newly created organization has obtained a ruling or determination letter under paragraph (d) of this section that it be treated as a section 509(a)(2) organization for its advance or extended advance ruling period, it can not rely upon the possibility it will meet the requirements of paragraph (a) of this section for a taxable year which begins before the close of either applicable computation period provided for in subdivision (i) *(b)* or *(c)* of this subparagraph. Therefore, an organization which has not obtained such a ruling or determination letter, in order to avoid the risks associated with subsequently being determined to be a private foundation, may comply with the rules applicable to private foundations, and may pay, for example, the tax imposed by section 4940. In that event, if the organization subsequently meets the requirements of paragraph (a) for either applicable computation period, it shall be treated as a section 509(a)(2) organization from its inception, and, therefore, any tax imposed under chapter 42 shall be refunded and section 509(b) shall not apply.

(iii) *Penalties.* If a newly created organization fails to obtain a ruling or determination letter under paragraph (d) of this section, and fails to meet the requirements of paragraph (a) of this section for the first applicable computation period provided for in subdivision (i) *(b)* or *(c)* of this subparagraph, see section 6651 for penalty for failure to file return and pay tax.

(iv) *Examples.* This subparagraph may be illustrated by the following examples:

Example 1. On January 1, 1972, A contributes $100,000 to X, an organization described in section 501(c)(3) which he created on such date. X is not described in section 509(a) (1), (3), or (4). X's governing instrument does not contain the provisions referred to in section 508(e). Therefore, A is not entitled to a deduction under section 170 for the $100,000 contribution by reason of section 508(d)(2)(A) unless X is described in section 509(a)(2). If X meets the requirements of section 509(a)(2) for 1972 and 1973 on an aggregate basis, then whether or not X met the requirements of section 509(a)(2) for 1972 based on the support received in 1972, X would not have to meet the governing instrument requirements of section 508(e), and section 508(d)(2)(A) would not prevent A from claiming the deduction under section 170 for 1972. If X fails to meet the requirements of section 509(a)(2) for both 1972 and, on an aggregate basis, 1972 and 1973, X would lose its exempt status under section 508(e) for both 1972 and 1973, and A would be barred by section 508(d)(2)(A) from claiming a deduction for the $100,000 contribution to X.

Example 2. Assume the same facts as in example 1 except that X's governing instrument contains provisions which meet the requirements of section 508(e) in the event X is a private foundation, but do not apply to X in the event X is not a private foundation. Whether or not X meets the requirements of section 509(a)(2) for 1972 based on the support received in 1972 or 1972 and 1973 on an aggregate basis, since X meets the requirements of section 508(e), section 508(d)(2)(A) would not bar A from claiming a deduction under section 170 for 1972 for the contribution to X.

(f) *Gifts and contributions distinguished from gross receipts*—(1) *In general.* In determining whether an organization normally receives more than one-third of its support from permitted sources, all *gifts* and *contributions* (within the meaning of section 509(a)(2)(A)(i)) received from permitted sources, are includible in the numerator of the support fraction in each taxable year. However, *gross receipts* (within the meaning of section 509(a)(2)(A)(ii)) from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity which is not an unrelated trade or business, are includible in the numerator of the support fraction in any taxable year only to the extent that such gross receipts do not exceed the limitation with respect to the greater of $5,000 or 1 percent of support which is describing paragraph (b) of this section. The terms *gifts* and *contributions* shall, for purposes of section 509(a)(2), have the same meaning as such terms have under section 170(c) and also include bequests, legacies, devises, and transfers within the meaning of section 2055 or 2106(a)(2). Thus, for purposes of section 509(a)(2)(A), any payment of money or transfer of property without adequate consideration shall be considered a *gift* or *contribution.* Where payment is made or property transferred as consideration for admissions, sales of merchandise, performance of services, or furnishing of facilities to the donor, the status of the payment or transfer under section 170(c) shall determine whether and to what extent such payment or transfer constitutes a *gift* or *contribution* under section 509(a)(2)(A)(i) as distinguished from *gross receipts* from related activities under section 509(a)(2)(A)(ii).

(2) *Valuation of property.* For purposes of section 509(a)(2), the amount includible in computing support with respect to gifts, grants or contributions of property or use of such property shall be the fair market or rental value of such property at the date of such gift or contribution.

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

Example. P is a local agricultural club described in section 501(c)(3). In order to encourage interest and proficiency by young people in farming and raising livestock, it makes awards at its annual fair for outstanding specimens of produce and livestock. Most of these awards are cash or other property donated by local businessmen. When the awards are made, the donors are given recognition for their donations by being identified as the donor of the award. The recognition given to donors is merely incidental to the making of the award to worthy youngsters. For these reasons, the donations will constitute *contributions* for purposes of section 509(a)(2)(A)(i). The amount includible in computing support with respect to such contributions is equal to the cash contributed or the fair market value of other property on the dates contributed.

(g) *Grants distinguished from gross receipts*—(1) *In general.* In determining whether an organization normally receives more than one-third of its support from public sources, all *grants* (within the meaning of section 509(a)(2)(A)(i)) received from permitted sources are includible in full in the numerator of the support fraction in each taxable year. However, *gross receipts* (within the meaning of section 509(a)(2)(A)(ii)) from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity which is not an unrelated trade or business, are includible in the numerator of the support fraction in any taxable year only to the extent that such gross receipts do not exceed the limitation with respect to the greater of $5,000 or 1 percent of support which is described in paragraph (b) of this section. A grant is normally made to encourage the grantee organization to carry on certain programs or activities in furtherance of its exempt purposes. It may contain certain terms and conditions imposed by the grantor to insure that the grantee's programs or activities are conducted in a manner compatible with the grantor's own programs and policies and beneficial to the public. The grantee may also perform a service or produce a work product which incidentally benefits the grantor. Because of the imposition of terms and conditions, the frequent similarlity of public purposes of grantor and grantee, and the possibility of benefit resulting to the grantor, amounts received as grants *for* the carrying on of exempt activities are sometimes difficult to distinguish from amounts received as gross receipts *from* the carrying on of exempt activities. The fact that the agreement, pursuant to which payment is made, is designated a *contract* or a *grant* is not controlling for purposes of classifying the payment under section 509(a)(2).

(2) *Distinguishing factors.* For purposes of section 509(a)(2)(A)(ii), in distinguishing the term *gross receipts* from the term *grants*, the term *gross receipts* means amounts received from an activity which is not an unrelated trade or business, if a specific service, facility, or product is provided to serve the direct and immediate needs of the payor, rather than primarily to confer a direct benefit upon the general public. In general, payments made primarily to enable the payor to realize or receive some economic or physical benefit as a result of the service, facility, or product obtained will be treated as *gross receipts* with respect to the payee. The fact that a profitmaking organization would, primarily for its own economic or physical betterment, contract with a nonprofit organization for the rendition of a comparable service, facility or product from such organization constitutes evidence that any payments received by the nonprofit payee organization (whether from a governmental unit, a nonprofit or a profitmaking organization) for such services, facilities or products are primarily for the economic or physical benefit of the payor and would therefore be considered *gross receipts,* rather than *grants* with respect to the payee organization. For example, if a nonprofit hospital described in section 170(b)(1)(A)(iii) engages an exempt research and development organization to develop a more economical system of preparing food for its own patients and personnel, and it can be established that a hospital operated for profit might engage the services of such an organization to perform a similar benefit for its economic betterment, such fact would constitute evidence that the payments received by the research and development organization constitute *gross receipts,* rather than *grants.* Research leading to the development of tangible products for the use or benefit of the payor will generally be treated as a service provided to serve the direct and immediate needs of the payor, while basic research or studies carried on in the physical or social sciences will generally be treated as primarily to confer a direct benefit upon the general public.

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

Example 1. M, a nonprofit research organization described in section 501(c)(3), engages in some contract research. It receives funds from the government to develop a specific electronic device needed to perfect articles of space equipment. The initiative for the project came solely from the government. Furthermore, the government could have contracted with profitmaking research organizations which carry on similar activities. The funds received from the government for this project are gross receipts and do not constitute *grants* within the meaning of section 509(a)(2)(A)(i). M provided a specific product at the government's request and thus was serving the direct and immediate needs of the payor within the meaning of subparagraph (2) of this paragraph.

Example 2. N is a nonprofit educational organization described in section 501(c)(3). Its principal activity is to operate institutes to train employees of various industries in the principles of management and administration. The government pays N to set up a special institute for certain government employees and to train them over a 2-year period. Management training is also provided by profitmaking organizations. The funds received are included as *gross receipts.* The particular services rendered were to serve the direct and immediate needs of the government in the training of its employees within the meaning of subparagraph (2) of this paragraph.

Example 3. The Office of Economic Opportunity makes a community action program grant to O, an organization described in section 509(a)(1). O serves as a *delegate agency* of OEO for purposes of financing a local community action program. As part of this program, O signs an agreement with X, an educational and charitable organization described in section 501(c)(3), to carry out a housing program for the benefit of poor families. Pursuant to this agreement, O pays X out of the funds provided by OEO to build or rehabilitate low income housing and to provide advisory services to other nonprofit organizations in order for them to meet similar housing objectives, all on a nonprofit basis. Payments made from O to X constitute *grants* for purposes of section 509(a)(2)(A) because such program is carried on primarily for the direct benefit of the community.

Example 4. P is an educational institute described in section 501(c)(3). It carries on studies and seminars to assist institutions of higher learning. It receives funds from the government to research and develop a program of black studies for institutions of higher learning. The performance of such a service confers a direct benefit upon the public. Because such program is carried on primarily for the direct benefit of the public, the funds are considered a *grant.*

Example 5. Q is an organization described in section 501(c)(3) which carries on medical research. Its efforts have primarily been directed toward cancer research. Q sought funds from the government for a particular project being contemplated in connection with its work. In order to encourage its activities, the government gives Q the sum of $25,000. The research project sponsored by government funds is primarily to provide direct benefit to the general public, rather than to serve the direct and immediate needs of the government. The funds are therefore considered a *grant.*

Example 6. R is a public service organization described in section 501(c)(3) and composed of State and local officials involved in public works activities. The Bureau of Solid Waste, Management of the Department of Health, Education, and Welfare paid R to study the feasibility of a particular system for disposal of solid waste. Upon completion of the study, R was required to prepare a final report setting forth its findings and conclusions. Although R is providing the Bureau of Solid Waste Management with a final report, such report is the result of basic research and study in the physical sciences and is primarily to provide direct benefit to the general public by serving to further the general functions of government, rather than a direct and immediate governmental needs. The funds paid to R are therefore a *grant* within the meaning of section 509(a)(2).

Example 7. R is the public service organization referred to in example 6. W, a municipality described in section 170(c)(1), decides to construct a sewage disposal plant. W pays R to study a number of possible locations for such plant and to make recommendations to W, based upon a number of factors, as to the best location. W instructed R that in making its recommendation, primary consideration should be given to minimizing the costs of the project to W. Since the study commissioned by W was primarily directed toward producing an economic benefit to W in the form of minimizing the costs of its project, the services rendered are treated as serving W's direct and immediate needs and are includible as *gross receipts* by R.

Example 8. S in an organization described in section 501(c)(3). It was organized and is operated to further African development and strengthen understanding between the United States and Africa. To further these purposes, S receives funds from the Agency for International Development and the Department of State under which S is required to carry out the following programs: Selection, transportation, orientation, counseling, and language training of African students admitted to American institutions of higher learning; payment of tuition, other fees, and maintenance of such students; and operation of schools and vocational training programs in underdeveloped countries for residents of those countries. Since the programs carried on by S are primarily to provide direct benefit to the general public, all of the funds received by S from the Federal agencies are considered *grants* within the meaning of section 509(a)(2).

(h) *Definition of membership fees*— (1) *General rule.* For purposes of section 509(a)(2), the fact that a membership organization provides services, admissions, facilities, or merchandise to its members as part of its overall activities will not, in itself, result in the classification of fees received from members as *gross receipts* rather than *membership fees.* If an organization uses membership fees as a means of selling admissions, merchandise, services, or the use of facilities to members of the general public who have no common goal or interest (other than the desire to purchase such admissions, merchandise, services, or use of facilities), then the income received from such fees shall not constitute *membership fees* under section 509(a)(2)(A)(i), but shall, if from a related activity, constitute *gross receipts* under section 509(a)(2)(A)(ii). On the other hand, to the extent the basic purpose for making the payment is to provide support for the organization rather than to purchase admissions, merchandise, services, or the use of facilities, the income received from such payment shall constitute *membership fees.*

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

Example 1. M is a symphony society described in section 501(c)(3). Its primary purpose is to support the local symphony orchestra. The organization has three classes of membership. Contributing members pay annual dues of $10, sustaining members pay $25, and honorary members pay $100. The dues are placed in a maintenance fund which is used to provide financial assistance in underwriting the orchestra's annual deficit. Members have the privilege of purchasing subscriptions to the concerts before they go on sale to the general public, but must pay the same price as any other member of the public. They also are entitled to attend a number of rehearsals each season without charge. Under these circumstances, M's receipts from the members constitute *membership fees* for purposes of section 509(a)(2)(A)(i).

Example 2. N is a theater association described in section 501(c)(3). Its purpose is to support a repertory company in the community in order to make live theatrical performances available to the public. The organization sponsors six plays each year. Members of the organization are entitled to a season subscription to the plays. The fee paid as dues approximates the retail price of the six plays, less a 10-percent discount. Tickets to each performance are also sold directly to the general public. The organization also holds a series of lectures on the theater which members may attend. Under these circumstances, the fees paid by members as dues will be considered *gross receipts* from a related activity. Although the fees are designated as membership fees, they are actually admissions to a series of plays.

(i) *Bureau* defined—(1) *In general.* The term *any bureau or similar agency of a governmental unit* (within the meaning of section 509(a)(2)(A)(ii)), refers to a specialized operating unit of the executive, judicial, or legislative branch of government where business is conducted under certain rules and regulations. Since the term *bureau* refers to a unit functioning at the operating, as distinct from the policymaking, level of government, it is normally descriptive of a subdivision of a department of government. The term *bureau,* for purposes of section 509(a)(2)(A)(ii), would therefore not usually include those levels of government which are basically policymaking or administrative, such as the office of the Secretary or Assistant Secretary of a department, but would consist of the highest operational level under such policymaking or administrative levels. Each subdivision of a larger unit within the Federal Government, which is headed by a Presidential appointee holding a position at or above Level V of the Executive Schedule under 5 U.S.C. 5316, will normally be considered an administrative or policymaking, rather than an operating, unit. Amounts received from a unit functioning at the policymaking or administrative level of government will be treated as received from one bureau or similar agency of such unit. Units of a governmental agency above the operating level shall be aggregated and considered a separate bureau for this purpose. Thus, an organization receiving gross receipts from both a policymaking or administrative unit and an operational unit of a department will be treated as receiving gross receipts from two *bureaus* within the meaning of section 509(a)(2)(A)(ii). For purposes of this subparagraph, the Departments of Air Force, Army, and Navy are separate departments and each is considered as having its own policymaking, administrative, and operating units.

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

Example 1. The Bureau of Health Insurance is considered a *bureau* within the meaning of section 509(a)(2)(A)(ii). It is a part of the Department of Health, Education, and Welfare, whose Secretary performs a policymaking function, and is under the Social Security Administration, which is basically an administrative unit. The Bureau of Health Insurance is in the first operating level within the Social Security Administration. Similarly, the National Cancer Institute would be considered a *bureau,* as it is an operating part of the National Institutes of Health within the Department of Health, Education, and Welfare.

Example 2. The Bureau for Africa and the Bureau for Latin America are considered *bureaus* within the meaning of section 509(a)(2)(A)(ii). Both are separate operating units under the administrator of the Agency for International development, a policy-making official. If an organization received gross receipts from both of these bureaus, the amount of gross receipts received from each would be subject to the greater of $5,000 or 1 percent limitation under section 509(a)(2)(A)(ii).

Example 3. The Bureau of International Affairs of the Civil Aeronautics Board is considered a *bureau* within the meaning of section 509(a)(2)(A)(ii). It is an operating unit under the administrative office of the Executive Director. The subdivisions of the Bureau of International Affairs are Geographic Areas and Project Development Staff. If an organization received gross receipts from these subdivisions, the total gross receipts from these subdivisions would be considered gross receipts from the same *bureau,* the Bureau of International Affairs, and would be subject to the greater of $5,000 or 1 percent limitation under section 509(a)(2)(A)(ii).

Example 4. The Department of Mental Health, a State agency which is an operational part of State X's Department of Public Health, is considered a *bureau.* The Department of Public Health is basically an administrative agency and the Department of Mental Health is at the first operational level within it.

Example 5. The Aeronautical Systems Division of the Air Force Systems Command, and other units on the same level, are considered separate *bureaus* with the meaning of section 509(a)(2)(A)(ii). They are part of the Department of the Air Force which is a separate department for this purpose, as are the Army and Navy. The Secretary and the Under Secretary of the Air Force perform the policy-making function, the Chief of Staff and the Air Force Systems Command are basically administrative, having a comprehensive complement of staff functions to provide administration for the various divisions. The Aeronautical Systems Division and other units on the same level are thus the first operating level, as evidenced by the fact that they are the units that let contracts and perform the various operating functions.

Example 6. The Division of Space Nuclear Systems, the Division of Biology and Medicine, and other units on the same level within the Atomic Energy Commission are each separate *bureaus* within the meaning of section 509(a)(2)(A)(ii). The Commissioners (which make up the Commission) are the policymakers. The general manager and the various assistant general managers perform the administrative function. The various divisions perform the operating function as evidenced by the fact that each has separate programs to pursue and contracts specifically for these various programs.

(j) *Grants from public charities*—(1) *General rule.* For purposes of the one-third support test in section 509(a)(2)(A), grants (as defined in paragraph (g) of this section) received from an organization described in section 509(a)(1) (hereinafter referred to in this subparagraph as a *public charity*) are generally includible in full in computing the numerator of the recipient's support fraction of the taxable year in question. It is sometimes necessary to determine whether the recipient of a grant from a public charity has received such support from the public charity as a grant, or whether the recipient has in fact received such support as an indirect contribution from a donor to the public charity. If the amount received is considered a grant from the public charity, it is fully includible in the numerator of the support fraction under section 509(a)(2)(A). However, if the amount received is considered to be an indirect contribution from one of the public charity's donors which has passed through the public chairty to the recipient organization, such amount will retain its character as a contribution from such donor and, if, for example, the donor is a substantial contributor (as defined in section 507(d)(2)) with respect to the ultimate recipient, such amount shall be excluded from the numerator of the support fraction under section 509(a)(2). If a public charity makes both an indirect contribution from its donor and an additional grant to the ultimate recipient, the indirect contribution shall be treated as made first.

(2) *Indirect contributions.* For purposes of subparagraph (1) of this paragraph, an indirect contribution is one which is expressly or impliedly ear-marked by the donor as being for, or for the benefit of, a particular recipient (rather than for a particular purpose).

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

Example 1. M, a national foundation for the encouragement of the musical arts, is an organization described in section 170(b)(1)(A)(vi). A gives M a donation of $5,000 without imposing any restrictions or conditions upon the gift. M subsequently makes a $5,000 grant to X, an organization devoted to giving public performances of chamber music. Since the grant to X is treated as being received from M, it is fully includible in the numerator of X's support fraction for the taxable year of receipt.

Example 2. Assume M is the same organization described in example 1. B gives M a donation of $10,000, but requires that M spend the money for the purpose of supporting organizations devoted to the advancement of contemporary American music. M has complete discretion as to the organizations of the type described to which it will make a grant. M decides to make grants of $5,000 each to Y and Z, both being organizations described in section 501(c)(3) and devoted to furthering contemporary American music. Since the grants to Y and Z are treated as being received from M, Y and Z may each include one of the $5,000 grants in the numerator of its support fraction for purposes of section 509(a)(2)(A). Although the donation to M was conditioned upon the use of the funds for a particular purpose, M was free to select the ultimate recipient.

Example 3. N is a national foundation for the encouragement of art and is an organization described in section 170(b)(1)(A)(vi). Grants to N are permitted to be earmarked for particular purposes. O, which is an art workshop devoted to training young artists and claiming status under section 509(a)(2), persuades C, a private foundation, to make a grant of $25,000 to N. C is a disqualified person with respect to O. C made the grant to N with the understanding that N would be bound to make a grant to O in the sum of $25,000, in addition to a matching grant of N's funds to O in the sum of $25,000. Only the $25,000 received directly from N is considered a grant from N. The other $25,000 is deemed an indirect contribution from C to O and is to be excluded from the numerator of O's support fraction.

(k) *Method of accounting.* For purposes of section 509(a)(2), an organization's support will be determined solely on the cash receipts and disbursement method of accounting described in section 446(c)(1). For example, if a grantor makes a grant to an organization payable over a term of years, such grant will be includible in the support fraction of the grantee organization only when and to the extent amounts payable under the grant are received by the grantee.

(l) *Gross receipts from section 513(a) (1), (2), or (3) activities.* For purposes of section 509(a)(2)(A)(ii), gross receipts from activities described in section 513(a) (1), (2), or (3) will be considered gross receipts from activities which are not unrelated trade or business.

(m) *Gross receipts distinguished from gross investment income.* (1) For purposes of section 509(a)(2), where the charitable purpose of an organization described in section 501(c)(3) is accomplished through the furnishing of facilities for a rental fee or loans to a particular class of persons, such as aged, sick, or needy persons, the support received from such persons will be considered *gross receipts* (within the meaning of section 509(d)(2)) from an activity which is not an unrelated trade or business, rather than *gross investment income.* However, if such organization also furnishes facilities or loans to persons who are not members of such class and such furnishing does not contribute importantly to the accomplishment of such organization's exempt purposes (aside from the need of such organization for income or funds or the use it makes of the profits derived), the support received from such furnishing will be considered *rents* or *interest* and therefore will be treated as *gross investment income* within the meaning of section 509(d)(4), unless such income is included in computing the tax imposed by section 511.

(2) The provisions of this paragraph may be illustrated by the following example:

Example. X, an organization described in section 501(c)(3), is organized and operated to provide living facilities for needy widows of deceased servicemen. X charges such widows a small rental fee for the use of such facilities. Since X is accomplishing its exempt purpose through the rental of such facilities, the support received from the widows is considered *gross receipts* within the meaning of section 509(d)(2). However, if X rents part of its facilities to persons having no relationship to X's exempt purpose, the support received from such rental will be considered *gross investment income* within the meaning of section 509(d)(4), unless such income is included in computing the tax imposed by section 511.

[T.D. 7212, 37 FR 21907, Oct. 17, 1972, as amended by T.D. 7784, 46 FR 37889, July 23, 1981; T.D. 8423, 57 FR 33443, July 29, 1992]

§1.509(a)–4 Supporting organizations.

(a) *In general.* (1) Section 509(a)(3) excludes from the definition of *private foundation* those organizations which meet the requirements of subparagraphs (A), (B), and (C) thereof.

(2) Section 509(a)(3)(A) provides that a section 509(a)(3) organization must be organized, and at all times thereafter operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in section 509(a) (1) or (2). Section 509(a)(3)(A) describes the nature of the support or benefit which a section 509(a)(3) organization must provide to one or more section 509(a) (1) or (2) organizations. For purposes of section 509(a)(3)(A), paragraph (b) of this section generally describes the organizational and operational tests; paragraph (c) of this section describes permissible purposes under the organizational test; paragraph (d) of this section describes the requirement of supporting or benefiting one or more *specified* publicly supported organizations; and paragraph (e) of this section describes permissible beneficiaries and activities under the operational test.

(3) Section 509(a)(3)(B) provides that a section 509(a)(3) organization must be operated, supervised, or controlled by or in connection with one or more organizations described in section 509(a) (1) or (2). Section 509(a)(3)(B) and paragraph (f) of this section describe the nature of the relationship which must exist between the section 509(a)(3) and section 509(a) (1) or (2) organizations. For purposes of section 509(a)(3)(B), paragraph (g) of this section defines *operated, supervised, or controlled by*; paragraph (h) of this section defines *supervised or controlled in connection with;* and paragraph (i) of this section defines *operated in connection with.*

(4) Section 509(a)(3)(C) provides that a section 509(a)(3) organization must not be controlled directly or indirectly by disqualified persons (other than foundation managers or organizations described in section 509(a) (1) or (2)). Section 509(a)(3)(C) and paragraph (j) of this section prescribe a limitation on the control over the section 509(a)(3) organization.

(5) For purposes of this section, the term *supporting organization* means either an organization described in section 509(a)(3) or an organization seeking section 509(a)(3) status, depending upon its context. For purposes of this section, the term *publicly supported organization* means an organization described in section 509(a) (1) or (2).

(b) *Organizational and operational tests.* (1) Under subparagraph (A) of section 509(a)(3), in order to qualify as a supporting organization, an organization must be both organized and operated exclusively *for the benefit of, to perform the functions of, or to carry out the purposes of* (hereinafter referred to in this section as being organized and operated *to support or benefit*) one or more specified publicly supported organizations. If an organization fails to meet either the organizational or the operational test, it cannot qualify as a supporting organization.

(2) In the case of supporting organizations created prior to January 1, 1970, the organizational and operational tests shall apply as of January 1, 1970. Therefore, even though the original articles of organization did not limit its purposes to those required under section 509(a)(3)(A) and even though it operated before January 1, 1970, for some purpose other than those required under section 509(a)(3)(A), an organization will satisfy the organizational and operational tests if, on January 1, 1970, and at all times thereafter, it is so constituted as to comply with these tests. For the special rules pertaining to the application of the organizational and operational tests to organizations terminating their private foundation status under the 12-month or 60-month termination period provided under section 507(b)(1)(B) by becoming *public* under section 509(a)(3), see the regulations under section 507(b).

(c) *Organizational test*—(1) *In general.* An organization is organized exclusively for one or more of the purposes specified in section 509(a)(3)(A) only if its articles of organization (as defined in §1.501(c)(3)–1(b)(2)):

(i) Limit the purposes of such organization to one or more of the purposes set forth in section 509(a)(3)(A);

(ii) Do not expressly empower the organization to engage in activities which are not in furtherance of the purposes referred to in subdivision (i) of this subparagraph;

(iii) State the specified publicly supported organizations on whose behalf such organization is to be operated (within the meaning of paragraph (d) of this section); and

(iv) Do not expressly empower the organization to operate to support or benefit any organization other than the specified publicly supported organizations referred to in subdivision (iii) of this subparagraph.

(2) *Purposes.* In meeting the organizational test, the organization's purposes, as stated in its articles, may be as broad as, or more specific than, the purposes set forth in section 509(a)(3)(A). Therefore, an organization which, by the terms of its articles, is formed *for the benefit of* one or more specified publicly supported organizations shall, if it otherwise meets the other requirements of this paragraph, be considered to have met the organizational test. Similarly, articles which state that an organization is formed *to perform the publishing functions* of a specified university are sufficient to comply with the organizational test. An organization which is *operated, supervised, or controlled by* (within the meaning of paragraph (g) of this section) or *supervised or controlled in connection with* (within the meaning of paragraph (h) of this section) one or more sections 509(a) (1) or (2) organizations to carry out the purposes of such organizations, will be considered as meeting the requirements of this paragraph if the purposes set forth in its articles are similar to, but no broader than, the purposes set forth in the articles of its controlling section 509(a) (1) or (2) organizations. If, however, the organization by which it is operated, supervised, or controlled is a publicly supported section 501(c) (4), (5), or (6) organization (deemed to be a section 509(a)(2) organization for purposes of section 509(a)(3) under the provisions of section 509(a)), the supporting organization will be considered as meeting the requirements of this paragraph if its articles require it to carry on charitable, etc., activities within the meaning of section 170(c)(2).

(3) *Limitations.* An organization is not organized exclusively for the purposes set forth in section 509(a)(3)(A) if its articles expressly permit it to operate to support or benefit any organization other than those specified publicly supported organizations referred to in subparagraph (1)(iii) of this paragraph. Thus, for example, an organization will not meet the organizational test under section 509(a)(3)(A) if its articles expressly empower it to pay over any part of its income to, or perform any service for, any organization other than those publicly supported organizations specified in its articles (within the meaning of paragraph (d) of this section). The fact that the actual operations of such organization have been exclusively for the benefit of the specified publicly supported organizations shall not be sufficient to permit it to meet the organizational test.

(d) *Specified organizations*—(1) *In general.* In order to meet the requirements of section 509(a)(3)(A), an organization must be organized and operated exclusively to support or benefit one or more *specified* publicly supported organizations. The manner in which the publicly supported organizations must be *specified* in the articles for purposes of section 509(a)(3)(A) will depend upon whether the supporting organization is *operated, supervised, or controlled by* or *supervised or controlled in connection with* (within the meaning of paragraphs (g) and (h) of this section) such organizations or whether it is *operated in connection with* (within the meaning of paragraph (i) of this section) such organizations.

(2) *Nondesignated publicly supported organizations; requirements.* (i) Except as provided in subdivision (iv) of this subparagraph, in order to meet the requirements of subparagraph (1) of this paragraph, the articles of the supporting organization must designate each of the *specified* organizations by name unless:

(a) The supporting organization is operated, supervised, or controlled by (within the meaning of paragraph (g) of this section), or is supervised or controlled in connection with (within the meaning of paragraph (h) of this section) one or more publicly supported organizations; and

(b) The articles of organization of the supporting organization require that it be operated to support or benefit one or more beneficiary organizations which are designated by class or purpose and which include:

(1) The publicly supported organizations referred to in *(a)* of this subdivision (without designating such organizations by name); or

(2) Publicly supported organizations which are closely related in purpose or function to those publicly supported organizations referred to in subdivision (i)*(a)* or this subparagraph (without designating such organization by name).

(ii) If a supporting organization is described in subdivision (i)*(a)* of this subparagraph, it will not be considered as failing to meet the requirements of subparagraph (1) of this paragraph that the publicly supported organizations be specified merely because its articles of organization permit the conditions described in subparagraphs (3) (i), (ii), and (iii) and (4)(i) *(a)* and *(b)* of this paragraph.

(iii) This subparagraph may be illustrated by the following examples:

Example 1. X is an organization described in section 501(c)(3) which operates for the benefit of institutions of higher learning in the State of Y. X is controlled by these institutions (within the meaning of paragraph (g) of this section) and such institutions are all section 509(a)(1) organizations. X's articles will meet the organizational test if they require X to operate for the benefit of institutions of higher learning or educational organizations in the State of Y (without naming each institution). X's articles would also meet the organizational test if they provided for the giving of scholarships to enable students to attend institutions of higher learning but only in the State of Y.

Example 2. M is an organization described in section 501(c)(3) which was organized and operated by representatives of N church to run a home for the aged. M is controlled (within the meaning of paragraph (g) of this section) by N church, a section 509(a)(1) organization. The care of the sick and the aged are longstanding temporal functions and purposes of organized religion. By operating a home for the aged, M is operating to support or benefit N church in carrying out one of its temporal purposes. Thus M's articles will meet the organizational test if they require M to care for the aged since M is operating to support one of N church's purposes (without designating N church by name).

(iv) A supporting organization will meet the requirements of subparagraph (1) of this paragraph even though its articles do not designate each of the *specified* organizations by name if:

(a) There has been an historic and continuing relationship between the supporting organization and the section 509(a) (1) or (2) organizations, and

(b) By reason of such relationship, there has developed a substantial identity of interests between such organizations.

(3) *Nondesignated publicly supported organizations; scope of rule.* If the requirements of subparagraph (2)(i) *(a)* of this paragraph are met, a supporting organization will not be considered as failing the test of being organized for the benefit of *specified* organizations solely because its articles:

(i) Permit the substitution of one publicly supported organization within a designated class for another publicly supported organization either in the same or a different class designated in the articles;

(ii) Permit the supporting organization to operate for the benefit of new or additional publicly supported organizations of the same or a different class designated in the articles; or

(iii) Permit the supporting organization to vary the amount of its support among different publicly supported organizations within the class or classes of organizations designated by the articles.

For example, X is an organization which operates for the benefit of private colleges in the State of Y. If X is controlled by these colleges (within the meaning of paragraph (g) of this section) and such colleges are all section 509(a)(1) organizations, X's articles will meet the organization test even if they permit X to operate for the benefit of any new colleges created in State Y in addition to the existing colleges or in lieu of one which has ceased to operate, or if they permit X to vary its support by paying more to one college than to another in a particular year.

(4) *Designated publicly supported organizations.* (i) If an organization is organized and operated to support one or more publicly supported organizations and it is *operated in connection with* such organization or organizations,

then, except as provided in subparagraph (2)(iv) of this paragraph, its articles of organization must, for purposes of satisfying the organizational test under section 509(a)(3)(A), designate the *specified* organizations by name. Under the circumstances described in this subparagraph, a supporting organization which has one or more *specified* organizations designated by name in its articles, will not be considered as failing the test of being organized for the benefit of *specified* organizations solely because its articles:

(a) Permit a publicly supported organization which is designated by class or purpose, rather than by name, to be substituted for the publicly supported organization or organizations designated by name in the articles, but only if such substitution is conditioned upon the occurrence of an event which is beyond the control of the supporting organization, such as loss of exemption, substantial failure or abandonment of operations, or dissolution of the publicly supported organization or organizations designated in the articles;

(b) Permit the supporting organization to operate for the benefit of a beneficiary organization which is not a publicly supported organization, but only if such supporting organization is currently operating for the benefit of a publicly supported organization and the possibility of its operating for the benefit of other than a publicly supported organization is a remote contingency; or

(c) Permit the supporting organization to vary the amount of its support between different designated organizations, so long as it meets the requirements of the integral part test set forth in paragraph (i)(3) of this section with respect to at least one beneficiary organization.

(ii) If the beneficiary organization referred to in subdivision (i)*(b)* of this subparagraph is not a publicly supported organization, the supporting organization will not then meet the operational test of paragraph (e)(1) of this section. Therefore, if a supporting organization substituted in accordance with such subdivision (i)*(b)* a beneficiary other than a publicly supported organization and operated in support of such beneficiary organization, the supporting organization would not be described in section 509(a)(3).

(iii) This subparagraph may be illustrated by the following example:

Example. X is a charitable trust described in section 4947(a)(1) organized in 1968. Under the terms of its trust instrument, X's trustees are required to pay over all of X's annual income to M University Medical School for urological research. If M University Medical School is unable or unwilling to devote these funds to urological research, the trustees are required to pay all of such income to N University Medical School. However if N University Medical School is also unable or unwilling to devote these funds to urological research, X's trustees are directed to choose a similar organization willing to apply X's funds for urological research. From 1968 to 1973, X pays all of its net income to M University Medical School pursuant to the terms of the trust. M and N are publicly supported organizations. Although the contingent remainderman may not be a publicly supported organization, the possibility that X may operate for the benefit of other than a publicly supported organization is, in 1973, a remote possibility, and X will be considered as operating for the benefit of a *specified* publicly supported organization under subdivision (i)*(b)* of this subparagraph. However, if, at some future date, X actually substituted a nonpublicly supported organization as beneficiary, X would fail the requirements of the operational test set forth in paragraph (e)(1) of this section.

(e) *Operational test*—(1) *Permissible beneficiaries.* A supporting organization will be regarded as *operated exclusively* to support one or more specified publicly supported organizations (hereinafter referred to as the *operational test*) only if it engages solely in activities which support or benefit the specified publicly supported organizations. Such activities may include making payments to or for the use of, or providing services or facilities for, individual members of the charitable class benefited by the specified publicly supported organization. A supporting organization may also, for example, make a payment indirectly through another unrelated organization to a member of a charitable class benefited by the specified publicly supported organization, but only if such a payment constitutes a grant to an individual rather than a grant to an organization. In determining whether a grant is indirectly to an individual rather than to an organization the same standard shall be applied as in §53.4945–4(a)(4) of this chapter. Similarly, an organization will be regarded as *operated exclusively* to support or benefit one or more specified publicly supported organizations even if it supports or benefits an organization, other than a private foundation, which is described in section 501(c)(3) and is operated, supervised, or controlled directly by or in connection with such publicly supported organizations, or which is described in section 511(a)(2)(B). However, an organization will not be regarded as operated exclusively if any part of its activities is in furtherance of a purpose other than supporting or benefiting one or more specified publicly supported organizations.

(2) *Permissible activities.* A supporting organization is not required to pay over its income to the publicly supported organizations in order to meet the operational test. It may satisfy the test by using its income to carry on an independent activity or program which supports or benefits the specified publicly supported organizations. All such support must, however, be limited to permissible beneficiaries in accordance with subparagraph (1) of this paragraph. The supporting organization may also engage in fund raising activities, such as solicitations, fund raising dinners, and unrelated trade or business to raise funds for the publicly supported organizations, or for the permissible beneficiaries.

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

Example 1. M is a separately incorporated alumni association of X University and is an organization described in section 501(c)(3). X University is designated in M's articles as the sole beneficiary of its support. M uses all of its dues and income to support its own program of educational activities for alumni, faculty, and students of X University and to encourage alumni to maintain a close relationship with the university and to make contributions to it. M does not distribute any of its income directly to X for the latter's general purposes. M pays no part of its funds to, or for the benefit of, any organization other than X. Under these circumstances, M is considered as operated exclusively to perform the functions and carry out the purpose of X. Although it does not pay over any of its funds to X, it carries on a program which both supports and benefits X.

Example 2. N is a separately incorporated religious and educational organization described in section 501(c)(3). It was formed and is operated by Y Church to provide religious training for the members of the church. While it does not maintain a regular faculty, N conducts a Sunday school, weekly adult education lectures on religious subjects, and other similar activities for the benefit of the church members. All of its funds are disbursed in furtherance of such activities and no part of its funds is paid to, or for the benefit of, any organization other than Y Church. N is considered as operated exclusively to perform the educational functions of Y Church and to carry out its religious purposes by providing various forms of religious instruction.

Example 3. P is an organization described in section 501(c)(3). Its primary activity is providing financial assistance to S, a publicly supported organization which aids underdeveloped nations in Central America. P's articles of organization designate S as the principal recipient of P's assistance. However, P also makes a small annual general purpose grant to T, a private foundation engaged in work similar to that carried on by S. T performs a particular function that assists in the overall aid program carried on by S. Even though P is operating primarily for the benefit of S, a specified publicly supported organization, it is not considered as operated exclusively for the purposes set forth in section 509(a)(3)(A). The grant to T, a private foundation, prevents it from complying with the operational test under section 509(a)(3)(A).

Example 4. Assume the same facts as example 3, except that T is a section 501(c)(3) organization other than a private foundation and is operated in connection with S. Under these circumstances, P will be considered as operated exclusively to support S within the meaning of section 509(a)(3)(A).

Example 5. Assume the same facts as example 3 except that instead of the annual general purpose grant made to T, each grant made by P to T is specifically earmarked for the training of social workers and teachers, designated by name, from Central America. Under these circumstances, P's grants to T would be treated as grants to the individual social workers and teachers under section 4945(d)(3) and §53.4945–4(a)(4), rather than as grants to T under section 4945(d)(4). These social workers and teachers are part of the charitable class benefitted by S. P would thus be considered as operating exclusively to support S within the meaning of section 509(a)(3)(A).

(f) *Nature of relationship required between organizations*—(1) *In general.* Section 509(a)(3)(B) describes the nature of the relationship required between a section 501(c)(3) organization and one or more publicly supported organizations in order for such section 501(c)(3) organization to qualify under the provisions of section 509(a)(3). To meet the requirements of section 509(a)(3), an organization must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations. If an organization does not stand in one of such relationships (as provided in this paragraph) to one or more publicly supported organizations, it is not an organization described in section 509(a)(3).

(2) *Types of relationships.* Section 509(a)(3)(B) sets forth three different types of relationships, one of which must be met in order to meet the requirements of subparagraph (1) of this paragraph. Thus, a supporting organization may be:

(i) Operated, supervised, or controlled by,

(ii) Supervised or controlled in connection with, or

(iii) Operated in connection with, one or more publicly supported organizations.

(3) *Requirements of relationships.* Although more than one type of relationship may exist in any one case, any relationship described in section 509(a)(3)(B) must insure that:

(i) The supporting organization will be responsive to the needs of demands of one or more publicly supported organizations; and

(ii) The supporting organization will constitute an integral part of, or maintain a significant involvement in, the operations of one or more publicly supported organizations.

(4) *General description of relationships.* In the case of supporting organizations which are *operated, supervised, or controlled by* one or more publicly supported organizations, the distinguishing feature of this type of relationship is the presence of a substantial degree of direction by the publicly supported organizations over the conduct of the supporting organization, as described in paragraph (g) of this section. In the case of supporting organizations which are *supervised or controlled in connection with* one or more publicly supported organizations, the distinguishing feature is the presence of common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors, as described in paragraph (h) of this section. In the case of a supporting organization which is *operated in connection with* one or more publicly supported organizations, the distinguishing feature is that the supporting organization is responsive to, and significantly involved in the operations of, the publicly supported organization, as described in paragraph (i) of this section.

(g) *Meaning of operated, supervised, or controlled by.* (1)(i) Each of the items *operated by, supervised by,* and *controlled by,* as used in section 509(a)(3)(B), presupposes a substantial degree of direction over the policies, programs, and activities of a supporting organization by one or more publicly supported organizations. The relationship required under any one of these terms is comparable to that of a parent and subsidiary, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization. This relationship is established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.

(ii) A supporting organization may be *operated, supervised, or controlled by* one or more publicly supported organizations within the meaning of section 509(a)(3)(B) even though its governing body is not comprised of representatives of the specified publicly supported organizations for whose benefit it is operated within the meaning of section 509(a)(3)(A). A supporting organization may be *operated, supervised, or controlled by* one or more publicly supported organizations (within the meaning of section 509(a)(3)(B)) and be operated *for the benefit of* one or more different publicly supported organizations (within the meaning of section 509(a)(3)(A)) only if it can be demonstrated that the purposes of the former organizations are carried out by benefitting the latter organizations.

(2) The provisions of this paragraph may be illustrated by the following examples:

Example 1. X is a university press which is organized and operated as a nonstock educational corporation to perform the publishing and printing for M University, a publicly supported organization. Control of X is vested in a Board of Governors appointed by the Board of Trustees of M University upon the recommendation of the president of the university. X is considered to be operated, supervised, or controlled by M University within the meaning of section 509(a)(3)(B).

Example 2. Y Council was organized under the joint sponsorship of seven independent publicly supported organizations, each of which is dedicated to the advancement of knowledge in a particular field of social science. The sponsoring organizations organized Y Council as a means of pooling their ideas and resources for the attainment of common objectives, including the conducting of scholarly studies and formal discussions in various fields of social science. Under Y Council's by-laws, each of the seven sponsoring organizations elects three members to Y's board of trustees for 3-year terms. Y's board also includes the president of Y Council and eight other individuals elected at large by the board. Pursuant to policies established or approved by the board, Y Council engages in research, planning, and evaluation in the social sciences and sponsors or arranges conferences, seminars, and similar programs for scholars and social scientists. It carries out these activities through its own full-time professional staff, through a part-time committee of scholars, and through grant recipients. Under the above circumstances, Y Council is subject to a substantial degree of direction by the sponsoring publicly supported organizations. It is therefore considered to be operated, supervised, or controlled by such sponsoring organizations within the meaning of section 509(a)(3)(B).

Example 3. Z is a charitable trust created by A in 1972. It has three trustees, all of whom are appointed by M University, a publicly supported organization. The trust was organized and is operated to pay over all of its net income for medical research to N, O, and P, each of which is specified in the trust, is a hospital described in section 509(a)(1), and is located in the same city as M. Members of M's biology department are permitted to use the research facilities of N, O, and P. Under subparagraph (1)(ii) of this paragraph, Z is considered to be operated, supervised, or controlled by M within the meaning of section 509(a)(3)(B), even though it is operated for the benefit of N, O, and P within the meaning of section 509(a)(3)(A).

(h) *Meaning of supervised or controlled in connection with.* (1) In order for a supporting organization to be *supervised or controlled in connection with* one or more publicly supported organizations, there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations to insure that the supporting organization will be responsive to the needs and requirements of the publicly supported organizations. Therefore, in order to meet such requirement, the control or management of the supporting organization must be vested in the same persons that control or manage the publicly supported organizations.

(2) A supporting organization will not be considered to be *supervised or controlled in connection with* one or more publicly supported organizations if such organization merely makes payments (mandatory or discretionary) to one or more named publicly supported organizations, even if the obligation to make payments to the named beneficiaries is enforceable under State law by such beneficiaries and the supporting organization's governing instrument contains provisions whose effect is described in section 508(e)(1) (A) and (B). Such arrangements do not provide a sufficient *connection* between the payor organization and the needs and requirements of the publicly supported organizations to constitute supervision or control in connection with such organizations.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example 1. A, a philanthropist, founded X school for orphan boys (a publicly supported organization). At the same time A founded X school, he also established Y trust into which he transferred all of the operating assets of the school, together with a substantial endowment for it. Under the provisions of the trust instrument, the same persons who control and manage the school also control and manage the trust. The sole function of Y trust is to hold legal title to X school's operating and endowment assets, to invest the endowment assets and to apply the income from the endowment to the benefit of the school in accordance with direction from the school's governing body. Under these circumstances, Y trust is organized and operated *for the benefit of* X school and is *supervised or controlled in connection with* such organization within the meaning of section 509(a)(3). The fact that the same persons control both X and Y insures Y's responsiveness to X's needs.

Example 2. In 1972, B, a philanthropist, created P, a charitable trust for the benefit of Z, a symphony orchestra described in section 509(a)(2). B transferred 100 shares of common stock to P. Under the terms of the trust instrument, the trustees (none of whom is under the control of B) were required to pay over all of the income produced by the trust assets to Z. The governing instrument of P contains certain provisions whose effect is described in section 508(e)(1) (A) and (B). Under applicable State law, Z can enforce the provisions of the trust instrument and compel payment to Z in a court of equity. There is no relationship between the trustees of P and the governing body of Z. Under these circumstances P is not supervised or controlled in connection with a publicly supported organization. Because of the lack of any common supervision or control by the trustees of P and the governing body of Z, P is not supervised or controlled in connection with Z within the meaning of section 509(a)(3)(B).

Example 3. T is a charitable trust described in section 501(c)(3) and created under the will of D. Prior to his death, D was a leader and very active in C church, a publicly supported organization. D created T to perpetuate his interest in, and assistance to, C. The sole purpose of T was to provide financial support for C and its related institutions. All of the original named trustees of T are members of C, are leaders in C, and hold important offices in one or more of C's related institutions. Successor trustees of T are by the terms of the charitable trust instrument to be chosen by the remaining trustees and are also to be members of C. All of the original trustees have represented that any successor trustee will be a leader in C and will hold an important office in one or more of C's related institutions. By reason of the foregoing relationship T and its trustees are responsive to the needs and requirements of C and its related institutions. Under these circumstances, T trust is organized and operated *for the benefit of* C and is *supervised or controlled in connection with* C and its related institutions within the meaning of section 509(a)(3)(B).

(i) *Meaning of operated in connection with*—(1) *General rule.* (i) Except as provided in subdivisions (ii) and (iii) of this subparagraph and subparagraph (4) of this paragraph, a supporting organization will be considered as being operated in connection with one or more publicly supported organizations only if it meets the *responsiveness test* which is defined in subparagraph (2) of this paragraph and the *integral part test* which is defined in subparagraph (3) of this paragraph.

(ii) In the case of an organization which was supporting or benefiting one or more publicly supported organizations before November 20, 1970, additional facts and circumstances, such as a historic and continuing relationship between organizations, may be taken into account, in addition to the factors described in subparagraph (2) of this paragraph, to establish compliance with the responsiveness test.

(iii) If:

(a) A supporting organization can establish that it has met the integral part test set forth in subparagraph (3)(iii) of this paragraph for any 5-year period, and

(b) Such organization cannot meet the requirements of such test for its current taxable year solely because the amount received by one or more of the publicly supported beneficiary organizations from such supporting organization is no longer sufficient, with respect to such beneficiary organizations, to satisfy subparagraph (3)(iii) of this paragraph, and

(c) There has been a historic and continuing relationship of support between such organizations between the end of such 5-year period and the taxable year in question,

then such supporting organization will be considered as meeting the requirements of the integral part test in subparagraph (3)(iii) of this paragraph for such taxable year.

(2) *Responsiveness test.* (i) For purposes of this paragraph, a supporting organization will be considered to meet the *responsiveness test* if the organization is responsive to the needs or demands of the publicly supported organizations within the meaning of this subparagraph. In order to meet this test, either subdivision (ii) or subdivision (iii) of this subparagraph must be satisfied.

(ii)*(a)* One or more officers, directors, or trustees of the supporting organization are elected or appointed by the officers, directors, trustees, or membership of the publicly supported organizations;

(b) One or more members of the governing bodies of the publicly supported organizations are also officers, directors, or trustees of, or hold other important offices in, the supporting organization; or

(c) The officers, directors, or trustees of the supporting organization maintain a close and continuous working relationship with the officers, directors, or trustees of the publicly supported organizations; and

(d) By reason of *(a), (b),* or *(c)* of this subdivision, the officers, directors or trustees of the publicly supported organizations have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making them, and the selection of recipients by such supporting organization, and in otherwise directing the use of the income or assets of such supporting organization.

(iii)*(a)* The supporting organization is a charitable trust under State law;

(b) Each specified publicly supported organization is a named beneficiary under such charitable trust's governing instrument; and

(c) The beneficiary organization has the power to enforce the trust and compel an accounting under State law.

(3) *Integral part test; general rule.* (i) For purposes of this paragraph, a supporting organization will be considered to meet the *integral part test* if it maintains a significant involvement in the operations of one or more publicly supported organizations and such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides. In order to meet this test, either subdivision (ii) or subdivision (iii) of this subparagraph must be satisfied.

(ii) The activities engaged in for or on behalf of the publicly supported organizations are activities to perform the functions of, or to carry out the purposes of, such organizations, and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves.

(iii) *(a)* The supporting organization makes payments of substantially all of its income to or for the use of one or more publicly supported organizations, and the amount of support received by one or more of such publicly supported organizations is sufficient to insure the attentiveness of such organizations to the operations of the supporting organization. In addition, a substantial amount of the total support of the supporting organization must go to those publicly supported organizations which meet the attentiveness requirement of this subdivision with respect to such supporting organization. Except as provided in (*b*) of this subdivision, the amount of support received by a publicly supported organization must represent a sufficient part of the organization's total support so as to insure such attentiveness. In applying the preceding sentence, if such supporting organization makes payments to, or for the use of, a particular department or school of a university, hospital or church, the total support of the department or school shall be substituted for the total support of the beneficiary organization.

(b) Even where the amount of support received by a publicly supported beneficiary organization does not represent a sufficient part of the beneficiary organization's total support, the amount of support received from a supporting organization may be sufficient to meet the requirements of this subdivision if it can be demonstrated that in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. This may be the case where either the supporting organization or the beneficiary organization earmarks the support received from the supporting organization for a particular program or activity, even if such program or activity is not the beneficiary organization's primary program or activity so long as such program or activity is a substantial one.

(c) This subdivision may be illustrated by the following examples:

Example 1. X, an organization described in section 501(c)(3), pays over all of its annual net income to Y, a museum described in section 509(a)(2). X meets the responsiveness test described in subparagraph (2) of this paragraph. In recent years, Y has earmarked the income received from X to underwrite the cost of carrying on a chamber music series consisting of 12 performances a year which are performed for the general public free of charge at its premises. Because of the expense involved in carrying on these recitals, Y is dependent upon the income from X for their continuation. Under these circumstances, X will be treated as providing Y with a sufficient portion of Y's total support to assure Y's attentiveness to X's operations, even though the chamber music series is not the primary part of Y's activities.

Example 2. M, an organization described in section 501(c)(3), pays over all of its annual net income to the Law School of N University, a publicly supported organization. M meets the responsiveness test described in subparagraph (2) of this paragraph. M has earmarked the income paid over to N's Law School to endow a chair in its Department of International Law. Without M's continued support, N might not continue to maintain this chair. Under these circumstances, M will be treated as providing N with a sufficient portion of N's total support to assure N's attentiveness to M's operations.

(d) All pertinent factors, including the number of beneficiaries, the length and nature of the relationship between the beneficiary and supporting organization and the purpose to which the funds are put (as illustrated by subdivision (iii) *(b)* and *(c)* of this subparagraph), will be considered in determining whether the amount of support received by a publicly supported beneficiary organization is sufficient to insure the attentiveness of such organization to the operations of the supporting organization. Normally the attentiveness of a beneficiary organization is motivated by reason of the amounts received from the supporting organization. Thus, the more substantial the amount involved, in terms of a percentage of the publicly supported organization's total support the greater the likelihood that the required degree of attentiveness will be present. However, in determining whether the amount received from the supporting organization is sufficient to insure the attentiveness of the beneficiary organization to the operations of the supporting organization (including attentiveness to the nature and yield of such supporting organization's investments), evidence of actual attentiveness by the beneficiary organization is of almost equal importance. An example of acceptable evidence of actual attentiveness is the imposition of a requirement that the supporting organization furnish reports at least annually for taxable years beginning after December 31, 1971, to the beneficiary organization to assist such beneficiary organization in insuring that the supporting organization has invested its endowment in assets productive of a reasonable rate of return (taking appreciation into account) and has not engaged in any activity which would give rise to liability for a tax imposed under sections 4941, 4943, 4944, or 4945 if such organization were a private foundation. The imposition of such requirement within 120 days after October 16, 1972, will be deemed to have retroactive effect to January 1, 1970, for purposes of determining whether a supporting organization has met the requirements of this subdivision for its first two taxable years beginning after December 31, 1969. The imposition of such requirement is, however, merely one of the factors in determining whether a supporting organization is complying with this subdivision and the absence of such requirement will not preclude an organization from classification as a supporting organization based on other factors.

(e) However, where none of the beneficiary organizations is dependent upon the supporting organization for a sufficient amount of the beneficiary organization's support within the meaning of this subdivision, the requirements of this subparagraph will not be satisfied, even though such beneficiary organizations have enforceable rights against such organization under State law.

(4) *Integral part test; transitional rule.* (i) A trust (whether or not exempt from taxation under section 501(a)) which on November 20, 1970, has met and continues to meet the requirements of subdivisions (ii) through (vi) of this subparagraph shall be treated as meeting the requirements of the integral part test (whether or not it meets the requirements of subparagraph (3) (ii) or (iii) of this paragraph) if for taxable

years beginning after October 16, 1972, the trustee of such trust makes annual written reports to all of the beneficiary publicly supported organizations with respect to such trust setting forth a description of the assets of the trust, including a detailed list of the assets and the income produced by such assets. A trust organization which meets the requirements of this subparagraph may request a ruling that it is described in section 509(a)(3) in such manner as the Commissioner may prescribe.

(ii) All the unexpired interests in the trust are devoted to one or more purposes described in section 170(c) (1) or (2)(B) and a deduction was allowed with respect to such interests under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), 2522, or corresponding provisions of prior law (or would have been allowed such a deduction if the trust had not been created before 1913).

(iii) The trust was created prior to November 20, 1970, and did not receive any grant, contribution, bequest or other transfer on or after such date. For purpose of this subdivision, a split-interest trust described in section 4947(a)(2) which was created prior to November 20, 1970, which was irrevocable on such date, and which becomes a charitable trust described in section 4947(a)(1) after such date shall be treated as having been created prior to such date;

(iv) The trust is required by its governing instrument to distribute all of its net income currently to a designated publicly supported beneficiary organization. Where more than one publicly supported beneficiary organization is designated in the governing instrument of a trust, all of the net income must be distributable and must be distributed currently to each of such beneficiary organizations in fixed shares pursuant to such governing instrument. For purposes of this subdivision, the governing instrument of a charitable trust shall be treated as requiring distribution to a designated beneficiary organization where the trust instrument describes the charitable purpose of the trust so completely that such description can apply to only one existing beneficiary organization and is of sufficient particularity as to vest in such organization rights against the trust enforceable in a court possessing equitable powers;

(v) The trustee of the trust does not have discretion to vary either the beneficiaries or the amounts payable to the beneficiaries. For purposes of this subdivision, a trustee shall not be treated as having such discretion where the trustee has discretion to make payments of principal to the single section 509(a) (1) or (2) organization that is currently entitled to receive all of the trust's income or where the trust instrument provides that the trustee may cease making income payments to a particular charitable beneficiary in the event of certain specific occurrences, such as the loss of exemption under section 501(c)(3) or classification under section 509(a) (1) or (2) by the beneficiary or the failure of the beneficiary to carry out its charitable purpose properly;

(vi) None of the trustees would be disqualified persons within the meaning of section 4946(a) (other than foundation managers under 4946(a)(1)(B)) with respect to the trust if such trust were treated as a private foundation.

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

Example 1. N is a nonprofit publishing organization described in section 501(c)(3). It does all of the publishing and printing for the churches of a particular denomination (which are publicly supported organizations). Control of the organization is vested in a five-man Board of Directors, which includes one church official and four lay members of the congregations of that denomination. N does no other printing or publishing. It publishes all of the churches' religious as well as secular tracts and materials. Under these circumstances, N is considered as being *operated in connection with* a number of publicly supported organizations. Publishing religious literature is an integral part of the churches' activities; it is carried on by N on behalf of the churches, and there is sufficient direction of N's activities by the churches to insure responsiveness by N to their needs.

Example 2. O, an alumni association described in section 501(c)(3), was formed to promote a spirit of loyalty among graduates of Y University, a publicly supported organization, and to effect united action in promoting the general welfare of the university. A special committee of Y's governing board meets with O and makes recommendations as to the allocation of O's program of gifts and scholarships to the university and its students. O also provides certain functions which would otherwise be part of Y's functions, such as maintaining records of alumni. O publishes a bulletin to keep alumni aware of the activities of the university. Under these circumstances O is considered to be operated in connection with Y within the meaning of section 509(a)(3)(B).

Example 3. P is a trust created under the will of A for the purpose of furthering musical education. As a means of accomplishing its purposes P founded X, a school of music described in section 509(a)(1). The trust instrument is thereafter amended to name X specifically as the beneficiary of the trust. X can enforce its equitable rights as trust beneficiary under State law. Members of the governing body of X form a minority of the foundation managers of P. For many years the organizations have been operated in close association with each other. P provides the principal endowment fund for the operation of X. In addition, while the governing body of X concerns itself with artistic policies, the foundation managers of P handle the budgetary concerns of X. X's annual budget is prepared with the assistance of P's foundation managers and is approved by P. Under these circumstances, P is considered to be operated in connection with X within the meaning of section 509(a)(3)(B).

Example 4. Q is a charitable trust described in section 501(c)(3) and created under the will of C. Prior to his death, C built H Hospital and deeded it to I University for use as a training and clinical facility for I's medical school. Both H and I are publicly supported organizations. C created Q to perpetuate his interest in, and assistance to, H Hospital. The sole purpose of Q was to provide financial support for H, the beneficiary organization named in C's will. H can enforce its equitable rights as trust beneficiary under State law. After the death of C, Q continued to provide substantial support for H. It was primarily responsible for the erecting of a new hospital building, as well as the construction of other facilities for the hospital. In addition, each medical department of H indicates during the year what its greatest needs are. Once these requests are approved by the medical director of I University's Medical School, they are presented to Q, and subject to the amount of Q's income (all of which is applied to H), these requests are honored and the new equipment of facility is supplied through Q's funds. The governing body of Q and those of H and I are completely independent. However, based on the above facts, Q is responsive to the needs of H, Q maintains a substantial involvement in the conduct of H, and H is substantially dependent upon the receipt of support from Q. Accordingly, Q is operated in connection with one or more section 509(a)(1) organizations within the meaning of section 509(a)(3)B).

Example 5. R is a charitable trust created under the will of B, who died in 1971. Its purpose is to hold assets as an endowment for S, a hospital, T, a university, and U, a national medical research organization (all being publicly supported organizations and specifically named in the trust instrument), and to distribute all of the income each year in equal shares among the three named beneficiaries. S, T, and U have certain enforceable rights against R under State law, including the right to compel an accounting. Except for making these annual payments, the trustees of R have no further contacts or relationships with S, T, or U. The payments by R to such organizations do not comprise a sufficient amount of support to meet the requirements of subparagraph (3) of this paragraph for any of these organizations. Although R meets the responsiveness test described in subparagraph (2) of this paragraph, it does not meet the integral part test described in subparagraph (3) of this paragraph. R is not, therefore, considered as operated in connection with one or more publicly supported organizations within the meaning of section 509(a)(3)B). However, if B had died prior to November 20, 1970, R could, upon meeting all of the requirements of subparagraph (4) of this paragraph, be considered as operated in connection with one or more of publicly supported organizations within the meaning of section 509(a)(3)(B).

Example 6. S is a charitable trust described in section 501(c)(3). S was created under the will of C in 1910 for the purpose of providing aged and indigent women with care and shelter. Prior to his death in 1910, C helped to create T, a home for aged women, through a substantial inter vivos contribution. Although T is not specifically named in C's will, the trustees of S (who are completely independent of T) have paid over all of S's income to T in furtherance of the trust's purposes since the death of C. S establishes that between 1910 and 1955, the amount of support received by T from S was sufficient support to satisfy the provisions of § 1.509(a)–4(i)(3)(iii). In 1956, T merged with U, a home for aged and indigent men, and V, a nursing home. S continued to pay all its income to W, the organization resulting from the merger of T, U, and V. However, as a result of the merger and certain changes in the methods of financing the operations, the payments made by S after 1955 no longer were sufficient to satisfy the integral part test of § 1.509(a)–4(i)(3)(iii). W qualifies as an organization described in section 509(a)(2). For the taxable year 1971, S meets the responsiveness test under § 1.509(a)–4(i)(2)(ii). Although W is not a named beneficiary under S's governing instrument, pursuant to § 1.509(a)–4(i)(1)(ii) the historic and continuing relationship between the organizations will be taken into account to establish compliance with the responsiveness test. Furthermore, pursuant to

§1.509(a)–4(i)(1)(iii), under the facts set forth above, the integral part test under §1.509(a)–4(i)(3)(iii) will be considered as being satisfied for the taxable year 1971. Thus S will be considered as *operated in connection with* W for the taxable year 1971.

(j) *Control by disqualified persons*— (1) *In general.* Under the provisions of section 509(a)(3)(C) a supporting organization may not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations. If a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor to the supporting organization, is appointed or designated as a foundation manager of the supporting organization by a publicly supported beneficiary organization to serve as the representative of such publicly supported organization, then for purposes of this paragraph such person will be regarded as a disqualified person, rather than as a representative of the publicly supported organization. An organization will be considered *controlled,* for purposes of section 509(a)(3)(C), if the disqualified persons, by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operation or may prevent such organization from performing such act. This includes, but is not limited to, the right of any substantial contributor or his spouse to designate annually the recipients, from among the publicly supported organizations of the income attributable to his contribution to the supporting organization. Except as provided in subparagraph (2) of this paragraph, a supporting organization will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of such persons is 50 percent or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization. Thus, if the governing body of a foundation is composed of five trustees, none of whom has a veto power over the actions of the foundation, and no more than two trustees are at any time disqualified persons, such foundation will not be considered to be controlled directly or indirectly by one or more disqualified persons by reason of this fact alone. However, all pertinent facts and circumstances including the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting rights with respect to stocks in which members of its governing body also have some interest, will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization.

(2) *Proof of independent control.* Notwithstanding subparagraph (1) of this paragraph, an organization shall be permitted to establish to the satisfaction of the Commissioner that disqualified persons do not directly or indirectly control it. For example, in the case of a religious organization operated in connection with a church, the fact that the majority of the organization's governing body is composed of lay persons who are substantial contributors to the organization will not disqualify the organization under section 509(a)(3)(C) if a representative of the church, such as a bishop or other official, has control over the policies and decisions of the organization.

(k) *Organizations operated in conjunction with certain section 501(c) (4), (5), or (6) organizations.* (1) For purposes of section 509(a)(3), an organization which is operated in conjunction with an organization described in section 501(c) (4), (5), or (6) (such as a social welfare organization, labor or agricultural organization, business league, or real estate board) shall, if it otherwise meets the requirements of section 509(a)(3), be considered an organization described in section 509(a)(3) if such section 501(c) (4), (5), or (6) organization would be described in section 509(a)(2) if it were an organization described in section 501(c)(3). The section 501(c) (4), (5), or (6) organization, which the supporting organization is operating in conjunction with, must therefore meet the one-third tests of a publicly supported organization set forth in section 509(a)(2).

(2) This paragraph may be illustrated by the following example:

Example. X medical association, described in section 501(c)(6), is supported by membership dues and funds resulting from the performance of its exempt activities. This support, which is entirely from permitted sources, constitutes more than one-third of X's support. X does not normally receive more than one-third of its support from items described in section 509(a)(2)(B). X organized and operated an endowment fund for the sole purpose of furthering medical education. The fund is an organization described in section 501(c)(3). Since more than one-third of X's support is derived from membership dues and from funds resulting from the performance of exempt purposes (all of which are from permitted sources) and not more than one-third of its support is from items described in section 509(a)(2)(B), it would be a publicly supported organization described in section 509(a)(2) if it were described in section 501(c)(3) rather than section 501(c)(6). Accordingly, if the fund otherwise meets the requirements of section 509(a)(3) with respect to X, it will be considered an organization described in section 509(a)(3).

[T.D. 7212, 37 FR 21916, Oct. 17, 1972, as amended by T.D. 7784, 46 FR 37890, July 23, 1981]

§ 1.509(a)–5 Special rules of attribution.

(a) *Retained character of gross investment income.* (1) For purposes of determining whether an organization meets the not–more–than–one–third support test set forth in section 509(a)(2)(B), amounts received by such organization from:

(i) An organization which seeks to be described in section 509(a)(3) by reason of its support of such organization; or

(ii) A charitable trust, corporation, fund, or association described in section 501(c)(3) (including a charitable trust described in section 4947(a)(1)) or a split interest trust described in section 4947(a)(2), which is required by its governing instrument or otherwise to distribute, or which normally does distribute, at least 25 percent of its adjusted net income (within the meaning of section 4942(f)) to such organization, and such distribution normally comprises at least 5 percent of such distributee organization's adjusted net income,

will retain their character as gross investment income (rather than gifts or contributions) to the extent that such amounts are characterized as gross investment income in the possession of the distributing organization described in subdivision (i) or (ii) of this subparagraph or, if the distributing organization is a split interest trust described in section 4947(a)(2), to the extent that such amounts would be characterized as gross investment income attributable to transfers in trust after May 26, 1969, if such trust were a private foundation. For purposes of this section, all income which is characterized as gross investment income in the possession of the distributing organization shall be deemed to be distributed first by such organization and shall retain its character as such in the possession of the recipient of amounts described in this paragraph. If an organization described in subdivision (i) or (ii) of this subparagraph makes distributions to more than one organization, the amount of gross investment income deemed distributed shall be prorated among the distributees.

(2) For purposes of subparagraph (1) of this paragraph, amounts paid by an organization to provide goods, services, or facilities for the direct benefit of an organization seeking section 509(a)(2) status (rather than for the direct benefit of the general public) shall be treated in the same manner as amounts received by the latter organization. Such amounts will be treated as gross investment income to the extent that such amounts are characterized as gross investment income in the possession of the organization spending such amounts. For example, X is an organization described in subparagraph (1)(i) of this paragraph. It uses part of its funds to provide Y, an organization seeking section 509(a)(2) status, with certain services which Y would otherwise be required to purchase on its own. To the extent that the funds used by X to provide such services for Y are characterized as gross investment income in the possession of X, such funds will be treated as gross investment income received by Y.

(3) An organization seeking section 509(a)(2) status shall file a separate statement with its return required by section 6033, setting forth all amounts received from organizations described

in paragraph (a)(1) (i) or (ii) of this section.

(b) *Relationships created for avoidance purposes.* (1) If a relationship between an organization seeking section 509(a)(3) status and an organization seeking section 509(a)(2) status:

(i) Is established or availed of after October 9, 1969, and

(ii) One of the purposes of establishing or utilizing such relationship is to avoid classification as a private foundation with respect to either organization, the character and amount of support received by the section 509(a)(3) organization will be attributed to the section 509(a)(2) organization for purposes of determining whether the latter meets the one-third support test and the not–more–than–one–third support test under section 509(a)(2). If a relationship described in this subparagraph is established or utilized by an organization seeking section 509(a)(3) status and two or more organizations seeking section 509(a)(2) status, the amount of support received by the former organization will be prorated among the latter organizations and the character of each class of support (as defined in section 509(d)) will be attributed pro rata to each such organization. The provisions of this paragraph and of paragraph (a) of this section are not mutually exclusive.

(2) In determining whether a relationship between one or more organizations seeking section 509(a)(2) status (hereinafter referred to as *beneficiary organizations*) and an organization seeking section 509(a)(3) status (hereinafter referred to as the *supporting organization*) has been established or availed of to avoid classification as a private foundation (within the meaning of subparagraph (1) of this paragraph), all pertinent facts and circumstances, including the following, shall be taken into account as evidence that a relationship was not established or availed of to avoid classification as a private foundation:

(i) The supporting organization is operated to support or benefit several specified beneficiary organizations.

(ii) The beneficiary organization has a substantial number of dues-paying members (in relation to the public it serves and the nature of its activities) and such members have an effective voice in the management of both the supporting and beneficiary organizations.

(iii) The beneficiary organization is composed of several membership organizations, each of which has a substantial number of members (in relation to the public it serves and the nature of its activities), and such membership organizations have an effective voice in the management of the supporting and beneficiary organizations.

(iv) The beneficiary organization receives a substantial amount of support from the general public, public charities, or governmental grants.

(v) The supporting organization uses its funds to carry on a meaningful program of activities to support or benefit the beneficiary organization and such use would, if such supporting organization were a private foundation, be sufficient to avoid the imposition of any tax upon such organization under section 4942.

(vi) The supporting organization is not able to exercise substantial control or influence over the beneficiary organization by reason of the former's receiving support or holding assets which are disproportionately large in comparison with the support received or the assets held by the latter.

(vii) Different persons manage the operations of the beneficiary and supporting organizations and each organization performs a different function.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example 1. M, an organization described in section 509(a)(2), is a council composed of 10 learned societies. Each member society has a large membership of scholars interested in a particular academic area. In 1970 M established N, an organization seeking section 509(a)(3) status, for the purpose of carrying on research and study projects of interest to the member societies. The principal source of funds for N's activities is from foundation and government grants and contracts. The principal source of funds for M's activities after the creation of N is membership dues. M continued to maintain a wide variety of activities for its members, such as publishing periodicals and carrying on seminars and conferences. N is subject to complete control by the governing body of M. Under these circumstances, the relationship between these organizations is not one which is described in subparagraph (1) of this paragraph.

Example 2. Q is a local medical research organization described in section 509(a)(2). Its fixed assets are negligible and it carries on research activities on a limited scale. It also makes a limited number of grants to scientists and doctors who are engaged in medical research of interest to Q. It receives support through small government grants and a few research contracts from private foundations. R is an organization described in section 501(c)(3). As of January 1, 1970, R was classified as a private foundation under section 509. It has a substantial endowment which it uses to make grants to various charitable and scientific organizations described in section 501(c)(3). During 1970, R agrees to subsidize the research activities of Q. R amends its governing instrument to provide specifically that all of R's support will be used for research activities which are approved and supervised by Q. R also amends its bylaws to permit a minority of Q's board of directors to be members of R's governing body. R then gives timely notification under section 507(b)(1)(B)(ii) that R is terminating its private foundation status by meeting the requirements of section 509(a)(3) by the end of the 12-month period described in section 507(b)(1)(B)(i). For purposes of determining whether R has met the requirements of section 509(a)(3) by the end of the 12-month period, as well as determining Q's status under section 509(a)(2), the character and amount of support received by R will be attributed to Q.

(c) *Effect on organizations claiming section 509(a)(3) status.* If an organization claiming section 509(a)(2) status fails to meet either the one-third support test or the not–more–than–one–third support test under section 509(a)(2) by reason of the application of the provisions of paragraph (a) or (b) of this section, and such organization is one of the specified organizations (within the meaning of section 509(a)(3)(A)) for whose support or benefit an organization claiming section 509(a)(3) status is operated, the organization claiming section 509(a)(3) status will not be considered to be operated exclusively to support or benefit one or more section 509(a) (1) or (2) organizations.

[T.D. 7212, 37 FR 21922, Oct. 17, 1972, as amended by T.D. 7290, 38 FR 31834, Nov. 19, 1973; T.D. 7784, 46 FR 37890, July 23, 1981]

§ 1.509(a)–6 Classification under section 509(a).

If an organization is described in section 509(a)(1) and also in another paragraph of section 509(a), it will be treated as described in section 509(a)(1). For purposes of this section, the parenthetical language *other than in clauses (vii) and (viii)* used in section 509(a)(1) shall be construed to mean *other than an organization which is described only in clause (vii) or (viii).* For example, X is an organization which is described in section 170(b)(1)(A)(vi), but could also meet the description of section 170(b)(1)(A)(viii) as an organization described in section 509(a)(2). For purposes of the one-third support test in section 509(a)(2)(A), contributions from X to other organizations will be treated as support from an organization described in section 170(b)(1)(A)(vi) rather than from an organization described in section 170(b)(1)(A)(viii).

[T.D. 7212, 37 FR 21923, Oct. 17, 1972]

§ 1.509(a)–7 Reliance by grantors and contributors to section 509(a) (1), (2), and (3) organizations.

(a) *General rule.* Once an organization has received a final ruling or determination letter classifying it as an organization described in section 509(a) (1), (2), or (3), the treatment of grants and contributions and the status of grantors and contributors to such organization under sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522 will not be affected by reason of a subsequent revocation by the service of the organization's classification as described in section 509(a) (1), (2), or (3) until the date on which notice of change of status is made to the public (such as by publication in the Internal Revenue Bulletin) or another applicable date, if any, specified in such public notice. In appropriate cases, however, the treatment of grants and contributions and the status of grantors and contributors to an organization described in section 509(a) (1), (2), or (3) may be affected pending verification of the continued classification of such organization under section 509(a) (1), (2), or (3). Notice to this affect will be made in a public announcement by the service. In such cases the effect of grants and contributions made after the date of the announcement will depend upon the statutory qualification of the organization as an organization described in section 509(a) (1), (2), or (3).

(b) *Exceptions.* (1) Paragraph (a) of this section shall not apply if the grantor or contributor:

(i) Had knowledge of the revocation of the ruling or determination letter classifying the organization as an organization described in section 509(a) (1), (2), or (3), or

(ii) Was in part responsible for, or was aware of, the act, the failure to act, or the substantial and material change on the part of the organization which gave rise to the revocation of the ruling or determination letter classifying the organization as an organization described in section 509(a) (1), (2), or (3).

(2) Paragraph (a) of this section shall not apply where a different rule is otherwise expressly provided in the regulations under sections 170(b)(1)(A), 507(b)(1)(B), or 509.

[T.D. 7212, 37 FR 21923, Oct. 17, 1972]

§1.509(b)–1 Continuation of private foundation status.

(a) *In general.* If an organization is a private foundation (within the meaning of section 509(a)) on October 9, 1969, or becomes a private foundation on any subsequent date, such organization shall be treated as a private foundation for all periods after October 9, 1969, or after such subsequent date, unless its status as such is terminated under section 507. Therefore, if an organization was described in section 501(c)(3) and was a private foundation within the meaning of section 509(a) on October 9, 1969, it shall be treated as a private foundation for all periods thereafter, even though it may also satisfy the requirements of an organization described in some other paragraph of section 501(c). For example, if on October 9, 1969, an organization was described in section 501(c)(3), but because of its activities, it could also have qualified as an organization described in section 501(c)(4), such organization will continue to be treated as a private foundation, if it was a private foundation within the meaning of section 509(a) on October 9, 1969.

(b) *Taxable private foundations.* If an organization is a private foundation on October 9, 1969, and it is determined that it is not exempt under section 501(a) as an organization described in section 501(c)(3) as of any date after October 9, 1969, such organization, even though it may operate thereafter as a taxable entity, will continue to be treated as a private foundation unless its status as such is terminated under section 507. For example, X organization is a private foundation on October 9, 1969. It is subsequently determined that, as of July 1, 1972, X is no longer exempt under section 501(a) as an organization described in section 501(c)(3) because, for example, it has not conformed its governing instrument pursuant to section 508(e). X will continue to be treated as a private foundation after July 1, 1972, unless its status as such is terminated under section 507. However, if an organization is not exempt under section 501(a) as an organization described in section 501(c)(3) on October 9, 1969, then it will not be treated as a private foundation within the meaning of section 509(a) by reason of section 509(b), unless it becomes a private foundation on a subsequent date.

[T.D. 7212, 37 FR 21924, Oct. 17, 1972]

§1.509(c)–1 Status of organization after termination of private foundation status.

(a) *In general.* For purposes of part II of subchapter F of this chapter, an organization whose status as a private foundation is terminated under section 507 shall be treated as an organization created on the day after the date of such termination. An organization whose private foundation status has been terminated under the provisions of section 507(a) will, if it continues to operate, be treated as a new organization and must, if it desires to be classified under section 501(c)(3), give notification that it is applying for recognition of section 501(c)(3) status pursuant to the provisions of section 508(a).

(b) *Effect upon section 507(d)(1).* If the private foundation status of an organization has been terminated under section 507(b)(1)(B) and the regulations thereunder, and:

(1) Such organization does not continue at all times thereafter to meet

the requirements of section 509(a) (1), (2), or (3) (and is therefore no longer excluded from the definition of a private foundation); and

(2) The status of such organization as a private foundation is thereafter terminated under section 507(a),

then the tax imposed under section 507(c)(1) upon the aggregate tax benefit (described in section 507(d)(1)) resulting from section 501(c)(3) status shall be computed only upon the aggregate tax benefit resulting after the date on which the organization again becomes a private foundation under subparagraph (1) of this paragraph.

[T.D. 7212, 37 FR 21924, Oct. 17, 1972]

§ 1.509(d)–1 Definition of support

For purposes of section 509(a)(2), the term *support* does not include amounts received in repayment of the principal of a loan or other indebtedness. See, however, section 509(e) as to amounts received as interest on a loan or other indebtedness.

[T.D. 7212, 37 FR 21924, Oct. 17, 1972]

§ 1.509(e)–1 Definition of gross investment income.

For the distinction between gross receipts and gross investment income, see § 1.509(a)–3(m).

(Sec. 7805, Internal Revenue Code of 1954, 68A Stat. 917; 26 U.S.C. 7805)

[T.D. 7212, 37 FR 21925, Oct. 17, 1972]

TAXATION OF BUSINESS INCOME OF CERTAIN EXEMPT ORGANIZATIONS

§ 1.511–1 Imposition and rates of tax.

Section 511(a) imposes a tax upon the unrelated business taxable income of certain organizations otherwise exempt from Federal income tax. Under section 511(a)(1), organizations described in section 511(a)(2)(A) and in paragraph (a) of § 1.511–2 and organizations described in section 511(a)(2)(B) are subject to normal tax and surtax at the corporate rates provided by section 11. Under section 511(b)(1), trusts described in section 511(b)(2) are subject to tax at the individual rates prescribed in section 1(d) of the Code as amended by the Tax Reform Act of 1969 (section 1 for taxable years ending before Jan. 1, 1971). The deduction for personal exemption provided in section 642(b) in the case of a trust taxable under subchapter J, chapter 1 of the Code, is not allowed in computing unrelated business taxable income.

[T.D. 7117, 36 FR 9421, May 25, 1971]

§ 1.511–2 Organizations subject to tax.

(a) *Organizations other than trusts and title holding companies.* (1)(i) The taxes imposed by section 511(a)(1) apply in the case of any organization (other than a trust described in section 511(b)(2) or an organization described in section 501(c)(1)) which is exempt from taxation under section 501(a) (except as provided in sections 507 through 515). For special rules concerning corporations described in section 501(c)(2), see paragraph (c) of this section.

(ii) In the case of an organization described in section 501(c)(4), (7), (8), (9), (10), (11), (12), (13), (14)(A), (15), (16), or (18), the taxes imposed by section 511(a)(1) apply only for taxable years beginning after December 31, 1969. In the case of an organization described in section 501(c)(14) (B) or (C), the taxes imposed by section 511(a)(1) apply only for taxable years beginning after February 2, 1966.

(2) The taxes imposed by section 511(a) apply in the case of any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof or by any agency or instrumentality of any one or more governments or political subdivisions. Such taxes also apply in the case of any corporation wholly owned by one or more such colleges or universities. As here used, the word *government* includes any foreign government (to the extent not contrary to any treaty obligation of the United States) and all domestic governments (the United States and any of its Territories or possessions, any State, and the District of Columbia). Elementary and secondary schools operated by such governments are not subject to the tax on unrelated business income.

(3)(i) For taxable years beginning before January 1, 1970, churches and associations or conventions of churches are exempt from the taxes imposed by section 511. The exemption is applicable only to an organization which itself is a church or an association or convention of churches. Subject to the provisions of subdivision (ii) of this subparagraph, religious organizations, including religious orders, if not themselves churches or associations or conventions of churches, and all other organizations which are organized or operated under church auspices, are subject to the tax imposed by section 511, whether or not they engage in religious, educational, or charitable activities approved by a church.

(ii) The term *church* includes a religious order or a religious organization if such order or organization *(a)* is an integral part of a church, and *(b)* is engaged in carrying out the functions of a church, whether as a civil law corporation or otherwise. In determining whether a religious order or organization is an integral part of a church, consideration will be given to the degree to which it is connected with, and controlled by, such church. A religious order or organization shall be considered to be engaged in carrying out the functions of a church if its duties include the ministration of sacerdotal functions and the conduct of religious worship. If a religious order or organization is not an integral part of a church, or if such an order or organization is not authorized to carry out the functions of a church (ministration of sacerdotal functions and conduct of religious worship) then it is subject to the tax imposed by section 511 whether or not it engages in religious, educational, or charitable activities approved by a church. What constitutes the conduct of religious worship or the ministration of sacerdotal functions depends on the tenets and practices of a particular religious body constituting a church. If a religious order or organization can fully meet the requirements stated in this subdivision, exemption from the tax imposed by section 511 will apply to all its activities, including those which it conducts through a separate corporation (other than a corporation described in section 501(c)(2)) or other separate entity which it wholly owns and which is not operated for the primary purpose of carrying on a trade or business for profit. Such exemption from tax will also apply to activities conducted through a separate corporation (other than a corporation described in section 501(c)(2)) or other separate entity which is wholly owned by more than one religious order or organization, if all such orders or organizations fully meet the requirements stated in this subdivision and if such corporation or other entity is not operated for the primary purpose of carrying on a trade or business for profit.

(iii) For taxable years beginning after December 31, 1969, churches and conventions or associations of churches are subject to the taxes imposed by section 511, unless otherwise entitled to the benefit of the transitional rules of section 512(b)(14) and §1.512(b)–1(i).

(b) *Trusts*—(1) *In general.* The taxes imposed by section 511(b) apply in the case of any trust which is exempt from taxation under section 501(a) (except as provided in sections 507 through 515), and which, if it were not for such exemption, would be subject to the provisions of subchapter J, chapter 1, of the Code. An organization which is considered as *trustee* of a stock bonus, pension, or profit-sharing plan described in section 401(a), a supplemental unemployment benefit trust described in section 501(c)(17), or a pension plan described in section 501(c)(18) (regardless of the form of such organization) is subject to the taxes imposed by section 511(b)(1) on its unrelated business income. However, if such an organization conducts a business which is a separate taxable entity on the basis of all the facts and circumstances, for example, an association taxable as a corporation, the business will be taxable as a feeder organization described in section 502.

(2) *Effective dates.* In the case of a trust described in section 501(c)(3), the taxes imposed by section 511(b) apply for taxable years beginning after December 31, 1953. In the case of a trust described in section 401(a), the taxes imposed by section 511(b) apply for taxable years beginning after June 30, 1954. In the case of a trust described in section 501(c)(17), the taxes imposed by section 511(b) apply for taxable years beginning after December 31, 1959. In

the case of any other trust described in subparagraph (1) of this paragraph, the taxes imposed by section 511(b) apply for taxable years beginning after December 31, 1969.

(c) *Title Holding Companies*—(1) *In general.* If a corporation described in section 501(c)(2) pays any amount of its net income for a taxable year to an organization exempt from taxation under section 501(a) (or would pay such an amount but for the fact that the expenses of collecting its income exceed its income), and if such corporation and such organization file a consolidated income tax return for such taxable year, then such corporation shall be treated, for purposes of the tax imposed by section 511(a), as being organized and operated for the same purposes as such organization, as well as for its title-holding purpose. Therefore, if an item of income of the section 501(c)(2) corporation is derived from a source which is related to the exempt function of the exempt organization to which such income is payable and with which such corporation files a consolidated return, such item is, together with all deductions directly connected therewith, excluded from the determination of unrelated business taxable income under section 512 and shall not be subject to the tax imposed by section 511(a). If, however, such item of income is derived from a source which is not so related, then such item, less all deductions directly connected therewith, is, subject to the modifications provided in section 512(b), unrelated business taxable income subject to the tax imposed by section 511(a).

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

Example. The income of X, a section 501(c)(2) corporation, is required to be distributed to exempt organization A. During the taxable year X realizes net income of $900,000 from source M and $100,000 from source N. Source M is related to A's exempt function, while source N is not so related. X and A file a consolidated return for such taxable year. X has net unrelated business income of $100,000, subject to the modifications in section 512(b).

(3) *Cross reference.* For rules relating generally to the filing of consolidated returns by certain organizations exempt from taxation under section 501(a), see section 1504(e) of the Code and § 1.1502–100.

(4) *Effective dates.* Subparagraphs (1) through (3) of this paragraph apply with respect to taxable years beginning after December 31, 1969. For taxable years beginning before January 1, 1970, a corporation described in section 501(c)(2) and otherwise exempt from taxation under section 501(a) is taxable upon its unrelated business taxable income only if such income is payable either:

(i) To a church or convention or association of churches, or

(ii) To any organization subject, for taxable years beginning before January 1, 1970, to the tax imposed by section 511(a)(1).

(d) The fact that any class of organizations exempt from taxation under section 501(a) is subject to the unrelated business income tax under section 511 and this section does not in any way enlarge the permissible scope of business activities of such class for purposes of the continued qualification of such class under section 501(a).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7183, 37 FR 7884, Apr. 21, 1972; T.D. 7632, 44 FR 42681, July 20, 1979]

§ 1.511–3 Provisions generally applicable to the tax on unrelated business income.

(a) *Assessment and collections.* Since the taxes imposed by section 511 are taxes imposed by subtitle A of the Code, all provisions of law and of the regulations applicable to the taxes imposed by subtitle A are applicable to the assessment and collection of the taxes imposed by section 511. Organizations subject to the tax imposed by section 511(a)(1) are subject to the same provisions, including penalties, as are provided in the case of the income tax of other corporations. In the case of a trust subject to the tax imposed by section 511(b)(1), the fiduciaries for such trust are subject to the same provisions, including penalties, as are applicable to fiduciaries in the case of the income tax of other trusts. See section 6151, *et seq.*, and the regulations prescribed thereunder, for provisions relating to payment of tax.

(b) *Returns.* For requirements of filing annual returns with respect to unrelated business taxable income by organizations subject to the tax on such income, see section 6012, paragraph (e) of §1.6012–2, and paragraph (a)(5) of §1.6012–3.

(c) *Taxable years, method of accounting, etc.* The taxable year (fiscal year or calendar year, as the case may be) of an organization shall be determined without regard to the fact that such organization may have been exempt from tax during any prior period. See sections 441 and 446, and the regulations thereunder in this part, and section 7701 and the regulations in part 301 of this chapter (Regulations on Procedure and Administration). Similarly, in computing unrelated business taxable income, the determination of the taxable year for which an item of income or expense is taken into account shall be made under the provisions of sections 441, 446, 451, and 461, and the regulations thereunder, whether or not the item arose during a taxable year beginning before, on, or after the effective date of the provisions imposing a tax upon unrelated business taxable income. If a method for treating bad debts was selected in a return of income (other than an information return) for a previous taxable year, the taxpayer must follow such method in its returns under section 511, unless such method is changed in accordance with the provisions of §1.166–1. A taxpayer which has not previously selected a method for treating bad debts may, in its first return under section 511, exercise the option granted in §1.166–1.

(d) *Foreign tax credit.* See section 515 for provisions applicable to the credit for foreign taxes provided in section 901.

§1.511–4 Minimum tax for tax preferences.

The tax imposed by section 56 applies to an organization subject to tax under section 511 with respect to items of tax preference which enter into the computation of unrelated business taxable income. For this purpose, only those items of income and those deductions entering into the determination of the tax imposed by this section are considered in the determination of the items of tax preference under section 57. For rules relating to the minimum tax for tax preferences, see sections 56 through 58 and the regulations thereunder.

[T.D. 7564, 43 FR 40494, Sept. 12, 1978]

§1.512(a)–1 Definition.

(a) *In general.* Except as otherwise provided in §1.512(a)–3, §1.512(a)–4, or paragraph (f) of this section, section 512(a)(1) defines *unrelated business taxable income* as the gross income derived from any unrelated trade or business regularly carried on, less those deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade or business, subject to certain modifications referred to in §1.512(b)–1. To be deductible in computing unrelated business taxable income, therefore, expenses, depreciation, and similar items not only must qualify as deductions allowed by chapter 1 of the Code, but also must be directly connected with the carrying on of unrelated trade or business. Except as provided in paragraph (d)(2) of this section, to be *directly connected with* the conduct of unrelated business for purposes of section 512, an item of deduction must have proximate and primary relationship to the carrying on of that business. In the case of an organization which derives gross income from the regular conduct of two or more unrelated business activities, unrelated business taxable income is the aggregate of gross income from all such unrelated business activities less the aggregate of the deductions allowed with respect to all such unrelated business activities. For the treatment of amounts of income or loss of common trust funds, see §1.584–2(c)(3).

(b) *Expenses attributable solely to unrelated business activities.* Expenses, depreciation, and similar items attributable solely to the conduct of unrelated business activities are proximately and primarily related to that business activity, and therefore qualify for deduction to the extent that they meet the requirements of section 162, section 167, or other relevant provisions of the Code, connected with the conduct of that activity and are deductible in computing unrelated business activities are directly connected with the conduct of that activity and are deductible in computing unrelated business taxable income if they otherwise qualify for deduction under the requirements of section 162. Similarly, depreciation of a building used entirely in the conduct of unrelated business activities would be an allowable deduction to the extent otherwise permitted by section 167.

(c) *Dual use of facilities or personnel.* Where facilities are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses, depreciation and similar items attributable to such facilities (as, for example, items of overhead), shall be allocated between the two uses on a reasonable basis. Similarly, where personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses and similar items attributable to such personnel (as, for example, items of salary) shall be allocated between the two uses on a reasonable basis. The portion of any such item so allocated to the unrelated trade or business activity is proximately and primarily related to that business activity, and shall be allowable as a deduction in computing unrelated business taxable income in the manner and to the extent permitted by section 162, section 167, or other relevant provisions of the Code. Thus, for example, assume that X, an exempt organization subject to the provisions of section 511, pays its president a salary of $20,000 a year. X derives gross income from the conduct of unrelated trade or business activities. The president devotes approximately 10 percent of his time during the year to the unrelated business activity. For purposes of computing X's unrelated business taxable income, a deduction of $2,000 (10 percent of $20,000), would be allowable for the salary paid to its president.

(d) *Exploitation of exempt activities*—(1) *In general.* In certain cases, gross income is derived from an unrelated trade or business activity which exploits an exempt activity. One example of such exploitation is the sale of advertising in a periodical of an exempt organization which contains editorial material related to the accomplishment of the organization's exempt purpose. Except as specified in subparagraph (2) of this paragraph and paragraph (f) of this section, in such cases, expenses, depreciation and similar items attributable to the conduct of the exempt activities are not deductible in computing unrelated business taxable income. Since such items are incident to an activity which is carried on in furtherance of the exempt purpose of the organization, they do not possess the necessary proximate and primary relationship to the unrelated trade or business activity and are therefore not directly connected with that business activity.

(2) *Allowable deductions.* Where an unrelated trade or business activity is of a kind carried on for profit by taxable organizations and where the exempt activity exploited by the business is a type of activity normally conducted by taxable organizations in pursuance of such business, expenses, depreciation, and similar items which are attributable to the exempt activity qualify as directly connected with the carrying on of the unrelated trade or business activity to the extent that:

(i) The aggregate of such items exceeds the income (if any) derived from or attributable to the exempt activity; and

(ii) The allocation of such excess to the unrelated trade or business activity does not result in a loss from such unrelated trade or business activity.

Under the rule of the preceding sentence, expenses, depreciation and similar items paid or incurred in the performance of an exempt activity must be allocated first to the exempt activity to the extent of the income derived from or attributable to the performance of that activity. Furthermore, such items are in no event allocable to the unrelated trade or business activity exploiting such exempt activity to the extent that their deduction would result in a loss carryover or carryback with respect to that trade or business activity. Similarly, they may not be taken into account in computing unrelated business taxable income attributable to any unrelated trade or business activity not exploiting the same exempt activity. See paragraph (f) of this section for the application of these rules to periodicals published by exempt organizations.

(e) *Example.* Paragraphs (a) through (d) of this section are illustrated by the following example:

Example. W is an exempt business league with a large membership. Under an arrangement with an advertising agency W regularly mails brochures, pamphlets and other advertising materials to its members, charging the agency an agreed amount per enclosure. The distribution of the advertising materials does not contribute importantly to the accomplishment of the purpose for which W is granted exemption. Accordingly, the payments made to W by the advertising agency constitute gross income from an unrelated trade or business activity. In computing W's unrelated business taxable income, the expenses attributable solely to the conduct of the business, or allocable to such business under the rule of paragraph (c) of this section, are allowable as deductions in accordance with the provisions of section 162. Such deductions include the costs of handling and mailing, the salaries of personnel used full-time in the unrelated business activity and an allocable portion of the salaries of personnel used both to carry on exempt activities and to conduct the unrelated business activity. However, costs of developing W's membership and carrying on its exempt activities are not deductible. Those costs are necessary to the maintenance of the intangible asset exploited in the unrelated business activity—W's membership—but are incurred primarily in connection with W's fundamental purpose as an exempt organization. As a consequence, they do not have proximate and primary relationship to the conduct of the unrelated business activity and do not qualify as directly connected with it.

(f) *Determination of unrelated business taxable income derived from sale of advertising in exempt organization periodicals*—(1) *In general.* Under section 513 (relating to the definition of unrelated trade or business) and §1.513–1, amounts realized by an exempt organization from the sale of advertising in a periodical constitute gross income from an unrelated trade or business activity involving the exploitation of an exempt activity; namely, the circulation and readership of the periodical developed through the production and distribution of the readership content of the periodical. Paragraph (d) of this section provides for the allowance of deductions attributable to the production and distribution of the readership content of the periodical. Thus, subject to the limitations of paragraph (d)(2) of this section, where the circulation and readership of an exempt organization periodical are utilized in connection with the sale of advertising in the periodical, expenses, depreciation, and similar items of deductions attributable to the production and distribution of the editorial or readership content of the periodical shall qualify as items of deductions directly connected with the unrelated advertising activity. Subparagraphs (2) through (6) of this paragraph provide rules for determining the amount of unrelated business taxable income attributable to the sale of advertising in exempt organization periodicals. Subparagraph (7) of this paragraph provides rules for determining when the unrelated business taxable income of two or more exempt organization periodicals may be determined on a consolidated basis.

(2) *Computation of unrelated business taxable income attributable to sale of advertising*—(i) *Excess advertising costs.* If the direct advertising costs of an exempt organization periodical (determined under subparagraph (6)(ii) of this paragraph) exceed gross advertising income (determined under subparagraph (3)(ii) of this paragraph), such excess shall be allowable as a deduction in determining unrelated business taxable income from any unrelated trade or business activity carried on by the organization.

(ii) *Excess advertising income.* If the gross advertising income of an exempt organization periodical exceeds direct advertising costs, paragraph (d)(2) of this section provides that items of deduction attributable to the production and distribution of the readership content of an exempt organization periodical shall qualify as items of deduction directly connected with unrelated advertising activity in computing the amount of unrelated business taxable income derived from the advertising activity to the extent that such items exceed the income derived from or attributable to such production and distribution, but only to the extent that such items do not result in a loss from such advertising activity. Furthermore, such items of deduction shall not qualify as directly connected with such advertising activity to the extent that their deduction would result in a loss carryback or carryover with respect to such advertising activity. Similarly, such items of deduction shall not be taken into account in computing unrelated business taxable income attributable to any unrelated trade or business activity other than such advertising activity. Thus:

(a) If the circulation income of the periodical (determined under subparagraph (3)(iii) of this paragraph) equals or exceeds the readership costs of such periodical (determined under subparagraph (6)(iii) of this paragraph), the unrelated business taxable income attributable to the periodical is the excess of the gross advertising income of the periodical over direct advertising costs; but

(b) If the readership costs of an exempt organization periodical exceed the circulation income of the periodical, the unrelated business taxable income is the excess, if any, of the total income attributable to the periodical (determined under subparagraph (3) of this paragraph) over the total periodical costs (as defined in subparagraph (6)(i) of this paragraph).

See subparagraph (7) of this paragraph for rules relating to the consolidation of two or more periodicals.

(iii) *Examples.* The application of this paragraph may be illustrated by the following examples. For purposes of these examples it is assumed that the production and distribution of the readership content of the periodical is related to the organization's exempt purpose.

Example 1. X, an exempt trade association, publishes a single periodical which carries advertising. During 1971, X realizes a total of $40,000 from the sale of advertising in the periodical (gross advertising income) and $60,000 from the sales of the periodical to members and nonmembers (circulation income). The total periodical costs are $90,000 of which $50,000 is directly connected with the sale and publication of advertising (direct advertising costs) and $40,000 is attributable to the production and distribution of the readership content (readership costs). Since the direct advertising costs of the periodical ($50,000) exceed gross advertising income ($40,000), pursuant to subdivision (i) of this subparagraph, the unrelated business taxable income attributable to advertising is determined solely on the basis of the income and deductions directly connected with the production and sale of the advertising:

Gross advertising revenue	$40,000
Direct advertising costs	(50,000)
Loss attributable to advertising	(10,000)

X has realized a loss of $10,000 from its advertising activity. This loss is an allowable deduction in computing X's unrelated business taxable income derived from any other unrelated trade or business activity.

Example 2. Assume the facts as stated in example 1, except that the circulation income of X periodical is $100,000 instead of $60,000, and that of the total periodical costs, $25,000 are direct advertising costs, and $65,000 are readership costs. Since the circulation income ($100,000) exceeds the total readership costs ($65,000), pursuant to subdivision (ii)*(a)* of this subparagraph the unrelated business taxable income attributable to the advertising activity is $15,000, the excess of gross advertising income ($40,000) over direct advertising costs ($25,000).

Example 3. Assume the facts as stated in example 1, except that of the total periodical costs, $20,000 are direct advertising costs and $70,000 are readership costs. Since the readership costs of the periodical ($70,000), exceed the circulation income ($60,000), pursuant to subdivision (ii) *(b)* of this subparagraph the unrelated business taxable income attributable to advertising is the excess of the total income attributable to the periodical over the total periodical costs. Thus, X has unrelated business taxable income attributable to the advertising activity of $10,000 ($100,000 total income attributable to the periodical less $90,000 total periodical costs).

Example 4. Assume the facts as stated in example 1, except that the total periodical costs are $120,000 of which $30,000 are direct advertising costs and $90,000 are readership costs. Since the readership costs of the periodical ($90,000), exceed the circulation income ($60,000), pursuant to subdivision (ii) *(b)* of this subparagraph the unrelated business taxable income attributable to advertising is the excess, if any, of the total income attributable to the periodical over the total periodical costs. Since the total income of the periodical ($100,000) does not exceed the total periodical costs ($120,000), X has not derived any unrelated business taxable income from the advertising activity. Further, only $70,000 of the $90,000 of readership costs may be deducted in computing unrelated business taxable income since as provided in subdivision (ii) of this subparagraph, such costs may be deducted, to the extent they exceed circulation income, only to the extent they do not result in a loss from the advertising activity. Thus, there is no loss from such activity, and no amount may be deducted on this account in computing X's unrelated trade or business income derived from any other unrelated trade or business activity.

(3) *Income attributable to exempt organization periodicals*—(i) *In general.* For purposes of this paragraph the total income attributable to an exempt organization periodical is the sum of its gross advertising income and its circulation income.

(ii) *Gross advertising income.* The term *gross advertising income* means all amounts derived from the unrelated advertising activities of an exempt organization periodical (or for purposes of this paragraph in the case of a taxable organization, all amounts derived from the advertising activities of the taxable organization).

(iii) *Circulation income.* The term *circulation income* means the income attributable to the production, distribution or circulation of a periodical (other than gross advertising income) including all amounts realized from or attributable to the sale or distribution of the readership content of the periodical, such as amounts realized from charges made for reprinting or republishing articles and special items in the periodical and amounts realized from sales of back issues. Where the right to receive an exempt organization periodical is associated with membership or similar status in such organization for which dues, fees or other charges are received (hereinafter referred to as *membership receipts*), circulation income includes the portion of such membership receipts allocable to the periodical (hereinafter referred to as *allocable membership receipts*). Allocable membership receipts is the amount which would have been charged and paid if:

(a) The periodical was that of a taxable organization.

(b) The periodical was published for profit, and

(c) The member was an unrelated party dealing with the taxable organization at arm's length.

See subparagraph (4) of this paragraph for a discussion of the factors to be considered in determining allocable membership receipts of an exempt organization periodical under the standard described in the preceding sentence.

(4) *Allocable membership receipts.* The allocable membership receipts of an exempt organization periodical shall be determined in accordance with the following rules:

(i) *Subscription price charged to nonmembers.* If 20 percent or more of the total circulation of a periodical consist of sales to nonmembers, the subscription price charged to such nonmembers shall determine the price of the periodical for purposes of allocating membership receipts to the periodical.

(ii) *Subscription price to nonmembers.* If paragraph (f)(4)(i) of this section does not apply and if the membership dues from 20 percent or more of the members of an exempt organization are less than those received from the other members because the former members do not receive the periodical, the amount of the reduction in membership dues for a member not receiving the periodical shall determine the price of the periodical for purposes of allocating membership receipts to the periodical.

(iii) *Pro rata allocation of membership receipts.* Since it may generally be assumed that membership receipts and gross advertising income are equally available for all the exempt activities (including the periodical) of the organization, the share of membership receipts allocated to the periodical, where paragraphs (f)(4) (i) and (ii) of this section do not apply, shall be an amount equal to the organization's membership receipts multiplied by a fraction the numerator of which is the total periodical costs and the denominator of which is such costs plus the cost of other exempt activities of the organization. For example, assume that an exempt organization has total periodical costs of $30,000 and other exempt costs of $70,000. Further assume that the membership receipts of the organization are $60,000 and that paragraphs (f)(4) (i) and (ii) of this section do not apply. Under these circumstances $18,000 ($60,000 times $30,000/$100,000) is allocated to the periodical's circulation income.

(5) *Examples.* The rules set forth in paragraph (f)(4) of this section may be illustrated by the following examples. For purposes of these examples it is assumed that the exempt organization periodical contains advertising, and that the production and distribution of

the readership content of the periodical is related to the organization's exempt purpose.

Example 1. U is an exempt scientific organization with 10,000 members who pay annual dues of $15 per year. One of U's activities is the publication of a monthly periodical which is distributed to all of its members. U also distributes 5,000 additional copies of its periodical to nonmember subscribers at a cost of $10 per year. Pursuant to paragraph (f)(4)(i) of this section, since the nonmember circulation of U's periodical represents 33⅓ percent of its total circulation the subscription price charged to nonmembers will be used to determine the portion of U's membership receipts allocable to the periodical. Thus, U's allocable membership receipts will be $100,000 ($10 times 10,000 members), and U's total circulation income for the periodical will be $150,000 ($100,000 from members plus $50,000 from sales to nonmembers).

Example 2. Assume the facts as stated in example 1, except that U sells only 500 copies of its periodical to nonmembers, at a price of $10 per year. Assume further that U's members may elect not to receive the periodical, in which case their annual dues are reduced from $15 per year to $6 per year, and that only 3,000 members elect to receive the periodical and pay the full dues of $15 per year. U's stated subscription price to members of $9 consistently results in an excess of total income (including gross advertising income) attributable to the periodical over total costs of the periodical. Since the 500 copies of the periodical distributed to nonmembers represents only 14 percent of the 3,500 copies distributed, pursuant to paragraph (f)(4)(i) of this section, the $10 subscription price charged to nonmembers will not be used in determining the portion of membership receipts allocable to the periodical. On the other hand, since 70 percent of the members elect not to receive the periodical and pay $9 less per year in dues, pursuant to paragraph (f)(4)(ii) of this section, such $9 price will be used in determining the subscription price charged to members. Thus, the allocable membership receipts will be $9 per member, or $27,000 ($9 times 3,000 copies) and U's total circulation income will be $32,000 ($27,000 plus $5,000).

Example 3. (a) W, an exempt trade association, has 800 members who pay annual dues of $50 per year. W publishes a monthly journal the editorial content and advertising of which are directed to the business interests of its own members. The journal is distributed to all of W's members and no receipts are derived from nonmembers.

(b) W has total receipts of $100,000 of which $40,000 ($50 x 800) are membership receipts and $60,000 are gross advertising income. W's total costs for the journal and other exempt activities is $100,000. W has total periodical costs of $76,000 of which $41,000 are direct advertising costs and $35,000 are readership costs.

(c) Paragraph (f)(4)(i) of this section will not apply since no copies are available to nonmembers. Therefore, the allocation of membership receipts shall be made in accordance with paragraph (f)(4)(iii) of this section. Based upon pro rata allocation of membership receipts (40,000) by a fraction the numerator of which is total periodical costs ($76,000) and the denominator of which is the total costs of the journal and the other exempt activities ($100,000), $30,400 ($76,000/$100,000 times $40,000) of membership receipts is circulation income.

(6) *Deductions attributable to exempt organization periodicals*—(i) *In general.* For purposes of this paragraph the term *total periodical costs* means the total deductions attributable to the periodical. For purposes of this paragraph the total periodical costs of an exempt organization periodical are the sum of the direct advertising costs of the periodical (determined under subdivision (ii) of this subparagraph) and the readership costs of the periodical (determined under subdivision (iii) of this subparagraph). Items of deduction properly attributable to exempt activities other than the publication of an exempt organization periodical may not be allocated to such periodical. Where items are attributable both to an exempt organization periodical and to other activities of an exempt organization, the allocation of such items must be made on a reasonable basis which fairly reflects the portion of such item properly attributable to each such activity. The method of allocation will vary with the nature of the item, but once adopted, a reasonable method of allocation with respect to an item must be used consistently. Thus, for example, salaries may generally be allocated among various activities on the basis of the time devoted to each activity; occupancy costs such as rent, heat and electricity may be allocated on the basis of the portion of space devoted to each activity; and depreciation may be allocated on the basis of space occupied and the portion of the particular asset utilized in each activity. Allocations based on dollar receipts from various exempt activities will generally not be reasonable since such receipts are usually not an accurate reflection of the

costs associated with activities carried on by exempt organizations.

(ii) *Direct advertising costs. (a)* The direct advertising costs of an exempt organization periodical include all expenses, depreciation, and similar items of deduction which are directly connected with the sale and publication of advertising as determined in accordance with paragraphs (a), (b), and (c) of this section. These items are allowable as deductions in the computation of unrelated business income of the organization for the taxable year to the extent they meet the requirements of section 162, section 167, or other relevant provisions of the Code. The items allowable as deductions under this subdivision do not include any items of deduction attributable to the production or distribution of the readership content of the periodical.

(b) The items allowable as deductions under this subdivision would include agency commissions and other direct selling costs, such as transportation and travel expenses, office salaries, promotion and research expenses, and direct office overhead directly connected with the sale of advertising lineage in the periodical. Also included would be other items of deduction commonly classified as advertising costs under standard account classification, such as art work and copy preparation, telephone, telegraph, postage, and similar costs directly connected with advertising.

(c) In addition to the items of deduction normally included in standard account classifications relating to advertising costs, it is also necessary to ascertain the portion of mechanical and distribution costs attributable to advertising lineage. For this purpose, the general account classifications of items includible in mechanical and distribution costs ordinarily employed in business-paper and consumer publication accounting provide a guide for the computation. Thus, the mechanical and distribution costs in such cases would include the portion of the costs and other expenses of composition, presswork, binding, mailing (including paper and wrappers used for mailing), and the bulk postage attributable to the advertising lineage of the publication. The portion of mechanical and distribution costs attributable to advertising lineage of the periodical will be determined on the basis of the ratio of advertising lineage to total lineage of the periodical, and the application of that ratio to the total mechanical and distribution costs of the periodical, where records are not kept in such a manner as to reflect more accurately the allocation of mechanical and distributions costs to advertising lineage of the periodical, and where there is no factor in the character of the periodical to indicate that such an allocation would be unreasonable.

(iii) *Readership costs.* The *readership costs* of an exempt organization periodical include expenses, depreciation or similar items which are directly connected with the production and distribution of the readership content of the periodical and which would otherwise be allowable as deductions in determining unrelated business taxable income under section 512 and the regulations thereunder if such production and distribution constituted an unrelated trade or business activity. Thus, readership costs include all the items of deduction attributable to an exempt organization periodical which are not allocated to direct advertising costs under subdivision (ii) of this subparagraph, including the portion of such items attributable to the readership content of the periodical, as opposed to the advertising content, and the portion of mechanical and distribution costs which is not attributable to advertising lineage in the periodical.

(7) *Consolidation*—(i) *In general.* Where an exempt organization subject to unrelated business income tax under section 511 publishes two or more periodicals for the production of income, it may treat the gross income from all (but not less than all) of such periodicals and the items of deduction directly connected with such periodicals (including readership costs of such periodicals), on a consolidated basis as if such periodicals were one periodical in determining the amount of unrelated business taxable income derived from the sale of advertising in such periodical. Such treatment must, however, be followed consistently and once adopted shall be binding unless the

consent of the Commissioner is obtained as provided in sections 446(e) and § 1.446–1(e).

(ii) *Production of income.* For purposes of this subparagraph, an exempt organization periodical is *published for the production of income* if:

(a) The organization generally receives gross advertising income from the periodical equal to at least 25 percent of the readership costs of such periodical, and

(b) The publication of such periodical is an activity engaged in for profit.

For purposes of the preceding sentence, the determination whether the publication of a periodical is an activity engaged in for profit is to be made by reference to objective standards taking into account all the facts and circumstances involved in each case. The facts and circumstances must indicate that the organization carries on the activity with the objective that the publication of the periodical will result in economic profit (without regard to tax consequences), although not necessarily in a particular year. Thus, an exempt organization periodical may be treated as having been published with such an objective even though in a particular year its total periodical costs exceed its total income. Similarly, if an exempt organization begins publishing a new periodical, the fact that the total periodical costs exceed the total income for the startup years because of a lack of advertising sales does not mean that the periodical was published without an objective of economic profit. The organization may establish that the activity was carried on with such an objective. This might be established by showing, for example, that there is a reasonable expectation that the total income, by reason of an increase in advertising sales, will exceed costs within a reasonable time. See § 1.183–2 for additional factors bearing on this determination.

(iii) *Example.* This subparagraph may be illustrated by the following example:

Example. Y, an exempt trade association, publishes three periodicals which it distributes to its members: a weekly newsletter, a monthly magazine, and quarterly journal. Both the monthly magazine and the quarterly journal contain advertising which accounts for gross advertising income equal to more than 25 percent of their respective readership costs. Similarly, the total income attributable to each such periodical has exceeded the total deductions attributable to each such periodical for substantially all the years they have been published. The newsletter carries no advertising and its annual subscription price is not intended to cover the cost of publication. The newsletter is a service of Y distributed to all of its members in an effort to keep them informed of changes occurring in the business world and is not engaged in for profit. Under these circumstances, Y may consolidate the income and deductions from the monthly and quarterly journals in computing its unrelated business taxable income, but may not consolidate the income and deductions attributable to the publication of the newsletter with the income and deductions of its other periodicals since the newsletter is not published for the production of income.

(g) *Foreign organizations*—(1) *In general.* The unrelated business taxable income of a foreign organization exempt from taxation under section 501(a) consists of:

(i) The organization's unrelated business taxable income which is derived from sources within the United States but which is not effectively connected with the conduct of a trade or business within the United States, plus

(ii) The organization's unrelated business taxable income effectively connected with the conduct of a trade or business within the United States (whether or not such income is derived from sources within the United States).

To determine whether income realized by a foreign organization is derived from sources within the United States or is effectively connected with the conduct of a trade or business within the United States, see part 1, subchapter N, chapter 1 of the Code (section 861 and following) and the regulations thereunder.

(2) *Effective dates.* Subparagraph (1) of this paragraph applies to taxable years beginning after December 31, 1969. For taxable years beginning on or before December 31, 1969, the unrelated business taxable income of a foreign organization exempt from taxation under section 501(a) consists of the organization's unrelated business taxable income which:

(i) For taxable years beginning after December 31, 1966, is effectively connected with the conduct of a trade or business within the United States, whether or not such income is derived from sources within the United States;

(ii) For taxable years beginning on or before December 31, 1966, is derived from sources within the United States.

(h) *Effective date.* Paragraphs (a) through (f) of this section are applicable with respect to taxable years beginning after December 12, 1967. However, if a taxpayer wishes to rely on the rules stated therein for taxable years beginning before December 13, 1967, he may do so.

[T.D. 7392, 40 FR 58638, Dec. 18, 1975, as amended by T.D. 7438, 41 FR 44392, Oct. 8, 1976; T.D. 7935, 49 FR 1694, Jan. 13, 1984]

§1.512(a)–2 Definition applicable to taxable years beginning before December 13, 1967.

(a) *In general.* The unrelated business taxable income which is subject to the tax imposed by section 511 is the gross income, derived by any organization to which section 511 applies, from any unrelated trade or business regularly carried on by it, less the deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade or business, subject to certain exceptions, additions, and limitations referred to below. In the case of an organization which regularly carries on two or more unrelated businesses, its unrelated business taxable income is the aggregate of its gross income from all such unrelated businesses, less the aggregate of the deductions allowed with respect to all such unrelated businesses. For provisions generally applicable to the unrelated business tax, see §1.511–3, and for rules applicable to the determination of the adjusted basis of property, see paragraph (a)(2) of §1.514(a)–1.

(b) *Effective date.* Except as provided in paragraph (f) of §1.512(a)–1, this section is applicable with respect to taxable years beginning before December 13, 1967.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6939, 32 FR 17660, Dec. 12, 1967]

§1.512(a)–3 [Reserved]

§1.512(a)–4 Special rules applicable to war veterans organizations.

(a) *In general.* For taxable years beginning after December 31, 1969, this section provides special rules for the determination of the unrelated business taxable income of an organization described in section 501(c)(19). In general, the rules contained in sections 511 through 514 which are applicable to any organization listed in section 501(c) apply in determining the unrelated business taxable income of an organization described in section 501(c)(19). However, that amount which is paid by members to the organization for the purpose described in paragraph (b)(1) of this section, if set aside from other organizational monies and accounts in an insurance set aside, may be excluded from the unrelated business taxable income of the organization. The insurance set aside shall be used exclusively for providing insurance benefits, for the purposes specified in section 170(c)(4) of the Code, for the reasonable costs of administering the insurance program that are directly related to such set aside, or for the reasonable costs of distributing funds for section 170(c)(4) purposes. If an amount so set aside is used for any purposes other than those described in the preceding sentence, it shall be included in unrelated business taxable income without regard to any modifications provided by section 512(b), in the taxable year in which it is withdrawn from such set aside. Amounts will be considered to have been withdrawn from an insurance set aside if they are used in any manner inconsistent with providing insurance benefits, paying the reasonable costs of administering the insurance program for section 170(c)(4) purposes and for costs of distributing funds for section 170(c)(4) purposes. An example of a use of funds which would be considered a withdrawal would be the use of such funds as security for a loan.

(b) *Insurance set aside*—(1) *Purpose of payments by members.* Payments by members (including commissions on such payments earned by the set aside as agent for an insurance company) into an insurance set aside must be for the sole purpose of obtaining life, sick, accident or health insurance benefits from the organization or for the reasonable costs of administration of the insurance program, except that such purpose is not violated when excess funds from an experience gain are utilized for those purposes specified in section 170(c)(4) or the reasonable costs of distributing funds for such purposes. Funds for any other purpose may not be set aside in the insurance set aside.

(2) *Income from set aside.* In addition to the payments by members described in paragraph (b)(1) of this section, only income from amounts in the insurance set aside (including commissions earned as agent for an insurance company) may be so set aside. Moreover unless such income is used for providing insurance benefits, for those purposes specified in section 170(c)(4), or for reasonable costs of administration, such income must be set aside within the period described in paragraph (b)(3) of this section in order to avoid being included as an item of unrelated business taxable income under section 512(a)(4).

(3) *Time within which income must be set aside.* Income from amounts in the insurance set aside generally must be set aside in the taxable year in which it would be includible in gross income but for this section. However, income set aside on or before the date prescribed for filing the organization's return of unrelated business taxable income (whether or not it had such income) for the taxable year (including any extension of time) may, at the election of the organization, be treated as having been set aside in such taxable year.

(4) *Computation of income from set aside.* Income from amounts in the insurance set aside shall consist solely of items of investment income from, and other gains derived from dealings in, property in the set aside. The deductions allowed against such items of income or other gains are those amounts which are related to the production of such income or other gains. Only the amounts of income or other gain which are in excess of such deductions may be set aside in the insurance set aside.

(5) *Requirements for set aside.* An amount is not properly set aside if the organization commingles it with any amount which is not to be set aside. However, adequate records describing the amount set aside and indicating that it is to be used for the designated purpose are sufficient. Amounts that are set aside need not be permanently committed to such use either under state law or by contract. Thus, for example, it is not necessary that the organization place these funds in an irrevocable trust. Although set aside income may be accumulated, any accumulation which is unreasonable in amount or duration is evidence that the income was not accumulated for the purposes set forth. For purposes of the preceding sentence, accumulations which are reasonably necessary for the purpose of providing life, sick, health, or accident insurance benefits on the basis of recognized mortality or morbidity tables and assumed rates of interest under an actuarially acceptable method would not be unreasonable even though such accumulations are quite large and the time between the receipt by the organization of such amounts and the date of payment of the benefits is quite long. For example, an accumulation of income for 20 years or longer which is determined to be reasonable necessary to pay life insurance benefits to members, their dependents or designated beneficiaries, generally would not be an unreasonable accumulation. Income which has been set aside may be invested, pending the action contemplated by the set aside, without being regarded as having been used for other purposes.

[T.D. 7438, 41 FR 44393, Oct. 8, 1976]

§ 1.512(a)–5T Questions and answers relating to the unrelated business taxable income of organizations described in paragraphs (9), (17) or (20) of Section 501(c) (temporary).

Q–1: What does section 512(a)(3), as amended by the Tax Reform Act of 1984 (Act), provide with respect to organizations described in paragraphs (9), (17) or (20) of section 501(c)?

A–1: In general, section 512(a)(3), as amended by section 511 of the Act, extends the rules for determining the unrelated business income tax of voluntary employees' beneficiary associations (VEBAs) to supplemental unemployment compensation benefit trusts (SUBs) and group legal service organizations (GLSOs). The section also restricts the amount of income that may be set aside by such organizations for exempt purposes.

Q–2: What is the effective date of the amendments to section 512(a)(3)?

A–2: The amendments to section 512(a)(3) will apply to income earned by VEBAs, SUBs or GLSOs after December 31, 1985, in the taxable years of such organizations ending after such date. For purposes of applying section 512(a)(3) to the first taxable year of such an organization ending after December 31, 1985, the income of the VEBA, SUB or GLSO earned after December 31, 1985, will be determined by allocating the total income earned for such taxable year on the basis of the calendar year 1985 and 1986 months in such taxable year. However, if a VEBA, SUB or GLSO is part of a plan that is maintained pursuant to one or more collective bargaining agreements (a) between employee representatives and one or more employers, and (b) which are in effect on July 1, 1985 (or ratified on or before that date), the amendments do not apply to income earned in a taxable year of a VEBA, SUB or GLSO beginning before the termination of the last of the collective bargaining agreements pursuant to which the plan is maintained (determined without regard to any extension of the contract agreed to after July 1, 1985). For purposes of the preceding sentence, any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added under section 511 of the Tax Reform Act 1984 (i.e., requirements under section 419, 419A, 512(a)(3)(E), and 4976) shall not be treated as a termination of such collective bargaining agreements.

Q–3: What amount of income may a VEBA, SUB or GLSO set aside for exempt purposes?

A–3: (a) Pursuant to section 512(a)(3)(E)(i), the amounts set aside in a VEBA, SUB, or GLSO (including a VEBA, SUB, or GLSO that is part of a 10 or more employer plan, as defined in section 419A(f)(6)(B)) as of the close of a taxable year of such VEBA, SUB, or GLSO to provide for the payment of life, sick, accident, or other benefits may not be taken into account for purposes of determining *exempt function income* to the extent that such amounts exceed the qualified asset account limit, determined under sections 419A(c) and 419A(f)(7), for such taxable year of the VEBA, SUB, or GLSO. In calculating the qualified asset account limit for this purpose, a reserve for post-retirement medical benefits under section 419A(c)(2)(A) is not to be taken into account.

(b) The exempt function income of a VEBA, SUB, or GLSO for a taxable year of such an organization, under section 512(a)(3)(B), includes: (1) Certain amounts paid by members of the VEBA, SUB, or GLSO within the meaning of the first sentence of section 512(a)(3)(B) (*member contributions*); and (2) other income of the VEBA, SUB, or GLSO (including earnings on member contributions) that is set aside for the payment of life, sick, accident, or other benefits to the extent that the total amount set aside in the VEBA, SUB or GLSO as of the close of the taxable year for any purpose (including member contributions and other income set aside in the VEBA, SUB, or GLSO as of the close of the year) does not exceed the qualified asset account limit for such taxable year of the organization. For purposes of section 512(c)(3)(B), member contributions include both employee contributions and employer contributions to the VEBA, SUB, or GLSO. In calculating the total amount set aside in a VEBA, SUB, or GLSO as of the close of a taxable year, certain assets with useful lives extending substantially beyond the end of the taxable year (e.g., buildings, and licenses) are not to be taken into account to the extent they are used in the provision of life, sick, accident, or other benefits. For example, cash and securities (and similar investments) held by a VEBA, SUB or GLSO are not disregarded in calculating the total amount set aside for this purpose because they are used to pay welfare benefits, rather than merely used in the provision of such benefits. Accordingly, the unrelated business taxable income of a VEBA, SUB, or GLSO for a taxable year of such an organization generally will equal the lesser of two amounts: the income of the VEBA, SUB, or GLSO for the taxable year (excluding member contributions); or, the excess of the total amount set aside as of the close of the taxable year (including member contributions, and excluding certain assets with a useful life extending substantially beyond the end of the taxable year to the extent they are used in the provision of welfare benefits) over the qualified asset account limit (calculated without regard to the otherwise permitted reserve for post-retirement medical benefits) for the taxable year. See §1.419A–2T for special rules relating to collectively bargained welfare benefit funds.

(c) The income of a VEBA, SUB, or GLSO for any taxable year includes gain realized by the organization on the sale or disposition of any asset during such year. The gain realized by a VEBA, SUB, or GLSO on the sale or disposition of an asset is equal to the amount realized by the organization over the basis of such asset (in the hands of the organization), reduced by any qualified direct costs attributable to such asset (under paragraphs (b), (c), and (d) of Q&A–6 of §1.419–1T).

Q–4: What transition rules apply to *existing reserves for post-retirement medical or life insurance benefits*?

A–4: (a) Section 512(a)(3)(E)(iii)(I) provides that income that is either directly or indirectly attributable to *existing reserves for post-retirement medical or life insurance benefits* will not be treated as unrelated business taxable income. An *existing reserve for post-retirement medical or life insurance benefits* (as defined in section 512(a)(3)(E)(iii)(II)) is the total amount of assets actually set aside in a VEBA, SUB, or GLSO on July 18, 1984 (calculated in the manner set forth in Q&A–3 of the regulation, and adjusted under paragraph (c) of Q&A–11 of § 1.419–1T), reduced by employer contributions to the fund on or before such date to the extent such contributions are not deductible for the taxable year of the employer containing July 18, 1984, and for any prior taxable year of the employer, for purposes of providing such post-retirement benefits. For purposes of the preceding sentence only, an amount that was not actually set aside on July 18, 1984, will be treated as having been actually set aside on such date if (1) such amount was incurred by the employer (without regard to section 461(h)) as of the close of the last taxable year of the VEBA, SUB, or GLSO ending before July 18, 1984, and (2) such amount was actually contributed to the VEBA, SUB, or GLSO within 8½ months following the close of such taxable year.

(b) In addition, section 512(a)(3)(E)(iii)(I) applies to existing reserves for such post-retirement benefits only to the extent that such *existing reserves* do not exceed the amount that could be accumulated under the principles set forth in Revenue Rulings 69–382, 1969–2, C.B. 28; 69–478, 1969–2 C.B. 29; and 73–599, 1973–2 C.B. 40. Thus, amounts attributable to such excess *existing reserves* are not within this transition rule eventhough they were actually set aside on July 18, 1984.

(c) All post-retirement medical or life insurance benefits (or other benefits to the extent paid with amounts set aside to provide post-retirement medical or life insurance benefits) provided after July 18, 1984 (whether or not the employer has maintained a reserve or fund for such benefits) are to be charged, first, against the *existing reserves* within this transition rule (including amounts attributable to *existing reserves* within this transition rule) for post-retirement medical benefits or for post-retirement life insurance benefits (as the case may be) and, second, against all other amounts. For this purpose, the qualified direct cost of an asset with a useful life extending substantially beyond the end of the taxable year (as determined under Q&A–6 of § 1.419–1T) will be treated as a benefit provided and thus charged against the *existing reserve* based on the extent to which such asset is used in the provision of post-retirement medical benefits or post-retirement life insurance benefits (as the case may be). All plans of an employer providing post-retirement medical benefits are to be treated as one plan for purposes of section 512(a)(3)(E)(iii)(III), and all plans of an employer providing post-retirement life insurance benefits are to be treated as one plan for purposes of section 512(a)(3)(E)(iii)(III).

(d) In calculating the unrelated business taxable income of a VEBA, SUB, or GLSO for a taxable year of such organization, the total income of the VEBA, SUB, or GLSO for the taxable year is reduced by the income attributable to *existing reserves* within the transition rule before such income is compared to the excess of the total amount set aside as of the close of the taxable year over the qualified asset account limit for the taxable year. Thus, for example, assume that the total income of a VEBA for a taxable year is $1,000, and that the excess of the total amount of the VEBA set aside as of the close of the taxable year over the applicable qualified asset account limit is $600. Assume also that of the $1,000 of total income, $500 is attributable to *existing reserves* within the transition rule of section 512(a)(3)(E)(iii)(I). The unrelated business income of this VEBA for the taxable year is equal to the lesser of the following two amounts: (1) the total income of the VEBA for the taxable year ($1,000), reduced to the extent that such income is attributable to *existing reserves* within the transition rule ($500); or (2) the excess of the total amount set aside as of the close of the taxable year over the applicable qualified asset account limit ($600). Thus, the unrelated business income of this VEBA for the taxable year is $500.

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§ 1.512(b)–1 Modifications.

Whether a particular item of income falls within any of the modifications provided in section 512(b) shall be determined by all the facts and circumstances of each case. For example, if a payment termed *rent* by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or joint venturer, such payment is not within the modification for rents. The modifications provided in section 512(b) are as follows:

(a) *Certain Investment Income*—(1) *In general.* Dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), annuities, income from notional principal contracts (as defined in Treasury Regulations 26 CFR 1.863–7 or regulations issued under section 446), other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner, and all deductions directly connected with any of the foregoing items of income shall be excluded in computing unrelated business taxable income.

(2) *Limitations.* The exclusions under paragraph (a)(1) of this section do not apply to income derived from and deductions in connection with debt-financed property (as defined in section 514(b)). Moreover, the exclusions under paragraph (a)(1) of this section do not apply to gains or losses from the sale, exchange, or other disposition of any property, or to gains or losses from the lapse or termination of options to buy or sell securities. For rules regarding the treatment of these gains and losses, see section 512(b)(5) and §1.512(b)–1(d). Furthermore, the exclusions under paragraph (a)(1) of this section do not apply to interest and annuities derived from and deductions in connection with controlled organizations. For rules regarding the treatment of such amounts, see section 512(b)(13) and §1.512(b)–1(l). Finally, the exclusions under paragraph (a)(1) of this section of income from notional principal contracts and income that the Commissioner determines to be substantially similar income from ordinary and routine investments do not apply to income earned by brokers or dealers (including organizations that make a market in derivative financial products, as described in Treasury Regulations 26 CFR 1.954–2T(a)(4)(iii)(B)).

(3) *Effective dates.* The effective dates of the rules of paragraphs (a)(1) and (a)(2) of this section that were in effect prior to August 30, 1991, remain the same. The exclusion under paragraph (a)(1) of this section of income from notional principal contracts is effective for amounts received after August 30, 1991. However, an organization may apply the exclusion under paragraph (a)(1) of this section of income from notional principal contracts prior to that date, provided that such amounts are treated consistently for all open taxable years. Unless otherwise provided by the Commissioner, the exclusion under paragraph (a)(1) of this section of income that the Commissioner determines to be substantially similar income from ordinary and routine investments is effective for amounts received after the date of the Commissioner's determination.

(b) *Royalties.* Royalties, including overriding royalties, and all deductions directly connected with such income shall be excluded in computing unrelated business taxable income. However, for taxable years beginning after December 31, 1969, certain royalties from and certain deductions in connection with either, debt-financed property (as defined in section 514(b)) or controlled organizations (as defined in paragraph (l) of this section) shall be included in computing unrelated business taxable income. Mineral royalties shall be excluded whether measured by production or by gross or taxable income from the mineral property. However, where an organization owns a working interest in a mineral property, and is not relieved of its share of the development costs by the terms of any agreement with an operator, income received from such an interest shall not be excluded. To the extent not treated as a loan under section 636, payments in discharge of mineral production payments shall be treated in the same manner as royalty payments for the purpose of computing unrelated business taxable income. To the extent treated as a loan under section 636, the amount of any payment in discharge of a production payment which is the equivalent of interest shall be treated as interest for purposes of section 512(b)(1) and paragraph (a) of this section.

(c) *Rents*—(1) *Taxable years beginning before January 1, 1970.* For taxable years beginning before January 1, 1970, rents from real property (including personal property leased with the real property) and the deductions directly connected therewith shall be excluded in computing unrelated business taxable income, except that certain rents from, and certain deductions in connection with, a business lease (as defined in section 514(f)) shall be included in computing unrelated business taxable income. See subparagraph (5) of this paragraph for rules governing amounts received for the rendering of services.

(2) *Taxable years beginning after December 31, 1969*—(i) *In general.* For taxable years beginning after December 31, 1969, except as provided in subdivision

(iii) of this subparagraph, rents from property described in subdivision (ii) of this subparagraph, and the deductions directly connected therewith, shall be excluded in computing unrelated business taxable income. However, notwithstanding subdivision (ii) of this subparagraph, certain rents from and certain deductions in connection with either debt-financed property (as defined in section 514(b)) or property rented to controlled organizations (as defined in paragraph (l) of this section) shall be included in computing unrelated business taxable income.

(ii) *Excluded rents.* The rents which are excluded from unrelated business income under section 512(b)(3)(A) and this paragraph are:

(a) Real property. All rents from real property; and

(b) Personal property. All rents from personal property leased with real property if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time sonal property are an incidental amount service by the lessee.

For purposes of the preceding sentence, rents attributable to personal property generally are not an incidental amount of the total rents if such rents exceed 10 percent of the total rents from all the property leased. For example, if the rents attributable to the personal property leased are determined to be $3,000 per year, and the total rents from all property leased are $10,000 per year, then such $3,000 amount is not to be excluded from the computation of unrelated business taxable income by operation of section 512(b)(3)(A)(ii) and this paragraph, since such amount is not an incidental portion of the total rents.

(iii) *Exception.* Subdivision (ii) of this subparagraph shall not apply, if either:

(a) Excess personal property rents. More than 50 percent of the total rents are attributable to personal property, determined at the time such personal property is first placed in service by the lessee; or

(b) Net profits. The determination of the amount of such rents depends in whole or in part on the income or profits derived by any person from the property leased, other than an amount based on a fixed percentage or percentages of the gross receipts or sales. For purposes of the preceding sentence, the rules contained in paragraph (b) (3) and (6) (other than paragraph (b)(6)(ii)) of §1.856–4 shall apply.

(iv) *Illustration.* This subparagraph may be illustrated by the following example:

Example. A, an exempt organization, owns a printing factory which consists of a building housing two printing presses and other equipment necessary for printing. On January 1, 1971, A rents the building and the printing equipment to B for $10,000 a year. The lease states that $9,000 of such rent is for the building and $1,000 for the printing equipment. However, it is determined that notwithstanding the terms of the lease $4,000, or 40 percent ($4,000/$10,000), of the rent is actually attributable to the printing equipment. During 1971, A has $3,000 of deductions, all of which are properly allocable to the land and building. Under these circumstances, A shall not take into account in computing its unrelated business taxable income the $6,000 of rent attributable to the building and the $3,000 of deductions directly connected with such rent. However, the $4,000 of rent attributable to the printing equipment is not excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3)(A)(ii) or this paragraph since such rent represents more than an incidental portion of the total rents.

(3) *Definitions and special rules.* For purposes of subparagraph (2) of this paragraph:

(i) *Real property defined.* The term *real property* means all real property, including any property described in sections 1245(a)(3)(C) and 1250(c) and the regulations thereunder.

(ii) *Personal property defined.* The term *personal property* means all personal property, including any property described in section 1245(a)(3)(B) and the regulations thereunder.

(iii) *Multiple leases.* If separate leases are entered into with respect to real and personal property, and such properties have an integrated use (e.g., one or more leases for real property and another lease or leases for personal property to be used upon such real property), all such leases shall be considered as one lease.

(iv) *Placed in service.* Property is *placed in service* by the lessee when it is first subject to his use in accordance with the terms of the lease. For example, property subject to a lease entered into on November 1, 1971, for a term commencing on January 1, 1972, shall be considered as placed in service on January 1, 1972, regardless of when the property is first actually used by the lessee.

(v) *Changes in rent charged or personal property rented.* If:

(a) By reason of the placing of additional or substitute personal property in service, there is an increase of 100 percent or more in the rent attributable to all the personal property leased, or

(b) There is a modification of the lease by which there is a change in the rent charged (whether or not there is a change in the amount of personal property rented), the rent attributable to personal property shall be recomputed to determine whether the exclusion under subparagraph (2)(ii)*(b)* of this paragraph or the exception under subparagraph (2)(iii)*(a)* of this paragraph applies. Any change in the treatment of rents, attributable to a recomputation under this subdivision, shall be effective only with respect to rents for the period beginning with the event which occasioned the recomputation.

(4) *Examples.* Subparagraphs (2) and (3) of this paragraph may be illustrated by the following examples:

Example 1. On January 1, 1971, A, an exempt organization, executes two leases with B. One is for the rental of a computer, with a stated annual rent of $750. The other is for the rental of office space in which to use the computer, at a stated annual rent of $7,250. The total annual rent under both leases for 1971 is $8,000. At the time the computer is first placed in service, however, taking both leases into consideration, it is determined that notwithstanding the terms of the leases $3,000, or 37.5 percent ($3,000/$8,000), of the rent is actually attributable to the computer. Therefore, for 1971, only the $5,000 ($8,000−$3,000) attributable to the rental of the office space is excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3).

Example 2. Assume the facts as stated in example 1. Assume further that the leases to which the computer and office space are subject in example 1 provide that the rent may be increased or decreased, depending upon the prevailing rental value for similar computers and office space. On January 1, 1972, the total annual rent is increased in the computer lease to $2,000, and in the office space lease to $9,000. For 1972, it is determined that notwithstanding the terms of the leases $6,000, or 54.5 percent ($6,000/$11,000), of the total rent is actually attributable to the computer as of that time. Even though the rent attributable to personal property now exceeds 50 percent of the total rent, the rent attributable to real property will continue to be excluded, since there was no modification of the terms of the leases and since the increase in the rent was not attributable to the placing of new personal property in service. See subparagraph (3)(v) of this paragraph. Thus, for 1972 the $5,000 of rent attributable to the office space continues to be excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3).

Example 3. Assume the facts as stated in example 1, except that on January 1, 1973, B rents a second computer from A, which is placed in service on that date. The total rent is increased to $2,000 for the computer lease and to $10,000 for the office space lease. It is determined at the time the second computer is first placed in service that notwithstanding the terms of the leases $7,000 of the rent is actually attributable to the computers. Since the rent attributable to personal property has increased by more than 100 percent ($4,000/$3,000=133 percent), a redetermination must be made pursuant to subparagraph (3)(v) *(a)* of this paragraph. As a result, 58.3 percent ($7,000/$12,000) of the total rent is determined to be attributable to personal property. Accordingly, since more than 50 percent of the total rent A receives is attributable to the personal property leased, none of the rents are excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3).

Example 4. Assume the facts as stated in example 3, except that on June 30, 1975, the lease between B and A is modified. The total rent for the computer lease is reduced to $1,500 and the total rent for the office space lease is reduced to $7,500. Pursuant to subdivision (3)(v)*(b)* of this paragraph, a redetermination is made as of June 30, 1975. As of the modification date, it is determined that notwithstanding the terms of the leases, the rent actually attributable to the computers is $4,000, or 44.4 percent ($4,000/$9,000), of the total rent. Since less than 50 percent of the total rent is now attributable to personal property, the rent attributable to real property ($5,000), for periods after June 30, 1975, is excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3). However, the rent attributable to personal property ($4,000) is not excluded from unrelated business taxable income for such periods by operation of section 512(b)(3), since it represents more than an incidental portion of the total rent.

(5) *Rendering of services.* For purposes of this paragraph, payments for the use or occupancy of rooms and other space

where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts, or motels, or for the use of occupancy of space in parking lots, warehouses, or storage garages, does not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exists, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in any office building, etc., are generally treated as rent from real property.

(d)(1) *Gains and losses from the sale, etc. of property.* There shall also be excluded from the computation of unrelated business taxable income gains or losses from the sale, exchange, or other disposition of property other than (i) stock in trade or other property of a kind which would properly be included in the inventory of the organization if on hand at the close of the taxable year, or (ii) property held primarily for sale to customers in the ordinary course of the trade or business. This exclusion does not apply with respect to the cutting of timber which is considered, upon the application of section 631(a), as a sale or exchange of such timber. In addition, for taxable years beginning after December 31, 1969, this exclusion does not apply to the gain derived from the sale or other disposition of debt-financed property (as defined in section 514(b)). Otherwise, the exclusion under section 512(b)(5) applies with respect to gains and losses from involuntary conversions, casualties, etc.

(2) There shall be excluded from the computation of unrelated business taxable income any gain from the lapse or termination after December 31, 1975, of options to buy or sell securities (as that term is defined in section 1236(c)). An option is considered terminated when the organization's obligation under the option ceases by any means other than by reason of the exercise or lapse of such option. If the exclusion is otherwise available it will apply whether or not the organization owns the securities upon which the option is written, that is, whether or not the option is *covered.* However, income from the lapse or termination of an option is excludable only if the option is written in connection with the organization's investment activities. Thus, for example, if the securities upon which the options are written are held by the organization as inventory or for sale to customers in the ordinary course of a trade or business, the income from the lapse or termination will not be excludable under the provisions of this paragraph. Similarly, if an organization is engaged in the trade or business of writing options (whether or not such options are covered) the exclusion will not be available.

(e) *Net operating losses.* (1) The net operating loss deduction provided in section 172 shall be allowed in computing unrelated business taxable income. However, the net operating loss carryback or carryover (from a taxable year for which the taxpayer is subject to the provisions of section 511) shall be determined under section 172 without taking into account any amount of income or deduction which is not included under section 511 in computing unrelated business taxable income. For example, a loss attributable to an unrelated trade or business shall not be diminished by reason of the receipt of dividend income.

(2) For the purpose of computing the net operating loss deduction provided by section 172, any prior taxable year for which an organization was not subject to the provisions of section 511, or a corresponding provision of prior law, shall not be taken into account. Thus, if the organization was not subject to the provisions of section 511 or Supplement U of the Internal Revenue Code of 1939 for a preceding taxable year, the net operating loss is not a carryback to such preceding taxable year, and the

net operating loss carryover to succeeding taxable years is not reduced by the taxable income for such preceding taxable year.

(3) A net operating loss carryback or carryover shall be allowed only from a taxable year for which the taxpayer is subject to the provisions of section 511, or a corresponding provision of prior law.

(4) In determining the span of years for which a net operating loss may be carried for purposes of section 172, taxable years in which an organization was not subject to the provisions of section 511 or a corresponding provision of prior law shall be taken into account. Thus, for example, if an organization is subject to the provisions of section 511 for the taxable year 1955 and has a net operating loss for that year, the last taxable year to which any part thereof may be carried over is the year 1960 regardless of whether the organization is subject to the provisions of section 511 in any of the intervening taxable years.

(f) *Research.* (1) Income derived from research for the United States or any of its agencies or instrumentalities or a State or political subdivision thereof, and all deductions directly connected with such income, shall be excluded in computing unrelated business taxable income.

(2) In the case of a college, university, or hospital, all income derived from research performed for any person and all deductions directly connected with such income, shall be excluded in computing unrelated business taxable income.

(3) In the case of an organization operated primarily for the purpose of carrying on fundamental research (as distinguished from applied research) the results of which are freely available to the general public, all income derived from research performed for any person and all deductions directly connected with such income shall be excluded in computing unrelated business taxable income.

(4) For the purpose of §§1.512(a)–1, 1.512(a)–2, and this section, the term *research* does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc. The term *fundamental research* does not include research carried on for the primary purpose of commercial or industrial application.

(g) *Charitable, etc., contributions.* (1) In computing the unrelated business taxable income of an organization described in section 511(a)(2) the deduction from gross income allowed by section 170 (relating to charitable contributions and gifts) shall be allowed, whether or not the contribution is directly connected with the carrying on of the trade or business. Section 512(b)(10) provides that this deduction shall not exceed 5 percent of the organization’s unrelated business taxable income computed without regard to that deduction. The provisions of section 170(b)(2) are not applicable to contributions by the organizations described in section 511(a)(2).

(2) In computing the unrelated business taxable income of a trust described in section 511(b)(2), the deduction allowed by section 170 (relating to charitable contributions and gifts) shall be allowed whether or not the contribution is directly connected with the carrying on of the trade or business. The deduction is limited as provided in section 170(b)(1) (A) and (B), except that the amounts so allowed are determined on the basis of unrelated business taxable income computed without regard to this deduction (rather than on the basis of adjusted gross income). For purposes of this deduction, a distribution by a trust described in section 511(b)(2) made pursuant to the trust instrument to a beneficiary described in section 170 shall be treated in the same manner as gifts or contributions.

(3) The contribution, whether made by a trust or other exempt organization, must be paid to another organization to be allowable. For example, a university described in section 501(c)(3) which is exempt from tax and which operates an unrelated business, shall be allowed a deduction, not in excess of 5 percent of its unrelated business taxable income, for gifts or contributions to another university described in section 501(c)(3) for educational work but

shall not be allowed any deduction for amounts expended in administering its own educational program.

(h) *Specific deduction*—(1) *In general.* In computing unrelated business taxable income a specific deduction from gross income of $1,000 is allowed. However, for taxable years beginning after December 31, 1969, such specific deduction is not allowed in computing the net operating loss under section 172 and paragraph (6) of section 512(b).

(2) *Special rule for a diocese, province of a religious order, or a convention or association of churches.* (i) In the case of a diocese, province of a religious order, or a convention or association of churches, there shall be allowed with respect to each parish, individual church, district, or other local unit a specific deduction equal to the lower of $1,000 or the gross income derived from an unrelated trade or business regularly conducted by such local unit. However, a diocese, province of a religious order, or a convention or association of churches shall not be entitled to a specific deduction for a local unit which, for a taxable year, files a separate return. In the case of a local unit which, for a taxable year, files a separate return, such local unit may claim a specific deduction equal to the lower of $1,000 or the gross income derived from any unrelated trade or business which it regularly conducts.

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

Example. X is an association of churches on the calendar year basis. X is divided into local units A, B, C, and D. During 1973, A, B, C, and D derive gross income of, respectively, $1,200, $800, $1,500, and $700 from unrelated businesses which they regularly conduct. Furthermore, for such taxable year, D files a separate return. X may claim a specific deduction of $1,000 with respect to A, $800 with respect to B, and $1,000 with respect to C. X may not claim a specific deduction with respect to D. D, however, may claim a specific deduction of $700 on its return.

(i) *Transitional period for churches.* (1)(i) In the case of an unrelated trade or business (as defined in section 513) carried on before May 27, 1969, by a church or convention or association of churches (as defined in § 1.511–2(a)(3)(ii)), or by the predecessor of a church or convention or association of churches which predecessor was itself a church or convention or association of churches, all gross income derived from such unrelated trade or business and all deductions directly connected with the carrying on of such unrelated trade or business shall be excluded from the determination of unrelated business taxable income under section 512(a) for all taxable years beginning before January 1, 1976. Notwithstanding the preceding sentence, in the case of income from debt-financed property (and the deductions attributable thereto), as defined in section 514, of a church or convention or association of churches or by the predecessor of a church or convention or association of churches, the provisions of paragraphs (a) through (e) of section 514 and paragraph (4) of section 512(b) shall apply for taxable years beginning after December 31, 1969.

(ii) The provisions of subdivision (i) may be illustrated by the following example:

Example. X, a church as defined in § 1.511–2(a)(3)(ii), realizes gross income from an unrelated business (as defined in section 513) of $100,000 for calendar year 1972. X's predecessor church, Y, began conducting such unrelated business in January 1, 1968. Of the $100,000 realized for calendar year 1972, $40,000 is attributable to debt-financed property (as defined in section 514). Since the unrelated business was conducted by Y prior to May 27, 1969, and since X's taxable year begins before January 1, 1976, that amount of the income realized from such business (and all deductions directly connected therewith) which is not attributable to debt-financed property shall be excluded from the determination of unrelated business taxable income under section 512(a). Therefore, of the $100,000 realized, $60,000 ($100,000 less $40,000 attributable to debt-financed property), and all deductions directly connected therewith shall be excluded from the determination of such unrelated business taxable income for purposes of imposition of the tax under section 511(a). The remaining $40,000 and the deductions attributable thereto shall be subject to the provisions of paragraphs (a) through (e) of section 514 and paragraph (4) of section 512(b).

(2) This paragraph shall not apply in the case of income from property, or deductions directly connected with such income, if title to the property is

held by a corporation described in section 501(c)(2) for a church or convention or association of churches. Thus, if such income is derived from an unrelated trade or business, the corporation shall be liable for tax imposed by section 511(a) on such income.

(j) *Special rule for certain unrelated trades or businesses carried on by a religious order or by an educational institution maintained by such order.* (1) Except as provided in subparagraph (2) of this paragraph, gross income realized by a religious order (or an educational organization described in section 170(b)(1)(A)(ii) maintained by such order) from an unrelated trade or business, together with all deductions directly connected therewith, shall be excluded from the determination of unrelated business taxable income under section 512(a), if:

(i) The trade or business has been operated by such order or by such institution since before May 27, 1959,

(ii) The trade or business consists of providing services under a license issued by a Federal regulatory agency,

(iii) More than 90 percent of the net income from the business is, for each taxable year for which gross income from such business is so excluded by reason of section 512(b)(15) and this paragraph, devoted to religious, charitable, or educational purposes, and

(iv) It is established to the satisfaction of an officer no lower than the Regional Commissioner that the rates or other charges for such services are fully competitive with rates or other charges charged for such services by persons not exempt from taxation. Rates or other charges for such services shall be considered as fully competitive with rates or other charges charged for such services by persons not exempt from taxation if the rates charged by such unrelated trade or business are neither materially higher nor materially lower than the rates charged by similar businesses operating in the same general area.

(2) The provisions of this paragraph shall not apply with respect to income from debt-financed property (as defined in section 514) and the deductions attributable thereto. For taxable years beginning after December 31, 1969, such income and deductions are subject to the provisions of paragraphs (a) through (e) of section 514 and paragraph (4) of section 512(b).

(k) *Income and deductions from debt-financed property.* For taxable years beginning after December 31, 1969, in the case of debt-financed property (as defined in section 514(b)), there shall be included in the unrelated business taxable income of an exempt organization, as an item of gross income derived from an unrelated trade or business, the amount of unrelated debt-financed income determined under section 514(a)(1) and §1.514(a)–1(a), and there shall be allowed, as a deduction with respect to such income, the amount determined under section 514(a)(2) and §1.514(a)–1(b).

(l) *Interest, annuities, royalties, and rents from controlled organizations*—(1) *In general.* For taxable years beginning after December 31, 1969, if an exempt organization (hereinafter referred to as the *controlling organization*) has control (as defined in subparagraph (4) of this paragraph) of another organization (hereinafter referred to as the *controlled organization*), the controlling organization shall include as an item of gross income in computing its unrelated business taxable income, the amount of interest, annuities, royalties, and rents derived from the controlled organization determined under subparagraph (2) or (3) of this paragraph. The preceding sentence shall apply whether or not the activity conducted by the controlling organization to derive such amounts represents a trade or business or is regularly carried on. Thus, amounts received by a controlling organization from the rental of its real property to a controlled organization may be included in the unrelated business taxable income of the controlling organization, even though the rental of such property is not an activity regularly carried on by the controlling organization.

(2) *Exempt controlled organization*—(i) *In general.* If the controlled organization is exempt from taxation under section 501(a), the amount referred to in subparagraph (1) of this paragraph is an amount which bears the same ratio to the interest, annuities, royalties, and rents received by the controlling

organization from the controlled organization as the unrelated business taxable income of the controlled organization bears to whichever of the following amounts is the greater:

(a) The taxable income of the controlled organization, computed as though the controlled organization were not exempt from taxation under section 501(a), or

(b) The unrelated business taxable income of the controlled organization,

both determined without regard to any amounts paid directly or indirectly to the controlling organization. The controlling organization shall be allowed all deductions directly connected with amounts included in gross income under the preceding sentence.

(ii) *Examples.* This subparagraph may be illustrated by the following examples:

Example 1. A, an exempt scientific organization described in section 501(c)(3), owns all the stock of B, another exempt scientific organization described in section 501(c)(3). During 1971, A rents space for a laboratory to B for $15,000 a year. A's total deductions for 1971 with respect to the leased property are $3,000: $1,000 for maintenance and $2,000 for depreciation. If B were not an exempt organization, its total taxable income would be $300,000, disregarding rent paid to A. B's unrelated business taxable income, disregarding rent paid to A, is $100,000. Under these circumstances, $4,000 of the rent paid by B will be included by A as net rental income in determining its unrelated business taxable income, computed as follows:

B's unrelated business taxable income (disregarding rent paid to A)	$100,000
B's taxable income (computed as though B were not exempt and disregarding rent paid to A)	300,000
Ratio ($100,000/$300,000)	⅓
Total rent	15,000
Total deductions	3,000
Rental income treated as gross income from an unrelated trade or business (⅓ of $15,000)	5,000
Less deductions directly connected with such income (⅓ of $3,000)	1,000
Net rental income included by A in computing its unrelated business taxable income	$4,000

Example 2. Assume the facts as stated in example 1, except that B's taxable income is $90,000 (computed as though B were not an exempt organization, and disregarding rents paid to A). B's unrelated business taxable income ($100,000) is therefore greater than its taxable income ($90,000). Thus, the ratio used to determine the portion of rent received by A which is to be taken into account is one since both the numerator and denominator of such ratio is B's unrelated business taxable income. Consequently, all the rent received by A from B ($15,000), and all the deductions directly connected therewith ($3,000), are included by A in computing its unrelated business taxable income.

(3) *Nonexempt controlled organization*—(i) *In general.* If the controlled organization is not exempt from taxation under section 501(a), the amount referred to in subparagraph (1) of this paragraph is an amount which bears the same ratio to the interest, annuities, royalties, and rents received by the controlling organization from the controlled organization as the *excess taxable income* (as defined in subdivision (ii) of this subparagraph) of the controlled organization bears to whichever of the following amounts is the greater:

(a) The taxable income of the controlled organization, or

(b) The excess taxable income of the controlled organization,

both determined without regard to any amount paid directly or indirectly to the controlling organization. The controlling organization shall be allowed all deductions which are directly connected with amounts included in gross income under the preceding sentence.

(ii) *Excess taxable income.* For purposes of this paragraph, the term *excess taxable income* means the excess of the controlled organization's taxable income over the amount of such taxable income which, if derived directly by the controlling organization, would not be unrelated business taxable income.

(iii) *Examples.* This subparagraph may be illustrated by the following examples:

Example 1. A, an exempt university described in section 501(c)(3), owns all the stock of M, a nonexempt organization. During 1971, M leases a factory and a dormitory from A for a total annual rent of $100,000. During the taxable year, M has $500,000 of taxable income, disregarding the rent paid to A: $150,000 from a dormitory for students of A university, and $350,000 from the operation of a factory which is a business unrelated to A's exempt purpose. A's deductions for 1971 with respect to the leased property are $4,000 for the dormitory and $16,000 for the factory. Under these circumstances, $56,000 of the rent paid by M will be included by A as net rental income in determining its unrelated business taxable income, computed as follows:

M’s taxable income (disregarding rent paid to A)	$500,000
Less taxable income from dormitory	150,000
Excess taxable income	$350,000
Ratio ($350,000/$500,000)	7⁄10
Total rent paid to A	$100,000
Total deductions ($4,000+$16,000)	20,000
Rental income treated as gross income from an unrelated trade or business (7⁄10 of $100,000)	70,000
Less deductions directly connected with such income (7⁄10 of $20,000)	14,000
Net rental income included by A in computing its unrelated business taxable income	$56,000

Example 2. Assume the facts as stated in example 1, except that M’s taxable income (disregarding rent paid to A) is $300,000, consisting of $350,000 from the operation of the factory and a $50,000 loss from the operation of the dormitory. Thus, M’s *excess taxable income* is also $300,000, since none of M’s taxable income would be excluded from the computation of A’s unrelated business taxable income if received directly by A. The ratio of M’s *excess taxable income* to its taxable income is therefore one ($300,000/ $300,000). Thus, all the rent received by A from M ($100,000), and all the deductions directly connected therewith ($20,000), are included in the computation of A’s unrelated business taxable income.

(4) *Control*—(i) *In general.* For purposes of this paragraph—

(a) Stock corporation. In the case of an organization which is a stock corporation, the term *control* means ownership by an exempt organization of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation.

(b) Nonstock organization. In the case of a nonstock organization, the term *control* means that at least 80 percent of the directors or trustees of such organization are either representatives of or directly or indirectly controlled by an exempt organization. A trustee or director is a representative of an exempt organization if he is a trustee, director, agent, or employee of such exempt organization. A trustee or director is controlled by an exempt organization if such organization has the power to remove such trustee or director and designate a new trustee or director.

(ii) *Gain or loss of control.* If control of an organization (as defined in subdivision (i) of this subparagraph) is acquired or relinquished during the taxable year, only the interest, annuities, royalties, and rents paid or accrued to the controlling organization in accordance with its method of accounting for that portion of the taxable year it has control shall be subject to the tax on unrelated business income.

(5) *Amounts taxable under other provisions of the Code*—(i) *In general.* Except as provided in subdivision (ii) of this subparagraph, section 512(b)(13) and this paragraph do not apply to amounts which are included in the computation of unrelated business taxable income by operation of any other provision of the Code. However, amounts which are not included in unrelated business taxable income by operation of section 512(a)(1), or which are excluded by operation of section 512(b) (1), (2), or (3), may be included in unrelated business taxable income by operation of section 512(b)(13) and this paragraph.

(ii) *Debt-financed property.* Rents derived from the lease of debt-financed property by a controlling organization to a controlled organization are subject to the rules contained in section 512(b)(13) and this paragraph. Thus, if a controlling organization leases debt-financed property to a controlled organization, the amount of rents includible in the controlling organization’s unrelated business taxable income shall first be determined under section 512(b)(13) and this paragraph, and only the portion of such rents not taken into account by operation of section 512(b)(13) are taken into account by operation of section 514. See example 3 of §1.514(b)–1(b)(3).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6939, 32 FR 17661, Dec. 12, 1967; T.D. 7177, 37 FR 7089, Apr. 8, 1972; T.D. 7183, 37 FR 7885, Apr. 21, 1972; T.D. 7261, 38 FR 5466, Mar. 1, 1973; 38 FR 6387, Mar. 9, 1973; T.D. 7632, 44 FR 42681, July 20, 1979; T.D. 7767, 46 FR 11265, Feb. 6, 1981; T.D. 8423, 57 FR 33443, July 29, 1992; 57 FR 42490, Sept. 15, 1992]

§1.512(c)–1 Special rules applicable to partnerships; in general.

In the event an organization to which section 511 applies is a member of a partnership regularly engaged in a trade or business which is an unrelated trade or business with respect to such organization, the organization shall include in computing its unrelated business taxable income so much of its share (whether or not distributed) of the partnership gross income as is derived from that unrelated business and its share of the deductions attributable thereto. For this purpose, both the gross income and the deductions shall be computed with the necessary adjustments for the exceptions, additions, and limitations referred to in section 512(b) and in § 1.512(b)–1. For example, if an exempt educational institution is a partner in a partnership which operates a factory and if such partnership also holds stock in a corporation, the exempt organization shall include in computing its unrelated business taxable income its share of the gross income from the operation of the factory, but not its share of any dividends received by the partnership from the corporation. If the taxable year of the organization differs from that of the partnership, the amounts included or deducted in computing unrelated business taxable income shall be based upon the income and deductions of the partnership for each taxable year of the partnership ending within or with the taxable year of the organization.

§ 1.513–1 Definition of unrelated trade or business.

(a) *In general.* As used in section 512 the term *unrelated business taxable income* means the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions and subject to the modifications provided in section 512. Section 513 specifies with certain exceptions that the phrase *unrelated trade or business* means, in the case of an organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)). (For certain exceptions from this definition, see paragraph (e) of this section. For a special definition of *unrelated trade or business* applicable to certain trusts, see section 513(b).) Therefore, unless one of the specific exceptions of section 512 or 513 is applicable, gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if: (1) It is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

(b) *Trade or business.* The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. On the other hand, where an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low-cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in competition with taxable organizations. However, in general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute *trade or business* within the meaning of section 162—and which, in addition, is not substantially related to the performance of exempt functions— presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 the term *trade or business* has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. Thus, the term *trade or business* in section 513 is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Thus, for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes or in compliance with the terms of section 513(a)(2). Similarly, activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization. However, where an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

(c) *Regularly carried on*—(1) *General principles.* In determining whether trade or business from which a particular amount of gross income derives is *regularly carried on,* within the meaning of section 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. This requirement must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete. Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be *regularly carried on* if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.

(2) *Application of principles in certain cases*—(i) *Normal time span of activities.* Where income producing activities are of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business. For example, the operation of a sandwich stand by a hospital auxiliary for only 2 weeks at a state fair would not be the regular conduct of trade or business. However, the conduct of year-round business activities for one day each week would constitute the regular carrying on of trade or business. Thus, the operation of a commercial parking lot on Saturday of each week would be the regular conduct of trade or business. Where income producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business. For example, the operation of a track for horse racing for several weeks of a year would be considered the regular conduct of trade or business because it is usual to carry on such trade or business only during a particular season.

(ii) *Intermittent activities; in general.* In determining whether or not intermittently conducted activities are regularly carried on, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by nonexempt organizations. In general, exempt organization business activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors. For example, the publication of advertising in programs for sports events or music or drama performances will not ordinarily be deemed to be the regular carrying on of business. Similarly, where an organization sells certain types of goods or services to a particular class of persons in pursuance of its exempt functions or *primarily for the convenience* of such persons within the meaning of section 513(a)(2) (as, for example, the sale of books by a college bookstore to students or the sale of pharmaceutical supplies by a hospital pharmacy to patients of the hospital), casual sales in the course of such activity which do not qualify as related to the exempt function involved or as described in section 513(a)(2) will not be treated as regular. On the other hand, where the nonqualifying sales are not merely casual, but are systematically and consistently promoted and carried on by the organization, they meet the section 512 requirement of regularity.

(iii) *Intermittent activities; special rule in certain cases of infrequent conduct.* Certain intermittent income producing activities occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as trade or business regularly carried on. For example, income producing or fund raising activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they recur only occasionally or sporadically. Furthermore, such activities will not be regarded as regularly carried on merely because they are conducted on an annually recurrent basis. Accordingly, income derived from the conduct of an annual dance or similar fund raising event for charity would not be income from trade or business regularly carried on.

(d) *Substantially related*—(1) *In general.* Gross income derives from *unrelated trade or business,* within the meaning of section 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question—the activities, that is, of producing or distributing the goods or performing the services involved—and the accomplishment of the organization's exempt purposes.

(2) *Type of relationship required.* Trade or business is *related* to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is *substantially related,* for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

(3) *Size and extent of activities.* In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Thus, where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business. Such income is not derived from the production or distribution of goods or the performance of services which contribute importantly to the accomplishment of any exempt purpose of the organization.

(4) *Application of principles*—(i) *Income from performance of exempt functions.* Gross income derived from charges for

the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business. The following examples illustrate the application of this principle:

Example 1. M, an organization described in section 501(c)(3), operates a school for training children in the performing arts, such as acting, singing, and dancing. It presents performances by its students and derives gross income from admission charges for the performances. The students' participation in performances before audiences is an essential part of their training. Since the income realized from the performances derives from activities which contribute importantly to the accomplishment of M's exempt purposes, it does not constitute gross income from unrelated trade or business. (For specific exclusion applicable in certain cases of contributed services, see section 513(a)(1) and paragraph (e)(1) of this section.)

Example 2. N is a trade union qualified for exemption under section 501(c)(5). To improve the trade skills of its members, N conducts refresher training courses and supplies handbooks and technical manuals. N receives payments from its members for these services and materials. However, the development and improvement of the skills of its members is one of the purposes for which exemption is granted N; and the activities described contribute importantly to that purpose. Therefore, the income derived from these activities does not constitute gross income from unrelated trade or business.

Example 3. O is an industry trade association qualified for exemption under section 501(c)(6). It presents a trade show in which members of its industry join in an exhibition of industry products. O derives income from charges made to exhibitors for exhibit space and admission fees charged patrons or viewers of the show. The show is not a sales facility for individual exhibitors; its purpose is the promotion and stimulation of interest in, and demand for, the industry's products in general, and it is conducted in a manner reasonably calculated to achieve that purpose. The stimulation of demand for the industry's products in general is one of the purposes for which exemption is granted O. Consequently, the activities productive of O's gross income from the show—that is, the promotion, organization and conduct of the exhibition—contribute importantly to the achievement of an exempt purpose, and the income does not constitute gross income from unrelated trade or business. See also section 513(d) and regulations thereunder regarding sales activity.

(ii) *Disposition of product of exempt functions.* Ordinarily, gross income from the sale of products which result from the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business if the product is sold in substantially the same state it is in on completion of the exempt functions. Thus, in the case of an organization described in section 501(c)(3) and engaged in a program of rehabilitation of handicapped persons, income from sale of articles made by such persons as a part of their rehabilitation training would not be gross income from conduct of unrelated trade or business. The income in such case would be from sale of products, the production of which contributed importantly to the accomplishment of purposes for which exemption is granted the organization—namely, rehabilitation of the handicapped. On the other hand, if a product resulting from an exempt function is utilized or exploited in further business endeavor beyond that reasonably appropriate or necessary for disposition in the state it is in upon completion of exempt functions, the gross income derived therefrom would be from conduct of unrelated trade or business. Thus, in the case of an experimental dairy herd maintained for scientific purposes by a research organization described in section 501(c)(3), income from sale of milk and cream produced in the ordinary course of operation of the project would not be gross income from conduct of unrelated trade or business. On the other hand, if the organization were to utilize the milk and cream in the further manufacture of food items such as ice cream, pastries, etc., the gross income from the sale of such products would be from the conduct of unrelated trade or business unless the manufacturing activities themselves contribute importantly to the accomplishment of an exempt purpose of the organization.

(iii) *Dual use of assets or facilities.* In certain cases, an asset or facility necessary to the conduct of exempt functions may also be employed in a commercial endeavor. In such cases, the mere fact of the use of the asset or facility in exempt functions does not, by itself, make the income from the commercial endeavor gross income from related trade or business. The test, instead, is whether the activities productive of the income in question contribute importantly to the accomplishment of exempt purposes. Assume, for example, that a museum exempt under section 501(c)(3) has a theater auditorium which is specially designed and equipped for showing of educational films in connection with its program of public education in the arts and sciences. The theater is a principal feature of the museum and is in continuous operation during the hours the museum is open to the public. If the organization were to operate the theater as an ordinary motion picture theater for public entertainment during the evening hours when the museum was closed, gross income from such operation would be gross income from conduct of unrelated trade or business.

(iv) *Exploitation of exempt functions.* In certain cases, activities carried on by an organization in the performance of exempt functions may generate good will or other intangibles which are capable of being exploited in commercial endeavors. Where an organization exploits such an intangible in commercial activities, the mere fact that the resultant income depends in part upon an exempt function of the organization does not make it gross income from related trade or business. In such cases, unless the commercial activities themselves contribute importantly to the accomplishment of an exempt purpose, the income which they produce is gross income from the conduct of unrelated trade or business. The application of this subdivision is illustrated in the following examples:

Example 1. U, an exempt scientific organization, enjoys an excellent reputation in the field of biological research. It exploits this reputation regularly by selling endorsements of various items of laboratory equipment to manufacturers. The endorsing of laboratory equipment does not contribute importantly to the accomplishment of any purpose for which exemption is granted U. Accordingly, the income derived from the sale of endorsements is gross income from unrelated trade or business.

Example 2. V, an exempt university, has a regular faculty and a regularly enrolled student body. During the school year, V sponsors the appearance of professional theater companies and symphony orchestras which present drama and musical performances for the students and faculty members. Members of the general public are also admitted. V advertises these performances and supervises advance ticket sales at various places, including such university facilities as the cafeteria and the university bookstore. V derives gross income from the conduct of the performances. However, while the presentation of the performances makes use of an intangible generated by V's exempt educational functions—the presence of the student body and faculty—the presentation of such drama and music events contributes importantly to the overall educational and cultural function of the university. Therefore, the income which V receives does not constitute gross income from the conduct of unrelated trade or business.

Example 3. W is an exempt business league with a large membership. Under an arrangement with an advertising agency, W regularly mails brochures, pamphlets and other commercial advertising materials to its members, for which service W charges the agency an agreed amount per enclosure. The distribution of the advertising materials does not contribute importantly to the accomplishment of any purpose for which W is granted exemption. Accordingly, the payments made to W by the advertising agency constitute gross income from unrelated trade or business.

Example 4. X, an exempt organization for the advancement of public interest in classical music, owns a radio station and operates it in a manner which contributes importantly to the accomplishment of the purposes for which the organization is granted exemption. However, in the course of the operation of the station the organization derives gross income from the regular sale of advertising time and services to commercial advertisers in the manner of an ordinary commercial station. Neither the sale of such time nor the performance of such services contributes importantly to the accomplishment of any purpose for which the organization is granted exemption. Notwithstanding the fact that the production of the advertising income depends upon the existence of the listening audience resulting from performance of exempt functions, such income is gross income from unrelated trade or business.

Example 5. Y, an exempt university, provides facilities, instruction and faculty supervision for a campus newspaper operated by its students. In addition to news items and editorial commentary, the newspaper publishes paid advertising. The solicitation, sale, and publication of the advertising are conducted by students, under the supervision and instruction of the university. Although the services rendered to advertisers are of a commercial character, the advertising business contributes importantly to the university's educational program through the training of the students involved. Hence, none of the income derived from publication of the newspaper constitutes gross income from unrelated trade or business. The same result would follow even though the newspaper is published by a separately incorporated section 501(c)(3) organization, qualified under the university rules for recognition of student activities, and even though such organization utilizes its own facilities and is independent of faculty supervision, but carries out its educational purposes by means of student instruction of other students in the editorial and advertising activities and student participation in those activities.

Example 6. Z is an association exempt under section 501(c)(6), formed to advance the interests of a particular profession and drawing its membership from the members of that profession. Z publishes a monthly journal containing articles and other editorial material which contribute importantly to the accomplishment of purposes for which exemption is granted the organization. Income from the sale of subscriptions to members and others in accordance with the organization's exempt purposes, therefore, does not constitute gross income from unrelated trade or business. In connection with the publication of the journal, Z also derives income from the regular sale of space and services for general consumer advertising, including advertising of such products as soft drinks, automobiles, articles of apparel, and home appliances. Neither the publication of such advertisements nor the performance of services for such commercial advertisers contributes importantly to the accomplishment of any purpose for which exemption is granted. Therefore, notwithstanding the fact that the production of income from advertising utilizes the circulation developed and maintained in performance of exempt functions, such income is gross income from unrelated trade or business.

Example 7. The facts are as described in the preceding example, except that the advertising in Z's journal promotes only products which are within the general area of professional interest of its members. Following a practice common among taxable magazines which publish advertising, Z requires its advertising to comply with certain general standards of taste, fairness, and accuracy; but within those limits the form, content, and manner of presentation of the advertising messages are governed by the basic objective of the advertisers to promote the sale of the advertised products. While the advertisements contain certain information, the informational function of the advertising is incidental to the controlling aim of stimulating demand for the advertised products and differs in no essential respect from the informational function of any commercial advertising. Like taxable publishers of advertising, Z accepts advertising only from those who are willing to pay its prescribed rates. Although continuing education of its members in matters pertaining to their profession is one of the purposes for which Z is granted exemption, the publication of advertising designed and selected in the manner of ordinary commercial advertising is not an educational activity of the kind contemplated by the exemption statute; it differs fundamentally from such an activity both in its governing objective and in its method. Accordingly, Z's publication of advertising does not contribute importantly to the accomplishment of its exempt purposes; and the income which it derives from advertising constitutes gross income from unrelated trade or business.

(e) *Exceptions.* Section 513(a) specifically states that the term *unrelated trade or business* does not include:

(1) Any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) Any trade or business carried on by an organization described in section 501(c)(3) or by a governmental college or university described in section 511(a)(2)(B), primarily for the convenience of its members, students, patients, officers, or employees; or, any trade or business carried on by a local association of employees described in section 501(c)(4) organized before May 27, 1969, which consists of the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual places of employment; or

(3) Any trade or business which consists of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.

An example of the operation of the first of the exceptions mentioned above would be an exempt orphanage operating a retail store and selling to the general public, where substantially all the work in carrying on such business is performed for the organization by volunteers without compensation. An example of the first part of the second exception, relating to an organization described in section 501(c)(3) or a governmental college or university described in section 511(a)(2)(B), would be a laundry operated by a college for the purpose of laundering dormitory linens and the clothing of students. The latter part of the second exception, dealing with certain sales by local employee associations, will not apply to sales of these items at locations other than the usual place of employment of the employees; therefore sales at such other locations will continue to be treated as unrelated trade or business. The third exception applies to so-called *thrift shops* operated by a tax-exempt organization where those desiring to benefit such organization contribute old clothes, books, furniture, et cetera, to be sold to the general public with the proceeds going to the exempt organization.

(f) *Special rule respecting publishing businesses prior to 1970.* For a special rule for taxable years beginning before January 1, 1970, with respect to publishing businesses carried on by an organization, see section 513(c) of the Code prior to its amendment by section 121(c) of the Tax Reform Act of 1969 (83 Stat. 542).

(g) *Effective date.* This section is applicable with respect to taxable years beginning after December 12, 1967. However, if a taxpayer wishes to rely on the rules stated in this section for taxable years beginning before December 13, 1967, it may do so.

[T.D. 6939, 32 FR 17657, Dec. 12, 1967; 32 FR 17890, Dec. 14, 1967; 32 FR 17938, Dec. 15, 1967; T.D. 7107, 36 FR 6421, Apr. 3, 1971; T.D. 7392, 40 FR 58642, Dec. 18, 1975; T.D. 7896, 48 FR 23817, May 27, 1983]

§ 1.513–2 Definition of unrelated trade or business applicable to taxable years beginning before December 13, 1967.

(a) *In general.* (1) As used in section 512(a), the term *unrelated business taxable income* includes only income from an unrelated trade or business regularly carried on, and the term *trade or business* has the same meaning as it has in section 162.

(2) The income of an exempt organization is subject to the tax on unrelated business income only if two conditions are present with respect to such income. The first condition is that the income must be from a trade or business which is regularly carried on by the organization. The second condition is that the trade or business must not be substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501, or in the case of an organization described in section 511(a)(2)(B) (governmental colleges, etc.) to the exercise or performance of any purpose or function described in section 501(c)(3). Whether or not an organization is subject to the tax imposed by section 511 shall be determined by the application of these tests to the particular circumstances involved in each individual case. For certain exceptions from the term *unrelated trade or business,* see paragraph (b) of this section.

(3) A trade or business is regularly carried on when the activity is conducted with sufficient consistency to indicate a continuing purpose of the organization to derive some of its income from such activity. An activity may be regularly carried on even though its performance is infrequent or seasonal.

(4) Ordinarily, a trade or business is substantially related to the activities for which an organization is granted exemption if the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption. In the usual case the nature and size of the trade or business must be compared with the nature and extent of the activities for which the organization is granted exemption in order to determine whether the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption. For example, the operation of a wheat farm is substantially related to the exempt activity of an agricultural college if the wheat farm is operated as a part of the educational program of the college,

and is not operated on a scale disproportionately large when compared with the educational program of the college. Similarly, a university radio station or press is considered a related trade or business if operated primarily as an integral part of the educational program of the university, but is considered an unrelated trade or business if operated in substantially the same manner as a commercial radio station or publishing house. A trade or business not otherwise related does not become substantially related to an organization's exempt purpose merely because incidental use is made of the trade or business in order to further the exempt purpose. For example, the manufacture and sale of a product by an exempt college would not become substantially related merely because students as part of their educational program perform clerical or bookkeeping functions in the business. In some cases, the business may be substantially related because it is a necessary part of the exempt activity. For example, in the case of an organization described in section 501(c)(3) and engaged in the rehabilitation of handicapped persons, the business of selling articles made by such persons as a part of their rehabilitation training would not be considered an unrelated business since such business is a necessary part of the rehabilitation program.

(5) If an organization receives a payment pursuant to a contract or agreement under which such organization is to perform research which constitutes an unrelated trade or business, the entire amount of such payment is income from an unrelated trade or business. See, however, section 512(b), (7), (8), and (9), relating to the exclusion from unrelated business taxable income of income derived from research for the United States, or any State, and of income derived from research performed for any person by a college, university, hospital, or organization operated primarily for the purpose of carrying on fundamental research the results of which are freely available to the general public.

(b) *Exceptions.* Section 513(a) specifically states that the term *unrelated trade or business* does not include:

(1) Any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) Any trade or business carried on by an organization described in section 501(c)(3) or by a governmental college or university described in section 511(a)(2)(B), primarily for the convenience of its members, students, patients, officers, or employees; or

(3) Any trade or business which consists of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.

An example of the operation of the first of the exceptions mentioned above would be an exempt orphanage operating a retail store and selling to the general public, where substantially all the work in carrying on such business is performed for the organization by volunteers without compensation. An example of the second exception would be a laundry operated by a college for the purpose of laundering dormitory linens and the clothing of students. The third exception applies to so-called *thrift shops* operated by a tax-exempt organization where those desiring to benefit such organization contribute old clothes, books, furniture, etc., to be sold to the general public with the proceeds going to the exempt organization.

(c) *Special rules respecting publishing businesses.* For a special rule with respect to publishing businesses carried on by an organization, see section 513(c) of the Code prior to its amendment by section 121(c) of the Tax Reform Act of 1969 (83 Stat. 542).

(d) *Effective date.* Except as provided in paragraph (g) of §1.513–1, this section is applicable with respect to taxable years beginning before December 13, 1967.

[Sec. 513 as amended by sec. 4, Act of July 14, 1960 (P.L. 86–667, 74 Stat. 536); secs. 121 (b)(4) and (c), Tax Reform Act of 1969 (83 Stat. 536, 542)]

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6525, 26 FR 190, Jan. 11, 1961; T.D. 6939, 32 FR 17657, Dec. 12, 1967; T.D. 7392, 40 FR 58643, Dec. 18, 1975; 40 FR 60053, Dec. 31, 1975]

§ 1.513–3 Qualified convention and trade show activity.

(a) *Introduction*—(1) *In general.* Section 513(d) and § 1.513–3(b) provide that convention and trade show activities carried on by a qualifying organization in connection with a qualified convention or trade show will not be treated as unrelated trade or business. Consequently, income from qualified convention and trade show activities, derived by a qualifying organization that sponsors the qualified convention or trade show, will not be subject to the tax imposed by section 511. Section 1.513–3(c) defines qualifying organizations and qualified conventions or trade shows. Section 1.513–3(d) concerns the treatment of income derived from certain activities, including rental of exhibition space at a qualified convention or trade show where sales activity is permitted, and the treatment of supplier exhibits at qualified conventions and trade shows.

(2) *Effective date.* This section is effective for taxable years beginning after October 4, 1976.

(b) *Qualified activities not unrelated.* A convention or trade show activity, as defined in section 513(d)(3)(A) and § 1.513–3(c)(4), will not be considered unrelated trade or business if it is conducted by a qualifying organization described in section 513(d)(3)(C) and § 1.513–3(c)(1), in conjunction with a qualified convention or trade show, as defined in section 513(d)(3)(B) and § 1.513–3(c)(2), sponsored by the qualifying organization. Such an activity is a qualified convention or trade show activity. A convention or trade show activity which is conducted by an organization described in section 501(c) (5) or (6), but which otherwise is not so qualified under this section, will be considered unrelated trade or business.

(c) *Definitions*—(1) *Qualifying organization.* Under section 513(d)(3)(C), a qualifying organization is one which:

(i) Is described in either section 501(c) (5) or (6), and

(ii) Regularly conducts as one of its substantial exempt purposes a qualified convention or trade show.

(2) *Qualified convention or trade show.* For purposes of this section, the term *qualified convention or trade show* means a show that meets the following requirements:

(i) It is conducted by a qualifying organization described in section 513(d)(3)(C);

(ii) At least one purpose of the sponsoring organization in conducting the show is the education of its members, or the promotion and stimulation of interest in, and demand for, the products or services of the industry (or segment thereof) of the members of the qualifying organization; and

(iii) The show is designed to achieve that purpose through the character of a significant portion of the exhibits or the character of conferences and seminars held at a convention or meeting.

(3) *Show.* For purposes of this section, the term *show* includes an international, national, state, regional, or local convention, annual meeting or show.

(4) *Convention and trade show activity.* For purposes of this section, convention and trade show activity means any activity of a kind traditionally carried on at shows. It includes, but is not limited to—

(i) Activities designed to attract to the show members of the sponsoring organization, members of an industry in general, and members of the public, to view industry products or services and to stimulate interest in, and demand for such products or services;

(ii) Activities designed to educate persons in the industry about new products or services or about new rules and regulations affecting the industry; and

(iii) Incidental activities, such as furnishing refreshments, of a kind traditionally carried on at such shows.

(d) *Certain activities*—(1) *Rental of exhibition space.* The rental of display space to exhibitors (including exhibitors who are suppliers) at a qualified trade show or at a qualified convention and trade show will not be considered unrelated trade or business even though the exhibitors who rent the space are permitted to sell or solicit orders.

(2) *Suppliers defined.* For purposes of subparagraph (1), a supplier's exhibit is one in which the exhibitor displays goods or services that are supplied to, rather than by, the members of the

qualifying organization in the conduct of such members' own trades or businesses.

(e) *Example.* The provisions of this section may be illustrated by the following examples:

Example 1. X, an organization described in section 501(c)(6), was formed to promote the construction industry. Its membership is made up of manufacturers of heavy construction machinery many of whom own, rent, or lease one or more digital computers produced by various computer manufacturers. X is a qualifying organization under section 513(d)(3)(C) that regularly holds an annual meeting. At this meeting a national industry sales campaign and methods of consumer financing for heavy construction machinery are discussed. In addition, new construction machinery developed for use in the industry is on display with representatives of the various manufacturers present to promote their machinery. Both members and nonmembers attend this portion of the conference. In addition, manufacturers of computers are present to educate X's members. While this aspect of the conference is a supplier exhibit (as defined in paragraph (d) of this section), income earned from such activity by X will not constitute unrelated business taxable income to X because the activity is conducted as part of a qualified trade show described in §1.513–3(c).

Example 2. Assume the same facts as in Example 1, but the only goods or services displayed are those of suppliers, the computer manufacturers. Selling and order taking are permitted. No member exhibits are maintained. Standing alone, this supplier exhibit (as defined in paragraph (d)(2) of this section) would constitute a supplier show and not a qualified convention or trade show. In this situation, however, the rental of exhibition space to suppliers is not unrelated trade or business. It is conducted by a qualifying organization in conjunction with a qualified convention or trade show. The show (the annual meeting) is a qualified convention or trade show because one of its purposes is the promotion and stimulation of interest in, and demand for, the products or services of the industry through the character of the annual meeting.

Example 3. Y is an organization described in section 501(c)(6). The organization conducts an annual show at which its members exhibit their products and services in order to promote public interest in the line of business. Potential customers are invited to the show, and sales and order taking are permitted. The organization secures the exhibition facility, undertakes the planning and direction of the show, and maintains exhibits designed to promote the line of business in general. The show is a qualified convention or trade show described in paragraph (c)(2) of this section. The provision of exhibition space to individual members is a qualified trade show activity, and is not unrelated trade or business.

Example 4. Z is an organization described in section 501(c)(6) that sponsors an annual show. As the sole activity at the show, suppliers to the members of Z exhibit their products and services for the purpose of stimulating the sale of their products. Selling and order taking are permitted. The show is a supplier show and does not meet the definition of a qualified convention show as it does not satisfy any of the three alternative bases for qualification. First, the show does not stimulate interest in the members' products through the character of product exhibits as the only products exhibited are those of suppliers rather than members. Second, the show does not stimulate interest in members' products through conferences or seminars as no such conferences are held at the show. Third, the show does not meet the definition of a qualified show on the basis of educational activities as the exhibition of suppliers' products is designed primarily to stimulate interest in, and sale of, suppliers' products. Thus, the organization's provision of exhibition space is not a qualified convention or trade show activity. Income derived from rentals of exhibition space to suppliers will be unrelated business taxable income under section 512.

[T.D. 7896, 48 FR 23817, May 27, 1983]

§1.513–5 Certain bingo games not unrelated trade or business.

(a) *In general.* Under section 513(f), and subject to the limitations in paragraph (C) of this section, in the case of an organization subject to the tax imposed by section 511, the term *unrelated trade or business* does not include any trade or business that consists of conducting bingo games (as defined in paragraph (d) of this section).

(b) *Exception.* The provisions of this section shall not apply with respect to any bingo game otherwise excluded from the term *unrelated trade or business* by reason of section 513(a)(1) and §1.513–1(e)(1) (relating to trades or businesses in which substantially all the work is performed without compensation).

(c) *Limitations*—(1) *Bingo games must be legal.* Paragraph (a) of this section shall not apply with respect to any bingo game conducted in violation of State or local law.

(2) *No commercial competition.* Paragraph (a) of this section shall not apply

with respect to any bingo game conducted in a jurisdiction in which bingo games are ordinarily carried out on a commercial basis. Bingo games are *ordinarily carried out on a commercial basis* within a jursidiction if they are regularly carried on (within the meaning of §1.513–1(c)) by for-profit organizations in any part of that jurisidiction. Normally, the entire State will constitute the appropriate jurisdiction for determining whether bingo games are ordinarily carried out on a commercial basis. However, if State law permits local jurisdictions to determine whether bingo games may be conducted by for-profit organizations, or if State law limits or confines the conduct of bingo games by for-profit organizations to specific local jurisdictions, then the local jurisdiction will constitute the appropriate jurisdiction for determining whether bingo games are ordinarily carried out on a commercial basis.

(3) *Examples.* The application of this paragraph is illustrated by the examples that follow. In each example, it is assumed that the bingo games referred to are operated by individuals who are compensated for their services. Accordingly, none of the bingo games would be excluded from the term *unrelated trade or business* under section 513 (a) (1).

Example 1. Church Z, a tax-exempt organization, conducts weekly bingo games in State O. State and local laws in State O expressly provide that bingo games may be conducted by tax-exempt organizations. Bingo games are not conducted in State O by any for-profit businesses. Since Z's bingo games are not conducted in violation of State or local law and are not the type of activity ordinarily carried out on a commercial basis in State O, Z's bingo games do not constitute unrelated trade or business.

Example 2. Rescue Squad X, a tax-exempt organization, conducts weekly bingo games in State M. State M has a statutory provision that prohibits all forms of gambling including bingo games. However, that law generally is not enforced by State officials against local charitable organizations such as X that conduct bingo games to raise funds. Since bingo games are illegal under State law, X's bingo games constitute unrelated trade or business regardless of the degree to which the State law is enforced.

≤*Example 3.* Veteran's organizations Y and X, both tax-exempt organizations, are organized under the laws of State N. State N has a statutory provision that permits bingo games to be conducted by tax-exempt organizations. In addition, State N permits bingo games to be conducted by for-profit organizations in city S, a resort community located in county R. Several for-profit organizations conduct nightly bingo games in city S. Y conducts weekly bingo games in city S. X conducts weekly bingo games in county R. Since State law confines the conduct of bingo games by for-profit organizations to city S, and since bingo games are regularly carried on there by those organizations, Y's bingo games conducted in city S constitute unrelated trade or business. However, X's bingo games conducted in county R outside of city S do not constitute unrelated trade or business.

(d) *Bingo game defined.* A bingo game is a game of chance played with cards that are generally printed with five rows of five squares each. Participants place markers over randomly called numbers on the cards in an attempt to form a preselected pattern such as a horizontal, vertical, or diagonal line, or all four corners. The first participant to form the preselected pattern wins the game. As used in this section, the term *bingo game* means any game of bingo of the type described above in which wagers are placed, winners are determined, and prizes or other property is distributed in the presence of all persons placing wagers in that game. The term *bingo game* does not refer to any game of chance (including, but not limited to, keno games, dice games, card games, and lotteries) other than the type of game described in this paragraph.

(e) *Effective date.* Section 513(f) and this section apply to taxable years beginning after December 31, 1969.

[T.D. 7699, 45 FR 33970, May 21, 1980]

§1.513–6 Certain hospital services not unrelated trade or business.

(a) *In general.* Under section 513(e), the furnishing of a service listed in section 501(e)(1)(A) by a hospital to one or more other hospitals will not constitute unrelated trade or business if—

(1) The service is provided solely to hospitals that have facilities to serve not more than 100 inpatients,

(2) The service would, if performed by the recipient hospital, constitute an activity consistent with that hospital's exempt purposes, and

(3) The service is provided at a fee not in excess of actual cost, including straight line depreciation and a reasonable rate of return on the capital goods used to provide the service. For purposes of this section, a rate of return on capital goods will be considered *reasonable* provided that it does not exceed, on an annual basis, the percentage described below which is based on the average of the rates of interest on special issues of public debt obligations issued to the Federal Hospital Insurance Trust Fund for each of the months included in the taxable year of the hospital during which the captial goods are used in providing the service. Determinations as to the cost of services and the applicable rate of return should be made as prescribed by 42 U.S.C. 1395x(v)(1) (A) and (B) and the regulations thereunder (permitting a health care facility to be reimbursed under the Medicare program for the *reasonable cost of (its) services,* including, in the case of certain proprietary facilities, a *reasonable return on equity capital*). For taxable years beginning on or before May 14, 1986, the rate of return shall be one and one-half times the average of the rates of interest on public debt obligations described above which were in effect on or before April 20, 1983.

(b) *Hospital defined.* As used in this section the word *hospital* means a hospital described in section 170(b)(1)(A)(iii).

(c) *Example.* The provisions of this section are illustrated by the following example:

Example. A large metropolitan hospital provides various services to other hospitals. The hospital furnishes a purchasing service to hosptials N and O, a data processing service to hospitals R and S, and a food service to hospitals X and Y. All the hospitals are described in section 170(b)(1)(A)(iii). All the hospitals have facilities to serve not more than 100 inpatients except hospital N. The services are furnished at cost to all hospitals except that hospital R is charged a fee in excess of cost for its use of the data processing service. The purchasing service constitutes unrelated trade or business because it is not provided solely to hospitals having facilities to serve not more than 100 inpatients.

The data processing service constitutes unrelated trade or business because it is provided at a fee in excess of cost. The food service satisfies all three requirements of paragraph (a) of this section and does not constitute unrelated trade or business.

(d) *Effective date.* Section 513(e) and this section apply to taxable years beginning after December 31, 1953.

[T.D. 8075, 51 FR 5322, Feb. 13, 1986; 51 FR 8490, Mar. 12, 1986]

§1.514(a)–1 Unrelated debt-financed income and deductions.

(a) *Income includible in gross income:*

(1) *Percentage of income taken into account*—(i) *In general.* For taxable years beginning after December 31, 1969, there shall be included with respect to each debt-financed property (as defined in section 514 and §1.514(b)–1) as an item of gross income derived from an unrelated trade or business the amount of unrelated debt-financed income (as defined in subdivision (ii) of this subparagraph). See paragraph (a)(5) of §1.514(c)–1 for special rules regarding indebtedness incurred before June 28, 1966, applicable for taxable years beginning before January 1, 1972, and for special rules applicable to churches or conventions or associations of churches.

(ii) *Unrelated debt-financed income.* The *unrelated debt-financed income* with respect to each debt-financed property is an amount which is the same percentage (but not in excess of 100 percent) of the total gross income derived during the taxable year from or on account of such property as:

(a) The average acquisition indebtedness (as defined in subparagraph (3) of this paragraph) with respect to the property is of

(b) The average adjusted basis of such property (as defined in subparagraph (2) of this paragraph).

(iii) *Debt/basis percentage.* The percentage determined under subdivision (ii) of this subparagraph is hereinafter referred to as the *debt/basis percentage.*

(iv) *Example.* Subdivisions (i), (ii), and (iii) of this subparagraph are illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. X, an exempt trade association, owns an office building which in 1971 produces $10,000 of gross rental income. The average adjusted basis of the building for 1971 is $100,000, and the average acquisition indebtedness with respect to the building for 1971 is $50,000. Accordingly, the debt/basis percentage for 1971 is 50 percent (the ratio of $50,000 to $100,000). Therefore, the unrelated debt-financed income with respect to the building for 1971 is $5,000 (50 percent of $10,000).

(v) *Gain from sale or other disposition.* If debt-financed property is sold or otherwise disposed of, there shall be included in computing unrelated business taxable income an amount with respect to such gain (or loss) which is the same percentage (but not in excess of 100 percent) of the total gain (or loss) derived from such sale or other disposition as:

(a) The highest acquisition indebtedness with respect to such property during the 12-month period, preceding the date of disposition, is of

(b) The average adjusted basis of such property.

The tax on the amount of gain (or loss) included in unrelated business taxable income pursuant to the preceding sentence shall be determined in accordance with the rules set forth in subchapter P, chapter 1 of the Code (relating to capital gains and losses). See also section 511(d) and the regulations thereunder (relating to the minimum tax for tax preferences).

(2) *Average adjusted basis*—(i) *In general.* The *average adjusted basis* of debt-financed property is the average amount of the adjusted basis of such property during that portion of the taxable year it is held by the organization. This amount is the average of:

(a) The adjusted basis of such property as of the first day during the taxable year that the organization holds the property, and

(b) The adjusted basis of such property as of the last day during the taxable year that the organization holds the property.

See section 1011 and the regulations thereunder for determination of the adjusted basis of property.

(ii) *Adjustments for prior taxable years.* For purposes of subdivision (i) of this subparagraph, the determination of the average adjusted basis of debt-financed property is not affected by the fact that the organization was exempt from taxation for prior taxable years. Proper adjustment must be made under section 1011 for the entire period since the acquisition of the property. For example, adjustment must be made for depreciation for all prior taxable years whether or not the organization was exempt from taxation for any such years. Similarly, the fact that only a portion of the depreciation allowance may be taken into account in computing the percentage of deductions allowable under section 514(a)(2) does not affect the amount of the adjustment for depreciation which is used in determining average adjusted basis.

(iii) *Cross reference.* For the determination of the basis of debt-financed property acquired in a complete or partial liquidation of a corporation in exchange for its stock, see § 1.514(d)–1.

(iv) *Example.* This subparagraph may be illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. On July 10, 1970, X, an exempt educational organization, purchased an office building for $510,000, using $300,000 of borrowed funds. During 1970 the only adjustment to basis is $20,000 for depreciation. As of December 31, 1970, the adjusted basis of the building is $490,000 and the indebtedness is still $300,000. X files its return on a calendar year basis. Under these circumstances, the debt/basis percentage for 1970 is 60 percent, calculated in the following manner:

	Basis
As of July 10, 1970 (acquisition date)	$510,000
As of December 31, 1970	490,000
Total	1,000,000

Average Adjusted basis:

$$\$1{,}000{,}000 \div 2 = \$500{,}000$$

Debt/basis percentage:

Average acquisition indebtedness ($300,000)/ Average adjusted basis ($500,000)=60 percent

For an illustration of the determination of the debt/basis percentage as changes in the acquisition indebtedness occur, see example 1 of subparagraph (3)(iii) of this paragraph.

(3) *Average acquisition indebtedness*—(i) *In general.* The *average acquisition indebtedness* with respect to debt-financed property is the average amount of the outstanding principal indebtedness during that portion of the taxable

year the property is held by the organization.

(ii) *Computation.* The average acquisition indebtedness is computed by determining the amount of the outstanding principal indebtedness on the first day in each calendar month during the taxable year that the organization holds the property, adding these amounts together, and then dividing this sum by the total number of months during the taxable year that the organization held such property. A fractional part of a month shall be treated as a full month in computing average acquisition indebtedness.

(iii) *Examples.* The application of this subparagraph may be illustrated by the following examples. For purposes of these examples it is assumed that the property is debt-financed property.

Example 1. Assume the facts as stated in the example in subparagraph (2)(iv) of this paragraph, except that beginning July 20, 1970, the organization makes payments of $21,000 a month ($20,000 of which is attributable to principal and $1,000 to interest). In this situation, the average acquisition indebtedness for 1970 is $250,000. Thus, the debt/basis percentage for 1970 is 50 percent, calculated in the following manner:

	Indebtedness on the first day in each calendar month that the property is held
Month:	
July	$300,000
August	280,000
September	260,000
October	240,000
November	220,000
December	200,000
Total	1,500,000

Average acquisition indebtedness:

$1,500,000÷6 months=$250,000

Debt/basis percentage:

Average acquisition indebtedness ($250,000)/ Average adjusted basis ($500,000)=50 percent

Example 2. Y, an exempt organization, owns stock in a corporation which it does not control. At the beginning of the year, Y has an outstanding principal indebtedness with respect to such stock of $12,000. Such indebtedness is paid off at the rate of $2,000 per month beginning January 30, so that it is retired at the end of 6 months. The average acquisition indebtedness for the taxable year is $3,500, calculated in the following manner:

	Indebtedness on the first day in each calendar month that the property is held
Month:	
January	$12,000
February	10,000
March	8,000
April	6,000
May	4,000
June	2,000
July thru December	0
Total	42,000

Average acquisition indebtedness:

$$\$42{,}000 \div 6 \text{ months} = \$3{,}500$$

(4) *Indeterminate price*—(i) *In general.* If an exempt organization acquires (or improves) property for an indeterminate price, the initial acquisition indebtedness and the unadjusted basis shall be determined in accordance with subdivisions (ii) and (iii) of this paragraph, unless the organization has obtained the consent of the Commissioner to use another method to compute such amounts.

(ii) *Unadjusted basis.* For purposes of this subparagraph, the unadjusted basis of property (or of an improvement) is the fair market value of the property (or improvement) on the date of acquisition (or the date of completion of the improvement). The average adjusted basis of such property shall be determined in accordance with paragraph (a)(2) of this section.

(iii) *Initial acquisition indebtedness.* For purposes of this subparagraph, the initial acquisition indebtedness is the fair market value of the property (or improvement) on the date of acquisition (or the date of completion of the improvement) less any down payment or other initial payment applied to the principal indebtedness. The average acquisition indebtednessith respect to such property shall be computed in accordance with paragraph (a)(3) of this section.

(iv) *Example.* The application of this subparagraph may be illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. On January 1, 1971, X, an exempt trade association, acquires an office building for a down payment of $310,000 and an agreement to pay 10 percent of the income generated by the building for 10 years. Neither the sales price nor the amount which X is obligated to pay in the future is certain. The fair market value of the building on the date of acquisition is $600,000. The depreciation allowance for 1971 is $40,000. Unless X obtains the consent of the Commissioner to use another method, the unadjusted basis of the property is $600,000 (the fair market value of the property on the date of acquisition), and the initial acquisition indebtedness is $290,000 (fair market value of $600,000 less initial payment of $310,000). Under these circumstances, the average adjusted basis of the property for 1971 is $580,000, calculated as follows:

[Initial fair market value+(initial fair market value less depreciation)] ÷2=[$600,000+($600,000−$40,000)] ÷2=$580,000.

If no payment other than the initial payment is made in 1971, the average acquisition indebtedness for 1971 is $290,000. Thus, the debt/basis percentage for 1971 is 50 percent, calculated as follows:

Average acquisition indebtedness ÷average adjusted basis=$290,000 ÷$580,000=50 percent

(b) *Deductions*—(1) *Percentage of deductions taken into account.* Except as provided in subparagraphs (4) and (5) of this paragraph, there shall be allowed as a deduction with respect to each debt-financed property an amount determined by applying the debt/basis percentage to the sum of the deductions allowable under subparagraph (2) of this paragraph.

(2) *Deductions allowable.* The deductions allowable are those items allowed as deductions by chapter 1 of the Code which are directly connected with the debt-financed property or the income therefrom (including the dividends received deductions allowed by sections 243, 244, and 245), except that:

(i) The allowable deductions are subject to the modifications provided by section 512(b) on computation of the unrelated business taxable income, and

(ii) If the debt-financed property is of a character which is subject to the allowance for depreciation provided in section 167, such allowance shall be computed only by use of the straight-line method of depreciation.

(3) *Directly connected with.* To be *directly connected with* debt-financed property or the income therefrom, an item of deduction must have proximate and primary relationship to such property or the income therefrom. Expenses, depreciation, and similar items attributable solely to such property are proximately and primarily related to such property or the income therefrom, and therefore qualify for deduction, to the extent they meet the requirements of subparagraph (2) of this paragraph. Thus, for example, if the straight-line depreciation allowance for an office building is $10,000 a year, an organization would be allowed a deduction for depreciation of $10,000 if the entire building were debt-financed property. However, if only one-half of the building were treated as debt-financed property, then the depreciation allowed as a deduction would be $5,000. (See example 2 of § 1.514(b)–1(b)(1)(iii).)

(4) *Capital losses*—(i) *In general.* If the sale or exchange of debt-financed property results in a capital loss, the amount of such loss taken into account in the taxable year in which the loss arises shall be computed in accordance with paragraph (a)(1)(v) of this section. If, however, any portion of such capital loss not taken into account in such year may be carried back or carried over to another taxable year, the debt/basis percentage is not applied to determine what portion of such capital loss may be taken as a deduction in the year to which such capital loss is carried.

(ii) *Example.* This subparagraph is illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. X, an exempt educational organization, owns securities which are capital assets and which it has held for more than 6 months. In 1972 X sells the securities at a loss of $20,000. The debt/basis percentage with respect to computing the gain (or loss) derived from the sale of the securities is 40 percent. Thus, X has sustained a capital loss of $8,000 (40 percent of $20,000) with respect to the sale of the securities. For 1972 and the preceding three taxable years X has no other capital transactions. Under these circumstances, the $8,000 of capital loss may be carried over to the succeeding 5 taxable years without further application of the debt/basis percentage.

(5) *Net operating loss*—(i) *In general.* If, after applying the debt/basis percentage to the income derived from debt-financed property and the deductions directly connected with such income, such deductions exceed such income, the organization has sustained a net operating loss for the taxable year. This amount may be carried back or carried over to other taxable years in accordance with section 512(b)(6). However, the debt/ basis percentage shall not be applied in such other years to determine the amounts that may be taken as a deduction in those years.

(ii) *Example.* This subparagraph may be illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. During 1974, Y, an exempt organization, receives $20,000 of rent from a building which it owns. Y has no other unrelated business taxable income for 1974. For 1974 the deductions directly connected with this building are property taxes of $5,000, interest of $5,000 on the acquisition indebtedness, and salary of $15,000 to the manager of the building. The debt/basis percentage for 1974 with respect to the building is 50 percent. Under these circumstances, Y shall take into account in computing its unrelated business taxable income for 1974, $10,000 of income (50 percent of $20,000) and $12,500 (50 percent of $25,000) of the deductions directly connected with such income. Thus, for 1974 Y has sustained a net operating loss of $2,500 ($10,000 of income less $12,500 of deductions) which may be carried back or carried over to other taxable years without further application of the debt/basis percentage.

[T.D. 7229, 37 FR 28143, Dec. 21, 1972]

§1.514(a)–2 Business lease rents and deductions for taxable years beginning before January 1, 1970.

(a) *Effective date.* This section applies to taxable years beginning before January 1, 1970.

(b) *In general*—(1) *Rents includible in gross income.* There shall be included with respect to each business lease, as an item of gross income derived from an unrelated trade or business, an amount which is the same percentage (but not in excess of 100 percent) of the total rents derived during the taxable year under such lease as:

(i) The amount of the business lease indebtedness at the close of the taxable year of the lessor tax-exempt organization, with respect to the premises covered by such lease, is of

(ii) The adjusted basis of such premises at the close of such taxable year.

For definition of business lease as a lease for a term of more than 5 years, and for rules for determining the computation of such 5-year term in certain specific situations, see §1.514(f)–1. For definition of business lease indebtedness and allocation of business lease indebtedness where only a portion of the property is subject to a business lease, see §1.514(g)–1.

(2) *Determination of basis.* For purposes of the unrelated business income tax the basis (unadjusted) of property is determined under section 1012, and the adjusted basis of property is determined under section 1011. The determination of the adjusted basis of property is not affected by the fact that the organization was exempt from tax for prior taxable years. Proper adjustment must be made under section 1011 for the entire period since the acquisition of the property. Thus adjustment must be made for depreciation for all taxable years whether or not the organization was exempt from tax for any of such years. Similarly, for taxable years during which the organization is subject to the tax on unrelated business taxable income the fact that only a portion of the deduction for depreciation is taken into account under paragraph (c) (1) of this section does not affect the amount of the adjustment for depreciation.

(3) *Examples.* The application of this paragraph may be illustrated by the following examples, in each of which it is assumed that the taxpayer makes its returns under section 511 on the basis of the calendar year, and that the lease is not substantially related to the purpose for which the organization is granted exemption from tax.

Example 1. Assume that a tax-exempt educational organization purchased property in 1952 for $600,000, using borrowed funds, and leased the building for a period of 20 years. Assume further that the adjusted basis of such building at the close of 1954 is $500,000 and that, at the close of 1954, $200,000 of the indebtedness incurred to acquire the property remains outstanding. Since the amount of the outstanding indebtedness is two-fifths of the adjusted basis of the building at the close of 1954, two-fifths of the gross rental received from the building during 1954 shall be included as an item of gross income in computing unrelated business taxable income. If, at the close of a subsequent taxable year, the outstanding indebtedness is $100,000 and the adjusted basis of the building is $400,000, one-fourth of the gross rental for such taxable year shall be included as an item of gross income in computing unrelated business taxable income for such taxable year.

Example 2. Assume that a tax-exempt organization owns a four-story building, that in 1954 it borrows $100,000 which it uses to improve the whole building, and that it thereafter in 1954 rents the first and second floors of the building under six-year leases at rentals of $4,000 a year. The third and fourth floors of the building are leased on a yearly basis during 1954. Assume, also, that the adjusted basis of the real property at the end of 1954 (after reflecting the expenditures for improving the building) is $200,000, allocable equally to each of the four stories. Under these facts, only one-half of the real property is subject to a business lease since only one-half is rented under a lease for more than 5 years. See § 1.514(f)–1. The percentage of the rent under such lease which is taken into account is determined by the ratio which the allocable part of the business lease indebtedness bears to the allocable part of the adjusted basis of the real property, that is, the ratio which one-half of the $100,000 of business lease indebtedness outstanding at the close of 1954, or $50,000, bears to one-half of the adjusted basis of the business lease premises at the close of 1954, or $100,000. The percentage of rent which is business lease income for 1954 is, therefore, one-half (the ratio of $50,000 to $100,000) of $8,000, or $4,000, and this amount of $4,000 is considered an item of gross income derived from an unrelated trade or business.

(c) *Deductions*—(1) *Deductions allowable against gross income.* The same percentage is used in determining both the portion of the rent and the portion of the deductions taken into account with respect to the business lease in computing unrelated business taxable income. Such percentage is applicable only to the sum of the following deductions allowable under section 161:

(i) Taxes and other expenses paid or accrued during the taxable year upon or with respect to the real property subject to the business lease;

(ii) Interest paid or accrued during the taxable year on the business lease indebtedness;

(iii) A reasonable allowance for exhaustion, wear and tear (including a reasonable allowance for obsolescence) of the real property subject to such lease.

Where only a portion of the real property is subject to the business lease, there shall be taken into account only those amounts of the above-listed deductions which are properly allocable to the premises covered by such lease.

(2) *Excess deductions.* The deductions allowable under subparagraph (1) of this paragraph with respect to a business lease are not limited by the amount included in gross income with respect to the rent from such lease. Any excess of such deductions over such gross income shall be applied against other items of gross income in computing unrelated business taxable income taxable under section 511(a).

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

Example. Assume the same facts as those in example 1 in paragraph (b)(3) of this section. Assume, also that for 1954 the organization pays taxes of $4,000 on the property, interest of $6,000 on its business lease indebtedness, and that the depreciation allowable for 1954 under section 167 is $10,000. Under the facts set forth in such example 1 and in this example, the deductions to be taken into account for 1954 in computing unrelated business taxable income would be two-fifths of the total of the deductions of $20,000, that is $8,000.

[T.D. 7229, 37 FR 28145, Dec. 21, 1972]

§ 1.514(b)–1 Definition of debt-financed property.

(a) *In general.* For purposes of section 514 and the regulations thereunder, the term *debt-financed property* means any property which is held to produce income (e.g., rental real estate, tangible personal property, and corporate stock), and with respect to which there is an acquisition indebtedness (determined without regard to whether the property is debt-financed property) at any time during the taxable year. The term *income* is not limited to recurring income but applies as well to gains from the disposition of property. Consequently, when any property held to produce income by an organization which is not used in a manner described in section 514(b)(1) (A), (B), (C), or (D) is disposed of at a gain during the taxable year, and there was an acquisition indebtedness outstanding with respect to such property at any time during the 12-month period preceding the date of disposition (even though such period covers more than 1 taxable year), such property is *debt-financed property*. For example, assume that on June 1, 1972, an organization is given mortgaged, unimproved property which it does not use in a manner described in section 514(b)(1) (A), (B), (C), or (D) and that the organization assumes payment of the mortgage on such property. On July 15, 1972, the organization sells such property for a gain. Such property is *debt-financed property* and such gain is taxable as unrelated debt-financed income. See section 514(c) and §1.514(c)–1 for rules relating to when there is acquisition indebtedness with respect to property. See paragraph (a) of §1.514(a)–1 for rules determining the amount of income or gain from debt-financed property which is treated as unrelated debt-financed income.

(b) *Exceptions*—(1) *Property related to certain exempt purposes.* (i) To the extent that the use of any property is substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by an organization of its charitable, educational, or other purpose or function constituting its basis for exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function designated in section 501(c)(3)) such property shall not be treated as *debt-financed property*. See §1.513–1 for principles applicable in determining whether there is a substantial relationship to the exempt purpose of the organization.

(ii) If substantially all of any property is used in a manner described in subdivision (i) of this subparagraph, such property shall not be treated as *debt-financed property*. In general the preceding sentence shall apply if 85 percent or more of the use of such property is devoted to the organization's exempt purpose. The extent to which property is used for a particular purpose shall be determined on the basis of all the facts and circumstances. These may include (where appropriate):

(a) A comparison of the portion of time such property is used for exempt purposes with the total time such property is used,

(b) A comparison of the portion of such property that is used for exempt purposes with the portion of such property that is used for all purposes, or

(c) Both the comparisons described in *(a)* and *(b)* of this subdivision.

(iii) This subparagraph may be illustrated by the following examples. For purposes of these examples it is assumed that the indebtedness is acquisition indebtedness.

Example 1. W, an exempt organization, owns a computer with respect to which there is an outstanding principal indebtedness and which is used by W in the performance of its exempt purpose. W sells time for the use of the computer to M corporation on occasions when the computer is not in full-time use by W. W uses the computer in furtherance of its exempt purpose more than 85 percent of the time it is in use and M uses the computer less than 15 percent of the total operating time the computer is in use. In this situation, substantially all the use of the computer is related to the performance of W's exempt purpose. Therefore, no portion of the computer is treated as debt-financed property.

Example 2. X, an exempt college, owns a four story office building which has been purchased with borrowed funds. In 1971, the lower two stories of the building are used to house computers which are used by X for administrative purposes. The top two stories are rented to the public for purposes not described in section 514(b)(1) (A), (B), (C), or (D). The gross income derived by X from the building is $6,000, all of which is attributable to the rents paid by tenants. There are $2,000 of expenses, allocable equally to each use of the building. The average adjusted basis of the building for 1971 is $100,000, and the outstanding principal indebtedness throughout 1971 is $60,000. Thus, the average acquisition indebtedness for 1971 is $60,000. In accordance with subdivision (i) of this subparagraph, only the upper half of the building is debt-financed property. Consequently, only the rental income and the deductions directly connected with such income are to be taken into account in computing unrelated business taxable income. The portion of such amounts to be taken into account is determined by multiplying the $6,000 of rental income and $1,000 of deductions directly connected with such rental income by the debt/basis percentage. The debt/basis percentage is the ratio which the allocable part of the average acquisition indebtedness is of the allocable part of the average adjusted basis of the property, that is, the ratio which $30,000 (one-half of $60,000) bears to $50,000 (one-half of $100,000). Thus, the debt/basis percentage for 1971 is 60 percent (the ratio of $30,000 to $50,000). Under these circumstances, X shall include net rental income of $3,000 in its unrelated business taxable income for 1971, computed as follows:

Total rental income	$6,000
Deductions directly connected with rental income	$1,000
Debt/basis percentage ($30,000/$50,000)	60%
Rental income treated as gross income from an unrelated trade or business (60 percent of $6,000)	$3,600
Less the allowable portion of deductions directly connected with such income (60 percent of $1,000)	$600
Net rental income included by X in computing its unrelated business taxable income pursuant to section 514	$3,000

Example 3. Assume the facts as stated in example 2 except that on December 31, 1971, X sells the building and realizes a long-term capital gain of $10,000. This is X's only capital transaction for 1971. An allocable portion of this gain is subject to tax. This amount is determined by multiplying the gain related to the nonexempt use, $5,000 (one-half of $10,000), by the ratio which the debtedness for the 12-month period preceding the date of sale, $30,000 (one-half of $60,000), is of the allocable part of the average adjusted basis, $50,000 (one-half of $100,000). Thus, the debt/basis percentage with respect to computing the gain (or loss) derived from the sale of the building is 60 percent (the ratio of $30,000 to $50,000). Consequently, $3,000 (60 percent of $5,000) is a net section 1201 gain (capital gain net income for taxable years beginning after December 31, 1976). The portion of such gain which is taxable shall be determined in accordance with rules contained in subchapter P, chapter 1 of the Code (relating to capital gains and losses). See also section 511(d) and the regulations thereunder (relating to the minimum tax for tax preferences).

(2) *Property used in an unrelated trade or business*—(i) *In general.* To the extent that the gross income from any property is treated as income from the conduct of an unrelated trade or business, such property shall not be treated as *debt-financed property*. However, any gain on the disposition of such property which is not included in the income of an unrelated trade or business by reason of section 512(b)(5) is includible as gross income derived *from or on account of debt-financed property* under paragraph (a)(1) of § 1.514(a)–1.

(ii) *Amounts specifically taxable under other provisions of the Code.* Section 514 does not apply to amounts which are otherwise included in the computation of unrelated business taxable income, such as rents from personal property includible pursuant to section 512(b)(13) or rents and interest from controlled organizations includible pursuant to section 512(b)(3). See paragraph (1)(5) of § 1. 512(b)–1 for the rules determining the manner in which amounts are taken into account where such amounts may be included in the computation of unrelated business taxable income by operation of more than one provision of the Code.

(3) *Examples.* Subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples. For purposes of these examples it is assumed that the indebtedness is acquisition indebtedness.

Example 1. X, an exempt scientific organization, owns a 10-story office building. During 1972, four stories are occupied by X's administrative offices, and the remaining six stories are rented to the public for purposes not described in section 514(b)(1) (A), (B), (C), or (D). On December 31, 1972, the building is sold and X realizes a long-term capital gain of $100,000. This is X's only capital transaction for 1972. The debt/basis percentage with respect to computing the gain (or loss) derived from the sale of the building is 30 percent. Since 40 percent of the building was used for X's exempt purpose, only 60 percent of the building is debt-financed property. Thus, only $60,000 of the gain (60 percent of $100,000) is subject to this section. Consequently, the amount of gain treated as unrelated debt-financed income is $18,000 ($60,000 multiplied by the debt/basis percentage of 30 percent). The portion of such $18,000 which is taxable shall be determined in accordance with the rules contained in subchapter P, chapter 1 of the Code. See also section 511(d) and the regulations thereunder (relating to the minimum tax for tax preferences).

Example 2. Y, an exempt organization, owns two properties, a restaurant and an office building. In 1972, all the space in the office building, except for the portion utilized by Y to house the administrative offices of the restaurant, is rented to the public for purposes not described in section 514(b)(1) (A), (B), (C), or (D). The average adjusted basis of the office building for 1972 is $2 million. The outstanding principal indebtedness throughout 1972 is $1 million. Thus, the highest acquisition indebtedness in the calendar year of 1972 is $1 million. It is determined that 30 percent of the space in the office building is used for the administrative functions engaged in by the employees of the organization with respect to the restaurant. Since the income attributable to the restaurant is attributable to the conduct of an unrelated trade or business, only 70 percent of the building is treated as debt-financed property for purposes of determining the portion of the rental income which is unrelated debt-financed income. On December 31, 1972, the office building is sold and Y realizes a long-term capital gain of $250,000. This is Y's only capital transaction for 1972. In accordance with subparagraph (2)(i) of this paragraph, all the gain derived from this sale is taken into account in computing the amount of such gain subject to tax. The portion of such gain which is taxable is determined by multiplying the $250,000 gain by the debt/basis percentage. The debt/basis percentage is the ratio which the highest acquisition indebtedness for the 12-month period preceding the date of sale, $1 million, is of the average adjusted basis, $2 million. Thus, the debt/basis percentage with respect to computing the gain (or loss) derived from the sale of the building is 50 percent (the ratio of $1 million to $2 million). Consequently, $125,000 (50 percent of $250,000) is a net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976). The amount of such gain which is taxable shall be determined in accordance with the rules contained in subchapter P, chapter 1 of the Code. See also section 511(d) and the regulations thereunder.

Example 3. (a) Z, an exempt university, owns all the stock of M, a nonexempt corporation. During 1971 M leases from Z University a factory unrelated to Z's exempt purpose and a dormitory for the students of Z, for a total annual rent of $100,000: $80,000 for the factory and $20,000 for the dormitory. During 1971, M has $500,000 of taxable income, disregarding the rent paid to Z: $150,000 from the dormitory and $350,000 from the factory. The factory is subject to a mortgage of $150,000. Its average adjusted basis for 1971 is determined to be $300,000. Z's deductions for 1971 with respect to the leased property are $4,000 for the dormitory and $16,000 for the factory. In accordance with subdivision (ii) of this subparagraph, section 514 applies only to that portion of the rent which is excluded from the computation of unrelated business taxable income by operation of section 512(b)(3) and not included in such computation pursuant to section 512(b)(13). Since all the rent received by Z is derived from real property, section 512(b)(3) would exclude all such rent from computation of Z's unrelated business taxable income. However, 70 percent of the rent paid to Z with respect to the factory and 70 percent of the deductions directly connected with such rent shall be taken into account by Z in determining its unrelated business taxable income pursuant to section 512(b)(15), computed as follows:

M's taxable income (disregarding rent paid to Z)	$500,000
Less taxable income from dormitory	$150,000
Excess taxable income	$350,000
Ratio ($350,000/$500,000)	7⁄10
Total rent paid to Z	$100,000
Total deductions ($4,000+$16,000)	$20,000
Rental income treated under section 512(b)(15) as gross income from an unrelated trade or business (7⁄10 of $100,000)	$70,000
Less deductions directly connected with such income (7⁄10 of $20,000)	$14,000
Net rental income included by Z in computing its unrelated business taxable income pursuant to section 512(b)(15)	$56,000

(b) Since only that portion of the rent derived from the factory and the deductions directly connected with such rent not taken into account pursuant to section 512(b)(15) may be included in computing unrelated business taxable income by operation of section 514, only $10,000 ($80,000 minus $70,000) of rent and $2,000 ($16,000 minus $14,000) of deductions are so taken into account. The portion of such amounts to be taken into account is determined by multiplying the $10,000 of income and $2,000 of deductions by the debt/basis percentage. The debt/basis percentage is the ratio which the average acquisition indebtedness ($150,000) is of the average adjusted basis of the property ($300,000). Thus, the debt/basis percentage for 1971 is 50 percent (the ratio of $150,000 to $300,000). Under these circumstances, Z shall include net rental income of $4,000 in its unrelated business taxable income for 1971, computed as follows:

Total rents	$10,000
Deductions directly connected with such rents	$2,000
Debt/basis percentage ($150,000/$300,000)	50%
Rental income treated as gross income from an unrelated trade or business (50 percent of $10,000)	$5,000
Less the allowable portion of deductions directly connected with such income (50 percent of $2,000)	$1,000
Net rental income included by Z in computing its unrelated business taxable income pursuant to section 514	$4,000

(4) *Property related to research activities.* To the extent that the gross income from any property is derived from research activities excluded from the tax on unrelated business income by paragraph (7), (8), or (9) of section 512(b), such property shall not be treated as *debt-financed property.*

(5) *Property used in thrift shops,* etc. To the extent that property is used in

any trade or business which is excepted from the definition of *unrelated trade or business* by paragraph (1), (2), or (3) of section 513(a), such property shall not be treated as *debt-financed property.*

(6) *Use by a related organization.* For purposes of subparagraph (1), (4), or (5) of this paragraph, use of property by a related exempt organization (as defined in paragraph (c)(2)(ii) of this section) for a purpose described in such subparagraphs shall be taken into account in order to determine the extent to which such property is used for a purpose described in such subparagraphs.

(c) *Special rules*—(1) *Medical clinic.* Property is not debt-financed property if it is real property subject to a lease to a medical clinic, and the lease is entered into primarily for purposes which are substantially related (aside from the need of such organization for income or funds or the use it makes of the rents derived) to the exercise or performance by the lessor of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501. For example, assume that an exempt hospital leases all of its clinic space to an unincorporated association of physicians and surgeons who, by the provisions of the lease, agree to provide all of the hospital's out-patient medical and surgical services and to train all of the hospital's residents and interns. In this situation, the rents received by the hospital from this clinic are not to be treated as unrelated debt-financed income.

(2) *Related exempt uses*—(i) *In general.* Property owned by an exempt organization and used by a related exempt organization or by an exempt organization related to such related exempt organization shall not be treated as *debt-financed property* to the extent such property is used by either organization in furtherance of the purpose constituting the basis for its exemption under section 501. Furthermore, property shall not be treated as *debt-financed property* to the extent such property is used by a related exempt organization for a purpose described in paragraph (b)(4) or (5) of this section.

(ii) *Related organizations.* For purposes of subdivision (i) of this subparagraph, an exempt organization is related to another exempt organization only if:

(a) One organization is an exempt holding company described in section 501(c)(2) and the other organization receives the profits derived by such exempt holding company,

(b) One organization has control of the other organization within the meaning of paragraph (1)(4) of § 1.512(b)-1,

(c) More than 50 percent of the members of one organization are members of the other organization, or

(d) Each organization is a local organization which is directly affiliated with a common state, national, or international organization which is also exempt.

(iii) *Examples.* This subparagraph may be illustrated by the following examples. For purposes of these examples it is assumed that the indebtedness is acquisition indebtedness.

Example 1. M, an exempt trade association described in section 501(c)(6), leases 70 percent of the space of an office building for furtherance of its exempt purpose. The title to such building is held by N, an exempt holding company described in section 501(c)(2), which acquired title to the building with borrowed funds. The other 30 percent of the space in this office building is leased to L, a nonstock exempt trade association described in section 501(c)(6). L uses such office space in furtherance of its exempt purpose. The members of L's Board of Trustees serves for fixed terms and M's Board of Directors has the power to select all such members. N pays over to M all the profits it derives from the leasing of space in this building to M and L. Accordingly, M is *related* to N (as such term is defined in subdivision (ii)*(a)* of this subparagraph) and L is *related* to M (as such term is defined in subdivision (ii)*(b)* of this subparagraph). Under these circumstances, since all the available space in the building is leased to either an exempt organization related to the exempt organization holding title to the building or an exempt organization related to such related exempt organization, no portion of the building is treated as debt-financed property.

Example 2. W, an exempt labor union described in section 501(c)(5), owns a 10-story office building which has been purchased with borrowed funds. Five floors of the building are used by W in furtherance of its exempt purpose. Four of the other floors are rented to X which is an exempt voluntary employees' beneficiary association described in section 501(c)(9), operated for the benefit of W's members. X uses such office space in furtherance of its exempt purpose. Seventy percent of the members of W are also members of X. Accordingly, X is *related* to W (as such term is defined in subdivision (ii)*(c)* of this subparagraph). The remaining floor of the building is rented to the general public for purposes not described in section 514(b)(1) (A), (B), (C), or (D). Under these circumstances, no portion of this building is treated as debt-financed property since more than 85 percent of the office space available in this building is used either by W or X, an exempt organization related to W, in furtherance of their respective exempt purpose. See paragraph (b)(1) of this section for rules relating to the use of property substantially related to an exempt purpose. See paragraph (b)(6) of this section for rules relating to uses by related exempt organizations.

Example 3. Assume the same facts as in example 2, except that W and X are each exempt local labor unions described in section 501(c)(5) having no common membership and are each affiliated with N, an exempt international labor union described in section 501(c)(5). Under these circumstances, no portion of this building is treated as debt-financed property since more than 85 percent of the office space available in this building is used either by W or X, an exempt organization related to W, in furtherance of their respective exempt purpose.

Example 4. Assume the same facts as in example 3, except that W and X are directly affiliated with different exempt international labor unions and that W and X are not otherwise affiliated with, or members of, a common exempt organization, other than an association of international labor unions. Under these circumstances, the portions of this building which are rented to X and to the general public are treated as debt-financed property since X is not related to W and W uses less than 85 percent of the building for its exempt purpose.

(3) *Life income contracts.* (i) Property shall not be treated as *debt-financed property* when:

(a) An individual transfers property to a trust or a fund subject to a contract providing that the income is to be paid to him or other individuals or both for a period of time not to exceed the life of such individual or individuals in a transaction in which the payments to the individual or individuals do not constitute the proceeds of a sale or exchange of the property so transferred, and

(b) The remainder interest is payable to an exempt organization described in section 501(c)(3).

(ii) Subdivision (i) of this subparagraph is illustrated by the following example.

Example. On January 1, 1967, A transfers property to X, an exempt organization described in section 501(c)(3), which immediately places the property in a fund. On January 1, 1971, A transfers additional property to X, which property is also placed in the fund. In exchange for each transfer, A receives income participation fund certificates which entitle him to a proportionate part of the fund's income for his life and for the life of another individual. None of the payments made by X are treated by the recipients as the proceeds of a sale or exchange of the property transferred. In this situation, none of the property received by X from A is treated as debt-financed property.

(d) *Property acquired for prospective exempt use*—(1) *Neighborhood land*— (i) *In general.* If an organization acquires real property for the principal purpose of using the land in the exercise or performance of its exempt purpose, commencing within 10 years of the time of acquisition, such property will not be treated as debt-financed property, so long as *(a)* such property is in the neighborhood of other property owned by the organization which is used in the performance of its exempt purpose, and *(b)* the organization does not abandon its intent to use the land in such a manner within the 10-year period. The rule expressed in this subdivision is hereinafter referred to as the *neighborhood land rule.*

(ii) *Neighborhood* defined. Property shall be considered in the *neighborhood* of property owned and used by the organization in the performance of its exempt purpose if the acquired property is contiguous with the exempt purpose property or would be contiguous with such property except for the interposition of a road, street, railroad, stream, or similar property. If the acquired property is not contiguous with exempt function property, it may still be in the *neighborhood* of such property, but only if it is within 1 mile of such property and the facts and circumstances of the particular situation make the acquisition of contiguous property unreasonable. Some of the criteria to consider in determining this question include the availability of land and the intended future use of the land. For example, a university attempts to purchase land contiguous to its present campus but cannot do so because the owners either refuse to sell or ask unreasonable prices. The nearest land of sufficient size and utility is a block away from the campus. The university purchases such land. Under these circumstances, the contiguity requirement is unreasonable and the land purchased would be considered *neighborhood land*.

(iii) *Exception*. The neighborhood land rule shall not apply to any property after the expiration of 10 years from the date of acquisition. Further, the neighborhood land rule shall apply after the first 5 years of the 10-year period only if the organization establishes to the satisfaction of the Commissioner that future use of the acquired land in furtherance of the organization's exempt purpose before the expiration of the 10-year period is reasonably certain. In order to satisfy the Commissioner, the organization does not necessarily have to show binding contracts. However, it must at least have a definite plan detailing a specific improvement and a completion date, and some affirmative action toward the fulfillment of such a plan. This information shall be forwarded to the Commissioner of Internal Revenue, Washington, DC 20224, for a ruling at least 90 days before the end of the fifth year after acquisition of the land.

(2) *Actual use*. If the neighborhood land rule is inapplicable because:

(i) The acquired land is not in the neighborhood of other property used by the organization in performance of its exempt purpose, or

(ii) The organization (for the period after the first 5 years of the 10-year period) is unable to establish to the satisfaction of the Commissioner that the use of the acquired land for its exempt purposes within the 10-year period is reasonably certain,

but the land is actually used by the organization in furtherance of its exempt purpose within the 10-year period, such property (subject to the provisions of subparagraph (4) of this paragraph) shall not be treated as debt-financed property for any period prior to such conversion.

(3) *Limitations*—(i) *Demolition or removal required. (a)* Subparagraphs (1) and (2) of this paragraph shall apply with respect to any structure on the land when acquired by the organization, or to the land occupied by the structure, only so long as the intended future use of the land in furtherance of the organization's exempt purpose requires that the structure be demolished or removed in order to use the land in such a manner. Thus, during the first 5 years after acquisition (and for subsequent years if there is a favorable ruling in accordance with subparagraph (1)(iii) of this paragraph) improved property is not debt-financed so long as the organization does not abandon its intent to demolish the existing structures and use the land in furtherance of its exempt purpose. Furthermore, if there is an actual demolition of such structures, the use made of the land need not be the one originally intended. Therefore, the actual use requirement of this subdivision may be satisfied by using the land in any manner which furthers the exempt purpose of the organization.

(b) Subdivision (i)*(a)* of this subparagraph may be illustrated by the following examples. For purposes of the following examples it is assumed that but for the application of the neighborhood land rule such property would be debt-financed property.

Example 1. An exempt university acquires a contiguous tract of land on which there is an apartment building. The university intends to demolish the apartment building and build classrooms and does not abandon this intent during the first 4 years after acquisition. In the fifth year after acquisition it abandons the intent to demolish and sells the apartment building. Under these circumstances, such property is not debt-financed property for the first 4 years after acquisition even though there was no eventual demolition or use made of such land in furtherance of the university's exempt purpose. However, such property is debt-financed property as of the time in the fifth year that the intent to demolish the building is abandoned and any gain on the sale of property is subject to section 514.

Example 2. Assume the facts as stated in Example 1 except that the university did not abandon its intent to demolish the existing building and construct a classroom building until the eighth year after acquisition when it sells the property. Assume further that the university did not receive a favorable ruling in accordance with subparagraph (1)(iii) of this paragraph. Under these circumstances, the building is debt- financed property for the sixth, seventh, and eighth years. It is not, however, treated as debt-financed property for the first 5 years after acquisition.

Example 3. Assume the facts as stated in Example 2 except that the university received a favorable ruling in accordance with subparagraph (1)(iii) of this paragraph. Under these circumstances, the building is not debt-financed property for the first 7 years after acquisition. It only becomes debt-financed property as of the time in the eighth year when the university abandoned its intent to demolish the existing structure.

Example 4. (1) Assume that a university acquires a contiguous tract of land containing an office building for the principal purpose of demolishing the office building and building a modern dormitory. Five years later the dormitory has not been constructed, and the university has failed to satisfy the Commissioner that the office building will be demolished and the land will be used in furtherance of its exempt purpose (and consequently has failed to obtain a favorable ruling under subparagraph (1)(iii) of this paragraph). In the ninth taxable year after acquisition the university converts the office building into an administration building. Under these circumstances, during the sixth, seventh, and eighth years after acquisition, the office building is treated as debt-financed property because the office building was not demolished or removed. Therefore, the income derived from such property during these years shall be subject to the tax on unrelated business income.

(2) Assume that instead of converting the office building to an administration building, the university demolishes the office building in the ninth taxable year after acquisition and then constructs a new administration building. Under these circumstances, the land would not be considered debt-financed property for any period following the acquisition, and the university would be entitled to a refund of taxes paid on the income derived from such property for the sixth through eighth taxable years after the acquisition in accordance with subparagraph (4) of this paragraph.

(ii) *Subsequent construction.* Subparagraphs (1) and (2) of this paragraph do not apply to structures erected on the land after the acquisition of the land.

(iii) *Property subject to business lease.* Subparagraphs (1) and (2) of this paragraph do not apply to property subject to a lease which is a business lease (as defined in §1.514(f)–1) whether the organization acquired the property subject to the lease or whether it executed the lease subsequent to acquisition. If only a portion of the real property is subject to a lease, paragraph (c) of §1.514(f)–1 applies in determining whether such lease is a business lease.

(4) *Refund of taxes.* (i) If an organization has not satisfied the actual use condition of subparagraph (2) of this paragraph or paragraph (e)(3) of this section before the date prescribed by law (including extensions) for filing the return for the taxable year, the tax for such year shall be computed without regard to the application of such actual use condition. However, if:

(a) A credit or refund of any overpayment of taxes is allowable for a prior taxable year as a result of the satisfaction of such actual use condition, and

(b) Such credit or refund is prevented by the operation of any law or rule of law (other than chapter 74, relating to closing agreements and compromises),

such credit or refund may nevertheless be allowed or made, if a claim is filed within 1 year after the close of the taxable year in which such actual use condition is satisfied. For a special rule with respect to the payment of interest at the rate of 4 percent per annum, see section 514(b)(3)(D), prior to its amendment by section 7(b) of the Act of January 3, 1975 (Pub. L. 93–625, 88 Stat. 2115).

(ii) This subparagraph may be illustrated by the following example. For purposes of this example it is assumed that but for the neighborhood land rule such property would be debt-financed property.

Example. Y, a calendar year exempt organization, acquires real property in January 1970, which is contiguous with other property used by Y in furtherance of its exempt purpose. However, Y does not satisfy the Commissioner by January 1975, that the existing structure will be demolished and the land will be used in furtherance of its exempt purpose. In accordance with this subparagraph, from 1975 until the property is converted to an exempt use, the income derived from such property shall be subject to the tax on unrelated business income. During July 1979, Y demolishes the existing structure on the land and begins using the land in furtherance of its exempt purpose. At this time Y may file claims for refund for the open years 1976 through 1978. Further, in accordance with this subparagraph, Y may also file a claim for refund for 1975, even though a claim for such taxable year may be barred by the statute of limitations, provided such claim is filed before the close of 1980.

(e) *Churches*—(1) *In general.* If a church or association or convention of churches acquires real property, for the principal purpose of using the land in the exercise or performance of its exempt purpose, commencing within 15 years of the time of acquisition, such property shall not be treated as debt-financed property so long as the organization does not abandon its intent to use the land in such a manner within the 15-year period.

(2) *Exception.* This paragraph shall not apply to any property after the expiration of the 15-year period. Further, this paragraph shall apply after the first 5 years of the 15-year period only if the church or association or convention of churches establishes to the satisfaction of the Commissioner that use of the acquired land in furtherance of the organization's exempt purpose before the expiration of the 15-year period is reasonably certain. For purposes of the preceding sentence, the rules contained in paragraph (d)(1)(iii) of this section with respect to satisfying the Commissioner that the exempt organization intends to use the land within the prescribed time in furtherance of its exempt purpose shall apply.

(3) *Actual use.* If the church or association or convention of churches for the period after the first 5 years of the 15-year period is unable to establish to the satisfaction of the Commissioner that the use of the acquired land for its exempt purpose within the 15-year period is reasonably certain, but such land is in fact converted to an exempt use within the 15-year period, the land (subject to the provisions of paragraph (d)(4) of this section) shall not be treated as debt-financed property for any period prior to such conversion.

(4) *Limitations.* The limitations stated in paragraph (d)(3)(i) and (ii) of this section shall similarly apply to the rules contained in this paragraph.

[T.D. 7229, 37 FR 28146, Dec. 21, 1972; 39 FR 6607, Feb. 21, 1974, as amended by T.D. 7384, 40 FR 49322, Oct. 22, 1975; T.D. 7632, 44 FR 42681, July 20, 1979; T.D. 7728, 45 FR 72651, Nov. 3, 1980]

§ 1.514(c)–1 Acquisition indebtedness.

(a) *In general*—(1) *Definition of acquisition indebtedness.* For purposes of section 514 and the regulations thereunder, the term *acquisition indebtedness* means, with respect to any debt-financed property, the outstanding amount of:

(i) The principal indebtedness incurred by the organization in acquiring or improving such property.

(ii) The principal indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and

(iii) The principal indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

Whether the incurrence of an indebtedness is reasonably foreseeable depends upon the facts and circumstances of each situation. The fact that an organization did not actually foresee the need for the incurrence of an indebtedness prior to the acquisition or improvement does not necessarily mean that the subsequent incurrence of indebtedness was not reasonably foreseeable.

(2) *Examples.* The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. X, an exempt organization, pledges some of its investment securities with a bank for a loan and uses the proceeds of such loan to purchase an office building which it leases to the public for purposes other than those described in section 514(b)(1) (A), (B), (C), or (D). The outstanding principal indebtedness with respect to the loan constitutes acquisition indebtedness incurred prior to the acquisition which would not have been incurred but for such acquisition.

Example 2. Y, an exempt scientific organization, mortgages its laboratory to replace working capital used in remodeling an office building which Y rents to an insurance company for purposes not described in section 514(b)(1) (A), (B), (C), or (D). The indebtedness is *acquisition indebtedness* since such indebtedness, though incurred subsequent to the improvement of the office building, would not have been incurred but for such improvement, and the indebtedness was reasonably foreseeable when, to make such improvement, Y reduced its working capital below the amount necessary to continue current operations.

Example 3. (a) U, an exempt private preparatory school, as its sole educational facility owns a classroom building which no longer meets the needs of U's students. In 1971, U sells this building for $3 million to Y, a corporation which it does not control. U receives $1 million as a down payment from Y and takes back a purchase money mortgage of $2 million which bears interest at 10 percent per annum. At the time U became the mortgagee of the $2 million purchase money mortgage, U realized that it would have to construct a new classroom building and knew that it would have to incur an indebtedness in the construction of the new classroom building. In 1972, U builds a new classroom building for a cost of $4 million. In connection with the construction of this building, U borrows $2.5 million from X Bank pursuant to a deed of trust bearing interest at 6 percent per annum. Under these circumstances, $2 million of the $2.5 million borrowed to finance construction of the new classroom building would not have been borrowed but for the retention of the $2 million purchase money mortgage. Since such indebtedness was reasonably foreseeable, $2 million of the $2.5 million borrowed to finance the construction of the new classroom building is acquisition indebtedness with respect to the purchase money mortgage and the purchase money mortgage is debt-financed property.

(b) In 1972, U receives $200,000 in interest from Y (10 percent of $2 million) and makes a $150,000 interest payment to X (6 percent of $2.5 million). In addition, assume that for 1972 the debt/basis percentage is 100 percent ($2 million/$2 million). Accordingly, all the interest and all the deductions directly connected with such interest income are to be taken into account in computing unrelated business taxable income. Thus, $200,000 of interest income and $120,000 ($150,000 × $2 million/$2.5 million) of deductions directly connected with such interest income are taken into account. Under these circumstances, U shall include net interest income of $80,000 ($200,000 of income less $120,000 of deductions directly connected with such income) in its unrelated business taxable income for 1972.

Example 4. In 1972 X, an exempt organization, forms a partnership with A and B. The partnership agreement provides that all three partners shall share equally in the profits of the partnership, shall each invest $3 million, and that X shall be a limited partner. X invests $1 million of its own funds in the partnership and $2 million of borrowed funds. The partnership purchases as its sole asset an office building which is leased to the general public for purposes other than those described in section 514(b)(1) (A), (B), (C), or (D). The office building cost the partnership $24 million of which $15 million is borrowed from Y bank. This loan is secured by a mortgage on the entire office building. By agreement with Y bank, X is held not to be personally liable for payment of such mortgage. By reason of section 702(b) the character of any item realized by the partnership and included in the partner's distributive share shall be determined as if the partner realized such item directly from the source from which it was realized by the partnership and in the same manner. Therefore, a portion of X's income from the building is debt-financed income. Under these circumstances, since both the $2 million indebtedness incurred by X in acquiring its partnership interest and $5 million, the allocable portion of the partnership's indebtedness incurred with respect to acquiring the office building which is attributable to X in computing the debt/basis percentage (one-third of $15 million), were incurred in acquiring income-producing property, X has acquisition indebtedness of $7 million ($2 million plus $5 million). Similarly, the allocable portion of the partnership's adjusted basis in the office building which is attributable to X in computing the debt-basis percentage is $8 million (one-third of $24 million). Assuming no payment with respect to either indebtedness and no adjustments to basis in 1972, X's average acquisition indebtedness is $7 million and X's average adjusted basis is $8 million for such year. Therefore, X's debt/basis percentage with respect to its share of the partnership income for 1972 is 87.5 percent ($7 million/$8 million).

(3) *Changes in use of property.* Since property used in a manner described in section 514(b)(1) (A), (B), (C), or (D) is not considered debt-financed property, indebtedness with respect to such property is not acquisition indebtedness. However, if an organization converts such property to a use which is not described in section 514(b)(1) (A), (B), (C), or (D) and such property is otherwise treated as debt-financed property, the outstanding principal indebtedness with respect to such property will thereafter be treated as *acquisition indebtedness.* For example, assume that in 1971 a university borrows funds to acquire an apartment building as housing for married students. In 1974 the university rents the apartment building to the public for purposes not described in section 514(b)(1) (A), (B), (C), or (D). The outstanding principal indebtedness is *acquisition indebtedness* as

of the time in 1974 when the building is first rented to the public.

(4) *Continued indebtedness.* If:

(i) An organization sells or exchanges property, subject to an indebtedness (incurred in a manner described in subparagraph (1) of this paragraph),

(ii) Acquires another property without retiring the indebtedness, and

(iii) The newly acquired property is otherwise treated as debt-financed property,

the outstanding principal indebtedness with respect to the acquired property is *acquisition indebtedness*, even though the original property was not debt-financed property. For example, to house its administrative offices, an exempt organization purchases a building with $600,000 of its own funds and $400,000 of borrowed funds secured by a pledge of its securities. It later sells the building for $1,000,000 without redeeming the pledge. It uses these proceeds to purchase an apartment building which it rents to the public for purposes not described in section 514(b)(1) (A), (B), (C), or (D). The indebtedness of $400,000 is *acquisition indebtedness* with respect to the apartment building even though the office building was not debt-financed property.

(5) *Indebtedness incurred before June 28, 1966.* For taxable years beginning before January 1, 1972, *acquisition indebtedness* does not include any indebtedness incurred before June 28, 1966, unless such indebtedness was incurred on rental real property subject to a business lease and such indebtedness constituted business lease indebtedness. Furthermore, in the case of a church or convention or association of churches, the preceding sentence applies without regard to whether the indebtedness incurred before June 28, 1966, constituted business lease indebtedness.

(b) *Property acquired subject to lien*—(1) *Mortgages.* Except as provided in subparagraphs (3) and (4) of this paragraph, whenever property is acquired subject to a mortgage, the amount of the outstanding principal indebtedness secured by such mortgage is treated as *acquisition indebtedness* with respect to such property even though the organization did not assume or agree to pay such indebtedness. The preceding sentence applies whether property is acquired by purchase, gift, devise, bequest, or any other means. Thus, for example, assume that an exempt organization pays $50,000 for real property valued at $150,000 and subject to a $100,000 mortgage. The $100,000 of outstanding principal indebtedness is *acquisition indebtedness* just as though the organization had borrowed $100,000 to buy the property.

(2) *Other liens.* For purposes of this paragraph, liens similar to mortgages shall be treated as mortgages. A lien is similar to a mortgage if title to property is encumbered by the lien for the benefit of a creditor. However, in the case where State law provides that a tax lien attaches to property prior to the time when such lien becomes due and payable, such lien shall not be treated as similar to a mortgage until after it has become due and payable and the organization has had an opportunity to pay such lien in accordance with State law. Liens similar to mortgages include (but are not limited to):

(i) Deeds of trust,

(ii) Conditional sales contracts,

(iii) Chattel mortgages,

(iv) Security interests under the Uniform Commercial Code,

(v) Pledges,

(vi) Agreements to hold title in escrow, and

(vii) Tax liens (other than those described in the third sentence of this subparagraph).

(3) *Certain encumbered property acquired by gift, bequest or devise*—(i) *Bequest or devise.* Where property subject to a mortgage is acquired by an organization by bequest or devise, the outstanding principal indebtedness secured by such mortgage is not to be treated as *acquisition indebtedness* during the 10-year period following the date of acquisition. For purposes of the preceding sentence, the date of acquisition is the date the organization receives the property.

(ii) *Gifts.* If an organization acquires property by gift subject to a mortgage, the outstanding principal indebtedness secured by such mortgage shall not be treated as *acquisition indebtedness* during the 10-year period following the date of such gift, so long as:

(a) The mortgage was placed on the property more than 5 years before the date of the gift, and

(b) The property was held by the donor for more than 5 years before the date of the gift.

For purposes of the preceding sentence, the date of the gift is the date the organization receives the property.

(iii) *Limitation.* Subdivisions (i) and (ii) of this subparagraph shall not apply if:

(a) The organization assumes and agrees to pay all or any part of the indebtedness secured by the mortgage, or

(b) The organization makes any payment for the equity owned by the decedent or the donor in the property (other than a payment pursuant to an annuity excluded from the definition of *acquisition indebtedness* by paragraph (e) of this section).

Whether an organization has assumed and agreed to pay all or any part of an indebtedness in order to acquire the property shall be determined by the facts and circumstances of each situation.

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

Example 1. A dies on January 1, 1971. His will devises an office building subject to a mortgage to U, an exempt organization described in section 501(c)(3). U does not at any time assume the mortgage. For the period 1971 through 1980, the outstanding principal indebtedness secured by the mortgage is not acquisition indebtedness. However, after December 31, 1980, the outstanding principal indebtedness secured by the mortgage is acquisition indebtedness if the building is otherwise treated as debt-financed property.

Example 2. Assume the facts as stated in example 1 except that on January 1, 1975, U assumes the mortgage. After January 1, 1975, the outstanding principal indebtedness secured by the mortgage is acquisition indebtedness if the building is otherwise treated as debt-financed property.

(4) *Bargain sale before October 9, 1969.* Where property subject to a mortgage is acquired by an organization before October 9, 1969, the outstanding principal indebtedness secured by such mortgage is not to be treated as *acquisition indebtedness* during the 10-year period following the date of acquisition if:

(i) The mortgage was placed on the property more than 5 years before the purchase, and

(ii) The organization paid the seller a total amount no greater than the amount of the seller's cost (including attorney's fees) directly related to the transfer of such property to the organization, but in any event no more than 10 percent of the value of the seller's equity in the property transferred.

(c) *Extension of obligations*—(1) *In general.* An extension, renewal, or refinancing of an obligation evidencing a preexisting indebtedness is considered as a continuation of the old indebtedness to the extent the outstanding principal amount thereof is not increased. Where the principal amount of the modified obligation exceeds the outstanding principal amount of the preexisting indebtedness, the excess shall be treated as a separate indebtedness for purposes of section 514 and the regulations thereunder. For example, if the interest rate on an obligation incurred prior to June 28, 1966, by an exempt university is modified subsequent to such date, the modified obligation shall be deemed to have been incurred prior to June 28, 1966. Thus, such an indebtedness will not be treated as acquisition indebtedness for taxable years beginning before January 1, 1972, unless the original indebtedness was business lease indebtedness (as defined in §1.514(g)–1).

(2) *Extension or renewal.* In general, any modification or substitution of the terms of an obligation by the organization shall be an extension or renewal of the original obligation, rather than the creation of a new indebtedness to the extent that the outstanding principal amount of the indebtedness is not increased. The following are examples of acts which result in the extension or renewal of an obligation:

(i) Substitution of liens to secure the obligation;

(ii) Substitution of obligees, whether or not with the consent of the organization;

(iii) Renewal, extension or acceleration of the payment terms of the obligation; and

(iv) Addition, deletion, or substitution of sureties or other primary or secondary obligors.

(3) *Allocation.* In cases where the outstanding principal amount of the modified obligation exceeds the outstanding principal amount of the unmodified obligation and only a portion of such refinanced indebtedness is to be treated as acquisition indebtedness, payments on the amount of the refinanced indebtedness shall be apportioned prorata between the amount of the preexisting indebtedness and the excess amount. For example, assume that an organization has an outstanding principal indebtedness of $500,000 which is treated as acquisition indebtedness. It borrows another $100,000, which is not acquisition indebtedness, from the same lending institution and gives the lender a $600,000 note for its total obligation. In this situation, a payment of $60,000 on the amount of the total obligation would reduce the acquisition indebtedness by $50,000 and the excess indebtedness by $10,000.

(d) *Indebtedness incurred in performing exempt purpose. Acquisition indebtedness* does not include the incurrence of an indebtedness inherent in the performance or exercise of the purpose or function constituting the basis of the organization's exemption. Thus, *acquisition indebtedness* does not include the indebtedness incurred by an exempt credit union in accepting deposits from its members or the obligation incurred by an exempt organization in accepting payments from its members to provide such members with insurance, retirement or other similar benefits.

(e) *Annuities*—(1) *Requirements.* The obligation to make payment of an annuity is not *acquisition indebtedness* if the annuity meets all the following requirements:

(i) It must be the sole consideration (other than a mortgage to which paragraph (b)(3) of this section applies) issued in exchange for the property acquired;

(ii) At the time of the exchange, the present value of the annuity (determined in accordance with subparagraph (2) of this paragraph) must be less than 90 percent of the value of the prior owner's equity in the property received in the exchange;

(iii) The annuity must be payable over the life of one individual in being at the time the annuity is issued, or over the lives of two individuals in being at such time; and

(iv) The annuity must be payable under a contract which:

(a) Does not guarantee a minimum number of payments or specify a maximum number of payments, and

(b) Does not provide for any adjustment of the amount of the annuity payments by reference to the income received from the transferred property or any other property.

(2) *Valuation.* For purposes of this paragraph, the value of an annuity at the time of exchange shall be computed in accordance with section 1011(b), § 1.1011–2(e)(1)(iii)*(b)*(2), and section 3 of Rev. Rul. 62–216, C.B. 1962–2, 30.

(3) *Examples.* The application of this paragraph may be illustrated by the following examples. For purposes of these examples it is assumed that the property transferred is used for purposes other than those described in section 514(b)(1) (A), (B), (C), or (D).

Example 1. On January 1, 1971, X, an exempt organization, receives property valued at $100,000 from donor A, a male aged 60. In return X promises to pay A $6,000 a year for the rest of A's life, with neither a minimum nor maximum number of payments specified. The annuity is payble on December 31, of each year. The amounts paid under the annuity are not dependent on the income derived from the property transferred to X. The present value of this annuity is $81,156, determined in accordance with Table A of Rev. Rul. 62–216. Since the value of the annuity is less than 90 percent of A's equity in the property transferred and the annuity meets all the other requirements of subparagraph (1) of this paragraph, the obligation to make annuity payments is not acquisition indebtedness.

Example 2. On January 1, 1971, B transfers an office building to Y, an exempt university, subject to a mortgage. In return Y agrees to pay B $5,000 a year for the rest of his life, with neither a minimum nor maximum number of payments specified. The amounts paid under the annuity are not dependent on the income derived from the property transferred to Y. It is determined that the actual value of the annuity is less than 90 percent of the value of B's equity in the property transferred. Y does not assume the mortgage. For the taxable years 1971 through 1980, the outstanding principal indebtedness secured by the mortgage is not treated as acquisition indebtedness. Further, Y's obligation to make annuity payments to B never constitutes acquisition indebtedness.

(f) *Certain Federal financing. Acquisition indebtedness* does not include an obligation to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons to the extent that it is insured by the Federal Housing Administration. Thus, for example, to the extent that an obligation is insured by the Federal Housing Administration under section 221(d)(3) (12 U.S.C. 1715(I)(d)(3)) or section 236 (12 U.S.C. 1715z–1) of title II of the National Housing Act, as amended, the obligation is not *acquisition indebtedness.*

(g) *Certain obligations of charitable remainder trusts.* For purposes of section 664(c) and §1.664–1(c), a charitable remainder trust (as defined in §1.664–1(a)(1)(iii)*(a)* does not incur *acquisition indebtedness* when the sole consideration it is required to pay in exchange for unencumbered property is an *annuity amount* or a *unitrust amount* (as defined in §1.664–1(a)(1)(iii)*(b)* and *(c)*).

[T.D. 7229, 37 FR 28151, Dec. 21, 1972; 38 FR 21918, Aug. 14, 1973; T.D. 7698, 45 FR 33973, May 21, 1980]

§1.514(c)–2 Permitted allocations under section 514(c)(9)(E).

(a) *Table of contents.* This paragraph contains a listing of the major headings of this §1.514(c)–2.

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(b) *Application of section 514(c)(9)(E), relating to debt-financed real property* *held by partnerships*—(1) *In general.* This § 1.514(c)–2 provides rules governing the application of section 514(c)(9)(E). To comply with section 514(c)(9)(E), the following two requirements must be met:

(i) *The fractions rule.* The allocation of items to a partner that is a qualified organization cannot result in that partner having a percentage share of overall partnership income for any partnership taxable year greater than that partner's fractions rule percentage (as defined in paragraph (c)(2) of this section).

(ii) *Substantial economic effect.* Each partnership allocation must have substantial economic effect. However, allocations that cannot have economic effect must be deemed to be in accordance with the partners' interests in the partnership pursuant to § 1.704–1(b)(4), or (if § 1.704–1(b)(4) does not provide a method for deeming the allocations to be in accordance with the partners' interests in the partnership) must otherwise comply with the requirements of § 1.704–1(b)(4). Allocations attributable to nonrecourse liabilities or partner nonrecourse debt must comply with the requirements of § 1.704–2(e) or § 1.704–2(i).

(2) *Manner in which fractions rule is applied*—(i) *In general.* A partnership must satisfy the fractions rule both on a prospective basis and on an actual basis for each taxable year of the partnership, commencing with the first taxable year of the partnership in which the partnership holds debt-financed real property and has a qualified organization as a partner. Generally, a partnership does not qualify for the unrelated business income tax exception provided by section 514(c)(9)(A) for any taxable year of its existence unless it satisfies the fractions rule for every year the fractions rule applies. However, if an actual allocation described in paragraph (e)(4), (h), (j)(2), or (m)(1)(ii) of this section (regarding certain allocations that are disregarded or not taken into account for purposes of the fractions rule until an actual allocation is made) causes the partnership to violate the fractions rule, the partnership ordinarily is treated as violating the fractions rule only for the taxable year of the actual allocation and subsequent taxable years. For purposes of applying the fractions rule, the term *partnership agreement* is defined in accordance with § 1.704–1(b)(2)(ii)(*h*), and informal understandings are considered part of the partnership agreement in appropriate circumstances. See paragraph (k) of this section for rules relating to changes in the partners' interests and *de minimis* exceptions to the fractions rule.

(ii) *Subsequent changes.* A subsequent change to a partnership agreement that causes the partnership to violate the fractions rule ordinarily causes the partnership's income to fail the exception provided by section 514(c)(9)(A) only for the taxable year of the change and subsequent taxable years.

(c) *General definitions*—(1) *Overall partnership income and loss.* Overall partnership income is the amount by which the aggregate items of partnership income and gain for the taxable year exceed the aggregate items of partnership loss and deduction for the year. Overall partnership loss is the amount by which the aggregate items of partnership loss and deduction for the taxable year exceed the aggregate items of partnership income and gain for the year.

(i) *Items taken into account in determining overall partnership income and loss.* Except as otherwise provided in this section, the partnership items that are included in computing overall partnership income or loss are those items of income, gain, loss, and deduction (including expenditures described in section 705(a)(2)(B)) that increase or decrease the partners' capital accounts under § 1.704–1(b)(2)(iv). Tax items allocable pursuant to section 704(c) or § 1.704–1(b)(2)(iv)(*f*)(*4*) are not included in computing overall partnership income or loss. Nonetheless, allocations pursuant to section 704(c) or § 1.704–1(b)(2)(iv)(*f*)(*4*) may be relevant in determining that this section is being applied in a manner that is inconsistent with the fractions rule. See paragraph (k)(4) of this section.

(ii) *Guaranteed payments to qualified organizations.* Except to the extent otherwise provided in paragraph (d) of this section—

(A) A guaranteed payment to a qualified organization is not treated as an item of partnership loss or deduction in computing overall partnership income or loss; and

(B) Income that a qualified organization may receive or accrue with respect to a guaranteed payment is treated as an allocable share of overall partnership income or loss for purposes of the fractions rule.

(2) *Fractions rule percentage.* A qualified organization's fractions rule percentage is that partner's percentage share of overall partnership loss for the partnership taxable year for which that partner's percentage share of overall partnership loss will be the smallest.

(3) *Definitions of certain terms by cross reference to partnership regulations. Minimum gain chargeback, nonrecourse deduction, nonrecourse liability, partner nonrecourse debt, partner nonrecourse debt minimum gain, partner nonrecourse debt minimum gain chargeback, partner nonrecourse deduction,* and *partnership minimum gain* have the meanings provided in §1.704–2.

(4) *Example.* The following example illustrates the provisions of this paragraph (c).

Example. Computation of overall partnership income and loss for a taxable year. (i) Taxable corporation TP and qualified organization QO form a partnership to own and operate encumbered real property. Under the partnership agreement, all items of income, gain, loss, deduction, and credit are allocated 50 percent to TP and 50 percent to QO. Neither partner is entitled to a preferred return. However, the partnership agreement provides for a $900 guaranteed payment for services to QO in each of the partnership's first two taxable years. No part of the guaranteed payments qualify as a reasonable guaranteed payment under paragraph (d) of this section.

(ii) The partnership violates the fractions rule. Due to the existence of the guaranteed payment, QO's percentage share of any overall partnership income in the first two years will exceed QO's fractions rule percentage. For example, the partnership might have bottom-line net income of $5,100 in its first taxable year that is comprised of $10,000 of rental income, $4,000 of salary expense, and the $900 guaranteed payment to QO. The guaranteed payment would not be treated as an item of deduction in computing overall partnership income or loss because it does not qualify as a reasonable guaranteed payment. See paragraph (c)(1)(ii)(A) of this section. Accordingly, overall partnership income for the year would be $6,000, which would consist of $10,000 of rental income less $4,000 of salary expense. See paragraph (c)(1)(i) of this section. The $900 QO would include in income with respect to the guaranteed payment would be treated as an allocable share of the $6,000 of overall partnership income. See paragraph (c)(1)(ii)(B) of this section. Therefore, QO's allocable share of the overall partnership income for the year would be $3,450, which would be comprised of the $900 of income pertaining to QO's guaranteed payment, plus QO's $2,550 allocable share of the partnership's net income for the year (50 percent of $5,100). QO's $3,450 allocable share of overall partnership income would equal 58 percent of the $6,000 of overall partnership income and would exceed QO's fractions rule percentage, which is less than 50 percent. (If there were no guaranteed payment, QO's fractions rule percentage would be 50 percent. However, the existence of the guaranteed payment to QO that is not disregarded for purposes of the fractions rule pursuant to paragraph (d) of this section means that QO's fractions rule percentage is less than 50 percent.)

(d) *Exclusion of reasonable preferred returns and guaranteed payments*—(1) *Overview.* This paragraph (d) sets forth requirements for disregarding reasonable preferred returns for capital and reasonable guaranteed payments for capital or services for purposes of the fractions rule. To qualify, the preferred return or guaranteed payment must be set forth in a binding, written partnership agreement.

(2) *Preferred returns.* Items of income (including gross income) and gain that may be allocated to a partner with respect to a current or cumulative reasonable preferred return for capital (including allocations of minimum gain attributable to nonrecourse liability (or partner nonrecourse debt) proceeds distributed to the partner as a reasonable preferred return) are disregarded in computing overall partnership income or loss for purposes of the fractions rule. Similarly, if a partnership agreement effects a reasonable preferred return with an allocation of what would otherwise be overall partnership income, those items comprising that allocation are disregarded in computing overall partnership income for purposes of the fractions rule.

(3) *Guaranteed payments.* A current or cumulative reasonable guaranteed payment to a qualified organization for

capital or services is treated as an item of deduction in computing overall partnership income or loss, and the income that the qualified organization may receive or accrue from the current or cumulative reasonable guaranteed payment is not treated as an allocable share of overall partnership income or loss. The treatment of a guaranteed payment as reasonable for purposes of section 514(c)(9)(E) does not affect its possible characterization as unrelated business taxable income under other provisions of the Internal Revenue Code.

(4) *Reasonable amount*—(i) *In general.* A guaranteed payment for services is reasonable only to the extent the amount of the payment is reasonable under §1.162–7 (relating to the deduction of compensation for personal services). A preferred return or guaranteed payment for capital is reasonable only to the extent it is computed, with respect to unreturned capital, at a rate that is commercially reasonable based on the relevant facts and circumstances.

(ii) *Safe harbor.* For purposes of this paragraph (d)(4), a rate is deemed to be commercially reasonable if it is no greater than four percentage points more than, or if it is no greater than 150 percent of, the highest long-term applicable federal rate (AFR) within the meaning of section 1274(d), for the month the partner's right to a preferred return or guaranteed payment is first established or for any month in the partnership taxable year for which the return or payment on capital is computed. A rate in excess of the rates described in the preceding sentence may be commercially reasonable, based on the relevant facts and circumstances.

(5) *Unreturned capital*—(i) *In general.* Unreturned capital is computed on a weighted-average basis and equals the excess of—

(A) The amount of money and the fair market value of property contributed by the partner to the partnership (net of liabilities assumed, or taken subject to, by the partnership); over

(B) The amount of money and the fair market value of property (net of liabilities assumed, or taken subject to, by the partner) distributed by the partnership to the partner as a return of capital.

(ii) *Return of capital.* In determining whether a distribution constitutes a return of capital, all relevant facts and circumstances are taken into account. However, the designation of distributions in a written partnership agreement generally will be respected in determining whether a distribution constitutes a return of capital, so long as the designation is economically reasonable.

(6) *Timing rules—*(i) *Limitation on allocations of income with respect to reasonable preferred returns for capital.* Items of income and gain (or part of what would otherwise be overall partnership income) that may be allocated to a partner in a taxable year with respect to a reasonable preferred return for capital are disregarded for purposes of the fractions rule only to the extent the allocable amount will not exceed—

(A) The aggregate of the amount that has been distributed to the partner as a reasonable preferred return for the taxable year of the allocation and prior taxable years, on or before the due date (not including extensions) for filing the partnership's return for the taxable year of the allocation; minus

(B) The aggregate amount of corresponding income and gain (and what would otherwise be overall partnership income) allocated to the partner in all prior years.

(ii) *Reasonable guaranteed payments may be deducted only when paid in cash.* If a partnership that avails itself of paragraph (d)(3) of this section would otherwise be required (by virtue of its method of accounting) to deduct a reasonable guaranteed payment to a qualified organization earlier than the taxable year in which it is paid in cash, the partnership must delay the deduction of the guaranteed payment until the taxable year it is paid in cash. For purposes of this paragraph (d)(6)(ii), a guaranteed payment that is paid in cash on or before the due date (not including extensions) for filing the partnership's return for a taxable year may be treated as paid in that prior taxable year.

(7) *Examples.* The following examples illustrate the provisions of this paragraph (d).

Facts. Qualified organization QO and taxable corporation TP form a partnership. QO contributes $9,000 to the partnership and TP contributes $1,000. The partnership borrows $50,000 from a third party lender and purchases an office building for $55,000. At all relevant times the safe harbor rate described in paragraph (d)(4)(ii) of this section equals 10 percent.

Example 1. Allocations made with respect to preferred returns. (i) The partnership agreement provides that in each taxable year the partnership's *distributable cash* is first to be distributed to QO as a 10 percent preferred return on its unreturned capital. To the extent the partnership has insufficient cash to pay QO its preferred return in any taxable year, the preferred return is compounded (at 10 percent) and is to be paid in future years to the extent the partnership has distributable cash. The partnership agreement first allocates gross income and gain 100 percent to QO, to the extent cash has been distributed to QO as a preferred return. All remaining profit or loss is allocated 50 percent to QO and 50 percent to TP.

(ii) The partnership satisfies the fractions rule. Items of income and gain that may be specially allocated to QO with respect to its preferred return are disregarded in computing overall partnership income or loss for purposes of the fractions rule because the requirements of paragraph (d) of this section are satisfied. After disregarding those allocations, QO's fractions rule percentage is 50 percent (see paragraph (c)(2) of this section), and under the partnership agreement QO may not be allocated more than 50 percent of overall partnership income in any taxable year.

(iii) The facts are the same as in paragraph (i) of this *Example 1,* except that QO's preferred return is computed on unreturned capital at a rate that exceeds a commercially reasonable rate. The partnership violates the fractions rule. The income and gain that may be specially allocated to QO with respect to the preferred return is not disregarded in computing overall partnership income or loss to the extent it exceeds a commercially reasonable rate. See paragraph (d) of this section. As a result, QO's fractions rule percentage is less than 50 percent (see paragraph (c)(2) of this section), and allocations of income and gain to QO with respect to its preferred return could result in QO being allocated more than 50 percent of the overall partnership income in a taxable year.

Example 2. Guaranteed payments and the computation of overall partnership income or loss. (i) The partnership agreement allocates all bottom-line partnership income and loss 50 percent to QO and 50 percent to TP throughout the life of the partnership. The partnership agreement provides that QO is entitled each year to a 10 percent guaranteed payment on unreturned capital. To the extent the partnership is unable to make a guaranteed payment in any taxable year, the unpaid amount is compounded at 10 percent and is to be paid in future years.

(ii) Assuming the requirements of paragraph (d)(6)(ii) of this section are met, the partnership satisfies the fractions rule. The guaranteed payment is disregarded for purposes of the fractions rule because it is computed with respect to unreturned capital at the safe harbor rate described in paragraph (d)(4)(ii) of this section. Therefore, the guaranteed payment is treated as an item of deduction in computing overall partnership income or loss, and the corresponding income that QO may receive or accrue with respect to the guaranteed payment is not treated as an allocable share of overall partnership income or loss. See paragraph (d)(3) of this section. Accordingly, QO's fractions rule percentage is 50 percent (see paragraph (c)(2) of this section), and under the partnership agreement QO may not be allocated more than 50 percent of overall partnership income in any taxable year.

(e) *Chargebacks and offsets*—(1) *In general.* The following allocations are disregarded in computing overall partnership income or loss for purposes of the fractions rule—

(i) Allocations of what would otherwise be overall partnership income that may be made to chargeback (i.e., reverse) prior disproportionately large allocations of overall partnership loss (or part of the overall partnership loss) to a qualified organization, and allocations of what would otherwise be overall partnership loss that may be made to chargeback prior disproportionately small allocations of overall partnership income (or part of the overall partnership income) to a qualified organization;

(ii) Allocations of income or gain that may be made to a partner pursuant to a minimum gain chargeback attributable to prior allocations of nonrecourse deductions to the partner;

(iii) Allocations of income or gain that may be made to a partner pursuant to a minimum gain chargeback attributable to prior allocations of partner nonrecourse deductions to the partner and allocations of income or gain that may be made to other partners to chargeback compensating allocations of other losses, deductions, or section 705(a)(2)(B) expenditures to the other partners; and

(iv) Allocations of items of income or gain that may be made to a partner pursuant to a qualified income offset, within the meaning of § 1.704–1(b)(2)(ii)(*d*).

(2) *Disproportionate allocations*—(i) *In general.* To qualify under paragraph (e)(1)(i) of this section, prior disproportionate allocations may be reversed in full or in part, and in any order, but must be reversed in the same ratio as originally made. A prior allocation is disproportionately large if the qualified organization's percentage share of that allocation exceeds its fractions rule percentage. A prior allocation is disproportionately small if the qualified organization's percentage share of that allocation is less than its fractions rule percentage. However, a prior allocation (or allocations) is not considered disproportionate unless the balance of the overall partnership income or loss for the taxable year of the allocation is allocated in a manner that would independently satisfy the fractions rule.

(ii) *Limitation on chargebacks of partial allocations.* Except in the case of a chargeback allocation pursuant to paragraph (e)(4) of this section, and except as otherwise provided by the Internal Revenue Service by revenue ruling, revenue procedure, or, on a case-by-case basis, by letter ruling, paragraph (e)(1)(i) of this section applies to a chargeback of an allocation of part of the overall partnership income or loss only if that part consists of a pro rata portion of each item of partnership income, gain, loss, and deduction (other than nonrecourse deductions, as well as partner nonrecourse deductions and compensating allocations) that is included in computing overall partnership income or loss.

(3) *Minimum gain chargebacks attributable to nonrecourse deductions.* Commencing with the first taxable year of the partnership in which a minimum gain chargeback (or partner nonrecourse debt minimum gain chargeback) occurs, a chargeback to a partner is attributable to nonrecourse deductions (or separately, on a debt-by-debt basis, to partner nonrecourse deductions) in the same proportion that the partner's percentage share of the partnership minimum gain (or separately, on a debt-by-debt basis, the partner nonrecourse debt minimum gain) at the end of the immediately preceding taxable year is attributable to nonrecourse deductions (or partner nonrecourse deductions). The partnership must determine the extent to which a partner's percentage share of the partnership minimum gain (or partner nonrecourse debt minimum gain) is attributable to deductions in a reasonable and consistent manner. For example, in those cases in which none of the exceptions contained in § 1.704–2(f) (2) through (5) are relevant, a partner's percentage share of the partnership minimum gain generally is attributable to nonrecourse deductions in the same ratio that—

(i) The aggregate amount of the nonrecourse deductions previously allocated to the partner but not charged back in prior taxable years; bears to

(ii) The sum of the amount described in paragraph (e)(3)(i) of this section, plus the aggregate amount of distributions previously made to the partner of proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain but not charged back in prior taxable years.

(4) *Minimum gain chargebacks attributable to distribution of nonrecourse debt proceeds*—(i) *Chargebacks disregarded until allocations made.* Allocations of items of income and gain that may be made pursuant to a provision in the partnership agreement that charges back minimum gain attributable to the distribution of proceeds of a nonrecourse liability (or a partner nonrecourse debt) are taken into account for purposes of the fractions rule only to the extent an allocation is made. (See paragraph (d)(2) of this section, pursuant to which there is permanently excluded chargeback allocations of minimum gain that are attributable to proceeds distributed as a reasonable preferred return.)

(ii) *Certain minimum gain chargebacks related to returns of capital.* Allocations of items of income or gain that (in accordance with § 1.704–2(f)(1)) may be made to a partner pursuant to a minimum gain chargeback attributable to the distribution of proceeds of a nonrecourse liability are disregarded in computing overall partnership income or loss for purposes of the fractions rule to the extent that the allocations (subject to the requirements of paragraph (e)(2) of this section) also charge back prior disproportionately large allocations of overall partnership loss (or part of the overall partnership loss) to a qualified organization. This exception applies only to the extent the disproportionately large allocation consisted of depreciation from real property (other than items of nonrecourse deduction or partner nonrecourse deduction) that subsequently was used to secure the nonrecourse liability providing the distributed proceeds, and only if those proceeds were distributed as a return of capital and in the same proportion as the disproportionately large allocation.

(5) *Examples.* The following examples illustrate the provisions of this paragraph (e).

Example 1. Chargebacks of disproportionately large allocations of overall partnership loss. (i) Qualified organization QO and taxable corporation TP form a partnership. QO contributes $900 to the partnership and TP contributes $100. The partnership agreement allocates overall partnership loss 50 percent to QO and 50 percent to TP until TP's capital account is reduced to zero; then 100 percent to QO until QO's capital account is reduced to zero; and thereafter 50 percent to QO and 50 percent to TP. *Overall partnership income* is allocated first 100 percent to QO to chargeback overall partnership loss allocated 100 percent to QO, and thereafter 50 percent to QO and 50 percent to TP.

(ii) The partnership satisfies the fractions rule. QO's fractions rule percentage is 50 percent. See paragraph (c)(2) of this section. Therefore, the 100 percent allocation of overall partnership loss to QO is disproportionately large. See paragraph (e)(2)(i) of this section. Accordingly, the 100 percent allocation to QO of what would otherwise be overall partnership income (if it were not disregarded), which charges back the disproportionately large allocation of overall partnership loss, is disregarded in computing overall partnership income and loss for purposes of the fractions rule. The 100 percent allocation is in the same ratio as the disproportionately large loss allocation, and the rest of the allocations for the taxable year of the disproportionately large loss allocation will independently satisfy the fractions rule. See paragraph (e)(2)(i) of this section. After disregarding the chargeback allocation of 100 percent of what would otherwise be overall partnership income, QO will not be allocated a percentage share of overall partnership income in excess of its fractions rule percentage for any taxable year.

Example 2. Chargebacks of disproportionately small allocations of overall partnership income. (i) Qualified organization QO and taxable corporation TP form a partnership. QO contributes $900 to the partnership and TP contributes $100. The partnership purchases real property with money contributed by its partners and with money borrowed by the partnership on a recourse basis. In any year, the partnership agreement allocates the first $500 of overall partnership income 50 percent to QO and 50 percent to TP; the next $100 of overall partnership income 100 percent to TP (as an incentive for TP to achieve significant profitability in managing the partnership's operations); and all remaining overall partnership income 50 percent to QO and 50 percent to TP. *Overall partnership loss* is allocated first 100 percent to TP to chargeback overall partnership income allocated 100 percent to TP at any time in the prior three years and not reversed; and thereafter 50 percent to QO and 50 percent to TP.

(ii) The partnership satisfies the fractions rule. QO's fractions rule percentage is 50 percent because qualifying chargebacks are disregarded pursuant to paragraph (e)(1)(i) in computing overall partnership income or loss. See paragraph (c)(2) of this section. The zero percent allocation to QO of what would otherwise be overall partnership loss is a qualifying chargeback that is disregarded because it is in the same ratio as the income allocation it charges back, because the rest of the allocations for the taxable year of that income allocation will independently satisfy the fractions rule (see paragraph (e)(2)(i) of this section), and because it charges back an allocation of zero overall partnership income to QO, which is proportionately smaller (i.e., disproportionately small) than QO's 50 percent fractions rule percentage. After disregarding the chargeback allocation of 100 percent of what would otherwise be overall partnership loss, QO will not be allocated a percentage share of overall partnership income in excess of its fractions rule percentage for any taxable year.

Example 3. Chargebacks of partner nonrecourse deductions and compensating allocations of other items. (i) Qualified organization QO and taxable corporation TP form a partnership to own and operate encumbered real property. QO and TP each contribute $500 to the partnership. In addition, QO makes a $300 nonrecourse loan to the partnership. The partnership agreement contains a partner nonrecourse debt minimum gain chargeback provision and a provision that allocates partner nonrecourse deductions to the partner who bears the economic burden of the deductions in accordance with §1.704–2. The partnership agreement also provides that to the extent partner nonrecourse deductions are allocated to QO in any taxable year, other compensating items of partnership loss or deduction (and, if appropriate, section 705(a)(2)(B) expenditures) will first be allocated 100 percent to TP. In addition, to the extent items of income or gain are allocated to QO in any taxable year pursuant to a partner nonrecourse debt minimum gain chargeback of deductions, items of partnership income and gain will first be allocated 100 percent to TP. The partnership agreement allocates all other overall partnership income or loss 50 percent to QO and 50 percent to TP.

(ii) The partnership satisfies the fractions rule on a prospective basis. The allocations of the partner nonrecourse deductions and the compensating allocation of other items of loss, deduction, and expenditure that may be made to TP (but which will not be made unless there is an allocation of partner nonrecourse deductions to QO) are not taken into account for purposes of the fractions rule until a taxable year in which an allocation is made. See paragraph (j)(1) of this section. In addition, partner nonrecourse debt minimum gain chargebacks of deductions and allocations of income or gain to other partners that chargeback compensating allocations of other deductions are disregarded in computing overall partnership income or loss for purposes of the fractions rule. See paragraph (e)(1)(iii) of this section. Since all other overall partnership income and loss is allocated 50 percent to QO and 50 percent to TP, QO's fractions rule percentage is 50 percent (see paragraph (c)(2) of this section), and QO will not be allocated a percentage share of overall partnership income in excess of its fractions rule percentage for any taxable year.

(iii) The facts are the same as in paragraph (i) of this *Example 3,* except that the partnership agreement provides that compensating allocations of loss or deduction (and section 705(a)(2)(B) expenditures) to TP will not be charged back until year 10. The partners expect $300 of partner nonrecourse deductions to be allocated to QO in year 1 and $300 of income or gain to be allocated to QO in year 2 pursuant to the partner nonrecourse debt minimum gain chargeback provision.

(iv) The partnership fails to satisfy the fractions rule on a prospective basis under the anti-abuse rule of paragraph (k)(4) of this section. If the partners' expectations prove correct, at the end of year 2, QO will have been allocated $300 of partner nonrecourse deductions and an offsetting $300 of partner nonrecourse debt minimum gain. However, the $300 of compensating deductions and losses that may be allocated to TP will not be charged back until year 10. Thus, during the period beginning at the end of year 2 and ending eight years later, there may be $300 more of unreversed deductions and losses allocated to TP than to QO, which would be inconsistent with the purpose of the fractions rule.

Example 4. Minimum gain chargeback attributable to distributions of nonrecourse debt proceeds. (i) Qualified organization QO and taxable corporation TP form a partnership. QO contributes $900 to the partnership and TP contributes $100. The partnership agreement generally allocates overall partnership income and loss 90 percent to QO and 10 percent to TP. However, the partnership agreement contains a minimum gain chargeback provision, and also provides that in any partnership taxable year in which there is a chargeback of partnership minimum gain to QO attributable to distributions of proceeds of nonrecourse liabilities, all other items comprising overall partnership income or loss will be allocated in a manner such that QO is not allocated more than 90 percent of the overall partnership income for the year.

(ii) The partnership satisfies the fractions rule on a prospective basis. QO's fractions rule percentage is 90 percent. See paragraph (c)(2) of this section. The chargeback that may be made to QO of minimum gain attributable to distributions of nonrecourse liability proceeds is taken into account for purposes of the fractions rule only to the extent an allocation is made. See paragraph (e)(4) of this section. Accordingly, that potential allocation to QO is disregarded in applying the fractions rule on a prospective basis (see paragraph (b)(2) of this section), and QO is treated as not being allocated a percentage share of overall partnership income in excess of its fractions rule percentage in any taxable year. (Similarly, QO is treated as not being allocated items of income or gain in a taxable year when the partnership has an overall partnership loss.)

(iii) In year 3, the partnership borrows $400 on a nonrecourse basis and distributes it to QO as a return of capital. In year 8, the partnership has $400 of gross income and cash flow and $300 of overall partnership income, and the partnership repays the $400 nonrecourse borrowing.

(iv) The partnership violates the fractions rule for year 8 and all future years. Pursuant to the minimum gain chargeback provision, the entire $400 of partnership gross income is allocated to QO. Accordingly, notwithstanding the curative provision in the partnership agreement that would allocate to TP the next $44 (($400÷.9)×10%) of income and gain included in computing overall partnership income, the partnership has no other items of income and gain to allocate to QO. Because the $400 of gross income actually allocated to QO is taken into account for purposes of the fractions rule in the year an allocation is made (see paragraph (e)(4) of this section), QO's percentage share of overall partnership income in year 8 is greater than 100 percent. Since this exceeds QO's fractions rule percentage (i.e., 90 percent), the partnership violates the fractions rule for year 8 and all subsequent taxable years. See paragraph (b)(2) of this section.

(f) *Exclusion of reasonable partner-specific items of deduction or loss.* Provided that the expenditures are allocated to the partners to whom they are attributable, the following partner-specific expenditures are disregarded in computing overall partnership income or loss for purposes of the fractions rule—

(1) Expenditures for additional record-keeping and accounting incurred in connection with the transfer of a partnership interest (including expenditures incurred in computing basis adjustments under section 743(b));

(2) Additional administrative costs that result from having a foreign partner;

(3) State and local taxes or expenditures relating to those taxes; and

(4) Expenditures designated by the Internal Revenue Service by revenue ruling or revenue procedure, or, on a case-by-case basis, by letter ruling. (See §601.601(d)(2)(ii)(*b*) of this chapter).

(g) *Exclusion of unlikely losses and deductions.* Unlikely losses or deductions (other than items of nonrecourse deduction) that may be specially allocated to partners that bear the economic burden of those losses or deductions are disregarded in computing overall partnership income or loss for purposes of the fractions rule, so long as a principal purpose of the allocation is not tax avoidance. To be excluded under this paragraph (g), a loss or deduction must have a low likelihood of occurring, taking into account all relevant facts, circumstances, and information available to the partners (including bona fide financial projections). The types of events that may give rise to unlikely losses or deductions, depending on the facts and circumstances, include tort and other third-party litigation that give rise to unforeseen liabilities in excess of reasonable insurance coverage; unanticipated labor strikes; unusual delays in securing required permits or licenses; abnormal weather conditions (considering the season and the job site); significant delays in leasing property due to an unanticipated severe economic downturn in the geographic area; unanticipated cost overruns; and the discovery of environmental conditions that require remediation. No inference is drawn as to whether a loss or deduction is unlikely from the fact that the partnership agreement includes a provision for allocating that loss or deduction.

(h) *Provisions preventing deficit capital account balances.* A provision in the partnership agreement that allocates items of loss or deduction away from a qualified organization in instances where allocating those items to the qualified organization would cause or increase a deficit balance in its capital account that the qualified organization is not obligated to restore (within the meaning of §1.704–1(b)(2)(ii) (*b*) or (*d*)), is disregarded for purposes of the fractions rule in taxable years of the partnership in which no such allocations are made pursuant to the provision. However, this exception applies only if, at the time the provision becomes part of the partnership agreement, all relevant facts, circumstances, and information (including bona fide financial projections) available to the partners reasonably indicate that it is unlikely that an allocation will be made pursuant to the provision during the life of the partnership.

(i) [Reserved]

(j) *Exception for partner nonrecourse deductions*—(1) *Partner nonrecourse deductions disregarded until actually allocated.* Items of partner nonrecourse deduction that may be allocated to a partner pursuant to §1.704–2, and compensating allocations of other items of loss, deduction, and section 705(a)(2)(B) expenditures that may be allocated to other partners, are not taken into account for purposes of the fractions rule until the taxable years in which they are allocated.

(2) *Disproportionate allocation of partner nonrecourse deductions to a qualified organization.* A violation of the fractions rule will be disregarded if it arises because an allocation of partner nonrecourse deductions to a qualified organization that is not motivated by tax avoidance reduces another qualified organization's fractions rule percentage below what it would have been absent the allocation of the partner nonrecourse deductions.

(k) *Special rules*—(1) *Changes in partnership allocations arising from a change* *in the partners' interests.* A qualified organization that acquires a partnership interest from another qualified organization is treated as a continuation of the prior qualified organization partner (to the extent of that acquired interest) for purposes of applying the fractions rule. Changes in partnership allocations that result from other transfers or shifts of partnership interests will be closely scrutinized (to determine whether the transfer or shift stems from a prior agreement, understanding, or plan or could otherwise be expected given the structure of the transaction), but generally will be taken into account only in determining whether the partnership satisfies the fractions rule in the taxable year of the change and subsequent taxable years.

(2) *De minimis interest rule*—(i) *In general.* Section 514(c)(9)(B)(vi) does not apply to a partnership otherwise subject to that section if—

(A) Qualified organizations do not hold, in the aggregate, interests of greater than five percent in the capital or profits of the partnership; and

(B) Taxable partners own substantial interests in the partnership through which they participate in the partnership on substantially the same terms as the qualified organization partners.

(ii) *Example.* Partnership *PRS* has two types of limited partnership interests that participate in partnership profits and losses on different terms. Qualified organizations (QOs) only own one type of limited partnership interest and own no general partnership interests. In the aggregate, the QOs own less than five percent of the capital and profits of *PRS*. Taxable partners also own the same type of limited partnership interest that the QOs own. These limited partnership interests owned by the taxable partners are 30 percent of the capital and profits of *PRS*. Thirty percent is a substantial interest in the partnership. Therefore, *PRS* satisfies paragraph (k)(2) of this section and section 514(c)(9)(B)(vi) does not apply.

(3) *De minimis allocations disregarded.* A qualified organization's fractions rule percentage of the partnership's items of loss and deduction, other than nonrecourse and partner nonrecourse deductions, that are allocated away from the qualified organization and to other partners in any taxable year are treated as having been allocated to the qualified organization for purposes of the fractions rule if—

(i) The allocation was neither planned nor motivated by tax avoidance; and

(ii) The total amount of those items of partnership loss or deduction is less than both—

(A) One percent of the partnership's aggregate items of gross loss and deduction for the taxable year; and

(B) $50,000.

(4) *Anti-abuse rule.* The purpose of the fractions rule is to prevent tax avoidance by limiting the permanent or temporary transfer of tax benefits from tax-exempt partners to taxable partners, whether by directing income or gain to tax-exempt partners, by directing losses, deductions, or credits to taxable partners, or by some other similar manner. This section may not be applied in a manner that is inconsistent with the purpose of the fractions rule.

(l) [Reserved].

(m) *Tiered partnerships*—(1) *In general.* If a qualified organization holds an indirect interest in real property through one or more tiers of partnerships (a chain), the fractions rule is satisfied only if—

(i) The avoidance of tax is not a principal purpose for using the tiered-ownership structure (investing in separate real properties through separate chains of partnerships so that section 514(c)(9)(E) is, effectively, applied on a property-by-property basis is not, in and of itself, a tax avoidance purpose); and

(ii) The relevant partnerships can demonstrate under any reasonable method that the relevant chains satisfy the requirements of paragraphs (b)(2) through (k) of this section. For purposes of applying § 1.704–2(k) under the independent chain approach described in Example 3 of paragraph (m)(2) of this section, allocations of items of income or gain that may be made pursuant to a provision in the partnership agreement that charges back minimum gain are taken into account for purposes of the fractions rule only to the extent an allocation is made.

(2) *Examples.* The following examples illustrate the provisions of this paragraph (m).

Example 1. Tiered partnerships—collapsing approach. (i) Qualified organization QO3 and taxable individual TP3 form upper-tier partnership P2. The P2 partnership agreement allocates overall partnership income 20 percent to QO3 and 80 percent to TP3. Overall partnership loss is allocated 30 percent to QO3 and 70 percent to TP3. P2 and taxable individual TP2 form lower-tier partnership P1. The P1 partnership agreement allocates overall partnership income 60 percent to P2 and 40 percent to TP2. Overall partnership loss is allocated 40 percent to P2 and 60 percent to TP2. The only asset of P2 (which has no outstanding debt) is its interest in P1. P1 purchases real property with money contributed by its partners and with borrowed money. There is no tax avoidance purpose for the use of the tiered-ownership structure, which is illustrated by the following diagram.

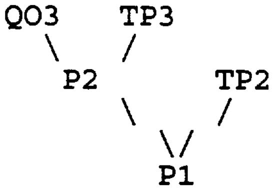

(ii) P2 can demonstrate that the P2/P1 chain satisfies the requirements of paragraphs (b)(2) through (k) of this section by collapsing the tiered-partnership structure. On a collapsed basis, QO3's fractions rule percentage is 12 percent (30 percent of 40 percent). See paragraph (c)(2) of this section. P2 satisfies the fractions rule because QO3 may not be allocated more than 12 percent (20 percent of 60 percent) of overall partnership income in any taxable year.

Example 2. Tiered partnerships—entity-by-entity approach. (i) Qualified organization QO3A is a partner with taxable individual TP3A in upper-tier partnership P2A. Qualified organization QO3B is a partner with taxable individual TP3B in upper-tier partnership P2B. P2A, P2B, and taxable individual TP2 are partners in lower-tier partnership P1, which owns encumbered real estate. None of QO3A, QO3B, TP3A, TP3B or TP2 has a direct or indirect ownership interest in each other. P2A has been established for the purpose of investing in numerous real estate properties independently of P2B and its partners. P2B has been established for the purpose of investing in numerous real estate properties independently of P2A and its partners. Neither P2A nor P2B has outstanding debt. There is no tax avoidance purpose for the use of the tiered-ownership structure, which is illustrated by the following diagram.

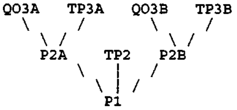

(ii) The P2A/P1 chain (Chain A) will satisfy the fractions rule if P1 and P2A can demonstrate in a reasonable manner that they satisfy the requirements of paragraphs (b)(2) through (k) of this section. The P2B/P1 chain (Chain B) will satisfy the fractions rule if P1 and P2B can demonstrate in a reasonable manner that they satisfy the requirements of paragraphs (b)(2) through (k) of this section. To meet its burden, P1 treats P2A and P2B as qualified organizations. Provided that the allocations that may be made by P1 would satisfy the fractions rule if P2A and P2B were direct qualified organization partners in P1, Chain A will satisfy the fractions rule (for the benefit of QO3A) if the allocations that may be made by P2A satisfy the requirements of paragraphs (b)(2) through (k) of this section. Similarly, Chain B will satisfy the fractions rule (for the benefit of QO3B) if the allocations that may be made by P2B satisfy the requirements of paragraphs (b)(2) through (k) of this section. Under these facts, QO3A does not have to know how income and loss may be allocated by P2B, and QO3B does not have to know how income and loss may be allocated by P2A. QO3A's and QO3B's burden would not change even if TP2 were not a partner in P1.

Example 3. Tiered partnerships—independent chain approach. (i) Qualified organization QO3 and taxable corporation TP3 form upper-tier partnership P2. P2 and taxable corporation TP2 form lower-tier partnership P1A. P2 and qualified organization QO2 form lower-tier partnership P1B. P2 has no outstanding debt. P1A and P1B each purchase real property with money contributed by their respective partners and with borrowed money. Each partnership's real property is completely unrelated to the real property owned by the other partnership. P1B's allocations do not satisfy the requirements of paragraphs (b)(2) through (k) of this section because of allocations that may be made to QO2. However, if P2's interest in P1B were completely disregarded, the P2/P1A chain would satisfy the requirements of paragraphs (b)(2) through (k) of this section. There is no tax avoidance purpose for the use of the tiered-ownership structure, which is illustrated by the following diagram.

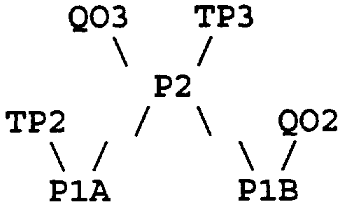

(ii) P2 satisfies the fractions rule with respect to the P2/P1A chain, but only if the P2 partnership agreement allocates those items allocated to P2 by P1A separately from those items allocated to P2 by P1B. For this purpose, allocations of items of income or gain that may be made pursuant to a provision in the partnership agreement that charges back minimum gain, are taken into account for purposes of the fractions rule only to the extent an allocation is made. See paragraph (m)(1)(ii) of this section. P2 does not satisfy the fractions rule with respect to the P2/P1B chain.

(n) *Effective date*—(1) *In general.* Section 514(c)(9)(E), as amended by sections 2004(h) (1) and (2) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100–647, applies generally with respect to property acquired by partnerships after October 13, 1987, and to partnership interests acquired after October 13, 1987.

(2) *General effective date of the regulations.* Section 1.514(c)–2 (a) through (m) applies with respect to partnership agreements entered into after December 30, 1992, property acquired by partnerships after December 30, 1992, and partnership interests acquired by qualified organizations after December 30, 1992 (other than a partnership interest that at all times after October 13, 1987, and prior to the acquisition was held by a qualified organization). For this purpose, paragraphs (a) through (m) of this section will be treated as satisfied with respect to partnership agreements entered into on or before May 13, 1994, property acquired by partnerships on or before May 13, 1994, and partnership interests acquired by qualified organizations on or before May 13, 1994, if the guidance set forth in (paragraphs (a) through (m) of §1.514(c)–2 of) PS–56–90, published at 1993–5 I.R.B. 42, February 1, 1993, is satisfied. (See §601.601(d)(2)(ii)(*b*) of this chapter).

(3) *Periods after June 24, 1990, and prior to December 30, 1992.* To satisfy the requirements of section 514(c)(9)(E) with respect to partnership agreements entered into after June 24, 1990, property acquired by partnerships after June 24, 1990, and partnership interests acquired by qualified organizations after June 24, 1990, (other than a partnership interest that at all times after October 13, 1987, and prior to the acquisition was held by a qualified organization) to which paragraph (n)(2) of this section does not apply, paragraphs (a) through (m) of this section must be satisfied as of the first day that section 514(c)(9)(E) applies with respect to the partnership, property, or acquired interest. For this purpose, paragraphs (a) through (m) of this section will be treated as satisfied if the guidance in sections I through VI of Notice 90–41, 90–1 C.B. 350, (see §601.601(d)(2)(ii)(*b*) of this chapter) has been followed.

(4) *Periods prior to the issuance of Notice 90–41.* With respect to partnerships commencing after October 13, 1987, property acquired by partnerships after October 13, 1987, and partnership interests acquired by qualified organizations after October 13, 1987, to which neither paragraph (n)(2) nor (n)(3) of this section applies, the Internal Revenue Service will not challenge an interpretation of section 514(c)(9)(E) that is reasonable in light of the underlying purposes of section 514(c)(9)(E) (as reflected in its legislative history) and that is consistently applied as of the first day that section 514(c)(9)(E) applies with respect to the partnership, property, or acquired interest. A reasonable interpretation includes an interpretation that substantially follows the guidance in either sections I through VI of Notice 90–41, (see §601.601(d)(2)(ii)(*b*) of this chapter) or paragraphs (a) through (m) of this section.

(5) Material modifications to partnership agreements. A material modification will cause a partnership agreement to be treated as a new partnership agreement in appropriate circumstances for purposes of this paragraph (n).

[T.D. 8539, 59 FR 24928, May 13, 1994]

§1.514(d)–1 Basis of debt-financed property acquired in corporate liquidation.

(a) If debt-financed property is acquired by an exempt organization in a complete or partial liquidation of a corporation in exchange for its stock, the organization's basis in such property shall be the same as it would be in the hands of the transferor corporation, increased by the amount of gain recognized to the transferor corporation upon such distribution and by the amount of any gain which is includible, on account of such distribution, in the gross income of the organization as unrelated debt-financed income.

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

Example. On July 1, 1970, T, an exempt trust, exchanges $15,000 of borrowed funds for 50 percent of the shares of M Corporation's stock. M uses $35,000 of borrowed funds in acquiring depreciable assets which are not used at any time for purposes described in section 514(b)(1) (A), (B), (C), or (D). On July 1, 1978, and for the 12-month period preceding this date, T's acquisition indebtedness with respect to M's stock has been $3,000. On this date, there is a complete liquidation of M Corporation to which section 331(a)(1) applies. In the liquidation T receives a distribution in kind of depreciable assets and assumes $7,000 of M's indebtedness which remains unpaid with respect to the depreciable assets. On this date, M's adjusted basis of these depreciable assets is $9,000, and such assets have a fair market value of $47,000. M recognizes gain of $6,000 with respect to this liquidation pursuant to sections 1245 and 1250. T realizes a gain of $25,000 (the difference between the excess of fair market value of the property received over the indebtedness assumed, $40,000 ($47,000–$7,000) and T's basis in M's stock, $15,000). A portion of this gain is to be treated as unrelated debt-financed income. This amount is determined by multiplying T's gain of $25,000 by the debt/basis percentage. The debt/basis percentage is 20 percent, the ratio which the average acquisition indebtedness ($3,000) is of the average adjusted basis ($15,000). Thus, $5,000 (20 percent of $25,000) is unrelated debt-financed income. This amount and the gain recognized pursuant to sections 1245 and 1250 are added to M's basis to determine T's basis in the property received. Consequently, T's basis in the property received from M Corporation is $20,000, determined as follows:

M Corporation's adjusted basis	$9,000
Gain recognized by M Corporation on the distribution	6,000
Unrelated debt-financed income recognized by T with respect to the distribution	5,000
T's transferred basis	20,000

[T.D. 7229, 37 FR 28153, Dec. 21, 1972]

§1.514(e)–1 Allocation rules.

Where only a portion of property is debt-financed property, proper allocation of the basis, indebtedness, income, and deductions with respect to such property must be made to determine the amount of income or gain derived from such property which is to be treated as unrelated debt-financed income. See examples 2 and 3 of paragraph (b)(1)(iii) of §1.514(b)–1 and examples 1, (2), and (3) of paragraph (b)(3)(iii) of §1.514(b)–1 for illustrations of proper allocation.

[T.D. 7229, 37 FR 28153, Dec. 21, 1972]

§1.514(f)–1 Definition of business lease.

(a) *In general.* The term *business lease* means any lease, with certain exceptions discussed in paragraph (c) of this section, for a term of more than 5 years of real property by an organization subject to section 511 (or by a partnership of which it is a member) if at the close of the organization's taxable year there is a business lease indebtedness as defined in section 514(g) and §1.514(g)–1 with respect to such property. For the purpose of this section the term *real property* and the term *premises* include personal property of the lessor tax-exempt organization leased by it to a lessee of its real estate if the lease of such personal property is made under, or in connection with, the lease of such real estate. For amounts of business lease rents and deductions to be included in computing unrelated business taxable income for taxable years beginning before January 1, 1970, see §1.514(a)–2.

(b) *Special rules.* (1) In computing the term of the lease, the period for which a lease may be renewed or extended by reason of an option contained therein shall be considered as part of the term. For example, a 3-year lease with an option for renewal for another such period is considered a lease for a term of 6 years. Another example is the case of a 1-year lease with option of renewal for another such term, where the parties at the end of each year renew the arrangement. In this case, during the fifth year (but not during the first 4 years), the lease falls within the 5-year rule, since the lease then involves 5 years and there is an option for the sixth year. In determining the term of the lease, an option for renewal of the lease is taken into account whether or not the exercise of the option depends upon conditions or contingencies.

(2) If the property is acquired subject to a lease, the term of such lease shall be considered to begin on the date of such acquisition. For example, if an exempt organization purchases, in whole or in part with borrowed funds, real property subject to a 10-year lease which has 3 years left to run, and such lease contains no right of renewal or extension, the lease shall be considered a 3-year lease and hence does not meet the definition of a business lease in section 514(f) and paragraph (a) of this section. However, if this lease contains an option to renew for a period of 3 years or more, it is a business lease.

(3) Under the provisions of section 514(f)(2)(B) a lease is considered as continuing for more than 5 years if the same lessee has occupied the premises for a total period of more than 5 years, whether the occupancy is under one or more leases, renewals, extensions, or continuations. Continued occupancy shall be considered to be by the same lessee if the occupants during the period are so related that losses in respect of sales or exchanges of property between them would be disallowed under section 267(a). Such period shall be considered as commencing not earlier than the date of the acquisition of the property by the tax-exempt organization or trust. This rule is applicable only in the sixth and succeeding years of such occupancy by the same lessee. See, however, paragraph (c)(3) of this section.

(c) *Exceptions.* (1) A lease shall not be considered a business lease if such lease is entered into primarily for a purpose which is substantially related (aside from the need of such organization for income or funds, or the use it makes of the rents derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption. For example, where a tax-exempt hospital leases real property owned by it to an association of doctors for use as a clinic, the rents derived under such lease would not be included in computing unrelated business taxable income if the clinic is substantially related to the carrying on of hospital functions. See § 1.513—1 for principles applicable in determining whether there is a substantial relationship to the exempt purpose of an organization.

(2) A lease is not a business lease if the lease is of premises in a building primarily designed for occupancy and occupied by the tax-exempt organization.

(3) If a lease for more than 5 years to a tenant is for only a portion of the real property, and space in the real property is rented during the taxable year under a lease for not more than 5 years to any other tenant of the tax-exempt organization, all leases of the real property for more than 5 years shall be considered as business leases during the taxable year only if:

(i) The rents derived from the real property during the taxable year under leases for more than 5 years represent 50 percent or more of the total rents derived during the taxable year from the real property; or the area of the premises occupied under leases for more than 5 years represents, at any time during the taxable year, 50 percent or more of the total area of the real property rented at such time; or

(ii) The rent derived from the real property during the taxable year from any tenant under a lease for more than 5 years, or from a group of tenants (under such leases) who are either members of an affiliated group (as defined in section 1504) or are partners, represents more than 10 percent of the total rents derived during the taxable year from such property; or the area of the premises occupied by any one such tenant, or by any such group of tenants, represents at any time during the taxable year more than 10 percent of the total area of the real property rented at such time.

In determining whether 50 percent or more of the total rents are derived from leases for more than 5 years, or whether 50 percent or more of the total area is occupied under leases for more than 5 years:

(iii) An occupancy which is considered to be a lease of more than 5 years solely by reason of the provisions of paragraph (b)(3) of this subparagraph shall not be treated as such a lease for purposes of subdivision (i) of this subparagraph, and

(iv) An occupancy which is considered to be a lease of more than 5 years solely by reason of the provisions of paragraph (b)(3) of this section shall be treated as such a lease for purposes of subdivision (ii) of this subparagraph, and

(v) If during the last half of the term of a lease a new lease is made to take effect after the expiration of such lease, the unexpired portion of the first lease will not be added to the second lease to determine whether such second lease is a lease for more than 5 years for purposes of subdivision (i) of this subparagraph.

(4) The application of subparagraph (3) of this paragraph may be illustrated by the following example:

Example. In 1954 an educational organization, which is on the calendar year basis, begins the erection of an 11-story apartment building using funds borrowed for that purpose, and immediately leases for a 10-year term the first floor to a real estate development company to sublet for stores and shops. As fast as the new apartments are completed, they are rented on an annual basis. At the end of 1959 all except the 10th and 11th floors are rented. Those two floors are completed during 1960 and rented. Assume that for 1954 and each subsequent taxable year through 1959, and for the taxable year 1963, the gross rental for the first floor represents more than 10 percent of the total gross rents derived during the taxable year from the building. Under this set of facts the 10-year lease of the first floor would be considered to be a business lease for all except the taxable years 1961, 1962, and 1964.

[T.D. 7229, 37 FR 28154, Dec. 21, 1972]

§1.514(g)–1 Business lease indebtedness.

(a) *Definition.* The term *business lease indebtedness* means, with respect to any real property leased by a tax-exempt organization for a term of more than 5 years, the unpaid amount of:

(1) The indebtedness incurred by the lessor tax-exempt organization in acquiring or improving such property;

(2) The indebtedness incurred by the lessor tax-exempt organization prior to the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and

(3) The indebtedness incurred by the lessor tax-exempt organization subsequent to the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of the indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

See paragraph (i) of this section with respect to subsidiary corporations.

(b) *Examples.* The rules of section 514(g) respecting business leases also cover certain cases where the leased property itself is not subject to an indebtedness. For example, they apply to cases such as the following:

Example 1. A university pledges some of its investment securities with a bank for a loan and uses the proceeds of such loan to purchase (either directly or through a subsidiary corporation) a building, which building is subject to a lease that then has more than 5 years to run. This would be an example of a business lease indebtedness incurred prior to the acquisition of the property which would not have been incurred but for such acquisition.

Example 2. If the building itself in example 1 in this paragraph is later mortgaged to raise funds to release the pledged securities, the lease would continue to be a business lease.

Example 3. If a scientific organization mortgages its laboratory building to replace working capital used in remodeling another one of its buildings or a building held by its subsidiary corporation, which other building is free of indebtedness and is subject to a lease that then has more than 5 years to run, the lease would be a business lease inasmuch as the indebtedness though incurred subsequent to the improvement of such property would not have been incurred but for such improvement, and the incurrence of the indebtedness was reasonably foreseeable when, to make such improvement, the organization reduced its working capital below the amount necessary to continue current operations.

(c) *Property acquired subject to lien.* Where real property is acquired subject to a mortgage or similar lien, whether the acquisition be by gift, bequest, devise, or purchase, the amount of the indebtedness secured by such mortgage or lien is a business lease indebtedness (unless paragraph (d)(1) of this section applies) even though the lessor does not assume or agree to pay the indebtedness. For example, a university pays $100,000 for real estate valued at $300,000 and subject to a $200,000 mortgage. For the purpose of the tax on unrelated business taxable income, the result is the same as if $200,000 of borrowed funds had been used to buy the property.

(d) *Certain property acquired by gifts, etc.* (1) Where real property was acquired by gift, bequest, or devise, before July 1, 1950, subject to a mortgage or other similar lien, the amount of such mortgage or other similar lien shall not be considered as an indebtedness of the lessor tax-exempt organization incurred in acquiring such property. An indebtedness not otherwise covered by this exception is not brought within the exception by reason of a transfer of the property between a parent and its subsidiary corporation.

(2) Where real property was acquired by gift, bequest, or devise, before July 1, 1950, subject to a lease requiring improvements in such property upon the happening of stated contingencies, indebtedness incurred in improving such property in accordance with the terms of such lease shall not be considered as indebtedness described in section 514(g) and in this section. An indebtedness not otherwise covered by this exception is not brought within the exception by reason of a transfer of the property between a parent and its subsidiary corporation.

(e) *Certain corporations described in section 501(c)(2).* In the case of a title holding corporation described in section 501(c)(2), all of the stock of which was acquired before July 1, 1950, by an organization described in section 501(c) (3), (5), or (6) (and more than one-third of such stock was acquired by such organization by gift or bequest), any indebtedness incurred by such corporation before July 1, 1950, and any indebtedness incurred by such corporation on or after such date in improving real property in accordance with the terms of a lease entered into before such date, shall not be considered an indebtedness described in section 514(g) and in this section with respect to either such section 501(c)(2) corporation or such section 501(c) (3), (5), or (6) organization.

(f) *Certain trusts described in section 401(a).* In the case of a trust described in section 401(a), or in the case of a corporation described in section 501(c)(2) all of the stock of which was acquired before March 1, 1954, by such a trust, any indebtedness incurred by such trust or such corporation before such date, in connection with real property which is leased before such date, and any indebtedness incurred by such trust or such corporation on or after such date necessary to carry out the terms of such lease, shall not be considered as an indebtedness described in section 514(g) and in this section.

(g) *Business lease on portion of property.* Where only a portion of the real property is subject to a business lease, proper allocation of the indebtedness applicable to the whole property must be made to the premises covered by the lease. See example 2 of paragraph (b)(3) of §1.514(a)–2.

(h) *Special rule applicable to trusts described in section 401(a).* If an employees' trust described in section 401(a) lends any money to another such employees' trust of the same employer, for the purpose of acquiring or improving real property, such loan will not be treated as an indebtedness of the borrowing trust except to the extent that the loaning trust:

(1) Incurs any indebtedness in order to make such loan;

(2) Incurred indebtedness before the making of such loan which would not have been incurred but for the making of such loan; or

(3) Incurred indebtedness after the making of such loan which would not have been incurred but for the making of such loan and which was reasonably foreseeable at the time of making such loan.

(i) *Subsidiary corporations.* The provisions of section 514(f), (g), and (h) are applicable whether or not a subsidiary corporation of the type described in section 501(c)(2) is availed of in making the business lease. For example, assume a parent organization borrows funds to purchase realty and sets up a separate section 501(c)(2) corporation as a subsidiary to hold the property. Such subsidiary corporation leases the property for a period of more than 5 years, collects the rents and pays over all of the income, less expenses, to the parent organization, the parent organization being liable for the indebtedness. Under these assumed facts, the lease by section 501(c)(2) subsidiary corporation would be a business lease with respect to such subsidiary corporation, and the rental income would be subject to the tax, whether or not the subsidiary itself assumes the indebtedness and whether or not the property is subject to the indebtedness.

(j) *Certain trusts described in section 501(c)(17).* (1) In the case of a supplemental unemployment benefit trust described in section 501(c)(17), or in the case of a corporation described in section 501(c)(2) all of the stock of which was acquired before January 1, 1960, by such a trust, any indebtedness incurred by such trust or such corporation before such date, in connection with real property which is leased before such date, and any indebtedness incurred by such trust or such corporation on or after such date necessary to carry out the terms of such lease, shall not be considered as an indebtedness described in section 514(g) and in this section.

(2) If a supplemental unemployment benefit trust described in section 501(c)(17) lends any money to another such supplemental unemployment benefit trust forming part of the same plan, for the purpose of acquiring or improving real property, such loan will not be treated as an indebtedness of the borrowing trust except to the extent that the loaning trust:

(i) Incurs any indebtedness in order to make such loan;

(ii) Incurred indebtedness before the making of such loan which would not have been incurred but for the making of such loan; or

(iii) Incurred indebtedness after the making of such loan which would not have been incurred but for the making of such loan and which was reasonably foreseeable at the time of making such loan.

[T.D. 7229, 37 FR 28155, Dec. 21, 1972]

Farmers' Cooperatives

§1.521–1 Farmers' cooperative marketing and purchasing associations; requirements for exemption under section 521.

(a)(1) Cooperative associations engaged in the marketing of farm products for farmers, fruit growers, livestock growers, dairymen, etc., and turning back to the producers the proceeds of the sales of their products, less the necessary operating expenses, on the basis of either the quantity or the value of the products furnished by them, are exempt from income tax except as otherwise provided in section 522, or part I, subchapter T chapter 1 of the Code, and the regulations thereunder. For instance, cooperative dairy companies which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among the producers upon the basis of either the quantity or the value of milk or of butterfat in the milk furnished by such producers, are exempt from the tax. If the proceeds of the business are distributed in any other way than on such a proportionate basis, the association does not meet the requirements of the Code and is not exempt. In other words, nonmember patrons must be treated the same as members insofar as the distribution of patronage dividends is concerned. Thus, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association. In order to show its cooperative nature and to establish compliance with the requirement of the Code that the proceeds of sales, less necessary expenses, be turned back to all producers on the basis of either the quantity or the value of the products furnished by them, it is necessary for such an association to keep permanent records of the business done both with members and nonmembers. The Code does not require, however, that the association keep ledger accounts with each producer selling through the association. Any permanent records which show that the association was operating during the taxable year on a cooperative basis in the distribution of patronage dividends to all producers will suffice. While under the Code patronage dividends must be paid to all producers on the same basis, this requirement is complied with if an association instead of paying patronage dividends to nonmember producers in cash, keeps permanent records from which the proportionate shares of the patronage dividends due to nonmember producers can be determined, and such shares are made applicable toward the purchase price of a share of stock or of a membership in the association. See, however, paragraph (c)(1) of § 1.1388–1 for the meaning of *payment in money* for purposes of qualifying a written notice of allocation.

(2) An association which has capital stock will not for such reason be denied exemption (i) if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and (ii) if substantially all of such stock (with the exception noted below) is owned by producers who market their products or purchase their supplies and equipment through the association. Any ownership of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers. If by statutory requirement all officers of an association must be shareholders, the ownership of a share of stock by a nonproducer to qualify him as an officer will not destroy the association's exemption. Likewise, if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional restriction or prohibition or other reason beyond the control of the association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption. The restriction placed on the ownership of capital stock of an exempt cooperative association shall not apply to nonvoting preferred stock, provided the owners of such stock are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends.

(3) The accumulation and maintenance of a reserve required by State statute, or the accumulation and maintenance of a reasonable reserve or surplus for any necessary purpose, such as to provide for the erection of buildings and facilities required in business or for the purchase and installation of machinery and equipment or to retire indebtedness incurred for such purposes, will not destroy the exemption. An association will not be denied exemption because it markets the products of nonmembers, provided the value of the products marketed for nonmembers does not exceed the value of the products marketed for members. Anyone who shares in the profits of a farmers' cooperative marketing association, and is entitled to participate in the management of the association, must be regarded as a member of such association within the meaning of section 521.

(b) Cooperative associations engaged in the purchasing of supplies and equipment for farmers, fruit growers, livestock growers, dairymen, etc., and turning over such supplies and equipment to them at actual cost, plus the necessary operating expenses, are exempt. The term *supplies and equipment* as used in section 521 includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household. The provisions of paragraph (a) of this section relating to a reserve or surplus and to capital stock shall apply to associations coming under this paragraph. An association which purchases supplies and equipment for nonmembers will not for such reason be denied exemption, provided the value of the purchases for nonmembers does not exceed the value of the supplies and equipment purchased for members, and provided the value of the purchases made for nonmembers who are not producers does not exceed 15 percent of the value of all its purchases.

(c) In order to be exempt under either paragraph (a) or (b) of this section an association must establish that it has no taxable income for its own account other than that reflected in a reserve or surplus authorized in paragraph (a) of this section. An association engaged both in marketing farm products and in purchasing supplies and equipment is exempt if as to each of its functions it meets the requirements of the Code. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under section 521 and this section. An association to be entitled to exemption must not only be organized but actually operated in the manner and for the purposes specified in section 521.

(d) Cooperative organizations engaged in occupations dissimilar from those of farmers, fruit growers, and the like, are not exempt.

(e) An organization is not exempt from taxation under this section merely because it claims that it complies with the requirements prescribed therein. In order to establish its exemption every organization claiming exemption under section 521 is required to file a Form 1028. The Form 1028, executed in accordance with the instructions on the form or issued therewith, should be filed with the district director for the internal revenue district in which is located the principal place of business or principal office of the organization. However, an organization which has been granted exemption under the provisions of the Internal Revenue Code of 1939 or prior law may rely on that ruling, unless affected by substantive changes in the Internal Revenue Code of 1954 or any changes in the character, purposes, or methods of operation of the organization, and it is not necessary in such case for the organization to request a new determination as to its exempt status.

(f) A cooperative association will not be denied exemption merely because it makes payments solely in nonqualified written notices of allocation to those patrons who do not consent as provided in section 1388 and §1.1388–1, but makes payments of 20 percent in cash and the remainder in qualified written notices of allocation to those patrons who do so consent. Nor will such an association be denied exemption merely because, in the case of patrons who have so consented, payments of less than $5 are made solely in nonqualified written notices of allocation while payments of $5 or more are made in the form of 20 percent in cash and the remainder in qualified written notices of allocation. In addition, a cooperative association will not be denied exemption if it pays a smaller amount of interest or dividends on nonqualified written notices of allocation held by persons who have not consented as provided in section 1388 and §1.1388–1 (or on per-unit retain certificates issued to patrons who are not qualifying patrons with respect thereto within the meaning of §1.61–5(d)(2)) than it pays on qualified written notices of allocation held by persons who have so consented (or on per-unit retain certificates issued to patrons who are qualifying patrons with respect thereto) provided that the amount of the interest or dividend reduction is reasonable in relation to the fact that the association receives no tax benefit with respect to such nonqualified written notices of allocation (or such certificates issued to nonqualifying patrons) until redeemed. However, such an association will be denied exemption if it otherwise treats patrons who have not consented (or are not qualifying patrons) differently from patrons who have consented (or are qualifying patrons), either with regard to the original payment or allocation or with regard to the redemption of written notices of allocation or per-unit retain certificates. For example, if such an association pays patronage dividends in the form of written notices of allocation accompanied by qualified checks, and provides that any patron who does not cash his check within a specified time will forfeit the portion of the patronage dividend represented by such check, then the cooperative association will be denied exemption under this section as it does not treat all patrons alike.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6643, 28 FR 3162, Apr. 2, 1963; T.D. 6855, 30 FR 13135, Oct. 15, 1965]

§ 1.522–1 Tax treatment of farmers' cooperative marketing and purchasing associations exempt under section 521.

(a) *In general.* (1) Section 522 is applicable to farmers', fruit growers', or like associations organized and operated on a cooperative basis in the manner prescribed in section 521. Although such an association is subject to both normal tax and surtax, as in the case of corporations generally, certain special rules for the computation of taxable income are provided in section 522(b) and § 1.522–2. For the purpose of any law which refers to organizations exempt from income taxes such an association shall, however, be considered as an organization exempt under section 501. Thus, the provisions of section 243, providing a credit for dividends received from a domestic corporation subject to taxation, are not applicable to dividends received from a cooperative association subject to section 522. The provisions of section 1501, relating to consolidated returns, are likewise not applicable.

(2) Rules governing the manner in which amounts allocated as patronage dividends, refunds, or rebates are to be taken into account in computing the taxable income of such an association are set forth in § 1.522–3. For the tax treatment, as to patrons, of amounts received during the taxable year as patronage dividends, rebates, or refunds, see section 61 and § 1.61–5.

(b) *Meaning of terms.* For purposes of §§ 1.522–1 to 1.522–3, inclusive, §§ 1.6044–1 and 1.61–5, the following terms shall have the meaning ascribed below:

(1) *Cooperative association.* The term *cooperative association* includes any corporation operating on a cooperative basis and allocating amounts to patrons on the basis of the business done with or for such patrons, except that the term does not include any cooperative or nonprofit corporation (including any cooperative or nonprofit corporation engaged in rural electrification) exempt from taxation under section 501(a) and described in section 501(c) (12) or (15) or any corporation subject to a tax imposed by subchapter L, chapter 1 of the Code (relating to insurance companies).

(2) *Patron.* The term *patron* includes any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association.

(3) *Allocation.* The term *allocation* includes distributions made by a cooperative association to a patron in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, similar documents, or in any other manner whereby there is disclosed to a patron the dollar amount apportioned on the books of the association for the account of such patron. Thus, a mere credit to the account of a patron on the books of the cooperative association, without disclosure to the patron, is not an allocation.

(4) *Patronage dividends, rebates, and refunds.* The term *patronage dividend, rebate, or refund* includes any amount allocated by a cooperative association, to the account of a patron on the basis of the business done with or for such patron. The following are not patronage dividends, rebates, or refunds:

(i) Amounts distributed in redemption of capital stock, or in redemption or satisfaction of certificates of indebtedness, revolving fund certificates, retain certificates, letters of advice, or other similar documents;

(ii) Amounts allocated (whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the amount of such dividend, refund, or rebate) by the association for products of members or other patrons to the extent such amounts are fixed without reference to the earnings of the cooperative association. For this purpose, the term *earnings* includes the excess of amounts retained (or assessed) by the association to cover expenses or other items over the amount of such expenses or other items.

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

Example 1. Cooperative A, a marketing association operating on a pooling basis, receives the products of patron W on January 5, 1954. On the same day Cooperative A advances to W 45 cents per unit for the products so delivered and allocates to him a *retain certificate* having a face value calculated at the rate of 5 cents per unit. During the operatiion of the pool, and before substantially all the products in the pool are disposed of, Cooperative A advances to W an additional 40 cents per unit, the amount being determined by reference to the market price of the products sold and the anticipated price of the unsold products. At the close of the pool on November 10, 1954, Cooperative A determines the excess of its receipts over the sum of its expenses and its previous advances to patrons, and allocates to W an additional 3 cents per unit and shares of the capital stock of A having an aggregate of face value calculated at the rate of 2 cents per unit.

The amount of patronage dividends, rebates, or refunds allocated to W during 1954 amount to 5 cents per unit, consisting of the aggregate of the following per-unit allocations: The amount of cash distribution (3 cents), and the face value of the capital stock of A (2 cents), which are fixed with reference to the earnings of A. The amount of the two distributions in cash (85 cents) and the face amount of the *retain certificate* (5 cents), which are fixed without reference to the earnings of A, do not constitute patronage dividends, rebates, or refunds.

Example 2. Cooperative B, a marketing association operating on a pooling basis, receives the products of patron X on March 5, 1954. On the same day Cooperative B pays to X $1.00 per unit for such products, this amount being determined by reference to the market price of the product when received, and issues to him a participation certificate having no face value but which entitles X on the close of the pool to the proceeds derived from the sale of his products less the previous payment of $1.00 and the expenses and other charges attributable to such products. On March 5, 1957, Cooperative B, having sold the products in the pool, having deducted the previous payments for such products, and having determined the expenses and other charges of the pool, redeems the participation certificate of X in cash for 10 cents per unit. The allocation made to X during 1957, amounting to 10 cents per unit, is a patronage dividend, rebate, or refund. Neither the payment to X in 1954 of $1.00 nor the issuance to him of the participation certificate in that year constitutes a patronage dividend, rebate, or refund within the meaning of this section.

Example 3. Cooperative C, a purchasing association, obtains supplies for patron Y on May 1, 1954, and receives in return therefor $100. On February 1, 1955, Cooperative C, having determined the excess of its receipts over its costs and expenses, allocates to Y a cash distribution of $1.00 and a revolving fund certificate of a face amount of $1.00. The amount of patronage dividends, rebates, or refunds allocated to Y for 1955 is $2.00, the aggregate of the cash distribution of $1.00, and the face amount, $1.00, of the revolving fund certificate.

Example 4. Cooperative D, a service association, sells the products of members on a fee basis. It receives the products of patron Z under an agreement not to pool his products with those of other members, to sell his products, and to deliver to him the proceeds of the sale. Patron Z makes payments to Cooperative D during 1954 aggregating $75 for service rendered him by Cooperative D during that year. On May 15, 1955, Cooperative D, having determined the excess of its receipts over its costs and expenses, allocates to Z a cash distribution of $2.00. Such amount is a patronage dividend, rebate, or refund allocated by Cooperative D during 1955.

(d) *Returns of exempt cooperative associations.* For requirements of annual returns by exempt cooperative associations, see sections 6012 and 6072(d) and paragraph (f) of §1.6012–2.

§1.522–2 Manner of taxation of cooperative associations subject to section 522.

(a) *In general.* Farmers', fruit growers', or like associations, organized and operated in compliance with the requirements of section 521 and §1.521–1 shall be subject to the taxes imposed by section 11 or section 1201, except that there shall be allowed as deductions from gross income, in addition to the other deductions allowable under chapter 1 of the Code, certain special deductions provided in section 522(b)(1)(A) and paragraph (c) of this section, and section 522(b)(1)(B) and paragraph (d) of this section. Amounts allocated as patronage dividends, refunds, or rebates, whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated, with respect to patronage for the taxable year or for preceding taxable years, shall be taken into account in the manner provided in section 522 and in §1.522–3.

(b) *Cooperative association exempt from tax before January 1, 1952.* (1) For the purpose of determining the method of accounting under section 446 in the case of a cooperative association which was exempt from tax for taxable years beginning prior to January 1, 1952, the method of accounting, recognized under sections 41, 42, and 43 of the Internal Revenue Code of 1939 and the regulations prescribed thereunder and utilized in the return of such association for its last taxable year to which the Internal Revenue Code of 1939 was applicable, shall be deemed to constitute the method of accounting regularly employed by the cooperative association. Any change from this method may be made only if permission is obtained from the Commissioner to change to another recognized method in accordance with section 446 and the regulations thereunder.

(2) In any case where inventories are an income-producing factor, see sections 471 and 472 and the regulations thereunder. The elective method of inventorying goods provided in section 472 may be adopted by the cooperative association for any taxable year beginning after December 31, 1953, in accordance with the requirements of section 472 and the regulations thereunder. However, in order to use such method for such a taxable year the cooperative association (unless it has used such method for a taxable year beginning after 1951 and before 1954 pursuant to an election exercised as provided in 26 CFR (1939) 39.22(d)–3 (Regulations 118) must exercise the election provided in section 472 and the regulations thereunder, even if it may have utilized such method for accounting purposes for taxable years beginning before January 1, 1952.

(3) The following rules shall be applicable in computing the net operating loss deduction provided in section 172: No net operating loss carryover shall be allowed from a taxable year beginning prior to January 1, 1952, for which the cooperative association was exempt from tax under section 101(12) of the Internal Revenue Code of 1939. In the case of a taxable year beginning prior to January 1, 1952, for which the association was not exempt under section 101(12) of the Internal Revenue Code of 1939 and of any taxable year beginning after December 31, 1951, the amount of the net operating loss carryback or carryover from such year shall not be reduced by reference to the income of any taxable year beginning prior to January 1, 1952, for which the association was exempt from tax under section 101(12) of the Internal Revenue Code of 1939. However, any taxable year beginning prior to January 1, 1952, for which the cooperative association was exempt under section 101(12) of the Internal Revenue Code of 1939 shall be taken into account in determining the period for which a net operating loss may be carried back or carried over, as the case may be.

(4) The adjustments to the cost or other basis provided in sections 1011 and 1016 and the regulations thereunder, are applicable for the entire period since the acquisition of the property. Thus, proper adjustment to basis must be made under section 1016 for depreciation, obsolescence, amortization, and depletion for all taxable years beginning prior to January 1, 1952, although the cooperative association was exempt from tax under section 521 or corresponding provisions of prior law for such years. However, no adjustment for percentage or discovery depletion is to be made for any year during which the association was exempt from tax. If a cooperative association has made a proper election in accordance with section 1020 and the regulations prescribed thereunder with respect to a taxable year beginning before 1952 in which the association was not exempt from tax, the adjustment to basis for depreciation for such years shall be limited in accordance with the provisions of section 1016(a)(2).

(5) In the case of tax exempt and partially taxable bonds purchased at a premium and subject to amortization under section 171, proper adjustment to basis must be made to reflect amortization with respect to such premium from the date of acquisition of the bond. (For principles governing the method of computation, see the example in paragraph (b) of §1.1016–9, relating to mutual savings banks, building and loan associations, and cooperative banks.) The basis of a fully taxable bond purchased at a premium shall be adjusted from the date of the election to amortize such premium in accordance with the provisions of section 171

except that no adjustment shall be allowable for such portion of the premium attributable to the period prior to the election.

(6) In the case of a mortgage acquired at a premium where the principal of such mortgage is payable in installments, adjustments to the basis for the premium must be made for all taxable years (whether or not the association was exempt from tax under section 521 during such years) in which installment payments are received. Such adjustments may be made on an individual mortgage basis or on a composite basis by reference to the average period of payments of the mortgage loans of such association. For the purpose of this adjustment, the term *premium* includes the excess of the acquisition value of the mortgage over its maturity value. The acquisition value of the mortgage is the cost including buying commissions, attorneys' fees or brokerage fees, but such value does not include amounts paid for accrued interest.

(c) *Deduction for dividends paid.* There is allowable as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 521 and §1.521–1, amounts paid as dividends during the taxable year upon the capital stock of the cooperative association. For the purpose of the preceding sentence, the term *capital stock* includes common stock (whether voting or nonvoting), preferred stock, or any other form of capital represented by capital retain certificates, revolving fund certificates, letters of advice, or other evidence of a proprietary interest in a cooperative association. Such deduction is applicable only to the taxable year in which the dividends are actually or constructively paid to the holder of capital stock or other proprietary interest of the cooperative association. If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mail, in a cover properly stamped and addressed to the shareholder at his last known address, at such time that in the ordinary handling of the mails the check would be received by such holder within the taxable year, a presumption arises that the dividend was paid to such holder in such year. The determination of whether a dividend has been paid to such holder by the corporation during its taxable year is in no way dependent upon the method of accounting regularly employed by the corporation in keeping its books. For further rules as to the determination of the right to a deduction for dividends paid, under certain specific circumstances, see section 561 and the regulations thereunder.

(d) *Deduction for amounts allocated from income not derived from patronage.* There is allowable as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 521 and §1.521–1 amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether such amounts are paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated to him. For this purpose, allocations made after the close of the taxable year and on or before the 15th day of the ninth month following the close of the taxable year shall be considered as made on the last day of such taxable year to the extent that such allocations are attributable to income derived during the taxable year or during years prior to the taxable year. As used in this paragraph, the term *income not derived from patronage* means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, from the sale or exchange of capital assets, constitutes income not derived from patronage. Business done with the United States shall constitute income not derived from patronage. In order that the deduction for income not derived from patronage may be applicable, it is necessary that the amount sought to be deducted be allocated on a patronage basis in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such income is attributable. Thus, if capital gains are realized from the sale or exchange of capital assets acquired and disposed of during the taxable year, income realized from such gains must be allocated to patrons of such year in proportion to the amount of business done by such patrons during the taxable year. Similarly, if capital gains are realized by the association from the sale or exchange of capital assets held for a period of more than one taxable year income realized from such gains must be allocated, in proportion insofar as is practicable, to the patrons of the taxable years during which the asset was owned by the association, and to the amount of business done by such patrons during such taxable years.

§ 1.522–3 Patronage dividends, rebates, or refunds; treatment as to cooperative associations entitled to tax treatment under section 522.

(a) *General rule.* Patronage dividends, refunds, or rebates, allocated by a cooperative association entitled to tax treatment under section 522 to a patron shall be taken into account in computing the gross income of such association for the taxable year, as an increase in its other cost of goods sold in the case of an association marketing products for patrons, or as a reduction in its gross receipts, in the case of an association purchasing supplies and equipment or performing services for patrons, as the case may be, if:

(1) The allocation is made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated, and

(2) The allocation is made on or before the 15th day of the ninth month following the close of the taxable year in which the amounts allocated were received by the cooperative association.

For the purpose of subparagraph (1) of this paragraph, amounts allocated by a cooperative association entitled to tax treatment under section 522 will be deemed allocated in fulfillment and satisfaction of a valid enforceable obligation, if made pursuant to provisions of the bylaws, articles of incorporation, or other contract, whereby the association is obligated to make such allocation after the retention of *reasonable reserves* and after payment of dividends on capital stock or other proprietary capital interests. Notwithstanding the provisions of subparagraphs (1) and (2) of this paragraph, amounts allocated as patronage dividends, refunds, or rebates during the taxable year, on or before the 15th day of the ninth month following the close of such year, with respect to patronage for years preceding the taxable year, shall be taken into account as an increase in its other cost of goods sold, or as a reduction in gross receipts, for the taxable year, as the case may be, where retention as *reasonable reserves* of the amounts so allocated beyond the year in which earned was proper in accordance with the provisions of section 521 and where the allocation is made to the patron on a patronage basis is proportion insofar as is practicable, to the amount of business done by such patrons during the taxable year or years in which the retained amounts were received by the cooperative association.

(b) *Examples.* This section may be illustrated by the following examples:

Example 1. E, a cooperative association entitled to tax treatment under section 522, organized without capital stock, is engaged in the business of marketing products for its patrons on a non-pool basis. The by-laws of Cooperative E provide that there shall be allocated to patrons as patronage dividends within a reasonable time following the close of the year all of the gross returns from sales, less expenses of operation for the year and amounts retained as *reasonable reserves* necessary to the operation of Cooperative E. At the close of the taxable year, 1954, it is determined that from the gross returns from sales less operating expenses and all taxes for such year, $5,000 is to be retained as *reasonable reserves* for various necessary purposes of Cooperative E. It is assumed that the retention of such amount is proper in accordance with the provisions of section 521. Such $5,000 is apportioned on the books of Cooperative E to patrons of 1954 on a patronage basis, or permanent records are kept from which an apportionment to such patrons can be made. On March 1, 1955, pursuant to the terms of the by-laws, $200,000, the balance of the gross returns for the taxable year, is allocated to patrons of 1954 on the basis of patronage. $100,000 of such $200,000 is allocated in cash. The remaining $100,000 is allocated in *retain certificates,* bearing no interest and redeemable in the discretion of the Board of Directors of Cooperative E. There may be added to the cost of goods sold by Cooperative E for 1954, $200,000 ($100,000 in cash, $100,000 in retain certificates), the total amount allocated as patronage dividends, rebates, or refunds in fulfillment and satisfaction of the obligation of the by-laws, on March 1, 1955, before the 15th day of the ninth month following the close of 1954. There may not be added to the cost of goods sold by Cooperative E for 1954, $5,000, the amount retained as reserves apportioned on the books, but not allocated as patronage dividends, rebates, or refunds.

Example 2. The facts are the same as example 1, it additionally appearing that at the close of 1955 it is determined by Cooperative E to allocate as cash patronage dividends, rebates, or refunds to patrons of 1954, $5,000, the amount retained as *reasonable reserves* for 1954 in accordance with the provisions of section 521. On March 1, 1956, such amount is allocated. There may be added to the cost of goods sold by Cooperative E for 1955, $5,000, the amount allocated with respect to patronage of a preceding year, 1954, properly maintained as a reserve under section 521.

§1.522–4 Taxable years affected.

Section 522 and §§1.522–1, 1.522–2, and 1.522–3, are applicable to taxable years beginning before January 1, 1963, and also to amounts paid during taxable years beginning after December 31, 1962, the tax treatment of which is not prescribed in section 1382 and the regulations thereunder.

[T.D. 6643, 28 FR 3163, Apr. 2, 1963]

§1.527–1 Political organizations; generally.

Section 527 provides that a political organization is considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes. A political organization is subject to tax only to the extent provided in section 527. In general, a political organization is an organization that is organized and operated primarily for an exempt function as defined in §1.527–2(c). Section 527 provides that a political organization is taxed on its political organization taxable income (see §1.527–4) which, in general, does not include the exempt function income (see §1.527–3) of the political organization. Furthermore, section 527 provides that an exempt organization, other than a political organization, may be subject to tax under section 527 when it expends an amount for an exempt function, see §1.527–6. The taxation of newsletter funds is provided under section 527(g) and §1.527–7. A special rule for principal campaign committees is provided under section 527(h) and §1.527–9.

[T.D. 8041, 50 FR 30817, July 30, 1985]

§1.527–2 Definitions.

For purposes of section 527 and these regulations:

(a) *Political organization*—(1) *In general.* A *political organization* is a party, committee, association, fund, or other organization (whether or not incorporated) organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures for an exempt function activity (as defined in paragraph (c) of this section). Accordingly, a political organization may include a committee or other group which accepts contributions or makes expenditures for the purpose of promoting the nomination of an individual for an elective public office in a primary election, or in a meeting or caucus of a political party. A segregated fund (as defined in paragraph (b) of this section) established and maintained by an individual may qualify as a political organization.

(2) *Organizational test.* A political organization meets the organizational test if its articles of organization provide that the primary purpose of the organization is to carry on one or more exempt functions. A political organization is not required to be formally chartered or established as a corporation, trust, or association. If an organization has no formal articles of organization, consideration is given to statements of the members of the organization at the time the organization is formed that they intend to operate the organization primarily to carry on one or more exempt functions.

(3) *Operational test.* A political organization does not have to engage exclusively in activities that are an exempt function. For example, a political organization may:

(i) Sponsor nonpartisan educational workshops which are not intended to influence or attempt to influence the selection, nomination, election, or appointment of any individual for public office,

(ii) Pay an incumbent's office expenses, or

(iii) Carry on social activities which are unrelated to its exempt function,

provided these are not the organization's primary activities. However, expenditures for purposes described in the preceding sentence are not for an exempt function. See § 1.527–2 (c) and (d). Furthermore, it is not necessary that a political organization operate in accordance with normal corporate formalities as ordinarily established in bylaws or under state law.

(b) *Segregated fund*—(1) *General rule.* A *segregated fund* is a fund which is established and maintained by a political organization or an individual separate from the assets of the organization or the personal assets of the individual. The purpose of such a fund must be to receive and segregate exempt function income (and earnings on such income) for use only for an exempt function or for an activity necessary to fulfill an exempt function. Accordingly, the amounts in the fund must be dedicated for use only for an exempt function. Thus, expenditures for the establishment or administration of a political organization or the solicitation of political contributions may be made from the segregated fund, if necessary to fulfill an exempt function. The fund must be clearly identified and established for the pruposes intended. A savings or checking account into which only contributions to the political organization are placed and from which only expenditures for exempt functions are made may be a segregated fund. If an organization that had designated a fund to be a segregated fund for purposes of segregating amounts referred to in section 527(c)(3) (A) through (D), expends more than an insubstantial amount from the segregated fund for activities that are not for an exempt function during a taxable year, the fund will not be treated as a segregated fund for such year. In such a case amounts referred to in section 527(c)(3)(A)–(D), segregated in such fund will not be exempt function income. Further, if more than insubstantial amounts segregated for an exempt function in prior years are expended for other than an exempt function the facts and circumstances may indicate that the fund was never a segregated fund as defined in this paragraph.

(2) *Record keeping.* The organization or individual maintaining a segregated fund must keep records that are adequate to verify receipts and disbursements of the fund and identify the exempt function activity for which each expenditure is made.

(c) *Exempt function*—(1) *Directly related expenses.* An *exempt function*, as defined in section 527(e)(2), includes all activities that are directly related to and support the process of influencing or attempting to influence the selection, nomination, election, or appointment of any individual to public office or office in a political organization (the selection process). Whether an expenditure is for an exempt function depends upon all the facts and circumstances. Generally, where an organization supports an individual's campaign for public office, the organization's activities and expenditures in futherance of the individual's election or appointment to that office are for an exempt function of the organization. The individual does not have to be an announced candidate for the office. Furthermore, the fact that an individual never becomes a candidate is not crucial in determining whether an organization is engaging in an exempt function. An activity engaged in between elections which is directly related to, and supports, the process of selection, nomination, or election of an individual in the next applicable political campaign is an exempt function activity.

(2) *Indirect expenses.* Expenditures that are not directly related to influencing or attempting to influence the selection process may also be an expenditure for an exempt function by a political organization. These are expenses which are necessary to support the directly related activities of the political organization. Activities which support the directly related activities are those which must be engaged in to allow the political organization to carry out the activity of influencing or attempting to influence the selection process. For example, expenses for

overhead and record keeping are necessary to allow the political organization to be established and to engage in political activities. Similarly, expenses incurred in soliciting contributions to the political organization are necessary to support the activities of the political organization.

(3) *Terminating activities.* An exempt function includes an activity which is in furtherance of the process of terminating a political organization's existence. For example, where a political organization is established for a single campaign, payment of campaign debts after the conclusion of the campaign is an exempt function activity.

(4) *Illegal expenditures.* Expenditures which are illegal or are for a judicially determined illegal activity are not considered expenditures in furtherance of an exempt function, even though such expenditures are made in connection with the selection process.

(5) *Examples.* The following examples illustrate the principles of paragraph (c) of this section. The term *exempt function* when used in the following examples means exempt function within the meaning of section 527(e)(2).

(i) *Example 1.* A wants to run for election to public office in State X. A is not a candidate. A travels throughout X in order to rally support for A's intended candidacy. While in X, A attends a convention of an organization for the purpose of attempting to solicit its support. The amount expended for travel, lodging, food, and similar expenses are for an exempt function.

(ii) *Example 2.* B, a member of the United States House of Representatives, is a candidate for reelection. B travels with B's spouse to the district B represents. B feels it is important for B's reelection that B's spouse accompany B. While in the district, B makes speeches and appearances for the purpose of persuading voters to reelect B. The travel expenses of B and B's spouse are for an exempt function.

(iii) *Example 3.* C is a candidate for public office. In connection with C's campaign, C takes voice and speech lessons to improve C's skills. The expenses for these lessons are for an exempt function.

(iv) *Example 4.* D, an officeholder and candidate for reelection, purchases tickets to a testimonial dinner. D's attendance at the dinner is intended to aid D's reelection. Such expenditures are for an exempt function.

(v) *Example 5.* E, an officeholder, expends amounts for periodicals of general circulation in order to keep informed on national and local issues. Such expenditures are not for an exempt function.

(vi) *Example 6.* N is an organization described in section 501(c) and is exempt from taxation under section 501(a). F is employed as president of N. F, as a representative of N, testifies in response to a written request from a Congressional committee in support of the confirmation of an individual to a cabinet position. The expenditures by N that are directly related to F's testimony are not for an exempt function.

(vii) *Example 7.* P is a political organization described in section 527(e)(2). Between elections P does not support any particular individual for public office. However, P does train staff members for the next election, drafts party rules, implements party reform proposals, and sponsors a party convention. The expenditures for these activities are for an exempt function.

(viii) *Example 8.* Q is a political organization described in section 527(e)(2). Q finances seminars and conferences which are intended to influence persons who attend to support individuals to public office whose political philosophy is in harmony with the political philosophy of Q. The expenditures for these activities are for an exempt function.

(d) *Public office.* The facts and circumstances of each case will determine whether a particular Federal, State, or local office is a *public office.* Principles consistent with those found under §53.4946–1(g)(2) (relating to the definition of public office) will be applied.

(e) *Principal campaign committee.* A *principal campaign committee* is the political committee designated by a candidate for Congress as his or her principal campaign committee for purposes of section 302(e) of the Federal Election Campaign Act of 1971 (2 U.S.C. section 432(e)), as amended, and section 527(h) and §1.527–9.

[T.D. 7744, 45 FR 85731, Dec. 30, 1980; as amended by T.D. 8041, 50 FR 30817, July 30, 1985]

§1.527–3 Exempt function income.

(a) *General rule*—(1) For purposes of section 527, exempt function income consists solely of amounts received as:

(i) Contributions of money or other property,

(ii) Membership dues, fees, or assessments from a member of a political organization, or

(iii) Proceeds from a political fund raising or entertainment event, or proceeds from the sale of political campaign materials, which are not received in the ordinary course of any trade or business,

but only to the extent such income is segregated for use only for exempt functions of the political organization.

(2) Income will be considered segregated for use only for an exempt function only if it is received into and disbursed from a segregated fund as defined in § 1.527–2(b).

(b) *Contributions.* The rules of section 271(b)(2) apply in determining whether the transfer of money or other property constitutes a contribution. Generally, money or other property, whether solicited personally, by mail, or through advertising, qualifies as a contribution. In addition, to the extent a political organization receives Federal, State, or local funds under the $1 *checkoff* provision (sections 9001–9013), or any other provision for financing of campaigns, such amounts are to be treated as contributions.

(c) *Dues, fees, and assessments.* Amounts received as membership fees and assessments from members of a political organization may constitute exempt function income to the political organization. Membership fees and assessments received in consideration for services, goods, or other items of value do not constitute exempt function income. However, filing fees paid by an individual directly or indirectly to a political party in order that the individual may run as a candidate in a primary election of the party (or run in a general election as a candidate of that party) are to be treated as exempt function income. For example, some States provide that a certain percentage of the first year's salary of the office sought must be paid to the State as a filing (or *qualifying*) fee and party assessment. The State then transfers part of this fee to the candidate's party. In such a case, the entire amount transferred to the party is to be treated as exempt function income. Furthermore, amounts paid by an individual directly to the party as a qualification fee are treated similarly.

(d) *Fund raising events*—(1) *In general.* Amounts received from fund raising and entertainment events are eligible for treatment as exempt function income if the events are political in nature and are not carried on in the ordinary course of a trade or business. Whether an event is *political* in nature depends on all facts and circumstances. One factor that indicates an event is a political event is the extent to which the event is related to a political activity aside from the need of the organization for income or funds. For example, an event that is intended to rally and encourage support for an individual for public office would be a political fund raising event. Examples of political events can include dinners, breakfasts, receptions, picnics, dances, and athletic exhibitions.

(2) *Ordinary course of any trade or business.* Whether an activity is in the ordinary course of a trade or business depends on the facts and circumstances of each case. Generally, proceeds from casual, sporadic fund raising or entertainment events are not in the ordinary course of a trade or business. Factors to be taken into account in determining whether an activity is a trade or business include the frequency of the activity, the manner in which the activity is conducted, and the span of time over which the activity is carried on.

(e) *Sale of campaign materials.* Amounts received from the sale of campaign materials are eligible for treatment as exempt function income if the sale is not carried on in the ordinary course of a trade or business (as defined in paragraph (d)(2) of this section), and is related to a political activity of the organization aside from the need of such organization for income or funds. Proceeds from the sale of political memorabilia, bumper stickers, campaign buttons, hats, shirts, political posters, stationery, jewelry, or cookbooks are related to such a political acitivity where such items can be identified as relating to distributing political literature or organizing voters to vote for a candidate for public office.

[T.D. 7744, 45 FR 85732, Dec. 30, 1980]

§1.527–4 Special rules for computation of political organization taxable income.

(a) *In general.* Political organization taxable income is determined according to the provisions of section 527(b) and the rules set forth in this section.

(b) *Limitation on capital losses.* If for any taxable year a political organization has a net capital loss, the rules of sections 1211(a) and 1212(a) apply.

(c) *Allowable deductions*—(1) *In general.* To be deductible in computing political organization taxable income, expenses, depreciation, and similar items must not only qualify as deductions allowed by chapter 1 of the Code, but must also be directly connected with the production of political organization taxable income.

(2) *Directly connected with defined.* To be *directly connected with* the production of political organization taxable income, an item of deduction must have a proximate and primary relationship to the production of such income and have been incurred in the production of such income. Items of deduction attributable solely to items of political organization taxable income are proximately and primarily related to such income. Whether an item of deduction is incurred in the production of political organization taxable income is determined on the basis of all the facts and circumstances of each case.

(3) *Dual use of facilities or personnel.* Expenses, depreciation, and similar items that are attributable to the production of exempt function income and political organization taxable income shall be allocated between the two on a reasonable and consistent basis. For example, where facilities are used both for an exempt function of the organization and for the production of political organization taxable income, expenses, depreciation, and similar items attributable to such facilities (for example, items of overhead) shall be allocated between the two uses of a reasonable and consistent basis. Similarly, where personnel are employed both for an exempt function and for the production of political organization taxable income, expenses and similar items attributable to such personnel (for example, items of salary) shall be allocated between the activities on a reasonable and consistent basis. The portion of any such item so allocated to the production of political organization taxable income is directly connected with such income and is allowable as a deduction in computing political organization taxable income to the extent that it qualifies as an item of deduction allowed by chapter 1 of the Code. Thus, for example, assume that X, a political organization, pays its manager a salary of $10,000 a year and that it derives political organization taxable income. If 10 percent of the manager's time during the year is devoted to deriving X's gross income (other than exempt function income), a deduction of $1,000 (10 percent of $10,000) would generally be allowable for purposes of computing X's political organization taxable income.

[T.D. 7744, 45 FR 85733, Dec. 30, 1980]

§1.527–5 Activities resulting in gross income to an individual or political organization.

(a) *In general*—(1) *General rule.* Amounts expended by a political organization for an exempt function are not income to the individual or individuals on whose behalf such expenditures are made. However, where a political organization expends any other amount for the personal use of any individual, the individual on whose behalf the amount is expended will be in receipt of income. Amounts are expended for the personal use of an individual where a direct or indirect financial benefit accrues to such individual. For example, if a political organization pays a personal legal obligation of a candidate for public office, such as the candidate's federal income tax liability, the amount paid is includible in such candidate's gross income. Similarly, if a political organization expends any amount of its exempt function income for other than an exempt function, and the expenditure results in a direct or indirect financial benefit to the political organization, it must include the amount of such expenditure in its gross income. For example, if a political organization expends exempt function income for making an improvement or addition to its facilities, or for equipment, which is not necessary for or used in carrying out an exempt function, the amount of the expenditure will be included in the political organization's gross income. However, if a political organization expends exempt function income to make ordinary and necessary repairs on the facilities the political organization uses in conducting its exempt function, such amounts will not be included in the political organization's gross income.

(2) *Expenditure for an illegal activity.* Expenditures by a political organization that are illegal or for an activity that is judicially determined to be illegal are treated as amounts not segregated for use only for the exempt function and shall be included in the political organization's taxable income. However, expenses incurred in defense of civil or criminal suits against the organization are not treated as taxable to the organization. Similarly, voluntary reimbursement to the participants in the illegal activity for similar expenses incurred by them are not taxable to the organization if the organization can demonstrate that such payments do not constitute a part of the inducement to engage in the illegal activity or part of the agreed upon compensation therefor. However, if the organization entered into an agreement with the participants to defray such expenses as part of the inducement, such payments would be treated as an expenditure for an illegal activity. Except where necessary to prevent the period of limitation for assessment and collection of a tax from expiring, a notice of deficiency will not generally be issued until after there has been a final determination of illegality by an appropriate court in a criminal proceeding.

(b) *Certain uses not treated as income to a candidate.* Except as otherwise provided in paragraph (a) of this section, if a political organization:

(1) Contributes any amount to or for the use of any political organization described in section 527(e)(1) or newsletter fund described in section 527(g),

(2) Contributes any amount to or for the use of any organization described in paragraph (1) and (2) of section 509(a) which is exempt from taxation under section 501(a), or

(3) Deposits any amount in the general fund of the U.S. Treasury or in the general fund of any State or local government,

such amount shall not be treated as an amount expended for the personal use of a candidate or other person. No deduction shall be allowed under the Internal Revenue Code of 1954 for the contribution or deposit described in the preceding sentence.

(c) *Excess funds*—(1) *General rule.* Generally, funds controlled by a political organization or other person after a campaign or election are excess funds and are treated as expended for the personal use of the person having control over the ultimate use of such funds. However, such funds will not be treated as excess funds to the extent they are:

(i) Transferred within a reasonable period of time by the person controlling the funds in accordance with paragraph (b) of this section, or

(ii) Held in reasonable anticipation of being used by the political organization for future exempt functions.

(2) *Excess funds transferred at death.* Where excess funds are held by an individual who dies, and these funds go to the individual's estate or any other person (other than an organization or fund described in paragraph (b) of this section), the funds are income of the decedent and will be included in the decedent's gross estate unless the estate or other person receiving such funds transfers the funds within a reasonable period of time in accordance with paragraph (b) of this section.

This paragraph (c)(2) will not apply where the individual who dies provides that the funds be transferred to an organization or fund described in paragraph (b) of this section.

[T.D. 7744, 45 FR 85733, Dec. 30, 1980]

§ 1.527–6 Inclusion of certain amounts in the gross income of an exempt organization which is not a political organization.

(a) *Exempt organizations—General rule.* If an organization described in section 501(c) which is exempt from tax under section 501(a) expends any amount for an exempt function, it may be subject to tax. There is included in the gross income of such organization for the taxable year an amount equal to the lesser of:

(1) The net investment income of such organization for the taxable year, or

(2) The aggregate amount expended during the taxable year for an exempt function.

The amount included will be treated as political organization taxable income.

(b) *Exempt function expenditures*—(1) *Directly related expenses.* (i) Except as provided in this section, the term *exempt function* will generally have the same meaning it has in §1.527–2(c). Thus, expenditures which are directly related to the selection process as defined in §1.527–2(c)(1) are expenditures for an exempt function. Expenditures for indirect expenses as defined in §1.527–2(c)(2), when made by a section 501(c) organization are for an exempt function only to the extent provided in paragraph (b)(2) of this section. Expenditures of a section 501 (c) organization which are otherwise allowable under the Federal Election Campaign Act or similar State statute are for an exempt function only to the extent provided in paragraph (b)(3) of this section.

(ii) An expenditure may be made for an exempt function directly or through another organization. A section 501(c) organization will not be absolutely liable under section 527(f)(1) for amounts transferred to an individual or organization. A section 501(c) organization is, however, required to take reasonable steps to ensure that the transferee does not use such amounts for an exempt function.

(2) *Indirect expenses.* [Reserved]

(3) *Expenditures allowed by Federal Election Campaign Act.* [Reserved]

(4) *Appointments or confirmations.* Where an organization described in paragraph (a) of this section appears before any legislative body in response to a written request by such body for the purpose of influencing the appointment or confirmation of an individual to a public office, any expenditure directly related to such appearance is not treated as an expenditure for an exempt function.

(5) *Nonpartisan activity.* Expenditures for nonpartisan activities by an organization to which paragraph (a) of this section applies are not expenditures for an exempt function. Nonpartisan activities include voter registration and *get-out-the-vote* campaigns. To be nonpartisan voter registration and *get-out-the-vote* campaigns must not be specifically identified by the organization with any candidate or political party.

(c) *Character of items included in gross income*—(1) *General rule.* The items of income included in the gross income of an organization under paragraph (a) of this section retain their character as ordinary income or capital gain.

(2) *Special rule in determining character of item.* If the amount included in gross income is determined under paragraph (a)(2)(ii) of this section, the character of the items of income is determined by multiplying the total amount included in gross income under such paragraph by a fraction, the numerator of which is the portion of the organization's net investment income that is gain from the sale or exchange of a capital asset, and the denominator of which is the organization's net investment income. For example, if $5,000 is included in the gross income of an organization under paragraph (a)(2) of this section, and the organization had $100,000 of net investment income of which $10,000 is long term capital gain, then $500 would be treated as long term capital gain:

$$\frac{\text{Capital gain}}{\text{net investment income}} \times \begin{array}{c}\text{Amount expended}\\ \text{on an exempt function}\end{array} = \begin{array}{c}\text{Portion of income}\\ \text{subject to tax under SS}\\ \text{section 1201}\end{array}$$

$$\frac{\$10{,}000}{\$100{,}000} \times \$5{,}000 = \$500$$

(d) *Modifications.* The modifications described in section 527(c)(2) apply in computing the tax under paragraph (a)(2) of this section. Thus, no net operating loss is allowed under section 172 nor is any deduction allowed under part VIII of subchapter B. However, there is allowed a specific deduction of $100.

(e) *Transfer not treated as exempt function expenditures.* Provided the provisions of this paragraph (e) are met, a transfer of political contributions or dues collected by a section 501(c) organization to a separate segregated fund as defined in paragraph (f) of this section is not treated as an expenditure for an exempt function (within the meaning of § 1.527–2(c)). Such transfers must be made promptly after the receipt of such amounts by the section 501(c) organization, and must be made directly to the separate segregated fund. A transfer is considered promptly and directly made if:

(1) The procedures followed by the section 501(c) organization satisfy the requirements of applicable Federal or State campaign law and regulations;

(2) The section 501(c) organization maintains adequate records to demonstrate that amounts transferred in fact consist of political contributions or dues, rather than investment income; and

(3) The political contributions or dues transferred were not used to earn investment income for the section 501(c) organization.

(f) *Separate segregated fund.* An organization or fund described in section 527(f)(3) is a separate segregated fund. To avoid the application of paragraph (a) of this section, an organization described in section 501(c) that is exempt from taxation under section 501(a) may, if it is consistent with its exempt status, establish and maintain such a separate segregated fund to receive contributions and make expenditures in a political campaign. If such a fund meets the requirements of § 1.527–2(a) (relating to the definition of a political organization), it shall be treated as a political organization subject to the provisions of section 527. A segregated fund established under the Federal Election Campaign Act will continue to be treated as a segregated fund when it engages in exempt function activities as defined in § 1.527–2(c), relating to State campaigns.

(g) *Effect of expenditures on exempt status.* Section 527(f) and this section do not sanction the intervention in any political campaign by an organization described in section 501(c) if such activity is inconsistent with its exempt status under section 501(c). For example, an organization described in section 501(c)(3) is precluded from engaging in any political campaign activities. The fact that section 527 imposes a tax on the exempt function (as defined in § 1.527–2(c)) expenditures of section 501(c) organizations and permits such organizations to establish separate segregated funds to engage in campaign activities does not sanction the participation in these activities by section 501(c)(3) organizations.

[T.D. 7744, 45 FR 85734, Dec. 30, 1980]

§ 1.527–7 Newsletter funds.

(a) *In general.* For purposes of this section, a fund established and maintained by an individual who holds, has been elected to, or is a candidate (within the meaning of section 41(c)(2)) for nomination or election to, any Federal, State, or local elective public office for the use by such individual exclusively for an exempt function, as defined in paragraph (c) of this section, shall be a newsletter fund. If assets of a newsletter fund are used for any purpose other than the exempt function of the newsletter fund as defined in paragraph (c) of this section, such amount shall be treated as expended for the personal use of the individual who established and maintained such fund. In addition, future contributions to such fund are treated as income to the individual who established and maintained the fund. In such a case, the facts and circumstances may indicate that the fund was never established and maintained exclusively for an exempt function as defined in paragraph (c) of this section.

(b) *Determination of taxable income.* A newsletter fund shall be treated as if it were a political organization for purposes of determining its taxable income. However, the specific $100 deduction provided by section 527(c)(2)(A) shall not be allowed.

(c) *Exempt function.* For purposes of this section, the exempt function of a newsletter fund consists solely of the preparation and circulation of the newsletter. Among the expenditures treated as preparation and circulation expenditures of the newsletter are:

(1) Secretarial services,

(2) Printing,

(3) Addressing, and

(4) Mailing.

(d) *Nonexempt function purposes.* Newsletter fund assets may not be used for campaign activities. Therefore, an exempt function of a newsletter fund does not include:

(1) Expenditures for an exempt function as defined in §1.527–2(c) or

(2) Transfers of unexpended amounts to a political organization described in section 527(e)(1).

(e) *Excess funds.* Excess funds held by a newsletter fund which has ceased to engage in the preparation and circulation of the newsletter are treated as expended for the personal use of the individual who established and maintained such fund. However, to the extent such excess funds are within a reasonable period of time:

(1) Contributed to or for the use of any organization described in paragraph (1) or (2) of section 509(a) which is exempt from taxation under section 501(a),

(2) Deposited in the general fund of the U.S. Treasury or in the general fund of any State or local government (including the District of Columbia), or

(3) Contributed to any other newsletter fund as described in paragraph (a) of this section,

the excess funds are not treated as expended for the personal use of such individual. In such a case the individual is not allowed a deduction under the Internal Revenue Code of 1954 for such contribution or deposit.

[T.D. 7744, 45 FR 85735, Dec. 30, 1980]

§1.527–8 Effective date; filing requirements; and miscellaneous provisions.

(a) *Assessment and collections.* Since the taxes imposed by section 527 are taxes imposed by subtitle A of the Code, all provisions of law and of the regulations applicable to the taxes imposed by subtitle A are applicable to the assessment and collection of the taxes imposed by section 527. Organizations subject to the tax imposed by section 527 are subject to the same provisions, including penalties, as are provided for corporations, in general, except that the requirements of section 6154 concerning the payment of estimated tax do not apply. See, generally, sections 6151, et. seq., and the regulations prescribed thereunder, for provisions relating to payment of tax.

(b) *Returns.* For requirements of filing annual returns with respect to political organization taxable income, see section 6012 (a) (6) and the applicable regulations.

(c) *Taxable years, method of accounting, etc.* The taxable year (fiscal year or calendar year, as the case may be) of a political organization is determined without regard to the fact that such organization may have been exempt from tax during any prior period. See sections 441 and 446, and the regulations thereunder in this part, and section 7701 and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration). Similarly, in computing political organization taxable income, the determination of the taxable year for which an item of income or expense is taken into account is made under the provisions of sections 441, 446, 451, 461, and the regulations thereunder, whether or not the item arose during a taxable year beginning before, on, or after the effective date of the provisions imposing a tax upon political organization taxable income. If a method for treating bad debts was selected in a return of income (other than an information return) for a previous taxable year, the taxpayer must follow such method in its returns under section 527, unless such method is changed in accordance with the provisions of §1.166–1. A taxpayer who has not previously selected a method for treating bad debts may, in its first return under section 6012 (a) (6), exercise the option granted in §1.166–1.

(d) *Effective date.* Except as provided in paragraph (b)(2) of §1.527–6 and in paragraph (a) of §1.527–9, the regulations under section 527 apply to taxable years beginning after December 31, 1974.

[T.D. 7744, 45 FR 85735, Dec. 30, 1980; as amended by T.D. 8041, 50 FR 30817, July 30, 1985]

§ 1.527–9 Special rule for principal campaign committees.

(a) *In general.* Effective with respect to taxable years beginning after December 31, 1981, the tax imposed by section 527(b) on the political organization taxable income of a principal campaign committee shall be computed by multiplying the political organization taxable income by the appropriate rates of tax specified in section 11(b). The political organization taxable income of a campaign committee not a principal campaign committee is taxed at the highest rate of tax specified in section 11(b). A candidate for Congress may designate one political committee to serve as his or her principal campaign committee for purposes of section 527(h)(1). If a designation is made, it shall be made in accordance with the requirements of paragraph (b) of this section. A candidate for Congress may have only one designation in effect at any time. Under 11 CFR 102.12, no political committee may be designated as the principal campaign committee of more than one candidate for Congress. Further, no political committee that supports or has supported more than one candidate for Congress may be designated as a principal campaign committee. No designation need be made where there is only one political campaign committee with respect to a candidate.

(b) *Manner of designation.* If a candidate for Congress elects to make a designation under section 527(h) and this section, he or she shall designate his or her principal campaign committee by appending a copy of his or her Statement of Candidacy (that is, the Federal Election Commission Form 2, or equivalent statement that the candidate filed with the Federal Election Commission under 11 CFR 101.1(a)), to the Form 1120–POL filed by the principal campaign committee for each taxable year for which the designation is effective. This designation may also be made by appending to the Form 1120–POL statement containing the following information: The name and address of the candidate for Congress; his or her taxpayer identification number; his or her party affiliation and the office sought; the district and State in which the office is sought; and the name and address of the principal campaign comittee. This designation shall be made on or before the due date (as extended) for filing Form 1120–POL. Only a candidate for Congress may make a designation in accordance with this paragraph.

(c) *Manner of revoking designation.* A designation of a principal campaign committee that has been filed in accordance with this section may be revoked only with the consent of the Commissioner. In general, the Commissioner will grant such consent in every case where the candidate for Congress has revoked his or her designation in compliance with the requirements of the Federal Election Commission by filing an amended Statement of Organization or its equivalent pursuant to 11 CFR 102.2(a)(2). In the case of the revocation of the designation of a principal campaign committee by a candidate followed by the designation of another principal campaign committee by such candidate, for purposes of determining the appropriate rate of tax under section 11(b) for a taxable year, the political organization taxable income of the first principal campaign committee shall be treated as that of the subsequent principal campaign committee. In a case where consent to revoke a designation of a principal campaign committee is granted and a new designation is filed, the Commissioner may condition his consent upon the agreement of the candidate for Congress to insure compliance with the preceding sentence.

[T.D. 8041, 50 FR 30817, July 30, 1985]

HOMEOWNERS ASSOCIATIONS

§ 1.528–1 Homeowners associations.

(a) *In general.* Section 528 only applies to taxable years of homeowners associations beginning after December 31, 1973. To qualify as a homeowners association an organization must either be a condominium management association or a residential real estate management association. For the purposes of Section 528 and the regulations under that section, the term *homeowners association* shall refer only to an organization described in section 528. Cooperative housing corporations and organizations based on a similar form of ownership are not eligible to be taxed as homeowners associations. As a general rule, membership in either a condominium management association or a residential real estate management association is confined to the developers and the owners of the units, residences, or lots. Furthermore, membership in either type of association is normally required as a condition of such ownership. However, if the membership of an organization consists of other homeowners associations, the owners of units, residences, or lots who are members of such other homeowners associations will be treated as the members of the organization for the purposes of the regulations under section 528.

(b) *Condominium.* The term *condominium* means an interest in real property consisting of an undivided interest in common in a portion of a parcel of real property (which may be a fee simple estate or an estate for years, such as a leasehold or subleasehold) together with a separate interest in space in a building located on such property. An interest in property is not a condominium unless the undivided interest in the common elements are vested in the unit holders. In addition, a condominium must meet the requirements of applicable state or local law relating to condominiums or horizontal property regimes.

(c) *Residential real estate management association.* Residential real estate management associations are normally composed of owners of single-family residential units located in a subdivision, development, or similar area. However, they may also include as members, owners of multiple-family dwelling units located in such areas. They are commonly formed to administer and enforce covenants relating to the architecture and appearance of the real estate development as well as to perform certain maintenance duties relating to common areas.

(d) *Tenants.* Tenants will not be considered members for purposes of meeting the source of income test under section 528(c)(1)(B) and §1.528–5. However, the fact that tenants of members of a homeowners association are permitted to be members of the association will not disqualify an association under section 528(c)(1) if it otherwise meets the requirements of section 528(c) and these regulations.

[T.D. 7692, 45 FR 26321, Apr. 18, 1980]

§1.528–2 Organized and operated to provide for the acquisition, construction, management, maintenance and care of association property.

(a) *Organized and operated*—(1) *Organized.* To be treated as a homeowners association an organization must be organized and operated primarily for the purpose of carrying on one or more of the exempt functions of a homeowners association. For the purposes of section 528 and these regulations, the exempt functions of a homeowners association are the acquisition, construction, management, maintenance, and care of association property. In determining whether an organization is organized and operated primarily to carry on one or more exempt functions, all the facts and circumstances of each case shall be considered. For example, when an organization provides in its articles of organization that its sole purpose is to carry on one or more exempt functions, in the absence of other relevant factors it will be considered to have met the organizational test. (The term *articles of organization* means the organization's corporate charter, trust instruments, articles of association or other instrument by which it is created.)

(2) *Operated.* An organization will be treated as being operated for the purpose of carrying on one or more of the exempt functions of a homeowners association if it meets the provisions of §§1.528–5 and 1.528–6.

(b) *Terms to be interpreted according to common meaning and usage.* As used in section 528 and these regulations, the terms acquisition, construction, management, maintenance, and care are to be interpreted according to their common meaning and usage. For example, maintenance of association property includes the painting and repairing of such property as well as the gardening and janitorial services associated with its upkeep. Similarly, the term *construction* of association property includes covenants or other rules for preserving the architectural and general appearance of the area. The term also includes regulations relating to the location, color and allowable building materials to be used in all structures. (For the definition of association property see § 1.528–3.)

[T.D. 7692, 45 FR 26321, Apr. 18, 1980]

§ 1.528–3 Association property.

(a) *Property owned by the organization. Association property* includes real and personal property owned by the organization or owned as tenants in common by the members of the organization. Such property must be available for the common benefit of all members of the organization and must be of a nature that tends to enhance the beneficial enjoyment of the private residences by their owners. If two or more facilities or items of property of a similar nature are owned by a homeowners association, and if the use of any particular facility or item is restricted to fewer than all association members, such facilities or items nevertheless will be considered association property if all association members are treated equitably and have similar rights with respect to comparable items or facilities. Among the types of property that ordinarily will be considered association property are swimming pools and tennis courts. On the other hand, facilities or areas set aside for the use of nonmembers, or in fact used primarily by nonmembers, are not association property for the purposes of this section. For example, property owned by an organization for the purpose of leasing it to groups consisting primarily of nonmembers to be used as a meeting place or a retreat will not be considered association property.

(b) *Property normally owned by a governmental unit. Association property* also includes areas and facilities traditionally recognized and accepted as being of direct governmental concern in the exercise of the powers and duties entrusted to governments to regulate community health, safety and welfare. Such areas and facilities would normally include roadways, parklands, sidewalks, streetlights and firehouses. Property described in this paragraph will be considered association property regardless of whether it is owned by the organization itself, by its members as tenants in common or by a governmental unit and used for the benefit of the residents of such unit including the members of the organization.

(c) *Privately owned property. Association property* may also include property owned privately by members of the organization. However, to be so included the condition of such property must affect the overall appearance or structure of the residential units which make up the organization. Such property may include the exterior walls and roofs of privately owned residences as well as the lawn and shrubbery on privately owned land and any other privately owned property the appearance of which may directly affect the appearance of the entire organization. However, privately owned property will not be considered association property unless:

(1) There is a covenant or similar requirement relating to exterior appearance or maintenance that applies on the same basis to all such property (or to a reasonable classification of such property);

(2) There is a pro rata mandatory assessment (at least once a year) on all members of the association for maintaining such property; and

(3) Membership in the organization is a condition of ownership of such property.

[T.D. 7692, 45 FR 26321, Apr. 18, 1980]

§ 1.528–4 Substantiality test.

(a) *In general.* In order for an organization to be considered a condominium management association or a residential real estate management association (and therefore in order for it to be considered a homeowners association), substantially all of its units, lots or buildings must be used by individuals for residences. For the purposes of applying paragraph (b) or (c) of this section, and organization which has attributes of both a condominium management association and a residential real estate management association shall be considered that association which, based on all the facts and circumstances, it more closely resembles. In addition, those paragraphs shall be applied based on conditions existing on the last day of the organization's taxable year.

(b) *Condominium management associations.* Substantially all of the units of a condominium management association will be considered as used by individuals for residences if at least 85% of the total square footage of all units within the project is used by individuals for residential purposes. If a completed unit has never been occupied, it will nonetheless be considered as used for residential purposes if, based on all the facts and circumstances, it appears to have been constructed for use as a residence. Similarly, a unit which is not occupied but which has been in the past will be considered as used for residential purposes if, based on all the facts and circumstances, it appears that it was constructed for use as a residence, and the last individual to occupy it did in fact use it as a residence. Units which are used for purposes auxiliary to residential use (such as laundry areas, swimming pools, tennis courts, storage rooms and areas used by maintenance personnel) shall be considered used for residential purposes.

(c) *Residential real estate management associations.* Substantially all of the lots or buildings of a residential real estate managment association (including unimproved lots) will be considered as used by individuals as residences if at least 85% of the lots are zoned for residential purposes. Lots shall be treated as zoned for residential purposes even if under such zoning lots may be used for parking spaces, swimming pools, tennis courts, schools, fire stations, libraries, churches and other similar purposes which are auxiliary to residential use. However, commercial shopping areas (and their auxiliary parking areas) are not lots zoned for residential purposes.

(d) *Exception.* Notwithstanding any other provision of this section, a unit, or building will not be considerd used for residential purposes, if for more than one-half the days in the association's taxable year, such unit, or building is occupied by a person or series of persons, each of whom so occupies such unit, or building for less than 30 days.

[T.D. 7692, 45 FR 26322, Apr. 18, 1980; T.D. 7692, 45 FR 24879, May 23, 1980]

§1.528–5 Source of income test.

An organization cannot qualify as a homeowners association under section 528 for a taxable year unless 60 percent or more of its gross income for such taxable year is exempt function income as defined in §1.528–9. The determiniation of whether an organization meets the provisions of this section shall be made after the close of the organization's taxable year.

[T.D. 7692, 45 FR 26322, Apr. 18, 1980]

§1.528–6 Expenditure test.

(a) *In general.* An organization cannot qualify as a homeowners association under section 528 for a taxable year unless 90 percent or more of its expenditures for such taxable year are qualifying expenditures as defined in paragraphs (b) and (c) of this section. The determination of whether an organization meets the provisions of this section shall be made after the close of the organization's taxable year. Investments or transfers of funds to be held to meet future costs shall not be taken into account as expenditures. For example, transfers to a sinking fund account for the replacement of a roof would not be considered an expenditure for the purposes of this section even if the roof is association property. In addition, excess assessments which are either rebated to members or applied against the members' following year's assessments will not be considered an expenditure for the purposes of this section.

(b) *Qualifying expenditures.* Qualifying expenditures are expenditures by an organization for the acquisition, construction, management, maintenance, and care of the organization's association property. They include both current operating and capital expenditures on association property. Qualifying expenditures include expenditures on association property despite the fact that such property may produce income which is not exempt function income. Thus expenditures on a swimming pool are qualifying expenditures despite the fact that fees from guests of members using the pool are not exempt function income. Where expenditures by an organization are used both for association property as well as other property, an allocation shall be made between the two uses on a reasonable basis. Only that portion of the expenditures which is properly allocable to the acquisition, construction, management, maintenance or care of association property, shall constitute qualifying expenditures.

(c) *Examples of qualifying expenditures.* Qualifying expenditures may include (but are not limited to) expenditures for:

(1) Salaries of an association manager and secretary;

(2) Paving of streets;

(3) Street signs;

(4) Security personnel;

(5) Legal fees;

(6) Upkeep of tennis courts;

(7) Swimming pools;

(8) Recreation rooms and halls;

(9) Replacement of common buildings, facilities, air conditioning, etc;

(10) Insurance premiums on association property;

(11) Accountant's fees;

(12) Improvement of private property to the extent it is association property; and

(13) Real estate and personal property taxes imposed on association property by a State or local government.

[T.D. 7692, 45 FR 26322, Apr. 18, 1980]

§ 1.528–7 Inurement.

An organization is not a homeowners association if any part of its net earnings inures (other than as a direct result of its engaging in one or more exempt functions) to the benefit of any private person. Thus, to the extent that members receive a benefit from the general maintenance, etc., of association property, this benefit generally would not constitute inurement. If an organization pays rebates from amounts other than exempt function income, such rebates will constitute inurement. In general, in determining whether an organization is in violation of this section, the principles used in making similar determinations under Section 501(c) will be applied.

[T.D. 7692, 45 FR 26323, Apr. 18, 1980]

§ 1.528–8 Election to be treated as a homeowners association.

(a) *General rule.* An organization wishing to be treated as a homeowners association under section 528 and this section for a taxable year must elect to be so treated. Except as otherwise provided in this section such election shall be made by the filing of a properly completed Form 1120–H (or such other form as the Secretary may prescribe). A separate election must be made for each taxable year.

(b) *Taxable years ending after December 30, 1976.* For taxable years ending after December 30, 1976, the election must be made not later than the time, including extensions, for filing an income tax return for the year in which the election is to apply.

(c) *Taxable years ending before December 31, 1976, for which a return was filed before January 31, 1977.* For taxable years ending before December 31, 1976, for which a return was filed before January 31, 1977, the election must be made not later than the time provided by law for filing a claim for credit or refund of overpayment of taxes for the year in which the election is to apply. Such an election shall be made by filing an amended return on Form 1120–H (or such other form as the Secretary may prescribe).

(d) *Taxable years ending before December 31, 1976, for which a return was not filed before January 31, 1977.* For taxable years ending before December 31, 1976, for which a return was not filed before January 31, 1977, the election must be made by October 20, 1980. Instead of making such an election in the manner described in paragraph (a) of this section, such an election may be made by a statement attached to the applicable income tax return or amended return for the year in which the election is made. The statement should identify the election being made, the period for which it applies and the taxpayer's basis for making the election.

(e) *Revocation of exempt status.* If an organization is notified after the close of a taxable year that its exemption for such taxable year under section 501(a) is being revoked retroactively, it may make a timely election under section 528 for such taxable year. Notwithstanding any other provisions of this section, such an election will be considered timely if it is made within 6 months after the date of revocation. The preceding sentence shall apply to revocations made after April 18, 1980. If the revocation was made on or before April 18, 1980, the election will be considered timely if it is made before the expiration of the period for filing a claim for credit or refund for the taxable year for which it is to apply.

(f) *Effect of election*—(1) *Revocation*. An election to be treated as an organization described in section 528 is binding on the organization for the taxable year and may not be revoked without the consent of the Commissioner.

(2) *Exception*. Notwithstanding paragraph (f)(1) of this section, an election under this section may be revoked prior to July 18, 1980. Such a revocation shall be made by filing a statement with the director of the Internal Revenue Service Center with whom the return of the organization for the year in which the revocation is to apply was filed. The statement shall include the following information:

(i) The name of the organization.

(ii) The fact that it is revoking an election made under section 528.

(iii) The taxable year for which the revocation is to apply.

[T.D. 7692, 45 FR 26323, Apr. 18, 1980]

§1.528–9 Exempt function income.

(a) *General rule*. For the purposes of section 528 exempt function income consists solely of income which is attributable to membership dues, fees, or assessments of owners of residential units or residential lots. It is not necessary that the source of income be labeled as membership dues, fees, or assessments. What is important is that such income be derived from owners of residential units or residential lots in their capacity as owner-members rather than in some other capacity such as customers for services. Generally, for the membership dues, fees, or assessments with respect to a residential unit or lot to be exempt function income, the unit must be used for (or the unit or lot must be expected to be used) for residential purposes. However, dues, fees, or assessments paid to an organization by a developer with respect to unfinished or finished but unsold units or lots shall be exempt function income even though the developer does not use the units or lots. If an assessment is more in the nature of a fee for the provision of services in the course of a trade or business than a fee for a common activity undertaken by a collective group of owners for the purpose of enhancing or maintaining the value of their residences, the assessment will not be considered exempt function income to the organization. Furthermore, income attributable to dues, fees, or assessments will not be considered exempt function income unless each member's liability for payment arises solely from membership in the association. Dues, fees, or assessments that are based on the extent, if any, to which a member avails him or herself of a facility or facilities are not exempt function income. For the purposes of section 528, dues, fees, or assessments which are based on the assessed value or size of property will be considered as arising solely as a result of membership in the organization. Regardless of the organization's method of accounting, excess assessments during a taxable year which are either rebated to the members or applied to their future assessments are not considered gross income and therefore will not be considered exempt function income for such taxable year. However, if such excess assessments are applied to a future year's assessments, they will be considered gross income and exempt function income for that future year. In addition, assessments in a taxable year, such as an assessment for a capital improvement, which are not treated as gross income do not enter into the determination of whether the organization meets the source of income test for that taxable year.

(b) *Examples of exempt function income*. Assessments which are considered more in the nature of a fee for common activity than for the providing of services and which will therefore generally be considered exempt function income include assessments made for the purpose of:

(1) Paying the principal and interest on debts incurred for the acquisition of association property;

(2) Paying real estate taxes on association property;

(3) Maintaining association property;

(4) Removing snow from public areas; and

(5) Removing trash.

(c) *Examples of receipts which are not exempt function income.* Exempt function income does not include:

(1) Amounts which are not includible in the organization's gross income other than by reason of section 528 (for example, tax-exempt interest);

(2) Amounts received from persons who are not members of the association;

(3) Amounts received from members for special use of the organization's facilities, the use of which is not available to all members as a result of having paid the dues, fees or assessments required to be paid by all members;

(4) Interest earned on amounts set aside in a sinking fund;

(5) Amounts received for work done on privately owned property which is not association property; or

(6) Amounts received from members in return for their transportation to or from shopping areas, work location, etc.

(d) *Special rule.* Notwithstanding paragraphs (a) and (c)(3) of this section, amounts received from members or tenants of residential units owned by members (notwithstanding § 1.528–1(d)) for special use of an association's facilities will be considered exempt function income if:

(1) The amounts paid by the members are not paid more than once in any 12 month period; and

(2) The privilege obtained from the payment of such amounts lasts for the entire 12 month period or portion thereof in which the facility is commonly in use.

Thus, amounts received as the result of payments by members of a yearly fee for use of tennis courts or a swimming pool shall be considered exempt function income. However, amounts received for the use of a building for an evening, weekend, week, etc., shall not be considered exempt function income.

[T.D. 7692, 45 FR 26323, Apr. 18, 1980]

§ 1.528–10 Special rules for computation of homeowners association taxable income and tax.

(a) *In general.* Homeowners association taxable income shall be determined according to the provisions of section 528(d) and the rules set forth in this section.

(b) *Limitation on capital losses.* If for any taxable year a homeowners association has a net capital loss, the rules of sections 1211(a) and 1212(a) shall apply.

(c) *Allowable deductions*—(1) *In general.* To be deductible in computing the unrelated business taxable income of a homeowners association, expenses, depreciation and similar items must not only qualify as items of deduction allowed by chapter 1 of the Code but must also be directly connected with the production of gross income (excluding exempt function income). To be *directly connected with* the production of gross income (excluding exempt function income), an item of deduction must have both proximate and primary relationship to the production of such income and have been incurred in the production of such income. Items of deduction attributable solely to items of gross income (excluding exempt function income) are proximately and primarily related to such income. Whether an item of deduction is incurred in the production of gross income (excluding exempt function income) is determined on the basis of all the facts and circumstances involved in each case.

(2) *Dual use of facilities or personnel.* Where facilities are used both for exempt functions of the organization and for the production of gross income (excluding exempt function income), expenses, depreciation and similar items attributable to such facilities (for example, items of overhead) shall be allocated between the two uses on a reasonable basis. Similarly where personnel are employed both for exempt functions and for the production of gross income (excluding exempt function income), expenses and similar items attributable to such personnel (for example, items of salary) shall be allocated between the two activities on a reasonable basis. The portion of any such item so allocated to the production of

gross income (excluding exempt function income) is directly connected with such income and shall be allowable as a deduction in computing homeowners association taxable income to the extent that it qualifies as an item of deduction allowed by chapter 1 of the Code. Thus, for example, assume that X, a homeowners association, pays its manager a salary of $10,000 a year and that it derives gross income other than exempt function income. If 10 percent of the manager's time during the year is devoted to deriving X's gross income (other than exempt function income), a deduction of $1,000 (10 percent of $10,000) would generally be allowable for purposes of computing X's homeowners association taxable income.

(d) *Investment credit.* A homeowners association is not entitled to an investment credit.

(e) *Cross reference.* For the definition of exempt function income, see §1.528–9.

[T.D. 7692, 45 FR 26324, Apr. 18, 1980]

CORPORATIONS USED TO AVOID INCOME TAX ON SHAREHOLDERS

CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS

§1.531–1 Imposition of tax.

Section 531 imposes (in addition to the other taxes imposed upon corporations by chapter 1 of the Code) a graduated tax on the accumulated taxable income of every corporation described in section 532 and §1.532–1. In the case of an affiliated group which makes or is required to make a consolidated return see §1.1502–43. All of the taxes on corporations under chapter 1 of the Code are treated as one tax for purposes of assessment, collection, payment, period of limitations, etc. See section 535 and §§1.535–1, 1.535–2, and 1.535–3 for the definition and determination of accumulated taxable income.

(Secs. 1502 and 7805 of the Internal Revenue Code of 1954 (68A Stat. 637, 917; 26 U.S.C. 1502, 7805))

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7937, 49 FR 3462, Jan. 27, 1984]

§1.532–1 Corporations subject to accumulated earnings tax.

(a) *General rule.* (1) The tax imposed by section 531 applies to any domestic or foreign corporation (not specifically excepted under section 532(b) and paragraph (b) of this section) formed or availed of to avoid or prevent the imposition of the individual income tax on its shareholders, or on the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of dividing or distributing them. See section 533 and §1.533–1, relating to evidence of purpose to avoid income tax with respect to shareholders.

(2) The tax imposed by section 531 may apply if the avoidance is accomplished through the formation or use of one corporation or a chain of corporations. For example, if the capital stock of the M Corporation is held by the N Corporation, the earnings and profits of the M Corporation would not be returned as income subject to the individual income tax until such earnings and profits of the M Corporation were distributed to the N Corporation and distributed in turn by the N Corporation to its shareholders. If either the M Corporation or the N Corporation was formed or is availed of for the purpose of avoiding or preventing the imposition of the individual income tax upon the shareholders of the N Corporation, the accumulated taxable income of the corporation so formed or availed of (M or N, as the case may be) is subject to the tax imposed by section 531.

(b) *Exceptions.* The accumulated earnings tax imposed by section 531 does not apply to a personal holding company (as defined in section 542), to a foreign personal holding company (as defined in section 552), or to a corporation exempt from tax under subchapter F, chapter 1 of the Code.

(c) *Foreign corporations.* Section 531 is applicable to any foreign corporation, whether resident or nonresident, with respect to any income derived from sources, within the United States, if any of its shareholders are subject to income tax on the distributions of the corporation by reason of being (1) citizens or residents of the United States, or (2) nonresident alien individuals to whom section 871 is applicable, or (3) foreign corporations if a beneficial interest therein is owned directly or indirectly by any shareholder specified in subparagraph (1) or (2) of this paragraph.

§ 1.533–1 Evidence of purpose to avoid income tax.

(a) *In general.* (1) The Commissioner's determination that a corporation was formed or availed of for the purpose of avoiding income tax with respect to shareholders is subject to disproof by competent evidence. Section 533(a) provides that the fact that earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders unless the corporation, by the preponderance of the evidence, shall prove to the contrary. The burden of proving that earnings and profits have been permitted to accumulate beyond the reasonable needs of the business may be shifted to the Commissioner under section 534. See §§ 1.534–1 through 1.534–4. Section 533(b) provides that the fact that the taxpayer is a mere holding or investment company shall be prima facie evidence of the purpose to avoid income tax with respect to shareholders.

(2) The existence or nonexistence of the purpose to avoid income tax with respect to shareholders may be indicated by circumstances other than the conditions specified in section 533. Whether or not such purpose was present depends upon the particular circumstances of each case. All circumstances which might be construed as evidence of the purpose to avoid income tax with respect to shareholders cannot be outlined, but among other things, the following will be considered:

(i) Dealings between the corporation and its shareholders, such as withdrawals by the shareholders as personal loans or the expenditure of funds by the corporation for the personal benefit of the shareholders,

(ii) The investment by the corporation of undistributed earnings in assets having no reasonable connection with the business of the corporation (see § 1.537–3), and

(iii) The extent to which the corporation has distributed its earnings and profits.

The fact that a corporation is a mere holding or investment company or has an accumulation of earnings and profits in excess of the reasonable needs of the business is not absolutely conclusive against it if the taxpayer satisfies the Commissioner that the corporation was neither formed nor availed of for the purpose of avoiding income tax with respect to shareholders.

(b) *General burden of proof and statutory presumptions.* The Commissioner may determine that the taxpayer was formed or availed of to avoid income tax with respect to shareholders through the medium of permitting earnings and profits to accumulate. In the case of litigation involving any such determination (except where the burden of proof is on the Commissioner under section 534), the burden of proving such determination wrong by a preponderance of the evidence, together with the corresponding burden of first going forward with the evidence, is on the taxpayer under principles applicable to income tax cases generally. For the burden of proof in a proceeding before the Tax Court with respect to the allegation that earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, see section 534 and §§ 1.534–2 through 1.534–4. For a definition of a holding or investment company, see paragraph (c) of this section. For determination of the reasonable needs of the business, see section 537 and §§ 1.537–1 through 1.537–3. If the taxpayer is a mere holding or investment company, and the Commissioner therefore determines that the corporation was formed or availed of for the purpose of avoiding income tax with respect to shareholders, then section 533(b) gives further weight to the presumption of correctness already arising from the Commissioner's determination by expressly providing an additional presumption of the existence of a purpose to avoid income tax with respect to shareholders. Further, if it is established (after complying with section 534 where applicable) that earnings and profits were permitted to accumulate beyond the reasonable needs of the business and the

Commissioner has therefore determined that the corporation was formed or availed of for the purpose of avoiding income tax with respect to shareholders, then section 533(a) adds still more weight to the Commissioner's determination. Under such circumstances, the existence of such an accumulation is made determinative of the purpose to avoid income tax with respect to shareholders unless the taxpayer proves to the contrary by the preponderance of the evidence.

(c) *Holding or investment company.* A corporation having practically no activities except holding property and collecting the income therefrom or investing therein shall be considered a holding company within the meaning of section 533(b). If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of section 533(b).

(d) *Small business investment companies.* A corporation which is licensed to operate as a small business investment company under the Small Business Investment Act of 1958 (15 U.S.C. ch. 14B) and the regulations thereunder (13 CFR part 107) will generally be considered to be a *mere holding or investment company* within the meaning of section 533(b). However, the presumption of the existence of the purpose to avoid income tax with respect to shareholders which results from the fact that such a company is a *mere holding or investment company* will be considered overcome so long as such company:

(1) Complies with all the provisions of the Small Business Investment Act of 1958 and the regulations thereunder; and

(2) Actively engages in the business of providing funds to small business concerns through investment in the equity capital of, or through the disbursement of long-term loans to, such concerns in such manner and under such terms as the company may fix in accordance with regulations promulgated by the Small Business Administration (see secs. 304 and 305 of the Small Business Investment Act of 1958, as amended (15 U.S.C. 684, 685)).

On the other hand, if such a company violates or fails to comply with any of the provisions of the Small Business Investment Act of 1958, as amended, or the regulations thereunder, or ceases to be actively engaged in the business of providing funds to small business concerns in the manner provided in subparagraph (2) of this paragraph, it will not be considered to have overcome the presumption by reason of any rules provided in this paragraph.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6652, 28 FR 4786, May 14, 1963]

§1.533–2 Statement required.

The corporation may be required to furnish a statement of its accumulated earnings and profits, the payment of dividends, the name and address of, and number of shares held by, each of its shareholders, the amounts that would be payable to each of the shareholders if the income of the corporation were distributed and other information required under section 6042.

§1.534–1 Burden of proof as to unreasonable accumulations generally.

For purposes of applying the presumption provided for in section 533(a) and in determining the extent of the accumulated earnings credit under section 535(c)(1), the burden of proof with respect to an allegation by the Commissioner that all or any part of the earnings and profits of the corporation have been permitted to accumulate beyond the reasonable needs of the business may vary under section 534 as between litigation in the Tax Court and that in any other court. In case of a proceeding in a court other than the Tax Court, see paragraph (b) of §1.533–1.

§1.534–2 Burden of proof as to unreasonable accumulations in cases before the Tax Court.

(a) *Burden of proof on Commissioner.* Under the general rule provided in section 534(a), in any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation is upon the Commissioner if:

(1) A notification, as provided for in section 534(b) and paragraph (c) of this section, has not been sent to the taxpayer; or

(2) A notification, as provided for in section 534(b) and paragraph (c) of this section, has been sent to the taxpayer and, in response to such notification, the taxpayer has submitted a statement, as provided in section 534(c) and paragraph (d) of this section, setting forth the ground or grounds (together with facts sufficient to show the basis thereof) on which it relies to establish that all or any part of its earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business. However, the burden of proof in the latter case is upon the Commissioner only with respect to the relevant ground or grounds set forth in the statement submitted by the taxpayer, and only if such ground or grounds are supported by facts (contained in the statement) sufficient to show the basis thereof.

(b) *Burden of proof on the taxpayer.* The burden of proof in a Tax Court proceeding with respect to an allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business is upon the taxpayer if:

(1) A notification, as provided for in section 534(b) and paragraph (c) of this section, has been sent to the taxpayer and the taxpayer has not submitted a statement, in response to such notification, as provided in section 534(c) and paragraph (d) of this section; or

(2) A statement has been submitted by the taxpayer in response to such notification, but the ground or grounds on which the taxpayer relies are not relevant to the allegation or, if relevant, the statement does not contain facts sufficient to show the basis thereof.

(c) *Notification to the taxpayer.* Under section 534(b) a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531 may be sent by registered mail (or by certified or registered mail, if the notification is mailed after September 2, 1958) to the taxpayer at any time before the mailing of the notice of deficiency in the case of a taxable year beginning after December 31, 1953, and ending after August 16, 1954. See § 1.534–4 for rules relating to taxable years subject to the Internal Revenue Code of 1939. See section 534(d) and § 1.534–3 with respect to a notification in the case of a jeopardy assessment.

(d) *Statement by taxpayer.* (1) A taxpayer who has received a notification, as provided in section 534(b) and paragraph (c) of this section, that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531, may, under section 534(c), submit a statement that all or any part of the earnings and profits of the corporation have not been permitted to accumulate beyond the reasonable needs of the business. Such statement shall set forth the ground or grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that there has been no accumulation of earnings and profits beyond the reasonable needs of the business. See paragraphs (a) and (b) of this section for rules concerning the effect of the statement with respect to burden of proof. See §§ 1.537–1 to 1.537–3, inclusive, relating to reasonable needs of the business.

(2) The taxpayer's statement, under section 534(c) and this paragraph, must be submitted to the Internal Revenue office which issued the notification (referred to in section 534(b) and paragraph (c) of this section) within 60 days after the mailing of such notification. If the taxpayer is unable, for good cause, to submit the statement within such 60-day period, an additional period not exceeding 30 days may be granted upon receipt in the Internal Revenue office concerned (before the expiration of the 60-day period provided herein) of a request from the taxpayer, setting forth the reasons for such request. See section 534(d) and § 1.534–3 with respect to a statement in the case of a jeopardy assessment.

§1.534–3 Jeopardy assessments in Tax Court cases.

In the case of a jeopardy assessment, a notice of deficiency is required to be sent to the taxpayer by registered mail (or by certified or registered mail, if the notice is mailed after September 2, 1958) within 60 days after the making of the assessment. See section 6861. If a jeopardy assessment is made before the mailing of the deficiency notice, then in the case of a proceeding in the Tax Court, if the deficiency notice informs the taxpayer that an amount of accumulated earnings tax is included in the deficiency, such notice shall constitute the notification provided for in section 534(b) and paragraph (c) of §1.534–2. Under such circumstances the statement described in section 534(c) and paragraph (d) of §1.534–2 shall instead be included in the taxpayer's petition to the Tax Court, if the taxpayer desires to submit such statement. See paragraph (b) of §1.534–2, relating to burden of proof on the taxpayer.

§1.535–1 Definition.

(a) The accumulated earnings tax is imposed by section 531 on the accumulated taxable income. Accumulated taxable income is the taxable income of the corporation with the adjustments prescribed by section 535(b) and §1.535–2, minus the sum of the dividends paid deduction and the accumulated earnings credit. See section 561 and the regulations thereunder, relating to the definition of the deduction for dividends paid, and section 535(c) and §1.535–3, relating to the accumulated earnings credit.

(b) In the case of a foreign corporation, whether resident or nonresident, which files or causes to be filed a return, the accumulated taxable income shall be the taxable income from sources within the United States with the adjustments prescribed by section 535(b) and §1.535–2 minus the sum of the dividends paid deduction and the accumulated earnings credit. In the case of a foreign corporation which files no return, the accumulated taxable income shall be the gross income from sources within the United States without allowance of any deductions (including the accumulated earnings credit).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7244, 37 FR 28897, Dec. 30, 1972]

§1.535–2 Adjustments to taxable income.

(a) *Taxes*—(1) *United States taxes.* In computing accumulated taxable income for any taxable year, there shall be allowed as a deduction the amount by which Federal income and excess profits taxes accrued during the taxable year exceed the credit provided by section 33 (relating to taxes of foreign countries and possessions of the United States), except that no deduction shall be allowed for (i) the accumulated earnings tax imposed by section 531 (or a corresponding section of a prior law), (ii) the personal holding company tax imposed by section 541 (or a corresponding section of a prior law), and (iii) the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939, for taxable years beginning after December 31, 1940. The deduction is for taxes accrued during the taxable year, regardless of whether the corporation uses an accrual method of accounting, the cash receipts and disbursements method, or any other allowable method of accounting. In computing the amount of taxes accrued, an unpaid tax which is being contested is not considered accrued until the contest is resolved.

(2) *Taxes of foreign countries and United States possessions.* In determining accumulated taxable income for any taxable year, if the taxpayer chooses the benefits of section 901 for such taxable year, a deduction shall be allowed for:

(i) The income, war profits, and excess profits taxes imposed by foreign countries or possessions of the United States and accrued during such taxable year, and

(ii) In the case of a domestic corporation, the foreign income taxes deemed to be paid for such taxable year under section 902(a) in accordance with §§1.902–1 and 1.902–2 or section 960(a)(1) in accordance with §1.960–7.

In no event shall the amount under subdivision (ii) of this subparagraph exceed the amount includible in gross income with respect to such taxes under section 78 and § 1.78–1. The credit for such taxes provided by section 901 shall not be allowed against the accumulated earnings tax imposed by section 531. See section 901(a).

(b) *Charitable contributions.* Section 535(b)(2) provides that, in computing the accumulated taxable income of a corporation, the deduction for charitable contributions shall be computed without regard to section 170(b)(2). Thus, the amount of charitable contributions made during the taxable year not allowable as a deduction under section 170 by reason of the limitations imposed by section 170(b)(2) shall be allowed as a deduction in computing accumulated taxable income for the taxable year. However, any excess of the amount of the charitable contributions made in a prior taxable year over the amount allowed as a deduction under section 170 for such year shall not be allowed as a deduction from taxable income in computing accumulated taxable income for the taxable year.

(c) *Special deductions disallowed.* Sections 241 through 248 provide for the allowance of special deductions for such items as partially tax-exempt interest, certain dividends received, dividends paid on certain preferred stock of public utilities, and organizational expenses. Such special deductions, except the deduction provided by section 248 (relating to organizational expenses) shall be disallowed in computing accumulated taxable income.

(d) *Net operating loss.* The net operating loss deduction provided in section 172 is not allowed for purposes of computing accumulated taxable income.

(e) *Capital losses.* (1) Losses from sales or exchanges of capital assets during the taxable year, which are disallowed as deductions under section 1211(a) in computing taxable income, shall be allowed as deductions in computing accumulated taxable income.

(2) The computation of the capital losses allowable as a deduction in computing accumulated taxable income may be illustrated by the following example:

Example. X Corporation has capital losses of $30,000 which are disallowed under section 1211(a) for the taxable year ended December 31, 1956. This amount represents a loss of $25,000 from the sale or exchange of capital assets during the taxable year ended December 31, 1956, plus a $5,000 capital loss carryover resulting from the sale or exchange of capital assets during the taxable year ended December 31, 1955. In computing accumulated taxable income for the taxable year ended December 31, 1956, only the loss of $25,000 arising from the sale or exchange of capital assets during that taxable year will be allowed as a deduction.

(f) *Long-term capital gains.* (1) There is allowed as a deduction in computing accumulated taxable income, the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined without regard to the capital loss carryover provided in section 1212) minus the taxes attributable to such excess as provided by section 535(b)(6). The tax attributable to such excess is the difference between:

(i) The taxes (except the accumulated earnings tax) imposed by subtitle A of the Code for such year, and

(ii) The taxes (except the accumulated earnings tax) imposed by subtitle A computed for such year as if taxable income were reduced by the excess of the net long-term capital gain over net short-term capital loss (including the capital loss carryover to such year).

Where the tax (except the accumulated earnings tax) imposed by subtitle A includes an amount computed under section 1201(a)(2), the tax attributable to such excess is such amount computed under section 1201(a)(2).

(2) The application of the rule in subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Assume that D Corporation, for the taxable year ended December 31, 1956, has taxable income of $103,000 of which $8,000 is the excess of net long-term capital gain of $12,000 over a net short-term capital loss of $9,000. The $9,000 net short-term capital loss includes a capital loss carryover of $5,000. The amount allowable as a deduction under section 535(b)(6) and subparagraph (1) of this paragraph is $7,250, computed as follows: Net long-term capital gain less net short-term capital loss (computed without regard to the capital loss carryover) is $8,000 (that is, $12,000 net long-term capital gain less $4,000 net short-term capital loss computed without regard to the capital loss carryover of $5,000). The tax attributable to the excess of net long-term capital gain over net short-term capital loss (computed by taking the capital loss carryover into account) is $750, that is, 25 percent of such excess of $3,000, computed under section 1201(a)(2). The difference of $7,250 ($8,000 less $750) is the amount allowable as a deduction in computing accumulated taxable income.

(3) Section 631(c) (relating to gain or loss in the case of disposal of coal or domestic iron ore) shall have no application in determining the amount of the deduction allowable under section 535(b)(6).

(g) *Capital loss carrybacks and carryovers.* Capital losses carried to a taxable year under section 1212(a) shall have no application for purposes of computing accumulated taxable income for such year.

(h) *Bank affiliates.* There is allowed the deduction provided by section 601 in the case of bank affiliates (as defined in section 2 of the Banking Act of 1933; 12 U. S. C. 221a(c)).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6805, 30 FR 3209, Mar. 9, 1965; T.D. 6841, 30 FR 9305, July 27, 1965; T.D. 7301, 39 FR 964, Jan. 4, 1974; T.D. 7649, 44 FR 60086, Oct. 18, 1979]

§1.535–3 Accumulated earnings credit.

(a) *In general.* As provided in section 535(a) and §1.535–1, the accumulated earnings credit, provided by section 535(c), reduces taxable income in computing accumulated taxable income. In the case of a corporation, not a mere holding or investment company, the accumulated earnings credit is determined as provided in paragraph (b) of this section and, in the case of a holding or investment company, as provided in paragraph (c) of this section.

(b) *Corporation which is not a mere holding or investment company*—(1) *General rule.* (i) In the case of a corporation, not a mere holding or investment company, the accumulated earnings credit is the amount equal to such part of the earnings and profits of the taxable year which is retained for the reasonable needs of the business, minus the deduction allowed by section 535(b)(6) (see paragraph (f) of §1.535–2, relating to the deduction for long-term capital gains). In no event shall the accumulated earnings credit be less than the minimum credit provided for in section 535(c)(2) and subparagraph (2) of this paragraph. The amount of the earnings and profits for the taxable year retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction for such taxable year. See section 561 and §§1.561–1 and 1.561–2, relating to the deduction for dividends paid.

(ii) In determining whether any amount of the earnings and profits of the taxable year has been retained for the reasonable needs of the business, the accumulated earnings and profits of prior years will be taken into consideration. Thus, for example, if such accumulated earnings and profits of prior years are sufficient for the reasonable needs of the business, then any earnings and profits of the current taxable year which are retained will not be considered to be retained for the reasonable needs of the business. See section 537 and §§1.537–1 and 1.537–2.

(2) *Minimum credit.* Section 535(c)(2) provides for the allowance of a minimum accumulated earnings credit in the case of a corporation which is not a mere holding or investment company. Except as otherwise provided in section 243(b)(3) and §1.243–5 (relating to effect of 100-percent dividends received deduction under section 243(b)) and sections 1561, 1562, and 1564 (relating to limitations on certain tax benefits in the case of certain controlled corporations), in the case of such a corporation, this minimum credit shall in no case be less than the amount by which $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975) exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year. See paragraph (d) of this section for the effect of dividends paid after the close of the taxable year in determining accumulated earnings and profits at the close of the preceding taxable year. In determining the amount of the minimum credit allowable under section 535(c)(2), the needs of the business are not taken into consideration. If the taxpayer has accumulated earnings and profits at the close of the preceding taxable year equal to or in excess of $150,000 ($100,000 in the case of taxable

years beginning before January 1, 1975), the credit, if any, is determined without regard to section 535(c)(2). It is not intended that the provision for the minimum credit shall in any way create an inference that an accumulation in excess of $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975) is unreasonable. The reasonable needs of the business may require the accumulation of more or less than $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975), depending upon the circumstances in the case, but such needs shall not be taken into consideration to any extent in cases where the minimum accumulated earnings credit is applicable. For a discussion of the reasonable needs of the business, see section 537 and §§ 1.537–1, 1.537–2, and 1.537–3.

(3) *Illustrations of accumulated earnings credit.* The computation of the accumulated earnings credit provided by section 535(c) may be illustrated by the following examples:

Example 1. The X Corporation, which is not a mere holding or investment company, has accumulated earnings and profits in the amount of $125,000 as of December 31, 1974. Thus, the minimum credit provided by section 535(c)(2) exceeds the accumulated earnings and profits of X by $25,000. It has earnings and profits for the taxable year ended December 31, 1975, in the amount of $100,000 and has a dividends paid deduction under section 561 in the amount of $30,000 so that the earnings and profits for the taxable year which are retained in the business amount to $70,000. Assume that it has been determined that the earnings and profits for the taxable year which may be retained for the reasonable needs of the business amount to $55,000 and that a deduction has been allowed under section 535(b)(6) in the amount of $5,000. Since the amount by which $150,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year is less than $50,000 ($55,000–$5,000), the minimum credit provided by section 535(c)(2) will not apply and the accumulated earnings credit must be computed under section 535(c)(1) on the basis of the reasonable needs of the business. In this case, the accumulated earnings credit for the taxable year ended December 31, 1975, will be $50,000 computed as follows:

Earnings and profits of the taxable year determined to be retained for the reasonable needs of the business	$55,000
Less: The deduction for long-term capital gains (less applicable tax) allowed under sec. 535(b)(6)	5,000
Accumulated earnings credit allowable under sec. 535(c)(1)	50,000

Example 2. The Z Corporation which is not a mere holding or investment company, has accumulated earnings and profits in the amount of $45,000 as of December 31, 1974; it has earnings and profits for the taxable year ended December 31, 1975, in the amount of $115,000 and has a dividends paid deduction under section 561 in the amount of $10,000, so that the earnings and profits for the taxable year which are retained amount to $105,000. Assume that it has been determined that the accumulated earnings and profits of the taxable year which may be retained for the reasonable needs of the business amount to $20,000 and that no deduction is allowable for long-term capital gains under section 535(b)(6). The accumulated earnings credit allowable under section 535(c)(1) on the basis of the reasonable needs of the business is determined to be only $20,000. However, since the amount by which $150,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year is more than $20,000, the minimum accumulated earnings credit provided by section 535(c)(2) is applicable. The allowable credit will be the amount by which $150,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year (*i.e.*, $105,000, $150,000 less $45,000 of accumulated earnings and profits at the close of the preceding taxable year).

(c) *Holding and investment companies.* Section 535(c)(3) provides that, in the case of a mere holding or investment company, the accumulated earnings credit shall be the amount, if any, by which $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975) exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year. Thus, if such a corporation has accumulated earnings equal to or in excess of $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975) at the close of its preceding taxable year, no accumulated earnings credit is allowable in computing the accumulated taxable income. See paragraph (c) of § 1.533–1 for a definition of a holding or investment company. For the accumulated earnings credit of a mere holding or investment company which is a member of an affiliated group which has elected the 100-percent dividends received deduction under section 243(b), see section 243(b)(3) and

§1.243–5. For the accumulated earnings credit of a mere holding or investment company which is a component member of a controlled group of corporations (as defined in section 1563), see sections 1561, 1562, and 1564.

(Sec. 1561(a) (83 Stat. 599; 26 U.S.C. 1561(a)))

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6992, 34 FR 826, Jan. 18, 1969; T.D. 7181, 37 FR 8066, Apr. 25, 1972; T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7376, 40 FR 42744, Sept. 16, 1975; T.D. 7528, 42 FR 64694, Dec. 28, 1977]

§1.536–1 Short taxable years.

Accumulated taxable income for a taxable year consisting of a period of less than 12 months shall not be placed on an annual basis for the purpose of the accumulated earnings tax imposed by section 531. In such cases accumulated taxable income shall be computed on the basis of the taxable income for such period of less than 12 months, adjusted in the manner provided by section 535(b) and §1.535–2.

§1.537–1 Reasonable needs of the business.

(a) *In general.* The term *reasonable needs of the business* includes (1) the reasonably anticipated needs of the business (including product liability loss reserves, as defined in paragraph (f) of this section), (2) the section 303 redemption needs of the business, as defined in paragraph (c) of this section, and (3) the excess business holdings redemption needs of the business as described in paragraph (d) of this section. See paragraph (e) of this section for additional rules relating to the section 303 redemption needs and the excess business holdings redemption needs of the business. An accumulation of the earnings and profits (including the undistributed earnings and profits of prior years) is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business. The need to retain earnings and profits must be directly connected with the needs of the corporation itself and must be for bona fide business purposes. For purposes of this paragraph the section 303 redemption needs of the business and the excess business holdings redemption needs of the business are deemed to be directly connected with the needs of the business and for a bona fide business purpose. See §1.537–3 for a discussion of what constitutes the business of the corporation. The extent to which earnings and profits have been distributed by the corporation may be taken into account in determining whether or not retained earnings and profits exceed the reasonable needs of the business. See §1.537–2, relating to grounds for accumulation of earnings and profits.

(b) *Reasonable anticipated needs.* (1) In order for a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs, there must be an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite, and feasible plans for the use of such accumulation. Such an accumulation need not be used immediately, nor must the plans for its use be consummated within a short period after the close of the taxable year, provided that such accumulation will be used within a reasonable time depending upon all the facts and circumstances relating to the future needs of the business. Where the future needs of the business are uncertain or vague, where the plans for the future use of an accumulation are not specific, definite, and feasible, or where the execution of such a plan is postponed indefinitely, an accumulation cannot be justified on the grounds of reasonably anticipated needs of the business.

(2) Consideration shall be given to reasonably anticipated needs as they exist on the basis of the facts at the close of the taxable year. Thus, subsequent events shall not be used for the purpose of showing that the retention of earnings or profits was unreasonable at the close of the taxable year if all the elements of reasonable anticipation are present at the close of such taxable year. However, subsequent events may be considered to determine whether the taxpayer actually intended to consummate or has actually consummated the plans for which the earnings and profits were accumulated. In this connection, projected expansion

or investment plans shall be reviewed in the light of the facts during each year and as they exist as of the close of the taxable year. If a corporation has justified an accumulation for future needs by plans never consummated, the amount of such an accumulation shall be taken into account in determining the reasonableness of subsequent accumulations.

(c) *Section 303 redemption needs of the business.* (1) The term *section 303 redemption needs* means, with respect to the taxable year of the corporation in which a shareholder of the corporation died or any taxable year thereafter, the amount needed (or reasonably anticipated to be needed) to redeem stock included in the gross estate of such shareholder but not in excess of the amount necessary to effect a distribution to which section 303 applies. For purposes of this paragraph, the term *shareholder* includes an individual in whose gross estate stock of the corporation is includable upon his death for Federal estate tax purposes.

(2) This paragraph applies to a corporation to which section 303(c) would apply if a distribution described therein were made.

(3) If stock included in the gross estate of a decedent is stock of two or more corporations described in section 303(b)(2)(B), the amount needed by each such corporation for section 303 redemption purposes under this section shall, unless the particular facts and circumstances indicate otherwise, be that amount which bears the same ratio to the amount described in section 303(a) as the fair market value of such corporation's stock included in the gross estate of such decedent bears to the fair market value of all of the stock of such corporations included in the gross estate. For example, facts and circumstances indicating that the allocation prescribed by this subparagraph is not required would include notice given to the corporations by the executor or administrator of the decedent's estate that he intends to request the redemption of stock of only one of such corporations or the redemption of stock of such corporations in a ratio which is unrelated to the respective fair market values of the stock of the corporations included in the decedent's gross estate.

(4) The provisions of this paragraph apply only to taxable years ending after May 26, 1969.

(d) *Excess business holdings redemption needs.* (1) The term *excess business holdings redemption needs* means, with respect to taxable years of the corporation ending after May 26, 1969, the amount needed (or reasonably anticipated to be needed) to redeem from a private foundation stock which:

(i) Such foundation held on May 26, 1969 (or which was received by such foundation pursuant to a will or irrevocable trust to which section 4943(c)(5) applies), and either

(ii) Constituted excess business holdings on such date or would have constituted excess business holdings as of that date if there were taken into account *(a)* stock received pursuant to a will or trust described in subdivision (i) of this subparagraph and *(b)* the reduction in the total outstanding stock of the corporation which would have resulted solely from the redemption of stock held by the private foundation, or

(iii) Constituted stock redemption of which before January 1, 1975, or after October 4, 1976, and before January 1, 1977, is, by reason of section 101(l)(2)(B) of the Tax Reform Act of 1969, as amended by section 1309 of the Tax Reform Act of 1976, and § 53.4941(d)–4(b), permitted without imposition of tax under section 4941, but only to the extent such stock is to be redeemed before January 1, 1975 or after October 4, 1976, and before January 1, 1977, or is to be redeemed thereafter pursuant to the terms of a binding contract entered into on or before such date to redeem all of the stock of the corporation held by the private foundation on such date.

(2) The purpose of subparagraph (1) of this paragraph is to facilitate a private-foundation's disposition of certain excess business holdings, in order for the private foundation not to be liable for tax under section 4943. See section 4943(c) and the regulations thereunder for the definition of excess business holdings. For purposes of section 537(b)(2) and this paragraph, however, any determination of the existence of excess business holdings shall be made

without taking into account the provisions of section 4943(c)(4) which treat certain excess business holdings as held by a disqualified person (rather than by the private foundation), except that the periods described in section 4943(c)(4) (B), (C), and (D), if applicable, shall be taken into account in determining the period during which an excess business holdings redemption need may be deemed to exist. Thus, an excess business holdings redemption need may, depending upon the facts and circumstances, be deemed to exist for a part or all of the 20-year, 15-year, or 10-year period specified in section 4943(c)(4)(B) during which the interest in the corporation held by the private foundation is treated as held by a disqualified person rather than by the private foundation, and, if applicable, (i) any suspension of such 20-year, 15-year, or 10-year period as provided by section 4943(c)(4)(C) and (ii) the 15-year *second phase* specified in section 4943(c)(4)(D). The foregoing sentence is not to be construed to prevent an accumulation of earnings and profits for the purpose of effecting a redemption of excess business holdings at a time or times prior to expiration of the periods described in such sentence. This subparagraph is not to be construed to prevent an accumulation of earnings and profits for the purpose of effecting a redemption described in subdivision (iii) of subparagraph (1) of this paragraph.

(3) The extent of an excess business holdings redemption need cannot exceed the total number of shares of stock so held or received by the private foundation (i) redemption of which alone would sufficiently reduce such private foundation's proportionate share of the corporation's total outstanding stock in order for the private foundation not to be liable for tax under section 4943, or (ii) redemption of which is, by reason of §53.4941(d)–4(b), permitted without imposition of tax under section 4941 provided that such redemption is accomplished within the period and in the manner prescribed in subdivision (iii) of subparagraph (1) of this paragraph. Thus, excess business holdings of a private foundation attributable to an increase in the private foundation's proportionate share of the corporation's total outstanding stock by reason of a redemption of stock after May 26, 1969, from any person other than the private foundation do not give rise to an excess business holdings redemption need.

(4) For purposes of subdivision (ii) of subparagraph (1) of this paragraph, an excess business holdings redemption need can arise with respect to shares of the corporation's stock under section 537(a)(3) only following actual acquisition by the private foundation of such shares and their characterization as an excess business holding. Thus, this paragraph does not apply to an accumulation of earnings and profits in one taxable year in anticipation of redemption of excess business holdings to be acquired by a private foundation in a subsequent year pursuant to a will or irrevocable trust to which section 4943(c)(5) applies or in anticipation of shares held becoming excess business holdings of the private foundation in a subsequent year by reason of additional shares to be received by the private foundation in such subsequent year pursuant to a will or irrevocable trust to which section 4943(c)(5) applies. Once having arisen, however, an excess business holdings redemption need may continue until redemption of the private foundation's excess business holdings described in this paragraph or other disposition of such excess business holdings by the private foundation.

(5) Notwithstanding any other provision of this paragraph, an excess business holdings redemption need will not be deemed to exist with respect to stock held by a private foundation the redemption of which would subject any person to tax under section 4941.

(6) For purposes of subdivision (ii) of subparagraph (1) of this paragraph, the number of shares of stock held by a private foundation on May 26, 1969 (or received pursuant to a will or irrevocable trust to which section 4943(c)(5) applies), redemption of which alone would sufficiently reduce such foundation's proportionate share of a corporation's total outstanding stock in order for the foundation not to be liable for tax under section 4943 may be determined by application of the following formula:

$$X = \frac{PH - (Y \times SO)}{1 - Y}$$

X=Number of shares to be redeemed.

Y=Maximum percentage of outstanding stock which private foundation can hold without being liable for tax under section 4943.

PH=Number of shares of stock held by private foundation on May 26, 1969, or received pursuant to a will or irrevocable trust to which section 4943(c)(5) applies.

SO=Total number of shares of stock outstanding unreduced by any redemption from a person other than the private foundation.

(7) The provisions of this paragraph may be illustrated by the following example:

Example. (i) On May 26, 1969, Private Foundation A holds 60 of the 100 outstanding shares of the capital stock of corporation X, which is not a disqualified person with respect to A. None of the remaining 40 shares is owned by a disqualified person within the meaning of section 4946(a). On June 1, 1975, X redeems 10 shares of its stock from individual B, thus reducing its outstanding stock to 90 shares. On June 1, 1976, A receives 20 additional shares of X stock by bequest under a will to which section 4943(c)(5) applies. As of June 1, 1976, then, A holds 80 of the 90 outstanding shares of X. Solely for purposes of this example and to illustrate the application of this paragraph, it will be assumed that in order not to be liable for the initial tax under section 4943, A must, before the close of the *second phase* described in section 4943(c)(4)(D), reduce its proportionate stock interest in X to 35 percent. A requests X to redeem from it a sufficient number of its shares to so reduce its proportionate stock interest in X to 35 percent, and X agrees to effect such a redemption.

(ii) As of May 26, 1969, A's excess business holdings are 25 shares of X, the number of shares which A would be required to dispose of to a person other than X in order to reduce its proportionate holdings in X to no more than 35 percent. If the disposition is to be by means of a redemption, however, A's excess business holdings on May 26, 1969, for purposes of determining X's excess business holdings redemption needs, are 39 shares, i.e., the number of shares X would be required to redeem in order to reduce A's proportionate stock interest to 35 percent. Although the redemption of 10 shares from B on June 1, 1975, creates additional excess business holdings of A because it effectively increases A's proportionate stock interest in X, this increase does not create an additional excess business holdings redemption need because it resulted from a redemption from a person other than A. The bequest of 20 shares of X received by A on June 1, 1976, creates a further excess business holdings redemption need as of that date in the amount needed (or reasonably anticipated to be needed) to redeem an additional 31 shares from A, *i.e.*, the number of shares which, when added to the excess business holdings of A on May 26, 1969, would have to be redeemed to reduce A's proportionate stock interest in X to 35 percent without taking the earlier redemption from B into account.

(e)(1) A determination whether and to what extent an amount is needed (or reasonably anticipated to be needed) for the purpose described in subparagraph (1) of paragraph (c) or (d) of this section is dependent upon the particular circumstances of the case, including the total amount of earnings and profits accumulated in prior years which may be available for such purpose and the existence of a reasonable expectation that a redemption described in paragraph (c) or (d) of this section will in fact be effected. Although paragraph (c) or (d) of this section may apply even though no redemption of stock is in fact effected, the failure to effect such redemption may be taken into account in determining whether the accumulation was needed (or reasonably anticipated to be needed) for a purpose described in paragraph (c) or (d).

(2) In applying subparagraph (1) of paragraph (c) or (d) of this section, the discharge of an obligation incurred to make a redemption shall be treated as the making of the redemption.

(3) In determining whether an accumulation is in excess of the reasonable needs of the business for a particular year, the fact that one of the exceptions specified in paragraph (c) or (d) of this section applies in a subsequent year is not to give rise to an inference that the accumulation would not have been for the reasonable needs of the business in the prior year. Also, no inference is to be drawn from the enactment of section 537(a) (2) and (3) that accumulations in any prior year would not have been for the reasonable needs of the business in the absence of such provisions. Thus, the reasonableness of accumulations in years prior to a year in which one of the exceptions specified in paragraph (c) or (d) of this section applies is to be determined solely upon

the facts and circumstances existing at the times the accumulations occur.

(f) *Product liability loss reserves.* (1) The term *product liability loss reserve* means, with respect to taxable years beginning after September 30, 1979, reasonable amounts accumulated for the payment of reasonably anticipated product liability losses, as defined in section 172(j) and §1.172–13(b)(1).

(2) For purposes of this paragraph, whether an accumulation for anticipated product liability losses is reasonable in amount and whether such anticipated product liability losses are likely to occur shall be determined in light of all facts and circumstances of the taxpayer making such accumulation. Some of the factors to be considered in determining the reasonableness of the accumulation include the taxpayer's previous product liability experience, the extent of the taxpayer's coverage by commercial product liability insurance, the income tax consequences of the taxpayer's ability to deduct product liability losses and related expenses, and the taxpayer's potential future liability due to defective products in light of the taxpayer's plans to expand the production of products currently being manufactured, provided such plans are specific, definite and feasible. Additionally, a factor to be considered in determining whether the accumulation is reasonable in amount is whether the taxpayer, in accounting for its potential future liability, took into account the reasonably estimated present value of the potential future liability.

(3) Only those accumulations made with respect to products that have been manufactured, leased, or sold shall be considered as accumulations made under this paragraph. Thus, for example, accumulations with respect to a product which has not progressed beyond the development stage are not reasonable accumulations under this paragraph.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7165, 37 FR 5022, Mar. 9, 1972, 37 FR 5703, Mar. 18, 1972; T.D. 7678, 44 FR 12416, Feb. 26, 1980; T.D. 8096, 51 FR 30483, Aug. 27, 1986]

§1.537–2 Grounds for accumulation of earnings and profits.

(a) *In general.* Whether a particular ground or grounds for the accumulation of earnings and profits indicate that the earnings and profits have been accumulated for the reasonable needs of the business or beyond such needs is dependent upon the particular circumstances of the case. Listed below in paragraphs (b) and (c) of this section are some of the grounds which may be used as guides under ordinary circumstances.

(b) *Reasonable accumulation of earnings and profits.* Although the following grounds are not exclusive, one or more of such grounds, if supported by sufficient facts, may indicate that the earnings and profits of a corporation are being accumulated for the reasonable needs of the business provided the general requirements under §§1.537–1 and 1.537–3 are satisfied:

(1) To provide for bona fide expansion of business or replacement of plant;

(2) To acquire a business enterprise through purchasing stock or assets;

(3) To provide for the retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations incurred on issue;

(4) To provide necessary working capital for the business, such as, for the procurement of inventories;

(5) To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation; or

(6) To provide for the payment of reasonably anticipated product liability losses, as defined in section 172(j), §1.172–13(b)(1), and §1.537–1(f).

(c) *Unreasonable accumulations of earnings and profits.* Although the following purposes are not exclusive, accumulations of earnings and profits to meet any one of such objectives may indicate that the earnings and profits of a corporation are being accumulated beyond the reasonable needs of the business:

(1) Loans to shareholders, or the expenditure of funds of the corporation

for the personal benefit of the shareholders;

(2) Loans having no reasonable relation to the conduct of the business made to relatives or friends of shareholders, or to other persons;

(3) Loans to another corporation, the business of which is not that of the taxpayer corporation, if the capital stock of such other corporation is owned, directly or indirectly, by the shareholder or shareholders of the taxpayer corporation and such shareholder or shareholders are in control of both corporations;

(4) Investments in properties, or securities which are unrelated to the activities of the business of the taxpayer corporation; or

(5) Retention of earnings and profits to provide against unrealistic hazards.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 8096, 51 FR 30484, Aug. 27, 1986]

§ 1.537–3 Business of the corporation.

(a) The business of a corporation is not merely that which it has previously carried on but includes, in general, any line of business which it may undertake.

(b) If one corporation owns the stock of another corporation and, in effect, operates the other corporation, the business of the latter corporation may be considered in substance, although not in legal form, the business of the first corporation. However, investment by a corporation of its earnings and profits in stock and securities of another corporation is not, of itself, to be regarded as employment of the earnings and profits in its business. Earnings and profits of the first corporation put into the second corporation through the purchase of stock or securities or otherwise, may, if a subsidiary relationship is established, constitute employment of the earnings and profits in its own business. Thus, the business of one corporation may be regarded as including the business of another corporation if such other corporation is a mere instrumentality of the first corporation; that may be established by showing that the first corporation owns at least 80 percent of the voting stock of the second corporation. If the taxpayer's ownership of stock is less than 80 percent in the other corporation, the determination of whether the funds are employed in a business operated by the taxpayer will depend upon the particular circumstances of the case. Moreover, the business of one corporation does not include the business of another corporation if such other corporation is a personal holding company, an investment company, or a corporation not engaged in the active conduct of a trade or business.

PERSONAL HOLDING COMPANIES

§ 1.541–1 Imposition of tax.

(a) Section 541 imposes a graduated tax upon corporations classified as personal holding companies under section 542. This tax, if applicable, is in addition to the tax imposed upon corporations generally under section 11. Unless specifically excepted under section 542(c) the tax applies to domestic and foreign corporations and, to the extent provided by section 542(b), to an affiliated group of corporations filing a consolidated return. Corporations classified as personal holding companies are exempt brom the accumulated earnings tax imposed under section 531 but are not exempt from other income taxes imposed upon corporations, generally, under any other provisions of the Code. Unlike the accumulated earnings tax imposed under section 531, the personal holding company tax imposed by section 541 applies to all personal holding companies as defined in section 542, whether or not they were formed or availed of to avoid income tax upon shareholders. See section 6501(f) and § 301.6501(f)–1 of this chapter (Regulations on Procedure and Administration) with respect to the period of limitation on assessment of personal holding company tax upon failure to file a schedule of personal holding company income.

(b) A foreign corporation, whether resident or nonresident, which is classified as a personal holding company is subject to the tax imposed under section 541 with respect to its income from sources within the United States, even though such income is not fixed or determinable annual or periodical income specified in section 881. A foreign corporation is not classified as a personal holding company subject to tax under section 541 if it is a foreign personal holding company as defined in section 552 or if it meets the requirements of the exception provided in section 542(c)(10).

§1.542–1 General rule.

A personal holding company is any corporation (other than one specifically excepted under section 542(c)) which, for the taxable year, meets:

(a) The gross income requirement specified in section 542(a)(1) and §1.542–2, and

(b) The stock ownership requirement specified in section 542(a)(2) and §1.542–3.

Both requirements must be satisfied with respect to each taxable year.

§1.542–2 Gross income requirement.

To meet the gross income requirement it is necessary that at least 80 percent of the total gross income of the corporation for the taxable year be personal holding company income as defined in section 543 and §§1.543–1 and 1.543–2. For the definition of *gross income* see section 61 and §§1.61–1 through 1.61–14. Under such provisions gross income is not necessarily synonymous with gross receipts. Further, in the case of transactions in stocks and securities and in commodities transactions, gross income for personal holding company tax purposes shall include only the excess of gains over losses from such transactions. See section 543(b), paragraph (b) (5) and (6) of §1.543–1 and §1.543–2. For determining the character of the amount includible in gross income under section 951(a), see paragraph (a) of §1.951–1.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6795, 30 FR 934, Jan. 29, 1965]

§1.542–3 Stock ownership requirement.

(a) *General rule.* To meet the stock ownership requirement, it is necessary that at some time during the last half of the taxable year more than 50 percent in value of the outstanding stock of the corporation be owned, directly or indirectly, by or for not more than 5 individuals. Any organization or trust to which subparagraph (1) of this paragraph applies shall be considered as one individual for purposes of this stock ownership requirement subject, however, to the exception in subparagraph (2) of this paragraph which is applicable only to taxable years beginning after December 31, 1954. Thus, if an organization or trust which is considered as an individual owns 51 percent in value of the outstanding stock of the corporation at any time during the last half of the taxable year, the stock ownership requirement will be met by ownership of the required percentage by one individual. See section 544 and §§1.544–1 through 1.544–7 for the determination of stock ownership.

(1) *An organization or trust considered as an individual.* Any of the following organizations or trusts shall be considered as an individual:

(i) An organization to which section 503 applies, namely, any organization described in section 501(c)(3) (relating to charitable, etc., organizations) or section 401(a) (relating to employees' pension trust, etc.) other than an organization excepted from the application of section 503 by paragraphs (1) to (5) of section 503(b). Therefore, a religious organization (other than a trust) excepted under section 503(b)(1) is not considered an individual for purposes of the stock ownership requirement of section 542(a)(2).

(ii) A portion of a trust permanently set aside or to be used exclusively for the purposes described in section 642(c), relating to amounts set aside for charitable purposes, or described in a corresponding provision of the prior income tax law (such as section 162(a), Internal Revenue Code of 1939).

(2) *Exception.* For taxable years beginning after December 31, 1954, an organization or trust to which subparagraph (1) of this paragraph applies shall not be considered an individual if all of the following conditions are met:

(i) It was organized or created before July 1, 1950.

(ii) At all times on or after July 1, 1950, and before the close of the taxable year, it owned all of the common stock and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

(iii) For the taxable year it is not denied exemption under section 504(a) or the unlimited charitable deduction under section 681(c). In determining whether, for the purpose of section 542(a)(2), exemption is not denied under section 504(a) or the unlimited charitable deduction is not denied under section 681(c) all the income of the corporation which is available for distribution as dividends to its shareholders shall be deemed to have been distributed at the close of the taxable year whether or not any portion of such income was in fact distributed. If the amounts described in section 504(a) or section 681(c), increased by the income of the corporation deemed distributed pursuant to the preceding sentence, would be sufficient to deny exemption or the unlimited charitable deduction, the organization or trust will be considered to be an individual for the purpose of section 542(a)(2). For the purpose of this subdivision the restrictions in sections 504(a)(1) and 681(c)(1) against unreasonable accumulations will not apply to income attributable to property of a decedent dying before January 1, 1951, which was transferrred during his lifetime to a trust or property that was transferred under his will to such trust, and

(iv) This subparagraph is illustrated by the following example:

Example. The X Charitable Foundation (an organization described in section 501(c)(3) to which section 503 is applicable) has owned all of the stock of the Y Corporation since Y's organization in 1949. Both X and Y are calendar-year corporations. At the end of the year 1955, X has accumulated $100,000 out of income and has actually paid out only $75,000 of this amount, leaving a balance of $25,000 on December 31, 1955. X was not denied an exemption under section 504(a) for the year 1955. Y, during the calendar year 1955, has $400,000 taxable income of which $200,000 is available for distribution as dividends at the end of the year. X will be considered to have accumulated out of income during the calendar year 1955 the amount of $225,000 for the purpose of determining whether it would have been denied an exemption under section 504(a)(1). If X would have been denied an exemption under section 504(a)(1) by reason of having been deemed to have accumulated $225,000, the stock ownership requirement of section 542(a)(2) and this section will have been satisfied. If Y Corporation also satisfies the gross income requirement of section 542(a)(1) and § 1.542–2 it will be a personal holding company.

(b) *Changes in stock outstanding.* It is necessary to consider any change in the stock outstanding during the last half of the taxable year, whether in the number of shares or classes of stock, or in the ownership thereof. Stock subscribed and paid for will be considered as stock outstanding, whether or not such stock is evidenced by issued certificates. Treasury stock shall not be considered as stock outstanding.

(c) *Value of stock outstanding.* The value of the stock outstanding shall be determined in the light of all the circumstances. The value may be determined upon the basis of the company's net worth, earning and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock. If the value of the stock is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return. In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6739, 29 FR 7713, June 17, 1964]

§ 1.542–4 Corporations filing consolidated returns.

(a) *General rule.* A consolidated return under section 1501 shall determine the application of the personal holding company tax to the group and to any member thereof on the basis of the consolidated gross income and consolidated personal holding company income of the group, as determined under the regulations prescribed pursuant to section 1502 (relating to consolidated returns); however, this rule shall not apply to either (1) an ineligible affiliated group as defined in section 542(b)(2) and paragraph (b) of this section, or (2) an affiliated group of corporations a member of which is excluded from the definition of a personal holding company under section 542(c) and paragraph (c) of this section. Thus, in the latter two instances the gross income requirement provided in section 542(a)(1) and § 1.542–2 shall apply to each individual member of the affiliated group of corporations.

(b) *Ineligible affiliated group.* (1) Except for certain affiliated railroad corporations, as provided in subparagraph (2) of this paragraph, an affiliated group of corporations is an ineligible affiliated group and therefore may not use its consolidated gross income and consolidated personal holding company income to determine the liability of the group or any member thereof for personal holding company tax (as provided in paragraph (a) of this section), if (i) any member of such group, including the common parent, derived gross income from sources outside the affiliated group for the taxable year in an amount equal to 10 percent or more of its gross income from all sources for that year and (ii) 80 percent or more of the gross income from sources outside the affiliated group consists of personal holding company income as defined in section 543 and §§1.543–1 and 1.543–2. For purposes of subdivision (i) of this subparagraph gross income shall not include certain dividend income received by a common parent from a corporation not a member of the affiliated group which qualifies under section 542(b)(4) and paragraph (d) of this section. See particularly the examples contained in paragraph (d)(2) of this section. Intercorporate dividends received by members of the affiliated group (including the common parent) are to be included in the gross income from all sources for purposes of the test in subdivision (i) of this subparagraph. For purposes of subdivision (ii) of this subparagraph, section 543 and paragraph (a) of §1.543–1 shall be applied as if the amount of gross income derived from sources outside the affiliated group by a corporation which is a member of such group is the gross income of such corporation.

(2) An affiliated group of railroad corporations shall not be considered to be an ineligible affiliated group, notwithstanding any other provisions of section 542(b)(2) and this paragraph, if the common parent of such group would be eligible to file a consolidated return under section 141 of the Internal Revenue Code of 1939 prior to its amendment by the Revenue Act of 1942 (56 Stat. 798).

(3) See section 562(d) and §1.562–3 for dividends paid deduction in the case of a distribution by a member of an ineligible affiliated group.

(4) The determination of whether an affiliated group of corporations is an ineligible group under section 542(b)(2) and this paragraph, may be illustrated by the following examples:

Example 1. Corporations X, Y, and Z constitute an affiliated group of corporations which files a consolidated return for the calendar year 1954; Corporations Y and Z are wholly-owned subsidiaries of Corporation X and derive no gross income from sources outside the affiliated group; Corporation X, the common parent, has gross income in the amount of $250,000 for the taxable year 1954. $200,000 of such gross income consists of dividends received from Corporations Y and Z. The remaining $50,000 was derived from sources outside the affiliated group, $40,000 of which represents personal holding company income as defined in section 543. The $50,000 included in the gross income of Corporation X and derived from sources outside the affiliated group is more than 10 percent of X's gross income ($50,000/$250,000) and the $40,000 which represents personal holding company income is 80 percent of $50,000 (the amount considered to be the gross income of Corporation X). Accordingly, Corporations X, Y, and Z would be an ineligible affiliated group and the gross income requirement under section 542(a)(1) and §1.542–2 would be applied to each corporation individually.

Example 2. If, in the above example, only $30,000 of the $50,000 derived from sources outside the affiliated group by Corporation X represented personal holding company income, this group of affiliated corporations would not be an ineligible affiliated group. Although the $50,000 representing the gross income of Corporation X from sources outside the affiliated group is more than 10 percent of its total gross income, the amount of $30,000 representing personal holding company income is not 80 percent or more of the amount considered to be gross income for the purpose of this test. Under section 542(b)(2) and subparagraph (1) of this paragraph both the gross income and the personal holding company income requirements must be satisfied in determining that an affiliated group constitutes an ineligible group. Since both of these requirements have not been satisfied in this example this group of affiliated corporations would not be an ineligible group.

(c) *Excluded corporations.* The general rule for determining liability of an affiliated group under paragraph (a) of this section shall not apply if any member thereof is a corporation which is excluded, under section 542(c), from the definition of a personal holding company.

(d) *Certain dividend income received by a common parent.* (1) Dividends received by the common parent of an affiliated group from a corporation which is not a member of the affiliated group shall not be included in gross income or personal holding company income, for the purpose of the test under section 542(b)(2):

(i) If such common parent owned, directly or indirectly, more than 50 percent of the outstanding voting stock of the dividend paying corporation at the time such common parent became entitled to the dividend, and

(ii) If the dividend paying corporation is not a personal holding company for the taxable year in which the dividends are paid.

Thus, if the tests in subdivisions (i) and (ii) of this subparagraph are met, the dividend income received by the common parent from such other corporation will not be considered gross income for purposes of the test in section 542(b)(2)(A) (paragraph (b) of this section), that is, either to determine gross income from sources outside the affiliated group or to determine gross income from all sources.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. Corporation X is the common parent of Corporation Y and Corporation Z and together they constitute an affiliated group which files a consolidated return under section 1501. Corporation Y and Corporation Z derived no income from sources outside the affiliated group. Corporation X, the common parent, had gross income of $100,000 for the calendar year 1954 of which amount $20,000 represented a dividend received from Corporation W, and $4,000 represented interest from Corporation T. The remaining gross income of X, $76,000, was received from Corporations Y and Z. Corporation X, for its entire taxable year, owned 60 percent of the voting stock of Corporation W which was not a personal holding company for the calendar year 1954. For the purpose of the gross income and personal holding company income test under section 542(b)(2) and paragraph (b) of this section, the $20,000 dividend received from Corporation W would not be included in the gross income or personal holding company income of Corporation X. The affiliated group would not be an ineligible group under section 542(b)(2) because 10 percent or more of its gross income was not from sources outside the affiliated group as required by section 542(b)(2)(A). Inasmuch as the $20,000 dividend from Corporation W is not included in the gross income of Corporation X for purposes of section 542(b)(2) Corporation X only has $4,000 gross income from sources outside the affiliated group which is only 5 percent of its gross income from all sources, $80,000.

Example 2. If, in example 1, Corporation X owned 50 percent or less of the voting stock of Corporation W at the time X became entitled to the dividend, or if Corporation W had been a personal holding company for the taxable year in which the dividends were paid, the $20,000 dividends received by Corporation X would be included in gross income and personal holding company income of Corporation X for the purpose of the test under section 542(b)(2) and paragraph (b) of this section. Thus, the affiliated group would be an ineligible affiliated group under section 542(b)(2) because 24 percent of its gross income was from sources outside the affiliated group ($24,000/$100,000) and 100 percent of this $24,000 was personal holding company income.

§1.543–1 Personal holding company income.

(a) *General rule.* The term *personal holding company income* means the portion of the gross income which consists of the classes of gross income described in paragraph (b) of this section. See section 543(b) and §1.543–2 for special limitations on gross income and personal holding company income in cases of gains from stocks', securities', and commodities' transactions.

(b) *Definitions*—(1) *Dividends.* The term *dividends* includes dividends as defined in section 316 and amounts required to be included in gross income under section 551 and §§1.551–1—1.551–2 (relating to foreign personal holding company income taxed to United States shareholders).

(2) *Interest.* The term *interest* means any amounts, includible in gross income, received for the use of money loaned. However, (i) interest which constitutes *rent* shall not be classified as interest but shall be classified as *rents* (see subparagraph (10) of this paragraph) and (ii) interest on amounts set aside in a reserve fund under section 511 or 607 of the Merchant Marine Act, 1936 (46 U.S.C. 1161 or 1177), shall

not be included in personal holding company income.

(3) *Royalties (other than mineral, oil, or gas royalties or certain copyright royalties).* The term *royalties* (other than mineral, oil, or gas royalties or certain copyright royalties) includes amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises, and other like property. It does not, however, include rents. For rules relating to rents see section 543(a)(7) and subparagraph (10) of this paragraph. For rules relating to mineral, oil, or gas royalties, see section 543(a)(8) and subparagraph (11) of this paragraph. For rules relating to certain copyright royalties for taxable years beginning after December 31, 1959, see section 543(a)(9) and subparagraph (12) of this paragraph.

(4) *Annuities.* The term *annuities* includes annuities only to the extent includible in the computation of gross income. See section 72 and §§1.72–1— 1.72–14 for rules relating to the inclusion of annuities in gross income.

(5) *Gains from the sale or exchange of stock or securities.* (i) Except in the case of regular dealers in stock or securities as provided in subdivision (ii) of this subparagraph, gross income and personal holding company income include the amount by which the gains exceed the losses from the sale or exchange of stock or securities. See section 543(b)(1) and §1.543–2 for provisions relating to this limitation. For this purpose, there shall be taken into account all those gains includible in gross income (including gains from liquidating dividends and other distributions from capital) and all those losses deductible from gross income which are considered under chapter 1 of the Code to be gains or losses from the sale or exchange of stock or securities. The term *stock or securities* as used in section 543(a)(2) and this subparagraph includes shares or certificates of stock, stock rights or warrants, or interest in any corporation (including any joint stock company, insurance company, association, or other organization classified as a corporation by the Code), certificates of interest or participation in any profit-sharing agreement, or in any oil, gas, or other mineral property, or lease, collateral trust certificates, voting trust certificates, bonds, debentures, certificates of indebtedness, notes, car trust certificates, bills of exchange, obligations issued by or on behalf of a State, Territory, or political subdivision thereof.

(ii) In the case of *regular dealers in stock or securities* there shall not be included gains or losses derived from the sale or exchange of stock or securities made in the normal course of business. The term *regular dealer in stock or securities* means a corporation with an established place of business regularly engaged in the purchase of stock or securities and their resale to customers. However, such corporations shall not be considered as regular dealers with respect to stock or securities which are held for investment. See section 1236 and §1.1236–1.

(6) *Gains from futures transactions in commodities.* Gross income and personal holding company income include the amount by which the gains exceed the losses from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange. See §1.543–2 for provisions relating to this limitation. In general, for the purpose of determining such excess, there are included all gains and losses on futures contracts which are speculative. However, for the purpose of determining such excess, there shall not be included gains or losses from cash transactions, or gains or losses by a producer, processor, merchant, or handler of the commodity, which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others. See section 1233 and §1.1233–1.

(7) *Estates and trusts.* Under section 543(a)(4) personal holding company income includes amounts includible in computing the taxable income of the corporation under part I, subchapter J, chapter 1 of the Code (relating to estates, trusts, and beneficiaries); and any gain derived by the corporation from the sale or other disposition of any interest in an estate or trust.

(8) *Personal service contracts.* (i) Under section 543(a)(5) amounts received

under a contract under which the corporation is to furnish personal services, as well as amounts received from the sale or other disposition of such contract, shall be included as personal holding company income if:

(a) Some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

(b) At any time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services. For this purpose, the amount of stock outstanding and its value shall be determined in accordance with the rules set forth in the last two sentences of paragraph (b) and in paragraph (c) of § 1.542–3. It should be noted that the stock ownership requirement of section 543(a)(5) and this subparagraph relates to the stock ownership at any time during the taxable year. For rules relating to the determination of stock ownership, see section 544 and §§ 1.544–1 through 1.544–7.

(ii) If the contract, in addition to requiring the performance of services by a 25-percent stockholder who is designated or who could be designated (as specified in section 543(a)(5) and subdivision (i) of this subparagraph), requires the performance of services by other persons which are important and essential, then only that portion of the amount received under such contract which is attributable to the personal services of the 25-percent stockholder shall constitute personal holding company income. Incidental personal services of other persons employed by the corporation to facilitate the performance of the services by the 25-percent stockholder, however, shall not constitute important or essential services. Under section 482 gross income, deductions, credits, or allowances between or among organizations, trades, or businesses may be allocated if it is determined that allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

(iii) The application of section 543(a)(5) and this subparagraph may be illustrated by the following examples:

Example 1. A, whose profession is that of an actor, owns all of the outstanding capital stock of the M Corporation. The M Corporation entered into a contract with A under which A was to perform personal services for the person or persons whom the M Corporation might designate, in consideration of which A was to receive $10,000 a year from the M Corporation. The M Corporation entered into a contract with the O Corporation in which A was designated to perform personal services for the O Corporation in consideration of which the O Corporation was to pay the M Corporation $500,000 a year. The $500,000 received by the M Corporation from the O Corporation constitutes personal holding company income.

Example 2. Assume the same facts as in example 1, except that, in addition to A's contract with the M Corporation, B, whose profession is that of a dancer and C, whose profession is that of a singer, were also under contract to the M Corporation to perform personal services for the person or persons whom the M Corporation might designate, in consideration of which they were each to receive $25,000 a year from the M Corporation. Neither B nor C were stockholders of the M Corporation. The contract entered into by the M Corporation with the O Corporation, in addition to designating that A was to perform personal services for the O Corporation, designated that B and C were also to perform personal services for the O Corporation. Although the O Corporation particularly desired the services of A for an entertainment program it planned, it also desired the services of B and C, who were prominent in their fields, to provide a good supporting cast for the program. The services of B and C required under the contract are determined to be important and essential; therefore, only that portion of the $500,000 received by the M Corporation which is attributable to the personal services of A constitutes personal holding company income. The same result would obtain although the dancer and the singer required by the contract were not designated by name but the contract gave the M Corporation discretion to select and provide the services of a singer and a dancer for the program and such services were provided.

Example 3. The N Corporation is engaged in engineering. Its entire outstanding capital stock is owned by four individuals. The N Corporation entered into a contract with the R Corporation to perform engineering services in consideration of which the R Corporation was to pay the N Corporation $50,000.

The individual who was to perform the services was not designated (by name or by description) in the contract and no one but the N Corporation had the right to designate (by name or by description) such individual. The $50,000 received by the N Corporation from the R Corporation does not constitute personal holding company income.

(9) *Compensation for use of property.* Under section 543(a)(6) amounts received as compensation for the use of, or right to use, property of the corporation shall be included as personal holding company income if, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property. Thus, if a shareholder who meets the stock ownership requirement of section 543(a)(6) and this subparagraph uses, or has the right to use, a yacht, residence, or other property owned by the corporation, the compensation to the corporation for such use, or right to use, the property constitutes personal holding company income. This is true even though the shareholder may acquire the use of, or the right to use, the property by means of a sublease or under any other arrangement involving parties other than the corporation and the shareholder. However, if the personal holding company income of the corporation (after excluding any such income described in section 543(a)(6) and this subparagraph, relating to compensation for use of property, and after excluding any such income described in section 543(a)(7) and subparagraph (10) of this paragraph, relating to rents) is not more than 10 percent of its gross income, compensation for the use of property shall not constitute personal holding company income. For purposes of the preceding sentence, in determining whether personal holding company income is more than 10 percent of gross income, copyright royalties constitute personal holding company income, regardless of whether such copyright royalties are excluded from personal holding company income under section 543(a)(9) and subparagraph (12)(ii) of this paragraph. For purposes of applying section 543(a)(6) and this subparagraph, the amount of stock outstanding and its value shall be determined in accordance with the rules set forth in the last two sentences of paragraph (b) and in paragraph (c) of §1.542–3. It should be noted that the stock ownership requirement of section 543(a)(6) and this subparagraph relates to the stock outstanding at any time during the entire taxable year. For rules relating to the determination of stock ownership, see section 544 and §§1.544–1 through 1.544–7.

(10) *Rents (including interest constituting rents).* Rents which are to be included as personal holding company income consist of compensation (however designated) for the use, or right to use, property of the corporation. The term *rents* does not include amounts includible in personal holding company income under section 543(a)(6) and subparagraph (9) of this paragraph. The amounts considered as rents include charter fees, etc., for the use of, or the right to use, property, as well as interest on debts owed to the corporation (to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of the corporation’s trade or business was sold or exchanged by the corporation). However, if the amount of the rents includible under section 543(a)(7) and this subparagraph constitutes 50 percent or more of the gross income of the corporation, such rents shall not be considered to be personal holding company income.

(11) *Mineral, oil, or gas royalties.* (i) The income from mineral, oil, or gas royalties is to be included as personal holding company income, unless *(a)* the aggregate amount of such royalties constitutes 50 percent or more of the gross income of the corporation for the taxable year and *(b)* the aggregate amount of deductions allowable under section 162 (other than compensation for personal services rendered by the shareholders of the corporation) equals 15 percent or more of the gross income of the corporation for the taxable year.

(ii) The term *mineral, oil, or gas royalties* means all royalties, including overriding royalties and, to the extent not treated as loans under section 636, mineral production payments, received from any interest in mineral, oil, or gas properties. The term *mineral* includes those minerals which are included within the meaning of the term *minerals* in the regulations under section 611.

(iii) The first sentence of subdivision (ii) of this subparagraph shall apply to overriding royalties received from the sublessee by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid, and to mineral, oil, or gas production payments, only with respect to amounts received after September 30, 1958.

(12) *Copyright royalties*—(i) *In general.* The income from copyright royalties constitutes, generally, personal holding company income. However, for taxable years beginning after December 31, 1959, those copyright royalties which come within the definition of *copyright royalties* in section 543(a)(9) and subdivision (iv) of this subparagraph shall be excluded from personal holding company income only if the conditions set forth in subdivision (ii) of this subparagraph are satisfied.

(ii) *Exclusion from personal holding company income.* For taxable years beginning after December 31, 1959, copyright royalties (as defined in section 543(a)(9) and subdivision (iv) of this subparagraph) shall be excluded from personal holding company income only if the conditions set forth in *(a), (b),* and *(c)* of this subdivision are met.

(a) Such copyright royalties for the taxable year must constitute 50 percent or more of the corporation's gross income. For this purpose, copyright royalties shall be computed by excluding royalties received for the use of, or the right to use, copyrights or interests in copyrights in works created, in whole or in part, by any person who, at any time during the corporation's taxable year, is a shareholder.

(b) Personal holding company income for the taxable year must be 10 percent or less of the corporation's gross income. For this purpose, personal holding company income shall be computed by excluding *(1)* copyright royalties (except that there shall be included royalties received for the use of, or the right to use, copyrights or interests in copyrights in works created, in whole or in part, by any shareholder owning, at any time during the corporation's taxable year, more than 10 percent in value of the outstanding stock of the corporation), and *(2)* dividends from any corporation in which the taxpayer owns, on the date the taxpayer becomes entitled to the dividends, at least 50 percent of all classes of stock entitled to vote and at least 50 percent of the total value of all classes of stock, provided the corporation which pays the dividends meets the requirements of subparagraphs (A), (B), and (C) of section 543(a)(9).

(c) The aggregate amount of the deductions allowable under section 162 must constitute 50 percent or more of the corporation's gross income for the taxable year. For this purpose, the deductions allowable under section 162 shall be computed by excluding deductions for compensation for personal services rendered by, and deductions for copyright and other royalties to, shareholders of the corporation.

(iii) *Determination of stock value and stock ownership.* For purposes of section 543(a)(9) and this subparagraph, the following rules shall apply:

(a) The amount and value of the outstanding stock of a corporation shall be determined in accordance with the rules set forth in the last two sentences of paragraph (b) and in paragraph (c) of § 1.542–3.

(b) The ownership of stock shall be determined in accordance with the rules set forth in section 544 and §§ 1.544–1 through 1.544–7.

(c) Any person who is considered to own stock within the meaning of section 544 and §§ 1.544–1 through 1.544–7 shall be a shareholder.

(iv) *Copyright royalties defined.* For purposes of section 543(a)(9) and this subparagraph, the term *copyright royalties* means compensation, however designated, for the use of, or the right to use, copyrights in works protected by copyright issued under title 17 of the United States Code (other than by reason of section 2 or 6 thereof), and to which copyright protection is also extended by the laws of any foreign country as a result of any international treaty, convention, or agreement to which the United States is a signatory. Thus, *copyright royalties* includes not only royalties from sources within the United States under protection of

United States laws relating to statutory copyrights but also royalties from sources within a foreign country with respect to United States statutory copyrights protected in such foreign country by any international treaty, convention, or agreement to which the United States is a signatory. The term *copyright royalties* includes compensation for the use of, or right to use, an interest in any such copyrighted works as well as payments from any person for performing rights in any such copyrighted works.

(v) *Compensation which is rent.* Section 543(a)(9) and subdivisions (i) through (iv) of this subparagraph shall not apply to compensation which is *rent* within the meaning of the second sentence of section 543(a)(7).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6739, 29 FR 7713, June 17, 1964; T.D. 7261, 38 FR 5467, Mar. 1, 1973]

§1.543–2 Limitation on gross income and personal holding company income in transactions involving stocks, securities, and commodities.

(a) Under section 543(b)(1) the gains which are to be included in gross income, and in personal holding company income with respect to transactions described in section 543(a)(2) and paragraph (b)(5) of §1.543–1, shall be the net gains from the sale or exchange of stock or securities. If there is an excess of losses over gains from such transactions, such excess (or net loss) shall not be used to reduce gross income or personal holding company income for purposes of the personal holding company tax. Similarly, under section 543(b)(2) the gains which are to be included in gross income, and in personal holding company income with respect to transactions described in section 543(a)(3) and paragraph (b)(6) of §1.543–1, shall be the net gains from commodity transactions which reflect personal holding company income. Any excess of losses over gains from such transactions (resulting in a net loss) shall not be used to reduce gross income or personal holding company income. The capital loss carryover under section 1212 shall not be taken into account.

(b) The application of section 543(b) may be illustrated by the following examples:

Example 1. The P Corporation, not a regular dealer in stocks and securities, received rentals of $250,000 for its property from a 25-percent shareholder, and also had gains of $50,000 during the taxable year from the sale of stocks and securities. It also had losses on the sale of stocks and securities in the amount of $30,000. Accordingly, P Corporation had gross income during the taxable year of $270,000 ($250,000 plus $20,000 net gain from the sales of stocks and securities). It had personal holding company income of $20,000. (The rentals of $250,000 would not be personal holding company income under section 543(a)(6) since the personal holding company income of the corporation, $20,000 (after excluding any such income described in section 543(a)(6)), is not more than 10 percent of its gross income.)

Example 2. The R Corporation, not a regular dealer in stocks or securities, realized total gains during the taxable year of $900,000 from commodity futures transactions and $200,000 from the sales of stocks and securities. It also sustained total losses of $1,000,000 on such commodity futures transactions, resulting in a net gain for the taxable year or $100,000. None of the commodity futures transactions are hedging or other types of futures transactions excluded from the application of section 543(a)(3). No part of the loss on commodity futures transactions is to be taken into account in determining personal holding company income and gross income for personal holding company tax purposes for the taxable year. The full amount of the $200,000 in gains from the sales of stocks and securities is to be included in personal holding company income and in gross income for personal holding company tax purposes for the taxable year.

§1.544–1 Constructive ownership.

(a) Rules relating to the constructive ownership of stock are provided by section 544 for the purpose of determining whether the stock ownership requirements of the following sections are satisfied:

(1) Section 542(a)(2), relating to ownership of stock by five or fewer individuals.

(2) Section 543(a)(5), relating to personal holding company income derived from personal service contracts.

(3) Section 543(a)(6), relating to personal holding company income derived from property used by shareholders.

(4) Section 543(a)(9), relating to personal holding company income derived from copyright royalties.

(b) Section 544 provides four general rules with respect to constructive ownership. These rules are:

(1) Constructive ownership by reason of indirect ownership. See section 544(a)(1) and § 1.544–2.

(2) Constructive ownership by reason of family and partnership ownership. See section 544(a) (2), (4), (5), and (6), and §§ 1.544–3, 1.544–6, and 1.544–7.

(3) Constructive ownership by reason of ownership of options. See section 544(a) (3), (4), (5), and (6), and §§ 1.544–4, 1.544–6, and 1.544–7.

(4) Constructive ownership by reason of ownership of convertible securities. See section 544(b) and § 1.544–5.

Each of the rules referred to in subparagraphs (2), (3), and (4) of this paragraph is applicable only if it has the effect of satisfying the stock ownership requirement of the section to which applicable; that is, when applied to section 542(a)(2), its effect is to make the corporation a personal holding company, or when applied to section 543(a)(5), section 543(a)(6), or section 543(a)(9), its effect is to make the amounts described in such provisions includible as personal holding company income.

(c) All forms and classes of stock, however denominated, which represent the interests of shareholders, members, or beneficiaries in the corporation shall be taken into consideration in applying the constructive ownership rules of section 544.

(d) For rules applicable in treating constructive ownership, determined by one application of section 544, as actual ownership for purposes of a second application of section 544, see section 544(a)(5) and § 1.544–6.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6739, 29 FR 7715, June 17, 1964]

§ 1.544–2 Constructive ownership by reason of indirect ownership.

The following example illustrates the application of section 544(a)(1), relating to constructive ownership by reason of indirect ownership:

Example. A and B, two individuals, are the exclusive and equal beneficiaries of a trust or estate which owns the entire capital stock of the M Corporation. The M Corporation in turn owns the entire capital stock of the N Corporation. Under such circumstances the entire capital stock of both the M Corporation and the N Corporation shall be considered as being owned equally by A and B as the individuals owning the beneficial interest therein.

§ 1.544–3 Constructive ownership by reason of family and partnership ownership.

(a) The following example illustrates the application of section 544(a)(2), relating to constructive ownership by reason of family and partnership ownership.

Example. The M Corporation at some time during the last half of the taxable year, had 1,800 shares of outstanding stock, 450 of which were held by various individuals having no relationship to one another and none of whom were partners, and the remaining 1,350 were held by 51 shareholders as follows:

Relationships	Shares	Shares	Shares	Shares	Shares
An individual	(A)100	(B)20	(C)20	(D)20	(E)20
His father	(AF)10	(BF)10	(CF)10	(DF)10	(EF)10
His wife	(AW)10	(BW)40	(CW)40	(DW)40	(EW)40
His brother	(AB)10	(BB)10	(CB)10	(DB)10	(EB)10
His son	(AS)10	(BS)40	(CS)40	(DS)40	(ES)40
His daughter by former marriage (son's. half-sister)	(ASHS)10	(BSHS)40	(CSHS)40	(DSHS)40	(ESHS)40
His brother's wife	(ABW)10	(BBW)10	(CBW)10	(DBW)160	(EBW)10
His wife's father	(AWF)10	(BWF)10	(CWF)110	(DWF)10	(EWF)10
His wife's brother	(AWB)10	(BWB)10	(CWB)10	(DWB)10	(EWB)10
His wife's brother's wife	(AWBW)10	(BWBW)10	(CWBW)10	(DWBW)10	(EWBW)110
Individual's partner	(AP)10				

By applying the statutory rule provided in section 544(a)(2) five individuals own more than 50 percent of the outstanding stock as follows:

A (including AF, AW, AB, AS, ASHS, AP)	160
B (including BF, BW, BB, BS, BSHS)	160
CW (including C, CS, CWF, CWB)	220
DB (including D, DF, DBW)	200
EWB (including EW, EWF, EWBW)	170
Total, or more than 50 percent	910

Individual A represents the obvious case where the head of the family owns the bulk of the family stock and naturally is the head of the group. A's partner owns 10 shares of the stock. Individual B represents the case where he is still head of the group because of the ownership of stock by his immediate family. Individuals C and D represent cases where the individuals fall in groups headed in C's case by his wife and in D's case by his brother because of the preponderance of holdings on the part of relatives by marriage. Individual E represents the case where the preponderant holdings of others eliminate that individual from the group.

(b) For the restriction on the applicability of the family and partnership ownership rules of this section, see paragraph (b) of §1.544–1. For rules relating to constructive ownership as actual ownership, see §1.544–6.

§1.544–4 Options.

The shares of stock which may be acquired by reason of an option shall be considered to be constructively owned by the individual having the option to acquire such stock. For example: If C, an individual, on March 1, 1955, purchases an option, or otherwise comes into possession of an option, to acquire 100 shares of the capital stock of M Corporation, such 100 shares of stock shall be considered to be constructively owned by C as if C had actually acquired the stock on that date. If C has an option on an option (or one of a series of options) to acquire such stock, he shall also be considered to have constructive ownership of the stock which may be acquired by reason of the option (or the series of options). Under such circumstances, C shall be considered to have acquired constructive ownership of the stock on the date he acquired his option. For the restriction on the applicability of the rule of this section, see paragraph (b) of §1.544–1.

§1.544–5 Convertible securities.

Under section 544(b) outstanding securities of a corporation such as bonds, debentures, or other corporate obligations, convertible into stock of the corporation (whether or not convertible during the taxable year) shall be considered as outstanding stock of the corporation. The consideration of convertible securities as outstanding stock is subject to the exception that, if some of the outstanding securities are convertible only after a later date than in the case of others, the class having the earlier conversion date may be considered as outstanding stock although the others are not so considered, but no convertible securities shall be considered as outstanding stock unless all outstanding securities having a prior conversion date are also so considered. For example, if outstanding securities are convertible in 1954, 1955 and 1956, those convertible in 1954 can be properly considered as outstanding stock without so considering those convertible in 1955 or 1956, and those convertible in 1954 and 1955 can be properly considered as outstanding stock without so considering those convertible in 1956. However, the securities convertible in 1955 could not be properly considered as outstanding stock without so considering those convertible in 1954 and the securities convertible in 1956 could not be properly considered as outstanding stock without so considering those convertible in 1954 and 1955. For the restriction on the applicability of the rule of this section, see paragraph (b) of §1.544–1.

§1.544–6 Constructive ownership as actual ownership.

(a) *General rules.* (1) Stock constructively owned by a person by reason of the application of the rule provided in section 544(a)(1), relating to stock not owned by an individual, shall be considered as actually owned by such person for the purpose of again applying such rule or of applying the family and partnership rule provided in section 544(a)(2), in order to make another person the constructive owner of such stock, and

(2) Stock constructively owned by a person by reason of the application of the option rule provided in section 544(a)(3) shall be considered as actually owned by such person for the purpose of applying either the rule provided in section 544(a)(1), relating to stock not owned by an individual, or the family and partnership rule provided in section 544(a)(2) in order to make another person the constructive owner of such stock, but

(3) Stock constructively owned by an individual by reason of the application of the family and partnership rule provided in section 544(a)(2) shall not be

considered as actually owned by such individual for the purpose of again applying such rule in order to make another individual the constructive owner of such stock.

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

Example 1. A's wife, AW, owns all the stock of the M Corporation, which in turn owns all the stock of the O Corporation. The O Corporation in turn owns all the stock of the P Corporation. Under the rule provided in section 544(a)(1), relating to stock not owned by an individual, the stock in the P Corporation owned by the O Corporation is considered to be owned constructively by the M Corporation, the sole shareholder of the O Corporation. Such constructive ownership of the stock of the M Corporation is considered as actual ownership for the purpose of again applying such rule in order to make AW, the sole shareholder of the M Corporation, the constructive owner of the stock of the P Corporation. Similarly, the constructive ownership of the stock by AW is considered as actual ownership for the purpose of applying the family and partnership rule provided in section 544(a)(2) in order to make A the constructive owner of the stock of the P Corporation, if such application is necessary for any of the purposes set forth in paragraph (b) of § 1.544–1. But the stock thus constructively owned by A may not be considered as actual ownership for the purpose of again applying the family and partnership rule in order to make another member of A's family, for example, A's father, the constructive owner of the stock of the P Corporation.

Example 2. B, an individual, owns all the stock of the R Corporation which has an option to acquire all the stock of the S Corporation, owned by C, an individual, who is not related to B. Under the option rule provided in section 544(a)(3) the R Corporation may be considered as owning constructively the stock of the S Corporation owned by C. Such constructive ownership of the stock by the R Corporation is considered as actual ownership for the purpose of applying the rule provided in section 544(a)(1), relating to stock not owned by an individual, in order to make B, the sole shareholder of the R Corporation, the constructive owner of the stock of the S Corporation. The stock thus constructively owned by B by reason of the application of the rule provided in section 544(a)(1) likewise is considered as actual ownership for the purpose, if necessary, of applying the family and partnership rule provided in section 544(a)(2), in order to make another member of B's family, for example, B's wife, BW, the constructive owner of the stock of the S Corporation. However, the family and partnership rule could not again be applied so as to make still another individual the constructive owner of the stock of the S Corporation, that is, the stock constructively owned by BW could not be considered as actually owned by her in order to make BW's father the constructive owner of such stock by a second application of the family and partnership rule.

§ 1.544–7 Option rule in lieu of family and partnership rule.

(a) If, in determining the ownership of stock, such stock may be considered as constructively owned by an individual by an application of either the family and partnership rule (section 544(a)(2)) or the option rule (section 544(a)(3)), such stock shall be considered as owned constructively by the individual by reason of the application of the option rule.

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

Example. Two brothers, A and B, each own 10 percent of the stock of the M Corporation, and A's wife, AW, also owns 10 percent of the stock of such corporation. AW's husband, A, has an option to acquire the stock owned by her at any time. It becomes necessary, for one of the purposes stated in section 544(a)(4), to determine the stock ownership of B in the M Corporation. If the family and partnership rule were the only rule that applied in the case, B would be considered, under that rule, as owning 20 percent of the stock of the M Corporation, namely, his own stock plus the stock owned by his brother. In that event, B could not be considered as owning the stock held by AW since (1) AW is not a member of B's family and (2) the constructive ownership of such stock by A through the application of the family and partnership rule in his case is not considered as actual ownership so as to make B the constructive owner by a second application of the same rule with respect to the ownership of the stock. However, there is more than the family and partnership rule involved in this example. As the holder of an option upon the stock, A may be considered the constructive owner of his wife's stock by the application of the option rule and without reference to the family relationship between A and AW. If A is considered as owning the stock of his wife by application of the option rule, then such constructive ownership by A is regarded as actual ownership for the purpose of applying the family and partnership rule so as to make another member of A's family, for example, B, the constructive owner of the stock. Hence, since A may be considered as owning his wife's stock by applying either the family-partnership rule or the option rule, the provisions of section 544(a)(6) apply and accordingly A must be considered the constructive owner of his wife's stock under the option rule rather than the family-partnership rule. B thus becomes the constructive owner of 30 percent of the stock of the M corporation, namely, his own 10 percent, A's 10 percent, and AW's 10 percent constructively owned by A as the holder of an option on the stock.

§1.545–1 Definition.

(a) Undistributed personal holding company income is the amount which is subject to the personal holding company tax imposed under section 541. Undistributed personal holding company income is the taxable income of the corporation adjusted in the manner described in section 545(b) and §1.545–2, and section 545(c) and §1.545–3, less the deduction for dividends paid. See part IV (section 561 and following), subchapter G, chapter 1 of the Code, and the regulations thereunder, relating to the dividends paid deduction.

(b) For purposes of the imposition of the personal holding company tax on a foreign corporation, resident or nonresident, which files or causes to be filed a return, the undistributed personal holding company income shall be computed on the basis of the taxable income from sources within the United States, and such income shall be adjusted in accordance with the principles of section 545(b) and §1.545–2, and section 545(c) and §1.545–3. For purposes of the imposition of such tax on a foreign corporation, resident or nonresident, which files no return, the undistributed personal holding company income shall be computed on the basis of the gross income from sources within the United States without allowance of any deductions. For purposes of this paragraph, a nonresident foreign corporation will be considered to have filed a return for any taxable year ending before September 9, 1958, if the return for any such taxable year is filed on or before February 5, 1960.

[T.D. 6949, 33 FR 5525, Apr. 9, 1968]

§1.545–2 Adjustments to taxable income.

(a) *Taxes*—(1) *General rule.* (i) In computing undistributed personal holding company income for any taxable year, there shall be allowed as a deduction the amount by which Federal income and excess profits taxes accrued during the taxable year exceed the credit provided by section 33 (relating to taxes of foreign countries and possessions of the United States), and the income, war profits, and excess profits taxes of foreign countries and possessions of the United States accrued during the taxable year (to the extent provided by subparagraph (3) of this paragraph), except that no deduction shall be allowed for *(a)* the accumulated earnings tax imposed by section 531 (or a corresponding section of a prior law), *(b)* the personal holding company tax imposed by section 541 (or a corresponding section of a prior law), and *(c)* the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939, for taxable years beginning after December 31, 1940. The deduction is for taxes for the taxable year, determined under the accrual method of accounting, regardless of whether the corporation uses an accrual method of accounting, the cash receipts and disbursement method, or any other allowable method of accounting. In computing the amount of taxes accrued, an unpaid tax which is being contested is not considered accrued until the contest is resolved.

(ii) However, the taxpayer shall deduct taxes paid, rather than taxes accrued, if it used that method with respect to Federal taxes for each taxable year for which it was subject to the tax imposed by section 500 of the Internal Revenue Code of 1939, unless an election is made under subparagraph (2) of this paragraph to deduct taxes accrued.

(2) *Election by taxpayer which deducted taxes paid.* (i) If the corporation was subject to the personal holding company tax imposed by section 500 of the Internal Revenue Code of 1939 and, for the purpose of that tax, deducted Federal taxes paid rather than such taxes accrued for each taxable year for which it was subject to such taxes, the corporation may elect for any taxable year ending after June 30, 1954, to deduct taxes accrued, including taxes of foreign countries and possessions of the United States, rather than taxes paid, for the purposes of the tax imposed by section 541 of the Internal Revenue Code of 1954. The election shall be made

by deducting such taxes accrued on Schedule PH, Form 1120, to be filed with the return. The schedule shall, in addition, contain a statement that the corporation has made such election and shall set forth the year to which such election was first applicable. The deduction of taxes accrued in the year of election precludes the deduction of taxes paid during such year. The election, if made, shall be irrevocable and the deduction for taxes accrued shall be allowed for the year of election and for all subsequent taxable years.

(ii) Pursuant to section 7851(a)(1)(C), the election provided for in subdivision (i) of this subparagraph may be made with respect to a taxable year ending after June 30, 1954, even though such taxable year is subject to the Internal Revenue Code of 1939.

(3) *Taxes of foreign countries and United States possessions.* In determining undistributed personal holding company income for any taxable year, if the taxpayer chooses the benefits of section 901 for such taxable year, a deduction shall be allowed for:

(i) The income, war profits, and excess profits taxes imposed by foreign countries or possessions of the United States and accrued (or paid, if required under subparagraph (1)(ii) of this paragraph) during such taxable year, and

(ii) In the case of a domestic corporation, the foreign income taxes deemed to be paid for such taxable year under section 902(a) in accordance with §§ 1.902–1 and 1.902–2 or section 960(a)(1) in accordance with § 1.960–7.

In no event shall the amount under subdivision (ii) of this subparagraph exceed the amount includible in gross income with respect to such taxes under section 78 and § 1.78–1. The credit for such taxes provided by section 901 shall not be allowed against the personal holding company tax imposed by section 541. See section 901(a).

(b) *Charitable contributions*—(1) *Taxable years beginning before January 1, 1970.* (i) Section 545(b)(2) provides that, in computing the deduction for charitable contributions for purposes of determining undistributed personal holding company income of a corporation for taxable years beginning before January 1, 1970, the limitations in section 170(b)(1) (A) and (B), relating to charitable contributions by individuals, shall apply and section 170(b) (2) and (5), relating to charitable contributions by corporations and carryover of certain excess charitable contributions made by individuals, respectively, shall not apply.

(ii) Although the limitations of section 170(b)(1) (A) and (B) are 10 and 20 percent, respectively, of the individual's adjusted gross income, the limitations are applied for purposes of section 545(b)(2) by using 10 and 20 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2), that is, the same amount of taxable income to which the 5-percent limitation applied. Thus, the term *adjusted gross income* when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments, other than the 5-percent limitation, provided in the first sentence of section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 545(b)(8), relating to expenses and depreciation applicable to property of the taxpayer. The carryover of charitable contributions made in a prior year, otherwise allowable as a deduction in computing taxable income to the extent provided in section 170(b)(2) and, with respect to contributions paid in taxable years beginning after December 31, 1963, in section 170(b)(5), shall not be allowed as a deduction in computing undistributed personal holding company income for any taxable year.

(iii) See § 1.170–2 with respect to the charitable contributions to which the 10-percent limitation is applicable and the charitable contributions to which the 20-percent limitation is applicable.

(2) *Taxable years beginning after December 31, 1969.* (i) Section 545(b)(2) provides that, in computing the deduction allowable for charitable contributions for purposes of determining undistributed personal holding company income of a corporation for taxable years beginning after December 31, 1969, the limitations in section 170(b)(1) (A), (B), and (D)(i) (relating to charitable contributions by individuals) shall apply, and section 170(b)(1)(D)(ii) (relating to

excess charitable contributions by individuals of certain capital gain property, section 170(b)(2) (relating to the 5-percent limitation on charitable contributions by corporations), and section 170(d) (relating to carryovers of excess contributions of individuals and corporations) shall not apply.

(ii) Although the limitations of section 170(b)(1) (A), (B), and (D)(i) are 50, 20, and 30 percent, respectively, of an individual's contribution base, these limitations are applied for purposes of section 545(b)(2) by using 50, 20, and 30 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2), that is, the same amount of taxable income to which the 5-percent limitation applies. Thus, the term *contribution base* when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments, other than the 5-percent limitation, provided in section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 545(b)(8), relating to expenses and depreciation applicable to property of the taxpayer. The carryover of charitable contributions made in a prior year, otherwise allowable as a deduction in computing taxable income to the extent provided in section 170(b)(1)(D)(ii) and (d), shall not be allowed as a deduction in computing undistributed personal holding company income for any taxable year.

(iii) See §1.170A–8 for the rules with respect to the charitable contributions to which the 50-, 20-, and 30-percent limitations apply.

(c) *Special deductions disallowed.* Part VIII, subchapter B, chapter 1 of the Code, allows corporations, in computing taxable income, special deductions for such matters as partially tax- exempt interest, certain dividends received, dividends paid on certain preferred stock of public utilities, organizational expenses, etc. See section 241. Such special deductions, except the deduction provided by section 248 (relating to organizational expenses) shall be disallowed in computing undistributed personal holding company income.

(d) *Net operating loss.* The net operating loss deduction provided in section 172 is not allowed for purposes of the computation of undistributed personal holding company income. For purposes of such a computation, however, there is allowed as a deduction the amount of the net operating loss (as defined in section 172(c)) for the preceding taxable year, except that, in computing undistributed personal holding company income for a taxable year beginning after December 31, 1957, the amount of such net operating loss shall be computed without the deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code.

(e) *Long-term capital gains.* (1) There is allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year, minus the taxes attributable to such excess, as provided in section 545(b)(5).

(2) Section 631(c) (relating to gain or loss in the case of disposal of coal or domestic iron ore) shall have no application.

(f) *Bank affiliates.* There is allowed the deduction provided by section 601 in the case of bank affiliates (as defined in section 2 of the Banking Act of 1933; 12 U.S.C. 221a (c)).

(g) *Payment of indebtedness incurred prior to January 1, 1934*—(1) *General rule.* In computing undistributed personal holding company income, section 545(b)(7) provides that there shall be allowed as a deduction amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred before January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness. See §1.545–3 for the deduction in computing undistributed personal holding company income of amounts used or irrevocably set aside to pay or retire qualified indebtedness (as defined in paragraph (d) of §1.545–3).

(2) *Indebtedness.* The term *indebtedness* means an obligation absolute and not contingent, to pay on demand or within a given time, in cash or other medium, a fixed amount. The term *indebtedness* does not include the obligation of a corporation on its capital stock. The indebtedness must have been incurred (or, if incurred by assumption, assumed) by the taxpayer

before January 1, 1934. An indebtedness evidenced by bonds, notes, or other obligations issued by a corporation is ordinarily incurred as of the date such obligations are issued and the amount of such indebtedness is the amount represented by the face value of the obligations. In the case of refunding, renewal, or other change in the form of an indebtedness, the giving of a new promise to pay by the taxpayer will not have the effect of changing the date the indebtedness was incurred.

(3) *Amounts used or irrevocably set aside.* The deduction is allowable, in any taxable year, only for amounts used or irrevocably set aside in that year. The use or irrevocable setting aside must be to effect the extinguishment or discharge of indebtedness. In the case of refunding, renewal, or other change in the form of an indebtedness, the mere giving of a new promise to pay by the taxpayer will not result in an allowable deduction. If amounts are set aside in one year, no deduction is allowable for such amounts for a later year in which actually paid. As long as all other conditions are satisfied, the aggregate amount allowable as a deduction for any taxable year includes all amounts (from whatever source) used and all amounts (from whatever source) irrevocably set aside, irrespective of whether in cash or other medium. Double deductions shall not be allowed.

(4) *Reasonableness of the amounts with reference to the size and terms of the indebtedness.* (i) The reasonableness of the amounts used or irrevocably set aside must be determined by reference to the size and terms of the particular indebtedness. Hence, all the facts and circumstances with respect to the nature, scope, conditions, amount, maturity, and other terms of the particular indebtedness must be shown in each case.

(ii) Ordinarily an amount used to pay or retire an indebtedness, in whole or in part, at or prior to the maturity and in accordance with the terms thereof will be considered reasonable, and may be allowable as a deduction for the year in which so used. However, if an amount has been set aside in a prior year for payment or retirement of the same indebtedness, the amount so set aside shall not be allowed as a deduction in the year of the payment.

(iii) All amounts irrevocably set aside for the payment or retirement of an indebtedness in accordance with and pursuant to the terms of the obligation, for example, the annual contribution to trustees required by the provisions of a mandatory sinking fund agreement, will be considered as complying with the requirement of reasonableness. To be considered reasonable, it is not necessary that the plan of retirement provide for a retroactive setting aside of amounts for years prior to that in which the plan is adopted. However, if a voluntary plan was adopted before 1934, no adjustment is allowable in respect of the amounts set aside in the years prior to 1934.

(5) *Burden of proof.* The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, the taxpayer must furnish the information required by the return, and such other information as the district director may require in substantiation of the deduction claimed.

(6) *Allowance to a successor corporation.* For allowance of deduction for pre-1934 indebtedness to a successor corporation, see section 381(c)(15).

(h) *Expenses and depreciation applicable to property of the taxpayer.* (1) In computing undistributed personal holding company income in the case of a personal holding company which owns or operates property, section 545(b)(8) provides a specific limitation with respect to the allowance of deductions for trade or business expenses and depreciation allocable to the operation or maintenance of such property. Under this limitation, these deductions shall not be allowed in an amount in excess of the aggregate amount of the rent or other compensation received for the use of, or the right to use, the property, unless it is established to the satisfaction of the Commissioner:

(i) That the rent or other compensation received was the highest obtainable, or if none was received, that none was obtainable;

(ii) That the property was held in the course of a business carried on bona fide for profit; and

(iii) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(2) The burden of proof will rest upon the taxpayer to sustain the deduction claimed. If, in computing undistributed personal holding company income, a personal holding company claims deductions for expenses and depreciation allocable to the operation and maintenance of property owned or operated by the company, in an aggregate amount in excess of the rent or other compensation received for the use of, or the right to use, the property, it shall attach to its income tax return a statement setting forth its claim for allowance of the additional deductions, together with a complete statement of the facts and circumstances pertinent to its claim and the arguments on which it relies. Such statement shall set forth:

(i) A description of the property;

(ii) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;

(iii) The name and address of the person from whom the property was acquired and the date the property was acquired;

(iv) The name and address of the person to whom the property is leased or rented, or the person permitted to use the property, and the number of shares of stock, if any, held by such person and the members of his family;

(v) The nature and gross amount of the rent or other compensation received for the use of, or the right to use, the property during the taxable year and for each of the five preceding years and the amount of the expenses incurred with respect to, and the depreciation sustained on, the property for such years;

(vi) Evidence that the rent or other compensation was the highest obtainable or, if none was received, a statement of the reasons therefore;

(vii) A copy of the contract, lease or rental agreement;

(viii) The purpose for which the property was used;

(ix) The business, carried on by the corporation, with respect to which the property was held and the gross income, expenses, and taxable income derived from the conduct of such business for the taxable year and for each of the five preceding years;

(x) A statement of any reasons which existed for expectation that the operation of the property would be profitable, or a statement of the necessity for the use of the property in the business of the corporation, and the reasons why the property was acquired; and

(xi) Any other information pertinent to the taxpayer's claim.

(i) *Amount of a lien in favor of the United States.* (1) If notices of lien are filed in the manner provided in section 6323(f), the amount of the liability to the United States outstanding at the close of the taxable year, and secured by such liens which are in effect at that time, shall be allowed as a deduction in computing undistributed personal holding company income. However, the amount of such deduction which may be allowed for any taxable year shall not exceed the taxable income (as adjusted for purposes of determining the undistributed personal holding company income, but without regard to the deduction under section 545(b)(9)) for such year. The fact that the amount of, or any part of, the outstanding obligation to the United States was deducted for one taxable year does not prevent its deduction for a subsequent taxable year to the extent the obligation is still outstanding at the close of the subsequent taxable year and is secured by a lien, notice of which has been filed.

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. If the taxpayer (on the calendar year basis) is subject to a lien (notice of which has been properly filed) in the amount of $500,000 at the close of the calendar year 1954 and has taxable income of $400,000 for such taxable year, the deduction allowable by reason of the lien for the calendar year 1954 is $400,000. If, at the close of the taxable year ended December 31, 1955, the taxpayer is still subject to the same lien of $500,000 and it has taxable income of $450,000, a deduction is allowed by reason of such lien in the amount of $450,000.

(3) When the obligation secured by the lien in favor of the United States has been satisfied or released, the sum of the amounts which have been allowed as deductions under section

545(b)(9) in respect of such obligation shall be restored to taxable income for the year in which such lien is satisfied or released. If only a part of the obligation secured by the lien has been satisfied, the sum of the amounts which have been allowed as deductions under section 545(b)(9) in respect of such part shall be included in taxable income for the year of the satisfaction for the purpose of determining undistributed personal holding company income. It should be noted, however, that only the sum of the amounts which have been allowed as deductions under section 545(b)(9) and subparagraph (1) of this paragraph shall be included in taxable income. Thus, any amounts which were allowed as deductions under section 504(e) of the Internal Revenue Code of 1939 shall not be included as taxable income for any taxable year under section 545(b)(9) and subparagraph (1) of this paragraph.

(4) The application of subparagraph (3) of this paragraph may be illustrated by the following example:

Example. Assume the same facts as in the example in subparagraph (2) of this paragraph, and assume further that the corporation has $100,000 taxable income both for 1956 (before including the $400,000 described below) and for 1957. In 1956, the corporation pays $200,000 of the obligation, thereby reducing its liability from $500,000 to $300,000. In such case, $400,000 is included in taxable income in computing its undistributed personal holding company income for 1956, that is, the sum of the $200,000 deduction for 1954 and the $200,000 deduction for 1955 in respect of the liability which is paid in 1956. In 1957, property of the corporation is discharged from the lien by reason of the fact that the value of the remaining property of the corporation exceeds double the outstanding liability. (See section 6325(b)(1).) Since this was not a release or satisfaction of the lien, no amount is added to taxable income for 1957 with respect to the property discharged from the lien. In 1958, the remaining property is released from the lien by reason of a bond being accepted under section 6325(a)(2). There is added to taxable income in computing undistributed personal holding company income for 1958, $850,000, that is, the sum of the deductions allowed for 1954, 1955, 1956, and 1957 in respect of the $300,000 liability, the lien for which was released in 1958. This amount of $850,000, is computed as follows:

Year	Outstanding liability	Taxable income	Deduction as limited by taxable income	Amount attributable to part payment of $200,000 in 1956	Amount attributable to release of lien in 1958
1954	$500,000	$400,000	$400,000	$200,000	$200,000
1955	500,000	450,000	450,000	200,000	250,000
1956	300,000	500,000	300,000		300,000
1957	300,000	100,000	100,000		100,000
Total					850,000

(5)(i) If an amount has been included in undistributed personal holding company income of the personal holding company by reason of section 545(b)(9), any shareholder of the company may elect to compute his income tax with respect to such of his dividends as are attributable to such amount as though such dividends were received ratably over the period the lien was in effect.

(ii) For purposes of section 545(b)(9), the dividends paid during the taxable year of the personal holding company (computed as of the close of such year) shall be deemed attributable first to undistributed personal holding company income by reason of section 545(b)(9) (computed as of the close of the taxable year of the personal holding company). If the period over which the lien was in effect consists of several taxable years of the personal holding company, the dividend deemed received for any taxable year shall be deemed received on the last day of such taxable year of the personal holding company.

(iii) Such election shall be made in a statement showing the amount of the deduction under section 545(b)(9) for each taxable year of the period in which the lien was in effect, the amount of such deduction, if any, which was added to undistributed personal holding company income in a later year or years as a result of partial satisfaction or release of such lien, and the details thereof, the taxable year or years to which such dividends are allocable, and a computation of tax, on the basis of the election, for all taxable years affected by such ratable allocation of the dividends. Further, the statement shall show the district director's office in which the returns, for the years to which the dividends are allocable, were filed, the kind of returns which were filed (separate returns or joint returns), and the name and address under which the returns were filed. The statement shall be attached to the shareholder's return for the taxable year for which the dividend would be reported but for such election.

(iv) The operation of this subparagraph may be illustrated as follows: If, in the example under subparagraph (4) of this paragraph, shareholder A owns 75 percent in value of the outstanding stock of the personal holding company, and receives a dividend of $540,000 from such company during 1958 (the total dividend distribution being $720,000) he may elect to compute his income tax with respect to the $540,000 in dividends for 1958 as if he had received $127,058.82 of such dividends for 1954 ($200,000/850,000 of $540,000), $158,823.53 of such dividends for 1955 ($250,000/850,000 of $540,000), $190,588.23 of such dividends for 1956 ($300,000/850,000 of $540,000), and $63,529.41 of such dividends for 1957 ($100,000/850,000 of $540,000). Accordingly, the tax computed for 1958 with respect to such dividends shall be the aggregate of the taxes attributable to such amounts had they been distributed in the respective years.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6805, 30 FR 3209, Mar. 9, 1965; T.D. 6841, 30 FR 9305, July 27, 1965; T.D. 6949, 33 FR 5526, Apr. 9, 1968; T.D. 7207, 37 FR 20796, Oct. 5, 1972; T.D. 7429, 41 FR 35492, Aug. 23, 1976; T.D. 7649, 44 FR 60086, Oct. 18, 1979]

§1.545–3 Special adjustment to taxable income.

(a) *In general.* In computing undistributed personal holding company income for any taxable year beginning after December 31, 1963, section 545(c)(1) provides that, except as otherwise provided in section 545(c), there shall be allowed as a deduction amounts used or amounts irrevocably set aside (to the extent reasonable with reference to the size and terms of the indebtedness) during such year to pay or retire qualified indebtedness (as defined in section 545(c)(3) and paragraph (d) of this section). The reasonableness of amounts irrevocably set aside shall be determined under the rules of paragraph (g)(4) of §1.545–2.

(b) *Amounts used or irrevocably set aside*—(1) *In general.* The deduction is allowable, in any taxable year, only for amounts used or irrevocably set aside in that year to extinguish or discharge qualified indebtedness. If amounts are set aside in 1 year, no deduction is allowable for a later year in which such amounts are actually paid. As long as all other conditions are satisfied, the aggregate amount allowable as a deduction for any taxable year includes all amounts (from whatever source) used and all amounts (from whatever source) irrevocably set aside, irrespective of whether in cash or other medium. The same item shall not be deducted more than once.

(2) *Refunding, etc., of qualified indebtedness.* (i) A refunding, renewal or mere change in the form of a qualified indebtedness which does not involve a substantial change in the economic terms of the indebtedness will not result in an allowable deduction whether or not funds are obtained from such refunding, renewal, or change in form, and whether or not such funds are applied on the prior obligation, and will not constitute a reduction in the amount of such qualified indebtedness. For purposes of this section, if, in connection with a refunding, renewal, or other change in the form of an indebtedness, the rate of interest or principal amount of such debt, or the date when payment is due with respect to such debt or significantly changed, or if, after the refunding, renewal, or other change in the form of such debt, the creditor to whom such debt is owed is neither the creditor to whom such debt was owed before such refunding, renewal, or other change, nor a person standing in a relationship to such creditor described in section 267(b), then a substantial change in the economic

terms of such indebtedness will normally have occurred.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example 1. On December 31, 1963, M owes $10,000 to X represented by a 6-percent, 90-day note payable on January 31, 1964. On January 31, 1964, M renews the debt, giving X a new 6-percent, 90-day note (payable on Apr. 30, 1964) and paying the accrued interest on the old note. Since the date when payment is due has been significantly changed, a substantial change in the economic terms of the indebtedness has occurred.

Example (). On December 31, 1963, S owes $5,000 to T represented by a 6-percent note payable on January 1, 1965. On December 23, 1964, S liquidates the note, giving T a new note for $5,000 due on January 2, 1965, and bearing interest at 6 percent. Since the transaction does not involve a substantial change in the economic terms of the indebtedness, the transaction will not result in an allowable deduction, and the amount of the qualified indebtedness will not be reduced.

Example 3. (i) On December 31, 1963, Q owes $45,000 to R represented by a demand note. On July 1, 1964, Q renews $30,000 of the indebtedness by issuing a new demand note to R and liquidates $15,000 of the debt. Since the principal amount of the debt has been significantly changed, there has been a substantial change in the economic terms of the indebtedness.

(ii) If Q had issued renewal notes for $44,000 and had paid only $1,000 of the total indebtedness, then a significant change in the principal amount of the debt would not have occurred and Q would have been entitled to only a $1,000 deduction (the amount actually paid during the taxable year). In addition, the amount of qualified indebtedness would have been reduced to $44,000.

(c) *Corporations to which applicable.* Section 545(c)(2) describes the corporations to which section 545(c) applies. In order to qualify under section 545(c)(2), the corporation must be one:

(1) Which for at least one of its two most recent taxable years ending before February 26, 1964, was not a personal holding company under section 542, but which would have been a personal holding company under section 542 for such taxable year if the law applicable for the first taxable year beginning after December 31, 1963, had been applicable to such taxable year; or

(2) Which is an acquiring corporation treated as a corporation described in subparagraph (1) of this paragraph by reason of section 381(c)(15) (relating to the carryover of certain indebtedness in corporate acquisitions), but only to the extent of the qualified indebtedness to which it has succeeded under section 381(c)(15) and the indebtedness referred to in paragraph (d)(1)(ii) of this section incurred to replace qualified indebtedness to which it has succeeded under section 381(c)(15).

The law applicable for the first taxable year beginning after December 31, 1963, for purposes of this paragraph means part II (section 541 and following), subchapter G, chapter 1 of the Code as applicable to such year but does not include amendments to other parts of the Code first applicable with respect to such year. For an example of a corporation described in subparagraph (1) of this paragraph see paragraph (f)(1) of § 1.333–5.

(d) *Qualified indebtedness*—(1) *General definition.* Except as provided in subparagraphs (2), (3), and (4) of this paragraph the term *qualified indebtedness* means:

(i) The outstanding indebtedness (as defined in subparagraph (6) of this paragraph) incurred after December 31, 1933, and before January 1, 1964, by the taxpayer (or to which the taxpayer succeeded in a transaction to which section 381(c)(15) applies), and

(ii) The outstanding indebtedness (as defined in subparagraph (6) of this paragraph) incurred after December 31, 1963, by the taxpayer (or to which the taxpayer succeeded in a transaction to which section 381(c)(15) applies) for the purpose of making a payment or set-aside referred to in paragraph (a) of this section in the same taxable year of the debtor in which such indebtedness was incurred. An indebtedness shall be deemed not to have been incurred for the purpose of making a payment or set-aside referred to in paragraph (a) of this section when such indebtedness is a consequence of a refunding, renewal or mere change in the form of a qualified indebtedness which does not involve a substantial change in the economic terms of the qualified indebtedness. (See paragraph (b)(2) of this section for the meaning of *substantial change in the economic terms of the indebtedness.*) In the case of such a payment or set-aside which is made on or after the first day of the first taxable year beginning after December 31, 1963, such indebtedness incurred after December 31, 1963, is treated as qualified indebtedness only to the extent that the deduction from taxable income otherwise allowed by section 545(c)(1) with respect to such payment or set-aside is treated as non-deductible by reason of the election referred to in paragraph (e) of this section.

(2) *Exception for indebtedness owed to certain shareholders.* For purposes of subparagraph (1) of this paragraph, qualified indebtedness does not include any amounts which were, at any time after December 31, 1963, and before the payment or set-aside to which this section applies, owed directly or indirectly to a person who at such time owned more than 10 percent in value of the taxpayer's outstanding stock. The rules of section 318(a) and the regulations thereunder apply for the purpose of determining ownership under this subparagraph. Amounts which cease to be qualified indebtedness by reason of this subparagraph may not subsequently become qualified indebtedness as a result of any change in the facts (for example, a subsequent sale of stock by the person to whom the amounts are directly or indirectly owed).

(3) *Reduction for amounts irrevocably set aside.* For purposes of subparagraph (1) of this paragraph, qualified indebtedness with respect to a particular contract is reduced when and to the extent that amounts are irrevocably set aside to pay or retire such indebtedness. An amount is not considered to be irrevocably set aside if any person could use such amount for any purpose other than the retirement of the qualified indebtedness with respect to which it was set aside. No deduction is allowed under section 545(c)(1) and this section for payments out of amounts previously set aside. Thus, for example, if a corporation, which is a June 30 fiscal year taxpayer, incurs indebtedness of $1 million on February 1, 1962, and, in accordance with its contract of indebtedness, irrevocably sets aside $50,000 in a sinking fund on February 1, of each of the years 1963, 1964, and 1965, then its qualified indebtedness on January 1, 1964, is $950,000 ($1 million less one set-aside of $50,000 in 1963). The corporation is not allowed a deduction under section 545(c)(1) for the set-aside of $50,000 made during its taxable year ending on June 30, 1964, since section 545(c) is applicable only to taxable years beginning after December 31, 1963, but the qualified indebtedness is nevertheless reduced by such amount. The corporation is allowed a deduction of $50,000 for its taxable year ending June 30, 1965, as a result of the set-aside made during such taxable year, and qualified indebtedness on July 1, 1965, is $850,000. No deduction is allowed to the corporation for a payment in any subsequent taxable year from the amounts so set aside.

(4) *Reduction on disposition of certain property.* (i) Section 545(c)(6) provides that the total amount of the taxpayer's qualified indebtedness (as determined under subdivision (ii) of this subparagraph) shall be reduced if property of a character subject to the allowance for exhaustion, wear and tear, obsolescence, amortization, or depletion is disposed of after December 31, 1963. The reduction is made pro rata (in accordance with subdivision (iii) of this subparagraph) for the taxable year of such disposition and is equal in total amount to the excess, if any, of:

(a) The adjusted basis of the property disposed of (determined under section 1011 and the regulations thereunder) immediately before such disposition; over

(b) The amount of qualified indebtedness which ceased to be qualified indebtedness with respect to the taxpayer by reason of the assumption of indebtedness by the transferee of the property disposed of (whether or not such indebtedness was incurred by the taxpayer in connection with the property disposed of).

For purposes of *(b)* of this subdivision, the transferee will be treated as having assumed qualified indebtedness if such transferee acquires real estate of which the taxpayer is the legal or equitable owner immediately before the transfer and which is subject to indebtedness that, with respect to the taxpayer, is qualified indebtedness immediately before the transfer, provided the taxpayer shows to the satisfaction of the Commissioner that under all the facts and circumstances it no longer bears the burden of discharging such indebtedness.

(ii) The indebtedness reduced under the rule of this subparagraph is the qualified indebtedness which is outstanding with respect to the taxpayer immediately after the disposition referred to in subdivision (i) of this subparagraph.

(iii) The reduction with respect to any particular contract of indebtedness under the rules of this subparagraph shall be determined by multiplying the total reduction (determined under subdivision (i) of this subparagraph) by the ratio which the amount of the qualified indebtedness owed with respect to such contract by the taxpayer on the date referred to in subdivision (ii) of this subparagraph bears to the aggregate qualified indebtedness owed by the taxpayer with respect to all contracts on such date.

(5) *Total debt consisting of both qualified and nonqualified indebtedness.* In any case where, with respect to a particular contract of indebtedness, a part of the total indebtedness owed with respect to such contract is qualified indebtedness and the other part is indebtedness which is not qualified indebtedness, then, any amount paid or irrevocably set aside with respect to such contract shall be allocated between both such parts pro rata unless the taxpayer clearly indicates in its return the part of the payment or set-aside which shall be allocated to the qualified indebtedness.

(6) *Outstanding indebtedness.* For purposes of determining qualified indebtedness, the term *indebtedness* has the same meaning that it has under section 545(b)(7) and paragraph (g)(2) of § 1.545–2. Indebtedness ceases to be outstanding when the taxpayer no longer has an obligation absolute and not contingent with respect to the payment of such debt. An indebtedness evidenced by bonds, notes, or other obligations issued by a corporation is ordinarily incurred as of the date such obligations are issued, and the amount of such indebtedness is the amount represented by the face value of the obligations. However, a refunding, renewal, or mere change in the form of an indebtedness which does not involve a substantial change in the economic terms of the indebtedness will not have the effect of changing the date the indebtedness was incurred. (See paragraph (b)(2) of this section for the meaning of *substantial change in the economic terms of the indebtedness.*) For purposes of this section, the outstanding indebtedness of a taxpayer includes a mortgage or other security interest on real estate of which such taxpayer is the legal or equitable owner (even though the taxpayer is not directly liable on the underlying evidence of indebtedness secured by such mortgage or security interest) provided such taxpayer shows to the satisfaction of the Commissioner that under all of the facts and circumstances it bears the burden of discharging such indebtedness. Thus, for example, if X acquires from Y property which is subject to a mortgage (X not assuming the indebtedness underlying such mortgage) and if X actually bears the burden of discharging the indebtedness, then, after the date of acquisition, such underlying indebtedness is outstanding indebtedness with respect to X, and, since Y's obligation to pay is in fact contingent upon X failing to discharge the indebtedness, such indebtedness is not outstanding indebtedness with respect to Y.

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

Example 1. M Corporation, a calendar year taxpayer has $600,000 of indebtedness outstanding on December 31, 1963 (which was incurred after 1933), represented by three demand notes. Individuals A and B (who are not shareholders) each hold one of M Corporation's notes in the amount of $150,000 and N Corporation (which is not a shareholder) holds M Corporation's note in the amount of $300,000. The note held by N Corporation is secured by a mortgage on certain depreciable real estate owned by M Corporation which has an adjusted basis to it on July 1, 1964, of $500,000. On July 1, 1964, M Corporation sells the depreciable real estate to O Corporation in consideration for $200,000 in cash and the assumption by O Corporation of the indebtedness on the note held by N Corporation. M Corporation borrows $200,000 on September 30, 1964, of which amount $150,000 is simultaneously applied to liquidate the note held by B. M Corporation's qualified indebtedness is reduced on July 1, 1964, by $300,000, the qualified indebtedness which ceased to be outstanding by reason of the transfer. In addition, the reduction (computed under section 545(c)(6) and subparagraph (4) of this paragraph) of M Corporation's qualified indebtedness by reason of the disposition of depreciable property on July 1, 1964, is as follows:

Outstanding qualified indebtedness after reduction of qualified indebtedness which ceased to be outstanding by reason of the transfer but before the sec. 545(c)(6) reduction	$300,000
Reduced by:	
The excess of the adjusted basis of depreciable real estate disposed of on July 1, 1964 ($500,000), over the amount of qualified indebtedness assumed by O Corporation ($300,000)	200,000
Qualified indebtedness after reductions from transfer and assumption of indebtedness	100,000

The pro-rata share of the reduction with respect to each debt is computed as follows:

Note held by A:	
Qualified indebtedness owed by taxpayer on the note held by A before the disposition of depreciable property	$150,000
Less the pro-rata share of the total reduction computed under subparagraph (4) of this paragraph allocable to such note $200,000× ($150,000÷$300,000)	100,000
Qualified indebtedness owed on the note held by A after the transfer	50,000
Note held by B:	
Qualified indebtedness owed by taxpayer on the note held by B before the transfer of depreciable property	$150,000
Less the pro-rata share of the total reduction computed under subparagraph (4) of this paragraph allocable to such note $200,000× ($150,000÷$300,000)	100,000
Qualified indebtedness owed on the note held by B after the transfer	50,000

Of the $150,000 paid by M Corporation on September 30, 1964, to retire the note held by B only $50,000 qualified as a use of an amount to pay or retire qualified indebtedness and, thus, only $50,000 is allowable as a deduction for purposes of computing undistributed personal holding company income for 1964.

Example 2. The facts are the same as in example 1 except that M Corporation elects in accordance with paragraph (e) of this section not to deduct $25,000 of the $50,000 amount otherwise deductible. Then $25,000 of the $200,000 of new indebtedness incurred by M Corporation is qualified indebtedness. If the payment on the note held by B had not been made until January 1, 1965, then the new indebtedness would not be qualified indebtedness since the payment was not made in the taxable year in which the new indebtedness was incurred. If M Corporation pays $40,000 on April 1 and July 1, 1965, on the indebtedness incurred September 30, 1964, then (unless M indicates otherwise in its return for 1965 in accordance with subparagraph (5) of this paragraph) the payments made on such dates must be allocated between qualified and nonqualified indebtedness in the following manner:

	Qualfied	Non-qualified
April 1 payment:		
$40,000×$25,000 (qualified)÷$200,000 (total indebtedness)	$5,000	
$40,000×$175,000 (nonqualified)÷$200,000 (total indebtedness)	....	$35,000
July 1 payment:		
$40,000×$20,000 (qualified)÷$160,000 (total indebtedness)	5,000	
$40,000×$140,000 (nonqualified)÷$160,000 (total indebtedness)	....	35,000
Total	10,000	70,000

Thus, a total of $10,000 of the two payments would be considered used to pay or retire qualified indebtedness. The results in examples 1 and 2 would be the same if O Corporation purchased the real estate subject to the indebtedness (not assuming the indebtedness) on the note held by N Corporation, provided M Corporation does not bear the burden of discharging such indebtedness after July 1, 1964.

Example 3. C owns all of the 1000 shares of outstanding capital stock of P Corporation. On December 31, 1963, P Corporation, a calendar year taxpayer, owes $200,000 of outstanding indebtedness to D and $500,000 of outstanding indebtedness to E. These debts were incurred after 1933. On January 15, 1964, P Corporation pays $100,000 in partial liquidation of the $500,000 indebtedness. On March 15, 1964, P Corporation pays $50,000 into a sinking fund with respect to the $200,000 indebtedness owed to D. On April 15, 1964, D purchases one-half of the shares owned by C, constituting 50 percent in value of P Corporation's outstanding stock. P Corporation, on June 15, 1964, pays $50,000 into a sinking fund with respect to the indebtedness owed to D. For purposes of the March 15, 1964, set-aside, the indebtedness owed to D ($200,000) is qualified indebtedness. However, the indebtedness owed to D is not qualified indebtedness for purposes of the June set-aside with respect to such indebtedness since D is a person who after December 31, 1963, and before the June set-aside, owned more than 10 percent in value of P Corporation's outstanding stock. Moreover, any subsequent set-asides made with respect to the indebtedness owed to D will not be made with respect to qualified indebtedness even if the shares owned by D are subsequently sold. Assuming no payments or set-asides are made by P Corporation after June 15, 1964, the P Corporation is entitled to a deduction of $150,000 under section 545(c)(1) for the calendar year 1964 for amounts paid and for amounts irrevocably set aside to pay or retire qualified indebtedness, and the total qualified indebtedness at the end of 1964 is $400,000. No additional deduction is allowed in subsequent taxable years for amounts paid out of the amounts set aside in 1964.

(e) *Election not to deduct*—(1) *In general.* Section 545(c)(4) provides that a taxpayer may elect to treat as nondeductible amounts otherwise deductible under section 545(c)(1) for the taxable year. The election shall be in the form of a statement of election filed on or before the 15th day of the third month following the close of the taxable year with respect to which the election applies. The election shall be irrevocable after such date.

(2) *Statement of election.* The statement of election referred to in subparagraph (1) of this paragraph shall be attached to the taxpayer's Schedule PH (Form 1120) for the year with respect to which such election applies, if such schedule is filed on or before the date referred to in subparagraph (1) of this paragraph. If the taxpayer's Schedule PH (Form 1120) is not filed on or before such date, then the statement of election shall clearly set forth the taxpayer's name, address, and employer identification number, shall be signed by an officer of the taxpayer who is authorized to sign a return of the taxpayer with respect to income, and shall be filed with the district director for the internal revenue district in which the taxpayer's income tax return (for the year with respect to which the election is applicable) would be filed. The following information shall be included in the statement of election:

(i) A statement that the taxpayer wishes to elect in accordance with section 545(c)(4);

(ii) The amounts paid or set aside which are to be treated as nondeductible under section 545(c)(4) and this section;

(iii) All information necessary to identify the qualified indebtedness with respect to which such amounts were paid or set aside;

(iv) The date on which such payments or set-asides were made; and

(v) All information necessary to identify the indebtedness (referred to in section 545(c)(3)(A)(ii) and paragraph (d)(1)(ii) of this section) incurred for the purpose of making the payments or set-asides which the taxpayer elects to treat as nondeductible, including:

(a) The date on which such indebtedness was incurred;

(b) The amount of such indebtedness;

(c) The person or persons to whom such indebtedness is owed; and

(d) A statement that such person or persons do not own more than 10 percent in value of the taxpayer's outstanding stock.

(f) *Limitation on deduction*—(1) *In general.* Section 545(c)(5) provides certain limitations on the deduction otherwise allowed by section 545(c)(1). Such deduction is reduced by the sum of the following amounts:

(i) The amount, if any, by which:

(a) The deductions allowed for the taxable year and all preceding taxable years beginning after December 31, 1963, for exhaustion, wear and tear, obsolescence, amortization, or depletion (other than such deductions which are disallowed in computing undistributed personal holding company income under the rule of paragraph (h) of § 1.545–2), exceed

(b) Any reduction, by reason of section 545(c)(5)(A) and this subdivision (i), of the deductions otherwise allowed by section 545(c)(1) for such preceding years; and

(ii) The amount, if any, by which:

(a) The deductions allowed under section 545(b)(5) (relating to long-term capital gain deduction) in computing undistributed personal holding company income for the taxable year and all preceding taxable years beginning after December 31, 1963, exceed

(b) Any reduction, by reason of section 545(c)(5)(B) and this subdivision (ii), of the deductions otherwise allowed by section 545(c)(1) for such preceding years.

(2) *Allocation of reduction.* If the total reduction required by subparagraph (1) of this paragraph is greater than the amount of the payment or set-aside made in respect of qualified indebtedness in a taxable year, then the portion of the reduction which is attributable to either section 545(c)(5)(A) or section

545(c)(5)(B), as the case may be, is that portion which bears the same ratio to the total reduction as the total reduction available under either section 545(c)(5)(A) or section 545(c)(5)(B), respectively, bears to the total reduction available under both such sections.

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

Example. (i) Q Corporation, a calendar year taxpayer, has qualified indebtedness of $400,000 on January 1, 1964, with respect to which payments of $50,000 are made on April 15, 1964, and 1965, and $300,000 on April 15, 1966. In the years 1964 and 1966, Q Corporation is allowed a deduction under section 545(b)(5) of $50,000 for the excess of its net long-term capital gain over its net short-term capital loss, minus the taxes attributable to such excess. Q Corporation is allowed a depreciation deduction of $50,000 for each of its taxable years 1964 through 1966. Q Corporation is a personal holding company with taxable income of $200,000 in each of the years 1964 and 1966.

(ii) For 1964, in computing undistributed personal holding company income, Q Corporation's taxable income is reduced by $50,000 by reason of the deduction under section 545(b)(5). No part of the depreciation deduction is disallowed under the rule of paragraph (h) of § 1.545–2. Q Corporation's deduction for payment of qualified indebtedness otherwise allowable under section 545(c)(1) and this section is reduced to zero by reason of the depreciation deduction and the capital gains deduction. The reduction by reason of section 545(c)(5)(A) and subparagraph (1)(i) of this paragraph (depreciation) is $25,000 [($50,000 ÷ $100,000) × $50,000], and the reduction by reason of section 545(c)(5)(B) and subparagraph (1) (ii) of this paragraph (capital gain) is $25,000 [($50,000 ÷ $100,000) × $50,000].

(iii) For 1966, Q Corporation is allowed a deduction for payment of qualified indebtedness of $100,000 computed as follows:

Amount paid in 1966 to retire qualified indebtedness			$300,000
Less the sum of:			
(a) Depreciation deductions allowed for 1964 through 1966 (3×$50,000)	$150,000		
Reduction of deductions in preceding taxable years (1964)	25,000	$125,000	
(b) Deduction allowed under section 545(b)(5) (relating to long-term capital gains) for 1964 through 1966	100,000		
Reduction of deductions in preceding taxable years (1964)	25,000	75,000	200,000
Deduction after reduction			100,000

(iv) If, in the year 1966, Q Corporation's depreciation deduction had been limited for purposes of computing undistributed personal holding company income to $25,000 by reason of section 545(b)(8), then Q Corporation's deduction for payment of qualified indebtedness would be $125,000, computed as follows:

Amounts paid in 1966 to retire qualified indebtedness			$300,000
Less the sum of:			
(a) Depreciation deductions allowed for 1964 through 1966	$125,000		
Reduction of deductions in preceding taxable year (1964)	25,000		
	$100,000		
(b) Deduction allowed under section 545(b)(5) (relating to long-term capital gains) for 1964 through 1966	100,000		
Reduction of deductions in preceding taxable years (1964)	25,000	75,000	175,000
Deduction after reduction			125,000

(g) *Burden of proof.* The burden of proof rests upon the taxpayer to sustain the deduction claimed under this section. In addition to any information required by this section, the taxpayer must furnish the information required by the return, and such other information as the district director may require in substantiation of the deduction claimed.

(h) *Application of section 381(c)(15).* Under section 381(c)(15), if an acquiring corporation assumes liability for qualified indebtedness in a transaction to which section 381(a) applies, then the acquiring corporation is considered to be the distributor or transferor corporation for purposes of section 545(c). Paragraph (c)(2) of this section reflects the application of section 381(c)(15) by including an acquiring corporation within the definition of corporation to which this section applies. Thus, the acquiring corporation is not required to meet the requirements of paragraph (c)(1) or paragraph (d)(1) of this section with respect to such acquired qualified indebtedness to which section 381(c)(15) is applicable. All the other provisions of this section apply in full to the acquiring corporation with respect to such acquired indebtedness.

[T.D. 6949, 33 FR 5526, Apr. 9, 1968; 33 FR 6091, Apr. 20, 1968]

§ 1.547–1 General rule.

Section 547 provides a method under which, by virtue of dividend distributions, a corporation may be relieved from the payment of a deficiency in the personal holding company tax imposed by section 541 (or by a corresponding provision of a prior income tax law), or may be entitled to a credit or refund of a part or all of any such deficiency which has been paid. The method provided by section 547 is to allow an additional deduction for a dividend distribution (which meets the requirements of this section) in computing undistributed personal holding company income for the taxable year for which a deficiency in personal holding company tax is determined. The additional deduction for deficiency dividends will not, however, be allowed for the purpose of determining interest, additional amounts, or assessable penalties, computed with respect to the personal holding company tax prior to the allowance of the additional deduction for deficiency dividends. Such amounts remain payable as if section 547 had not been enacted.

§ 1.547–2 Requirements for deficiency dividends.

(a) *In general.* There are certain requirements which must be fulfilled before a deduction is allowed for a deficiency dividend under section 547 and this section. These are:

(1) The taxpayer's liability for personal holding company tax shall be determined only in the manner provided in section 547(c) and paragraph (b)(1) of this section.

(2) The deficiency dividend shall be paid by the corporation on, or within 90 days after, the date of such determination and prior to the filing of a claim under section 547(e) and paragraph (b)(2) of this section for deduction for deficiency dividends. This claim must be filed within 120 days after such determination.

(3) The deficiency dividend must be of such a nature as would have permitted its inclusion in the computation of a deduction for dividends paid under section 561 for the taxable year with respect to which the liability for personal holding company tax exists, if it had been distributed during such year. See section 562 and §§ 1.562–1 through 1.562–3. In this connection, it should be noted that under section 316(b)(2), the term *dividend* means (in addition to the usual meaning under section 316(a)) any distribution of property (whether or not a dividend as defined in section 316(a)) made by a corporation to its shareholders, to the extent of its undistributed personal holding company income (determined under section 545 and §§ 1.545–1 and 1.545–2 without regard to section 316(b)(2)) for the taxable year in respect of which the distribution is made.

(b) *Special rules*—(1) *Nature and details of determination.* (i) A determination of a taxpayer's liability for personal holding company tax shall, for the purposes of section 547, be established in the manner specified in section 547(c) and this subparagraph.

(ii) The date of determination by a decision of the Tax Court of the United States is the date upon which such decision becomes final, as prescribed in section 7481.

(iii) The slate upon which a judgment of a court becomes final, which is the date of the determination in such cases, must be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari if no such petition is duly filed within such time.

(iv) The date of determination by a closing agreement, made under section 7121, is the date such agreement is approved by the Commissioner.

(v) A determination under section 547(c)(3) may be made by an agreement signed by the district director or such other official to whom authority to sign the agreement is delegated, and by or on behalf of the taxpayer. The agreement shall set forth the total amount of the liability for personal holding company tax for the taxable year or years. An agreement under this subdivision which is signed by the district director (or such other official to whom authority to sign the agreement is delegated) on or after July 15, 1963, shall be sent to the taxpayer at his last known address by either registered or certified mail. If registered mail is used for such purpose, the date of registration shall be treated as the date of determination; if certified mail is used for such purpose, the date of the postmark on the sender's receipt for such mail shall be treated as the date of determination. However, if a dividend is paid by the corporation before such registration or postmark date but on or after the date such agreement is signed by the district director or such other official to whom authority to sign the agreement is delegated, the date of determination shall be such date of signing. The date of determination with respect to an agreement which is signed by the district director (or such other official to whom authority to sign the agreement is delegated) before July 15, 1963, shall be the date of the postmark on the cover envelope in which such agreement is sent by ordinary mail, except that if a dividend is paid by the corporation before such postmark date but on or after the date such agreement is signed by the district director or such other official to whom authority to sign the agreement is delegated, the date of determination shall be such date of signing.

(2) *Claim for deduction*—(i) *Contents of claim.* A claim for deduction for a deficiency dividend shall be made with the requisite declaration, on Form 976 and shall contain the following information:

(a) The name and address of the corporation;

(b) The place and date of incorporation;

(c) The amount of the deficiency determined with respect to the tax imposed by section 541 (or a corresponding provision of a prior income tax law) and the taxable year or years involved; the amount of the unpaid deficiency or, if the deficiency has been paid in whole or in part, the date of payment and the amount thereof; a statement as to how the deficiency was established, if unpaid; or if paid in whole or in part, how it was established that any portion of the amount paid was a deficiency at the time when paid and, in either case whether it was by an agreement under section 547(c)(3), by a closing agreement under section 7121, or by a decision of the Tax Court or court judgment and the date thereof; if established by a final judgment in a suit against the United States for refund, the date of payment of the deficiency, the date the claim for refund was filed, and the date the suit was brought; if established by a Tax Court decision or court judgment, a copy thereof shall be attached, together with an explanation of how the decision became final; if established by an agreement under section 547(c)(3), a copy of such agreement shall be attached;

(d) The amount and date of payment of the dividend with respect to which the claim for the deduction for deficiency dividends is filed;

(e) A statement setting forth the various classes of stock outstanding, the name and address of each shareholder, the class and number of shares held by each on the date of payment of the dividend with respect to which the claim is filed, and the amount of such dividend paid to each shareholder;

(f) The amount claimed as a deduction for deficiency dividends; and

(g) Such other information as may be required by the claim form.

(ii) *Filing of claim and corporate resolution.* The claim together with a certified copy of the resolution of the board of directors or other authority, authorizing the payment of the dividend with respect to which the claim is filed, shall be filed with the district director for the internal revenue district in which the return is filed.

(iii) *Carryover of deficiency dividends paid by acquiring corporation.* In the case of the acquisition of assets of a corporation by another corporation in a distribution or transfer described in section 381(a), the distributor or transferor corporation shall be entitled to a deduction for any deficiency dividends (as defined in section 547(d)) paid by the acquiring corporation with respect to such distributor or transferor corporation. See section 381(c)(17).

(68A Stat. 192, 917; 26 U.S.C. 547(c), 7805)

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6657, 28 FR 5720, June 12, 1963; T.D. 7604, 44 FR 18661, Mar. 29, 1979]

§ 1.547–3 Claim for credit or refund.

(a) If a deficiency in personal holding company tax is asserted for any taxable year, and the corporation has paid any portion of such asserted deficiency, it is entitled to a credit or refund of such payment to the extent that such payment constitutes an overpayment as the result of a deduction for a deficiency dividend as provided in section 547 and §§ 1.547–1 through 1.547–7. It should be noted that a *determination* under section 547(c) and paragraph (b)(1) of § 1.547–2, of taxpayer's liability for personal holding company tax may take place subsequent to the time the deficiency was paid. To secure credit or refund of such overpayment, the taxpayer must file a claim on Form 843 in addition to the claim for the deduction for deficiency dividends required under section 547(e) and paragraph (b)(2) of § 1.547–2.

(b) No interest shall be allowed on such credit or refund.

(c) Such credit or refund will be allowed as if, on the date of the determination under section 547(c) and paragraph (b)(1) of § 1.547–2, two years remained before the expiration of the period of limitation on the filing of claim for refund for the taxable year to which the overpayment relates.

§ 1.547–4 Effect on dividends paid deduction.

The deficiency dividends deduction shall be allowed as of the date the claim is filed. No duplication of deductions with respect to any deficiency dividends is permitted. If a corporation claims and receives the benefit of the provisions of section 547 (or the corresponding section 506 of the Internal Revenue Code of 1939, or section 407 of the Revenue Act of 1938 (52 Stat. 447)), based upon a distribution of deficiency dividends, that distribution does not become a part of the dividends paid deduction under section 561. Likewise, it will not be made the basis of a dividends paid deduction under section 561 by reason of the application of section 563(b), relating to dividends paid after the close of the taxable year and on or before the 15th day of the third month following the close of such taxable year.

§ 1.547–5 Deduction denied in case of fraud or wilful failure to file timely return.

No deduction for deficiency dividends shall be allowed under section 547(a) if the determination contains a finding that any part of the deficiency is due to fraud with intent to evade tax, or to wilful failure to file an income tax return within the time prescribed by law or prescribed by the Secretary or his delegate in pursuance of law. See § 1.547–7 for effective date.

§ 1.547–6 Suspension of statute of limitations and stay of collection.

(a) *Statute of limitations.* If the corporation files a claim for a deduction for deficiency dividends under section 547(e) and paragraph (b)(2) of § 1.547–2, the running of the statute of limitations upon assessment, distraint, and collection in court in respect of the deficiency, and all interest, additional amounts, or assessable penalties, shall be suspended for a period of two years after the date of the determination under section 547(c) and paragraph (b)(1) of § 1.547–2.

(b) *Stay of collection.* If a deficiency in personal holding company tax is established by a determination under section 547(c) and paragraph (b)(1) of § 1.547–2, collection by distraint or court proceeding (except in case of jeopardy), of the deficiency and all interest, additional amounts, and assessable penalties, shall be stayed for a period of 120 days after the date of such determination, and, to the extent any part of such deficiency remains after deduction for deficiency dividends, for an additional period until the date the claim is disallowed. After such claim is allowed or rejected, either in whole or in part, the amount of the deficiency which was not eliminated by the application of section 547, together with interest, additional amounts and assessable penalties, will be assessed and collected in the usual manner.

§1.547–7 Effective date.

The deduction for deficiency dividends, in computing personal holding company tax for any taxable year, is allowable only with respect to determinations under section 547(c) made after November 14, 1954 (the date falling 90 days after the date of enactment of the Internal Revenue Code of 1954). If the taxable year with respect to which the deficiency is asserted began before January 1, 1954, the deficiency dividends deduction shall include only the amounts which would have been includible in the computation of the basic surtax credit for such taxable year under the Internal Revenue Code of 1939. Section 547(g), relating to the denial of a deficiency dividends deduction if the determination contains a finding that any part of the deficiency is due to fraud, etc., shall apply only if the taxable year with respect to which the deficiency is asserted begins after December 31, 1953.

FOREIGN PERSONAL HOLDING COMPANIES

§1.551–1 General rule.

Part III (section 551 and following), subchapter G, chapter 1 of the Code, does not impose a tax on foreign personal holding companies. The undistributed foreign personal holding company income of such companies, however, must be included in the manner and to the extent set forth in section 551, in the gross income of their *United States shareholders,* that is, the shareholders who are individual citizens or residents of the United States, domestic corporations, domestic partnerships, and estates or trusts other than estates or trusts the gross income of which under subtitle A of the Code includes only income from sources within the United States.

§1.551–2 Amount included in gross income.

(a) The undistributed foreign personal holding company income is included only in the gross income of the United States shareholders who were shareholders in the company on the last day of its taxable year on which a United States group (as defined in section 552(a)(2)) existed with respect to the company. Such United States shareholders, accordingly, are determined by the stock holdings as of such specified time. This rule applies to every United States shareholder who was a shareholder in the company at the specified time regardless of whether the United States shareholder is included within the United States group. For example, a domestic corporation which is a United States shareholder at the specified time must return its distributive share in the undistributed foreign personal holding company income even though the domestic corporation cannot be included within the United States group since, under section 554, the stock it owns in the foreign corporation is considered as being owned proportionately by its shareholders for the purpose of determining whether the foreign corporation is a foreign personal holding company.

(b) The United States shareholders must include in their gross income their distributive shares of that proportion of the undistributed foreign personal holding company income for the taxable year of the company which is equal in ratio to that which the portion of the taxable year up to and including the last day on which the United States group with respect to the company existed bears to the entire taxable year. Thus, if the last day in the taxable year on which the required United States group existed was also the end of the taxable year, the portion of the taxable year up to and incding such last day would be equal to 100 percent and, in such case, the United States shareholders would be required to return their distributive shares in the entire undistributed foreign personal holding company income. But if the last day on which the required United States group existed was September 30, and the taxable year was a calendar year, the portion of the taxable year up to and including such last day would be equal to nine-twelfths and, in that case, the United States shareholders would be required to return their distributive shares in only nine-twelfths of the undistributed foreign personal holding company income.

(c) The amount which each United States shareholder must return is that amount which he would have received as a dividend if the above-specified portion of the undistributed foreign personal holding company income had in fact been distributed by the foreign personal holding company as a dividend on the last day of its taxable year on which the required United States group existed. Such amount is determined, therefore, by the interest of the United States shareholder in the foreign personal holding company, that is, by the number of shares of stock owned by the United States shareholder and the relative rights of his class of stock, if there are several classes of stock outstanding. Thus, if a foreign personal holding company has both common and preferred stock outstanding and the preferred shareholders are entitled to a specified dividend before any distribution may be made to the common shareholders, then the assumed distribution of the stated portion of the undistributed foreign personal holding company income must first be treated as a payment of the specified dividend on the preferred stock before any part may be allocated as a dividend on the common stock.

(d) The assumed distribution of the required portion of the undistributed foreign personal holding company income must be returned as dividend income by the United States shareholders for their respective taxable years in which or with which the taxable year of the foreign personal holding company ends. For example, if the M Corporation, whose taxable year is the calendar year, is a foreign personal holding company for 1954 and if A, one of its United States shareholders, makes returns on a calendar year basis, while B, another United States shareholder, makes returns on the basis of a fiscal year ending November 30, A must return his assumed dividend as income for the taxable year 1954 and B must return his distributive share as income for the fiscal year ending November 30, 1955. In applying this rule, the date as of which the United States group last existed with respect to the company is immaterial. Thus, in the foregoing example, if September 30, 1954, was the last day on which the United States group with respect to the M Corporation existed, B would still be required to return his assumed dividend as income for the fiscal year ending November 30, 1955, even though September 30, 1954, the date as of which the distribution is assumed to have been made, does not fall within such fiscal year.

(e) For the treatment of gain on the sale of certain stock, see section 306(f) and paragraph (h) of § 1.306–3.

§ 1.551–3 Deduction for obligations of the United States and its instrumentalities.

(a) Each United States shareholder required to return his distributive share of undistributed foreign personal holding company income for any taxable year shall take into account in computing the credit against tax under section 35, or the deduction under section 242, whichever is allowable to such shareholder, his proportionate share of whatever interest on obligations of the United States or its instrumentalities (as specified in sections 35 or 242, as the case may be) may be included in the gross income of the company for such taxable year, with the exception of any such interest as may be so included by reason of the application of the provisions of section 555. For reduction of credit for such interest on account of amortizable bond premium, see section 171 and the regulations thereunder.

(b) The rule set forth in paragraph (a) of this section may be illustrated by the following example:

Example. The M Corporation is a foreign personal holding company which owns all the stock of the N Corporation, another foreign personal holding company. Both companies receive interest on obligations of the United States or its instrumentalities as specified in section 35. In determining the amount of the credit allowable under section 35 (if the shareholder is an individual) or the deduction allowable under section 242 (if the shareholder is a corporation), the United States shareholder of the M Corporation would be entitled to a credit or a deduction, as the case may be, only for his proportionate share of the interest received by that Company and not for any part of the interest received by the N Corporation, regardless of whether the interest received by the N Corporation is included in the gross income of the M Corporation as an actual dividend or as a constructive dividend under section 555.

§ 1.551–4 Information in return.

The information required by section 551(d) in the returns of certain United

States shareholders relates only to the taxable year of a foreign personal holding company for which any part of such corporation's undistributed foreign personal holding company income must be included in gross income by the United States shareholder of whom the information is required. The information shall be submitted as a part of the income tax return in the form of a statement attached to the return.

§1.551–5 Effect on capital account of foreign personal holding company and basis of stock in hands of shareholders.

(a) Sections 551(e) and 551(f) are designed to prevent double taxation with respect to the undistributed foreign personal holding company income.

(b) The application of sections 551(e) and 551(f) may be illustrated by the following examples:

Example 1. The M Corporation is a foreign personal holding company. Seventy-five percent in value of its capital stock is owned by A, a citizen of the United States, and the remainder, or 25 percent, of its stock is owned by B, a nonresident alien individual. For the calendar year 1954 the M Corporation has an undistributed foreign personal holding company income of $100,000. A is required to include $75,000 of such income in gross income as a dividend in his return for the calendar year 1954. The $100,000 is treated as paid-in surplus or as a contribution to the capital of the M Corporation and its accumulated earnings and profits as of the close of the calendar year 1954 are correspondingly reduced. If after treating such $100,000 as paid-in surplus or as a contribution to capital, the M Corporation has no accumulated earnings and profits at the close of 1954, and if for the calendar year 1955, the M Corporation had no earnings and profits, but distributed $40,000, the amount so distributed would be a nontaxable distribution and would not be included in the gross income of either A or B for the calendar year 1955. If, however, after treating the $100,000 as paid-in surplus or as a contribution to capital, the M Corporation had accumulated earnings and profits of $100,000 at the close of 1954, the facts otherwise being the same, the distributions in 1955 would be taxable to A as a dividend, and the taxability of such distributions to B would depend upon the application of section 861(a)(2), relating to the treatment of dividends from a foreign corporation as income from sources within or without the United States.

Example 2. In example 1 assume the basis of A's stock to be $300,000. If A includes in gross income in his return for the calendar year 1954, $75,000 as a dividend from the M Corporation, the basis of his stock would be $375,000. After the nontaxable distribution of $30,000 to A by the M Corporation in 1955 (75 percent of the $40,000 distribution) the basis of A's stock, assuming no other changes, would be $345,000. If A failed to include the $75,000 as a dividend in gross income in his return for 1954 and his failure was not discovered until after the 6-year period of limitations had expired, the application of the rule would not increase the basis of A's stock. The subsequent nontaxable distribution of $30,000 to A in 1955 would reduce his basis of $300,000 to $270,000, thus tending to compensate for his failure to include the amount of $75,000 as a dividend in his gross income for 1954. If the undistributed foreign personal holding company income of the M Corporation is readjusted within the statutory period of limitations, thus increasing or decreasing the amount A would have to include in his gross income, proper adjustment is required to be made to the basis of A's stock on account of such readjustment.

§1.552–1 Definition of foreign personal holding company.

(a) A foreign personal holding company is any foreign corporation, other than a corporation exempt from taxation under subchapter F (section 501 and following), chapter 1 of the Code, and other than certain banking institutions which satisfy the requirements of section 552(b)(2) and paragraph (b) of §1.552–4 which for the taxable year meets (1) the gross income requirement specified in section 552(a)(1); and (2) the stock ownership requirement specified in section 552(a)(2). Both requirements must be satisfied with respect to each taxable year.

(b) A foreign corporation which comes within the classification of a foreign personal holding company is not subject to taxation either under section 531 or section 541. See sections 532(b)(2) and 542(c)(5). The fact that a foreign corporation is a foreign personal holding company does not relieve the corporation from liability for the taxes imposed generally upon foreign corporations, such as the taxes imposed by sections 881 and 882, since such taxes apply regardless of the classification of the foreign corporation as a foreign personal holding company.

§ 1.552–2 Gross income requirement.

(a) To meet the gross income requirement, it is necessary that either of the following percentages of gross income of the corporation for the taxable year (including the additions to gross income provided in section 555(b) as required by section 555(c)(2)) be foreign personal holding company income as defined in section 553:

(1) 60 percent or more; or

(2) 50 percent or more if the foreign corporation has been classified as a foreign personal holding company for any taxable year ending after August 26, 1937, unless:

(i) A taxable year has intervened since the last taxable year for which it was so classified, during no part of which the stock ownership requirement specified in section 552(a)(2) exists; or

(ii) Three consecutive years have intervened since the last taxable year for which it was so classified, during each of which its foreign personal holding company income was less than 50 percent of its gross income.

(b) In determining whether the foreign personal holding company income is equal to the required percentage of the total gross income, the determination must not be made upon the basis of gross receipts, since gross income is not synonymous with gross receipts. For meaning of gross income in this part, see section 555 and § 1.555–1.

§ 1.552–3 Stock ownership requirement.

(a) To meet the stock ownership requirement, it is necessary that at some time in the taxable year more than 50 percent in value of the outstanding stock of the foreign corporation be owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States, herein referred to as *United States group*. For the purpose of the requirement under section 552(a)(2), section 554 provides that the ownership of the stock must be determined under the rules prescribed by section 544 (relating to rules for determining stock ownership in the case of personal holding companies generally). Accordingly, section 544 and §§ 1.544–1 through 1.544–7 are applicable for purposes of section 552(a)(2) and this section as if each reference in section 544 and §§ 1.544–1 through 1.544–7 to a personal holding company or to part II (section 541 and following), subchapter G, chapter 1 of the Code, was a reference to a foreign personal holding company or to part III (section 551 and following), subchapter G, chapter 1 of the Code, as the case may be.

(b) It is necessary to consider any change in the stock outstanding during the taxable year, whether in the number of shares or classes of stock, or in the ownership thereof, since a corporation comes within the classification if the statutory conditions with respect to stock ownership are present at any time during the taxable year.

(c) In determining whether the statutory conditions with respect to stock ownership are present at any time during the taxable year, the phrase *in value* shall, in the light of all the circumstances, be deemed the value of the corporate stock outstanding at such time (not including treasury stock). This value may be determined upon the basis of the company's net worth, earning and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock. If the value of the stock which is used is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return. In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class therein.

§ 1.552–4 Certain excluded banks.

(a) A corporation is excluded from the definition of *foreign personal holding company* if it is organized and doing business under the banking and credit laws of a foreign country and if it establishes to the satisfaction of the Commissioner that it was not formed or availed of for the purpose of evading or avoiding United States income taxes which would otherwise be imposed on its shareholders. If this is established, the Commissioner, or such other official to whom authority may be delegated, will certify, by letter to the corporation, that it is not a foreign personal holding company.

(b) An application for certification under section 552(b)(2) shall be made in writing to the Commissioner of Internal Revenue, Washington DC 20225, Attention: Director of International Operations. A separate application shall be filed for each taxable year for which certification is requested, and the application shall be accompanied by a completed Form 958 for the taxable year. See section 6035. The following information shall be set forth in, or submitted with, the application:

(1) A complete reference to the banking or credit laws of the foreign country under which the corporation operates;

(2) A statement as to the extent of the corporation's business in receiving deposits and making loans and discounts and similar banking and credit operations;

(3) A statement as to the extent of the operations of the corporation other than such banking and credit operations;

(4) A statement as to whether the banking and credit operations of the corporation are customary for it;

(5) A statement setting forth the degree and manner of supervision exercised over it by the foreign government under its banking and credit laws; a copy (in English) of the corporation's last annual financial statement, as submitted to the Government authority having jurisdiction over it, shall be submitted with the application;

(6) A statement setting forth the business reasons of the corporation for not distributing the amount which would be its undistributed foreign personal holding company income if the corporation were not excluded under section 552(b);

(7) A statement setting forth the extent of the corporation's profits which must be retained as reserves under the foreign law;

(8) A statement setting forth the date or dates when the corporation reasonably expects to distribute is undistributed foreign personal holding company income for the taxable year;

(9) A statement setting forth the name and address of each of the individuals described in section 552(a)(2), the extent of their stock ownership in the corporation, and the amount of distributions or other payments to such stockholders, including, but not limited to, dividends, compensation, interest, and rents; and

(10) Any other facts or information the corporation may wish to submit to show that it was not formed or availed of for the purpose of evading or avoiding United States income taxes which would otherwise be imposed on its shareholders.

The corporation shall also furnish such other information requested as necessary by the Director of International Operations. The application for certification, together with the information required by this paragraph, should be filed within 60 days after the close of the taxable year of the corporation or before November 9, 1958, whichever is later. However, if the corporation is unable, for good cause, to submit the application for certification within such 60-day period, additional time may be granted by the Director of International Operations upon receipt of a request from the corporation setting forth the reasons for such request.

§1.552–5 United States shareholder of excluded bank.

A copy of the certification issued to an excluded bank under section 552(b)(2) and §1.552–4 shall be filed with, and made a part of, the income tax return for the taxable year of each United States shareholder of such foreign corporation, if he has been a shareholder of such corporation for any part of such year. If the certificate has not been issued at the time the return of the United States shareholder is filed, the shareholder shall compute the tax on his return by treating the bank as a foreign personal holding company. If a certificate is issued after the return is filed, the United States shareholder may file a claim for refund or an amended return, and shall attach thereto a copy of the certification.

§ 1.553–1 Foreign personal holding company income.

Foreign personal holding company income shall consist of the items defined under section 543 and §§ 1.543–1 and 1.543–2, relating to personal holding company income, with the following exceptions:

(a) The entire amount received as *interest*, whether or not treated as rent, shall be considered to be foreign personal holding company income. Thus, the exception in the second sentence of section 543(a)(1) and paragraph (b)(2) of § 1.543–1 (relating to interest treated as rent under section 543(a)(7) and paragraph (b)(10) of § 1.543–1), is inapplicable for the purpose of determining foreign personal holding company income. Similarly, section 543(a)(7) and paragraph (b)(10) of § 1.543–1 are applied for this purpose without regard to the interest described in that section.

(b)(1) The entire amount received as *royalties*, whether or not mineral, oil, or gas royalties, or copyright royalties, shall be considered to be foreign personal holding company income. Thus, subparagraphs (A) and (B) of section 543(a)(8) and paragraph (b)(11)(i) *(a)* and *(b)* of § 1.543–1 (relating to mineral, oil, or gas royalties), and subparagraphs (A), (B), and (C) of section 543(a)(9) and paragraph (b) (12)(ii) of § 1.543–1 (relating to copyright royalties), are inapplicable for the purpose of determining foreign personal holding company income.

(2) In computing foreign personal holding company income, the first sentence of paragraph (b)(11)(ii) of § 1.543–1 shall apply to overriding royalties received from the sublessee by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid, and to mineral, oil, or gas production payments, only with respect to amounts received after September 30, 1958.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6739, 29 FR 7715, June 17, 1964]

§ 1.554–1 Stock ownership.

For regulations under section 554, see § 1.552–3.

§ 1.555–1 General rule.

The gross income of a foreign corporation which is a foreign personal holding company is computed the same as if the foreign corporation were a domestic corporation which is a personal holding company. See section 542(a)(1) and § 1.542–2. The gross income of a foreign personal holding company thus includes income from all sources, whether within or without the United States, which is not specifically excluded from gross income under any other provisions of the Code. For example, the gross income of a foreign personal holding company includes all income from sources outside the United States even though the foreign personal holding company is a foreign corporation not engaged in trade or business within the United States. However, the gross income of a foreign corporation which is a foreign personal holding company shall not include, with respect to a United States shareholder described in section 951(b), dividends received by such corporation which are excluded under section 959(b) from the income of such corporation with respect to such shareholder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6795, 30 FR 934, Jan. 29, 1965]

§ 1.555–2 Additions to gross income.

(a) If, for any taxable year:

(1) A foreign corporation meets the stock ownership requirement specified in section 552(a)(2) and § 1.552–3, regardless of whatever day in its taxable year is the last day on which the required United States group exists, and

(2) Such foreign corporation is a shareholder in a foreign personal holding company on any day of a taxable year of the second company which ends with or within the taxable year of the first company and such day is the last day in the taxable year of the second company in which the United States group exists with respect to the second company, then for the purpose of:

(i) Determining whether the first company meets the specified gross income requirement so as to come within the classification of a foreign personal holding company, and

(ii) Determining the undistributed foreign personal holding company income of the first company which (in the event the first company is a foreign personal holding company) is to be included, in whole or in part, in the gross income of its shareholders, whether United States shareholders or other foreign personal holding companies,

there shall be included as a dividend in the gross income of the first company for the taxable year in which or with which the taxable year of the second company ends, the amount the first company would have received as a dividend, if on the last day referred to in this subparagraph there had been distributed by the second company, and received by the shareholders, an amount which bears the same ratio to the undistributed foreign personal holding company income of the second company for its taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year. The foregoing rules apply to any chain of foreign corporations regardless of the number of corporations included in the chain.

(b) The application of section 555(b) may be illustrated by the following examples:

Example 1. The X Corporation is a foreign corporation whose stock is owned by A, a United States citizen. The X Corporation owns the entire stock of the Y Corporation, another foreign corporation. The taxable year of the X Corporation is the calendar year and the taxable year of the Y Corporation is the fiscal year ending June 30. For the fiscal year ending June 30, 1955, more than the required percentage of the Y Corporation's gross income consists of foreign personal holding company income and no part of the earnings for such year is distributed as dividends. On the basis of these facts the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1955. The X Corporation meets the stock ownership requirement and constitutes a foreign personal holding company for 1955, if it also meets the gross income requirement. For the purpose of determining whether the X Corporation meets the gross income requirements, the entire undistributed foreign personal holding company income of the Y Corporation for the fiscal year ending June 30, 1955, must be included as a dividend in the gross income of the X Corporation for 1955, since:

(1) The X Corporation was a shareholder in the Y Corporation on a day (June 30, 1955) in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation, which day was the last day in the taxable year of the Y Corporation on which the United States group required with respect to the Y Corporation existed,

(2) Such last day was also the end of the Y Corporation's taxable year so that the portion of the taxable year of the Y Corporation up to and including such last day is equal to 100 percent of the taxable year of the Y Corporation, and, therefore, the portion of the undistributed foreign personal holding company income of the Y Corporation includible in the gross income of its shareholders is likewise equal to 100 percent, and

(3) The X Corporation being the sole shareholder of the Y Corporation must include such portion in its gross income for 1955, the taxable year in which or with which the taxable year of the Y Corporation ends. If, after the inclusion of the presumptive dividend in its gross income, the X Corporation is a foreign personal holding company for 1955, then the undistributed foreign personal holding company income of the Y Corporation must also be included as a dividend in the gross income of the X Corporation in determining its undistributed foreign personal holding company income which is to be included in the gross income of A, the sole shareholder in the X Corporation. On the other hand, if, after including such presumptive dividend, the X Corporation does not constitute a foreign personal holding company, the undistributed foreign personal holding company income of the Y Corporation is not includible in the gross income of the X Corporation.

Example 2. The X Corporation referred to in example 1 sold the stock in the Y Corporation to other interests on September 30, 1955, so that after that date no United States group existed with respect to the Y Corporation. For the fiscal year ending June 30, 1956, more than the required percentage of the gross income of the Y Corporation consists of foreign personal holding company income. The taxable income of the Y Corporation for such fiscal year amounts to $1,000,000, of which $900,000 is distributed in dividends after September 30, 1955. The undistributed foreign personal holding company income of the Y Corporation for such fiscal year amounts to $100,000. Upon the basis of these facts the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1956, since at one time in such fiscal year, or from July 1 to and including September 30, 1955, it meets the stock ownership requirement, and the gross income requirement is also satisfied. In determining whether the X Corporation constitutes a foreign personal holding company for 1956, a portion of the undistributed foreign personal holding company income of the Y Corporation for the fiscal year ending June 30, 1956 (three-twelfths of $100,000, or $25,000), must be included as a dividend in the gross income of the X Corporation, since:

(1) The X Corporation was a shareholder in the Y Corporation on September 30, 1955, or on a day in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation which day was the last day in the Y Corporation's taxable year on which the United States group required with respect to the Y Corporation existed.

(2) The portion of the taxable year of the Y Corporation up to and including such day is three-twelfths of the entire taxable year of the Y Corporation and, therefore, the portion of the undistributed foreign personal holding company income of the Y Corporation includible in the gross income of its shareholders also is equal to three-twelfths, and

(3) The X Corporation, being the sole shareholder of the Y Corporation at the time the United States group with respect to the Y Corporation last existed, must include all of such portion in its gross income for 1956, the taxable year of the X Corporation in which or with which the taxable year of the Y Corporation ends.

It is to be observed that three-twelfths of the undistributed foreign personal holding company income of the Y Corporation for the entire taxable year and not the earnings realized by the Y Corporation up to and including September 30, 1955, the last day on which the United States group with respect to the Y Corporation existed, must be included in the gross income of the X Corporation.

Example 3. The X Corporation referred to in example 1 sold the stock in the Y Corporation to other interests on September 30, 1955, so that after that date a different United States group existed with respect to the Y Corporation. Assuming that the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1956, no part of the undistributed foreign personal holding company income of the Y Corporation for such fiscal year would, in this instance, be includible in the gross income of the X Corporation for the year 1956, in determining whether the X Corporation is a foreign personal holding company for that year. In such case, the undistributed foreign personal holding company income of the Y Corporation is includible in the gross income of the other foreign personal holding companies, if any, and of the United States shareholders who are shareholders in the Y Corporation the day after September 30, 1955, which was the last day in the taxable year of the Y Corporation on which the United States group with respect to the Y Corporation existed. If, however, the X Corporation sells 90 percent of its stock in the Y Corporation and thus is a minority shareholder in the Y Corporation on the last day of the taxable year of the Y Corporation on which the United States group with respect to the Y Corporation exists, the portion of the undistributed foreign personal holding company income allocable to the minority interests of the X Corporation would be includible in the gross income of the X Corporation, even though on such last day the United States group is not the same with respect to both corporations.

Example 4. If the Y Corporation in example 1 owns all of the stock of the Z Corporation, another foreign corporation, there would be a chain of three foreign corporations. In such case, assuming that the Z Corporation is a foreign personal holding company for a taxable year ending with or within the taxable year of the Y Corporation, the undistributed foreign personal holding company income of the Z Corporation would be included in the gross income of the Y Corporation for the purpose of determining whether the Y Corporation comes within the classification of a foreign personal holding company. If, after the inclusion of such presumptive dividend, the Y Corporation is a foreign personal holding company, the undistributed foreign personal holding company income of the Z Corporation would be included in the gross income of the Y Corporation in determining the undistributed foreign personal holding company income of the Y Corporation which is includible in the gross income of its shareholder, the X Corporation. The same process would be repeated with respect to determining whether the X Corporation is a foreign personal holding company and in determining its undistributed foreign personal holding company income. If all three corporations are foreign personal holding companies, the undistributed foreign personal holding company income of each would, in this manner, be reflected as a dividend in the gross income of A, the ultimate beneficial shareholder of the chain. In the event that after the inclusion of the undistributed foreign personal holding company income of the Z Corporation in the gross income of the Y Corporation, the Y Corporation is not a foreign personal holding company, then no part of the income of either the Z Corporation or the Y Corporation would be includible in the gross income of the X Corporation. In that event, whether the X Corporation is a foreign personal holding company, and its undistributed foreign personal holding company income, would be determined independently of the income of the Y Corporation and the Z Corporation.

§ 1.556–1 Definition.

Undistributed foreign personal holding company income is the amount which is to be included in the gross income of the United States shareholders under section 551(b) and §1.551–2. Undistributed foreign personal holding company income is the taxable income of the foreign personal holding company, as defined in section 63(a) (computed without regard to subchapter N, chapter 1 of the Code), and adjusted in the manner described in section 556(b) and §1.556–2, less the deduction for dividends paid (§§1.561–1 through 1.565–6). See §1.556–3 for an illustration of the computation of undistributed foreign personal holding company income.

§1.556–2 Adjustments to taxable income.

(a) *Taxes*—(1) *General rule.* (i) In computing undistributed foreign personal holding company income for any taxable year, there shall be allowed as a deduction the Federal income and excess profits taxes accrued during the taxable year except that no deduction shall be allowed for *(a)* the accumulated earnings tax imposed by section 531 (or a corresponding section of a prior law), *(b)* the personal holding company tax imposed by section 541 (or a corresponding section of a prior law), and (c) the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940. The deduction is for taxes for the taxable year determined under the accrual method of accounting, regardless of whether the corporation uses an accrual method of accounting, the cash receipts and disbursements method, or any other allowable method of accounting. In computing the amount of taxes accrued, an unpaid tax which is being contested is not considered accrued until the contest is resolved.

(ii) However, the corporation shall deduct taxes paid, rather than taxes accrued, if it used that method with respect to Federal taxes for each taxable year for which it was subject to the provisions of supplement P, subchapter C, chapter 1 of the Internal Revenue Code of 1939, unless an election is made under subparagraph (2) of this paragraph to deduct taxes accrued.

(2) *Election by corporation which deducted taxes paid.* (i) If the corporation was subject to supplement P, subchapter C, chapter 1 of the Internal Revenue Code of 1939, and, for the purpose of computing undistributed supplement P net income under such Code, deducted Federal taxes paid, rather than such taxes accrued, for each taxable year for which it was subject to supplement P of the 1939 Code, the corporation may elect for any taxable year ending after August 16, 1954, to deduct taxes accrued, rather than taxes paid, for the purpose of computing its undistributed foreign personal holding company income. The election shall be made by deducting such taxes accrued in the return (Form 958) required to be filed for such taxable year. The return shall, in addition, contain a statement that the corporation has made such election and shall set forth the year to which such election was first applicable. The deduction of taxes accrued in the year of election precludes the deduction of taxes paid during such year. The election, if made, shall be irrevocable and the deduction for taxes accrued shall be allowed for the year of election and for all subsequent taxable years. See section 6035 and the regulations thereunder for rules relative to the filing of returns of officers, directors, and shareholders of foreign personal holding companies.

(ii) Pursuant to section 7851(a)(1)(C), the election provided for in subdivision (i) of this subparagraph may be made with respect to a taxable year ending after August 16, 1954, even though such taxable year is subject to the Internal Revenue Code of 1939.

(3) *Taxes of foreign countries and United States possessions.* In computing taxable income, a foreign personal holding company is allowed a deduction under section 164 for income, war profits, and excess-profits taxes paid or accrued during the taxable year to foreign countries or possessions of the United States, but is not allowed the foreign tax credit under section 901. Therefore, in computing undistributed foreign personal holding company income for any taxable year, no adjustment under section 556(b)(1) is allowed for such taxes.

(b) *Charitable contributions*—(1) *Taxable years beginning before January 1, 1970.* (i) Section 556(b)(2) provides that, in computing the deduction for charitable contributions for purposes of determining the undistributed foreign personal holding company income of a corporation for taxable years beginning before January 1, 1970, the limitations in section 170(b)(1)(A) and (B), relating to charitable contributions by individuals, shall apply and section 170(b)(2) and (5), relating to charitable contributions by corporations and carryover of certain excess charitable contributions made by individuals, respectively, shall not apply.

(ii) Although the limitations of section 170(b)(1)(A) and (B) are 10 and 20 percent, respectively, of the individual's adjusted gross income, the limitations are applied for purposes of section 556(b)(2) by using 10 and 20 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2), that is, the same amount of taxable income to which the 5-percent limitation applied. Thus, the term *adjusted gross income* when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments, other than the 5-percent limitation, provided in the first sentence of section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 556(b)(5), relating to expenses and depreciation applicable to property of the taxpayer, and section 556(b)(6), relating to taxes and contributions to pension trusts, and without the inclusion of the amounts includible as dividends under section 555(b), relating to the inclusion in gross income of a foreign personal holding company of its distributive share of the undistributed foreign personal holding company income of another company in which it is a shareholder. The carryover of charitable contributions made in a prior year, otherwise allowable as a deduction in computing taxable income to the extent provided in section 170(b)(2) and, with respect to contributions paid in taxable years beginning after December 31, 1963, in section 170(b)(5), shall not be allowed as a deduction in computing undistributed foreign personal holding company income for any taxable year.

(iii) See § 1.170–2 with respect to the charitable contributions to which the 10-percent limitation is applicable and the charitable contributions to which the 20-percent limitation is applicable.

(2) *Taxable years beginning after December 31, 1969.* (i) Section 556(b)(2) provides that, in computing the deduction allowable for charitable contributions for purposes of determining the undistributed foreign personal holding company income of a corporation for taxable years beginning after December 31, 1969, the limitations in section 170(b)(1) (A), (B), and (D)(i) (relating to charitable contributions by individuals) shall apply, and section 170(b)(1)(D)(ii) (relating to excess charitable contributions by individuals of certain capital gain property), section 170(b)(2) (relating to the 5-percent limitation on charitable contributions by corporations), and section 170(d) (relating to carryovers of excess contributions of individuals and corporations) shall not apply.

(ii) Although the limitations of section 170(b)(1) (A), (B), and (D)(i) are 50, 20, and 30 percent, respectively, of an individual's contribution base, these limitations are applied for purposes of section 556(b)(2) by using 50, 20, and 30 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2), that is, the same amount of taxable income to which the 5-percent limitation applies. Thus, the term *contribution base* when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments, other than the 5-percent limitation, provided in section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 556(b)(5), relating to expenses and depreciation applicable to property of the taxpayer, and section 556(b)(6), relating to taxes and contributions to pension trusts, and without the inclusion of the amounts includible as dividends under section 555(b), relating to the inclusion in gross income of a foreign personal holding company of its distributive share of the undistributed foreign personal holding company income of another company in which it is a shareholder. The carryover of charitable contributions made in a prior year, otherwise allowable as a deduction in computing taxable income to the extent provided in section 170(b)(1) (D) (ii) and (d), shall not be allowed as a deduction in computing undistributed foreign personal holding company income for any taxable year.

(iii) See §1.170A–8 for the rules with respect to the charitable contributions to which the 50-, 20-, and 30-percent limitations apply.

(c) *Special deductions disallowed.* Part VIII, subchapter B, chapter 1 of the Code allows corporations special deductions in computing taxable income for such matters as partially tax-exempt interest, certain dividends received, dividends paid on certain preferred stock of public utilities, organizational expenses, etc. See section 241. For purposes of computing undistributed foreign personal holding company income, such special deductions, except the deduction provided by section 248 (relating to organizational expenditures) and, with respect to such a computation for a taxable year ending before January 1, 1958, the deduction provided by section 242 (relating to partially tax-exempt interest), shall be disallowed.

(d) *Net operating loss.* The net operating loss deduction provided in section 172 is not allowed for purposes of the computation of undistributed foreign personal holding company income. For purposes of such a computation, however, there is allowed as a deduction the amount of the net operating loss (as defined in section 172(c)) for the preceding taxable year, except that, in computing undistributed foreign personal holding company income for a taxable year ending after December 31, 1957, the amount of such net operating loss shall be computed without the deductions provided in part VIII (section 241 and following) except section 248, relating to organizational expenditures, subchapter B, chapter 1 of the Code.

(e) *Expenses and depreciation applicable to property of the corporation.* (1) Section 556(b)(5) provides a specific limitation in computing undistributed foreign personal holding company income, with respect to the allowance of deductions for trade or business expenses and depreciation which are allocable to the operation and maintenance of property owned or operated by a foreign personal holding company. Under this limitation these deductions shall not be allowed in excess of the aggregate amount of the rent or other compensation received for the use of, or the right to use, the property, unless it is established to the satisfaction of the Commissioner:

(i) That the rent or other compensation received was the highest obtainable, or if none was received, that none was obtainable;

(ii) That the property was held in the course of a business carried on bona fide for profit; and

(iii) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(2) The burden of proof will rest upon the taxpayer to sustain the deduction claimed. If a United States shareholder, in computing his distributive share of undistributed foreign personal holding company income to be included in gross income in his individual return (see section 551, and §§1.551–1 and 1.551–2), claims deductions for expenses and depreciation allocable to the operation and maintenance of property owned or operated by the company, in an aggregate amount in excess of the rent or other compensation received for the use of, or the right to use, the property, he shall attach to his income tax return a statement setting forth his claim for allowance of the additional deductions, together with a complete statement of the facts and circumstances pertinent to his claim and the arguments on which he relies. Such statement shall set forth:

(i) A description of the property;

(ii) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;

(iii) The name and address of the person from whom the property was acquired and the date the property was acquired;

(iv) The name and address of the person to whom the property is leased or rented, or the person permitted to use the property, and the number of shares of stock, if any, held by such person and the members of his family;

(v) The nature and gross amount of the rent or other compensation received for the use of, or the right to use, the property during the taxable year and for each of the five preceding years and the amount of the expenses incurred with respect to, and the depreciation sustained on, the property for such years;

(vi) Evidence that the rent or other compensation was the highest obtainable, or, if none was received, a statement of the reasons therefor;

(vii) A copy of the contract, lease or rental agreement;

(viii) The purpose for which the property was used;

(ix) The business carried on by the corporation with respect to which the property was held and the gross income, expenses, and taxable income derived from the conduct of such business for the taxable year and for each of the five preceding years;

(x) A statement of any reasons which existed for expectation that the operation of the property would be profitable, or a statement of the necessity for the use of the property in the business of the corporation, and the reasons why the property was acquired; and

(xi) Any other information pertinent to the taxpayer's claim.

(f) *Taxes and contributions to pension trusts.* Section 164(e) provides for deduction by a corporation for taxes of a shareholder paid by it; section 404 provides for deduction by an employer for its contributions to an employees' trust, etc. For the purpose of computing undistributed foreign personal holding company income, neither of these deductions is allowable.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7207, 37 FR 20796, Oct. 5, 1972]

§ 1.556–3 Illustration of computation of undistributed foreign personal holding company income.

The method of computation of the undistributed foreign personal holding company income may be illustrated by the following example:

Example. (a) The following facts exist with respect to the M Corporation, a foreign personal holding company, for the calendar year 1954:

(1) The gross income of the corporation as defined in section 555 amounts to $300,000, of which $85,000 represents its distributive share of the undistributed foreign personal holding company income of another foreign personal holding company in which it is a shareholder, $200,000 consists of dividends, $10,000 consists of fully taxable interest, and the remainder ($5,000) consists of rent received from the principal shareholder of the corporation for the use of property owned by the corporation.

(2) The expenses of the corporation amount to $85,000, of which $75,000 is allocable to the maintenance and operation of the property used by the principal shareholder and $10,000 consists of ordinary and necessary office expenses allowable as a deduction. The claim for deduction for the expenses of, and depreciation on, the rented property in excess of the rent received for its use is not established as provided in section 556(b)(5). The yearly depreciation on the rented property amounts to $30,000.

(3) Federal income tax withheld at the source on the income of the corporation from sources within the United States amounts to $59,125.

(4) No gain from the sale or exchange of stock or securities is realized during the taxable year, but losses in the amount of $10,000 are sustained from the sale of stock or securities which constitute capital assets. Such losses are not allowed as a deduction in any amount. See section 1211(a).

(5) Contributions, payment of which is made to or for the use of donees described in section 170(b)(1)(A) for the purposes therein specified, amount to $15,000, of which $5,000 is deductible in computing taxable income under section 63.

(6) Dividends paid by the corporation to its shareholders during the taxable year amount to $50,000.

(b) The taxable income of the corporation (including the distributive share of the undistributed foreign personal holding company income of the other foreign personal holding company) is $180,000, computed as follows (assuming for the purposes of this example only that the expenses of, and depreciation on, the rental property are deductible under sections 162 and 167):

Income (Section 61)	
Dividends	$200,000
Interest	10,000
Rent	5,000
Gross income as defined in section 61	215,000
Add:	
Distributive share of undistributed income of the other foreign personal holding company (considered as a dividend)	85,000
Gross income as defined in section 555	300,000

Deductions (Section 161)	
Expenses allocable to operation of the rented property	$75,000
Depreciation of the rented property	30,000
Ordinary and necessary expenses (office)	10,000
Contributions (within the 5-percent limitation specified in section 170(b) (2)	5,000
	120,000
Taxable income for purposes of computing undistributed foreign personal holding company income	180,000

(c) The undistributed foreign personal holding company income of the corporation is $160,875, computed as follows:

Taxable income for purposes of computing undistributed foreign personal holding company income	$180,000
Add (see section 556(b)):	
Contributions deductible in computing taxable income under section 63	5,000
Excess property expenses and depreciation over amount of rent received for use of property ($105,000 − $5,000)	100,000
Total	105,000
Deduct (see section 556(b)):	
Federal income taxes	59,125
Contributions (within the percentage limitations specified in section 170(b)(1) (A) and (B), determined under the rules provided in section 556(b)(2))	15,000
Total	74,125
Net additions under section 556(b)	30,875
Taxable income, as adjusted under section 556(b)	210,875
Less: Deduction for dividends paid (see section 561)	50,000
Undistributed foreign personal holding company income	160,875

Deduction for Dividends Paid

§ 1.561–1 Deduction for dividends paid.

(a) The deduction for dividends paid is applicable in determining accumulated taxable income under section 535, undistributed personal holding company income under section 545, undistributed foreign personal holding company income under section 556, investment company taxable income under section 852, and real estate investment trust taxable income under section 857. The deduction for dividends paid includes:

(1) The dividends paid during the taxable year;

(2) The consent dividends for the taxable year, determined as provided in section 565; and

(3) In the case of a personal holding company, the dividend carryover computed as provided in section 564.

(b) For dividends for which the dividends paid deduction is allowable, see section 562 and § 1.562–1. As to when dividends are considered paid, see § 1.561–2.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4093, Apr. 28, 1962]

§ 1.561–2 When dividends are considered paid.

(a) *In general.* (1) A dividend will be considered as paid when it is received by the shareholder. A deduction for dividends paid during the taxable year will not be permitted unless the shareholder receives the dividend during the taxable year for which the deduction is claimed. See section 563 for special rule with respect to dividends paid after the close of the taxable year.

(2) If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mails, in a cover properly stamped and addressed to the shareholder at his last known address, at such time that in the ordinary handling of the mails the check would be received by the shareholder within the taxable year, a presumption arises that the dividend was paid to the shareholder in such year.

(3) The payment of a dividend during the taxable year to the authorized agent of the shareholder will be deemed payment of the dividend to the shareholder during such year.

(4) If a corporation, instead of paying the dividend directly to the shareholder, credits the account of the shareholder on the books of the corporation with the amount of the dividend, the deduction for a dividend paid will not be permitted unless it be shown to the satisfaction of the Commissioner that such crediting constituted payment of the dividend to the shareholder within the taxable year.

(5) A deduction will not be permitted for the amount of a dividend credited during the taxable year upon an obligation of the shareholder to the corporation unless it is shown to the satisfaction of the Commissioner that such crediting constituted payment of the

dividend to the shareholder within the taxable year.

(6) If the dividend is payable in obligations of the corporation, they should be entered or registered in the taxable year on the books of the corporation, in the name of the shareholder (or his nominee or transferee), and, in the case of obligations payable to bearer, should be received in the taxable year by the shareholder (or his nominee or transferee) to constitute payment of the dividend within the taxable year.

(7) In the case of a dividend from which the tax has been deducted and withheld as required by chapter 3 (section 1441 and following), of the Code the dividend is considered as paid when such deducting and withholding occur.

(b) *Methods of accounting.* The determination of whether a dividend has been paid to the shareholder by the corporation during its taxable year is in no way dependent upon the method of accounting regularly employed by the corporation in keeping its books or upon the method of accounting upon the basis of which the taxable income of the corporation is computed.

(c) *Records.* Every corporation claiming a deduction for dividends paid shall keep such permanent records as are necessary (1) to establish that the dividends with respect to which such deduction is claimed were actually paid during the taxable year and (2) to supply the information required to be filed with the income tax return of the corporation. Such corporation shall file with its return (i) a copy of the dividend resolution; and (ii) a concise statement of the pertinent facts relating to the payment of the dividend, clearly specifying *(a)* the medium of payment and *(b)* if not paid in money, the fair market value and adjusted basis (or face value, if paid in its own obligations) on the date of distribution of the property distributed and the manner in which such fair market value and adjusted basis were determined. Canceled dividend checks and receipts obtained from shareholders acknowledging payment of dividends paid otherwise than by check need not be filed with the return but shall be kept by the corporation as a part of its records.

§ 1.562–1 Dividends for which the dividends paid deduction is allowable.

(a) *General rule.* Except as otherwise provided in section 562 (b) and (d), the term *dividend,* for purposes of determining dividends eligible for the dividends paid deduction, refers only to a dividend described in section 316 (relating to definition of dividends for purposes of corporate distributions). No distribution, however, which is preferential within the meaning of section 562(c) and § 1.562–2 shall be eligible for the dividends paid deduction. Moreover, when computing the dividends paid deduction with respect to a U.S. person (as defined in section 957(d)), no distribution which is excluded from the gross income of a foreign corporation under section 959(b) with respect to such person or from gross income of such person under section 959(a) shall be eligible for such deduction. Further, for purposes of the dividends paid deduction, the term *dividend* does not include a distribution in liquidation unless the distribution is treated as a dividend under section 316(b)(2) and paragraph (b)(2) of § 1.316–1, or under section 333(e)(1) and paragraph (c) of § 1.333–4 or paragraph (c)(2), (d)(1)(ii), or (d)(2) of § 1.333–5, or qualifies under section 562(b) and paragraph (b) of this section. If a dividend is paid in property (other than money) the amount of the dividends paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution. See paragraph (b)(2) of this section for special rules with respect to liquidating distributions by personal holding companies occurring during a taxable year of the distributing corporation beginning after December 31, 1963. Also see section 563 for special rules with respect to dividends paid after the close of the taxable year.

(b) *Distributions in liquidation*—(1) *General rule*—(i) *In general.* In the case of amounts distributed in liquidation by any corporation during a taxable year of such corporation beginning before January 1, 1964, or by a corporation other than a personal holding company (as defined in section 542) or a foreign personal holding company (as defined in section 552) during a taxable year of such a corporation beginning after December 31, 1963, section 562(b) makes an exception to the general rule that a deduction for dividends paid is permitted only with respect to dividends described in section 316. In order to qualify under that exception, the distribution must be one either in complete or partial liquidation of a corporation pursuant to sections 331, 332, or 333. See subparagraph (2) of this paragraph for rules relating to the treatment of distributions in complete liquidation made by a corporation which is a personal holding company to corporate shareholders during a taxable year of such distributing corporation beginning after December 31, 1963. As provided by section 346(a), for the purpose of section 562(b), a partial liquidation includes a redemption of stock to which section 302 applies. Amounts distributed in liquidation in a transaction which is preceded, or followed, by a transfer to another corporation of all or part of the assets of the liquidating corporation, may not be eligible for the dividends paid deduction.

(ii) *Amount of dividends paid deduction allowable—(a) General rule.* In the case of distributions in liquidation with respect to which a deduction for dividends paid is permissible under subdivision (i) of this subparagraph, the amount of the deduction is equal to the part of such distribution which is properly chargeable to the earnings and profits accumulated after February 28, 1913. To determine the amount properly chargeable to the earnings and profits accumulated after February 28, 1913, there must be deducted from the amount of the distribution that part allocable to capital account. The capital account, for the purposes of this subdivision, includes not only amounts representing the par or stated value of the stock with respect to which the liquidation distribution is made, but also that stock's proper share of the paid-in surplus, and such other corporate items, if any, which, for purposes of income taxation, are treated like capital in that they are not taxable dividends when distributed but are applied against and reduce the basis of the stock. The remainder of the distribution in liquidation is, ordinarily, properly chargeable to the earnings and profits accumulated after February 28, 1913. Thus, if there is a deficit in earnings and profits on the first day of a taxable year, and the earnings and profits for such taxable year do not exceed such deficit, no dividends paid deduction would be allowed for such taxable year with respect to a distribution in liquidation; if the earnings and profits for such taxable year exceed the deficit in earnings and profits which existed on the first day of such taxable year, then a dividends paid deduction would be allowed to the extent of such excess.

(b) Special rule. Section 562(b)(1)(B) provides that in the case of a complete liquidation occurring within 24 months after the adoption of a plan of liquidation the amount of the deduction is equal to the earnings and profits for each taxable year in which distributions are made. Thus, if there is a distribution in liquidation pursuant to section 333, or a distribution in complete liquidation pursuant to section 331(a)(1) or 332 which occurs within a 24-month period after the adoption of a plan of liquidation, a dividends paid deduction will be allowable to the extent of the current earnings and profits for the taxable year or years even though there was a deficit in earnings and profits on the first day of such taxable year or years. In computing the earnings and profits for the taxable year in which the distributions are made, computation shall be made with the inclusion of capital gains and without any deduction for capital losses.

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

Example 1. The Y Corporation, which makes its income tax returns on the calendar year basis, was organized on January 1, 1910, with an authorized and outstanding capital stock of 2,000 shares of common stock of a par value of $100 each and 1,000 shares of participating preferred stock of a par value of $100 each. The preferred stock was to receive annual dividends of $7 per share and $100 per share on complete liquidation of the corporation in priority to any payments on common stock, and was to participate equally with the common stock in either instance after the common stock had received a similar amount. However, the preferred stock was redeemable in whole or in part at the option of the board of directors at any time at

$106 per share plus its proportion of the earnings of the company at the time of such redemption. In 1910 the preferred stock was issued at $106 per share, for a total of $106,000 and the common stock was issued, at $100 per share, for a total of $200,000. On July 15, 1954, the company had a paid-in surplus of $6,000, consisting of the premium received on the preferred stock; earnings and profits of $30,000 accumulated prior to March 1, 1913; and earnings and profits accumulated since February 28, 1913, of $75,000. On July 15, 1954, the option with respect to the preferred stock was exercised and the entire amount of such stock was redeemed at $141 per share or a total of $141,000 in a transaction upon which gain or loss to the distributees resulting from the exchange was determined and recognized under section 302(a). The amount of the distribution allocable to capital account was $116,000 ($100,000 attributable to par value, $6,000 attributable to paid-in surplus, and $10,000 attributable to earnings and profits accumulated prior to March 1, 1913). The remainder, $25,000 ($141,000, the amount of the distribution, less $116,000, the amount allocable to capital account) is properly chargeable to the earnings and profits accumulated since February 28, 1913, and is deductible as dividends paid.

Example 2. The M Corporation, a calendar year taxpayer, is completely liquidated on November 1, 1955, pursuant to a plan of liquidation adopted April 1, 1955. On January 1, 1955, the M Corporation has a deficit in earnings and profits of $100,000. During the period January 1, 1955, to the date of liquidation, November 1, 1955, it has earnings and profits of $10,000. The M Corporation is entitled to a dividends paid deduction in the amount of $10,000 as a result of its distribution in complete liquidation on November 1, 1955.

Example 3. The N Corporation, a calendar year taxpayer, is completely liquidated on July 1, 1958, pursuant to a plan of liquidation adopted February 1, 1955. No distributions in liquidation were made pursuant to the plan of liquidation adopted February 1, 1955, until the distribution in complete liquidation on July 1, 1958. On January 1, 1958, N Corporation had a deficit in earnings and profits of $30,000. During the period January 1, 1958, to the date of liquidation, July 1, 1958, the N Corporation has earnings and profits of $5,000. The N Corporation is not entitled to any deduction for dividends paid as a result of the distribution in complete liquidation on July 1, 1958. If the earnings and profits for the period January 1, 1958, to July 1, 1958, had been $32,000, the N Corporation would have been entitled to a deduction for dividends paid in the amount of $2,000.

(2) *Special rule*—(i) *Distributions to corporate shareholders.* In the case of amounts distributed in complete liquidation of a personal holding company (as defined in section 542) within 24 months after the adoption of a plan of liquidation, section 562(b)(2) makes a further exception to the general rule that a deduction for dividends paid is permitted only with respect to dividends described in section 316. The exception referred to in the preceding sentence applies only to distributions made in any taxable year of the distributing corporation beginning after December 31, 1963. Under the exception, the amount of any distribution within the 24-month period pursuant to the plan shall be treated as a dividend for purposes of computing the dividends paid deduction, but:

(a) Only to the extent that such amount is distributed to corporate distributees, and

(b) Only to the extent that such amount represents such corporate distributees' allocable share of undistributed personal holding company income for the taxable year of such distribution (computed without regard to section 316(b)(2)(B) and section 562(b)(2)).

Amounts distributed in liquidation in a transaction which is preceded, or followed, by a transfer to another corporation of all or part of the assets of the liquidating corporation, may not be eligible for the dividends paid deduction.

(ii) *Corporate distributees' allocable share.* For purposes of subdivision (i)*(b)* of this subparagraph:

(a) Except as provided in *(b)* of this subdivision, the corporate distributees' allocable share of undistributed personal holding company income for the taxable year of the distribution (computed without regard to sections 316(b)(2)(B) and 562(b)(2)) shall be determined by multiplying such undistributed personal holding company income by the ratio which the aggregate value of the stock held by all corporate shareholders immediately before the record date of the last liquidating distribution in such year bears to the total value of all stock outstanding on such date. For rules applicable in a case where the distributing corporation has more than one class of stock, see *(c)* of this subdivision (ii).

(b) If more than one liquidating distribution was made during the year,

and if, after the record date of the first distribution but before the record date of the last distribution, there was a change in the relative shareholdings as between corporate shareholders and noncorporate shareholders, then the corporate distributees' allocable share of undistributed personal holding company income for the taxable year of the distributions (computed without regard to sections 316(b)(2)(B) and 562(b)(2)) shall be determined as follows:

(1) First, allocate the corporation's undistributed personal holding company income for the taxable year among the distributions made during such year by reference to the ratio which the aggregate amount of each distribution bears to the total amount of all distributions during such year;

(2) Second, determine the corporate distributees' allocable share of the corporation's undistributed personal holding company income for each distribution by multiplying the amount determined under *(1)* of this subdivision *(b)* for each distribution by the ratio which the aggregate value of the stock held by all corporate shareholders immediately before the record date of such distribution bears to the total value of all stock outstanding on such date; and

(3) Last, determine the sum of the corporate distributees' allocable share of the corporation's undistributed personal holding company income for all such distributions.

For rules applicable in a case where the distributing corporation has more than one class of stock, see *(c)* of this subdivision (ii).

(c) Where the distributing corporation has more than one class of stock:

(1) The undistributed personal holding company income for the taxable year in which, or in respect of which, the distribution was made shall be treated as a fund from which dividends may properly be paid and shall be allocated between or among the classes of stock in a manner consistent with the dividend rights of such classes under local law and the pertinent governing instruments, such as, for example, the distributing corporation's articles or certificate of incorporation and bylaws;

(2) The corporate distributees' allocable share of the undistributed personal holding company income for each class of stock shall be determined separately in accordance with the rules set forth in *(a)* and *(b)* of this subdivision (ii) as if each class of stock were the only class of stock outstanding; and

(3) The sum of the corporate distributees' allocable share of the undistributed personal holding company income for the taxable year in which, or in respect of which, the distribution was made shall be the sum of the corporate distributees' allocable share of the undistributed personal holding company income for all classes of stock.

(d) For purposes of this subdivision (ii), in any case where the record date of a liquidating distribution cannot be ascertained, the record date of the distribution shall be the date on which the liquidating distribution was actually made.

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

Example. O Corporation, a calendar year taxpayer is completely liquidated on December 31, 1964, pursuant to a plan of liquidation adopted July 1, 1964. No distributions in liquidation were made pursuant to the plan of liquidation adopted July 1, 1964, until the distribution in complete liquidation on December 31, 1964. O Corporation has undistributed personal holding company income of $300,000 for the year 1964 (computed without regard to section 316(b)(2)(B) and section 562(b)(2)). On December 31, 1964, immediately before the record date of the distribution in complete liquidation, P Corporation owns 100 shares of O Corporation's outstanding stock and individual A owns the remaining 200 shares. All shares are equal in value. The amount which represents P Corporation's allocable share of undistributed personal holding company income is $100,000(100 shares÷300 shares×$300,000), and for purposes of computing the dividends paid deduction, such amount is treated as a dividend under section 562(b)(2) provided that the liquidating distribution to P Corporation equals or exceeds $100,000. P Corporation does not treat the $100,000 distributed to it as a dividend to which section 301 applies. For an example of the treatment of the distribution to individual A see example 5 of paragraph (e) of §1.316–1.

(iv) *Distributions to noncorporate shareholders.* For the rules for determining the extent to which distributions in complete liquidation made to noncorporate shareholders by a personal holding company are dividends within the meaning of section 562(a), see section 316(b)(2)(B) and paragraph (b)(2) of § 1.316–1.

(c) *Special definition of dividend for nonliquidating distributions by personal holding companies.* Section 316(b)(2)(A) provides that in the case of a corporation which, under the law applicable to the taxable year in which or in respect of which a distribution is made, is a personal holding company, the term *dividend* (in addition to the general meaning set forth in section 316(a)) also means a nonliquidating distribution to its shareholders to the extent of the corporation's undistributed personal holding company income (determined under section 545 without regard to such distributions) for the taxable year in which or in respect of which the distribution is made. See paragraph (b)(1) of § 1.316–1.

[T.D. 6949, 33 FR 5529, Apr. 9, 1968, as amended by T.D. 7767, 46 FR 11265, Feb. 6, 1981]

§ 1.562–2 Preferential dividends.

(a) Section 562(c) imposes a limitation upon the general rule that a corporation is entitled to a deduction for dividends paid with respect to all dividends which it actually pays during the taxable year. Before a corporation may be entitled to any such deduction with respect to a distribution regardless of the medium in which the distribution is made, every shareholder of the class of stock with respect to which the distribution is made must be treated the same as every other shareholder of that class, and no class of stock may be treated otherwise than in accordance with its dividend rights as a class. The limitation imposed by section 562(c) is unqualified, except in the case of an actual distribution made in connection with a consent distribution (see section 565), if the entire distribution composed of such actual distribution and consent distribution is not preferential. The existence of a preference is sufficient to prohibit the deduction regardless of the fact (1) that such preference is authorized by all the shareholders of the corporation or (2) that the part of the distribution received by the shareholder benefited by the preference is taxable to him as a dividend. A corporation will not be entitled to a deduction for dividends paid with respect to any distribution upon a class of stock if there is distributed to any shareholder of such class (in proportion to the number of shares held by him) more or less than his pro rata part of the distribution as compared with the distribution made to any other shareholder of the same class. Nor will a corporation be entitled to a deduction for dividends paid in the case of any distribution upon a class of stock if there is distributed upon such class of stock more or less than the amount to which it is entitled as compared with any other class of stock. A preference exists if any rights to preference inherent in any class of stock are violated. The disallowance, where any preference in fact exists, extends to the entire amount of the distribution and not merely to a part of such distribution. As used in this section, the term *distribution* includes a dividend as defined in subchapter C, chapter 1 of the Code, and a distribution in liquidation referred to in section 562(b).

(b) The application of the provisions of section 562(c) may be illustrated by the following examples:

Example 1. A, B, C, and D are the owners of all the shares of class A common stock in the M Corporation, which makes its income tax returns on a calendar year basis. With the consent of all the shareholders, the M Corporation on July 15, 1954, declared a dividend of $5 a share payable in cash on August 1, 1954, to A. On September 15, 1954, it declared a dividend of $5 a share payable in cash on October 1, 1954, to B, C, and D. No allowance for dividends paid for the taxable year 1954 is permitted to the M Corporation with respect to any part of the dividends paid on August 1, 1954, and October 1, 1954.

Example 2. The N Corporation, which makes its income tax returns on the calendar year basis, has a capital of $100,000 (consisting of 1,000 shares of common stock of a par value of $100) and earnings or profits accumulated after February 28, 1913, in the amount of $50,000. In the year 1954, the N Corporation distributes $7,500 in cancellation of 50 shares of the stock owned by three of the four shareholders of the corporation. No deduction for dividends paid is permissible under section 562(c) and paragraph (a) of this section with respect to such distribution.

Example 3. The P Corporation has two classes of stock outstanding, 10 shares of cumulative preferred, owned by E, entitled to $5 per share and on which no dividends have been paid for two years, and 10 shares of common, owned by F. On December 31, 1954, the corporation distributes a dividend of $125, $50 to E, and $75 to F. The corporation is entitled to no deduction for any part of such dividend paid, since there has been a preference to F. If, however, the corporation had distributed $100 to E and $25 to F, it would have been entitled to include $125 as a dividend paid deduction.

§1.562–3 Distributions by a member of an affiliated group.

A personal holding company which files or is required to file a consolidated return with other members of an affiliated group may be required to file a separate personal holding company schedule by reason of the limitations and exceptions provided in section 542(b) and §1.542–4. Section 562(d) provides that in such case the dividends paid deduction shall be allowed to the personal holding company, with respect to a distribution made to any member of the affiliated group, if such distribution would constitute a dividend if it were made to a shareholder which is not a member of the affiliated group.

§1.563–1 Accumulated earnings tax.

In the determination of the dividends paid deduction for purposes of the accumulated earnings tax imposed by section 531, a dividend paid after the close of any taxable year and on or before the 15th day of the third month following the close of such taxable year shall be considered as paid during such taxable year, and shall not be included in the computation of the dividends paid deduction for the year of payment. However, the rule provided in section 563(a) is not applicable to dividends paid during the first two and one-half months of the first taxable year of the corporation subject to tax under chapter 1 of the Internal Revenue Code of 1954.

§1.563–2 Personal holding company tax.

In the case of a personal holding company subject to the provisions of section 541, dividends paid after the close of the taxable year and before the 15th day of the third month thereafter shall be included in the computation of the dividends paid deduction for the taxable year only if the taxpayer so elects in its return for such taxable year. The election shall be made by including such dividends in computing its dividends paid deduction. The amount of such dividends which may be included in computing the dividends paid deduction for the taxable year shall not exceed either:

(a) The undistributed personal holding company income of the corporation for the taxable year, computed without regard to this section, or

(b) In the case of a taxable year beginning after December 31, 1969, 20 percent (10 percent, in the case of a taxable year beginning before Jan. 1, 1970) of the sum of the dividends paid during the taxable year (not including consent dividends), computed without regard to this section.

In computing the amount of the dividends paid deduction allowable for any taxable year, the amount allowed by reason of section 563(b) for any preceding taxable year is considered a dividend paid in such preceding taxable year and not in the year of actual distribution. Thus, a double deduction is not allowable.

[T.D. 7079, 35 FR 18587, Dec. 8, 1970]

§1.563–3 Dividends considered as paid on last day of taxable year.

(a) *General rule.* Where a distribution made after the close of the taxable year is considered as paid during such taxable year, for purposes of applying section 562(a) the distribution shall be considered as made on the last day of such taxable year.

(b) *Personal holding company tax.* In the case of a corporation which under the law applicable to the taxable year in respect of which a distribution is made under section 563(b) and §1.563–2 is a personal holding company under the law applicable to such taxable year, section 316(b)(2) provides that the term dividend means (in addition to the general rule under section 316(a)) any distribution to the extent of the corporation’s undistributed personal holding company income (determined under section 545 without regard to distributions under section 316(b)(2)) for such year. See paragraph (b) of §1.316–1.

(c) *Dividends paid on or before December 15, 1955.* The Act of June 15, 1955 (Public Law 74, 84th Cong., 69 Stat. 136), repealed sections 452 and 462 of the Code, relating to prepaid income and reserve for estimated expenses. Under section 4(c)(4) of that Act, dividends paid after the 15th day of the third month following the close of the taxable year and on or before December 15, 1955, may be treated as having been paid on the last day of the taxable year for purposes of the accumulated earnings tax or the personal holding company tax and in the case of regulated investment companies, but only to the extent that such dividends are attributable to an increase in taxable income for the taxable year by reason of the repeal of sections 452 and 462. See paragraph (b) of § 1.9000–8, relating to treatment of certain dividends, prescribed pursuant to section 4(c)(4) of the Act of June 15, 1955.

§ 1.564–1 Dividend carryover.

(a) *General rule.* The dividend carryover from the two preceding years, allowable only to personal holding companies, is includible in the dividends paid deduction under section 561. It is computed as follows:

(1) If, for each of the preceding two years, the deduction for dividends paid under section 561 (determined without regard to the dividend carryover to each such year) exceeds the taxable income (adjusted as provided in section 545 for purposes of determining undistributed personal holding company income) then the dividend carryover to the taxable year is the sum of both such excess amounts.

(2) If the deduction for dividends paid under section 561 for the second preceding year (determined without regard to the dividend carryover to such year) exceeds the taxable income for such year (adjusted as provided in section 545), and if the taxable income for the first preceding year (as so adjusted) exceeds the dividends paid deduction for such first preceding year (as so determined), then the dividend carryover to the taxable year shall be such excess amount for the second preceding year, less such excess amount for the first preceding year.

(3) If for the first preceding year the deduction for dividends paid under section 561 (determined without regard to the dividend carryover to such year) exceeds the taxable income (adjusted as provided in section 545) for such year, and such excess is not present in the second preceding year, then the dividend carryover to the taxable year shall be such excess amount for the first preceding year.

(b) *Dividend carryover from year in which taxpayer was not a personal holding company.* In computing the dividend carryover, the taxable income as adjusted under section 545 of any preceding taxable year shall be determined as if the corporation was, under the law applicable to such taxable year, a personal holding company.

(c) *Dividend carryover from year in which taxpayer was subject to 1939 Code.* In a case where the first or the second preceding taxable year began before the taxpayer's first taxable year under the Internal Revenue Code of 1954, the amount of the dividend carryover shall be determined under the Internal Revenue Code of 1939.

(d) *Statement to be filed with return.* Every corporation claiming a dividend carryover for any taxable year shall file with its return for such year a concise statement setting forth the amount of the dividend carryover claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the dividend carryover claimed.

(e) *Computation of dividend carryover.* The computation of the dividend carryover may be illustrated by the following examples:

Example 1. The X Corporation, which files its income tax returns on the calendar year basis, has taxable income, adjusted as required by section 545, in the amount of $110,000 and has a dividends paid deduction of $150,000 for the year 1954. For 1955, its taxable income, adjusted as required by section 545, is $200,000 and its dividends paid deduction is $300,000. The dividend carryover to the year 1956 is $140,000, computed as follows:

Dividends paid deduction for 1954	$150,000
Taxable income for 1954	110,000
Dividend carryover from 1954	40,000
Dividends paid deduction for 1955	300,000
Taxable income for 1955	200,000

Dividend carryover from 1955	100,000
Dividend carryover for 2 preceding taxable years, allowable as a deduction for the year 1956	140,000

Example 2. The Y Corporation, which files its income tax returns on the calendar year basis, has taxable income, adjusted as required by section 545, in the amount of $100,000 and has a dividends paid deduction of $150,000 for the year 1954. For 1955, its taxable income, adjusted as required by section 545, is $200,000 and its dividends paid deduction is $170,000. The dividend carryover to the year 1956 is $20,000 computed as follows:

Dividends paid deduction for 1954	$150,000
Taxable income for 1954	100,000
Dividend carryover from 1954	50,000
Taxable income for 1955	200,000
Dividends paid deduction for 1955	170,000
Excess of taxable income over dividends paid deduction	30,000
Dividend carryover for second preceding taxable year, allowable as a deduction for the year 1956	20,000

§1.565–1 General rule.

(a) *Consent dividends.* The dividends paid deduction, as defined in section 561, includes the consent dividends for the taxable year. A consent dividend is a hypothetical distribution (as distinguished from an actual distribution) made by:

(1) A corporation that has a reasonable basis to believe that it is subject to the accumulated earnings tax imposed in part I of subchapter G, chapter 1 of the Code, or

(2) A corporation described in part II (personal holding companies or a corporation with adjusted income from rents described in section 543(a)(2)(A) which utilizes the consent dividends described in section 543(a)(2)(B)(iii) to avoid personal holding company status) or part III (foreign personal holding companies) of subchapter G or in part I (regulated investment companies) or part II (real estate investment trusts) of subchapter M, chapter 1 of the Code.

A consent dividend may be made by a corporation described in this paragraph to any person who owns consent stock on the last day of the taxable year of such corporation and who agrees to treat the hypothetical distribution as an actual dividend, subject to the limitations in section 565, §1.565–2, and paragraph (c)(2) of this section, by filing a consent at the time and in the manner specified in paragraph (b) of this section.

(b) *Making and filing of consents.* (1) A consent shall be made on Form 972 in accordance with this section and the instructions on the form issued therewith. It may be made only by or on behalf of a person who was the actual owner on the last day of the corporation's taxable year of any class of consent stock, that is, the person who would have been required to include in gross income any dividends on such stock actually distributed on the last day of such year. Form 972 shall contain or be verified by a written declaration that it is made under the penalties of perjury. In the consent such person must agree to include in gross income for his taxable year in which or with which the taxable year of the corporation ends a specific amount as a taxable dividend.

(2) See paragraph (c) of this section and §1.565–2 for the rules as to when all or a portion of the amount so specified will be disregarded for tax purposes.

(3) A consent may be filed at any time not later than the due date of the corporation's income tax return for the taxable year for which the dividends paid deduction is claimed. With such return, and not later than the due date thereof, the corporation must file Forms 972 duly executed by each consenting shareholder, and a return on Form 973 showing by classes the stock outstanding on the first and last days of the taxable year, the dividend rights of such stock, distributions made during the taxable year to shareholders, and giving all the other information required by the form. Form 973 shall contain or be verified by a written declaration that is made under the penalties of perjury.

(c) *Taxability of amounts specified in consents.* (1) The filing of a consent is irrevocable, and except as otherwise provided in section 565(b), §1.565–2, and paragraph (c)(2) of this section, the full amount specified in a consent filed by a shareholder of a corporation described in paragraph (a) of this section shall be included in the gross income of the shareholder as a taxable dividend.

Where the shareholder is taxable on a dividend only if received from sources within the United States, the amount specified in the consent of the shareholder shall be treated as a dividend from sources within the United States in the same manner as if the dividend has been paid in money to the shareholder on the last day of the corporation's taxable year. See paragraph (b) of this section relating to the making and filing of consents, and section 565(e) and § 1.565–5, with respect to the payment requirement in the case of nonresident aliens and foreign corporations.

(2) To the extent that the Commissioner determines that the corporation making a consent dividend is not a corporation described in paragraph (a) of this section, the amount specified in the consent is not a consent dividend and the amount specified in the consent will not be included in the gross income of the shareholder. In addition, where a corporation is described in paragraph (a)(1) but not paragraph (a)(2) of this section, to the extent that the Commissioner determines that the amount specified in a consent is larger than the amount of earnings subject to the accumulated earnings tax imposed by part I of subchapter G, such excess is not a consent dividend under paragraph (a) of this section and will not be included in the gross income of the shareholder.

(3) Except as provided in section 565(b), § 1.565–2 and paragraph (c)(2) of this section, once a shareholder's consent is filed, the full amount specified in such consent must be included in the shareholder's gross income as a taxable dividend, and the ground upon which a deduction for consent dividends is denied the corporation does not affect the taxability of a shareholder whose consent has been filed for the amount specified in the consent. For example, although described in part I, II, or III of subchapter G, or part I or II of subchapter M, chapter 1 of the Code, the corporation's taxable income (as adjusted under section 535(b), 545(b), 556(b), 852(b)(2), or 857(b)(2), as appropriate) may be less than the total of the consent dividends.

(4) A shareholder who is a nonresident alien or a foreign corporation is taxable on the full amount of the consent dividend that otherwise qualifies under this section even though that payment has not been made as required by section 565(e) and § 1.565–5.

(5) Income of a foreign corporation is not subject to the tax on accumulated earnings under part I of subchapter G, chapter 1 of the Code except to the extent of U.S. source income, adjusted as permitted under section 535. See section 535 (b) and (d) and § 1.535–1(b). Therefore, foreign source earnings (other than those distributions subject to resourcing under section 535(d)) of a foreign corporation that is not described in paragraph (a)(2) of this section cannot qualify for consent dividend treatment. Accordingly, a consent dividend made by a foreign corporation described in paragraph (a)(1) of this section shall not be effective with respect to all of the corporation's earnings, but shall relate solely to earnings which would have been, in the absence of the consent dividend, subject to the accumulated earnings tax.

[T.D. 8244, 54 FR 10538, Mar. 14, 1989]

§ 1.565–2 Limitations.

(a) *General rule.* Amounts specified in consents filed by shareholders or other beneficial owners of a corporation described in § 1.565–1(a) are not treated as consent dividends to the extent that—

(1) They would constitute a preferential dividend or

(2) They would not constitute a dividend (as defined in section 316),

if distributed in money to shareholders on the last day of the taxable year of the corporation. If any portion of any amount specified in a consent filed by a shareholder of a corporation described in the preceding sentence is not treated as a consent dividend under section 565(b) and this section, it is disregarded for all tax purposes. For example, it is not taxable to the consenting shareholder, and paragraph (c) of § 1.565–1 is not applicable to this portion of the amount specified in the consent.

(b) *Preferential Distribution.* (1) A preferential distribution is an actual distribution, or a consent distribution, or a combination of the two, which involves a preference to one or more shares of stock as compared with other shares of the same class or to one class of stock as compared with any other class of stock. See section 562(c) and §1.562–2.

(2) The application of section 565 (b) (1) and §1.565–2 (b) may be illustrated by the following examples:

Example 1. The X Corporation, a personal holding company, which makes its income tax returns on the calendar year basis, has 200 shares of stock outstanding, owned by A and B in equal amounts. On December 15, 1987, the corporation distributes $600 to B and $100 to A. As a part of the same distribution, A executes a consent to include $500 in his gross income as a taxable dividend although such amount is not distributed to him. The X Corporation, assuming the other requirements of section 565 have been complied with, is entitled to a consent dividends deduction of $500. Although the consent dividend is deemed to have been paid on December 31, 1987, the last day of the taxable year of the corporation, the total amount of all distributions constitutes a single nonpreferential distribution of $1200.

Example 2. The Y corporation, a personal holding company, which makes its income tax returns on the calendar year basis, has one class of consent stock outstanding, owned in equal amounts by A, B, and C. If A and B each receive a distribution in cash of $5,000 and C consents to include $3,000 in gross income as a taxable dividend, the combined actual and consent distribution of $13,000 is preferential. See section 562 (c) and §1.562–2 (a). Similarly, if no one receives a distribution in cash, but A and B each consents to include $5,000 as a taxable dividend in gross income and C agrees to include only $3,000, the entire consent distribution is preferential.

Example 3. The Z Corporation, which makes its income tax returns on the calendar year basis and is subject, for the taxable year in question, to the accumulated earnings tax, has only two classes of stock outstanding, each class being consent stock and consisting of 500 shares. Class A, with a par value of $40 per share, is entitled to two-thirds of any distribution of earnings and profits. Class B, with a par value of $20 per share, is entitled to one-third of any distribution of earnings and profits. On December 15, 1987, there is distributed on the class B stock $2 per share, or $1,000, and shareholders of the class A stock consent to include in gross income amounts equal to $2 per share, or $1,000. The entire distribution of $2,000 is preferential, inasmuch as the class B stock has received more than its pro rata share of the combined amounts of the actual distributions and the consent distributions.

(c) *Section 316 Limitation.* (1) An additional limitation under section 565 (b) is that the amounts specified in consents which may be treated as consent dividends cannot exceed the amounts which would constitute a dividend (as defined in section 316) if the corporation had distributed the total specified amounts in money to shareholders on the last day of the taxable year of the corporation. If only a portion of such total would constitute a dividend, then only a corresponding portion of each specified amount is treated as a consent dividend.

(2) The application of section 565 (b) (2) and §1.565–2 (c) may be illustrated by the following example:

Example. The X Corporation, a corporation described in §1.565–(a) (1) or (2), which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, owned in equal amounts by A and B. It makes no distributions during the taxable year 1987. Its earnings and profits for the calendar year 1987 amount to $8,000, there being at the beginning of such year no accumulated earnings or profits. A and B execute proper consents to include $5,000 each in their gross income as a dividend received by them on December 31, 1987. The sum of the amounts specified in the consents executed by A and B is $10,000, but if $10,000 had actually been distributed by the X corporation on December 31, 1987, only $8,000 would have constituted a dividend under section 316 (a). The amount which could be considered as consent dividends in computing the dividends paid deduction for purposes of the accumulated earnings tax is limited to $8,000, or $4,000 of the $5,000 specified in each consent. The remaining $1,000 in each consent is disregarded for all tax purposes. (In the case of a personal holding company, see also the example in §1.565–3(b).)

[T.D. 8244, 54 FR 10539, Mar. 14, 1989]

§1.565–3 Effect of consent.

(a) *General Rule.* The amount of the consent dividend that is described in paragraph (a) of §1.565–1 shall be considered, for all purposes of the Code, as if it were distributed in money by the corporation to the shareholder on the last day of the taxable year of the corporation, received by the shareholder on such day, and immediately contributed by the shareholder as paid-in capital to the corporation on such day. Thus, the amount of the consent dividend will be treated by the shareholder as a dividend. The shareholder will be entitled to the dividends received deduction under section 243 or 245 with respect to such consent dividend. The basis of the shareholder's consent stock in a corporation will be increased by the amount thus treated in his hands as a dividend which he is considered as having contributed to the corporation as paid-in capital. The amount of the current dividend will also be treated as a dividend received from sources within the United States in the same manner as if the dividend had been paid in money to the shareholders. Among other effects of the consent dividend, the earnings and profits of the corporation will be decreased by the amount of the consent dividends. Moreover, if the shareholder is a corporation, its accumulated earnings and profits will be increased by the amount of the consent dividend with respect to which it makes a consent.

(b) *Example.* The application of section 565 (c) may be illustrated by the following example:

Example. Corporation A, a personal holding company and a calendar year taxpayer, has one shareholder, individual B, whose consent to include $10,000 in his gross income for the calendar year 1987 has been timely filed. A has $8,000 of earnings and profits at the beginning of 1987. A has $10,000 of undistributed personal holding company income (determined without regard to distributions under section 316(b)(2)) for 1987. B must include $10,000 in his gross income as a taxable income and is treated as having immediately contributed $10,000 to A as paid-in capital. See section 316(b)(2).

[T.D. 8244, 54 FR 10540, Mar. 14, 1989]

§ 1.565–4 Consent dividends and other distributions.

Section 565(d) provides a rule applicable where a distribution is made in part in consent dividends and in part in money or other property. With respect to such a distribution the entire amount specified in the consents and the amount of such money or other property shall be considered together. Thus, if as a part of the same distribution consents are filed by some of the shareholders and cash is distributed to other shareholders, for example, those who may be unwilling to sign consents, the total amount of the cash and the amounts specified in the consents will be viewed as a single distribution to determine the tax effects of such distribution. For example, the total of such amounts must be considered to determine whether the distribution (including the amounts specified in the consents) is preferential and whether any part of such distribution would not be dividends if the total amounts specified in the consents were distributed in cash. See paragraph (b)(2) of § 1.565–2 for examples illustrating the treatment of distributions which consist in part of consent dividends and in part of other property.

§ 1.565–5 Nonresident aliens and foreign corporations.

(a) *Withholding.* In the event that a corporation makes a consent dividend, as described in § 1.565–1 (a), to a shareholder that is subject to a withholding tax under section 1441 or 1442 on a distribution of cash or other property, the corporation must remit an amount of tax equal to the withholding tax that would be imposed under section 1441 or 1442 if an actual cash distribution equal to the consent dividend had been paid to the shareholder on the last day of the corporation's taxable year. Such payment must be in one of the following forms:

(1) Cash,

(2) United States postal money order,

(3) Certified check drawn on a domestic bank, provided that the law of the place where the bank is located does not permit the certification to be rescinded prior to presentation,

(4) A cashier's check of a domestic bank, or

(5) A draft on a domestic bank or a foreign bank maintaining a United States agency or branch and payable in United States funds.

The amount of such payment shall be credited against the tax imposed on the shareholder.

[T.D. 8244, 54 FR 10540, Mar. 14, 1989]

§ 1.565–6 Definitions.

(a) *Consent stock.* (1) The term *consent stock* includes what is generally known as common stock. It also includes participating preferred stock, the participation rights of which are unlimited.

(2) The definition of consent stock may be illustrated by the following example:

Example. If in the case of the X Corporation, a personal holding company, there is only one class of stock outstanding, it would all be consent stock. If, on the other hand, there were two classes of stock, class A and class B, and class A was entitled to 6 percent before any distribution could be made on class B, but class B was entitled to everything distributed after class A had received its 6 percent, only class B stock would be consent stock. Similarly, if class A, after receiving its 6 percent, was to participate equally or in some fixed proportion with class B until it had received a second 6 percent, after which class B alone was entitled to any further distributions, only class B stock would be consent stock. The same result would follow if the order of preferences were class A 6 percent, then class B 6 percent, then class A a second 6 percent, either alone or in conjunction with class B, then class B the remainder. If, however, class A stock is entitled to ultimate participation without limit as to amount, then it, too, may be consent stock. For example, if class A is to receive 3 percent and then share equally or in some fixed proportion with class B in the remainder of the earnings or profits distributed, both class A stock and class B stock are consent stock.

(b) *Preferred dividends.* (1) The term *preferred dividends* includes all fixed amounts (whether determined by percentage of par value, a stated return expressed in a certain number of dollars per share, or otherwise) the distribution of which on any class of stock is a condition precedent to a further distribution of earnings or profits (not including a distribution in partial or complete liquidation). A distribution, though expressed in terms of a fixed amount, is not a preferred dividend, however, unless it is preferred over a subsequent distribution within the taxable year upon some class or classes of stock other than one on which it is payable.

(2) The definition of preferred dividends may be illustrated by the following example:

Example. If, in the case of the X Corporation, there are only two classes of stock outstanding, class A and class B, and class A is entitled to a distribution of 6 percent of par, after which the balance of the earnings and profits are distributable on class B exclusively, class A's 6 percent is a preferred dividend. If the order of preferences is class A $6 per share, class B $6 per share, then class A and class B in fixed proportions until class A receives $3 more per share, then class B the remainder, all of class A's $9 per share and $6 per share of the amount distributable on class B are preferred dividends. The amount which class B is entitled to receive in conjunction with the payment to class A of its last $3 per share is not a preferred dividend, because the payment of such amount is preferred over no subsequent distribution except one made on class B itself. Finally, if a distribution must be $6 on class A, $6 on class B, then on class A and class B share and share alike, the distribution on class A of $6 and the distribution on class B of $6 are both preferred dividends.

[54 FR 10540, Mar. 14, 1989]

BANKING INSTITUTIONS

Rules of General Application to Banking Institutions

§1.581–1 Banks.

(a) In order to be a bank as defined in section 581, an institution must be a corporation for federal tax purposes. See §301.7701–2(b) of this chapter for the definition of a corporation.

(b) This section is effective as of January 1, 1997.

[T.D. 8697, 61 FR 66588, Dec. 18, 1996]

§1.581–2 Mutual savings banks, building and loan associations, and cooperative banks.

(a) While the general principles for determining the taxable income of a corporation are applicable to a mutual savings bank, a building and loan association, and a cooperative bank not having capital stock represented by shares, there are certain exceptions and special rules governing the computation in the case of such institutions. See section 593 for special rules concerning reserves for bad debts. See section 591 and §1.591–1, relating to dividends paid by banking corporations, for special rules concerning deductions for amounts paid to, or credited to the accounts of, depositors or holders of withdrawable accounts as dividends. See also section 594 and §1.594–1 for special rules governing the taxation of a mutual savings bank conducting a life insurance business.

(b) For the purpose of computing the net operating loss deduction provided in section 172, any taxable year for which a mutual savings bank, building and loan association, or a cooperative bank not having capital stock represented by shares was exempt from tax shall be disregarded. Thus, no net operating loss carryover shall be allowed from a taxable year beginning before January 1, 1952, and, in the case of any taxable year beginning after December 31, 1951, the amount of the net operating loss carryback or carryover from such year shall not be reduced by reference to the income of any taxable year beginning before January 1, 1952.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8697, 61 FR 66588, Dec. 18, 1996]

§ 1.581–3 Definition of bank prior to September 28, 1962.

Prior to September 28, 1962, for purposes of sections 582 and 584, the term *bank* means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under section 11(k) of the Federal Reserve Act (38 Stat. 262; 12 U.S.C. 248(k)), and which is subject by law to supervision and examination by State, Territorial, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

[T.D. 6651, 28 FR 4950, May 17, 1963]

§ 1.582–1 Bad debts, losses, and gains with respect to securities held by financial institutions.

(a) *Bad debt deduction for banks.* A bank, as defined in section 581, is allowed a deduction for bad debts to the extent and in the manner provided by subsections (a), (b), and (c) of section 166 with respect to a debt which has become worthless in whole or in part and which is evidenced by a security (a bond, debenture, note, certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money) issued by any corporation (including governments and their political subdivisions), with interest coupons or in registered form.

(b) *Worthless stock in affiliated bank.* For purposes of section 165(g)(1), relating to the deduction for losses involving worthless securities, if the taxpayer is a bank (as defined in section 581) and owns directly at least 80 percent of each class of stock of another bank, stock in such other bank shall not be treated as a capital asset.

(c) *Pre-1970 sales and exchanges of bonds, etc., by banks.* For taxable years beginning before July 12, 1969, with respect to the taxation under subtitle A of the Code of a bank (as defined in section 581), if the losses of the taxable year from sales or exchanges of bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including one issued by a government or political subdivision thereof), exceed the gains of the taxable year from such sales or exchanges, no such sale or exchange shall be considered a sale or exchange of a capital asset.

(d) *Post-1969 sales and exchanges of securities by financial institutions.* For taxable years beginning after July 11, 1969, the sale or exchange of a security is not considered the sale or exchange of a capital asset if such sale or exchange is made by a financial institution to which any of the following sections applies: Section 585 (relating to banks), 586 (relating to small business investment companies and business development corporations), or 593 (relating to mutual savings banks, domestic building and loan associations, and cooperative banks). This paragraph shall apply to determine the character of gain or loss from the sale or exchange of a security notwithstanding any other provision of subtitle A of the Code, such as section 1233 (relating to short sales). However, this paragraph shall have no effect in the determination of whether a security is a capital asset under section 1221 for purposes of applying any other provision of the Code, such as section 1232 (relating to original issue discount). For purposes of this paragraph, a security is a bond, debenture, note, or certificate or other evidence of indebtedness, issued by any person. See paragraphs (e) and (f) of this section for special transitional rules applicable, respectively, to banks and to small business investment companies and business development corporations.

(e) *Transition rule for qualifying securities held by banks*—(1) *In general.* Notwithstanding the provisions of paragraph (d) of this section, if the net long-term capital gain from sales and exchanges of qualifying securities exceeds the net short-term capital loss from such sales and exchanges in any taxable year beginning after July 11, 1969, such excess shall be treated as long-term capital gain, but in an amount not to exceed the net gain from sales and exchanges of securities in such year. For purposes of computing such net gain, a capital loss carried to the taxable year under section 1212 shall not be taken into account. See section 1222 and the regulations thereunder for definitions of the terms *net long-term capital gain* and *net short-term capital loss.* For purposes of this paragraph:

(i) The term *security* means a security within the meaning of paragraph (d) of this section.

(ii) The term *qualifying security* means a security which is held by the bank on July 11, 1969, and continuously thereafter until it is first sold or exchanged by the bank.

See also subparagraph (4) of this paragraph for rules under which the time certain securities are held is deemed to include a period of time determined under section 1223 (1) and (2) with respect to such security.

(2) *Computation of capital gain or loss.* For purposes of this paragraph, the amount of gain or loss from the sale or exchange of a qualifying security treated as capital gain or loss is determined by multiplying the amount of gain or loss recognized from such sale or exchange by a fraction the numerator of which is the number of days before July 12, 1969, that such security was held by the bank and the denominator of which is the sum of the number of days included in the numerator and the number of days the security was held by the bank after July 11, 1969.

(3) *Special rules.* For purposes of subparagraphs (1) and (2) of this paragraph, the following items are not taken into account:

(i) Any amount treated as original issue discount under section 1232, and

(ii) Any amount which, without regard to section 582(c) and this section, would be treated as gain or loss from the sale or exchange of property which is not a capital asset, such as an amount which is realized from the sale or exchange of a security which is held by a bank as a dealer in securities.

(4) *Holding period in certain cases.* For purposes of this paragraph:

(i) The time a security received in an exchange is deemed to have been held by a bank includes a period of time determined under section 1223(1) with respect to such security.

(ii) The time a security transferred to a bank from another bank is deemed to have been held by the transferee bank includes a period of time determined under section 1223(2) with respect to such security.

For example, if a bank on December 3, 1972, surrendered an obligation of the United States which it held as a capital asset on July 11, 1969, in a transaction to which section 1037 applied, the time during which the newly received obligation is deemed to have been held includes the time during which the surrendered obligation was deemed to have been held by the bank. Because the surrendered obligation was held on July 11, 1969, the newly acquired obligation is deemed to have been held on that date and is a qualifying security. The period during which the surrendered obligation is deemed to have been held is taken into account in computing the fraction determined under subparagraph (2) of this paragraph with respect to the newly received obligation.

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

Example 1. Bank A, a calendar year taxpayer, purchased a qualifying security on July 14, 1968, and held it to maturity on August 20, 1970, when it was redeemed. The redemption resulted in a taxable gain of $10,000. The security was held by the bank for 363 days before July 12, 1969, and for a total of 768 days. During the taxable year, the bank had no other gains and no losses from sales or exchanges of qualifying securities, but had a net loss of $4,000 from sales of securities other than qualifying securities. The portion of the gain from the redemption of the qualifying security treated as capital gain under subparagraph (2) of this paragraph is $4,726.56 (363/768×$10,000). Because the net gain of the taxable year from sales and exchanges of securities, $6,000 ($10,000 − $4,000), exceeds the portion of the gain on the sale of the qualifying security treated as capital gain under this paragraph, $4,726.56 is treated as long-term capital gain on the sale of the qualifying security for the taxable year.

Example 2. Assume the same facts as in example 1, except that the bank's net loss of the taxable year from the sale of securities other than qualifying securities was $7,000. The amount considered as long-term capital gain under this paragraph is limited by the amount of gain on the sale of securities to $3,000 ($10,000 − $7,000).

(f) *Small business investment companies and business development corporations*—(1) *Election.* In the case of a small business investment company or a business development corporation, described in section 586(a), section 582(c) does not apply for taxable years beginning after July 11, 1969, and before July 11, 1974, unless the taxpayer elects that such section shall apply. In the case of a small business investment company, see paragraph (a)(1) of § 1.1243–1 if such an election is made, but see paragraph (a)(2) of § 1.1243–1 if such an election is not made. Such election applies to all such taxable years and, except as provided in subparagraph (3) of this paragraph, is irrevocable. Such election must be made not later than (i) the time, including extensions thereof, prescribed by law for filing the taxpayer's income tax return for its first taxable year beginning after July 11, 1969, or (ii) June 8, 1970, whichever is later.

(2) *Manner of making election.* An election pursuant to the provisions of this paragraph is made by the taxpayer by a written statement attached to the taxpayer's income tax return (or an amended return) for its first taxable year beginning after July 11, 1969. Such statement shall indicate that the election is made pursuant to section 433(d) of the Tax Reform Act of 1969 (83 Stat. 624). The taxpayer shall attach to its income tax return for each subsequent taxable year to which such election is applicable a statement indicating that the election has been made and the amount to which it applies for such year.

(3) *Revocation of election.* An election made pursuant to subparagraph (2) of this paragraph shall be irrevocable unless:

(i) A written application for consent to revoke the election, setting forth the reasons therefor, is filed with the Commissioner within 90 days after the permanent regulations relating to section 433(d)(2) of the Tax Reform Act of 1969 (83 Stat. 624) are filed with the Office of the Federal Register, and

(ii) The Commissioner consents to the revocation.

The revocation is effective for all taxable years to which the election applied.

[T.D. 7171, 37 FR 5620, Mar. 17, 1972; 37 FR 6400, Mar. 29, 1972]

§ 1.584–1 Common trust funds.

(a) *Method of taxation.* A common trust fund maintained by a bank is not subject to taxation under this chapter and is not considered a corporation. Its participants are taxed on their proportionate share of income from the common trust fund.

(b) *Conditions for qualification.* (1) For a fund to be qualified as a common trust fund it must be maintained by a bank (as defined in section 581) in conformity with the rules and regulations of the Comptroller of the Currency, exclusively for the collective investment and reinvestment of contributions to the fund by the bank. The bank may either act alone or with one or more other fiduciaries, but it must act solely in its capacity as one or a combination of the following: (i) As a trustee of a trust created by will, deed, agreement, declaration of trust, or order of court; (ii) as an executor of a will or as an administrator of an estate; (iii) as a guardian (by whatever name known under local law) of the estate of an infant, of an incompentent individual, or of an absent individual; or (iv) on or after October 3, 1976, as a custodian of a Uniform Gifts to Minors account. A Uniform Gifts to Minors account is an account established pursuant to a State law substantially similar to the Uniform Gifts to Minors Act. (*See* the Uniform Gifts to Minors Act of 1956 or the Uniform Gifts to Minors Act of 1966, as published by the National Conference of Commissioners on Uniform

State Laws.) The Commissioner will publish a list of the States whose laws he determines to be substantially similar to such uniform acts. A bank that maintains a Uniform Gifts to Minors Act account must establish, to the satisfaction of the Commissioner or his delegate, that with respect to the account the bank has duties and responsibilities similar to the duties and responsibilities of a trustee or guardian.

(2) A common trust fund may be a participant in another common trust fund.

(c) *Affiliated groups.* For taxable years beginning after December 31, 1975, two or more banks that are members of the same affiliated group (within the meaning of section 1504) are treated, for purposes of section 584, as one bank for the period of their affiliation. A common trust fund may be maintained by one or by more than one member of an affiliated group. Any member of the group may, but need not, contribute to the fund. Further, for purposes of this paragraph, members of an affiliated group may be, but need not be, cotrustees of the common trust fund.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7935, 49 FR 1694, Jan. 13, 1984]

§1.584–2 Income of participants in common trust fund.

(a) Each participant in a common trust fund is required to include in computing its taxable income for its taxable year within which or with which the taxable year of the fund ends, whether or not distributed and whether or not distributable:

(1) Its proportionate share of short-term capital gains and losses, computed as provided in §1.584–3;

(2) Its proportionate share of long-term capital gains and losses, computed as provided in §1.584–3; and

(3) Its proportionate share of the ordinary taxable income or the ordinary net loss of the common trust fund, computed as provided in §1.584–3.

(b) Any tax withheld at the source from income of the fund (*e.g.*, under section 1441) is deemed to have been withheld proportionately from the participants to whom such income is allocated.

(c)(1) The proportionate share of each participant's short-term capital gains and losses, long-term capital gains and losses, ordinary taxable income or ordinary net loss, dividends and interest received, and tax withheld at the source shall be determined under the method of accounting adopted by the bank in accordance with the written plan by which the common trust fund is established and administered, provided such method clearly reflects the income of each participant.

(2) Items of income and deductions shall be allocated to the periods between valuation dates established by the plan within the taxable year in which they were realized. Ordinary taxable income or ordinary net loss, short-term capital gains and losses, long-term capital gains and losses, and tax withheld at the source shall be computed for each period. The participants' proportionate shares of income and losses for each period shall then be determined.

(3) For taxable years beginning on or after September 22, 1980, any amount of income or loss of the common trust fund which is included in the computation of a participant's taxable income for the taxable year shall be treated as income or loss from an unrelated trade or business to the extent that such amount would have been income or loss from an unrelated trade or business if such participant had made directly the investments of the common trust fund.

(4) The provisions of this paragraph may be illustrated by the following example:

Example. (i) The plan of a common trust fund provides for quarterly valuation dates and for the computation and the distribution of the income upon a quarterly basis, except that there shall be no distribution of capital gains. The participants are as follows: Trusts A, B, C, and D for the first quarter; Trusts A, B, C, and E for the second quarter; and Trusts A, B, F, and G for the third and fourth quarters, the participants having equal participating interests. As computed upon the quarterly basis, the ordinary taxable income, the short-term capital gain, and the long-term capital loss for the taxable year were as follows:

	First quarter	Second quarter	Third quarter	Fourth quarter	Total
Ordinary taxable income	$200	$300	$200	$400	$1,100
Short-term capital gain	200	100	200	100	600
Long-term capital loss	100	200	100	200	600

(ii) The participants' shares of ordinary taxable income are as follows:

PARTICIPANTS' SHARES OF ORDINARY TAXABLE INCOME

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$50	$75	$50	$100	$275
B	50	75	50	100	275
C	50	75	....	....	125
D	50	....	....	....	50
E	....	75	....	....	75
F	....	....	50	100	150
G	....	....	50	100	150
Total	200	300	200	400	1,100

(iii) The participants' shares of the short-term capital gain are as follows:

PARTICIPANTS' SHARES OF SHORT-TERM CAPITAL GAIN

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$50	$25	$50	$25	$150
B	50	25	50	25	150
C	50	25	....	....	75
D	50	....	....	....	50
E	....	25	....	....	25
F	....	....	50	25	75
G	....	....	50	25	75
Total	200	100	200	100	600

(iv) The participants' shares of the long-term capital loss are as follows:

PARTICIPANTS' SHARES OF LONG-TERM CAPITAL LOSS

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$25	$50	$25	$50	$150
B	25	50	25	50	150
C	25	50	....	....	75
D	25	....	....	....	25
E	....	50	....	....	50
F	....	....	25	50	75
G	....	....	25	50	75
Total	100	200	100	200	600

(v) If in the above example the common trust fund also had short-term capital losses and long-term capital gains, the treatment of such gains or losses would be similar to that accorded to the short-term capital gains and long-term capital losses in the above example.

(vi) Assume in the above example that participant Trust A qualified as a trust forming part of a pension, profit sharing, or stock bonus plan under section 401(a). Assume further that 20 percent of the ordinary taxable income of the common trust fund would be unrelated business taxable income (as defined under section 512(a)(1)) if received directly by Trust A. Under paragraph (c)(3), participant Trust A, for purposes of computing its taxable income, must treat its proportionate share of the common trust fund's ordinary taxable income as income from an unrelated trade or business to the extent such amount would have been income from an unrelated trade or business if Trust A had directly made the investments of the common trust fund. Therefore, participant Trust A must take into account 20 percent of its proportionate share of the common trust fund's ordinary taxable income as income from an unrelated trade or business.

(d) The provisions of part I, subchapter J, chapter 1 of the Code, or, as the case may be, the provisions of subchapters D, F, or H of chapter 1 of the Code, are applicable in determining the extent to which each participant's proportionate share of any income or loss of the common trust fund is taxable to the participant, or to a person other than the participant.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7935, 49 FR 1694, Jan. 13, 1984; T.D. 8662, 61 FR 19546, May 2, 1996]

§ 1.584–3 Computation of common trust fund income.

The taxable income of the common trust fund shall be computed in the same manner and on the same basis as in the case of an individual, except that:

(a) No deduction shall be allowed under section 170 (relating to charitable, etc., contributions and gifts);

(b) The gains and losses from sales or exchanges of capital assets of the common trust fund are required to be segregated. A common trust fund is not allowed the benefit of the capital loss carryover provided by section 1212; and

(c) The ordinary taxable income (the excess of the gross income over deductions) or the ordinary net loss (the excess of the deductions over the gross income) shall be computed after excluding all items of gain and loss from sales or exchanges of capital assets.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7935, 49 FR 1694, Jan. 13, 1984]

§1.584–4 Admission and withdrawal of participants in the common trust fund.

(a) *Gain or loss.* The common trust fund realizes no gain or loss by the admission or withdrawal of a participant, and the basis of the assets and the period for which they are deemed to have been held by the common trust fund for the purposes of section 1202 are unaffected by such an admission or withdrawal. For taxable years of participants ending after April 7, 1976, and for transfers occurring after that date, the transfer of property by a participant to a common trust fund is treated as a sale or exchange of the property transferred. If a participant withdraws the whole or any part of its participating interest from the common trust fund, such withdrawal shall be treated as a sale or exchange by the participant of the participating interest or portion thereof which is so withdrawn. A participant is not deemed to have withdrawn any part of its participating interest in the common trust fund so as to have completed a closed transaction by reason of the segregation and administration of an investment of the fund, pursuant to the provisions of 12 CFR 9.18(b)(7) (or, for periods before September 28, 1962, 12 CFR 206.17(c)(7)), for the benefit of all the then participants in the common trust fund. Such segregated investment shall be considered as held by, or on behalf of, the common trust fund for the benefit ratably of all participants in the common trust fund at the time of segregation, and any income or loss arising from its administration and liquidation shall constitute income or loss to the common trust fund apportionable among the participants for whose benefit the investment was segregated. When a participating interest is transferred by a bank, or by two or more banks that are members of the same affiliated group (within the meaning of section 1504), as a result of the combination of two or more common trust funds or the division of a single common trust fund, the transfer to the surviving or divided fund is not considered to be an admission or a withdrawal if the combining, dividing, and resulting common trust funds have diversified portfolios. For purposes of this paragraph (a), a common trust fund has a diversified portfolio if it satisfies the 25 and 50-percent tests of section 368(a)(2)(F)(ii), applying the relevant provisions of section 368(a)(2)(F). However, Government securities are included in total assets for purposes of the denominator of the 25 and 50-percent tests (unless the Government securities are acquired to meet the 25 and 50-percent tests), but are not treated as securities of an issuer for purposes of the numerator of the 25 and 50-percent tests. In addition, for a transfer of a participating interest in a division of a common trust fund not to be considered an admission or withdrawal, each participant's pro rata interest in each of the resulting common trust funds must be substantially the same as was the participant's pro rata interest in the dividing fund. However, in the case of the division of a common trust fund maintained by two or more banks that are members of the same affiliated group resulting from the termination of such affiliation, the division will be treated as meeting the requirements of the preceding sentence if the written plans of operation of the resulting common trust funds are substantially identical to the plan of operation of the dividing common trust fund, each of the assets of the dividing common trust fund are distributed substantially pro rata to each of the resulting common trust funds, and each participant's aggregate interest in the assets of the resulting common trust funds of which he or she is a participant is substantially the same as was the participant's pro rata interest in the assets of the dividing common trust fund. The plan of operation of a resulting common trust fund will not be considered to be substantially identical to that of the dividing common trust fund where, for example, the plan of operation of the resulting common trust fund contains restrictions as to the types of participants that may invest in the common trust fund where such restrictions were not present in the plan of operation of the dividing common trust fund.

(b) *Basis for gain or loss upon withdrawal.* The participant's gain or loss upon withdrawal of its participating interest or portion thereof shall be measured by the difference between the amount received upon such withdrawal and the adjusted basis of the participating interest or portion thereof withdrawn plus the additions prescribed in paragraph (c) of this section and minus the reductions prescribed in paragraph (d) of this section. The amount received by the participant shall be the sum of any money plus the fair market value of property (other than money) received upon such withdrawal. The basis of the participating interest or portion thereof withdrawn shall be the sum of any money plus the fair market value of any property (other than money) contributed by the participant to the common trust fund to acquire the participating interest or portion thereof withdrawn. Such basis shall not be reduced on account of the segregation of any investment in the common trust fund pursuant to the provisions of 12 CFR 9.18(b)(7) (or, for periods before September 28, 1962, 12 CFR 206.17(c)(7)). For the purpose of making the adjustments, additions, and reductions with respect to basis as prescribed in this paragraph, the ward, rather than the guardian, shall be deemed to be the participant; and the grantor, rather than the trust, shall be deemed to be the participant, to the extent that the income of the trust is taxable to the grantor under subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code.

(c) *Additions to basis.* As prescribed in paragraph (b) of this section, in computing the gain or loss upon the withdrawal of a participating interest or portion thereof, there shall be added to the basis of the participating interest or portion thereof withdrawn an amount equal to the aggregate of the following items (to the extent that they were properly allocated to the participant for a taxable year of the common trust fund and were not distributed to the participant prior to withdrawal):

(1) Wholly exempt income of the common trust fund for any taxable year,

(2) Net income of the common trust fund for the taxable years beginning after December 31, 1935, and prior to January 1, 1938,

(3) Net short-term capital gain of the common trust fund for each taxable year beginning after December 31, 1937,

(4) The excess of the gains over the losses recognized to the common trust fund upon sales or exchanges of capital assets held (i) for more than 18 months for taxable years beginning after December 31, 1937, and before January 1, 1942, (ii) for more than 6 months for taxable years beginning after December 31, 1941, and before January 1, 1977, (iii) for more than 9 months for taxable years beginning in 1977, and (iv) for more than 1 year for taxable years beginning after December 31, 1977, and

(5) Ordinary net or taxable income of the common trust fund for each taxable year beginning after December 31, 1937.

(d) *Reductions in basis.* As prescribed in paragraph (b) of this section, in computing the gain or loss upon the withdrawal of a participating interest or portion thereof, the basis of the participating interest or portion thereof withdrawn shall be reduced by such portions of the following items as were allocable to the participant with respect to the participating interest or portion thereof withdrawn:

(1) The amount of the excess of the allowable deductions of the common trust fund over its gross income for the taxable years beginning after December 31, 1935, and before January 1, 1938, and

(2) The amount of the net short-term capital loss, net long-term capital loss, and ordinary net loss of the common trust fund for each taxable year beginning after December 31, 1937.

(e) *Effective date.* The eighth sentence of paragraph (a) of this section is effective for combinations and divisions of common trust funds completed on or after May 2, 1996.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6651, 28 FR 4950, May 17, 1963; T.D. 7935, 49 FR 1695, Jan. 13, 1984; T.D. 8662, 61 FR 19546, May 2, 1996; 61 FR 39072, July 26, 1996]

§1.584–5 Returns of banks with respect to common trust funds.

For rules applicable to filing returns of common trust funds, see section 6032 and the regulations thereunder.

§1.584–6 Net operating loss deduction.

The net operating loss deduction is not allowed to a common trust fund. Each participant in a common trust fund, however, will be allowed the benefits of such deduction. In the computation of such deduction, a participant in a common trust fund shall take into account its pro rata share of items of income, gain, loss, deduction, or credit of the common trust fund. The character of any such item shall be determined as if the participant had realized such item directly from the source from which realized by the common trust fund, or incurred such item in the same manner as incurred by the common trust fund.

§1.585–1 Reserve for losses on loans of banks.

(a) *General rule.* As an alternative to a deduction from gross income under section 166(a) for specific debts which become worthless in whole or in part, a financial institution to which section 585 and this section apply shall be allowed a deduction under section 585(a) (or, for taxable years beginning before January 1, 1987, section 166(c)), for a reasonable addition to a reserve for bad debts provided such financial institution has adopted or adopts the reserve method of treating bad debts in accordance with paragraph (b) of §1.166–1. In the case of such a taxpayer the amount of the reasonable addition to such reserve for a taxable year beginning after July 11, 1969, shall be an amount determined by the taxpayer which does not exceed the amount computed under §1.585–2. Such reasonable addition for the taxable year shall be an amount at least equal to the amount provided by §1.585–2(a)(2). For each taxable year the taxpayer must include in its income tax return (or amended return) for that year a computation of the amount of the addition determined under this section showing the method used to determine that amount. The use of a particular method in the return for a taxable year is not a binding election by the taxpayer to apply such method either for such taxable year or for subsequent taxable years. A financial institution to which section 585 and this section apply which adopts the reserve method is not entitled to charge off any bad debts pursuant to section 166(a) with respect to a loan (as defined in §1.585–2(e)(2). Except as provided by §1.585–3, the reserve for bad debts of a financial institution to which section 585 and this section apply shall be established and maintained in the same manner as is provided by section 585 (or, for taxable years beginning before January 1, 1987, section 166(c)) and the regulations under section 166 with respect to reserves for bad debts. Except as provided by this section, no deduction is allowable for an addition to a reserve for losses on loans as defined in §1.585–2(e)(2) of a financial institution to which section 585 and this section apply. For rules relating to deduction with respect to debts which are not loans (as defined in §1.585–2(e)(2)), see section 166(a) and the regulations thereunder. For rules relating to a debt evidenced by a security (as defined in section 165(g)(2)(C), see sections 166 and 582(a) and the regulations thereunder. For the definition of certain terms, see paragraph (e) of §1.585–2. For rules relating to a transaction to which section 381(a) applies, see §1.585–4. For rules relating to large banks, see §§1.585–5 through 1.585–8.

(b) *Application of section*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, section 585 and this section apply to the following financial institutions—

(i) Any bank (as defined in section 581 and the regulations thereunder) other than a mutual savings bank, domestic building and loan association, or cooperative bank, to which section 593 applies; and

(ii) Any corporation to which paragraph (b)(1)(i) of this section would apply except for the fact that it is a foreign corporation and in the case of any such foreign corporation, the rules provided by section 585(a) and (b), this section, §§ 1.585–2, 1.585–3, and 1.585–4 apply only with respect to loans outstanding the interest on which is effectively connected with the conduct of a banking business within the United States.

(2) *Exception.* For taxable years beginning after December 31, 1986, section 585(a) and (b) and this section do not apply to any large bank (as defined in § 1.585–5(b)). For these years, a large bank may not deduct any amount under section 585 or any other section for an addition to a reserve for bad debts.

(Sec. 585(b)(4), of the Internal Revenue Code of 1954 (83 Stat. 618; (26 U.S.C. 585(b)(4))))

[T.D. 7532, 43 FR 3109, Jan. 23, 1978, as amended by T.D. 8513, 58 FR 68757, Dec. 29, 1993; 59 FR 15502, Apr. 1, 1994]

§ 1.585–2 Addition to reserve.

(a) *In general*—(1) *Maximum addition.* For taxable years beginning before January 1, 1988, the maximum reasonable addition to the reserve for losses on loans as defined in paragraph (e)(2) of this section is the amount allowable under the percentage method provided by paragraph (b) of this section or the experience method provided by paragraph (c) of this section, whichever is greater. For taxable years beginning after December 31, 1987, the maximum reasonable addition to the reserve for losses on loans is the amount determined under the experience method provided by paragraph (c) of this section.

(2) *Minimum addition.* For taxable years beginning after December 31, 1976, and before January 1, 1988, a taxpayer to which this section applies shall make a minimum addition to the reserve for losses on loans as defined in paragraph (e)(2) of this section. For purposes of this subparagraph, the term *minimum addition* means an addition to the reserve for losses on loans in an amount equal to the lesser of (i) the amount allowable under section 585 (b)(3)(A) and paragraph (c)(1)(ii) of this section, or (ii) the maximum amount allowable under section 585 (b)(2) and paragraph (b) of this section. For taxable years beginning after December 31, 1987, a taxpayer to which this section applies shall make a minimum addition to the reserve for losses on loans for each taxable year in an amount equal to the amount allowable under section 585 (b)(3)(A) and paragraph (c)(1)(ii) of this section.

(b) *Percentage method*—(1) *In general*—(i) *Maximum addition.* Except as limited under subparagraph (2) of this paragraph, the maximum reasonable addition to the reserve for losses on loans under the percentage method for a taxable year is the amount determined under paragraph (b)(1) (ii), (iii), or (iv) of this section, whichever is applicable. For purposes of this paragraph, the term *allowable percentage* means 1.8 percent for taxable years beginning before 1976; 1.2 percent for taxable years beginning after 1975 but before 1982; 1.0 percent for taxable years beginning in 1982; and 0.6 percent for taxable years beginning after 1982 and before 1988. This paragraph does not apply for taxable years beginning after 1987.

(ii) *Reserve less than allowable percentage of eligible loans.* (A) If the reserve for losses on loans as of the close of the base year is less than the allowable percentage for the taxable year multiplied by the eligible loans outstanding at the close of the base year, the amount determined under this subdivision for the taxable year is the amount necessary to increase the balance of the reserve for losses on loans as of the close of the taxable year to an amount equal to the allowable percentage for the taxable year multiplied by the eligible loans outstanding at the close of that year, except that the amount determined with respect to the reserve deficiency shall not exceed one-fifth of the reserve deficiency. For purposes of this section, the term *reserve deficiency* means the excess of the allowable percentage for the taxable year multiplied by the eligible loans outstanding at the close of the base year over the reserve for losses on loans as of the close of the base year. Where a taxpayer has recoveries of bad debts for a taxable year which exceed the bad debts sustained for such year, the taxpayer is not required to reduce its otherwise permissible current addition by the amount of the net recovery. A reasonable addition attributable to an increase in eligible loans outstanding at the close of the taxable year over eligible loans outstanding at the close of the base year may be made only for the portion of such increase which does not exceed the excess of eligible loans outstanding at the close of the taxable year over the sum of the amount of eligible loans outstanding at the close of the base year and the amount of previous increases in such loans for which an addition was made in taxable years ending after the close of the base year. For purposes of this subdivision, the order in which the factors which make up the annual reserve addition shall be claimed is:

(*1*) An amount equal to one-fifth of the reserve deficiency;

(*2*) Net bad debts charged to the reserve; and

(*3*) An amount attributable to an increase in the amount of eligible loans outstanding.

(B) For its first taxable year, a newly organized financial institution to which §1.585–1 and this section apply shall be considered to have no reserve deficiency. For example, a new financial institution would compute its annual reserve addition by including in such addition an amount not in excess of the sum of (*1*) the amount of its net bad debts charged to the reserve for the taxable year, and (*2*) the allowable percentage of the increase in its eligible loans outstanding at the close of the taxable year over the amount of its loans outstanding (zero) at the end of the year preceding its first taxable year. Such amount would be subject to the 0.6 percent limitations provided in subparagraph (2) of the paragraph.

(C) The application of the rules provided by this subdivision may be illustrated by the following example:

Example. The X Bank is a commercial bank which has a calendar year as its taxable year. X adopted the reserve method of accounting for bad debts in 1950. On December 31, 1969, X has $1,000,000 of outstanding eligible loans and a balance of $13,000 in its reserve for losses on loans. The base year is 1969 and, consequently, X has a reserve deficiency of $5,000 ((1.8%×$1,000,000) − $13,000).

(a) During 1970, X has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1970, X has $1,050,000 of outstanding eligible loans. The maximum reasonable addition under the percentage method is $2,900 which consists of $1,000 of reserve deficiency (⅕×$5,000), the $1,000 in net bad debts charged to the reserve for losses on loans, and $900 attributable to the increase in the balance of eligible loans (1.8%×($1,050,000 − $1,000,000)). Assuming that X makes an addition to the reserve for losses on loans of $2,900 for the year, the balance of the reserve as of December 31, 1970 is $14,900 ($13,000 − $1,000 + $2,900).

(b) During 1971, X has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1971, X has $800,000 of outstanding eligible loans. The allowable percentage of eligible loans is $14,400 (1.8%×$800,000). The maximum reasonable addition under the percentage method is $500 which is a portion of one-fifth of the reserve deficiency. Assuming that X makes an addition to the reserve for losses on loans of $500 for the year, the balance of the reserve as of December 31, 1971, is $14,400 ($14,900 − $1,000 + $500).

(c) During 1972, X has net bad debts of $600 charged to the reserve for losses on loans. On December 31, 1972, X has $850,000 of outstanding eligible loans. The allowable percentage of eligible loans is $15,300 (1.8%×$850,000). The maximum reasonable addition under the percentage method is $1,500 which consists of $1,000 of reserve deficiency (⅕×$5,000) and $500 of the net bad debts charged to the reserve for losses on loans in 1971. Even though the full addition with respect to the reserve deficiency in 1971 was not made, the amount of the addition that can be made in 1972 with respect to the reserve deficiency is limited to one-fifth of such deficiency. Assuming that X makes an addition to the reserve for losses on loans of $1,500 for the year, the balance of the reserve as of December 31, 1972, is $15,300 ($14,400 − $600 + $1,500).

(d) During 1973, X did not have any net bad debts charged to the reserve for losses on loans. On December 31, 1973, X has $1,000,000 of outstanding eligible loans. The allowable percentage of eligible loans is $18,000 (1.8%×$1,000,000). The maximum reasonable addition under the percentage method is $2,100 which consists of $1,000 of reserve deficiency (⅕×$5,000), $500 of net bad debts charged to the reserve for losses in 1971, and $600 of net bad debts charged to the reserve in 1972. Although outstanding eligible loans increased from $850,000 in 1972 to $1,000,000 in 1973, no addition is permitted with respect to the increase because the amount of eligible loans outstanding at the close of 1973 ($1,000,000) does not exceed the sum of the amount of such loans at the close of the base year ($1,000,000) and the amount of previous increases in such loans for which an addition was made in taxable years ending after the close of the base year ($50,000 loan increase in 1970). Assuming that X makes an addition to the reserve for losses on loans of $2,100, the balance of the reserve as of December 31, 1973, is $17,400 ($15,300 + $2,100).

(iii) *Reserve equal to or greater than allowable percentage and eligible loans have not declined.* If the reserve for losses on loans as of the close of the base year is equal to or greater than the allowable percentage for the taxable year multiplied by the eligible loans outstanding at the close of the base year and if the amount of eligible loans outstanding at the close of the taxable year is equal to or greater than the amount of eligible loans outstanding at the close of the base year, the amount determined under this subdivision is the amount necessary to increase the reserve to the greater of (A) the allowable percentage for the taxable year multiplied by the eligible loans outstanding at the close of the year, or (B) the balance of the reserve as of the close of the base year. The application of the rule provided by this subdivision may be illustrated by the following example:

Example. The M Bank is a commercial bank which has a calendar year as its taxable year. M adopted the reserve method of accounting for bad debts in 1950. On December 31, 1969, M has $1,000,000 of outstanding eligible loans and a balance of $20,000 in its reserve for losses on loans.

(a) During 1970, M has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1970, M has $1,100,000 of outstanding eligible loans. The allowable percentage of eligible loans is $19,800 (1.8%×$1,100,000). The maximum reasonable addition under the percentage method is $1,000 which is the amount sufficient to increase the balance of the reserve as of the close of the taxable year to the balance of the reserve as of the close of the 1969 base year ($20,000). Assuming that M makes an addition to the reserve for losses on loans of $1,000 for the year, the balance of the reserve as of December 31, 1970, is $20,000 ($20,000 − $1,000 + $1,000).

(b) During 1971, M has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1971, M has $1,300,000 of outstanding eligible loans. The allowable percentage of eligible loans is $23,400 (1.8%×$1,300,000). The maximum reasonable addition under the percentage method is $4,400 which is the amount sufficient to increase the balance of the reserve to the allowable percentage of eligible loans outstanding at the close of the taxable year. Assuming that M makes an addition to the reserve for losses on loans of $4,400 for the year, the balance of the reserve as of December 31, 1971, is $23,400 ($20,000 − $1,000 + $4,400).

(c) During 1972, M has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1972, M has $1,200,000 of outstanding eligible loans. The allowable percentage of eligible loans is $21,600 (1.8%×$1,200,000). No reasonable addition may be made under the percentage method because the reserve for losses on loans ($22,400, i.e., $23,400 − $1,000) is greater than the allowable percentage of eligible loans outstanding at the close of the taxable year ($21,600) and the balance of the reserve as of the close of the base year ($20,000). Assuming that no amount is added under the experience method provided by paragraph (c) of this section, the balance of the reserve for losses on loans as of December 31, 1972, is $22,400 ($23,400 − $1,000).

(d) During 1973, M has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1973, M has $1,200,000 of outstanding eligible loans. The allowable percentage of eligible loans is $21,600 (1.8%×$1,200,000). The maximum reasonable addition under the percentage method is $200 which is the amount sufficient to increase the reserve for losses on loans to the allowable percentage of eligible loans outstanding at the close of the taxable year. Assuming that M makes an addition to the reserve for losses on loans of $200 for the year, the balance of the reserve as of December 31, 1973, is $21,600 ($22,400 − $1,000+$200).

(iv) *Reserve greater than allowable percentage and eligible loans have declined.* If the reserve for losses on loans as of the close of the base year is equal to or greater than the allowable percentage of eligible loans outstanding at such time and if the amount of eligible loans at the close of the taxable year is less than the amount of eligible loans outstanding at the close of the base year, the amount determined under this subdivision is the amount necessary to increase the balance of the reserve to the amount which bears the same ratio to eligible loans outstanding at the close of the taxable year as the balance of the reserve as of the close of the base year bears to the amount of eligible loans outstanding at the close of the base year. The application of the rule provided by this subdivision may be illustrated by the following example:

Example. The N Bank is a commercial bank which has a calendar year as its taxable year. N adopted the reserve method of accounting for bad debts in 1950. On December

31, 1969, N has $1,000,000 of outstanding eligible loans and a balance of $20,000 in its reserve for losses on loans.

(a) During 1970, N has net bad debts of $3,000 charged to the reserve for losses on loans. On December 31, 1970, N has $900,000 of outstanding eligible loans. The maximum reasonable addition under the percentage method is $1,000, which is the amount necessary to increase the balance of the reserve to the amount ($18,000) which bears the same ratio to eligible loans outstanding at the close of the taxable year ($900,000) as the balance of the reserve as of the close of the base year ($20,000) bears to the amount of the eligible loans outstanding at the close of the base year ($1,000,000). Assuming that N makes an addition to the reserve for losses on loans of $1,000 for the year, the balance of the reserve as of December 31, 1970, is $18,000 ($20,000 − $3,000+$1,000).

(b) During 1971, N has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1971, N has $1,100,000 of outstanding eligible loans. The maximum reasonable addition under the percentage method, determined under subdivision (iii) of this subparagraph, is $3,000 which is the amount necessary to increase the balance of the reserve to the greater of the allowable percentage of eligible loans outstanding at the close of the taxable year ($19,800) or the balance of the reserve at the close of the base year ($20,000). Assuming that N makes an addition to the reserve for losses on loans of $3,000 for the year, the balance of the reserve as of December 31, 1971 is $20,000 ($18,000 − $1,000+$3,000).

(2) *Limitations.* Notwithstanding any other provision of this paragraph, the maximum reasonable addition to the reserve for losses on loans under the percentage method shall not exceed the greater of:

(i) Six-tenths of 1 percent of the eligible loans outstanding at the close of the taxable year, or

(ii) An amount sufficient to increase the reserve for losses on loans at the close of the taxable year to six-tenths of 1 percent of the eligible loans outstanding at the close of the taxable year.

The application of the rules provided by this subparagraph may be illustrated by the following example:

Example. The Y Bank begins business as a commercial bank on July 1, 1974. Y adopts the calendar year as its taxable year and the reserve method of accounting for bad debts.

(a) During 1974, Y has net bad debts of $1,000. On December 31, 1974, Y has $1,000,000 of outstanding eligible loans. Under subparagraph (1)(ii)(B) of this paragraph, because Y is a newly-organized financial institution, there is no reserve deficiency. Except for the limitations of this subparagraph, the maximum reasonable addition under subparagraph (1)(ii)(A) of this paragraph would be the amount of net bad debts charged to the reserve for losses ($1,000) plus the allowable percentage of outstanding eligible loans at the close of the taxable year $18,000 (1.8%×$1,000,000). However, because of the limitations of this subparagraph, the maximum reasonable addition to the reserve for losses on loans under the percentage method is an amount sufficient to increase the balance of the reserve for losses on loans to $6,000 which is 0.6 percent of the eligible loans outstanding at the close of the taxable year. Assuming that Y makes an addition to the reserve for losses on loans of $7,000 for the year, the balance of the reserve as of December 31, 1974, is $6,000 ($7,000 − $1,000). The $7,000 consists of the $1,000 in net bad debts and $6,000 attributable to the increase in eligible loans outstanding.

(b) During 1975, Y has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1975, Y has $1,000,000 of outstanding eligible loans. Except for the limitations of this subparagraph, the maximum reasonable addition under subparagraph (1)(ii)(A) of this paragraph would be the amount of net bad debts charged to the reserve for losses ($1,000) plus an amount attributable to the increase in the amount of eligible loans outstanding with respect to which no reasonable addition was allowed in 1974 ($12,000, *i.e.*, $18,000 − $6,000). However, because of the limitations of this paragraph, the maximum reasonable addition to the reserve for losses on loans under the percentage method is $6,000 which is an amount equal to 0.6 percent of the eligible loans outstanding at the close of the taxable year. This amount consists of net bad debts of $1,000 and $5,000 attributable to a portion of the increase in eligible loans in 1974 with respect to which no reasonable addition was allowable for 1974. Assuming that Y makes an addition to the reserve for losses on loans of $6,000 for the year, the balance of the reserve as of December 31, 1975, is $11,000 ($6,000 − $1,000 + $6,000).

(c) During 1976, Y has net bad debts charged to the reserve for losses on loans of $1,000. On December 31, 1976, Y has $1,000,000 in outstanding eligible loans. At the close of 1975 (Y’s base year for 1976), the amount of outstanding eligible loans was also $1,000,000. Consequently, there is a reserve deficiency of $1,000 ((1.2%×$1,000,000)—$11,000). The maximum reasonable addition to the reserve for losses under subparagraph (1)(ii)(A) of this paragraph is $1,200 which consists of one-fifth of the reserve deficiency ($1,000×⅕=$200) and the net bad debts charged to the reserve for losses on loans for the year ($1,000). Because that amount is less than 0.6 percent of the eligible loans outstanding at the close of the taxable year (0.6%×$1,000,000=$6,000), the limitations of this subparagraph do not apply. Assuming that Y makes an addition to the reserve for losses on loans of $1,200 for the year, the balance of the reserve as of December 31, 1976, is $11,200 ($11,000 − $1,000 + $1,200).

(c) *Experience method*—(1) *In general*—(i) *Maximum addition.* The amount determined under this paragraph for a taxable year is the amount necessary to increase the balance of the reserve for losses on loans (as of the close of the taxable year) to the greater of the amount determined under subdivision (ii) or (iii) of this subparagraph. For special rules for a new financial institution, see subparagraph (2) of this paragraph.

(ii) *Six-year moving average amount.* The amount determined under this subdivision is the amount which bears the same ratio to loans outstanding at the close of the taxable year as (A) the total bad debts sustained during the taxable year and the 5 preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period, bears to (B) the sum of the loans outstanding at the close of such 6 (or fewer) taxable years. For purposes of applying this subdivision, a period shorter than 6 years generally would be appropriate only where there is a change in the type of a substantial portion of the loans outstanding such that the risk of loss is substantially increased. For example, if the major portion of a bank's portfolio of loans changes from agricultural loans to industrial loans which results in a substantial increase in the risk of loss, a period shorter than 6 years may be appropriate. Similarly, a bank which has recently altered its lending practices to include in its portfolio of loans consumer-installment loans, when it had previously made only commercial loans, may also qualify to use a period shorter than six years. A decline in the general economic conditions in the area, which substantially increase the risk of loss, is a relevant factor which may be considered. In any case, however, approval to use a shorter period will not be granted unless the taxpayer supplies specific evidence that the loans outstanding at the close of the taxable years for the shorter period requested are not comparable in nature and risk to loans outstanding at the close of the six taxable years. The fact that a bank's bad debt experience has shown a substantial increase is not, by itself, sufficient to justify use of a shorter period. If approval is granted to use a shorter period, the experience for those taxable years which are excluded shall not be used for any subsequent year. A request for approval to exclude the experience of a prior taxable year shall not be considered unless it is sent to the Commissioner at least 30 days before the close of the first taxable year for which such approval is requested.

(iii) *Base year amount.* The amount determined under this subdivision is the lower of (A) the balance of the reserve as of the close of the base year, or (B) if the amount of loans outstanding at the close of the taxable year is less than the amount of loans outstanding at the close of the base year, the amount which bears the same ratio to loans outstanding at the close of the taxable year as the balance of the reserve as of the close of the base year bears to the amount of loans outstanding at the close of the base year.

(2) *Special rules for new financial institutions*—(i) *In general.* In the case of any taxable year preceded by less than 5 authorization years (as defined in paragraph (e)(5) of this section), subparagraph (1) of this paragraph shall be applied with the adjustments provided by subdivision (ii) of this subparagraph.

(ii) *Adjustments.* (A) The total bad debts for the 6-year period computed under subparagraph (1)(ii)(A) of this paragraph shall be the sum of:

(*1*) The bad debts sustained by the taxpayer during its authorization years, adjusted for recoveries of bad debts for such years, and

(*2*) That fraction of the total bad debts sustained by a comparable bank (as defined in paragraph (e)(7) of this section) during the comparison years (as defined in paragraph (e)(6) of this section), adjusted for recoveries of bad debts for such years, which bears the same ratio to such total as the average loans outstanding of the taxpayer during the authorization years bears to the average loans outstanding of the comparable bank during the comparison years.

(B) The total amount of loans outstanding during the 6-year period computed under subparagraph (1)(ii)(B) of this paragraph shall be six times the average loans outstanding of the taxpayer during the authorization years.

(d) *Change in accounting method from specific charge-off method to reserve method of treating bad debts*—(1) *In general.* If a bank is granted permission in accordance with §1.446–1(e)(3) to change its method of accounting for bad debts from a method under which specific bad debt items are deducted to the reserve method of treating bad debts, the taxpayer shall effect the change as provided in subparagraphs (2) and (3) of this paragraph.

(2) *Initial balance of the reserve.* The initial balance of the reserve at the close of the year of change shall be no less than the minimum addition as described in paragraph (a)(2) of this section and shall be no larger than the greater of:

(i) The allowable percentage of eligible loans outstanding at the close of the taxable year of change, or

(ii) The amount which bears the same ratio to loans outstanding at the close of the taxable year as the total bad debts sustained during the taxable year and the 5 preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period, bears to the sum of the loans outstanding at the close of such 6 or fewer taxable years.

In the case of taxable years beginning after 1987, the initial balance of the reserve at the end of the year of change shall be the amount specified in subdivision (ii) of this subparagraph.

(3) *Deduction with respect to initial balance.* The deduction with respect to the initial balance of the reserve at the close of the taxable year of change, determined under subparagraph (2) of this paragraph, is allowable ratably over a period of 10 years commencing with the taxable year of change (or a shorter period as may be approved by the Commissioner). Thus, the bad debt deduction under section 166 for the taxable year of change will consist of the amount of debts determined to be wholly or partially worthless and charged-off during such taxable year plus one-tenth (if a 10-year period is used) of the amount of the reserve determined under subparagraph (2) of this paragraph. For each of the 9 taxable years following the taxable year of change, the bad debt deduction will consist of the reasonable addition to the reserve for bad debts for each such year as provided by section 585, as otherwise determined, plus one-tenth of the amount determined to be the initial balance of the reserve under subparagraph (2) of this paragraph. The amount established as a bad debt reserve for the taxable year of change under subparagraph (2) of this paragraph shall be considered as the balance of the reserve for purposes of determining the amount of subsequent additions to such reserve, even though the entire amount of the reserve may not have been deducted under section 585(a)(1) or former section 166(c) because of the requirement that it be deducted over a number of years.

(e) *Definitions*—(1) *Base year*—(i) *Percentage method.* For purposes of paragraph (b) of this section (relating to the percentage method), the term *base year* means: For years beginning before 1976, the last taxable year beginning on or before July 11, 1969; for taxable years beginning after 1975 but before 1983, the last taxable year beginning before 1976; and, for taxable years beginning after 1982, the last taxable year beginning before 1983. However, for purposes of section 585(b)(2)(A) the term *base year* means the last taxable year before the most recent adoption of the percentage method, if later than the base year as determined under the preceding sentence.

(ii) *Experience method.* For purposes of paragraph (c) of this section (relating to the experience method), the term *base year* means (A) the last taxable year before the most recent adoption of the experience method, or (B) the last taxable year beginning on or before July 11, 1969, which ever is later; and for taxable years beginning after 1987, the last taxable year beginning before 1988.

(iii) *Example.* The application of the rules provided by this subparagraph may be illustrated by the following example:

Example. The T Bank is a commercial bank which has a calendar year as its taxable year. T adopted the reserve method of accounting for bad debts in 1950. On December 31, 1969, T has $1,000,000 of outstanding eligible loans and a balance of $19,300 in its reserve for losses on loans.

(a) During 1970, T has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1970, T has $1,050,000 of outstanding eligible loans. T elects the percentage method. The base year is 1969. The maximum reasonable addition under the percentage method of $1,000 which is the amount sufficient to increase the balance of the reserve as of the close of the taxable year to the balance of the reserve as of the close of the base year 1969 ($19.300). Assuming that T makes an addition to the reserve for losses on loans of $1,000 for the year, the balance of the reserve for losses on loans as of December 31, 1970, is $19,300 ($19,300 − $1,000+$1,000).

(b) During 1971, T has net bad debts of $8,000 charged to the reserve for losses on loans. On December 31, 1971, T has $1,100,000 of outstanding eligible loans. T elects the experience method. The base year is 1970. The maximum reasonable addition under the experience method is $8,000 which is the amount sufficient to increase the balance of the reserve as of the close of the taxable year to the balance of the reserve as of the close of the 1970 base year ($19,300). Assuming that T makes an addition to the reserve for losses on loans of $8,000 for the year, the balance of the reserve for losses on loans as of December 31, 1971, is $19,300, ($19,300 − $8,000+$8,000).

(c) During 1972, T has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1972, T has $1,200,000 of outstanding eligible loans. T elects the percentage method. The base year is 1971 and there is a reserve deficiency of $500 ((1.8%×$1,100,000) − $19,300). The maximum reasonable addition under the percentage method is $2,900 which consists of $100 of reserve deficiency (⅕×$500), the $1,000 in net bad debts charged to the reserve for losses on loans, and $1,800 attributable to the increase in the balance of eligible loans (1.8%×($1,200,000 − $1,100,000)). Assuming that T makes an addition to the reserve for losses on loans of $2,900 for the year, the balance of the reserve for losses on loans as of December 31, 1972, is $21,200 ($19,300 − $1,000+$2,900).

(2) *Loan*—(i) *General rule.* For purposes of this section and §§ 1.585–1, 1.585–3, and 1.585–4, the term *loan* means debt as the term *debt* is used in section 166 and the regulations thereunder. The term *loan* includes (but is not limited to) the following items:

(A) An overdraft in one or more deposit accounts by a customer in good faith whether or not other deposit accounts of the same customer have balances in excess of the overdraft;

(B) A bankers acceptance purchased or discounted by a bank; and

(C) A loan participation to the extent that the taxpayer bears a risk of loss.

For purposes of (B) of this subdivision (i), a bankers acceptance shall be considered as a loan made by the bank which purchased or discounted the bankers acceptance and not a loan made by the originating bank.

(ii) *Exceptions.* Notwithstanding the provisions of subdivision (i) of this subparagraph, the term *loan* does not include the following items:

(A) Discount or interest receivable reflected in the face amount of an outstanding loan, which discount or interest has not been included in gross income;

(B) For taxable years beginning after December 31, 1976, commercial paper, however acquired by the bank, including, for example, short-term promissory notes which may be purchased on the open market;

(C) For taxable years beginning after December 31, 1976, a debt evidenced by a security (as defined in section 165(g)(2)(C) and the regulations thereunder);

(D) Any loan which is entered into or acquired for the primary purpose of enlarging the otherwise available bad debt deduction;

(E) Loans which have been contractually committed to the extent that funds have not been disbursed to the borrower or disbursed on behalf of the borrower; and

(F) Any transaction which is in violation of a Federal or State statute that governs the activities of the financial institution.

(3) *Eligible loan*—(i) *General rule.* For purposes of this section and §§ 1.585–3 and 1.585–4, the term *eligible loan* means a loan (as defined in subparagraph (2) of this paragraph) which is incurred in the course of the normal customer loan activities of a financial institution and

which is not a loan described in subdivision (ii) of this subparagraph. Nothing within the preceding sentence will be construed to exclude from the term *eligible loan* a bona fide loan in a new market or under a novel repayment arrangement if the likelihood of nonrepayment is at least as great as that of other customer loans of the financial institution.

(ii) *Exceptions.* Loans which do not constitute eligible loans include:

(A) A loan to a bank (as defined in section 581 and the regulations thereunder) or to a domestic branch of a foreign corporation to which §1.585–1 applies, including a repurchase transaction or other similar transaction;

(B) Bank funds on deposit in any bank (foreign or domestic) such as a deposit represented by a certificate of deposit or any other form of instrument evidencing the deposit of a sum of money with the issuing bank that will be available on or after a stated date or period of time;

(C) A sale or loan of Federal funds irrespective of the purchaser or borrower;

(D) A loan, to the extent that it is directly or indirectly made to, guaranteed by, or insured by the United States, a possession or instrumentality thereof, or a State or political subdivision thereof; and

(E) A loan which is secured by a deposit in the lending financial institution or in a bank as defined in section 581 or a domestic branch of a foreign corporation to which this section applies to the extent that the financial institution has control over withdrawal of such deposit.

(iii) *Definition of loan which is secured by a deposit.* For purposes of subdivision (ii)(E) of this subparagraph:

(A) A loan is considered secured if the loan is on the security of any instrument which makes the deposit specific security for the payment of the loan, provided that such instrument is of such a nature that in the event of default the deposit could be subjected to the satisfaction of the loan;

(B) A deposit includes a guarantee deposit in the form of a *holdback,* pledged collateral that has been reduced to cash, and loan payments that are maintained in a separate account; and

(C) Control over the withdrawal of a deposit is evidenced by possession of a passbook, certificate of deposit, note, or other similar instrument the possession of which is normally required to permit withdrawal. The lending financial institution does not have control over withdrawal of the deposit if the deposit can be withdrawn without consent of the lending financial institution. Thus, the lending financial institution normally does not have control over the withdrawal of a deposit in an account merely because the borrower agrees to maintain a minimum, average, or compensating balance.

(4) *Predecessor.* For purposes of this section, the term *predecessor* means (i) any taxpayer which transferred more than 50 percent of the total amount of its assets to the taxpayer and is described in §1.585–1, or (ii) any predecessor of such predecessor.

(5) *Authorization years.* For purposes of this section, the term *authorization years* means the number of years, containing 12 complete months, between (i) the first day of the first full taxable year of the taxpayer for which it (or any predecessor) was authorized to do business as a financial institution described in §1.585–1, and (ii) the taxable year.

(6) *Comparison years.* For purposes of this section, the term *comparison years* means those consecutive taxable years containing 12 complete months of a comparable bank, the last of which ends within 12 months immediately preceding the beginning of the first taxable year of the taxpayer, which are equal in number to six minus the number of authorization years of the taxpayer.

(7) *Comparable bank.* For purposes of this section, the term *comparable bank* means all the financial institutions described in §1.585–1 located within the same Federal Reserve district.

(8) *Average loans outstanding.* For purposes of this section, the term *average loans outstanding* means the sum of the loans outstanding at the close of each taxable year of a period divided by the number of taxable years in such period.

(9) *Adjusted for recoveries of bad debts.* For purposes of this section, the term

adjusted for recoveries of bad debts means an adjustment for the full amount recovered with respect to bad debts previously charged to the reserve during any of the applicable taxable years.

(Sec. 585(b)(4), of the Internal Revenue Code of 1954 (83 Stat. 618; (26 U.S.C. 585(b)(4))))

[T.D. 7532, 43 FR 3109, Jan. 23, 1978, as amended by T.D. 7835, 47 FR 42342, Sept. 27, 1982; T.D. 8513, 58 FR 68757, Dec. 29, 1993]

§ 1.585–3 Special rules.

(a) *Treatment of reserve.* For taxable years beginning after July 11, 1969, if a financial institution to which section 585 and § 1.585–1 apply establishes a reserve pursuant to section 585(a) (or, for taxable years beginning before January 1, 1987, section 166(c)), any bad debt in respect of a loan (whether or not such loan is an eligible loan) must be charged to the reserve for losses on loans provided for by § 1.585–1 for the taxable year in which the bad debt occurs. For such a year, any recovery of a bad debt previously charged to the reserve account in respect of a loan (whether or not such loan is an eligible loan) must be credited to such reserve in the taxable year of recovery regardless of whether such credit causes the reserve to exceed the permissible amount. If, as a result of net recoveries during the taxable year, the reserve balance exceeds the permissible amount, a taxpayer is not required to report the excess as taxable income. In such a case, the excess over the otherwise permissible amount in the reserve account precludes current reasonable additions to the reserve and may affect future reasonable additions. Recoveries of bad debts which were not charged to the reserve shall not be credited to such reserve, but shall be treated as taxable income subject to the provisions of section 111. No item other than a loan as defined in § 1.585–2 (e)(2) shall be charged to the reserve for losses on loans.

(b) *Accounting for reserve.* A financial institution to which section 585 and § 1.585–1 apply which establishes a reserve pursuant to section 585(a) (or, for taxable years beginning before January 1, 1987, section 166(c)) shall establish and maintain a permanent record of such reserve. Copies of Federal income tax returns and amended returns with attached schedules satisfy the requirements of this paragraph provided that such returns are permanently maintained by the financial institution and the balance of the reserve for losses on loans established pursuant to section 585(a) (or former section 166(c)) can be readily reconciled with the reserve for losses on loans maintained by the financial institution for financial statement purposes. The requirements of this paragraph would also be satisfied if a financial institution establishes and maintains a permanent subsidiary ledger reflecting an account for the reserve for losses on loans established pursuant to section 585(a) (or former section 166(c)) provided the balance in such account can be readily reconciled with the balance of the reserve for losses on loans for financial statement purposes maintained in any other ledger. The permanent records maintained pursuant to this section must reflect any changes in the amount initially added to the reserve for losses on loans and the amount finally determined by the taxpayer to be a reasonable addition to the reserve for losses on loans.

(Sec. 585(b)(4), of the Internal Revenue Code of 1954 (83 Stat. 618; (26 U.S.C. 585(b)(4))))

[T.D. 7532, 43 FR 3114, Jan. 23, 1978, as amended by T.D. 8513, 58 FR 68757, Dec. 29, 1993]

§ 1.585–4 Reorganizations and asset acquisitions.

(a) *In general.* In computing a reasonable addition to the reserve for losses on loans for the first taxable year ending after a transaction to which section 381(a) applies and for subsequent taxable years, the separate reserves for losses on loans, the amount of loans outstanding, the total bad debts sustained (adjusted for recoveries), and the amount of eligible loans outstanding of the distributor or transferor corporation and the acquiring corporation (or, in the case of a consolidation, the transferor corporations) shall be combined for all applicable years. Thus, for example, in applying § 1.585–2(c)(1)(i) for the first taxable year ending after the distribution or transfer, the total bad debts sustained during the 5 preceding taxable years are the sum of the bad debts sustained by the acquiring corporation for the 5 preceding taxable years and bad debts sustained by the distributor or transferor corporation for the taxable year ending on the date of distribution or transfer and the 4 preceding taxable years.

(b) *Base year and base year amounts of acquiring corporation*—(1) *Base year.* For transactions to which section 381(a) applies, the base year of the acquiring corporation for the first taxable year ending after the date of distribution or transfer shall be the last taxable year ending on or before the date of distribution or transfer. The balance of the reserve, the amount of loans outstanding, and the amount of eligible loans outstanding at the close of such base year shall be determined in accordance with the provisions of subparagraph (2)(i) of this paragraph. For taxable years subsequent to the first taxable year ending after the date of distribution or transfer, the base year of the acquiring corporation shall be the more recent of the base year provided by the first sentence of this subparagraph or the base year provided by §1.585–2(e)(1). If §1.585–2(e)(1) provides the more recent base year, the balance of the reserve for losses on loans, the amount of loans outstanding, and the amount of eligible loans outstanding shall be determined at the close of such base year without regard to this paragraph.

(2) *Base year amounts*—(i) *Method of determination.* The balance of the reserve for losses on loans, the amount of loans outstanding, and the amount of eligible loans outstanding at the close of the base year provided by the first sentence of subparagraph (1) of this paragraph shall be the total of such amounts of the distributor or transferor corporation and the acquiring corporation (or, in the case of a consolidation, the transferor corporations) at the close of what would have been their respective base years determined under §1.585–2(e)(1) if the distribution or transfer to which section 381(a) applies had not occurred, except that the method (experience or percentage) used or adopted by the acquiring corporation to determine its reasonable addition to a reserve for losses on loans for the first taxable year ending after the date of the distribution or transfer shall be considered to be the method that the distributor or transferor corporation (or, in the case of a consolidation, that the transferor corporation) would have used or adopted for its first taxable year ending after the date of distribution or transfer if the distribution or transfer had not occurred.

(ii) *Examples.* The application of the rule provided by this subparagraph may be illustrated by the following examples:

Example 1. The X Corporation and the Y Corporation are commercial banks both of which have a calendar year as a taxable year. Both X and Y adopted the reserve method of accounting for bad debts prior to July 11, 1969. For the taxable year 1970 through 1973, X and Y determined their reasonable additions to a reserve for losses on loans as defined in §1.585–2(e)(2) under the percentage method. On June 30, 1974, the X Bank is merged into the Y Bank; for its short taxable year ending on June 30, 1974, X determines its reasonable addition under the percentage method. If, for the taxable year ending on December 31, 1974 (the first taxable year ending after the date of distribution or transfer), Y determines its reasonable addition to a reserve for losses on loans under the percentage method, then at the close of the base year the reserve balance, the amount of outstanding loans, and the amount of eligible loans outstanding are the sum of X's and Y's respective amounts at the close of the taxable year ending December 31, 1969 (the base year of both X and Y determined under §1.585–2(e)(1) as if the distribution or transfer had not taken place). If, instead of the above, Y adopts the experience method of determining its reasonable addition to a reserve for losses for the taxable year 1974, than at the close of the base year (1973) the reserve balances, the amount of loans outstanding, and the amount of eligible loans outstanding are the sum of X's respective amounts at the close of its short taxable year ending on June 30, 1974 (X's last taxable year before its (Y's) most recent adoption of the experience method) and of Y's respective amounts at the close of its taxable year 1973 (Y's last taxable year before its most recent adoption of the experience method).

Example 2. The M Corporation and the N Corporation are commercial banks. M has a fiscal year ending September 30, as its taxable year and N has a calendar year as its taxable year. Both M and N adopted the reserve method of accounting for bad debts prior to July 11, 1969. For the taxable years ending in 1970, 1971, and 1972, M determined its reasonable addition to a reserve for losses under the percentage method; for the taxable year ending in 1973 M adopted the experience method. For the taxable years 1970 through 1973 N determined its reasonable addition under the percentage method. M is merged into N on June 30, 1974, and for its short taxable year ending on June 30, 1974, M determines its reasonable addition under the experience method. If, for the taxable year ending on December 31, 1974 (the first taxable year ending after the date of distribution or transfer), N determines its reasonable addition to a reserve for losses under the percentage method, then at the close of the base year (1973) the reserve balance, the amount of loans outstanding, and the amount of eligible loans outstanding are the sum of M's respective amounts at the close of (a) if M had a reserve deficiency as of June 30, 1974, its short taxable year ending on June 30, 1974 (M's last taxable year before its (N's) most recent adoption of the percentage method), or (b) if M did not have a reserve deficiency, the taxable year ending on September 30, 1969, and N's respective amounts at the close of its taxable year 1979. If, instead of the above, N adopts the experience method for the taxable year 1974, then at the close of the base year the reserve balance, the amount of outstanding loans, and the amount of eligible loans outstanding are the sum of M's respective amounts at the close of its taxable year ending on September 30, 1972 (the last taxable year before M's most recent adoption of the experience method), and N's respective amounts at the close of the taxable year 1973 (the last taxable year ending before N's most recent adoption of the experience method).

(Sec. 585(b)(4), of the Internal Revenue Code of 1954 (83 Stat. 618; (26 U.S.C. 585(b)(4))))

[T.D. 7532, 43 FR 3114, Jan. 23, 1978]

§ 1.585–5 Denial of bad debt reserves for large banks.

(a) *General rule.* For taxable years beginning after December 31, 1986, a large bank (as defined in paragraph (b) of this section) may not deduct any amount under section 585 or any other section for an addition to a reserve for bad debts. However, for these years, except as provided in § 1.585–7, a large bank may deduct amounts allowed under section 166(a) for specific debts that become worthless in whole or in part. Any large bank that maintained a reserve for bad debts under section 585 for the taxable year immediately preceding its disqualification year (as defined in paragraph (d)(1) of this section) must follow the rules prescribed by § 1.585–6 or § 1.585–7 for changing from the reserve method of accounting for bad debts that is allowed by section 585, to the specific charge-off method of accounting for bad debts, in its disqualification year. However, except as may be provided otherwise in regulations prescribed under section 593, the rules prescribed by §§ 1.585–6 and 1.585–7 do not apply to a large bank that maintained a reserve for bad debts under section 593 for the taxable year immediately preceding its disqualification year.

(b) *Large bank*—(1) *General definition.* For purposes of this section, a large bank is any institution described in § 1.585–1(b)(1) (i) or (ii) if, for the taxable year (or for any preceding taxable year beginning after December 31, 1986)—

(i) The average total assets of the institution (determined under paragraph (c) of this section) exceed $500,000,000; or

(ii) The institution is a member of a parent-subsidiary controlled group (as defined in paragraph (d)(2) of this section) and the average total assets of the group exceed $500,000,000.

(2) *Large bank resulting from transfer by large bank*—(i) *In general.* If a corporation acquires the assets of a large bank (as defined in this paragraph (b)) in an acquisition to which paragraph (b)(2) (ii), (iii) or (iv) of this section applies, the acquiring corporation (the acquiror) is treated as a large bank for any taxable year ending after the date of the acquisition in which it is an institution described in § 1.585–1(b)(1) (i) or (ii).

(ii) *Transfer of significant portion of assets where control is retained.* This paragraph (b)(2)(ii) applies to any direct or indirect acquisition of a significant portion of a large bank's assets if, after the acquisition, the transferor large bank owns more than 50 percent (by vote or value) of the outstanding stock of the acquiror. For this purpose, stock of an acquiror is considered owned by a transferor bank if the stock is owned by any member of a parent-subsidiary controlled group (as defined in paragraph (d)(2) of this section) of which the bank is a member, by any related party within the meaning of section 267(b) or 707(b), or by any person that received the stock in a transaction to which section 355 applies.

(iii) *Transfer to which section 381 applies.* This paragraph (b)(2)(iii) applies to any acquisition to which section 381(a) applies if, immediately after the acquisition, the acquiror's principal method of accounting for bad debts (determined under §1.381(c)(4)–1(c)(2)) with respect to its banking business is the specific charge-off method. In applying §1.381(c)(4)–1(c)(2) for this purpose, the following rules apply: A transferor large bank is considered to use the specific charge-off method for all of its loans immediately before the acquisition; an acquiror is considered to use a reserve method for all of its loans immediately before the acquisition; and all banking businesses of the acquiror immediately after the acquisition are treated as one integrated business. See §§1.585–6(c)(3) and 1.585–7(d)(2) for rules on the treatment of assets acquired from large banks in section 381(a) transactions.

(iv) *Transfer of substantially all assets to related party.* This paragraph (b)(2)(iv) applies to any direct or indirect acquisition of substantially all of a large bank's assets if the transferor large bank and the acquiror are related parties before or after the acquisition and a principal purpose of the acquisition is to avoid treating the acquired assets as those of a large bank. A transferor bank and an acquiror are considered to be related parties for this purpose if they are members of the same parent-subsidiary controlled group (as defined in paragraph (d)(2) of this section) or related parties within the meaning of section 267(b) or 707(b).

(3) *Examples.* The following examples illustrate the principles of this paragraph (b):

Example 1. Bank M, a calendar year taxpayer, is an institution described in §1.585–1(b)(1)(i). For its taxable year beginning on January 1, 1987, M has average total assets of $600 million. Since M's average total assets for 1987 exceed $500 million, M is a large bank for that year. Pursuant to §1.585–5(d)(1), 1987 is M's disqualification year. If M maintained a bad debt reserve under section 585 for its immediately preceding taxable year (1986), M must change in 1987 to the specific charge-off method of accounting for bad debts, in accordance with §1.585–6 or §1.585–7.

Example 2. Assume the same facts as in Example 1. Also assume that in 1988 M disposes of a portion of its assets and, as a result, M's average total assets for taxable year 1988 fall to $400 million. M remains a large bank for taxable year 1988 and succeeding taxable years, since its average total assets for a preceding taxable year (1987) beginning after December 31, 1986, exceeded $500 million.

Example 3. Bank P, a calendar year taxpayer, is an institution described in §1.585–1(b)(1)(i). P has average total assets of $300 million for its taxable year beginning on January 1, 1988. For the same year, P is a member of a parent-subsidiary controlled group (within the meaning of §1.585–5(d)(2)) that has average total assets of $800 million. In February 1989, the group sells its stock in P to several individual investors. P is a large bank for taxable year 1988 because it is a member of a group described in §1.585–5(b)(1)(ii) for that year. P also is a large bank for taxable year 1989 and succeeding taxable years because it was a member of a group described in §1.585–5(b)(1)(ii) for a preceding taxable year (1988) beginning after December 31, 1986.

Example 4. Assume the same facts as in Example 3, except that P's stock is purchased by a corporation that is not a large bank under §1.585–5(b). Also assume that the purchasing corporation elects under section 338 to treat the stock purchase as an asset acquisition. Under section 338, P is considered to have sold all of its assets on the purchase date and is treated as a new corporation that purchased these assets on the next day. Since P is treated as a new corporation, its prior membership in a group described in §1.585–5(b)(1)(ii) does not cause it to be treated as a large bank for taxable years ending after the date of its sale by the group. However, P may be treated as a large bank because of new membership in such a group or pursuant to §1.585–5(b)(1)(i) or (b)(2).

Example 5. Bank Q is a large bank, within the meaning of §1.585–5(b)(1), for its taxable year beginning on January 1, 1988, and hence for all later years. On March 1, 1989, Q transfers $200 million of its $600 million of assets to Bank R, a newly created subsidiary, in a transaction to which section 351 applies; these assets are R's only assets. On the same day, Q then spins off R in a transaction to which section 355 applies. After these transactions, the shareholders of Q own more than 50 percent of R's outstanding stock. Although R's average total assets do not exceed $500 million, R becomes a large bank on March 1, 1989, pursuant to §1.585–5(b)(2)(ii). These transactions do not affect Q's status as a large bank.

Example 6. Bank S is a large bank, within the meaning of §1.585–5(b)(1)(ii), for its taxable year beginning on January 1, 1987. As a result, S changes to the specific charge-off method of accounting for bad debts in that year. Bank T, which is not a large bank under §1.585–5(b), uses the reserve method of accounting for bad debts. On June 30, 1988, T acquires substantially all of S's assets in a transaction to which section 381(a) applies. Immediately before the acquisition, S's banking business has total assets of $200 million, and T's has total assets of $250 million. To determine whether T is a large bank under § 1.585–5(b)(2)(iii) for taxable years ending after the acquisition, it is necessary to determine T's principal method of accounting for bad debts with respect to its banking business immediately after the acquisition. This determination requires an application of § 1.381(c)(4)–1(c)(2). For this purpose, T's original and acquired banking businesses are treated as an integrated business. Applying § 1.381(c)(4)–1(c)(2), it is determined that the business's principal method of accounting for bad debts immediately after the acquisition is the reserve method. Hence, the acquisition does not cause T to become a large bank under § 1.585–5(b)(2)(iii).

(c) *Average total assets*—(1) *In general.* For purposes of paragraph (b)(1) of this section, and except as otherwise provided in paragraph (c)(3)(ii) of this section, the average total assets of an institution or group for any taxable year are determined by—

(i) Computing, for each report date (as defined in paragraph (c)(2) of this section) within the taxable year, the amount of total assets (as defined in paragraph (c)(3) of this section) held by the institution or group as of the close of business on the report date;

(ii) Adding these amounts; and

(iii) Dividing the sum of these amounts by the number of report dates within the taxable year.

(2) *Report date*—(i) *Institutions*—(A) *In general.* A report date for an institution generally is the last day of the regular period for which the institution must report to its primary Federal regulatory agency. However, an institution that is required to report to its primary Federal regulatory agency more frequently than quarterly may choose the last day of the calendar quarter as its report date, and an institution that is required to report to its primary Federal regulatory agency less frequently than quarterly must choose the last day of the calendar quarter as its report date. If an institution does not have a Federal regulatory agency, its primary State regulatory agency is considered its primary Federal regulatory agency for purposes of this paragraph (c)(2)(i)(A). In the case of a short taxable year that does not otherwise include a report date, the first or last day of the taxable year is the institution's report date for the year.

(B) *Alternative report date.* In lieu of the report date prescribed by paragraph (c)(2)(i)(A) of this section, for any taxable year an institution may choose as its report date the last day of any regular interval in the taxable year that is more frequent than quarterly (such as bi-monthly, monthly, weekly, or daily).

(ii) *Groups.* If all members of a parent-subsidiary controlled group have the same taxable year, a report date for the group is the report date, determined under paragraph (c)(2)(i) of this section, for any one member of the group that is an institution described in § 1.585–1(b)(1) (i) or (ii). The same report date must be used in applying paragraph (b)(1)(ii) of this section to all members of the group for a taxable year. If all members of a parent-subsidiary controlled group do not have the same taxable year, a report date for the group must be determined under similar principles.

(iii) *Member of group for only part of taxable year.* If an institution is a member of a parent-subsidiary controlled group for only part of a taxable year, paragraph (b)(1)(ii) of this section is applied to the institution for that year on the basis of the group's average total assets for the portion of the year that the institution is a member of the group. Thus, only the group's report dates (as determined under paragraph (c)(2)(ii) of this section) that are included in that portion of the year are taken into account in determining the group's average total assets for purposes of applying paragraph (b)(1)(ii) of this section to the institution. If no report date of the group is included in that portion of the year, the first or last day of that portion of the year must be treated as the group's report date for purposes of this paragraph (c)(2)(iii).

(3) *Total assets*—(i) *All corporations.* The amount of total assets held by an institution or group is the amount of cash, plus the sum of the adjusted bases of all other assets, held by the institution or group. For this purpose, the adjusted basis of an asset generally is its basis for Federal income tax purposes, determined under sections 1012,

1016 and other applicable sections of the Internal Revenue Code. In determining the amount of total assets held by a group, any asset of a member of the group that is an interest in another member of the group is not to be counted.

(ii) *Foreign corporations.* In determining the amount of total assets held by a foreign corporation, all of the corporation's assets are taken into account, including those that are not effectively connected with the conduct of a banking business within the United States. In the case of a foreign corporation that is not engaged in a trade or business in the United States, the adjusted basis of an asset must be determined substantially in accordance with United States tax principles as provided in regulations under section 964. In the case of a foreign corporation that is engaged in a trade or business in the United States, the amount of its average total assets for a taxable year (within the meaning of paragraph (c)(1) of this section) is the amount of the corporation's average worldwide assets used for purposes of computing the interest expense deduction allowable under section 882 and §1.882–5 for the taxable year.

(4) *Estimated adjusted tax bases*—(i) *In general.* The amount of the adjusted Federal income tax bases (tax bases) of assets held on a report date may be estimated, for purposes of applying paragraph (c)(3) of this section. This estimate must be based on the adjusted bases of the assets on that date as determined by reference to the asset holder's books and records maintained for financial reporting purposes (book bases). The estimate must reflect any change in the ratio between the asset holder's tax and book bases of assets that occurs during the taxable year, and the estimate must assume that this change occurs ratably. If an institution or group member estimates the tax bases of assets held on any report date during a taxable year, it must do so for all assets (other than cash) held on that report date, and it must do so for all other report dates during the year. However, the tax bases of assets may not be estimated for any report date that is the first or last day of the taxable year or that is determined under paragraph (c)(2)(i)(B) of this section.

(ii) *Formulas.* The estimated amount of the tax bases of assets held on any report date during a taxable year is based on the following variables: The total book bases of the assets on the report date (B); the asset holder's *tax/book ratio* as of the close of the preceding taxable year (R); and the result (whether positive or negative) obtained when R is subtracted from the asset holder's *tax/book ratio* as of the close of the current taxable year (Y). For purposes of determining R and Y, an asset holder's *tax/book ratio* is the ratio of the total tax bases of all of the holder's assets (other than cash), to the total book bases of those assets. If an asset holder's taxable year is the calendar year and its report date is the last day of the calendar quarter, its estimated tax bases of assets held on the first three report dates of the year are determined under the following formulas:

1st Report Date=$B\times(R+\frac{1}{4}Y)$
2nd Report Date=$B\times(R+\frac{1}{2}Y)$
3rd Report Date=$B\times(R+\frac{3}{4}Y)$

(5) *Examples.* The following examples illustrate the principles of this paragraph (c):

Example 1. Bank U is a fiscal year taxpayer, and its fiscal year ends on January 31. U reports to its primary Federal regulatory agency as of the last day of the calendar quarter. U does not choose under §1.585–5(c)(2)(i)(B) a report date more frequent than quarterly. Thus, U's report dates under §1.585–5(c)(2)(i)(A) are March 31, June 30, September 30, and December 31. For its taxable year beginning on February 1, 1987, U has total assets (within the meaning of §1.585–5(c)(3)) of $480 million on March 31, $490 million on June 30, $510 million on September 30, and $540 million on December 31. Thus, pursuant to §1.585–5(c)(1), U's average total assets for its taxable year beginning on February 1, 1987, are $505 million.

Example 2. Bank W is a calendar year taxpayer, and its report date (within the meaning of §1.585–5(c)(2)(i)(A)) is the last day of the calendar quarter. Pursuant to §1.585–5(c)(4), W chooses to estimate the tax bases of its assets for 1990. Therefore, W must estimate the tax bases of all of its assets (other than cash) for its first three report dates in 1990. Since W's fourth report date (December 31) is the last day of its taxable year, the tax bases of its assets may not be estimated for this date. The adjusted tax bases of all of W's assets (other than cash) are $450z on December 31, 1989, and $480z on December 31, 1990.

The book bases of those assets are $500z on December 31, 1989; $520z on March 31, 1990; $540z on June 30, 1990; $560z on September 30, 1990; and $600z on December 31, 1990. Applying the formulas provided in §1.585–5(c)(4)(ii), W's tax/book ratio as of the close of 1989 (R), is 0.9 (450z/500z). W's tax/book ratio as of the close of 1990 is 0.8 (480z/600z). Thus, Y is −0.1. The estimated adjusted tax bases of all of W's assets (other than cash) on the first three report dates of 1990 are as follows:

$$\begin{aligned}
\text{1st} &= \text{B}\times(\text{R}+1\ 4\text{Y})\\
&= \$520\text{z}\times[0.9+1\ 4(-0.1)]\\
&= \$455\text{z}\\
\text{2nd} &= \text{B}\times(\text{R}+1\ 2\text{Y})\\
&= \$540\text{z}\times[0.9+1\ 2(-0.1)]\\
&= \$459\text{z}\\
\text{3rd} &= \text{B}\times(\text{R}+3\ 4\text{Y})\\
&= \$560\text{z}\times[0.9+3\ 4(-0.1)]\\
&= \$462\text{z}
\end{aligned}$$

(d) *Definitions.* The following definitions apply for purposes of this section and §§1.585–6, 1.585–7 and 1.585–8:

(1) *Disqualification year.* A bank's disqualification year is its first taxable year beginning after December 31, 1986, for which the bank is a large bank within the meaning of paragraph (b) of this section.

(2) *Parent-subsidiary controlled group.* A parent-subsidiary controlled group includes all of the members of a controlled group of corporations described in section 1563(a)(1). The members of such a group are determined without regard to whether any member is an *excluded member* described in section 1563(b)(2), a foreign entity, or a commercial bank.

(3) *Example.* The following example illustrates the principles of this paragraph (d):

Example. Bank X is a large bank within the meaning of §1.585–5(b)(1)(i). Bank Y is not a large bank under §1.585–5(b), and it maintains a bad debt reserve under section 585. In 1988, X purchases all of the stock of Y. If the acquisition causes Y to become a member of a parent-subsidiary controlled group described in §1.585–5(b)(1)(ii), Y is a large bank beginning in its first taxable year that ends after the date of the acquisition. Pursuant to §1.585–5(d)(1), this year is Y's disqualification year. Y must change in this year to the specific charge-off method of accounting for bad debts, in accordance with §1.585–6 or §1.585–7.

[T.D. 8513, 58 FR 68757, Dec. 29, 1993; 59 FR 15502, Apr. 1, 1994]

§1.585–6 Recapture method of changing from the reserve method of section 585.

(a) *General rule.* This section applies to any large bank (as defined in §1.585–5(b)) that maintained a reserve for bad debts under section 585 for the taxable year immediately preceding its disqualification year (as defined in §1.585–5(d)(1)) and that does not elect the cut-off method set forth in §1.585–7. Except as otherwise provided in paragraphs (c) and (d) of this section, any bank to which this section applies must include in income the amount of its net section 481(a) adjustment (as defined in paragraph (b)(3) of this section) over the four-year period beginning with the bank's disqualification year. If a bank follows the rules prescribed by this section, its change to the specific charge-off method of accounting for bad debts in its disqualification year will be treated as a change in accounting method that is made with the consent of the Commissioner. Paragraph (b) of this section specifies the portion of the net section 481(a) adjustment to be included in income in each year of the recapture period; paragraph (c) of this section provides rules on the effect of disposing of loans; and paragraph (d) of this section provides rules on the suspension of recapture by financially troubled banks.

(b) *Four-year spread of net section 481(a) adjustment*—(1) *In general.* If a bank to which this section applies does not make the election allowed by paragraph (b)(2) of this section, the bank must include in income the following portions of its net section 481(a) adjustment in each year of the four-year recapture period: 10 percent in the bank's disqualification year; 20 percent in its first taxable year after its disqualification year; 30 percent in its second taxable year after its disqualification year; and 40 percent in its third taxable year after its disqualification year.

(2) *Election to include more than 10 percent in disqualification year.* A bank to which this section applies may elect to

include in income, in its disqualification year, any percentage of its net section 481(a) adjustment that is larger than 10 percent. Any such election must be made at the time and in the manner prescribed by §1.585–8. If a bank makes such an election, the bank must include in income the remainder, if any, of its net section 481(a) adjustment in the following portions: 2⁄9 of the remainder in the bank's first taxable year after its disqualification year; 1⁄3 of the remainder in its second taxable year after its disqualification year; and 4⁄9 of the remainder in its third taxable year after its disqualification year. For this purpose, the remainder of a bank's net section 481(a) adjustment is any portion of the adjustment that the bank does not elect to include in income in its disqualification year.

(3) *Net section 481(a) adjustment.* For purposes of this section, the amount of a bank's net section 481(a) adjustment is the amount of the bank's reserve for bad debts as of the close of the taxable year immediately preceding its disqualification year. Since the change from the reserve method of section 585 is initiated by the taxpayer, the amount of the bank's bad debt reserve for this purpose is not reduced by amounts attributable to taxable years beginning before 1954.

(4) *Examples.* The following examples illustrate the principles of this paragraph (b):

Example 1. Bank M is a large bank within the meaning of §1.585–5(b). M's disqualification year is its taxable year beginning on January 1, 1989, and M maintained a bad debt reserve under section 585 for the preceding taxable year. Pursuant to §1.585–5(a), M must change from the reserve method of accounting for bad debts to the specific charge-off method in its disqualification year. M does not elect the cut-off method set forth in §1.585–7. Thus, M must follow the recapture method set forth in this §1.585–6. M's net section 481(a) adjustment, as defined in §1.585–6(b)(3), is $2 million. M does not make the election allowed by §1.585–6(b)(2). Pursuant to §1.585–6(b)(1), M must include the following amounts in income: $200,000 in taxable year 1989; $400,000 in 1990; $600,000 in 1991; and $800,000 in 1992.

Example 2. Assume the same facts as in Example 1, except that M elects under §1.585–6(b)(2) to recapture 55 percent of its net section 481(a) adjustment in its disqualification year. Pursuant to §1.585–6(b)(2), M must include the following amounts in income: $1,100,000 in taxable year 1989; $200,000 in 1990; $300,000 in 1991; and $400,000 in 1992.

(c) *Effect of disposing of loans*—(1) *In general.* Except as provided in paragraphs (c)(2) and (c)(3) of this section, if a bank to which this section applies sells or otherwise disposes of any of its outstanding loans on or after the first day of its disqualification year, the disposition does not affect the bank's obligation under this section to include in income the amount of its net section 481(a) adjustment, and the disposition does not affect the amount of this adjustment.

(2) *Cessation of banking business*—(i) *In general.* If a bank to which this section applies ceases to engage in the business of banking before it is otherwise required to include in income the full amount of its net section 481(a) adjustment, the bank must include in income the remaining amount of the adjustment in the taxable year in which it ceases to engage in the business of banking. For this purpose, and except as provided in paragraph (c)(2)(ii) of this section, whether a bank ceases to engage in the business of banking is determined under the principles of §1.446–1(e)(3)(ii) and its administrative procedures.

(ii) *Transition rule.* A bank that ceases to engage in the business of banking as the result of a transaction to which section 381(a) applies is not treated as ceasing to engage in the business of banking if, on or before March 29, 1994, either the transaction occurs or the bank enters into a binding written agreement to carry out the transaction.

(3) *Certain section 381 transactions.* This paragraph (c)(3) applies if a bank to which this section applies transfers outstanding loans to another corporation on or after the first day of the bank's disqualification year (and before it has included in income the full amount of its net section 481(a) adjustment) in a transaction to which section 381(a) applies, and under paragraph (c)(2) (i) or (ii) of this section the transferor bank is not treated as ceasing to engage in the business of banking as a

result of the transaction. If this paragraph (c)(3) applies, the acquiring corporation (the acquiror) steps into the shoes of the transferor with respect to using the recapture method prescribed by this section and assumes all of the transferor's rights and obligations under paragraph (b) of this section. The unrecaptured balance of the transferor's net section 481(a) adjustment carries over in the transaction to the acquiror, and the acquiror must complete the four-year recapture procedure begun by the transferor. In applying this procedure, the transferor's taxable year that ends on or includes the date of the acquisition and the acquiror's first taxable year ending after the date of the acquisition represent two consecutive taxable years within the four-year recapture period.

(4) *Examples.* The following examples illustrate the principles of this paragraph (c):

Example 1. Bank P is a bank to which this § 1.585–6 applies. P's disqualification year is its taxable year beginning on January 1, 1989, and P recaptures 10 percent of its net section 481(a) adjustment in that year pursuant to § 1.585–6(b)(1). In July 1990 P disposes of a portion of its loan portfolio in a transaction to which section 381(a) does not apply, and P continues to engage in the business of banking. Pursuant to § 1.585–6(c)(1), the disposition does not affect P's obligation under § 1.585–6(b)(1) to recapture the remainder of its net section 481(a) adjustment in 1990, 1991 and 1992. Nor does the disposition affect the amount of the adjustment.

Example 2. Assume the same facts as in Example 1, except that P ceases to engage in the business of banking in 1990, as determined under the principles of § 1.446–1(e)(3)(ii) and its administrative procedures. Pursuant to § 1.585–6(c)(2)(i), in 1990 P must include in income the remaining 90 percent of its net section 481(a) adjustment.

Example 3. Assume the same facts as in Example 1, except that P's 1990 disposition of loans is a transaction to which section 381(a) applies, P ceases to engage in the business of banking as a result of the transaction, and P's taxable year ends on the date of the transaction. Thus, in the transaction, P transfers substantially all of its loans to an acquiring corporation (Q). Q is a calendar year taxpayer. Because the transaction occurred before March 29, 1994, the transition rule of § 1.585–6(c)(2)(ii) applies, and P is not treated as ceasing to engage in the business of banking. Pursuant to § 1.585–6(c)(3), Q steps into P's shoes with respect to using the recapture method prescribed by § 1.585–6. The unrecaptured balance of P's net section 481(a) adjustment carries over to Q in the section 381(a) transaction, and Q must complete the four-year recapture procedure begun by P. Pursuant to §§ 1.585–6(b) and 1.585–6(c)(3), P includes 20 percent of its net section 481(a) adjustment in income in its taxable year ending on the date of the section 381(a) transaction, and Q includes 30 percent of the adjustment in income in 1990 and 40 percent in 1991.

Example 4. Assume the same facts as in Example 3. Assume also that Q becomes a large bank under § 1.585–5(b) as a result of the transaction and maintained a bad debt reserve immediately before the transaction. Q must change to the specific charge-off method for all of its loans in the first taxable year that it is a large bank. Thus, Q not only completes the recapture procedure begun by P but also follows the rules prescribed by § 1.585–6 or § 1.585–7 with respect to its own reserve.

Example 5. Assume the same facts as in Example 3. Assume also that Q is not a large bank after the transaction and properly establishes a bad debt reserve for the loans it receives in the transaction. This establishment of the reserve results in a new negative section 481(a) adjustment. Thus, Q not only completes the recapture procedure begun by P but also takes into account the new negative adjustment as required under section 381.

(d) *Suspension of recapture by financially troubled banks*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, a bank that is financially troubled (within the meaning of paragraph (d)(3) of this section) for any taxable year must not include any amount in income under paragraphs (a) and (b) of this section for that taxable year and must disregard that taxable year in applying paragraphs (a) and (b) of this section to other taxable years. See paragraph (d)(4) of this section for rules on determining estimated tax payments of financially troubled banks, and see paragraph (d)(5) of this section for examples illustrating this paragraph (d).

(2) *Election to recapture.* A bank that is financially troubled (within the meaning of paragraph (d)(3) of this section) for its disqualification year may elect to include in income, in one taxable year, any percentage of its net section 481(a) adjustment that is greater than 10 percent. This election may be made for the bank's disqualification year, for the first taxable year after the disqualification year in which the

bank is not financially troubled (within the meaning of paragraph (d)(3) of this section), or for any intervening taxable year. Any such election must be made at the time and in the manner prescribed by §1.585–8. A bank that makes this election must include an amount in income under paragraphs (a) and (b) of this section in the year for which the election is made (election year) and must not disregard this year in applying paragraphs (a) and (b) of this section to other taxable years. Such a bank must follow the rules of paragraph (b)(2) of this section in applying paragraph (b) of this section to later taxable years, treating the election year as the disqualification year for purposes of applying paragraph (b)(2) of this section. However, if the bank is financially troubled for any year after its election year, the bank must not include any amount in income under paragraphs (a) and (b) of this section for the later year and must disregard the later year in applying paragraphs (a) and (b) of this section to other taxable years.

(3) *Definition of financially troubled*—(i) *In general.* For purposes of this section, a bank is considered financially troubled for any taxable year if the bank's nonperforming loan percentage for that year exceeds 75 percent. For this purpose, a bank's nonperforming loan percentage is the percentage determined by dividing the sum of the outstanding balances of the bank's nonperforming loans (as defined in paragraph (d)(3)(iii) of this section) as of the close of each quarter of the taxable year, by the sum of the amounts of the bank's equity (as defined in paragraph (d)(3)(iv) of this section) as of the close of each such quarter. The quarters for a short taxable year of at least 3 months are the same as those of the bank's annual accounting period, except that quarters ending before or after the short year are disregarded. If a taxable year consists of less than 3 months, the first or last day of the taxable year is treated as the last day of its only quarter. In lieu of determining its nonperforming loan percentage on the basis of loans and equity as of the close of each quarter of the taxable year, a bank may, for all years, determine this percentage on the basis of loans and equity as of the close of each report date (as defined in §1.585–5(c)(2), without regard to §1.585–5(c)(2)(i)(B)). In the case of a bank that is a foreign corporation, all nonperforming loans and equity of the bank are taken into account, including loans and equity that are not effectively connected with the conduct of a banking business within the United States.

(ii) *Parent-subsidiary controlled groups*—(A) *In general.* If a bank is a member of a parent-subsidiary controlled group (as defined in §1.585–5(d)(2)) for the taxable year, the nonperforming loans and the equity of all members of the bank's financial group (as determined under paragraph (d)(3)(ii)(B) of this section) are treated as the nonperforming loans and the equity of the bank for purposes of paragraph (d)(3)(i) of this section. However, any equity interest that a member of a bank's financial group holds in another member of this group is not to be counted in determining equity. Similarly, any loan that a member of a bank's financial group makes to another member of the group is not to be counted in determining nonperforming loans. All banks that are members of the same parent-subsidiary controlled group must (for all taxable years that they are members of this group) determine their nonperforming loan percentage on the basis of the close of each quarter of the taxable year, or all must (for all such taxable years) determine this percentage on the basis of the close of each report date (as determined under §1.585–5(c)(2)(ii), applied without regard to §1.585–5(c)(2)(i)(B)).

(B) *Financial group*—(*1*) *In general.* All banks that are members of the same parent-subsidiary controlled group must (for all taxable years that they are members of this group) determine their financial group under paragraph (d)(3)(ii)(B)(*2*) of this section, or all must (for all such taxable years) determine their financial group under paragraph (d)(3)(ii)(B)(*3*) of this section.

(*2*) *Financial institution members of parent-subsidiary controlled group.* A bank's financial group, determined under this paragraph (d)(3)(ii)(B)(*2*), consists of all financial institutions within the meaning of section 265(b)(5) (and comparable foreign financial institutions) that are members of the parent-subsidiary controlled group of which the bank is a member.

(*3*) *All members of parent-subsidiary controlled group.* A bank's financial group, determined under this paragraph (d)(3)(ii)(B)(*3*), consists of all members of the parent-subsidiary controlled group of which the bank is a member.

(iii) *Nonperforming loan*—(A) *In general.* For purposes of this section, a nonperforming loan is any loan (as defined in paragraph (d)(3)(iii)(B) of this section) that is considered to be nonperforming by the holder's primary Federal regulatory agency. Nonperforming loans include the following types of loans as defined by the Federal Financial Institutions Examination Council: Loans that are past due 90 days or more and still accruing; loans that are in nonaccrual status; and loans that are restructured troubled debt. A loan is not considered to be nonperforming merely because it is past due, if it is past due less than 90 days. The outstanding balances of nonperforming loans are determined on the basis of amounts that are required to be reported to the holder's primary Federal regulatory agency. For purposes of this paragraph (d)(3)(iii)(A), a holder that does not have a Federal regulatory agency is treated as Federally regulated under the standards prescribed by the Federal Financial Institutions Examination Council.

(B) *Loan.* For purposes of paragraph (d)(3)(iii)(A) of this section, a loan is any extension of credit that is defined and treated as a loan under the standards prescribed by the Federal Financial Institutions Examination Council. (Accordingly, a troubled debt restructuring that is in substance a foreclosure or repossession is not considered a loan.) In addition, a debt evidenced by a security issued by a foreign government is treated as a loan if the security is issued as an integral part of a restructuring of one or more troubled loans to the foreign government (or an agency or instrumentality thereof). Similarly, a deposit with the central bank of a foreign country is treated as a loan if the deposit is made under a deposit facility agreement that is entered into as an integral part of a restructuring of one or more troubled loans to the foreign country's government (or an agency or instrumentality thereof).

(iv) *Equity.* For purposes of this section, the equity of a bank or other financial institution is its equity (i.e., assets minus liabilities) as required to be reported to the institution's primary Federal regulatory agency (or, if the institution does not have a Federal regulatory agency, as required under the standards prescribed by the Federal Financial Institutions Examination Council). The balance in a reserve for bad debts is not treated as equity.

(4) *Estimated tax payments of financially troubled banks.* For purposes of applying section 6655(e)(2)(A)(i) with respect to any installment of estimated tax, a bank that is financially troubled as of the due date of the installment is treated as if no amount will be included in income under paragraphs (a) and (b) of this section for the taxable year. For this purpose, a bank is considered financially troubled as of the due date of an installment of estimated tax only if its nonperforming loan percentage (computed under paragraph (d)(3) of this section) would exceed 75 percent for a short taxable year ending on that date. For purposes of computing this nonperforming loan percentage, the ending of such a short taxable year would not cause the last day of that year to be treated as the last day of a quarter of the taxable year.

(5) *Examples.* The following examples illustrate the principles of this paragraph (d):

Example 1. Bank R is a bank to which this § 1.585–6 applies. R's disqualification year is its taxable year beginning on January 1, 1987. R is not financially troubled (within the meaning of § 1.585–6(d)(3)) for taxable year 1987 or for any taxable year after 1989, but it is financially troubled for taxable years 1988 and 1989. Since R is not financially troubled for its disqualification year, R must include an amount in income under § 1.585–6 (a) and (b) for that year (taxable year 1987). R may make the election allowed by § 1.585–6(b)(2) for that year. Since R is financially troubled for taxable years 1988 and 1989, pursuant to § 1.585–6(d)(1) R does not include any amount in income under § 1.585–6 (a) and (b) for these years, and it treats taxable years 1990, 1991 and 1992 as the first, second and third taxable years after its disqualification year for purposes of applying §1.585–6 (a) and (b).

Example 2. Assume the same facts as in Example 1, except that R is financially troubled for taxable year 1987 (its disqualification year). R may make the election allowed by §1.585–6(d)(2) for 1987 (the disqualification year), for 1990 (the first year after the disqualification year in which R is not financially troubled), or for 1988 or 1989 (the intervening years). R elects to include 60 percent of its net section 481(a) adjustment in income in 1987. Thus, the remainder of the adjustment, for purposes of applying the rules of §1.585–6(b)(2), is 40 percent. R must include in income 2/9 of the remainder in 1990, 1/3 of the remainder in 1991, and 4/9 of the remainder in 1992.

Example 3. Bank S, which is not a member of a parent-subsidiary controlled group, is a bank to which this §1.585–6 applies. S's disqualification year is its taxable year beginning on January 1, 1987. S determines its nonperforming loan percentage under §1.585–6(d)(3) on a quarterly basis. S is not financially troubled for taxable year 1987 and includes 10 percent of its net section 481(a) adjustment in income in that year. S's outstanding balance of nonperforming loans (as defined in §1.585–6(d)(3)(iii)) is $80 million on March 31, 1988; $68 million on June 30, 1988; and $59 million on September 30, 1988. The amount of S's equity (as defined in §1.585–6(d)(3)(iv)) is $100 million on each of these three dates. Thus, S's nonperforming loan percentage, computed under §1.585–6(d)(3), would be 80 percent (80/100) for a short taxable year ending on April 15 or June 15, 74 percent [(80+68) ÷ 200] for a short taxable year ending on September 15, and 69 percent [(80+68+59) ÷ 300] for a short taxable year ending on December 15. Since S's nonperforming loan percentage for a short taxable year ending on April 15 or June 15 would exceed 75 percent, pursuant to §1.585–6(d)(4) S is considered financially troubled as of these dates. Thus, S is treated as if no amount will be included in income under §1.585–6 (a) and (b) for the year for purposes of applying section 6655(e)(2)(A)(i) with respect to the installments of estimated tax that are due on April 15, 1988, and June 15, 1988. However, since S's nonperforming loan percentage for a short taxable year ending on September 15 or December 15 would not exceed 75 percent, S is not considered financially troubled as of these dates. Thus, S is treated as if 20 percent of its net section 481(a) adjustment will be included in income under §1.585–6 (a) and (b) for the year for purposes of applying section 6655(e)(2)(A)(i) with respect to the installments of estimated tax that are due on September 15, 1988, and December 15, 1988.

[T.D. 8513, 58 FR 68760, Dec. 29, 1993; 59 FR 15502, Apr. 1, 1994]

§1.585–7 Elective cut-off method of changing from the reserve method of section 585.

(a) *General rule.* Any large bank (as defined in §1.585–5(b)) that maintained a reserve for bad debts under section 585 for the taxable year immediately preceding its disqualification year (as defined in §1.585–5(d)(1)) may elect to use the cut-off method set forth in this section. Any such election must be made at the time and in the manner prescribed by §1.585–8. If a bank makes this election, the bank must maintain its bad debt reserve for its pre- disqualification loans, as prescribed in paragraph (b) of this section, and the bank must include in income any excess balance in this reserve, as required by paragraph (c) of this section. The bank may not deduct, for its disqualification year or any subsequent taxable year, any amount allowed under section 166(a) for pre-disqualification loans (as defined in paragraph (b)(2) of this section) that become worthless in whole or in part, except as allowed by paragraph (b)(1) of this section. However, except as provided in paragraph (d)(3) of this section, the bank may deduct, for its disqualification year or any subsequent taxable year, amounts allowed under section 166(a) for loans that the bank originates or acquires on or after the first day of its disqualification year and that become worthless in whole or in part. If a bank makes the election allowed by this paragraph (a), its change to the specific charge-off method of accounting for bad debts in its disqualification year does not give rise to a section 481(a) adjustment.

(b) *Maintaining reserve for pre-disqualification loans*—(1) *In general.* A bank that makes the election allowed by paragraph (a) of this section must maintain its bad debt reserve for its pre-disqualification loans (as defined in paragraph (b)(2) of this section). Except as provided in paragraph (d)(3) of this section, the bank must charge against the reserve the amount of any losses resulting from these loans (including losses resulting from the sale or other disposition of these loans), and the bank must add to the reserve the amount of recoveries with respect to these loans. In general, the reserve must be maintained in the manner provided by former section 166(c) of the Internal Revenue Code and the regulations thereunder. However, after the balance in the reserve is reduced to zero, the bank is to account for any losses and recoveries with respect to outstanding pre-disqualification loans under the specific charge-off method of accounting for bad debts, as if the bank always had accounted for these loans under this method.

(2) *Definition of pre-disqualification loans.* For purposes of this section, a pre-disqualification loan of a bank is any loan that the bank held on the last day of its taxable year immediately preceding its disqualification year (as defined in § 1.585–5(d)(1)). If the amount of a pre-disqualification loan is increased during or after the disqualification year, the amount of the increase is not treated as a pre-disqualification loan.

(c) *Amount to be included in income when reserve balance exceeds loan balance.* If, as of the close of any taxable year, the balance in a bank's reserve that is maintained under paragraph (b) of this section exceeds the balance of the bank's outstanding pre-disqualification loans, the bank must include in income the amount of the excess for the taxable year. The balance in the reserve is then reduced by the amount of this excess. See paragraph (d) of this section for rules on the application of this paragraph (c) when a bank disposes of loans.

(d) *Effect of disposing of loans*—(1) *In general.* Except as provided in paragraphs (d)(2) and (d)(3) of this section, if a bank that makes the election allowed by paragraph (a) of this section sells or otherwise disposes of any of its outstanding pre-disqualification loans, the bank is to reduce the balance of its outstanding pre-disqualification loans by the amount of the loans disposed of, for purposes of applying paragraph (c) of this section.

(2) *Section 381 transactions.* If a bank that makes the election allowed by paragraph (a) of this section transfers outstanding pre-disqualification loans to another corporation in a transaction to which section 381(a) applies, the acquiring corporation (the acquiror) must follow the rules of paragraph (d)(2)(i) or (ii) of this section.

(i) *Acquiror completes cut-off method of change.* Except as provided in paragraph (d)(2)(ii) of this section, the acquiror steps into the shoes of the transferor in the section 381(a) transaction with respect to using the cut-off method of change. Thus, the transferor's bad debt reserve immediately before the section 381(a) transaction carries over to the acquiror, and the acquiror must complete the cut-off method begun by the transferor. For purposes of completing the transferor's cut-off method, the acquiror's balance of outstanding pre-disqualification loans immediately after the section 381(a) transaction is the balance of these loans that it receives in the transaction, and the acquiror assumes all of the transferor's rights and obligations under this section.

(ii) *Acquiror uses reserve method.* If the acquiror is not a large bank (within the meaning of § 1.585–5(b)) immediately after the section 381(a) transaction and uses a reserve method of accounting for bad debts attributable to the pre-disqualification loans (and any other loans) received in the transaction, the acquiror does not step into the shoes of the transferor with respect to using the cut-off method of change. The transferor's bad debt reserve immediately before the section 381(a) transaction carries over to the acquiror, but the acquiror does not continue the cut-off method begun by the transferor. If the six-year moving average amount (as defined in § 1.585–2(c)(1)(ii)) for all of the loans received in the transaction exceeds the balance of the reserve that carries over to the acquiror, the acquiror increases this balance by the amount of the excess. Any such increase in the reserve results in a negative section 481(a) adjustment that is taken into account as required under section 381.

(3) *Dispositions intended to change the status of pre-disqualification loans.* This paragraph (d)(3) applies if a bank that makes the election allowed by paragraph (a) of this section sells, exchanges, or otherwise disposes of a significant amount of its pre-disqualification loans (as defined in paragraph (b)(2) of this section) and a principal

purpose of the transaction is to avoid the provisions of this section by increasing the amount of loans for which deductions are allowable under the specific charge-off method. If this paragraph (d)(3) applies, the District Director may disregard the disposition for purposes of paragraphs (b)(1) and (d)(1) of this section or treat the replacement loans as pre-disqualification loans. If loans are so treated as pre-disqualification loans, no deductions are allowable under the specific charge-off method for the loans, except as provided in paragraph (b)(1) of this section, and the disposition that causes the loans to be so treated may be disregarded for purposes of paragraphs (b)(1) and (d)(1) of this section. If a bank sells pre-disqualification loans and uses the proceeds of the sale to originate new loans, this paragraph (d)(3) does not apply to the transaction.

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

Example 1. Bank M is a bank that properly elects to use the cut-off method set forth in this §1.585–7. M's disqualification year is its taxable year beginning on January 1, 1987. On December 31, 1986, M had outstanding loans of $700 million (pre-disqualification loans), and the balance in its bad debt reserve was $10 million. M must maintain its reserve for its pre-disqualification loans in accordance with §1.585–7(b), and it may not deduct any addition to this reserve for taxable year 1987 or any later year. For these years, M may deduct amounts allowed under section 166(a) for loans that it originates or acquires after December 31, 1986, and that become worthless in whole or in part.

Example 2. Assume the same facts as in Example 1. Also assume that in 1987 M collects $150 million of its pre- disqualification loans, M determines that $2 million of its pre-disqualification loans are worthless, and M recovers $1 million of pre-disqualification loans that it had previously charged against the reserve as worthless. On December 31, 1987, the balance in M's bad debt reserve is $9 million ($10 million − $2 million + $1 million), and the balance of its outstanding pre-disqualification loans is $548 million ($700 million − $150 million − $2 million).

Example 3. Assume the same facts as in Examples 1 and 2. Also assume that on December 31, 1990, the balance in M's bad debt reserve is $5 million and the balance of its outstanding pre-disqualification loans is $25 million. In 1991 M collects $21 million of its outstanding pre-disqualification loans and determines that $1 million of its outstanding pre-disqualification loans are worthless. Thus, on December 31, 1991, the balance in M's bad debt reserve is $4 million ($5 million − $1 million), and the balance of its outstanding pre-disqualification loans is $3 million ($25 million − $21 million − $1 million). Accordingly, M must include $1 million ($4 million − $3 million) in income in taxable year 1991, pursuant to §1.585–7(c). On January 1, 1992, the balance in M's reserve is $3 million ($4 million − $1 million).

Example 4. Assume the same facts as in Examples 1 through 3. Also assume that in 1992 M transfers substantially all of its assets to another corporation (N) in a transaction to which section 381(a) applies, and N is treated as a large bank under §1.585–5(b)(2) for taxable years ending after the date of the transaction. Pursuant to §1.585–7(d)(2)(i), N steps into M's shoes with respect to using the cut-off method. M's bad debt reserve immediately before the section 381(a) transaction carries over to N, and N must complete the cut-off procedure begun by M. For this purpose, N's balance of outstanding pre-disqualification loans immediately after the section 381(a) transaction is the balance of these loans that it receives from M.

Example 5. Assume the same facts as in Examples 1 through 4, except that N is not treated as a large bank after the section 381(a) transaction. Also assume that N uses the reserve method of section 585 and plans to use this method for all of the loans it acquires from M (including loans that were not pre-disqualification loans). Pursuant to §1.585–7(d)(2)(ii), M's bad debt reserve immediately before the section 381(a) transaction carries over to N in the transaction; however, N does not continue the cut-off procedure begun by M and does not treat any loan as a pre-disqualification loan. If the six-year moving average amount (as defined in §1.585–2(c)(1)(ii)) for all of N's newly acquired loans exceeds the balance of the reserve that carries over to N, N increases this balance by the amount of the excess. Any such increase in the reserve results in a negative section 481(a) adjustment that is taken into account as required under section 381.

[T.D. 8513, 58 FR 68762, Dec. 29, 1993; 59 FR 15502, Apr. 1, 1994]

§1.585–8 Rules for making and revoking elections under §§1.585–6 and 1.585–7.

(a) *Time of making elections*—(1) *In general.* Any election under §1.585–6(b)(2), §1.585–6(d)(2) or §1.585–7(a) must be made on or before the later of-

(i) February 28, 1994; or

(ii) The due date (taking extensions into account) of the electing bank's original tax return for its disqualification year (as defined in §1.585–5(d)(1)) or, for elections under §1.585–6(d)(2), the year for which the election is made.

(2) *No extension of time for payment.* Payments of tax due must be made in accordance with chapter 62 of the Internal Revenue Code. However, if an election under § 1.585–6(b)(2), § 1.585–6(d)(2) or § 1.585–7(a) is made or revoked on or before February 28, 1994 and the making or revoking of the election results in an underpayment of estimated tax (within the meaning of section 6655(a)) with respect to an installment of estimated tax due on or before the date the election was so made or revoked, no addition to tax will be imposed under section 6655(a) with respect to the amount of the underpayment attributable to the making or revoking of the election.

(b) *Manner of making elections*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, an electing bank must make any election under § 1.585–6(b)(2), § 1.585–6(d)(2) or § 1.585–7(a) by attaching a statement to its tax return (or amended return) for its disqualification year or, for elections under § 1.585–6(d)(2), the year for which the election is made. This statement must contain the following information:

(i) The name, address and taxpayer identification number of the electing bank;

(ii) The nature of the election being made (i.e., whether the election is to include in income more than 10 percent of the bank's net section 481(a) adjustment under § 1.585–6 (b)(2) or (d)(2) or to use the cut-off method under § 1.585–7); and

(iii) If the election is under § 1.585–6(b)(2) or (d)(2), the percentage being elected.

(2) *Certain tax returns filed before December 29, 1993.* A bank is deemed to have made an election under § 1.585–6(b)(2) or (d)(2) if the bank evidences its intent to make an election under section 585(c)(3)(A)(iii)(I) or section 585(c)(3)(B)(ii) for its disqualification year (or, for elections under § 1.585–6(d)(2), the election year), by designating a specific recapture amount on its tax return or amended return for that year (or attaching a statement in accordance with § 301.9100–7T(a)(3)(i) of this chapter), and the return is filed before December 29, 1993. A bank is deemed to have made an election under § 1.585–7(a) if the bank evidences its intent to make an election under section 585(c)(4) for its disqualification year by attaching a statement in accordance with § 301.9100–7T(a)(3)(i) of this chapter to its tax return or amended return for that year, and the return is filed before December 29, 1993.

(c) *Revocation of elections*—(1) *On or before final date for making election.* An election under § 1.585–6(b)(2), § 1.585–6(d)(2) or § 1.585–7(a) may be revoked without the consent of the Commissioner on or before the final date prescribed by paragraph (a)(1) of this section for making the election. To do so, the bank that made the election must file an amended tax return for its disqualification year (or, for elections under § 1.585–6(d)(2), the year for which the election was made) and attach a statement that—

(i) Includes the bank's name, address and taxpayer identification number;

(ii) Identifies and withdraws the previous election; and

(iii) If the bank is making a new election under § 1.585–6(b)(2), § 1.585–6(d)(2) or § 1.585–7(a), contains the information described in paragraphs (b)(1)(ii) and (b)(1)(iii) of this section.

(2) *After final date for making election.* An election under § 1.585–6(b)(2), § 1.585–6(d)(2) or § 1.585–7(a) may be revoked only with the consent of the Commissioner after the final date prescribed by paragraph (a)(1) of this section for making the election. The Commissioner will grant this consent only in extraordinary circumstances.

(d) *Elections by banks that are members of parent-subsidiary controlled groups.* In the case of a bank that is a member of a parent-subsidiary controlled group (as defined in § 1.585–5(d)(2)), any election under § 1.585–6(b)(2), § 1.585–6(d)(2) or § 1.585–7(a) with respect to the bank is to be made separately by the bank. An election made by one member of such a group is not binding on any other member of the group.

(e) *Elections made or revoked by amended return on or before February 28, 1994.* This paragraph (e) applies to any election that a bank seeks to make under paragraph (b) of this section, or revoke under paragraph (c) of this section, by means of an amended return that is filed on or before February 28, 1994. To make or revoke an election to which this paragraph (e) applies, a bank must file (before expiration of each applicable period of limitations under section 6501) this amended return and amended returns for all taxable years after the taxable year for which the election is made or revoked by amended return, to any extent necessary to report the bank's tax liability in a manner consistent with the making or revoking of the election by amended return.

[T.D. 8513, 58 FR 68764, Dec. 29, 1993; 59 FR 4583, Feb. 1, 1994; 59 FR 15502, Apr. 1, 1994]

§1.586–1 Reserve for losses on loans of small business investment companies, etc.

(a) *General rule.* As an alternative to a deduction from gross income under section 166(a) for specific debts which become worthless in whole or in part, a taxpayer which is a financial institution to which section 586 and this section apply is allowed a deduction under section 166(c) for a reasonable addition to a reserve for bad debts provided such financial institution has adopted or adopts the reserve method of treating bad debts in accordance with paragraph (b) of §1.166–1. In the case of such a taxpayer, the amount of the reasonable addition to such reserve for a taxable year beginning after July 11, 1969, shall be an amount determined by the taxpayer which does not exceed the amount computed under §1.586–2. A financial institution to which section 586 and this section apply which adopts the reserve method is not entitled to charge-off any bad debts pursuant to section 166(a) with respect to a loan (as defined in §1.586–2(c)(2)). Except as provided by §1.586–2, regarding the manner of computation of the addition to the reserve for bad debts, the reserve for bad debts of a financial institution to which this section applies shall be maintained in the same manner as is provided by section 166(c) and the regulations thereunder with respect to reserves for bad debts. Except as provided by this section, no deduction is allowable for an addition to a reserve for bad debts of a financial institution to which section 586 and this section apply. For rules relating to deduction with respect to debts which are not loans (as defined in §1.586–2(c)(2)), see section 166(a) and the regulations thereunder.

(b) *Application of section.* Section 586 and this section shall apply only to the following financial institutions:

(1) Any small business investment company operating under the Small Business Investment Act of 1958 as amended and supplemented (72 Stat. 689), and

(2) Any business development corporation, which for purposes of this section, means a corporation which was created by or pursuant to an act of a State legislature for purposes of promoting, maintaining, and assisting the economy and industry within such State on a regional or statewide basis by making loans which would generally not be made by banks (as defined in section 581 and the regulations thereunder) within such region or State in the ordinary course of their businesses (except on the basis of a partial participation), and which is operated primarily for such purposes.

[T.D. 7444, 41 FR 53482, Dec. 7, 1976]

§1.586–2 Addition to reserve.

(a) *General rule.* Except as provided by paragraph (b) of this section, the amount computed under this section is the amount necessary to increase the balance of the reserve for bad debts (as of the close of the taxable year) to the greater of:

(1) The amount which bears the same ratio to loans outstanding at the close of the taxable year as (i) the total bad debts sustained during the taxable year and the 5 preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period, bears to (ii) the sum of the loans outstanding at the close of such 6 or fewer taxable years, or

(2) The lower of:

(i) The balance of the reserve as of the close of the base year, or

(ii) If the amount of loans outstanding at the close of the taxable year is less than the amount of loans outstanding at the close of the base year, the amount which bears the same ratio to loans outstanding at the close of the taxable year as the balance of the reserve as of the close of the base year bears to the amount of loans outstanding at the close of the base year.

For purposes of subparagraph (2) of this paragraph, the term *base year* means the last taxable year beginning on or before July 11, 1969. For purposes of applying this paragraph, a period shorter than the 6 years generally would be appropriate only where there is a change in the type of a substantial portion of the loans outstanding such that the risk of loss is substantially increased. For example, if the major portion of a business development corporation's portfolio of loans changes from agricultural loans to industrial loans which results in a substantial increase in the risk of loss, a period shorter than the 6 years may be appropriate. If approval is granted to use a shorter period, the experience for those taxable years which are excluded shall not be used for any subsequent year. A request for approval to exclude the experience of a prior taxable year shall not be considered unless it is sent to the Commissioner at least 30 days before the close of the current taxable year. The request shall include a statement of the reasons such experience should be excluded.

(b) *New financial institutions*—(1) *Small business investment companies.* In the case of a new financial institution which is a small business investment company to which section 586 applies, the amount computed under this section is the greater of the amount computed under paragraph (a) of this section or the amount necessary to increase the balance of the reserve for bad debts as of the close of the taxable year to the amount which bears the same ratio to loans outstanding at the close of the taxable year as:

(i) The total bad debts (as determined by the Commissioner) sustained by all such small business investment companies during the 12-month period ending on March 31 that ends with or within the taxpayer's previous taxable year, and during the five 12-month periods ending on March 31 that precede such 12-month period, adjusted for recoveries of bad debts during such periods (as determined by the Commissioner), bears to

(ii) The sum of the loans outstanding (as determined by the Commissioner) by all such small business investment companies at the close of each of such six 12-month periods ending on March 31.

(2) *Business development corporations.* In the case of a new financial institution which is a business development corporation to which section 586 applies, the amount computed under this section is the greater of the amount computed under paragraph (a) of this section or the amount necessary to increase the balance of the reserve for bad debts as of the close of the taxable year to the amount which bears the same ratio to loans outstanding at the close of the taxable year as:

(i) The total bad debts (as determined by the Commissioner) sustained by all such business development corporations during the calendar year ending with or within the taxpayer's previous taxable year and during the 5 calendar years preceding such calendar year, adjusted for recoveries of bad debts during such period (as determined by the Commissioner), bears to

(ii) The sum of the loans outstanding (as determined by the Commissioner) by all such business development corporations at the close of each of such 6 calendar years.

(c) *Definitions.* For purposes of this section:

(1) *New financial institution.* A financial institution is a new financial institution for any taxable year beginning less than 10 years after the day on which it (or any predecessor) was authorized to do business as a financial institution described in the applicable subparagraph of § 1.586–1(b). For this purpose, the term *predecessor* means (i) any taxpayer which transferred more than 50 percent of the total amount of its assets to the taxpayer and is described in the same subparagraph of § 1.586–1(b) which describes the taxpayer, or (ii) any predecessor of such predecessor.

(2) *Loan.* (i) The term *loan* means debt, as the term *debt* is used in section 166 and the regulations there-under.

(ii) The term *loan* does not include the following items:

(A) Discount or interest receivable reflected in the face amount of an outstanding loan, which discount or interest has not been included in gross income;

(B) A debt evidenced by a security (as defined in section 165(g)(2)(C) and the regulations thereunder); and

(C) Any loan which is entered into or acquired for the primary purpose of enlarging the otherwise available bad debt deduction.

[T.D. 7444, 41 FR 53482, Dec. 7, 1976]

MUTUAL SAVINGS BANKS, ETC.

§1.591–1 Deduction for dividends paid on deposits.

(a) *In general.* (1) In the case of a taxpayer described in paragraph (c)(1) or (2) of this section, whichever is applicable, there are allowed as deductions from gross income amounts which during the taxable year are paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts, if such amounts paid or credited are withdrawable on demand subject only to customary notice of intention to withdraw.

(2) The deduction provided in section 591 is applicable to the taxable year in which amounts credited as dividends or interest become withdrawable by the depositor or holder of an account subject only to customary notice of intention to withdraw. Thus, amounts which, as of the last day of the taxable year, are credited as dividends or interest, but which are not withdrawable by depositors or holders of accounts until the following business day, are deductible under section 591 in the year subsequent to the taxable year in which they were so credited. A deduction under this section will not be denied by reason of the fact that the amounts credited as dividends or interest, otherwise deductible under section 591, are subject to the terms of a pledge agreement between the taxpayer and the depositor or holder of an account. In the case of a domestic building and loan association having nonwithdrawable capital stock represented by shares, no deduction is allowable under this section for amounts paid or credited as dividends on such shares. In the case of a taxable year ending after December 31, 1962, for special rules governing the treatment of dividends or interest paid or credited for periods representing more than 12 months, see section 461(e).

(b) *Serial associations, bonus plans, etc.* If a taxpayer described in paragraph (c)(1) or (2) of this section, whichever is applicable, operates in whole or in part as a serial association, maintains a bonus plan, or issues shares, or accepts deposits, subject to fines, penalties, forfeitures, or other withdrawal fees, it may deduct under section 591 the total amount credited as dividends or interest upon such shares or deposits, credited to a bonus account for such shares or deposits, or allocated to a series of shares for the taxable year, notwithstanding that as a customary condition of withdrawal:

(1) Amounts invested in, and earnings credited to, series shares must be withdrawn in multiples of even shares, or

(2) Such taxpayer has the right, pursuant to bylaw, contract, or otherwise, to retain or recover a portion of the total amount invested in, or credited as earnings upon, such shares or deposits, such bonus account, or series of shares, as a fine, penalty, forfeiture, or other withdrawal fee.

In any taxable year in which the right referred to in subparagraph (2) of this paragraph is exercised, there is includible in the gross income of such taxpayer for such taxable year amounts retained or recovered by the taxpayer pursuant to the exercise of such right. If the provisions of paragraph (a) of §1.163–4 (relating to deductions for original issue discount) apply to deposits made with respect to a certificate of deposit, time deposit, bonus plan or other deposit arrangement, the provisions of this paragraph shall not apply.

(c) *Effective date.* The provisions of paragraphs (a) and (b) of this section shall apply to:

(1) Dividends or interest paid or credited after October 16, 1962, by any taxpayer which (at the time of such payment or credit) qualifies as (i) a mutual savings bank not having capital stock represented by shares, (ii) a domestic building and loan association (as defined in section 7701(a)(19)), (iii) a

cooperative bank (as defined in section 7701(a)(32)), or (iv) any other savings institution chartered and supervised as a savings and loan or similar association under Federal or State law; and

(2) Dividends paid or credited before October 17, 1962, by any taxpayer which (at the time of such payment or credit) qualifies as (i) a mutual savings bank not having capital stock represented by shares, (ii) a cooperative bank without capital stock organized and operated for mutual purposes and without profit, or (iii) a domestic building and loan association (as defined in section 7701(a)(19) before amendment by section 6(c) of the Revenue Act of 1962 (76 Stat. 982)).

[T.D. 6728, 29 FR 5855, May 5, 1964, as amended by T.D. 7154, 36 FR 24997, Dec. 28, 1971]

§ 1.592–1 Repayment of certain loans by mutual savings banks, building and loan associations, and cooperative banks.

There is deductible, under section 592, from the gross income of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit, amounts paid by such institutions during the taxable year in repayment of loans made before September 1, 1951, by the United States or any agency or instrumentality thereof which is wholly owned by the United States, or by any mutual fund established under the authority of the laws of any State. For example, amounts paid by such institution in repayment of loans made by the Reconstruction Finance Corporation before September 1, 1951, are deductible under this section. Section 592 is not applicable, however, in the case of amounts paid in repayment of loans made by an agency or instrumentality not wholly owned by the United States.

§ 1.593–1 Additions to reserve for bad debts.

(a) *In general.* A mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit may, as an alternative to a deduction from gross income under section 166(a) for specific debts which become worthless in whole or in part, deduct amounts credited to a reserve for bad debts in the manner and under the circumstances prescribed in this section and § 1.593–2. In the case of such an institution, the selection of either of the alternative methods for treating bad debts may be made by the taxpayer in the return for its first taxable year beginning after December 31, 1951. The method selected shall be subject to the approval of the Commissioner upon examination of the return. If the method selected is approved, it must be followed in returns for subsequent years, unless permission is granted by the Commissioner to change to another method. Application for permission to change the method of treating bad debts shall be made at least 30 days prior to the close of the taxable year for which the change is to be effective.

(b) *Addition to reserve.* Except as otherwise provided in § 1.593–2, the reasonable addition to a reserve for bad debts shall be any amount determined by the taxpayer which does not exceed the lesser of:

(1) The amount of its taxable income for the taxable year, computed without regard to section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income (such as section 170, relating to charitable, etc., contributions and gifts), or

(2) The amount by which 12 percent of the total deposits or withdrawable accounts of its depositors at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of the taxable year.

(c) *Adjustments to reserve.* Bad debt losses sustained during the taxable year shall be charged against the bad debt reserve. Recoveries of debts charged against the bad debt reserve during a prior taxable year in which the institution was subject to tax under chapter 1 of the Internal Revenue Code of 1954 or under chapter 1 of the Internal Revenue Code of 1939 shall be credited to the bad debt reserve. The establishment of such reserve and all adjustments made thereto must be reflected on the regular books of account of the institution at the close of the taxable year, or as soon as practicable thereafter. Minimum amounts credited in compliance with Federal or State statutes, regulations, or supervisory orders to reserve or similar accounts, or additional amounts credited to such reserve or similar accounts and permissive under such statutes, regulations, or orders, against which charges may be made for the purpose of absorbing losses sustained by an institution, will be deemed to have been credited to the bad debt reserve.

(d) *Definitions.* When used in this section and in §1.593–2:

(1) *Institution.* The term *institution* means either a mutual savings bank not having capital stock represented by shares, a domestic building and loan association as defined in section 7701(a)(19), or a cooperative bank without capital stock organized and operated for mutual purposes and without profit.

(2) *Surplus, undivided profits, and reserves.* (i) The phrase *surplus, undivided profits, and reserves* means the amount by which the total assets of an institution exceed the amount of the total liabilities of such an institution.

(ii) For this purpose the term *total assets* means the sum of money, plus the aggregate of the adjusted basis of the property other than money, held by an institution. Such adjusted basis for any asset is its adjusted basis for determining gain upon sale or exchange for Federal income tax purposes. (See sections 1011 through 1022, and the regulations thereunder. For special rules with respect to adjustments to basis for prior taxable years during which the institution was exempt from tax, see section 1016(a)(3) and the regulations thereunder.) The determination of the total assets of any taxpayer shall conform to the method of accounting employed by such taxpayer in determining taxable income and to the rules applicable in determining its earnings and profits.

(iii) The term *total liabilities* means all liabilities of the taxpayer, which are fixed and determined, absolute and not contingent, and includes those items which constitute liabilities in the sense of debts or obligations. The total deposits or withdrawable accounts, as defined in subparagraph (3) of this paragraph, shall be considered a liability. In the case of a building and loan association having permanent nonwithdrawable capital stock represented by shares, the paid-in amount of such stock shall also be considered a liability. Reserves for contingencies and other reserves, however, which are mere appropriations of surplus, are not liabilities.

(3) *Total deposits or withdrawable accounts.* The phrase *total deposits or withdrawable accounts* means the aggregate of (i) amounts placed with an institution for deposit or investment and (ii) earnings outstanding on the books of account of the institution at the close of the taxable year which have been credited as dividends upon such accounts prior to the close of the taxable year, except that such term, in the case of a building and loan association, does not include permanent nonwithdrawable capital stock represented by shares, or earnings credited thereon.

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

Example 1. (i) Institution X, which keeps its books on the basis of the calendar year, has surplus, reserves, and undivided profits of $800,000 as of January 1, 1955, and total deposits or withdrawable accounts of $10,000,000 as of December 31, 1955. During 1955 the institution credits $30,000, as required by a Federal agency, to a Federal insurance reserve for the sole purpose of absorbing losses. Likewise, it credits $25,000, as permitted by State statute, to another reserve fund for the purpose of absorbing losses. In 1955 Institution X charges $5,000 against its bad debt reserve for losses sustained during the taxable year.

(ii) The taxable income of Institution X for the taxable year 1955, computed without regard to section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income, is $200,000.

(iii) Upon the basis of the facts as stated in subdivision (i) of this example, the amount by which 12 percent of the total deposits or withdrawable accounts of Institution X at the close of taxable year 1955 exceeds the sum of such institution's surplus, undivided profits, and reserves at the beginning of the taxable year is $400,000 (12 percent of $10,000,000, minus $800,000).

(iv) Institution X, therefore, may deduct, for the taxable year 1955, as an addition to a reserve for bad debts, any amount it may determine that does not exceed the lesser of the amounts determined in subdivision (ii) or (iii) of this example. That amount is $200,000 (as determined in subdivision (ii) of this example). Since under paragraph (c) of this section, the $30,000 credited to the reserve as required by the Federal agency and the $25,000 credited to the reserve as permitted by the State statute are regarded as amounts credited to a reserve for bad debts account Institution X can credit an additional $145,000 ($200,000 minus $55,000) to a general reserve for bad debts account at any time during the taxable year.

(v) The loss of $5,000 charged to the bad debt reserve during the taxable year does not affect the amount of the addition to the bad debt reserve provided for in paragraph (b) of this section. It is of significance only in determining the surplus, undivided profits, and reserves of Institution X as of January 1, 1956.

Example 2. The taxable income of Institution Y for the taxable year 1955, computed without regard to the deduction under section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income, is determined to be $250,000. The amount by which 12 percent of the total deposits or withdrawable accounts of Institution Y at the close of the taxable year exceeds the sum of such institution's surplus, undivided profits, and reserves at the beginning of the taxable year is $500,000. Institution Y credits $250,000 to its bad debt reserve in 1955. In 1957, it is determined that the correct taxable income of Institution Y for 1955, computed without regard to any deduction under section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income, is $275,000 and not $250,000. Assuming that Institution Y credits the additional $25,000 to its bad debt reserve, $275,000 is allowable as a deduction from gross income for such institution for the taxable year 1955.

§ 1.593–2 Additions to reserve for bad debts where surplus, reserves, and undivided profits equal or exceed 12 percent of deposits or withdrawable accounts.

Where 12 percent of the total deposits or withdrawable accounts of an institution at the close of the taxable year is equal to or less than the sum of such institution's surplus, undivided profits, and reserves at the beginning of the taxable year, a reasonable addition to the reserve for bad debts as determined under the general provisions of section 166(c) may be allowable as a deduction from gross income. In making such determination, there shall be taken into account (a) surplus or bad debt reserves existing at the close of December 31, 1951 (i.e., the amount of surplus, undivided profits, and reserves accumulated prior to January 1, 1952, and in existence at the close of December 31, 1951), and (b) changes in the surplus, undivided profits, and reserves of the institution from December 31, 1951, until the beginning of the taxable year. A deduction for an addition to the reserve for bad debts pursuant to this section will be authorized only in those cases where the institution proves to the satisfaction of the Commissioner that the bad debt experience of the institution warrants an addition to the reserve for bad debts in excess of that provided in paragraph (b) of § 1.593–1. For definitions, see paragraph (d) of § 1.593–1.

§ 1.593–3 Taxable years affected.

Sections 1.593–1 and 1.593–2 apply only to taxable years beginning after December 31, 1953, and ending after August 16, 1954, but before January 1, 1963, and all references to sections of the Code are to the Internal Revenue Code of 1954 before amendment by the Revenue Act of 1962. Sections 1.593–4 through 1.593–11 apply only to taxable years ending after December 31, 1962, and all references to sections of the Code are to the Internal Revenue Code of 1954 after amendment by the Revenue Act of 1962.

[T.D. 6728, 29 FR 5857, May 5, 1964]

§ 1.593–4 Organizations to which section 593 applies.

The provisions of section 593 and §§ 1.593–5 through 1.593–11 (except subsection (f) of section 593 and § 1.593–10) apply to any mutual savings bank not having capital stock represented by shares, any domestic building and loan association, and any cooperative bank without capital stock organized and operated for mutual purposes and without profit. The term *thrift institution*, as used in this section and §§ 1.593–5 through 1.593–11, refers to any such financial institution. For definition of the terms *domestic building and loan association* and *cooperative bank*, see paragraphs (19) and (32), respectively, of section 7701(a).

[T.D. 549, 43 FR 21454, May 18, 1978]

§1.593–5 Addition to reserves for bad debts.

(a) *Amount of addition.* As an alternative to a deduction from gross income under section 166(a) for specific debts which become worthless in whole or in part, a thrift institution is allowed a deduction under section 166(c) for a reasonable addition to a reserve for bad debts. In the case of a thrift institution, the amount of the reasonable addition to such reserve for a taxable year may not exceed:

(1) For taxable years beginning after July 11, 1969, the sum of (i) the amount determined to be the reasonable addition to the reserve for losses on nonqualifying loans, determined in the same manner as is provided with respect to additions to the reserve for losses on qualifying real property loans under paragraph (d) of §1.593–6A (relating to the experience method), and (ii) the amount determined under §1.593–6A to be the reasonable addition to the reserve for losses on qualifying real property loans, or

(2) For taxable years beginning before July 12, 1969, the sum of (i) the amount determined under §1.166–4 to be the reasonable addition to the reserve for losses on nonqualifying loans, and (ii) the amount determined under §1.593–6 to be the reasonable addition to the reserve for losses on qualifying real property loans.

(b) *Crediting to reserves required*—(1) *In general.* The amounts referred to in paragraph (a) (1) and (2) of this section must be credited, respectively, to the reserve for losses on nonqualifying loans and to the reserve for losses on qualifying real property loans by the close of the taxable year, or as soon as practicable thereafter. For rules with respect to accounting for such reserves see paragraph (a)(2) of §1.593–7.

(2) *Subsequent adjustments.* If an adjustment with respect to the income tax return for a taxable year is made, and if such adjustment (whether initiated by the taxpayer or the Commissioner) has the effect of permitting an increase, or requiring a reduction, in the amount claimed on such return as an addition to the reserve for losses on nonqualifying loans or to the reserve for losses on qualifying real property loans, then the amount initially credited to such reserve for such year pursuant to subparagraph (1) of this paragraph may have to be increased or decreased, as the case may be, to the extent necessary to reflect such adjustment.

(c) *Transition year.* For rules governing the computation of taxable income in the case of a taxable year beginning in 1962 and ending in 1963, see §1.593–9.

[T.D. 6728, 29 FR 5857, May 5, 1964, as amended by T.D. 549, 43 FR 21455, May 18, 1978]

§1.593–6 Pre-1970 addition to reserve for losses on qualifying real property loans.

(a) *In general.* For purposes of paragraph (a)(2)(ii) of §1.593–5, the amount of the addition to the reserve for losses on qualifying real property loans for any taxable year beginning before July 12, 1969, is the amount which the taxpayer determines to constitute a reasonable addition to such reserve for such year. However, the amount so determined for such year:

(1) Cannot exceed the largest of the amounts computed under one of the three methods described in paragraph (b), (c), or (d) of this section (relating, respectively, to the percentage of taxable income method, the percentage of real property loans method, and the experience method),

(2) Cannot exceed the maximum permissible addition described in paragraph (e) of this section (if applicable), and

(3) Shall be determined without regard to any amount charged for any taxable year against the reserve for losses on qualifying real property loans pursuant to §1.593–10 (relating to certain distributions to shareholders by a domestic building and loan association).

For each taxable year the taxpayer must include in its income tax return for such year a computation of the addition under this section. The use of a particular method in the return for a taxable year is not a binding election by the taxpayer to apply such method either for such taxable year or for subsequent taxable years. Thus, in the case of a subsequent adjustment described in paragraph (b)(2) of § 1.593–5 which has the effect of permitting an increase, or requiring a reduction, in the amount claimed in the return for a taxable year as an addition to the reserve for losses on qualifying real property loans, the amount of such addition may be recomputed under whichever method the taxpayer selects for the purposes of such recomputation, irrespective of the method initially applied for such taxable year. However, a taxpayer may not subsequently reduce the amount claimed in the return for a taxable year for the purpose of obtaining a larger deduction in a later year.

(b) *Percentage of taxable income method*—(1) *In general.* The amount determined under the percentage of taxable income method for any taxable year is an amount equal to 60 percent of the taxable income for such year, minus the amount determined under § 1.166–4 as a reasonable addition for such year to the reserve for losses on nonqualifying loans. However, the amount determined under such method shall not exceed the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for losses on qualifying real property loans to an amount equal to 6 percent of such loans outstanding at such time.

(2) *Taxable income defined.* For purposes of this paragraph, taxable income shall be computed:

(i) By excluding from gross income any amount included therein by reason of the application of § 1.593–10 (relating to certain distributions to shareholders by a domestic building and loan association);

(ii) Without regard to any deduction allowable under section 166(c) for an addition to a reserve for bad debts;

(iii) Without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income (such as section 170, relating to charitable, etc., contributions and gifts), other than sections 243, 244, and 245 (relating to deductions for dividends received); and

(iv) Without regard to any net operating loss carryback to such year under section 172.

In computing the deductions under sections 243, 244, and 245, section 246(b) (relating to limitation on aggregate amount of deduction) shall not apply. For purposes of subdivision (iii) of this subparagraph, a net operating loss deduction under section 172 is not a deduction the amount of which is dependent upon the amount of taxable income.

(c) *Percentage of real property loans method*—(1) *General rule.* The amount determined under the percentage of real property loans method for any taxable year is the amount necessary to increase the balance (as of the close of such year) of the reserve for losses on qualifying real property loans to:

(i) An amount equal to 3 percent of such loans outstanding at such time, plus

(ii) In the case of a taxpayer described in subparagraph (2) of this paragraph, an amount equal to:

(a) The lesser of 2 percent of such loans outstanding at such time, or $80,000, reduced (but not below zero) by

(b) The balance as of the close of such year, if any, of such taxpayer’s supplemental reserve for losses on loans.

(2) *Certain new companies.* (i) Subparagraph (1)(ii) of this paragraph applies only in the case of a taxpayer which is a new company, and which does not have capital stock with respect to which distributions of property (as defined in section 317(a)) are not allowable as a deduction under section 591.

(ii) For purposes of this subparagraph, a taxpayer is a new company for any taxable year only if such year begins not more than 10 calendar years after the first day on which such taxpayer, or any predecessor of such taxpayer, was authorized by Federal or State law to do business as *(a)* a mutual savings bank not having capital stock represented by shares, *(b)* a domestic building and loan association, *(c)* a cooperative bank without capital stock organized and operated for mutual purposes and without profit, or *(d)* any other savings institution chartered and supervised as a savings and loan or similar association under Federal or State law.

(iii) As used in subdivision (ii) of this subparagraph, the term *calendar year* has the meaning assigned to such term in section 441 (relating to the period for computation of taxable income); and the term *predecessor* means any organization which transferred more than 50 percent of the total amount of its assets to the taxpayer, and which, prior to the time of such transfer, was *(a)* authorized by Federal or State law to do business as a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit, or *(b)* any other savings institution chartered and supervised as a savings and loan or similar association under Federal or State law. The term *predecessor* also means any predecessor of such predecessor.

(d) *Experience method.* The amount determined under the experience method for any taxable year is the amount determined under § 1.166–4 to be a reasonable addition for such year to the reserve for losses on qualifying real property loans.

(e) *Maximum permissible addition where percentage of taxable income method or percentage of real property loans method is applied*—(1) *12 percent of deposits limitation.* If, for the taxable year, the taxpayer uses either the percentage of taxable income method described in paragraph (b) of this section or the percentage of real property loans method described in paragraph (c) of this section, then (unless subparagraph (2) of this paragraph applies) the maximum permissible addition for such year is equal to the lesser of:

(i) The amount determined under such paragraph (b) or (c), or

(ii) An amount which, when added to the amount determined under § 1.166–4 as an addition for such year to the reserve for losses on nonqualifying loans, equals the amount by which 12 percent of the total deposits or withdrawable accounts of depositors of the taxpayer at the close of such year exceeds the sum of the taxpayer's surplus, undivided profits, and reserves at the beginning of such year (taking into account any portion thereof which is attributable to the period before the first taxable year beginning after December 31, 1951).

For definition of the terms *surplus, undivided profits, and reserves* and *total deposits or withdrawable accounts,* see paragraph (f) of this section.

(2) *Special rule where a domestic building and loan association or cooperative bank exceeds certain assets limitations.* If, for the taxable year, the taxpayer uses either the percentage of taxable income method described in paragraph (b) of this section or the percentage of real property loans method described in paragraph (c) of this section, and if for such year such taxpayer qualifies as a domestic building and loan association under the first sentence of paragraph (19) of section 7701(a) (or as a cooperative bank under paragraph (32) thereof) solely by reason of the application of the second sentence of such paragraph (19) (that is, solely by reason of the fact that for such year more than 36 percent, but not more than 41 percent, of the amount of the total assets of such association or bank consists of assets other than assets described in section 7701(a)(19)(D)(ii)), then the maximum permissible addition for such year is equal to the amount determined under subparagraph (1) of this paragraph, reduced in accordance with the following table:

If the percentage of the taxpayer's assets which are not assets described in section 7701(a)(1()(D)(ii) exceeds—*Percent*	But does not exceed—*Percent*	The reduction shall be the following proportion of the amount determined under such subparagraph (1)—
36	37	1⁄12
37	38	1⁄6
38	39	1⁄4
39	40	1⁄3
40	41	5⁄12

(f) *Definitions.* For purposes of this section:

(1) *Surplus, undivided profits, and reserves.* The term *surplus, undivided profits, and reserves* means the amount by which the total assets of the taxpayer exceed its total liabilities. The determination of such total assets and total liabilities shall conform to the method of accounting employed by the taxpayer in determining taxable income and to the rules applicable in determining its earnings and profits. Total deposits or withdrawable accounts (as defined in subparagraph (3) of this

paragraph but determined as of the beginning of the taxable year) shall be considered a liability. In the case of a domestic building and loan association having permanent nonwithdrawable capital stock represented by shares, the paid-in amount of such stock shall also be considered a liability. However, reserves for contingencies and other reserves which are mere appropriations of surplus are not liabilities for purposes of this section.

(2) *Total assets.* The term *total assets* means the sum of money (including time or demand deposits with, or withdrawable accounts in, any financial institution), plus the aggregate of the adjusted basis (determined under § 1.1011–1) of the property other than money held by the taxpayer. For special rules with respect to adjustments to basis in the case of property acquired by the taxpayer in a transaction described in section 595(a), see section 595.

(3) *Total deposits or withdrawable accounts.* The term *total deposits or withdrawable amounts* means the total of the amounts placed with the taxpayer for deposit or investment. Such term also includes earnings outstanding on the books of account of the taxpayer at the close of the taxable year which have been credited as dividends or interest upon such deposits or withdrawable accounts prior to the close of such taxable year, and which are withdrawable on demand subject only to customary notice of intention to withdraw. In the case of a domestic building and loan association, however, such phrase does not include permanent nonwithdrawable capital stock represented by shares, or earnings credited thereon.

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

Example 1—(i) *Facts.* X is a domestic building and loan association which was organized in 1947 and which makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. X's accounts contain the following entries:

Account	Balance as of—	
	Jan. 1, 1965	Dec. 31, 1965
Total deposits or withdrawable accounts	$1,000,000	$1,200,000
Nonqualifying loans	50,000	60,000
Qualifying real property loans	900,000	940,000
Reserve for losses on nonqualifying loans	200	*160
Reserve for losses on qualifying real property loans	24,000	*21,000
Supplemental reserve for losses on loans	60,800	60,800
Surplus, undivided profits, and other reserves	15,000	18,040

*Computed before any addition for 1965 under section 166(c).

X's taxable income for 1965 (before any deductible addition to a reserve for bad debts and without regard to charitable contributions of $200) is $20,000, computed as follows:

Interest and other income	$19,940
Dividends received from Y Corporation, a domestic corporation subject to taxation under chapter 1 of the Code	400
	20,340
Deduction for 85 percent of dividends received computed without regard to the limitation of section 246(b)	340
Taxable income	20,000

It is assumed that under § 1.166–4 X's addition for 1965 to its reserve for losses on nonqualifying loans is $80.

(ii) *Computation of addition to reserve for losses on qualifying real property loans—(a) In general.* X determines that the reasonable addition for 1965 to its reserve for losses on qualifying real property loans is $11,920. Such amount, compared under the percentage of taxable income method, is the largest of the amounts determined under *(b), (c),* and *(d)* of this subdivision, and does not exceed the 12 percent of deposits limitation computed under *(e)* of this subdivision.

(b) Percentage of taxable income method. The amount determined under the percentage of taxable income method is $11,920, that is, 60 percent of the taxable income for 1965, or $12,000 (60 percent of $20,000), minus $80, the addition for such year to the reserve for losses on nonqualifying loans. This amount is not subject to reduction under the 6 percent of qualifying real property loans limitation described in paragraph (b) (1) of this section since the addition of $11,920 to the $21,000 balance of the reserve for losses on qualifying real property loans at the close of 1965 will not increase such balance to an amount in excess of $56,400, that is, 6 percent of such loans of $940,000 outstanding at such time.

(c) Percentage of real property loans method. Since X is not a new company within the meaning of paragraph (c) (2) of this section, the amount determined under the percentage of real property loans method is $7,200, that is, the amount necessary to increase the balance of the reserve for losses on qualifying real property loans at the close of 1965 from $21,000 to an amount equal to 3 percent of such loans outstanding at such time, or $28,200 (3 percent of $940,000).

(d) Experience method. The amount determined under the experience method is zero since it is assumed that the $21,000 balance of the reserve for losses on qualifying real property loans at the close of 1965 before any addition for such year exceeds the maximum amount to which such reserve could be increased under such method.

(e) 12 percent of deposits limitation. The amount determined under the 12 percent of deposits limitation is $43,920, that is, $44,000 (the excess of 12 percent of $1,200,000 of deposits at the close of 1965, or $144,000, over the $100,000 of surplus, undivided profits, and reserves at the beginning of such year), minus $80, the addition for such year to the reserve for losses on nonqualifying loans. Since such $43,920 is greater than $11,920 (the amount determined under (b) of this subdivision), the 12 percent of deposits limitation does not apply for 1965.

(iii) *Computation of taxable income for 1965.* X's taxable income for 1965, after deducting the additions for such year to its reserves for losses on nonqualifying loans and on qualifying real property loans, after deducting the charitable contributions which were not taken into account in computing taxable income for purposes of the addition to the reserve for losses on qualifying real property loans, after including in taxable income dividends received from Y Corporation, and after taking into account the deduction for dividends received under section 243 (subject to the limitation in section 246(b)), is $7,800, computed as follows:

Interest and other income	$19,940	
Dividends received from Y Corporation	400	
		$20,340
Less:		
Deduction for charitable contributions	200	
85 percent of dividends received from Y Corporation	340	
Additions to reserves for bad debts	12,000	
		12,540
Taxable income		7,800

Example 2. Assume the same facts as in example 1, except that X Corporation was organized in 1957, and qualifies for the taxable year 1965 as a new company within the meaning of paragraph (c) (2) of this section. The maximum permissible addition for 1965 to X's reserve for losses on qualifying real property loans is $18,000, the amount computed under the percentage of real property loans method, since such amount is greater than (i) $11,920, the amount computed under the percentage of taxable income method, or (ii) zero, the amount computed under the experience method. The $18,000 amount (as computed under the percentage of real property loans method) is the amount necessary to increase the reserve for losses on qualifying real property loans from the $21,000 closing balance to $39,000, computed as follows:

3 percent of $940,000 of qualifying real property loans at close of 1965		$28,200
Plus:		
Lesser of $80,000 or $18,800 (2 percent of such loans of $940,000)	$18,800	
Reduced by the balance of supplemental reserve for losses on loans	8,000	
	$10,800	
		39,000

Example 3. Assume the same facts as in example 1, except that for 1965, 38.4 percent of X's total assets consist of assets other than the assets described in section 7701(a)(19)(D)(ii). In such case, the maximum permissible addition of $11,920 for such year to the reserve for losses on qualifying real property loans (as determined under subdivision (ii) of example 1) would be reduced by $2,980 (¼ of $11,920) to $8,940.

[T.D. 6728, 29 FR 5857, May 5, 1964, as amended by T.D. 549, 43 FR 21455, May 18, 1978]

§1.593–6A Post-1969 addition to reserve for losses on qualifying real property loans.

(a) *In general*—(1) *Amount of addition determined for the taxable year.* For purposes of paragraph (a)(1)(ii) of §1.593–5, the amount of the addition to the reserve for losses on qualifying real property loans for any taxable year beginning after July 11, 1969, is the amount which the taxpayer determines to constitute a reasonable addition to such reserve for such year. However, the amount so determined for such year:

(i) Cannot exceed the largest of the amount determined under section 593 (b) (2), (3), or (4) (relating, respectively, to the percentage of taxable income method, the percentage method, and the experience method), and

(ii) Shall be determined without regard to any amount charged for any taxable year against the reserve for losses on qualifying real property loans pursuant to §1.593–10 (relating to certain distributions to shareholders by a domestic building and loan association).

For each taxable year the taxpayer must include in its income tax return for such year a computation of the amount of the addition determined under this section. The use of a particular method in the return for a taxable year is not a binding election by the taxpayer to apply such method either for such taxable year or for subsequent taxable years. Thus, in the case of a subsequent adjustment described in paragraph (b)(2) of §1.593–5 which has the effect of permitting an increase, or requiring a reduction, in the amount claimed in the return for a taxable year as an addition to the reserve for losses on qualifying real property loans, the amount of such addition may be recomputed under whichever method the taxpayer selects for the purpose of such recomputation, irrespective of the method initially applied for such taxable year.

(2) *Method of determination.* For purposes of this section and §1.596–1 (relating to limitation on dividends received deduction), a thrift institution is deemed to have determined the addition to its reserve for losses on qualifying real property loans for the taxable year under the percentage of taxable income method provided by section 593(b)(2) and paragraph (b) of this section if the amount finally determined to be a reasonable addition for such year to such reserve exceeds the amount determined for such year under section 593(b)(3) (relating to the percentage method) and exceeds the amount determined for such year under section 593(b)(4) (relating to the experience method).

(b) *Percentage of taxable income method*—(1) *In general.* Subject to the limitations described in subparagraph (4) of this paragraph and in paragraph (e) of this section, the amount determined under section 593(b)(2) and this paragraph for the taxable year, if such section and paragraph are applicable, is an amount equal to the applicable percentage of the taxable income for such year, reduced by the amount determined under subparagraph (3) of this paragraph. For this purpose, taxable income is computed as provided in subparagraph (5) of this paragraph, and the applicable percentage (except as reduced under subparagraph (2) of this paragraph) is determined under the following table:

For a taxable year beginning in—	The applicable percentage under this subparagraph is—
1969	60 percent.
1970	57 percent.
1971	54 percent.
1972	51 percent.
1973	49 percent.
1974	47 percent.
1975	45 percent.
1976	43 percent.
1977	42 percent.
1978	41 percent.
1979 or thereafter	40 percent.

(2) *Reduction of applicable percentage in certain cases*—(i) *General rules.* If for the taxable year the percentage of the assets of a thrift institution, which are assets described in section 7701(a)(19)(C) (relating to assets of a domestic building and loan association) is less than:

(*a*) 82 percent of the total assets in the case of a thrift institution other than a mutual savings bank, the applicable percentage for such year provided by subparagraph (1) of this paragraph is reduced by three-fourths of 1 percentage point for each 1 percentage point of such difference; or

(*b*) 72 percent of the total assets in the case of a thrift institution which is a mutual savings bank, the applicable percentage for such year provided by subparagraph (1) of this paragraph is reduced by 1½ percentage points for each 1 percentage point of such difference.

If such percentage is less than 60 percent of the total assets in the case of any thrift institution (less than 50 percent of the total assets for a taxable year beginning before 1973 in the case of a thrift institution which is a mutual savings bank), section 593(b)(2) and this paragraph are not applicable. The percentage of total assets specified in this subparagraph is computed as of the close of the taxable year or, at the option of the taxpayer, may be computed on the basis of the average assets outstanding during the taxable year. Such average is determined by computing such percentage either as of the close of each month, as of the close of each quarter, or as of the close of each semiannual period during the taxable year and by using the yearly average of the monthly, quarterly, or semiannual percentages. A thrift institution which is a mutual savings bank and which determines the amount of the reasonable addition for the taxable year to the reserve for losses on qualifying real property loans under this paragraph shall file for such taxable year a statement which shall show the amount of assets defined in paragraph (e) of §402.1–2 (Temporary Regulations on Procedure and Administration under Tax Reform Act of 1969) as of the close of the taxable year and a brief description and the amount of all other assets, together with a description of the method used in determining such amounts. If the percentage specified in this subparagraph is computed by such thrift institution on the basis of the average assets outstanding during the taxable year, the statement shall also show such information as of the end of each month, each quarter, or each semiannual period and the manner of calculating the average.

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

Example. M is a cooperative bank to which section 593 applies. For its taxable year beginning in 1970, 80.4 percent of M's assets (computed as of the close of such year) constitute assets described in section 7701(a)(19)(C). M's assets which are assets described in section 7701(a)(19)(C), when computed on semiannual, quarterly, and monthly bases, constitute 79.8, 79.6, and 79.5 percent, respectively, of its total assets computed on the corresponding bases. M's applicable percentage for 1970 is 56.25 percent, determined as follows:

	Percent
Percentage of total assets specified in (*a*) of subdivision (i) of this subparagraph	82.0
Percentage of total assets constituting assets described in section 7701(a)(19)(C)	80.4
Difference	1.6
Applicable percentage determined under table in subparagraph (1) of this paragraph	57.0
Reduction of applicable percentage required by (*a*) of subdivision (i) of this subparagraph (¾ of 1 percentage point for each full percentage point of difference)	.75
Applicable percentage	56.25

(3) *Reduction for addition to reserve for nonqualifying loans*—(i) *General rule.* Subparagraph (1) of this paragraph provides that, subject to certain limitations, the amount determined under the percentage of taxable income method provided by section 593(b)(2) and this paragraph for the taxable year is an amount equal to the applicable percentage of the taxable income for such year, reduced by the amount determined under this subparagraph. In the case of a thrift institution other than a mutual savings bank, the amount determined under this subparagraph is an amount equal to the amount determined under paragraph (a)(1)(i) of §1.593–5 to be a reasonable addition for the taxable year to the reserve for losses on nonqualifying loans multiplied by a fraction:

(a) The numerator of which is 18 percent, and

(b) The denominator of which is the percentage (in no case less than 18 percent) of the assets of the taxpayer for such year which are not assets defined in paragraph (e) of §402.1–2 of this chapter.

In the case of a thrift institution which is a mutual savings bank, the amount determined under this subparagraph is an amount determined in the manner described in the preceding sentence, except that the numerator of the fraction described therein is 28 percent, and the denominator of such fraction shall not be less than 28 percent. For purposes of this subparagraph, the percentage of assets for a taxable year which are not assets defined in paragraph (e) of §402.1–2 of this chapter is determined upon the same annual or average basis as is used in determining the percentage specified in subparagraph (2) of this paragraph.

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

Example 1. K is a domestic building and loan association to which section 593 applies. The amount determined under subparagraph (1) of this paragraph (before reduction by the amount determined under this subparagraph) to be the reasonable addition for the taxable year to K's reserve for losses on qualifying real property loans is $100,000. The amount determined under paragraph (a)(1)(i) of § 1.593–5 as the reasonable addition for the taxable year to the association's reserve for losses on nonqualifying loans is $10,000. The percentage of K's assets which are not assets defined in paragraph (e) of § 402.1–2 is 24 percent. The amount determined under subparagraph (1) of this paragraph ($100,000) must be reduced by $7,500.

$10,000×18 percent/24 percent.

Therefore, subject to the limitations described in subparagraph (4) of this paragraph and in paragraph (e) of this section, the amount determined under this paragraph to be the reasonable addition for the taxable year to K's reserve for losses on qualifying real property loans is $92,500 ($100,000 less $7,500).

Example 2. The facts are the same as in example 1, except that the percentage of K's assets which are not assets defined in paragraph (e) of § 402.1–2 is 12 percent. The amount determined under subparagraph (1) of this paragraph (before reduction by the amount determined under this subparagraph) to be the reasonable addition for the taxable year to K's reserve for losses on qualifying real property loans must be reduced by $10,000.

$10,000×18 percent/18 percent.

Because the denominator of the fraction may not be less than 18 percent, the fraction used in determining the amount of such reduction is equal to 1.

(4) *Overall limitation.* The amount determined under this paragraph shall not exceed the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for losses on qualifying real property loans to 6 percent of such loans outstanding at such time.

(5) *Computation of taxable income.* For purposes of this paragraph, taxable income is computed:

(i) By excluding from gross income any amount included therein by reason of the application of section 593(e) and § 1.593–10 (relating to certain distributions to shareholders by a domestic building and loan association).

(ii) Without regard to any deduction allowable under section 166(c) (whether or not determined under section 593) and the regulations thereunder for an addition to a reserve for bad debts.

(iii) (*a*) By excluding from gross income an amount equal to the excess (if any) or (*1*) the total gains of the taxable year arising from sales and exchanges at a gain of (*i*) obligations the interest on which is excludable from gross income under section 103, and (*ii*) corporate stock, over (*2*) the total losses of such year arising from sales and exchanges at a loss of such obligations and stock.

(*b*) The provisions of this subdivision (iii) may be illustrated by the following example:

Example. For its taxable year beginning in 1971, the gains and losses of a domestic building and loan association from sales of stock and securities (all of which were made on December 31, 1971) were as follows:

	Gain	Loss
Municipal bonds acquired July 1, 1969, the interest on which is excludable from income under sec. 103	$25,000	....
Stock of Corporation A, acquired July 14, 1971	....	$6,000
Stock of Corporation B, acquired Dec. 22, 1970	$3,000	....

For purposes of this paragraph, the association's taxable income for 1971 is computed by excluding $22,000 ($25,000+$3,000−$6,000) from its gross income.

(iv) By excluding from gross income an amount equal to the lesser of (*a*) three-eighths of the net long-term capital gain for the taxable year or (b) three-eighths of the net long-term capital gain for the taxable year from the sale or exchange of property other than property described in subdivision (iii) of this subparagraph.

(v)(*a*) By excluding from gross income so much of the amount of dividends with respect to which a deduction is allowable under part VIII, subchapter B, chapter 1, subtitle A of theCode (section 241 and following) as is in excess of the applicable percentage (determined under subparagraphs (1) and (2) of this paragraph) of the dividends received deduction (determined under part VIII, subchapter B, chapter 1, subtitle A of the Code, without regard to section 596) for the taxable year.

(*b*) The provisions of this subdivision (v) may be illustrated by the following example:

Example. For its taxable year beginning in 1977, a domestic building and loan association receives dividends of $100 with respect to which a dividends received deduction of $85 is allowable under section 243(a)(1). The association receives no other dividends for the taxable year. The association's applicable percentage for the taxable year, as determined under subparagraphs (1) and (2) of this paragraph, is 42 percent. For purposes of this paragraph, the association's taxable income is computed by excluding from gross income the excess of the amount of dividends received ($100) over the applicable percentage of the allowable dividends received deduction (42 percent of $85, or $35.70), computed without regard to section 596. Thus, for purposes of this paragraph, $64.30 ($100 less $35.70) is excluded from gross income. See section 596 and §1.596–1 with respect to the computation of the dividends received deduction for purposes of determining taxable income under section 63(a).

(vi) For taxable years beginning before January 1, 1978, without regard to any deduction the amount of which is computed upon, or may be subject to a limitation computed upon, the amount of taxable income, and without regard to any net operating loss carryback to such year from a taxable year beginning before January 1, 1979. (For purposes of this subparagraph, a net operating loss deduction under section 172 is not a deduction the amount of which may be subject to a limitation computed upon the amount of taxable income.)

(vii) For taxable years beginning after December 31, 1977, by taking into account any deduction the amount of which is computed upon or may be subject to a limitation computed upon the amount of taxable income, and any other deduction or loss allowed under subtitle A of the Code, such as any deduction allowable under section 172 or any loss allowable under section 1212 (a), unless otherwise provided in this subparagraph.

(c) *Percentage method.* [Reserved]

(d) *Experience method.* [Reserved]

(e) *Percentage of deposits limitation where percentage of taxable income method or percentage method is applied.* If the amount determined by the taxpayer to constitute a reasonable addition for the taxable year to the reserve for losses on qualifying real property loans is greater than the amount determined under paragraph (d) of this section (relating to the experience method), the amount so determined cannot exceed an amount which, when added to the amount determined under paragraph (a)(1)(i) of §1.593–5 to be a reasonable addition for such year to the reserve for losses on nonqualifying loans, equals the amount by which 12 percent of the total deposits or withdrawable accounts of depositors of the taxpayer at the close of such year exceeds the sum of the taxpayer's surplus, undivided profits, and reserves at the beginning of such year (taking into account any portion thereof which is attributable to the period before the first taxable year beginning after December 31, 1951. The terms *surplus, undivided profit, and reserves* and *total deposits or withdrawable accounts* have the same meanings as are assigned to them in paragraph (f) of §1.593.6.

[T.D. 549, 43 FR 21455, May 18, 1978, as amended by T.D. 7626, 44 FR 31177, May 31, 1979]

§1.593–7 Establishment and treatment of reserves for bad debts.

(a) *Establishment of reserves*—(1) *In general.* A taxpayer described in §1.593–4 shall establish and maintain a reserve for losses on nonqualifying loans, a reserve for losses on qualifying real property loans, and, if required under paragraph (b)(4) or (c)(3)(i)(*c*) of this section, a supplemental reserve for losses on loans. For rules governing the crediting of additions to the reserve for losses on nonqualifying loans and the reserve for losses on qualifying real property loans, see paragraph (b) of §1.593–5.

(2) *Accounting for reserves.* (i) The taxpayer shall establish and maintain as a permanent part of its regular books of account an account for each of the reserves established pursuant to subparagraph (1) of this paragraph. For purposes of the preceding sentence, a taxpayer may establish and maintain a permanent subsidiary ledger containing an account for each of such reserves. If a taxpayer maintains such a permanent subsidiary ledger, the total of the reserve accounts in such ledger and the total of the reserve accounts in any other ledger must be reconciled.

(ii) Any credit or charge to a reserve established pursuant to subparagraph (1) of this paragraph must be made to such reserve irrespective of whether the amount thereof is also credited or charged to any surplus, reserve, or other account which the taxpayer may be required or permitted to maintain pursuant to any Federal or State statute, regulation, or supervisory order. Minimum amounts credited in compliance with such Federal or State statutes, regulations, or supervisory orders to reserve or similar accounts, or additional amounts credited to such reserve or similar accounts and permissible under such statutes, regulations, or orders, against which charges may be made for the purpose of absorbing losses sustained by the taxpayer, may also be credited to the reserve for losses on nonqualifying loans or the reserve for losses on qualifying real property loans, provided that the total of the amounts so credited to the reserve for losses on nonqualifying loans, or to the reserve for losses on qualifying real property loans, for any taxable years does not exceed the amount described in subparagraph (1) or (2) of §1.593–5(a) (whichever applies) as the addition to such reserve for such year year.

(b) *Allocation of pre-1963 reserves*— (1) *In general.* In the case of a taxpayer described in §1.593–4, the pre-1963 reserves, if any, of such taxpayer shall be allocated to (and constitute the opening balance of) the reserve for losses on nonqualifying loans, the reserve for losses on qualifying real property loans, and, if required under subparagraph (4) of this paragraph, the supplemental reserve for losses on loans. The term *pre-1963 reserves* means the net amount (determined as of the close of December 31, 1962) accumulated for taxable years beginning after December 31, 1951, in the taxpayer's reserve for bad debts pursuant to section 166(c) of the Internal Revenue Code of 1954 and section 23(k) (1) of the Internal Revenue Code of 1939 (including the amount of any bad debt reserves acquired from another taxpayer). For purposes of the preceding sentence in the case of a taxable year beginning before January 1, 1963, and ending after December 31, 1962, the part of such year occurring before January 1, 1963, shall be treated as a taxable year. Thus, the pre-1963 reserves of the taxpayer shall be an amount equal to:

(i) The sum of the amounts allowed as deductions for additions to a reserve for bad debts for taxable years beginning after December 31, 1951, and ending before January 1, 1963, plus

(ii) In the case of a taxable year beginning before January 1, 1963, and ending after December 31, 1962, the amount (determined under §1.593–1 or 1.593–2) which would be allowable under section 166(c) as a deduction for an addition to a reserve for bad debts for the part of such year occurring before January 1, 1963, if such part year constituted a taxable year, minus

(iii) The total amount of bad debts charged against a reserve for bad debts during the period which begins with the opening of the first taxable year beginning after December 31, 1951, and which ends at the close of December 31, 1962 plus

(iv) The total amount of recoveries during the period described in subdivision (iii) of this subparagraph, on bad debts charged against a reserve for bad debts in a taxable year beginning after December 31, 1951.

(2) *Allocation to opening balance of reserve for losses on nonqualifying loans.* (i) As of the close of December 31, 1962 the pre-1963 reserves shall first be allocated to (and constitute the opening balance of) the reserve for losses on nonqualifying loans in an amount equal to the lesser of *(a)* the amount of such pre-1963 reserves, or *(b)* the amount determined under subdivision (ii) of this subparagraph.

(ii) The amount referred to in subdivision (i)*(b)* of this subparagraph shall be the amount which would constitute a reasonable addition to the reserve for losses on nonqualifying loans under §1.166–4 for a period in which the taxpayer's nonqualifying loans increased from zero to the amount thereof outstanding at the close of December 31, 1962.

(3) *Allocation to opening balance of reserve for losses on qualifying real property loans.* (i) Any portion of the pre-1963 reserves remaining after the allocation provided in subparagraph (2) of this paragraph shall, as of the close of December 31, 1962, be allocated to (and constitute the opening balance of) the reserve for losses on qualifying real property loans in an amount equal to the lesser of *(a)* the amount of such remaining portion, or *(b)* the amount determined under subdivision (ii) of this

subparagraph. If the amount described in *(a)* of the preceding sentence is less than the amount described in *(b)* thereof, see §1.593–8 for allocation of pre-1952 surplus, if any, to the opening balance of such reserve.

(ii) The amount referred to in subdivision (i)*(b)* of this subparagraph shall be an amount equal to the greater of:

(a) 3 percent of the taxpayer's qualifying real property loans outstanding at the close of December 31, 1962, or

(b) The amount which would constitute a reasonable addition to the reserve for losses on such loans under §1.166–4 for a period in which the amount of such loans increased from zero to the amount thereof outstanding at the close of December 31, 1962.

(4) *Allocation to supplemental reserve for losses on loans.* Any portion of the pre-1963 reserves remaining after the allocations provided in subparagraphs (2) and (3) of this paragraph shall be allocated in its entirety to the supplemental reserve for losses on loans. (5) *Examples.* This paragraph may be illustrated by the following examples:

Example 1—(i) *Facts.* X Corporation, a domestic building and loan association organized on April 1, 1954, makes its returns on the basis of a taxable year ending March 31 and the reserve method of accounting for bad debts. For its taxable years ending March 31, 1955, through March 31, 1962, X was allowed a total of $750,000 as deductible additions to its reserve for bad debts under section 166(c). For its taxable year ending March 31, 1963, X was allowed a deduction under section 166(c) for an addition to a reserve for bad debts. Of such deduction $46,000 was determined under §1.593–1 (relating to additions to reserve for bad debts) by reference to §1.593–9 (relating to taxable income for taxable years beginning in 1962 and ending in 1963) as the amount which would be allowable for the period April 1 through December 31, 1962, if such period constituted a taxable year. During the taxable years ending March 31, 1955, through March 31, 1963, X charged bad debts of $55,000 against its reserve for bad debts and made recoveries on such debts of $10,000. Of such bad debt charges and recoveries, $50,000 was charged off and $9,000 was recovered prior to January 1, 1963. At the close of December 31, 1962, X had outstanding nonqualifying loans of $500,000 and outstanding qualifying real property loans of $10 million. It is assumed that, under §1.166–4, $2,000 would constitute a reasonable addition to the reserve for losses on nonqualifying loans for a period in which such loans increased from zero to $500,000 and $20,000 would constitute a reasonable addition to the reserve for losses on qualifying real property loans for a period in which such loans increased from zero to $10 million.

(ii) *Pre-1963 reserves determined.* X's pre-1963 reserves are $755,000, computed as follows:

Deductible additions to reserve for bad debts:.		
Years ending March 31, 1955 through March 31, 1962	$750,000	
Period April 1 through December 31, 1962	46,000	
		$796,000
Less:		
Net bad debt losses for period April 1, 1954 through December 31, 1962:		
Bad debts	50,000	
Recoveries	(9,000)	41,000
		755,000

(iii) *Allocation to opening balance of reserve for losses on nonqualifying loans.* The portion of the $755,000 of pre-1963 reserves to be allocated to the reserve for losses on nonqualifying loans as the opening balance thereof is $2,000 since such amount would constitute a reasonable addition to the reserve for losses on nonqualifying loans under §1.166–4 for a period in which the amount of such loans increased from zero to $500,000.

(iv) *Allocation to opening balance of reserve for losses on qualifying real property loans.* Of the $753,000 ($755,000 minus $2,000) of pre-1963 reserves remaining after the allocation described in subdivision (iii) of this example, $300,000 (3 percent of $10 million, the total amount of qualifying real property loans outstanding at the close of December 31, 1962) is allocated to the opening balance of the reserve for losses on qualifying real property loans, since such amount is greater than $20,000, the amount which would constitute a reasonable addition to the reserve for losses on such loans under §1.166–4 for a period in which the amount of such loans increased from zero to $10 million.

(v) *Allocation to supplemental reserve for losses on loans.* The balance of the pre-1963 reserves, or $453,000 ($755,000 minus the sum of $2,000 and $300,000), is allocated in its entirety to the supplemental reserve for losses on loans.

Example 2. Assume the same facts as in example 1, except that X was organized in 1936, and on December 31, 1962, had pre-1963 reserves of only $15,000 (rather than $755,000). In such case, $2,000 of such pre-1963 reserves would be allocated to, and constitute the opening balance of, the reserve for losses on nonqualifying loans, and $13,000 ($15,000 minus $2,000) would be allocated to and constitute part of the opening balance of the reserve for losses on qualifying real property loans. However, since such $13,000 is less than $300,000 (3 percent of $10 million), the opening balance of the reserve for losses on qualifying real property loans must be increased by so much of the taxpayer's pre-1952 surplus as is necessary to increase such opening balance to $300,000. For rules on the allocation of pre-1952 surplus to the opening balance of the reserve for losses on qualifying real property loans, see § 1.593–8.

(c) *Treatment of reserves*—(1) *In general.* Except as provided in paragraph (d) of § 1.593–8 (relating to the allocation of pre-1952 surplus), each of the reserves established pursuant to paragraph (a) of this section shall be treated, for purposes of subtitle A of the Code, as a reserve for bad debts, except that no deduction shall be allowed under section 166 for any addition to the supplemental reserve for losses on loans. Accordingly, if in any taxable year the taxpayer charges any of the reserves established pursuant to paragraph (a) of this section for an item other than a bad debt, gross income for such year shall be increased by the amount of such charge. For special rules in case of certain nondeductible distributions to shareholders by a domestic building and loan association, see § 1.593–10.

(2) *Bad debt losses.* Any bad debt in respect of a nonqualifying loan shall be charged against the reserve for losses on nonqualifying loans, and any bad debt in respect of a qualifying real property loan shall be charged against the reserve for losses on qualifying real property loans. At the option of the taxpayer, however, any bad debt in respect of either class of loans may be charged in whole or in part against the supplemental reserve for losses on loans.

(3) *Recoveries of bad debts.* Any amount recovered after December 31, 1962, in respect of a bad debt shall be credited to the reserves established pursuant to paragraph (a) of this section in the following manner:

(i) If the recovery is in respect of a bad debt which was charged prior to January 1, 1963, against a reserve for bad debts established pursuant to section 166(c) of the Internal Revenue Code of 1954, or section 23(k)(1) of the Internal Revenue Code of 1939, then the amount recovered shall be credited:

(a) First, to the reserve for losses on nonqualifying loans in an amount equal to the amount, if any, by which the amount determined under subdivision (ii) of paragraph (b)(2) of this section exceeds the opening balance of such reserve (determined under such paragraph (b)(2)),

(b) Second, to the reserve for losses on qualifying real property loans in an amount equal to the amount, if any, by which the amount determined under subdivision (ii) of paragraph (b)(3) of this section exceeds the opening balance of such reserve (determined under such paragraph (b)(3)), and

(c) Finally, to the supplemental reserve for losses on loans.

For purposes of determining the amounts of the credits under *(a)* and *(b)* of this subdivision, the opening balances of the reserve for losses on nonqualifying loans and the reserve for losses on qualifying real property loans shall be deemed to include the sum of the amounts of any prior credits made to such reserves pursuant to this subdivision.

(ii) If the recovery is in respect of a bad debt which is charged after December 31, 1962, against only one of the reserves established pursuant to paragraph (a) of this section, the entire amount recovered shall be credited to the reserve so charged.

(iii) If the recovery is in respect of a bad debt which is charged after December 31, 1962, against more than one of the reserves established pursuant to paragraph (a) of this section, then the amount recovered shall be credited to each of the reserves so charged in the ratio which the amount of the bad debt charged against such reserve bears to the total amount of such bad debt charged against both such reserves.

(iv) Subdivision (i) of this subparagraph may be illustrated by the following example:

Example. In 1962, the taxpayer sustained a bad debt of $10,000, which was charged against a reserve for bad debts established pursuant to section 166(c). As of the close of December 31, 1962, the balance of the taxpayer's reserve for losses on nonqualifying loans was $2,000, the amount determined under paragraph (b)(2)(ii) of this section. As of the same time, the balance of the taxpayer's reserve for losses on qualifying real property loans was $100,000, but the amount determined under paragraph (b)(3)(ii) of this section was $106,000. In 1963, the taxpayer recovers $8,000 of the $10,000 charged off in 1962. Of the $8,000 recovered in 1963, $6,000 ($106,000 minus $100,000) is credited to the reserve for losses on qualifying real property loans, and the balance of $2,000 is credited to the supplemental reserve for losses on loans.

[T.D. 6728, 29 FR 5859, May 5, 1964, as amended by T.D. 549, 43 FR 21457, May 18, 1978]

§1.593–8 Allocation of pre-1952 surplus to opening balance of reserve for losses on qualifying real property loans.

(a) *General rule.* In the case of a taxpayer described in §1.593–4, if the amount of pre-1963 reserves allocated (under paragraph (b)(3)(i) of §1.593–7) to the opening balance of the reserve for losses on qualifying real property loans is less than an amount equal to the greater of:

(1) The total amount of qualifying real property loans outstanding at the close of December 31, 1962, multiplied by 3 percent, or

(2) The amount which would constitute a reasonable addition to the reserve for losses on such loans under §1.166–4 for a period in which the amount of such loans increased from zero to the amount thereof outstanding at the close of December 31, 1962,

then such opening balance shall be increased by an amount equal to so much of the *pre-1952 surplus* of the taxpayer as is necessary to increase such opening balance to the greater of the amounts described in subparagraph (1) or (2) of this paragraph. The amount of such increase shall be deemed to be included in such opening balance solely for the limited purpose described in paragraph (d) of this section.

(b) *Pre-1952 surplus defined*—(1) *In general.* For purposes of this section and §1.593–7, the term *pre-1952 surplus* means an amount equal to:

(i) The sum of the taxpayer's surplus, undivided profits, and reserves determined (under the principles of paragraph (d)(2) of §1.593–1) as of the close of the taxpayer's last taxable year beginning before January 1, 1952 (including any amount acquired from another taxpayer), minus

(ii) The amount of any impairments of such sum (as determined under paragraph (c) of this section).

(2) *Reduction for certain excludable interest.* (i) The amount otherwise determined under subparagraph (1) of this paragraph may, at the option of the taxpayer, be reduced by the portion, if any, of such amount which is attributable to interest which would have been excludable from gross income of such taxpayer under section 22(b)(4) of the Internal Revenue Code of 1939 (relating to interest on governmental obligations) or the corresponding provisions of prior revenue laws, had such taxpayer been subject, when such interest was received or accrued, to the income tax imposed by such Code or prior revenue laws.

(ii) For purposes of subdivision (i) of this subparagraph, the portion of the amount otherwise determined under subparagraph (1) of this paragraph which is attributable to interest which would have been excludable from gross income shall be determined by multiplying such amount by the ratio which:

(a) The total amount of such excludable interest for the period before the taxpayer's first taxable year beginning after December 31, 1951, bears to

(b) The total amount of the taxpayer's gross income, plus the total amount of such excludable interest, for such period.

If the amount determined under subparagraph (1)(i) of this paragraph includes any amount acquired from another taxpayer, then the gross income and excludable interest of the taxpayer for the period before its first taxable year beginning after December 31, 1951, shall include the gross income and excludable interest (for the same period) of such other taxpayer.

(c) *Impairment of surplus, undivided profits, and reserves*—(1) *General rule.* In the case of a taxable year beginning after December 31, 1951, and ending before January 1, 1963, if for such year:

(i) The amount described in paragraph (b)(1)(i) of this section (as decreased under subparagraph (3)(i) of this paragraph), exceeds

(ii) The sum of the taxpayer's surplus, undivided profits, and reserves (excluding the amount of any pre-1963 reserves) determined as of the close of such year under the principles of paragraph (d)(2) of § 1.593–1,

then the amount described in paragraph (b)(1)(i) of this section may, at the option of the taxpayer, be reduced by the amount of such excess.

(2) *Transition year.* In the case of a taxable year beginning before January 1, 1963, and ending after December 31, 1962, the part of such year which occurs before January 1, 1963, shall be considered to be a taxable year for purposes of subparagraph (1) of this paragraph.

(3) *Rules for applying subparagraph (1).* (i) For purposes of subparagraph (1)(i) of this paragraph, the amount described in paragraph (b)(1)(i) of this section shall be decreased by the total of any reductions under subparagraph (1) of this paragraph for prior taxable years; and

(ii) For purposes of subparagraph (1)(ii) of this paragraph, the term *pre-1963 reserves* means the amount determined under the principles of paragraph (b)(1) of § 1.593–7 for the period which begins with the first day of the first taxable year beginning after December 31, 1951, and which ends at the close of the taxable year with respect to which the computation under subparagraph (1) is being made.

(d) *Treatment of pre-1952 surplus.* Any portion of the taxpayer's pre-1952 surplus which, pursuant to paragraph (a) of this section, is deemed to be included in the opening balance of the reserve for losses on qualifying real property loans shall not be treated as a reserve for bad debts for any purpose other than computing for any taxable year the amount determined under the method described in paragraph (b), (c), or (d) of § 1.593–6 (relating, respectively, to the percentage of taxable income method, the percentage of real property loans method, and the experience method) or paragraph (b), (c), or (d) of § 1.593–6A (relating, respectively, to the percentage of taxable income method, the percentage method, and the experience method). For such limited purpose, such portion shall be deemed to remain in, and constitute a part of, the reserve for losses on qualifying real property loans. For all other purposes, such portion will retain its character as part of the taxpayer's pre-1952 surplus.

(e) *Example.* The provisions of this section may be illustrated by the following example:

Example —(1) *Facts.* X Corporation, a mutual savings bank organized in 1934, makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. For the taxable years 1934 through 1951, X's gross income was $2.7 million, in addition to which X received $300,000 of interest which would have been excludable from gross income under section 22(b)(4) of the Internal Revenue Code of 1939, or the corresponding provisions of prior revenue laws, if X had been subject to the income tax imposed by such Code or prior revenue laws when such interest was received. At the close of 1951, the sum of X's surplus, undivided profits, and reserves was $650,000. At the close of 1954, X had pre-1963 reserves of $10,000, and surplus, undivided profits, and reserves of $630,000. At the close of 1955, X had pre-1963 reserves of $15,000, and surplus, undivided profits, and reserves of $625,000. At the close of 1962, X had pre-1963 reserves of $55,000, nonqualifying loans of $4 million, and qualifying real property loans of $10 million. It is assumed that, under § 1.166–4, $16,000 would constitute a reasonable addition to the reserve for losses on nonqualifying loans for a period in which such loans increased from zero to $4 million and $20,000 would constitute a reasonable addition to the reserve for losses on qualifying real property loans for a period in which such loans increased from zero to $10 million.

(2) *Impairment of surplus, undivided profits, and reserves for 1954.* The sum of X's surplus, undivided profits, and reserves at the close of 1951 was impaired during 1954 by $30,000, computed as follows:

Sum of surplus, undivided profits, and reserves at close of 1951	$650,000
Less:	
Sum of surplus, undivided profits, and reserves at close of 1954, excluding pre-1963 reserves at close of such year ($630,000 minus $10,000)	620,000
	30,000

(3) *Impairment of surplus, undivided profits, and reserves for 1955.* The sum of X's surplus, undivided profits, and reserves at the close of 1951 was further impaired during 1955 by $10,000, computed as follows:

Sum of surplus, undivided profits, and reserves at close of 1951, decreased by amount of 1954 impairment ($650,000 minus $30,000)	$620,000
Less:	
Sum of surplus, undivided profits, and reserves at close of 1955, excluding pre-1963 reserves at close of such year ($625,000 minus $15,000)	610,000

	10,000

(4) *Pre-1952 surplus.* X's pre-1952 surplus is $549,000, computed as follows:

Sum of surplus, undivided profits and reserves at close of 1951	$650,000	
Less:		
Sum of impairments for 1954 and 1955 ($30,000 plus $10,000)	40,000	
		$610,000
Less:		
Portion of such $610,000 which is attributable to excludable interest ($610,000 multiplied by $300,000/$3 million)		61,000
		549,000

(5) *Allocation of pre-1963 reserves to reserve for losses on nonqualifying loans and to reserve for losses on qualifying real property loans.* Of the $55,000 of pre-1963 reserves at the close of 1962, $16,000 (the amount which would constitute a reasonable addition to the reserve for losses on nonqualifying loans for a period in which such loans increased from zero to $4 million) shall be allocated to, and constitute the opening balance of, the reserve for losses on nonqualifying loans, and the balance of $39,000 ($55,000 minus $16,000) shall be allocated to, and constitute a part of the opening balance of, the reserve for losses on qualifying real property loans.

(6) *Allocation of pre-1952 surplus to reserve for losses on qualifying real property loans.* X's pre-1963 reserves are not sufficient to bring the opening balance of the reserve for losses on qualifying real property loans to $300,000, which is an amount equal to the greater of:

(i) $300,000 (*i.e.*, $10 million of qualifying real property loans outstanding at the close of 1962, multiplied by 3 percent), or

(ii) $20,000 (the amount which would constitute a reasonable addition to the reserve for losses on such loans under § 1.166–4 for a period in which the amount of such loans increased from zero to the $10 million).

Therefore, $261,000 ($300,000 minus $39,000) of X's pre-1952 surplus of $549,000 shall be deemed to be included in the opening balance of such reserve in order to increase such opening balance to $300,000.

[T.D. 6728, 29 FR 5861, May 5, 1964, as amended by T.D. 549, 43 FR 21457, May 18, 1978]

§ 1.593–10 Certain distributions to shareholders by a domestic building and loan association.

(a) *In general.* Section 593(f) provides that if a domestic building and loan association (as defined in section 7701(a)(19) and the regulations thereunder) distributes property after December 31, 1962, to a shareholder with respect to its stock and if the amount of such distribution is not allowable to the association as a deduction under section 591 (relating to deduction for dividends paid on deposits), then, notwithstanding any other provision of the Code, the distribution shall be treated as provided in paragraphs (b) and (c) of this section. For purposes of the preceding sentence, the term *distribution* includes any distribution in redemption of stock to which section 302(a) or 303 applies, or in partial or complete liquidation of the association, as well as any other distribution which the association may make to a shareholder with respect to its stock. For definition of the term *property*, see section 317(a). For determination of the amount of a distribution, see section 301(b). For taxable years beginning after July 11, 1969, this paragraph is not applicable to any transaction to which section 381 (relating to carryovers in certain corporate acquisitions) and the regulations thereunder apply.

(b) *Distributions out of certain reserves*—(1) *Distributions not in exchange for stock.* If the distribution is not a redemption to which section 302(a) or 303 applies or in partial or complete liquidation of the association, then to the extent that the distribution is not out of earnings and profits of the taxable year (within the meaning of section 316(a)(2)) or out of earnings and profits accumulated in taxable years beginning after December 31, 1951, the distribution shall be treated as made out of:

(i) First, the reserve for losses on qualifying real property loans (determined under subparagraph (3) of this paragraph), to the extent thereof,

(ii) Second, the supplemental reserve for losses on loans, to the extent thereof, and

(iii) Finally, such other accounts as may be proper.

(2) *Distributions in redemption of stock or in liquidation.* If the distribution is a redemption to which section 302(a) or 303 applies, or in partial or complete liquidation of the association, the distribution shall be treated as made out of:

(i) First, the reserve for losses on qualifying real property loans (as determined under subparagraph (3) of this paragraph), to the extent thereof,

(ii) Second, the supplemental reserve for losses on loans, to the extent thereof,

(iii) Third, earnings and profits of the taxable year (within the meaning of section 316(a)(2)),

(iv) Fourth, earnings and profits accumulated in taxable years beginning after December 31, 1951, and

(v) Finally, such other accounts as may be proper.

(3) *Special rule.* For purposes of subparagraphs (1)(i) and (2)(i) of this paragraph, the reserve for losses on qualifying real property loans shall be an amount equal to:

(i) The balance of such reserve determined as of the close of the taxable year after all adjustments for such year have been made (including the addition for such year determined under § 1.593–6 or § 1.593–6A (whichever is applicable)), minus.

(ii) The sum of:

(a) The amount which would have constituted the opening balance of such reserve (at the close of December 31, 1962) if such opening balance had been determined under the experience method described in paragraph (b)(3)(ii)*(b)* of § 1.593–7 (relating to allocation of pre-1963 reserves to the opening balance of the reserve for losses on qualifying real property loans), and

(b) The total amount of the annual additions which would have been made to such reserve under section 166(c) for taxable years ending after December 31, 1962, if each such addition had been determined under the experience method described in paragraph (d) of § 1.593–6 or paragraph (d) of § 1.593–6A, whichever is applicable for the taxable year of such addition.

For purposes of subdivision (i) of this subparagraph, the balance of the reserve for losses on qualifying real property loans shall include the total amount of any pre-1963 reserves allocated thereto under paragraph (b)(3) of § 1.593–7, but shall not include any pre-1952 surplus which is deemed to be included therein under paragraph (a) of § 1.593–8 (relating to allocation of pre-1952 surplus to the opening balance of the reserve for losses on qualifying real property loans).

(c) *Amount charged against reserve and included in gross income*—(1) *In general.* If a distribution is treated under paragraph (b) (1) or (2) of this section as having been made out of the reserve for losses on qualifying real property loans or out of the supplemental reserve for losses on loans, such reserves shall be charged with, and gross income for the taxable year shall be increased by, an amount equal to the lesser of:

(i) The amount of such reserves, or

(ii) The amount which, when reduced by the amount of income tax imposed by chapter 1 of the Code and attributable to the inclusion of such amount in gross income, is equal to the amount of such distribution.

(2) *Special rule.* For purposes of subparagraph (1)(ii) of this paragraph, in determining the income tax attributable to the inclusion of an amount in gross income, taxable income shall be determined without regard to any net operating loss carryback to the taxable year under section 172.

(d) *Examples.* This section may be illustrated by the following examples:

Example 1 —(i) *Facts.* X Corporation, a domestic building and loan association having nonwithdrawable capital stock represented by shares, was organized in 1946, and makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. As of the close of December 31, 1962, X had $6,900 of earnings and profits accumulated in taxable years beginning after December 31, 1951. X's taxable income for 1963 is $30,000 (computed prior to the inclusion of any amount in gross income for such year under section 593(f)) and during such year X received tax-exempt interest of $500. X's earnings and profits for 1963 (computed at the close of the taxable year without diminution by reason of any distributions made during the taxable year) is $20,400. The opening balance of X's reserve for losses on qualifying real property loans as of the close of December 31, 1962 (determined under paragraph (b)(3)(ii)*(a)* of § 1.593–7) was $24,500. Pre-1963 reserves of $22,500 were included in such opening balance, but it is assumed that pre-1963 reserves of only $2,500 would have been included in the opening balance if the opening balance had been determined under the experience method described in paragraph (b)(3)(ii)*(b)* of § 1.593–7. Pre-1952 surplus of $2,000 was deemed included in such opening balance under paragraph (a) of § 1.593–8. The deductible addition to such reserve for 1963 is

$47,000. It is assumed that the addition to such reserve for 1963 would have been $2,200 if such addition had been computed under the experience method described in paragraph (d) of §1.593–6. On each of four dates during 1963 (January 1, April 1, July 1, and October 1), X made a $12,000 distribution (which was not a redemption to which section 302(a) or 303 applied or in partial or complete liquidation of X) to its shareholders with respect to its stock.

(ii) *Reserve for losses on qualifying real property loans.* For purposes of paragraph (b)(1)(i) of this section, X's reserve for losses on qualifying real property loans is $64,800, computed as follows:

Closing balance of reserve for losses on qualifying real property loans after addition for 1963 ($24,500 opening balance plus $47,000 addition)		$71,500
Minus:		
Amount of pre-1963 reserves which would have been included in opening balance under experience method	2,500	
Total additions which would have been made under experience method	2,200	
Pre-1952 surplus included in opening balance	2,000	
		6,700
		64,800

(iii) *Treatment of distributions.* Of each $12,000 quarterly distribution, $5,100 ($20,400) earnings and profits of the taxable year divided by 4) is out of X's earnings and profits of the taxable year (within the meaning of section 316(a)(2)); the remainder of the January 1 distribution, $6,900 ($12,000 minus $5,100), is out of X's earnings and profits accumulated in taxable years beginning after December 31, 1951. Since $20,700 ($6,900 multiplied by 3) is not out of X's earnings and profits, such amount shall be treated as made out of X's reserve for losses on qualifying real property loans (as determined under subdivision (ii) of this example).

(iv) *Amount charged against reserve for losses on qualifying real property loans and included in gross income.* The reserve for losses on qualifying real property loans is charged with, and X's gross income for 1963 is increased by, $43,124, which is the lesser of:

(a) $64,800 (the reserve as of December 31, 1963, as determined under subdivision (ii) of this example), or

(b) $43,124, *i.e.*, the amount which, when reduced by the amount of income tax attributable to the inclusion of such amount in gross income, $22,424 ($43,124 multiplied by a tax rate of 52 percent), is equal to the amount of such distribution, $20,700.

Example 2 —(i) *Facts.* Assume the same facts as in example 1 and the following additional facts: X's taxable income for 1964 is $6,000. The deductible addition to the reserve for losses on qualifying real property loans for 1964 is $11,000, but it is assumed that only $2,676 would have been the addition to such reserve for 1964 if such addition had been computed under the experience method described in paragraph (d) of §1.593–6. On December 31, 1964, X makes a $10,000 distribution in a redemption to which section 302(a) applies.

(ii) *Reserve for losses on qualifying real property loans.* For purposes of paragraph (b)(2)(i) of this section, X's reserve for losses on qualifying real property loans is $30,000, computed as follows:

Closing balance of reserve for losses on qualifying real property loans after addition for 1964 ($71,500 opening balance plus $11,000 addition)		$82,500
Minus:		
Amount of pre-1963 reserves which would have been included in opening balance under the experience method	$2,500	
Total additions which would have been made under the experience method ($2,200 for 1963 plus $2,676 for 1964)	4,876	
Pre-1952 surplus included in opening balance	2,000	
		9,376
		73,124
Less charge against reserve under subdivision (iv) of example 1 for 1963 distribution		43,124
		30,000

(iii) *Treatment of distribution.* The $10,000 distribution in a redemption to which section 302(a) applies shall be treated as made out of X's reserve for losses on qualifying real property loans (as determined under subdivision (ii) of this example).

(iv) *Amount charged against reserve for losses on qualifying real property loans and included in gross income.* The reserve for losses on qualifying real property loans is charged with, and X's gross income for 1964 is increased by, $12,820, which is the lesser of:

(a) $30,000 (the reserve as of December 31, 1964, as determined under subdivision (ii) of this example), or

(b) $12,820, *i.e.*, the amount which, when reduced by the amount of income tax attributable to the inclusion of such amount in gross income, $2,820 ($12,820 multiplied by a tax rate of 22 percent), is equal to the amount of such distribution, $10,000.

Example 3 —(i) *Facts.* X Corporation, a domestic building and loan association having nonwithdrawable capital stock represented by shares, was organized in 1946, and makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. As of the close of December 31, 1962, X had $6,900 of earnings and profits accumulated in taxable years beginning after December 31, 1951. X's taxable income for 1963 is $30,000 (computed prior to the inclusion of any amount in gross income for such year under section 593(f)) and during such year X received tax-exempt interest of $500. X's earnings and profits for 1963 (computed at the close of the taxable year without diminution by reason of any distributions made during the taxable year) is $20,400. The opening balance of X's reserve for losses on qualifying real property loans as of the close of December 31, 1962 (determined under paragraph (b)(3)(ii)*(a)* of § 1.593–7) was $24,500. Pre-1963 reserves of $24,500 were included in such opening balance, but it is assumed that pre-1963 reserves of only $4,500 would have been included in the opening balance if the opening balance had been determined under the experience method described in paragraph (b)(3)(ii)*(b)* of § 1.593–7. The deductible addition to such reserve for 1963 is $500. It is assumed that the addition to such reserve for 1963 would have been $100 if such addition had been computed under the experience method described in paragraph (d) of § 1.593–6. As of December 31, 1963, the balance of X's supplemental reserve for losses on loans is $30,000. On each of four dates during 1963 (January 1, April 1, July 1, and October 1), X made a $12,000 distribution (which was not a redemption to which section 302(a) or 303 applied or in partial or complete liquidation of X) to its shareholders with respect to its stock.

(ii) *Reserve for losses on qualifying real property loans.* For purposes of paragraph (b)(1)(i) of this section, X's reserve for losses on qualifying real property loans is $20,400, computed as follows:

Closing balance of reserve for losses on qualifying real property loans after addition for 1963 ($24,500 opening balance plus $500 addition) ..		$25,000
Minus:		
Amount of pre-1963 reserves which would have been included in opening balance under experience method	$4,500	
Total additions which would have been made under experience method	100	
		4,600
		20,400

(iii) *Treatment of distributions.* Of each $12,000 quarterly distribution, $5,100 ($20,400 earnings and profits of the taxable year divided by 4) is out of X's earnings and profits of the taxable year (within the meaning of section 316(a)(2)); the remainder of the January 1 distribution, $6,900 ($12,000 minus $5,100), is out of X's earnings and profits accumulated in taxable years beginning after December 31, 1951. Since $20,700 ($6,900 multiplied by 3) is not out of X's earnings and profits, $20,400 of such amount shall be treated as made outof X's reserve for losses on qualifying real property loans (as determined under subdivision (ii) of this example) and $300 ($20,700 minus $20,400) shall be treated as made out of X's supplemental reserve for losses on loans.

(iv) *Amount included in gross income.* X's gross income for 1963 is increased by $43,124, which is the lesser of:

(a) $50,400 ($20,400, the reserve for losses on qualifying real property loans, as determined under subdivision (ii) of this example, plus $30,000, the supplemental reserve for losses on loans), or

(b) $43,124, *i.e.*, the amount which, when reduced by the amount of income tax attributable to the inclusion of such amount in gross income, $22,424 ($43,124 multiplied by a tax rate of 52 percent), is equal to the amount of such distribution, $20,700.

(v) *Amount charged against reserve for losses on qualifying real property loans and supplemental reserve for losses on loans.* The reserve for losses on qualifying real property loans is charged with $20,400 (the balance of the reserve as of December 31, 1963, as determined under subdivision (ii) of this example), and the supplemental reserve for losses on loans is charged with $22,724 ($43,124, the amount included in gross income under subdivision (iv) of this example, minus $20,400).

[T.D. 6728, 29 FR 5862, May 5, 1964, as amended by T.D. 549, 43 FR 21457, May 18, 1978]

§ 1.593–11 Qualifying real property loan and nonqualifying loan defined.

(a) *Loan defined.* For purposes of this section, the term *loan* means debt, as the term *debt* is used in section 166 and the regulations thereunder. The term *loan* also includes a redeemable ground rent (as defined in section 1055 (c)) which is owned by the taxpayer, and any property acquired by the taxpayer in a transaction described in section 595(a). For determination of the amount of a loan, see paragraph (d) of this section.

(b) *Qualifying real property loan defined*—(1) *General rule.* For purposes of §§ 1.593–4 through 1.593–10, the term *qualifying real property loan* means any loan (other than a loan described in subparagraph (5) of this paragraph) which is secured by an interest in qualifying real property. For purposes of this section, the term *real property* means any property which, under the law of the jurisdiction in which such property is situated, constitutes real property. The term *real property* also includes a mobile unit which is permanently fixed to real property. The determination of whether a mobile unit is permanently fixed to real property shall be made on the basis of facts and circumstances in each particular case. For example, a mobile unit is permanently fixed to real property during a taxable year if, except for a brief period during which the unit is transported to a site, such unit was placed upon a foundation at a site with wheels and axles removed, affixed to the ground by means of straps, and connected to water, sewer, gas, and electric facilities. See paragraph (e) of this section for the treatment of a REMIC interest as a qualifying real property loan.

(2) *Meaning of Secured.* A loan will be considered as *secured* only if the loan is on the security of any instrument (such as a mortgage, deed of trust, or land contract) which makes the interest of the debtor in the property described therein specific security for the payment of the loan, provided that such instrument is of such a nature that, in the event of default, the property could be subjected to the satisfaction of the loan with the same priority as a mortgage or deed of trust in the jurisdiction in which the property is situated.

(3) *Meaning of interest.* The word *interest* means an interest in real property which, under the law of the jurisdiction in which such property is situated, constitutes either (i) an interest in fee in such property, (or in the case of a mobile unit, an ownership interest), (ii) a leasehold interest in such property extending or renewable automatically for a period of at least 30 years, or at least 10 years beyond the date scheduled for the final payment on the loan secured by such interest, (iii) a leasehold interest in improved residential real property consisting of a structure or structures containing, in the aggregate, no more than four family units extending for a period of at least 2 years beyond the date scheduled for the final payment on the loan secured by such interest, or (iv) a leasehold interest in such property held subject to a redeemable ground rent defined in section 1055(c).

(4) *Meaning of qualifying real property.* The term *qualifying real property* means any real property which is improved real property, or which from the proceeds of the loan will become improved real property. As used in the preceding sentence, the term *improved real property* means:

(i) Land on which is located any building of a permanent nature (such as a house, mobile unit, apartment house, office building, hospital, shopping center, warehouse, garage, or other similar permanent structure), provided that the value of such building is substantial in relation to the value of such land,

(ii) Any building lot or site which, by reason of installations and improvements that have been completed in keeping with applicable governmental requirements and with general practice in the community, is a building lot or site ready for the construction of any building of a permanent nature within the meaning of paragraph (b)(4)(i) of this section.

(iii) Real property which, because of its state of improvement, produces sufficient income to maintain such real property and retire the loan in accordance with the terms thereof, or

(iv) A mobile unit which is permanently fixed to real property.

(5) *Loans not included.* The term *qualifying real property loan* does not include:

(i) Any loan evidenced by a security as defined in section 165(g)(2)(C),

(ii) Any loan (whether or not evidenced by a security as so defined) the primary obligor on which is *(a)* a government or a political subdivision or instrumentality thereof, *(b)* a bank (as defined in section 581), or *(c)* another member of the same affiliated group,

(iii) Any loan to the extent such loan is secured by a deposit in or share of the taxpayer (including a share of nonwithdrawable capital stock), determined as of the close of the taxable year, and

(iv) Any loan which (within a 60-day period beginning in one taxable year of the taxpayer and ending in the next taxable year of such taxpayer) is made or acquired, and then repaid or disposed of, unless both the transaction by which the loan is made or acquired and the transaction by which the loan is repaid or disposed of are established to the satisfaction of the district director to be for bona fide business purposes.

As used in subdivision (ii)*(c)* of this subparagraph, the term *affiliated group* shall have the meaning assigned to such term by section 1504(a) (relating to the definition of an affiliated group), except that the phrase *more than 50 percent* shall be substituted for the phrase *at least 80 percent* each place the latter phrase appears in section 1504(a), and all corporations shall be treated as includible corporations (without regard to any of the exclusions provided in section 1504(b)).

(c) *Nonqualifying loan defined.* For purposes of §§ 1.593–4 through 1.593–9, the term *nonqualifying loan* means any loan which is not a qualifying real property loan.

(d) *Amount of loan determined*—(1) *General rule.* Except as provided in subparagraph (2) of this paragraph, the amount of any qualifying real property loan or nonqualifying loan, for purposes of section 593, is the adjusted basis of such loan as determined under § 1.1011–1. However, the adjusted basis, determined under § 1.1011–1, of any *loan in process* does not include the unadvanced portion of such loan. For the basis of a redeemable ground rent reserved or created by the taxpayer before April 11, 1963, see section 1055(b)(3); and for the basis of a loan represented by property acquired by the taxpayer in a transaction described in section 595(a), see section 595(c).

(2) *Limitation.* If the total amount advanced on any loan exceeds the loan value of any interest in qualifying real property which secures such loan, then the portion of such loan which, as of the close of any taxable year, will be considered as a qualifying real property loan shall be determined under the principles of section 7701(a)(19) and the regulations thereunder.

(e) *Treatment of REMIC interests as qualifying real property loans*—(1) *In general.* For purposes of section 593 and §§ 1.593–4 through 1.593–10, if, for any calendar quarter, at least 95 percent of a REMIC's assets (as determined in accordance with § 1.860F–4(e)(1)(ii) or § 1.6049–7(f)(3)) are qualifying real property loans (as defined in paragraph (b) of this section), then, for that calendar quarter, all the regular and residual interests in that REMIC are treated as qualifying real property loans. If less than 95 percent of a REMIC's assets are qualifying real property loans, then a percentage of each regular or residual interest is treated as a qualifying real property loan. The percentage equals the percentage of the REMIC's assets that are qualifying real property loans. See § 1.860F–4(e)(1)(ii)(B) and § 1.6049–7(f)(3) for information required to be provided to regular and residual interest holders if the 95-percent test is not met.

(2) *Treatment of REMIC assets for section 593 purposes*—(i) *Manufactured housing treated as qualifying real property.* For purposes of paragraph (e)(1) of this section, the term ‘‘qualifying real property’’ includes manufactured housing treated as a single family residence under section 25(e)(10).

(ii) *Status of cash flow investments.* For purposes of paragraph (e)(1) of this section, cash flow investments (as defined in section 860G(a)(6) and § 1.860G–2(g)(1)) are treated as qualifying real property loans.

[T.D. 6728, 29 FR 5864, May 5, 1964, as amended by T.D. 549, 43 FR 21458, May 18, 1978; T.D. 8458, 57 FR 61298, Dec. 24, 1992]

§ 1.594–1 Mutual savings banks conducting life insurance business.

(a) *Scope of application.* Section 594 applies to the case of a mutual savings bank not having capital stock represented by shares which conducts a life insurance business, if:

(1) The conduct of the life insurance business is authorized under State law,

(2) The life insurance business is carried on in a separate department of the bank,

(3) The books of account of the life insurance business are maintained separately from other departments of the bank, and

(4) The life insurance department of the bank would, if it were treated as a separate corporation, qualify as a life insurance company under section 801.

(b) *Computation of tax.* In the case of a mutual savings bank conducting a life insurance business to which section 594 is applicable, the tax upon such bank consists of the sum of the following:

(1) A partial tax computed under section 11 upon the taxable income of the bank determined without regard to any items of income or deduction properly allocable to the life insurance department, and

(2) A partial tax computed on the income (or, in the case of taxable years beginning before January 1, 1955, the taxable income (as defined in section 803)) of the life insurance department determined without regard to any items of income or deduction not properly allocable to such department, at the rates and in the manner provided in subchapter L (section 801 and following), chapter 1 of the Code, with respect to life insurance companies.

§1.595–1 Treatment of foreclosed property by certain creditors.

(a) *Nonrecognition of gain or loss on the acquisition of security property by certain creditors*—(1) *In general.* Section 595(a) provides that in the case of a creditor which is an organization described in section 593(a) (that is, a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit), no gain or loss shall be recognized, and no debt shall be considered as becoming worthless or partially worthless for purposes of section 166 (relating to bad debts), as the result of a transaction by which such creditor bids in at foreclosure, or reduces to ownership or possession by agreement or process of law, any property (whether real or personal, tangible or intangible) which was security for the payment of any indebtedness (whether or not a qualifying real property loan as defined in section 593(e)(1)). The treatment provided by section 595(a) is mandatory (regardless of whether such creditor utilizes the specific deduction or reserve method of accounting for bad debts) if, for the taxable year in which the property is bid in at foreclosure, or reduced to ownership or possession by agreement or process of law, the creditor is an organization described in section 593(a), even though the creditor subsequently becomes an organization not described in section 593(a). For definition of the terms *domestic building and loan association* and *cooperative bank* for taxable years beginning after October 16, 1962, see paragraphs (19) and (32), respectively, of section 7701(a).

(2) *Effective date.* Section 595 applies to any transaction (described in subparagraph (1) of this paragraph) occurring after December 31, 1962, except that such section does not apply to any such transaction in which the taxable event determined without regard to section 595 (that is, the sale or exchange to the creditor of the security property by reason of the default or anticipated default of the debtor) occurred before January 1, 1963.

(b) *Rules for determining when security property is reduced to ownership or possession by agreement or process of law*—(1) *Ownership or possession.* For purposes of this section, security property shall be considered as reduced to ownership or possession by agreement or process of law on the earliest date on which the creditor, by reason of the default or anticipated default of the debtor:

(i) Acquires, by agreement or process of law, a title to, or a right or interest in, the security property which under local law is indefeasible and which the creditor can validly dispose of apart from the indebtedness which the property secures, or

(ii) Acquires, by agreement or process of law, an enforceable right to direct the use to which the security property shall be put, including, in the case of real property, whether or not the property shall continue to be occupied by the debtor who has defaulted (regardless of whether such creditor has obtained indefeasible title to the property), or

(iii) Sells or otherwise disposes of the security property or any interest therein.

(2) *Agreement or process of law.* The reduction of security property to ownership or possession by agreement includes, where valid under local law, such methods as voluntary conveyance from the debtor (including a conveyance directly to the Federal Housing Commissioner) and abandonment to the creditor. The reduction of security

property to ownership or possession by process of law includes foreclosure proceedings in which a competitive bid is entered, such as foreclosure by judicial sale or by power of sale contained in the loan agreement without recourse to the courts, as well as those types of foreclosure proceedings in which a competitive bid is not entered, such as strict foreclosure and foreclosure by entry and possession, by writ of entry, or by publication or notice.

(c) *Examples.* The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. On January 31, 1963, X, a creditor which is an organization described in section 593(a), purchases at a foreclosure sale residential real property which was security for a debt owing to X, and with respect to which the debtor has defaulted. Under local law, there is a 1-year statutory redemption period (during which period the debtor is entitled to remain in possession) so that X must wait until February 1, 1964, to obtain indefeasible title to the property. No gain or loss is recognized by reason of the purchase at the foreclosure sale on January 31, 1963. However, the date on which the security property is considered as reduced to ownership or possession by agreement or process of law is February 1, 1964. If, under local law, there were no statutory redemption period so that X obtained indefeasible title to the security property at the foreclosure sale, the date on which the security property would be considered as so reduced is January 31, 1963. Furthermore, with respect to either of the preceding situations, if the foreclosure sale had occurred on November 1, 1962 (instead of on January 31, 1963), section 595 would not apply to the transaction since the taxable event in respect of such transaction occurred prior to January 1, 1963.

Example 2. The facts are the same as in example 1, except that instead of purchasing the property at a foreclosure sale, X, pursuant to the provisions of local law, enters upon the security property on January 31, 1963, and acquires an enforceable right to direct whether the property shall continue to be occupied by the debtor. X does not obtain indefeasible title to the property until February 1, 1964. The date on which the security property is considered as reduced to ownership or possession by agreement or process of law is January 31, 1963.

(d) *Basis of acquired property.* Section 595(c) provides that the basis of any property to which section 595(a) applies (hereinafter referred to as *acquired property*) shall be the adjusted basis of the indebtedness for which such property was security, determined as of the date of acquisition of such property, properly increased for costs of acquisition. The date of acquisition is the date, determined under paragraph (b) of this section, on which the security property is reduced to ownership or possession by agreement or process of law. Costs of acquisition are expenditures incurred by the creditor (for example, fees for an attorney, master, trustee, auctioneer, for publication, acquiring title, clearing liens, filing and recording, and court costs) which are directly related to the foreclosure sale or proceeding, or to the other process used to reduce the security property to ownership or possession, or both, by agreement or process of law. For purposes of determining the adjusted basis of the indebtedness for which the acquired property was security, there shall be included the amount of any unpaid interest with respect to such indebtedness, but only to the extent that it has been included in gross income. The basis of the acquired property, as determined under this paragraph, shall be adjusted in accordance with the rules provided in paragraph (e) of this section.

(e) *Characteristics of acquired property*—(1) *Depreciation; decline in fair market value.* Section 595(b) provides, in part, that for purposes of section 166 (relating to bad debts) acquired property shall be considered as property having the same characteristics as the indebtedness for which such property was security. Thus, no deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion shall be allowed to a creditor with respect to acquired property. However, if, at any time, the adjusted basis of the acquired property exceeds the fair market value of such property (determined by proper appraisal and without regard to any outstanding right of redemption), and the creditor can establish (in the same manner as worthlessness in whole or in part is established for purposes of section 166) that an amount equal to any portion of such excess will not be collected with respect to the indebtedness for which such property was security, the creditor may treat such portion, under the provisions of section 166, as a worthless debt. In such case, the basis of the acquired property shall be reduced by the amount treated as a worthless debt.

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

Example. X Corporation, a creditor which is an organization described in section 593(a), makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. In 1963, A defaults in his payments on a debt owed to X which is secured by residential real property. X reduces the property to ownership or possession by agreement or process of law by bidding it in at a foreclosure sale for $23,000. The adjusted basis of the indebtedness at the date of acquisition of the property (increased for costs of acquisition) is $25,000, and this amount becomes the basis of the acquired property. X obtains a deficiency judgment against A for $2,000. Later in 1963, a proper appraisal enables X to establish that the fair market value of the property is $18,000. X is also able to establish (under the rules of section 166 and the regulations thereunder) that due to A's poor financial condition only $1,000 can be collected on the outstanding deficiency judgment. For the year 1963, X may charge its bad debt reserve for $6,000, computed as follows:

Basis of acquired property	$25,000
Less: Fair market value of acquired property	18,000
Excess	7,000
Less: Collectible portion of deficiency judgment	1,000
Portion of excess treated as worthless debt	6,000

(3) *Capital improvements made after date of acquisition not treated as acquired property.* Except as provided in subparagraph (4) of this paragraph, the term *acquired property* does not include capital improvements made after the date of (acquisition within the meaning of paragraph (d) of this section) of the property. Thus, the applicable deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion shall be allowed, if otherwise allowable, for improvements which are made by the creditor with respect to acquired property and which are properly chargeable to the capital account. If the creditor sells or otherwise disposes of the acquired property with such capital improvements, any amount realized by reason of such sale or other disposition shall be allocated in proportion to the respective fair market values of the acquired property and such capital improvements. The portion of the amount realized which is allocable to the acquired property shall be treated in accordance with the rules prescribed in subparagraph (6) of this paragraph. The portion of the amount realized which is allocable to such capital improvements shall be treated under the applicable rules governing the sale or other disposition of such property and without regard to section 595.

(4) *Treatment of minor capital improvements as acquired property.* A creditor may treat any minor capital improvements which it makes to a particular acquired property after the date of acquisition (within the meaning of paragraph (d) of this section) in the same manner as the acquired property, provided such creditor treats all minor capital improvements with respect to that particular acquired property in such manner. For purposes of section 595, a capital improvement shall be considered as *minor* only if the cost of such improvement does not exceed $3,000.

(5) *Records for capital improvements.* For purposes of subparagraphs (3) and (4) of this paragraph, the creditor must maintain such records as are necessary to clearly reflect, with respect to each particular acquired property, the cost of each capital improvement and whether the taxpayer treated minor capital improvements with respect to such property in the same manner as the acquired property.

(6) *Amounts realized with respect to acquired property.* Section 595(b) provides, in part, that any amount realized with respect to acquired property shall be treated as a payment on account of the indebtedness for which such property was security, and any loss with respect thereto shall be treated as a bad debt to which the provisions of section 166 (relating to bad debts) apply. An amount realized with respect to acquired property means an amount representing a recovery of capital, such as proceeds from the sale or other disposition of the property, payments on the original indebtedness made by or on behalf of the debtor (including amounts received under an insurance contract with the Federal Housing Administration or a guarantee by the Veterans'

Administration), and collections on a deficiency judgment obtained against the debtor (other than amounts treated as interest under applicable local law). Amounts realized with respect to acquired property include amounts which otherwise would be treated in the manner prescribed in section 351 (relating to transfer to a corporation controlled by transferor), section 354 (relating to exchanges of stock and securities in certain reorganizations), section 453 (relating to installment method), section 1031 (relating to exchange of property held for productive use or for investment), or section 1033 (relating to involuntary conversions). For purposes of section 595(b), if a corporation distributes acquired property in a distribution to which section 311 (relating to taxability of corporation on distribution) or section 336 (relating to nonrecognition of gain or loss to a corporation on distribution of its property in partial or complete liquidation) applies, the fair market value of the acquired property at the time of the distribution shall be treated as an amount realized with respect to such property. However, no amount shall be considered realized by reason of the distribution or transfer of acquired property in a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies, and in the case of such a distribution or transfer the acquired property shall be treated by the distributee or transferee as having the same characteristics as it had in the hands of the distributor or transferor at the time of such distribution or transfer. The following rules shall apply to amounts realized with respect to acquired property:

(i) Any amount realized shall be applied against and reduce the adjusted basis of the acquired property, and to the extent that such amount exceeds the adjusted basis, it shall, in the case of a creditor using the specific deduction method of accounting for bad debts, be included in gross income as ordinary income, or, in the case of a creditor using the reserve method of accounting for bad debts, be credited to the appropriate bad debt reserve (that is, the reserve for losses on qualifying real property loans or the reserve for losses on nonqualifying loans). Any amounts credited during the taxable year to a reserve for bad debts pursuant to this subdivision shall not be considered as a part of the addition under section 593 for such year, but shall be included in the balance of the reserve for purposes of computing such addition to the reserve for such taxable year. Thus, for example, an amount credited to the reserve for losses on qualifying real property loans during a taxable year shall not be considered as a part of the addition to such reserve computed under the percentage of taxable income method. However, the amount of such credit shall be included in the balance of such reserve for the purpose of determining the amount necessary to increase the balance of such reserve (as of the close of such taxable year) to an amount equal to 3 percent of qualifying real property loans and for the purpose of determining whether such balance exceeds 6 percent of such loans.

(ii) If an amount realized on the sale or other disposition of the acquired property is insufficient to restore to the creditor the adjusted basis of the property, the difference between such adjusted basis and such amount realized shall be treated as a bad debt to which the provisions of section 166 apply. If the creditor subsequently realizes an additional amount with respect to the original indebtedness or the acquired property, such additional amount shall be treated as the recovery of a bad debt.

(7) *Treatment of rents, similar amounts, and expenses.* Section 595 does not change the treatment of rents, royalties, dividends, interest, or similar amounts received or accrued by the creditor with respect to acquired property, nor does it change the treatment of expenses incurred with respect to such property. (See, however, subparagraph (1) of this paragraph for treatment of depreciation, etc.) Thus, for example, if the acquired property is a governmental obligation within the meaning of section 103 (relating to interest on certain governmental obligations), interest payments received by the creditor with respect to such obligation would not be included in gross income.

(8) *Examples.* The provisions of subparagraphs (6) and (7) of this paragraph may be illustrated by the following examples:

Example 1 (i) *Facts.* X Corporation, a creditor which is an organization described in section 593(a), uses the reserve method of accounting for bad debts. On May 1, 1964, X reduces to ownership or possession by agreement or process of law improved real property which is security for an indebtedness of A which is in default. On the date of acquisition there remains unpaid on the indebtedness $20,000 principal and $700 interest. X has previously included the $700 interest in gross income. Subsequent to acquisition, X incurs expenses totaling $500 for maintenance, and during the period June 1 through September 30, 1964, rents the property for a total rental of $400. Under local law, X is accountable to A for the rents received and A is accountable to X for the expenses incurred. There are no other receipts or expenses until October 1, 1964, at which time X sells the acquired property for $22,000. Under local law, A is not entitled to any portion of the sales proceeds.

(ii) *Treatment of rents, expenses, and sales proceeds.* X would treat rents, expenses, and sales proceeds in the following manner:

Basis of acquired property at acquisition (adjusted basis of indebtedness, i.e., $20,000 principal plus $700 interest)	$20,700
Plus: Expenses charged to debtor	500
	21,200
Less: Rents credited to debtor	400
Adjusted basis of acquired property at sale	20,800
Less: Portion of $22,000 sales proceeds applied in reduction of adjusted basis of acquired property	20,800
	0
Portion of sales proceeds credited to reserve for losses on qualifying real property loans ($22,000 minus $20,800)	1,200

(iii) *Creditor using specific deduction method.* If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the $1,200 portion of the sales proceeds would be treated as ordinary income.

Example 2 (i) *Facts.* The facts are the same as in example 1 except that under local law X is not accountable to A for any portion of the rents received and A is not accountable to X for the expenses incurred by X.

(ii) *Treatment of rents and expenses.* X includes in gross income the total rent receipts of $400 and deducts (if otherwise allowable) the expenses of $500.

(iii) *Treatment of sales proceeds.* As the result of the sale of the acquired property, X credits $1,300 to the reserve for losses on qualifying real property loans, computed as follows:

Basis of acquired property at acquisition and at date of sale (adjusted basis of indebtedness, i.e., $20,000 principal plus $700 interest)	$20,700
Less: Portion of $22,000 sales proceeds applied in reduction of adjusted basis of acquired property	20,700
	0
Portion of sales proceeds credited to reserve for losses on qualifying real property loans ($22,000 minus $20,700)	1,300

(iv) *Creditor using specific deduction method.* If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the $1,300 portion of the sales proceeds would be treated as ordinary income.

Example 3 (i) *Facts.* The facts are the same in example 1 except that X sells the acquired property for $15,000.

(ii) *Treatment of rents, expenses, and sales proceeds.* X would treat rents, expenses, and sales proceeds in the following manner:

Basis of acquired property at acquisition (adjusted basis of indebtedness, i.e., $20,000 principal plus $700 interest)	$20,700
Plus: Expenses charged to debtor	500
	21,200
Less: Rents credited to debtor	400
Adjusted basis of acquired property at sale	20,800
Less: Portion of $15,000 sales proceeds applied in reduction of adjusted basis of acquired property	15,000
Amount charged to reserve for losses on qualifying real property loans	5,800

(iii) *Creditor using specific deduction method.* If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the excess of $5,800 would be allowed as a specific bad debt deduction.

[T.D. 6814, 30 FR 4473, Apr. 7, 1965]

§1.596–1 Limitation on dividends received deduction.

(a) *In general.* For taxable years beginning after July 11, 1969, in the case of mutual savings banks, domestic building and loan associations, and cooperative banks, if the addition to the reserve for losses on qualifying real property loans for the taxable year is determined under section 593(b)(2) (relating to the percentage of taxable income method), the total amount allowed as a deduction with respect to dividends received under part VIII, subchapter B, chapter 1, subtitle A of the Code (section 241 *et seq.*) (determined without regard to section 596 and this section) for such taxable year is reduced as provided by this section. In such case, the dividends received deduction otherwise determined under part VIII, subchapter B, chapter 1, subtitle A of the Code, is reduced by an amount equal to the applicable percentage for such year (determined solely under subparagraphs (A) and (B) of section 593(b)(2) and the regulations thereunder) of such total amount. For the rule under which a mutual savings bank, domestic building and loan association, or cooperative bank is deemed to have determined the addition to its reserve for losses on qualifying real property loans for the taxable year under section 593(b)(2), see § 1.593–6A(a)(2).

(b) *Example.* The provisions of this section may be illustrated by the following example:

Example. X Corporation, a domestic building and loan association, determines the addition to its reserve for losses on qualifying real property loans under section 593(b)(2) for its taxable year beginning in 1971. During that taxable year, X Corporation received a total of $100,000 as dividends from domestic corporations subject to tax under chapter 1 of the Code. X Corporation received no other dividends during the taxable year. Under part VIII, subchapter B, chapter 1, subtitle A of the Code, a deduction, determined without regard to section 596 and this section, of $85,000 would be allowed with respect to the dividends. For the taxable year, the applicable percentage, determined under subparagraphs (A) and (B) of section 593(b)(2), is 54 percent. Under section 596 and this section, the amount allowed as a deduction under section 243 and the regulations thereunder is reduced by $45,900 (54 percent of $85,000) to $39,100 ($85,000 less $45,900).

(c) *Dividends received by members of a controlled group.* If a thrift institution that computes a deduction under section 593(b)(2) is a member of a controlled group of corporations (within the meaning of section 1563(a), determined by substituting *50 percent* for *80 percent* each place it appears therein) and if the thrift institution, without a bona fide business purpose, transfers stock, directly or indirectly, to another member of the group, the Commissioner may allocate any dividends with respect to the stock to the thrift institution. If the Commissioner allocates a dividend to a thrifty institution under this paragraph (c), the Commissioner will also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation, at a time and in a manner consistent with the procedures of § 1.482–1(d)(2). This paragraph (c) applies to taxable years ending on or after August 30, 1975.

[T.D. 7149, 36 FR 20944, Nov. 2, 1971, as amended by T.D. 7631, 44 FR 40496, July 11, 1979]

§ 1.597–1 Definitions.

For purposes of the regulations under section 597—

(a) Unless the context otherwise requires, the terms *consolidated group, member* and *subsidiary* have the meanings provided in § 1.1502–1; and

(b) The following terms have the meanings provided below—

Acquiring. The term *Acquiring* means a corporation that is a transferee in a Taxable Transfer, other than a deemed transferee in a Taxable Transfer described in § 1.597–5(b).

Agency. The term *Agency* means the Resolution Trust Corporation, the Federal Deposit Insurance Corporation, any similar instrumentality of the United States government, and any predecessor or successor of the foregoing (including the Federal Savings and Loan Insurance Corporation).

Agency Control. An Institution or entity is under *Agency Control* if Agency is conservator or receiver of the Institution or entity, or if Agency has the right to appoint any of the Institution's or entity's directors.

Agency Obligation. The term *Agency Obligation* means a debt instrument that Agency issues to an Institution or to a direct or indirect owner of an Institution.

Bridge Bank. The term *Bridge Bank* means an Institution that is organized by Agency to hold assets and liabilities of another Institution and that continues the operation of the other Institution's business pending its acquisition or liquidation, and that is any of the following—

(1) A national bank chartered by the Comptroller of the Currency under section 11(n) of the Federal Deposit Insurance Act (12 U.S.C. 1821(n)) or section 21A(b)(10)(A) of the Federal Home Loan Bank Act (12 U.S.C. 1441a(b)(10)(A)) or any successor sections;

(2) A Federal savings association chartered by the Director of the Office

of Thrift Supervision under section 21A(b)(10)(A) of the Federal Home Loan Bank Act (12 U.S.C. 1441a(b)(10)(A)) or any successor section; or

(3) A similar Institution chartered under any other statutory provisions.

Consolidated Subsidiary. The term *Consolidated Subsidiary* means a member of the consolidated group of which an Institution is a member that bears the same relationship to the Institution that the members of a consolidated group bear to their common parent under section 1504(a)(1).

Continuing Equity. An Institution has *Continuing Equity* for any taxable year if, on the last day of the taxable year, the Institution is not (1) a Bridge Bank, (2) in Agency receivership, or (3) treated as a New Entity.

Controlled Entity. The term *Controlled Entity* means an entity under Agency Control.

Federal Financial Assistance (FFA). The term *Federal Financial Assistance* (FFA), as defined by section 597(c), means any money or property provided by Agency to an Institution or to a direct or indirect owner of stock in an Institution under section 406(f) of the National Housing Act (12 U.S.C. 1729(f)), section 21A(b)(4) of the Federal Home Loan Bank Act (12 U.S.C. 1441a(b)(4)), section 11(f) or 13(c) of the Federal Deposit Insurance Act (12 U.S.C. 1821(f), 1823(c)), or under any similar provision of law. Any such money or property is FFA, regardless of whether the Institution or any of its affiliates issues Agency a note or other obligation, stock, warrants, or other rights to acquire stock in connection with Agency's provision of the money or property. FFA includes Net Worth Assistance, Loss Guarantee payments, yield maintenance payments, cost to carry or cost of funds reimbursement payments, expense reimbursement or indemnity payments, and interest (including original issue discount) on an Agency Obligation.

Institution. The term *Institution* means an entity that is, or immediately before being placed under Agency Control was, a bank or domestic building and loan association within the meaning of section 597 (including a Bridge Bank). Except as otherwise provided in the regulations under section 597, the term *Institution* includes a New Entity or Acquiring that is a bank or domestic building and loan association within the meaning of section 597.

Loss Guarantee. The term *Loss Guarantee* means an agreement pursuant to which Agency or a Controlled Entity guarantees or agrees to pay an Institution a specified amount upon the disposition or charge-off (in whole or in part) of specific assets, an agreement pursuant to which an Institution has a right to put assets to Agency or a Controlled Entity at a specified price, or a similar arrangement.

Net Worth Assistance. The term *Net Worth Assistance* means money or property (including an Agency Obligation to the extent it has a fixed principal amount) that Agency provides as an integral part of a Taxable Transfer, other than FFA that accrues after the date of the Taxable Transfer. For example, Net Worth Assistance does not include Loss Guarantee payments, yield maintenance payments, cost to carry or cost of funds reimbursement payments, or expense reimbursement or indemnity payments. An Agency Obligation is considered to have a fixed principal amount notwithstanding an agreement providing for its adjustment after issuance to reflect a more accurate determination of the condition of the Institution at the time of the acquisition.

New Entity. The term *New Entity* means the new corporation that is treated as purchasing all of the assets of an Old Entity in a Taxable Transfer described in §1.597–5(b).

Old Entity. The term *Old Entity* means the Institution or Consolidated Subsidiary that is treated as selling all of its assets in a Taxable Transfer described in §1.597–5(b).

Residual Entity. The term *Residual Entity* means the entity that remains after an Institution transfers deposit liabilities to a Bridge Bank.

Taxable Transfer. The term *Taxable Transfer* has the meaning provided in §1.597–5(a)(1).

[T.D.8641, 60 FR 66094, Dec. 21, 1995]

§1.597–2 Taxation of Federal financial assistance.

(a) *Inclusion in income*—(1) *In general.* Except as otherwise provided in the regulations under section 597, all FFA is includible as ordinary income to the recipient at the time the FFA is received or accrued in accordance with the recipient's method of accounting. The amount of FFA received or accrued is the amount of any money, the fair market value of any property (other than an Agency Obligation), and the issue price of any Agency Obligation (determined under § 1.597–3(c)(2)). An Institution (and not the nominal recipient) is treated as receiving directly any FFA that Agency provides in a taxable year to a direct or indirect shareholder of the Institution, to the extent money or property is transferred to the Institution pursuant to an agreement with Agency.

(2) *Cross references.* See paragraph (c) of this section for rules regarding the timing of inclusion of certain FFA. See paragraph (d) of this section for additional rules regarding the treatment of FFA received in connection with transfers of money or property to Agency or a Controlled Entity, or paid pursuant to a Loss Guarantee. See § 1.597–5(c)(1) for additional rules regarding the inclusion of Net Worth Assistance in the income of an Institution.

(b) *Basis of property that is FFA.* If FFA consists of property, the Institution's basis in the property equals the fair market value of the property (other than an Agency Obligation) or the issue price of the Agency Obligation, as determined under § 1.597–3(c)(2).

(c) *Timing of inclusion of certain FFA*—(1) *Scope.* This paragraph (c) limits the amount of FFA an Institution must include in income currently under certain circumstances and provides rules for the deferred inclusion in income of amounts in excess of those limits. This paragraph (c) does not apply to a New Entity or Acquiring.

(2) *Amount currently included in income by an Institution without Continuing Equity.* The amount of FFA an Institution without Continuing Equity must include in income in a taxable year under paragraph (a)(1) of this section is limited to the sum of—

(i) The excess at the beginning of the taxable year of the Institution's liabilities over the adjusted bases of the Institution's assets; and

(ii) The amount by which the excess for the taxable year of the Institution's deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) over its gross income (determined without regard to FFA) is greater than the excess at the beginning of the taxable year of the adjusted bases of the Institution's assets over the Institution's liabilities.

(3) *Amount currently included in income by an Institution with Continuing Equity.* The amount of FFA an Institution with Continuing Equity must include in income in a taxable year under paragraph (a)(1) of this section is limited to the sum of—

(i) The excess at the beginning of the taxable year of the Institution's liabilities over the adjusted bases of the Institution's assets;

(ii) The greater of—

(A) The excess for the taxable year of the Institution's deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) over its gross income (determined without regard to FFA); or

(B) The excess for the taxable year of the deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) of the consolidated group of which the Institution is a member on the last day of the Institution's taxable year over the group's gross income (determined without regard to FFA); and

(iii) The excess of the amount of any net operating loss carryover of the Institution (or in the case of a carryover from a consolidated return year of the Institution's current consolidated group, the net operating loss carryover of the group) to the taxable year over the amount described in paragraph (c)(3)(i) of this section.

(4) *Deferred FFA*—(i) *Maintenance of account.* An Institution must establish a deferred FFA account commencing in the first taxable year in which it receives FFA that is not currently included in income under paragraph (c)(2) or (c)(3) of this section, and must maintain that account in accordance with the requirements of this paragraph (c)(4). The Institution must add the

amount of any FFA that is not currently included in income under paragraph (c)(2) or (c)(3) of this section to its deferred FFA account. The Institution must decrease the balance of its deferred FFA account by the amount of deferred FFA included in income under paragraphs (c)(4)(ii), (iv) and (v) of this section. (See also paragraph (d)(5)(i)(B) of this section for other adjustments that decrease the deferred FFA account.) If, under paragraph (c)(3) of this section, FFA is not currently included in income in a taxable year, the Institution thereafter must maintain its deferred FFA account on a FIFO (first in, first out) basis (e.g., for purposes of the first sentence of paragraph (c)(4)(iv) of this section).

(ii) *Deferred FFA recapture.* In any taxable year in which an Institution has a balance in its deferred FFA account, it must include in income an amount equal to the lesser of the amount described in paragraph (c)(4)(iii) of this section or the balance in its deferred FFA account.

(iii) *Annual recapture amount*—(A) *Institutions without Continuing Equity*—(*1*) *In general.* In the case of an Institution without Continuing Equity, the amount described in this paragraph (c)(4)(iii) is the amount by which—

(*i*) The excess for the taxable year of the Institution's deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) over its gross income (taking into account FFA included in income under paragraph (c)(2) of this section); is greater than

(*ii*) The Institution's remaining equity as of the beginning of the taxable year.

(*2*) *Remaining equity.* The Institution's remaining equity is—

(*i*) The amount at the beginning of the taxable year in which the deferred FFA account was established equal to the adjusted bases of the Institution's assets minus the Institution's liabilities (which amount may be positive or negative); plus

(*ii*) The Institution's taxable income (computed without regard to any carryover from any other year) in any subsequent taxable year or years; minus

(*iii*) The excess in any subsequent taxable year or years of the Institution's deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) over its gross income.

(B) *Institutions with Continuing Equity.* In the case of an Institution with Continuing Equity, the amount described in this paragraph (c)(4)(iii) is the amount by which the Institution's deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) exceed its gross income (taking into account FFA included in income under paragraph (c)(3) of this section).

(iv) *Additional deferred FFA recapture by an Institution with Continuing Equity.* To the extent that, as of the end of a taxable year, the cumulative amount of FFA deferred under paragraph (c)(3) of this section that an Institution with Continuing Equity has recaptured under this paragraph (c)(4) is less than the cumulative amount of FFA deferred under paragraph (c)(3) of this section that the Institution would have recaptured if that FFA had been included in income ratably over the six taxable years immediately following the taxable year of deferral, the Institution must include that difference in income for the taxable year. An Institution with Continuing Equity must include in income the balance of its deferred FFA account in the taxable year in which it liquidates, ceases to do business, transfers (other than to a Bridge Bank) substantially all of its assets and liabilities, or is deemed to transfer all of its assets under §1.597–5(b).

(v) *Optional accelerated recapture of deferred FFA.* An Institution that has a deferred FFA account may include in income the balance of its deferred FFA account on its timely filed (including extensions) original income tax return for any taxable year that it is not under Agency Control. The balance of its deferred FFA account is income on the last day of that year.

(5) *Exceptions to limitations on use of losses.* In computing an Institution's taxable income or alternative minimum taxable income for a taxable year, sections 56(d)(1), 382 and 383 and §§1.1502–15T, 1.1502–21T, and 1.1502–22T

(or §§ 1.1502–15A, 1.1502–21A, and 1.1502–22A, as appropriate) do not limit the use of the attributes of the Institution to the extent, if any, that the inclusion of FFA (including recaptured FFA) in income results in taxable income or alternative minimum taxable income (determined without regard to this paragraph (c)(5)) for the taxable year. This paragraph (c)(5) does not apply to any limitation under section 382 or 383 or § 1.1502–15T, 1.1502–21T or 1.1502–22T (or § 1.1502–15A, 1.1502–21A or 1.1502–22A, as appropriate) that arose in connection with or prior to a corporation becoming a Consolidated Subsidiary of the Institution.

(6) *Operating rules*—(i) *Bad debt reserves.* For purposes of paragraphs (c)(2), (c)(3) and (c)(4) of this section, the adjusted bases of an Institution's assets are reduced by the amount of the Institution's reserves for bad debts under section 585 or 593, other than supplemental reserves under section 593.

(ii) *Aggregation of Consolidated Subsidiaries.* For purposes of this paragraph (c), an Institution is treated as a single entity that includes the income, expenses, assets, liabilities, and attributes of its Consolidated Subsidiaries, with appropriate adjustments to prevent duplication.

(iii) *Alternative minimum tax.* To compute the alternative minimum taxable income attributable to FFA of an Institution for any taxable year under section 55, the rules of this section, and related rules, are applied by using alternative minimum tax basis, deductions, and all other items required to be taken into account. All other alternative minimum tax provisions continue to apply.

(7) *Earnings and profits.* FFA that is not currently included in income under this paragraph (c) is included in earnings and profits for all purposes of the Internal Revenue Code to the extent and at the time it is included in income under this paragraph (c).

(d) *Transfers of money or property to Agency, and property subject to a Loss Guarantee*—(1) *Transfers of property to Agency.* The transfer of property to Agency or a Controlled Entity is a taxable sale or exchange in which the Institution is treated as realizing an amount equal to—

(i) The property's fair market value; or

(ii) For property subject to a Loss Guarantee, the greater of the property's fair market value or the guaranteed value or price at which the property can be put at the time of transfer.

(2) *FFA with respect to property covered by a Loss Guarantee other than on transfer to Agency.* (i) FFA provided pursuant to a Loss Guarantee with respect to covered property is included in the amount realized with respect to the property to the extent the total amount realized does not exceed the greater of—

(A) The property's fair market value; or

(B) The guaranteed value or price at which the property can be put at the time of transfer.

(ii) For the purposes of this paragraph (d)(2), references to an amount realized include amounts obtained in whole or partial satisfaction of loans, amounts obtained by virtue of charging off or marking to market covered property, and other amounts similarly related to property, whether or not disposed of.

(3) *Treatment of FFA received in exchange for property.* FFA included in the amount realized for property under this paragraph (d) is not includible in income under paragraph (a)(1) of this section. The amount realized is treated in the same manner as if realized from a person other than Agency or a Controlled Entity. For example, gain attributable to FFA received with respect to a capital asset retains its character as capital gain. Similarly, FFA received with respect to property that has been charged off for income tax purposes is treated as a recovery to the extent of the amount previously charged off. Any FFA provided in excess of the amount realized under this paragraph (d) is includible in income under paragraph (a)(1) of this section.

(4) *Adjustment to FFA*—(i) *In general.* If an Institution pays or transfers money or property to Agency or a Controlled Entity, the amount of money and fair market value of the property is an adjustment to its FFA to the extent the amount paid and transferred

exceeds the amount of money and fair market value of property Agency or a Controlled Entity provides in exchange.

(ii) *Deposit insurance.* This paragraph (d)(4) does not apply to amounts paid to Agency with respect to deposit insurance.

(iii) *Treatment of an interest held by Agency or a Controlled Entity*—(A) *In general.* For purposes of this paragraph (d), an interest described in § 1.597–3(b) is not treated as property when transferred by the issuer to Agency or a Controlled Entity nor when acquired from Agency or a Controlled Entity by the issuer.

(B) *Dispositions to persons other than issuer.* On the date Agency or a Controlled Entity transfers an interest described in § 1.597–3(b) to a holder other than the issuer, Agency or a Controlled Entity, the issuer is treated for purposes of this paragraph (d)(4) as having transferred to Agency an amount of money equal to the sum of the amount of money and the fair market value of property that was paid by the new holder as consideration for the interest.

(iv) *Consolidated groups.* For purposes of this paragraph (d), an Institution will be treated as having made any transfer to Agency or a Controlled Entity that was made by any other member of its consolidated group. The consolidated group must make appropriate investment basis adjustments to the extent the member transferring money or other property is not the member that received FFA.

(5) *Manner of making adjustments to FFA*—(i) *Reduction of FFA and deferred FFA.* An Institution adjusts its FFA under paragraph (d)(4) of this section by reducing in the following order and in an aggregate amount not greater than the adjustment—

(A) The amount of any FFA that is otherwise includible in income for the taxable year (before application of paragraph (c) of this section); and

(B) The balance (but not below zero) in the deferred FFA account, if any, maintained under paragraph (c)(4) of this section.

(ii) *Deduction of excess amounts.* If the amount of the adjustment exceeds the sum of the amounts described in paragraph (d)(5)(i) of this section, the Institution may deduct the excess to the extent the deduction does not exceed the amount of FFA included in income for prior taxable years reduced by the amount of deductions allowable under this paragraph (d)(5)(ii) in prior taxable years.

(iii) *Additional adjustments.* Any adjustment to FFA in excess of the sum of the amounts described in paragraphs (d)(5)(i) and (ii) of this section is treated—

(A) By an Institution other than a New Entity or Acquiring, as a deduction of the amount in excess of FFA received that is required to be transferred to Agency under section 11(g) of the Federal Deposit Insurance Act (12 U.S.C. 1821(g)); or

(B) By a New Entity or Acquiring, as an adjustment to the purchase price paid in the Taxable Transfer (see § 1.338(b)–3T).

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

Example 1. Timing of inclusion of FFA in income. (i) Institution M, a calendar year taxpayer without Continuing Equity because it is in Agency receivership, is not a member of a consolidated group and has not been acquired in a Taxable Transfer. On January 1, 1997, M has assets with a total adjusted basis of $100 million and total liabilities of $120 million. M's deductions do not exceed its gross income (determined without regard to FFA) for 1997. Agency provides $30 million of FFA to M in 1997. The amount of this FFA that M must include in income in 1997 is limited by § 1.597–2(c)(2) to $20 million, the amount by which M's liabilities ($120 million) exceed the total adjusted basis of its assets ($100 million) at the beginning of the taxable year. Pursuant to § 1.597–2(c)(4)(i), M must establish a deferred FFA account for the remaining $10 million.

(ii) If Agency instead lends M the $30 million, M's indebtedness to Agency is disregarded and the results are the same as in paragraph (i) of this *Example 1.* Section 597(c); §§ 1.597–1(b) (defining FFA) and 1.597–3(b).

Example 2. Transfer of property to Agency. (i) Institution M, a calendar year taxpayer without Continuing Equity because it is in Agency receivership, is not a member of a consolidated group and has not been acquired in a Taxable Transfer. At the beginning of 1998, M's remaining equity is $0 and M has a deferred FFA account of $10 million. Agency does not provide any FFA to M in 1998. During the year, M transfers property not covered by a Loss Guarantee to Agency and does not receive any consideration. The property has an adjusted basis of $5 million and a fair market value of $1 million at the time of the transfer. M has no other taxable income or loss in 1998.

(ii) Under § 1.597–2(d)(1), M is treated as selling the property for $1 million, its fair market value, thus recognizing a $4 million loss ($5 million–$1 million). In addition, because M did not receive any consideration from Agency, under § 1.597–2(d)(4) M has an adjustment to FFA of $1 million, the amount by which the fair market value of the transferred property ($1 million) exceeds the consideration M received from Agency ($0). Because no FFA is provided to M in 1998, this adjustment reduces the balance of M's deferred FFA account to $9 million ($10 million–$1 million). Section 1.597–2(d)(5)(i)(B). Because M's $4 million loss causes M's deductions to exceed its gross income by $4 million in 1998 and M has no remaining equity, under § 1.597–2(c)(4)(iii)(A) M must include $4 million of deferred FFA in income, and must decrease the remaining $9 million balance of its deferred FFA account by the same amount, leaving a balance of $5 million.

Example 3. Loss Guarantee. Institution Q, a calendar year taxpayer, sells an asset covered by a Loss Guarantee to an unrelated third party for $4,000. Q's adjusted basis in the asset at the time of sale and the asset's guaranteed value are both $10,000. Pursuant to the Loss Guarantee, Agency pays Q $6,000 ($10,000–$4,000). Q's amount realized from the sale of the asset is $10,000 ($4,000 from the third party and $6,000 from Agency). Section 1.597–2(d)(2). Q realizes no gain or loss on the sale ($10,000–$10,000 = $0), and therefore includes none of the $6,000 of FFA it receives pursuant to the Loss Guarantee in income. Section 1.597–2(d)(3).

[T.D. 8641, 60 FR 66095, Dec. 21, 1995; 61 FR 12135, Mar. 25, 1996, as amended by T.D. 8677, 61 FR 33322, June 27, 1996]

§ 1.597–3 Other rules.

(a) *Ownership of assets.* For all income tax purposes, an Institution is treated as the owner of all assets covered by a Loss Guarantee, yield maintenance agreement, or cost to carry or cost of funds reimbursement agreement, regardless of whether Agency (or a Controlled Entity) otherwise would be treated as the owner under general principles of income taxation.

(b) *Debt and equity interests received by Agency.* Debt instruments, stock, warrants, or other rights to acquire stock of an Institution (or any of its affiliates) that Agency or a Controlled Entity receives in connection with a transaction in which FFA is provided are not treated as debt, stock or other equity interests of or in the issuer for any purpose of the Internal Revenue Code while held by Agency or a Controlled Entity. On the date Agency or a Controlled Entity transfers an interest described in this paragraph (b) to a holder other than Agency or a Controlled Entity, the interest is treated as having been newly issued by the issuer to the holder with an issue price equal to the sum of the amount of money and the fair market value of property paid by the new holder in exchange for the interest.

(c) *Agency Obligations*—(1) *In general.* Except as otherwise provided in this paragraph (c), the original issue discount rules of sections 1271 *et seq.* apply to Agency Obligations.

(2) *Issue price of Agency Obligations provided as Net Worth Assistance.* The issue price of an Agency Obligation that is provided as Net Worth Assistance and that bears interest at either a single fixed rate or a qualified floating rate (and provides for no contingent payments) is the lesser of the sum of the present values of all payments due under the obligation, discounted at a rate equal to the applicable Federal rate (within the meaning of section 1274(d) (1) and (3)) in effect for the date of issuance, or the stated principal amount of the obligation. The issue price of an Agency Obligation that bears a qualified floating rate of interest (within the meaning of § 1.1275–5(b)) is determined by treating the obligation as bearing a fixed rate of interest equal to the rate in effect on the date of issuance under the obligation.

(3) *Adjustments to principal amount.* Except as provided in § 1.597–5(d)(2)(iv), this paragraph (c)(3) applies if Agency modifies or exchanges an Agency Obligation provided as Net Worth Assistance (or a successor obligation). The issue price of the modified or new Agency Obligation is determined under paragraphs (c) (1) and (2) of this section. If the issue price is greater than the adjusted issue price of the existing Agency Obligation, the difference is treated as FFA. If the issue price is less than the adjusted issue price of the

existing Agency Obligation, the difference is treated as an adjustment to FFA under §1.597–2(d)(4).

(d) *Successors.* To the extent necessary to effectuate the purposes of the regulations under section 597, an entity's treatment under the regulations applies to its successor. A successor includes a transferee in a transaction to which section 381(a) applies or a Bridge Bank to which another Bridge Bank transfers deposit liabilities.

(e) *Loss disallowance.* For purposes of §1.1502–20, FFA and the amount described in §1.597–4(g)(3) are treated as an extraordinary gain disposition within the meaning of §1.1502–20(c)(2)(i) and a Taxable Transfer is treated as an applicable asset acquisition under section 1060(c) within the meaning of §1.1502–20(c)(2)(i)(A)(*4*).

(f) *Losses and deductions with respect to covered assets.* Prior to the disposition of an asset covered by a Loss Guarantee, the asset cannot be charged off, marked to a market value, depreciated, amortized, or otherwise treated in a manner that supposes an actual or possible diminution of value below the greater of the asset's highest guaranteed value or the highest price at which the asset can be put.

(g) *Anti-abuse rule.* The regulations under section 597 must be applied in a manner consistent with the purposes of section 597. Accordingly, if, in structuring or engaging in any transaction, a principal purpose is to achieve a tax result that is inconsistent with the purposes of section 597 and the regulations thereunder, the Commissioner can make appropriate adjustments to income, deductions and other items that would be consistent with those purposes.

[T.D. 8641, 60 FR 66097, Dec. 21, 1995]

§1.597–4 Bridge Banks and Agency Control.

(a) *Scope.* This section provides rules that apply to a Bridge Bank or other *Institution* under Agency Control and to transactions in which an Institution transfers deposit liabilities (whether or not the Institution also transfers assets) to a Bridge Bank.

(b) *Status as taxpayer.* A Bridge Bank or other Institution under Agency Control is a corporation within the meaning of section 7701(a)(3) for all purposes of the Internal Revenue Code and is subject to all Internal Revenue Code provisions that generally apply to corporations, including those relating to methods of accounting and to requirements for filing returns, even if Agency owns stock of the Institution.

(c) *No section 382 ownership change.* The imposition of Agency Control, the cancellation of Institution stock by Agency, a transaction in which an Institution transfers deposit liabilities to a Bridge Bank, and an election under paragraph (g) of this section are disregarded in determining whether an ownership change has occurred within the meaning of section 382(g).

(d) *Transfers to Bridge Banks*—(1) *In general.* Except as otherwise provided in paragraph (g) of this section, the rules of this paragraph (d) apply to transfers to Bridge Banks. In general, a Bridge Bank and its associated Residual Entity are together treated as the successor entity to the transferring Institution. If an Institution transfers deposit liabilities to a Bridge Bank (whether or not it also transfers assets), the Institution recognizes no gain or loss on the transfer and the Bridge Bank succeeds to the transferring Institution's basis in any transferred assets. The associated Residual Entity retains its basis in any assets it continues to hold. Immediately after the transfer, the Bridge Bank succeeds to and takes into account the transferring Institution's items described in section 381(c) (subject to the conditions and limitations specified in section 381(c)), taxpayer identification number (''TIN''), deferred FFA account, and account receivable for future FFA as described in paragraph (g)(4)(ii) of this section. The Bridge Bank also succeeds to and continues the transferring Institution's taxable year.

(2) *Transfers to a Bridge Bank from multiple Institutions.* If two or more Institutions transfer deposit liabilities to the same Bridge Bank, the rules in paragraph (d)(1) of this section are modified to the extent provided in this paragraph (d)(2). The Bridge Bank succeeds to the TIN and continues the taxable year of the Institution that transfers the largest amount of deposits.

The taxable years of the other transferring Institutions close at the time of the transfer. If all the transferor Institutions are members of the same consolidated group, the Bridge Bank's carryback of losses to the Institution that transfers the largest amount of deposits is not limited by section 381(b)(3). The limitations of section 381(b)(3) do apply to the Bridge Bank's carrybacks of losses to all other transferor Institutions. If the transferor Institutions are not all members of the same consolidated group, the limitations of section 381(b)(3) apply with respect to all transferor Institutions. See paragraph (g)(6)(ii) of this section for additional rules that apply if two or more Institutions that are not members of the same consolidated group transfer deposit liabilities to the same Bridge Bank.

(e) *Treatment of Bridge Bank and Residual Entity as a single entity.* A Bridge Bank and its associated Residual Entity or Entities are treated as a single entity for income tax purposes and must file a single combined income tax return. The Bridge Bank is responsible for filing all income tax returns and statements for this single entity and is the agent of each associated Residual Entity to the same extent as if the Bridge Bank were the common parent of a consolidated group including the Residual Entity. The term *Institution* includes a Residual Entity that files a combined return with its associated Bridge Bank.

(f) *Rules applicable to members of consolidated groups*—(1) *Status as members.* Unless an election is made under paragraph (g) of this section, Agency Control of an Institution does not terminate the Institution's membership in a consolidated group. Stock of a subsidiary that is canceled by Agency is treated as held by the members of the consolidated group that held the stock prior to its cancellation. If an Institution is a member of a consolidated group immediately before it transfers deposit liabilities to a Bridge Bank, the Bridge Bank succeeds to the Institution's status as the common parent or, unless an election is made under paragraph (g) of this section, as a subsidiary of the group. If a Bridge Bank succeeds to an Institution's status as a subsidiary, its stock is treated as held by the shareholders of the transferring Institution, and the stock basis or excess loss account of the Institution carries over to the Bridge Bank. A Bridge Bank is treated as owning stock owned by its associated Residual Entities, including for purposes of determining membership in an affiliated group.

(2) *No 30-day election to be excluded from consolidated group.* Neither an Institution nor any of its Consolidated Subsidiaries may be excluded from a consolidated group for a taxable year under § 1.1502–76(b)(5)(ii), as contained in 26 CFR part 1 edition revised April 1, 1994, if the Institution is under Agency Control at any time during the year.

(3) *Coordination with consolidated return regulations.* The provisions of the regulations under section 597 take precedence over conflicting provisions in the regulations under section 1502.

(g) *Elective disaffiliation*—(1) *In general.* A consolidated group of which an Institution is a subsidiary may elect irrevocably not to include the Institution in its affiliated group if the Institution is placed in Agency receivership (whether or not assets or deposit liabilities of the Institution are transferred to a Bridge Bank). See paragraph (g)(6) of this section for circumstances under which a consolidated group is deemed to make this election.

(2) *Consequences of election.* If the election under this paragraph (g) is made with respect to an Institution, the following consequences occur immediately before the subsidiary Institution to which the election applies is placed in Agency receivership (or, in the case of a deemed election under paragraph (g)(6) of this section, immediately before the consolidated group is deemed to make the election) and in the following order—

(i) All adjustments of the Institution and its Consolidated Subsidiaries under section 481 are accelerated;

(ii) Deferred intercompany gains and losses with respect to the Institution and its Consolidated Subsidiaries are taken into account and the Institution and its Consolidated Subsidiaries take into account any other items required under the regulations under section

1502 for members that become nonmembers within the meaning of §1.1502–32(d)(4);

(iii) The taxable year of the Institution and its Consolidated Subsidiaries closes and the Institution includes the amount described in paragraph (g)(3) of this section in income as ordinary income as its last item for that taxable year;

(iv) The members of the consolidated group owning the common stock of the Institution include in income any excess loss account with respect to the Institution's stock under §1.1502–19 and any other items required under the regulations under section 1502 for members that own stock of corporations that become nonmembers within the meaning of §1.1502–32(d)(4); and

(v) If the Institution's liabilities exceed the aggregate fair market value of its assets on the date the Institution is placed in Agency receivership (or, in the case of a deemed election under paragraph (g)(6) of this section, on the date the consolidated group is deemed to make the election), the members of the consolidated group treat their stock in the Institution as worthless. (See §§1.337(d)-1 and 1.1502–20 for potential limitations on the group's worthless stock deduction.) In all other cases, the consolidated group will be treated as owning stock of a nonmember corporation until such stock is disposed of or becomes worthless under rules otherwise applicable.

(3) *Toll charge.* The amount described in this paragraph (g)(3) is the excess of the Institution's liabilities over the adjusted bases of its assets immediately before the Institution is placed in Agency receivership (or, in the case of a deemed election under paragraph (g)(6) of this section, immediately before the consolidated group is deemed to make the election). In computing this amount, the adjusted bases of an Institution's assets are reduced by the amount of the Institution's reserves for bad debts under section 585 or 593, other than supplemental reserves under section 593. For purposes of this paragraph (g)(3), an Institution is treated as a single entity that includes the assets and liabilities of its Consolidated Subsidiaries, with appropriate adjustments to prevent duplication. The amount described in this paragraph (g)(3) for alternative minimum tax purposes is determined using alternative minimum tax basis, deductions, and all other items required to be taken into account. In computing the increase in the group's taxable income or alternative minimum taxable income, sections 56(d)(1), 382 and 383 and §§1.1502–15T, 1.1502–21T and 1.1502–22T (or §§1.1502–15A, 1.1502–21A and 1.1502–22A, as appropriate) do not limit the use of the attributes of the Institution and its Consolidated Subsidiaries to the extent, if any, that the inclusion of the amount described in this paragraph (g)(3) in income would result in the group having taxable income or alternative minimum taxable income (determined without regard to this sentence) for the taxable year. The preceding sentence does not apply to any limitation under section 382 or 383 or §1.1502–15T, 1.1502–21T, or 1.1502–22T (or §1.1502–15A, 1.1502–21A, or 1.1502–22A, as appropriate) that arose in connection with or prior to a corporation becoming a Consolidated Subsidiary of the Institution.

(4) *Treatment of Institutions after disaffiliation*—(i) *In general.* If the election under this paragraph (g) is made with respect to an Institution, immediately after the Institution is placed in Agency receivership (or, in the case of a deemed election under paragraph (g)(6) of this section, immediately after the consolidated group is deemed to make the election), the Institution and each of its Consolidated Subsidiaries are treated for income tax purposes as new corporations that are not members of the electing group's affiliated group. Each new corporation retains the TIN of the corresponding disaffiliated corporation and is treated as having received the assets and liabilities of the corresponding disaffiliated corporation in a transaction to which section 351 applies (and in which no gain was recognized under section 357(c) or otherwise). Thus, the new corporation has no net operating or capital loss carryforwards. An election under this paragraph (g) does not terminate the single entity treatment of a Bridge Bank and its Residual Entities provided in paragraph (e) of this section.

(ii) *FFA.* A new Institution is treated as having a non-interest bearing, non-transferable account receivable for future FFA with a basis equal to the amount described in paragraph (g)(3) of this section. If a disaffiliated Institution has a deferred FFA account at the time of its disaffiliation, the corresponding new Institution succeeds to and takes into account that deferred FFA account.

(iii) *Filing of consolidated returns.* If a disaffiliated Institution has Consolidated Subsidiaries at the time of its disaffiliation, the corresponding new Institution is required to file a consolidated income tax return with the subsidiaries in accordance with the regulations under section 1502.

(iv) *Status as Institution.* If an Institution is disaffiliated under this paragraph (g), the resulting new corporation is treated as an Institution for purposes of the regulations under section 597 regardless of whether it is a bank or domestic building and loan association within the meaning of section 597.

(v) *Loss carrybacks.* To the extent a carryback of losses would result in a refund being paid to a fiduciary under section 6402(i), an Institution or Consolidated Subsidiary with respect to which an election under this paragraph (g) (other than under paragraph (g)(6)(ii) of this section) applies is allowed to carry back losses as if the Institution or Consolidated Subsidiary had continued to be a member of the consolidated group that made the election.

(5) *Affirmative election*—(i) *Original Institution*—(A) *Manner of making election.* Except as otherwise provided in paragraph (g)(6) of this section, a consolidated group makes the election provided by this paragraph (g) by sending a written statement by certified mail to the affected Institution on or before the later of 120 days after its placement in Agency receivership or May 31, 1996. The statement must contain the following legend at the top of the page: ‘‘THIS IS AN ELECTION UNDER § 1.597–4(g) TO EXCLUDE THE BELOW-REFERENCED INSTITUTION AND CONSOLIDATED SUBSIDIARIES FROM THE AFFILIATED GROUP,’’ and must include the names and taxpayer identification numbers of the common parent and of the Institution and Consolidated Subsidiaries to which the election applies, and the date on which the Institution was placed in Agency receivership. The consolidated group must send a similar statement to all subsidiary Institutions placed in Agency receivership during the consistency period described in paragraph (g)(5)(ii) of this section. (Failure to satisfy the requirement in the preceding sentence, however, does not invalidate the election with respect to any subsidiary Institution placed in Agency receivership during the consistency period described in paragraph (g)(5)(ii) of this section.) The consolidated group must include a copy of any election statement and accompanying certified mail receipt as part of its first income tax return filed after the due date under this paragraph (g)(5) for such statement. A statement must be attached to this return indicating that the individual who signed the election was authorized to do so on behalf of the consolidated group. Agency cannot make this election under the authority of section 6402(i) or otherwise.

(B) *Consistency limitation on affirmative elections.* A consolidated group may make an affirmative election under this paragraph (g)(5) with respect to a subsidiary Institution placed in Agency receivership only if the group made, or is deemed to have made, the election under this paragraph (g) with respect to every subsidiary Institution of the group placed in Agency receivership on or after May 10, 1989 and within five years preceding the date the subject Institution was placed in Agency receivership.

(ii) *Effect on Institutions placed in receivership simultaneously or subsequently.* An election under this paragraph (g), other than under paragraph (g)(6)(ii) of this section, applies to the Institution with respect to which the election is made or deemed made (the original Institution) and each subsidiary Institution of the group placed in Agency receivership or deconsolidated in contemplation of Agency Control or the receipt of FFA simultaneously with the original Institution or within five years thereafter.

(6) *Deemed Election*—(i) *Deconsolidations in contemplation.* If one or more members of a consolidated group deconsolidate (within the meaning of §1.1502–19(c)(1)(ii)(B)) a subsidiary Institution in contemplation of Agency Control or the receipt of FFA, the consolidated group is deemed to make the election described in this paragraph (g) with respect to the Institution on the date the deconsolidation occurs. A subsidiary Institution is conclusively presumed to have been deconsolidated in contemplation of Agency Control or the receipt of FFA if either event occurs within six months after the deconsolidation.

(ii) *Transfers to a Bridge Bank from multiple groups.* On the day an Institution's transfer of deposit liabilities to a Bridge Bank results in the Bridge Bank holding deposit liabilities from both a subsidiary Institution and an Institution not included in the subsidiary Institution's consolidated group, each consolidated group of which a transferring Institution or the Bridge Bank is a subsidiary is deemed to make the election described in this paragraph (g) with respect to its subsidiary Institution. If deposit liabilities of another Institution that is a subsidiary member of any consolidated group subsequently are transferred to the Bridge Bank, the consolidated group of which the Institution is a subsidiary is deemed to make the election described in this paragraph (g) with respect to that Institution at the time of the subsequent transfer.

(h) *Examples.* The following examples illustrate the provisions of this section:

Facts. Corporation X, the common parent of a consolidated group, owns all the stock (with a basis of $4 million) of Institution M, an insolvent Institution with no Consolidated Subsidiaries. At the close of business on April 30, 1996, M has $4 million of deposit liabilities, $1 million of other liabilities, and assets with an adjusted basis of $4 million and a fair market value of $3 million.

Example 1. Effect of receivership on consolidation. On May 1, 1996, Agency places M in receivership and begins liquidating M. X does not make an election under §1.597–4(g). M remains a member of the X consolidated group after May 1, 1996. Section 1.597–4(f)(1).

Example 2. Effect of Bridge Bank on consolidation—(i) *Additional facts.* On May 1, 1996, Agency places M in receivership and causes M to transfer all of its assets and deposit liabilities to Bridge Bank MB.

(ii) *Consequences without an election to disaffiliate.* M recognizes no gain or loss from the transfer and MB succeeds to M's basis in the transferred assets, M's items described in section 381(c) (subject to the conditions and limitations specified in section 381(c)) and TIN. Section 1.597–4(d)(1). (If M had a deferred FFA account, MB would also succeed to that account. Section 1.597–4(d)(1).) MB continues M's taxable year and succeeds to M's status as a member of the X consolidated group after May 1, 1996. Section 1.597–4 (d)(1) and (f). MB and M are treated as a single entity for income tax purposes. Section 1.597–4(e).

(iii) *Consequences with an election to disaffiliate.* If, on July 1, 1996, X makes an election under §1.597–4(g) with respect to M, the following consequences are treated as occurring immediately before M was placed in Agency receivership. M must include $1 million ($5 million of liabilities—$4 million of adjusted basis) in income as of May 1, 1996. Section 1.597–4(g) (2) and (3). M is then treated as a new corporation that is not a member of the X consolidated group and that has assets (including a $1 million account receivable for future FFA) with a basis of $5 million and $5 million of liabilities received from disaffiliated corporation M in a section 351 transaction. New corporation M retains the TIN of disaffiliated corporation M. Section 1.597–4(g)(4). Immediately after the disaffiliation, new corporation M is treated as transferring its assets and deposit liabilities to Bridge Bank MB. New corporation M recognizes no gain or loss from the transfer and MB succeeds to M's TIN and taxable year. Section 1.597–4(d)(1). Bridge Bank MB is treated as a single entity that includes M and has $5 million of liabilities, an account receivable for future FFA with a basis of $1 million, and other assets with a basis of $4 million. Section 1.597–4(d)(1).

[T.D. 8641, 60 FR 66098, Dec. 21, 1995, as amended by T.D. 8677, 61 FR 33322, 33323, June 27, 1996]

§1.597–5 Taxable Transfers.

(a) *Taxable Transfers*—(1) *Defined.* The term *Taxable Transfer* means—

(i) A transaction in which an entity transfers to a transferee other than a Bridge Bank—

(A) Any deposit liability (whether or not the Institution also transfers assets), if FFA is provided in connection with the transaction; or

(B) Any asset for which Agency or a Controlled Entity has any financial obligation (e.g., pursuant to a Loss Guarantee or Agency Obligation); or

(ii) A deemed transfer of assets described in paragraph (b) of this section.

(2) *Scope.* This section provides rules governing Taxable Transfers. Rules applicable to both actual and deemed asset acquisitions are provided in paragraphs (c) and (d) of this section. Special rules applicable only to deemed asset acquisitions are provided in paragraph (e) of this section.

(b) *Deemed asset acquisitions upon stock purchase*—(1) *In general.* In a deemed transfer of assets under this paragraph (b), an Institution (including a Bridge Bank or a Residual Entity) or a Consolidated Subsidiary of the Institution (the Old Entity) is treated as selling all of its assets in a single transaction and is treated as a new corporation (the New Entity) that purchases all of the Old Entity's assets at the close of the day immediately preceding the occurrence of an event described in paragraph (b)(2) of this section. However, such an event results in a deemed transfer of assets under this paragraph (b) only if it occurs—

(i) In connection with a transaction in which FFA is provided;

(ii) While the Old Entity is a Bridge Bank;

(iii) While the Old Entity has a positive balance in a deferred FFA account (see § 1.597–2(c)(4)(v) regarding the optional accelerated recapture of deferred FFA); or

(iv) With respect to a Consolidated Subsidiary, while the Institution of which it is a Consolidated Subsidiary is under Agency Control.

(2) *Events.* A deemed transfer of assets under this paragraph (b) results if the Old Entity—

(i) Becomes a non-member within the meaning of § 1.1502–32(d)(4) of its consolidated group (other than pursuant to an election under § 1.597–4(g));

(ii) Becomes a member of an affiliated group of which it was not previously a member (other than pursuant to an election under § 1.597–4(g)); or

(iii) Issues stock such that the stock that was outstanding before the imposition of Agency Control or the occurrence of any transaction in connection with the provision of FFA represents 50 percent or less of the vote or value of its outstanding stock (disregarding stock described in section 1504(a)(4) and stock owned by Agency or a Controlled Entity).

(3) *Bridge Banks and Residual Entities.* If a Bridge Bank is treated as selling all of its assets to a New Entity under this paragraph (b), each associated Residual Entity is treated as simultaneously selling its assets to a New Entity in a Taxable Transfer described in this paragraph (b).

(c) *Treatment of transferor*—(1) *FFA in connection with a Taxable Transfer.* A transferor in a Taxable Transfer is treated as having directly received immediately before a Taxable Transfer any Net Worth Assistance that Agency provides to the New Entity or Acquiring in connection with the transfer. (See § 1.597–2 (a) and (c) for rules regarding the inclusion of FFA in income and § 1.597–2(a)(1) for related rules regarding FFA provided to shareholders.) The Net Worth Assistance is treated as an asset of the transferor that is sold to the New Entity or Acquiring in the Taxable Transfer.

(2) *Amount realized in a Taxable Transfer.* In a Taxable Transfer described in paragraph (a)(1)(i) of this section, the amount realized is determined under section 1001(b) by reference to the consideration paid for the assets. In a Taxable Transfer described in paragraph (a)(1)(ii) of this section, the amount realized is the sum of the grossed-up basis of the stock acquired in connection with the Taxable Transfer (excluding stock acquired from the Old or New Entity), plus the amount of liabilities assumed or taken subject to in the deemed transfer, plus other relevant items. The grossed-up basis of the acquired stock equals the acquirors' basis in the acquired stock divided by the percentage of the Old Entity's stock (by value) attributable to the acquired stock.

(3) *Allocation of amount realized*—(i) *In general.* The amount realized under paragraph (c)(2) of this section is allocated among the assets transferred in the Taxable Transfer in the same manner as amounts are allocated among assets under § 1.338(b)–2T(b), (c)(1) and (2).

(ii) *Modifications to general rule.* This paragraph (c)(3)(ii) modifies certain of the allocation rules of paragraph (c)(3)(i) of this section. Agency Obligations and assets covered by Loss Guarantees in the hands of the New Entity or Acquiring are treated as Class II assets. Stock of a Consolidated Subsidiary is treated as a Class II asset to the extent the fair market value of the Consolidated Subsidiary's Class I and Class II assets exceeds the amount of its liabilities. The fair market value of an Agency Obligation is deemed to equal its adjusted issue price immediately before the Taxable Transfer. The fair market value of an asset covered by a Loss Guarantee immediately after the Taxable Transfer is deemed to be not less than the greater of the asset's highest guaranteed value or the highest price at which the asset can be put.

(d) *Treatment of a New Entity and Acquiring*—(1) *Purchase price.* The purchase price for assets acquired in a Taxable Transfer described in paragraph (a)(1)(i) of this section is the cost of the assets acquired. See §1.1060–1T(c)(1). The purchase price for assets acquired in a Taxable Transfer described in paragraph (a)(1)(ii) of this section is the sum of the grossed-up basis of the stock acquired in connection with the Taxable Transfer (excluding stock acquired from the Old or New Entity), plus the amount of liabilities assumed or taken subject to in the deemed transfer, plus other relevant items. The grossed-up basis of the acquired stock equals the acquirors' basis in the acquired stock divided by the percentage of the Old Entity's stock (by value) attributable to the acquired stock. FFA provided in connection with a Taxable Transfer is not included in the New Entity's or Acquiring's purchase price for the acquired assets. Any Net Worth Assistance so provided is treated as an asset of the transferor sold to the New Entity or Acquiring in the Taxable Transfer.

(2) *Allocation of basis*—(i) *In general.* Except as otherwise provided in this paragraph (d)(2), the purchase price determined under paragraph (d)(1) of this section is allocated among the assets transferred in the Taxable Transfer in the same manner as amounts are allocated among assets under §1.338(b)–2T(b), (c)(1) and (2).

(ii) *Modifications to general rule.* The allocation rules contained in paragraph (c)(3)(ii) of this section apply to the allocation of basis among assets acquired in a Taxable Transfer. No basis is allocable to Agency's agreement to provide Loss Guarantees, yield maintenance payments, cost to carry or cost of funds reimbursement payments, or expense reimbursement or indemnity payments. A New Entity's basis in assets it receives from its shareholders is determined under general principles of income taxation and is not governed by this paragraph (d).

(iii) *Allowance and recapture of additional basis in certain cases.* If the fair market value of the Class I and Class II assets acquired in a Taxable Transfer is greater than the New Entity's or Acquiring's purchase price for the acquired assets, the basis of the Class I and Class II assets equals their fair market value. The amount by which the fair market value of the Class I and Class II assets exceeds the purchase price is included ratably as ordinary income by the New Entity or Acquiring over a period of six taxable years beginning in the year of the Taxable Transfer. The New Entity or Acquiring must include as ordinary income the entire amount remaining to be recaptured under the preceding sentence in the taxable year in which an event occurs that would accelerate inclusion of an adjustment under section 481.

(iv) *Certain post-transfer adjustments*—(A) *Agency Obligations.* If an adjustment to the principal amount of an Agency Obligation or cash payment to reflect a more accurate determination of the condition of the Institution at the time of the Taxable Transfer is made before the earlier of the date the New Entity or Acquiring files its first post-transfer income tax return or the due date of that return (including extensions), the New Entity or Acquiring must adjust its basis in its acquired assets to reflect the adjustment. In making adjustments to the New Entity's or Acquiring's basis in its acquired assets, paragraph (c)(3)(ii) of this section is applied by treating an adjustment to the principal amount of an Agency Obligation pursuant to the first sentence of this paragraph (d)(2)(iv)(A) as occurring immediately before the Taxable

Transfer. (See § 1.597–3(c)(3) for rules regarding other adjustments to the principal amount of an Agency Obligation.)

(B) *Assets covered by a Loss Guarantee.* If, immediately after a Taxable Transfer, an asset is not covered by a Loss Guarantee but the New Entity or Acquiring has the right to designate specific assets that will be covered by a Loss Guarantee, the New Entity or Acquiring must treat any asset so designated as having been subject to the Loss Guarantee at the time of the Taxable Transfer. The New Entity or Acquiring must adjust its basis in the covered assets and in its other acquired assets to reflect the designation in the manner provided by paragraph (d)(2) of this section. The New Entity or Acquiring must make appropriate adjustments in subsequent taxable years if the designation is made after the New Entity or Acquiring files its first post-transfer income tax return or the due date of that return (including extensions) has passed.

(e) *Special rules applicable to Taxable Transfers that are deemed asset acquisitions*—(1) *Taxpayer identification numbers.* Except as provided in paragraph (e)(3) of this section, a New Entity succeeds to the TIN of the transferor in a deemed sale under paragraph (b) of this section.

(2) *Consolidated Subsidiaries*—(i) *In general.* A Consolidated Subsidiary that is treated as selling its assets in a Taxable Transfer under paragraph (b) of this section is treated as engaging immediately thereafter in a complete liquidation to which section 332 applies. The consolidated group of which the Consolidated Subsidiary is a member does not take into account gain or loss on the sale, exchange, or cancellation of stock of the Consolidated Subsidiary in connection with the Taxable Transfer.

(ii) *Certain minority shareholders.* Shareholders of the Consolidated Subsidiary that are not members of the consolidated group that includes the Institution do not recognize gain or loss with respect to shares of Consolidated Subsidiary stock retained by the shareholder. The shareholder's basis for that stock is not affected by the Taxable Transfer.

(3) *Bridge Banks and Residual Entities*—(i) *In general.* A Bridge Bank or Residual Entity's sale of assets to a New Entity under paragraph (b) of this section is treated as made by a single entity under § 1.597–4(e). The New Entity deemed to acquire the assets of a Residual Entity under paragraph (b) of this section is not treated as a single entity with the Bridge Bank (or with the New Entity acquiring the Bridge Bank's assets) and must obtain a new TIN.

(ii) *Treatment of consolidated groups.* At the time of a Taxable Transfer described in paragraph (a)(1)(ii) of this section, treatment of a Bridge Bank as a subsidiary member of a consolidated group under § 1.597–4(f)(1) ceases. However, the New Entity deemed to acquire the assets of a Residual Entity is a member of the selling consolidated group after the deemed sale. The group's basis or excess loss account in the stock of the New Entity that is deemed to acquire the assets of the Residual Entity is the group's basis or excess loss account in the stock of the Bridge Bank immediately before the deemed sale, as adjusted for the results of the sale.

(4) *Certain returns.* If an Old Entity without Continuing Equity is not a subsidiary of a consolidated group at the time of the Taxable Transfer, the controlling Agency must file all income tax returns for the Old Entity for periods ending on or prior to the date of the deemed sale described in paragraph (b) of this section that are not filed as of that date.

(5) *Basis limited to fair market value.* If all of the stock of the corporation is not acquired on the date of the Taxable Transfer, the Commissioner may make appropriate adjustments under paragraphs (c) and (d) of this section to the extent using a grossed-up basis of the stock of a corporation results in an aggregate amount realized for, or basis in, the assets other than the aggregate fair market value of the assets.

(f) *Examples.* The following examples illustrate the provisions of this section:

Example 1. Branch sale resulting in Taxable Transfer. (i) Institution M is a calendar year taxpayer in Agency receivership. M is not a member of a consolidated group. On January

1, 1997, M has $200 million of liabilities (including deposit liabilities) and assets with an adjusted basis of $100 million. M has no income or loss for 1997 and, except as described below, receives no FFA. On September 30, 1997, Agency causes M to transfer six branches (with assets having an adjusted basis of $1 million) together with $120 million of deposit liabilities to N. In connection with the transfer, Agency provides $121 million in cash to N.

(ii) The transaction is a Taxable Transfer in which M receives $121 million of Net Worth Assistance. Section 1.597–5(a)(1). (M is treated as directly receiving the $121 million of Net Worth Assistance immediately before the Taxable Transfer. Section 1.597–5(c)(1).) M transfers branches having a basis of $1 million and is treated as transferring $121 million in cash (the Net Worth Assistance) to N in exchange for N's assumption of $120 million of liabilities. Thus, M realizes a loss of $2 million on the transfer. The amount of the FFA M must include in its income in 1997 is limited by §1.597–2(c) to $102 million, which is the sum of the $100 million excess of M's liabilities ($200 million) over the total adjusted basis of its assets ($100 million) at the beginning of 1997, plus the $2 million excess for the taxable year, which results from the Taxable Transfer, of M's deductions (other than carryovers) over its gross income other than FFA. M must establish a deferred FFA account for the remaining $19 million of FFA. Section 1.597–2(c)(4).

(iii) N, as Acquiring, must allocate its $120 million purchase price for the assets acquired from M among those assets. Cash is a Class I asset. The branch assets are in Classes III and IV. N's adjusted basis in the cash is its amount, i.e., $121 million. Section 1.597–5(d)(2). Because this amount exceeds N's purchase price for all of the acquired assets by $1 million, N allocates no basis to the other acquired assets and, under §1.597–5(d)(2), must recapture the $1 million excess at an annual rate of $166,667 in the six consecutive taxable years beginning with 1997 (subject to acceleration for certain events).

Example 2. Stock issuance by Bridge Bank causing Taxable Transfer. (i) On April 1, 1996, Institution P is placed in receivership and caused to transfer assets and liabilities to Bridge Bank PB. On August 31, 1996, the assets of PB consist of $20 million in cash, loans outstanding with an adjusted basis of $50 million and a fair market value of $40 million, and other non-financial assets (primarily branch assets and equipment) with an adjusted basis of $5 million. PB has deposit liabilities of $95 million and other liabilities of $5 million. P, the Residual Entity, holds real estate with an adjusted basis of $10 million and claims in litigation having a zero basis. P retains no deposit liabilities and has no other liabilities (except its liability to Agency for having caused its deposit liabilities to be satisfied).

(ii) On September 1, 1996, Agency causes PB to issue 100 percent of its common stock for $2 million cash to X. On the same day, Agency issues a $25 million note to PB. The note bears a fixed rate of interest in excess of the applicable federal rate in effect for September 1, 1996. Agency provides Loss Guarantees guaranteeing PB a value of $50 million for PB's loans outstanding.

(iii) The stock issuance is a Taxable Transfer in which PB is treated as selling all of its assets to a new corporation, New PB. Section 1.597–5(b)(1). PB is treated as directly receiving $25 million of Net Worth Assistance (the issue price of the Agency Obligation) immediately before the Taxable Transfer. Section 1.597–3(c)(2); §1.597- 5(c)(1). The amount of FFA PB must include in income is determined under §1.597–2(a) and (c). PB in turn is deemed to transfer the note to New PB in the Taxable Transfer, together with $20 million of cash, all its loans outstanding (with a basis of $50 million) and its other non-financial assets (with a basis of $5 million). The amount realized by PB from the sale is $100 million, the amount of PB's liabilities deemed to be assumed by New PB. This amount realized equals PB's basis in its assets and thus, PB realizes no gain or loss on the transfer to New PB.

(iv) Residual Entity P also is treated as selling all its assets (consisting of real estate and claims in litigation) for $0 (the amount of consideration received by P) to a new corporation (New P) in a Taxable Transfer. Section 1.597–5(b)(3). (P's only liability is to Agency and a liability to Agency is not treated as a debt under §1.597–3(b).) Thus, P realizes a $10 million loss on the transfer to New P. The combined return filed by PB and P for 1996 will reflect a total loss on the Taxable Transfer of $10 million ($0 for PB and $10 million for P). Section 1.597–5(e)(3). That return also will reflect FFA income from the Net Worth Assistance, determined under §1.597–2 (a) and (c).

(v) New PB is treated as having acquired the assets it acquired from PB for $100 million, the amount of liabilities assumed. In allocating basis among these assets, New PB treats the Agency note and the loans outstanding (which are covered by Loss Guarantees) as Class II assets. For the purpose of allocating basis, the fair market value of the Agency note is deemed to equal its adjusted issue price immediately before the transfer, $25 million. The fair market value of the loans is deemed not to be less than the guaranteed value of $50 million.

(vi) New P is treated as having acquired its assets for no consideration. Thus its basis in its assets immediately after the transfer is zero. New PB and New P are not treated as a single entity. Section 1.597–5(e)(3).

Example 3. Taxable Transfer of previously disaffiliated Institution. (i) Corporation X, the common parent of a consolidated group, owns all the stock of Institution M, an insolvent Institution with no Consolidated Subsidiaries. On April 30, 1996, M has $4 million of deposit liabilities, $1 million of other liabilities, and assets with an adjusted basis of $4 million and a fair market value of $3 million. On May 1, 1996, Agency places M in receivership. X elects under § 1.597–4(g) to disaffiliate M. Accordingly, as of May 1, 1996, new corporation M is not a member of the X consolidated group. On May 1, 1996, Agency causes M to transfer all of its assets and liabilities to Bridge Bank MB. Under § 1.597–4(e), MB and M are thereafter treated as a single entity which has $5 million of liabilities, an account receivable for future FFA with a basis of $1 million, and other assets with a basis of $4 million. Section 1.597–4(g)(4).

(ii) During May 1996, MB earns $25,000 of interest income and accrues $20,000 of interest expense on depositor accounts and there is no net change in deposits other than the additional $20,000 of interest expense accrued on depositor accounts. MB pays $5,000 of wage expenses and has no other items of income or expense.

(iii) On June 1, 1996, Agency causes MB to issue 100 percent of its stock to corporation Y. In connection with the stock issuance, Agency provides an Agency Obligation for $2 million and no other FFA.

(iv) The stock issuance results in a Taxable Transfer. Section 1.597–5(b). MB is treated as receiving the Agency Obligation immediately prior to the Taxable Transfer. Section 1.597–5(c)(1). MB has $1 million of basis in its account receivable for FFA. This receivable is treated as satisfied, offsetting $1 million of the $2 million of FFA provided by Agency in connection with the Taxable Transfer. The status of the remaining $1 million of FFA as includible income is determined as of the end of the taxable year under § 1.597–2(c). However, under § 1.597–2(b), MB obtains a $2 million basis in the Agency Obligation received as FFA.

(v) Under § 1.597–5(c)(2), in the Taxable Transfer, Old Entity MB is treated as selling, to New Entity MB, all of Old Entity MB's assets, having a basis of $6,020,000 (the original $4 million of asset basis as of April 30, 1996, plus $20,000 net cash from May 1996 activities, plus $2 million in the Agency Obligation received as FFA), for $5,020,000, the amount of Old Entity MB's liabilities assumed by New Entity MB pursuant to the Taxable Transfer. Therefore, Old Entity MB recognizes, in the aggregate, a loss of $1 million from the Taxable Transfer.

(vi) Because this $1 million loss causes Old Entity MB's deductions to exceed its gross income (determined without regard to FFA) by $1 million, Old Entity MB must include in its income the $1 million of FFA not offset by the FFA receivable. Section 1.597–2(c). (As of May 1, 1996, Old Entity MB's liabilities ($5,000,000) did not exceed MB's $5 million adjusted basis of its assets. For the taxable year, MB's deductions of $1,025,000 ($1,000,000 loss from the Taxable Transfer, $20,000 interest expense and $5,000 of wage expense) exceeded its gross income (disregarding FFA) of $25,000 (interest income) by $1,000,000. Thus, under § 1.597–2(c), MB includes in income the entire $1,000,000 of FFA not offset by the FFA receivable.)

(vii) Therefore, Old Entity MB's taxable income for the taxable year ending on the date of the Taxable Transfer is $0.

(viii) Residual Entity M is also deemed to engage in a deemed sale of its assets to New Entity M under § 1.597–5(b)(3), but there are no tax consequences as M has no assets or liabilities at the time of the deemed sale.

(ix) Under § 1.597–5(d)(1), New Entity MB is treated as purchasing Old Entity MB's assets for $5,020,000, the amount of New Entity MB's liabilities. Of this, $2,000,000 is allocated to the $2 million Agency Obligation, and $3,020,000 is allocated to the other assets New Entity MB is treated as purchasing in the Taxable Transfer.

Example 4. Loss Sharing. Institution N acquires assets and assumes liabilities of another Institution in a Taxable Transfer. Among the assets transferred are three parcels of real estate. In the hands of the transferring Institution, these assets had book values of $100,000 each. In connection with the Taxable Transfer, Agency agrees to reimburse Institution N for 80 percent of any loss (based on the original book value) realized on the disposition or charge-off of the three properties. This arrangement constitutes a Loss Guarantee. Thus, in allocating basis, Institution N treats the three parcels as Class II assets. By virtue of the arrangement with the Agency, Institution N is assured that the parcels will not be worth less to it than $80,000 each, because even if the properties are worthless, Agency will reimburse 80 percent of the loss. Although Institution could obtain payments under the Loss Guarantee if the properties are worth more, it is not guaranteed that it will realize more than $80,000. Accordingly, $80,000 is the highest guaranteed value of the three parcels. Institution N will allocate basis to the Class II assets up to their fair market value. For this purpose, the fair market value of the three parcels is not less than $80,000 each. Section 1.597–5(d)(2)(ii); § 1.597–5(c)(3)(ii).

[T.D. 8641, 60 FR 66101, Dec. 21, 1995]

§ 1.597–6 Limitation on collection of income tax.

(a) *Limitation on collection where tax is borne by Agency.* If an Institution without Continuing Equity (or any of its

Consolidated Subsidiaries) is liable for income tax that is attributable to the inclusion in income of FFA or gain from a Taxable Transfer, the tax will not be collected if it would be borne by Agency. The final determination of whether the tax would be borne by Agency is within the sole discretion of the Commissioner. In determining whether tax would be borne by Agency, the Commissioner will disregard indemnity, tax-sharing, or similar obligations of Agency, an Institution, or its Consolidated Subsidiaries. Collection of the several income tax liability under §1.1502–6 from members of an Institution's consolidated group other than the Institution or its Consolidated Subsidiaries is not affected by this section. Income tax will continue to be subject to collection except as specifically limited in this section. This section does not apply to taxes other than income taxes.

(b) *Amount of tax attributable to FFA or gain on a Taxable Transfer.* For purposes of paragraph (a) of this section, the amount of income tax in a taxable year attributable to the inclusion of FFA or gain from a Taxable Transfer in the income of an Institution (or a Consolidated Subsidiary) is the excess of the actual income tax liability of the Institution (or the consolidated group in which the Institution is a member) over the income tax liability of the Institution (or the consolidated group in which the Institution is a member) determined without regard to FFA or gain or loss on the Taxable Transfer.

(c) *Reporting of uncollected tax.* A taxpayer must specify on the front page of Form 1120 (U.S. Corporate Income Tax Return), to the left of the space provided for ''Total Tax,'' the amount of income tax for the taxable year that is potentially not subject to collection under this section. If an Institution is a subsidiary member of a consolidated group, the amount specified as not subject to collection is zero.

(d) *Assessments of tax to offset refunds.* Income tax that is not collected under this section will be assessed and, thus, used to offset any claim for refund made by or on behalf of the Institution, the Consolidated Subsidiary or any other corporation with several liability for the tax.

(e) *Collection of taxes from Acquiring or a New Entity*—(1) *Acquiring.* No income tax liability (including the several liability for taxes under §1.1502–6) of a transferor in a Taxable Transfer will be collected from Acquiring.

(2) *New Entity.* Income tax liability (including the several liability for taxes under §1.1502–6) of a transferor in a Taxable Transfer will be collected from a New Entity only if stock that was outstanding in the Old Entity remains outstanding as stock in the New Entity or is reacquired or exchanged for consideration.

(f) *Effect on section 7507.* This section supersedes the application of section 7507, and the regulations thereunder, for the assessment and collection of income tax attributable to FFA.

[T.D.8641, 60 FR 66103, Dec. 21, 1995]

§1.597–7 Effective date.

(a) *FIRREA effective date.* Section 597, as amended by section 1401 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Public Law 101–73, is generally effective for any FFA received or accrued by an Institution on or after May 10, 1989, and for any transaction in connection with which such FFA is provided, unless the FFA is provided in connection with an acquisition occurring prior to May 10, 1989. See §1.597–8 for rules regarding FFA received or accrued on or after May 10, 1989, that relates to an acquisition that occurred before May 10, 1989.

(b) *Effective date of regulations.* Except as otherwise provided in this section, §§1.597–1 through 1.597–6 apply to taxable years ending on or after April 22, 1992. However, the provisions of §§1.597–1 through 1.597–6 do not apply to FFA received or accrued for taxable years ending on or after April 22, 1992, in connection with an Agency assisted acquisition within the meaning of Notice 89–102 (1989–2 C.B. 436; see §601.601(d)(2)) (which does not include a transfer to a Bridge Bank), that occurs before April 22, 1992. Taxpayers not subject to §§1.597–1 through 1.597–6 must comply with an interpretation of the statute that is reasonable in light of the legislative history and applicable administrative pronouncements. For this purpose, the rules contained in Notice 89–102 apply to the extent provided in the Notice.

(c) *Elective application to prior years and transactions*—(1) *In general.* Except as limited in this paragraph (c), an election is available to apply §§ 1.597–1 through 1.597–6 to taxable years prior to the general effective date of these regulations. A consolidated group may elect to apply §§ 1.597–1 through 1.597–6 for all members of the group in all taxable years to which section 597, as amended by FIRREA, applies. The common parent makes the election for the group. An entity that is not a member of a consolidated group may elect to apply §§ 1.597–1 through 1.597–6 to all taxable years to which section 597, as amended by FIRREA, applies for which it is not a member of a consolidated group. The election is irrevocable.

(2) *Election unavailable in certain cases*—(i) *Statute of limitations closed.* The election cannot be made if the period for assessment and collection of tax has expired under the rules of section 6501 for any taxable year in which §§ 1.597–1 through 1.597–6 would affect the determination of the electing entity's or group's income, deductions, gain, loss, basis, or other items.

(ii) *No section 338 election under Notice 89–102.* The election cannot be made with respect to an Institution if, under Notice 89–102, it was a Target with respect to which a qualified stock purchase was made, a timely election under section 338 was not made, and on April 22, 1992, a timely election under section 338 could not be made.

(iii) *Inconsistent treatment of Institution that would be New Entity.* If, under § 1.597–5(b), an Institution would become a New Entity before April 22, 1992, the election cannot be made with respect to that Institution unless elections are made by all relevant persons such that §§ 1.597–1 through 1.597–6 apply both before and after the deemed sale under § 1.597–5. However, this requirement does not apply if, under §§ 1.597–1 through 1.597–6, the Institution would not have Continuing Equity prior to the deemed sale.

(3) *Expense reimbursements.* Notice 89–102, 1989–2 C.B. 436, provides that reimbursements paid or accrued pursuant to an expense reimbursement or indemnity arrangement are not included in income but the taxpayer may not deduct, or otherwise take into account, the item of cost or expense to which the reimbursement or indemnity payment relates. With respect to an Agency assisted acquisition within the meaning of Notice 89–102 that occurs before April 22, 1992, a taxpayer that elects to apply these regulations retroactively under this paragraph (c) may continue to account for these items under the rules of Notice 89–102.

(4) *Procedural rules*—(i) *Manner of making election.* An Institution or consolidated group makes the election provided by this paragraph (c) by attaching a written statement to, and including it as a part of, the taxpayer's or consolidated group's first annual income tax return filed on or after March 15, 1996. The statement must contain the following legend at the top of the page: ''THIS IS AN ELECTION UNDER § 1.597–7(c),'' and must contain the name, address and employer identification number of the taxpayer or common parent making the election. The statement must include a declaration that ''TAXPAYER AGREES TO EXTEND THE STATUTE OF LIMITATIONS ON ASSESSMENT FOR THREE YEARS FROM THE DATE OF THE FILING OF THIS ELECTION UNDER § 1.597–7(c), IF THE LIMITATIONS PERIOD WOULD EXPIRE EARLIER WITHOUT SUCH EXTENSION, FOR ANY ITEMS AFFECTED IN ANY TAXABLE YEAR BY THE FILING OF THIS ELECTION,'' and a declaration that either ''AMENDED RETURNS WILL BE FILED FOR ALL TAXABLE YEARS AFFECTED BY THE FILING OF THIS ELECTION WITHIN 180 DAYS OF MAKING THIS STATEMENT, UNLESS SUCH REQUIREMENT IS WAIVED IN WRITING BY THE DISTRICT DIRECTOR OR HIS DELEGATE'' or ''ALL RETURNS PREVIOUSLY FILED ARE CONSISTENT WITH THE PROVISIONS OF §§ 1.597–1 THROUGH 1.597–6,'' and be signed by an individual who is authorized to make the election under this paragraph (c) on behalf of the taxpayer. An election with respect to a

consolidated group must be made by the common parent of the group, not Agency, and applies to all members of the group.

(ii) *Effect of elective disaffiliation.* To make the affirmative election described in §1.597–4(g)(5) for an Institution placed in Agency receivership in a taxable year ending before April 22, 1992, the consolidated group must send the affected Institution the statement described in §1.597–4(g)(5) on or before May 31, 1996. Notwithstanding the requirements of paragraph (c)(4)(i) of this section, a consolidated group sending such a statement is deemed to make the election described in, and to agree to the conditions contained in, this paragraph (c). The consolidated group must nevertheless attach the statement described in paragraph (c)(4)(i) of this section to its first annual income tax return filed on or after March 15, 1996.

(d) *Reliance on prior guidance*—(1) *Notice 89–102.* Taxpayers may rely on Notice 89–102, 1989–2 C.B. 436, to the extent they acted in reliance on that Notice prior to April 22, 1992. Such reliance must be reasonable and transactions with respect to which taxpayers rely must be consistent with the overriding policies of section 597, as expressed in the legislative history.

(2) *Notice FI–46–89*—(i) *In general.* Notice FI–46–89 was published in the FEDERAL REGISTER on April 23, 1992 (57 FR 14804). Taxpayers may rely on the provisions of §§1.597–1 through 1.597–6 of that notice to the extent they acted in reliance on those provisions prior to December 21, 1995. Such reliance must be reasonable and transactions with respect to which taxpayers rely must be consistent with the overriding policies of section 597, as expressed in the legislative history, as well as the overriding policies of notice FI–46–89.

(ii) *Taxable Transfers.* Any taxpayer described in this paragraph (d) that, under notice FI–46–89, would be a New Entity or Acquiring with respect to a Taxable Transfer on or after April 22, 1992, and before December 21, 1995, may apply the rules of that notice with respect to such transaction.

[T.D. 8641, 60 FR 66104, Dec. 21, 1995]

§1.597–8 Transitional rules for Federal financial assistance.

(a) *Scope.* This section provides transitional rules for the tax consequences of Federal financial assistance received or accrued on or after May 10, 1989, if the assistance payment relates to an acquisition that occurred before that date.

(b) *Transitional rules.* The tax consequences of any payment of Federal financial assistance received or accrued on or after May 10, 1989, are governed by the applicable provisions of section 597 that were in effect prior to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (''FIRREA'') if either—

(1) The payment—

(i) Is pursuant to an acquisition of a bank or domestic building and loan association before May 10, 1989,

(ii) Is provided pursuant to an assistance agreement executed before May 10, 1989,

(iii) Is provided to a party to that agreement or to such other party as the Commissioner may determine appropriate by letter ruling or other written guidance, and

(iv) Would, if provided before May 10, 1989, have been governed by applicable provisions of section 597 that were in effect prior to FIRREA; or

(2) The payment—

(i) Represents a prepayment of (or a payment in lieu of) a fixed or contingent right to Federal financial assistance that would have satisfied the conditions of paragraphs (b)(1)(i), (ii) and (iv) of this section, and

(ii) Is provided to a party described in paragraph (b)(1)(iii) of this section

(c) *Definition of Federal financial assistance.* Federal financial assistance for purposes of this section has the meaning prescribed by section 597(c) as amended by FIRREA.

(d) *Examples.* The following examples illustrate the provisions of this section:

Example 1. X corporation acquired Y, a domestic building and loan association on September 10, 1988. Pursuant to a written agreement executed at the time of the acquisition, Y received Federal financial assistance that included a note bearing a market rate of interest, the right to future payments if certain assets were sold at a loss, and the right to future payments if the income produced by certain assets was less than an agreed upon amount. On December 1, 1991, an agreement was executed in which Y relinquished its rights to Federal financial assistance under the September 10, 1988 agreement in return for a lump sum payment. The lump sum payment represented a prepayment of the principal and accrued but unpaid interest for the note, and the rights to the contingent future loss and income payments. The entire prepayment is excluded from the income of Y because it is a prepayment of Federal financial assistance and the assistance (i) would have been provided pursuant to an acquisition that occurred before May 10, 1989, would have been provided pursuant to an assistance agreement executed before May 10, 1989, and would, if it had been provided prior to May 10, 1989, have been governed by a pre-FIRREA version of section 597; and (ii) the prepayment is paid to a party to the assistance agreement.

Example 2. The facts are the same as those in *Example 1,* except that the note bears an above market rate of interest and part of the lump sum represents a premium payment for the note. The portion of the lump sum allocable to the premium payment is also excluded from the income of Y because the payment represents the present value of the right to future Federal financial assistance in the form of interest.

Example 3. The facts are the same as those in *Example 1,* except that a portion of the lump sum payment represents compensation for additional expenses Y may incur in the future because of termination of the September 10, 1988 agreement. The portion of the lump sum payment allocable to the compensation for additional expenses must be included in the income of Y because it is not a prepayment of Federal financial assistance provided for by a written agreement entered into prior to May 10, 1989.

Example 4. The facts are the same as those in *Example 1,* except that instead of a new assistance agreement, the September 10, 1988 assistance agreement was modified on December 1, 1991. The modified agreement provided new Federal financial assistance in addition to the amounts previously agreed to. None of the new Federal financial assistance is governed by this regulation because the new assistance was not provided for by a written agreement entered into prior to May 10, 1989. The modification does not, however, affect the tax treatment of assistance provided for by the agreement prior to its modification.

(e) *Effective Date.* This section is effective April 23, 1992 for assistance received or accrued on or after May 10, 1989 in connection with acquisitions before that date.

[T.D. 8406, 57 FR 14795, Apr. 23, 1992. Redesignated and amended by T.D. 8471, 58 FR 18149, Apr. 8, 1993]

BANK AFFILIATES

§ 1.601–1 Special deduction for bank affiliates.

(a) The special deduction described in section 601 is allowed:

(1) To a holding company affiliate of a bank, as defined in section 2 of the Banking Act of 1933 (12 U.S.C. 221a), which holding company affiliate holds, at the end of the taxable year, a general voting permit granted by the Board of Governors of the Federal Reserve System.

(2) In the amount of the earnings or profits of such holding company affiliate which, in compliance with section 5144 of the Revised Statutes (12 U.S.C. 61), has been devoted by it during the taxable year to the acquisition of readily marketable assets other than bank stock.

(3) Upon certification by the Board of Governors of the Federal Reserve System to the Commissioner that such an amount of the earnings or profits has been so devoted by such affiliate during the taxable year.

No deduction is allowable under section 601 for the amount of readily marketable assets in excess of what is required by section 5144 of the Revised Statutes (12 U.S.C. 61) to be acquired by such affiliate, or in excess of the taxable income for the taxable year computed without regard to the special deductions for corporations provided in part VIII (section 241 and following), subchapter B, chapter 1 of the Code. Nor may the aggregate of the deductions allowable under section 601 and the credits allowable under the corresponding provision of any prior income tax law for all taxable years exceed the amount required to be devoted under such section 5144 to the acquisition of readily marketable assets other than bank stock.

(b) Every taxpayer claiming a deduction provided for in section 601 shall attach to its return a supplementary statement setting forth all the facts and information upon which the claim is predicated, including such facts and information as the Board of Governors of the Federal Reserve System may prescribe as necessary to enable it, upon the request of the Commissioner subsequent to the filing of the return, to certify to the Commissioner the amount of earnings or profits devoted to the acquisition of such readily marketable assets. A certified copy of such supplementary statement shall be forwarded by the taxpayer to the Board of Governors at the time of the filing of the return. The holding company affiliate shall also furnish the Board of Governors such further information as the Board shall require. For the requirements with respect to the amount of such readily marketable assets which must be acquired and maintained by a holding company affiliate to which a voting permit has been granted, see section 5144(b) and (c) of the Revised Statutes (12 U.S.C. 61).

NATURAL RESOURCES

DEDUCTIONS

§1.611–0 Regulatory authority.

Sections 1.611–1 through 1.614–8, inclusive, are prescribed under the authority granted the Secretary or his delegate by section 611(a) of the Code to prescribe regulations under which a reasonable allowance for depletion and depreciation of improvements shall be allowed, according to the peculiar conditions in each case, in the case of mines, oil and gas wells, other natural deposits and timber.

[T.D. 6965, 33 FR 10692, July 26, 1968]

§1.611–1 Allowance of deduction for depletion.

(a) *Depletion of mines, oil and gas wells, other natural deposits, and timber*—(1) *In general.* Section 611 provides that there shall be allowed as a deduction in computing taxable income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion. In the case of standing timber, the depletion allowance shall be computed solely upon the adjusted basis of the property. In the case of other exhaustible natural resources the allowance for depletion shall be computed upon either the adjusted depletion basis of the property (see section 612, relating to cost depletion) or upon a percentage of gross income from the property (see section 613, relating to percentage depletion), whichever results in the greater allowance for depletion for any taxable year. In no case will depletion based upon discovery value be allowed.

(2) See §1.611–5 for methods of depreciation relating to improvements connected with mineral or timber properties.

(3) See paragraph (d) of this section for definition of terms.

(b) *Economic interest.* (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. For an exception in the case of certain mineral production payments, see section 636 and the regulations thereunder. A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.

(2) No depletion deduction shall be allowed the owner with respect to any timber, coal, or domestic iron ore that such owner has disposed of under any form of contract by virtue of which he retains an economic interest in such timber, coal, or iron ore, if such disposal is considered a sale of timber, coal, or domestic iron ore under section 631 (b) or (c).

(c) *Special rules*—(1) *In general.* For the purpose of the equitable apportionment of depletion among the several owners of economic interests in a mineral deposit or standing timber, if the value of any mineral or timber must be ascertained as of any specific date for the determination of the basis for depletion, the values of such several interests therein may be determined separately, but, when determined as of the same date, shall together never exceed the value at that date of the mineral or timber as a whole.

(2) *Leases.* In the case of a lease, the deduction for depletion under section 611 shall be equitably apportioned between the lessor and lessee. In the case of a lease or other contract providing for the sharing of economic interests in a mineral deposit or standing timber, such deduction shall be computed by each taxpayer by reference to the adjusted basis of his property determined in accordance with sections 611 and 612, or computed in accordance with section 613, if applicable, and the regulations thereunder.

(3) *Life tenant and remainderman.* In the case of property held by one person for life with remainder to another person, the deduction for depletion under section 611 shall be computed as if the life tenant were the absolute owner of the property so that he will be entitled to the deduction during his life, and thereafter the deduction, if any, shall be allowed to the remainderman.

(4) *Mineral or timber property held in trust.* If a mineral property or timber property is held in trust, the allowable deduction for depletion is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income from such property allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depletion in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depletion reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each. For example:

(i) If under the trust instrument of local law the income of a trust computed without regard to depletion is to be distributed to a named beneficiary, the beneficiary is entitled to the deduction to the exclusion of the trustee.

(ii) If under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depletion in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction). The same result would follow if the trustee sets aside income for a depletion reserve pursuant to discretionary authority to do so in the governing instrument.

No effect shall be given to any allocation of the depletion deduction which gives any beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument, except as otherwise provided in this paragraph when the trust instrument or local law requires or permits the trustee to maintain a reserve for depletion.

(5) *Mineral or timber property held by estate.* In the case of a mineral property or timber property held by an estate the deduction for depletion under section 611 shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of income of the estate from such property which is allocable to each.

(d) *Definitions.* As used in this part, and the regulations thereunder, the term:

(1) *Property* means—(i) in the case of minerals, each separate economic interest owned in each mineral deposit in each separate tract or parcel of land or an aggregation or combination of such mineral interests permitted under section 614 (b), (c), (d), or (e); and (ii) in the case of timber, an economic interest in standing timber in each tract or block representing a separate timber account (see paragraph (d) of § 1.611–3). For rules with respect to waste or residue of prior mining, see paragraph (c) of § 1.614–1. When, in the regulations

under this part, either the word *mineral* or *timber* precedes the word *property,* such adjectives are used only to classify the type of *property* involved. For further explanation of the term *property,* see section 614 and the regulations thereunder.

(2) *Fair market value* of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase.

(3) *Mineral enterprise* is the mineral deposit or deposits and improvements, if any, used in mining or in the production of oil and gas, and only so much of the surface of the land as is necessary for purposes of mineral extraction. The value of the mineral enterprise is the combined value of its component parts.

(4) *Mineral deposit* refers to minerals in place. When a mineral enterprise is acquired as a unit, the cost of any interest in the mineral deposit or deposits is that proportion of the total cost of the mineral enterprise which the value of the interest in the deposit or deposits bears to the value of the entire enterprise at the time of its acquisition.

(5) *Minerals* includes ores of the metals, coal, oil, gas, and all other natural metallic and nonmetallic deposits, except minerals derived from sea water, the air, or from similar inexhaustible sources. It includes but is not limited to all of the minerals and other natural deposits subject to depletion based upon a percentage of gross income from the property under section 613 and the regulations thereunder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9305, July 27, 1965; T.D. 7261, 38 FR 5467, Mar. 1, 1973]

§1.611–2 Rules applicable to mines, oil and gas wells, and other natural deposits.

(a) *Computation of cost depletion of mines, oil and gas wells, and other natural deposits.* (1) The basis upon which cost depletion is to be allowed in respect of any mineral property is the basis provided for in section 612 and the regulations thereunder. After the amount of such basis applicable to the mineral property has been determined for the taxable year, the cost depletion for that year shall be computed by dividing such amount by the number of units of mineral remaining as of the taxable year (see subparagraph (3) of this paragraph), and by multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year (see subparagraph (2) of this paragraph). In the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as tons of ore, barrels of oil, or thousands of cubic feet of natural gas.

(2) As used in this paragraph, the phrase *number of units sold within the taxable year:*

(i) In the case of a taxpayer reporting income on the cash receipts and disbursements method, includes units for which payments were received within the taxable year although produced or sold prior to the taxable year, and excludes units sold but not paid for in the taxable year, and

(ii) In the case of a taxpayer reporting income on the accrual method, shall be determined from the taxpayer's inventories kept in physical quantities and in a manner consistent with his method of inventory accounting under section 471 or 472.

The phrase does not include units with respect to which depletion deductions were allowed or allowable prior to the taxable year.

(3) *The number of units of mineral remaining as of the taxable year* is the number of units of mineral remaining at the end of the year to be recovered from the property (including units recovered but not sold) plus the *number of units sold within the taxable year* as defined in this section.

(4) In the case of a natural gas well where the annual production is not metered and is not capable of being estimated with reasonable accuracy, the taxpayer may compute the cost depletion allowance in respect of such property for the taxable year by multiplying the adjusted basis of the property by a fraction, the numerator of which is equal to the decline in rock pressure during the taxable year and the denominator of which is equal to the expected total decline in rock pressure from the beginning of the taxable year to the economic limit of production. Taxpayers computing depletion by this

method must keep accurate records of periodical pressure determinations.

(5) If an aggregation of two or more separate mineral properties is made during a taxable year under section 614, cost depletion for each such property shall be computed separately for that portion of the taxable year ending immediately before the effective date of the aggregation. Cost depletion with respect to the aggregated property shall be computed for that portion of the taxable year beginning on such effective date. The allowance for cost depletion for the taxable year shall be the sum of such cost depletion computations. For purposes of this paragraph, each such portion of the taxable year shall be considered as a taxable year. Similar rules shall be applied where a separate mineral property is properly removed from an existing aggregation during a taxable year. See section 614 and the regulations thereunder for rules relating to the effective date of an aggregation of mineral interests and for rules relating to the adjusted basis of an aggregation.

(6) The apportionment of the deduction among the several owners of economic interests in the mineral deposit or deposits will be made as provided in paragraph (c) of § 1.611–1.

(b) *Depletion accounts of mineral property.* (1) Every taxpayer claiming and making a deduction for depletion of mineral property shall keep a separate account in which shall be accurately recorded the cost or other basis provided by section 1012, of such property together with subsequent allowable capital additions to each account and all the other adjustments required by section 1016.

(2) Mineral property accounts shall thereafter be credited annually with the amounts of the depletion so computed in accordance with section 611 or 613 and the regulations thereunder; or the amounts of the depletion computed in shall be credited to depletion reserve accounts. No further deductions for cost depletion shall be allowed when the sum of the credits for depletion equals the cost or other basis of the property, plus allowable capital additions. However, depletion deductions may be allowable thereafter computed upon a percentage of gross income from the property. See section 613 and the regulations thereunder. In no event shall percentage depletion in excess of cost or other basis of the property be credited to the improvements account or the depreciation reserve account.

(c) *Determination of mineral contents of deposits.* (1) If it is necessary to estimate or determine with respect to any mineral deposit as of any specific date the total recoverable units (tons, pounds, ounces, barrels, thousands of cubic feet, or other measure) of mineral products reasonably known, or on good evidence believed, to have existed in place as of that date, the estimate or determination must be made according to the method current in the industry and in the light of the most accurate and reliable information obtainable. In the selection of a unit of estimate, preference shall be given to the principal unit (or units) paid for in the product marketed. The estimate of the recoverable units of the mineral products in the deposit for the purposes of valuation and depletion shall include as to both quantity and grade:

(i) The ores and minerals *in sight, blocked out, developed,* or *assured,* in the usual or conventional meaning of these terms with respect to the type of the deposits, and

(ii) *Probable* or *prospective* ores or minerals (in the corresponding sense), that is, ores or minerals that are believed to exist on the basis of good evidence although not actually known to occur on the basis of existing development. Such *probable* or *prospective* ores or minerals may be estimated:

(a) As to quantity, only in case they are extensions of known deposits or are new bodies or masses whose existence is indicated by geological surveys or other evidence to a high degree of probability, and

(b) As to grade, only in accordance with the best indications available as to richness.

(2) If the number of recoverable units of mineral in the deposit has been previously estimated for the prior year or years, and if there has been no known change in the facts upon which the prior estimate was based, the number of recoverable units of mineral in the deposit as of the taxable year will be the number remaining from the prior

estimate. However, for any taxable year for which it is ascertained either by the taxpayer or the district director from any source, such as operations or development work prior to the close of the taxable year, that the remaining recoverable mineral units as of the taxable year are materially greater or less than the number remaining from the prior estimate, then the estimate of the remaining recoverable units shall be revised, and the annual cost depletion allowance with respect to the property for the taxable year and for subsequent taxable years will be based upon the revised estimate until a change in the facts requires another revision. Such revised estimate will not, however, change the adjusted basis for depletion.

(d) *Determination of fair market value of mineral properties, and improvements, if any.* (1) If the fair market value of the mineral property and improvements at a specified date is to be determined for the purpose of ascertaining the basis, such value must be determined, subject to approval or revision by the district director, by the owner of such property and improvements in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments or subsequent improvements in methods of extraction and treatment of the mineral product. The district director will give due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties and improvements, bona fide offers, market value of stock or shares, royalties and rentals, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property and improvements was in question, the amount at which the property and improvements may have been inventoried or appraised in probate or similar proceedings, and disinterested appraisals by approved methods.

(2) If the fair market value must be ascertained as of a certain date, analytical appraisal methods of valuation, such as the present value method will not be used:

(i) If the value of a mineral property and improvements, if any, can be determined upon the basis of cost or comparative values and replacement value of equipment, or

(ii) If the fair market value can reasonably be determined by any other method.

(e) *Determination of the fair market value of mineral property by the present value method.* (1) To determine the fair market value of a mineral property and improvements by the present value method, the essential factors must be determined for each mineral deposit. The essential factors in determining the fair market value of mineral deposits are:

(i) The total quantity of mineral in terms of the principal or customary unit (or units) paid for in the product marketed,

(ii) The quantity of mineral expected to be recovered during each operating period,

(iii) The average quality or grade of the mineral reserves,

(iv) The allocation of the total expected profit to the several processes or operations necessary for the preparation of the mineral for market,

(v) The probable operating life of the deposit in years,

(vi) The development cost,

(vii) The operating cost,

(viii) The total expected profit,

(ix) The rate at which this profit will be obtained, and

(x) The rate of interest commensurate with the risk for the particular deposit.

(2) If the mineral deposit has been sufficiently developed, the valuation factors specified in subparagraph (1) of this paragraph may be determined from past operating experience. In the application of factors derived from past experience, full allowance should be made for probable future variations in the rate of exhaustion, quality or grade of the mineral, percentage of recovery, cost of development, production, interest rate, and selling price of the product marketed during the expected operating life of the mineral deposit. Mineral deposits for which these factors cannot be determined with reasonable accuracy from past operating experience may also be valued by the present

value method; but the factors must be deduced from concurrent evidence, such as the general type of the deposit, the characteristics of the district in which it occurs, the habit of the mineral deposits, the intensity of mineralization, the oil-gas ratio, the rate at which additional mineral has been disclosed by exploitation, the stage of the operating life of the deposit, and any other evidence tending to establish a reasonable estimate of the required factors.

(3) Mineral deposits of different grades, locations, and probable dates of extraction should be valued separately. The mineral content of a deposit shall be determined in accordance with paragraph (c) of this section. In estimating the average grade of the developed and prospective mineral, account should be taken of probable increases or decreases as indicated by the operating history. The rate of exhaustion of a mineral deposit should be determined with due regard to the limitations imposed by plant capacity, by the character of the deposit, by the ability to market the mineral product, by labor conditions, and by the operating program in force or reasonably to be expected for future operations. The operating life of a mineral deposit is that number of years necessary for the exhaustion of both the developed and prospective mineral content at the rate determined as above. The operating life of oil and gas wells is also influenced by the natural decline in pressure and flow, and by voluntary or enforced curtailment of production. The operating cost includes all current expense of producing, preparing, and marketing the mineral product sold (due consideration being given to taxes) exclusive of allowable capital additions, as described in §§ 1.612–2 and 1.612–4, and deductions for depreciation and depletion, but including cost of repairs. This cost of repairs is not to be confused with the depreciation deduction by which the cost of improvements is returned to the taxpayer free from tax. In general, no estimates of these factors will be approved by the district director which are not supported by the operating experience of the property or which are derived from different and arbitrarily selected periods.

(4) The value of each mineral deposit is measured by the expected gross income (the number of units of mineral recoverable in marketable form multiplied by the estimated market price per unit) less the estimated operating cost, reduced to a present value as of the date for which the valuation is made at the rate of interest commensurate with the risk for the operating life, and further reduced by the value at that date of the improvements and of the capital additions, if any, necessary to realize the profits. The degree of risk is generally lowest in cases where the factors of valuation are fully supported by the operating record of the mineral enterprise before the date for which the valuation is made. On the other hand, higher risks ordinarily attach to appraisals upon any other basis.

(f) *Revaluation of mineral property not allowed.* No revaluation of a mineral property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner.

(g) *Statement to be attached to return when valuation, depletion, or depreciation of mineral property or improvements are claimed.* (1) For the first taxable year ending before December 31, 1967, for which a taxpayer asserts a value for any mineral property or improvement as of a specific date or claims a deduction for depletion, or depreciation, there shall be attached to the return of the taxpayer for such taxable year a statement setting forth, in complete, summary form, the pertinent information required by this paragraph with respect to each such mineral property or improvement (including oil and gas properties or improvements). The summary statement shall be deemed a part of the income tax return to which it relates. In addition to such summary statement, the taxpayer must assemble, segregate and have readily available at his principal place of business, all the supporting data (listed in subparagraphs (2), (3), and (4) of this paragraph) which is used in compiling the summary statement. For taxable years after such first taxable year, and ending before December 31, 1967, the taxpayer need attach to his return only an explanation of the changes, if any, in the information previously furnished. For example, when a taxpayer has filed adequate maps with the district director he may be relieved of filing further maps of the same area, if all additional information necessary for keeping the maps up-to-date is filed each year. In any case in which any of the information required by this paragraph has been previously filed by the taxpayer (including information furnished in accordance with corresponding provisions of prior regulations), such information need not be filed again, but a statement should be attached to the return of the taxpayer indicating clearly when and in what form such information was previously filed. For provisions relating to the data which shall be submitted with returns for taxable years ending on or after December 31, 1967, see subparagraph (5) of this paragraph.

(2) The information referred to in subparagraph (1) of this paragraph is as follows:

(i) An adequate map showing the name, description, location, date of surveys, and identification of the deposit or deposits;

(ii) A description of the character of the taxpayer's property, accompanied by a copy of the instrument or instruments by which it was acquired;

(iii) The date of acquisition of the property, the exact terms and dates of expiration of all leases involved, and if terminated, the reasons therefor;

(iv) The cost of the mineral property and improvements, stating the amount paid to each vendor, with his name and address;

(v) The date as of which the mineral property and improvements are valued, if a valuation is necessary to establish the basis as provided by section 1012;

(vi) The value of the mineral property and improvements on that date with a statement of the precise method by which it was determined;

(vii) An allocation of the cost or value among the mineral property, improvements and the surface of the land for purposes other than mineral production;

(viii) The estimated number of units of each kind of mineral at the end of the taxable year, and also at the date of acquisition, if acquired during the taxable year or at the date as of which any valuation is made, together with an explanation of the method used in the estimation, the name and address of the person making the estimate, and an average analysis which will indicate the quality of the mineral valued, including the grade or gravity in the case of oil;

(ix) The number of units sold and the number of units for which payment was received or accrued during the year for which the return is made (in the case of newly developed oil and gas deposits it is desirable that this information be furnished by months);

(x) The gross amount received from the sale of mineral;

(xi) The amount of depreciation for the taxable year and the amount of cost depletion for the taxable year;

(xii) The amounts of depletion and depreciation, if any, stated separately, which for each and every prior year:

(a) Were allowed (see section 1016(a)(2)),

(b) Were allowable, and

(c) Would have been allowable without reference to percentage or discovery depletion;

(xiii) The fractions (however measured) of gross production from the deposit or deposits to which the taxpayer and other persons are entitled together with the names and addresses of such other persons; and

(xiv) Any other data which will be helpful in determining the reasonableness of the valuation asserted or of the deductions claimed.

(3) In the case of oil and gas properties, the following information with respect to each property is required in addition to that information set forth in subparagraph (2) of this paragraph:

(i) The number of acres of producing oil or gas land and, if additional acreage is claimed to be proven, the amount of such acreage and the reasons for believing it to be proven;

(ii) The number of wells producing at the beginning and end of the taxable year;

(iii) The date of completion of each well finished during the taxable year;

(iv) The date of abandonment of each well abandoned during the taxable year;

(v) Maps showing the location of the tracts or leases and of the producing and abandoned wells, dry holes, and proven oil and gas lands (the maps should show depth, initial production, and date of completion of each well, etc., to the extent that these data are available);

(vi) The number of pay sands and average thickness of each pay sand or zone;

(vii) The average depth to the top of each of the different pay sands;

(viii) The annual production of the deposit or of the individual wells, if the latter information is available, from the beginning of its productivity to the end of the taxable year, the average number of wells producing during each year, and the initial daily production of each well (the extent to which oil or gas is used for fuel on the premises should be stated with reasonable accuracy);

(ix) All available data regarding change in operating conditions, such as unit operation, proration, flooding, use of air-gas lift, vacuum, shooting, and similar information, which have a direct effect on the production of the deposit; and

(x) Available geological information having a probable bearing on the oil and gas content; information with respect to edge water, water drive, bottom hole pressures, oil-gas ratio, porosity of reservoir rock, percentage of recovery, expected date of cessation of natural flow, decline in estimated potential, and characteristics similar to characteristics of other known fields.

(4) For rules relating to an additional statement to be attached to the return when the depletion deduction is computed upon a percentage of gross income from the property, see § 1.613–6.

(5) A taxpayer who claims a total deduction of more than $200 for depletion of mines, oil and gas wells, or other natural deposits for the taxable year ending on or after December 31, 1967, and before December 31, 1968, shall submit with his return for such taxable year a filled-out Form M (Mines and Other Natural Deposits— Depletion Data) or Form O (Oil and Gas Depletion Data). See section 6011(a). For the purpose of this subparagraph, the determination under section 631(c) of gain or loss upon the disposition of coal or domestic iron ore with a retained economic interest shall not be regarded as the claiming of a deduction for depletion. Such forms shall be filed for any subsequent taxable year if the Commissioner determines that the forms are required for such year. Where appropriate, both Form M and Form O shall be filed. Forms M and O shall be deemed to be part of the return to which they relate. If a taxpayer mines more than one mineral, a separate Form M shall be filed for each such mineral. If a taxpayer has both domestic and foreign properties, separate forms shall be filed for each country in which a taxpayer's properties are located. All data relating to a taxpayer's domestic oil and gas properties shall be summarized on a single Form O, and data relating to a taxpayer's domestic mineral properties (other than oil and gas properties) shall be summarized on a single Form M for each mineral. Similarly, all data relating to a taxpayer's oil and gas properties in a specific foreign country shall be summarized on a single Form O, and data relating to a taxpayer's mineral properties (other than oil and gas properties) in a specific foreign country shall be summarized on a single Form M for each mineral. In addition, the taxpayer shall assemble, segregate, and have readily available at his principal place of business, the data listed in subparagraphs (2), (3), and (4) of this paragraph.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6938, 32 FR 17518, Dec. 7, 1967; T.D. 7170, 37 FR 5373, Mar. 15, 1972]

§ 1.611–3 Rules applicable to timber.

(a) *Capital recoverable through depletion allowance in case of timber.* In general, the capital remaining in any year recoverable through depletion allowances is the basis provided by section

612 and the regulations thereunder. For the method of determining fair market value and quantity of timber, see paragraphs (d), (e), and (f) of this section. For capitalization of carrying charges, see section 1016(a)(1)(A). Amounts paid or incurred in connection with the planting of timber (including planting for Christmas tree purposes) shall be capitalized and recoverable through depletion allowances. Such amounts include, for example, expenditures made for the preparation of the timber site for planting or for natural seeding and the cost of seedlings. The apportionment of deductions between the several owners of economic interests in standing timber will be made as provided in paragraph (c) of § 1.611–1.

(b) *Computation of allowance for depletion of timber for taxable year.* (1) The depletion of timber takes place at the time timber is cut, but the amount of depletion allowable with respect to timber that has been cut may be computed when the quantity of cut timber is first accurately measured in the process of exploitation. To the extent that depletion is allowable in a particular taxable year with respect to timber the products of which are not sold during such year, the depletion so allowable shall be included as an item of cost in the closing inventory of such products for such year.

(2) The depletion unit of the timber for a given timber account in a given year shall be the quotient obtained by dividing (i) the basis provided by section 1012 and adjusted as provided by section 1016, of the timber on hand at the beginning of the year plus the cost of the number of units of timber acquired during the year plus proper additions to capital, by (ii) the total number of units of timber on hand in the given account at the beginning of the year plus the cost of the number of units of timber acquired during the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account. The number of units of timber of a given timber account cut during any taxable year multiplied by the depletion unit of that timber account applicable to such year shall be the amount of depletion allowable for the taxable year. Those taxpayers who keep their accounts on a monthly basis may, at their option, keep their depletion accounts on such basis, in which case the amount allowable on account of depletion for a given month will be determined in the manner outlined herein for a given year. The total amount of the allowance for depletion in any taxable year shall be the sum of the amounts allowable for the several timber accounts. For a description of timber accounts, see paragraphs (c) and (d) of this section.

(3) When a taxpayer has elected to treat the cutting of timber as a sale or exchange of such timber under the provisions of section 631(a), he shall reduce the timber account containing such timber by an amount equal to the adjusted depletion basis of such timber. In computing any further gain or loss on such timber, see paragraph (e) of § 1.631–1.

(c) *Timber depletion accounts on books.* (1) Every taxpayer claiming or expecting to claim a deduction for depletion of timber property shall keep accurate ledger accounts in which shall be recorded the cost or other basis provided by section 1012 of the property and land together with subsequent allowable capital additions in each account and all other adjustments provided by section 1016 and the regulations thereunder.

(2) In such accounts there shall be set up separately the quantity of timber, the quantity of land, and the quantity of other resources, if any, and a proper part of the total cost or value shall be allocated to each after proper provision for immature timber growth. See paragraph (d) of this section. The timber accounts shall be credited each year with the amount of the charges to the depletion accounts computed in accordance with paragraph (b) of this section or the amount of the charges to the depletion accounts shall be credited to depletion reserve accounts. When the sum of the credits for depletion equals the cost or other basis of the timber property, plus subsequent allowable capital additions, no further deduction for depletion will be allowed.

(d) *Aggregating timber and land for purposes of valuation and accounting.* (1) With a view to logical and reasonable valuation of timber, the taxpayer shall include his timber in one or more accounts. In general, each such account shall include all of the taxpayer's timber which is located in one *block*. A block may be an operation unit which includes all the taxpayer's timber which would logically go to a single given point of manufacture. In those cases in which the point of manufacture is at a considerable distance, or in which the logs or other products will probably be sold in a log or other market, the block may be a logging unit which includes all of the taxpayer's timber which would logically be removed by a single logging development. Blocks may also be established by geographical or political boundaries or by logical management areas. Timber acquired under cutting contracts should be carried in separate accounts and shall not constitute part of any block. In exceptional cases, provided there are good and substantial reasons, and subject to approval or revision by the district director on audit, the taxpayer may divide the timber in a given block into two or more accounts. For example, timber owned on February 28, 1913, and that purchased subsequently may be kept in separate accounts, or timber owned on February 28, 1913, and the timber purchased since that date in several distinct transactions may be kept in several distinct accounts. Individual tree species or groups of tree species may be carried in distinct accounts, or special timber products may be carried in distinct accounts. Blocks may be divided into two or more accounts based on the character of the timber or its accessibility, or scattered tracts may be included in separate accounts. If such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

(2) The timber accounts mentioned in subparagraph (1) of this paragraph shall not include any part of the value or cost, as the case may be, of the land. In a manner similar to that prescribed in subparagraph (1) of this paragraph, the land in a given *block* may be carried in a single land account or may be divided into two or more accounts on the basis of its character or accessibility. When such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

(3) The total value or total cost, as the case may be, of land and timber shall be equitably allocated to the timber and land accounts, respectively. In cases in which immature timber growth is a factor, a reasonable portion of the total value or cost shall be allocated to such immature timber, and when the timber becomes merchantable such value or cost shall be recoverable through depletion allowances.

(4) Each of the several land and timber accounts carried on the books of the taxpayer shall be definitely described as to their location on the ground either by maps or by legal descriptions.

(5) For good and substantial reasons satisfactory to the district director, or as required by the district director on audit, the timber or the land accounts may be readjusted by dividing individual accounts, by combining two or more accounts, or by dividing and recombining accounts.

(e) *Determination of quantity of timber.* Each taxpayer claiming or expecting to claim a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board measure, log scale, cords, or other units) of timber reasonably known, or on good evidence believed, to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, whichever date is applicable in determining the basis for cost depletion. This estimate shall state as nearly as possible the number of units which would have been found present by careful estimate made on the specified date with the object of determining 100 percent of the quantity of timber which the area covered by the specific account would have produced on that date if all of the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. If subsequently during the ownership of the taxpayer making the return, as the result of the growth of the timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, or of operations or development work, it is ascertained either by the taxpayer or the district director that there remain on the ground, available for utilization, more or less units of timber at the close of the taxable year (or at the close of the month if the taxpayer keeps his depletion accounts on a monthly basis) than remain in the timber account or accounts on the basis of the original estimate, then the original estimate (but not the basis for depletion) shall be revised. The depletion unit shall be changed when such revision has been made. The annual charge to the depletion account with respect to the property shall be computed by using such revised unit for the taxable year for which the revision is made and all subsequent taxable years until a change in facts requires another revision.

(f) *Determination of fair market value of timber property.* (1) If the fair market value of the property at a specified date is the basis for depletion deductions, such value shall be determined, subject to approval or revision by the district director upon audit, by the owner of the property in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, and methods of exploitation, in degree of utilization, etc. Such factors as the following will be given due consideration:

(i) Character and quality of the timber as determined by species, age, size, condition, etc.;

(ii) The quantity of timber per acre, the total quantity under consideration, and the location of the timber in question with reference to other timber;

(iii) Accessibility of the timber (location with reference to distance from a common carrier, the topography and other features of the ground upon which the timber stands and over which it must be transported in process of exploitation, the probable cost of exploitation and the climate and the state of industrial development of the locality); and

(iv) The freight rates by common carrier to important markets.

(2) The timber in each particular case will be valued on its own merits and not on the basis of general averages for regions; however, the value placed upon it, taking into consideration such factors as those mentioned in this paragraph, will be coistent with that of other similar timber in the region. The district director will give weight and consideration to any and all facts and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, the margin between the cost of production and the price realized for timber products, market value of stock or shares, royalties and rentals, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property has been involved, the amount at which the property may have been inventoried or appraised in probate or similar proceedings, disinterested appraisals by approved methods, and other factors.

(g) *Revaluation of timber property not allowed.* No revaluation of a timber property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner. The depletion unit shall be revised when such a revaluation of a timber property has been made and the annual charge to the depletion account with respect to the property shall be computed by using such revised unit for the taxable year for which such revision is made and for all subsequent taxable years.

(h) *Information to be furnished by taxpayer claiming depletion of timber.* A taxpayer claiming a deduction for depletion of timber and for depreciation of plant and other improvements shall attach to his income tax return a filled-out Form T-Timber for the taxable year covered by the income tax return, including the following information:

(1) A map where necessary to show clearly timber and land acquired, timber cut, and timber and land sold;

(2) Description of, cost of, and terms of purchase of timberland or timber, or cutting rights, including timber or timber rights acquired under any type of contract;

(3) Profit or loss from sale of land, or timber, or both;

(4) Description of timber with respect to which claim for loss, if any, is made;

(5) Record of timber cut;

(6) Changes in each timber account as a result of purchase, sale, cutting, reestimate, or loss;

(7) Changes in improvements accounts as the result of additions to or deductions from capital and depreciation, and computation of profit or loss on sale or other disposition of such improvements;

(8) Operation data with respect to raw and finished material handled and inventoried;

(9) Statement as to application of the election under section 631(a) and pertinent information in support of the fair market value claimed thereunder;

(10) Information with respect to land ownership and capital investment in timberland; and

(11) Any other data which will be helpful in determining the reasonableness of the depletion or depreciation deductions claimed in the return.

§ 1.611–4 Depletion as a factor in computing earnings and profits for dividend purposes.

For rules with respect to computation of earnings and profits where depletion is a factor in the case of corporations, see paragraph (c)(1) of § 1.312–6.

§ 1.611–5 Depreciation of improvements.

(a) *In general.* Section 611 provides in the case of mines, oil and gas wells, other natural deposits, and timber that there shall be allowed as a deduction a reasonable allowance for depreciation of improvements. Such allowance shall include exhaustion, wear and tear, and obsolescence. The deduction allowed under section 611 shall be determined under the provisions of section 167 and the regulations thereunder. For purposes of section 167 the unit of production method may, under appropriate circumstances, be considered a reasonable method under section 167(a), and therefore, not subject to the limitations prescribed by section 167(b).

(b) *Special rules for mines, oil and gas wells, other natural deposits and timber.* (1) For principles governing the apportioning of depreciation allowances under sections 611 and 167 in the case of property held by one person for life with remainder to another or in the case of property held in trust or by an estate, see § 1.167(h)–1.

(2) A reasonable allowance for depreciation on account of obsolescence or decay shall be required in an appropriate case during periods when the improvement is not used in production or is used in producing at a rate below its normal capacity. This rule is applicable whether or not the taxpayer uses the unit of production method.

(3) See sections 615 and 616 and the regulations thereunder for special rules for treatment of allowances for depreciation of improvements with respect to the exploration and development of a mine or other natural deposit (other than oil or gas).

(4) In the case of operating oil or gas properties, the deduction for depreciation shall be allowed for those costs of improvements such as machinery, tools, equipment, pipes, and other similar items and the costs of installation which are not treated as a deductible expense under section 263(c). See § 1.612–4.

(c) *Accounting and recordkeeping.* See § 1.167(a)–7 for accounting and recordkeeping requirements for taxpayers claiming deductions under section 611 and this section.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3655, Mar. 24, 1964; T.D. 6836, 30 FR 8902, July 15, 1965]

§ 1.612–1 Basis for allowance of cost depletion.

(a) *In general.* The basis upon which the deduction for cost depletion under section 611 is to be allowed in respect of any mineral or timber property is the adjusted basis provided in section 1011 for the purpose of determining gain upon the sale or other disposition of such property except as provided in paragraph (b) of this section. The adjusted basis of such property is the cost or other basis determined under section 1012, relating to the basis of property, adjusted as provided in section 1016, relating to adjustments to basis, and the regulations under such sections. In the case of the sale of a part of such property, the unrecovered basis thereof shall be allocated to the part sold and the part retained.

(b) *Special rules.* (1) The basis for cost depletion of mineral or timber property does not include:

(i) Amounts recoverable through depreciation deductions, through deferred expenses, and through deductions other than depletion, and

(ii) The residual value of land and improvements at the end of operations.

In the case of any mineral property the basis for cost depletion does not include amounts representing the cost or value of land for purposes other than mineral production. Furthermore, in the case of certain mineral properties, such basis does not include exploration or development expenditures which are treated under section 615(b) or 616(b) as deferred expenses to be taken into account as deductions on a ratable basis as the units of minerals benefited thereby are produced and sold. However, there shall be included in the basis for cost depletion of oil and gas property the amounts of capitalized drilling and development costs which, as provided in §1.612–4, are recoverable through depletion deductions. In the case of timber property, the basis for cost depletion does not include amounts representing the cost or value of land.

(2) Where a taxpayer elects to treat the cutting of timber as a sale or exchange of such timber, the basis for cost depletion shall be the fair market value of such timber as of the first day of the taxable year in which such timber is cut and such value shall be considered for such taxable year and all subsequent taxable years as the cost of such timber for all purposes for which such cost is a necessary factor. See section 631(a).

(c) *Cross references.* In cases where the valuation, revaluation, or mineral content of deposits is a factor, see paragraphs (c), (d), (e), and (f) of §1.611–2. In cases where the valuation, revaluation, or quantity of timber is a factor, see paragraphs (e), (f), and (g) of §1.611–3. For definitions of the terms *property, fair market value, mineral enterprise, mineral deposit,* and *minerals,* see paragraph (d) of §1.611–1. For rules with respect to treatment of depletion accounts on taxpayers' books, see paragraph (b) of §1.611–2 in the case of mineral property, and paragraph (c) of §1.611–3 in the case of timber property.

§1.612–2 Allowable capital additions in case of mines.

(a) *In general.* Expenditures for improvements and for replacements, not including expenditures for ordinary and necessary maintenance and repairs, shall ordinarily be charged to capital account recoverable through depreciation deductions. Expenditures for equipment (including its installation and housing) and for replacements thereof, which are necessary to maintain the normal output solely because of the recession of the working faces of the mine and which:

(1) Do not increase the value of the mine, or

(2) Do not decrease the cost of production of mineral units, or

(3) Do not represent an amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made shall be deducted as ordinary and necessary business expenses.

(b) *Special rule.* For special provisions applicable to treatment of expenditures for certain exploration and development costs (other than for the acquisition, restoration, or betterment of improvements) with respect to minerals other than oil or gas, see sections 615 and 616 and the regulations thereunder.

§1.612–3 Depletion; treatment of bonus and advanced royalty.

(a) *Bonus.* (1) If a bonus in addition to royalties is received upon the grant of an economic interest in a mineral deposit, or standing timber, there shall be allowed to the payee as a cost depletion deduction in respect of the bonus an amount equal to that proportion of his basis for depletion as provided in section 612 and §1.612–1 which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the payee's basis for depletion and the remainder of the basis is recoverable through depletion deductions as the royalties are thereafter received. (But see paragraph (e) of this section.) For example, a taxpayer leases mineral property to another reserving a one-eighth royalty and in addition receives a bonus of $10,000. Assuming that the taxpayer's basis with respect to the mineral property is $21,000 and that the royalties expected to be received are estimated to total $20,000, the depletion on the bonus would be $7,000:

[$21,000 (basis)×$10,000 (bonus)]÷$30,000 (bonus plus estimated royalties).

The remaining $14,000 of basis will be recovered through depletion as the royalties are received.

(2) If the grant of an economic interest in a mineral deposit or standing timber with respect to which a bonus was received expires, terminates, or is abandoned before there has been any income derived from the extraction of mineral or cutting of timber, the payee shall adjust his capital account by restoring thereto the depletion deduction taken on the bonus and a corresponding amount must be returned as income in the year of such expiration, termination, or abandonment.

(3) In the case of the payor, payment of the bonus constitutes a capital investment made for the acquisition of an economic interest in a mineral deposit or standing timber recoverable through the depletion allowance. See paragraph (c)(5)(ii) of §1.613–2 in cases in which percentage depletion is used.

(b) *Advanced royalties.* (1) If the owner of an operating interest in a mineral deposit or standing timber is required to pay royalties on a specified number of units of such mineral or timber annually whether or not extracted or cut within the year, and may apply any amounts paid on account of units not extracted or cut within the year against the royalty on the mineral or timber thereafter extracted or cut, the payee shall compute cost depletion on the number of units so paid for in advance of extraction or cutting and shall treat the amount so determined as an allowable deduction for depletion from the gross income of the year in which such payment or payments are made. No deduction for depletion by such payee shall be claimed or allowed in any subsequent year on account of the extraction or cutting in such year of any mineral or timber so paid for in advance and for which deduction has once been made. (But see paragraph (e) of this section.)

(2) If the right to extract minerals or to cut timber against which the advanced royalties may be applied expires, terminates, or is abandoned before all such minerals or timber have been extracted or cut, the payee shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of any units of mineral or timber paid for in advance but not extracted or cut, and a corresponding amount must be returned as income for the year of such expiration, termination or abandonment. (But see paragraph (e) of this section.)

(3) The payor shall treat the advanced royalties paid or accrued in connection with mineral property as deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid or accrued, is sold. For purposes of the preceding sentence, in the case of mineral sold before production the mineral product is considered to be sold when the mineral is produced (i.e., when a mineral product first exists). However, in the case of advanced mineral royalties paid or accrued in connection with mineral property as a result of a minimum royalty provision, the payor, at his option, may instead treat the advanced royalties as deductions from gross income for the year in which the advanced royalties are paid or accrued. See section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For purposes of this paragraph, a minimum royalty provision requires that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount. For

purposes of the preceding sentence, in the case of a lease which is subject to renewal or extension, the period for which it can be renewed or extended shall be treated as part of the term of the original lease. For special rules applicable when the payor is a sublessor of coal or domestic iron ore, see paragraph (b)(3) of §1.631–3. Every taxpayer who pays or accrues advanced royalties resulting from a minimum royalty provision must make an election as to the treatment of all such advanced royalties in his return for the first taxable year ending after December 31, 1939, in which the advanced royalties are paid or accrued. The taxpayer's treatment of the advanced royalties for the first year shall be deemed to be the exercise of the election. Accordingly, a failure to deduct the advanced royalties for that year will constitute an election to have all the advanced royalties treated as deductions for the year of the sale of the mineral product in respect of which the advanced royalties are paid or accrued. See section 7807(b)(2). For additional rules relating to elections in the case of partners and partnerships, see section 703(b) and the regulations thereunder. the provisions of this subparagraph do not allow as deductions from gross income amounts disallowed as deductions under other provisions of the Code, such as section 461 (relating to general rule for taxable year of deduction), section 465 (relating to deductions limited to amount at risk in case of certain activities), or section 704(d) (relating to limitation on allowance to partners of partnership losses).

(4) The application of subparagraphs (2) and (3) of this paragraph may be illustrated by the following examples:

Example 1. B leased certain mineral lands from A under a lease in which A reserved a royalty of 10 cents a ton on minerals mined and sold by B. The lease also provided that B had to pay an annual minimum royalty of $10,000 representing the amount due on 100,000 tons of the particular mineral whether or not B mined and sold that amount. It was further provided that, if B did not mine and sell 100,000 tons in any year, he could mine and sell in any subsequent year the amount of mineral on which he had paid the royalty without the payment of any additional royalty. However, this right of recoupment was limited to minerals mined and sold in any later year in excess of the 100,000 tons represented by the $10,000 minimum royalty required to be paid for that later year. Assume that in 1956 B paid A the minimum royalty of $10,000, but mined and sold only 60,000 tons of the mineral and that in 1957 he abandoned the lease without any further production. Since the $10,000 represents royalties on 100,000 tons of mineral and only 60,000 tons were mined and sold, A must restore in 1957 to his capital account the depletion deductions taken in 1956 on $4,000 on account of the 40,000 tons paid for in advance but not mined and sold, and must also return the corresponding amount as income in 1957.

Example 2. Assume that B, under the lease in example 1, paid the $10,000 minimum royalty and mined no minerals in 1956 but that in 1957 B mined and sold 200,000 tons of mineral. If this is B's first such expenditure, B has an option, for the purpose of computing taxable income under section 63, to deduct in 1956 the $10,000 paid in that year although no mineral was mined, or to take the deduction in 1957 when the mineral, for which the $10,000 was paid in 1956, was mined and sold. (For treatment under percentage depletion, see example in paragraph (c)(5)(iii) of §1.613–2.)

(c) *Delay rental.* (1) A delay rental is an amount paid for the privilege of deferring development of the property and which could have been avoided by abandonment of the lease, or by commencement of development operations, or by obtaining production.

(2) Since a delay rental is in the nature of rent it is ordinary income to the payee and not subject to depletion. The payor may at his election deduct such amount as an expense, or under section 266 and the regulations thereunder, charge it to depletable capital account.

(d) *Percentage depletion deduction with respect to bonus and advanced royalty.* In lieu of the allowance based on cost depletion computed under paragraphs (a) and (b) of this section, the payees referred to therein may be allowed a depletion deduction in respect of any bonus or advanced royalty for the taxable year in an amount computed on the basis of the percentage of gross income from the property as provided in section 613 and the regulations thereunder. However, for special rules applicable to certain bonuses and advanced royalties received in connection with oil or gas properties, see paragraph (j) of §1.613A–3.

(e) *Cross reference.* In the case of bonuses and advanced royalties received in connection with a contract of disposal of timber covered by section 631(b) or coal or iron ore covered by section 631(c), see that section and the regulations thereunder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9305, July 27, 1965; T.D. 7523, 42 FR 63641, Dec. 19, 1977; T.D. 8348, 56 FR 21938, May 13, 1991]

§ 1.612–4 Charges to capital and to expense in case of oil and gas wells.

(a) *Option with respect to intangible drilling and development costs.* In accordance with the provisions of section 263(c), intangible drilling and development costs incurred by an operator (one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) in the development of oil and gas properties may at his option be chargeable to capital or to expense. This option applies to all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas. Such expenditures have for convenience been termed intangible drilling and development costs. They include the cost to operators of any drilling or development work (excluding amounts payable only out of production or gross or net proceeds from production, if such amounts are depletable income to the recipient, and amounts properly allocable to cost of depreciable property) done for them by contractors under any form of contract, including turnkey contracts. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used:

(1) In the drilling, shooting, and cleaning of wells,

(2) In such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells, and

(3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

In general, this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. For the purpose of this option, labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Included in this option are all costs of drilling and development undertaken (directly or through a contract) by an operator of an oil and gas property whether incurred by him prior or subsequent to the formal grant or assignment to him of operating rights (a leasehold interest, or other form of operating rights, or working interest); except that in any case where any drilling or development project is undertaken for the grant or assignment of a fraction of the operating rights, only that part of the costs thereof which is attributable to such fractional interest is within this option. In the excepted cases, costs of the project undertaken, including depreciable equipment furnished, to the extent allocable to fractions of the operating rights held by others, must be capitalized as the depletable capital cost of the fractional interest thus acquired.

(b) *Recovery of optional items, if capitalized.* (1) Items returnable through depletion: If the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are returnable through depletion insofar as they are not represented by physical property. For the purposes of this section the expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting, and cleaning of wells, are considered not to be represented by physical property, and when charged to capital account are returnable through depletion.

(2) Items returnable through depreciation: If the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are returnable through depreciation insofar as they are represented by physical property. Such expenditures are amounts paid for wages, fuel, repairs,

hauling, supplies, etc., used in the installation of casing and equipment and in the construction on the property of derricks and other physical structures.

(3) In the case of capitalized intangible drilling and development costs incurred under a contract, such costs shall be allocated between the foregoing classes of items specified in subparagraphs (1) and (2) for the purpose of determining the depletion and depreciation allowances.

(4) Option with respect to cost of nonproductive wells: If the operator has elected to capitalize intangible drilling and development costs, then an additional option is accorded with respect to intangible drilling and development costs incurred in drilling a nonproductive well. Such costs incurred in drilling a nonproductive well may be deducted by the taxpayer as an ordinary loss provided a proper election is made in the return for the first taxable year beginning after December 31, 1942, in which such a nonproductive well is completed. Such election with respect to intangible drilling and development costs of nonproductive wells is a new election, and, when made, shall be binding for all subsequent years. Any taxpayer who incurs optional drilling and development costs in drilling a nonproductive well must make a clear statement of election under this option in the return for the first taxable year beginning after December 31, 1942, in which such nonproductive well is completed. The absence of a clear indication in such return of an election to deduct as ordinary losses intangible drilling and development costs of nonproductive wells shall be deemed to be an election to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the extent that they are represented by physical property.

(c) *Nonoptional items distinguished.* (1) Capital items: The option with respect to intangible drilling and development costs does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value. Examples of such items are the costs of the actual materials in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc. The option does not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment, facilities, or structures, not incident to or necessary for the drilling of wells, such as structures for storing or treating oil or gas. These are capital items and are returnable through depreciation.

(2) Expense items: Expenditures which must be charged off as expense, regardless of the option provided by this section, are those for labor, fuel, repairs, hauling, supplies, etc., in connection with the operation of the wells and of other facilities on the property for the production of oil or gas.

(d) *Manner of making election.* The option granted in paragraph (a) of this section to charge intangible drilling and development costs to expense may be exercised by claiming intangible drilling and development costs as a deduction on the taxpayer's return for the first taxable year in which the taxpayer pays or incurs such costs; no formal statement is necessary. If the taxpayer fails to deduct such costs as expenses in such return, he shall be deemed to have elected to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the extent that they are represented by physical property.

(e) *Effect of option and election.* This section does not grant a new option under paragraph (a) of this section or new election under paragraph (b) of this section. Section 3 of the Act of October 23, 1962 (Public Law 87–863, 76 Stat. 1142) granted any taxpayer who had exercised an option to capitalize intangible drilling and development costs under Regulations 111, §29.23(m)–16 (1939 Code) or Regulations 118, §39.23(m)–16 (1939 Code) a new option for the first taxable year ending after October 22, 1962, to deduct such costs as expenses. Unless he has exercised the new option granted by such Act, any taxpayer who exercised an option or made an election under the regulations described in the preceding sentence is, by such option or election, bound with respect to all intangible drilling and development costs (whether made before January 1, 1954, or after December 31, 1953) in connection with oil and gas properties. See section 7807(b)(2). Any taxpayer who has not made intangible drilling and development expenditures in any taxable year beginning after December 31, 1942, prior to his first taxable year beginning after December 31, 1953, and ending after August 16, 1954, must exercise the option granted in paragraph (a) of this section in the return for the first taxable year in which the taxpayer pays or incurs such expenditures. If such return is required by law (including extensions thereof) to be filed before November 1, 1965, the option under paragraph (a) of this section, or the election under paragraph (b) of this section, may be exercised or changed not later than November 1, 1965. The exercise of or change in such option or election shall be effective with respect to the earliest taxable year to which the option or election is applicable in respect of which assessment of a deficiency or credit or refund of an overpayment, as the case may be, resulting from such exercise or change is not prevented by any law or rule of law on the date such option is exercised or such election is made. Any such option or election shall be binding upon the taxpayer for the first taxable year for which it is effective and for all subsequent taxable years.

[T.D. 6836, 30 FR 8902, July 15, 1965]

§ 1.612–5 Charges to capital and to expense in case of geothermal wells.

(a) *Option with respect to intangible drilling and development costs.* In accordance with the provisions of section 263(c), intangible drilling and development costs incurred by an operator (one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) in the development of a geothermal deposit (as defined in section 613(e)(3) and the regulations thereunder) may at the operator's option be chargeable to capital or to expense. This option applies to all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of geothermal steam or hot water. Such expenditures have for convenience been termed intangible drilling and development costs. They include the cost to operators of any drilling or development work (excluding amounts payable only out of production or gross or net proceeds from production, if such amounts are depletable income to the recipient, and amounts properly allocable to cost of depreciable property) done for them by contractors under any form of contract, including turnkey contracts. Examples of items to which this option applies are all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used:

(1) In the drilling, shooting, and cleaning of wells,

(2) In such clearing of ground, draining, road making, surveying, and geological work as are necessary in preparation for the drilling of wells, and

(3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of geothermal steam or hot water.

In general, this option applies only to expenditures for those drilling and developing items which in themselves do *not* have a salvage value. For the purpose of *this* option, labor, fuel, repairs, hauling, supplies, etc. are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Included in this option are all costs of drilling and development undertaken (directly or through a contract) by an operator of a geothermal property whether incurred by the operator prior or subsequent to the formal grant or assignment of operating rights (a leasehold interest, or other form of operating rights, or working interest); except that in any case where any drilling or development project is undertaken for the grant or assignment of a fraction of the operating rights, only that part of the costs thereof which is attributable to such fractional interest is within this option. In the excepted cases, costs of the project undertaken, including depreciable equipment furnished, to the extent allocable to fractions of the operating rights held by others, must be capitalized as the depletable capital cost of the fractional interest thus acquired.

(b) *Recovery of optional items, if capitalized.* (1) Items recoverable through depletion: If the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are recoverable through depletion insofar as they are not represented by physical property. For the purposes of this section the expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting, and cleaning of wells, are considered not to be represented by physical property, and when charged to capital account are recoverable through depletion.

(2) Items recoverable through depreciation: If the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are recoverable through depreciation insofar as they are represented by physical property. Such expenditures are amounts paid for wages, fuel, repairs, hauling, supplies, etc. used in the installation of casing and equipment and in the construction on the property of derricks and other physical structures.

(3) In the case of capitalized intangible drilling and development costs incurred under a contract, such costs shall be allocated between the foregoing classes of items specified in paragraphs (b)(1) and (2) of this section for the purpose of determining the depletion and depreciation allowances.

(4) Option with respect to cost of nonproductive wells: If the operator has elected to capitalize intangible drilling and development costs; then an additional option is accorded with respect to intangible drilling and development costs incurred in drilling a nonproductive well. Such costs incurred in drilling a nonproductive well may be deducted by the taxpayer as an ordinary loss provided a proper election is made in the taxpayer's original or amended return for the first taxable year ending on or after October 1, 1978, in which such a nonproductive well is completed. The taxpayer must make a clear statement of election under this option in the return or amended return. The election may be revoked by the filing of an amended return that does not contain such a statement. The absence of a clear indication in such return of an election to deduct as ordinary losses intangible drilling and development costs of nonproductive wells shall be deemed to be an election to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the exent that they are represented by physical property. Upon the expiration of the time for filing a claim for credit or refund of any overpayment of tax imposed by chapter 1 of the Code with respect to the first taxable year ending on or after October 1, 1978 in which a nonproductive well is completed, the taxpayer is bound for all subsequent years by his exercise of the option to deduct intangible drilling and development costs of nonproductive wells as an ordinary loss or his deemed election to recover such costs through depletion or depreciation.

(c) *Nonoptional items distinguished*—(1) *Capital Items:* The option with respect to intangible drilling and development costs does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value. Examples of such items are the costs of the actual materials in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc. The option does not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment, facilities, or structures, not incident to or necessary for the drilling of wells, such as structures for treating geothermal steam or hot water. These are capital items and are recoverable through depreciation.

(2) *Expense items:* Expenditures which must be charged off as expense, regardless of the option provided by this section, are those for labor, fuel, repairs, hauling, supplies, etc., in connection with the operation of the wells and of

other facilities on the property for the production of geothermal steam or hot water.

(d) *Manner of making election.* The option granted in paragraph (a) of this section to charge intangible drilling and development costs to expense may be exercised by claiming intangible drilling and development costs as a deduction on the taxpayer's original or amended return for the first taxable year ending on or after October 1, 1978, in which the taxpayer pays or incurs such costs with respect to a geothermal well commenced on or after that date. No formal statement is necessary. The exercise of the option may be revoked by the filing of an amended return that does not claim such a deduction. If the taxpayer fails to deduct such costs as expenses in any such return, he shall be deemed to have elected to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the extent that they are represented by physical property. Upon the expiration of the time for filing a claim for credit or refund of any overpayment of tax imposed by chapter 1 of the Code with respect to the first taxable year ending on or after October 1, 1978, in which the taxpayer pays or incurs intangible drilling and development costs with respect to a goethermal well commenced on or after that date, the taxpayer is bound by his exercise of the option to charge such costs to expense or his deemed election to recover such costs through depletion or depreciation for that year and for all subsequent years.

(e) *Effective date.* The option granted by paragraph (a) of this section is available only for taxable years ending on or after October 1, 1978, with respect to geothermal wells commenced on or after that date.

(Secs. 263, 9805, Internal Revenue Code of 1954 (92 Stat. 3201, 26 U.S.C. 362; 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7806, 47 FR 4061, Jan. 28, 1982]

§ 1.613–1 Percentage depletion; general rule.

(a) *In general.* In the case of a taxpayer computing the deduction for depletion under section 611 with respect to minerals on the basis of a percentage of gross income from the property, as defined in section 613(c) and §§ 1.613–3 and 1.613–4, the deduction shall be the percentage of the gross income as specified in section 613(b) and § 1.613–2. The deduction shall not exceed 50 percent (100 percent in the case of oil and gas properties for taxable years beginning after December 31, 1990) of the taxpayer's taxable income from the property (computed without regard to the allowance for depletion). The taxable income shall be computed in accordance with § 1.613–5. In no case shall the deduction for depletion computed under this section be less than the deduction computed upon the cost or other basis of the property provided in section 612 and the regulations thereunder. The apportionment of the deduction between the several owners of economic interests in a mineral deposit will be made as provided in paragraph (c) of § 1.611–1. For rules with respect to "gross income from the property" and for definition of the term "mining," see §§ 1.613–3 and 1.613–4. For definitions of the terms "property," "mineral deposit," and "minerals," see paragraph (d) of § 1.611–1.

(b) *Denial of percentage depletion in case of oil and gas wells.* Except as otherwise provided in section 613A and the regulations thereunder, in the case of oil or gas which is produced after December 31, 1974, and to which gross income is attributable after that date, the allowance for depletion shall be computed without regard to section 613.

[T.D. 8348, 56 FR 21938, May 13, 1991, as amended by T.D. 8437, 57 FR 43899, Sept. 23, 1992]

§ 1.613–2 Percentage depletion rates.

(a) *In general.* Subject to the provisions of paragraph (b) of this section and as provided in section 613(b), in the case of mines, wells, or other natural deposits, a taxpayer may deduct as an allowance for depletion under section 611 the percentages of gross income from the property as set forth in subparagraphs (1), (2), and (3) of this paragraph.

(1) *Without regard to situs of deposits.* The following rates are applicable to

the minerals listed in this subparagraph regardless of the situs of the deposits from which the minerals are produced:

(i) 27½ percent—Gas wells, oil wells.

(ii) 23 percent—Sulfur, uranium.

(iii) 15 percent—Ball clay, bentonite, china clay, metal mines,[1] sagger clay, rock asphalt, vermiculite.

(iv) 10 percent—Asbestos,[1] brucite, coal, lignite, perlite, sodium chloride, wollastonite.

(v) 5 percent—Brick and tile clay, gravel, mollusk shells (including clam shells and oyster shells), peat, pumice, sand, scoria, shale, stone (except dimension or ornamental stone). If from brine wells—Bromine, calcium chloride, magnesium chloride.

(2) *Production from United States deposits.* A rate of 23 percent is applicable to the minerals listed in this subparagraph if produced from deposits within the United States:

Anorthosite.[2]
Asbestos.
Bauxite.
Beryl.[3]
Celestite.
Chromite.
Corundum.
Fluorspar.
Graphite.
Ilmenite.
Kyanite.
Mica.
Olivine.
Quartz crystals (radio grade).
Rutile.
Block Steatite talc.
Zircon.

Ores of the following metals—

Antimony.
Beryllium.[4]
Bismuth.
Cadmium.
Cobalt.
Columbium.
Lead
Lithium.
Manganese.
Mercury.
Nickel.
Platinum.
latinum group metals.
Tantalum.
Thorium.
Tin.
Titanium.
Tungsten.
Vanadium.
Zinc.

(3) *Other minerals.* A rate of 15 percent is applicable to the minerals listed in this subparagraph regardless of the situs of the deposits from which the minerals are produced, provided the minerals are not used or sold for use by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. If, however, such minerals are sold or used for the purposes described in the preceding sentence, a rate of 5 percent is applicable to any of such minerals unless sold on bid in direct competition with a bona fide bid to sell any of the minerals listed in subdivision (iii) of subparagraph (1) of this paragraph, in which case the rate is 15 percent. In addition, the provisions of this subparagraph are not applicable with respect to any of the minerals listed herein if the rate prescribed in subparagraph (2) of this paragraph is applicable.

Aplite.
Barite.
Bauxite.
Beryl.[5]
Borax.
Calcium carbonates.
Clay, refractory and fire.[6]
Diatomaceous earth.
Dolomite.
Fedlspar.
Flake Graphite.

(4) For purposes of this section, the term *all other minerals* does not include (i) soil, sod, dirt, turf, water, or mosses; or (ii) minerals from sea water, the air, or similar inexhaustible sources. However, the term *all other minerals* is not limited in meaning to the minerals listed in section 613(b), but includes all other minerals (except those to which a specific percentage rate applies under subparagraphs (1), (2), (3), (4), and (5) of section 613(b)): For example, gypsum, novaculite, natural mineral pigments, quartz sand and quartz pebbles, graphite and kyanite (if section 613(b)(2)(B) does not apply), and anorthosite to the extent that alumina and aluminum compounds are not extracted therefrom. The 15–percent rate applies to such *all other minerals* when used or sold for use by the mine owner or operator for purposes other than as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. When any such minerals are used or sold for use by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes, the 5–percent rate applies except that, when sold for such

[1] Not applicable if the rate prescribed in subparagraph (2) of this paragraph is applicable.

[2] The rate prescribed in this subparagraph does not apply except to the extent that alumina and aluminum compounds are extracted therefrom.

[3] Applicable only for taxable years beginning before January 1, 1964.

[4] Applicable only for taxable years beginning after December 31, 1963.

[5] Applicable only for taxable years beginning before January 1, 1964.

[6] Not applicable for taxable years beginning after December 31, 1960.

use by the mine owner or operator on a bid in direct competition with a bona fide bid to sell a mineral listed in section 613(b)(3), the 15-percent rate applies. For example, limestone sold on a bid in direct competition with a bona fide bid to sell rock asphalt for road building purposes may be entitled to a 15-percent rate. In every case the taxpayer must establish to the satisfaction of the district director that there was a bona fide bid to sell a mineral listed under section 613(b)(3) by a person other than the taxpayer, and that the mineral sold by the taxpayer was sold on a bid in direct competition with such bona fide bid to sell such other material.

Fluorspar
Fullers earth.
Barnet.
Gilsonite.
Granite
Lepidolite.
Limestone.
Magnesite.
Magnesium carbonates
Marble.
Mica
Phosphate rock.

Potash.
Quartzite.
Slate.
Soapstone.
Spodumene.
Stone (dimension or[7] ornamental).
Talc (including pyrophyllite).
Thernardite.
Tripoli.
Trona.
All other minerals[7]

(b) *Definition of terms.* (1) For purposes of this section, the minerals indicated below shall have the following meanings:

(i) Clay, brick and tile—Clay used or sold for use in the manufacture of common brick, drain and roofing tile, sewer pipe, flower pots, and kindred products (other than clay specifically identified as a clay for which a 15 percent rate of percentage allowance is provided).

(ii) Clay, refractory and fire—Clay which has a pyrometric cone equivalent of 19 or higher.

(iii) Pumice—All pumice including pumicite.

(iv) Scoria—Only scoria produced from natural deposits.

(2) For purposes of this section, the term *United States* means the States and the District of Columbia. See section 7701(a)(9).

(3) For purposes of this section, the term *dimension stone* means blocks and slabs of natural stone, subsequently cut to definite shapes and sizes and used or sold for such uses as building stone (excluding rubble), monumental stone, paving blocks, curbing and flagging. For purposes of this section, *ornamental stone* means blocks and slabs of natural stone, subsequently cut to definite shapes and sizes and used or sold for use for making ornaments or statues.

(c) *Rules for application of paragraph (a) of this section.* (1) In no case may the allowance for depletion computed upon the basis of a percentage of gross income from the property exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For rules relating to the computation of such taxable income, see §1.613–5.

(2) In cases in which there are produced from a mineral property two or more minerals, each entitled to a different percentage depletion rate under section 613(b) and this section or any of which is entitled to cost depletion only, the percentage depletion allowance is the sum of the results obtained by applying the percentage applicable to each mineral (zero, if not entitled to percentage depletion) to the *gross income from the property* attributable to such mineral. The sum so computed is subject to the limitation provided in section 613(a) and §1.613–1, that is, 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). Such taxable income (computed in accordance with §1.613–4) is the total taxable income resulting from the sale of all minerals produced from the mineral property (as defined in section 614 and the regulations thereunder). The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Pyrite, an iron sulfide, may be sold for either its sulfur content or its iron content, or both. Sulfur is entitled to a percentage depletion deduction based on 23 percent of gross income from the property whereas the percentage depletion deduction for iron is based on 15 percent of such gross income. Therefore, in the case of a taxpayer who sells pyrite for both its sulfur and iron content, 23 percent of his gross income from sulfur plus 15 percent of his gross income

[7] The 15-percent rate is applicable only to stone used or sold for use by the mine owner or operator as dimension stone or ornamental stone.

from iron would be his maximum allowable percentage depletion deduction. However, this maximum deduction would be subject to the limitation provided for in section 613(a), *i.e.,* 50 percent of *taxable income from the property (computed without allowance for depletion),* such taxable income being the overall taxable income resulting from the sale of both minerals contained in the deposit.

Example 2. Oil and gas are produced from a single mineral property of a taxpayer who operates a retail outlet for the sale of oil products within the meaning of section 613A(d)(2). The taxpayer is not entitled to percentage depletion on the gross income attributable to the oil, but is entitled to percentage depletion on the gross income attributable to gas which is regulated gas under section 613A(b)(2)(B). Accordingly, the taxpayer's maximum allowable percentage depletion deduction would be zero percent of gross income from the property with respect to oil, plus 22 percent (see section 613A(b)(1)) of gross income from the property with respect to gas. This maximum deduction would be subject to the limitation provided for in section 613(a), *i.e.,* 50 percent of *taxable income from the property (computed without allowance for depletion),* such taxable income being the overall taxable income resulting from the sale of both oil and gas. However, in the case of oil or gas production which qualifies for percentage depletion under section 613A(c), see the special allocation rules contained in section 613A(c)(7) (C) and (E) and § 1.613A–4.

(3) Except as provided in section 613(d) and the regulations thereunder relating to special rules for determining rates of depletion for taxable years ending after December 31, 1953, to which the Internal Revenue Code of 1939 applies:

(i) The percentage rates set forth in this section are applicable only for taxable years beginning after December 31, 1953, and ending after August 16, 1954; and

(ii) The percentage rates set forth in 26 CFR (1939) 39.23(m)–5 (Regulations 118) are applicable for taxable years beginning before January 1, 1954, or ending before August 17, 1954.

(4) Percentage depletion is not allowable with respect to the income from a disposal of coal (including lignite) or domestic iron ore (as defined in paragraph (e) of § 1.631–3) with a retained economic interest to the extent that such income is treated as from a sale of coal or iron ore under section 631(c) and § 1.631–3. Rents or royalties paid or incurred by a taxpayer with respect to coal (including lignite) or domestic iron ore shall be excluded by such taxpayer in determining *gross income from the property* without regard to the treatment under section 631(c) of such rents and royalties in the hands of the recipient.

(5)(i) In all cases there shall be excluded in determining the *gross income from the property* an amount equal to any rents or royalties (which are depletable income to the payee) which are paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from *gross income from the property*. The following example illustrates this rule:

Example. A leases coal-bearing lands to B on condition that B will annually pay a royalty of 25 cents a ton on coal mined and sold by B. During the year 1956, B mines and sells f.o.b. mine 100,000 tons of coal for $600,000. In computing *gross income from the property* for the year 1956, B will exclude $25,000 (100,000 tons×$0.25) in computing his allowable percentage depletion deduction. B's allowable percentage depletion deduction (without reference to the limitation based on taxable income from the property) for the year 1956 will be $57,500 (($600,000 − $25,000)×10 percent).

(ii) If bonus payments have been paid in respect of the property in any taxable year or any prior taxable years, there shall be excluded in determining the *gross income from the property*, an amount equal to that part of such payments which is allocable to the product sold (or otherwise giving rise to gross income) for the taxable year. For purposes of the preceding sentence, bonus payments include payments by the lessee with respect to a production payment which is treated as a bonus under section 636(c). Such a production payment is equally allocable to all mineral from the mineral property burdened thereby. The following examples illustrate the provisions of this subdivision:

Example 1. In 1956, A leases oil bearing lands to B, receiving $200,000 as a bonus and reserving a royalty of one-eighth of the proceeds of all oil produced and sold. It is estimated at the time the lease is entered into that there are 1,000,000 barrels of oil recoverable. In 1956, B produces and sells 100,000 barrels for $240,000. In computing his *gross income from the property* for the year 1956, B will exclude $30,000 (⅛ of $240,000), the royalty paid to A, and $20,000 (100,000 bbls. sold/ 1,000,000 bbls. estimated to be available ×

$200,000 bonus), the portion of the bonus allocable to the oil produced and sold during the year. However, in computing B's taxable income under section 63, the $20,000 attributable to the bonus payment shall not be either excluded or deducted from B's gross income computed under section 61. (See paragraph (a)(3) of § 1.612–3.)

Example 2. In 1971, C leases to D oil bearing lands estimated to contain 1,000,000 barrels of oil, reserving a royalty of one-eighth of the proceeds of all oil produced and sold and a $500,000 production payment payable out of 50 percent of the first oil produced and sold attributable to the seven-eighths operating interest. In 1972, D produces and sells 100,000 barrels of oil. In computing his *gross income from the property* for the year 1972, D will exclude, in addition to the royalty paid to C, $50,000 (100,000 bbls. sold/1,000,000 bbls. estimated to be available × $500,000 treated under section 636(c) as a bonus), the portion of the production payment allocable to the oil produced and sold during the taxable year. However, in computing D's taxable income under section 63, the $50,000 attributable to the retained production payment shall not be either excluded or deducted from D's gross income computed under section 61.

(iii) If advanced royalties have been paid in respect of the property in any taxable year, the amount excluded from *gross income from the property* of the payor for the current taxable year on account of such payment, shall be an amount equal to the deduction for such taxable year taken on account of such payment pursuant to paragraph (b)(3) of § 1.612–3.

Example. If B in example 2 in paragraph (b)(4) of § 1.612–3, elects to deduct in 1956 the $10,000 paid to A in that year, he must exclude the same amount from *gross income from the property* in 1956; however, if B elects to defer the deduction until 1957 when he mined and sold the mineral, he must exclude the $10,000 from *gross income from the property* in 1957.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9306, July 27, 1965; T.D. 7170, 37 FR 5374, Mar. 15, 1972; T.D. 7261, 38 FR 5467, Mar. 1, 1973; T.D. 7487, 42 FR 24263, May 13, 1977]

§ 1.613–3 Gross income from the property.

Oil and gas wells. In the case of oil and gas wells, *gross income from the property,* as used in section 613(c)(1), means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or filed price of the oil or gas before conversion or transportation.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6965, 33 FR 10692, July 26, 1968; T.D. 8474, 58 FR 25557, Apr. 27, 1993]

§ 1.613–4 Gross income from the property in the case of minerals other than oil and gas.

(a) *In general.* The rules contained in this section are applicable to the determination of gross income from the property in the case of minerals other than oil and gas and the rules contained in § 1.613–3 are not applicable to such determination, notwithstanding provisions to the contrary in § 1.613–3. The term *gross income from the property,* as used in section 613(c)(1), means, in the case of a mineral property other than an oil or gas property, gross income from mining. *Gross income from mining* is that amount of income which is attributable to the extraction of the ores or minerals from the ground and the application of mining processes, including mining transportation. For the purpose of this section, *ordinary treatment processes* (applicable to the taxable years beginning before January 1, 1961) and *treatment processes considered as mining* (applicable to the taxable years beginning after December 31, 1960) will be referred to as *mining processes.* Processes, including packaging and transportation, which do not qualify as mining will be referred to as *nonmining processes.* Also for the purpose of this section, transportation which qualifies as *mining* will be referred to as *mining transportation* and transportation which does not qualify as *mining* will be referred to as *nonmining transportation.* See paragraph (f) of this section for the definition of the term *mining* and paragraph (g) of this section for rules relating to nonmining processes.

(b) *Sales prior to the application of nonmining processes including nonmining transportation.* (1) Subject to the adjustments required by paragraph (e)(1) of this section, gross income from mining means (except as provided in subparagraph (2) of this paragraph) the actual amount for which the ore or mineral is sold if the taxpayer sells the ore or mineral:

(i) As it emerges from the mine, prior to the application of any process other than a mining process or any transportation, or

(ii) After application of only mining processes, including mining transportation, and before any nonmining transportation.

If the taxpayer sells his ore or mineral in more than one form, and if only mining processes are applied to the ore or mineral, gross income from mining is the actual amount for which the various forms of the ore or mineral are sold, after any adjustments required by paragraph (e)(1) of this section. For example, if, at his mine or quarry, a taxpayer sells several sizes of crushed gypsum and also sells gypsum fines produced as an incidental byproduct of his crushing operations, without applying any nonmining processes, gross income from mining will ordinarily be the total amount for which such crushed gypsum and fines are actually sold. See paragraphs (f) and (g) of this section for provisions defining mining and nonmining processes for various minerals.

(2) In the case of sales between members of a controlled group (including sales as to which the district director exercises his authority under section 482 and the regulations thereunder), the prices for such sales (which shall be deemed to be the actual amount for which the ore or mineral is sold) shall be determined, if possible, by use of the representative market or field price method, as described in paragraph (c) of this section; otherwise such prices shall be determined by the appropriate pricing method as provided in paragraph (d)(1) of this section. For the definitions of the terms *controlled* and *group,* see paragraph (j) (1) and (2) of this section.

(c) *Cases where a representative market or field price for the taxpayer's ore or mineral can be ascertained*—(1) *General rule.* If the taxpayer processes the ore or mineral before sale by the application of nonmining processes (including nonmining transportation), or uses it in his operations, gross income from mining shall be computed by use of the representative market or field price of an ore or mineral of like kind and grade as the taxpayer's ore or mineral after the application of the mining processes actually applied (if any), including mining transportation (if any), and before any nonmining transportation, subject to any adjustments required by paragraph (e)(1) of this section. See paragraph (e)(2)(i) of this section for certain other situations in which this paragraph shall apply. The objective in computing gross income from mining by the representative market or field price method is to ascertain, on the basis of an analysis of actual competitive sales by the taxpayer or others, the dollar figure or amount which most nearly represents the approximate price at which the taxpayer, in light of market conditions, could have sold his ores or minerals if, prior to the application of nonmining processes, the taxpayer had sold the quantities and types of ores and minerals to which he applied nonmining processes. If it is possible to determine a market or field price under the provisions of this paragraph, and if that price is determined to be representative, the taxpayer's gross income from mining shall be determined on the basis of that price and not under the provisions of paragraph (d) of this section. The taxpayer's own actual sales prices for ores or minerals of like kind and grade shall be taken into account when establishing market or field prices, provided that those sales are determined to be representative.

(2) *Criteria for determining whether an ore or mineral is of like kind and grade as the taxpayer's ore or mineral.* An ore or mineral will be considered to be of like kind and grade as the taxpayer's ore or mineral if, in common commercial practice, it is sufficiently similar in chemical, mineralogical, or physical characteristics to the taxpayer's ore or mineral that it is used, or is commercially suitable for use, for essentially the same purposes as the uses to which the taxpayer's ore or mineral is put. Whether an ore or mineral is of like kind and grade as the taxpayer's ore or mineral will generally be determined

by reference to industrial or commercial specifications and by consideration of chemical and physical data relating to the minerals and deposits in question. The fact that the taxpayer applies slightly different size reduction processes, or the fact that the taxpayer uses slightly different benefication processes, or the fact that the taxpayer sells his ore or mineral for different purposes, will not, in itself, prevent another person's ore or mineral from being considered to be of like kind and grade as the taxpayer's ore or mineral. On the other hand, the fact that the taxpayer's ore or mineral is suitable for the same general commercial use as another person's ore or mineral will not cause the two ores or minerals to be considered to be of like kind and grade if the desirable natural constituents of the two ores or minerals are markedly different substances. For example, anthracite coal will not be considered to be of like kind as bituminous coal merely because both types of coal can be used as fuel. Similarly, bituminous coal which does not possess coking qualities will not be considered to be of like grade as bituminous coking coal. However, in the case of a taxpayer who mines and uses his bituminous coal in the production of coke, all bituminous coals in the same marketing area will be considered to be of like kind, and all such bituminous coals having the same or similar coking quality suitable for commercial use by coke producers will be considered to be of like grade as the coal mined and used by the taxpayer.

Fine distinctions between various grades of minerals are to be avoided unless those distinctions are clearly shown to have genuine commercial significance.

(3) *Factors to be considered in determining the representative market or field price for the taxpayer's ore or mineral.* In determining the representative market or field price for the taxpayer's ore or mineral, consideration shall be given only to prices of ores or minerals of like kind and grade as the taxpayer's ore or mineral and with which, under commercially accepted standards, the taxpayer's ore or mineral would be considered to be in competition if it were sold under the conditions described in paragraph (b)(1) of this section. A weighted average of the competitive selling prices of ores or minerals of like kind and grade as the taxpayer's, beneficiated only by mining processes, if any, in the relevant markets, although not determinative of the representative market or field price, is an important factor in the determination of that price. The taxpayer's own competitive sales prices for minerals which have been subjected only to mining processes shall be taken into account in computing such a weighted average. For purposes of the preceding sentence, if the district director has exercised his authority under section 482 and the regulations thereunder and has determined the appropriate price with respect to specific sales transactions by the taxpayer, that price shall be deemed to be a competitive sales price for those transactions. Sales or purchases, including the taxpayer's, of ores or minerals of like kind and grade as the taxpayer's, will be taken into consideration in determining the representative market or field price for the taxpayer's ore or mineral only if those sales or purchases are the result of competitive transactions. The identity of the taxpayer's relevant markets (including their accessibility to the taxpayer), and the representative market or field price within those markets, are necessarily factual determinations to be made on the basis of the facts and circumstances of each individual case. For the purpose of determining the representative market or field price for the taxpayer's ore or mineral, exceptional, insignificant, unusual, tie-in, or accommodation sales shall be disregarded. Except as provided above, representative market or field prices shall not be determined by reference to prices established between members of a controlled group. See paragraph (j) of this section for the definitions of the terms *controlled* and *group*.

(4) *Use of prices of mineral of different grade.* If there is no representative market or field price for a mineral of like kind and grade as the taxpayer's, representative market or field prices for an ore or mineral which is of like kind but which is not of like grade as his ore or mineral may be used, with appropriate adjustments for differences

in mineral content. Representative market or field prices of an ore or mineral of like kind but not of like grade may be used only if such adjustments are readily ascertainable. For example, it may be appropriate in a particular case to establish the representative market or field price for an ore having 50 percent X mineral content by reference to the representative market or field price for the same kind of ore having 60 percent X mineral content with an appropriate adjustment for the differences in the valuable mineral content of the two ores, any differences in processing costs attributable to impurities, and any other relevant factors.

(5) *Information to be furnished by a taxpayer computing gross income from mining by use of a representative market or field price.* A taxpayer who computes his gross income from mining pursuant to the provisions of this paragraph shall attach to his return a summary statement indicating the prices used by him in computing gross income from mining under this paragraph and the source of his information as to those prices, and the relevant supporting data shall be assembled, segregated, and made readily available at the taxpayer's principal place of business.

(6) *Limitation on gross income from mining computed under the provisions of this paragraph.* It shall be presumed that a price is not a representative market or field price for the taxpayer's ore or mineral if the sum of such price plus the total of all costs of the nonmining processes (including nonmining transportation) which the taxpayer applies to his ore or mineral regularly exceeds the taxpayer's actual sales price of his product. For example, if on a regular basis the total of all costs of nonmining processes applied by the taxpayer to coal for the purpose of making coke is $12 per ton, and if the taxpayer's actual sale price for such coke is $18 per ton, a price of $7 per ton would not be a representative market or field price for the taxpayer's coal which is used for making coke. In order to rebut the presumption set forth in the first sentence of this subparagraph, it must be established that the loss on nonmining operations is directly attributable to unusual, peculiar and nonrecurring factors rather than to the use of a market or field price which is not representative. For example, the first sentence of this subparagraph shall not apply if the taxpayer establishes in an appropriate case that the loss on nonmining operations is directly attributable to an event such as a fire, flood, explosion, earthquake, or strike.

(d) *Cases where a representative market or field price cannot be ascertained*— (1) *General rule.* (i) If it is impossible to determine a representative market or field price as described in paragraph (c) of this section then, except as provided in subdivision (ii) of this subparagraph, gross income from mining shall be computed by use of the proportionate profits method as set forth in subparagraph (4) of this paragraph. A method of computing gross income from mining under the provisions of this paragraph shall not be deemed to be a method of accounting for purposes of paragraph (e) of §1.446–1.

(ii)*(a)* The Office of the Assistant Commissioner (Technical) may determine that a method of computation is more appropriate than the proportionate profits method or the method being used by the taxpayer. The taxpayer may request such a determination (see *(d)* of this subdivision (ii)). If the taxpayer is using a method of computation which has been determined by the Office of Assistant Commissioner (Technical) to be more appropriate than the proportionate profits method, such method shall continue to be used until it is determined by the Office of Assistant Commissioner (Technical) that either the proportionate profits method or another method is more appropriate.

(b) The proportionate profits method is more appropriate than the method being used under *(a)* if, under the particular facts and circumstances, the method being used under *(a)* consistently fails to clearly reflect gross income from mining and the proportionate profits method more clearly reflects gross income from mining for the taxable year.

(c) An alternative method (a method other than the method being used under *(a)* (if any) and the proportionate profits method) is more appropriate than the method being used under *(a)*

(if any) and the proportionate profits method if, under the particular facts and circumstances, the latter methods consistently fail to clearly reflect gross income from mining, and the alternative method being considered more clearly reflects gross income from mining on a consistent basis than the method being used under *(a)* (if any) and the proportionate profits method. When determining whether a method of computation clearly reflects gross income from mining, it is relevant to compare the gross income from mining produced by such method with the gross income from mining, on an equivalent amount of production, which results from the computation methods used by competitors. When determining the acceptability of proposed alternative methods, primary consideration will be given to computation methods based upon representative charges for ores, minerals, products, or services. See paragraph (c) of this section for principles determining the representative character of a charge.

(d) Application for permission to compute gross income from mining by use of an alternative method shall be made by submitting a request to the Commissioner of Internal Revenue, Attention: Assistant Commissioner (Technical), Washington, DC 20224.

(e) Among the alternative methods of computation to which consideration will be given, provided that the requirements of this subdivision (ii) are met, are the methods listed in subparagraphs (5), (6), and (7) of this paragraph. The order in which these methods are listed is not significant, and the listing of these methods does not preclude a request to make use of a method which is not listed.

(iii) Approval and continued use of any method of computation under this paragraph depends upon all the facts and circumstances in each case, and shall be subject to such terms and conditions as may be necessary in the opinion of the Commissioner to reflect clearly the gross income from mining. Accordingly, the use of such a method for any taxable year shall be subject to review and change.

(2) *Costs to be used in computing gross income from mining by use of methods based on the taxpayer's costs.* In determining the taxpayer's gross income from mining by use of methods based on the taxpayer's costs, only costs actually paid or incurred shall be taken into consideration. In general, if the taxpayer has consistently employed a reasonable method of determining the costs of the various individual phases of his mining and nonmining processes (such as extraction, loading for shipment, calcining, packaging, etc.), such method shall not be disturbed. The amount of any particular item to be taken into account shall, for taxable years beginning after November 30, 1968, be the amount used in determining the taxpayer's income for tax purposes. For example, the depreciation lives, methods, and records used for tax purposes, if different from those used for book purposes, shall be the basis for determining the amount of depreciation to be used. However, a taxpayer may continue to use a reasonable method for determining those costs on the basis of the amounts computed for cost control or similar financial or accounting books and records if that method has been used consistently and is applied to the determination of all those costs.

(3) *Treatment of particular items in computing gross income from the mining by use of methods based on the taxpayer's costs.* (i) Except as specifically provided elsewhere in this section, when determining gross income from mining by use of methods based on the taxpayer's costs, the costs attributable to mining transportation shall be treated as mining costs, and the costs attributable to nonmining transportation shall be treated as nonmining costs. Accordingly, except as specifically provided elsewhere in this section, all profits attributable to mining transportation shall be treated as mining profits, and all profits attributable to nonmining transportation shall be treated as nonmining profits. For this purpose, mining transportation means so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to plants or mills in which other mining processes are applied thereto as is not in excess of 50 miles or, if the taxpayer files an application

pursuant to paragraph (h) of this section and the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over the greater distance. Further, for this purpose, nonmining transportation includes the transportation (whether or not by common carrier) of ores, minerals, or the products produced therefrom, from the point of extraction from the ground to nonmining facilities, or from a mining facility to a nonmining facility, or from one nonmining facility to another, or from a nonmining facility to the customers who purchase the taxpayer's first marketable product or group of products. See paragraph (e)(2) of this section for provisions relating to purchased transportation to the customer and paragraph (g)(3) of this section for provisions relating to transportation the primary purpose of which is marketing or distribution. In the absence of other methods which clearly reflect the costs of the various phases of transportation, the cost attributable to nonmining transportation shall be an amount which is in the same ratio to the costs incurred for the total transportation as the distance of the nonmining transportation is to the distance of the total transportation. As an example, where the plants or mills in which mining processes are applied to ores or minerals are in excess of 50 miles from the point of extraction from the ground (or in excess of a greater distance approved by the Commissioner), the costs incurred for transportation to those plants or mills in excess of 50 miles (or of that greater distance) shall be treated as nonmining costs in determining gross income from mining. Accordingly, all profits attributable to that excess transportation are treated as nonmining profits. However, except in the case of transportation performed in conveyances owned or leased by the taxpayer, the preceding sentence shall apply only to taxable years beginning after November 30, 1968.

(ii) In determining gross income from mining by use of methods based on the taxpayer's costs, a process shall not be considered as a mining process to the extent it is applied to ores, minerals, or other materials with respect to which the taxpayer is not entitled to a deduction for depletion under section 611. The costs of such nondepletable ores, minerals, or materials; the costs of the processes (including blending, size reduction, etc.) applied thereto; and the transportation costs thereof, if any, shall be considered as nominating costs in determining gross income from mining. If a mining process is applied to an admixture of depletable and nondepletable material, the cost of the process and the cost of transportation, if any, attributable to the nondepletable material shall be considered as nonmining costs in determining gross income from mining. Accordingly, all profits attributable thereto are treated as nonmining profits. In the absence of other methods which clearly reflect the cost attributable to the processing and transportation, if any, of the nondepletable admixed material, that cost shall be deemed to be that proportion of the costs which the tonnage of nondepletable material bears to the total tonnage of both depletable and nondepletable material.

(iii) In determining gross income from mining by use of methods based on the taxpayer's costs:

(a) The costs attributable to containers, bags, packages, pallets, and similar items as well as the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

(b) The costs attributable to the bulk loading of manufactured products shall be considered as nonmining costs.

(c) The costs attributable to the operation of warehouses or distribution terminals for manufactured products shall be considered as nonmining costs.

Accordingly, all profits attributable thereto are treated as nonmining profits.

(iv) In computing gross income from mining by the use of methods based on the taxpayer's costs, the principles set forth in paragraph (c) of §1.613–5 shall apply when determining whether selling expenses and trade association dues are to be treated, in whole or in part, as mining costs or as nonmining costs. To the extent that selling expenses and trade association dues are treated as nonmining costs, all profits attributable thereto are treated as nonmining profits.

(v) See paragraph (e)(1) of this section for provisions excluding certain allowances from the taxpayer's gross sales and costs of his first marketable product or group of products.

(4) *Proportionate profits method.* (i) The objective of the *proportionate profits method* of computation is to ascertain gross income from mining by applying the principle that each dollar of the total costs paid or incurred to produce, sell, and transport the first marketable product or group of products (as defined in subdivision (iv) of this subparagraph) earns the same percentage of profit. Accordingly, in the proportionate profits method no ranking of costs is permissible which results in excluding or minimizing the effect of any costs incurred to produce, sell, and transport the first marketable product or group of products. For purposes of this subparagraph, members of a controlled group shall be treated as divisions of a single taxpayer. See paragraph (j) of this section for the definitions of the terms *controlled* and *group*.

(ii) The proportionate profits method of computation is applied by multiplying the taxpayer's gross sales (actual or constructive) of his first marketable product or group of products (after making the adjustments required by paragraph (e) of this section) by a fraction whose numerator is the sum of all the costs allocable to those mining processes which are applied to produce, sell, and transport the first marketable product or group of products, and whose denominator is the total of all the mining and nonmining costs paid or incurred to produce, sell, and transport the first marketable product or group of products (after making the adjustments required by this paragraph and paragraph (e) of this section). The method as described herein is merely a restatement of the method formerly set forth in the second sentence of Regulations 118, section 39.23(m)–1 (e)(3) (1939 Code). The proportionate profits method of computation may be illustrated by the following equation:

$$\frac{\text{Mining costs}}{\text{Total costs}} \times \text{Gross sales} = \text{Gross income from mining}$$

(iii) Those costs which are paid or incurred by the taxpayer to produce, sell, and transport the first marketable product or group of products, and which are not directly identifiable with either a particular mining process or a particular nonmining process shall, in the absence of a specific provision of this section providing an apportionment method, be apportioned to mining and to nonmining by use of a method which is reasonable under the circumstances. One method which may be reasonable in a particular case is an allocation based on the proportion that the direct costs of mining processes and the direct costs of nonmining processes bear to each other. For example, the salary of a corporate officer engaged in overseeing all of the taxpayer's processes is an expense which may reasonably be apportioned on the basis of the ratio between the direct costs of mining and nonmining processes. On the other hand, an expense such as workmen's compensation premiums would normally be apportioned on the basis of direct labor costs. For the rule relating to selling expenses, see paragraph (c)(4) of § 1.613–5.

(iv) As used in this section, the term *first marketable product or group of products* means the product (or group of essentially the same products) produced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing area. For this purpose, bulk and packaged products are considered to be essentially the same product. Sales between members of a controlled group (as defined in paragraph (j) of this section) shall not be considered in making a determination under this subdivision. The first marketable product or group of products does not include any product which results from additional manufacturing or other nonmining processes applied to the product or products first marketed in significant quantities by the taxpayer or others in the taxpayer's marketing area. For example, if a cement manufacturer sells his own finished cement in bulk and bags and also sells concrete blocks or dry ready-mix aggregates containing additives, the finished cement, in bulk and bags, constitutes the first marketable product or group of products produced by him. Similarly, if an integrated iron ore and steel producer sells both pig iron in various sizes and rolled sheet iron or shapes, his first marketable product is the pig iron in its various sizes. Further, if an integrated clay and brick producer sells both unglazed bricks and tiles of various shapes and sizes and additionally manufactured bricks and tiles which are specially glazed, the unglazed products, both packaged and unpackaged, constitute his first marketable product or group of products.

(v)*(a)* As used in this subparagraph, the term *gross sales (actual or constructive)* means the total of the taxpayer's actual competitive sales to others of the first marketable product or group of products, plus the taxpayer's constructive sales of the first marketable product or group of products used or retained for use in his own subsequent operations, subject to the adjustments required by paragraph (e) of this section. See *(b)* of this subdivision in the case of actual sales between members of controlled groups and in the case of constructive sales. A *constructive sale* occurs when a miner-manufacturer is deemed, for percentage depletion purposes, to be selling the first marketable product or group of products to himself.

(b) In the case of sales between members of a controlled group as to which the district director has exercised his authority under section 482 and the regulations thereunder and has determined the appropriate price with respect to specific sales transactions, that price shall be deemed, for those transactions, to be the actual amount for which the first marketable product or group of products is sold for purposes of this subdivision (v). In the case of all other sales between members of a controlled group, and in the case of constructive sales, the prices for such sales shall be determined by use of the principles set forth in paragraph (c) of this section, subject to the adjustments required by paragraph (e) of this section. In the case of constructive sales, see paragraph (c)(4) of this section for rules relating to information to be furnished by the taxpayer.

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

Example 1. (a) Facts. A is engaged in the mining of a mineral to which section 613 applies and in the application thereto of nonmining processes. During 1968, A incurred extraction costs of $35,000; other mining costs of $56,000; $150,000 for manufacturing costs; $46,000 for other nonmining processes; and $14,000 for the company president's salary and similiar costs resulting from both nonmining and mining processes. During that year, A produced and sold 70,000 tons of his first marketable product for an actual gross sales price of $420,000, after the adjustments required by paragraph (e) of this section. A representative market or field price for A's mineral before the application of nonmining processes cannot be established.

(b) Computation. (1) The computation of A's gross income from mining by use of the proportionate profits method involves two steps. The first step is to apportion A's costs to mining and to nonmining. A apportions the company president's salary and similiar costs to mining and to nonmining in the manner described in the second and third sentences of subdivision (iii) of this subparagraph, and apportions his remaining costs as follows:

Cost	Mining	Nonmining	Total
Extraction	$35,000		$35,000
Other mining processes	56,000		56,000
Manufacturing		$150,000	150,000
Other nonmining processes		46,000	46,000
Subtotal	91,000	196,000	287,000
President's salary and similar costs	4,439	9,561	14,000
Total costs	95,439	205,561	301,000

(2) The second step is to apply the proportionate profits fraction so as to compute A's gross income from mining. To do this, A first

computes his gross sales of his first marketable group of products, in this case $420,000. A multiplies his actual gross sales of $420,000 by the proportionate profits fraction, whose numerator consists of his total mining costs ($95,439) and whose denominator consists of his total costs ($301,000). Thus, A's gross income from mining is $133,170 (*i.e.,* 95,439/301,000ths of A's actual gross sales of $420,000).

Example 2. B, who leases a mineral property from C, is engaged in the mining of a mineral to which section 613 applies and in the application thereto of nonmining processes. Pursuant to the terms of the lease, B is required to pay C 10 cents for each ton of mineral which B mines. During 1971, B extracted 100,000 tons of mineral. He sold his first marketable product for an actual gross sales price of $225,000 after the adjustments required by paragraph (e) of this section. A representative market or field price for B's mineral before the application of nonmining processes cannot be established. During 1971, with respect to the 100,000 tons of mineral extracted, B incurred mining costs of $50,000 and nonmining costs of $100,000, and paid $10,000 to C as C's royalty. Since the royalty payment is considered to be C's share of the gross income from mining under section 613(a), it is not considered to be either a mining cost or a nonmining cost of B. B's gross income from mining is $65,000 under the proportionate profits method, determined as follows: The $225,000 gross receipts must be multiplied by the proportionate profits fraction which is $50,000 mining costs over $150,000 total costs ($50,000+$100,000 nonmining costs). Since the resulting $75,000 is the total gross income from mining with respect to the property, it must be allocated between B's lease interest and C's royalty interest. The $10,000 paid to C must be subtracted from the $75,000 leaving $65,000 which represents B's gross income from mining. C's gross income from mining is the royalty he received or $10,000.

(5) *Representative schedule method.* The *representative schedule method* is a pricing formula which uses representative finished product prices, penalties, charges and adjustments, established in arms-length transactions between unrelated parties, to determine the market or field price for a crude mineral product. The representative character of a price, penalty, charge, or adjustment shall be determined by applying the principles set forth in paragraph (c) of this section. The representative schedule method is principally intended for use in those industries in which such a schedule-type pricing method is in general use to determine the price paid to unintegrated mineral producers for their crude mineral product. For example, if unintegrated producers of copper concentrate in a particular field or market customarily sell their product at prices which are determined in accordance with a schedule-type pricing formula, consideration will be given to the determination of concentrate prices for integrated copper producers in accordance with the same pricing formula. The representative schedule method shall not be used if it is impossible to determine one or more of the elements in the representative schedule formula by reference to prices, penalties, charges, or adjustments established in representative transactions between unrelated parties. See paragraph (c) of this section for principles determining the representative character of a charge.

(6) *Method using prices outside the taxpayer's market.* Under the *other market method* the taxpayer uses representative market or field prices established outside his markets, provided that conditions there are substantially the same as in his markets. For example, it may be appropriate in a particular case to establish the representative market or field price for pellets containing 60 percent iron which are produced and used in market area X by reference to the representative market or field price for pellets containing 60 percent iron which are produced and sold in adjacent market area Y, provided that conditions in the two marketing areas are shown to be substantially the same.

(7) *Rate of return on investment method.* [Reserved]

(e) *Reductions of sales price in computing gross income from mining*—(1) *Discounts.* If a taxpayer computes gross income from mining under the provisions of paragraph (b)(1) of this section, trade discounts and, for taxable years beginning after November 30, 1968, cash discounts actually allowed by the taxpayer shall be subtracted from the sale price of the taxpayer's ore or mineral. If a taxpayer computes gross income from mining under the provisions of paragraph (c) of this section, any such discounts actually allowed (if not otherwise taken into account) by the person or persons making the sales on the basis of which the representative market or field price for the taxpayer's ore or mineral is to be determined shall be subtracted from the sale price in computing such representative market or field price. If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, such discounts actually allowed (if not otherwise taken into account) shall be subtracted from the gross sales (actual or constructive), and shall not be considered a cost, of the first marketable product or group of products. The provisions of this subparagraph shall apply to arrangements which have the same effect as trade or cash discounts, regardless of the form of the arrangements.

(2) *Purchased transportation to the customer.* (i) A taxpayer who computes gross income from mining under the provisions of paragraph (c) of this section and who sells his ore or mineral after the application of only mining processes but after nonmining transportation shall use as the representative market or field price his delivered price (if otherwise representative) reduced by costs paid or incurred by him for purchased transportation to the customer as defined in subdivision (iii) of this subparagraph. If the transportation by the taxpayer is not purchased transportation to the customer, or if the taxpayer does not sell the ore or mineral until after the application of nonmining processes, and if other producers in the taxpayer's marketing area sell significant quantities of an ore or mineral of like kind and grade after the application of only mining processes but after purchased transportation to the customer, the representative delivered price at which the ore or mineral is sold by those other producers reduced by representative costs of purchased transportation to the customer paid or incurred by those producers shall be used by the taxpayer as the representative market or field price for his ore or mineral in applying paragraph (c) of this section. Furthermore, appropriate adjustments shall be made to take into account differences in mode of transportation and distance. When applying this subdivision, the representative market or field price so computed shall not exceed the taxpayer's delivered price less his actual costs of transportation to the customer. For purposes of this subdivision, any delivered price shall be adjusted as provided in subparagraph (1) of this paragraph.

(ii) If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, the cost of purchased transportation to the customer (as defined in subdivision (iii) of this subparagraph) shall be excluded from the gross sales of his first marketable product or group of products (after any adjustments required by subparagraph (1) of this paragraph), and from the denominator of the proportionate profits fraction, so as not to attribute profits to the cost of that transportation. Similar transportation cost adjustments may be made, if appropriate, in the case of other methods of computation which are based on the taxpayer's costs. For the treatment of costs and profits attributable to transportation which is not purchased transportation to the customer as defined in subdivision (iii) of this subparagraph, see paragraph (d)(3)(i) of this section.

(iii) For purposes of this section, the term *purchased transportation to the customer* means, in general, nonmining transportation of the taxpayer's minerals or mineral products to the customer:

(a) Which is not performed in conveyances owned or leased directly or indirectly, in whole or in part, by the taxpayer,

(b) Which is performed solely to deliver the taxpayer's minerals or mineral products to the customer, rather than to transport such minerals or products for packaging or other additional processing by the taxpayer (other than incidental storage or handling), and

(c) With respect to which the taxpayer ordinarily does not earn any profit.

For purposes of the preceding sentence, transportation which is performed by a person controlling or controlled by the taxpayer (within the meaning of paragraph (j)(1) of this section) shall be deemed to have been performed in conveyances owned or leased by the taxpayer unless it is established by the taxpayer that the price charged by the controlling or controlled person for such transportation constitutes an arm's-length charge (under the standard described in paragraph (b)(1) of § 1.482–1). The term *purchased transportation to the customer* includes transportation to a warehouse, terminal, or distribution facility owned or operated by the taxpayer, provided that such transportation is performed under the conditions described in the first sentence of this subdivision. A taxpayer will not be deemed ordinarily to earn a profit on transportation merely because charges for the transportation are included in the stated selling price, rather than being separately stated or segregated from other billing. A taxpayer will not be deemed ordinarily to earn a profit on transportation if the rates for the transportation constitute an arm's-length charge ordinarily paid by shippers of the same product in similar circumstances. If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, the term *purchased transportation to the customer* refers to transportation which conforms to the other requirements of this subdivision and which is performed to transport the taxpayer's first marketable product or group of products (as defined in paragraph (d)(4)(iv) of this section) rather than to transport minerals or mineral products which do not yet constitute the taxpayer's first marketable product or group of products.

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

Example 1. A is engaged in the mining of an ore of mineral M and in the production and sale of M concentrate. A retains a portion of his concentrate for use in his own nonmining operations. During 1968, A sold 100,000 tons of M concentrate of ore mined and processed by him, which sales constituted a significant portion of his total production. Eighty thousand tons of that concentrate were sold by A on the basis of a representative price (after adjustments required by subparagraph (1) of this paragraph) of $30 per ton f.o.b. mine or plant, resulting in gross income from mining of $2,400,000. The remaining 20,000 tons were sold by A, both directly and through terminals, on the basis of a delivered price (after adjustments required by subparagraph (1) of this paragraph) at City X of $40 per ton. The delivered price included $15 per ton cost of purchased transportation from the mine or plant to customers in City X. The representative market or field price of the concentrate sold by A on the basis of a delivered price is $25 per ton, determined by subtracting the cost of the purchased transportation to the customer ($15 per ton) from the delivered price for the concentrate ($40 per ton). Accordingly, A's gross income from mining with respect to the 20,000 tons of M concentrate sold on a delivered basis is $500,000. The representative market or field price for the concentrate retained by A and used in his own nonmining operations may be computed by reference to the weighted average price for both A's f.o.b. mine and A's delivered sales of concentrate, with the delivered sales prices reduced in the manner described above. On this basis, the representative market or field price for the retained concentrate is $29 per ton.

Example 2. B is engaged in the mining of an ore of mineral N and in the production of N concentrate. B retained all but an insignificant amount of his concentrate for use in his own nonmining operations. Other producers in B's marketing area sell significant amounts of N concentrate of like kind and grade, both on an f.o.b. mine or plant basis and on a delivered basis. In this case, the prices for both the f.o.b. and the delivered sales made by other producers (after any adjustments required by subparagraph (1) of this paragraph), after reduction of the delivered prices by the cost of purchased transportation to the customer, shall, if such prices are otherwise representative, be taken into account in establishing the representative market or field price for the N concentrate produced and used by B.

(f) *Definition of mining*—(1) *In general.* The term *mining* includes only:

(i) The extraction of ores or minerals from the ground;

(ii) Mining processes, as described in subparagraphs (2) through (6) of this paragraph; and

(iii) So much of the transportation (whether or not by common carrier) of ores or minerals from the point of extraction of the ores or minerals from the ground to the plants or mills in which the processes referred to in subdivision (ii) of this subparagraph are applied thereto as is not in excess of 50 miles, and, if the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over such greater distance as the Commissioner authorizes. See paragraph (h) of this section for rules relating to the filing of applications to treat as mining any transportation in excess of 50 miles.

(2) *Definition of mining processes.* (i) As used in subparagraph (1)(ii) of this paragraph, the term *mining processes* means, for taxable years beginning before January 1, 1961, the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, including the following processes (and the processes necessary or incidental thereto), and, for taxable years beginning after December 31, 1960, the following processes (and the processes necessary or incidental thereto):

(a) In the case of coal—cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment;

(b) In the case of sulfur recovered by the Frasch process—cleaning, pumping to vats, cooling, breaking, and loading for shipment;

(c) In the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and ores or minerals which are customarily sold in the form of a crude mineral product (as defined in subparagraph (3)(iv) of this paragraph):

(1) Where applied for the purpose of bringing to shipping grade and form (as defined in subparagraph (3)(iii) of this paragraph)—sorting, concentrating, sintering, and substantially equivalent processes, and

(2) Loading for shipment.

(d) In the case of lead, zinc, copper, gold, silver, uranium, or fluorspar ores, potash, and ores or minerals which are not customarily sold in the form of the crude mineral product—crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore or the mineral or minerals from other material from the mine or other natural deposit; and

(e) In the case of the following ores or minerals:

(1) The furnacing of quicksilver ores,

(2) The pulverization of talc,

(3) The burning of magnesite, and

(4) The sintering and nodulizing of phosphate rock.

(ii) The term *mining processes* also includes the following processes (and, except as otherwise provided in this subdivision, the processes necessary or incidental thereto):

(a) For taxable years beginning after December 31, 1960, in the case of calcium carbonates and other minerals when used in making cement—all processes (other than preheating the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;

(b) For taxable years beginning after December 31, 1960, and before November 14, 1966, in the case of clay to which former section 613(b)(5)(B) applied, and for taxable years beginning after November 13, 1966, in the case of clay to which section 613(b) (5) or (6) (B) applies—crushing, grinding, and separating the clay from waste, but not including any subsequent process;

(c) For taxable years beginning after October 9, 1969, in the case of minerals (other than sodium chloride) extracted from brines pumped from a saline perennial lake (as defined in paragraph (b) of § 1.613–2)—the extraction of such minerals from the brines, but in no case including any further processing or refining of such extracted minerals; and

(d) For taxable years beginning after December 30, 1969, in the case of oil shale (as defined in paragraph (b) of § 1.613–2)—extraction from the ground, crushing, loading into the retort, and retorting, but in no case hydrogenation, refining, or any other process subsequent to retorting.

(iii) A process is *necessary* to another related process if it is prerequisite to the performance of the other process. For example, if the concentrating of low-grade iron ores to bring to shipping grade and form cannot be effectively accomplished without fine pulverization, such pulverization shall be treated as a process which is *necessary* to the concentration process. Accordingly, because concentration is a mining process, such pulverization is also a mining process. Furthermore, if mining processes cannot be effectively applied to a mineral without storage of the mineral while awaiting the application of such processes, such storage shall be treated as a process which is *necessary* to the accomplishment of such mining processes. A process is *incidental* to another related process if the cost thereof is insubstantial in relation to the cost of the other process, or if the process is merely the coincidental result of the application of the other process. For example, the sprinkling of coal, prior to loading for shipment, with dots of paper to identify the coal for tradename purposes will be considered incidental to the loading where the cost of that sprinkling is insubstantial in relation to the cost of the loading process. Also, where crushing of a crude mineral is treated as a mining process, the production of fines as a byproduct is ordinarily the coincidental result of the application of a mining process. If a taxpayer demonstrates that, as a factual matter, a particular process is necessary or incidental to a process named as a mining process in section 613(c)(4) of this paragraph, the necessary or incidental process will also be considered a mining process.

(iv) The term *mining* does not include purchasing minerals from another. Accordingly, the processes listed in this paragraph shall be considered as mining processes only to the extent that they are applied by a mine owner or operator to an ore or mineral in respect of which he is entitled to a deduction for depletion under section 611. The application of these processes to purchased ores, minerals, or materials does not constitute mining.

(3) *Processes recognized as mining for ores or minerals covered by section 613(c)(4)(C).* (i) As used in section 613(c)(4)(C) and subparagraph (2)(i) *(c)* of this paragraph, the terms *sorting* and *concentrating* mean the process of eliminating substantial amounts of the impurities or foreign matter associated with the ores or minerals in their natural state, or of separating two or more valuable minerals or ores, without changing the physical or chemical identity of the ores or minerals. Examples of sorting and concentrating processes are hand or mechanical sorting, magnetic separation, gravity concentration, jigging, the use of shaking or concentrating tables, the use of spiral concentrators, the use of sluices or sluice boxes, sink-and-float processes, classifiers, hydrotators and flotation processes. Under section 613(c)(4)(C), sorting and concentration will be considered mining processes only where they are applied to bring an ore or mineral to shipping grade and form.

(ii) As used in section 613(c)(4)(C) and subparagraph (2)(i)*(c)* of this paragraph, the term *sintering* means the agglomeration of fine particles by heating to a temperature at which incipient, but not complete, fusion occurs. Sintering will be considered a mining process only where it is applied to an ore or mineral, or a concentrate of an ore or mineral, as an auxiliary process necessary to bring the ore or mineral to shipping form. A thermal action which is applied in the manufacture of a finished product will not be considered to be a mining process even though such thermal action may cause the agglomeration of fine particles by incipient fusion, and even though such action does not cause a chemical change in the agglomerated particles. For example, the sintering of finely ground iron ore concentrate, prior to shipment from the concentration plant, for the purpose of preventing the risk of loss of the finely divided particles during shipment is considered a mining process. On the other hand, for example, a heating process applied to expand or harden clay, shale, perlite, vermiculite, or other materials in the course of the manufacture of lightweight aggregate or other building materials is not considered to be a mining process.

(iii) As used in section 613(c)(4)(C) and this section, to *bring to shipping grade and form* means, with respect to taxable years beginning after December 31, 1960, to bring (by the application of mining processes at the mine or concentration plant) the quality or size of an ore or mineral to the stage or stages at which the ore or mineral is shipped to customers or used in nonmining processes (as defined in paragraph (g) of this section) by the taxpayer.

(iv) An ore or mineral is *customarily sold in the form of a crude mineral product*, within the meaning of section 613 (c)(4)(C), if a significant portion of the production thereof is sold or used in a nonmining process prior to the alteration of its inherent mineral content by some form of beneficiation, concentration, or ore dressing. An ore or mineral does not lose its classification as a crude mineral product by reason of the fact that, before sale or use in a nonmining process, the ore or mineral may be crushed or subjected to other processes which do not alter its inherent mineral content. Whether the portion of production sold or used in the form of a crude mineral product is a significant portion of the total production of an ore or mineral is a question of fact.

(4) *Type of processes recognized as mining for ores or minerals covered by section 613(c)(4)(D).* Cyanidation, leaching, crystallization, and precipitation, which are listed in section 613(c)(4)(D) as treatment processes considered as mining, and the processes (or combination of processes) which are substantially equivalent thereto, will be recognized as mining only to the extent that they are applied to the taxpayer's ore or mineral for the purpose of separation or extraction of the valuable mineral product or products from the ore, or for the purpose of separation or extraction of the mineral or minerals from other material extracted from the mine or other natural deposit. A process, no matter how denominated, will not be recognized as mining if the process beneficiates the ore or mineral to the degree that such process, in effect, constitutes smelting, refining, or any other nonmining process within the meaning of paragraph (g) of this section. As used in section 613(c)(4)(D) and subparagraph (2)(i) *(d)* of this paragraph, the term *concentration* has the meaning set forth in the first two sentences of subparagraph (3)(i) of this paragraph.

(5) *Processes recognized as mining under section 613(c)(4)(I).* Under the authority granted the Secretary or his delegate in section 613(c)(4)(I), the processes which are described in subdivisions (i) through (iv) of this subparagraph, and the processes necessary or incidental thereto, are recognized as mining processes for taxable years beginning after December 31, 1960. The processes described in subdivisions (i) through (iv) of this subparagraph are in addition to the specific processes recognized as mining under section 613(c)(4). Such additional processes are:

(i) Crushing and grinding, but not fine pulverization (as defined in paragraph (g) (6) (v) of this section);

(ii) Size classification processes applied to the products of an allowable mining process;

(iii) Drying to remove free water, provided that such drying does not change the physical or chemical identity or composition of the mineral; and

(iv) Washing or cleaning the surface of mineral particles (including the washing of sand and gravel and the treatment of kaolin particles to remove surface stains), provided that such washing or cleaning does not activate or otherwise change the physical or chemical structure of the mineral particles.

(6) In the case of a process applied subsequent to a nonmining process, see paragraph (g)(2) of this section.

(g) *Nonmining processes*—(1) *General rule.* Unless they are otherwise provided for in paragraph (f) of this section as mining processes (or are necessary or incidental to processes listed therein), the following processes are not considered to be mining processes—electrolytic deposition, roasting, calcining, thermal or electric smelting, refining, polishing, fine pulverization, blending with other materials, treatment effecting a chemical change, thermal action, and molding or shaping. See subparagraph (6) of this paragraph for definitions of certain of these terms.

(2) *Processes subsequent to nonmining processes.* Notwithstanding any other provision of this section, a process applied subsequent to a nonmining process (other than nonmining transportation) shall also be considered to be a nonmining process. Exceptions to this rule shall be made, however, in those instances in which the rule would discriminate between similarly situated producers of the same mineral. For example, roasting is specifically designated in subparagraph (1) of this paragraph as a nonmining process, but in the case of minerals referred to in section 613(c)(4)(C) sintering is recognized as a mining process. If certain

impurities in an ore can only be removed by roasting in order to bring it to the same shipping grade and form as a competitive sintered ore of the same kind which requires no roasting, the subsequent sintering of the roasted ore will be treated as a mining process. In that case, however, the roasting of the ore will nonetheless continue to be treated as a nonmining process.

(3) *Transportation for the purpose of marketing or distribution; storage.* Transportation the primary purpose of which is marketing, distribution, or delivery for the application of only nonmining processes shall not be considered as mining. Nor shall transportation be considered as mining merely because, during the course of such transportation, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow. Similarly, storage or warehousing of manufactured products shall not be considered as mining. The preceding sentence shall apply even though, during the course of such storage or warehousing, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow.

(4) *Manufacturing, etc.* The production, packaging, distribution, and marketing of manufactured products, and the processes necessary or incidental thereto, are nonmining processes.

(5) *Transformation processes.* Processes which effect a substantial physical or chemical change in a crude mineral product, or which transform a crude mineral product into new or different mineral products, or into refined or manufactured products, are nonmining processes except to the extent that such processes are allowed as mining processes under section 613(c) or under paragraph (f) of this section.

(6) *Definitions.* As used in section 613(c)(5) and this section:

(i) The term *calcining* refers to processes used to expel the volatile portions of a mineral by the application of heat, as, for example, the burning of carbonate rock to produce lime, the heating of gypsum to produce calcined gypsum or plaster of Paris, or the heating of clays to reduce water of crystallization.

(ii) The term *thermal smelting* refers to processes which reduce, separate, or remove impurities from ores or minerals by the application of heat, as, for example, the furnacing of copper concentrates, the heating of iron ores, concentrates, or pellets in a blast furnace to produce pig iron, or the heating of iron ores or concentrates in a direct reduction kiln to produce a feed for direct conversion into steel.

(iii) The term *refining* refers to processes (other than mining processes designated in section 613(c)(4) or this section) used to eliminate impurities or foreign matter from smelted or partially processed metallic and nonmetallic ores and minerals, as, for example, the refining of blister copper. In general, a refining process is designed to achieve a high degree of purity by removing relatively small amounts of impurities or foreign matter from smelted or partially processed ores or minerals.

(iv) The term *polishing* refers to processes used to smooth the surface of minerals, as, for example, sawing applied to finish rough cut blocks of stone, sand finishing, buffing, or otherwise smoothing blocks of stone.

(v) The term *fine pulverization* refers to any grinding or other size reduction process applied to reduce the normal topsize of a mineral product to less than .0331 inches, which is the size opening in a No. 20 Screen (U.S. Standard Sieve Series). A mineral product will be considered to have a normal topsize of .0331 inches if at least 98 percent of the product will pass through a No. 20 Screen (U.S. Standard Sieve Series), provided that at least 5 percent of the product is retained on a No. 45 Screen (U.S. Standard Sieve Series). Compliance with the normal topsize test may also be demonstrated by other tests which are shown to be reasonable in the circumstances. The normal topsize test shall be applied to the product of the operation of each separate and distinct piece of size reduction equipment utilized (such as a roller mill), rather than to the final products for sale. Fine pulverization includes the repeated recirculation of material through crushing or grinding equipment to accomplish fine pulverization. Separating or screening the product of a fine pulverization process (including separation by air or water flotation) shall be treated as a nonmining process.

(vi) The term *blending with other materials* refers to processes used to blend different kinds of minerals with one another, as, for example, blending iodine with common salt for the purpose of producing iodized table salt.

(vii) The term *treatment effecting a chemical change* refers to processes which transform or modify the chemical composition of a crude mineral, as, for example, the coking of coal. The term does not include the use of chemicals to clean the surface of mineral particles provided that such cleaning does not make any change in the physical or chemical structure of the mineral particles.

(viii) The term *thermal action* refers to processes which involve the application of artificial heat to ores or minerals, such as, for example, the burning of bricks, the coking of coal, the expansion or popping of perlite, the exfoliation of vermiculite, the heat treatment of garnet, and the heating of shale, clay, or slate to produce lightweight aggregates. The term does not include drying to remove free water.

(h) *Application to treat, as mining, transportation in excess of 50 miles.* If a taxpayer desires to include in the computation of his gross income from mining transportation in excess of 50 miles from the point of extraction of the minerals from the ground, he shall file an original and one copy of an application for the inclusion of such greater distance with the Commissioner of Internal Revenue, Washington, DC 20224. The application must include a statement setting forth in detail the facts concerning the physical and other requirements which prevented the construction and operation of the plant (in which mining processes, as defined in paragraph (f) of this section, are applied) at a place nearer to the point of extraction from the ground. These facts must be sufficient to apprise the Commissioner of the exact basis of the application. If the taxpayer's return is filed prior to receipt of notice of the Commissioner's action upon the application, a copy of such application shall be attached to the return. If, after an application is approved by the Commissioner, there is a material change in any of the facts relied upon in such application, a new application must be submitted by the taxpayer.

(i) *Extraction from waste or residue. Extraction of ores or minerals from the ground* means not only the extraction of ores or minerals from a deposit, but also the extraction by mine owners or operators of ores or minerals from waste or residue of their prior mining. It is immaterial whether the waste or residue results from the process of extraction from the ground or from application of mining processes as defined in paragraph (f) of this section. However, extraction of ores or minerals from waste or residue which results from processes which are not allowable as mining processes is not treated as mining. *Extraction of ores or minerals from the ground* does not include extraction of ores or minerals by the purchaser of waste or residue or the purchaser of the rights to extract ores or minerals from waste or residue. The term *purchaser* does not apply to any person who acquires a mineral property, including waste or residue, in a tax-free exchange, such as a corporate reorganization, from a person who was entitled to a depletion allowance upon ores or minerals produced from such waste or residue, or from a person who would have been entitled to such depletion allowance had section 613(c)(3) been in effect at the time of the transfer. The term *purchaser* also does not apply to a lessee who has renewed a mineral lease if the lessee was entitled to a depletion allowance (or would have been so entitled had section 613(c)(3) been in effect at the time of the renewal) upon ores or minerals produced from waste or residue before renewal of the lease. It is not necessary, for purposes of the preceding sentence, that the mineral lease contain an option for renewal. The term *purchaser* does include a person who acquires waste or residue in a taxable transaction, even though such waste or residue is acquired merely as an incidental part of the entire mineral enterprise. For special rules with respect to certain corporate acquisitions referred to in section 381(a), see section 381(c)(18) and the regulations thereunder.

(j) *Definition of controlled group.* When used in this section:

(1) The term *controlled* includes any kind of control, direct or indirect, whether or not legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(2) The term *group* means the organizations, trades, or businesses owned or controlled by the same interests.

[T.D. 7170, 37 FR 5374, Mar. 15, 1972]

§ 1.613–5 Taxable income from the property.

(a) *General rule.* The term *taxable income from the property (computed without allowance for depletion),* as used in section 613 and this part, means *gross income from the property* as defined in section 613(c) and §§ 1.613–3 and 1.613–4, less all allowable deductions (excluding any deduction for depletion) which are attributable to mining processes, including mining transportation, with respect to which depletion is claimed. These deductible items include operating expenses, certain selling expenses, administrative and financial overhead, depreciation, taxes deductible under section 162 or 164, losses sustained, intangible drilling and development costs, exploration and development expenditures, etc. See paragraph (c) of this section for special rules relating to discounts and to certain of these deductible items. Expenditures which may be attributable both to the mineral property upon which depletion is claimed and to other activities shall be properly apportioned to the mineral property and to such other activities. Furthermore, where a taxpayer has more than one mineral property, deductions which are not directly attributable to a specific mineral property shall be properly apportioned among the several properties. In determining the taxpayer's taxable income from the property, the amount of any particular item to be taken into account shall be determined in accordance with the principles set forth in paragraph (d)(2) and (3) of § 1.613–4.

(b) *Special rule; decrease in mining expenses resulting from gain recognized under section 1245(a)(1).* (1) If during any taxable year beginning after December 31, 1962, the taxpayer disposes of an item of section 1245 property (as defined in section 1245(a)(3)) which has been used in connection with a mineral property, then for the purpose of computing the taxable income from such mineral property for such taxable year, the allowable deductions taken into account with respect to expenses of mining (that is, expenses attributable to a mineral property other than an oil and gas property) shall be decreased by an amount equal to the portion of any gain recognized under section 1245(a)(1) (relating to treatment of gain from dispositions of certain depreciable property as ordinary income) which is properly allocable to such mineral property in respect of which the taxable income is being computed. The portion of such gain which is properly allocable to such mineral property shall bear the same ratio to the total of such gain as:

(i) The portion of the *adjustments reflected in the adjusted basis* (as such term is defined in paragraph (a)(2) of § 1.1245–2, relating to definition of recomputed basis) of such section 1245 property, which were allowable as deductions from the *gross income from the property* (as defined in section 613 (c) and § 1.613–3) in computing the taxable income from such mineral property, bears to

(ii) The total of the *adjustments reflected in the adjusted basis* of such section 1245 property.

(2) For the purposes of this paragraph, the adjustments reflected in the adjusted basis of the section 1245 property disposed of shall be deemed to have been taken into account in computing the taxable income from the mineral property for any taxable year notwithstanding that for the taxable year the allowance for depletion was determined without reference to percentage depletion under section 613.

(3) If the amount of gain described in subparagraph (1) of this paragraph allocable to a mineral property for a taxable year exceeds the allowable deductions otherwise taken into account in computing the taxable income from the mineral property for the taxable year, the excess may not be taken into account in computing the taxable income from the mineral property for any other taxable year.

(4) To the extent that the adjustments reflected in the adjusted basis of the section 1245 property are allocable to mineral property which the taxpayer no longer owns in the taxable year in which he disposes of the section 1245 property, the gain recognized under section 1245(a)(1) does not result in any tax benefit to the taxpayer under this paragraph since he has no taxable income from the mineral property for such year. However, if a taxpayer has, in the taxable year in which he disposes of an item of section 1245 property, only a portion of the original mineral property to which gain described in subparagraph (1) of this paragraph with respect to the section 1245 property is properly allocable, the entire amount of that gain shall nevertheless be taken into account in computing the taxable income of the remaining portion of the mineral property. Furthermore, the fact that a mineral property to which section 1245 gain is properly allocable is (in the taxable year in which the taxpayer disposes of an item of section 1245 property) no longer in existence merely because the mineral property has been made a part of an aggregation or has been deaggregated will not result in the loss of tax benefits under this section. Accordingly,

(i) If a taxpayer has made an aggregation of mineral properties (see section 614 and the regulations thereunder), the amount of any gain described in subparagraph (1) of this paragraph which is properly allocable to the aggregation shall include the portion of any gain which would be properly allocable to the mineral properties which existed separately prior to the aggregation and of which the aggregation is or was composed, if the prior mineral properties had not been aggregated; and

(ii) If a taxpayer has deaggregated a mineral property, the amount of any gain described in subparagraph (1) of this paragraph which is properly allocable to each of the resulting mineral properties shall include a part of the portion of any gain which would be properly allocable to the prior aggregation if the aggregation had not been deaggregated, the part properly allocable to each of the resulting properties being determined by allocating the gain between the resulting properties in the same manner as basis is allocated between them for tax purposes (see paragraph (a)(2) of §1.614–6 and example 5 of subparagraph (7) of this paragraph).

(5) In any case in which it is necessary to determine the portion of any gain recognized under section 1245(a)(1) which is properly allocable to the mineral property in respect of which the taxable income is being computed, the taxpayer shall have available permanent records of all the facts necessary to determine with reasonable accuracy the amount of such portion. In the absence of such records, none of the gain recognized under section 1245(a)(1) shall be allocable to such mineral property.

(6) As used in this paragraph, the term *mineral property* has the meaning assigned to it by section 614 and §1.614–1.

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

Example 1. A, who uses the calendar year as his taxable year, operated and treated as separate properties mines Nos. 1 and 2. On January 1, 1963, A acquired a truck which was section 1245 property. During 1963 and 1964 the truck was used 25 percent of the time at mine No. 1 and 75 percent of the time at mine No. 2. For each such year the depreciation adjustments allowed in respect of the truck were $800 (the amount allowable). In computing the taxable income from mines Nos. 1 and 2 for each such year, $200 (25 percent of $800) of the depreciation adjustments was allocated by A to mine No. 1 and $600 (75 percent of $800) to mine No. 2. Thus, for the 2 years, the total of the depreciation adjustments on the truck was $1,600, of which $400 was allocated to mine No. 1 and $1,200 to mine No. 2. On January 1, 1965, A recognized upon sale of the truck a gain of $500 to which section 1245(a)(1) applied. During 1965, A did not recognize any other gain to which section 1245(a)(1) applied. In computing taxable income from the mines for 1965, the expenses otherwise required to be taken into account are reduced by $125 (that is $400/$1,600 of $500) for mine No. 1 and by $375 (that is $1,200/$1,600 of $500) for mine No. 2.

Example 2. The situation is the same as in example 1, except that the truck in question is used 25 percent of the time at mine No. 1, and 75 percent of the time in a nonmining business owned by A. Accordingly, in computing taxable income from A's mines for 1965, the expenses for mine No. 1 otherwise required to be taken into account are reduced by $125 (that is $400/$1,600 of $500), but no reduction is made in the expenses for mine No. 2, since the truck in question was not used in connection with that mineral property.

Example 3. The situation is the same as in example 1, except that the truck in question was used exclusively at mine No. 1 in 1963. On January 1, 1964, the truck was transferred to mine No. 2, and was used exclusively at mine No. 2 during the remaining period prior to its sale. However, A continued to own and operate mine No. 1. For the 2 years 1963 and 1964, the total of the depreciation adjustments on the truck was $1,600, of which $800 was allocated to mine No. 1 and $800 to mine No. 2. In computing taxable income from A's mines for 1965, the expenses for mines Nos. 1 and 2 otherwise required to be taken into account are reduced by $250 each (that is $800/$1,600 of $500). If A had sold mine No. 1 on January 1, 1964, no reduction in expenses would be allowable as a result of the operation of the truck at mine No. 1, since A would no longer have owned mine No. 1 in the year in which the truck was sold.

Example 4. On January 1, 1963, B, who uses the calendar year as his taxable year and who normally allocates depreciation costs to mines according to the percentage of time which the depreciable asset is used with respect to the mines, acquired a truck which was section 1245 property. During 1963 the truck was used exclusively on mine No. 1, which B operated and treated as a separate property. The depreciation adjustments allowed in respect of the truck for 1963 were $1,000 (the amount allowable), which amount was allocated to mine No. 1 in computing the taxable income therefrom. On January 1, 1964, B acquired and began operating mine No. 2 and elected under section 614(c) to aggregate and treat as one property mines Nos. 1 and 2. During 1964 B used the truck 60 percent of the time for mine No. 1 and 40 percent of the time for mine No. 2. For 1964 the depreciation adjustments allowed in respect of the truck were $1,000 (the amount allowable), which amount was allocated to the aggregation of mines Nos. 1 and 2 in computing the taxable income therefrom. On December 31, 1964, B sold mine No. 2. For 1965 the depreciation adjustments allowed in respect to the truck were $1,000 (the amount allowable), which amount was allocated to mine No. 1 in computing the taxable income therefrom. On January 1, 1966, B recognized gain upon sale of the truck of $600 to which section 1245(a)(1) applied. In computing the taxable income from mine No. 1 for 1966, the expenses otherwise required to be taken into account are reduced by $600, since all the depreciation adjustments allowed with respect to the truck, including those allowed with respect to the use of the truck at mine No. 2 ($400 for 1964), relate to the same mineral property from which B had taxable income in 1966, the taxable year in which he sold the truck.

Example 5. On January 1, 1962, A, who uses the calendar year as his taxable year, elected under section 614(c) to aggregate and treat as one mineral property his operating mineral interests in mines Nos. 1 and 2. On January 1, 1963, A acquired a truck which was section 1245 property, to be used at both mine No. 1 and mine No. 2. A later elected (with the consent of the Commissioner) to deaggregate mines Nos. 1 and 2, and this deaggregation became effective on January 1, 1964. At the time of deaggregation, half of the tax basis of the aggregated property was allocated to mine No. 1, and the other half to mine No. 2. During each of the years 1963 and 1964, the truck was used 25 percent of the time on mine No. 1 and 75 percent of the time on mine No. 2, and the depreciation adjustments allowed in respect of the truck were $800 (the amount allowable). On January 1, 1965, A recognized upon sale of the truck a gain of $500 to which section 1245(a)(1) applied. In computing taxable income from A's mines for 1965, the expenses otherwise required to be taken into account are reduced by $187.50 (that is half of $250 for 1963 and $200/$800 of $250 for 1964) for mine No. 1 and by $312.50 (that is half of $250 for 1963 and $600/$800 of $250 for 1964) for mine No. 2.

(c) *Treatment of particular items in computing taxable income from the property.* In determining taxable income from the property under the provisions of paragraph (a) of this section:

(1) Trade or cash discounts (or allowances determined to have the same effect as trade or cash discounts) which are actually allowed to the taxpayer in connection with the acquisition of property, supplies, or services shall not be included in the cost of such property, supplies, or services.

(2) Intangible drilling and development costs which are deducted under section 263(c) and § 1.612–4 shall be subtracted from the gross income from the property.

(3) Exploration and development expenditures which are deducted for the

taxable year under sections 615, 616, or 617 shall be subtracted from the gross income from the property.

(4)(i) Selling expenses, if any, paid or incurred with respect to a raw mineral product shall be subtracted from gross income from the property. See subdivision (iii) of this subparagraph for the definition of the term *raw mineral product.* For example, the selling expenses paid or incurred by a producer of raw mineral products with respect to products such as crude oil, raw gas, coal, iron ore, or crushed dolomite shall be subtracted from gross income from the property.

(ii) A reasonable portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property. Such reasonable portion shall be equivalent to the typical selling expenses which are incurred by unintegrated miners or producers in the same mineral industry so as to maintain equality in the tax treatment of unintegrated miners or producers in comparison with integrated miner-manufacturers or producer-manufacturers. If unintegrated miners or producers in the same mineral industry do not typically incur any selling expenses, then no portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property when determining the taxpayer's taxable income from the property.

(iii) For purposes of this subparagraph, a product will be considered to be a raw mineral product if (in the case of oil and gas) it is sold in the immediate vicinity of the well or if (in the case of minerals other than oil and gas) it is sold under the conditions described in paragraph (b)(1) of §1.613–4. In addition, a product will be considered to be a raw mineral product if only insubstantial value is added to the product by nonmining processes (or, in the case of oil and gas, by conversion or transportation processes). For example, in the case of a producer of crushed granite poultry grit, both bulk and bagged grit will be deemed to be a raw mineral product for purposes of the selling expense rule set forth in this subparagraph.

(iv) The term *selling expenses*, for purposes of this subparagraph, includes sales management salaries, rent of sales offices, sales clerical expenses, salesmen's salaries, sales commissions and bonuses, advertising expenses, sales traveling expenses, and similar expenses, together with an allocable share of the costs of supporting services, but the term does not include delivery expenses.

(5) Taxes which are taken as a credit rather than as a deduction or which are capitalized shall not be subtracted from the gross income from the property.

(6) Trade association dues paid or incurred by a producer of crude oil or gas or a raw mineral product shall be subtracted from the gross income from the property. See subparagraph (4) (iii) of this paragraph for the definition of the term *raw mineral product.* In addition, a reasonable portion of the trade association dues incurred by a producer of a refined, manufactured, or fabricated product shall also be subtracted from gross income from the property if the activities of the association relate to production, treatment and marketing of the crude oil or gas or raw mineral product. One reasonable method of allocating the trade association dues described in the preceding sentence is an allocation based on the proportion that the direct costs of mining processes and the direct costs of nonmining processes (or in the case of oil and gas, conversion and transportation processes) bear to each other. The foregoing rules shall apply even though one of the principal purposes of an association is to advise, promote, or assist in the production, marketing, or sale of refined, manufactured, or fabricated products. For example, a reasonable portion of the trade association dues paid to an association which promotes the sale of cement, refined petroleum, or copper products shall be subtracted from gross income from the property.

[T.D. 6955, 33 FR 6968, May 9, 1968. Redesignated by T.D. 7170, 37 FR 5374, Mar. 15, 1972, as amended by T.D. 7170, 37 FR 5381, Mar. 15, 1972]

§ 1.613–6 Statement to be attached to return when depletion is claimed on percentage basis.

In addition to the requirements set forth in paragraph (g) of § 1.611–2, a taxpayer who claims the percentage depletion deduction under section 613 for any taxable year shall attach to his return for such year a statement setting forth in complete, summary form, with respect to each property for which such deduction is allowable, the following information:

(a) All data necessary for the determination of the *gross income from the property*, as defined in §§ 1.613–3 from 1.613–4, including:

(1) Amounts paid as rents or royalties including amounts which the recipient treats under section 631(c),

(2) Proportion and amount of bonus excluded, and

(3) Amounts paid to holders of other interests in the mineral deposit.

(b) All additional data necessary for the determination of the *taxable income from the property (computed without the allowance for depletion)*, as defined in § 1.613–5.

[T.D. 7170, 37 FR 5382, Mar. 15, 1972]

§ 1.613–7 Application of percentage depletion rates provided in section 613(b) to certain taxable years ending in 1954.

(a) *Election of taxpayer.* In the case of any taxable year ending after December 31, 1953, to which the Internal Revenue Code of 1939 is applicable, the taxpayer may elect in accordance with section 613(d) and this section to apply the appropriate percentage depletion rate specified in section 613 in respect of any mineral property (within the meaning of the 1939 Code). In the case of mines, wells, or other natural deposits listed in section 613(b), the election may be made by the taxpayer irrespective of whether his depletion allowance with respect to the property for the taxable year was computed upon the basis of cost, discovery value, or upon a percentage of gross income from the property. Once made, the election shall be irrevocable with respect to the property for which it is exercised. The election may be made for any mineral property of the taxpayer and need not be made for all such properties. *Gross income from the property* and *net income from the property* shall have the same meaning as those terms are used in 26 CFR (1939) 39.23(m)–1 (Regulations 118).

(b) *Computation of depletion allowance.* The depletion allowance for any taxable year with respect to any property for which the taxpayer makes the election under section 613(d) shall be an amount equal to the sum of:

(1) That portion of a tentative allowance, computed under the provisions of the Internal Revenue Code of 1939 (without regard to paragraph (1) of section 613(d)), which the number of days in the taxable year prior to January 1, 1954, bears to the total number of days in such taxable year; plus

(2) That portion of a tentative allowance, computed by using the appropriate percentage depletion rate specified in section 613(b) (but otherwise computed under the provisions of the Internal Revenue Code of 1939), which the number of days in the taxable year after December 31, 1953, bears to the total number of days in such taxable year.

In the case of any taxable year beginning after December 31, 1953, and ending before August 17, 1954, the depletion allowance with respect to any property for which the taxpayer makes the election under section 613(d) shall be computed under the provisions of the Internal Revenue Code of 1939, except that the appropriate percentage depletion rate specified in section 613(b) shall be used. In making such computation, *gross income from the property* and *net income from the property* shall be determined in the same manner as specified in paragraph (a) of this section.

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

Example 1. A is a taxpayer who reports income on the basis of a taxable year ending June 30. For the taxable year ended June 30, 1954, A had gross income from a uranium property in the amount of $100,000 and his depletion allowance was computed with reference to percentage depletion. His net income from this property, for purposes of limiting the depletion allowance, was $40,000. The 15-percent rate of depletion provided for in the Internal Revenue Code of 1939 for metal mines resulted in a depletion allowance for the taxable year of $15,000. Percentage depletion computed with reference to the 23-percent rate provided for uranium under section 613(b) is $23,000 ($100,000 times 23 percent). However, the allowance computed on this basis is limited to $20,000 (50 percent of A's net income from the property). If A exercises the election provided for in section 613(d) his depletion allowance for the taxable year is the aggregate of $7,561.64 (184/365 times $15,000) plus $9,917.80 (181/365 times $20,000) or $17,479.44

Example 2. Assume the same facts as in example 1 except that A's depletion allowance was computed on the basis of cost and amounted to $17,500. If the election is made, A's allowance for the taxable year is the aggregate of $8,821.92 (184/365 times $17,500) plus $9,917.80 (181/365 times $20,000) or $18,739.72.

(d) *Requirement for making election.* (1) The election under section 613(d) shall be made by filing a statement with the district director with whom the income tax return was filed for the taxable year to which the election is applicable. Such statement shall indicate that an election is being made under section 613(d), shall contain a recomputation of the depletion allowance and the tax liability for all taxable years affected by the exercise of the election, and shall be accompanied either by a claim for refund or credit or by an amended return or returns, whichever is appropriate.

(2) If the treatment of any item upon which a tax previously determined was based, or if the application of any provisions of the internal revenue laws with respect to such tax, depends upon the amount of income (e.g., charitable contributions, foreign tax credit, dividends received credit, and medical expenses), readjustment in these particulars will be necessary as part of any recomputation in conformity with the change in the amount of the income which results solely from the making of the election under section 613(d).

(e) *Administrative provisions; etc.* (1) Section 36(b) of the Technical Amendments Act of 1958 (72 Stat. 1633) provides as follows:

> *Sec. 36. Percentage depletion rates for certain taxable years ending in 1954.* * * *
>
> (b) *Statute of limitations, etc.; interest.* If refund or credit of any overpayment resulting from the application of the amendment made by subsection (a) of this section is prevented on the date of the enactment of this Act, or within 6 months from such date, by the operation of any law or rule of law (other than section 3760 of the Internal Revenue Code of 1939 or section 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and other than section 3761 of the Internal Revenue Code of 1939 or section 7122 of the Internal Revenue Code of 1954, relating to compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed within 6 months from such date. No interest shall be paid on any overpayment resulting from the application of the amendment made by subsection (a) of this section.

(2) If refund or credit of any overpayment resulting from the application of section 613(d) is prevented on September 2, 1958, or on or before March 2, 1959, by the operation of any law or rule of law (other than section 3760 of the Internal Revenue Code of 1939 or section 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and other than section 3761 of the Internal Revenue Code of 1939 or section 7122 of the Internal Revenue Code of 1954, relating to compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed on or before March 2, 1959. If such refund or credit is not prevented on or before March 2, 1959, the time for filing claim therefor shall be governed by the rules of law generally applicable to credits and refunds.

(3) The amount of any refund or credit which is allowable by reason of section 613(d) shall not exceed the decrease in income tax liability resulting solely from the application of the percentage rates specified in section 613(b). No interest shall be allowed or paid on any overpayment resulting from the application of section 613(d).

(4) For purposes of this section the *decrease in income tax liability* shall be the amount by which the tax previously determined (as defined in section 3801(d) of the Internal Revenue Code of 1939) exceeds the tax as recomputed under section 613(d) and this section.

(f) *Adjustment to basis.* Proper adjustment shall be made to the basis of any property as required by section 113(b)(1) of the Internal Revenue Code of 1939 and 26 CFR (1939) 39.113(b)*(1)*–1(c) (Regulations 118) to reflect any change in the depletion allowance resulting from the application of section 613(d) of the Internal Revenue Code of 1954.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960. Redesignated by T.D. 7170, 37 FR 5374, Mar. 15, 1972]

§1.613A–0 Limitations on percentage depletion in the case of oil and gas wells; table of contents.

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(h) Depletable oil quantity.
(i) Depletable natural gas quantity.
(j) Barrel.
(k) Secondary or tertiary production.
(l) Controlled group of corporations.
(m) Related person.
(n) Transfer.
(o) Transferee.
(p) Interest in proven oil or gas property.
(q) Amount disallowed.
(r) Retailer.

(s) Refiner.

[T.D. 8348, 56 FR 21938, May 13, 1991, as amended by T.D. 8437, 57 FR 43899, Sept. 23, 1992]

§1.613A–1 Post-1974 limitations on percentage depletion in case of oil and gas wells; general rule.

Except as otherwise provided in section 613A and the regulations thereunder, in the case of oil or gas which is produced after December 31, 1974, and to which gross income from the property is attributable after such year, the allowance for depletion under section 611 with respect to any oil or gas well shall be computed without regard to section 613. In the case of a taxable year beginning before January 1, 1975, and ending after that date, the percentage depletion allowance (but not the cost depletion allowance) with respect to oil and gas wells for such taxable year shall be determined by treating the portion thereof in 1974 as if it were a short taxable year for purposes of section 613 and the portion thereof in 1975 as if it were a short taxable year for purposes of section 613A.

[T.D. 7487, 42 FR 24264, May 13, 1977]

§1.613A–2 Exemption for certain domestic gas wells.

(a) The allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to:

(1) Regulated natural gas (as defined in paragraph (c) of §1.613A–7),

(2) Natural gas sold under a fixed contract (as defined in paragraph (d) of §1.613A–7), and

(3) Any geothermal deposit in the United States or in a possession of the United States that is determined to be a gas well within the meaning of former section 613(b)(1)(A) (as in effect before enactment of the Tax Reduction Act of 1975) for taxable years ending after December 31, 1974, and before October 1, 1978 (see section 613(e) for depletion on geothermal deposits thereafter),

(b) For taxable years ending after September 30, 1978, the allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to any qualified natural gas from geopressured brine (as defined in paragraph (e) of §1.613A–7), and 10 percent shall be deemed to be specified in section 613(b) for purposes of section 613(a).

(c) For special rules applicable to partnerships, S corporations, trusts, and estates, see paragraphs (e), (f), and (g) of §1.613A–3.

(d) The provisions of this section may be illustrated by the following examples:

Example 1. A is a producer of natural gas which is sold by A under a contract in effect on February 1, 1975. The contract provides for an increase in the price of the gas sold under the contract to the highest price paid to a producer for natural gas in the area. The gas sold by A qualifies under section 613A(b)(1)(B) for percentage depletion as gas sold under a fixed contract until its price increases, but is presumed not to qualify thereafter unless A demonstrates by clear and convincing evidence that the price increase in no event takes increases in tax liabilities into account.

Example 2. B is a producer of natural gas which is sold by B under a contract in effect on February 1, 1975. The contract provides that beginning January 1, 1980, the price of the gas may be renegotiated. Such a provision does not disqualify gas from qualifying for the exemption under section 613A(b)(1)(B) with respect to the gas sold prior to January 1, 1980. However, gas sold on or after January 1, 1980, does not qualify for the exemption whether or not the price of the gas is renegotiated.

[T.D. 8348, 56 FR 21939, May 13, 1991, as amended by T.D. 8437, 57 FR 43899, Sept. 23, 1992; 58 FR 6678, Feb. 1, 1993]

§1.613A–3 Exemption for independent producers and royalty owners.

(a) *General rules.* (1) Except as provided in section 613A(d) and §1.613A–4, the allowance for depletion under section 611 with respect to oil or gas which is produced after December 31, 1974, and to which gross income from the property is attributable after that date, shall be computed in accordance with section 613 with respect to:

(i) So much of the taxpayer's average daily production (as defined in paragraph (f) of §1.613A–7) of domestic crude oil (as defined in paragraphs (a) and (g) of §1.613A–7) as does not exceed the taxpayer's depletable oil quantity (as defined in paragraph (h) of §1.613A–7), and

(ii) So much of the taxpayer's average daily production of domestic natural gas (as defined in paragraphs (a) and (b) of § 1.613A–7) as does not exceed the taxpayer's depletable natural gas quantity (as defined in paragraph (i) of § 1.613A–7), and the applicable percentage (determined in accordance with the table in paragraph (c) of this section shall be deemed to be specified in section 613(b) for purposes of section 613(a).

(2) Except as provided in section 613A(d) and § 1.613A–4, the allowance for depletion under section 611 with respect to oil or gas which is produced after December 31, 1974, and to which gross income from the property is attributable after that date and before January 1, 1984, shall be computed in accordance with section 613 with respect to:

(i) So much of the taxpayer's average daily secondary or tertiary production (as defined in paragraph (k) of § 1.613A–7) of domestic crude oil as does not exceed the taxpayer's depletable oil quantity (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990), and

(ii) So much of the taxpayer's average daily secondary or tertiary production of domestic natural gas as does not exceed the taxpayer's depletable natural gas quantity (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990), and 22 percent shall be deemed to be specified in section 613(b) for purposes of section 613(a).

(3) For purposes of this section, there shall not be taken into account any production with respect to which percentage depletion is allowed pursuant to section 613A(b) or is not allowable by reason of section 613A(c)(9), as in effect prior to the Revenue Reconciliation Act of 1990.

(4) The provisions of this paragraph may be illustrated by the following examples:

Example 1. A, a calendar year taxpayer, owns an oil producing property with 100,000 barrels of production to which income was attributable for 1975 and a gas producing property with 1,200,000,000 cubic feet of production to which income was attributable for 1975. Under section 613A(c)(4), the oil equivalent of 1,200,000,000 cubic feet of gas is 200,000 barrels, bringing A's total production of oil and gas to which income was attributable for 1975 to the equivalent of 300,000 barrels of oil. A's average daily production was 821.92 barrels (300,000 barrels÷ 365 days) which is less than the depletable oil quantity (2,000 barrels) before reduuction for any election by A under section 613A(c)(4). Accordingly, A may make an election with respect to A's entire gas production and thereby be entitled to percentage depletion with respect to A's entire 1975 income from production of oil and gas. A's allowable depletion pursuant to section 613A(c) and A's oil and gas properties would be the amount determined under section 613(a) computed at the 22 percent rate specified in section 613A(c)(5), as in effect prior to the Revenue Reconciliation Act 1990, for 1975.

Example 2. B, a calendar year taxpayer, owns oil producing properties with 365,000 barrels of production to which income was attributable for 1975. B was a retailer of oil and gas for only the last 3 months of 1975. B's average daily production for 1975 was 1,000 barrels (365,000 barrels÷365 days).

Example 3. C, a calendar year taxpayer, owns property X with 500,000 barrels of primary production to which income was attributable for 1975 and property Y with 200,000 barrels of primary production to which income was attributable for 1975. Property Y had been transferred to C on January 1, 1975, on which date it was a proven property. Therefore, the exemption under section 613A(c)(1) does not apply to C with respect to production from property Y. In determining C's depletable oil quantity for the year, the production from property Y is not taken into account. Thus, C's average daily prduction for 1975 was 1,369.86 barrels (500,000 barrels÷365).

Example 4. D owns an oil property with producing wells X and Y on it. In 1975 D converts well X into an injection well. Prior to the application of the secondary process, it is estimated that without the application of the process the annual production from well X would have been 50x barrels of oil and from well Y would have been 100x barrels of oil. For the taxable year in which injection is commenced production from well X is 10x barrels and from well Y is 180x barrels. Forty x barrels of oil [190x barrels of oil (actual production from the property)—150x barrels (estimate of primary production from the property)] qualify as secondary production.

Example 5. E, a calendar year taxpayer, owns a domestic oil well which produced 100,000 barrels of oil in 1980. The proceeds from the sale of 15,000 barrels of that production are not includible in E's income until 1981. The 15,000 barrels produced in 1980 are included in E's average daily production for 1981 and excluded from such production for

1980. The tentative quantity and the percentage depletion rate for 1981 are applicable to the 15,000 barrels of oil.

(b) *Phase-out table.* For purposes of section 613A(c)(3)(A)(i) and §1.613A–7(h) (relating to depletable oil quantity)—

In the case of production after 1974 and to which gross income from the property is attributable for the calendar year:	The tentative quantity in barrels per day is:
1975	2,000
1976	1,800
1977	1,600
1978	1,400
1979	1,200
1980 and thereafter	1,000

(c) *Applicable percentage.* For purposes of section 613A(c)(1) and paragraph (a) of this section—

In the case of production after 1974 and to which gross income from the property is attributable for the calendar year:	The applicable percentage is:
1975	22
1976	22
1977	22
1978	22
1979	22
1980	22
1981	20
1982	18
1983	16
1984 and thereafter	15

(d) *Production in excess of depletable quantity*—(1) *Primary production.* (i) If the taxpayer's average daily production of domestic crude oil exceeds his depletable oil quantity, the allowance for depletion pursuant to section 613A(c)(1)(A) and paragraph (a)(1)(i) of this section with respect to oil produced during the taxable year from each property in the United States shall be that amount which bears the same ratio to the amount of depletion which would have been allowable under section 613(a) for all of the taxpayer's oil produced from the property during the taxable year (computed as if section 613 applied to all of the production at the rate specified in paragraph (c) of this section) as the amount of his depletable oil quantity bears to the aggregate number of barrels representing the average daily production of domestic crude oil of the taxpayer for such year.

(ii) If the taxpayer's average daily production of domestic natural gas exceeds his depletable natural gas quantity, the allowance for depletion pursuant to section 613A(c)(1)(B) and paragraph (a)(1)(ii) of this section with respect to natural gas produced during the taxable year from each property in the United States shall be that amount which bears the same ratio to the amount of depletion which would have been allowable pursuant to section 613(a) for all of the taxpayer's natural gas produced from the property during the taxable year (computed as if section 613 applied to all of the production at the rate specified in paragraph (c) of this section) as the amount of his depletable natural gas quantity in cubic feet bears to the aggregate number of cubic feet representing the average daily production of domestic natural gas of the taxpayer for such year.

(2) *Secondary or tertiary production.* (i) If the taxpayer's average daily secondary or tertiary production of domestic crude oil exceeds his depletable oil quantity (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990), the allowance for depletion pursuant to section 613A(c)(6)(A)(i), as in effect prior to the Revenue Reconciliation Act of 1990, and paragraph (a)(2)(i) of this section with respect to oil produced during the taxable year from each property in the United States shall be that amount which bears the same ratio to the amount of depletion which would have been allowable pursuant to section 613(a) for all of the taxpayer's secondary or tertiary production of oil from the property during the taxable year (computed as if section 613 applied to all of the production at the rate specified in paragraph (a)(2) of this section) as the amount of his depletable oil quantity (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990) bears to the aggregate number of barrels representing the average daily secondary or tertiary production of domestic crude oil of the taxpayer for such year.

(ii) If the taxpayer's average daily secondary or tertiary production of domestic natural gas exceeds his depletable natural gas quantity (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of

1990), the allowance for depletion pursuant to section 613A(c)(6)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990, and paragraph (a)(2)(ii) of this section with respect to natural gas produced during the taxable year from each property in the United States shall be that amount which bears the same ratio to the amount of depletion which would have been allowable pursuant to section 613(a) for all of the taxpayer's secondary or tertiary production of natural gas from the property during the taxable year (computed as if section 613 applied to all of the production at the rate specified in paragraph (a)(2) of this section) as the amount of his depletable natural gas quantity in cubic feet (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990) bears to the aggregate number of cubic feet representing the average daily secondary or tertiary production of domestic natural gas of the taxpayer for such year.

(iii) This paragraph (d)(2) shall not apply after December 31, 1983.

(3) *Taxable income from the property*. If both oil and gas are produced from the property during the taxable year, then for purposes of section 613A(c)(7) (A) and (B) and paragraph (d) of this section the taxable income from the property, in applying the taxable income limitation in section 613(a), shall be allocated between the oil production and the gas production in proportion to the gross income from the property during the taxable year from each. If both gas with respect to which section 613A(b) and § 1.613A–2 apply and oil or gas with respect to which section 613A(c) and this section apply are produced from the property during the taxable year, then for purposes of section 613A(d)(1) and paragraph (a) of § 1.613A–4 the taxable income from the property, in applying the taxable income limitation in section 613(a), shall also be so allocated. In addition, if both primary production and secondary or tertiary production (to which gross income from the property is attributable before January 1, 1984) are produced from the property during the taxable year and the total amount of production is in excess of the depletable quantity, then for purposes of paragraph (d) of this section the taxable income from the property, in applying the taxable income limitation in section 613(a), shall also be so allocated.

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

Example 1. A owns Y and Z oil producing properties. With respect to properties Y and Z, the percentage depletion allowable pursuant to section 613(a) (computed as if section 613 applied to all of the production at the rate specified in section 613A(c)(5)) for 1975 was $100x and $200x, respectively. A's average daily production for 1975 was 4,000 barrels. A's allowable depletion pursuant to section 613A(c) with respect to property Y was $50x ($100x depletion×2,000 depletable oil quantity/ 4,000 average daily production). A's allowable depletion pursuant to section 613A(c) with respect to property Z was $100x ($200x depletion×2,000 depletable oil quantity/ 4,000 average daily production).

Example 2. B owns gas producing properties which had secondary gas production for 1975 of 3,285,000,000 cubic feet, which under section 613A(c)(4) is equivalent to 547,500 barrels of oil. B's average daily secondary production of gas for 1975 was equivalent to 1,500 barrels (547,500 barrels÷365). B elected to have section 613A(c)(4) apply to the gas production. With respect to the production, the percentage depletion allowable pursuant to section 613(a) (computed at the rate specified in section 613A(c)(6)(A), as in effect prior to the Revenue Reconciliation Act of 1990) was $150x. B also owns an oil producing property which had primary oil production for 1975 of 365,000 barrels. B's average daily production of oil for 1975 was 1,000 barrels (365,000÷365). With respect to the oil property, the percentage depletion allowable pursuant to section 613(a) (computed as if section 613 applied to all of the production at the rate specified in section 613A(c)(5), as in effect prior to the Revenue Reconciliation Act of 1990) was $100x. B's depletable oil quantity for 1975 was 500 barrels (2,000 barrels tentative quantity −1,500 barrels average daily secondary production). B's allowable depletion pursuant to section 613A(c) with respect to the oil property was $50x ($100x depletion×500 depletable oil quantity/ 1,000 average daily production).

Example 3. Assume the same facts as in *Example 2* except that B's primary production was 6,000,000 cubic feet of natural gas daily rather than its equivalent under section 613A(c)(4) of 1,000 barrels of oil and that B elected to have that section apply to such gas. B's allowable depletion pursuant to section 613A(c) with respect to B's primary production is $50x, the same as in example 2.

Example 4. C is a partner with a one-third interest in Partnerships CDE and CFG with each partnership owning a single oil property. C's percentage depletion allowable under section 613(a) (computed as if section 613 applied to all of the production at the rate specified in section 613A(c)(5), as in effect prior to the the Revenue Reconciliation Act of 1990) for 1975 was $20x with respect to 495,000 barrels (his allocable share of Partnership CDE production) and $40x with respect to 600,000 barrels (his allocable share of Partnership CFG production). C's average daily production is 3,000 barrels (1,095,000 total production÷365 days). C's allowable depletion pursuant to section 613A(c) with respect to C's share of the production of Partnership CDE is $13.33x ($20x depletion×2,000 depletable oil quantity/ 3,000 average daily production). C's allowable depletion pursuant to section 613A(c) with respect to C's share of the production of Partnership CFG is $26.67x ($40x depletion×2,000 depletable oil quantity/ 3,000 average daily production). See §1.613A–3(e) for the rules on computing depletion in the case of a partnership.

Example 5. H owns a property which, during H's fiscal year which began on June 1, 1975, and ended on May 31, 1976, produced gas qualifying under section 613A(b) and oil qualifying under section 613A(c). For the fiscal year H's gross income from the property was $400x, of which $100x was from gas and $300x was from oil. For the oil his gross income from the property for the period beginning June 1, 1975, and ending December 31, 1975, was $100x and for the 1976 portion of the fiscal year was $200x. The percentage depletion allowance (before applying the 50 percent limitation of section 613(a) or the 65 percent limitation of section 613A(d)(1)) was $22x for the gas, $22x for the oil in 1975, and $44x for the oil in 1976. H's taxable income from the property for the fiscal year was $100x. In accordance with paragraph (d)(3) of this section, the taxable income from the property is allocated $25x to the gas:

$$\left[\begin{array}{c}\$100\text{x taxable income}\\ \text{from the property}\end{array}\left(\frac{\$100\text{x gross income from gas from the property}}{\$400\text{x total gross income from the property}}\right)\right]$$

$25x to the 1975 oil:

$$\left[\begin{array}{c}\$100\text{x taxable income}\\ \text{from the property}\end{array}\left(\frac{\$100\text{x gross income from 1975 oil from the property}}{\$400\text{x total gross income from the property}}\right)\right]$$

and $50x to the 1976 oil:

$$\left[\begin{array}{c}\$100\text{x taxable income}\\ \text{from the property}\end{array}\left(\frac{\$200\text{x gross income from 1976 oil from the property}}{\$400\text{x total gross income from the property}}\right)\right]$$

With the application of the 50 percent of taxable income from the property limitation, the allowable percentage depletion (computed without reference to section 613A) is limited to $12.50x for the gas, $12.50x for the oil in 1975, and $25x for the oil in 1976.

(e) *Partnerships*—(1) *General rule.* In the case of a partnership, the depletion allowance under section 611 with respect to production from domestic oil and gas properties shall be computed separately by the partners and not by the partnership. The determination of whether cost or percentage depletion is applicable is to be made at the partner level. The partnership must allocate to each partner the partner's proportionate share of the adjusted basis of each partnership oil or gas property in accordance with the provisions of paragraphs (e)(2) through (e)(6) of this section. This allocation of the adjusted basis of oil or gas property does not affect a partner's adjusted basis in his or her partnership interest.

(2) *Initial allocation of adjusted basis of oil or gas property among partners*—(i) *General rule.* Each partner shall be allocated his or her proportionate share of the adjusted basis of each partnership domestic oil or gas property. The initial allocation of adjusted basis is to be made as of the later of the date of acquisition of the oil or gas property by the partnership or January 1, 1975.

(ii) *Allocation methods.* Except as otherwise provided in paragraph (e)(5) of this section, the provisions of this paragraph (e)(2)(ii) govern the determination under paragraph (e)(2)(i) of this section of a partner's proportionate share of the adjusted basis of oil or gas property. Each partner's proportionate share is determined in accordance with the partner's proportionate interest in partnership capital at the time of the allocation unless both—

(A) The partnership agreement provides that a partner's share of the adjusted basis of one or more properties is determined in accordance with his or her proportionate interest in partnership income; and

(B) At the time of allocation under the partnership agreement the share of each partner in partnership income is reasonably expected to be substantially unchanged throughout the life of the partnership, other than changes merely to reflect the admission of a new partner, an increase in a partners' interest in consideration for money, property, or services, or a partial or complete withdrawal of an existing partner.

If the requirements of paragraph (e)(2)(ii) (A) and (B) of this section are met, a partner's proportionate share is determined in accordance with his or her proportionate interest in partnership income. The partners' shares of adjusted basis are determined on a property-by-property basis. Accordingly, the basis of one property may be allocated in proportion to capital and the basis of another property may be allocated in proportion to income. See §§ 1.613A–3(e)(5) and 1.704–1(b)(4)(v) for special rules concerning allocation of the adjusted basis of oil and gas properties.

(3) *Adjustments by partnership to allocated adjusted bases*—(i) *Capital expenditures by partnership.* Appropriate adjustments shall be made to the partners' adjusted bases in any domestic oil and gas property for any partnership capital expenditures relating to such property that are made after the initial allocation. These adjustments shall be allocated among the partners in accordance with the principles set forth in paragraph (e)(2)(ii) of this section.

(ii) *Admission of a new partner or increase in partner's interest*—(A) *In general.* Upon a contribution of money, other property, or services to the partnership by a new or existing partner (''contributing partner'') as consideration for an interest in the partnership, the partnership shall allocate, in accordance with paragraph (e)(3)(ii)(B) of this section, a share of the partnership's basis in each existing oil and gas property to the contributing partner, and each existing partner shall reduce, in accordance with paragraph (e)(3)(ii)(C) of this section, his or her share of the partnership's basis in such property.

(B) *Allocation of basis to contributing partner.* The partnership shall allocate to a contributing partner his or her proportionate share (determined under paragraph (e)(2)(ii) of this section in accordance with the partner's proportionate interest in partnership capital or income) of the partnership's adjusted basis in each existing partnership oil or gas property. For purposes of this allocation, the partnership's adjusted basis in such property equals the aggregate of its partner's adjusted bases in the property, as determined under paragraph (e)(3)(iii) of this section.

(C) *Reduction of existing partners' bases.* Each existing partner's basis in each existing partnership oil or gas property is reduced by the percentage of the partnership's aggregate basis in the property that is allocated to the contributing partner. Thus, if one-third of the partnership's aggregate basis in a property is allocated to a contributing partner because the contributing partner has a one-third interest in partnership capital, after the admission of the contributing partner each existing partner's basis (including the contributing partner's pre-existing basis if such partner is also an existing partner) in each property equals the partner's basis (prior to the admission) reduced by one-third.

(iii) *Determination of aggregate of partners' adjusted bases in the property*—(A) *In general.* To determine the aggregate of its partners' adjusted bases for purposes of this paragraph (e)(3), the partnership must determine each partner's adjusted basis under either paragraph (e)(3)(iii)(B) (written data) or paragraph (e)(3)(iii)(C) (assumptions) of this section. The partnership is permitted to determine the bases of some partners under paragraph (e)(3)(iii)(B) of this section and of others under paragraph (e)(3)(iii)(C) of this section. For this purpose, a partner's basis in an oil or gas property does not include any basis adjustment under section 743(b).

(B) *Written data.* A partnership may determine a partners' basis in an oil or gas property by using written data provided by a partner stating the amount of the partner's adjusted basis or depletion deductions with respect to the property unless the partnership knows or has reason to know that the written data is inaccurate. In determining depletion deductions, a partner must treat as actually deducted any amount disallowed and carried over as a result of the 65 percent-of-income limitation of section 613A(d)(1). If a partnership does not receive written data upon which it may rely, the partnership must use the assumptions provided in paragraph (e)(3)(iii)(C) of this section in determining a partner's adjusted basis in an oil or gas property.

(C) *Assumptions.* Except as provided in paragraph (e)(3)(iv)(B) of this section, a partnership that does not use written data pursuant to paragraph (e)(3)(iii)(B) of this section to determine a partner's basis must use the following assumptions to determine the partner's adjusted basis in an oil and gas property:

(*1*) The partner deducted his or her share of deductions under section 263(c) in the first year in which the partner could claim a deduction for such amounts, unless the partnership elected to capitalize such amounts;

(*2*) The partner was not subject to the 65 percent-of-income limitation of section 613A(d)(1) with respect to the partner's depletion allowance under section 611; and

(*3*) The partner was not subject to the following limitations, with respect to the partner's depletion allowance under section 611, except to the extent a limitation applied at the partnership level: the taxable income limitation of section 613(a); the depletable quantity limitations of section 613A(c); the prohibition against claiming percentage depletion on transferred proven property under section 613A(c)(9), prior to its repeal; or the limitations of section 613A(d) (2), (3), and (4) (exclusion of retailers and refiners).

(iv) *Withdrawal of partner or decrease in partner's interest*—(A) *In general.* Upon a distribution of money or other property to a withdrawing partner as consideration for an interest in the partnership, the withdrawing partner's adjusted basis in each domestic oil or gas property that continues to be held by the partnership is allocated to the remaining partners in proportion to their proportionate interest in partnership capital or income after taking into account any increase or decrease as a result of the event giving rise to the reallocation. A similar rule shall apply in the case of a diminution of a continuing partner's interest in the partnership.

(B) *Special rule for determining a withdrawing partner's basis in the property.* If a partnership is required to determine a withdrawing partner's adjusted basis using the assumptions under paragraph (e)(3)(iii)(C) of this section, the partnership may rebut the assumption in paragraph (e)(3)(iii)(C)(*3*) of this section that the withdrawing partner was not subject to the limitations of sections 613A(d) (2), (3), and (4) exclusion of retailers and refiners) by demonstrating that the withdrawing partner was subject to the limitations of sections 613A(d) (2), (3), or (4).

(v) *Effective date.* The provisions of §1.613A–3(e)(3) (i) through (iv) are effective for taxable years beginning after May 13, 1991. However, a partnership may elect to apply these provisions to taxable years beginning on or before May 13, 1991.

(4) *Determination of a partner's interest in partnership capital or income.* For purposes of this paragraph (e), a partner's interest in partnership capital or income is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. See the factors listed in § 1.704–1(b)(3)(ii).

(5) *Special rules on allocation of adjusted basis to partners.* An allocation or reallocation of the adjusted basis of oil or gas property is pursuant to this paragraph (e) of this section deemed to be in accordance with the partner's proportionate interest in partnership capital or income for purposes of this paragraph (e) where so provided in § 1.704–1(b)(4)(v). In addition, in connection with a revaluation described in § 1.704–1(b)(2)(iv)(*f*), the basis of an oil or gas property is allocated among the partners based on the principles used under § 1.704–1(b)(4)(i) of allocating tax items to take into account variations between the adjusted basis of the property and its fair market value. In the case of an oil or gas property contributed to a partnership by a partner, section 704(c) is taken into account in determining the partner's share of the adjusted basis.

(6) *Miscellaneous rules*—(i) Each partner must separately keep records of his or her share of the adjusted basis in each domestic oil or gas property of the partnership, adjust his or her share of such basis pursuant to section 1016 (including adjustments for any depletion allowed or allowable with respect to such property), and use that adjusted basis each year in the computation of his or her cost depletion or in the computation of his or her gain or loss on the disposition (including abandonment) of the property by the partnership.

(ii) The adjusted basis of a partner's interest in a partnership is decreased (but not below zero) pursuant to section 705(a)(3) by the amount of the depletion deduction allowed or allowable to the partner with respect to a domestic oil or gas property to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to the partner under section 613A(c)(7)(D), as adjusted by the partner after the initial allocation. Section 705(a)(1)(C) does not apply to depletion deductions that are not included in a partner's distributive share under section 702. Accordingly, the adjusted basis of a partner's interest in a partnership is not increased under section 705(a)(1)(C) with respect to depletion of oil or gas properties. See § 1.705–1(a)(2)(iii).

(iii) Upon the disposition of an oil or gas property by the partnership, each partner must subtract the partner's adjusted basis in the property from his or her allocable portion of the amount realized from the sale of the property to determine gain or loss. The partner's allocable portion of amount realized must, except to the extent governed by section 704(c) (or related principles under § 1.704–1(b)(4)(i)), be determined in accordance with § 1.704–1(b)(4)(v). Except as otherwise provided (e.g., section 751), the sale of a partnership interest is not treated as a sale of an oil and gas property.

(iv) In the case of a transfer of an interest in a partnership, the transferor partner's adjusted basis in each partnership oil or gas property carries over to the transferee partner. If an election under section 754 (relating to optional adjustment to the basis of partnership property) is in effect, such basis is adjusted in accordance with section 743.

(v) For purposes of section 732 (relating to basis of distributed property other than money) and section 734(b) (relating to optional adjustment to basis of partnership property), the partnership's adjusted basis in oil and gas property is an amount equal to the aggregate of its partners' adjusted bases in the property as determined under the rules provided in paragraph (e)(3) of this section.

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

Example 1. A, B, and C have equal interests in capital in Partnership ABC. On January 1, 1992, the partnership acquired a producing domestic oil property. The partnership's basis in the property was $90x. The partnership allocated the adjusted basis of the property to each partner in proportion to the partner's interest in partnership capital. Accordingly, each partner was allocated an adjusted basis of $30x. Each partner must separately compute his or her depletion allowance. The amount of percentage depletion allowable for each partner for 1992 was $10x. On January 1, 1993, each partner's adjusted basis in the property was $20x ($30x minus $10x). On January 1, 1993, the oil property was sold for $150x. Each partner's gain was $30x ($50x allocable share of amount realized minus the partner's adjusted basis of $20x). Each partner must adjust the partner's adjusted basis in his or her partnership interest to reflect the gain.

Example 2. The facts are the same as in *Example 1* except that on January 1, 1993, the property was not sold but transferred by the partnership to partner A. A's basis in the property was $60x (the sum of A's, B's, and C's adjusted bases in the property).

Example 3. The facts are the same as in *Example 1* with the exception that in 1992 C was a retailer of oil and gas and was only entitled to a cost depletion deduction of $5x. C's gain from the sale of the mineral property on January 1, 1993, was $25x ($50x allocable share of amount realized minus C's adjusted basis of $25x ($30x minus $5x)).

Example 4. D, a calendar year taxpayer, is a partner in Partnership DEF which owns a domestic producing oil property. On January 1, 1993, the partnership's adjusted basis in the property was $900x. On January 1, 1993, D's adjusted basis in D's partnership interest was $300x and D's adjusted basis in the partnership's oil property was $300x. D's allowable percentage depletion for 1993 with respect to production from the oil property was $50x. On January 1, 1994, D's adjusted basis in D's partnership interest was $250x and D's adjusted basis in the partnership's oil property was $250x ($300x minus $50x).

Example 5. On January 1, 1990, G has an adjusted basis of $5x in partnership GH's proven domestic oil property, which is the sole asset of the partnership. On January 1, 1990 G sells G's partnership interest to I for $100x when the election under section 754 is in effect. I has a special basis adjustment for the oil property of $95x (the difference between I's basis, $100x, and I's share of the basis of the partnership property, $5x). I is not entitled to percentage depletion with respect to I's distributive share of the oil property income because I is a transferee of an interest in a proven oil property. However, I is entitled to cost depletion and for this purpose I's interest in the oil property has an adjusted basis to I of $100x ($5x, plus I's special basis adjustment of $95x).

Example 6. On January 1, 1960, Partnership JK acquired a domestic producing oil property. On January 1, 1990, the partnership's adjusted basis in the property was zero. On January 1, 1990, L is admitted as a partner to the partnership. Since the partnership's adjusted basis in the the oil property is zero, L's proportionate share of the basis in the property is also zero. L is not entitled to percentage depletion because L is a transferee of a proven oil property (see paragraph (g) of this section). Since the property's basis is zero, L is also not entitled to any cost depletion with respect to production from the property.

Example 7. (i) O and P have equal interests in capital in Partnership OP. On January 1, 1991, the partnership acquired an unproven domestic oil property X the basis of which is $200x to the partnership. The partnership allocates $100x of the basis of the property to each partner in accordance with each partner's proportionate interest in partnership capital. For the 1991 taxable year, O has a $10x cost depletion allowance and P has a $25x percentage depletion allowance. Accordingly, at the end of the 1991 taxable year, O's adjusted basis in the property is $90x, and P's adjusted basis in the property is $75x. On January 1, 1992, Q is admitted as an equal partner. The partnership does not use written data from the partners and must therefore assume that each partner was entitled to $25x depletion based on the assumptions provided in §1.613A–3(e)(3)(iii). This would result in a $50x combined depletion allowance for the partners and an aggregate adjusted basis in the oil property of $150x. Accordingly, the partnership allocates $50x of the basis of the property to Q, one-third of the aggregate adjusted basis determined by the partnership. O and P must each reduce their basis in the property by one-third. Accordingly, after the admission of Q, O's adjusted basis in the property is $60x ($90x minus $30x), and P's adjusted basis in the property is $50x ($75x minus $25x).

(ii) Assume the same facts as in paragraph (i) of this *Example 7* except that O informs the partnership that its adjusted basis in the property is $90x (determined without regard to section 613A(d)(1)). The partnership uses the written data provided by O and determines the aggregate adjusted basis in the property to be $165x ($90x+$75x). Accordingly, the partnership allocates $55x (⅓ of $165x) of the basis of the property to Q, and O and P must each reduce their adjusted basis in the property by one-third, as in paragraph (i) of this *Example 7.* Thus, after the admission of Q, O's adjusted basis in the property is $60x and P's adjusted basis in the property is $50x.

(f) *S corporations.* For purposes of section 613A(c)(13), adjustments to shareholders' adjusted bases in any domestic oil or gas property to reflect capital expenditures by S corporations, the addition of a new shareholder or an increase in a shareholder's interest by reason of a contribution to the S corporation, the redemption of a shareholder's interest, or other appropriate transaction shall be made in accordance with principles similar to the principles under §1.613A–3(e) applicable to the entry or withdrawal of a partner.

(g) *Trusts and estates.* (1) In the case of production from domestic oil and gas properties held by a trust or estate, the depletion allowance under section 611 shall be computed initially by the trust or estate. The determination of whether cost or percentage depletion is applicable shall be made at the trust or estate level, but such determination shall not result in the disallowance of cost depletion to a beneficiary of a trust or estate for whom cost depletion exceeds percentage depletion. The limitations contained in section 613A (c) and (d), other than section 613A(d)(1), shall be applied at the trust or estate level in its computation of percentage depletion pursuant to section 613A and shall also be applied by a beneficiary with respect to any percentage depletion apportioned to the beneficiary by the trust or estate. The limitation of section 613A(d)(1) shall be applied by each taxpayer (*i.e.*, trust, estate or beneficiary) only with respect to its allocable share of percentage depletion under section 611(b) (3) or (4). For purposes of adjustments to the basis of oil or gas properties held by a trust or estate, in the absence of clear and convincing evidence to the contrary, it shall be presumed that no beneficiary is affected by any section 613A (d) limitations or by the rules contained in section 613A(c)(8) and (9) (relating to businesses under common control and members of the same family and to transfers, respectively), as in effect prior to the Revenue Reconciliation Act of 1990, or has any oil or gas production from sources other than the trust or estate.

(2) The provisions of this paragraph may be illustrated by the following examples.

Example 1. A is the income beneficiary of a trust the only asset of which is a domestic producing oil property. The trust instrument requires that an amount which equals 10 percent of the gross income from the property be set aside annually as a reserve for depletion. In 1975 the property a had production of 1,095,000 barrels of oil. The trust's gross income from the property in 1975 was $30,000x. In that year, after setting aside $3,000x of income for the reserve for depletion, the trustee distributed the remaining income to A which represented 80 percent of the trust's net income. The percentage depletion computed by the trust with respect to the production (computed as if section 613 applied to all of the production at the rate specified in section 613A(c)(5), as in effect prior to the Revenue Reconciliation Act of 1990) for 1975 was $6,600x. The trust's average daily production for 1975 was 3,000 barrels (1,095,000 ÷ 365 days). The trust's allowable depletion pursuant to section 613A(c) with respect to the production was $4,400x:

$$\left[\$6{,}600\text{x depletion}\left(\frac{2{,}000\text{ depletable oil quantity}}{3{,}000\text{ average daily production}}\right)\right]$$

Pursuant to §1.611–1(c)(4)(ii), the percentage depletion of $4,400x was apportioned between the trustee and A so that the trustee received $3,000x (an amount equal to the amount of income set aside for the reserve for depletion) and A received $1,400x of the depletion deduction. The $1,400x depletion received by A is attributable to 80 percent of the trust's depletable oil quantity, *i.e.*, 1,600 barrels per day.

Example 2. B, a retailer of oil and gas, is the income beneficiary of a trust the only asset of which is a domestic producing oil property. In 1975 the trustee distributed one-half of the trust's net income and accumulated the other one-half for the benefit of the remainderman. One-half of the percentage depletion computed by the trust with respect to the production from the property was apportioned to B. Since B is a retailer of oil and gas, B is not entitled to deduct any of the percentage depletion apportioned to B. However, B is entitled to take cost depletion with respect to one-half of the production from the oil property, notwithstanding the fact that depletion was computed at the trust level on the basis of percentage depletion.

(h) *Businesses under common control; members of the same family*—(1) *Component members of a controlled group.* For purposes of only the depletable quantity limitations contained in section 613A (c) and this section, component members of a controlled group of corporations (as defined in paragraph (1) of §1.613A–7) shall be treated as one taxpayer. Accordingly, the group shares the depletable oil (or natural gas) quantity prescribed for a taxpayer for the taxable year and the secondary production (to which gross income from the property is attributable before January 1, 1984) of a member of the group will reduce the other members' share of the group's depletable quantity.

(2) *Aggregation of business entities under common control.* If 50 percent or more of the beneficial interest in any two or more entities (*i.e.*, corporations, trust, or estates) is owned by the same or related persons (taking into account only each person who owns at least 5 percent of the beneficial interest in an entity and with respect to such person his or her entire interest) as defined in paragraph (m) (2) of §1.613A–7, the tentative quantity determined under the table in section 613A(c)(3)(B) (as in effect prior to the Revenue Reconciliation Act of 1990) for a taxpayer for the taxable year shall be allocated among all such entities in proportion to their respective production. This paragraph (h)(2) shall not apply to component members of a controlled group of corporations (as defined in §1.613A–7 (1)). For purposes of determining ownership interest, an interest owned by or for a corporation, partnership, trust, or estate shall be considered as owned directly both by itself and proportionately by its shareholders, partners, or beneficiaries, as the case may be.

(3) *Allocation among members of the same family.* In the case of individuals who are members of the same family, the tentative quantity determined under the table in section 613A (c)(3)(B) (as in effect prior to the Revenue Reconciliation Act of 1990) for a taxpayer for the taxable year shall be allocated among such individuals in proportion to the respective production of barrels of domestic crude oil (and the equivalent in barrels to the cubic feet of natural gas determined under paragraph (h)(4)(ii) of this section) during the period in question by such individuals.

(4) *Special rules.* For purposes of section 613A (c)(8) and this section—

(i) The family of an individual includes only his spouse and minor children, and

(ii) Each 6,000 cubic feet of domestic natural gas shall be treated as 1 barrel of domestic crude oil.

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

Example 1. A owns 50 percent of the stock of Corporation M and 50 percent of the stock of Corporation N. Both corporations are calendar year taxpayers. For 1975 Corporation M's production of domestic crude oil was 8,000,000 barrels (365,000 of which was secondary production) and Corporation N's was 2,000,000 barrels (all of which was primary production). The tentative quantity (2,000 barrels per day) determined under the table in section 613A (c)(3)(B) (as in effect prior to the Revenue Reconciliation Act of 1990) must be allocated between the two corporations in proportion to their respective barrels of production of domestic crude oil during the taxable year. Corporation M's allocable share of the tentative quantity is 1,600 barrels:

$$\left[2{,}000\left(\frac{8{,}000{,}000}{10{,}000{,}000}\right)\right]$$

and Corporation N's allocable share is 400 barrels:

$$\left[2{,}000\left(\frac{2{,}000{,}000}{10{,}000{,}000}\right)\right]$$

With respect to M's primary production, M's depletable oil quantity is 600 barrels (1,600 barrels – 1,000 barrels [365,000 secondary production ÷ 365 days]). N's depletable oil quantity, unaffected by M's secondary production, is 400 barrels.

Example 2. Assume the same facts as in *Example 1* except that Corporation M is a retailer and Corporation N is not selling its oil through Corporation M. Because Corporation M is a retailer, no portion of the tentative quantity is allocated to Corporation M. Accordingly, Corporation N's depletable oil quantity is the entire 2,000 barrels per day because section 613A (c), which contains the allocation requirements, is inapplicable to retailers.

Example 3. Corporations O and P are members of a controlled group and are treated as one taxpayer as provided in paragraph (h)(1) of this section. Corporation O owns oil properties A and B. Property A had primary production for 1975 of 800,000 barrels of oil. Property B had secondary production for 1975 of 365,000 barrels of oil. Corporation P owns oil property C which had primary production of 660,000 barrels for 1975. The allowable percentage depletion with respect to property B's secondary production was $360x. The controlled group's average daily production was 4,000 barrels [(800,000 + 660,000) ÷ 365]. The controlled group's depletable oil quantity was 1,000 barrels [2,000 tentative quantity − 1,000 average daily secondary production (365,000 ÷ 365)]. The allowable percentage depletion pursuant to section 613 (a) (computed as if section 613 applied to all of the production at the rate specified in section 613A (c)(5), as in effect prior to the Revenue Reconciliation Act of 1990) was $800x with respect to production from property A and $660x with respect to production from property C.

Corporation O's allowable depletion pursuant to section 613A (c) with respect to property B's secondary production (for which depletion is allowable before primary production) for 1975 was $360x. Corporation O's allowable depletion pursuant to section 613A (c) with respect to property A was $200x:

$$\left[\$800\text{x depletion}\left(\frac{1{,}000\text{ depletable oil quantity}}{4{,}000\text{ average daily production}}\right)\right]$$

Therefore, Corporation O's allowable depletion pursuant to section 613A (c) was $560x ($360x relating to property B plus $200x relating to property A). Corporation P's allowable depletion pursuant to section 613A (c) with respect to property C was $165x:

$$\left[\$660\text{x depletion}\left(\frac{1{,}000\text{ depletable oil quantity}}{4{,}000\text{ average daily production}}\right)\right]$$

(i) *Transfer of oil or gas property*—(1) *General rule*—(i) *In general.* Except as provided in paragraph (i)(2) of this section, in the case of a transfer (as defined in paragraph (n) of § 1.613A–7) of an interest in any proven oil or gas property (as defined in paragraph (p) of § 1.613A–7), paragraph (a)(1) of this section shall not apply to a transferee (as defined in paragraph (o) of § 1.613A–7) with respect to production of crude oil or natural gas attributable to such interest, and such production shall not be taken into account for any computation by the transferee under this section.

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

Example 1. On January 1, 1975, Individual A transfers proven oil properties to Corporation M in an exchange to which section 351 applies for shares of its stock. Since there is no allocation requirement pursuant to section 613A(c)(8) between A (the transferor) and Corporation M (the transferee), the transfer of the proven properties by A is a transfer for purposes of section 613A(c)(9) (as in effect prior to the Revenue Reconciliation Act of 1990) and percentage depletion is not allowable to Corporation M with respect to such properties.

Example 2. On January 1, 1975, Corporation N sells proven oil property to Corporation O, its wholly-owned subsidiary. Because the transfer was made between corporations which are members of the same controlled group of corporations, Corporation O is entitled to percentage depletion with respect to production from the property so long as the tentative oil quantity is allocated between the two corporations. If Corporation N were a retailer, the tentative oil quantity would not be required to be allocated between the two corporations (see example 2 of § 1.613A–3(h)(5)), and Corporation O would not be entitled to percentage depletion on the production from the property.

Example 3. B, owner of a proven oil property, died on January 1, 1975. Pursuant to the provisions of B's will, B's estate transferred the oil property on April 1, 1975, into a trust. On July 1, 1976, pursuant to a requirement in B's will, the trustee distributed the oil property to C. The transfer of the oil property by the estate to the trust and the later distribution of the property by the trust to C are transfers at death. Therefore, the trust was entitled to compute percentage depletion with respect to the production from the oil property when the property was owned by the trust and C is entitled to percentage depletion with respect to production from the oil property after the trust distributes the property to C.

Example 4. On January 1, 1975, property which produces oil resulting from secondary processes was transferred to D. The exemption under section 613A(c) applies to D because section 613A(c)(9) (relating to transfers of oil or gas property), as in effect in 1975, does not apply with respect to secondary production. In addition, even if at the time of the transfer the production from the property was primary and D applied secondary processes to the property transferred and obtained secondary production, D would be entitled to percentage depletion with respect to the secondary production.

Example 5. On July 1, 1975, E and F entered into a contract whereby F is given the privilege of drilling a well on E's unproven property, and if F does so F is to own the entire working interest in the property until F has recoverd all the costs of drilling, equipping, and operating the well. Thereafter, 50 percent of the working interest would revert to E. In accordance with the contract, 50 percent of the working interest reverted to E on July 1, 1976. F is entitled to percentage depletion because the transfer of the working interest to F occurred when the property was unproven on July 1, 1975, which is the date of the contract establishing F's right to the working interest. E is entitled to percentage depletion with respect to this working interest since the reversion of such interest with respect to which E was eligible for percentage depletion is not a transfer. However, if on the date of the contract E's property was proven (although not proven when E acquired the property), F would not be entitled to claim percentage depletion with respect to any of the working interest income. Nonetheless, E would still be entitled to percentage depletion with respect to E's working interest since the reversion of the interest is not a transfer.

Example 6. On January 1, 1975, G subleased an oil property to H, retaining a ⅛ royalty interest with the option to convert G's royalty into a 50-percent working interest. On July 1, 1975, the property was proven and on July 1, 1976, G exercised G's option. G is entitled to claim percentage depletion with respect to G's working interest since the conversion of the royalty interest which is eligible for percentage depletion pursuant to section 613A(c) into an interest which constituted part of an interest previously owned by G is not a transfer pursuant to §1.613A–7(n)(8).

Example 7. I and J (both of whom are minors) are beneficiaries of a trust which owned a proven oil property. The oil property was transferred to the trust on January 1, 1975, by the father of I and J. For 1975, the trustee allocated all the income from the oil property to I. For 1976, the trustee allocated all the income from such property to J. On January 1, 1977, the trustee distributed the property to I and J as equal tenants in common. Since I, J, and their father are members of the same family within the meaning of section 613A(c)(8)(C), the transfer of the property to the trust by the father, the shifting of income between I and J, and the distribution of the oil property by the trust to I and J are not transfers for purposes of section 613A(c)(9) (as in effect prior to the Revenue Reconciliation Act of 1990). However, the distribution of the oil property will constitute a transfer to each distributee on the date on which the distributee reaches majority under state law.

Example 8. In 1975, K transferred a proven oil property productive at 5,000 feet to L. Subsequent to the transfer, L drilled new wells on the property finding another reservoir at 10,000 feet. The two zones were combined under section 614 as a single property. L is not entitled to percentage depletion on the gross income attributable to the production from the productive zone at 5,000 feet, but is entitled to percentage depletion on the gross income attributable to the production from the productive zone at 10,000 feet because that zone was not part of the proven property until the date of development expenses by L, which is after the date of the transfer. Accordingly, L's maximum allowable percentage depletion deduction for 1975 would be zero percent of gross income from the property with respect to the production from 5,000 feet, plus 22 percent of gross income from the property with respect to the production from 10,000 feet. This maximum deduction would be subject to the limitation provided for in section 613(a), *i.e.*,50 percent of ''taxable income from the property (computed without allowance for depletion),'' such taxable income being the overall taxable income resulting from the sale of production from both zones, and would also be subject to the limitations provided in section 613A. The production from the productive zone at 5,000 feet is not taken into account in determining K's depletable oil quantity for the year.

Example 9. On July 1, 1975, M transferred an oil property with a fair market value of $100x to N. On February 1, 1976, N commenced production of oil from the property. The fair market value of the property on February 1, 1976, as reduced by actual costs incurred by N for equipment and intangible drilling and development costs, was $300x. Because the value of the property on transfer was not 50 percent or more of the value on February 1, 1976, the property transferred to N was not a proven property (see §1.613A–7(p)). However, if there had been only marginal production from the property so that the fair market value of the property on February 1, 1976, was $40x rather than $300x, the property transferred to N would have been a proven property provided the other requirements of a proven property were met.

Example 10. O is the owner of a remainder interest in a trust created January 1, 1970. On that date, the trust held oil and gas properties. On January 1, 1976, O's interest for the first time entitled O to the trust's income from oil and gas production from the properties. The reversion of the remainder interest to O is not a transfer (see § 1.613A–7(n)(7)). Accordingly, the transfer of the interest in oil and gas property to O is deemed to have occurred on January 1, 1970, the date O's interest was created.

Example 11. On January 1, 1976, P, Q, and R entered into a partnership for the acquisition of oil and gas leases. It was agreed that the sharing of income will be divided equally among P, Q, and R. However, it was further agreed that with respect to the first production obtained from each property acquired P will receive 80 percent thereof and Q and R each will receive 10 percent thereof until $100x has been received by P. Assume these allocations have substantial economic effect under section 704 of the Code and the regulations thereunder. On February 1, 1976, Partnership PQR acquired an unproven property and production therefrom was shared pursuant to the partnership agreement. P is entitled to percentage depletion with respect to the production allocated to him since the transfer of right to the production is deemed to have been made on the date the partnership agreement became applicable to the specific property, at which time the property was unproven. See § 1.613A–7(n) for rules relating to the definition of transfer. Similarly, when $100x has been obtained and Q and R each commence receiving 33⅓ percent of the revenue, Q and R are entitled to percentage depletion with respect to their entire interests. However, if the property had been proven when acquired by the partnership, P, Q, and R would not be entitled to claim any percentage depletion with respect to production from the property.

Example 12. On December 30, 1960, S placed producing oil property in trust for the benefit of S's nephew, T, and executed a trust agreement which required the trustee of the trust to transfer the oil property to T on January 1, 1975. The trustee's transfer of the oil property to T on January 1, 1975, is deemed to have occurred on December 30, 1960 (see § 1.613A–7(n)). Since the transfer is deemed to have occurred before January 1, 1975, section 613A(c) applies with respect to the production from the oil property. Moreover, if the trustee was not required to transfer the oil property on a specific date but was given discretion to select the date of transfer, the transfer of such property would still be deemed to have occurred on December 30, 1960. However, the result would be different if the trust agreement had provided that the trustee, at the trustee's discretion, may transfer the oil property to T on January 1, 1975, but is not under any obligation to transfer the property to T on January 1, 1975, or on any other date. Since the transfer was discretionary, the date of the actual transfer governs.

Example 13. On January 1, 1974, U acquired an oil property. On February 1, 1974, U granted V an option to purchase the oil property. V exercised V's option on March 2, 1975, and subsequently the oil property was conveyed to V. The date of the transfer was March 2, 1975, the day V exercised V's option (on which date both parties were bound).

Example 14. On July 1, 1974, W executed a deed conveying oil and gas property to X. W delivered the deed to X on January 1, 1975. Under state law, the mere execution of the deed without delivery did not give X any rights in the property. Title to the oil property passed to X on the date of delivery. Therefore, the date of transfer was January 1, 1975.

Example 15. Y, owner of a proven oil property, transferred Y's interest therein on July 25, 1975, to a revocable trust of which Y is treated as the owner under section 676. Y is not deemed a transferee and section 613A(c) applies to Y because immediately preceding the transfer Y was entitled to percentage depletion on the production from the property.

Example 16. On January 1, 1975, a proven oil property was transferred to Z; therefore, section 613A(c)(1) did not apply with respect to the production from such property. After Z's death, neither Z's estate nor its beneficiaries are entitled to percentage depletion with respect to the decedent's oil property since Z was a transferee of proven property.

Example 17. Partnership ABC, owner of proven oil and gas properties, admitted D as a partner in 1975 in consideration of cash. The shares of Partners A, B, and C of the partnership income were proportionately reduced so that D had a 25 percent interest in the income. D is not entitled to percentage depletion with respect to D's share of partnership oil and gas income because D is a transferee for purposes of section 613A(c)(9) (as in effect prior to the Revenue Reconciliation Act of 1990). See § 1.613A–7(n).

Example 18. On January 1, 1975, E and F formed Partnership EF to which E contributed proven oil property. For 1975, pursuant to the partnership agreement 70 percent of the mineral income from the property was allocated to E and 30 percent of the mineral income from the property was allocated F. F is not entitled to percentage depletion with respect to production from the property because F is a transferee of an interest in proven property. However, E is not a transferee of an interest in proven property because E was entitled to percentage depletion on the oil produced with respect to the property immediately before the transfer. Therefore, E is entitled to percentage depletion with respect to the income allocated to E. However, if in 1976 the partnership agreement were revised so that E's interest in the income was increased by 10 percent, E would not be entitled to percentage depletion with respect to the additional 10 percent interest because E is a transferee with respect thereto.

Example 19. G is the owner of a ⅓ interest in a partnership owning a proven oil property, and as such is entitled to ⅓ of the income from the property. G received a distribution on July 1, 1975, from the partnership of a ⅓ interest in the proven oil property. Although the transfer of such interest is a transfer for purposes of section 613A(c)(9) (as in effect prior to the Revenue Reconciliation Act of 1990), G is still entitled to percentage depletion with respect to the ⅓ interest in the oil production from the property since G was entitled to percentage depletion on such production with respect to such property immediately before the transfer. If the entire property were distributed to G, G's percentage depletion allowance would still be based on only ⅓ of the oil produced.

Example 20. H and I contributed property X and property Y respectively to Partnership HI. The partnership agreement provides that all the gross income from property X is to be allocated to H and all the gross income from property Y is to be allocated to I. Assume these allocations have substantial economic effect under section 704 of the Code and the regulations thereunder. For 1975 H and I each received $100x gross income. Although the contributions of the properties by H and I are transfers for purposes of section 613A(c)(9) (as in effect prior to the Revenue Reconciliation Act of 1990), both H and I are entitled to percentage depletion with respect to the $100x income received since each was entitled to a percentage depletion allowance with respect to the property contributed immediately before the transfer. However, if no special allocation of income were made but H and I are to share equally in the income from both properties, each would be entitled to a depletion allowance based on only one-half of the production with respect to the property he had contributed. If property X produces $100x of gross income from the property and property Y produces $200x of gross income from the property, H would be entitled to percentage depletion but only with respect to $50x (50 percent of $100x) of gross income from the property and I would be entitled to percentage depletion with respect to $100x (50 percent of $200x) of gross income from the property.

(2) *Transfers after October 11, 1990*—(i) *General rule.* Section 613A(c) (9) and (10), as in effect prior to the Revenue Reconciliation Act of 1990 (relating to prohibition of percentage depletion on transferred proven properties) has been repealed effective for transfers after October 11, 1990. Accordingly, a transferee of a proven oil or gas property transferred after October 11, 1990 is permitted to claim percentage depletion with respect to production from the property. For purposes of transfers of property occurring before October 12, 1990 under section 613A(c)(10), prior to its repeal, the disposition of stock after October 11, 1990 by a transferor will not result in a reduction in the depletable quantity of the transferee corporation under section 613A(c)(10)(F).

(ii) *Transfer.* The term ''transfer'' has the same meaning as under §1.613A–7(n).

(iii) *Transferee.* A person shall not be treated as a transferee with respect to a transferred property to the extent that such person held an interest in the property but was not entitled to a percentage depletion allowance on mineral produced with respect to the property immediately before the transfer. Thus, for example, if a taxpayer who is not entitled to claim percentage depletion on a proven property transfers the property to a partnership for an interest in the partnership, the taxpayer is not a transferee with respect to the property in the hands of the partnership.

(iv) *Effective date.* The provisions of paragraph (i)(2) of §1.613A–3 are effective for transfers occurring after May 13, 1991. However, a taxpayer may elect to apply these provisions to transfers occurring after October 11, 1990 and on or before May 13, 1991.

(v) *Examples.* The examples below illustrate the provisions of this subparagraph. The examples ignore the application of any restriction on percentage depletion other than the proven property transfer rule.

Example 1. On December 31, 1991, A transfers a proven oil property to B. B may claim percentage depletion with respect to production from the property regardless of whether production from the property was eligible for percentage depletion in A's hands (even if A were a retailer or refiner of oil or gas).

Example 2. On October 10, 1990, A transfers a proven oil property to B. B may not claim percentage depletion with respect to production from the property.

Example 3. On January 1, 1990, C purchases a proven oil property. Because C is a transferee of a proven property, production from the property is not eligible for percentage depletion in C's hands. On December 31, 1991, C contributes the property to Corporation M, an S corporation in which C owns 100 percent of the stock. The contribution of the property is a transfer, but C is not a transferee with respect to the property in the hands of the corporation. Accordingly, C may not claim percentage depletion with respect to production from the property. However, if prior to the contribution C had been entitled to claim percentage depletion with respect to production from the property, C would be entitled to claim percentage depletion with respect to production from the property after the contribution.

Example 4. On December 31, 1991, C contributes a proven oil property (with respect to which C is not entitled to claim percentage depletion) to Corporation N, an S corporation in which C owns 30 percent and D owns 70 percent of the stock. The contribution of the property is a transfer, but C is not a transferee with respect to the property in the hands of the corporation. Accordingly, C may not claim percentage depletion with respect to C's share of the production from the property. D is a transferee with respect to the property in the hands of Corporation N, and may claim percentage depletion with respect to D's share of production from the property.

Example 5. On December 31, 1991, D transfers a proven oil property (with respect to which D is not entitled to claim percentage depletion) to DE, an equal partnership between D and E. E is a transferee with respect to the property and may claim percentage depletion with respect to production from the property allocated to E under the DE partnership agreement. D is not a transferee with respect to the property, and may not claim percentage depletion with respect to production from the property allocated to D under the DE partnership agreement. However, if D had been entitled to claim percentage depletion with respect to production from the property, then D would be entitled to claim percentage depletion with respect to production from the property in the hands of DE.

Example 6. On January 1, 1990, Corporation P contributes a proven property to Corporation O, its wholly owned subsidiary. Under §1.613A–7(n)(4), the contribution is not treated as a transfer, but only for so long as the tentative quantity is required under section 613A(c)(8) to be allocated between P and O. On December 31, 1991, P sells 90% of the O stock to an unrelated person; accordingly, the tentative quantity is no longer required under section 613A(c)(8) to be allocated between P and O. After the sale of O stock, production from the property in O's hands is eligible for percentage depletion because a transfer of a proven property is deemed to occur upon the transfer of the stock.

Example 7. On October 10, 1990, G transfers a proven oil property to his minor son, H. G had been entitled to claim percentage depletion with respect to production from the property. Under §1.613A–7(n)(5), H is permitted to claim percentage depletion for so long as G and H are related persons under section 613A(c)(8)(C). On December 31, 1991, H reaches majority and is no longer related to G under section 613A(c)(8)(C). H is entitled to continue to claim percentage depletion on production from the property because the property is treated as being transferred to H on December 31, 1991.

Example 8. On December 31, 1991, I sells a proven property to J, her husband. I had not been entitled to claim percentage depletion with respect to production from the property. Under §1.613A–7(n)(5), the sale is not a transfer because it is made between persons related under section 613A(c)(8). Accordingly, J may not claim percentage depletion with respect to production from the property. If, however, I had been entitled to claim percentage depletion with respect to production from the property, J would be entitled to claim percentage depletion with respect to production from the property.

Example 9. On December 31, 1991, L inherits a proven property from K. K had not been entitled to claim percentage depletion with respect to production from the property. Under §1.613A–7(n)(1), the inheritance is not a transfer. Accordingly, L may not claim percentage depletion with respect to production from the property. If, however, K had been entitled to claim percentage depletion with respect to production from the property, L would be entitled to claim percentage depletion with respect to production from the property.

Example 10. On December 31, 1991, Corporation R, a calendar year taxpayer, made an S election effective for the taxable year beginning January 1, 1992 and succeeding taxable years. Since Corporation R is deemed to have transferred its oil and gas properties on January 1, 1992, the shareholders of Corporation R are eligible to claim percentage depletion with respect to the production from the properties.

Example 11. Assume the same facts as in *Example 10* except that Corporation R makes the S election on December 31, 1989, effective for the taxable year beginning January 1, 1990 and succeeding taxable years. Since Corporation R is deemed to have transferred its oil and gas properties on January 1, 1990, the shareholders of Corporation R are not eligible to claim percentage depletion with respect to the production from the properties.

(j) *Percentage depletion with respect to bonuses and advanced royalties*—(1) *Amounts received or accrued after August 16, 1986.* In computing the percentage depletion allowance pursuant to section 613A(c) with respect to amounts received or accrued after August 16, 1986, there shall not be taken into account any advance royalty (to the extent that actual production during the taxable year is insufficient to earn such royalty), lease bonus, or other amount payable without regard to production, even though the amount may be taken into account for purposes of sections 61 and 612 (relating to definitions of gross income and cost depletion, respectively).

(2) *Amounts received or accrued before August 17, 1986.* (i) A lease bonus or advanced royalty received or accrued before August 17, 1986, with respect to oil or gas property shall be taken into account for purposes of percentage depletion in the taxable year such payment is includible in income. Percentage depletion shall be determined according to the depletion rate and depletable oil and natural gas limitations of section 613A(c)(1) and §1.613A–3(a) applicable on the date of such inclusion. The payee of the bonus or advanced royalty shall apply the depletable oil and natural gas quantity limitations by attributing a specific number of barrels of oil or cubic feet of natural gas to the lease bonus or advanced royalty. The determination of the number of barrels of oil or cubic feet of natural gas shall be based on the average price of oil or gas produced from the property during the taxable year. If oil or gas is not produced from the property during that year, or if the oil or gas is not sold before conversion or transportation from the premises, the number of barrels of oil or cubic feet of gas shall be based on a price (as of the date of the bonus or advanced royalty) determined under the constructive pricing principles applicable under section 613(a), generally the representative market or field price. In the case where no oil or gas has been produced in such year, the constructive price applicable to the type of production expected to be produced from the property shall apply. However, if the first actual production from the property in a later year is different from the type of production upon which the conversion of the bonus or advanced royalty into barrels of oil or cubic feet of gas was based and the period of limitations on assessment has not expired (see section 6501) for the year in which the lease bonus or advanced royalty is includible in income, the taxpayer should promptly file an amended return, if necessary. In the amended return the conversion shall be recomputed taking into account the pricing applicable to the actual production. For purposes of paragraph (f) of §1.613A–7, the number of barrels of oil or cubic feet of natural gas attributed to a lease bonus or advanced royalty is deemed to have been extracted on the date the bonus or advanced royalty is includible in the payee's income.

(ii) For purposes of applying the depletable oil and natural gas quantity limitations in taxable years after the year in which the advanced royalty payment is included in income, the payee of an advanced royalty which is recouped out of future production shall not include production which recoups the advanced royalty in such later years. The payor of a bonus or advanced royalty that is not recouped from future production may reduce the production to be taken into account for purposes of applying the depletable quantity limitations in each year in which the payor's gross income from the property is adjusted under §1.613–2(c)(5)(ii) to reflect the bonus paid by an amount determined by dividing the portion of the bonus required to be excluded from the payor's gross income from the property by the price of oil or gas applicable to the payee for converting the bonus into barrels of oil or cubic feet of gas.

(iii) See §1.612–3 (a)(2) and (b)(2) for rules relating to the requirement that certain depletion deductions allowed with respect to lease bonuses and advanced royalties be restored to income.

(k) *Special rules for fiscal year taxpayers.* In applying this section to a taxable year which is not a calendar year, each portion of such taxable year which occurs during a single calendar year shall be treated as if it were a short taxable year.

(l) *Information furnished by partnerships, trusts, estates, and operators.* Each partnership, trust, or estate producing domestic crude oil or natural gas, and each operator of a well from which domestic crude oil or natural gas was produced, shall provide each partner, beneficiary, or person holding a nonoperating interest, as the case may be, with all information in its possession necessary to determine the amount of his depletion deduction allowable with respect to such crude oil or natural gas. For example, for each property a partnership is required to provide each partner with partnership information relating to the partner's allocable share of gross income from the property, the partner's allocable share of operating expenses, the partner's allocable share of depreciation, the partner's share of allocated overhead, the partner's share of estimated reserves, the partner's share of production in barrels or cubic feet for the taxable year, the partner's original share of the partnership adjusted basis of properties producing domestic crude oil or domestic natural gas, the partner's allocable share of any adjustments made to the basis of such properties by the partnership, and the percentage by which existing partners must reduce their bases in a partnership oil or gas property upon entry of a partner by contribution. In addition, upon the disposition of an oil or gas property by the partnership, the partnership shall inform each partner of his allocable portion of the amount realized from the sale of the property.

[T.D. 8348, 56 FR 21939, May 13, 1991; 57 FR 4913, Feb. 10, 1992; 57 FR 9599, Mar. 19, 1992, as amended by T.D. 8437, 57 FR 43900, Sept. 23, 1992; 57 FR 60474, Dec. 21, 1992; 58 FR 6678, Feb. 1, 1993]

§ 1.613A–4 Limitations on application of § 1.613A–3 exemption.

(a) *Limitation based on taxable income.* (1) The aggregate amount of a taxpayer's deductions allowed pursuant to section 613A(c) for the taxable year shall not exceed 65 percent of the taxpayer's taxable income (reduced in the case of an individual by the zero bracket amount for taxable years beginning after December 31, 1976, and before January 1, 1987) for the year, adjusted to eliminate the effects of:

(i) Any depletion with respect to an oil or gas property (other than a gas property with respect to which the depletion allowance for all production is determined pursuant to section 613A(b)) for which percentage depletion would exceed cost depletion in the absence of the depletable quantity limitations contained in section 613A(c) (1) and (6) (as in effect prior to the Revenue Reconciliation Act of 1990) or the taxable income limitation contained in section 613A(d)(1);

(ii) Any net operating loss carryback to the taxable year under section 172;

(iii) Any capital loss carryback to the taxable year under section 1212; and

(iv) In the case of a trust, any distributions to its beneficiaries, except in the case of any trust where any beneficiary of such trust is a member of the family (as defined in section 267(c)(4)) of a settlor who created inter vivos and testamentary trusts for members of the family and such settlor died within the last 6 days of the 5th month in 1970, and the law in the jurisdiction in which such trust was created requires all or a portion of the gross or net proceeds of any royalty or other interest in oil, gas, or other mineral representing any percentage depletion allowance to be allocated to the principal of the trust.

The amount disallowed (as defined in paragraph (q) of § 1.613A–7) shall be carried over to the succeeding year and treated as an amount allowable as a deduction pursuant to section 613A(c) for such succeeding year, subject to the 65-percent limitation of section 613A(d)(1). For rules relating to corporations filing a consolidated return, see the regulations under section 1502. With respect to fiscal year taxpayers, except as provided in § 1.613A–1 for taxable years beginning before January 1, 1975, and ending after that date, the limitation shall be calculated on the entire fiscal year and not applied with respect to each short period included in a fiscal year. For purposes of basis adjustments and determining whether cost depletion exceeds percentage depletion with respect to the production from a property, any amount disallowed as a deduction after the application of this paragraph shall be allocated to the respective properties from which the oil or gas was produced in proportion to the percentage depletion otherwise allowable to such properties pursuant to section 613A(c). Accordingly, the maximum amount which may be allowable as a deduction pursuant to section 613A(c) after application of this paragraph (65 percent × adjusted taxable income) shall be allocated to properties for which percentage depletion pursuant to section 613A(c) would be allowed in the absence of the limitation contained in section 613A(d)(1) by application of the same proportion. However, once it is determined that after application of this paragraph cost depletion exceeds percentage depletion with respect to a property, the maximum amount determined under the preceding sentence shall be reallocated among the remaining properties, and the portion of the amount disallowed which is allocable to such property shall be the amount by which percentage depletion pursuant to section 613A(c) before application of this paragraph exceeds cost depletion. See example 1 of paragraph (a)(2) of this section. If the taxpayer becomes entitled to the deduction in a later year (*i.e.*, because the disallowed depletion does not exceed 65 percent of the taxpayer's taxable income for that year after taking account of any percentage depletion deduction otherwise allowable for that year), then the basis of the taxpayer's properties must be adjusted downward (but not below zero) by the amount of the deduction in proportion to the portion of the amount disallowed to the respective properties in the year of the disallowance. However, if the property in question was disposed of by the taxpayer prior to the beginning of such later year, the amount of the deduction in such later year shall be reduced by the difference between the taxpayer's adjusted basis in the property at the time it is disposed of and the adjusted basis which the taxpayer would have had in the property in the absence of the 65-percent limitation.

(2) The application of this paragraph may be illustrated by the following examples:

Example 1. A owns producing oil properties M, N, and O. With respect to property M, the depletion allowable pursuant to section 613A(c) for 1975 without regard to section 613A(d)(1) was $60× (cost depletion would have been $40×). With respect to property N, the depletion allowable pursuant to section 613A(c) for 1975 without regard to section 613A(d)(1) was $90× (cost depletion would have been zero). With respect to property O, the depletion pursuant to section 613A(c) for 1975 without regard to section 613A(d)(1) was $50× (cost depletion would have been $10X). A's taxable income (as adjusted under §1.613A–4(a)(1)) for 1975 was $100×; accordingly, A's percentage depletion pursuant to section 613A(c) for 1975 must be reduced from $200× to $65× (65 percent × $100× taxable income). Of that amount, $19.5×:

$$\left[65\text{x dollars}\left(\frac{\$60\text{x}}{\$60\text{x}+\$90\text{x}+\$50\text{x}}\right)\right]$$

is tentatively allocated to property M, $29.25×:

$$\left[65\text{x dollars}\left(\frac{\$90\text{x}}{\$90\text{x}+\$60\text{x}+\$50\text{x}}\right)\right]$$

is tentatively allocated to property N, and $16.25×:

$$\left[65\text{x dollars}\left(\frac{\$50\text{x}}{\$50\text{x}+\$90\text{x}+\$60\text{x}}\right)\right]$$

is tentatively allocated to property O.

Since cost depletion of $40× with respect to property M exceeded the percentage depletion of $19.5× allowable on such property, A claimed the cost depletion. Accordingly, the only percentage depletion deduction allowable to A pursuant to section 613A(c) for 1975 is with respect to properties N and O. Therefore, the $65× ceiling applies to the percentage depletion allowable on properties N and O. Of that amount, $41.79×:

$$\left[65\text{x dollars}\left(\frac{\$90\text{x}}{\$90\text{x}+\$50\text{x}}\right)\right]$$

is allocated to property N, and $23.21×:

$$\left[65\text{x dollars}\left(\frac{\$50\text{x}}{\$50\text{x}+\$90\text{x}}\right)\right]$$

is allocated to property O.

Accordingly, A is allowed a total depletion deduction of $105× ($40× cost depletion on property M + $41.79× percentage depletion on property N + $23.21× percentage depletion on property O). The amount disallowed to A under section 613A(d)(1) is $95× ($200× aggregate depletion allowable before application of section 613A(d)(1) − $105× [$40× cost depletion allowable on property M + $41.79× percentage depletion allowable on property N after application of section 613A(d)(1) + $23.21× depletion allowable on property O after application of section 613A(d)(1)]). For purposes of basis adjustments, $20× ($60× percentage depletion before limitation − $40× cost depletion allowed) of the amount disallowed is allocated to property M. The balance of the amount disallowed of $75× is allocated $48.21×:

$$\left[75\text{x dollars}\left(\frac{\$90\text{x}}{\$90\text{x}+\$50\text{x}}\right)\right]$$

to property N, and

$$\left[75\text{x dollars}\left(\frac{50\text{x}}{\$50\text{x}+\$90\text{x}}\right)\right]$$

to property O.

Example 2. The amount disallowed to B as a deduction under this paragraph is $50x for 1975 and $125x for 1976 (including the $50x carried over from 1975). B may carry forward the $125x as a deduction to 1977 and subsequent years.

Example 3. C is a fiscal year taxpayer whose fiscal year ended on May 31, 1975. For purposes of applying the 65 percent of taxable income limitation, the period beginning January 1, 1975, and ending May 31, 1975, is treated as a short taxable year. The depletion allowable pursuant to section 613A(c) without regard to section 613A(d)(1) for such short taxable year was $80x and A's taxable income (as adjusted under § 1.613A–4(a)(1)) during such short taxable year was $100x. Only $65x (65 percent x $100x adjusted taxable income) of the deduction pursuant to section 613A(c) was deductible for such portion of 1975, in addition to any percentage depletion allowable for June 1, 1974, through December 31, 1974. With respect to the taxable year commencing June 1, 1975, and ending May 31, 1976, the 65 percent limitation is applied to the taxable income for the entire taxable year.

Example 4. Under the trust law of State X, a trustee is required to allocate 22 percent of gross mineral income to the principal of a trust for purposes of maintaining a reserve for depletion and the depletion deduction is entirely allocated to the trustee. In 1975 the gross income of a trust in State X the only assets of which were oil properties was $1,000. The trust's allowable percentage depletion pursuant to section 613A(c) without regard to section 613A(d)(1) was $220. The trust incurred expenses of $150 for the taxable year and made distributions to beneficiaries (who are not described in the exception for family members set forth in paragraph (a)(1)(iv) of this section) of $630 ($1,000 gross income −$220 allocated to principal −$150 expenses). The trust's deduction for personal exemption under section 642(b) is $300. For purposes of applying the 65 percent limitation, the trust's taxable income was $550 ($1,000 gross income −$150 expenses −$300 exemption). The limitation under section 613A(d)(1) was $357.50 (65% x $550 taxable income). Accordingly, the trust's percentage depletion allowance was unaffected by the 65 percent limitation.

Example 5. In 1980 the gross income of the estate of D was $1,000. The only assets of the estate were oil properties. The estate's adjusted basis in the oil properties was $0. The estate's allowable percentage depletion pursuant to section 613A(c) without regard to section 613A(d)(1) was $220. The estate incurred expenses of $150 for the taxable year and made distributions to beneficiaries of $425. The distributions thus equaled one half of the net income of the estate (ignoring depletion). Under section 611(b)(4), the percentage depletion is apportioned equally between the estate and its beneficiary. The distribution amount of $425 is deductible under section 661(a) in computing the taxable income of the estate. For purposes of applying the 65 percent limitation to the percentage depletion apportioned to the estate, the estate's taxable income was $0 ($1,000 gross income −$150 expenses −$425 distribution −$600 exemption). The limitation under section 613A(d)(1) was therefore also $0 (65% x $0 taxable income). Accordingly, the $110 amount is disallowed to the estate for the taxable year but may be carried forward by the estate as a deduction to 1981 and subsequent years. The beneficiaries shall apply the 65 percent limitation to the $110 percentage depletion apportioned to them based on their respective taxable incomes.

Example 6. In 1975 E sold an oil property for which E's adjusted basis was $20x. The amount disallowed for 1975 to E under section 613A(d) was $10x. The amount of the carryover under that section to 1976 was $0 ($10x disallowed amount −$10x [$20x adjusted basis of property on sale −$10x adjusted basis which taxpayer would have had in the property in the absence of the 65-percent limitation]). However, if the adjusted basis of the property on disposition had been $0, the amount of the carryover to 1976 would have been $10x ($10x disallowed amount −$0 adjusted basis of property on sale).

Example 7. In 1975 F owned producing properties M, N, O, P, Q, and R. With respect to property M, the allowable cost depletion was $100x (the allowable percentage depletion pursuant to section 613A(c) without regard to the depletable quantity and taxable income limitations contained in section 613A(c)(1),

(6) and (d)(1) would have been $90x). With respect to property N, the allowable percentage depletion pursuant to section 613A(c) before applying section 613A(d)(1) was $80x (cost depletion would have been $0). With respect to property O, the allowable cost depletion was $60x (the allowable percentage depletion pursuant to section 613A(c) would have been $70x, except that the application of section 613A(d)(1) reduced allowable percentage depletion to less than $60x). With respect to property P, the allowable percentage depletion pursuant to section 613A(b) was $55x (cost depletion would have been $40x). With respect to property Q, which produces both gas subject to section 613A(b)(1)(B) and oil subject to section 613A(c), the allowable percentage depletion was $45x (cost depletion would have been $40x). With respect to property R, the allowable cost depletion was $40x (the allowable percentage depletion pursuant to section 613A(c) would have been $50x, except that the application of section 613A(c)(7)(A) reduced allowable percentage depletion to less than $40x). Under paragraph (a)(1)(i) of this section, for purposes of applying the 65 percent limitation under section 613A(d)(1), F's taxable income must be reduced by the allowable depletion with respect to property M (for which cost depletion exceeded percentage depletion even in the absence of section 613A(c)(1), (6), and (d)) and property P (for which all depletion is determined pursuant to section 613A(b)), but shall not be reduced by the allowable depletion with respect to properties N, O, Q, and R.

(b) *Retailers excluded.* (1) Section 613A(c) and §1.613A–3 shall not apply in the case of any taxpayer who is a retailer as defined in paragraph (r) of §1.613A–7.

(2) The application of this paragraph may be illustrated by the following examples (those that involve sales through retail outlets assume, unless otherwise stated, that the $5,000,000 gross receipts requirement section 613A(d)(2) is met):

Example 1. A, owner of producing oil and gas properties, also owns 5 percent in value of the stock of Corporation M, a retailer of oil and gas. None of A's production is sold through Corporation M. Since A may benefit from Corporation M's sales of oil and gas through A's ownership interest in Corporation M, A is considered to be selling oil or natural gas through Corporation M, a related person. Accordingly, the exemption under section 613A(c) does not apply to A, even though none of A's production is sold through Corporation M.

Example 2. Assume the same facts as in *Example 1* except that A has gross receipts of $2 million from sales of oil for the taxable year from A's retail outlets and Corporation M has gross receipts of $4 million from sales of oil for the taxable year from its retail outlets. For purposes of the $5 million gross receipts requirement of section 613A(d)(2), A is treated as having gross receipts of $6 million. Accordingly, the exemption under section 613A(c) does not apply to A.

Example 3. Corporation N, a retailer of oil and gas, owns 5 percent in value of the stock of Corporation O, owner of producing oil and gas properties. None of Corporation O's production is sold through Corporation N. Since Corporation O has no direct or indirect ownership interest in Corporation N, and therefore does not benefit from Corporation N's sales of oil and gas, and since none of Corporation O's production is sold through Corporation N, the exemption under section 613A(c) applies to Corporation O.

Example 4. Corporation P, a producer of oil, owns 70 percent in value of the stock of Corporation Q. Corporation Q owns 30 percent in value of the stock of Corporation R. Corporation R owns 30 percent in value of the stock of Corporation S, a retailer of oil and gas. P indirectly owns 6.3 percent (70 percent × 30 percent × 30 percent) in value of the stock of Corporation S. Since P may benefit from Corporation S's sales of oil and gas through P's indirect ownership interest in Corporation S, P is not entitled to percentage depletion.

Example 5. B is the owner of certain oil and gas properties in Texas and is also the owner of a service station in Washington, DC, which B leases to Corporation T. None of B's production is sold to Corporation T. The exemption under section 613A(c) applies to B. However, if sales of B's production were made to Corporation T and the gross receipts from such sales of B's production to Corporation T exceed 5 million dollars, the exemption under section 613A(c) would not apply to B because B is selling oil or natural gas to a person given authority to occupy a retail outlet leased by the taxpayer, B.

Example 6. C has a ⅛ royalty interest and Corporation U has a ⅞ working interest in an oil property. Corporation V, a retailer of oil, owns 5 percent in value of the stock of Corporation U. C has no interest in either corporation. All of the production from the property is sold through Corporation V, C receiving from Corporation U ⅛ of its receipts therefrom. The exemption under section 613A(c) does not apply to Corporation U because Corporation U is selling oil of natural gas through Corporation V, a related person that is a retailer. However, the exemption applies to C because C, as owner of a nonoperating mineral interest, is not treated as an operator of a retail outlet merely because C's oil and gas is sold on C's behalf through a retail outlet operated by an unrelated person.

Example 7. D owns and operates retail grocery stores where refined oil may be purchased. D also owns oil and gas producing properties. If the sales of refined oil at each store location constitute less than 5 percent of the gross receipts from all sales made at that store, D is not considered a retailer by reason of such sales.

Example 8. Lessee E sells natural gas to lessor F directly from a wellhead gathering pipelines system for F's local agricultural use, in transactions incidental to the acquisition of a natural gas lease. The sales of natural gas to F are not sales through a retail outlet.

Example 9. Corporation W produces natural gas, some of which it sells at retail. For purposes of determining whether Corporation W is a retailer selling gas through a retail outlet within the meaning of § 1.613A–7(r), the business office of Corporation W where a purchaser would normally contact the corporation with respect to its sales to the purchaser is considered the place at which those sales of natural gas are made.

Example 10. G, husband, is the sole owner and operator of a retail outlet which sells oil and gas. H, wife, owns producing oil and gas properties. G is not related to H for purposes of section 613A(d).

Example 11. I, husband, and J, wife, are community property owners of 10 percent in value of the stock of Corporation X which is a retailer of oil and gas. I and J are each treated as owning 5 percent of Corporation X. Therefore, neither I nor J qualify for the exemption under section 613A(c).

Example 12. Corporation Y, an electing small business corporation as defined in section 1371 (as in effect prior to the enactment of the subchapter S Revision Act of 1982), owns producing oil and gas properties. K, a retailer of oil and gas, is a 50 percent interest shareholder of Corporation Y. None of Corporation Y's production is sold through K. Corporation Y is eligible for percentage depletion.

Example 13. Corporation Z, a producer of natural gas, makes bulk sales of natural gas to industrial users. For purposes of determining whether Corporation Z is a retailer under § 1.613A–7(r), the bulk sales are disregarded.

Example 14. L, a calendar year taxpayer, is the owner of a producing oil property. On September 1, 1976, L purchased a chain of gasoline service stations. Therefore, L was a retailer of oil and gas for the last 122 days of 1976. L's gross income from the oil property for the taxable year was $150x and L's taxable income from the property was $30x. L is treated as a retailer with respect to $50x of gross income from the property ($150x × 122/366) and $10x of taxable income from the property ($30x × 122/366). Therefore, L is entitled to percentage depletion with respect to $100x of gross income from the property ($150x minus $50x). However, the allowable percentage depletion is limited by the 50 percent of taxable income from the property limitation to $10x (50 percent times $20x taxable income ($30x minus $10x)).

Example 15. Corporation M is a partner in Partnership MNO which is the owner of an operating interest in a producing oil property. Corporation P, a retailer of oil and gas, owns 5 percent in value of the stock of Corporation M. Partnership MNO sells its production to Corporation P. Corporation M is retailing oil through Corporation P, a related person, because its share of the oil is being sold on its behalf by the partnership through a retail outlet operated by a person related to Corporation M. Therefore, the exemption under section 613A(c) does not apply to Corporation M.

Example 16. AA and BB are beneficiaries of a trust which is a retailer of oil and gas. AA has an interest in the income of the trust for AA's lifetime which, actuarially determined, represents more than 5 percent of the beneficial interests in the trust. BB's interest in the trust, which entitles BB to 5 percent of the corpus of the trust 5 years after AA's death, represents less than 5 percent of the beneficial interests in the trust prior to AA's death and represents more than 5 percent after AA's death. The trust is a related person of AA but not BB while AA is alive. Accordingly, during AA's lifetime BB is not disqualified from the exemption provided by section 613A(c), but AA is.

Example 17. Assume the same facts as in *Example 16,* except that AA's interest in the income of the trust represents 4 percent of the beneficial interests in the trust. AA is disqualified from the exemption provided by section 613A(c) with respect to the income from the trust but not with respect to income from other sources.

(c) *Certain refiners excluded.* (1) Section 613A(c) and § 1.613A–3 shall not apply in the case of any taxpayer who is a refiner as defined in paragraph (s) of § 1.613A–7.

(2) The provisions of this paragraph may be illustrated by the following examples:

Example 1. Corporation M owns a refinery which has refinery runs in excess of 50,000 barrels on at least one day during the taxable year. Corporation M also owns a 5 percent interest in Corporation N, owner of producing oil and gas properties. None of Corporation N's production is sold to Corporation M. The exemption under section 613A(c) does not apply to Corporation N because Corporation M, a related person of Corporation N, engages in the refining of crude oil.

Example 2. A and B are equal partners in Partnership AB, which owns oil and gas producing properties. A owns a refinery which has refinery runs in excess of 50,000 barrels on at least one day during the taxable year and which buys all of Partnership AB's production. B has no ownership interest in any refinery. B is not a refiner.

[T.D. 8348, 56 FR 21946, May 13, 1991; 57 FR 4913, Feb. 10, 1992]

§1.613A–5 Election under section 613A(c)(4).

The election under section 613A(c)(4) is an annual election which the taxpayer may make by claiming percentage depletion deductions for the taxable year based upon such election. The election may be made, on an original or amended tax return or a claim for credit or refund, at any time prior to the expiration of the statutory period (including any extensions thereof) for the filing of a claim for credit or refund by the taxpayer. The election may be changed by the taxpayer by filing an amended return or a claim for credit or refund. The election allows the taxpayer to treat as his depletable natural gas quantity an amount equal to 6,000 cubic feet multiplied by the number of barrels of the taxpayer's depletable oil quantity to which the election applies. The election applies to secondary or tertiary production, as well as primary production, but in determining the taxpayer's depletable natural gas quantity with respect to secondary or tertiary production the taxpayer's depletable oil quantity shall be determined without regard to section 613A(c)(3)(A)(ii) with respect to production from secondary or tertiary processes.

[T.D. 7487, 42 FR 24264, May 13, 1977]

§1.613A–6 Recordkeeping requirements.

(a) *Principal value of property demonstrated.* In the case of a transfer (as defined in §1.613A–7(n)) after December 31, 1974, of an interest in an oil or gas property (as defined in §1.613A–7(p)), the transferee (as defined in section 1.613A–7(o)) shall keep records showing the terms of the transfer, any geological and geophysical data in the possession of the transferee or other exploratory data with respect to the property transferred, and any other information which bears upon the question of whether at the time of the transfer the principal value of the property transferred had been demonstrated by prospecting, exploration, and discovery work.

(b) *Production from secondary or tertiary processes.* Every taxpayer who claims depletion with respect to oil or gas produced by secondary or tertiary processes (as defined in §1.613A–7(k)) shall keep records of the secondary and tertiary processes applied and maintain records of the amount of production so resulting.

(c) *Retention of records.* The records required by this section shall be kept at all times available for inspection by authorized Internal Revenue officers or employees, and shall be retained so long as the contents may become material in the administration of any Internal Revenue law.

[T.D. 7487, 42 FR 24264, May 13, 1977]

§1.613A–7 Definitions.

For purposes of section 613A and the regulations thereunder—

(a) *Domestic.* The term *domestic,* as applied to oil and gas wells (or to production from such wells), refers to wells located in the United States or in a possession of the United States, as defined in section 638 and the regulations thereunder.

(b) *Natural gas.* The term *natural gas* means any product (other than crude oil as defined in paragraph (g) of this section) of an oil or gas well if a deduction for depletion is allowable under section 611 with respect to such product.

(c) *Regulated natural gas.* Natural gas is considered to be "regulated" only if all of the following requirements are met:

(1) The gas must be domestic gas produced and sold by the producer (whether for himself or on behalf of another person) before July 1, 1976,

(2) The price for which the gas is sold by the producer must not be adjusted to reflect to any extent the increase in liability of the seller for tax under chapter 1 of the Code by reason of the repeal of percentage depletion for gas,

(3) The sale of the gas must have been subject to the jurisdiction of the Federal Power Commission for regulatory purposes,

(4) An order or certificate of the Federal Power Commission must be in effect (or a proceeding to obtain such an order or certificate must have been instituted), and

(5) The price at which the gas is sold must be taken into account, directly or indirectly, in the issuance of the order or certificate by the Federal Power Commission. Price increases after February 1, 1975, are presumed to take increases in tax liabilities into account unless the taxpayer demonstrates to the contrary by clear and convincing evidence that the increases are wholly attributable to a purpose or purposes unrelated to the repeal of percentage depletion for gas (*e.g.*, where the record of the Federal Power Commission clearly establishes that the Commission did not take the repeal into account). Increases to reflect additional State and local real property or severance taxes, increases for additional operating costs (such as costs of secondary or tertiary processes), adjustments for inflation, increases for additional drilling and related costs, or increases to reflect changes in the quality of gas sold, are some examples of increases that are not attributable to the repeal of percentage depletion for gas. In the absence of a statement in writing by the Federal Power Commission that the price of the gas in question was not in fact regulated, the requirement of paragraph (c)(5) of this section is deemed to have been met in any case in which the Federal Power Commission issued an order or certificate approving the sale to an interstate pipeline company or, in a case in which it is established by the taxpayer that the Federal Power Commission has influenced the price of such gas, an order or certificate permitting the interstate transportation of such gas. In addition, an ‘‘emergency’’ sale of natural gas to an interstate pipeline, which, pursuant to the authority contained in 18 CFR 2.68, 2.70, 157.22, and 157.29, may be made without prior order approving the sale, is deemed to have met the requirements of paragraph (c) (3), (4), and (5) of this section. For purposes of meeting the requirements under this paragraph, it is not necessary that the total gas production from a property qualify as ‘‘regulated natural gas.’’ The determination of whether mineral production is ‘‘regulated natural gas’’ shall be made with respect to each sale of the mineral or minerals produced.

(d) *Natural gas sold under a fixed contract.* The term *natural gas sold under a fixed contract* means domestic natural gas sold by the producer (whether for himself or on behalf of another person) under a contract, in effect on February 1, 1975, and at all times thereafter before such sale, under which the price for the gas during such period cannot be adjusted to reflect to any extent the increase in liabilities of the seller for tax under chapter 1 of the Code by reason of the repeal of percentage depletion for gas. The term may include gas sold under a fixed contract even though production sold under the contract had previously been treated as regulated natural gas. Price increases after February 1, 1975, are presumed to take increases in tax liabilities into account unless the taxpayer demonstrates to the contrary by clear and convincing evidence. Paragraph (c) of this section provides examples of increases which do not take increases in tax liabilities into account. However, if an adjustment provided for in the contract permits the possible increase in federal income tax liability of the seller to be taken into account to any extent, the gas sold under the contract after such an increase becomes permissible is not gas sold under a fixed contract. If the adjustment provided for in the contract provides for an increase in the price of the contract to the highest price paid to a producer for natural gas in the area, or if the price may be renegotiated, then gas sold under the contract after such an increase becomes permissible is presumed not to be sold under a fixed contract unless the taxpayer demonstrates by clear and convincing evidence that the price increase in no event takes increases in tax liabilities into account. For purposes of meeting the requirements of this paragraph, it is not necessary that the total gas production from a property qualify as ‘‘natural gas sold under a fixed contract,’’ for the determination of ‘‘natural gas sold under a fixed contract’’ is to be made with respect to each sale of each type of natural gas sold pursuant to each contract.

(e) *Qualified natural gas from geopressured brine.* The term ‘‘qualified natural gas from geopressured brine’’ means any natural gas which is determined in accordance with section 503 of the Natural Gas Policy Act of 1978 to be produced from geopressured brine and which is produced from any well the drilling of which began after September 30, 1978, and before January 1, 1984.

(f) *Average daily production.* (1) The term *average daily production* means the taxpayer's aggregate production of domestic crude oil or natural gas, as the case may be, which is extracted after December 31, 1974, and to which gross income from the property is attributable during the taxable year divided by the number of days in such year. As used in the preceding sentence the term *taxpayer* includes a small business corporation as defined in section 1371 (as in effect prior to the enactment of the subchapter S Revision Act of 1982) and the regulations thereunder. Notwithstanding the provisions of §1.612–3 and except as provided in §1.613A–3(j)(2), in computing the average daily production for a taxable year only oil or gas which has been actually produced by the close of such taxable year is taken into account. Average daily production does not include production resulting from secondary or tertiary processes to which gross income from the property is attributable before January 1, 1984.

(2) In the case of a fiscal-year taxpayer, paragraph (f)(1) of this section shall be applied separately to each short taxable year under section 613A(c)(11), as in effect prior to the Revenue Reconciliation Act of 1990.

(3) In the case of a taxpayer holding a partial interest in the production from any property (including an interest of a partner in property of a partnership or a net profit interest) such taxpayer's production shall be considered to be that amount of such production determined by multiplying the total production (which is produced after December 31, 1974, and to which gross income from the property is attributable during the taxable year) of the property by the taxpayer's percentage participation in the gross revenues from the property during the year. However, the portion of trust (or estate) production allocable to a beneficiary shall not exceed that amount of the trust's (or estate's) depletable oil quantity determined by multiplying such quantity by the beneficiary's percentage interest in the trust's (or estate's) gross income from the property.

(g) *Crude oil.* For purposes of section 613A and the regulations thereunder, the term *crude oil* means—

(1) A mixture of hydrocarbons which existed in the liquid phase in natural underground reservoirs and which remains liquid at atmospheric pressure after passing through surface separating facilities,

(2) Hydrocarbons which existed in the gaseous phase in natural underground reservoirs but which are liquid at atmospheric pressure after being recovered from oil well (casinghead) gas in lease separators, and

(3) Natural gas liquid recovered from gas well effluent in lease separators or field facilities before any conversion process has been applied to such production.

(h) *Depletable oil quantity.* The taxpayer's depletable oil quantity, within the meaning of section 613A(c)(1)(A), shall be equal to the tentative quantity determined under the table contained in section 613A(c)(3)(B) and paragraph (b) of §1.613A–3 (except that, in the case of determinations with respect to days prior to January 1, 1984, such quantity shall be reduced (but not below zero) by the taxpayer's average daily secondary or tertiary production for the taxable year).

(i) *Depletable natural gas quantity.* The taxpayer's depletable natural gas quantity, within the meaning of section 613A(c)(1)(B), shall be equal to 6,000 cubic feet multiplied by the number of barrels of the taxpayer's depletable oil quantity to which the taxpayer elects to have section 613A(c)(4) apply. The taxpayer's depletable oil quantity for any taxable year shall be reduced (in addition to any reduction required to be made under paragraph (h) of this section) by the number of barrels with respect to which an election under section 613A(c)(4) for natural gas has been made. See §1.613A–5.

(j) *Barrel.* The term *barrel* means 42 United States gallons.

(k) *Secondary or tertiary production.* For purposes of section 613A the term *secondary or tertiary production* means the increased production of domestic crude oil or natural gas from a property at any time after the application of a secondary or tertiary process. The increased production is the excess of actual production over the maximum primary production which would have resulted during the taxable year if the secondary or tertiary process had not been applied. The increased production may be due to an increase in either the rate or the duration of recovery. A secondary or tertiary process is a process applied for the recovery of hydrocarbons in which liquids, gases, or other matter is injected into the reservoir to supplement or augment the natural forces required to move the hydrocarbons through the reservoir. However, no process which must be introduced early in the productive life of the mineral property in order to be reasonably effective (such as cycling of gas in the case of a gas-condensate reservoir) is a secondary or tertiary process. A process (such as fire flooding or miscible fluid injection) introduced early in the productive life of the mineral property will not be disqualified as a secondary or tertiary process if a later introduction of the process in the property would still have been reasonably effective.

(l) *Controlled group of corporations.* The term *controlled group of corporations* has the meaning given to such term by section 1563(a), except that section 1563(b)(2) shall not apply and except that ‘‘more than 50 percent’’ shall be substituted for ‘‘ at least 80 percent’’ each place it appears in section 1563(a).

(m) *Related person.* (1) A person is a *related person* to another person, within the meaning of section 613A(d) (2) and (4), paragraphs (b) and (c) of §1.613A–4, and paragraphs (r) and (s) of this section, if either a significant ownership interest in such person is held by the other, or a third person has a significant ownership interest in both such persons. For purposes of determining a significant ownership interest, an interest owned by or for a corporation, partnership, trust, or estate shall be considered as owned directly both by itself and proportionately by its shareholders, partners, or beneficiaries, as the case may be. The term *significant ownership* means—

(i) With respect to any corporation, direct or indirect ownership of 5 percent or more in value of the outstanding stock of such corporation,

(ii) With respect to a partnership, direct or indirect ownership of 5 percent or more interest in the profits or capital of such partnership, and

(iii) With respect to an estate or trust, direct or indirect ownership of 5 percent or more of the beneficial interests in such estate or trust. The relative percentage ownership of beneficiaries of an estate or trust in the beneficial interests therein shall be determined under actuarial principles.

(2) A person is a ‘‘related person’’ to another person, within the meaning of section 613A(c)(8)(B) and paragraph (h)(2) of §1.613A–3, if such persons are members of the same controlled group of corporations or if the relationship between such persons would result in a disallowance of losses under section 267 or 707(b), except that for this purpose the family of an individual includes only the individual’s spouse and minor children.

(n) *Transfer.* The term *transfer* means any change in ownership for federal tax purposes after December 31, 1974, by sale, exchange, gift, lease, sublease, assignment, contract, or other disposition (including any contribution to or any distribution by a corporation, partnership, or trust), any change in the membership of a partnership or the beneficiaries of a trust, or any other change by which a taxpayer’s proportionate share of the income subject to depletion of an oil or gas property is increased. For taxable years beginning after 1982, the term ‘‘transfer’’ includes an election by a C corporation to be an S corporation (properties deemed transferred by the C corporation on the day the election first becomes effective) and a termination of an S election (each shareholder’s pro rata share of assets of S corporation deemed transferred to C corporation on the day that the termination first becomes effective). However, the term does not include—

(1) A transfer of property at death (including a distribution by an estate, whether or not a pro rata distribution),

(2) An exchange to which section 351 applies,

(3) A change of beneficiaries of a trust by reason of the death, birth, or adoption of any vested beneficiary if the transferee was a beneficiary of the trust or is a lineal descendant of the settlor or any other vested beneficiary of the trust, except in the case of any trust where any beneficiary of the trust is a member of the family (as defined in section 267(c)(4)) of a settlor who created inter vivos and testamentary trusts for members of the family and the settlor died within the last six days of the fifth month in 1970, and the law in the jurisdiction in which the trust was created requires all or a portion of the gross or net proceeds of any royalty or other interest in oil, gas, or other mineral representing any percentage depletion allowance to be allocated to the principal of the trust,

(4) A transfer of property between corporations which are members of the same controlled group of corporations (as defined in section 613A(c)(8)(D)(i)),

(5) A transfer of property between business entities which are under common control (within the meaning of section 613A(c)(8)(B)) or between related persons in the same family (within the meaning of section 613A(c)(8)(C)),

(6) A transfer of property between a trust and members of the same family (within the meaning of section 613A(c)(8)(C)) to the extent that both (i) the beneficiaries of the trust are and continue to be members of the family that transferred the property, and (ii) the tentative oil quantity is allocated among the members of such family,

(7) A reversion of all or part of an interest with respect to which the taxpayer was eligible for percentage depletion pursuant to section 613A(c), or

(8) A conversion of a retained interest which is eligible for such depletion into an interest which constituted all or part of an interest previously owned by the taxpayer also eligible for such depletion.

However, paragraph (n) (2), (4), and (5) of this section shall apply only so long as the tentative quantity determined under the table contained in section 613A(c)(3)(B) (as in effect prior to the Revenue Reconciliation Act of 1990) is required to be allocated under section 613A(c)(8) between the transferor and transferee, or among members of a controlled group of corporations. In the case of an individual transferor, the allocation test of the preceding sentence shall not be failed merely because of the death of the transferor. For purposes of paragraph (n) (3) and (6), an individual adopted by a beneficiary is a lineal descendant of that beneficiary. For purposes of paragraph (n) (7) and (8), a taxpayer previously ineligible for percentage depletion solely by reason of section 613A(d) (2) or (4) will be considered to have been eligible for such depletion. A transfer is deemed to occur on the day on which a contract or other commitment to transfer the property becomes binding upon both the transferor and transferee, or, if no such contract or commitment is made, on the day on which ownership of the interest in oil or gas property passes to the transferee.

(o) *Transferee.* The term ''transferee'', as used in section 613A(c)(9), paragraph (i)(1) of §1.613A–3, and this section includes the original transferee of proven property and his or her successors in interest (excluding successors in interest of proven property transferred after October 11, 1990). A person shall not be treated as a transferee of an interest in a proven oil or gas property to the extent that such person was entitled to a percentage depletion allowance on mineral produced with respect to the property immediately before the transfer. However, a person shall be treated as a transferee of an interest in a proven property to the extent that the interest such person receives is greater than the interest in the property the person held immediately before the transfer. For example, where the owner of a proven oil property transfers his or her entire interest therein to a partnership of which he or she is a member and, as a consequence, becomes entitled to a depletion allowance based on only one-third of the oil produced with respect to that property, the owner (the transferor) is not denied percentage depletion with respect to the one-third interest in oil production which the owner still possesses. If the partnership agreement had made an effective allocation (under section 704 and § 1.704.1) of all the income in respect of such property to the transferor partner, that partner would be entitled to percentage depletion on the entire oil production from that property. For this purpose, a person who has transferred oil or gas property pursuant to a unitization or pooling agreement shall be treated as having been entitled to a depletion allowance immediately before the transfer to that person of the interest in the unit or pool with respect to all of the mineral in respect of which the person receives gross income from the property pursuant to the unitization or pooling agreement, except to the extent such income is attributable to consideration paid by that person for such interest in addition to that person's contribution of the oil or gas property and equipment affixed thereto.

(p) *Interest in proven oil or gas property.* The term *interest in an oil or gas property* means an economic interest in oil or gas property. An economic interest includes working or operating interests, royalties, overriding royalties, net profits interests, and, to the extent not treated as loans under section 636, production payments from oil or gas properties. The term also includes an interest in a partnership, S corporation, small business corporation, or trust holding an economic interest in oil or gas property but does not include shares of stock in a corporation (other than an S corporation and small business corporation) owning such an interest. An oil or gas property is ''proven'' if its principal value has been demonstrated by prospecting, exploration, or discovery work. The principal value of the property has been demonstrated by prospecting, exploration, or discovery work only if at the time of the transfer—

(1) Any oil or gas has been produced from a deposit, whether or not produced by the taxpayer or from the property transferred;

(2) Prospecting, exploration, or discovery work indicate that it is probable that the property will have gross income from oil or gas from the deposit sufficient to justify development of the property; and

(3) The fair market value of the property is 50 percent or more of the fair market value of the property, minus actual expenses of the transferee for equipment and intangible drilling and development costs, at the time of the first production from the property subsequent to the transfer and before the tansferee transfers his or her interest.

For purposes of this paragraph, the property is to be determined by applying section 614 and the regulations thereunder to the transferee at the time of the transfer. If the transfer is of an interest in a partnership, S corporation, small business corporation, or trust, the determination shall be made with respect to each property owned by the partnership, S corporation, small business corporation, or trust. The term *prospecting, exploration, or discovery work* includes activities which produce information relating to the existence, location, extent, or quality of any deposit of oil or gas, such as seismograph surveys and drilling activities (whether for exploration or for the production of oil or gas).

(q) *Amount disallowed.* The amount disallowed, within the meaning of section 613A(d)(1) and paragraph (a) of § 1.613A–4, is the excess of the amount of the aggregate of the taxpayer's allowable depletion deductions (whether based upon cost or percentage depletion) computed without regard to section 613A(d)(1) over the amount of the aggregate of such deductions computed with regard to such section. The disallowed amount shall be carried over to the succeeding year and treated as an amount allowable as a deduction pursuant to section 613A(c) for the succeeding year, subject to the 65-percent limitation of section 613A(d)(1) and the rules contained in § 1.613A–4(a).

(r) *Retailer.* (1) Except as otherwise provided in paragraph (r)(2) of this section, the term *retailer* means any taxpayer who directly, or through a related person (as defined in paragraph (m)(1) of this section), sells oil or natural gas, or any product derived from oil or natural gas—

(i) Through any retail outlet operated by the taxpayer or a related person, or

(ii) To any person—

(A) Obligated under an agreement or contract with the taxpayer or a related person to use a trademark, trade name, or service mark or name owned by such taxpayer or a related person, in marketing or distributing oil or natural gas or any product derived from oil or natural gas, or

(B) Given authority, pursuant to an agreement or contract with the taxpayer or a related person, to occupy any retail outlet owned, leased, or in any way controlled by the taxpayer or a related person.

For purposes of the preceding sentence, bulk sales (*i.e.*, sales in very large quantities) of oil or natural gas (but not bulk sales of any product derived from oil or natural gas) to commercial or industrial users shall be disregarded. Bulk sales made after September 18, 1982, of aviation fuels to the Department of Defense shall be also disregarded. In addition, sales of oil or natural gas (whether or not produced by the taxpayer), or of any product derived from oil or natural gas, which are made outside the United States shall be disregarded if no domestic production of oil, natural gas (or products derived therefrom) of the taxpayer or a related person is exported during the taxable year or the immediately preceding taxable year.

(2) Notwithstanding paragraph (r)(1) of this section, the taxpayer shall not be considered a retailer in any case where, during the taxable year of the taxpayer, the combined gross receipts from sales (excluding sales for resale) of oil or natural gas, or products derived therefrom, of all retail outlets taken into account under paragraph (r)(1) of this section (including sales through a retail outlet of oil, natural gas, or a product derived from oil or natural gas which had previously been the subject of a sale described in paragraph (r)(1)(ii) of this section) do not exceed $5 million. If the taxpayer's combined gross receipts for the taxable year exceed $5 million, the taxpayer will be treated as a retailer as of the first day in which a retail sale was made. For purposes of paragraph (r)(1) of this section, a taxpayer shall be deemed to be selling oil or natural gas (or a product derived therefrom) through a related person in any case in which any sale of oil or natural gas (or a derivative product) by the related person produces gross income from which the taxpayer may benefit by reason of the taxpayer's direct or indirect ownership interest in the related person. In such cases (and in any other case in which the taxpayer is selling through a retail outlet referred to in section 613A(d)(2)(A) or is selling such items to a person described in section 613A(d)(2)(B)), it is immaterial whether the oil or natural gas which is sold, or from which is derived a product which is sold, was produced by the taxpayer. A taxpayer shall be deemed to be selling oil or natural gas (or a derivative product) through a retail outlet operated by a related person in any case in which a related person who operates a retail outlet acquires for resale oil or natural gas (or a derivative product) which the taxpayer produced or caused to be made available for acquisition by the related person pursuant to an arrangement whereby some or all of the taxpayer's production is marketed. An owner of a nonoperating mineral interest (such as a royalty) shall not be treated as an operator of a retail outlet merely because the owner's oil or gas is sold on the owner's behalf through a retail outlet operated by an unrelated person. In addition, the mere fact that a member of a partnership is a retailer shall not result in characterization of the remaining partners as retailers. However, any partner of a partnership who has a 5 percent or more interest in any entity actually engaging in retail activities (including the partnership or another entity to which the partnership is related) is treated as a retailer. See paragraph (m)(1) of this section for rules on the ownership interest by partners in an entity related to a partnership. Similarly, if a trust or estate is a retailer, only its beneficiaries having a 5 percent or more current income interest from the trust or estate are treated as retailers. A person who is a retailer during a portion of the taxable year shall be treated as a retailer with respect to a fraction of that person's gross and taxable income from oil or gas properties for the taxable year, the numerator of which is the number of days during the taxable year in which

the taxpayer is a retailer and the denominator of which is the total number of days during the taxable year; except that a person who ceases to be a retailer during the taxable year before the first production of oil or gas during such year shall not be treated as a retailer for any portion of such year.

(3) For purposes of this paragraph (r), the term *any product derived from oil or natural gas* means gasoline, kerosene, Number 2 fuel oil, refined lubricating oils, diesel fuel, butane, propane, and similar products which are recovered from petroleum refineries or extracted from natural gas in field facilities or natural gas processing plants. The term *retail outlet* means any place where sales of oil or natural gas (excluding bulk sales of such items to commercial or industrial users), or a product of oil or natural gas (excluding bulk sales of aviation fuels to the Department of Defense), accounting for more than 5 percent of the gross receipts from all sales made at such place during the taxpayer's taxable year, are systematically made for any purpose other than for resale. For this purpose, sales of oil or natural gas, or any product derived from oil or natural gas, to a person for refining are considered as sales made for resale.

(s) *Refiner.* A person is a refiner if such person or a related person (as defined in paragraph (m)(1) of this section) engages in the refining of crude oil (whether or not owned by such person or related person) and if the total refinery runs of such person and any related persons exceed 50,000 barrels on any day during the taxable year. A refinery run is the volume of inputs of crude oil (excluding any product derived from oil) into the refining stream. For purposes of this paragraph, crude oil refined outside the United States shall be taken into account. Refining is any operation by which the physical or chemical characteristics of crude oil are changed, exclusive of such operations as passing crude oil through separators to remove gas, placing crude oil in settling tanks to recover basic sediment and water, dehydrating crude oil, and blending of crude oil products.

[T.D. 8348, 56 FR 21949, May 13, 1991; 57 FR 4913, Feb. 10, 1992, as amended by T.D. 8437, 57 FR 43903, Sept. 23, 1992; 58 FR 6678, Feb. 1, 1993]

§ 1.614–0 Introduction.

Section 614 relates to the definition of property and to the various special rules by means of which taxpayers are permitted to aggregate or combine separate properties or to treat such properties as separate. These rules are set forth in detail in §§ 1.614–1 through 1.614–8. Section 1.614–1 sets forth rules under section 614(a) relating to the definition of the term *property*. Section 1.614–2 contains the rules relating to the election under section 614(b), as it existed prior to its amendment by section 226(a) of the Revenue Act of 1964, to aggregate operating mineral interests. In the case of mines, the rules contained in § 1.614–2 are applicable only to taxable years beginning before January 1, 1958, to which the Internal Revenue Code of 1954 applies. In the case of oil and gas wells, the rules contained in § 1.614–2 are applicable only to taxable years beginning before January 1, 1964, to which the Internal Revenue Code of 1954 applies. In the case of oil and gas wells, the taxpayer may, however, for taxable years beginning before January 1, 1964, treat any operating mineral interests as if section 614 (a) and (b) (as it existed prior to its amendment by section 226(a) of the Revenue Act of 1964) had not been enacted. If any operating mineral interests are so treated, the rules contained in § 1.614–2 are not applicable to such interests and such interests are, in respect of taxable years beginning before January 1, 1964, subject to the rules set forth in § 1.614–4 relating to the Internal Revenue Code of 1939 treatment of separate operating mineral interests in the case of oil and gas wells. Section 1.614–3 prescribes the rules relating to the election under section 614(c)(1) permitting the aggregation of operating mineral interests in the cases of mines for taxable years beginning after December 31, 1957. Section 1.614–3 also sets forth rules relating to the election under section 614(c)(2) in the case of mines by means of which a taxpayer is permitted to treat a single operating mineral interest as more than one such interest for taxable years beginning after December 31, 1957. At the election of the taxpayer with respect to an operating unit, the rules contained in §1.614–3 are also applicable to taxable years beginning before January 1, 1958, to which the Internal Revenue Code of 1954 applies. If the taxpayer makes such an election, the rules contained in §1.614–2 are not applicable to any of the operating mineral interests which are part of the operating unit with respect to which the election described in §1.614–3 is made. Section 1.614–5 sets forth the rules relating to the aggregation of nonoperating mineral interests. Section 1.614–6 contains the rules relating to basis, holding period, and abandonment and casualty losses where properties have been aggregated or combined. Section 1.614–7 relates to the extension of time for performing certain acts. Section 1.614–8 contains the rules relating to the elections under section 614(b) as amended by section 226(a) of the Revenue Act of 1964 to treat separate operating mineral interests in the case of oil and gas wells as separate properties or in combination for taxable years beginning after December 31, 1963.

[T.D. 6859, 30 FR 13699, Oct. 28, 1965]

§1.614–1 Definition of property.

(a) *General rule.* (1) For purposes of subtitle A of the Code, in the case of mines, wells, and other natural deposits, the term *property* means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

(2) The term *interest* means an economic interest in a mineral deposit. See paragraph (b) of §1.611–1. The term includes working or operating interests, royalties, overriding royalties, net profits interests, and, to the extent not treated as loans under section 636, production payments.

(3) The term *tract or parcel of land* is merely descriptive of the physical scope of the land to which the taxpayer's interest relates. It is not descriptive of the nature of his rights or interests in the land. All contiguous areas (even though separately described) included in a single conveyance or grant or in separate conveyances or grants at the same time from the same owner constitute a single separate tract or parcel of land. Areas included in separate conveyances or grants (whether or not at the same time) from separate owners are separate tracts or parcels of land even though the areas described may be contiguous. If the taxpayer's rights or interests within the same tract or parcel of land are dissimilar, then each such dissimilar interest constitutes a separate property. If the taxpayer's rights or interests (whether or not dissimilar) within the same tract or parcel of land relate to more than one separate mineral deposit, then his interest with respect to each such separate deposit is a separate property.

(4) Upon the transfer of a *property* in any transaction in which the basis of such property in the hands of the transferee is determined by reference to the basis of such property in the hands of the transferor, such property shall, notwithstanding the provisions of subparagraph (3) of this paragraph, retain the same status and identity in the hands of the transferee as it had in the hands of the transferor. See paragraph (c) of §1.614–6 if the transferor has made a binding election to treat a separate mineral interest as a separate property, to treat a separate mineral interest as more than one property under section 614(c), or to treat two or more separate mineral interests as an aggregated or combined property under section 614(b) (as it existed either before or after its amendment by section 226(a) of the Revenue Act of 1964), (c), or (e).

(5) The provisions of this paragraph may be illustrated by the following examples:

Example 1. A taxpayer owns one tract of land under which lie three separate and distinct seams of coal. Therefore, the taxpayer owns three separate mineral interests each of which constitutes a separate property.

Example 2. A taxpayer conducts mining operations on eight tracts of land as a single unit. He acquired his interests in each of the eight tracts from separate owners. Even if each tract of land contains part of the same mineral deposit, the taxpayer owns eight separate mineral interests each of which constitutes a separate property.

Example 3. A taxpayer owns a tract of land under which lies one mineral deposit. The taxpayer operates a well on part of the tract and leases to another operator the mineral rights in the remainder retaining a royalty interest therein. The taxpayer thereafter owns two separate mineral interests each of which constitutes a separate property.

Example 4. In 1954, a taxpayer acquires from a single owner, in a single deed, three noncontiguous tracts of mineral land for a single consideration. Even if each tract contains part of the same mineral deposit, the taxpayer owns three separate mineral interests each of which constitutes a separate property.

Example 5. In 1954, taxpayer A simultaneously acquires in fee two contiguous tracts of mineral land from two separate owners. The same mineral deposit underlies both tracts. Thereafter, taxpayer A owns two separate mineral interests each of which constitutes a separate property.

Example 6. Assume that in 1955, taxpayer A, in example 5, leases the two contiguous tracts of mineral land that he acquired in 1954 to taxpayer B by means of a single lease. Thereafter, taxpayer B owns one mineral interest which constitutes a separate property for such time as the lease continues in existence.

Example 7. Assume that in 1955, taxpayer A, in example 5, sells at the same time all the mineral land he acquired in 1954 to taxpayer B. Thereafter, taxpayer B owns one mineral interest which constitutes a separate property. If taxpayer B acquires the mineral land in a transaction in which the basis of such mineral land in his hands is determined by reference to the basis of such mineral land in the hands of taxpayer A, then taxpayer B owns two separate mineral interests each of which constitutes a separate property.

Example 8. In 1954, taxpayer A simultaneously acquires two contiguous leasehold interests from two separate owners. The same mineral deposit underlies both tracts. Thereafter, taxpayer A owns two separate mineral interests each of which constitutes a separate property.

Example 9. In 1955, taxpayer A, in example 8, simultaneously assigns the two leases to taxpayer B. Thereafter, taxpayer B owns two separate mineral interests each of which constitutes a separate property.

(b) *Separation of interests treated as single property* under prior regulations. Each separate mineral interest which, in accordance with paragraph (a) of this section, is a separate property shall be so treated, notwithstanding the fact that the taxpayer under paragraph (i) of § 39.23(m)–1 of this chapter (Regulations 118) and corresponding provisions of prior regulations may have treated more than one of such interests as a *single property*. The basis of each such separate property must be established by a reasonable method. See, however, section 614 (b) and (d) (as they existed prior to amendment by section 226 of the Revenue Act of 1964), section 614 (c) and (e), and §§ 1.614–2, 1.614–3, 1.614–4, and 1.614–5 for special rules relating to the treatment of two or more separate mineral interests as a single property.

(c) *Treatment of a waste bank or residue.* A waste bank or residue of prior mining, the extraction of ores or minerals from which is treated as mining under section 613(c)(3), shall not be considered to be a separate mineral deposit but is a part of the mineral deposit from which it was extracted. However, if the owner of such waste bank or residue has disposed of the deposit from which the waste bank or residue was accumulated, or if the waste bank or residue cannot practicably be attributed to a particular deposit of the owner, the waste bank or residue will be regarded as a separate deposit.

[T.D. 6524, 26 FR 147, Jan. 10, 1961, as amended by T.D. 6859, 30 FR 13699, Oct. 28, 1965; T.D. 7261, 38 FR 5467, Mar. 1, 1973]

§ 1.614–2 Election to aggregate separate operating mineral interests under section 614(b) prior to its amendment by Revenue Act of 1964.

(a) *General rule.* (1) The provisions of this section relate to the election, under section 614(b) prior to its amendment by section 226(a) of the Revenue Act of 1964, to aggregate separate operating mineral interests, and, unless otherwise indicated, all references in this section to section 614(b) or any paragraph or subparagraph thereof are references to section 614(b) or a paragraph or subparagraph thereof as it existed prior to such amendment. Notwithstanding the preceding sentence, the definitions contained in paragraphs (b) and (c) of this section shall apply both before and after such amendment. All references in this section to section 614(d) are references to section 614(d) as it existed prior to its amendment by section 226(b)(3) of the Revenue Act of 1964.

(2) A taxpayer who owns two or more separate operating mineral interests, which constitute part or all of an operating unit, may elect under section 614(b) and this section to form one aggregation of any two or more of such operating mineral interests and to treat such aggregation as one property. Any operating mineral interest which the taxpayer does not elect to include within the aggregation within the time prescribed in paragraph (d) of this section shall be treated as a separate property. The aggregation of separate properties which results from exercising the election shall be considered as one property for all purposes of subtitle A of the Code. The preceding sentence does not preclude the use of more than one account under a single method of computing depreciation or the use of more than one method of computing depreciation under section 167, if otherwise proper. Any reasonable and consistently applied method or methods of computing depreciation of the improvements made with respect to the separate properties aggregated may be continued in accordance with section 167 and the regulations thereunder. Operating interests in different minerals which comprise part or all of the same operating unit may be included in the aggregation. It is not necessary for purposes of the aggregation that the separate operating mineral interests be included in a single tract or parcel of land or in contiguous tracts or parcels of land so long as such interests are a part of the same operating unit. Under section 614(b), a taxpayer cannot elect to form more than one aggregation of separate operating mineral interests within one operating unit. For definitions of *operating mineral interest* and *operating unit* see respectively paragraphs (b) and (c) of this section.

(b) *Operating mineral interest defined.* The term *operating mineral interest* means a separate mineral interest as described in section 614(a), in respect of which the costs of production are required to be taken into account by the taxpayer for purposes of computing the limitation of 50 percent of the taxable income from the property in determining the deduction for percentage depletion computed under section 613, or such costs would be so required to be taken into account if the mine, well, or other natural deposit were in the production stage. The term does not include royalty interests or similar interests, such as production payments or net profits interests. For the purpose of determining whether a mineral interest is an operating mineral interest, *costs of production* do not include intangible drilling and development costs, exploration expenditures under section 615, or development expenditures under section 616. Taxes, such as production taxes, payable by holders of nonoperating interests are not considered costs of production for this purpose. A taxpayer may not aggregate operating mineral interests and nonoperating mineral interests such as royalty interests.

(c) *Operating unit defined.* (1) The term *operating unit* refers to the operating mineral interests which are operated together for the purpose of producing minerals. An *operating unit* of a particular taxpayer must be determined on the basis of his own operations. It is recognized that operating units may not be uniform in the various natural resources industries or in any one of the natural resources industries, such as coal, oil and gas, and the like. As to a particular taxpayer, business reasons may require the formation of operating units that vary in size and content. The term *operating unit* refers to a producing unit, and not to an administrative or sales organization. Among the factors which indicate that mineral interests are operated together as a unit are:

(i) Common field or operating personnel,

(ii) Common supply and maintenance facilities,

(iii) Common processing or treatment plants, and

(iv) Common storage facilities.

However, operating mineral interests which are geographically widespread may not be treated as parts of the same operating unit merely because a single set of accounting records, a single executive organization, or a single sales force is maintained by the taxpayer with respect to such interests, or merely because the products of such interests are processed at the same treatment plant.

(2) If aggregated, an undeveloped operating mineral interest shall be aggregated only with those interests with which it will be operated as a unit when it reaches the production stage.

(3) While a taxpayer may operate an operating mineral interest through an agent, a coowner may aggregate only his operating mineral interests that are actually operated as a unit. For example, if A owned and actually operated the entire working interest in lease X and also owned an undivided fraction of lease Y in which B owned the remaining interest and which B actually operated as a unit with lease Z, A may not aggregate his interest in lease X with his undivided interest in lease Y, since they are not actually operated as a unit.

(4) The determination of the taxpayer as to what constitutes an operating unit is to be accepted unless there is a clear and convincing basis for a change in such determination.

(d) *Manner and scope of election*— (1) *Election; when made.* (i) Except as provided in subparagraph (2)(ii) of this paragraph, the election under section 614(b) and paragraph (a) of this section to treat an mineral interest as part of an aggregation shall be made not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof), for whichever of the following taxable years is the later:

(a) The first taxable year beginning after December 31, 1953, and ending after August 16, 1954, or

(b) The first taxable year in which any expenditure for exploration, development, or operation in respect of the separate operating mineral interest is made by the taxpayer after the acquisition of such interest.

See, however, paragraph (c) of § 1.614–6 as to the binding effect of an election where the basis of a separate operating mineral interest in the hands of the taxpayer is determined by reference to the basis in the hands of a transferor. The election under section 614(b) may not be made with respect to any taxable year beginning after December 31, 1957, except in the case of oil and gas wells. See paragraph (e) of this section for rules with respect to the termination of the election under section 614(b) except in the case of oil and gas wells. If an expenditure has been made in respect of a separate operating mineral interest, it is immaterial whether or not any proven deposit has been discovered with respect to such interest when such expenditure has been made. The provisions of this subdivision may be illustrated by the following example:

Example. Taxpayer A is producing from an oil and gas horizon and in 1958 he drills for the purpose of locating a deeper horizon which will be operated in the same operating unit as the upper producing horizon. At the end of the taxable year 1958 he has expended $50,000 drilling for the purpose of locating a deeper horizon although at such time there is no assurance that such a horizon will be found. If taxpayer A desires to aggregate the deeper horizon, if found, with the upper horizon under section 614(b), he must elect to do so in his return for 1958. If the election to aggregate the upper and lower horizons as one property is made, the drilling expenditures with respect to the prospective lower horizon must be taken into account along with the income and expenses with respect to the upper producing horizon in computing the depletion allowance on the aggregated property.

However, where expenditures for development of, or production from, a particular mineral deposit result in the discovery of another mineral deposit, the election with respect to such other deposit shall be made for the taxable year in which it is discovered and not for the taxable year in which the expenditures were first made which resulted in such discovery.

(ii) Except in the case of oil and gas wells, if a taxpayer fails to make an election under section 614(b) to aggregate a particular operating mineral interest on or before the time prescribed for the making of such election, such interest will be treated as if an election had been made under section 614(b) to treat it as a separate property and it cannot be included in any aggregation within the operating unit of which it is a part unless the taxpayer obtains the consent of the Commissioner. However, where the taxpayer owns more than one property within an operating unit, but has elected to treat such properties separately and one or more additional operating mineral interests are subsequently acquired, any one or more of the latter may be aggregated with one of the existing separate properties within the operating unit but not with more than one of them since they cannot be validly aggregated with each other.

(iii) In the case of oil and gas wells, if the taxpayer fails to make an election under section 614(b) with respect to a particular operating mineral interest on or before the time prescribed for the making of such election, the taxpayer shall be deemed to have treated such interest under the provisions of section 614(d). See section 614(d) and §1.614–4.

(iv) For purposes of section 614(b), the acquisition of an option to acquire an economic interest in minerals in place does not constitute the acquisition of a mineral interest. Thus, a taxpayer who makes expenditures for the exploration of minerals on a particular tract under an option to acquire an economic interest in minerals in place is not required to make an election with respect to such interest at that time. Furthermore, the election need not be made in the taxable year in which payments are made for the acquisition of a lease, such as the payment of a bonus, unless exploratory, development, or operation expenditures are made thereafter with respect to the property in that year.

(2) *Election; how made.* (i) The election under section 614(b) must be made by a statement attached to the income tax return of the taxpayer for the first taxable year for which the election is made. This statement shall indicate that the taxpayer is making an aggregation of separate operating mineral interests within an operating unit under section 614(b) and shall contain a description of the aggregation and describe the operating mineral interests within the operating unit which are to be treated as separate properties apart from the aggregation. A general description, accompanied by maps appropriately marked, which accurately circumscribes the scope of the aggregation and identifies the properties which are to be treated separately will be sufficient. The statement shall also contain a description of the operating unit in sufficient detail to show that the aggregated operating mineral interests are properly within a single operating unit. See paragraph (c) of this section. The taxpayer shall maintain adequate records and maps in support of the above information. In the event expenditures are first made on an operating mineral interest within an operating unit after an election with respect to the aggregation of interests in that operating unit has been made, the taxpayer shall furnish only information describing such operating mineral interest, its location in the operating unit, and whether it is to be included within the aggregation.

(ii) If the taxpayer made or did not make the election under section 614(b) with respect to a particular operating mineral interest and the last day prescribed by law for filing the return (including extensions of time therefor) on which the election was required to be made falls on or before May 1, 1961, consent is hereby given to the taxpayer to make or change the election not later than May 1, 1961. Any such election or change of such election shall be effective with respect to the earliest taxable year to which the election is applicable in respect of which assessment of a deficiency or credit or refund of an overpayment, as the case may be, resulting from such election or change is not prevented by any law or rule of law on the date such election or change is made. An election or change of election made pursuant to this subdivision shall be binding upon the taxpayer for the first taxable year for which it is effective and for all subsequent taxable years unless consent to a different treatment is obtained from the Commissioner. (See, however, paragraph (e) of this section for rules relating to the termination and nonapplicability of the election under section 614(b) except in the case of oil and gas wells.) Such election or change shall be made in the form of a statement setting forth the nature of the election or change, including information substantially the same as that required by subdivision (i) of this subparagraph, and shall be accompanied by an amended return or returns if necessary or, if appropriate, a claim for refund or credit. The appropriate documents must be filed on or before May 1, 1961 with the district director for the district in which the original return was filed.

(3) *Election; when effective.* If a taxpayer has elected to aggregate an operating mineral interest, the date on which the aggregation becomes effective is the earliest date within the taxable year affected, on which the taxpayer incurred any expenditure for exploration, development, or operation of such interest. The application of this rule may be illustrated by the following examples:

Example 1. In 1953, a taxpayer owned and operated mineral interests Nos. 1, 2, and 3. All three interests form one operating unit. The taxpayer, who files his return on a calendar year basis, continued to own and operate these interests during the year 1954, and in his return for that year, filed on April 15, 1955, elected to aggregate these three interests. As the result of this election, the aggregation was effective for all purposes of subtitle A of the Code as of January 1, 1954.

Example 2. Assume that, on March 1, 1955, the taxpayer described in example 1 acquired operating mineral interest No. 4 which was also a part of the operating unit composed of operating mineral interests Nos. 1, 2, and 3, that he made his first expenditure for exploration with respect to operating mineral interest No. 4 on September 1, 1955, and that, in his return filed on April 15, 1956, he elected to aggregate operating mineral interest No. 4 with the aggregation consisting of Nos. 1, 2, and 3. As the result of that election, operating mineral interest No. 4 became a part of the aggregation for all purposes of subtitle of the Code on September 1, 1955.

(4) *Election; binding effect.* A valid election made under section 614(b) and this section shall be binding upon the taxpayer for the taxable year for which made and all subsequent taxable years unless consent to make a change is obtained from the Commissioner. However, see paragraph (e) of this section for rules with respect to the termination of the election under section 614(b) except in the case of oil and gas wells. For rules relating to the binding effect of an election where the basis of a separate or an aggregated property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, see paragraph (c) of §1.614–6. A taxpayer can neither include within the aggregation a separate operating mineral interest which he had previously elected to treat separately, nor exclude from the aggregation a separate operating mineral interest previously included therein unless consent to do so is obtained from the Commissioner. A change in tax consequences alone is not sufficient to obtain consent to change the treatment of an operating mineral interest. However, consent may be appropriate where, for example, there has been a substantial change in the taxpayer's operations so that a major part of an aggregation becomes a part of another operating unit. Applications for consent shall be made in writing to the Commissioner of Internal Revenue, Washington, DC 20224. The application must be accompanied by a statement indicating the reason or reasons for the change and furnishing the information required under subdivision (i) of subparagraph (2) of this paragraph, unless such information has been previously filed and is current.

(5) *Invalid aggregations*—(i) *In general.* In addition to aggregations which are invalid under section 614(b) because of the failure to make timely elections, aggregations may be invalid under such section in situations which may be divided into two general categories. The first category involves basic aggregations which were timely but otherwise initially invalid. The second category involves invalid additions of operating mineral interests to basic aggregations which additions became subject to the election in years subsequent to the year in which the initial basic aggregation or aggregations were formed.

(ii) *Invalid basic aggregations.* The term *invalid basic aggregations* refers to those aggregations which are initially invalid. Generally, such basic aggregations will be invalid because more than one aggregation has been formed within an operating unit or because operating mineral interests in two or more operating units have been improperly aggregated. For any year in which an invalid basic aggregation exists, each operating mineral interest included in such aggregation shall be treated for all purposes as a separate property unless consent is obtained from the Commissioner to treat any such interest in a different manner. Consent will be granted in appropriate cases as, for example, where the taxpayer demonstrates that he inadvertently formed an invalid basic aggregation. The provisions of this subdivision may be illustrated by the following examples:

Example 1. In 1953, taxpayer A owned six operating mineral interests, designated No. 1 through No. 6, and he continued to own and operate such interests during 1954. He acquired no other operating mineral interests during such year. All six of these operating mineral interests form one operating unit. Assume that A elected under section 614(b) to aggregate operating mineral interests Nos. 1 through 3 into one aggregation and Nos. 4 through 6 into another aggregation. Since A has formed two aggregations in one operating unit, they are invalid basic aggregations. Therefore, interests Nos. 1 through 6 must be treated as separate properties for 1954 and all subsequent taxable years unless consent is obtained from the Commissioner to treat any of such interests in a different manner.

Example 2. Assume the same facts as in example 1 and assume also that, in his return for 1954, A correctly elected to aggregate all six operating mineral interests into one aggregation under section 614(b). Assume further that all these operating mineral interests continued to be in one operating unit for the years 1954, 1955, and 1956 but that, because of changes in the facts and circumstances of A’s operations, in 1957 operating mineral interests Nos. 1, 2, and 3 became a part of one operating unit and Nos. 4, 5, and 6 became a part of another operating unit. Notwithstanding the change in operations, the election made by A shall continue to be binding unless consent to change such election is obtained from the Commissioner.

(iii) *Invalid additions.* The term *additions* refers to the additions that a taxpayer makes by electing to aggregate an operating mineral interest with an aggregation formed in a previous year. Such additions will be invalid where the taxpayer either elected to aggregate an operating mineral interest with an invalid basic aggregation or elected to aggregate an operating mineral interest which is part of one operating unit with an aggregation of operating mineral interests which is a part of another operating unit. An operating mineral interest which is invalidly added to either a valid basic aggregation or to an invalid basic aggregation shall be considered as a separate property unless consent is obtained from the Commissioner to treat such interest in a different manner. The following are examples of invalid additions:

Example 1. In 1953, taxpayer A owned six operating mineral interests designated No. 1 through No. 6 and he continued to own and operate such interests during 1954. He acquired no other operating mineral interests during that year. Nos. 1 through 3 formed one operating unit and Nos. 4 through 6 formed another operating unit. In his return for 1954, A incorrectly elected to aggregate all six operating mineral interests into one aggregation under section 614(b). In 1955, A acquired and commenced development of operating mineral interest No. 7 which is correctly a part of the operating unit of which operating mineral interests Nos. 1, 2, and 3 are a part. A elected under section 614(b), for the year 1955, to aggregate operating mineral interest No. 7 with the invalid basic aggregation composed of Nos. 1 through 6. Since operating mineral interest No. 7 was aggregated with an invalid basic aggregation, it is an invalid addition and must be treated as a separate property unless consent is obtained from the Commissioner to treat it in a different manner.

Example 2. In 1953, taxpayer A owned nine operating mineral interests designated No. 1 through No. 9. During 1954, he continued to own and operate such interests and acquired no other operating mineral interest. Interests No. 1 through No. 3 form one operating unit, Nos. 4 through 6 form another operating unit, and Nos. 7 through 9 form a third operating unit. For the year 1954, A elected under section 614(b) to aggregate operating mineral interests Nos. 1, 2, 3, and 4 into one aggregation, to treat Nos. 5 and 6 as separate properties, and to aggregate Nos. 7, 8, and 9 into another aggregation. Assume that in 1955 A acquired and commenced development of operating mineral interest No. 10 which was a part of the operating unit composed of Nos. 1, 2, and 3. Assume further that he elected under section 614(b) to aggregate No. 10 with the aggregation composed of Nos. 7, 8, and 9. This would be an invalid addition to a valid basic aggregation since operating mineral interest No. 10 was not properly a part of the operating unit formed by Nos. 7, 8, and 9. Therefore, interest No. 10 must be treated as a separate property for 1955 and all subsequent taxable years unless consent is obtained from the Commissioner to treat it in a different manner. However, the valid basic aggregation composed of interests Nos. 7 through 9 is not affected by the invalid addition of interest No. 10.

Example 3. Assume the same facts as in example 2 except that A elected under section 614(b) in 1955 to aggregate No. 10 with the aggregation of Nos. 1 through 4. This would also be an invalid addition because the aggregation composed of Nos. 1 through 4 is an invalid basic aggregation since operating mineral interest No. 4 is not a part of the operating unit consisting of Nos. 1, 2, and 3. Therefore, interest No. 10 must be treated as a separate property for 1955 and all subsequent taxable years unless consent is obtained from the Commissioner to treat such interest in a different manner.

(e) *Termination of election*—(1) *Taxable years beginning after December 31, 1963, in the case of oil and gas wells.* In the case of oil and gas wells, the election provided for under section 614(b) and paragraph (a) of this section to form an aggregation of separate operating mineral interests shall not apply with respect to any taxable year beginning after December 31, 1963. In addition, if a taxpayer treated certain separate operating mineral interests in a single tract or parcel of land as separate rather than as an aggregation and decides to continue such treatment for taxable years beginning after December 31, 1963, he must make an appropriate election under section 614(b) as amended by the Revenue Act of 1964. See § 1.614–8.

(2) *Taxable years beginning after December 31, 1957, in the case of mines.* Except in the case of oil and gas wells, the election provided for under section 614(b) and paragraph (a) of this section to form an aggregation of separate operating mineral interests shall not apply with respect to any taxable year beginning after December 31, 1957. Thus, if a taxpayer makes a binding election under section 614(b) to form an aggregation of separate operating mineral interests within an operating unit for taxable years beginning before January 1, 1958, he must make a new election for the first taxable year beginning after December 31, 1957, under section 614(c) within the time prescribed in § 1.614–3 if he wishes to aggregate any separate operating mineral interests within such operating unit. A new election must be made under section 614(c) notwithstanding the fact that the aggregation formed under section 614(b) would constitute a valid aggregation under section 614(c). Failure to make such an election within the time prescribed shall constitute an election to treat each separate operating mineral interest within the operating unit as a separate property for taxable years beginning after December 31, 1957.

(3) *Taxable years beginning before January 1, 1958, in the case of mines.* An election made under section 614(b) and paragraph (a) of this section to form an aggregation of separate operating mineral interests within a particular operating unit shall not apply with respect to any taxable year beginning prior to January 1, 1958, for which the taxpayer makes an election under section 614(c)(3)(B) and paragraph (f)(2) of § 1.614–3 which is applicable to any separate operating mineral interest within the same operating unit. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. In 1953, taxpayer A owned six separate operating mineral interests, designated No. 1 through No. 6, which he operated as a unit. Operating mineral interests Nos. 1 through 5 comprise a mine, and operating mineral interest No. 6 represents one mineral deposit in a single tract of land which is being extracted by means of two mines. Taxpayer A previously made a binding election under section 614(b) to aggregate operating mineral interests Nos. 1 through 5 and to treat operating mineral interest No. 6 as a separate property. Under section 614(c)(2) and (3)(B) taxpayer A makes an election which is applicable for the taxable year 1954 and all subsequent taxable years to treat operating mineral interest No. 6 as two separate operating mineral interests. Therefore, the previous election of taxpayer A to aggregate operating mineral interests Nos. 1 through 5 under section 614(b) does not apply. Unless taxpayer A also makes an election to aggregate operating mineral interests Nos. 1 through 5 as one property under section 614(c)(1) and (3)(B) within the time prescribed in paragraph (f)(2) of § 1.614–3, he shall be deemed to have made an election to treat each of such interests as a separate property for 1954 and all subsequent taxable years.

Example 2. In 1953, taxpayer B owned six separate operating mineral interests, designated No. 1 through No. 6, which he operated as a unit. Operating mineral interests Nos. 1 through 3 comprise a mine and Nos. 4 through 6 comprise a second mine. Taxpayer B previously made a binding election under section 614(b) to aggregate operating mineral interests Nos. 1 through 8 and to treat Nos. 4 through 6 as separate properties. Under section 614(c) (1) and (3)(B) taxpayer B makes an election which is applicable for the taxable year 1954 and all subsequent taxable years to aggregate operating mineral interests Nos. 4 through 6 as one property. The previous election of the taxpayer under section 614(b) to aggregate operating mineral interests Nos. 1 through 3 does not apply even though such aggregation would constitute a valid aggregation if formed under section 614(c)(1). Therefore, if taxpayer B wishes to continue to treat operating mineral interests Nos. 1 through 3 as one property, he must also make an election to do so under section 614(c) (1) and (3)(B) within the time prescribed in paragraph (f)(2) of §1.614–3.

(4) *Bases of separate operating mineral interests.* If an aggregation formed under section 614(b) is terminated by reason of the provisions of section 614(b)(4)(A), is terminated under section 614(b)(4)(B) for any taxable year after the first taxable year to which the election under section 614(b) applies, or is terminated by reason of the provisions of section 614(b) as amended by the Revenue Act of 1964, the bases of the separate operating mineral interests (and combinations thereof) included in such aggregation shall be determined in accordance with the rules contained in paragraph (a)(2) of §1.614–6 as of the first day of the first taxable year for which the termination is effective. However, if by reason of the provisions of section 614(b)(4)(B), an election to aggregate under section 614(b) does not apply for any taxable year for which such election was made, the bases of the separate operating mineral interests included in the aggregation formed under section 614(b) shall be determined without regard to the election under section 614(b).

(f) *Alternative treatment of separate operating mineral interests in the case of oil and gas wells.* For rules relating to an alternative treatment of separate operating mineral interests in the case of oil and gas wells, see §1.614–4.

[T.D. 6524, 26 FR 147, Jan. 10, 1961, as amended by T.D. 6859, 30 FR 13700, Oct. 28, 1965]

§1.614–3 Rules relating to separate operating mineral interests in the case of mines.

(a) *Election to aggregate separate operating mineral interests*—(1) *General rule.* Except in the case of oil and gas wells, a taxpayer who owns two or more separate operating mineral interests, which constitute part or all of the same operating unit, may elect under section 614(c)(1) and this paragraph to form an aggregation of all such operating mineral interests which comprise any one mine or any two or more mines and to treat such aggregation as one property. The aggregated property which results from the exercise of such election shall be considered as one property for all purposes of subtitle A of the Code. The preceding sentence does not preclude the use of more than one account under a single method of computing depreciation or the use of more than one method of computing depreciation under section 167, if otherwise proper. Any reasonable and consistently applied method or methods of computing depreciation of the improvements made with respect to the separate properties aggregated may be continued in accordance with section 167 and the regulations thereunder. It is not necessary for purposes of the aggregation that the separate operating mineral interests be included in a single tract or parcel of land or in contiguous tracts or parcels of land so long as such interests constitute part or all of the same operating unit. A taxpayer may elect to form more than one aggregation of separate operating mineral interests within one operating unit so long as each aggregation consists of all the separate operating mineral interests which comprise any one mine or any two or more mines. Thus, no aggregation may include any separate operating mineral interest which is a part of a mine without including all of the separate operating mineral interests which comprise such mine in the first taxable year for which the election to aggregate is effective. Any separate operating mineral interest which becomes a part of such mine in a subsequent taxable year must also be included in such aggregation as of the taxable year that such interest becomes a part of such mine. The taxable year in which such interest becomes a part of such mine shall be determined upon the basis of the facts and circumstances of the particular case. If a taxpayer fails to make an election under this paragraph to aggregate a particular operating mineral interest (other than an interest which becomes a part of a mine with respect to which the interests have been aggregated in a prior taxable year) on or before the last day prescribed for making such an election, such interest shall be treated as if an election had been made to treat it as a separate property. A taxpayer may not aggregate operating mineral interests and nonoperating mineral interests such as royalty interests. For definitions of the terms *operating mineral interest, operating unit,* and *mine,* see respectively paragraphs (c), (d), and (e) of this section.

(2) *Aggregation in subsequent taxable years.* If the taxpayer has made an election under section 614(c)(1) for a particular taxable year with respect to any operating mineral interest or interests within a particular operating unit, and if, for a subsequent taxable year, the taxpayer desires to make an election with respect to an additional operating mineral interest within the same operating unit, then whether or not the taxpayer may elect to include such additional interest in an aggregation or treat it as a separate property depends upon the nature of such additional interest and of the taxpayer's previous elections. If the additional interest is a part of a mine with respect to which the other interests have been aggregated, the additional interest must be included in such aggregation. If the additional interest is a part of a mine with respect to which the other interests have been treated as separate properties, the additional interest must be treated as a separate property. If the additional interest is part of a mine which previously consisted of only a single interest which has not been aggregated with any other mine, such additional interest may be aggregated or treated as a separate property. If the additional interest is an entire mine, it may, at the election of the taxpayer, (i) be added to any aggregation within the same operating unit, (ii) be aggregated with any other single interest which is an entire mine provided both interests are within the same operating unit even though such single interest has previously been treated as a separate property, or (iii) be treated as a separate property.

(b) *Election to treat a single operating mineral interest as more than one property*—(1) *General rule.* Except in the case of oil and gas wells, a taxpayer who owns a separate operating mineral interest in a mineral deposit in a single tract or parcel of land may elect under section 614(c)(2) and this paragraph to treat such interest as two or more separate operating mineral interests if such mineral deposit is being developed or extracted by means of two or more mines. In order for this election to be applicable, there must be at least two mines with respect to each of which an expenditure for development or operation has been made by the taxpayer. The election under section 614(c)(2) may also be made with respect to a separate operating mineral interest formed by a previous election under section 614(c)(2) at such time as the mineral deposit previously allocated to such interest is being developed or extracted by means of two or more mines. If there is more than one mineral deposit in a single tract or parcel of land, an election under section 614(c)(2) with respect to any one of such mineral deposits has no application to the other mineral deposits. The election under section 614(c)(2) may not be made with respect to an aggregated property or with respect to any operating mineral interest which is a part of any aggregation formed by the taxpayer unless the taxpayer obtains consent from the Commissioner. Such consent will not be granted where the principal purpose for the request to make the election is based on tax consequences. Application for such consent shall be made in writing to the Commissioner of Internal Revenue, Washington, DC 20224. The application must be accompanied by a statement setting forth in detail the reason or reasons for the request to exercise the election with respect to an aggregated property.

(2) *Allocation of mineral deposit.* If the taxpayer elects to treat a separate operating mineral interest in a mineral deposit in a single tract or parcel of land as more than one separate operating mineral interest, then all of such mineral deposit therein and all of the portion of the tract or parcel of land allocated thereto must be allocated to the newly formed separate operating mineral interests. A portion of such mineral deposit and such tract or parcel of land must be allocated to each such newly formed separate operating

mineral interest. There must be at least one mine, with respect to which an expenditure for development or operation has been made by the taxpayer, with respect to each such portion. The extent of the portion to be allocated to each newly formed separate operating mineral interest is to be determined upon the basis of the facts and circumstances of the particular case.

(3) *Basis of newly formed separate operating mineral interests.* The adjusted basis of each of the separate operating mineral interests formed by the making of the election under section 614(c)(2) shall be determined by apportioning the adjusted basis of the separate operating mineral interest with respect to which such election was made between (or among) the newly formed separate operating mineral interests in the same proportion as the fair market value of each such newly formed interest (as of the date on which the election becomes effective) bears to the total fair market value of the interest with respect to which the election was made as of such date.

(4) *Aggregation of newly formed separate operating mineral interests.* Any separate operating mineral interest formed by the making of the election under section 614(c)(2) may be included as a part of an aggregation subject to the requirements of paragraph (a) of this section, provided that the time for making the election under section 614(c)(1) to include such separate operating mineral interest in such aggregation has not expired. See paragraph (f) of this section. The provisions of this subparagraph may be illustrated by the following example:

Example. In 1958, taxpayer A acquired two separate operating mineral interests designated No. 1 and No. 2. Each is an interest in a single mineral deposit in a single tract of land. In the same year, taxpayer A made his first development expenditure with respect to a mine on operating mineral interest No. 1 and a mine on operating mineral interest No. 2. Operating mineral interests Nos. 1 and 2 are operated as a unit. Taxpayer A did not elect to aggregate operating mineral interests Nos. 1 and 2 under section 614(c)(1) within the time prescribed for making such an election. In 1960 taxpayer A made his first development expenditure with respect to a second mine on operating mineral interest No. 2. Taxpayer A elected under section 614(c)(2) to treat operating mineral interest No. 2 as two separate operating mineral interests, designated as Nos. 2(a) and 2(b), for the taxable year 1960 and all subsequent taxable years. No. 2(a) contained the mine for which the first development expenditure was made in 1958, and No. 2(b) contained the mine for which the first development expenditure was made in 1960. If taxpayer A wishes to do so, he may elect to aggregate mineral interests Nos. 1 and 2(b) under section 614(c)(1) for the taxable year 1960 and all subsequent taxable years since the first development expenditure with respect to the mine on operating mineral interest No. 2(b) was made during the taxable year 1960. Taxpayer A may not elect to aggregate mineral interests Nos. 1 and 2(a) under such section since the time for making such an election has expired.

(c) *Operating mineral interest defined.* For the definition of the term *operating mineral interest* as used in this section, see paragraph (b) of §1.614–2.

(d) *Operating unit defined.* For the definition of the term *operating unit* as used in this section, see paragraph (c) of §1.614–2.

(e) *Mine defined.* For purposes of this section, the term *mine* means any excavation or other workings or series of related excavations or related workings, as the case may be, for the purpose of extracting any known mineral deposit except oil and gas deposits. For the purpose of the preceding sentence, the term *excavations* or *workings* includes quarries, pits, shafts, and wells (except oil and gas wells). The number of excavations or workings that constitute a mine is to be determined upon the basis of the facts and circumstances of the particular case such as the nature and position of the mineral deposit or deposits, the method of mining the mineral, the location of the excavations or other workings in relation to the mineral deposit or deposits, and the topography of the area. The determination of the taxpayer as to the composition of a mine is to be accepted unless there is a clear and convincing basis for a change in such determination.

(f) *Manner and scope of election*—(1) *Election to apply section 614(c) (1) and (2) for taxable years beginning after December 31, 1957.* Except as provided in subparagraphs (2) and (3) of this paragraph, the election under section

614(c)(1) and paragraph (a) of this section to treat an operating mineral interest as part of an aggregation shall be made under section 614(c)(3)(A) not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for whichever of the following taxable years is the later:

(i) The first taxable year beginning after December 31, 1957, or

(ii) The first taxable year in which any expenditure for development or operation in respect of the separate operating mineral interest is made by the taxpayer after the acquisition of such interest.

Except as provided in subparagraphs (2) and (3) of this paragraph, the election under section 614(c)(2) and paragraph (b) of this section to treat a single operating mineral interest as more than one operating mineral interest shall be made under section 614(c)(3)(A) not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for whichever of the following taxable years is the later:

(iii) The first taxable year beginning after December 31, 1957, or

(iv) The first taxable year in which expenditures for development or operation of more than one mine in respect of the separate operating mineral interest are made by the taxpayer after the acquisition of such interest.

However, if the latest time at which an election may be made under this subparagraph falls on or before May 1, 1961, such election may be made or modified at any time on or before May 1, 1961. See paragraph (c) of § 1.614–6 as to the binding effect of an election where the basis of a separate operating mineral interest in the hands of the taxpayer is determined by reference to the basis in the hands of a transferor.

(2) *Election to apply section 614(c) (1) and (2) for taxable years beginning before January 1, 1958.* In accordance with section 614(c)(3)(B), the election under section 614(c) (1) and paragraph (a) of this section to treat an operating mineral interest as part of an aggregation may, at the election of the taxpayer, be made not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for whichever of the following taxable years is the later:

(i) The first taxable year beginning after December 31, 1953, and ending after August 16, 1954, for which assessment of a deficiency or credit or refund of an overpayment, as the case may be, resulting from an election under section 614(c)(1), is not prevented on September 2, 1958, by the operation of any law or rule of law, or

(ii) The first taxable year in which any expenditure for development or operation in respect of the separate operating mineral interest is made by the taxpayer after the acquisition of such interest.

In accordance with section 614(c) (3)(B), the election under section 614(c)(2) and paragraph (b) of this section to treat an operating mineral interest as more than one operating mineral interest may, at the election of the taxpayer, be made not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for whichever of the following taxable years is the later:

(iii) The first taxable year beginning after December 31, 1953, and ending after August 16, 1954, for which assessment of a deficiency or credit or refund of an overpayment, as the case may be, resulting from an election under section 614(c)(2), is not prevented on September 2, 1958, by the operation of any law or rule of law, or

(iv) The first taxable year in which expenditures for development or operation of more than one mine in respect of the separate operating mineral interest are made by the taxpayer after the acquisition of such interest.

However, if the latest time at which an election may be made under this subparagraph falls on or before May 1, 1961, such election may be made or modified at any time on or before May 1, 1961. See paragraph (c) of § 1.614–6 as to the binding effect of an election where the basis of a separate operating mineral interest in the hands of the taxpayer is determined by reference to the basis in the hands of a transferor.

(3) *Limitation.* If the taxpayer makes an election under section 614(c) (1) or (2) in accordance with section 614(c)(3)(B) and subparagraph (2) of this

paragraph with respect to any operating mineral interest which constitutes part or all of an operating unit, such taxpayer may not make any election under section 614(c) (1) or (2) in accordance with section 614(c)(3)(A) and subparagraph (1) of this paragraph with respect to any operating mineral interest which constitutes part or all of such operating unit. The provisions of this subparagraph may be illustrated by the following example:

Example: In 1953, taxpayer A owned six separate operating mineral interests, designated No. 1 through No. 6, which he operated as a unit. Operating mineral interests Nos. 1 through 5 comprise a mine, and operating mineral interest No. 6 represents one mineral deposit in a single tract of land which is being extracted by means of two mines. In accordance with section 614(c)(3)(B) and subparagraph (2) of this paragraph, taxpayer A elects under section 614(c)(2) to treat operating mineral interest No. 6 as two separate operating mineral interests for the taxable year 1954 and all subsequent taxable years. Unless taxpayer A also makes an election under section 614(c)(1) to aggregate operating mineral interests Nos. 1 through 5 for the taxable year 1954 and all subsequent taxable years in accordance with section 614(c)(3)(B) and subparagraph (2) of this paragraph, he shall be deemed to have made an election to treat each of such interests as a separate property. Taxpayer A may not elect, under section 614(c) (1) and (3)(A), to aggregate operating mineral interests Nos. 1 through 5 for the taxable year 1958 or any subsequent taxable year.

(4) *Statute of limitations.* If the taxpayer makes any election in accordance with section 614(c)(3)(B) and subparagraph (2) of this paragraph and if assessment of any deficiency for any taxable year resulting from such election is prevented on May 1, 1961, or at any time within one year after such first day, by the operation of any law or rule of law, such assessment may, nevertheless, be made within one year after May 1, 1961. Any election by a taxpayer in accordance with section 614(c)(3)(B) shall constitute consent to the assessment of any deficiency resulting from any such election. If refund or credit of any overpayment of income tax resulting from any election made in accordance with section 614(c)(3)(B) is prevented on May 1, 1961, or at any time within one year after May 1, 1961, by the operation of any law or rule of law, refund or credit of such overpayment may, nevertheless, be made or allowed but only if claim therefor is filed within one year after May 1, 1961. This subparagraph shall not apply with respect to any taxable year of a taxpayer for which an assessment of a deficiency resulting from an election made in accordance with section 614(c)(3)(B) or a refund or credit of an overpayment resulting from any such election, as the case may be, is prevented by the operation of any law or rule of law on September 2, 1958.

(5) *Elections—how made*—(i) *General rule.* Except as provided in subdivision (ii) of this subparagraph, an election under section 614(c) (1) or (2) and paragraph (a) or (b) of this section must be made by a statement attached to the income tax return of the taxpayer for the first taxable year for which the election is made. The statement shall contain the following information:

(a) Whether the taxpayer is making an election or elections with respect to the operating unit in accordance with section 614(c)(3) (A) or (B);

(b) A description of the operating unit of the taxpayer in sufficient detail to identify the operating mineral interests which are included within such operating unit;

(c) A description of each aggregation to be formed within the operating unit in sufficient detail to show that each aggregation consists of all the separate operating mineral interests which comprise any one mine or any two or more mines;

(d) A description of each separate operating mineral interest within the operating unit which is to be treated as a separate property in sufficient detail to show that such interest is not a part of any mine for which an election to aggregate has been made;

(e) The taxable year in which the first expenditure for development or operation was made by the taxpayer with respect to each separate operating mineral interest within the operating unit, but if the first expenditure for development or operation has not been made with respect to a separate operating mineral interest before the close of the taxable year for which the election

under this section is made, such information should also be included;

(f) A description of each separate operating mineral interest within the operating unit which the taxpayer elects to treat as more than one such interest under section 614(c)(2) in sufficient detail to show that the separate operating mineral interest was not a part of an aggregation formed by the taxpayer under section 614(c)(1) for any taxable year prior to the taxable year for which the election under section 614(c)(2) is made, and to show that the mineral deposit representing the separate operating mineral interest is being developed or extracted by means of two or more mines;

(g) The taxable year in which the first expenditure for development or operation was made by the taxpayer with respect to each mine on the separate operating mineral interest that the taxpayer is electing to treat as more than one such interest; and

(h) The allocation of the mineral deposit representing the separate operating mineral interest between (or among) the newly formed interests and the method by which such allocation was made.

For the purpose of applying subdivisions *(e)* and *(g)* of this subdivision, if the first expenditure for development or operation with respect to a separate operating mineral interest or a mine was made prior to the first taxable year for which the election with respect to such interest or mine is applicable, the taxpayer may state that such is the case in lieu of identifying the exact taxable year in which such first expenditure was made. In any case where part of the information required under this subdivision can be adequately supplied by means of appropriately marked maps, the statement may be accompanied by such maps and may omit the required descriptive material to the extent replaced by the maps. The taxpayer shall maintain adequate records and maps in support of the above information. In the event that the first expenditure for development or operation with respect to a separate operating mineral interest is made by the taxpayer in a taxable year subsequent to the taxable year for which an election under this section has been made with respect to the operating unit of which such interest is a part, the taxpayer shall furnish information describing such interest in sufficient detail to identify it as a part of such operating unit, to show whether it is a part of a mine with respect to which the interests have previously been aggregated or have previously been treated as separate properties, and to indicate whether it is to be included within an aggregation.

(ii) *Special rule.* If the last day prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for the first taxable year for which an election under section 614(c) (1) or (2) is made falls before May 1, 1961, the statement of election or modification thereof for such taxable year must be filed on or before May 1, 1961, with the district director for the district in which such return was filed. The statement must contain the information as required in subdivision (i) of this subparagraph, must indicate the first taxable year for which the election contained therein is made, and shall be accompanied by an amended return or returns if necessary or, if appropriate, a claim for refund or credit.

(6) *Elections; when effective.* If the taxpayer has elected to form an aggregation under section 614(c)(1) and this section, the date on which the aggregation becomes effective is the first day of the first taxable year for which the election is made; except that if any separate operating mineral interest included in such aggregation was acquired after such first day, the date on which the inclusion of such interest in such aggregation becomes effective is the date of its acquisition. If the taxpayer elects to add another operating mineral interest to such aggregation for a subsequent taxable year, the date on which aggregation of the additional interest becomes effective is the first day of such subsequent taxable year or the date of acquisition of such interest, whichever is later. If an operating mineral interest is required to be included in the aggregation for a subsequent taxable year because such interest becomes a part of a mine which the taxpayer has previously elected to aggregate, the date on which the inclusion of

such interest in the aggregation becomes effective is the first day of the subsequent taxable year or the date of acquisition of such interest, whichever is later. If the taxpayer has elected to treat a separate operating mineral interest as more than one such interest, the date on which the election becomes effective is the first day of the first taxable year for which the election is made or the earliest date on which the first expenditure for development or operation has been made by the taxpayer with respect to a mine on each newly formed separate operating mineral interest, whichever is later.

(7) *Elections; binding effect.* A valid election under section 614(c) (1) or (2) whether made in accordance with section 614(c)(3) (A) or (B) shall be binding upon the taxpayer for the taxable year for which made and for all subsequent taxable years unless consent to change the treatment of an operating mineral interest with respect to which an election has been made is obtained from the Commissioner. For rules relating to the binding effect of an election where the basis of a separate or an aggregated property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, see paragraph (c) of §1.614–6. A taxpayer can neither include within an aggregation a separate operating mineral interest which he has previously elected to treat as a separate property, nor exclude from an aggregation a separate operating mineral interest which he has properly elected to include within such aggregation unless consent to do so is obtained from the Commissioner. A change in tax consequences alone is not sufficient to obtain consent to change the treatment of an operating mineral interest. However, consent may be appropriate where, for example, there has been a substantial change in the taxpayer's operations so that a major part of an aggregation becomes a part of another operating unit. Applications for consent shall be made in writing to the Commissioner of Internal Revenue, Washington, DC 20224. The application must be accompanied by a statement indicating the reason or reasons for the change and furnishing the information required in subparagraph (5)(i) of this paragraph, unless such information has been previously filed and is current.

(8) *Invalid aggregations*—(i) *General rule.* In addition to aggregations which are invalid under this section because of the failure to make timely elections, aggregations may be invalid under this section in situations which may be divided into two general categories. The first category involves invalid basic aggregations. The second category involves invalid additions to basic aggregations.

(ii) *Invalid basic aggregations.* The term *invalid basic aggregations* refers to aggregations which are initially invalid. Generally, a basic aggregation is initially invalid because it does not include all the separate operating mineral interests which comprise a complete mine or mines or because it includes separate operating mineral interests which are not part of the same operating unit. If the taxpayer makes an invalid basic aggregation, each of the separate operating mineral interests included in such aggregation shall be treated as a separate property for the first taxable year for which the election is made and for all subsequent taxable years unless consent is obtained from the Commissioner to treat any such interest in a different manner. Consent will be granted in appropriate cases. For example, assume that the taxpayer elects to form an aggregation of the operating mineral interests which comprise one or more complete mines. If the taxpayer demonstrates that he inadvertently failed to include a minor part of one of the aggregated mines or inadvertently included a minor part of another mine that is not a part of the aggregation, consent will ordinarily be granted to maintain the aggregation by including the part omitted or by excluding the part included. The provisions of this subdivision may be illustrated by the following examples:

Example 1. In 1958, taxpayer A owned ten operating mineral interests, designated No. 1 through No. 10, which he operated as a unit. Interests Nos. 1 through 5 comprised mine X, and interests Nos. 6 through 10 comprised mine Y. Taxpayer A had made his first development expenditure with respect to each of the ten interests before January 1, 1958. Taxpayer A elected under section 614(c) (1) and (3)(A) to aggregate interests Nos. 1 through 8 for 1958 and all subsequent taxable years. The aggregation formed by taxpayer A is an invalid basic aggregation because it does not include all the operating mineral interests which comprise a complete mine or mines. Therefore, interests Nos. 1 through 8 must be treated as separate properties for 1958 and all subsequent taxable years unless consent is obtained from the Commissioner to treat any of such interests in a different manner.

Example 2. In 1958, taxpayer B owned ten operating mineral interests designated No. 1 through No. 10. Interests Nos. 1 through 5 comprised mine X, and interests Nos. 6 through 10 comprised mine Y. Taxpayer B had made his first development expenditure with respect to each of the ten interests before January 1, 1958. Taxpayer B elected under section 614(c) (1) and (3)(A) to aggregate interests Nos. 1 through 10 for 1958 and all subsequent taxable years. Upon audit, it was determined that mines X and Y were in two separate operating units. Therefore, the aggregation formed by taxpayer B is invalid, and interests Nos. 1 through 10 must be treated as separate properties for 1958 and all subsequent taxable years unless consent is obtained from the Commissioner to treat any of such interests in a different manner.

(iii) *Invalid additions.* The term *invalid addition* refers to an operating mineral interest which is invalidly aggregated with an existing aggregation. Generally, an addition is invalid because it is a part of a mine and is aggregated with an aggregation which does not include other interests which are parts of the same mine, or because it is in one operating unit and is included as part of an aggregation which is in another operating unit. If an invalid addition is properly a part of a mine with respect to which other interests have been validly aggregated for a taxable year prior to the first taxable year for which the election to aggregate the invalid addition is made, then the invalid addition shall be included in the aggregation of which it is properly a part for such first taxable year and all subsequent taxable years. Any other invalid addition shall be treated as a separate property for the first taxable year for which the election to aggregate such addition is made and for all subsequent taxable years unless consent is obtained from the Commissioner to treat any such interest in a different manner. The provisions of this subdivision may be illustrated by the following examples:

Example 1. In 1958, taxpayer A owned six operating mineral interests, designated No. 1 through No. 6, which he operated as a unit. Interests Nos. 1 through 3 comprised mine X, and interests Nos. 4 through 6 comprised mine Y. Taxpayer A had made his first development expenditure with respect to each of the six interests before January 1, 1958. Taxpayer A elected under section 614(c) (1) and (3)(A) to aggregate interests Nos. 1 through 3 for 1958 and all subsequent taxable years. He elected to treat interests Nos. 4 through 6 as separate properties for 1958 and all subsequent taxable years. In 1959, taxpayer A acquired and made his first development expenditure with respect to interest No. 7. Interest No. 7 was a part of the mine composed of interests Nos. 4 through 6. Taxpayer A elected under section 614(c) (1) and (3)(A) to aggregate interest No. 7 with the aggregation of interests Nos. 1 through 3 for 1959 and all subsequent taxable years. Interest No. 7 is an invalid addition and must be treated as a separate property for 1959 and all subsequent taxable years. It cannot be aggregated with interests Nos. 4 through 6 since taxpayer A has previously elected to treat such interests as separate properties. However, the valid basic aggregation composed of interests Nos. 1 through 3 is not affected by the invalid addition of interest No. 7.

Example 2. Assume the same facts as in example 1 except that taxpayer A elected under section 614(c) (1) and (3)(A) to aggregate interests Nos. 1 through 3 as one aggregation and interests Nos. 4 through 6 as another aggregation for 1958 and all subsequent taxable years. The aggregation of interest No. 7 with the aggregation consisting of interests Nos. 1 through 3 constitutes an invalid addition. Interest No. 7 must be included in the aggregation consisting of interests Nos. 4 through 6 for 1959 and all subsequent taxable years.

Example 3. In 1958, taxpayer B owned three operating mineral interests, designated No. 1 through No. 3, which comprised mine X. Taxpayer B had made his first development expenditure with respect to each of the three interests before January 1, 1958. Taxpayer B elected under section 614(c) (1) and (3)(A) to aggregate interests Nos. 1 through 3 for 1958 and all subsequent taxable years. In 1959, taxpayer B acquired interests Nos. 4 through 7 which comprised mine Y. Taxpayer B made his first development expenditure with respect to each of the four interests during 1959. Taxpayer B elected under section 614(c) (1) and (3)(A) to aggregate interests Nos. 4 through 6 and to aggregate interest No. 7 with the aggregation consisting of interests Nos. 1 through 3 for 1959 and all subsequent taxable years. The aggregation consisting of interests Nos. 4 through 6 is an invalid basic aggregation, and the aggregation of interest No. 7 is an invalid addition. Interests Nos. 4 through 7 must be treated as separate properties for 1959 and all subsequent taxable years unless consent is obtained from the Commissioner to treat such interests in a different manner.

(g) *Special rule as to deductions under section 615(a) prior to aggregation*—(1) *General rule.* If an aggregation of operating mineral interests under section 614(c)(1) and paragraph (a) of this section includes any interest or interests in respect of which exploration expenditures, paid or incurred after the acquisition of such interest or interests, were deducted by the taxpayer under section 615(a) for any taxable year which precedes the date on which such aggregation becomes effective, then the tax imposed by chapter 1 of the Code for the taxable year or years in which such exploration expenditures were so deducted shall be recomputed in accordance with the rules contained in this paragraph. If an operating mineral interest is added to such aggregation for a subsequent taxable year and exploration expenditures made with respect to such interest after its acquisition were deducted by the taxpayer under section 615(a) for any taxable year which precedes the date on which the aggregation of such additional interest becomes effective, then the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year or years in which such exploration expenditures were so deducted shall be recomputed. For purposes of this paragraph, such taxable year or years shall be referred to as the taxable year or years for which a recomputation is required to be made. See paragraph (f)(6) of this section for rules relating to the date on which an aggregation becomes effective or the date on which the aggregation of an additional interest to an aggregation becomes effective. See subparagraph (3) of this paragraph for rules relating to the method of recomputation of tax. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. In 1954, taxpayer A owned two operating mineral interests designated Nos. 1 and 2. Interest No. 1 was in the production stage prior to 1954. The first exploration expenditures with respect to interest No. 2 were made by taxpayer A in 1954 and were deducted under section 615(a) on his return for that year. In 1955, taxpayer A made his first development expenditure with respect to interest No. 2, and thereafter it was operated with interest No. 1 as a unit. Taxpayer A elected under section 614(c) (1) and (3)(B) to form an aggregation of interests Nos. 1 and 2 for 1955 and all subsequent taxable years. Taxpayer A must recompute his tax for 1954 in accordance with this paragraph.

Example 2. Assume the same facts as in example 1 except that, in 1957, taxpayer A acquired another operating mineral interest, designated No. 3, made his first exploration expenditures with respect to such interest in that year, and deducted such expenditures under section 615(a) on his return for that year. In 1958, taxpayer A made his first development expenditure with respect to interest No. 3. Interest No. 3 was part of the same operating unit as interests Nos. 1 and 2. Taxpayer A elected under section 614(c) (1) and (3)(B) to add interest No. 3 to his aggregation of interests Nos. 1 and 2 for 1958 and all subsequent taxable years. Taxpayer A must recompute his tax for 1957 in accordance with this paragraph.

(2) *Exceptions*—(i) *Taxable years beginning before January 1, 1958.* In the case of exploration expenditures deducted by the taxpayer with respect to an operating mineral interest for any taxable year beginning before January 1, 1958, subparagraph (1) of this paragraph shall apply only if the taxpayer has made an election under section 614(c) (1) or (2) with respect to the operating unit of which such interest is a part and such election applies to the taxable year for which such exploration expenditures were deducted. Thus, if the taxpayer does not make an election with respect to the operating unit under section 614(c) (1) or (2) and (3)(B), subparagraph (1) of this paragraph does not apply in the case of exploration expenditures deducted with respect to any operating mineral interest which is a part of such operating unit for any taxable year beginning before January 1, 1958. The provisions of this subdivision may be illustrated by the following examples:

Example 1. In 1956, taxpayer A acquired two operating mineral interests designated Nos. 1 and 2. Interest No. 1 was in the production stage at that time. Taxpayer A made his first exploration expenditures with respect to interest No. 2 in 1956, 1957, and 1958 and deducted such expenditures under section 615(a) on his returns for such years. In 1959, taxpayer A made his first development expenditure with respect to interest No. 2. Interests Nos. 1 and 2 were operated as a unit. Taxpayer A elected under section 614(c) (1) and (3)(A) to aggregate interests Nos. 1 and 2 for 1959 and all subsequent taxable years. Only the exploration expenditures deducted by the taxpayer for 1958 must be taken into account for purposes of applying subparagraph (1) of this paragraph.

Example 2. In 1954, taxpayer B owned two operating mineral interests, designated Nos. 1 and 2, which he operated as a unit. Interest No. 1 was in the production stage at that time, and interest No. 2 represented one mineral deposit in a single tract of land which was being extracted by means of two mines. Under section 614(c) (2) and (3)(B), taxpayer B elects to treat interest No. 2 as two separate operating mineral interests, designated as Nos. 2(a) and 2(b), for 1954 and all subsequent taxable years. In 1955, taxpayer B acquired operating mineral interest No. 3. He made his first exploration expenditures with respect to interest No. 3 in 1955, 1956, and 1957 and deducted such expenditures under section 615(a) on his returns for such years. In 1958, taxpayer B made his first development expenditure with respect to interest No. 3, and thereafter it was operated with interests Nos. 1, 2(a), and 2(b) as a unit. Taxpayer B elects under section 614(c) (1) and (3)(B) to aggregate interests Nos. 1 and 3 for 1958 and all subsequent taxable years. The exploration expenditures deducted by the taxpayer for 1955, 1956, and 1957 must be taken into account for purposes of applying subparagraph (1) of this paragraph since the taxpayer has made an election under section 614(c)(2) with respect to the operating unit of which interest No. 3 is a part and such election applies to the taxable years 1955, 1956, and 1957.

(ii) *Interests formed pursuant to an election under section 614(c)(2).* In the case of exploration expenditures deducted with respect to an operating mineral interest which the taxpayer elects to treat as more than one such interest under section 614(c)(2) and paragraph (b) of this section, subparagraph (1) of this paragraph shall not apply. Thus, if the taxpayer deducts exploration expenditures with respect to an operating mineral interest, subsequently elects to treat such interest as more than one interest under section 614(c)(2), and includes one of the newly formed interests in an aggregation under section 614(c)(1), subparagraph (1) of this paragraph does not apply in the case of the exploration expenditures deducted with respect to the interest which the taxpayer elected to treat as more than one interest. The provisions of this subdivision may be illustrated by the following examples:

Example 1. In 1958, taxpayer A acquired two operating mineral interests, designated Nos. 1 and 2, which he operated as a unit. Each interest was an interest in a single mineral deposit in a single tract or parcel of land. There was a mine in the production stage of each of two interests at that time. Taxpayer A elected under section 614(c)(1)(B) to treat interests Nos. 1 and 2 as separate properties. In 1959 and 1960, taxpayer A made exploration expenditures with respect to interest No. 2 for the purpose of extracting the mineral by means of a second mine, and he deducted such expenditures on his returns for such years. In 1961, taxpayer A made his first development expenditure with respect to a second mine on interest No. 2. Taxpayer A elected under section 614(c)(2) to treat interest No. 2 as two separate operating mineral interests, designated as Nos. 2(a) and 2(b), for 1961 and all subsequent taxable years. Interest No. 2(a) contained the producing mine and interest No. 2(b) contained the subsequently developed mine. In his return for 1961, taxpayer A also elected under section 614(c)(1)(A) to aggregate interests Nos. 1 and 2(b) for 1961 and all subsequent taxable years. The exploration expenditures deducted with respect to interest No. 2 prior to the effective date of the formation of interests Nos. 2(a) and 2(b) need not be taken into account for purposes of applying subparagraph (1) of this paragraph.

Example 2. In 1954, taxpayer B owned two operating mineral interests designated Nos. 1 and 2. Interest No. 1 was an interest in a single mineral deposit in a single tract of land which was being extracted by means of two mines. Taxpayer B elected under section 614(c) (2) and (3)(B) to treat interest No. 1 as two separate operating mineral interests, designated as Nos. 1(a) and 1(b), for 1954 and all subsequent taxable years. In 1955, 1956, and 1957, taxpayer B made exploration expenditures with respect to interest No. 2 and deducted such expenditures on his returns for such years. In 1958, taxpayer B made his first development expenditure with respect to interest No. 2, and, on his return for that year, taxpayer B elected to aggregate interests Nos. 1(a) and 2 under section 614(c)(1) for 1958 and all subsequent taxable years. The exploration expenditures deducted with respect to interest No. 2 for 1955, 1956, and 1957 shall be taken into account for purposes of applying subparagraph (1) of this paragraph since such exploration expenditures were deducted with respect to an interest to which this subdivision does not apply.

(3) *Recomputation of tax*—(i) *General rule.* In the case of an aggregation formed under section 614(c)(1) and paragraph (a) of this section in respect of which a recomputation of tax is required to be made under the provisions

of subparagraphs (1) and (2) of this paragraph for any taxable year or years, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 shall be recomputed for each such taxable year as if:

(a) The taxpayer had elected to form an aggregation for the taxable year for which the recomputation is required to be made, and

(b) Such aggregation had included all the interests included in the aggregation formed under section 614(c)(1) except those interests which the taxpayer did not own during the taxable year for which the recomputation is required to be made and those interests in respect of which the taxpayer had made no expenditures for exploration, development, or operation before or during the taxable year for which the recomputation is required to be made.

If a recomputation of tax is required to be made for any taxable year in the case of the aggregation of an additional interest to an existing aggregation under section 614(c)(1), such recomputation shall be made as if:

(c) The taxpayer had elected to form an aggregation for the taxable year for which the recomputation is required to be made, and

(d) Such aggregation had included all the interests included in the aggregation formed under section 614(c)(1) (including any interest which the taxpayer had disposed of prior to the date on which the aggregation of the additional interest becomes effective) except those interests which the taxpayer did not own during the taxable year for which the recomputation is required to be made and those interests in respect of which the taxpayer had made no expenditures for exploration, development, or operation before or during the taxable year for which the recomputation is required to be made.

For purposes of this paragraph, any aggregation which is treated as having been formed under subdivisions *(a)* and *(b)* or under subdivisions *(c)* and *(d)* shall be referred to as the *constructed aggregated property*.

(ii) *Recomputation of depletion allowance.* The taxpayer shall compute the depletion allowance with respect to the constructed aggregated property for the taxable year for which the recomputation is required to be made. In making this computation, cost depletion for such taxable year shall be computed with reference to the depletion unit for the constructed aggregated property. See paragraph (a) of §1.611–2. Percentage depletion for such taxable year shall not exceed 50 percent of the taxable income from the constructed aggregated property computed in accordance with §1.613–5. If a recomputation is required to be made for the same taxable year with respect to any other aggregation or aggregations formed by the taxpayer under section 614(c)(1), the depletion allowance with respect to the other constructed aggregated property or properties shall be similarly computed. If, for a taxable year in respect of which a recomputation is required, the sum of the depletion allowance or allowances as computed under this subdivision is less than the sum of the depletion allowance or allowances actually deducted for such taxable year with respect to all the properties required to be taken into account in making the computation under this subdivision, then the total depletion allowance deducted by the taxpayer for such taxable year shall be reduced by the difference. The taxable income or net operating loss of the taxpayer for such taxable year shall be adjusted to reflect such reduction for purposes of the recomputation of tax. However, if for a taxable year in respect of which a recomputation is required, the sum of the depletion allowance or allowances as computed under this subdivision exceeds the sum of the depletion allowance or allowances actually deducted for such taxable year with respect to all the properties required to be taken into account in making the computation under this subdivision, the recomputation of tax for such taxable year is disregarded for purposes of applying section 614(c)(4) (B), (C), and (D).

(iii) *Effect of recomputation with respect to items based on amount of income.* In making the recomputation of tax under this subparagraph for any taxable year, any deduction, credit, or other allowance which is based upon the adjusted gross income or taxable income of the taxpayer for such year shall be recomputed taking into account the adjustment required under subdivision (ii) of this subparagraph. For example, if a corporate taxpayer's taxable income is increased under the provisions of such subdivision, then the amount of charitable contributions which may be deducted under the limitation contained in section 170(b)(2) shall be correspondingly increased for purposes of the recomputation. Moreover, the effect that the recomputation of any deduction, credit, or other allowance for a taxable year has on the tax imposed for any other taxable year shall also be taken into account for purposes of the recomputation of tax under this subparagraph. Any change in items of tax preferences (as defined in section 57 and the regulations thereunder) must also be taken into account for purposes of the recomputation under this subparagraph.

(iv) *Effect of recomputation with respect to a net operating loss and a net operating loss deduction.* If the recomputation of tax under this subparagraph for the taxable year for which the recomputation is required to be made results in a reduction of a net operating loss for such year, then the taxpayer shall take into account the effect of such reduction on the tax imposed by chapter I of the Internal Revenue Code of 1954 (or by corresponding provisions of the Internal Revenue Code of 1939) for any taxable year affected by such reduction. If the recomputation of tax for the taxable year for which the recomputation is required to be made results in an increase in taxable income as defined in section 172(b)(2) for such year, then the taxpayer shall take into account the effect of such increase on the tax imposed by chapter I of the Internal Revenue Code of 1954 (or by corresponding provisions of the Internal Revenue Code of 1939) for any taxable year affected by such increase. Furthermore, in making the recomputation of tax for any taxable year for which the recomputation is required to be made, the taxpayer shall take into account any change in the net operating loss deduction for such year resulting from the recomputation of tax for any other taxable year for which a recomputation is required to be made. For provisions relating to the net operating loss deduction, see section 172 and the regulations thereunder. For rules relating to the effect of the net operating loss deduction on the minimum tax for tax preferences see section 56 and the regulations thereunder and § 1.58–7.

(v) *Determination of increase in tax.* If the taxpayer elects to form an aggregation or aggregations for a taxable year under section 614(c)(1) and if a recomputation of tax is required to be made under this paragraph for any prior taxable year or years, then the taxpayer shall compute the difference between the tax, including the tax imposed by section 56 (relating to the minimum tax for tax preferences), as recomputed under this subparagraph for such prior taxable year or years (and other taxable years affected by the recomputation) and the tax liability previously determined (computed without regard to section 614(c)(4)) with respect to such prior taxable year or years (and other taxable years affected by the recomputation). If the taxpayer is subsequently required to make a recomputation with respect to any taxable year or years for which he has previously made a recomputation, then the taxpayer shall compute the difference between the tax as subsequently recomputed for such taxable year or years (and other taxable years affected by the subsequent recomputation) and the tax as previously recomputed for such taxable year or years (and other taxable years affected by the subsequent recomputation). For treatment of the increase in tax resulting from the recomputation of tax under this subparagraph, see subparagraph (4) of this paragraph.

(4) *Treatment of increase in tax*—(i) *General rule.* If the taxpayer elects to form an aggregation or aggregations for a taxable year under section 614(c)(1) and if a recomputation of tax is required to be made for any prior taxable year or years, then the total increase in tax resulting from such recomputation determined under subparagraph (3)(v) of this paragraph shall be taken into account in the first taxable year to which the election to form such aggregation or aggregations is applicable and in each succeeding taxable year until the full amount of such total

increase in tax has been taken into account. The number of taxable years over which such total increase shall be taken into account shall be equal to the number of taxable years for which a recomputation of tax is required to be made under subparagraph (1) of this paragraph as limited by subparagraph (2) of this paragraph and for which such recomputation results in a reduction of the taxpayer's depletion allowance under subparagraph (3)(ii) of this paragraph. The amount of the increase in tax which is to be taken into account in a taxable year is determined by dividing the total increase in tax by the number of taxable years over which such total increase is to be taken into account. The tax imposed by chapter I of the Code for each of the taxable years over which the total increase in tax is to be taken into account shall be increased by the amount determined in accordance with the preceding sentence. However, such increase in tax for each of such taxable years shall have no effect upon the determination of the amount of any credit against the tax for any of such taxable years. For example, the amount of such increase shall not affect the computation of the limitation on the foreign tax credit under section 904. The amount of the increase in tax which is required to be taken into account by the taxpayer in a particular taxable year under section 614(c)(4)(C) shall be treated as a tax imposed with respect to such taxable years even though, without regard to section 614(c)(4) and this paragraph, such taxpayer would otherwise have no tax liability for such taxable year.

(ii) *Increase in tax not determinable as of first taxable year of aggregation.* If the recomputation of tax under subparagraph (3) of this paragraph, for any taxable year or years prior to the first taxable year to which the election to form an aggregation or aggregations under section 614(c)(1) applies, results in a reduction of any net operating loss carryover to a taxable year subsequent to such first taxable year, then the total increase in tax resulting from the recomputation is not determinable as of such first taxable year. In such case, the total increase in tax shall be taken into account in equal installments in the first taxable year for which such total increase is determinable and in each succeeding taxable year for which a portion of the increase in tax would have been taken into account under subdivision (i) of this subparagraph if the total increase had been determinable as of the first taxable year to which the election to form the aggregation or aggregations under section 614(c)(1) applies. The provisions of this subdivision may be illustrated by the following example:

Example. Assume that taxpayer A elects under section 614(c)(1) to form an aggregation for 1960 and all subsequent taxable years. Assume further that taxpayer A is required to recompute his tax for four prior taxable years under subparagraphs (1) and (2) of this paragraph and that the recomputation for each of such taxable years results in a reduction of taxpayer A's depletion allowance. Under subdivision (i) of this subparagraph, the total increase in tax resulting from the recomputation is to be taken into account in equal installments in 1960, 1961, 1962, and 1963. However, if the total increase in tax is not determinable until 1961 because the recomputation for the prior taxable years results in the reduction of a net operating loss carryover to 1961, then the total increase shall be taken into account in equal installments in 1961, 1962, and 1963. In like manner, if the total increase in tax is not determinable until 1962, it shall be taken into account in equal installments in 1962 and 1963.

(iii) *Death or cessation of existence of taxpayer.* If the taxpayer dies or ceases to exist, the portion of the increase in tax determined under subparagraph (3)(v) of this paragraph which has not been taken into account under subdivision (i) or (ii) of this subparagraph for taxable years prior to the taxable year of the occurrence of such death or such cessation of existence, as the case may be, shall be taken into account for the taxable year in which such death or such cessation of existence, as the case may be, occurs.

(5) *Adjustments to basis of aggregated property.* If the taxpayer elects to form an aggregated property or properties under section 614(c)(1) for a taxable year and if a recomputation of tax is required to be made for any taxable year which results in reduction of the depletion allowance previously deducted by the taxpayer for such year, then proper adjustments shall be made with respect to the adjusted basis of

such aggregated property or properties. In such a case:

(i) If the sum of the depletion allowances actually deducted with respect to the interests included in a constructed aggregated property exceeds the depletion allowance computed under subparagraph (3)(ii) of this paragraph with respect to such constructed aggregated property, the adjusted basis of the aggregated property formed under section 614(c)(1) shall be increased by such excess, and

(ii) If the depletion allowance computed under subparagraph (3)(ii) of this paragraph with respect to a constructed aggregated property exceeds the sum of the depletion allowances actually deducted with respect to the interests included in such constructed aggregated property, the adjusted basis of the aggregated property formed under section 614(c)(1) shall be reduced (but not below zero) by such excess.

However, the adjusted basis of an aggregated property formed under section 614(c)(1) may be increased only to the extent such excess would have resulted in an increase in such adjusted basis if taken into account under paragraph (a) of § 1.614–6. Thus, if depletion previously allowed with respect to the separate operating mineral interests included in the aggregation formed under section 614(c)(1) exceeds the total of the unadjusted bases of such interests by $5,000, and if the recomputation of tax required to be made under this paragraph results in a depletion allowance which is $7,000 less than the depletion actually deducted with respect to such interests, then the adjusted basis of such aggregation may be increased by only $2,000. If, with respect to the same aggregated property formed under section 614(c)(1), adjustments to adjusted basis are required under this subparagraph as a result of recomputation of tax for two or more taxable years, the total or net amount of such adjustments shall be taken into account. Any adjustment to the adjusted basis of an aggregation required by this subparagraph shall be taken into account as of the effective date of the election to form such aggregation under section 614(c)(1) and shall be effective for all purposes of subtitle A of the Code. For other rules relating to the determination of the adjusted basis of an aggregated property, see paragraph (a) of § 1.614–6.

[T.D. 6524, 26 FR 150, Jan. 10, 1961, as amended by T.D. 7170, 37 FR 5382, Mar. 15, 1972; T.D. 7564, 43 FR 40494, Sept. 12, 1978]

§ 1.614–4 Treatment under the Internal Revenue Code of 1939 with respect to separate operating mineral interests for taxable years beginning before January 1, 1964, in the case of oil and gas wells.

(a) *General rule.* (1) All references in this section to section 614(b) or any paragraph or subparagraph thereof are references to section 614(b) or a paragraph or subparagraph thereof as it existed prior to its amendment by section 226(a) of the Revenue Act of 1964. All references in this section to section 614(d) are references to section 614(d) as it existed prior to its amendment by section 226(b)(3) of the Revenue Act of 1964.

(2) For taxable years beginning before January 1, 1964, in the case of oil and gas wells, a taxpayer may treat under section 614(d) and this section any property as if section 614 (a) and (b) had not been enacted. For purposes of this section, the term *property* means each separate operating mineral interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land. Separate tracts or parcels of land exist not only when areas of land are separated geographically, but also when areas of land are separated by means of the execution of conveyances or leases. If the taxpayer treats any property or properties under this section, the taxpayer must treat each such property as a separate property except that the taxpayer may treat any two or more properties that are included within the same tract or parcel of land as a single property provided such treatment is consistently followed. If the taxpayer treats two or more properties as a single property under this section, such properties shall be considered as a single property for all purposes of subtitle A of the Internal Revenue Code of 1954. The taxpayer may not make more than one combination of properties within the same tract or parcel of land. Thus, if the taxpayer treats two or more properties that are included within the

same tract or parcel of land as a single property, each of the remaining properties included within such tract or parcel of land shall be treated as a separate property. If the taxpayer has treated two or more properties that are included within the same tract or parcel of land as a single property and subsequently discovers or acquires an additional mineral deposit within the same tract or parcel of land, he may include his interest in such deposit with the two or more properties which are being treated as a single property or he may treat his interest in such deposit as a separate property. If the taxpayer has treated each property included within a tract or parcel of land as a separate property and subsequently discovers or acquires an additional mineral deposit within the same tract or parcel of land, he may combine his interest in such deposit with any one of the separate properties included within the tract or parcel of land, but not with more than one of them since they cannot be validly combined with each other. The taxpayer may not combine properties which are included within different tracts or parcels of land under this section irrespective of whether such tracts or parcels of land are contiguous. The treatment of a property as a separate property or the treatment of two or more properties included within a single tract or parcel of land as a single property under this section shall be binding upon the taxpayer for the first taxable year for which such treatment is effective and for all subsequent taxable years beginning before January 1, 1964. For the continuation of such treatment under §1.614–8 for taxable years beginning after December 31, 1963, see paragraph (d) of §1.614–8. For provisions relating to the first taxable year for which treatment under this section becomes effective, see paragraph (d) of this section.

(b) *Treatment consistent with treatment for taxable years prior to 1954.* If the taxpayer has treated properties in a manner consistent with the rules contained in paragraph (a) of this section for taxable years to which the Internal Revenue Code of 1939 applies and if the taxpayer desires to treat such properties under section 614(d), then such properties must continue to be treated in the same manner. The provisions of this paragraph may be illustrated by the following examples:

Example 1. In 1950, taxpayer A owned two separate tracts of land designated No. 1 and No. 2. Each tract contained three mineral deposits. In the case of tract No. 1, taxpayer A treated the three mineral deposits as a single property. In the case of tract No. 2, taxpayer A treated the first mineral deposit as a separate property and treated the second and third mineral deposits as a single property. This treatment was consistently followed for the taxable years 1950, 1951, 1952, and 1953. Taxpayer A desires, for 1954 and subsequent taxable years, to treat the properties in tracts Nos. 1 and 2 as if section 614 (a) and (b) had not been enacted. For 1954 and subsequent taxable years, the three deposits in tract No. 1 must be treated as a single property; the first deposit in tract No. 2 must be treated as a separate property; and the second and third deposits in tract No. 2 must be treated as a single property.

Example 2. Assume the same facts as in example 1 except that, at the time the treatment under this section is adopted, assessment of any deficiency or credit or refund of any overpayment for the taxable years 1954 and 1955 resulting from the treatment of properties under this section is prevented by the operation of the statute of limitations. For 1956 and subsequent taxable years, the three deposits in tract No. 1 must be treated as a single property; the first deposit in tract No. 2 must be treated as a separate property; and the second and third deposits in tract No. 2 must be treated as a single property.

(c) *Bases of separate properties previously included in an aggregation under section 614(b).* If the taxpayer has made an election under section 614(b) to form an aggregation of operating mineral interests and if such taxpayer subsequently revokes such election for all taxable years for which it was made and treats the properties that are included within such aggregation under section 614(d) and this section by filing the statement required by paragraph (e) of this section, then the adjusted basis of each separate property (as defined in paragraph (a) of this section) that is a part of such aggregation shall be determined as if the taxpayer had made no election under section 614(b). However, if, at the time of the filing of the statement revoking the election under section 614(b), assessment of any deficiency or credit or refund of any overpayment, as the case may be, resulting from such revocation is prevented by the operation of any law or rule of law for any taxable year or years for which the election under section 614(b) was made, then the adjusted basis of each separate property that is a part of the aggregation shall be determined in accordance with the provisions contained in paragraph (a)(2) of § 1.614.6 as of the first day of the first taxable year for which the revocation is effective. After determining the adjusted basis of each separate property included within the aggregation, the taxpayer may treat such properties in any manner which is in accordance with paragraph (a) of this section. See, however, paragraph (b) of this section. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Taxpayer A owns two separate tracts of land, designated No. 1 and No. 2, each of which contains three mineral deposits. The interests in the two tracts of land constitute an operating unit as defined in paragraph (c) of § 1.614–2. Taxpayer A elects under section 614(b) to form an aggregation of all the interests in the operating unit for 1954 and all subsequent taxable years. Subsequently, taxpayer A revokes such election by filing a statement in accordance with paragraph (e) of this section. Such revocation is effective for 1956 and subsequent taxable years because, at the time of the filing of the statement of revocation, assessment of any deficiency or credit or refund of any overpayment for the taxable years 1954 and 1955 resulting from such revocation is prevented by the operation of the statute of limitations. The adjusted bases of the six properties that are included within the aggregation shall be determined in accordance with paragraph (a)(2) of § 1.614–6 as of the beginning of the taxable year 1956.

Example 2. Assume the same facts as in example 1 and, in addition, assume that for taxable years to which the Internal Revenue Code of 1939 is applicable, taxpayer A treated the three deposits in tract No. 1 as a single property and the three deposits in tract No. 2 as a single property. After determining the adjusted basis of each of the six properties as illustrated in example 1, the adjusted basis of the three properties in tract No. 1 must be combined and the adjusted bases of the three properties in tract No. 2 must be combined since the manner in which such properties were treated for taxable years to which the Internal Revenue Code of 1939 is applicable is consistent with the rules contained in paragraph (a) of this section.

(d) *Treatment; when effective.* If a taxpayer treats any property in accordance with this section, then such treatment shall be effective for whichever of the following taxable years is the later:

(1) The latest taxable year for which an election could have been made with respect to such property under section 614(b); or

(2) The first taxable year beginning after December 31, 1953, and ending after August 16, 1954, in respect of which assessment of a deficiency or credit or refund of an overpayment, as the case may be, resulting from the treatment of such property under this section, is not prevented by the operation of any law or rule of law on the date such treatment is adopted.

(e) *Manner of adopting the treatment of properties under this section.* If the taxpayer does not make an election under section 614(b) with respect to a property within the time prescribed for making such an election, then the taxpayer shall be deemed to have treated such property under this section. In such case, the manner in which such property is treated in filing the taxpayer's income tax return for the first taxable year for which the treatment of such property is effective under paragraph (d) of this section shall establish the treatment which must be consistently followed with respect to such property for subsequent taxable years. However, if the income tax return for such first taxable year is filed prior to May 1, 1961, then the taxpayer may adopt the treatment provided for under this section with respect to the property by filing a statement at any time on or before May 1, 1961, with the district director for the district in which the taxpayer's income tax return was filed for the first taxable year for which the treatment of such property is effective under paragraph (d) of this section. Such statement shall set forth the first taxable year for which the treatment of the property under this section is effective, shall revoke any previous elections made with respect to such property under section 614(b), shall state the manner in which such property was treated for taxable years subject to the Internal Revenue Code of 1939, shall state the manner in which such property is to be treated under this section, and shall be accompanied by an amended return or returns if necessary.

(f) *Certain treatment under this section precludes election to aggregate under section 614(b) with respect to the same operating unit.* If the taxpayer's treatment of any properties that are included within an operating unit (as defined in paragraph (c) of §1.614–2) under section 614(d) and this section would constitute an aggregation under section 614(b) and if such taxpayer elects, or has elected, to form an aggregation within the same operating unit under section 614(b) for any taxable year for which the treatment under section 614(d) is effective, then the election made under section 614(b) shall not apply for any such taxable year.

[T.D. 6524, 26 FR 157, Jan. 10, 1961, as amended by T.D. 6859, 30 FR 13700, Oct. 28, 1965]

§1.614–5 Special rules as to aggregating nonoperating mineral interests.

(a) *Aggregating nonoperating mineral interests for taxable years beginning before January 1, 1958.* Upon proper showing to the Commissioner, a taxpayer who owns two or more separate nonoperating mineral interests in a single tract or parcel of land, or in two or more contiguous tracts or parcels of land, shall be permitted to aggregate all such interests in each separate kind of mineral deposit and treat them as one property. Permission will be granted by the Commissioner only if the taxpayer establishes that he will sustain an undue hardship if such nonoperating mineral interests are not treated as one property. Such hardship may exist, for example, if it is impossible for the taxpayer to determine the boundaries, source, or costs of the separate interests, or if a taxpayer who owns a single royalty interest, production payment, or net profits interest cannot determine the separate deposits from which his payments will be derived. In no event shall undue hardship be deemed to exist solely by reason of tax disadvantage. The treatment of such interests as one property shall be applicable for all purposes of subtitle A of the Internal Revenue Code of 1954. In no event may nonoperating mineral interests in tracts or parcels of land which are not contiguous be treated as one property. The term *two or more contiguous tracts or parcels of land* means tracts or parcels of land which have common boundaries. Common boundaries include survey lines, public roads, or similar easements for the use of land without the existence of an intervening mineral right between the tracts or parcels of land. Tracts or parcels of land which touch only at a common corner are not contiguous. For the definition of *nonoperating mineral interests,* see paragraph (g) of this section.

(b) *Manner and scope of election*— (1) *Time for filing application for permission to aggregate separate nonoperating mineral interests under paragraph (a) of this section.* The application for permission to aggregate separate nonoperating mineral interests under paragraph (a) of this section shall be filed at any time on or before May 1, 1961. Such application shall indicate the first taxable year for which the aggregation is to be formed. If, prior to January 10, 1961, an application has been filed, the taxpayer need file only a supplemental application containing such additional information as is necessary to comply with the requirements of subparagraph (2) of this paragraph.

(2) *Contents of application and returns under permission.* The application for permission to aggregate nonoperating mineral interests under paragraph (a) of this section shall include a complete statement of the facts upon which the taxpayer relies to show the undue hardship which would result if such an aggregation was not permitted. Such application shall also include a description of the nonoperating mineral interests owned by the taxpayer within the tract or tracts of land involved. A general description, accompanied by maps appropriately marked, which accurately circumscribes the scope of the aggregation and shows that the taxpayer is aggregating all the nonoperating mineral interests in a particular kind of mineral deposit within the tract or tracts of land involved will be sufficient. If the Commissioner grants permission, a copy of the letter granting such permission shall be filed with the district director for the district in which the taxpayer's income tax return was filed for the first taxable year for which such permission applies, and

shall be accompanied by an amended return or returns if necessary.

(3) *Election; binding effect.* The election to aggregate separate nonoperating mineral interests under paragraph (a) of this section shall be binding upon the taxpayer for the first taxable year for which made and all subsequent taxable years beginning before January 1, 1958, unless consent to make a change is obtained from the Commissioner. The application for consent to make a change must set forth in detail the reason or reasons for such change. Consent to a different treatment shall not be granted where the principal purpose for such change is due to tax consequences. For rules relating to the binding effect of an election where the basis of an aggregated property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, see paragraph (c) of § 1.614–6.

(4) *Aggregations under the Internal Revenue Code of 1939.* An application for permission to aggregate nonoperating mineral interests under paragraph (a) of this section shall be submitted in accordance with the requirements of this paragraph notwithstanding the fact that the taxpayer may have aggregated such interests for taxable years to which the Internal Revenue Code of 1939 is applicable. If such interests were aggregated for taxable years to which the Internal Revenue Code of 1939 applies and the aggregation was approved by the Internal Revenue Service for such years after full consideration thereof on its merits, such approval will generally be accepted as evidence that undue hardship would result if the aggregation were not permitted.

(c) *Termination of aggregation of nonoperating mineral interests*—(1) *General rule.* Any aggregation of nonoperating mineral interests formed under paragraphs (a) and (b) of this section shall not apply with respect to any taxable year beginning after December 31, 1957. Thus, if a taxpayer makes a binding election to form such an aggregation for taxable years beginning before January 1, 1958, then in order to form an aggregation with respect to any taxable year beginning after December 31, 1957, he must obtain permission in accordance with the rules prescribed in paragraphs (d) and (e) of this section.

(2) *Bases of separate nonoperating mineral interests.* If a taxpayer forms an aggregation of nonoperating mineral interests under paragraphs (a) and (b) of this section which is terminated under subparagraph (1) of this paragraph, the adjusted bases of the separate nonoperating mineral interests included in such aggregation shall be determined in accordance with paragraph (a)(2) of § 1.614–6.

(d) *Aggregating nonoperating mineral interests for taxable years beginning after December 31, 1957, or for earlier taxable years.* Upon proper showing to the Commissioner, a taxpayer who owns two or more separate nonoperating mineral interests in a single tract or parcel of land, or in two or more adjacent tracts or parcels of land, shall be permitted, under section 614(e), to form an aggregation of all of such interests in each separate kind of mineral deposit and treat such aggregation as one property. Permission shall be granted by the Commissioner only if the taxpayer establishes that a principal purpose in forming the aggregation is not the avoidance of tax. The fact that the aggregation of nonoperating mineral interests will result in a substantial reduction in tax is evidence that avoidance of tax is a principal purpose of the taxpayer. An aggregation formed under the provisions of this paragraph shall be considered as one property for all purposes of the Code. In no event may nonoperating mineral interests in tracts or parcels of land which are not adjacent be aggregated and treated as one property. The term *two or more adjacent tracts or parcels of land* means tracts or parcels of land that are in reasonably close proximity to each other depending on the facts and circumstances of each case. Adjacent tracts or parcels of land do not necessarily have any common boundaries, and may be separated by intervening mineral rights. For the definition of *nonoperating mineral interests,* see paragraph (g) of this section.

(e) *Manner and scope of election*— (1) *Time for filing application for permission to aggregate separate nonoperating mineral interests under section 614(e).* The application for permission to aggregate separate nonoperating mineral interests under section 614(e) and paragraph (d) of this section shall be made in writing to the Commissioner of Internal Revenue, Washington, DC 20224. Such application shall be filed within 90 days after the beginning of the first taxable year beginning after December 31, 1957, for which aggregation is desired or within 90 days after the acquisition of one of the nonoperating mineral interests which is to be included in the aggregation, whichever is later. However, if the last day on which the application may be filed under this paragraph falls before May 1, 1961, such application may be filed at any time on or before May 1, 1961. If, prior to January 10, 1961, an application has been filed, the taxpayer need file only a supplemental application containing such additional information as is necessary to comply with subparagraph (4) of this paragraph.

(2) *Election to apply section 614(e) retroactively.* The application for permission to aggregate separate nonoperating mineral interests under section 614 (e) and paragraph (d) of this section may be filed, at the election of the taxpayer, for any taxable year beginning before January 1, 1958, to which the Internal Revenue Code of 1954 is applicable. In such case, the application may be filed at any time on or before May 1, 1961. Such application shall designate the first taxable year for which the aggregation is to be formed. If, prior to January 10, 1961, an application has been filed, the taxpayer need file only a supplemental application containing such additional information as is necessary to comply with the requirements of subparagraph (4) of this paragraph.

(3) *Limitation.* If the taxpayer forms any aggregation of nonoperating mineral interests under subparagraph (2) of this paragraph, then any aggregation of nonoperating mineral interests formed under paragraphs (a) and (b) of this section shall not apply for any taxable year. The provisions of this subparagraph may be illustrated by the following example:

Example. In 1954, taxpayer A owns six separate nonoperating mineral interests designated No. 1 through No. 6. Interests Nos. 1 through 3 are royalty interests in contiguous tracts of land. Interests Nos. 4 through 6, which are located in an entirely different area from interests Nos. 1 through 3, are royalty interests in tracts of land which are not contiguous but which are adjacent to each other. In 1959 taxpayer A obtains permission and elects under section 614(e) and subparagraph (2) of this paragraph to form an aggregation of interests Nos. 4 through 6 for 1956 and all subsequent taxable years. Taxpayer A may not elect to form an aggregation of interests Nos. 1 through 3 under paragraphs (a) and (b) of this section for 1954 or any subsequent taxable year. If taxpayer A wishes to form an aggregation of interests Nos. 1 through 3, he must obtain permission under paragraph (d) of this section and this paragraph.

(4) *Contents of application and returns under permission.* The application for permission to aggregate nonoperating mineral interests under section 614(e) and paragraph (d) of this section shall include a complete statement of the facts upon which the taxpayer relies to show that avoidance of tax is not a principal purpose of forming the aggregation. Such application shall also include a description of the nonoperating mineral interests within the tract or tracts of land involved. A general description, accompanied by maps appropriately marked, which accurately circumscribes the scope of the aggregation and shows that the taxpayer is aggregating all the nonoperating mineral interests in a particular kind of mineral deposit within the tract or tracts of land involved will be sufficient. If the Commissioner grants permission, a copy of the letter granting such permission shall be attached to the taxpayer's income tax return for the first taxable year for which such permission applies. If the taxpayer has already filed such return, a copy of the letter of permission shall be filed with the district director for the district in which such return was filed and shall be accompanied by an amended return or returns if necessary or, if appropriate, a claim for credit or refund.

(5) *Election; binding effect.* The election to aggregate separate nonoperating mineral interests under section 614 (e) and paragraph (d) of this section shall be binding upon the taxpayer for the first taxable year for which made and for all subsequent taxable years

unless consent to make a change is obtained from the Commissioner. The application for consent to make a change must set forth in detail the reason or reasons for such change. Consent to a different treatment shall not be granted where the principal purpose for such change is due to tax consequences. For rules relating to the binding effect of an election where the basis of an aggregated property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, see paragraph (c) of § 1.614–6.

(6) *Aggregations under the Internal Revenue Code of 1939.* An application for permission to aggregate nonoperating mineral interests under section 614 (e) and paragraph (d) of this section shall be submitted in accordance with the requirements of this paragraph notwithstanding the fact that the taxpayer may have aggregated such interests for taxable years to which the Internal Revenue Code of 1939 is applicable. If such interests were aggregated for taxable years to which the Internal Revenue Code of 1939 applies and the aggregation was approved by the Internal Revenue Service for such years after full consideration thereof on its merits, such approval will generally be accepted as evidence that avoidance of tax is not a principal purpose of forming the aggregation.

(f) *Elections; when effective.* If the taxpayer has elected to form an aggregation under either paragraph (a) or paragraph (d) of this section, the date on which the aggregation becomes effective is the first day of the first taxable year for which the election is made; except that if any separate nonoperating mineral interest included in such aggregation was acquired after such first day, the date on which the inclusion of such interest in such aggregation becomes effective is the date of its acquisition.

(g) *Definition of nonoperating mineral interests.* For purposes of this section, *nonoperating mineral interests* includes only those interests described in section 614(a) which are not operating mineral interests within the meaning of paragraph (b) of § 1.614–2. The taxpayer who holds the operating or working rights in a mineral deposit, but is not actually conducting operations with respect to such deposit, does not have a nonoperating mineral interest in such deposit notwithstanding the fact that he intends to transfer such operating rights at a later time.

[T.D. 6524, 26 FR 158, Jan. 10, 1961]

§ 1.614–6 Rules applicable to basis, holding period, and abandonment losses where mineral interests have been aggregated or combined.

(a) *Basis of property resulting from aggregation or combination*—(1) *General rule.* (i) When a taxpayer has aggregated as one property two or more interests under section 614(b) (prior to its amendment by section 226(a) of the Revenue Act of 1964), (c), or (e), the unadjusted basis of such aggregated property shall be the sum of the unadjusted bases of the various mineral interests aggregated. The adjusted basis of the aggregated property on the effective date of the aggregation shall be the unadjusted basis of the aggregated property, adjusted by the total of all adjustments to the bases of the several mineral interests aggregated as required by section 1016 to the effective date of aggregation. Thereafter, the adjustments to basis required by section 1016 shall apply to the total adjusted basis of the aggregated property for all purposes of subtitle A of the Code.

(ii) When a taxpayer has combined as one property two or more interests under section 614(b) (as amended by section 226(a) of the Revenue Act of 1964), the adjusted basis of such combined property shall be the sum of:

(a) The unadjusted bases of all such interests which have never been included in an aggregation; and

(b) The adjusted bases of all such interests which at some time have been included in an aggregation, as of the date on which they ceased to participate in an aggregation;

adjusted by the total of all adjustments to the bases of the several mineral interests combined, as required by section 1016,

(c) In the case of interests described in *(a)*, for the entire period of the taxpayer's ownership of such interest; and

(d) In the case of interests described in *(b)*, for the period, if any, between the time of deaggregation and the time of combination.

Thereafter, the adjustments to basis required by section 1016 shall apply to the total adjusted basis of the combined property for all purposes of subtitle A of the Code.

(2) *Bases upon disposition of part of, or termination of, or change in, an aggregated or combined property*—(i) *In general. (a)* When a taxpayer has aggregated or combined two or more separate mineral interests as one property under section 614(b) (either before or after its amendment by section 226(a) of the Revenue Act of 1964), (c), or (e) and thereafter sells, exchanges, or otherwise disposes of part of such property, the total adjusted basis of the property as of the date of sale, exchange, or other disposition shall be apportioned to determine the adjusted basis of the part disposed of and the part retained for purposes of computing gain or loss, depletion and for all other purposes of subtitle A of the Code. Such adjusted basis shall be determined by apportioning the total adjusted basis of the property between the part of the property disposed of and the part retained in the same proportion as the fair market value of each part (as of the date of sale, exchange, or other disposition) bears to the total fair market value of the property as of such date. For determining gain or loss on the sale or exchange of any part of the aggregated or combined property, the adjusted basis of the aggregated or combined property (from which the adjusted basis of the part is determined) shall not be reduced below zero.

(b) If, for any taxable year after the first taxable year for which an aggregation under section 614(b) (prior to its amendment by section 226(a) of the Revenue Act of 1964), (c), or (e) is effective:

(1) Any such aggregation is terminated for any reason other than the expiration of an aggregation by reason of section 614(b) as amended by section 226(a) of the Revenue Act of 1964 (see subdivision (ii) of this subparagraph), or

(2) The treatment of any mineral interests in any such aggregation is changed after obtaining the consent of the Commissioner,

then the adjusted basis of the aggregated property as of the first day of the first taxable year for which such termination or change is effective shall be apportioned to determine the adjusted bases of the resultant separate mineral interests, as of such first day, for purposes of computing gain or loss, depletion, and for all other purposes of subtitle A of the Code. The adjusted bases of such separate mineral interests shall be determined by apportioning the adjusted basis of the aggregated property (as of the first day of the first taxable year for which such termination or change is effective) between or among such interests in the same proportion as the fair market value of each such interest (as of such first day) bears to the total fair market value of the aggregated property as of such first day. For the purpose of determining the adjusted bases of the separate mineral interests, the adjusted basis of the aggregated property (from which the adjusted basis of each separate mineral interest is determined) shall not be reduced below zero.

(ii) *Allocation of basis of aggregation of operating mineral interests in oil and gas wells as of the first day of the first taxable year beginning after December 31, 1963—(a) Fair market value method.* Unless the taxpayer elects to use the allocation of adjustments method of determining basis provided in (b) of this subdivision (ii), the adjusted basis as of the first day of the first taxable year beginning after December 31, 1963, of each interest which was participating in an aggregation of operating mineral interests on the day preceding such first day shall be determined by multiplying the adjusted basis of the aggregation by a fraction the numerator of which is the fair market value of such interest and the denominator of which is the fair market value of such aggregation. For purposes of this subdivision *(a)*, the adjusted basis and the fair market value of the aggregation, and the fair market value of such interest, shall be determined as of the day preceding the first day of the first taxable year which begins after December 31, 1963. Unless the taxpayer elects to use the allocation of adjustments method, he shall obtain accurate and reliable information, and keep records with respect thereto, establishing all facts necessary for making the computation prescribed in this subdivision *(a).* See example 5 of subparagraph (3) of this paragraph.

(b) Allocation of adjustments method. (i) The taxpayer may elect to determine basis by an allocation of adjustments in lieu of the fair market value method prescribed in *(a)* of this subdivision (ii). In such a case, the adjusted basis (as of the first day of the first taxable year beginning after December 31, 1963) of each interest which was participating in an aggregation of operating mineral interests on the day preceding such first day is the unadjusted basis of such interest immediately after its acquisition by the taxpayer, adjusted by the total of all adjustments to its basis as required by section 1016 to the effective date of aggregation, and by that portion of those section 1016 adjustments to the basis of the aggregation which is reasonably attributable to such interest. For this purpose, two or more interests which are being combined upon deaggregation shall be treated as one interest. An adjustment to the basis of the aggregation is reasonably attributable to such interest to the extent that the adjustment thereto resulted from inclusion of the interest in the aggregation, even though such interest would not have been entitled to the adjustment to the same extent if such interest had been treated separately because of the 50 percent of taxable income limitation or for any other reason. In a case in which the amount of a percentage depletion deduction which was allowed with respect to an aggregation was limited by the 50 percent of taxable income limitation of section 613(a), the portion of such amount which is attributable to each of the interests in the aggregation shall be determined by multiplying such amount by a fraction, the numerator of which is the gross income from such interest and the denominator of which is the gross income from the aggregation. The determination as to which property a particular adjustment is attributable may be based upon records of production or any other facts which establish the reasonableness of the determination. See example 6 of subparagraph (3) of this paragraph.

(ii) If, under the adjustment described in *(i)* of this subdivision *(b),* the total of the adjusted bases of the interests which were included in the aggregation exceeds the adjusted basis of the aggregation, the adjusted bases of the interests shall be further adjusted so that the total of the adjusted bases of the interests equals the adjusted basis of the aggregation. This further adjustment shall be made by reducing the basis of each interest (other than an interest having a basis of zero) by an amount which is determined by multiplying such excess by a fraction, the numerator of which is the adjusted basis of such interest after making the adjustment described in *(i)* of this subdivision *(b)* and the denominator of which is the total of the adjusted bases of all such interests after making the adjustment described in *(i)* of this subdivision *(b).* See example 6 of subparagraph (3) of this paragraph.

(iii) The election provided for in this subdivision *(b)* shall be made not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for the first taxable year beginning after December 31, 1963, and shall be made in a statement attached to such return.

(3) The application of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. A taxpayer owning three operating mineral interests, designated Nos. 1, 2, and 3, within a single operating unit, properly elects to aggregate such properties under section 614(b) for the calendar year 1954 in his income tax return filed on April 15, 1955. The unadjusted bases and adjustments under section 1016 for depletion through December 31, 1953, in respect of such properties are as follows:

	Unadjusted basis	Adjustments under Section 1016
No. 1	$25,000	$27,000
No. 2	18,000	10,000
No. 3	15,000	4,000
Total	58,000	41,000

The adjusted basis of the aggregated property as of January 1, 1954, is $17,000 ($58,000–$41,000).

Example 2. Assume the same facts as in example 1, except that a portion of the aggregated property is sold on June 1, 1956, for $15,000 which is also the fair market value of such portion on the date of sale. In order to determine the gain or loss from this sale as well as the adjusted basis of the retained property, an apportionment must be made. The aggregated property had a fair market value of $25,000 on the date of sale. From January 1, 1954, through May 31, 1956, $10,000 of depletion has been allowed with respect to the aggregated property. The adjusted basis of the portion sold is determined as follows:

$$\begin{array}{c}\text{\$7,000 (adjusted basis}\\ \text{of aggregated property)}\end{array} \times \frac{\$15{,}000}{\$25{,}000} = \begin{array}{c}\text{\$4,200 (adjusted basis}\\ \text{of portion sold)}\end{array}$$

Therefore, the gain on this sale of the portion sold is $10,800 ($15,000–$4,200). The adjusted basis of the property retained is $2,800 ($7,000–$4,200).

Example 3. Assume the same facts as in example 2, except that instead of selling, the taxpayer subleases one of the leases making up the aggregated property, retaining a one-eighth royalty interest therein. The fair market value of such lease is $15,000 on the date of the sublease. The adjusted basis of such royalty interest is $4,200 which is computed as follows:

$$\begin{array}{c}\text{\$7,000 (adjusted basis}\\ \text{of aggregated property)}\end{array} \times \frac{\$15{,}000}{\$25{,}000} \begin{array}{l}\text{(FMV of portion transferred)}\\ \text{(FMV of aggregated property)}\end{array}$$

Example 4. In 1953, a taxpayer owned mineral interests Nos. 1, 2, and 3 which he operated as a unit. He owned no other operating interests during that year. The unadjusted bases of these properties were $10,000, $15,000, and $20,000, respectively, and depletion allowed through December 31, 1953, was $5,000 with respect to each property. The taxpayer operated these properties during the year 1954 and, in addition, operated as part of the unit mineral interest No. 4 which he acquired on July 1, 1954, on which date he made the first exploration expenditure with respect thereto. He paid $20,000 for No. 4. In his return for the calendar year 1954, the taxpayer elected under section 614(b) to aggregate all of these mineral interests. The taxpayer must compute cost depletion for the calendar year 1954 on the basis of an aggregated property with an adjusted basis of $30,000 ($45,000–$15,000) for the period from January 1 to June 30, and with an adjusted basis of $50,000 (less depletion for the first six months) for the period from July 1 to December 31. If applicable, the taxpayer must compute percentage depletion on the basis of gross income and taxable income from the aggregated property for the entire year, including the gross income and deductions with respect to operating mineral interest No. 4 for the period from July 1 to December 31. If a portion of the aggregated property is sold during the first six months, its adjusted basis must be determined at the time of sale with an adjustment for depletion to the date of sale. If percentage depletion is applicable, it must be allocated on an equitable basis to the periods prior and subsequent to the date of sale in order to determine the adjustment for depletion to the date of sale.

Example 5. A taxpayer owns two operating mineral interests in oil wells, designated Nos. 1 and 2, in tract A, and another such interest, designated No. 3, in tract B. All three interests are in the same operating unit (as defined in paragraph (c) of §1.614– 2). The taxpayer, who is on a calendar year basis, has properly elected under §1.614–2 to aggregate such interests for the calendar years 1954 through 1963. The unadjusted bases and adjustments under section 1016 for depletion through December 31, 1953, in respect of such interests are as follows:

	Unadjusted basis	Adjustments under section 1016
No. 1	$42,000	$11,000
No. 2	37,000	4,000
No. 3	19,000	23,000
Total	98,000	38,000

The adjusted basis of the aggregated property as of January 1, 1954, is therefore $60,000 ($98,000 minus $38,000). The taxpayer properly elects under section 614(b) and §1.614–8 to treat Nos. 1 and 2 as separate properties for the calendar year 1964 and thereafter and does not elect to use the allocation of adjustments method of determining basis provided in subparagraph (2) (ii) *(b)* of this paragraph. No. 3 will be treated as a separate property, also, because it is in a different tract than the taxpayer's other interests. From January 1, 1954, through December 31, 1963, $50,000 of depletion has been allowed with respect to the aggregated property, leaving an adjusted basis of $10,000 ($60,000 minus $50,000) on January 1, 1964. On December 31, 1963, the aggregated property has a fair market value of $40,000. Nos. 1, 2, and 3 have fair market values of $16,000, $22,000, and $2,000, respectively. Accordingly, the adjusted bases of Nos. 1, 2, and 3 on January 1, 1964, are $4,000,

$$\left(\begin{array}{l}\$10{,}000\,\text{(adjusted basis}\\ \text{of aggregated property)}\end{array}\times\frac{16{,}000}{40{,}000}\right),$$

$5,500 [$10,000×(22,000/40,000)], and

$500 [$10,000×(2,000/40,000)] respectively.

Example 6. A taxpayer owns four operating mineral interests in oil wells, designated Nos. 1, 2, 3, and 4. All four interests are in the same operating unit and the same tract or parcel of land. The taxpayer, who is on a calendar year basis, has properly elected under § 1.614–2 to aggregate such interests for the calendar years 1954 through 1963. The taxpayer properly elects under section 614(b) and paragraph (a) of § 1.614–8 to treat Nos. 1 and 2 as separate properties for the calendar year 1964 and thereafter. The taxpayer also properly elects to use the allocation of adjustments method of determining basis as provided in subparagraph (2) (ii) *(b)* of this paragraph. The unadjusted bases of Nos. 1, 2, and combined 3 and 4, the adjustments attributable to each, and the deaggregated basis of each (prior to further adjustment as provided in subparagraph (2) (ii) *(b) (ii)* of this paragraph) are as follows:

	Basis upon acquisition	Adjustments to time of aggregation	Attributable adjustments during aggregation	Basis upon deaggregation after first adjustment
No. 1	$35,000	$1,000	$16,000	$18,000
No. 2	30,000	11,000	23,000	0
No. 3	25,000	3,000	5,000	....
No. 4	10,000	12,000	9,000	6,000
Total	100,000	27,000	53,000	24,000

The total of the adjusted bases (prior to further adjustment) of the interests which were included in the aggregation is $24,000 while the adjusted basis of the aggregation is $20,000 ($100,000 minus the sum of $27,000 and $53,000). Therefore, the adjusted bases of the interests are further reduced by $4,000 ($24,000 minus $20,000). The adjusted basis of No. 1 of $18,000 is further reduced by $3,000 [$4,000×(18,000÷24,000)] to $15,000. Similarly, the adjusted basis of combined Nos. 3 and 4 of $6,000 is further reduced by $1,000 [$4,000×(6,000÷24,000)] to $5,000. Assume further that the taxpayer also owns interest No. 5 in the same tract or parcel of land, that such interest was not a part of any aggregation, that such interest had a basis of $15,000 upon acquisition and had subsequent adjustments in reduction of basis totalling $17,000, and that the taxpayer does not elect to treat such interest as a separate property. In such case, Nos. 3, 4, and 5 will be combined. The combination will have an adjusted basis of $3,000, determined by adding the unadjusted basis of No. 5 ($15,000) and the adjusted bases of combined Nos. 3 and 4 upon deaggregation ($5,000), and subtracting from the total thereof ($20,000) the adjustments to No. 5 ($17,000).

(4) *Basis for gain and loss where mineral interests acquired before March 1, 1913, are included in an aggregation.* Where mineral interests acquired before March 1, 1913, are included in an aggregation under section 614 (b), (c), or (e), the aggregated property has two bases, one for the determination of gain and another for the determination of loss upon the disposition of the whole or a part of the aggregated property. For the purpose of determining gain, the adjusted basis of the aggregated property on the effective date of aggregation shall be the sum of:

(i) The unadjusted bases of those mineral interests acquired on or after March 1, 1913, plus

(ii) The cost of any interest acquired before March 1, 1913 (adjusted for the period before March 1, 1913), or the fair market value of such interest as of March 1, 1913, whichever is greater,

and such sum shall be adjusted by the total of all adjustments to the bases of the several mineral interests aggregated as required by section 1016 to the effective date of aggregation. For the purpose of determining loss, the adjusted basis of the aggregated property on the effective date of aggregation shall be the sum of:

(iii) The unadjusted bases of those mineral interests acquired on or after March 1, 1913, plus

(iv) The cost of those interests acquired before March 1, 1913, adjusted for the period before March 1, 1913,

and such sum shall be adjusted by the total of all adjustments to the bases of the several mineral interests aggregated as required by section 1016 to the effective date of aggregation. Thereafter, the adjustments to basis required by section 1016 shall apply to the total adjusted basis of the aggregated property for all purposes of the Code. Upon disposition of a part of the aggregated property, or upon termination of the aggregation for any reason, or upon change in the treatment of any mineral interests in the aggregation with consent of the Commissioner, the adjusted basis for determining gain and the adjusted basis for determining loss with respect to each resultant part of the aggregated property shall be determined in accordance with subparagraph (2) of this paragraph. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. At the close of 1953 a taxpayer owned two operating mineral interests designated as Nos. 1 and 2 in the same operating unit. Operating mineral interest No. 1 was acquired by the taxpayer before March 1, 1913, and on such date its basis with reference to its fair market value was $50,000 and its adjusted basis with reference to its cost was $44,000. The unadjusted basis of operating mineral interest No. 2, acquired after March 1, 1913, was $30,000. Adjustments under section 1016 for depletion from March 1, 1913, through December 31, 1953, were $37,000 for operating mineral interest No. 1 and $20,000 for operating mineral interest No. 2. Assume that the taxpayer elected for the taxable year 1954 to aggregate operating mineral interests Nos. 1 and 2. The adjusted basis of the aggregated property as of January 1, 1954, for the purpose of determining gain would be $23,000 ($50,000 plus $30,000) minus ($37,000 plus $20,000). For the purpose of determining loss, the adjusted basis would be $17,000 ($44,000 plus $30,000) minus ($37,000 plus $20,000).

Example 2. Assume the same facts as in example 1 and further assume that for the taxable years 1954 and 1955, the taxpayer was allowed $5,000 of depletion on the aggregated property, that on January 1, 1956, he sold a portion of the aggregated property for $20,000, and that, as of January 1, 1956, the aggregated property had a fair market value of $24,000. At the time of sale, the adjusted basis of the aggregated property for the purpose of determining gain was $18,000 ($23,000–$5,000); and the adjusted basis for the purpose of determining loss was $12,000 ($17,000–$5,000). The adjusted basis of the portion sold would be computed as follows:

$$\frac{\$20{,}000\ \text{(FMV of portion sold)}}{\$24{,}000\ \text{(FMV of aggregated property)}} \times \begin{array}{c}\$18{,}000\ \text{(adjusted}\\ \text{basis for gain)}\end{array} = \begin{array}{c}\$15{,}000\ \text{(adjusted}\\ \text{basis of portion sold)}\end{array}$$

Taxpayer's gain would then be computed as follows:

$$\begin{array}{rrl} & \$20{,}000 & \text{(amount received for portion sold)}\\ \text{Less:} & \underline{\$15{,}000} & \text{(adjusted basis of portion sold)}\\ & \$5{,}000 & \text{(gain on portion sold)}\end{array}$$

The adjusted basis of the portion retained as of January 1, 1956, for the purpose of determining gain is $3,000 ($18,000–$15,000). For the purpose of determining loss, the adjusted basis is $2,000 ($12,000–$10,000).

Example 3. Assume the same facts as in example 2, except that a portion of the aggregated property was sold for $5,000 and that the fair market value of the aggregated property at the time of sale was $10,000. The adjusted basis of the portion sold would be computed as follows:

$$\frac{\$5{,}000\ \text{(FMV of portion sold)}}{\$10{,}000\ \text{(FMV of aggregated property)}} \times \begin{array}{c}\$12{,}000\ \text{(adjusted}\\ \text{basis for loss)}\end{array} = \begin{array}{c}\$6{,}000\ \text{(adjusted basis}\\ \text{of portion sold)}\end{array}$$

Taxpayers loss would then be computed as follows:

	$5,000	(amount received for portion sold)
Less:	$6,000	(adjusted basis of portion sold)
	($1,000)	(loss on portion sold)

(5) *Basis for gain and loss where mineral interests acquired before March 1, 1913, are included in a combination and one or more of such interests have not previously been included in an aggregation.* Where mineral interests acquired before March 1, 1913, are included in a combination under section 614(b) and § 1.614–8 and one or more of such interests have not previously been included in an aggregation, the combined property has two bases, one for the determination of gain and another for the determination of loss upon the disposition of the whole or a part of the combined property. For the purpose of determining gain, the adjusted basis of the combined property on the effective date of combination shall be the sum of:

(i) The adjusted bases at the time of deaggregation, as determined under subparagraph (2) of this paragraph, of all interests which have previously been included in an aggregation,

(ii) The unadjusted bases of other mineral interests acquired on or after March 1, 1913, and

(iii) The cost of each other interest acquired before March 1, 1913 (adjusted for the period before March 1, 1913), or the fair market value of such interest as of March 1, 1913, whichever is greater,

and such sum shall be adjusted by the total of all adjustments to the bases of the mineral interests as required by section 1016 to the effective date of combination. For the purpose of determining loss, the adjusted basis of the combined property on the effective date of combination shall be the sum of:

(iv) The adjusted bases at the time of deaggregation, as determined under subparagraph (2) of this paragraph, of all interests which have previously been included in an aggregation.

(v) The unadjusted bases of other mineral interests acquired on or after March 1, 1913, and

(vi) The cost of other mineral interests acquired before March 1, 1913, adjusted for the period before March 1, 1913,

and such sum shall be adjusted by the total of all adjustments to the bases of the mineral interests as required by section 1016 to the effective date of combination. Thereafter, the adjustments to basis required by section 1016 shall apply to the total adjusted basis of the combined property for all purposes of the Code. Upon disposition of a part of the combined property, the adjusted basis for determining gain and the adjusted basis for determining loss with respect to each resultant part of the combined property shall be determined in accordance with subparagraph (2) of this paragraph.

(b) *Holding period of aggregated or combined properties.* Where a taxpayer sells or exchanges either a part or all of an aggregated or combined property which includes part or all of a mineral interest which the taxpayer has held for (1 year 6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less, the sales price and adjusted basis attributable to the interest sold must be apportioned in proportion to the relative fair market values as of the date of sale to determine the amount of income represented by the sale of property held for (1 year 6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less. The application of this rule may be illustrated by the following example:

Example. Taxpayer A owns operating mineral interests Nos. 1, 2, and 3. He acquired interests Nos. 1 and 2 in 1953 but purchased and made development expenditures on interest No. 3 on December 1, 1954. In his return for the taxable year 1954, taxpayer A elects to aggregate interests Nos. 1, 2, and 3 which are operated as a unit. On May 1, 1955, taxpayer A sells the north half of the aggregated property which includes portions of interests Nos. 1, 2, and 3. The sales price of the north half was $80,000; the adjusted basis of the aggregated property as of the date of sale was $20,000; and the fair market value of the aggregated property as of the date of sale was $100,000. The adjusted basis applicable to the north half is computed as follows:

$$\frac{\$80{,}000\text{ (FMV of portion sold)}}{\$100{,}000\text{ (FMV of aggregated property)}}\times\$20{,}000\text{ (adjusted basis of aggregated property)}=\$16{,}000\text{ (adjusted basis of portion sold)}$$

The total gain on the sale is $64,000 ($80,000 − $16,000).

The gain attributable to the sale of the portion held for six months or less is computed as follows (assuming that the fair market value of the portion of No. 3 included in the sale as of the date of sale was $30,000):

$$\frac{\$30{,}000\text{ (FMV of portion of No. 3 sold)}}{\$80{,}000\text{ (FMV of north half)}}\times\$16{,}000\text{ (adjusted basis of north half)}=\$6{,}000\text{ (adjusted basis of portion of No. 3 sold)}$$

The gain on the portion of No. 3 sold is $24,000 ($30,000–$6,000).

(c) *Acquisition of property with transferor's basis.* If a separate property or an aggregated or combined property is acquired in a transaction in which the basis of such property in the hands of the taxpayer is determined by reference to the basis of such property in the hands of a transferor, then the election of such transferor as to the treatment of such separate, aggregated, or combined property shall be binding upon the taxpayer for all taxable years ending after the transfer unless, in the case of an aggregation, the aggregation terminates or consent to make a change is obtained under paragraph (d) (4) of §1.614–2, paragraph (f) (7) of §1.614–3, or paragraph (b) (3) or (e) (5) of §1.614–5, whichever is applicable.

(d) *Abandonment and casualty losses.* In the case of mineral interests which are aggregated or combined as one property, no losses resulting from worthlessness or abandonment are allowable until all the mineral rights in the entire aggregated or combined property are proven to be worthless or until the entire aggregated or combined property is disposed of or abandoned. Casualty losses are allowable in accordance with the rules applicable to casualty losses in general. For rules applicable to losses in general, see section 165 and the regulations thereunder.

[T.D. 6524, 26 FR 159, Jan. 10, 1961, as amended by T.D. 6859, 30 FR 13701, Oct. 28, 1965; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§1.614–7 Extension of time for performing certain acts.

Sections 1.614–2 to 1.614–5, inclusive, require certain acts to be performed on or before May 1, 1961 (the first day of the first month which begins more than 90 days after the regulations under section 614 were published in the FEDERAL REGISTER as a Treasury decision). The district director may, upon good cause shown, extend for a period not exceeding 6 months the period within which such acts are to be performed, and shall, if the interests of the Government would otherwise be jeopardized thereby, grant such an extension only if the taxpayer and the district director agree in writing to a corresponding or greater extension of the period prescribed for the assessment of the tax, or in the case of taxable years described in section 614(c)(3)(E), the assessment of the tax resulting from the exercise or change in an election.

[T.D. 6561, 26 FR 3523, Apr. 25, 1961]

§ 1.614–8 Elections with respect to separate operating mineral interests for taxable years beginning after December 31, 1963, in the case of oil and gas wells.

(a) *Election to treat separate operating mineral interests as separate properties*—(1) *General rule.* If a taxpayer has more than one operating mineral interest in oil and gas wells in one tract or parcel of land, he may elect to treat one or more of such interests as separate properties for taxable years beginning after December 31, 1963. Any such interests with respect to which the taxpayer does not so elect shall be combined and treated as one property. Nonoperating mineral interests may not be included in such combination. There may be only one such combination in one tract or parcel. Any such combination of interests shall be considered as one property for all purposes of subtitle A of the Code for the period to which the election applies. The preceding sentence does not preclude the use of more than one account under a single method of computing depreciation or the use of more than one method of computing depreciation under section 167, if otherwise proper. Any reasonable and consistently applied method or methods of computing depreciation of the improvements made with respect to the separate interests which are combined may be continued in accordance with section 167 and the regulations thereunder. Except as provided in paragraph (b) of this section, such an interest in one tract or parcel may not be combined with such an interest in another tract or parcel. For rules with respect to the allocation of the basis of an aggregation of separate operating mineral interests under this section among such interests as of the first day of the first taxable year beginning after December 31, 1963, see paragraph (a) (2) (ii) of § 1.614–6. For the definition of *operating mineral interest* see paragraph (b) of § 1.614–2.

(2) *Election in respect of newly discovered or acquired interest or interest ceasing to participate in cooperative or unit plan of operation.* (i) If the taxpayer makes an election under this paragraph in respect of an operating mineral interest in a tract or parcel of land and, after the taxable year for which such election is made, an additional operating mineral interest in the same tract or parcel is discovered or acquired by the taxpayer or is the subject of an election under this paragraph because it ceases to participate in a cooperative or unit plan of operation to which paragraph (b) of this section applies, the additional operating mineral interest shall be treated:

(a) If there is no combination of interests in such tract or parcel, as a separate property unless the taxpayer elects to combine it with another interest, or

(b) If there is a combination of interests in such tract or parcel, as part of such combination unless the taxpayer elects to treat it as a separate property.

(ii) The application of this subparagraph may be illustrated by the following example:

Example. Prior to 1964 a taxpayer acquired, and incurred development expenditures with respect to, three operating mineral interests in oil, designated Nos. 1, 2, and 3. All three interests are in the same tract or parcel of land. For the taxable year 1964, the taxpayer elects to treat such interests as three separate properties. During the taxable year 1965, the taxpayer discovers and incurs development costs with respect to a fourth operating mineral interest, No. 4, in the same tract of land. During the taxable year 1966, the taxpayer discovers and incurs development costs with respect to a fifth operating mineral interest, No. 5, in the same tract of land. If the taxpayer makes no election relative to No. 4 for 1965, such interest will thereafter be treated as a separate property. Alternatively, the taxpayer may make an election for 1965 to combine No. 4 with any one (and only one) of the three other interests and to treat such combination as one property. If, for example, he elects to combine No. 4 with No. 3, then in 1966, No. 5 will automatically become part of the combination of Nos. 3 and 4 if no election is made to treat it as a separate property. After the combination of Nos. 3 and 4 is formed, Nos. 1 and 2, which were acquired or discovered prior to the formation of the combination and which were not included in such combination within the time prescribed, may not be included in that or any other combination. However, see subparagraph (3) (iv) of this paragraph.

(3) *Manner and scope of election*— (i) *Election; when made.* Except as provided hereafter in this subdivision (i), any election under subparagraph (1) or (2) of this paragraph shall be made for each operating mineral interest not later than the time prescribed by law for filing the income tax return (including extensions thereof) for whichever of the following taxable years is later:

(a) The first taxable year beginning after December 31, 1963; or

(b) The first taxable year in which any expenditure for development or operation in respect of such operating mineral interest is made by the taxpayer after his acquisition of such interest.

Notwithstanding the provisions of *(a)* and *(b),* if it is determined that the operating mineral interest in respect of which the election is to be made was, during what would otherwise be the entire effective period of the election insofar as it would apply to the appropriate taxable year determined under *(a)* and *(b),* participating in a cooperative or unit plan of operation to which section 614(b)(3) applies, the election shall be made not later than the time prescribed by law for filing the income tax return (including extensions thereof) for the taxable year in which the interest ceases to participate in the cooperative or unit plan. See subdivision (iii) of this subparagraph for provisions relating to the effective date of an election and paragraph (b) of this section for provisions relating to certain unitization or pooling arrangements. For purposes of this subparagraph, expenditures for development include any intangible drilling or development costs within the purview of section 263(c). Delay rentals are not considered as expenditures for development. For purposes of this subparagraph, the acquisition of an option to acquire an economic interest in minerals in place does not constitute the acquisition of a mineral interest.

(ii) *Election; how made.* Any election under this paragraph shall be made by a statement attached to the income tax return of the taxpayer for the first taxable year for which the election is made. This statement shall identify by name, code number, or other means the operating mineral interests within the same tract or parcel of land which the taxpayer is electing to treat as separate properties or in combination, as the case may be. The statement shall also identify by name, code number, or other means the tract or parcel and shall set forth the facts upon which its treatment as a single and entire tract or parcel is based. See paragraph (a) (3) of §1.614–1. However, if the taxpayer is electing to treat all of his operating mineral interests in a tract or parcel as separate properties, a blanket election with respect to all of such interests in that tract or parcel which are owned by the taxpayer at the time the election is made will suffice and only the tract or parcel itself need be so identified. The taxpayer shall maintain and have available records and maps sufficient to clearly define the tract or parcel and all of the taxpayer's operating mineral interests therein.

(iii) *Election; when combination effective.* *(a)* If, by reason of the exercise or nonexercise of an election under this paragraph, a combination is formed of two or more operating mineral interests, all of which are owned and operated by a taxpayer on the first day of the first taxable year beginning after December 31, 1963, and are not participating in a cooperative or unit plan of operation to which paragraph (b) of this section applies on such first day, the combination is effective on such first day.

(b) If, by reason of the exercise or nonexercise of an election under this paragraph, a combination of operating mineral interests not described in *(a)* of this subdivision (including a combination described in *(a)* to which another operating mineral interest is added) is formed, the date on which each operating mineral interest which is being combined by the taxpayer for the first time enters into the combination is the later of *(1)* the earliest date within the taxable year affected on which the taxpayer incurred any expenditure for development or operation of such interest at a time when such interest was not participating in a cooperative or unit plan of operation to which paragraph

(b) of this section applies, or *(2)* the earliest date on which the taxpayer incurred any expenditure for development or operation of any other interest with which such interest is to be combined at a time when such other interest was not participating in a cooperative or unit plan of operation to which paragraph (b) of this section applies.

(c) The application of these provisions may be illustrated by the following examples:

Example 1. In 1963, a taxpayer owned and operated mineral interests Nos. 1 and 2, both of which are in the same tract or parcel of land. Neither No. 1 nor No. 2 participates in a cooperative or unit plan of operation. The taxpayer, who is on a calendar year basis, continued to own and operate these interests during the year 1964, and made no election with respect to such interests in his income tax return for that year. As a result, Nos. 1 and 2 are combined as of January 1, 1964.

Example 2. Assume that the taxpayer described in example 1 discovered operating mineral interests Nos. 3 and 4 in the same tract or parcel of land as Nos. 1 and 2, that he made his first expenditures for the development of No. 3 on June 1, 1964, and of No. 4 on September 1, 1964, and that, in a timely return for 1964, he elected to treat No. 3 as a separate property and made no election with respect to No. 4. As a result, No. 3 is treated as a separate property and No. 4 joins the combination of Nos. 1 and 2 as of September 1, 1964.

Example 3. On March 1, 1964, a taxpayer acquired a tract or parcel of land containing operating mineral interests Nos. 1 and 2. The taxpayer made his first operating expenditures on No. 1 on April 1, 1964. On October 1, 1964, the taxpayer made his first development expenditures with respect to operating mineral interest No. 2. The taxpayer made no election with respect to these interests. As a result, Nos. 1 and 2 enter into a combination as of October 1, 1964.

(iv) *Election; binding effect.* A valid election made under section 614(b) and this subparagraph shall be binding upon the taxpayer for the first taxable year for which made and for all subsequent taxable years. However, notwithstanding the preceding sentence, an election to treat one or more operating mineral interests as separate properties shall not prevent the making of a later election to combine a newly discovered or acquired operating mineral interest with one of such interests, if no other combination exists in the tract or parcel of land on the date when the later election would become effective under subdivision (iii) of this subparagraph. Nor will an election to treat an operating mineral interest as a separate property prevent its treatment with another interest as a single property under paragraph (b) of this section if such interest later participates in a cooperative or unit plan of operation to which paragraph (b) applies. For rules relating to the binding effect of an election in certain cases in which the basis of a separate or combined property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, see paragraph (c) of § 1.614–6.

(b) *Certain unitization or pooling arrangements.* (1) Except as provided in this paragraph, if one or more of the taxpayer's operating mineral interests, or a part or parts thereof, participate, under a voluntary or compulsory unitization or pooling agreement as defined in subparagraph (6) of this paragraph, in a single cooperative or unit plan of operation, then for the period of such participation in taxable years beginning after December 31, 1963, such interest or interests, and part or parts thereof, included in such unit, shall be treated for purposes of subtitle A of the Code as one property, separate from the interest or interests, or part or parts thereof, not included in such unit.

(2) Subparagraph (1) of this paragraph shall apply to a voluntary agreement only if all the operating mineral interests covered by the agreement are in the same deposit or are in two or more deposits, the joint development or production of which is logical, without taking tax benefits into account, from the standpoint of geology, convenience, economy, or conservation, and which are in tracts or parcels of land which are contiguous or in close proximity. Operating mineral interests under a voluntary agreement to which subparagraph (1) does not apply are subject to the rules contained in paragraph (a) of this section. For purposes of this paragraph an agreement is voluntary unless required by the laws or rulings of any State or any agency of any State.

(3) Notwithstanding the provisions of subparagraph (1) of this paragraph, if

the taxpayer, for the last taxable year beginning before January 1, 1964, treated as separate properties two or more operating mineral interests which participate, under a voluntary or compulsory unitization or pooling agreement entered into in any taxable year beginning before January 1, 1964, in a single cooperative or unit plan of operation, and if it is determined that such treatment was proper under the law applicable to such taxable year, the taxpayer may continue to treat all such interests in a consistent manner for the period of such participation. If it is determined that such treatment was not proper under the law applicable to such taxable year, or if the taxpayer does not continue to treat all such interests in a manner consistent with the treatment of them for the last taxable year beginning before January 1, 1964, the treatment of the interests shall be in accordance with the provisions of subparagraph (1).

(4) If only a part of an operating mineral interest, which interest is not being treated under paragraph (a) of this section as part of a combination of interests, participates in a unit or pool, such part shall, for the period of its participation in the unit or pool, be treated for purposes of this section as being separate from the nonparticipating portion of the operating mineral interest of which it is a part. A portion of the adjusted basis and of the units of mineral of such operating mineral interest remaining at the beginning of the period described in the preceding sentence shall be allocated to the participating part in accordance with the principles contained in paragraph (a)(2)(i)*(a)* of §1.614–6 as if such participating part had been sold. If participation in the unit or pool ends, the separate status of the participating part shall immediately terminate. At such time the adjusted basis of such part and the units of mineral with respect to such part remaining at the time of termination shall be added to the adjusted basis and to the remaining units of mineral of the nonparticipating portion of the operating mineral interest. During the period of participation in the unit or pool such participating part shall not be treated separately from the nonparticipating portion of the operating mineral interest in applying section 165.

(5) Where an operating mineral interest which is being treated under paragraph (a) of this section as part of a combination of interests begins participation in a unit or pool, the combination shall remain in force but the treatment of such participating interest as a part of the combination shall be suspended for the period of its participation in the unit or pool. If, for example, a taxpayer owns operating mineral interests Nos. 1, 2, and 3 in a single tract or parcel of land, elects to treat No. 1 as a separate property (with mineral interests Nos. 2 and 3 thus being combined), is later required by an agency of a State to place No. 2 in a unit, and subsequently discovers operating mineral interest No. 4 in the same tract or parcel of land, then under paragraph (a)(2)(i)*(b)* of this section No. 4 will automatically be combined with No. 3 unless the taxpayer elects to treat it as a separate property. Under this subparagraph, an interest may be treated as part of a combination for a portion of a taxable year and as part of a unit or pool for a portion of a taxable year. At the commencement of participation in the unit or pool, a portion of the adjusted basis of the combination and a portion of the units of mineral with respect to the combination remaining at that time shall be allocated to such participating interest in accordance with the principles contained in paragraph (a)(2)(i)*(a)* of §1.614–6 as if such interest had been sold. During the period of participation in the unit or pool such participating interest is nevertheless treated as a part of the combination for purposes of paragraph (d) of §1.614–6. If participation in the unit or pool ends, the treatment of such interest as participating in the unit or pool shall immediately terminate. At such time, the adjusted basis of the participating interest and the units of mineral with respect to such interest remaining at the time of termination shall be added to the adjusted basis and to the remaining units of mineral of the nonparticipating portion of the combination. In determining the adjusted basis of the participating interest at the time of termination there shall be

taken into account any section 1016 adjustments attributable to such interest for the period of its participation in the unit or pool. If two or more operating mineral interests of the taxpayer participate in a unit or pool and are treated as one property under subparagraph (1) of this paragraph, and if participation by such interests in the unit or pool terminates, the adjusted basis of each such interest at the time of termination shall be separately determined. If the total of the adjusted bases of such interests upon termination of their participation in the unit or pool exceeds the adjusted basis of such one property, then the adjusted bases of such interests shall be further adjusted by applying the principles contained in paragraph (a)(2)(ii)*(b)(ii)* of § 1.614–6 so that the total of the adjusted bases of such interests equals the adjusted basis of such one property. In addition, the units of oil and gas estimated to be attributable to a participating interest at the time of termination of participation shall be restored to the units of oil and gas of the combination of which it is a part. The rules stated in this subparagraph with respect to an operating mineral interest which is being treated under paragraph (a) of this section as part of a combination and which begins participation in a unit or pool shall also apply to a portion of an operating mineral interest which is being treated under paragraph (a) as part of a combination if such portion begins participation in a unit or pool.

(6) As used in this paragraph, the term *unitization or pooling agreement* means an agreement under which two or more persons owning operating mineral interests agree to have the interests operated on a unified basis and further agree to share in production on a stipulated percentage or fractional basis regardless of from which interest or interests the oil or gas is produced. In addition, in a situation in which one person owns operating mineral interests in several leases, an agreement of such person with his several royalty owners to determine the royalties payable to each on a stipulated percentage basis regardless of from which lease or leases oil or gas is obtained is also considered to be a unitization or pooling agreement. No formal cross-conveyance of properties is necessary. An agreement between co-owners of a tract or parcel of land or a part thereof for the development of the property by one of such co-owners for the account of all is not a unitization or pooling agreement, provided that the agreement does not affect ownership of minerals or entitle any such co-owner to share in production from any operating mineral interests other than his own.

(c) *Operating mineral interest defined.* For the definition of the term *operating mineral interest* as used in this section, see paragraph (b) of § 1.614–2.

(d) *Alternative treatment under Internal Revenue Code of 1939.* If, on the day preceding the first day of the first taxable year beginning after December 31, 1963, the taxpayer has any operating mineral interests which he treats under section 614(d) (as in effect before the amendments made by the Revenue Act of 1964) and § 1.614–4, such treatment shall be continued and shall be deemed to have been adopted pursuant to the provisions of section 614(b) and paragraph (a) of this section. Accordingly, a taxpayer, who has four operating mineral interests in a single tract or parcel of land, and who has treated two of such interests as one property and two of such interests as separate properties under section 614(d) prior to the first day of the first taxable year beginning after December 31, 1963, is deemed to have adopted such treatment pursuant to the provisions of section 614(b) and paragraph (a) of this section. Hence, in the absence of an election to the contrary, a fifth operating mineral interest in the same tract or parcel acquired by the taxpayer in a taxable year beginning after December 31, 1963, will, after an expenditure for development or operation, be combined with the combination of two interests made under section 614(d). Furthermore, an election which was made for a taxable year beginning before January 1, 1964, under section 614(d) as then in effect will be binding for all taxable years beginning after December 31, 1963, even though the time for making an election under section 614(b) and paragraph (a) of this section has not elapsed.

[T.D. 6859, 30 FR 13703, Oct. 28, 1965]

§1.615–1 Pre-1970 exploration expenditures.

(a) *General rule.* Section 615 prescribes rules for the treatment of expenditures (paid or incurred before January 1, 1970) for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (other than oil or gas) paid or incurred by the taxpayer before the beginning of the development stage of the mine or other natural deposit. Such expenditures hereinafter in the regulations under section 615 will be referred to as exploration expenditures. The development stage of the mine or other natural deposit will be deemed to begin at the time when, in consideration of all the facts and circumstances (including the actions of the taxpayer), deposits of ore or other mineral are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. A taxpayer who elects under section (e) may treat exploration expenditures under either section 615(a) or section 615(b). See §1.615–6 for the method of making the election to treat exploration expenditures under section 615. Under section 615(a), a taxpayer may, at his option, deduct exploration expenditures paid or incurred in an amount not to exceed $100,000 for any taxable year. Under section 615(b) and §1.615–2, he may elect to defer any part of such amount and deduct such part on a ratable basis as the units of produced minerals benefited by such expenditures are sold. If the taxpayer does not treat exploration expenditures under either section 615 (a) or (b) in any year for which his election under section 615(e) is effective, the expenditures for such year will be charged to depletable capital account. The option to deduct under section 615(a) and the election to defer under section 615(b), however, are subject to the limitation provided in section 615(c) and §1.615–4. In the case of certain corporations which are members of an affiliated group which has elected the 100 percent dividends received deduction under section 243(b), see section 243(b) (3) and §1.243–5 for limitations on the option to deduct under section 615(a) and the election to defer under section 615(b).

(b) *Expenditures to which section 615 is not applicable.* (1) Section 615 is not applicable to expenditures which would be allowed as a deduction for the taxable year without regard to such section.

(2) Section 615 is not applicable to expenditures which are reflected in improvements subject to allowances for depreciation under sections 167 and 611. However, allowances for depreciation of such improvements which are used in the exploration of ores or minerals are considered exploration expenditures under section 615. If such improvements are used only in part for exploration during a taxable year, an allocable portion of the allowance for depreciation shall be treated as an exploration expenditure.

(3) Section 615 is applicable to exploration expenditures paid or incurred by a taxpayer in connection with the acquisition of a fractional share of the working or operating interest to the extent of the fractional interest so acquired by the taxpayer. The expenditures attributable to the remaining fractional share shall be considered as the cost of his acquired interest and shall be recovered through depletion allowances. For example, taxpayer A owns mineral leases on unexplored mineral lands and agrees to convey an undivided three-fourths (¾) interest in such leases to taxpayer B provided B will pay all of the exploration expenditures for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral which will be incurred before the beginning of the development stage. B shall treat three-fourths of such amount under section 615, and shall treat one-fourth of such amount as part of the cost of his interest, recoverable through depletion.

(4) The provisions of section 615 do not apply to costs of exploration which are reflected in the amount which the taxpayer paid or incurred to acquire the property. Such provisions apply only to costs paid or incurred by the taxpayer for exploration undertaken directly or through a contract by the taxpayer. See, however, sections 381(a)

and 381(c) (10) for special rules with respect to deferred exploration expenditures in certain corporate acquisitions.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7192, 37 FR 12938, June 30, 1972]

§ 1.615–2 Deduction of pre-1970 exploration expenditures in the year paid or incurred.

(a) *In general.* (1) If the election to treat exploration expenditures under section 615 has been made or is deemed made under § 1.615–6(b) subject to the total limitation of $100,000, a taxpayer who has made exploration expenditures prior to January 1, 1970, with respect to more than one mine or other natural deposit may deduct for a taxable year for which such election is effective any portion of such expenditures attributable to each mine or deposit. With respect to a particular mine or other natural deposit, a taxpayer who has made the election described in the preceding sentence may deduct under section 615(a) a portion of the exploration expenditures and may defer and deduct under section 615(b) the balance of such expenditures. For any taxable year for which the election to treat exploration expenditures under section 615 is effective, the taxpayer must charge any amount of exploration expenditures in excess of $100,000 to capital account and must charge to capital account whatever amount has not been deducted currently or deferred. For example, taxpayer A who has elected under section 615(e) has three mines, X, Y, and Z. In the taxable year 1967, A makes exploration expenditures of $75,000 with respect to each mine. The total allowable deduction for exploration expenditures is $100,000. A deducts $50,000 and defers $25,000 with respect to X. He deducts $25,000, and charges to capital account $50,000 with respect to Y, and charges to capital account the entire $75,000 paid with respect to Z. Thus, A has deducted or deferred $100,000 and capitalized the excess.

(2) Except as provided in section 615(e) and § 1.615–6, a taxpayer cannot change his treatment of exploration expenditures for a taxable year after the due date (including extensions of time) for filing the return for the taxable year except where it is subsequently determined that any part of such exploration expenditures deducted under section 615(a) or deferred under section 615(b) are not exploration expenditures for the taxable year. Where the taxpayer has made the election to treat exploration expenditures under section 615 and it is subsequently determined that part of the expenditures deducted under section 615(a) or deferred under section 615(b), for a taxable year, were not exploration expenditures for such taxable year, the exploration expenditures required to be charged to capital account for such taxable year by reason of the limitation may be deducted or deferred (to the extent of the subsequent determination) and proper adjustment made to capital account. A taxpayer claiming a deduction under section 615(a) shall indicate clearly on his income tax return the amount of the deduction claimed under such section with respect to each mine or other natural deposit. Such mine or deposit shall be identified by an adequate description.

[T.D. 7192, 37 FR 12938, June 30, 1972]

§ 1.615–3 Election to defer pre-1970 exploration expenditures.

(a) *General rule.* A taxpayer who makes the election provided in section 615(e) may defer any portion of the exploration expenditures made before January 1, 1970, with respect to each mine or other natural deposit, subject to the limitations described in section 615(c) and § 1.615–4. The amounts so deferred shall be deducted ratably as the units of produced ores or minerals discovered or explored by reason of such expenditures are sold.

(b) *Effect and manner of making election.* (1) The election to defer exploration expenditures shall apply only to expenditures for the taxable year for which made. However, once made, the election shall be binding with respect to the expenditures for that taxable year. Thus, a taxpayer cannot revoke his election for any reason whatsoever.

(2) The election shall be made for each mine or other natural deposit by a clear indication on the return or by a statement filed with the district director with whom the return was filed, not later than the time prescribed by law

for filing such return (including extensions thereof) for the taxable year to which such election is applicable.

(c) *Expenditures made by the owner who retains a non-operating mineral interest.* (1) A taxpayer who elects to defer exploration expenditures and thereafter transfers his interest in the mine or other natural deposit, retaining an economic interest therein, shall deduct an amount attributable to such interest on a pro rata basis as the interest pays out. For example, a taxpayer who defers exploration expenditures and then leases his deposit, retaining a royalty interest therein, shall deduct the deferred expenditures ratably as he receives royalties. If the taxpayer receives a bonus or advanced royalties in connection with the transfer of his interest, he shall deduct deferred expenditures allocable to such bonus or advanced royalties in an amount which is in the same proportion to the total of such costs as the bonus or advanced royalties bears to the bonus and total royalties expected to be received. Also, in the case of a transfer of a mine or other natural deposit by a taxpayer who retains a production payment therein, he shall deduct the exploration expenditures ratably over the payments expected to be received.

(2) Where a taxpayer receives an amount, in addition to retaining an economic interest, which amount is treated as from the sale or exchange of a capital asset or property treated under section 1231 (except coal or iron ore to which section 631(c) applies), the deferred exploration expenditures shall be allocated between the interest sold and the interest retained in proportion to the fair market values of each interest as of the date of sale. The amount allocated to the interest sold may not be deducted, but shall be a part of the basis of such interest.

(d) *Losses from abandonment.* Section 165 and the regulations thereunder contain general rules relating to the treatment of losses resulting from abandonment.

(e) *Computation of amount of deduction.* The amount of the deduction allowable during the taxable year is an amount A, which bears the same ratio to B (the total deferred exploration expenditures for a particular mine or other natural deposit reduced by the amount of such expenditures deducted in prior taxable years) as C (the number of units of the ore or mineral benefited by such expenditures sold during the taxable year) bears to D (the number of units of ore or mineral benefited by such expenditures remaining as of the taxable year). For the purposes of this proportion, the *number of units of ore or mineral benefited by such expenditures remaining as of the taxable year* is the number of units of ore or mineral benefited by the deferred exploration expenditures remaining at the end of the year to be recovered from the mine or other natural deposit (including units benefited by such expenditures recovered but not sold) plus the number of units benefited by such expenditures sold within the taxable year. The principles outlined in §1.611–2 are applicable in estimating the number of units remaining as of the taxable year and the number of units sold during the taxable year. The estimate is subject to revision in accordance with that section in the event it is ascertained from any source, such as operations or development work, that the remaining units are materially greater or less than the number of units remaining from a prior estimate.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6685, 28 FR 11405, Oct. 24, 1963; T.D. 6841, 30 FR 9306, July 27, 1965; T.D. 7192, 37 FR 12939, June 30, 1972]

§1.615–4 Limitation of amount deductible.

(a) *Taxable years beginning before July 7, 1960.* For any taxable year beginning before July 7, 1960 (including taxable years of less than 12 months), a taxpayer may deduct or defer exploration expenditures paid or incurred in the taxable year in an amount not in excess of $100,000. However, for such taxable years, the taxpayer may not avail himself of the provisions of section 615 for more than four taxable years (including taxable years of less than 12 months and taxable years subject to the Internal Revenue Code of 1939). Such four taxable years need not be consecutive. In determining the number of years in which a taxpayer has availed himself of section 615, a year for which he makes an election to defer exploration expenditures shall count as one year. Any subsequent taxable year in which such deferred expenditures are deducted shall not be taken into account as one of the four years. For purposes of the 4-year limitation, a year in which both a deduction and an election to defer are availed of by the taxpayer shall be taken into account as only one year.

(b) *Taxable years beginning after July 6, 1960.* For any taxable year beginning after July 6, 1960 (including taxable years of less than 12 months), a taxpayer who is otherwise eligible may deduct or defer exploration expenditures paid or incurred before January 1, 1970, in the lesser of the following amounts:

(1) The amount paid or incurred in the taxable year,

(2) $100,000, or

(3) $400,000 minus all amounts deducted or deferred for taxable years ending after December 31, 1950.

For purposes of this paragraph, the number of taxable years for which the taxpayer availed himself of the provisions of section 615 or the corresponding provisions of prior law is immaterial.

(c) *Special rules for previously deferred expenditures.* In determining whether an election to defer was availed of in applying the limitations of paragraphs (a) and (b) of this section, there shall be taken into account any year with respect to which amounts were deferred but not fully deducted because of a sale or other disposition of the mineral property, even though the balance of the deferred amounts was treated as part of the basis of the mineral property in determining gain or loss from the sale.

(d) *Example of application of provisions.* The application of the provisions of subparagraphs (a) and (b) of this section may be illustrated by the following example:

Example. A taxpayer on the calendar year basis, who has never claimed the benefits of section 615, or section 23(ff) of the 1939 Code, expended $200,000 for exploration expenditures during the year 1956. For each of the years 1957, 1958, 1959, and 1960 the taxpayer had exploration costs of $80,000. The taxpayer deducted or deferred the maximum amounts allowed for each of the years 1956, 1957, 1958, and 1959. None of the $80,000 expenditures for 1960 could be deducted or deferred by the taxpayer because he had already deducted or deferred exploration expenditures for 4 prior years. In 1961 the taxpayer expended $200,000 for exploration expenditures. The maximum amount the taxpayer may deduct or defer for the taxable year 1961 is $60,000 computed as follows:

(1) Add all yearly amounts deducted or deferred for exploration expenditures by the taxpayer for prior years.

Year	Expenditures	Deducted or deferred
1956	$200,000	$100,000
1957	80,000	80,000
1958	80,000	80,000
1959	80,000	80,000
1960	80,000	0
Total	....	340,000

(2) Subtract the sum of the amounts obtained in (1), $340,000, from $400,000, the maximum amount allowable to the taxpayer for deductions or deferrals of exploration expenditures.

Maximum amount allowable to taxpayer	$400,000
Sum of amounts obtained in (1)	340,000
	60,000

(e) *Transferee of mineral property.* (1) Where an individual or corporation transfers any property to the taxpayer and the transfer is one to which any of the subdivisions of this subparagraph apply, the taxpayer shall take into account for purposes of the 4-year limitation described in paragraph (a) of this section, all years that the transferor deducted or deferred exploration expenditures, and for purposes of the $400,000 limitation described in paragraph (b) of this section, all amounts that the transferor deducted or deferred.

(i) The taxpayer acquired any mineral property in a transaction described in section 23(ff)(3) of the Internal Revenue Code of 1939, excluding the reference therein to section 113(a)(13).

(ii) The taxpayer would be entitled under section 381(c)(10) to deduct exploration expenditures if the transferor (or distributor) corporation had elected to defer such expenditures. For example, if the taxpayer acquired any mineral property in a transaction described in section 381(a) (relating to the acquisition of assets through certain corporate liquidations and reorganizations), there shall be taken into account in applying the limitations of paragraph (a) of this section the years in which the transferor exercised the election to defer or deduct exploration expenditures, and there shall be taken into account in applying the limitations of paragraph (b) of this section any amount so deducted or deferred. See also section 381(c)(10) and the regulations thereunder.

(iii) The taxpayer acquired any mineral property under circumstances which make applicable the following sections of the Internal Revenue Code:

(a) Section 334(b)(1), relating to the liquidation of a subsidiary where the basis of the property in the hands of the distributee is the same as it would be in the hands of the transferor.

(b) Section 362 (a) and (b), relating to property acquired by a corporation as paid-in surplus or as a contribution to capital, or in connection with a transaction to which section 351 applies.

(c) Section 372(a), relating to reorganization in certain receiverships and bankruptcy proceedings.

(d) Section 373(b)(1), relating to property of a railroad corporation acquired in certain bankruptcy or recivership proceedings.

(e) Section 1051, relating to property acquired by a corporation that is a member of an affiliated group.

(f) Section 1082, relating to property acquired pursuant to a Securities Exchange Commission order.

(2) For purposes of subparagraph (1) of this paragraph, it is immaterial whether a deduction has been allowed or an election has been made by the transferor with respect to the specific mineral property transferred.

(3) Where a mineral property is acquired under any circumstance except those described in subparagraph (1) of this paragraph, the taxpayer is not required to take into account the election exercised by or deduction allowed to his transferor.

(4) For purposes of applying the limitations imposed by section 615(c): (i) the partner, and not the partnership, shall be considered as the taxpayer (see paragraph (a)(8)(iii) of §1.702–1), and (ii) an electing small business corporation, as defined in section 1371(b), and not its shareholders, shall be considered as the taxpayer.

(5) For purposes of subparagraph (1)(iii)*(b)* of this paragraph: (i) if mineral property is acquired from a partnership, the transfer shall be considered as having been made by the individual partners, so that the number of years for which section 615 has been availed of by each partner and the amounts which each partner has deducted or deferred under section 615 shall be taken into account, or (ii) if on interest in a partnership having mineral property is transferred, the transfer shall be considered as a transfer of mineral property by the partner or partners relinquishing an interest, so that the number of years for which section 615 has been availed of by each such partner and the amounts which each such partner has deducted or deferred under section 615 shall be taken into account.

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

Example 1. A calendar year taxpayer who has never claimed the benefits of section 615 received in 1956 a mineral deposit from X Corporation upon a distribution in complete liquidation of the latter under conditions which would make the provisions of section 334(b)(1) applicable in determining the basis of the property in the hands of the taxpayer. During the year 1955 X Corporation expended $60,000 for exploration expenditures which it elected to treat as deferred expenses. Assume further that the taxpayer made similar expenditures of $150,000, $125,000, $100,000, $60,000, and $180,000 for the years 1956, 1957, 1958, 1959, and 1961, respectively, which the taxpayer elected to deduct for each of those years to the extent allowable. No such expenditures were made for 1960. On the basis of these facts, the taxpayer may deduct or defer $100,000 for each of the years 1956, 1957, and 1958. No deduction or deferral is allowable for 1959 since the 4-year limitation of paragraph (a) of this section applies. The taxpayer may deduct or defer a maximum of $40,000 for 1961 since the $400,000 limitation of paragraph (b) of this section applies, but the 4-year limitation of paragraph (a) does not apply.

Example 2. Assume the same facts stated in example 1 except that, prior to acquisition by the taxpayer of the deposit from X Corporation in 1956, X Corporation had acquired the deposit in 1954 in a similar distribution from Y Corporation which, in the years 1952 and 1953, deducted exploration costs paid in respect of an entirely different deposit in the amounts of $30,000 and $50,000, respectively. Under these circumstances, the taxpayer may deduct or defer exploration expenditures paid or incurred in the amount of $100,000 for 1956. No deduction or deferral is allowable to the taxpayer for expenditures made in 1957, 1958, and 1959 since the 4-year limitation of paragraph (a) applies. The taxpayer may deduct or defer a maximum of $100,000 for 1961 since the 4-year limitation of paragraph (a) of this section no longer applies. If the taxpayer deducted or deferred $100,000 for each of the years 1956 and 1961 and also made exploration expenditures in 1962, the taxpayer may deduct or defer a maximum of $60,000 for that year under the $400,000 limitation of paragraph (b) of this section.

Example 3. In 1957, A and B transfer assets to a corporation under circumstances making section 351 applicable to such a transfer. Among the assets transferred by A is a mineral lease with respect to certain coal lands. A has deducted exploration expenditures under section 615 for the years 1954 and 1956 in the amounts of $50,000 and $100,000, respectively, made with respect to other deposits not included in the transfer to the corporation. The corporation shall be required to take into account the deductions previously made by A for purposes of applying the limitations of paragraphs (a) and (b) of this section.

Example 4. In 1956, A, B, and C form a partnership for the purpose of exploring for, developing, and producing uranium. A contributes a uranium lease to the partnership. A had individually made exploration expenses in the amount of $50,000 and $100,000 with respect to other mineral properties not contributed to the partnership and which he has deducted under section 615(a) for the years 1954 and 1955, respectively. B contributes a uranium lease to the partnership on which he made exploration expenditures in the amount of $100,000 in 1955 which he elected to defer under section 615(b). This is the only year in which B has used section 615. C contributes only cash to the partnership and has not previously used section 615. Subject to the limitations of section 615, for taxable years beginning before July 7, 1960, A may deduct or defer exploration expenses for two more taxable years (either as to expenditures incurred by him individually or with respect to his distributive share of partnership exploration expenses). B may deduct or defer exploration expenditures for three more years, and C may deduct or defer exploration expenditures for four years. For taxable years beginning after July 6, 1960, subject in each case to the $100,000 limitation per year, A may deduct or defer exploration expenditures in an amount not in excess of $250,000 ($400,000–$150,000), either as to expenditures incurred by him individually or with respect to his distributive share of partnership exploration expenditures. B may similarly deduct or defer exploration expenditures in an amount not in excess of $300,000 ($400,000–$100,000), and C may deduct or defer exploration expenditures in an amount not in excess of $400,000.

[T.D. 6685, 28 FR 11405, Oct. 24, 1963; as amended by T.D. 7192, 37 FR 12939, June 30, 1972

§ 1.615–5 Time for making election with respect to returns due on or before May 2, 1960.

In the case of any taxable year beginning after December 31, 1953, and ending after August 16, 1954, the income tax return for which is due not later than May 2, 1960, the time for exercising any option or making any election under section 615 shall expire on May 2, 1960.

§ 1.615–6 Election to deduct under section 615.

(a) *General rule.* The election to deduct or defer exploration expenditures under section 615 shall be made in a statement filed with the director of the Internal Revenue service center with whom the taxpayer's income tax return is required to be filed. If the election is made within the time period prescribed for filing an income tax return (including extensions thereof) for the first taxable year ending after September 12, 1966, during which the taxpayer pays or incurs expenditures which are within the scope of section 615 and which are paid or incurred by him after September 12, 1966, this statement shall be attached to the taxpayer's income tax return for such taxable year. If the election is made after the time prescribed for filing such return but before the expiration of the period (described in paragraph (e) of this section) for making the election under section 615(e), the statement must be signed by the taxpayer or his authorized representative. The statement shall be filed even though the taxpayer charges to capital account all such expenditures paid or incurred by him during such taxable year after such date. The statement shall clearly indicate that the taxpayer elects to have section 615 apply to all amounts deducted or deferred by him with respect to exploration expenditures paid or incurred after September 12, 1966, and before January 1, 1970. If the taxpayer desires, he may file this statement by attaching it to his return for a taxable year prior to the first taxable year ending after September 12, 1966, in which he pays or incurs exploration expenditures. Except as provided in paragraph (b) of this section, if the taxpayer does not file such a statement within the period prescribed by section 615(e) and paragraph (e) of this section, any amounts deducted by him with respect to exploration expenditures paid or incurred after September 12, 1966, will be deemed to have been deducted pursuant to an election under section 617(a).

(b) *Exception.* The last sentence of paragraph (a) of this section shall not apply if all exploration expenditures paid or incurred by the taxpayer after September 12, 1966, and before January 1, 1970, and deducted by him on his income tax return for the first taxable year ending after September 12, 1966, during which he pays or incurs such expenditures are outside the scope of section 617(a) (as it existed before its amendment by section 504(b) of the Tax Reform Act of 1969). For example, assume that, in his return for his taxable year ending December 31, 1966, a calendar-year taxpayer deducts exploration expenditures paid or incurred after September 12, 1966, and does not attach to his return the statement described in paragraph (a) of this section. However, all of the exploration expenditures paid or incurred by the taxpayer after September 12, 1966, and before the end of the taxable year were paid or incurred with respect to minerals located neither in the United States nor on the Outer Continental Shelf. The taxpayer will be deemed to have made an election under section 615(e) by deducting all or part of those expenditures as expenses in his income tax return.

(c) *Information to be furnished.* A taxpayer who makes or has made an election under section 615(e) with respect to expenditures paid or incurred after September 12, 1966, and before January 1, 1970, shall indicate clearly on his income tax return for each taxable year for which he deducts any such expenditures the amount of the deduction claimed under section 615 (a) or (b) with respect to each property or mine. The property or mine shall be identified by a description adequate to permit application of the rules of section 615(g) (relating to effect of transfer of mineral property).

(d) *Effect of election*—(1) *In general.* A taxpayer who has made or is deemed to have made an election under section 615(e) may not make an election under section 617(a) with respect to expenditures made before January 1, 1970, unless, within the period set forth in section 615(e), he revokes his election under section 615(e). Except as provided in paragraph (a)(2) of §1.615–2, a taxpayer who makes an election under section 615(e) may not change his treatment of exploration expenditures deducted, deferred, or capitalized pursuant to such election unless he revokes the election made under section 615(e).

(2) *Transfer of mineral property.* The binding effect of a taxpayer's election under section 615(e) shall not be affected by his receiving property with respect to which deductions have been allowed under section 617(a). However, see section 615(g)(2) and §1.615–7 for rules under which amounts deducted under section 615 by a transferor may be subject to recapture in the hands of a transferee who has made an election under section 617(a). See §1.617–3(d)(2)(ii) for rules under which amounts deducted under section 617(a) by a transferor may be subject to recapture in the hands of a transferee who has made an election under section 615(e).

(e) *Time for making election under section 615(e).* A taxpayer may not make an election under section 615(e) after the expiration of the 3-year period beginning with the date prescribed by section 6072 or other provision of law for filing the taxpayer's income tax return for the first taxable year ending after September 12, 1966, in which the taxpayer pays or incurs expenditures to which section 615(a) would apply if an election were made under section 615(e). This 3-year period shall be determined without regard to any extension of time for filing the taxpayer's income tax return for such year. An election under section 615(e) may not be made after the expiration of the 3-year period even though the taxpayer charged to capital account, or erroneously deducted as development expenditures under section 616, all exploration expenditures paid or incurred by him after September 12, 1966, and before the end of his first taxable year ending after September 12, 1966, in which he paid or incurred such expenditures.

(f) *Revocation of section 615(e) election*— (1) *Manner of revoking election.* A taxpayer may revoke an election made by him under section 615(e) by filing with the director of the Internal Revenue service center with whom the taxpayer's income tax return is required to be filed, within the period set forth in subparagraph (2) of this paragraph, a statement, signed by the taxpayer or his authorized representative, which sets forth that the taxpayer is revoking the election previously made by him with respect to exploration expenditures paid or incurred after September 12, 1966, and states with whom and where the document making the election was filed. Such revocation shall be a revocation for all taxable years for which the taxpayer's election was in effect and the taxpayer revoking such an election shall file amended income tax returns, reflecting any increase or decrease in tax attributable to the revocation of election. In applying the revocation of election to the years affected there shall be taken into account the effect that any adjustments resulting from the revocation of election shall have on other items affected thereby (such as the deduction for charitable contributions, the foreign tax credit, net operating loss, and other deductions or credits the amount of which is limited by the taxpayer's income) and the effect that adjustments of any such items have on items in other taxable years.

(2) *Time for revoking election under section 615(e).* An election under section 615(e) may be revoked at any time before the expiration of the 3-year period described in paragraph (e) of this section. Such an election may not be revoked after the expiration of the 3-year period.

(3) *Additional information to be furnished by a transferor of mineral property.* If, before revoking his election, the taxpayer has transferred any mineral property with respect to which he deducted exploration expenditures paid or incurred after September 12, 1966, and before January 1, 1970, to another person in a transaction as a result of which the basis of such property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, the statement submitted pursuant to subparagraph (1) of this paragraph shall state that such property has been so transferred and shall identify the transferee, the property transferred, and the date of the transfer. The preceding sentence shall not apply in the case of any mineral property transferred after December 31, 1969.

(g) *Taxable years beginning before September 13, 1966, and ending after September 12, 1966*—(1) *In general.* An election made under section 615(e) applies only to expenditures paid or incurred after September 12, 1966. The income tax treatment of exploration expenditures paid or incurred before September 13, 1966, will be determined in accordance with the provisions of section 615 prior to its amendment by the Act of September 12, 1966 (Public Law 89–570, 80 Stat. 759). If a taxpayer makes an election under section 615(e) in his income tax return for a taxable year which begins before September 13, 1966, and which ends after September 12, 1966, amounts deducted and amounts deferred under section 615 with respect to expenditures paid or incurred during such taxable year but before September 13, 1966, will be taken into account in determining whether the $100,000 limitation set forth in section 615(a) is reached during the taxable year. Similarly, a taxpayer who makes an election under section 615(e) shall take into account expenditures deducted or deferred under section 615 for the period prior to September 13, 1966, in determining when the $400,000 overall limitation set forth in section 615(c) is reached. The fact that a taxpayer deducts or defers under section 615 exploration expenditures paid or incurred prior to September 13, 1966, shall not affect his right to make an election under section 617(a) to deduct under section 617 expenditures paid or incurred after September 12, 1966.

(2) *Allocation in case of inadequate records.* If a taxpayer pays or incurs exploration expenditures during a taxable year beginning before September 13, 1966, and ending after September 12, 1966, but his records as to any mine or property are inadequate to permit a determination of the amount paid or incurred during the portion of the year ending after September 12, 1966, and the amount paid or incurred on or before such date, the exploration expenditures, as to which the records are inadequate, paid or incurred with respect to the mine or property during the taxable year shall be allocated to each part year (that is, the part occurring before September 13, 1966, and the part occurring after September 12, 1966) in the same ratio which the number of days in each such part year bears to the number of days in the entire taxable year. For example, if the records of a calendar year taxpayer for 1966 are inadequate to permit a determination of the amount of exploration expenditures paid or incurred with respect to a certain mine or property after September 12, 1966, and the amount paid or incurred before September 13, 1966, 255/365 of the total exploration expenditures paid or incurred by the taxpayer with respect to the mine or property during 1966 shall be allocated to the period beginning January 1, 1966, and ending September 12, 1966, and 110/365 of the total exploration expenditures paid or incurred with respect to the mine or property during 1966 shall be allocated to the period beginning September 13, 1966, and ending December 31, 1966.

(3) *Partnership elections.* With respect to exploration expenditures paid or incurred by a partnership before September 13, 1966, the option to deduct under section 615(a) and the election to defer under section 615(b) shall be made by the partnership, rather than by the individual partners. With respect to exploration expenditures paid or incurred by a partnership after September 12, 1966, all elections under sections 615 and 617 as to the tax treatment of a partner's distributive share of exploration expenditures paid or incurred by a partnership of which he is a member shall be made by the individual partner, rather than by the partnership. See section 703(b) and the regulations thereunder.

[T.D. 7192, 37 FR 12939, June 30, 1972]

§1.615–7 Effect of transfer of mineral property.

(a) *Transfer before election by transferor.* (1) If mineral property is transferred in a transaction as a result of which the basis of the property in the hands of the transferee is determined in whole or in part by reference to the basis in the hands of the transferor and the transferor had not made an election under either section 615(e) or 617(a) at the time of the transfer, no election made by the transferor after the transfer shall apply with respect to expenditures properly chargeable to the transferred property which were paid or incurred before the date of the transfer.

(2) For purposes of subparagraph (1) of this paragraph, a transferor of mineral property who made an election under section 617(a) or section 615(e) before the transfer but who revokes such election after such transfer and does not make an election under either section before the expiration of the 3-year period prescribed by section 6072 or other provision of law for filing his income tax return for the taxable year in which such transfer occurred shall be treated with respect to such property as not having made an election under either section.

(b) *Transfer after election by transferor.* If a transferee who at the time of the transfer of a mineral property has not made an election under section 617(a) receives property in a transaction in which the basis of such property in his hands is determined in whole or in part by reference to its basis in the hands of the transferor and with respect to such property the transferor has deducted expenditures under section 617(a), the adjusted exploration expenditures properly chargeable to the property immediately after the transfer shall be treated as expenditures allowed as deductions under section 617(a) to the transferee. See section 617 and the regulations thereunder.

(c) *Transfer after election by transferee.* (1) If a transferee who makes an election under section 617(a) receives before January 1, 1970, mineral property in a transaction in which the basis of such property in his hands is determined in whole or in part by reference to the basis of the property in the hands of the transferor and the transferor had in effect at the time of the transfer an election under section 615(e), an amount equal to the total of the amounts allowed as deductions to the transferor under section 615 with respect to the transferred mineral property shall be treated as expenditures allowed as deductions under section 617(a) to the transferee. The preceding sentence shall not apply to expenditures which would not have been reflected in the basis of the property in the hands of the transferor had the transferor not made the section 615(e) election.

(2) Any expenditures with respect to the transferred property deferred by the transferor under section 615(b) which are not allowed as deductions to him prior to transfer of the property may not be deducted by the transferee and in his hands shall be charged to capital account.

[T.D. 7192, 37 FR 12940, June 30, 1972]

§ 1.615–8 Termination of section 615.

(a) *In general.* The provisions of section 615 shall not apply to exploration expenditures paid or incurred after December 31, 1969. Expenditures paid or incurred before January 1, 1970, which were deferred under section 615(b) will be deductible under such section after such date as the units of ore or mineral discovered or explored by reason of such expenditures are sold. An election under section 615(e) with respect to expenditures paid or incurred prior to January 1, 1970, shall remain in effect with respect to such expenditures unless it is revoked under section 615(e) and § 1.615–6. See § 1.615–9 for treatment of a section 615(e) election with respect to expenditures paid or incurred after December 31, 1969.

(b) *Taxable years beginning before January 1, 1970, and ending after December 31, 1969*—(1) *In general.* The termination of section 615 applies to expenditures paid or incurred after December 31, 1969. The income tax treatment of exploration expenditures paid or incurred before January 1, 1970, will be determined in accordance with the provisions of sections 615 and 617 prior to their amendment by the Tax Reform Act of 1969 (83 Stat. 487). The fact that on his income tax return for a taxable year beginning before January 1, 1970, and ending after December 31, 1969, a taxpayer deducts under section 615 expenditures paid or incurred before January 1, 1970, shall not affect his right to deduct under section 617(a) expenditures paid or incurred during such taxable year after December 31, 1969.

(2) *Allocation in case of inadequate records.* If a taxpayer pays or incurs exploration expenditures during a taxable year beginning before January 1, 1970, and ending after December 31, 1969, but his records are inadequate to permit a determination of the amount paid or incurred during the portion of the year ending after December 31, 1969, and the amount paid or incurred on or before such date, the exploration expenditures as to which the records are inadequate paid or incurred with respect to the mine or property during the taxable year shall be allocated to each part of the year (that is, the part before January 1, 1970, and the part occurring after December 31, 1969) in the same ratio which the number of days in each such part year bears to the number of days in the entire taxable year.

[T.D. 7192, 37 FR 12941, June 30, 1972]

§ 1.615–9 Notification under Tax Reform Act of 1969.

(a) *In general.* An election under section 615(e) with respect to exploration expenditures paid or incurred prior to January 1, 1970, shall be treated as an election under section 617(a) with respect to exploration expenditures paid or incurred after December 31, 1969.

(b) *Exception.* Paragraph (a) of this section shall not apply to an election under section 615(e) if the taxpayer files the notice described in paragraph (c) of this section or the taxpayer revokes his election under section 615(e) before the date prescribed for the filing of notice under paragraph (c)(2) of this section.

(c) *Filing of notice*—(1) *In general.* The notice not to have a section 615(e) election treated as a section 617(a) election shall be made in a statement filed with the Director of the Internal Revenue service center with whom the taxpayer's income tax return is required to be filed. If the election is made within the time period prescribed for filing an income tax return (including extensions thereof) for the first taxable year during which the taxpayer pays or incurs, after December 31, 1969, expenditures which would be deductible by the taxpayer under section 617(a) if he made a valid election to deduct exploration expenditures under such section, the statement shall be attached to the taxpayer's income tax return for such year. If the statement is filed after the time prescribed for filing such return but before the expiration of the period (described in paragraph (e) of this section) for filing the notice, the statement must be signed by the taxpayer or his authorized representative. The statement shall be filed even though the taxpayer charges to capital account all such expenditures paid or incurred by him after December 31, 1969. If the taxpayer desires, he may file this statement by attaching it to his return for a taxable year prior to the first taxable year in which he pays or incurs after December 31, 1969, expenditures which would be deductible by him under section 617(a) if at such time he had in effect a valid election under such section.

(2) *Information to be furnished.* The notice shall clearly state that the taxpayer elects not to have his section 615(e) election treated as an election under section 617(a). The notice shall state the first taxable year for which the section 615(e) election was effective and with whom and where the election was filed.

(d) *Effect of notification.* A taxpayer who has filed notice pursuant to this section may make an election under section 617(a) with respect to exploration expenditures paid or incurred after December 31, 1969, without revoking either his section 615(e) election or his notice under this section.

(e) *Time for filing notice.* A taxpayer may not file the notice described in paragraph (c)(1) of this section after the expiration of the 3-year period beginning with the date prescribed by section 6072 or other provision of law for filing the taxpayer's income tax return for the first taxable year in which the taxpayer pays or incurs after December 31, 1969, expenditures which would be deductible by him if he made the election under section 617(a). This 3-year period shall be determined without regard to any extension of time for filing the taxpayer's income tax return.

[T.D. 7192, 37 FR 12941, June 30, 1972]

§1.616–1 Development expenditures.

(a) *General rule.* Section 616 prescribes rules for treating expenditures paid or incurred during the taxable year by the taxpayer for the development of a mine or other natural deposit (other than an oil or gas well). Development expenditures under section 616 are those which are made after such time when, in consideration of all the facts and circumstances (including actions of the taxpayer), deposits of ore or other mineral are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. Under section 616(a), a taxpayer is allowed a deduction for development expenditures whether or not such expenditures are made in the development or production state of the mine or other natural deposit. Under section 616(b), the taxpayer may elect to defer development expenditures made in the development or producing stage and to deduct such expenditures ratably as the minerals or ores benefited are sold. While the mine or other natural deposit is in the development stage, the election applies only to that portion of the development expenditures which is in excess of net receipts from the mine or other natural deposit. See §1.616–2 for rules with respect to the election to defer. It is not necessary that the taxpayer incur the development costs directly. He may engage a contractor to make the expenditures on his behalf.

(b) *Expenditures to which section 616 is not applicable.* (1) Section 616 is not applicable to development expenditures which are deductible for the taxable year under any other provision of the internal revenue laws.

(2) Section 616 is not applicable to expenditures which are reflected in improvements subject to allowances for depreciation under sections 167 and 611. However, allowance for depreciation of

such improvements which are used in the development of ores or minerals are considered development expenditures under section 616. If such improvements are used only in part for development during a taxable year, an allocable portion of the allowance for depreciation shall be treated as a development expenditure.

(3) Section 616 is applicable to development expenditures paid or incurred by a taxpayer in connection with the acquisition of a fractional share of the working or operating interest to the extent of the fractional interest so acquired. The expenditure attributable to the remaining fractional share shall be considered as part of the cost of his acquired interest and shall be capitalized and recovered through depletion allowances. For example, taxpayer A owns mineral leases on undeveloped mineral lands. A agrees to convey an undivided three-fourths (¾) interest in such leases to B, provided B will pay all of the expenditures incurred during the development stage of the deposits on these leases. B may deduct three-fourths (¾) of such amount under section 616, but shall treat one-fourth of such amount as part of the cost of his interest, recoverable through depletion.

(4) The provisions of section 616 do not apply to costs of development paid or incurred by a prior owner which are reflected in the amount which the taxpayer paid or incurred to acquire the property. Such provisions apply only to costs paid or incurred by the taxpayer for development undertaken directly or through contract by the taxpayer. See, however, section 381(a) and 381(c)(10) for special rules with respect to deferred development expenditures in certain corporate acquisitions.

(c) *Mine or other natural deposit.* Section 616 has reference to expenditures made for the development of a mine or other natural deposit. Within an aggregated property, as that term is defined in section 614 (b) and (c), or within a single tract or parcel of land, there may be more than one mine or other natural deposit. Where a property, as determined under section 614, contains more than one mine or other natural deposit, the taxpayer may deduct under section 616(a) the development expenditures made with respect to one of such mines or deposits, and may defer under section 616(b) the development expenditures made with respect to another of such mines or deposits. Where there is more than one mine with respect to a single underlying deposit, the taxpayer may deduct under section 616(a) the development expenditures made with respect to one of such mines, and may defer under section 616(b) the development expenditures made with respect to another of such mines. The taxpayer must treat consistently all development expenditures with respect to each such mine or other natural deposit in a taxable year. The taxpayer must make a separate determination of the units of minerals or ores benefited in a mine or other natural deposit (regardless of the computation of the depletion allowance) in order that deferred expenditures with respect to such mine or deposit may be deducted on a ratable basis. See paragraph (f) of § 1.616–2.

§ 1.616–2 Election to defer.

(a) *General rule.* In lieu of taking a deduction under section 616(a), in the taxable year when the development expenditures are paid or incurred, a taxpayer may elect under section 616(b) to treat such expenditures with respect to each mine or other natural deposit as deferred expenses to be deducted ratably as the units of the produced ore or minerals benefited by such expenditures are sold. Section 616(b) is applicable to development expenditures paid or incurred both in the development and producing stage of the mine or other natural deposit. However, in the case of such expenditures made in the development stage, this election is applicable only to the excess of the amount of such expenditures over the net receipts from the ore or minerals from such mine or deposit received or accrued during the development stage and in the same taxable year as the expenditures were paid or incurred. Such development expenditures not in excess of such net receipts shall be subject to the provisions of section 616(a).

(b) *Producing stage; definition of.* The mine or other natural deposit will be considered to be in a producing stage when the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or when the principal activity of the mine or other natural deposit is the production of developed ores or minerals rather than the development of additional ores or minerals for mining.

(c) *Expenditures made by the owner who retains a nonoperating interest.* (1) A taxpayer who elects to defer development expenditures and thereafter transfers his interest in the mine or other natural deposit, retaining an economic interest therein, shall deduct an amount attributable to such interest on a pro rata basis as the interest pays out. For example, a taxpayer who defers development expenditures and then leases his deposit, retaining a royalty interest therein, shall deduct the deferred expenditures ratably as he receives the royalties. If the taxpayer receives a bonus or advanced royalties in connection with the transfer of his interest, he shall deduct the deferred expenditures allocable to such bonus or advanced royalties in an amount which is in the same proportion to the total of such costs as the bonus or advanced royalties bears to the bonus and total royalties expected to be received. Also, in the case of a transfer of a mine or other natural deposit by a taxpayer who retains a production payment therein, he may deduct the development expenditures ratably over the payments expected to be received.

(2) Where a taxpayer receives an amount, in addition to retaining an economic interest, which amount is treated as from the sale or exchange of a capital asset or property treated under section 1231 (except coal or iron ore to which section 631(c) applies), the deferred development expenditures shall be allocated between the interest sold and the interest retained in proportion to the fair market value of each interest as of the date of sale. The amount allocated to the interest sold may not be deducted, but shall be a part of the basis of such interest for the purpose of determining gain or loss upon the sale thereof.

(d) *Losses from abandonment.* Section 165 and the regulations thereunder contain general rules relating to the treatment of losses resulting from abandonment.

(e) *Effect of election.* (1) The election to defer development expenditures shall apply only to expenditures for the taxable year for which made. However, once made, the election shall be binding with respect to the expenditures for that taxable year. Thus, a taxpayer cannot revoke his election for any reason whatsoever.

(2) The election shall be made for each mine or other natural deposit by a clear indication on the return or by a statement filed with the district director with whom the return was filed, not later than the time prescribed by law for filing such return (including extensions thereof) for the taxable year to which such election is applicable.

(f) *Computation of amount of deduction.* The amount of the deduction allowable during the taxable year is an amount A, which bears the same ratio to B (the total deferred development expenditures for a particular mine or other natural deposit reduced by the amount of such expenditures deducted in prior taxable years) as C (the number of units of the ore or mineral benefited by such expenditures sold during the taxable year) bears to D (the number of units of ore or mineral benefited by such expenditures remaining as of the taxable year). For the purposes of this proportion, the *number of units of ore or mineral benefited by such expenditures remaining as of the taxable year* is the number of units of ore or mineral benefited by the deferred development expenditures remaining at the end of the year to be recovered from the mine or other natural deposit (including units benefited by such expenditures recovered but not sold) plus the number of units benefited by such expenditures sold within the taxable year. The principles outlined in §1.611–2 are applicable in estimating the number of units remaining as of the taxable year and the number of units sold during the taxable year. The estimate is subject to revision in accordance with that section in the event it is ascertained, from any source, such as operations or development work, that the remaining units are materially greater or less than the number of units remaining from a prior estimate.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9307, July 27, 1965]

§ 1.616–3 Time for making election with respect to returns due on or before May 2, 1960.

In the case of any taxable year beginning after December 31, 1953, and ending after August 16, 1954, the income tax return for which is due not later than May 2, 1960, the time to deduct or defer development expenditures for such a year under section 616 (a) or (b) shall expire on May 2, 1960.

§ 1.617–1 Exploration expenditures.

(a) *General rule.* Section 617 prescribes rules for the treatment of expenditures paid or incurred after September 12, 1966, for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral for which a deduction for depletion is allowable under section 613 (other than oil or gas) paid or incurred by the taxpayer before the beginning of the development stage of the mine or other natural deposit. Such expenditures hereinafter in the regulations under section 617 will be referred to as exploration expenditures. The development stage of the mine or other natural deposit will be deemed to begin at the time when, in consideration of all the facts and circumstances (including the actions of the taxpayer), deposits of ore or other mineral are disclosed in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. For example, core drilling expenditures paid or incurred by the taxpayer to ascertain the existence of commercially marketable ore are exploration expenditures within the meaning of this section. Also, expenditures for exploratory drilling from within a producing mine to ascertain the existence of what appears (on the basis of all of the facts and circumstances known at the time of the expenditures) to be a different ore deposit are exploration expenditures within the meaning of this section. Expenditures paid or incurred in connection with core drilling to further delineate the extent and location of an existing commercially marketable deposit to facilitate its development are development expenditures. Under section 617(a), a taxpayer may deduct exploration expenditures paid or incurred for the exploration of any deposit of ore or other mineral subject to the limitation of section 617(h). Under section 617(b), a taxpayer shall recapture the exploration expenditures previously deducted under section 617(a) either through including in income an amount equal to the amount of the adjusted exploration expenditures (as defined in section 617(f)) or through disallowance of the deduction for depletion under section 611. Certain rules are provided in section 617(c) for recapture of exploration expenditures made with respect to property for which the taxpayer later receives a bonus or royalty. Under section 617(d), gain from dispositions of mining property, with respect to which exploration expenditures have been previously deducted, is to be recognized notwithstanding certain other provisions of the Code.

(b) *Expenditures to which section 617 is not applicable.* (1) Section 617 is not applicable to expenditures which would be allowed as deductions for the taxable year without regard to section 617.

(2) Section 617 is not applicable to expenditures which are reflected in improvements subject to allowances for depreciation under sections 167 and 611. However, allowances for depreciation of such improvements which are used in the exploration of ores or minerals are considered exploration expenditures under section 617. If such improvements are used only in part for exploration during the taxable year, an allocable portion of the allowance for depreciation shall be treated as an exploration expenditure.

(3) Section 617 is applicable to exploration expenditures paid or incurred by a taxpayer in connection with the acquisition of a fractional share of the working or operating interest to the extent of the fractional interest so acquired by the taxpayer. The expenditures attributable to the remaining fractional share shall be considered as the cost of his acquired interest and shall be recovered through depletion allowances. For example, taxpayer A owns mineral leases on unexplored

mineral lands and agrees to convey an undivided three-fourths (3⁄4) interest in such leases to taxpayer B provided B will pay all of the expenses for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral which will be incurred before the beginning of the development stage. B may elect to treat three-fourths of such amount under section 617. B must treat one-fourth of such amount as part of the cost of his interest, recoverable through depletion.

(4) Section 617 is not applicable to costs of exploration which are reflected in the amount which the taxpayer paid or incurred to acquire the property. Section 617 applies only to costs paid or incurred by the taxpayer for exploration undertaken directly or through a contract by the taxpayer. See, however, sections 381(a) and 381(c)(10) for special rules with respect to deferred exploration expenditures in certain corporate acquisitions.

(5) Section 617 is not applicable to amounts paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of oil or gas or of any mineral with respect to which a deduction for percentage depletion is not allowable under section 613. The purpose of the expenditure shall be determined by reference to the facts and circumstances at the time the expenditure is paid or incurred.

(c) *Elections*—(1) *Election to deduct under section 617(a).* (i) The election to deduct exploration expenditures under section 617(a) may be made by deducting such expenditures in the taxpayer's income tax return for his first taxable year ending after September 12, 1966, for which the taxpayer desires to deduct exploration expenditures which are paid or incurred by him during such taxable year and after September 12, 1966. This election may be exercised by deducting such exploration expenditures either in the taxpayer's return for such taxable year or in an amended return filed before the expiration of the period for filing a claim for credit or refund of income tax for such taxable year. Where the election is made in an amended return for a taxable year prior to the most recent year for which the taxpayer has filed a return, the taxpayer shall file amended income tax returns, reflecting any increase or decrease in tax attributable to the election, for all subsequent taxable years affected by the election for which he has filed income tax returns before making the election. See section 617(a)(2)(C) and subparagraph (4) of this paragraph for provisions relating to extension of the period of limitations for the assessment of any deficiency for any taxable year to the extent the deficiency is attributable to an election or revocation of an election under section 617(a). In applying the election to the years affected, there shall be taken into account the effect that any adjustments resulting from the election shall have on other items affected thereby (such as the deduction for charitable contributions, the foreign tax credit, net operating loss, and other deductions or credits the amount of which is limited by the taxpayer's income) and the effect that adjustments of any such items have on items of other taxable years. Amended returns filed for taxable years subsequent to the taxable year for which the election under section 617(a) is made by amended return shall, where appropriate, apply the recapture rules of subsections (b), (c), and (d) of section 617. See §§1.617–3 and 1.617–4.

(ii) A taxpayer who makes or has made an election under section 617(a) shall state clearly on his income tax return for each taxable year for which he deducts exploration expenditures the amount of the deduction claimed under section 617(a) with respect to each property or mine. Such property or mine shall be identified by a description adequate to permit application of the recapture rules of section 617 (b), (c), and (d).

(iii) A taxpayer who has made an election under section 617(a) may not make an election under section 615(e) unless, within the period set forth in section 615(e), he revokes his election under section 617(a). A taxpayer who has made and has not revoked an election under section 617(a) may not, in his return for the taxable year for which the election is made or for any subsequent taxable year, charge to capital account any exploration expenditures which are deductible by him under section 617(a); and he must deduct all such expenditures as expenses in computing adjusted gross income. Any exploration expenditures paid or incurred after December 31, 1969, which are not deductible by the taxpayer under section 617(a) solely because of the application of section 617(h) shall be charged to capital account.

(2) *Time for making elections.* The election under section 617(a) may be made at any time before the expiration of the period prescribed for filing a claim for credit or refund of the tax imposed by chapter 1 for the first taxable year for which the taxpayer desires to deduct exploration expenditures under section 617(a).

(3) *Revocation of election to deduct.* (i) A taxpayer may revoke an election made by him under section 617(a) by filing with the Internal Revenue service center with which the taxpayer's income tax return is required to be filed, within the period set forth in subdivision (ii) of this subparagraph, a statement, signed by the taxpayer or his authorized representative, which sets forth that the taxpayer is revoking the section 617(a) election previously made by him and states with whom and where the document making the election was filed. A taxpayer revoking a section 617(a) election shall file amended income tax returns which reflect any increase or decrease in tax attributable to the revocation of election for all taxable years affected by the revocation of election for which he has filed income tax returns before revoking the election. See section 617(a)(2)(C) and subparagraph (4) of this paragraph for provisions relating to extension of the period of limitations for the assessment of any deficiency attributable to an election or revocation of an election under section 617(a). In applying the revocation of election to the years affected, there shall be taken into account the effect that any adjustments resulting from the revocation of election shall have on other items affected thereby (such as the deduction for charitable contributions, the foreign tax credit, net operating loss, and other deductions or credits the amount of which is limited by the taxpayer's income) and the effect that adjustments of any such items have on items of other taxable years.

(ii) An election under section 617(a) may be revoked before the expiration of the last day of the third month following the month in which the final regulations under section 617(a) are published in the FEDERAL REGISTER. After the expiration of this period, a taxpayer who has made an election under section 617(a) may not revoke that election unless he obtains the prior consent of the Commissioner of Internal Revenue. Consent will not be granted where a principal purpose for the revocation of the election is to circumvent the recapture provisions of section 517 (b), (c), or (d). The request for consent shall be made in writing to the Commissioner of Internal Revenue, Attention T:I:E, Washington, DC 20224. The request shall include in detail:

(a) The reason or reasons for the revocation of election under section 617(a);

(b) An itemization of the taxpayer's deductions under section 617(a);

(c) A description of all properties and detailed information of the exploration activities with respect to which the taxpayer has taken deductions under section 617(a);

(d) A description of any development or production activities on all properties with respect to which exploration expenditures were deducted under section 617(a); and

(e) A recomputation of the tax for each prior taxable year affected by the revocation. A letter setting forth the Commissioner's determination will be mailed to the taxpayer. If consent is granted, a copy of the letter granting such consent shall be filed with the director of the Internal Revenue service center with which the taxpayer's income tax return is required to be filed and shall be accompanied by an amended return or returns, if necessary.

(iii) If, before revoking his election, the taxpayer has transferred any mineral property with respect to which he deducted exploration expenditures under section 617(a), to another person in a transaction as a result of which the basis of such property in the hands of the transferee is determined in whole or in part by reference to the basis in the hands of the transferor, the statement submitted pursuant to subdivision (i) of this paragraph shall state that such property has been so transferred, shall identify the transferee, the property transferred, the date of the transfer, and shall indicate the amount of the adjusted exploration expenditures with respect to such property on such date.

(4) *Deficiency attributable to election or revocation of election.* The statutory period for the assessment of any deficiency for any taxable year, to the extent such deficiency is attributable to an election or revocation of an election under section 617(a), shall not expire before the last day of the 2-year period which begins on the day after the date on which such election or revocation of election is made; and such deficiency may be assessed at any time before the expiration of such 2-year period, notwithstanding any law or rule which would otherwise prevent such assessment.

[T.D. 7192, 37 FR 12942, June 30, 1972]

§1.617–2 Limitation on amount deductible.

(a) *Expenditures paid or incurred before January 1, 1970.* In the case of expenditures paid or incurred before January 1, 1970, a taxpayer may deduct exploration expenditures paid or incurred during the taxable year with respect to any deposit of ore or other mineral for which a deduction for percentage depletion is allowable under section 613 (other than oil or gas) in the United States or on the Outer Continental Shelf (within the meaning of section 2 of the Outer Continental Shelf Lands Act, as amended and supplemented; 43 U.S.C. 1331).

(b) *Expenditures paid or incurred after December 31, 1969.* In the case of exploration expenditures paid or incurred after December 31, 1969, with respect to any deposit of ore or other mineral for which a deduction for percentage depletion is allowable under section 613 (other than oil or gas), a taxpayer may deduct:

(1) The amount of such expenditures paid or incurred during the taxable year with respect to any such deposit in the United States (as defined in section 638 and the regulations thereunder), and

(2) With respect to any such deposit located outside the United States (as defined in section 638 and the regulations thereunder) the lesser of:

(i) The amount of the exploration expenditures paid or incurred with respect to such deposits during the taxable year, or

(ii) $400,000 minus the sum of the amount to be deducted under subparagraph (1) of this paragraph for the taxable year and all amounts deducted or treated as deferred expenses during all preceding taxable years under section 617 and section 615 of the Internal Revenue Code of 1954 and section 23(ff) of the Internal Revenue Code of 1939. See paragraph (d) of this section for application of the limitation in the case of a transferee of a mining property.

(c) *Examples.* The application of the provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. A, a calendar-year taxpayer who has claimed the benefits of section 615, expended $100,000 for exploration expenditures during the year 1966. For each of the years 1967, 1968, 1969, and 1970 A had exploration costs of $80,000 all with respect to coal deposits located within the United States. A deducted or deferred the maximum amounts allowable for each of the years 1966 ($100,000), 1967 ($80,000), 1968 ($80,000), and 1969 ($80,000). The $80,000 of exploration expenditures for 1970 may be deducted under section 617 by A.

Example 2. B, a calendar-year taxpayer claimed deductions of $100,000 per year under section 615 for the years 1968 and 1969. In 1970, B deducted $150,000 under section 617 for exploration conducted with respect to coal deposits in the United States. In 1971, B paid $150,000 with respect to exploration of tin deposits outside the United States. The maximum amount B may deduct with respect to the foreign exploration in 1971 is $50,000 computed as follows:

(a) Add all amounts deducted or deferred for exploration expenditures by B for all years:

Year	Expenditures	Deducted or deferred
1968	$100,000	$100,000
1969	100,000	100,000
1970	150,000	150,000
Total	....	350,000

(b) Subtract from $400,000 (the maximum amount allowable to B for deduction of foreign exploration expenditures) the sum of the amounts obtained in (a) $350,000:

Maximum amount allowable to taxpayer	$400,000
Sum of amounts obtained in (a)	350,000
	50,000

Example 3. Assume the same facts as in example 2 except that in 1971 in addition to the $150,000 paid with respect to exploration outside the United States, B paid $100,000 with respect to exploration within the United States. As the following computation indicates, B may not deduct any amount with respect to the foreign exploration:

(a) Add all amounts deducted or deferred for exploration expenditures in prior years and the exploration expenditures with respect to exploration in the United States to be deducted in 1971:

Year	Expenditures	Deducted or deferred
1968	$100,000	$100,000
1969	100,000	100,000
1970	150,000	150,000
1971	250,000	[1] 100,000
Total		450,000

[1] Domestic.

(b)Because the sum of the amounts obtained in (a), $450,000, exceeds $400,000 no deduction would be allowable to B with respect to foreign exploration expenditures for 1971.

(d) *Transferee of mineral property.* (1) Where an individual or corporation transfers any mining property to the taxpayer, the taxpayer shall take into account for purposes of the $400,000 limitation described in paragraph (b)(ii) of this section all amounts deducted and amounts treated as deferred expenses by the transferor if:

(i) The taxpayer acquired any mineral property from the transferor in a transaction described in section 23(ff)(3) of the Internal Revenue Code of 1939, excluding the reference therein to section 113(a)(13),

(ii) The taxpayer acquired any mineral property by reason of the acquisition of assets of a corporation in a transaction described in section 381(a) as a result of which the taxpayer succeeds to and takes into account the items described in section 381(c),

(iii) The taxpayer acquired any mineral property under circumstances which make applicable any of the following sections of the Internal Revenue Code:

(a) Section 334(b)(1), relating to the liquidation of a subsidiary where the basis of the property in the hands of the distributee is the same as it would be in the hands of the transferor.

(b) Section 362 (a) and (b), relating to property acquired by a corporation as paid-in surplus or as a contribution to capital, or in connection with a transaction to which section 351 applies.

(c) Section 372(a), relating to reorganization in certain receiverships and bankruptcy proceedings.

(d) Section 373(b)(1), relating to property of a railroad corporation acquired in certain bankruptcy or receivership proceedings.

(e) Section 1051, relating to property acquired by a corporation that is a member of an affiliated group.

(f) Section 1082, relating to property acquired pursuant to a Securities Exchange Commission order.

(2) For purposes of applying the limitations imposed by section 617(h):

(i) The partner, and not the partnership, shall be considered as the taxpayer (see paragraph (a)(8)(iii) of § 1.702–1), and

(ii) An electing small business corporation, as defined in section 1371(b), and not its shareholders, shall be considered as the taxpayer.

(3) For purposes of subparagraph (1)(iii) *(b)* of this paragraph, relating to a transaction to which section 362 (a) and (b) applies or to which section 351 applies:

(i) If mineral property is acquired from a partnership, the transfer shall be considered as having been made by the individual partners, so that the amounts which each partner has deducted or deferred under sections 615 and 617 of the Internal Revenue Code of 1954 and section 23(ff) of the Internal Revenue Code of 1939 shall be taken into account, or

(ii) If an interest in a partnership having mineral property is transferred, the transfer shall be considered as a transfer of mineral property by the partner or partners relinquishing an interest, so that the amounts which each such partner has deducted or deferred under sections 615 and 617 of the Internal Revenue Code of 1954 and section 23(ff) of the Internal Revenue Code of 1939 shall be taken into account.

(e) *Examples.* The application of the provisions of this section may be illustrated by the following example:

Example 1. A calendar year taxpayer (who has never claimed the benefits of section 617) received in 1970 a mineral deposit from X Corporation upon a distribution in complete liquidation of the latter under conditions which make the provisions of section 334(b)(1) applicable in determining the basis of the property in the hands of the taxpayer. During the year 1969, X Corporation expended $60,000 for exploration expenditures which it elected to treat under section 615(b) as deferred expenses. Subsequent to the transfer the taxpayer made similar expenditures for domestic exploration of $250,000 and $140,000, for the years 1970, and 1971, respectively, which the taxpayer elected to deduct. In 1972, the taxpayer made expenditures for domestic exploration of $100,000 and for foreign exploration of $50,000. The taxpayer may deduct the $100,000 domestic exploration expenditures but may not deduct any portion of the $50,000 of foreign exploration expenditures because the $400,000 limitation of section 617(h) applies.

Example 2. In 1971, A and B transfer assets to a corporation in a transfer to which section 351 applied. Among the assets transferred by A is a mineral lease with respect to certain coal lands. A has deducted exploration expenditures under section 615 for the years 1968 and 1969 in the amounts of $50,000 and $100,000, respectively, made with respect to other deposits not included in the transfer to the corporation. The corporation is required to take into account the deductions previously made by A for purpose of applying the $400,000 limitation on deduction of foreign exploration expenditures. Thus, if in 1970 the corporation incurred $400,000 of foreign exploration expenditures, the maximum which it could deduct under section 617(a) is $250,000.

[T.D. 7192, 37 FR 12944, June 30, 1972]

§1.617–3 Recapture of exploration expenditures.

(a) *In general.* (1)(i) Except as provided in subparagraphs (2) and (3) of this paragraph, if in any taxable year any mine (as defined in paragraph (c) of this section) with respect to which deductions have been allowed under section 617(a) reaches the producing stage (as defined in paragraph (c) of this section) the deduction for depletion under section 611 (whether determined under §1.611–2 or under section 613) with respect to the property shall be disallowed for the taxable year and each subsequent taxable year until the aggregate amount of depletion which would be allowable but for section 617(b)(1)(B) and this subparagraph equals the amount of the adjusted exploration expenditures (determined under section 617(f)(1) and paragraph (d) of this section) attributable to the mine. The preceding sentence shall apply notwithstanding the fact that such mine is not in the producing stage at the close of such taxable year. In the case of a taxpayer who owns more than one property in a mine with respect to which he has been allowed deductions under section 617(a), the depletion deduction described in the second preceding sentence shall be disallowed with respect to all of the properties until the aggregate amount of depletion disallowed under section 617(b)(1)(B) is equal to the adjusted exploration expenditures with respect to the mine. In the case of a taxpayer who elects under section 614(c)(1) to aggregate a mine, with respect to which he has been allowed deductions under section 617(a), with another mine, no deduction for depletion will be allowable under section 611 with respect to the aggregated property until the amount of depletion disallowed under section 617(b)(1)(B) equals the adjusted exploration expenditures attributable to all of the producing mines included in the aggregated property.

(ii) If a taxpayer who has made an election under section 617(a) receives or accrues a bonus or royalty with respect to a mining property with respect to which deductions have been allowed under section 617(a), the deduction for depletion under section 611 with respect to such bonus or royalty (whether determined under §1.611–2 or under section 613) shall be disallowed for the taxable year of receipt or accrual and each subsequent taxable year until the aggregate amount of the depletion disallowed under section 617(c) and this section equals the amount of the adjusted exploration expenditures with respect to the property to which the bonus or royalty relates. The preceding sentence shall not apply if the bonus or royalty is paid with respect to a mineral for which a deduction is not allowable under section 617(a). In the case of the disposal of coal or domestic iron ore with a retained economic interest, see paragraph (a)(2) of §1.617–4.

(2) If the taxpayer so elects with respect to all mines as to which deductions have been allowed under section

617(a) and which reach the producing stage during the taxable year, he shall include in gross income (but not *gross income from the property* for purposes of section 613) for such taxable year an amount equal to the adjusted exploration expenditures (determined under section 617(f)(1) and paragraph (d) of this section) with respect to all of such mines. The amount so included in income shall be treated for purposes of subtitle A of the Internal Revenue Code as expenditures which are paid or incurred on the respective dates on which the mines reach the producing stage and which are properly chargeable to capital account. The fact that a taxpayer does not make the election described in this subparagraph for a taxable year during which mines with respect to which deductions have been allowed under section 617(a) reach the producing stage shall not preclude the taxpayer from making the election with respect to other mines which reach the producing stage during subsequent taxable years. However, the election described in this subparagraph may not be made for any taxable year with respect to any mines which reached the producing stage during a preceding taxable year.

(3) The provisions of section 617(b)(1) and subparagraphs (1) and (2) of this paragraph do not apply in the case of any deposit of oil or gas. For example, A in exploring for sulphur incurred $500,000 of exploration expenditures which he deducted under section 617(a). In the following year, A did not find sulphur but on the same mineral property located commercially marketable quantities of oil and gas. In computing the depletion allowance with respect to the oil and gas, no depletion would be disallowed because of section 617(b)(1).

(4) In the case of exploration expenditures which are paid or incurred with respect to a mining property which contains more than one mine, the provisions of subparagraphs (1) and (2) of this paragraph shall apply only to the amount of the adjusted exploration expenditures properly chargeable to the mine or mines which reach the producing stage during the taxable year. For example, A owns a mining property which contains mines X, Y, and Z. For 1970, A deducted under section 617(a), $250,000 with respect to X, $100,000 with respect to Y and $70,000 with respect to Z. In 1971, mine X reaches the producing stage. At that time, A will only have to recapture the $250,000 attributable to mine X.

(b) *Manner and time for making election.* (1) A taxpayer will be deemed not to have elected pursuant to section 617(b)(1)(A) and paragraph (a)(2) of this section unless he clearly indicates such election on his income tax return for the taxable year in which the mine with respect to which deductions were allowed under section 617(a) reaches the producing stage.

(2) The election described in paragraph (a)(2) of this section may be made (or changed) not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year in which the mine with respect to which deductions were allowed under section 617(a) reaches the producing stage.

(c) *Definitions*—(1) *Mine.* The term *mine* includes all quarries, pits, shafts, and wells, and any other excavations or workings for the purpose of extracting any known deposit of ore or other mineral.

(2) *Producing stage.* A mine will be considered to have reached the producing stage when (i) the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or (ii) the principal activity of the mine is the production of developed ores or minerals rather than the development of additional ores or minerals for mining.

(3) *Mining property.* The term *mining property* means any property (as the term is defined in section 614(a) after the application of subsections (c) and (e) thereof) with respect to which any expenditures allowed as deductions under section 617(a) are properly chargeable.

(d) *Adjusted exploration expenditures*—(1) *In general.* The term *adjusted exploration expenditures* means, with respect to any property or mine:

(i) The aggregate amount of the expenditures allowed as deductions under section 617(a) for the taxable year and all preceding taxable years to the taxpayer or any other person which are properly chargeable to such property or mine and which (but for the election under section 617(a)) would be reflected in the adjusted basis of such property or mine, reduced by

(ii) The excess, if any, of the amount which would have been allowable for all taxable years under section 613 but for the deduction of such expenditures over the amount allowable for depletion under section 611 (determined without regard to section 617(b)(1)(B)). The amount determined under the preceding sentence shall be reduced by the aggregate of the amounts included in gross income for the taxable year and all preceding taxable years under section 617(b) or (c) and the amount treated under section 617(d) as gain from the sale or exchange of the property which is neither a capital asset nor property described in section 1231.

(iii) If a taxpayer pays or incurs exploration expenditures on a property which contains a producing mine and if such taxpayer deducts any portion of such expenditures under section 617(a), an amount equal to the amount so deducted shall be taken into account in computing the taxpayer's *taxable income from the property* for the purposes of the limitation on the percentage depletion deduction under section 613(a) and the regulations thereunder. The amount of the adjusted exploration expenditures with respect to the producing mine shall be reduced by an amount equal to the amount by which the taxpayer's deduction under 617(a) (described in the preceding sentence) reduces the taxpayer's deduction for depletion for the taxable year. See example 1 in subparagraph (6) of this paragraph.

(iv) For purposes of §1.617–4, the aggregate amount of adjusted exploration expenditures with respect to a mining property includes the aggregate amount of adjusted exploration expenditures properly allocable to all mines on such property.

(v) *(a)* For purposes of paragraph (a)(1) of this section, the aggregate amount of the adjusted exploration expenditures is determined as of the close of the taxpayer's taxable year.

(b) For purposes of §1.617–4, the aggregate amount of the adjusted exploration expenditures is determined as of the date of the disposition of the mining property or portion thereof.

(2) *Adjustments for certain expenditures of other taxpayers or in respect of other property*. (i) For purposes of subparagraph (1) of this paragraph, the exploration expenditures which must be taken into account in determining the adjusted exploration expenditures with respect to any property or mine are not limited to those expenditures with respect to the property disposed of or which entered the production stage nor are such expenditures limited to those deducted by the taxpayer. For the manner of determining the amount of adjusted exploration expenditures immediately after certain dispositions, see subparagraph (4) of this paragraph.

(ii) If a transferee who at the time of the transfer has not made an election under section 617(a) (including a transferee who has made an election under section 615(e)) receives mineral property in a transaction in which the basis of such property in his hands is determined in whole or in part by reference to its basis in the hands of the transferor and with respect to such property the transferor has deducted exploration expenditures under section 617(a), the adjusted exploration expenditures immediately after such transfer shall be treated as exploration expenditures allowed as deductions under section 617(a) to the transferee.

(iii) If a transferee who makes an election under section 617(a) receives mineral property in a transaction in which the basis of such property in his hands is determined in whole or in part by reference to the basis of such property in the hands of the transferor and the transferor had in effect at the time of the transfer an election under section 615(e), an amount equal to the total of the amounts allowed as deductions to the transferor under section 615 with respect to the transferred property shall be treated as expenditures allowed as deductions under section 617(a) to the transferee. The preceding sentence shall not apply to expenditures which could not have been reflected in the basis of the property in the hands of the transferee had the transferor not made the section 615(e) election.

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

Example 1. On July 14, 1969, A purchased mineral property Z for $10,000. After deducting exploration expenditures of $20,000 under section 617(a), A transferred the property to his son as a gift on July 9, 1970. Since the exception for gifts in section 617(d)(3) (by incorporation by reference of the provisions of section 1245(b)(1)) applies, A does not recognize gain under section 617(d). On September 30, 1972 after deducting exploration expenditures of $150,000 under section 617(a), the son transfers the mineral property to corporation X in a transaction under which no gain is recognized by the son under section 351. Since the exception of section 617(d)(3) (by incorporation by reference of the provisions of section 1245(b)(3)) applies, the son does not recognize gain under section 617(d). On November 14, 1972, corporation X sells the mineral property. No deductions for exploration expenditures were taken by corporation X. The amount of the adjusted exploration expenditures with respect to mineral property Z to be recaptured by corporation X upon such sale is $170,000 (the total amount deducted by A and the son).

Example 2. Assume the same facts as in example 1 except that A deducted the $20,000 of exploration expenditures under section 615(a). The amount of the adjusted exploration expenditures with respect to mineral property Z in corporation X's hands is $170,000 (the $20,000 deducted under section 615(a) by A plus the $150,000 deducted under section 617(a) by the son).

(3) *Allocation of certain expenditures.* A project area consists of that territory which the taxpayer has determined by analysis of certain variables (the size and topography of the area to be explored, existing information with respect to that area and nearby areas, and the quantity of equipment, men, and money available) can be explored advantageously as a single integrated operation. If exploration expenditures are paid or incurred with respect to a project area and one or more areas of interest are identified within such project area, the entire amount of such expenditures shall be allocated equally to each such area of interest. If an area of interest contains one or more mines or deposits the expenditures allocable to such area of interest shall be allocated (i) if only one mine or deposit is located or identified, entirely to such mine or deposit, or (ii) if more than one mine or deposit is located or identified, equally among the various mines or deposits located. For purposes of this subparagraph, the term *area of interest* means each separable, noncontiguous portion of the project area which is identified as possessing sufficient mineral-producing potential to merit further exploration. The provisions of this subparagraph may be illustrated by the following example: A pays $100,000 for the exploration of a project area which results in the identification of two areas of interest. A pays an additional $60,000 for the exploration of one of the areas of interest in which he locates mineral deposit X and mineral deposit Y. With respect to the exploration of deposit X he incurs an additional $100,000 of expenses and with respect to deposit Y he incurs an additional $200,000 of expenses. The exploration expenditures properly attributable to deposit X would be $155,000 ($100,000 plus one-half of $50,000 plus one-half of $60,000) and the exploration expenditures properly attributable to deposit Y would be $255,000 ($200,000 plus one-half of $50,000 plus one-half of $60,000).

(4) *Partnership distributions.* The adjusted exploration expenditures with respect to any property or mine received by a taxpayer in a distribution with respect to all or part of his interest in a partnership (i) include the adjusted exploration expenditures (not otherwise included under section 617(f)(1)) with respect to such property or mine immediately prior to such distribution and (ii) shall be reduced by the amount of gain to which section 751(b) applies realized by the partnership (as constituted after the distribution) on the distribution of such property or mine. In the case of any property or mine held by a partnership after a distribution to a partner to which section 751(b) applies, the adjusted exploration expenditures with respect to such property or mine shall be reduced by the amount of gain (if any) to which section 751(b) applies realized by such partner with respect to such distribution on account of such property or mine.

(5) *Amount of transferee's adjusted exploration expenditures immediately after certain acquisitions*—(i) *Transactions in which basis is determined by reference to*

the cost or fair market value of the property transferred. (a) If on the date a person acquires mining property his basis for the property is determined solely by reference to its cost (within the meaning of section 1012), then on such date the amount of the adjusted exploration expenditures for the mining property in such person's hands is zero.

(b) If on the date a person acquires mining property his basis for the property is determined solely by reason of the application of section 301(d) (relating to basis of property received in corporate distribution) or section 334(a) (relating to basis of property received in a liquidation in which gain or loss is recognized), then on such date the amount of the adjusted exploration expenditures for the mining property in such person's hands is zero.

(c) If on the date a person acquires mining property his basis for the property is determined solely under the provisions of section 334(b)(2) or (c) (relating to basis of property received in certain corporate liquidations), then on such date the amount of the adjusted exploration expenditures for the mining property in such person's hands is zero.

(d) If on the date a person acquires mining property from a decedent such person's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the property on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), then on the date of acquisition the amount of the adjusted exploration expenditures for the mining property in such person's hands is zero.

(ii) *Gifts and certain tax-free transactions. (a)* If mining property is disposed of in a transaction described in *(b)* of this subdivision (ii), then the amount of the adjusted exploration expenditures for the mining property in the hands of a transferee immediately after the disposition shall be an amount equal to:

(1) The amount of the adjusted exploration expenditures with respect to the mining property in the hands of the transferor immediately before the disposition, minus

(2) The amount of any gain taken into account under section 617(d) by the transferor upon the disposition.

(b) The transactions referred to in *(a)* of this subdivision (ii) are:

(1) A disposition which is in part a sale or exchange and in part a gift, or

(2) A disposition which is described in section 617(d) through the incorporation by reference of the provisions of section 1245(b)(3) (relating to certain tax free transactions).

(iii) *Property acquired from a decedent.* If mining property is acquired in a transfer at death to which section 617(d) applies through incorporation by reference of the provisions of section 1245(b)(2), the amount of the adjusted exploration expenditures with respect to the mining property in the hands of the transferee immediately after the transfer shall include the amount, if any, of the exploration expenditures deducted by the transferee before the decedent's death, to the extent that the basis of the mining property (determined under section 1014(a)) is required to be reduced under the second sentence of section 1014(b)(9) (relating to adjustments to basis where the property is acquired from a decedent prior to his death).

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

Example 1. A owns the working interest in a large tract of land located in the United States. A's interest in the entire tract of land constitutes one property for purposes of section 614. In the northwest corner of this tract is an operating mine, X, producing an ore of beryllium, which is entitled to a percentage depletion rate of 22 percent under section 613(b)(2)(B). During 1971, A conducts an exploration program in the southeast corner of this same tract of land, and he incurs $400,000 of expenditures to which section 617(a)(1) applies in connection with this exploration program. A elects to deduct this amount as expenses under section 617(a). During 1971, A's *gross income from the property* computed under section 613 was $1 million, with respect to the property encompassing mine X and the area in which exploration was conducted. A's *taxable income from the property* computed under section 613, before adjustment to reflect the deductions taken with respect to the property during the year under section 617, was $400,000. The cost depletion deduction allowable and deducted with respect to the property during 1971 was $50,000. The amount of adjusted exploration expenditures chargeable to the exploratory mine (hereinafter referred to as mine Y) at the close of 1971 is $250,000, computed as follows:

Expenditures allowed as deductions under sec. 617(a)		$400,000
Gross income from the property	$1,000,000	
22 percent thereof	220,000	
Taxable income from the property, before adjustment to reflect deductions allowed under sec. 617 during year	400,000	
50 percent thereof—tentative deduction	200,000	
Taxable income from the property after adjustment to reflect deductions allowed under sec. 617 during year ($400,000 minus $400,000)	0	
Cost depletion allowed for year	50,000	
Amount by which allowance for depletion under sec. 611 was reduced on account of deductions under sec. 617 ($200,000 minus $50,000)		150,000
Adjusted exploration expenditures at end of 1971		250,000

Example 2. Assume the same facts as in example 1. Assume further that mine Y, with respect to which exploration expenditures were deducted in 1971, enters the producing stage in 1972, and that no deductions were taken under section 617 with respect to that mine after 1971. A does not make an election under section 617(b)(1)(A) during 1972. Assume that the depletion deduction which would be allowable for 1972 with respect to the property (which includes both mines) but for the application of section 617(b)(1)(B) is $100,000. Pursuant to section 617(b)(1)(B), this depletion deduction is disallowed. Therefore, the amount of adjusted exploration expenditures with respect to mine Y at the end of 1972 is $150,000 ($250,000 less $100,000).

[T.D. 7192, 37 FR 12945, June 30, 1972]

§ 1.617–4 Treatment of gain from disposition of certain mining property.

(a) *In general.* (1) In general, section 617(d)(1) provides, that, upon a disposition of mining property, the lower of (i) the *adjusted exploration expenditures* (as defined in section 617(f)(1) and paragraph (d) of § 1.617–3) with respect to the property, or (ii) the amount, if any, by which the amount realized on the sale, exchange, or involuntary conversion (or the fair market value of the property on any other disposition, exceeds the adjusted basis of the property, shall be treated as gain from the sale of exchange of property which is neither a capital asset nor property described in section 1231 (that is, shall be recognized as ordinary income). However, any amount recognized under the preceding sentence shall not be included by the taxpayer in his *gross income from the property* for purposes of section 613. Generally, the ordinary income treatment applies even though in the absence of section 617(d) no gain would be recognized under any other provision of the Code. For example, if a corporation distributes mining property as a dividend, gain may be recognized as ordinary income to the corporation even though, in the absence of section 617, section 311(a) would preclude any recognition of gain to the corporation. For an exception to the recognition of gain with respect to dispositions which involve mineral production payments, see section 636 and the regulations thereunder. For the definition of the term *mining property*, see section 617(f)(2) and paragraph (c)(3), of § 1.617–3. For exceptions and limitations to the application of section 617(d)(1), see section 617(d)(3) and paragraph (c) of this section.

(2) In the case of a sale, exchange, or involuntary conversion of mining property, the gain to which section 617(d)(1) applies is the lower of the adjusted exploration expenditures with respect to such property or the excess of the amount realized upon the disposition of the property over the adjusted basis of the property. In the case of a disposition of mining property other than by a manner described in the preceding sentence, the gain to which section 617(d)(1) applies is the lower of the adjusted exploration expenditures with respect to such property or the excess of the fair market value of the property on the date of disposition over the adjusted basis of the property. In the case of a disposal of coal or domestic iron ore subject to a retained economic interest to which section 631(c) applies, the excess of the amount realized over the adjusted basis of the mining property shall be treated as equal to the gain, if any, referred to in section 631(c). For determination of the amount realized upon a disposition of

mining property and nonmining property, see paragraph (c)(3)(i) of this section.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example 1. On July 14, 1970, A purchased undeveloped mining property for $100,000. During 1970, A incurred with respect to the property, $50,000 of exploration expenditures which he deducts under section 617(a). In 1971, A incurred $150,000 of exploration expenditures with respect to the property which he deducts on his income tax return. On January 2, 1972, A sells the mining property to B for $250,000. A's gain on the sale is $150,000 ($250,000 amount realized minus $100,000 basis). Since the excess of the amount realized over the adjusted basis of the mining property is less than the adjusted exploration expenditures with respect to the property ($200,000), the entire gain is treated as ordinary income under section 617(d)(1).

Example 2. Assume the same facts as in example 1 except that A sells the mining property to B for $400,000, thereby realizing gain of $300,000 ($400,000 minus $100,000 basis). Since the amount of adjusted exploration expenditures with respect to the mining property ($200,000) is less than the amount realized upon its disposition ($300,000), an amount equal to the amount of adjusted exploration expenditures is treated as ordinary income under section 617(d)(1). The remaining $100,000 is treated by A without regard to section 617(d)(1).

(4) Section 617(d) does not apply to losses. Thus, section 617(d) does not apply if a loss is realized upon a sale, exchange, or involuntary conversion of mining property, nor does section 617(d) apply to a disposition of mining property other than by way of sale, exchange, or involuntary conversion if at the time of the disposition the fair market value of such property is not greater than its adjusted basis.

(b) *Disposition of portion of mining property.* (1) For purposes of section 617(d)(1) and paragraph (a) of this section, except as provided in subparagraph (3) of this paragraph, in the case of the disposition of a portion of a mining property (other than an undivided interest), the entire amount of the adjusted exploration expenditures with respect to such property shall be treated as attributable to such portion to the extent of the amount of the gain to which section 617(d)(1) applies. If the amount of the gain to which section 617(d)(1) applies is less than the amount of the adjusted exploration expenditures with respect to the property, the balance of the adjusted exploration expenditures shall remain subject to recapture in the hands of the taxpayer under the provisions of section 617 (b), (c), and (d). The disposition of a portion of a mining property (other than an undivided interest) includes the disposition of a geographical portion of a mining property. For example, assume that A owns an 80-acre tract of land with respect to which he has deducted exploration expenditures under section 617(a). If A were to sell the north 40 acres, the entire amount of the adjusted exploration expenditures with respect to the 80-acre tract would be treated as attributable to the 40-acre portion sold (to the extent of the amount of the gain to which section 617(d)(1) applies).

(2) For purposes of section 617(d)(1), except as provided in subparagraph (3) of this paragraph, in the case of the disposition of an undivided interest in a mining property (or portion thereof) a proportionate part of the adjusted exploration expenditures with respect to such property shall be treated as attributable to such undivided interest to the extent of the amount of the gain to which section 617(d)(1) applies. For example, assume that A owns an 80-acre tract of land with respect to which he has deducted exploration expenditures under section 617(a). If A were to sell an undivided 40 percent interest in such tract, 40 percent of the adjusted exploration expenditures with respect to the 80-acre tract would be treated as attributable to the 40 percent of the 80-acre tract disposed of (to the extent of the amount of the gain to which section 617(d)(1) applies).

(3) Section 617(d)(2) and subparagraphs (1) and (2) of this paragraph shall not apply to any expenditure to the extent that such expenditure relates neither to the portion (or interest therein) disposed of nor to any mine, in the property held by the taxpayer before the disposition, which has reached the producing stage. In any case where a taxpayer disposes of a mining property (or interest therein) and treats adjusted exploration expenditures with respect to the mining property as if they relate neither to the portion (or

interest therein) disposed of nor to any mine, in the property held by the taxpayer before the disposition, which has reached the producing stage, the taxpayer shall attach to its return for the taxable year in which the disposition occurred, a statement which includes:

(i) A description of the portion (or interest therein) disposed of;

(ii) A description of the mineral property which included the portion (or interest therein) disposed of;

(iii) An itemization of all expenditures deducted under sections 617 and 615 with respect to such mineral property; and

(iv) A description of the location of all producing mines on such mineral property.

(c) *Exceptions.* (1)(i) Section 617(d)(3) provides, through incorporation by reference of the provisions of section 1245(b)(1), that no gain shall be recognized under section 617(d) upon a disposition by gift of mining property. For purposes of this subparagraph, the term *gift* means, except to the extent that subdivision (ii) of this subparagraph applies, a transfer of mining property which, in the hands of the transferee, has a basis determined under the provisions of section 1015 (a) or (d) (relating to basis of property acquired by gift). For reduction in amount of the charitable contribution in case of a gift of section 617 property, see section 170(e) and paragraph (c)(3) of § 1.170–1.

(ii) Where a disposition of mining property is in part a sale or exchange and in part a gift, the gain to which section 617(d) applies is the lower of the adjusted exploration expenditures with respect to such property or the excess of the amount realized upon the disposition of the property over the adjusted basis of such property.

(2) Section 617(d)(3) provides, through incorporation by reference of the provisions of section 1245(b)(2), that, except as provided in section 691 (relating to income in respect to a decedent), no gain shall be recognized under section 617(d) upon a transfer at death. For purposes of this paragraph, the term *transfer at death* means a transfer of mining property which property, in the hands of the transferee, has a basis determined under the provisions of section 1014(a) (relating to basis of property acquired from a decedent) because of the death of the transferor.

(3)(i) Section 617(d) provides, through incorporation by reference of the provisions of section 1245(b)(3), that upon a transfer of property described in subdivision (ii) of this subparagraph, the amount of gain taken into account by the transferor under section 617(d) shall not exceed the amount of gain recognized to the transferor on the transfer (determined without regard to section 617). For purposes of this subdivision, in case of a transfer of mining property and nonmining property in one transaction, the amount realized from the disposition of the mining property shall be deemed to be equal to the amount which bears the same ratio to the total amount realized as the fair market value of the mining property bears to the aggregate fair market value of all of the property transferred. The preceding sentence shall be applied solely for purposes of computing the portion of the total gain (determined without regard to section 617) which shall be recognized as ordinary income under section 617(d). Section 617(d)(3) does not apply to a disposition of mining property to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 of the Code.

(ii) The transfers referred to in subdivision (i) of this subparagraph are transfers of mining property in which the basis of the mining property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(a) Section 332 (relating to distributions in complete liquidation of an 80-percent-or-more controlled subsidiary corporation). See subdivision (iii) of this subparagraph.

(b) Section 351 (relating to transfer to a corporation controlled by transferor).

(c) Section 361 (relating to exchanges pursuant to certain corporate reorganizations).

(d) Section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings).

(e) Section 374(a) (relating to exchanges pursuant to certain railroad reorganizations).

(f) Section 721 (relating to transfers to a partnership in exchange for a partnership interest).

(g) Section 731 (relating to distributions by a partnership to a partner).

(iii) In the case of a distribution in complete liquidation of an 80-percent-or-more controlled subsidiary to which section 332 applies, the limitation provided in section 617(d)(3), through incorporation by reference of the provisions of section 1245(b)(3), is confined to instances in which the basis of the mining property in the hands of the transferee is determined under section 334(b)(1), by reference to its basis in the hands of the transferor. Thus, for example, the limitation may apply in respect of a liquidating distribution of mining property by an 80-percent-or-more controlled corporation to the parent corporation, but does not apply in respect of a liquidating distribution of mining property to a minority shareholder. Section 617(d)(3) does not apply to a liquidating distribution of property by an 80-percent-or-more controlled subsidiary to its parent if the parent's basis for the property is determined, under section 334(b)(2), by reference to its basis in the stock of the subsidiary.

[T.D. 7192, 37 FR 12947, June 30, 1972]

EXCLUSIONS FROM GROSS INCOME

§1.621–1 Payments to encourage exploration, development, and mining for defense purposes.

(a) *General rule.* (1) Under section 621, a taxpayer shall exclude from gross income amounts which are paid to him:

(i) By the United States or by an agency or instrumentality of the United States,

(ii) As a grant, gift, bounty, bonus, premium, incentive, subsidy, loan, or advance,

(iii) For the encouragement of exploration for, or development or mining of, a critical and strategic mineral or metal,

(iv) Pursuant to or in connection with an undertaking by the taxpayer to explore for, or develop or produce, such mineral or metal and to expend or use any amounts so received for the purpose and in accordance with the terms and conditions upon which such amounts are paid, which undertaking has been approved by the United States or by an agency or instrumentality of the United States, and

(v) For which the taxpayer has accounted, or is required to account, to an appropriate agency of the United States Government for the expenditure or use thereof for the purpose and in accordance with the terms and conditions upon which such amounts are paid.

In order for section 621 to apply, such amount must qualify under each of the foregoing subdivisions of this paragraph. Under section 621, there shall also be excluded from gross income any income attributable to the forgiveness or discharge of any indebtedness arising from amounts to which such section applies.

(2) Section 621 is applicable whether or not the payee is obligated to repay to the United States any portion or all of the amount so received. However, such section is not applicable to any loan or advance for the repayment of which the borrower's liability is unconditional and legally enforceable.

(3) Except as provided in paragraph (e) of this section any expenditure attributable to an amount received by a taxpayer to which section 621 applies shall not be deductible by the taxpayer as an expense under subtitle A of the Code, nor shall any such expenditure increase the basis of the taxpayer's property either for determining gain or loss on sale, exchange, or other disposition, or for computing depletion or depreciation (including amortization under section 168).

(b) *Allowance as part of purchase price.* (1) Section 621 is not applicable to any part of the purchase price of a critical and strategic mineral or metal which amount is received, whether before, on, or after delivery from the United States or any agency or instrumentality thereof, and irrespective of whether such purchase price is below, at, or above the currently prevailing market price.

(2) However, a payment of a separate and specific amount for the encouragement of exploration for, or development or mining of, a critical and strategic mineral or metal shall not be considered to be a part of the purchase

price of such mineral or metal merely because such payment is added to, or included with, the payment of such purchase price.

(c) *Payments for expenditures previously deducted or capitalized.* (1) Where amounts described in section 621 and this section are paid to a taxpayer in reimbursement for expenditures previously allowed as a deduction, the taxpayer shall include in gross income that portion of such amounts which is equivalent to the deduction for such expenditures allowed to the taxpayer and which deduction resulted in a reduction for any taxable year of the taxpayer's taxes under subtitle A of the Code (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws.

(2) Where amounts described in section 621 and this section are paid to the taxpayer in reimbursement for expenditures which have been deferred under sections 615 and 616 (relating to exploration and development expenditures) the taxpayer shall include in gross income that portion of such amounts which is equivalent to any deduction for such expenditures allowed to the taxpayer and which deduction resulted in a reduction for any taxable year of the taxpayer's taxes under subtitle A of the Code (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws. The portion of such amounts, equivalent to expenditures which are reflected in the adjusted basis of the assets to which charged, shall be excluded from gross income, and such adjusted basis shall be decreased by the amount of such exclusion.

(3) Where amounts described in section 621 and this section are paid to the taxpayer in reimbursement for expenditures which have been charged to capital account (either to a depletable or depreciable account), there shall be included in the taxpayer's gross income that portion of such amounts which is equivalent to such capital expenditures that have been recovered through cost depletion or depreciation deductions and which deductions have resulted in a reduction of the taxpayer's taxes for any taxable year under subtitle A of the Code (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws. The portion of such amounts which is equivalent to the expenditures which are reflected in the adjusted basis of the asset to which charged shall be excluded from gross income. The adjusted basis of such assets shall be reduced by the amount of such exclusion from gross income.

(4) Where amounts described in section 621 and this section are paid to the taxpayer in reimbursement for expenditures which have been charged to a depletable capital account, such amounts shall be excluded to the extent such expenditures are recovered through depletion deductions computed under section 613 (relating to percentage depletion).

(5) The amount of reimbursed expenditures charged to an account (depletable or depreciable) and recovered through depletion or depreciation deductions for any taxable year shall be that proportion of the total deductions allowed with respect to such account that such reimbursed expenditures bear to the total amount in the account. For example, in 1956 A incurs exploration expenditures of $12,000 which he charges to a depletable capital account. This brings the total amount in this account to $36,000 which is the adjusted basis of the property on January 1, 1957. In 1957, A is allowed a deduction for cost depletion of $9,000 which resulted in a reduction of A's income taxes. One-third of this deduction is attributable to the $12,000 of exploration expenditures since they were a third of the total in the capital account on January 1, 1957. Therefore, on January 1, 1958, these exploration expenditures make up $9,000 of the remaining $27,000 in the account. If on January 1, 1958, A receives $12,000, which qualifies under section 621, in reimbursement for these exploration expenditures, he must report $3,000 as income and reduce the capital account by $9,000.

(d) *Definition.* As used in section 621 and this section, the term *critical and strategic minerals or metals* means minerals and metals which are considered by those departments, agencies, and instrumentalities of the United States charged with the encouragement of exploration for, and development and mining of, critical and strategic minerals and metals, to constitute critical and strategic minerals and metals for defense purposes. See, for example, 30 CFR 301.3 (Regulations for Obtaining Federal Assistance in Financing Explorations for Mineral Reserves, Excluding Organic Fuels, in the United States, its Territories and Possessions).

(e) *Repayments of amounts excluded under section 621.* Upon the repayment by the taxpayer of any portion of any amount to which section 621 applies and which portion has been expended for the purpose and in accordance with the terms and conditions upon which it was paid to the taxpayer, any expenditures attributable to such amount made by the taxpayer shall be treated as if such expenditures had been made at the time of such repayment. Such expenditures shall to the extent of the repayment be expensed or capitalized, as the case may be, in the order in which they were actually made or in such other manner as may be adopted by the taxpayer with the approval of the Commissioner.

SALES AND EXCHANGES

§1.631–1 Election to consider cutting as sale or exchange.

(a) *Effect of election.* (1) Section 631 (a) provides an election to certain taxpayers to treat the difference between the actual cost or other basis of certain timber cut during the taxable year and its fair market value as standing timber on the first day of such year as gain or loss from a sale or exchange under section 1231. Thereafter, any subsequent gain or loss shall be determined in accordance with paragraph (e) of this section.

(2) For the purposes of section 631(a) and this section, timber shall be considered cut at the time when in the ordinary course of business the quantity of timber felled is first definitely determined.

(3) The election may be made with respect to any taxable year even though such election was not made with respect to a previous taxable year. If an election has been made under the provisions of section 631(a), or corresponding provisions of prior internal revenue laws, such election shall be binding upon the taxpayer not only for the taxable year for which the election is made but also for all subsequent taxable years, unless the Commissioner on showing by the taxpayer of undue hardship permits the taxpayer to revoke his election for such subsequent taxable years. If the taxpayer has revoked a previous election, such revocation shall preclude any further elections unless the taxpayer obtains the consent of the Commissioner.

(4) Such election shall apply with respect to all timber which the taxpayer has owned, or has had a contract right to cut, for a period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) prior to when such timber is cut for sale or for use in the taxpayer’s trade or business, irrespective of whether such timber or contract right was acquired before or after the election. (For purposes of the preceding sentence, the rules with respect to the holding period of property contained in section 1223 shall be applicable.) However, timber which is not cut for sale or for use in the taxpayer’s trade or business (for example, firewood cut for the taxpayer’s own household consumption) shall not be considered to have been sold or exchanged upon the cutting thereof.

(b) *Who may make election.* (1) A taxpayer who has owned, or has held a contract right to cut, timber for a period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) prior to when the timber is cut may elect under section 631(a) to consider the cutting of such timber during such year for sale or for use in the taxpayer’s trade or business as a sale or exchange of the timber so cut. In order to have a *contract right to cut timber* within the meaning of section 631(a) and this section, a taxpayer must have a right to sell the timber cut under the contract on his own account or to use such cut timber in his trade or business.

(2) For purposes of section 631(a) and this section, the term *timber* includes evergreen trees which are more than

six years old at the time severed from their roots and are sold for ornamental purposes, such as Christmas decorations. Section 631(a) is not applicable to evergreen trees which are sold in a live state, whether or not for ornamental purposes. Tops and other parts of standing timber are not considered as evergreen trees within the meaning of section 631(a). The term *evergreen trees* is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

(c) *Manner of making election.* The election under section 631(a) must be made by the taxpayer in his income tax return for the taxable year for which the election is applicable, and such election cannot be made in an amended return for such year. The election in the return shall take the form of a computation under the provisions of section 631(a) and section 1231.

(d) *Computation of gain or loss under the election.* (1) If the cutting of timber is considered as a sale or exchange pursuant to an election made under section 631(a), gain or loss shall be recognized to the taxpayer in an amount equal to the difference between the adjusted basis for depletion in the hands of the taxpayer of the timber which has been cut during the taxable year and the fair market value of such timber as of the first day of the taxable year in which such timber is cut. The adjusted basis for depletion of the cut timber shall be based upon the number of units of timber cut during the taxable year which are considered to be sold or exchanged and upon the depletion unit of the timber in the timber account or accounts pertaining to the timber cut, and shall be computed in the same manner as is provided in section 611 and the regulations thereunder with respect to the computation of the allowance for depletion.

(2) The fair market value of the timber as of the first day of the taxable year in which such timber is cut shall be determined, subject to approval or revision by the district director upon examination of the taxpayer's return, by the taxpayer in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, methods of exploitation, degree of utilization, etc. The value sought will be the selling price, assuming a transfer between a willing seller and a willing buyer as of that particular day. Due consideration will be given to the factors and the principles involved in the determination of the fair market value of timber as described in the regulations under section 611.

(3) The fair market value as of the beginning of the taxable year of the standing timber cut during the year shall be considered to be the cost of such timber, in lieu of the actual cost or other basis of such timber, for all purposes for which such cost is a necessary factor. See paragraph (e) of this section.

(4) For any taxable year for which the cutting of timber is considered to be a sale or exchange of such timber under section 631(a), the timber so cut shall be considered as property used in the trade or business for the purposes of section 1231, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether such timber is property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether the gain or loss considered to have resulted from the cutting of the timber will be considered to be gain or loss resulting from the sale or exchange of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) depends upon the application of section 1231 to the taxpayer for the taxable year. See section 1231 and the regulations thereunder.

(e) *Computaton of subsequent gain or loss.* (1) In case the products of the timber are sold after cutting, either in the form of logs or lumber or in the form of manufactured products, the income from such actual sales shall be considered ordinary income. When the election under section 631(a) is in effect, the cost of standing timber cut during the taxable year is determined as if the taxpayer had purchased such timber on the first day of the taxable year. Thus, in determining the cost of the products so sold, the cost of the timber shall be the fair market value on the first day of the taxable year in which the standing timber was cut, in lieu of the actual cost or other basis of such timber.

(2) This is also the rule in case the products of the timber cut during one taxable year, with respect to which an election has been made under section 631(a), are sold during a subsequent taxable year, whether or not the election provided in section 631(a) is applicable with respect to such subsequent year. If the products of the timber cut during a taxable year with respect to which an election under section 631(a) was made were not sold during such year and are included in inventory at the close of such year, the fair market value as of the beginning of the year of the timber cut during the year shall be used in lieu of the actual cost of such timber in computing the closing inventory for such year and the opening inventory for the succeeding year. With respect to the costs applicable in the determination of the amount of such inventories, there shall be included the fair market value of the timber cut, the costs of cutting, logging, and all other expenses incident to the cost of converting the standing timber into the products in inventory. See section 471 and the regulations thereunder. The fact that the fair market value as of the first day of the taxable year in which the timber is cut is deemed to be the cost of such timber shall not preclude the taxpayer from computing its inventories upon the basis of cost or market, whichever is lower, if such is the method used by the taxpayer. Nor shall it preclude the taxpayer from computing its inventories under the last-in, first-out inventory method provided by section 472 if such section is applicable to, and has been elected by, the taxpayer.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7730, 45 FR 72650, Nov. 3, 1980]

§1.631–2 Gain or loss upon the disposal of timber under cutting contract.

(a) *In general.* (1) If an owner disposes of timber held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) before such disposal, under any form or type of contract whereby he retains an economic interest in such timber, the disposal shall be considered to be a sale of such timber. The difference between the amounts realized from disposal of such timber in any taxable year and the adjusted basis for depletion thereof shall be considered to be a gain or loss upon the sale of such timber for such year. Such adjusted basis shall be computed in the same manner as provided in section 611 and the regulations thereunder with respect to the allowance for depletion. See paragraph (e)(2) of this section for definition of *owner*. For the purpose of determining whether or not the timber disposed of was held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) before such disposal the rules with respect to the holding period of property contained in section 1223 shall be applicable.

(2) In the case of such a disposal, the provisions of section 1231 apply and such timber shall be considered to be property used in the trade or business for the taxable year in which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether such timber is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether gain or loss resulting from the disposition of the timber which is considered to have been sold will be deemed to be gain or loss resulting from a sale of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) will depend upon the application of section 1231 to the taxpayer for the taxable year.

(b) *Determination of date of disposal.* (1) For purposes of section 631(b) and this section, the date of disposal of timber shall be deemed to be the date such timber is cut. However, if payment is made to the owner under the contract for timber before such timber is cut the owner may elect to treat the date of payment as the date of disposal of such timber. Such election shall be effective only for purposes of determining the holding period of such timber. Neither section 631(b) nor the election thereunder has any effect on the time of reporting gain or loss. See subchapter E, chapter 1 of the Code and the regulations thereunder. See paragraph (c)(2) of this section for the effect of exercising the election with respect to the payment for timber held for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less. See paragraph (d) of this section for the treatment of payments received in advance of cutting.

(2) For purposes of section 631(b) and this section, the *date such timber is cut* means the date when in the ordinary course of business the quantity of timber felled is first definitely determined.

(c) *Manner and effect of election to treat date of payment as the date of disposal.* (1) The election to treat the date of payment as the date of disposal of timber shall be evidenced by a statement attached to the taxpayer's income tax return filed on or before the due date (including extensions thereof) for the taxable year in which the payment is received. The statement shall specify the advance payments which are subject to the election and shall identify the contract under which the payments are made. However, in no case shall the time for making the election under section 631(b) expire before the close of March 21, 1958.

(2) Where the election to treat the date of payment as the date of disposal is made with respect to a payment made in advance of cutting, and such payment is made 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less from the date the timber disposed of was acquired, section 631(b) shall not apply to such payment irrespective of the date such timber is cut, since the timber was not held for more than six months prior to disposal.

(d) *Payments received in advance of cutting.* (1) Where the conditions of paragraph (a) of this section are met, amounts received or accrued prior to cutting (such as advance royalty payments or minimum royalty payments) shall be treated under section 631(b) as realized from the sale of timber if the contract of disposal provides that such amounts are to be applied as payment for timber subsequently cut. Such amounts will be so treated irrespective of whether or not an election has been made under paragraph (c) of this section to treat the date of payment as the date of disposal. For example, if no election has been made under paragraph (c) of this section, amounts received or accrued prior to cutting will be treated as realized from the sale of timber, provided the timber paid for is cut more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the date of acquisition of such timber.

(2) However, if the right to cut timber under the contract expires, terminates, or is abandoned before the timber which has been paid for is cut, the taxpayer shall treat payments attributable to the uncut timber as ordinary income and not as received from the sale of timber under section 631(b). Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received or accrued. The recomputation shall be made in the form of an amended return where necessary.

(3)(i) Bonuses received or accrued by an owner in connection with the grant of a contract of disposal shall be treated under section 631(b) as amounts realized from the sale of timber to the extent attributable to timber held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(ii) The adjusted depletion basis attributable to the bonus shall be determined under the provisions of section 612 and the regulations thereunder. This subdivision may be illustrated as follows:

Example. Taxpayer A has held timber having a depletion basis of $90,000 for two months when he enters into a contract of disposal with B. B pays A a bonus of $5,000 upon the execution of the contract and agrees to pay X dollars per unit of timber to A as the timber is cut. A does not exercise the election to treat the date of payment as the date of disposal. It is estimated that there are 50,000 units of timber subject to the contract and that the total estimated royalties to be paid to A will be $95,000. A must report the bonus in the taxable year it is received or accrued by him. The portion of the basis of the timber attributable to the bonus is determined by the following formula:

$$\frac{\text{Bonus}}{\text{Bonus} + \text{amount of expected royalties}} \times \text{Basis of timber} = \text{Basis attributable to bonus}$$

$$\frac{\$5{,}000}{\$100{,}000} \times \$90{,}000 = \$4{,}500$$

(iii) To the extent attributable to timber not held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), such bonuses shall be treated as ordinary income subject to depletion. In order to determine the amount of the bonus allocable to timber not held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), the bonus shall be apportioned ratably over the estimated number of units of timber covered by the contract of disposal. This subdivision may be illustrated as follows:

Example. Assume under the facts stated in the example in subdivision (ii) of this subparagraph that B cuts 10,000 units of timber that have been held by A for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), or less. The amount of the bonus (as well as the royalties) attributable to these units must be reported as ordinary income subject to depletion. The amount of the bonus attributable to these units is determined by the following formula:

$$\frac{\begin{array}{c}\text{Number of units cut}\\ \text{held for six months or less}\end{array}}{\text{Total units covered by the contract}} \times \text{Amount of bonus} = \begin{array}{c}\text{Amount of bonus treated}\\ \text{as ordinary income}\\ \text{subject to depletion}\end{array}$$

$$\frac{10{,}000}{50{,}000} \times \$5{,}000 = \$1{,}000$$

The amount of the depletion attributable to the portion of the bonus received for timber held for six months or less is determined by the following formula:

$$\frac{\begin{array}{c}\text{Amount of bonus attributable to}\\ \text{timber held for six month or less}\end{array}}{\text{Total bonus}} \times \begin{array}{c}\text{Adjusted basis for}\\ \text{depletion of bonus}\end{array} = \begin{array}{c}\text{Depletion allowance on timber}\\ \text{held for six months or less}\end{array}$$

$$\frac{\$1{,}000}{\$5{,}000} \times \$4{,}500 = \$900$$

The amount of the bonus attributable to timber held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), and which is treated under section 631 (b) as realized from the sale of timber would be $4,000. The gain on such amount is $400 ($4,000 − $3,600).

(iv) If the right to cut timber under the contract of disposal expires, terminates, or is abandoned before any timber is cut, the taxpayer shall treat the bonus received under such contract as ordinary income, not subject to depletion. Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such bonus was received. The recomputation shall be made in the form of an amended return where necessary.

(e) *Other rules for application of section.* (1) Amounts paid by the lessee for timber or the acquisition of timber cutting rights, whether designated as such or as a rental, royalty, or bonus, shall be treated as the cost of timber and constitute part of the lessee's depletable basis of the timber, irrespective of the treatment accorded such payments in the hands of the lessor.

(2) The provisions of section 631(b) apply only to an owner of timber. An owner of timber means any person who owns an interest in timber, including a sublessor and a holder of a contract to cut timber. Such owner of timber must have a right to cut timber for sale on his own account or for use in his trade or business in order to own an interest in timber within the meaning of section 631(b).

(3) For purposes of section 631(b) and this section, the term *timber* includes evergreen trees which are more than 6 years old at the time severed from their roots and are sold for ornamental purposes such as Christmas decorations. Tops and other parts of standing timber are not considered as evergreen trees within the meaning of section 631(b). The term *evergreen trees* is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.631–3 Gain or loss upon the disposal of coal or domestic iron ore with a retained economic interest.

(a) *In general.* (1) The provisions of section 631(c) apply to an owner who disposes of coal (including lignite), or iron ore mined in the United States, held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) before such disposal under any form or type of contract whereby he retains an economic interest in such coal or iron ore. The difference between the amount realized from disposal of the coal or iron ore in any taxable year, and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272, shall be gain or loss upon the sale of the coal or iron ore. See paragraph (b)(4) of this section for the definition of *owner.* See paragraph (e) of this section for special rules relating to iron ore.

(2) In the case of such a disposal, the provisions of section 1231 apply, and the coal or iron ore shall be considered to be property used in the trade or business for the taxable year in which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether the coal or iron ore is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether gain or loss resulting from the disposition of the coal or iron ore which is considered to have been sold will be deemed to be gain or loss resulting from a sale of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) will depend on the application of section 1231 to the taxpayer for the taxable year; *i.e.,* if the gains do not exceed the losses, they shall not be considered as gains and losses from sales or exchanges of capital assets but shall be treated as ordinary gains and losses.

(b) *Rules for application of section.* (1) For purposes of section 631(c) and this section, the date of disposal of the coal or iron ore shall be deemed to be the date the coal or iron ore is mined. If the coal or iron ore has been held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) on the date it is mined, it is immaterial that it had not been held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) on the date of the contract. There shall be no allowance for percentage depletion provided in section 613 with respect to amounts which are considered to be realized from the sale of coal or iron ore under section 631(c).

(2) The term *adjusted depletion basis* as used in section 631(c) and this section means the basis for allowance of cost depletion provided in section 612 and the regulations thereunder. Such *adjusted depletion basis* shall include exploration or development expenditures treated as deferred expenses under section 615(b) or 616(b), or corresponding provisions of prior income tax laws, and be reduced by adjustments under section 1016(a) (9) and (10), or corresponding provisions of prior income tax laws, relating to deductions of deferred expenses for exploration or development expenditures in the taxable year or any prior taxable years. The depletion unit of the coal or iron ore disposed of shall be determined under the rules provided in the regulations under section 611, relating to cost depletion.

(3)(i) In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties (except rents and royalties paid by a lessee with respect to coal or iron ore disposed of by the lessee as an *owner* under section 631(c)) shall be determined without regard to the provisions of section 631(c). Thus, the amounts of rents and royalties paid or incurred by a lessee with respect to coal or iron ore shall be excluded from the lessee's gross income from the property for the purpose of determining his percentage depletion without regard to the treatment of such rents or royalties in the hands of the recipient under this section. See section 613 and the regulations thereunder.

(ii)*(a)* However, a lessee who is also a sublessor may dispose of coal or iron ore as an *owner* under section 631(c). Rents and royalties paid with respect to coal or iron ore disposed of by such a lessee under section 631(c) shall increase the adjusted depletion basis of the coal or iron ore and are not otherwise deductible.

(b) The provisions of this subdivision may be illustrated by the following example:

Example. B is a sublessor of a coal lease; A is the lessor; and C is the sublessee. B pays A a royalty of 50 cents per ton. C pays B a royalty of 60 cents per ton. The amount realized by B under section 631(c) is 60 cents per ton and will be reduced by the adjusted depletion basis of 50 cents per ton, leaving a gain of 10 cents per ton taxable under section 631(c).

(4)(i) The provision of this section apply only to an owner who has disposed of coal or iron ore and retained an economic interest. For the purposes of section 631(c) and this section, the word *owner* means any person who owns an economic interest in coal or iron ore in place, including a sublessor thereof. A person who merely acquires an economic interest and has not disposed of coal or iron ore under a contract retaining an economic interest does not qualify under section 631(c). A successor to the interest of a person who has disposed of coal or iron ore under a contract by virtue of which he retained an economic interest in such coal or iron ore is also entitled to the benefits of this section. Section 631(c) and this section shall not apply with respect to any income realized by any owner as co-adventurer, partner, or principal in the mining of such coal or iron ore.

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

Example 1. A owns a tract of coal land in fee. A leases to B the right to mine all the coal in this tract in return for a royalty of 30 cents per ton. B subleases his right to mine coal in this tract to C, who agrees to pay A 30 cents per ton and to pay to B an additional royalty of 10 cents per ton. Section 631(c) applies to the royalties of both A and B, if the other requisites of the section have been met.

Example 2. Assume the same facts as in example 1, except that A dies leaving his royalty interest to D. D has an economic interest in the coal in place and qualifies for section 631(c) treatment with respect to his share of the royalties since he is a successor in title to A.

Example. Assume the same facts as in example 1, except that E agrees to pay a sum of money to C in return for 10 cents per ton on the coal mined by C. E has an economic interest, since he must look solely to the extraction of the coal for the return of his investment. However, E has not made a disposal of coal under a contract wherein he retains an economic interest, and, therefore does not qualify under section 631(c). E is entitled to depletion on his royalties.

(c) *Payments received in advance of mining.* (1)(i) Where the conditions of paragraph (a) of this section are met, amounts received or accrued prior to mining shall be treated under section 631(c) as received from the sale of coal or iron ore if the contract of disposal provides that such amounts are to be applied as payment for coal or iron ore subsequently mined. For example, advance royalty payments or minimum royalty payments received by an owner of coal or iron ore qualify under section 631(c) where the contract of disposal grants the lessee the right to apply such royalties in payment of coal or iron ore mined at a later time.

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

Example. A acquires coal rights on January 1. On January 30, A enters into a contract of disposal providing that mining shall begin July 2, and mining actually begins no earlier. Any advance payments which A receives qualify under section 631(c).

(2) However, if the right to mine coal or iron ore under the contract expires, terminates, or is abandoned before the coal or iron ore which had been paid for is mined, the taxpayer shall treat payments attributable to the unmined coal or iron ore as ordinary income and not as received from the sale of coal or iron ore under section 631(c). Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received. The recomputation shall be made in the form of an amended return where necessary.

(3) Bonuses received or accrued by an owner in connection with the grant of a contract of disposal shall be treated under section 631(c) as received from the sale of coal or iron ore to the extent attributable to coal or iron ore held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). The rules contained in paragraph (d) of § 1.631–2 relating to bonuses in the case of contracts for the disposal of timber shall be equally applicable in the case of bonuses received for the grant of a contract of disposal of coal or iron ore under this section.

(d) *Nonapplication of section.* Section 631(c) shall not affect the application of the provisions of subchapter G, chapter 1 of the Code, relating to corporations used to avoid income tax on shareholders. For example, for the purposes of applying section 543 (relating to personal holding companies), the amounts received from a disposal of coal or iron ore subject to section 631(c) shall be considered as mineral royalties. The determination of whether an amount received under a contract to which section 631(c) applies is *personal holding company income* shall be made in accordance with section 543 and the regulations thereunder, without regard to section 631(c) or this section. See also paragraph (e) of § 1.272–1.

(e) *Special rules with regard to iron ore.* (1) With regard to iron ore, section 631(c) and this section apply only to amounts received or accrued in taxable years beginning after December 31, 1963, attributable to iron ore mined in such taxable years.

(2) Section 631(c) and this section apply only to disposals of iron ore mined in the United States.

(3) For the purposes of section 631(c) and this section, iron ore is any ore which is used as a source of iron, including but not limited to taconite and jaspilite.

(4) Section 631(c) shall not apply to any disposal of iron ore to a person whose relationship to the person disposing of such iron ore would result in the disallowance of losses under section 267 or 707(b).

(5) Section 631(c)(2) results in the denial of section 631(c) treatment in the case of a contract for disposal of iron ore entered into with a person owned or controlled, directly or indirectly, by the same interests which own or control the person disposing of the iron ore, even though section 631(c) treatment would not be denied under the

provisions of section 631(c)(1). For example, section 631(c) treatment is denied in the case of a contract for disposal of iron ore entered into between two *brother and sister* corporations, or a parent corporation and its subsidiary. The presence or absence of control shall be determined by applying the same standards as are applied under section 482 (relating to the allocation of income and deductions between taxpayers).

[T.D. 6841, 30 FR 9307, July 27, 1965, as amended by T.D. 7730, 45 FR 72650, Nov. 3, 1980]

§1.632–1 Tax on sale of oil or gas properties.

(a) If the taxpayer, by prospecting and locating claims or by exploring or discovering undeveloped claims, has demonstrated the principal value of oil or gas property, which prior to his efforts had a relatively minor value, the portion of the tax (or, in the case of taxable years beginning before Jan. 1, 1971, the surtax) imposed by section 1 attributable to a sale of such property, or of any interest of the taxpayer therein, shall not exceed 33 percent (or, in the case of taxable year beginning before Jan. 1, 1971, 30 percent) of the selling price of such property or such interest. Shares of stock in a corporation owning oil or gas property do not constitute an interest in such property. To determine the application of section 632 to a particular case, the taxpayer should first compute the tax (or surtax) imposed by section 1 upon his entire taxable income, including the taxable income from any sale of such property or interest therein, without regard to section 632. The proportion of the tax (or surtax) so computed, indicated by the ratio which the taxpayer's taxable income from the sale of the property or interest therein, computed as prescribed in this section, bears to his total taxable income is the portion of the tax attributable to such sale and, if it exceeds 33 percent (or 30 percent) of the selling price of such property or interest, such portion of the tax (or surtax) shall be reduced to that amount.

(b) In determining the portion of the taxable income attributable to the sale of such oil or gas property or interest therein, the taxpayer shall allocate to the gross income derived from such sale, and to the gross income derived from all other sources, the expenses, losses, and other deductions properly appertaining thereto and shall apply any general expenses, losses, and deductions (which cannot properly be otherwise allocated) ratably to the gross income from all sources. The gross income derived from the sale of such oil or gas property or interest therein, less the deductions properly appertaining thereto and less its proportion of any general deductions, shall be the taxable income attributable to such sale. The taxpayer shall submit with his return a statement fully explaining the manner in which such expenses, losses, and deductions are allocated or apportioned.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7117, 36 FR 9421, May 25, 1971]

MINERAL PRODUCTION PAYMENTS

§1.636–1 Treatment of production payments as loans.

(a) *In general.* (1)(i) For purposes of subtitle A of the Internal Revenue Code of 1954, a production payment (as defined in paragraph (a) of §1.636–3) to which this section applies shall be treated as a loan on the mineral property (or properties) burdened thereby and not as an economic interest in mineral in place, except to the extent that §1.636–2 or paragraph (b) of this section applies. See paragraph (b) of §1.611–1. A production payment carved out of mineral property which remains in the hands of the person carving out the production payment immediately after the transfer of such production payment shall be treated as a mortgage loan on the mineral property burdened thereby. A production payment created and retained upon the transfer of the mineral property burdened by such production payment shall be treated as a purchase money mortgage loan on the mineral property burdened thereby. Such production payments will be referred to hereinafter in the regulations under section 636 as carved-out production payments and retained production payments, respectively. Moreover, in the case of a transaction involving a production payment treated as a loan pursuant to this section, the production payment shall constitute an item of income (not subject to depletion), consideration for a sale or exchange, a contribution to capital, or a gift if in the transaction a debt obligation used in lieu of the production payment would constitute such an item of income, consideration, contribution to capital, or gift, as the case may be. For the definition of the term *transfer* see paragraph (c) of § 1.636–3.

(ii) The payer of a production payment treated as a loan pursuant to this section shall include the proceeds from (or, if paid in kind, the value of) the mineral produced and applied to the satisfaction of the production payment in his gross income and *gross income from the property* (see section 613(a)) for the taxable year so applied. The payee shall include in his gross income (but not *gross income from the property*) amounts received with respect to such production payment to the extent that such amounts would be includible in gross income if such production payment were a loan. The payer and payee shall determine their allowable deductions as if such production payment were a loan. See section 483, relating to interest on certain deferred payments in the case of a production payment created and retained upon the transfer of the mineral property burdened thereby, or in the case of a production payment transferred in exchange for property. See section 1232 in the case of a production payment which is originally transferred by a corporation at a discount and is a capital asset in the hands of the payee. In the case of a carved-out production payment treated as a mortgage loan pursuant to this section, the consideration received for such production payment by the taxpayer who created it is not included in either gross income or *gross income from the property* by such taxpayer.

(2) If a production payment is treated as a loan pursuant to this section, no transfer of such production payment or any property burdened thereby (other than a transfer between the payer and payee of the production payment which, if the production payment were a loan, would extinguish the loan) shall cause it to cease to be so treated. For example, A sells operating mineral interest X to B for $100,000, subject to a $500,000 retained production payment payable out of X. Subsequently, A sells the production payment to C, and B sells X to D. C and D must treat the production payment as a purchase money mortgage loan.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example 1. On December 22, 1972, A, a cash-basis calendar-year taxpayer who owns operating mineral interest X, carves out of X a production payment in favor of B for $300,000 plus interest, payable out of 50 percent of the first oil produced and sold from X. In 1972, A treats the $300,000 received from B for the production payment as the proceeds of a mortgage loan on X. In 1973, A produces and sells 125,000 barrels of oil for $373,500. A pays B $186,750 with respect to the production payment, $168,750 being principal and $18,000 being interest. In computing his gross income and *gross income from the property* for the year 1973, A includes the $373,500 and takes as deductions the allowable expenses paid in production of such mineral. A also takes a deduction under section 163 for the $18,000 interest paid with respect to the production payment. For 1973, B would treat $18,000 as ordinary income not subject to the allowance for depletion under section 611.

Example 2. Assume the same facts as in example 1 except that the principal amount of the production payment is to be increased by the amount of the ad valorem tax on the mineral attributable to the production payment which is paid by B. Under State law, the ad valorem tax with respect to the mineral attributable to the production payment is a liability of the owner of the production payment. For 1973, B inlcudes the amount received with respect to such taxes as income and takes a deduction under section 164 for the taxes paid by him. Since the ad valorem taxes paid by B are his liability under State law, A may not take a deduction under section 164 for such taxes.

Example 3. On December 31, 1974, C, a calendar-year taxpayer and owner of the operating mineral interest Y, sells Y to D for $10,000 cash and retains a $40,000 production payment payable out of Y. At the time D acquires the property, it is estimated that 500,000 tons of mineral are recoverable from the property. In 1975, D produces a total of 50,000 tons from the property. D's cost depletion for 1975 is $5,000 determined as follows:

Basis in property: $50,000	
Total recoverable units: 500,000	
Rate of depletion per ton: ($50,000÷500,000)	$0.10
Cost depletion for year: ($0.10 ×50,000)	$5,000

(b) *Exception.* (1) A production payment carved out of a mineral property (or properties) for exploration or development of such property (or properties) shall not be treated as a mortgage loan under section 636(a) and this section to the extent *gross income from the property* (for purposes of section 613) would not be realized by the taxpayer creating such production payment, under the law existing at the time of the creation of such production payment, in the absence of section 636(a). See section 83 and the regulations thereunder, relating to property transferred in connection with the performance of services. For purposes of section 636(a) and this paragraph, an expenditure is for exploration or development to the extent that it is necessary for ascertaining the existence, location, extent, or quality of any deposit of mineral or is incident to and necessary for the preparation of a deposit for the production of mineral. However, an expenditure which relates primarily to the production of mineral (as, for example, in the case of a pilot water flood program with respect to the secondary recovery of oil) is not for exploration or development as those terms are used in section 636(a) and this paragraph. Whether or not a production payment is carved out for exploration or development shall be determined in light of all relevant facts and circumstances, including any prior production of mineral from the mineral deposit burdened by the production payment. However, a production payment shall not be treated as carved out for exploration or development to the extent that the consideration for the production payment:

(i) Is not pledged for use in the future exploration or development of the mineral property (or properties) which is burdened by the production payment;

(ii) May be used for the exploration or development of any other property, or for any other purpose than that described in subdivision (i) of this subparagraph;

(iii) Does not consist of a binding obligation of the payee of the production payment to pay expenses of the exploration or development described in subdivision (i) of this subparagraph; or

(iv) Does not consist of a binding obligation of the payee of the production payment to provide services, materials, supplies, or equipment for the exploration or development described in subdivision (i) of this subparagraph.

(2) In the case of a carved-out production payment only a portion of which is subject to the exception provided in this paragraph, the rules contained in paragraph (a) of this section with respect to the treatment of income and deductions where a production payment is treated as a loan shall apply to the portion of the taxpayer's income or expenses attributable to the production payment which bears the same ratio to the total amount of such income or expenses, as the case may be, as the amount of the consideration for the production payment which would have been realized as income in the absence of section 636(a), by the taxpayer creating such production payment, bears to the total consideration to the taxpayer for the production payment. For example, A, owner of a mineral property, carves out a production payment in favor of B for $600,000 plus interest in return for $600,000 cash. A pledges to use $400,000 for the development of the burdened mineral property. In each of the payout years loan treatment applies to one-third of the income and expenses of A and B attributable to the production payment.

(c) *Treatment upon disposition or termination of mineral property burdened by production payment.* (1)(i) In the case of a sale or other disposition of the mineral property burdened by a production payment treated as a loan pursuant to this section, there shall be included in determining the amount realized upon such disposition an amount equal to the outstanding principal balance of such production payment on the date of such disposition. However, if such a production payment is created in connection with the disposition, the amount to be so included shall be the fair market value of the production payment, rather than its principal amount, if the fair market value is established by clear and convincing evidence to be an amount which differs from the principal amount. See section 1001 and the regulations thereunder. In determining the cost of the transferred mineral property to the transferee for purposes of section 1012, the outstanding principal balance of the production payment shall be included in the cost.

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

Example 1. A, the owner of mineral property X which is burdened by a carved-out production payment to which section 636(a) applies having an outstanding principal balance of $10,000, sells property X to B, an individual, for $100,000 cash. The amount realized by A on the sale of property X is $110,000. B's basis in property X for cost depletion and other purposes is also $110,000.

Example 2. Assume the same facts as in example 1 except that the production payment is retained by A in connection with the sale of property X to B, that section 636(b) applies to the production payment, that the production payment includes, in addition to the $10,000 principal amount, an additional amount equivalent to interest at a rate which precludes application of section 483, and that the fair market value of the production payment is $9,000. The amount realized by A on the sale of property X is $109,000. B's basis in property X for cost depletion and other purposes is $110,000. A's basis in the retained production payment is $9,000. If the production payment is paid in full, A realizes income of $1,000 plus the amount equivalent to interest, which income is includible in A's gross income at the time when such amounts would be so includible if such production payment were a loan.

Example 3. C, the owner of mineral property Y, sells the mineral property to D for $500,000 cash. Property Y is burdened by a carved-out production payment with an outstanding principal balance of $600,000, 40 percent of the consideration for which was pledged for the development of property Y. The amount realized by C on the sale is $860,000 ($500,000 plus $600,000×.60). D's basis in property Y for cost depletion and other purposes is $860,000.

(2) In the case of the expiration, termination, or abandonment of a mineral property burdened by a production payment treated as a loan pursuant to this section, for purposes of determining the amount of any loss under section 165 with respect to the burdened mineral property the adjusted basis of such property shall be reduced (but not below zero) by an amount equal to the outstanding principal balance of such production payment on the date of such expiration, termination, or abandonment. Thus, in example 2 in subparagraph (1)(ii) of this paragraph, if B abandons the mineral property at a time when $5,000 of the principal amount of the production payment remains unsatisfied, B's adjusted basis immediately before the abandonment would be reduced by $5,000 for determining his loss on abandonment under section 165.

(3) In the case of a transfer of a portion of the mineral property burdened by a production payment treated as a loan pursuant to this section, such production payment shall be apportioned between the transferred portion and the retained portion by allocating to such transferred portion that part of the outstanding principal balance of the production payment which bears the same ratio to such balance as the value of such transferred portion (exclusive of any value not related to the burdened mineral) bears to the total value of the burdened mineral property (exclusive of any value not related to the burdened mineral).

(4) In general, the entire amount of gain or loss realized pursuant to this paragraph shall be recognized in the taxable year of such realization. See section 1211 for limitation on capital losses. This subparagraph shall not affect the applicability of rules providing exceptions to the recognition of gain or loss which has been realized (e.g., a transfer to which section 351 or 1031 applies). However, see section 357(c) with respect to the assumption of liabilities in excess of basis in certain tax-free exchanges. Furthermore, in the case of a transaction which otherwise qualifies, gain realized on a transfer of a mineral property to which section 636(b) applies may be returned on the installment method under section 453.

[T.D. 7261, 38 FR 5463, Mar. 1, 1973]

§ 1.636–2 Production payments retained in leasing transactions.

(a) *Treatment by lessee.* In the case of a production payment (as defined in paragraph (a) of § 1.636–3) which is retained by the lessor in a leasing transaction (including a sublease or the exercise of an option to acquire a lease or sublease), the lessee (or his successors in interest) shall treat the retained production payment for purposes of subtitle A of the Code as if it were a bonus granted by the lessee to the lessor payable in installments. Accordingly, the lessee shall include the proceeds from (or, if paid in kind, the value of) the mineral produced and applied to the satisfaction of the production payment in his gross income for the taxable year so applied. The lessee shall capitalize each payment (including any interest and any amounts added on to the production payment other than amounts for which the lessee would be liable in the absence of the production payment) paid or incurred with respect to such production payment. See paragraph (c)(5)(ii) of §1.613–2 for rules relating to computation of percentage depletion with respect to a mineral property burdened by a production payment treated as a bonus under section 636(c) and this section.

(b) *Treatment by lessor.* The lessor who retains a production payment in a leasing transaction (or his successors in interest) shall treat the production payment without regard to the provisions of section 636 and §1.636–1. Thus, the production payment will be treated as an economic interest in the mineral in place in the hands of the lessor (or his successors in interest) and the receipts in discharge of the production payment will constitute ordinary income subject to depletion.

(c) *Example.* The provisions of this section may be illustrated by the following example:

Example. In 1971, A leases a mineral property to B reserving a one-eighth royalty and a production payment (as defined in §1.636–3(a)) with a principal amount of $300,000 plus an amount equivalent to interest. In 1972, B pays to A $60,000 with respect to the principal amount of the production payment plus $16,350 equivalent to interest. The adjusted basis of the property in the hands of B for cost depletion and other purposes for 1972 and subsequent years will include (subject to proper adjustment under section 1016) the $76,350 paid to A. In 1973, B pays to A $60,000 with respect to the principal amount of the production payment plus $12,750 equivalent to interest. The adjusted basis of the property in the hands of B for cost depletion and other purposes for 1973 and subsequent years will include (subject to proper adjustment under section 1016) the $72,750 paid to A. The $76,350 received by A in 1972, and the $72,750 received by A in 1973, will constitute ordinary income subject to depletion in the hands of A in the years of receipt of such amounts by A.

[T.D. 7261, 38 FR 5465, Mar. 1, 1973]

§1.636–3 Definitions.

For purposes of section 636 and the regulations thereunder:

(a) *Production payment.* (1) The term *production payment* means, in general, a right to a specified share of the production from mineral in place (if, as, and when produced), or the proceeds from such production. Such right must be an economic interest in such mineral in place. It may burden more than one mineral property, and the burdened mineral property need not be an operating mineral interest. Such right must have an expected economic life (at the time of its creation) of shorter duration than the economic life of one or more of the mineral properties burdened thereby. A right to mineral in place which can be required to be satisfied by other than the production of mineral from the burdened mineral property is not an economic interest in mineral in place. A production payment may be limited by a dollar amount, a quantum of mineral, or a period of time. A right to mineral in place has an economic life of shorter duration than the economic life of a mineral property burdened thereby only if such right may not reasonably be expected to extend in substantial amounts over the entire productive life of such mineral property. The term *production payment* includes payments which are commonly referred to as *in-oil payments, gas payments,* or *mineral payments.*

(2) A right which is in substance economically equivalent to a production payment shall be treated as a production payment for purposes of section 636 and the regulations thereunder, regardless of the language used to describe such right, the method of creation of such right, or the form in which such right is cast (even though such form is that of an operating mineral interest). Whether or not a right is in substance economically equivalent to a production payment shall be determined from all the facts and circumstances. An example of an interest which is to be treated as a production payment under this subparagraph is

that portion of a *royalty* which is attributable to so much of the rate of the royalty which exceeds the lowest possible rate of the royalty at any subsequent time (disregarding any reductions in the rate of the royalty which are based solely upon changes in volume of production within a specified period of no more than 1 year). For example, assume that A creates a royalty with respect to a mineral property owned by A equal to 5 percent for 5 years and thereafter equal to 4 percent for the balance of the life of the property. An amount equal to 1 percent for 5 years shall be treated as a production payment. On the other hand, if A leases a coal mine to B in return for a royalty of 30 cents per ton on the first 500,000 tons of coal produced from the mine in each year and 20 cents per ton on all coal in excess of 500,000 tons produced from the mine in each year, the fact that the royalty may decline to 20 cents per ton on some of the coal in each year does not result in a production payment of 10 cents per ton of coal on the first 500,000 tons in any year. Another example of an interest which is to be treated as a production payment under this subparagraph is the interest in a partnership engaged in operating oil properties of a partner who provides capital for the partnership if such interest is subject to a right of another person or persons to acquire or terminate it upon terms which merely provide for such partner's recovery of his capital investment and a reasonable return thereon.

(b) *Property.* The term *property* has the meaning assigned to it in section 614(a), without the application of section 614 (b), (c), or (e).

(c) *Transfer.* The term *transfer* means any sale, exchange, gift, bequest, devise, or other disposition (including a distribution by an estate or a contribution to or distribution by a corporation, partnership, or trust).

[T.D. 7261, 38 FR 5465, Mar. 1, 1973]

§1.636–4 Effective dates of section 636.

(a) *In general.* Except as provided hereinafter in this section, section 636 and §§1.636–1, 1.636–2, and 1.636–3 apply to production payments created on or after August 7, 1969, other than production payments created before January 1, 1971, pursuant to a binding contract entered into before August 7, 1969.

(b) *Election.* Under section 503(c)(2) of the Tax Reform Act of 1969, if the taxpayer so elects, section 636(a) of the Code and §§1.636–1 and 1.636–3 apply to all production payments carved out by him after the beginning of his last taxable year ending before August 7, 1969, including such production payments created after such date pursuant to a binding contract entered into before such date. No interest shall be allowed on any refund or credit of any overpayment of tax resulting from an election under section 503(c)(2) for any taxable year ending before August 7, 1969. The provisions of this paragraph may be illustrated by the following example:

Example. A, a fiscal-year taxpayer whose taxable year ends on October 31, carved out and sold (from a producing property) production payments on October 1, 1967, and on July 9, 1969. On August 1, 1969, A entered into a binding contract to create another carved-out production payment (from a different producing property) and the production payment was carved out on December 22, 1969. If A elects under section 503(c)(2), the production payments carved out on July 9, 1969, and December 22, 1969, are treated as mortgage loans under section 636(a). The production payment carved out on October 1, 1967, is not treated as a mortgage loan under section 636(a) because it was carved out before the beginning of A's last taxable year ending before August 7, 1969.

(c) *Time and manner of making election.* (1) Any election under section 503(c)(2) of the Tax Reform Act of 1969 must be made not later than May 30, 1973.

(2) An election under section 503(c)(2) shall be made by a statement attached to the taxpayer's income tax return (or amended return) for the first taxable year in which the taxpayer created a production payment (i) to which the election applies, and (ii) which, in the absence of section 636, would not have been treated as a loan. A statement shall also be attached to an amended return for each subsequent taxable year for which he has filed his income tax return before making the election, but only if his tax liability for such year is affected by the election. Each such statement shall indicate the taxpayer's election under section 503(c)(2), and shall identify by date, amount,

parties, and burdened mineral properties all production payments described in subdivisions (i) and (ii) of this subparagraph which have been created by the date on which the statement is filed. However, a taxpayer who, prior to the date on which permanent regulations under this section are published in the FEDERAL REGISTER, made a valid election under section 503(c)(2) pursuant to §§301.9100–17T and 301.9100–18T of this chapter are not required to amend statements previously furnished which meet the requirements of §301.9100–17T(b)(1)(ii) of this chapter unless requested to do so by the district director. In applying the election to the taxable years affected, there shall be taken into account the effect that any adjustments resulting therefrom have on other items affected thereby and the effect that adjustments of any such items have on other taxable years. In the case of a member of a consolidated return group (as defined in paragraph (a) of §1.1502–1), section 503(c)(2) and paragraphs (b), (c), and (d) of this section shall be applied as if such member filed a separate return.

(d) *Revocation of election.* A valid election under section 503(c)(2) shall be binding upon the taxpayer unless consent to revoke the election is obtained from the Commissioner. The application to revoke such election must be made in writing to the Commissioner of Internal Revenue, Washington, D.C. 20224, not later than May 30, 1973. Such application must set forth the reasons therefor and a recomputation of the tax reflecting such revocation for each prior taxable year affected by the revocation, whether or not the period of limitations for credit or refund or assessment and collection has expired with respect to such taxable year. Consent shall not be given in any case in which the revocation would result in an increase in the taxpayer's tax liability for a taxable year for which such period of limitations has expired unless the taxpayer waives his right to assert the statute of limitations.

(e) *Special rule.* (1) Except as provided in subparagraph (2) of this paragraph, in the case of a taxpayer who does not make the election provided in section 503(c)(2) of the Tax Reform Act of 1969, section 636 of the Code applies to production payments carved out during the taxable year which includes August 7, 1969, as provided in paragraph (a) of this section, only to the extent that the aggregate amount of such production payments exceeds the lesser of:

(i) The excess of:

(a) The aggregate amount of production payments carved out and sold by the taxpayer during the 12-month period immediately preceding his taxable year which includes August 7, 1969, over

(b) The aggregate amount of production payments carved out and sold before August 7, 1969, by the taxpayer during his taxable year which includes such date, or

(ii) The amount necessary to increase the amount of the taxpayer's gross income within the meaning of chapter 1 of subtitle A of the Code, for his taxable year which includes August 7, 1969, to an amount equal to the amount of his deductions (other than any deduction under section 172) allowable for such year under such chapter.

In applying the preceding sentence, production payments carved out for exploration or development are to be taken into account only to the extent, if any, that *gross income from the property* (for purposes of section 613) would have been realized by the taxpayer creating such production payment under the law existing at the time of the creation of such production payment, in the absence of section 636(a).

(2) Subparagraph (1) of this paragraph shall not apply for any taxable year for purposes of determining the amount of any deduction for cost or percentage depletion allowable under section 611 or the limitation on any foreign tax credit under section 904.

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

Example 1. (a) A, a calendar-year taxpayer who does not make the election provided in section 503(c)(2) of the Tax Reform Act of 1969, carves out and sells on December 31, 1968, a $500,000 production payment. Further, A carves out and sells on March 4, 1969, a $300,000 production payment, and on November 14, 1969, a $150,000 production payment. None of the production payments are carved out for exploration or development. During

1969, A has gross income of $600,000 (determined initially for this purpose by treating the $150,000 production payment carved out on November 14, 1969, as a loan) and allowable deductions of $700,000.

(b) The provisions of section 636 do not apply to a portion of the November 14, 1969, production payment for purposes other than section 611 and section 904 of the Code, determined as follows:

(1) Amount of production payment carved out in 1969 on or after August 7, 1969	$150,000
(2) Amount of production payment carved out during 1968	500,000
(3) Amount of production payment carved out during 1969 taxable year before August 7, 1969	300,000
(4) Item (2) minus item (3)	200,000
(5) Excess of allowable deductions over gross income for 1969	100,000
(6) Amount of production payment carved out in 1969 on or after August 7, 1969, to which section 636 does not apply (lesser of items (1), (4), and (5))	100,000

Thus, A will not treat $100,000 of the consideration received for the production payment carved out on November 14, 1969, as a loan and as a result his gross income for 1969 will be $700,000. However, in computing percentage depletion, A will not include the $100,000 in *gross income from property* and in computing cost depletion A will not include the mineral units attributable thereto. Nor, will A include the $100,000 in determining the limitation on foreign tax credit under section 904.

Example 2. Assume the same facts as in example 1 except that for taxable year 1969 A's gross income (determined initially for this purpose by treating the November 14, 1969, production payment as a loan) exceeds the amount of his allowable deductions under chapter 1 of subtitle A of the Code. The entire amount of the November 14, 1969, production payment is treated as a mortgage loan under section 636(a).

[T.D. 7261, 38 FR 5465, Mar. 1, 1973, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

CONTINENTAL SHELF AREAS

§ 1.638–1 Continental Shelf areas.

(a) *General rule.* For purposes of applying any provision of chapter 1, 2, 3, or 24 (including section 861(a)(3), 862(a)(3), 1441, 3402, or other provisions dealing with the performance of personal services), with respect to mines, oil and gas wells, and other natural deposits:

(1) *United States and possession of the United States.* The terms *United States* and *possession of the United States* when used in a geographical sense include the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States or such possession and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration for, and exploitation of, natural resources. The terms *Continental Shelf of the United States* and *Continental Shelf of a possession of the United States,* as used in this section, refer to the seabed and subsoil included, respectively, in the terms *United States* and *possession of the United States,* as provided in the preceding sentence.

(2) *Foreign country.* The term *foreign country* when used in a geographical sense includes the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the foreign country and over which such foreign country has exclusive rights, in accordance with international law, with respect to the exploration for, and exploitation of, natural resources, but this sentence applies only if such foreign country exercises, directly or indirectly, taxing jurisdiction with respect to such exploration or exploitation. The term *foreign continental shelf,* as used in this section, refers to the seabed and subsoil described in the preceding sentence. A foreign country is not to be treated as a country contiguous to the United States by reason of the application of section 638 and this section.

(b) *Exercise of taxing jurisdiction.* For purposes of paragraph (a)(2) of this section, the exercise, directly or indirectly, of taxing jurisdiction with respect to the exploration for, or exploitation of, natural resources is deemed to include (but is not limited to) those cases in which a foreign country:

(1) Imposes a tax upon assets, equipment, or other property connected with or income derived from such exploration or exploitation, or

(2) Requires natural resources referred to in paragraph (a)(2) of this section to be transported to points within its landward boundaries and then levies a tax upon such natural resources or upon the income derived from the sale thereof.

A foreign country which, for purposes of paragraph (a)(2) of this section, exercises taxing jurisdiction by the imposition of tax upon any person, property, or activity engaged in or related to the exploration for, or exploitation of, natural resources in the seabed or subsoil referred to in paragraph (a)(2) of this section, or the income therefrom of any taxpayer, is deemed to exercise taxing jurisdiction over all such persons, property, and activities and over all income therefrom of all such taxpayers; thus, for example, a foreign country which imposes tax upon a person engaged in exploitation of oil and gas wells in its seabed and subsoil referred to in paragraph (a)(2) of this section is deemed to exercise taxing jurisdiction over property related to exploration for other natural deposits in such seabed and subsoil. A foreign country is deemed to be imposing tax upon a person, property, activity, or income described in the preceding sentence if such foreign country exempts such person, property, activity, or income from tax for a period not in excess of 10 years from the commencement of such exploration or exploitation. Except in the case of a foreign country which is deemed under the preceding sentence to impose tax by virtue of an exemption for a period not in excess of 10 years, a foreign country which exempts all persons, property, and activities engaged in or related to the exploration for, or exploitation of, natural resources in the seabed or subsoil referred to in paragraph (a)(2) of this section and the income therefrom, from taxation is deemed not to be exercising, directly or indirectly, taxing jurisdiction for purposes of paragraph (a)(2) of this section. For purposes of paragraph (a)(2) of this section, the exercise of taxing jurisdiction with respect to any type of tax constitutes the exercise of taxing jurisdiction with respect to all types of taxes. However, a royalty or other charge (whether payable in a lump sum or over a period of time or in amounts dependent upon the volume of production of natural resources) for the right to explore for or exploit natural resources does not constitute a tax.

(c) *Scope.* (1) For purposes of applying this section, persons, property, or activities which are engaged in or related to the exploration for, or exploitation of, mines, oil and gas wells, or other natural deposits need not be physically upon, connected, or attached to the seabed or subsoil referred to in subparagraph (1) or (2) of paragraph (a) of this section to be deemed to be within the United States, a possession of the United States, or a foreign country, as the case may be, to the extent provided in subparagraph (2) or (3) and subparagraph (4) of this paragraph.

(2) Persons, property, or activities which are not in a foreign country (determined without regard to section 638 or this section), and which are engaged in or related to the exploration for, or exploitation of, mines, oil and gas wells, or other natural deposits of the seabed or subsoil referred to in paragraph (a)(1) of this section, are generally within the United States or a possession of the United States, as the case may be, unless such persons, property, or activities are solely involved in or constitute transportation to (or from) the site of exploration or exploitation from (or to) a foreign country, other than transportation on a regular basis from (or to) a base of operations.

(3) Persons, property, or activities which are not in the United States or in a third country (determined in each case without regard to section 638 or this section), and which are engaged in or related to the exploration for, or exploitation of, mines, oil and gas wells, or other natural deposits of the seabed or subsoil of a foreign country referred to in paragraph (a)(2) of this section, are generally within such foreign country, unless such persons, property, or activities are solely involved in or constitute transportation to (or from) the site of exploration or exploitation from (or to) the United States or a possession of the United States or a third country, as the case may be, other than transportation on a regular basis from (or to) a base of operations.

(4) Persons, property, or activities are within the United States, a possession of the United States, or a foreign country, as the case may be, pursuant to this paragraph, only to the extent such persons, property, or activities are engaged in or related to the exploration for or exploitation of, mines, oil

and gas wells, or other natural deposits.

(d) *Natural deposits and natural resources.* For purposes of this section, the terms *natural deposits* and *natural resources* mean nonliving resources to which section 611(a) applies. Such terms do not include sedentary species (organisms which, at the harvestable stage, either are immovable on or under the seabed or are unable to move except in constant physical contact with the seabed or subsoil), fish or other animal or plant life.

(e) *Rights under international law.* Nothing in this section shall prejudice or affect the freedoms of the high seas and other rights under international law, or the exercise of such freedoms and rights by the United States or foreign countries.

(f) *Examples.* The application of the provisions of section 638 and this section may be illustrated by the following examples:

Example 1. A, a citizen of the United States employed as an engineer, is engaged in the exploitation of oil and is physically present on an offshore oil drilling platform operated by employees of L Corporation. Such platform is affixed to the foreign continental shelf of foreign country X. Assuming that foreign country X exercises taxing jurisdiction as provided in paragraph (b) of this section, A is to be treated as being employed in foreign country X with respect to compensation for his employment for purposes of chapters 1 and 24.

Example 2. The facts are the same as in example 1 except that B, a citizen of the United States engaged in the private practice of law, is physically present on such platform for the sole purpose of interviewing his client, A, whom he represents in a domestic relations matter. Since B is not engaged in activities related to the exploration for, or exploitation of, natural deposits, he is not to be treated as being in foreign country X for purposes of chapters 1 and 2.

Example 3. The facts are the same as in example 1 except that C, a citizen of the United States engaged in the private practice of medicine, is physically present on such platform for the purpose of making routine physical examinations of L Corporation's employees who are engaged in the exploitation of oil on the platform. C is paid by L Corporation to give such examinations on the platform at regular intervals in order to determine whether the state of any employee's health is such that he should not continue work on the platform. The balance of C's medical practice is conducted at his office on the U.S. mainland. Since C is engaged in activities related to the exploitation of oil, he is treated as being in foreign country X under section 638 and this section while making physical examinations on L Corporation's platform, provided that foreign country X exercise taxing jurisdiction as provided in paragraph (b) of this section. For purposes of chapters 1 and 2, amounts paid by L Corporation to C are treated as derived from sources within foreign country X.

Example 4. C, a nonresident alien individual employed as an engineer in a foreign country, designs equipment for use on oil drilling platforms affixed to the continental shelf of the United States and engaged in the exploitation of oil. Although C's activities in this respect are related to the exploitation of oil, C is not treated as being in the United States under section 638 and this section by reason of such activities.

Example 5. M Corporation, a domestic corporation, chartered a ship from N Corporation, also a domestic corporation, under a time charter under which N Corporation's personnel continued to navigate and manage the shop. M Corporation equipped the ship with special oil exploration equipment and furnished its personnel to operate the equipment. The ship then commenced to explore for oil in the foreign Continental Shelf of foreign country Y. Foreign country Y exercises taxing jurisdiction as provided in paragraph (b) of this section. The ship is treated as being within foreign country Y under section 638 and this section for the period it was engaged in the exploration for oil in such foreign Continental Shelf. Thus, the entire income derived during such period by N Corporation from the charter is income derived from sources within foreign country Y, since N Corporation had property and employees engaged in the exploration for oil in such foreign Continental Shelf.

Example 6. The facts are the same as in example 5 except that C, a citizen of the United States, was employed by N Corporation as a cook and was physically present on the ship. C's sole duties consisted of cooking meals for personnel aboard such ship. In such case, as C's activities are related to the exploration for oil, C is to be treated as being in foreign country Y under section 638 and this section for the period he was aboard such ship while it was engaged in activities relating to the exploration for oil in the foreign Continental Shelf referred to in example 5. For purposes of chapters 1 and 24, C's compensation as a cook for such period is treated as derived from sources without the United States.

Example 7. Z Corporation, a foreign corporation, entered into a contract with Y Corporation, a United States corporation, to engage in exploratory oil drilling activities on a leasehold held by Y Corporation. Such leasehold was located in the Continental

Shelf of the United States. Since Z Corporation is engaged in and has property and activities which are engaged in the exploration for oil, such property and activities are to be treated as being in the United States under section 638 and this section for the period such property and activities were engaged in or related to the exploraton for oil in the Continental Shelf of the Unid States and were not in a foreign country. For purposes of chapters 1 and 3, amounts paid to Z Corporation pursuant to the contract are treated as derived from sources within the United States.

Example 8. M Corporation is a controlled foreign corporation (within the meaning of section 957(b)) for its entire taxable year beginning in 1972. During such taxable year, M Corporation issues a policy of insurance relating to fire damage to an offshore oil drilling platform, owned by N Corporation (a foreign corporation), which is attached to the Continental Shelf of the United States. The income attributable to the issuing of such policy would be taxed under subchapter L, chapter 1, subtitle A of the Code (as modified, for this purpose, by section 953(b) (1), (2), and (3)) if such income were the income of a domestic insurance corporation. Since N Corporation's oil drilling platform is located within the United States under section 638 and this section, M Corporation's income attributable to the issuing of the insurance in connection with such platform is income derived from the insurance of United States risks, within the meaning of section 953(a)(1)(A).

[T.D. 7277, 38 FR 12740, May 15, 1973]

§1.638–2 Effective date.

The specific requirements and limitations of §1.638–1 apply on and after December 30, 1969.

[T.D. 7277, 38 FR 12742, May 15, 1973]

SUBCHAPTER A—INCOME TAX (Continued)

PART 1—INCOME TAXES (Continued)

NORMAL TAXES AND SURTAXES (CONTINUED)

ESTATES, TRUSTS, BENEFICIARIES, AND DECEDENTS

ESTATES, TRUSTS, AND BENEFICIARIES

GENERAL RULES FOR TAXATION OF ESTATES AND TRUSTS

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AUTHORITY: 26 U.S.C. 7805, unless otherwise noted.

Section 1.701–2 also issued under 26 U.S.C. 701 through 761.

Section 1.704–3 also issued under 26 U.S.C. 704(c).

Section 1.704–3T also issued under 26 U.S.C. 704(c).

Section 1.704–4 also issued under 26 U.S.C. 704(c).

Section 1.706–1T also issued under 26 U.S.C. 706(b).

Sections 1.707–2 through 1.707–9 also issued under 26 U.S.C. 707(a)(2).

Section 1.721–1 also issued under 26 U.S.C. 721.

Section 1.731–2 also issued under 26 U.S.C. 731(c).

Section 1.761–2 also issued under 26 U.S.C. 446(b) and 26 U.S.C. 761(a).

Section 1.809–10 also issued under 26 U.S.C. 809(b)(2) and (g)(3).

Section 1.832–4 also issued under 26 U.S.C. 832(b)(5)(A).

Sections 1.846–1 through 1.846–4 also issued under 26 U.S.C. 846.

Section 1.848–2 also issued under 26 U.S.C. 845(b) and 26 U.S.C. 848(d)(4)(B).

Section 1.848–3 also issued under 26 U.S.C. 848(d)(4)(B).

SOURCE: T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, unless otherwise noted.

ESTATES, TRUSTS, BENEFICIARIES, AND DECEDENTS

ESTATES, TRUSTS, AND BENEFICIARIES

GENERAL RULES FOR TAXATION OF ESTATES AND TRUSTS

§ 1.641 [Reserved]

§ 1.641(a)–0 Scope of subchapter J.

(a) *In general.* Subchapter J (sections 641 and following), chapter 1 of the Code, deals with the taxation of income of estates and trusts and their beneficiaries, and of income in respect of decedents. Part I of subchapter J contains general rules for taxation of estates and trusts (subpart A), specific rules relating to trusts which distribute current income only (subpart B), estates and trusts which may accumulate income or which distribute corpus (subpart C), treatment of excess distributions by trusts (subpart D), grantors and other persons treated as substantial owners (subpart E), and miscellaneous provisions relating to limitations on charitable deductions, income of an estate or trust in case of divorce, and taxable years to which the provisions of subchapter J are applicable (subpart F). Part I has no application to any organization which is not to be classified for tax purposes as a trust under the classification rules of §§301.7701–2, 301.7701–3, and 301.7701–4 of this chapter (Regulations on Procedure and Administration). Part II of subchapter J relates to the treatment of income in respect of decedents. However, the provisions of subchapter J do not apply to employee trusts subject to subchapters D and F, chapter 1 of the Code, and common trust funds subject to subchapter H, chapter 1 of the Code.

(b) *Scope of subparts A, B, C, and D.* Subparts A, B, C, and D (section 641 and following), part I, subchapter J, chapter 1 of the Code, relate to the taxation of estates and trusts and their beneficiaries. These subparts have no application to any portion of the corpus or income of a trust which is to be regarded, within the meaning of the Code, as that of the grantor or others treated as its substantial owners. See subpart E (section 671 and following), Part I, subchapter J, chapter 1 of the Code, and the regulations thereunder for rules for the treatment of any portion of a trust where the grantor (or another person) is treated as the substantial owner. So-called alimony trusts are treated under subparts A, B, C, and D, except to the extent otherwise provided in section 71 or section 682. These subparts have no application to beneficiaries of nonexempt employees' trusts. See section 402(b) and the regulations thereunder.

(c) *Multiple trusts.* Multiple trusts that have:

(1) No substantially independent purposes (such as independent dispositive purposes),

(2) The same grantor and substantially the same beneficiary, and

(3) The avoidance or mitigation of (*i*) the progressive rates of tax (including mitigation as a result of deferral of tax) or *(ii)* the minimum tax for tax preferences imposed by section 56 as their principal purpose,

shall be consolidated and treated as one trust for the purposes of subchapter J.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 731, Jan. 17, 1969; T.D. 7204, 37 FR 17158, Aug. 25, 1972]

§1.641(a)–1 Imposition of tax; application of tax.

For taxable years beginning after December 31, 1970, section 641 prescribes that the taxes imposed by section 1(d), as amended by the Tax Reform Act of 1969, shall apply to the income of estates or of any kind of property held in trust. For taxable years ending before January 1, 1971, section 641 prescribes that the taxes imposed upon individuals by chapter 1 of the Code apply to the income of estates or of any kind of property held in trust. The rates of tax, the statutory provisions respecting gross income, and, with certain exceptions, the deductions and credits allowed to individuals apply also to estates and trust.

[T.D. 7117, 36 FR 9421, May 25, 1971]

§1.641(a)–2 Gross income of estates and trusts.

The gross income of an estate or trust is determined in the same manner as that of an individual. Thus, the gross income of an estate or trust consists of all items of gross income received during the taxable year, including:

(a) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(b) Income accumulated or held for future distribution under the terms of the will or trust;

(c) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

(d) Income received by estates of deceased persons during the period of administration or settlement of the estate; and

(e) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated. The several classes of income enumerated in this section do not exclude others which also may come within the general purposes of section 641.

§1.641(b)–1 Computation and payment of tax; deductions and credits of estates and trusts.

Generally, the deductions and credits allowed to individuals are also allowed to estates and trusts. However, there are special rules for the computation of certain deductions and for the allocation between the estate or trust and the beneficiaries of certain credits and deductions. See section 642 and the regulations thereunder. In addition, an estate or trust is allowed to deduct, in computing its taxable income, the deductions provided by sections 651 and 661 and regulations thereunder, relating to distributions to beneficiaries.

§1.641(b)–2 Filing of returns and payment of the tax.

(a) The fiduciary is required to make and file the return and pay the tax on the taxable income of an estate or of a trust. Liability for the payment of the tax on the taxable income of an estate attaches to the person of the executor or administrator up to and after his discharge if, prior to distribution and discharge, he had notice of his tax obligations or failed to exercise due diligence in ascertaining whether or not such obligations existed. For the extent of such liability, see section 3467 of the Revised Statutes, as amended by section 518 of the Revenue Act of 1934 (31 U. S. C. 192). Liability for the tax also follows the assets of the estate distributed to heirs, devisees, legatees, and distributees, who may be required to discharge the amount of the tax due and unpaid to the extent of the distributive shares received by them. See section 6901. The same considerations apply to trusts.

(b) The estate of an infant, incompetent, or other person under a disability, or, in general, of an individual or corporation in receivership or a corporation in bankruptcy is not a taxable entity separate from the person for whom the fiduciary is acting, in that respect differing from the estate of a deceased person or of a trust. See section 6012(b) (2) and (3) for provisions relating to the obligation of the fiduciary with respect to returns of such persons.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6580, 26 FR 11486, Dec. 5, 1961]

§1.641(b)–3 Termination of estates and trusts.

(a) The income of an estate of a deceased person is that which is received by the estate during the period of administration or settlement. The period of administration or settlement is the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates. For example, where an executor who is also named as trustee under a will fails to obtain his discharge as executor, the period of administration continues only until the duties of administration are complete and he actually assumes his duties as trustee, whether or not pursuant to a court order. However, the period of administration of an estate cannot be unduly prolonged. If the administration of an estate is unreasonably prolonged, the estate is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. Further, an estate will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).

(b) Generally, the determination of whether a trust has terminated depends upon whether the property held in trust has been distributed to the persons entitled to succeed to the property upon termination of the trust rather than upon the technicality of whether or not the trustee has rendered his final accounting. A trust does not automatically terminate upon the happening of the event by which the duration of the trust is measured. A reasonable time is permitted after such event for the trustee to perform the duties necessary to complete the administration of the trust. Thus, if under the terms of the governing instrument, the trust is to terminate upon the death of the life beneficiary and the corpus is to be distributed to the remainderman, the trust continues after the death of the life beneficiary for a period reasonably necessary to a proper winding up of the affairs of the trust. However, the winding up of a trust cannot be unduly postponed and if the distribution of the trust corpus is unreasonably delayed, the trust is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the trustee to complete the administration of the trust. Further, a trust will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).

(c)(1) Except as provided in subparagraph (2) of this paragraph, during the period between the occurrence of an event which causes a trust to terminate and the time when the trust is considered as terminated under this section, whether or not the income and the excess of capital gains over capital losses of the trust are to be considered as amounts required to be distributed currently to the ultimate distributee for the year in which they are received depends upon the principles stated in §1.651(a)–2. See §1.663–1 *et seq.* for application of the separate share rule.

(2)(i) Except in cases to which the last sentence of this subdivision applies, for taxable years of a trust ending before September 1, 1957, subparagraph (1) of this paragraph shall not apply and the rule of subdivision (ii) of this subparagraph shall apply unless the trustee elects to have subparagraph (1) of this paragraph apply. Such election shall be made by the trustee in a statement filed on or before April 15, 1959, with the district director with whom such trust's return for any such taxable year was filed. The election provided by this subdivision shall not be available if the treatment given the income and the excess of capital gains over capital losses for taxable years for which returns have been filed was consistent with the provisions of subparagraph (1) of this paragraph.

(ii) The rule referred to in subdivision (i) of this subparagraph is as follows: During the period between the occurrence of an event which causes a trust to terminate and the time when a trust is considered as terminated under this section, the income and the excess of capital gains over capital losses of the trust are in general considered as amounts required to be distributed for the year in which they are received. For example, a trust instrument provides for the payment of income to A during her life, and upon her death for the payment of the corpus to B. The trust reports on the basis of the calendar year. A dies on November 1, 1955, but no distribution is made to B until January 15, 1956. The income of the trust and the excess of capital gains over capital losses for the entire year 1955, to the extent not paid, credited, or required to be distributed to A or A's estate, are treated under sections 661 and 662 as amounts required to be distributed to B for the year 1955.

(d) If a trust or the administration or settlement of an estate is considered terminated under this section for Federal income tax purposes (as for instance, because administration has been unduly prolonged), the gross income, deductions, and credits of the estate or trust are, subsequent to the termination, considered the gross income, deductions, and credits of the person or persons succeeding to the property of the estate or trust.

§ 1.642(a)(1)–1 Partially tax-exempt interest.

An estate or trust is allowed the credit against tax for partially tax-exempt interest provided by section 35 only to the extent that the credit does not relate to interest properly allocable to a beneficiary under section 652 or 662 and the regulations thereunder. A beneficiary of an estate or trust is allowed the credit against tax for partially tax-exempt interest provided by section 35 only to the extent that the credit relates to interest properly allocable to him under section 652 or 662 and the regulations thereunder. If an estate or trust holds partially tax-exempt bonds and elects under section 171 to treat the premium on the bonds as amortizable, the credit allowable under section 35, with respect to the bond interest (whether allowable to the estate or trust or to the beneficiary), is reduced under section 171(a)(3) by reducing the shares of the interest allocable, respectively, to the estate or trust and its beneficiary by the portion of the amortization deduction attributable to the shares.

§ 1.642(a)(2)–1 Foreign taxes.

An estate or trust is allowed the credit against tax for taxes imposed by foreign countries and possessions of the United States to the extent allowed by section 901 only for so much of those taxes as are not properly allocable under that section to the beneficiaries. See section 901(b)(4). For purposes of section 901(b)(4), the term *beneficiaries* includes charitable beneficiaries.

§ 1.642(a)(3)–1 Dividends received by an estate or trust.

An estate or trust is allowed a credit against the tax for dividends received on or before December 31, 1964 (see section 34), only for so much of the dividends as are not properly allocable to any beneficiary under section 652 or 662. Section 642(a)(3), and this section do not apply to amounts received as dividends after December 31, 1964. For treatment of the credit in the hands of the beneficiary see § 1.652(b)–1.

[T.D. 6777, 29 FR 17808, Dec. 16, 1964]

§ 1.642(a)(3)–2 Time of receipt of dividends by beneficiary.

In general, dividends are deemed received by a beneficiary in the taxable year in which they are includible in his gross income under section 652 or 662. For example, a simple trust, reporting on the basis of a fiscal year ending October 30, receives quarterly dividends on November 3, 1954, and February 3, May 3, and August 3, 1955. These dividends are all allocable to beneficiary A, reporting on a calendar year basis, under section 652 and are deemed received by A in 1955. See section 652(c). Accordingly, A may take all these dividends into account in determining his credit for dividends received under section 34 and his dividends exclusion under section 116. However, solely for purposes of determining whether dividends deemed received by individuals from trusts or estates qualify under the time limitations of section 34(a) or section 116(a), section 642(a)(3) provides that the time of receipt of the dividends by the trust or estate is also considered the time of receipt by the beneficiary. For example, a simple trust reporting on the basis of a fiscal year ending October 30 receives quarterly dividends on December 3, 1953, and March 3, June 3, and September 3, 1954. These dividends are all allocable to beneficiary A, reporting on the calendar year basis, under section 652 and are includible in his income for 1954. However, for purposes of section 34(a) or section 116(a), these dividends are deemed received by A on the same dates that the trust received them. Accordingly, A may take into account in determining the credit under section 34 only those dividends received by the trust on September 3, 1954, since the dividend received credit is not allowed under section 34 for dividends received before August 1, 1954 (or after December 31, 1964). Section 642(a)(3) and this section do not apply to amounts received by an estate or trust as dividends after December 31, 1964. However, the rules in this section relating to time of receipt of dividends by a beneficiary are applicable to dividends received by an estate or trust prior to January 1, 1965, and accordingly, such dividends are deemed to be received by the beneficiary (even though received after December 31, 1964) on the same dates that the estate or trust received them for purposes of determining the credit under section 34 or the exclusion under section 116.

[T.D. 6777, 29 FR 17808, Dec. 16, 1964]

§1.642(a)(3)–3 Cross reference.

See §1.683–2(c) for examples relating to the treatment of dividends received by an estate or trust during a fiscal year beginning in 1953 and ending in 1954.

§1.642(b)–1 Deduction for personal exemption.

In lieu of the deduction for personal exemptions provided by section 151:

(a) An estate is allowed a deduction of $600,

(b) A trust which, under its governing instrument, is required to distribute currently all of its income for the taxable year is allowed a deduction of $300, and

(c) All other trusts are allowed a deduction of $100.

A trust which, under its governing instrument, is required to distribute all of its income currently is allowed a deduction of $300, even though it also distributes amounts other than income in the taxable year and even though it may be required to make distributions which would qualify for the charitable contributions deduction under section 642(c) (and therefore does not qualify as a ‘‘simple trust’’ under sections 651–652). A trust for the payment of an annuity is allowed a deduction of $300 in a taxable year in which the amount of the annuity required to be paid equals or exceeds all the income of the trust for the taxable year. For the meaning of the term *income required to be distributed currently,* see §1.651(a)–2.

§1.642(c)–0 Effective dates.

The provisions of section 642(c) (other than section 642(c)(5)) and of §§1.642 (c)–1 through 1.642(c)–4 apply to amounts paid, permanently set aside, or to be used for a charitable purpose in taxable years beginning after December 31, 1969. The provisions of section 642(c)(5) and of §§1.642(c)–5 through 1.642(c)–7 apply to transfers in trust made after July 31, 1969. For provisions relating to amounts paid, permanently set aside, or to be used for a charitable purpose in taxable years beginning before January 1, 1970, see 26 CFR 1.642(c)–1 through 1.642(c)–4 (Rev. as of Jan. 1, 1971).

[T.D. 7357, 40 FR 23739, June 2, 1975]

§1.642(c)–1 Unlimited deduction for amounts paid for a charitable purpose.

(a) *In general.* (1) Any part of the gross income of an estate, or trust which, pursuant to the terms of the governing instrument is paid (or treated under paragraph (b) of this section as paid) during the taxable year for a purpose specified in section 170(c) shall be allowed as a deduction to such estate or trust in lieu of the limited charitable contributions deduction authorized by section 170(a). In applying this paragraph without reference to paragraph (b) of this section, a deduction shall be allowed for an amount paid during the taxable year in respect of gross income received in a previous taxable year, but only if no deduction was allowed for any previous taxable year for the amount so paid.

(2) In determining whether an amount is paid for a purpose specified in section 170(c)(2) the provisions of section 170(c)(2)(A) shall not be taken into account. Thus, an amount paid to a corporation, trust, or community chest, fund, or foundation otherwise described in section 170(c)(2) shall be considered paid for a purpose specified in section 170(c) even though the corporation, trust, or community chest, fund, or foundation is not created or organized in the United States, any State, the District of Columbia, or any possession of the United States.

(3) See section 642(c)(6) and §1.642(c)–4 for disallowance of a deduction under this section to a trust which is, or is treated under section 4947(a)(1) as though it were a private foundation (as defined in section 509(a) and the regulations thereunder) and not exempt from taxation under section 501(a).

(b) *Election to treat contributions as paid in preceding taxable year*—(1) *In general.* For purposes of determining the deduction allowed under paragraph (a) of this section, the fiduciary (as defined in section 7701(a)(6)) of an estate or trust may elect under section 642(c)(1) to treat as paid during the taxable year (whether or not such year begins before January 1, 1970) any amount of gross income received during such taxable year or any preceding taxable year which is otherwise deductible under such paragraph and which is paid after the close of such taxable year but on or before the last day of the next succeeding taxable year of the estate or trust. The preceding sentence applies only in the case of payments actually made in a taxable year which is a taxable year beginning after December 31, 1969. No election shall be made, however, in respect of any amount which was deducted for any previous taxable year or which is deducted for the taxable year in which such amount is paid.

(2) *Time for making election.* The election under subparagraph (1) of this paragraph shall be made not later than the time, including extensions thereof, prescribed by law for filing the income tax return for the succeeding taxable year. Such election shall, except as provided in subparagraph (4) of this paragraph, become irrevocable after the last day prescribed for making it. Having made the election for any taxable year, the fiduciary may, within the time prescribed for making it, revoke the election without the consent of the Commissioner.

(3) *Manner of making the election.* The election shall be made by filing with the income tax return (or an amended return) for the taxable year in which the contribution is treated as paid a statement which:

(i) States the name and address of the fiduciary,

(ii) Identifies the estate or trust for which the fiduciary is acting,

(iii) Indicates that the fiduciary is making an election under section 642(c)(1) in respect of contributions treated as paid during such taxable year,

(iv) Gives the name and address of each organization to which any such contribution is paid, and

(v) States the amount of each contribution and date of actual payment or, if applicable, the total amount of contributions paid to each organization during the succeeding taxable year, to be treated as paid in the preceding taxable year.

(4) *Revocation of certain elections with consent.* An application to revoke with the consent of the Commissioner any election made on or before June 8, 1970, must be in writing and must be filed not later than September 2, 1975.

No consent will be granted to revoke an election for any taxable year for which the assessment of a deficiency is prevented by the operation of any law or rule of law. If consent to revoke the election is granted, the fiduciary must attach a copy of the consent to the return (or amended return) for each taxable year affected by the revocation. The application must be addressed to the Commissioner of Internal Revenue, Washington, DC 20224, and must indicate:

(i) The name and address of the fiduciary and the estate or trust for which he was acting,

(ii) The taxable year for which the election was made,

(iii) The office of the district director, or the service center, where the return (or amended return) for the year of election was filed, and

(iv) The reason for revoking the election.

[T.D. 7357, 40 FR 23739, June 2, 1975; 40 FR 24361, June 6, 1975]

§ 1.642(c)–2 Unlimited deduction for amounts permanently set aside for a charitable purpose.

(a) *Estates.* Any part of the gross income of an estate which pursuant to the terms of the will:

(1) Is permanently set aside during the taxable year for a purpose specified in section 170(c), or

(2) Is to be used (within or without the United States or any of its possessions) exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance, or operation of a public cemetery not operated for profit,

shall be allowed as a deduction to the estate in lieu of the limited charitable contributions deduction authorized by section 170(a).

(b) *Certain trusts*—(1) *In general.* Any part of the gross income of a trust to which either subparagraph (3) or (4) of this paragraph applies, that by the terms of the governing instrument:

(i) Is permanently set aside during the taxable year for a purpose specified in section 170(c), or

(ii) Is to be used (within or without the United States or any of its possessions) exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance, or operation of a public cemetery not operated for profit,

shall be allowed, subject to the limitation provided in subparagraph (2) of this paragraph, as a deduction to the trust in lieu of the limited charitable contributions deduction authorized by section 170(a). The preceding sentence applied only to a trust which is required by the terms of its governing instrument to set amounts aside. See section 642(c)(6) and §1.642(c)–4 for disallowance of a deduction under this section to a trust which is, or is treated under section 4947(a)(1) as though it were, a private foundation (as defined in section 509(a) and the regulations thereunder) that is not exempt from taxation under section 501(a).

(2) *Limitation of deduction.* Subparagraph (1) of this paragraph applies only to the gross income earned by a trust with respect to amounts transferred to the trust under a will executed on or before October 9, 1969, and satisfying the requirements of subparagraph (4) of this paragraph or transferred to the trust on or before October 9, 1969. For such purposes, any income, gains, or losses, which are derived at any time from the amounts so transferred to the trust shall also be taken into account in applying subparagraph (1) of this paragraph. If any such amount so transferred to the trust is invested or reinvested at any time, any asset received by the trust upon such investment or reinvestment shall also be treated as an amount which was so transferred to the trust. In the case of a trust to which this paragraph applies which contains (i) amounts transferred pursuant to transfers described in the first sentence of this subparagraph and (ii) amounts transferred pursuant to transfers not so described, subparagraph (1) of this paragraph shall apply only if the amounts described in subdivision (i) of this subparagraph, together with all income, gains, and losses derived therefrom, are separately accounted for from the amounts described in subdivision (ii) of this subparagraph, together with all income, gains, and losses derived therefrom. Such separate accounting shall be carried out consistently with the principles of paragraph (c)(4) of §53.4947–1 of this chapter (Foundation Excise Tax Regulations), relating to accounting for segregated amounts of split-interest trusts.

(3) *Trusts created on or before October 9, 1969.* A trust to which this subparagraph applies is a trust, testamentary or otherwise, which was created on or before October 9, 1969, and which qualifies under either subdivision (i) or (ii) of this subparagraph.

(i) *Transfer of irrevocable remainder interest to charity.* To qualify under this subdivision the trust must have been created under the terms of an instrument granting an irrevocable remainder interest in such trust to or for the use of an organization described in section 170(c). If the instrument granted a revocable remainder interest but the power to revoke such interest terminated on or before October 9, 1969, without the remainder interest having been revoked, the remainder interest will be treated as irrevocable for purposes of the preceding sentence.

(ii) *Grantor under a mental disability to change terms of trust.* (A) To qualify under this subdivision (ii) the trust must have been created by a grantor who was at all times after October 9, 1969, under a mental disability to change the terms of the trust. The term *mental disability* for this purpose means mental incompetence to change the terms of the trust, whether or not there has been an adjudication of mental incompetence and whether or not there has been an appointment of a committee, guardian, fiduciary, or other person charged with the care of the person or property of the grantor.

(B) If the grantor has not been adjudged mentally incompetent, the trustee must obtain from a qualified physician a certificate stating that the grantor of the trust has been mentally incompetent at all times after October 9, 1969, and that there is no reasonable probability that the grantor's mental capacity will ever improve to the extent that he will be mentally competent to change the terms of the trust. A copy of this certification must be filed with the first return on which a deduction is claimed by reason of this subdivision (ii) and subparagraph (1) of this paragraph. Thereafter, a statement referring to such medical opinion must be attached to any return for a taxable year for which such a deduction is claimed and during which the grantor's mental incompetence continues. The original certificate must be retained by the trustee of the trust.

(C) If the grantor has been adjudged mentally incompetent, a copy of the judgment or decree, and any modification thereof, must be filed with the first return on which a deduction is claimed by reason of this subdivision (ii) and subparagraph (1) of this paragraph. Thereafter, a statement referring to such judgment or decree must be attached to any return for a taxable year for which such a deduction is claimed and during which the grantor's mental incompetence continues. A copy of such judgment or decree must also be retained by the trustee of the trust.

(D) This subdivision (ii) applies even though a person charged with the care of the person or property of the grantor has the power to change the terms of the trust.

(4) *Testamentary trust established by will executed on or before October 9, 1969.* A trust to which this subparagraph applies is a trust which was established by will executed on or before October 9, 1969, and which qualifies under either subdivision (i), (ii), or (iii) of this subparagraph. This subparagraph does not apply, however, to that portion of any trust, not established by a will executed on or before October 9, 1969, which was transferred to such trust by a will executed on or before October 9, 1969. Nor does it apply to that portion of any trust, not established by a will executed on or before October 9, 1969, which was subject to a testamentary power of appointment that fails by reason of the testator's nonexercise of the power in a will executed on or before October 9, 1969.

(i) *Testator dying within 3 years without republishing his will.* To qualify under this subdivision the trust must have been established by the will of a testator who died after October 9, 1969, but before October 9, 1972, without having amended any dispositive provision of the will after October 9, 1969, by codicil or otherwise.

(ii) *Testator having no right to change his will.* To qualify under this subdivision the trust must have been established by the will of a testator who died after October 9, 1969, and who at no time after that date had the right to change any portion of such will pertaining to such trust. This subdivision could apply, for example, where a contract has been entered into for the execution of wills containing reciprocal provisions as well as provisions for the benefit of an organization described in section 170(c) and under applicable local law the surviving testator is prohibited from revoking his will because he has accepted the benefit of the provisions of the will of the other contracting party.

(iii) *Testator under a mental disability to republish his will.* To qualify under this subdivision the trust must have been established by the will of a testator who died after October 8, 1972, without having amended any dispositive provision of such will after October 9, 1969, and before October 9, 1972, by codicil or otherwise, and who is under a mental disability at all times after October 8, 1972, to amend such will, by codicil or otherwise. The provisions of subparagraph (3)(ii) of this paragraph with respect to mental incompetence apply for purposes of this subdivision.

(iv) *Amendment of dispositive provisions.* The provisions of paragraph (e)(4) and (5) of § 20.2055–2 of this chapter (Estate Tax Regulations) are to be applied under subdivisions (i) and (iii) of this subparagraph in determining whether there has been an amendment of a dispositive provision of a will.

(c) *Pooled income funds.* Any part of the gross income of a pooled income fund to which § 1.642(c)–5 applies for the taxable year that is attributable to net long-term capital gain (as defined in section 1222(7)) which, pursuant to the terms of the governing instrument, is permanently set aside during the taxable year for a purpose specified in section 170(c) shall be allowed as a deduction to the fund in lieu of the limited charitable contributions deduction authorized by section 170(a). No deduction shall be allowed under this paragraph for any portion of the gross income of such fund which is (1) attributable to income other than net long-term capital gain (2) earned with respect to amounts transferred to such fund before August 1, 1969. However, see paragraph (b) of this section for a deduction (subject to the limitations of such paragraph) for amounts permanently set aside by a pooled income fund which meets the requirements of that paragraph. The principles of paragraph (b) or (2) of this section with respect to investment, reinvestment, and separate accounting shall apply under this paragraph in the case of amounts transferred to the fund after July 31, 1969.

(d) *Disallowance of deduction for certain amounts not deemed to be permanently set aside for charitable purposes.* No amount will be considered to be permanently set aside, or to be used, for a purpose described in paragraph (a) or (b)(1) of this section unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is so remote as to be negligible. Thus, for example, where there is possibility of the invasion of the corpus of a charitable remainder trust, as defined in §1.664–1(a)(1)(ii), in order to make payment of the annuity amount or unitrust amount, no deduction will be allowed under paragraph (a) of this section in respect of any amount set aside by an estate for distribution to such a charitable remainder trust.

For treatment of distributions by an estate to a charitable remainder trust, see paragraph (a)(5)(iii) of §1.664–1.

[T.D. 7357, 40 FR 23740, June 2, 1975; 40 FR 24361, June 6, 1975]

§1.642(c)–3 Adjustments and other special rules for determining unlimited charitable contributions deduction.

(a) *Income in respect of a decedent.* For purposes of §§1.642(c)–1 and 1.642(c)–2, an amount received by an estate or trust which is includible in its gross income under section 691(a)(1) as income in respect of a decedent shall be included in the gross income of the estate or trust.

(b) *Reduction of charitable contributions deduction by amounts not included in gross income.* (1) If an estate, pooled income fund, or other trust pays, permanently sets aside, or uses any amount of its income for a purpose specified in section 642(c) (1), (2) or (3) and that amount includes any items of estate or trust income not entering into the gross income of the estate or trust, the deduction allowable under §1.642(c)–1 or §1.642(c)–2 is limited to the gross income so paid, permanently set aside, or used. In the case of a pooled income fund for which a deduction is allowable under paragraph (c) of §1.642(c)–2 for amounts permanently set aside, only the gross income of the fund which is attributable to net long-term capital gain (as defined in section 1222(7)) shall be taken into account.

(2) In determining whether the amounts of income so paid, permanently set aside, or used for a purpose specified in section 642(c) (1), (2), or (3) include particular items of income of an estate or trust not included in gross income, the specific provision controls if the governing instrument specifically provides as to the source out of which amounts are to be paid, permanently set aside, or used for such a purpose.

In the absence of specific provisions in the governing instrument, an amount to which section 642(c) (1), (2) or (3) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. See paragraph (b) of §1.643(a)–5 for the method of determining the allocable portion of exempt income and foreign income.

(3) For examples showing the determination of the character of an amount deductible under §1.642(c)–1 or

§ 1.642(c)–2, see examples 1 and 2 in § 1.662(b)–2 and paragraph (e) of the example in § 1.662(c)–4.

(4) For the purpose of this paragraph, the provisions of section 116 are not to be taken into account.

(c) *Capital gains included in charitable contribution.* Where any amount of the income paid, permanently set aside, or used for a purpose specified in section 642(c) (1), (2), or (3), is attributable to net long-term capital gain (as defined in section 1222(7)), the amount of the deduction otherwise allowable under § 1.642(c)–1 or § 1.642(c)–2, must be adjusted for any deduction provided in section 1202 of 50 percent of the excess, if any, of the net long-term capital gain over the net short-term capital loss. For determination of the extent to which the contribution to which § 1.642(c)–1 or § 1.642(c)–2 applies is deemed to consist of net long-term capital gains, see paragraph (b) of this section. The application of this paragraph may be illustrated by the following examples:

Example 1. Under the terms of the trust instrument, the income of a trust described in § 1.642(c)–2 (b)(3)(i) is currently distributable to A during his life and capital gains are allocable to corpus. No provision is made in the trust instrument for the invasion of corpus for the benefit of A. Upon A's death the corpus of the trust is to be distributed to M University, an organization described in section 501(c)(3) which is exempt from taxation under section 501(a). During the taxable year ending December 31, 1970, the trust has long-term capital gains of $100,000 from property transferred to it on or before October 9, 1969, which are permanently set aside for charitable purposes. The trust includes $100,000 in gross income but is allowed a deduction of $50,000 under section 1202 for the long-term capital gains and a charitable contributions deduction of $50,000 under section 642(c)(2) ($100,000 permanently set aside for charitable purposes less $50,000 allowed as a deduction under section 1202 with respect to such $100,000).

Example 2. Under the terms of the will, $200,000 of the income (including $100,000 capital gains) for the taxable year 1972 of an estate is distributed, one-quarter to each of two individual beneficiaries and one-half to N University, an organization described in section 501(c)(3) which is exempt from taxation under section 501(a). During 1972 the estate has ordinary income of $200,000, long-term capital gains of $100,000, and no capital losses. It is assumed that for 1972 the estate has no other items of income or any deductions other than those discussed herein. The entire capital gains of $100,000 are included in the gross income of the estate for 1972, and N University receives $100,000 from the estate in such year. However, the amount allowable to the estate under section 642(c)(1) is subject to appropriate adjustment for the deduction allowable under section 1202. In view of the distributions of $25,000 of capital gains to each of the individual beneficiaries, the deduction allowable to the estate under section 1202 is limited by such section to $25,000 [($100,000 capital gains less $50,000 capital gains includible in income of individual beneficiaries under section 662) × 50%]. Since the whole of this $25,000 deduction under section 1202 is attributable to the distribution of $50,000 of capital gains to N University, the deduction allowable to the estate in 1972 under section 642(c)(1) is $75,000 [$100,000 (distributed to N) less $25,000 (proper adjustment for section 1202 deduction)].

Example 3. Under the terms of the trust instrument, 30 percent of the gross income (exclusive of capital gains) of a trust described in § 1.642(c)–2(b)(3)(i) is currently distributed to B, the sole income beneficiary. Net capital gains (capital gain net income for taxable years beginning after December 31, 1976) and undistributed ordinary income are allocable to corpus. No provision is made in the trust instrument for the invasion of corpus for the benefit of B. Upon B's death the remainder of the trust is to be distributed to M Church. During the taxable year 1972, the trust has ordinary income of $100,000, long-term capital gains of $15,000, short-term capital gains of $1,000, long-term capital losses of $5,000, and short-term capital losses of $2,500. It is assumed that the trust has no other items of income or any deductions other than those discussed herein. All the ordinary income and capital gains and losses are attributable to amounts transferred to the trust before October 9, 1969. The trust includes in gross income for 1972 the total amount of $116,000 [$100,000 (ordinary income)+$16,000 (total capital gains determined without regard to capital losses)]. Pursuant to the terms of the governing instrument the trust distributes to B in 1972 the amount of $30,000 ($100,000×30%). The balance of $78,500 [($116,000 less $7,500 capital losses) −030,000 distribution] is available for the set-aside for charitable purposes. In determining taxable income for 1972 the capital losses of $7,500 ($5,000+$2,500) are allowable in full under section 1211(b)(1). The net capital gain (capital gain net income for taxable years beginning after December 31, 1976) of $8,500 ($16,000 less $7,500) is the excess of the net long-term capital gain of $10,000 ($15,000 less $5,000) over the net short-term capital loss of $1,500 ($2,500 less $1,000). The deduction under section 1202 is $4,250 ($8,500×50%), all of which is attributable to the set-aside for charitable purposes. Accordingly, for 1972 the deduction allowable to the trust under section 642(c)(2) is $74,250 [$78,500 (set-aside for M) less $4,250 (proper adjustment for section 1202 deduction)].

Example 4. During the taxable year a pooled income fund, as defined in §1.642(c)–5, has in addition to ordinary income long-term capital gains of $150,000, short-term capital gains of $15,000, long-term capital losses of $100,000, and short-term capital losses of $10,000. Under the Declaration of Trust and pursuant to State law net long-term capital gain is allocable to corpus and net short-term capital gain is to be distributed to the income beneficiaries of the fund. All the capital gains and losses are attributable to amounts transferred to the fund after July 31, 1969. In view of the distribution of the net short-term capital gain of $5,000 ($15,000 less $10,000) to the income beneficiaries, the deduction allowed to the fund under section 1202 is limited by such section to $25,000 [($150,000 (long-term capital gains) less $100,000 (long-term capital losses))×50%]. Since the whole of this deduction under section 1202 is attributable to the set-aside for charitable purposes, the deduction of $50,000 ($150,000 less $100,000) otherwise allowable under section 642(c)(3) is subject to appropriate adjustment under section 642(c)(4) for the deduction allowable under section 1202. Accordingly, the amount of the set-aside deduction is $25,000 [$50,000 (set-aside for public charity) less $25,000 (proper adjustment for section 1202 deduction)].

Example 5. The facts are the same as in example 4 except that under the Declaration of Trust and pursuant to State law all the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for the taxable year is allocable to corpus of the fund. The fund would thus include in gross income total capital gains of $165,000 ($150,000+$15,000). In determining taxable income for the taxable year the capital losses of $110,000 ($100,000+$10,000) are allowable in full under section 1211(b)(1). The net capital gain of $55,000 ($165,000 less $110,000) is available for the set-aside for charitable purposes under section 642(c)(3) only in the amount of the net long-term capital gain of $50,000 ($150,000 long-term gains less $100,000 long-term losses). The deduction under section 1202 is $25,000 ($50,000×50%), all of which is attributable to the set-aside for charitable purposes. Accordingly, the deduction allowable to the fund under section 642(c)(3) is $25,000 [$50,000 (set-aside for public charity) less $25,000 (proper adjustment for section 1202 deduction)]. The $5,000 balance of net capital gain (capital gain net income for taxable years beginning after December 31, 1976) is taken into account in determining taxable income of the pooled income fund for the taxable year.

(d) *Disallowance of deduction for amounts allocable to unrelated business income.* In the case of a trust, the deduction otherwise allowable under §1.642(c)–1 or §1.642(c)–2 is disallowed to the extent of amounts allocable to the trust's unrelated business income. See section 681(a) and the regulations thereunder.

(e) *Disallowance of deduction in certain cases.* For disallowance of certain deductions otherwise allowable under section 642(c) (1), (2), or (3), see sections 508(d) and 4948(c)(4).

(f) *Information returns.* For rules applicable to the annual information return that must be filed by trusts claiming a deduction under section 642(c) for the taxable year, see section 6034 and the regulations thereunder.

[T.D. 7357, 40 FR 23741, June 2, 1975; 40 FR 24361, June 6, 1975, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§1.642(c)–4 Nonexempt private foundations.

In the case of a trust which is, or is treated under section 4947(a)(1) as though it were, a private foundation (as defined in section 509(a) and the regulations thereunder) that is not exempt from taxation under section 501(a) for the taxable year, a deduction for amounts paid or permanently set aside, or used for a purpose specified in section 642(c) (1), or (2) shall not be allowed under §1.642(c)–1 or §1.642(c)–2, but such trust shall, subject to the provisions applicable to individuals, be allowed a deduction under section 170 for charitable contributions paid during the taxable year. Section 642(c)(6) and this section do not apply to a trust described in section 4947(a)(1) unless such trust fails to meet the requirements of section 508(e). However, if on October 9, 1969, or at any time thereafter, a trust is recognized as being exempt from taxation under section 501(a) as an organization described in section 501(c)(3), if at such time such trust is a private foundation, and if at any time thereafter such trust is determined not to be exempt from taxation under section 501(a) as an organization described in section 501(c)(3), section 642(c)(6) and this section will apply to such trust. See § 1.509 (b)–1 (b).

[T.D. 7357, 40 FR 23742, June 2, 1975; 40 FR 24362, June 6, 1975]

§ 1.642(c)–5 Definition of pooled income fund.

(a) *In general*—(1) *Application of provisions.* Section 642(c)(5) prescribes certain rules for the valuation of contributions involving transfers to certain funds described in that section as pooled income funds. This section sets forth the requirements for qualifying as a pooled income fund and provides for the manner of allocating the income of the fund to the beneficiaries. Section 1.642(c)–6 provides for the valuation of a remainder interest in property transferred to a pooled income fund. Section 1.642(c)–7 provides transitional rules under which certain funds may be amended so as to qualify as pooled income funds in respect to transfers of property occurring after July 31, 1969.

(2) *Tax status of fund and its beneficiaries.* Notwithstanding any other provision of this chapter, a fund which meets the requirements of a pooled income fund, as defined in section 642(c)(5) and paragraph (b) of this section, shall not be treated as an association within the meaning of section 7701(a)(3). Such a fund, which need not be a trust under local law, and its beneficiaries shall be taxable under part I, subchapter J, chapter 1 of the Code, but the provisions of subpart E (relating to grantors and others treated as substantial owners) of such part shall not apply to such fund.

(3) *Recognition of gain or loss on transfer to fund.* No gain or loss shall be recognized to the donor on the transfer of property to a pooled income fund. In such case, the fund's basis and holding period with respect to property transferred to the fund by a donor shall be determined as provided in sections 1015(b) and 1223(2). If, however, a donor transfers property to a pooled income fund and, in addition to creating or retaining a life income interest therein, receives property from the fund, or transfers property to the fund which is subject to an indebtedness, this subparagraph shall not apply to the gain realized by reason of (i) the receipt of such property or (ii) the amount of such indebtedness, whether or not assumed by the pooled income fund, which is required to be treated as an amount realized on the transfer. For applicability of the bargain sale rules, see section 1011(b) and the regulations thereunder.

(4) *Charitable contributions deduction.* A charitable contributions deduction for the value of the remainder interest, as determined under § 1.642(c)–6, may be allowed under section 170, 2055, 2106, or 2522, where there is a transfer of property to a pooled income fund. For a special rule relating to the reduction of the amount of a charitable contribution of certain ordinary income property or capital gain property, see section 170(e)(1) (A) or (B)(i) and the regulations thereunder.

(5) *Definitions.* For purposes of this section, §§ 1.642(c)–6 and 1.642(c)–7:

(i) The term *income* has the same meaning as it does under section 643(b) and the regulations thereunder.

(ii) The term *donor* includes a decedent who makes a testamentary transfer of property to a pooled income fund.

(iii) The term *governing instrument* means either the governing plan under which the pooled income fund is established and administered or the instrument of transfer, as the context requires.

(iv) The term *public charity* means an organization described in clause (i) to (vi) of section 170(b)(1)(A). If an organization is described in clause (i) to (vi) of section 170(b)(1)(A) and is also described in clause (viii) of such section, it shall be treated as a public charity.

(v) The term *fair market value*, when used with respect to property, means its value in excess of the indebtedness or charges against such property.

(vi) The term *determination date* means each day within the taxable year of a pooled income fund on which a valuation is made of the property in the fund. The property in the fund shall be valued on the first day of the taxable year of the fund and on at least 3 other days within the taxable year. The period between any two consecutive determination dates within the taxable year shall not be greater than 3 calendar months. In the case of a taxable year of less than 12 months, the property in the fund shall be valued on the first day of such taxable year and on such other days within such year as occur at successive intervals of no greater than 3 calendar months. Where a valuation date falls on a Saturday, Sunday, or legal holiday (as defined in section 7503 and the regulations thereunder), the valuation may be made on either the next preceding day which is not a Saturday, Sunday, or legal holiday or the next succeeding day which is not a Saturday, Sunday, or legal holiday, so long as the next such preceding day or next such succeeding day is consistently used where the valuation date falls on a Saturday, Sunday, or legal holiday.

(6) *Cross references.* (i) See section 4947(a)(2) and section 4947(b)(3)(B) for the application to pooled income funds of the provisions relating to private foundations and section 508(e) for rules relating to provisions required in the governing instrument prohibiting certain activities specified in section 4947(a)(2).

(ii) For rules for postponing the time for deduction of a charitable contribution of a future interest in tangible personal property, see section 170(a)(3) and the regulations thereunder.

(b) *Requirements for qualification as a pooled income fund.* A pooled income fund to which this section applies must satisfy all of the following requirements:

(1) *Contribution of remainder interest to charity.* Each donor must transfer property to the fund and contribute an irrevocable remainder interest in such property to or for the use of a public charity, retaining for himself, or creating for another beneficiary or beneficiaries, a life income interest in the transferred property. A contingent remainder interest shall not be treated as an irrevocable remainder interest for purposes of this subparagraph.

(2) *Creation of life income interest.* Each donor must retain for himself for life an income interest in the property transferred to such fund, or create an income interest in such property for the life of one or more beneficiaries, each of whom must be living at the time of the transfer of the property to the fund by the donor. The term *one or more beneficiaries* includes those members of a named class who are alive and can be ascertained at the time of the transfer of the property to the fund. In the event more than one beneficiary of the income interest is designated, such beneficiaries may enjoy their shares of income concurrently, consecutively, or both concurrently and consecutively. The donor may retain the power exercisable only by will to revoke or terminate the income interest of any designated beneficiary other than the public charity. The governing instrument must specify at the time of the transfer the particular beneficiary or beneficiaries to whom the income is payable and the share of income distributable to each person so specified. The public charity to or for the use of which the remainder interest is contributed may also be designated as one of the beneficiaries of an income interest. The donor need not retain or create a life interest in all the income from the property transferred to the fund provided any income not payable under the terms of the governing instrument to an income beneficiary is contributed to, and within the taxable year in which it is received is paid to, the same public charity to or for the use of which the remainder interest is contributed. No charitable contributions deduction shall be allowed to the donor for the value of such income interest of the public charity or for the amount of any such income paid to such organization.

(3) *Commingling of property required.* The property transferred to the fund by each donor must be commingled with, and invested or reinvested with, other property transferred to the fund by other donors satisfying the requirements of subparagraphs (1) and (2) of this paragraph. The governing instrument of the pooled income fund must contain a provision requiring compliance with the preceding sentence. The public charity to or for the use of which the remainder interest is contributed may maintain more than one pooled income fund, provided that each such fund is maintained by the organization and is not a device to permit a group of donors to create a fund which may be subject to their manipulation. The fund must not include property transferred under arrangements other

than those specified in section 642(c)(5) and this paragraph. However, a fund shall not be disqualified as a pooled income fund under this paragraph because any portion of its properties is invested or reinvested jointly with other properties, not a part of the pooled income fund, which are held by, or for the use of, the public charity which maintains the fund, as for example, with securities in the general endowment fund of the public charity to or for the use of which the remainder interest is contributed. Where such joint investment or reinvestment of properties occurs, records must be maintained which sufficiently identify the portion of the total fund which is owned by the pooled income fund and the income earned by, and attributable to, such portion. Such a joint investment or reinvestment of properties shall not be treated as an association or partnership for purposes of the Code. A bank which serves as trustee of more than one pooled income fund may maintain a common trust fund to which section 584 applies for the collective investment and reinvestment of moneys of such funds.

(4) *Prohibition against exempt securities.* The property transferred to the fund by any donor must not include any securities, the income from which is exempt from tax under subtitle A of the Code, and the fund must not invest in such securities. The governing instrument of the fund must contain specific prohibitions against accepting or investing in such securities.

(5) *Maintenance by charitable organization required.* The fund must be maintained by the same public charity to or for the use of which the irrevocable remainder interest is contributed. The requirement of maintenance will be satisfied where the public charity exercises control directly or indirectly over the fund. For example, this requirement of control shall ordinarily be met when the public charity has the power to remove the trustee or trustees of the fund and designate a new trustee or trustees. A national organization which carries out its purposes through local organizations, chapters, or auxiliary bodies with which it has an identity of aims and purposes may maintain a pooled income fund (otherwise satisfying the requirements of this paragraph) in which one or more local organizations, chapters, or auxiliary bodies which are public charities have been named as recipients of the remainder interests. For example, a national church body may maintain a pooled income fund where donors have transferred property to such fund and contributed an irrevocable remainder interest therein to or for the use of various local churches or educational institutions of such body. The fact that such local organizations or chapters have been separately incorporated from the national organization is immaterial.

(6) *Prohibition against donor or beneficiary serving as trustee.* The fund must not have, and the governing instrument must prohibit the fund from having, as a trustee a donor to the fund or a beneficiary (other than the public charity to or for the use of which the remainder interest is contributed) of an income interest in any property transferred to such fund. Thus, if a donor or beneficiary (other than such public charity) directly or indirectly has general responsibilities with respect to the fund which are ordinarily exercised by a trustee, such fund does not meet the requirements of section 642(c)(5) and this paragraph. The fact that a donor of property to the fund, or a beneficiary of the fund, is a trustee, officer, director, or other official of the public charity to or for the use of which the remainder interest is contributed ordinarily will not prevent the fund from meeting the requirements of section 642(c)(5) and this paragraph.

(7) *Income of beneficiary to be based on rate of return of fund.* Each beneficiary entitled to income of any taxable year of the fund must receive such income in an amount determined by the rate of return earned by the fund for such taxable year with respect to his income interest, computed as provided in paragraph (c) of this section. The governing instrument of the fund shall direct the trustee to distribute income currently or within the first 65 days following the close of the taxable year in which the income is earned. Any such payment made after the close of the taxable year shall be treated as paid on the last day of the taxable year. A statement

shall be attached to the return of the pooled income fund indicating the date and amount of such payments after the close of the taxable year. Subject to the provisions of part I, subchapter J, chapter 1 of the Code, the beneficiary shall include in his gross income all amounts properly paid, credited, or required to be distributed to the beneficiary during the taxable year or years of the fund ending within or with his taxable year. The governing instrument shall provide that the income interest of any designated beneficiary shall either terminate with the last regular payment which was made before the death of the beneficiary or be prorated to the date of his death.

(8) *Termination of life income interest.* Upon the termination of the income interest retained or created by any donor, the trustee shall sever from the fund an amount equal to the value of the remainder interest in the property upon which the income interest is based. The value of the remainder interest for such purpose may be either (i) its value as of the determination date next succeeding the termination of the income interest or (ii) its value as of the date on which the last regular payment was made before the death of the beneficiary if the income interest is terminated on such payment date. The amount so severed from the fund must either be paid to, or retained for the use of, the designated public charity, as provided in the governing instrument. However, see subparagraph (3) of this paragraph for rules relating to commingling of property.

(c) *Allocation of income to beneficiary*—(1) *In general.* Every income interest retained or created in property transferred to a pooled income fund shall be assigned a proportionate share of the annual income earned by the fund, such share, or unit of participation, being based on the fair market value of such property on the date of transfer, as provided in this paragraph.

(2) *Units of participation*—(i) *Unit plan. (a)* On each transfer of property by a donor to a pooled income fund, one or more units of participation in the fund shall be assigned to the beneficiary or beneficiaries of the income interest retained or created in such property, the number of units of participation being equal to the number obtained by dividing the fair market value of the property by the fair market value of a unit in the fund at the time of the transfer.

(b) The fair market value of a unit in the fund at the time of the transfer shall be determined by dividing the fair market value of all property in the fund at such time by the number of units then in the fund. The initial fair market value of a unit in a pooled income fund shall be the fair market value of the property transferred to the fund divided by the number of units assigned to the income interest in that property. The value of each unit of participation will fluctuate with each new transfer of property to the fund in relation to the appreciation or depreciation in the fair market value of the property in the fund, but all units in the fund will always have equal value.

(c) The share of income allocated to to each unit of participation shall be determined by dividing the income of the fund for the taxable year by the outstanding number of units in the fund at the end of such year, except that, consistently with paragraph (b)(7) of this section, income shall be allocated to units outstanding during only part of such year by taking into consideration the period of time such units are outstanding. For this purpose the actual income of such part of the taxable year, or a prorated portion of the annual income, may be used, after making such adjustments as are reasonably necessary to reflect fluctuations during the year in the fair market value of the property in the fund.

(ii) *Other plans.* The governing instrument of the fund may provide any other reasonable method not described in subdivision (i) of this subparagraph for assigning units of participation in the fund and allocating income to such units which reaches a result reasonably consistent with the provisions of such subdivision.

(iii) *Transfers between determination dates.* For purposes of subdivisions (i) and (ii) of this subparagraph, if a transfer of property to the fund by a donor occurs on other than a determination date, the number of units of participation assigned to the income interest in such property may be determined by using the fair market value of the property in the fund on the determination date immediately preceding the date of transfer (determined without regard to the property so transferred), subject, however, to appropriate adjustments on the next succeeding determination date. Such adjustments may be made by any reasonable method, including the use of a method whereby the fair market value of the property in the fund at the time of the transfer is deemed to be the average of the fair market values of the property in the fund on the determination dates immediately preceding and succeeding the date of transfer. For purposes of determining such average any property transferred to the fund between such preceding and succeeding dates, or on such succeeding date, shall be excluded. The application of this subdivision may be illustrated by the following example:

Example. The determination dates of a pooled income fund are the first day of each calendar month. On April 1, 1971, the fair market value of the property in the fund is $100,000, at which time 1,000 units of participation are outstanding with a value of $100 each. On April 15, 1971, B transfers property with a fair market value of $50,000 to the fund, retaining for himself for life an income interest in such property. No other property is transferred to the fund after April 1, 1971. On May 1, 1971, the fair market value of the property in the fund, including the property transferred by B, is $160,000. The average of the fair market values of the property in the fund (excluding the property transferred by B) on April 1 and May 1, 1971, is $105,000 ($100,000+ [$160,000−$50,000]÷2). Accordingly, the fair market value of a unit of participation in the fund on April 15, 1971, at the time of B's transfer may be deemed to be $105 ($105,000/1,000 units), and B is assigned 476.19 units of participation in the fund ($50,000/ $105).

(3) *Special rule for partial allocation of income to charity.* Notwithstanding subparagraph (2) of this paragraph, the governing instrument may provide that a unit of participation is entitled to share in the income of the fund in a lesser amount than would otherwise be determined under such subparagraph, provided that the income otherwise allocable to the unit under such subparagraph is paid within the taxable year in which it is received to the public charity to or for the use of which the remainder interest is contributed under the governing instrument.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. On July 1, 1970, A and B transfer separate properties with a fair market value of $20,000 and $10,000, respectively, to a newly created pooled income fund which is maintained by Y University and uses as its taxable year the fiscal year ending June 30. A and B each retain in themselves for life an income interest in such property, the remainder interest being contributed to Y University. The pooled income fund assigns an initial value of $100 to each unit of participation in the fund, and under the governing instruments A receives 200 units, and B receives 100 units, in the fund. On October 1, 1970, which is a determination date, C transfers property to the fund with a fair market value of $12,000, retaining in himself for life an income interest in such property and contributing the remainder interest to Y University. The fair market value of the property in the fund at the time of C's transfer is $36,000. The fair market value of A's and B's units at the time of such transfer is $120 each ($36,000/300). By reason of his transfer of property C is assigned 100 units of participation in the fund ($12,000/$120).

Example 2. Assume that the pooled income fund in example 1 earns $2,600 for its taxable year ending June 30, 1971, and there are no further contributions of property to the fund in such year. Further assume $300 is earned in the first quarter ending September 30, 1970. Therefore, the fund earns $1 per unit for the first quarter ($300 divided by 300 units outstanding) and $5.75 per unit for the remainder of the taxable year ([$2,600−$300] divided by 400 units outstanding). If the fund distributes its income for the year based on its actual earnings per quarter, the income must be distributed as follows:

Beneficiary	Share of income
A	$1,350 ([200×$1]+[200×$5.75]).
B	$675 ([100×$1]+[100×$5.75]).
C	$575 (100×$5.75).

Example 3. (a) On July 1, 1970, A and B transfer separate properties with a fair market value of $10,000 and $20,000, respectively, to a newly created pooled income fund which is maintained by X University and uses as its taxable year the fiscal year ending June 30. A and B each retain in themselves an income interest for life in such property, the remainder interest being contributed to X University. The governing instrument provides that each unit of participation in the fund shall have a value of not more than its initial fair market value; the instrument also provides that the income allocable to appreciation in

the fair market value of such unit (to the extent in excess of its initial fair market value) at the end of each quarter of the fiscal year is to be distributed currently to X University. On October 1, 1970, which is a determination date, C contributes to the fund property with a fair market value of $60,000 and retains in himself an income interest for life in such property, the remainder interest being contributed to X University. The initial fair market value of the units assigned to A, B, and C is $100. A, B, and C's units of participation are as follows:

Beneficiary	*Units of participation*
A	100 ($10,000 divided by $100).
B	200 ($20,000 divided by $100).
C	100 ($10,000 divided by $100).

(b) The fair market value of the property in the fund at the time of C's contribution is $40,000. Assuming the fair market value of the property in the fund is $100,000 on December 31, 1970, and that the income of the fund for the second quarter ending December 31, 1970, is $2,000, the income is shared by the income beneficiaries and X University as follows:

Beneficiary	*Allocation of income*
A, B, and C	90% ($90,000 divided by $100,000).
X University	10% ($10,000 divided by $100,000).

(c) For the quarter ending December 31, 1970, each unit of participation is allocated $2 (90 percent×$2,000 divided by 900) of the income earned for that quarter. A, B, C, and X University share in the income as follows:

Beneficiary	*Share of income*
A	$200 (100×$2).
B	$400 (200×$2).
C	$1,200 (600×$2).
X University	$200 (10%×$2,000).

[T.D. 7105, 36 FR 6477, Apr. 6, 1971; 36 FR 7004, Apr. 13, 1971, as amended by T.D. 7125, 36 FR 11032, June 8, 1971; T.D. 7357, 40 FR 23742, June 2, 1975; T.D. 7633, 44 FR 57925, Oct. 9, 1979]

§ 1.642(c)–6 Valuation of a remainder interest in property transferred to a pooled income fund after April 30, 1989.

(a) *In general.* (1) For purposes of sections 170, 2055, 2106, and 2522, the fair market value of a remainder interest in property transferred to a pooled income fund is its present value determined under paragraph (d) of this section.

(2) The present value of a remainder interest at the time of the transfer of property to the pooled income fund is determined by computing the present value (at the time of the transfer) of the life income interest and subtracting that value from the fair market value of the transferred property on the valuation date. The fact that the income beneficiary may not receive the last income payment, as provided in paragraph (b)(7) of § 1.642(c)–5, is not taken into account for purposes of determining the value of the life income interest. For purposes of this section, the valuation date is the date on which property is transferred to the fund by the donor except that, for purposes of section 2055 or 2106, it is the alternate valuation date, if elected, under the provisions and limitations set forth in section 2032 and the regulations thereunder.

(3) Any claim for a deduction on any return for the value of the remainder interest in property transferred to a pooled income fund must be supported by a statement attached to the return showing the computation of the present value of the interest.

(b) *Actuarial computations by the Internal Revenue Service.* The regulations in this and in related sections provide tables of actuarial factors and examples that illustrate the use of the tables in determining the value of remainder interests in property. Section 1.7520–1(c)(2) refers to government publications that provide additional tables of factors and examples of computations for more complex situations. If the computation requires the use of a factor that is not provided in this section, the Commissioner may supply the factor upon a request for a ruling. A request for a ruling must be accompanied by a recitation of the facts including the pooled income fund's highest yearly rate of return for the 3 taxable years immediately preceding the date of transfer, the date of birth of each measuring life, and copies of the relevant documents. A request for a ruling must comply with the instructions for requesting a ruling published periodically in the Internal Revenue Bulletin (see §§ 601.201 and 601.601(d)(2)(ii)(*b*) of this chapter) and include payment of the required user fee. If the Commissioner furnishes the factor, a copy of the letter supplying the factor should be attached to the tax return in which the deduction is claimed. If the Commissioner does not furnish the factor, the taxpayer must furnish a factor computed in accordance with the principles set forth in this section.

(c) *Computation of pooled income fund's yearly rate of return.* (1) For purposes of determining the present value of the life income interest, the yearly rate of return earned by a pooled income fund for a taxable year is the percentage obtained by dividing the amount of income earned by the pooled income fund for the taxable year by an amount equal to—

(i) The average fair market value of the property in such fund for that taxable year; less

(ii) The corrective term adjustment.

(2) The average fair market value of the property in a pooled income fund for a taxable year shall be the sum of the amounts of the fair market value of all property held by the pooled income fund on each determination date, as defined in paragraph (a)(5)(vi) of § 1.642(c)–5, of such taxable year divided by the number of determination dates in such taxable year. For such purposes the fair market value of property held by the fund shall be determined without including any income earned by the fund.

(3)(i) The corrective term adjustment shall be the sum of the products obtained by multiplying each income payment made by the pooled income fund within its taxable year by the percentage set forth in column (2) of the following table opposite the period within such year, set forth in column (1), which includes the date on which that payment is made:

TABLE

(1) *Payment period*	(2) *Percentage of payment*
Last week of 4th quarter	0
Balance of 4th quarter	25
Last week of 3d quarter	25
Balance of 3d quarter	50
Last week of 2d quarter	50
Balance of 2d quarter	75
Last week of 1st quarter	75
Balance of 1st quarter	100

(ii) If the taxable year of the fund consists of less than 12 months, the corrective term adjustment shall be the sum of the products obtained by multiplying each income payment made by the pooled income fund within such taxable year by the percentage obtained by subtracting from 1 a fraction the numerator of which is the number of days from the first day of such taxable year to the date of such income payment and the denominator of which is 365.

(4) A pooled income fund's method of calculating its yearly rate of return must be supported by a full statement attached to the income tax return of the pooled income fund for each taxable year.

(5) The application of this paragraph may be illustrated by the following examples:

Example 1. (a) The pooled income fund maintained by W University has established determination dates on the first day of each calendar quarter. The pooled income fund is on a calendar-year basis. The pooled income fund earned $5,000 of income during 1971. The fair market value of its property (determined without including any income earned by the fund), and the income paid out, on the first day of each calendar quarter in 1971 are as follows:

Date	Fair market value of property	Income payment
Jan. 1	$100,000	$1,200
Apr. 1	105,000	1,200
July 1	95,000	1,200
Oct. 1	100,000	1,400
	400,000	5,000

(b) The average fair market value of the property in the fund for 1971 is $100,000 ($400,000, divided by 4).

(c) The corrective term adjustment for 1971 is $3,050, determined by applying the percentages obtained in column (2) of the table in subparagraph (3) of this paragraph:

Multiplication:	*Product*
100%×$1,200	$1,200
75%×$1,200	900
50%×$1,200	600
25%×$1,400	350
Sum of products	3,050

(d) The pooled income fund's yearly rate of return for 1971 is 5.157 percent, determined as follows:

$$\$5{,}000 \div \$100{,}000 - \$3{,}050 = 0.05157$$

Example 2. (a) The pooled income fund maintained by X University has established determination dates on the first day of each calendar quarter. The pooled income fund is on a calendar-year basis. The pooled income fund earned $5,000 of income during 1971 and paid out $3,000 on December 15, 1971, and $2,000 on January 15, 1972, the last amount being treated under paragraph (b)(7) of §1.642(c)–5 as paid on December 31, 1971. The fair market value of its property (determined without including any income earned by the fund) on the determination dates in 1971 and the income paid out during 1971 are as follows:

Date	Fair market value of property	Income payment
Jan. 1	$125,000	
Apr. 1	125,000	
July 1	75,000	
Oct. 1	75,000	
Dec. 15		$3,000
Dec. 31		2,000
	400,000	5,000

(b) The average fair market value of the property in the fund for 1971 is $100,000 ($400,000 divided by 4).

(c) The corrective term adjustment for 1971 is $750, determined by applying the percentages obtained in column (2) of the table in subparagraph (3) of this paragraph:

	Product
Multiplication:	
0%×$2,000	
25%×$3,000	$750
Sum of products	750

(d) The pooled income fund's yearly rate of return for 1971 is 5.038 percent, determined as follows:

$$\$5,000 \div \$100,000 - \$750 = 0.05038$$

(d) *Valuation.* The present value of the remainder interest in property transferred to a pooled income fund after April 30, 1989, is determined under paragraph (e) of this section. The present value of the remainder interest in property transferred to a pooled income fund for which the valuation date is before May 1, 1989, is determined under the following sections:

Valuation dates		Applicable regulations
After	Before	
.	01–01–52	1.642(c)–6A(a)
12–31–51	01–01–71	1.642(c)–6A(b)
12–31–70	12–01–83	1.642(c)–6A(c)
11–30–83	05–01–89	1.642(c)–6A(d)

(e) *Present value of the remainder interest in the case of transfers to pooled income funds for which the valuation date is after April 30, 1989*—(1) *In general.* In the case of transfers to pooled income funds for which the valuation date is after April 30, 1989, the present value of a remainder interest is determined under this section. See, however, §1.7520–3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). The present value of a remainder interest that is dependent on the termination of the life of one individual is computed by the use of Table S in paragraph (e)(5) of this section. For purposes of the computations under this section, the age of an individual is the age at the individual's nearest birthday. If the valuation date of a transfer to a pooled income fund is after April 30, 1989, and before June 10, 1994, a transferor can rely on Notice 89–24, 1989–1 C.B. 660, or Notice 89–60, 1989–1 C.B. 700, in valuing the transferred interest. (See §601.601(d)(2)(ii)(*b*) of this chapter.)

(2) *Present value of a remainder interest.* The present value of a remainder interest in property transferred to a pooled income fund is computed on the basis of—

(i) Life contingencies determined from the values of *lx* that are set forth in Table 80CNSMT in §20.2031–7(d)(6) of this chapter (Estate Tax Regulations); and

(ii) Discount at a rate of interest, compounded annually, equal to the highest yearly rate of return of pooled income fund for the 3 taxable years immediately preceding its taxable year in which the transfer of property to the fund is made. For purposes of this paragraph (e), the yearly rate of return of a pooled income fund is determined as provided in §1.642(c)–6(c) unless the highest rate of return is deemed to be the rate described in paragraph (e)(3) of this section for funds in existence less than 3 taxable years. For purposes of this paragraph (e)(2)(ii), the first taxable year of a pooled income fund is considered a taxable year even though the taxable year consists of less than 12 months. However, appropriate adjustments must be made to annualize the rate of return earned by the fund for that period. Where it appears from the facts and circumstances that the highest yearly rate of return of the fund for the 3 taxable years immediately preceding the taxable year in which the transfer of property is made has been purposely manipulated to be substantially less than the rate of return that would otherwise be reasonably anticipated with the purpose of obtaining an excessive charitable deduction, that rate of return may not be used. In that case, the highest yearly rate of return of the fund is determined by treating the fund as a pooled income fund that has been in existence for less than 3 preceding taxable years.

(3) *Pooled income funds in existence less than 3 taxable years.* If a pooled income fund has been in existence less than 3 taxable years immediately preceding the taxable year in which the transfer is made to the fund and the transfer to the fund is made after April 30, 1989, the highest rate of return is deemed to be the interest rate (rounded to the nearest two-tenths of one percent) that is 1 percent less than the highest annual average of the monthly section 7520 rates for the 3 calendar years immediately preceding the calendar year in which the transfer to the pooled income fund is made. The deemed rate of return for transfers to new pooled income funds is recomputed each calendar year using the monthly section 7520 rates for the 3-year period immediately preceding the calendar year in which each transfer to the fund is made until the fund has been in existence for 3 taxable years and can compute its highest rate of return for the 3 taxable years immediately preceding the taxable year in which the transfer of property to the fund is made in accordance with the rules set forth in the first sentence of paragraph (e)(2)(ii) of this section.

(4) *Computation of value of remainder interest.* The factor that is used in determining the present value of a remainder interest that is dependent on the termination of the life of one individual is the factor from Table S in paragraph (e)(5) of this section under the appropriate yearly rate of return opposite the number that corresponds to the age of the individual upon whose life the value of the remainder interest is based. The tables in paragraph (e)(5) of this section include factors for yearly rates of return from 4.2 to 14 percent. Many actuarial factors not contained in the tables in paragraph (e)(5) of this section are contained in Table S in Internal Revenue Service Publication 1457, ‘‘Actuarial Values, Alpha Volume,’’ (8–89). A copy of this publication may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. For other situations, see § 1.642(c)–6(b). If the yearly rate of return is a percentage that is between the yearly rates of return for which factors are provided, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the fair market value of the property on the valuation date by the appropriate remainder factor. This paragraph may be illustrated by the following example:

Example. A, who will be 55 years old on May 8, 1990, transfers $100,000 to a pooled income fund on January 1, 1990, and retains a life income interest in the property. The highest yearly rate of return earned by the fund for its 3 preceding taxable years is 9.47 percent. In Table S, the remainder factor opposite 55 years under 9.4 percent is .18785 and under 9.6 percent is .18322. The present value of the remainder interest is $18,623.00, computed as follows:

Factor at 9.4 percent for age 55	.18785
Factor at 9.6 percent for age 55	.18322
Difference	.00463

Interpolation adjustment:

$$\frac{9.47\% - 9.4\%}{0.2\%} = \frac{x}{.00463}$$

$$x = .00162$$

Factor at 9.4 percent for age 55	.18785
Less: Interpolation adjustment	.00162
Interpolated factor	.18623
Present value of remainder interest: ($100,000×.18623)	$18,623.00

(5) *Actuarial tables.* In the case of transfers for which the valuation date

is after April 30, 1989, the present value of a remainder interest dependent on the termination of one life in the case of a transfer to a pooled income fund is determined by use of the following tables:

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS

[Applicable after April 30, 1989]

Age	Interest rate									
	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
0	.07389	.06749	.06188	.05695	.05261	.04879	.04541	.04243	.03978	.03744
1	.06494	.05832	.05250	.04738	.04287	.03889	.03537	.03226	.02950	.02705
2	.06678	.05999	.05401	.04874	.04410	.03999	.03636	.03314	.03028	.02773
3	.06897	.06200	.05587	.05045	.04567	.04143	.03768	.03435	.03139	.02875
4	.07139	.06425	.05796	.05239	.04746	.04310	.03922	.03578	.03271	.02998
5	.07401	.06669	.06023	.05451	.04944	.04494	.04094	.03738	.03421	.03137
6	.07677	.06928	.06265	.05677	.05156	.04692	.04279	.03911	.03583	.03289
7	.07968	.07201	.06521	.05918	.05381	.04903	.04477	.04097	.03757	.03453
8	.08274	.07489	.06792	.06172	.05621	.05129	.04689	.04297	.03945	.03630
9	.08597	.07794	.07079	.06443	.05876	.05370	.04917	.04511	.04148	.03821
10	.08936	.08115	.07383	.06730	.06147	.05626	.05159	.04741	.04365	.04027
11	.09293	.08453	.07704	.07035	.06436	.05900	.05419	.04988	.04599	.04250
12	.09666	.08807	.08040	.07354	.06739	.06188	.05693	.05248	.04847	.04486
13	.10049	.09172	.08387	.07684	.07053	.06487	.05977	.05518	.05104	.04731
14	.10437	.09541	.08738	.08017	.07370	.06788	.06263	.05791	.05364	.04978
15	.10827	.09912	.09090	.08352	.07688	.07090	.06551	.06064	.05623	.05225
16	.11220	.10285	.09445	.08689	.08008	.07394	.06839	.06337	.05883	.05472
17	.11615	.10661	.09802	.09028	.08330	.07699	.07129	.06612	.06144	.05719
18	.12017	.11043	.10165	.09373	.08656	.08009	.07422	.06890	.06408	.05969
19	.12428	.11434	.10537	.09726	.08992	.08327	.07724	.07177	.06679	.06226
20	.12850	.11836	.10919	.10089	.09337	.08654	.08035	.07471	.06959	.06492
21	.13282	.12248	.11311	.10462	.09692	.08991	.08355	.07775	.07247	.06765
22	.13728	.12673	.11717	.10848	.10059	.09341	.08686	.08090	.07546	.07049
23	.14188	.13113	.12136	.11248	.10440	.09703	.09032	.08418	.07858	.07345
24	.14667	.13572	.12575	.11667	.10839	.10084	.09395	.08764	.08187	.07659
25	.15167	.14051	.13034	.12106	.11259	.10486	.09778	.09130	.08536	.07991
26	.15690	.14554	.13517	.12569	.11703	.10910	.10184	.09518	.08907	.08346
27	.16237	.15081	.14024	.13056	.12171	.11359	.10614	.09930	.09302	.08724
28	.16808	.15632	.14555	.13567	.12662	.11831	.11068	.10366	.09720	.09125
29	.17404	.16208	.15110	.14104	.13179	.12329	.11547	.10827	.10163	.09551
30	.18025	.16808	.15692	.14665	.13721	.12852	.12051	.11313	.10631	.10002
31	.18672	.17436	.16300	.15255	.14291	.13403	.12584	.11827	.11127	.10480
32	.19344	.18090	.16935	.15870	.14888	.13980	.13142	.12367	.11650	.10985
33	.20044	.18772	.17598	.16514	.15513	.14587	.13730	.12936	.12201	.11519
34	.20770	.19480	.18287	.17185	.16165	.15221	.14345	.13533	.12780	.12080
35	.21522	.20215	.19005	.17884	.16846	.15883	.14989	.14159	.13388	.12670
36	.22299	.20974	.19747	.18609	.17552	.16571	.15660	.14812	.14022	.13287
37	.23101	.21760	.20516	.19360	.18286	.17288	.16358	.15492	.14685	.13933
38	.23928	.22572	.21311	.20139	.19048	.18032	.17085	.16201	.15377	.14607
39	.24780	.23409	.22133	.20945	.19837	.18804	.17840	.16939	.16097	.15310
40	.25658	.24273	.22982	.21778	.20654	.19605	.18624	.17706	.16847	.16043
41	.26560	.25163	.23858	.22639	.21499	.20434	.19436	.18502	.17627	.16806
42	.27486	.26076	.24758	.23525	.22370	.21289	.20276	.19326	.18434	.17597
43	.28435	.27013	.25683	.24436	.23268	.22172	.21143	.20177	.19270	.18416
44	.29407	.27975	.26633	.25373	.24191	.23081	.22038	.21057	.20134	.19265
45	.30402	.28961	.27608	.26337	.25142	.24019	.22962	.21966	.21028	.20144
46	.31420	.29970	.28608	.27326	.26120	.24983	.23913	.22904	.21951	.21053
47	.32460	.31004	.29632	.28341	.27123	.25975	.24892	.23870	.22904	.21991
48	.33521	.32058	.30679	.29379	.28151	.26992	.25897	.24862	.23883	.22957
49	.34599	.33132	.31746	.30438	.29201	.28032	.26926	.25879	.24888	.23949
50	.35695	.34224	.32833	.31518	.30273	.29094	.27978	.26921	.25918	.24966
51	.36809	.35335	.33940	.32619	.31367	.30180	.29055	.27987	.26973	.26010
52	.37944	.36468	.35070	.33744	.32486	.31292	.30158	.29081	.28057	.27083
53	.39098	.37622	.36222	.34892	.33629	.32429	.31288	.30203	.29170	.28186
54	.40269	.38794	.37393	.36062	.34795	.33590	.32442	.31349	.30308	.29316
55	.41457	.39985	.38585	.37252	.35983	.34774	.33621	.32522	.31474	.30473
56	.42662	.41194	.39796	.38464	.37193	.35981	.34824	.33720	.32666	.31658
57	.43884	.42422	.41028	.39697	.38426	.37213	.36053	.34945	.33885	.32872
58	.45123	.43668	.42279	.40951	.39682	.38468	.37307	.36196	.35132	.34114
59	.46377	.44931	.43547	.42224	.40958	.39745	.38584	.37471	.36405	.35383
60	.47643	.46206	.44830	.43513	.42250	.41040	.39880	.38767	.37699	.36674
61	.48916	.47491	.46124	.44814	.43556	.42350	.41192	.40080	.39012	.37985
62	.50196	.48783	.47427	.46124	.44874	.43672	.42518	.41408	.40340	.39314
63	.51480	.50081	.48736	.47444	.46201	.45006	.43856	.42749	.41684	.40658
64	.52770	.51386	.50054	.48773	.47540	.46352	.45208	.44105	.43043	.42019

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

Age	Interest rate									
	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
65	.54069	.52701	.51384	.50115	.48892	.47713	.46577	.45480	.44422	.43401
66	.55378	.54029	.52727	.51472	.50262	.49093	.47965	.46876	.45824	.44808
67	.56697	.55368	.54084	.52845	.51648	.50491	.49373	.48293	.47248	.46238
68	.58026	.56717	.55453	.54231	.53049	.51905	.50800	.49729	.48694	.47691
69	.59358	.58072	.56828	.55624	.54459	.53330	.52238	.51179	.50154	.49160
70	.60689	.59427	.58205	.57021	.55874	.54762	.53683	.52638	.51624	.50641
71	.62014	.60778	.59578	.58415	.57287	.56193	.55131	.54100	.53099	.52126
72	.63334	.62123	.60948	.59808	.58700	.57624	.56579	.55563	.54577	.53617
73	.64648	.63465	.62315	.61198	.60112	.59056	.58029	.57030	.56059	.55113
74	.65961	.64806	.63682	.62590	.61527	.60492	.59485	.58504	.57550	.56620
75	.67274	.66149	.65054	.63987	.62948	.61936	.60950	.59990	.59053	.58140
76	.68589	.67495	.66429	.65390	.64377	.63390	.62427	.61487	.60570	.59676
77	.69903	.68841	.67806	.66796	.65811	.64849	.63910	.62993	.62097	.61223
78	.71209	.70182	.69179	.68199	.67242	.66307	.65393	.64501	.63628	.62775
79	.72500	.71507	.70537	.69588	.68660	.67754	.66867	.65999	.65151	.64321
80	.73768	.72809	.71872	.70955	.70058	.69180	.68320	.67479	.66655	.65849
81	.75001	.74077	.73173	.72288	.71422	.70573	.69741	.68926	.68128	.67345
82	.76195	.75306	.74435	.73582	.72746	.71926	.71123	.70335	.69562	.68804
83	.77346	.76491	.75654	.74832	.74026	.73236	.72460	.71699	.70952	.70219
84	.78456	.77636	.76831	.76041	.75265	.74503	.73756	.73021	.72300	.71592
85	.79530	.78743	.77971	.77212	.76466	.75733	.75014	.74306	.73611	.72928
86	.80560	.79806	.79065	.78337	.77621	.76917	.76225	.75544	.74875	.74216
87	.81535	.80813	.80103	.79404	.78717	.78041	.77375	.76720	.76076	.75442
88	.82462	.81771	.81090	.80420	.79760	.79111	.78472	.77842	.77223	.76612
89	.83356	.82694	.82043	.81401	.80769	.80147	.79533	.78929	.78334	.77747
90	.84225	.83593	.82971	.82357	.81753	.81157	.80570	.79991	.79420	.78857
91	.85058	.84455	.83861	.83276	.82698	.82129	.81567	.81013	.80466	.79927
92	.85838	.85263	.84696	.84137	.83585	.83040	.82503	.81973	.81449	.80933
93	.86557	.86009	.85467	.84932	.84405	.83884	.83370	.82862	.82360	.81865
94	.87212	.86687	.86169	.85657	.85152	.84653	.84160	.83673	.83192	.82717
95	.87801	.87298	.86801	.86310	.85825	.85345	.84872	.84404	.83941	.83484
96	.88322	.87838	.87360	.86888	.86420	.85959	.85502	.85051	.84605	.84165
97	.88795	.88328	.87867	.87411	.86961	.86515	.86074	.85639	.85208	.84782
98	.89220	.88769	.88323	.87883	.87447	.87016	.86589	.86167	.85750	.85337
99	.89612	.89176	.88745	.88318	.87895	.87478	.87064	.86656	.86251	.85850
100	.89977	.89555	.89136	.88722	.88313	.87908	.87506	.87109	.86716	.86327
101	.90326	.89917	.89511	.89110	.88712	.88318	.87929	.87543	.87161	.86783
102	.90690	.90294	.89901	.89513	.89128	.88746	.88369	.87995	.87624	.87257
103	.91076	.90694	.90315	.89940	.89569	.89200	.88835	.88474	.88116	.87760
104	.91504	.91138	.90775	.90415	.90058	.89704	.89354	.89006	.88661	.88319
105	.92027	.91681	.91337	.90996	.90658	.90322	.89989	.89659	.89331	.89006
106	.92763	.92445	.92130	.91816	.91506	.91197	.90890	.90586	.90284	.89983
107	.93799	.93523	.93249	.92977	.92707	.92438	.92170	.91905	.91641	.91378
108	.95429	.95223	.95018	.94814	.94611	.94409	.94208	.94008	.93809	.93611
109	.97985	.97893	.97801	.97710	.97619	.97529	.97438	.97348	.97259	.97170

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS

[Applicable after April 30, 1989]

Age	Interest rate									
	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
0	.03535	.03349	.03183	.03035	.02902	.02783	.02676	.02579	.02492	.02413
1	.02486	.02292	.02119	.01963	.01824	.01699	.01587	.01486	.01395	.01312
2	.02547	.02345	.02164	.02002	.01857	.01727	.01609	.01504	.01408	.01321
3	.02640	.02429	.02241	.02073	.01921	.01785	.01662	.01552	.01451	.01361
4	.02753	.02535	.02339	.02163	.02005	.01863	.01735	.01619	.01514	.01418
5	.02883	.02656	.02453	.02269	.02105	.01956	.01822	.01700	.01590	.01490
6	.03026	.02790	.02578	.02387	.02215	.02060	.01919	.01792	.01677	.01572
7	.03180	.02935	.02714	.02515	.02336	.02174	.02027	.01894	.01773	.01664
8	.03347	.03092	.02863	.02656	.02469	.02300	.02146	.02007	.01881	.01766
9	.03528	.03263	.03025	.02810	.02615	.02438	.02278	.02133	.02000	.01880
10	.03723	.03449	.03201	.02977	.02774	.02590	.02423	.02271	.02133	.02006
11	.03935	.03650	.03393	.03160	.02949	.02757	.02583	.02424	.02279	.02147
12	.04160	.03865	.03598	.03356	.03136	.02936	.02755	.02589	.02438	.02299
13	.04394	.04088	.03811	.03560	.03331	.03123	.02934	.02761	.02603	.02458
14	.04629	.04312	.04025	.03764	.03527	.03311	.03113	.02933	.02768	.02617

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

Age	Interest rate									
	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
15	.04864	.04536	.04238	.03968	.03721	.03496	.03290	.03103	.02930	.02773
16	.05099	.04759	.04451	.04170	.03913	.03679	.03466	.03270	.03090	.02926
17	.05333	.04982	.04662	.04370	.04104	.03861	.03638	.03434	.03247	.03075
18	.05570	.05207	.04875	.04573	.04296	.04044	.03812	.03599	.03404	.03225
19	.05814	.05438	.05095	.04781	.04494	.04231	.03990	.03769	.03565	.03378
20	.06065	.05677	.05321	.04996	.04698	.04424	.04173	.03943	.03731	.03535
21	.06325	.05922	.05554	.05217	.04907	.04623	.04362	.04122	.03901	.03697
22	.06594	.06178	.05797	.05447	.05126	.04831	.04559	.04309	.04078	.03865
23	.06876	.06446	.06051	.05688	.05355	.05048	.04766	.04505	.04265	.04042
24	.07174	.06729	.06321	.05945	.05599	.05281	.04987	.04715	.04465	.04233
25	.07491	.07031	.06609	.06219	.05861	.05530	.05224	.04941	.04680	.04438
26	.07830	.07355	.06918	.06515	.06142	.05799	.05481	.05187	.04915	.04662
27	.08192	.07702	.07250	.06832	.06446	.06090	.05759	.05454	.05170	.04906
28	.08577	.08071	.07603	.07171	.06772	.06402	.06059	.05740	.05445	.05170
29	.08986	.08464	.07981	.07534	.07120	.06736	.06380	.06049	.05742	.05456
30	.09420	.08882	.08383	.07921	.07492	.07095	.06725	.06381	.06061	.05763
31	.09881	.09327	.08812	.08335	.07891	.07479	.07095	.06738	.06405	.06095
32	.10369	.09797	.09267	.08774	.08315	.07888	.07491	.07120	.06774	.06451
33	.10885	.10297	.09750	.09241	.08767	.08325	.07913	.07529	.07170	.06834
34	.11430	.10824	.10261	.09736	.09246	.08790	.08363	.07964	.07592	.07243
35	.12002	.11380	.10800	.10259	.09754	.09282	.08841	.08428	.08041	.07679
36	.12602	.11963	.11366	.10809	.10288	.09800	.09344	.08917	.08516	.08140
37	.13230	.12574	.11961	.11387	.10850	.10347	.09876	.09433	.09018	.08628
38	.13887	.13214	.12584	.11994	.11441	.10922	.10436	.09978	.09549	.09145
39	.14573	.13883	.13237	.12630	.12061	.11527	.11025	.10553	.10109	.09690
40	.15290	.14583	.13920	.13297	.12712	.12162	.11644	.11157	.10698	.10266
41	.16036	.15312	.14633	.13994	.13393	.12827	.12294	.11792	.11318	.10871
42	.16810	.16071	.15375	.14720	.14103	.13522	.12973	.12456	.11967	.11505
43	.17614	.16858	.16146	.15475	.14842	.14245	.13682	.13149	.12645	.12169
44	.18447	.17675	.16948	.16261	.15613	.15000	.14421	.13873	.13355	.12864
45	.19310	.18524	.17780	.17078	.16414	.15787	.15192	.14630	.14096	.13591
46	.20204	.19402	.18644	.17926	.17247	.16604	.15995	.15418	.14870	.14350
47	.21128	.20311	.19538	.18806	.18112	.17454	.16830	.16238	.15676	.15141
48	.22080	.21249	.20462	.19716	.19007	.18335	.17696	.17090	.16513	.15964
49	.23059	.22214	.21413	.20653	.19930	.19244	.18591	.17970	.17379	.16816
50	.24063	.23206	.22391	.21617	.20881	.20180	.19514	.18879	.18274	.17697
51	.25095	.24225	.23398	.22610	.21861	.21147	.20466	.19818	.19199	.18609
52	.26157	.25275	.24436	.23636	.22874	.22147	.21453	.20791	.20159	.19556
53	.27249	.26357	.25505	.24694	.23919	.23180	.22474	.21799	.21154	.20537
54	.28369	.27466	.26604	.25782	.24995	.24244	.23526	.22839	.22181	.21552
55	.29518	.28605	.27734	.26900	.26103	.25341	.24611	.23912	.23243	.22601
56	.30695	.29774	.28893	.28050	.27242	.26469	.25728	.25019	.24338	.23685
57	.31902	.30973	.30084	.29232	.28415	.27632	.26881	.26161	.25469	.24805
58	.33138	.32203	.31306	.30446	.29621	.28829	.28069	.27339	.26637	.25962
59	.34402	.33461	.32558	.31691	.30859	.30059	.29290	.28550	.27839	.27155
60	.35690	.34745	.33836	.32963	.32124	.31317	.30540	.29792	.29073	.28379
61	.36999	.36050	.35137	.34259	.33414	.32601	.31817	.31062	.30334	.29633
62	.38325	.37374	.36458	.35576	.34726	.33907	.33117	.32356	.31621	.30912
63	.39669	.38717	.37799	.36913	.36060	.35236	.34441	.33674	.32933	.32217
64	.41031	.40078	.39159	.38272	.37415	.36588	.35789	.35016	.34270	.33548
65	.42416	.41464	.40545	.39656	.38798	.37968	.37166	.36390	.35639	.34912
66	.43825	.42876	.41958	.41070	.40211	.39380	.38576	.37797	.37043	.36312
67	.45260	.44315	.43399	.42513	.41655	.40824	.40019	.39238	.38482	.37749
68	.46720	.45779	.44868	.43985	.43129	.42299	.41494	.40713	.39956	.39221
69	.48197	.47263	.46357	.45478	.44625	.43798	.42995	.42215	.41458	.40722
70	.49686	.48760	.47861	.46988	.46140	.45316	.44516	.43738	.42983	.42248
71	.51182	.50265	.49374	.48508	.47666	.46847	.46051	.45276	.44523	.43790
72	.52685	.51778	.50896	.50038	.49203	.48390	.47599	.46829	.46079	.45349
73	.54194	.53298	.52426	.51578	.50751	.49946	.49161	.48397	.47652	.46926
74	.55714	.54832	.53972	.53134	.52317	.51520	.50744	.49986	.49247	.48527
75	.57250	.56382	.55536	.54710	.53904	.53118	.52351	.51601	.50870	.50156
76	.58803	.57951	.57120	.56308	.55515	.54740	.53984	.53245	.52522	.51817
77	.60369	.59535	.58720	.57923	.57144	.56383	.55639	.54912	.54200	.53504
78	.61942	.61126	.60329	.59549	.58787	.58040	.57310	.56596	.55896	.55212
79	.63508	.62713	.61935	.61174	.60428	.59698	.58983	.58283	.57597	.56925
80	.65059	.64285	.63527	.62785	.62058	.61345	.60646	.59961	.59290	.58632
81	.66579	.65827	.65090	.64368	.63659	.62965	.62283	.61615	.60959	.60316
82	.68061	.67332	.66616	.65914	.65226	.64550	.63886	.63235	.62595	.61968
83	.69499	.68793	.68099	.67418	.66749	.66092	.65447	.64813	.64191	.63579

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

Age	Interest rate									
	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
84	.70896	.70213	.69541	.68881	.68233	.67595	.66969	.66353	.65748	.65153
85	.72256	.71596	.70947	.70308	.69681	.69063	.68456	.67859	.67271	.66693
86	.73569	.72931	.72305	.71688	.71081	.70484	.69896	.69318	.68748	.68188
87	.74818	.74204	.73599	.73003	.72417	.71839	.71271	.70711	.70159	.69616
88	.76011	.75419	.74836	.74261	.73695	.73137	.72588	.72046	.71512	.70986
89	.77169	.76599	.76037	.75484	.74938	.74400	.73870	.73347	.72831	.72323
90	.78302	.77755	.77215	.76683	.76158	.75640	.75129	.74625	.74128	.73638
91	.79395	.78870	.78352	.77842	.77337	.76840	.76349	.75864	.75385	.74913
92	.80423	.79920	.79423	.78933	.78449	.77971	.77499	.77033	.76572	.76118
93	.81377	.80894	.80417	.79946	.79481	.79022	.78568	.78120	.77677	.77239
94	.82247	.81784	.81325	.80873	.80425	.79983	.79547	.79115	.78688	.78266
95	.83033	.82586	.82145	.81709	.81278	.80852	.80431	.80014	.79602	.79195
96	.83729	.83298	.82872	.82451	.82034	.81622	.81215	.80812	.80414	.80019
97	.84361	.83944	.83532	.83124	.82721	.82322	.81927	.81537	.81151	.80769
98	.84929	.84525	.84126	.83730	.83339	.82952	.82569	.82190	.81815	.81443
99	.85454	.85062	.84674	.84290	.83910	.83534	.83161	.82792	.82427	.82066
100	.85942	.85561	.85184	.84810	.84440	.84074	.83711	.83352	.82997	.82644
101	.86408	.86037	.85670	.85306	.84946	.84589	.84236	.83886	.83539	.83196
102	.86894	.86534	.86177	.85823	.85473	.85126	.84782	.84442	.84104	.83770
103	.87408	.87060	.86714	.86371	.86032	.85695	.85362	.85031	.84703	.84378
104	.87980	.87644	.87311	.86980	.86653	.86328	.86005	.85686	.85369	.85054
105	.88684	.88363	.88046	.87731	.87418	.87108	.86800	.86494	.86191	.85890
106	.89685	.89389	.89095	.88804	.88514	.88226	.87940	.87656	.87374	.87094
107	.91117	.90858	.90600	.90344	.90089	.89836	.89584	.89334	.89085	.88838
108	.93414	.93217	.93022	.92828	.92634	.92442	.92250	.92060	.91870	.91681
109	.97081	.96992	.96904	.96816	.96729	.96642	.96555	.96468	.96382	.96296

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS

[Applicable after April 30, 1989]

Age	Interest rate									
	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
0	.02341	.02276	.02217	.02163	.02114	.02069	.02027	.01989	.01954	.01922
1	.01237	.01170	.01108	.01052	.01000	.00953	.00910	.00871	.00834	.00801
2	.01243	.01172	.01107	.01048	.00994	.00944	.00899	.00857	.00819	.00784
3	.01278	.01203	.01135	.01073	.01016	.00964	.00916	.00872	.00832	.00795
4	.01332	.01253	.01182	.01116	.01056	.01001	.00951	.00904	.00862	.00822
5	.01400	.01317	.01241	.01172	.01109	.01051	.00998	.00949	.00904	.00862
6	.01477	.01390	.01310	.01238	.01171	.01110	.01054	.01002	.00954	.00910
7	.01563	.01472	.01389	.01312	.01242	.01178	.01118	.01064	.01013	.00966
8	.01660	.01564	.01477	.01396	.01322	.01254	.01192	.01134	.01081	.01031
9	.01770	.01669	.01577	.01492	.01414	.01342	.01276	.01216	.01159	.01107
10	.01891	.01785	.01688	.01599	.01517	.01442	.01372	.01308	.01249	.01194
11	.02026	.01915	.01814	.01720	.01634	.01555	.01481	.01414	.01351	.01293
12	.02173	.02056	.01950	.01852	.01761	.01678	.01601	.01529	.01463	.01402
13	.02326	.02204	.02092	.01989	.01895	.01807	.01726	.01651	.01582	.01517
14	.02478	.02351	.02234	.02126	.02027	.01935	.01850	.01771	.01698	.01630
15	.02628	.02495	.02372	.02259	.02155	.02058	.01969	.01886	.01810	.01738
16	.02774	.02635	.02507	.02388	.02279	.02178	.02084	.01997	.01917	.01842
17	.02917	.02772	.02637	.02513	.02399	.02293	.02194	.02103	.02018	.01940
18	.03059	.02907	.02767	.02637	.02517	.02406	.02302	.02207	.02118	.02035
19	.03205	.03046	.02899	.02763	.02637	.02521	.02412	.02312	.02218	.02131
20	.03355	.03188	.03035	.02892	.02760	.02638	.02524	.02419	.02320	.02229
21	.03509	.03334	.03173	.03024	.02886	.02758	.02638	.02527	.02424	.02328
22	.03669	.03487	.03318	.03162	.03017	.02882	.02757	.02640	.02532	.02430
23	.03837	.03646	.03470	.03306	.03154	.03013	.02881	.02759	.02644	.02538
24	.04018	.03819	.03634	.03463	.03303	.03155	.03016	.02888	.02767	.02655
25	.04214	.04006	.03812	.03633	.03465	.03309	.03164	.03029	.02902	.02784
26	.04428	.04210	.04008	.03820	.03644	.03481	.03328	.03186	.03052	.02928
27	.04662	.04434	.04223	.04025	.03841	.03670	.03509	.03360	.03219	.03088
28	.04915	.04677	.04456	.04249	.04056	.03876	.03708	.03550	.03403	.03264
29	.05189	.04941	.04709	.04493	.04291	.04102	.03925	.03760	.03604	.03458
30	.05485	.05226	.04984	.04757	.04546	.04348	.04162	.03988	.03825	.03671
31	.05805	.05535	.05282	.05045	.04824	.04616	.04421	.04238	.04067	.03905
32	.06149	.05867	.05603	.05356	.05124	.04906	.04702	.04510	.04329	.04160
33	.06520	.06226	.05950	.05692	.05449	.05221	.05007	.04806	.04616	.04438

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

Age	Interest rate									
	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
34	.06916	.06609	.06322	.06052	.05799	.05560	.05336	.05125	.04926	.04738
35	.07339	.07020	.06720	.06439	.06174	.05925	.05690	.05469	.05260	.05063
36	.07787	.07455	.07143	.06850	.06573	.06313	.06068	.05836	.05617	.05411
37	.08262	.07917	.07593	.07287	.06999	.06727	.06470	.06228	.05999	.05783
38	.08765	.08407	.08069	.07751	.07451	.07167	.06899	.06646	.06407	.06180
39	.09296	.08925	.08574	.08243	.07931	.07635	.07356	.07092	.06841	.06604
40	.09858	.09472	.09109	.08765	.08440	.08132	.07841	.07565	.07303	.07055
41	.10449	.10050	.09673	.09316	.08978	.08658	.08355	.08067	.07794	.07535
42	.11069	.10656	.10265	.09895	.09544	.09212	.08896	.08596	.08312	.08041
43	.11718	.11291	.10887	.10503	.10140	.09794	.09466	.09154	.08858	.08576
44	.12399	.11958	.11540	.11143	.10766	.10407	.10067	.09743	.09434	.09141
45	.13111	.12656	.12224	.11814	.11423	.11052	.10699	.10362	.10042	.09736
46	.13856	.13387	.12941	.12516	.12113	.11728	.11362	.11013	.10680	.10363
47	.14633	.14150	.13690	.13252	.12835	.12438	.12059	.11697	.11352	.11022
48	.15442	.14945	.14471	.14020	.13589	.13179	.12787	.12412	.12055	.11713
49	.16280	.15769	.15281	.14816	.14373	.13949	.13544	.13157	.12787	.12433
50	.17147	.16622	.16121	.15643	.15186	.14749	.14331	.13931	.13548	.13182
51	.18045	.17507	.16993	.16501	.16030	.15580	.15150	.14737	.14342	.13963
52	.18979	.18427	.17899	.17394	.16911	.16448	.16004	.15579	.15172	.14780
53	.19947	.19383	.18842	.18324	.17828	.17352	.16896	.16458	.16038	.15635
54	.20950	.20372	.19819	.19288	.18779	.18291	.17822	.17372	.16940	.16524
55	.21986	.21397	.20831	.20288	.19767	.19266	.18785	.18322	.17878	.17450
56	.23058	.22457	.21879	.21324	.20791	.20278	.19785	.19310	.18854	.18414
57	.24167	.23554	.22965	.22399	.21854	.21329	.20824	.20338	.19870	.19419
58	.25314	.24690	.24090	.23512	.22956	.22420	.21904	.21407	.20927	.20464
59	.26497	.25863	.25252	.24664	.24097	.23550	.23023	.22515	.22024	.21551
60	.27712	.27068	.26448	.25849	.25272	.24716	.24178	.23659	.23158	.22674
61	.28956	.28304	.27674	.27067	.26480	.25913	.25366	.24837	.24325	.23831
62	.30228	.29567	.28929	.28312	.27717	.27141	.26584	.26045	.25524	.25020
63	.31525	.30857	.30211	.29586	.28982	.28397	.27832	.27284	.26754	.26240
64	.32851	.32176	.31522	.30890	.30278	.29685	.29111	.28555	.28016	.27493
65	.34209	.33528	.32868	.32229	.31610	.31010	.30429	.29865	.29317	.28787
66	.35604	.34918	.34253	.33609	.32983	.32377	.31788	.31217	.30663	.30124
67	.37037	.36347	.35678	.35028	.34398	.33786	.33191	.32614	.32053	.31508
68	.38508	.37815	.37142	.36489	.35854	.35237	.34638	.34055	.33488	.32937
69	.40008	.39313	.38638	.37982	.37344	.36724	.36120	.35533	.34961	.34405
70	.41533	.40838	.40162	.39504	.38864	.38241	.37634	.37043	.36468	.35907
71	.43076	.42382	.41705	.41047	.40405	.39780	.39171	.38578	.38000	.37436
72	.44638	.43945	.43269	.42611	.41969	.41344	.40733	.40138	.39558	.38991
73	.46218	.45527	.44854	.44197	.43556	.42931	.42321	.41725	.41143	.40575
74	.47823	.47137	.46466	.45812	.45173	.44549	.43940	.43345	.42763	.42195
75	.49459	.48777	.48112	.47462	.46826	.46205	.45598	.45004	.44424	.43856
76	.51127	.50452	.49793	.49148	.48517	.47900	.47297	.46706	.46129	.45563
77	.52823	.52157	.51505	.50867	.50243	.49632	.49033	.48447	.47873	.47311
78	.54541	.53885	.53242	.52613	.51996	.51392	.50800	.50220	.49652	.49094
79	.56267	.55621	.54989	.54369	.53762	.53166	.52582	.52009	.51448	.50897
80	.57987	.57354	.56733	.56125	.55527	.54941	.54366	.53802	.53248	.52705
81	.59685	.59065	.58457	.57860	.57274	.56699	.56134	.55579	.55035	.54499
82	.61351	.60746	.60151	.59567	.58993	.58429	.57875	.57331	.56796	.56270
83	.62978	.62387	.61806	.61236	.60675	.60123	.59581	.59047	.58523	.58007
84	.64567	.63992	.63426	.62869	.62321	.61783	.61253	.60731	.60218	.59713
85	.66125	.65565	.65014	.64472	.63938	.63413	.62896	.62387	.61886	.61392
86	.67636	.67092	.66557	.66030	.65511	.65000	.64496	.64000	.63511	.63030
87	.69081	.68554	.68034	.67522	.67018	.66520	.66031	.65548	.65071	.64602
88	.70468	.69957	.69453	.68956	.68466	.67983	.67507	.67037	.66574	.66117
89	.71821	.71326	.70838	.70357	.69882	.69414	.68952	.68495	.68045	.67601
90	.73153	.72676	.72204	.71739	.71280	.70827	.70379	.69938	.69502	.69071
91	.74447	.73986	.73532	.73083	.72640	.72202	.71770	.71343	.70921	.70504
92	.75669	.75225	.74787	.74354	.73927	.73504	.73087	.72674	.72267	.71864
93	.76807	.76379	.75957	.75540	.75127	.74719	.74317	.73918	.73524	.73135
94	.77849	.77437	.77030	.76627	.76229	.75835	.75446	.75061	.74680	.74303
95	.78792	.78394	.78001	.77611	.77226	.76845	.76468	.76096	.75727	.75362
96	.79630	.79244	.78863	.78485	.78112	.77742	.77377	.77015	.76657	.76303
97	.80391	.80016	.79646	.79280	.78917	.78559	.78203	.77852	.77504	.77160
98	.81076	.80712	.80352	.79996	.79643	.79294	.78948	.78606	.78267	.77931
99	.81709	.81354	.81004	.80657	.80313	.79972	.79635	.79302	.78971	.78644
100	.82296	.81950	.81609	.81270	.80934	.80602	.80273	.79947	.79624	.79304
101	.82855	.82518	.82185	.81854	.81526	.81201	.80880	.80561	.80245	.79932
102	.83438	.83110	.82785	.82462	.82142	.81826	.81512	.81200	.80892	.80586

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

Age	Interest rate									
	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
103	.84056	.83737	.83420	.83106	.82795	.82487	.82181	.81878	.81577	.81279
104	.84743	.84433	.84127	.83822	.83521	.83221	.82924	.82630	.82338	.82048
105	.85591	.85295	.85001	.84709	.84419	.84132	.83846	.83563	.83282	.83003
106	.86816	.86540	.86266	.85993	.85723	.85454	.85187	.84922	.84659	.84397
107	.88592	.88348	.88105	.87863	.87623	.87384	.87147	.86911	.86676	.86443
108	.91493	.91306	.91119	.90934	.90749	.90566	.90383	.90201	.90020	.89840
109	.96211	.96125	.96041	.95956	.95872	.95788	.95704	.95620	.95537	.95455

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS

[Applicable after April 30, 1989]

Age	Interest rate									
	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
0	.01891	.01864	.01838	.01814	.01791	.01770	.01750	.01732	.01715	.01698
1	.00770	.00741	.00715	.00690	.00667	.00646	.00626	.00608	.00590	.00574
2	.00751	.00721	.00693	.00667	.00643	.00620	.00600	.00580	.00562	.00544
3	.00760	.00728	.00699	.00671	.00646	.00622	.00600	.00579	.00560	.00541
4	.00786	.00752	.00721	.00692	.00665	.00639	.00616	.00594	.00573	.00554
5	.00824	.00788	.00755	.00724	.00695	.00668	.00643	.00620	.00598	.00578
6	.00869	.00832	.00796	.00764	.00733	.00705	.00678	.00654	.00630	.00608
7	.00923	.00883	.00846	.00811	.00779	.00749	.00720	.00694	.00669	.00646
8	.00986	.00943	.00904	.00867	.00833	.00801	.00771	.00743	.00716	.00692
9	.01059	.01014	.00972	.00933	.00897	.00863	.00831	.00801	.00773	.00747
10	.01142	.01095	.01051	.01009	.00971	.00935	.00901	.00869	.00840	.00812
11	.01239	.01189	.01142	.01098	.01057	.01019	.00983	.00950	.00918	.00889
12	.01345	.01292	.01243	.01197	.01154	.01113	.01075	.01040	.01007	.00975
13	.01457	.01401	.01349	.01300	.01255	.01212	.01172	.01135	.01100	.01067
14	.01567	.01508	.01453	.01402	.01354	.01309	.01267	.01227	.01190	.01155
15	.01672	.01610	.01552	.01498	.01448	.01400	.01356	.01314	.01275	.01238
16	.01772	.01707	.01646	.01589	.01536	.01486	.01439	.01396	.01354	.01315
17	.01866	.01798	.01734	.01674	.01618	.01566	.01516	.01470	.01427	.01386
18	.01958	.01886	.01818	.01755	.01697	.01641	.01590	.01541	.01495	.01452
19	.02050	.01974	.01903	.01837	.01775	.01717	.01662	.01611	.01563	.01517
20	.02143	.02064	.01989	.01919	.01854	.01793	.01735	.01681	.01630	.01582
21	.02238	.02154	.02075	.02002	.01933	.01868	.01807	.01750	.01696	.01646
22	.02336	.02247	.02164	.02087	.02014	.01946	.01882	.01821	.01764	.01711
23	.02438	.02345	.02257	.02176	.02099	.02027	.01959	.01895	.01835	.01778
24	.02550	.02451	.02359	.02273	.02192	.02115	.02044	.01976	.01913	.01853
25	.02673	.02569	.02472	.02381	.02295	.02214	.02138	.02067	.01999	.01936
26	.02811	.02701	.02598	.02502	.02411	.02326	.02246	.02170	.02098	.02031
27	.02965	.02849	.02741	.02639	.02543	.02452	.02367	.02287	.02211	.02140
28	.03134	.03013	.02898	.02790	.02689	.02593	.02503	.02418	.02338	.02262
29	.03322	.03193	.03072	.02958	.02851	.02750	.02654	.02564	.02479	.02398
30	.03527	.03391	.03264	.03143	.03030	.02923	.02821	.02726	.02635	.02550
31	.03753	.03610	.03475	.03348	.03228	.03115	.03008	.02907	.02811	.02720
32	.04000	.03849	.03707	.03573	.03446	.03326	.03213	.03105	.03004	.02907
33	.04269	.04111	.03961	.03819	.03685	.03558	.03438	.03325	.03217	.03115
34	.04561	.04394	.04236	.04087	.03946	.03812	.03685	.03565	.03451	.03342
35	.04877	.04702	.04535	.04378	.04229	.04087	.03953	.03826	.03706	.03591
36	.05215	.05031	.04856	.04690	.04533	.04384	.04242	.04108	.03980	.03859
37	.05578	.05384	.05200	.05025	.04860	.04703	.04553	.04411	.04276	.04148
38	.05965	.05761	.05568	.05385	.05211	.05045	.04888	.04738	.04595	.04460
39	.06379	.06165	.05962	.05770	.05587	.05412	.05247	.05089	.04939	.04795
40	.06820	.06596	.06383	.06181	.05989	.05806	.05631	.05465	.05307	.05155
41	.07288	.07054	.06832	.06620	.06418	.06226	.06042	.05868	.05701	.05541
42	.07784	.07539	.07306	.07085	.06873	.06671	.06479	.06295	.06119	.05952
43	.08308	.08052	.07808	.07576	.07355	.07143	.06941	.06748	.06564	.06387
44	.08861	.08594	.08340	.08097	.07865	.07644	.07432	.07230	.07036	.06851
45	.09445	.09167	.08901	.08648	.08406	.08174	.07953	.07741	.07538	.07343
46	.10060	.09770	.09494	.09230	.08977	.08735	.08503	.08281	.08068	.07865
47	.10707	.10406	.10119	.09843	.09579	.09327	.09085	.08853	.08630	.08417
48	.11386	.11073	.10774	.10487	.10213	.09949	.09697	.09455	.09222	.08999
49	.12094	.11769	.11458	.11160	.10874	.10600	.10337	.10084	.09842	.09609
50	.12831	.12494	.12172	.11862	.11565	.11280	.11006	.10743	.10490	.10247
51	.13600	.13251	.12917	.12596	.12288	.11991	.11706	.11432	.11169	.10915
52	.14405	.14044	.13698	.13366	.13046	.12738	.12442	.12157	.11883	.11619

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

Age	Interest rate									
	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
53	.15247	.14875	.14517	.14172	.13841	.13522	.13215	.12919	.12635	.12360
54	.16124	.15740	.15370	.15014	.14671	.14341	.14023	.13717	.13421	.13136
55	.17039	.16642	.16261	.15893	.15539	.15198	.14868	.14551	.14244	.13948
56	.17991	.17583	.17190	.16811	.16445	.16092	.15752	.15423	.15106	.14799
57	.18984	.18564	.18160	.17769	.17392	.17029	.16677	.16338	.16010	.15692
58	.20018	.19587	.19172	.18770	.18382	.18007	.17645	.17295	.16956	.16628
59	.21093	.20652	.20225	.19812	.19414	.19028	.18655	.18294	.17945	.17606
60	.22206	.21753	.21316	.20893	.20483	.20087	.19703	.19332	.18972	.18624
61	.23353	.22890	.22442	.22009	.21589	.21182	.20788	.20407	.20037	.19678
62	.24532	.24059	.23601	.23158	.22728	.22311	.21907	.21515	.21135	.20767
63	.25742	.25260	.24793	.24339	.23900	.23473	.23060	.22658	.22268	.21890
64	.26987	.26495	.26019	.25556	.25107	.24671	.24248	.23837	.23438	.23050
65	.28271	.27771	.27286	.26815	.26357	.25912	.25480	.25059	.24651	.24254
66	.29601	.29093	.28600	.28120	.27654	.27200	.26760	.26331	.25913	.25507
67	.30978	.30462	.29961	.29474	.29000	.28539	.28090	.27653	.27227	.26813
68	.32401	.31879	.31371	.30877	.30396	.29927	.29471	.29027	.28593	.28171
69	.33863	.33336	.32822	.32322	.31835	.31359	.30896	.30445	.30005	.29576
70	.35361	.34829	.34310	.33804	.33311	.32830	.32361	.31903	.31457	.31021
71	.36886	.36349	.35826	.35316	.34818	.34332	.33858	.33394	.32942	.32500
72	.38439	.37899	.37373	.36858	.36356	.35866	.35387	.34919	.34461	.34015
73	.40021	.39479	.38950	.38432	.37927	.37433	.36950	.36478	.36016	.35565
74	.41639	.41096	.40565	.40046	.39538	.39042	.38556	.38081	.37616	.37161
75	.43301	.42758	.42226	.41706	.41198	.40699	.40212	.39734	.39267	.38809
76	.45009	.44467	.43937	.43417	.42908	.42410	.41921	.41443	.40974	.40514
77	.46761	.46221	.45693	.45175	.44667	.44170	.43682	.43203	.42734	.42274
78	.48548	.48013	.47488	.46973	.46468	.45972	.45486	.45009	.44541	.44082
79	.50356	.49826	.49306	.48795	.48294	.47802	.47319	.46845	.46379	.45922
80	.52171	.51647	.51133	.50628	.50132	.49644	.49166	.48695	.48233	.47779
81	.53974	.53457	.52950	.52451	.51961	.51479	.51006	.50541	.50083	.49633
82	.55753	.55245	.54745	.54254	.53771	.53296	.52828	.52369	.51917	.51472
83	.57500	.57001	.56510	.56026	.55551	.55083	.54623	.54170	.53724	.53285
84	.59216	.58726	.58245	.57770	.57304	.56844	.56391	.55945	.55506	.55074
85	.60906	.60428	.59956	.59492	.59034	.58583	.58139	.57702	.57270	.56845
86	.62555	.62088	.61627	.61173	.60725	.60284	.59849	.59420	.58997	.58580
87	.64139	.63683	.63233	.62790	.62352	.61921	.61495	.61076	.60661	.60253
88	.65666	.65221	.64783	.64350	.63923	.63502	.63086	.62675	.62270	.61871
89	.67163	.66730	.66304	.65882	.65466	.65055	.64650	.64249	.63854	.63463
90	.68646	.68226	.67812	.67402	.66998	.66599	.66204	.65814	.65430	.65049
91	.70093	.69686	.69285	.68888	.68496	.68108	.67725	.67347	.66973	.66604
92	.71466	.71073	.70684	.70300	.69920	.69545	.69173	.68806	.68444	.68085
93	.72750	.72370	.71994	.71622	.71254	.70890	.70530	.70174	.69822	.69474
94	.73931	.73562	.73198	.72838	.72481	.72129	.71780	.71434	.71093	.70755
95	.75001	.74644	.74291	.73941	.73595	.73253	.72914	.72579	.72247	.71919
96	.75953	.75606	.75262	.74923	.74586	.74253	.73924	.73598	.73275	.72955
97	.76819	.76481	.76147	.75816	.75489	.75165	.74844	.74526	.74211	.73899
98	.77599	.77270	.76944	.76621	.76302	.75986	.75672	.75362	.75054	.74750
99	.78319	.77998	.77680	.77365	.77053	.76744	.76437	.76134	.75833	.75535
100	.78987	.78673	.78362	.78054	.77748	.77446	.77146	.76849	.76555	.76263
101	.79622	.79315	.79010	.78708	.78409	.78113	.77819	.77528	.77239	.76953
102	.80283	.79983	.79685	.79390	.79097	.78807	.78519	.78234	.77951	.77671
103	.80983	.80690	.80399	.80111	.79825	.79541	.79260	.78981	.78705	.78430
104	.81760	.81475	.81192	.80912	.80633	.80357	.80083	.79810	.79541	.79273
105	.82726	.82451	.82178	.81907	.81638	.81371	.81106	.80843	.80582	.80322
106	.84137	.83879	.83623	.83368	.83115	.82863	.82614	.82366	.82119	.81874
107	.86211	.85981	.85751	.85523	.85297	.85071	.84847	.84624	.84403	.84182
108	.89660	.89481	.89304	.89127	.88950	.88775	.88601	.88427	.88254	.88081
109	.95372	.95290	.95208	.95126	.95045	.94964	.94883	.94803	.94723	.94643

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS

[Applicable after April 30, 1989]

Age	Interest rate									
	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
0	.01683	.01669	.01655	.01642	.01630	.01618	.01607	.01596	.01586	.01576
1	.00559	.00544	.00531	.00518	.00506	.00494	.00484	.00473	.00464	.00454
2	.00528	.00513	.00499	.00485	.00473	.00461	.00449	.00439	.00428	.00419

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

Age	Interest rate									
	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
3	.00524	.00508	.00493	.00479	.00465	.00453	.00441	.00429	.00419	.00408
4	.00536	.00519	.00503	.00488	.00473	.00460	.00447	.00435	.00423	.00412
5	.00558	.00540	.00523	.00507	.00492	.00477	.00464	.00451	.00439	.00427
6	.00588	.00569	.00550	.00533	.00517	.00502	.00487	.00473	.00460	.00448
7	.00624	.00604	.00584	.00566	.00549	.00532	.00517	.00502	.00488	.00475
8	.00668	.00646	.00626	.00606	.00588	.00570	.00554	.00538	.00523	.00509
9	.00722	.00699	.00677	.00656	.00636	.00617	.00600	.00583	.00567	.00552
10	.00785	.00761	.00737	.00715	.00694	.00674	.00655	.00637	.00620	.00604
11	.00861	.00835	.00810	.00786	.00764	.00743	.00723	.00704	.00686	.00668
12	.00946	.00918	.00891	.00866	.00843	.00820	.00799	.00779	.00760	.00741
13	.01035	.01006	.00978	.00951	.00927	.00903	.00880	.00859	.00839	.00819
14	.01122	.01091	.01061	.01034	.01007	.00982	.00958	.00936	.00914	.00894
15	.01203	.01171	.01140	.01110	.01082	.01056	.01031	.01007	.00985	.00963
16	.01279	.01244	.01211	.01181	.01151	.01123	.01097	.01072	.01048	.01025
17	.01347	.01311	.01276	.01244	.01213	.01184	.01156	.01130	.01104	.01081
18	.01411	.01373	.01336	.01302	.01270	.01239	.01210	.01182	.01155	.01130
19	.01474	.01434	.01396	.01359	.01325	.01293	.01262	.01233	.01205	.01178
20	.01537	.01494	.01454	.01415	.01379	.01345	.01313	.01282	.01252	.01224
21	.01598	.01553	.01510	.01470	.01432	.01396	.01361	.01329	.01298	.01268
22	.01660	.01613	.01568	.01525	.01485	.01446	.01410	.01375	.01343	.01312
23	.01725	.01674	.01627	.01581	.01539	.01498	.01460	.01423	.01388	.01355
24	.01796	.01742	.01692	.01644	.01599	.01556	.01515	.01476	.01439	.01404
25	.01876	.01819	.01765	.01714	.01666	.01621	.01577	.01536	.01497	.01460
26	.01967	.01907	.01850	.01796	.01745	.01696	.01650	.01606	.01565	.01525
27	.02072	.02008	.01948	.01890	.01836	.01784	.01735	.01688	.01644	.01601
28	.02190	.02122	.02057	.01996	.01938	.01883	.01831	.01781	.01734	.01689
29	.02322	.02249	.02181	.02116	.02054	.01996	.01940	.01887	.01836	.01788
30	.02469	.02392	.02319	.02250	.02184	.02122	.02062	.02006	.01952	.01900
31	.02634	.02552	.02475	.02401	.02331	.02264	.02201	.02140	.02083	.02028
32	.02816	.02729	.02647	.02568	.02494	.02423	.02355	.02291	.02229	.02170
33	.03018	.02926	.02838	.02755	.02675	.02600	.02528	.02459	.02393	.02331
34	.03239	.03142	.03048	.02960	.02875	.02795	.02718	.02645	.02575	.02508
35	.03482	.03378	.03279	.03185	.03095	.03009	.02928	.02850	.02775	.02704
36	.03743	.03633	.03528	.03428	.03333	.03242	.03155	.03072	.02992	.02916
37	.04026	.03909	.03798	.03692	.03591	.03494	.03401	.03313	.03228	.03147
38	.04330	.04207	.04089	.03977	.03869	.03767	.03668	.03574	.03484	.03398
39	.04658	.04528	.04403	.04284	.04170	.04061	.03957	.03857	.03762	.03670
40	.05011	.04873	.04741	.04615	.04495	.04379	.04269	.04163	.04061	.03964
41	.05389	.05244	.05104	.04971	.04844	.04721	.04604	.04492	.04384	.04281
42	.05791	.05638	.05491	.05350	.05216	.05086	.04962	.04844	.04729	.04620
43	.06219	.06057	.05902	.05754	.05612	.05475	.05344	.05218	.05098	.04981
44	.06673	.06503	.06340	.06184	.06034	.05890	.05752	.05619	.05491	.05368
45	.07157	.06978	.06806	.06642	.06484	.06332	.06186	.06046	.05911	.05781
46	.07669	.07481	.07301	.07128	.06962	.06802	.06649	.06501	.06358	.06221
47	.08212	.08015	.07826	.07645	.07470	.07302	.07140	.06984	.06834	.06690
48	.08784	.08578	.08380	.08190	.08006	.07830	.07660	.07496	.07338	.07186
49	.09384	.09169	.08961	.08762	.08570	.08384	.08206	.08034	.07868	.07708
50	.10013	.09787	.09570	.09361	.09160	.08966	.08779	.08598	.08424	.08256
51	.10671	.10436	.10209	.09991	.09780	.09577	.09381	.09192	.09009	.08832
52	.11365	.11120	.10883	.10655	.10435	.10222	.10017	.09819	.09628	.09442
53	.12095	.11840	.11593	.11355	.11126	.10904	.10689	.10482	.10282	.10088
54	.12860	.12595	.12338	.12090	.11851	.11619	.11396	.11179	.10970	.10767
55	.13663	.13386	.13120	.12862	.12613	.12372	.12138	.11912	.11694	.11482
56	.14503	.14217	.13940	.13672	.13413	.13162	.12919	.12683	.12456	.12235
57	.15385	.15089	.14801	.14523	.14254	.13994	.13741	.13496	.13259	.13029
58	.16311	.16004	.15706	.15418	.15139	.14868	.14606	.14352	.14105	.13866
59	.17279	.16961	.16654	.16355	.16066	.15786	.15514	.15250	.14994	.14745
60	.18286	.17958	.17640	.17332	.17033	.16743	.16462	.16188	.15922	.15664
61	.19330	.18992	.18665	.18347	.18038	.17738	.17447	.17164	.16889	.16622
62	.20409	.20061	.19724	.19396	.19078	.18768	.18467	.18175	.17891	.17614
63	.21522	.21165	.20818	.20480	.20152	.19833	.19523	.19221	.18928	.18642
64	.22672	.22306	.21949	.21602	.21265	.20937	.20617	.20306	.20003	.19708
65	.23867	.23491	.23125	.22769	.22423	.22085	.21757	.21437	.21125	.20821
66	.25112	.24727	.24353	.23988	.23632	.23286	.22948	.22619	.22299	.21986
67	.26409	.26016	.25633	.25260	.24896	.24541	.24195	.23857	.23528	.23206
68	.27760	.27359	.26968	.26586	.26214	.25851	.25497	.25151	.24814	.24484
69	.29157	.28748	.28350	.27961	.27581	.27211	.26849	.26495	.26150	.25812
70	.30596	.30181	.29775	.29379	.28992	.28614	.28245	.27884	.27532	.27187
71	.32069	.31648	.31236	.30833	.30440	.30055	.29679	.29312	.28952	.28600

TABLE S.—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

Age	Interest rate									
	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
72	.33578	.33151	.32733	.32325	.31925	.31535	.31152	.30778	.30412	.30054
73	.35123	.34691	.34269	.33855	.33450	.33054	.32666	.32286	.31914	.31550
74	.36715	.36279	.35852	.35434	.35024	.34623	.34230	.33845	.33468	.33098
75	.38360	.37921	.37491	.37069	.36656	.36250	.35853	.35464	.35082	.34708
76	.40064	.39623	.39190	.38765	.38349	.37941	.37540	.37148	.36762	.36384
77	.41823	.41381	.40947	.40521	.40103	.39692	.39290	.38895	.38507	.38126
78	.43632	.43189	.42755	.42329	.41910	.41499	.41095	.40698	.40309	.39926
79	.45473	.45032	.44599	.44173	.43755	.43344	.42940	.42543	.42153	.41770
80	.47333	.46894	.46463	.46040	.45623	.45213	.44811	.44414	.44025	.43642
81	.49191	.48755	.48328	.47907	.47493	.47085	.46684	.46290	.45902	.45520
82	.51034	.50603	.50179	.49762	.49351	.48947	.48549	.48157	.47772	.47392
83	.52852	.52427	.52008	.51595	.51189	.50788	.50394	.50006	.49623	.49246
84	.54648	.54228	.53815	.53407	.53006	.52610	.52221	.51836	.51458	.51084
85	.56426	.56013	.55606	.55205	.54810	.54420	.54035	.53656	.53282	.52913
86	.58169	.57764	.57364	.56970	.56581	.56197	.55818	.55445	.55076	.54713
87	.59850	.59452	.59060	.58673	.58291	.57913	.57541	.57174	.56811	.56453
88	.61476	.61086	.60702	.60322	.59947	.59577	.59212	.58851	.58494	.58142
89	.63078	.62697	.62321	.61950	.61583	.61220	.60862	.60508	.60159	.59813
90	.64674	.64302	.63935	.63573	.63215	.62861	.62511	.62165	.61823	.61485
91	.66238	.65877	.65520	.65167	.64819	.64474	.64133	.63795	.63462	.63132
92	.67730	.67379	.67032	.66689	.66350	.66014	.65682	.65354	.65029	.64708
93	.69130	.68789	.68452	.68119	.67789	.67463	.67140	.66820	.66504	.66191
94	.70421	.70090	.69762	.69438	.69118	.68800	.68486	.68175	.67867	.67563
95	.71594	.71272	.70954	.70639	.70326	.70017	.69712	.69409	.69109	.68812
96	.72638	.72325	.72014	.71707	.71403	.71101	.70803	.70507	.70215	.69925
97	.73590	.73285	.72982	.72682	.72385	.72090	.71799	.71510	.71224	.70941
98	.74448	.74149	.73853	.73560	.73269	.72981	.72696	.72414	.72134	.71856
99	.75240	.74948	.74658	.74371	.74086	.73805	.73525	.73248	.72974	.72702
100	.75974	.75687	.75403	.75121	.74842	.74566	.74292	.74020	.73751	.73484
101	.76669	.76388	.76109	.75833	.75559	.75287	.75018	.74751	.74486	.74223
102	.77393	.77117	.76844	.76573	.76304	.76037	.75773	.75511	.75251	.74993
103	.78158	.77888	.77620	.77355	.77091	.76830	.76571	.76313	.76058	.75805
104	.79007	.78743	.78482	.78222	.77964	.77709	.77455	.77203	.76953	.76705
105	.80065	.79809	.79556	.79304	.79054	.78805	.78559	.78314	.78071	.77829
106	.81631	.81389	.81149	.80911	.80674	.80438	.80204	.79972	.79741	.79511
107	.83963	.83745	.83529	.83313	.83099	.82886	.82674	.82463	.82254	.82045
108	.87910	.87739	.87569	.87400	.87232	.87064	.86897	.86731	.86566	.86401
109	.94563	.94484	.94405	.94326	.94248	.94170	.94092	.94014	.93937	.93860

(f) *Effective date.* This section is effective as of May 1, 1989.

[T.D. 7105, 36 FR 6480, Apr. 6, 1971; 36 FR 9512, May 26, 1971; 36 FR 12290, June 30, 1971, as amended by T.D. 7955, 49 FR 19976, May 11, 1984; T.D. 8540, 59 FR 30105, June 10, 1994]

§1.642(c)–7 Transitional rules with respect to pooled income funds.

(a) *In general*—(1) *Amendment of certain funds.* A fund created before May 7, 1971, and not otherwise qualifying as a pooled income fund may be treated as a pooled income fund to which §1.642(c)–5 applies if on July 31, 1969, or on each date of transfer of property to the fund occurring after July 31, 1969, it possessed the initial characteristics described in paragraph (b) of this section and is amended, in the time and manner provided in paragraph (c) of this section, to meet all the requirements of section 642(c)(5) and §1.642(c)–5. If a fund to which this subparagraph applies is amended in the time and manner provided in paragraph (c) of this section it shall be treated as provided in paragraph (d) of this section for the period beginning on August 1, 1969, or, if later, on the date of its creation and ending the day before the date on which it meets the requirements of section 642(c)(5) and §1.642(c)–5.

(2) *Severance of a portion of a fund.* Any portion of a fund created before May 7, 1971, which consists of property transferred to such fund after July 31, 1969, may be severed from such fund consistently with the principles of paragraph (c)(2) of this section and established before January 1, 1972, as a separate pooled income fund, provided

that on and after the date of severance the severed fund meets all the requirements of section 642(c)(5) and § 1.642(c)–5. A separate fund which is established pursuant to this subparagraph shall be treated as provided in paragraph (d) of this section for the period beginning on the day of the first transfer of property which becomes part of the separate fund and ending the day before the day on which the separate fund meets the requirements of section 642(c)(5) and § 1.642(c)–5.

(b) *Initial characteristics required.* A fund described in paragraph (a)(1) of this section shall not be treated as a pooled income fund to which section 642(c)(5) applies, even though it is amended as provided in paragraph (c) of this section, unless it possessed the following characteristics on July 31, 1969, or on each date of transfer of property to the fund occurring after July 31, 1969:

(1) It satisfied the requirements of section 642(c)(5)(A) other than that the fund be a trust;

(2) It was constituted in a way to attract and contain commingled properties transferred to the fund by more than one donor satisfying such requirements; and

(3) Each beneficiary of a life income interest which was retained or created in any property transferred to the fund was entitled to receive, but not less often than annually, a proportional share of the annual income earned by the fund, such share being based on the fair market value of the property in which such life interest was retained or created.

(c) *Amendment requirements.* (1) A fund described in paragraph (a)(1) of this section and possessing the initial characteristics described in paragraph (b) of this section on the date prescribed therein shall be treated as a pooled income fund if it is amended to meet all the requirements of section 642(c)(5) and § 1.642(c)–5 before January 1, 1972, or, if later, on or before the 30th day after the date on which any judicial proceedings commenced before January 1, 1972, which are required to amend its governing instrument or any other instrument which does not permit it to meet such requirements, become final. However, see paragraph (d) of this section for limitation on the period in which a claim for credit or refund may be filed.

(2) In addition, if the transferred property described in paragraph (b)(2) of this section is commingled with other property, the transferred property must be separated on or before the date specified in subparagraph (1) of this paragraph from the other property and allocated to the fund in accordance with the transferred property's percentage share of the fair market value of the total commingled property on the date of separation. The percentage share shall be the ratio which the fair market value of the transferred property on the date of separation bears to the fair market value of the total commingled property on that date and shall be computed in a manner consistent with paragraph (c) of § 1.642(c)–5. The property which is so allocated to the fund shall be treated as property received from transfers which meet the requirements of section 642(c)(5), and such transfers shall be treated as made on the dates on which the properties giving rise to such allocation were transferred to the fund by the respective donors. The property so allocated to the fund must be representative of all the commingled property other than securities the income from which is exempt from tax under subtitle A of the Code; compensating increases in other commingled property allocated to the fund shall be made where such tax-exempt securities are not allocated to the fund. The application of this subparagraph may be illustrated by the following example:

Example. (a) The trustees of X fund are in the process of amending it in order to qualify as a pooled income fund. The property transferred to the X fund was commingled with other property transferred to the organization by which the fund was established. After taking into account the various transfers and the appreciation in the fair market value of all the properties, the fair market value of the property allocated to the fund on the various transfer dates is set forth in the following schedule and determined in the manner indicated:

TRANSFERS

Date of transfer	Value of all property before transfer	Trust property	Other property	Value of all property after transfer	Property allocated to fund
	(1)	(2)	(3)	(4)	(5)
January 1, 1968	....	$100,000	$100,000	$200,000	[1]$100,000
September 30, 1968	$300,000	100,000	....	400,000	[2]250,000
January 15, 1969	480,000	60,000	....	540,000	[3]360,000
November 11, 1969	600,000	200,000	....	800,000	[4]600,000

[1] $100,000=(the amount in column (2)).

[2] $250,000=([$100,000/$200,000×$300,000]+$100,000).

[3] $360,000=([$250,000/$400,000×$480,000]+$60,000).

[4] $600,000=([$360,000/$540,000×$600,000]+$200,000).

(b) On September 30, 1970, the trustees decide to separate the property of X fund from the other property. The fair market value of all the commingled property is $1 million on September 30, 1970, and there were no additional transfers to the fund after November 11, 1969. Accordingly, the fair market value of the property required to be allocated to X fund must be $750,000 ($600,000/$800,000×$1,000,000), and X fund's percentage share of the commingled property is 75 percent ($750,000/$1,000,000). Accordingly, assuming that the commingled property consists of Y stock with a fair market value of $800,000 and Z bonds with a fair market value of $200,000, there must be allocated to X fund at the close of September 30, 1970, Y stock with a value of $600,000 ($800,000×75%) and Z bonds with a value of $150,000 ($200,000×75%).

(d) *Transactions before amendment of or severance from fund.* (1) A fund which is amended pursuant to paragraph (c) of this section, or is severed from a fund pursuant to paragraph (a)(2) of this section, shall be treated for all purposes, including the allowance of a deduction for any charitable contribution, as if it were before its amendment or severance a pooled income fund to which section 642(c)(5) and §1.642(c)–5 apply. Thus, for example, where a donor transferred property in trust to such an amended or severed fund on August 1, 1969, but before its amendment or severance under this section, a charitable contributions deduction for the value of the remainder interest may be allowed under section 170, 2055, 2106, or 2522. The deduction may not be allowed, however, until the fund is amended or severed pursuant to this section and shall be allowed only if a claim for credit or refund is filed within the period of limitation prescribed by section 6511(a).

(2) For purposes of determining under §1.642(c)–6 the highest yearly rate of return earned by a fund (which is amended pursuant to paragraph (c) of this section) for the 3 preceding taxable years, taxable years of the fund preceding its taxable year in which the fund is so amended and qualifies as a pooled income fund under this section shall be used provided that the fund did not at any time during such preceding years hold any investments in securities the income from which is exempt from tax under subtitle A of the Code. If any such tax-exempt securities were held during such period by such amended fund, or if the fund consists of a portion of a fund which is severed pursuant to paragraph (a)(2) of this section, the highest yearly rate of return under §1.642(c)–6 shall be determined by treating the fund as a pooled income fund which has been in existence for less than 3 taxable years preceding the taxable year in which the transfer of property to the fund is made.

(3) Property transferred to a fund before its amendment pursuant to paragraph (c) of this section, or before its severance under paragraph (a)(2) of this section, shall be treated as property received from transfers which meet the requirements of section 642(c)(5).

[T.D. 7105, 36 FR 6486, Apr. 6, 1971, as amended by T.D. 7125, 36 FR 11032, June 8, 1971; T.D. 8540, 59 FR 30102, June 10, 1994]

§1.642(d)–1 Net operating loss deduction.

The net operating loss deduction allowed by section 172 is available to estates and trusts generally, with the following exceptions and limitations:

(a) In computing gross income and deductions for the purposes of section 172, a trust shall exclude that portion of the income and deductions attributable to the grantor or another person under sections 671 through 678 (relating to grantors and others treated as substantial owners).

(b) An estate or trust shall not, for the purposes of section 172, avail itself of the deductions allowed by section 642(c) (relating to charitable contributions deductions) and sections 651 and 661 (relating to deductions for distributions).

§ 1.642(e)–1 Depreciation and depletion.

An estate or trust is allowed the deductions for depreciation and depletion, but only to the extent the deductions are not apportioned to beneficiaries under sections 167(h) and 611(b). For purposes of sections 167(h) and 611(b), the term *beneficiaries* includes charitable beneficiaries. See the regulations under those sections.

[T.D. 6712, 29 FR 3655, Mar. 24, 1964]

§ 1.642(f)–1 Amortization deductions.

An estate or trust is allowed amortization deductions with respect to an emergency facility as defined in section 168(d), with respect to a certified pollution control facility as defined in section 169(d), with respect to qualified railroad rolling stock as defined in section 184(d), with respect to certified coal mine safety equipment as defined in section 187(d), with respect to on-the-job training and child-care facilities as defined in section 188(b), and with respect to certain rehabilitations of certified historic structures as defined in section 191, in the same manner and to the same extent as in the case of an individual. However, the principles governing the apportionment of the deductions for depreciation and depletion between fiduciaries and the beneficiaries of an estate or trust (see sections 167(h) and 611(b) and the regulations thereunder) shall be applicable with respect to such amortization deductions.

[T.D. 7700, 45 FR 38055, June 6, 1980]

§ 1.642(g)–1 Disallowance of double deductions; in general.

Amounts allowable under section 2053(a)(2) (relating to administration expenses) or under section 2054 (relating to losses during administration) as deductions in computing the taxable estate of a decedent are not allowed as deductions in computing the taxable income of the estate unless there is filed a statement, in duplicate, to the effect that the items have not been allowed as deductions from the gross estate of the decedent under section 2053 or 2054 and that all rights to have such items allowed at any time as deductions under section 2053 or 2054 are waived. The statement should be filed with the return for the year for which the items are claimed as deductions or with the district director for the internal revenue district in which the return was filed, for association with the return. The statement may be filed at any time before the expiration of the statutory period of limitation applicable to the taxable year for which the deduction is sought. Allowance of a deduction in computing an estate's taxable income is not precluded by claiming a deduction in the estate tax return, so long as the estate tax deduction is not finally allowed and the statement is filed. However, after a statement is filed under section 642(g) with respect to a particular item or portion of an item, the item cannot thereafter be allowed as a deduction for estate tax purposes since the waiver operates as a relinquishment of the right to have the deduction allowed at any time under section 2053 or 2054.

§ 1.642(g)–2 Deductions included.

It is not required that the total deductions, or the total amount of any deduction, to which section 642(g) is applicable be treated in the same way. One deduction or portion of a deduction may be allowed for income tax purposes if the appropriate statement is filed, while another deduction or portion is allowed for estate tax purposes. Section 642(g) has no application to deductions for taxes, interest, business expenses, and other items accrued at the date of a decedent's death so that they are allowable as a deduction under section 2053(a)(3) for estate tax purposes as claims against the estate, and are also allowable under section 691(b) as deductions in respect of a decedent for income tax purposes. However, section 642(g) is applicable to deductions for interest, business expenses, and other items not accrued at the date of the decedent's death so that they are allowable as deductions for estate tax purposes only as administration expenses under section 2053(a)(2). Although deductible under section 2053(a)(3) in determining the value of the taxable estate of a decedent, medical, dental, etc., expenses of a decedent which are paid by the estate of the decedent are not deductible in computing the taxable income of the estate. See section 213(d) and the regulations thereunder for rules relating to the deductibility of such expenses in computing the taxable income of the decedent.

§1.642(h)–1 Unused loss carryovers on termination of an estate or trust.

(a) If, on the final termination of an estate or trust, a net operating loss carryover under section 172 or a capital loss carryover under section 1212 would be allowable to the estate or trust in a taxable year subsequent to the taxable year of termination but for the termination, the carryover or carryovers are allowed under section 642(h)(1) to the beneficiaries succeeding to the property of the estate or trust. See §1.641(b)–3 for the determination of when an estate or trust terminates.

(b) The net operating loss carryover and the capital loss carryover are the same in the hands of a beneficiary as in the estate or trust, except that the capital loss carryover in the hands of a beneficiary which is a corporation is a short-term loss irrespective of whether it would have been a long-term or short-term capital loss in the hands of the estate or trust. The net operating loss carryover and the capital loss carryover are taken into account in computing taxable income, adjusted gross income, and the tax imposed by section 56 (relating to the minimum tax for tax preferences). The first taxable year of the beneficiary to which the loss shall be carried over is the taxable year of the beneficiary in which or with which the estate or trust terminates. However, for purposes of determining the number of years to which a net operating loss, or a capital loss under paragraph (a) of §1.1212–1, may be carried over by a beneficiary, the last taxable year of the estate or trust (whether or not a short taxable year) and the first taxable year of the beneficiary to which a loss is carried over each constitute a taxable year, and, in the case of a beneficiary of an estate or trust that is a corporation, capital losses carried over by the estate or trust to any taxable year of the estate or trust beginning after December 31, 1963, shall be treated as if they were incurred in the last taxable year of the estate or trust (whether or not a short taxable year). For the treatment of the net operating loss carryover when the last taxable year of the estate or trust is the last taxable year to which such loss can be carried over, see §1.642(h)–2.

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

Example 1. A trust distributes all of its assets to A, the sole remainderman, and terminates on December 31, 1954, when it has a capital loss carryover of $10,000 attributable to transactions during the taxable year 1952. A, who reports on the calendar year basis, otherwise has ordinary income of $10,000 and capital gains of $4,000 for the taxable year 1954. A would offset his capital gains of $4,000 against the capital loss of the trust and, in addition, deduct under section 1211(b) $1,000 on his return for the taxable year 1954. The balance of the capital loss carryover of $5,000 may be carried over only to the years 1955 and 1956, in accordance with paragraph (a) of §1.1212–1 and the rules of this section.

Example 2. A trust distributes all of its assets, one-half to A, an individual, and one-half to X, a corporation, who are the sole remaindermen, and terminates on December 31, 1966, when it has a short-term capital loss carryover of $20,000 attributable to short-term transactions during the taxable years 1964, 1965, and 1966, and a long-term capital loss carryover of $12,000 attributable to long-term transactions during such years. A, who reports on the calendar year basis, otherwise has ordinary income of $15,000, short-term capital gains of $4,000 and long-term capital gains of $6,000, for the taxable year 1966. A would offset his short-term capital gains of $4,000 against his share of the short-term capital loss carryover of the trust, $10,000 (one-half of $20,000), and, in addition deduct under section 1211(b) $1,000 (treated as a short-term gain for purposes of computing capital loss carryovers) on his return for the taxable year 1966. A would also offset his long-term capital gains of $6,000 against his share of the long-term capital loss carryover of the trust, $6,000 (one-half of $12,000). The balance of A's share of the short-term capital loss carryover, $5,000, may be carried over as a short-term capital loss carryover to the succeeding taxable year and treated as a short-term capital loss incurred in such succeeding taxable year in accordance with paragraph (b) of § 1.1212–1. X, which also reports on the calendar year basis, otherwise has capital gains of $4,000 for the taxable year 1966. X would offset its capital gains of $4,000 against its share of the capital loss carryovers of the trust, $16,000 (the sum of one-half of each the short-term carryover and the long-term carryover of the trust), on its return for the taxable year 1966. The balance of X's share, $12,000, may be carried over as a short-term capital loss only to the years 1967, 1968, 1969, and 1970, in accordance with paragraph (a) of § 1.1212–1 and the rules of this section.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6828, 30 FR 7805, June 17, 1965; T.D. 7564, 43 FR 40495, Sept. 12, 1978]

§ 1.642(h)–2 Excess deductions on termination of an estate or trust.

(a) If, on the termination of an estate or trust, the estate or trust has for its last taxable year deductions (other than the deductions allowed under section 642(b) (relating to personal exemption) or section 642(c) (relating to charitable contributions)) in excess of gross income, the excess is allowed under section 642(h)(2) as a deduction to the beneficiaries succeeding to the property of the estate or trust. The deduction is allowed only in computing taxable income and must be taken into account in computing the items of tax preference of the beneficiary; it is not allowed in computing adjusted gross income. The deduction is allowable only in the taxable year of the beneficiary in which or with which the estate or trust terminates, whether the year of termination of the estate or trust is of normal duration or is a short taxable year. For example: Assume that a trust distributes all of its assets to B and terminates on December 31, 1954. As of that date it has excess deductions, for example, because of corpus commissions on termination, of $18,000. B, who reported on the calendar year basis, could claim the $18,000 as a deduction for the taxable year 1954. However, if the deduction (when added to his other deductions) exceeds his gross income, the excess may not be carried over to the year 1955 or subsequent years.

(b) A deduction based upon a net operating loss carryover will never be allowed to beneficiaries under both paragraphs (1) and (2) of section 642(h). Accordingly, a net operating loss deduction which is allowable to beneficiaries succeeding to the property of the estate or trust under the provisions of paragraph (1) of section 642(h) cannot also be considered a deduction for purposes of paragraph (2) of section 642(h) and paragraph (a) of this section. However, if the last taxable year of the estate or trust is the last year in which a deduction on account of a net operating loss may be taken, the deduction, to the extent not absorbed in that taxable year by the estate or trust, is considered an ''excess deduction'' under section 642(h)(2) and paragraph (a) of this section.

(c) Any item of income or deduction, or any part thereof, which is taken into account in determining the net operating loss or capital loss carryover of the estate or trust for its last taxable year shall not be taken into account again in determining excess deductions on termination of the trust or estate within the meaning of section 642(h)(2) and paragraph (a) of this section (see example in § 1.642(h)–5).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7564, 43 FR 40495, Sept. 12, 1978]

§ 1.642(h)–3 Meaning of "beneficiaries succeeding to the property of the estate or trust".

(a) The phrase *beneficiaries succeeding to the property of the estate or trust* means those beneficiaries upon termination of the estate or trust who bear the burden of any loss for which a carryover is allowed, or of any excess of deductions over gross income for which a deduction is allowed, under section 642(h).

(b) With reference to an intestate estate, the phrase means the heirs and next of kin to whom the estate is distributed, or if the estate is insolvent, to whom it would have been distributed if it had not been insolvent. If a decedent's spouse is entitled to a specified dollar amount of property before any distribution to other heirs and next of kin, and if the estate is less than that amount, the spouse is the beneficiary succeeding to the property of the estate or trust to the extent of the deficiency in amount.

(c) In the case of a testate estate, the phrase normally means the residuary beneficiaries (including a residuary trust), and not specific legatees or devisees, pecuniary legatees, or other nonresiduary beneficiaries. However, the phrase does not include the recipient of a specific sum of money even though it is payable out of the residue, except to the extent that it is not payable in full. On the other hand, the phrase includes a beneficiary (including a trust) who is not strictly a residuary beneficiary but whose devise or bequest is determined by the value of the decedent's estate as reduced by the loss or deductions in question. Thus the phrase includes:

(1) A beneficiary of a fraction of a decedent's net estate after payment of debts, expenses, etc.;

(2) A nonresiduary legatee or devisee, to the extent of any deficiency in his legacy or devise resulting from the insufficiency of the estate to satisfy it in full;

(3) A surviving spouse receiving a fractional share of an estate in fee under a statutory right of election, to the extent that the loss or deductions are taken into account in determining the share. However, the phrase does not include a recipient of dower or curtesy, or any income beneficiary of the estate or trust from which the loss or excess deduction is carried over.

(d) The principles discussed in paragraph (c) of this section are equally applicable to trust beneficiaries. A remainderman who receives all or a fractional share of the property of a trust as a result of the final termination of the trust is a beneficiary succeeding to the property of the trust. For example, if property is transferred to pay the income to A for life and then to pay $10,000 to B and distribute the balance of the trust corpus to C, C and not B is considered to be the succeeding beneficiary except to the extent that the trust corpus is insufficient to pay B $10,000.

§ 1.642(h)–4 Allocation.

The carryovers and excess deductions to which section 642(h) applies are allocated among the beneficiaries succeeding to the property of an estate or trust (see § 1.642(h)–3) proportionately according to the share of each in the burden of the loss or deductions. A person who qualified as a beneficiary succeeding to the property of an estate or trust with respect to one amount and does not qualify with respect to another amount is a beneficiary succeeding to the property of the estate or trust as to the amount with respect to which he qualifies. The application of this section may be illustrated by the following example:

Example. A decedent's will leaves $100,000 to A, and the residue of his estate equally to B and C. His estate is sufficient to pay only $90,000 to A, and nothing to B and C. There is an excess of deductions over gross income for the last taxable year of the estate or trust of $5,000, and a capital loss carryover of $15,000, to both of which section 642(h) applies. A is a beneficiary succeeding to the property of the estate to the extent of $10,000, and since the total of the excess of deductions and the loss carryover is $20,000, A is entitled to the benefit of one half of each item, and the remaining half is divided equally between B and C.

§ 1.642(h)–5 Example.

The application of section 642(h) may be illustrated by the following example:

Example. (a) A decedent dies January 31, 1954, leaving a will which provides for distributing all her estate equally to A and an existing trust for B. The period of administration of the estate terminates on December 31, 1954, at which time all the property of the estate is distributed to A and the trust. A reports his income for tax purposes on a calendar year basis, and the trust reports its income on the basis of a fiscal year ending August 31. During the period of the administration, the estate has the following items of income and deductions:

Taxable interest	$2,500
Business income	3,000
Total	5,500
Business expenses (including administrative expense allocable to business income)	5,000

Administrative expenses and corpus commissions not allocable to business income	9,800
Total deductions	14,800

It also has a capital loss of $5,000.

(b) Under section 642(h)(1), an unused net operating loss carryover of the estate on termination of $2,000 will be allowable to: A to the extent of $1,000 for his taxable year 1954 and the next four taxable years in accordance with section 172; and to the trust to the extent of $1,000 for its taxable year ending August 31, 1955, and its next four taxable years. The amount of the net operating loss carryover is computed as follows:

Deductions of estate for 1954	$14,800
Less adjustment under section 172(d)(4) (deductions not attributable to a trade or business ($9,800) allowable only to extent of gross income not derived from such trade or business ($2,500))	7,300
Deductions as adjusted	7,500
Gross income of estate for 1954	5,500
Net operating loss of estate for 1954	2,000
(No deduction for capital loss of $5,000 under section 172(d)(2))	

Neither A nor the trust will be allowed to carry back any part of the net operating loss made available to them under section 642(h)(1).

(c) Under section 642(h)(2), excess deductions of the estate of $7,300 will be allowed as a deduction to A to the extent of $3,650 for the calendar year 1954 and to the trust to the extent of $3,650 for the taxable year ending August 31, 1955. The deduction of $7,300 for administrative expenses and corpus commissions is the only amount which was not taken into account in determining the net operating loss of the estate ($9,800 of such expenses less $2,500 taken into account).

(d) Under section 642(h)(1), there will be allowable to A a capital loss carryover of $2,500 for his taxable year 1954 and for his next 4 taxable years in accordance with paragraph (a) of § 1.1212–1. There will be allowable to the trust a similar capital loss carryover of $2,500 for its taxable year ending August 31, 1955, and its next 4 taxable years (but see paragraph (b) of § 1.643(a)–3), (for taxable years beginning after December 31, 1963, net capital losses may be carried over indefinitely by beneficiaries other than corporations, in accordance with § 1.642(h)–1 and paragraph (b) of § 1.1212–1.)

(e) The carryovers and excess deductions are not allowable directly to B, the trust beneficiary, but to the extent the distributable net income of the trust is reduced by the carryovers and excess deductions B may receive indirect benefit.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6828, 30 FR 7806, June 17, 1965]

§ 1.642(i)–1 Certain distributions by cemetery perpetual care funds.

(a) *In general.* Section 642 (i) provides that amounts distributed during taxable years ending after December 31, 1963, by a cemetery perpetual care fund trust for the care and maintenance of gravesites shall be treated as distributions solely for purposes of sections 651 and 661. The deduction for such a distribution is allowable only if the fund is taxable as a trust. In addition, the fund must have been created pursuant to local law by a taxable cemetery corporation (as defined in § 1.642 (i)–2 (a)) expressly for the care and maintenance of cemetery property. A care fund will be treated as having been created by a taxable cemetery corporation (‘‘cemetery’’) if the distributee cemetery is taxable, even though the care fund was created by the distributee cemetery in a year that it was tax-exempt or by a predecessor of such distributee cemetery which was tax-exempt in the year the fund was established. The deduction is the amount of the distributions during the fund's taxable year to the cemetery corporation for such care and maintenance that would be otherwise allowable under section 651 or 661, but in no event is to exceed the limitations described in paragraphs (b) and (c) of this section. The provisions of this paragraph shall not have the effect of extending the period of limitations under section 6511.

(b) *Limitation on amount of deduction.* The deduction in any taxable year may not exceed the product of $5 multiplied by the aggregate number of gravesites sold by the cemetery corporation before the beginning of the taxable year of the trust. In general, the aggregate number of gravesites sold shall be the aggregate number of interment rights sold by the cemetery corporation (including gravesites sold by the cemetery before a care fund trust law was enacted). In addition, the number of gravesites sold shall include gravesites used to make welfare burials. Welfare burials and pre-trust fund law gravesites shall be included only to the extent that the cemetery cares for and maintain such gravesites. For purposes of this section, a gravesite is sold as of the date on which the purchaser acquires interment rights enforceable under local law. The aggregate number of gravesites includes only those gravesites with respect to which the fund or taxable cemetery corporation has an obligation for care and maintenance.

(c) *Requirements for deductibility of distributions for care and maintenance*—(1) *Obligation for care and maintenance.* A deduction is allowed only for distributions for the care and maintenance of gravesites with respect to which the fund or taxable cemetery corporation has an obligation for care and maintenance. Such obligation may be established by the trust instrument, by local law, or by the cemetery's practice of caring for and maintaining gravesites, such as welfare burial plots or gravesites sold before the enactment of a care fund trust law.

(2) *Distribution actually used for care and maintenance.* The amount of a deduction otherwise allowable for care fund distributions in any taxable year shall not exceed the portion of such distributions expended by the distributee cemetery corporation for the care and maintenance of gravesites before the end of the fund's taxable year following the taxable year in which it makes the distributions. A 6-month extension of time for filing the trust's return may be obtained upon request under section 6081. The failure of a cemetery to expend the care fund's distributions within a reasonable time before the due date for filing the return will be considered reasonable grounds for granting a 6-month extension of time for section 6081. For purposes of this paragraph, any amount expended by the care fund directly for the care and maintenance of gravesites shall be treated as an additional care fund distribution which is expended on the day of distribution by the cemetery corporation. The fund shall be allowed a deduction for such direct expenditure in the fund's taxable year during which the expenditure is made.

(3) *Example.* The application of paragraph (c)(2) of this section is illustrated by the following example:

A, a calendar-year perpetual care fund trust, meeting the requirements of section 642 (i), makes a $10,000 distribution on December 1, 1978 to X, a taxable cemetery corporation operating on a May 31 fiscal year. From this $10,000 distribution, the cemetery makes the following expenditures for the care and maintenance of gravesites: $2,000 on December 20, 1978; $4,000 on June 1, 1979; $2,000 on October 1, 1979; and $1,000 on April 1, 1980. In addition, as authorized by the trust instrument, A itself makes a direct $1,000 payment to a contractor on September 1, 1979 for qualifying care and maintenance work performed. As a result of these transactions, A will be allowed an $8,000 deduction for its 1978 taxable year attributable to the cemetery's expenditures, and a $1,000 deduction for its 1979 taxable year attributable to the fund's direct payment. A will not be allowed a deduction for its 1978 taxable year for the cemetery's expenditure of either the $1,000 expended on April 1, 1980 or the remaining unspent portion of the original $10,000 distribution. The trustee may request a 6-month extension in order to allow the fund until October 15, 1979 to file its return for 1978.

(d) *Certified statement made by cemetery officials to fund trustees.* A trustee of a cemetery perpetual care fund shall not be held personally liable for civil or criminal penalties resulting from false statements on the trust's tax return to the extent that such false statements resulted from the trustee's reliance on a certified statement made by the cemetery specifying the number of interments sold by the cemetery or the amount of the cemetery's expenditures for care and maintenance. The statement must indicate the basis upon which the cemetery determined what portion of its expenditures were made for the care and maintenance of gravesites. The statement must be certified by an officer or employee of the cemetery who has the responsibility to make or account for expenditures for care and maintenance. A copy of this statement shall be retained by the trustee along with the trust's return and shall be made available for inspection upon request by the Secretary. This paragraph does not relieve the care fund trust of its liability to pay the proper amount of tax due and to maintain adequate records to substantiate each of its deductions, including the deduction provided in section 642(i) and this section.

[T.D. 7651, 44 FR 61596, Oct. 26, 1979]

§ 1.642(i)–2 Definitions.

(a) *Taxable cemetery corporation.* For purposes of section 642(i) and this section, the meaning of the term *taxable cemetery corporation* is limited to a corporation (within the meaning of section 7701(a)(3)) engaged in the business of owning and operating a cemetery that either (1) is not exempt from Federal tax, or (2) is subject to tax under section 511 with respect to its cemetery activities.

(b) *Pursuant to local law.* A cemetery perpetual care fund is created pursuant to local law if:

(1) The governing law of the relevant jurisdiction (State, district, county, parish, etc.) requires or expressly permits the creation of such a fund, or

(2) The legally enforceable bylaws or contracts of a taxable cemetery corporation require a perpetual care fund.

(c) *Gravesite.* A gravesite is any type of interment right that has been sold by a cemetery, including, but not limited to, a burial lot, mausoleum, lawn crypt, niche, or scattering ground. For purposes of § 1.642 (i)–1, the term *gravesites* includes only those gravesites with respect to which the care fund or cemetery has an obligation for care and maintenance within the meaning of § 1.642 (i)–1(c)(1).

(d) *Care and maintenance.* For purposes of section 642(i) and this section, the term *care and maintenance of gravesite* shall be generally defined in accordance with the definition of such term under the local law pursuant to which the cemetery perpetual care fund is created. If the applicable local law contains no definition, care and maintenance of gravesites may include the upkeep, repair and preservation of those portions of cemetery property in which gravesites (as defined in paragraph (c) of this section) have been sold; including gardening, road maintenance, water line and drain repair and other activities reasonably necessary to the preservation of cemetery property. The costs for care and maintenance include, but are not limited to, expenditures for the maintenance, repair and replacement of machinery, tools, and equipment, compensation of employees performing such work, insurance premiums, reasonable payments for employees' pension and other benefit plans, and the costs of maintaining necessary records of lot ownership, transfers and burials. However, if some of the expenditures of the cemetery corporation, such as officers' salaries, are for both care and maintenance and for other purposes, the expenditures must be properly allocated between care and maintenance of gravesites and the other purposes. Only those expenditures that are properly allocable to those portions of cemetery property in which gravesites have been sold qualify as expenditures for care and maintenance of gravesites.

[T.D. 7651, 44 FR 61596, Oct. 26, 1979]

§ 1.643(a)–0 Distributable net income; deduction for distributions; in general.

The term *distributable net income* has no application except in the taxation of estates and trusts and their beneficiaries. It limits the deductions allowable to estates and trusts for amounts paid, credited, or required to be distributed to beneficiaries and is used to determine how much of an amount paid, credited, or required to be distributed to a beneficiary will be includible in his gross income. It is also used to determine the character of distributions to the beneficiaries. Distributable net income means for any taxable year, the taxable income (as defined in section 63) of the estate or trust, computed with the modifications set forth in §§ 1.643(a)–1 through 1.643(a)–7.

§ 1.643(a)–1 Deduction for distributions.

The deduction allowable to a trust under section 651 and to an estate or trust under section 661 for amounts paid, credited, or required to be distributed to beneficiaries is not allowed in the computation of distributable net income.

§1.643(a)–2 Deduction for personal exemption.

The deduction for personal exemption under section 642(b) is not allowed in the computation of distributable net income.

§1.643(a)–3 Capital gains and losses.

(a) Except as provided in §1.643(a)–6, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income, and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary unless they are:

(1) Allocated to income under the terms of the governing instrument or local law by the fiduciary on its books or by notice to the beneficiary,

(2) Allocated to corpus and actually distributed to beneficiaries during the taxable year, or

(3) Utilized (pursuant to the terms of the governing instrument or the practice followed by the fiduciary) in determining the amount which is distributed or required to be distributed.

However, if capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

(b) Losses from the sale or exchange of capital assets are excluded in computing distributable net income except to the extent that they enter into the determination of any capital gains that are paid, credited, or required to be distributed to any beneficiary during the taxable year (but see §1.642(h)–1 with respect to capital loss carryovers in the year of final termination of an estate or trust).

(c) The deduction under section 1202 (relating to capital gains) is taken into account in computing distributable net income to the extent that it is allocable to capital gains which are paid, permanently set aside, or to be used for the purposes specified in section 642(c). See the regulations under section 642(c) to determine the extent to which the amount so paid, permanently set aside, or to be used consists of capital gains. The deduction for capital gains provided in section 1202 insofar as it is allocable to the remainder of the capital gains is not taken into account.

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

Example 1. A trust is created to pay the income to A for life, with a discretionary power in the trustee to invade principal for A's benefit. In the taxable year, $10,000 is realized from the sale of securities at a profit, and $10,000 in excess of income is distributed to A. The capital gain is not allocated to A by the trustee. During the taxable year the trustee received and paid out $5,000 of dividends. No other cash was received or on hand during the taxable year. The capital gain will not ordinarily be included in distributable net income. However, if the trustee follows a regular practice of distributing the exact net proceeds of the sale of trust property, capital gains will be included in distributable net income.

Example 2. The result in example 1 would have been the same if the trustee had been directed to pay an annuity of $15,000 a year to A (instead of being directed to pay the income to A with a discretionary power to distribute principal).

Example 3. The trustee of a trust containing Blackacre and other property is directed to hold Blackacre for ten years, and then sell it and distribute its proceeds to A. Any capital gain realized from the sale of Blackacre will be included in distributable net income.

Example 4. A trust instrument directs that the income shall be paid to A, and that the principal shall be distributed to A when he reaches age 35. All capital gains realized in the year of termination will be included in distributable net income. (See §1.641(b)–3 for the determination of the year of final termination and the taxability of capital gains realized after the terminating event and before final distribution.)

Example 5. If in example 4 the trustee had been directed to distribute half of the principal to A when he reached 35, the capital gain would be included in distributable net income (and in the distribution to A) to the extent the capital gain is allocable to A under the governing instrument and local law. Thus, if the trust assets consisted entirely of 100 shares of corporation M stock and the trustee sold half the shares and distributed the proceeds to A, the entire capital gain would normally be considered as allocated to A. On the other hand, if the trustee sold all the shares and distributed half the proceeds to A, half the capital gain would be considered as allocable to A.

Example 6. If in example 4 the trustee had been directed to pay $10,000 to B before making distribution to A, no portion of the capital gains would be allocable to B since the distribution to B is a gift of a specific sum of money within the meaning of section 663(a)(1).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 731, Jan. 17, 1969; T.D. 7357, 40 FR 23742, June 2, 1975]

§ 1.643(a)–4 Extraordinary dividends and taxable stock dividends.

In the case solely of a trust which qualifies under subpart B (section 651 and following) as a ''simple trust,'' there are excluded from distributable net income extraordinary dividends (whether paid in cash or in kind) or taxable stock dividends which are not distributed or credited to a beneficiary because the fiduciary in good faith determines that under the terms of the governing instrument and applicable local law such dividends are allocable to corpus. See section 665(e), paragraph (b) of § 1.665(e)–1, and paragraph (b) of § 1.665(e)–1A for the treatment of such dividends upon subsequent distribution.

[T.D. 7204, 37 FR 17134, Aug. 25, 1972]

§ 1.643(a)–5 Tax-exempt interest.

(a) There is included in distributable net income any tax-exempt interest excluded from gross income under section 103, reduced by disbursements allocable to such interest which would have been deductible under section 212 but for the provisions of section 265 (relating to disallowance of deductions allocable to tax-exempt income).

(b) If the estate or trust is allowed a charitable contributions deduction under section 642(c), the amounts specified in paragraph (a) of this section and § 1.643(a)–6 are reduced by the portion deemed to be included in income paid, permanently set aside, or to be used for the purposes specified in section 642(c). If the governing instrument specifically provides as to the source out of which amounts are paid, permanently set aside, or to be used for such charitable purposes, the specific provisions control. In the absence of specific provisions in the governing instrument, an amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. For illustrations showing the determination of the character of an amount deductible under section 642(c), see examples 1 and 2 of § 1.662(b)–2 and paragraph (e) of § 1.662(c)–4.

§ 1.643(a)–6 Income of foreign trust.

(a) *Distributable net income of a foreign trust.* In the case of a foreign trust (see section 7701(a)(31)), the determination of distributable net income is subject to the following rules:

(1) There is included in distributable net income the amounts of gross income from sources without the United States, reduced by disbursements allocable to such foreign income which would have been deductible but for the provisions of section 265 (relating to disallowance of deductions allocable to tax exempt income). See paragraph (b) of § 1.643(a)–5 for rules applicable when an estate or trust is allowed a charitable contributions deduction under section 642(c).

(2) In the case of a distribution made by a trust before January 1, 1963, for purposes of determining the distributable net income of the trust for the taxable year in which the distribution is made, or for any prior taxable year;

(i) Gross income from sources within the United States is determined by taking into account the provisions of section 894 (relating to income exempt under treaty); and

(ii) Distributable net income is determined by taking into account the provisions of section 643(a)(3) (relating to exclusion of certain gains from the sale or exchange of capital assets).

(3) In the case of a distribution made by a trust after December 31, 1962, for purposes of determining the distributable net income of the trust for any taxable year, whether ending before January 1, 1963, or after December 31, 1962;

(i) Gross income (for the entire foreign trust) from sources within the United States is determined without regard to the provisions of section 894 (relating to income exempt under treaty);

(ii) In respect of a foreign trust created by a U.S. person (whether such trust constitutes the whole or only a portion of the entire foreign trust) (see section 643(d) and § 1.643(d)–1), there shall be included in gross income gains from the sale or exchange of capital assets reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges, and the deduction under section 1202 (relating to deduction for capital gains) shall not be taken into account; and

(iii) In respect of a foreign trust created by a person other than a U.S. person (whether such trust constitutes the whole or only a portion of the entire foreign trust) (see section 643(d) and §1.643(d)–1), distributable net income is determined by taking into account all of the provisions of section 643 except section 643(a)(6)(C) (relating to gains from the sale or exchange of capital assets by a foreign trust created by a U.S. person).

(b) *Examples.* The application of this section, showing the computation of distributable net income for one of the taxable years for which such a computation must be made, may be illustrated by the following examples:

Example 1. (1) A trust is created in 1952 under the laws of Country X by the transfer to a trustee in Country X of money and property by a U.S. person. The entire trust constitutes a foreign trust created by a U.S. person. The income from the trust corpus is to be accumulated until the beneficiary, a resident citizen of the United States who was born in 1944, reaches the age of 21 years, and upon his reaching that age, the corpus and accumulated income are to be distributed to him. The trust instrument provides that capital gains are to be allocated to corpus and are not to be paid, credited, or required to be distributed to any beneficiary during the taxable year or paid, permanently set aside, or to be used for the purposes specified in section 642(c). Under the terms of a tax convention between the United States and Country X, interest income received by the trust from U.S. sources is exempt from U.S. taxation. In 1965 the corpus and accumulated income are distributed to the beneficiary. During the taxable year 1964, the trust has the following items of income, loss, and expense:

Interest on bonds of a U.S. corporation	$10,000
Net long-term capital gain from U.S. sources	30,000
Gross income from investments in Country X	40,000
Net short-term capital loss from U.S. sources	5,000
Expenses allocable to gross income from investments in Country X	5,000

(2) The distributable net income for the taxable year 1964 of the foreign trust created by a U.S. person, determined under section 643(a), is $70,000, computed as follows:

Interest on bonds of a U.S. corporation		$10,000
Gross income from investments in Country X		40,000
Net long-term capital gain from U.S. sources	$30,000	
Less: Net short-term capital loss from U.S. sources	5,000	
Excess of net long-term capital gain over net short-term capital loss		25,000
Total		75,000
Less: Expenses allocable to income from investments in Country X		5,000
Distributable net income		70,000

(3) In determining the distributable net income of $70,000, the taxable income of the trust is computed with the following modifications: No deduction is allowed for the personal exemption of the trust (section 643(a)(2)); the interest received on bonds of a U.S. corporation is included in the trust gross income despite the fact that such interest is exempt from U.S. tax under the provisions of the tax treaty between Country X and the United States (section 643(a)(6) (see H. Con. Res. (B)); the excess of net long-term capital gain over net short-term capital loss allocable to corpus is included in distributable net income, but such excess is not subject to the deduction under section 1202 (section 643(a)(6)(C)); and the amount representing gross income from investments in Country X is included, but such amount is reduced by the amount of the disbursements allocable to such income (section 643(a)(6)(A)).

Example 2. (1) The facts are the same as in example 1 except that money or property has also been transferred to the trust by a person other than a U.S. person and, pursuant to the provisions of §1.643(d)–1, during 1964 only 60 percent of the entire trust constitutes a foreign trust created by a U.S. person.

(2) The distributable net income for the taxable year 1964 of the foreign trust created by a U.S. person, determined under section 643(a), is $42,000 computed as follows:

Interest on bonds of a U.S. corporation (60 percent of $10,000)		$6,000
Gross income from investments in Country X (60 percent of $40,000)		24,000
Net long-term capital gain from U.S. sources (60 percent of $30,000)	$18,000	
Less: Net short-term capital loss from U.S. sources (60 percent of $5,000)	3,000	
		15,000
Total		45,000
Less: Expenses allocable to income from investments in Country X (60 percent of $5,000)		3,000
Distributable net income		42,000

(3) The distributable net income for the taxable year 1964 of the portion of the entire foreign trust which does not constitute a foreign trust created by a U.S. person, determined under section 643(a), is $18,000, computed as follows:

Interest on bonds of a U.S. corporation (40 percent of $10,000)	$4,000
Gross income from investments in Country X (40 percent of $40,000)	16,000
Total	20,000
Less: Expenses allocable to income from investments in Country X (40 percent of $5,000)	2,000
Distributable net income	18,000

(4) The distributable net income of the entire foreign trust for the taxable year 1964 is $60,000, computed as follows:

Distributable net income of the foreign trust created by a U.S. person	$42,000
Distributable net income of that portion of the entire foreign trust which does not constitute a foreign trust created by a U.S. person	18,000
Distributable net income of the entire foreign trust	60,000

It should be noted that the difference between the $70,000 distributable net income of the foreign trust in example 1 and the $60,000 distributable net income of the entire foreign trust in this example is due to the $10,000 (40 percent of $25,000) net capital gain (capital gain net income for taxable years beginning after December 31, 1976) which under section 643(a)(3) is excluded from the distributable net income of that portion of the foreign trust in example 2 which does not constitute a foreign trust created by a U.S. person.

[T.D. 6989, 34 FR 731, Jan. 17, 1969, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.643(a)–7 Dividends.

Dividends excluded from gross income under section 116 (relating to partial exclusion of dividends received) are included in distributable net income. For this purpose, adjustments similar to those required by § 1.643(a)–5 with respect to expenses allocable to tax-exempt income and to income included in amounts paid or set aside for charitable purposes are not made. See the regulations under section 642(c).

[T.D. 7357, 40 FR 23742, June 2, 1975]

§ 1.643(b)–1 Definition of "income".

For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Code, the term *income* when not preceded by the words ''taxable'', ''distributable net'', ''undistributed net'', or ''gross'', means the amount of income of an estate or trust for the taxable year determined under the terms of its governing instrument and applicable local law. Trust provisions which depart fundamentally from concepts of local law in the determination of what constitutes income are not recognized for this purpose. For example, if a trust instrument directs that all the trust income shall be paid to A, but defines ordinary dividends and interest as corpus, the trust will not be considered one which under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to ''simple'' trusts).

§ 1.643(b)–2 Dividends allocated to corpus.

Extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law are not considered ''income'' for purposes of subpart A, B, C, or D, part I, subchapter J, chapter 1 of the Code. See section 643(a)(4), § 1.643(a)–4, § 1.643(d)–2, section 665(e), paragraph (b) of § 1.665(e)–1, and paragraph (b) of § 1.665(e)–1A for the treatment of such items in the computation of distributable net income.

[T.D. 7204, 37 FR 17134, Aug. 25, 1972]

§ 1.643(c)–1 Definition of "beneficiary".

An heir, legatee, or devisee (including an estate or trust) is a beneficiary. A trust created under a decedent's will is a beneficiary of the decedent's estate. The following persons are treated as beneficiaries:

(a) Any person with respect to an amount used to discharge or satisfy that person's legal obligation as that term is used in § 1.662(a)–4.

(b) The grantor of a trust with respect to an amount applied or distributed for the support of a dependent under the circumstances specified in section 677(b) out of corpus or out of other than income for the taxable year of the trust.

(c) The trustee or cotrustee of a trust with respect to an amount applied or distributed for the support of a dependent under the circumstances specified in section 678(c) out of corpus or out of other than income for the taxable year of the trust.

§1.643(d)–1 Definition of "foreign trust created by a United States person".

(a) *In general.* For the purpose of part I, subchapter J, chapter 1 of the Internal Revenue Code, the term *foreign trust created by a United States person* means that portion of a foreign trust (as defined in section 7701(a)(31)) attributable to money or property (including all accumulated earnings, profits, or gains attributable to such money or property) of a U.S. person (as defined in section 7701(a)(30)) transferred directly or indirectly, or under the will of a decedent who at the date of his death was a U.S. citizen or resident, to the foreign trust. A foreign trust created by a person who is not a U.S. person, to which a U.S. person transfers his money or property, is a foreign trust created by a U.S. person to the extent that the fair market value of the entire foreign trust is attributable to money or property of the U.S. person transferred to the foreign trust. The transfer of money or property to the foreign trust may be made either directly or indirectly by a U.S. person. Transfers of money or property to a foreign trust do not include transfers of money or property pursuant to a sale or exchange which is made for a full and adequate consideration. Transfers to which section 643(d) and this section apply are transfers of money or property which establish or increase the corpus of a foreign trust. The rules set forth in this section with respect to transfers by a U.S. person to a foreign trust also are applicable with respect to transfers under the will of a decedent who at the date of his death was a U.S. citizen or resident. For provisions relating to the information returns which are required to be filed with respect to the creation of or transfers to foreign trusts, see section 6048 and §16.3–1 of this chapter (Temporary Regulations under the Revenue Act of 1962).

(b) *Determination of a foreign trust created by a U.S. person*—(1) *Transfers of money or property only by a U.S. person.* If all the items of money or property constituting the corpus of a foreign trust are transferred to the trust by a U.S. person, the entire foreign trust is a foreign trust created by a U.S. person.

(2) *Transfers of money or property by both a U.S. person and a person other than a U.S. person; transfers required to be treated as separate funds.* Where there are transfers of money or property by both a U.S. person and a person other than a U.S. person to a foreign trust, and it is necessary, either by reason of the provisions of the governing instrument of the trust or by reason of some other requirement such as local law, that the trustee treat the entire foreign trust as composed of two separate funds, one consisting of the money or property (including all accumulated earnings, profits, or gains attributable to such money or property) transferred by the U.S. person and the other consisting of the money or property (including all accumulated earnings, profits, or gains attributable to such money or property) transferred by the person other than the U.S. person, the foreign trust created by a U.S. person shall be the fund consisting of the money or property transferred by the U.S. person. See example 1 in paragraph (c) of this section.

(3) *Transfers of money or property by both a U.S. person and a person other than a U.S. person; transfers not required to be treated as separate funds.* Where the corpus of a foreign trust consists of money or property transferred to the trust (simultaneously or at different times) by a U.S. person and by a person who is not a U.S. person, the foreign trust created by a U.S. person within the meaning of section 643(d) is that portion of the entire foreign trust which, immediately after any transfer of money or property to the trust, the fair market value of money or property (including all accumulated earnings, profits, or gains attributable to such money or property) transferred to the foreign trust by the U.S. person bears to the fair market value of the corpus (including all accumulated earnings, profits, or gains attributable to the corpus) of the entire foreign trust.

(c) *Examples.* The provisions of paragraph (b) of this section may be illustrated by the following examples. Example 1 illustrates the application of paragraph (b)(2) of this section. Example (2) illustrates the application of paragraph (b)(3) of this section in a case where there is no provision in the governing instrument of the trust or elsewhere which would require the trustee to treat the corpus of the trust as composed of more than one fund.

Example 1. On January 1, 1964, the date of the creation of a foreign trust, a U.S. person transfers to it stock of a U.S. corporation with a fair market value of $50,000. On the same day, a person other than a U.S. person transfers to the trust Country X bonds with a fair market value of $25,000. The governing instrument of the trust provides that the income from the stock of the U.S. corporation is to be accumulated until A, a U.S. beneficiary, reaches the age of 21 years, and upon his reaching that age, the stock and income accumulated thereon are to be distributed to him. The governing instrument of the trust further provides that the income from the Country X bonds is to be accumulated until B, a U.S. beneficiary, reaches the age of 21 years, and upon his reaching that age, the bonds and income accumulated thereon are to be distributed to him. To comply with the provisions of the governing instrument of the trust that the income from the stock of the U.S. corporation be accumulated and distributed to A and that the income from the Country X bonds be accumulated and distributed to B, it is necessary that the trustee treat the transfers as two separate funds. The fund consisting of the stock of the U.S. corporation is a foreign trust created by a U.S. person.

Example 2. On January 1, 1964, the date of the creation of a foreign trust, a U.S. person transfers to it property having a fair market value of $60,000 and a person other than a U.S. person transfers to it property having a fair market value of $40,000. Immediately after these transfers, the foreign trust created by a U.S. person is 60 percent of the entire foreign trust, determined as follows:

$60,000 (Value of property transferred by U.S. person)/$100,000 (Value of entire property transferred to trust)=60 percent

The undistributed net income for the calendar years 1964 and 1965 is $20,000 which increases the value of the entire foreign trust to $120,000 ($100,000 plus $20,000). Accordingly, as of December 31, 1965, the portion of the foreign trust created by the U.S. person is $72,000 (60 percent of $120,000). On January 1, 1966, the U.S. person transfers property having a fair market value of $40,000 increasing the value of the entire foreign trust to $160,000 ($120,000 plus $40,000) and increasing the value of the portion of the foreign trust created by the U.S. person to $112,000 ($72,000 plus $40,000). Immediately, after this transfer, the foreign trust created by the U.S. person is 70 percent of the entire foreign trust, determined as follows:

$112,000 (Value of property transferred by U.S. person)/$160,000 (Value of entire property transferred to the trust)=70 percent

[T.D. 6989, 34 FR 732, Jan. 17, 1969]

§1.643(d)–2 Illustration of the provisions of section 643.

(a) The provisions of section 643 may be illustrated by the following example:

Example. (1) Under the terms of the trust instrument, the income of a trust is required to be currently distributed to W during her life. Capital gains are allocable to corpus and all expenses are charges against corpus. During the taxable year the trust has the following items of income and expenses:

Dividends from domestic corporations	$30,000
Extraordinary dividends allocated to corpus by the trustee in good faith	20,000
Taxable interest	10,000
Tax-exempt interest	10,000
Long-term capital gains	10,000
Trustee's commissions and miscellaneous expenses allocable to corpus	5,000

(2) The ‘‘income’’ of the trust determined under section 643(b) which is currently distributable to W is $50,000, consisting of dividends of $30,000, taxable interest of $10,000, and tax-exempt interest of $10,000. The trustee's commissions and miscellaneous expenses allocable to tax-exempt interest amount to $1,000 (10,000/50,000× $5,000).

(3) The ‘‘distributable net income’’ determined under section 643(a) amounts to $45,000, computed as follows:

Dividends from domestic corporations		$30,000
Taxable interest		10,000
Nontaxable interest	$10,000	
Less: Expenses allocable thereto	1,000	
		9,000
Total		49,000
Less: Expenses ($5,000 less $1,000 allocable to tax-exempt interest)		4,000
Distributable net income		45,000

In determining the distributable net income of $45,000, the taxable income of the trust is computed with the following modifications: No deductions are allowed for distributions to W and for personal exemption of the trust (section 643(a) (1) and (2)); capital gains allocable to corpus are excluded and the deduction allowable under section 1202 is not taken into account (section 643(a)(3)): the extraordinary dividends allocated to corpus by the trustee in good faith are excluded (sections 643(a)(4)); and the tax- exempt interest (as adjusted for expenses) and the dividend exclusion of $50 are included) section 643(a) (5) and (7)).

(b) See paragraph (c) of the example in §1.661(c)–2 for the computation of distributable net income where there is a charitable contributions deduction.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960. Redesignated, T.D. 6989, 34 FR 732, Jan. 1, 1969]

POOLED INCOME FUND ACTUARIAL TABLES APPLICABLE BEFORE MAY 1, 1989

§1.642(c)–6A Valuation of charitable remainder interests for which the valuation date is before May 1, 1989.

(a) *Valuation of charitable remainder interests for which the valuation date is before January 1, 1952.* There was no provision for the qualification of pooled income funds under section 642 until 1969. See §20.2031–7A(a) of this chapter (Estate Tax Regulations) for the determination of the present value of a charitable remainder interest created before January 1, 1952.

(b) *Valuation of charitable remainder interests for which the valuation date is after December 31, 1951, and before January 1, 1971.* No charitable deduction is allowable for a transfer to a pooled income fund for which the valuation date is after the effective dates of the Tax Reform Act of 1969 unless the pooled income fund meets the requirements of section 642(c)(5). See §20.2031–7A(b) of this chapter (Estate Tax Regulations) for the determination of the present value of a charitable remainder interest for which the valuation date is after December 31, 1951, and before January 1, 1971.

(c) *Present value of remainder interest in the case of transfers to pooled income funds for which the valuation date is after December 31, 1970, and before December 1, 1983.* For the determination of the present value of a remainder interest in property transferred to a pooled income fund for which the valuation date is after December 31, 1970, and before December 1, 1983, see §20.2031–7A(c) of this chapter (Estate Tax Regulations) and former §1.642(c)–6(e) (as contained in the 26 CFR part 1 edition revised as of April 1, 1994).

(d) *Present value of remainder interest dependent on the termination of one life in the case of transfers to pooled income funds made after November 30, 1983, for which the valuation date is before May 1, 1989*—(1) *In general.* For transfers to pooled income funds made after November 30, 1983, for which the valuation date is before May 1, 1989, the present value of the remainder interest at the time of the transfer of property to the fund is determined by computing the present value (at the time of the transfer) of the life income interest in the transferred property (as determined under paragraph (d)(2) of this section) and subtracting that value from the fair market value of the transferred property on the valuation date. The present value of a remainder interest that is dependent on the termination of the life of one individual is computed by use of Table G in paragraph (d)(4) of this section. For purposes of the computation under this section, the age of an individual is to be taken as the age of the individual at the individual's nearest birthday.

(2) *Present value of life income interest.* The present value of the life income interest in property transferred to a pooled income fund shall be computed on the basis of:

(i) Life contingencies determined from the values of *lx* that are set forth in Table LN of §20.2031–7A(d)(6) of this chapter (Estate Tax Regulations); and

(ii) Discount at a rate of interest, compounded annually, equal to the highest yearly rate of return of the pooled income fund for the 3 taxable years immediately preceding its taxable year in which the transfer of property to the fund is made. For purposes of this paragraph (d)(2), the yearly rate of return of a pooled income fund is determined as provided in §1.642(c)–6(c) unless the highest yearly rate of return is deemed to be 9 percent. For purposes of this paragraph (d)(2), the first taxable year of a pooled income fund is considered a taxable year even though the taxable year consists of less than 12 months. However, appropriate adjustments must be made to annualize the rate of return earned by the fund for that period. Where it appears from the facts and circumstances that the highest yearly rate of return for the 3 taxable years immediately preceding the taxable year in which the transfer of property is made has been purposely manipulated to be substantially less than the rate of return that would otherwise be reasonably anticipated with the purpose of obtaining an excessive charitable deduction, that rate of return may not be used. In that case, the highest yearly rate of return of the fund is determined by treating the fund as a pooled income fund that has been in existence for less than 3 preceding taxable years. If a pooled income fund has been in existence less than 3 taxable years immediately preceding the taxable year in which the transfer of property to the fund is made, the highest yearly rate of return is deemed to be 9 percent.

(3) *Computation of value of remainder interest.* The factor which is used in determining the present value of the remainder interest is the factor under the appropriate yearly rate of return in column (2) of Table G opposite the number in column (1) which corresponds to the age of the individual upon whose life the value of the remainder interest is based. If the yearly rate of return is a percentage which is between yearly rates of return for which factors are provided in Table G, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying, by the factor determined under this paragraph (d)(3), the fair market value on the appropriate valuation date. If the yearly rate of return is below 2.2 percent or above 14 percent, see § 1.642(c)–6(b). This paragraph (d)(3) may be illustrated by the following example:

Example. A, who will be 50 years old on April 15, 1985, transfers $100,000 to a pooled income fund on January 1, 1985, and retains a life income interest in such property. The highest yearly rate of return earned by the fund for its 3 preceding taxable years is 9.9 percent. In Table G the figure in column (2) opposite 50 years under 9.8 percent is .15653 and under 10 percent is .15257. The present value of the remainder interest is $15,455, computed as follows:

Factor at 9.8 percent for person aged 50	.15653
Factor at 10 percent for person aged 50 ..	.15257
Difference	.00396
Interpolation adjustment:	

$$\frac{9.9\% - 9.8\%}{.2\%} = \frac{x}{.00396}$$

Factor at 9.8 percent for person aged 50	0.15653
Less:	
Interpolation adjustment	.00198
Interpolated factor	.15455
Present value of remainder interest ($100,000 × .15455	$15,455

(4) *Actuarial tables.* The following tables shall be used in the application of the provisions of this section.

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	2.2%	2.4%	2.6%	2.8%	3.0%
0	.23930	.21334	.19077	.17113	.15401
1	.22891	.20224	.17903	.15880	.14114
2	.23297	.20610	.18265	.16218	.14429
3	.23744	.21035	.18669	.16600	.14787
4	.24212	.21485	.19098	.17006	.15171
5	.24701	.21955	.19547	.17434	.15577
6	.25207	.22442	.20015	.17880	.16001
7	.25726	.22944	.20497	.18342	.16441
8	.26259	.23461	.20995	.18820	.16898
9	.26809	.23995	.21511	.19315	.17373
10	.27373	.24544	.22043	.19828	.17865
11	.27953	.25110	.22592	.20358	.18375
12	.28546	.25690	.23156	.20904	.18902
13	.29149	.26280	.23731	.21462	.19440
14	.29757	.26877	.24312	.22026	.19986
15	.30368	.27476	.24896	.22593	.20535
16	.30978	.28075	.25481	.23161	.21085
17	.31589	.28676	.26068	.23732	.21637
18	.32204	.29280	.26659	.24306	.22193
19	.32825	.29892	.27257	.24889	.22759
20	.33457	.30514	.27867	.25484	.23336
21	.34099	.31148	.28489	.26092	.23927
22	.34751	.31794	.29124	.26712	.24532
23	.35416	.32452	.29773	.27348	.25152
24	.36096	.33127	.30439	.28002	.25791
25	.36793	.33821	.31124	.28676	.26452
26	.37509	.34535	.31832	.29374	.27136
27	.38244	.35269	.32560	.30093	.27844
28	.38998	.36023	.33311	.30836	.28577
29	.39767	.36795	.34080	.31599	.29330
30	.40553	.37584	.34868	.32382	.30104
31	.41352	.38388	.35672	.33182	.30897
32	.42165	.39208	.36494	.34001	.31710
33	.42993	.40044	.37333	.34839	.32543
34	.43834	.40894	.38188	.35694	.33395
35	.44689	.41760	.39060	.36567	.34266
36	.45556	.42640	.39947	.37458	.35156
37	.46435	.43534	.40850	.38365	.36063
38	.47325	.44440	.41767	.39288	.36987
39	.48226	.45358	.42696	.40225	.37927
40	.49136	.46288	.43640	.41177	.38884
41	.50056	.47228	.44596	.42143	.39856
42	.50988	.48182	.45566	.43125	.40846
43	.51927	.49145	.46547	.44120	.41850
44	.52874	.50118	.47540	.45128	.42869
45	.53828	.51099	.48543	.46146	.43899
46	.54788	.52088	.49554	.47176	.44943
47	.55754	.53083	.50574	.48216	.45998
48	.56726	.54087	.51604	.49267	.47065
49	.57703	.55097	.52642	.50327	.48144
50	.58685	.56114	.53688	.51398	.49234
51	.59670	.57136	.54740	.52476	.50333
52	.60658	.58161	.55798	.53560	.51441
53	.61647	.59189	.56859	.54651	.52556
54	.62635	.60217	.57923	.55744	.53675
55	.63622	.61246	.58987	.56840	.54798

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	2.2%	2.4%	2.6%	2.8%	3.0%
56	.64606	.62273	.60052	.57937	.55923
57	.65589	.63299	.61117	.59037	.57052
58	.66569	.64324	.62181	.60136	.58183
59	.67546	.65347	.63246	.61237	.59316
60	.68521	.66368	.64309	.62338	.60450
61	.69492	.67388	.65372	.63440	.61587
62	.70461	.68406	.66434	.64542	.62726
63	.71425	.69420	.67494	.65643	.63865
64	.72384	.70430	.68550	.66742	.65002
65	.73336	.71434	.69602	.67837	.66137
66	.74281	.72431	.70647	.68926	.67267
67	.75216	.73419	.71684	.70009	.68391
68	.76143	.74399	.72714	.71085	.69509
69	.77060	.75370	.73735	.72153	.70622
70	.77969	.76334	.74750	.73215	.71728
71	.78870	.77290	.75758	.74272	.72830
72	.79764	.78240	.76760	.75323	.73928
73	.80646	.79178	.77751	.76364	.75016
74	.81511	.80099	.78725	.77387	.76086
75	.82353	.80995	.79674	.78386	.77132
76	.83169	.81866	.80596	.79357	.78149
77	.83960	.82710	.81491	.80301	.79139
78	.84727	.83530	.82360	.81218	.80101
79	.85473	.84328	.83207	.82112	.81041
80	.86201	.85106	.84034	.82986	.81960
81	.86905	.85861	.84837	.83835	.82853
82	.87585	.86589	.85612	.84655	.83717
83	.88239	.87291	.86360	.85447	.84552
84	.88873	.87971	.87085	.86216	.85362
85	.89487	.88630	.87789	.86963	.86150
86	.90070	.89258	.88459	.87674	.86901
87	.90609	.89838	.89079	.88332	.87597
88	.91106	.90372	.89650	.88939	.88239
89	.91570	.90872	.90184	.89507	.88839
90	.92014	.91350	.90696	.90051	.89416
91	.92435	.91804	.91182	.90569	.89964
92	.92822	.92222	.91630	.91045	.90469
93	.93170	.92597	.92032	.91474	.90923
94	.93477	.92929	.92387	.91853	.91325
95	.93743	.93216	.92695	.92181	.91673
96	.93967	.93458	.92955	.92458	.91966
97	.94167	.93674	.93186	.92704	.92228
98	.94342	.93863	.93389	.92921	.92457
99	94508	94041	.93580	.93124	.92673
100 ..	.94672	.94218	.93770	.93326	.92887
101 ..	.94819	.94377	.93940	.93508	.93080
102 ..	.94979	.94550	.94125	.93704	.93288
103 ..	.95180	.94766	.94357	.93952	.93550
104 ..	.95377	.94979	.94585	.94194	.93806
105 ..	.95663	.95288	.94916	.94547	.94181
106 ..	.96101	.95762	.95425	.95091	.94760
107 ..	.96688	.96398	.96110	.95824	.95539
108 ..	.97569	.97354	.97141	.96928	.96717
109 ..	.98924	.98828	.98733	.98638	.98544

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	3.2%	3.4%	3.6%	3.8%	4.0%
0	.13908	.12603	.11461	.10461	.09583
1	.12570	.11220	.10036	.08998	.08086
2	.12862	.11489	.10284	.09225	.08293
3	.13198	.11802	.10576	.09496	.08544
4	.13559	.12141	.10893	.09793	.08821
5	.13943	.12503	.11234	.10112	.09121
6	.14345	.12884	.11593	.10451	.09439
7	.14763	.13280	.11968	.10805	.09773
8	.15198	.13694	.12360	.11176	.10125
9	.15652	.14126	.12771	.11567	.10495
10	.16123	.14576	.13200	.11975	.10883
11	.16613	.15045	.13648	.12402	.11290
12	.17119	.15531	.14113	.12847	.11715
13	.17638	.16029	.14591	.13304	.12152
14	.18164	.16535	.15076	.13769	.12597
15	.18693	.17044	.15565	.14238	.13045
16	.19224	.17554	.16055	.14707	.13494
17	.19756	.18066	.16547	.15178	.13945
18	.20294	.18584	.17044	.15655	.14401
19	.20840	.19110	.17550	.16140	.14866
20	.21399	.19650	.18069	.16639	.15344
21	.21972	.20203	.18602	.17152	.15836
22	.22559	.20771	.19151	.17680	.16344
23	.23162	.21356	.19716	.18225	.16869
24	.23784	.21960	.20301	.18791	.17414
25	.24429	.22588	.20910	.19380	.17984
26	.25098	.23240	.21545	.19996	.18581
27	.25792	.23918	.22206	.20639	.19205
28	.26512	.24623	.22894	.21310	.19858
29	.27253	.25350	.23605	.22004	.20534
30	.28016	.26100	.24341	.22724	.21236
31	.28799	.26871	.25097	.23464	.21961
32	.29603	.27664	.25877	.24230	.22710
33	.30428	.28478	.26679	.25018	.23484
34	.31273	.29314	.27504	.25830	.24280
35	.32139	.30172	.28351	.26665	.25102
36	.33024	.31050	.29220	.27523	.25948
37	.33929	.31949	.30111	.28404	.26816
38	.34851	.32867	.31022	.29305	.27707
39	.35791	.33804	.31953	.30228	.28620
40	.36749	.34759	.32904	.31172	.29555
41	.37724	.35733	.33874	.32137	.30512
42	.38717	.36727	.34866	.33124	.31493
43	.39727	.37739	.35877	.34132	.32495
44	.40752	.38768	.36906	.35159	.33518
45	.41791	.39811	.37952	.36204	.34560
46	.42844	.40871	.39014	.37267	.35621
47	.43910	.41944	.40092	.38347	.36701
48	.44990	.43034	.41188	.39446	.37801
49	.46083	.44137	.42299	.40562	.38919
50	.47189	.45256	.43427	.41695	.40056
51	.48306	.46386	.44567	.42844	.41209
52	.49432	.47528	.45721	.44006	.42378
53	.50567	.48679	.46886	.45182	.43562
54	.51708	.49838	.48060	.46367	.44756
55	.52854	.51004	.49242	.47563	.45962
56	.54004	.52175	.50430	.48766	.47177
57	.55159	.53352	.51626	.49978	.48402
58	.56316	.54533	.52827	.51196	.49636
59	.57478	.55719	.54036	.52424	.50879
60	.58643	.56910	.55250	.53658	.52131
61	.59811	.58107	.56471	.54901	.53393
62	.60982	.59307	.57697	.56150	.54662
63	.62155	.60510	.58928	.57405	.55940
64	.63327	.61714	.60161	.58664	.57222
65	.64498	.62918	.61395	.59926	.58508

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	3.2%	3.4%	3.6%	3.8%	4.0%
66	.65666	.64120	.62628	.61188	.59796
67	.66829	.65319	.63859	.62448	.61083
68	.67986	.66512	.65086	.63706	.62370
69	.69139	.67702	.66311	.64963	.63656
70	.70286	.68888	.67533	.66218	.64942
71	.71431	.70073	.68754	.67474	.66231
72	.72572	.71255	.69974	.68730	.67520
73	.73704	.72429	.71188	.69980	.68805
74	.74819	.73586	.72384	.71214	.70075
75	.75909	.74718	.73557	.72424	.71320
76	.76971	.75822	.74700	.73606	.72538
77	.78004	.76897	.75815	.74758	.73726
78	.79010	.77944	.76902	.75883	.74886
79	.79993	.78968	.77965	.76984	.76023
80	.80955	.79971	.79008	.78064	.77140
81	.81891	.80948	.80024	.79118	.78230
82	.82796	.81894	.81009	.80140	.79288
83	.83672	.82810	.81962	.81131	.80314
84	.84525	.83700	82891	.82096	.81314
85	.85352	.84567	.83795	.83037	.82291
86	.86141	.85394	.84659	.83936	.83224
87	.86874	.86162	.85461	.84771	.84092
88	.87549	.86870	.86201	.85542	.84893
89	.88182	.87534	.86895	.86266	.85645
90	.88789	.88171	.87562	86961	.86369
91	.89367	.88779	.88198	.87625	.87059
92	.89900	.89338	.88784	.88237	.87697
93	.90379	.89842	.89312	.88788	.88271
94	.90803	.90288	.89780	.89277	.88781
95	.91171	.90675	.90185	.89701	.89223
96	.91481	.91001	.90527	.90058	.89594
97	.91757	.91291	.90831	.90376	.89926
98	.91999	.91546	.91098	.90655	.90217
99	.92227	.91786	.91349	.90917	.90490
100 ..	.92453	.92023	.91598	.91177	.90761
101 ..	.92656	.92236	.91821	.91410	.91003
102 ..	.92875	.92467	.92063	.91662	.91266
103 ..	.93152	.92758	.92367	.91980	91597
104 ..	.93423	.93042	.92665	.92291	.91920
105 ..	.93818	.93458	.93101	.92747	.92395
106 ..	.94430	.94104	.93779	.93457	.93127
107 ..	95256	.94975	.94696	.94418	.94143
108 ..	.96507	96298	.96090	.95883	.95676
109 ..	.98450	.98356	.98263	.98170	.98077

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	4.2%	4.4%	4.6%	4.8%	5.0%
0	.08811	.08132	.07534	.07006	.06539
1	.07283	.06576	.05952	.05400	.04912
2	.07471	.06746	.06106	.05539	.05037
3	.07704	.06962	.06304	.05722	.05205
4	.07962	.07202	.06528	.05930	.05398
5	.08243	.07464	.06773	.06159	.05612
6	.08542	.07745	.07037	.06406	.05844
7	.08857	.08042	.07316	.06669	.06091
8	.09189	.08355	.07612	.06948	.06354

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	4.2%	4.4%	4.6%	4.8%	5.0%
9	.09540	.08687	.07926	.07245	.06635
10	.09908	.09037	.08258	.07560	.06934
11	.10296	.09406	.08609	.07894	.07251
12	.10701	.09793	.08977	.08245	.07586
13	.11119	.10191	.09358	.08608	.07932
14	.11544	.10597	.09745	.08978	.08285
15	.11972	.11007	.10136	.09350	.08640
16	.12402	.11416	.10527	.09723	.08995
17	.12832	.11827	.10919	.10096	.09351
18	.13268	.12243	.11315	.10474	.09711
19	.13712	.12667	.11720	.10860	.10078
20	.14170	.13105	.12138	.11259	.10459
21	.14642	.13557	.12570	.11671	.10853
22	.15129	.14024	.13017	.12099	.11261
23	.15634	.14508	.13481	.12544	.11687
24	.16159	.15013	.13967	.13009	.12133
25	.16709	.15543	.14477	.13500	.12604
26	.17286	.16101	.15014	.14018	.13103
27	.17891	.16686	.15580	.14564	.13630
28	.18525	.17301	.16175	.15140	.14187
29	.19183	.17940	.16796	.15742	.14770
30	.19867	.18606	.17443	.16370	.15380
31	.20574	.19295	.18114	.17023	.16013
32	.21307	.20010	.18811	.17702	.16674
33	.22064	.20751	.19535	.18407	.17362
34	.22846	.21516	.20283	.19138	.18075
35	.23653	.22307	.21058	.19896	.18816
36	.24484	.23124	.21859	.20681	.19584
37	.25340	.23966	.22685	.21492	.20379
38	.26219	.24831	.23536	.22328	.21199
39	.27120	.25720	.24411	.23188	.22044
40	.28045	.26633	.25311	.24075	.22916
41	.28992	.27569	.26236	.24986	.23814
42	.29965	.28532	.27188	.25926	.24741
43	.30960	.29518	.28163	.26890	.25693
44	.31977	.30527	.29164	.27880	.26671
45	.33013	.31557	.30185	.28892	.27673
46	.34071	.32609	.31230	.29929	.28700
47	.35148	.33681	.32296	.30988	.29750
48	.36246	.34777	.33387	.32072	.30826
49	.37364	.35893	.34499	.33179	.31927
50	.38503	.37030	.35634	.34310	.33053
51	.39659	.38187	.36790	.35462	.34201
52	.40832	.39362	.37965	.36636	.35371
53	.42021	.40554	.39158	.37829	.36562
54	.43222	.41760	.40367	.39039	.37771
55	.44436	.42980	.41591	.40264	.38997
56	.45660	.44212	.42828	.41504	.40239
57	.46897	.45456	.44079	.42760	.41498
58	.48142	.46712	.45342	.44030	.42771
59	.49399	.47980	.46620	.45314	.44062
60	.50666	.49260	.47910	.46613	.45367
61	.51944	.50552	.49214	.47927	.46690
62	.53232	.51856	.50531	.49256	.48028
63	.54529	.53169	.51860	.50598	.49381
64	.55832	.54491	.53198	.51950	.50746
65	.57140	.55819	.54544	.53312	.52121
66	.58451	.57152	.55895	.54681	.53506
67	.59763	.58486	.57251	.56054	.54896
68	.61076	.59823	.58609	.57432	.56292
69	.62390	.61162	.59971	.58816	.57695
70	.63705	.62503	.61337	.60204	.59104
71	.65023	.63849	.62709	.61600	.60522
72	.66344	.65199	.64086	.63003	.61949
73	.67661	.66547	.65463	.64407	.63378
74	.68964	.67882	.66827	.65798	.64796

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	4.2%	4.4%	4.6%	4.8%	5.0%
75	.70243	.69193	.68168	.67168	.66192
76	.71495	.70477	.69482	.68511	.67563
77	.72717	.71731	.70768	.69826	.68905
78	.73912	.72959	.72026	.71114	.70221
79	.75083	.74163	.73262	.72379	.71515
80	.76235	.75348	.74479	.73627	.72792
81	.77360	.76506	.75669	.74848	.74043
82	.78452	.77632	.76827	.76036	.75260
83	.79513	.78725	.77952	.77192	.76446
84	.80547	.79792	.79051	.78322	.77606
85	.81557	.80836	.80126	.79429	.78742
86	.82524	.81835	.81157	.80489	.79832
87	.83423	.82764	.82115	.81477	.80847
88	.84253	.83623	.83002	.82390	.81787
89	.85033	.84430	.83836	.83250	.82672
90	.85784	.85208	.84639	.84079	.83525
91	.86502	.85951	.85408	.84871	.84342
92	.87164	.86638	.86118	.85605	.85098
93	.87761	.87257	.86759	.86267	.85781
94	.88290	.87806	.87327	.86854	.86386
95	.88750	.88282	.87820	.87364	.86913
96	.89136	.88683	.88236	.87793	.87355
97	.89481	.89041	.88606	.88176	.87750
98	.89783	.89354	.88930	.88511	.88096
99	.90067	.89649	.89235	.88826	.88420
100 ..	.90349	.89941	.89538	.89138	.88743
101 ..	.90600	.90202	.89807	.89416	.89029
102 ..	.90873	.90484	.90099	.89717	.89339
103 ..	.91217	.90841	.90468	.90099	.99733
104 ..	.91553	.91188	.90827	.90469	.90114
105 ..	.92047	.91701	.91358	.91018	.90680
106 ..	.92819	.92504	.92191	.91880	.91571
107 ..	.93868	.93596	.93325	.93056	.92788
108 ..	.95471	.95267	.95064	.94862	.94661
109 ..	.97985	.97893	.97801	.97710	.97619

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	5.2%	5.4%	5.6%	5.8%	6.0%
0	.06126	.05759	.05433	.05143	.04884
1	.04480	.04096	.03754	.03450	.03179
2	.04591	.04194	.03841	.03527	.03246
3	.04745	.04336	.03972	.03646	.03355
4	.04924	.04502	.04125	.03789	.03487
5	.05124	.04689	.04300	.03952	.03639
6	.05342	.04893	.04492	.04131	.03808
7	.05574	.05112	.04697	.04324	.03990
8	.05822	.05346	.04918	.04533	.04186
9	.06089	.05598	.05156	.04759	.04400
10	.06372	.05866	.05411	.05000	.04630
11	.06673	.06153	.05684	.05260	.04877
12	.06992	.06457	.05973	.05536	.05141
13	.07322	.06772	.06274	.05824	.05415
14	.07659	.07093	.06581	.06117	.05695
15	.07998	.07417	.06890	.06411	.05976
16	.08337	.07739	.07197	.06704	.06255
17	.08675	.08062	.07504	.06996	.06533

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	5.2%	5.4%	5.6%	5.8%	6.0%
18	.09018	.08387	.07813	.07290	.06813
19	.09367	.08720	.08130	.07591	.07099
20	.09730	.09065	.08458	.07904	.07397
21	.10106	.09423	.08800	.08229	.07707
22	.10496	.09796	.09155	.08568	.08030
23	.10903	.10185	.09526	.08923	.08368
24	.11330	.10594	.09918	.09297	.08726
25	.11782	.11028	.10334	.09696	.09108
26	.12262	.11489	.10778	.10122	.09518
27	.12771	.11979	.11249	.10576	.09955
28	.13309	.12499	.11751	.11060	.10421
29	.13873	.13044	.12278	.11570	.10914
30	.14464	.13617	.12833	.12107	.11433
31	.15079	.14214	.13412	.12668	.11977
32	.15722	.14838	.14018	.13256	.12548
33	.16391	.15490	.14652	.13873	.13147
34	.17087	.16168	.15312	.14515	.13772
35	.17811	.16874	.16001	.15186	.14426
36	.18562	.17608	.16717	.15886	.15108
37	.19340	.18369	.17462	.16613	.15819
38	.20144	.19157	.18233	.17368	.16557
39	.20974	.19971	.19031	.18149	.17322
40	.21830	.20812	.19856	.18959	.18115
41	.22714	.21681	.20710	.19797	.18938
42	.23627	.22579	.21594	.20665	.19791
43	.24566	.23505	.22505	.21562	.20673
44	.25532	.24458	.23445	.22488	.21585
45	.26522	.25436	.24410	.23440	.22523
46	.27538	.26441	.25402	.24420	.23490
47	.28579	.27471	.26421	.25427	.24484
48	.29647	.28529	.27469	.26463	.25508
49	.30739	.29613	.28543	.27527	.26562
50	.31859	.30724	.29646	.28620	.27645
51	.33001	.31860	.30774	.29740	.28755
52	.34167	.33020	.31928	.30886	.29893
53	.35355	.34204	.33105	.32057	.31056
54	.36562	.35407	.34304	.33250	.32243
55	.37787	.36630	.35523	.34465	.33452
56	.39029	.37870	.36761	.35699	.34682
57	.40289	.39130	.38020	.36956	.35935
58	.41565	.40408	.39297	.38231	.37208
59	.42859	.41704	.40595	.39529	.38504
60	.44170	.43019	.41912	.40847	.39822
61	.45499	.44353	.43250	.42187	.41164
62	.46845	.45706	.44607	.43548	.42527
63	.48208	.47076	.45984	.44930	.43913
64	.49583	.48461	.47377	.46329	.45317
65	.50971	.49859	.48784	.47744	.46738
66	.52369	.51269	.50204	.49173	.48175
67	.53774	.52688	.51635	.50614	.49625
68	.55187	.54115	.53075	.52066	.51088
69	.56607	.55551	.54526	.53530	.52563
70	.58035	.56997	.55987	.55006	.54053
71	.59474	.58455	.57463	.56498	.55559
72	.60923	.59924	.58952	.58004	.57082
73	.62375	.61398	.60446	.59518	.58613
74	.63818	.62864	.61933	.61026	.60140
75	.65240	.64310	.63402	.62515	.61649
76	.66636	.65731	.64846	.63981	.63135
77	.68005	.67124	.66263	.65420	.64596
78	.69347	.68492	.67655	.66836	.66033
79	.70669	.69840	.69028	.68232	.67452
80	.71973	.71171	.70384	.69613	.68856
81	.73252	.72477	.71717	.70970	.70237
82	.74499	.73751	.73016	.72295	.71587
83	.75713	.74992	.74284	.73589	.72905

Table G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	5.2%	5.4%	5.6%	5.8%	6.0%
84	.76901	.76208	.75527	.74857	.74198
85	.78067	.77402	.76748	.76104	.75471
86	.79185	.78548	.77921	.77304	.76695
87	.80228	.79617	.79015	.78423	.77838
88	.81193	.80607	.80029	.79460	.78899
89	.82102	.81540	.80985	.80438	.79899
90	.82979	.82441	.81909	.81384	.80867
91	.83820	.83304	.82795	.82292	.81796
92	.84598	.84104	.83616	.83134	.82657
93	.85300	.84826	.84357	.83894	.83437
94	.85924	.85468	.85017	.84570	.84130
95	.86466	.86025	.85589	.85158	.84732
96	.86922	.86494	.86071	.85652	.85238
97	.87329	.86913	.86501	.86093	.85690
98	.87685	.87279	.86877	.86479	.86085
99	.88019	.87622	.87230	.86841	.86456
100	.88351	.87964	.87580	.87200	.86824
101	.88646	.88267	.87891	.87519	.87150
102	.88965	.88594	.88227	.87863	.87503
103	.89370	.89011	.88654	.88301	.87952
104	.89763	.89414	.89068	.88725	.88385
105	.90345	.90013	.89683	.89356	.89032
106	.91265	.90961	.90658	.90358	.90060
107	.92522	.92258	.91995	.91734	.91474
108	.94461	.94262	.94063	.93866	.93670
109	.97529	.97438	.97348	.97259	.97170

Table G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	6.2%	6.4%	6.6%	6.8%	7.0%
0	.04653	.04447	.04262	.04095	.03946
1	.02937	.02720	.02525	.02351	.02194
2	.02994	.02769	.02567	.02385	.02221
3	.03094	.02860	.02650	.02460	.02290
4	.03216	.02973	.02755	.02558	.92380
5	.03359	.03106	.02879	.02674	.02488
6	.03517	.03255	.03019	.02805	.02612
7	.03688	.03416	.03171	.02949	.02747
8	.03874	.03592	.03337	.03106	.02896
9	.04077	.03784	.03519	.03279	.03061
10	.04295	.03992	.03717	.03467	.03240
11	.04531	.04217	.03931	.03672	.03436
12	.04782	.04457	.04161	.03892	.02647
13	.05045	.04708	.04402	.04122	.03868
14	.05312	.04964	.04646	.04357	.04093
15	.05581	.05220	.04891	.04591	.04317
16	.05847	.05474	.05134	.04822	.04538
17	.06111	.05726	.05374	.05051	.04756
18	.06378	.05979	.05615	.05280	.04974
19	.06650	.06238	.05861	.05514	.05196
20	.06933	.06507	.06117	.05758	.05429
21	.07228	.06788	.06384	.06013	.05671
22	.07535	.07081	.06664	.06279	.05925
23	.07858	.07389	.06958	.06559	.06192
24	.08201	.07717	.07270	.06858	.06477
25	.08567	.08067	.07606	.07179	.06785
26	.08960	.08444	.07968	.07527	.07118

Table G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	6.2%	6.4%	6.6%	6.8%	7.0%
27	.09380	.08849	.08357	.07901	.07478
28	.09830	.09283	.08775	.08304	.07867
29	.10306	.09742	.09218	.08732	.08280
30	.10808	.10228	.09688	.09187	.08720
31	.11335	.10738	.10182	.09665	.09182
32	.11889	.11275	.10704	.10170	.09672
33	.12471	.11840	.11252	.10703	.10189
34	.13079	.12432	.11827	.11261	.10732
35	.13716	.13052	.12431	.11849	.11305
36	.14381	.13701	.13063	.12465	.11905
37	.15075	.14378	.13724	.13110	.12534
38	.15796	.15083	.14412	.13782	.13190
39	.16545	.15815	.15129	.14483	.13875
40	.17322	.16576	.15874	.15212	.14589
41	.18129	.17367	.16649	.15971	.15332
42	.18967	.18190	.17456	.16763	.16108
43	.19834	.19041	.18293	.17585	.16915
44	.20731	.19924	.19160	.18437	.17753
45	.21655	.20834	.20055	.19318	.18619
46	.22608	.21773	.20981	.20229	.19516
47	.23590	.22741	.21935	.21170	.20443
48	.24602	.23741	.22922	.22144	.21403
49	.25644	.24770	.23939	.23148	.22394
50	.26716	.25831	.24989	.24185	.23419
51	.27816	.26921	.26068	.25253	.24475
52	.28945	.28040	.27176	.26351	.25562
53	.30100	.29187	.28313	.27478	.26679
54	.31279	.30357	.29475	.28631	.27822
55	.32482	.31553	.30663	.29810	.28992
56	.33707	.32771	.31875	.31014	.30188
57	.34955	.34015	.33112	.32244	.31411
58	.36225	.35280	.34372	.33499	.32659
59	.37519	.36571	.35659	.34781	.33936
60	.38836	.37886	.36971	.36089	.35239
61	.40177	.39226	.38309	.37425	.36572
62	.41542	.40591	.39674	.38788	.37932
63	.42930	.41981	.41064	.40178	.39321
64	.44338	.43392	.42477	.41591	.40734
65	.45765	.44823	.43910	.43027	.42171
66	.47208	.46271	.45364	.44483	.43630
67	.48666	.47736	.46834	.45958	.45108
68	.50138	.49215	.48320	.47450	.46605
69	.51624	.50711	.49824	.48961	.48122
70	.53125	.52223	.51345	.50491	.49660
71	.54645	.53755	.52889	.52045	.51223
72	.56183	.55307	.54453	.53621	.52809
73	.57731	.56870	.56030	.55211	.54412
74	.59275	.58431	.57606	.56801	.56015
75	.60803	.59976	.59168	.58379	.57607
76	.62308	.61500	.60709	.59936	.59179
77	.63789	.63000	.62227	.61470	.60730
78	.65247	.64477	.63723	.62984	.62261
79	.66687	.65938	.65203	.64483	.63777
80	.68114	.67386	.66672	.65971	.65284
81	.69518	.68812	.68119	.67438	.66770
82	.70891	.70207	.69535	.68875	.68227
83	.72232	.71572	.70922	.70283	.69655
84	.73550	.72913	.72285	.71668	.71061
85	.74847	.74234	.73630	.73035	.72449
86	.76096	.75506	.74925	.74353	.73789
87	.77263	.76696	.76137	.75585	.75042
88	.78345	.77799	.77261	.76730	.76207
89	.79367	.78842	.78323	.77812	.77308
90	.80356	.79851	.79353	.78862	.78376
91	.81306	.80821	.80344	.79871	.79405
92	.82187	.81722	.81263	.80810	.80361

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	6.2%	6.4%	6.6%	6.8%	7.0%
93	.82984	.82538	.82096	.81659	.81228
94	.83694	.83263	.82837	.82416	.81999
95	.84310	.83893	.83481	.83073	.82670
96	.84829	.84424	.84023	.83626	.83234
97	.85291	.84897	.84506	.84120	.83738
98	.85696	.85310	.84929	.84551	.84177
99	.86075	.85698	.85325	.84956	.84590
100 ..	.86452	.86084	.85719	.85357	.85000
101 ..	.86785	.86424	.86066	.85711	.85360
102 ..	.87146	.86792	.86442	.86094	.85750
103 ..	.87605	.87261	.86921	.86583	.86248
104 ..	.88047	.87713	.87382	.87053	.86727
105 ..	.88710	.88390	.88073	.87758	.87446
106 ..	.89764	.89471	.89179	.88889	.88601
107 ..	.91216	.90960	.90705	.90451	.90199
108 ..	.93474	.93280	.93086	.92894	.92702
109 ..	.97081	.96992	.96904	.96816	.96729

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	7.2%	7.4%	7.6%	7.8%	8.0%
0	.03811	.03689	.03579	.03479	.03388
1	.02052	.01924	.01809	.01704	.01609
2	.02074	.01940	.01819	.01710	.01611
3	.02136	.01996	.01870	.01756	.01652
4	.02219	.02074	.01942	.01822	.01713
5	.02321	.02169	.02031	.01905	.01791
6	.02437	.02278	.02134	.02003	.01883
7	.02565	.02399	.02248	.02111	.01986
8	.02706	.02533	.02376	.02232	.02101
9	.02863	.02682	.02518	.02367	.02230
10	.03034	.02846	.02674	.02517	.02373
11	.03221	.03025	.02846	.02682	.02532
12	.03424	.03219	.03032	.02861	.02704
13	.03635	.03422	.03228	.03049	.02885
14	.03851	.03630	.03427	.03240	.03069
15	.04066	.03836	.03624	.03430	.03252
16	.04277	.04037	.03817	.03615	.03429
17	.04485	.04236	.04007	.03796	.03602
18	.04693	.04434	.04196	.03976	.03773
19	.04904	.04635	.04387	.04159	.03947
20	.05125	.04845	.04588	.04349	.04129
21	.05356	.05065	.04797	.04549	.04319
22	.05597	.05295	.05016	.04758	.04519
23	.05853	.05539	.05248	.04979	.04730
24	.06124	.05799	.05497	.05217	.04957
25	.06420	.06081	.05767	.05475	.05205
26	.06739	.06388	.06062	.05758	.05476
27	.07086	.06721	.06382	.06067	.05773
28	.07460	.07082	.06730	.06402	.06097
29	.07859	.07467	.07102	.06762	.06444
30	.08284	.07879	.07500	.07146	.06815
31	.08733	.08312	.07920	.07553	.07209
32	.09207	.08773	.08366	.07986	.07629
33	.09709	.09260	.08839	.08445	.08075
34	.10237	.09773	.09338	.08929	.08546
35	.10794	.10315	.09865	.09442	.09045

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	7.2%	7.4%	7.6%	7.8%	8.0%
36	.11379	.10884	.10420	.09983	.09572
37	.11992	.11483	.11003	.10552	.10126
38	.12633	.12108	.11614	.11148	.10708
39	.13302	.12762	.12253	.11772	.11318
40	.14000	.13445	.12921	.12425	.11957
41	.14728	.14158	.13619	.13109	.12626
42	.15490	.14904	.14350	.13825	.13328
43	.16260	.15680	.15111	.145072	.14060
44	17104	.16488	.15905	.15351	.14825
45	.17955	.17326	.16727	.16159	.15619
46	.18838	.18194	.17582	.16999	.16445
47	.19751	.19093	.18467	.17870	.17302
48	.20698	.20026	.19386	.18776	.18194
49	.21676	.20991	.20338	.19715	.19119
50	.22689	.21991	.21325	.20689	.20080
51	.23732	.23023	.22344	.21695	.21074
52	.24808	.24086	.23396	.22735	.22102
53	.25914	.25181	.24479	.23807	.24252
54	.27047	.26304	.25591	.24908	.25372
55	.28208	.27455	.26733	.26039	.25372
56	.29395	.28633	.37901	.27197	.26521
57	.30610	.29840	.29099	.28386	.27700
58	.31851	.31074	.30325	.29604	.28909
59	.33122	.32337	.31581	.30853	.30150
60	.34420	.33630	.32867	.32132	.31422
61	.35748	.34953	.34185	.33444	.32727
62	.37106	.36307	.35535	.34788	.34066
63	.38492	.37691	.36915	.36165	.35438
64	.39905	.39102	.38324	.37571	.36841
65	.41342	.40539	.39760	.39005	.38272
66	.42803	.42000	.41221	.40465	.39731
67	.44283	.43483	.42705	.41949	.41215
68	.45784	.44987	.44211	.43457	.42724
69	.47307	.46513	.45741	.44990	.44254
70	.48851	.48063	.47296	.46549	.45821
71	.50422	.49641	.48880	.48139	.47416
72	.52018	.51246	.50493	.49758	.49042
73	.53631	.52870	.52126	.51400	.50691
74	.55247	.54497	.53764	.53048	.52347
75	.56852	.56115	.55393	.54687	.53997
76	.58439	.57714	.57005	.56311	.55632
77	.60005	.59294	.58599	.57917	.57249
78	.61551	.60856	.60174	.59506	.58851
79	.63084	.62405	.61739	.61085	.60443
80	.64609	.63946	.63296	.62657	.62030
81	.66114	.65469	.64835	.64213	.63602
82	.67589	.66963	.66347	.65742	.65146
83	.60937	.68429	.67831	.67243	.66664
84	.70463	.69875	.69296	.68726	.68165
85	.71872	.71304	.70745	.70194	.69651
86	.73233	.72685	.72146	.71614	.71089
87	.74507	.73978	.73458	.72944	.72438
88	.75691	.75181	.74679	.74183	.73694
89	.76810	.76319	.75834	.75355	.74883
90	.77897	.77424	.76957	.76496	.76040
91	.78945	.78490	.78040	.77596	.77158
92	.79919	.79481	.79048	.78621	.78198
93	.80801	.80380	.79963	.79550	.79143
94	.81587	.81180	.80777	.80379	.79985
95	.82271	.81877	.81487	.81100	.80719
96	.82846	.82462	.82083	.81707	.81335
97	.83360	.82985	.82615	.82248	.81885
98	.33808	.83441	.83079	.82720	.82365
99	.84228	.83869	.83514	.83163	.82815
100 ..	.84645	.84294	.83947	.83603	.83262
101 ..	.85012	.84668	.84327	.83988	.83653

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	7.2%	7.4%	7.6%	7.8%	8.0%
102 ..	.85409	.85072	.84737	.84405	.84077
103 ..	.85917	.85588	.85262	.84939	.84619
104 ..	.86403	.86083	.85765	.85449	.85136
105 ..	.87136	.86829	.86524	.86221	.85921
106 ..	.88315	.88032	.87750	.87470	.87192
107 ..	.89949	.89700	.89452	.89206	.88961
108 ..	.92511	.92321	.92132	.91944	.91757
109 ..	.96642	.96555	.96468	.96382	.96296

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	8.2%	8.4%	8.6%	8.8%	9.0%
0	.03305	.03230	.03161	.03098	.03040
1	.01523	.01444	.01372	.01307	.01247
2	.01520	.01438	.01362	.01294	.01230
3	.01557	.01470	.01391	.01319	.01253
4	.01613	.01522	.01439	.01363	.01294
5	.01687	.01591	.01504	.01424	.01351
6	.01774	.01674	.01582	.01498	.01421
7	.01871	.01766	.01670	.01581	.01500
8	.01980	.01870	.01769	.01676	.01591
9	.02104	.01989	.01883	.01785	.01695
10	.02241	.02120	.02009	.01906	.01812
11	.02394	.02267	.02150	.02042	.01943
12	.02560	.02427	.02305	.02192	.02088
13	.02734	.02595	.02467	.02349	.02240
14	.02912	.02766	.02632	.02509	.02394
15	.03087	.02935	.02795	.02666	.02546
16	.03257	.03099	.02952	.02817	.02691
17	.03423	.03257	.03104	.02962	.02831
18	.03586	.03414	.03253	.03105	.02967
19	.03752	.03572	.03404	.03249	.03105
20	.03925	.03737	.03562	.03399	.03248
21	.04107	.03910	.03727	.03557	.03398
22	.04297	.04091	.03899	.03722	.03556
23	.04498	.04283	.04083	.03897	.03723
24	.04715	.04491	.04282	.04087	.03905
25	.04953	.04718	.04499	.04295	.04105
26	.05213	.04968	.04740	.04527	.04327
27	.05499	.05243	.05005	.04782	.04573
28	.05811	.05545	.05295	.05062	.04844
29	.06146	.05868	.05608	.05365	.05136
30	.06506	.06217	.05945	.05691	.05452
31	.06888	.06586	.06303	.06038	.05789
32	.07295	.06981	.06687	.06410	.06149
33	.07728	.07401	.07095	.06806	.06535
34	.08185	.07846	.07527	.07227	.06944
35	.08671	.08319	.07988	.07675	.07380
36	.09184	.08819	.08475	.08150	.07843
37	.09725	.09347	.08989	.08652	.08332
38	.10293	.09901	.09531	.09180	.08848
39	.10889	.10483	.10099	.09736	.09391
40	.11514	.11094	.10697	.10320	.09963
41	.12168	.11735	.11324	.10934	.10564
42	.12856	.12409	.11984	.11581	.11197
43	.13574	.13113	.12675	.12258	.11862
44	.14325	.13850	.13398	.12967	.12558

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	8.2%	8.4%	8.6%	8.8%	9.0%
45	.15105	.14616	.14150	.13706	.13283
46	.15917	.15414	.14935	.14478	.14041
47	.16760	.16244	.15751	.15280	.14831
48	.17639	.17109	.16602	.16119	.15656
49	.18551	.18007	.17488	.16991	.16516
50	.19499	.18942	.18410	.17900	.17412
51	.20480	.19911	.19366	.18844	.18343
52	.21495	.20914	.20357	.19822	.19309
53	.22544	.21951	.21381	.20835	.20309
54	.23622	.23018	.22437	.21878	.21341
55	.24732	.24116	.23524	.22954	.22406
56	.25870	.25244	.24641	.24060	.23501
57	.27040	.26404	.25791	.25200	.24630
58	.28239	.27594	.26971	.26370	.25791
59	.29472	.28817	.28186	.27576	.26987
60	.30736	.30074	.29434	.28816	.28218
61	.32035	.31365	.30718	.30092	.29486
62	.33368	.32692	.32038	.31405	.30791
63	.34735	.34054	.33394	.32754	.32134
64	.36133	.35448	.34783	.34138	.33512
65	.37562	.36873	.36204	.35554	.34924
66	.39019	.38327	.37655	.37002	.36367
67	.40502	.39809	.39134	.38479	.37841
68	.42011	.41317	.40642	.39985	.39345
69	.43547	.42854	.42179	.41522	.40882
70	.45112	.44421	.43748	.43091	.42451
71	.46711	.46023	.45352	.44698	.44059
72	.48342	.47659	.46992	.46341	.45705
73	.49998	.49321	.48660	.48014	.47382
74	.51663	.50994	.50339	.49699	.49073
75	.53322	.52661	.52014	.51381	.50762
76	.54967	.54315	.53678	.53053	.52440
77	.56595	.55954	.55326	.54710	.54106
78	.58209	.57579	.56961	.56355	.55761
79	.59814	.59196	.58590	.57995	.57410
80	.61415	.60810	.60217	.59633	.59060
81	.63001	.62410	.61830	.61260	.60699
82	.64561	.63985	.63419	.62862	.62314
83	.66095	.65535	.64983	.64441	.63907
84	.67612	.67068	.66533	.66005	.65486
85	.69116	.68589	.68070	.67559	.67055
86	.70573	.70063	.69561	.69066	.68578
87	.71939	.71446	.70961	.70481	.70009
88	.73211	.72735	.72265	.71801	.71343
89	.74417	.73956	.73501	.73053	.72609
90	.75590	.75146	.74707	.74273	.73845
91	.76724	.76296	.75873	.75454	.75041
92	.77781	.77368	.76960	.76556	.76158
93	.78740	.78342	.77948	.77558	.77173
94	.79596	.79210	.78829	.78452	.78079
95	.80341	.79967	.79597	.79231	.78869
96	.80967	.80603	.80242	.79885	.79532
97	.81526	.81170	.80818	.80470	.80125
98	.82013	.81665	.81320	.80979	.80641
99	.82470	.82129	.81791	.81456	.81125
100 ..	.82924	.82590	.82258	.81930	.81605
101 ..	.83322	.82993	.82667	.82344	.82024
102 ..	.83751	.83428	.83108	.82791	.82477
103 ..	.84301	.83986	.83674	.83365	.83058
104 ..	.84826	.84518	.84213	.83910	.83610
105 ..	.85623	.85327	.85033	.84741	.84452
106 ..	.86915	.86641	.86369	.86098	.85829
107 ..	.88718	.88476	.88236	.87997	.87759
108 ..	.91571	.91385	.91201	.91017	.90834
109 ..	.96211	.96125	.96041	.95956	.95872

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	9.2%	9.4%	9.6%	9.8%	10.0%
0	.02987	.02938	.02893	.02851	.02812
1	.01192	.01141	.01094	.01051	.01012
2	.01173	.01119	.01070	.01025	.00983
3	.01192	.01136	.01084	.01036	.00992
4	.01229	.01170	.01116	.01066	.01019
5	.01283	.01221	.01164	.01111	.01062
6	.01350	.01284	.01224	.01168	.01116
7	.01425	.01356	.01292	.01233	.01178
8	.01512	.01439	.01372	.01309	.01252
9	.01612	.01535	.01464	.01398	.01337
10	.01724	.01644	.01569	.01499	.01435
11	.01851	.01766	.01688	.01615	.01547
12	.01991	.01902	.01819	.01742	.01671
13	.02139	.02045	.01958	.01877	.01802
14	.02288	.02190	.02098	.02013	.01934
15	.02435	.02331	.02235	.02146	.02063
16	.02575	.02466	.02366	.02272	.02185
17	.02709	.02595	.02490	.02391	.02300
18	.02839	.02721	.02610	.02507	.02410
19	.02971	.02846	.02730	.02621	.02520
20	.03108	.02977	.02855	.02741	.02635
21	.03251	.03114	.02986	.02866	.02755
22	.03402	.03258	.03123	.02998	.02880
23	.03562	.03410	.03269	.03137	.03014
24	.03735	.03577	.03428	.03290	.03159
25	.03927	.03761	.03605	.03459	.03322
26	.04141	.03966	.03803	.03649	.03505
27	.04377	.04194	.04023	.03861	.03710
28	.04639	.04447	.04267	.04098	.03938
29	.04922	.04721	.04532	.04354	.04187
30	.05228	.05017	.04819	.04633	.04457
31	.05554	.05334	.05126	.04930	.04746
32	.05904	.05674	.05456	.05251	.05058
33	.06279	.06038	.05810	.05595	.05392
34	.06677	.06435	.06187	.05962	.05750
35	.07102	.06839	.06590	.06355	.06132
36	.07553	.07278	.07019	.06773	.06540
37	.08030	.07745	.07474	.07217	.06974
38	.08534	.08237	.07955	.07687	.07433
39	.09065	.08755	.08462	.08182	.07917
40	.09624	.09302	.08996	.08706	.08429
41	.10212	.09878	.09560	.09258	.08970
42	.10833	.10486	.10156	.09842	.09543
43	.11484	.11125	.10783	.10456	.10145
44	.12167	.11795	.11441	.11102	.10779
45	.12880	.12495	.12128	.11777	.11442
46	.13625	.13227	.12847	.12484	.12137
47	.14402	.13991	.13599	.13223	.12863
48	.15214	.14791	.14385	.13997	.13626
49	.16060	.15625	.15207	.14806	.14422
50	.16944	.16496	.16065	.15653	.15257
51	.17862	.17401	.16959	.16534	.16126
52	.18816	.18343	.17888	.17451	.17031
53	.19805	.19320	.18853	.18404	.17972
54	.20825	.20328	.19850	.19390	.18946
55	.21878	.21370	.20881	.20409	.19954
56	.22963	.22443	.21943	.21460	.20994
57	.24081	.23551	.23040	.22546	.22069
58	.25231	.24691	.24170	.23665	.23178
59	.26418	.25868	.25336	.24822	.24325
60	.27640	.27081	.26540	.26016	.25509
61	.28899	.28332	.27782	.27249	.26733
62	.30197	.29622	.29064	.28523	.27998
63	.31533	.30950	.30385	.29836	.29304
64	.32905	.32316	.31743	.31188	.30648
65	.34311	.33716	.33138	.32576	.32030
66	.35751	.35151	.34568	.34001	.33449
67	.37221	.36618	.36030	.35459	.34902
68	.38723	.38116	.37526	.36950	.36390
69	.40257	.39649	.39056	.38478	.37914
70	.41826	.41217	.40623	.40043	.39478
71	.43435	.42827	.42233	.41652	.41086
72	.45084	.44478	.43885	.43305	.42739
73	.46765	.46161	.45571	.44994	.44429
74	.48460	.47861	.47274	.46700	.46138
75	.50155	.49561	.48979	.48409	.47851
76	.51841	.51253	.50677	.50112	.49559
77	.53514	.52934	.52364	.51806	.51258
78	.55177	.54605	.54043	.53492	.52951
79	.56837	.56273	.55720	.55177	.54643
80	.58497	.57944	.57401	.56866	.56341
81	.60148	.59606	.59073	.58548	.58033
82	.61775	.61245	.60723	.60210	.59705
83	.63381	.62863	.62354	.61852	.61358
84	.64974	.64470	.63973	.63484	.63002
85	.66558	.66068	.65586	.65110	.64641
86	.68096	.67622	.67154	.66692	.66236
87	.69542	.69082	.68628	.68180	.67738
88	.70891	.70445	.70005	.69570	.69141
89	.72172	.71739	.71312	.70891	.70474
90	.73422	.73004	.72591	.72182	.71779
91	.74632	.74229	.73829	.73435	.73045
92	.75763	.75373	.74988	.74606	.74229
93	.76791	.76414	.76042	.75673	.75308
94	.77710	.77345	.76983	.76626	.76272
95	.78510	.78155	.77804	.77457	.77113
96	.79183	.78837	.78494	.78155	.77819
97	.79783	.79445	.79110	.78779	.78450
98	.80306	.79975	.79647	.79322	.79000
99	.80797	.80471	.80149	.79830	.79514
100 ..	.81283	.80964	.80648	.80335	.80025
101 ..	.81708	.81394	.81082	.80774	.80468
102 ..	.82165	.81856	.81550	.81247	.80946
103 ..	.82754	.82452	.82153	.81857	.81563
104 ..	.83312	.83017	.82723	.82433	.82144
105 ..	.84165	.83880	.83597	.83316	.83038
106 ..	.85562	.85297	.85034	.84772	.84512
107 ..	.87523	.87288	.87054	.86822	.86591
108 ..	.90652	.90471	.90291	.90111	.89932
109 ..	.95788	.95704	.95620	.95537	.95455

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	10.2%	10.4%	10.6%	10.8%	11.0%
0	.02776	.02743	.02712	.02682	.02655
1	.00975	.00941	.00909	.00880	.00852
2	.00945	.00909	.00875	.00844	.00816
3	.00952	.00914	.00879	.00846	.00815
4	.00976	.00936	.00899	.00865	.00832
5	.01016	.00974	.00935	.00898	.00864
6	.01068	.01023	.00981	.00943	.00907
7	.01128	.01080	.01036	.00995	.00957
8	.01198	.01148	.01101	.01058	.01017

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	10.2%	10.4%	10.6%	10.8%	11.0%
9	.01281	.01228	.01179	.01133	.01090
10	.01375	.01319	.01267	.01219	.01173
11	.01483	.01425	.01370	.01318	.01270
12	.01604	.01542	.01484	.01430	.01379
13	.01732	.01666	.01605	.01548	.01494
14	.01860	.01792	.01727	.01667	.01610
15	.01986	.01913	.01845	.01782	.01723
16	.02103	.02027	.01956	.01889	.01827
17	.02214	.02134	.02059	.01989	.01923
18	.02320	.02236	.02157	.02084	.02014
19	.02426	.02337	.02254	.02177	.02104
20	.02536	.02442	.02355	.02273	.02197
21	.02650	.02552	.02460	.02374	.02293
22	.02770	.02667	.02570	.02479	.02394
23	.02898	.02789	.02687	.02591	.02501
24	.03037	.02923	.02815	.02714	.02619
25	.03194	.03073	.02960	.02853	.02752
26	.03370	.03243	.03123	.03010	.02904
27	.03568	.03434	.03307	.03188	.03076
28	.03789	.03647	.03514	.03389	.03271
29	.04029	.03880	.03740	.03608	.03483
30	.04291	.04135	.03987	.03848	.03716
31	.04572	.04407	.04252	.04105	.03966
32	.04875	.04702	.04538	.04384	.04237
33	.05200	.05019	.04847	.04684	.04530
34	.05548	.05358	.05177	.05006	.04843
35	.05921	.05722	.05532	.05352	.05181
36	.06319	.06110	.05911	.05722	.05543
37	.06743	.06524	.06315	.06117	.05929
38	.07191	.06962	.06744	.06536	.06338
39	.07665	.074425	.07197	.06980	.06773
40	.08166	.07916	.07677	.07450	.07233
41	.08696	.08434	.08185	.07947	.07721
42	.09257	.08985	.08725	.08477	.08239
43	.09848	.09564	.09293	.09034	.08787
44	.10470	.10175	.09893	.09623	.09365
45	.11121	.10815	.10522	.10241	.09972
46	.11805	.11486	.11182	.10890	.10610
47	.12519	.12189	.11873	.11569	.11279
48	.13269	.12927	.12600	.12285	.11983
49	.14054	.13600	.13361	.13035	.12721
50	.14876	.14511	.14160	.13822	.13497
51	.15734	.15356	.14994	.14645	.14309
52	.16627	.16238	.15864	.15504	.15156
53	.17557	.17156	.16770	.16399	.16040
54	.18519	.18107	.17710	.17327	.16957
55	.19515	.19092	.18684	.18290	.17909
56	.20544	.20110	.19691	.19286	.18894
57	.21609	.21164	.20734	.20318	.19916
58	.22707	.22252	.21811	.21385	.20972
59	.23844	.23378	.22928	.22491	.22068
60	.25018	.24543	.24082	.23636	.23203
61	.26233	.25749	.25279	.24823	.24381
62	.27490	.26996	.26517	.26052	.25601
63	.28787	.28286	.27798	.27325	.26865
64	.30124	.29615	.29120	.28639	.28171
65	.31500	.30983	.30481	.29993	.29517
66	.32912	.32390	.31881	.31386	.30904
67	.34360	.33832	.33318	.32817	.32328
68	.35843	.35311	.34791	.34285	.33791
69	.37365	.36828	.36305	.35794	.35296
70	.38925	.38386	.37860	.37346	.36844
71	.40532	.39991	.39463	.38946	.38442
72	.42185	.41644	.41115	.40597	.40091
73	.43876	.43336	.42807	.42289	.41782
74	.45588	.45050	.44522	.44005	.43499
75	.47304	.46769	.46244	.45729	.45225
76	.49016	.48485	.47963	.47451	.46949
77	.50721	.50193	.49676	.49168	.48670
78	.52419	.51898	.51385	.50882	.50388
79	.54119	.53604	.53097	.52600	.52111
80	.55825	.55318	.54819	.54328	.53846
81	.57526	.57027	.56536	.56053	.55578
82	.59208	.58718	.58236	.57762	.57295
83	.60871	.60392	.59920	.59455	.58997
84	.62527	.62059	.61597	.61143	.60695
85	.64179	.63723	.63273	.62830	.62393
86	.65787	.65344	.64907	.64475	.64050
87	.67302	.66871	.66446	.66026	.65612
88	.68717	.68298	.67885	.67477	.67074
89	.70063	.69656	.69255	.68858	.68466
90	.71380	.70986	.70597	.70212	.69831
91	.72659	.72278	.71901	.71528	.71160
92	.73856	.73488	.73123	.72762	.72405
93	.74947	.74590	.74236	.73887	.73541
94	.75922	.75575	.75233	.74893	.74557
95	.76773	.76436	.76102	.75772	.75445
96	.77487	.77158	.76832	.76510	.76190
97	.78125	.77803	.77485	.77169	.76856
98	.78681	.78365	.78052	.77742	.77435
99	.79201	.78891	.78583	.78279	.77977
100 ..	.79717	.79412	.79111	.78811	.78515
101 ..	.80165	.79865	.79568	.79273	.78981
102 ..	.80648	.80353	.80060	.79769	.79481
103 ..	.81271	.80982	.80695	.80411	.80129
104 ..	.81858	.81574	.81292	.81013	.80736
105 ..	.83761	.82487	.82214	.81943	.81675
106 ..	.84254	.83998	.83743	.83490	.83238
107 ..	.86362	.86133	.85906	.85681	.85456
108 ..	.89755	.89577	.89401	.89226	.89051
109 ..	.95372	.95290	.95208	.95126	.95045

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	11.2%	11.4%	11.6%	11.8%	12.0%
0	.02630	.02606	.02583	.02562	.02542
1	.00827	.00803	.00780	.00759	.00739
2	.00789	.00763	.00740	.00718	.00697
3	.00787	.00760	.00736	.00712	.00690
4	.00802	.00774	.00748	.00723	.00700
5	.00832	.00802	.00774	.00748	.00724
6	.00873	.00841	.00812	.00784	.00758
7	.00921	.00888	.00856	.00827	.00799
8	.00979	.00944	.00910	.00879	.00850
9	.01049	.01012	.00976	.00943	.00912
10	.01131	.01091	.01053	.01018	.00985
11	.01225	.01183	.01143	.01106	.01070
12	.01331	.01286	.01244	.01205	.01168
13	.01444	.01397	.01352	.01311	.01271
14	.01558	.01508	.01461	.01417	.01375
15	.01667	.01614	.01565	.01519	.01475
16	.01768	.01713	.01661	.01612	.01566
17	.01862	.01803	.01749	.01697	.01649

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	11.2%	11.4%	11.6%	11.8%	12.0%
18	.01949	.01888	.01831	.01776	.01725
19	.02035	.01971	.01910	.01853	.01799
20	.02124	.02056	.01992	.01932	.01875
21	.02217	.02145	.02078	.02014	.01954
22	.02313	.02238	.02166	.02099	.02035
23	.02416	.02336	.02261	.02190	.02122
24	.02529	.02445	.02365	.02290	.02218
25	.02657	.02568	.02484	.02404	.02328
26	.02804	.02710	.02620	.02536	.02456
27	.02970	.02870	.02776	.02686	.02601
28	.03159	.03053	.02953	.02858	.02768
29	.03365	.03253	.03147	.03047	.02951
30	.03591	.03473	.03361	.03255	.03154
31	.03834	.03709	.03591	.03478	.03372
32	.04098	.03966	.03841	.03722	.03610
33	.04383	.04244	.04112	.03987	.03867
34	.04689	.04543	.04403	.04271	.04145
35	.05019	.04865	.04718	.04578	.04445
36	.05372	.05210	.05055	.04907	.04767
37	.05749	.05578	.05416	.05260	.05112
38	.06150	.05970	.05799	.05636	.05480
39	.06575	.06387	.06207	.06035	.05871
40	.07026	.06828	.06639	.06459	.06286
41	.07504	.07297	.07099	.06909	.06728
42	.08013	.07796	.07589	.07390	.07200
43	.08550	.08323	.08106	.07898	.07699
44	.09118	.08881	.08654	.08437	.08228
45	.09714	.09467	.09230	.09003	.08784
46	.10341	.10084	.09837	.09599	.09371
47	.10999	.10731	.10473	.10226	.09988
48	.11693	.11414	.11145	.10888	.10639
49	.12420	.12130	.11852	.11583	.11325
50	.13185	.12884	.12595	.12316	.12047
51	.13985	.13674	.13373	.13084	.12805
52	.14822	.14499	.14188	.13888	.13598
53	.15695	.15361	.15039	.14729	.14428
54	.16601	.16256	.15924	.15602	.15292
55	.17542	.17186	.16843	.16511	.16190
56	.18516	.18150	.17796	.17454	.17122
57	.19527	.19150	.18786	.18433	.18091
58	.20573	.20186	.19811	.19448	.19096
59	.21659	.21262	.20877	.20504	.20142
60	.22784	.22377	.21982	.21599	.21227
61	.23952	.23535	.23131	.22738	.22357
62	.25163	.24737	.24324	.23922	.23531
63	.26418	.25984	.25561	.25151	.24751
64	.27716	.27273	.26842	.26423	.26015
65	.29054	.28604	.28165	.27738	.27322
66	.30434	.29976	.29530	.29096	.28672
67	.31852	.31388	.30935	.30494	.30063
68	.33310	.32840	.32381	.31933	.31496
69	.34809	.34334	.33870	.33417	.32975
70	.36353	.35874	.35405	.34948	.34500
71	.37948	.37466	.36994	.36532	.36081
72	.39595	.39111	.38636	.38172	.37718
73	.41286	.40801	.40325	.39859	.39403
74	.43004	.42518	.42042	.41575	.41118
75	.44730	.44245	.43770	.43304	.42846
76	.46457	.45974	.45500	.45035	.44579
77	.48181	.47700	.47229	.46766	.46311
78	.49903	.49426	.48958	.48497	.48045
79	.51631	.51159	.50694	.50238	.49789
80	.53371	.52905	.52446	.51994	.51550
81	.55110	.54650	.54197	.53752	.53313
82	.56835	.56382	.55937	.55497	.55065
83	.58546	.58101	.57663	.57231	.56806
84	.60253	.59817	.59388	.58965	.58547
85	.61961	.61536	.61116	.60703	.60294
86	.63630	.63215	.62806	.62402	.62004
87	.65203	.64800	.64401	.64007	.63619
88	.66676	.66282	.65894	.65510	.65131
89	.68079	.67696	.67318	.66944	.66574
90	.69455	.69084	.68716	.68353	.67993
91	.70795	.70435	.70078	.69726	.69377
92	.72052	.71703	.71357	.71015	.70677
93	.73198	.72860	.72524	.72192	.71864
94	.74225	.73896	.73570	.73248	.72928
95	.75121	.74801	.74483	.74169	.73858
96	.75874	.75561	.75250	.74943	.74639
97	.76546	.76240	.75936	.75635	.75336
98	.77131	.76830	.76531	.76235	.75942
99	.77678	.77382	.77088	.76798	.76509
100 ..	.78221	.77930	.77642	.77356	.77072
101 ..	.78691	.78404	.78119	.77837	.77557
102 ..	.79196	.78912	.78632	.78353	.78077
103 ..	.79849	.79572	.79297	.79024	.78753
104 ..	.80460	.80188	.79917	.79648	.79381
105 ..	.81408	.81143	.80881	.80620	.80361
106 ..	.82989	.82740	.82494	.82249	.82006
107 ..	.85233	.85012	.84791	.84572	.84353
108 ..	.88877	.88704	.88532	.88361	.88190
109 ..	.94964	.94883	.94803	.94723	.94643

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	12.2%	12.4%	12.6%	12.8%	13.0%
0	.02523	.02505	.02488	.02472	.02456
1	.00721	.00703	.00687	.00671	.00657
2	.00678	.00659	.00642	.00626	.00610
3	.00670	.00650	.00632	.00615	.00599
4	.00678	.00658	.00638	.00620	.00603
5	.00701	.00679	.00658	.00639	.00620
6	.00733	.00710	.00688	.00668	.00648
7	.00733	.00748	.00725	.00703	.00682
8	.00822	.00796	.00771	.00748	.00726
9	.00882	.00854	.00828	.00803	.00780
10	.00953	.00924	.00896	.00869	.00844
11	.01037	.01006	.00976	.00948	.00922
12	.01132	.01099	.01068	.01038	.01010
13	.01234	.01199	.01166	.01134	.01104
14	.01336	.01299	.01264	.01231	.01199
15	.01434	.01395	.01358	.01323	.01289
16	.01522	.01481	.01442	.01405	.01371
17	.01603	.01559	.01518	.01480	.01443
18	.01677	.01631	.01588	.01547	.01508
19	.01748	.01700	.01654	.01611	.01570
20	.01821	.01770	.01722	.01677	.01633
21	.01897	.01843	.01792	.01744	.01698
22	.01975	.01918	.01864	.01813	.01765
23	.02059	.01998	.01941	.01887	.01836
24	.02151	.02087	.02027	.01970	.01915
25	.02257	.02189	.02125	.02064	.02006
26	.02380	.02308	.02240	.02175	.02114

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	12.2%	12.4%	12.6%	12.8%	13.0%
27	.02521	.02445	.02373	.02304	.02239
28	.02683	.02602	.02525	.02452	.02383
29	.02861	.02775	.02694	.02616	.02543
30	.03058	.02967	.02881	.02798	.02720
31	.03270	.03174	.03082	.02995	.02911
32	.03502	.03400	.03303	.03210	.03122
33	.03754	.03646	.03543	.03444	.03350
34	.04025	.03910	.03801	.03697	.03597
35	.04318	.04197	.04081	.03971	.03865
36	.04633	.04505	.04383	.04266	.04154
37	.04971	.04836	.04707	.04583	.04465
38	.05331	.05188	.05052	.04922	.04797
39	.05714	.05564	.05420	.05282	.05150
40	.06121	.05963	.05812	.05667	.05528
41	.06554	.06388	.06229	.06076	.05929
42	.07018	.06843	.06675	.06514	.06360
43	.07508	.07324	.07148	.06979	.06817
44	.08028	.07325	.07651	.07473	.07303
45	.08575	.08373	.08180	.07993	.07814
46	.09152	.08941	.08738	.08543	.08355
47	.09759	.09539	.09326	.09122	.08926
48	.10401	.10171	.09949	.09735	.09530
49	.11076	.10836	.10605	.10382	.10167
50	.11788	.11538	.11297	.11065	.10840
51	.12535	.12276	.12025	.11782	.11548
52	.13319	.13049	.12788	.12536	.12292
53	.14139	.13858	.13588	.13326	.13072
54	.14992	.14701	.14420	.14149	.13885
55	.15880	.15579	.15288	.15006	.14733
56	.16801	.16491	.16190	.15898	.15615
57	.17760	.17439	.17128	.16827	.16534
58	.18755	.18424	.18103	.17792	.17489
59	.19790	.19450	.19119	.18798	.18486
60	.20866	.20516	.20175	.19844	.19523
61	.21986	.21626	.21276	.20936	.20605
62	.23151	.22782	.22423	.22073	.21733
63	.24362	.23984	.23616	.23257	.22908
64	.25617	.25231	.24854	.24487	.24129
65	.26917	.26522	.26137	.25761	.25395
66	.28259	.27857	.27464	.27081	.26707
67	.29643	.29233	.28833	.28443	.38061
68	.31070	.30653	.30246	.29849	.29461
69	.32542	.32120	.31707	.31303	.30908
70	.34063	.33635	.33217	.32807	.32407
71	.35639	.35207	.34784	.34370	.33965
72	.37273	.36837	.36410	.35993	.35583
73	.38955	.38517	.38088	.37667	.37255
74	.40670	.40230	.39799	.39377	.38962
75	.42398	.41958	.41526	.41102	.40686
76	.44131	.43691	.43259	.42825	.42419
77	.45864	.45425	.44994	.44571	.44155
78	.47601	.47164	.46734	.46312	.45897
79	.49348	.48914	.48487	.48067	.47654
80	.51112	.50682	.50259	.49842	.49432
81	.52881	.52455	.52036	.51624	.51218
82	.54639	.54219	.53805	.53398	.52996
83	.56386	.55973	.55566	.55164	.54768
84	.58136	.57730	.57329	.56934	.56545
85	.59891	.59494	.59102	.58715	.58333
86	.61610	.61222	.60839	.60460	.60086
87	.62335	.62856	.62481	.62111	.61746
88	.64757	.64386	.64021	.63659	.63302
89	.66209	.65848	.65491	.65139	.64790
90	.67638	.67287	.66939	.66596	.66256
91	.69032	.68691	.68353	.68019	.67689
92	.70342	.70011	.69683	.69359	.69038
93	.71539	.71217	.70899	.70584	.70271
94	.72612	.72299	.71989	.71683	.71379
95	.73550	.43245	.72943	.72643	.72347
96	.74337	.74039	.73743	.73450	.73160
97	.75041	.74748	.74458	.74171	.73886
98	.74652	.75364	.75079	.74797	.74517
99	.76224	.75941	.75660	.75382	.75106
100 ..	.76791	.76513	.76237	.75963	.75692
101 ..	.77280	.77005	.76732	.67462	.76194
102 ..	.77804	.77532	.77263	.76996	.76732
103 ..	.78485	.78218	.77954	.77692	.77432
104 ..	.79117	.78854	.78594	.78335	.78078
105 ..	.80103	.79848	.78595	.79343	.79093
106 ..	.81764	.81524	.81285	.81048	.80813
107 ..	.84137	.93921	.83706	.83493	.83281
108 ..	.88020	.87851	.87682	.87515	.87348
109 ..	.94563	.94484	.94405	.94326	.94248

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	13.2%	13.4%	13.6%	13.8%	14.0%
0	.02442	.02428	.02414	.02402	.02389
1	.00643	.00629	.00617	.00605	.00594
2	.00596	.00582	.00569	.00556	.00544
3	.00583	.00569	.00555	.00542	.00529
4	.00586	.00571	.00556	.00542	.00529
5	.00603	.00587	.00571	.00556	.00542
6	.00630	.00612	.00595	.00580	.00565
7	.00663	.00644	.00626	.00610	.00594
8	.00705	.00685	.00666	.00648	.00631
9	.00757	.00736	.00716	.00697	.00679
10	.00821	.00798	.00777	.00756	.00737
11	.00896	.00872	.00850	.00828	.00807
12	.00983	.00958	.00934	.00911	.00889
13	.01076	.01049	.01024	.00999	.00976
14	.01170	.01141	.01114	.01088	.01064
15	.01258	.01228	.01200	.01172	.01147
16	.01337	.01306	.01276	.01247	.01220
17	.01408	.01375	.01343	.01313	.01284
18	.01471	.01436	.01403	.01371	.01341
19	.01531	.01494	.01459	.01426	.01394
20	.01592	.01553	.01516	.01481	.01447
21	.01655	.01614	.01574	.01537	.01502
22	.01719	.01675	.01634	.01594	.01557
23	.01787	.01741	.01697	.01655	.01615
24	.01863	.01814	.01768	.01723	.01681
25	.01952	.01899	.01850	.01802	.01757
26	.02056	.02000	.01947	.01897	.01849
27	.02177	.02118	.02061	.02008	.01956
28	.02317	.02254	.02194	.02137	.02082
29	.02472	.02405	.02342	.02281	.02223
30	.02645	.02574	.02506	.02441	.02379
31	.02832	.02756	.02684	.02615	.02549
32	.03037	.02957	.02880	.02806	.02736
33	.03261	.03175	.03093	.03015	.02940
34	.03502	.03411	.03324	.03241	.03162
35	.03764	.03668	.03576	.03488	.03403

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	13.2%	13.4%	13.6%	13.8%	14.0%
36	.04048	.03945	.03847	.03754	.03664
37	.04352	.04244	.04140	.04040	.03945
38	.04677	.04563	.04453	.04347	.04246
39	.05024	.04903	.04787	.04675	.04568
40	.05394	.05266	.05143	.05025	.04912
41	.05789	.05653	.05524	.05399	.05279
42	.06212	.06069	.05932	.05800	.05674
43	.06661	.06511	.06366	.06227	.06093
44	.07138	.06980	.06828	.06682	.06541
45	.07642	.07476	.07316	.07162	.07013
46	.08174	.08000	.07832	.07670	.07514
47	.08736	.08553	.08377	.08207	.08042
48	.09331	.09140	.08955	.08776	.08604
49	.09959	.09759	.09565	.09378	.09198
50	.10624	.10414	.10212	.10016	.09827
51	.11322	.11104	.10892	.10688	.10490
52	.12057	.11829	.11608	.11395	.11188
53	.12827	.12590	.12360	.12138	.11922
54	.13631	.13384	.13145	.12913	.12689
55	.14469	.14213	.13964	.13724	.13490
56	.15341	.15075	.14817	.14567	.14324
57	.16250	.15975	.15708	.15448	.15196
58	.17196	.16911	.16634	.16365	.16104
59	.18183	.17888	.17602	.17324	.17053
60	.19210	.18906	.18611	.18323	.18043
61	.20283	.19970	.19665	.19368	.19079
62	.21402	.21079	.20766	.20460	.20162
63	.22568	.22237	.21914	.21600	.21293
64	.23780	.23440	.23109	.22786	.22471
65	.25038	.24690	.24350	.24019	.23695
66	.26342	.25986	.25638	.25298	.24967
67	.27689	.27325	.26970	.26623	.26284
68	.29081	.28711	.28248	.27994	.27647
69	.30523	.30145	.29776	.29415	.29062
70	.32015	.31632	.31257	.30890	.30530
71	.33568	.33179	.32799	.32426	.32061
72	.35182	.34789	.34404	.34027	.33657
73	.36851	.36455	.36066	.35685	.35311
74	.38555	.38156	.37765	.37381	.37004
75	.40278	.39877	.39484	.39098	.38710
76	.42010	.41608	.41213	.40826	.40445
77	.43746	.43344	.42949	.42561	.42179
78	.45489	.45088	.44693	.44305	.43923
79	.47248	.46848	.46454	.46067	.45686
80	.49028	.48631	.48240	.47854	.47475
82	.50818	.50423	.50035	.49653	.59276
82	.52600	.52210	.51826	.51447	.51074
83	.54377	.53992	.53613	.53238	.52869
84	.56160	.55781	.55407	.55038	.54674
85	.57956	.57584	.57216	.56854	.56496
86	.59717	.59353	.58993	.58638	.58287
87	.61385	.61028	.60676	.60328	.59984
88	.62950	.62601	.62256	.61915	.61578
89	.64445	.64104	.63767	.63434	.63105
90	.65920	.65588	.65259	.64934	.64612
91	.67362	.67039	.66719	.66402	.66089
92	.68720	.68405	.68094	.67786	.67481
93	.69962	.69657	.69354	.69054	.68757
94	.71078	.70780	.70485	.70193	.69903
95	.72053	.71763	.71475	.71189	.70906
96	.72872	.72587	.72305	.72026	.71748
97	.73604	.73325	.73048	.72773	.72501
98	.74239	.73964	.73692	.73422	.73154
99	.74833	.74562	.74294	.74028	.73764
100 ..	.75423	.75156	.74892	.74630	.74370
101 ..	.75928	.75664	.75403	.75144	.74887
102 ..	.76469	.76209	.75950	.75694	.75440
103 ..	.77174	.76918	.76664	.76413	.76163
104 ..	.77824	.77571	.77320	.77071	.76824
105 ..	.78845	.78599	.78354	.78111	.77870
106 ..	.80579	.80346	.80115	.79885	.79657
107 ..	.83070	.82860	.82652	.82444	.82238
108 ..	.87182	.87016	.86852	.86688	.86525
109 ..	.94170	.94092	.94014	.93937	.93860

[Redesignated from 36 FR 6480, Apr. 6, 1971. T.D. 8540, 59 FR 30102, 30105, 30116, June 10, 1994]

TRUSTS WHICH DISTRIBUTE CURRENT INCOME ONLY

§1.651(a)–1 Simple trusts; deduction for distributions; in general.

Section 651 is applicable only to a trust the governing instruments of which:

(a) Requires that the trust distribute all of its income currently for the taxable year, and

(b) Does not provide that any amounts may be paid, permanently set aside, or used in the taxable year for the charitable, etc., purposes specified in section 642(c),

and does not make any distribution other than of current income. A trust to which section 651 applies is referred to in this part as a ‘‘simple’’ trust. Trusts subject to section 661 are referred to as ‘‘complex’’ trusts. A trust may be a simple trust for one year and a complex trust for another year. It should be noted that under section 651 a trust qualifies as a simple trust in a taxable year in which it is required to distribute all its income currently and makes no other distributions, whether or not distributions of current income are in fact made. On the other hand a trust is not a complex trust by reason of distributions of amounts other than income unless such distributions are in fact made during the taxable year, whether or not they are required in that year.

§ 1.651(a)–2 Income required to be distributed currently.

(a) The determination of whether trust income is required to be distributed currently depends upon the terms of the trust instrument and the applicable local law. For this purpose, if the trust instrument provides that the trustee in determining the distributable income shall first retain a reserve for depreciation or otherwise make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the retention of current income for that purpose will not disqualify the trust from being a ''simple'' trust. The fiduciary must be under a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed until after the close of the trust's taxable year. For example: Under the terms of the trust instrument, all of the income is currently distributable to A. The trust reports on the calendar year basis and as a matter of practical necessity makes distribution to A of each quarter's income on the fifteenth day of the month following the close of the quarter. The distribution made by the trust on January 15, 1955, of the income for the fourth quarter of 1954 does not disqualify the trust from treatment in 1955 under section 651, since the income is required to be distributed currently. However, if the terms of a trust require that none of the income be distributed until after the year of its receipt by the trust, the income of the trust is not required to be distributed currently and the trust is not a simple trust. For definition of the term ''income'' see section 643(b) and § 1.643(b)–1.

(b) It is immaterial, for purposes of determining whether all the income is required to be distributed currently, that the amount of income allocated to a particular beneficiary is not specified in the instrument. For example, if the fiduciary is required to distribute all the income currently, but has discretion to ''sprinkle'' the income among a class of beneficiaries, or among named beneficiaries, in such amount as he may see fit, all the income is required to be distributed currently, even though the amount distributable to a particular beneficiary is unknown until the fiduciary has exercised his discretion.

(c) If in one taxable year of a trust its income for that year is required or permitted to be accumulated, and in another taxable year its income for the year is required to be distributed currently (and no other amounts are distributed), the trust is a simple trust for the latter year. For example, a trust under which income may be accumulated until a beneficiary is 21 years old, and thereafter must be distributed currently, is a simple trust for taxable years beginning after the beneficiary reaches the age of 21 years in which no other amounts are distributed.

§ 1.651(a)–3 Distribution of amounts other than income.

(a) A trust does not qualify for treatment under section 651 for any taxable year in which it actually distributes corpus. For example, a trust which is required to distribute all of its income currently would not qualify as a simple trust under section 651 in the year of its termination since in that year actual distributions of corpus would be made.

(b) A trust, otherwise qualifying under section 651, which may make a distribution of corpus in the discretion of the trustee, or which is required under the terms of its governing instrument to make a distribution of corpus upon the happening of a specified event, will be disqualified for treatment under section 651 only for the taxable year in which an actual distribution of corpus is made. For example: Under the terms of a trust, which is required to distribute all of its income currently, half of the corpus is to be distributed to beneficiary A when he becomes 30 years of age. The trust reports on the calendar year basis. On December 28, 1954, A becomes 30 years of age and the trustee distributes half of the corpus of the trust to him on January 3, 1955. The trust will be disqualified for treatment under section 651 only for the taxable year 1955, the year in which an actual distribution of corpus is made.

(c) See section 661 and the regulations thereunder for the treatment of trusts which distribute corpus or claim the charitable contributions deduction provided by section 642(c).

§1.651(a)–4 Charitable purposes.

A trust is not considered to be a trust which may pay, permanently set aside, or use any amount for charitable, etc., purposes for any taxable year for which it is not allowed a charitable, etc., deduction under section 642(c). Therefore, a trust with a remainder to a charitable organization is not disqualified for treatment as a simple trust if either (a) the remainder is subject to a contingency, so that no deduction would be allowed for capital gains or other amounts added to corpus as amounts permanently set aside for a charitable, etc., purpose under section 642 (c), or (b) the trust receives no capital gains or other income added to corpus for the taxable year for which such a deduction would be allowed.

§1.651(a)–5 Estates.

Subpart B has no application to an estate.

§1.651(b)–1 Deduction for distributions to beneficiaries.

In computing its taxable income, a simple trust is allowed a deduction for the amount of income which is required under the terms of the trust instrument to be distributed currently to beneficiaries. If the amount of income required to be distributed currently exceeds the distributable net income, the deduction allowable to the trust is limited to the amount of the distributable net income. For this purpose the amount of income required to be distributed currently, or distributable net income, whichever is applicable, does not include items of trust income (adjusted for deductions allocable thereto) which are not included in the gross income of the trust. For determination of the character of the income required to be distributed currently, see §1.652(b)–2. Accordingly, for the purposes of determining the deduction allowable to the trust under section 651, distributable net income is computed without the modifications specified in paragraphs (5), (6), and (7) of section 643(a), relating to tax-exempt interest, foreign income, and excluded dividends. For example: Assume that the distributable net income of a trust as computed under section 643(a) amounts to $99,000 but includes nontaxable income of $9,000. Then distributable net income for the purpose of determining the deduction allowable under section 651 is $90,000 ($99,000 less $9,000 nontaxable income).

§1.652(a)–1 Simple trusts; inclusion of amounts in income of beneficiaries.

Subject to the rules in §§1.652(a)–2 and 1.652(b)–1, a beneficiary of a simple trust includes in his gross income for the taxable year the amounts of income required to be distributed to him for such year, whether or not distributed. Thus, the income of a simple trust is includible in the beneficiary’s gross income for the taxable year in which the income is required to be distributed currently even though, as a matter of practical necessity, the income is not distributed until after the close of the taxable year of the trust. See §1.642(a)(3)–2 with respect to time of receipt of dividends. See §1.652(c)–1 for treatment of amounts required to be distributed where a beneficiary and the trust have different taxable years. The term *income required to be distributed currently* includes income required to be distributed currently which is in fact used to discharge or satisfy any person’s legal obligation as that term is used in §1.662(a)–4.

§1.652(a)–2 Distributions in excess of distributable net income.

If the amount of income required to be distributed currently to beneficiaries exceeds the distributable net income of the trust (as defined in section 643(a)), each beneficiary includes in his gross income an amount equivalent to his proportionate share of such distributable net income. Thus, if beneficiary A is to receive two-thirds of the trust income and B is to receive one-third, and the income required to be distributed currently is $99,000, A will receive $66,000 and B, $33,000. However, if the distributable net income, as determined under section 643(a) is only $90,000, A will include two-thirds ($60,000) of that sum in his gross income, and B will include one-third ($30,000) in his gross income. See §§1.652(b)–1 and 1.652(b)–2, however, for amounts which are not includible in the gross income of a beneficiary because of their tax-exempt character.

§ 1.652(b)–1 Character of amounts.

In determining the gross income of a beneficiary, the amounts includible under § 1.652(a)–1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652(a)–1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of determining the availability to the beneficiary of the dividends received credit under section 34 (for dividends received on or before December 31, 1964) and the dividend exclusion under section 116. Also, to the extent that the amounts specified in § 1.652(a)–1 consist of ''earned income'' in the hands of the trust under the provisions of section 1348 such amount shall be treated under section 1348 as ''earned income'' in the hands of the beneficiary. Similarly, to the extent such amounts consist of an amount received as a part of a lump sum distribution from a qualified plan and to which the provisions of section 72(n) would apply in the hands of the trust, such amount shall be treated as subject to such section in the hands of the beneficiary except where such amount is deemed under section 666(a) to have been distributed in a preceding taxable year of the trust and the partial tax described in section 668(a)(2) is determined under section 668(b)(1)(B). The tax treatment of amounts determined under § 1.652(a)–1 depends upon the beneficiary's status with respect to them not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.

[T.D. 7204, 37 FR 17134, Aug. 25, 1972]

§ 1.652(b)–2 Allocation of income items.

(a) The amounts specified in § 1.652(a)–1 which are required to be included in the gross income of a beneficiary are treated as consisting of the same proportion of each class of items entering into distributable net income of the trust (as defined in section 643(a)) as the total of each class bears to such distributable net income, unless the terms of the trust specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For example: Assume that under the terms of the governing instrument, beneficiary A is to receive currently one-half of the trust income and beneficiaries B and C are each to receive currently one-quarter, and the distributable net income of the trust (after allocation of expenses) consists of dividends of $10,000, taxable interest of $10,000, and tax-exempt interest of $4,000. A will be deemed to have received $5,000 of dividends, $5,000 of taxable interest, and $2,000 of tax-exempt interest; B and C will each be deemed to have received $2,500 of dividends, $2,500 of taxable interest, and $1,000 of tax-exempt interest. However, if the terms of the trust specifically allocate different classes of income to different beneficiaries, entirely or in part, or if local law requires such an allocation, each beneficiary will be deemed to have received those items of income specifically allocated to him.

(b) The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation. For example:

(1) Allocation pursuant to a provision in a trust instrument granting the trustee discretion to allocate different classes of income to different beneficiaries is not a specific allocation by the terms of the trust.

(2) Allocation pursuant to a provision directing the trustee to pay all of one income to A, or $10,000 out of the income to A, and the balance of the income to B, but directing the trustee first to allocate a specific class of income to A's share (to the extent there is income of that class and to the extent it does not exceed A's share) is not a specific allocation by the terms of the trust.

(3) Allocation pursuant to a provision directing the trustee to pay half the class of income (whatever it may be) to A, and the balance of the income to B, is a specific allocation by the terms of the trust.

§1.652(b)–3 Allocation of deductions.

Items of deduction of a trust that enter into the computation of distributable net income are to be allocated among the items of income in accordance with the following principles:

(a) All deductible items directly attributable to one class of income (except dividends excluded under section 116) are allocated thereto. For example, repairs to, taxes on, and other expenses directly attributable to the maintenance of rental property or the collection of rental income are allocated to rental income. See §1.642(e)–1 for treatment of depreciation of rental property. Similarly, all expenditures directly attributable to a business carried on by a trust are allocated to the income from such business. If the deductions directly attributable to a particular class of income exceed that income, the excess is applied against other classes of income in the manner provided in paragraph (d) of this section.

(b) The deductions which are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must be allocated to nontaxable income (except dividends excluded under section 116) pursuant to section 265 and the regulations thereunder. For example, if the income of a trust is $30,000 (after direct expenses), consisting equally of $10,000 of dividends, tax-exempt interest, and rents, and income commissions amount to $3,000, one-third ($1,000) of such commissions should be allocated to tax-exempt interest, but the balance of $2,000 may be allocated to the rents or dividends in such proportions as the trustee may elect. The fact that the governing instrument or applicable local law treats certain items of deduction as attributable to corpus or to income not included in distributable net income does not affect allocation under this paragraph. For instance, if in the example set forth in this paragraph the trust also had capital gains which are allocable to corpus under the terms of the trust instrument, no part of the deductions would be allocable thereto since the capital gains are excluded from the computation of distributable net income under section 643(a)(3).

(c) Examples of expenses which are considered as not directly attributable to a specific class of income are trustee's commissions, the rental of safe deposit boxes, and State income and personal property taxes.

(d) To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income in the manner provided in paragraph (b) of this section, except that any excess deductions attributable to tax-exempt income (other than dividends excluded under section 116) may not be offset against any other class of income. See section 265 and the regulations thereunder. Thus, if the trust has rents, taxable interest, dividends, and tax-exempt interest, and the deductions directly attributable to the rents exceed the rental income, the excess may be allocated to the taxable interest or dividends in such proportions as the fiduciary may elect. However, if the excess deductions are attributable to the tax-exempt interest, they may not be allocated to either the rents, taxable interest, or dividends.

§1.652(c)–1 Different taxable years.

If a beneficiary has a different taxable year (as defined in section 441 or 442) from the taxable year of the trust, the amount he is required to include in gross income in accordance with section 652 (a) and (b) is based on the income of the trust for any taxable year or years ending with or within his taxable year. This rule applies to taxable years of normal duration as well as to so-called short taxable years. Income of the trust for its taxable year or years is determined in accordance with its method of accounting and without regard to that of the beneficiary.

§ 1.652(c)–2 Death of individual beneficiaries.

If income is required to be distributed currently to a beneficiary, by a trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the income is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under section 652 for the taxable year of the trust in which his last taxable year ends. Thus, the distributable net income of the taxable year of the trust determines the extent to which the income required to be distributed currently to the beneficiary is included in his gross income for his last taxable year or in the gross income of his estate. (Section 652(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)–3 with respect to separate share treatment for the periods before and after the decedent's death. If the trust does not qualify as a simple trust for the taxable year of the trust in which the last taxable year of the beneficiary ends, see section 662(c) and § 1.662(c)–2.

§ 1.652(c)–3 Termination of existence of other beneficiaries.

If the existence of a beneficiary which is not an individual terminates, the amount to be included under section 652(a) in its gross income for its last taxable year is computed with reference to §§ 1.652(c)–1 and 1.652(c)–2 as if the beneficiary were a deceased individual, except that income required to be distributed prior to the termination but actually distributed to the beneficiary's successor in interest is included in the beneficiary's income for its last taxable year.

§ 1.652(c)–4 Illustration of the provisions of sections 651 and 652.

The rules applicable to a trust required to distribute all of its income currently to its beneficiaries may be illustrated by the following example:

Example. (a) Under the terms of a simple trust all of the income is to be distributed equally to beneficiaries A and B and capital gains are to be allocated to corpus. The trust and both beneficiaries file returns on the calendar year basis. No provision is made in the governing instrument with respect to depreciation. During the taxable year 1955, the trust had the following items of income and expense:

Rents	$25,000
Dividends of domestic corporations	50,000
Tax-exempt interest on municipal bonds	25,000
Long-term capital gains	15,000
Taxes and expenses directly attributable to rents	5,000
Trustee's commissions allocable to income account	2,600
Trustee's commissions allocable to principal account	1,300
Depreciation	5,000

(b) The income of the trust for fiduciary accounting purposes is $92,400, computed as follows:

Rents		$25,000
Dividends		50,000
Tax-exempt interest		25,000
Total		100,000
Deductions:		
Expenses directly attributable to rental income	$5,000	
Trustee's commissions allocable to income account	2,600	
		7,600
Income computed under section 643(b)		92,400

One-half ($46,200) of the income of $92,400 is currently distributable to each beneficiary.

(c) The distributable net income of the trust computed under section 643(a) is $91,100, determined as follows (cents are disregarded in the computation):

Rents		$25,000
Dividends		50,000
Tax-exempt interest	$25,000	
Less: Expenses allocable thereto (25,000/100,000 ×$3,900)	975	
		24,025
Total		99,025
Deductions:		
Expenses directly attributable to rental income	$5,000	
Trustee's commissions ($3,900 less $975 allocable to tax-exempt interest)	2,925	
		7,925
Distributable net income		91,100

In computing the distributable net income of $91,100, the taxable income of the trust was computed with the following modifications: No deductions were allowed for distributions to the beneficiaries and for personal exemption of the trust (section 643(a) (1) and (2)); capital gains were excluded and no deduction under section 1202 (relating to the 50-percent deduction for long-term capital gains) was taken into account (section 643(a)(3)); the tax-exempt interest (as adjusted for expenses) and the dividend exclusion of $50 were included (section 643(a) (5) and (7)). Since all of the income of the trust is required to be currently distributed, no deduction is allowable for depreciation in the absence of specific provisions in the governing instrument providing for the keeping of the trust corpus intact. See section 167(h) and the regulations thereunder.

(d) The deduction allowable to the trust under section 651(a) for distributions to the beneficiaries is $67,025, computed as follows:

Distributable net income computed under section 643(a) (see paragraph (c))		$91,100
Less:		
Tax-exempt interest as adjusted	$24,025	
Dividend exclusion	50	
		24,075
Distributable net income as determined under section 651(b)		67,025

Since the amount of the income ($92,400) required to be distributed currently by the trust exceeds the distributable net income ($67,025) as computed under section 651(b), the deduction allowable under section 651(a) is limited to the distributable net income of $67,025.

(e) The taxable income of the trust is $7,200 computed as follows:

Rents		$25,000
Dividends ($50,000 less $50 exclusion)		49,950
Long-term capital gains		15,000
Gross income		89,950
Deductions:		
Rental expenses	$5,000	
Trustee's commissions	2,925	
Capital gain deduction	7,500	
Distributions to beneficiaries	67,025	
Personal exemption	300	
		82,750
Taxable income		7,200

The trust is not allowed a deduction for the portion ($975) of the trustee's commissions allocable to tax-exempt interest in computing its taxable income.

(f) In determining the character of the amounts includible in the gross income of A and B, it is assumed that the trustee elects to allocate to rents the expenses not directly attributable to a specific item of income other than the portion ($975) of such expenses allocated to tax-exempt interest. The allocation of expenses among the items of income is shown below:

	Rents	Dividends	Tax-exempt interest	Total
Income for trust accounting purposes	$25,000	$50,000	$25,000	$100,000
Less:				
Rental expenses	5,000			5,000
Trustee's commissions	2,925		975	3,900
Total deductions	7,925	0	975	8,900
Character of amounts in the hands of the beneficiaries	17,075	50,000	24,025	[1]91,100

[1] Distributable net income.

Inasmuch as the income of the trust is to be distributed equally to A and B, each is deemed to have received one-half of each item of income; that is, rents of $8,537.50, dividends of $25,000, and tax-exempt interest of $12,012.50. The dividends of $25,000 allocated to each beneficiary are to be aggregated with his other dividends (if any) for purposes of the dividend exclusion provided by section 116 and the dividend received credit allowed under section 34. Also, each beneficiary is allowed a deduction of $2,500 for depreciation of rental property attributable to the portion (one-half) of the income of the trust distributed to him.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3655, Mar. 24, 1964]

ESTATES AND TRUSTS WHICH MAY ACCUMULATE INCOME OR WHICH DISTRIBUTE CORPUS

§ 1.661(a)–1 Estates and trusts accumulating income or distributing corpus; general.

Subpart C, part I, subchapter J, chapter 1 of the Code, is applicable to all decedents' estates and their beneficiaries, and to trusts and their beneficiaries other than trusts subject to the provisions of subpart B of such part I (relating to trusts which distribute current income only, or ''simple'' trusts). A trust which is required to distribute amounts other than income during the taxable year may be subject to subpart B, and not subpart C, in the absence of an actual distribution of amounts other than income during the taxable year. See §§ 1.651(a)–1 and 1.651(a)–3. A trust to which subpart C is applicable is referred to as a ''complex'' trust in this part. Section 661 has no application to amounts excluded under section 663(a).

§ 1.661(a)–2 Deduction for distributions to beneficiaries.

(a) In computing the taxable income of an estate or trust there is allowed under section 661(a) as a deduction for distributions to beneficiaries the sum of:

(1) The amount of income for the taxable year which is required to be distributed currently, and

(2) Any other amounts properly paid or credited or required to be distributed for such taxable year.

However, the total amount deductible under section 661(a) cannot exceed the distributable net income as computed under section 643(a) and as modified by section 661(c). See § 1.661(c)–1.

(b) The term *income required to be distributed currently* includes any amount required to be distributed which may be paid out of income or corpus (such as an annuity), to the extent it is paid out of income for the taxable year. See § 1.651(a)–2 which sets forth additional rules which are applicable in determining whether income of an estate or trust is required to be distributed currently.

(c) The term *any other amounts properly paid, credited, or required to be distributed* includes all amounts properly paid, credited, or required to be distributed by an estate or trust during the taxable year other than income required to be distributed currently. Thus, the term includes the payment of an annuity to the extent it is not paid out of income for the taxable year, and a distribution of property in kind (see paragraph (f) of this section). However, see section 663(a) and regulations thereunder for distributions which are not included. Where the income of an estate or trust may be accumulated or distributed in the discretion of the fiduciary, or where the fiduciary has a power to distribute corpus to a beneficiary, any such discretionary distribution would qualify under section 661(a)(2). The term also includes an amount applied or distributed for the support of a dependent of a grantor or of a trustee or cotrustee under the circumstances described in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year.

(d) The terms *income required to be distributed currently* and *any other amounts properly paid or credited or required to be distributed* also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)–4.

(e) The terms *income required to be distributed currently* and *any other amounts properly paid or credited or required to be distributed* include amounts paid, or required to be paid, during the taxable year pursuant to a court order or decree or under local law, by a decedent's estate as an allowance or award for the support of the decedent's widow or other dependent for a limited period during the administration of the estate. The term *any other amounts properly paid or credited or required to be distributed* does not include the value of any interest in real estate owned by a decedent, title to which under local law passes directly from the decedent to his heirs or devisees.

(f) If property is paid, credited, or required to be distributed in kind:

(1) No gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of the distribution, unless the distribution is in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed.

(2) In determining the amount deductible by the trust or estate and includible in the gross income of the beneficiary the property distributed in kind is taken into account at its fair

market value at the time it was distributed, credited, or required to be distributed.

(3) The basis of the property in the hands of the beneficiary is its fair market value at the time it was paid, credited, or required to be distributed, to the extent such value is included in the gross income of the beneficiary. To the extent that the value of property distributed in kind is not included in the gross income of the beneficiary, its basis in the hands of the beneficiary is governed by the rules in sections 1014 and 1015 and the regulations thereunder. For this purpose, if the total value of cash and property distributed, credited, or required to be distributed in kind to a beneficiary in any taxable year exceeds the amount includible in his gross income for that year, the value of the property other than cash is normally considered as includible in his gross income only to the extent that the amount includible exceeds the cash paid, credited, or required to be distributed to the beneficiary in that year. Further, to the extent that the value of different items of property other than cash is includible in the gross income of a beneficiary in accordance with the preceding sentence, a pro rata portion of the total value of each item of property distributed, credited, or required to be distributed is normally considered as includible in the beneficiary's gross income.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7287, 38 FR 26912, Sept. 27, 1973]

§1.661(b)–1 Character of amounts distributed; in general.

In the absence of specific provisions in the governing instrument for the allocation of different classes of income, or unless local law requires such an allocation, the amount deductible for distributions to beneficiaries under section 661(a) is treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income. For example, if a trust has distributable net income of $20,000, consisting of $10,000 each of taxable interest and royalties and distributes $10,000 to beneficiary A, the deduction of $10,000 allowable under section 661(a) is deemed to consist of $5,000 each of taxable interest and royalties, unless the trust instrument specifically provides for the distribution or accumulation of different classes of income or unless local law requires such an allocation. See also §1.661(c)–1.

§1.661(b)–2 Character of amounts distributed when charitable contributions are made.

In the application of the rule stated in §1.661(b)–1, the items of deduction which enter into the computation of distributable net income are allocated among the items of income which enter into the computation of distributable net income in accordance with the rules set forth in §1.652(b)–3, except that, in the absence of specific provisions in the governing instrument, or unless local law requires a different apportionment, amounts paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642(c) are first ratably apportioned among each class of items of income entering into the computation of the distributable net income of the estate or trust, in accordance with the rules set out in paragraph (b) of §1.643(a)–5.

§1.661(c)–1 Limitation on deduction.

An estate or trust is not allowed a deduction under section 661(a) for any amount which is treated under section 661(b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust. For example, if in 1962, a trust, which reports on the calendar year basis, has distributable net income of $20,000, which is deemed to consist of $10,000 of dividends and $10,000 of tax-exempt interest, and distributes $10,000 to beneficiary A, the deduction allowable under section 661(a) (computed without regard to section 661(c)) would amount to $10,000 consisting of $5,000 of dividends and $5,000 of tax-exempt interest. The deduction actually allowable under section 661(a) as limited by section 661(c) is $4,975, since no deduction is allowable for the $5,000 of tax-exempt interest and the $25 deemed distributed out of the $50 of dividends excluded under section 116, items of distributable net income which are not included in the gross income of the estate or trust.

[T.D. 6777, 29 FR 17809, Dec. 16, 1964]

§ 1.661(c)–2 Illustration of the provisions of section 661.

The provisions of section 661 may be illustrated by the following example:

Example. (a) Under the terms of a trust, which reports on the calendar year basis, $10,000 a year is required to be paid out of income to a designated charity. The balance of the income may, in the trustee's discretion, be accumulated or distributed to beneficiary A. Expenses are allocable against income and the trust instrument requires a reserve for depreciation. During the taxable year 1955 the trustee contributes $10,000 to charity and in his discretion distributes $15,000 of income to A. The trust has the following items of income and expense for the taxable year 1955:

Dividends	$10,000
Partially tax-exempt interest	10,000
Fully tax-exempt interest	10,000
Rents	20,000
Rental expenses	2,000
Depreciation of rental property	3,000
Trustee's commissions	5,000

(b) The income of the trust for fiduciary accounting purposes is $40,000, computed as follows:

Dividends		$10,000
Partially tax-exempt interest		10,000
Fully tax-exempt interest		10,000
Rents		20,000
Total		50,000
Less:		
Rental expenses	$2,000	
Depreciation	3,000	
Trustee's commissions	5,000	
		10,000
Income as computed under section 643(b)		40,000

(c) The distributable net income of the trust as computed under section 643(a) is $30,000, determined as follows:

Rents			$20,000
Dividends			10,000
Partially tax-exempt interest			10,000
Fully tax-exempt interest		$10,000	
Less:			
Expenses allocable thereto (10,000/50,000×$5,000)	$1,000		
Charitable contributions allocable thereto (10,000/50,000×$10,000)	2,000		
		3,000	
			7,000
Total			47,000
Deductions:			
Rental expenses		2,000	
Depreciation of rental property		3,000	
Trustee's commissions ($5,000 less $1,000 allocated to tax-exempt interest)		4,000	
Charitable contributions ($10,000 less $2,000 allocated to tax-exempt interest)		8,000	
			17,000
Distributable net income (section 643(a))			30,000

(d) The character of the amounts distributed under section 661(a), determined in accordance with the rules prescribed in §§ 1.661(b)–1 and 1.661(b)–2 is shown by the following table (for the purpose of this allocation, it is assumed that the trustee elected to allocate the trustee's commissions to rental income except for the amount required to be allocated to tax-exempt interest):

	Rental income	Taxable dividends	Excluded dividends	Partially tax-exempt interest	Tax-exempt interest	Total
Trust income	$20,000	$9,950	$50	$10,000	$10,000	$50,000
Less:						
Charitable contributions	4,000	2,000		2,000	2,000	10,000
Rental expenses	2,000					2,000
Depreciation	3,000					3,000

	Rental income	Taxable dividends	Excluded dividends	Partially tax-exempt interest	Tax-exempt interest	Total
Trustee's commissions	4,000				1,000	5,000
Total deductions	13,000	2,000	0	2,000	3,000	20,000
Distributable net income	7,000	7,950	50	8,000	7,000	30,000
Amounts deemed distributed under section 661(a) before applying the limitation of section 661(c)	3,500	3,975	25	4,000	3,500	15,000

In the absence of specific provisions in the trust instrument for the allocation of different classes of income, the charitable contribution is deemed to consist of a pro rata portion of the gross amount of each items of income of the trust (except dividends excluded under section 116) and the trust is deemed to have distributed to A a pro rata portion (one-half) of each item of income included in distributable net income.

(e) The taxable income of the trust is $11,375 computed as follows:

Rental income		$20,000
Dividends ($10,000 less $50 exclusion)		9,950
Partially tax-exempt interest		10,000
Gross income		39,950
Deductions:		
Rental expenses	$2,000	
Depreciation of rental property	3,000	
Trustee's commissions	4,000	
Charitable contributions	8,000	
Distributions to A	11,475	
Personal exemption	100	
		28,575
Taxable income		11,375

In computing the taxable income of the trust no deduction is allowable for the portions of the charitable contributions deduction ($2,000) and trustee's commissions ($1,000) which are treated under section 661(b) as attributable to the tax-exempt interest excludable from gross income. Also, of the dividends of $4,000 deemed to have been distributed to A under section 661(a), $25 (25/50ths of $50) is deemed to have been distributed from the excluded dividends and is not an allowable deduction to the trust. Accordingly, the deduction allowable under section 661 is deemed to be composed of $3,500 rental income, $3,975 of dividends, and $4,000 partially tax-exempt interest. No deduction is allowable for the portion of tax-exempt interest or for the portion of the excluded dividends deemed to have been distributed to the beneficiary.

(f) The trust is entitled to the credit allowed by section 34 with respect to dividends of $5,975 ($9,950 less $3,975 distributed to A) included in gross income. Also, the trust is allowed the credit provided by section 35 with respect to partially tax-exempt interest of $6,000 ($10,000 less $4,000 deemed distributed to A) included in gross income.

(g) Dividends of $4,000 allocable to A are to be aggregated with his other dividends (if any) for purposes of the dividend exclusion under section 116 and the dividend received credit under section 84.

§1.662(a)–1 Inclusion of amounts in gross income of beneficiaries of estates and complex trusts; general.

There is included in the gross income of a beneficiary of an estate or complex trust the sum of:

(a) Amounts of income required to be distributed currently to him, and

(b) All other amounts properly paid, credited, or required to be distributed to him

by the estate or trust. The preceding sentence is subject to the rules contained in §1.662(a)–2 (relating to currently distributable income), §1.662(a)–3 (relating to other amounts distributed), and §§1.662(b)–1 and 1.662(b)–2 (relating to character of amounts). Section 662 has no application to amounts excluded under section 663(a).

§ 1.662(a)–2 Currently distributable income.

(a) There is first included in the gross income of each beneficiary under section 662(a)(1) the amount of income for the taxable year of the estate or trust required to be distributed currently to him, subject to the provisions of paragraph (b) of this section. Such amount is included in the beneficiary's gross income whether or not it is actually distributed.

(b) If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (as defined in section 643(a) but computed without taking into account the payment, crediting, or setting aside of an amount for which a charitable contributions deduction is allowable under section 642(c)) of the estate or trust, then there is included in the gross income of each beneficiary an amount which bears the same ratio to distributable net income (as so computed) as the amount of income required to be distributed currently to the beneficiary bears to the amount required to be distributed currently to all beneficiaries.

(c) The phrase *the amount of income for the taxable year required to be distributed currently* includes any amount required to be paid out of income or corpus to the extent the amount is satisfied out of income for the taxable year. Thus, an annuity required to be paid in all events (either out of income or corpus) would qualify as income required to be distributed currently to the extent there is income (as defined in section 643(b)) not paid, credited, or required to be distributed to other beneficiaries for the taxable year. If an annuity or a portion of an annuity is deemed under this paragraph to be income required to be distributed currently, it is treated in all respects in the same manner as an amount of income actually required to be distributed currently. The phrase *the amount of income for the taxable year required to be distributed currently* also includes any amount required to be paid during the taxable year in all events (either out of income or corpus) pursuant to a court order or decree or under local law, by a decedent's estate as an allowance or award for the support of the decedent's widow or other dependent for a limited period during the administration of the estate to the extent there is income (as defined in section 643(b)) of the estate for the taxable year not paid, credited, or required to be distributed to other beneficiaries.

(d) If an annuity is paid, credited, or required to be distributed tax free, that is, under a provision whereby the executor or trustee will pay the income tax of the annuitant resulting from the receipt of the annuity, the payment of or for the tax by the executor or trustee will be treated as income paid, credited, or required to be distributed currently to the extent it is made out of income.

(e) The application of the rules stated in this section may be illustrated by the following examples:

Example 1. (1) Assume that under the terms of the trust instrument $5,000 is to be paid to X charity out of income each year; that $20,000 of income is currently distributable to A; and that an annuity of $12,000 is to be paid to B out of income or corpus. All expenses are charges against income and capital gains are allocable to corpus. During the taxable year the trust had income of $30,000 (after the payment of expenses) derived from taxable interest and made the payments to X charity and distributions to A and B as required by the governing instrument.

(2) The amounts treated as distributed currently under section 662(a)(1) total $25,000 ($20,000 to A and $5,000 to B). Since the charitable contribution is out of income the amount of income available for B's annuity is only $5,000. The distributable net income of the trust computed under section 643(a) without taking into consideration the charitable contributions deduction of $5,000 as provided by section 661(a)(1), is $30,000. Since the amounts treated as distributed currently of $25,000 do not exceed the distributable net income (as modified) of $30,000, A is required to include $20,000 in his gross income and B is required to include $5,000 in his gross income under section 662(a)(1).

Example 2. Assume the same facts as in paragraph (1) of example 1, except that the trust has, in addition, $10,000 of administration expenses, commissions, etc., chargeable to corpus. The amounts treated as distributed currently under section 662(a)(1) total $25,000 ($20,000 to A and $5,000 to B), since trust income under section 643(b) remains the same as in example 1. Distributable net income of the trust computed under section 643(a) but without taking into account the charitable contributions deduction of $5,000 as provided by section 662(a)(1) is only

$20,000. Since the amounts treated as distributed currently of $25,000 exceed the distributable net income (as so computed) of $20,000, A is required to include $16,000 (20,000/25,000 of $20,000) in his gross income and B is required to include $4,000 (5,000/25,000 of $20,000) in his gross income under section 662(a)(1). Because A and B are beneficiaries of amounts of income required to be distributed currently, they do not benefit from the reduction of distributable net income by the charitable contributions deduction.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7287, 38 FR 26912, Sept. 27, 1973]

§1.662(a)–3 Other amounts distributed.

(a) There is included in the gross income of a beneficiary under section 662(a)(2) any amount properly paid, credited, or required to be distributed to the beneficiary for the taxable year, other than (1) income required to be distributed currently, as determined under §1.662(a)–2, (2) amounts excluded under section 663(a) and the regulations thereunder, and (3) amounts in excess of distributable net income (see paragraph (c) of this section). An amount which is credited or required to be distributed is included in the gross income of a beneficiary whether or not it is actually distributed.

(b) Some of the payments to be included under paragraph (a) of this section are: (1) A distribution made to a beneficiary in the discretion of the fiduciary; (2) a distribution required by the terms of the governing instrument upon the happening of a specified event; (3) an annuity which is required to be paid in all events but which is payable only out of corpus; (4) a distribution of property in kind (see paragraph (f) of §1.661(a)–2); (5) an amount applied or distributed for the support of a dependent of a grantor or a trustee or cotrustee under the circumstances specified in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year; and (6) an amount required to be paid during the taxable year pursuant to a court order or decree or under local law, by a decedent's estate as an allowance or award for the support of the decedent's widow or other dependent for a limited period during the administration of the estate which is payable only out of corpus of the estate under the order or decree or local law.

(c) If the sum of the amounts of income required to be distributed currently (as determined under §1.662(a)–2) and other amounts properly paid, credited, or required to be distributed (as determined under paragraph (a) of this section) exceeds distributable net income (as defined in section 643(a)), then such other amounts properly paid, credited, or required to be distributed are included in gross income of the beneficiary but only to the extent of the excess of such distributable net income over the amounts of income required to be distributed currently. If the other amounts are paid, credited, or required to be distributed to more than one beneficiary, each beneficiary includes in gross income his proportionate share of the amount includible in gross income pursuant to the preceding sentence. The proportionate share is an amount which bears the same ratio to distributable net income (reduced by amounts of income required to be distributed currently) as the other amounts (as determined under paragraphs (a) and (d) of this section) distributed to the beneficiary bear to the other amounts distributed to all beneficiaries. For treatment of excess distributions by trusts, see sections 665 to 668, inclusive, and the regulations thereunder.

(d) The application of the rules stated in this section may be illustrated by the following example:

Example. The terms of a trust require the distribution annually of $10,000 of income to A. If any income remains, it may be accumulated or distributed to B, C, and D in amounts in the trustee's discretion. He may also invade corpus for the benefit of A, B, C, or D. In the taxable year, the trust has $20,000 of income after the deduction of all expenses. Distributable net income is $20,000. The trustee distributes $10,000 of income to A. Of the remaining $10,000 of income, he distributes $3,000 each to B, C, and D, and also distributes an additional $5,000 to A. A includes $10,000 in income under section 662(a)(1). The ‘‘other amounts distributed’’ amount of $14,000, includible in the income of the recipients to the extent of $10,000, distributable net income less the income currently distributable to A. A will include an additional $3,571 (5,000/14,000×$10,000) in income under this section, and B, C, and D will each include $2,143 (3,000/14,000×$10,000).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7287, 38 FR 26913, Sept. 27, 1973]

§ 1.662(a)–4 Amounts used in discharge of a legal obligation.

Any amount which, pursuant to the terms of a will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of any person is included in the gross income of such person under section 662(a) (1) or (2), whichever is applicable, as though directly distributed to him as a beneficiary, except in cases to which section 71 (relating to alimony payments) or section 682 (relating to income of a trust in case of divorce, etc.) applies. The term *legal obligation* includes a legal obligation to support another person if, and only if, the obligation is not affected by the adequacy of the dependent's own resources. For example, a parent has a ''legal obligation'' within the meaning of the preceding sentence to support his minor child if under local law property or income from property owned by the child cannot be used for his support so long as his parent is able to support him. On the other hand, if under local law a mother may use the resources of a child for the child's support in lieu of supporting him herself, no obligation of support exists within the meaning of this paragraph, whether or not income is actually used for support. Similarly, since under local law a child ordinarily is obligated to support his parent only if the parent's earnings and resources are insufficient for the purpose, no obligation exists whether or not the parent's earnings and resources are sufficient. In any event the amount of trust income which is included in the gross income of a person obligated to support a dependent is limited by the extent of his legal obligation under local law. In the case of a parent's obligation to support his child, to the extent that the parent's legal obligation of support, including education, is determined under local law by the family's station in life and by the means of the parent, it is to be determined without consideration of the trust income in question.

§ 1.662(b)–1 Character of amounts; when no charitable contributions are made.

In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)–1 through 1.662(a)–4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in § 1.652(b)–1 shall apply.

§ 1.662(b)–2 Character of amounts; when charitable contributions are made.

When a charitable contribution is made, the principles contained in §§ 1.652(b)–1 and 1.662(b)–1 generally apply. However, before the allocation of other deductions among the items of distributable net income, the charitable contributions deduction allowed under section 642(c) is (in the absence of specific allocation under the terms of the governing instrument or the requirement under local law of a different allocation) allocated among the classes of income entering into the computation of estate or trust income in accordance with the rules set forth in paragraph (b) of § 1.643(a)–5. In the application of the preceding sentence, for the purpose of allocating items of income and deductions to beneficiaries to whom income is required to be distributed currently, the amount of the charitable contributions deduction is disregarded to the extent that it exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed currently. The application of this section may be illustrated by the following examples (of which example (1) is illustrative of the preceding sentence):

Example 1. (a) A trust instrument provides that $30,000 of its income must be distributed currently to A, and the balance may either be distributed to B, distributed to a designated charity, or accumulated. Accumulated income may be distributed to B and to the charity. The trust for its taxable year has $40,000 of taxable interest and $10,000 of tax-exempt income, with no expenses. The trustee distributed $30,000 to A, $50,000 to charity X, and $10,000 to B.

(b) Distributable net income for the purpose of determining the character of the distribution to A is $30,000 (the charitable contributions deduction, for this purpose, being taken into account only to the extent of $20,000, the difference between the income of the trust for the taxable year, $50,000, and the amount required to be distributed currently, $30,000).

(c) The charitable contributions deduction taken into account, $20,000, is allocated proportionately to the items of income of the trust, $16,000 to taxable interest and $4,000 to tax-exempt income.

(d) Under section 662(a)(1), the amount of income required to be distributed currently to A is $30,000, which consists of the balance of these items, $24,000 of taxable interest and $6,000 of tax-exempt income.

(e) In determining the amount to be included in the gross income of B under section 662 for the taxable year, however, the entire charitable contributions deduction is taken into account, with the result that there is no distributable net income and therefore no amount to be included in gross income.

(f) See subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code for application of the throwback provisions to the distribution made to B.

Example 2. The net income of a trust is payable to A for life, with the remainder to a charitable organization. Under the terms of the trust instrument and local law capital gains are added to corpus. During the taxable year the trust receives dividends of $10,000 and realized a long-term capital gain of $10,000, for which a long-term capital gain deduction of $5,000 is allowed under section 1202. Since under the trust instrument and local law the capital gains are allocated to the charitable organization, and since the capital gain deduction is directly attributable to the capital gain, the charitable contributions deduction and the capital gain deduction are both allocable to the capital gain, and dividends in the amount of $10,000 are allocable to A.

§1.662(c)–1 Different taxable years.

If a beneficiary has a different taxable year (as defined in section 441 or 442) from the taxable year of an estate or trust, the amount he is required to include in gross income in accordance with section 662 (a) and (b) is based upon the distributable net income of the estate or trust and the amounts properly paid, credited, or required to be distributed to the beneficiary for any taxable year or years of the estate or trust ending with or within his taxable year. This rule applies as to so-called short taxable years as well as taxable years of normal duration. Income of an estate or trust for its taxable year or years is determined in accordance with its method of accounting and without regard to that of the beneficiary.

§1.662(c)–2 Death of individual beneficiary.

If an amount specified in section 662(a) (1) or (2) is paid, credited, or required to be distributed by an estate or trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the amount is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under section 662 for the taxable year of the estate or trust in which his last taxable year ends. Thus, the distributable net income and the amounts paid, credited, or required to be distributed for the taxable year of the estate or trust, determine the extent to which the amounts paid, credited, or required to be distributed to the beneficiary are included in his gross income for his last taxable year or in the gross income of his estate. (Section 662(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of §1.663(c)–3 with respect to separate share treatment for the periods before and after the death of a trust's beneficiary.

§ 1.662(c)–3 Termination of existence of other beneficiaries.

If the existence of a beneficiary which is not an individual terminates, the amount to be included under section 662(a) in its gross income for the last taxable year is computed with reference to §§ 1.662(c)–1 and 1.662(c)–2 as if the beneficiary were a deceased individual, except that income required to be distributed prior to the termination but actually distributed to the beneficiary's successor in interest is included in the beneficiary's income for its last taxable year.

§ 1.662(c)–4 Illustration of the provisions of sections 661 and 662.

The provisions of sections 661 and 662 may be illustrated in general by the following example:

Example. (a) Under the terms of a testamentary trust one-half of the trust income is to be distributed currently to W, the decedent's wife, for her life. The remaining trust income may, in the trustee's discretion, either be paid to D, the grantor's daughter, paid to designated charities, or accumulated. The trust is to terminate at the death of W and the principal will then be payable to D. No provision is made in the trust instrument with respect to depreciation of rental property. Capital gains are allocable to the principal account under the applicable local law. The trust and both beneficiaries file returns on the calendar year basis. The records of the fiduciary show the following items of income and deduction for the taxable year 1955:

Rents	$50,000
Dividends of domestic corporations	50,000
Tax-exempt interest	20,000
Partially tax-exempt interest	10,000
Capital gains (long term)	20,000
Depreciation of rental property	10,000
Expenses attributable to rental income	15,400
Trustee's commissions allocable to income account	2,800
Trustee's commissions allocable to principal account	1,100

(b) The income for trust accounting purposes is $111,800, and the trustee distributes one-half ($55,900) to W and in his discretion makes a contribution of one-quarter ($27,950) to charity X and distributes the remaining one-quarter ($27,950) to D. The total of the distributions to beneficiaries is $83,850, consisting of (1) income required to be distributed currently to W of $55,900 and (2) other amounts properly paid or credited to D of $27,950. The income for trust accounting purposes of $111,800 is determined as follows:

Rents		$50,000
Dividends		50,000
Tax-exempt interest		20,000
Partially tax-exempt interest		10,000
Total		130,000
Less:		
Rental expenses	$15,400	
Trustee's commissions allocable to income account	2,800	
		18,200
Income as computed under section 643(b)	111,800	

(c) The distributable net income of the trust as computed under section 643(a) is $82,750, determined as follows:

Rents			$50,000
Dividends			50,000
Partially tax-exempt interest			10,000
Tax-exempt interest		$20,000	
Less:			
Trustee's commissions allocable thereto (20,000/130,000 of $3,900)	$600		
Charitable contributions allocable thereto (20,000/130,000 of $27,950)	4,300		
		4,900	
			15,100
Total			125,100
Deductions:			
Rental expenses		15,400	
Trustee's commissions ($3,900 less $600 allocated to tax-exempt interest)		3,300	
Charitable deduction ($27,950 less $4,300 attributable to tax-exempt interest)		23,650	
			42,350
Distributable net income			82,750

In computing the distributable net income of $82,750, the taxable income of the trust was computed with the following modifications: No deductions were allowed for distributions to beneficiaries and for personal exemption of the trust (section 643(a) (1) and (2)); capital gains were excluded and no deduction under section 1202 (relating to the 50 percent deduction for long-term capital gains) was taken into account (section 643(a)(3)); and the tax-exempt interest (as adjusted for expenses and charitable contributions) and the dividend exclusion of $50 were included (section 643(a) (5) and (7)).

(d) Inasmuch as the distributable net income of $82,750 as determined under section 643(a) is less than the sum of the amounts distributed to W and D of $83,850, the deduction allowable to the trust under section 661(a) is such distributable net income as modified under section 661(c) to exclude therefrom the items of income not included in the gross income of the trust, as follows:

Distributable net income		$82,750
Less:		
Tax-exempt interest (as adjusted for expenses and the charitable contributions)	$15,100	
Dividend exclusion allowable under section 116	50	
		15,150
Deduction allowable under section 661(a)		67,600

(e) For the purpose of determining the character of the amounts deductible under section 642(c) and section 661(a), the trustee elected to offset the trustee's commissions (other than the portion required to be allocated to tax-exempt interest) against the rental income. The following table shows the determination of the character of the amounts deemed distributed to beneficiaries and contributed to charity.

	Rents	Taxable dividends	Excluded dividends	Tax exempt interest	Partially tax exempt interest	Total
Trust income	$50,000	$49,950	$50	$20,000	$10,000	$130,000
Less:						
Charitable contribution	10,750	10,750		4,300	2,150	27,950
Rental expenses	15,400					15,400
Trustee's commissions	3,300			600		3,900
Total deductions	29,450	10,750	0	4,900	2,150	47,250
Amounts distributable to beneficiaries	20,550	39,200	50	15,100	7,850	82,750

The character of the charitable contribution is determined by multiplying the total charitable contribution ($27,950) by a fraction consisting of each item of trust income, respectively, over the total trust income, except that no part of the dividends excluded from gross income are deemed included in the charitable contribution. For example, the charitable contribution is deemed to consist of rents of $10,750 (50,000/130,000× $27,950).

(f) The taxable income of the trust is $9,900 determined as follows:

Rental income		$50,000
Dividends ($50,000 less $50 exclusion)		49,950
Partially tax-exempt interest		10,000
Capital gains		20,000
Gross income		129,950
Deductions:		
Rental expenses	15,400	
Trustee's commissions	3,300	
Charitable contributions	23,650	
Capital gain deduction	10,000	
Distributions to beneficiaries	67,600	
Personal exemption	100	
		120,050
Taxable income		9,900

(g) In computing the amount includible in W's gross income under section 662(a)(1), the $55,900 distribution to her is deemed to be composed of the following proportions of the items of income deemed to have been distributed to the beneficiaries by the trust (see paragraph (e) of this example):

Rents (20,550/82,750×$55,900)	$13,882
Dividends (39,250/82,750×$55,900)	26,515
Partially tax-exempt interest (7,850/82,750×$55,900)	5,303
Tax-exempt interest (15,100/82,750×$55,900)	10,200
Total	55,900

Accordingly, W will exclude $10,200 of tax-exempt interest from gross income and will receive the credits and exclusion for dividends received and for partially tax-exempt interest provided in sections 34, 116, and 35, respectively, with respect to the dividends and partially tax-exempt interest deemed to have been distributed to her, her share of the dividends being aggregated with other dividends received by her for purposes of the dividend credit and exclusion. In addition, she may deduct a share of the depreciation deduction proportionate to the trust income allocable to her; that is, one-half of the total depreciation deduction, or $5,000.

(h) Inasmuch as the sum of the amount of income required to be distributed currently to W ($55,900) and the other amounts properly paid, credited, or required to be distributed to D ($27,950) exceeds the distributable net income ($82,750) of the trust as determined under section 643(a), D is deemed to have received $26,850 ($82,750 less $55,900) for income tax purposes. The character of the amounts deemed distributed to her is determined as follows:

Rents (20,550/82,750×$26,850)	$6,668
Dividends (39,250/82,750×$26,850)	12,735
Partially tax-exempt interest (7,850/82,750×$26,850)	2,547
Tax-exempt interest (15,100/82,750×$26,850)	4,900

Total	26,850

Accordingly, D will exclude $4,900 of tax-exempt interest from gross income and will receive the crddits and exclusion for dividends received and for partially tax-exempt interest provided in sections 34, 116, and 35, respectively, with respect to the dividends and partially tax-exempt interest deemed to have been distributed to her, her share of the dividends being aggregated with other dividends received by her for purposes of the dividend credit and exclusion. In addition, she may deduct a share of the depreciation deduction proportionate to the trust income allocable to her; that is, one-fourth of the total depreciation deduction, or $2,500.

(i) [Reserved]

(j) The remaining $2,500 of the depreciation deduction is allocated to the amount distributed to charity X and is hence non-deductible by the trust, W, or D. (See § 1.642(e)–1.)

§ 1.663(a)–1 Special rules applicable to sections 661 and 662; exclusions; gifts, bequests, etc.

(a) *In general.* A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under section 661 and is not included in the gross income of a beneficiary under section 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments. Thus, in order for a gift or bequest to be excludable from the gross income of the recipient, (1) it must qualify as a gift or bequest of a specific sum of money or of specific property (see paragraph (b) of this section), and (2) the terms of the governing instrument must not provide for its payment in more than three installments (see paragraph (c) of this section). The date when the estate came into existence or the date when the trust was created is immaterial.

(b) *Definition of a gift or bequest of a specific sum of money or of specific property.* (1) In order to qualify as a gift or bequest of a specific sum of money or of specific property under section 663(a), the amount of money or the identity of the specific property must be ascertainable under the terms of a testator's will as of the date of his death, or under the terms of an inter vivos trust instrument as of the date of the inception of the trust. For example, bequests to a decedent's son of the decedent's interest in a partnership and to his daughter of a sum of money equal to the value of the partnership interest are bequests of specific property and of a specific sum of money, respectively. On the other hand, a bequest to the decedent's spouse of money or property, to be selected by the decedent's executor, equal in value to a fraction of the decedent's ''adjusted gross estate'' is neither a bequest of a specific sum of money or of specific property. The identity of the property and the amount of money specified in the preceding sentence are dependent both on the exercise of the executor's discretion and on the payment of administration expenses and other charges, neither of which are facts existing on the date of the decedent's death. It is immaterial that the value of the bequest is determinable after the decedent's death before the bequest is satisfied (so that gain or loss may be realized by the estate in the transfer of property in satisfaction of it).

(2) The following amounts are not considered as gifts or bequests of a sum of money or of specific property within the meaning of this paragraph:

(i) An amount which can be paid or credited only from the income of an estate or trust, whether from the income for the year of payment or crediting, or from the income accumulated from a prior year;

(ii) An annuity, or periodic gifts of specific property in lieu of or having the effect of an annuity;

(iii) A residuary estate or the corpus of a trust; or

(iv) A gift or bequest paid in a lump sum or in not more than three installments, if the gift or bequest is required to be paid in more than three installments under the terms of the governing instrument.

(3) The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples, in which it is assumed that the gift or bequest is not required to be made in more than three installments (see paragraph (c)):

Example 1. Under the terms of a will, a legacy of $5,000 was left to A, 1,000 shares of X company stock was left to W, and the balance of the estate was to be divided equally between W and X. No provision was made in the will for the disposition of income of the estate during the period of administration. The estate had income of $25,000 during the taxable year 1954, which was accumulated and added to corpus for estate accounting purposes. During the taxable year, the executor paid the legacy of $5,000 in a lump sum to A and transferred the X company stock to W. No other distributions to beneficiaries were made during the taxable year. The distributions to A and W qualify as exclusions within the meaning of section 663(a)(1).

Example (2). Under the terms of a will, the testator's estate was to be divided equally between A and B. No provision was made in the will for the disposition of income of the estate during the period of administration. The estate had income of $50,000 for the taxable year 1954. In accordance with an agreement among the beneficiaries that part of the assets of the estate would be distributed in kind to the beneficiaries, stock in corporation X was distributed to A during 1954. The fair market value of the stock was $40,000 on the date of distribution. No other distribution was made during the year. The distribution does not qualify as an exclusion within the meaning of section 663(a)(1), since it is not a specific gift to A required by the terms of the will. Accordingly, the fair market value of the property ($40,000) represents a distribution within the meaning of section 661(a) and section 662(a) (see paragraph (c) of §1.661(a)–2).

Example (3). Under the terms of a trust instrument, income is to be accumulated during the minority of A. Upon A's reaching the age of 21, $10,000 is to be distributed to B out of income or corpus. Also at that time, $10,000 is to be distributed to C out of the accumulated income and the remainder of the accumulations are to be paid to A. A is then to receive all the income until he is 25, when the trust is to terminate. Only the distribution to B would qualify for exclusion under section 663(a)(1).

(4) A gift or bequest of a specific sum of money or of specific property is not disqualified under this paragraph solely because its payment is subject to a condition. For example, provision for a payment by a trust to beneficiary A of $10,000 when he reaches age 25, and $10,000 when he reaches age 30, with payment over to B of any amount not paid to A because of his death, is a gift to A of a specific sum of money payable in two installments, within the meaning of this paragraph, even though the exact amount payable to A cannot be ascertained with certainty under the terms of the trust instrument.

(c) *Installment payments.* (1) In determining whether a gift or bequest of a specific sum of money or of specific property, as defined in paragraph (b) of this section, is required to be paid or credited to a particular beneficiary in more than three installments:

(i) Gifts or bequests of articles for personal use (such as personal and household effects, automobiles, and the like) are disregarded.

(ii) Specifically devised real property, the title to which passes directly from the decedent to the devisee under local law, is not taken into account, since it would not constitute an amount paid, credited, or required to be distributed under section 661 (see paragraph (e) of §1.661(a)–2).

(iii) All gifts and bequests under a decedent's will (which are not disregarded pursuant to subdivisions (i) and (ii) of this subparagraph) for which no time of payment or crediting is specified, and which are to be paid or credited in the ordinary course of administration of the decedent's estate, are considered as required to be paid or credited in a single installment.

(iv) All gifts and bequests (which are not disregarded pursuant to subdivisions (i) and (ii) of this subparagraph) payable at any one specified time under the terms of the governing instrument are taken into account as a single installment.

For purposes of determining the number of installments paid or credited to a particular beneficiary, a decedent's estate and a testamentary trust shall each be treated as a separate entity.

(2) The application of the rules stated in subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). (i) Under the terms of a decedent's will, $10,000 in cash, household furniture, a watch, an automobile, 100 shares of X company stock, 1,000 bushels of grain, 500 head of cattle, and a farm (title to which passed directly to A under local law) are bequeathed or devised outright to A. The will also provides for the creation of a trust for the benefit of A, under the terms of which there are required to be distributed to A, $10,000 in cash and 100 shares of Y company stock when he reaches 25 years of age, $25,000 in cash and 200 shares of Y company stock when he reaches 30 years of age, and $50,000 in cash and 300 shares of Y company stock when he reaches 35 years of age.

(ii) The furniture, watch, automobile, and the farm are excluded in determining whether any gift or bequest is required to be paid or credited to A in more than three installments. These items qualify for the exclusion under section 663(a)(1) regardless of the treatment of the other items of property bequeathed to A.

(iii) The $10,000 in cash, the shares of X company stock, the grain, the cattle and the assets required to create the trust, to be paid or credited by the estate to A and the trust are considered as required to be paid or credited in a single installment to each, regardless of the manner of payment or distribution by the executor, since no time of payment or crediting is specified in the will. The $10,000 in cash and shares of Y company stock required to be distributed by the trust to A when he is 25 years old are considered as required to be paid or distributed as one installment under the trust. Likewise, the distributions to be made by the trust to A when he is 30 and 35 years old are each considered as one installment under the trust. Since the total number of installments to be made by the estate does not exceed three, all of the items of money and property distributed by the estate qualify for the exclusion under section 663(a)(1). Similarly, the three distributions by the trust qualify.

Example (2). Assume the same facts as in example (1), except that another distribution of a specified sum of money is required to be made by the trust to A when he becomes 40 years old. This distribution would also qualify as an installment, thus making four installments in all under the trust. None of the gifts to A under the trust would qualify for the exclusion under section 663(a)(1). The situation as to the estate, however, would not be changed.

Example (3). A trust instrument provides that A and B are each to receive $75,000 in installments of $25,000, to be paid in alternate years. The trustee distributes $25,000 to A in 1954, 1956, and 1958, and to B in 1955, 1957, and 1959. The gifts to A and B qualify for exclusion under section 663(a)(1), although a total of six payments is made. The gifts of $75,000 to each beneficiary are to be separately treated.

§ 1.663(a)–2 Charitable, etc., distributions.

Any amount paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642(c) and which is allowable as a deduction under that section is not allowed as a deduction to an estate or trust under section 661 or treated as an amount distributed for purposes of determining the amounts includible in gross income of beneficiaries under section 662. Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c). For purposes of this section, the deduction provided in section 642(c) is computed without regard to the provisions of section 508(d), section 681, or section 4948(c)(4) (concerning unrelated business income and private foundations).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7428, 41 FR 34627, Aug. 16, 1976]

§ 1.663(a)–3 Denial of double deduction.

No amount deemed to have been distributed to a beneficiary in a preceding year under section 651 or 661 is included in amounts falling within section 661(a) or 662(a). For example, assume that all of the income of a trust is required to be distributed currently to beneficiary A and both the trust and A report on the calendar year basis. For administrative convenience, the trustee distributes in January and February 1956 a portion of the income of the trust required to be distributed in 1955. The portion of the income for 1955 which was distributed by the trust in 1956 may not be claimed as a deduction by the trust for 1956 since it is deductible by the trust and includible in A's gross income for the taxable year 1955.

§ 1.663(b)–1 Distributions in first 65 days of taxable year; scope.

(a) *Taxable years beginning after December 31, 1968*—(1) *General rule.* With respect to taxable years beginning after December 31, 1968, the fiduciary of a trust may elect under section (b) to 663 treat any amount or portion thereof that is properly paid or credited to a beneficiary within the first 65 days following the close of the taxable year as an amount that was properly paid or credited on the last day of such taxable year.

(2) *Effect of election.* (i) An election is effective only with respect to the taxable year for which the election is made. In the case of distributions made

after May 8, 1972, the amount to which the election applies shall not exceed:

(a) The amount of income of the trust (as defined in §1.643(b)–1) for the taxable year for which the election is made, or

(b) The amount of distributable net income of the trust (as defined in §§1.643(a)–1 through 1.643(a)–7) for such taxable year, if greater,

reduced by any amounts paid, credited, or required to be distributed in such taxable year other than those amounts considered paid or credited in a preceding taxable year by reason of section 663(b) and this section. An election shall be made for each taxable year for which the treatment is desired. The application of this paragraph may be illustrated by the following example:

Example. X Trust, a calendar year trust, has $1,000 of income (as defined in §1.643(b)–1) and $800 of distributable net income (as defined in §§1.643(a)–1 through 1.643(a)–7) in 1972. The trust properly pays $550 to A, a beneficiary, on January 15, 1972, which the trustee elects to treat under section 663(b) as paid on December 31, 1971. The trust also properly pays to A $600 on July 19, 1972, and $450 on January 17, 1973. For 1972, the maximum amount that may be elected under this subdivision to be treated as properly paid or credited on the last day of 1972 is $400 ($1,000 − $600). The $550 paid on January 15, 1972, does not reduce the maximum amount to which the election may apply, because that amount is treated as properly paid on December 31, 1971.

(ii) If an election is made with respect to a taxable year of a trust, this section shall apply only to those amounts which are properly paid or credited within the first 65 days following such year and which are so designated by the fiduciary in his election. Any amount considered under section 663(b) as having been distributed in the preceding taxable year shall be so treated for all purposes. For example, in determining the beneficiary's tax liability, such amount shall be considered as having been received by the beneficiary in his taxable year in which or with which the last day of the preceding taxable year of the trust ends.

(b) *Taxable years beginning before January 1, 1969.* With respect to taxable years of a trust beginning before January 1, 1969, the fiduciary of the trust may elect under section 663(b) to treat distributions within the first 65 days following such taxable year as amounts which were paid or credited on the last day of such taxable year, if:

(1) The trust was in existence prior to January 1, 1954;

(2) An amount in excess of the income of the immediately preceding taxable year may not (under the terms of the governing instrument) be distributed in any taxable year; and

(3) The fiduciary elects (as provided in §1.663(b)–2) to have section 663(b) apply.

[T.D. 7204, 37 FR 17135, Aug. 25, 1972]

§1.663(b)–2 Election.

(a) *Manner and time of election; irrevocability*—(1) *When return is required to be filed.* If a trust return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in the appropriate place on such return. The election under this subparagraph shall be made not later than the time prescribed by law for filing such return (including extensions thereof). Such election shall become irrevocable after the last day prescribed for making it.

(2) *When no return is required to be filed.* If no return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in a statement filed with the internal revenue office with which a return by such trust would be filed if such trust were required to file a return for such taxable year. See section 6091 and the regulations thereunder for place for filing returns. The election under this subparagraph shall be made not later than the time prescribed by law for filing a return if such trust were required to file a return for such taxable year. Such election shall become irrevocable after the last day prescribed for making it.

(b) *Elections under prior law.* Elections made pursuant to section 663(b) prior to its amendment by section 331(b) of the Tax Reform Act of 1969 (83 Stat. 598), which, under prior law, were irrevocable for the taxable year for which the election was made and all subsequent years, are not effective for taxable years beginning after December 31, 1968. In the case of a trust for which an election was made under prior law, the fiduciary shall make the election for each taxable year beginning after December 31, 1968, for which the treatment provided by section 663(b) is desired.

[T.D. 7204, 37 FR 17135, Aug. 25, 1972]

§ 1.663(c)–1 Separate shares treated as separate trusts; in general.

(a) If a single trust has more than one beneficiary, and if different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts for the sole purpose of determining the amount of distributable net income allocable to the respective beneficiaries under sections 661 and 662. Application of this rule will be significant in, for example, situations in which income is accumulated for beneficiary A but a distribution is made to beneficiary B of both income and corpus in an amount exceeding the share of income that would be distributable to B had there been separate trusts. In the absence of a separate share rule B would be taxed on income which is accumulated for A. The division of distributable net income into separate shares will limit the tax liability of B. Section 663(c) does not affect the principles of applicable law in situations in which a single trust instrument creates not one but several separate trusts, as opposed to separate shares in the same trust within the meaning of this section.

(b) The separate share rule does not permit the treatment of separate shares as separate trusts for any purpose other than the application of distributable net income. It does not, for instance, permit the treatment of separate shares as separate trusts for purposes of:

(1) The filing of returns and payment of tax,

(2) The exclusion of dividends under section 116,

(3) The deduction of personal exemption under section 642(b), and

(4) The allowance to beneficiaries succeeding to the trust property of excess deductions and unused net operating loss and capital loss carryovers on termination of the trust under section 642(h).

(c) The separate share rule may be applicable even though separate and independent accounts are not maintained and are not required to be maintained for each share on the books of account of the trust, and even though no physical segregation of assets is made or required.

(d) Separate share treatment is not elective. Thus, if a trust is properly treated as having separate and independent shares, such treatment must prevail in all taxable years of the trust unless an event occurs as a result of which the terms of the trust instrument and the requirements of proper administration require different treatment.

§ 1.663(c)–2 Computation of distributable net income.

The amount of distributable net income for any share under section 663(c) is computed for each share as if each share constituted a separate trust. Accordingly, any deduction or any loss which is applicable solely to one separate share of the trust is not available to any other share of the same trust.

§ 1.663(c)–3 Applicability of separate share rule.

(a) The applicability of the separate share rule provided by section 663(c) will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. Thus, if an instrument directs a trustee to divide the testator's residuary estate into separate shares (which under applicable law do not constitute separate trusts) for each of the testator's children and the trustee is given discretion, with respect to each share, to distribute or accumulate income or to distribute principal or accumulated income, or to do both, separate shares will exist under section 663(c). In determining whether separate shares exist, it is immaterial whether the principal and any accumulated income of each share is ultimately distributable to the beneficiary of such share, to his descendants, to his appointees under a general or special power of appointment, or to any other beneficiaries (including a charitable organization) designated to receive his share of the trust and accumulated income upon termination of the beneficiary's interest in the share. Thus, a separate share may exist if the instrument provides that upon the death of the beneficiary of the share, the share will be added to the shares of the other beneficiaries of the trust.

(b) Separate share treatment will not be applied to a trust or portion of a trust subject to a power to: (1) Distribute, apportion, or accumulate income, or (2) distribute corpus to or for one or more beneficiaries within a group or class of beneficiaries, unless payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made (under the governing instrument) so that substantially separate and independent shares exist.

(c) A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is separate and independent from another share in which one or more beneficiaries have an interest. Likewise, the same person may be a beneficiary of more than one separate share.

(d) Separate share treatment may be given to a trust or portion of a trust otherwise qualifying under this section if the trust or portion of a trust is subject to a power to pay out to a beneficiary of a share (of such trust or portion) an amount of corpus in excess of his proportionate share of the corpus of the trust if the possibility of exercise of the power is remote. For example, if the trust is subject to a power to invade the entire corpus for the health, education, support, or maintenance of A, separate share treatment is applied if exercise of the power requires consideration of A's other income which is so substantial as to make the possibility of exercise of the power remote. If instead it appears that A and B have separate shares in a trust, subject to a power to invade the entire corpus for the comfort, pleasure, desire, or happiness of A, separate share treatment shall not be applied.

(e) For taxable years ending before December 31, 1978, the separate share rule may also be applicable to successive interests in point of time, as for instance in the case of a trust providing for a life estate to A and a second life estate or outright remainder to B. In such a case, in the taxable year of a trust in which a beneficiary dies items of income and deduction properly allocable under trust accounting principles to the period before a beneficiary's death are attributed to one share, and those allocable to the period after the beneficiary's death are attributed to the other share. Separate share treatment is not available to a succeeding interest, however, with respect to distributions which would otherwise be deemed distributed in a taxable year of the earlier interest under the throwback provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code. The application of this paragraph may be illustrated by the following example:

Example. A trust instrument directs that the income of a trust is to be paid to A for her life. After her death income may be distributed to B or accumulated. A dies on June 1, 1956. The trust keeps its books on the basis of the calendar year. The trust instrument permits invasions of corpus for the benefit of A and B, and an invasion of corpus was in fact made for A's benefit in 1956. In determining the distributable net income of the trust for the purpose of determining the amounts includible in A's income, income and deductions properly allocable to the period before A's death are treated as income and deductions of a separate share; and for that purpose no account is taken of income and deductions allocable to the period after A's death.

(f) Separate share treatment is not applicable to an estate.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7633, 44 FR 57926, Oct. 9, 1979]

§1.663(c)–4 Example.

Section 663(c) may be illustrated by the following example:

Example. (a) A single trust was created in 1940 for the benefit of A, B, and C, who were aged 6, 4, and 2, respectively. Under the terms of the instrument, the trust income is required to be divided into three equal shares. Each beneficiary's share of the income is to be accumulated until he becomes

21 years of age. When a beneficiary reaches the age of 21, his share of the income may thereafter be either accumulated or distributed to him in the discretion of the trustee. The trustee also has discretion to invade corpus for the benefit of any beneficiary to the extent of his share of the trust estate, and the trust instrument requires that the beneficiary's right to future income and corpus will be proportionately reduced. When each beneficiary reaches 35 years of age, his share of the trust estate shall be paid over to him. The interest in the trust estate of any beneficiary dying without issue and before he has attained the age of 35 is to be equally divided between the other beneficiaries of the trust. All expenses of the trust are allocable to income under the terms of the trust instrument.

(b) No distributions of income or corpus were made by the trustee prior to 1955, although A became 21 years of age on June 30, 1954. During the taxable year of 1955, the trust has income from royalties of $20,000 and expenses of $5,000. The trustee in his discretion distributes $12,000 to A. Both A and the trust report on the calendar year basis.

(c) The trust qualifies for the separate share treatment under section 663(c) and the distributable net income must be divided into three parts for the purpose of determining the amount deductible by the trust under section 661 and the amount includible in A's gross income under section 662.

(d) The distributable net income of each share of the trust is $5,000 ($6,667 less $1,667). Since the amount ($12,000) distributed to A during 1955 exceeds the distributable net income of $5,000 allocated to his share, the trust is deemed to have distributed to him $5,000 of 1955 income and $7,000 of amounts other than 1955 income. Accordingly, the trust is allowed a deduction of $5,000 under section 661. The taxable income of the trust for 1955 is $9,900, computed as follows:

Royalties	$20,000	
Deductions:		
Expenses	$5,000	
Distribution to A	5,000	
Personal exemption	100	
		10,100
Taxable income		9,900

(e) In accordance with section 662, A must include in his gross income for 1955 an amount equal to the portion ($5,000) of the distributable net income of the trust allocated to his share. Also, the excess distribution of $7,000 made by the trust is subject to the throwback provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, and the regulations thereunder.

§1.664–1 Charitable remainder trusts.

(a) *In general*—(1) *Introduction*—(i) *General description of a charitable remainder trust.* Generally, a charitable remainder trust is a trust which provides for a specified distribution, at least annually, to one or more beneficiaries, at least one of which is not a charity, for life or for a term of years, with an irrevocable remainder interest to be held for the benefit of, or paid over to, charity. The specified distribution to be paid at least annually must be a sum certain which is not less than 5 percent of the initial net fair market value of all property placed in trust (in the case of a charitable remainder annuity trust) or a fixed percentage which is not less than 5 percent of the net fair market value of the trust assets, valued annually (in the case of a charitable remainder unitrust). A trust created after July 31, 1969, which is a charitable remainder trust is exempt from all of the taxes imposed by subtitle A of the Code for any taxable year of the trust except a taxable year in which it has unrelated business taxable income.

(ii) *Scope.* This section provides definitions, general rules governing the creation and administration of a charitable remainder trust, and rules governing the taxation of the trust and its beneficiaries. For the application of certain foundation rules to charitable remainder trusts, see paragraph (b) of this section. If the trust has unrelated business taxable income, see paragraph (c) of this section. For the treatment of distributions to recipients, see paragraph (d) of this section. For the treatment of distributions to charity, see paragraph (e) of this section. For the time limitations for amendment of governing instruments, see paragraph (f) of this section. For transitional rules under which particular requirements are inapplicable to certain trusts, see paragraph (g) of this section. Section 1.664–2 provides rules relating solely to a charitable remainder annuity trust. Section 1.664–3 provides rules relating solely to a charitable remainder unitrust. Section 1.664–4 provides rules governing the calculation of the fair market value of the remainder interest in a charitable remainder unitrust. For rules relating to the filing of returns for a charitable remainder trust, see paragraph (a)(6) of §1.6012–3 and section 6034 and the regulations thereunder.

(iii) *Definitions.* As used in this section and §§1.664–2, 1.664–3, and 1.664–4:

(a) Charitable remainder trust. The term *charitable remainder trust* means a trust with respect to which a deduction is allowable under section 170, 2055, 2106, or 2522 and which meets the description of a charitable remainder annuity trust (as described in §1.664–2) or a charitable remainder unitrust (as described in §1.664–3).

(b) Annuity amount. The term *annuity amount* means the amount described in paragraph (a)(1) of §1.664–2 which is payable, at least annually, to the beneficiary of a charitable remainder annuity trust.

(c) Unitrust amount. The term *unitrust amount* means the amount described in paragraph (a)(1) of §1.664–3 which is payable, at least annually, to the beneficiary of a charitable remainder unitrust.

(d) Recipient. The term *recipient* means the beneficiary who receives the possession or beneficial enjoyment of the annuity amount or unitrust amount.

(e) Governing instrument. The term *governing instrument* has the same meaning as in section 508(e) and the regulations thereunder.

(2) *Requirement that the trust must be either a charitable remainder annuity trust or a charitable remainder unitrust.* A trust is a charitable remainder trust only if it is either a charitable remainder annuity trust in every respect or a charitable remainder unitrust in every respect. For example, a trust which provides for the payment each year to a noncharitable beneficiary of the greater of a sum certain or a fixed percentage of the annual value of the trust assets is not a charitable remainder trust inasmuch as the trust is neither a charitable remainder annuity trust (for the reason that the payment for the year may be a fixed percentage of the annual value of the trust assets which is not a ‘‘sum certain’’) nor a charitable remainder unitrust (for the reason that the payment for the year may be a sum certain which is not a ‘‘fixed percentage’’ of the annual value of the trust assets).

(3) *Restrictions on investments.* A trust is not a charitable remainder trust if the provisions of the trust include a provision which restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. In the case of transactions with, or for the benefit of, a disqualified person, see section 4941(d) and the regulations thereunder for rules relating to the definition of self-dealing.

(4) *Requirement that trust must meet definition of and function exclusively as a charitable remainder trust from its creation.* In order for a trust to be a charitable remainder trust, it must meet the definition of and function exclusively as a charitable remainder trust from the creation of the trust. Solely for the purposes of section 664 and the regulations thereunder, the trust will be deemed to be created at the earliest time that neither the grantor nor any other person is treated as the owner of the entire trust under subpart E, part 1, subchapter J, chapter 1, subtitle A of the Code (relating to grantors and others treated as substantial owners), but in no event prior to the time property is first transferred to the trust. For purposes of the preceding sentence, neither the grantor nor his spouse shall be treated as the owner of the trust under such subpart E merely because the grantor or his spouse is named as a recipient. See examples 1 through 3 of subparagraph (6) of this paragraph for illustrations of the foregoing rule.

(5) *Rules applicable to testamentary transfers*—(i) *Deferral of annuity or unitrust amount.* Notwithstanding subparagraph (4) of this paragraph and §§1.664–2 and 1.664–3, for purposes of sections 2055 and 2106 a charitable remainder trust shall be deemed created at the date of death of the decedent (even though the trust is not funded until the end of a reasonable period of administration or settlement) if the obligation to pay the annuity or unitrust amount with respect to the property passing in trust at the death of the decedent begins as of the date of death of the decedent, even though the

requirement to pay such amount is deferred in accordance with the rules provided in this subparagraph. If permitted by applicable local law or authorized by the provisions of the governing instrument, the requirement to pay such amount may be deferred until the end of the taxable year of the trust in which occurs the complete funding of the trust. Within a reasonable period after such time, the trust must pay (in the case of an underpayment) or must receive from the recipient (in the case of an overpayment) the difference between:

(a) Any annuity or unitrust amounts actually paid, plus interest on such amounts computed at the rate of interest specified in paragraph (a)(5)(iv) of this section, compounded annually, and

(b) The annuity or unitrust amounts payable, plus interest on such amounts computed at the rate of interest specified in paragraph (a)(5)(iv) of this section, compounded annually.

The amounts payable shall be retroactively determined by using the taxable year, valuation method, and valuation dates which are ultimately adopted by the charitable remainder trust. See subdivision (ii) of this subparagraph for rules relating to retroactive determination of the amount payable under a charitable remainder unitrust. See paragraph (d)(4) of this section for rules relating to the year of inclusion in the case of an underpayment to a recipient and the allowance of a deduction in the case of an overpayment to a recipient.

(ii) For purposes of retroactively determining the amount under subdivision (i)*(b)* of this subparagraph, the governing instrument of a charitable remainder unitrust may provide that the amount described in subdivision (i)*(b)* of this subparagraph with respect to property passing in trust at the death of the decedent for the period which begins on the date of death of the decedent and ends on the earlier of the date of death of the last recipient or the end of the taxable year of the trust in which occurs the complete funding of the trust shall be computed by multiplying:

(a) The sum of *(1)* the value, on the earlier of the date of death of the last recipient or the last day in such taxable year, of the property held in trust which is attributable to property passing to the trust at the death of the decedent, *(2)* any distributions in respect of unitrust amounts made by the trust or estate before such date, and *(3)* interest on such distributions computed at the rate of interest specified in paragraph (a)(5)(iv) of this section, compounded annually, from the date of distribution to such date by:

(*b*) (*1*) In the case of transfers made after November 30, 1983, for which the valuation date is before May 1, 1989, a factor equal to 1.000000 less the factor under the appropriate adjusted payout rate in column 2 of Table D in § 1.664–4A(d)(6) opposite the number of years in column 1 between the date of death of the decedent and the date of the earlier of the death of the last recipient or the last day of such taxable year.

(*2*) In the case of transfers for which the valuation date is after April 30, 1989, a factor equal to 1.000000 less the factor under the appropriate adjusted payout rate in Table D in § 1.664–4(e)(6) opposite the number of years in column 1 between the date of death of the decedent and the date of the earlier of the death of the last recipient or the last day of such taxable year. The appropriate adjusted payout rate is determined by using the appropriate Table F contained in § 1.664–4(e)(6) for the section 7520 rate for the month of the valuation date.

(*3*) If the number of years between the date of death and the date of the earlier of the death of the last recipient or the last day of such taxable year is between periods for which factors are provided, a linear interpolation must be made.

(iii) *Treatment of distributions.* The treatment of a distribution to a charitable remainder trust, or to a recipient in respect of an annuity or unitrust amount, paid, credited, or required to be distributed by an estate, or by a trust which is not a charitable remainder trust, shall be governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664. In the case of a charitable remainder trust which is partially or fully funded during the period of administration of an estate or settlement of a trust (which is not a charitable remainder trust), the treatment of any amount paid, credited, or required to be distributed by the charitable remainder trust shall be governed by the rules of section 664.

(iv) *Rate of interest.* The following rates of interest shall apply for purposes of paragraphs (a)(5) (i) through (iii) of this section:

(*a*) The section 7520 rate for the month in which the valuation date with respect to the transfer is (or one of the prior two months if elected under §1.7520–2(b)) after April 30, 1989;

(*b*) 10 percent for instruments executed or amended (other than in the case of a reformation under section 2055(e)(3)) on or after August 9, 1984, and before May 1, 1989, and not subsequently amended;

(*c*) 6 percent or 10 percent for instruments executed or amended (other than in the case of a reformation under section 2055(e)(3)) after October 24, 1983, and before August 9, 1984; and

(*d*) 6 percent for instruments executed before October 25, 1983, and not subsequently amended (other than in the case of a reformation under section 2055(e)(3)).

(6) *Examples.* The application of the rules in paragraphs (a)(4) and (a)(5) of this section require the use of actuarial factors contained in §1.664–4(e), §1.664–4A(d), and former §1.664–4(d) (as contained in the 26 CFR Part 1 edition revised as of April 1, 1994) and may be illustrated by use of the following examples:

Example (1). On September 19, 1971, H transfers property to a trust over which he retains an inter vivos power of revocation. The trust is to pay W 5 percent of the value of the trust assets, valued annually, for her life, remainder to charity. The trust would satisfy all of the requirements of section 664 if it were irrevocable. For purposes of section 664, the trust is not deemed created in 1971 because H is treated as the owner of the entire trust under subpart E. On May 26, 1975, H predeceases W at which time the trust becomes irrevocable. For purposes of section 664, the trust is deemed created on May 26, 1975, because that is the earliest date on which H is not treated as the owner of the entire trust under subpart E. The trust becomes a charitable remainder trust on May 26, 1975, because it meets the definition of a charitable remainder trust from its creation.

Example (2). The facts are the same as in example (1), except that H retains the inter vivos power to revoke only one-half of the trust. For purposes of section 664, the trust is deemed created on September 19, 1971, because on that date the grantor is not treated as the owner of the entire trust under subpart E. Consequently, a charitable deduction is not allowable either at the creation of the trust or at H's death because the trust does not meet the definition of a charitable remainder trust from the date of its creation. The trust does not meet the definition of a charitable remainder trust from the date of its creation because the trust is subject to a partial power to revoke on such date.

Example (3). The facts are the same as in example (1), except that the residue of H's estate is to be paid to the trust and the trust is required to pay H's debts. The trust is not a charitable remainder trust at H's death because it does not function exclusively as a charitable remainder trust from the date of its creation which, in this case, is the date it becomes irrevocable.

Example (4). (i) In 1971, H transfers property to Trust A over which he retains an inter vivos power of revocation. Trust A, which is not a charitable remainder trust, is to provide income or corpus to W until the death of H. Upon H's death the trust is required by its governing instrument to pay the debts and administration expenses of H's estate, and then to terminate and distribute all of the remaining assets to a separate Trust B which meets the definition of a charitable remainder annuity trust.

(ii) Trust B will be charitable remainder trust from the date of its funding because it will function exclusively as a charitable remainder trust from its creation. For purposes of section 2055, Trust B will be deemed created at H's death if the obligation to pay the annuity amount begins on the date of H's death. For purposes of section 664, Trust B becomes a charitable remainder trust as soon as it is partially or completely funded. Consequently, unless Trust B has unrelated business taxable income, the income of the trust is exempt from all taxes imposed by subtitle A of the Code, and any distributions by the trust, even before it is completely funded, are governed by the rules of section 664. Any distributions made by Trust A, including distributions to a recipient in respect of annuity amounts, are governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664.

Example (5). In 1973, H dies testate leaving the net residue of his estate (after payment by the estate of all debts and administration expenses) to a trust which meets the definition of a charitable remainder unitrust. For purposes of section 2055, the trust is deemed created at H's death if the requirement to pay the unitrust amount begins on H's death and is a charitable remainder trust even though the estate is obligated to pay debts and administration expenses.

For purposes of section 664, the trust becomes a charitable remainder trust as soon as it is partially or completely funded. Consequently, unless the trust has unrelated business taxable income, the income of the trust is exempt from all taxes imposed by subtitle A of the Code, and any distributions by the trust, even before it is completely funded, are governed by the rules of section 664. Any distributions made by H's estate, including distributions to a recipient in respect of unitrust amounts, are governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664.

Example (6). (i) On January 1, 1974, H dies testate leaving the residue of his estate to a charitable remainder unitrust. The governing instrument provides that, beginning at H's death, the trustee is to make annual payments to W, on December 31 of each year of 5 percent of the net fair market value of the trust assets, valued as of December 31 of each year, for W's life and to pay the remainder to charity at the death of W. The governing instrument also provides that the actual payment of the unitrust amount need not be made until the end of the taxable year of the trust in which occurs the complete funding of the trust. The governing instrument also provides that the amount payable with respect to the period between the date of death and the end of such taxable year shall be computed under the special method provided in subparagraph (5)(ii) of this paragraph. The governing instrument provides that, within a reasonable period after the end of the taxable year of the trust in which occurs the complete funding of the trust, the trustee shall pay (in the case of an underpayment) or shall receive from the recipient (in the case of an overpayment) the difference between the unitrust amounts paid (plus interest at 6 percentage compounded annually) and the amount computed under the special method. The trust is completely funded on September 20, 1976. No amounts were paid before June 30, 1977. The trust adopts a fiscal year of July 1 to June 30. The net fair market value of the trust assets on June 30, 1977, is $100,000.

(ii) Because no amounts were paid prior to the end of the taxable year in which the trust was completely funded, the amount payable at the end of such taxable year is equal to the net fair market value of the trust assets on the last day of such taxable year (June 30, 1977) multiplied by a factor equal to 1.0 minus the factor in Table D corresponding to the number of years in the period between the date of death and the end of such taxable year. The adjusted payout rate (determined under § 1.664–4A(c)) is 5 percent. Because the last day of the taxable year in which the trust is completely funded in June 30, 1977, there are 3 181/365 years in such period. Because there is no factor given in Table D for such a period, a linear interpolation must be made:

1.0 minus 0.814506 (factor at 5 percent for 4 years)	0.185494
1.0 minus 0.857375 (factor at 5 percent for 3 years)	.142625
Difference	.042869

$$181 \div 365 = X \div 0.042869$$

$$X = 0.021258$$

1.0 minus 0.857375 (factor at 5 percent for 3 years	0.142625
Plus: X	.021258
Interpolated factor	.163883

Thus, the amount payable for the period from January 1, 1974, to June 30, 1977, is $16,388.30 ($100,000×0.163883). Thereafter, the trust assets must be valued on December 31 of each year and 5 percent of such value paid annually to W for her life.

(7) *Valuation of unmarketable assets*—(i) *In general.* If unmarketable assets are transferred to or held by a trust, the trust will not be a trust with respect to which a deduction is available under section 170, 2055, 2106, or 2522, or will be treated as failing to function exclusively as a charitable remainder trust unless, whenever the trust is required to value such assets, the valuation is—

(*a*) Performed exclusively by an independent trustee; or

(*b*) Determined by a *current qualified appraisal,* as defined in § 1.170A–13(c)(3), from a *qualified appraiser,* as defined in § 1.170A–13(c)(5).

(ii) *Unmarketable assets.* Unmarketable assets are assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely-held stock, and an unregistered security for which there is no available exemption permitting public sale.

(iii) *Independent trustee.* An independent trustee is a person who is not the grantor of the trust, a noncharitable beneficiary, or a related or subordinate party to the grantor, the grantor's spouse, or a noncharitable beneficiary (within the meaning of section 672(c) and the applicable regulations).

(b) *Application of certain foundation rules to charitable remainder trusts.* See section 4947(a)(2) and section 4947(b)(3)(B) and the regulations thereunder for the application to charitable remainder trusts of certain provisions relating to private foundations. See section 508(e) for rules relating to required provisions in governing instruments prohibiting certain activities specified in section 4947(a)(2).

(c) *Taxation of nonexempt charitable remainder trusts.* If the charitable remainder trust has any unrelated business taxable income (within the meaning of section 512 and the regulations thereunder, determined as if part III, subchapter F, chapter 1, subtitle A of the Code applied to such trust) for any taxable year, the trust is subject to all of the taxes imposed by subtitle A of the Code for such taxable year. For taxable years beginning after December 31, 1969, unrelated business taxable income includes debt-financed income. The taxes imposed by subtitle A of the Code upon a nonexempt charitable remainder trust shall be computed under the rules prescribed by subparts A and C, part 1, subchapter J, chapter 1, subtitle A of the Code for trusts which may accumulate income or which distribute corpus. The provisions of subpart E, part 1 of such subchapter J are not applicable with respect to a nonexempt charitable remainder trust. The application of the above rules may be illustrated by the following example:

Example. In 1975, a charitable remainder trust which has a calendar year as its taxable year has $1,000 of ordinary income, including $100 of unrelated business taxable income, and no deductions other than under sections 642(b) and 661(a). The trust is required to pay out $700 for 1975 to a noncharitable recipient. Because the trust has some unrelated business taxable income in 1975, it is not exempt for such year. Consequently, the trust is taxable on all of its income as a complex trust. Under section 661(a) of the Code, the trust is allowed a deduction of $700. Under section 642(b) of the Code, the trust is allowed a deduction of $100. Consequently, the taxable income of the trust for 1975 is $200 ($1,000 − $700 − $100).

(d) *Treatment of annual distributions to recipients*—(1) *Character of distributions*—(i) *Order of distributions.* Annuity and unitrust amounts shall be treated as having the following characteristics in the hands of the recipients (whether or not the trust is exempt) without credit for any taxes which are imposed by subtitle A of the Code on the trust:

(a) Ordinary income. First, as ordinary income to the extent of the sum of the trust's ordinary income for the taxable year of the trust and its undistributed ordinary income for prior years. An ordinary loss for the current year shall be used to reduce undistributed ordinary income for prior years and any excess shall be carried forward indefinitely to reduce ordinary income for future years. For purposes of this section, the amount of current and prior years' income shall be computed without regard to the deduction for net operating losses provided by sections 172 or 642(d).

(b) Capital gain. Second, as capital gain to the extent of the trust's undistributed capital gains. Undistributed capital gains of the trust are determined on a cumulative net basis under the rules of this subdivision without regard to the provisions of section 1212.

(1) Long- and short-term capital gains. If, in any taxable year of the trust, the trust has both undistributed short-term capital gain and undistributed long-term capital gain, then the short term capital gain shall be deemed distributed prior to any long-term capital gain.

(2) Capital losses in excess of capital gains. If the trust has for any taxable year capital losses in excess of capital gains, any excess of the net short-term capital loss over the net long-term capital gain for such year shall be a short-term capital loss in the succeeding taxable year and any excess of the net long-term capital loss over the net short-term capital gain for such year shall be a long-term capital loss in the succeeding taxable year.

(3) Capital gains in excess of capital losses. If the trust has for any taxable year capital gains in excess of capital losses, any excess of the net short-term capital gain over the net long-term capital loss for such year shall be, to the extent not deemed distributed, a short-term capital gain in the succeeding taxable year and any excess of the net long-term capital gain over the net short-term capital loss for such year shall be, to the extent not deemed

distributed, a long-term capital gain in the succeeding taxable year.

The application of the rules in this subdivision *(b)* may be illustrated by the following example:

Example. (i) The X Trust is a charitable remainder trust created on January 1, 1975, and has the calendar year as its taxable year. During the years indicated, it has the following capital transactions:

1975:	
Long-term capital loss	$10
Short-term capital gain	5
1976:	
Short-term capital gain	20
Short-term capital loss	5
1977:	
Long-term capital gain	15

Distributions for 1975 and 1976 were not in excess of current and accumulated ordinary income for those years. In 1977, distributions exceeded current and accumulated ordinary income by $5.

(ii) The treatment of the 1975 and 1976 transactions is as follows:

1975:	
Long-term capital loss recognized	$(10)
Short-term capital gain recognized	5
Net long-term capital loss carried forward to 1976	(5)
1976:	
Short-term capital gain recognized	20
Short-term capital loss recognized	(5)
Long-term capital loss carried forward from 1975	(5)
Net short-term capital gain carried forward to 1977	$10
1977:	
Long-term capital gain recognized	15
Net short-term capital gain carried forward from 1976	10

(iii) In 1977, the trust has long-term capital gain of $15 and short-term capital gain of $10. If the trust has both short-term capital gain and long-term capital gain for the same taxable year, the short-term capital gain is deemed distributed prior to the long-term capital gain. Therefore, the distribution of $5 in 1977 is deemed to be short-term capital gain. The undistributed net short-term capital gain of $5 is a short-term capital gain carried forward to 1978. The undistributed net long-term capital gain of $15 is a long-term capital gain carried forward to 1978.

(c) Other income. Third, as other income (including income excluded under part III, subchapter B, chapter 1, subtitle A of the Code) to the extent of the sum of the trust's other income for the taxable year and its undistributed other income for prior years. A loss in this category for the current year shall be used to reduce undistributed income in such category for prior years and any excess shall be carried forward indefinitely to reduce such income for future years.

(d) Corpus. Finally, as a distribution of trust corpus. For purposes of this section, the term *corpus* means the net fair market value of the trust assets less the total undistributed income (but not loss) in each of the above categories.

(ii) *Rules relating to character of distributions.* The determination of the character of amounts distributed shall be made as of the end of the taxable year of the trust. Amounts treated as paid from one of the categories of income described in *(a), (b),* or *(c)* of subdivision (i) of this subparagraph shall be treated as consisting of the same proportion of each class of items included in such category as the total of the current and accumulated income of each class of items bears to the total of the current and accumulated income for that category. A loss in one of such categories may not be used to reduce a gain in any other category. The provisions of subparts D and E, part 1, subchapter J, chapter 1, subtitle A of the Code are not applicable with respect to a charitable remainder trust (regardless of whether the trust is exempt).

(iii) *Example.* The following example illustrates the application of this paragraph (d)(1):

Example. (i) *X* is a charitable remainder unitrust described in section 664(d)(2) and (3). The annual unitrust amount is the lesser of the amount of trust income, as defined in § 1.664–3(a)(1)(i)(*b*), or six percent of the net fair market value of the trust assets valued annually. The net fair market value of the trust assets on the valuation date in 1996 is $150,000. During 1996, *X* has $7,500 of income after allocating all expenses. All of *X*'s income for 1996 is tax-exempt income. At the end of 1996, *X*'s ordinary income for the current taxable year and undistributed ordinary income for prior years are both zero; *X*'s capital gain for the current taxable year is zero and undistributed capital gain for prior years is $30,000; and *X*'s tax-exempt income for the current year is $7,500 and undistributed tax-exempt income for prior years is $2,500.

(ii) Because the trust income of $7,500 is less than the fixed percentage amount of $9,000, the unitrust amount for 1996 is $7,500. The character of that amount in the hands of the recipient of the unitrust amount is determined under section 664(b). Because the unitrust amount is less than *X*'s undistributed capital gain income, the recipient of the unitrust amount treats the distribution of $7,500 as capital gain. At the beginning of 1997, *X*'s undistributed capital gain for prior years is reduced to $22,500, and *X*'s undistributed tax-exempt income is increased to $10,000.

(2) *Allocation of deductions.* Items of deduction of the trust for a taxable year of the trust which are deductible in determining taxable income (other than the deductions permitted by sections 642(b), 642(c), 661, and 1202) which are directly attributable to one or more classes of items within a category of income or to corpus (determined under subparagraph (1)(i) of this paragraph) shall be allocated to such classes of items or to corpus. All other allowable deductions for such taxable year which are not directly attributable to one or more classes of items within a category of income or to corpus (other than the deductions permitted by sections 642(b), 642(c), 661, and 1202) shall be allocated among the classes of items within the category (excluding classes of items with net losses) on the basis of the gross income of such classes for such taxable year reduced by the deductions allocated thereto under the first sentence of this subparagraph, but in no event shall the amount of expenses allocated to any class of items exceed such income of such class for the taxable year. Items of deduction which are not allocable under the above two sentences (other than the deductions permitted by sections 642(b), 642(c), 661, and 1202) may be allocated in any manner. All taxes imposed by subtitle A of the Code for which the trust is liable because it has unrelated business taxable income and all taxes imposed by chapter 42 of the Code shall be allocated to corpus. Any expense which is not deductible in determining taxable income and which is not allocable to any class of items described in subparagraph (1)(i)*(c)* of this paragraph shall be allocated to corpus. The deductions allowable to a trust under sections 642(b), 642(c), 661, and 1202 are not allowed in determining the amount or character of any class of items within a category of income or corpus in the categories described in subparagraph (1) of this paragraph.

(3) *Allocation of income among recipients.* If there are two or more recipients, each will be treated as receiving his pro rata portion of the categories of income and corpus. The application of this rule may be illustrated by the following example:

Example. X transfers $40,000 to a charitable remainder annuity trust which is to pay $3,000 per year to X and $2,000 per year to Y for a term of 5 years. During the first taxable year the trust has $3,000 of ordinary income, $500 of capital gain, and $500 of tax-exempt income after allocation of all expenses. X is treated as receiving ordinary income of $1,800 ($3,000/$5,000×$3,000), capital gain of $300 ($3,000/$5,000×$500), tax exempt income of $300 ($3,000/$5,000×$500), and corpus of $600 ($3,000/$5,000×[$5,000−$4,000]). Y is treated as receiving ordinary income of $1,200 ($2,000/$5,000×$3,000), capital gain of $200 ($2,000/$5,000×$500), tax exempt income of $200 ($2,000/$5,000×$500), and corpus of $400 ($2,000/$5,000×[$5,000−$4,000]).

(4) *Year of inclusion*—(i) *General rule.* To the extent required by this paragraph, the annuity or unitrust amount is includible in the recipient's gross income for the taxable year in which the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the taxable year of the trust. If a recipient has a different taxable year (as defined in section 441 or 442) from the taxable year of the trust, the amount he is required to include in gross income to the extent required by this paragraph shall be included in his taxable year in which or with which ends the taxable year of the trust in which such amount is required to be distributed.

(ii) *Payments resulting from incorrect valuations.* Notwithstanding subdivision (i) of this subparagraph, any payments which are made or required to be distributed by a charitable remainder trust pursuant to paragraph (a)(5) of this section, under paragraph (f)(3) of this section because of an amendment to the governing instrument, or under paragraphs (a)(1) of §§1.664–2 and 1.664–3 because of an incorrect valuation, shall, to the extent required by this paragraph, be included in the gross income of the recipient in his taxable year in which or with which ends the taxable year of the trust in which the amount is paid, credited, or required to be distributed. For rules relating to required adjustments of underpayments and overpayments of the annuity or unitrust amounts in respect of payments made prior to the amendment of a governing instrument, see paragraph (f)(3) of this section. There is allowable to a recipient a deduction from gross income for any amounts repaid to the trust because of an overpayment during the reasonable period of administration or settlement or until the trust is fully funded, because of an amendment, or because of an incorrect valuation, to the extent such amounts were included in his gross income. See section 1341 and the regulations thereunder for rules relating to the computation of tax where a taxpayer restores substantial amounts held under a claim of right.

(iii) *Rules applicable to year of recipient's death.* If the taxable year of the trust does not end with or within the last taxable year of the recipient because of the recipient's death, the extent to which the annuity or unitrust amount required to be distributed to him is included in the gross income of the recipient for his last taxable year, or in the gross income of his estate, is determined by making the computations required under this paragraph for the taxable year of the trust in which his last taxable year ends. (The last sentence of subdivision (i) of this subparagraph does not apply to such amounts.) The gross income for the last taxable year of a recipient on the cash basis includes (to the extent required by this paragraph) amounts actually distributed to the recipient before his death. Amounts required to be distributed which are distributed to his estate, are included (to the extent required by this paragraph) in the gross income of the estate as income in respect of a decedent under section 691.

(5) *Distributions in kind.* The annuity or unitrust amount may be paid in cash or in other property. In the case of a distribution made in other property, the amount paid, credited, or required to be distributed shall be considered as an amount realized by the trust from the sale or other disposition of property. The basis of the property in the hands of the recipient is its fair market value at the time it was paid, credited, or required to be distributed. The application of these rules may be illustrated by the following example:

Example. On January 1, 1971, X creates a charitable remainder annuity trust, whose taxable year is the calendar year, under which X is to receive $5,000 per year. During 1971, the trust receives $500 of ordinary income. On December 31, 1971, the trust distributed cash of $500 and a capital asset of the trust having a fair market value of $4,500 and a basis of $2,200. The trust is deemed to have realized a capital gain of $2,300. X treats the distribution of $5,000 as being ordinary income of $500, capital gain of $2,300 and trust corpus of $2,200. The basis of the distributed property is $4,500 in the hands of X.

(e) *Other distributions*—(1) *Character of distributions.* An amount distributed by the trust to an organization described in section 170(c) other than the annuity or unitrust amount shall be considered as a distribution of corpus and of those categories of income specified in paragraph (d)(1) of this section in an order inverse to that prescribed in such paragraph. The character of such amount shall be determined as of the end of the taxable year of the trust in which the distribution is made after the character of the annuity or unitrust amount has been determined.

(2) *Distributions in kind.* In the case of a distribution of an amount to which subparagraph (1) of this paragraph applies, no gain or loss is realized by the trust by reason of a distribution in kind unless such distribution is in satisfaction of a right to receive a distribution of a specific dollar amount or in specific property other than that distributed.

(f) *Effective date*—(1) *General rule.* The provisions of this section are effective with respect to transfers in trust made after July 31, 1969. Any trust created (within the meaning of applicable local law) prior to August 1, 1969, is not a charitable remainder trust even if it otherwise satisfies the definition of a charitable remainder trust.

(2) *Transfers to pre-1970 trusts.* Property transferred to a trust created (within the meaning of applicable local law) before August 1, 1969, whose governing instrument provides that an organization described in section 170(c)

receives an irrevocable remainder interest in such trust, shall, for purposes of subparagraphs (1) and (3) of this paragraph, be deemed transferred to a trust created on the date of such transfer provided that the transfer occurs after July 31, 1969, and prior to October 18, 1971, and the transferred property and any undistributed income therefrom is severed and placed in a separate trust before December 31, 1972, or if later, on or before the 30th day after the date on which any judicial proceedings begun before December 31, 1972, which are required to sever such property, become final.

(3) *Amendment of post-1969 trusts.* A trust created (within the meaning of applicable local law) subsequent to July 31, 1969, and prior to December 31, 1972, which is not a charitable remainder trust at the date of its creation, may be treated as a charitable remainder trust from the date it would be deemed created under §1.664–1(a) (4) and (5)(i) for all purposes: *Provided,* That all the following requirements are met:

(i) At the time of the creation of the trust, the governing instrument provides that an organization described in section 170(c) receives an irrevocable remainder interest in such trust.

(ii) The governing instrument of the trust is amended so that the trust will meet the definition of a charitable remainder trust and, if applicable, will meet the requirement of paragraph (a)(5)(i) of this section that obligation to make payment of the annuity or unitrust amount with respect to property passing at death begin as of the date of death, before December 31, 1972, or if later, on or before the 30th day after the date on which any judicial proceedings which are begun before December 31, 1972, and which are required to amend its governing instrument, become final. In the case of a trust created (within the meaning of applicable local law) subsequent to July 31, 1969, and prior to December 31, 1972, the provisions of section 508(d)(2)(A) shall not apply if the governing instrument of the trust is amended so as to comply with the requirements of section 508(e) before December 31, 1972, or if later, on or before the 30th day after the date on which any judicial proceedings which are begun before December 31, 1972, and which are required to amend its governing instrument, become final. Notwithstanding the provisions of paragraphs (a)(3) and (a)(4) of §§1.664–2 and 1.664–3, the governing instrument may grant to the trustee a power to amend the governing instrument for the sole purpose of complying with the requirements of this section and §1.664–2 or §1.664–3: *Provided,* That at the creation of the trust, the governing instrument *(a)* provides for the payment of a unitrust amount described in §1.664–3(a)(1)(i) or an annuity which meets the requirements of paragraph (a)(2) of §1.664–2 or §1.664–3, *(b)* designates the recipients of the trust and the period for which the amount described in (*a*) of this subdivision (ii) is to be paid, and *(c)* provides that an organization described in section 170(c) receives an irrevocable remainder interest in such trust. The mere granting of such a power is not sufficient to meet the requirements of this subparagraph that the governing instrument be amended in the manner and within the time limitations of this subparagraph.

(iii)*(a)* Where the amount of the distributions which would have been made by the trust to a recipient if the amended provisions of such trust had been in effect from the time of creation of such trust exceeds the amount of the distributions made by the trust prior to its amendment, the trust pays an amount equal to such excess to the recipient.

(b) Where the amount of distributions made to the recipient prior to the amendment of the trust exceeds the amount of the distributions which would have been made by such trust if the amended provisions of such trust had been in effect from the time of creation of such trust, such excess is repaid to the trust by the recipient.

See paragraph (d)(4) of this section for rules relating to the year of inclusion in the case of an underpayment to a recipient and the allowance of a deduction in the case of an overpayment to a recipient. A deduction for a transfer to a charitable remainder trust shall not be allowed until the requirements of this paragraph are met and then only if the deduction is claimed on a timely filed return (including extensions) or on a claim for refund filed within the period of limitations prescribed by section 6511(a).

(4) *Valuation of unmarketable assets.* The rules contained in paragraph (a)(7) of this section are applicable for trusts created on or after December 10, 1998. A trust in existence as of December 10, 1998, whose governing instrument requires that an independent trustee value the trust's unmarketable assets may be amended or reformed to permit a valuation method that satisfies the requirements of paragraph (a)(7) of this section for taxable years beginning on or after December 10, 1998.

(g) *Transitional effective date.* Notwithstanding any other provision of this section, § 1.664–2 or § 1.664–3, the requirement of paragraph (a)(5)(i) of this section that interest accrue on overpayments and underpayments, the requirement of paragraph (a)(5)(ii) of this section that the unitrust amount accruing under the formula provided therein cease with the death of the last recipient, and the requirement that the governing instrument of the trust contain the provisions specified in paragraph (a)(1)(iv) of § 1.664–2 (relating to computation of the annuity amount in certain circumstances), paragraph (a)(1)(v) of § 1.664–3 (relating to computation of the unitrust amount in certain circumstances), paragraphs (b) of §§ 1.664–2 and 1.664–3 (relating to additional contributions), and paragraph (a)(1)(iii) of § 1.664–3 (relating to incorrect valuations), paragraphs (a)(6)(iv) of §§ 1.664–2 and 1.664–3 (relating to alternative remaindermen) shall not apply to:

(1) A will executed on or before December 31, 1972, if:

(i) The testator dies before December 31, 1975, without having republished the will after December 31, 1972, by codicil or otherwise.

(ii) The testator at no time after December 31, 1972, had the right to change the provisions of the will which pertain to the trust, or

(iii) The will is not republished by codicil or otherwise before December 31, 1975, and the testator is on such date and at all times thereafter under a mental disability to republish the will by codicil or otherwise, or

(2) A trust executed on or before December 31, 1972, if:

(i) The grantor dies before December 31, 1975, without having amended the trust after December 31, 1972,

(ii) The trust is irrevocable on December 31, 1972, or

(iii) The trust is not amended before December 31, 1975, and the grantor is on such date and at all times thereafter under a mental disability to change the terms of the trust.

[T.D. 7202, 37 FR 16913, Aug. 23, 1972; 37 FR 28288, Dec. 22, 1972, as amended by T.D. 7955, 49 FR 19983, May 11, 1984; T.D. 8540, 59 FR 30102, 30116, June 10, 1994; T.D. 8791, 63 FR 68191, Dec. 10, 1998]

§ 1.664–2 Charitable remainder annuity trust.

(a) *Description.* A charitable remainder annuity trust is a trust which complies with the applicable provisions of § 1.664–1 and meets all of the following requirements:

(1) *Required payment of annuity amount*—(i) *Payment of sum certain at least annually.* The governing instrument provides that the trust will pay a sum certain not less often than annually to a person or persons described in paragraph (a)(3) of this section for each taxable year of the period specified in paragraph (a)(5) of this section.

(*a*) *General rule applicable to all trusts.* A trust will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of § 1.664–1(a)(4)) merely because the annuity amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the entire annuity amount in the hands of the recipient is characterized only as income from the categories described in section 664(b)(1), (2), or (3), except to the extent it is characterized as corpus described in section 664(b)(4) because—

(*1*) The trust distributes property (other than cash) that it owned at the close of the taxable year to pay the annuity amount; and

(*2*) The trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year in which the annuity amount is due.

(*b*) *Special rule for trusts created before* December 10, 1998. In addition to the circumstances described in paragraph (a)(1)(i)(*a*) of this section, a trust created before December 10, 1998, will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of § 1.664–1(a)(4)) merely because the annuity amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the sum certain to be paid each year as the annuity amount is 15 percent or less of the initial net fair market value of the property irrevocably passing in trust as determined for federal tax purposes.

(*c*) *Reasonable time.* For this paragraph (a)(1)(i), a reasonable time will not ordinarily extend beyond the date by which the trustee is required to file Form 5227, ''Split-Interest Trust Information Return,'' (including extensions) for the taxable year.

(*d*) *Example.* The following example illustrates the rules in paragraph (a)(1)(i)(*a*) of this section:

Example. X is a charitable remainder annuity trust described in section 664(d)(1) that was created after December 10, 1998. The prorated annuity amount payable from *X* for Year 1 is $100. The trustee does not pay the annuity amount to the recipient by the close of Year 1. At the end of Year 1, *X* has only $95 in the ordinary income category under section 664(b)(1) and no income in the capital gain or tax-exempt income categories under section 664(b)(2) or (3), respectively. By April 15 of Year 2, in addition to $95 in cash, the trustee distributes to the recipient of the annuity a capital asset with a $5 fair market value and a $2 adjusted basis to pay the $100 annuity amount due for Year 1. The trust owned the asset at the end of Year 1. Under § 1.664–1(d)(5), the distribution is treated as a sale by *X*, resulting in *X* recognizing a $3 capital gain. The trustee elects to treat the capital gain as occurring on the last day of Year 1. Under § 1.664–1(d)(1), the character of the annuity amount for Year 1 in the recipient's hands is $95 of ordinary income, $3 of capital gain income, and $2 of trust corpus. For Year 1, *X* satisfied paragraph (a)(1)(i)(*a*) of this section.

(*e*) *Effective date.* This paragraph (a)(1)(i) is applicable for taxable years ending after April 18, 1997.

(ii) *Definition of sum certain.* A sum certain is a stated dollar amount which is the same either as to each recipient or as to the total amount payable for each year of such period. For example, a provision for an amount which is the same every year to A until his death and concurrently an amount which is the same every year to B until his death, with the amount to each recipient to terminate at his death, would satisfy the above rule. Similarly, provisions for an amount to A and B for their joint lives and then to the survivor would satisfy the above rule. In the case of a distribution to an organization described in section 170(c) at the death of a recipient or the expiration of a term of years, the governing instrument may provide for a reduction of the stated amount payable after such a distribution: *Provided,* That:

(a) The reduced amount payable is the same either as to each recipient or as to the total amount payable for each year of the balance of such period, and

(b) The requirements of subparagraph (2)(ii) of this paragraph are met.

(iii) *Sum certain stated as a fraction or percentage.* The stated dollar amount may be expressed as a fraction or a percentage of the initial net fair market value of the property irrevocably passing in trust as finally determined for Federal tax purposes. If the stated dollar amount is so expressed and such market value is incorrectly determined by the fiduciary, the requirement of this subparagraph will be satisfied if the governing instrument provides that in such event the trust shall pay to the recipient (in the case of an undervaluation) or be repaid by the recipient (in the case of an overvaluation) an amount equal to the difference between the amount which the trust should have paid the recipient if the correct value were used and the amount which the trust actually paid the recipient.

Such payments or repayments must be made within a reasonable period after the final determination of such value. Any payment due to a recipient by reason of such incorrect valuation shall be considered to be a payment required to be distributed at the time of such final determination for purposes of paragraph (d)(4)(ii) of § 1.664–1. See paragraph (d)(4) of § 1.664–1 for rules relating to the year of inclusion of such payments and the allowance of a deduction for such repayments. See paragraph (b) of this section for rules relating to future contributions. For rules relating to required adjustments for underpayments or overpayments of the amount described in this paragraph in respect of payments made during a reasonable period of administration, see paragraph (a)(5) of § 1.664–1. The application of the rule permitting the stated dollar amount to be expressed as a fraction or a percentage of the initial net fair market value of the property irrevocably passing in trust as finally determined for Federal tax purposes may be illustrated by the following example:

Example. The will of X provides for the transfer of one-half of his residuary estate to a charitable remainder annuity trust which is required to pay to W for life an annuity equal to 5 percent of the initial net fair market value of the interest passing in trust as finally determined for Federal tax purposes. The annuity is to be paid on December 31 of each year computed from the date of X's death. The will also provides that if such initial net fair market value is incorrectly determined, the trust shall pay to W, in the case of an undervaluation, or be repaid by W, in the case of an overvaluation, an amount equal to the difference between the amount which the trust should have paid if the correct value were used and the amount which the trust actually paid. X dies on March 1, 1971. The executor files an estate tax return showing the value of the residuary estate as $250,000 before reduction for taxes and expenses of $50,000. The executor paid to W $4,192 ([$250,000 − $50,000]×1/2×5 percent×306/365) on December 31, 1971. On January 1, 1972, the executor transfers one-half of the residue of the estate to the trust. The trust adopts the calendar year as its taxable year. The value of the residuary estate is finally determined for Federal tax purposes to be $240,000 ($290,000 − $50,000). Accordingly, the amount which the executor should have paid to W is $5,030 ([$290,000 − $50,000]× 1/2×5 percent×306/365). Consequently, an additional amount of $838 ($5,030 − $4,192) must be paid to W within a reasonable period after the final determination of value for Federal tax purposes.

(iv) *Computation of annuity amount in certain circumstances—(a) Short taxable years.* The governing instrument provides that, in the case of a taxable year which is for a period of less than 12 months other than the taxable year in which occurs the end of the period specified in subparagraph (5) of this paragraph, the annuity amount determined under subdivision (i) of this subparagraph shall be the amount otherwise determined under that subdivision multiplied by a fraction the numerator of which is the number of days in the taxable year of the trust and the denominator of which is 365 (366 if February 29 is a day included in the numerator).

(b) Last taxable year of period. The governing instrument provides that, in the case of the taxable year in which occurs the end of the period specified in subparagraph (5) of this paragraph, the annuity amount which must be distributed under subdivision (i) of this subparagraph shall be the amount otherwise determined under that subdivision multiplied by a fraction the numerator of which is the number of days in the period beginning on the first day of such taxable year and ending on the last day of the period specified in subparagraph (5) of this paragraph and the denominator of which is 365 (366 if February 29 is a day included in the numerator). See subparagraph (5) of this paragraph for a special rule allowing termination of payment of the annuity amount with the regular payment next preceding the termination of the period specified therein.

(2) *Minimum annuity amount*—(i) *General rule.* The total amount payable under subparagraph (1) of this paragraph is not less than 5 percent of the initial net fair market value of the property placed in trust as finally determined for Federal tax purposes.

(ii) *Reduction of annuity amount in certain cases.* A trust will not fail to meet the requirements of this subparagraph by reason of the fact that it provides for a reduction of the stated amount payable upon the death of a recipient or the expiration of a term of years provided that:

(a) A distribution is made to an organization described in section 170(c) at the death of such recipient or the expiration of such term of years, and

(b) The total amounts payable each year under subparagraph (1) of this paragraph after such distribution are not less than a stated dollar amount which bears the same ratio to 5 percent of the initial net fair market value of the trust assets as the net fair market value of the trust assets immediately after such distribution bears to the net fair market value of the trust assets immediately before such distribution.

(iii) *Rule applicable to inter vivos trust which does not provide for payment of minimum annuity amount.* In the case where the grantor of an inter vivos trust underestimates in good faith the initial net fair market value of the property placed in trust as finally determined for Federal tax purposes and specifies a fixed dollar amount for the annuity which is less than 5 percent of the initial net fair market value of the property placed in trust as finally determined for Federal tax purposes, the trust will be deemed to have met the 5 percent requirement if the grantor or his representative consents, by appropriate agreement with the District Director, to accept an amount equal to 20 times the annuity as the fair market value of the property placed in trust for purposes of determining the appropriate charitable contributions deduction.

(3) *Permissible recipients*—(i) *General rule.* The amount described in subparagraph (1) of this paragraph is payable to or for the use of a named person or persons, at least one of which is not an organization described in section 170(c). If the amount described in subparagraph (1) of this paragraph is to be paid to an individual or individuals, all such individuals must be living at the time of the creation of the trust. A named person or persons may include members of a named class provided that, in the case of a class which includes any individual, all such individuals must be alive and ascertainable at the time of the creation of the trust unless the period for which the annuity amount is to be paid to such class consists solely of a term of years. For example, in the case of a testamentary trust, the testator's will may provide that an amount shall be paid to his children living at his death.

(ii) *Power to alter amount paid to recipients.* A trust is not a charitable remainder annuity trust if any person has the power to alter the amount to be paid to any named person other than an organization described in section 170(c) if such power would cause any person to be treated as the owner of the trust, or any portion thereof, if subpart E, part 1, subchapter J, chapter 1, subtitle A of the Code were applicable to such trust. See paragraph (a)(4) of this section for a rule permitting the retention by a grantor of a testamentary power to revoke or terminate the interest of any recipient other than an organization described in section 170(c). For example, the governing instrument may not grant the trustee the power to allocate the annuity among members of a class unless such power falls within one of the exceptions to section 674(a).

(4) *Other payments.* No amount other than the amount described in subparagraph (1) of this paragraph may be paid to or for the use of any person other than an organization described in section 170(c). An amount is not paid to or for the use of any person other than an organization described in section 170(c) if the amount is transferred for full and adequate consideration. The trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than an organization described in section 170(c). Notwithstanding the preceding sentence, the grantor may retain the power exercisable only by will to revoke or terminate the interest of any recipient other than an organization described in section 170(c). The governing instrument may provide that any amount other than the amount described in subparagraph (1) of this paragraph shall be paid (or may be paid in the discretion of the trustee) to an organization described in section 170(c) provided that in the case of distributions in kind, the adjusted basis of the property distributed is fairly representative of the adjusted basis of the property available for payment on the date of payment. For example, the governing instrument may provide that a

portion of the trust assets may be distributed currently, or upon the death of one or more recipients, to an organization described in section 170(c).

(5) *Period of payment of annuity amount*—(i) *General rules.* The period for which an amount described in subparagraph (1) of this paragraph is payable begins with the first year of the charitable remainder trust and continues either for the life or lives of a named individual or individuals or for a term of years not to exceed 20 years. Only an individual or an organization described in section 170(c) may receive an amount for the life of an individual. If an individual receives an amount for life, it must be solely for his life. Payment of the amount described in subparagraph (1) of this paragraph may terminate with the regular payment next preceding the termination of the period described in this subparagraph. The fact that the recipient may not receive such last payment shall not be taken into account for purposes of determining the present value of the remainder interest. In the case of an amount payable for a term of years, the length of the term of years shall be ascertainable with certainty at the time of the creation of the trust, except that the term may be terminated by the death of the recipient or by the grantor's exercise by will of a retained power to revoke or terminate the interest of any recipient other than an organization described in section 170(c). In any event, the period may not extend beyond either the life or lives of a named individual or individuals or a term of years not to exceed 20 years. For example, the governing instrument may not provide for the payment of an annuity amount to A for his life and then to B for a term of years because it is possible for the period to last longer than either the lives of recipients in being at the creation of the trust or a term of years not to exceed 20 years. On the other hand, the governing instrument may provide for the payment of an annuity amount to A for his life and then to B for his life or a term of years (not to exceed 20 years), whichever is shorter (but not longer), if both A and B are in being at the creation of the trust because it is not possible for the period to last longer than the lives of recipients in being at the creation of the trust.

(ii) *Relationship to 5 percent requirement.* The 5 percent requirement provided in subparagraph (2) of this paragraph must be met until the termination of all of the payments described in subparagraph (1) of this paragraph. For example, the following provisions would satisfy the above rules:

(a) An amount equal to at least 5 percent of the initial net fair market value of the property placed in trust to A and B for their joint lives and then to the survivor for his life;

(b) An amount equal to at least 5 percent of the initial net fair market value of the property placed in trust to A for life or for a term of years not longer than 20 years, whichever is longer (or shorter);

(c) An amount equal to at least 5 percent of the initial net fair market value of the property placed in trust to A for a term of years not longer than 20 years and then to B for life (provided B was living at the date of creation of the trust);

(d) An amount to A for his life and concurrently an amount to B for his life (the amount to each recipient to terminate at his death) if the amount given to each individual is not less than 5 percent of the initial net fair market value of the property placed in trust; or

(e) An amount to A for his life and concurrently an equal amount to B for his life, and at the death of the first to die, the trust to distribute one-half of the then value of its assets to an organization described in section 170(c), if the total of the amounts given to A and B is not less than 5 percent of the initial net fair market value of the property placed in trust.

(6) *Permissible remaindermen*—(i) *General rule.* At the end of the period specified in subparagraph (5) of this paragraph the entire corpus of the trust is required to be irrevocably transferred, in whole or in part, to or for the use of one or more organizations described in section 170(c) or retained, in whole or in part, for such use.

(ii) *Treatment of trust.* If all of the trust corpus is to be retained for such use, the taxable year of the trust shall terminate at the end of the period specified in subparagraph (5) of this paragraph and the trust shall cease to be treated as a charitable remainder trust for all purposes. If all or any portion of the trust corpus is to be transferred to or for the use of such organization or organizations, the trustee shall have a reasonable time after the period specified in subparagraph (5) of this paragraph to complete the settlement of the trust. During such time, the trust shall continue to be treated as a charitable remainder trust for all purposes, such as sections 664, 4947(a)(2), and 4947(b)(3)(B). Upon the expiration of such period, the taxable year of the trust shall terminate and the trust shall cease to be treated as a charitable remainder trust for all purposes. If the trust continues in existence, it will be subject to the provisions of section 4947(a)(1) unless the trust is exempt from taxation under section 501(a). For purposes of determining whether the trust is exempt under section 501(a) as an organization described in section 501(c)(3), the trust shall be deemed to have been created at the time it ceases to be treated as a charitable remainder trust.

(iii) *Concurrent or successive remaindermen.* Where interests in the corpus of the trust are given to more than one organization described in section 170(c) such interests may be enjoyed by them either concurrently or successively.

(iv) *Alternative remaindermen.* The governing instrument shall provide that if an organization to or for the use of which the trust corpus is to be transferred or for the use of which the trust corpus is to be retained is not an organization described in section 170(c) at the time any amount is to be irrevocably transferred to or for the use of such organization, such amount shall be transferred to or for the use of one or more alternative organizations which are described in section 170(c) at such time or retained for such use. Such alternative organization or organizations may be selected in any manner provided by the terms of the governing instrument.

(b) *Additional contributions.* A trust is not a charitable remainder annuity trust unless its governing instrument provides that no additional contributions may be made to the charitable remainder annuity trust after the initial contribution. For purposes of this section, all property passing to a charitable remainder annuity trust by reason of death of the grantor shall be considered one contribution.

(c) *Calculation of the fair market value of the remainder interest of a charitable remainder annuity trust.* For purposes of sections 170, 2055, 2106, and 2522, the fair market value of the remainder interest of a charitable remainder annuity trust (as described in this section) is the net fair market value (as of the appropriate valuation date) of the property placed in trust less the present value of the annuity. For purposes of this section, *valuation date* means, in general, the date on which the property is transferred to the trust by the donor regardless of when the trust is created. In the case of transfers to a charitable remainder annuity trust for which the valuation date is after April 30, 1989, if an election is made under section 7520 and §1.7520–2(b) to compute the present value of the charitable interest by use of the interest rate component for either of the 2 months preceding the month in which the transfer is made, the month so elected is the valuation date for purposes of determining the interest rate and mortality tables. For purposes of section 2055 or 2106, the valuation date is the date of death unless the alternate valuation date is elected in accordance with section 2032, in which event, and within the limitations set forth in section 2032 and the regulations thereunder, the valuation date is the alternate valuation date. If the decedent's estate elects the alternate valuation date under section 2032 and also elects, under section 7520 and §1.7520–2(b), to use the interest rate component for one of the 2 months preceding the alternate valuation date, the month so elected is the valuation date for purposes of determining the interest rate and mortality tables. The present value of an annuity is computed under §20.2031–7(d) of this chapter (Estate Tax Regulations) for transfers for which the valuation date is after April 30, 1989, or under §20.2031–7A (a) through (d) of this chapter, whichever is applicable, for transfers for which the valuation date is before May 1, 1989. See, however, §1.7520–3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). If the valuation date of a transfer to a charitable remainder annuity trust is after April 30, 1989, and before June 10, 1994, a transferor can rely on Notice 89–24, 1989–1 C.B. 660, or Notice 89–60, 1989–1 C.B. 700 (See §601.601(d)(2)(ii)(*b*) of this chapter), in valuing the transferred interest.

(d) *Deduction for transfers to a charitable remainder annuity trust.* For rules relating to a deduction for transfers to a charitable remainder annuity trust, see section 170, 2055, 2106, or 2522 and the regulations thereunder. Any claim for deduction on any return for the value of a remainder interest in a charitable remainder annuity trust must be supported by a full statement attached to the return showing the computation of the present value of such interest. The deduction allowed by section 170 is limited to the fair market value of the remainder interest of a charitable remainder annuity trust regardless of whether an organization described in section 170(c) also receives a portion of the annuity. For a special rule relating to the reduction of the amount of a charitable contribution deduction with respect to a contribution of certain ordinary income property or capital gain property, see section 170(e)(1)(A) or 170(e)(1)(B)(i) and the regulations thereunder. For rules for postponing the time for deduction of a charitable contribution of a future interest in tangible personal property, see section 170(a)(3) and the regulations thereunder.

[T.D. 7202, 37 FR 16918, Aug. 23, 1972, as amended by T.D. 7955, 49 FR 19983, May 11, 1984; T.D. 8540, 59 FR 30116, June 10, 1994; T.D. 8791, 63 FR 68191, Dec. 10, 1998]

§1.664–3 Charitable remainder unitrust.

(a) *Description.* A charitable remainder unitrust is a trust which complies with the applicable provisions of §1.664–1 and meets all of the following requirements:

(1) *Required payment of unitrust amount*—(i) *Payment of fixed percentage at least annually*—(*a*) *General rule.* The governing instrument provides that the trust will pay not less often than annually a fixed percentage of the net fair market value of the trust assets determined annually to a person or persons described in paragraph (a)(3) of this section for each taxable year of the period specified in paragraph (a)(5) of this section. This paragraph (a)(1)(i)(*a*) is applicable for taxable years ending after April 18, 1997.

(*b*) *Income exception.* Instead of the amount described in *(a)* of this subdivision (i), the governing instrument may provide that the trust shall pay for any year either the amount described in *(1)* or the total of the amounts described in *(1)* and *(2)* of this subdivision *(b)*.

(*1*) The amount of trust income for a taxable year to the extent that such amount is not more than the amount required to be distributed under paragraph (a)(1)(i)(*a*) of this section.

(*2*) An amount of trust income for a taxable year that is in excess of the amount required to be distributed under paragraph (a)(1)(i)(*a*) of this section for such year to the extent that (by reason of paragraph (a)(1)(i)(*b*)(*1*) of this section) the aggregate of the amounts paid in prior years was less than the aggregate of such required amounts.

(*3*) For this paragraph (a)(1)(i)(*b*), trust income means income as defined under section 643(b) and the applicable regulations.

(*4*) For this paragraph (a)(1)(i)(*b*), proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of contribution.

(*5*) The rules in paragraphs (a)(1)(i)(*b*)(*1*), (*2*), and (*3*) of this section are applicable for taxable years ending after April 18, 1997, and the rule in paragraph (a)(1)(i)(*b*)(*4*) of this section is applicable for sales or exchanges that occur after April 18, 1997.

(*c*) *Combination of methods.* Instead of the amount described in paragraph (a)(1)(i)(*a*) or (*b*) of this section, the governing instrument may provide that the trust will pay not less often than annually the amount described in paragraph (a)(1)(i)(*b*) of this section for an initial period and then pay the amount described in paragraph (a)(1)(i)(*a*) of this section (calculated using the same fixed percentage) for the remaining years of the trust only if the governing instrument provides that—

(*1*) The change from the method prescribed in paragraph (a)(1)(i)(*b*) of this section to the method prescribed in paragraph (a)(1)(i)(*a*) of this section is triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other persons;

(*2*) The change from the method prescribed in paragraph (a)(1)(i)(*b*) of this section to the method prescribed in paragraph (a)(1)(i)(*a*) of this section occurs at the beginning of the taxable year that immediately follows the taxable year during which the date or event specified under paragraph (a)(1)(i)(*c*)(*1*) of this section occurs; and

(*3*) Following the trust's conversion to the method described in paragraph (a)(1)(i)(*a*) of this section, the trust will pay at least annually to the permissible recipients the amount described only in paragraph (a)(1)(i)(*a*) of this section and not any amount described in paragraph (a)(1)(i)(*b*) of this section.

(*d*) *Triggering event.* For purposes of paragraph (a)(1)(i)(*c*)(*1*) of this section, a triggering event based on the sale of unmarketable assets as defined in § 1.664–1(a)(7)(ii), or the marriage, divorce, death, or birth of a child with respect to any individual will not be considered discretionary with, or within the control of, the trustees or any other persons.

(*e*) *Examples.* The following examples illustrate the rules in paragraph (a)(1)(i)(*c*) of this section. For each example, assume that the governing instrument of charitable remainder unitrust *Y* provides that *Y* will initially pay not less often than annually the amount described in paragraph (a)(1)(i)(*b*) of this section and then pay the amount described in paragraph (a)(1)(i)(*a*) of this section (calculated using the same fixed percentage) for the remaining years of the trust and that the requirements of paragraphs (a)(1)(i)(*c*)(*2*) and (*3*) of this section are satisfied. The examples are as follows:

Example 1. Y is funded with the donor's former personal residence. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the trust sells the residence. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 2. is funded with cash and an unregistered security for which there is no available exemption permitting public sale under the Securities and Exchange Commission rules. The governing instrument of *Y* provides that the change in method for computing the annual unitrust amount is triggered on the earlier of the date when the stock is sold or at the time the restrictions on its public sale lapse or are otherwise lifted. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 3. Y is funded with cash and with a security that may be publicly traded under the Securities and Exchange Commission rules. The governing instrument of *Y* provides that the change in method for computing the annual unitrust amount is triggered when the stock is sold. *Y* does not provide for a combination of methods that satisfies the requirements of paragraph (a)(1)(i)(*c*) of this section because the sale of the publicly-traded stock is within the discretion of the trustee.

Example 4. S establishes *Y* for her granddaughter, *G*, when *G* is 10 years old. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which *G* turns 18 years old. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 5. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the donor is married. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 6. The governing instrument of *Y* provides that if the donor divorces, the change in method for computing the annual unitrust amount will occur as of the first day of the year following the year of the divorce. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 7. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary's first child is born. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 8. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary's father dies. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 9. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary's financial advisor determines that the beneficiary should begin receiving payments under the second prescribed payment method. Because the change in methods for paying the unitrust amount is triggered by an event that is within a person's control, *Y* does not provide for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 10. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary submits a request to the trustee that the trust convert to the second prescribed payment method. Because the change in methods for paying the unitrust amount is triggered by an event that is within a person's control, *Y* does not provide for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

(*f*) *Effective date*—(*1*) *General rule.* Paragraphs (a)(1)(i)(*c*), (*d*), and (*e*) of this section are applicable for charitable remainder trusts created on or after December 10, 1998.

(*2*) *General rule regarding reformations of combination of method unitrusts.* If a trust is created on or after December 10, 1998, and contains a provision allowing a change in calculating the unitrust amount that does not comply with the provisions of paragraph (a)(1)(i)(*c*) of this section, the trust will qualify as a charitable remainder unitrust only if it is amended or reformed to use the initial method for computing the unitrust amount throughout the term of the trust, or is reformed in accordance with paragraph (a)(1)(i)(*f*)(*3*) of this section. If a trust was created before December 10, 1998, and contains a provision allowing a change in calculating the unitrust amount that does not comply with the provisions of paragraph (a)(1)(i)(*c*) of this section, the trust may be reformed to use the initial method for computing the unitrust amount throughout the term of the trust without causing the trust to fail to function exclusively as a charitable remainder unitrust under § 1.664–1(a)(4), or may be reformed in accordance with paragraph (a)(1)(i)(*f*)(*3*) of this section. Except as provided in paragraph (a)(1)(i)(*f*)(*3*) of this section, a qualified charitable remainder unitrust will not continue to qualify as a charitable remainder unitrust if it is amended or reformed to add a provision allowing a change in the method for calculating the unitrust amount.

(*3*) *Special rule for reformations of trusts that begin by June 8, 1999.* Notwithstanding paragraph (a)(1)(i)(*f*)(*2*) of this section, if a trust either provides for payment of the unitrust amount under a combination of methods that is not permitted under paragraph (a)(1)(i)(*c*) of this section, or provides for payment of the unitrust amount under only the method prescribed in paragraph (a)(1)(i)(*b*) of this section, then the trust may be reformed to allow for a combination of methods permitted under paragraph (a)(1)(i)(*c*) of this section without causing the trust to fail to function exclusively as a charitable remainder unitrust under § 1.664–1(a)(4) or to engage in an act of self-dealing under section 4941 if the trustee begins legal proceedings to reform by June 8, 1999. The triggering event under the reformed governing instrument may not occur in a year prior to the year in which the court issues the order reforming the trust, except for situations in which the governing instrument prior to reformation already provided for payment of the unitrust amount under a combination of methods that is not permitted under paragraph (a)(1)(i)(*c*) of this section and the triggering event occurred prior to the reformation.

(*g*) *Payment under general rule for fixed percentage trusts.* When the unitrust amount is computed under paragraph (a)(1)(i)(*a*) of this section, a trust will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of § 1.664–1(a)(4)) merely because the unitrust amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the entire unitrust amount in the hands of the recipient is characterized only as income from the categories described in section 664(b)(1), (2), or (3), except to the extent it is characterized as corpus described in section 664(b)(4) because—

(*1*) The trust distributes property (other than cash) that it owned at the close of the taxable year to pay the unitrust amount; and

(*2*) The trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year for which the unitrust amount is due.

(*h*) *Special rule for fixed percentage trusts created before December 10, 1998.* When the unitrust amount is computed under paragraph (a)(1)(i)(*a*) of this section, a trust created before December 10, 1998, will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of §1.664–1(a)(4)) merely because the unitrust amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the fixed percentage to be paid each year as the unitrust amount is 15 percent or less of the net fair market value of the trust assets as determined under paragraph (a)(1)(iv) of this section.

(*i*) *Example.* The following example illustrates the rules in paragraph (a)(1)(i)(*g*) of this section:

Example. X is a charitable remainder unitrust that calculates the unitrust amount under paragraph (a)(1)(i)(*a*) of this section. *X* was created after December 10, 1998. The prorated unitrust amount payable from *X* for Year 1 is $100. The trustee does not pay the unitrust amount to the recipient by the end of the Year 1. At the end of Year 1, *X* has only $95 in the ordinary income category under section 664(b)(1) and no income in the capital gain or tax-exempt income categories under section 664(b) (2) or (3), respectively. By April 15 of Year 2, in addition to $95 in cash, the trustee distributes to the unitrust recipient a capital asset with a $5 fair market value and a $2 adjusted basis to pay the $100 unitrust amount due for Year 1. The trust owned the asset at the end of Year 1. Under §1.664–1(d)(5), the distribution is treated as a sale by *X*, resulting in *X* recognizing a $3 capital gain. The trustee elects to treat the capital gain as occurring on the last day of Year 1. Under §1.664–1(d)(1), the character of the unitrust amount for Year 1 in the recipient's hands is $95 of ordinary income, $3 of capital gain income, and $2 of trust corpus. For Year 1, *X* satisfied paragraph (a)(1)(i)(*g*) of this section.

(*j*) *Payment under income exception.* When the unitrust amount is computed under paragraph (a)(1)(i)(*b*) of this section, a trust will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of §1.664–1(a)(4)) merely because payment of the unitrust amount is made after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year.

(*k*) *Reasonable time.* For paragraphs (a)(1)(i) (*g*), (*h*), and (*j*) of this section, a reasonable time will not ordinarily extend beyond the date by which the trustee is required to file Form 5227, ‘‘Split-Interest Trust Information Return,’’ (including extensions) for the taxable year.

(*l*) *Effective date.* Paragraphs (a)(1)(i) (*g*), (*h*), (*i*), (*j*), and (*k*) of this section are applicable for taxable years ending after April 18, 1997.

(ii) *Definition of fixed percentage.* The fixed percentage may be expressed either as a fraction or as a percentage and must be payable each year in the period specified in subparagraph (5) of this paragraph. A percentage is fixed if the percentage is the same either as to each recipient or as to the total percentage payable each year of such period. For example, provision for a fixed percentage which is the same every year to A until his death and concurrently a fixed percentage which is the same every year to B until his death, the fixed percentage to each recipient to terminate at his death, would satisfy the rule. Similarly, provision for a fixed percentage to A and B for their joint lives and then to the survivor would satisfy the rule. In the case of a distribution to an organization described in section 170(c) at the death of a recipient or the expiration of a term of years, the governing instrument may provide for a reduction of the fixed percentage payable after such distribution *Provided* That:

(a) The reduced fixed percentage is the same either as to each recipient or as to the total amount payable for each year of the balance of such period, and

(b) The requirements of subparagraph (2)(ii) of this paragraph are met.

(iii) *Rules applicable to incorrect valuations.* The governing instrument provides that in the case where the net fair market value of the trust assets is incorrectly determined by the fiduciary, the trust shall pay to the recipient (in the case of an undervaluation) or be repaid by the recipient (in the case of an overvaluation) an amount equal to the difference between the amount which the trust should have paid the recipient if the correct value were used and the amount which the trust actually paid the recipient. Such payments or repayments must be made within a reasonable period after the final determination of such value. Any payment due to a recipient by reason of such incorrect valuation shall be considered to be a payment required to be distributed at the time of such final determination for purposes of paragraph (d)(4)(ii) of §1.664–1. See paragraph (d)(4) of §1.664–1 for rules relating to the year of inclusion of such payments and the allowance of a deduction for such repayments. See paragraph (b) of this section for rules relating to additional contributions.

(iv) *Rules applicable to valuation.* In computing the net fair market value of the trust assets there shall be taken into account all assets and liabilities without regard to whether particular items are taken into account in determining the income of the trust. The net fair market value of the trust assets may be determined on any one date during the taxable year of the trust, or by taking the average of valuations made on more than one date during the taxable year of the trust, so long as the same valuation date or dates and valuation methods are used each year. If the governing instrument does not specify the valuation date or dates, the trustee must select such date or dates and indicate the selection on the first return on Form 5227, ‘‘Split-Interest Trust Information Return,’’ that the trust must file. The amount described in subdivision (i)*(a)* of this subparagraph which must be paid each year must be based upon the valuation for such year.

(v) *Computation of unitrust amount in certain circumstances—(a) Short taxable years.* The governing instrument provides that, in the case of a taxable year which is for a period of less than 12 months other than the taxable year in which occurs the end of the period specified in subparagraph (5) of this paragraph:

(1) The amount determined under subdivision (i)*(a)* of this subparagraph shall be the amount otherwise determined under that subdivision multiplied by a fraction the numerator of which is the number of days in the taxable year of the trust and the denominator of which is 365 (366 if February 29 is a day included in the numerator),

(2) The amount determined under subdivision (i)*(b)* of this subparagraph shall be computed by using the amount determined under subdivision *(a)(1)* of this subdivision (v), and

(3) If no valuation date occurs before the end of the taxable year of the trust, the trust assets shall be valued as of the last day of the taxable year of the trust.

(b) Last taxable year of period. (1) The governing instrument provides that, in the case of the taxable year in which occurs the end of the period specified in subparagraph (5) of this paragraph:

(i) The unitrust amount which must be distributed under subdivision (i)*(a)* of this subparagraph shall be the amount otherwise determined under that subdivision multiplied by a fraction the numerator of which is the number of days in the period beginning on the first day of such taxable year and ending on the last day of the period specified in subparagraph (5) of this paragraph and the denominator of

which is 365 (366 if February 29 is a day included in the numerator),

(ii) The amount determined under subdivision (i)(*b*) of this subparagraph shall be computed by using the amount determined under *(b)(1)(i)* of this subdivision (v), and

(iii) If no valuation date occurs before the end of such period, the trust assets shall be valued as of the last day of such period.

(2) See subparagraph (5) of this paragraph for a special rule allowing termination of payment of the unitrust amount with the regular payment next preceding the termination of the period specified therein.

(2) *Minimum unitrust amount*—(i) *General rule.* The fixed percentage described in subparagraph (1)(i) of this paragraph with respect to all beneficiaries taken together is not less than 5 percent.

(ii) *Reduction of unitrust amount in certain cases.* A trust will not fail to meet the requirements of this subparagraph by reason of the fact that it provides for a reduction of the fixed percentage payable upon the death of a recipient or the expiration of a term of years *Provided* That:

(a) A distribution is made to an organization described in section 170(c) at the death of such recipient or the expiration of such term of years, and

(b) The total of the percentage payable under subparagraph (1) of this paragraph after such distribution is not less than 5 percent.

(3) *Permissible recipients*—(i) *General rule.* The amount described in subparagraph (1) of this paragraph is payable to or for the use of a named person or persons, at least one of which is not an organization described in section 170(c). If the amount described in subparagraph (1) of this paragraph is to be paid to an individual or individuals, all such individuals must be living at the time of creation of the trust. A named person or persons may include members of a named class except in the case of a class which includes any individual, all such individuals must be alive and ascertainable at the time of the creation of the trust unless the period for which the unitrust amount is to be paid to such class consists solely of a term of years. For example, in the case of a testamentary trust, the testator's will may provide that the required amount shall be paid to his children living at his death.

(ii) *Power to alter amount paid to recipients.* A trust is not a charitable remainder unitrust if any person has the power to alter the amount to be paid to any named person other than an organization described in section 170(c) if such power would cause any person to be treated as the owner of the trust, or any portion thereof, if subpart E, part 1, subchapter J, chapter 1, subtitle A of the Code were applicable to such trust. See paragraph (a)(4) of this section for a rule permitting the retention by a grantor of a testamentary power to revoke or terminate the interest of any recipient other than an organization described in section 170(c). For example, the governing instrument may not grant the trustee the power to allocate the fixed percentage among members of a class unless such power falls within one of the exceptions to section 674(a).

(4) *Other payments.* No amount other than the amount described in subparagraph (1) of this paragraph may be paid to or for the use of any person other than an organization described in section 170(c). An amount is not paid to or for the use of any person other than an organization described in section 170(c) if the amount is transferred for full and adequate consideration. The trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than an organization described in section 170(c). Notwithstanding the preceding sentence, the grantor may retain the power exercisable only by will to revoke or terminate the interest of any recipient other than an organization described in section 170(c). The governing instrument may provide that any amount other than the amount described in subparagraph (1) of this paragraph shall be paid (or may be paid in the discretion of the trustee) to an organization described in section 170(c) provided that, in the case of distributions in kind, the adjusted basis of the property distributed is fairly representative of the adjusted basis of the property available for payment on the date

of payment. For example, the governing instrument may provide that a portion of the trust assets may be distributed currently, or upon the death of one or more recipients, to an organization described in section 170(c).

(5) *Period of payment of unitrust amount*—(i) *General rules.* The period for which an amount described in subparagraph (1) of this paragraph is payable begins with the first year of the charitable remainder trust and continues either for the life or lives of a named individual or individuals or for a term of years not to exceed 20 years. Only an individual or an organization described in section 170(c) may receive an amount for the life of an individual. If an individual receives an amount for life, it must be solely for his life. Payment of the amount described in subparagraph (1) of this paragraph may terminate with the regular payment next preceding the termination of the period described in this subparagraph. The fact that the recipient may not receive such last payment shall not be taken into account for purposes of determining the present value of the remainder interest. In the case of an amount payable for a term of years, the length of the term of years shall be ascertainable with certainty at the time of the creation of the trust, except that the term may be terminated by the death of the recipient or by the grantor's exercise by will of a retained power to revoke or terminate the interest of any recipient other than an organization described in section 170(c). In any event, the period may not extend beyond either the life or lives of a named individual or individuals or a term of years not to exceed 20 years. For example, the governing instrument may not provide for the payment of a unitrust amount to A for his life and then to B for a term of years because it is possible for the period to last longer than either the lives of recipients in being at the creation of the trust or a term of years not to exceed 20 years. On the other hand, the governing instrument may provide for the payment of a unitrust amount to A for his life and then to B for his life or a term of years (not to exceed 20 years), whichever is shorter (but not longer), if both A and B are in being at the creation of the trust because it is not possible for the period to last longer than the lives of recipients in being at the creation of the trust.

(ii) *Relationship to 5 percent requirement.* The 5 percent requirement provided in subparagraph (2) of this paragraph must be met until the termination of all of the payments described in subparagraph (1) of this paragraph. For example, the following provisions would satisfy the above rules:

(a) A fixed percentage of at least 5 percent to A and B for their joint lives and then to the survivor for his life;

(b) A fixed percentage of at least 5 percent to A for life or for a term of years not longer than 20 years, whichever is longer (or shorter);

(c) A fixed percentage of at least 5 percent to A for life or for a term of years not longer than 20 years and then to B for life (provided B was living at the creation of the trust);

(d) A fixed percentage to A for his life and concurrently a fixed percentage to B for his life (the percentage to each recipient to terminate at his death) if the percentage given to each individual is not less than 5 percent;

(e) A fixed percentage to A for his life and concurrently an equal percentage to B for his life, and at the death of the first to die, the trust to distribute one-half of the then value of its assets to an organization described in section 170(c) if the total of the percentages is not less than 5 percent for the entire period described in this subparagraph.

(6) *Permissible remaindermen*—(i) *General rule.* At the end of the period specified in subparagraph (5) of this paragraph, the entire corpus of the trust is required to be irrevocably transferred, in whole or in part, to or for the use of one or more organizations described in section 170(c) or retained, in whole or in part, for such use.

(ii) *Treatment of trust.* If all of the trust corpus is to be retained for such use, the taxable year of the trust shall terminate at the end of the period specified in subparagraph (5) of this paragraph and the trust shall cease to be treated as a charitable remainder trust for all purposes. If all or any portion of the trust corpus is to be transferred to or for the use of such organization or organizations, the trustee shall have a reasonable time after the period specified in subparagraph (5) of this paragraph to complete the settlement of the trust. During such time, the trust shall continue to be treated as a charitable remainder trust for all purposes, such as section 664, 4947(a)(2), and 4947(b)(3)(B). Upon the expiration of such period, the taxable year of the trust shall terminate and the trust shall cease to be treated as a charitable remainder trust for all purposes. If the trust continues in existence, it will be subject to the provisions of section 4947(a)(1) unless the trust is exempt from taxation under section 501(a). For purposes of determining whether the trust is exempt under section 501(a) as an organization described in section 501(c)(3), the trust shall be deemed to have been created at the time it ceases to be treated as a charitable remainder trust.

(iii) *Concurrent or successive remaindermen.* Where interests in the corpus of the trust are given to more than one organization described in section 170(c) such interests may be enjoyed by them either concurrently or successively.

(iv) *Alternative remaindermen.* The governing instrument shall provide that if an organization to or for the use of which the trust corpus is to be transferred or for the use of which the trust corpus is to be retained is not an organization described in section 170(c) at the time any amount is to be irrevocably transferred to or for the use of such organization, such amount shall be transferred to or for the use of or retained for the use of one or more alternative organizations which are described in section 170(c) at such time. Such alternative organization or organizations may be selected in any manner provided by the terms of the governing instrument.

(b) *Additional contributions.* A trust is not a charitable remainder annuity trust unless its governing instrument either prohibits additional contributions to the trust after the initial contribution or provides that for the taxable year of the trust in which the additional contribution is made:

(1) Where no valuation date occurs after the time of the contribution and during the taxable year in which the contribution is made, the additional property shall be valued as of the time of contribution; and

(2) The amount described in paragraph (a)(1)(i)*(a)* of this section shall be computed by multiplying the fixed percentage by the sum of (i) the net fair market value of the trust assets (excluding the value of the additional property and any earned income from and any appreciation on such property after its contribution), and (ii) that proportion of the value of the additional property (that was excluded under subdivision (i) of this paragraph), which the number of days in the period which begins with the date of contribution and ends with the earlier of the last day of such taxable year or the last day of the period described in paragraph (a)(5) of this section bears to the number of days in the period which begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the period described in paragraph (a)(5) of this section.

For purposes of this section, all property passing to a charitable remainder unitrust by reason of death of the grantor shall be considered one contribution. The application of the preceding rules may be illustrated by the following examples:

Example 1. On March 2, 1971, X makes an additional contribution of property to a charitable remainder unitrust. The taxable year of the trust is the calendar year and the regular valuation date is January 1 of each year. For purposes of computing the required payout with respect to the additional contribution for the year of contribution, the additional contribution is valued on March 2, 1971, the time of contribution. The property had a value on that date of $5,000. Income from such property in the amount of $250 was received on December 31, 1971. The required payout with respect to the additional contribution for the year of contribution is $208 (5 percent×$5,000×305/365). The income earned after the date of the contribution and after the regular valuation date does not enter into the computation.

Example 2. On July 1, 1971, X makes an additional contribution of $10,000 to a charitable remainder unitrust. The taxable year of the trust is the calendar year and the regular valuation date is December 31 of each year. The fixed percentage is 5 percent. Between July 1, 1971, and December 31, 1971, the additional property appreciates in value to $12,500 and earns $500 of income. Because the regular valuation date for the year of contribution occurs after the date of the additional contribution, the additional contribution including income earned by it is valued on the regular valuation date. Thus, the required payout with respect to the additional contribution is $325.87 (5 percent×[$12,500+$500]×183/365).

(c) *Calculation of the fair market value of the remainder interest of a charitable remainder unitrust.* See § 1.664–4 for rules relating to the calculation of the fair market value of the remainder interest of a charitable remainder unitrust.

(d) *Deduction for transfers to a charitable remainder unitrust.* For rules relating to a deduction for transfers to a charitable remainder unitrust, see section 170, 2055, 2106, or 2522 and the regulations thereunder. The deduction allowed by section 170 for transfers to charity is limited to the fair market value of the remainder interest of a charitable remainder unitrusts regardless of whether an organization described in section 170(c) also receives a portion of the amount described in § 1.664–3(a)(1). For a special rule relating to the reduction of the amount of a charitable contribution deduction with respect to a contribution of certain ordinary income property or capital gain property, see section 170(e)(1) (A) or (B)(i) and the regulations thereunder. For rules for postponing the time for deduction of a charitable contribution of a future interest in tangible personal property, see section 170(a)(3) and the regulations thereunder.

[T.D. 7202, 37 FR 16920, Aug. 23, 1972, as amended by T.D. 8791, 63 FR 68192, Dec. 10, 1998]

§ 1.664–4 Calculation of the fair market value of the remainder interest in a charitable remainder unitrust.

(a) *Rules for determining present value.* For purposes of sections 170, 2055, 2106, and 2522, the fair market value of a remainder interest in a charitable remainder unitrust (as described in § 1.664–3) is its present value determined under paragraph (d) of this section. The present value determined under this section shall be computed on the basis of—

(1) Life contingencies determined as to each life involved, from the values of *lx* set forth in Table 80CNSMT contained in § 20.2031–7(d)(6) of this chapter (Estate Tax Regulations) in the case of transfers for which the valuation date is after April 30, 1989, or column 2 of Table LN, of § 20.2031–7A(d)(6) of this chapter in the case of transfers made after November 30, 1983, for which the valuation date is before May 1, 1989. See § 20.2031–7A (a) through (c) of this chapter, whichever is applicable, for transfers for which the valuation date is before December 1, 1983;

(2) Interest at the section 7520 rate in the case of transfers for which the valuation date is after April 30, 1989, or 10 percent in the case of transfers to charitable remainder unitrusts made after November 30, 1983, for which the valuation date is before May 1, 1989. See § 20.2031–7A (a) through (c) of this chapter, whichever is applicable, for transfers for which the valuation date is before December 1, 1983; and

(3) The assumption that the amount described in § 1.664–3(a)(1)(*i*)(*a*) is distributed in accordance with the payout sequence described in the governing instrument. If the governing instrument does not prescribe when the distribution is made during the period for which the payment is made, for purposes of this section, the distribution is considered payable on the first day of the period for which the payment is made.

(b) *Actuarial Computations by the Internal Revenue Service.* The regulations in this and in related sections provide tables of actuarial factors and examples that illustrate the use of the tables in determining the value of remainder interests in property. Section 1.7520–1(c)(2) refers to government publications that provide additional tables of factors and examples of computations for more complex situations. If the computation requires the use of a factor that is not provided in this section, the Commissioner may supply the factor upon a request for a ruling. A request for a ruling must be accompanied by a recitation of the facts including the date of birth of each measuring life, and copies of the relevant documents. A request for a ruling must comply with the instructions for requesting a ruling published periodically in the Internal Revenue Bulletin (See § 601.601(d)(2)(ii)(*b*) of this chapter) and include payment of the required user fee. If the Commissioner furnishes the factor, a copy of the letter supplying the factor should be attached to the tax return in which the deduction is claimed. If the Commissioner does not furnish the factor, the taxpayer must furnish a factor computed in accordance with the principles set forth in this section.

(c) *Statement supporting deduction required.* Any claim for a deduction on any return for the value of a remainder interest in a charitable remainder unitrust must be supported by a full statement attached to the return showing the computation of the present value of such interest.

(d) *Valuation.* The fair market value of a remainder interest in a charitable remainder unitrust (as described in §1.664–3) for transfers for which the valuation date is after April 30, 1989, is its present value determined under paragraph (e) of this section. The fair market value of a remainder interest in a charitable remainder unitrust (as described in §1.664–3) for transfers for which the valuation date is before May 1, 1989, is its present value determined under the following sections:

Valuation dates		Applicable regulations
After	Before	
	01–01–52	1.664–4A(a)
12–31–51	01–01–71	1.664–4A(b)
12–31–70	12–01–83	1.664–4A(c)
11–30–83	05–01–89	1.664–4A(d)

(e) *Valuation of charitable remainder unitrusts having certain payout sequences for transfers for which the valuation date is after April 30, 1989*—(1) *In general.* Except as otherwise provided in paragraph (e)(2) of this section, in the case of transfers for which the valuation date is after April 30, 1989, the present value of a remainder interest is determined under paragraphs (e)(3) through (e)(6) of this section, provided that the amount of the payout as of any payout date during any taxable year of the trust is not larger than the amount that the trust could distribute on such date under §1.664–3(a)(1)(v) if the taxable year of the trust were to end on such date. See, however, §1.7520–3(b) (relating to exceptions to the use of the prescribed tables under certain circumstances).

(2) *Transitional rules for valuation of charitable remainder unitrusts.* (i) If the valuation date of a transfer to a charitable remainder unitrust is after April 30, 1989, and before June 10, 1994, a transferor can rely upon Notice 89–24, 1989–1 C.B. 660, or Notice 89–60, 1989–1 C.B. 700, in valuing the transferred interest. (See §601.601(d)(2)(ii)(*b*) of this chapter.)

(ii) For purposes of sections 2055, 2106, or 2624, if on May 1, 1989, the decedent was mentally incompetent so that the disposition of the property could not be changed, and the decedent died after April 30, 1989, without having regained competency to dispose of the decedent's property, or the decedent died within 90 days of the date that the decedent first regained competency after April 30, 1989, the present value of a remainder interest determined under this section is determined as if the valuation date with respect to the decedent's gross estate is either before May 1, 1989, or after April 30, 1989, at the option of the decedent's executor.

(3) *Adjusted payout rate.* For transfers for which the valuation date is after April 30, 1989, the adjusted payout rate is determined by using the appropriate Table F, contained in paragraph (e)(6) of this section, for the section 7520 interest rate applicable to the transfer. If the interest rate is between 4.2 and 14 percent, see paragraph (e)(6) of this section. If the interest rate is below 4.2 percent or greater than 14 percent, see §1.664–4(b). The adjusted payout rate is determined by multiplying the fixed percentage described in §1.664–3(a)(1)(i)(*a*) by the factor describing the payout sequence of the trust and the number of months by which the valuation date for the first full taxable year of the trust precedes the first payout date for such taxable year. If the governing instrument does not prescribe when the distribution or distributions shall be made during the taxable year of the trust, see §1.664–4(a). In the case of a trust having a payout sequence for which no figures have been provided by the appropriate table, and in the case of a trust that determines the fair market value of the trust assets by taking the average of valuations on more than one date during the taxable year, see §1.664–4(b).

(4) *Period is a term of years.* If the period described in § 1.664–3(a)(5) is a term of years, the factor that is used in determining the present value of the remainder interest for transfers for which the valuation date is after April 30, 1989, is the factor under the appropriate adjusted payout rate in Table D in paragraph (e)(6) of this section corresponding to the number of years in the years. If the adjusted payout rate is an amount that is between adjusted payout rates for which factors are provided in Table D, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the appropriate valuation date) of the property placed in trust by the factor determined under this paragraph. For purposes of this section, the valuation date is, in the case of an inter vivos transfer, the date on which the property is transferred to the trust by the donor. However, if an election is made under section 7520 and § 1.7520–2(b) to compute the present value of the charitable interest by use of the interest rate component for either of the 2 months preceding the month in which the date of transfer falls, the month so elected is the valuation date for purposes of determining the interest rate and mortality tables. In the case of a testamentary transfer under section 2055, 2106, or 2624, the valuation date is the date of death, unless the alternate valuation date is elected under section 2032, in which event, and within the limitations set forth in section 2032 and the regulations thereunder, the valuation date is the alternate valuation date. If the decedent's estate elects the alternate valuation date under section 2032 and also elects, under section 7520 and § 1.7520–2(b), to use the interest rate component for one of the 2 months preceding the alternate valuation date, the month so elected is the valuation date for purposes of determining the interest rate and mortality tables. If the adjusted payout rate is between 4.2 and 14 percent, see paragraph (e)(6) of this section. If the adjusted payout rate is less than 4.2 percent or greater than 14 percent, see § 1.664–4(b). The application of this paragraph may be illustrated by the following example:

Example. D transfers $100,000 to a charitable remainder unitrust on January 1, 1990. The trust instrument requires that the trust pay 8 percent of the fair market value of the trust assets as of January 1st for a term of 12 years to D in quarterly payments (March 31, June 30, September 30, and December 31). The section 7520 rate of January 1990 is 9.6 percent. Under Table F(9.6), the appropriate adjustment factor is .944628 for quarterly payments payable at the end of each quarter. The adjusted payout rate is 7.557 (8%×.944628). Based on the remainder factors in Table D, the present value of the remainder interest is $38,950.30, computed as follows:

Factor at 7.4 percent for 12 years	.397495
Factor at 7.6 percent for 12 years	.387314
Difference	.010181

Interpolation adjustment:

$$\frac{9.47\% - 9.4\%}{0.2\%} = \frac{x}{.00463}$$

$$x = .00162$$

Factor at 7.4 percent for 12 years	.397495
Less: Interpolation adjustment	.007992
Interpolated factor	.389503
Present value of remainder interest: ($100,000×.389503)	$38,950.30

(5) *Period is the life of one individual.* If the period described in § 1.664–3(a)(5) is the life of one individual, the factor that is used in determining the present value of the remainder interest for transfers for which the valuation date is after April 30, 1989, is the factor in Table U(1) in paragraph (e)(6) of this section under the appropriate adjusted payout. For purposes of the computations described in this paragraph, the age of an individual is the age of that individual at the individual's nearest birthday. If the adjusted payout rate is an amount that is between adjusted payout rates for which factors are provided in the appropriate table, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the valuation

date as determined in paragraph (e)(4) of this section) of the property placed in trust by the factor determined under this paragraph (e)(5). If the adjusted payout rate is between 4.2 and 14 percent, see paragraph (e)(6) of this section. If the adjusted payout rate is below 4.2 percent or greater than 14 percent, see §1.664–4(b). The application of this paragraph may be illustrated by the following example:

Example. A, who will be 45 years old on February 19, 1990, transfers $100,000 to a charitable remainder unitrust on January 1, 1990. The trust instrument requires that the trust pay to A semiannually (on June 30 and December 31) 9 percent of the fair market value of the trust assets as of January 1st during A's life. The section 7520 rate for January 1990 is 9.6 percent. Under Table F(9.6), the appropriate adjustment factor is .933805 for semiannual payments payable at the end of the semiannual period. The adjusted payout rate is 8.404 (9%×.933805). Based on the remainder factors in Table U(1), the present value of the remainder interest is $11,098.00, computed as follows:

Factor at 8.4 percent at age 45 ...	.11106
Factor at 8.6 percent at age 45 ...	.10683
Difference	.00423

Interpolation adjustment:

$$\frac{8.404\% - 8.4\%}{0.2\%} = \frac{x}{.00423}$$

$$x = .00008$$

Factor at 8.4 percent at age 45	.11106
Less: Interpolation adjustment	.00008
Interpolated Factor	.11098
Present value of remainder interest:	
($100,000×.11098)	$11,098.00

(6) *Actuarial tables for transfers for which the valuation date is after April 30, 1989.* For transfers for which the valuation date is after April 30, 1989, the present value of a charitable remainder unitrust interest that is dependent on a term of years or the termination of a life interest is determined by using the section 7520 rate and the tables set forth below. See, however, §1.7520–3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). Many actuarial factors not contained in the following tables are contained in Internal Revenue Service Publication 1458, "Actuarial Values, Beta Volume," (8–89). A copy of this publication may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402.

TABLE D.—SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM CERTAIN IN A CHARITABLE REMAINDER UNITRUST

[Applicable after April 30, 1989]

Years	Adjusted payout rate									
	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
1	.958000	.956000	.954000	.952000	.950000	.948000	.946000	.944000	.942000	.940000
2	.917764	.913936	.910116	.906304	.902500	.898704	.894916	.891136	.887364	.883600
3	.879218	.873723	.868251	.862801	.857375	.851971	.846591	.841232	.835897	.830584
4	.842291	.835279	.828311	.821387	.814506	.807669	.800875	.794123	.787415	.780749
5	.806915	.798527	.790209	.781960	.773781	.765670	.757627	.749652	.741745	.733904
6	.773024	.763392	.753859	.744426	.735092	.725855	.716716	.707672	.698724	.689870
7	.740557	.729802	.719182	.708694	.698337	.688111	.678013	.668042	.658198	.648478
8	.709454	.697691	.686099	.674677	.663420	.652329	.641400	.630632	.620022	.609569
9	.679657	.666993	.654539	.642292	.630249	.618408	.606765	.595317	.584061	.572995
10	.651111	.637645	.624430	.611462	.598737	.586251	.573999	.561979	.550185	.538615
11	.623764	.609589	.595706	.582112	.568800	.555766	.543003	.530508	.518275	.506298
12	.597566	.582767	.568304	.554170	.540360	.526866	.513681	.500800	.488215	.475920
13	.572469	.557125	.542162	.527570	.513342	.499469	.485942	.472755	.459898	.447365
14	.548425	.532611	.517222	.502247	.487675	.473496	.459701	.446281	.433224	.420523
15	.525391	.509177	.493430	.478139	.463291	.448875	.434878	.421289	.408097	.395292
16	.503325	.486773	.470732	.455188	.440127	.425533	.411394	.397697	.384427	.371574
17	.482185	.465355	.449079	.433339	.418120	.403405	.389179	.375426	.362131	.349280
18	.461933	.444879	.428421	.412539	.397214	.382428	.368163	.354402	.341127	.328323

TABLE D.—SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM CERTAIN IN A CHARITABLE REMAINDER UNITRUST—Continued

[Applicable after April 30, 1989]

Years	Adjusted payout rate									
	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
19	.442532	.425304	.408714	.392737	.377354	.362542	.348282	.334555	.321342	.308624
20	.423946	.406591	.389913	.373886	.358486	.343690	.329475	.315820	.302704	.290106

TABLE D.—SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM CERTAIN IN A CHARITABLE REMAINDER UNITRUST

[Applicable after April 30, 1989]

Years	Adjusted payout rate									
	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
1	.938000	.936000	.934000	.932000	.930000	.928000	.926000	.924000	.922000	.920000
2	.879844	.876096	.872356	.868624	.864900	.861184	.857476	.853776	.850084	.846400
3	.825294	.820026	.814781	.809558	.804357	.799179	.794023	.788889	.783777	.778688
4	.774125	.767544	.761005	.754508	.748052	.741638	.735265	.728933	.722643	.716393
5	.726130	.718421	.710779	.703201	.695688	.688240	.680855	.673535	.666277	.659082
6	.681110	.672442	.663867	.655383	.646990	.638687	.630472	.622346	.614307	.606355
7	.638881	.629406	.620052	.610817	.601701	.592701	.583817	.575048	.566391	.557847
8	.599270	.589124	.579129	.569282	.559582	.550027	.540615	.531344	.522213	.513219
9	.562115	.551420	.540906	.530571	.520411	.510425	.500609	.490962	.481480	.472161
10	.527264	.516129	.505206	.494492	.483982	.473674	.463564	.453649	.443925	.434388
11	.494574	.483097	.471863	.460866	.450104	.439570	.429260	.419171	.409298	.399637
12	.463910	.452179	.440720	.429527	.418596	.407921	.397495	.387314	.377373	.367666
13	.435148	.423239	.411632	.400320	.389295	.378550	.368081	.357879	.347938	.338253
14	.408169	.396152	.384465	.373098	.362044	.351295	.340843	.330680	.320799	.311193
15	.382862	.370798	.359090	.347727	.336701	.326002	.315620	.305548	.295777	.286297
16	.359125	.347067	.335390	.324082	.313132	.302529	.292264	.282326	.272706	.263394
17	.336859	.324855	.313254	.302044	.291213	.280747	.270637	.260870	.251435	.242322
18	.315974	.304064	.292579	.281505	.270828	.260533	.250610	.241044	.231823	.222936
19	.296383	.284604	.273269	.262363	.251870	.241775	.232065	.222724	.213741	.205101
20	.278008	.266389	.255233	.244522	.234239	.224367	.214892	.205797	.197069	.188693

TABLE D.—SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM CERTAIN IN A CHARITABLE REMAINDER UNITRUST

[Applicable after April 30, 1989]

Years	Adjusted payout rate									
	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
1	.918000	.916000	.914000	.912000	.910000	.908000	.906000	.904000	.902000	.900000
2	.842724	.839056	.835396	.831744	.828100	.824464	.820836	.817216	.813604	.810000
3	.773621	.768575	.763552	.758551	.753571	.748613	.743677	.738763	.733871	.729000
4	.710184	.704015	.697886	.691798	.685750	.679741	.673772	.667842	.661951	.656100
5	.651949	.644878	.637868	.630920	.624032	.617205	.610437	.603729	.597080	.590490
6	.598489	.590708	.583012	.575399	.567869	.560422	.553056	.545771	.538566	.531441
7	.549413	.541089	.532873	.524764	.516761	.508863	.501069	.493377	.485787	.478297
8	.504361	.495637	.487046	.478585	.470253	.462048	.453968	.446013	.438180	.430467
9	.463003	.454004	.445160	.436469	.427930	.419539	.411295	.403196	.395238	.387420
10	.425037	.415867	.406876	.398060	.389416	.380942	.372634	.364489	.356505	.348678
11	.390184	.380934	.371885	.363031	.354369	.345895	.337606	.329498	.321567	.313811
12	.358189	.348936	.339902	.331084	.322475	.314073	.305871	.297866	.290054	.282430
13	.328817	.319625	.310671	.301949	.293453	.285178	.277119	.269271	.261628	.254187
14	.301854	.292777	.283953	.275377	.267042	.258942	.251070	.243421	.235989	.228768
15	.277102	.268184	.259533	.251144	.243008	.235119	.227469	.220053	.212862	.205891
16	.254380	.245656	.237213	.229043	.221137	.213488	.206087	.198928	.192001	.185302
17	.233521	.225021	.216813	.208887	.201235	.193847	.186715	.179830	.173185	.166772
18	.214372	.206119	.198167	.190505	.183124	.176013	.169164	.162567	.156213	.150095
19	.196794	.188805	.181125	.173741	.166643	.159820	.153262	.146960	.140904	.135085
20	.180657	.172946	.165548	.158452	.151645	.145117	.138856	.132852	.127096	.121577

TABLE D.—SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM CERTAIN IN A CHARITABLE REMAINDER UNITRUST

[Applicable after April 30, 1989]

Years	Adjusted payout rate									
	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
1	.898000	.896000	.894000	.892000	.890000	.888000	.886000	.884000	.882000	.880000
2	.806404	.802816	.799236	.795664	.792100	.788544	.784996	.781456	.777924	.774400
3	.724151	.719323	.714517	.709732	.704969	.700227	.695506	.690807	.686129	.681472
4	.650287	.644514	.638778	.633081	.627422	.621802	.616219	.610673	.605166	.599695
5	.583958	.577484	.571068	.564708	.558406	.552160	.545970	.539835	.533756	.527732
6	.524394	.517426	.510535	.503720	.496981	.490318	.483729	.477214	.470773	.464404
7	.470906	.463613	.456418	.449318	.442313	.435402	.428584	.421858	.415222	.408676
8	.422874	.415398	.408038	.400792	.393659	.386637	.379726	.372922	.366226	.359635
9	.379741	.372196	.364786	.357506	.350356	.343334	.336437	.329663	.323011	.316478
10	.341007	.333488	.326118	.318896	.311817	.304881	.298083	.291422	.284896	.278501
11	.306224	.298805	.291550	.284455	.277517	.270734	.264102	.257617	.251278	.245081
12	.274989	.267729	.260645	.253734	.246990	.240412	.233994	.227734	.221627	.215671
13	.246941	.239886	.233017	.226331	.219821	.213486	.207319	.201317	.195475	.189791
14	.221753	.214937	.208317	.201887	.195641	.189575	.183684	.177964	.172409	.167016
15	.199134	.192584	.186236	.180083	.174121	.168343	.162744	.157320	.152065	.146974
16	.178822	.172555	.166495	.160634	.154967	.149488	.144191	.139071	.134121	.129337
17	.160582	.154609	.148846	.143286	.137921	.132746	.127754	.122939	.118295	.113817
18	.144203	.138530	.133069	.127811	.122750	.117878	.113190	.108678	.104336	.100159
19	.129494	.124123	.118963	.114007	.109247	.104676	.100286	.096071	.092024	.088140
20	.116286	.111214	.106353	.101694	.097230	.092952	.088853	.084927	.081166	.077563

TABLE D.—SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM CERTAIN IN A CHARITABLE REMAINDER UNITRUST

[Applicable after April 30, 1989]

Years	Adjusted payout rate									
	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
1	.878000	.876000	.874000	.872000	.870000	.868000	.866000	.864000	.862000	.860000
2	.770884	.767376	.763876	.760384	.756900	.753424	.749956	.746496	.743044	.739600
3	.676836	.672221	.667628	.663055	.658503	.653972	.649462	.644973	.640504	.636056
4	.594262	.588866	.583507	.578184	.572898	.567648	.562434	.557256	.552114	.547008
5	.521762	.515847	.509985	.504176	.498421	.492718	.487068	.481469	.475923	.470427
6	.458107	.451882	.445727	.439642	.433626	.427679	.421801	.415990	.410245	.404567
7	.402218	.395848	.389565	.383368	.377255	.371226	.365279	.359415	.353631	.347928
8	.353147	.346763	.340480	.334297	.328212	.322224	.316332	.310535	.304830	.299218
9	.310063	.303764	.297579	.291507	.285544	.279690	.273944	.268302	.262764	.257327
10	.272236	.266098	.260084	.254194	.248423	.242771	.237235	.231813	.226502	.221302
11	.239023	.233102	.227314	.221657	.216128	.210725	.205446	.200286	.195245	.190319
12	.209862	.204197	.198672	.193285	.188032	.182910	.177916	.173047	.168301	.163675
13	.184259	.178877	.173640	.168544	.163588	.158766	.154075	.149513	.145076	.140760
14	.161779	.156696	.151761	.146971	.142321	.137809	.133429	.129179	.125055	.121054
15	.142042	.137266	.132639	.128158	.123819	.119618	.115550	.111611	.107798	.104106
16	.124713	.120245	.115927	.111754	.107723	.103828	.100066	.096432	.092922	.089531
17	.109498	.105334	.101320	.097450	.093719	.090123	.086657	.083317	.080098	.076997
18	.096139	.092273	.088554	.084976	.081535	.078227	.075045	.071986	.069045	.066217
19	.084410	.080831	.077396	.074099	.070936	.067901	.064989	.062196	.059517	.056947
20	.074112	.070808	.067644	.064614	.061714	.058938	.056280	.053737	.051303	.048974

TABLE F(4.2).—WITH INTEREST AT 4.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.989820	.984755	.981389
1	2	.996577	.986432	.981385	.978030
2	3	.993166	.983056	.978026	
3	4	.989767	.979691	.974679	
4	5	.986380	.976338		

TABLE F(4.2).—WITH INTEREST AT 4.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS—Continued

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
5	6	.983004	.972996		
6	7	.979639	.969666		
7	8	.976286			
8	9	.972945			
9	10	.969615			
10	11	.966296			
11	12	.962989			
12	....	.959693			

TABLE F(4.4).—WITH INTEREST AT 4.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.989350	.984054	.980533
1	2	.996418	.985806	.980529	.977021
2	3	.992849	.982275	.977017	
3	4	.989293	.978757	.973517	
4	5	.985749	.975251		
5	6	.982219	.971758		
6	7	.978700	.968277		
7	8	.975195			
8	9	.971702			
9	10	.968221			
10	11	.964753			
11	12	.961298			
12	....	.957854			

TABLE F(4.6).—WITH INTEREST AT 4.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.988882	.983354	.979680
1	2	.996259	.985183	.979676	.976015
2	3	.992532	.981498	.976011	
3	4	.988820	.977826	.972360	
4	5	.985121	.974168		
5	6	.981436	.970524		
6	7	.977764	.966894		
7	8	.974107			
8	9	.970463			
9	10	.966832			
10	11	.963216			
11	12	.959613			
12	....	.956023			

TABLE F(4.8).—WITH INTEREST AT 4.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.988415	.982657	.978830
1	2	.996101	.984561	.978825	.975013
2	3	.992217	.980722	.975008	
3	4	.988348	.976898	.971206	
4	5	.984494	.973089		
5	6	.980655	.969294		
6	7	.976831	.965515		
7	8	.973022			
8	9	.969228			
9	10	.965448			
10	11	.961684			
11	12	.957934			
12	....	.954198			

TABLE F(5.0).—WITH INTEREST AT 5.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.987950	.981961	.977982
1	2	.995942	.983941	.977977	.974014
2	3	.991901	.979949	.974009	
3	4	.987877	.975973	.970057	
4	5	.983868	.972013		
5	6	.979876	.968069		
6	7	.975900	.964141		
7	8	.971940			
8	9	.967997			
9	10	.964069			
10	11	.960157			
11	12	.956261			
12	....	.952381			

TABLE F(5.2).—WITH INTEREST AT 5.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.987486	.981268	.977137
1	2	.995784	.983323	.977132	.973018
2	3	.991587	.979178	.973012	
3	4	.987407	.975050	.968911	
4	5	.983244	.970940		
5	6	.979099	.966847		
6	7	.974972	.962771		
7	8	.970862			
8	9	.966769			
9	10	.962694			
10	11	.958636			
11	12	.954594			
12	....	.950570			

TABLE F(5.4).—WITH INTEREST AT 5.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.987023	.980577	.976295
1	2	.995627	.982707	.976289	.972026
2	3	.991273	.978409	.972019	
3	4	.986938	.974131	.967769	
4	5	.982622	.969871		
5	6	.978325	.965629		
6	7	.974047	.961407		
7	8	.969787			
8	9	.965546			
9	10	.961323			
10	11	.957119			
11	12	.952934			
12	....	.948767			

TABLE F(5.6).—WITH INTEREST AT 5.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.986562	.979888	.975455
1	2	.995470	.982092	.975449	.971036
2	3	.990960	.977643	.971029	
3	4	.986470	.973214	.966630	
4	5	.982001	.968805		
5	6	.977552	.964416		
6	7	.973124	.960047		
7	8	.968715			
8	9	.964326			
9	10	.959958			
10	11	.955609			
11	12	.951279			
12	....	.946970			

TABLE F(5.8).—WITH INTEREST AT 5.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.986102	.979201	.974618
1	2	.995313	.981480	.974611	.970050
2	3	.990647	.976879	.970043	
3	4	.986004	.972300	.965496	
4	5	.981382	.967743		
5	6	.976782	.963206		
6	7	.972203	.958692		
7	8	.967646			
8	9	.963111			
9	10	.958596			
10	11	.954103			
11	12	.949631			
12	....	.945180			

TABLE F(6.0).—WITH INTEREST AT 6.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.985643	.978516	.973784
1	2	.995156	.980869	.973776	.969067
2	3	.990336	.976117	.969059	
3	4	.985538	.971389	.964365	
4	5	.980764	.966684		
5	6	.976014	.962001		
6	7	.971286	.957341		
7	8	.966581			
8	9	.961899			
9	10	.957239			
10	11	.952603			
11	12	.947988			
12	....	.943396			

TABLE F(6.2).—WITH INTEREST AT 6.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.985185	.977833	.972952
1	2	.995000	.980259	.972944	.968087
2	3	.990024	.975358	.968079	
3	4	.985074	.970481	.963238	
4	5	.980148	.965628		
5	6	.975247	.960799		
6	7	.970371	.955995		
7	8	.965519			
8	9	.960691			
9	10	.955887			
10	11	.951107			
11	12	.946352			
12	....	.941620			

TABLE F(6.4).—WITH INTEREST AT 6.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.984729	.977152	.972122
1	2	.994844	.979652	.972114	.967110
2	3	.989714	.974600	.967101	
3	4	.984611	.969575	.962115	
4	5	.979534	.964576		
5	6	.974483	.959602		
6	7	.969458	.954654		
7	8	.964460			
8	9	.959487			
9	10	.954539			
10	11	.949617			
11	12	.944721			

TABLE F(6.4).—WITH INTEREST AT 6.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS—Continued

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
12	....	.939850			

TABLE F(6.6).—WITH INTEREST AT 6.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.984274	.976473	.971295
1	2	.994688	.979046	.971286	.966136
2	3	.989404	.973845	.966127	
3	4	.984149	.968672	.960995	
4	5	.978921	.963527		
5	6	.973721	.958408		
6	7	.968549	.953317		
7	8	.963404			
8	9	.958286			
9	10	.953196			
10	11	.948132			
11	12	.943096			
12	....	.938086			

TABLE F(6.8).—WITH INTEREST AT 6.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.983821	.975796	.970471
1	2	.994533	.978442	.970461	.965165
2	3	.989095	.973092	.965156	
3	4	.983688	.967772	.959879	
4	5	.978309	.962481		
5	6	.972961	.957219		
6	7	.967641	.951985		
7	8	.962351			
8	9	.957089			
9	10	.951857			
10	11	.946653			
11	12	.941477			
12	....	.936330			

TABLE F(7.0).—WITH INTEREST AT 7.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.983368	.975122	.969649
1	2	.994378	.977839	.969639	.964198
2	3	.988787	.972342	.964187	
3	4	.983228	.966875	.958766	
4	5	.977700	.961439		
5	6	.972203	.956033		
6	7	.966736	.950658		
7	8	.961301			
8	9	.955896			
9	10	.950522			
10	11	.945178			
11	12	.939864			
12	....	.934579			

TABLE F(7.2).—WITH INTEREST AT 7.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.982917	.974449	.968830
1	2	.994223	.977239	.968819	.963233
2	3	.988479	.971593	.963222	
3	4	.982769	.965980	.957658	
4	5	.977091	.960400		
5	6	.971446	.954851		
6	7	.965834	.949335		
7	8	.960255			
8	9	.954707			
9	10	.949192			
10	11	.943708			
11	12	.938256			
12	....	.932836			

TABLE F(7.4).—WITH INTEREST AT 7.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.982467	.973778	.968013
1	2	.994068	.976640	.968002	.962271
2	3	.988172	.970847	.962260	
3	4	.982311	.965088	.956552	
4	5	.976484	.959364		
5	6	.970692	.953673		
6	7	.964935	.948017		
7	8	.959211			
8	9	.953521			
9	10	.947866			
10	11	.942243			
11	12	.936654			

TABLE F(7.4).—WITH INTEREST AT 7.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS—Continued

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
12	....	.931099			

TABLE F(7.6).—WITH INTEREST AT 7.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.982019	.973109	.967199
1	2	.993914	.976042	.967187	.961313
2	3	.987866	.970103	.961301	
3	4	.981854	.964199	.955451	
4	5	.975879	.958331		
5	6	.969940	.952499		
6	7	.964037	.946703		
7	8	.958171			
8	9	.952340			
9	10	.946544			
10	11	.940784			
11	12	.935058			
12	....	.929368			

TABLE F(7.8).—WITH INTEREST AT 7.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.0000000	.981571	.972442	.966387
1	2	.993761	.975447	.966374	.960357
2	3	.987560	.969361	.960345	
3	4	.981398	.963312	.954353	
4	5	.975275	.957302		
5	6	.969190	.951329		
6	7	.963143	.945393		
7	8	.957133			
8	9	.951161			
9	10	.945227			
10	11	.939329			
11	12	.933468			
12	....	.927644			

TABLE F(8.0).—WITH INTEREST AT 8.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.981125	.971777	.965578
1	2	.993607	.974853	.965564	.959405
2	3	.987255	.968621	.959392	
3	4	980944	.962429	.953258	
4	5	.974673	.956276		
5	6	.968442	.950162		
6	7	.962250	.944088		
7	8	.956099			
8	9	.949987			
9	10	.943913			
10	11	.937879			
11	12	.931883			
12	....	.925926			

TABLE F(8.2).—WITH INTEREST AT 8.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.980680	.971114	.964771
1	2	.993454	.974261	.964757	.958455
2	3	.986951	.967883	.958441	
3	4	.980490	.961547	.952167	
4	5	.974072	.955253		
5	6	.967695	.949000		
6	7	.961361	.942788		
7	8	.955068			
8	9	.948816			
9	10	.942605			
10	11	.936434			
11	12	.930304			
12	....	.924214			

TABLE F(8.2).—WITH INTEREST AT 8.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.980237	.970453	.963966
1	2	.993301	.973670	.963952	.957509
2	3	.986647	.967148	.957494	
3	4	.980037	.960669	.951080	
4	5	.973472	.954233		
5	6	.966951	.947841		
6	7	.960473	.941491		
7	8	.954039			
8	9	.947648			
9	10	.941300			
10	11	.934994			
11	12	.928731			
12	....	.922509			

Table F(8.6).—With Interest at 8.6 Percent, Showing Factors for Computation of the Adjusted Payout Rate for Certain Valuations

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.979794	.969794	.963164
1	2	.993148	.973081	.963149	.956565
2	3	.986344	.966414	.956550	
3	4	.979586	.959793	.949996	
4	5	.972874	.953217		
5	6	.966209	.946686		
6	7	.959589	.940199		
7	8	.953014			
8	9	.946484			
9	10	.940000			
10	11	.933559			
11	12	.927163			
12	....	.920810			

Table F(8.8).—WITH INTEREST AT 8.8 Percent, Showing Factors for Computation of the Adjusted Payout Rate for Certain Valuations

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.979353	.969136	.962364
1	2	.992996	.972494	.962349	.955624
2	3	.986041	.965683	.955609	
3	4	.979135	.958919	.948916	
4	5	.972278	.952203		
5	6	.965468	.945534		
6	7	.958706	.938912		
7	8	.951992			
8	9	.945324			
9	10	.938703			
10	11	.932129			
11	12	.925600			
12	....	.919118			

Table F(9.0).—With Interest at 9.0 Percent, Showing Factors for Computation of the Adjusted Payout Rate for Certain Valuations

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.978913	.968481	.961567
1	2	.992844	.971908	.961551	.954686
2	3	.985740	.964954	.954670	
3	4	.978686	.958049	.947839	
4	5	.971683	.951193		
5	6	.964730	.944387		
6	7	.957826	.937629		
7	8	.950972			
8	9	.944167			
9	10	.937411			
10	11	.930703			
11	12	.924043			
12	....	.917431			

Table F(9.2).—With Interest at 9.2 Percent, Showing Factors for Computation of the Adjusted Payout Rate for Certain Valuations

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.978474	.967827	.960772
1	2	.992693	.971324	.960755	.953752
2	3	.985439	.964226	.953734	
3	4	.978238	.957180	.946765	
4	5	.971089	.950186		
5	6	.963993	.943242		
6	7	.956949	.936350		
7	8	.949956			
8	9	.943014			
9	10	.936123			
10	11	.929283			
11	12	.922492			
12	....	.915751			

Table F (9.4).—With Interest at 9.4 Percent, Showing Factors for Computation of the Adjusted Payout Rate for Certain valuations

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.978037	.967176	.959980
1	2	.992541	.970742	.959962	.952820
2	3	.985138	.963501	.952802	
3	4	.977790	.956315	.945695	
4	5	.970497	.949182		
5	6	.963258	.942102		
6	7	.956074	.935075		
7	8	.948942			
8	9	.941865			
9	10	.934839			
10	11	.927867			
11	12	.920946			
12	....	.914077			

Table F(9.6).—With Interest at 9.6 Percent, Showing Factors for Computation of the Adjusted Payout Rate for Certain valuations

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.977600	.966526	.959190
1	2	.992390	.970161	.959171	.951890
2	3	.984838	.962778	.951872	
3	4	.977344	.955452	.944628	
4	5	.969906	.948181		
5	6	.962526	.940965		
6	7	.955201	.933805		
7	8	.947932			
8	9	.940718			
9	10	.933560			
10	11	.926455			
11	12	.919405			
12	....	.912409			

TABLE F(9.8).—WITH INTEREST AT 9.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.977165	.965878	.958402
1	2	.992239	.969582	.958382	.950964
2	3	.984539	.962057	.950945	
3	4	.976898	.954591	.943565	
4	5	.969317	.947183		
5	6	.961795	.939832		
6	7	.954331	.932539		
7	8	.946924			
8	9	.939576			
9	10	.932284			
10	11	.925049			
11	12	.917870			
12	....	.910747			

TABLE F(10.0).—WITH INTEREST AT 10.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.976731	.965232	.957616
1	2	.992089	.969004	.957596	.950041
2	3	.984240	.961338	.950021	
3	4	.976454	.953733	.942505	
4	5	.968729	.946188		
5	6	.961066	.938703		
6	7	.953463	.931277		
7	8	.945920			
8	9	.938436			
9	10	.931012			
10	11	.923647			
11	12	.916340			
12	....	.909091			

TABLE F(10.2).—WITH INTEREST AT 10.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.976298	.964588	.956833
1	2	.991939	.968428	.956812	.949120
2	3	.983943	.960622	.949099	
3	4	.976011	.952878	.941448	
4	5	.968143	.945196		
5	6	.960338	.937577		
6	7	.952597	.930019		
7	8	.944918			
8	9	.937301			
9	10	.929745			
10	11	.922250			
11	12	.914816			
12	....	.907441			

TABLE F(10.4).—WITH INTEREST AT 10.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.975867	.963946	.956052
1	2	.991789	.967854	.956031	.948202
2	3	.983645	.959907	.948181	
3	4	.975568	.952025	.940395	
4	5	.967558	.944208		
5	6	.959613	.936455		
6	7	.951734	.928765		
7	8	.943919			
8	9	.936168			
9	10	.928481			
10	11	.920858			
11	12	.913296			
12	....	.905797			

TABLE F(10.6).—WITH INTEREST AT 10.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.975436	.963305	.955274
1	2	.991639	.967281	.955252	.947287
2	3	.983349	.959194	.947265	
3	4	.975127	.951174	.939345	
4	5	.966974	.943222		
5	6	.958890	.935336		
6	7	.950873	.927516		
7	8	.942923			
8	9	.935039			
9	10	.927222			
10	11	.919470			
11	12	.911782			
12	....	.904159			

TABLE F(10.8).—WITH INTEREST AT 10.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.975007	.962667	.954498
1	2	.991490	.966710	.954475	.946375
2	3	.983052	.958483	.946352	
3	4	.974687	.950327	.938299	
4	5	.966392	.942239		
5	6	.958168	.934221		
6	7	.950014	.926271		
7	8	.941930			
8	9	.933914			
9	10	.925966			
10	11	.918086			
11	12	.910273			
12	....	.902527			

TABLE F(11.0).—WITH INTEREST AT 11.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.974579	.962030	.953724
1	2	.991341	.966140	.953700	.945466
2	3	.982757	.957774	.945442	
3	4	.974247	.949481	.937255	
4	5	.965811	.941260		
5	6	.957449	.933109		
6	7	.949158	.925029		
7	8	.940939			
8	9	.932792			
9	10	.924715			
10	11	.916708			
11	12	.908770			
12	....	.900901			

TABLE F(11.2).—WITH INTEREST AT 11.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.974152	.961395	.952952
1	2	.991192	.965572	.952927	.944559
2	3	.982462	.957068	.944534	
3	4	.973809	.948638	.936215	
4	5	.965232	.940283		
5	6	.956731	.932001		
6	7	.948304	.923792		
7	8	.939952			
8	9	.931673			
9	10	.923467			
10	11	.915333			
11	12	.907272			
12	....	.899281			

TABLE F(11.4).—WITH INTEREST AT 11.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.973726	.960762	.952183
1	2	.991044	.965005	.952157	.943655
2	3	.982168	.956363	.943630	
3	4	.973372	.947798	.935178	
4	5	.964654	.939309		
5	6	.956015	.930896		
6	7	.947452	.922559		
7	8	.938967			
8	9	.930557			
9	10	.922223			
10	11	.913964			
11	12	.905778			
12	....	.897666			

TABLE F(11.6).—WITH INTEREST AT 11.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.973302	.960130	.951416
1	2	.990896	.964440	.951389	.942754
2	3	.981874	.955660	.942728	
3	4	.972935	.946959	.934145	
4	5	.964077	.938338		
5	6	.955300	.929795		
6	7	.946603	.921330		
7	8	.937985			
8	9	.929445			
9	10	.920984			
10	11	.912599			
11	12	.904290			
12	....	.896057			

TABLE F(11.8).—WITH INTEREST AT 11.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Seminannual period	Quarterly period	Monthly period
	1	1.000000	.972878	.959501	.950651
1	2	.990748	.963877	.950624	.941855
2	3	.981582	.954959	.941828	
3	4	.972500	.946124	.933114	
4	5	.963502	.937370		
5	6	.954588	.928698		
6	7	.945756	.920105		
7	8	.937006			
8	9	.928337			
9	10	.919748			
10	11	.911238			
11	12	.902807			
12	....	.894454			

TABLE F(12.0).—WITH INTEREST AT 12.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Seminannual period	Quarterly period	Monthly period
	1	1.000000	.972456	.958873	.949888
1	2	.990600	.963315	.949860	.940960
2	3	.981289	.954260	.940932	
3	4	.972065	.945290	.932087	
4	5	.962928	.936405		
5	6	.953877	.927603		
6	7	.944911	.918884		
7	8	.936029			
8	9	.927231			
9	10	.918515			
10	11	.909882			
11	12	.901329			
12	....	.892857			

TABLE F(12.2).—WITH INTEREST AT 12.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.972034	.958247	.949128
1	2	.990453	.962754	.949099	.940067
2	3	.980997	.953563	.940038	
3	4	.971632	.944460	.931063	
4	5	.962356	.935443		
5	6	.953168	.926512		
6	7	.944069	.917667		
7	8	.935056			
8	9	.926129			
9	10	.917287			
10	11	.908530			
11	12	.899856			
12	....	.891266			

TABLE F(12.4).—WITH INTEREST AT 12.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Montly period
	1	1.000000	.971614	.957623	.948370
1	2	.990306	.962195	.948340	.939176
2	3	.980706	.952868	.939147	
3	4	.971199	.943631	.930043	
4	5	.961785	.934484		
5	6	.952461	.925425		
6	7	.943228	.916454		
7	8	.934085			
8	9	.925030			
9	10	.916063			
10	11	.907183			
11	12	.898389			
12	....	.889680			

TABLE F(12.6).—WITH INTEREST AT 12.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	but less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.971195	.957000	.947614
1	2	.990159	.961638	.947583	.938289
2	3	.980416	.952175	.938258	
3	4	.970768	.942805	.929025	
4	5	.961215	.933527		
5	6	.951756	.924341		
6	7	.942390	.915245		
7	8	.933117			
8	9	.923934			
9	10	.914842			
10	11	.905840			
11	12	.896926			

TABLE F(12.6).—WITH INTEREST AT 12.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS—Continued

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	but less than	Annual period	Semiannual period	Quarterly period	Monthly period
12	....	.888099			

TABLE F(12.8).—WITH INTEREST AT 12.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	but less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.970777	.956379	.946860
1	2	.990013	.961082	.946828	.937403
2	3	.980126	.951484	.937372	
3	4	.970337	.941981	.928011	
4	5	.960647	.932574		
5	6	.951053	.923260		
6	7	.941554	.914040		
7	8	.932151			
8	9	.922842			
9	10	.913625			
10	11	.904501			
11	12	.895468			
12	....	.886525			

TABLE F(13.0).—WITH INTEREST AT 13.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.970360	.955760	.946108
1	2	.989867	.960528	.946075	.936521
2	3	.979836	.950795	.936489	
3	4	.969908	.941160	.926999	
4	5	.960079	.931623		
5	6	.950351	.922183		
6	7	.940721	.912838		
7	8	.931188			
8	9	.921753			
9	10	.912412			
10	11	.903167			
11	12	.894015			
12	....	.884956			

TABLE F(13.2).—WITH INTEREST AT 13.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.969945	.955143	.945359
1	2	.989721	.959975	.945325	.935641
2	3	.979548	.950107	.935608	
3	4	.969479	.940341	.925991	
4	5	.959514	.930675		
5	6	.949651	.921109		
6	7	.939889	.911641		
7	8	.930228			
8	9	.920667			
9	10	.911203			
10	11	.901837			
11	12	.892567			
12	....	.883392			

TABLE F(13.4).—WITH INTEREST AT 13.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quaterly period	Monthly period
	1	1.000000	.969530	.954527	.944611
1	2	.989575	.959423	.944577	.934764
2	3	.979260	.949422	.934730	
3	4	.969051	.939524	.924986	
4	5	.958949	.929730		
5	6	.948953	.920038		
6	7	.939060	.910447		
7	8	.929271			
8	9	.919584			
9	10	.909998			
10	11	.900511			
11	12	.891124			
12	....	.881834			

TABLE F(13.6).—WITH INTEREST AT 13.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quaterly period	Monthly period
	1	1.000000	.969117	.953913	.943866
1	2	.989430	.958873	.943831	.933890
2	3	.978972	.948738	.933854	
3	4	.968624	.938710	.923984	
4	5	.958386	.928788		
5	6	.948256	.918971		
6	7	.938233	.909257		
7	8	.928316			
8	9	.918504			
9	10	.908796			
10	11	.899190			
11	12	.889686			
12	....	.880282			

TABLE F(13.8).—WITH INTEREST AT 13.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.968704	.953301	.943123
1	2	.989285	.958325	.943087	.933018
2	3	.978685	.948056	.932982	
3	4	.968199	.937898	.922985	
4	5	.957824	.927849		
5	6	.947561	.917907		
6	7	.937408	.908072		
7	8	.927364			
8	9	.917428			
9	10	.907598			
10	11	.897873			
11	12	.888252			
12	....	.878735			

TABLE F(14.0).—WITH INTEREST AT 14.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first rull taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.968293	.952691	.942382
1	2	.989140	.957778	.942345	.932148
2	3	.978399	.947377	.932111	
3	4	.967774	.937088	.921989	
4	5	.957264	.926912		
5	6	.946868	.916846		
6	7	.936586	.906889		
7	8	.926415			
8	9	.916354			
9	10	.906403			
10	11	.896560			
11	12	.886824			
12	....	.877193			

TABLE U(1).—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS

[Applicable After April 30, 1989]

Age	Adjusted payout rate									
	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
0	.06797	.06181	.05645	.05177	.04768	.04410	.04096	.03820	.03578	.03364
1	.05881	.05243	.04686	.04199	.03773	.03400	.03072	.02784	.02531	.02308
2	.06049	.05394	.04821	.04319	.03880	.03494	.03155	.02856	.02593	.02361
3	.06252	.05579	.04990	.04473	.04020	.03621	.03270	.02961	.02688	.02446
4	.06479	.05788	.05182	.04650	.04183	.03771	.03408	.03087	.02804	.02553
5	.06724	.06016	.05393	.04845	.04363	.03937	.03562	.03230	.02936	.02675
6	.06984	.06257	.05618	.05054	.04557	.04117	.03729	.03385	.03080	.02809
7	.07259	.06513	.05856	.05276	.04764	.04310	.03909	.03552	.03236	.02954
8	.07548	.06784	.06109	.05513	.04985	.04517	.04102	.03733	.03405	.03113
9	.07854	.07071	.06378	.05765	.05221	.04738	.04310	.03928	.03588	.03285
10	.08176	.07374	.06663	.06033	.05473	.04976	.04533	.04138	.03786	.03471
11	.08517	.07695	.06966	.06319	.05743	.05230	.04772	.04364	.04000	.03673
12	.08872	.08031	.07284	.06619	.06026	.05498	.05026	.04604	.04227	.03889
13	.09238	.08378	.07612	.06929	.06320	.05776	.05289	.04853	.04463	.04113
14	.09608	.08728	.07943	.07243	.06616	.06056	.05554	.05104	.04701	.04338
15	.09981	.09081	.08276	.07557	.06914	.06337	.05820	.05356	.04938	.04563
16	.10356	.09435	.08612	.07874	.07213	.06619	.06086	.05607	.05176	.04787

TABLE U(1).—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable After April 30, 1989]

Age	Adjusted payout rate									
	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
17	.10733	.09792	.08949	.08192	.07513	.06902	.06353	.05858	.05413	.05010
18	.11117	.10155	.09291	.08515	.07817	.07189	.06623	.06113	.05652	.05236
19	.11509	.10526	.09642	.08847	.08130	.07484	.06901	.06375	.05899	.05469
20	.11913	.10908	.10003	.09188	.08452	.07788	.07188	.06645	.06154	.05708
21	.12326	.11300	.10375	.09539	.08784	.08101	.07483	.06923	.06416	.05955
22	.12753	.11705	.10758	.09902	.09127	.08426	.07789	.07212	.06688	.06212
23	.13195	.12125	.11156	.10279	.09484	.08763	.08109	.07514	.06973	.06481
24	.13655	.12563	.11573	.10675	.09860	.09119	.08446	.07833	.07274	.06766
25	.14136	.13022	.12010	.11091	.10255	.09495	.08802	.08171	.07595	.07069
26	.14640	.13504	.12471	.11530	.10674	.09893	.09181	.08531	.07937	.07394
27	.15169	.14011	.12956	.11994	.11117	.10316	.09584	.08915	.08302	.07742
28	.15721	.14542	.13465	.12482	.11583	.10762	.10010	.09322	.08691	.08112
29	.16299	.15097	.13999	.12994	.12075	.11233	.10461	.09753	.09104	.08507
30	.16901	.15678	.14559	.13533	.12592	.11729	.10937	.10210	.09541	.08926
31	.17531	.16287	.15146	.14099	.13137	.12254	.11441	.10694	.10006	.09372
32	.18186	.16921	.15759	.14691	.13709	.12804	.11972	.11205	.10497	.09844
33	.18869	.17584	.16401	.15312	.14309	.13384	.12531	.11744	.11017	.10345
34	.19578	.18273	.17070	.15961	.14937	.13992	.13119	.12312	.11565	.10874
35	.20315	.18990	.17767	.16637	.15593	.14628	.13735	.12908	.12142	.11431
36	.21076	.19732	.18490	.17340	.16276	.15291	.14377	.13531	.12745	.12016
37	.21863	.20501	.19239	.18071	.16987	.15982	.15049	.14182	.13377	.12628
38	.22676	.21296	.20016	.18828	.17725	.16701	.15748	.14862	.14037	.13269
39	.23515	.22118	.20820	.19614	.18492	.17448	.16476	.15571	.14727	.13940
40	.24379	.22967	.21652	.20428	.19288	.18225	.17234	.16310	.15447	.14641
41	.25270	.23842	.22511	.21270	.20112	.19031	.18021	.17078	.16197	.15372
42	.26184	.24742	.23395	.22137	.20962	.19864	.18836	.17875	.16975	.16132
43	.27123	.25666	.24305	.23031	.21840	.20724	.19679	.18700	.17782	.16921
44	.28085	.26616	.25241	.23952	.22745	.21613	.20551	.19554	.18618	.17739
45	.29072	.27591	.26203	.24901	.23678	.22530	.21452	.20438	.19485	.18589
46	.30082	.28591	.27191	.25875	.24639	.23476	.22381	.21352	.20382	.19468
47	.31116	.29616	.28204	.26877	.25626	.24449	.23340	.22295	.21309	.20379
48	.32171	.30663	.29241	.27902	.26640	.25449	.24326	.23265	.22264	.21318
49	.33245	.31730	.30300	.28950	.27676	.26473	.25336	.24262	.23246	.22285
50	.34338	.32816	.31379	.30020	.28735	.27521	.26371	.25283	.24253	.23277
51	.35449	.33923	.32479	.31112	.29818	.28593	.27431	.26331	.25287	.24297
52	.36582	.35053	.33603	.32230	.30927	.29692	.28520	.27408	.26352	.25349
53	.37736	.36205	.34751	.33372	.32063	.30819	.29637	.28514	.27446	.26431
54	.38909	.37376	.35921	.34537	.33221	.31970	.30780	.29647	.28569	.27542
55	.40099	.38568	.37111	.35724	.34404	.33146	.31949	.30807	.29719	.28681
56	.41308	.39779	.38322	.36934	.35610	.34348	.33143	.31994	.30898	.29851
57	.42536	.41011	.39555	.38167	.36841	.35575	.34366	.33210	.32106	.31051
58	.43781	.42262	.40810	.39422	.38096	.36828	.35615	.34454	.33344	.32281
59	.45043	.43530	.42083	.40698	.39373	.38104	.36888	.35724	.34609	.33540
60	.46318	.44813	.43372	.41992	.40668	.39400	.38183	.37017	.35898	.34824
61	.47602	.46107	.44674	.43299	.41979	.40713	.39497	.38329	.37207	.36129
62	.48893	.47410	.45986	.44617	.43303	.42039	.40825	.39657	.38534	.37454
63	.50190	.48720	.47306	.45946	.44638	.43379	.42168	.41001	.39878	.38796
64	.51494	.50038	.48636	.47286	.45986	.44733	.43526	.42362	.41240	.40158
65	.52808	.51368	.49980	.48641	.47350	.46104	.44903	.43743	.42624	.41544
66	.54134	.52711	.51338	.50013	.48733	.47496	.46302	.45148	.44033	.42956
67	.55471	.54068	.52712	.51401	.50134	.48908	.47723	.46577	.45467	.44394
68	.56820	.55437	.54100	.52805	.51552	.50339	.49165	.48027	.46925	.45858
69	.58172	.56812	.55495	.54219	.52982	.51783	.50620	.49494	.48401	.47341
70	.59526	.58190	.56894	.55637	.54417	.53234	.52086	.50971	.49889	.48838
71	.60874	.59564	.58291	.57055	.55854	.54687	.53554	.52453	.51382	.50342
72	.62218	.60934	.59685	.58471	.57291	.56143	.55026	.53939	.52882	.51854
73	.63557	.62301	.61078	.59887	.58728	.57600	.56501	.55431	.54389	.53373
74	.64896	.63669	.62472	.61307	.60171	.59064	.57985	.56932	.55906	.54906
75	.66237	.65040	.63872	.62733	.61622	.60538	.59480	.58447	.57439	.56455
76	.67581	.66416	.65279	.64168	.63083	.62023	.60988	.59977	.58989	.58023
77	.68925	.67793	.66688	.65606	.64550	.63516	.62506	.61517	.60551	.59605
78	.70263	.69166	.68093	.67044	.66016	.65010	.64026	.63062	.62119	.61195
79	.71585	.70525	.69486	.68468	.67471	.66495	.65538	.64600	.63681	.62780
80	.72885	.71860	.70856	.69872	.68906	.67959	.67031	.66120	.65227	.64350
81	.74150	.73162	.72193	.71242	.70308	.69392	.68492	.67609	.66742	.65890
82	.75376	.74425	.73490	.72572	.71671	.70785	.69915	.69059	.68219	.67393
83	.76559	.75643	.74744	.73859	.72989	.72134	.71293	.70466	.69652	.68852
84	.77700	.76821	.75955	.75104	.74266	.73441	.72629	.71831	.71044	.70270

TABLE U(1).—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable After April 30, 1989]

Age	Adjusted payout rate									
	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
85	.78805	.77961	.77130	.76311	.75505	.74711	.73929	.73158	.72399	.71652
86	.79866	.79056	.78258	.77472	.76697	.75933	.75180	.74438	.73707	.72985
87	.80870	.80094	.79329	.78574	.77829	.77095	.76370	.75656	.74951	.74255
88	.81825	.81081	.80348	.79623	.78908	.78202	.77506	.76818	.76139	.75469
89	.82746	.82035	.81332	.80638	.79952	.79275	.78606	.77945	.77292	.76647
90	.83643	.82963	.82291	.81627	.80971	.80322	.79681	.79047	.78420	.77801
91	.84503	.83854	.83212	.82578	.81950	.81330	.80716	.80109	.79509	.78915
92	.85308	.84689	.84076	.83470	.82870	.82276	.81689	.81107	.80532	.79963
93	.86052	.85460	.84875	.84295	.83721	.83152	.82590	.82033	.81481	.80935
94	.86729	.86163	.85602	.85046	.84496	.83951	.83412	.82877	.82348	.81823
95	.87338	.86795	.86257	.85723	.85195	.84672	.84153	.83639	.83129	.82624
96	.87877	.87354	.86836	.86323	.85814	.85309	.84809	.84313	.83822	.83334
97	.88365	.87861	.87362	.86867	.86375	.85888	.85405	.84926	.84450	.83979
98	.88805	.88318	.87835	.87356	.86880	.86409	.85941	.85477	.85016	.84559
99	.89210	.88739	.88271	.87807	.87347	.86890	.86436	.85986	.85539	.85095
100	.89588	.89131	.88678	.88227	.87780	.87337	.86896	.86459	.86024	.85593
101	.89949	.89506	.89066	.88629	.88195	.87764	.87336	.86911	.86488	.86069
102	.90325	.89897	.89471	.89047	.88627	.88209	.87794	.87381	.86971	.86564
103	.90724	.90311	.89900	.89491	.89085	.88681	.88279	.87880	.87484	.87089
104	.91167	.90770	.90376	.89983	.89593	.89205	.88819	.88435	.88053	.87673
105	.91708	.91333	.90959	.90587	.90217	.89848	.89481	.89116	.88752	.88391
106	.92470	.92126	.91782	.91440	.91100	.90760	.90422	.90085	.89749	.89414
107	.93545	.93246	.92948	.92650	.92353	.92057	.91762	.91467	.91173	.90880
108	.95239	.95016	.94792	.94569	.94346	.94123	.93900	.93678	.93456	.93234
109	.97900	.97800	.97700	.97600	.97500	.97400	.97300	.97200	.97100	.97000

TABLE U(1).—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS

[Applicable After April 30, 1989]

Age	Adjusted payout rate									
	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
0	.03176	.03009	.02861	.02730	.02613	.02509	.02416	.02333	.02258	.02191
1	.02110	.01936	.01781	.01644	.01522	.01413	.01316	.01229	.01150	.01080
2	.02156	.01974	.01812	.01669	.01541	.01427	.01325	.01234	.01152	.01078
3	.02233	.02043	.01875	.01725	.01591	.01471	.01364	.01268	.01182	.01105
4	.02330	.02132	.01956	.01800	.01660	.01535	.01422	.01322	.01231	.01149
5	.02443	.02237	.02054	.01890	.01743	.01612	.01494	.01389	.01293	.01208
6	.02568	.02353	.02162	.01990	.01837	.01700	.01576	.01465	.01365	.01275
7	.02704	.02480	.02280	.02102	.01941	.01798	.01668	.01552	.01446	.01351
8	.02852	.02619	.02411	.02224	.02057	.01906	.01770	.01648	.01537	.01437
9	.03014	.02772	.02554	.02360	.02184	.02027	.01885	.01756	.01640	.01535
10	.03190	.02938	.02711	.02508	.02325	.02160	.02012	.01877	.01755	.01645
11	.03381	.03119	.02883	.02672	.02481	.02308	.02153	.02012	.01884	.01768
12	.03585	.03313	.03068	.02847	.02648	.02468	.02305	.02157	.02023	.01902
13	.03798	.03515	.03260	.03030	.02822	.02635	.02464	.02310	.02170	.02042
14	.04012	.03718	.03453	.03213	.02997	.02801	.02623	.02462	.02315	.02181
15	.04225	.03919	.03644	.03395	.03169	.02965	.02779	.02611	.02457	.02317
16	.04436	.04120	.03833	.03574	.03339	.03126	.02932	.02756	.02595	.02449
17	.04647	.04319	.04021	.03752	.03507	.03285	.03082	.02898	.02730	.02577
18	.04860	.04519	.04210	.03930	.03675	.03443	.03232	.03040	.02864	.02703
19	.05079	.04725	.04404	.04113	.03847	.03606	.03386	.03185	.03001	.02833
20	.05304	.04938	.04604	.04301	.04025	.03773	.03543	.03333	.03141	.02965
21	.05537	.05157	.04811	.04495	.04208	.03945	.03705	.03486	.03285	.03101
22	.05779	.05385	.05025	.04698	.04398	.04125	.03874	.03645	.03435	.03242
23	.06032	.05623	.05250	.04910	.04598	.04313	.04052	.03812	.03592	.03390
24	.06302	.05878	.05491	.05136	.04812	.04515	.04242	.03992	.03762	.03550
25	.06589	.06150	.05748	.05380	.05042	.04733	.04448	.04187	.03946	.03725
26	.06897	.06442	.06025	.05643	.05292	.04969	.04673	.04400	.04148	.03916
27	.07228	.06757	.06325	.05928	.05563	.05227	.04917	.04632	.04369	.04126
28	.07582	.07094	.06646	.06234	.05854	.05504	.05182	.04884	.04609	.04355
29	.07958	.07454	.06990	.06562	.06167	.05804	.05468	.05157	.04870	.04604
30	.08360	.07838	.07357	.06913	.06504	.06125	.05775	.05452	.05152	.04874
31	.08788	.08249	.07751	.07291	.06866	.06472	.06108	.05771	.05457	.05167
32	.09242	.08685	.08170	.07694	.07252	.06844	.06465	.06113	.05786	.05483
33	.09724	.09149	.08617	.08124	.07666	.07242	.06848	.06482	.06141	.05824

TABLE U(1).—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable After April 30, 1989]

Age	Adjusted payout rate									
	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
34	.10234	.09641	.09091	.08581	.08107	.07667	.07257	.06876	.06521	.06191
35	.10773	.10161	.09594	.09066	.08575	.08119	.07694	.07298	.06928	.06583
36	.11338	.10708	.10122	.09577	.09070	.08597	.08156	.07744	.07360	.07001
37	.11932	.11283	.10680	.10117	.09592	.09102	.08645	.08217	.07818	.07444
38	.12554	.11887	.11265	.10685	.10142	.09636	.09162	.08719	.08304	.07915
39	.13206	.12521	.11880	.11282	.10722	.10198	.09708	.09249	.08818	.08414
40	.13888	.13184	.12526	.11909	.11332	.10791	.10284	.09808	.09361	.08942
41	.14601	.13878	.13201	.12567	.11972	.11414	.10890	.10398	.09935	.09499
42	.15342	.14601	.13906	.13254	.12641	.12066	.11525	.11016	.10537	.10086
43	.16112	.15353	.14640	.13970	.13340	.12747	.12189	.11663	.11168	.10701
44	.16913	.16136	.15406	.14718	.14070	.13460	.12885	.12342	.11830	.11347
45	.17745	.16951	.16202	.15497	.14832	.14204	.13612	.13053	.12525	.12025
46	.18608	.17796	.17030	.16308	.15625	.14981	.14372	.13796	.13251	.12735
47	.19501	.18673	.17890	.17150	.16451	.15790	.15164	.14571	.14010	.13478
48	.20425	.19579	.18780	.18024	.17308	.16630	.15987	.15378	.14800	.14252
49	.21375	.20514	.19698	.18926	.18193	.17499	.16840	.16214	.15620	.15056
50	.22352	.21476	.20644	.19856	.19107	.18396	.17721	.17080	.16470	.15890
51	.23358	.22467	.21620	.20816	.20051	.19325	.18634	.17976	.17350	.16755
52	.24396	.23490	.22628	.21809	.21030	.20288	.19581	.18908	.18267	.17655
53	.25465	.24545	.23670	.22836	.22042	.21285	.20563	.19875	.19218	.18592
54	.26563	.25631	.24742	.23895	.23086	.22315	.21579	.20876	.20204	.19562
55	.27692	.26747	.25846	.24986	.24164	.23379	.22628	.21911	.21225	.20568
56	.28850	.27895	.26982	.26109	.25275	.24476	.23712	.22981	.22281	.21611
57	.30041	.29076	.28152	.27267	.26421	.25610	.24833	.24089	.23376	.22691
58	.31263	.30288	.29355	.28460	.27602	.26780	.25991	.25234	.24508	.23811
59	.32515	.31532	.30590	.29685	.28817	.27984	.27184	.26416	.25677	.24968
60	.33793	.32803	.31853	.30940	.30062	.29219	.28409	.27630	.26880	.26159
61	.35093	.34098	.33141	.32220	.31335	.30483	.29663	.28873	.28113	.27381
62	.36414	.35414	.34451	.33524	.32631	.31771	.30942	.30144	.29374	.28631
63	.37754	.36750	.35783	.34850	.33951	.33084	.32247	.31440	.30661	.29910
64	.39115	.38108	.37137	.36200	.35296	.34422	.33579	.32765	.31978	.31217
65	.40500	.39493	.38519	.37579	.36670	.35792	.34943	.34122	.33328	.32560
66	.41914	.40906	.39932	.38990	.38079	.37197	.36343	.35517	.34717	.33943
67	.43355	.42350	.41376	.40434	.39521	.38636	.37780	.36950	.36145	.35365
68	.44824	.43822	.42851	.41909	.40996	.40111	.39252	.38419	.37611	.36827
69	.46313	.45316	.44348	.43409	.42498	.41613	.40754	.39919	.39109	.38322
70	.47818	.46827	.45864	.44929	.44020	.43137	.42279	.41445	.40634	.39845
71	.49331	.48348	.47391	.46461	.45557	.44677	.43821	.42988	.42177	.41388
72	.50853	.49879	.48930	.48007	.47108	.46233	.45380	.44550	.43741	.42952
73	.52384	.51421	.50482	.49566	.48674	.47805	.46957	.46130	.45324	.44538
74	.53930	.52979	.52050	.51145	.50261	.49399	.48557	.47736	.46934	.46152
75	.55495	.54557	.53641	.52747	.51873	.51020	.50187	.49372	.48577	.47799
76	.57079	.56157	.55256	.54374	.53513	.52670	.51847	.51041	.50253	.49483
77	.58680	.57775	.56890	.56024	.55176	.54346	.53534	.52739	.51960	.51198
78	.60291	.59405	.58537	.57687	.56855	.56040	.55241	.54458	.53691	.52940
79	.61898	.61032	.60184	.59353	.58537	.57738	.56954	.56185	.55431	.54691
80	.63491	.62647	.61819	.61007	.60210	.59428	.58660	.57907	.57167	.56441
81	.65054	.64234	.63427	.62636	.61858	.61094	.60344	.59606	.58882	.58170
82	.66582	.65784	.65000	.64229	.63472	.62727	.61994	.61274	.60566	.59870
83	.68065	.67291	.66530	.65781	.65044	.64319	.63605	.62903	.62212	.61532
84	.69508	.68758	.68020	.67293	.66577	.65872	.65178	.64495	.63821	.63158
85	.70915	.70190	.69475	.68770	.68076	.67392	.66718	.66054	.65399	.64754
86	.72274	.71573	.70882	.70200	.69528	.68865	.68212	.67567	.66931	.66304
87	.73569	.72892	.72224	.71565	.70915	.70273	.69639	.69014	.68397	.67788
88	.74807	.74154	.73509	.72872	.72243	.71622	.71009	.70403	.69805	.69214
89	.76010	.75381	.74759	.74144	.73537	.72937	.72344	.71758	.71179	.70607
90	.77189	.76584	.75985	.75394	.74809	.74230	.73659	.73093	.72534	.71981
91	.78327	.77746	.77171	.76603	.76040	.75484	.74933	.74388	.73850	.73316
92	.79399	.78841	.78289	.77743	.77202	.76667	.76137	.75613	.75093	.74579
93	.80394	.79858	.79328	.78803	.78283	.77768	.77258	.76753	.76252	.75757
94	.81303	.80788	.80278	.79773	.79272	.78776	.78284	.77797	.77315	.76837
95	.82124	.81628	.81136	.80649	.80166	.79687	.79213	.78742	.78276	.77814
96	.82851	.82372	.81897	.81426	.80959	.80496	.80036	.79581	.79129	.78682
97	.83512	.83048	.82588	.82132	.81679	.81230	.80785	.80343	.79905	.79471
98	.84106	.83656	.83210	.82767	.82328	.81892	.81459	.81030	.80604	.80181
99	.84655	.84218	.83785	.83354	.82927	.82503	.82082	.81664	.81249	.80837
100	.85165	.84740	.84318	.83899	.83483	.83070	.82660	.82252	.81848	.81446
101	.85652	.85238	.84827	.84419	.84013	.83611	.83210	.82813	.82418	.82026

TABLE U(1).—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable After April 30, 1989]

Age	Adjusted payout rate									
	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
102	.86159	.85757	.85358	.84960	.84566	.84174	.83784	.83397	.83012	.82630
103	.86697	.86307	.85920	.85535	.85152	.84771	.84392	.84016	.83642	.83270
104	.87295	.86919	.86544	.86172	.85802	.85434	.85068	.84704	.84341	.83981
105	.88030	.87672	.87315	.86959	.86605	.86253	.85903	.85554	.85207	.84861
106	.89081	.88749	.88418	.88088	.87760	.87433	.87106	.86782	.86458	.86135
107	.90588	.90296	.90005	.89715	.89425	.89137	.88849	.88561	.88275	.87989
108	.93013	.92791	.92570	.92350	.92129	.91909	.91689	.91469	.91250	.91031
109	.96900	.96800	.96700	.96600	.96500	.96400	.96300	.96200	.96100	.96000

TABLE U(1).—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS

[Applicable after APRIL 30, 1989]

Age	Adjusted payout rate									
	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
0	.02130	.02075	.02025	.01980	.01939	.01901	.01867	.01835	.01806	.01779
1	.01017	.00960	.00908	.00861	.00819	.00780	.00745	.00712	.00683	.00655
2	.01011	.00951	.00897	.00848	.00803	.00762	.00725	.00690	.00659	.00630
3	.01035	.00971	.00914	.00862	.00815	.00771	.00732	.00696	.00663	.00632
4	.01076	.01009	.00948	.00894	.00843	.00798	.00756	.00718	.00683	.00650
5	.01130	.01059	.00996	.00938	.00885	.00836	.00792	.00752	.00714	.00680
6	.01193	.01119	.01051	.00990	.00934	.00883	.00836	.00793	.00754	.00717
7	.01265	.01187	.01116	.01051	.00992	.00938	.00888	.00842	.00800	.00762
8	.01347	.01264	.01189	.01121	.01058	.01001	.00948	.00900	.00856	.00815
9	.01440	.01353	.01274	.01201	.01135	.01075	.01019	.00968	.00921	.00877
10	.01544	.01453	.01369	.01293	.01223	.01159	.01101	.01046	.00997	.00950
11	.01662	.01566	.01478	.01398	.01324	.01257	.01195	.01137	.01085	.01036
12	.01791	.01690	.01597	.01513	.01435	.01364	.01298	.01238	.01182	.01131
13	.01926	.01820	.01722	.01634	.01552	.01477	.01408	.01344	.01285	.01231
14	.02059	.01948	.01846	.01752	.01667	.01588	.01515	.01448	.01386	.01328
15	.02189	.02072	.01965	.01867	.01777	.01694	.01617	.01547	.01481	.01421
16	.02315	.02192	.02080	.01977	.01882	.01795	.01714	.01640	.01572	.01508
17	.02436	.02308	.02190	.02082	.01982	.01891	.01806	.01728	.01656	.01589
18	.02556	.02422	.02298	.02184	.02080	.01983	.01894	.01812	.01736	.01665
19	.02679	.02537	.02408	.02288	.02178	.02077	.01983	.01897	.01817	.01742
20	.02804	.02656	.02519	.02394	.02278	.02172	.02073	.01982	.01898	.01819
21	.02932	.02776	.02633	.02501	.02380	.02268	.02164	.02068	.01979	.01896
22	.03065	.02902	.02751	.02613	.02485	.02367	.02258	.02157	.02063	.01976
23	.03204	.03033	.02876	.02730	.02595	.02471	.02356	.02249	.02150	.02058
24	.03356	.03176	.03010	.02857	.02716	.02585	.02463	.02351	.02246	.02149
25	.03520	.03332	.03158	.02997	.02848	.02710	.02582	.02463	.02352	.02249
26	.03702	.03504	.03321	.03152	.02995	.02850	.02714	.02589	.02472	.02363
27	.03902	.03695	.03502	.03324	.03159	.03006	.02863	.02730	.02607	.02492
28	.04120	.03902	.03700	.03513	.03339	.03178	.03027	.02887	.02757	.02635
29	.04358	.04129	.03917	.03720	.03537	.03367	.03208	.03061	.02923	.02794
30	.04616	.04376	.04154	.03947	.03754	.03575	.03408	.03251	.03106	.02969
31	.04897	.04646	.04413	.04195	.03993	.03804	.03627	.03463	.03309	.03165
32	.05200	.04938	.04693	.04465	.04252	.04053	.03867	.03693	.03531	.03378
33	.05529	.05254	.04998	.04758	.04534	.04325	.04130	.03946	.03775	.03614
34	.05883	.05595	.05326	.05075	.04840	.04620	.04414	.04221	.04040	.03870
35	.06262	.05961	.05680	.05417	.05170	.04939	.04723	.04520	.04329	.04149
36	.06665	.06351	.06057	.05781	.05523	.05280	.05053	.04839	.04638	.04449
37	.07094	.06766	.06459	.06171	.05900	.05646	.05407	.05182	.04971	.04771
38	.07550	.07208	.06888	.06586	.06303	.06037	.05786	.05550	.05327	.05118
39	.08034	.07678	.07344	.07029	.06733	.06454	.06191	.05943	.05709	.05489
40	.08547	.08177	.07828	.07499	.07190	.06898	.06623	.06363	.06118	.05886
41	.09090	.08704	.08341	.07998	.07675	.07371	.07083	.06811	.06553	.06310
42	.09661	.09260	.08882	.08525	.08188	.07870	.07569	.07284	.07015	.06760
43	.10260	.09844	.09451	.09080	.08729	.08397	.08083	.07785	.07503	.07236
44	.10891	.10459	.10051	.09666	.09300	.08954	.08626	.08316	.08021	.07741
45	.11553	.11106	.10683	.10282	.09902	.09542	.09201	.08876	.08568	.08276
46	.12247	.11784	.11346	.10930	.10536	.10161	.09806	.09468	.09146	.08841
47	.12974	.12496	.12042	.11611	.11202	.10813	.10443	.10091	.09756	.09438
48	.13732	.13238	.12769	.12323	.11899	.11495	.11111	.10745	.10397	.10065
49	.14520	.14011	.13526	.13064	.12625	.12207	.11809	.11429	.11066	.10721
50	.15338	.14812	.14312	.13836	.13381	.12948	.12535	.12141	.11765	.11405

TABLE U(1).—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after APRIL 30, 1989]

Age	Adjusted payout rate									
	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
51	.16187	.15646	.15130	.14639	.14169	.13721	.13294	.12885	.12495	.12121
52	.17072	.16516	.15985	.15478	.14993	.14531	.14088	.13665	.13261	.12873
53	.17993	.17422	.16876	.16353	.15854	.15377	.14920	.14482	.14064	.13662
54	.18949	.18362	.17801	.17264	.16750	.16258	.15787	.15335	.14902	.14486
55	.19940	.19339	.18763	.18212	.17683	.17176	.16690	.16224	.15777	.15348
56	.20968	.20353	.19762	.19196	.18654	.18132	.17632	.17152	.16691	.16247
57	.22035	.21406	.20802	.20222	.19665	.19129	.18615	.18121	.17646	.17189
58	.23142	.22499	.21881	.21287	.20717	.20168	.19640	.19132	.18643	.18172
59	.24286	.23630	.23000	.22393	.21809	.21247	.20705	.20184	.19682	.19198
60	.25465	.24797	.24154	.23534	.22938	.22363	.21808	.21274	.20759	.20262
61	.26676	.25996	.25341	.24710	.24101	.23513	.22946	.22399	.21871	.21361
62	.27916	.27225	.26559	.25916	.25295	.24695	.24117	.23557	.23017	.22495
63	.29184	.28483	.27806	.27152	.26520	.25909	.25319	.24748	.24196	.23661
64	.30483	.29772	.29085	.28421	.27779	.27157	.26555	.25973	.25409	.24863
65	.31817	.31098	.30402	.29729	.29076	.28444	.27832	.27240	.26665	.26108
66	.33192	.32466	.31762	.31079	.30418	.29777	.29155	.28552	.27968	.27400
67	.34609	.33876	.33164	.32474	.31805	.31156	.30525	.29913	.29319	.28742
68	.36066	.35328	.34610	.33914	.33238	.32581	.31943	.31323	.30720	.30134
69	.37558	.36815	.36093	.35391	.34709	.34045	.33400	.32773	.32163	.31569
70	.39078	.38332	.37606	.36900	.36213	.35545	.34894	.34260	.33643	.33042
71	.40620	.39872	.39144	.38435	.37744	.37071	.36415	.35776	.35153	.34547
72	.42184	.41435	.40706	.39994	.39301	.38625	.37965	.37322	.36694	.36082
73	.43771	.43023	.42293	.41581	.40886	.40207	.39545	.38899	.38267	.37651
74	.45387	.44641	.43912	.43201	.42505	.41826	.41163	.40514	.39881	.39261
75	.47039	.46296	.45570	.44861	.44167	.43488	.42824	.42175	.41541	.40920
76	.48729	.47991	.47269	.46563	.45872	.45196	.44534	.43886	.43251	.42630
77	.50452	.49722	.49006	.48305	.47619	.46946	.46287	.45642	.45009	.44389
78	.52203	.51481	.50773	.50079	.49399	.48732	.48078	.47437	.46808	.46191
79	.53966	.53254	.52556	.51870	.51198	.50538	.49891	.49255	.48632	.48019
80	.55728	.55028	.54340	.53665	.53002	.52351	.51712	.51083	.50466	.49860
81	.57471	.56784	.56109	.55445	.54792	.54151	.53521	.52901	.52292	.51692
82	.59186	.58512	.57850	.57199	.56558	.55927	.55307	.54697	.54097	.53506
83	.60863	.60204	.59556	.58918	.58289	.57671	.57062	.56462	.55872	.55290
84	.62505	.61862	.61228	.60604	.59989	.59383	.58786	.58198	.57618	.57047
85	.64118	.63491	.62873	.62263	.61663	.61070	.60486	.59911	.59343	.58783
86	.65685	.65075	.64473	.63879	.63294	.62716	.62145	.61583	.61027	.60479
87	.67187	.66594	.66008	.65430	.64859	.64296	.63739	.63190	.62647	.62112
88	.68631	.68054	.67485	.66923	.66367	.65818	.65276	.64740	.64211	.63688
89	.70042	.69483	.68930	.68384	.67845	.67311	.66784	.66262	.65747	.65237
90	.71434	.70894	.70359	.69830	.69307	.68790	.68278	.67772	.67271	.66775
91	.72789	.72266	.71750	.71239	.70733	.70232	.69736	.69246	.68760	.68280
92	.74070	.73567	.73068	.72574	.72085	.71601	.71121	.70647	.70176	.69711
93	.75266	.74780	.74298	.73821	.73348	.72880	.72417	.71957	.71502	.71051
94	.76363	.75893	.75428	.74967	.74510	.74057	.73608	.73163	.72722	.72285
95	.77356	.76901	.76451	.76005	.75562	.75123	.74688	.74257	.73829	.73405
96	.78237	.77797	.77360	.76927	.76497	.76071	.75648	.75229	.74813	.74401
97	.79039	.78612	.78187	.77766	.77348	.76934	.76523	.76115	.75710	.75308
98	.79762	.79345	.78932	.78522	.78115	.77711	.77310	.76913	.76518	.76126
99	.80429	.80023	.79620	.79220	.78823	.78429	.78038	.77649	.77264	.76881
100	.81047	.80651	.80258	.79867	.79479	.79094	.78712	.78332	.77955	.77580
101	.81636	.81249	.80865	.80483	.80104	.79727	.79352	.78981	.78611	.78244
102	.82250	.81872	.81497	.81124	.80754	.80386	.80020	.79656	.79295	.78936
103	.82900	.82532	.82167	.81804	.81442	.81083	.80726	.80371	.80018	.79667
104	.83622	.83266	.82911	.82558	.82207	.81858	.81510	.81165	.80821	.80479
105	.84517	.84174	.83833	.83494	.83156	.82819	.82485	.82151	.81820	.81489
106	.85814	.85494	.85175	.84857	.84540	.84225	.83911	.83598	.83286	.82975
107	.87704	.87420	.87136	.86853	.86571	.86290	.86009	.85729	.85450	.85171
108	.90812	.90593	.90375	.90156	.89939	.89721	.89504	.89286	.89070	.88853
109	.95900	.95800	.95700	.95600	.95500	.95400	.95300	.95200	.95100	.95000

TABLE U(1).—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS

[Applicable after APRIL 30, 1989]

Age	Adjusted payout rate									
	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
0	.01754	.01731	.01710	.01690	.01671	.01654	.01638	.01622	.01608	.01594

TABLE U(1).—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after APRIL 30, 1989]

Age	Adjusted payout rate									
	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
1	.00630	.00607	.00585	.00565	.00547	.00530	.00514	.00499	.00485	.00472
2	.00604	.00579	.00557	.00536	.00516	.00498	.00481	.00465	.00451	.00437
3	.00604	.00578	.00554	.00532	.00511	.00492	.00474	.00458	.00442	.00427
4	.00621	.00593	.00568	.00544	.00522	.00502	.00483	.00465	.00448	.00433
5	.00648	.00619	.00592	.00567	.00544	.00522	.00502	.00483	.00465	.00449
6	.00684	.00653	.00624	.00597	.00572	.00549	.00528	.00507	.00489	.00471
7	.00726	.00693	.00663	.00634	.00608	.00583	.00560	.00539	.00518	.00499
8	.00777	.00742	.00709	.00679	.00651	.00624	.00600	.00577	.00555	.00535
9	.00837	.00800	.00765	.00733	.00703	.00675	.00649	.00625	.00602	.00580
10	.00908	.00868	.00832	.00797	.00765	.00736	.00708	.00682	.00657	.00634
11	.00991	.00949	.00910	.00874	.00840	.00808	.00779	.00751	.00725	.00700
12	.01083	.01039	.00997	.00959	.00923	.00890	.00858	.00829	.00801	.00775
13	.01181	.01134	.01090	.01049	.01012	.00976	.00943	.00912	.00883	.00855
14	.01275	.01226	.01180	.01137	.01097	.01060	.01025	.00992	.00961	.00932
15	.01365	.01313	.01264	.01219	.01177	.01138	.01101	.01066	.01034	.01003
16	.01449	.01394	.01343	.01295	.01251	.01209	.01171	.01134	.01100	.01068
17	.01526	.01469	.01415	.01365	.01318	.01274	.01233	.01195	.01159	.01125
18	.01600	.01539	.01482	.01430	.01380	.01334	.01291	.01251	.01213	.01177
19	.01673	.01609	.01550	.01494	.01442	.01393	.01348	.01305	.01265	.01227
20	.01747	.01679	.01616	.01557	.01502	.01451	.01403	.01358	.01316	.01276
21	.01820	.01748	.01682	.01620	.01562	.01508	.01457	.01409	.01365	.01323
22	.01895	.01819	.01749	.01683	.01622	.01565	.01511	.01461	.01414	.01369
23	.01972	.01893	.01818	.01749	.01684	.01624	.01567	.01514	.01464	.01417
24	.02058	.01974	.01895	.01822	.01753	.01689	.01629	.01572	.01519	.01469
25	.02154	.02064	.01981	.01903	.01830	.01762	.01698	.01638	.01582	.01529
26	.02262	.02167	.02079	.01996	.01919	.01847	.01779	.01715	.01655	.01599
27	.02385	.02284	.02191	.02103	.02021	.01944	.01872	.01804	.01740	.01680
28	.02521	.02415	.02316	.02222	.02135	.02053	.01977	.01904	.01836	.01772
29	.02673	.02561	.02455	.02357	.02264	.02177	.02095	.02018	.01946	.01877
30	.02842	.02723	.02611	.02506	.02407	.02315	.02227	.02146	.02068	.01996
31	.03030	.02903	.02784	.02673	.02568	.02470	.02377	.02290	.02207	.02130
32	.03235	.03101	.02976	.02857	.02746	.02641	.02543	.02450	.02362	.02279
33	.03463	.03321	.03188	.03062	.02944	.02833	.02728	.02629	.02535	.02447
34	.03711	.03561	.03419	.03286	.03161	.03043	.02931	.02826	.02726	.02632
35	.03981	.03822	.03672	.03531	.03398	.03273	.03154	.03042	.02936	.02836
36	.04271	.04103	.03945	.03796	.03655	.03522	.03396	.03277	.03164	.03057
37	.04584	.04407	.04239	.04081	.03932	.03791	.03657	.03531	.03411	.03297
38	.04920	.04733	.04556	.04389	.04231	.04082	.03940	.03806	.03679	.03558
39	.05280	.05083	.04897	.04721	.04554	.04396	.04246	.04103	.03968	.03840
40	.05667	.05459	.05263	.05077	.04901	.04733	.04575	.04424	.04280	.04144
41	.06080	.05861	.05655	.05459	.05272	.05096	.04928	.04768	.04617	.04472
42	.06518	.06289	.06071	.05864	.05668	.05482	.05305	.05136	.04975	.04822
43	.06982	.06742	.06513	.06296	.06089	.05893	.05706	.05528	.05358	.05196
44	.07475	.07223	.06983	.06754	.06537	.06330	.06133	.05945	.05766	.05595
45	.07998	.07733	.07481	.07242	.07014	.06796	.06588	.06390	.06202	.06021
46	.08550	.08273	.08010	.07758	.07519	.07290	.07072	.06864	.06665	.06474
47	.09134	.08845	.08569	.08306	.08055	.07815	.07586	.07367	.07157	.06957
48	.09748	.09446	.09158	.08882	.08619	.08368	.08128	.07898	.07678	.07467
49	.10391	.10076	.09775	.09487	.09212	.08949	.08697	.08456	.08225	.08003
50	.11062	.10734	.10420	.10120	.09832	.09557	.09293	.09041	.08798	.08566
51	.11764	.11423	.11096	.10783	.10483	.10195	.09919	.09655	.09401	.09158
52	.12503	.12148	.11807	.11481	.11168	.10868	.10581	.10304	.10039	.09784
53	.13278	.12909	.12556	.12216	.11891	.11578	.11278	.10989	.10712	.10445
54	.14088	.13706	.13339	.12986	.12648	.12322	.12009	.11709	.11419	.11141
55	.14936	.14540	.14159	.13793	.13442	.13103	.12778	.12464	.12163	.11872
56	.15821	.15412	.15018	.14639	.14274	.13923	.13584	.13258	.12944	.12642
57	.16749	.16326	.15918	.15526	.15148	.14784	.14433	.14094	.13768	.13453
58	.17719	.17282	.16862	.16456	.16065	.15688	.15324	.14973	.14634	.14306
59	.18731	.18281	.17847	.17429	.17025	.16634	.16258	.15894	.15543	.15203
60	.19782	.19319	.18872	.18440	.18023	.17621	.17231	.16855	.16491	.16139
61	.20869	.20393	.19934	.19489	.19060	.18644	.18242	.17854	.17477	.17113
62	.21990	.21502	.21029	.20573	.20131	.19703	.19289	.18887	.18499	.18123
63	.23144	.22644	.22159	.21690	.21236	.20796	.20370	.19956	.19556	.19167
64	.24335	.23823	.23326	.22845	.22379	.21927	.21489	.21063	.20651	.20250
65	.25568	.25045	.24537	.24044	.23566	.23103	.22653	.22216	.21791	.21379
66	.26850	.26316	.25797	.25293	.24804	.24329	.23868	.23420	.22984	.22560
67	.28182	.27637	.27108	.26594	.26095	.25609	.25137	.24678	.24231	.23797
68	.29565	.29011	.28472	.27949	.27439	.26943	.26461	.25991	.25534	.25089

TABLE U(1).—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after APRIL 30, 1989]

Age	Adjusted payout rate									
	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
69	.30991	.30429	.29882	.29349	.28830	.28325	.27833	.27354	.26887	.26432
70	.32457	.31887	.31332	.30791	.30264	.29750	.29249	.28760	.28284	.27820
71	.33955	.33378	.32816	.32267	.31732	.31210	.30701	.30204	.29719	.29246
72	.35485	.34902	.34333	.33778	.33236	.32707	.32190	.31686	.31193	.30711
73	.37049	.36461	.35887	.35326	.34778	.34242	.33719	.33207	.32707	.32218
74	.38656	.38064	.37485	.36920	.36366	.35825	.35296	.34778	.34272	.33776
75	.40312	.39717	.39136	.38566	.38009	.37464	.36930	.36407	.35895	.35394
76	.42022	.41426	.40842	.40271	.39711	.39163	.38625	.38099	.37583	.37077
77	.43782	.43187	.42603	.42031	.41470	.40920	.40380	.39851	.39332	.38823
78	.45586	.44992	.44410	.43839	.43278	.42728	.42188	.41658	.41138	.40627
79	.47418	.46828	.46248	.45679	.45120	.44572	.44033	.43503	.42983	.42472
80	.49264	.48679	.48103	.47538	.46982	.46436	.45900	.45372	.44853	.44343
81	.51103	.50524	.49954	.49394	.48843	.48301	.47768	.47243	.46727	.46219
82	.52925	.52352	.51789	.51235	.50690	.50153	.49624	.49104	.48591	.48087
83	.54718	.54154	.53598	.53051	.52512	.51981	.51459	.50943	.50436	.49936
84	.56484	.55930	.55383	.54844	.54313	.53789	.53273	.52764	.52262	.51767
85	.58231	.57686	.57149	.56619	.56096	.55581	.55072	.54571	.54076	.53588
86	.59939	.59405	.58878	.58358	.57845	.57339	.56839	.56346	.55858	.55377
87	.61583	.61061	.60545	.60035	.59532	.59035	.58545	.58060	.57581	.57108
88	.63171	.62661	.62156	.61658	.61165	.60678	.60196	.59721	.59251	.58786
89	.64733	.64235	.63742	.63255	.62774	.62298	.61827	.61361	.60900	.60444
90	.66285	.65801	.65321	.64847	.64377	.63913	.63453	.62998	.62548	.62103
91	.67804	.67334	.66868	.66407	.65950	.65498	.65050	.64607	.64169	.63735
92	.69250	.68793	.68341	.67893	.67450	.67011	.66575	.66144	.65718	.65295
93	.70604	.70162	.69723	.69288	.68858	.68431	.68008	.67589	.67174	.66762
94	.71852	.71422	.70997	.70575	.70156	.69742	.69331	.68923	.68519	.68119
95	.72984	.72567	.72154	.71744	.71337	.70934	.70534	.70137	.69744	.69354
96	.73992	.73586	.73183	.72784	.72388	.71995	.71605	.71218	.70835	.70454
97	.74910	.74514	.74122	.73733	.73346	.72963	.72582	.72205	.71830	.71458
98	.75737	.75351	.74967	.74587	.74209	.73835	.73463	.73093	.72727	.72363
99	.76501	.76123	.75748	.75376	.75007	.74640	.74276	.73914	.73555	.73198
100	.77208	.76838	.76471	.76107	.75745	.75385	.75028	.74673	.74321	.73971
101	.77879	.77517	.77157	.76800	.76444	.76092	.75741	.75392	.75046	.74702
102	.78579	.78224	.77871	.77521	.77173	.76827	.76483	.76141	.75801	.75463
103	.79318	.78971	.78626	.78283	.77942	.77604	.77266	.76931	.76598	.76267
104	.80139	.79801	.79464	.79129	.78796	.78465	.78136	.77808	.77482	.77157
105	.81161	.80834	.80508	.80184	.79861	.79540	.79220	.78902	.78585	.78270
106	.82665	.82357	.82049	.81743	.81438	.81134	.80831	.80530	.80229	.79930
107	.84893	.84616	.84340	.84064	.83789	.83515	.83241	.82969	.82696	.82425
108	.88637	.88421	.88205	.87989	.87774	.87559	.87344	.87129	.86915	.86701
109	.94900	.94800	.94700	.94600	.94500	.94400	.94300	.94200	.94100	.94000

TABLE U(1).—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS

[Applicable after April 30, 1989]

Age	Adjusted payout rate									
	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
0	.01581	.01569	.01557	.01546	.01536	.01526	.01516	.01507	.01499	.01490
1	.00459	.00448	.00437	.00426	.00417	.00407	.00399	.00390	.00382	.00375
2	.00424	.00412	.00400	.00389	.00379	.00369	.00360	.00352	.00343	.00335
3	.00414	.00401	.00389	.00377	.00366	.00356	.00346	.00337	.00328	.00320
4	.00418	.00404	.00391	.00379	.00368	.00357	.00347	.00337	.00327	.00319
5	.00433	.00418	.00405	.00391	.00379	.00368	.00357	.00346	.00336	.00327
6	.00454	.00439	.00424	.00410	.00397	.00384	.00372	.00361	.00351	.00341
7	.00482	.00465	.00449	.00434	.00420	.00407	.00394	.00382	.00371	.00360
8	.00516	.00498	.00481	.00465	.00450	.00436	.00422	.00410	.00397	.00386
9	.00560	.00541	.00523	.00505	.00489	.00474	.00459	.00446	.00433	.00420
10	.00613	.00592	.00573	.00555	.00537	.00521	.00505	.00491	.00477	.00463
11	.00677	.00655	.00635	.00615	.00597	.00580	.00563	.00547	.00532	.00518
12	.00751	.00728	.00706	.00685	.00666	.00647	.00629	.00613	.00597	.00581
13	.00829	.00805	.00782	.00760	.00739	.00719	.00701	.00683	.00666	.00650
14	.00905	.00879	.00854	.00831	.00809	.00789	.00769	.00750	.00732	.00715
15	.00974	.00947	.00921	.00897	.00874	.00852	.00831	.00811	.00793	.00775
16	.01037	.01009	.00982	.00956	.00932	.00909	.00887	.00866	.00846	.00827
17	.01093	.01063	.01034	.01007	.00982	.00958	.00935	.00913	.00892	.00873

TABLE U(1).—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

Age	Adjusted payout rate									
	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
18	.01143	.01112	.01082	.01053	.01027	.01001	.00977	.00954	.00933	.00912
19	.01192	.01159	.01127	.01097	.01069	.01043	.01017	.00993	.00970	.00949
20	.01239	.01204	.01170	.01139	.01109	.01081	.01055	.01029	.01005	.00983
21	.01283	.01246	.01211	.01178	.01147	.01117	.01089	.01063	.01037	.01013
22	.01328	.01288	.01251	.01216	.01183	.01152	.01122	.01094	.01067	.01042
23	.01372	.01331	.01292	.01254	.01219	.01186	.01155	.01125	.01097	.01070
24	.01422	.01378	.01336	.01297	.01260	.01225	.01191	.01160	.01130	.01101
25	.01479	.01432	.01388	.01346	.01306	.01269	.01233	.01200	.01168	.01138
26	.01545	.01495	.01448	.01404	.01362	.01322	.01284	.01248	.01214	.01182
27	.01623	.01570	.01520	.01472	.01427	.01385	.01344	.01306	.01270	.01235
28	.01712	.01655	.01601	.01551	.01503	.01457	.01414	.01373	.01334	.01298
29	.01813	.01752	.01695	.01641	.01589	.01541	.01494	.01451	.01409	.01370
30	.01927	.01862	.01801	.01743	.01688	.01635	.01586	.01539	.01495	.01452
31	.02056	.01987	.01922	.01859	.01801	.01745	.01692	.01642	.01594	.01548
32	.02201	.02127	.02057	.01990	.01927	.01868	.01811	.01757	.01706	.01657
33	.02363	.02284	.02209	.02138	.02071	.02007	.01946	.01888	.01833	.01781
34	.02543	.02458	.02378	.02302	.02230	.02162	.02096	.02034	.01975	.01919
35	.02741	.02651	.02565	.02484	.02407	.02333	.02264	.02197	.02134	.02073
36	.02956	.02859	.02768	.02681	.02599	.02520	.02446	.02374	.02307	.02242
37	.03189	.03087	.02990	.02897	.02809	.02725	.02645	.02569	.02496	.02427
38	.03443	.03334	.03230	.03131	.03037	.02948	.02862	.02781	.02703	.02628
39	.03718	.03602	.03491	.03386	.03285	.03190	.03099	.03011	.02928	.02849
40	.04015	.03891	.03774	.03662	.03555	.03453	.03355	.03262	.03173	.03088
41	.04335	.04204	.04079	.03959	.03846	.03737	.03633	.03534	.03439	.03348
42	.04677	.04538	.04405	.04278	.04157	.04042	.03931	.03825	.03724	.03627
43	.05042	.04894	.04754	.04619	.04491	.04368	.04250	.04138	.04030	.03926
44	.05432	.05276	.05127	.04984	.04848	.04718	.04593	.04473	.04358	.04248
45	.05849	.05684	.05526	.05375	.05231	.05092	.04960	.04832	.04710	.04593
46	.06292	.06118	.05952	.05792	.05639	.05492	.05352	.05217	.05087	.04963
47	.06765	.06581	.06405	.06237	.06075	.05920	.05771	.05628	.05491	.05359
48	.07265	.07071	.06886	.06708	.06537	.06373	.06216	.06064	.05919	.05779
49	.07791	.07587	.07392	.07204	.07024	.06851	.06685	.06525	.06371	.06223
50	.08343	.08129	.07923	.07726	.07536	.07354	.07178	.07009	.06847	.06690
51	.08924	.08699	.08483	.08276	.08076	.07884	.07699	.07520	.07349	.07183
52	.09539	.09303	.09076	.08858	.08648	.08446	.08251	.08064	.07883	.07708
53	.10189	.09942	.09704	.09475	.09255	.09043	.08838	.08640	.08450	.08266
54	.10872	.10614	.10365	.10126	.09894	.09672	.09456	.09249	.09049	.08855
55	.11592	.11322	.11062	.10811	.10569	.10335	.10110	.09892	.09682	.09478
56	.12350	.12068	.11796	.11534	.11281	.11036	.10800	.10571	.10350	.10137
57	.13148	.12855	.12572	.12298	.12033	.11777	.11530	.11291	.11060	.10836
58	.13990	.13685	.13389	.13104	.12828	.12561	.12303	.12053	.11811	.11576
59	.14875	.14557	.14250	.13953	.13665	.13387	.13118	.12856	.12604	.12359
60	.15799	.15469	.15150	.14841	.14542	.14253	.13972	.13700	.13436	.13180
61	.16761	.16419	.16088	.15768	.15457	.15156	.14864	.14580	.14305	.14039
62	.17758	.17404	.17062	.16729	.16407	.16094	.15791	.15496	.15210	.14932
63	.18791	.18425	.18071	.17726	.17392	.17068	.16753	.16447	.16150	.15861
64	.19862	.19484	.19118	.18762	.18417	.18081	.17754	.17437	.17129	.16829
65	.20979	.20590	.20212	.19845	.19487	.19140	.18802	.18474	.18154	.17843
66	.22149	.21748	.21359	.20980	.20612	.20253	.19904	.19564	.19233	.18911
67	.23374	.22962	.22562	.22172	.21792	.21423	.21062	.20712	.20370	.20037
68	.24656	.24234	.23822	.23422	.23031	.22651	.22280	.21919	.21566	.21222
69	.25988	.25556	.25134	.24724	.24323	.23932	.23551	.23179	.22816	.22461
70	.27367	.26925	.26493	.26073	.25662	.25261	.24870	.24488	.24115	.23750
71	.28784	.28333	.27892	.27462	.27042	.26631	.26230	.25839	.25456	.25082
72	.30241	.29781	.29332	.28893	.28464	.28044	.27634	.27233	.26841	.26457
73	.31740	.31272	.30815	.30368	.29930	.29502	.29084	.28674	.28273	.27880
74	.33291	.32817	.32352	.31897	.31452	.31016	.30589	.30171	.29762	.29361
75	.34903	.34422	.33951	.33490	.33038	.32595	.32161	.31735	.31318	.30909
76	.36581	.36095	.35619	.35152	.34694	.34245	.33805	.33373	.32949	.32533
77	.38324	.37835	.37354	.36883	.36420	.35966	.35520	.35083	.34654	.34232
78	.40126	.39634	.39150	.38676	.38210	.37752	.37302	.36861	.36427	.36001
79	.41970	.41476	.40992	.40515	.40047	.39587	.39135	.38690	.38253	.37823
80	.43842	.43348	.42864	.42387	.41918	.41456	.41002	.40556	.40117	.39685
81	.45719	.45228	.44744	.44267	.43799	.43337	.42883	.42436	.41996	.41562
82	.47590	.47101	.46619	.46145	.45677	.45217	.44764	.44317	.43877	.43443
83	.49443	.48957	.48478	.48007	.47542	.47084	.46632	.46187	.45748	.45315
84	.51279	.50798	.50324	.49856	.49394	.48939	.48490	.48048	.47611	.47180
85	.53106	.52630	.52161	.51698	.51241	.50790	.50345	.49906	.49473	.49045

TABLE U(1).—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

Age	Adjusted payout rate									
	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
86	.54902	.54434	.53971	.53514	.53062	.52616	.52176	.51741	.51312	.50888
87	.56640	.56178	.55722	.55271	.54826	.54386	.53951	.53521	.53097	.52677
88	.58326	.57872	.57423	.56979	.56541	.56107	.55678	.55254	.54834	.54420
89	.59994	.59548	.59107	.58671	.58240	.57813	.57391	.56973	.56560	.56152
90	.61662	.61226	.60794	.60367	.59944	.59526	.59112	.58702	.58296	.57894
91	.63305	.62879	.62457	.62040	.61627	.61217	.60812	.60411	.60013	.59619
92	.64876	.64461	.64050	.63643	.63239	.62839	.62443	.62051	.61662	.61277
93	.66355	.65950	.65550	.65153	.64759	.64369	.63983	.63600	.63220	.62843
94	.67722	.67328	.66938	.66551	.66167	.65786	.65409	.65035	.64664	.64296
95	.68967	.68583	.68203	.67825	.67451	.67079	.66711	.66345	.65983	.65623
96	.70076	.69701	.69330	.68961	.68595	.68231	.67871	.67513	.67158	.66806
97	.71089	.70722	.70359	.69998	.69640	.69284	.68931	.68581	.68234	.67888
98	.72001	.71642	.71286	.70933	.70582	.70233	.69887	.69544	.69203	.68864
99	.72844	.72492	.72143	.71796	.71452	.71110	.70770	.70433	.70098	.69765
100	.73623	.73278	.72935	.72594	.72256	.71920	.71586	.71254	.70924	.70597
101	.74361	.74021	.73684	.73349	.73016	.72685	.72356	.72029	.71704	.71382
102	.75128	.74794	.74463	.74133	.73806	.73480	.73157	.72835	.72515	.72198
103	.75938	.75610	.75284	.74961	.74639	.74319	.74000	.73684	.73369	.73056
104	.76835	.76514	.76194	.75877	.75561	.75246	.74934	.74623	.74313	.74005
105	.77956	.77643	.77332	.77023	.76714	.76408	.76102	.75798	.75496	.75195
106	.79632	.79334	.79038	.78743	.78449	.78157	.77865	.77575	.77285	.76997
107	.82154	.81884	.81615	.81346	.81079	.80811	.80545	.80279	.80014	.79750
108	.86487	.86274	.86061	.85848	.85635	.85423	.85210	.84998	.84787	.84575
109	.93900	.93800	.93700	.93600	.93500	.93400	.93300	.93200	.93100	.93000

(f) *Effective date.* This section is effective as of May 1, 1989.

[T.D. 8540, 59 FR 30117, June 10, 1994]

TREATMENT OF EXCESS DISTRIBUTIONS OF TRUSTS APPLICABLE TO TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1969

§ 1.665(a)–0 Excess distributions by trusts; scope of subpart D.

Subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code, in the case of trusts other than foreign trusts created by U.S. persons, is designed generally to prevent a shift of tax burden to a trust from a beneficiary or beneficiaries. In the case of a foreign trust created by a U.S. person, subpart D is designed to prevent certain other tax avoidance possibilities. To accomplish these ends, subpart D provides special rules for treatment of amounts paid, credited, or required to be distributed by a complex trust (subject to subpart C (section 661 and following) of such part I) in any year in excess of distributable net income for that year. Such an excess distribution is defined as an accumulation distribution, subject to the limitations in section 665 (b) or (c). An accumulation distribution, in the case of a trust other than a foreign trust created by a U.S. person, is ‘‘thrown back’’ to each of the 5 preceding years in inverse order. In the case of a foreign trust created by a U.S. person such an accumulation distribution is ‘‘thrown back,’’ in inverse order, to each of the preceding years to which the Internal Revenue Code of 1954 applies. That is, an accumulation distribution will be taxed to the beneficiaries of the trust in the year the distribution is made or required, but, in general, only to the extent of the distributable net income of those years which was not in fact distributed. However, with respect to a distribution by a trust other than a foreign trust created by a U.S. person, the resulting tax will not be greater than the aggregate of the taxes that would have been attributable to the amount thrown back to previous years had they been included in gross income of the beneficiaries in those years. In the case of a foreign trust created by a U.S. person, the resulting tax is computed under the provisions of section 669. To prevent double taxation, both in the case of a foreign trust created by a U.S. person, and a trust other than a foreign trust created by a U.S. person, the beneficiaries receive a credit for any taxes previously paid by the trust which are attributable to the excess thrown back and which are creditable under the provisions of chapter 1 of the Internal Revenue Code. Subpart D does not apply to any estate.

[T.D. 6989, 34 FR 733, Jan. 17, 1969]

§1.665(a)–1 Undistributed net income.

(a) The term *undistributed net income* means for any taxable year the distributable net income of the trust for that year as determined under section 643(a), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in paragraphs (1) and (2) of section 661(a), and

(2) The amount of taxes imposed on the trust, as defined in §1.665(d)–1.

The application of the rule in this paragraph to the first year of a trust in which income is accumulated may be illustrated by the following example:

Example. Assume that under the terms of the trust, $10,000 of income is required to be distributed currently to A and the trustee has discretion to make additional distributions to A. During the taxable year 1954 the trust had distributable net income of $30,100 derived from royalties and the trustee made distributions of $20,000 to A. The taxable income of the trust is $10,000 on which a tax of $2,640 is paid. The undistributed net income of the trust as of the close of the taxable year 1954 is $7,460 computed as follows:

Distributable net income		$30,100
Less:		
Income currently distributable to A	$10,000	
Other amounts distributed to A	10,000	
Taxes imposed on the trust (see §1.665(d)–1)	2,640	
		22,640
Undistributed net income		7,460

See also paragraphs (e)(1) and (f)(1) of §1.668(b)–2 for additional illustrations of the application of the rule in this paragraph to the first year of a trust in which income is accumulated.

(b) The undistributed net income of a foreign trust created by a U.S. person for any taxable year is the distributable net income of such trust (see §1.643(a)–6 and the examples set forth in paragraph (b) thereof), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in paragraphs (1) and (2) of section 661(a), and

(2) The amount of taxes imposed on such trust by chapter 1 of the Internal Revenue Code, which are attributable to items of income which are required to be included in such distributable net income. For purposes of subparagraph (2) of this paragraph, the amount of taxes imposed on the trust (for any taxable year), by chapter 1 of the Internal Revenue Code is the amount of taxes imposed pursuant to the provisions of section 871 which is properly allocable to the undistributed portion of the distributable net income. See §1.665(d)–1. The amount of taxes imposed pursuant to the provisions of section 871 is the difference between the total tax imposed pursuant to the provisions of that section on the foreign trust created by a U.S. person for the year and the amount which would have been imposed on such trust had all the distributable net income, as determined under section 643(a), been distributed. The application of the rule in this paragraph may be illustrated by the following examples:

Example 1. A trust was created in 1952 under the laws of Country X by the transfer to a trustee in Country X of money or property by a U.S. person. The entire trust constitutes a foreign trust created by a U.S. person. The governing instrument of the trust provides that $7,000 of income is required to be distributed currently to a U.S. beneficiary and gives the trustee discretion to make additional distributions to the beneficiary. During the taxable year 1963 the trust had income of $10,000 from dividends of a U.S. corporation (on which Federal income taxes of $3,000 were imposed pursuant to the provisions of section 871 and withheld under section 1441 resulting in the receipt by the trust of cash in the amount of $7,000), $20,000 in capital gains from the sale of stock of a Country Y corporation, and $30,000 from dividends of a Country X corporation, none of the gross income of which was derived from sources within the United States. The trustee did not file a U.S. income tax return for the taxable year 1963. The distributable net income of the trust before distributions to the beneficiary for 1963 is $60,000 ($57,000 of which is cash). During 1963 the trustee made distributions to the U.S. beneficiary equaling one-half of the trust's distributable net income or $30,000. Thus, the U.S. beneficiary is treated as having had distributed to him $5,000 (composed of $3,500 as a cash distribution and $1,500 as the tax imposed pursuant to the provisions of section 871 and withheld under section 1441), representing one-half of the income from U.S. sources; $10,000 in cash, representing one-half of the capital gains from the sale of stock of the Country Y corporation; and $15,000 in cash, representing one-half of the income from Country X sources for a total of $30,000. The undistributed net income of the trust at the close of taxable year 1963 is $28,500 computed as follows:

Distributable net income		$60,000
Less:		
(1) Amounts distributed to the beneficiary—.		
Income currently distributed to the beneficiary	$7,000	
Other amounts distributed to the beneficiary	21,500	
Taxes under sec. 871 deemed distributed to the beneficiary	1,500	
Total amounts distributed to the beneficiary	30,000	
(2) Amount of taxes imposed on the trust under chapter 1 of the Code (See § 1.665(d)–1)	1,500	
Total		31,500
Undistributed net income		28,500

Example 2. The facts are the same as in example 1 except that property has been transferred to the trust by a person other than a U.S. person, and during 1963 the foreign trust created by a U.S. person was 60 percent of the entire foreign trust. The trustee paid no income taxes to Country X in 1963.

(1) The undistributed net income of the foreign trust created by a U.S. person for 1963 is $17,100, computed as follows:

Distributable net income (60% of each item of gross income of entire trust):		
60% of $10,000 U.S. dividends		$6,000
60% of $20,000 Country X capital gains		12,000
60% of $30,000 Country X dividends		18,000
Total		36,000
Less:		
(i) Amounts distributed to the beneficiary—		
Income currently distributed to the beneficiary (60% of $7,000)	$4,200	
Other amounts distributed to the beneficiary (60% of $21,500)	12,900	
Taxes under sec. 871 deemed distributed to the beneficiary (60% of $1,500)	900	
Total amounts distributed to the beneficiary	18,000	
(ii) Amount of taxes imposed on the trust under chapter 1 of the Code (See § 1.665(d)–1) (60% of $1,500)	$900	
Total		$18,900
Undistributed net income		17,100

(2) The undistributed net income of the portion of the entire trust which is not a foreign trust created by a U.S. person for 1963 is $11,400, computed as follows:

Distributed net income (40% of each item of gross income of entire trust)		
40% of $10,000 U.S. dividends		$4,000
40% of $20,000 Country X capital gains		8,000
40% of Country X dividends		12,000
Total		24,000
Less:		
(i) Amounts distributed to the beneficiary—		
Income currently distributed to the beneficiary (40% of $7,000)	$2,800	
Other amounts distributed to the beneficiary (40% of $21,500)	8,600	
Taxes under sec. 871 deemed distributed to the beneficiary (40% of $1,500)	600	
Total amounts distributed to the beneficiary	12,000	
(ii) Amount of taxes imposed on the trust under chapter 1 of the Code (See § 1.665(d)–1) (40% of $1,500)	$600	
Total		$12,600
Undistributed net income		11,400

(c) However, the undistributed net income for any year to which an accumulation distribution for a later year may be thrown back may be reduced by accumulation distributions in intervening years and also by any taxes imposed on the trust which are deemed to be distributed under section 666 by reason of the accumulation distributions. On the other hand, undistributed net income for any year will not be reduced by any distributions in an intervening year which are excluded from the definition of an accumulation distribution under section 665(b), or which are excluded under section 663(a)(1), relating to gifts, bequests, etc. See paragraph (f)(5) of § 1.668(b)–2 for an illustration of the reduction of undistributed net income for any year by a subsequent accumulation distribution.

[T.D. 6989, 34 FR 733, 741, Jan. 17, 1969]

§1.665(b)–1 Accumulation distributions of trusts other than certain foreign trusts; in general.

(a) Subject to the limitations set forth in §1.665(b)–2, in the case of a trust other than a foreign trust created by a U.S. person, the term *accumulation distribution* for any taxable year means an amount (if in excess of $2,000), by which the amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2) for that year exceed the distributable net income (determined under section 643(a)) of the trust, reduced (but not below zero) by the amount of income required to be distributed currently. (In computing the amount of an accumulation distribution pursuant to the preceding sentence, there is taken into account amounts applied or distributed for the support of a dependent under the circumstances specified in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year and amounts used to discharge or satisfy any person's legal obligation as that term is used in §1.662(a)–4.) If the distribution as so computed is $2,000 or less, it is not an accumulation distribution within the meaning of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code. If the distribution exceeds $2,000, then the full amount is an accumulation distribution for the purposes of subpart D.

(b) Although amounts properly paid, credited, or required to be distributed under section 661(a)(2) do not exceed the income of the trust during the taxable year, an accumulation distribution may result if such amounts exceed distributable net income reduced (but not below zero) by the amount required to be distributed currently. This may result from the fact that expenses allocable to corpus are taken into account in determining taxable income and hence distributable net income. However, in the case of a trust other than a foreign trust created by a U.S. person, the provisions of subpart D will not apply unless there is undistributed net income in at least one of the five preceding taxable years. See section 666 and the regulations thereunder.

(c) The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples (it is assumed in each case that the exclusions provided in §1.665(b)–2 do not apply):

Example 1. A trustee properly makes a distribution to a beneficiary of $20,000 during the taxable year 1956, of which $10,000 is income required to be distributed currently to the beneficiary. The distributable net income of the trust is $15,000. There is an accumulation distribution of $5,000 computed as follows:

Total distribution		$20,000
Less: Income required to be distributed currently (section 661(a)(1))		10,000
Other amounts distributed (section 661(a)(2))		10,000
Distributable net income	$15,000	
Less: Income required to be distributed currently	10,000	
Balance of distributable net income		5,000
Accumulation distribution		5,000

Example 2. Under the terms of the trust instrument, an annuity of $15,000 is required to be paid to A out of income each year and the trustee may in his discretion make distributions out of income or corpus to B. During the taxable year the trust had income of $18,000, as defined in section 643(b), and expenses allocable to corpus of $5,000. Distributable net income amounted to $13,000. The trustee distributed $15,000 of income to A and in the exercise of his discretion, paid $5,000 to B. There is an accumulation distribution of $5,000 computed as follows:

Total distribution		$20,000
Less: Income required to be distributed currently to A (section 661(a)(1))		15,000
Other amounts distributed (section 661(a)(2))		5,000
Distributable net income	$13,000	
Less: Income required to be distributed currently to A	15,000	
Balance of distributable net income		0
Accumulation distribution to B		5,000

Example 3. Under the terms of a trust instrument, the trustee may either accumulate the trust income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. During the taxable year, the trust had income as defined in section 643(b) of $22,000 and expenses of $5,000 allocable to corpus. Distributable net income amounts to $17,000. The trustee distributed $10,000 each to A and B during the taxable year. There is an accumulation distribution of $3,000 computed as follows:

Total distribution		$20,000
Less: income required to be distributed currently		0
Other amounts distributed (section 661(a)(2))		20,000

Distributable net income	17,000
Accumulation distribution	3,000

(d) There are not taken into account, in computing the accumulation distribution for any taxable year, any amounts deemed distributed in that year because of an accumulation distribution in a later year.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 734, Jan. 17, 1969]

§ 1.665(b)–2 Exclusions from accumulation distributions in the case of trusts (other than a foreign trust created by a U.S. person).

(a) In the case of a trust other than a foreign trust created by a U.S. person, certain amounts paid, credited, or required to be distributed to a beneficiary are excluded under section 665(b) in determining whether there is an accumulation distribution for the purposes of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code. These exclusions are solely for the purpose of determining the amount allocable to preceding years under section 666 and in no way affect the determination under subpart C (section 661 and following) of such part I of the beneficiary's tax liability for the year of distribution. Further, amounts excluded from accumulation distributions do not reduce the amount of undistributed net income for the 5 years preceding the year of distribution.

(b) The amounts excluded from the computation of an accumulation distribution are discussed in the following subparagraphs:

(1) *Distributions from accumulations while a beneficiary is under 21.* (i) The first exception to the definition of an accumulation distribution is for amounts paid, credited, or required to be distributed to a beneficiary who was under 21 years of age or unborn when it was accumulated. A distribution is to be considered as so paid, credited, or required to be distributed to the extent, and only to the extent, that there is no undistributed net income for taxable years preceding the year of distribution other than undistributed net income accumulated while the beneficiary was under 21. If a distribution can be made from income accumulated either before or after a beneficiary reaches 21, it will be considered as made from the most recently accumulated income, and it will be so considered even though the governing instrument directs that distributions be charged first against the earliest accumulations.

(ii) As was indicated in paragraph (a) of this section, a distribution of an amount excepted from the definition of an accumulation distribution will not reduce undistributed net income for the purpose of determining the effect of a future accumulation distribution. Thus, a distribution to a beneficiary of income accumulated before he reached 21 would not reduce the undistributed net income includible in a future accumulation distribution to another beneficiary. However, all future distributions to the same beneficiary, or to another beneficiary to whom a distribution would be excepted under the provisions of this subparagraph, would be excepted from the definition of an accumulation distribution to the extent that they could not be paid, credited, or required to be distributed from other accumulated income.

(iii) The following examples illustrate the application of the foregoing rules of this subparagraph (in each of these examples it is assumed that the exceptions in section 665(b) (2), (3), and (4) do not apply):

(a) Income is to be accumulated until A reaches 21 when the corpus and accumulated income are to be distributed to him. The distribution is not an accumulation distribution.

(b) Income is to be accumulated until A is 21, when it is to be distributed to him but the corpus is to remain in trust. A distribution of the accumulated income to A when he reaches 21 is not an accumulation distribution.

(c) Income is to be accumulated and added to corpus until A reaches 21, when he is to receive one-third of the corpus (including accumulations). Thereafter all the income is to be paid to A until he is 23 when the remaining corpus (including accumulations) is to be paid to him. If A dies under that age any undistributed portion is to be paid to B. Distributions to A at 21 and 23 out of accumulations are not accumulation distributions even though they

include accumulated income. However, if A died at the age of 22, when B was 23, a distribution to B would be an accumulation distribution to the extent of income accumulations since B reached 21, and the amount of undistributed net income includible in the distribution will not be reduced by the previous distribution to A.

(d) Income is to be accumulated and added to corpus until A is 21. After he is 21, he is entitled to all the income and, in addition, to distributions of corpus in the discretion of the trustee. When he reaches 25 he is entitled to the corpus. Distributions to A are not accumulation distributions, whether they are discretionary or upon termination of the trust.

(e) The facts are the same as in the preceding example, except that income is to be accumulated until A is 23. Distributions to A are accumulation distributions to the extent of income accumulated after A reached 21.

(f) Income may be distributed among a testator's children or accumulated and added to corpus until the youngest child is 21, when the corpus is to be distributed to the testator's then living descendants. Upon termination of the trust, the corpus is distributed to A, age 21; B, age 23; and C, the child of a deceased child, age 3. The distributions to A and C are not accumulation distributions. The distribution to B is an accumulation distribution to the extent of income accumulated after he reaches 21. (If the terms of the trust were such that it was subject to the separate share treatment under section 663(c), the distribution to B would be an accumulation distribution only to the extent of income accumulated for B's separate share since he reached 21.)

(g) Income may be distributed to A or accumulated and added to corpus during A's life. Upon the death of A the corpus is to be distributed to B. B is 23 at A's death. The distribution is an accumulation distribution to the extent of income accumulated since B reached 21.

(2) *Emergency distributions.* The second exclusion from the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary to meet his emergency needs. Whether or not a distribution falls within this exclusion depends upon the facts and circumstances causing the distribution. A distribution based upon an unforeseen or unforeseeable combination of circumstances requiring immediate help to the beneficiary would qualify for the exclusion. However, the beneficiary must be in actual need of the distribution and the fact that he had other sufficient resources would tend to negate the conclusion that a distribution was to meet his emergency needs. Ordinary distributions for the support, maintenance, or education of the beneficiary would not qualify for the exclusion.

(3) *Certain distributions at specified ages.* The third exclusion from the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary upon the beneficiary's attaining a specified age or ages; provided, (i) the total number of such distributions with respect to that beneficiary cannot exceed 4; (ii) the period between each such distribution is 4 years or more; and (iii) on January 1, 1954, such distributions were required by the specific terms of the governing instrument. Any discretionary invasion of corpus at other times is not excluded under this subparagraph, but does not affect the status of distributions that would otherwise be excluded. If more than four distributions are required to be made to a particular beneficiary at specified ages if he survives to receive them, none of the distributions will be excluded, even though the beneficiary dies before he receives more than four. On the other hand, a direction to make additional distributions to a remainderman will not affect the status of distributions required to be made to the primary beneficiary. For example, a trust agreement provided on January 1, 1954, that when A reached age 25 he would receive one-eighth of the corpus and accumulated income, as then constituted, and similar distributions at ages 30, 35, and 40. It also provided for similar distributions to B after A's death, and for additional discretionary distributions to both A and B. Required distributions to both A and B are excluded, regardless of whether discretionary distributions are made, but discretionary distributions are not excluded. On the other

hand, if an additional distribution to A was directed when he reached 45, no distributions to him would be excluded, regardless of when he died.

(4) *Certain final distributions.* (i) The last exception to the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary as a final distribution of a trust if the final distribution is made more than 9 years after the date of the last transfer to such trust.

(ii) The term *last transfer to such trust* includes only transfers, whether by the original grantor or by a third person, made with a donative intent. A transfer arising out of a property right held by the trust is excluded, such as a transfer by a debtor in satisfaction of his indebtedness, or a distribution in liquidation or reorganization of a corporation. If the terms of two or more trusts include cross-remainders on the deaths of life beneficiaries, the donative transfers occurred at the time the trusts were created. The addition of the corpus of one trust to that of another when a remainder falls in is therefore not a new transfer within the meaning of section 665(b)(4).

(iii) For example, under the terms of a trust created July 1, 1950, with an original corpus of $100,000, by H for the benefit of his wife, W, the income of the trust is to be accumulated and added to corpus. Upon the expiration of a 10-year period, the trust is to terminate and its assets, including all accumulated income, are to be distributed to W. No transfers were made by H or other persons to the trust after it was created. Both the trust and W file returns on the calendar year basis. In accordance with its terms, the trust terminated on June 30, 1960, and on August 1, 1960, the trustee made a final distribution of the assets of the trust to W, consisting of investments derived from $100,000 of donated principal, accumulated income of $30,000 attributable to the period July 1, 1950, through December 31, 1959, and income of $3,000 attributable to the period the trust was in existence during 1960. Subpart D is inapplicable to the $3,000 of income of the trust for 1960 since that amount would be deductible by the trust and includible in W's gross income for that year to the extent provided in subpart C. However, the balance of the distribution will qualify as an exclusion from the provisions of subpart D.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 735, Jan. 17, 1969]

§ 1.665(b)–3 Exclusions under section 663(a)(1).

Subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, has no application to an amount which qualifies as an exclusion under section 663(a)(1), relating to gifts, bequests, etc.

§ 1.665(c)–1 Accumulation distributions of certain foreign trusts; in general.

(a) In the case of a foreign trust created by a U.S. person, the term *accumulation distribution* for any taxable year means an amount by which the amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2) for that year exceed the distributable net income (determined under section 643(a)) of the trust, reduced (but not below zero) by the amount of income required to be distributed currently. (In computing the amount of an accumulation distribution pursuant to the preceding sentence, there is taken into account amounts applied or distributed for the support of a dependent under circumstances specified in section 677(b) and section 678(c) out of corpus or out of other than income for the taxable year and amounts used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)–4.)

(b) Although amounts properly paid, credited, or required to be distributed under section 661(a)(2) do not exceed the income of the trust during the taxable year, an accumulation distribution may result if such amounts exceed distributable net income reduced (but not below zero) by the amount required to be distributed currently. This may result from the fact that expenses allocable to corpus are taken into account in determining taxable income and hence distributable net income. However, the provisions of subpart D will not apply unless there is undistributed net income in at least one of the preceding taxable years which began after

December 31, 1953, and ended after August 16, 1954. See section 666 and the regulations thereunder.

(c) The provisions of paragraphs (a) and (b) of this section may be illustrated by the examples provided in paragraph (c) of §1.665(b)–1.

[T.D. 6989, 34 FR 735, Jan. 17, 1969]

§1.665(c)–2 Indirect payments to the beneficiary.

(a) *In general.* Except as provided in paragraph (b) of this section, for purposes of section 665 any amount paid to a U.S. person which is from a payor who is not a U.S. person and which is derived directly or indirectly from a foreign trust created by a U.S. person shall be deemed in the year of payment to the U.S. person to have been directly paid to the U.S. person by the trust. For example, if a nonresident alien receives a distribution from a foreign trust created by a U.S. person and then pays the amount of the distribution over to a U.S. person, the payment of such amount to the U.S. person represents an accumulation distribution to the U.S. person from the trust to the extent that the amount received would have been an accumulation distribution had the trust paid the amount directly to the U.S. person in the year in which the payment was received by the U.S. person. This section also applies in a case where a nonresident alien receives indirectly an accumulation distribution from a foreign trust created by a U.S. person and then pays it over to a U.S. person. An example of such a transaction is one where the foreign trust created by a U.S. person makes the distribution to an intervening foreign trust created by either a U.S. person or a person other than a U.S. person and the intervening trust distributes the amount received to a nonresident alien who in turn pays it over to a U.S. person. Under these circumstances, it is deemed that the payment received by the U.S. person was received directly from a foreign trust created by a U.S. person.

(b) *Limitation.* In the case of a distribution to a beneficiary who is a U.S. person, paragraph (a) of this section does not apply if the distribution is received by such beneficiary under circumstances indicating lack of intent on the part of the parties to circumvent the purposes for which section 7 of the Revenue Act of 1962 (76 Stat. 985) was enacted.

[T.D. 6989, 34 FR 735, Jan. 17, 1969]

§1.665(d)–1 Taxes imposed on the trust.

(a) For the purpose of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, the term *taxes imposed on the trust* means (for any taxable year) the amount of Federal income taxes which are properly allocable to the undistributed portion of the distributable net income. This amount is the difference between the total taxes of the trust for the year and the amount which would have been paid by the trust had all of the distributable net income, as determined under section 643(a), been distributed. Thus, in determining the amount of taxes imposed on the trust for the purposes of subpart D, there is excluded the portion of the taxes paid by the trust which is attributable to items of gross income which are not includible in distributable net income, such as capital gains allocable to corpus. The rule stated in this paragraph may be illustrated by the following example:

Example. (1) Under the terms of a trust which reports on the calendar year basis the income may be accumulated or distributed to A in the discretion of the trustee and capital gains are allocable to corpus. During the taxable year 1954, the trust had income of $20,000 from royalties, long-term capital gains of $10,000, and expenses of $2,000. The trustee in his discretion made a distribution of $10,000 to A. The taxes imposed on the trust for the purposes of this subpart are $2,713, determined as shown below.

(2) The distributable net income of the trust computed under section 643(a) is $18,000 (royalties of $20,000 less expenses of $2,000). The total taxes paid by the trust are $3,787, computed as follows:

Royalties		$20,000
Capital gains		10,000
Gross income		30,000
Deductions:		
Expenses	$2,000	
Distributions to A	10,000	
Capital gain deduction	5,000	
Personal exemption	100	
		17,100
Taxable income		12,900
Total income taxes		3,787

(3) The amount of taxes which would have been paid by the trust, had all of the distributable net income ($18,000) of the trust been distributed to A, is $1,074, computed as follows:

Taxable income of the trust	$12,900
Less: Undistributed portion of distributable net income ($18,000 − $10,000)	8,000
Balance of taxable income	4,900
Income taxes on $4,900	1,074

(4) The amount of taxes imposed on the trust as defined in this paragraph is $2,713, computed as follows:

Total taxes	$3,787
Taxes which would have been paid by the trust had all of the distributable net income been distributed	1,074
Taxes imposed on the trust as defined in this paragraph	2,713

(b) If in any subsequent year an accumulation distribution is made by the trust which results in a throwback to the taxable year, the taxes of the taxable year allocable to the undistributed portion of distributable net income (the taxes imposed on the trust), after the close of the subsequent year, are the taxes prescribed in paragraph (a) of this section reduced by the taxes of the taxable year allowed as credits to beneficiaries on account of amounts deemed distributed on the last day of the taxable year under section 666. See paragraph (f)(4) of §1.668(b)–2 for an illustration of the application of this paragraph.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960. Redesignated by T.D. 6989, 34 FR 735, Jan. 17, 1969]

§1.665(e)–1 Preceding taxable year.

(a) *Definition.* For purposes of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code of 1954, the term *preceding taxable year* does not include any taxable year to which such part I does not apply. See section 683 and regulations thereunder. Accordingly, the provisions of such subpart D may not, in general, be applied to any taxable year which begins before 1954 or ends before August 17, 1954. For example, if a trust (reporting on the calendar year basis) makes a distribution during the calendar year 1955 of income accumulated during prior years and the distribution exceeds the distributable net income of 1955, the excess distribution may be allocated under such subpart D to 1954, but it may not be allocated to 1953 and preceding years, since the Internal Revenue Code of 1939 applies to those years.

(b) *Simple trusts subject to subpart D.* An accumulation distribution may be properly allocated to a preceding taxable year in which the trust qualified as a simple trust (that is, qualified for treatment under subpart B (section 651 and following) of such part I). In such event, the trust is treated for such preceding taxable year in all respects as if it were a trust to which subpart C (section 661 and following) of such part I applies. An example of such a circumstance would be in the case of a trust (required under the trust instrument to distribute all of its income currently) which received in the preceding taxable year extraordinary dividends or taxable stock dividends which the trustee in good faith allocated to corpus, but which are subsequently determined to be currently distributable to the beneficiary. See section 643(a)(4) and §1.643(a)–4. The trust would qualify for treatment under such subpart C for the year of distribution of the extraordinary dividends or taxable stock dividends, because the distribution is not out of income of the current taxable year and would be treated as other amounts properly paid or credited or required to be distributed for such taxable year within the meaning of section 661(a)(2). Also, in the case of a trust other than a foreign trust created by a U.S. person, the distribution would qualify as an accumulation distribution for the purposes of such subpart D if in excess of $2,000 and not excepted under section 665(b) and the regulations thereunder. In the case of a foreign trust created by a U.S. person, the distribution, regardless of the amount, would qualify as an accumulation distribution for the purposes of subpart D. For the purposes only of such subpart D, the trust would be treated as subject to the provisions of such subpart C for the preceding taxable year in which the extraordinary or taxable stock dividends were received and in computing undistributed net income for such preceding year, the extraordinary or taxable stock dividends would be included in distributable net income under section 643(a). The rule stated in the preceding sentence would also apply if the distribution in the later year were made out of corpus without regard to a determination that the extraordinary dividends or taxable stock dividends in question were currently distributable to the beneficiary.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 735, Jan. 17, 1969. Redesignated by T.D. 6989, 34 FR 735, Jan. 17, 1969]

§1.665(e)–2 Application of separate share rule.

In trusts to which the separate share rule of section 663(c) is applicable for any taxable year, subpart D (section 665 and following), part I, subchapter J, of the Code, is applied as if each share were a separate trust. Thus, ‘‘undistributed net income’’ and the amount of an ‘‘accumulation distribution’’ are computed separately for each share. The ‘‘taxes imposed on the trust’’ are allocated as follows:

(a) There is first allocated to each separate share that portion of the ‘‘taxes imposed on the trust’’, computed before the allowance of credits under section 642(a), which bears the same relation to the total that the distributable net income of the separate share bears to the distributable net income of the trust, adjusted for this purpose as follows:

(1) There is excluded from distributable net income of the trust and of each separate share any tax-exempt interest, foreign income of a foreign trust, and excluded dividends, to the extent such amounts are included in distributable net income pursuant to section 643(a) (5), (6), and (7); and

(2) The distributable net income of the trust is reduced by any deductions allowable under section 661 for amounts paid, credited, or required to be distributed during the taxable year, and the distributable net income of each separate share is reduced by any such deduction allocable to that share.

(b) The taxes so determined for each separate share are then reduced by that portion of the credits against tax allowable to the trust under section 642(a) in computing the ‘‘taxes imposed on the trust’’ which bear the same relation to the total that the items of income allocable to the separate share with respect to which the credit is allowed bear to the total of such items of the trust. The amount of taxes imposed on the trust allocable to a separate share as so determined is then reduced by the amount of the taxes allowed under sections 667 and 668 as a credit to a beneficiary of the separate share on account of any accumulation distribution determined for any taxable year intervening between the year for which the determination is made and the year of an accumulation distribution with respect to which the determination is made. See paragraph (b) of §1.665(d)–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 741, Jan. 17, 1969. Redesignated by T.D. 6989, 34 FR 736, Jan. 17, 1969]

§1.666(a)–1A Amount allocated.

(a) *In general.* In the case of a trust that is subject to subpart C of part I of subchapter J of chapter 1 of the Code (relating to estates and trusts that may accumulate income or that distribute corpus), section 666(a) prescribes rules for determining the taxable years from which an accumulation distribution will be deemed to have been made and the extent to which the accumulation distribution is considered to consist of undistributed net income. In general, an accumulation distribution made in taxable years beginning after December 31, 1969, is deemed to have been made first from the earliest preceding taxable year of the trust for which there is undistributed net income. An accumulation distribution made in a taxable year beginning before January 1, 1970, is deemed to have been made first from the most recent preceding taxable year of the trust for which there is undistributed net income. See §1.665(e)–1A for the definition of ‘‘preceding taxable year.’’

(b) *Distributions by domestic trusts*—(1) *Taxable years beginning after December 31, 1973.* An accumulation distribution made by a trust (other than a foreign trust created by a U.S. person) in any taxable year beginning after December 31, 1973, is allocated to the preceding taxable years of the trust (defined in §1.665(e)–1A(a)(1)(ii) as those beginning after December 31, 1968) according to the amount of undistributed net income of the trust for such years. For this purpose, an accumulation distribution is first to be allocated to the earliest such preceding taxable year in which there is undistributed net income and shall then be allocated, beginning with the next earliest, to any remaining preceding taxable years of the trust. The portion of the accumulation distribution allocated to the earliest preceding taxable year is the amount of the undistributed net income for that preceding taxable year. The portion of the accumulation distribution allocated to any preceding taxable year subsequent to the earliest such preceding taxable year is the excess of the accumulation distribution over the aggregate of the undistributed net income for all earlier preceding taxable years. See paragraph (d) of this section for adjustments to undistributed net income for prior distributions. The provisions of this subparagraph may be illustrated by the following example:

Example. In 1977, a domestic trust reporting on the calendar year basis makes an accumulation distribution of $33,000. Therefore, years before 1969 are ignored. In 1969, the trust had $6,000 of undistributed net income; in 1970, $4,000; in 1971, none; in 1972, $7,000; in 1973, $5,000; in 1974, $8,000; in 1975, $6,000; and $4,000 in 1976. The accumulation distribution is deemed distributed $6,000 in 1969, $4,000 in 1970, none in 1971, $7,000 in 1972, $5,000 in 1973, $8,000 in 1974, and $3,000 in 1975.

(2) *Taxable years beginning after December 31, 1969, and before January 1, 1974.* If a trust (other than a foreign trust created by a U.S. person) makes an accumulation distribution in a taxable year beginning after December 31, 1969, and before January 1, 1974, the distribution will be deemed distributed in the same manner as accumulation distributions qualifying under subparagraph (1) of this paragraph, except that the first year to which the distribution may be thrown back cannot be earlier than the fifth taxable year of the trust preceding the year in which the accumulation distribution is made. Thus, for example, in the case of an accumulation distribution made in the taxable year of a domestic trust which begins on January 1, 1972, the taxable year of the trust beginning on January 1, 1967, would be the first year in which the distribution was deemed made, assuming that there was undistributed net income for 1967. See also § 1.665(e)–1A(a)(1). The provisions of this subparagraph may be illustrated by the following example:

Example. In 1973, a domestic trust, reporting on the calendar year basis, makes an accumulation distribution of $25,000. In 1968, the fifth year preceding 1973, the trust had $7,000 of undistributed net income; in 1969, none; in 1970, $12,000; in 1971, $4,000; in 1972, $4,000. The accumulation distribution is deemed distributed in the amounts of $7,000 in 1968, none in 1969, $12,000 in 1970, $4,000 in 1971, and $2,000 in 1972.

(3) *Taxable years beginning after December 31, 1968, and before January 1, 1970.* Accumulation distributions made in taxable years of the trust beginning after December 31, 1968, and before January 1, 1970, are allocated to prior years according to § 1.666(a)–1.

(c) *Distributions by foreign trusts*— (1) *Foreign trusts created solely by U.S. persons*—(i) *Taxable years beginning after December 31, 1969.* If a foreign trust created by a U.S. person makes an accumulation distribution in any taxable year beginning after December 31, 1969, the distribution is allocated to the trust's preceding taxable years (defined in § 1.665(e)–1A(a)(2) as those beginning after Dec. 31, 1953, and ending after Aug. 16, 1954) according to the amount of undistributed net income of the trust for such years. For this purpose, an accumulation distribution is first allocated to the earliest such preceding taxable year in which there is undistributed net income and shall then be allocated in turn, beginning with the next earliest, to any remaining preceding taxable years of the trust. The portion of the accumulation distribution allocated to the earliest preceding taxable year is the amount of the undistributed net income for that preceding taxable year. The portion of the accumulation distribution allocated to any preceding taxable year subsequent to the earliest such preceding taxable year is the excess of the accumulation distribution over the aggregate of the undistributed net income for all earlier preceding taxable years. See paragraph (d) of this section for adjustments to undistributed net income for prior distributions. The provisions of this subdivision may be illustrated by the following example:

Example. In 1971, a foreign trust created by a U.S. person, reporting on the calendar year basis, makes an accumulation distribution of $50,000. In 1961, the trust had $12,000 of undistributed net income; in 1962, none; in 1963, $10,000; in 1964, $8,000; in 1965, $5,000; in 1966, $14,000; in 1967, none; in 1968, $3,000; in 1969, $2,000; and in 1970, $1,000. The accumulation distribution is deemed distributed in the amounts of $12,000 in 1961, none in 1962, $10,000 in 1963, $8,000 in 1964, $5,000 in 1965, $14,000 in 1966, none in 1967, and $1,000 in 1968.

(ii) *Taxable years beginning after December 31, 1968, and before January 1, 1970.* Accumulation distributions made in taxable years of the trust beginning after December 31, 1968, and before January 1, 1970, are allocated to prior years according to §1.666(a)–1.

(2) *Foreign trusts created partly by U.S. persons*—(i) *Taxable years beginning after December 31, 1969.* If a trust that is in part a foreign trust created by a U.S. person and in part a foreign trust created by a person other than a U.S. person makes an accumulation distribution in any year after December 31, 1969, the distribution is deemed made from the undistributed net income of the foreign trust created by a U.S. person in the proportion that the total undistributed net income for all preceding years of the foreign trust created by the U.S. person bears to the total undistributed net income for all years of the entire foreign trust. In addition, such distribution is deemed made from the undistributed net income of the foreign trust created by a person other than a U.S. person in the proportion that the total undistributed net income for all preceding years of the foreign trust created by a person other than a U.S. person bears to the total undistributed net income for all years of the entire foreign trust. Accordingly, an accumulation distribution of such a trust is composed of two portions with one portion relating to the undistributed net income of the foreign trust created by the U.S. person and the other portion relating to the undistributed net income of the foreign trust created by the person other than a U.S. person. For these purposes, each portion of an accumulation distribution made in any taxable year is first allocated to each of such preceding taxable years in turn, beginning with the earliest preceding taxable year, as defined in §1.665(e)–1A(a), of the applicable foreign trusts, to the extent of the undistributed net income for the such trust for each of those years. Thus, each portion of an accumulation distribution is deemed to have been made from the earliest accumulated income of the applicable trust. If the foreign trust created by a U.S. person makes an accumulation distribution in any year beginning after December 31, 1969, the distribution is included in the beneficiary's income for that year to the extent of the undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. The provisions of this subdivision may be illustrated by the following example:

Example. A trust is created in 1962 under the laws of Country X by the transfer to a trustee in Country X of property by both a U.S. person and a person other than a U.S. person. Both the trust and the only beneficiary of the trust (who is a U.S. person) report their taxable income on a calendar year basis. On March 31, 1974, the trust makes an accumulation distribution of $150,000 to the beneficiary. The distributable net income of both the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person for each year is computed in accordance with the provisions of paragraph (b)(3) of §1.643(d)–1 and the undistributed net income for each portion of the trust for each year is computed as described in paragraph (b) of §1.665(a)–1A. For taxable years 1962 through 1973, the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person had the following amounts of undistributed net income:

Year	Undistributed net income-portion of the trust created by a U.S. person	Undistributed net income-portion of the trust created by a person other than a U.S. person
1962 ...	$7,000	$4,000
1963 ...	12,000	7,000
1964 ...	None	None
1965 ...	11,000	5,000
1966 ...	8,000	3,000
1967 ...	None	None
1968 ...	4,000	2,000
1969 ...	17,000	8,000
1970 ...	16,000	9,000
1971 ...	None	None

Year	Undistributed net income-portion of the trust created by a U.S. person	Undistributed net income-portion of the trust created by a person other than a U.S. person
1972 ...	25,000	12,000
1973 ...	20,000	10,000
Totals	120,000	60,000

The accumulation distribution in the amount of $150,000 is deemed to have been distributed in the amount of $100,000 (120,000/180,000×$150,000) from the portion of the trust which is a foreign trust created by a U.S. person and in the amount of $39,000, which is less than $50,000 (60,000/180,000×$150,000), from the portion of the trust which is a foreign trust created by a person other than a U.S. person computed as follows:

Year	Throwback to preceding years of foreign trust created by a U.S. person	Throwback to preceding years of portion of the entire foreign trust which is not a foreign trust created by a U.S. person
1962	$7,000	None
1963	12,000	None
1964	None	None
1965	$11,000	None
1966	8,000	None
1967	None	None
1968	4,000	None
1969	17,000	$8,000
1970	16,000	9,000
1971	None	None
1972	$25,000	$12,000
1973	None	10,000
Totals	100,000	39,000

Pursuant to this paragraph, the accumulation distribution in the amount of $100,000 from the portion of the trust which is a foreign trust created by a U.S. person is included in the beneficiary's income for 1974, as the amount represents undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. The accumulation distribution in the amount of $50,000 from the portion of the trust which is a foreign trust created by a person other than a U.S. person is included in the beneficiary's income for 1974 to the extent of the undistributed net income of the trust for the preceding years beginning after December 31, 1968. Accordingly, with respect to the portion of the trust which is a foreign trust created by a person other than a U.S. person, only the undistributed net income for the years 1969 through 1973, which totals $39,000, is includible in the beneficiary's income for 1974. Thus, of the $150,000 distribution made in 1974, the beneficiary is required to include a total of $139,000 in his income for 1974. The balance of $11,000 is deemed to represent a distribution of corpus.

(ii) *Taxable years beginning after December 31, 1968, and before January 1, 1970.* Accumulation distributions made in taxable years of the trust beginning after December 31, 1968, and before January 1, 1970, are allocated to prior years according to § 1.666(a)–1.

(3) *Foreign trusts created by non-U.S. persons.* To the extent that a foreign trust is a foreign trust created by a person other than a U.S. person, an accumulation distribution is included in the beneficiary's income for the year paid, credited, or required to be distributed to the extent provided under paragraph (b) of this section.

(d) *Reduction of undistributed net income for prior accumulation distributions.* For the purposes of allocating to any preceding taxable year an accumulation distribution of the taxable year, the undistributed net income of such preceding taxable year is reduced by the amount from such year deemed distributed in any accumulation distribution of undistributed net income made in any taxable year intervening between such preceding taxable year and the taxable year. Accordingly, for example, if a trust has undistributed net income for 1974 and makes accumulation distributions during the taxable years 1978 and 1979, in determining that part of the 1979 accumulation distribution that is thrown back to 1974 the undistributed net income for 1974 is first reduced by the amount of the undistributed net income for 1974 deemed distributed in the 1978 accumulation distribution.

(e) *Rule when no undistributed net income.* If, before the application of the provisions of subpart D to an accumulation distribution for the taxable year, there is no undistributed net income for a preceding taxable year, then no portion of the accumulation distribution is undistributed net income deemed distributed on the last day of such preceding taxable year. Thus, if an accumulation distribution is made during the taxable year 1975 from a trust whose earliest preceding taxable year is taxable year 1970, and the trust had no undistributed net income for 1970, then no portion of the 1975 accumulation distribution is undistributed net income deemed distributed on the last day of 1970.

[T.D. 7204, 37 FR 17143, Aug. 25, 1972]

§1.666(b)–1A Total taxes deemed distributed.

(a) If an accumulation distribution is deemed under §1.666(a)–1A to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed net income for such preceding taxable year, then an additional amount equal to the ‘‘taxes imposed on the trust attributable to the undistributed net income’’ (as defined in §1.665(d)–1A(b)) for such preceding taxable year is also deemed distributed under section 661(a)(2). For example, a trust has undistributed net income of $8,000 for the taxable year 1974. The taxes imposed on the trust attributable to the undistributed net income are $3,032. During the taxable year 1977, an accumulation distribution of $8,000 is made to the beneficiary, which is deemed under §1.666(a)–1A to have been distributed on the last day of 1974. The 1977 accumulation distribution is not less than the 1974 undistributed net income. Accordingly, the taxes of $3,032 imposed on the trust attributable to the undistributed net income for 1974 are also deemed to have been distributed on the last day of 1974. Thus, a total of $11,032 will be deemed to have been distributed on the last day of 1974.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed net income are computed after taking into account any accumulation distributions of taxable years intervening between such preceding taxable year and the taxable year. See paragraph (d) of §1.666(a)–1A.

[T.D. 7204, 37 FR 17145, Aug. 25, 1972]

§1.666(c)–1A Pro rata portion of taxes deemed distributed.

(a) If an accumulation distribution is deemed under §1.666(a)–1A to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed net income for such preceding taxable year, then an additional amount is also deemed distributed under section 661(a)(2). The additional amount is equal to the ‘‘taxes imposed on the trust attributable to the undistributed net income’’ (as defined in §1.665(a)–1A(b)) for such preceding taxable year, multiplied by a fraction, the numerator of which is the amount of the accumulation distribution allocated to such preceding taxable year and the denominator of which is the undistributed net income for such preceding taxable year. See paragraph (b) of example 1 and paragraphs (c) and (f) of example 2 in §1.666(c)–2A for illustrations of this paragraph.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed net income are computed after taking into account any accumulation distributions of any taxable years intervening between such preceding taxable year and the taxable year. See paragraph (d) of §1.666(a)–1A and paragraph (c) of example 1 and paragraphs (e) and (h) of example 2 in §1.666(c)–2A.

[T.D. 7204, 37 FR 17145, Aug. 25, 1972]

§1.666(c)–2A Illustration of the provisions of section 666 (a), (b), and (c).

The application of the provisions of §§1.666(a)–1A, 1.666(b)–1A, and 1.666(c)–1A may be illustrated by the following examples:

Example 1. (a) A trust created on January 1, 1974, makes accumulation distributions as follows:

1979	$7,000
1980	26,000

For 1974 through 1978, the undistributed portion of distributable net income, taxes imposed on the trust attributable to the undistributed net income, and undistributed net income are as follows:

Year	Undistributed portion of distributable net income	Taxes imposed on the trust attributable to the undistributed net income	Undistributed net income
1974	$12,100	$3,400	$8,700
1975	16,100	5,200	10,900
1976	6,100	1,360	4,740
1977	None	None	None
1978	10,100	2,640	7,460

The trust has no undistributed capital gain.

(b) Since the entire amount of the accumulation distribution for 1979 ($7,000) is less than the undistributed net income for 1974 ($8,700), an additional amount of $2,736 (7,000/8,700×$3,400) is deemed distributed under section 666(c).

(c) In allocating the accumulation distribution for 1980, the amount of undistributed net income for 1974 will reflect the accumulation distribution for 1979. The undistributed net income for 1974 will then be $1,700 and the taxes imposed on the trust for 1974 will be $664, determined as follows:

Undistributed net income as of the close of 1974	$8,700
Less: Accumulation distribution (1979)	7,000
Balance (undistributed net income as of the close of 1979)	1,700
Taxes imposed on the trust attributable to the undistributed net income as of the close of 1979 (1,700/8,700×$3,400)	664

(d) The accumulation distribution of $26,000 for 1980 is deemed to have been made on the last day of the preceding taxable years of the trust to the extent of $24,800, the total of the undistributed net income for such years, as shown in the tabulation below. In addition, $9,864, the total taxes imposed on the trust attributable to the undistributed net income for such years is also deemed to have been distributed on the last day of such years, as shown below:

Year	Undistributed net income	Taxes imposed on the trust
1974	$1,700	$664
1975	10,900	5,200
1976	4,740	1,360
1977	None	None
1978	7,460	2,640
1979	None	None

Example 2. (a) Under the terms of a trust instrument, the trustee has discretion to accumulate or distribute the income to X and to invade corpus for the benefit of X. The entire income of the trust is from royalties. Both X and the trust report on the calendar year basis. All of the income for 1974 was accumulated. The distributable net income of the trust for the taxable year 1974 is $20,100 and the income taxes paid by the trust for 1974 attributable to the undistributed net income are $7,260. All of the income for 1975 and 1976 was distributed and in addition the trustee made accumulation distributions within the meaning of section 665(b) of $5,420 for each year.

(b) The undistributed net income of the trust determined under section 665(a) as of the close of 1974, is $12,840, computed as follows:

Distributable net income	$20,100
Less: Taxes imposed on the trust attributable to the undistributed net income	7,260
Undistributed net income as of the close of 1974	12,840

(c) The accumulation distribution of $5,420 made during the taxable year 1975 is deemed under section 666(a) to have been made on December 31, 1974. Since this accumulation distribution is less than the 1974 undistributed net income of $12,840, a portion of the taxes imposed on the trust for 1974 is also deemed under section 666(c) to have been distributed on December 31, 1974. The total amount deemed to have been distributed to X on December 31, 1974 is $8,484, computed as follows:

Accumulation distribution	$5,420
Taxes deemed distributed (5,420/12,840×$7,260)	3,064
Total	8,484

(d) After the application of the provisions of subpart D to the accumulation distribution of 1975, the undistributed net income of the trust for 1974 is $7,420, computed as follows:

Undistributed net income as of the close of 1974	$12,840
Less: 1975 accumulation distribution deemed distributed on December 31, 1974 (paragraph (c) of this example)	5,420
Undistributed net income for 1974 as of the close of 1975	7,420

(e) The taxes imposed on the trust attributable to the undistributed net income for the taxable year 1974, as adjusted to give effect to the 1975 accumulation distribution, amount to $4,196, computed as follows:

Taxes imposed on the trust attributable to undistributed net income as of the close of 1974	$7,260

Less: Taxes deemed distributed in 1974	3,064
Taxes attributable to the undistributed net income determined as of the close of 1975	4,196

(f) The accumulation distribution of $5,420 made during the taxable year 1976 is, under section 666(a), deemed a distribution to X on December 31, 1974, within the meaning of section 661(a)(2). Since the accumulation distribution is less than the 1974 adjusted undistributed net income of $7,420, the trust is deemed under section 666(c) also to have distributed on December 31, 1974, a portion of the taxes imposed on the trust for 1974. The total amount deemed to be distributed on December 31, 1974, with respect to the accumulation distribution made in 1976, is $8,484, computed as follows:

Accumulation distribution	$5,420
Taxes deemed distributed (5,420/7,420×$4,196)	3,064
Total	8,484

(g) After the application of the provisions of subpart D to the accumulation distribution of 1976, the undistributed net income of the trust for 1974 is $2,000, computed as follows:

Undistributed net income for 1974 as of the close of 1975	$7,420
Less: 1976 accumulation distribution deemed distributed on December 31, 1974 (paragraph (f) of this example)	5,420
Undistributed net income for 1974 as of the close of 1976	2,000

(h) The taxes imposed on the trust attributable to the undistributed net income of the trust for the taxable year 1974, determined as of the close of the taxable year 1976, amount to $1,132 ($4,196 less $3,064).

[T.D. 7204, 37 FR 17145, Aug. 25, 1972]

§1.666(d)–1A Information required from trusts.

(a) *Adequate records required.* For all taxable years of a trust, the trustee must retain copies of the trust's income tax return as well as information pertaining to any adjustments in the tax shown as due on the return. The trustee shall also keep the records of the trust required to be retained by section 6001 and the regulations thereunder for each taxable year as to which the period of limitations on assessment of tax under section 6501 has not expired. If the trustee fails to produce such copies and records, and such failure is due to circumstances beyond the reasonable control of the trustee or any predecessor trustee, the trustee may reconstruct the amount of corpus, accumulated income, etc., from competent sources (including, to the extent permissible, Internal Revenue Service records). To the extent that an accurate reconstruction can be made for a taxable year, the requirements of this paragraph shall be deemed satisfied for such year.

(b) *Rule when information is not available*—(1) *Accumulation distributions.* If adequate records (as required by paragraph (a) of this section) are not available to determine the proper application of subpart D to an accumulation distribution made in a taxable year by a trust, such accumulation distribution shall be deemed to consist of undistributed net income earned during the earliest preceding taxable year (as defined in §1.665(e)–1A) of the trust in which it can be established that the trust was in existence. If adequate records are available for some years, but not for others, the accumulation distribution shall be allocated first to the earliest preceding taxable year of the trust for which there are adequate records and then to each subsequent preceding taxable year for which there are adequate records. To the extent that the distribution is not allocated in such manner to years for which adequate records are available, it will be deemed distributed on the last day of the earliest preceding taxable year of the trust in which it is established that the trust was in existence and for which the trust has no records. The provisions of this subparagraph may be illustrated by the following example:

Example. A trust makes a distribution in 1975 of $100,000. The trustee has adequate records for 1973, 1974, and 1975. The records show that the trust is on the calendar year basis, had distributable net income in 1975 of $20,000, and undistributed net income in 1974 of $15,000, and in 1973 of $16,000. The trustee has no other records of the trust except for a copy of the trust instrument showing that the trust was established on January 1, 1965. He establishes that the loss of the records was due to circumstances beyond his control. Since the distribution is made in 1975, the earliest "preceding taxable year", as defined in §1.665(e)–1A, is 1969. Since $80,000 of the distribution is an accumulation distribution, and $31,000 thereof is allocated to 1974 and

1973, $49,000 is deemed to have been distributed on the last day of 1969.

(2) *Taxes.* (i) If an amount is deemed under this paragraph to be undistributed net income allocated to a preceding taxable year for which adequate records are not available, there shall be deemed to be ‘‘taxes imposed on the trust’’ for such preceding taxable year an amount equal to the taxes that the trust would have paid if the deemed undistributed net income were the amount remaining when the taxes were subtracted from taxable income of the trust for such year. For example, assume that an accumulation distribution in 1975 of $100,000 is deemed to be undistributed net income from 1971, and that the taxable income required to produce $100,000 after taxes in 1971 would be $284,966. Therefore the amount deemed to be ‘‘taxes imposed on the trust’’ for such preceding taxable year is $184,966.

(ii) The credit allowed by section 667(b) shall not be allowed for any amount deemed under this subparagraph to be ‘‘taxes imposed on the trust.’’

[T.D. 7204, 37 FR 17146, Aug. 25, 1972]

§ 1.666(a)–1 Amount allocated.

(a)(1) If a trust other than a foreign trust created by a U.S. person makes an accumulation distribution in any taxable year, the distribution is included in the beneficiary’s gross income for that year to the extent of the undistributed net income of the trust for the preceding 5 years. It is therefore necessary to determine the extent to which there is undistributed net income for the preceding 5 years. For this purpose, an accumulation distribution made in any taxable year is allocated to each of the 5 preceding taxable years in turn, beginning with the most recent year, to the extent of the undistributed net income of each of those years. Thus, an accumulation distribution is deemed to have been made from the most recently accumulated income of the trust.

(2) If a foreign trust created by a U.S. person makes an accumulation distribution in any year after December 31, 1962, the distribution is included in the beneficiary’s gross income for that year to the extent of the undistributed net income of the trust for the trust’s preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. It is therefore necessary to determine the extent to which there is undistributed net income for such preceding taxable years. For this purpose, an accumulation distribution made in any taxable year is first allocated to each of such preceding taxable years in turn, beginning with the most recent year, to the extent of the undistributed net income of each of those years. Thus, an accumulation distribution is deemed to have been made from the most recently accumulated income of the trust.

(3) If a trust that is in part a foreign trust created by a U.S. person and in part a foreign trust created by a person other than a U.S. person makes an accumulation distribution in any year after December 31, 1962, the distribution is deemed made from the undistributed net income of the foreign trust created by a U.S. person in the proportion that the total undistributed net income for all preceding years of the foreign trust created by the U.S. person bears to the total undistributed net income for all years of the entire foreign trust. In addition, such distribution is deemed made from the undistributed net income of the foreign trust created by a person other than a U.S. person in the proportion that the total undistributed net income for all preceding years of the foreign trust created by a person other than a U.S. person bears to the total undistributed net income for all years of the entire foreign trust. Accordingly, an accumulation distribution of such a trust is composed of two portions with one portion relating to the undistributed net income of the foreign trust created by the U.S. person and the other portion relating to the undistributed net income of the foreign trust created by the person other than a U.S. person. For these purposes, each portion of an accumulation distribution made in any taxable year is first allocated to each of such preceding taxable years in turn, beginning with the most recent year, to the extent of the undistributed net income for the applicable foreign trust

for each of those years. Thus, each portion of an accumulation distribution is deemed to have been made from the most recently accumulated income of the applicable trust. If the foreign trust created by a U.S. person makes an accumulation distribution in any year after December 31, 1962, the distribution is included in the beneficiary's gross income for that year to the extent of the undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. If the foreign trust created by a person other than a U.S. person makes an accumulation distribution in any taxable year, the distribution is included in the beneficiary's gross income for that year to the extent of the undistributed net income of the trust for the preceding 5 years.

(b) If, before the application of the provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, to an accumulation distribution for the taxable year, there is no undistributed net income for a preceding taxable year, then no portion of the accumulation distribution is deemed distributed on the last day of such preceding taxable year. Thus, if an accumulation distribution is made during the taxable year 1960 and the trust had no undistributed net income for the taxable year 1959, then no portion of the 1960 accumulation distribution is deemed distributed on the last day of 1959. For purposes of subpart D, the term *5 preceding taxable years* includes only the 5 taxable years immediately preceding the taxable year in which the accumulation distribution is made and which are subject to part I (section 641 and following) of such subchapter J even though the trust has no undistributed net income during one or more of those years.

(c) Paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. In 1964, a domestic trust, reporting on the calendar year basis, makes an accumulation distribution of $25,000. In 1963, the trust had $7,000 of undistributed net income; in 1962, none; in 1961, $12,000; in 1960, $4,000; in 1959, $4,000. The accumulation distribution is deemed distributed $7,000 in 1963, none in 1962, $12,000 in 1961, $4,000 in 1960, and $2,000 in 1959.

Example 2. In 1964, a foreign trust created by a U.S. person, reporting on the calendar year basis, makes an accumulation distribution of $50,000. In 1963, the trust had $12,000 of undistributed net income; in 1962, none; in 1961, $10,000; in 1960, $8,000; in 1959, $5,000; in 1958, $14,000; in 1957, none; in 1956, $3,000; in 1955, $2,000; and in 1954, $1,000. The accumulation distribution is deemed distributed $12,000 in 1963, none in 1962, $10,000 in 1961, $8,000 in 1960, $5,000 in 1959, $14,000 in 1958, none in 1957, $1,000 in 1956.

Example 3. A trust is created in 1952 under the laws of Country X by the transfer to a trustee in Country X of money and property by both a U.S. person and a person other than a U.S. person. Both the trust and the only beneficiary of the trust (who is a U.S. person) report their taxable income on a calendar year basis. On March 31, 1964, the trust makes an accumulation distribution of $150,000 to the U.S. beneficiary. The distributable net income of both the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person for each year is computed in accordance with the provisions of paragraph (b)(3) of §1.643(d)–1 and the undistributed net income for each portion of the trust for each year is computed as described in paragraph (b) of §1.665(a)–1. For the taxable years 1952 through 1963, the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person had the following amounts of undistributed net income:

Year	Undistributed net income—portion of the trust created by a U.S. person	Undistributed net income—portion of the trust created by a person other than a U.S. person
1963	$20,000	$10,000
1962	25,000	12,000
1961	None	None
1960	16,000	9,000
1959	17,000	8,000
1958	4,000	2,000
1957	None	None
1956	8,000	3,000
1955	11,000	5,000
1954	None	None
1953	12,000	7,000
1952	7,000	4,000
Totals	120,000	60,000

The accumulation distribution in the amount of $150,000 is deemed to have been distributed in the amount of $100,000 (120,000/180,000×$150,000) from the portion of the trust which is a foreign trust created by a U.S. person, and in the amount of $50,000 (60,000/180,000×$150,000) from the portion of the trust which is a foreign trust created by a person other than a U.S. person computed as follows:

Year	Throwback to preceding years of foreign trust created by a U.S. person	Throwback to preceding years of portion of the entire foreign trust which is not a foreign trust created by a U.S. person
1963	$20,000	$10,000
1962	25,000	12,000
1961	None	None
1960	16,000	9,000
1959	17,000	8,000
1958	4,000	2,000
1957	None	None
1956	8,000	3,000
1955	10,000	5,000
1954	None	None
1953	None	1,000
1952	None	None
Totals	100,000	50,000

Pursuant to paragraph (a)(3) of this section, the accumulation distribution in the amount of $100,000 from the portion of the trust which is a foreign trust created by a U.S. person is included in the beneficiary's gross income for 1964, as this amount represents undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. The accumulation distribution in the amount of $50,000 from the portion of the trust which is a foreign trust created by a person other than a U.S. person is included in the beneficiary's gross income for 1964 to the extent of the undistributed net income of the trust for the preceding 5 years. Accordingly, with respect to the portion of the trust which is a foreign trust created by a person other than a U.S. person only the undistributed net income for the years 1959 through 1963 which totals $39,000 is includible in the beneficiary's gross income for 1964. Thus, of the $150,000 distribution made in 1964, the beneficiary is required to include a total of $139,000 in his gross income for 1964.

Example 4. Assume the same facts as in example 3 and, in addition, that by December 31, 1964, the undistributed net income for 1964 is determined to be $20,000, and that in accordance with the provisions of paragraph (b)(3) of § 1.643(d)–1 and paragraph (b) of § 1.665(a)–1, $10,000 is allocated to the portion of the trust which is a foreign trust created by a U.S. person and $10,000 is allocated to the portion of the trust which is a foreign trust created by a person other than a U.S. person. On March 31, 1965, the trust makes an accumulation distribution of $25,000 to the U.S. beneficiary. For the taxable years 1952 through 1964, the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person had the following amounts of undistributed net income:

Year	Undistributed net income—portion of the trust created by a U.S. person	Undistributed net income—portion of the trust created by a person other than a U.S. person
1964	$10,000	$10,000
1963	None	None
1962	None	None
1961	None	None
1960	None	None
1959	None	None
1958	None	None
1957	None	None
1956	None	None
1955	1,000	None
1954	None	None
1953	12,000	6,000
1952	7,000	4,000
Totals	30,000	20,000

The accumulation distribution is deemed to have been distributed in the amount of $15,000 (30,000/50,000×$25,000), from the portion of the trust which is a foreign trust created by a U.S. person, and in the amount of $10,000 (20,000/50,000×$25,000) from the portion of the trust which is a foreign trust created by a person other than a U.S. person computed as follows:

Year	Throwback to preceding years of foreign trust created by U.S. person	Throwback to preceding years of portion of the entire foreign trust which is not a foreign trust created by a U.S. person
1964	$10,000	$10,000
1963	None	None
1962	None	None
1961	None	None
1960	None	None
1959	None	None
1958	None	None
1957	None	None
1956	None	None
1955	1,000	None
1954	None	None
1953	4,000	None
1952	None	None
Totals	15,000	10,000

Pursuant to paragraph (a)(3) of this section, only $11,000 of the accumulation distribution in the amount of $15,000 from the portion of the trust which is a foreign trust created by a U.S. person is includible in the beneficiary's gross income for 1965 as the $11,000 amount represents undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. The accumulation distribution in the amount of $10,000 from the portion of the trust which is a foreign trust created by a person other than a U.S. person is included in the beneficiary's gross income for 1965 to the extent of the undistributed net income of the trust for the preceding 5 years. Accordingly, the entire $10,000 (representing the undistributed net income for the year 1964) is includible in the beneficiary's gross income for 1965. Thus, of the $25,000 distribution made in 1965, the beneficiary is required to include a total of $21,000 in his gross income for 1965.

(d) For the purposes of allocating to any preceding taxable year an accumulation distribution of the taxable year, the undistributed net income of such preceding taxable year is computed without regard to the accumulation distribution of the taxable year or of taxable years following the taxable year. However, accumulation distributions of any taxable years intervening between such preceding taxable year and the taxable year are taken into account. Accordingly, if a trust has undistributed net income for the taxable year 1954 and makes an accumulation distribution during the taxable year 1955, the undistributed net income for 1954 is computed without regard to the accumulation distribution for 1955 or any subsequent year. If the trust makes a further accumulation distribution for 1956, the undistributed net income for 1954 is computed without regard to the accumulation distribution for 1956 or subsequent years; but in determining the undistributed net income for 1954 for purposes of the 1956 accumulation distribution the accumulation distribution for 1955 will be taken into account.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 736, Jan. 17, 1969]

§1.666(b)–1 Total taxes deemed distributed.

(a) If an accumulation distribution is deemed under §1.666(a)–1 to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed net income for such preceding taxable year, then an additional amount equal to the ‘‘taxes imposed on the trust’’ (as defined in §1.665(d)–1) for such preceding taxable year is likewise deemed distributed under section 661(a)(2). For example, a trust has taxable income of $11,032 (not including any capital gains) and undistributed net income of $8,000 for the taxable year 1954. The taxes imposed on the trust are $3,032. During the taxable year 1955, an accumulation distribution of $8,000 is made to the beneficiary, which is deemed under §1.666(a)–1 to have been distributed on the last day of 1954. The taxes imposed on the trust for 1954 of $3,032 are also deemed to have been distributed on the last day of 1954 since the 1955 accumulation distribution is not less than the 1954 undistributed net income. Thus, a total of $11,032 will be deemed to have been distributed on the last day of 1954 because of the accumulation distribution of $8,000 made in 1955.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year is computed without regard to the accumulation distribution of the taxable year or any taxable year following such taxable year. However, any accumulation distribution of taxable years intervening between such preceding taxable year and the taxable year are taken into account. See paragraph (d) of §1.666(a)–1 and paragraphs (f)(5) and (g)(1) of §1.668(b)–2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 741, Jan. 17, 1969]

§1.666(c)–1 Pro rata portion of taxes deemed distributed.

(a) If an accumulation distribution is deemed under §1.666(a)–1 to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed net income for such preceding taxable year, then an additional amount is likewise deemed distributed under section 661(a)(2). The additional amount is equal to the taxes imposed on the trust, as defined in §1.665(d)–1, for such preceding taxable year, multiplied by the fraction of which the numerator is the amount of the accumulation distribution and the denominator is the undistributed net income for such preceding taxable year. See paragraph (b) of example 1 and paragraphs (c) and (f) of example 2 in §1.666(c)–2, and paragraph (f)(2) of §1.668(b)–2 for illustrations of this paragraph.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year is computed without regard to the accumulation distribution of the taxable year or any taxable year following the taxable year. However, accumulation distributions of any taxable years intervening between such preceding taxable year and the taxable year are taken into account. See paragraph (d) of § 1.666(a)–1, paragraph (c) of example 1 and paragraphs (e) and (h) of example 2 in § 1.666(c)–2 and paragraph (f)(5)(iii) of § 1.668(b)–2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 741, Jan. 17, 1969]

§ 1.666(c)–2 Illustration of the provisions of section 666.

The application of the provisions of §§ 1.666(a)–1, 1.666(b)–1, and 1.666(c)–1 may be illustrated by the following examples:

Example 1. (a) A trust makes accumulation distributions as follows:

1959	$7,000
1960	25,000

For 1954 through 1958, the undistributed portion of distributable net income taxes imposed on the trust, and undistributed net income are as follows:

Year	Undistributed portion of distributable net income	Taxes imposed on the trust	Undistributed net income
1958	$12,100	$3,400	$8,700
1957	16,100	5,200	10,900
1956	6,100	1,360	4,740
1955	None	None	None
1954	10,100	2,640	7,460

(b) Since the entire amount of the accumulation distribution for 1959 ($7,000), determined without regard to the accumulation distribution for 1960, is less than the undistributed net income for 1958 ($8,700), an additional amount of $2,736 (7,000/ 8,700×$3,400) is likewise deemed distributed under section 666(c).

(c) In allocating the accumulation distribution for 1960, the undistributed net income for 1958 will take into account the accumulation distribution for 1959, and the additional amount of taxes imposed on the trust for 1958 deemed distributed. The undistributed net income for 1958 will then be $1,906; and the taxes imposed on the trust for 1958 will then be $458, determined as follows:

Undistributed portion of distributable net income as of the close of 1958		$12,100
Less:		
Accumulation distribution (1959)	$7,000	
Taxes deemed distributed under section 666(c) (7,000/ 8,700×$3,400)	2,736	
		9,736
Balance (undistributed portion of distributable net income as of the close of 1959)		2,364
Less: Personal exemption		100
Balance		2,264
Taxes imposed on the trust (income taxes on $2,264)		458
Undistributed portion of distributable net income as of the close of 1959		2,364
Less: Income taxes attributable thereto		458
Undistributed net income for 1958 as of the close of 1959		1,906

(d) The accumulation distribution of $25,000 for 1960 is deemed to have been made on the last day of the 5 preceding taxable years of the trust to the extent of $17,546, the total of the undistributed net income for such years, as shown in the tabulation below. In addition, $7,018, the total taxes imposed on the trust for such years is also deemed to have been distributed on the last day of such years, as shown below:

Year	Undistributed net income	Taxes imposed on the trust
1959	None	None
1958	$1,906	$458
1957	10,900	5,200
1956	4,740	1,360
1955	None	None

(e) No portion of the 1960 accumulation distribution is deemed made on the last day of 1954 because, as to 1960, 1954 is the sixth preceding taxable year.

Example 2. (a) Under the terms of a trust instrument, the trustee has discretion to accumulate or distribute the income to X and to invade corpus for the benefit of X. The entire income of the trust is from royalties. Both X and the trust report on the calendar year basis. All of the income for 1954 was accumulated. The distributable net income of the trust for the taxable year 1954 is $20,100 and the income taxes paid by the trust for 1954 with respect to its distributable net income are $7,260. All of the income for 1955 and 1956 was distributed and in addition the trustee made accumulation distributions within the meaning of section 665(b) of $6,420 for each year.

(b) The undistributed net income of the trust determined under section 665(a) as of the close of 1954, is $12,840, computed as follows:

Distributable net income	$20,100
Less: Taxes imposed on the trust	7,260
Undistributed net income as of the close of 1954	12,840

(c) The accumulation distribution of $6,420 made during the taxable year 1955 is deemed under section 666(a) to have been made on December 31, 1954. Since this accumulation distribution is less than the 1954 undistributed net income of $12,840, a portion of the taxes imposed on the trust for 1954 is also deemed under section 666(c) to have been distributed on December 31, 1954. The total amount deemed to have been distributed to X on December 31, 1954, is $10,050, computed as follows:

Accumulation distribution	$6,420
Taxes deemed distributed (6,420/12,840×$7,260)	3,630
Total	10,050

(d) After the application of the provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, to the accumulation distribution of 1955, the undistributed portion of the distributable net income of the trust for 1954, is $10,050, and the taxes imposed with respect thereto are $2,623, computed as follows:

Distributable net income as of the close of 1954	$20,100
Less: 1955 accumulation distribution and taxes deemed distributed on December 31, 1954 (paragraph (c) of this example)	10,050
Undistributed portion of the 1954 distributable net income adjusted as of the close of 1955	10,050
Less: Personal exemption	100
Balance	9,950
Income taxes on $9,950	2,623

(e) The undistributed net income of the trust for the taxable year 1954, as adjusted to give effect to the 1955 accumulation distribution, is $7,427, computed as follows:

Undistributed portion of distributable net income as of the close of 1955	$10,050
Less: Income taxes applicable thereto	2,623
Undistributed net income determined as of the close of 1955	7,427

(f) Inasmuch as all of the income of the trust for the taxable year 1955 was distributed to X, the trust had no undistributed net income for that year. Accordingly, the accumulation distribution of $6,420 made during the taxable year 1956 is, under section 666(a), deemed a distribution to X on December 31, 1954, within the meaning of section 661(a)(2). Since this accumulation distribution is less than the 1954 adjusted undistributed net income of $7,427, the trust is deemed under section 666(c) also to have distributed on December 31, 1954, a portion of the taxes imposed on the trust for 1954. The total amount deemed to be distributed on December 31, 1954, with respect to the accumulation distribution made in 1956, is $8,687, computed as follows:

Accumulation distribution	$6,420
Taxes deemed distributed (6,420/7,427×$2,623)	2,267
Total	8,687

(g) After the application of the provisions of subpart D to the accumulation distribution of 1956, the undistributed portion of the distributable net income of the trust for 1954, is $1,363, and the taxes imposed on the trust with respect thereto are $253, computed as follows:

Undistributed portion of distributable net income as of the close of 1955	$10,050
Less: 1956 accumulation distribution and taxes deemed distributed on December 31, 1954 (paragraph (f) of this example)	8,687
Undistributed portion of distributable net income as of the close of 1956	1,363
Less: Personal exemption	100
Balance	1,263
Income taxes on $1,263	253

(h) The undistributed net income of the trust for the taxable year 1954, determined as of the close of the taxable year 1956, is $1,110 ($1,363 less $253).

§1.667–1 Denial of refund to trusts.

(a) If an amount is deemed under section 666 to be an amount paid, credited, or required to be distributed on the last day of a preceding taxable year, the trust is not allowed a refund or credit of the amount of ''taxes imposed on the trust'', as defined in §1.665(d)–1, which would not have been payable for the preceding taxable year had the trust in fact made such distribution on the last day of such year. However, such taxes are allowed as a credit under section 668(b) against the tax of the beneficiaries who are treated as having received the distributions in the preceding taxable year. The amount of taxes which may not be refunded or credited to the trust under this paragraph and which are allowed as a credit under section 668(b) against the tax of the beneficiaries, is an amount equal to the excess of:

(1) The taxes imposed on the trust (as defined in section 665(d) and §1.655(d)–1) for any preceding taxable year (computed without regard to the accumulation distribution for the taxable year) over

(2) The amount of taxes for such preceding taxable year which would be imposed on the undistributed portion of distributable net income of the trust for such preceding taxable year after the application of subpart D (section

665 and following), part I, subchapter J, chapter 1 of the Code, on account of the accumulation distribution determined for the taxable year.

It should be noted that the credit under section 667 is computed by the use of a different ratio from that used for computing the amount of taxes deemed distributed under section 666(c).

(b) Paragraph (a) of this section may be illustrated by the following examples:

Example 1. In 1954, a trust of which A is the sole beneficiary has taxable income of $20,000 (including capital gains of $5,100 allocable to corpus less a personal exemption of $100), on which a tax of $7,260 is paid.

The undistributed portion of distributable net income is $15,000, to which $6,160 of the tax is allocable under section 665. The undistributed net income is therefore $8,840 ($15,000 minus $6,160). In 1955, the trust makes an accumulation distribution of $8,840. Under section 666(b), the total taxes for 1954 attributable to the undistributed net income are deemed distributed, so $15,000 is deemed distributed. The amount of the tax which may not be refunded to the trust under section 667 and the credit to which A is entitled under section 668(b) is the excess of $6,160 over zero, since after the distribution and the application of subpart D there is no remaining undistributed portion of distributable net income for 1954.

Example 2. The same trust as in example 1 of this paragraph distributes $5,000 in 1955, rather than $8,840. The amount of the tax which may not be refunded to the trust but which is available to A as a credit is $4,044, computed as follows:

Accumulation distribution in 1955		$5,000
Taxes deemed distributed under section 666(c) (5,000/8,840×$6,160)		3,484
Total amount deemed distributed out of the undistributed portion of distributable net income		8,484
Tax attributable to the undistributed portion of distributable net income ($15,000) before 1955 distribution (see example 1 of this paragraph)		6,160
Tax on $11,516 (taxable income of $20,000 minus $8,484, amount deemed distributed)	$3,216	
Tax on $5,000 (capital gains of $5,100, less personal exemption of $100, allocable to corpus)	1,100	
Tax attributable to undistributed portion of distributable net income after 1955 distribution		2,116
Refund disallowed to the trust and credit available to A in 1955		4,044

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 741, Jan. 17, 1969]

§ 1.667(a)–1A Denial of refund to trusts.

If an amount is deemed under section 666 or 669 to be an amount paid, credited, or required to be distributed on the last day of a preceding taxable year, the trust is not allowed a refund or credit of the amount of ‘‘taxes imposed on the trust’’, as defined in § 1.665(d)–1A. However, such taxes imposed on the trust are allowed as a credit under section 667(b) against the tax of certain beneficiaries who are treated as having received the distributions in the preceding taxable year.

[T.D. 7204, 37 FR 17147, Aug. 25, 1972]

§ 1.667(b)–1A Authorization of credit to beneficiary for taxes imposed on the trust.

(a) *Determination of credit*—(1) *In general.* Section 667(b) allows under certain circumstances a credit (without interest) against the tax imposed by subtitle A of the Code on the beneficiary for the taxable year in which the accumulation distribution is required to be included in income under section 668(a). In the case of an accumulation distribution consisting only of undistributed net income, the amount of such credit is the total of the taxes deemed distributed to such beneficiary under section 666 (b) and (c) as a result of such accumulation distribution for preceding taxable years of the trust on the last day of which such beneficiary was in being, less the amount of such taxes for such preceding taxable years taken into account in reducing the amount of partial tax determined under § 1.668(b)–1A. In the case of an accumulation distribution consisting only of undistributed capital gain, the amount of such credit is the total of the taxes deemed distributed as a result of the accumulation distribution to such beneficiary under section 669 (d) and (e) for preceding taxable years of the trust on the last day of which such beneficiary was in being, less the amount of such taxes for such preceding taxable years taken into account in reducing the amount of partial tax determined under § 1.669(b)–1A. In the case of an accumulation distribution consisting of both undistributed net income and undistributed capital gain, a credit will not be available unless the total taxes deemed distributed to the beneficiary for all preceding taxable years as a result of the accumulation distribution exceeds the beneficiary's partial tax determined under §§1.668(b)–1A and 1.669(b)–1A without reference to the taxes deemed distributed. A credit is not allowed for any taxes deemed distributed as a result of an accumulation distribution to a beneficiary by reason of sections 666 (b) and (c) or sections 669 (d) and (e) for a preceding taxable year of the trust before the beneficiary was born or created. However, if as a result of an accumulation distribution the total taxes deemed distributed under sections 668(a)(2) and 668(a)(3) in preceding taxable years before the beneficiary was born or created exceed the partial taxes attributable to amounts deemed distributed in such years, such excess may be used to offset any liability for partial taxes attributable to amounts deemed distributed as a result of the same accumulation distribution in preceding taxable years after the beneficiary was born or created.

(2) *Exact method.* In the case of the tax computed under the exact method provided in §§1.668(b)–1A(b) and 1.669(b)–1A(b), the credit allowed by this section is computed as follows:

(i) Compute the total taxes deemed distributed under §§1.666(b)–1A and 1.666(c)–1A or §§1.669(d)–1A and 1.669(e)–1A, whichever are appropriate, for the preceding taxable years of the trust on the last day of which the beneficiary was in being.

(ii) Compute the total of the amounts of tax determined under §1.668(b)–1A(b)(1) or §1.669(b)–1A(b) (1), whichever is appropriate, for the prior taxable years of the beneficiary in which he was in being.

If the amount determined under subdivision (i) of this subparagraph does not exceed the amount determined under subdivision (ii) of this subparagraph, no credit is allowable. If the amount determined under subdivision (i) of this subparagraph exceeds the amount determined under subdivision (ii) of this subparagraph, the credit allowable is the lesser of the amount of such excess or the amount of taxes deemed distributed to the beneficiary for all preceding taxable years to the extent that such taxes are not used in §1.668(b)–1A(b)(2) or §1.669(b)–1A(b)(2) in determining the beneficiary's partial tax under section 668(a)(2) or 668(a)(3). The application of this subparagraph may be illustrated by the following example:

Example. An accumulation distribution made in 1975 is deemed distribution in 1973 and 1974, years in which the beneficiary was in being. The taxes deemed distributed in such years are $4,000 and $2,000, respectively, totaling $6,000. The amounts of tax computed under §1.668(b)–1A(b)(1) attributable to the amounts thrown back are $3,000 and $2,000, respectively, totaling $5,000. The credit allowable under this subparagraph is therefore $1,000 ($6,000 less $5,000).

(3) *Short-cut method.* In the case of the tax computed under the short-cut method provided in §1.668(b)–1A(c) or §1.669(b)–1A(c), the credit allowed by this section is computed as follows:

(i) Compute the total taxes deemed distributed in all preceding taxable years of the trust under §§1.666(b)–1A and 1.666(c)–1A or §§1.669(d)–1A and 1.669(e)–1A, whichever are appropriate.

(ii) Compute the beneficiary's partial tax determined under either §1.668(b)–1A(c)(1)(v) or §1.669(b)–1A (c)(1)(v), whichever is appropriate.

If the amount determined under subdivision (i) of this subparagraph does not exceed the amount determined under subdivision (ii) of this subparagraph, no credit is allowable. If the amount determined under subdivision (i) of this subparagraph exceeds the amount determined under subdivision (ii) of this subparagraph,

(iii) Compute the total taxes deemed distributed under §§1.666(b)–1A and 1.666(c)–1A or §§1.669(d)–1A and 1.669(e)–1A, which are appropriate, for the preceding taxable years of the trust on the last day of which the beneficiary was in being.

(iv) Multiply the amount by which subdivision (i) of this subparagraph exceeds subdivision (ii) of this subparagraph by a fraction, the numerator of which is the amount determined under subdivision (iii) of this subparagraph and the denominator of which is the amount determined under subdivision (i) of this subparagraph. The result is the allowable credit. The application of this subparagraph may be illustrated by the following example:

Example. An accumulation distribution that consists only of undistributed net income is made in 1975. The taxes deemed distributed in the preceding years under §§ 1.666(b)–1A and 1.666(c)–1A are $15,000. The amount determined under § 1.668(b)–1A(c)(1)(v) is $12,000. The beneficiary was in being on the last day of all but one preceding taxable year in which the accumulation distribution was deemed made, and the taxes deemed distributed in those years was $10,000. Therefore, the excess of the subdivision (i) amount over the subdivision (ii) amount is $3,000, and is multiplied by 10,000/15,000, resulting in an answer of $2,000, which is the credit allowable when computed under the short-cut method.

(b) *Year of credit.* The credit to which a beneficiary is entitled under this section is allowed for the taxable year in which the accumulation distribution (to which the credit relates) is required to be included in the income of the beneficiary under section 668(a). Any excess over the total tax liability of the beneficiary for such year is treated as an overpayment of tax by the beneficiary. See section 6401(b) and the regulations thereunder.

[T.D. 7204, 37 FR 17147, Aug. 25, 1972]

§ 1.668(a)–1A Amounts treated as received in prior taxable years; inclusion in gross income.

(a) Section 668(a) provides that the total of the amounts treated under sections 666 and 669 as having been distributed by the trust on the last day of a preceding taxable year of the trust shall be included in the income of the beneficiary or beneficiaries receiving them. The total of such amounts is includable in the income of each beneficiary to the extent the amounts would have been included under section 662 (a)(2) and (b) as if the total had actually been an amount properly paid by the trust under section 661 (a)(2) on the last day of such preceding taxable year. The total is included in the income of the beneficiary for the taxable year of the beneficiary in which such amounts are in fact paid, credited, or required to be distributed unless the taxable year of the beneficiary differs from the taxable year of the trust (see section 662(c) and the regulations thereunder). The character of the amounts treated as received by a beneficiary in prior taxable years, including taxes deemed distributed, in the hands of the beneficiary is determined by the rules set forth in section 662(b) and the regulations thereunder.

(b) Any deduction allowed to the trust in computing distributable net income for a preceding taxable year (such as depreciation, depletion, etc.) is not deemed allocable to a beneficiary because of amounts included in a beneficiary’s gross income under this section since the deduction has already been utilized in reducing the amount included in the beneficiary’s income.

(c) For purposes of applying section 668(a)(3), a trust shall be considered to be other than a ‘‘trust which is not required to distribute all of its income currently’’ for each taxable year prior to the first taxable year beginning after December 31, 1968, and ending after November 30, 1969, in which income is accumulated. Income will not be deemed to have been accumulated for purposes of applying section 668(a)(3) in a year if the trustee makes a determination, as evidenced by a statement on the return, to distribute all of the trust’s income for such year and also makes a good faith determination as to the amount of such income and actually distributed for such year the entire amount so determined. The term ‘‘income,’’ as used in the preceding two sentences, is defined in §§ 1.643(b)–1 and 1.643(b)–2. Since, under such definitions, certain items may be included in distributable net income but are not, under applicable local law, ‘‘income’’ (as, for example, certain extraordinary dividends), a trust that has undistributed net income from such sources might still qualify as a trust that has not accumulated income. Also, for example, if a trust establishes a reserve for depreciation or depletion and applicable local law permits the deduction for such reserve in the computation of ‘‘income,’’ amounts so added to the reserve do not constitute an accumulation of income. If a trust has separate shares, and any share accumulates income, all shares of the trust will be considered to have accumulated income for purposes of section 668(a)(3). Amounts retained by a trust or a portion of a trust that is subject to subpart E (sections 671–678) shall not be considered accumulated income.

(d) See section 1302(a)(2)(B) to the effect that amounts included in the income of a beneficiary of a trust under section 668(a) are not eligible for income averaging.

[T.D. 7204, 37 FR 17148, Aug. 25, 1972]

§1.668(a)–2A Allocation among beneficiaries; in general.

The portion of the total amount includible in income under §1.668(a)–1A which is includible in the income of a particular beneficiary is based upon the ratio determined under the second sentence of section 662(a)(2) for the taxable year (and not for the preceding taxable year). This section may be illustrated by the following example:

Example. (a) Under the terms of a trust instrument, the trustee may accumulate the income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. The distributable net income of the trust for taxable year 1975 is $10,000. The trust had undistributed net income for taxable year 1973, the first year of the trust, of $5,000, to which a tax of $1,100 was allocable. On May 1, 1975, the trustee distributes $10,000 to A, and on November 29, 1975, he distributes $5,000 to B. Thus, of the total distribution of $15,000, A received two-thirds and B receives one-third.

(b) For the purposes of determining the amounts includible in the beneficiaries' gross income for 1975, the trust is deemed to have made the following distributions:

Amount distributed out of 1975 income (distributable net income)	$10,000
Accumulation distribution deemed distributed by the trust on the last day of 1973 under section 666(a)	5,000
Taxes imposed on the trust attributable to the undistributed net income deemed distributed under section 666(b)	1,100

(c) A will include in his income for 1975 two-thirds of each item shown in paragraph (b) of this example. Thus, he will include in gross income $6,666.67 (10,000/15,000× $10,000) of the 1975 distributable net income of the trust as provided in section 662(a)(2) (which is not an amount includable in his income under §1.668(a)–1A(a)). He will include in his income $3,333.33 (10,000/15,000×$5,000) of the accumulation distribution and $733.33 (10,000/15,000× $1,100) of the taxes imposed on the trust, as provided in section 668(a).

(d) B will include in his income for 1975 one-third of each item shown in paragraph (b) of this example, computed in the manner shown in paragraph (c) of this example.

(e) To the extent the total accumulation distribution consists of undistributed net income and undistributed capital gain, A and B shall be treated as receiving a pro rata share of each for the preceding taxable year 1973.

[T.D. 7204, 37 FR 17148, Aug. 25, 1972]

§1.668(a)–3A Determination of tax.

In a taxable year in which an amount is included in a beneficiary's income under §1.668(a)–1A(a), the tax on the beneficiary for such taxable year is determined only as provided in section 668 and consists of the sum of:

(a) A partial tax computed on (1) the beneficiary's taxable income reduced by (2) an amount equal to the total amounts includible in his income under §1.668(a)–1A(a), at the rate and in the manner as if section 668 had not been enacted,

(b) A partial tax determined as provided in §1.668(b)–1A, and

(c) In the case of a beneficiary of a trust which is not required to distribute all of its income currently, a partial tax determined as provided in §1.669(b)–1A.

[T.D. 7204, 37 FR 17148, Aug. 25, 1972]

§1.668(b)–1A Tax on distribution.

(a) *In general.* The partial tax imposed on the beneficiary by section 668(a)(2) shall be the lesser of:

(1) The tax computed under paragraph (b) of this section (the ‘‘exact'' method), or

(2) The tax computed under paragraph (c) of this section (the ‘‘shortcut'' method),

except as provided in §1.668(b)–4A (relating to failure to furnish proper information) and paragraph (d) of this section (relating to disallowance of short-cut method). For purposes of this paragraph, the method used in the return shall be accepted as the method that produces the lesser tax. The beneficiary's choice of the two methods is not dependent upon the method that he uses to compute his partial tax imposed by section 668(a)(3).

(b) *Computation of partial tax by the exact method.* The partial tax referred to in paragraph (a)(1) of this section is computed as follows:

(1) First, compute the tax attributable to the section 666 amounts for each of the preceding taxable years.

For purposes of this paragraph, the ‘‘section 666 amounts’’ for a preceding taxable year are the amounts deemed distributed under section 666(a) on the last day of the preceding taxable year, plus the amount of taxes deemed distributed on such day under section 666 (b) or (c). The tax attributable to such amounts in each prior taxable year of the beneficiary is the difference between the tax for such year computed with the inclusion of the section 666 amounts in the beneficiary's gross income and the tax for such year computed without including them in such gross income. Tax computations for each such year shall reflect a taxpayer's marital, dependency, exemption, and filing status for such year. To the extent the undistributed net income of a trust deemed distributed in an accumulation distribution includes amounts received as an accumulation distribution from another trust, for purposes of this paragraph they shall be considered as amounts deemed distributed by the trust under section 666(a) on the last day of each of the preceding taxable years in which such amounts were accumulated by such other trust. For example, assume trust Z, a calendar year trust, received in its taxable year 1975 an accumulation distribution from trust Y, a calendar year trust, that included undistributed net income and taxes of trust Y for the taxable years 1972, 1973, and 1974. To the extent an accumulation distribution made by trust Z in its taxable year 1976 includes such undistributed net income and taxes, it shall be considered an accumulation distribution by trust Z in the taxable year 1976 and under section 666(a) will be deemed distributed on the last day of the preceding taxable years 1972, 1973, and 1974.

(2) From the sum of the taxes for the prior taxable years attributable to the section 666 amounts (computed in accordance with subparagraph (1) of this paragraph), subtract so much of the amount of taxes deemed distributed to the beneficiary under §§ 1.666(b)–1A and 1.666(c)–1A as does not exceed such sum. The resulting amount, if any, is the partial tax, computed under the exact method, for the taxable year in which the accumulation distribution is paid, credited, or required to be distributed to the beneficiary.

(3) The provisions of this paragraph may be illustrated by the following example:

Example. (i) Assume that in 1979 a trust makes an accumulation distribution of $15,000 to A. The accumulation distribution is allocated under section 666(a) in the amounts of $5,000 to 1971, $4,000 to 1972, and $6,000 to 1973. Under section 666 (b) and (c), taxes in the amounts of $935, $715, and $1,155 (totaling $2,805) are deemed distributed in 1971, 1972, and 1973, respectively.

(ii) A, the beneficiary, had taxable income and paid income tax in 1971–73 as follows:

Year	Taxable income	Tax
1971	$10,000	$2,190
1972	12,000	2,830
1973	14,000	3,550

(iii) Taxes attributable to the section 666 amounts (paragraph (i) of this example) are $6,979, computed as follows:

1971		
Taxable income including section 666 amounts ($10,000 + $5,000 + $935)	$15,935	
Tax on $15,935		$4,305
Less: Tax paid by A in 1971		2,190
Tax attributable to 1971 section 666 amounts		2,115
1972		
Taxable income including section 666 amounts ($12,000 + $4,000 + $715)	$16,715	
Tax on $16,715		$4,620
Less: Tax paid by A in 1972		2,830
Tax attributable to 1972 section 666 amounts		1,790
1973		
Taxable income including section 666 amounts ($14,000 + $6,000 + $1,155)	$21,155	
Tax on $21,155		$6,624
Less: Tax paid by A in 1973		3,550
Tax attributable to 1973 section 666 amounts		3,074
Total tax attributable to section 666 amounts:		
1971	$2,115	
1972	1,790	
1973	3,074	
Total	6,979	

(iv) The partial tax computed under the exact method is $4,174, computed by subtracting the taxes deemed distributed ($2,805) from the tax attributable to the section 666 amounts ($6,979).

(c) *Computation of tax by the short- cut method.* (1) The tax referred to in paragraph (a)(2) of this section is computed as follows:

(i) First, determine the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed. For purposes of the preceding sentence, the preceding taxable years of a trust that has received an accumulation distribution from another trust shall include the taxable years of such other trust in which an amount was deemed distributed in such accumulation distribution. For example, assume trust Z, a calendar year trust, received in its taxable year 1975 an accumulation distribution from trust Y, a calendar year trust, that included undistributed net income of trust Y for the taxable years 1972, 1973, and 1974. To the extent an accumulation distribution made by trust Z in its taxable year 1976 includes such undistributed net income, it shall be considered an accumulation distribution by trust Z in the taxable year 1976 and under section 666(a) will be deemed distributed on the last day of the preceding taxable years 1972, 1973, and 1974. For purposes of this subparagraph, such number of preceding taxable years of the trust shall not include any preceding taxable year of the trust in which the undistributed net income deemed distributed is less than 25 percent of *(a)* the total amounts deemed under section 666(a) to be undistributed net income from preceding taxable years divided by *(b)* the number of such preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed without application of this sentence. For example, assume that an accumulation distribution of $90,000 made to a beneficiary in 1979 is deemed distributed in the amounts of $29,000 in each of the years 1972, 1973, and 1974, and $3,000 in 1975. The number of preceding taxable years on the last day of which an amount was deemed distributed without reference to the second sentence of this subparagraph is four. However, the distribution deemed made in 1975 ($3,000) is less than $5,625, which is 25 percent of *(a)* the total undistributed net income deemed distributed under section 666(a) ($90,000) divided by *(b)* the number of such preceding taxable years (4), or $22,500. Therefore, for purposes of this subparagraph the accumulation distribution is deemed distributed in only 3 preceding taxable years (1972, 1973, and 1974).

(ii) Second, divide the amount (representing the accumulation distribution and taxes deemed distributed) required under section 668(a) to be included in the income of the beneficiary for the taxable year by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed (determined as provided in subdivision (i) of this subparagraph). The amount determined under this subdivision, including taxes deemed distributed, consists of the same proportion of each class of income as the total of each class of income deemed distributed in the accumulation distribution bears to the total undistributed net income from such preceding taxable years deemed distributed in the accumulation distribution. For example, assume that an amount of $50,000 is deemed distributed under section 666(a) from undistributed net income of 5 preceding taxable years of the trust, and consists of $25,000 of interest, $15,000 of dividends, and $10,000 of net rental income. Taxes attributable to such amounts in the amount of $10,000 are also deemed distributed. The amount determined under this subdivision, $12,000 ($50,000 income plus $10,000 tax divided by 5 years), is deemed to consist of $6,000 in interest, $3,600 in dividends, and $2,400 in net rental income.

(iii) Third, compute the tax of the beneficiary for each of the 3 taxable years immediately preceding the year in which the accumulation distribution is paid, credited, or required to be distributed to him,

(a) With the inclusion in gross income of the beneficiary for each of such 3 years of the amount determined under subdivision (ii) of this subparagraph, and

(b) Without such inclusion.

The difference between the amount of tax computed under *(a)* of this subdivision for each year and the amount computed under *(b)* of this subdivision for that year is the additional tax resulting from the inclusion in gross income for that year of the amount determined under subdivision (ii) of this subparagraph. For example, assume that a distribution of $12,000, is includible in the income of each of the beneficiary's 3 preceding taxable years when his income (without the inclusion of the accumulation distribution) was $20,000, $30,000, and $40,000. The inclusion of $12,000 in income would produce taxable income of $32,000, $42,000, and $52,000, and the tax attributable to such increases would be $4,000, $5,000, and $6,000, respectively.

(iv) Fourth, add the additional taxes resulting from the application of subdivision (iii) of this subparagraph and then divide this amount by 3. For example, if these additional taxes are $4,000, $5,000, and $6,000 for the 3 preceding taxable years, this amount would be $5,000 ($4,000+$5,000+ $6,000 divided by 3).

(v) Fifth, the resulting amount is then multiplied by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed (previously determined under subdivision (i) of this subparagraph). For example, if an amount is deemed distributed for 5 preceding taxable years, the resulting amount would be five times the $5,000 amount.

(vi) Sixth, the resulting amount, less so much of the amount of taxes deemed distributed to the beneficiary under §§ 1.666(b)–1A and 1.666(c)–1A as does not exceed such resulting amount, is the tax under the short-cut method provided in section 668(b)(1)(B).

(2) The computation of the tax by the short-cut method may be illustrated by the following example:

Example: In 1971, X creates a trust which is to accumulate its income and pay the income to Y when Y reaches 30. Y is 19. Over the 11 years of the trust, the trust earns $1,200 of interest income annually and has expenses each year of $100 allocable to the production of income. The trust pays a total tax of $1,450 on the accumulated income. In 1981, when Y reaches 30, the $9,550 of accumulated undistributed net income and the $1,100 of current net income are distributed to Y. Y is treated as having received a total distribution of $11,000 (the $9,550 accumulation distribution plus the taxes paid by the trust which are deemed to have been distributed to Y). The income of the current year (1981) is taxed directly to Y. The computation is as follows: $11,000 (accumulation distribution plus taxes) divided by 10 (number of years out of which distribution was made) equals $1,100. The $1,100 added to the income of the beneficiary's preceding 3 years produces increases in tax as follows:

1980	$350
1979	300
1978	250
Total	900

$900 (total additional tax) divided by 3 equals $300 (average annual increase in tax). $300 (average annual increase in tax) times 10 equals $3,000, from which is deducted the amount of taxes ($1,450) paid by the trust attributable to the undistributed net income deemed distributed. The amount of tax to be paid currently under the short-cut method is therefore $1,550.

(d) *Disallowance of short-cut method.* If, in any prior taxable year of the beneficiary in which any part of the accumulation distribution of undistributed net income is deemed to have been distributed under section 666(a) to such beneficiary, any part of prior accumulation distributions of undistributed net income by each of two or more other trusts is deemed under section 666(a) to have been distributed to such beneficiary, then the short-cut method under paragraph (c) of this section may not be used and the partial tax imposed by section 668(a)(2) shall be computed only under the exact method under paragraph (b) of this section. For example, assume that, in 1978, trust X makes an accumulation distribution of undistributed net income to A, who is on the calendar year basis, and part of the accumulation distribution is deemed under section 666(a) to have been distributed on March 31, 1974. In 1977, A had received an accumulation distribution of undistributed net income from both trust Y and trust Z. Part of the accumulation distribution from trust Y was deemed under section 666(a) to have been distributed to A on June 30, 1974, and part of the accumulation distribution from trust Z was deemed under section 666(a) to have been distributed to A on December 31, 1974. Because there were portions of accumulation distributions of undistributed net income from two other trusts deemed distributed within the same prior taxable year of A (1974), the 1978 accumulation distribution from trust X may not be computed under the short-cut method provided in paragraph (c) of this section. Therefore the exact method under paragraph (b) of this section must be used to compute the tax imposed by section 666(a)(2).

[T.D. 7204, 37 FR 17149, Aug. 25, 1972]

§1.668(b)–2A Special rules applicable to section 668.

(a) *Rule when beneficiary not in existence on the last day of a taxable year.* If a beneficiary was not in existence on the last day of a preceding taxable year of the trust with respect to which a distribution is deemed made under section 666(a), it shall be assumed, for purposes of the computations under paragraphs (b) and (c) of §1.668(b)–1A, that the beneficiary:

(1) Was in existence on such last day,

(2) Was a calendar year taxpayer,

(3) Had no gross income other than the amounts deemed distributed to him from such trust in his calendar year in which such last day occurred and from all other trusts from which amounts are deemed to have been distributed to him in such calendar year,

(4) If an individual, was unmarried and had no dependents,

(5) Had no deductions other than the standard deduction, if applicable, under section 141 for such calendar year, and

(6) Was entitled to the personal exemption under section 151 or 642(b).

For example, assume that part of an accumulation distribution made in 1980 is deemed under section 666(a) to have been distributed to the beneficiary, A, in 1973; $10,000 of a prior accumulation distribution was deemed distributed in 1973. A was born on October 9, 1975. It will be assumed for purposes of §1.668(b)–1A that A was alive in 1973, was on the calendar year basis, had no income other than (i) the $10,000 from the earlier accumulation distribution deemed distributed in 1973, and (ii) the part of the 1980 distribution deemed distributed in 1973, and had no deductions other than the personal exemption provided in section 151. It should be noted that the standard deduction for 1973 will be available to A with respect to the distribution only to the extent it qualifies as ‘‘earned income’’ in the hands of the trust. See section 141(e) and the regulations thereunder and §1.652(b)–1. If A were a trust or estate created after 1973, the same assumptions would apply, except that the trust or estate would not be entitled to the standard deduction and would receive the personal exemption provided under section 642(b) in the same manner as allowed under such section for A’s first actual taxable year.

(b) *Effect of other distributions.* The income of the beneficiary, for any of his prior taxable years for which a tax is being recomputed under §1.668(b)–1A, shall include any amounts of prior accumulation distributions (including prior capital gain distributions) deemed distributed under sections 666 and 669 in such prior taxable year. For purposes of the preceding sentence, a ‘‘prior accumulation distribution’’ is a distribution from the same or another trust which was paid, credited, or required to be distributed in a prior taxable year of the beneficiary. The term ‘‘prior accumulation distribution’’ also includes accumulation distributions of other trusts which were paid, credited, or required to be distributed to the beneficiary in the same taxable year and which the beneficiary has determined under paragraph (c) of this section to treat as having been distributed before the accumulation distribution for which tax is being computed under §1.668(b)–1A. Any capital gain distribution from the same trust paid, credited, or required to be distributed in the same taxable year of the beneficiary shall not be considered under this paragraph to be a ‘‘prior capital gain distribution.’’

(c) *Multiple distributions in the same taxable year.* For purposes of paragraph (b) of this section, accumulation distributions made from more than one trust in the same taxable year of the beneficiary, regardless of when in the taxable year they were actually made, shall be treated as having been made consecutively, in whichever order the beneficiary may determine. However, the beneficiary must treat them as having been made in the same order for the purpose of computing the partial tax on the several accumulation distributions. The beneficiary shall indicate the order he has determined to deem the accumulation distributions to have been received by him on his return for the taxable year. A failure by him so to indicate, however, shall not affect his right to make such determination. The purpose of this rule is to assure that the tax resulting from the later (as so deemed under this paragraph) distribution is computed with the inclusion of the earlier distribution in the taxable base and that the tax resulting from the earlier (as so deemed under this paragraph) distribution is computed with the later distribution excluded from the taxable base.

(d) *Examples.* The provisions of paragraphs (b) and (c) of this section may be illustrated by the following examples:

Example 1. In 1978, trust X made an accumulation distribution of undistributed net income to A, a calendar year taxpayer, of which $3,000 was deemed to have been distributed in 1974. In 1980, trust X makes another accumulation distribution of undistributed net income to A, $10,000 of which is deemed under section 666 to have been distributed in 1974. Also in 1980, trust Y makes an accumulation distribution of undistributed net income to A, of which $5,000 is deemed under section 666 to have been distributed in 1974. A determines to treat the 1980 distribution from trust Y as having been made prior to the 1980 distribution from trust X. In computing the tax on the 1980 trust Y distribution, A's gross income for 1974 includes (i) the $3,000 deemed distributed from the 1978 distribution, and (ii) the $5,000 deemed distributed in 1974 from the 1980 trust Y accumulation distribution. To compute A's tax under the exact method for 1974 on the $10,000 from the 1980 trust X accumulation distribution deemed distributed in 1974, A's gross income for 1974 includes (i) the $10,000, (ii) the $3,000 previously deemed distributed in 1974 from the 1978 trust X accumulation distribution, and (iii) the $5,000 deemed distribution in 1974 from the 1980 trust Y accumulation distribution.

Example 2. In 1978, trust T makes an accumulation distribution of undistributed net income to B, a calendar year taxpayer. Determination of the tax on the accumulation distribution under the short-cut method requires the use of B's gross income for 1975, 1976, and 1977. In 1977, B received an accumulation distribution of undistributed net income from trust U, of which $2,000 was deemed to have been distributed in 1975, and $3,000 in 1976. B's gross income for 1975, for purposes of using the short-cut method to determine the tax from the trust T accumulation distribution, will be deemed to include the $2,000 deemed distributed in 1975 by trust U, and his gross income for 1976 will be deemed to include the $3,000 deemed distributed by trust U in 1976.

[T.D. 7204, 37 FR 17151, Aug. 25, 1972]

§ 1.668(b)–3A Computation of the beneficiary's income and tax for a prior taxable year.

(a) *Basis for computation.* (1) The beneficiary's income and tax paid for any prior taxable year for which a recomputation is involved under either the exact method or the short-cut method shall be determined by reference to the information required to be furnished by him under § 1.668(b)–4A(a). The gross income, related deductions, and taxes paid for a prior taxable year of the beneficiary as finally determined shall be used for computation purposes. The term ''as finally determined'' has reference to the final status of the gross income, deductions, credits, and taxes of the taxable year after the expiration of the period of limitations or after completion of any court action regarding the tax for the taxable year.

(2) If any computations rely on the beneficiary's return for a prior taxable year for which the applicable period of limitations on assessment under section 6501 has expired, and such return shows a mathematical error on its face which resulted in the wrong amount of tax being paid for such year, the determination of both the tax for such year computed with the inclusion of the section 666 amount in the beneficiary's gross income and the tax for such year computed without including such amounts in such gross income shall be based upon the return after the correction of such mathematical errors, and the beneficiary shall be credited for the correct amount of tax that should have been properly paid.

(b) *Effect of allocation of undistributed net income on items based on amount of income and with respect to a net operating loss, a charitable contributions carryover, or a capital loss carryover.* (1) In computing the tax for any taxable year under either the exact method or the short-cut method, any item which depends upon the amount of gross income, adjusted gross income, or taxable income shall be recomputed to take into consideration the amount of undistributed net income allocated to such year. For example, if $1,000 of undistributed net income is allocated to 1970, adjusted gross income for 1970 is increased from $5,000 to $6,000. The allowable 50 percent charitable deduction under section 170(b)(1)(A) is then increased and the amount of the nondeductible medical expenses under section 213 (3 percent of adjusted gross income) is also increased.

(2) In computing the tax attributable to the undistributed net income deemed distributed to the beneficiary in any of his prior taxable years under either the exact method or the short-cut method, the effect of amounts of undistributed net income on a net operating loss carryback or carryover, a charitable contributions carryover, or a capital loss carryback or carryover, shall be taken into account. In determining the amount of tax attributable to such deemed distribution, a computation shall also be made for any taxable year which is affected by a net operating loss carryback or carryover, by a charitable contributions carryover, or by a capital loss carryback or carryover determined by reference to the taxable year to which amounts are allocated under either method and which carryback or carryover is reduced or increased by such amounts so allocated. The provisions of this subparagraph may be illustrated by the following example:

Example. In 1978, a trust makes an accumulation distribution of undistributed net income to X of $50,000 that is deemed under section 666(a) to have been distributed in 1972. X had income in 1972, 1973, and 1973, and had a net operating loss in 1975 that offset his taxable income (computed as provided in §1.172–5) for those years, as follows:

Year	Actual income (or loss)	Income after net operating loss carryback (n.o.l.c.b.)
1972	$10,000	$0
1973	50,000	0
1974	50,000	10,000
1975	(100,000)	0

As a result of the allocation of the 1973 accumulation distribution to 1972, X's income for 1972, 1973, 1974, and 1975, after taking into account the 1975 n.o.l.c.b., is deemed to be as follows:

Year	Income deemed to have been earned after consideration of n.o.l.c.b., and accumulation distribution
1972	0 ($10,000+$50,000 – $60,000 n.o.l.c.b.).
1973	$10,000 ($50,000 – $40,000 balance of n.o.l.c.b.).
1974	$50,000.
1975	0.

Therefore, the tax on the 1978 accumulation distribution to X is the tax X would have paid in 1973 and 1974 had he had the above income in such years.

(c) *Averaging.* A beneficiary who uses the exact method may recompute his tax for a prior taxable year by using income averaging for all of his actual income for that year, plus the amount deemed distributed in that year under section 666, even though he may not have actually used section 1301 to determine his income tax for such taxable year. For purposes of such recomputation, the beneficiary's income for all other taxable years involved must include any amounts deemed distributed in such years from the current and all prior accumulation distributions. See §1.668(b)–4A(c)(3) for additional information requirements. The beneficiary may not apply the provisions of this paragraph to a taxable year in which an amount is deemed to be income by reason of §1.666(d)–1A(b). The accumulation distribution itself is not eligible for income averaging in the years in which it is paid, credited, or required to be distributed. See section 1302 (a)(2)(B) and the regulations thereunder.

[T.D. 7204, 37 FR 17151, Aug. 25, 1972]

§1.668(b)–4A Information requirements with respect to beneficiary.

(a) *Information to be supplied by beneficiary*—(1) *In general.* The beneficiary must supply the information required by subparagraph (3) of this paragraph for any prior taxable year for which a recomputation is required under either the exact method or the short-cut method. Such information shall be filed with the beneficiary's return for the year in which the tax under section 668(a)(2) is imposed.

(2) *Failure to furnish.* If the beneficiary fails to furnish the information required by this paragraph for any prior year involved in the exact method, he may not use such method and

the tax computed under paragraph (c) of § 1.668(b)–1A (the short-cut method) shall be deemed to be the amount of partial tax imposed by section 668(a)(2). See, however, paragraph (b) of this section for an exception to this rule where the short-cut method is not permitted. If he cannot furnish the information required for a prior year involved in the short-cut method, such year will be recomputed on the basis of the best information available.

(3) *Information required.* The beneficiary shall file the following items with his income tax return for the taxable year in which the accumulation distribution is included in income:

(i) A statement showing the gross income, adjustments, deductions, credits, taxes paid, and computations for each of his taxable years for which a computation is required under the method by which he computes his partial tax imposed by section 668(a)(2). Such statement shall include such amounts for the taxable year as adjusted by any events subsequent to such year, such as any adjustment resulting from the determination of a deficiency or an overpayment, or from a court action regarding the tax.

(ii) A copy of the statement required by this subparagraph to be furnished by the beneficiary for any prior taxable year in which an accumulation distribution was received by him which was also deemed distributed in whole or in part in the prior taxable year for which the statement under subdivision (i) of this subparagraph is required.

(iii) A copy of any statements furnished the beneficiary by the trustee (such as schedules E and J of Form 1041, etc.) with regard to the current taxable year or any prior taxable year for which a statement is furnished under subdivision (i) of this subparagraph.

(b) *Exception.* If by reason of § 1.668(b)–1A(e) the beneficiary may not compute the partial tax on the accumulation distribution under § 1.668(b)–1A(c) (the short-cut method), the provisions of subparagraph (2) of paragraph (a) of this section shall not apply. In such case, if the beneficiary fails to provide the information required by subparagraph (3) of paragraph (a) of this section for any prior taxable year, the district director shall, by utilizing whatever information is available to him (including information supplied by the beneficiary), determine the beneficiary's income and related expenses for such prior taxable year.

(c) *Records to be supplied by the beneficiary*—(1) *Year when return was filed.* If the beneficiary filed an income tax return for a taxable year for which a recomputation is necessary, and the period of limitations on assessment under section 6501 for such year has expired as of the filing of the return for the year in which the accumulation distribution was made, then a copy of such return, plus proof of any changes of liability for such year due to the determination of a deficiency or an overpayment, court action, etc., shall, to the extent they verify the statements required under paragraph (a) of this section, serve as proof of such statements. If the period of limitations on assessment under section 6501 for a prior taxable year has not expired as of the filing of the beneficiary's return for the year in which the accumulation distribution was received, then the records required by section 6001 to be retained by the beneficiary for such prior taxable year shall serve as the basis of proof of the statements required to be filed under paragraph (a) of this section.

(2) *Year for which no return was filed.* If the beneficiary did not file a return for a taxable year for which a recomputation is necessary, he shall be deemed to have had in such year, in the absence of proof to the contrary, gross income in the amount equal to the maximum amount of gross income that he could have received without having had to file a return under section 6012 for such year.

(3) *Distributions deemed averaged.* In order for a beneficiary to use income averaging with respect to a prior taxable year (see § 1.668(b)–3A(c)), he must furnish all the information that would support the computation under section 1301 as if the distribution were actually received and averaged in such prior taxable year, even if a portion of the information relates to years in which no amount was deemed distributed to the beneficiary.

[T.D. 7204, 37 FR 17152, Aug. 25, 1972]

§1.668(a)–1 Amounts treated as received in prior taxable years; inclusion in gross income.

(a) Section 668(a) provides that the total of the amounts treated under section 666 as having been distributed by the trust on the last day of a preceding taxable year of the trust shall be included in the gross income of the beneficiary or beneficiaries receiving them. The total of such amounts is includible in the gross income of each beneficiary to the extent the amounts would have been included under section 662 (a)(2) and (b) if the total had actually been paid by the trust on the last day of such preceding taxable year. The total is included in the gross income of the beneficiary for the taxable year of the beneficiary in which such amounts are in fact paid, credited, or required to be distributed unless the taxable year of the beneficiary differs from the taxable year of the trust (see section 662(c) and the regulations thereunder). The character of the amounts treated as received by a beneficiary in prior taxable years, including taxes deemed distributed, in the hands of the beneficiary is determined by the rules set forth in section 662(b) and the regulations thereunder. See paragraphs (h)(1)(ii) and (j)(1)(ii) of §1.668(b)–2.

(b) The total of the amounts treated under section 666 as having been distributed by the trust on the last day of a preceding taxable year of the trust are included as prescribed in paragraph (a) of this section in the gross income of the beneficiary even though as of that day the beneficiary would not have been entitled to receive them had they actually been distributed on that day.

(c) Any deduction allowed to the trust in computing distributable net income for a preceding taxable year (such as depreciation, depletion, etc.) is not deemed allocable to a beneficiary because of amounts included in a beneficiary's gross income under this section since the deduction has already been utilized in reducing the amount included in the beneficiary's income.

§1.668(a)–2 Allocation among beneficiaries; in general.

The portion of the total amount includible in gross income under §1.668 (a)–1 which is includible in the gross income of a particular beneficiary is based upon the ratio determined under the second sentence of section 662(a)(2) for the taxable year (and not for the preceding taxable year). This section may be illustrated by the following example:

Example. (a) Under the terms of a trust instrument, the trustee may accumulate the income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. The distributable net income of the trust for the taxable year 1955 is $10,000. The trust had undistributed net income for the taxable year 1954 of $5,000, to which a tax of $1,100 was allocable. During the taxable year 1955, the trustee distributes $10,000 to A and $5,000 to B. Thus, of the total distribution of $15,000, A received two-thirds and B received one-third.

(b) For the purposes of determining the amounts includible in the beneficiaries' gross income for 1955, the trust is deemed to have made the following distributions:

Amount distributed out of 1955 income (distributable net income)	$10,000
Accumulation distribution deemed distributed by the trust on the last day of 1954 under section 666(a)	5,000
Taxes imposed on the trust deemed distributed under section 666(b)	1,100

(c) A will include in his gross income for 1955 two-thirds of each item shown in paragraph (b) of this example. Thus, he will include in gross income $6,666.67 (10,000/ 15,000×$10,000) of the 1955 distributable net income of the trust as provided in section 662(a)(2), and $3,333.33 (10,000/ 15,000×$5,000) of the accumulation distribution and $733.33 (10,000/15,000×$1,100) of the taxes imposed on the trust as provided in section 668(a).

(d) B will include in his gross income for 1955 one-third of each item shown in paragraph (b) of this example, computed in the manner shown in paragraph (c) of this example.

§1.668(a)–3 Excluded amounts.

When a trust pays, credits, or is required to distribute to a beneficiary amounts which are excluded under section 665(b) (1), (2), (3), or (4) from the computation of an accumulation distribution, the amount includible under subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, in the gross income of the beneficiaries pursuant to §1.668(a)–1 is first allocated to the beneficiaries as provided in §1.668(a)–2 and, second, the amount allocable to the beneficiary receiving amounts which are excluded under section 665(b) (1), (2), (3), or (4) is reduced by the excluded amounts. This section may be illustrated by the following examples, in which it is assumed the trusts and beneficiaries report on the calendar year basis and the income of the trusts was derived entirely from taxable interest:

Example 1. (a) A trust in 1957 has income as defined in section 643(b) of $35,000 and expenses allocable to corpus of $5,000. Its distributable net income is, therefore, $30,000 ($35,000 – $5,000). The undistributed net income of the trust and the taxes imposed on the trust were $12,840 and $7,260, respectively, for each of the years 1956, 1955, and 1954. The terms of the trust instrument provide for the accumulation of income during the minority of beneficiaries A and B. However, the trustee may make discretionary distributions to either beneficiary after he becomes 21 years of age. Also, the trustee may invade corpus for the benefit of A and B. B became 21 years of age on January 1, 1957, and, as of that date, A was 25 years old. The trustee distributed $50,000 each to A and B during 1957.

(b) Since each beneficiary received one-half of the total amount distributed by the trust, each must include in gross income under section 662(a)(2) one-half ($15,000) of the distributable net income ($30,000) of the trust for 1957.

(c) The excess distribution of $35,000 ($50,000 – $15,000) received by B is excluded from the determination of an accumulation distribution under section 665(b)(1) and accordingly is not includible in B's gross income under section 668(a). Nor is such amount treated as an accumulation distribution for the purpose of determining the amount includible in A's gross income under section 668(a).

(d) The accumulation distribution of the trust is $35,000, computed as follows:

Total distribution by the trust	....	$100,000
Less:		
Distributable net income for 1957	$30,000	
Excess distribution to B	35,000	
		65,000
Accumulation distribution to A		35,000

(e) The accumulation distribution of $35,000 will be allocated to the preceding taxable years 1956, 1955, and 1954, and the trust will be deemed to have made the following distributions to A on the last day of those years:

	1956	1955	1954	Total
Undistributed net income ...	$12,840	$12,840	$9,320	$35,000
Taxes imposed on the trust ..	7,260	7,260	5,270	19,790
Total	20,100	20,100	14,590	54,790

Thus, A will include $54,790 in his gross income for 1957 under section 668(a). A will, however, receive credit against his tax under section 668(b).

Example 2. (a) Under the terms of a trust the trustee may make discretionary distributions out of income to A during her life. The balance of the income is to be accumulated during the minority of her son, B, and is to be distributed to him when he becomes 21 years of age. Thereafter the trustee may also make discretionary payments of income to B. Also, the trustee may invade corpus for the benefit of A and B. B became 21 years of age on December 31, 1955. The distributable net income of the trust for 1955 is $30,000. It had undistributed net income of $12,840 for the preceding taxable year 1954 and the taxes imposed on the trust for such year were $7,260. The trustee distributed $15,000 to A during 1955 and on December 31, 1955, he distributed $60,000 to B, which represented income accumulated during his minority.

(b) Since B received four-fifths of the total amount ($75,000) distributed by the trust during 1955, he must include in his gross income under section 662(a)(2) four-fifths ($24,000) of the distributable net income ($30,000) of the trust for 1955. A will include in her gross income under section 662(a)(2) one-fifth ($6,000) of the distributable net income ($30,000) of the trust for 1955.

(c) The excess distribution of $36,000 ($60,000 – $24,000) received by B is excluded from the determination of an accumulation distribution under section 665(b)(1) and accordingly is not includible in his gross income under section 668(a).

(d) The amount treated as an accumulation distribution for the purpose of determining the amount includible in A's gross income for 1955 under section 668(a) is $9,000, computed as follows:

Total distribution by the trust	....	$75,000
Less:		
Distributable net income for 1955	$30,000	
Excess distribution to B	36,000	
		66,000
Amount treated as an accumulation distribution		9,000

(e) Inasmuch as the amount of $9,000 is less than the total undistributed net income of the trust ($12,840) for the preceding taxable year 1954, a pro rata portion of the taxes imposed on the trust for that year are also deemed distributed by the trust. Thus, A will include $14,089 in her gross income for 1955 under section 668 (a) computed as follows:

1954	
Accumulation distribution	$9,000
Taxes imposed on the trust (9,000/12,840×$7,260)	5,089
Total	14,089

A will, however, receive credit against her tax under section 668(b).

§1.668(a)–4 Tax attributable to throwback.

(a) The tax attributable to amounts deemed distributed under section 666 is imposed on the beneficiary for the taxable year of the beneficiary in which the accumulation distribution is made unless the taxable year of the beneficiary is different from that of the trust (see section 662(c) and the regulations thereunder). In the case of a trust (other than a foreign trust created by a U.S. person), the tax cannot be greater than the aggregate of the taxes attributable to those amounts had they been included, in accordance with the provisions of section 662 (a)(2) and (b), in the gross income of the beneficiary for the preceding taxable year or years in which they were deemed distributed. In the case of a foreign trust created by a U.S. person, the tax on the beneficiary shall be computed in accordance with the provisions of section 669 and the regulations thereunder. The tax liability of the beneficiary of a trust (other than a foreign trust created by a U.S. person), including the portion of an entire foreign trust which does not constitute a foreign trust created by a U.S. person (see §1.643(d)–1), for the taxable year is computed in the following manner:

(1) First, compute the amount of tax for the taxable year attributable to the section 666 amounts which are included in the gross income of the beneficiary for the year. The tax attributable to those amounts is the difference between the tax for the taxable year computed with the inclusion of the section 666 amounts in gross income and the tax computed without including them in gross income.

(2) Next, compute the tax attributable to the section 666 amounts for each of the preceding taxable years as if they had been included in gross income for those years. The tax attributable to such amounts in each such preceding taxable year is the difference between the tax for such preceding year computed with the inclusion of the section 666 amounts in gross income and the tax for such year computed without including them in gross income. The tax computation for each preceding year shall reflect the taxpayer's marital and dependency status for that year.

(3) The total tax for the taxable year is the tax for that year computed without including the section 666 amounts, *plus:*

(i) The amount of the tax for the taxable year attributable to the section 666 amounts (computed in accordance with subparagraph (1) of this paragraph), or (ii) The sum of the taxes for the preceding taxable years attributable to the section 666 amounts (computed in accordance with subparagraph (2) of this paragraph),

whichever is the smaller.

(b) The provisions of paragraph (a) of this section may be illustrated by the following example:

Example. (1) During the taxable year 1956, $10,000 is deemed distributed under section 666 to a beneficiary, of which $6,000 is deemed distributed by the trust on the last day of 1955 and $4,000 on the last day of 1954. The beneficiary had taxable income (after deductions) from other sources of $5,000 for 1956, $10,000 for 1955, and $10,000 for 1954. The beneficiary's tax liability for 1956 is $4,730 determined as follows:

Year 1956	
Tax on $15,000 (taxable income including section 666 amounts)	$4,730
Tax on $5,000 (taxable income excluding section 666 amounts)	1,100
Tax attributable to section 666 amounts	3,630

Year 1955	
Tax on $16,000 (taxable income including section 666 amounts)	$5,200
Tax on $10,000 (taxable income excluding section 666 amounts)	2,640
Tax attributable to section 666 amounts	2,560

Year 1954	
Tax on $14,000 (taxable income including section 666 amounts)	$4,260
Tax on $10,000 (taxable income excluding section 666 amounts)	2,640
Tax attributable to section 666 amounts	1,620

(2) Inasmuch as the tax of $3,630 attributable to the section 666 amounts as computed at 1956 rates is less than the aggregate of the taxes of $4,180 ($2,560 plus $1,620) determined for the preceding taxable years the amount of $3,630 is added to the tax ($1,100) computed for 1956 without including the section 666 amounts.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 737, Jan. 17, 1969]

§ 1.668(b)–1 Credit for taxes paid by the trust.

(a) The taxes imposed on a complex trust for a taxable year which would not have been payable by the trust if amounts deemed under section 666 to have been distributed in the year had in fact been distributed in the year are not allowable as a refund to the trust but are allowable as a credit against the tax of the beneficiaries to whom the amounts described in section 666(a) are distributed.

(b) The credit to which a beneficiary is entitled under section 668(b) is allowed for the taxable year in which the accumulation distribution (to which the credit relates) is required to be included in the gross income of the beneficiary. Any excess over the total tax liability of the beneficiary is treated as an overpayment of tax by the beneficiary.

(c) The beneficiary is entitled to a portion of the credit described in paragraph (a) of this section in the ratio which the amount of the accumulation distribution to him bears to the accumulation distributions to all the beneficiaries.

§ 1.668(b)–2 Illustration of the provisions of subpart D.

The provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, other than provisions relating to a foreign trust created by a U.S. person, may be illustrated by the following example:

Example. (a) *Facts.* (1) Under the terms of a trust instrument, one-half of the trust income is required to be distributed currently to beneficiary A. The trustee may in his discretion accumulate the balance of the income of the trust or he may make distributions to B out of income or corpus. The trust is to terminate upon the death of A and the corpus is to be distributed to B. Capital gains are allocable to corpus. All of the expenses of the trust are charges against income. The trust instrument provides for a reserve for depreciation, so that depreciation is deductible in computing distributable net income. The trust and both beneficiaries report on the calendar year basis. The trust had long-term capital gains of $20,000 for 1954, and $10,000 for 1955, which were allocated to corpus. The distributable net income of the trust as determined under section 643(a) for 1954, 1955, 1956, and 1957 is deemed to consist of the following items of income:

	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1954	$15,000	$20,000	$10,000	$5,000	$50,000
1955	10,000	15,000	10,000	5,000	40,000
1956	10,000	20,000	15,000	5,000	50,000
1957	10,000	15,000	15,000	5,000	45,000

(2) One-half ($7,500) of the dividends for 1954 was received by the trust on or before July 31, 1954, and the balance was received after that date.

(3) The following distributions were made by the trustee to A and B during the taxable years 1954 through 1957:

	A	B
1954	$25,000	None
1955	20,000	None
1956	25,000	$45,000
1957	22,500	29,550

(b) *Distributions to A.* A is deemed to have received one-half of each item of income entering into the computation of distributable net income as shown in paragraph (a)(1) of this example. See § 1.662(a)–2 for rules for the treatment of currently distributable income in the hands of the beneficiary.

(c) *Tax liability of the trust*—(1) *1954.* (i) The tax liability of the trust for the taxable year 1954 is $13,451, computed as follows:

Distributable net income under section 643(a) (paragraph (a)(1) of this example)		$50,000
Less amounts not includible in gross income:		
Tax-exempt interest	$5,000	
Dividend exclusion	50	
		5,050
Distributable net income as adjusted		44,950
Add: Capital gains (long-term)		20,000
Total		64,950
Deductions:		
Distributions to A	$22,475	
Capital gain deduction	$10,000	
Personal exemption	100	
		32,575
Taxable income		32,375
Alternative tax		13,601
Dividend received credit		150
Tax liability		13,451

(ii) See paragraph (b) of this example for character of income deemed distributed to A and section 661 for rules for computing the amount deductible by a trust for distributions to beneficiaries. Inasmuch as one-half of the dividends of the trust is deemed to be distributed to A, $25 of such distribution is deemed to be made from the dividend exclusion of $50, and the balance from dividends included in the gross income of the trust (that is, since the year 1954 is involved, $3,725 from dividends received on or before July 31, 1954, and $3,750 from dividends received after July 31, 1954). The trust is entitled to a dividend received credit attributable to the dividends of $3,750 received after July 31, 1954, which were not distributed to any beneficiary during the taxable year.

(2) *1955.* (i) The tax liability of the trust for the taxable year 1955 is $8,189, computed as follows:

Distributable net income under section 643(a) (paragraph (a)(1) of this example)		$40,000
Less amounts not includible in gross income:		
Tax-exempt interest	$5,000	
Dividend exclusion	50	
		5,050
Distributable net income as adjusted		34,950
Add: Capital gains (long-term)		10,000
Total		44,950
Deductions:		
Distributions to A	$17,475	
Capital gain deduction	5,000	
Personal exemption	100	
		22,575
Taxable income		22,375
Alternative tax		8,388
Dividend received credit		199
Tax liability		8,189

(ii) See paragraph (b) of this example for character of income deemed distributed to A and section 661 for rules for computing the amount deductible by a trust for distributions to beneficiaries. Inasmuch as one-half ($4,975) of the dividends of $9,950 ($10,000 less dividend exclusion of $50) included in the gross income of the trust is deemed distributed to A, the trust is entitled to a dividend received credit with respect to the dividends of $4,975 which were not distributed to any beneficiary during the taxable year.

(3) *1956 and 1957.* The trust had no tax liability for the taxable years 1956 and 1957 since all of its income was distributed during such years.

(d) *Accumulation distributions.* (1) Accumulation distributions of $20,000 and $7,050, as defined in section 665(b), were made to B during the years 1956 and 1957, respectively, computed as shown below:

	1956	1957
Distributable net income of the trust as computed under section 643(a)	$50,000	$45,000
Less. Income currently distributable to A	25,000	22,500
Balance of income	25,000	22,500
Other amounts distributed to B	45,000	29,550
Accumulation distributions to B	20,000	7,050

(2) B is deemed to have received one-half of each item of income entering into the computation of distributable net income (shown in paragraph (a)(1) of this example) for the years 1956 and 1957.

(3) The accumulation distribution for 1956 must first be allocated to the preceding taxable years as provided in section 666. After the application of the provisions of subpart D to the 1956 accumulation distribution and to the undistributed net incomes of the preceding taxable years, a similar allocation must be made of the 1957 accumulation distribution.

(e) *Throwback of 1956 accumulation distribution to 1955.* The accumulation distribution of $20,000 for 1956 must be allocated to the first preceding taxable year 1955, before allocation is made to the second preceding taxable year 1954.

(1) *1955 Undistributed net income.* (i) The undistributed net income of the trust for 1955, determined as of the close of 1955, is $12,885, computed as follows:

Distributable net income as computed under section 643(a) (paragraph (a)(1) of this example)		$40,000
Less:		
Distributions to A	$20,000	
Taxes imposed on the trust	7,115	
	27,115	
Undistributed net income as of the close of 1955	12,885	

(ii) The taxes imposed on the trust of $7,115 are that portion of the taxes paid by the trust for 1955 which is attributable to the undistributed portion of distributable net income included in the taxable income of the trust (the ‘‘balance’’ in the computation below) and is determined as follows:

Taxable income (paragraph (c)(2)(i) of this example			$22,375
Capital gains allocable to corpus		$10,000	
Less:			
Capital gain deduction	$5,000		
Personal exemption	100		
		5,100	
Portion of taxable income allocable to corpus			4,900
Balance			17,475
Total taxes paid by the trust			8,189
Taxes on income ($4,900) allocable to corpus			1,074
Taxes imposed on the trust (section 665(c))			7,115

(iii) The amount of $1,074 is the taxes which the trust would have paid for 1955 had all of the distributable net income been distributed during the year.

(2) *Allocation of 1956 accumulation distribution to the preceding taxable year 1955.* The portion of the 1956 accumulation distribution which is deemed under section 666(a) to be distributed to B on the last day of 1955 (the first preceding taxable year) is $12,885, an amount equal to the undistributed net income for 1955. An additional amount equal to the taxes imposed on the trust ($7,115) is, under section 666(b), also deemed to be distributed to B on the last day of 1955. Thus, a total of $20,000 ($12,885 plus $7,115) is deemed to be distributed to B on December 31, 1955, by reason of the allocation of the 1956 accumulation distribution to the first preceding taxable year. See paragraph (h) of this example for the treatment of the amount of $20,000 in the hands of B.

(3) *Character of amounts deemed distributed.* Inasmuch as one-half of the 1955 distributable net income of the trust as determined under section 643(a) was currently distributable to A and the balance of such income is deemed under section 666 to be distributed to B on December 31, 1955, the distribution to B is deemed to consist of one-half of each item of income entering into the computation of the 1955 distributable net income; that is, dividends of $5,000, rents of $7,500, taxable interest of $5,000, and tax-exempt interest of $2,500.

(4) *Credit for taxes paid by the trust.* The amount of the taxes for the year 1955 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B for 1956 under section 668(b) is $7,115. See also paragraph (h)(3) of this example.

(5) *Effect of application of provisions of subpart D to the year 1955.* After the allocation of the 1956 accumulation distribution to the preceding taxable year 1955, the undistributed portion of the distributable net income, the undistributed net income, and the taxes imposed on the trust for 1955 are zero. The portion of the 1956 accumulation distribution which is unabsorbed by the 1955 undistributed net income is $7,115, determined as follows:

1956 accumulation distribution (paragraph (d)(1) of this example)	$20,000
Less: Amount allocable to 1955	12,885
Balance allocable to second preceding taxable year 1954	7,115

(f) *Throwback of 1956 accumulation distribution to 1954.* The unabsorbed portion of the 1956 accumulation distribution of $7,115 is allocable to the second preceding taxable year 1954 and is treated under section 666 as a distribution to B on the last day of such year.

(1) *1954 Undistributed net income.* (i) The undistributed net income of the trust for 1954, determined as of the close of 1954, is $14,155, computed as follows:

Distributable net income as computed under section 643(a) (paragraph (a)(1) of this example)		$50,000
Less:		
Distributions to A	$25,000	
Taxes imposed on the trust	10,845	
		35,845
Undistributed net income as of the close of 1954		14,155

(ii) The taxes imposed on the trust of $10,845 are that portion of the taxes paid by the trust for 1954 which is attributable to the undistributed portion of distributable net income included in the taxable income of the trust (the ‘‘balance’’ in the computation below in this subdivision) and is determined as follows:

Taxable income (paragraph (c)(1)(i) of this example)			$32,375
Capital gains allocable to corpus		$20,000	
Less:			
Capital gain deduction	$10,000		
Personal exemption	100		
		10,100	
Portion of taxable income allocable to corpus			9,900
Balance			22,475
Total taxes paid by the trust			13,451
Taxes on income ($9,900) allocable to corpus			2,606
Taxes imposed on the trust (section 665(c))			10,845

(iii) The amount of $2,606 is the taxes which the trust would have paid for 1954 had all of the distributable net income been distributed during that year.

(2) *Allocation of 1956 accumulation distribution to the second preceding taxable year 1954.* Since the unabsorbed portion of the 1956 accumulation distribution of $7,115 is less than the 1954 undistributed net income of $14,155, the trust is deemed under section 666(c) to have also distributed an additional amount ($5,451) equal to a pro rata portion (7,115/14,155×$10,845) of the taxes imposed on the trust for 1954. Thus, a total of $12,566 ($7,115 plus $5,451) is deemed to be distributed to B on December 31, 1954, by reason of the throwback of the 1956 accumulation distribution. See paragraph (h) of this example for the treatment of the amount of $12,566 in the hands of B.

(3) *Character of amounts deemed distributed to B.* The amount of $12,566 which, under section 666, is deemed to be distributed to B on December 31, 1954, is deemed to be composed of the following items of income of the trust: Dividends, $3,770 (15,000/50,000×$12,566); rents, $5,026 (20,000/50,000×$12,566); taxable interest, $2,513 (10,000/50,000×$12,566); and tax-exempt interest, $1,257 (5,000/50,000×$12,566). One-half of the dividends of $3,770 is considered as distributed from the dividends received by the trust on or before July 31, 1954, of which $13

(3,770/15,000×$50) is deemed distributed from the dividends excluded under section 116, and the other half as distributed from the dividends received after July 31, 1954. Thus, of the total of $12,566 deemed distributed to B, $11,296 is considered as made from income included in the gross income of the trust and $1,270 from non-taxable income of the trust.

(4) *Credit for taxes paid by the trust.* The amount of the taxes for the year 1954 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B for 1956 under section 668(b), because of the allocation of the 1956 accumulation distribution to 1954, is $5,401, computed as follows:

Taxable income of the trust as of the close of 1954 (paragraph (c)(1) of this example)	$32,375
Less: Amount deemed distributed to B under section 666 from the taxable income of the trust	11,296
Taxable income adjusted as of the close of 1956	21,079
(Taxes on $21,079 (alternative tax)	$8,050
Taxes on income allocable to corpus (subparagraph (1)(ii) of this paragraph)	$2,606
Taxes imposed on the trust determined as of the close of 1956	5,444

Taxes imposed on the trust determined as of the close of 1954	$10,845
Taxes imposed on the trust determined as of the close of 1956	5,444
Amount of taxes allowed as a credit to B under section 668(b)	5,401

(5) *Effect of application of provisions of subpart D to the year 1954.* (i) The undistributed portion of the distributable net income of the trust for the year 1954, determined as of the close of 1956, is $12,434, computed as follows:

Distributable net income (section 643(a))		$50,000
Less:		
Amount currently distributable to A	$25,000	
Amount deemed distributed to B under section 666	12,566	
		37,566
Undistributed portion of distributable net income as of the close of 1956		12,434

(ii) The amount of $12,434 is deemed to consist of dividends of $3,730, rents of $4,974, taxable interest of $2,487, and tax-exempt interest of $1,243, determined as follows:

	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
Trust income	$15,000	$20,000	$10,000	$5,000	[1] $50,000
Distributions:					
To A	7,500	10,000	5,000	2,500	[2] 25,000
To B	3,770	5,026	2,513	1,257	[3] 12,566
Total	11,270	15,026	7,513	3,757	37,566
Balance	3,730	4,974	2,487	1,243	12,434

[1] See paragraph (a)(1) of this example.

[2] See paragraph (b) of this example.

[3] See paragraph (f)(3) of this example.

(iii) The undistributed net income of the trust for 1954, determined as of the close of 1956, is $6,990, computed as follows:

Undistributed portion of distributable net income as of the close of 1956	$12,434
Less: Taxes imposed on the trust determined as of the close of 1956 (subparagraph (4) of this paragraph)	5,444
Undistributed net income as of the close of 1956	6,990

(g) *Throwback of 1957 accumulation distribution.* Inasmuch as all of the income of the trust for the first preceding taxable year 1956 was distributed during such year and the trust had no undistributed net income for the second preceding taxable year 1955 after the application of subpart D to the accumulation distribution made during 1956, the 1957 accumulation distribution of $7,050 is allocable to the third preceding taxable year 1954. See paragraph (d)(1) of this example for computation of the accumulation distribution.

(1) *Allocation of 1957 accumulation distribution to the preceding taxable year 1954.* The portion of the 1957 accumulation distribution which is deemed under section 666(a) to be distributed to B on the last day of 1954 is $6,990, an amount equal to the undistributed net income of the trust for 1954, determined as of the close of 1956. An additional amount equal to the taxes imposed on the trust ($5,444), determined as of the close of 1956, is under section 666(b) also deemed to be distributed to B on the last day of 1954. See paragraph (f) (4) and (5) of this example. Thus, a total of $12,434 ($6,990 plus $5,444) is deemed to be distributed to B on December

31, 1954, by reason of the allocation of the 1957 accumulation distribution to the taxable year 1954. See paragraph (j) of this example for the treatment of the amount of $12,434 in the hands of B.

(2) *Character of amounts deemed distributed.* Inasmuch as the balance of the 1954 distributable net income of the trust is deemed under section 666 to be distributed to B on December 31, 1954, the distribution is deemed to consist of dividends of $3,730, rents of $4,974, taxable interest of $2,487, and tax-exempt interest of $1,243. See paragraph (f)(5)(ii) of this example.

(3) *Credit for taxes paid by the trust.* The amount of taxes for the year 1954 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B under section 668(b) is $5,444, the amount of taxes imposed on the trust determined as of the close of 1956. See paragraph (f)(4) of this example.

(4) *Effect of application of provisions of subpart D to the year 1954.* After the allocation of the 1957 accumulation distribution to the preceding taxable year 1954, the undistributed portion of the distributable net income, the undistributed net income, and the taxes imposed on the trust for 1954 are zero. The balance of $60 ($7,050 less $6,990) of the 1957 accumulation distribution remaining after the allocation of the accumulation distribution to the year 1954, may not be allocated to the year 1953 since that year is not subject to the provisions of the Internal Revenue Code of 1954.

(h) *Determination of B's tax liability; taxable year 1956*—(1) *Amount of trust income includible in gross income.* (i) Of the amount of $45,000 distributed by the trust to B during the taxable year 1956, $25,000 is treated as a distribution out of trust income for that year within the meaning of section 662(a)(2), and $20,000 as an accumulation distribution within the meaning of section 665(b) (see paragraph (d) of this example). However, $12,885 plus taxes of $7,115 is deemed distributed to B on December 31, 1955, and $7,115 plus taxes of $5,451 on December 31, 1954, under section 666 by reason of the accumulation distribution made during 1956, and these amounts are includible in B's gross income for 1956 to the extent that they would have been includible in his gross income under section 662 (a)(2) and (b) for 1955 and 1954, respectively, had they been distributed on the last day of those years.

(ii) The amounts distributed to B out of trust income for the year 1956, and the amounts deemed distributed out of income for the preceding taxable years 1955 and 1954 have the following character for the purpose of determining the amount includible in B's gross income for 1956:

Year	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1956	$5,000	$10,000	$7,500	$2,500	[1] $25,000
1955	5,000	7,500	5,000	2,500	[2] 20,000
1954	3,770	5,026	2,513	1,257	[3] 12,566
Total	13,770	22,526	15,013	6,257	57,566

[1] See paragraph (d)(2) of this example.
[2] See paragraph (e)(3) of this example.
[3] See paragraph (f)(3) of this example.

Thus, B will include in gross income for 1956 dividends of $13,770 (subject to the dividend exclusion), rents of $22,526, and taxable interest of $15,013, and will exclude the tax-exempt interest of $6,257.

(2) *Computation of tax.* (i) For the purpose of computing B's tax liability, it is assumed that he was single during the taxable years 1954, 1955, and 1956, and that his taxable income (derived from salary) for each of the years 1954 and 1955 amounted to $13,400 on which a tax of $4,002 was paid for each year. It is also assumed that his income (other than distributions from the trust) for 1956 was $15,000 derived from salary, and he had allowable deductions of $10,600, which included the deduction for personal exemption.

(ii) The computation of the tax for the taxable year 1956 attributable to the section 666 amounts which are included in B's gross income for such year, as provided in paragraph (a)(1) of § 1.668(a)–4, is as follows:

	(1) Section 666 amounts excluded	(2) Section 666 amounts included
Salary	$15,000	$15,000
Income from trust:		
Dividends ($50 excluded)	4,950	13,720
Rents	10,000	22,526
Taxable interest	7,500	15,013
Total	37,450	66,259
Less: Allowable deductions	10,600	10,600
Taxable income	26,850	55,659
Total tax	11,267	31,064
Less: Dividend received credit	198	475
Tax liability	$11,069	30,589

	(1) Section 666 amounts excluded	(2) Section 666 amounts included
Tax on income from which section 666 amounts are excluded	....	11,069
1956 tax attributable to section 666 amounts	....	19,520

Only that portion of the dividends received by the trust after July 31, 1954, and deemed distributed to B under section 666, on the last day of such year is included in computing the dividend received credit shown in column (2). See paragraph (f)(3) of this example.

(iii) The computation of the taxes for the preceding taxable years attributable to the section 666 amounts which are deemed distributed by the trust on the last day of these years, as provided in paragraph (a)(2) of §1.668(a)–4, is as follows:

	Preceding taxable years	
	First 1955	Second 1954
Taxable income previously reported	$13,400	$13,400
Section 666 amounts:		
Dividends ($50 excluded)	4,950	3,720
Rents	7,500	5,026
Taxable interest	5,000	2,513
Taxable income as adjusted	30,850	24,659
Total tax	13,747	9,949
Less: Dividend received credit	198	75
Balance of tax	13,549	9,874
Tax liability	4,002	4,002
Tax attributable to section 666 amounts	9,547	5,872

Only that portion ($1,885) of the dividends received by the trust after July 31, 1954, and deemed distributed under section 666 on the last day of that year, is included in computing the dividend received credit of $75 for the year 1954. See paragraph (f)(3) of this example.

(iv) Inasmuch as the aggregate of the taxes of $15,419 ($9,547 plus $5,872) attributable to the section 666 amounts as determined for the preceding taxable years is less than the tax of $19,520 determined for the taxable year 1956, the amount of $15,419 shall be added to the tax computed for 1956 without including the section 666 amounts. Thus, B's tax liability for 1956 is $26,488 ($11,069 plus $15,419).

(3) *Credits against the tax.* B is allowed under section 668(b) a credit of $12,516 ($5,401 for 1954 and $7,115 for 1955) against his 1956 tax liability for the taxes paid by the trust for the preceding taxable years and which may not be refunded or credited to the trust under section 667. See paragraphs (e)(4) and (f)(4) of this example.

(i) [Reserved]

(j) *Taxable year 1957*—(1) *Amount of trust income includible in gross income.* (i) Of the amount of $29,550 distributed by the trust to B during the taxable year 1957, $22,500 is treated as a distribution out of trust income for that year within the meaning of section 662(a)(2), and $7,050 as an accumulation distribution within the meaning of section 665(b) (see paragraph (d) of this example). However, $6,990 plus taxes of $5,444 is deemed distributed to B on December 31, 1954, under section 666 by reason of the accumulation distribution made during 1957, and that amount is includible in B's gross income for 1957, to the extent that it would have been includible in his gross income under section 662 (a)(2) and (b) for 1954, had it been distributed on the last day of that year.

(ii) The amounts deemed distributed to B out of trust income for the year 1957 and the preceding taxable year 1954 are deemed to have the following character for the purpose of determining the amount includible in B's gross income for 1957:

Year	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1957	$5,000	$7,500	$7,500	$2,500	[1]$22,500
1954	3,730	4,974	2,487	1,243	[2]12,434
Total	8,730	12,474	9,987	3,743	34,934

[1] See paragraph (d)(2) of this example.

[2] See paragraph (g)(2) of this example.

Thus, B will include in gross income for the year 1957 dividends of $8,730 (subject to the dividend exclusion), rents of $12,474, and taxable interest of $9,987 and will exclude the tax-exempt interest of $3,743.

(2) *Computation of tax.* (i) For the purpose of computing B's tax liability for 1957, it is assumed that he was single for the entire year and had income (other than distributions from the trust) of $15,000 from salary. Also, he had allowable deductions of $8,100, which included the deductions for personal exemption.

(ii) The computation of the tax for the taxable year 1957 attributable to the section 666 amounts which are included in B's gross income for that year, as provided in paragraph (a)(1) of § 1.668(a)–4, is as follows:

	Section 666 amounts excluded	Section 666 amounts included
Salary	$15,000	$15,000
Trust income:		
Dividends ($50 excluded)	4,950	8,680
Rents	7,500	12,474
Taxable interest	7,500	9,987
Total	34,950	46,141
Less: Allowable deductions	8,100	8,100
Taxable income	26,850	38,041
Total tax	11,267	18,388
Less: Dividends received credit	198	275
Tax liability	11,069	18,113
Tax on income from which section 666 amounts are excluded		11,069
1957 tax attributable to section 666 amounts		7,044

See explanation following computation in paragraph (h)(2)(ii) of this example with respect to the computation of the dividend received credit on dividends received by the trust in 1954.

(iii) The amount of tax, computed at 1954 rates, attributable to the section 666 amounts which are deemed to have been distributed by the trust on the last day of 1954, is $6,939, computed as follows:

1954 taxable income as adjusted (paragraph (h)(2)(iii) of this example)		$24,659
Section 666 amounts:		
Dividends		3,730
Rents		4,974
Taxable interest		2,487
Taxable income as adjusted		35,850
Total tax		16,963
Less: Dividends received credit		150
Balance of tax		16,813
Tax liability for 1954	$4,002	
Tax attributable to 1956 accumulation distribution this example)	5,872	
		9,874
Tax attributable to the section 666 amounts distributed in 1957		6,939

Only that portion ($3,750) of the dividends received by the trust after July 31, 1954, and deemed distributed under section 666 on the last day of that year, is included in computing the dividend received credit of $150. See paragraphs (f)(3) and (g)(2) of this example.

(iv) Inasmuch as the tax of $6,939 attributable to the section 666 amounts as determined for the preceding taxable year 1954 is less than the tax of $7,044 attributable to these amounts for the year 1957, the amount of $6,939 shall be added to the tax computed for 1957 without including in gross income the section 666 amounts. Thus, B's tax liability for 1957 is $18,008 ($11,069 plus $6,939).

(3) *Credit against the tax.* B is allowed under section 668(b) a credit of $5,444 against his 1957 tax liability for the balance of the taxes paid by the trust for 1954 and which may not be refunded or credited to the trust under section 667. See paragraph(g)(3) of this example.

(Sec. 669(a) as amended by sec. 331(a), Tax Reform Act 1969 (83 Stat. 592))

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 738, Jan. 17, 1969]

§ 1.669(a)–1A Amount allocated.

(a) *In general.* After a trust has distributed all of its undistributed net income, the rules concerning the treatment of capital gain distributions (prescribed under section 669) may become applicable to an accumulation distribution. This section prescribes rules to determine from which years capital gain distributions are considered to be made. For the definition of ''capital gain distribution,'' see § 1.665(g)–1A. Section 669 does not apply to a trust that has distributed all of its income currently since its inception. See § 1.668(a)–1A(c). Capital gain retains its character in the hands of the beneficiary. See § 1.669(f)–1A. A capital gain distribution to more than one beneficiary will be allocated among them. See § 16.668(a)–2A.

(b) *First-in, first-out rule.* A capital gain distribution is allocated to the preceding taxable years of the trust (as defined in § 1.665(e)–1A(a)(1)(iii)), according to the undistributed capital gain of the trust for such years. For this purpose, a capital gain distribution is first allocated to the earliest such preceding taxable year in which there is undistributed capital gain and shall then be allocated in turn, beginning with the next earliest, to any remaining preceding taxable years of the trust. The portion of the capital gain distribution allocated to the earliest preceding taxable year is the amount of undistributed capital gain for that preceding taxable year. The portion of the capital gain distribution allocated to any preceding taxable year subsequent to the earliest such preceding taxable year is the excess of the capital gain distribution over the aggregate of the undistributed capital gain for all earlier preceding taxable years. See paragraph (c) of this section for adjustments to undistributed capital gain for prior distributions.

(c) *Reduction of undistributed capital gain for prior capital gain distributions.* For the purposes of allocating to any preceding taxable year a capital gain distribution of the taxable year, the undistributed capital gain of such preceding taxable year is reduced by the amount from such year deemed distributed in any capital gain distribution made in any taxable year intervening between such preceding taxable year and the taxable year. Accordingly, for example, if a trust subject to the capital gain throwback has no undistributed net income but has undistributed capital gain for 1974, and makes capital gain distributions during the taxable years 1978 and 1979, then in determining that part of the 1979 capital gain distribution that is thrown back to 1974, the undistributed capital gain for 1974 is reduced by the amount of such undistributed capital gain for 1974 deemed distributed in the 1978 capital gain distribution.

(d) *Rule when no undistributed capital gain.* If, before the application of the provisions of subpart D to a capital gain distribution for the taxable year, there is no undistributed capital gain for a preceding taxable year, then no portion of the capital gain distribution is deemed distributed on the last day of such preceding taxable year. Thus, for example, if a capital gain distribution is made during the taxable year 1975 from a trust whose earliest preceding taxable year is taxable year 1970, and the trust had no undistributed capital gain for 1970, then no portion of the 1975 capital gain distribution is deemed distributed on the last day of 1970.

(e) *Example.* The provisions of this section may be illustrated by the following example:

Example. In 1977, a trust reporting on the calendar year basis makes a capital gain distribution of $33,000. In 1969, the trust had $6,000 of undistributed capital gain; in 1970, $4,000; in 1971, none; in 1972, $7,000; in 1973, $5,000; in 1974, $8,000; in 1975, $6,000; in 1976, $4,000; and $6,000 in 1977. The capital gain distribution is deemed distributed $6,000 in 1969, $4,000 in 1970, none in 1971, $7,000 in 1972, $5,000 in 1973, $8,000 in 1974, and $3,000 in 1975.

[T.D. 7204, 37 FR 17153, Aug. 25, 1972]

§1.669(b)–1A Tax on distribution.

(a) *In general.* The partial tax imposed on the beneficiary by section 668(a)(3) shall be the lesser of:

(1) The tax computed under paragraph (b) of this section (the ‘‘exact’’ method), or

(2) The tax computed under paragraph (c) of this section (the ‘‘short-cut’’ method),

except as provided in §1.669(c)–3A (relating to failure to furnish proper information) and paragraph (d) of this section (relating to disallowance of short-cut method). For purposes of this paragraph, the method used in the return shall be accepted as the method that produces the lesser tax. The beneficiary’s choice of the two methods is not dependent upon the method that he uses to compute his partial tax imposed by section 668(a)(2).

(b) *Computation of partial tax by the exact method.* The partial tax referred to in paragraph (a)(1) of this section is computed as follows:

(1) First, compute the tax attributable to the section 669 amounts for each of the preceding taxable years. For purposes of this paragraph, the ‘‘section 669 amounts’’ for a preceding taxable year are the amounts deemed distributed under section 669(a) on the last day of such preceding taxable year, plus the amount of taxes deemed distributed on such day under section 669 (d) or (e). The tax attributable to such amounts in each prior taxable year of the beneficiary is the difference between the tax for such year computed with the inclusion of the section 669 amounts in the beneficiary’s gross income and the tax for such year computed with the inclusion of them in such gross income. Tax computations for each such year shall reflect a taxpayer’s marital, dependency, exemption, and filing status for such year. To the extent the undistributed capital gain of a trust deemed distributed in a capital gain distribution includes amounts received as a capital gain distribution from another trust, for purposes of this paragraph they shall be

considered as amounts deemed distributed by the trust under section 669(a) on the last day of each of the preceding taxable years in which such amounts were accumulated by such other trust. For example, assume trust Z, a calendar year trust received in its taxable year 1975 a capital gain distribution from trust Y, a calendar year trust, that included undistributed capital gain of trust Y for the taxable years 1972, 1973, and 1974. To the extent a capital gain distribution made by trust Z in its taxable year 1976 includes such undistributed capital gain, it shall be considered a capital gain distribution by trust Z in the taxable year 1976 and under section 669(a) will be deemed distributed on the last day of the preceding taxable years 1972, 1973, and 1974.

(2) From the sum of the taxes for the prior taxable years attributable to the section 669(a) amounts (computed in accordance with subparagraph (1) of this paragraph), subtract so much of the amount of taxes deemed distributed to the beneficiary under §§ 1.669(d)–1A and 1.669(e)–1A as does not exceed such sum. The resulting amount, if any, is the partial tax on the beneficiary, computed under the exact method, for the taxable year in which the capital gain distribution is paid, credited, or required to be distributed to the beneficiary.

(c) *Computation of tax by the short-cut method.* (1) The tax referred to in paragraph (a)(2) of this section is computed as follows:

(i) First, determine the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 669(a) to have been distributed. For purposes of the preceding sentence, the preceding taxable years of a trust that has received a capital gain distribution from another trust shall include the taxable years of such other trust in which an amount was deemed distributed in such capital gain distribution. For example, assume trust Z, a calendar year trust, received in its taxable year 1975 a capital gain distribution from trust Y, a calendar year trust, that included undistributed capital gain of trust Y for the taxable years 1972, 1973, and 1974. To the extent a capital gain distribution made by trust Z in its taxable year 1976 includes such undistributed capital gain, it shall be considered a capital gain distribution by trust Z in the taxable year 1976 and under section 669(a) will be deemed distributed on the last day of the preceding taxable years 1972, 1973, and 1974. For purposes of this subparagraph, such number of preceding taxable years of the trust shall not include any preceding taxable year of the trust in which the undistributed capital gain deemed distributed is less than 25 percent of *(a)* the total amounts deemed under section 669(a) to be undistributed capital gain from preceding taxable years, divided by *(b)* the number of such preceding taxable years of the trust on the last day of which an amount is deemed under section 669(a) to have been distributed without application of this sentence. For example, assume that a capital gain distribution of $90,000 made to a beneficiary in 1979 is deemed distributed in the amounts of $29,000 in each of the years 1972, 1973, and 1974, and $3,000 in 1975. The number of preceding taxable years on the last day of which an amount was deemed distributed without reference to the second sentence of this subparagraph is 4. However, the distribution deemed made in 1975 ($3,000) is less than $5,625, which is 25 percent of *(a)* the total undistributed capital gain deemed distributed under section 669(a) ($90,000) divided by *(b)* the number of such preceding taxable years (4), or $22,500. Therefore, for purposes of this subparagraph, the capital gain distribution is deemed distributed in only 3 preceding taxable years (1972, 1973, and 1974).

(ii) Second, divide the amount (representing the capital gain distribution and taxes deemed distributed) required under section 668(a) to be included in the income of the beneficiary for the taxable year by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 669(a) to have been distributed (determined as provided in subdivision (i) of this paragraph). The amount determined under this subdivision, including taxes deemed distributed, consists of the same proportion of long-term and short-term capital gain as the total of each type of capital gain deemed distributed in the capital gain distribution bears to the total undistributed capital gain from such preceding taxable years deemed distributed in the capital gain distribution. For example, assume that an amount of $50,000 is deemed distributed under section 669(a) from undistributed capital gain of 5 preceding taxable years of the trust, and consists of $30,000 of long-term capital gain and $20,000 of short-term capital gain. Taxes attributable to such amounts in the amount of $10,000 are also deemed distributed. The amount determined under this subdivision, $12,000 ($50,000 income plus $10,000 tax, divided by 5 years), is deemed to consist of $7,200 of long-term capital gain and $4,800 in short-term capital gain.

(iii) Third, compute the tax of the beneficiary for each of the 3 taxable years immediately preceding the year in which the capital gain distribution is paid, credited, or required to be distributed to him,

(a) With the inclusion in gross income of the beneficiary for each of such 3 years of the amount determined under subdivision (ii) of this subparagraph, and

(b) Without such inclusion.

The difference between the amount of tax computed under (a) of this subdivision for each year and the amount computed under (b) of this subdivision for that year is the additional tax resulting from the inclusion in gross income for that year of the amount determined under subdivision (ii) of this subparagraph.

(iv) Fourth, add the additional taxes resulting from the application of subdivision (iii) of this subparagraph and then divide this amount by 3.

(v) Fifth, the resulting amount is then multiplied by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 669(a) to have been distributed (previously determined under subdivision (i) of this subparagraph).

(vi) The resulting amount, less so much of the amount of taxes deemed distributed to the beneficiary under §§1.669(d)–1A and 1.669(e)–1A as does not exceed such resulting amount, is the tax under the short-cut method provided in section 669(b)(1)(B).

(2) See §1.668(b)–1A(c) for examples of the short-cut method in the context of an accumulation distribution.

(d) *Disallowance of short-cut method.* If, in any prior taxable year of the beneficiary in which any part of the capital gain distribution is deemed to have been distributed under section 669(a) to such beneficiary, any part of prior capital gain distributions by each of two or more other trusts is deemed under section 669(a) to have been distributed to such beneficiary, then the short-cut method under paragraph (c) of this section may not be used and the partial tax imposed by section 668(a)(3) shall be computed only under the exact method under paragraph (b) of this section. For example, assume that, in 1978, trust X makes a capital gain distribution to A, who is on the calendar year basis, and part of the distribution is deemed under section 669(a) to have been distributed on March 31, 1974. In 1977, A had received a capital gain distribution from both trust Y and trust Z. Part of the capital gain distribution from trust Y was deemed under section 669(a) to have been distributed to A on June 30, 1974, and part of the capital gain distribution from trust Z was deemed under section 669(a) to have been distributed to A on December 31, 1974. Because there were portions of capital gain distributions from two other trusts deemed distributed within the same prior taxable year of A (1974), the 1978 capital gain distribution from trust X may not be computed under the short-cut method provided in paragraph (c) of this section. Therefore the exact method under paragraph (b) of this section must be used to compute the tax imposed by section 668(a)(3).

[T.D. 7204, 37 FR 17153, Aug. 25, 1972]

§1.669(c)–1A Special rules applicable to section 669.

(a) *Effect of other distributions.* The income of the beneficiary, for any of his prior taxable years for which a tax is being recomputed under §1.669(b)–1A, shall include any amounts of prior accumulation distributions (including prior capital gain distributions) deemed distributed under sections 666 and 669 in such prior taxable year. For purposes of the preceding sentence, a *prior accumulation distribution* is a distribution from the same or another trust which was paid, credited, or required to be distributed in a prior taxable year of the beneficiary. The term *prior accumulation distribution* also includes accumulation distributions of the same or other trusts which were distributed to the beneficiary in the same taxable year. The term ''prior capital gain distribution'' also includes capital gain distributions of other trusts which were paid, credited, or required to be distributed to the beneficiary in the same taxable year and which the beneficiary has determined under paragraph (b) of this section to treat as having been distributed before the capital gain distribution for which tax is being computed under § 1.669(b)–1A.

(b) *Multiple distributions in the same taxable year.* For purposes of paragraph (a) of this section, capital gain distributions made from more than one trust in the same taxable year of the beneficiary, regardless of when in the taxable year they were actually made, shall be treated as having been made consecutively, in whichever order the beneficiary may determine. However, the beneficiary must treat them as having been made in the same order for the purpose of computing the partial tax on the several capital gain distributions. The beneficiary shall indicate the order he has determined to deem the capital gain distributions to have been received by him on his return for the taxable year. A failure by him so to indicate, however, shall not affect his right to make such determination. The purpose of this rule is to assure that the tax resulting from the later (as so deemed under this paragraph) distribution is computed with the inclusion of the earlier distribution in the taxable base and that the tax resulting from the earlier (as so deemed under this paragraph) distribution is computed with the later distribution excluded from the taxable base.

(c) *Rule when beneficiary not in existence on the last day of a taxable year.* If a beneficiary was not in existence on the last day of a preceding taxable year of the trust with respect to which a distribution is deemed made under section 669(a), it shall be assumed, for purposes of the computations under paragraphs (b) and (c) of § 1.669(b)–1A, that the beneficiary:

(1) Was in existence on such last day,

(2) Was a calendar year taxpayer,

(3) Had no gross income other than the amounts deemed distributed to him from such trust in his calendar year in which such last day occurred and from all other trusts from which amounts are deemed to have been distributed to him in such calendar year,

(4) If an individual, was unmarried and had no dependents,

(5) Had no deductions other than the standard deduction, if applicable, under section 141 for such calendar year, and

(6) Was entitled to the personal exemption under section 151 or 642(b).

For example, assume that part of a capital gain distribution made in 1980 is deemed under section 669(a) to have been distributed to the beneficiary, A, in 1973. $10,000 of a prior accumulation distribution was deemed distributed in 1973. A was born on October 9, 1975. It will be assumed for purposes of § 1.669(b)–1A that A was alive in 1973, was on the calendar year basis, had no income other than (i) the $10,000 from the accumulation distribution deemed distributed in 1973 and (ii) the part of the 1980 distribution deemed distributed in 1973, and had no deductions other than the personal exemption provided in section 151. If A were a trust or estate created after 1973, the same assumptions would apply, except that the trust or estate would not be entitled to the standard deduction and would receive the personal exemption provided under section 642(b) in the same manner as allowed under such section for A's first actual taxable year.

(d) *Examples.* The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. In 1978, trust X made a capital gain distribution to A, a calendar year taxpayer, of which $3,000 was deemed to have been distributed in 1974. In 1980, trust X makes another capital gain distribution to A, $10,000 of which is deemed under section 669(a) to have been distributed in 1974. Also in 1980, trust Y makes a capital gain distribution to A, of which $5,000 is deemed under section 669(a) to have been distributed in 1974. A determines to treat the 1980 distribution from trust Y as having been made prior to the 1980 distribution from trust X. In computing the tax on the 1980 trust Y distribution, A's gross income for 1974 includes (i) the $3,000 deemed distributed from the 1978 distribution, and (ii) the $5,000 deemed distributed in 1974 from the 1980 Trust Y capital gain distribution. To compute A's tax under the exact method for 1974 on the $10,000 from the 1980 trust X capital gain distribution deemed distributed in 1974. A's gross income for 1974 includes (i) the $10,000, (ii) the $3,000 previously deemed distributed in 1974 from the 1978 trust X capital gain distribution, and (iii) the $5,000 deemed distributed in 1974 from the 1980 trust Y capital gain distribution.

Example 2. In 1978, trust T makes a capital gain distribution to B, a calendar year taxpayer. Determination of the tax on the distribution under the short-cut method requires the use of B's gross income for 1975, 1976, and 1977. In 1977, B received an accumulation distribution from trust U, of which $2,000 was deemed to have been distributed in 1975, and $3,000 in 1976. B's gross income for 1975, for purposes of using the short-cut method to determine the tax from the trust T capital gain distribution, will be deemed to include the $2,000 deemed distributed in 1975 by trust U, and his gross income for 1976 will be deemed to include the $3,000 deemed distributed by trust U in 1976.

[T.D. 7204, 37 FR 17155, Aug. 25, 1972]

§1.669(c)–2A Computation of the beneficiary's income and tax for a prior taxable year.

(a) *Basis for computation.* (1) The beneficiary's income and tax paid for any prior taxable year for which a recomputation is involved under either the exact method or the short-cut method shall be determined by reference to the information required to be furnished by him under §1.669(c)–3A(a). The gross income, related deductions, and taxes paid for a prior taxable year of the beneficiary as finally determined shall be used for recomputation purposes. The term *as finally determined* shall have the same meaning for purposes of this section as in §1.668(b)–3A(a).

(2) If any computations rely on the beneficiary's return for a prior taxable year for which the applicable period of limitations on assessment under section 6501 has expired, and such return shows a mathematical error on its face which resulted in the wrong amount of tax being paid for such year, the determination of both the tax for such year computed with the inclusion of the section 669 amounts in the beneficiary's gross income, and the tax for such year computed without including such amounts in such gross income, shall be based upon the return after the correction of such mathematical errors.

(b) *Effect of allocation of undistributed capital gain on items based on amount of income and with respect to a net operating loss, a charitable contributions carryover, or a capital loss carryover.* (1) In computing the tax for any taxable year under either the exact method or the short-cut method, any item which depends upon the amount of gross income, adjusted gross income, or taxable income shall be recomputed to take into consideration the amount of undistributed capital gain allocated to such year. For example, if $2,000 of undistributed long-term capital gain is allocated to 1970, adjusted gross income for 1970 is increased from $5,000 to $6,000. The allowable 50 percent charitable deduction under section 170(b)(1)(A) is then increased and the amount of the nondeductible medical expenses under section 213 (3 percent of adjusted gross income) is also increased.

(2) In computing the tax attributable to the undistributed capital gain deemed distributed to the beneficiary in any of his prior taxable years under either the exact method or the short-cut method, the effect of amounts of undistributed capital gain on a net operating loss carryback or carryover, a charitable contributions carryover, or a capital loss carryback or carryover, shall be taken into account. In determining the amount of tax attributable to such deemed distribution, a computation shall also be made for any taxable year which is affected by a net operating loss carryback or carryover, by a charitable contributions carryover, or by a capital loss carryback or carryover determined by reference to the taxable year to which amounts are allocated under either method and which carryback or carryover is reduced or increased by such amounts so allocated.

[T.D. 7204, 37 FR 17155, Aug. 25, 1972]

§ 1.669(c)–3A Information requirements with respect to beneficiary.

(a) *Information to be supplied by beneficiary*—(1) *Use of exact method.* The beneficiary must supply the information required by subparagraph (3) of § 1.668(b)–4A(a) for any prior taxable year for which a recomputation is required under either the exact method or the short-cut method. Such information shall be filed with the beneficiary's return for the year in which the tax under section 668(a)(3) is imposed.

(2) *Failure to furnish.* If the beneficiary fails to furnish the information required by this paragraph for any prior year involved in the exact method, he may not use such method and the tax computed under paragraph (c) of § 1.669(b)–1A (the short-cut method) shall be deemed to be the amount of partial tax imposed by section 668(a)(3). See, however, paragraph (b) of this section for an exception to this rule where the short-cut method is not permitted. If he cannot furnish the information required for a prior year involved in the short-cut method, such year will be recomputed on the basis of the best information available.

(b) *Exception.* If, by reason of § 1.669(b)–1A(e), the beneficiary may not compute the partial tax on the capital gain distribution under § 1.669(b)–1A(c) (the short-cut method), the provisions of subparagraph (2) of paragraph (a) of this section shall not apply. In such case, if the beneficiary fails to provide the information required by § 1.668(b)–4A(a)(3) for any prior taxable year, the district director shall, by utilizing whatever information is available to him (including information supplied by the beneficiary), determine the beneficiary's income and related expenses for such prior taxable year.

[T.D. 7204, 37 FR 17156, Aug. 25, 1972]

§ 1.669(d)–1A Total taxes deemed distributed.

(a) If a capital gain distribution is deemed under § 1.669(a)–1A to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed capital gain for such preceding taxable year, then an additional amount equal to the ''taxes imposed on the trust attributable to the undistributed capital gain'' (as defined in § 1.665(d)–1A(c)) for such preceding taxable year is also deemed to have been properly distributed. For example, assume a trust has no distributable net income and has undistributed capital gain of $18,010 for the taxable year 1974. The taxes imposed on the trust attributable to the undistributed capital gain are $2,190. During the taxable year 1977, a capital gain distribution of $18,010 is made to the beneficiary which is deemed under § 1.669(a)–1A to have been distributed on the last day of 1974. The 1977 capital gain distribution is not less than the 1974 undistributed capital gain. Accordingly, taxes of $2,190 imposed on the trust attributable to the undistributed capital gain for 1974 are also deemed to have been distributed on the last day of 1974. Thus, a total of $20,200 will be deemed to have been distributed on the last day of 1974.

(b) For the purpose of paragraph (a) of this section, the undistributed capital gain of any preceding taxable year and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed capital gain are computed after taking into account any capital gain distributions of taxable years intervening between such preceding taxable year and the taxable year. See paragraph (c) of § 1.669(a)–1A.

[T.D. 7204, 37 FR 17156, Aug. 25, 1972]

§ 1.669(e)–1A Pro rata portion of taxes deemed distributed.

(a) If a capital gain distribution is deemed under § 1.669(a)–1A to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed capital gain for such preceding taxable year, then an additional amount is also deemed to have been properly distributed. The additional amount is equal to the ''taxes imposed on the trust attributable to the undistributed capital gain'' (as defined in § 1.665(d)–1A(c)) for such preceding taxable year, multiplied by a fraction, the numerator of which is the amount of the capital gain distribution allocated to such preceding taxable year and the denominator of which is the undistributed capital gain for such preceding taxable year. See paragraph

(b) of example 1 and paragraphs (c) and (f) of example 2 in § 1.669(e)–2A for illustrations of this paragraph.

(b) For the purpose of paragraph (a) of this section, the undistributed capital gain of any preceding taxable year and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed capital gain are computed after taking into account any capital gain distributions of any taxable years intervening between such preceding taxable year and the taxable year. See paragraph (c) of § 1.669(a)–1A, paragraph (c) of example 1 and paragraphs (e) and (h) of example 2 in § 1.669(e)–2A.

[T.D. 7204, 37 FR 17156, Aug. 25, 1972]

§ 1.669(e)–2A Illustration of the provisions of section 669.

The application of the provisions of §§ 1.669(a)–1A, 1.669(d)–1A, and 1.669(e)–1A may be illustrated by the following examples:

Example 1. (a) A trust created on January 1, 1974, makes capital gain distributions as follows:

1979	$14,000
1980	60,000

The trust had accumulated income in 1974.

For 1974 through 1978, the undistributed portion of capital gain, taxes imposed on the trust attributable to the undistributed capital gain, and undistributed capital gain are as follows:

Year	Undistributed portion of capital gain	Taxes imposed on the trust attributable to the undistributed capital gain	Undistributed capital gain
1974	$24,200	$2,830	$21,370
1975	32,200	4,330	27,870
1976	12,200	1,130	11,070
1977	None	None	None
1978	10,200	910	9,290

(b) Since the entire amount of the capital gain distribution for 1979 ($14,000), determined without regard to the capital gain distribution for 1980, is less than the undistributed capital gain for 1974 ($21,370), an additional amount of $1,854 (14,000/21,370× $2,830) is deemed distributed under section 669(e).

(c) In allocating the capital gain distribution for 1980, the amount of undistributed capital gain for 1974 will reflect the capital gain distribution for 1979. The undistributed capital gain for 1974 will then be $7,370 and the taxes imposed on the trust for 1974 will be $976, determined as follows:

Undistributed capital gain as of the close of 1974	$21,370
Less: Capital gain distribution (1979)	14,000
Balance (undistributed capital gain as of the close of 1979)	7,370
Taxes imposed on the trust attributable to the undistributed capital gain as of the close of 1979 (7,370/ 21,370×2,830)	976

(d) The capital gain distribution of $60,000 for 1980 is deemed to have been made on the last day of the preceding taxable years of the trust to the extent of $55,600, the total of the undistributed capital gain for such years, as shown in the tabulation below. In addition, $7,346, the total taxes imposed on the trust attributable to the undistributed capital gain for such years is also deemed to have been distributed on the last day of such years, as shown below:

Year	Undistributed capital gain	Taxes imposed on the trust attributable to the undistributed capital gain
1974	$7,370	$976
1975	27,870	4,330
1976	11,070	1,130
1977	None	None
1978	9,290	910
1979	None	None
Total	55,600	7,346

Example 2. (a) Under the terms of a trust instrument, the trustee has discretion to accumulate or distribute the income to X and to invade corpus for the benefit of X. The trust is subject to capital gain throwback. Both X and the trust report on the calendar year basis. All of the income for 1974 was distributed and the capital gain was accumulated. The capital gain of the trust for the taxable year 1974 is $40,200 and the income taxes paid by the trust for 1974 attributable to the undistributed capital gain are $6,070. All of the income and capital gains for 1975 and 1976 were distributed and in addition the trustee made capital gain distributions within the meaning of section 665(g) of $8,000 for each year.

(b) The undistributed capital gain of the trust determined under section 665(f) as of the close of 1974 is $34,130, computed as follows:

Capital gain	$40,200
Less: Taxes imposed on the trust attributable to the undistributed capital gain	6,070
Undistributed capital gain as of the close of 1974	34,130

(c) The capital gain distribution of $8,000 made during the taxable year 1975 is deemed under section 669(a) to have been made on December 31, 1974. Since this capital gain distribution is less than the 1974 undistributed capital gain of $34,130, a portion of the taxes imposed on the trust for 1974 is also deemed under section 669(e) to have been distributed on December 31, 1974. The total amount deemed to have been distributed to X on December 31, 1974, is $9,486, computed as follows:

Capital gain distribution	$8,000
Taxes deemed distributed (8,000/34,130×$6,070)	1,423
Total	9,423

(d) After the application of the provisions of subpart D to the capital gain distribution of 1975, the undistributed capital gain of the trust for 1974 is $26,130, computed as follows:

Undistributed capital gain as of the close of 1974	$34,130
Less: 1975 capital gain distribution deemed distributed on December 31, 1974 (paragraph (c) of this example)	8,000
Undistributed capital gain for 1974 as of the close of 1975	26,130

(e) The taxes imposed on the trust attributable to the undistributed capital gain for the taxable year 1974, as adjusted to give effective to the 1975 capital gain distribution, amount to $4,647, computed as follows:

Taxes imposed on the trust attributable to undistributed capital gain as of the close of 1974	$6,070
Less: Taxes deemed distributed in 1974	1,423
Taxes attributable to the undistributed capital gain determined as of the close of 1975	4,647

(f) The capital gain distribution of $8,000 made during the taxable year 1976 is, under section 669(a), deemed an amount properly distributed to X on December 31, 1974. Since the capital gain distribution is less than the 1974 adjusted undistributed capital gain of $26,130, the trust is deemed under section 669(e) also to have distributed on December 31, 1974, a portion of the taxes imposed on the trust for 1974. The total amount deemed to be distributed on December 31, 1974, with respect to the capital gain distribution made in 1976, is $9,423, computed as follows:

Capital gain distribution	$8,000
Taxes deemed distributed (8,000/26,130×$4,647)	1,423
Total	9,423

(g) After the application of the provisions of subpart D to the capital gain distribution of 1976, the undistributed capital gain of the trust for 1974 is $18,130, computed as follows:

Undistributed capital gain for 1974 as of the close of 1975	$26,130
Less:	
1976 capital gain distribution deemed distributed on December 31, 1974 (paragraph (f) of this example)	8,000
Undistributed capital gain for 1974 as of the close of 1976	18,130

(h) The taxes imposed on the trust attributable to the undistributed capital gain of the trust for the taxable year 1974, determined as of the close of the taxable year 1976, amount to $3,224 ($4,647 less $1,423).

[T.D. 7204, 37 FR 17156, Aug. 25, 1972]

§ 1.669(f)–1A Character of capital gain.

Amounts distributed as a capital gain distribution and the taxes attributable thereto (determined under § 1.665(d)–1A(c)) retain the character that the gain had with respect to the trust. Thus, a capital gain that was taxed to the trust as a ‘‘long-term’’ capital gain and the pro rata amount of taxes attributable to such long-term gain shall be treated to the beneficiary as a ‘‘long-term’’ capital gain when they are deemed distributed as part of a capital gain distribution. If a trust has different types of capital gain for the same taxable year, and all of the capital gains are not deemed distributed for such year under section 669(a), the amount deemed distributed from such year (including taxes deemed distributed) shall be treated as consisting of the different types of gains in the ratio that the total of each such type of gains of the trust bears to the total of all such gains for the taxable year. For example, assume that in 1975 a trust had net long-term capital gains of $4,000 and net short-term capital gains of $2,000. Taxes attributable to such undistributed capital gain were $700. Therefore, undistributed capital gain for 1975 is $5,300. In 1980, the trust distributes $2,650 that is deemed to be undistributed capital gain from 1975. Such distribution is deemed to consist of long-term gain of $1,766.67 and short-term gain of $883.33. The taxes deemed distributed of $350 consist of long-term gain of $233.33 and short-term gain of $116.67.

[T.D. 7204, 37 FR 17157, Aug. 25, 1972]

§1.669(f)–2A Exception for capital gain distributions from certain trusts.

(a) *General rule.* If a capital gain distribution is paid, credited, or required to be distributed before January 1, 1973, from a trust that was in existence on December 31, 1969, section 669 shall not apply and no tax shall be imposed on such capital gain distribution under section 668(a)(3). If capital gain distributions from more than one such trust are paid, credited, or required to be distributed to a beneficiary before January 1, 1973, the exception under the preceding sentence shall apply only to the capital gain distributions from one of the trusts. The beneficiary shall indicate on his income tax return for the taxable year in which the distribution would otherwise be included in income under section 668(a) the trust to which the exception provided by this section shall apply.

(b) *Special rule for section 2056(b)(5) trust.* A capital gain distribution paid, credited, or required to be distributed by a trust that qualifies under section 2056(b)(5) of the Code (commonly known as a ‘‘marital deduction trust’’) to a surviving spouse shall, in general, not be taxed under section 668(a)(3) since such a trust is required to distribute all of its income annually or more often. See section 2056(b)(5) and the regulations thereunder.

(c) *Effect of exception.* If this section applies to a capital gain distribution from a trust, such distribution shall reduce the undistributed capital gain of the trust. Since section 669 does not apply to such capital gain distribution, no amount of taxes paid by the trust attributable to such capital gain distribution are deemed distributed under section 669 (d) and (e).

[T.D. 7204, 37 FR 17157, Aug. 25, 1972]

§1.669(a)–1 Limitation on tax.

(a) *In general.* Section 669 provides that, at the election of a beneficiary who is a U.S. person (as defined in section 7701(a)(30)) and who satisfies the requirements of section 669(b) (that certain information with respect to the operation and accounts of the trust be supplied), the tax attributable to the amounts treated under section 668(a) as having been received by him, from a foreign trust created by a U.S. person, on the last day of a preceding taxable year of the trust shall not be greater than the tax computed under section 669(a)(1)(A) (the computation under this provision will hereinafter be referred to as the ‘‘exact throwback’’ method) or under section 669(a)(1)(B) (the computation under this provision will hereinafter be referred to as the ‘‘short-cut throwback’’ method). This election of the beneficiary with respect to the taxable year of the beneficiary in which the distribution is made shall be made with the district director before the expiration of the period of limitations for assessment provided in section 6501 for such taxable year.

(b) *Where no election is made.* If the beneficiary does not make the election provided in section 669(a) in the manner required in section 669(b) and §1.669(b)–2, or furnish the information with respect to the operation and accounts of the foreign trust created by a U.S. person required by section 669(b) and §1.669(b)–1, the tax on an accumulation distribution treated under section 668(a) as having been received by him from such foreign trust on the last day of a preceding taxable year of the trust shall be computed without reference to section 668 or 669. In such case, the entire accumulation distribution will be included in the gross income of the beneficiary in the year in which it is paid, credited, or required to be distributed, and tax for such year will be computed on the basis of the beneficiary’s total taxable income for the year after taking into account such inclusion in gross income.

(c) *Year for which tax is payable.* The tax, regardless of the manner in which computed, of the beneficiary which is attributable to an accumulation distribution is imposed on the beneficiary for the taxable year of the beneficiary in which the accumulation distribution is made to him unless the taxable year of the beneficiary is different from that of the trust. See section 662(c) and §1.662(c)–1.

[T.D. 6989, 34 FR 738, Jan. 17, 1969]

§1.669(a)–2 Rules applicable to section 669 computations.

(a) *In general.* (1) Section 668(a) provides that the total of the amounts treated under section 666 as having been distributed by the foreign trust created by a U.S. person on the last day of a preceding taxable year of such trust shall be included in the gross income of the beneficiary or the beneficiaries who are U.S. persons receiving them. The total of such amounts is includible in the gross income of each beneficiary to the extent the amount would have been included in his gross income under section 662 (a)(2) and (b) if the total had actually been paid by the trust on the last day of such preceding taxable year. The total is included in the gross income of the beneficiary for the taxable year of the beneficiary in which such amounts are in fact paid, credited, or required to be distributed unless the taxable year of the beneficiary differs from the taxable year of the trust (see section 662(c) and § 1.662(c)–1). The character of the amounts treated as received by a beneficiary in prior taxable years, including taxes deemed distributed, in the hands of the beneficiary is determined by the rules contained in section 662(b) and §§ 1.662(b)–1 and 1.662(b)–2.

(2) The total of the amounts treated under section 666 as having been distributed by the trust on the last day of a preceding taxable year of the trust are included as prescribed in subparagraph (1) of this paragraph in the gross income of the beneficiary even though as of that day the beneficiary would not have been entitled to receive them had they actually been distributed on that day.

(3) Any deduction allowed to the trust in computing distributable net income for a preceding taxable year (such as depreciation, depletion, etc.) is not deemed allocable to a beneficiary because of the amounts included in a beneficiary's gross income under this section since the deduction has already been utilized in reducing the amount included in the beneficiary's income.

(b) *Allocation among beneficiaries of a foreign trust.* Where there is more than one beneficiary the portion of the total amount includible in gross income under paragraph (a) of this section which is includible in the gross income of a beneficiary who is a U.S. person is based upon the ratio determined under the second sentence of section 662(a)(2) for the taxable year in which distributed (and not for the preceding taxable year). This paragraph may be illustrated by the example in § 1.668(a)–2.

(c) *Treatment of income taxes paid by the trust*—(1) *Current distributions.* The income taxes imposed by the provisions of section 871 on the income of a foreign trust created by a U.S. person shall be included in the gross income of the beneficiary, who is a U.S. person, for the taxable year in which such income is paid, credited, or required to be distributed to the beneficiary.

(2) *Accumulation distribution.* (i) If an accumulation distribution is deemed under § 1.666(a)–1 to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed net income for such preceding taxable year, then an additional amount equal to the taxes imposed on the trust pursuant to the provisions of section 871 for such preceding taxable year is likewise deemed distributed under section 661(a)(2).

(ii) If an accumulation distribution is deemed under § 1.666(a)–1 to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed net income for such preceding taxable year, then an additional amount (representing taxes) is likewise deemed distributed under section 661(a)(2). The additional amount is equal to the taxes imposed on the trust pursuant to the provisions of section 871 for such preceding taxable year, multiplied by the fraction the numerator of which is the amount of the accumulation distribution attributable to such preceding taxable year and the denominator of which is the undistributed net income for such preceding taxable year.

(3) *Credits under sections 32 and 668(b).* Credit under section 32 is allowable to the beneficiary for income taxes withheld at source under subchapters A and B of chapter 3 and which are deemed distributed to him. Credit under section 668(b) is allowable to the beneficiary for income taxes imposed upon the foreign trust by section 871(b). These credits shall be allowed against the tax of the beneficiary for the taxable year of the beneficiary in which

the income is paid, credited, or required to be distributed to him, or in which the accumulation distribution to which such taxes relate is made to him.

(d) *Credit for foreign income taxes paid by the trust.* To the extent provided in section 901, credit under section 33 is allowable to the beneficiary for the foreign taxes paid or accrued by the trust to a foreign country.

[T.D. 6989, 34 FR 738, Jan. 17, 1969]

§1.669(a)–3 Tax computed by the exact throwback method.

(a) *Tax attributable to amounts treated as received in preceding taxable years.* If a taxpayer elects to compute the tax, on amounts deemed distributed under section 666, by the exact throwback method provided in section 669(a)(1)(A), the tax liability of the beneficiary for the taxable year in which the accumulation distribution is paid, credited, or required to be distributed is computed as provided in paragraph (b) of this section. The beneficiary may not elect to use the exact throwback method of computing his tax on an accumulation distribution as provided in section 669(a)(1)(A) if he were not alive on the last day of each preceding taxable year of the foreign trust created by a U.S. person with respect to which a distribution is deemed made under section 666(a). Thus, if a portion of an amount received as an accumulation distribution was accumulated by the trust during years before the beneficiary was born, the beneficiary is not permitted to elect the exact throwback method provided in section 669(a)(1)(A). See §1.669(a)–4 for the computation of the tax on an accumulation distribution by the short-cut throwback method provided in section 669(a)(1)(B) under these circumstances.

(b) *Computation of tax.* The tax referred to in paragraph (a) of this section is computed as follows:

(1) First, compute the tax attributable to the section 666 amounts for each of the preceding taxable years. To determine the section 666 amounts attributable to each of the preceding taxable years, see §1.666(a)–1. The tax attributable to such amounts in each such preceding taxable year is the difference between the tax for such preceding taxable year computed with the inclusion of the section 666 amounts in gross income, and the tax for such year computed without including them in gross income. Tax computations for each preceding year shall reflect the taxpayer's marital and dependency status for that year.

(2) Second, add

(i) The sum of the taxes for the preceding taxable years attributable to the section 666 amounts (computed in accordance with subparagraph (1) of this paragraph), and

(ii) The tax for the taxable year of the beneficiary in which the accumulation distribution is paid, credited, or required to be distributed to him, computed without including the section 666 amounts in gross income.

The total of these amounts is the beneficiary's tax, computed under section 669(a)(1)(A) for the taxable year in which the accumulation distribution is paid, credited, or required to be distributed to him.

(c) *Effect of prior election.* In computing the tax attributable to an accumulation distribution for the taxable year in which such accumulation distribution is paid, credited, or required to be distributed to him, the beneficiary in computing the tax attributable to section 666 amounts for each of the preceding taxable years, must include in his gross income for each such year the section 666 amounts deemed distributed to him in such year resulting from prior accumulation distributions made to him in taxable years prior to the current taxable year. These section 666 amounts resulting from such prior accumulation distributions must be included in the gross income for such preceding taxable year even though the tax on the accumulation distribution of such prior taxable year was computed by the short-cut throwback method provided in section 669(a)(1)(B) and §1.669(a)–4.

[T.D. 6989, 34 FR 739, Jan. 17, 1969]

§1.669(a)–4 Tax attributable to short-cut throwback method.

(a) *Manner of computing tax.* If a beneficiary has elected under section 669(a) to compute the tax on the amounts deemed distributed under section 666 by the short-cut throwback method provided in section 669(a)(1)(B), the tax liability of the beneficiary for the taxable year is computed in the following manner:

(1) First, determine the number of preceding taxable years of the trust, on the last day of which an amount is deemed under section 666(a) to have been distributed. In any case where there has been a prior accumulation distribution with respect to which the beneficiary has elected to compute his tax either by the exact throwback method or by the short-cut throwback method, or to which the next to the last sentence of section 668(a) has applied, for purposes of an election to use the short-cut throwback method with respect to a subsequent accumulation distribution, in determining the number of preceding taxable years of the trust with respect to which an amount of the subsequent accumulation distribution is deemed distributed to a beneficiary under section 666(a), there shall be excluded any preceding taxable year during which any part of the prior accumulation distribution was deemed distributed to the beneficiary. For example, assume that an accumulation distribution of $90,000 made to a beneficiary in 1963 is deemed distributed in the amounts of $25,000 in each of the years 1962, 1961, and 1960, and in the amount of $15,000 in 1959, and a subsequent accumulation distribution of $85,000 made to the same beneficiary in 1964 is deemed distributed in the amount of $10,000 during 1959, and $25,000 during each of the years 1958, 1957, and 1956. The accumulation distribution made in 1963 is deemed distributed in 4 preceding taxable years of the trust (1962, 1961, 1960, and 1959). Inasmuch as the year 1959 was a year during which part of the 1963 accumulation distribution was deemed distributed, for purposes of determining the number of preceding taxable years in which the accumulation distribution of $85,000 made in 1964 is deemed distributed, the year 1959 is excluded and the $85,000 accumulation distribution is deemed distributed in three preceding taxable years (1958, 1957, and 1956),

(2) Second, divide the number of preceding taxable years of the trust, on the last day of which an amount is deemed under section 666(a) to have been distributed (determined as provided in subparagraph (1) of this paragraph) into the amount (representing an accumulation distribution made by a foreign trust created by a U.S. person) required to be included under section 669(a) in the gross income of the beneficiary for the taxable year,

(3) Third, compute the tax of the beneficiary for the current taxable year (the year in which the accumulation distribution is paid, credited, or required to be distributed to him) and for each of the 2 taxable years immediately preceding such year,

(i) With the inclusion in gross income of the beneficiary for each of such 3 years of the amount determined under subparagraph (2) of this paragraph, and

(ii) Without such inclusion.

The difference between the amount of tax computed under subdivision (i) of this subparagraph for each year and the amount computed under subdivision (ii) of this subparagraph for that year is the additional tax resulting from the inclusion in gross income for that year of the amount determined under subparagraph (2) of this paragraph. If the number of preceding taxable years of the trust, on the last day of which an amount is deemed under section 666(a) to have been distributed, is less than three, the taxable years of the beneficiary for which this recomputation is made shall equal the number of years in which an amount is deemed under section 666(a) to have been distributed, commencing with the taxable year of the beneficiary in which the accumulation distribution is paid, credited, or required to be distributed to him. If the beneficiary was not alive during one of the two taxable years immediately preceding the taxable year, the tax resulting from the inclusion of the amount determined in subparagraph (2) of this paragraph in the gross income of the beneficiary will be computed only for the taxable year in which the accumulation distribution was paid, credited, or required to be distributed to him and the preceding year during which the beneficiary was alive. In the event the beneficiary was not alive during either of the 2 years immediately preceding the taxable year in which the accumulation distribution was paid, credited, or required to be distributed, the tax shall be computed on the basis of the beneficiary's taxable year without regard to the inclusion in income required by section 668(a) of any amount other than pursuant to section 669(a)(1)(B). For example, assume that a foreign trust created by a U.S. person accumulates $3,000 of income in 1964 and $7,000 in 1963 and then distributes the accumulated income on January 1, 1965, to a beneficiary who is a U.S. person. The limitation on tax is determined by recomputing the beneficiary's gross income for 1964 and 1965 by adding $5,000 to his gross income for each year. If the same distribution were made to an infant who was born in 1965, the limitation on tax would be computed by adding $5,000 to his gross income for such year. In the case of the infant, the resulting increase in tax would be multiplied by two to arrive at the limitation on the increase in his tax for 1965 attributable to such distribution.

(4) Fourth, add the additional taxes resulting from the application of subparagraph (3) of this paragraph for the taxable year and the 2 taxable years (or the 1 taxable year, where applicable) immediately preceding the year in which the accumulation distribution is paid, credited, or required to be distributed and then divide this amount by three (or two, where applicable). The resulting amount is then multiplied by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed (previously determined under subparagraph (1) of this paragraph). The resulting amount is the tax, under the short-cut throwback method provided in section 669(a)(1)(B), which is attributable to the amounts treated under section 668(a) as having been received by the beneficiary from a foreign trust created by a U.S. person on the last day of the preceding taxable year.

(5) Fifth, add the amount determined under subparagraph (4) of this paragraph to the beneficiary's tax for the taxable year in which the accumulation distribution was paid, credited, or required to be distributed to him, computed without inclusion of the accumulation distribution in gross income for that year. The total is the beneficiary's income tax for such year.

(b) *Credit for tax paid by trust.* The income taxes deemed distributed to a beneficiary in the manner described in paragraphs (c) and (d) of §1.669(a)–2 are included in the beneficiary's gross income for purposes of the computations required by this section. To the extent provided in §1.669(a)–2, credits for such taxes are allowable to the beneficiary. In the computations under the short-cut throwback method provided in section 669(a)(1)(B), the rules set forth in section 662(b) and §1.662(b)–1 shall be applied in determining the character, in the hands of the beneficiary, of the amounts, including taxes includible in the distribution or deemed distributed, treated as received by a beneficiary in prior taxable years. For example, if one-fifth of such amounts represents tax-free income, then one-fifth of the amount determined under paragraph (a)(2) of this section shall be treated as tax-free income.

[T.D. 6989, 34 FR 739, Jan. 17, 1969]

§1.669(b)–1 Information requirements.

The election of a beneficiary who is a U.S. person to apply the limitations on tax provided in section 669(a) shall not be effective unless the beneficiary, at or before the time the election is made, supplies, in a letter addressed to the district director for the internal revenue district in which the taxpayer files his return (or the Director of International Operations where appropriate), or in a statement attached to his return, the following information with respect to the operation and accounts of the foreign trust created by a U.S. person for each of the preceding taxable years, on the last day of which an amount is deemed distributed under section 666(a):

(a) The gross income of the trust: The gross income should be separated to show the amount of each type of income received by the trust and to identify its source. For example, the beneficiary should list separately, by type (dividends, rents, capital gains, taxable interest, exempt interest, etc.) and source (name and country of payor), each item of income included in the gross income of the trust. For this purpose, the gross income of the trust includes gross income from U.S. sources which is exempt from taxation under section 894.

(b) The amount of tax withheld under section 1441 by the United States on income from sources within the United States.

(c) The amount of the tax paid to each foreign country by the trust.

(d) The expenses of the trust attributable to each type of income disclosed in paragraph (b) of this section, and the general expenses of the trust.

(e) The distributions, if any, made by the trust to the beneficiaries (including those who are not U.S. persons). These distributions should be separated into amounts of income required to be distributed currently within the meaning of section 661(a)(1), and any other amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2).

(f) Any other information which is necessary for the computation of tax on the accumulation distribution as provided in section 669(a).

(g) If the foreign trust created by a U.S. person is less than the entire foreign trust, the information listed in paragraphs (a) through (f) of this section shall also be furnished with respect to that portion of the entire foreign trust which is not a foreign trust created by a U.S. person.

[T.D. 6989, 34 FR 740, Jan. 17, 1969]

§1.669(b)–2 Manner of exercising election.

(a) *By whom election is to be made.* Except as otherwise provided in this paragraph, a taxpayer whose tax liability is affected by the election shall make the election provided in section 669(a). In the case of a partnership, or a corporation electing under the provisions of subchapter S, chapter 1 of the Code, the election shall be exercised by the partnership or such corporation.

(b) *Time and manner of making election.* The election under section 669(a) may be made, or revoked, at any time before the expiration of the period provided in section 6501 for assessment of the tax. If an election is revoked, a new election may be made at any time before the expiration of such period. The election (or a revocation of an election) may be made in a letter addressed to the district director of internal revenue for the district in which the taxpayer files his tax return (or the Director of International Operations where appropriate) or may be made in a statement attached to the return. In any case where all the information described in §1.669(b)–1 is not furnished at or before the time the beneficiary signifies his intention of making an election and by reason thereof an election has not been made, and subsequent thereto, but before the expiration of the period provided in section 6501 for the assessment of the tax, there is furnished the required information not previously furnished, the election will be considered as made at the time such additional information is furnished.

[T.D. 6989, 34 FR 740, Jan. 17, 1969]

UNITRUST ACTUARIAL TABLES APPLICABLE BEFORE MAY 1, 1989

§1.664–4A Valuation of charitable remainder interests for which the valuation date is before May 1, 1989.

(a) *Valuation of charitable remainder interests for which the valuation date is before January 1, 1952.* There was no provision for the qualification of a charitable remainder unitrust under section 664 until 1969. See §20.2031–7A(a) of this chapter (Estate Tax Regulations) for the determination of the present value of a charitable interest for which the valuation date is before January 1, 1952.

(b) *Valuation of charitable remainder interests for which the valuation date is after December 31, 1951, and before January 1, 1971.* No charitable deduction is allowable for a transfer to a unitrust for which the valuation date is after the effective dates of the Tax Reform Act of 1969 unless the unitrust meets the requirements of section 664. See §20.2031–7A(b) of this chapter (Estate Tax Regulations) for the determination of the present value of a charitable remainder interest for which the valuation date is after December 31, 1951, and before January 1, 1971.

(c) *Valuation of charitable remainder unitrusts having certain payout sequences for transfers for which the valuation date is after December 31, 1970, and before December 1, 1983.* For the determination of the present value of a charitable remainder unitrust for which the valuation date is after December 31, 1970, and before December 1, 1983, see §20.2031–7A(c) of this chapter (Estate Tax Regulations) and former §1.664–4(d) (as contained in the 26 CFR part 1 edition revised as of April 1, 1994).

(d) *Valuation of charitable remainder unitrusts having certain payout sequences for transfers for which the valuation date is after November 30, 1983, and before May 1, 1989*—(1) *In general.* Except as otherwise provided in paragraph (d)(2) of this section, in the case of transfers made after November 30, 1983, for which the valuation date is before May 1, 1989, the present value of a remainder interest that is dependent on a term of years or the termination of the life of one individual is determined under paragraphs (d)(3) through (d)(6) of this section, provided that the amount of the payout as of any payout date during any taxable year of the trust is not larger than the amount that the trust could distribute on such date under §1.664–3(a)(1)(v) if the taxable year of the trust were to end on such date. The present value of the remainder interest in the trust is determined by computing the adjusted payout rate (as defined in paragraph (d)(3) of this section) and following the procedure outlined in paragraph (d)(4) or (d)(5) of this section, whichever is applicable. The present value of a remainder interest that is dependent on a term of years is computed under paragraph (d)(4) of this section. The present value of a remainder interest that is dependent on the termination of the life of one individual is computed under paragraph (d)(5) of this section. See paragraph (d)(2) of this section for testamentary transfers for which the valuation date is after November 30, 1983, and before August 9, 1984.

(2) *Rules for determining the present value for testamentary transfers where the decedent dies after November 30, 1983, and before August 9, 1984.* For purposes of section 2055 or 2106, if—

(i) The decedent dies after November 30, 1983, and before August 9, 1984; or

(ii) On December 1, 1983, the decedent was mentally incompetent so that the disposition of the property could not be changed, and the decedent died after November 30, 1983, without regaining competency to dispose of the decedent's property, or died within 90 days of the date on which the decedent first regained competency, the present value determined under this section of a remainder interest is determined in accordance with paragraph (d)(1) and paragraphs (d)(3) through (d)(6) of this section, or §1.664–4A(c), at the option of the taxpayer.

(3) *Adjusted payout rate.* The adjusted payout rate is determined by multiplying the fixed percentage described in paragraph (a)(1)(i)(*a*) of §1.664–3 by the figure in column (2) of Table F(1) which describes the payout sequence of the trust opposite the number in column (1) of Table F(1) which corresponds to the number of months by which the valuation date for the first full taxable year of the trust precedes the first payout date for such taxable year. If the governing instrument does not prescribe when the distribution shall be made during the taxable year of the trust, see §1.664–4(a). In the case of a trust having a payout sequence for which no figures have been provided by Table F (1) and in the case of a trust which determines the fair market value of the trust assets by taking the average of valuations on more than one date during the taxable year, see §1.664–4(b).

(4) *Period is a term of years.* If the period described in paragraph (a)(5) of §1.664–3 is a term of years, the factor which is used in determining the present value of the remainder interest is the factor under the appropriate adjusted payout rate in column (2) of Table D in paragraph (d)(6) of this section opposite the number in column (1) of Table D which corresponds to the number of years in the term. If the adjusted payout rate is an amount which is between adjusted payout rates for which factors are provided in Table D, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the appropriate valuation date) of the property placed in trust by the factor determined under this paragraph (d)(4). For purposes of this section, the term *appropriate valuation date* means the date on which the property is transferred to

the trust by the donor except that, for purposes of section 2055 or 2106, it means the date of death unless the alternate valuation date is elected in accordance with section 2032 and the regulations thereunder in which event it means the alternate valuation date. If the adjusted payout rate is greater than 14 percent, see § 1.664–4(b). The application of this paragraph (d)(4) may be illustrated by the following example:

Example. D transfers $100,000 to a charitable remainder unitrust on January 1, 1985. The trust instrument requires that the trust pay to D semiannually (on June 30 and December 31) 10 percent of the fair market value of the trust assets as of June 30th for a term of 15 years. The adjusted payout rate is 9.767 percent (10% x 0.976731). The present value of the remainder interest is $21,404.90, computed as follows:

Factor at 9.6 percent for 15 years	0.220053
Factor at 9.8 percent for 15 years	.212862
Difference	.007191

$$\frac{9.767\% - 9.6\%}{0.2\%} = \frac{X}{.007191}$$

$9.767\% - 9.6 \div 0.2\% = x \div .007191$

$X = .006004$

Factor at 9.6 percent for 15 years	0.220053
Less: X	.006004
Interpolated factor	.214049

Present value of remainder interest=$100,000×0.214049=$21,404.90

(5) *Period is the life of one individual.* If the period described in paragraph (a)(5) of § 1.664–3 is the life of one individual, the factor that is used in determining the present value of the remainder interest is the factor under the appropriate adjusted payout rate in column (2) of Table E in paragraph (d)(6) of this section opposite the number in column (1) that corresponds to the age of the individual whose life measures the period. For purposes of the computations described in this paragraph (b)(5), the age of an individual is to be taken as the age of that individual at the individual's nearest birthday. If the adjusted payout rate is an amount which is between adjusted payout rates for which factors are provided for in Table E, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the appropriate valuation date) of the property placed in trust by the factor determined under this paragraph (b)(5). If the adjusted payout rate is greater than 14 percent, see § 1.664–4(b). The application of this paragraph may be illustrated by the following example:

Example. A, who will be 50 years old on April 15, 1985, transfers $100,000 to a charitable remainder unitrust on January 1, 1985. The trust instrument requires that the trust pay to A at the end of each taxable year of the trust 10 percent of the fair market value of the trust assets as of the beginning of each taxable year of the trust. The adjusted payout rate is 9.091 percent (10 percent × .909091). The present value of the remainder interest is $15,259.00 computed as follows:

Factor at 9 percent at age 50	0.15472
Factor at 9.2 percent at age 50	.15003
Difference	.00469

9.091% − 9%÷0.2%=X÷0.00469
x=0.00213

Factor at 9 percent at age 50	.15472
Less: X	.00213
Interpolated factor	.15259

Present value of remainder interest=
$100,000×0.15259=$15,259.00

(6) *Actuarial tables for transfers for which the valuation date is after November 30, 1983, and before May 1, 1989.* The following tables shall be used in the application of the provisions of this section:

TABLE D

TABLE D—TERM CERTAIN—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	2.2%	2.4%	2.6%	2.8%	3.0%
1	.978000	.976000	.974000	.972000	.970000
2	.956484	.952576	.948676	.944784	.940900
3	.935441	.929714	.924010	.918330	.912673
4	.914862	.907401	.899986	.892617	.885293
5	.894735	.885623	.876587	.867624	.858734
6	.875051	.864368	.853795	.843330	.832972
7	.855799	.843624	.831597	.819717	.807983
8	.836972	.823377	.809975	.796765	.783743
9	.818558	.803616	.788916	.774455	.760231
10	.800550	.784329	.768404	.752771	.737424
11	.782938	.765505	.748425	.731693	.715301
12	.765713	.747133	.728966	.711206	.693842
13	.748868	.729202	.710013	.691292	.673027
14	.732393	.711701	.691553	.671936	.652836
15	.716280	.694620	.673573	.653121	.633251
16	.700522	.677949	.656060	.634834	.614254
17	.685110	.661678	.639002	.617059	.595826
18	.670038	.645798	.622388	.599781	.577951
19	.655297	.630299	.606206	.582987	.560613

Table D—Continued

Table D—Term Certain—Table Showing the Present Worth of a Remainder Interest Postponed for a Term of Years in a Charitable Remainder Unitrust Having the Adjusted Payout Rate Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Years	(2) Adjusted payout rate				
	2.2%	2.4%	2.6%	2.8%	3.0%
20	.640881	.615172	.590445	.566664	.543794

Table D

Table D—Term Certain—Table Showing the Present Worth of a Remainder Interest Postponed for a Term of Years in a Charitable Remainder Unitrust Having the Adjusted Payout Rate Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Years	(2) Adjusted payout rate				
	3.2%	3.4%	3.6%	3.8%	4.0%
1	.968000	.966000	.964000	.962000	.960000
2	.937024	.933156	.929296	.925444	.921600
3	.907039	.901429	.895841	.890277	.884736
4	.878014	.870780	.863591	.856447	.849347
5	.849918	.841174	.832502	.823902	.815373
6	.822720	.812574	.802532	.792593	.782758
7	.796393	.784946	.773641	.762475	.751447
8	.770909	.758258	.745790	.733501	.721390
9	.746239	.732477	.718941	.705628	.692534
10	.722360	.707573	.693059	.678814	.664833
11	.699244	.683516	.668109	.653019	.638239
12	.676868	.660276	.644057	.628204	.612710
13	.655209	.637827	.620871	.604332	.588201
14	.634242	.616141	.598520	.581368	.564673
15	.613946	.595192	.576973	.559276	.542086
16	.594300	.574955	.556202	.538023	.520403
17	.575282	.555407	.536179	.517578	.499587
18	.556873	.536523	.516876	.497911	.479603
19	.539053	.518281	.498269	.478990	.460419
20	.521804	.500660	.480331	.460788	.442002

Table D

Table D—Term Certain—Table Showing the Present Worth of a Remainder Interest Postponed for a Term of Years in a Charitable Remainder Unitrust Having the Adjusted Payout Rate Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Years	(2) Adjusted payout rate				
	4.2%	4.4%	4.6%	4.8%	5.0%
1	.958000	.956000	.954000	.952000	.950000
2	.917764	.913936	.910116	.906304	.902500
3	.879218	.873723	.868251	.862801	.857375
4	.842291	.835279	.828311	.821387	.814506
5	.806915	.798527	.790209	.781960	.773781
6	.773024	.763392	.753859	.744426	.735092
7	.740557	.729802	.719182	.708694	.698337
8	.709454	.697691	.686099	.674677	.663420
9	.679657	.666993	.654539	.642292	.630249
10	.651111	.637645	.624430	.611462	.598737
11	.623764	.609589	.595706	.582112	.568800
12	.597566	.582767	.568304	.554170	.540360
13	.572469	.557125	.542162	.527570	.513342
14	.548425	.532611	.517222	.502247	.487675
15	.525391	.509177	.493430	.478139	.463291
16	.503325	.486773	.470732	.455188	.440127
17	.482185	.465355	.449079	.433339	.418120
18	.461933	.444879	.428421	.412539	.397214

Table D—Continued

Table D—Term Certain—Table Showing the Present Worth of a Remainder Interest Postponed for a Term of Years in a Charitable Remainder Unitrust Having the Adjusted Payout Rate Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Years	(2) Adjusted payout rate				
	4.2%	4.4%	4.6%	4.8%	5.0%
19	.442532	.425304	.408714	.392737	.377354
20	.423946	.406591	.389913	.373886	.358486

Table D

Table D—Term Certain—Table Showing the Present Worth of a Remainder Interest Postponed for a Term of Years in a Charitable Remainder Unitrust Having the Adjusted Payout Rate Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Years	(2) Adjusted payout rate				
	5.2%	5.4%	5.6%	5.8%	6.0%
1	.948000	.946000	.944000	.942000	.940000
2	.898704	.894916	.891136	.887364	.883600
3	.851971	.846591	.841232	.835897	.830584
4	.807669	.800875	.794123	.787415	.780749
5	.765670	.757627	.749652	.741745	.733904
6	.725855	.716716	.707672	.689724	.689870
7	.688111	.678013	.668042	.658198	.648478
8	.652329	.641400	.630632	.620022	.609569
9	.618408	.606765	.595317	.584061	.572995
10	.586251	.573999	.561979	.550185	.538615
11	.555766	.543003	.530508	.518275	.506298
12	.526866	.513681	.500800	.488215	.475920
13	.499469	.485942	.472755	.459898	.447365
14	.473496	.459701	.446281	.433224	.420523
15	.448875	.434878	.421289	.408097	.395292
16	.425533	.411394	.397697	.384427	.371574
17	.403405	.389179	.375426	.362131	.349280
18	.382428	.368163	.354402	.341127	.328323
19	.362542	.348282	.334555	.321342	.308624
20	.343690	.329475	.315820	.302704	.290106

Table D

Table D—Term Certain—Table Showing the Present Worth of a Remainder Interest Postponed for a Term of Years in a Charitable Remainder Unitrust Having the Adjusted Payout Rate Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Years	(2) Adjusted payout rate				
	6.2%	6.4%	6.6%	6.8%	7.0%
1	.938000	.936000	.934000	.932000	.930000
2	.879844	.876096	.872356	.868624	.864900
3	.825294	.820026	.814781	.809558	.804357
4	.774125	.767544	.761005	.754508	.748052
5	.726130	.718421	.710779	.703201	.695688
6	.681110	.672442	.663867	.655383	.646990
7	.638881	.629406	.620052	.610817	.601701
8	.599270	.589124	.579129	.569282	.559582
9	.562115	.551420	.540906	.530571	.520411
10	.527264	.516129	.505206	.494492	.483982
11	.494574	.483097	.471863	.460866	.450104
12	.463910	.452179	.440720	.429527	.418596
13	.435148	.423239	.411632	.400320	.389295
14	.408169	.396152	.384465	.373098	.362044
15	.382862	.370798	.359090	.347727	.336701
16	.359125	.347067	.335390	.324082	.313132
17	.336859	.324855	.313254	.302044	.291213

TABLE D—Continued

TABLE D—TERM CERTAIN—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	6.2%	6.4%	6.6%	6.8%	7.0%
18	.315974	.304064	.292579	.281505	.270828
19	.296383	.284604	.273269	.262363	.251870
20	.278008	.266389	.255233	.244522	.234239

TABLE D

TABLE D—TERM CERTAIN—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	7.2%	7.4%	7.6%	7.8%	8.0%
1	.928000	.926000	.924000	.922000	.920000
2	.861184	.857476	.853776	.850084	.846400
3	.799179	.794023	.788889	.783777	.778688
4	.741638	.735265	.728933	.722643	.716393
5	.688240	.680855	.673535	.666277	.659082
6	.638687	.630472	.622346	.614307	.606355
7	.592701	.583817	.575048	.566391	.557847
8	.550027	.540615	.531344	.522213	.513219
9	.510425	.500609	.490962	.481480	.472161
10	.473674	.463564	.453649	.443925	.434388
11	.439570	.429260	.419171	.409298	.399637
12	.407921	.397495	.387314	.377373	.367666
13	.378550	.368081	.357879	.347938	.338253
14	.351295	.340843	.330680	.320799	.311193
15	.326002	.315620	.305548	.295777	.286297
16	.302529	.292264	.282326	.272706	.263394
17	.280747	.270637	.260870	.251435	.242322
18	.260533	.250610	.241044	.231823	.222936
19	.241775	.232065	.222724	.213741	.205101
20	.224367	.214892	.205797	.197069	.188693

TABLE D

TABLE D—TERM CERTAIN—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	8.2%	8.4%	8.6%	8.8%	9.0%
1	.918000	.916000	.914000	.912000	.910000
2	.842724	.839056	.835396	.831744	.828100
3	.773621	.768575	.763552	.758551	.753571
4	.710184	.704015	.697886	.691798	.685750
5	.651949	.644878	.637868	.630920	.624032
6	.598489	.590708	.583012	.575399	.567869
7	.549413	.541089	.532873	.524764	.516761
8	.504361	.495637	.487046	.478585	.470253
9	.463003	.454004	.445160	.436469	.427930
10	.425037	.415867	.406876	.398060	.389416
11	.390184	.380934	.371885	.363031	.354369
12	.358189	.348936	.339902	.331084	.322475
13	.328817	.319625	.310671	.301949	.293453
14	.301854	.292777	.283953	.275377	.267042
15	.277102	.268184	.259533	.251144	.243008
16	.254380	.245656	.237213	.229043	.221137
17	.233521	.225021	.216813	.208887	.201235
18	.214372	.206119	.198167	.190505	.183124
19	.196794	.188805	.181125	.173741	.166643
20	.180657	.172946	.165548	.158452	.151645

TABLE D

TABLE D—TERM CERTAIN—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	9.2%	9.4%	9.6%	9.8$	10.0%
1	.908000	.906000	.904000	.902000	.900000
2	.824464	.820836	.817216	.813604	.810000
3	.748613	.743677	.738763	.733871	.729000
4	.679741	.673772	.667842	.661951	.656100
5	.617205	.610437	.603729	.597080	.590490
6	.560422	.553056	.545771	.538566	.531441
7	.508863	.501069	.493377	.485787	.478297
8	.462048	.453968	.446013	.438180	.430467
9	.419539	.411295	.403196	.395238	.387420
10	.380942	.372634	.364489	.356505	.348678
11	.345895	.337606	.329498	.321567	.313811
12	.314073	.305871	.297866	.290054	.282430
13	.285178	.277119	.269271	.261628	.254187
14	.258942	.251070	.243421	.235989	.228768
15	.235119	.227469	.220053	.212862	.205891
16	.213488	.206087	.198928	.192001	.185302
17	.193847	.186715	.179830	.173185	.166772
18	.176013	.169164	.162567	.156213	.150095
19	.159820	.153262	.146960	.140904	.135085
20	.145117	.138856	.132852	.127096	.121577

TABLE D

TABLE D—TERM CERTAIN—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	10.2%	10.4%	10.6%	10.8%	11.0%
1	.898000	.896000	.894000	.892000	.890000
2	.806404	.802816	.799236	.795664	.792100
3	.724151	.719323	.714517	.709732	.704969
4	.650287	.644514	.638778	.633081	.627422
5	.583958	.577484	.571068	.564708	.558406
6	.524394	.517426	.510535	.503720	.496981
7	.470906	.463613	.456418	.448318	.442313
8	.422874	.415398	.408038	.400792	.393659
9	.379741	.372196	.364786	.357506	.350356
10	.341007	.333488	.326118	.318896	.311817
11	.306224	.298805	.291550	.284455	.277517
12	.274989	.267729	.260645	.253734	.246990
13	.246941	.239886	.233017	.226331	.219821
14	.221753	.214937	.208317	.201887	.195641
15	.199134	.192584	.186236	.180083	.174121

TABLE D—Continued

TABLE D—TERM CERTAIN—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	10.2%	10.4%	10.6%	10.8%	11.0%
16	.178822	.172555	.166495	.160634	.154967
17	.160582	.154609	.148846	.143286	.137921
18	.144203	.138530	.133069	.127811	.122750
19	.129494	.124123	.118963	.114007	.109247
20	.116286	.111214	.106353	.101694	.097230

TABLE D

TABLE D—TERM CERTAIN—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	11.2%	11.4%	11.6%	11.8%	12.0%
1	.888000	.886000	.884000	.882000	.880000
2	.788544	.784996	.781456	.777924	.774400
3	.700227	.695506	.690807	.686129	.681472
4	.621802	.616219	.610673	.605166	.599695
5	.552160	.545970	.539835	.533756	.527732
6	.490318	.483729	.477214	.470773	.464404
7	.435402	.428584	.421858	.415222	.408676
8	.386637	.379726	.372922	.366226	.359635
9	.343334	.336437	.329663	.323011	.316478
10	.304881	.298083	.291422	.284896	.278501
11	.270734	.264102	.257617	.251278	.245081
12	.240412	.233994	.227734	.221627	.215671
13	.213486	.207319	.201317	.195475	.189791
14	.189575	.183684	.177964	.172409	.167016
15	.168343	.162744	.157320	.152065	.146974
16	.149488	.144191	.139071	.134121	.129337
17	.132746	.127754	.122939	.118295	.113817
18	.117878	.113190	.108678	.104336	.100159
19	.104676	.100286	.096071	.092024	.088140
20	.092952	.088853	.084927	.081166	.077563

TABLE D

TABLE D—TERM CERTAIN—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	12.2%	12.4%	12.6%	12.8%	13.0%
1	.878000	.876000	.874000	.872000	.870000
2	.770884	.767376	.763876	.760384	.756900
3	.676836	.672221	.667628	.663055	.658503
4	.594262	.588866	.583507	.578184	.572898
5	.521762	.515847	.509985	.504176	.498421
6	.458107	.451882	.445727	.439642	.433626
7	.402218	.395848	.389565	.383368	.377255
8	.353147	.346763	.340480	.334297	.328212
9	.310063	.303764	.297579	.291507	.285544
10	.272236	.266098	.260084	.254194	.248423
11	.239023	.233102	.227314	.221657	.216128
12	.209862	.204197	.198672	.193285	.188032
13	.184259	.178877	.173640	.168544	.163588
14	.161779	.156696	.151761	.146971	.142321

TABLE D—Continued

TABLE D—TERM CERTAIN—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	12.2%	12.4%	12.6%	12.8%	13.0%
15	.142042	.137266	.132639	.128158	.123819
16	.124713	.120245	.115927	.111754	.107723
17	.109498	.105334	.101320	.097450	.093719
18	.096139	.092273	.088554	.084976	.081535
19	.084410	.080831	.077396	.074099	.070936
20	.074112	.070808	.067644	.064614	.061714

TABLE D

TABLE D—TERM CERTAIN—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	13.2%	13.4%	13.6%	13.8%	14.0%
1	.868000	.866000	.864000	.862000	.860000
2	.753424	.749956	.746496	.743044	.739600
3	.653972	.649462	.644973	.640504	.636056
4	.567648	.562434	.557256	.552114	.547008
5	.492718	.487068	.481469	.475923	.470427
6	.427679	.421801	.415990	.410245	.404567
7	.371226	.365279	.359415	.353631	.347928
8	.322224	.316332	.310535	.304830	.299218
9	.279690	.274944	.268302	.262764	.257327
10	.242771	.237235	.231813	.226502	.221302
11	.210725	.205446	.200286	.195245	.190319
12	.182910	.177916	.173047	.168301	.163675
13	.158766	.154075	.149513	.145076	.140760
14	.137809	.133429	.129179	.125055	.121054
15	.119618	.115550	.111611	.107798	.104106
16	.103828	.100066	.096432	.092922	.089531
17	.090123	.086657	.083317	.080098	.076997
18	.078227	.075045	.071986	.069045	.066217
19	.067901	.064989	.062196	.059517	.056947
20	.058938	.056280	.053737	.051303	.048974

TABLE D

TABLE D—TERM CERTAIN—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	14.2%	14.4%	14.6%	14.8%	15.0%
1	.858000	.856000	.854000	.852000	.850000
2	.736164	.732736	.729316	.725904	.722500
3	.631629	.627222	.622836	.618470	.614125
4	.541937	.536902	.531902	.526937	.522006
5	.464982	.459588	.454244	.448950	.443705
6	.398955	.393407	.387925	.382505	.377150
7	.342303	.336757	.331288	.325895	.320577
8	.293696	.288264	.282920	.277662	.274291
9	.251991	.246754	.241613	.236568	.231617
10	.216209	.211221	.206338	.201556	.196874
11	.185507	.180805	.176212	.171726	.167343
12	.159165	.154769	.150485	.146310	.142242
13	.136564	.132483	.128515	.124656	.120905

Table D—Continued

Table D—Term Certain—Table Showing the Present Worth of a Remainder Interest Postponed for a Term of Years in a Charitable Remainder Unitrust Having the Adjusted Payout Rate Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Years	(2) Adjusted payout rate				
	14.2%	14.4%	14.6%	14.8%	15.0%
14	.117172	.113405	.109751	.106207	.102770
15	.100533	.097075	.093728	.090489	.087354
16	.086257	.083096	.080043	.077096	.074251
17	.074009	.071130	.068357	.065686	.063113
18	.063500	.060887	.058377	.055965	.053646
19	.054483	.052120	.049854	.047682	.045599
20	.046746	.044614	.042575	.040625	.038760

Table E

Table E—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Unitrust Having the Adjusted Payout Rate Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Adjusted payout rate				
	2.2%	2.4%	2.6%	2.8%	3.0%
0	.23253	.20635	.18364	.16394	.14683
1	.22196	.19506	.17170	.15139	.13372
2	.22597	.19884	.17523	.15468	.13676
3	.23039	.20304	.17920	.15840	.14024
4	.23503	.20747	.18340	.16237	.14397
5	.23988	.21211	.18783	.16656	.14793
6	.24489	.21693	.19243	.17094	.15207
7	.25004	.22189	.19718	.17546	.15637
8	.25534	.22701	.20209	.18016	.16084
9	.26080	.23230	.20718	.18503	.16549
10	.26640	.23774	.21243	.19008	.17031
11	.27217	.24335	.21786	.19530	.17532
12	.27807	.24911	.22344	.20068	.18049
13	.28407	.25497	.22913	.20618	.18579
14	.29013	.26089	.23489	.21175	.19115
15	.29621	.26684	.24067	.21735	.19655
16	.30229	.27279	.24647	.22296	.20196
17	.30838	.27876	.25228	.22859	.20739
18	.31451	.28477	.25813	.23427	.21287
19	.32070	.29085	.26407	.24003	.21844
20	.32699	.29704	.27012	.24591	.22413
21	.33339	.30335	.27629	.25192	.22996
22	.33991	.30977	.28259	.25807	.23592
23	.34655	.31634	.28904	.26437	.24205
24	.35334	.32306	.29566	.27085	.24836
25	.36031	.32998	.30248	.27754	.25490
26	.36746	.33710	.30952	.28446	.26167
27	.37481	.34443	.31678	.29161	.26869
28	.38236	.35197	.32427	.29901	.27596
29	.39006	.35968	.33194	.30660	.28344
30	.39793	.36757	.33980	.31439	.29113
31	.40594	.37561	.34783	.32237	.29902
32	.41410	.38383	.35605	.33054	.30711
33	.42240	.39220	.36444	.33890	.31541
34	.43084	.40072	.37299	.34744	.32389
35	.43942	.40941	.38172	.35617	.33258
36	.44813	.41824	.39061	.36508	.34146
37	.45696	.42720	.39966	.37416	.35053
38	.46591	.43630	.40885	.38339	.35977
39	.47496	.44552	.41818	.39278	.36917
40	.48412	.45486	.42765	.40232	.37875
41	.49338	.46432	.43725	.41201	.38849
42	.50275	.47391	.44700	.42187	.39840
43	.51221	.48360	.45686	.43186	.40847
44	.52175	.49340	.46685	.44199	.41870
45	.53136	.50327	.47693	.45223	.42905
46	.54104	.51323	.48712	.46259	.43953
47	.55077	.52327	.49739	.47305	.45013
48	.56058	.53339	.50777	.48363	.46087
49	.57043	.54358	.51823	.49432	.47173
50	.58035	.55384	.52879	.50510	.48271
51	.59029	.56415	.53940	.51597	.49379
52	.60027	.57450	.55008	.52692	.50496
53	.61026	.58488	.56080	.53793	.51620
54	.62025	.59528	.57154	.54897	.52750
55	.63022	.60567	.58230	.56004	.53884
56	.64018	.61606	.59306	.57113	.55021
57	.65012	.62644	.60384	.58225	.56163
58	.66004	.63681	.61461	.59337	.57306
59	.66993	.64717	.62538	.60452	.58453
60	.67979	.65751	.63615	.61567	.59602
61	.68963	.66784	.64692	.62683	.60754
62	.69944	.67815	.65769	.63801	.61908
63	.70922	.68844	.66843	.64918	.63063
64	.71893	.69868	.67915	.66032	.64217
65	.72859	.70886	.68982	.67144	.65369
66	.73817	.71897	.70043	.68250	.66517
67	.74766	.72901	.71096	.69350	.67660
68	.75706	.73896	.72142	.70443	.68796
69	.76637	.74882	.73181	.71530	.69928
70	.77559	.75861	.74212	.72610	.71053
71	.78475	.76833	.75237	1.73685	1.72176
72	.79383	.77799	.76257	.74756	.73294
73	.80279	.78753	.77266	.75816	.74403
74	.81158	.79689	.78256	.76858	.75494
75	.82013	.80602	.79223	.77876	.76561
76	.82844	.81488	.80163	.78867	.77599
77	.83648	.82347	.81075	.79829	.78609
78	.84428	.83182	.81961	.80764	.79592
79	.85187	.83994	.82824	.81677	.80552
80	.85927	.84787	.83668	.82569	.81491
81	.86645	.85556	.84487	.83437	.82404
82	.87336	.86299	.85278	.84275	.83288
83	.88003	.87014	.86042	.85084	.84142
84	.88648	.87708	.86782	.85870	.84971
85	.89273	.88381	.87501	.86633	.85778
86	.89868	.89021	.88185	.87360	.86547
87	.90417	.89613	.88818	.88034	.87260
88	.90923	.90158	.89402	.88655	.87917
89	.91396	.90668	.89948	.89237	.88533
90	.91849	.91156	.90471	.89794	.89124
91	.92278	.91620	.90968	.90324	.89686
92	.92673	.92046	.91426	.90812	.90204
93	.93027	.92429	.91837	.91251	.90670
94	.93341	.92768	.92201	.91639	.91082
95	.93612	.93062	.92516	.91976	.91440
96	.93841	.93309	.92782	.92259	.91740
97	.94044	.93529	.93018	.92512	.92009
98	.94223	.93723	.93226	.92733	.92244
99	.94392	.93905	.93421	.92942	.92466
100 ..	.94559	.94086	.93615	.93149	.92685
101 ..	.94709	.94248	.93790	.93334	.92882
102 ..	.94873	.94424	.93979	.93536	.93096
103 ..	.95077	.94645	.94216	.93789	.93365
104 ..	.95278	.94862	.94449	.94037	.93628
105 ..	.95570	.95178	.94787	.94399	.94012
106 ..	.96017	.95662	.95309	.94957	.94607
107 ..	.96616	.96313	.96010	.95709	.95408
108 ..	.97515	.97291	.97067	.96843	.96620
109 ..	.98900	.98800	.98700	.98600	.98500

Table E—Continued

Table E—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Unitrust Having the Adjusted Payout Rate Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	3.2%	3.4%	3.6%	3.8%	4.0%
0	.13196	.11901	.10774	.09791	.08933
1	.11834	.10493	.09324	.08303	.07410
2	.12113	.10749	.09557	.08514	.07601
3	.12437	.11050	.09835	.08770	.07837
4	.12787	.11376	.10138	.09052	.08098
5	.13159	.11725	.10465	.09357	.08382
6	.13549	.12092	.10810	.09680	.08684
7	.13956	.12476	.11171	.10019	.09002
8	.14380	.12877	.11549	.10376	.09337
9	.14822	.13296	.11946	.10751	.09691
10	.15282	.13734	.12361	.11144	.10063
11	.15761	.14190	.12795	.11556	.10454
12	.16257	.14663	.13247	.11986	.10863
13	.16764	.15149	.13711	.12428	.12283
14	.17279	.15643	.14182	.12878	.11712
15	.17798	.16140	.14657	.13331	.12143
16	.18318	.16638	.15133	.13785	.12576
17	.18840	.17138	.15611	.14241	.13010
18	.19367	.17643	.16094	.14702	.13449
19	.19903	.18157	.16586	.15172	.13897
20	.20452	.18685	.17092	.15655	.14358
21	.21014	.19226	.17612	.16153	.14833
22	.21591	.19783	.18146	.16665	.15324
23	.22185	.20356	.18698	.17195	.15832
24	.22798	.20949	.19270	.17746	.16361
25	.23434	.21565	.19866	.18321	.16914
26	.24094	.22207	.20489	.18922	.17494
27	.24780	.22875	.21138	.19551	.18102
28	.25492	.23570	.21814	.20208	.18739
29	.26226	.24288	.22514	.20889	.19400
30	.26982	.25029	.23239	.21596	.20088
31	.27759	.25792	.23985	.22324	.20798
32	.28557	.26577	.24755	.23078	.21533
33	.29377	.27385	.25548	.23855	.22293
34	.30217	.28214	.26364	.24656	.23077
35	.31079	.29065	.27203	.25481	.23887
36	.31961	.29939	.28065	.26330	.24721
37	.32863	.30833	.28950	.27202	.25579
38	.33784	.31747	.29855	.28096	.26460
39	.34722	.32680	.30780	.29011	.27363
40	.35679	.33633	.31727	.29948	.28290
41	.36654	.34606	.32693	.30908	.29239
42	.37648	.35599	.33683	.31890	.30213
43	.38659	.36610	.34691	.32894	.31209
44	.39687	.37640	.35720	.33918	.32227
45	.40728	.38685	.36765	.34961	.33265
46	.41785	.39746	.37828	.36023	.34323
47	.42856	.40823	.38908	.37103	.35400
48	.43941	.41917	.40006	.38202	.36499
49	.45040	.43025	.41121	.39320	.37617
50	.46153	.44149	.42252	.40457	.38756
51	.47277	.45286	.43398	.41609	.39911
52	.48412	.46435	.44558	.42776	.41084
53	.49556	.47595	.45731	.43958	.42272
54	.50707	.48763	.46913	.45151	.43473
55	.51864	.49939	.48104	.46354	.44685
56	.53026	.51121	.49303	.47567	.45908
57	.54192	.52310	.50510	.48789	.47143
58	.55363	.53503	.51723	.50019	.48387
59	.56538	.54703	.52945	.51258	.49642
60	.57717	.55909	.54173	.52506	.50906
61	.58901	.57120	.55408	.53763	.52181
62	.60087	.58336	.56650	.55028	.53466
63	.61277	.59556	.57898	.56300	.54760
64	.62467	.60778	.59149	.57577	.56060
65	.63655	.62000	.60402	.58857	.57365

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	3.2%	3.4%	3.6%	3.8%	4.0%
66	.64842	.63221	.61654	.60139	.58672
67	.66023	.64439	.62905	.61420	.59980
68	.67200	.65653	.64154	.62699	.61289
69	.68373	.66865	.65400	.63978	.62598
70	.69541	.68072	.66645	.65257	.63908
71	.70708	.69279	.67890	.66538	.65222
72	.71870	.70484	.69134	.67819	.66538
73	.73025	.71682	.70372	.69095	.67850
74	.74163	.72863	.71595	.70356	.69147
75	.75275	.74019	.72792	.71593	.70421
76	.76360	.75147	.73962	.72802	.71667
77	.77415	.76246	.75102	.73981	.72883
78	.78443	.77318	.76214	.75133	.74073
79	.79448	.78365	.77303	.76261	.75238
80	.80432	.79392	.78371	.77369	.76384
81	.81390	.80393	.79413	.78450	.77504
82	.82317	.81362	.80423	.79499	.78590
83	.83214	.82301	.81402	.80517	.79645
84	.84086	.83214	.82355	.81508	.80674
85	.84935	.84104	.83284	.82476	.81679
86	.85745	.84953	.84172	.83401	.82640
87	.86496	.85741	.84996	.84260	.83533
88	.87189	.86468	.85757	.85054	.84359
89	.87838	.87150	.86471	.85799	.85135
90	.88461	.87806	.87157	.86516	.85881
91	.89055	.88430	.87812	.87200	.86594
92	.89602	.89006	.88416	.87831	.87252
93	.90094	.89524	.88959	.88400	.87846
94	.90530	.89983	.89441	.88904	.88372
95	.90908	.90381	.89359	.89341	.88828
96	.91226	.90716	.90211	.89709	.89212
97	.91510	.91015	.90525	.90038	.89555
98	.91759	.91277	.90800	.90326	.89855
99	.91993	.91524	.91058	.90596	.90137
100 ..	.92225	.91768	.91315	.90865	.90417
101 ..	.92433	.91987	.91544	.91104	.90667
102 ..	.92659	.92225	.91793	.91364	.90938
103 ..	.92943	.92524	.92107	.91692	.91280
104 ..	.93221	.92816	.92413	.92012	.91614
105 ..	.93627	.93244	.92863	.92483	.92105
106 ..	.94257	.93909	.93562	.93217	.92872
107 ..	.95107	.94808	.94509	.94211	.93914
108 ..	.96396	.96173	.95950	.95728	.95505
109 ..	.98400	.98300	.98200	.98100	.98000

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	4.2%	4.4%	4.6%	4.8%	5.0%
0	.08183	.07527	.06952	.06448	.06005
1	.06629	.05945	.05344	.04817	.04354
2	.06801	.06098	.05481	.04939	.04460
3	.07017	.06297	.05663	.05104	.04611
4	.07259	.06520	.05868	.05294	.04786
5	.07523	.06765	.06096	.05505	.04982
6	.07805	.07029	.06342	.05734	.05195
7	.08103	.07307	.06603	.05978	.05423
8	.08418	.07603	.06880	.06238	.05666

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	4.2%	4.4%	4.6%	4.8%	5.0%
9	.08752	.07917	.07175	.06516	.05928
10	.09103	.08249	.07488	.06811	.06206
11	.09473	.08600	.07820	.07125	.06503
12	.09861	.08968	.08169	.07456	.06817
13	.10261	.09348	.08530	.07799	.07142
14	.10669	.09735	.08899	.08148	.07474
15	.11080	.10126	.09269	.08500	.07808
16	.11491	.10516	.09640	.08852	.08142
17	.11903	.10908	.10012	.09204	.08475
18	.12321	.11304	.10387	.09560	.08812
19	.12747	.11709	.10771	.09923	.09156
20	.13186	.12126	.11168	.10300	.09513
21	.13639	.12558	.11578	.10690	.09883
22	.14108	.13005	.12004	.11094	.10268
23	.14594	.13469	.12446	.11516	.10669
24	.15101	.13954	.12910	.11958	.11091
25	.15632	.14464	.13398	.12426	.11537
26	.16191	.15001	.13914	.12920	.12011
27	.16778	.15567	.14459	.13444	.12514
28	.17394	.16162	.15032	.13997	.13046
29	.18035	.16782	.15632	.14575	.13604
30	.18702	.17429	.16259	.15181	.14189
31	.19393	.18100	.16909	.15811	.14799
32	.20109	.18797	.17586	.16468	.15436
33	.20851	.19520	.18290	.17152	.16100
34	.21618	.20268	.19018	.17861	.16789
35	.22411	.21043	.19775	.18599	.17508
36	.23228	.21844	.20558	.19363	.18253
37	.24071	.22670	.21367	.20154	.19026
38	.24938	.23521	.22201	.20971	.19825
39	.25827	.24396	.23060	.21814	.20650
40	.26741	.25295	.23945	.22682	.21502
41	.27679	.26220	.24855	.23577	.22381
42	.28642	.27172	.25793	.24501	.23289
43	.29629	.28147	.26756	.25450	.24224
44	.30639	.29147	.27745	.26426	.25186
45	.31669	.30169	.28756	.27426	.26173
46	.32722	.31213	.29791	.28450	.27185
47	.33795	.32280	.30849	.29498	.28222
48	.34890	.33370	.31932	.30573	.29287
49	.36007	.34482	.33039	.31672	.30377
50	.37144	.35617	.34170	.32797	.31494
51	.38301	.36773	.35322	.33944	.32635
52	.39476	.37948	.36495	.35113	.33799
53	.40668	.39141	.37688	.36304	.34986
54	.41874	.40350	.38897	.37512	.36191
55	.43093	.41574	.40123	.38739	.37416
56	.44324	.42811	.41364	.39980	.38657
57	.45568	.44062	.42620	.41240	.39918
58	.46823	.45325	.43890	.42514	.41194
59	.48091	.46603	.45175	.43805	.42489
60	.49370	.47893	.46475	.45112	.43802
61	.50661	.49198	.47790	.46436	.45133
62	.51963	.50515	.49120	.47776	.46481
63	.53275	.51844	.50463	.49131	.47846
64	.54596	.53182	.51817	.50498	.49225
65	.55922	.54528	.53180	.51877	.50616
66	.57253	.55880	.54551	.53264	.52018
67	.58586	.57235	.55926	.54657	.53427
68	.59921	.58594	.57306	.56057	.54845
69	.61258	.59956	.58692	.57463	.56270
70	.62597	.61322	.60082	.58877	.57704
71	.63941	.62695	.61481	.60300	.59149
72	.65289	.64073	.62887	.61731	.60605
73	.66635	.65449	.64293	.63165	.62064
74	.67976	.66814	.65688	.64588	.63514
75	.69275	.68156	.67061	.65990	.64944
76	.70557	.69470	.68407	.67366	.66348
77	.71809	.70756	.69724	.68714	.67724
78	.73033	.72014	.71015	.70036	.69075
79	.74235	.73251	.72284	.71336	.70405
80	.75417	.74468	.73535	.72619	.71718
81	.76573	.75659	.74759	.73875	.73006
82	.77696	.76816	.75951	.75099	.74261
83	.78787	.77942	.77110	.76291	.75484
84	.79852	.79042	.78243	.77457	.76681
85	.80893	.80118	.79353	.78599	.77856
86	.81889	.81148	.80417	.79695	.78983
87	.82816	.82107	.81408	.80716	.80034
88	.83673	.82994	.82324	.81662	.81007
89	.84478	.83828	.83186	.82551	.81923
90	.85253	.84632	.84018	.83410	.82808
91	.85994	.85401	.84813	.84232	.83656
92	.86679	.86111	.85549	.84993	.84441
93	.87296	.86752	.86213	.85679	.85150
94	.87844	.87321	.86803	.86289	.85780
95	.88319	.87815	.87314	.86818	.86327
96	.88719	.88230	.87745	.87264	.86787
97	.89076	.88601	.88129	.87661	.87197
98	.89388	.88925	.88465	.88009	.87556
99	.89682	.89230	.88781	.88336	.87894
100 ..	.89973	.89533	.89095	.88660	.88228
101 ..	.90233	.89802	.89374	.88948	.88526
102 ..	.90515	.90094	.89676	.89260	.88848
103 ..	.90871	.90464	.90059	.89656	.89256
104 ..	.91217	.90823	.90431	.90040	.89652
105 ..	.91729	.91354	.90981	.90610	.90240
106 ..	.92529	.92187	.91846	.91507	.91169
107 ..	.93617	.93322	.93027	.92732	.92439
108 ..	.95283	.95062	.94840	.94619	.94398
109 ..	.97900	.97800	.97700	.97600	.97500

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	5.2%	5.4%	5.6%	5.8%	6.0%
0	.05615	.05272	.04969	.04701	.04464
1	.03945	.03585	.03268	.02986	.02737
2	.04039	.03667	.03337	.03046	.02787
3	.04176	.03791	.03450	.03147	.02879
4	.04336	.03938	.03585	.03272	.02993
5	.04518	.04107	.03741	.03416	.03127
6	.04717	.04292	.03914	.03577	.03276
7	.04929	.04490	.04099	.03750	.03438
8	.05158	.04704	.04300	.03938	.03615
9	.05404	.04936	.04518	.04143	.03808
10	.05666	.05183	.04751	.04364	.04016
11	.05947	.05449	.05003	.04602	.04242
12	.06245	.05731	.05271	.04856	.04484
13	.06554	.06025	.05549	.05121	.04735
14	.06869	.06324	.05834	.05391	.04992
15	.07186	.06625	.06119	.05662	.05250
16	.07502	.06924	.06403	.05931	.05504
17	.07817	.07223	.06685	.06199	.05757

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	5.2%	5.4%	5.6%	5.8%	6.0%
18	.08136	.07524	.06970	.06468	.06012
19	.08462	.07832	.07261	.06743	.06272
20	.08800	.08152	.07564	.07029	.06542
21	.09151	.08485	.07879	.07327	.06824
22	.09516	.08831	.08207	.07638	.07119
23	.09897	.09193	.08551	.07964	.07428
24	.10299	.09576	.08915	.08310	.07756
25	.10725	.09982	.09302	.08679	.08108
26	.11179	.10416	.09717	.09075	.08486
27	.11661	.10878	.10160	.09500	.08892
28	.12173	.11370	.10632	.09953	.09328
29	.12710	.11888	.11130	.10432	.09788
30	.13276	.12433	.11656	.10938	.10276
31	.13865	.13002	.12205	.11469	.10787
32	.14482	.13599	.12783	.12026	.11326
33	.15126	.14223	.13387	.12612	.11892
34	.15796	.14874	.14018	.13223	.12485
35	.16494	.15553	.14678	.13864	.13107
36	.17221	.16260	.15366	.14533	.13757
37	.17975	.16996	.16082	.15231	.14435
38	.18756	.17758	.16826	.15955	.15142
39	.19563	.18547	.17597	.16708	.15875
40	.20397	.19364	.18395	.17488	.16638
41	.21259	.20209	.19223	.18298	.17430
42	.22152	.21084	.20082	.19140	.18254
43	.23071	.21988	.20969	.20010	.19107
44	.24019	.22920	.21885	.20910	.19991
45	.24992	.23878	.22828	.21837	.20902
46	.25991	.24864	.23799	.22793	.21842
47	.27016	.25876	.24798	.23777	.22812
48	.28070	.26918	.25826	.24792	.23812
49	.29150	.27987	.26883	.25837	.24843
50	.30258	.29084	.27970	.26911	.25905
51	.31391	.30208	.29084	.28014	.26996
52	.32548	.31358	.30224	.29144	.28115
53	.33729	.32532	.31390	.30302	.29263
54	.34931	.33728	.32579	.31482	.30434
55	.36152	.34945	.33790	.32686	.31631
56	.37392	.36181	.35022	.33912	.32850
57	.38652	.37438	.36276	.35162	.34093
58	.39929	.38715	.37550	.36432	.35359
59	.41226	.40013	.38847	.37727	.36650
60	.42542	.41331	.40165	.39044	.37965
61	.43878	.42670	.41506	.40386	.39306
62	.45233	.44029	.42869	.41750	.40671
63	.46606	.45409	.44253	.43138	.42060
64	.47994	.46805	.45656	.44545	.43471
65	.49397	.48217	.47076	.45971	.44902
66	.50811	.49642	.48510	.47413	.46350
67	.52235	.51079	.49957	.48869	.47814
68	.53668	.52525	.51416	.50339	.49293
69	.55110	.53983	.52888	.51823	.50788
70	.56563	.55453	.54373	.53322	.52299
71	.58029	.56938	.55875	.54839	.53830
72	.59507	.58436	.57392	.56374	.55380
73	.60990	.59941	.58917	.57918	.56942
74	.62465	.61439	.60437	.59458	.58502
75	.63920	.62919	.61940	.60983	.60046
76	.65351	.64375	.63419	.62484	.61568
77	.66755	.65804	.64873	.63961	.63066
78	.68133	.67209	.66303	.65414	.64542
79	.69492	.68595	.67714	.66850	.66001
80	.70834	.69965	.69111	.68272	.67448
81	.72151	.71311	.70484	.69671	.68872
82	.73436	.72624	.71825	.71039	.70265
83	.74689	.73906	.73135	.72376	.71627
84	.75917	.75163	.74421	.73688	.72967
85	.77122	.76398	.75685	.74980	.74286
86	.78280	.77586	.76901	.76224	.75556
87	.79359	.78693	.78036	.77386	.76744
88	.80360	.79720	.79088	.78463	.77846
89	.81302	.80688	.80081	.79480	.78886
90	.82213	.81624	.81041	.80465	.79894
91	.83086	.82522	.81963	.81410	.80862
92	.83895	.83354	.82818	.82287	.81762
93	.84626	.84106	.83591	.83081	.82575
94	.85275	.84774	.84278	.83787	.83299
95	.85839	.85355	.84876	.84400	.83929
96	.86313	.85844	.85378	.84916	.84458
97	.86737	.86280	.85826	.85377	.84930
98	.87107	.86661	.86218	.85779	.85343
99	.87455	.87019	.86586	.86157	.85730
100	.87800	.87374	.86951	.86532	.86115
101	.88106	.87689	.87275	.86863	.86455
102	.88437	.88030	.87625	.87222	.86822
103	.88858	.88463	.88070	.87679	.87290
104	.89266	.88882	.88500	.88120	.87741
105	.89872	.89506	.89141	.88778	.88417
106	.90832	.90496	.90161	.89828	.89496
107	.92146	.91854	.91562	.91271	.90981
108	.94177	.93956	.93736	.93516	.93296
109	.97400	.97300	.97200	.97100	.97000

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted Payout Rate				
	6.2%	6.4%	6.6%	6.8%	7.0%
0	.04253	.04066	.03899	.03751	.03618
1	.02516	.02320	.02145	.01989	.01850
2	.02557	.02353	.02171	.02008	.01862
3	.02640	.02427	.02237	.02067	.01915
4	.02744	.02523	.02325	.02147	.01988
5	.02868	.02638	.02431	.02246	.02080
6	.03008	.02767	.02552	.02359	.02185
7	.03159	.02909	.02685	.02483	.02302
8	.03325	.03065	.02831	.02621	.02432
9	.03507	.03236	.02993	.02774	.02576
10	.03704	.03423	.03170	.02941	.02735
11	.03918	.03626	.03363	.03125	.02910
12	.04148	.03845	.03571	.03323	.03099
13	.04387	.04073	.03788	.03531	.03297
14	.04632	.04305	.04010	.03742	.03499
15	.04876	.04538	.04231	.03953	.03699
16	.05118	.04767	.04449	.04159	.03896
17	.05357	.04994	.04663	.04362	.04088
18	.05598	.05221	.04878	.04565	.04280
19	.05843	.05453	.05097	.04772	.04476
20	.06099	.05694	.05325	.04988	.04679
21	.06365	.05946	.05564	.05213	.04893
22	.06644	.06210	.05813	.05449	.05116
23	.06937	.06488	.06076	.05699	.05352
24	.07249	.06784	.06357	.05965	.05605
25	.07584	.07103	.06660	.06254	.05879
26	.07945	.07447	.06989	.06567	.06178

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted Payout Rate				
	6.2%	6.4%	6.6%	6.8%	7.0%
27	.08334	.07819	.07345	.06907	.06503
28	.08751	.08219	.07729	.07275	.06856
29	.09194	.08645	.98137	.07667	.07233
30	.09663	.09096	.08572	.08086	.07635
31	.10156	.09572	.09030	.08527	.08060
32	.10677	.10074	.09515	.08995	.08512
33	.11224	.10604	.10027	.09490	.08990
34	.11798	.11159	.10564	.10010	.09494
35	.12401	.11744	.11131	.10560	.10026
36	.13033	.12357	.11727	.11137	.10586
37	.13693	.12999	.12350	.11743	.11175
38	.14380	.13668	.13002	.12377	.11791
39	.15096	.14366	.13681	.13038	.12436
40	.15841	.15092	.14390	.13729	.13109
41	.16615	.15848	.15128	.14450	.13812
42	.17421	.16637	.15899	.15204	.14549
43	.18257	.17456	.16700	.15988	.15316
44	.19124	.18306	.17533	.16804	.16115
45	.20018	.19184	.18395	.17649	.16943
46	.20943	.20092	.19287	.18524	.17802
47	.21897	.21030	.20209	.19431	.18692
48	.22883	.22001	.21165	.20371	.19616
49	.23900	.23004	.22152	.21343	.20573
50	.24948	.24039	.23173	.22349	.21565
51	.26027	.25104	.24225	.23387	.22589
52	.27135	.26200	.25308	.24457	.23645
53	.28271	.27325	.26421	.25558	.24733
54	.29433	.28476	.27561	.26686	.25848
55	.30621	.29654	.28728	.27842	.26993
56	.31832	.30856	.29921	.29025	.28165
57	.33068	.32085	.31142	.30236	.29367
58	.34329	.33339	.32388	.31474	.30595
59	.35615	.34620	.33662	.32741	.31855
60	.36927	.35927	.34964	.34037	.33143
61	.38265	.37262	.36295	.35362	.34463
62	.39630	.38625	.37655	.36718	.35814
63	.41020	.40014	.39043	.38104	.37196
64	.42432	.41428	.40456	.39516	.38606
65	.43866	.42864	.41893	.40953	.40042
66	.45320	.44321	.43353	.42414	.41503
67	.46790	.45796	.44832	.43896	.42987
68	.48277	.47289	.46330	.45398	.44492
69	.49781	.48802	.47849	.46923	.46021
70	.51303	.50333	.49389	.48470	.47574
71	.52847	.51888	.50954	.50044	.49156
72	.54412	.53466	.52544	.51644	.50766
73	.55990	.55059	.54151	.52363	.52396
74	.57566	.56652	.55758	.54885	.54030
75	.59129	.58232	.57354	.56496	.55655
76	.60671	.59792	.58932	.58089	.57263
77	.62189	.61330	.60487	.59661	.58851
78	.63687	.62847	.62024	.61215	.60422
79	.65168	.64349	.63546	.62756	.61981
80	.66637	.65841	.65058	.64289	.63532
81	.68085	.67312	.66551	.65802	.65066
82	.69503	.68753	.68014	.67287	.66571
83	.70890	.70164	.69448	.68743	.68048
84	.72255	.71553	.70861	.70179	.69506
85	.73600	.72924	.72257	.71598	.70948
86	.74897	.7446	.73693	.72969	.72342
87	.76109	.75483	.74864	.74252	.73647
88	.77235	.76631	.76035	.75445	.74862
89	.78298	.77717	.77142	.76573	.76011
90	.79329	.78770	.78217	.77669	.77127
91	.80320	.79783	.79252	.78725	.78204
92	.81241	.80725	.80214	.79708	.79206

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted Payout Rate				
	6.2%	6.4%	6.6%	6.8%	7.0%
93	.82074	.81578	.81086	.80598	.80115
94	.82816	.82337	.81862	.81391	.80924
95	.83461	.82997	.82537	.82081	.81629
96	.84003	.83552	.82105	.82661	.82221
97	.84487	.84048	.83612	.82179	.82750
98	.84910	.84481	.84054	.83631	.83211
99	.85307	.84887	.84469	.84055	.83644
100 ..	.85701	.85290	.84882	.84476	.84073
101 ..	.86049	.85645	.85244	.84846	.84451
102 ..	.86424	.86029	.85637	.85247	.84859
103 ..	.86904	.86520	.86138	.85758	.85381
104 ..	.87365	.86991	.86619	.86249	.85880
105 ..	.88058	.87700	.87343	.86988	.86635
106 ..	.89165	.88835	.88506	.88179	.87852
107 ..	.90692	.90404	.90116	.89829	.89542
108 ..	.93077	.92858	.92639	.92420	.92201
109 ..	.96900	.96800	.96700	.96600	.96500

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	7.2%	7.4%	7.6%	7.8%	8.0%
0	.03499	.03392	.03296	.03209	.03130
1	.01725	.01613	.01513	.01422	.01340
2	.01732	.01615	.01509	.01414	.01329
3	.01778	.01656	.01545	.01446	.01356
4	.01846	.01717	.01601	.01497	.01402
5	.01930	.01796	.01674	.01574	.01465
6	.02029	.01888	.01761	.01645	.01541
7	.02138	.01991	.01857	.01736	.01627
8	.02261	.02106	.01966	.01839	.01724
9	.02397	.02236	.02089	.01956	.01835
10	.02548	.02379	.02225	.02086	.01959
11	.02715	.02538	.02377	.02231	.02098
12	.02895	.02710	.02542	.02389	.02250
13	.03085	.02892	.02716	.02556	.02410
14	.03278	.03076	.02893	.02725	.02572
15	.03469	.03259	.03067	.02892	.02732
16	.03656	.03437	.03237	.03054	.02886
17	.03938	.03610	.03401	.03210	.03035
18	.04020	.03782	.03564	.03364	.03181
19	.04204	.03956	.03729	.03520	.03328
20	.04397	.04138	.03901	.03683	.03483
21	.04599	.04329	.04081	.03853	.03644
22	.04810	.04529	.04270	.04032	.03813
23	.05033	.04740	.04470	.04222	.03992
24	.05273	.04968	.04686	.04427	.04187
25	.05534	.05216	.04922	.04651	.04400
26	.05819	.05488	.05182	.04898	.04636
27	.06130	.05785	.05466	.05170	.04896
28	.06468	.06109	.05777	.05468	.05182
29	.06830	.06457	.06110	.05789	.05490
30	.07217	.06829	.06469	.06134	.05822
31	.07627	.07224	.06849	.06500	.06174
32	.08062	.07644	.07254	.06891	.06552
33	.08524	.08090	.07686	.07308	.06955
34	.09012	.08562	.08142	.07749	.07382
35	.09528	.09062	.08626	.08218	.07836

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	7.2%	7.4%	7.6%	7.8%	8.0%
36	.10071	.09589	.09137	.08714	.08317
37	.10643	.10144	.09676	.09237	.08825
38	.11242	.10727	.10243	.09788	.09361
39	.11869	.11337	.10837	.10366	.09923
40	.12526	.11977	.11460	.10973	.10514
41	.13212	.12646	.12113	.11609	.11135
42	.13931	.13349	.12799	.12279	.11789
43	.14681	.14082	.13515	.12980	.12473
44	.15463	.14847	.14264	.13712	.13189
45	.16274	.15642	.15042	.14474	.13935
46	.17117	.16468	.15853	.15268	.14713
47	.17991	.17326	.16694	.16094	.15523
48	.18900	.18219	.17571	.16955	.16368
49	.19841	.19145	.18481	.17850	.17248
50	.20818	.20106	.19428	.18781	.18163
51	.21827	.21101	.20407	.19745	.19113
52	.22869	.22129	.21421	.20745	.20098
53	.23944	.23190	.22468	.21778	.21117
54	.25047	.24280	.23545	.22841	.22167
55	.26180	.25400	.24653	.23936	.23249
56	.27341	.26550	.25790	.25061	.24361
57	.28532	.27729	.26959	.26218	.25505
58	.29751	.28938	.28157	.27405	.26681
59	.31001	.30180	.29388	.28626	.27892
60	.32282	.31452	.30652	.29880	.29136
61	.33595	.32758	.31950	.31169	.30416
62	.34941	.34097	.33282	.32494	.31733
63	.36318	.35469	.34648	.33854	.33085
64	.37725	.36872	.36046	.35246	.34472
65	.39159	.38304	.37474	.36670	.35891
66	.40620	.39763	.38931	.38124	.37340
67	.42104	.41247	.40414	.39605	.38819
68	.43611	.42755	.41923	.41113	.40326
69	.45144	.44290	.43459	.42650	.41863
70	.46702	.45852	.45025	.44218	.43432
71	.48291	.47447	.46623	.45820	.45037
72	.49909	.49072	.48255	.47458	.46679
73	.51549	.50721	.49912	.49912	.48349
74	.53195	.52377	.51578	.50796	.50031
75	.54832	.54027	.53238	.52466	.51710
76	.56454	.55661	.54884	.54123	.53377
77	.58057	.57278	.56514	.55765	.55030
78	.59644	.58879	.58129	.58393	.56670
79	.61219	.60471	.59736	.59013	.58304
80	.62788	.62057	.61338	.60632	.59936
81	.64341	.63628	.62926	.62236	.61556
82	.65866	.65172	.64488	.63815	.63151
83	.67364	.66689	.66024	.65369	.64723
84	.68843	.68189	.67544	.66907	.66279
85	.70307	.69674	.69050	.68433	.67825
86	.71723	.71112	.70508	.69912	.69323
87	.73050	.72460	.71877	.71300	.70731
88	.74285	.73715	.73151	.72593	.72042
89	.75454	.74903	.74358	.73819	.73286
90	.76591	.76060	.75534	.75014	.74499
91	.77688	.77176	.76670	.76169	.75672
92	.78709	.78217	.77729	.77245	.76766
93	.79635	.79160	.78690	.78223	.77761
94	.80461	.80002	.79547	.79096	.78648
95	.81180	.80735	.80394	.79856	.79421
96	.81784	.81351	.80921	.80494	.80071
97	.82324	.81901	.81481	.81065	.80651
98	.82794	.82380	.81969	.81562	.81157
99	.83235	.82830	.83427	.82028	.81631
100	.83674	.83276	.82882	.82490	.82101
101	.84058	.83668	.83280	.82895	.82512
102	.84474	.84091	.83710	.83332	.82956
103	.85006	.84633	.84262	.83893	.83526
104	.85514	.85150	.84787	.84427	.84068
105	.86284	.85934	.85585	.85239	.84893
106	.87527	.87204	.86881	.86559	.86239
107	.89257	.88972	.88688	.88404	.88121
108	.91983	.91765	.91547	.91330	.91113
109	.96400	.96300	.96200	.96100	.96000

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	8.2%	8.4%	8.6%	8.8%	9.0%
0	.03059	.02995	.02936	.02882	.02833
1	.01267	.01200	.01139	.01084	.01033
2	.01251	.01181	.01117	.01059	.01006
3	.01274	.01200	.01133	.01072	.01016
4	.01316	.01239	.01168	.01103	.01044
5	.01375	.01293	.01218	.01150	.01088
6	.01446	.01360	.01281	.01209	.01144
7	.01527	.01436	.01353	.01277	.01208
8	.01619	.01523	.01436	.01356	.01283
9	.01725	.01624	.01532	.01448	.01370
10	.01843	.01737	.01640	.01551	.01470
11	.01976	.01865	.01763	.01669	.01583
12	.02122	.02005	.01898	.01800	.01709
13	.02276	.02153	.02041	.01937	.01842
14	.02432	.02303	.02185	.02077	.01977
15	.02585	.02451	.02327	.02213	.02108
16	.02732	.02591	.02462	.02342	.02232
17	.02874	.02726	.02590	.02465	.02349
18	.03013	.02858	.02715	.02584	.02462
19	.03152	.02990	.02841	.02703	.02575
20	.03298	.03128	.02971	.02826	.02692
21	.03451	.03272	.03108	.02956	.02815
22	.03611	.03424	.03251	.03091	.02944
23	.03781	.03585	.03404	.03236	.03081
24	.03965	.03760	.03570	.03393	.03230
25	.04168	.03953	.03753	.03568	.03396
26	.04393	.04168	.03958	.03764	.03583
27	.04642	.04406	.04186	.03982	.03792
28	.04916	.04669	.04439	.04224	.04025
29	.05212	.04953	.04712	.04487	.04277
30	.05531	.05260	.05008	.04772	.04552
31	.05871	.05588	.05324	.05077	.04846
32	.06236	.05940	.05663	.05405	.05163
33	.06625	.06316	.06027	.05756	.05502
34	.07038	.06716	.06414	.06131	.05865
35	.07478	.07142	.06827	.06531	.06253
36	.07944	.07595	.07266	.06957	.06667
37	.08438	.08074	.07732	.07410	.07106
38	.08958	.08580	.08223	.07888	.07571
39	.09506	.09112	.08742	.08392	.08061
40	.10081	.09673	.09288	.08924	.08580
41	.10687	.10263	.09863	.09484	.09126
42	.11325	.10886	.10471	.10078	.09705
43	.11993	.11539	.11109	.10701	.10314
44	.12694	.12224	.11779	.11356	.10955

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	8.2%	8.4%	8.6%	8.8%	9.0%
45	.13424	.12939	.12478	.12040	.11624
46	.14186	.13686	.13210	.12757	.12326
47	.14980	.14464	.13973	.13505	.13059
48	.15810	.15278	.14772	.14289	.13828
49	.16674	.16127	.15605	.15107	.14631
50	.17574	.17012	.16475	.15962	.15472
51	.18510	.17932	.17381	.16853	.16348
52	.19480	.18888	.18322	.17779	.17260
53	.20484	.19878	.19298	.18741	.18208
54	.21520	.20901	.20306	.19735	.19188
55	.22589	.21955	.21347	.20763	.20202
56	.23688	.23041	.22420	.21822	.21248
57	.24820	.24161	.23527	.22917	.22329
58	.25984	.25313	.24667	.24044	.23444
59	.27184	.26501	.25843	.25209	.24596
60	.28417	.27724	.27055	.26409	.25786
61	.29688	.28985	.28306	.27650	.27015
62	.30996	.30284	.29596	.28929	.28285
63	.32341	.31621	.30924	.30249	.29595
64	.33721	.32994	.32289	.31605	.30943
65	.35134	.34401	.33689	.32999	.32329
66	.36580	.35841	.35124	.34427	.33750
67	.38055	.37312	.36590	.35889	.35206
68	.39559	.38814	.38089	.37383	.36696
69	.41096	.40349	.39622	.38913	.38222
70	.42665	.41918	.41190	.40480	.39787
71	.44273	.43527	.42799	.42089	.41395
72	.45919	.45176	.44450	.43741	.43049
73	.47594	.46856	.46134	.45428	.44738
74	.49283	.48550	.47834	.47132	.46446
75	.50969	.50244	.49534	.48838	.48157
76	.52646	.51929	.51226	.50537	.49862
77	.54309	.53601	.52907	.52226	.51558
78	.55960	.55263	.54579	.53907	.53247
79	.57606	.56921	.56248	.55586	.54935
80	.59253	.58580	.57919	.57269	.56629
81	.60887	.60229	.59581	.58943	.58315
82	.62498	.61855	.61221	.60597	.59982
83	.64086	.63459	.62840	.62230	.61629
84	.65660	.65049	.64447	.63852	.63266
85	.67224	.66631	.66046	.65468	.64898
86	.68742	.68167	.67600	.67040	.66486
87	.70168	.69611	.69061	.68518	.67980
88	.71497	.70958	.70425	.69897	.69376
89	.72758	.72236	.71720	.71208	.70702
90	.73989	.73484	.72985	.72490	.72000
91	.75180	.74693	.74210	.73732	.73259
92	.76292	.75821	.75355	.74894	.74436
93	.77302	.76848	.76397	.75951	.75508
94	.78204	.77764	.77328	.76895	.76466
95	.78991	.78563	.78139	.77719	.77302
96	.79651	.79234	.78821	.78411	.78003
97	.80241	.79834	.79430	.79029	.78630
98	.80755	.80356	.79960	.79567	.79176
99	.81236	.80845	.80456	.80071	.79687
100 ..	.81715	.81331	.80949	.80571	.80195
101 ..	.82132	.81754	.81379	.81006	.80636
102 ..	.82582	.82211	.81842	.81476	.81111
103 ..	.83162	.82799	.82439	.82080	.81724
104 ..	.83711	.83356	.83003	.82652	.82302
105 ..	.84550	.84208	.83867	.83528	.83191
106 ..	.85920	.85602	.85285	.84969	.84655
107 ..	.87839	.87558	.87277	.86997	.86718
108 ..	.90896	.90679	.90463	.90246	.90030
109 ..	.95900	.95800	.95700	.95600	.95500

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout Rate				
	9.2%	9.4%	9.6%	9.8%	10.0%
0	.02788	.02747	.02709	.02673	.02641
1	.00987	.00945	.00906	.00871	.00838
2	.00957	.00913	.00872	.00835	.00800
3	.00965	.00918	.00875	.00836	.00799
4	.00991	.00941	.00896	.00854	.00815
5	.01031	.00979	.00931	.00887	.00846
6	.01084	.01028	.00978	.00931	.00888
7	.01144	.01086	.01032	.00983	.00937
8	.01216	.01154	.01097	.01044	.00996
9	.01299	.01234	.01174	.01118	.01067
10	.01395	.01326	.01262	.01204	.01149
11	.01504	.01432	.01364	.01302	.01245
12	.01626	.01549	.01478	.01413	.01352
13	.01755	.01674	.01599	.01530	.01466
14	.01885	.01800	.01721	.01648	.01581
15	.02011	.01922	.01839	.01762	.01691
16	.02130	.02036	.01949	.01869	.01794
17	.02243	.02144	.02052	.01967	.01888
18	.02350	.02246	.02150	.02061	.01978
19	.02457	.02348	.02247	.02153	.02065
20	.02569	.02454	.02347	.02248	.02156
21	.02685	.02564	.02452	.02347	.02250
22	.02806	.02679	.02561	.02451	.02348
23	.02936	.02802	.02677	.02561	.02453
24	.03078	.02937	.02805	.02683	.02569
25	.03236	.03087	.02949	.02820	.02699
26	.03415	.03258	.03112	.02975	.02848
27	.03615	.03450	.03295	.03151	.03017
28	.03838	.03664	.03502	.03350	.03208
29	.04081	.03898	.03727	.03567	.03416
30	.04346	.04154	.03973	.03804	.03646
31	.04630	.04427	.04237	.04059	.03892
32	.04936	.04723	.04523	.04335	.04159
33	.05264	.05041	.04831	.04633	.04448
34	.05615	.05381	.05160	.04952	.04757
35	.05992	.05746	.05514	.05296	.05090
36	.06393	.06135	.05892	.05663	.05447
37	.06820	.06550	.06295	.06055	.05828
38	.07272	.06990	.06723	.06471	.06233
39	.07749	.07454	.07175	.06912	.06662
40	.08254	.07946	.07655	.07379	.07117
41	.08787	.08466	.08162	.07073	.07599
42	.09352	.09018	.08700	.08399	.08112
43	.09947	.09599	.09268	.08953	.08654
44	.10573	.10211	.09866	.09539	.09227
45	.11229	.10852	.10494	.10152	.09827
46	.11916	.11525	.11153	.10798	.10459
47	.12634	.12229	.11843	.11474	.11122
48	.13388	.12969	.12568	.12186	.11820
49	.14177	.13743	.13329	.12932	.12553
50	.15003	.14555	.14126	.13716	.13322
51	.15865	.15402	.14959	.14534	.14127
52	.16763	.16286	.15828	.15390	.14969
53	.17696	.17205	.16734	.16281	.15847
54	.18662	.18157	.17672	.17206	.16758
55	.19662	.19144	.18645	.18165	.17703
56	.20695	.20163	.19651	.19157	.18682
57	.21763	.21218	.20693	.20186	.19698
58	.22865	.22307	.21769	.21250	.20749
59	.24005	.23435	.22885	.22353	.21839
60	.25183	.24601	.24038	.23494	.22969
61	.26401	.25808	.25234	.24678	.24141
62	.27661	.27056	.26471	.25905	.25356
63	.28961	.28347	.27752	.27175	.26615
64	.30300	.29677	.29072	.28486	.27916
65	.31678	.31046	.30433	.29837	.29259

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout Rate				
	9.2%	9.4%	9.6%	9.8%	10.0%
66	.33093	.32454	.31832	.31228	.30641
67	.34542	.33897	.33268	.32657	.32062
68	.36027	.35376	.34742	.34124	.33522
69	.37550	.36894	.36255	.35632	.35024
70	.39111	.38452	.37809	.37182	.36570
71	.40719	.40058	.39412	.38782	.38166
72	.42372	.41710	.41064	.40432	.39814
73	.44062	.43402	.42756	.42124	.41506
74	.45774	.45116	.44471	.43840	.43223
75	.47489	.46834	.46193	.45565	.44949
76	.49199	.48550	.47913	.47288	.46675
77	.50902	.50258	.49626	.49006	.48397
78	.52598	.51962	.51336	.50721	.50117
79	.54295	.53667	.53049	.52441	.51843
80	.55999	.55380	.54771	.54171	.53581
81	.57697	.57088	.56489	.55899	.55317
82	.59375	.58778	.58190	.57610	.57039
83	.61036	.60451	.59875	.59306	.58746
84	.62687	.62116	.61553	.60997	.60448
85	.64335	.63779	.63230	.62688	.62152
86	.65939	.65398	.64864	.64337	.63816
87	.67449	.66924	.66405	.65892	.65384
88	.68860	.68350	.67845	.67346	.66852
89	.70202	.69706	.69216	.68731	.68250
90	.71515	.71035	.70559	.70088	.69622
91	.72790	.72325	.71865	.71409	.70957
92	.73982	.73533	.73087	.72646	.72208
93	.75069	.74634	.74202	.73774	.73350
94	.76040	.75618	.75199	.74784	.74372
95	.76888	.76477	.76070	.75666	.75265
96	.77599	.77199	.76801	.76406	.76014
97	.78235	.77843	.77454	.77067	.76684
98	.78789	.78404	.78022	.77642	.77266
99	.79307	.78929	.78554	.78181	.77811
100	.79821	.79450	.79081	.78715	.78351
101	.80268	.79902	.79539	.79178	.78819
102	.80749	.80389	.80031	.79676	.79322
103	.81370	.81018	.80668	.80319	.79973
104	.81955	.81609	.81265	.80923	.80582
105	.82855	.82520	.82187	.81856	.81526
106	.84341	.84029	.83718	.83408	.83099
107	.86439	.86162	.85884	.85608	.85332
108	.89815	.89599	.89384	.89169	.88955
109	.95400	.95300	.95200	.95100	.95000

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	10.2%	10.4%	10.6%	10.8%	11.0%
0	.02610	.02582	.02556	.02531	.02508
1	.00807	.00779	.00753	.00729	.00707
2	.00769	.00739	.00712	.00686	.00663
3	.00766	.00735	.00706	.00679	.00654
4	.00780	.00747	.00716	.00688	.00662
5	.00808	.00773	.00741	.00711	.00683
6	.00848	.00811	.00776	.00744	.00715
7	.00894	.00855	.00819	.00785	.00753
8	.00951	.00909	.00871	.00835	.00801
9	.01019	.00975	.00934	.00896	.00860
10	.01099	.01052	.01008	.00967	.00930
11	.01191	.01142	.01095	.01052	.01012
12	.01295	.01243	.01194	.01148	.01106
13	.01406	.01351	.01299	.01251	.01206
14	.01518	.01459	.01405	.01354	.01306
15	.01625	.01563	.01506	.01452	.01402
16	.01724	.01659	.01599	.01542	.01489
17	.01815	.01747	.01683	.01624	.01568
18	.01901	.01829	.01761	.01699	.01640
19	.01984	.01908	.01837	.01771	.01709
20	.02070	.01990	.01915	.01846	.01780
21	.02160	.02075	.01996	.01923	.01854
22	.02253	.02164	.02080	.02003	.01930
23	.02352	.02258	.02170	.02088	.02010
24	.02462	.02362	.02269	.02182	.02100
25	.02586	.02481	.02382	.02289	.02203
26	.02729	.02617	.02512	.02414	.02322
27	.02891	.02772	.02662	.02558	.02460
28	.03074	.02949	.02832	.02722	.02618
29	.03276	.03143	.03019	.02902	.02792
30	.03497	.03357	.03225	.03102	.02985
31	.03735	.03587	.03448	.03317	.03193
32	.03993	.03837	.03690	.03551	.03420
33	.04273	.04108	.03952	.03806	.03667
34	.04572	.04399	.04234	.04079	.03933
35	.04896	.04713	.04539	.04376	.04221
36	.05243	.05049	.04867	.04694	.04530
37	.05613	.05410	.05217	.05035	.04862
38	.06007	.05793	.05591	.05399	.05217
39	.06425	.06200	.05987	.05785	.05593
40	.06869	.06633	.06409	.06197	.05995
41	.07339	.07092	.06857	.06634	.06421
42	.07840	.07581	.07335	.07101	.06878
43	.08370	.08099	.07841	.07595	.07361
44	.08930	.08646	.08377	.08119	.07874
45	.09517	.09222	.08940	.08670	.08413
46	.10136	.09828	.09533	.09252	.08983
47	.10786	.10464	.10157	.09864	.09582
48	.11470	.11136	.10816	.10510	.10216
49	.12189	.11842	.11509	.11190	.10884
50	.12946	.12585	.12239	.11907	.11588
51	.13737	.13363	.13003	.12659	.12327
52	.14565	.14177	.13805	.13447	.13103
53	.15429	.15028	.14642	.14271	.13914
54	.16327	.15912	.15513	.15129	.14759
55	.17259	.16831	.16419	.16022	.15639
56	.18225	.17784	.17358	.16948	.16553
57	.19227	.18773	.18335	.17912	.17503
58	.20265	.19798	.19347	.18911	.18490
59	.21343	.20863	.20400	.19951	.19518
60	.22460	.21968	.21492	.21032	.20586
61	.23620	.23117	.22629	.22156	.21698
62	.24824	.24309	.23810	.23325	.22856
63	.26073	.25546	.25036	.24540	.24060
64	.27364	.26827	.26306	.25800	.25308
65	.28696	.28150	.27619	.27103	.26601
66	.30070	.29515	.28974	.28449	.27937
67	.31483	.30919	.30371	.29836	.29316
68	.32936	.32365	.31808	.31266	.30737
69	.34432	.33854	.33290	.32741	.32204
70	.35972	.35389	.34820	.34264	.33721
71	.37565	.36977	.36403	.35842	.35294
72	.39210	.38619	.38042	.37477	.36924
73	.40900	.40308	.39728	.39161	.38605
74	.42618	.42025	.41444	.40876	.40318

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	10.2%	10.4%	10.6%	10.8%	11.0%
75	.44345	.43753	.43173	.42604	.42046
76	.46073	.45483	.44904	.44336	.43779
77	.47799	.47212	.46635	.46069	.45513
78	.49524	.48941	.48368	.47805	.47252
79	.51256	.50678	.50110	.49551	.49001
80	.53001	.52429	.51867	.51313	.50769
81	.54745	.54181	.53626	.53079	.52541
82	.56476	.55921	.55374	.54835	.54303
83	.58193	.57648	.57110	.56579	.56056
84	.59907	.59373	.58845	.58325	.57811
85	.61624	.61102	.60586	.60077	.59574
86	.63300	.62791	.62289	.61791	.61300
87	.64883	.64387	.63896	.63411	.62932
88	.66363	.65880	.65402	.64929	.64461
89	.67775	.67304	.66838	.66377	.65921
90	.69160	.68703	.68250	.67802	.67357
91	.70509	.70066	.69626	.69191	.68760
92	.71775	.71345	.70919	.70496	.70078
93	.72929	.72512	.72099	.71689	.71282
94	.73964	.73559	.73157	.72758	.72362
95	.74867	.74472	.74081	.73692	.73306
96	.75625	.75239	.74856	.74476	.74099
97	.76303	.75925	.75550	.75177	.74807
98	.76892	.76521	.76152	.75786	.75422
99	.77443	.77078	.76715	.76355	.75998
100 ..	.77990	.77631	.77275	.76921	.76569
101 ..	.78463	.78109	.77757	.77407	.77060
102 ..	.78971	.78622	.78275	.77930	.77587
103 ..	.79629	.79287	.78947	.78608	.78272
104 ..	.80244	.79907	.79572	.79239	.78907
105 ..	.81198	.80871	.80546	.88222	.79900
106 ..	.82792	.82485	.82180	.81876	.81572
107 ..	.85057	.84783	.84509	.84237	.83964
108 ..	.88740	.88526	.88312	.88098	.87885
109 ..	.94900	.94800	.94700	.94600	.94500

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	11.2%	11.4%	11.6%	11.8%	12.0%
0	.02487	.02466	.02447	.02429	.02412
1	.00686	.00666	.00648	.00631	.00615
2	.00641	.00620	.00601	.00583	.00566
3	.00631	.00609	.00589	.00570	.00552
4	.00637	.00614	.00593	.00573	.00554
5	.00657	.00633	.00610	.00588	.00568
6	.00687	.00661	.00637	.00614	.00593
7	.00724	.00696	.00670	.00646	.00623
8	.00770	.00740	.00713	.00687	.00663
9	.00827	.00795	.00766	.00739	.00713
10	.00894	.00861	.00830	.00800	.00773
11	.00974	.00939	.00906	.00875	.00846
12	.01066	.01029	.00993	.00961	.00929
13	.01164	.01124	.01087	.01052	.01019
14	.01262	.01220	.01181	.01144	.01109
15	.01355	.01311	.01270	.01231	.01194
16	.01440	.01394	.01350	.01309	.01271
17	.01516	.01467	.01421	.01378	.01337

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	11.2%	11.4%	11.6%	11.8%	12.0%
18	.01585	.01534	.01485	.01440	.01397
19	.01651	.01597	.01546	.01498	.01453
20	.01719	.01662	.01608	.01557	.01510
21	.01789	.01728	.01672	.01618	.01568
22	.01861	.01797	.01737	.01680	.01627
23	.01938	.01870	.01806	.01746	.01689
24	.02023	.01951	.01883	.01819	.01759
25	.02121	.02045	.01973	.01905	.01841
26	.02236	.02155	.02078	.02006	.01938
27	.02368	.02282	.02200	.02124	.02051
28	.02521	.02429	.02342	.02261	.02183
29	.02689	.02591	.02499	.02412	.02330
30	.02875	.02772	.02674	.02581	.02494
31	.03076	.02966	.02863	.02764	.02671
32	.03297	.03180	.03070	.02965	.02866
33	.03536	.03412	.03295	.03184	.03079
34	.03794	.03663	.03539	.03421	.03309
35	.04074	.03935	.03803	.03678	.03559
36	.04375	.04228	.04089	.03956	.03830
37	.04699	.04543	.04395	.04255	.04122
38	.05044	.04879	.04723	.04575	.04433
39	.05411	.05238	.5073	.04916	.04766
40	.05802	.05620	.05445	.05279	.05121
41	.06219	.06026	.05843	.05668	.05550
42	.06665	.06462	.06269	.06084	.05908
43	.07138	.06924	.06721	.06526	.06341
44	.07639	.07415	.07202	.06997	.06801
45	.08168	.07933	.07708	.07493	.07287
46	.08726	.08480	.08244	.08018	.07802
47	.09313	.09056	.08809	.08572	.08345
48	.09935	.09666	.09408	.09160	.08922
49	.10591	.10309	.10039	.09780	.09531
50	.11282	.10989	.10707	.10436	.10176
51	.12009	.11703	.11409	.11127	.10855
52	.12772	.12454	.12147	.11853	.11569
53	.13571	.13340	.12922	.12615	.12319
54	.14403	.14060	.13729	.13410	.13102
55	.15270	.14914	.14571	.14240	.13920
56	.16171	.15802	.15447	.15103	.14771
57	.17109	.16728	.16360	.16004	.15660
58	.18083	.17690	.17309	.16941	.16585
59	.19098	.18692	.18299	.17919	.17551
60	.20154	.19736	.19331	.18938	.18558
61	.21254	.20824	.20407	.20003	.19610
62	.22400	.21958	.21530	.21113	.20709
63	.23593	.23139	.22699	.22272	.21856
64	.24830	.24366	.23915	.23476	.23050
65	.26113	.25638	.25176	.24727	.24290
66	.27439	.26955	.26483	.26023	.25576
67	.28808	.28314	.27833	.27364	.26906
68	.30221	.29718	.29228	.28750	.28283
69	.31681	.31170	.30672	.30185	.29710
70	.33190	.32673	.32167	.31672	.31189
71	.34758	.34234	.33721	.33220	.32731
72	.36384	35855	.35337	.34831	.34335
73	.38061	.37529	.37007	.36496	.35996
74	.39772	.39237	.38713	.38199	.37695
75	.41499	.40962	.40436	.39920	.39413
76	.43232	.42695	.42168	.41650	.41142
77	.44967	.44431	.43904	.43386	.42878
78	.46708	.46173	.45647	.45130	.44622
79	.48460	.47928	.47405	.46890	.46383
80	.50232	.49705	.49185	.48673	.48169
81	.52010	.51487	.50973	.50465	.49965
82	.53779	.53263	.52754	.52252	.51757
83	.55540	.55031	.54529	.54033	.53544

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	11.2%	11.4%	11.6%	11.8%	12.0%
84	.57304	.56804	.56309	.55822	.55340
85	.59077	.58586	.58102	.57623	.57150
86	.60815	.60335	.59860	.59392	.58928
87	.62458	.61989	.61525	.61066	.60613
88	.63998	.63540	.63086	.62638	.62194
89	.65469	.65022	.64579	.64141	.63707
90	.66918	.66482	.66050	.65623	.65199
91	.68332	.67909	.67489	.67073	.66661
92	.69662	.69251	.68843	.68439	.68038
93	.70879	.70479	.70082	.69689	.69299
94	.71970	.71581	.71195	.70812	.70432
95	.72924	.72544	.72167	.71793	.71422
96	.73724	.73353	.72984	.72618	.72254
97	.74440	.74076	.73714	.73354	.72998
98	.75061	.74703	.74347	.73994	.73643
99	.75642	.75290	.74939	.74591	.74245
100	.76219	.75872	.75527	.75184	.74844
101	.76715	.76372	.76031	.75692	.75356
102	.77246	.76908	.76571	.76236	.75904
103	.77937	.77605	.77274	.76945	.76618
104	.78577	.78249	.77923	.77598	.77275
105	.79579	.79259	.78941	.78625	.78310
106	.81270	.80969	.80670	.80371	.80073
107	.83693	.83422	.83152	.82883	.82614
108	.87672	.87459	.87246	.87034	.86822
109	.94400	.94300	.94200	.94100	.94000

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	12.2%	12.4%	12.6%	12.8%	13.0%
0	.02396	.02380	.02366	.02352	.02338
1	.00600	.00585	.00572	.00559	.00547
2	.00550	.00535	.00521	.00508	.00495
3	.00536	.00520	.00505	.00491	.00478
4	.00536	.00519	.00504	.00489	.00475
5	.00549	.00532	.00515	.00499	.00484
6	.00572	.00554	.00536	.00519	.00503
7	.00602	.00582	.00563	.00545	.00528
8	.00640	.00618	.00598	.00579	.00561
9	.00688	.00665	.00644	.00623	.00604
10	.00747	.00723	.00699	.00678	.00657
11	.00818	.00792	.00767	.00744	.00722
12	.00900	.00873	.00846	.00822	.00798
13	.00988	.00959	.00931	.00905	.00880
14	.01077	.01046	.01017	.00989	.00963
15	.01160	.01127	.01097	.01067	.01040
16	.01234	.01200	.01167	.01137	.01108
17	.01299	.01263	.01229	.01197	.01166
18	.01357	.01319	.01283	.01249	.01217
19	.01410	.01370	.01332	.01297	.01263
20	.01465	.01422	.01382	.01345	.01309
21	.01520	.01475	.01433	.01393	.01355
22	.01576	.01529	.01484	.01442	.01402
23	.01636	.01586	.01538	.01493	.01450
24	.01703	.01649	.01599	.01551	.01505
25	.01781	.01724	.01670	.01619	.01571
26	.01874	.01813	.01756	.01701	.01650

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	12.2%	12.4%	12.6%	12.8%	13.0%
27	.01983	.01918	.01857	.01799	.01744
28	.02111	.02042	.01976	.01915	.01856
29	.02253	.02179	.02110	.02044	.01981
30	.02411	.02333	.02259	.02188	.02121
31	.02583	.02500	.02421	.02345	.02274
32	.02772	.02683	.02599	.02519	.02443
33	.02979	.02885	.02795	.02709	.02628
34	.03203	.03102	.03006	.02915	.02829
35	.03447	.03340	.03238	.03141	.03048
36	.03710	.03597	.03488	.03385	.03286
37	.03995	.03874	.03758	.03649	.03544
38	.04299	.04170	.04048	.03931	.03820
39	.04623	.04487	.04358	.04234	.04115
40	.04970	.04826	.04689	.04558	.04432
41	.05341	.05189	.05043	.04904	.04771
42	.05739	.05578	.05424	.05277	.05136
43	.06163	.05993	.05830	.05674	.05525
44	.06614	.06435	.06263	.06099	.05941
45	.07090	.06901	.06720	.06547	.06380
46	.07595	.07396	.07206	.07023	.06847
47	.08128	.07919	.07718	.07525	.07340
48	.08693	.08474	.08263	.08061	.07866
49	.09291	.09061	.08840	.08627	.08423
50	.09925	.09684	.09452	.09229	.09014
51	.10593	.10341	.10098	.09864	.09638
52	.11296	.11032	.10778	.10534	.10297
53	.12034	.11759	.11494	.11238	.10991
54	.12805	.12519	.12243	.11976	.11718
55	.13611	.13313	.13025	.12747	.12478
56	.14451	.14141	.13841	.13551	.13271
57	.15327	.15005	.14694	.14393	.14101
58	.16240	.15906	.15583	.15270	.14967
59	.17194	.16848	.16513	.16189	.15874
60	.18189	.17831	.17485	.17148	.16822
61	.19230	.18860	.18502	.18154	.17816
62	.20317	.19936	.19566	.19207	.18857
63	.21453	.21060	.20679	.20308	.19947
64	.22635	.22231	.21839	.21457	.21085
65	.23864	.23450	.23046	.22653	.22271
66	.25140	.24715	.24301	.23898	.23505
67	.26461	.26026	.25602	.25188	.24785
68	.27828	.27384	.26950	.26527	.26114
69	.29246	.28793	.28350	.27918	.27496
70	.30718	.30256	.29805	.29364	.28933
71	.32251	.31783	.31324	.30876	.30437
72	.33850	.33375	.32910	.32455	.32009
73	.35506	.35026	.34555	.34094	.33642
74	.37201	.36716	.36241	.35776	.35319
75	.38916	.38429	.37950	.37481	.37020
76	.40644	.40154	.39673	.39200	.38737
77	.42378	.41887	.41404	.40930	.40464
78	.44123	.43631	.43148	.42673	.42205
79	.45885	.45394	.44911	.44436	.43969
80	.47673	.47184	.46703	.46229	.45763
81	.49473	.48987	.48509	.48037	.47573
82	.51269	.50787	.50313	.49845	.49383
83	.53062	.52586	.52116	.51653	.51195
84	.54864	.54395	.53931	.53473	.53021
85	.56683	.56221	.55765	.55314	.54869
86	.58470	.58017	.57570	.57127	.56689
87	.60164	.59720	.59281	.58847	.58417
88	.61754	.61320	.60889	.60464	.60042
89	.63277	.62851	.62430	.62013	.61600
90	.64780	.64364	.63953	.63545	.63141
91	.66252	.65848	.65446	.65049	.64655
92	.67640	.67246	.66856	.66468	.66084

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	12.2%	12.4%	12.6%	12.8%	13.0%
93	.68912	.68528	.68148	.67770	.67396
94	.70055	.69680	.69309	.68941	.68576
95	.71054	.70689	.70326	.69966	.69609
96	.71893	.71535	.71180	.70827	.70476
97	.72643	.72292	.71943	.71596	.71252
98	.73294	.72948	.72604	.72263	.71924
99	.73902	.73561	.73222	.72886	.72551
100	.74506	.74170	.73836	.73504	.73174
101	.75021	.74689	.74359	.74030	.73704
102	.75573	.75244	.74918	.74593	.74270
103	.76293	.75970	.75649	.75329	.75011
104	.76954	.76634	.76316	.76000	.75685
105	.77996	.77684	.77373	.77064	.76756
106	.79777	.79481	.79187	.78894	.78602
107	.82346	.82078	.81812	.81546	.81281
108	.86610	.86398	.86187	.85976	.85765
109	.93900	.93800	.93700	.93600	.93500

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	13.2%	13.4%	13.6%	13.8%	14.0%
0	.02325	.02313	.02301	.02290	.02279
1	.00536	.00525	.00514	.00505	.00495
2	.00484	.00472	.00462	.00451	.00442
3	.00465	.00453	.00442	.00431	.00421
4	.00461	.00449	.00437	.00426	.00415
5	.00470	.00457	.00444	.00432	.00421
6	.00488	.00474	.00460	.00447	.00435
7	.00512	.00496	.00482	.00468	.00455
8	.00543	.00527	.00512	.00497	.00483
9	.00585	.00568	.00551	.00536	.00521
10	.00637	.00619	.00601	.00584	.00568
11	.00701	.00681	.00662	.00644	.00627
12	.00776	.00755	.00735	.00716	.00697
13	.00857	.00734	.00813	.00793	.00773
14	.00938	.00914	.00892	.00870	.00850
15	.01014	.00989	.00965	.00942	.00921
16	.01080	.01054	.01029	.01005	.00983
17	.01137	.01109	.01083	.01058	.01035
18	.01186	.01157	.01130	.01103	.01078
19	.01230	.01300	.01171	.01143	.01117
20	.01275	.01243	.01212	.01183	.01155
21	.01319	.01285	.01253	.01222	.01193
22	.01364	.01328	.01293	.01261	.01230
23	.01410	.01372	.01336	.01301	.01268
24	.01463	.01422	.01383	.01347	.01312
25	.01525	.01482	.01441	.01401	.01364
26	.01601	.01555	.01511	.01469	.01430
27	.01692	.01643	.01596	.01551	.01509
28	.01800	.01748	.01697	.01650	.01604
29	.01922	.01865	.01812	.01760	.01712
30	.02058	.01998	.01940	.01886	.01833
31	.02206	.02142	.02080	.02022	.01966
32	.02370	.02301	.02236	.02173	.02113
33	.02550	.02477	.02407	.02340	.02276
34	.02746	.02667	.02592	.02521	.02452
35	.02960	.02876	.02796	.02719	.02646
36	.03193	.03103	.03017	.02936	.02858
37	.03444	.03348	.03257	.03170	.03087
38	.03714	.03612	.03515	.03422	.03333
39	.04002	.03894	.03791	.03692	.03597
40	.04312	.04197	.04087	.03891	.03880
41	.04643	.04521	.04404	.04292	.04185
42	.05001	.04871	.04747	.04628	.04514
43	.05382	.05245	.05113	.04987	.04865
44	.05789	.05644	.05505	.05371	.05242
45	.06220	.06067	.05919	.05777	.05641
46	.06678	.06516	.06360	.06210	.06065
47	.07162	.06991	.06826	.06668	.06515
48	.07678	.07498	.07324	.07157	.06996
49	.08225	.08035	.07852	.07676	.07506
50	.08807	.08607	.08415	.08229	.08050
51	.09421	.09211	.09009	.08814	.08625
52	.10070	.09850	.09637	.09432	.09234
53	.10753	.10523	.10300	.10085	.09877
54	.11468	.11227	.10994	.10769	.10551
55	.12218	.11966	.11722	.11487	.11258
56	.12999	.12737	.12483	.12236	.11998
57	.13818	.13545	.13279	.13022	.12773
58	.14673	.14388	.14112	.13844	.13584
59	.15568	.15272	.14985	.14706	.14435
60	.16505	.16198	.15899	.15609	.15327
61	.17488	.17169	.16859	.16558	.16265
62	.18518	.18187	.17866	.17554	.17251
63	.19596	.19255	.18923	.18600	.18285
64	.20723	.20371	.20028	.19694	.19368
65	.21898	.21535	.21181	.20836	.20500
66	.23121	.22748	.22383	.22028	.21681
67	.24392	.24008	.23633	.23267	.22910
68	.25711	.25317	.24932	.24556	.24189
69	.27083	.26680	.26285	.25900	.25523
70	.28512	.28100	.27697	.27302	.26916
71	.30007	.29587	.29176	.28773	.28378
72	.31572	.31145	.30726	.30315	.29913
73	.33199	.32765	.32340	.31923	.31514
74	.34871	.34431	.34000	.33577	.33162
75	.36568	.36124	.35688	.35260	.34840
76	.38281	.37833	.37393	.36961	.36537
77	.40006	.39555	.39113	.38677	.38249
78	.41745	.41293	.40848	.40410	.39980
79	.43508	.43055	.42609	.42170	.41737
80	.45303	.44850	.44404	.43964	.43531
81	.47115	.46663	.46218	.45779	.45347
82	.48928	.48479	.48036	.47599	.47168
83	.50744	.50298	.49858	.49424	.48995
84	.52575	.52134	.51698	.51268	.50843
85	.54429	.53994	.53564	.53139	.52720
86	.56257	.55829	.55406	.54988	.54574
87	.57993	.57572	.57156	.56745	.56338
88	.59625	.59212	.58804	.58399	.57999
89	.61191	.60786	.60384	.59987	.59594
90	.62741	.62344	.61952	.61562	.61177
91	.64264	.63877	.63493	.63113	.62736
92	.65703	.65326	.64951	.64580	.64212
93	.67024	.66656	.66291	.65928	.65568
94	.68213	.67854	.67497	.67142	.66791
95	.69255	.68903	.68554	.68207	.67863
96	.70128	.69783	.69440	.69100	.68762
97	.70910	.70570	.70233	.69899	.69566
98	.71587	.71252	.70920	.70590	.70263
99	.72219	.71889	.71562	.71236	.70913
100	.72847	.72522	.72189	.71877	.71558
101	.73380	.73058	.72738	.72420	.72104

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	13.2%	13.4%	13.6%	13.8%	14.0%
102 ..	.73949	.73630	.73313	.72998	.72685
103 ..	.74695	.74381	.74068	.73758	.73449
104 ..	.75372	.75060	.74751	.74442	.74136
105 ..	.76449	.76144	.75840	.75538	.75237
106 ..	.78311	.78021	.77732	.77444	.77157
107 ..	.81016	.80752	.80489	.80227	.79965
108 ..	.85554	.85344	.85134	.84924	.84715
109 ..	.93400	.93300	.93200	.93100	.93000

TABLE F (1)

TABLE F(1)—10 PERCENT—TABLE SHOWING FACTORS FOR COMPUTATIONS OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS AND PAYOUT SEQUENCES—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Number of months by which the valuation date precedes the first payout		(2) Factors for payout at the end of each			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1		.976731	.965232	.957616
1	2	.992089	.969004	.957596	.950041
2	3	.984240	.961338	.950021	
3	4	.976454	.953733	.942505	
4	5	.968729	.946188		
5	6	.961066	.938703		
6	7	.953463	.931277		
7	8	.945920			
8	9	.938436			
9	10	.931012			
10	11	.923647			
11	12	.916340			
12		.909091			

[T.D. 8540, 59 FR 30102, 30116, 30117, 30148, June 10, 1994]

TREATMENT OF EXCESS DISTRIBUTIONS OF TRUSTS APPLICABLE TO TAXABLE YEARS BEGINNING ON OR AFTER JANUARY 1, 1969

§1.665(a)–0A Excess distributions by trusts; scope of subpart D.

(a) *In general.* (1) Subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code as amended by the Tax Reform Act of 1969, is designed to tax the beneficiary of a trust that accumulates, rather than distributes, all or part of its income currently (i.e., an accumulation trust), in most cases, as if the income had been currently distributed to the beneficiary instead of accumulated by the trusts. Accordingly, subpart D provides special rules for the treatment of amounts paid, credited, or required to be distributed by a complex trust (one that is subject to subpart C (section 661 and following) of such part I) in any year in excess of ‘‘distributable net income’’ (as defined in section 643 (a)) for that year. Such an excess distribution is an ‘‘accumulation distribution’’ (as defined in section 665(b)). The special rules of subpart D are generally inapplicable to amounts paid, credited, or required to be distributed by a trust in a taxable year in which it qualifies as a simple trust (one that is subject to subpart B (section 651 and following) of such part I). However, see §1.665(e)–1A(b) for rules relating to the treatment of a simple trust as a complex trust.

(2) An accumulation distribution is deemed to consist of, first, ‘‘undistributed net income’’ (as defined in section 665(a)) of the trust from preceding taxable years, and, after all the undistributed net income for all preceding taxable years has been deemed distributed, ‘‘undistributed capital gain’’ (as defined in section 665(f)) of the trust for all preceding taxable years commencing with the first year such amounts were accumulated. An accumulation distribution of undistributed

capital gain is a ''capital gain distribution'' (as defined in section 665(g)). To the extent an accumulation distribution exceeds the ''undistributed net income'' and ''undistributed capital gain'' so determined, it is deemed to consist of corpus.

(3) The accumulation distribution is ''thrown back'' to the earliest ''preceding taxable year'' of the trust, which, in the case of distributions made for a taxable year beginning after December 31, 1973, from a trust (other than a foreign trust created by a U.S. person), is any taxable year beginning after December 31, 1968. Special transitional rules apply for distributions made in taxable years beginning before January 1, 1974. In the case of a foreign trust created by a U.S. person, a ''preceding taxable year'' is any year of the trust to which the Code applies.

(4) A distribution of undistributed net income (included in an accumulation distribution) and a capital gain distribution will be included in the income of the beneficiary in the year they are actually paid, credited, or required to be distributed to him. The tax on the distribution will be approximately the amount of tax the beneficiary would have paid with respect to the distribution had the income and capital gain been distributed to the beneficiary in the year earned by the trust. An additional amount equal to the ''taxes imposed on the trust'' for the preceding year is also deemed distributed. To prevent double taxation, however, the beneficiary receives a credit for such taxes.

(b) *Effective dates.* All regulations sections under subpart D (sections 665 through 669) which have an ''A'' suffix (such as §1.665(a)A and §1.666(b)–1A) are applicable to taxable years beginning on or after January 1, 1969, and all references therein to sections 665 through 669 are references to such sections as amended by the Tax Reform Act of 1969. Sections without the ''A'' suffix (such as §1.666(b)–1) are applicable only to taxable years beginning before January 1, 1969, and all references therein to sections 665 through 669 are references to such sections before amendment by the Tax Reform Act of 1969.

(c) *Examples.* Where examples contained in the regulations under subpart D refer to tax rates for years after 1968, such tax rates are not necessarily the actual rates for such years, but are only used for example purposes.

(d) *Applicability to estates.* Subpart D does not apply to any estate.

[T.D. 7204, 37 FR 17135, Aug. 25, 1972]

§1.665(a)–1A Undistributed net income.

(a) *Domestic trusts.* The term *undistributed net income,* in the case of a trust (other than a foreign trust created by a U.S. person) means, for any taxable year beginning after December 31, 1968, the distributable net income of the trust for that year (as determined under section 643(a)), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in section 661(a), and

(2) The amount of taxes imposed on the trust attributable to such distributable net income, as defined in §1.665 (d)–1A. The application of the rule in this paragraph to a taxable year of a trust in which income is accumulated may be illustrated by the following example:

Example. Under the terms of the trust, $10,000 of income is required to be distributed currently to A and the trustee has discretion to make additional distributions to A. During the taxable year 1971 the trust had distributable net income of $30,100 derived from royalties and the trustee made distributions of $20,000 to A. The taxable income of the trust is $10,000 on which a tax of $2,190 is paid. The undistributed net income of the trust for the taxable year 1971 is $7,910, computed as follows:

Distributable net income	$30,100
Less:	
Income currently distributable to A	$10,000
Other amounts distributed to A	10,000
Taxes imposed on the trust attributable to the undistributed net income (see §1.665(d)–1A)	2,190
Total	22,190
Undistributed net income	7,910

(b) *Foreign trusts.* The undistributed net income of a foreign trust created by a U.S. person for any taxable year is the distributable net income of such trust (see §1.643(a)–6 and the examples set forth in paragraph (b) thereof), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in section 661(a), and

(2) The amount of taxes imposed on such trust by chapter 1 of the Internal Revenue Code, which are attributable to items of income which are required to be included in such distributable net income.

For purposes of subparagraph (2) of this paragraph, the amount of taxes imposed on the trust for any taxable year by chapter 1 of the Internal Revenue Code is the amount of taxes imposed pursuant to section 871 (relating to tax on non-resident alien individuals) which is properly allocable to the undistributed portion of the distributable net income. See §1.665(d)–1A. The amount of taxes imposed pursuant to section 871 is the difference between the total tax imposed pursuant to that section on the foreign trust created by a U.S. person for the year and the amount which would have been imposed on such trust had all the distributable net income, as determined under section 643(a), been distributed. The application of the rule in this paragraph may be illustrated by the following examples:

Example 1. A trust was created in 1952 under the laws of Country X by the transfer to a trustee in Country X of property by a U.S. person. The entire trust constitutes a foreign trust created by a U.S. person. The governing instrument of the trust provides that $7,000 of income is required to be distributed currently to a U.S. beneficiary and gives the trustee discretion to make additional distributions to the beneficiary. During the taxable year 1973 the trust had income of $10,000 from dividends of a U.S. corporation (on which Federal income taxes of $3,000 were imposed pursuant to section 871 and withheld under section 1441, resulting in the receipt by the trust of cash in the amount of $7,000), $20,000 in capital gains from the sale of stock of a Country Y corporation and $30,000 from dividends of a Country X corporation, none of the gross income of which was derived from sources within the United States. No income taxes were required to be paid to Country X or Country Y in 1973. The trustee did not file a U.S. income tax return for the taxable year 1973. The distributable net income of the trust before distributions to the beneficiary for 1973 is $60,000 ($57,000 of which is cash). During 1973 the trustee made distributions to the U.S. beneficiary equaling one-half of the trust's distributable net income. Thus, the U.S. beneficiary is treated as having had distributed to him $5,000 (composed of $3,500 as a cash distribution and $1,500 as the tax imposed pursuant to section 871 and withheld under section 1441), representing one-half of the income from U.S. sources; $10,000 in cash, representing one-half of the capital gains from the sale of stock of the Country Y corporation; and $15,000 in cash, representing one-half of the income from Country X sources for a total of $30,000. The undistributed net income of the trust at the close of taxable year 1973 is $28,500 computed as follows:

Distributable net income	$60,000
Less:	
(1) Amounts distributed to the beneficiary:	
Income currently distributed to the beneficiary	$7,000
Other amounts distributed to the beneficiary	21,500
Taxes under sec. 871 deemed distributed to the beneficiary	1,500
Total amounts distributed to the beneficiary	80,000
(2) Amount of taxes imposed on the trust under chapter 1 of the Code attributable to the undistributed net income (See §1.665 (d)–1A) $3,000 less $1,500)	$1,500
Total	$31,500
Undistributed net income	28,500

Example 2. The facts are the same as in example 1 except that property has been transferred to the trust by a person other than a U.S. person, and during 1973 the foreign trust created by a U.S. person was 60 percent of the entire foreign trust. The trustee paid no income taxes to Country X or Country Y in 1973.

(1) The undistributed net income of the portion of the entire trust which is a foreign trust created by a U.S. person for 1973 is $17,100, computed as follows:

Distributable net income (60% of each item of gross income of entire trust):		
60% of $10,000 U.S. dividends		$6,000
60% of $20,000 Country X capital gains		12,000
60% of $30,000 Country X dividends		18,000
Total		36,000
Less:		
(i) Amounts distributed to the beneficiary—		
Income currently distributed to the beneficiary (60% of $7,000)	$4,200	
Other amounts distributed to the beneficiary (60% of $21,500)	12,900	

Taxes under sec. 871 deemed distributed to the beneficiary (60% of $1,500)	900	
Total amounts distributed to the beneficiary	18,000	
(ii) Amount of taxes imposed on the trust under chapter 1 of the Code attributable to the undistributed net income (see §1.665 (d)–1A) (60% of $1,500)	900	
Total		18,900
Undistributed net income		17,100

(2) The undistributed net income of the portion of the entire trust which is not a foreign trust created by a U.S. person for 1973 is $11,400, computed as follows:

Distributable net income (40% of each item of gross income of entire trust)		
40% of $10,000 U.S. dividends		$4,000
40% of $20,000 Country X capital gains		8,000
40% of $30,000 Country X dividends		12,000
Total		24,000
Less:		
(i) Amounts distributed to the beneficiary—		
Income currently distributed to the beneficiary (40% of $7,000)	$2,800	
Other amounts distributed to the beneficiary (40% of $21,500)	8,600	
Taxes under sec. 871 deemed distributed to the beneficiary (40% of $1,500)	600	
Total amounts distributed to the beneficiary	12,000	
(ii) Amount of taxes imposed on the trust under chapter 1 of the Code attributable to the undistributed net income (See §1.665 (d)–1A) (40% of $1,500)	600	
Total		12,600
Undistributed net income		11,400

(c) *Effect of prior distributions.* The undistributed net income for any year to which an accumulation distribution for a later year may be thrown back will be reduced by accumulation distributions in intervening years that are required to be thrown back to such year. For example, if a trust has undistributed net income for 1975, and an accumulation distribution is made in 1980, there must be taken into account the effect on undistributed net income for 1975 of any accumulation distribution made in 1976, 1977, 1978, or 1979. However, undistributed net income for any year will not be reduced by any distributions in any intervening years that are excluded under section 663(a)(1), relating to gifts, bequests, etc. See paragraph (d) of §1.666(a)–1A for an illustration of the reduction of undistributed net income for any year by a subsequent accumulation distribution.

(d) *Distributions made in taxable years beginning before January 1, 1974.* For special rules relating to accumulation distributions of undistributed net income made in taxable years of the trust beginning before January 1, 1974, see §1.665(b)–2A.

[T.D. 7204, 37 FR 17136, Aug. 25, 1972]

§1.665(b)–1A Accumulation distributions.

(a) *In general.* (1) For any taxable year of a trust the term *accumulation distribution* means an amount by which the amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2) (*i.e.,* all amounts properly paid, credited, or required to be distributed to the beneficiary other than income required to be distributed currently within the meaning of section 661(a)(1)) for that year exceed the distributable net income (determined under section 643(a)) of the trust, reduced (but not below zero) by the amount of income required to be distributed currently. To the extent provided in section 663(b) and the regulations thereunder, distributions made within the first 65 days following a taxable year may be treated as having been distributed on the last day of such taxable year.

(2) An accumulation distribution also includes, for a taxable year of the trust, any amount to which section 661(a)(2) and the preceding paragraph are inapplicable and which is paid, credited, or required to be distributed during the taxable year of the trust by reason of the exercise of a power to appoint, distribute, consume, or withdraw corpus of the trust or income of the trust accumulated in a preceding taxable year. No accumulation distribution is deemed to be made solely because the grantor or any other person is treated as owner of a portion of the trust by reason of an unexercised power to appoint, distribute, consume, or withdraw corpus or accumulated income of the trust. Nor will an accumulation distribution be deemed to have

been made by reason of the exercise of a power that may affect only taxable income previously attributed to the holders of such power under subpart E (section 671 and following). See example 4 of paragraph (d) of this section for an example of an accumulation distribution occurring as a result of the exercise of a power of withdrawal.

(3) Although amounts properly paid or credited under section 661(a) do not exceed the income of the trust during the taxable year, an accumulation distribution may result if the amounts properly paid or credited under section 661(a)(2) exceed distributable net income reduced (but not below zero) by the amount required to be distributed currently under section 661(a)(1). This may occur, for example, when expenses, interest, taxes, or other items allocable to corpus are taken into account in determining taxable income and hence causing distributable net income to be less than the trust's income.

(b) *Payments that are accumulation distributions.* The following are some instances in which an accumulation distribution may arise:

(1) *One trust to another.* A distribution from one trust to another trust is generally an accumulation distribution. See §1.643(c)–1. This general rule will apply regardless of whether the distribution is to an existing trust or to a newly created trust and regardless of whether the trust to which the distribution is made was created by the same person who created the trust from which the distribution is made or a different person. However, a distribution made from one trust to a second trust will be deemed an accumulation distribution by the first trust to an ultimate beneficiary of the second trust if the primary purpose of the distribution to the second trust is to avoid the capital gain distribution provisions (see section 669 and the regulations thereunder). An amount passing from one separate share of a trust to another separate share of the same trust is not an accumulation distribution. See §1.665(g)–2A. For rules relating to the computation of the beneficiary's tax under section 668 by reason of an accumulation distribution from the second trust, see paragraphs (b)(1) and (c)(1)(i) of §1.668(b)–1A and paragraphs (b)(1) and (c)(1)(i) of §1.669(b)–1A.

(2) *Income accumulated during minority.* A distribution of income accumulated during the minority of the beneficiary is generally an accumulation distribution. For example, if a trust accumulates income until the beneficiary's 21st birthday, and then distributes the income to the beneficiary, such a distribution is an accumulation distribution. However, see §1.665(b)–2A for rules governing income accumulated in taxable years beginning before January 1, 1969.

(3) *Amounts paid for support.* To the extent that amounts forming all or part of an accumulation distribution are applied or distributed for the support of a dependent under the circumstances specified in section 677(b) or section 678(c) or are used to discharge or satisfy any person's legal obligation as that term is used in §1.662(a)–4, such amounts will be considered as having been distributed directly to the person whose obligation is being satisfied.

(c) *Payments that are not accumulation distributions*—(1) *Gifts, bequests, etc., described in section 663(a)(1).* A gift or bequest of a specific sum of money or of specific property described in section 663(a)(1) is not an accumulation distribution.

(2) *Charitable payments.* Any amount paid, permanently set aside, or used for the purposes specified in section 642(c) is not an accumulation distribution, even though no charitable deduction is allowed under such section with respect to such payment.

(3) *Income required to be distributed currently.* No accumulation distribution will arise by reason of a payment of income required to be distributed currently even though such income exceeds the distributable net income of the trust because the payment is an amount specified in section 661(a)(1).

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

Example 1. A trustee properly makes a distribution to a beneficiary of $20,000 during the taxable year 1976, of which $10,000 is income required to be distributed currently to the beneficiary. The distributable net income of the trust is $15,000. There is an accumulation distribution of $5,000 computed as follows.

Total distribution		$20,000
Less: Income required to be distributed currently (section 661(a)(1))		10,000
Other amounts distributed (section 661(a)(2))		10,000
Distributable net income	$15,000	
Less: Income required to be distributed currently	10,000	
Balance of distributable net income		5,000
Accumulation distribution		5,000

Example 2. Under the terms of the trust instrument, an annuity of $15,000 is required to be paid to A out of income each year and the trustee may in his discretion make distributions out of income or corpus to B. During the taxable year the trust had income of $18,000, as defined in section 643(b), and expenses allocable to corpus of $5,000. Distributable net income amounted to $13,000. The trustee distributed $15,000 of income to A and, in the exercise of his discretion, paid $5,000 to B. There is an accumulation distribution of $5,000 computed as follows:

Total distribution		$20,000
Less: Income required to be distributed currently to A (section 661(a)(1))		15,000
Other amounts distributed (section 661(a)(2))		5,000
Distributable net income	$13,000	
Less: Income required to be distributed currently to A	15,000	
Balance of distributable net income		0
Accumulation distribution to B		5,000

Example 3. Under the terms of a trust instrument, the trustee may either accumulate the trust income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. During the taxable year, the trust had income as defined in section 643(b) of $22,000 and expenses of $5,000 allocable to corpus. Distributable net income amounts to $17,000. The trustee distributed $10,000 each to A and B during the taxable year. There is an accumulation distribution of $3,000 computed as follows:

Total distribution		$20,000
Less: Income required to be distributed currently		0
Other amounts distributed (section 661(a)(2))		20,000
Distributable net income	$17,000	
Less: Income required to be distributed currently	0	
Balance of distributable net income		17,000
Accumulation distribution		3,000

Example 4. A dies in 1974 and bequeaths one-half the residue of his estate in trust. His widow, W, is given a power, exercisable solely by her, to require the trustee to pay her each year of the trust $5,000 from corpus. W's right to exercise such power was exercisable at any time during the year but was not cumulative, so that, upon her failure to exercise it before the end of any taxable year of the trust, her right as to that year lapsed. The trust's taxable year is the calendar year. During the calendar years 1975 and 1976, W did not exercise her right and it lapsed as to those years. In the calendar years 1977 and 1978, in which years the trust had not distributable net income, she exercised her right and withdrew $4,000 in 1977 and $5,000 in 1978. No accumulation distribution was made by the trust in the calendar years 1975 and 1976. An accumulation distribution of $4,000 was made in 1977 and an accumulation distribution of $5,000 was made in 1978. The accumulation distribution for the years 1977 and 1978 is not reduced by any amount of income of the trust attributable to her under section 678 by reason of her power of withdrawal.

[T.D. 7204, 37 FR 17137, Aug. 25, 1972]

§ 1.665(b)–2A Special rules for accumulation distributions made in taxable years beginning before January 1, 1974.

(a) *General rule.* Section 331(d)(2)(A) of the Tax Reform Act of 1969 excludes certain accumulated income from the tax imposed by section 668(a)(2) by providing certain exceptions from the definition of an ''accumulation distribution.'' Any amount paid, credited, or required to be distributed by a trust (other than a foreign trust created by a U.S. person) during a taxable year of the trust beginning after December 31, 1968, and before January 1, 1974, shall not be subject to the tax imposed by section 668(a)(2) to the extent of the portion of such amount that (1) would be allocated under section 666(a) to a preceding taxable year of the trust beginning before January 1, 1969, and (2) would not have been deemed an accumulation distribution because of the provisions of paragraphs (1), (2), (3), or (4) of section 665(b) as in effect on December 31, 1968, had the trust distributed such amounts on the last day of its last taxable year beginning before January 1, 1969. However, the $2,000 *de minimis* exception formerly in section 665(b) does not apply in the case of any distribution made in a taxable year of a trust beginning after December 31, 1968. Amounts to which this exclusion applies shall reduce the undistributed net income of the trust for the preceding taxable year or years to which such amounts would be allocated under section 666(a). However, since section 668(a)(2) does not apply to such amounts, no amount of taxes imposed on the trust allocable to such undistributed net income is deemed distributed under section 666 (b) and (c).

(b) *Application of general rule.* The rule expressed in paragraph (a) of this section is applied to the exceptions formerly in section 665(b) as follows:

(1) *Distributions from amounts accumulated while beneficiary is under 21.* (i) Paragraph (1) of section 665(b) as in effect on December 31, 1968, provided that amounts paid, credited, or required to be distributed to a beneficiary as income accumulated before the birth of such beneficiary or before such beneficiary attains the age of 21 were not to be considered to be accumulation distributions. If an accumulation distribution is made in a taxable year of the trust beginning after December 31, 1968, and before January 1, 1974, and under section 666(a) such accumulation distribution would be allocated to a preceding taxable year beginning before January 1, 1969, no tax shall be imposed under section 668(a)(2) to the extent the income earned by the trust for such preceding taxable year would be deemed under §1.665(b)–2(b)(1) to have been accumulated before the beneficiary's birth or before his 21st birthday. The provisions of this subparagraph may be illustrated by the following example:

Example. A trust on the calendar year basis was established on January 1, 1965, to accumulate the income during the minority of B, and to pay the accumulated income over to B upon his attaining the age of 21. B's 21st birthday is January 1, 1973. On January 2, 1973, the trustee pays over to B all the accumulated income of the trust. The distribution is an accumulation distribution that may be allocated under section 666(a) to 1968, 1969, 1970, 1971, and 1972 (the 5 preceding taxable years as defined in §1.665(e)–1A). To the extent the distribution is allocated to 1968, no tax is imposed under section 668(a)(2).

(ii) As indicated in paragraph (a) of this section, a distribution of an amount excepted from the tax otherwise imposed under section 668(a)(2) will reduce undistributed net income for the purpose of determining the effect of a future distribution. Thus, under the facts of the example in subdivision (i) of this subparagraph, the undistributed net income for the trust's taxable year 1968 would be reduced by the amount of the distribution allocated to that year under section 666(a).

(2) *Emergency distributions.* Paragraph (2) of section 665(b) as in effect on December 31, 1968, provided an exclusion from the definition of an accumulation distribution for amounts properly paid or credited to a beneficiary to meet his emergency needs. Therefore, if an accumulation distribution is made from a trust in a taxable year beginning before January 1, 1974, and under section 666(a) such accumulation distribution would be allocated to a preceding taxable year of the trust beginning before January 1, 1969, no tax shall be imposed under section 668(a)(2) if such distribution would have been considered an emergency distribution under §1.665(b)–2(b)(2) had it been made in a taxable year of the trust beginning before January 1, 1969. For example, assume a trust on a calendar year basis in 1972 makes an accumulation distribution which under §1.665(b)–2(b) (2) would be considered an emergency distribution and under section 666(a) the distribution would be allocated to the years 1967, 1968, and 1969. To the extent such amount is allocated to 1967 and 1968, no tax would be imposed under section 668(a)(2).

(3) *Certain distributions at specified ages.* Paragraph (3) of section 665(b) as in effect on December 31, 1968, provided an exclusion (in the case of certain trusts created before January 1, 1954) from the definition of an accumulation distribution for amounts properly paid or credited to a beneficiary upon his attaining a specified age or ages, subject to certain restrictions (see §1.665(b)–2(b)(3)). Therefore, a distribution from a trust in a taxable year beginning after December 31, 1968, will not be subject to the tax imposed under section 668(a)(2) to the extent such distribution would be allocated to a preceding taxable year of the trust beginning before January 1, 1969, if such distribution would have qualified under the provisions of §1.665(b)–2(b)(3) had it been made in a taxable year of the

trust to which such section was applicable.

(4) *Certain final distributions.* Paragraph (4) of section 665(b) as in effect on December 31, 1968, provided an exclusion from the definition of an accumulation distribution for amounts properly paid or credited to a beneficiary as a final distribution of the trust if such final distribution was made more than 9 years after the date of the last transfer to such trust. Therefore, amounts properly paid or credited to a beneficiary as a final distribution of a trust in a taxable year of a trust beginning after December 31, 1968, and before January 1, 1974, will not be subject to the tax imposed under section 668(a)(2) to the extent such distribution would be allocated to a preceding taxable year of the trust beginning before January 1, 1969, if such final distribution was made more than 9 years after the date of the last transfer to such trust. The provisions of this subparagraph may be illustrated by the following example:

Example. A trust on a calendar year basis was established on January 1, 1958, and no additional transfers were made to it. On January 1, 1973, the trustee terminates the trust and on the same day he makes a final distribution to the beneficiary, B. The distribution is an accumulation distribution that may be allocated under section 666(a) to 1968, 1969, 1970, 1971, and 1972 (the 5 preceding taxable years as defined in § 1.665(e)–1A). Because more than 9 years elapsed between the date of the last transfer to the trust and the date of final distribution, the distribution is not taxed under section 668 (a) (2) to the extent it would be allocated to 1968 under section 666(a).

[T.D. 7204, 37 FR 17138, Aug. 25, 1972]

§ 1.665(c)–1A Special rule applicable to distributions by certain foreign trusts.

(a) *In general.* Except as provided in paragraph (b) of this section, for purposes of section 665 any amount paid to a U.S. person which is from a payor who is not a U.S. person and which is derived directly or indirectly from a foreign trust created by a U.S. person shall be deemed in the year of payment to the U.S. person to have been directly paid to the U.S. person by the trust. For example, if a nonresident alien receives a distribution from a foreign trust created by a U.S. person and then pays the amount of the distribution over to a U.S. person, the payment of such amount to the U.S. person represents an accumulation distribution to the U.S. person from the trust to the extent that the amount received would have been an accumulation distribution had the trust paid the amount directly to the U.S. person in the year in which the payment was received by the U.S. person. This section also applies in a case where a nonresident alien receives indirectly an accumulation distribution from a foreign trust created by a U.S. person and then pays it over to a U.S. person. An example of such a transaction is one where the foreign trust created by a U.S. person makes the distribution to an intervening foreign trust created by either a U.S. person or a person other than a U.S. person and the intervening trust distributes the amount received to a nonresident alien who in turn pays it over to a U.S. person. Under these circumstances, it is deemed that the payment received by the U.S. person was received directly from a foreign trust created by a U.S. person.

(b) *Limitation.* In the case of a distribution to a beneficiary who is a U.S. person, paragraph (a) of this section does not apply if the distribution is received by such beneficiary under circumstances indicating lack of intent on the part of the parties to circumvent the purposes for which section 7 of the Revenue Act of 1962 (76 Stat. 985) was enacted.

[T.D. 7204, 37 FR 17139 Aug. 25, 1972]

§ 1.665(d)–1A Taxes imposed on the trust.

(a) *In general.* (1) For purposes of subpart D, the term *taxes imposed on the trust* means the amount of Federal income taxes properly imposed for any taxable year on the trust that are attributable to the undistributed portions of distributable net income and gains in excess of losses from the sales or exchanges of capital assets. Except as provided in paragraph (c)(2) of this section, the minimum tax for tax preferences imposed by section 56 is not a tax attributable to the undistributed portions of distributable net income and gains in excess of losses from the sales or exchanges of capital assets. See section 56 and the regulations thereunder.

(2) In the case of a trust that has received an accumulation distribution from another trust, the term *taxes imposed on the trust* also includes the amount of taxes deemed distributed under §§1.666(b)–1A, 1.666(c)–1A, 1.669(d)–1A, and 1.669(e)–1A (whichever are applicable) as a result of such accumulation distribution, to the extent that they were taken into account under paragraphs (b)(2) or (c)(1)(vi) of §1.668 (b)–1A and (b)(2) or (c)(1)(vi) of §1.669(b)–1A in computing the partial tax on such accumulation distribution. For example, assume that trust A, a calendar year trust, makes an accumulation distribution in 1975 to trust B, also on the calendar year basis, in connection with which $500 of taxes are deemed under §1.666(b)–1A to be distributed to trust B. The partial tax on the accumulation distribution is computed under paragraph (b) of §1.668(b)–1A (the exact method) to be $600 and all of the $500 is used under paragraph (b)(2) of §1.668(b)–1A to reduce the partial tax to $100. The taxes imposed on trust B for 1975 will, in addition to the $100 partial tax, also include the $500 used to reduce the partial tax.

(b) *Taxes imposed on the trust attributable to undistributed net income.* (1) For the purpose of subpart D, the term *taxes imposed on the trust attributable to the undistributed net income* means the amount of Federal income taxes for the taxable year properly allocable to the undistributed portion of the distributable net income for such taxable year. This amount is (i) an amount that bears the same relationship to the total taxes of the trust for the year (other than the minimum tax for tax preferences imposed by section 56), computed after the allowance of credits under section 642(a), as *(a)* the taxable income of the trust, other than the capital gains not included in distributable net income less their share of section 1202 deduction, bears to *(b)* the total taxable income of the trust for such year or, (ii) if the alternative tax computation under section 1201(b) is used and there are no net short-term gains, an amount equal to such total taxes less the amount of the alternative tax imposed on the trust and attributable to the capital gain. Thus, for the purposes of subpart D, in determining the amount of taxes imposed on the trust attributable to the undistributed net income, that portion of the taxes paid by the trust attributable to capital gain allocable to corpus is excluded. The rule stated in this subparagraph may be illustrated by the following example, which assumes that the alternative tax computation is not used:

Example. (1) Under the terms of a trust, which reports on the calendar year basis, the income may be accumulated or distributed to A in the discretion of the trustee and capital gains are allocable to corpus. During the taxable year 1974, the trust had income of $20,000 from royalties, long-term capital gains of $10,000, and expenses of $2,000. The trustee in his discretion made a distribution of $10,000 to A. The taxes imposed on the trust for such year attributable to the undistributed net income are $2,319, determined as shown below.

(2) The distributable net income of the trust computed under section 643(a) is $18,000 (royalties of $20,000 less expenses of $2,000). The total taxes paid by the trust are $3,787, computed as follows:

Royalties		$20,000
Capital gain allocable to corpus		10,000
Gross income		30,000
Deductions:		
Expenses	$2,000	
Distributions to A	10,000	
Capital gain deduction	5,000	
Personal exemption	100	
		17,100
Taxable income		12,900
Total income taxes		3,787

(3) Taxable income other than capital gains less the section 1202 deduction is $7,900 ($12,900 − ($10,000 − $5,000)). Therefore, the amount of taxes imposed on the trust attributable to the undistributed net income is $2,319, computed as follows:

$3,787 (total taxes) × $7,900 (taxable income other than capital gains not included in d.n.i. less the 1202 deduction) divided by $12,900 (taxable income)	$2,319

(2) If in any taxable year an accumulation distribution of undistributed net income is made by the trust which results in a throwback to a prior year, the taxes of the prior year imposed on the trust attributable to any remaining undistributed net income of such prior year are the taxes prescribed in

subparagraph (1) of this paragraph reduced by the taxes of the prior year deemed distributed under section 666 (b) or (c). The provisions of this subparagraph may be illustrated by the following example:

Example. Assume the same facts as in the example in subparagraph (1) of this paragraph. In 1975 the trust makes an accumulation distribution, of which an amount of undistributed net income is deemed distributed in 1974. Taxes imposed on the trust (in the amount of $1,000) attributable to the undistributed net income are therefore deemed distributed in such year. Consequently, the taxes imposed on the trust subsequent to the 1975 distribution attributable to the remaining undistributed net income are $1,319 ($2,319 less $1,000).

(c) *Taxes imposed on the trust attributable to undistributed capital gain*—(1) *Regular tax.* For the purpose of subpart D the term *taxes imposed on the trust attributable to undistributed capital gain* means the amount of Federal income taxes for the taxable year properly attributable to that portion of the excess of capital gains over capital losses of the trust that is allocable to corpus for such taxable year. Such amount is the total of:

(i) The amount computed under subparagraph (2) of this paragraph (the minimum tax), plus

(ii) The amount that bears the same relationship to the total taxes of the trust for the year (other than the minimum tax), computed after the allowance of credits under section 642(a), as *(a)* the excess of capital gains over capital losses for such year that are not included in distributable net income, computed after its share of the deduction under section 1202 (relating to the deduction for capital gains) has been taken into account, bears to the greater of *(b)* the total taxable income of the trust for such year, or *(c)* the amount of capital gains computed under *(a)* of this subdivision.

However, if the alternative tax computation under section 1201(b) is used and there are no net short-term gains, the amount is the amount of the alternative tax imposed on the trust and attributable to the capital gain. The application of this subparagraph may be illustrated by the following example, which assumes that the alternative tax computation is not used:

Example. Assume the same facts as in the example in paragraph (b)(1). The capital gains not included in d.n.i. are $10,000, and the deduction under section 1202 is $5,000. The amount of taxes imposed on the trust attributable to undistributed capital gain is $1,468, computed as follows:

$3,787 (total taxes) × $5,000 (capital gains not included in d.n.i. less section 1202 deductions) divided by $12,900 (taxable income)	$1,468

(2) *Minimum tax.* The term *taxes imposed on the trust attributable to the undistributed capital gain* also includes the minimum tax for tax preferences imposed on the trust by section 56 with respect to the undistributed capital gain. The amount of such minimum tax so included bears the same relation to the total amount of minimum tax imposed on the trust by section 56 for the taxable year as one-half the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977) (as defined in section 1222(11)) from such taxable year bears to the sum of the items of tax preference of the trust for such taxable year which are apportioned to the trust in accordance with § 1.58–3(a) (1).

(3) *Reduction for prior distribution.* If in any taxable year a capital gain distribution is made by the trust which results in a throwback to a prior year, the taxes of the prior year imposed on the trust attributable to any remaining undistributed capital gain of the prior year are the taxes prescribed in subparagraph (1) of this paragraph reduced by the taxes of the prior year deemed distributed under section 669 (d) or (e). The provisions of this subparagraph may be illustrated by the following example:

Example. Assume the same facts as in the example in subparagraph (1) of this paragraph. In 1976, the trust makes a capital gain distribution, of which an amount of undistributed capital gain is deemed distributed in 1974. Taxes imposed on the trust (in the amount of $500) attributable to the undistributed capital gain are therefore deemed distributed in such year. Consequently, the taxes imposed on the trust attributable to the remaining undistributed capital gain are $968 ($1,468 less $500).

[T.D. 7204, 37 FR 17139, Aug. 25, 1972, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§1.665(e)–1A Preceding taxable year.

(a) *Definition*—(1) *Domestic trusts*— (i) *In general.* For purposes of subpart D, in the case of a trust other than a foreign trust created by a U.S. person, the term *preceding taxable year* serves to identify and limit the taxable years of a trust to which an accumulation distribution consisting of undistributed net income or undistributed capital gain may be allocated (or ‘‘thrown back’’) under section 666(a) and 669(a). An accumulation distribution consisting of undistributed net income or undistributed capital gain may not be allocated or ‘‘thrown back’’ to a taxable year of a trust if such year is not a ‘‘preceding taxable year.’’

(ii) *Accumulation distributions.* In the case of an accumulation distribution consisting of undistributed net income made in a taxable year beginning before January 1, 1974, any taxable year of the trust that precedes by more than 5 years the taxable year of the trust in which such accumulation distribution was made is not a ‘‘preceding taxable year.’’ Thus, for a domestic trust on a calendar year basis, calendar year 1967 is not a ‘‘preceding taxable year’’ with respect to an accumulation distribution made in calendar year 1973, whereas calendar year 1968 is a ‘‘preceding taxable year.’’ In the case of an accumulation distribution made during a taxable year beginning after December 31, 1973, any taxable year of the trust that begins before January 1, 1969, is not a ‘‘preceding taxable year.’’ Thus, for a domestic trust on a calendar year basis, calendar year 1968 is not a ‘‘preceding taxable year’’ with respect to an accumulation distribution made in calendar year 1975, whereas calendar year 1969 is a ‘‘preceding taxable year.’’

(iii) *Capital gain distributions.* In the case of an accumulation distribution that is a capital gain distribution, any taxable year of the trust that *(a)* begins before January 1, 1969, or *(b)* is prior to the first year in which income is accumulated, whichever occurs later, is not a ‘‘preceding taxable year.’’ Thus, for the purpose of capital gain distributions and section 669, only taxable years beginning after December 31, 1968, can be ‘‘preceding taxable years.’’ See §1.688(a)–1A(c).

(2) *Foreign trusts created by U.S. persons.* For purposes of subpart D, in the case of a foreign trust created by a U.S. person, the term ‘‘preceding taxable year’’ does not include any taxable year to which part I of subchapter J does not apply. See section 683 and regulations thereunder. Accordingly, the provisions of subpart D may not, in the case of a foreign trust created by a U.S. person, be applied to any taxable year which begins before 1954 or ends before August 17, 1954. For example, if a foreign trust created by a U.S. person (reporting on the calendar year basis) makes a distribution during the calendar year 1970 of income accumulated during prior years, the earliest year of the trust to which the accumulation distribution may be allocated under such subpart D is 1954, but it may not be allocated to 1953 and prior years, since the Internal Revenue Code of 1939 applies to those years.

(b) *Simple trusts.* A taxable year of a trust during which the trust was a simple trust (that is, was subject to subpart B) for the entire year shall not be considered a ‘‘preceding taxable year’’ unless during such year the trust received ‘‘outside income’’ or unless the trustee did not distribute all of the income of the trust that was required to be distributed currently for such year. In such event, undistributed net income for such year shall not exceed the greater of the ‘‘outside income’’ or income not distributed during such year. For purposes of this paragraph, the term *outside income* means amounts that are included in distributable net income of the trust for the year but that are not ‘‘income’’ of the trust as that term is defined in §1.643(b)–1. Some examples of ‘‘outside income’’ are:

(1) Income taxable to the trust under section 691;

(2) Unrealized accounts receivable that were assigned to the trust; and

(3) Distributions from another trust that include distributable net income or undistributed net income of such other trust.

The term *outside income,* however, does not include amounts received as distributions from an estate, other than income specified in (1) and (2), for which the estate was allowed a deduction under section 661(a). The application of this paragraph may be illustrated by the following examples:

Example 1. By his will D creates a trust for his widow W. The terms of the trust require that the income be distributed currently (i.e., it is a simple trust), and authorize the trustee to make discretionary payments of corpus to W. Upon W's death the trust corpus is to be distributed to D's then living issue. The executor of D's will makes a $10,000 distribution of corpus to the trust that carries out estate income consisting of dividends and interest to the trust under section 662(a)(2). The trust reports this income as its only income on its income tax return for its taxable year in which ends the taxable year of the estate in which the $10,000 distribution was made, and pays a tax thereon of $2,106. Thus, the trust has undistributed net income of $7,894 ($10,000 −$2,106). Several years later the trustee makes a discretionary corpus payment of $15,000 to W. This payment is an accumulation distribution under section 665(b). However, since the trust had no ''outside income'' in the year of the estate distribution, such year is not a preceding taxable year. Thus, W is not treated as receiving undistributed net income of $7,894 and taxes thereon of $2,106 for the purpose of including the same in her gross income under section 668. The result would be the same if the invasion power were not exercised and the accumulation distribution occurred as a result of the distribution of the corpus to D's issue upon the death of W.

Example 2. Trust A, a simple trust on the calendar year basis, received in 1972 extraordinary dividends or taxable stock dividends that the trustee in good faith allocated to corpus, but that are determined in 1974 to have been currently distributable to the beneficiary. See section 643(a)(4) and § 1.643(a)–4. Trust A would qualify for treatment under subpart C for 1974, the year of distribution of the extraordinary dividends or taxable stock dividends, because the distribution is not out of income of the current taxable year and is treated as another amount properly paid or credited or required to be distributed for such taxable year within the meaning of section 661(a) (2). Also, the distribution in 1974 qualifies as an accumulation distribution for the purposes of subpart D. For purposes only of such subpart D, trust A would be treated as subject to the provisions of such subpart C for 1972, the preceding taxable year in which the extraordinary or taxable stock dividends were received, and, in computing undistributed net income for 1972, the extraordinary or taxable stock dividends would be included in distributable net income under section 643(a). The rule stated in the preceding sentence would also apply if the distribution in 1974 was made out of corpus without regard to a determination that the extraordinary dividends or taxable stock dividends in question were currently distributable to the beneficiary.

[T.D. 7204, 37 FR 17141, Aug. 25, 1972]

§ 1.665(f)–1A Undistributed capital gain.

(a) *Domestic trusts.* (1) The term *undistributed capital gain* means (in the case of a trust other than a foreign trust created by a U.S. person), for any taxable year of the trust beginning after December 31, 1968, the gains in excess of losses for that year from the sale or exchange of capital assets of the trust less:

(i) The amount of such gains that are included in distributable net income under section 643(a)(3) and § 1.643(a)–3.

(ii) The amount of taxes imposed on the trust for such year attributable to such gains, as defined in § 1.665(d)–1A, and

(iii) In the case of a trust that does not use the alternative method for computing taxes on capital gains of the taxable year, the excess of deductions (other than deductions allowed under section 642(b) relating to personal exemption or section 642(c) relating to charitable contributions) over distributable net income for such year to the extent such excess deductions are properly allowable in determining taxable income for such year.

For purposes of computing the amount of capital gain under this paragraph, no deduction under section 1202, relating to deduction for excess of capital gains over capital losses, shall be taken into account. The application of this subparagraph may be illustrated by the following example:

Example. Under the terms of the trust, the trustee must distribute all income currently and has discretion to distribute capital gain to A or to allocate it to corpus. During the taxable year 1971 the trust recognized capital gain in the amount of $15,000, and capital losses of $5,000, and had interest income (after expenses) of $6,000. The trustee distributed $8,000 to A, consisting of $6,000 of interest and $2,000 of capital gain. The $2,000 of gain distributed to A is included in the computation of distributable net income under § 1.643(a)–3. The balance of the capital gain is not included in distributable net income since it is allocated to corpus and not paid, credited, or required to be distributed to any beneficiary. The trust paid taxes of $671, all of which are attributable under §1.665(d)–1A to the undistributed capital gain. The amount of undistributed capital gain of the trust for 1971 is therefore $7,329, computed as follows:

Total capital gains	$15,000
Less: Capital losses	5,000
Gains in excess of losses	10,000
Less:	
Amount of capital gain included in distributable net income	2,000
Taxes imposed on the trust attributable to the undistributed capital gain (see §1.665(d)–1A)	671
	2,671
Undistributed capital gain	7,329

(2) For purposes of subparagraph (1) of this paragraph, the term *losses for that year* includes losses of the trusts from the sale or exchange of capital assets in preceding taxable years not included in the computation of distributable net income of any year, reduced by such losses taken into account in a subsequent preceding taxable year in computing undistributed capital gain but not reduced by such losses taken into account in determining the deduction under section 1211. See section 1212(b)(2) and the regulations thereunder. For example, assume that a trust had a net long-term capital loss in 1970 of $5,000. During the years 1971 through 1975, the trust had no capital gains or capital losses. In 1976, it has a long-term capital gain of $8,000, which it allocates to corpus and does not distribute to a beneficiary, but has no taxes attributable to such gain. The undistributed capital gain for 1976 is $8,000 − $5,000, or $3,000, even though all or a part of the $5,000 loss was claimed under section 1211 as a deduction in years 1970 through 1975.

(b) *Foreign trusts.* Distributable net income for a taxable year of a foreign trust created by a U.S. person includes capital gains in excess of capital losses for such year (see §1.643(a)–6(a)(3)). Thus, a foreign trust created by a U.S. person can never have any undistributed capital gain.

[T.D. 7204, 37 FR 17142, Aug. 25, 1972]

§1.665(g)–1A Capital gain distribution.

For any taxable year of a trust, the term *capital gain distribution* means, to the extent of the undistributed capital gain of the trust, that portion of an accumulation distribution that exceeds the amount of such accumulation distribution deemed under section 666(a) to be undistributed net income of the trust for all preceding taxable years. See §1.665(b)–1A for the definition of ‘‘accumulation distribution’’. For any such taxable year the undistributed capital gain includes the total undistributed capital gain for all years of the trust beginning with the first taxable year beginning after December 31, 1968, in which income (as determined under section 643(b)) is accumulated, and ending before such taxable year. See §1.665(g)–2A for application of the separate share rule. The application of this section may be illustrated by the following example:

Example. A trust on the calendar year basis made the following accumulations. For purposes of this example, the undistributed net income is the same as income under applicable local law. No income was accumulated prior to 1970.

Year	Undistributed net income	Undistributed capital gain
1969	None	$10,000
1970	$1,000	3,000
1971	None	4,000

The trust has distributable net income in 1972 of $2,000 and recognizes capital gains of $4,500 that are allocable to corpus. On December 31, 1972, the trustee makes a distribution of $20,000 to the beneficiary. There is an accumulation distribution of $18,000 $20,000 distribution less $2,000 d.n.i.) that consists of undistributed net income of $1,000 (see §1.666(a)–1A) and a capital gain distribution of $7,000. The capital gain distribution is computed as follows:

Accumulation distribution	$18,000
Less: Undistributed net income	1,000
Balance	17,000
Capital gain distribution (undistributed capital gain of the trust for 1972 ($3,000 from 1970 and $4,000 from 1971))	7,000
Balance (corpus)	10,000

No undistributed capital gain is deemed distributed from 1969 because 1969 is a year prior to the first year in which income is accumulated (1970). The accumulation distribution is not deemed to consist of any part of the capital gains recognized in 1972.

[T.D. 7204, 37 FR 17142, Aug. 25, 1972]

§ 1.665(g)–2A Application of separate share rule.

(a) *In general.* If the separate share rule of section 663(c) is applicable for any taxable year of a trust, subpart D is applied as if each share were a separate trust except as provided in paragraph (c) of this section and in § 1.668(a)–1A(c). Thus, the amounts of an ''accumulation distribution'', ''undistributed net income'', ''undistributed capital gain'', and ''capital gain distribution'' are computed separately for each share.

(b) *Allocation of taxes—undistributed net income.* The ''taxes imposed on the trust attributable to the undistributed net income'' are allocated as follows:

(1) There is first allocated to each separate share that portion of the ''taxes imposed on the trust attributable to the undistributed net income'' (as defined in § 1.665(d)–1A(b)), computed before the allowance of any credits under section 642(a), that bears the same relation to the total of such taxes that the distributable net income of the separate share bears to the distributable net income of the trust, adjusted for this purpose as follows:

(i) There is excluded from distributable net income of the trust and of each separate share any tax-exempt interest, foreign income of a foreign trust, and excluded dividends, to the extent such amounts are included in distributable net income pursuant to section 643(a) (5), (6), and (7); and

(ii) The distributable net income of the trust is reduced by any deductions allowable under section 661 for amounts paid, credited, or required to be distributed during the taxable year, and the distributable net income of each separate share is reduced by any such deduction allocable to that share.

(2) The taxes so determined for each separate share are then reduced by that portion of the credits against tax allowable to the trust under section 642(a) in computing the ''taxes imposed on the trust'' that bears the same relation to the total of such credits that the items of distributable net income allocable to the separate share with respect to which the credit is allowed bear to the total of such items of the trust.

(c) *Allocation of taxes—undistributed capital gain.* The ''taxes imposed on the trust attributable to undistributed capital gain'' are allocated as follows:

(1) There is first allocated to each separate share that portion of the ''taxes imposed on the trust attributable to undistributed capital gain'' (as defined in § 1.665(d)–1A(c)), computed before the allowance of any credits under section 642(a), that bears the same relation to the total of such taxes that the undistributed capital gain (prior to the deduction of taxes under section 665(c)(2)) of the separate share bears to the total such undistributed capital gain of the trust.

(2) The taxes so determined for each separate share are then reduced by that portion of the credits against tax allowable to the trust under section 642(a) in computing the ''taxes imposed on the trust'' that bears the same relation to the total of such credits that the capital gain allocable to the separate share with respect to which the credit is allowed bear to the total of such capital gain of the trust.

(d) *Termination of a separate share.* (1) If upon termination of a separate share, an amount is properly paid, credited, or required to be distributed by the trust under section 661(a)(2) to a beneficiary from such share, an accumulation distribution will be deemed to have been made to the extent of such amount. In determining the distributable net income of such share, only those items of income and deduction for the taxable year of the trust in which such share terminates, properly allocable to such share, shall be taken into consideration.

(2) No accumulation distribution will be deemed to have been made upon the termination of a separate share to the extent that the property constituting such share, or a portion thereof, continues to be held as a part of the same trust. The undistributed net income, undistributed capital gain, and the taxes imposed on the trust attributable to such items, if any, for all preceding taxable years (reduced by any amounts deemed distributed under sections 666(a) and 669(a) by reason of any accumulation distribution of undistributed net income or undistributed capital

gain in prior years or the current taxable year), which were allocable to the terminating share, shall be treated as being applicable to the trust itself. However, no adjustment will be made to the amounts deemed distributed under sections 666 and 669 by reason of an accumulation distribution of undistributed net income or undistributed capital gain from the surviving share or shares made in years prior to the year in which the terminating share was added to such surviving share or shares.

(3) The provisions of this paragraph may be illustrated by the following example:

Example. A trust was established under the will of X for the benefit of his wife and upon her death the property was to continue in the same trust for his two sons, Y and Z. The separate share rule is applicable to this trust. The trustee had discretion to pay or accumulate the income to the wife, and after her death was to pay each son's share to him after he attained the age of 25. When the wife died, Y was 23 and Z was 28.

(1) Upon the death of X's widow, there is no accumulation distribution. The entire trust is split into two equal shares, and therefore the undistributed net income and the undistributed capital gain of the trust are split into two shares.

(2) The distribution to Z of his share after his mother's death is an accumulation distribution of his separate share of one-half of the undistributed net income and undistributed capital gain.

[T.D. 7204, 37 FR 17142, Aug. 25, 1972]

GRANTORS AND OTHERS TREATED AS SUBSTANTIAL OWNERS

§1.671–1 Grantors and others treated as substantial owners; scope.

(a) Subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, contains provisions taxing income of a trust to the grantor or another person under certain circumstances even though he is not treated as a beneficiary under subparts A through D (section 641 and following) of such part I. Sections 671 and 672 contain general provisions relating to the entire subpart. Sections 673 through 677 define the circumstances under which income of a trust is taxed to a grantor. These circumstances are in general as follows:

(1) If the grantor has retained a reversionary interest in the trust, within specified time limits (section 673);

(2) If the grantor or a nonadverse party has certain powers over the beneficial interests under the trust (section 674);

(3) If certain administrative powers over the trust exist under which the grantor can or does benefit (section 675).

(4) If the grantor or a nonadverse party has a power to revoke the trust or return the corpus to the grantor (section 676); or

(5) If the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse (section 677).

Under section 678, income of a trust is taxed to a person other than the grantor to the extent that he has the sole power to vest corpus or income in himself.

(b) Sections 671 through 677 do not apply if the income of a trust is taxable to a grantor's spouse under section 71 or 682 (relating respectively to alimony and separate maintenance payments, and the income of an estate or trust in the case of divorce, etc.).

(c) Except as provided in such subpart E, income of a trust is not included in computing the taxable income and credits of a grantor or another person solely on the grounds of his dominion and control over the trust. However, the provisions of subpart E do not apply in situations involving an assignment of future income, whether or not the assignment is to a trust. Thus, for example, a person who assigns his right to future income under an employment contract may be taxed on that income even though the assignment is to a trust over which the assignor has retained none of the controls specified in sections 671 through 677. Similarly, a bondholder who assigns his right to interest may be taxed on interest payments even though the assignment is to an uncontrolled trust. Nor are the rules as to family partnerships affected by the provisions of subpart E, even though a partnership interest is held in trust. Likewise, these sections have no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement. In addition, the limitation of the last sentence of section 671 does not prevent any person from being taxed on the income of a trust when it is used to discharge his legal obligation. See § 1.662 (a)–4. He is then treated as a beneficiary under subparts A through D or treated as an owner under section 677 because the income is distributed for his benefit, and not because of his dominion or control over the trust.

(d) The provisions of subpart E are not applicable with respect to a pooled income fund as defined in paragraph (5) of section 642(c) and the regulations thereunder, a charitable remainder annuity trust as defined in paragraph (1) of section 664(d) and the regulations thereunder, or a charitable remainder unitrust as defined in paragraph (2) of section 664(d) and the regulations thereunder.

(e) For the effective date of subpart E see section 683 and the regulations thereunder.

(f) For rules relating to the treatment of liabilities resulting on the sale or other disposition of encumbered trust property due to a renunciation of powers by the grantor or other owner, see § 1.1001–2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7148, 36 FR 20749, Oct. 29, 1971; T.D. 7741, 45 FR 81745, Dec. 12, 1980]

§ 1.671–2 Applicable principles.

(a) Under section 671 a grantor or another person includes in computing his taxable income and credits those items of income, deduction, and credit against tax which are attributable to or included in any portion of a trust of which he is treated as the owner. Sections 673 through 678 set forth the rules for determining when the grantor or another person is treated as the owner of any portion of a trust. The rules for determining the items of income, deduction, and credit against tax that are attributable to or included in a portion of the trust are set forth in § 1.671–3.

(b) Since the principle underlying subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, is in general that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed, it is ordinarily immaterial whether the income involved constitutes income or corpus for trust accounting purposes. Accordingly, when it is stated in the regulations under subpart E that ‘‘income’’ is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes. When it is intended to emphasize that income for trust accounting purposes (determined in accordance with the provisions set forth in § 1.643(b)–1 is meant, the phrase ‘‘ordinary income’’ is used.

(c) An item of income, deduction, or credit included in computing the taxable income and credits of a grantor or another person under section 671 is treated as if it had been received or paid directly by the grantor or other person (whether or not an individual). For example, a charitable contribution made by a trust which is attributed to the grantor (an individual) under sections 671 through 677 will be aggregated with his other charitable contributions to determine their deductibility under the limitations of section 170(b)(1). Likewise, dividends received by a trust from sources in a particular foreign country which are attributed to a grantor or another person under subpart E will be aggregated with his other income from sources within that country to determine whether the taxpayer is subject to the limitations of section 904 with respect to credit for the tax paid to that country.

(d) Items of income, deduction, and credit not attributed to or included in any portion of a trust of which the grantor or another person is treated as the owner under subpart E are subject to the provisions of subparts A through D (section 641 and following), of such part I.

(e) The term *grantor* as used in the regulations under subpart E includes a corporation.

§1.671–3 Attribution or inclusion of income, deductions, and credits against tax.

(a) When a grantor or another person is treated under subpart E (section 671 and following) as the owner of any portion of a trust, there are included in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. For example:

(1) If a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as owner.

(2) If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Items that relate both to the portion treated as owned by the grantor and to the balance of the trust must be apportioned in a manner that is reasonable in the light of all the circumstances of each case, including the terms of the governing instrument, local law, and the practice of the trustee if it is reasonable and consistent.

(3) If the portion of a trust treated as owned by a grantor or another person consists of an undivided fractional interest in the trust, or of an interest represented by a dollar amount, a pro rata share of each item of income, deduction, and credit is normally allocated to the portion. Thus, where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocated to corpus, such as capital gains) is attributed to the portion. The numerator of this fraction is the amount which is subject to the control of the grantor or other person and the denominator is normally the fair market value of the trust corpus at the beginning of the taxable year in question. The share not treated as owned by the grantor or other person is governed by the provisions of subparts A through D. See the last three sentences of paragraph (c) of this section for the principles applicable if the portion treated as owned consists of an interest in part of the ordinary income in contrast to an interest in corpus alone.

(b) If a grantor or another person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and other income allocable to corpus. For example:

(1) Only ordinary income is included by reason of an interest in or a power over ordinary income alone. Thus, if a grantor is treated under section 673 as an owner by reason of a reversionary interest in ordinary income only, items of income allocable to corpus will not be included in the portion he is treated as owning. Similarly, if a grantor or another person is treated under sections 674–678 as an owner of a portion by reason of a power over ordinary income only, items of income allocable to corpus are not included in that portion. (See paragraph (c) of this section to determine the treatment of deductions and credits when only ordinary income is included in the portion.)

(2) Only income allocable to corpus is included by reason of an interest in or a power over corpus alone, if satisfaction of the interest or an exercise of the power will not result in an interest in or the exercise of a power over ordinary income which would itself cause that income to be included. For example, if a grantor has a reversionary interest in a trust which is not such as to require that he be treated as an owner under section 673, he may nevertheless be treated as an owner under section 677(a)(2) since any income allocable to corpus is accumulated for future distribution to him, but items of income included in determining ordinary income are not included in the portion he is treated as owning. Similarly, he may have a power over corpus which is such that he is treated as an owner under section 674 or 676 (a), but ordinary income will not be included in the portion he owns, if his power can only affect income received after a period of time such that he would not be treated

as an owner of the income if the power were a reversionary interest. (See paragraph (c) of this section to determine the treatment of deductions and credits when only income allocated to corpus is included in the portion.)

(3) Both ordinary income and other income allocable to corpus are included by reason of an interest in or a power over both ordinary income and corpus, or an interest in or a power over corpus alone which does not come within the provisions of subparagraph (2) of this paragraph. For example, if a grantor is treated under section 673 as the owner of a portion of a trust by reason of a reversionary interest in corpus, both ordinary income and other income allocable to corpus are included in the portion. Further, a grantor includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated under section 674 or 676 as an owner because of a power over corpus which can affect income received within a period such that he would be treated as an owner under section 673 if the power were a reversionary interest. Similarly, a grantor or another person includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated as an owner under section 675 or 678 because of a power over corpus.

(c) If only income allocable to corpus is included in computing a grantor's tax liability, he will take into account in that computation only those items of income, deductions, and credit which would not be included under subparts A through D in the computation of the tax liability of the current income beneficiaries if all distributable net income had actually been distributed to those beneficiaries. On the other hand, if the grantor or another person is treated as an owner solely because of his interest in or power over ordinary income alone, he will take into account in computing his tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to corpus which enter into the computation of distributable net income. If the grantor or other person is treated as an owner because of his power over or right to a dollar amount of ordinary income, he will first take into account a portion of those items of income and expense entering into the computation of ordinary income under the trust instrument or local law sufficient to produce income of the dollar amount required. There will then be attributable to him a pro rata portion of other items entering into the computation of distributable net income under subparts A through D, such as expenses allocable to corpus, and a pro rata portion of credits of the trust. For examples of computations under this paragraph, see paragraph (g) of § 1.677(a)–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 742, Jan. 17, 1969]

§ 1.671–4 Method of reporting.

(a) *Portion of trust treated as owned by the grantor or another person.* Except as otherwise provided in paragraph (b) of this section, items of income, deduction, and credit attributable to any portion of a trust which, under the provisions of subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code, is treated as owned by the grantor or another person are not reported by the trust on Form 1041, but are shown on a separate statement to be attached to that form. Section 301.7701–4(e)(2) of this chapter provides guidance on how these reporting rules apply to an environmental remediation trust.

(b) *A trust all of which is treated as owned by one or more grantors or other persons*—(1) *In general.* In the case of a trust all of which is treated as owned by one or more grantors or other persons, and which is not described in paragraph (b)(6) or (7) of this section, the trustee may, but is not required to, report by one of the methods described in this paragraph (b) rather than by the method described in paragraph (a) of this section. A trustee may not report, however, pursuant to paragraph (b)(2)(i)(A) of this section unless the grantor or other person treated as the owner of the trust provides to the trustee a complete Form W–9 or acceptable substitute Form W–9 signed under penalties of perjury. See section 3406 and the regulations thereunder for the information to include on, and the manner of executing, the Form W–9, depending upon the type of reportable payments made.

(2) *A trust all of which is treated as owned by one grantor or by one other person*—(i) *In general.* In the case of a trust all of which is treated as owned by one grantor or one other person, the trustee reporting under this paragraph (b) must either—

(A) Furnish the name and taxpayer identification number (TIN) of the grantor or other person treated as the owner of the trust, and the address of the trust, to all payors during the taxable year, and comply with the additional requirements described in paragraph (b)(2)(ii) of this section; or

(B) Furnish the name, TIN, and address of the trust to all payors during the taxable year, and comply with the additional requirements described in paragraph (b)(2)(iii) of this section.

(ii) *Additional obligations of the trustee when name and TIN of the grantor or other person treated as the owner of the trust and the address of the trust are furnished to payors.* (A) Unless the grantor or other person treated as the owner of the trust is the trustee or a co-trustee of the trust, the trustee must furnish the grantor or other person treated as the owner of the trust with a statement that—

(*1*) Shows all items of income, deduction, and credit of the trust for the taxable year;

(*2*) Identifies the payor of each item of income;

(*3*) Provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(*4*) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(B) The trustee is not required to file any type of return with the Internal Revenue Service.

(iii) *Additional obligations of the trustee when name, TIN, and address of the trust are furnished to payors*—(A) *Obligation to file Forms 1099.* The trustee must file with the Internal Revenue Service the appropriate Forms 1099, reporting the income or gross proceeds paid to the trust during the taxable year, and showing the trust as the payor and the grantor or other person treated as the owner of the trust as the payee. The trustee has the same obligations for filing the appropriate Forms 1099 as would a payor making reportable payments, except that the trustee must report each type of income in the aggregate, and each item of gross proceeds separately. See paragraph (b)(5) of this section regarding the amounts required to be included on any Forms 1099 filed by the trustee.

(B) *Obligation to furnish statement.* (*1*) Unless the grantor or other person treated as the owner of the trust is the trustee or a co-trustee of the trust, the trustee must also furnish to the grantor or other person treated as the owner of the trust a statement that—

(*i*) Shows all items of income, deduction, and credit of the trust for the taxable year;

(*ii*) Provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(*iii*) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(*2*) By furnishing the statement, the trustee satisfies the obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee.

(iv) *Examples.* The following examples illustrate the provisions of this paragraph (b)(2):

Example 1. G, a United States citizen, creates an irrevocable trust which provides that the ordinary income is to be payable to him for life and that on his death the corpus shall be distributed to B, an unrelated person. Except for the right to receive income, G retains no right or power which would cause him to be treated as an owner under sections 671 through 679. Under the applicable local law, capital gains must be added to corpus. Since G has a right to receive income, he is treated as an owner of a portion of the trust under section 677. The tax consequences of any items of capital gain of the trust are governed by the provisions of subparts A, B, C, and D (section 641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code. Because not all of the trust is treated as owned by the grantor or another person, the trustee may not report by the methods described in paragraph (b)(2) of this section.

Example 2. (i)(A) On January 2, 1996, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. During the 1996 taxable year the trust has the following items of income and gross proceeds:

Interest	$2,500
Dividends	3,205
Proceeds from sale of B stock	2,000

(B) The trust has no items of deduction or credit.

(ii)(A) The payors of the interest paid to the trust are X ($2,000), Y ($300), and Z ($200). The payors of the dividends paid to the trust are A ($3,200), and D ($5). The payor of the gross proceeds paid to the trust is D, a brokerage firm, which held the B stock as the nominee for the trust. The B stock was purchased by T for $1,500 on January 3, 1996, and sold by T on November 29, 1996. T chooses to report pursuant to paragraph (b)(2)(i)(B) of this section, and therefore furnishes the name, TIN, and address of the trust to X, Y, Z, A, and D. X, Y, and Z each furnish T with a Form 1099–INT showing the trust as the payee. A furnishes T with a Form 1099–DIV showing the trust as the payee. D does not furnish T with a Form 1099–DIV because D paid a dividend of less than $10 to T. D furnishes T with a Form 1099–B showing the trust as the payee.

(B) On or before February 28, 1997, T files a Form 1099–INT with the Internal Revenue Service on which T reports interest attributable to G, as the owner of the trust, of $2,500; a Form 1099–DIV on which T reports dividends attributable to G, as the owner of the trust, of $3,205; and a Form 1099–B on which T reports gross proceeds from the sale of B stock attributable to G, as the owner of the trust, of $2,000. On or before April 15, 1997, T furnishes a statement to G which lists the following items of income and information necessary for G to take the items into account in computing G's taxable income:

Interest	$2,500
Dividends	3,205
Gain from sale of B stock	500

Information regarding sale of B stock:

Proceeds	$2,000
Basis	1,500
Date acquired	1/03/96
Date sold	11/29/96

(C) T informs G that any items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(D) T has complied with T's obligations under this section.

(iii)(A) Same facts as paragraphs (i) and (ii) of this *Example 2,* except that G contributed the B stock to the trust on January 2, 1996. On or before April 15, 1997, T furnishes a statement to G which lists the following items of income and information necessary for G to take the items into account in computing G's taxable income:

Interest	$2,500
Dividends	3,205

Information regarding sale of B stock:

Proceeds	$2,000
Date sold	11/29/96

(B) T informs G that any items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(C) T has complied with T's obligations under this section.

Example 3. On January 2, 1996, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. The only asset of the trust is an interest in C, a common trust fund under section 584(a). T chooses to report pursuant to paragraph (b)(2)(i)(B) of this section and therefore furnishes the name, TIN, and address of the trust to C. C files a Form 1065 and a Schedule K–1 (Partner's Share of Income, Credits, Deductions, etc.) showing the name, TIN, and address of the trust with the Internal Revenue Service and furnishes a copy to T. Because the trust did not receive any amounts described in paragraph (b)(5) of this section, T does not file any type of return with the Internal Revenue Service. On or before April 15, 1997, T furnishes G with a statement that shows all items of income, deduction, and credit of the trust for the 1996 taxable year. In addition, T informs G that any items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person. T has complied with T's obligations under this section.

(3) *A trust all of which is treated as owned by two or more grantors or other persons*—(i) *In general.* In the case of a trust all of which is treated as owned

by two or more grantors or other persons, the trustee must furnish the name, TIN, and address of the trust to all payors for the taxable year, and comply with the additional requirements described in paragraph (b)(3)(ii) of this section.

(ii) *Additional obligations of trustee*—(A) *Obligation to file Forms 1099.* The trustee must file with the Internal Revenue Service the appropriate Forms 1099, reporting the items of income paid to the trust by all payors during the taxable year attributable to the portion of the trust treated as owned by each grantor or other person, and showing the trust as the payor and each grantor or other person treated as an owner of the trust as the payee. The trustee has the same obligations for filing the appropriate Forms 1099 as would a payor making reportable payments, except that the trustee must report each type of income in the aggregate, and each item of gross proceeds separately. See paragraph (b)(5) of this section regarding the amounts required to be included on any Forms 1099 filed by the trustee.

(B) *Obligation to furnish statement.* (*1*) The trustee must also furnish to each grantor or other person treated as an owner of the trust a statement that—

(*i*) Shows all items of income, deduction, and credit of the trust for the taxable year attributable to the portion of the trust treated as owned by the grantor or other person;

(*ii*) Provides the grantor or other person treated as an owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(*iii*) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(*2*) Except for the requirements pursuant to section 3406 and the regulations thereunder, by furnishing the statement, the trustee satisfies the obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee.

(4) *Persons treated as payors*—(i) *In general.* For purposes of this section, the term payor means any person who is required by any provision of the Internal Revenue Code and the regulations thereunder to make any type of information return (including Form 1099 or Schedule K–1) with respect to the trust for the taxable year, including persons who make payments to the trust or who collect (or otherwise act as middlemen with respect to) payments on behalf of the trust.

(ii) *Application to brokers and customers.* For purposes of this section, a broker, within the meaning of section 6045, is considered a payor. A customer, within the meaning of section 6045, is considered a payee.

(5) *Amounts required to be included on Forms 1099 filed by the trustee*—(i) *In general.* The amounts that must be included on any Forms 1099 required to be filed by the trustee pursuant to this section do not include any amounts that are reportable by the payor on an information return other than Form 1099. For example, in the case of a trust which owns an interest in a partnership, the trust's distributive share of the income and gain of the partnership is not includible on any Forms 1099 filed by the trustee pursuant to this section because the distributive share is reportable by the partnership on Schedule K–1.

(ii) *Example.* The following example illustrates the provisions of this paragraph (b)(5):

Example. (i)(A) On January 2, 1996, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. The assets of the trust during the 1996 taxable year are shares of stock in X, an S corporation, a limited partnership interest in P, shares of stock in M, and shares of stock in N. T chooses to report pursuant to paragraph (b)(2)(i)(B) of this section and therefore furnishes the name, TIN, and address of the trust to X, P, M, and N. M furnishes T with a Form 1099–DIV showing the trust as the payee. N does not furnish T with a Form 1099–DIV because N paid a dividend of less than $10 to T. X and P furnish T with Schedule K–1 (Shareholder's Share of Income, Credits, Deductions, etc.) and Schedule K–1 (Partner's Share of Income, Credits, Deductions, etc.), respectively, showing the trust's name, TIN, and address.

(B) For the 1996 taxable year the trust has the following items of income and deduction:

Dividends paid by M	$12
Dividends paid by N	6
Administrative expense	$20

Items reported by X on Schedule K–1 attributable to trust's shares of stock in X:

Interest	$20
Dividends	35

Items reported by P on Schedule K–1 attributable to trust's limited partnership interest in P:

Ordinary income	$300

(ii)(A) On or before February 28, 1997, T files with the Internal Revenue Service a Form 1099–DIV on which T reports dividends attributable to G as the owner of the trust in the amount of $18. T does not file any other returns.

(*B*) T has complied with T's obligation under paragraph (b)(2)(iii)(A) of this section to file the appropriate Forms 1099.

(6) *Trusts that cannot report under this paragraph (b).* The following trusts cannot use the methods of reporting described in this paragraph (b)—

(i) A common trust fund as defined in section 584(a);

(ii) A trust that has its situs or any of its assets located outside the United States;

(iii) A trust that is a qualified subchapter S trust as defined in section 1361(d)(3);

(iv) A trust all of which is treated as owned by one grantor or one other person whose taxable year is a fiscal year;

(v) A trust all of which is treated as owned by one grantor or one other person who is not a United States person; or

(vi) A trust all of which is treated as owned by two or more grantors or other persons, one of whom is not a United States person.

(7) *Grantors or other persons who are treated as owners of the trust and are exempt recipients for information reporting purposes*—(i) *Trust treated as owned by one grantor or one other person.* The trustee of a trust all of which is treated as owned by one grantor or one other person may not report pursuant to this paragraph (b) if the grantor or other person is an exempt recipient for information reporting purposes.

(ii) *Trust treated as owned by two or more grantors or other persons.* The trustee of a trust, all of which is treated as owned by two or more grantors or other persons, may not report pursuant to this paragraph (b) if one or more grantors or other persons treated as owners are exempt recipients for information reporting purposes unless—

(A) At least one grantor or one other person who is treated as an owner of the trust is a person who is not an exempt recipient for information reporting purposes; and

(B) The trustee reports without regard to whether any of the grantors or other persons treated as owners of the trust are exempt recipients for information reporting purposes.

(8) *Husband and wife who make a single return jointly.* A trust all of which is treated as owned by a husband and wife who make a single return jointly of income taxes for the taxable year under section 6013 is considered to be owned by one grantor for purposes of this paragraph (b).

(c) *Due date for Forms 1099 required to be filed by trustee.* The due date for any Forms 1099 required to be filed with the Internal Revenue Service by a trustee pursuant to this section is the due date otherwise in effect for filing Forms 1099.

(d) *Due date and other requirements with respect to statement required to be furnished by trustee.* The due date for the statement required to be furnished by a trustee to the grantor or other person treated as an owner of the trust pursuant to this section is the date specified by section 6034A(a). The trustee must maintain in its records a copy of the statement furnished to the grantor or other person treated as an owner of the trust for a period of three years from the due date for furnishing such statement specified in this paragraph (d).

(e) *Backup withholding requirements*—(1) *Trustee reporting under paragraph (b)(2)(i)(A) of this section.* In order for the trustee to be able to report pursuant to paragraph (b)(2)(i)(A) of this section and to furnish to all payors the name and TIN of the grantor or other person treated as the owner of the trust, the grantor or other person must provide a complete Form W–9 to the trustee in the manner provided in paragraph (b)(1) of this section, and the trustee must give the name and TIN shown on that Form W–9 to all payors.

In addition, if the Form W–9 indicates that the grantor or other person is subject to backup withholding, the trustee must notify all payors of reportable interest and dividend payments of the requirement to backup withhold. If the Form W–9 indicates that the grantor or other person is not subject to backup withholding, the trustee does not have to notify the payors that backup withholding is not required. The trustee should not give the Form W–9, or a copy thereof, to a payor because the Form W–9 contains the address of the grantor or other person and paragraph (b)(2)(i)(A) of this section requires the trustee to furnish the address of the trust to all payors and not the address of the grantor or other person. The trustee acts as the agent of the grantor or other person for purposes of furnishing to the payors the information required by this paragraph (e)(1). Thus, a payor may rely on the name and TIN provided to the payor by the trustee, and, if given, on the trustee's statement that the grantor is subject to backup withholding.

(2) *Other backup withholding requirements.* Whether a trustee is treated as a payor for purposes of backup withholding is determined pursuant to section 3406 and the regulations thereunder.

(f) *Penalties for failure to file a correct Form 1099 or furnish a correct statement.* A trustee who fails to file a correct Form 1099 or to furnish a correct statement to a grantor or other person treated as an owner of the trust as required by paragraph (b) of this section is subject to the penalties provided by sections 6721 and 6722 and the regulations thereunder.

(g) *Changing reporting methods*—(1) *Changing from reporting by filing Form 1041 to a method described in paragraph (b) of this section.* If the trustee has filed a Form 1041 for any taxable year ending before January 1, 1996 (and has not filed a final Form 1041 pursuant to §1.671–4(b)(3) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995)), or files a Form 1041 for any taxable year thereafter, the trustee must file a final Form 1041 for the taxable year which ends after January 1, 1995, and which immediately precedes the first taxable year for which the trustee reports pursuant to paragraph (b) of this section, on the front of which form the trustee must write: ‘‘Pursuant to §1.671–4(g), this is the final Form 1041 for this grantor trust.’’.

(2) *Changing from reporting by a method described in paragraph (b) of this section to the filing of a Form 1041.* The trustee of a trust who reported pursuant to paragraph (b) of this section for a taxable year may report pursuant to paragraph (a) of this section for subsequent taxable years. If the trustee reported pursuant to paragraph (b)(2)(i)(A) of this section, and therefore furnished the name and TIN of the grantor to all payors, the trustee must furnish the name, TIN, and address of the trust to all payors for such subsequent taxable years. If the trustee reported pursuant to paragraph (b)(2)(i)(B) or (b)(3)(i) of this section, and therefore furnished the name and TIN of the trust to all payors, the trustee must indicate on each Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) that it files (or appropriately on magnetic media) for the final taxable year for which the trustee so reports that it is the final return of the trust.

(3) *Changing between methods described in paragraph (b) of this section*—(i) *Changing from furnishing the TIN of the grantor to furnishing the TIN of the trust.* The trustee of a trust who reported pursuant to paragraph (b)(2)(i)(A) of this section for a taxable year, and therefore furnished the name and TIN of the grantor to all payors, may report pursuant to paragraph (b)(2)(i)(B) of this section, and furnish the name and TIN of the trust to all payors, for subsequent taxable years.

(ii) *Changing from furnishing the TIN of the trust to furnishing the TIN of the grantor.* The trustee of a trust who reported pursuant to paragraph (b)(2)(i)(B) of this section for a taxable year, and therefore furnished the name and TIN of the trust to all payors, may report pursuant to paragraph (b)(2)(i)(A) of this section, and furnish the name and TIN of the grantor to all payors, for subsequent taxable years. The trustee, however, must indicate on each Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) that it files (or appropriately on magnetic media) for the final taxable year for which the trustee reports pursuant to paragraph (b)(2)(i)(B) of this section that it is the final return of the trust.

(4) *Example.* The following example illustrates the provisions of paragraph (g) of this section:

Example. (i) On January 3, 1994, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. On or before April 17, 1995, T files with the Internal Revenue Service a Form 1041 with an attached statement for the 1994 taxable year showing the items of income, deduction, and credit of the trust. On or before April 15, 1996, T files with the Internal Revenue Service a Form 1041 with an attached statement for the 1995 taxable year showing the items of income, deduction, and credit of the trust. On the Form 1041, T states that ''pursuant to §1.671–4(g), this is the final Form 1041 for this grantor trust.'' T may report pursuant to paragraph (b) of this section for the 1996 taxable year.

(ii) T reports pursuant to paragraph (b)(2)(i)(B) of this section, and therefore furnishes the name, TIN, and address of the trust to all payors, for the 1996 and 1997 taxable years. T chooses to report pursuant to paragraph (a) of this section for the 1998 taxable year. On each Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) which T files for the 1997 taxable year (or appropriately on magnetic media), T indicates that it is the trust's final return. On or before April 15, 1999, T files with the Internal Revenue Service a Form 1041 with an attached statement showing the items of income, deduction, and credit of the trust. On the Form 1041, T uses the same TIN which T used on the Forms 1041 and Forms 1099 it filed for previous taxable years. T has complied with T's obligations under paragraph (g)(2) of this section.

(h) *Effective date and transition rule*—(1) *Effective date.* The trustee of a trust any portion of which is treated as owned by one or more grantors or other persons must report pursuant to this section for taxable years beginning on or after January 1, 1996.

(2) *Transition rule.* For taxable years beginning prior to January 1, 1996, the Internal Revenue Service will not challenge the manner of reporting of—

(i) A trustee of a trust all of which is treated as owned by one or more grantors or other persons who did not report in accordance with §1.671–4(a) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995) as in effect for taxable years beginning prior to January 1, 1996, but did report in a manner substantially similar to one of the reporting methods described in paragraph (b) of this section; or

(ii) A trustee of two or more trusts all of which are treated as owned by one or more grantors or other persons who filed a single Form 1041 for all of the trusts, rather than a separate Form 1041 for each trust, provided that the items of income, deduction, and credit of each trust were shown on a statement attached to the single Form 1041.

(i) *Cross-reference.* For rules relating to employer identification numbers, and to the obligation of a payor of income or proceeds to the trust to furnish to the payee a statement to recipient, see §301.6109–1(a)(2) of this chapter.

[T.D. 8633, 60 FR 66087, Dec. 21, 1995, as amended by T.D. 8668, 61 FR 19191, May 1, 1996]

§1.672(a)–1 Definition of adverse party.

(a) Under section 672(a) an adverse party is defined as any person having a substantial beneficial interest in a trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust. A trustee is not an adverse party merely because of his interest as trustee. A person having a general power of appointment over the trust property is deemed to have a beneficial interest in the trust. An interest is a substantial interest if its value in relation to the total value of the property subject to the power is not insignificant.

(b) Ordinarily, a beneficiary will be an adverse party, but if his right to share in the income or corpus of a trust is limited to only a part, he may be an adverse party only as to that part. Thus, if A, B, C, and D are equal income beneficiaries of a trust and the grantor can revoke with A's consent, the grantor is treated as the owner of a portion which represents three-fourths of the trust; and items of income, deduction, and credit attributable to that portion are included in determining the tax of the grantor.

(c) The interest of an ordinary income beneficiary of a trust may or may not be adverse with respect to the exercise of a power over corpus. Thus, if the income of a trust is payable to A for life, with a power (which is not a general power of appointment) in A to appoint the corpus to the grantor either during his life or by will, A's interest is adverse to the return of the corpus to the grantor during A's life, but is not adverse to a return of the corpus after A's death. In other words, A's interest is adverse as to ordinary income but is not adverse as to income allocable to corpus. Therefore, assuming no other relevant facts exist, the grantor would not be taxable on the ordinary income of the trust under section 674, 676, or 677, but would be taxable under section 677 on income allocable to corpus (such as capital gains), since it may in the discretion of a nonadverse party be accumulated for future distribution to the grantor. Similarly, the interest of a contingent income beneficiary is adverse to a return of corpus to the grantor before the termination of his interest but not to a return of corpus after the termination of his interest.

(d) The interest of a remainderman is adverse to the exercise of any power over the corpus of a trust, but not to the exercise of a power over any income interest preceding his remainder. For example, if the grantor creates a trust which provides for income to be distributed to A for 10 years and then for the corpus to go to X if he is then living, a power exercisable by X to revest corpus in the grantor is a power exercisable by an adverse party; however, a power exercisable by X to distribute part or all of the ordinary income to the grantor may be a power exercisable by a nonadverse party (which would cause the ordinary income to be taxed to the grantor).

§1.672(b)–1 Nonadverse party.

A *nonadverse party* is any person who is not an adverse party.

§1.672(c)–1 Related or subordinate party.

Section 672(c) defines the term ''related or subordinate party''. The term, as used in sections 674(c) and 675(3), means any nonadverse party who is the grantor's spouse if living with the grantor; the grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; or a subordinate employee of a corporation in which the grantor is an executive. For purposes of sections 674(c) and 675(3), these persons are presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on them unless shown not to be subservient by a preponderance of the evidence.

§1.672(d)–1 Power subject to condition precedent.

Section 672(d) provides that a person is considered to have a power described in subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, even though the exercise of the power is subject to a precedent giving of notice or takes effect only after the expiration of a certain period of time. However, although a person may be considered to have such a power, the grantor will nevertheless not be treated as an owner by reason of the power if its exercise can only affect beneficial enjoyment of income received after the expiration of a period of time such that, if the power were a reversionary interest, he would not be treated as an owner under section 673. See sections 674(b)(2), 676(b), and the last sentence of section 677(a). Thus, for example, if a grantor creates a trust for the benefit of his son and retains a power to revoke which takes effect only after the expiration of 2 years from the date of exercise, he is treated as an owner from the inception of the trust. However, if the grantor retains a power to revoke, exercisable at any time, which can only affect the beneficial enjoyment of the ordinary income of a trust received after the expiration of 10 years commencing with the date of the transfer in trust, or after the death of the income beneficiary, the power does not cause him to be treated as an owner with respect to ordinary income during the first 10 years of the trust or during the income beneficiary's life, as the case may be. See section 676(b).

§ 1.673(a)–1 Reversionary interests; income payable to beneficiaries other than certain charitable organizations; general rule.

(a) Under section 673(a), a grantor, in general, is treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or income if, as of the inception of that portion of the trust, the grantor's interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of transfer of that portion of the trust. However, the following types of reversionary interests are excepted from the general rule of the preceding sentence:

(1) A reversionary interest after the death of the income beneficiary of a trust (see paragraph (b) of this section); and

(2) Except in the case of transfers in trust made after April 22, 1969, a reversionary interest in a charitable trust meeting the requirements of section 673(b) (see § 1.673(b)–1). Even though the duration of the trust may be such that the grantor is not treated as its owner under section 673, and therefore is not taxed on the ordinary income, he may nevertheless be treated as an owner under section 677(a)(2) if he has a reversionary interest in the corpus. In the latter case, items of income, deduction, and credit allocable to corpus, such as capital gains and losses, will be included in the portion he owns. See § 1.671–3 and the regulations under section 677. See § 1.673(d)–1 with respect to a postponement of the date specified for reacquisition of a reversionary interest.

(b) Section 673(c) provides that a grantor is not treated as the owner of any portion of a trust by reason of section 673 if his reversionary interest in the portion is not to take effect in possession or enjoyment until the death of the person or persons to whom the income of the portion is regardless of the life expectancies of the income beneficiaries. If his reversionary interest is to take effect on or after the death of an income beneficiary or upon the expiration of a specific term of years, whichever is earlier, the grantor is treated as the owner if the specific term of years is less than 10 years (but not if the term is 10 years or longer).

(c) Where the grantor's reversionary interest in a portion of a trust is to take effect in possession or enjoyment by reason of some event other than the expiration of a specific term of years or the death of the income beneficiary, the grantor is treated as the owner of the portion if the event may reasonably be expected to occur within 10 years from the date of transfer of that portion, but he is not treated as the owner under section 673 if the event may not reasonably be expected to occur within 10 years from that date. For example, if the reversionary interest in any portion of a trust is to take effect on or after the death of the grantor (or any person other than the person to whom the income is payable) the grantor is treated under section 673 as the owner of the portion if the life expectancy of the grantor (or other person) is less than 10 years on the date of transfer of the portion, but not if the life expectancy is 10 years or longer. If the reversionary interest in any portion is to take effect on or after the death of the grantor (or any person other than the person to whom the income is payable) or upon the expiration of a specific term of years, whichever is earlier, the grantor is treated as the owner of the portion if on the date of transfer of the portion either the life expectancy of the grantor (or other person) or the specific term is less than 10 years; however, if both the life expectancy and the specific term are 10 years or longer the grantor is not treated as the owner of the portion under section 673. Similarly, if the grantor has a reversionary interest in any portion which will take effect at the death of the income beneficiary or the grantor, whichever is earlier, the grantor is not treated as an owner of the portion unless his life expectancy is less than 10 years.

(d) It is immaterial that a reversionary interest in corpus or income is subject to a contingency if the reversionary interest may, taking the contingency into consideration, reasonably be expected to take effect in possession or enjoyment within 10 years. For example, the grantor is taxable where the trust income is to be paid to the grantor's son for 3 years, and the corpus is then to be returned to the grantor if he survives that period, or to be paid to the grantor's son if he is already decreased.

(e) See section 671 and §§1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7357, 40 FR 23742, June 2, 1975]

§1.673(b)–1 Income payable to charitable beneficiaries before amendment by Tax Reform Act of 1969).

(a) Pursuant to section 673(b) a grantor is not treated as an owner of any portion of a trust under section 673, even though he has a reversionary interest which will take effect within 10 years, to the extent that, under the terms of the trust, the income of the portion is irrevocably payable for a period of at least 2 years (commencing with the date of the transfer) to a designated beneficiary of the type described in section 170(b)(1)(A).

(b) Income must be irrevocably payable to a designated beneficiary for at least 2 years commencing with the date of the transfer before the benefit of section 673(b) will apply. Thus, section 673(b) will not apply if income of a trust is irrevocably payable to University A for 1 year and then to University B for the next year; or if income of a trust may be allocated among two or more charitable beneficiaries in the discretion of the trustee or any other person. On the other hand, section 673(b) will apply if half the income of a trust is irrevocably payable to University A and the other half is irrevocably payable to University B for two years.

(c) Section 673(b) applies to the period of 2 years or longer during which income is paid to a designated beneficiary of the type described in section 170(b)(1)(A) (i), (ii), or (iii), even though the trust term is to extend beyond that period. However, the other provisions of section 673 apply to the part of the trust term, if any, that extends beyond that period. This paragraph may be illustrated by the following example:

Example. G transfers property in trust with the ordinary income payable to University C (which qualifies under section 170(b)(1)(A)(ii)) for 3 years, and then to his son, B, for 5 years. At the expiration of the term the trust reverts to G. G is not taxed under section 673 of the trust income payable to University C for the first 3 years because of the application of section 673(b). However, he is taxed on income for the next 5 years because he has a reversionary interest which will take effect within 10 years commencing with the date of the transfer. On the other hand, if the income were payable to University C for 3 years and then to R for 7 years so that the trust corpus would not be returned to G within 10 years, G would not be taxable under section 673 on income payable to University C and to B during any part of the term.

(d) This section does not apply to transfers in trust made after April 22, 1969.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by TD, 6605, 27 FR 8097, Aug. 15, 1962; T.D. 7357, 40 FR 23743, June 2, 1975]

§1.673(c)–1 Reversionary interest after income beneficiary's death.

The subject matter of section 673(c) is covered in paragraph (b) of §1.673(a)–1.

§1.673(d)–1 Postponement of date specified for reacquisition.

Any postponement of the date specified for the reacquisition of possession or enjoyment of any reversionary interest is considered a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. However, the grantor will not be treated as the owner of any portion of a trust for any taxable year by reason of the foregoing sentence if he would not be so treated in the absence of any postponement. The rules contained in this section may be illustrated by the following example:

Example. G places property in trust for the benefit of his son B. Upon the expiration of 12 years or the earlier death of B the property is to be paid over to G or his estate. After the expiration of 9 years G extends the term of the trust for an additional 2 years. G is considered to have made a new transfer in trust for a term of 5 years (the remaining 3 years of the original transfer plus the 2-year extension). However, he is not treated as the owner of the trust under section 673 for the first 3 years of the new term because he would not be so treated if the term of the trust had not been extended. G is treated as the owner of the trust, however, for the remaining 2 years.

§ 1.674(a)–1 Power to control beneficial enjoyment; scope of section 674.

(a) Under section 674, the grantor is treated as the owner of a portion of trust if the grantor or a nonadverse party has a power, beyond specified limits, to dispose of the beneficial enjoyment of the income or corpus, whether the power is a fiduciary power, a power of appointment, or any other power. Section 674(a) states in general terms that the grantor is treated as the owner in every case in which he or a nonadverse party can affect the beneficial enjoyment of a portion of a trust, the limitations being set forth as exceptions in subsections (b), (c), and (d) of section 674. These exceptions are discussed in detail in §§ 1.674(b)–1 through 1.674(d)—1. Certain limitations applicable to section 674 (b), (c), and (d) are set forth in § 1.674(d)–2. Section 674(b) describes powers which are excepted regardless of who holds them. Section 674(c) describes additional powers of trustees which are excepted if at least half the trustees are independent, and if the grantor is not a trustee. Section 674(d) describes a further power which is excepted if it is held by trustees other than the grantor or his spouse (if living with the grantor).

(b) In general terms the grantor is treated as the owner of a portion of a trust if he or a nonadverse party or both has a power to dispose of the beneficial enjoyment of the corpus or income unless the power is one of the following:

(1) *Miscellaneous powers over either ordinary income or corpus.* (i) A power that can only affect the beneficial enjoyment of income (including capital gains) received after a period of time such that the grantor would not be treated as an owner under section 673 if the power were a reversionary interest (section 674(b)(2));

(ii) A testamentary power held by anyone (other than a testamentary power held by the grantor over accumulated income) (section 674(b)(3));

(iii) A power to choose between charitable beneficiaries or to affect the manner of their enjoyment of a beneficial interest (section 674(b)(4));

(iv) A power to allocate receipts and disbursements between income and corpus (section 674(b)(8)).

(2) *Powers of distribution primarily affecting only one beneficiary.* (i) A power to distribute corpus to or for a current income beneficiary, if the distribution must be charged against the share of corpus from which the beneficiary may receive income (section 674(b)(5)(B));

(ii) A power to distribute income to or for a current income beneficiary or to accumulate it either *(a)* if accumulated income must either be payable to the beneficiary from whom it was withheld or as described in paragraph (b)(6) of § 1.674(b)–1 (section 674(b) (6)); *(b)* if the power is to apply income to the support of a dependent of the grantor, and the income is not so applied (section 674(b)(1)); or *(c)* if the beneficiary is under 21 or under a legal disability and accumulated income is added to corpus (section 674(b)(7)).

(3) *Powers of distribution affecting more than one beneficiary.* A power to distribute corpus or income to or among one or more beneficiaries or to accumulate income, either (i) if the power is held by a trustee or trustees other than the grantor, at least half of whom are independent (section 674(c)), or (ii) if the power is limited by a reasonably definite standard in the trust instrument, and in the case of a power over income, if in addition the power is held by a trustee or trustees other than the grantor and the grantor's spouse living with the grantor (section 674(b)(5)(A) and (d)). (These powers include both powers to ‘‘sprinkle’’ income or corpus among current beneficiaries, and powers to shift income or corpus between current beneficiaries and remaindermen; however, certain of the powers described under subparagraph (2) of this paragraph can have the latter effect incidentally.)

(c) See section 671 and §§ 1.671–2 and 1.671–3 for rules for the treatment of income, deductions, and credits when a person is treated as the owner of all or only a portion of a trust.

§1.674(b)–1 Excepted powers exercisable by any person.

(a) Paragraph (b) (1) through (8) of this section sets forth a number of powers which may be exercisable by any person without causing the grantor to be treated as an owner of a trust under section 674(a). Further, with the exception of powers described in paragraph (b)(1) of this section, it is immaterial whether these powers are held in the capacity of trustee. It makes no difference under section 674(b) that the person holding the power is the grantor, or a related or subordinate party (with the qualifications noted in paragraph (b) (1) and (3) of this section).

(b) The exceptions referred to in paragraph (a) of this section are as follows (see, however, the limitations set forth in §1.674(d)–2):

(1) *Powers to apply income to support of a dependent.* Section 674(b)(1) provides, in effect, that regardless of the general rule of section 674(a), the income of a trust will not be considered as taxable to the grantor merely because in the discretion of any person (other than a grantor who is not acting as a trustee or cotrustee) it may be used for the support of a beneficiary whom the grantor is legally obligated to support, except to the extent that it is in fact used for that purpose. See section 677(b) and the regulations thereunder.

(2) *Powers affecting beneficial enjoyment only after a period.* Section 674(b)(2) provides an exception to section 674(a) if the exercise of a power can only affect the beneficial enjoyment of the income of a trust received after a period of time which is such that a grantor would not be treated as an owner under section 673 if the power were a reversionary interest. See §§1.673(a)–1 and 1.673(b)–1. For example, if a trust created on January 1, 1955, provides for the payment of income to the grantor's son, and the grantor reserves the power to substitute other beneficiaries of income or corpus in lieu of his son on or after January 1, 1965, the grantor is not treated under section 674 as the owner of the trust with respect to ordinary income received before January 1, 1965. But the grantor will be treated as an owner on and after that date unless the power is relinquished. If the beginning of the period during which the grantor may substitute beneficiaries is postponed, the rules set forth in §1.673(d)–1 are applicable in order to determine whether the grantor should be treated as an owner during the period following the postponement.

(3) *Testamentary powers.* Under paragraph (3) of section 674(b) a power in any person to control beneficial enjoyment exercisable only by will does not cause a grantor to be treated as an owner under section 674(a). However, this exception does not apply to income accumulated for testamentary disposition by the grantor or to income which may be accumulated for such distribution in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. For example, if a trust instrument provides that the income is to be accumulated during the grantor's life and that the grantor may appoint the accumulated income by will, the grantor is treated as the owner of the trust. Moreover, if a trust instrument provides that the income is payable to another person for his life, but the grantor has a testamentary power of appointment over the remainder, and under the trust instrument and local law capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion. (See §1.671–3.)

(4) *Powers to determine beneficial enjoyment of charitable beneficiaries.* Under paragraph (4) of section 674(b) a power in any person to determine the beneficial enjoyment of corpus or income which is irrevocably payable (currently or in the future) for purposes specified in section 170(c) (relating to definition of charitable contributions) will not cause the grantor to be treated as an owner under section 674(a). For example, if a grantor creates a trust, the income of which is irrevocably payable solely to educational or other organizations that qualify under section 170(c), he is not treated as an owner under section 674 although he retains the power to allocate the income among such organizations.

(5) *Powers to distribute corpus.* Paragraph (5) of section 674(b) provides an exception to section 674(a) for powers

to distribute corpus, subject to certain limitations, as follows:

(i) If the power is limited by a reasonably definite standard which is set forth in the trust instrument, it may extend to corpus distributions to any beneficiary or beneficiaries or class of beneficiaries (whether income beneficiaries or remaindermen) without causing the grantor to be treated as an owner under section 674. See section 674(b)(5)(A). It is not required that the standard consist of the needs and circumstances of the beneficiary. A clearly measurable standard under which the holder of a power is legally accountable is deemed a reasonably definite standard for this purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; or to enable him to maintain his accustomed standard of living; or to meet an emergency, would be limited by a reasonably definite standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not limited by a reasonably definite standard. The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no reasonably definite standard exists.

(ii) If the power is not limited by a reasonably definite standard set forth in the trust instrument, the exception applies only if distributions of corpus may be made solely in favor of current income beneficiaries, and any corpus distribution to the current income beneficiary must be chargeable against the proportionate part of corpus held in trust for payment of income to that beneficiary as if it constituted a separate trust (whether or not physically segregated). See section 674(b)(5)(B).

(iii) This subparagraph may be illustrated by the following examples:

Example 1. A trust instrument provides for payment of the income to the grantor's two brothers for life, and for payment of the corpus to the grantor's nephews in equal shares. The grantor reserves the power to distribute corpus to pay medical expenses that may be incurred by his brothers or nephews. The grantor is not treated as an owner by reason of this power because section 674(b)(5)(A) excepts a power, exercisable by any person, to invade corpus for any beneficiary, including a remainderman, if the power is limited by a reasonably definite standard which is set forth in the trust instrument. However, if the power were also exercisable in favor of a person (for example, a sister) who was not otherwise a beneficiary of the trust, section 674(b)(5)(A) would not be applicable.

Example 2. The facts are the same as in example 1 except that the grantor reserves the power to distribute any part of the corpus to his brothers or to his nephews for their happiness. The grantor is treated as the owner of the trust. Paragraph (5)(A) of section 674(b) is inapplicable because the power is not limited by a reasonably definite standard. Paragraph (5)(B) is inapplicable because the power to distribute corpus permits a distribution of corpus to persons other than current income beneficiaries.

Example 3. A trust instrument provides for payment of the income to the grantor's two adult sons in equal shares for 10 years, after which the corpus is to be distributed to his grandchildren in equal shares. The grantor reserves the power to pay over to each son up to one-half of the corpus during the 10-year period, but any such payment shall proportionately reduce subsequent income and corpus payments made to the son receiving the corpus. Thus, if one-half of the corpus is paid to one son, all the income from the remaining half is thereafter payable to the other son. The grantor is not treated as an owner under section 674(a) by reason of this power because it qualifies under the exception of section 674(b)(5)(B).

(6) *Powers to withhold income temporarily.* (i) Section 674(b)(6) excepts a power which, in general, enables the holder merely to effect a postponement in the time when the ordinary income is enjoyed by a current income beneficiary. Specifically, there is excepted a power to distribute or apply ordinary income to or for a current income beneficiary or to accumulate the income, if the accumulated income must ultimately be payable either:

(a) To the beneficiary from whom it was withheld, his estate, or his appointees (or persons designated by name, as a class, or otherwise as alternate takers in default of appointment)

under a power of appointment held by the beneficiary which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate (section 674(b)(6)(A));

(b) To the beneficiary from whom it was withheld, or if he does not survive a date of distribution which could reasonably be expected to occur within his lifetime, to his appointees (or alternate takers in default of appointment) under any power of appointment, general or special, or if he has no power of appointment to one or more designated alternate takers (other than the grantor of the grantor's estate) whose shares have been irrevocably specified in the trust instrument (section 674(b)(6)(A) and the flush material following); or

(c) On termination of the trust, or in conjunction with a distribution of corpus which is augmented by the accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument, or if any beneficiary does not survive a date of distribution which would reasonably be expected to occur within his lifetime, to his appointees (or alternate takers in default of appointment) under any power of appointment, general or special, or if he has no power of appointment to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified in the trust instrument (section 674(b)(6)(B) and the flush material following).

(In the application of *(a)* of this subdivision, if the accumulated income of a trust is ultimately payable to the estate of the current income beneficiary or is ultimately payable to his appointees or takers in default of appointment, under a power of the type described in *(a)* of this subdivision, it need not be payable to the beneficiary from whom it was withheld under any circumstances. Furthermore, if a trust otherwise qualifies for the exception in *(a)* of this subdivision the trust income will not be considered to be taxable to the grantor under section 677 by reason of the existence of the power of appointment referred to in *(a)* of this subdivision.) In general, the exception in section 674(b)(6) is not applicable if the power is in substance one to shift ordinary income from one beneficiary to another. Thus, a power will not qualify for this exception if ordinary income may be distributed to beneficiary A, or may be added to corpus which is ultimately payable to beneficiary B, a remainderman who is not a current income beneficiary. However, section 674(b)(6)(B), and *(c)* of this subdivision, permit a limited power to shift ordinary income among current income beneficiaries, as illustrated in example 1 of this subparagraph.

(ii) The application of section 674(b)(6) may be illustrated by the following examples:

Example 1. A trust instrument provides that the income shall be paid in equal shares to the grantor's two adult daughters but the grantor reserves the power to withhold from either beneficiary any part of that beneficiary's share of income and to add it to the corpus of the trust until the younger daughter reaches the age of 30 years. When the younger daughter reaches the age of 30, the trust is to terminate and the corpus is to be divided equally between the two daughters or their estates. Although exercise of this power may permit the shifting of accumulated income from one beneficiary to the other (since the corpus with the accumulations is to be divided equally) the power is excepted under section 674(b)(6)(B) and subdivision (i)*(c)* of this subparagraph.

Example 2. The facts are the same as in example 1, except that the grantor of the trust reserves the power to distribute accumulated income to the beneficiaries in such shares as he chooses. The combined powers are not excepted by section 674(b)(6)(B) since income accumulated pursuant to the first power is neither required to be payable only in conjunction with a corpus distribution nor required to be payable in shares specified in the trust instrument. See, however, section 674(c) and §1.674(c)–1 for the effect of such a power if it is exercisable only by independent trustees.

Example 3. A trust provides for payment of income to the grantor's adult son with the grantor retaining the power to accumulate the income until the grantor's death, when all accumulations are to be paid to the son. If the son predeceases the grantor, all accumulations are, at the death of the grantor, to be paid to his daughter, or if she is not living, to alternate takers (which do not include the grantor's estate) in specified shares. The power is excepted under section 674(b)(6)(A) since the date of distribution (the date of the grantor's death) may, in the usual case, reasonably be expected to occur during the beneficiary's (the son's) lifetime.

It is not necessary that the accumulations be payable to the son's estate or his appointees if he should predecease the grantor for this exception to apply.

(7) *Power to withhold income during disability.* Section 674(b)(7) provides an exception for a power which, in general, will permit ordinary income to be withheld during the legal disability of an income beneficiary or while he is under 21. Specifically, there is excepted a power, exercisable only during the existence of a legal disability of any current income beneficiary or the period during which any income beneficiary is under the age of 21 years, to distribute or apply ordinary income to or for that beneficiary or to accumulate the income and add it to corpus. To qualify under this exception it is not necessary that the income ultimately be payable to the income beneficiary from whom it was withheld, his estate, or his appointees; that is, the accumulated income may be added to corpus and ultimately distributed to others. For example, the grantor is not treated as an owner under section 674 if the income of a trust is payable to his son for life, remainder to his grandchildren, although he reserves the power to accumulate income and add it to corpus while his son is under 21.

(8) *Powers to allocate between corpus and income.* Paragraph (8) of section 674(b) provides that a power to allocate receipts and disbursements between corpus and income, even though expressed in broad language, will not cause the grantor to be treated as an owner under the general rule of section 674(a).

§ 1.674(c)–1 Excepted powers exercisable only by independent trustees.

Section 674(c) provides an exception to the general rule of section 674(a) for certain powers that are exercisable by independent trustees. This exception is in addition to those provided for under section 674(b) which may be held by any person including an independent trustee. The powers to which section 674(c) apply are powers (a) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, or (b) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries). In order for such a power to fall within the exception of section 674(c) it must be exercisable solely (without the approval or consent of any other person) by a trustee or trustees none of whom is the grantor and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. (See section 672(c) for definitions of these terms.) An example of the application of section 674(c) is a trust whose income is payable to the grantor's three adult sons with power in an independent trustee to allocate without restriction the amounts of income to be paid to each son each year. Such a power does not cause the grantor to be treated as the owner of the trust. See however, the limitations set forth in § 1.674(d)–2.

§ 1.674(d)–1 Excepted powers exercisable by any trustee other than grantor or spouse.

Section 674(d) provides an additional exception to the general rule of section 674(a) for a power to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries or to, for, or within a class of beneficiaries, whether or not the conditions of section 674(b) (6) or (7) are satisfied, if the power is solely exercisable (without the approval or consent of any other person) by a trustee or trustees none of whom is the grantor or spouse living with the grantor, and if the power is limited by a reasonably definite external standard set forth in the trust instrument (see paragraph (b)(5) of § 1.674(b)–1 with respect to what constitutes a reasonably definite standard). See, however, the limitations set forth in § 1.674(d)–2.

§ 1.674(d)–2 Limitations on exceptions in section 674 (b), (c), and (d).

(a) *Power to remove trustee.* A power in the grantor to remove, substitute, or add trustees (other than a power exercisable only upon limited conditions which do not exist during the taxable year, such as the death or resignation of, or breach of fiduciary duty by, an existing trustee) may prevent a trust from qualifying under section 674 (c) or (d). For example, if a grantor has an unrestricted power to remove an independent trustee and substitute any person including himself as trustee, the trust will not qualify under section 674 (c) or (d). On the other hand if the grantor's power to remove, substitute, or add trustees is limited so that its exercise could not alter the trust in a manner that would disqualify it under section 674 (c) or (d), as the case may be, the power itself does not disqualify the trust. Thus, for example, a power in the grantor to remove or discharge an independent trustee on the condition that he substitute another independent trustee will not prevent a trust from qualifying under section 674(c).

(b) *Power to add beneficiaries.* The exceptions described in section 674 (b) (5), (6), and (7), (c), and (d), are not applicable if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where the action is to provide for after-born or after-adopted children. This limitation does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed to his interest in the trust (so that he would be an adverse party as to the exercise or nonexercise of that power). For example, the limitation does not apply to a power in a beneficiary of a nonspendthrift trust to assign his interest. Nor does the limitation apply to a power held by any person which would qualify as an exception under section 674(b)(3) (relating to testamentary powers).

§1.675–1 Administrative powers.

(a) *General rule.* Section 675 provides in effect that the grantor is treated as the owner of any portion of a trust if under the terms of the trust instrument or circumstances attendant on its operation administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust. If a grantor retains a power to amend the administrative provisions of a trust instrument which is broad enough to permit an amendment causing the grantor to be treated as the owner of a portion of the trust under section 675, he will be treated as the owner of the portion from its inception. See section 671 and §§1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

(b) *Prohibited controls.* The circumstances which cause administrative controls to be considered exercisable primarily for the benefit of the grantor are specifically described in paragraphs (1) through (4) of section 675 as follows:

(1) The existence of a power, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party, which enables the grantor or any other person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income of the trust for less than adequate consideration in money or money's worth. Whether the existence of the power itself will constitute the holder an adverse party will depend on the particular circumstances.

(2) The existence of a power exercisable by the grantor or a nonadverse party, or both, which enables the grantor to borrow the corpus or income of the trust, directly or indirectly, without adequate interest or adequate security. However, this paragraph does not apply where a trustee (other than the grantor acting alone) is authorized under a general lending power to make loans to any person without regard to interest or security. A general lending power in the grantor, acting alone as trustee, under which he has power to determine interest rates and the adequacy of security is not in itself an indication that the grantor has power to borrow the corpus or income without adequate interest or security.

(3) The circumstance that the grantor has directly or indirectly borrowed the corpus or income of the trust and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence does not apply to a loan which provides for adequate interest and adequate security, if it is made by a trustee other than the grantor or a related or subordinate trustee subservient to the grantor. See section 672(c) for definition of ''a related or subordinate party''.

(4) The existence of certain powers of administration exercisable in a nonfiduciary capacity by any nonadverse party without the approval or consent of any person in a fiduciary capacity. The term *powers of administration* means one or more of the following powers:

(i) A power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control;

(ii) A power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or

(iii) A power to reacquire the trust corpus by substituting other property of an equivalent value.

If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. This presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.

(c) *Authority of trustee.* The mere fact that a power exercisable by a trustee is described in broad language does not indicate that the trustee is authorized to purchase, exchange, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money's worth, or is authorized to lend the trust property or income to the grantor without adequate interest. On the other hand, such authority may be indicated by the actual administration of the trust.

§ 1.676(a)–1 Power to revest title to portion of trust property in grantor; general rule.

If a power to revest in the grantor title to any portion of a trust is exercisable by the grantor or a nonadverse party, or both, without the approval or consent of an adverse party, the grantor is treated as the owner of that portion, except as provided in section 676(b) (relating to powers affecting beneficial enjoyment of income only after the expiration of certain periods of time). If the title to a portion of the trust will revest in the grantor upon the exercise of a power by the grantor or a nonadverse party, or both, the grantor is treated as the owner of that portion regardless of whether the power is a power to revoke, to terminate, to alter or amend, or to appoint. See section 671 and §§ 1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

§ 1.676(b)–1 Powers exercisable only after a period of time.

Section 676(b) provides an exception to the general rule of section 676(a) when the exercise of a power can only affect the beneficial enjoyment of the income of a trust received after the expiration of a period of time which is such that a grantor would not be treated as the owner of that portion, except as power were a reversionary interest. See §§ 1.673(a)–1 and 1.673(b)–1. Thus, for example, a grantor is excepted from the general rule of section 676(a) with respect to ordinary income if exercise of a power to revest corpus in him cannot affect the beneficial enjoyment of the income received within 10 years after the date of transfer of that portion of the trust. It is immaterial for this purpose that the power is vested at the time of the transfer. However, the grantor is subject to the general rule of section 676(a) after the expiration of the period unless the power is relinquished. Thus, in the above example, the grantor may be treated as the owner and be taxed on all income in the eleventh and succeeding years if exercise of the power can affect beneficial enjoyment of income received in those years. If the beginning of the period during which the grantor may revest is postponed, the rules set forth in §1.673(d)–1 are applicable to determine whether the grantor should be treated as an owner during the period following the postponement.

§1.677(a)–1 Income for benefit of grantor; general rule.

(a)(1) *Scope.* Section 677 deals with the treatment of the grantor of a trust as the owner of a portion of the trust because he has retained an interest in the income from that portion. For convenience, ''grantor'' and ''spouse'' are generally referred to in the masculine and feminine genders, respectively, but if the grantor is a woman the reference to ''grantor'' is to her and the reference to ''spouse'' is to her husband. Section 677 also deals with the treatment of the grantor of a trust as the owner of a portion of the trust because the income from property transferred in trust after October 9, 1969, is, or may be, distributed to his spouse or applied to the payment of premiums on policies of insurance on the life of his spouse. However, section 677 does not apply when the income of a trust is taxable to a grantor's spouse under section 71 (relating to alimony and separate maintenance payments) or section 682 (relating to income of an estate or trust in case of divorce, etc.). See section 671–1(b).

(2) *Cross references.* See section 671 and §§1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or a portion of a trust.

(b) *Income for benefit of grantor or his spouse; general rule*—(1) *Property transferred in trust prior to October 10, 1969.* With respect to property transferred in trust prior to October 10, 1969, the grantor is treated, under section 677, in any taxable year as the owner (whether or not he is treated as an owner under section 674) of a portion of a trust of which the income for the taxable year or for a period not within the exception described in paragraph (e) of this section is, or in the discretion of the grantor or a nonadverse party, or both (without the approval or consent of any adverse party) may be:

(i) Distributed to the grantor;

(ii) Held or accumulated for future distribution to the grantor; or

(iii) Applied to the payment of premiums on policies of insurance on the life of the grantor, except policies of insurance irrevocably payable for a charitable purpose specified in section 170(c).

(2) *Property transferred in trust after October 9, 1969.* With respect to property transferred in trust after October 9, 1969, the grantor is treated, under section 677, in any taxable year as the owner (whether or not he is treated as an owner under section 674) of a portion of a trust of which the income for the taxable year or for a period not within the exception described in paragraph (e) of this section is, or in the discretion of the grantor, or his spouse, or a nonadverse party, or any combination thereof (without the approval or consent of any adverse party other than the grantor's spouse) may be:

(i) Distributed to the grantor or the grantor's spouse;

(ii) Held or accumulated for future distribution to the grantor or the grantor's spouse; or

(iii) Applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, except policies of insurance irrevocably payable for a charitable purpose specified in section 170(c).

With respect to the treatment of a grantor as the owner of a portion of a trust solely because its income is, or may be, distributed or held or accumulated for future distribution to a beneficiary who is his spouse or applied to the payment of premiums for insurance on the spouse's life, section 677(a) applies to the income of a trust solely during the period of the marriage of the grantor to a beneficiary. In the case of divorce or separation, see sections 71 and 682 and the regulations thereunder.

(c) *Constructive distribution; cessation of interest.* Under section 677 the grantor is treated as the owner of a portion of a trust if he has retained any interest which might, without the approval or consent of an adverse party, enable him to have the income from that portion distributed to him at some time either actually or constructively (subject to the exception described in paragraph (e) of this section). In the case of a transfer in trust after October 9, 1969, the grantor is also treated as the owner of a portion of a trust if he has granted or retained any interest which might, without the approval or consent of an adverse party (other than the grantor's spouse), enable his spouse to have the income from the portion at some time, whether or not within the grantor's lifetime, distributed to the spouse either actually or constructively. See paragraph (b)(2) of this section for additional rules relating to the income of a trust prior to the grantor's marriage to a beneficiary. Constructive distribution to the grantor or to his spouse includes payment on behalf of the grantor or his spouse to another in obedience to his or her direction and payment of premiums upon policies of insurance on the grantor's, or his spouse's, life (other than policies of insurance irrevocably payable for charitable purposes specified in section 170(c)). If the grantor (in the case of property transferred prior to Oct. 10, 1969) or the grantor and his spouse (in the case of property transferred after Oct. 9, 1969) are divested permanently and completely of every interest described in this paragraph, the grantor is not treated as an owner under section 677 after that divesting. The word "interest" as used in this paragraph does not include the possibility that the grantor or his spouse might receive back from a beneficiary an interest in a trust by inheritance. Further, with respect to transfers in trust prior to October 10, 1969, the word "interest" does not include the possibility that the grantor might receive back from a beneficiary an interest in a trust as a surviving spouse under a statutory right of election or a similar right.

(d) *Discharge of legal obligation of grantor or his spouse.* Under section 677 a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor (or his spouse in the case of property transferred in trust by the grantor after October 9, 1969). However, see § 1.677(b)–1 for special rules for trusts whose income may not be applied for the discharge of any legal obligation of the grantor or the grantor's spouse other than the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor or grantor's spouse is legally obligated to support. See § 301.7701–4(e) of this chapter for rules on the classification of and application of section 677 to an environmental remediation trust.

(e) *Exception for certain discretionary rights affecting income.* The last sentence of section 677(a) provides that a grantor shall not be treated as the owner when a discretionary right can only affect the beneficial enjoyment of the income of a trust received after a period of time during which a grantor would not be treated as an owner under section 673 if the power were a reversionary interest. See §§ 1.673(a)–1 and 1.673(b)–1. For example, if the ordinary income of a trust is payable to B for 10 years and then in the grantor's discretion income or corpus may be paid to B or to the grantor (or his spouse in the case of property transferred in trust by the grantor after October 9, 1969), the grantor is not treated as an owner with respect to the ordinary income under section 677 during the first 10 years. He will be treated as an owner under section 677 after the expiration of the 10-year period unless the power is relinquished. If the beginning of the period during which the grantor may substitute beneficiaries is postponed, the rules set forth in § 1.673(d)–1 are applicable in determining whether the grantor should be treated as an owner during the period following the postponement.

(f) *Accumulation of income.* If income is accumulated in any taxable year for future distribution to the grantor (or his spouse in the case of property transferred in trust by the grantor after Oct. 9, 1969), section 677(a)(2) treats the grantor as an owner for that taxable year. The exception set forth in the last sentence of section 677(a) does not apply merely because the grantor (or his spouse in the case of property transferred in trust by the grantor after Oct. 9, 1969) must await the expiration of a period of time before he or she can receive or exercise discretion over previously accumulated income of the trust, even though the period is such that the grantor would not be treated as an owner under section 673 if a reversionary interest were involved. Thus, if income (including capital gains) of a trust is to be accumulated for 10 years and then will be, or at the discretion of the grantor, or his spouse in the case of property transferred in trust after October 9, 1969, or a nonadverse party, may be, distributed to the grantor (or his spouse in the case of property transferred in trust after Oct. 9, 1969), the grantor is treated as the owner of the trust from its inception. If income attributable to transfers after October 9, 1969 is accumulated in any taxable year during the grantor's lifetime for future distribution to his spouse, section 677(a)(2) treats the grantor as an owner for that taxable year even though his spouse may not receive or exercise discretion over such income prior to the grantor's death.

(g) *Examples.* The application of section 677(a) may be illustrated by the following examples:

Example 1. G creates an irrevocable trust which provides that the ordinary income is to be payable to him for life and that on his death the corpus shall be distributed to B, an unrelated person. Except for the right to receive income, G retains no right or power which would cause him to be treated as an owner under sections 671 through 677. Under the applicable local law capital gains must be applied to corpus. During the taxable year 1970 the trust has the following items of gross income and deductions:

Dividends	$5,000
Capital gain	1,000
Expenses allocable to income	200
Expenses allocable to corpus	100

Since G has a right to receive income he is treated as an owner of a portion of the trust under section 677. Accordingly, he should include the $5,000 of dividends, $200 income expense, and $100 corpus expense in the computation of his taxable income for 1970. He should not include the $1,000 capital gain since that is not attributable to the portion of the trust that he owns. See §1.671–3(b). The tax consequences of the capital gain are governed by the provisions of subparts A, B, C, and D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Had the trust sustained a capital loss in any amount the loss would likewise not be included in the computation of G's taxable income, but would also be governed by the provisions of such subparts.

Example 2. G creates a trust which provides that the ordinary income is payable to his adult son. Ten years and one day from the date of transfer or on the death of his son, whichever is earlier, corpus is to revert to G. In addition, G retains a discretionary right to receive $5,000 of ordinary income each year. (Absent the exercise of this right all the ordinary income is to be distributed to his son.) G retained no other right or power which would cause him to be treated as an owner under subpart E (section 671 and following). Under the terms of the trust instrument and applicable local law capital gains must be applied to corpus. During the taxable year 1970 the trust had the following items of income and deductions:

Dividends	$10,000
Capital gain	2,000
Expenses allocable to income	400
Expenses allocable to corpus	200

Since the capital gain is held or accumulated for future distributions to G, he is treated under section 677(a)(2) as an owner of a portion of the trust to which the gain is attributable. See §1.671–3(b).

Therefore, he must include the capital gain in the computation of his taxable income. (Had the trust sustained a capital loss in any amount, G would likewise include that loss in the computation of his taxable income.) In addition, because of G's discretionary right (whether exercised or not) he is treated as the owner of a portion of the trust which will permit a distribution of income to him of $5,000. Accordingly, G includes dividends of $5,208.33 and income expenses of $208.33 in computing his taxable income, determined in the following manner:

Total dividends	$10,000.00
Less: Expenses allocable to income	400.00
Distributable income of the trust	9,600.00
Portion of dividends attributable to G (5,000/9,600×$10,000)	5,208.33
Portion of income expenses attributable to G (5,000/9,600× $400)	208.33
Amount of income subject to discretionary right	5,000.00

In accordance with §1.671–3(c), G also takes into account $104.17 (5,000/9,600×$200) of corpus expenses in computing his tax liability. The portion of the dividends and expenses of the trust not attributable to G are governed by the provisions of subparts A through D.

[T.D. 7148, 36 FR 20749, Oct. 29, 1971, as amended by T.D. 8668, 61 FR 19191, May 1, 1996]

§1.677(b)–1 Trusts for support.

(a) Section 677(b) provides that a grantor is not treated as the owner of a trust merely because its income may in the discretion of any person other than the grantor (except when he is acting as trustee or cotrustee) be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse in the case of income from property transferred in trust after October 9, 1969), such as the child of the grantor, whom the grantor or his spouse is legally obligated to support. If income of the current year of the trust is actually so applied or distributed the grantor may be treated as the owner of any portion of the trust under section 677 to that extent, even though it might have been applied or distributed for other purposes. In the case of property transferred to a trust before October 10, 1969, for the benefit of the grantor's spouse, the grantor may be treated as the owner to the extent income of the current year is actually applied for the support or maintenance of his spouse.

(b) If any amount applied or distributed for the support of a beneficiary, including the grantor's spouse in the case of property transferred in trust before October 10, 1969, whom the grantor is legally obligated to support is paid out of corpus or out of income other than income of the current year, the grantor is treated as a beneficiary of the trust, and the amount applied or distributed is considered to be an amount paid within the meaning of section 661(a)(2), taxable to the grantor under section 662. Thus, he is subject to the other relevant portions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Accordingly, the grantor may be taxed on an accumulation distribution or a capital gain distribution under subpart D (section 665 and following) of such part I. Those provisions are applied on the basis that the grantor is the beneficiary.

(c) For the purpose of determining the items of income, deduction, and credit of a trust to be included under this section in computing the grantor's tax liability, the income of the trust for the taxable year of distribution will be deemed to have been first distributed. For example, in the case of a trust reporting on the calendar year basis, a distribution made on January 1, 1956, will be deemed to have been made out of ordinary income of the trust for the calendar year 1956 to the extent of the income for that year even though the trust had received no income as of January 1, 1956. Thus, if a distribution of $10,000 is made on January 1, 1956, for the support of the grantor's dependent, the grantor will be treated as the owner of the trust for 1956 to that extent. If the trust received dividends of $5,000 and incurred expenses of $1,000 during that year but subsequent to January 1, he will take into account dividends of $5,000 and expenses of $1,000 in computing his tax liability for 1956. In addition, the grantor will be treated as a beneficiary of the trust with respect to the $6,000 ($10,000 less distributable income of $4,000 (dividends of $5,000 less expenses of $1,000)) paid out of corpus or out of other than income of the current year. See paragraph (b) of this section.

(d) The exception provided in section 677(b) relates solely to the satisfaction of the grantor's legal obligation to support or maintain a beneficiary. Consequently, the general rule of section 677(a) is applicable when in the discretion of the grantor or nonadverse parties income of a trust may be applied in discharge of a grantor's obligations other than his obligation of support or maintenance falling within section 677(b). Thus, if the grantor creates a trust the income of which may in the discretion of a nonadverse party be applied in the payment of the grantor's debts, such as the payment of his rent or other household expenses, he is treated as an owner of the trust regardless of whether the income is actually so applied.

(e) The general rule of section 677(a), and not section 677(b), is applicable if discretion to apply or distribute income of a trust rests solely in the grantor, or in the grantor in conjunction with other persons, unless in either case the grantor has such discretion as trustee or cotrustee.

(f) The general rule of section 677(a), and not section 677(b), is applicable to the extent that income is required, without any discretionary determination, to be applied to the support of a beneficiary whom the grantor is legally obligated to support.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7148, 36 FR 20750, Oct. 29, 1971]

§1.678(a)–1 Person other than grantor treated as substantial owner; general rule.

(a) Where a person other than the grantor of a trust has a power exercisable solely by himself to vest the corpus or the income of any portion of a testamentary or inter vivos trust in himself, he is treated under section 678(a) as the owner of that portion, except as provided in section 678(b) (involving taxation of the grantor) and section 678(c) (involving and obligation of support). The holder of such a power also is treated as an owner of the trust even though he has partially released or otherwise modified the power so that he can no longer vest the corpus or income in himself, if he has retained such control of the trust as would, if retained by a grantor, subject the grantor to treatment as the owner under sections 671 to 677, inclusive. See section 671 and §§1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit where a person is treated as the owner of all or only a portion of a trust.

(b) Section 678(a) treats a person as an owner of a trust if he has a power exercisable solely by himself to apply the income or corpus for the satisfaction of his legal obligations, other than an obligation to support a dependent (see §1.678(c)–1 subject to the limitation of section 678(b). Section 678 does not apply if the power is not exercisable solely by himself. However, see §1.662(a)–4 for principles applicable to income of a trust which, pursuant to the terms of the trust instrument, is used to satisfy the obligations of a person other than the grantor.

§1.678(b)–1 If grantor is treated as the owner.

Section 678(a) does not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust is treated as the owner under sections 671 to 677, inclusive.

§1.678(c)–1 Trusts for support.

(a) Section 678(a) does not apply to a power which enables the holder, in the capacity of trustee or cotrustee, to apply the income of the trust to the support or maintenance of a person whom the holder is obligated to support, except to the extent the income is so applied. See paragraphs (a), (b), and (c) of §1.677(b)–1 for applicable principles where any amount is applied for the support or maintenance of a person whom the holder is obligated to support.

(b) The general rule in section 678(a) (and not the exception in section 678(c)) is applicable in any case in which the holder of a power exercisable solely by himself is able, in any capacity other than that of trustee or cotrustee, to apply the income in discharge of his obligation of support or maintenance.

(c) Section 678(c) is concerned with the taxability of income subject to a power described in section 678(a). It has no application to the taxability of income which is either required to be applied pursuant to the terms of the trust instrument or is applied pursuant to a power which is not described in section 678(a), the taxability of such income being governed by other provisions of the Code. See §1.662(a)–4.

§1.678(d)–1 Renunciation of power.

Section 678(a) does not apply to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

MISCELLANEOUS

§1.681(a)–1 Limitation on charitable contributions deductions of trusts; scope of section 681.

Under section 681, the unlimited charitable contributions deduction otherwise allowable to a trust under section 642(c) is, in general, subject to percentage limitations, corresponding to those applicable to contributions by an individual under section 170(b)(1) (A) and (B), under the following circumstances;

(a) To the extent that the deduction is allocable to ‘‘unrelated business income’’;

(b) For taxable years beginning before January 1, 1970, if the trust has engaged in a prohibited transaction;

(c) For taxable years beginning before January 1, 1970, if income is accumulated for a charitable purpose and the accumulation is (1) unreasonable, (2) substantially diverted to a noncharitable purpose, or (3) invested against the interests of the charitable beneficiaries.

Further, if the circumstance set forth in paragraph (a) or (c) of this section is applicable, the deduction is limited to income actually paid out for charitable purposes, and is not allowed for income only set aside or to be used for those purposes. If the circumstance set forth in paragraph (b) of this section is applicable, deductions for contributions to the trust may be disallowed. The provisions of section 681 are discussed in detail in §§ 1.681(a)–2 through 1.681(c)–1. For definition of the term ''income'', see section 643(b) and § 1.643(b)–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7428, 41 FR 34627, Aug. 16, 1976]

§ 1.681(a)–2 Limitation on charitable contributions deduction of trusts with trade or business income.

(a) *In general.* No charitable contributions deduction is allowable to a trust under section 642(c) for any taxable year for amounts allocable to the trust's unrelated business income for the taxable year. For the purpose of section 681(a) the term *unrelated business income* of a trust means an amount which would be computed as the trust's unrelated business taxable income under section 512 and the regulations thereunder, if the trust were an organization exempt from tax under section 501(a) by reason of section 501(c)(3). For the purpose of the computation under section 512, the term *unrelated trade or business* includes a trade or business carried on by a partnership of which a trust is a member, as well as one carried on by the trust itself. While the charitable contributions deduction under section 642(c) is entirely disallowed by section 681(a) for amounts allocable to ''unrelated business income'', a partial deduction is nevertheless allowed for such amounts by the operation of section 512(b)(11), as illustrated in paragraphs (b) and (c) of this section. This partial deduction is subject to the percentage limitations applicable to contributions by an individual under section 170(b)(1) (A) and (B), and is not allowed for amounts set aside or to be used for charitable purposes but not actually paid out during the taxable year. Charitable contributions deductions otherwise allowable under section 170, 545(b)(2), or 642(c) for contributions to a trust are not disallowed solely because the trust has unrelated business income.

(b) *Determination of amounts allocable to unrelated business income.* In determining the amount for which a charitable contributions deduction would otherwise be allowable under section 642(c) which are allocable to unrelated business income, and therefore not allowable as a deduction, the following steps are taken:

(1) There is first determined the amount which would be computed as the trust's unrelated business taxable income under section 512 and the regulations thereunder if the trust were an organization exempt from tax under section 501(a) by reason of section 501(c)(3), but without taking the charitable contributions deduction allowed under section 512(b)(11).

(2) The amount for which a charitable contributions deduction would otherwise be allowable under section 642(c) is then allocated between the amount determined in subparagraph (1) of this paragraph and any other income of the trust. Unless the facts clearly indicate to the contrary, the allocation to the amount determined in subparagraph (1) of this paragraph is made on the basis of the ratio (but not in excess of 100 percent) of the amount determined in subparagraph (1) of this paragraph to the taxable income of the trust, determined without the deduction for personal exemption under section 642(b), the charitable contributions deduction under section 642(c), or the deduction for distributions to beneficiaries under section 661(a).

(3) The amount for which a charitable contributions deduction would otherwise be allowable under section 642(c) which is allocable to unrelated business income as determined in subparagraph (2) of this paragraph, and

therefore not allowable as a deduction, is the amount determined in subparagraph (2) of this paragraph reduced by the charitable contributions deduction which would be allowed under section 512(b)(11) if the trust were an organization exempt from tax under section 501(a) by reason of section 501(c)(3).

(c) *Examples.* (1) The application of this section may be illustrated by the following examples, in which it is assumed that the Y charity is not a charitable organization qualifying under section 170(b)(1)(A) (see subparagraph (2) of this paragraph):

Example 1. The X trust has income of $50,000. There is included in this amount a net profit of $31,000 from the operation of a trade or business. The trustee is required to pay half of the trust income to A, an individual, and the balance of the trust income to the Y charity, an organization described in section 170(c)(2). The trustee pays each beneficiary $25,000. Under these facts, the unrelated business income of the trust (computed before the charitable contributions deduction which would be allowed under section 512(b)(11)) is $30,000 ($31,000 less the deduction of $1,000 allowed by section 512(b)(12)). The deduction otherwise allowable under section 642(c) is $25,000, the amount paid to the Y charity. The portion allocable to the unrelated business income (computed as prescribed in paragraph (b)(2) of this section) is $15,000, that is, an amount which bears the same ratio to $25,000 as $30,000 bears to $50,000. The portion allocable to the unrelated business income, and therefore disallowed as a deduction, is $15,000 reduced by $6,000 (20 percent of $30,000, the charitable contributions deduction which would be allowable under section 512(b)(11)), or $9,000.

Example 2. Assume the same facts as in example 1, except that the trustee has discretion as to the portion of the trust income to be paid to each beneficiary, and the trustee pays $40,000 to A and $10,000 to the Y charity. The deduction otherwise allowable under section 642(c) is $10,000. The portion allocable to the unrelated business income computed as prescribed in paragraph (b)(2) of this section is $6,000, that is, an amount which bears the same ratio to $10,000 as $30,000 bears to $50,000. Since this amount does not exceed the charitable contributions deduction which would be allowable under section 512(b)(11) ($6,000, determined as in example 1), no portion of it is disallowed as a deduction.

Example 3. Assume the same facts as in example 1, except that the terms of the trust instrument require the trustee to pay to the Y charity the trust income, if any, derived from the trade or business, and to pay to A all the trust income derived from other sources. The trustee pays $31,000 to the Y charity and $19,000 to A. The deduction otherwise allowable under section 642(c) is $31,000. Since the entire income from the trade or business is paid to Y charity, the amount allocable to the unrelated business income computed before the charitable contributions deduction under section 512(b)(11) is $30,000 ($31,000 less the deduction of $1,000 allowed by section 512(b)(12)). The amount allocable to the unrelated business income and therefore disallowed as a deduction is $24,000 ($30,000 less $6,000).

Example 4. (i) Under the terms of the trust, the trustee is required to pay half of the trust income to A, an individual, for his life, and the balance of the trust income to the Y charity, an organization described in section 170(c)(2). Capital gains are allocable to corpus and upon A's death the trust is to terminate and the corpus is to be distributed to the Y charity. The trust has taxable income of $50,000 computed without any deduction for personal exemption, charitable contributions, or distributions. The amount of $50,000 includes $10,000 capital gains, $30,000 ($31,000 less the $1,000 deduction allowed under section 512(b)(12)) unrelated business income (computed before the charitable contributions deduction which would be allowed under section 512(b)(11)) and other income of $9,000. The trustee pays each beneficiary $20,000.

(ii) The deduction otherwise allowable under section 642(c) is $30,000 ($20,000 paid to Y charity and $10,000 capital gains allocated to corpus and permanently set aside for charitable purposes). The portion allocable to the unrelated business income is $15,000, that is, an amount which bears the same ratio to $20,000 (the amount paid to Y charity) as $30,000 bears to $40,000 ($50,000 less $10,000 capital gains allocable to corpus). The portion allocable to the unrelated business income, and therefore disallowed as a deduction, is $15,000 reduced by $6,000 (the charitable contributions deduction which would be allowable under section 512(b)(11)), or $9,000.

(2) If, in the examples in subparagraph (1) of this paragraph, the Y charity were a charitable organization qualifying under section 170(b)(1)(A), then the deduction allowable under section 512(b)(11) would be computed at a rate of 30 percent.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6605, 27 FR 8097, Aug. 15, 1962]

§ 1.681(b)–1 Cross reference.

For disallowance of certain charitable, etc., deductions otherwise allowable under section 642(c), see sections 508(d) and 4948(c)(4). See also 26 CFR 1.681(b)–1 and 1.681(c)–1 (rev. as of Apr. 1, 1974) for provisions applying before January 1, 1970.

[T.D. 7428, 41 FR 34627, Aug. 16, 1976]

§ 1.682(a)–1 Income of trust in case of divorce, etc.

(a) *In general.* (1) Section 682(a) provides rules in certain cases for determining the taxability of income of trusts as between spouses who are divorced, or who are separated under a decree of separate maintenance or a written separation agreement. In such cases, the spouse actually entitled to receive payments from the trust is considered the beneficiary rather than the spouse in discharge of whose obligations the payments are made, except to the extent that the payments are specified to be for the support of the obligor spouse's minor children in the divorce or separate maintenance decree, the separation agreement or the governing trust instrument. For convenience, the beneficiary spouse will hereafter in this section and in § 1.682(b)–1 be referred to as the ‘‘wife'' and the obligor spouse from whom she is divorced or legally separated as the ‘‘husband''. (See section 7701(a)(17).) Thus, under section 682(a) income of a trust:

(i) Which is paid, credited, or required to be distributed to the wife in a taxable year of the wife, and

(ii) Which, except for the provisions of section 682, would be includible in the gross income of her husband,

is includible in her gross income and is not includible in his gross income.

(2) Section 682(a) does not apply in any case to which section 71 applies. Although section 682(a) and section 71 seemingly cover some of the same situations, there are important differences between them. Thus, section 682(a) applies, for example, to a trust created before the divorce or separation and not in contemplation of it, while section 71 applies only if the creation of the trust or payments by a previously created trust are in discharge of an obligation imposed upon or assumed by the husband (or made specific) under the court order or decree divorcing or legally separating the husband and wife, or a written instrument incident to the divorce status or legal separation status, or a written separation agreement. If section 71 applies, it requires inclusion in the wife's income of the full amount of periodic payments received attributable to property in trust (whether or not out of trust income), while, if section 71 does not apply, section 682(a) requires amounts paid, credited, or required to be distributed to her to be included only to the extent they are includible in the taxable income of a trust beneficiary under subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code.

(3) Section 682(a) is designed to produce uniformity as between cases in which, without section 682(a), the income of a so-called alimony trust would be taxable to the husband because of his continuing obligation to support his wife or former wife, and other cases in which the income of a so-called alimony trust is taxable to the wife or former wife because of the termination of the husband's obligation. Furthermore, section 682(a) taxes trust income to the wife in all cases in which the husband would otherwise be taxed not only because of the discharge of his alimony obligation but also because of his retention of control over the trust income or corpus. Section 682(a) applies whether the wife is the beneficiary under the terms of the trust instrument or is an assignee of a beneficiary.

(4) The application of section 682(a) may be illustrated by the following examples, in which it is assumed that both the husband and wife make their income tax returns on a calendar year basis:

Example 1. Upon the marriage of H and W, H irrevocably transfers property in trust to pay the income to W for her life for support, maintenance, and all other expenses. Some years later, W obtains a legal separation from H under an order of court. W, relying upon the income from the trust payable to her, does not ask for any provision for her support and the decree recites that since W is adequately provided for by the trust, no further provision is being made for her. Under these facts, section 682(a), rather than section 71, is applicable. Under the provisions of section 682(a), the income of the trust which becomes payable to W after the order of separation is includible in her income and is deductible by the trust. No part of the income is includible in H's income or deductible by him.

Example 2. H transfers property in trust for the benefit of W, retaining the power to revoke the trust at any time. H, however, promises that if he revokes the trust he will transfer to W property in the value of $100,000. The transfer in trust and the agreement were not incident to divorce, but some years later W divorces H. The court decree is silent as to alimony and the trust. After the divorce, income of the trust which becomes payable to W is taxable to her, and is not taxable to H or deductible by him. If H later terminates the trust and transfers $100,000 of property to W, the $100,000 is not income to W nor deductible by H.

(b) *Alimony trust income designated for support of minor children.* Section 682(a) does not require the inclusion in the wife's income of trust income which the terms of the divorce or separate maintenance decree, separation agreement, or trust instrument fix in terms of an amount of money or a portion of the income as a sum which is payable for the support of minor children of the husband. The portion of the income which is payable for the support of the minor children is includible in the husband's income. If in such a case trust income fixed in terms of an amount of money is to be paid but a lesser amount becomes payable, the trust income is considered to be payable for the support of the husband's minor children to the extent of the sum which would be payable for their support out of the originally specified amount of trust income. This rule is similar to that provided in the case of periodic payments under section 71. See §1.71–1.

§1.682(b)–1 Application of trust rules to alimony payments.

(a) For the purpose of the application of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code, the wife described in section 682 or section 71 who is entitled to receive payments attributable to property in trust is considered a beneficiary of the trust, whether or not the payments are made for the benefit of the husband in discharge of his obligations. A wife treated as a beneficiary of a trust under this section is also treated as the beneficiary of such trust for purposes of the tax imposed by section 56 (relating to the minimum tax for tax preferences). For rules relating to the treatment of items of tax preference with respect to a beneficiary of a trust, see §1.58–3.

(b) A periodic payment includible in the wife's gross income under section 71 attributable to property in trust is included in full in her gross income in her taxable year in which any part is required to be included under section 652 or 662. Assume, for example, in a case in which both the wife and the trust file income tax returns on the calendar year basis, that an annuity of $5,000 is to be paid to the wife by the trustee every December 31 (out of trust income if possible and, if not, out of corpus) pursuant to the terms of a divorce decree. Of the $5,000 distributable on December 31, 1954, $4,000 is payable out of income and $1,000 out of corpus. The actual distribution is made in 1955. Although the periodic payment is received by the wife in 1955, since under section 662 the $4,000 income distributable on December 31, 1954, is to be included in the wife's income for 1954, the $1,000 payment out of corpus is also to be included in her income for 1954.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7564, 43 FR 40495, Sept. 12, 1978]

§1.682(c)–1 Definitions.

For definitions of the terms ''husband'' and ''wife'' as used in section 682, see section 7701(a)(17) and the regulations thereunder.

§1.683–1 Applicability of provisions; general rule.

Part I (section 641 and following), subchapter J, chapter 1 of the Code, applies to estates and trusts and to beneficiaries only with respect to taxable years which begin after December 31, 1953, and end after August 16, 1954 the date of enactment of the Internal Revenue Code of 1954. In the case of an estate or trust, the date on which a trust is created or amended or on which an estate commences, and the taxable years of beneficiaries, grantors, or decedents concerned are immaterial. This provision applies equally to taxable years of normal and of abbreviated length.

§ 1.683–2 Exceptions.

(a) In the case of any beneficiary of an estate or trust, sections 641 through 682 do not apply to any amount paid, credited, or to be distributed by an estate or trust in any taxable year of the estate or trust which begins before January 1, 1954, or which ends before August 17, 1954. Whether an amount so paid, credited, or to be distributed is to be included in the gross income of a beneficiary is determined with reference to the Internal Revenue Code of 1939. Thus, if a trust in its fiscal year ending June 30, 1954, distributed its current income to a beneficiary on June 30, 1954, the extent to which the distribution is includible in the beneficiary's gross income for his taxable year (the calendar year 1954) and the character of such income will be determined under the Internal Revenue Code of 1939. The Internal Revenue Code of 1954, however, determines the beneficiary's tax liability for a taxable year of the beneficiary to which such Code applies, with respect even to gross income of the beneficiary determined under the Internal Revenue Code of 1939 in accordance with this paragraph. Accordingly, the beneficiary is allowed credits and deductions pursuant to the Internal Revenue Code of 1954 for a taxable year governed by the Internal Revenue Code of 1954. See subparagraph (ii) of example (1) in paragraph (c) of this section.

(b) For purposes of determining the time of receipt of dividends under sections 34 (for purposes of the credit for dividends received on or before December 31, 1964) and 116, the dividends paid, credited, or to be distributed to a beneficiary are deemed to have been received by the beneficiary ratably on the same dates that the dividends were received by the estate or trust.

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

Example 1. (i) A trust, reporting on the fiscal year basis, receives in its taxable year ending November 30, 1954, dividends on December 3, 1953, and April 3, July 5, and October 4, 1954. It distributes the dividends to A, its sole beneficiary (who reports on the calendar year basis) on November 30, 1954. Since the trust has received dividends in a taxable year ending after July 31, 1954, it will receive a dividend credit under section 34 with respect to dividends received which otherwise qualify under that section, in this case dividends received on October 4, 1954 (i. e., received after July 31, 1954). See section 7851(a)(1)(C). This credit, however, is reduced to the extent the dividends are allocable to the beneficiary as a result of income being paid, credited, or required to be distributed to him. The trust will also be permitted the dividend exclusion under section 116, since it received its dividends in a taxable year ending after July 31, 1954.

(ii) A is entitled to the section 34 credit with respect to the portion of the October 4, 1954, dividends which is distributed to him even though the determination of whether the amount distributed to him is includible in his gross income is made under the Internal Revenue Code of 1939. The credit allowable to the trust is reduced proportionately to the extent A is deemed to have received the October 4 dividends. A is not entitled to a credit with respect to the dividends received by the trust on December 3, 1953, and April 3, and July 5, 1954, because, although he receives after July 31, 1954, the distribution resulting from the trust's receipt of dividends, he is deemed to have received the dividends ratably with the trust on dates prior to July 31, 1954. In determining the exclusion under section 116 to which he is entitled, all the dividends received by the trust in 1954 and distributed to him are aggregated with any other dividends received by him in 1954, since he is deemed to have received such dividends in 1954 and therefore within a taxable year ending after July 31, 1954. He is not, however, entitled to the exclusion for the dividends received by the trust in December 1953.

Example 2. (i) A simple trust reports on the basis of a fiscal year ending July 31. It receives dividends on October 3, 1953, and January 4, April 3, and July 5, 1954. It distributes the dividends to A, its sole beneficiary, on September 1, 1954. The trust, receiving dividends in a taxable year ending prior to August 17, 1954, is entitled neither to the dividend received credit under section 34 nor the dividend exclusion under section 116.

(ii) A (reporting on the calendar year basis) is not entitled to the section 34 credit, because, although he receives after July 31, 1954, the distribution resulting from the trust's receipt of dividends, he is deemed to have received the dividends ratably with the trust, that is, on October 3, 1953, and January 4, April 3, and July 5, 1954. He is, however, entitled to the section 116 exclusion with respect to the dividends received by the trust in 1954 (along with other dividends received by him in 1954) and distributed to him, since he is deemed to have received such dividends on January 4, April 3, and July 5, 1954, each a date in this taxable year ending after July 31, 1954. He is entitled to no exclusion for the dividends received by the trust on October 3, 1953, since he is deemed to receive the resulting distribution on the same date, which falls within a taxable year of his which ends before August 1, 1954, although he is required to include the October 1953 dividends in his 1954 income. See section 164 of the Internal Revenue Code of 1939.

Example 3. A simple trust on a fiscal year ending July 31, 1954, receives dividends August 5 and November 4, 1953. It distributes the dividends to A, its sole beneficiary (who is on a calendar year basis), on September 1, 1954. Neither the trust nor A is entitled to a credit under section 34 or an exclusion under section 116.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6777, 29 FR 17809, Dec. 16, 1964]

§1.683–3 Application of the 65-day rule of the Internal Revenue Code of 1939.

If an amount is paid, credited, or to be distributed in the first 65 days of the first taxable year of an estate or trust (heretofore subject to the provisions of the Internal Revenue Code of 1939) to which the Internal Revenue Code of 1954 applies and the amount would be treated, if the Internal Revenue Code of 1939 were applicable, as if paid, credited, or to be distributed on the last day of the preceding taxable year, sections 641 through 682 do not apply to the amount. The amount so paid, credited, or to be distributed is taken into account as provided in the Internal Revenue Code of 1939. See 26 CFR (1939) 39.162–2 (c) and (d) (Regulations 118).

INCOME IN RESPECT OF DECEDENTS

§1.691(a)–1 Income in respect of a decedent.

(a) *Scope of section 691.* In general, the regulations under section 691 cover: (1) The provisions requiring that amounts which are not includible in gross income for the decedent's last taxable year or for a prior taxable year be included in the gross income of the estate or persons receiving such income to the extent that such amounts constitute ‘‘income in respect of a decedent’’; (2) the taxable effect of a transfer of the right to such income; (3) the treatment of certain deductions and credit in respect of a decedent which are not allowable to the decedent for the taxable period ending with his death or for a prior taxable year; (4) the allowance to a recipient of income in respect of a decedent of a deduction for estate taxes attributable to the inclusion of the value of the right to such income in the decedent's estate; (5) special provisions with respect to installment obligations acquired from a decedent and with respect to the allowance of a deduction for estate taxes to a surviving annuitant under a joint and survivor annuity contract; and (6) special provisions relating to installment obligations transmitted at death when prior law applied to the transmission.

(b) *General definition.* In general, the term *income in respect of a decedent* refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent. See the regulations under section 451. Thus, the term includes:

(1) All accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;

(2) Income accrued solely by reason of the decedent's death in case of a decedent who reports his income by use of an accrual method of accounting; and

(3) Income to which the decedent had a contingent claim at the time of his death.

See sections 736 and 753 and the regulations thereunder for ‘‘income in respect of a decedent’’ in the case of a deceased partner.

(c) *Prior decedent.* The term *income in respect of a decedent* also includes the amount of all items of gross income in respect of a prior decedent, if (1) the right to receive such amount was acquired by the decedent by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent and if (2) the amount of gross income in respect of the prior decedent was not properly includible in computing the decedent's taxable income for the taxable year ending with the date of his death or for a previous taxable year. See example 2 of paragraph (b) of § 1.691(a)–2.

(d) *Items excluded from gross income.* Section 691 applies only to the amount of items of gross income in respect of a decedent, and items which are excluded from gross income under subtitle A of the Code are not within the provisions of section 691.

(e) *Cross reference.* For items deemed to be income in respect of a decedent for purposes of the deduction for estate taxes provided by section 691(c), see paragraph (c) of § 1.691(c)–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6808, 30 FR 3435, Mar. 16, 1965]

§ 1.691(a)–2 Inclusion in gross income by recipients.

(a) Under section 691(a)(1), income in respect of a decedent shall be included in the gross income, for the taxable year when received, of:

(1) The estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

(2) The person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or

(3) The person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

These amounts are included in the income of the estate or of such persons when received by them whether or not they report income by use of the cash receipts and disbursements methods.

(b) The application of paragraph (a) of this section may be illustrated by the following examples, in each of which it is assumed that the decedent kept his books by use of the cash receipts and disbursements method.

Example 1. The decedent was entitled at the date of his death to a large salary payment to be made in equal annual installments over five years. His estate, after collecting two installments, distributed the right to the remaining installment payments to the residuary legatee of the estate. The estate must include in its gross income the two installments received by it, and the legatee must include in his gross income each of the three installments received by him.

Example 2. A widow acquired, by bequest from her husband, the right to receive renewal commissions on life insurance sold by him in his lifetime, which commissions were payable over a period of years. The widow died before having received all of such commissions, and her son inherited the right to receive the rest of the commissions. The commissions received by the widow were includible in her gross income. The commissions received by the son were not includible in the widow's gross income but must be included in the gross income of the son.

Example 3. The decedent owned a Series E United States savings bond, with his wife as co-owner or beneficiary, but died before the payment of such bond. The entire amount of interest accruing on the bond and not includible in income by the decedent, not just the amount accruing after the death of the decedent, would be treated as income to his wife when the bond is paid.

Example 4. A, prior to his death, acquired 10,000 shares of the capital stock of the X Corporation at a cost of $100 per share. During his lifetime, A had entered into an agreement with X Corporation whereby X Corporation agreed to purchase and the decedent agreed that his executor would sell the 10,000 shares of X Corporation stock owned by him at the book value of the stock at the date of A's death. Upon A's death, the shares are sold by A's executor for $500 a share pursuant to the agreement. Since the sale of stock is consummated after A's death, there is no income in respect of a decedent with respect to the appreciation in value of A's stock to the date of his death. If, in this example, A had in fact sold the stock during his lifetime but payment had not been received before his death, any gain on the sale would constitute income in respect of a decedent when the proceeds were received.

Example 5. (1) A owned and operated an apple orchard. During his lifetime, A sold and delivered 1,000 bushels of apples to X, a canning factory, but did not receive payment before his death. A also entered into negotiations to sell 3,000 bushels of apples to Y, a canning factory, but did not complete the sale before his death. After A's death, the executor received payment from X. He also completed the sale to Y and transferred to Y 1,200 bushels of apples on hand at A's death and harvested and transferred an additional 1,800 bushels. The gain from the sale of apples by A to X constitutes income in respect of a decedent when received. On the other hand, the gain from the sale of apples by the executor to Y does not.

(2) Assume that, instead of the transaction entered into with Y, A had disposed of the 1,200 bushels of harvested apples by delivering them to Z, a cooperative association,

for processing and sale. Each year the association commingles the fruit received from all of its members into a pool and assigns to each member a percentage interest in the pool based on the fruit delivered by him. After the fruit is processed and the products are sold, the association distributes the net proceeds from the pool to its members in proportion to their interests in the pool. After A's death, the association made distributions to the executor with respect to A's share of the proceeds from the pool in which A had in interest. Under such circumstances, the proceeds from the disposition of the 1,200 bushels of apples constitute income in respect of a decedent.

§1.691(a)–3 Character of gross income.

(a) The right to receive an amount of income in respect of a decedent shall be treated in the hands of the estate, or by the person entitled to receive such amount by bequest, devise, or inheritance from the decedent or by reason of his death, as if it had been acquired in the transaction by which the decedent (or a prior decedent) acquired such right, and shall be considered as having the same character it would have had if the decedent (or a prior decedent) had lived and received such amount. The provisions of section 1014(a), relating to the basis of property acquired from a decedent, do not apply to these amounts in the hands of the estate and such persons. See section 1014(c).

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

(1) If the income would have been capital gain to the decedent, if he had lived and had received it, from the sale of property, held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), the income, when received, shall be treated in the hands of the estate or of such person as capital gain from the sale of the property, held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), in the same manner as if such person had held the property for the period the decedent held it, and had made the sale.

(2) If the income is interest on United States obligations which were owned by the decedent, such income shall be treated as interest on United States obligations in the hands of the person receiving it, for the purpose of determining the credit provided by section 35, as if such person had owned the obligations with respect to which such interest is paid.

(3) If the amounts received would be subject to special treatment under part I (section 1301 and following), subchapter Q, chapter 1 of the Code, relating to income attributable to serveral taxable years, as in effect for taxable years beginning before January 1, 1964, if the decedent had lived and included such amounts in his gross income, such sections apply with respect to the recipient of the income.

(4) The provisions of sections 632 and 1347, relating to the tax attributable to the sale of certain oil or gas property and to certain claims against the United States, apply to any amount included in gross income, the right to which was obtained by the decedent by a sale or claim within the provisions of those sections.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6885, 31 FR 7803, June 2, 1966; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§1.691(a)–4 Transfer of right to income in respect of a decedent.

(a) Section 691(a)(2) provides the rules governing the treatment of income in respect of a decedent (or a prior decedent) in the event a right to receive such income is transferred by the estate or person entitled thereto by bequest, devise, or inheritance, or by reason of the death of the decedent. In general, the transferor must include in his gross income for the taxable period in which the transfer occurs the amount of the consideration, if any, received for the right or the fair market value of the right at the time of the transfer, whichever is greater. Thus, upon a sale of such right by the estate or person entitled to receive it, the fair market value of the right or the amount received upon the sale, whichever is greater, is included in the gross income of the vendor. Similarly, if such right is disposed of by gift, the fair market value of the right at the time of the gift must be included in the gross income of the donor. In the case of a satisfaction of an installment obligation at other than face value, which is likewise considered a transfer under section 691(a)(2), see § 1.691(a)–5.

(b) If the estate of a decedent or any person transmits the right to income in respect of a decedent to another who would be required by section 691(a)(1) to include such income when received in his gross income, only the transferee will include such income when received in his gross income. In this situation, a transfer within the meaning of section 691(a)(2) has not occurred. This paragraph may be illustrated by the following:

(1) If a person entitled to income in respect of a decedent dies before receiving such income, only his estate or other person entitled to such income by bequest, devise, or inheritance from the latter decedent, or by reason of the death of the latter decedent, must include such amount in gross income when received.

(2) If a right to income in respect of a decedent is transferred by an estate to a specific or residuary legatee, only the specific or residuary legatee must include such income in gross income when received.

(3) If a trust to which is bequeathed a right of a decedent to certain payments of income terminates and transfers the right to a beneficiary, only the beneficiary must include such income in gross income when received.

If the transferee described in subparagraphs (1), (2), and (3) of this paragraph transfers his right to receive the amounts in the manner described in paragraph (a) of this section, the principles contained in paragraph (a) are applied to such transfer. On the other hand, if the transferee transmits his right in the manner described in this paragraph, the principles of this paragraph are again applied to such transfer.

§ 1.691(a)–5 Installment obligations acquired from decedent.

(a) Section 691(a)(4) has reference to an installment obligation which remains uncollected by a decedent (or a prior decedent) and which was originally acquired in a transaction the income from which was properly reportable by the decedent on the installment method under section 453. Under the provisions of section 691(a)(4), an amount equal to the excess of the face value of the obligation over its basis in the hands of the decedent (determined under section 453(d)(2) and the regulations thereunder) shall be considered an amount of income in respect of a decedent and shall be treated as such. The decedent's estate (or the person entitled to receive such income by bequest or inheritance from the decedent or by reason of the decedent's death) shall include in its gross income when received the same proportion of any payment in satisfaction of such obligations as would be returnable as income by the decedent if he had lived and received such payment. No gain on account of the transmission of such obligations by the decedent's death is required to be reported as income in the return of the decedent for the year of his death. See § 1.691(e)–1 for special provisions relating to the filing of an election to have the provisions of section 691(a)(4) apply in the case of installment obligations in respect of which section 44(d) of the Internal Revenue Code of 1939 (or corresponding provisions of prior law) would have applied but for the filing of a bond referred to therein.

(b) If an installment obligation described in paragraph (a) of this section is transferred within the meaning of section 691(a)(2) and paragraph (a) of § 1.691(a)–4, the entire installment obligation transferred shall be considered a right to income in respect of a decedent but the amount includible in the gross income of the transferor shall be reduced by an amount equal to the basis of the obligation in the hands of the decedent (determined under section 453(d)(2) and the regulations thereunder) adjusted, however, to take into account the receipt of any installment payments after the decedent's death and before such transfer. Thus, the amount includible in the gross income of the transferor shall be the fair market value of such obligation at the time of the transfer or the consideration received for the transfer of the installment obligation, whichever is greater, reduced by the basis of the obligation as described in the preceding sentence. For purposes of this paragraph, the term ''transfer'' in section 691(a)(2) and paragraph (a) of § 1.691(a)–

4 includes the satisfaction of an installment obligation at other than face value.

(c) The application of this section may be illustrated by the following example:

Example. An heir of a decedent is entitled to collect an installment obligation with a face value of $100, a fair market value of $80, and a basis in the hands of the decedent of $60. If the heir collects the obligation at face value, the excess of the amount collected over the basis is considered income in respect of a decedent and includible in the gross income of the heir under section 691(a)(1). In this case, the amount includible would be $40 ($100 less $60). If the heir collects the obligation at $90, an amount other than face value, the entire obligation is considered a right to receive income in respect of a decedent but the amount ordinarily required to be included in the heir's gross income under section 691(a)(2) (namely, the consideration received in satisfaction of the installment obligation or its fair market value, whichever is greater) shall be reduced by the amount of the basis of the obligation in the hands of the decedent. In this case, the amount includible would be $30 ($90 less $60).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6808, 30 FR 3435, Mar. 16, 1965]

§1.691(b)–1 Allowance of deductions and credit in respect to decedents.

(a) Under section 691(b) the expenses, interest, and taxes described in sections 162, 163, 164, and 212 for which the decedent (or a prior decedent) was liable, which were not properly allowable as a deduction in his last taxable year or any prior taxable year, are allowed when paid:

(1) As a deduction by the estate; or

(2) If the estate was not liable to pay such obligation, as a deduction by the person who by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent acquires, subject to such obligation, an interest in property of the decedent (or the prior decedent).

Similar treatment is given to the foreign tax credit provided by section 33. For the purposes of subparagraph (2) of this paragraph, the right to receive an amount of gross income in respect of a decedent is considered property of the decedent; on the other hand, it is not necessary for a person, otherwise within the provisions of subparagraph (2) of this paragraph, to receive the right to any income in respect of a decedent. Thus, an heir who receives a right to income in respect of a decedent (by reason of the death of the decedent) subject to any income tax imposed by a foreign country during the decedent's life, which tax must be satisfied out of such income, is entitled to the credit provided by section 33 when he pays the tax. If a decedent who reported income by use of the cash receipts and disbursements method owned real property on which accrued taxes had become a lien, and if such property passed directly to the heir of the decedent in a jurisdiction in which real property does not become a part of a decedent's estate, the heir, upon paying such taxes, may take the same deduction under section 164 that would be allowed to the decedent if, while alive, he had made such payment.

(b) The deduction for percentage depletion is allowable only to the person (described in section 691(a)(1)) who receives the income in respect of the decedent to which the deduction relates, whether or not such person receives the property from which such income is derived. Thus, an heir who (by reason of the decedent's death) receives income derived from sales of units of mineral by the decedent (who reported income by use of the cash receipts and disbursements method) shall be allowed the deduction for percentage depletion, computed on the gross income from such number of units as if the heir had the same economic interest in the property as the decedent. Such heir need not also receive any interest in the mineral property other than such income. If the decedent did not compute his deduction for depletion on the basis of percentage depletion, any deduction for depletion to which the decedent was entitled at the date of his death would be allowable in computing his taxable income for his last taxable year, and there can be no deduction in respect of the decedent by any other person for such depletion.

§ 1.691(c)–1 Deduction for estate tax attributable to income in respect of a decedent.

(a) *In general.* A person who is required to include in gross income for any taxable year an amount of income in respect of a decedent may deduct for the same taxable year that portion of the estate tax imposed upon the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive such amount. The deduction is determined as follows:

(1) Ascertain the net value in the decedent's estate of the items which are included under section 691 in computing gross income. This is the excess of the value included in the gross estate on account of the items of gross income in respect of the decedent (see § 1.691(a)–1 and paragraph (c) of this section) over the deductions from the gross estate for claims which represent the deductions and credit in respect of the decedent (see § 1.691(b)–1). But see section 691(d) and paragraph (b) of § 1.691(d)–1 for computation of the special value of a survivor's annuity to be used in computing the net value for estate tax purposes in cases involving joint and survivor annuities.

(2) Ascertain the portion of the estate tax attributable to the inclusion in the gross estate of such net value. This is the excess of the estate tax over the estate tax computed without including such net value in the gross estate. In computing the estate tax without including such net value in the gross estate, any estate tax deduction (such as the marital deduction) which may be based upon the gross estate shall be recomputed so as to take into account the exclusion of such net value from the gross estate. See example 2, paragraph (e) of § 1.691(d)–1.

For purposes of this section, the term *estate tax* means the tax imposed under section 2001 or 2101 (or the corresponding provisions of the Internal Revenue Code of 1939), reduced by the credits against such tax. Each person including in gross income an amount of income in respect of a decedent may deduct as his share of the portion of the estate tax (computed under subparagraph (2) of this paragraph) an amount which bears the same ratio to such portion as the value in the gross estate of the right to the income included by such person in gross income (or the amount included in gross income if lower) bears to the value in the gross estate of all the items of gross income in respect of the decedent.

(b) *Prior decedent.* If a person is required to include in gross income an amount of income in respect of a prior decedent, such person may deduct for the same taxable year that portion of the estate tax imposed upon the prior decedent's estate which is attributable to the inclusion in the prior decedent's estate of the value of the right to receive such amount. This deduction is computed in the same manner as provided in paragraph (a) of this section and is in addition to the deduction for estate tax imposed upon the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive such amount.

(c) *Amounts deemed to be income in respect of a decedent.* For purposes of allowing the deduction under section 691(c), the following items are also considered to be income in respect of a decedent under section 691(a):

(1) The value for estate tax purposes of stock options in respect of which amounts are includible in gross income under section 421(b) (prior to amendment by section 221(a) of the Revenue Act of 1964), in the case of taxable years ending before January 1, 1964, or under section 422(c)(1), 423(c), or 424(c)(1), whichever is applicable, in the case of taxable years ending after December 31, 1963. See section 421(d)(6) (prior to amendment by sec. 221(a) of the Revenue Act of 1964), in the case of taxable years ending before January 1, 1964, and section 421(c)(2), in the case of taxable years ending after December 31, 1963.

(2) Amounts received by a surviving annuitant during his life expectancy period as an annuity under a joint and survivor annuity contract to the extent included in gross income under section 72. See section 691(d).

(d) *Examples.* Paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. X, an attorney who kept his books by use of the cash receipts and disbursements method, was entitled at the date of his death to a fee for services rendered in a case not completed at the time of his death, which fee was valued in his estate at $1,000, and to accrued bond interest, which was valued in his estate at $500. In all, $1,500 was included in his gross estate in respect of income described in section 691(a)(1). There were deducted as claims against his estate $150 for business expenses for which his estate was liable and $50 for taxes accrued on certain property which he owned. In all, $200 was deducted for claims which represent amounts described in section 691(b) which are allowable as deductions to his estate or to the beneficiaries of his estate. His gross estate was $185,000 and, considering deductions of $15,000 and an exemption of $60,000, his taxable estate amounted to $110,000. The estate tax on this amount is $23,700 from which is subtracted a $75 credit for State death taxes leaving an estate tax liability of $23,625. In the year following the closing of X's estate, the fee in the amount of $1,200 was collected by X's son, who was the sole beneficiary of the estate. This amount was included under section 691(a)(1)(C) in the son's gross income. The son may deduct, in computing his taxable income for such year, $260 on account of the estate tax attributable to such income, computed as follows:

(1) (i) Value of income described in section 691(a)(1) included in computing gross estate	$1,500
(ii) Deductions in computing gross estate for claims representing deductions described in section 691(b)	200
(iii) Net value of items described in section 691(a)(1)	1,300
(2) (i) Estate tax	23,625
(ii) Less: Estate tax computed without including $1,300 (item (1)(iii)) in gross estate	23,235
(iii) Portion of estate tax attributable to net value of items described in section 691(a)(1)	390
(3) (i) Value in gross estate of items described in section 691(a)(1) received in taxable year (fee)	1,000
(ii) Value in gross estate of all income items described in section 691(a)(1) (item (1)(i))	1,500
(iii) Part of estate tax deductible on account of receipt of $1,200 fee (1,000/1,500 of $390)	260

Although $1,200 was later collected as the fee, only the $1,000 actually included in the gross estate is used in the above computations. However, to avoid distortion, section 691(c) provides that if the value included in the gross estate is greater than the amount finally collected, only the amount collected shall be used in the above computations. Thus, if the amount collected as the fee were only $500, the estate tax deductible on the receipt of such amount would be 500/1,500 of $390, or $130. With respect to taxable years ending before January 1, 1964, see paragraph (d)(3) of §1.421–5 for a similar example involving a restricted stock option. With respect to taxable years ending after December 31, 1963, see paragraph (c)(3) of §1.421–8 for a similar example involving a stock option subject to the provisions of part II of subchapter D.

Example 2. Assume that in example 1 the fee valued at $1,000 had been earned by prior decedent Y and had been inherited by X who died before collecting it. With regard to the son, the fee would be considered income in respect of a prior decedent. Assume further that the fee was valued at $1,000 in Y's estate, that the net value in Y's estate of items described in section 691 (a)(1) was $5,000 and that the estate tax imposed on Y's estate attributable to such net value was $550. In such case, the portion of such estate tax attributable to the fee would be 1,000/5,000 of $550, or $110. When the son collects the $1,200 fee, he will receive for the same taxable year a deduction of $110 with respect to the estate tax imposed on the estate of prior decedent Y as well as the deduction of $260 (as computed in example 1) with respect to the estate tax imposed on the estate of decedent X.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6887, 31 FR 8812, June 24, 1966]

§1.691(c)–2 Estates and trusts.

(a) In the case of an estate or trust, the deduction prescribed in section 691(c) is determined in the same manner as described in §1.691(c)–1, with the following exceptions:

(1) If any amount properly paid, credited, or required to be distributed by an estate or trust to a beneficiary consists of income in respect of a decedent received by the estate or trust during the taxable year:

(i) Such income shall be excluded in determining the income in respect of the decedent with respect to which the estate or trust is entitled to a deduction under section 691(c), and

(ii) Such income shall be considered income in respect of a decedent to such beneficiary for purposes of allowing the deduction under section 691(c) to such beneficiary.

(2) For determination of the amount of income in respect of a decedent received by the beneficiary, see sections 652 and 662, and §§1.652(b)–2 and 1.662(b)–2. However, for this purpose, distributable net income as defined in section 643 (a) and the regulations thereunder shall be computed without taking into account the estate tax deduction provided in section 691(c) and this section. Distributable net income

as modified under the preceding sentence shall be applied for other relevant purposes of subchapter J, chapter 1 of the Code, such as the deduction provided by section 651 or 661, or subpart D, part I of subchapter J, relating to excess distributions by trusts.

(3) The rule stated in subparagraph (1) of this paragraph does not apply to income in respect of a decedent which is properly allocable to corpus by the fiduciary during the taxable year but which is distributed to a beneficiary in a subsequent year. The deduction provided by section 691(c) in such a case is allowable only to the estate or trust. If any amount properly paid, credited, or required to be distributed by a trust qualifies as a distribution under section 666, the fact that a portion thereof constitutes income in respect of a decedent shall be disregarded for the purposes of determining the deduction of the trust and of the beneficiaries under section 691(c) since the deduction for estate taxes was taken into consideration in computing the undistributed net income of the trust for the preceding taxable year.

(b) This section shall apply only to amounts properly paid, credited, or required to be distributed in taxable years of an estate or trust beginning after December 31, 1953, and ending after August 16, 1954, except as otherwise provided in paragraph (c) of this section.

(c) In the case of an estate or trust heretofore taxable under the provisions of the Internal Revenue Code of 1939, amounts paid, credited, or to be distributed during its first taxable year subject to the Internal Revenue Code of 1954 which would have been treated as paid, credited, or to be distributed on the last day of the preceding taxable year if the Internal Revenue Code of 1939 were still applicable shall not be subject to the provisions of section 691(c)(1)(B) or this section. See section 683 and the regulations thereunder.

(d) The provisions of this section may be illustrated by the following example, in which it is assumed that the estate and the beneficiary make their returns on the calendar year basis:

Example. (1) The fiduciary of an estate receives taxable interest of $5,500 and income in respect of a decedent of $4,500 during the taxable year. Neither the will of the decedent nor local law requires the allocation to corpus of income in respect of a decedent. The estate tax attributable to the income in respect of a decedent is $1,500. In his discretion, the fiduciary distributes $2,000 (falling within sections 661(a) and 662(a)) to a beneficiary during that year. On these facts the fiduciary and beneficiary are respectively entitled to estate tax deductions of $1,200 and $300, computed as follows:

(2) Distributable net income computed under section 643(a) without regard to the estate tax deduction under section 691(c) is $10,000, computed as follows:

Taxable interest	$5,500
Income in respect of a decedent	4,500
Total	10,000

(3) Inasmuch as the distributable net income of $10,000 exceeds the amount of $2,000 distributed to the beneficiary, the deduction allowable to the estate under section 661(a) and the amount taxable to the beneficiary under section 662(a) is $2,000.

(4) The character of the amounts distributed to the beneficiary under section 662 (b) is shown in the following table:

	Taxable interest	Income in respect of a decedent	Total
Distributable net income	$5,500	$4,500	$10,000
Amount deemed distributed under section 662(b)	1,100	900	2,000

(5) Accordingly, the beneficiary will be entitled to an estate tax deduction of $300 (900/4,500×$1,500) and the estate will be entitled to an estate tax deduction of $1,200 (3,600/4,500×$1,500).

(6) The taxable income of the estate is $6,200, computed as follows:

Gross income		$10,000
Less:		
Distributions to the beneficiary	$2,000	
Estate tax deduction under section 691(c)	1,200	
Personal exemption	600	
		3,800
Taxable income		6,200

§ 1.691(d)–1 Amounts received by surviving annuitant under joint and survivor annuity contract.

(a) *In general.* Under section 691(d), annuity payments received by a surviving annuitant under a joint and survivor annuity contract (to the extent indicated in paragraph (b) of this section) are treated as income in respect of a decedent under section 691(a) for the purpose of allowing the deduction for estate tax provided for in section

691(c)(1)(A). This section applies only if the deceased annuitant died after December 31, 1953, and after the annuity starting date as defined in section 72(c)(4).

(b) *Special value for surviving annuitant's payments.* Section 691(d) provides a special value for the surviving annuitant's payments to determine the amount of the estate tax deduction provided for in section 691(c)(1)(A). This special value is determined by multiplying:

(1) The excess of the value of the annuity at the date of death of the deceased annuitant over the total amount excludable from the gross income of the surviving annuitant under section 72 during his life expectancy period (see paragraph (d)(1)(i) of this section)

by

(2) A fraction consisting of the value of the annuity for estate tax purposes over the value of the annuity at the date of death of the deceased annuitant.

This special value is used for the purpose of determining the net value for estate tax purposes (see section 691(c)(2)(B) and paragraph (a)(1) of §1.691(c)–1) and for the purpose of determining the portion of estate tax attributable to the survivor's annuity (see paragraph (a) of §1.691(c)–1).

(c) *Amount of deduction.* The portion of estate tax attributable to the survivor's annuity (see paragraph (a) of §1.691(c)–1) is allowable as a deduction to the surviving annuitant over his life expectancy period. If the surviving annuitant continues to receive annuity payments beyond this period, there is no further deduction under section 691(d). If the surviving annuitant dies before expiration of such period, there is no compensating adjustment for the unused deduction.

(d) *Definitions.* (1) For purposes of section 691(d) and this section:

(i) The term *life expectancy period* means the period beginning with the first day of the first period for which an amount is received by the surviving annuitant under the contract and ending with the close of the taxable year with or in which falls the termination of the life expectancy of the surviving annuitant.

(ii) The life expectancy of the surviving annuitant shall be determined as of the date of death of the deceased annuitant, with reference to actuarial Table I set forth in §1.72–9 (but without making any adjustment under paragraph (a)(2) of §1.72–5).

(iii) The value of the annuity at the date of death of the deceased annuitant shall be the entire value of the survivor's annuity determined by reference to the principles set forth in section 2031 and the regulations thereunder, relating to the valuation of annuities for estate tax purposes.

(iv) The value of the annuity for estate tax purposes shall be that portion of the value determined under subdivision (iii) of this subparagraph which was includible in the deceased annuitant's gross estate.

(2) The determination of the ''life expectancy period'' of the survivor for purposes of section 691(d) may be illustrated by the following example:

Example. H and W file their income tax returns on the calendar year basis. H dies on July 15, 1955, on which date W is 70 years of age. On August 1, 1955, W receives a monthly payment under a joint and survivor annuity contract. W's life expectancy determined as of the date of H's death is 15 years as determined from Table I in §1.72–9; thus her life expectancy ends on July 14, 1970. Under the provisions of section 691(d), her life expectancy period begins as of July 1, 1955, and ends as of December 31, 1970, thus giving her a life expectancy period of 15 1/2 years.

(e) *Examples.* The application of section 691(d) and this section may be illustrated by the following examples:

Example 1. (1) H and W, husband and wife, purchased a joint and survivor annuity contract for $203,800 providing for monthly payments of $1,000 starting January 28, 1954, and continuing for their joint lives and for the remaining life of the survivor. H contributed $152,850 and W contributed $50,950 to the cost of the annuity. As of the annuity starting date, January 1, 1954, H's age at his nearest birthday was 70 and W's age at her nearest birthday was 67. H dies on January 1, 1957, and beginning on January 28, 1957, W receives her monthly payments of $1,000. The value of the annuity at the date of H's death is $159,000 (see paragraph (d)(1)(iii) of this section), and the value of the annuity for estate tax purposes (see paragraph (d)(1)(iv) of this section) is $119,250 (152,850/203,800 of $159,000). As of the date of H's death, W's age is 70 and her life expectancy period is 15 years (see paragraph (d) of this section for method of computation). Both H and W reported income by use of the cash receipts and disbursements method and filed income tax returns on the calendar year basis.

(2) The following computations illustrate the application of section 72 in determining the excludable portions of the annuity payments to W during her life expectancy period:

Amount of annuity payments per year (12×$1,000)	$12,000
Life expectancy of H and W as of the annuity starting date (see section 72(c)(3)(A) and Table II of § 1.72–9 (male, age 70; female, age 67))	19.7
Expected return as of the annuity starting date, January 1, 1954 ($12,000×19.7 as determined under section 72(c)(3)(A) and paragraph (b) of § 1.72–5)	$236,400
Investment in the contract as of the annuity starting date, Jan. 1, 1954 (see section 72(c)(1) and paragraph (a) of § 1.72–6)	$203,800
Exclusion ratio (203,800/236,400 as determined under section 72(b) and § 1.72–4) (percent)	86.2
Exclusion per year under section 72 ($12,000×86.2 percent)	$10,344
Excludable during W's life expectancy period ($10,344×15)	$155,160

(3) For the purpose of computing the deduction for estate tax under section 691(c), the value for estate tax purposes of the amounts includible in W's gross income and considered income in respect of a decedent by virtue of section 691(d)(1) is $2,880. This amount is arrived at in accordance with the formula contained in section 691(d)(2), as follows:

Value of annuity at the date of H's death	$159,000
Total amount excludable from W's gross income under section 72 during W's life expectancy period (see subparagraph (2) of this example)	$155,160
Excess	$3,840
Ratio which value of annuity for estate tax purposes bears to value of annuity at date of H's death (119,250/159,000) (percent)	75
Value for estate tax purposes (75 percent of $3,840)	$2,880

This amount ($2,880) is included in the items of income under section 691(a)(1) for the purpose of determining the estate tax attributable to each item under section 691(c)(1)(A). The estate tax determined to be attributable to the item of $2,880 is then allowed as a deduction to W over her 15-year life expectancy period (see example 2 of this paragraph).

Example 2. Assume, in addition to the facts contained in example 1 of this paragraph, that H was an attorney and was entitled at the date of his death to a fee for services rendered in a case not completed at the time of his death, which fee was valued at $1,000, and to accrued bond interest, which was valued at $500. Taking into consideration the annuity payments of example 1, valued at $2,880, a total of $4,380 was included in his gross estate in respect of income described in section 691(a)(1). There were deducted as claims against his estate $280 for business expenses for which his estate was liable and $100 for taxes accrued on certain property which he owned. In all, $380 was deducted for claims which represent amounts described in section 691(b) which are allowable as deductions to his estate or to the beneficiaries of his estate. His gross estate was $404,250 and considering deductions of $15,000, a marital deduction of $119,250 (assuming the annuity to be the only qualifying gift) and an exemption of $60,000, his taxable estate amounted to $210,000. The estate tax on this amount is $53,700 from which is subtracted a $175 credit for State death taxes, leaving an estate tax liability of $53,525. W may deduct, in computing her taxable income during each year of her 15-year life expectancy period, $14.73 on account of the estate tax attributable to the value for estate tax purposes of that portion of the annuity payments considered income in respect of a decedent, computed as follows:

(1)(i) Value of income described in section 691(a)(1) included in computing gross estate	$4,380.00
(ii) Deductions in computing gross estate for claims representing deductions described in section 691(b)	380.00
(iii) Net value of items described in section 691(a) (1)	4,000.00
(2)(i) Estate tax	53,525.00
(ii) Less: estate tax computed without including $4,000 (item (1) (iii)) in gross estate and by reducing marital deduction by $2,880 (portion of item (1)(iii) allowed as a marital deduction)	53,189.00
(iii) Portion of estate tax attributable to net value of income items	336.00
(3)(i) Value in gross estate of income attributable to annuity payments	2,880.00
(ii) Value in gross estate of all income items described in section 691(a)(1) (item (1)(i))	4,380.00
(iii) Part of estate tax attributable to annuity income (2,880/4,380 of $336)	220.93
(iv) Deduction each year on account of estate tax attributable to annuity income ($220.93÷15 (life expectancy period))	14.73

§ 1.691(e)–1 Installment obligations transmitted at death when prior law applied.

(a) *In general*—(1) *Application of prior law.* Under section 44(d) of the Internal Revenue Code of 1939 and corresponding provisions of prior law, gains and losses on account of the transmission of installment obligations at the death of a holder of such obligations were required to be reported in the return of the decedent for the year of his death. However, an exception to this rule was provided if there was filed with the Commissioner a bond assuring the return as income of any payment in satisfaction of these obligations in the same proportion as would have been returnable as income by the decedent had he lived and received such payments. Obligations in respect of which such bond was filed are referred to in this section as ‘‘obligations assured by bond’’.

(2) *Application of present law.* Section 691(a)(4) of the Internal Revenue Code of 1954 (effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954) in effect makes the exception which under prior law applied to obligations assured by bond the general rule for obligations transmitted at death, but contains no requirement for a bond. Section 691(e)(1) provides that if the holder of the installment obligation makes a proper election, the provisions of section 691(a)(4) shall apply in the case of obligations assured by bond. Section 691(e)(1) further provides that the estate tax deduction provided by section 691(c)(1) is not allowable for any amount included in gross income by reason of filing such an election.

(b) *Manner and scope of election*—(1) *In general.* The election to have obligations assured by bond treated as obligations to which section 691(a)(4) applies shall be made by the filing of a statement with respect to each bond to be released, containing the following information:

(i) The name and address of the decedent from whom the obligations assured by bond were transmitted, the date of his death, and the internal revenue district in which the last income tax return of the decedent was filed.

(ii) A schedule of all obligations assured by the bond on which is listed—

(a) The name and address of the obligors, face amount, date of maturity, and manner of payment of each obligation,

(b) The name, identifying number (provided under section 6109 and the regulations thereunder), and address of each person holding the obligations, and

(c) The name, identifying number, and address, of each person who at the time of the election possesses an interest in each obligation, and a description of such interest.

(iii) The total amount of income in respect of the obligations which would have been reportable as income by the decedent if he had lived and received such payment.

(iv) The amount of income referred to in subdivision (iii) of this subparagraph which has previously been included in gross income.

(v) An unqualified statement, signed by all persons holding the obligations, that they elect to have the provisions of section 691(a)(4) apply to such obligations and that such election shall be binding upon them, all current beneficiaries, and any person to whom the obligations may be transmitted by gift, bequest, or inheritance.

(vi) A declaration that the election is made under the penalties of perjury.

(2) *Filing of statement.* The statement with respect to each bond to be released shall be filed in duplicate with the district director of internal revenue for the district in which the bond is maintained. The statement shall be filed not later than the time prescribed for filing the return for the first taxable year (including any extension of time for such filing) to which the election applies.

(3) *Effect of election.* The election referred to in subparagraph (1) of this paragraph shall be irrevocable. Once an election is made with respect to an obligation assured by bond, it shall apply to all payments made in satisfaction of such obligation which were received during the first taxable year to which the election applies and to all such payments received during each taxable year thereafter, whether the recipient is the person who made the election, a current beneficiary, or a person to whom the obligation may be transmitted by gift, bequest, or inheritance. Therefore, all payments received to which the election applies shall be treated as payments made on installment obligations to which section 691(a)(4) applies. However, the estate tax deduction provided by section 691(c) is not allowable for any such payment. The application of this subparagraph may be illustrated by the following example:

Example. A, the holder of an installment obligation, died in 1952. The installment obligation was transmitted at A’s death to B who filed a bond on Form 1132 pursuant to paragraph (c) of §39.44–5 of Regulations 118

(26 CFR part 39, 1939 ed.) for the necessary amount. On January 1, 1965, B, a calendar year taxpayer, filed an election under section 691(e) to treat the obligation assured by bond as an obligation to which section 691(a)(4) applies, and B's bond was released for 1964 and subsequent taxable years. B died on June 1, 1965, and the obligation was bequeathed to C. On January 1, 1966, C received an installment payment on the obligation which had been assured by the bond. Because B filed an election with respect to the obligation assured by bond, C is required to treat the proper proportion of the January 1, 1966, payment and all subsequent payments made in satisfaction of this obligation as income in respect of a decedent. However, no estate tax deduction is allowable to C under section 691(c)(1) for any estate tax attributable to the inclusion of the value of such obligation in the estate of either A or B.

(c) *Release of bond.* If an election according to the provisions of paragraph (b) of this section is filed, the liability under any bond filed under section 44(d) of the 1939 Code (or the corresponding provisions of prior law) shall be released with respect to each taxable year to which such election applies. However, the liability under any such bond for an earlier taxable year to which the election does not apply shall not be released until the district director of internal revenue for the district in which the bond is maintained is assured that the proper portion of each installment payment received in such taxable year has been reported and the tax thereon paid.

[T.D. 6808, 30 FR 3436, Mar. 16, 1965]

§ 1.691(f)–1 Cross reference.

See section 753 and the regulations thereunder for application of section 691 to income in respect of a deceased partner.

[T.D. 6808, 30 FR 3436, Mar. 16, 1965]

§ 1.692–1 Abatement of income taxes of certain members of the Armed Forces of the United States upon death.

(a)(1) This section applies if:

(i) An individual dies while in active service as a member of the Armed Forces of the United States, and

(ii) His death occurs while he is serving in a combat zone (as determined under section 112), or at any place as a result of wounds, disease, or injury incurred while he was serving in a combat zone.

(2) If an individuals dies as described in paragraph (a)(1), the following liabilities for tax, under subtitle A of the Internal Revenue Code of 1954 or under chapter 1 of the Internal Revenue Code of 1939, are canceled:

(i) The libaility of the deceased individual, for the last taxable year, ending on the date of his death, and for any prior taxable year ending on or after the first day he served in a combat zone in active service as a member of the U.S. Armed Forces after June 24, 1950, and

(ii) The liability of any other person to the extent the liability is attributable to an amount received after the individual's death (including income in respect of a decedent under section 691) which would have been includible in the individual's gross income for his taxable year in which the date of his death falls (determined as if he had survived).

If the tax (including interest, additions to the tax, and additional amounts) is assessed, the assessment will be abated. If the amount of the tax is collected (regardless of the date of collection), the amount so collected will be credited or refunded as an overpayment.

(3) If an individual dies as described in paragraph (a)(1), there will not be assessed any amount of tax of the indvidual for taxable years preceding the years specified in paragraph (a)(2), under subtitle A of the Internal Revenue Code of 1954, chapter 1 of the Internal Revenue Code of 1939, or corresponding provisions of prior revenue laws, remaining unpaid as of the date of death. If any such unpaid tax (including interest, additions to the tax, and additional amounts) has been assessed, the assessments will be abated. If the amount of any such unpaid tax is collected after the date of death, the amount so collected will be credited or refunded as an overpayment.

(4) As to what constitutes active service as a member of the Armed Forces, service in a combat zone, and wounds, disease, or injury incurred while serving in a combat zone, see section 112. As to who are members of the Armed Forces, see section 7701(a)(15).

As to the period of time within which any claim for refund must be filed, see sections 6511(a) and 7508(a)(1)(E).

(b) If such an individual and his spouse have for any such year filed a joint return, the tax abated, credited, or refunded pursuant to the provisions of section 692 for such year shall be an amount equal to that portion of the joint tax liability which is the same percentage of such joint tax liability as a tax computed upon the separate income of such individual is of the sum of the taxes computed upon the separate income of such individual and his spouse, but with respect to taxable years ending before June 24, 1950, and with respect to taxable years ending before the first day such individual served in a combat zone, as determined under section 112, the amount so abated, credited, or refunded shall not exceed the amount unpaid at the date of death. For such purpose, the separate tax of each spouse:

(1) For taxable years beginning after December 31, 1953, and ending after August 16, 1954, shall be the tax computed under subtitle A of the Internal Revenue Code of 1954 before the application of sections 31, 32, 6401(b), and 6402, but after the application of section 33, as if such spouse were required to make a separate income tax return; and

(2) For taxable years beginning before January 1, 1954, and for taxable years beginning after December 31, 1953, and ending before August 17, 1954, shall be the tax computed under chapter 1 of the Internal Revenue Code of 1939 before the application of sections 32, 35, and 322(a), but after the application of section 31, as if such spouse were required to make a separate income tax return.

(c) If such an individual and his spouse filed a joint declaration of estimated tax for the taxable year ending with the date of his death, the estimated tax paid pursuant to such declaration may be treated as the estimated tax of either such individual or his spouse, or may be divided between them, in such manner as his legal representative and such spouse may agree. Should they agree to treat such estimated tax, or any portion thereof, as the estimated tax of such individual, the estimated tax so paid shall be credited or refunded as an overpayment for the taxable year ending with the date of his death.

(d) For the purpose of determining the tax which is unpaid at the date of death, amounts deducted and withheld under chapter 24, subtitle C of the Internal Revenue Code of 1954, or under subchapter D, chapter 9 of the Internal Revenue Code of 1939 (relating to income tax withheld at source on wages), constitute payment of tax imposed under subtitle A of the Internal Revenue Code of 1954 or under chapter 1 of the Internal Revenue Code of 1939, as the case may be.

(e) This section shall have no application whatsoever with respect to the liability of an individual as a transferee of property of a taxpayer where such liability relates to the tax imposed upon the taxpayer by subtitle A of the Internal Revenue Code of 1954 or by chapter 1 of the Internal Revenue Code of 1939.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7543, 43 FR 19392, May 5, 1978]

Partners and Partnerships

DETERMINATION OF TAX LIABILITY

§1.701–1 Partners, not partnership, subject to tax.

Partners are liable for income tax only in their separate capacities. Partnerships as such are not subject to the income tax imposed by subtitle A but are required to make returns of income under the provisions of section 6031 and the regulations thereunder. For definition of the terms ‘‘partner’’ and ‘‘partnership’’, see sections 761 and 7701(a)(2), and the regulations thereunder. For provisions relating to the election of certain partnerships to be taxed as domestic corporations, see section 1361 and the regulations thereunder.

§1.701–2 Anti-abuse rule.

(a) *Intent of subchapter K.* Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements—

(1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.

(2) The form of each partnership transaction must be respected under substance over form principles.

(3) Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, *proper reflection of income*). However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement of this paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (2) of this section to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. See, for example, paragraph (d) *Example 6* of this section (relating to the value-equals-basis rule in § 1.704–1(b)(2)(iii)(*c*)), paragraph (d) *Example 9* of this section (relating to the election under section 754 to adjust basis in partnership property), and paragraph (d) *Examples 10 and 11* of this section (relating to the basis in property distributed by a partnership under section 732). See also, for example, §§ 1.704–3(e)(1) and 1.752–2(e)(4) (providing certain de minimis exceptions).

(b) *Application of subchapter K rules.* The provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K as set forth in paragraph (a) of this section (*intent of subchapter K*). Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K—

(1) The purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners;

(2) One or more of the purported partners of the partnership should not be treated as a partner;

(3) The methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income;

(4) The partnership's items of income, gain, loss, deduction, or credit should be reallocated; or

(5) The claimed tax treatment should otherwise be adjusted or modified.

(c) *Facts and circumstances analysis; factors.* Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. The factors set forth below may be indicative, but do not necessarily establish, that a partnership was used in such a manner. These factors are illustrative only, and therefore may not be the only factors taken into account in making the determination under this section. Moreover, the weight given to any factor (whether specified in this paragraph or otherwise) depends on all the facts and circumstances. The presence or absence of any factor described in this paragraph does not create a presumption that a partnership was (or was not) used in such a manner. Factors include:

(1) The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;

(2) The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. For example, this analysis may indicate that it was contemplated that a partner who was necessary to achieve the intended tax results and whose interest in the partnership was liquidated or disposed of (in whole or in part) would be a partner only temporarily in order to provide the claimed tax benefits to the remaining partners;

(3) One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities (through distribution preferences, indemnity or loss guaranty agreements, or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

(4) Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

(5) Partnership items are allocated in compliance with the literal language of §§1.704–1 and 1.704–2 but with results that are inconsistent with the purpose of section 704(b) and those regulations. In this regard, particular scrutiny will be paid to partnerships in which income or gain is specially allocated to one or more partners that may be legally or effectively exempt from federal taxation (for example, a foreign person, an exempt organization, an insolvent taxpayer, or a taxpayer with unused federal tax attributes such as net operating losses, capital losses, or foreign tax credits);

(6) The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or

(7) The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related party).

(d) *Examples.* The following examples illustrate the principles of paragraphs (a), (b), and (c) of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise indicated, parties to the transactions are not related to one another.

Example 1. Choice of entity; avoidance of entity-level tax; use of partnership consistent with the intent of subchapter K. (i) A and B form limited partnership PRS to conduct a bona fide business. A, the corporate general partner, has a 1% partnership interest. B, the individual limited partner, has a 99% interest. PRS is properly classified as a partnership under §§301.7701–2 and 301.7701–3. A and B chose limited partnership form as a means to provide B with limited liability without subjecting the income from the business operations to an entity-level tax.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. Although B has retained, indirectly, substantially all of the benefits and burdens of ownership of the money or property B contributed to PRS (see paragraph (c)(6) of this section), the decision to organize and conduct business through PRS under these circumstances is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 2. Choice of entity; avoidance of subchapter S shareholder requirements; use of partnership consistent with the intent of subchapter K. (i) A and B form partnership PRS to conduct a bona fide business. A is a corporation that has elected to be treated as an S corporation under subchapter S. B is a nonresident alien. PRS is properly classified as a partnership under §§ 301.7701–2 and 301.7701–3. Because section 1361(b) prohibits B from being a shareholder in A, A and B chose partnership form, rather than admit B as a shareholder in A, as a means to retain the benefits of subchapter S treatment for A and its shareholders.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Although it may be argued that the form of the partnership transaction should not be respected because it does not reflect its substance (inasmuch as application of the substance over form doctrine arguably could result in B being treated as a shareholder of A, thereby invalidating A's subchapter S election), the facts indicate otherwise. The shareholders of A are subject to tax on their pro rata shares of A's income (see section 1361 *et seq.*), and B is subject to tax on B's distributive share of partnership income (see sections 871 and 875). Thus, the form in which this arrangement is cast accurately reflects its substance as a separate partnership and S corporation. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 3. Choice of entity; avoidance of more restrictive foreign tax credit limitation; use of partnership consistent with the intent of subchapter K. (i) X, a domestic corporation, and Y, a foreign corporation, form partnership PRS under the laws of foreign Country A to conduct a bona fide joint business. X and Y each owns a 50% interest in PRS. PRS is properly classified as a partnership under §§ 301.7701–2 and 301.7701–3. PRS pays income taxes to Country A. X and Y chose partnership form to enable X to qualify for a direct foreign tax credit under section 901, with look-through treatment under § 1.904–5(h)(1). Conversely, if PRS were a foreign corporation for U.S. tax purposes, X would be entitled only to indirect foreign tax credits under section 902 with respect to dividend distributions from PRS. The look-through rules, however, would not apply, and pursuant to section 904(d)(1)(E) and § 1.904–4(g), the dividends and associated taxes would be subject to a separate foreign tax credit limitation for dividends from PRS, a noncontrolled section 902 corporation.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS in order to take advantage of the look-through rules for foreign tax credit purposes, thereby maximizing X's use of its proper share of foreign taxes paid by PRS, is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 4. Choice of entity; avoidance of gain recognition under sections 351(e) and 357(c); use of partnership consistent with the intent of subchapter K. (i) X, ABC, and DEF form limited partnership PRS to conduct a bona fide real estate management business. PRS is properly classified as a partnership under §§ 301.7701–2 and 301.7701–3. X, the general partner, is a newly formed corporation that elects to be treated as a real estate investment trust as defined in section 856. X offers its stock to the public and contributes substantially all of the proceeds from the public offering to PRS. ABC and DEF, the limited partners, are existing partnerships with substantial real estate holdings. ABC and DEF contribute all of their real property assets to PRS, subject to liabilities that exceed their respective aggregate bases in the real property contributed, and terminate under section 708(b)(1)(A). In addition, some of the former partners of ABC and DEF each have the right, beginning two years after the formation of PRS, to require the redemption of their limited partnership interests in PRS in exchange for cash or X stock (at X's option) equal to the fair market value of their respective interests in PRS at the time of the redemption. These partners are not compelled, as a legal or practical matter, to exercise their exchange rights at any time. X, ABC, and DEF chose to form a partnership rather than have ABC and DEF invest directly in X to allow ABC and DEF to avoid recognition of gain under sections 351(e) and 357(c). Because PRS would not be treated as an investment company within the meaning of section 351(e) if PRS were incorporated (so long as it did not elect under section 856), section 721(a) applies to the contribution of the real property to PRS. See section 721(b).

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS, thereby avoiding the tax consequences that would have resulted from contributing the existing partnerships' real estate assets to X (by applying the rules of sections 721, 731, and 752 in lieu of the rules of sections 351(e) and 357(c)), is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Although it may be argued that the form of the transaction should not be respected because it does not reflect its substance (inasmuch as the present value of the partners' aggregate federal tax liability is substantially less than would be the case if the transaction were integrated and treated as a contribution of the encumbered assets by ABC and DEF directly to X, see paragraph (c)(2) of this section), the facts indicate otherwise. For example, the right of some of the former ABC and DEF partners after two years to exchange their PRS interests for cash or X stock (at X's option) equal to the fair market value of their PRS interest at that time would not require that right to be considered as exercised prior to its actual exercise. Moreover, X may make other real estate investments and other business decisions, including the decision to raise additional capital for those purposes. Thus, although it may be likely that some or all of the partners with the right to do so will, at some point, exercise their exchange rights, and thereby receive either cash or X stock, the form of the transaction as a separate partnership and real estate investment trust is respected under substance over form principles (see paragraph (a)(2) of this section). The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 5. Special allocations; dividends received deductions; use of partnership consistent with the intent of subchapter K. (i) Corporations X and Y contribute equal amounts to PRS, a bona fide partnership formed to make joint investments. PRS pays $100x for a share of common stock of Z, an unrelated corporation, which has historically paid an annual dividend of $6x. PRS specially allocates the dividend income on the Z stock to X to the extent of the London Inter-Bank Offered Rate (LIBOR) on the record date, applied to X's contribution of $50x, and allocates the remainder of the dividend income to Y. All other items of partnership income and loss are allocated equally between X and Y. The allocations under the partnership agreement have substantial economic effect within the meaning of §1.704–1(b)(2). In addition to avoiding an entity-level tax, a principal purpose for the formation of the partnership was to invest in the Z common stock and to allocate the dividend income from the stock to provide X with a floating-rate return based on LIBOR, while permitting X and Y to claim the dividends received deduction under section 243 on the dividends allocated to each of them.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Section 704(b) and §1.704–1(b)(2) permit income realized by the partnership to be allocated validly to the partners separate from the partners' respective ownership of the capital to which the allocations relate, provided that the allocations satisfy both the literal requirements of the statute and regulations and the purpose of those provisions (see paragraph (c)(5) of this section). Section 704(e)(2) is not applicable to the facts of this example (otherwise, the allocations would be required to be proportionate to the partners' ownership of contributed capital). The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 6. Special allocations; nonrecourse financing; low-income housing credit; use of partnership consistent with the intent of subchapter K. (i) A and B, high-bracket taxpayers, and X, a corporation with net operating loss carryforwards, form general partnership PRS to own and operate a building that qualifies for the low-income housing credit provided by section 42. The project is financed with both cash contributions from the partners and nonrecourse indebtedness. The partnership agreement provides for special allocations of income and deductions, including the allocation of all depreciation deductions attributable to the building to A and B equally in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the building. The section 42 credits are allocated to A and B in accordance with the allocation of depreciation deductions. PRS's allocations comply with all applicable regulations, including the requirements of §§1.704–1(b)(2)(ii) (pertaining to economic effect) and 1.704–2(e) (requirements for allocations of nonrecourse deductions). The nonrecourse indebtedness is validly allocated to the partners under the rules of §1.752–3, thereby increasing the basis of the partners' respective partnership interests. The basis increase created by the nonrecourse indebtedness enables A and B to deduct their distributive share of losses from the partnership (subject to all other applicable limitations under the Internal Revenue Code) against their nonpartnership income and to apply the credits against their tax liability.

(ii) At a time when the depreciation deductions attributable to the building are not treated as nonrecourse deductions under §1.704–2(c) (because there is no net increase in partnership minimum gain during the year), the special allocation of depreciation deductions to A and B has substantial economic effect because of the value-equals-basis safe harbor contained in § 1.704–1(b)(2)(iii)(*c*) and the fact that A and B would bear the economic burden of any decline in the value of the building (to the extent of the partnership's investment in the building), notwithstanding that A and B believe it is unlikely that the building will decline in value (and, accordingly, they anticipate significant timing benefits through the special allocation). Moreover, in later years, when the depreciation deductions attributable to the building are treated as nonrecourse deductions under § 1.704–2(c), the special allocation of depreciation deductions to A and B is considered to be consistent with the partners' interests in the partnership under § 1.704–2(e).

(iii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a) (1), (2), and (3) of this section have been satisfied. Section 704(b), § 1.704–1(b)(2), and § 1.704–2(e) allow partnership items of income, gain, loss, deduction, and credit to be allocated validly to the partners separate from the partners' respective ownership of the capital to which the allocations relate, provided that the allocations satisfy both the literal requirements of the statute and regulations and the purpose of those provisions (see paragraph (c)(5) of this section). Moreover, the application of the value-equals-basis safe harbor and the provisions of § 1.704–2(e) with respect to the allocations to A and B, and the tax results of the application of those provisions, taking into account all the facts and circumstances, are clearly contemplated. Accordingly, even if the allocations would not otherwise be considered to satisfy the proper reflection of income standard in paragraph (a)(3) of this section, that requirement will be treated as satisfied under these facts. Thus, even though the partners' aggregate federal tax liability may be substantially less than had the partners owned the partnership's assets directly (due to X's inability to use its allocable share of the partnership's losses and credits) (see paragraph (c)(1) of this section), the transaction is not inconsistent with the intent of subchapter K. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 7. Partner with nominal interest; temporary partner; use of partnership not consistent with the intent of subchapter K. (i) Pursuant to a plan a principal purpose of which is to generate artificial losses and thereby shelter from federal taxation a substantial amount of income, X (a foreign corporation), Y (a domestic corporation), and Z (a promoter) form partnership PRS by contributing $9,000*x*, $990*x*, and $10*x*, respectively, for proportionate interests (90.0%, 9.9%, and 0.1%, respectively) in the capital and profits of PRS. PRS purchases offshore equipment for $10,000*x* and validly leases the equipment offshore for a term representing most of its projected useful life. Shortly thereafter, PRS sells its rights to receive income under the lease to a third party for $9,000*x*, and allocates the resulting $9,000*x* of income $8,100*x* to X, $891*x* to Y, and $9*x* to Z. PRS thereafter makes a distribution of $9,000*x* to X in complete liquidation of its interest. Under § 1.704–1(b)(2)(iv)(*f*), PRS restates the partners' capital accounts immediately before making the liquidating distribution to X to reflect its assets consisting of the offshore equipment worth $1,000*x* and $9,000*x* in cash. Thus, because the capital accounts immediately before the distribution reflect assets of $19,000*x* (that is, the initial capital contributions of $10,000*x* plus the $9,000*x* of income realized from the sale of the lease), PRS allocates a $9,000*x* book loss among the partners (for capital account purposes only), resulting in restated capital accounts for X, Y, and Z of $9,000*x*, $990*x*, and $10*x*, respectively. Thereafter, PRS purchases real property by borrowing the $8,000*x* purchase price on a recourse basis, which increases Y's and Z's bases in their respective partnership interests from $1,881*x* and $19*x*, to $9,801*x* and $99*x*, respectively (reflecting Y's and Z's adjusted interests in the partnership of 99% and 1%, respectively). PRS subsequently sells the offshore equipment, subject to the lease, for $1,000*x* and allocates the $9,000*x* tax loss $8,910*x* to Y and $90*x* to Z. Y's and Z's bases in their partnership interests are therefore reduced to $891*x* and $9*x*, respectively.

(ii) On these facts, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes (see paragraph (c) of this section). Accordingly, the transaction lacks a substantial business purpose (see paragraph (a)(1) of this section). In addition, factors (1), (2), (3), and (5) of paragraph (c) of this section indicate that PRS was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with the intent of subchapter K. On these facts, PRS is not bona fide (see paragraph (a)(1) of this section), and the transaction is not respected under applicable substance over form principles (see paragraph (a)(2) of this section) and does not properly reflect the income of Y (see paragraph (a)(3) of this section). Thus, PRS has been formed and availed of with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or the validity of the allocations under §1.704–1(b)(2) (see paragraph (h) of this section)), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

Example 8. Plan to duplicate losses through absence of section 754 election; use of partnership not consistent with the intent of subchapter K. (i) A owns land with a basis of $100*x* and a fair market value of $60*x*. A would like to sell the land to B. A and B devise a plan a principal purpose of which is to permit the duplication, for a substantial period of time, of the tax benefit of A's built-in loss in the land. To effect this plan, A, C (A's brother), and W (C's wife) form partnership PRS, to which A contributes the land, and C and W each contribute $30*x*. All partnership items are shared in proportion to the partners' respective contributions to PRS. PRS invests the cash in an investment asset (that is not a marketable security within the meaning of section 731(c)). PRS also leases the land to B under a three-year lease pursuant to which B has the option to purchase the land from PRS upon the expiration of the lease for an amount equal to its fair market value at that time. All lease proceeds received are immediately distributed to the partners. In year 3, at a time when the values of the partnership's assets have not materially changed, PRS agrees with A to liquidate A's interest in exchange for the investment asset held by PRS. Under section 732(b), A's basis in the asset distributed equals $100*x*, A's basis in A's partnership interest immediately before the distribution. Shortly thereafter, A sells the investment asset to X, an unrelated party, recognizing a $40*x* loss.

(ii) PRS does not make an election under section 754. Accordingly, PRS's basis in the land contributed by A remains $100*x*. At the end of year 3, pursuant to the lease option, PRS sells the land to B for $60*x* (its fair market value). Thus, PRS recognizes a $40*x* loss on the sale, which is allocated equally between C and W. C's and W's bases in their partnership interests are reduced to $10*x* each pursuant to section 705. Their respective interests are worth $30*x* each. Thus, upon liquidation of PRS (or their interests therein), each of C and W will recognize $20*x* of gain. However, PRS's continued existence defers recognition of that gain indefinitely. Thus, if this arrangement is respected, C and W duplicate for their benefit A's built-in loss in the land prior to its contribution to PRS.

(iii) On these facts, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes (see paragraph (c) of this section). Accordingly, the transaction lacks a substantial business purpose (see paragraph (a)(1) of this section). In addition, factors (1), (2), and (4) of paragraph (c) of this section indicate that PRS was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with the intent of subchapter K. On these facts, PRS is not bona fide (see paragraph (a)(1) of this section), and the transaction is not respected under applicable substance over form principles (see paragraph (a)(2) of this section). Further, the tax consequences to the partners do not properly reflect the partners' income; and Congress did not contemplate application of section 754 to partnerships such as PRS, which was formed for a principal purpose of producing a double tax benefit from a single economic loss (see paragraph (a)(3) of this section). Thus, PRS has been formed and availed of with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or other statutory authorities, such as the substance over form doctrine or the disguised sale rules under section 707 (see paragraph (h) of this section)), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

Example 9. Absence of section 754 election; use of partnership consistent with the intent of subchapter K. (i) PRS is a bona fide partnership formed to engage in investment activities with contributions of cash from each partner. Several years after joining PRS, A, a partner with a capital account balance and basis in its partnership interest of $100*x*, wishes to withdraw from PRS. The partnership agreement entitles A to receive the balance of A's capital account in cash or securities owned by PRS at the time of withdrawal, as mutually agreed to by A and the managing general partner, P. P and A agree to distribute to A $100*x* worth of non-marketable securities (see section 731(c)) in which PRS has an aggregate basis of $20*x*. Upon distribution, A's aggregate basis in the securities is $100*x* under section 732(b). PRS does not make an election to adjust the basis in its remaining assets under section 754. Thus, PRS's basis in its remaining assets is unaffected by the distribution. In contrast, if a section 754 election had been in effect for the year of the distribution, under these facts section 734(b) would have required PRS to adjust the basis in its remaining assets downward by the amount of the untaxed appreciation in the distributed property, thus reflecting that gain in PRS's retained assets. In selecting the assets to be distributed, A and P had a principal purpose to take advantage of the facts that A's basis in the securities will be determined by reference to A's basis in its partnership interest under section 732(b), and because PRS will not make an election under section 754, the remaining partners of PRS will likely enjoy a federal tax timing advantage (i.e., from the $80*x* of additional basis in its assets that would have been eliminated if the section 754 election had been made) that is inconsistent with proper reflection of income under paragraph (a)(3) of this section.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1) and (2) of this section have been satisfied. The validity of the tax treatment of this transaction is therefore dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard under paragraph (a)(3) of this section. A's basis in the distributed securities is properly determined under section 732(b). The benefit to the remaining partners is a result of PRS not having made an election under section 754. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, paragraph (a)(3) of this section provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the requirements of paragraphs (a)(1) and (2) of this section), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

(iii) In general, the adjustments that would be made if an election under section 754 were in effect are necessary to minimize distortions between the partners' bases in their partnership interests and the partnership's basis in its assets following, for example, a distribution to a partner. The electivity of section 754 is intended to provide administrative convenience for bona fide partnerships that are engaged in transactions for a substantial business purpose, by providing those partnerships the option of not adjusting their bases in their remaining assets following a distribution to a partner. Congress clearly recognized that if the section 754 election were not made, basis distortions may result. Taking into account all the facts and circumstances of the transaction, the electivity of section 754 in the context of the distribution from PRS to A, and the ultimate tax consequences that follow from the failure to make the election with respect to the transaction, are clearly contemplated by section 754. Thus, the tax consequences of this transaction will be treated as satisfying the proper reflection of income standard under paragraph (a)(3) of this section. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 10. Basis adjustments under section 732; use of partnership consistent with the intent of subchapter K. (i) A, B, and C are partners in partnership PRS, which has for several years been engaged in substantial bona fide business activities. For valid business reasons, the partners agree that A's interest in PRS, which has a value and basis of $100*x*, will be liquidated with the following assets of PRS: a nondepreciable asset with a value of $60*x* and a basis to PRS of $40*x*, and related equipment with two years of cost recovery remaining and a value and basis to PRS of $40*x*. Neither asset is described in section 751 and the transaction is not described in section 732(d). Under section 732 (b) and (c), A's $100*x* basis in A's partnership interest will be allocated between the nondepreciable asset and the equipment received in the liquidating distribution in proportion to PRS's bases in those assets, or $50*x* to the nondepreciable asset and $50*x* to the equipment. Thus, A will have a $10*x* built-in gain in the nondepreciable asset ($60*x* value less $50*x* basis) and a $10*x* built-in loss in the equipment ($50*x* basis less $40*x* value), which it expects to recover rapidly through cost recovery deductions. In selecting the assets to be distributed to A, the partners had a principal purpose to take advantage of the fact that A's basis in the assets will be determined by reference to A's basis in A's partnership interest, thus, in effect, shifting a portion of A's basis from the nondepreciable asset to the equipment, which in turn would allow A to recover that portion of its basis more rapidly. This shift provides a federal tax timing advantage to A, with no offsetting detriment to B or C.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1) and (2) of this section have been satisfied. The validity of the tax treatment of this transaction is therefore dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard under paragraph (a)(3) of this section. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, paragraph (a)(3) of this section provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but the application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the requirements of paragraphs (a)(1) and (2) of this section), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

(iii) A's basis in the assets distributed to it was determined under section 732 (b) and (c). The transaction does not properly reflect A's income due to the basis distortions caused by the distribution and the shifting of basis from a nondepreciable to a depreciable asset. However, the basis rules under section 732, which in some situations can produce tax results that are inconsistent with the proper reflection of income standard (see paragraph (a)(3) of this section), are intended to provide simplifying administrative rules for bona fide partnerships that are engaged in transactions with a substantial business purpose. Taking into account all the facts and circumstances of the transaction, the application of the basis rules under section 732 to the distribution from PRS to A, and the ultimate tax consequences of the application of that provision of subchapter K, are clearly contemplated. Thus, the application of section 732 to this transaction will be treated as satisfying the proper reflection of income standard under paragraph (a)(3) of this section. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 11. Basis adjustments under section 732; plan or arrangement to distort basis allocations artificially; use of partnership not consistent with the intent of subchapter K. (i) Partnership PRS has for several years been engaged in the development and management of commercial real estate projects. X, an unrelated party, desires to acquire undeveloped land owned by PRS, which has a value of $95*x* and a basis of $5*x*. X expects to hold the land indefinitely after its acquisition. Pursuant to a plan a principal purpose of which is to permit X to acquire and hold the land but nevertheless to recover for tax purposes a substantial portion of the purchase price for the land, X contributes $100*x* to PRS for an interest therein. Subsequently (at a time when the value of the partnership's assets have not materially changed), PRS distributes to X in liquidation of its interest in PRS the land and another asset with a value and basis to PRS of $5*x*. The second asset is an insignificant part of the economic transaction but is important to achieve the desired tax results. Under section 732 (b) and (c), X's $100*x* basis in its partnership interest is allocated between the assets distributed to it in proportion to their bases to PRS, or $50*x* each. Thereafter, X plans to sell the second asset for its value of $5*x*, recognizing a loss of $45*x*. In this manner, X will, in effect, recover a substantial portion of the purchase price of the land almost immediately. In selecting the assets to be distributed to X, the partners had a principal purpose to take advantage of the fact that X's basis in the assets will be determined under section 732 (b) and (c), thus, in effect, shifting a portion of X's basis economically allocable to the land that X intends to retain to an inconsequential asset that X intends to dispose of quickly. This shift provides a federal tax timing advantage to X, with no offsetting detriment to any of PRS's other partners.

(ii) Although section 732 recognizes that basis distortions can occur in certain situations, which may produce tax results that do not satisfy the proper reflection of income standard of paragraph (a)(3) of this section, the provision is intended only to provide ancillary, simplifying tax results for bona fide partnership transactions that are engaged in for substantial business purposes. Section 732 is not intended to serve as the basis for plans or arrangements in which inconsequential or immaterial assets are included in the distribution with a principal purpose of obtaining substantially favorable tax results by virtue of the statute's simplifying rules. The transaction does not properly reflect X's income due to the basis distortions caused by the distribution that result in shifting a significant portion of X's basis to this inconsequential asset. Moreover, the proper reflection of income standard contained in paragraph (a)(3) of this section is not treated as satisfied, because, taking into account all the facts and circumstances, the application of section 732 to this arrangement, and the ultimate tax consequences that would thereby result, were not clearly contemplated by that provision of subchapter K. In addition, by using a partnership (if respected), the partners' aggregate federal tax liability would be substantially less than had they owned the partnership's assets directly (see paragraph (c)(1) of this section). On these facts, PRS has been formed and availed of with a principal purpose to reduce the taxpayers' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under applicable judicial principles and statutory authorities, such as the disguised sale rules under section 707, see paragraph (h) of this section), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

(e) *Abuse of entity treatment*—(1) *General rule.* The Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder.

(2) *Clearly contemplated entity treatment.* Paragraph (e)(1) of this section does not apply to the extent that—

(i) A provision of the Internal Revenue Code or the regulations promulgated thereunder prescribes the treatment of a partnership as an entity, in whole or in part, and

(ii) That treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

(f) *Examples.* The following examples illustrate the principles of paragraph (e) of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise indicated, parties to the transactions are not related to one another.

Example 1. Aggregate treatment of partnership appropriate to carry out purpose of section 163(e)(5). (i) Corporations X and Y are partners in partnership PRS, which for several years has engaged in substantial bona fide business activities. As part of these business activities, PRS issues certain high yield discount obligations to an unrelated third party. Section 163(e)(5) defers (and in certain circumstances disallows) the interest deductions on this type of obligation if issued by a corporation. PRS, X, and Y take the position that, because PRS is a partnership and not a corporation, section 163(e)(5) is not applicable.

(ii) Section 163(e)(5) does not prescribe the treatment of a partnership as an entity for purposes of that section. The purpose of section 163(e)(5) is to limit corporate-level interest deductions on certain obligations. The treatment of PRS as an entity could result in a partnership with corporate partners issuing those obligations and thereby circumventing the purpose of section 163(e)(5), because the corporate partner would deduct its distributive share of the interest on obligations that would have been deferred until paid or disallowed had the corporation issued its share of the obligation directly. Thus, under paragraph (e)(1) of this section, PRS is properly treated as an aggregate of its partners for purposes of applying section 163(e)(5) (regardless of whether any party had a tax avoidance purpose in having PRS issue the obligation). Each partner of PRS will therefore be treated as issuing its share of the obligations for purposes of determining the deductibility of its distributive share of any interest on the obligations. See also section 163(i)(5)(B).

Example 2. Aggregate treatment of partnership appropriate to carry out purpose of section 1059. (i) Corporations X and Y are partners in partnership PRS, which for several years has engaged in substantial bona fide business activities. As part of these business activities, PRS purchases 50 shares of Corporation Z common stock. Six months later, Corporation Z announces an extraordinary dividend (within the meaning of section 1059). Section 1059(a) generally provides that if any corporation receives an extraordinary dividend with respect to any share of stock and the corporation has not held the stock for more than two years before the dividend announcement date, the basis in the stock held by the corporation is reduced by the nontaxed portion of the dividend. PRS, X, and Y take the position that section 1059(a) is not applicable because PRS is a partnership and not a corporation.

(ii) Section 1059(a) does not prescribe the treatment of a partnership as an entity for purposes of that section. The purpose of section 1059(a) is to limit the benefits of the dividends received deduction with respect to extraordinary dividends. The treatment of PRS as an entity could result in corporate partners in the partnership receiving dividends through partnerships in circumvention of the intent of section 1059. Thus, under paragraph (e)(1) of this section, PRS is properly treated as an aggregate of its partners for purposes of applying section 1059 (regardless of whether any party had a tax avoidance purpose in acquiring the Z stock through PRS). Each partner of PRS will therefore be treated as owning its share of the stock. Accordingly, PRS must make appropriate adjustments to the basis of the Corporation Z stock, and the partners must also make adjustments to the basis in their respective interests in PRS under section 705(a)(2)(B). See also section 1059(g)(1).

Example 3. Prescribed entity treatment of partnership; determination of CFC status clearly contemplated. (i) X, a domestic corporation, and Y, a foreign corporation, intend to conduct a joint venture in foreign Country A. They form PRS, a bona fide domestic general partnership in which X owns a 40% interest and Y owns a 60% interest. PRS is properly classified as a partnership under §§ 301.7701–2 and 301.7701–3. PRS holds 100% of the voting stock of Z, a Country A entity that is classified as an association taxable as a corporation for federal tax purposes under § 301.7701–2. Z conducts its business operations in Country A. By investing in Z through a domestic partnership, X seeks to obtain the benefit of the look-through rules of section 904(d)(3) and, as a result, maximize its ability to claim credits for its proper share of Country A taxes expected to be incurred by Z.

(ii) Pursuant to sections 957(c) and 7701(a)(30), PRS is a United States person. Therefore, because it owns 10% or more of the voting stock of Z, PRS satisfies the definition of a U.S. shareholder under section 951(b). Under section 957(a), Z is a controlled foreign corporation (CFC) because more than 50% of the voting power or value of its stock is owned by PRS. Consequently, under section 904(d)(3), X qualifies for look-through treatment in computing its credit for foreign taxes paid or accrued by Z. In contrast, if X and Y owned their interests in Z directly, Z would not be a CFC because only 40% of its stock would be owned by U.S. shareholders. X's credit for foreign taxes paid or accrued by Z in that case would be subject to a separate foreign tax credit limitation for dividends from Z, a noncontrolled section 902 corporation. See section 904(d)(1)(E) and §1.904–4(g).

(iii) Sections 957(c) and 7701(a)(30) prescribe the treatment of a domestic partnership as an entity for purposes of defining a U.S. shareholder, and thus, for purposes of determining whether a foreign corporation is a CFC. The CFC rules prevent the deferral by U.S. shareholders of U.S. taxation of certain earnings of the CFC and reduce disparities that otherwise might occur between the amount of income subject to a particular foreign tax credit limitation when a taxpayer earns income abroad directly rather than indirectly through a CFC. The application of the look-through rules for foreign tax credit purposes is appropriately tied to CFC status. See sections 904(d)(2)(E) and 904(d)(3). This analysis confirms that Congress clearly contemplated that taxpayers could use a bona fide domestic partnership to subject themselves to the CFC regime, and the resulting application of the look-through rules of section 904(d)(3). Accordingly, under paragraph (e) of this section, the Commissioner cannot treat PRS as an aggregate of its partners for purposes of determining X's foreign tax credit limitation.

(g) *Effective date.* Paragraphs (a), (b), (c), and (d) of this section are effective for all transactions involving a partnership that occur on or after May 12, 1994. Paragraphs (e) and (f) of this section are effective for all transactions involving a partnership that occur on or after December 29, 1994.

(h) *Scope and application.* This section applies solely with respect to taxes under subtitle A of the Internal Revenue Code, and for purposes of this section, any reference to a federal tax is limited to any tax imposed under subtitle A of the Internal Revenue Code.

(i) *Application of nonstatutory principles and other statutory authorities.* The Commissioner can continue to assert and to rely upon applicable nonstatutory principles and other statutory and regulatory authorities to challenge transactions. This section does not limit the applicability of those principles and authorities.

[T.D. 8588, 60 FR 27, Jan. 3, 1995; T.D. 8588, 60 FR 9776, 9777, Feb. 22, 1995, as amended by T.D. 8592, 60 FR 18741, April 13, 1995]

§1.702–1 Income and credits of partner.

(a) *General rule.* Each partner is required to take into account separately in his return his distributive share, whether or not distributed, of each class or item of partnership income, gain, loss, deduction, or credit described in subparagraphs (1) through (9) of this paragraph. (For the taxable year in which a partner includes his distributive share of partnership taxable income, see section 706(a) and §1.706–1(a). Such distributive share shall be determined as provided in section 704 and §1.704–1.) Accordingly, in determining his income tax:

(1) Each partner shall take into account, as part of his gains and losses from sales or exchanges of capital assets held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), his distributive share of the combined net amount of such gains and losses of the partnership.

(2) Each partner shall take into account, as part of his gains and losses from sales or exchanges of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), his distributive share of the combined net amount of such gains and losses of the partnership.

(3) Each partner shall take into account, as part of his gains and losses from sales or exchanges of property described in section 1231 (relating to property used in the trade or business and involuntary conversions), his distributive share of the combined net

amount of such gains and losses of the partnership. The partnership shall not combine such items with items set forth in subparagraph (1) or (2) of this paragraph.

(4) Each partner shall take into account, as part of the charitable contributions paid by him, his distributive share of each class of charitable contributions paid by the partnership within the partnership's taxable year. Section 170 determines the extent to which such amount may be allowed as a deduction to the partner. For the definition of the term ''charitable contribution'', see section 170(c).

(5) Each partner shall take into account, as part of the dividends received by him from domestic corporations, his distributive share of dividends received by the partnership, with respect to which the partner is entitled to a credit under section 34 (for dividends received on or before December 31, 1964), an exclusion under section 116, or a deduction under part VIII, subchapter B, chapter 1 of the Code.

(6) Each partner shall take into account, as part of his taxes described in section 901 which have been paid or accrued to foreign countries or to possessions of the United States, his distributive share of such taxes which have been paid or accrued by the partnership, according to its method of treating such taxes. A partner may elect to treat his total amount of such taxes, including his distributive share of such taxes of the partnership, as a deduction under section 164 or as a credit under section 901, subject to the provisions of sections 901 through 905.

(7) Each partner shall take into account, as part of the partially tax-exempt interest received by him on obligations of the United States or on obligations of instrumentalities of the United States, as described in section 35 or section 242, his distributive share of such partially tax-exempt interest received by the partnership. However, if the partnership elects to amortize premiums on bonds as provided in section 171, the amount received on such obligations by the partnership shall be reduced by the amortizable bond premium applicable to such obligations as provided in section 171(a)(3).

(8)(i) Each partner shall take into account separately, as part of any class of income, gain, loss, deduction, or credit, his distributive share of the following items: Recoveries of bad debts, prior taxes, and delinquency amounts (section 111); gains and losses from wagering transactions (section 165(d)); soil and water conservation expenditures (section 175); nonbusiness expenses as described in section 212; medical, dental, etc., expenses (section 213); expenses for care of certain dependents (section 214); alimony, etc., payments (section 215); amounts representing taxes and interest paid to cooperative housing corporations (section 216); intangible drilling and developments costs (section 263(c)); pre-1970 exploration expenditures (section 615); certain mining exploration expenditures (section 617); income, gain, or loss to the partnership under section 751(b); and any items of income, gain, loss, deduction, or credit subject to a special allocation under the partnership agreement which differs from the allocation of partnership taxable income or loss generally.

(ii) Each partner must also take into account separately his distributive share of any partnership item which if separately taken into account by any partner would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately. Thus, if any partner would qualify for the retirement income credit under section 37 if the partnership pensions and annuities, interest, rents, dividends, and earned income were separately stated, such items must be separately stated for all partners. Under section 911(a), if any partner is a bona fide resident of a foreign country who may exclude from his gross income the part of his distributive share which qualifies as earned income as defined in section 911(b), the earned income of the partnership for all partners must be separately stated. Similarly, all relevant items of income or deduction of the partnership must be separately stated for all partners in determining the applicability of section 270 (relating to ''hobby losses'') and the recomputation of tax thereunder for any partner.

(iii) Each partner shall aggregate the amount of his separate deductions or exclusions and his distributive share of partnership deductions or exclusions separately stated in determining the amount allowable to him of any deduction or exclusion under subtitle A of the Code as to which a limitation is imposed. For example, partner A has individual domestic exploration expenditures of $300,000. He is also a member of the AB partnership which in 1971 in its first year of operation has foreign exploration expenditures of $400,000. A's distributable share of this item is $200,000. However, the total amount of his distributable share that A can deduct as exploration expenditures under section 617(a) is limited to $100,000 in view of the limitation provided in section 617(h). Therefore, the excess of $100,000 ($200,000 minus $100,000) is not deductible by A.

(9) Each partner shall also take into account separately his distributive share of the taxable income or loss of the partnership, exclusive of items requiring separate computations under subparagraphs (1) through (8) of this paragraph. For limitation on allowance of a partner's distributive share of partnership losses, see section 704(d) and paragraph (d) of §1.704–1.

(b) *Character of items constituting distributive share.* The character in the hands of a partner of any item of income, gain, loss, deduction, or credit described in section 702(a)(1) through (8) shall be determined as if such item were realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership. For example, a partner's distributive share of gain from the sale of depreciable property used in the trade or business of the partnership shall be considered as gain from the sale of such depreciable property in the hands of the partner. Similarly, a partner's distributive share of partnership ''hobby losses'' (section 270) or his distributive share of partnership charitable contributions to organizations qualifying under section 170(b)(1)(A) retains such character in the hands of the partner.

(c) *Gross income of a partner.* (1) Where it is necessary to determine the amount or character of the gross income of a partner, his gross income shall include the partner's distributive share of the gross income of the partnership, that is, the amount of gross income of the partnership from which was derived the partner's distributive share of partnership taxable income or loss (including items described in section 702(a)(1) through (8)). For example, a partner is required to include his distributive share of partnership gross income:

(i) In computing his gross income for the purpose of determining the necessity of filing a return (section 6012 (a));

(ii) In determining the application of the provisions permitting the spreading of income for services rendered over a 36-month period (section 1301, as in effect for taxable years beginning before January 1, 1964);

(iii) In computing the amount of gross income received from sources within possessions of the United States (section 931); and

(iv) In determining a partner's ''gross income from farming'' (sections 175 and 6073).

(2) In determining the applicability of the 6-year period of limitation on assessment and collection provided in section 6501(e) (relating to omission of more than 25 percent of gross income), a partner's gross income includes his distributive share of partnership gross income (as described in section 6501(e)(1)(A)(i)). In this respect, the amount of partnership gross income from which was derived the partner's distributive share of any item of partnership income, gain, loss, deduction, or credit (as included or disclosed in the partner's return) is considered as an amount of gross income stated in the partner's return for the purposes of section 6501(e). For example, A, who is entitled to one-fourth of the profits of the ABCD partnership, which has $10,000 gross income and $2,000 taxable income, reports only $300 as his distributive share of partnership profits. A should have shown $500 as his distributive share of profits, which amount was derived from $2,500 of partnership gross income. However, since A included only $300 on his return without explaining in the return the difference of $200, he is regarded as having stated in his return only $1,500 ($300/

$500 of $2,500) as gross income from the partnership.

(d) *Partners in community property States.* If separate returns are made by a husband and wife domiciled in a community property State, and only one spouse is a member of the partnership, the part of his or her distributive share of any item or items listed in paragraph (a) (1) through (9) of this section which is community property, or which is derived from community property, should be reported by the husband and wife in equal proportions.

(e) *Special rules on requirement to separately state meal, travel, and entertainment expenses.* Each partner shall take into account separately his or her distributive share of meal, travel, and entertainment expenses paid or incurred after December 31, 1986, by partnerships that have taxable years beginning before January 1, 1987, and ending with or within partner's taxable years beginning on or after January 1, 1987. In addition, with respect to skybox rentals under section 274 (1) (2), each partner shall take into account separately his or her distributive share of rents paid or incurred after December 31, 1986, by partnerships that have taxable years beginning before January 1, 1989, and ending with or within partners' taxable years beginning on or after January 1, 1987.

(f) *Cross—references.* For special rules in accordance with the principles of section 702 applicable solely for the purpose of the tax imposed by section 56 (relating to the minimum tax for tax preferences) see § 1.58–2(a). In the case of a disposition of an oil or gas property by the partnership, see the rules contained in section 613A(c)(7)(D) and § 1.613A–3(e).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6605, 27 FR 8097, Aug. 15, 1962; T.D. 6777, 29 FR 17809, Dec. 16, 1964; T.D. 6885, 31 FR 7803, June 2, 1966; T.D. 7192, 37 FR 12949, June 30, 1972; T.D. 7564, 43 FR 40496, Sept. 12, 1978; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 8247, 54 FR 13680, Apr. 5, 1989; T.D. 8348, 56 FR 21952, May 13, 1991; 57 FR 4913, Feb. 10, 1992]

§ 1.702–2 Net operating loss deduction of partner.

For the purpose of determining a net operating loss deduction under section 172, a partner shall take into account his distributive share of items of income, gain, loss, deduction, or credit of the partnership. The character of any such item shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. See section 702(b) and paragraph (b) of § 1.702–1. To the extent necessary to determine the allowance under section 172(d)(4) of the nonbusiness deductions of a partner (arising from both partnership and nonpartnership sources), the partner shall separately take into account his distributive share of the deductions of the partnership which are not attributable to a trade or business and combine such amount with his nonbusiness deductions from nonpartnership sources. Such partner shall also separately take into account his distributive share of the gross income of the partnership not derived from a trade or business and combine such amount with his nonbusiness income from nonpartnership sources. See section 172 and the regulations thereunder.

§ 1.702–3T 4-Year spread (temporary).

(a) *Applicability.* This section applies to a partner in a partnership if—

(1) The partnership is required by section 806 of the Tax Reform Act of 1986 (the 1986 Act), Pub. L. 99–514, 100 Stat. 2362, to change its taxable year for the first taxable year beginning after December 31, 1986 (partnership's year of change); and

(2) As a result of such change in taxable year, items from more than one taxable year of the partnership would, but for the provisions of this section, be included in the taxable year of the partner with or within which the partnership's year of change ends.

(b) *Partner's treatment of items from the partnership's year of change*—(1) *In general.* Except as provided in paragraph (c) of this section, if a partner's share of ‘‘income items’’ exceeds the partner's share of ‘‘expense items,’’ the partner's share of each and every income and expense item shall be taken into account ratably (and retain its character) over the partner's first 4 taxable years beginning with the partner's taxable year with or within which the partnership's year of change ends.

(2) *Definitions*—(i) *Income items.* For purposes of this section, the term *income items* means the sum of—

(A) The partner's distributive share of taxable income (exclusive of separately stated items) from the partnership's year of change,

(B) The partner's distributive share of all separately stated income or gain items from the partnership's year of change, and

(C) Any amount includible in the partner's income under section 707(c) on account of payments during the partnership's year of change.

(ii) *Expense items.* For purposes of this section, the term *expense items* means the sum of—

(A) The partner's distributive share of taxable loss (exclusive of separately stated items) from the partnership's year of change, and

(B) The partner's distributive share of all separately stated items of loss or deduction from the partnership's year of change.

(c) *Electing out of 4-year spread.* A partner may elect out of the rules of paragraph (b) of this section by meeting the requirements of § 301.9100–7T of this chapter (temporary regulations relating to elections under the Tax Reform Act of 1986).

(d) *Special rules for a partner that is a partnership or S corporation*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, a partner that is a partnership or S corporation may, if otherwise eligible, use the 4-year spread (with respect to partnership interests owned by the partner) described in this section.

(2) *Certain partners prohibited from using 4-year spread*—(i) *In general.* Except as provided in paragraph (d)(2)(ii) of this section, a partner that is a partnership or S corporation may not use the 4-year spread (with respect to partnership interests owned by the partner) if such partner is also changing its taxable year pursuant to section 806 of the 1986 Act.

(ii) *Exception.* If a partner's year of change does not include any income or expense items with respect to the partnership's year of change, such partner may, if otherwise eligible, use the 4-year spread (with respect to such partnership interest) described in this section even though the partner is a partnership or S corporation. See examples 13 and 14 in paragraph (h) of this section.

(e) *Basis of partner's interest.* The basis of a partner's interest in a partnership shall be determined as if the partner elected not to spread the partnership items over 4 years, regardless of whether such election was in fact made. Thus, for example, if a partner is eligible for the 4-year spread and does not elect out of the 4-year spread pursuant to paragraph (c) of this section, the partner's basis in the partnership interest will be increased in the first year of the 4-year spread period by an amount equal to the excess of the income items over the expense items. However, the partner's basis will not be increased again, with respect to the unamortized income and expense items, as they are amortized over the 4-year spread period.

(f) *Effect on other provisions of the Code.* Except as provided in paragraph (e) of this section, determinations with respect to a partner, for purposes of other provisions of the Code, must be made with regard to the manner in which partnership items are taken into account under the rules of this section. Thus, for example, a partner who does not elect out of the 4-year spread must take into account, for purposes of determining net earnings from self-employment under section 1402(a) for a taxable year, only the ratable portion of partnership items for that taxable year.

(g) *Treatment of dispositions*—(1) *In general.* If a partnership interest is disposed of before the last taxable year in the 4-year spread period, unamortized income and expense items that are attributable to the interest disposed of and that would be taken into account by the partner for subsequent taxable years in the 4-year spread period shall be taken into account by the partner as determined under paragraph (g)(2) of this section. For purposes of this section, the term *disposed of* means any transfer, including (but not limited to) transfers by sale, exchange, gift, and by reason of death.

(2) *Year unamortized items taken into account*—(i) *In general.* If, at the end of a partner's taxable year, the fraction determined under paragraph (g)(2)(ii) of this section is—

(A) Greater than ⅔, the partner must continue to take the unamortized income and expense items into account ratably over the 4-year spread period;

(B) Greater than ⅓ but less than or equal to ⅔, the partner must, in addition to its ratable amortization, take into account in such year 50 percent of the income and expense items that would otherwise be unamortized at the end of such year (however, this paragraph (g)(2)(i)(B) is only applied once with respect to a partner's interest in a particular partnership); or

(C) Less than or equal to ⅓, the partner must take into account the entire balance of unamortized income and expense items in such year.

(ii) *Determination of fraction.* For purposes of paragraph (g)(2)(i) of this section, the numerator of the fraction is the partner's proportionate interest in the partnership at the end of the partner's taxable year and the denominator is the partner's proportionate interest in the partnership as of the last day of the partnership's year of change.

(h) *Examples.* The provisions of this section may be illustrated by the following examples.

Example 1. Assume that P1, a partnership with a taxable year ending September 30, is required by the 1986 Act to change its taxable year to a calendar year. All of the partners of P1 are individual taxpayers reporting on a calendar year. P1 is required to change to a calendar year for its taxable year beginning October 1, 1987, and to file a return for the short taxable year ending December 31, 1987. Based on the above facts, the partners of P1 are required to include the items from more than one taxable year of P1 in income for their 1987 taxable year. Thus, under paragraph (b) of this section, if a partner's share of income items exceeds the partner's share of expense items, the partner's share of each and every income and expense item shall be taken into account ratably by such partner in each of the partner's first four taxable years' beginning with the partner's 1987 taxable year, unless such partner elects under paragraph (c) of this section to include all such amounts in his 1987 taxable year.

Example 2. Assume the same facts as in example 1, except P1 is a personal service corporation with all of its employee-owners reporting on a calendar year. Although P1 is required to change to a calendar year for its taxable year beginning October 1, 1987, neither P1 nor its employee-owners obtain the benefits of a 4-year spread. Pursuant to section 806(e)(2)(C) of the 1986 Act, the 4-year spread provision is only applicable to short taxable years of partnerships and S corporations required to change their taxable year under the 1986 Act.

Example 3. Assume the same facts as example 1 and that I is one of the individual partners of P1. Further assume that I's distributive share of P1's taxable income for the short taxable year ended December 31, 1987 (*i.e.*, P1's year of change), is $10,000. In addition, I has $8,000 of separately stated expense from P1's year of change. Since I's income items (*i.e.*, $10,000 of taxable income) exceed I's expense items (*i.e.*, $8,000 of separately stated expense) attributable to P1's year of change, I is eligible for the 4-year spread provided by this section. If I does not elect out of the 4-year spread, I will recognize $2,500 of taxable income and $2,000 of separately stated expense in his 1987 calendar year return. Assuming I does not dispose of his partnership interest in P1 by December 31, 1989, the remaining $7,500 of taxable income and $6,000 of separately stated expense will be amortized (and retain its character) over I's next three taxable years (*i.e.*, 1988, 1989 and 1990).

Example 4. Assume the same facts as example 3, except that I disposes of his entire interest in P1 during 1988. Pursuant to paragraph (g) of this section, I would recognize $7,500 of taxable income and $6,000 of separately stated expense in his 1988 calendar year return.

Example 5. Assume the same facts as in example 3, except that I disposes of 50 percent of his interest in P1 during 1989. Pursuant to paragraph (g) of this section, I would recognize $3,750 of taxable income in his 1989 calendar year return ($2,500 ratable portion for 1989 plus 50 percent of the $2,500 of income items that would otherwise be unamortized at the end of 1989). I would also recognize $3,000 of separately stated expense items in 1989 ($2,000 ratable portion for 1989 plus 50 percent of the $2,000 of separately stated expense items that would otherwise be unamortized at the end of 1989).

Example 6. Assume the same facts as in example 1, except that X, a personal service corporation as defined in section 441(i), is a partner of P1. X is a calendar year taxpayer, and thus is not required to change its taxable year under the 1986 Act. The same result occurs as in example 1 (*i.e.*, unless X elects to the contrary, X is required to include one fourth of its share of income and expense items from P1's year of change in the first four taxable years of X beginning with the 1987 taxable year).

Example 7. Assume the same facts as in example 6, except that X is a fiscal year personal service corporation with a taxable year ending September 30. X is required under the 1986 Act to change to a calendar year for its taxable year beginning October 1, 1987, and to file a return for its short year ending December 31, 1987. Based on the above facts, X is not required to include the items from more than one taxable year of P1 in any one taxable year of X. Thus, the provisions of this section do not apply to X, and X is required to include the full amount of income and expense items from P1's year of change in X's taxable income for X's short year ending December 31. Under section 443 of the Code, X is required to annualize the taxable income for its short year ending December 31, 1987.

Example 8. Assume that P2 is a partnership with a taxable year ending September 30. Under the 1986 Act, P2 would have been required to change its taxable year to a calendar year, effective for the taxable year beginning October 1, 1987. However, P2 properly changed its taxable year to a calendar year for the year beginning October 1, 1986, and filed a return for the short period ending December 31, 1986. The provisions of the 1986 Act do not apply to P2 because the short year ending December 31, 1986, was not required by the amendments made by section 806 of the 1986 Act. Thus, the partners of P2 are required to take all items of income and expense for the short taxable year ending December 31, 1986, into account for the taxable year with or within which such short year ends.

Example 9. Assume that P3 is a partnership with a taxable year ending March 31 and I, a calendar year individual, is a partner in P3. Under the 1986 Act, P3 would have been required to change its taxable year to a calendar year. However, under Rev. Proc. 87–32, P3 establishes and changes to a natural business year beginning with the taxable year ending June 30, 1987. Thus, P3 is required to change its taxable year under section 806 of the 1986 Act, and I is required to include items from more than one taxable year of P3 in one of her taxable years. Furthermore, I's share of P3's income items exceeds her share of P3's expense items for the short period April 1, 1987 through June 30, 1987. Accordingly, under this section, unless I elects to the contrary, I is required to take one fourth of her share of items of income and expense from P3's short taxable year ending June 30, 1987 into account for her taxable year ending December 31, 1987.

Example 10. Assume that P4 is a partnership with a taxable year ending March 31. Y, a C corporation, owns a 51 percent interest in the profits and capital of P4. Y reports its income on the basis of a taxable year ending March 31. P4 establishes and changes to a natural business year beginning with the taxable year ending June 30, 1987, under Rev. Proc. 87–32. Under the above facts, P4 is not required to change its taxable year because its March 31 taxable year was the taxable year of Y, the partner owning a majority of the partnership's profits and capital. Therefore, the remaining partners of P4 owning 49 percent of the profits and capital are not permitted the 4-year spread of the items of income and expense with respect to the short year, even though they may be required to include their distributive share of P4's items from more than one taxable year in one of their years.

Example 11. Assume that X and Y are C corporations with taxable years ending June 30. Each owns a 50-percent interest in the profits and capital of partnership P5. P5 has a taxable year ending March 31. Assume that P5 cannot establish a business purpose in order to retain a taxable year ending March 31, and thus P5 must change to a June 30 taxable year, the taxable year of its partners. Furthermore, assume that X's share of P5's income items exceeds its share of P5's expense items for P5's short taxable year ending June 30, 1987. Unless X elects out of the 4-year spread, the taxable year ending June 30, 1987, is the first of the four taxable years in which X must take into account its share of the items of income and expense resulting from P5's short taxable year ending June 30, 1987.

Example 12. Assume that I, an individual who reports income on the basis of the calendar year, is a partner in two partnerships, P6 and P7. Both partnerships have a taxable year ending September 30. Neither partnership can establish a business purpose for retaining its taxable year. Consequently, each partnership will change its taxable year to December 31, for the taxable year beginning October 1, 1987. The election to avoid a 4-year spread is made at the partner level; in addition, a partner may make such elections on a partnership-by-partnership basis. Thus, assuming I is eligible to obtain the 4-year spread with respect to income and expense items from partnerships P6 and P7, I may use the 4-year spread with respect to items from P6, while not using the 4-year spread with respect to items from P7.

Example 13. I, an individual taxpayer using a calendar year, owns an interest in P8, a partnership using a taxable year ending June 30. Furthermore, P8 owns an interest in P9, a partnership with a taxable year ending March 31. Under section 806 of the 1986 Act, P8 will be required to change to a taxable year ending December 31, while P9 will be required to change to a taxable year ending June 30. As a result, P8's year of change will be July 1 through December 31, 1987, while P9's year of change will be from April 1 through June 30, 1987. Since P9's year of change does not end with or within P8's year of change, paragraph (d)(2) of this section does not prevent P8 from obtaining a 4-year spread with respect to its interest in P9.

Example 14. The facts are the same as in example 13, except that P9 has a taxable year ending September 30, and under the 1986 Act P9 is required to change to a taxable year ending December 31. Therefore, P9's year of change will be from October 1, 1987 through December 31, 1987. Although P8's year of change from July 1, 1987 through December 31, 1987 includes two taxable years of P9 (*i.e.*, October 1, 1986 through September 30, 1987 and October 1, 1987 through December 31, 1987), paragraph (d)(2) of this section prohibits P8 from using the 4-year spread with respect to its interest in P9, because P9's year of change ends with or within P8's year of change.

[T.D. 8167, 52 FR 48530, Dec. 23, 1987, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

§ 1.703–1 Partnership computations.

(a) *Income and deductions.* (1) The taxable income of a partnership shall be computed in the same manner as the taxable income of an individual, except as otherwise provided in this section. A partnership is required to state separately in its return the items described in section 702(a)(1) through (7) and, in addition, to attach to its return a statement setting forth separately those items described in section 702(a)(8) which the partner is required to take into account separately in determining his income tax. See paragraph (a)(8) of § 1.702–1. The partnership is further required to compute and to state separately in its return:

(i) As taxable income under section 702(a)(9), the total of all other items of gross income (not separately stated) over the total of all other allowable deductions (not separately stated), or

(ii) As loss under section 702(a)(9), the total of all other allowable deductions (not separately stated) over the total of all other items of gross income (not separately stated).

The taxable income or loss so computed shall be accounted for by the partners in accordance with their partnership agreement.

(2) The partnership is not allowed the following deductions:

(i) The standard deduction provided in section 141.

(ii) The deduction for personal exemptions provided in section 151.

(iii) The deduction provided in section 164(a) for taxes, described in section 901, paid or accrued to foreign countries or possessions of the United States. Each partner's distributive share of such taxes shall be accounted for separately by him as provided in section 702(a)(6).

(iv) The deduction for charitable contributions provided in section 170. Each partner is considered as having paid within his taxable year his distributive share of any contribution or gift, payment of which was actually made by the partnership within its taxable year ending within or with the partner's taxable year. This item shall be accounted for separately by the partners as provided in section 702(a)(4). See also paragraph (b) of § 1.702–1.

(v) The net operating loss deduction provided in section 172. See § 1.702–2.

(vi) The additional itemized deductions for individuals provided in part VII, subchapter B, chapter 1 of the Code, as follows: Expenses for production of income (section 212); medical, dental, etc., expenses (section 213); expenses for care of certain dependents (section 214); alimony, etc., payments (section 215); and amounts representing taxes and interest paid to cooperative housing corporation (section 216). However, see paragraph (a)(8) of § 1.702–1.

(vii) The deduction for depletion under section 611 with respect to domestic oil or gas which is produced after December 31, 1974, and to which gross income from the property is attributable after such year.

(viii) The deduction for capital gains provided by section 1202 and the deduction for capital loss carryover provided by section 1212.

(b) *Elections of the partnership*—(1) *General rule.* Any elections (other than those described in subparagraph (2) of this paragraph) affecting the computation of income derived from a partnership shall be made by the partnership. For example, elections of methods of accounting, of computing depreciation, of treating soil and water conservation expenditures, and the option to deduct as expenses intangible drilling and development costs, shall be made by the partnership and not by the partners separately. All partnership elections are applicable to all partners equally, but any election made by a partnership shall not apply to any partner's nonpartnership interests.

(2) *Exceptions.* (i) Each partner shall add his distributive share of taxes described in section 901 paid or accrued by the partnership to foreign countries or possessions of the United States (according to its method of treating such taxes) to any such taxes paid or accrued by him (according to his method of treating such taxes), and may elect to use the total amount either as a credit against tax or as a deduction from income.

(ii) Each partner shall add his distributive share of expenses described in section 615 or section 617 paid or accrued by the partnership to any such expenses paid or accrued by him and shall treat the total amount according to his method of treating such expenses, notwithstanding the treatment of the expenses by the partnership.

(iii) Each partner who is a nonresident alien individual or a foreign corporation shall add his distributive share of income derived by the partnership from real property located in the United States, as described in section 871(d)(1) or 882(d)(1), to any such income derived by him and may elect under §1.871–10 to treat all such income as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7192, 37 FR 12949, June 30, 1972; T.D. 7332, 39 FR 44232, Dec. 23, 1974; T.D. 8348, 56 FR 21952, May 13, 1991]

§1.704–1 Partner's distributive share.

(a) *Effect of partnership agreement.* A partner's distributive share of any item or class of items of income, gain, loss, deduction, or credit of the partnership shall be determined by the partnership agreement, unless otherwise provided by section 704 and paragraphs (b) through (e) of this section. For definition of partnership agreement see section 761(c).

(b) *Determination of partner's distributive share*—(0) *Cross-references.*

Heading	Section
Cross-references	1.704–1(b)(2)(iv)(*d*)(*2*)
In general	1.704–1(b)(2)(iv)(*d*)(*3*)
Basic principles	1.704–1(b)(1)(i)
Effective dates	1.704–1(b)(2)(iv)(*e*)(*1*)
Effect of other sections	1.704–1(b)(2)(iv)(*e*)(*2*)
Other possible tax consequences.	1.704–1(b)(1)(iv)
Purported allocations	1.704–1(b)(1)(v)
Section 704(c) determinations.	1.704–1(b)(1)(vi)
Bottom line allocations	1.704–1(b)(1)(vii)
Substantial economic effect	1.704–1(b)(2)
Two-part analysis	1.704–1(b)(2)(i)
Economic effect	1.704–1(b)(2)(ii)
Fundamental principles.	1.704–1(b)(2)(ii)(*a*)
Three requirements	1.704–1(b)(2)(ii)(*b*)
Obligation to restore deficit.	1.704–1(b)(2)(ii)(*c*)
Alternate test for economic effect.	1.704–1(b)(2)(ii)(*d*)
Partial economic effect.	1.704–1(b)(2)(ii)(*e*)
Reduction of obligation to restore.	1.704–1(b)(2)(ii)(*f*)
Liquidation defined	1.704–1(b)(2)(ii)(*g*)
Partnership agreement defined.	1.704–1(b)(2)(ii)(*h*)
Economic effect equivalence.	1.704–1(b)(2)(ii)(*i*)
Substantiality	1.704–1(b)(2)(iii)
General rules	1.704–1(b)(2)(iii)(*a*)
Shifting tax consequences.	1.704–1(b)(2)(iii)(*b*)
Transitory allocations.	1.704–1(b)(2)(iii)(*c*)
Maintenance of capital accounts.	1.704–1(b)(2)(iv)
In general	1.704–1(b)(2)(iv)(*a*)
Basic rules	1.704–1(b)(2)(iv)(*b*)
Treatment of liabilities	1.704–1(b)(2)(iv)(*c*)
Contributed property	1.704–1(b)(2)(iv)(*d*)
In general	1.704–1(b)(2)(iv)(*d*)(*1*)
Contribution of promissory notes.	1.704–1(b)(2)(*d*)(*2*)
Section 704(c) considerations.	1.704–1(b)(2)(*iv*)(*3*)
Distributed property	1.704–1(b)(2)(iv)(*e*)
In general	1.704–1(2)(iv)(*e*)(*1*)
Distribution of promissory notes.	1.704–1(b)(2)(*e*)(*2*)
Revaluations of property	1.704–1(b)(2)(iv)(*f*)
Adjustments to reflect book value.	1.704–1(b)(2)(iv)(*g*)
In general	1.704–1(b)(2)(iv)(*g*)(*1*)
Payables and receivables.	1.704–1(b)(2)(iv)(*g*)(*2*)
Determining amount of book items.	1.704–1(b)(2)(iv)(*g*)(*3*)
Determinations of fair market value.	1.704–1(b)(2)(iv)(*h*)
Section 705(a)(2)(B) expenditures.	1.704–1(b)(2)(iv)(*i*)
In general	1.704–1(b)(2)(iv)(*i*)(*1*)
Expenses described in section 709.	1.704–1(b)(2)(iv)(*i*)(*2*)
Disallowed losses	1.704–1(b)(2)(iv)(*i*)(*3*)
Basis adjustments to section 38 property.	1.704–1(b)(2)(iv)(*j*)
Depletion of oil and gas properties.	1.704–1(b)(2)(iv)(*k*)
In general	1.704–1(b)(2)(iv)(*k*)(*1*)
Simulated depletion	1.704–1(b)(2)(iv)(*k*)(*2*)
Actual depletion	1.704–1(b)(2)(iv)(*k*)(*3*)
Effect of book values	1.704–1(b)(2)(iv)(*k*)(*4*)
Transfers of partnership interests.	1.704–1(b)(2)(iv)(l)
Section 754 elections	1.704–1(b)(2)(iv)(m)
In general	1.704–1(b)(2)(iv)(*m*)(*1*)

Heading	Section
Section 743 adjustments.	1.704–1(b)(2)(iv)(*m*)(*2*)
Section 732 adjustments.	1.704–1(b)(2)(iv)(*m*)(*3*)
Section 734 adjustments.	1.704–1(b)(2) iv)(*m*)(*4*)
Limitations on adjustments.	1.704–1(b)(2) iv)(*m*)(*5*)
Partnership level characterization.	1.704–1(b)(2)(iv)(*n*)
Guaranteed payments	1.704–1(b)(2)(iv)(*o*)
Minor discrepancies	1.704–1(b)(2)(iv)(*p*)
Adjustments where guidance is lacking.	1.704–1(b)(2)(iv)(*q*)
Restatement of capital accounts.	1.704–1(b)(2)(iv)(*r*)
Partner's interest in the partnership.	1.704–1(b)(3)
In general	1.704–1(b)(3)(i)
Factors considered ..	1.704–1(b)(3)(ii)
Certain determinations.	1.704–1(b)(3)(iii)
Special rules	1.704–1(b)(4)
Allocations to reflect revaluations.	1.704–1(b)(4)(i)
Credits	1.704–1(b)(4)(ii)
Excess percentage depletion.	1.704–1(b)(4)(iii)
Allocations attributable to nonrecourse liabilities.	1.704–1(b)(4)(iv)
Allocations under section 613A(c(7)(D).	1.704–1(b)(4)(v)
Amendments to partnership agreement.	1.704–1(b)(4)(vi)
Recapture	1.704–1(b)(4)(vii)
Examples	1.704–1(b)(5)

(1) *In general*—(i) *Basic principles.* Under section 704(b) if a partnership agreement does not provide for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner, or if the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner but such allocation does not have substantial economic effect, then the partner's distributive share of such income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with such partner's interest in the partnership (taking into account all facts and circumstances). If the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner, there are three ways in which such allocation will be respected under section 704(b) and this paragraph. First, the allocation can have substantial economic effect in accordance with paragraph (b)(2) of this section. Second, taking into account all facts and circumstances, the allocation can be in accordance with the partner's interest in the partnership. See paragraph (b)(3) of this section. Third, the allocation can be deemed to be in accordance with the partner's interest in the partnership pursuant to one of the special rules contained in paragraph (b)(4) of this section and § 1.704–2. To the extent an allocation under the partnership agreement of income, gain, loss, deduction, or credit (or item thereof) to a partner does not have substantial economic effect, is not in accordance with the partner's interest in the partnership, and is not deemed to be in accordance with the partner's interest in the partnership, such income, gain, loss, deduction, or credit (or item thereof) will be reallocated in accordance with the partner's interest in the partnership (determined under paragraph (b)(3) of this section).

(ii) *Effective dates.* The provisions of this paragraph are effective for partnership taxable years beginning after December 31, 1975. However, for partnership taxable years beginning after December 31, 1975, but before May 1, 1986, (January 1, 1987, in the case of allocations of nonrecourse deductions as defined in paragraph (b)(4)(iv)(*a*) of this section) an allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner that is not respected under this paragraph nevertheless will be respected under section 704(b) if such allocation has substantial economic effect or is in accordance with the partners' interests in the partnership as those terms have been interpreted under the relevant case law, the legislative history of section 210(d) of the Tax Reform Act of 1976, and the provisions of this paragraph in effect for partnership taxable years beginning before May 1, 1986.

(iii) *Effect of other sections.* The determination of a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) under section 704(b) and this paragraph is not conclusive as to the tax treatment of a partner with respect to such distributive share. For example, an allocation of loss or deduction to a partner that is respected under section 704(b) and this paragraph may not be deductible by such partner if the partner lacks the requisite motive for economic gain (see, *e.g., Goldstein v. Commissioner,* 364 F.2d 734 (2d Cir. 1966)), or may be disallowed for that taxable year (and held in suspense) if the limitations of section 465 or section 704(d) are applicable. Similarly, an allocation that is respected under section 704(b) and this paragraph nevertheless may be reallocated under other provisions, such as section 482, section 704(e)(2), section 706(d) (and related assignment of income principles), and paragraph (b)(2)(ii) of §1.751–1. If a partnership has a section 754 election in effect, a partner's distributive share of partnership income, gain, loss, or deduction may be affected as provided in §1.743–1 (see paragraph (b)(2)(iv)(*m*)(*2*) of this section). A deduction that appears to be a nonrecourse deduction deemed to be in accordance with the partners' interests in the partnership may not be such because purported nonrecourse liabilities of the partnership in fact constitute equity rather than debt. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address the effect of other sections or limitations on such allocations.

(iv) *Other possible tax consequences.* Allocations that are respected under section 704(b) and this paragraph may give rise to other tax consequences, such as those resulting from the application of section 61, section 83, section 751, section 2501, paragraph (f) of §1.46–3, §1.47–6, paragraph (b)(1) of §1.721–1 (and related principles), and paragraph (e) of §1.752–1. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address other tax consequences that may result from such allocations.

(v) *Purported allocations.* Section 704(b) and this paragraph do not apply to a purported allocation if it is made to a person who is not a partner of the partnership (see section 7701(a)(2) and paragraph (d) of §301.7701–3) or to a person who is not receiving the purported allocation in his capacity as a partner (see section 707(a) and paragraph (a) of §1.707–1).

(vi) *Section 704(c) determinations.* Section 704(c) and §1.704–3 generally require that if property is contributed by a partner to a partnership, the partners' distributive shares of income, gain, loss, and deduction, as computed for tax purposes, with respect to the property are determined so as to take account of the variation between the adjusted tax basis and fair market value of the property. Although section 704(b) does not directly determine the partners' distributive shares of tax items governed by section 704(c), the partners' distributive shares of tax items may be determined under section 704(c) and §1.704–3 (depending on the allocation method chosen by the partnership under §1.704–3) with reference to the partners' distributive shares of the corresponding book items, as determined under section 704(b) and this paragraph. (See paragraphs (b)(2)(iv)(*d*) and (b)(4)(i) of this section.) See §1.704–3 for methods of making allocations under section 704(c), and §1.704–3(d)(2) for a special rule in determining the amount of book items if the remedial allocation method is chosen by the partnership. See also paragraph (b)(5) *Example (13)* (i) of this section.

(vii) *Bottom line allocations.* Section 704(b) and this paragraph are applicable to allocations of income, gain, loss, deduction, and credit, allocations of specific items of income, gain, loss, deduction, and credit, and allocations of partnership net or ‘‘bottom line'' taxable income and loss. An allocation to a partner of a share of partnership net or ‘‘bottom line'' taxable income or loss shall be treated as an allocation to such partner of the same share of each item of income, gain, loss, and deduction that is taken into account in computing such net or ‘‘bottom line'' taxable income or loss. See example 15(i) of paragraph (b)(5) of this section.

(2) *Substantial economic effect*—(i) *Two-part analysis.* The determination of whether an allocation of income, gain, loss, or deduction (or item thereof) to a partner has substantial economic effect involves a two-part analysis that is made as of the end of the partnership taxable year to which the allocation relates. First, the allocation must have economic effect (within the meaning of paragraph (b)(2)(ii) of this section).

Second, the economic effect of the allocation must be substantial (within the meaning of paragraph (b)(2)(iii) of this section).

(ii) *Economic effect*—(*a*) *Fundamental principles.* In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.

(*b*) *Three requirements.* Based on the principles contained in paragraph (b)(2)(ii)(*a*) of this section, and except as otherwise provided in this paragraph, an allocation of income, gain, loss, or deduction (or item thereof) to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides—

(*1*) For the determination and maintenance of the partners' capital accounts in accordance with the rules of paragraph (b)(2)(iv) of this section,

(*2*) Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (*2*) and requirement (*3*) of this paragraph (b)(2)(ii)(*b*)), by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), and

(*3*) If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (*3*)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with requirement (*2*) of this paragraph (b)(2)(*ii*)(*b*)).

For purposes of the preceding sentence, a partnership taxable year shall be determined without regard to section 706(c)(2)(A). Requirements (*2*) and (*3*) of this paragraph (b)(2)(ii)(*b*) are not violated if all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners (or one or more persons related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to a partner) pursuant to an agreement negotiated at arm's length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid the principles of the second sentence of paragraph (b)(2)(ii)(*a*) of this section. In addition, requirement (*2*) of this paragraph (b)(2)(ii)(*b*) is not violated if, upon the liquidation of the partnership, the capital accounts of the partners are increased or decreased pursuant to paragraph (b)(2)(iv)(*f*) of this section as of the date of such liquidation and the partnership makes liquidating distributions within the time set out in that requirement (*2*) in the ratios of the partners' positive capital accounts, except that it does not distribute reserves reasonably required to provide for liabilities (contingent or otherwise) of the partnership and installment obligations owed to the partnership, so long as such withheld amounts are distributed as soon as practicable and in the ratios of the partners' positive capital account balances. See examples 1(i) and (ii), (4)(i), (8)(i), and (16)(i) of paragraph (b)(5) of this section.

(*c*) *Obligation to restore deficit.* If a partner is not expressly obligated to restore the deficit balance in his capital account, such partner nevertheless will be treated as obligated to restore the deficit balance in his capital account (in accordance with requirement

(*3*) of paragraph (b)(2)(ii)(*b*) of this section) to the extent of—

(*1*) The outstanding principal balance of any promissory note (of which such partner is the maker) contributed to the partnership by such partner (other than a promissory note that is readily tradable on an established securities market), and

(*2*) The amount of any unconditional obligation of such partner (whether imposed by the partnership agreement or by State or local law) to make subsequent contributions to the partnership (other than pursuant to a promissory note of which such partner is the maker),

provided that such note or obligation is required to be satisfied at a time no later than the end of the partnership taxable year in which such partner's interest is liquidated (or, if later, within 90 days after the date of such liquidation). If a promissory note referred to in the previous sentence is negotiable, a partner will be considered required to satisfy such note within the time period specified in such sentence if the partnership agreement provides that, in lieu of actual satisfication, the partnership will retain such note and such partner will contribute to the partnership the excess, if any, of the outstanding principal balance of such note over its fair market value at the time of liquidation. See paragraph (b)(2)(iv)(*d*)(*2*) of this section. See examples (1)(ix) and (x) of paragraph (b)(5) of this section. A partner in no event will be considered obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (*3*) of paragraph (b)(2)(ii)(*b*) of this section) to the extent such partner's obligation is not legally enforceable, or the facts and circumstances otherwise indicate a plan to avoid or circumvent such obligation. See paragraphs (b)(2)(ii)(*f*), (b)(2)(ii)(*h*), and (b)(4)(vi) of this section for other rules regarding such obligation. For purposes of this paragraph (b)(2), if a partner contributes a promissory note to the partnership during a partnership taxable year beginning after December 29, 1988 and the maker of such note is a person related to such partner (within the meaning of §1.752–1T(h), but without regard to subdivision (4) of that section), then such promissory note shall be treated as a promissory note of which such partner is the maker.

(*d*) *Alternate test for economic effect.* If—

(*1*) Requirements (*1*) and (*2*) of paragraph (b)(2)(ii)(*b*) of this section are satisfied, and

(*2*) The partner to whom an allocation is made is not obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (*3*) of paragraph (b)(2)(ii)(*b*) of this section), or is obligated to restore only a limited dollar amount of such deficit balance, and

(*3*) The partnership agreement contains a ‘‘qualified income offset,’’

such allocation will be considered to have economic effect under this paragraph (b)(2)(ii)(*d*) to the extent such allocation does not cause or increase a deficit balance in such partner's capital account (in excess of any limited dollar amount of such deficit balance that such partner is obligated to restore) as of the end of the partnership taxable year to which such allocation relates. In determining the extent to which the previous sentence is satisfied, such partner's capital account also shall be reduced for—

(*4*) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner's capital account under paragraph (b)(2)(iv)(*k*) of this section for depletion allowances with respect to oil and gas properties of the partnership, and

(*5*) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of §751–1, and

(*6*) Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner's capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made (other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(*e*) of this section or under §1.704–2(f); however, increases to a partner's capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain).

For purposes of determining the amount of expected distributions and expected capital account increases described in (*6*) above, the rule set out in paragraph (b)(2)(iii)(*c*) of this section concerning the presumed value of partnership property shall apply. The partnership agreement contains a ''qualified income offset'' if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in (*4*), (*5*), or (*6*) above, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible. Allocations of items of income and gain made pursuant to the immediately preceding sentence shall be deemed to be made in accordance with the partners' interests in the partnership if requirements (*1*) and (*2*) of paragraph (b)(2)(ii)(*b*) of this section are satisfied. See examples (1)(iii), (iv), (v), (vi), (viii), (ix), and (x), (15), and (16)(ii) of paragraph (b)(5) of this section.

(*e*) *Partial economic effect.* If only a portion of an allocation made to a partner with respect to a partnership taxable year has economic effect, both the portion that has economic effect and the portion that is reallocated shall consist of a proportionate share of all items that made up the allocation to such partner for such year. See examples (15) (ii) and (iii) of paragraph (b)(5) of this section.

(*f*) *Reduction of obligation to restore.* If requirements (*1*) and (*2*) of paragraph (b)(2)(ii)(*b*) of this section are satisfied, a partner's obligation to restore the deficit balance in his capital account (or any limited dollar amount thereof) to the partnership may be eliminated or reduced as of the end of a partnership taxable year without affecting the validity of prior allocations (see paragraph (b)(4)(vi) of this section) to the extent the deficit balance (if any) in such partner's capital account, after reduction for the items described in (*4*), (*5*), and (*6*) of paragraph (b)(2)(ii)(*d*) of this section, will not exceed the partner's remaining obligation (if any) to restore the deficit balance in his capital account. See example (1)(viii) of paragraph (b)(5) of this section.

(*g*) *Liquidation defined.* For purposes of this paragraph, a liquidation of a partner's interest in the partnership occurs upon the earlier of (*1*) the date upon which there is a liquidation of the partnership, or (*2*) the date upon which there is a liquidation of the partner's interest in the partnership under paragraph (d) of § 1.761–1. For purposes of this paragraph, the liquidation of a partnership occurs upon the earlier of (*3*) the date upon which the partnership is terminated under section 708(b)(1), or (*4*) the date upon which the partnership ceases to be a going concern (even though it may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its partners). Requirements (*2*) and (*3*) of paragraph (b)(2)(ii)(*b*) of this section will be considered unsatisfied if the liquidation of a partner's interest in the partnership is delayed after its primary business activities have been terminated (for example, by continuing to engage in a relatively minor amount of business activity, if such actions themselves do not cause the partnership to terminate pursuant to section 708(b)(1)) for a principal purpose of deferring any distribution pursuant to requirement (*2*) of paragraph (b)(2)(ii)(*b*) of this section or deferring any partner's obligations under requirement (*3*) of paragraph (b)(2)(ii)(*b*) of this section.

(*h*) *Partnership agreement defined.* For purposes of this paragraph, the partnership agreement includes all agreements among the partners, or between one or more partners and the partnership, concerning affairs of the partnership and responsibilities of partners, whether oral or written, and whether or not embodied in a document referred to by the partners as the partnership agreement. Thus, in determining whether distributions are required in all cases to be made in accordance with the partners' positive capital account balances (requirement (*2*) of paragraph (b)(2)(ii)(*b*) of this section), and in determining the extent to which a partner is obligated to restore a deficit balance in his capital account (requirement (*3*) of paragraph (b)(2)(ii)(*b*) of this section), all arrangements among partners, or between one or more partners and the partnership relating to the partnership, direct and indirect, including puts, options, and other buy-sell agreements, and any other ‘‘stop-loss’’ arrangement, are considered to be part of the partnership agreement. (Thus, for example, if one partner who assumes a liability of the partnership is indemnified by another partner for a portion of such liability, the indemnifying partner (depending upon the particular facts) may be viewed as in effect having a partial deficit makeup obligation as a result of such indemnity agreement.) In addition, the partnership agreement includes provisions of Federal, State, or local law that govern the affairs of the partnership or are considered under such law to be a part of the partnership agreement (see the last sentence of paragraph (c) of §1.761–1). For purposes of this paragraph (b)(2)(ii)(*h*), an agreement with a partner or a partnership shall include an agreement with a person related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to such partner or partnership. For purposes of the preceding sentence, sections 267(b) and 707(b)(1) shall be applied for partnership taxable years beginning after December 29, 1988 by *(1)* substituting ‘‘80 percent or more’’ for ‘‘more than 50 percent’’ each place it appears in such sections, *(2)* excluding brothers and sisters from the members of a person’s family, and *(3)* disregarding §267(f)(1)(A).

(*i*) *Economic effect equivalence.* Allocations made to a partner that do not otherwise have economic effect under this paragraph (b)(2)(ii) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if requirements (*1*), (*2*), and (*3*) of paragraph (b)(2)(ii)(*b*) of this section had been satisfied, regardless of the economic performance of the partnership. See examples (4)(ii) and (iii) of paragraph (b)(5) of this section.

(iii) *Substantiality*—(*a*) *General rules.* Except as otherwise provided in this paragraph (b)(2)(iii), the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Notwithstanding the preceding sentence, the economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement, (*1*) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (*2*) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner’s tax attributes that are unrelated to the partnership will be taken into account. See examples 5 and 9 of paragraph (b)(5) of this section. The economic effect of an allocation is not substantial in the two situtations described in paragraphs (b)(2)(iii) (*b*) and (*c*) of this section. However, even if an allocation is not described therein, its economic effect may be insubstantial under the general rules stated in this paragraph (b)(2)(iii)(*a*). References in this paragraph (b)(2)(iii) to allocations include capital account adjustments made pursuant to paragraph (b)(2)(iv)(*k*) of this section.

(*b*) *Shifting tax consequences.* The economic effect of an allocation (or allocations) in a partnership taxable year is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, there is a strong likelihood that—

(*1*) The net increases and decreases that will be recorded in the partners' respective capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such year if the allocations were not contained in the partnership agreement, and

(*2*) The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership).

If, at the end of a partnership taxable year to which an allocation (or allocations) relates, the net increases and decreases that are recorded in the partners' respective capital accounts do not differ substantially from the net increases and decreases that would have been recorded in such partners' respective capital accounts had the allocation (or allocations) not been contained in the partnership agreement, and the total tax liability of the partners is (as described in (*2*) above) less than it would have been had the allocation (or allocations) not been contained in the partnership agreement, it will be presumed that, at the time the allocation (or allocations) became part of such partnership agreement, there was a strong likelihood that these results would occur. This presumption may be overcome by a showing of facts and circumstances that prove otherwise. See examples 6, 7(ii) and (iii), and (10)(ii) of paragraph (b)(5) of this section.

(*c*) *Transitory allocations.* If a partnership agreement provides for the possibility that one or more allocations (the ''original allocation(s)'') will be largely offset by one or more other allocations (the ''offsetting allocation(s)''), and, at the time the allocations become part of the partnership agreement, there is a strong likelihood that—

(*1*) The net increases and decreases that will be recorded in the partners' respective capital accounts for the taxable years to which the allocations relate will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such years if the original allocation(s) and offsetting allocation(s) were not contained in the partnership agreement, and

(*2*) The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership)

the economic effect of the original allocation(s) and offsetting allocation(s) will not be substantial. If, at the end of a partnership taxable year to which an offsetting allocation(s) relates, the net increases and decreases recorded in the partners' respective capital accounts do not differ substantially from the net increases and decreases that would have been recorded in such partners' respective capital accounts had the original allocation(s) and the offsetting allocation(s) not been contained in the partnership agreement, and the total tax liability of the partners is (as described in (*2*) above) less than it would have been had such allocations not been contained in the partnership agreement, it will be presumed that, at the time the allocations became part of the partnership agreement, there was a strong likelihood that these results would occur. This presumption may be overcome by a showing of facts and circumstances that prove otherwise. See examples (1)(xi), (2), (3), (7), (8)(ii), and (17) of paragraph (b)(5) of this section. Notwithstanding the foregoing, the original allocation(s) and the offsetting allocation(s) will not be insubstantial (under this paragraph (b)(2)(iii)(*c*)) and, for purposes of paragraph (b)(2)(iii)(*a*), it will be presumed that there is a reasonable possibility that the allocations will affect substantially the dollar amounts to be received by the partners from the partnership if, at the time the allocations become part of the partnership agreement, there is a strong likelihood that the offsetting allocation(s) will not, in large part, be made within five years after the original allocation(s) is made (determined on a first-in, first-out basis). See example 2 of paragraph (b)(5) of this section. For purposes of applying the provisions of this paragraph (b)(2)(iii) (and paragraphs (b)(2)(ii)(*d*)(*6*) and (b)(3)(iii) of this section), the adjusted tax basis of partnership property (or, if partnership property is properly reflected on the books of the partnership at a book value that differs from its adjusted tax basis, the book value of such property) will be presumed to be the fair market value of such property, and adjustments to the adjusted tax basis (or book value) of such property will be presumed to be matched by corresponding changes in such property's fair market value. Thus, there cannot be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by an allocation (or allocations) of gain or loss from the disposition of partnership property. See examples 1 (vi) and (xi) of paragraph (b)(5) of this section.

(iv) *Maintenance of capital accounts—(a) In general.* The economic effect test described in paragraph (b)(2)(ii) of this section requires an examination of the capital accounts of the partners of a partnership, as maintained under the partnership agreement. Except as otherwise provided in paragraph (b)(2)(ii)(*i*) of this section, an allocation of income, gain, loss, or deduction will not have economic effect under paragraph (b)(2)(ii) of this section, and will not be deemed to be in accordance with a partner's interest in the partnership under paragraph (b)(4) of this section, unless the capital accounts of the partners are determined and maintained throughout the full term of the partnership in accordance with the capital accounting rules of this paragraph (b)(2)(iv).

(*b*) *Basic rules.* Except as otherwise provided in this paragraph (b)(2)(iv), the partners' capital accounts will be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) if, and only if, each partner's capital account is increased by (*1*) the amount of money contributed by him to the partnership, (*2*) the fair market value of property contributed by him to the partnership (net of liabilities secured by such contributed property that the partnership is considered to assume or take subject to under section 752), and (*3*) allocations to him of partnership income and gain (or items thereof), including income and gain exempt from tax and income and gain described in paragraph (b)(2)(iv)(*g*) of this section, but excluding income and gain described in paragraph (b)(4)(i) of this section; and is decreased by (*4*) the amount of money distributed to him by the partnership, (*5*) the fair market value of property distributed to him by the partnership (net of liabilities secured by such distributed property that such partner is considered to assume or take subject to under section 752), (*6*) allocations to him of expenditures of the partnership described in section 705 (a)(2)(B), and (*7*) allocations of partnership loss and deduction (or item thereof), including loss and deduction described in paragraph (b)(2)(iv)(*g*) of this section, but excluding items described in (*6*) above and loss or deduction described in paragraphs (b)(4)(i) or (b)(4)(iii) of this section; and is otherwise adjusted in accordance with the additional rules set forth in this paragraph (b)(2)(iv). For purposes of this paragraph, a partner who has more than one interest in a partnership shall have a single capital account that reflects all such interests, regardless of the class of interests owned by such partner (*e.g.*, general or limited) and regardless of the time or manner in which such interests were acquired.

(*c*) *Treatment of liabilities.* For purposes of this paragraph (b)(2)(iv), (*1*) money contributed by a partner to a partnership includes the amount of any partnership liabilities that are assumed by such partner (other than liabilities described in paragraph (b)(2)(iv)(*b*)(*5*) of this section that are assumed by a distributee partner) but does not include increases in such partner's share of partnership liabilities (see section 752(a)), and (*2*) money distributed to a partner by a partnership includes the amount of such partner's individual liabilities that are assumed by the partnership (other than liabilities described in paragraph (b)(2)(iv)(*b*)(*2*) of this section that are assumed by the partnership) but does not include decreases in such partner's share of partnership liabilities (see section 752(b)). For purposes of this paragraph (b)(2)(iv)(*c*), liabilities are considered assumed only to the extent the assuming party is thereby subjected to personal liability with respect to such obligation, the obligee is aware of the assumption and can directly enforce the assuming party's obligation, and, as between the assuming party and the party from whom the liability is assumed, the assuming party is ultimately liable.

(*d*) *Contributed property*—(*1*) *In general.* The basic capital accounting rules contained in paragraph (b)(2)(iv)(*b*) of this section require that a partner's capital account be increased by the fair market value of property contributed to the partnership by such partner on the date of contribution. See *Example 13*(i) of paragraph (b)(5) of this section. Consistent with section 752(c), section 7701(g) does not apply in determining such fair market value.

(*2*) *Contribution of promissory notes.* Notwithstanding the general rule of paragraph (b)(2)(iv)(*b*)(*2*) of this section, except as provided in this paragraph (b)(2)(iv)(*d*)(*2*), if a promissory note is contributed to a partnership by a partner who is the maker of such note, such partner's capital account will be increased with respect to such note only when there is a taxable disposition of such note by the partnership or when the partner makes principal payments on such note. See example (1)(ix) of paragraph (b)(5) of this section. The first sentence of this paragraph (b)(2)(iv)(*d*)(*2*) shall not apply if the note referred to therein is readily tradable on an established securities market. See also paragraph (b)(2)(ii)(*c*) of this section. Furthermore, a partner whose interest is liquidated will be considered as satisfying his obligation to restore the deficit balance in his capital account to the extent of (*i*) the fair market value, at the time of contribution, of any negotiable promissory note (of which such partner is the maker) that such partner contributes to the partnership on or after the date his interest is liquidated and within the time specified in paragraph (b)(2)(ii)(*b*)(*3*) of this section, and (*ii*) the fair market value, at the time of liquidation, of the unsatisfied portion of any negotiable promissory note (of which such partner is the maker) that such partner previously contributed to the partnership. For purposes of the preceding sentence, the fair market value of a note will be no less than the outstanding principal balance of such note, provided that such note bears interest at a rate no less than the applicable federal rate at the time of valuation.

(*3*) *Section 704(c) considerations.* Section 704(c) and § 1.704–3 govern the determination of the partners' distributive shares of income, gain, loss, and deduction, as computed for tax purposes, with respect to property contributed to a partnership (see paragraph (b)(1)(vi) of this section). In cases where section 704(c) and § 1.704–3 apply to partnership property, the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless the partnership agreement requires that the partners' capital accounts be adjusted in accordance with paragraph (b)(2)(iv)(*g*) of this section for allocations to them of income, gain, loss, and deduction (including depreciation, depletion, amortization, or other cost recovery) as computed for book purposes, with respect to the property. See, however, § 1.704–3(d)(2) for a special rule in determining the amount of book items if the partnership chooses the remedial allocation method. See also *Example (13)* (i) of paragraph (b)(5) of this section. Capital accounts are not adjusted to reflect allocations under section 704(c) and § 1.704–3 (e.g., tax allocations of precontribution gain or loss).

(*e*) *Distributed property*—(*1*) *In general.* The basic capital accounting rules contained in paragraph (b)(2)(iv) (*b*) of this section require that a partner's capital account be decreased by the fair market value of property distributed by the partnership (without regard to section 7701(g)) to such partner (whether in connection with a liquidation or otherwise). To satisfy this requirement, the capital accounts of the partners first must be adjusted to reflect the manner in which the unrealized income, gain, loss, and deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for the fair market value of such property (taking section 7701(g) into account) on the date of distribution. See example (14)(v) of paragraph (b)(5) of this section.

(*2*) *Distribution of promissory notes.* Notwithstanding the general rule of paragraph (b)(2)(iv)(*b*)(*5*), except as provided in this paragraph (b)(2)(iv)(*e*)(*2*), if a promissory note is distributed to a partner by a partnership that is the maker of such note, such partner's capital account will be decreased with respect to such note only when there is a taxable disposition of such note by the partner or when the partnership makes principal payments on the note. The previous sentence shall not apply if a note distributed to a partner by a partnership who is the maker of such note is readily tradable on an established securities market. Furthermore, the capital account of a partner whose interest in a partnership is liquidated will be reduced to the extent of (*i*) the fair market value, at the time of distribution, of any negotiable promissory note (of which such partnership is the maker) that such partnership distributes to the partner on or after the date such partner's interest is liquidated and within the time specified in paragraph (b)(2)(ii)(*b*)(*2*) of this section, and (*ii*) the fair market value, at the time of liquidation, of the unsatisfied portion of any negotiable promissory note (of which such partnership is the maker) that such partnership previously distributed to the partner. For purposes of the preceding sentence, the fair market value of a note will be no less than the outstanding principal balance of such note, provided that such note bears interest at a rate no less than the applicable Federal rate at time of valuation.

(*f*) *Revaluations of property.* A partnership agreement may, upon the occurrence of certain events, increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property (including intangible assets such as goodwill) on the partnership's books. Capital accounts so adjusted will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless—

(*1*) The adjustments are based on the fair market value of partnership property (taking section 7701(g) into account) on the date of adjustment, and

(*2*) The adjustments reflect the manner in which the unrealized income, gain, loss, or deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for such fair market value on that date, and

(*3*) The partnership agreement requires that the partners' capital accounts be adjusted in accordance with paragraph (b)(2)(iv)(*g*) of this section for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property, and

(*4*) The partnership agreement requires that the partners' distributive shares of depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property be determined so as to take account of the variation between the adjusted tax basis and book value of such property in the same manner as under section 704(c) (see paragraph (b)(4)(i) of this section), and

(*5*) The adjustments are made principally for a substantial non-tax business purpose—

(*i*) In connection with a contribution of money or other property (other than a *de minimis* amount) to the partnership by a new or existing partner as consideration for an interest in the partnership, or

(*ii*) In connection with the liquidation of the partnership or a distribution of money or other property (other than a *de minimis* amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, or (*iii*) Under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

See examples 14 and 18 of paragraph (b)(5) of this section. If the capital accounts of the partners are not adjusted to reflect the fair market value of partnership property when an interest in the partnership is acquired from or relinquished to the partnership, paragraphs (b)(1)(iii) and (b)(1)(iv) of this section should be consulted regarding the potential tax consequences that may arise if the principles of section 704(c) are not applied to determine the partners' distributive shares of depreciation, depletion, amortization, and gain or loss as computed for tax purposes, with respect to such property.

(*g*) *Adjustments to reflect book value*—(*1*) *In general.* Under paragraphs (b)(2)(iv)(*d*) and (b)(2)(iv)(*f*) of this section, property may be properly reflected on the books of the partnership at a book value that differs from the adjusted tax basis of such property. In these circumstances, paragraphs (b)(2)(iv)(*d*)(*3*) and (b)(2)(iv)(*f*)(*3*) of this section provide that the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless the partnership agreement requires the partners' capital accounts to be adjusted in accordance with this paragraph (b)(2)(iv)(*g*) for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property. In determining whether the economic effect of an allocation of book items is substantial, consideration will be given to the effect of such allocation on the determination of the partners' distributive shares of corresponding tax items under section 704(c) and paragraph (b)(4)(i) of this section. See example 17 of paragraph (b)(5) of this section. If an allocation of book items under the partnership agreement does not have substantial economic effect (as determined under paragraphs (b)(2)(ii) and (b)(2)(iii) of this section), or is not otherwise respected under this paragraph, such items will be reallocated in accordance with the partners' interests in the partnership, and such reallocation will be the basis upon which the partners' distributive shares of the corresponding tax items are determined under section 704(c) and paragraph (b)(4)(i) of this section. See examples 13, 14, and 18 of paragraph (b)(5) of this section.

(*2*) *Payables and receivables.* References in this paragraph (b)(2)(iv) and paragraph (b)(4)(i) of this section to book and tax depreciation, depletion, amortization, and gain or loss with respect to property that has an adjusted tax basis that differs from book value include, under analogous rules and principles, the unrealized income or deduction with respect to accounts receivable, accounts payable, and other accrued but unpaid items.

(*3*) *Determining amount of book items.* The partners' capital accounts will not be considered adjusted in accordance with this paragraph (b)(2)(iv)(*g*) unless the amount of book depreciation, depletion, or amortization for a period with respect to an item of partnership property is the amount that bears the same relationship to the book value of such property as the depreciation (or cost recovery deduction), depletion, or amortization computed for tax purposes with respect to such property for such period bears to the adjusted tax basis of such property. If such property has a zero adjusted tax basis, the book depreciation, depletion, or amortization may be determined under any reasonable method selected by the partnership.

(*h*) *Determinations of fair market value.* For purposes of this paragraph (b)(2)(iv), the fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise revalued by a partnership, will be regarded as correct, provided that (*1*) such value is reasonably agreed to among the partners in arm's-length negotiations, and (*2*) the partners have sufficiently adverse interests. If, however, these conditions are not satisfied and the value assigned to such property is overstated or understated (by more than an insignificant amount), the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv). Valuation of property contributed to the partnership, distributed by the partnership, or otherwise revalued by the partnership shall be on a property-by-property basis, except to the extent the regulations under section 704(c) permit otherwise.

(*i*) *Section 705(a)(2)(B) expenditures—(1) In general.* The basic capital accounting rules contained in paragraph (b)(2)(iv)(*b*) of this section require that a partner's capital account be decreased by allocations made to such partner of expenditures described in section 705(a)(2)(B). See example 11 of paragraph (b)(5) of this section. If an allocation of these expenditures under the partnership agreement does not have substantial economic effect (as determined under paragraphs (b)(2)(ii) and (b)(2)(iii) of this section), or is not otherwise respected under this paragraph, such expenditures will be reallocated in accordance with the partners' interest in the partnership.

(*2*) *Expenses described in section 709.* Except for amounts with respect to which an election is properly made under section 709(b), amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such a partnership shall, solely for purposes of this paragraph, be treated as section 705(a)(2)(B) expenditures, and upon liquidation of the partnership no further capital account adjustments will be made in respect thereof.

(*3*) *Disallowed losses.* If a deduction for a loss incurred in connection with the sale or exchange of partnership property is disallowed to the partnership under section 267(a)(1) or section 707(b), that deduction shall, solely for purposes of this paragraph, be treated as a section 705(a)(2)(B) expenditure.

(*j*) *Basis adjustments to section 38 property.* The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless such capital accounts are adjusted by the partners' shares of any upward or downward basis adjustments allocated to them under this paragraph (b)(2)(iv)(*j*). When there is a reduction in the adjusted tax basis of partnership section 38 property under section 48(q)(1) or section 48(q)(3), section 48(q)(6) provides for an equivalent downward adjustment to the aggregate basis of partnership interests (and no additional adjustment is made under section 705(a)(2)(B)). These downward basis adjustments shall be shared among the partners in the same proportion as the adjusted tax basis or cost of (or the qualified investment in) such section 38 property is allocated among the partners under paragraph (f) of §1.46–3 (or paragraph (a)(4)(iv) of §1.48–8). Conversely, when there is an increase in the adjusted tax basis of partnership section 38 property under section 48(q)(2), section 48(q)(6) provides for an equivalent upward adjustment to the aggregate basis of partnership interests. These upward adjustments shall be allocated among the partners in the same proportion as the investment tax credit from such property is recaptured by the partners under §1.47–6.

(*k*) *Depletion of oil and gas properties*—(1) *In general.* The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless such capital accounts are adjusted for depletion and gain or loss with respect to the oil or gas properties of the partnership in accordance with this paragraph (b)(2)(iv)(*k*).

(*2*) *Simulated depletion.* Except as provided in paragraph (b)(2)(iv)(*k*) (*3*) of this section, a partnership shall, solely for purposes of maintaining capital accounts under this paragraph, compute simulated depletion allowances with respect to its oil and gas properties at the partnership level. These allowances shall be computed on each depletable oil or gas property of the partnership by using either the cost depletion method or the percentage depletion method (computed in accordance with section 613 at the rates specified in section 613A(c)(5) without regard to the limitations of section 613A, which theoretically could apply to any partner) for each partnership taxable year that the property is owned by the partnership and subject to depletion. The choice between the simulated cost depletion method and the simulated percentage depletion method shall be made on a property-by-property basis in the first partnership taxable year beginning after April 30, 1986, for which it is relevent for the property, and shall be binding for all partnership taxable years during which the oil or gas property is held by the partnership. The partnership shall make downward adjustments to the capital accounts of the partners for the simulated depletion allowance with respect to each oil or gas property of the partnership, in the same proportion as such partners (or their precedecessors in interest) were properly allocated the adjusted tax basis of each such property. The aggregate capital account adjustments for simulated percentage depletion allowances with respect to an oil or gas property of the partnership shall not exceed the aggregate adjusted tax basis allocated to the partners with respect to such property. Upon the taxable disposition of an oil or gas property by a partnership, such partnership's simulated gain or loss shall be determined by subtracting its simulated adjusted basis in such property from the amount realized upon such disposition. (The partnership's simulated adjusted basis in an oil or gas property is determined in the same manner as adjusted tax basis except that simulated depletion allowances are taken into account instead of actual depletion allowances.) The capital accounts of the partners shall be adjusted upward by the amount of any simulated gain in proportion to such partners' allocable shares of the portion of the total amount realized from the disposition of such property that exceeds the partnership's simulated adjusted basis in such property. The capital accounts of such partners shall be adjusted downward by the amount of any simulated loss in proportion to such partners' allocable shares of the total amount realized from the disposition of such property that represents recovery of the partnership's simulated adjusted basis in such property. See section 613A(c)(7)(D) and the regulations thereunder and paragraph (b)(4)(v) of this section. See example (19)(iv) of paragraph (b)(5) of this section.

(*3*) *Actual depletion.* Pursuant to section 613A(c)(7)(D) and the regulations thereunder, the depletion allowance under section 611 with respect to the oil and gas properties of a partnership is computed separately by the partners. Accordingly, in lieu of adjusting the partner's capital accounts as provided in paragraph (b)(2)(iv)(*k*)(*2*) of this section, the partnership may make downward adjustments to the capital account of each partner equal to such partner's depletion allowance with respect to each oil or gas property of the partnership (for the partner's taxable year that ends with or within the partnership's taxable year). The aggregate adjustments to the capital account of a partner for depletion allowances with respect to an oil or gas property of the partnership shall not exceed the adjusted tax basis allocated to such partner with respect to such property. Upon the taxable disposition of an oil or gas property by a partnership, the capital account of each partner shall be adjusted upward by the amount of any excess of such partner's allocable share of the total amount realized from the disposition of such property over such partner's remaining adjusted tax basis in such property. If there is no such excess, the capital account of such partner shall be adjusted downward by the amount of any excess of such partner's remaining adjusted tax basis in such property over such partner's allocable share of the total amount realized from the disposition thereof. See section 613A(c)(7)(4)(D) and the regulations thereunder and paragraph (b)(4)(v) of this section.

(*4*) *Effect of book values.* If an oil or gas property of the partnership is, under paragraphs (b)(2)(iv(*d*) or (b)(2)(iv)(*f*) of this section, properly reflected on the books of the partnership at a book value that differs from the adjusted tax basis of such property, the rules contained in this paragraph (b)(2)(iv)(*k*) and paragraph (b)(4)(v) of this section shall be applied with reference to such book value. A revaluation of a partnership oil or gas property under paragraph (b)(2)(iv)(*f*) of this section may give rise to a reallocation of the adjusted tax basis of such property, or a change in the partners' relative shares of simulated depletion from such property, only to the extent permitted by section 613A(c)(7)(D) and the regulations thereunder.

(*l*) *Transfers of partnership interests.* The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless, upon the transfer of all or a part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner. (See paragraph (b)(2)(iv)(*m*) of this section for rules concerning the effect of a section 754 election on the capital accounts of the partners.) If the transfer of an interest in a partnership causes a termination of the partnership under section 708(b)(1)(B), the capital account of the transferee partner and the capital accounts of the other partners of the terminated partnership carry over to the new partnership that is formed as a result of the termination of the partnership under §1.708–1(b)(1)(iv). Moreover, the deemed contribution of assets and liabilities by the terminated partnership to a new partnership and the deemed liquidation of the terminated partnership that occur under §1.708–1(b)(1)(iv) are disregarded for purposes of this paragraph (b)(2)(iv). See *Example 13* of paragraph (b)(5) of this section and the example in §1.708–1(b)(1)(iv). The previous three sentences apply to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, the sentences may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply the sentences to the termination in a consistent manner.

(*m*) *Section 754 elections*—(*1*) *In general.* The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless, upon adjustment to the adjusted tax basis of partnership property under section 732, 734, or 743, the capital accounts of the partners are adjusted as provided in this paragraph (b)(2)(iv)(*m*).

(*2*) *Section 743 adjustments.* In the case of a transfer of all or a part of an interest in a partnership that has a section 754 election in effect for the partnership taxable year in which such transfer occurs, adjustments to the adjusted tax basis of partnership property under section 743 shall not be reflected in the capital account of the transferee partner or on the books of the partnership, and subsequent capital account adjustments for distributions (see paragraph (b)(2)(iv)(*e*)(1) of this section) and for depreciation, depletion, amortization, and gain or loss with respect to such property will disregard the effect of such basis adjustment. The preceding sentence shall not apply to the extent such basis adjustment is allocated to the common basis of partnership property under paragraph (b)(1) of §1.734–2; in these cases, such basis adjustment shall, except as provided in paragraph (b)(2)(iv)(*m*)(*5*) of this section, give rise to adjustments to the capital accounts of the partners in accordance with their interests in the partnership under paragraph (b)(3) of this section. See examples 13 (iii) and (iv) of paragraph (b)(5) of this section.

(*3*) *Section 732 adjustments.* In the case of a transfer of all or a part of an interest in a partnership that does not have a section 754 election in effect for the partnership taxable year in which such transfer occurs, adjustments to the adjusted tax basis of partnership property under section 732(d) will be treated in the capital accounts of the partners in the same manner as section 743 basis adjustments are treated under paragraph (b)(2)(iv)(*m*)(*2*) of this section.

(*4*) Section 734 adjustments. Except as provided in paragraph (b)(2)(iv)(*m*)(*5*) of this section, in the case of a distribution of property in liquidation of a partner's interest in the partnership by a partnership that has a section 754 election in effect for the partnership taxable year in which the distribution occurs, the partner who receives the distribution that gives rise to the adjustment to the adjusted tax basis of partnership property under section 734 shall have a corresponding adjustment made to his capital account. If such distribution is made other than in liquidation of a partner's interest in the partnership, however, except as provided in paragraph (b)(2)(iv)(*m*)(*5*) of this section, the capital accounts of the partners shall be adjusted by the amount of the adjustment to the adjusted tax basis of partnership property under section 734, and such capital account adjustment shall be shared among the partners in the manner in which the unrealized income and gain that is displaced by such adjustment would have been shared if the property whose basis is adjusted were sold immediately prior to such adjustment for its recomputed adjusted tax basis.

(*5*) *Limitations on adjustments.* Adjustments may be made to the capital account of a partner (or his successor in interest) in respect of basis adjustments to partnership property under sections 732, 734, and 743 only to the extent that such basis adjustments (i) are permitted to be made to one or more items of partnership property under section 755, and (ii) result in an increase or a decrease in the amount at which such property is carried on the partnership's balance sheet, as computed for book purposes. For example, if the book value of partnership property exceeds the adjusted tax basis of such property, a basis adjustment to such property may be reflected in a partner's capital account only to the extent such adjustment exceeds the difference between the book value of such property and the adjusted tax basis of such property prior to such adjustment.

(*n*) *Partnership level characterization.* Except as otherwise provided in paragraph (b)(2)(iv)(k) of this section, the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless adjustments to such capital accounts in respect of partnership income, gain, loss, deduction, and section 705(a)(2)(B) expenditures (or item thereof) are made with reference to the Federal tax treatment of such items (and in the case of book items, with reference to the Federal tax treatment of the corresponding tax items) at the partnership level, without regard to any requisite or elective tax treatment of such items at the partner level (for example, under section 58(i)). However, a partnership that incurs mining exploration expenditures will determine the Federal tax treatment of income, gain, loss, and deduction with respect to the property to which such expenditures relate at the partnership level only after first taking into account the elections made by its partners under section 617 and section 703(b)(4).

(*o*) *Guaranteed payments.* Guaranteed payments to a partner under section 707(c) cause the capital account of the recipient partner to be adjusted only to the extent of such partner's distributive share of any partnership deduction, loss, or other downward capital account adjustment resulting from such payment.

(*p*) *Minor discrepancies.* Discrepancies between the balances in the respective capital accounts of the partners and the balances that would be in such respective capital accounts if they had been determined and maintained in accordance with this paragraph (b)(2)(iv) will not adversely affect the validity of an allocation, provided that such discrepancies are minor and are attributable to good faith error by the partnership.

(*q*) *Adjustments where guidance is lacking.* If the rules of this paragraph (b)(2)(iv) fail to provide guidance on how adjustments to the capital accounts of the partners should be made to reflect particular adjustments to partnership capital on the books of the partnership, such capital accounts will not be considered to be determined and maintained in accordance with those rules unless such capital account adjustments are made in a manner that (*1*) maintains equality between the aggregate governing capital accounts of the partners and the amount of partnership capital reflected on the partnership's balance sheet, as computed for book purposes, (*2*) is consistent with the underlying economic arrangement of the partners, and (*3*) is based, wherever practicable, on Federal tax accounting principles.

(*r*) *Restatement of capital accounts.* With respect to partnerships that began operating in a taxable year beginning before May 1, 1986, the capital accounts of the partners of which have not been determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) since inception, such capital accounts shall not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) for taxable years beginning after April 30, 1986, unless either—

(*1*) Such capital accounts are adjusted, effective for the first partnership taxable year beginning after April 30, 1986, to reflect the fair market value of partnership property as of the first day of such taxable year, and in connection with such adjustment, the rules contained in paragraph (b)(2)(iv)(*f*) (*2*), (*3*), and (*4*) of this section are satisfied, or

(*2*) The differences between the balance in each partner's capital account and the balance that would be in such partner's capital account if capital accounts had been determined and maintained in accordance with this paragraph (b)(2)(iv) throughout the full term of the partnership are not significant (for example, such differences are solely attributable to a failure to provide for treatment of section 709 expenses in accordance with the rules of paragraph (b)(2)(iv)(*i*)(*2*) of this section or to a failure to follow the rules in paragraph (b)(2)(iv)(*m*) of this section), and capital accounts are adjusted to bring them into conformity with the rules of this paragraph (b)(2)(iv) no later than the end of the first partnership taxable year beginning after April 30, 1986.

With respect to a partnership that began operating in a taxable year beginning before May 1, 1986, modifications to the partnership agreement adopted on or before November 1, 1988, to make the capital account adjustments required to comply with this paragraph, and otherwise to satisfy the requirements of this paragraph, will be treated as if such modifications were included in the partnership agreement before the end of the first partnership taxable year beginning after April 30, 1986. However, compliance with the previous sentences will have no bearing on the validity of allocations that relate to partnership taxable years beginning before May 1, 1986.

(3) *Partner's interest in the partnership*—(i) *In general.* References in section 704(b) and this paragraph to a partner's interest in the partnership, or to the partners' interests in the partnership, signify the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated. Except with respect to partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership), this sharing arrangement may or may not correspond to the overall economic arrangement of the partners. Thus, a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in a particular item of income or deduction. (For example, in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit make-up obligation that causes such partner to have a negative capital account, it may be necessary to allocate a disproporationate amount of gross income of the partnership to such partner for such year so as to bring that partner's capital account back up to zero.) The determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners. All partners' interests in the partnership are presumed to be equal (determined on a per capita basis). However, this presumption may be rebutted by the taxpayer or the Internal Revenue Service by establishing facts and circumstances that show that the partners' interests in the partnership are otherwise.

(ii) *Factors considered.* In determining a partner's interest in the partnership, the following factors are among those that will be considered:

(*a*) The partners' relative contributions to the partnership,

(*b*) The interests of the partners in economic profits and losses (if different than that in taxable income or loss),

(*c*) The interests of the partners in cash flow and other non-liquidating distributions, and

(*d*) The rights of the partners to distributions of capital upon liquidation.

The provisions of this subparagraph (b)(3) are illustrated by examples (1)(i) and (ii), (4)(i), (5)(i) and (ii), (6), (7), (8), (10)(ii), (16)(i), and (19)(iii) of paragraph (b)(5) of this section. See paragraph (b)(4)(i) of this section concerning rules for determining the partners' interests in the partnership with respect to certain tax items.

(iii) *Certain determinations.* If—

(*a*) Requirements (*1*) and (*2*) of paragraph (b)(2)(ii)(*b*) of this section are satisfied, and

(*b*) All or a portion of an allocation of income, gain, loss, or deduction made to a partner for a partnership taxable year does not have economic effect under paragraph (b)(2)(ii) of this section.

the partners' interests in the partnership with respect to the portion of the allocation that lacks economic effect will be determined by comparing the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the taxable year to which the allocation relates with the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the prior taxable year, and adjusting the result for the items described in (*4*), (*5*), and (*6*) of paragraph (b)(2)(ii)(*d*) of this section. A determination made under this paragraph (b)(3)(iii) will have no force if the economic effect of valid allocations made in the same manner is insubstantial under paragraph (b)(2)(iii) of this section. See examples 1 (iv), (v), and (vi), and 15 (ii) and (iii) of paragraph (b)(5) of this section.

(4) *Special rules*—(i) *Allocations to reflect revaluations.* If partnership property is, under paragraphs (b)(2)(iv)(*d*) or (b)(2)(iv)(*f*) of this section, properly reflected in the capital accounts of the partners and on the books of the partnership at a book value that differs from the adjusted tax basis of such property, then depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property will be greater or less than the depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property. In these cases the capital accounts of the partners are required to be adjusted solely for allocations of the book items to such partners (see paragraph (b)(2)(iv)(*g*) of this section), and the partners' shares of the corresponding tax items are not independently reflected by further adjustments to the partners' capital accounts. Thus, separate allocations of these tax items cannot have economic effect under paragraph (b)(2)(ii)(*b*)(*1*) of this section, and the partners' distributive shares of such tax items must (unless governed by section 704(c)) be determined in accordance with the partners' interests in the partnership. These tax items must be shared among the partners in a manner that takes account of the variation between the adjusted tax basis of such property and its book value in the same manner as variations between the adjusted tax basis and fair market value of property contributed to the partnership are taken into account in determining the partners' shares of tax items under section 704(c). See examples 14 and 18 of paragraph (b)(5) of this section.

(ii) *Credits.* Allocations of tax credits and tax credit recapture are not reflected by adjustments to the partners' capital accounts (except to the extent that adjustments to the adjusted tax basis of partnership section 38 property in respect of tax credits and tax credit recapture give rise to capital account adjustments under paragraph (b)(2)(iv)(*j*) of this section). Thus, such allocations cannot have economic effect under paragraph (b)(2)(ii)(*b*)(*1*) of this section, and the tax credits and tax credit recapture must be allocated in accordance with the partners' interests in the partnership as of the time the tax credit or credit recapture arises. With respect to the investment tax credit provided by section 38, allocations of cost or qualified investment made in accordance with paragraph (f) of §1.46–3 and paragraph (a)(4)(iv) of §1.48–8 shall be deemed to be made in accordance with the partners' interests in the partnership. With respect to other tax credits, if a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustments) for such year, then the partners' interests in the partnership with respect to such credit (or the cost giving rise thereto) shall be in the same proportion as such partners' respective distributive shares of such loss or deduction (and adjustments). See example 11 of paragraph (b)(5) of this section. Identical principles shall apply in determining the partners' interests in the partnership with respect to tax credits that arise from receipts of the partnership (whether or not taxable).

(iii) *Excess percentage depletion.* To the extent the percentage depletion in respect of an item of depletable property of the partnership exceeds the adjusted tax basis of such property, allocations of such excess percentage depletion are not reflected by adjustments to the partners' capital accounts. Thus, such allocations cannot have economic effect under paragraph (b)(2)(ii)(*b*)(*1*) of this section, and such excess percentage depletion must be allocated in accordance with the partners' interests in the partnership. The partners' interests in the partnership for a partnership taxable year with respect to such excess percentage depletion shall be in the same proportion as such partners' respective distributive shares of gross income from the depletable property (as determined under section 613(c)) for such year. See example 12 of paragraph (b)(5) of this section. See paragraphs (b)(2)(iv)(*k*) and (b)(4)(v) of this section for special rules concerning oil and gas properties of the partnership.

(iv) *Allocations attributable to nonrecourse liabilities.* The rules for allocations attributable to nonrecourse liabilities are contained in §1.704–2.

(v) *Allocations under section 613A(c)(7)(D).* Allocations of the adjusted tax basis of a partnership oil or gas property are controlled by section 613A(c)(7)(D) and the regulations thereunder. However, if the partnership agreement provides for an allocation of the adjusted tax basis of an oil or gas property among the partners, and such allocation is not otherwise governed under section 704(c) (or related principles under paragraph (b)(4)(i) of this section), that allocation will be recognized as being in accordance with the partners' interests in partnership capital under section 613A(c)(7)(D), provided (*a*) such allocation does not give rise to capital account adjustments under paragraph (b)(2)(iv)(*k*) of this section, the economic effect of which is insubstantial (as determined under paragraph (b)(2)(iii) of this section), and (*b*) all other material allocations and capital account adjustments under the partnership agreement are recognized under this paragraph (b). Otherwise, such adjusted tax basis must be allocated among the partners pursuant to section 613A(c)(7)(D) in accordance with the partners' actual interests in partnership capital or income. For purposes of section 613A(c)(7)(D) the partners' allocable shares of the amount realized upon the partnership's taxable disposition of an oil or gas property will, except to the extent governed by section 704(c) (or related principles under paragraph (b)(4)(i) of this section), be determined under this paragraph (b)(4)(v). If, pursuant to paragraph (b)(2)(iv)(*k*)(*2*) of this section, the partners' capital accounts are adjusted to reflect the simulated depletion of an oil or gas property of the partnership, the portion of the total amount realized by the partnership upon the taxable disposition of such property that represents recovery of its simulated adjusted tax basis therein will be allocated to the partners in the same proportion as the aggregate adjusted tax basis of such property was allocated to such partners (or their predecessors in interest). If, pursuant to paragraph (b)(2)(iv)(*k*)(*3*) of this section, the partners' capital accounts are adjusted to reflect the actual depletion of an oil or gas property of the partnership, the portion of the total amount realized by the partnership upon the taxable disposition of such property that equals the partners' aggregate remaining adjusted basis therein will be allocated to the partners in proportion to their respective remaining adjusted tax bases in such property. An allocation provided by the partnership agreement of the portion of the total amount realized by the partnership on its taxable disposition of an oil or gas property that exceeds the portion of the total amount realized allocated under either of the previous two sentences (whichever is applicable) shall be deemed to be made in accordance with the partners' allocable shares of such amount realized, provided (*c*) such allocation does not give rise to capital account adjustments under paragraph (b)(2)(iv)(*k*) of this section the economic effect of which is insubstantial (as determined under paragraph (b)(2)(ii) of this section), and (*d*) all other allocations and capital account adjustments under the partnership agreement are recognized under this paragraph. Otherwise, the partners' allocable shares of the total amount realized by the partnership on its taxable disposition of an oil or gas property shall be determined in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section. See example 19 of paragraph (b)(5) of this section. (See paragraph (b)(2)(iv)(*k*) of this section for the determination of appropriate adjustments to the partners' capital accounts relating to section 613A(c)(7)(D).)

(vi) *Amendments to partnership agreement.* If an allocation has substantial economic effect under paragraph (b)(2) of this section or is deemed to be made in accordance with the partners' interests in the partnership under paragraph (b)(4) of this section under the partnership agreement that is effective for the taxable year to which such allocation relates, and such partnership agreement thereafter is modified, both the tax consequences of the modification and the facts and circumstances surrounding the modification will be closely scrutinized to determine whether the purported modification was part of the original agreement. If it is determined that the purported modification was part of the original agreement, prior allocations may be reallocated in a manner consistent with the modified terms of the agreement, and subsequent allocations may be reallocated to take account of such modified terms. For example, if a partner is obligated by the partnership agreement to restore the deficit balance in his capital account (or any limited dollar amount thereof) in accordance with requirement (*3*) of paragraph (b)(2)(ii)(*b*) of this section and, thereafter, such obligation is eliminated or reduced (other than as provided in paragraph (b)(2)(ii)(*f*) of this section), or is not complied with in a timely manner, such elimination, reduction, or noncompliance may be treated as if it always were part of the partnership agreement for purposes of making any reallocations and determining the appropriate limitations period.

(vii) *Recapture.* For special rules applicable to the allocation of recapture income or credit, see paragraph (e) of § 1.1245–1, paragraph (f) of § 1.1250–1, paragraph (c) of § 1.1254–1, and paragraph (a) of § 1.47–6.

(5) *Examples.* The operation of the rules in this paragraph is illustrated by the following examples:

Example 1. (i) A and B form a general partnership with cash contributions of $40,000 each, which cash is used to purchase depreciable personal property at a cost of $80,000. The partnership elects under section 48(q)(4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such property. The partnership agreement provides that A and B will have equal shares of taxable income and loss (computed without regard to cost recovery deductions) and cash flow and that all cost recovery deductions on the property will be allocated to A. The agreement further provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of the section, but that upon liquidation of the partnership, distributions will be made equally between the partners (regardless of capital account balances) and no partner will be required to restore the deficit balance in his capital account for distribution to partners with positive capital accounts balances. In the partnership's first taxable year, it recognizes operating income equal to its operating expenses and has an additional $20,000 cost recovery deduction, which is allocated entirely to A. That A and B will be entitled to equal distributions on liquidation, even through A is allocated the entire $20,000 cost recovery deduction, indicates A will not bear the full risk of the economic loss corresponding to such deduction if such loss occurs. Under paragraph (b)(2)(ii) of this section, the allocation lacks economic effect and will be disregarded. The partners made equal contributions to the partnership, share equally in other taxable income and loss and in cash flow, and will share equally in liquidation proceeds, indicating that their actual economic arrangement is to bear the risk imposed by the potential decrease in the value of the property equally. Thus, under paragraph (b)(3) of this section the partners' interests in the partnership are equal, and the cost recovery deduction will be reallocated equally between A and B.

(ii) Asssume the same facts as in (i) except that the partnership agreement provides that liquidation proceeds will be distributed in accordance with capital account balances if the partnership is liquidated during the first five years of its existence but that liquidation proceeds will be distributed equally if the partnership is liquidated thereafter. Since the partnership agreement does not provide for the requirement contained in paragraph (b)(2)(ii)(*b*)(*2*) of this section to be satisified throughout the term of the partnership, the partnership allocations do not have economic effect. Even if the partnership agreement provided for the requirement contained in paragraph (b)(2)(ii)(*b*)(*2*) to be satisified throughout the term of the partnership, such allocations would not have economic effect unless the requirement contained in paragraph (b)(2)(ii)(*b*)(*3*) of this section or the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section were satisfied.

(iii) Assume the same facts as in (i) except that distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partners' positive capital account balances throughout the term of the partnership (as set forth in paragraph (b)(2)(ii)(*b*)(*2*) of this section). Assume further that the partnership agreement contains a qualified income offset (as defined in paragraph (b)(2)(ii)(*d*) of this section) and that, as of the end of each partnership taxable year, the items described in paragraphs (b)(2)(ii)(*d*)(*4*), (*5*), and (*6*) of this section are not reasonably expected to cause or increase a deficit balance in A's capital account.

	A	B
Capital account upon formation	$40,000	$40,000
Less: year 1 cost recovery deduction	(20,000)	0
Capital account at end of year 1	$20,000	$40,000

Under the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section, the allocation of the $20,000 cost recovery deduction to A has economic effect.

(iv) Assume the same facts as in (iii) and that in the partnership's second taxable year it recognizes operating income equal to its operating expenses and has a $25,000 cost recovery deduction which, under the partnership agreement, is allocated entirely to A.

	A	B
Capital account at beginning of year 2	$20,000	$40,000
Less: year 2 cost recovery deduction	(25,000)	0
Capital account at end of year 2	($5,000)	$40,000

The allocation of the $25,000 cost recovery deduction to A satisfies that alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section only to the extent of $20,000. Therefore, only $20,000 of such allocation has economic effect, and the remaining $5,000 must be reallocated in accordance with the partners' interests in the partnership. Under the partnership agreement, if the property were sold immediately following the end of the partnership's second taxable year for $35,000 (its adjusted tax basis), the $35,000 would be distributed to B. Thus, B, and not A, bears the economic burden corresponding to $5,000 of the $25,000 cost recovery deduction allocated to A. Under paragraph (b)(3)(iii) of this section, $5,000 of such cost recovery deduction will be reallocated to B.

(v) Assume the same facts as in (iv) except that the cost recovery deduction for the partnershp's second taxable year is $20,000 instead of $25,000. The allocation of such cost recovery deduction to A has economic effect under the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section. Assume further that the property is sold for $35,000 immediately following the end of the partnership's second taxable year, resulting in a $5,000 taxable loss ($40,000 adjusted tax basis less $35,000 sales price), and the partnership is liquidated.

	A	B
Capital account at beginning of year 2	$20,000	$40,000
Less: year 2 cost recovery dedustion	(20,000)	0
Capital account at end of year 2	0	$40,000
Less: loss on sale	(2,500)	(2,500)
Capital account before liquidation	($2,500)	$37,500

Under the partnership agreement the $35,000 sales proceeds are distributed to B. Since B bears the entire economic burden corresponding to the $5,000 taxable loss from the sale of the property, the allocation of $2,500 of such loss to A does not have economic effect and must be reallocated in accordance with the partners' interests in the partnership. Under paragraph (b)(3)(iii) of this section, such $2,500 loss will be reallocated to B.

(vi) Assume the same facts as in (iv) except that the cost recovery deduction for the partnership's second taxable year is $20,000 instead of $25,000, and that as of the end of the partnership's second taxable year it is reasonably expected that during its third taxable year the partnership will (1) have operating income equal to its operating expenses (but will have no cost recovery deductions), (2) borrow $10,000 (recourse) and distribute such amount $5,000 to A and $5,000 to B, and (3) thereafter sell the partnership property, repay the $10,000 liability, and liquidate. In determining the extent to which the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section is satisfied as of the end of the partnership's second taxable year, the fair market value of partnership property is presumed to be equal to its adjusted tax basis (in accordance with paragraph (b)(2)(iii)(*c*) of this section). Thus, it is presumed that the selling price of such property during the partnership's third taxable year will be its $40,000 adjusted tax basis. Accordingly, there can be no reasonable expectation that there will be increases to A's capital account in the partnership's third taxable year that will offset the expected $5,000 distribution to A. Therefore, the distribution of the loan proceeds must be taken into account in determining to what extent the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) is satisfied.

	A	B
Capital account at beginning of year 2	$20,000	$40,000
Less: expected future distribution	(5,000)	(5,000)
Less: year 2 cost recovery deduction	(20,000)	(0)
Hypothetical capital account at end of year 2	($5,000)	$35,000

Upon sale of the partnership property, the $40,000 presumed sales proceeds would be used to repay the $10,000 liability, and the remaining $30,000 would be distributed to B. Under these circumstances the allocation of the $20,000 cost recovery deduction to A in the partnership's second taxable year satisfies the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section only to the extent of $15,000. Under paragraph (b)(3)(iii) of this section, the remaining $5,000 of such deduction will be reallocated to B. The results in this example would be the same even if the partnership agreement also provided that any gain (whether ordinary income or capital gain) upon the sale of the property would be allocated to A to the extent of the prior allocations of cost recovery deductions to him, and, at end of the partnership's second taxable year, the partners were confident that the gain on the sale of the property in the partnership's third taxable year would be sufficient to offset the expected $5,000 distribution to A.

(vii) Assume the same facts as in (iv) except that the partnership agreement also provides that any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraph (b)(2)(ii)(*b*)(*3*) of this section). Thus, if the property were sold for $35,000 immediately after the end of the partnership's second taxable year, the $35,000 would be distributed to B, A would contribute $5,000 (the deficit balance in his capital account) to the partnership, and that $5,000 would be distributed to B. The allocation of the entire $25,000 cost recovery deduction to A in the partnership's second taxable year has economic effect.

(viii) Assume the same facts as in (vii) except that A's obligation to restore the deficit balance in his capital account is limited to a maximum of $5,000. The allocation of the $25,000 cost recovery deduction to A in the partnership's second taxable year has economic effect under the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section. At the end of such year, A makes an additional $5,000 contribution to the partnership (thereby eliminating the $5,000 deficit balance in his capital account). Under paragraph (b)(2)(ii)(*f*) of this section, A's obligation to restore up to $5,000 of the deficit balance in his capital account may be eliminated after he contributes the additional $5,000 without affecting the validity of prior allocations.

(ix) Assume the same facts as in (iv) except that upon formation of the partnership A also contributes to the partnership his negotiable promissory note with a $5,000 principal balance. The note unconditionally obligates A to pay an additional $5,000 to the partnership at the earlier of (a) the beginning of the partnership's fourth taxable year, or (b) the end of the partnership taxable year in which A's interest is liquidated. Under paragraph (b)(2)(ii)(*c*) of this section, A is considered obligated to restore up to $5,000 of the deficit balance in his capital account to the partnership. Accordingly, under the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section, the allocation of the $25,000 cost recovery deduction to A in the partnership's second taxable year has economic effect. The results in this example would be the same if (1) the note A contributed to the partnership were payable only at the end of the partnership's fourth taxable year (so that A would not be required to satisfy the note upon liquidation of his interest in the partnership), and (2) the partnership agreement provided that upon liquidation of A's interest, the partnership would retain A's note, and A would contribute to the partnership the excess of the outstanding principal balance of the note over its then fair market value.

(x) Assume the same facts as in (ix) except that A's obligation to contribute an additional $5,000 to the partnership is not evidenced by a promissory note. Instead, the partnership agreement imposes upon A the obligation to make an additional $5,000 contribution to the partnership at the earlier of (a) the beginning of the partnership's fourth taxable year, or (b) the end of the partnership taxable year in which A's interest is liquidated. Under paragraph (b)(2)(ii)(*c*) of this section, as a result of A's deferred contribution requirement, A is considered obligated to restore up to $5,000 of the deficit balance in his capital account to the partnership. Accordingly, under the alternate economic effect test contained in paragraph (b)(2)(*ii*)(*d*) of this section, the allocation of the $25,000 cost recovery deduction to A in the partnership's second taxable year has economic effect.

(xi) Assume the same facts as in (vii) except that the partnership agreement also provides that any gain (whether ordinary income or capital gain) upon the sale of the property will be allocated to A to the extent of the prior allocations to A of cost recovery deductions from such property, and additional gain will be allocated equally between A and B. At the time the allocations of cost recovery deductions were made to A, the partners believed there would be gain on the sale of the property in an amount sufficient to offset the allocations of cost recovery deductions to A. Nevertheless, the existence of the gain chargeback provision will not cause the economic effect of the allocations to be insubstantial under paragraph (b)(2)(iii)(*c*) of this section, since in testing whether the economic effect of such allocations is substantial, the recovery property is presumed to decrease in value by the amount of such deductions.

Example 2. C and D form a general partnership solely to acquire and lease machinery that is 5-year recovery property under section 168. Each contributes $100,000, and the partnership obtains an $800,000 recourse loan to purchase the machinery. The partnership elects under section 48(q)(4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such machinery. The partnership, C, and D have calendar taxable years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*)(*2*) and (*3*) of this section). The partnership agreement further provides that (a) partnership net taxable loss will be allocated 90 percent to C and 10 percent to D until such time as there is partnership net taxable income, and therefore C will be allocated 90 percent of such taxable income until he has been allocated partnership net taxable income equal to the partnership net taxable loss previously allocated to him, (b) all further partnership net taxable income or loss will be allocated equally between C and D, and (c) distributions of operating cash flow will be made equally between C and D. The partnership enters into a 12-year lease with a financially secure corporation under which the partnership expects to have a net taxable loss in each of its first 5 partnership taxable years due to cost recovery deductions with respect to the machinery and net taxable income in each of its following 7 partnership taxable years, in part due to the absence of such cost recovery deductions. There is a strong likelihood that the partnership's net taxable loss in partnership taxable years 1 through 5 will be $100,000, $90,000, $80,000, $70,000, and $60,000, respectively, and the partnership's net taxable income in partnership taxable years 6 through 12 will be $40,000, $50,000, $60,000, $70,000, $80,000, $90,000, and $100,000, respectively. Even though there is a strong likelihood that the allocations of net taxable loss in years 1 through 5 will be largely offset by other allocations in partnership taxable years 6 through 12, and even if it is assumed that the total tax liability of the partners in years 1 through 12 will be less than if the allocations had not been provided in the partnership agreement, the economic effect of the allocations will not be insubstantial under paragraph (b)(2)(iii)(*c*) of this section. This is because at the time such allocations became part of the partnership agreement, there was a strong likelihood that the allocations of net taxable loss in years 1 through 5 would not be largely offset by allocations of income within 5 years (determined on a first-in, first-out basis). The year 1 allocation will not be offset until years 6, 7, and 8, the year 2 allocation will not be offset until years 8 and 9, the year 3 allocation will not be offset until years 9 and 10, the year 4 allocation will not be offset until years 10 and 11, and the year 5 allocation will not be offset until years 11 and 12.

Example 3. E and F enter into a partnership agreement to develop and market experimental electronic devices. E contributes $2,500 cash and agrees to devote his full-time services to the partnership. F contributes $100,000 cash and agrees to obtain a loan for the partnership for any additional capital needs. The partnership agreement provides that all deductions for research and experimental expenditures and interest on partnership loans are to be allocated to F. In addition, F will be allocated 90 percent, and E 10 percent, of partnership taxable income or loss, computed net of the deductions for such research and experimental expenditures and interest, until F has received allocations of such taxable income equal to the sum of such research and experimental expenditures, such interest expense, and his share of such taxable loss. Thereafter, E and F will share all taxable income and loss equally. Operating cash flow will be distributed equally between E and F. The partnership agreement also provides that E's and F's capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*)(*2*) and (*3*) of this section). These allocations have economic effect. In addition, in view of the nature of the partnership's activities, there is not a strong likelihood at the time the allocations become part of the partnership agreement that the economic effect of the allocations to F of deductions for research and experimental expenditures and interest on partnership loans will be largely offset by allocations to F of partnership net taxable income. The economic effect of the allocations is substantial.

Example 4. (i) G and H contribute $75,000 and $25,000, respectively, in forming a general partnership. The partnership agreement provides that all income, gain, loss, and deduction will be allocated equally between the partners, that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, but that all partnership distributions will, regardless of capital account balances, be made 75 percent to G and 25 percent to H. Following the liquidation of the partnership, neither partner is required to restore the deficit balance in his capital account to the partnership for distribution to partners with positive capital account balances. The allocations in the partnership agreement do not have economic effect. Since contributions were made in a 75/25 ratio and the partnership agreement indicates that all economic profits and losses of the partnership are to be shared in a 75/25 ratio, under paragraph (b)(3) of this section, partnership income, gain, loss, and deduction will be reallocated 75 percent to G and 25 percent to H.

(ii) Assume the same facts as in (i) except that the partnership maintains no capital accounts and the partnership agreement provides that all income, gain, loss, deduction, and credit will be allocated 75 percent to G and 25 percent to H. G and H are ultimately liable (under a State law right of contribution) for 75 percent and 25 percent, respectively, of any debts of the partnership. Although the allocations do not satisfy the requirements of paragraph (b)(2)(ii)(*b*) of this section, the allocations have economic effect under the economic effect equivalence test of paragraph (b)(2)(ii)(*i*) of this section.

(iii) Assume the same facts as in (i) except that the partnership agreement provides that any partner with a deficit balance in his capital account must restore that deficit to the partnership (as set forth in paragraph (b)(2)(ii)(*b*)(*2*) of this section). Although the allocations do not satisfy the requirements of paragraph (b)(2)(ii)(*b*) of this section, the allocations have economic effect under the economic effect equivalence test of paragraph (b)(2)(ii)(*i*) of this section.

Example 5. (i) Individuals I and J are the only partners of an investment partnership. The partnership owns corporate stocks, corporate debt instruments, and tax-exempt debt instruments. Over the next several years, I expects to be in the 50 percent marginal tax bracket, and J expects to be in the 15 percent marginal tax bracket. There is a strong likelihood that in each of the next several years the partnership will realize between $450 and $550 of tax-exempt interest and between $450 and $550 of a combination of taxable interest and dividends from its investments. I and J made equal capital contributions to the partnership, and they have agreed to share equally in gains and losses from the sale of the partnership's investment securities. I and J agree, however, that rather than share interest and dividends of the partnership equally, they will allocate the partnership's tax-exempt interest 80 percent to I and 20 percent to J and will distribute cash derived from interest received on the tax-exempt bonds in the same percentages. In addition, they agree to allocate 100 percent of the partnership's taxable interest and dividends to J and to distribute cash derived from interest and dividends received on the corporate stocks and debt instruments 100 percent to J. The partnership agreement further provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partner's positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). The allocation of taxable interest and dividends and tax-exempt interest has economic effect, but that economic effect is not substantial under the general rules set forth in paragraph (b)(2)(iii) of this section. Without the allocation I would be allocated between $225 and $275 of tax-exempt interest and between $225 and $275 of a combination of taxable interest and dividends, which (net of Federal income taxes he would owe on such income) would give I between $337.50 and $412.50 after tax. With the allocation, however, I will be allocated between $360 and $440 of tax-exempt interest and no taxable interest and dividends, which (net of Federal income taxes) will give I between $360 and $440 after tax. Thus, at the time the allocations became part of the partnership agreement, I is expected to enhance his after-tax economic consequences as a result of the allocations. On the other hand, there is a strong likelihood that neither I nor J will substantially diminish his after-tax economic consequences as a result of the allocations. Under the combination of likely investment outcomes least favorable for J, the partnership would realize $550 of tax-exempt interest and $450 of taxable interest and dividends, giving J $492.50 after tax (which is more than the $466.25 after tax J would have received if each of such amounts had been allocated equally between the partners). Under the combination of likely investment outcomes least favorable for I, the partnership would realize $450 of tax-exempt interest and $550 of taxable interest and dividends, giving I $360 after tax (which is not substantially less than the $362.50 he would have received if each of such amounts had been allocated equally between the partners). Accordingly, the allocations in the partnership agreement must be reallocated in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section.

(ii) Assume the same facts as in (i). In addition, assume that in the first partnership taxable year in which the allocation arrangement described in (i) applies, the partnership realizes $450 of tax-exempt interest and $550 of taxable interest and dividends, so that, pursuant to the partnership agreement, I's capital account is credited with $360 (80 percent of the tax-exempt interest), and J's capital account is credited with $640 (20 percent of the tax-exempt interest and 100 percent of the taxable interest and dividends). The allocations of tax-exempt interest and taxable interest and dividends (which do not have substantial economic effect for the reasons stated in (i) will be disregarded and will be reallocated. Since under the partnership agreement I will receive 36 percent (360/1,000) and J will receive 64 percent (640/1,000) of the partnership's total investment income in such year, under paragraph (b)(3) of this section the partnership's tax-exempt interest and taxable interest and dividends each will be reallocated 36 percent to I and 64 percent to J.

Example 6. K and L are equal partners in a general partnership formed to acquire and operate property described in section 1231(b). The partnership, K, and L have calendar taxable years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, that distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and that any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). For a taxable year in which the partnership expects to incur a loss on the sale of a portion of such property, the partnership agreement is amended (at the beginning of the taxable year) to allocate such loss to K, who expects to have no gains from the sale of depreciable property described in section 1231(b) in that taxable year, and to allocate an equivalent amount of partnership loss and deduction for that year of a different character to L, who expects to have such gains. Any partnership loss and deduction in excess of these allocations will be allocated equally between K and L. The amendment is effective only for that taxable year. At the time the partnership agreement is amended, there is a strong likelihood that the partnership will incur deduction or loss in the taxable year other than loss from the sale of property described in section 1231(b) in an amount that will substantially equal or exceed the expected amount of the section 1231(b) loss. The allocations in such taxable year have economic effect. However, the economic effect of the allocations is insubstantial under the test described in paragraph (b)(2)(iii) (*b*) of this section because there is a strong likelihood, at the time the allocations become part of the partnership agreement, that the net increases and decreases to K's and L's capital accounts will be the same at the end of the taxable year to which they apply with such allocations in effect as they would have been in the absence of such allocations, and that the total taxes of K and L for such year will be reduced as a result of such allocations. If in fact the partnership incurs deduction or loss, other than loss from the sale of property described in section 1231(b), in an amount at least equal to the section 1231(b) loss, the loss and deduction in such taxable year will be reallocated equally between K and L under paragraph (b)(3) of this section. If not, the loss from the sale of property described in section 1231(b) and the items of deduction and other loss realized in such year will be reallocated between K and L in proportion to the net decreases in their capital accounts due to the allocation of such items under the partnership agreement.

Example 7. (i) M and N are partners in the MN general partnership, which is engaged in an active business. Income, gain, loss, and deduction from MN's business is allocated equally between M and N. The partnership, M, and N have calendar taxable years. Under the partnership agreement the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partner's positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). In order to enhance the credit standing of the partnership, the partners contribute surplus funds to the partnership, which the partners agree to invest in equal dollar amounts of tax-exempt bonds and corporate stock for the partnership's first 3 taxable years. M is expected to be in a higher marginal tax bracket than N during those 3 years. At the time the decision to make these investments is made, it is agreed that, during the 3-year period of the investment, M will be allocated 90 percent and N 10 percent of the interest income from the tax-exempt bonds as well as any gain or loss from the sale thereof, and that M will be allocated 10 percent and N 90 percent of the dividend income from the corporate stock as well as any gain or loss from the sale thereof. At the time the allocations concerning the investments become part of the partnership agreement, there is not a strong likelihood that the gain or loss from the sale of the stock will be substantially equal to the gain or loss from the sale of the tax-exempt bonds, but there is a strong likelihood that the tax-exempt interest and the taxable dividends realized from these investments during the 3-year period will not differ substantially. These allocations have economic effect, and the economic effect of the allocations of the gain or loss on the sale of the tax-exempt bonds and corporate stock is substantial. The economic effect of the allocations of the tax-exempt interest and the taxable dividends, however, is not substantial under the test described in paragraph (b)(2)(iii)(*c*) of this section because there is a strong likelihood, at the time the allocations become part of the partnership agreement, that at the end of the 3-year period to which such allocations relate, the net increases and decreases to M's and N's capital accounts will be the same with such allocations as they would have been in the absence of such allocations, and that the total taxes of M and N for the taxable years to which such allocations relate will be reduced as a result of such allocations. If in fact the amounts of the tax-exempt interest and taxable dividends earned by the partnership during the 3-year period are equal, the tax-exempt interest and taxable dividends will be reallocated to the partners in equal shares under paragraph (b)(3) of this section. If not, the tax-exempt interest and taxable dividends will be reallocated between M and N in proportion to the net increases in their capital accounts during such 3-year period due to the allocation of such items under the partnership agreement.

(ii) Assume the same facts as in (i) except that gain or loss from the sale of the tax-exempt bonds and corporate stock will be allocated equally between M and N and the partnership agreement provides that the 90/10 allocation arrangement with respect to the investment income applies only to the first $10,000 of interest income from the tax-exempt bonds and the first $10,000 of dividend income from the corporate stock, and only to the first taxable year of the partnership. There is a strong likelihood at the time the 90/10 allocation of the investment income became part of the partnership agreement that in the first taxable year of the partnership, the partnership will earn more than $10,000 of tax-exempt interest and more than $10,000 of taxable dividends. The allocations of tax-exempt interest and taxable dividends provided in the partnership agreement have economic effect, but under the test contained in paragraph (b)(2)(iii)(*b*) of this section, such economic effect is not substantial for the same reasons stated in (i) (but applied to the 1 taxable year, rather than to a 3-year period). If in fact the partnership realizes at least $10,000 of tax-exempt interest and at least $10,000 of taxable dividends in such year, the allocations of such interest income and dividend income will be reallocated equally between M and N under paragraph (b)(3) of this section. If not, the tax-exempt interest and taxable dividends will be reallocated between M and N in proportion to the net increases in their capital accounts due to the allocations of such items under the partnership agreement.

(iii) Assume the same facts as in (ii) except that at the time the 90/10 allocation of investment income becomes part of the partnership agreement, there is not a strong likelihood that (1) the partnership will earn $10,000 or more of tax-exempt interest and $10,000 or more of taxable dividends in the partnership's first taxable year, and (2) the amount of tax-exempt interest and taxable dividends earned during such year will be substantially the same. Under these facts the economic effect of the allocations generally will be substantial. (Additional facts may exist in certain cases, however, so that the allocation is insubstantial under the second sentence of paragraph (b)(2)(iii). See example 5 above.)

Example 8. (i) O and P are equal partners in the OP general partnership. The partnership, O, and P have calendar taxable years. Partner O has a net operating loss carryover from another venture that is due to expire at the end of the partnership's second taxable year. Otherwise, both partners expect to be in the 50 percent marginal tax bracket in the next several taxable years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). The partnership agreement is amended (at the beginning of the partnership's second taxable year) to allocate all the partnership net taxable income for that year to O. Future partnership net taxable loss is to be allocated to O, and future partnership net taxable income to P, until the allocation of income to O in the partnership's second taxable year is offset. It is further agreed orally that in the event the partnership is liquidated prior to completion of such offset, O's capital account will be adjusted downward to the extent of one-half of the allocations of income to O in the partnership's second taxable year that have not been offset by other allocations, P's capital account will be adjusted upward by a like amount, and liquidation proceeds will be distributed in accordance with the partners' adjusted capital account balances. As a result of this oral amendment, all allocations of partnership net taxable income and net taxable loss made pursuant to the amendment executed at the beginning of the partnership's second taxable year lack economic effect and will be disregarded. Under the partnership agreement other allocations are made equally to O and P, and O and P will share equally in liquidation proceeds, indicating that the partners' interests in the partnership are equal. Thus, the disregarded allocations will be reallocated equally between the partners under paragraph (b)(3) of this section.

(ii) Assume the same facts as in (i) except that there is no agreement that O's and P's capital accounts will be adjusted downward and upward, respectively, to the extent of one-half of the partnership net taxable income allocated to O in the partnership's second taxable year that is not offset subsequently by other allocations. The income of the partnership is generated primarily by fixed interest payments received with respect to highly rated corporate bonds, which are expected to produce sufficient net taxable income prior to the end of the partnership's seventh taxable year to offset in large part the net taxable income to be allocated to O in the partnership's second taxable year. Thus, at the time the allocations are made part of the partnership agreement, there is a strong likelihood that the allocation of net taxable income to be made to O in the second taxable year will be offset in large part within 5 taxable years thereafter. These allocations have economic effect. However, the economic effect of the allocation of partnership net taxable income to O in the partnership's second taxable year, as well as the offsetting allocations to P, is not substantial under the test contained in paragraph (b)(2)(iii)(*c*) of this section because there is a strong likelihood that the net increases or decreases in O's and P's capital accounts will be the same at the end of the partnership's seventh taxable year with such allocations as they would have been in the absence of such allocations, and the total taxes of O and P for the taxable years to which such allocations relate will be reduced as a result of such allocations. If in fact the partnership, in its taxable years 3 through 7, realizes sufficient net taxable income to offset the amount allocated to O in the second taxable year, the allocations provided in the partnership agreement will be reallocated equally between the partners under paragraph (b)(3) of this section.

Example 9. Q and R form a limited partnership with contributions of $20,000 and $180,000, respectively. Q, the limited partner, is a corporation that has $2,000,000 of net operating loss carryforwards that will not expire for 8 years. Q does not expect to have sufficient income (apart from the income of the partnership) to absorb any of such net operating loss carryforwards. R, the general partner, is a corporation that expects to be in the 46 percent marginal tax bracket for several years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). The partnership's cash, together with the proceeds of an $800,000 loan, are invested in assets that are expected to produce taxable income and cash flow (before debt service) of approximately $150,000 a year for the first 8 years of the partnership's operations. In addition, it is expected that the partnership's total taxable income in its first 8 taxable years will not exceed $2,000,000. The partnership's $150,000 of cash flow in each of its first 8 years will be used to retire the $800,000 loan. The partnership agreement provides that partnership net taxable income will be allocated 90 percent to Q and 10 percent to R in the first through eighth partnership taxable years, and 90 percent to R and 10 percent to Q in all subsequent partnership taxable years. Net taxable loss will be allocated 90 percent to R and 10 percent to Q in all partnership taxable years. All distributions of cash from the partnership to partners (other than the priority distributions to Q described below) will be made 90 percent to R and 10 percent to Q. At the end of the partnership's eighth taxable year, the amount of Q's capital account in excess of one-ninth of R's capital account on such date will be designated as Q's ''excess capital account.'' Beginning in the ninth taxable year of the partnership, the undistributed portion of Q's excess capital account will begin to bear interest (which will be paid and deducted under section 707(c) at a rate of interest below the rate that the partnership can borrow from commercial lenders, and over the next several years (following the eight year) the partnership will make priority cash distributions to Q in prearranged percentages of Q's excess capital account designed to amortize Q's excess capital account and the interest thereon over a prearranged period. In addition, the partnership's agreement prevents Q from causing his interest in the partnership from being liquidated (and thereby receiving the balance in his capital account) without R's consent until Q's excess capital account has been eliminated. The below market rate of interest and the period over which the amortization will take place are prescribed such that, as of the end of the partnership's eighth taxable year, the present value of Q's right to receive such priority distributions is approximately 46 percent of the amount of Q's excess capital account as of such date. However, because the partnership's income for its first 8 taxable years will be realized approximately ratably over that period, the present value of Q's right to receive the priority distributions with respect to its excess capital account is, as of the date the partnership agreement is entered into, less than the present value of the additional Federal income taxes for which R would be liable if, during the partnership's first 8 taxable years, all partnership income were to be allocated 90 percent to R and 10 to Q. The allocations of partnership taxable income to Q and R in the first through eighth partnership taxable years have economic effect. However, such economic effect is not substantial under the general rules set forth in paragraph (b)(2)(iii) of this section. This is true because R may enhance his after-tax economic consequences, on a present value basis, as a result of the allocations to Q of 90 percent of partnership's income during taxable years 1 through 8, and there is a strong likelihood that neither R nor Q will substantially diminish its after-tax economic consequences, on a present value basis, as a result of such allocation. Accordingly, partnership taxable income for partnership taxable years 1 through 8 will be reallocated in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section.

Example 10. (i) S and T form a general partnership to operate a travel agency. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). The partnership agreement provides that T, a resident of a foreign country, will be allocated 90 percent, and S 10 percent, of the income, gain, loss, and deduction derived from operations conducted by T within his country, and all remaining income, gain, loss, and deduction will be allocated equally. The amount of such income, gain, loss, or deduction cannot be predicted with any reasonable certainty. The allocations provided by the partnership agreement have substantial economic effect.

(ii) Assume the same facts as in (i) except that the partnership agreement provides that all income, gain, loss, and deduction of the partnership will be shared equally, but that T will be allocated all income, gain, loss, and deduction derived from operations conducted by him within his country as a part of his equal share of partnership income, gain, loss, and deduction, upon to the amount of such share. Assume the total tax liability of S and T for each year to which these allocations relate will be reduced as a result of such allocation. These allocations have economic effect. However, such economic effect is not substantial under the test stated in paragraph (b)(2)(iii)(*b*) of this section because, at the time the allocations became part of the partnership agreement, there is a strong likelihood that the net increases and decreases to S's and T's capital accounts will be the same at the end of each partnership taxable year with such allocations as they would have been in the absence of such allocations, and that the total tax liability of S and T for each year to which such allocations relate will be reduced as a result of such allocations. Thus, all items of partnership income, gain, loss, and income, gain, loss, and deduction will be reallocated equally between S and T under paragraph (b)(3) of this section.

Example 11. (i) U and V share equally all income, gain, loss, and deduction of the UV general partnership, as well as all non-liquidating distributions made by the partnership. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore such deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). The agreement further provides that the partners will be allocated equal shares of any section 705(a)(2)(B) expenditures of the partnership. In the partnership's first taxable year, it pays qualified first-year wages of $6,000 and is entitled to a $3,000 targeted jobs tax credit under sections 44B and 51 of the Code. Under section 280C the partnership must reduce its deduction for wages paid by the $3,000 credit claimed (which amount constitutes a section 705(a)(2)(B) expenditure). The partnership agreement allocates the credit to U. Although the allocations of wage deductions and section 705(a)(2)(B) expenditures have substantial economic effect, the allocation of tax credit cannot have economic effect since it cannot properly be reflected in the partners' capital accounts. Furthermore, the allocation is not in accordance with the special partners' interests in the partnership rule contained in paragraph (b)(4)(ii) of this section. Under that rule, since the expenses that gave rise to the credit are shared equally by the partners, the credit will be shared equally between U and V.

(ii) Assume the same facts as in (i) and that at the beginning of the partnership's second taxable year, the partnership agreement is amended to allocate to U all wage expenses incurred in that year (including wage expenses that constitute section 705(a)(2)(B) expenditures) whether or not such wages qualify for the credit. The partnership agreement contains no offsetting allocations. That taxable year the partnership pays $8,000 in total wages to its employees. Assume that the partnership has operating income equal to its operating expenses (exclusive of expenses for wages). Assume further that $6,000 of the $8,000 wage expense constitutes qualified first-year wages. U is allocated the $3,000 deduction and the $3,000 section 705(a)(2)(B) expenditure attributable to the $6,000 of qualified first-year wages, as well as the deduction for the other $2,000 in wage expenses. The allocations of wage deductions and section 705(a)(2)(B) expenditures have substantial economic effect. Furthermore, since the wage credit is allocated in the same proportion as the expenses that gave rise to the credit, and the allocation of those expenses has substantial economic effect, the allocation of such credit to U is in accordance with the special partners' interests in the partnership rule contained in paragraph (b)(4)(ii) of this section and is recognized thereunder.

Example 12. (i) W and X form a general partnership for the purpose of mining iron ore. W makes an initial contribution of $75,000, and X makes an initial contribution of $25,000. The partnership agreement provides that non-liquidating distributions will be made 75 percent to W and 25 percent to X, and that all items of income, gain, loss, and deduction will be allocated 75 percent to W and 25 percent to X, except that all percentage depletion deductions will be allocated to W. The agreement further provides that the partners' capital accounts will be determined and maintained in accordance with paragraphs (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore such deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). Assume that the adjusted tax basis of the partnership's only depletable iron ore property is $1,000 and that the percentage depletion deduction for the taxable year with respect to such property is $1,500. The allocation of partnership income, gain, loss, and deduction (excluding the percentage depletion deduction) as well as the allocation of $1,000 of the percentage depletion deduction have substantial economic effect. The allocation to W of the remaining $500 of the percentage depletion deduction, representing the excess of percentage depletion over adjusted tax basis of the iron ore property, cannot have economic effect since such amount cannot properly be reflected in the partners' capital accounts. Furthermore, the allocation to W of that $500 excess percentage depletion deduction is not in accordance with the special partners' interests in the partnership rule contained in paragraph (b)(4)(iii) of this section, under which such $500 excess depletion deduction (and all further percentage depletion deductions from the mine) will be reallocated 75 percent to W and 25 percent to X.

(ii) Assume the same facts as in (i) except that the partnership agreement provides that all percentage depletion deductions of the partnership will be allocated 75 percent to W and 25 percent to X. Once again, the allocation of partnership income, gain, loss, and deduction (excluding the percentage depletion deduction) as well as the allocation of $1,000 of the percentage depletion deduction have substantial economic effect. Furthermore, since the $500 portion of the percentage depletion deduction that exceeds the adjusted basis of such iron ore property is allocated in the same manner as valid allocations of the gross income from such property during the taxable year (*i.e.*, 75 percent to W and 25 percent to X), the allocation of the $500 excess percentage depletion contained in the partnership agreement is in accordance with the special partners' interests in the partnership rule contained in paragraph (b)(4)(iii) of this section.

Example 13. (i) Y and Z form a brokerage general partnership for the purpose of investing and trading in marketable securities. Y contributes cash of $10,000, and Z contributes securities of P corporation, which have an adjusted basis of $3,000 and a fair market value of $10,000. The partnership would not be an investment company under section 351(e) if it were incorporated. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). The partnership uses the interim closing of the books method for purposes of section 706. The initial capital accounts of Y and Z are fixed at $10,000 each. The agreement further provides that all partnership distributions, income, gain, loss, deduction, and credit will be shared equally between Y and Z, except that the taxable gain attributable to the precontribution appreciation in the value of the securities of P corporation will be allocated to Z in accordance with section 704(c). During the partnership's first taxable year, it sells the securities of P corporation for $12,000, resulting in a $2,000 book gain ($12,000 less $10,000 book value) and a $9,000 taxable gain ($12,000 less $3,000 adjusted tax basis). The partnership has no other income, gain, loss, or deductions for the taxable year. The gain from the sale of the securities is allocated as follows:

	Y		Z	
	Tax	Book	Tax	Book
Capital account upon formation	$10,000	$10,000	$3,000	$10,000
Plus: gain	1,000	1,000	8,000	1,000
Capital account at end of year 1	$11,000	$11,000	$11,000	$11,000

The allocation of the $2,000 book gain, $1,000 each to Y and Z, has substantial economic effect. Furthermore, under section 704(c) the partners' distributive shares of the $9,000 taxable gain are $1,000 to Y and $8,000 to Z.

(ii) Assume the same facts as in (i) and that at the beginning of the partnership's second taxable year, it invests its $22,000 of cash in securities of G Corp. The G Corp. securities increase in value to $40,000, at which time Y sells 50 percent of his partnership interest (*i.e.*, a 25 percent interest in the partnership) to LK for $10,000. The partnership does not have a section 754 election in effect for the partnership taxable year during which such sale occurs. In accordance with paragraph (b)(2)(iv)(*l*) of this section, the partnership agreement provides that LK inherits 50 percent of Y's $11,000 capital account balance. Thus, following the sale, LK and Y each have a capital account of $5,500, and Z's capital account remains at $11,000. Prior to the end of the partnership's second taxable year, the securities are sold for their $40,000 fair market value, resulting in an $18,000 taxable gain ($40,000 less $22,000 adjusted tax basis). The partnership has no other income, gain, loss, or deduction in such taxable year. Under the partnership agreement the $18,000 taxable gain is allocated as follows:

	Y	Z	LK
Capital account before sale of securities	$5,500	$11,000	$5,500
Plus: gain	4,500	9,000	4,500
Capital account at end of year 2	$10,000	$20,000	$10,000

The allocation of the $18,000 taxable gain has substantial economic effect.

(iii) Assume the same facts as in (ii) except that the partnership has a section 754 election in effect for the partnership taxable year during which Y sells 50 percent of his interest to LK. Accordingly, under § 1.743–1 there is a $4,500 basis increase to the G Corp. securities with respect to LK. Notwithstanding this basis adjustment, as a result of the sale of the G Corp. securities, LK's capital account is, as in (ii), increased by $4,500. The fact that LK recognizes no taxable gain from such sale (due to his $4,500 section 743 basis adjustment) is irrelevant for capital accounting purposes since, in accordance with paragraph (b)(2)(iv)(*m*)(*2*) of this section, that basis adjustment is disregarded in the maintenance and computation of the partners' capital accounts.

(iv) Assume the same facts as in (iii) except that immediately following Y's sale of 50 percent of this interest to LK, the G Corp. securities decrease in value to $32,000 and are sold. The $10,000 taxable gain ($32,000 less $22,000 adjusted tax basis) is allocated as follows:

	Y	Z	LK
Capital account before sale of securities	$5,500	$11,000	$5,500
Plus: gain	2,500	5,000	2,500
Capital account at end of the year 2	$8,000	$16,000	$8,000

The fact that LK recognizes a $2,000 taxable loss from the sale of the G Corp. securities (due to his $4,500 section 743 basis adjustment) is irrelevant for capital accounting purposes since, in accordance with paragraph (b)(2)(iv)(*m*)(*2*) of this section, that basis adjustment is disregarded in the maintenance and computation of the partners' capital accounts.

(v) Assume the same facts as in (ii) except that Y sells 100 percent of his partnership interest (*i.e.*, a 50 percent interest in the partnership) to LK for $20,000. Under section 708(b)(1)(B) the partnership terminates. Under paragraph (b)(1)(iv) of § 1.708–1, there is a constructive liquidation of the partnership. Immediately preceding the constructive liquidation, the capital accounts of Z and LK equal $11,000 each (LK having inherited Y's $11,000 capital account) and the book value of the G Corp. securities is $22,000 (original purchase price of securities). Under paragraph (b)(2)(iv)(*l*) of this section, the deemed contribution of assets and liabilities by the terminated partnership to the new partnership and the deemed liquidation of the terminated partnership that occur under §1.708–1(b)(1)(iv) in connection with the constructive liquidation of the terminated partnership are disregarded in the maintenance and computation of the partners' capital accounts. As a result, the capital accounts of Z and LK in the new partnership equal $11,000 each (their capital accounts in the terminated partnership immediately prior to the termination), and the book value of the G Corp. securities remains $22,000 (its book value immediately prior to the termination). This *Example 13*(v) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this *Example 13*(v) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this *Example 13*(v) to the termination in a consistent manner.

Example 14. (i) MC and RW form a general partnership to which each contributes $10,000. The $20,000 is invested in securities of Ventureco (which are not readily tradable on an established securities market). In each of the partnership's taxable years, it recognizes operating income equal to its operating deductions (excluding gain or loss from the sale of securities). The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*)(*2*) and (*3*) of this section). The partnership uses the interim closing of the books method for purposes of section 706. Assume that the Ventureco securities subsequently appreciate in value to $50,000. At that time SK makes a $25,000 cash contribution to the partnership (thereby acquiring a one-third interest in the partnership), and the $25,000 is placed in a bank account. Upon SK's admission to the partnership, the capital accounts of MC and RW (which were $10,000 each prior to SK's admission) are, in accordance with paragraph (b)(2)(iv)(*f*) of this section, adjusted upward (to $25,000 each) to reflect their shares of the unrealized appreciation in the Ventureco securities that occurred before SK was admitted to the partnership. Immediately after SK's admission to the partnership, the securities are sold for their $50,000 fair market value, resulting in taxable gain of $30,000 ($50,000 less $20,000 adjusted tax basis) and no book gain or loss. An allocation of the $30,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(*f*) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the $30,000 taxable gain will, in accordance with section 704(c) principles, be shared $15,000 to MC and $15,000 to RW, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

	MC		RW		SK	
	Tax	Book	Tax	Book	Tax	Book
Capital account following SK's admission	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Plus: gain	15,000	0	15,000	0	0	0
Capital account following sale	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000

(ii) Assume the same facts as (i), except that after SK's admission to the partnership, the Ventureco securities appreciate in value to $74,000 and are sold, resulting in taxable gain of $54,000 ($74,000 less $20,000 adjusted tax basis) and book gain of $24,000 ($74,000 less $50,000 book value). Under the partnership agreement the $24,000 book gain (the appreciation in value occurring after SK became a partner) is allocated equally among MC, RW, and SK, and such allocations have substantial economic effect. An allocation of the $54,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(*f*) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the taxable gain will, in accordance with section 704(c) principles, be shared $23,000 to MC $23,000 to RW, and $8,000 to SK, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

	MC		RW		SK	
	Tax	Book	Tax	Book	Tax	Book
Capital account following SK's admission	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Plus: gain	23,000	8,000	23,000	8,000	8,000	8,000
Capital account following sale	$33,000	$33,000	$33,000	$33,000	$33,000	$33,000

(iii) Assume the same facts as (i) except that after SK's admission to the partnership, the Ventureco securities depreciate in value to $44,000 and are sold, resulting in taxable gain of $24,000 ($44,000 less $20,000 adjusted tax basis) and a book loss of $6,000 ($50,000 book value less $44,000). Under the partnership agreement the $6,000 book loss is allocated equally among MC, RW, and SK, and such allocations have substantial economic effect. An allocation of the $24,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(*f*) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the $24,000 taxable gain will, in accordance with section 704(c) principles, be shared equally between MC and RW, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

	MC		RW		SK	
	Tax	Book	Tax	Book	Tax	Book
Capital account following SK's admission	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Plus: gain	12,000	0	12,000	0	0	0
Less: loss	0	(2,000)	0	(2,000)	0	(2,000)
Capital account following sale	$22,000	$23,000	$22,000	$23,000	$25,000	$25,000

That SK bears an economic loss of $2,000 without a corresponding taxable loss is attributable entirely to the ''ceiling rule.'' See paragraph (c)(2) of § 1.704–1.

(iv) Assume the same facts as in (ii) except that upon the admission of SK the capital accounts of MC and RW are not each adjusted upward from $10,000 to $25,000 to reflect the appreciation in the partnership's securities that occurred before SK was admitted to the partnership. Rather, upon SK's admission to the partnership, the partnership agreement is amended to provide that the first $30,000 of taxable gain upon the sale of such securities will be allocated equally between MC and RW, and that all other income, gain, loss, and deduction will be allocated equally between MC, RW, and SK. When the securities are sold for $74,000, the $54,000 of taxable gain is so allocated. These allocations of taxable gain have substantial economic effect. (If the agreement instead provides for all taxable gain (including the $30,000 taxable gain attributable to the appreciation in the securities prior to SK's admission to the partnership) to be allocated equally between MC, RW, and SK, the partners should consider whether, and to what extent, the provisions of paragraphs (b)(1)(iii) and (iv) of this section are applicable.)

(v) Assume the same facts as in (iv) except that instead of selling the securities, the partnership makes a distribution of the securities (which have a fair market value of $74,000). Assume the distribution does not give rise to a transaction described in section 707(a)(2)(B). In accordance with paragraph (b)(2)(iv)(*e*) of this section, the partners' capital accounts are adjusted immediately prior to the distribution to reflect how taxable gain ($54,000) would have been allocated had the securities been sold for their $74,000 fair market value, and capital account adjustments in respect of the distribution of the securities are made with reference to the $74,000 ''booked-up'' fair market value.

	MC	RW	SK
Capital account before adjustment	$10,000	$10,000	$25,000
Deemed sale adjustment	23,000	23,000	8,000
Less: distribution	(24,667)	(24,667)	(24,667)
Capital account after distribution	$8,333	$8,333	$8,333

(vi) Assume the same facts as in (i) except that the partnership does not sell the Ventureco securities. During the next 3 years the fair market value of the Ventureco securities remains at $50,000, and the partnership engages in no other investment activities. Thus, at the end of that period the balance sheet of the partnership and the partners' capital accounts are the same as they were at the beginning of such period. At the end of the 3 years, MC's interest in the partnership is liquidated for the $25,000 cash held by the partnership. Assume the distribution does not give rise to a transaction described in section 707(a)(2)(B). Assume further that the partnership has a section 754 election in effect for the taxable year during which such liquidation occurs. Under sections 734(b) and 755 the partnership increases the basis of the Ventureco securities by the $15,000 basis adjustment (the excess of $25,000 over the $10,000 adjusted tax basis of MC's partnership interest).

	MC		RW		SK	
	Tax	Book	Tax	Book	Tax	Book
Capital account before distribution	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Plus: basis adjustment	15,000	0	0	0	0	0
Less: distribution	(25,000)	(25,000)	0	0	0	0
Capital account account after liquidation	0	0	$10,000	$25,000	$25,000	$25,000

(vii) Assume the same facts as in (vi) except that the partnership has no section 754 election in effect for the taxable year during which such liquidation occurs.

	MC		RW		SK	
	Tax	Book	Tax	Book	Tax	Book
Capital account before distribution	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Less: distribution	(25,000)	(25,000)	0	0	0	0
Capital account after liquidation	($15,000)	0	$10,000	$25,000	$25,000	$25,000

Following the liquidation of MC's interest in the partnership, the Ventureco securities are sold for their $50,000 fair market value, resulting in no book gain or loss but a $30,000 taxable gain. An allocation of this $30,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(*f*) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that $15,000 of such taxable gain will, in accordance with section 704(c) principles, be included in RW's distributive share, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section. The remaining $15,000 of such gain will, under paragraph (b)(3) of this section, be shared equally between RW and SK.

Example 15. (i) JB and DK form a limited partnership for the purpose of purchasing residential real estate to lease. JB, the limited partner, contributes $13,500, and DK, the general partner, contributes $1,500. The partnership, which uses the cash receipts and disbursements method of accounting, purchases a building for $100,000 (on leased land), incurring a recourse mortgage of $85,000 that requires the payment of interest only for a period of 3 years. The partnership agreement provides that partnership net taxable income and loss will be allocated 90 percent to JB and 10 percent to DK, the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances (as set forth in paragraph (b)(2)(ii)(*b*)(*2*) of this section), and JB is not required to restore any deficit balance in his capital account, but DK is so required. The partnership agreement contains a qualified income offset (as defined in paragraph (b)(2)(ii)(*d*) of this section). As of the end of each of the partnership's first 3 taxable years, the items described in paragraphs (b)(2)(ii)(*d*)(*4*), (*5*), and (*6*) of this section are not reasonably expected to cause or increase a deficit balance in JB's capital account. In the partnership's first taxable year, it has rental income of $10,000, operating expenses of $2,000, interest expense of $8,000, and cost recovery deductions of $12,000. Under the partnership agreement JB and DK are allocated $10,800 and $1,200, respectively, of the $12,000 net taxable loss incurred in the partnership's first taxable year.

	JB	DK
Capital account upon formation	$13,500	$1,500
Less: year 1 net loss	(10,800)	(1,200)
Capital account at end of year 1	$2,700	$300

The alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section is satisfied as of the end of the partnership's first taxable year. Thus, the allocation made in the partnership's first taxable year has economic effect.

(ii) Assume the same facts as in (i) and that in the partnership's second taxable year it again has rental income of $10,000, operating expenses of $2,000, interest expense of $8,000, and cost recovery deductions of $12,000. Under the partnership agreement JB and DK are allocated $10,800 and $1,200, respectively, of the $12,000 net taxable loss incurred in the partnership's second taxable year.

	JB	DK
Capital account at beginning of year 1	$2,700	$300
Less: year 2 net loss	(10,800)	(1,200)
Capital account at end of year 2	($8,100)	($900)

Only $2,700 of the $10,800 net taxable loss allocated to JB satisfies the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section as of the end of the partnership's second taxable year. The allocation of such $2,700 net taxable loss to JB (consisting of $2,250 of rental income, $450 of operating expenses, $1,800 of interest expense, and $2,700 of cost recovery deductions) has economic effect. The remaining $8,100 of net taxable loss allocated by the partnership agreement to JB must be reallocated in accordance with the partners' interests in the partnership. Under paragraph (b)(3)(iii) of this section, the determination of the partners' interests in the remaining $8,100 net taxable loss is made by comparing how distributions (and contributions) would be made if the partnership sold its property at its adjusted tax basis and liquidated immediately following the end of the partnership's first taxable year with the results of such a sale and liquidation immediately following the end of the partnership's second taxable year. If the partnership's real property were sold for its $88,000 adjusted tax basis and the partnership were liquidated immediately following the end of the partnership's first taxable year, the $88,000 sales proceeds would be used to repay the $85,000 note, and there would be $3,000 remaining in the partnership, which would be used to make liquidating distributions to DK and JB of $300 and $2,700, respectively. If such property were sold for its $76,000 adjusted tax basis and the partnership were liquidated immediately following the end of the partnership's second taxable year, DK would be required to contribute $9,000 to the partnership in order for the partnership to repay the $85,000 note, and there would be no assets remaining in the partnership to distribute. A comparison of these outcomes indicates that JB bore $2,700 and DK $9,300 of the economic burden that corresponds to the $12,000 net taxable loss. Thus, in addition to the $1,200 net taxable loss allocated to DK under the partnership agreement, $8,100 of net taxable loss will be reallocated to DK under paragraph (b)(3)(iii) of this section. Similarly, for subsequent taxable years, absent an increase in JB's capital account, all net taxable loss allocated to JB under the partnership agreement will be reallocated to DK.

(iii) Assume the same facts as in (ii) and that in the partnership's third taxable year there is rental income of $35,000, operating expenses of $2,000, interest expense of $8,000, and cost recovery deductions of $10,000. The capital accounts of the partners maintained on the books of the partnership do not take into account the reallocation to DK of the $8,100 net taxable loss in the partnership's second taxable year. Thus, an allocation of the $15,000 net taxable income $13,500 to JB and $1,500 to DK (as dictated by the partnership agreement and as reflected in the capital accounts of the partners) does not have economic effect. The partners' interests in the partnership with respect to such $15,000 taxable gain again is made in the manner described in paragraph (b) (3) (iii) of this section. If the partnership's real property were sold for its $76,000 adjusted tax basis and the partnership were liquidated immediately following the end of the partnership's second taxable year, DK would be required to contribute $9,000 to the partnership in order for the partnership to repay the $85,000 note, and there would be no assets remaining to distribute. If such property were sold for its $66,000 adjusted tax basis and the partnership were liquidated immediately following the end of the partnership's third taxable year, the $91,000 ($66,000 sales proceeds plus $25,000 cash on hand) would be used to repay the $85,000 note and there would be $6,000 remaining in the partnership, which would be used to make liquidating distributions to DK and JB of $600 and $5,400, respectively. Accordingly, under paragraph (b) (3) (iii) of this section the $15,000 net taxable income in the partnership's third taxable year will be reallocated $9,600 to DK (minus $9,000 at end of the second taxable year to positive $600 at end of the third taxable year) and $5,400 to JB (zero at end of the second taxable year to positive $5,400 at end of the third taxable year).

Example 16. (i) KG and WN form a limited partnership for the purpose of investing in improved real estate. KG, the general partner, contributes $10,000 to the partnership, and WN, the limited partner, contributes $990,000 to the partnership. The $1,000,000 is used to purchase an apartment building on leased land. The partnership agreement provides that (1) the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section; (2) cash will be distributed first to WN until such time as he has received the amount of his original capital contribution ($990,000), next to KG until such time as he has received the amount of his original capital contribution ($10,000), and thereafter equally between WN and KG; (3) partnership net taxable income will be allocated 99 percent to WN and 1 percent to KG until the cumulative net taxable income allocated for all taxable years is equal to the cumulative net taxable loss previously allocated to the partners, and thereafter equally between WN and KG; (4) partnership net taxable loss will be allocated 99 percent to WN and 1 percent to KG, unless net taxable income has previously been allocated equally between WN and KG, in which case such net taxable loss first will be allocated equally until the cumulative net taxable loss allocated for all taxable years is equal to the cumulative net taxable income previously allocated to the partners; and (5) upon liquidation, WN is not required to restore any deficit balance in his capital account, but KG is so required. Since distributions in liquidation are not required to be made in accordance with the partners' positive capital account balances, and since WN is not required, upon the liquidation of his interest, to restore the deficit balance in his capital account to the partnership, the allocations provided by the partnership agreement do not have economic effect and will be reallocated in accordance with the partners' interests in the partnership under paragraph (b) (3) of this section.

(ii) Assume the same facts as in (i) except that the partnership agreement further provides that distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partners' positive capital account balances (as set forth in paragraph (b)(2)(ii)(*b*)(*2*) of this section). Assume further that the partnership agreement contains a qualified income offset (as defined in paragraph (b)(2)(ii)(*d*) of this section) and that, as of the end of each partnership taxable year, the items described in paragraphs (b)(2)(iii)(*d*) (*4*), (*5*), and (*6*) of this section are not reasonably expected to cause or increase a deficit balance in WN's capital account. The allocations provided by the partnership agreement have economic effect.

Example 17. FG and RP form a partnership with FG contributing cash of $100 and RP contributing property, with 2 years of cost recovery deductions remaining, that has an adjusted tax basis of $80 and a fair market value of $100. The partnership, FG, and RP have calendar taxable years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, liquidation proceeds will be made in accordance with capital account balances, and each partner is liable to restore the deficit balance in his capital account to the partnership upon liquidation of his interest (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). FG expects to be in a substantially higher tax bracket than RP in the partnership's first taxable year. In the partnership's second taxable year, and in subsequent taxable years, it is expected that both will be in approximately equivalent tax brackets. The partnership agreement allocates all items equally except that all $50 of book depreciation is allocated to FG in the partnership's first taxable year and all $50 of book depreciation is allocated to RP in the partnership's second taxable year. If the allocation to FG of all book depreciation in the partnership's first taxable year is respected, FG would be entitled under section 704(c) to the entire cost recovery deduction ($40) for such year. Likewise, if the allocation to RP of all the book depreciation in the partnership's second taxable year is respected, RP would be entitled under section 704(c) to the entire cost recovery deduction ($40) for such year. The allocation of book depreciation to FG and RP in the partnership's first 2 taxable years has economic effect within the meaning of paragraph (b)(2)(ii) of this section. However, the economic effect of these allocations is not substantial under the test described in paragraph (b)(2)(iii)(*c*) of this section since there is a strong likelihood at the time such allocations became part of the partnership agreement that at the end of the 2-year period to which such allocations relate, the net increases and decreases to FG's and RP's capital accounts will be the same with such allocations as they would have been in the absence of such allocation, and the total tax liability of FG and RP for the taxable years to which the section 704(c) determinations relate would be reduced as a result of the allocations of book depreciation. As a result the allocations of book depreciation in the partnership agreement will be disregarded. FG and RP will be allocated such book depreciation in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section. Under these facts the book depreciation deductions will be reallocated equally between the partners, and section 704(c) will be applied with reference to such reallocation of book depreciation.

Example 18 . (i) WM and JL form a general partnership by each contributing $300,000 thereto. The partnership uses the $600,000 to purchase an item of tangible personal property, which it leases out. The partnership elects under section 48 (q)(4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such property. The partnership agreement provides that (1) the partners' capital account will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, (2) distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances (as set forth in paragraph (b)(2)(ii)(*b*)(*2*) of this section), (3) any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraph (b)(2)(ii)(*b*)(*3*) of this section), (4) all income, gain, loss, and deduction of the partnership will be allocated equally between the partners, and (5) all nonliquidating distributions of the partnership will be made equally between the partners. Assume that in each of the partnership's taxable years, it recognizes operating income equal to its operating deductions (excluding cost recovery and depreciation deductions and gain or loss on the sale of its property). During its first 2 taxable years, the partnership has an additional $200,000 cost recovery deduction in each year. Pursuant to the partnership agreement these items are allocated equally between WM and JL.

	WM	*JL*
Capital account upon formation	$300,000	$300,000
Less: Net loss for years 1 and 2 ...	*(200,000)*	*(200,000)*
Capital account at end of year 2	$100,000	$100,000

The allocations made in the partnership's first 2 taxable years have substantial economic effect.

(ii) Assume the same facts as in (i) and that MK is admitted to the partnership at the beginning of the partnership's third taxable year. At the time of his admission, the fair market value of the partnership property is $600,000. MK contributes $300,000 to the partnership in exchange for an equal one-third interest in the partnership, and, as permitted under paragraph (b)(2)(iv)(*g*), the capital accounts of WM and JL are adjusted upward to $300,000 each to reflect the fair market value of partnership property. In addition, the partnership agreement is modified to provide that depreciation and gain or loss, as computed for tax purposes, with respect to the partnership property that appreciated prior to MK's admission will be shared among the partners in a manner that takes account of the variation between such property's $200,000 adjusted tax basis and its $600,000 book value in accordance with paragraph (b)(2)(iv)(*f*) and the special rule contained in paragraph (b)(4)(i) of this section. Depreciation and gain or loss, as computed for book purposes, with respect to such property will be allocated equally among the partners and, in accordance with paragraph (b)(2)(iv)(*g*) of this section, will be reflected in the partner's capital accounts, as will all other partnership income, gain, loss, and deduction. Since the requirements of (b)(2)(iv)(*g*) of this section are satisfied, the capital accounts of the partners (as adjusted) continue to be maintained in accordance with paragraph (B)(2)(iv) of this section.

(iii) Assume the same facts as in (ii) and that immediately after MK's admission to the partnership, the partnership property is sold for $600,000, resulting in a taxable gain of $400,000 ($600,000 less $200,000 adjusted tax basis) and no book gain or loss, and the partnership is liquidated. An allocation of the $400,000 taxable gain cannot have economic effect because such gain cannot properly be reflected in the partners' book capital accounts. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $400,000 taxable gain will, in accordance with section 704(c) principles, be shared equally between WM and JL.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Plus: gain	200,000	0	200,000	0	0	0
Capital account before liquidation	$300,000	$300,000	$300,000	$300,000	$300,000	$300,000

The $900,000 of partnership cash ($600,000 sales proceeds plus $300,000 contributed by MK) is distributed equally among WM, JL, and MK in accordance with their adjusted positive capital account balances, each of which is $300,000.

(iv) Assume the same facts as in (iii) except that prior to liquidation the property appreciates and is sold for $900,000, resulting in a taxable gain of $700,000 ($900,000 less $200,000 adjusted tax basis) and a book gain of $300,000 ($900,000 less $600,000 book value). Under the partnership agreement the $300,000 of book gain is allocated equally among the partners, and such allocation has substantial economic effect.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Plus: gain	300,000	100,000	300,000	100,000	100,000	100,000
Capital account before liquidation	$400,000	$400,000	$400,000	$400,000	$400,000	$400,000

Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $700,000 taxable gain is, in accordance with section 704(c) principles, shared $300,000 to JL, $300,000 to WM, and $100,000 to MK. This ensures that (1) WM and JL share equally the $400,000 taxable gain that is attributable to appreciation in the property that occurred prior to MK's admission to the partnership in the same manner as it was reflected in their capital accounts upon MK's admission, and (2) WM, JL, and MK share equally the additional $300,000 taxable gain in the same manner as they shared the $300,000 book gain.

(v) Assume the same facts as in (ii) except that shortly after MK's admission the property depreciates and is sold for $450,000, resulting in a taxable gain of $250,000 ($450,000 less $200,000 adjusted tax basis) and a book loss of $150,000 (450,000 less $600,000 book value). Under the partnership agreement these items are allocated as follow:

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Plus: gain	125,000	0	125,000	0	0	0
Less: loss	0	(50,000)	0	(50,000)	0	(50,000)
Capital account before liquidation	$225,000	$250,000	$225,000	$250,000	$300,000	$250,000

The $150,000 book loss is allocated equally among the partners, and such allocation has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $250,000 taxable gain is, in accordance with section 704(c) principles, shared equally between WM and JL. The fact that MK bears an economic loss of $50,000 without a corresponding taxable loss is attributable entirely to the ''ceiling rule.'' See paragraph (c)(2) of §1.704–1.

(vi) Assume the same facts as in (ii) except that the property depreciates and is sold for $170,000, resulting in a $30,000 taxable loss ($200,000 adjusted tax basis less $170,000) and a book loss of $430,000 ($600,000 book value less $170,000). The book loss of $430,000 is allocated equally among the partners ($143,333 each) and has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the entire $30,000 taxable loss is, in accordance with section 704(c) principles, included in MK's distributive share.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Less Loss	0	(143,333)	0	(143,333)	(30,000)	(143,333)
Capital account before liquidation	$100,000	$156,667	$100,000	$156,667	$270,000	$156,667

(vii) Assume the same facts as in (ii) and that during the partnership's third taxable year, the partnership has an additional $100,000 cost recovery deduction and $300,000 book depreciation deduction attributable to the property purchased by the partnership in its first taxable year. The $300,000 book depreciation deduction is allocated equally among the partners, and that allocation has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $100,000 cost recovery deduction for the partnership's third taxable year is, in accordance with section 704(c) principles, included in MK's distributive share. This is because under these facts those principles require MK to include the cost recovery deduction for such property in his distributive share up to the amount of the book depreciation deduction for such property properly allocated to him.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Less: recovery/depreciation deduction for year 3	0	(100,000)	0	(100,000)	(100,000)	(100,000)
Capital account at end of year 3	$100,000	$200,000	$100,000	$200,000	$200,000	$200,000

(viii) Assume the same facts as in (vii) except that upon MK's admission the partnership property has an adjusted tax basis of $220,000 (instead of $200,000), and thus the cost recovery deduction for the partnership's third taxable year is $110,000. Assume further that upon MK's admission WM and JL have adjusted capital account balances of $110,000 and $100,000, respectively. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the excess $10,000 cost recovery deduction ($110,000 less $100,000 included in MK's distributive share) is, in accordance with section 704 (c) principles, shared equally between WM and JL and is so included in their respective distributive shares for the partnership's third taxable year.

(ix) Assume the same facts as in (vii) except that upon MK's admission the partnership agreement is amended to allocate the first $400,000 of book depreciation and loss on partnership property equally between WM and JL and the last $200,000 of such book depreciation and loss to MK. Assume such allocations have substantial economic effect. Pursuant to this amendment the $300,000 book depreciation deduction in the partnership's third taxable year is allocated equally between WM and JL. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $100,000 cost recovery deduction is, in accordance with section 704(c) principles, shared equally between WM and JL. In the partnership's fourth taxable year, it has a $60,000 cost recovery deduction and a $180,000 book depreciation deduction. Under the amendment described above, the $180,000 book depreciation deduction is allocated $50,000 to WM, $50,000 to JL, and $80,000 to MK. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $60,000 cost recovery deduction is, in accordance with section 704(c) principles, included entirely in MK's distributive share.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Less:						
(a) recovery/depreciation deduction for year 3	(50,000)	(150,000)	(50,000)	(150,000)	0	0
(b) recovery/depreciation deduction for year 4	0	(50,000)	0	(50,000)	(60,000)	(80,000)
Capital account at end of year 4	$50,000	$100,000	$50,000	$100,000	$240,000	$220,000

(x) Assume the same facts as in (vii) and that at the beginning of the partnership's third taxable year, the partnership purchases a second item of tangible personal property for $300,000 and elects under section 48(q) (4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such property. The partnership agreement is amended to allocate the first $150,000 of cost recovery deductions and loss from such property to WM and the next $150,000 of cost recovery deductions and loss from such property equally between JL and MK. Thus, in the partnership's third taxable year it has, in addition to the items specified in (vii), a cost recovery and book depreciation deduction of $100,000 attributable to the newly acquired property, which is allocated entirely to WM.

As in (vii), the allocation of the $300,000 book depreciation attributable to the property purchased in the partnership's first taxable year equally among the partners has substantial economic effect, and consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement properly provides for the entire $100,000 cost recovery deduction attributable to such property to be included in MK's distributive share. Furthermore, the allocation to WM of the $100,000 cost recovery deduction attributable to the property purchased in the partnership's third taxable year has substantial economic effect.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Less:						
(a) recovery/depreciation deduction for property bought in year 1	0	(100,000)	0	(100,000)	(100,000)	(100,000)
(b) recovery/depreciation deduction for property bought in year 3	(100,000)	(100,000)	0	0	0	0
Capital account at end of year 3	0	$100,000	$100,000	$200,000	$200,000	$200,000

(xi) Assume the same facts as in (x) and that at the beginning of the partnership's fourth taxable year, the properties purchased in the partnership's first and third taxable years are disposed of for $90,000 and $180,000, respectively, and the partnership is liquidated. With respect to the property purchased in the first taxable year, there is a book loss of $210,000 ($300,000 book value less $90,000) and a taxable loss of $10,000 ($100,000 adjusted tax basis less $90,000). The book loss is allocated equally among the partners, and such allocation has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the taxable loss of $10,000 will, in accordance with section 704(c) principles, be included entirely in MK's distributive share. With respect to the property purchased in the partnership's third taxable year, there is a book and taxable loss of $20,000. Pursuant to the partnership agreement this loss is allocated entirely to WM, and such allocation has substantial economic effect.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 4	0	$100,000	$100,000	$200,000	$200,000	$200,000
Less:						
(a) loss on property bought in year 1	0	(70,000)	0	(70,000)	(10,000)	(70,000)
(b) loss on property bought in year 3	(20,000)	(20,000)	0	0	0	0
Capital account before liquidation	($20,000)	$10,000	$100,000	$130,000	$190,000	$130,000

Partnership liquidation proceeds ($270,000) are properly distributed in accordance with the partners' adjusted positive book capital account balances ($10,000 to WM, $130,000 to JL and $130,000 to MK).

(xii) Assume the same facts as in (x) and that in the partnership's fourth taxable year it has a cost recovery deduction of $60,000 and book depreciation deduction of $180,000 attributable to the property purchased in the partnership's first taxable year, and a cost recovery and book depreciation deduction of $100,000 attributable to the property purchased in the partnership's third taxable year. The $180,000 book depreciation deduction attributable to the property purchased in the partnership's first taxable year is allocated equally among the partners, and such allocation has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $60,000 cost recovery deduction attributable to the property purchased in the first taxable year is, in accordance with section 704(c) principles, included entirely in MK's distributive share. Furthermore, the $100,000 cost recovery deduction attributable to the property purchased in the third taxable year is allocated $50,000 to WM, $25,000 to JL, and $25,000 to MK, and such allocation has substantial economic effect.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 4	0	$100,000	$100,000	$200,000	$200,000	$200,000
Less:						
(a) recovery/depreciation deduction for property bought in year 1	0	(60,000)	0	(60,000)	(60,000)	(60,000)
(b) recovery/depreciation deduction for property bought in year 3	(50,000)	(50,000)	(25,000)	(25,000)	(25,000)	(25,000)
Capital account at end of year 4	($50,000)	($10,000)	$75,000	$115,000	$115,000	$115,000

At the end of the partnership's fourth taxable year the adjusted tax bases of the partnership properties acquired in its first and third taxable years are $40,000 and $100,000, respectively. If the properties are disposed of at the beginning of the partnership's fifth taxable year for their adjusted tax bases, there would be no taxable gain or loss, a book loss of $80,000 on the property purchased in the partnership's first taxable year ($120,000 book value less $40,000), and cash available for distribution of $140,000.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 5	($50,000)	($10,000)	$75,000	$115,000	$115,000	$115,000
Less: loss	0	(26,667)	0	(26,667)	0	(26,667)
Capital account before liquidation	($50,000)	($36,667)	$75,000	$88,333	$115,000	$88,333

If the partnership is then liquidated, the $140,000 of cash on hand plus the $36,667 balance that WM would be required to contribute to the partnership (the deficit balance in his book capital account) would be distributed equally between JL and MK in accordance with their adjusted positive book capital account balances.

(xiii) Assume the same facts as in (i). Any tax preferences under section 57(a)(12) attributable to the partnership's cost recovery deductions in the first 2 taxable years will be taken into account equally by WM and JL. If the partnership agreement instead provides that the partnership's cost recovery deductions in its first 2 taxable years are allocated 25 percent to WM and 75 percent to JL (and such allocations have substantial economic effect), the tax preferences attributable to such cost recovery deductions would be taken into account 25 percent by WM and 75 percent by JL. The conclusion in the previous sentence is unchanged even if the partnership's operating expenses (exclusive of cost recovery and depreciation deductions) exceed its operating income in each of the partnership's first 2 taxable years, the resulting net loss is allocated entirely to WM, and the cost recovery deductions are allocated 25 percent to WM and 75 percent to JL (provided such allocations have substantial economic effect). If the partnership agreement instead provides that all income, gain, loss, and deduction (including cost recovery and depreciations) are allocated equally between JL and WM, the tax preferences attributable to the cost recovery deductions would be taken into account equally by JL and WM. In this case, if the partnership has a $100,000 cost recovery deduction in its first taxable year and an additional net loss of $100,000 in its first taxable year (*i.e.*, its operating expenses exceed its operating income by $100,000) and purports to categorize JL's $100,000 distributive share of partnership loss as being attributable to the cost recovery deduction and WM's $100,000 distributive share of partnership loss as being attributable to the net loss, the economic effect of such allocations is not substantial, and each partner will be allocated one-half of all partnership income, gain, loss, and deduction and will take into account one-half of the tax preferences attributable to the cost recovery deductions.

Example 19. (i) DG and JC form a general partnership for the purpose of drilling oil wells. DG contributes an oil lease, which has a fair market value and adjusted tax basis of $100,000. JC contributes $100,000 in cash, which is used to finance the drilling operations. The partnership agreement provides that DG is credited with a capital account of $100,000, and JC is credited with a capital account of $100,000. The agreement further provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore such deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b) (*2*) and (*3*) of this section. The partnership chooses to adjust capital accounts on a simulated cost depletion basis and elects under section 48(q)(4) to reduce the amount of investment tax credit in lieu of adjusting the basis of its section 38 property. The agreement further provides that (1) all additional cash requirements of the partnership will be borne equally by DG and JC, (2) the deductions attributable to the property (including money) contributed by each partner will be allocated to such partner, (3) all other income, gain, loss, and deductions (and item thereof) will be allocated equally between DG and JC, and (4) all cash from operations will be distributed equally between DG and JC. In the partnership's first taxable year $80,000 of partnership intangible drilling cost deductions and $20,000 of cost recovery deductions on partnership equipment are allocated to JC, and the $100,000 basis of the lease is, for purposes of the depletion allowance under sections 611 and 613A(c)(7)(D), allocated to DG. The allocations of income, gain, loss, and deduction provided in the partnership agreement have substantial economic effect. Furthermore, since the allocation of the entire basis of the lease to DG will not result in capital account adjustments (under paragraph (b)(2)(*iv*)(*k*) of this section) the economic effect of which is insubstantial, and since all other partnership allocations are recognized under this paragraph, the allocation of the $100,000 adjusted basis of the lease to DG is, under paragraph (b)(4)(v) of this section, recognized as being in accordance with the partners' interests in partnership capital for purposes of section 613A(c)(7)(D).

(ii) Assume the same facts as in (i) except that the partnership agreement provides that (1) all additional cash requirements of the partnership for additional expenses will be funded by additional contributions from JC, (2) all cash from operations will first be distributed to JC until the excess of such cash distributions over the amount of such additional expense equals his initial $100,000 contributions, (3) all deductions attributable to such additional operating expenses will be allocated to JC, and (4) all income will be allocated to JC until the aggregate amount of income allocated to him equals the amount of partnership operating expenses funded by his initial $100,000 contribution plus the amount of additional operating expenses paid from contributions made solely by him. The allocations of income, gain, loss, and deduction provided in partnership agreement have economic effect. In addition, the economic effect of the allocations provided in the agreement is substantial. Because the partnership's drilling activities are sufficiently speculative, there is not a strong likelihood at the time the disproportionate allocations of loss and deduction to JC are provided for by the partnership agreement that the economic effect of such allocations will be largely offset by allocations of income. In addition, since the allocation of the entire basis of the lease to DG will not result in capital account adjustments (under paragraph (b)(2)(*iv*)(*k*) of this section) the economic effect of which is insubstantial, and since all other partnership allocations are recognized under this paragraph, the allocation of the adjusted basis of the lease to DG is, under paragraph (b)(4)(v) of this section, recognized as being in accordance with the partners' interests in partnership capital under section 613A(c)(7)(D).

(iii) Assume the same facts as in (i) except that all distributions, including those made upon liquidation of the partnership, will be made equally between DG and JC, and no partner is obligated to restore the deficit balance in his capital account to the partnership following the liquidation of his interest for distribution to partners with positive capital account balances. Since liquidation proceeds will be distributed equally between DG and JC irrespective of their capital account balances, and since no partner is required to restore the deficit balance in his capital account to the partnership upon liquidation (in accordance with paragraph (b)(2)(ii)(b)(3) of this section), the allocations of income, gain, loss, and deduction provided in the partnership agreement do not have economic effect and must be reallocated in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section. Under these facts all partnership income, gain, loss, and deduction (and item thereof) will be reallocated equally between JC and DG. Furthermore, the allocation of the $100,000 adjusted tax basis of the lease of DG is not, under paragraph (b)(4)(v) of this section, deemed to be in accordance with the partners' interests in partnership capital under section 613A(c)(7)(D), and such basis must be reallocated in accordance with the partners' interests in partnership capital or income as determined under section 613A(c)(7)(D). The results in this example would be the same if JC's initial cash contribution were $1,000,000 (instead of $100,000), but in such case the partners should consider whether, and to what extent, the provisions of paragraph (b)(1) of §1.721–1, and principles related thereto, may be applicable.

(iv) Assume the same facts as in (i) and that for the partnership's first taxable year the simulated depletion deduction with respect to the lease is $10,000. Since DG properly was allocated the entire depletable basis of the lease (such allocation having been recognized as being in accordance with DG's interest in partnership capital with respect to such lease), under paragraph (b)(2)(iv)(*k*)(*1*) of this section the partnership's $10,000 simulated depletion deduction is allocated to DG and will reduce his capital account accordingly. If (prior to any additional simulated depletion deductions) the lease is sold for $100,000, paragraph (b)(4)(v) of this section requires that the first $90,000 (*i.e.,* the partnership's simulated adjusted basis in the lease) out of the $100,000 amount realized on such sale be allocated to DG (but does not directly affect his capital account). The partnership agreement allocates the remaining $10,000 amount realized equally between JC and DG (but such allocation does not directly affect their capital accounts). This allocation of the $10,000 portion of amount realized that exceeds the partnership's simulated adjusted basis in the lease will be treated as being in accordance with the partners' allocable shares of such amount realized under section 613A(c)(7)(D) because such allocation will not result in capital account adjustments (under paragraph (b)(2)(iv)(*k*) of this section) the economic effect of which is insubstantial, and all other partnership allocations are recognized under this paragraph. Under paragraph (b)(2)(iv)(*k*) of this section, the partners' capital accounts are adjusted upward by the partnership's simulated gain of $10,000

($100,000 sales price less $90,000 simulated adjusted basis) in proportion to such partners' allocable shares of the $10,000 portion of the total amount realized that exceeds the partnership's $90,000 simulated adjusted basis ($5,000 to JC and $5,000 to DG). If the lease is sold for $50,000, under paragraph (b)(4)(v) of this section the entire $50,000 amount realized on the sale of the lease will be allocated to DG (but will not directly affect his capital account). Under paragraph (b)(2)(iv)(*k*) of this section the partners' capital accounts will be adjusted downward by the partnership's $40,000 simulated loss ($50,000 sales price less $90,000 simulated adjusted basis) in proportion to the partners' allocable shares of the total amount realized from the property that represents recovery of the partnership's simulated adjusted basis therein. Accordingly, DG's capital account will be reduced by such $40,000.

(c) *Contributed property; cross-reference.* See § 1.704–3 for methods of making allocations that take into account precontribution appreciation or diminution in value of property contributed by a partner to a partnership.

(d) *Limitation on allowance of losses.* (1) A partner's distributive share of partnership loss will be allowed only to the extent of the adjusted basis (before reduction by current year's losses) of such partner's interest in the partnership at the end of the partnership taxable year in which such loss occurred. A partner's share of loss in excess of his adjusted basis at the end of the partnership taxable year will not be allowed for that year. However, any loss so disallowed shall be allowed as a deduction at the end of the first succeeding partnership taxable year, and subsequent partnership taxable years, to the extent that the partner's adjusted basis for his partnership interest at the end of any such year exceeds zero (before reduction by such loss for such year).

(2) In computing the adjusted basis of a partner's interest for the purpose of ascertaining the extent to which a partner's distributive share of partnership loss shall be allowed as a deduction for the taxable year, the basis shall first be increased under section 705(a)(1) and decreased under section 705(a)(2), except for losses of the taxable year and losses previously disallowed. If the partner's distributive share of the aggregate of items of loss specified in section 702(a) (1), (2), (3), (8), and (9) exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under section 704(d) must be allocated to his distributive share of each such loss. This allocation shall be determined by taking the proportion that each loss bears to the total of all such losses. For purposes of the preceding sentence, the total losses for the taxable year shall be the sum of his distributive share of losses for the current year and his losses disallowed and carried forward from prior years.

(3) For the treatment of certain liabilities of the partner or partnership, see section 752 and § 1.752–1.

(4) The provisions of this paragraph may be illustrated by the following examples:

Example 1. At the end of the partnership taxable year 1955, partnership AB has a loss of $20,000. Partner A's distributive share of this loss is $10,000. At the end of such year, A's adjusted basis for his interest in the partnership (not taking into account his distributive share of the loss) is $6,000. Under section 704(d), A's distributive share of partnership loss is allowed to him (in his taxable year within or with which the partnership taxable year ends) only to the extent of his adjusted basis of $6,000. The $6,000 loss allowed for 1955 decreases the adjusted basis of A's interest to zero. Assume that, at the end of partnership taxable year 1956, A's share of partnership income has increased the adjusted basis of A's interest in the partnership to $3,000 (not taking into account the $4,000 loss disallowed in 1955). Of the $4,000 loss disallowed for the partnership taxable year 1955, $3,000 is allowed A for the partnership taxable year 1956, thus again decreasing the adjusted basis of his interest to zero. If, at the end of partnership taxable year 1957, A has an adjusted basis of his interest of at least $1,000 (not taking into account the disallowed loss of $1,000), he will be allowed the $1,000 loss previously disallowed.

Example 2. At the end of partnership taxable year 1955, partnership CD has a loss of $20,000. Partner C's distributive share of this loss is $10,000. The adjusted basis of his interest in the partnership (not taking into account his distributive share of such loss) is $6,000. Therefore, $4,000 of the loss is disallowed. At the end of partnership taxable year 1956, the partnership has no taxable income or loss, but owes $8,000 to a bank for money borrowed. Since C's share of this liability is $4,000, the basis of his partnership interest is increased from zero to $4,000. (See sections 752 and 722, and §§ 1.752–1 and 1.722–1.) C is allowed the $4,000 loss, disallowed for the preceding year under section 704(d), for his taxable year within or with which partnership taxable year 1956 ends.

Example 3. At the end of partnership taxable year 1955, partner C has the following distributive share of partnership items described in section 702(a): Long-term capital loss, $4,000; short-term capital loss, $2,000; income as described in section 702(a)(9), $4,000. Partner C's adjusted basis for his partnership interest at the end of 1955, before adjustment for any of the above items, is $1,000. As adjusted under section 705(a)(1)(A), C's basis is increased from $1,000 to $5,000 at the end of the year. C's total distributive share of partnership loss is $6,000. Since without regard to losses, C has a basis of only $5,000, C is allowed only $5,000/$6,000 of each loss, that is, $3,333 of his long-term capital loss, and $1,667 of his short-term capital loss. C must carry forward to succeeding taxable years $667 as a long-term capital loss and $333 as a short-term capital loss.

(e) *Family partnerships*—(1) *In general*—(i) *Introduction.* The production of income by a partnership is attributable to the capital or services, or both, contributed by the partners. The provisions of subchapter K, chapter 1 of the Code, are to be read in the light of their relationship to section 61, which requires, inter alia, that income be taxed to the person who earns it through his own labor and skill and the utilization of his own capital.

(ii) *Recognition of donee as partner.* With respect to partnerships in which capital is a material income-producing factor, section 704(e)(1) provides that a person shall be recognized as a partner for income tax purposes if he owns a capital interest in such a partnership whether or not such interest is derived by purchase or gift from any other person. If a capital interest in a partnership in which capital is a material income-producing factor is created by gift, section 704(e)(2) provides that the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such distributive share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such distributive share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. For rules of allocation in such cases, see subparagraph (3) of this paragraph.

(iii) *Requirement of complete transfer to donee.* A donee or purchaser of a capital interest in a partnership is not recognized as a partner under the principles of section 704(e)(1) unless such interest is acquired in a bona fide transaction, not a mere sham for tax avoidance or evasion purposes, and the donee or purchaser is the real owner of such interest. To be recognized, a transfer must vest dominion and control of the partnership interest in the transferee. The existence of such dominion and control in the donee is to be determined from all the facts and circumstances. A transfer is not recognized if the transferor retains such incidents of ownership that the transferee has not acquired full and complete ownership of the partnership interest. Transactions between members of a family will be closely scrutinized, and the circumstances, not only at the time of the purported transfer but also during the periods preceding and following it, will be taken into consideration in determining the bona fides or lack of bona fides of the purported gift or sale. A partnership may be recognized for income tax purposes as to some partners but not as to others.

(iv) *Capital as a material income-producing factor.* For purposes of section 704(e)(1), the determination as to whether capital is a material income-producing factor must be made by reference to all the facts of each case. Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. In general, capital is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership. On the other hand, capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment.

(v) *Capital interest in a partnership.* For purposes of section 704(e), a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.

(2) *Basic tests as to ownership*—(i) *In general.* Whether an alleged partner who is a donee of a capital interest in a partnership is the real owner of such capital interest, and whether the donee has dominion and control over such interest, must be ascertained from all the facts and circumstances of the particular case. Isolated facts are not determinative; the reality of the donee's ownership is to be determined in the light of the transaction as a whole. The execution of legally sufficient and irrevocable deeds or other instruments of gift under State law is a factor to be taken into account but is not determinative of ownership by the donee for the purposes of section 704(e). The reality of the transfer and of the donee's ownership of the property attributed to him are to be ascertained from the conduct of the parties with respect to the alleged gift and not by any mechanical or formal test. Some of the more important factors to be considered in determining whether the donee has acquired ownership of the capital interest in a partnership are indicated in subdivisions (ii) to (x), inclusive, of this subparagraph.

(ii) *Retained controls.* The donor may have retained such controls of the interest which he has purported to transfer to the donee that the donor should be treated as remaining the substantial owner of the interest. Controls of particular significance include, for example, the following:

(a) Retention of control of the distribution of amounts of income or restrictions on the distributions of amounts of income (other than amounts retained in the partnership annually with the consent of the partners, including the donee partner, for the reasonable needs of the business). If there is a partnership agreement providing for a managing partner or partners, then amounts of income may be retained in the partnership without the acquiescence of all the partners if such amounts are retained for the reasonable needs of the business.

(b) Limitation of the right of the donee to liquidate or sell his interest in the partnership at his discretion without financial detriment.

(c) Retention of control of assets essential to the business (for example, through retention of assets leased to the alleged partnership).

(d) Retention of management powers inconsistent with normal relationships among partners. Retention by the donor of control of business management or of voting control, such as is common in ordinary business relationships, is not by itself to be considered as inconsistent with normal relationships among partners, provided the donee is free to liquidate his interest at his discretion without financial detriment. The donee shall not be considered free to liquidate his interest unless, considering all the facts, it is evident that the donee is independent of the donor and has such maturity and understanding of his rights as to be capable of deciding to exercise, and capable of exercising, his right to withdraw his capital interest from the partnership.

The existence of some of the indicated controls, though amounting to less than substantial ownership retained by the donor, may be considered along with other facts and circumstances as tending to show the lack of reality of the partnership interest of the donee.

(iii) *Indirect controls.* Controls inconsistent with ownership by the donee may be exercised indirectly as well as directly, for example, through a separate business organization, estate, trust, individual, or other partnership. Where such indirect controls exist, the reality of the donee's interest will be determined as if such controls were exercisable directly.

(iv) *Participation in management.* Substantial participation by the donee in the control and management of the business (including participation in the major policy decisions affecting the business) is strong evidence of a donee partner's exercise of dominion and control over his interest. Such participation presupposes sufficient maturity and experience on the part of the donee to deal with the business problems of the partnership.

(v) *Income distributions.* The actual distribution to a donee partner of the entire amount or a major portion of his distributive share of the business income for the sole benefit and use of the donee is substantial evidence of the reality of the donee's interest, provided the donor has not retained controls inconsistent with real ownership by the donee. Amounts distributed are not considered to be used for the donee's sole benefit if, for example, they are deposited, loaned, or invested in such manner that the donor controls or can control the use or enjoyment of such funds.

(vi) *Conduct of partnership business.* In determining the reality of the donee's ownership of a capital interest in a partnership, consideration shall be given to whether the donee is actually treated as a partner in the operation of the business. Whether or not the donee has been held out publicly as a partner in the conduct of the business, in relations with customers, or with creditors or other sources of financing, is of primary significance. Other factors of significance in this connection include:

(a) Compliance with local partnership, fictitious names, and business registration statutes.

(b) Control of business bank accounts.

(c) Recognition of the donee's rights in distributions of partnership property and profits.

(d) Recognition of the donee's interest in insurance policies, leases, and other business contracts and in litigation affecting business.

(e) The existence of written agreements, records, or memoranda, contemporaneous with the taxable year or years concerned, establishing the nature of the partnership agreement and the rights and liabilities of the respective partners.

(f) Filing of partnership tax returns as required by law.

However, despite formal compliance with the above factors, other circumstances may indicate that the donor has retained substantial ownership of the interest purportedly transferred to the donee.

(vii) *Trustees as partners.* A trustee may be recognized as a partner for income tax purposes under the principles relating to family partnerships generally as applied to the particular facts of the trust-partnership arrangement. A trustee who is unrelated to and independent of the grantor, and who participates as a partner and receives distribution of the income distributable to the trust, will ordinarily be recognized as the legal owner of the partnership interest which he holds in trust unless the grantor has retained controls inconsistent with such ownership. However, if the grantor is the trustee, or if the trustee is amenable to the will of the grantor, the provisions of the trust instrument (particularly as to whether the trustee is subject to the responsibilities of a fiduciary), the provisions of the partnership agreement, and the conduct of the parties must all be taken into account in determining whether the trustee in a fiduciary capacity has become the real owner of the partnership interest. Where the grantor (or person amenable to his will) is the trustee, the trust may be recognized as a partner only if the grantor (or such other person) in his participation in the affairs of the partnership actively represents and protects the interests of the beneficiaries in accordance with the obligations of a fiduciary and does not subordinate such interests to the interests of the grantor. Furthermore, if the grantor (or person amenable to his will) is the trustee, the following factors will be given particular consideration:

(a) Whether the trust is recognized as a partner in business dealings with customers and creditors, and

(b) Whether, if any amount of the partnership income is not properly retained for the reasonable needs of the business, the trust's share of such amount is distributed to the trust annually and paid to the beneficiaries or reinvested with regard solely to the interests of the beneficiaries.

(viii) *Interests (not held in trust) of minor children.* Except where a minor child is shown to be competent to manage his own property and participate in the partnership activities in accordance with his interest in the property, a minor child generally will not be recognized as a member of a partnership unless control of the property is exercised by another person as fiduciary for the sole benefit of the child, and unless there is such judicial supervision of the conduct of the fiduciary as is required by law. The use of the child's property or income for support for which a parent is legally responsible will be considered a use for the parent's benefit. ''Judicial supervision of the conduct of the fiduciary'' includes filing of such accountings and reports as are required by law of the fiduciary who participates in the affairs of the partnership on behalf of the minor. A minor child will be considered as competent to manage his own property if he actually has sufficient maturity and experience to be treated by disinterested persons as competent to enter business dealings and otherwise to conduct his affairs on a basis of equality with adult persons, notwithstanding legal disabilities of the minor under State law.

(ix) *Donees as limited partners.* The recognition of a donee's interest in a limited partnership will depend, as in the case of other donated interests, on whether the transfer of property is real and on whether the donee has acquired dominion and control over the interest purportedly transferred to him. To be recognized for Federal income tax purposes, a limited partnership must be organized and conducted in accordance with the requirements of the applicable State limited-partnership law. The absence of services and participation in management by a donee in a limited partnership is immaterial if the limited partnership meets all the other requirements prescribed in this paragraph. If the limited partner's right to transfer or liquidate his interest is subject to substantial restrictions (for example, where the interest of the limited partner is not assignable in a real sense or where such interest may be required to be left in the business for a long term of years), or if the general partner retains any other control which substantially limits any of the rights which would ordinarily be exercisable by unrelated limited partners in normal business relationships, such restrictions on the right to transfer or liquidate, or retention of other control, will be considered strong evidence as to the lack of reality of ownership by the donee.

(x) *Motive.* If the reality of the transfer of interest is satisfactorily established, the motives for the transaction are generally immaterial. However, the presence or absence of a tax-avoidance motive is one of many factors to be considered in determining the reality of the ownership of a capital interest acquired by gift.

(3) *Allocation of family partnership income*—(i) *In general.* (*a*) Where a capital interest in a partnership in which capital is a material income-producing factor is created by gift, the donee's distributive share shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such distributive share attributable to donated capital is proportionately greater than the distributive share attributable to the donor's capital. For the purpose of section 704, a capital interest in a partnership purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The ''family'' of any individual, for the purpose of the preceding sentence, shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons.

(b) To the extent that the partnership agreement does not allocate the partnership income in accordance with *(a)* of this subdivision, the distributive shares of the partnership income of the donor and donee shall be reallocated by making a reasonable allowance for the services of the donor and by attributing the balance of such income (other than a reasonable allowance for the services, if any, rendered by the donee) to the partnership capital of the donor and donee. The portion of income, if any, thus attributable to partnership capital for the taxable year shall be allocated between the donor and donee in accordance with their respective interests in partnership capital.

(c) In determining a reasonable allowance for services rendered by the partners, consideration shall be given to all the facts and circumstances of the business, including the fact that some of the partners may have greater managerial responsibility than others. There shall also be considered the amount that would ordinarily be paid in order to obtain comparable services from a person not having an interest in the partnership.

(d) The distributive share of partnership income, as determined under (*b*) of this subdivision, of a partner who rendered services to the partnership before entering the Armed Forces of the United States shall not be diminished because of absence due to military service. Such distributive share shall be adjusted to reflect increases or decreases in the capital interest of the absent partner. However, the partners may by agreement allocate a smaller share to the absent partner due to his absence.

(ii) *Special rules. (a)* The provisions of subdivision (i) of this subparagraph, relating to allocation of family partnership income, are applicable where the interest in the partnership is created by gift, indirectly or directly. Where the partnership interest is created indirectly, the term *donor* may include persons other than the nominal transferor. This rule may be illustrated by the following examples:

Example 1. A father gives property to his son who shortly thereafter conveys the property to a partnership consisting of the father and the son. The partnership interest of the son may be considered created by gift and the father may be considered the donor of the son's partnership interest.

Example 2. A father, the owner of a business conducted as a sole proprietorship, transfers the business to a partnership consisting of his wife and himself. The wife subsequently conveys her interest to their son. In such case, the father, as well as the mother, may be considered the donor of the son's partnership interest.

Example 3. A father makes a gift to his son of stock in the family corporation. The corporation is subsequently liquidated. The son later contributes the property received in the liquidation of the corporation to a partnership consisting of his father and himself. In such case, for purposes of section 704, the son's partnership interest may be considered created by gift and the father may be considered the donor of his son's partnership interest.

(b) The allocation rules set forth in section 704(e) and subdivision (i) of this subparagraph apply in any case in which the transfer or creation of the partnership interest has any of the substantial characteristics of a gift. Thus, allocation may be required where transfer of a partnership interest is made between members of a family (including collaterals) under a purported purchase agreement, if the characteristics of a gift are ascertained from the terms of the purchase agreement, the terms of any loan or credit arrangements made to finance the purchase, or from other relevant data.

(c) In the case of a limited partnership, for the purpose of the allocation provisions of subdivision (i) of this subparagraph, consideration shall be given to the fact that a general partner, unlike a limited partner, risks his credit in the partnership business.

(4) *Purchased interest*—(i) *In general.* If a purported purchase of a capital interest in a partnership does not meet the requirements of subdivision (ii) of this subparagraph, the ownership by the transferee of such capital interest will be recognized only if it qualifies under the requirements applicable to a transfer of a partnership interest by gifts. In a case not qualifying under subdivision (ii) of this subparagraph, if payment of any part of the purchase price is made out of partnership earnings, the transaction may be regarded in the same light as a purported gift subject to deferred enjoyment of income. Such a transaction may be lacking in reality either as a gift or as a bona fide purchase.

(ii) *Tests as to reality of purchased interests.* A purchase of a capital interest in a partnership, either directly or by means of a loan or credit extended by a member of the family, will be recognized as bona fide if:

(a) It can be shown that the purchase has the usual characteristics of an arm's-length transaction, considering all relevant factors, including the terms of the purchase agreement (as to price, due date of payment, rate of interest, and security, if any) and the

terms of any loan or credit arrangement collateral to the purchase agreement; the credit standing of the purchaser (apart from relationship to the seller) and the capacity of the purchaser to incur a legally binding obligation; or

(b) It can be shown, in the absence of characteristics of an arm's-length transaction, that the purchase was genuinely intended to promote the success of the business by securing participation of the purchaser in the business or by adding his credit to that of the other participants.

However, if the alleged purchase price or loan has not been paid or the obligation otherwise discharged, the factors indicated in (*a*) and (*b*) of this subdivision shall be taken into account only as an aid in determining whether a bona fide purchase or loan obligation existed.

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§ 1.704–2 Allocations attributable to nonrecourse liabilities.

(a) *Table of contents.* This paragraph contains a listing of the major headings of this § 1.704–2.

§ 1.704–2 Allocations attributable to nonrecourse liabilities.

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(m) Examples.

(b) *General principles and definitions*—(1) *Definition of and allocations of nonrecourse deductions.* Allocations of losses, deductions, or section 705(a)(2)(B) expenditures attributable to partnership nonrecourse liabilities (''nonrecourse deductions'') cannot have economic effect because the creditor alone bears any economic burden that corresponds to those allocations. Thus, nonrecourse deductions must be allocated in accordance with the partners' interests in the partnership. Paragraph (e) of this section provides a test that deems allocations of nonrecourse deductions to be in accordance with the partners' interests in the partnership. If that test is not satisfied, the partners' distributive shares of nonrecourse deductions are determined under §1.704–1(b)(3), according to the partners' overall economic interests in the partnership. See also paragraph (i) of this section for special rules regarding the allocation of deductions attributable to nonrecourse liabilities for which a partner bears the economic risk of loss (as described in paragraph (b)(4) of this section).

(2) *Definition of and allocations pursuant to a minimum gain chargeback.* To the extent a nonrecourse liability exceeds the adjusted tax basis of the partnership property it encumbers, a disposition of that property will generate gain that at least equals that excess (''partnership minimum gain''). An increase in partnership minimum gain is created by a decrease in the adjusted tax basis of property encumbered by a nonrecourse liability below the amount of that liability and by a partnership nonrecourse borrowing that exceeds the adjusted tax basis of the property encumbered by the borrowing. Partnership minimum gain decreases as reductions occur in the amount by which the nonrecourse liability exceeds the adjusted tax basis of the property encumbered by the liability. Allocations of gain attributable to a decrease in partnership minimum gain (a ''minimum gain chargeback,'' as required under paragraph (f) of this section) cannot have economic effect because the gain merely offsets nonrecourse deductions previously claimed by the partnership. Thus, to avoid impairing the economic effect of other allocations, allocations pursuant to a minimum gain chargeback must be made to the partners that either were allocated nonrecourse deductions or received distributions of proceeds attributable to a nonrecourse borrowing. Paragraph (e) of this section provides a test that, if met, deems allocations of partnership income pursuant to a minimum gain chargeback to be in accordance with the partners' interests in the partnership. If property encumbered by a nonrecourse liability is reflected on the partnership's books at a value that differs from its adjusted tax basis, paragraph (d)(3) of this section provides that minimum gain is determined with reference to the property's book basis. See also paragraph (i)(4) of this section for special rules regarding the minimum gain chargeback requirement for partner nonrecourse debt.

(3) *Definition of nonrecourse liability. Nonrecourse liability* means a nonrecourse liability as defined in §1.752–1(a)(2).

(4) *Definition of partner nonrecourse debt. Partner nonrecourse debt* or *partner nonrecourse liability* means any partnership liability to the extent the liability is nonrecourse for purposes of §1.1001–2, and a partner or related person (within the meaning of §1.752–4(b)) bears the economic risk of loss under §1.752–2 because, for example, the partner or related person is the creditor or a guarantor.

(c) *Amount of nonrecourse deductions.* The amount of nonrecourse deductions for a partnership taxable year equals the net increase in partnership minimum gain during the year (determined under paragraph (d) of this section), reduced (but not below zero) by the aggregate distributions made during the year of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain (determined under paragraph (h) of this section). See paragraph (m), *Examples* (1)(i) and (vi), (2), and (3) of this section. However, increases in partnership minimum gain resulting from conversions, refinancings, or other changes to a debt instrument (as described in paragraph (g)(3)) do not generate nonrecourse deductions. Generally, nonrecourse deductions consist first of certain depreciation or cost recovery deductions and then, if necessary, a pro rata portion of other partnership losses, deductions, and section 705(a)(2)(B) expenditures for that year; excess nonrecourse deductions are carried over. See paragraphs (j)(1) (ii) and (iii) of this section for more specific ordering rules. See also paragraph (m), *Example* (1)(iv) of this section.

(d) *Partnership minimum gain*—(1) *Amount of partnership minimum gain.* The amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains. The amount of partnership minimum gain includes minimum gain arising from a conversion, refinancing, or other change to a debt instrument, as described in paragraph (g)(3) of this section, only to the extent a partner is allocated a share of that minimum gain. For any partnership taxable year, the net increase or decrease in partnership minimum gain is determined by comparing the partnership minimum gain on the last day of the immediately preceding taxable year with the partnership minimum gain on the last day of the current taxable year. See paragraph (m), *Examples* (1) (i) and (iv), (2), and (3) of this section.

(2) *Property subject to more than one liability.* (i) *In general.* If property is subject to more than one liability, only the portion of the property's adjusted tax basis that is allocated to a nonrecourse liability under paragraph (d)(2)(ii) of this section is used to compute minimum gain with respect to that liability.

(ii) *Allocating liabilities.* If property is subject to two or more liabilities of equal priority, the property's adjusted tax basis is allocated among the liabilities in proportion to their outstanding balances. If property is subject to two or more liabilities of unequal priority, the adjusted tax basis is allocated first to the liability of the highest priority to the extent of its outstanding balance and then to each liability in descending order of priority to the extent of its outstanding balance, until fully allocated. See paragraph (m), *Example* (1) (v) and (vii) of this section.

(3) *Partnership minimum gain if there is a book/tax disparity.* If partnership property subject to one or more nonrecourse liabilities is, under § 1.704–1(b)(2)(iv) (*d*), (*f*), or (*r*), reflected on the partnership's books at a value that differs from its adjusted tax basis, the determinations under this section are made with reference to the property's book value. See section 704(c) and § 1.704–1(b)(4)(i) for principles that govern the treatment of a partner's share of minimum gain that is eliminated by the revaluation. See also paragraph (m), *Example* (3) of this section.

(4) *Special rule for year of revaluation.* If the partners' capital accounts are increased pursuant to § 1.704–1(b)(2)(iv) (*d*), (*f*), or (*r*) to reflect a revaluation of partnership property subject to a nonrecourse liability, the net increase or decrease in partnership minimum gain for the partnership taxable year of the revaluation is determined by:

(i) First calculating the net decrease or increase in partnership minimum gain using the current year's book values and the prior year's partnership minimum gain amount; and

(ii) Then adding back any decrease in minimum gain arising solely from the revaluation.

See paragraph (m), *Example* (3)(iii) of this section. If the partners' capital accounts are decreased to reflect a revaluation, the net increases or decreases in partnership minimum gain are determined in the same manner as in the year before the revaluation, but by using book values rather than adjusted tax bases. See section 7701(g) and § 1.704–1(b)(2)(iv)(*f*)(*1*) (property being revalued cannot be booked down below the amount of any nonrecourse liability to which the property is subject).

(e) *Requirements to be satisfied.* Allocations of nonrecourse deductions are deemed to be in accordance with the partners' interests in the partnership only if—

(1) Throughout the full term of the partnership requirements (*1*) and (*2*) of §1.704–1(b)(2)(ii)(*b*) are satisfied (*i.e.*, capital accounts are maintained in accordance with §1.704–1(b)(2)(iv) and liquidating distributions are required to be made in accordance with positive capital account balances), and requirement (*3*) of either §1.704–1(b)(2)(ii)(*b*) or §1.704–1(b)(2)(ii)(*d*) is satisfied (*i.e.*, partners with deficit capital accounts have an unconditional deficit restoration obligation or agree to a qualified income offset);

(2) Beginning in the first taxable year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, the partnership agreement provides for allocations of nonrecourse deductions in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities;

(3) Beginning in the first taxable year of the partnership that it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, and thereafter throughout the full term of the partnership, the partnership agreement contains a provision that complies with the minimum gain chargeback requirement of paragraph (f) of this section; and

(4) All other material allocations and capital account adjustments under the partnership agreement are recognized under §1.704–1(b) (without regard to whether allocations of adjusted tax basis and amount realized under section 613A(c)(7)(D) are recognized under §1.704–1(b)(4)(v)).

(f) *Minimum gain chargeback requirement*—(1) *In general.* If there is a net decrease in partnership minimum gain for a partnership taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of partnership income and gain for that year equal to that partner's share of the net decrease in partnership minimum gain (within the meaning of paragraph (g)(2)).

(2) *Exception for certain conversions and refinancings.* A partner is not subject to the minimum gain chargeback requirement to the extent the partner's share of the net decrease in partnership minimum gain is caused by a guarantee, refinancing, or other change in the debt instrument causing it to become partially or wholly recourse debt or partner nonrecourse debt, and the partner bears the economic risk of loss (within the meaning of §1.752–2) for the newly guaranteed, refinanced, or otherwise changed liability.

(3) *Exception for certain capital contributions.* A partner is not subject to the minimum gain chargeback requirement to the extent the partner contributes capital to the partnership that is used to repay the nonrecourse liability or is used to increase the basis of the property subject to the nonrecourse liability, and the partner's share of the net decrease in partnership minimum gain results from the repayment or the increase to the property's basis. See paragraph (m), *Example* (1)(iv) of this section.

(4) *Waiver for certain income allocations that fail to meet minimum gain chargeback requirement if minimum gain chargeback distorts economic arrangement.* In any taxable year that a partnership has a net decrease in partnership minimum gain, if the minimum gain chargeback requirement would cause a distortion in the economic arrangement among the partners and it is not expected that the partnership will have sufficient other income to correct that distortion, the Commissioner has the discretion, if requested by the partnership, to waive the minimum gain chargeback requirement. The following facts must be demonstrated in order for a request for a waiver to be considered:

(i) The partners have made capital contributions or received net income allocations that have restored the previous nonrecourse deductions and the distributions attributable to proceeds of a nonrecourse liability; and

(ii) The minimum gain chargeback requirement would distort the partners' economic arrangement as reflected in the partnership agreement and as evidenced over the term of the partnership by the partnership's allocations and distributions and the partners' contributions.

(5) *Additional exceptions.* The Commissioner may, by revenue ruling, provide additional exceptions to the minimum gain chargeback requirement.

(6) *Partnership items subject to the minimum gain chargeback requirement.* Any minimum gain chargeback required for a partnership taxable year consists first of certain gains recognized from the disposition of partnership property subject to one or more partnership nonrecourse liabilities and then if necessary consists of a pro rata portion of the partnership's other items of income and gain for that year. If the amount of the minimum gain chargeback requirement exceeds the partnership's income and gains for the taxable year, the excess carries over. See paragraphs (j)(2)(i) and (iii) of this section for more specific ordering rules.

(7) *Examples.* The following examples illustrate the provisions in § 1.704–2(f).

Example. 1. Partnership AB consists of two partners, limited partner A and general partner B. Partner A contributes $90 and Partner B contributes $10 to the partnership. The partnership agreement has a minimum gain chargeback provision and provides that, except as otherwise required by section 704(c), all losses will be allocated 90 percent to A and 10 percent to B; and that all income will be allocated first to restore previous losses and thereafter 50 percent to A and 50 percent to B. Distributions are made first to return initial capital to the partners and then 50 percent to A and 50 percent to B. Final distributions are made in accordance with capital account balances. The partnership borrows $200 on a nonrecourse basis from an unrelated third party and purchases an asset for $300. The partnership's only tax item for each of the first three years in $100 of depreciation on the asset. A's and B's shares of minimum gain (under paragraph (g) of this section) and deficit capital account balances are $180 and $20 respectively at the end of the third year. In the fourth year, the partnership earns $400 of net operating income and allocates the first $300 to restore the previous losses (*i.e.*, $270 to A and $30 to B); the last $100 is allocated $50 each. The partnership distributes $200 of the available cash that same year; the first $100 is distributed $90 to A and $10 to B to return their capital contributions; the last $100 is distributed $50 each to reflect their ratio for sharing profits.

	A	B
Capital account on formation	$90	$10
Less: Net loss in years 1–3	($270)	($30)
Capital account at end of year 3	($180)	($20)
Allocation of operating income to restore nonrecourse deductions	$180	$20
Allocation of operating income to restore capital contributions	$90	$10
Allocation of operating income to reflect profits	$50	$50
Capital accounts after allocation of operating income	$140	$60
Distribution reflecting capital contribution	($90)	($10)
Distribution in profit-sharing ratio	($50)	($50)
Capital accounts following distribution	($0)	($0)

In the fifth year, the partnership sells the property for $300 and realizes $300 of gain. $200 of the proceeds are used to pay the nonrecourse lender. The partnership has $300 to distribute, and the partners expect to share that equally. Absent a waiver under paragraph (f)(4) of this section, the minimum gain chargeback would require the partnership to allocate the first $200 of the gain $180 to A and $20 to B, which would distort their economic arrangement. This allocation, together with the allocation of the $100 profit $50 to each partner, would result in A having a positive capital account balance of $230 and B having a positive capital account balance of $70. The allocation of income in year 4 in effect anticipated the minimum gain chargeback that did not occur until year 5. Assuming the partnership would not have sufficient other income to correct the distortion that would otherwise result, the partnership may request that the Commissioner exercise his or her discretion to waive the minimum gain chargeback requirement and recognize allocations that would allow A and B to share equally the gain on the sale of the property. These allocations would bring the partners' capital accounts to $150 each, allowing them to share the last $300 equally. The Commissioner may, in his or her discretion, permit this allocation pursuant to paragraph (f)(4) of this section because the minimum gain chargeback would distort the partners' economic arrangement over the term of the partnership as reflected in the partnership agreement and as evidenced by the partners' contributions and the partnership's allocations and distributions.

Example 2. A and B form a partnership, contribute $25 each to the partnership's capital, and agree to share all losses and profits 50 percent each. Neither partner has an unconditional deficit restoration obligation and all the requirements in paragraph (e) of this section are met. The partnership obtains a nonrecourse loan from an unrelated third party of $100 and purchases two assets, stock for $50 and depreciable property for $100. The nonrecourse loan is secured by the partnership's depreciable property. The partnership generates $20 of depreciation in each of the first five years as its only tax item. These deductions are properly treated as nonrecourse deductions and the allocation of these deductions 50 percent to A and 50 percent to B is deemed to be in accordance with the partners' interests in the partnership. At the end of year five, A and B each have a $25 deficit capital account and a $50 share of partnership minimum gain. In the beginning of year six, (at the lender's request), A guarantees the entire nonrecourse liability. Pursuant to paragraph (d)(1) of this section, the partnership has a net decrease in minimum gain of $100 and under paragraph (g)(2) of this section, A's and B's shares of that net decrease are $50 each. Under paragraph (f)(1) of this section (the minimum gain chargeback requirement), B is subject to a $50 minimum gain chargeback. Because the partnership has no gross income in year six, the entire $50 carries over as a minimum gain chargeback requirement to succeeding taxable years until their is enough income to cover the minimum gain chargeback requirement. Under the exception to the minimum gain chargeback in paragraph (f)(2) of this section, A is not subject to a minimum gain chargeback for A's $50 share of the net decrease because A bears the economic risk of loss for the liability. Instead, A's share of partner nonrecourse debt minimum gain is $50 pursuant to paragraph (i)(3) of this section. In year seven, the partnership earns $100 of net operating income and uses the money to repay the entire $100 nonrecourse debt (that A has guaranteed). Under paragraph (i)(3) of this section, the partnership has a net decrease in partner nonrecourse debt minimum gain of $50. B must be allocated $50 of the operating income pursuant to the carried over minimum gain chargeback requirement; pursuant to paragraph (i)(4) of this section, the other $50 of operating income must be allocated to A as a partner nonrecourse debt minimum gain chargeback.

(g) *Shares of partnership minimum gain*—(1) *Partner's share of partnership minimum gain.* Except as increased in paragraph (g) (3) of this section, a partner's share of partnership minimum gain at the end of any partnership taxable year equals:

(i) The sum of nonrecourse deductions allocated to that partner (and to that partner's predecessors in interest) up to that time and the distributions made to that partner (and to that partner's predecessors' in interest) up to that time of proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain (see paragraph (h)(1) of this section); minus

(ii) The sum of that partner's (and that partner's predecessors' in interest) aggregate share of the net decreases in partnership minimum gain plus their aggregate share of decreases resulting from revaluations of partnership property subject to one or more partnership nonrecourse liabilities.

For purposes of §1.704–1(b)(2)(ii)(*d*), a partner's share of partnership minimum gain is added to the limited dollar amount, if any, of the deficit balance in the partner's capital account that the partner is obligated to restore. See paragraph (m), *Examples* (1)(i) and (3)(i) of this section.

(2) *Partner's share of the net decrease in partnership minimum gain.* A partner's share of the net decrease in partnership minimum gain is the amount of the total net decrease multiplied by the partner's percentage share of the partnership's minimum gain at the end of the immediately preceding taxable year. A partner's share of any decrease in partnership minimum gain resulting from a revaluation of partnership property equals the increase in the partner's capital account attributable to the revaluation to the extent the reduction in minimum gain is caused by the revaluation. See paragraph (m), *Example* (3)(ii) of this section.

(3) *Conversions of recourse or partner nonrecourse debt into nonrecourse debt.* A partner's share of partnership minimum gain is increased to the extent provided in this paragraph (g)(3) if a refinancing, the lapse of a guarantee, or other change to a debt instrument causes a recourse or partner nonrecourse liability to become partially or wholly nonrecourse. If a recourse liability becomes a nonrecourse liability, a partner has a share of the partnership's minimum gain that results from the conversion equal to the partner's deficit capital account (determined under §1.704–1(b)(2)(iv)) to the extent the partner no longer bears the economic burden for the entire deficit capital account as a result of the conversion. For purposes of the preceding

sentence, the determination of the extent to which a partner bears the economic burden for a deficit capital account is made by determining the consequences to the partner in the case of a complete liquidation of the partnership immediately after the conversion applying the rules described in § 1.704–1(b)(2)(iii)(*c*) that deem the value of partnership property to equal its basis, taking into account section 7701(g) in the case of property that secures nonrecourse indebtedness. If a partner nonrecourse debt becomes a nonrecourse liability, the partner's share of partnership minimum gain is increased to the extent the partner is not subject to the minimum gain chargeback requirement under paragraph (i)(4) of this section.

(h) *Distribution of nonrecourse liability proceeds allocable to an increase in partnership minimum gain*—(1) *In general.* If during its taxable year a partnership makes a distribution to the partners allocable to the proceeds of a nonrecourse liability, the distribution is allocable to an increase in partnership minimum gain to the extent the increase results from encumbering partnership property with aggregate nonrecourse liabilities that exceed the property's adjusted tax basis. See paragraph (m), *Example* (1)(vi) of this section. If the net increase in partnership minimum gain for a partnership taxable year is allocable to more than one nonrecourse liability, the net increase is allocated among the liabilities in proportion to the amount each liability contributed to the increase in minimum gain.

(2) *Distribution allocable to nonrecourse liability proceeds.* A partnership may use any reasonable method to determine whether a distribution by the partnership to one or more partners is allocable to proceeds of a nonrecourse liability. The rules prescribed under § 1.163–8T for allocating debt proceeds among expenditures (applying those rules to the partnership as if it were an individual) constitute a reasonable method for determining whether the nonrecourse liability proceeds are distributed to the partners and the partners to whom the proceeds are distributed.

(3) *Option when there is an obligation to restore.* A partnership may treat any distribution to a partner of the proceeds of a nonrecourse liability (that would otherwise be allocable to an increase in partnership minimum gain) as a distribution that is not allocable to an increase in partnership minimum gain to the extent the distribution does not cause or increase a deficit balance in the partner's capital account that exceeds the amount the partner is otherwise obligated to restore (within the meaning of § 1.704–1(b)(2)(ii)(*c*)) as of the end of the partnership taxable year in which the distribution occurs.

(4) *Carryover to immediately succeeding taxable year.* The carryover rule of this paragraph applies if the net increase in partnership minimum gain for a partnership taxable year that is allocable to a nonrecourse liability under paragraph (h)(2) of this section exceeds the distributions allocable to the proceeds of the liability (‘‘excess allocable amount’’), and all or part of the net increase in partnership minimum gain for the year is carried over as an increase in partnership minimum gain for the immediately succeeding taxable year (pursuant to paragraph (j)(1)(iii) of this section). If the carryover rule of this paragraph applies, the excess allocable amount (or the amount carried over under paragraph (j)(1)(iii) of this section, if less) is treated in the succeeding taxable year as an increase in partnership minimum gain that arose in that year as a result of incurring the nonrecourse liability to which the excess allocable amount is attributable. See paragraph (m), *Example* (1)(vi) of this section. If for a partnership taxable year there is an excess allocable amount with respect to more than one partnership nonrecourse liability, the excess allocable amount is allocated to each liability in proportion to the amount each liability contributed to the increase in minimum gain.

(i) *Partnership nonrecourse liabilities where a partner bears the economic risk of loss*—(1) *In general.* Partnership losses, deductions, or section 705(a)(2)(B) expenditures that are attributable to a particular partner nonrecourse liability (‘‘partner nonrecourse deductions,’’ as defined in paragraph (i)(2) of this section) must be allocated to the partner that bears the economic risk of loss for the liability. If more than one partner bears the economic risk of loss for a partner nonrecourse liability, any partner nonrecourse deductions attributable to that liability must be allocated among the partners according to the ratio in which they bear the economic risk of loss. If partners bear the economic risk of loss for different portions of a liability, each portion is treated as a separate partner nonrecourse liability.

(2) *Definition of and determination of partner nonrecourse deductions.* For any partnership taxable year, the amount of partner nonrecourse deductions with respect to a partner nonrecourse debt equals the net increase during the year in minimum gain attributable to the partner nonrecourse debt (‘‘partner nonrecourse debt minimum gain’’), reduced (but not below zero) by proceeds of the liability distributed during the year to the partner bearing the economic risk of loss for the liability that are both attributable to the liability and allocable to an increase in the partner nonrecourse debt minimum gain. See paragraph (m), *Example* (1)(viii) and (ix) of this section. The determination of which partnership items constitute the partner nonrecourse deductions with respect to a partner nonrecourse debt must be made in a manner consistent with the provisions of paragraphs (c) and (j)(1) (i) and (iii) of this section.

(3) *Determination of partner nonrecourse debt minimum gain.* For any partnership taxable year, the determination of partner nonrecourse debt minimum gain and the net increase or decrease in partner nonrecourse debt minimum gain must be made in a manner consistent with the provisions of paragraphs (d) and (g)(3) of this section.

(4) *Chargeback of partner nonrecourse debt minimum gain.* If during a partnership taxable year there is a net decrease in partner nonrecourse debt minimum gain, any partner with a share of that partner nonrecourse debt minimum gain (determined under paragraph (i)(5) of this section) as of the beginning of the year must be allocated items of income and gain for the year (and, if necessary, for succeeding years) equal to that partner’s share of the net decrease in the partner nonrecourse debt minimum gain. A partner’s share of the net decrease in partner nonrecourse debt minimum gain is determined in a manner consistent with the provisions of paragraph (g)(2) of this section. A partner is not subject to this minimum gain chargeback, however, to the extent the net decrease in partner nonrecourse debt minimum gain arises because the liability ceases to be partner nonrecourse debt due to a conversion, refinancing, or other change in the debt instrument that causes it to become partially or wholly a nonrecourse liability. The amount that would otherwise be subject to the partner nonrecourse debt minimum gain chargeback is added to the partner’s share of partnership minimum gain under paragraph (g)(3) of this section. In addition, rules consistent with the provisions of paragraphs (f) (2), (3), (4), and (5) of this section apply with respect to partner nonrecourse debt in appropriate circumstances. The determination of which items of partnership income and gain must be allocated pursuant to this paragraph (i)(4) is made in a manner that is consistent with the provisions of paragraph (f)(6) of this section. See paragraph (j)(2) (ii) and (iii) of this section for more specific rules.

(5) *Partner’s share of partner nonrecourse debt minimum gain.* A partner’s share of partner nonrecourse debt minimum gain at the end of any partnership taxable year is determined in a manner consistent with the provisions of paragraphs (g)(1) and (g)(3) of this section with respect to each particular partner nonrecourse debt for which the partner bears the economic risk of loss. For purposes of §1.704–1(b)(2)(ii)(*d*), a partner’s share of partner nonrecourse debt minimum gain is added to the limited dollar amount, if any, of the deficit balance in the partner’s capital account that the partner is obligated to restore, and the partner is not otherwise considered to have a deficit restoration obligation as a result of bearing the economic risk of loss for any partner nonrecourse debt. See paragraph (m), *Example* (1)(viii) of this section.

(6) *Distribution of partner nonrecourse debt proceeds allocable to an increase in partner nonrecourse debt minimum gain.* Rules consistent with the provisions of paragraph (h) of this section apply to distributions of the proceeds of partner nonrecourse debt.

(j) *Ordering rules.* For purposes of this section, the following ordering rules apply to partnership items. Notwithstanding any other provision in this section and § 1.704–1, allocations of partner nonrecourse deductions, nonrecourse deductions, and minimum gain chargebacks are made before any other allocations.

(1) *Treatment of partnership losses and deductions.* (i) *Partner nonrecourse deductions.* Partnership losses, deductions, and section 705(a)(2)(B) expenditures are treated as partner nonrecourse deductions in the amount determined under paragraph (i)(2) of this section (determining partner nonrecourse deductions) in the following order:

(A) First, depreciation or cost recovery deductions with respect to property that is subject to partner nonrecourse debt;

(B) Then, if necessary, a pro rata portion of the partnership's other deductions, losses, and section 705(a)(2)(B) items.

Depreciation or cost recovery deductions with respect to property that is subject to a partnership nonrecourse liability is first treated as a partnership nonrecourse deduction and any excess is treated as a partner nonrecourse deduction under this paragraph (j)(1)(i).

(ii) *Partnership nonrecourse deductions.* Partnership losses, deductions, and section 705(a)(2)(B) expenditures are treated as partnership nonrecourse deductions in the amount determined under paragraph (c) of this section (determining nonrecourse deductions) in the following order:

(A) First, depreciation or cost recovery deductions with respect to property that is subject to partnership nonrecourse liabilities;

(B) Then, if necessary, a pro rata portion of the partnership's other deductions, losses, and section 705(a)(2)(B) items.

Depreciation or cost recovery deductions with respect to property that is subject to partner nonrecourse debt is first treated as a partner nonrecourse deduction and any excess is treated as a partnership nonrecourse deduction under this paragraph (j)(1)(ii). Any other item that is treated as a partner nonrecourse deduction will in no event be treated as a partnership nonrecourse deduction.

(iii) *Carryover to succeeding taxable year.* If the amount of partner nonrecourse deductions or nonrecourse deductions exceeds the partnership's losses, deductions, and section 705(a)(2)(B) expenditures for the taxable year (determined under paragraphs (j)(1) (i) and (ii) of this section), the excess is treated as an increase in partner nonrecourse debt minimum gain or partnership minimum gain in the immediately succeeding partnership taxable year. See paragraph (m), *Example* (1)(vi) of this section.

(2) *Treatment of partnership income and gains.* (i) *Minimum gain chargeback.* Items of partnership income and gain equal to the minimum gain chargeback requirement (determined under paragraph (f) of this section) are allocated as a minimum gain chargeback in the following order:

(A) First, gain from the disposition of property subject to partnership nonrecourse liabilities;

(B) Then, if necessary, a pro rata portion of the partnership's other items of income and gain for that year.

Gain from the disposition of property subject to partner nonrecourse debt is allocated to satisfy a minimum gain chargeback requirement for partnership nonrecourse debt only to the extent not allocated under paragraph (j)(2)(ii) of this section.

(ii) *Chargeback attributable to decrease in partner nonrecourse debt minimum gain.* Items of partnership income and gain equal to the partner nonrecourse debt minimum gain chargeback (determined under paragraph (i)(4) of this section) are allocated to satisfy a partner nonrecourse debt minimum gain chargeback in the following order:

(A) First, gain from the disposition of property subject to partner nonrecourse debt;

(B) Then, if necessary, a pro rata portion of the partnership's other items of income and gain for that year.

Gain from the disposition of property subject to a partnership nonrecourse liability is allocated to satisfy a partner nonrecourse debt minimum gain chargeback only to the extent not allocated under paragraph (j)(2)(i) of this section. An item of partnership income and gain that is allocated to satisfy a minimum gain chargeback under paragraph (f) of this section is not allocated to satisfy a minimum gain chargeback under paragraph (i)(4).

(iii) *Carryover to succeeding taxable year.* If a minimum gain chargeback requirement (determined under paragraphs (f) and (i)(4) of this section) exceeds the partnership's income and gains for the taxable year, the excess is treated as a minimum gain chargeback requirement in the immediately succeeding partnership taxable years until fully charged back.

(k) *Tiered partnerships.* For purposes of this section, the following rules determine the effect on partnership minimum gain when a partnership (''upper-tier partnership'') is a partner in another partnership (''lower-tier partnership'').

(1) *Increase in upper-tier partnership's minimum gain.* The sum of the nonrecourse deductions that the lower-tier partnership allocates to the upper-tier partnership for any taxable year of the upper-tier partnership, and the distributions made during that taxable year from the lower-tier partnership to the upper-tier partnership of proceeds of nonrecourse debt that are allocable to an increase in the lower-tier partnership's minimum gain, is treated as an increase in the upper-tier partnership's minimum gain.

(2) *Decrease in upper-tier partnership's minimum gain.* The upper-tier partnership's share for its taxable year of the lower-tier partnership's net decrease in its minimum gain is treated as a decrease in the upper-tier partnership's minimum gain for that taxable year.

(3) *Nonrecourse debt proceeds distributed from the lower-tier partnership to the upper-tier partnership.* All distributions from the lower-tier partnership to the upper-tier partnership during the upper-tier partnership's taxable year of proceeds of a nonrecourse liability allocable to an increase in the lower-tier partnership's minimum gain are treated as proceeds of a nonrecourse liability of the upper-tier partnership. The increase in the upper-tier partnership's minimum gain (under paragraph (k)(1) of this section) attributable to the receipt of those distributions is, for purposes of paragraph (h) of this section, treated as an increase in the upper-tier partnership's minimum gain arising from encumbering property of the upper-tier partnership with a nonrecourse liability of the upper-tier partnership.

(4) *Nonrecourse deductions of lower-tier partnership treated as depreciation by upper-tier partnership.* For purposes of paragraph (c) of this section, all nonrecourse deductions allocated by the lower-tier partnership to the upper-tier partnership for the upper-tier partnership's taxable year are treated as depreciation or cost recovery deductions with respect to property owned by the upper-tier partnership and subject to a nonrecourse liability of the upper-tier partnership with respect to which minimum gain increased during the year by the amount of the nonrecourse deductions.

(5) *Coordination with partner nonrecourse debt rules.* The lower-tier partnership's liabilities that are treated as the upper-tier partnership's liabilities under §1.752–4(a) are treated as the upper-tier partnership's liabilities for purposes of applying paragraph (i) of this section. Rules consistent with the provisions of paragraphs (k)(1) through (k)(4) of this section apply to determine the allocations that the upper-tier partnership must make with respect to any liability that constitutes a nonrecourse debt for which one or more partners of the upper-tier partnership bear the economic risk of loss.

(l) *Effective dates*—(1) *In general*—(i) *Prospective application.* Except as otherwise provided in this paragraph (l), this section applies for partnership taxable years beginning on or after December 28, 1991. For the rules applicable to taxable years beginning after December 29, 1988, and before December 28, 1991, see former §1.704–1T(b)(4)(iv). For the rules applicable to taxable years beginning on or before December 29, 1988, see former §1.704–1(b)(4)(iv).

(ii) *Partnerships subject to temporary regulations.* If a partnership agreement entered into after December 29, 1988, and before December 28, 1991, or a partnership agreement entered into on or before December 29, 1988, that elected to apply former § 1.704–1T(b)(4)(iv) (as contained in the CFR edition revised as of April 1, 1991), complied with the provisions of former § 1.704–1T(b)(4)(iv) before December 28, 1991—

(A) The provisions of former § 1.704–1T(b)(4)(iv) continue to apply to the partnership for any taxable year beginning on or after December 28, 1991, (unless the partnership makes an election under paragraph (l)(4) of this section) and ending before any subsequent material modification to the partnership agreement; and

(B) The provisions of this section do not apply to the partnership for any of those taxable years.

(iii) *Partnerships subject to former regulations.* If a partnership agreement entered into on or before December 29, 1988, complied with the provisions of former § 1.704–1(b)(4)(iv)(*d*) on or before that date—

(A) The provisions of former § 1.704–1(b)(4)(iv) (*a*) through (*f*) continue to apply to the partnership for any taxable year beginning after that date (unless the partnership made an election under § 1.704–1T(b)(4)(iv)(*m*)(*4*) in a partnership taxable year ending before December 28, 1991, or makes an election under paragraph (l)(4) of this section) and ending before any subsequent material modification to the partnership agreement; and

(B) The provisions of this section do not apply to the partnership for any of those taxable years.

(2) *Special rule applicable to pre-January 30, 1989, related party nonrecourse debt.* For purposes of this section and former § 1.704–1T(b)(4)(iv), if—

(i) A partnership liability would, but for this paragraph (l)(2) of this section, constitute a partner nonrecourse debt; and

(ii) Sections 1.752–1 through 1.752–3 or former §§ 1.752–1T through –3T (whichever is applicable) do not apply to the liability;

the liability is, notwithstanding paragraphs (i) and (b)(4) of this section, treated as a nonrecourse liability of the partnership, and not as a partner nonrecourse debt, to the extent the liability would be so treated under this section (or § 1.704–1T(b)(4)(iv)) if the determination of the extent to which one or more partners bears the economic risk of loss for the liability under § 1.752–1 or former § 1.752–1T were made without regard to the economic risk of loss that any partner would otherwise be considered to bear for the liability by reason of any obligation undertaken or interest as a creditor acquired prior to January 30, 1989, by a person related to the partner (within the meaning of § 1.752–4(b) or former § 1.752–1T(h)). For purposes of the preceding sentence, if a related person undertakes an obligation or acquires an interest as a creditor on or after January 30, 1989, pursuant to a written binding contract in effect prior to January 30, 1989, and at all times thereafter, the obligation or interest as a creditor is treated as if it were undertaken or acquired prior to January 30, 1989. However, for partnership taxable years beginning on or after December 29, 1988, a pre-January 30, 1989, liability, other than a liability subject to paragraph (l)(3) of this section or former § 1.704–1T(b)(4)(iv)(*m*)(*3*) (whichever is applicable), that is treated as grandfathered under former §§ 1.752–1T through –3T (whichever is applicable) will be treated as a nonrecourse liability for purposes of this section provided that all partners in the partnership consistently treat the liability as nonrecourse for partnership taxable years beginning on or after December 29, 1988.

(3) *Transition rule for pre-March 1, 1984, partner nonrecourse debt.* If a partnership liability would, but for this paragraph (l)(3) or former § 1.704–1T(b)(4)(iv), constitute a partner nonrecourse debt and the liability constitutes grandfathered partner nonrecourse debt that is appropriately treated as a nonrecourse liability of the partnership under § 1.752–1 (as in effect prior to December 29, 1988)—

(i) The liability is, notwithstanding paragraphs (i) and (b)(4) of this section, former § 1.704–1T(b)(4)(iv), and former § 1.704–1(b)(4)(iv), treated as a nonrecourse liability of the partnership for purposes of this section and for purposes of former § 1.704–1T(b)(4)(iv) and former § 1.704–1(b)(4)(iv) to the extent of the amount, if any, by which the smallest outstanding balance of the liability during the period beginning at the end of the first partnership taxable year ending on or after December 31, 1986, and ending at the time of any determination under this paragraph (l)(3)(i) or former §1.704–1T(b)(4)(iv)(*m*)(*3*)(*i*) exceeds the aggregate amount of the adjusted basis (or book value) of partnership property allocable to the liability (determined in accordance with former §1.704–1(b)(4)(iv)(*c*) (*1*) and (*2*) at the end of the first partnership taxable year ending on or after December 31, 1986); and

(ii) In applying this section to the liability, former §1.704–1(b)(4)(iv)(*c*) (*1*) and (*2*) is applied as if all of the adjusted basis of partnership property allocable to the liability is allocable to the portion of the liability that is treated as a partner nonrecourse debt and as if none of the adjusted basis of partnership property that is allocable to the liability is allocable to the portion of the liability that is treated as a nonrecourse liability under this paragraph (l)(3) and former §1.704–1T (b)(4)(iv)(*m*)(*3*)(*i*).

For purposes of the preceding sentence, a grandfathered partner debt is any partnership liability that was not subject to former §§1.752–1T and –3T but that would have been subject to those sections under §1.752–4T(b) if the liability had arisen (other than pursuant to a written binding contract) on or after March 1, 1984. A partnership liability is not considered to have been subject to §§1.752–2T and –3T solely because a portion of the liability was treated as a liability to which those sections apply under §1.752–4(e).

(4) *Election.* A partnership may elect to apply the provisions of this section to the first taxable year of the partnership ending on or after December 28, 1991. An election under this paragraph (l)(4) is made by attaching a written statement to the partnership return for the first taxable year of the partnership ending on or after December 28, 1991. The written statement must include the name, address, and taxpayer identification number of the partnership making the statement and must declare that an election is made under this paragraph (l)(4).

(m) *Examples.* The principles of this section are illustrated by the following examples:

Example 1. Nonrecourse deductions and partnerships minimum gain. For *Example* 1, unless otherwise provided, the following facts are assumed. LP, the limited partner, and GP, the general partner, form a limited partnership to acquire and operate a commercial office building. LP contributes $180,000, and GP contributes $20,000. The partnership obtains an $800,000 nonrecourse loan and purchases the building (on leased land) for $1,000,000. The nonrecourse loan is secured only by the building, and no principal payments are due for 5 years. The partnership agreement provides that GP will be required to restore any deficit balance in GP's capital account following the liquidation of GP's interest (as set forth in §1.704–1 (b) (2)(ii)(*b*)(*3*)), and LP will not be required to restore any deficit balance in LP's capital account following the liquidation of LP's interest. The partnership agreement contains the following provisions required by paragraph (e) of this section: a qualified income offset (as defined in §1.704–1(b)(2)(ii)(*d*)); a minimum gain chargeback (in accordance with paragraph (f) of this section); a provision that the partners' capital accounts will be determined and maintained in accordance with §1.704–1(b)(2)(ii)(*b*)(*1*); and a provision that distributions will be made in accordance with partners' positive capital account balances (as set forth in §1.704–1(b)(2)(ii)(*b*)(*2*)). In addition, as of the end of each partnership taxable year discussed herein, the items described in §1.704–1(b)(2)(ii)(*d*) (*4*), (*5*), and (*6*) are not reasonably expected to cause or increase a deficit balance in LP's capital account. The partnership agreement provides that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, all partnership items will be allocated 90 percent to LP and 10 percent to GP until the first time when the partnership has recognized items of income and gain that exceed the items of loss and deduction it has recognized over its life, and all further partnership items will be allocated equally between LP and GP. Finally, the partnership agreement provides that all distributions, other than distributions in liquidation of the partnership or of a partner's interest in the partnership, will be made 90 percent to LP and 10 percent to GP until a total of $200,000 has been distributed, and thereafter all the distributions will be made equally to LP and GP. In each of the partnership's first 2 taxable years, it generates rental income of $95,000, operating expenses (including land lease payments) of $10,000, interest expense of $80,000, and a depreciation deduction of $90,000, resulting in a net taxable loss of $85,000 in each of those years. The allocations of these losses 90 per percent to

LP and 10 percent to GP have substantial economic effect.

	LP	GP
Capital account on formation	$180,000	$20,000
Less: net loss in years 1 and 2	(153,000)	(17,000)
Capital account at end of year 2	$27,000	$3,000

In the partnership's third taxable year, it again generates rental income of $95,000, operating expenses of $10,000, interest expense of $80,000, and a depreciation deduction of $90,000, resulting in net taxable loss of $85,000. The partnership makes no distributions.

(i) *Calculation of nonrecourse deductions and partnership minimum gain.* If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the end of the third year, it would realize $70,000 of gain ($800,000 amount realized less $730,000 adjusted tax basis). Because the amount of partnership minimum gain at the end of the third year (and the net increase in partnership minimum gain during the year) is $70,000, there are partnership nonrecourse deductions for that year of $70,000, consisting of depreciation deductions allowable with respect to the building of $70,000. Pursuant to the partnership agreement, all partnership items comprising the net taxable loss of $85,000, including the $70,000 nonrecourse deduction, are allocated 90 percent to LP and 10 percent to GP. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect.

	LP	GP
Capital account at end of year 2	$27,000	$3,000
Less: net loss in year 3 (without nonrecourse deductions)	(13,500)	(1,500)
Less: nonrecourse deductions in year 3	(63,000)	(7,000)
Capital account at end of year 3	($49,500)	($5,500)

The allocation of the $70,000 nonrecourse deduction satisfies requirement (2) of paragraph (e) of this section because it is consistent with allocations having substantial economic effect of other significant partnership items attributable to the building. Because the remaining requirements of paragraph (e) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be in accordance with the partners' interests in the partnership. At the end of the partnership's third taxable year, LP's and GP's shares of partnership minimum gain are $63,000 and $7,000, respectively. Therefore, pursuant to paragraph (g)(1) of this section, LP is treated as obligated to restore a deficit capital account balance of $63,000, so that in the succeeding year LP could be allocated up to an additional $13,500 of partnership deductions, losses, and section 705(a)(2)(B) items that are not nonrecourse deductions. Even though this allocation would increase a deficit capital account balance, it would be considered to have economic effect under the alternate economic effect test contained in § 1.704–1(b)(2)(ii)(*d*). If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the beginning of the partnership's fourth taxable year (and had no other economic activity in that year), the partnership minimum gain would be decreased from $70,000 to zero, and the minimum gain chargeback would require that LP and GP be allocated $63,000 and $7,000, respectively, of the gain from that disposition.

(ii) *Illustration of reasonable consistency requirement.* Assume instead that the partnership agreement provides that all nonrecourse deductions of the partnership will be allocated equally between LP and GP. Furthermore, at the time the partnership agreement is entered into, there is a reasonable likelihood that over the partnership's life it will realize amounts of income and gain significantly in excess of amounts of loss and deduction (other than nonrecourse deductions). The equal allocation of excess income and gain has substantial economic effect.

	LP	GP
Capital account on formation	$180,000	$20,000
Less: net loss in years 1 and 2	(153,000)	(17,000)
Less: net loss in year (without nonrecourse deductions)	(13,500)	(1,500)
Less: nonrecourse deductions in year 3	(35,000)	(35,000)
Capital account at end of year 3	($21,500)	($33,500)

The allocation of the $70,000 nonrecourse deduction equally between LP and GP satisfies requirement (2) of paragraph (e) of this section because the allocation is consistent with allocations, which will have substantial economic effect, of other significant partnership items attributable to the building. Because the remaining requirements of paragraph (e) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be in accordance with the partners' interests in the partnership. The allocation of the nonrecourse deductions 75 percent to LP and 25 percent to GP (or in any other ratio between 90 percent to LP/10 percent to GP and 50 percent to LP/50 percent to GP) also would satisfy requirement (2) of paragraph (e) of this section.

(iii) *Allocation of nonrecourse deductions that fails reasonable consistency requirement.* Assume instead that the partnership agreement provides that LP will be allocated 99 percent, and GP 1 percent, of all nonrecourse deductions of the partnership. Allocating nonrecourse deductions this way does not satisfy requirement (2) of paragraph (e) of this section because the allocations are not reasonably consistent with allocations, having substantial economic effect, of any other significant partnership item attributable to the building. Therefore, the allocation of nonrecourse deductions will be disregarded, and the nonrecourse deductions of the partnership will be reallocated according to the partners' overall economic interests in the partnership, determined under §1.704–1(b)(3)(ii).

(iv) *Capital contribution to pay down nonrecourse debt.* At the beginning of the partnership's fourth taxable year, LP contributes $144,000 and GP contributes $16,000 of addition capital to the partnership, which the partnership immediately uses to reduce the amount of its nonrecourse liability from $800,000 to $640,000. In addition, in the partnership's fourth taxable year, it generates rental income of $95,000, operating expenses of $10,000, interest expense of $64,000 (consistent with the debt reduction), and a depreciation deduction of $90,000, resulting in a net taxable loss of $69,000. If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the end of that year, it would realize no gain ($640,000 amount realized less $640,000 adjusted tax basis). Therefore, the amount of partnership minimum gain at the end of the year is zero, which represents a net decrease in partnership minimum gain of $70,000 during the year. LP's and GP's shares of this net decrease are $63,000 and $7,000 respectively, so that at the end of the partnership's fourth taxable year, LP's and GP's shares of partnership minimum gain are zero. Although there has been a net decrease in partnership minimum gain, pursuant to paragraph (f)(3) of this section LP and GP are not subject to a minimum gain chargeback.

	LP	GP
Capital account at end of year 3	($49,500)	($5,500)
Plus: contribution	144,000	16,000
Less: net loss in year 4	(62,100)	(6,900)
Capital account at end of year 4	$32,400	$3,600
Minimum gain chargeback carryforward	$0	$0

(v) *Loans of unequal priority.* Assume instead that the building acquired by the partnership is secured by a $700,000 nonrecourse loan and a $100,000 recourse loan, subordinate in priority to the nonrecourse loan. Under paragraph (d)(2) of this section, $700,000 of the adjusted basis of the building at the end of the partnership's third taxable year is allocated to the nonrecourse liability (with the remaining $30,000 allocated to the recourse liability) so that if the partnership disposed of the building in full satisfaction of the nonrecourse liability at the end of that year, it would realize no gain ($700,000 amount realized less $700,000 adjusted tax basis). Therefore, there is no minimum gain (or increase in minimum gain) at the end of the partnership's third taxable year. If, however, the $700,000 nonrecourse loan were subordinate in priority to the $100,000 recourse loan, under paragraph (d)(2) of this section, the first $100,000 of adjusted tax basis in the building would be allocated to the recourse liability, leaving only $630,000 of the adjusted basis of the building to be allocated to the $700,000 nonrecourse loan. In that case, the balance of the $700,000 nonrecourse liability would exceed the adjusted tax basis of the building by $70,000, so that there would be $70,000 of minimum gain (and a $70,000 increase in partnership minimum gain) in the partnership's third taxable year.

(vi) *Nonrecourse borrowing; distribution of proceeds in subsequent year.* The partnership obtains an additional nonrecourse loan of $200,000 at the end of its fourth taxable year, secured by a second mortgage on the building, and distributes $180,000 of this cash to its partners at the beginning of its fifth taxable year. In addition, in its fourth and fifth taxable years, the partnership again generates rental income of $95,000, operating expenses of $10,000, interest expense of $80,000 ($100,000 in the fifth taxable year reflecting the interest paid on both liabilities), and a depreciation deduction of $90,000, resulting in a net taxable loss of $85,000 ($105,000 in the fifth taxable year reflecting the interest paid on both liabilities). The partnership has distributed its $5,000 of operating cash flow in each year ($95,000 of rental income less $10,000 of operating expense and $80,000 of interest expense) to LP and GP at the end of each year. If the partnership were to dispose of the building in full satisfaction of both nonrecourse liabilities at the end of its fourth taxable year, the partnership would realize $360,000 of gain ($1,000,000 amount realized less $640,000 adjusted tax basis). Thus, the net increase in partnership minimum gain during the partnership's fourth taxable year is $290,000 ($360,000 of minimum gain at the end of the fourth year less $70,000 of minimum gain at the end of the third year). Because the partnership did not distribute any of the proceeds of the loan it obtained in its fourth year during that year, the potential amount of partnership nonrecourse deductions for that year is $290,000. Under paragraph (c) of this section, if the partnership had distributed the proceeds of that loan to its partners at the end of its fourth year, the partnership's nonrecourse deductions for that year would have been reduced by the amount of that distribution because the proceeds of that loan are allocable to an increase in partnership minimum gain under paragraph (h)(1) of this section. Because the nonrecourse deductions of $290,000 for the partnership's fourth taxable year exceed its total deductions for that year, all $180,000 of the partnership's deductions for that year are treated as nonrecourse deductions, and the $110,000 excess nonrecourse deductions are treated as an increase in partnership minimum gain in the partnership's fifth taxable year under paragraph (c) of this section.

	LP	GP
Capital account at end of year 3 (including cash flow distributions)	($63,000)	($7,000)
Plus: rental income in year 4	85,500	9,500
Less: nonrecourse deductions in year 4	(162,000)	(18,000)
Less: cash flow distributions in year 4	(4,500)	(500)
Capital account at end of year 4	($144,000)	($16,000)

At the end of the partnership's fourth taxable year, LP's and GP's shares of partnership minimum gain are $225,000 and $25,000, respectively (because the $110,000 excess of nonrecourse deductions is carried forward to the next year). If the partnership were to dispose of the building in full satisfaction of the nonrecourse liabilities at the end of its fifth taxable year, the partnership would realize $450,000 of gain ($1,000,000 amount realized less $550,000 adjusted tax basis). Therefore, the net increase in partnership minimum gain during the partnership's fifth taxable year is $200,000 ($110,000 deemed increase plus the $90,000 by which minimum gain at the end of the fifth year exceeds minimum gain at the end of the fourth year ($450,000 less $360,000)). At the beginning of its fifth year, the partnership distributes $180,000 of the loan proceeds (retaining $20,000 to pay the additional interest expense). Under paragraph (h) of this section, the first $110,000 of this distribution (an amount equal to the deemed increase in partnership minimum gain for the year) is considered allocable to an increase in partnership minimum gain for the year. As a result, the amount of nonrecourse deductions for the partnership's fifth taxable year is $90,000 ($200,000 net increase in minimum gain less $110,000 distribution of nonrecourse liability proceeds allocable to an increase in partnership minimum gain), and the nonrecourse deductions consist solely of the $90,000 depreciation deduction allowable with respect to the building. As a result of the distributions during the partnership's fifth taxable year, the total distributions to the partners over the partnership's life equal $205,000. Therefore, the last $5,000 distributed to the partners during the fifth year will be divided equally between them under the partnership agreement. Thus, out of the $185,000 total distribution during the partnership's fifth taxable year, the first $180,000 is distributed 90 percent to LP and 10 percent to GP, and the last $5,000 is divided equally between them.

	LP	GP
Capital account at end of year 4	($144,000)	($16,000)
Less: net loss in year 5 (without nonrecourse deductions)	(13,500)	(1,500)
Less: nonrecourse deductions in year 5	(81,000)	(9,000)
Less: distribution of loan proceeds	(162,000)	(18,000)
Less: cash flow distribution in year 5	(2,500)	(2,500)
Capital account at end of year 5	($403,000)	($47,000)

At the end of the partnership's fifth taxable year, LP's share of partnership minimum gain is $405,000 ($225,000 share of minimum gain at the end of the fourth year plus $81,000 of nonrecourse deductions for the fifth year and a $99,000 distribution of nonrecourse liability proceeds that are allocable to an increase in minimum gain) and GP's share of partnership minimum gain is $45,000 ($25,000 share of minimum gain at the end of the fourth year plus $9,000 of nonrecourse deductions for the fifth year and an $11,000 distribution of nonrecourse liability proceeds that are allocable to an increase in minimum gain).

(vii) *Partner guarantee of nonrecourse debt.* LP and GP personally guarantee the ‘‘first’’ $100,000 of the $800,000 nonrecourse loan (*i.e.*, only if the building is worth less than $100,000 will they be called upon to make up any deficiency). Under paragraph (d)(2) of this section, only $630,000 of the adjusted tax basis of the building is allocated to the $700,000 nonrecourse portion of the loan because the collateral will be applied first to satisfy the $100,000 guaranteed portion, making it superior in priority to the remainder of the loan. On the other hand, if LP and GP were to guarantee the ‘‘last’’ $100,000 (*i.e.*, if the building is worth less than $800,000, they will be called upon to make up the deficiency up to $100,000), $700,000 of the adjusted tax basis of the building would be allocated to the $700,000 nonrecourse portion of the loan because the guaranteed portion would be inferior in priority to it.

(viii) *Partner nonrecourse debt.* Assume instead that the $800,000 loan is made by LP, the limited partner. Under paragraph (b)(4) of this section, the $800,000 obligation does not constitute a nonrecourse liability of the partnership for purposes of this section because LP, a partner, bears the economic risk of loss for that loan within the meaning of §1.752–2. Instead, the $800,000 loan constitutes a partner nonrecourse debt under paragraph (b)(4) of this section. In the partnership's third taxable year, partnership minimum gain would have increased by $70,000 if the debt were a nonrecourse liability of the partnership. Thus, under paragraph (i)(3) of this section, there is a net increase of $70,000 in the minimum gain attributable to the $800,000 partner nonrecourse debt for the partnership's third taxable year, and $70,000 of the $90,000 depreciation deduction from the building for the partnership's third taxable year constitutes a partner nonrecourse deduction with respect to the debt. See paragraph (i)(4) of this section. Under paragraph (i)(2) of this section, this partner nonrecourse deduction must be allocated to LP, the partner that bears the economic risk of loss for that liability.

(ix) *Nonrecourse debt and partner nonrecourse debt of differing priorities.* As in *Example* 1 (viii) of this paragraph (m), the $800,000 loan is made to the partnership by LP, the limited partner, but the loan is a purchase money loan that ''wraps around'' a $700,000 underlying nonrecourse note (also secured by the building) issued by LP to an unrelated person in connection with LP's acquisition of the building. Under these circumstances, LP bears the economic risk of loss with respect to only $100,000 of the liability within the meaning of §1.752–2. See §1.752–2(f) (*Example* 6). Therefore, for purposes of paragraph (d) of this section, the $800,000 liability is treated as a $700,000 nonrecourse liability of the partnership and a $100,000 partner nonrecourse debt (inferior in priority to the $700,000 liability) of the partnership for which LP bears the economic risk of loss. Under paragraph (i)(2) of this section, $70,000 of the $90,000 depreciation deduction realized in the partnership's third taxable year constitutes a partner nonrecourse deduction that must be allocated to LP.

Example. 2. *Netting of increases and decreases in partnership minimum gain.* For *Example* 2 unless otherwise provided, the following facts are assumed. X and Y form a general partnership to acquire and operate residential real properties. Each partner contributes $150,000 to the partnership. The partnership obtains a $1,500,000 nonrecourse loan and purchases 3 apartment buildings (on leased land) for $720,000 (''Property A''), $540,000 (''Property B''), and $540,000 (''Property C''). The nonrecourse loan is secured only by the 3 buildings, and no principal payments are due for 5 years. In each of the partnership's first 3 taxable years, it generates rental income of $225,000, operating expenses (including land lease payments) of $50,000, interest expense of $175,000, and depreciation deductions on the 3 properties of $150,000 ($60,000 on Property A and $45,000 on each of Property B and Property C), resulting in a net taxable loss of $150,000 in each of those years. The partnership makes no distributions to X or Y.

(i) *Calculation of net increases and decreases in partnership minimum gain.* If the partnership were to dispose of the 3 apartment buildings in full satisfaction of its nonrecourse liability at the end of its third taxable year, it would realize $150,000 of gain ($1,500,000 amount realized less $1,350,000 adjusted tax basis). Because the amount of partnership minimum gain at the end of that year (and the net increase in partnership minimum gain during that year) is $150,000, the amount of partnership nonrecourse deductions for that year is $150,000, consisting of depreciation deductions allowable with respect to the 3 apartment buildings of $150,000. The result would be the same if the partnership obtained 3 separate nonrecourse loans that were ''cross-collateralized'' (*i.e.,* if each separate loan were secured by all 3 of the apartment buildings).

(ii) *Netting of increases and decreases in partnership minimum gain when there is a disposition.* At the beginning of the partnership's fourth taxable year, the partnership (with the permission of the nonrecourse lender) disposes of Property A for $835,000 and uses a portion of the proceeds to repay $600,000 of the nonrecourse liability (the principal amount attributable to Property A), reducing the balance to $900,000. As a result of the disposition, the partnership realizes gain of $295,000 ($835,000 amount realized less $540,000 adjusted tax basis). If the disposition is viewed in isolation, the partnership has generated minimum gain of $60,000 on the sale of Property A ($600,000 of debt reduction less $540,000 adjusted tax basis). However, during the partnership's fourth taxable year it also generates rental income of $135,000, operating expenses of $30,000, interest expense of $105,000, and depreciation deductions of $90,000 ($45,000 on each remaining building). If the partnership were to dispose of the remaining two buildings in full satisfaction of its nonrecourse liability at the end of the partnership's fourth taxable year, it would realize gain of $180,000 ($900,000 amount realized less $720,000 aggregate adjusted tax basis), which is the amount of partnership minimum gain at the end of the year. Because the partnership minimum gain increased from $150,000 to $180,000 during the partnership's fourth taxable year, the amount of partnership nonrecourse deductions for that year is $30,000, consisting of a ratable portion of depreciation deductions allowable with respect to the two remaining apartment buildings. No minimum gain chargeback is required for the taxable year, even though the partnership disposed of one of the properties subject to the nonrecourse liability during the year, because there is no net decrease in partnership minimum gain for the year. See paragraph (f)(1) of this section.

Example. 3. *Nonrecourse deductions and partnership minimum gain before third partner is admitted.* For purposes of *Example 3,* unless otherwise provided, the following facts are assumed. Additional facts are given in each of *Examples 3* (ii), (iii), and (iv). A and B form a limited partnership to acquire and lease machinery that is 5-year recovery property. A, the limited partner, and B, the general partner, contribute $100,000 each to the partnership, which obtains an $800,000 nonrecourse loan and purchases the machinery for $1,000,000. The nonrecourse loan is secured only by the machinery. The principal amount of the loan is to be repaid $50,000 per year during each of the partnership's first 5 taxable years, with the remaining $550,000 of unpaid principal due on the first day of the partnership's sixth taxable year. The partnership agreement contains all of the provisions required by paragraph (e) of this section, and, as of the end of each partnership taxable year discussed herein, the items described in § 1.704–1(b)(2)(ii)(*d*) (*4*), (*5*), and (*6*) are not reasonably expected to cause or increase a deficit balance in A's or B's capital account. The partnership agreement provides that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, all partnership items will be allocated equally between A and B. Finally, the partnership agreement provides that all distributions, other than distributions in liquidation of the partnership or of a partner's interest in the partnership, will be made equally between A and B. In the partnership's first taxable year it generates rental income of $130,000, interest expense of $80,000, and a depreciation deduction of $150,000, resulting in a net taxable loss of $100,000. In addition, the partnership repays $50,000 of the nonrecourse liability, reducing that liability to $750,000. Allocations of these losses equally between A and B have substantial economic effect.

	A	B
Capital account on formation	$100,000	$100,000
Less: net loss in year 1	(50,000)	(50,000)
Capital account at end of year 1	$50,000	$50,000

In the partnership's second taxable year, it generates rental income of $130,000, interest expense of $75,000, and a depreciation deduction of $220,000, resulting in a net taxable loss of $165,000. In addition, the partnership repays $50,000 of the nonrecourse liability, reducing that liability to $700,000, and distributes $2,500 of cash to each partner. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of that year, it would realize $70,000 of gain ($700,000 amount realized less $630,000 adjusted tax basis). Therefore, the amount of partnership minimum gain at the end of that year (and the net increase in partnership minimum gain during the year) is $70,000, and the amount of partnership nonrecourse deductions for the year is $70,000. The partnership nonrecourse deductions for its second taxable year consist of $70,000 of the depreciation deductions allowable with respect to the machinery. Pursuant to the partnership agreement, all partnership items comprising the net taxable loss of $165,000, including the $70,000 nonrecourse deduction, are allocated equally between A and B. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect.

	A	B
Capital account at end of year 1	$50,000	$50,000
Less: net loss in year 2 (without nonrecourse deductions)	(47,500)	(47,500)
Less: nonrecourse deductions in year 2	(35,000)	(35,000)
Less: distribution	(2,500)	(2,500)
Capital account at end of year 2	($35,000)	($35,000)

(i) *Calculation of nonrecourse deductions and partnership minimum gain.* Because all of the requirements of paragraph (e) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be made in accordance with the partners' interests in the partnership. At the end of the partnership's second taxable year, A's and B's shares of partnership minimum gain are $35,000 each. Therefore, pursuant to paragraph (g)(1) of this section, A and B are treated as obligated to restore deficit balances in their capital accounts of $35,000 each. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the beginning of the partnership's third taxable year (and had no other economic activity in that year), the partnership minimum gain would be decreased from $70,000 to zero. A's and B's shares of that net decrease would be $35,000 each. Upon that disposition, the minimum gain chargeback would require that A and B each be allocated $35,000 of that gain before any other allocation is made under section 704 (b) with respect to partnership items for the partnership's third taxable year.

(ii) *Nonrecourse deductions and restatement of capital accounts.* (a) *Additional facts.* C is admitted to the partnership at the beginning of the partnership's third taxable year. At the time of C's admission, the fair market value of the machinery is $900,000. C contributes $100,000 to the partnership (the partnership invests $95,000 of this in undeveloped land and holds the other $5,000 in cash) in exchange for an interest in the partnership. In connection with C's admission to the partnership, the partnership's machinery is revalued on the partnership's books to reflect its fair market value of $900,000. Pursuant to § 1.704–1(b)(2)(iv)(*f*), the capital accounts of A and B are adjusted upwards to $100,000 each to reflect the revaluation of the partnership's machinery. This adjustment reflects the manner in which the partnership gain of $270,000 ($900,000 fair market value minus $630,000 adjusted tax basis) would be shared if the machinery were sold for its fair market value immediately prior to C's admission to the partnership.

	A	B
Capital account before C's admission	($35,000)	($35,000)
Deemed sale adjustment	135,000	135,000
Capital account adjusted for C's admission	$100,000	$100,000

The partnership agreement is modified to provide that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, partnership income, gain, loss, and deduction, as computed for book purposes, are allocated equally among the partners, and those allocations are reflected in the partners' capital accounts. The partnership agreement also is modified to provide that depreciation and gain or loss, as computed for tax purposes, with respect to the machinery will be shared among the partners in a manner that takes account of the variation between the property's $630,000 adjusted tax basis and its $900,000 book value, in accordance with §1.704–1(b)(2)(iv)(*f*) and the special rule contained in §1.704–1(b)(4)(i).

(b) *Effect of revaluation.* Because the requirements of §1.704–1(b)(2)(iv)(*g*) are satisfied, the capital accounts of the partners (as adjusted) continue to be maintained in accordance with §1.704–1(b)(2)(iv). If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability immediately following the revaluation of the machinery, it would realize no book gain ($700,000 amount realized less $900,000 book value). As a result of the revaluation of the machinery upward by $270,000, under part (i) of paragraph (d)(4) of this section, the partnership minimum gain is reduced from $70,000 immediately prior to the revaluation to zero; but under part (ii) of paragraph (d)(4) of this section, the partnership minimum gain is increased by the $70,000 decrease arising solely from the revaluation. Accordingly, there is no net increase or decrease solely on account of the revaluation, and so no minimum gain chargeback is triggered. All future nonrecourse deductions that occur will be the nonrecourse deductions as calculated for book purposes, and will be charged to all 3 partners in accordance with the partnership agreement. For purposes of determining the partners' shares of minimum gain under paragraph (g) of this section, A's and B's shares of the decrease resulting from the revaluation are $35,000 each. However, as illustrated below, under section 704(c) principles, the tax capital accounts of A and B will eventually be charged $35,000 each, reflecting their 50 percent shares of the decrease in partnership minimum gain that resulted from the revaluation.

(iii) *Allocation of nonrecourse deductions following restatement of capital accounts.* (a) *Additional facts.* During the partnership's third taxable year, the partnership generates rental income of $130,000, interest expense of $70,000 a tax depreciation deduction of $210,000, and a book depreciation deduction (attributable to the machinery) of $300,000. As a result, the partnership has a net taxable loss of $150,000 and a net book loss of $240,000. In addition, the partnership repays $50,000 of the nonrecourse liability (after the data of C's admission), reducing the liability to $650,000 and distributes $5,000 of cash to each partner.

(b) *Allocations.* If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of the year, $50,000 of book gain would result ($650,000 amount realized less $600,000 book basis). Therefore, the amount of partnership minimum gain at the end of the year is $50,000, which represents a net decrease in partnership minimum gain of $20,000 during the year. (This is so even though there would be an increase in partnership minimum gain in the partnership's third taxable year if minimum gain were computed with reference to the adjusted tax basis of the machinery.) Nevertheless, pursuant to paragraph (d)(4) of this section, the amount of nonrecourse deductions of the partnership for its third taxable year is $50,000 (the net increase in partnership minimum gain during the year determined by adding back the $70,000 decrease in partnership minimum gain attributable to the revaluation of the machinery to the $20,000 net decrease in partnership minimum gain during the year). The $50,000 of partnership nonrecourse deductions for the year consist of book depreciation deductions allowable with respect to the machinery of $50,000. Pursuant to the partnership agreement, all partnership items comprising the net book loss of $240,000, including the $50,000 nonrecourse deduction, are allocated equally among the partners. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in §1.704–1(b)(4)(i), the partnership agreement provides that the depreciation deduction for tax purposes of $210,000 for the partnership's third taxable year is, in accordance with section 704(c) principles, shared $55,000 to A, $55,000 to B, and $100,000 to C.

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	($35,000)	$100,000	($35,000)	$100,0000	$100,000	$100,000

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Less: nonrecourse deductions	(9,166)	(16,666)	(9,166)	(16,666)	(16,666)	(16,666)
Less: items other than nonrecourse deductions in year 3	(25,834)	(63,334)	(25,834)	(63,334)	(63,334)	(63,334)
Less: distribution	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
Capital account at end of year 3	($75,000)	$15,000	($75,000)	$15,000	$15,000	$15,000

Because the requirements of paragraph (e) of this section are satisfied, the allocation of the nonrecourse deduction is deemed to be made in accordance with the partners' interests in the partnership. At the end of the partnership's third taxable year, A's, B's, and C's shares of partnership minimum gain are $16,666 each.

(iv) *Subsequent allocation of nonrecourse deductions following restatement of capital accounts.* (a) *Additional facts.* The partners' capital accounts at the end of the second and third taxable years of the partnership are as stated in *Example* 3(iii) of this paragraph (m). In addition, during the partnership's fourth taxable year the partnership generates rental income of $130,000, interest expense of $65,000, a tax depreciation deduction of $210,000, and a book depreciation deduction (attributable to the machinery) of $300,000. As a result, the partnership has a net taxable loss of $145,000 and a net book loss of $235,000. In addition, the partnership repays $50,000 of the nonrecourse liability, reducing that liability to $600,000, and distributes $5,000 of cash to each partner.

(b) *Allocations.* If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of the fourth year, $300,000 of book gain would result ($600,000 amount realized less $300,000 book value). Therefore, the amount of partnership minimum gain as of the end of the year is $300,000, which represents a net increase in partnership minimum gain during the year of $250,000. Thus, the amount of partnership nonrecourse deductions for that year equals $250,000, consisting of book depreciation deductions of $250,000. Pursuant to the partnership agreement, all partnership items comprising the net book loss of $235,000, including the $250,000 nonrecourse deduction, are allocated equally among the partners. That allocation of all items, other than the nonrecourse deductions, has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in § 1.704–1(b)(4)(i), the partnership agreement provides that the depreciation deduction for tax purposes of $210,000 in the partnership's fourth taxable year is, in accordance with section 704(c) principles, allocated $55,000 to A, $55,000 to B, and $100,000 to C.

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account at end year 3	($75,000)	$15,000	($75,000)	$15,000	$15,000	$15,000
Less: nonrecourse deductions	(45,833)	(83,333)	(45,833)	(83,333)	(83,333)	(83,333)
Plus: items other than nonrecourse deduction in year 4	12,499	5,000	12,499	5,000	5,000	5,000
Less: distribution	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
Capital account at end of year 4	($113,334)	($68,333)	($113,333)	($68,333)	($68,333)	($68,333)

The allocation of the $250,000 nonrecourse deduction equally among A, B, and C satisfies requirement (2) of paragraph (e) of this section. Because all of the requirements of paragraph (e) of this section are satisfied, the allocation is deemed to be in accordance with the partners' interests in the partnership. At the end of the partnership's fourth taxable year, A's, B's, and C's shares of partnership minimum gain are $100,000 each.

(v) *Disposition of partnership property following restatement of capital accounts.* (a) *Additional facts.* The partners' capital accounts at the end of the fourth taxable year of the partnership are as stated above in (iv). In addition, at the beginning of the partnership's fifth taxable year it sells the machinery for $650,000 (using $600,000 of the proceeds to repay the nonrecourse liability), resulting in a taxable gain of $440,000 ($650,000 amount realized less $210,000 adjusted tax basis) and a book gain of $350,000 ($650,000 amount realized less $300,000 book basis). The partnership has no other items of income, gain, loss, or deduction for the year.

(b) *Effect of disposition.* As a result of the sale, partnership minimum gain is reduced from $300,000 to zero, reducing A's, B's, and

C's shares of partnership minimum gain to zero from $100,000 each. The minimum gain chargeback requires that A, B, and C each be allocated $100,000 of that gain (an amount equal to each partner's share of the net decrease in partnership minimum gain resulting from the sale) before any allocation is made to them under section 704(b) with respect to partnership items for the partnership's fifth taxable year. Thus, the allocation of the first $300,000 of book gain $100,000 to each of the partners is deemed to be in accordance with the partners' interests in the partnership under paragraph (e) of this section. The allocation of the remaining $50,000 of book gain equally among the partners has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in § 1.704–1(b)(4)(i), the partnership agreement provides that the $440,000 taxable gain is, in accordance with section 704(c) principles, allocated $161,667 to A, $161,667 to B, and $116,666 to C.

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account at end of year 4	($113,334)	($68,333)	($113,334)	($68,333)	($68,333)	($68,333)
Plus: minimum gain chargeback	138,573	100,000	138,573	100,000	100,000	100,000
Plus: additional gain	23,094	16,666	23,094	16,666	16,666	16,666
Capital account before liquidation	$48,333	$48,333	$48,333	$48,333	$48,333	$48,333

Example. 4. *Allocations of increase in partnership minimum gain among partnership properties.* For *Example* 4, unless otherwise provided, the following facts are assumed. A partnership owns 4 properties, each of which is subject to a nonrecourse liability of the partnership. During a taxable year of the partnership, the following events take place. First, the partnership generates a depreciation deduction (for both book and tax purposes) with respect to Property W of $10,000 and repays $5,000 of the nonrecourse liability secured only by that property, resulting in an increase in minimum gain with respect to that liability of $5,000. Second, the partnership generates a depreciation deduction (for both book and tax purposes) with respect to Property X of $10,000 and repays none of the nonrecourse liability secured by that property, resulting in an increase in minimum gain with respect to that liability of $10,000. Third, the partnership generates a depreciation deduction (for both book and tax purposes) of $2,000 with respect to Property Y and repays $11,000 of the nonrecourse liability secured only by that property, resulting in a decrease in minimum gain with respect to that liability of $9,000 (although at the end of that year, there remains minimum gain with respect to that liability). Finally, the partnership borrows $5,000 on a nonrecourse basis, giving as the only security for that liability Property Z, a parcel of undeveloped land with an adjusted tax basis (and book value) of $2,000, resulting in a net increase in minimum gain with respect to that liability of $3,000.

(i) *Allocation of increase in partnership minimum gain.* The net increase in partnership minimum gain during that partnership taxable year is $9,000, so that the amount of nonrecourse deductions of the partnership for that taxable year is $9,000. Those nonrecourse deductions consist of $3,000 of depreciation deductions with respect to Property W and $6,000 of depreciation deductions with respect to Property X. See paragraph (c) of this section. The amount of nonrecourse deductions consisting of depreciation deductions is determined as follows. With respect to the nonrecourse liability secured by Property Z, for which there is no depreciation deduction, the amount of depreciation deductions that constitutes nonrecourse deductions is zero. Similarly, with respect to the nonrecourse liability secured by Property Y, for which there is no increase in minimum gain, the amount of depreciation deductions that constitutes nonrecourse deductions is zero. With respect to each of the nonrecourse liabilities secured by Properties W and X, which are secured by property for which there are depreciation deductions and for which there is an increase in minimum gain, the amount of depreciation deductions that constitutes nonrecourse deductions is determined by the following formula:

net increase in the partnership minimum gain for that taxable year X total depreciation deductions for that taxable year on the specific property securing the nonrecourse liability to the extent minimum gain increased on that liability (divided by) total depreciation deductions for that taxable year on all properties securing nonrecourse liabilities to the extent of the aggregate increase in minimum gain on all those liabilities.

Thus, for the liability secured by Property W, the amount is $9,000 times $5,000/$15,000, or $3,000. For the liability secured by Property X, the amount is $9,000 times $10,000/ $15,000, or $6,000. (If one depreciable property secured two partnership nonrecourse liabilities, the amount of depreciation or book depreciation with respect to that property would be allocated among those liabilities in accordance with the method by which adjusted basis is allocated under paragraph (d)(2) of this section).

(ii) *Alternative allocation of increase in partnership minimum gain among partnership properties.* Assume instead that the loan secured by Property Z is $15,000 (rather than $5,000), resulting in a net increase in minimum gain with respect to that liability of $13,000. Thus, the net increase in partnership minimum gain is $19,000, and the amount of nonrecourse deductions of the partnership for that taxable year is $19,000. Those nonrecourse deductions consist of $5,000 of depreciation deductions with respect to Property W, $10,000 of depreciation deductions with respect to Property X, and a pro rata portion of the partnership's other items of deduction, loss, and section 705(a)(2)(B) expenditure for that year. The method for computing the amounts of depreciation deductions that constitute nonrecourse deductions is the same as in (i) of this *Example* 4 for the liabilities secured by Properties Y and Z. With respect to each of the nonrecourse liabilities secured by Properties W and X, the amount of depreciation deductions that constitutes nonrecourse deductions equals the total depreciation deductions with respect to the partnership property securing that particular liability to the extent of the increase in minimum gain with respect to that liability.

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§ 1.704–3 Contributed property.

(a) *In general*—(1) *General principles.* The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. Notwithstanding any other provision of this section, the allocations must be made using a reasonable method that is consistent with the purpose of section 704(c). For this purpose, an allocation method includes the application of all of the rules of this section (e.g., aggregation rules). An allocation method is not necessarily unreasonable merely because another allocation method would result in a higher aggregate tax liability. Paragraphs (b), (c), and (d) of this section describe allocation methods that are generally reasonable. Other methods may be reasonable in appropriate circumstances. Nevertheless, in the absence of specific published guidance, it is not reasonable to use an allocation method in which the basis of property contributed to the partnership is increased (or decreased) to reflect built-in gain (or loss), or a method under which the partnership creates tax allocations of income, gain, loss, or deduction independent of allocations affecting book capital accounts. See § 1.704–3(d). Paragraph (e) of this section contains special rules and exceptions.

(2) *Operating rules.* Except as provided in paragraphs (e)(2) and (e)(3) of this section, section 704(c) and this section apply on a property-by-property basis. Therefore, in determining whether there is a disparity between adjusted tax basis and fair market value, the built-in gains and built-in losses on items of contributed property cannot be aggregated. A partnership may use different methods with respect to different items of contributed property, provided that the partnership and the partners consistently apply a single reasonable method for each item of contributed property and that the overall method or combination of methods are reasonable based on the facts and circumstances and consistent with the purpose of section 704(c). It may be unreasonable to use one method for appreciated property and another method for depreciated property. Similarly, it may be unreasonable to use the traditional method for built-in gain property contributed by a partner with a high marginal tax rate while using curative allocations for built-in gain property contributed by a partner with a low marginal tax rate. A new partnership formed as the result of the termination of a partnership under section 708(b)(1)(B) is not required to use the same method as the terminated partnership with respect to section 704(c) property deemed contributed to the new partnership by the terminated partnership under § 1.708–1(b)(1)(iv). The previous sentence applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9,

1997; however, the sentence may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply the sentence to the termination in a consistent manner.

(3) *Definitions*—(i) *Section 704(c) property.* Property contributed to a partnership is section 704(c) property if at the time of contribution its book value differs from the contributing partner's adjusted tax basis. For purposes of this section, book value is determined as contemplated by §1.704–1(b). Therefore, book value is equal to fair market value at the time of contribution and is subsequently adjusted for cost recovery and other events that affect the basis of the property. For a partnership that maintains capital accounts in accordance with §1.704–1(b)(2)(iv), the book value of property is initially the value used in determining the contributing partner's capital account under §1.704–1(b)(2)(iv)(*d*), and is appropriately adjusted thereafter (e.g., for book cost recovery under §§1.704–1(b)(2)(iv)(*g*)(*3*) and 1.704–3(d)(2) and other events that affect the basis of the property). A partnership that does not maintain capital accounts under §1.704–1(b)(2)(iv) must comply with this section using a book capital account based on the same principles (i.e., a book capital account that reflects the fair market value of property at the time of contribution and that is subsequently adjusted for cost recovery and other events that affect the basis of the property). Property deemed contributed to a new partnership as the result of the termination of a partnership under section 708(b)(1)(B) is treated as section 704(c) property in the hands of the new partnership only to the extent that the property was section 704(c) property in the hands of the terminated partnership immediately prior to the termination. See §1.708–1(b)(1)(iv) for an example of the application of this rule. The previous two sentences apply to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, the sentences may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply the sentences to the termination in a consistent manner.

(ii) *Built-in gain and built-in loss.* The built-in gain on section 704(c) property is the excess of the property's book value over the contributing partner's adjusted tax basis upon contribution. The built-in gain is thereafter reduced by decreases in the difference between the property's book value and adjusted tax basis. The built-in loss on section 704(c) property is the excess of the contributing partner's adjusted tax basis over the property's book value upon contribution. The built-in loss is thereafter reduced by decreases in the difference between the property's adjusted tax basis and book value.

(4) *Accounts payable and other accrued but unpaid items.* Accounts payable and other accrued but unpaid items contributed by a partner using the cash receipts and disbursements method of accounting are treated as section 704(c) property for purposes of applying the rules of this section.

(5) *Other provisions of the Internal Revenue Code.* Section 704(c) and this section apply to a contribution of property to the partnership only if the contribution is governed by section 721, taking into account other provisions of the Internal Revenue Code. For example, to the extent that a transfer of property to a partnership is a sale under section 707, the transfer is not a contribution of property to which section 704(c) applies.

(6) *Other applications of section 704(c) principles*—(i) *Revaluations under section 704(b).* The principles of this section apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to §1.704–1(b)(2)(iv)(*f*) (reverse section 704(c) allocations). Partnerships are not required to use the same allocation method for reverse section 704(c) allocations as for contributed property, even if at the time of revaluation the property is already subject to section 704(c) and paragraph (a) of this section. In addition, partnerships are not required to use the same allocation method for reverse section 704(c) allocations each time the partnership revalues its property. A partnership that makes allocations with respect to revalued property must use a reasonable

method that is consistent with the purposes of section 704(b) and (c).

(ii) *Basis adjustments.* A partnership making adjustments under § 1.743–1(b) or 1.751–1(a)(2) must account for built-in gain or loss under section 704(c) in accordance with the principles of this section.

(7) *Transfers of a partnership interest.* If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner.

(8) *Disposition of property in nonrecognition transaction.* If a partnership disposes of section 704(c) property in a nonrecognition transaction in which no gain or loss is recognized, the substituted basis property (within the meaning of section 7701(a)(42)) is treated as section 704(c) property with the same amount of built-in gain or loss as the section 704(c) property disposed of by the partnership. If gain or loss is recognized in such a transaction, appropriate adjustments must be made. The allocation method for the substituted basis property must be consistent with the allocation method chosen for the original property. If a partnership transfers an item of section 704(c) property together with other property to a corporation under section 351, in order to preserve that item's built-in gain or loss, the basis in the stock received in exchange for the section 704(c) property is determined as if each item of section 704(c) property had been the only property transferred to the corporation by the partnership.

(9) *Tiered partnerships.* If a partnership contributes section 704(c) property to a second partnership (the lower-tier partnership), or if a partner that has contributed section 704(c) property to a partnership contributes that partnership interest to a second partnership (the upper-tier partnership), the upper-tier partnership must allocate its distributive share of lower-tier partnership items with respect to that section 704(c) property in a manner that takes into account the contributing partner's remaining built-in gain or loss. Allocations made under this paragraph will be considered to be made in a manner that meets the requirements of § 1.704–1(b)(2)(iv)(*q*) (relating to capital account adjustments where guidance is lacking).

(10) *Anti-abuse rule.* An allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

(11) *Contributing and noncontributing partners' recapture shares.* For special rules applicable to the allocation of depreciation recapture with respect to property contributed by a partner to a partnership, see §§ 1.1245–1(e)(2) and 1.1250–1(f).

(b) *Traditional method*—(1) *In general.* This paragraph (b) describes the traditional method of making section 704(c) allocations. In general, the traditional method requires that when the partnership has income, gain, loss, or deduction attributable to section 704(c) property, it must make appropriate allocations to the partners to avoid shifting the tax consequences of the built-in gain or loss. Under this rule, if the partnership sells section 704(c) property and recognizes gain or loss, built-in gain or loss on the property is allocated to the contributing partner. If the partnership sells a portion of, or an interest in, section 704(c) property, a proportionate part of the built-in gain or loss is allocated to the contributing partner. For section 704(c) property subject to amortization, depletion, depreciation, or other cost recovery, the allocation of deductions attributable to these items takes into account built-in gain or loss on the property. For example, tax allocations to the noncontributing partners of cost recovery deductions with respect to section 704(c) property generally must, to the extent possible, equal book allocations to those partners. However, the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year (the ceiling rule). If a partnership has no property the allocations from which are limited by the ceiling rule, the traditional method is reasonable when used for all contributed property.

(2) *Examples.* The following examples illustrate the principles of the traditional method.

Example 1. Operation of the traditional method—(i) *Calculation of built-in gain on contribution.* A and B form partnership AB and agree that each will be allocated a 50 percent share of all partnership items and that AB will make allocations under section 704(c) using the traditional method under paragraph (b) of this section. A contributes depreciable property with an adjusted tax basis of $4,000 and a book value of $10,000, and B contributes $10,000 cash. Under paragraph (a)(3) of this section, A has built-in gain of $6,000, the excess of the partnership's book value for the property ($10,000) over A's adjusted tax basis in the property at the time of contribution ($4,000).

(ii) *Allocation of tax depreciation.* The property is depreciated using the straight-line method over a 10-year recovery period. Because the property depreciates at an annual rate of 10 percent, B would have been entitled to a depreciation deduction of $500 per year for both book and tax purposes if the adjusted tax basis of the property equalled its fair market value at the time of contribution. Although each partner is allocated $500 of book depreciation per year, the partnership is allowed a tax depreciation deduction of only $400 per year (10 percent of $4,000). The partnership can allocate only $400 of tax depreciation under the ceiling rule of paragraph (b)(1) of this section, and it must be allocated entirely to B. In AB's first year, the proceeds generated by the equipment exactly equal AB's operating expenses. At the end of that year, the book value of the property is $9,000 ($10,000 less the $1,000 book depreciation deduction), and the adjusted tax basis is $3,600 ($4,000 less the $400 tax depreciation deduction). A's built-in gain with respect to the property decreases to $5,400 ($9,000 book value less $3,600 adjusted tax basis). Also, at the end of AB's first year, A has a $9,500 book capital account and a $4,000 tax basis in A's partnership interest. B has a $9,500 book capital account and a $9,600 adjusted tax basis in B's partnership interest.

(iii) *Sale of the property.* If AB sells the property at the beginning of AB's second year for $9,000, AB realizes tax gain of $5,400 ($9,000, the amount realized, less the adjusted tax basis of $3,600). Under paragraph (b)(1) of this section, the entire $5,400 gain must be allocated to A because the property A contributed has that much built-in gain remaining. If AB sells the property at the beginning of AB's second year for $10,000, AB realizes tax gain of $6,400 ($10,000, the amount realized, less the adjusted tax basis of $3,600). Under paragraph (b)(1) of this section, only $5,400 of gain must be allocated to A to account for A's built-in gain. The remaining $1,000 of gain is allocated equally between A and B in accordance with the partnership agreement. If AB sells the property for less than the $9,000 book value, AB realizes tax gain of less than $5,400, and the entire gain must be allocated to A.

(iv) *Termination and liquidation of partnership.* If AB sells the property at the beginning of AB's second year for $9,000, and AB engages in no other transactions that year, A will recognize a gain of $5,400, and B will recognize no income or loss. A's adjusted tax basis for A's interest in AB will then be $9,400 ($4,000, A's original tax basis, increased by the gain of $5,400). B's adjusted tax basis for B's interest in AB will be $9,600 ($10,000, B's original tax basis, less the $400 depreciation deduction in the first partnership year). If the partnership then terminates and distributes its assets ($19,000 in cash) to A and B in proportion to their capital account balances, A will recognize a capital gain of $100 ($9,500, the amount distributed to A, less $9,400, the adjusted tax basis of A's interest). B will recognize a capital loss of $100 (the excess of B's adjusted tax basis, $9,600, over the amount received, $9,500).

Example 2. Unreasonable use of the traditional method—(i) *Facts.* C and D form partnership CD and agree that each will be allocated a 50 percent share of all partnership items and that CD will make allocations under section 704(c) using the traditional method under paragraph (b) of this section. C contributes equipment with an adjusted tax basis of $1,000 and a book value of $10,000, with a view to taking advantage of the fact that the equipment has only one year remaining on its cost recovery schedule although its remaining economic life is significantly longer. At the time of contribution, C has a built-in gain of $9,000 and the equipment is section 704(c) property. D contributes $10,000 of cash, which CD uses to buy securities. D has substantial net operating loss carryforwards that D anticipates will otherwise expire unused. Under §1.704–1(b)(2)(iv)(*g*)(3), the partnership must allocate the $10,000 of book depreciation to the partners in the first year of the partnership. Thus, there is $10,000 of book depreciation and $1,000 of tax depreciation in the partnership's first year. CD sells the equipment during the second year for $10,000 and recognizes a $10,000 gain ($10,000, the amount realized, less the adjusted tax basis of $0).

(ii) *Unreasonable use of method*—(A) At the beginning of the second year, both the book value and adjusted tax basis of the equipment are $0. Therefore, there is no remaining built-in gain. The $10,000 gain on the sale of the equipment in the second year is allocated $5,000 each to C and D. The interaction of the partnership's one-year write-off of the entire book value of the equipment and the use of the traditional method results in a shift of $4,000 of the precontribution gain in the equipment from C to D (D's $5,000 share of CD's $10,000 gain, less the $1,000 tax depreciation deduction previously allocated to D).

(B) The traditional method is not reasonable under paragraph (a)(10) of this section because the contribution of property is made, and the traditional method is used, with a view to shifting a significant amount of taxable income to a partner with a low marginal tax rate and away from a partner with a high marginal tax rate.

(C) Under these facts, if the partnership agreement in effect for the year of contribution had provided that tax gain from the sale of the property (if any) would always be allocated first to C to offset the effect of the ceiling rule limitation, the allocation method would not violate the anti-abuse rule of paragraph (a)(10) of this section. See paragraph (c)(3) of this section. Under other facts, (for example, if the partnership holds multiple section 704(c) properties and either uses multiple allocation methods or uses a single allocation method where one or more of the properties are subject to the ceiling rule) the allocation to C may not be reasonable.

(c) *Traditional method with curative allocations*—(1) *In general.* To correct distortions created by the ceiling rule, a partnership using the traditional method under paragraph (b) of this section may make reasonable curative allocations to reduce or eliminate disparities between book and tax items of noncontributing partners. A curative allocation is an allocation of income, gain, loss, or deduction for tax purposes that differs from the partnership's allocation of the corresponding book item. For example, if a noncontributing partner is allocated less tax depreciation than book depreciation with respect to an item of section 704(c) property, the partnership may make a curative allocation to that partner of tax depreciation from another item of partnership property to make up the difference, notwithstanding that the corresponding book depreciation is allocated to the contributing partner. A partnership may limit its curative allocations to allocations of one or more particular tax items (e.g., only depreciation from a specific property or properties) even if the allocation of those available items does not offset fully the effect of the ceiling rule.

(2) *Consistency.* A partnership must be consistent in its application of curative allocations with respect to each item of section 704(c) property from year to year.

(3) *Reasonable curative allocations*—(i) *Amount.* A curative allocation is not reasonable to the extent it exceeds the amount necessary to offset the effect of the ceiling rule for the current taxable year or, in the case of a curative allocation upon disposition of the property, for prior taxable years.

(ii) *Timing.* The period of time over which the curative allocations are made is a factor in determining whether the allocations are reasonable. Notwithstanding paragraph (c)(3)(i) of this section, a partnership may make curative allocations in a taxable year to offset the effect of the ceiling rule for a prior taxable year if those allocations are made over a reasonable period of time, such as over the property's economic life, and are provided for under the partnership agreement in effect for the year of contribution. See paragraph (c)(4) *Example 3* (ii)(C) of this section.

(iii) *Type*—(A) *In general.* To be reasonable, a curative allocation of income, gain, loss, or deduction must be expected to have substantially the same effect on each partner's tax liability as the tax item limited by the ceiling rule. The expectation must exist at the time the section 704(c) property is obligated to be (or is) contributed to the partnership and the allocation with respect to that property becomes part of the partnership agreement. However, the expectation is tested at the time the allocation with respect to that property is actually made if the partnership agreement is not sufficiently specific as to the precise manner in which allocations are to be made with respect to that property. Under this paragraph (c), if the item limited by the ceiling rule is loss from the sale of property, a curative allocation of gain must be expected to have substantially the same effect as would an allocation to that partner of gain with respect to the sale of the property. If the item limited by the ceiling rule is depreciation or other cost recovery, a curative allocation of income to the contributing partner must be expected to have substantially the same effect as would an allocation to that partner of partnership income with respect to the contributed property. For example, if depreciation deductions with respect to leased equipment contributed by a tax-exempt partner are limited by the ceiling rule, a curative allocation of dividend or interest income to that partner generally is not reasonable, although a curative allocation of depreciation deductions from other leased equipment to the noncontributing partner is reasonable. Similarly, under this rule, if depreciation deductions apportioned to foreign source income in a particular statutory grouping under section 904(d) are limited by the ceiling rule, a curative allocation of income from another statutory grouping to the contributing partner generally is not reasonable, although a curative allocation of income from the same statutory grouping and of the same character is reasonable.

(B) *Exception for allocation from disposition of contributed property.* If cost recovery has been limited by the ceiling rule, the general limitation on character does not apply to income from the disposition of contributed property subject to the ceiling rule, but only if properly provided for in the partnership agreement in effect for the year of contribution or revaluation. For example, if allocations of depreciation deductions to a noncontributing partner have been limited by the ceiling rule, a curative allocation to the contributing partner of gain from the sale of that property, if properly provided for in the partnership agreement, is reasonable for purposes of paragraph (c)(3)(iii)(A) of this section even if not of the same character.

(4) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. Reasonable and unreasonable curative allocations—(i) *Facts.* E and F form partnership EF and agree that each will be allocated a 50 percent share of all partnership items and that EF will make allocations under section 704(c) using the traditional method with curative allocations under paragraph (c) of this section. E contributes equipment with an adjusted tax basis of $4,000 and a book value of $10,000. The equipment has 10 years remaining on its cost recovery schedule and is depreciable using the straight-line method. At the time of contribution, E has a built-in gain of $6,000, and therefore, the equipment is section 704(c) property. F contributes $10,000 of cash, which EF uses to buy inventory for resale. In EF's first year, the revenue generated by the equipment equals EF's operating expenses. The equipment generates $1,000 of book depreciation and $400 of tax depreciation for each of 10 years. At the end of the first year EF sells all the inventory for $10,700, recognizing $700 of income. The partners anticipate that the inventory income will have substantially the same effect on their tax liabilities as income from E's contributed equipment. Under the traditional method of paragraph (b) of this section, E and F would each be allocated $350 of income from the sale of inventory for book and tax purposes and $500 of depreciation for book purposes. The $400 of tax depreciation would all be allocated to F. Thus, at the end of the first year, E and F's book and tax capital accounts would be as follows:

E		F		
Book	Tax	Book	Tax	
$10,000	$4,000	$10,000	$10,000	Initial contribution.
<500>	<0>	<500>	<400>	Depreciation.
350	350	350	350	Sales income.
9,850	4,350	9,850	9,950	

(ii) *Reasonable curative allocation.* Because the ceiling rule would cause a disparity of $100 between F's book and tax capital accounts, EF may properly allocate to E under paragraph (c) of this section an additional $100 of income from the sale of inventory for tax purposes. This allocation results in capital accounts at the end of EF's first year as follows:

E		F		
Book	Tax	Book	Tax	
$10,000	$4,000	$10,000	$10,000	Initial contribution.
<500>	<0>	<500>	<400>	Depreciation.
350	450	350	250	Sales income.
9,850	4,450	9,850	9,850	

(iii) *Unreasonable curative allocation.* (A) The facts are the same as in paragraphs (i) and (ii) of this *Example 1,* except that E and F choose to allocate all the income from the sale of the inventory to E for tax purposes, although they share it equally for book purposes. This allocation results in capital accounts at the end of EF's first year as follows:

E		F		
Book	Tax	Book	Tax	
$10,000	$4,000	$10,000	$10,000	Initial contribution.
<500>	<0>	<500>	<400>	Depreciation.
350	700	350	0	Sales income.
9,850	4,700	9,850	9,600	

(B) This curative allocation is not reasonable under paragraph (c)(3)(i) of this section because the allocation exceeds the amount necessary to offset the disparity caused by the ceiling rule.

Example 2. Curative allocations limited to depreciation—(i) *Facts.* G and H form partnership GH and agree that each will be allocated a 50 percent share of all partnership items and that GH will make allocations under section 704(c) using the traditional method with curative allocations under paragraph (c) of this section, but only to the extent that the partnership has sufficient tax depreciation deductions. G contributes property G1, with an adjusted tax basis of $3,000 and a fair market value of $10,000, and H contributes property H1, with an adjusted tax basis of $6,000 and a fair market value of $10,000. Both properties have 5 years remaining on their cost recovery schedules and are depreciable using the straight-line method. At the time of contribution, G1 has a built-in gain of $7,000 and H1 has a built-in gain of $4,000, and therefore, both properties are section 704(c) property. G1 generates $600 of tax depreciation and $2,000 of book depreciation for each of five years. H1 generates $1,200 of tax depreciation and $2,000 of book depreciation for each of 5 years. In addition, the properties each generate $500 of operating income annually. G and H are each allocated $1,000 of book depreciation for each property. Under the traditional method of paragraph (b) of this section, G would be allocated $0 of tax depreciation for G1 and $1,000 for H1, and H would be allocated $600 of tax depreciation for G1 and $200 for H1. Thus, at the end of the first year, G and H's book and tax capital accounts would be as follows:

G		H		
Book	Tax	Book	Tax	
$10,000	$3,000	$10,000	$6,000	Initial contribution.
<1,000>	<0>	<1,000>	<600>	G1 depreciation.
<1,000>	<1,000>	<1,000>	<200>	H1 depreciation.
500	500	500	500	Operating income.
8,500	2,500	8,500	5,700	

(ii) *Curative allocations.* Under the traditional method, G is allocated more depreciation deductions than H, even though H contributed property with a smaller disparity reflected on GH's book and tax capital accounts. GH makes curative allocations to H of an additional $400 of tax depreciation each year, which reduces the disparities between G and H's book and tax capital accounts ratably each year. These allocations are reasonable provided the allocations meet the other requirements of this section. As a result of their agreement, at the end of the first year, G and H's capital accounts are as follows:

G		H		
Book	Tax	Book	Tax	
$10,000	$3,000	$10,000	$6,000	Initial contribution.
<1,000>	<0>	<1,000>	<600>	G1 depreciation.
<1,000>	<600>	<1,000>	<600>	H1 depreciation.
500	500	500	500	Operating income.
8,500	2,900	8,500	5,300	

Example 3. Unreasonable use of curative allocations—(i) *Facts.* J and K form partnership JK and agree that each will receive a 50 percent share of all partnership items and that JK will make allocations under section 704(c) using the traditional method with curative allocations under paragraph (c) of this section. J contributes equipment with an adjusted tax basis of $1,000 and a book value of $10,000, with a view to taking advantage of the fact that the equipment has only one year remaining on its cost recovery schedule although it has an estimated remaining economic life of 10 years. J has substantial net operating loss carryforwards that J anticipates will otherwise expire unused. At the time of contribution, J has a built-in gain of $9,000, and therefore, the equipment is section 704(c) property. K contributes $10,000 of cash, which JK uses to buy inventory for resale. In JK's first year, the revenues generated by the equipment exactly equal JK's operating expenses. Under §1.704–1(b)(2)(iv)(*g*)(*3*), the partnership must allocate the $10,000 of book depreciation to the partners in the first year of the partnership. Thus, there is $10,000 of book depreciation and $1,000 of tax depreciation in the partnership's first year. In addition, at the end of the first year JK sells all of the inventory for $18,000, recognizing $8,000 of income. The partners anticipate that the inventory income will have substantially the same effect on their tax liabilities as income from J's contributed equipment. Under the traditional method of paragraph (b) of this section, J and K's book and tax capital accounts at the end of the first year would be as follows:

J		K		
Book	Tax	Book	Tax	
$10,000	$1,000	$10,000	$10,000	Initial contribution.
<5,000>	<0>	<5,000>	<1,000>	Depreciation.
4,000	4,000	4,000	4,000	Sales income.
9,000	5,000	9,000	13,000	

(ii) *Unreasonable use of method.* (A) The use of curative allocations under these facts to offset immediately the full effect of the ceiling rule would result in the following book and tax capital accounts at the end of JK's first year:

J		K		
Book	Tax	Book	Tax	
$10,000	$1,000	$10,000	$10,000	Initial contribution.
<5,000>	<0>	<5,000>	<1,000>	Depreciation.
4,000	8,000	4,000	0	Sales income.
9,000	9,000	9,000	9,000	

(B) This curative allocation is not reasonable under paragraph (a)(10) of this section because the contribution of property is made and the curative allocation method is used with a view to shifting a significant amount of partnership taxable income to a partner with a low marginal tax rate and away from a partner with a high marginal tax rate, within a period of time significantly shorter than the economic life of the property.

(C) The property has only one year remaining on its cost recovery schedule even though its economic life is considerably longer. Under these facts, if the partnership agreement had provided for curative allocations over a reasonable period of time, such as over the property's economic life, rather than over its remaining cost recovery period, the allocations would have been reasonable. See paragraph (c)(3)(ii) of this section. Thus, in this example, JK would make a curative allocation of $400 of sales income to J in the partnership's first year (10 percent of $4,000). J and K's book and tax capital accounts at the end of the first year would be as follows:

J		K		
Book	Tax	Book	Tax	
$10,000	$1,000	$10,000	$10,000	Initial contribution.
<5,000>	<0>	<5,000>	<1,000>	Depreciation.
4,000	4,400	4,000	3,600	Sales income.
9,000	5,400	9,000	12,600	

(d) *Remedial allocation method*—(1) *In general.* A partnership may adopt the remedial allocation method described in this paragraph to eliminate distortions caused by the ceiling rule. A partnership adopting the remedial allocation method eliminates those distortions by creating remedial items and allocating those items to its partners. Under the remedial allocation method, the partnership first determines the amount of book items under paragraph (d)(2) of this section and the partners' distributive shares of these items under section 704(b). The partnership then allocates the corresponding tax items recognized by the partnership, if any, using the traditional method described in paragraph (b)(1) of this section. If the ceiling rule (as defined in paragraph (b)(1) of this section) causes the book allocation of an item to a noncontributing partner to differ from the tax allocation of the same item to the noncontributing partner, the partnership creates a remedial item of income, gain, loss, or deduction equal to the full amount of the difference and allocates it to the noncontributing partner. The partnership simultaneously creates an offsetting remedial item in an identical amount and allocates it to the contributing partner.

(2) *Determining the amount of book items.* Under the remedial allocation method, a partnership determines the amount of book items attributable to contributed property in the following manner rather than under the rules of § 1.704–1(b)(2)(iv)(*g*)(*3*). The portion of the partnership's book basis in the property equal to the adjusted tax basis in the property at the time of contribution is recovered in the same manner as the adjusted tax basis in the property is recovered (generally, over the property's remaining recovery period under section 168(i)(7) or other applicable Internal Revenue Code section). The remainder of the partnership's book basis in the property (the amount by which book basis exceeds adjusted tax basis) is recovered using any recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the same type as the contributed property) that is placed in service at the time of contribution.

(3) *Type.* Remedial allocations of income, gain, loss, or deduction to the noncontributing partner have the same tax attributes as the tax item limited by the ceiling rule. The tax attributes of offsetting remedial allocations of income, gain, loss, or deduction to the contributing partner are determined by reference to the item limited by the ceiling rule. Thus, for example, if the ceiling rule limited item is loss from the sale of contributed property, the offsetting remedial allocation to the contributing partner must be gain from the sale of that property. Conversely, if the ceiling rule limited item is gain from the sale of contributed property, the offsetting remedial allocation to the contributing partner must be loss from the sale of that property. If the ceiling rule limited item is depreciation or other cost recovery from the contributed property, the offsetting remedial allocation to the contributing partner must be income of the type

produced (directly or indirectly) by that property. Any partner level tax attributes are determined at the partner level. For example, if the ceiling rule limited item is depreciation from property used in a rental activity, the remedial allocation to the noncontributing partner is depreciation from property used in a rental activity and the offsetting remedial allocation to the contributing partner is ordinary income from that rental activity. Each partner then applies section 469 to the allocations as appropriate.

(4) *Effect of remedial items*—(i) *Effect on partnership.* Remedial items do not affect the partnership's computation of its taxable income under section 703 and do not affect the partnership's adjusted tax basis in partnership property.

(ii) *Effect on partners.* Remedial items are notional tax items created by the partnership solely for tax purposes and do not affect the partners' book capital accounts. Remedial items have the same effect as actual tax items on a partner's tax liability and on the partner's adjusted tax basis in the partnership interest.

(5) *Limitations on use of methods involving remedial allocations*—(i) *Limitation on taxpayers.* In the absence of published guidance, the remedial allocation method described in this paragraph (d) is the only reasonable section 704(c) method permitting the creation of notional tax items.

(ii) *Limitation on Internal Revenue Service.* In exercising its authority under paragraph (a)(10) of this section to make adjustments if a partnership's allocation method is not reasonable, the Internal Revenue Service will not require a partnership to use the remedial allocation method described in this paragraph (d) or any other method involving the creation of notional tax items.

(6) *Adjustments to application of method.* The Commissioner may, by published guidance, prescribe adjustments to the remedial allocation method under this paragraph (d) as necessary or appropriate. This guidance may, for example, prescribe adjustments to the remedial allocation method to prevent the duplication or omission of items of income or deduction or to reflect more clearly the partners' income or the income of a transferee of a partner.

(7) *Examples.* The following examples illustrate the principles of this paragraph (d).

Example 1. Remedial allocation method—(i) *Facts.* On January 1, L and M form partnership LM and agree that each will be allocated a 50 percent share of all partnership items. The partnership agreement provides that LM will make allocations under section 704(c) using the remedial allocation method under this paragraph (d) and that the straight-line method will be used to recover excess book basis. L contributes depreciable property with an adjusted tax basis of $4,000 and a fair market value of $10,000. The property is depreciated using the straight-line method with a 10-year recovery period and has 4 years remaining on its recovery period. M contributes $10,000, which the partnership uses to purchase land. Except for the depreciation deductions, LM's expenses equal its income in each year of the 10 years commencing with the year the partnership is formed.

(ii) *Years 1 through 4.* Under the remedial allocation method of this paragraph (d), LM has book depreciation for each of its first 4 years of $1,600 [$1,000 ($4,000 adjusted tax basis divided by the 4-year remaining recovery period) plus $600 ($6,000 excess of book value over tax basis, divided by the *new* 10-year recovery period)]. (For the purpose of simplifying the example, the partnership's book depreciation is determined without regard to any first-year depreciation conventions.) Under the partnership agreement, L and M are each allocated 50 percent ($800) of the book depreciation. M is allocated $800 of tax depreciation and L is allocated the remaining $200 of tax depreciation ($1,000–$800). See paragraph (d)(1) of this section. No remedial allocations are made because the ceiling rule does not result in a book allocation of depreciation to M different from the tax allocation. The allocations result in capital accounts at the end of LM's first 4 years as follows:

	L		M	
	Book	Tax	Book	Tax
Initial contribution ..	$10,000	$4,000	$10,000	$10,000
Depreciation	<3,200>	<800>	<3,200>	<3,200>
	$6,800	$3,200	$6,800	$6,800

(iii) *Subsequent years.* (A) For each of years 5 through 10, LM has $600 of book depreciation ($6,000 excess of initial book value over adjusted tax basis divided by the 10-year recovery period that commented in year 1), but no tax depreciation. Under the partnership agreement, the $600 of book depreciation is allocated equally to L and M. Because of the application of the ceiling rule in year 5, M would be allotted $300 of book depreciation, but no tax depreciation. Thus, at the end of LM's fifth year L's and M's book and tax capital accounts would be as follows:

	L		M	
	Book	Tax	Book	Tax
End of year 4	$6,800	$3,200	$6,800	$6,800
Depreciation	<300>		<300>	
	$6,500	$3,200	$6,500	$6,800

(B) Because the ceiling rule would cause an annual disparity of $300 between M's allocations of book and tax depreciation, LM must make remedial allocations of $300 of tax depreciation deductions to M under the remedial allocation method for each of years 5 through 10. LM must also make an offsetting remedial allocation to L of $300 of taxable income, which must be of the same type as income produced by the property. At the end of year 5, LM's capital accounts are as follows:

	L		M	
	Book	Tax	Book	Tax
End of year 4	$6,800	$3,200	$6,800	$6,800
Depreciation	<300>		<300>	
Remedial allocations		300		<300>
	$6,500	$3,500	$6,500	$6,500

(C) At the end of year 10, LM's capital accounts are as follows:

	L		M	
	Book	Tax	Book	Tax
End of year 5	$6,500	$3,500	$6,500	$6,500
Depreciation	<1,500>		<1,500>	
Remedial allocations		1,500		<1,500>
	$5,000	$5,000	$5,000	$5,000

Example 2. Remedial allocations on sale—(i) *Facts.* N and P form partnership NP and agree that each will be allocated a 50 percent share of all partnership items. The partnership agreement provides that NP will make allocations under section 704(c) using the remedial allocation method under this paragraph (d). N contributes Blackacre (land) with an adjusted tax basis of $4,000 and a fair market value of $10,000. Because N has a built-in gain of $6,000, Blackacre is section 704(c) property. P contributes Whiteacre (land) with an adjusted tax basis and fair market value of $10,000. At the end of NP's first year, NP sells Blackacre to Q for $9,000 and recognizes a capital gain of $5,000 ($9,000 amount realized less $4,000 adjusted tax basis) and a book loss of $1,000 ($9,000 amount realized less $10,000 book basis). NP has no other items of income, gain, loss, or deduction. If the ceiling rule were applied, N would be allocated the entire $5,000 of tax gain and N and P would each be allocated $500 of book loss. Thus, at the end of NP's first year N's and P's book and tax capital accounts would be as follows:

	N		P	
	Book	Tax	Book	Tax
Initial contribution	$10,000	$4,000	$10,000	$10,000
Sale of Blackacre	<500>	5,000	<500>	
	$9,500	$9,000	$9,500	$10,000

(ii) *Remedial allocation.* Because the ceiling rule would cause a disparity of $500 between P's allocation of book and tax loss, NP must make a remedial allocation of $500 of capital loss to P and an offsetting remedial allocation to N of an additional $500 of capital gain. These allocations result in capital accounts at the end of NP's first year as follows:

	N		P	
	Book	Tax	Book	Tax
Initial contribution	$10,000	$4,000	$10,000	$10,000
Sale of Blackacre	<500>	5,000	<500>	
Remedial allocations		500		<500>
	$9,500	$9,500	$9,500	$9,500

Example 3. Remedial allocation where built-in gain property sold for book and tax loss—(i) *Facts.* The facts are the same as in Example 2, except that at the end of NP's first year, NP sells Blackacre to Q for $3,000 and recognizes a capital loss of $1,000 ($3,000 amount realized less $4,000 adjusted tax basis) and a book loss of $7,000 ($3,000 amount realized less $10,000 book basis). If the ceiling rule were applied, P would be allocated the entire $1,000 of tax loss and N and P would each be

allocated $3,500 of book loss. Thus, at the end of NP's first year, N's and P's book and tax capital accounts would be as follows:

	N		P	
	Book	Tax	Book	Tax
Initial contribution ..	$10,000	$4,000	$10,000	$10,000
Sale of Blackacre	<3,500>	0	<3,500>	<1,000>
	$6,500	$4,000	$6,500	$9,000

(ii) *Remedial allocation.* Because the ceiling rule would cause a disparity of $2,500 between P's allocation of book and tax loss on the sale of Blackacre, NP must make a remedial allocation of $2,500 of capital loss to P and an offsetting remedial allocation to N of $2,500 of capital gain. These allocations result in capital accounts at the end of NP's first year as follows:

	N		P	
	Book	Tax	Book	Tax
Initial contribution ..	$10,000	$4,000	$10,000	$10,000
Sale of Blackacre	<3,500>	0	<3,500>	<1,000>
Remedial Allocations	....	2,500	....	<2,500>
	$6,500	$6,500	$6,500	$6,500

(e) *Exceptions and special rules*—(1) *Small disparities*—(i) *General rule.* If a partner contributes one or more items of property to a partnership within a single taxable year of the partnership, and the disparity between the book value of the property and the contributing partner's adjusted tax basis in the property is a small disparity, the partnership may—

(A) Use a reasonable section 704(c) method;

(B) Disregard the application of section 704(c) to the property; or

(C) Defer the application of section 704(c) to the property until the disposition of the property.

(ii) *Definition of small disparity.* A disparity between book value and adjusted tax basis is a small disparity if the book value of all properties contributed by one partner during the partnership taxable year does not differ from the adjusted tax basis by more than 15 percent of the adjusted tax basis, and the total gross disparity does not exceed $20,000.

(2) *Aggregation.* Each of the following types of property may be aggregated for purposes of making allocations under section 704(c) and this section if contributed by one partner during the partnership taxable year.

(i) *Depreciable property.* All property, other than real property, that is included in the same general asset account of the contributing partner and the partnership under section 168.

(ii) *Zero-basis property.* All property with a basis equal to zero, other than real property.

(iii) *Inventory.* For partnerships that do not use a specific identification method of accounting, each item of inventory, other than qualified financial assets (as defined in paragraph (e)(3)(ii) of this section).

(3) *Special aggregation rule for securities partnerships*—(i) *General rule.* For purposes of making reverse section 704(c) allocations, a securities partnership may aggregate gains and losses from qualified financial assets using any reasonable approach that is consistent with the purpose of section 704(c). Notwithstanding paragraphs (a)(2) and (a)(6)(i) of this section, once a partnership adopts an aggregate approach, that partnership must apply the same aggregate approach to all of its qualified financial assets for all taxable years in which the partnership qualifies as a securities partnership. Paragraphs (e)(3)(iv) and (e)(3)(v) of this section describe approaches for aggregating reverse section 704(c) gains and losses that are generally reasonable. Other approaches may be reasonable in appropriate circumstances. See, however, paragraph (a)(10) of this section, which describes the circumstances under which section 704(c) methods, including the aggregate approaches described in this paragraph (e)(3), are not reasonable. A partnership using an aggregate approach must separately account for any built-in gain or loss from contributed property.

(ii) *Qualified financial assets*—(A) *In general.* A qualified financial asset is any personal property (including stock) that is actively traded. Actively traded means actively traded as defined in §1.1092(d)–1 (defining actively traded property for purposes of the straddle rules).

(B) *Management companies.* For a management company, qualified financial assets also include the following, even if not actively traded: shares of stock in a corporation; notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; evidences of an interest in, or derivative financial instruments in, any security, currency, or commodity, including any option, forward or futures contract, or short position; or any similar financial instrument.

(C) *Partnership interests.* An interest in a partnership is not a qualified financial asset for purposes of this paragraph (e)(3)(ii). However, for purposes of this paragraph (e)(3), a partnership (upper-tier partnership) that holds an interest in a securities partnership (lower-tier partnership) must take into account the lower-tier partnership's assets and qualified financial assets as follows:

(*1*) In determining whether the upper-tier partnership qualifies as an investment partnership, the upper-tier partnership must treat its proportionate share of the lower-tier securities partnership's assets as assets of the upper-tier partnership; and

(*2*) If the upper-tier partnership adopts an aggregate approach under this paragraph (e)(3), the upper-tier partnership must aggregate the gains and losses from its directly held qualified financial assets with its distributive share of the gains and losses from the qualified financial assets of the lower-tier securities partnership.

(iii) *Securities partnership*—(A) *In general.* A partnership is a securities partnership if the partnership is either a management company or an investment partnership, and the partnership makes all of its book allocations in proportion to the partners' relative book capital accounts (except for reasonable special allocations to a partner that provides management services or investment advisory services to the partnership).

(B) *Definitions*—(*1*) *Management company.* A partnership is a management company if it is registered with the Securities and Exchange Commission as a management company under the Investment Company Act of 1940, as amended (15 U.S.C. 80a).

(*2*) *Investment partnership.* A partnership is an investment partnership if:

(*i*) On the date of each capital account restatement, the partnership holds qualified financial assets that constitute at least 90 percent of the fair market value of the partnership's non-cash assets; and

(*ii*) The partnership reasonably expects, as of the end of the first taxable year in which the partnership adopts an aggregate approach under this paragraph (e)(3), to make revaluations at least annually.

(iv) *Partial netting approach.* This paragraph (e)(3)(iv) describes the partial netting approach of making reverse section 704(c) allocations. See Example 1 of paragraph (e)(3)(ix) of this section for an illustration of the partial netting approach. To use the partial netting approach, the partnership must establish appropriate accounts for each partner for the purpose of taking into account each partner's share of the book gains and losses and determining each partner's share of the tax gains and losses. Under the partial netting approach, on the date of each capital account restatement, the partnership:

(A) Nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners;

(B) Separately aggregates all tax gains and all tax losses from qualified financial assets since the last capital account restatement; and

(C) Separately allocates the aggregate tax gain and aggregate tax loss to the partners in a manner that reduces the disparity between the book capital account balances and the tax capital account balances (book-tax disparities) of the individual partners.

(v) *Full netting approach.* This paragraph (e)(3)(v) describes the full netting approach of making reverse section 704(c) allocations on an aggregate basis. See Example 2 of paragraph (e)(3)(ix) of this section for an illustration of the full netting approach. To use the full netting approach, the partnership must establish appropriate accounts for each partner for the purpose of taking into account each partner's share of the book gains and losses and determining each partner's share of the tax gains and losses. Under the full netting approach, on the date of each capital account restatement, the partnership:

(A) Nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners;

(B) Nets tax gains and tax losses from qualified financial assets since the last capital account restatement; and

(C) Allocates the net tax gain (or net tax loss) to the partners in a manner that reduces the book-tax disparities of the individual partners.

(vi) *Type of tax gain or loss.* The character and other tax attributes of gain or loss allocated to the partners under this paragraph (e)(3) must:

(A) Preserve the tax attributes of each item of gain or loss realized by the partnership;

(B) Be determined under an approach that is consistently applied; and

(C) Not be determined with a view to reducing substantially the present value of the partners' aggregate tax liability.

(vii) *Disqualified securities partnerships.* A securities partnership that adopts an aggregate approach under this paragraph (e)(3) and subsequently fails to qualify as a securities partnership must make reverse section 704(c) allocations on an asset-by-asset basis after the date of disqualification. The partnership, however, is not required to disaggregate the book gain or book loss from qualified asset revaluations before the date of disqualification when making reverse section 704(c) allocations on or after the date of disqualification.

(viii) *Transitional rule for qualified financial assets revalued after effective date.* A securities partnership revaluing its qualified financial assets pursuant to §1.704–1(b)(2)(iv)(*f*) on or after the effective date of this section may use any reasonable approach to coordinate with revaluations that occurred prior to the effective date of this section.

(ix) *Examples.* The following examples illustrate the principles of this paragraph (e)(3).

Example 1. Operation of the partial netting approach—(i) *Facts.* Two regulated investment companies, X and Y, each contribute $150,000 in cash to form PRS, a partnership that registers as a management company. The partnership agreement provides that book items will be allocated in accordance with the partners' relative book capital accounts, that book capital accounts will be adjusted to reflect daily revaluations of property pursuant to §1.704–1(b)(2)(iv)(*f*)(*5*)(*iii*), and that reverse section 704(c) allocations will be made using the partial netting approach described in paragraph (e)(3)(iv) of this section. X and Y each have an initial book capital account of $150,000. In addition, the partnership establishes for each of X and Y a revaluation account with a beginning balance of $0. On Day 1, PRS buys Stock 1, Stock 2, and Stock 3 for $100,000 each. On Day 2, Stock 1 increases in value from $100,000 to $102,000, Stock 2 increases in value from $100,000 to $105,000, and Stock 3 declines in value from $100,000 to $98,000. At the end of Day 2, Z, a regulated investment company, joins PRS by contributing $152,500 in cash for a one-third interest in the partnership [$152,500 divided by $300,000 (initial values of stock) +$5,000 (net gain at end of Day 2)+ $152,500]. PRS uses this cash to purchase Stock 4. PRS establishes a revaluation account for Z with a $0 beginning balance. As of the close of Day 3, Stock 1 increases in value from $102,000 to $105,000, and Stocks 2, 3, and 4 decrease in value from $105,000 to $102,000, from $98,000 to $96,000, and from $152,500 to $151,500, respectively. At the end of Day 3, PRS sells Stocks 2 and 3.

(ii) *Book allocations—Day 2.* At the end of Day 2, PRS revalues the partnership's qualified financial assets and increases X's and Y's book capital accounts by each partner's 50 percent share of the $5,000 ($2,000 + $5,000 − $2,000) net increase in the value of the partnership's assets during Day 2. PRS increases X's and Y's respective revaluation account balances by $2,500 each to reflect the amount by which each partner's book capital account increased on Day 2. Z's capital account is not affected because Z did not join PRS until the end of Day 2. At the beginning of Day 3, the partnership's accounts are as follows:

	Stock 1	Stock 2	Stock 3	Stock 4
Opening Balance	$100,000	$100,000	$100,000	....
Day 2 Adjustment	2,000	5,000	(2,000)	....
Total	$102,000	$105,000	$98,000	$152,500

	X		
	Book	Tax	Revaluation account
Opening Balance	$150,000	$150,000	0
Day 2 Adjustment	2,500	0	$2,500
Closing Balance	$152,500	$150,000	$2,500

	Y		
	Book	Tax	Revaluation account
Opening Balance	$150,000	$150,000	0
Day 2 Adjustment	2,500	0	$2,500
Closing balance	$152,500	$150,000	$2,500

	Z		
	Book	Tax	Revaluation account
Opening Balance			
Day 2 Adjustment			
Closing Balance	$152,500	$152,500	$0

(iii) *Book and tax allocations—Day 3.* At the end of Day 3, PRS decreases the book capital accounts of X, Y, and Z by $1,000 to reflect each partner's share of the $3,000 ($3,000—$3,000—$2,000—$1,000) net decrease in the value of the partnership's qualified financial assets. PRS also reduces each partner's revaluation account balance by $1,000. Accordingly, X's and Y's revaluation account balances are reduced to $1,500 each and Z's revaluation account balance is ($1,000). PRS then separately allocates the tax gain from the sale of Stock 2 and the tax loss from the sale of Stock 3. The $2,000 of tax gain recognized on the sale of Stock 2 ($102,000—$100,000) is allocated among the partners with positive revaluation account balances in accordance with the relative balances of those revaluation accounts. X's and Y's revaluation accounts have equal positive balances; thus, PRS allocates $1,000 of the gain from the sale of Stock 2 to X and $1,000 of that gain to Y. PRS allocates none of the gain from the sale to Z because Z's revaluation account balance is negative. The $4,000 of tax loss recognized from the sale of Stock 3 ($96,000—$100,000) is allocated first to the partners with negative revaluation account balances to the extent of those balances. Because Z is the only partner with a negative revaluation account balance, the tax loss is allocated first to Z to the extent of Z's ($1,000) balance. The remaining $3,000 of tax loss is allocated among the partners in accordance with their distributive shares of the loss. Accordingly, PRS allocates $1,000 of tax loss from the sale of Stock 3 to each of X and Y. PRS also allocates an additional $1,000 of the tax loss to Z, so that Z's total share of the tax loss from the sale of Stock 3 is $2,000. PRS then reduces each partner's revaluation account balance by the amount of any tax gain allocated to that partner and increases each partner's revaluation account balance by the amount of any tax loss allocated to that partner. At the beginning of Day 4, the partnership's accounts are as follows:

	Stock 1	Stock 2	Stock 3	Stock 4
Opening Balance	$100,000	$100,000	$100,000	$152,500
Day 2 Adjustment	2,000	5,000	(2,000)	
Day 3 Adjustment	$3,000	(3,000)	(2,000)	(1,000)
Total	$105,000	$102,000	$96,000	$151,500

	X and Y		
	Book	Tax	Revaluation account
Opening Balance	$150,000	$150,000	0
Day 2 Adjustment	2,500	0	$2,500
Day 3 Adjustment	(1,000)	0	($1,000)
Total	$151,500	$150,000	$1,500
Gain from Stock 2	0	$1,000	(1,000)
Loss from Stock 3	0	($1,000)	1,000
Closing Balance	$151,500	$150,000	$1,500

	Z		
	Book	Tax	Revaluation account
Opening Balance	$152,500	$152,500	0
Day 3 Adjustment	(1,000)	0	($1,000)
Total	$151,500	$152,500	($1,000)
Gain from Stock 2	0	0	0
Loss from Stock 3	0	(2,000)	2,000
Closing Balance	$151,500	$150,500	$1,000

Example 2. Operation of the full netting approach—(i) *Facts.* The facts are the same as in Example 1, except that the partnership agreement provides that PRS will make reverse section 704(c) allocations using the full netting approach described in paragraph (e)(3)(v) of this section.

(ii) *Book allocations—Days 2 and 3.* PRS allocates its book gains and losses in the manner described in paragraphs (ii) and (iii) of Example 1 (the partial netting approach). Thus, at the end of Day 2, PRS increases the book capital accounts of X and Y by $2,500 to reflect the appreciation in the parntership's assets from the close of Day 1 to the close of Day 2 and records that increase in the revaluation account created for each partner. At the end of Day 3, PRS decreases the book capital accounts of X, Y, and Z by $1,000 to reflect each partner's share of the decline in value of the partnership's assets from Day 2 to Day 3 and reduces each partner's revaluation account by a corresponding amount.

(iii) *Tax allocations—Day 3.* After making the book adjustments described in the previous paragraph, PRS allocates its net tax gain (or net tax loss) from its sales of qualified financial assets during Day 3. To do so, PRS first determines its net tax gain (or net tax loss) recognized from its sales of qualified financial assets for the day. There is a $2,000 net tax loss ($2,000 gain from the sale of Stock 2 less $4,000 loss from the sale of Stock 3) on the sale of PRS's qualified financial assets. Because Z is the only partner with a negative revaluation account balance, the partnership's net tax loss is allocated first to Z to the extent of Z's ($1,000) revaluation account balance. The remaining net tax loss is allocated among the partners in accoradnce with their distributive shares of loss. Thus, PRS allocates $333.33 of the $2,000 net tax loss to each of X and Y. PRS also allocates an additional $333.33 of the net tax loss to Z, so that the total net tax loss allocation to Z is $1,333.33. PRS then increases each partner's revaluation account balance by the amount of net tax loss allocated to that partner. At the beginning of Day 4, the partnership's accounts are as follows:

	Stock 1	Stock 2	Stock 3	Stock 4
Opening Balance	$100,000	$100,000	$100,000	$152,500
Day 2 Adjustment	2,000	5,000	(2,000)	....
Day 3 Adjustment	3,000	(3,000)	(2,000)	($1,000)
Total	$105,000	$102,000	$96,000	$151,500

	X and Y		
	Book	Tax	Revaluation account
Opening Balance	$150,000	$150,000	0
Day 2 Adjustment	$2,500	0	$2,500
Day 3 Adjustment	(1,000)	0	(1,000)
Total	$151,500	$150,000	$1,500
Net Tax Loss-Stocks 2 & 3	0	(333)	333
Closing Balance	$151,500	$149,667	$1,833

	Z		
	Book	Tax	Revaluation account
Opening Balance	$152,500	$152,500	0
Day 3 Adjustment	(1,000)	0	($1,000)
Total	$151,500	$152,500	($1,000)
Net Tax Loss-Stocks 2 & 3	0	(1,333)	1,333
Closing Balance	$151,500	$151,167	$333

(4) *Aggregation as permitted by the Commissioner.* The Commissioner may, by published guidance or by letter ruling, permit:

(i) Aggregation of properties other than those described in paragraphs (e)(2) and (e)(3) of this section;

(ii) Partnerships and partners not described in paragraph (e)(3) of this section to aggregate gain and loss from qualified financial assets; and

(iii) Aggregation of qualified financial assets for purposes of making section 704(c) allocations in the same manner as that described in paragraph (e)(3) of this section.

(f) *Effective date.* With the exception of paragraph (a)(11) of this section, this section applies to properties contributed to a partnership and to restatements pursuant to §1.704–1(b)(2)(iv)*(f)* on or after December 21, 1993. Paragraph (a)(11) of this section applies to properties contributed by a partner to a partnership on or after August 20, 1997. However, partnerships may rely on paragraph (a)(11) of this section for properties contributed before August 20, 1997 and disposed of on or after August 20, 1997.

[T.D. 8500, 58 FR 67679, Dec. 22, 1993; 59 FR 4140, Jan. 28, 1994, as amended by T.D. 8585, 59 FR 66728, Dec. 28, 1994; 60 FR 11906, Mar. 3, 1995; T.D. 8717, 62 FR 25500, May 9, 1997; T.D. 8730, 62 FR 44215, Aug. 20, 1997]

§1.704–4 Distribution of contributed property.

(a) *Determination of gain and loss*—(1) *In general.* A partner that contributes section 704(c) property to a partnership must recognize gain or loss under section 704(c)(1)(B) and this section on the distribution of such property to another partner within five years of its contribution to the partnership in an amount equal to the gain or loss that would have been allocated to such partner under section 704(c)(1)(A) and § 1.704–3 if the distributed property had been sold by the partnership to the distributee partner for its fair market value at the time of the distribution. See § 1.704–3(a)(3)(i) for a definition of section 704(c) property.

(2) *Transactions to which section 704(c)(1)(B) applies.* Section 704(c)(1)(B) and this section apply only to the extent that a distribution by a partnership is a distribution to a partner acting in the capacity of a partner within the meaning of section 731.

(3) *Fair market value of property.* The fair market value of the distributed section 704(c) property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value that a partnership assigns to distributed section 704(c) property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.

(4) *Determination of five-year period*—(i) *General rule.* The five-year period specified in paragraph (a)(1) of this section begins on and includes the date of contribution.

(ii) *Section 708(b)(1)(B) terminations.* A termination of the partnership under section 708(b)(1)(B) does not begin a new five-year period for each partner with respect to the built-in gain and built-in loss property that the terminated partnership is deemed to contribute to the new partnership under § 1.708–1(b)(1)(iv). See § 1.704–3(a)(3)(ii) for the definitions of built-in gain and built-in loss on section 704(c) property. This paragraph (a)(4)(ii) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (a)(4)(ii) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (a)(4)(ii) to the termination in a consistent manner.

(5) *Examples.* The following examples illustrate the rules of this paragraph (a). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example 1. Recognition of gain. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes $10,000 cash and Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $4,000. Thus, there is a built-in gain of $6,000 on Property A at the time of contribution. B contributes $10,000 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. C contributes $20,000 cash.

(ii) On December 31, 1998, Property A and Property B are distributed to C in complete liquidation of C's interest in the partnership.

(iii) A would have recognized $6,000 of gain under section 704(c)(1)(A) and § 1.704–3 on the sale of Property A at the time of the distribution ($10,000 fair market value less $4,000 adjusted tax basis). As a result, A must recognize $6,000 of gain on the distribution of Property A to C. B would not have recognized any gain or loss under section 704(c)(1)(A) and § 1.704–3 on the sale of Property B at the time of distribution because Property B was not section 704(c) property. As a result, B does not recognize any gain or loss on the distribution of Property B.

Example 2. Effect of post-contribution depreciation deductions. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, depreciable property with a fair market value of $30,000 and an adjusted tax basis of $20,000. Therefore, there is a built-in gain of $10,000 on Property A. B and C each contribute $30,000 cash. ABC uses the traditional method of making section 704(c) allocations described in § 1.704–3(b) with respect to Property A.

(ii) Property A is depreciated using the straight-line method over its remaining 10-year recovery period. The partnership has book depreciation of $3,000 per year (10 percent of the $30,000 book basis), and each partner is allocated $1,000 of book depreciation per year (one-third of the total annual book depreciation of $3,000). The partnership has a tax depreciation deduction of $2,000 per year (10 percent of the $20,000 tax basis in Property A). This $2,000 tax depreciation deduction is allocated equally between B and C, the noncontributing partners with respect to Property A.

(iii) At the end of the third year, the book value of Property A is $21,000 ($30,000 initial book value less $9,000 aggregate book depreciation) and the adjusted tax basis is $14,000 ($20,000 initial tax basis less $6,000 aggregate tax depreciation). A's remaining section 704(c)(1)(A) built-in gain with respect to Property A is $7,000 ($21,000 book value less $14,000 adjusted tax basis).

(iv) On December 31, 1997, Property A is distributed to B in complete liquidation of B's interest in the partnership. If Property A had been sold for its fair market value at the time of the distribution, A would have recognized $7,000 of gain under section 704(c)(1)(A) and §1.704–3(b). Therefore, A recognizes $7,000 of gain on the distribution of Property A to B.

Example 3. Effect of remedial method. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A1, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $5,000, and Property A2, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. B and C each contribute $20,000 cash. ABC uses the remedial method of making section 704(c) allocations described in §1.704–3(d) with respect to Property A1.

(ii) On December 31, 1998, when the fair market value of Property A1 has decreased to $7,000, Property A1 is distributed to C in a current distribution. If Property A1 had been sold by the partnership at the time of the distribution, ABC would have recognized the $2,000 of remaining built-in gain under section 704(c)(1)(A) on the sale (fair market value of $7,000 less $5,000 adjusted tax basis). All of this gain would have been allocated to A. ABC would also have recognized a book loss of $3,000 ($10,000 original book value less $7,000 current fair market value of the property). Book loss in the amount of $2,000 would have been allocated equally between B and C. Under the remedial method, $2,000 of tax loss would also have been allocated equally to B and C to match their share of the book loss. As a result, $2,000 of gain would also have been allocated to A as an offsetting remedial allocation. A would have recognized $4,000 of total gain under section 704(c)(1)(A) on the sale of Property A1 ($2,000 of section 704(c) recognized gain plus $2,000 remedial gain). Therefore, A recognizes $4,000 of gain on the distribution of Property A1 to C under this section.

(b) *Character of gain or loss*—(1) *General rule.* Gain or loss recognized by the contributing partner under section 704(c)(1)(B) and this section has the same character as the gain or loss that would have resulted if the distributed property had been sold by the partnership to the distributee partner at the time of the distribution.

(2) *Example.* The following example illustrates the rule of this paragraph (b). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example. Character of gain. (i) On January 1, 1995, A and B form partnership AB. A contributes $10,000 and Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $4,000, in exchange for a 25 percent interest in partnership capital and profits. B contributes $60,000 cash for a 75 percent interest in partnership capital and profits.

(ii) On December 31, 1998, Property A is distributed to B in a current distribution. Property A is used in a trade or business of B.

(iii) A would have recognized $6,000 of gain under section 704(c)(1)(A) on a sale of Property A at the time of the distribution (the difference between the fair market value ($10,000) and the adjusted tax basis ($4,000) of the property at that time). Because Property A is not a capital asset in the hands of Partner B and B holds more than 50 percent of partnership capital and profits, the character of the gain on a sale of Property A to B would have been ordinary income under section 707(b)(2). Therefore, the character of the gain to A on the distribution of Property A to B is ordinary income.

(c) *Exceptions*—(1) *Property contributed on or before October 3, 1989.* Section 704(c)(1)(B) and this section do not apply to property contributed to the partnership on or before October 3, 1989.

(2) *Certain liquidations.* Section 704(c)(1)(B) and this section do not apply to a distribution of an interest in section 704(c) property to a partner other than the contributing partner in a liquidation of the partnership if—

(i) The contributing partner receives an interest in the section 704(c) property contributed by that partner (and no other property); and

(ii) The built-in gain or loss in the interest distributed to the contributing partner, determined immediately after the distribution, is equal to or greater than the built-in gain or loss on the property that would have been allocated to the contributing partner under section 704(c)(1)(A) and § 1.704–3 on a sale of the contributed property to an unrelated party immediately before the distribution.

(3) *Section 708(b)(1)(B) terminations.* Section 704(c)(1)(B) and this section do not apply to the deemed distribution of interests in a new partnership caused by the termination of a partnership under section 708(b)(1)(B). A subsequent distribution of section 704(c) property by the new partnership to a partner of the new partnership is subject to section 704(c)(1)(B) to the same extent that a distribution by the terminated partnership would have been subject to section 704(c)(1)(B). See also § 1.737–2(a) for a similar rule in the context of section 737. This paragraph (c)(3) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (c)(3) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (c)(3) to the termination in a consistent manner.

(4) *Complete transfer to another partnership.* Section 704(c)(1)(B) and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement. A subsequent distribution of section 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to section 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to section 704(c)(1)(B). See § 1.737–2(b) for a similar rule in the context of section 737.

(5) *Incorporation of a partnership.* Section 704(c)(1)(B) and this section do not apply to an incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction. See § 1.737–2(c) for a similar rule in the context of section 737.

(6) *Undivided interests.* Section 704(c)(1)(B) and this section do not apply to a distribution of an undivided interest in property to the extent that the undivided interest does not exceed the undivided interest, if any, contributed by the distributee partner in the same property. See § 1.737–2(d)(4) for the application of section 737 in a similar context. The portion of the undivided interest in property retained by the partnership after the distribution, if any, that is treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee partner.

(7) *Example.* The following example illustrates the rule of paragraph (c)(2) of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example. (i) On January 1, 1995, A and B form partnership AB, as equal partners. A contributes Property A, nondepreciable real property with a fair market value and adjusted tax basis of $20,000. B contributes Property B, nondepreciable real property with a fair market value of $20,000 and an adjusted tax basis of $10,000. Property B therefore has a built-in gain of $10,000 at the time of contribution.

(ii) On December 31, 1998, the partnership liquidates when the fair market value of Property A has not changed, but the fair market value of Property B has increased to $40,000.

(iii) In the liquidation, A receives Property A and a 25 percent interest in Property B. This interest in Property B has a fair market value of $10,000 to A, reflecting the fact that A was entitled to 50 percent of the $20,000 post-contribution appreciation in Property B. The partnership distributes to B a 75 percent interest in Property B with a fair market value of $30,000. B's basis in this portion of Property B is $10,000 under section 732(b). As a result, B has a built-in gain of $20,000 in this portion of Property B immediately after the distribution ($30,000 fair market value less $10,000 adjusted tax basis). This built-in gain is greater than the $10,000 of built-in gain in Property B at the time of contribution to the partnership. B therefore does not recognize any gain on the distribution of a portion of Property B to A under this section.

(d) *Special rules*—(1) *Nonrecognition transactions.* Property received by the partnership in exchange for section 704(c) property in a nonrecognition transaction is treated as the section 704(c) property for purposes of section 704(c)(1)(B) and this section to the extent that the property received is treated as section 704(c) property under §1.704–3(a)(8). See §1.737–2(d)(3) for a similar rule in the context of section 737.

(2) *Transfers of a partnership interest.* The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner. See §1.704–3(a)(7).

(3) *Distributions of like-kind property.* If section 704(c) property is distributed to a partner other than the contributing partner and like-kind property (within the meaning of section 1031) is distributed to the contributing partner no later than the earlier of (i) 180 days following the date of the distribution to the non-contributing partner, or (ii) the due date (determined with regard to extensions) of the contributing partner's income tax return for the taxable year of the distribution to the non-contributing partner, the amount of gain or loss, if any, that the contributing partner would otherwise have recognized under section 704(c)(1)(B) and this section is reduced by the amount of built-in gain or loss in the distributed like-kind property in the hands of the contributing partner immediately after the distribution. The contributing partner's basis in the distributed like-kind property is determined as if the like-kind property were distributed in an unrelated distribution prior to the distribution of any other property distributed as part of the same distribution and is determined without regard to the increase in the contributing partner's adjusted tax basis in the partnership interest under section 704(c)(1)(B) and this section. See §1.707–3 for provisions treating the distribution of the like-kind property to the contributing partner as a disguised sale in certain situations.

(4) *Example.* The following example illustrates the rules of this paragraph (d). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example. Distribution of like-kind property. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $20,000 and an adjusted tax basis of $10,000. B and C each contribute $20,000 cash. The partnership subsequently buys Property X, nondepreciable real property of a like-kind to Property A with a fair market value and adjusted tax basis of $8,000. The fair market value of Property X subsequently increases to $10,000.

(ii) On December 31, 1998, Property A is distributed to B in a current distribution. At the same time, Property X is distributed to A in a current distribution. The distribution of Property X does not result in the contribution of Property A being properly characterized as a disguised sale to the partnership under §1.707–3. A's basis in Property X is $8,000 under section 732(a)(1). A therefore has $2,000 of built-in gain in Property X ($10,000 fair market value less $8,000 adjusted tax basis).

(iii) A would generally recognize $10,000 of gain under section 704(c)(1)(B) on the distribution of Property A, the difference between the fair market value ($20,000) of the property and its adjusted tax basis ($10,000). This gain is reduced, however, by the amount of the built-in gain of Property X in the hands of A. As a result, A recognizes only $8,000 of gain on the distribution of Property A to B under section 704(c)(1)(B) and this section.

(e) *Basis adjustments*—(1) *Contributing partner's basis in the partnership interest.* The basis of the contributing partner's interest in the partnership is increased by the amount of the gain, or decreased by the amount of the loss, recognized by the partner under section 704(c)(1)(B) and this section. This increase or decrease is taken into account in determining (i) the contributing partner's adjusted tax basis under section 732 for any property distributed to the partner in a distribution that is part of the same distribution as the distribution of the contributed property, other than like-kind property described in paragraph (d)(3) of this section (pertaining to the special rule for distributions of like-kind property), and (ii) the amount of the gain recognized by the contributing partner under section 731 or section 737, if any, on a distribution of money or property to the contributing partner that is part of the same distribution as the distribution of the contributed property. For a determination of basis in a distribution subject to section 737, see § 1.737–3(a).

(2) *Partnership's basis in partnership property.* The partnership's adjusted tax basis in the distributed section 704(c) property is increased or decreased immediately before the distribution by the amount of gain or loss recognized by the contributing partner under section 704(c)(1)(B) and this section. Any increase or decrease in basis is therefore taken into account in determining the distributee partner's adjusted tax basis in the distributed property under section 732. For a determination of basis in a distribution subject to section 737, see § 1.737–3(b).

(3) *Section 754 adjustments.* The basis adjustments to partnership property made pursuant to paragraph (e)(2) of this section are not elective and must be made regardless of whether the partnership has an election in effect under section 754. Any adjustments to the bases of partnership property (including the distributed section 704(c) property) under section 734(b) pursuant to a section 754 election must be made after (and must take into account) the adjustments to basis made under paragraph (e)(2) of this section. See § 1.737–3(c)(4) for a similar rule in the context of section 737.

(4) *Example.* The following example illustrates the rules of this paragraph (e). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example. Basis adjustment. On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes $10,000 cash and Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $4,000. B and C each contribute $20,000 cash.

(ii) On December 31, 1998, Property A is distributed to B in a current distribution.

(iii) Under paragraph (a) of this section, A recognizes $6,000 of gain on the distribution of Property A because that is the amount of gain that would have been allocated to A under section 704(c)(1)(A) and § 1.704–3 on a sale of Property A for its fair market value at the time of the distribution (fair market value of Property A ($10,000) less its adjusted tax basis at the time of distribution ($4,000)). The adjusted tax basis of A's partnership interest is increased from $14,000 to $20,000 to reflect this gain. The partnership's adjusted tax basis in Property A is increased from $4,000 to $10,000 immediately prior to its distribution to B. B's adjusted tax basis in Property A is therefore $10,000 under section 732(a)(1).

(f) *Anti-abuse rule*—(1) *In general.* The rules of section 704(c)(1)(B) and this section must be applied in a manner consistent with the purpose of section 704(c)(1)(B). Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 704(c)(1)(B), the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 704(c)(1)(B) and this section. Whether a tax result is inconsistent with the purpose of section 704(c)(1)(B) and this section must be determined based on all the facts and circumstances. See § 1.737–4 for an anti-abuse rule and examples in the context of section 737.

(2) *Examples.* The following examples illustrate the anti-abuse rule of this paragraph (f). The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an

example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example 1. Distribution in substance made within five-year period; results inconsistent with the purpose of section 704(c)(1)(B). (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $1,000. B and C each contributes $10,000 cash.

(ii) On December 31, 1998, the partners desire to distribute Property A to B in complete liquidation of B's interest in the partnership. If Property A were distributed at that time, however, A would recognize $9,000 of gain under section 704(c)(1)(B), the difference between the $10,000 fair market value and the $1,000 adjusted tax basis of Property A, because Property A was contributed to the partnership less than five years before December 31, 1998. On becoming aware of this potential gain recognition, and with a principal purpose of avoiding such gain, the partners amend the partnership agreement on December 31, 1998, and take any other steps necessary to provide that substantially all of the economic risks and benefits of Property A are borne by B as of December 31, 1998, and that substantially all of the economic risks and benefits of all other partnership property are borne by A and C. The partnership holds Property A until January 5, 2000, at which time it is distributed to B in complete liquidation of B's interest in the partnership.

(iii) The actual distribution of Property A occurred more than five years after the contribution of the property to the partnership. The steps taken by the partnership on December 31, 1998, however, are the functional equivalent of an actual distribution of Property A to B in complete liquidation of B's interest in the partnership as of that date. Section 704(c)(1)(B) requires recognition of gain when contributed section 704(c) property is in substance distributed to another partner within five years of its contribution to the partnership. Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as those in this *Example 1* that have the effect of a distribution of property within five years of the date of its contribution to the partnership would effectively undermine the purpose of section 704(c)(1)(B) and this section. As a result, the steps taken by the partnership on December 31, 1998, are treated as causing a distribution of Property A to B for purposes of section 704(c)(1)(B) on that date, and A recognizes gain of $9,000 under section 704(c)(1)(B) and this section at that time.

(iv) Alternatively, if on becoming aware of the potential gain recognition to A on a distribution of Property A on December 31, 1998, the partners had instead agreed that B would continue as a partner with no changes to the partnership agreement or to B's economic interest in partnership operations, the distribution of Property A to B on January 5, 2000, would not have been inconsistent with the purpose of section 704(c)(1)(B) and this section. In that situation, Property A would not have been distributed until after the expiration of the five-year period specified in section 704(c)(1)(B) and this section. Deferring the distribution of Property A until the end of the five-year period for a principal purpose of avoiding the recognition of gain under section 704(c)(1)(B) and this section is not inconsistent with the purpose of section 704(c)(1)(B). Therefore, A would not have recognized gain on the distribution of Property A in that case.

Example 2. Suspension of five-year period in manner consistent with the purpose of section 704(c)(1)(B). (i) A, B, and C form partnership ABC on January 1, 1995, to conduct bona fide business activities. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $1,000, in exchange for a 49.5 percent interest in partnership capital and profits. B contributes $10,000 in cash for a 49.5 percent interest in partnership capital and profits. C contributes cash for a 1 percent interest in partnership capital and profits. A and B are wholly owned subsidiaries of the same affiliated group and continue to control the management of Property A by virtue of their controlling interests in the partnership. The partnership is formed pursuant to a plan a principal purpose of which is to minimize the period of time that A would have to remain a partner with a potential acquiror of Property A.

(ii) On December 31, 1997, D is admitted as a partner to the partnership in exchange for $10,000 cash.

(iii) On January 5, 2000, Property A is distributed to D in complete liquidation of D's interest in the partnership.

(iv) The distribution of Property A to D occurred more than five years after the contribution of the property to the partnership. On these facts, however, a principal purpose of the transaction was to minimize the period of time that A would have to remain partners with a potential acquiror of Property A, and treating the five-year period of section 704(c)(1)(B) as running during a time when Property A was still effectively owned through the partnership by members of the contributing affiliated group of which A is a member is inconsistent with the purpose of section 704(c)(1)(B). Prior to the admission of D as a partner, the pooling of assets between A and B, on the one hand, and C, on the other hand, although sufficient to constitute ABC as a valid partnership for federal income tax purposes, is not a sufficient pooling of assets for purposes of running the five-year period with respect to the distribution of Property A to D. Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as those in this *Example 2* would have the effect of substantially nullifying the five-year requirement of section 704(c)(1)(B) and this section and elevating the form of the transaction over its substance. As a result, with respect to the distribution of Property A to D, the five-year period of section 704(c)(1)(B) is tolled until the admission of D as a partner on December 31, 1997. Therefore, the distribution of Property A occurred before the end of the five-year period of section 704(c)(1)(B), and A recognizes gain of $9,000 under section 704(c)(1)(B) on the distribution.

(g) *Effective date.* This section applies to distributions by a partnership to a partner on or after January 9, 1995.

[T.D. 8642, 60 FR 66730, Dec. 26, 1995, as amended by T.D. 8717, 62 FR 25500, May 9, 1997]

§ 1.705–1 Determination of basis of partner's interest.

(a) *General rule.* (1) Section 705 and this section provide rules for determining the adjusted basis of a partner's interest in a partnership. A partner is required to determine the adjusted basis of his interest in a partnership only when necessary for the determination of his tax liability or that of any other person. The determination of the adjusted basis of a partnership interest is ordinarily made as of the end of a partnership taxable year. Thus, for example, such year-end determination is necessary in ascertaining the extent to which a partner's distributive share of partnership losses may be allowed. See section 704(d). However, where there has been a sale or exchange of all or a part of a partnership interest or a liquidation of a partner's entire interest in a partnership, the adjusted basis of the partner's interest should be determined as of the date of sale or exchange or liquidation. The adjusted basis of a partner's interest in a partnership is determined without regard to any amount shown in the partnership books as the partner's ''capital'', ''equity'', or similar account. For example, A contributes property with an adjusted basis to him of $400 (and a value of $1,000) to a partnership. B contributes $1,000 cash. While under their agreement each may have a ''capital account'' in the partnership of $1,000, the adjusted basis of A's interest is only $400 and B's interest $1,000.

(2) The original basis of a partner's interest in a partnership shall be determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests). Such basis shall be increased under section 722 by any further contributions to the partnership and by the sum of the partner's distributive share for the taxable year and prior taxable years of:

(i) Taxable income of the partnership as determined under section 703(a),

(ii) Tax-exempt receipts of the partnership, and

(iii) The excess of the deductions for depletion over the basis of the depletable property, unless the property is an oil or gas property the basis of which has been allocated to partners under section 613A(c)(7)(D).

(3) The basis shall be decreased (but not below zero) by distributions from the partnership as provided in section 733 and by the sum of the partner's distributive share for the taxable year and prior taxable years of:

(i) Partnership losses (including capital losses), and

(ii) Partnership expenditures which are not deductible in computing partnership taxable income or loss and which are not capital expenditures.

(4) The basis shall be decreased (but not below zero) by the amount of the partner's deduction for depletion allowable under section 611 for any partnership oil and gas property to the extent the deduction does not exceed the proportionate share of the adjusted basis of the property allocated to the partner under section 613A(c)(7)(D).

(5) The basis shall be adjusted (but not below zero) to reflect any gain or

loss to the partner resulting from a disposition by the partnership of a domestic oil or gas property after December 31, 1974.

(6) For the effect of liabilities in determining the amount of contributions made by a partner to a partnership or the amount of distributions made by a partnership to a partner, see section 752 and §1.752–1, relating to the treatment of certain liabilities. In determining the basis of a partnership interest on the effective date of subchapter K, chapter 1 of the Code, or any of the sections thereof, the partner's share of partnership liabilities on that date shall be included.

(b) *Alternative rule.* In certain cases, the adjusted basis of a partner's interest in a partnership may be determined by reference to the partner's share of the adjusted basis of partnership property which would be distributable upon termination of the partnership. The alternative rule may be used to determine the adjusted basis of a partner's interest where circumstances are such that the partner cannot practicably apply the general rule set forth in section 705(a) and paragraph (a) of this section, or where, from a consideration of all the facts, it is, in the opinion of the Commissioner, reasonable to conclude that the result produced will not vary substantially from the result obtainable under the general rule. Where the alternative rule is used, adjustments may be necessary in determining the adjusted basis of a partner's interest in a partnership. Adjustments would be required, for example, in order to reflect in a partner's share of the adjusted basis of partnership property any significant discrepancies arising as a result of contributed property, transfers of partnership interests, or distributions of property to the partners. The operation of the alternative rules may be illustrated by the following examples:

Example 1. The ABC partnership, in which A, B, and C are equal partners, owns various properties with a total adjusted basis of $1,500 and has earned and retained an additional $1,500. The total adjusted basis of partnership property is thus $3,000. Each partner's share in the adjusted basis of partnership property is one-third of this amount, or $1,000. Under the alternative rule, this amount represents each partner's adjusted basis for his partnership interest.

Example 2. Assume that partner A in example 1 of this paragraph sells his partnership interest to D for $1,250 at a time when the partnership property with an adjusted basis of $1,500 had appreciated in value to $3,000, and when the partnership also had $750 in cash. The total adjusted basis of all partnership property is $2,250 and the value of such property is $3,750. D's basis for his partnership interest is his cost, $1,250. However, his one-third share of the adjusted basis of partnership property is only $750. Therefore, for the purposes of the alternative rule, D has an adjustment of $500 in determining the basis of his interest. This amount represents the difference between the cost of his partnership interest and his share of partnership basis at the time of his purchase. If the partnership subsequently earns and retains an additional $1,500, its property will have an adjusted basis of $3,750. D's adjusted basis for his interest under the alternative rule is $1,750, determined by adding $500, his basis adjustment to $1,250 (his one-third share of the $3,750 adjusted basis of partnership property). If the partnership distributes $250 to each partner in a current distribution, D's adjusted basis for his interest will be $1,500 ($1,000, his one-third share of the remaining basis of partnership property, $3,000, plus his basis adjustment of $500).

Example 3. Assume that BCD partnership in example 2 of this paragraph continues to operate. In 1960, D proposes to sell his partnership interest and wishes to evaluate the tax consequences of such sale. It is necessary, therefore, to determine the adjusted basis of his interest in the partnership. Assume further that D cannot determine the adjusted basis of his interest under the general rule. The balance sheet of the BCD partnership is as follows:

Assets	Adjusted basis per books	Market value
Cash	$3,000	$3,000
Receivables	4,000	4,000
Depreciable property	5,000	5,000
Land held for investment	18,000	30,000
Total	30,000	42,000

Liabilities and capital	Per books
Liabilities	$6,000
Capital accounts:	
B	4,500
C	4,500
D	15,000
Total	30,000

The $15,000 representing the amount of D's capital account does not reflect the $500 basis adjustment arising from D's purchase of his interest. See example 2 of this paragraph. The adjusted basis of D's partnership interest determined under the alternative rule is as follows:

D's share of the adjusted basis of partnership property (reduced by the amount of liabilities) at time of proposed sale	$15,000
D's share of partnership liabilities (under the partnership agreement liabilities are shared equally)	2,000
D's basis adjustment from example 2	500
Adjusted basis of D's interest at the time of proposed sale, as determined under alternative rule	17,500

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8437, 57 FR 43903, Sept. 23, 1992]

§ 1.706–1 Taxable years of partner and partnership.

(a) *Year in which partnership income is includible.* (1) In computing his taxable income for a taxable year, a partner is required to include his distributive share of partnership items set forth in section 702 for any partnership year ending within or with his taxable year. A partner shall also include in his taxable income for a taxable year ''guaranteed payments'' under section 707(c) which are made to him in a partnership taxable year ending within or with his taxable year. The provisions of this subparagraph may be illustrated by the following example:

Example. Partner A reports his income for a calendar year, while the partnership of which he is a member reports its income for a fiscal year ending May 31. During the partnership taxable year ending May 31, 1956, A received guaranteed payments of $1,200 for services and for the use of capital. Of this amount, $700 was received by A between June 1 and December 31, 1955, and the remaining $500 was received by him between January 1 and May 31, 1956. This entire $1,200 received by A is includible in his taxable income for the calendar year 1956 (together with his distributive share of partnership items set forth in section 702 for the partnership taxable year ending May 31, 1956).

(2) If a partner receives distributions under section 731 or sells or exchanges all or part of his partnership interest, any gain or loss arising therefrom does not constitute partnership income and is includible in the partner's gross income for his taxable year in which the payment is made. See sections 451 and 461.

(b) *Adoption or change in taxable year*—(1) *Partnership taxable year.* (i) The taxable year of a partnership shall be determined as though the partnership were a taxpayer.

(ii) A newly formed partnership may adopt a taxable year which is the same as the taxable year of all its principal partners (or the same as the taxable year to which all of its principal partners are concurrently changing) without securing prior approval from the Commissioner, or it may adopt a calendar year without securing prior approval from the Commissioner if all its principal partners are not on the same taxable year. In any other case, a newly formed partnership must secure prior approval from the Commissioner for the adoption of a taxable year.

(iii) An existing partnership may not change its taxable year without securing prior approval from the Commissioner, unless all its principal partners have the same taxable year to which the partnership changes, or unless all its principal partners concurrently change to such taxable year.

(2) *Partner's taxable year.* A partner may not change his taxable year without securing prior approval from the Commissioner. See section 442 and the regulations thereunder.

(3) *Principal partner.* For the purpose of this paragraph, a principal partner is a partner having an interest of 5 percent or more in partnership profits or capital.

(4) *Application for approval*—(i) *Change.* Application for a change in a taxable year shall be filed on Form 1128 with the Commissioner of Internal Revenue, Washington, DC 20224. If the short period involved in the change ends after December 31, 1973, such form shall be filed on or before the 15th day of the second calendar month following the close of such short period; if such short period ends before January 1, 1974, such form shall be filed on or before the last day of the first calendar month following the close of such short period.

(ii) *Adoption.* Where a newly formed partnership is required to secure prior approval from the Commissioner for the adoption of a taxable year, the partnership shall file an application on Form 1128 with the Commissioner on or before the last day of the month following the close of the taxable year to be adopted. The partnership shall modify Form 1128 to the extent necessary to indicate that it is an application for adoption of a taxable year.

(iii) *Business purpose.* Where prior approval is required under this paragraph, the applicant must establish a business purpose to the satisfaction of the Commissioner. For example, partnership AB, which is on a calendar year, is engaged in a business which has a natural business year (the annual accounting period encompassing all related income and expenses) ending on September 30th. The intention of the partnership to make its tax year coincide with such natural business year constitutes a sufficient business purpose.

(5) *Returns*—(i) *Partner.* A partner who changes his taxable year shall make his return for a short period in accordance with section 443, and shall attach to the return a copy of the letter from the Commissioner granting approval for the change of taxable year.

(ii) *Partnership. (a)* A partnership which changes its taxable year shall make its return for a short period in accordance with section 443, but shall not annualize the partnership taxable income. The partnership shall attach to the return either a copy of the letter from the Commissioner granting approval of the change of taxable year, or a statement indicating that the partnership is changing its taxable year to the same taxable year as that of all its principal partners or to the same taxable year as that to which all its principal partners are concurrently changing.

(b) Any newly formed partnership shall file with its first return either:

(1) A copy of the letter from the Commissioner approving the adoption of a partnership taxable year which is not the same as the taxable year of all its principal partners; or

(2) A statement indicating that the taxable year it has adopted is the same as the taxable year of all its principal partners, or that all its principal partners are concurrently changing to the taxable year it has adopted; or

(3) A statement that all its principal partners are not on the same taxable year and that it is adopting a calendar year without prior approval.

(6) *Effective date.* Section 706(b) applies to any partnership which adopts or changes to a taxable year beginning on or after April 2, 1954, and to any partner who changes to a taxable year beginning on or after that date. For the purpose of applying this provision, section 708 (relating to the continuation of a partnership) applies to any such taxable year. See section 771(b)(1) and paragraph (b)(1) of §1.771–1. If a partnership has changed to or adopted, or if a partner has changed to, a taxable year beginning on or after April 2, 1954, without obtaining prior approval of the Commissioner, and if, under the provisions of this paragraph, prior approval is required for the change or adoption, such annual accounting period will not be accepted as a taxable year until approval thereof is secured. Under these circumstances, an application to change to or adopt the desired taxable year will be considered timely if filed before August 23, 1956.

(7) *Cross-reference to §1.442–2T and §1.442–3T.* For special rules applicable to certain changes in annual accounting period where the short period involved in the change ends in 1986 or 1987, see §1.442–2T. For special rules applicable to certain adoptions and retentions of a taxable year ending in 1986 or 1987, see §1.442–3T.

(c) *Closing of partnership year*—(1) *General rule.* Section 706(c) and this paragraph provide rules governing the closing of partnership years. The closing of a partnership taxable year or a termination of a partnership for Federal income tax purposes is not necessarily governed by the ''dissolution'', ''liquidation'', etc., of a partnership under State or local law. The taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's entire interest in the partnership (as defined in section 761(d)), or the sale or exchange of a partner's interest in the partnership, except in the case of a termination of a partnership and except as provided in subparagraph (2) of this paragraph. In the case of termination, the partnership taxable year closes for all partners as of the date of termination. See section 708(b) and paragraph (b) of §1.708–1.

(2) *Partner who retires or sells interest in partnership*—(i) *Disposition of entire interest.* A partnership taxable year shall close with respect to a partner who sells or exchanges his entire interest in a partnership, and with respect to a partner whose entire interest is liquidated. However, a partnership taxable year with respect to a partner who dies shall not close prior to the end of such partnership taxable year, or the time when such partner's interest (held by his estate or other successor) is liquidated or sold or exchanged, whichever is earlier. See subparagraph (3) of this paragraph.

(ii) *Inclusions in taxable income.* In the case of a sale, exchange, or liquidation of a partner's entire interest in a partnership, the partner shall include in his taxable income for his taxable year within or with which his membership in the partnership ends, his distributive share of items described in section 702(a), and any guaranteed payments under section 707(c), for his partnership taxable year ending with the date of such sale, exchange, or liquidation. In order to avoid an interim closing of the partnership books, such partner's distributive share of items described in section 702(a) may, by agreement among the partners, be estimated by taking his pro rata part of the amount of such items he would have included in his taxable income had he remained a partner until the end of the partnership taxable year. The proration may be based on the portion of the taxable year that has elapsed prior to the sale, exchange, or liquidation, or may be determined under any other method that is reasonable. Any partner who is the transferee of such partner's interest shall include in his taxable income, as his distributive share of items described in section 702(a) with respect to the acquired interest, the pro rata part (determined by the method used by the transferor partner) of the amount of such items he would have included had he been a partner from the beginning of the taxable year of the partnership. The application of this subdivision may be illustrated by the following example:

Example. Assume that a partner selling his partnership interest on June 30, 1955, has an adjusted basis for his interest of $5,000 on that date; that his pro rata share of partnership income up to June 30 is $15,000; and that he sells his interest for $20,000. Under the provisions of section 706(c)(2), the partnership year with respect to him closes at the time of the sale. The $15,000 is includible in his income as his distributive share and, under section 705, it increases the basis of his partnership interest to $20,000, which is also the selling price of his interest. Therefore, no gain is realized on the sale of his partnership interest. The purchaser of this partnership interest shall include in his income as his distributive share his pro rata part of partnership income for the remainder of the partnership taxable year.

(3) *Partner who dies.* (i) When a partner dies, the partnership taxable year shall not close with respect to such partner prior to the end of the partnership taxable year. The partnership taxable year shall continue both for the remaining partners and the decedent partner. Where the death of a partner results in the termination of the partnership, the partnership taxable year shall close for all partners on the date of such termination under section 708(b)(1)(A). See also paragraph (b)(1)(i)(*b*) of §1.708–1 for the continuation of a 2-member partnership under certain circumstances after the death of a partner. However, if the decedent partner's estate or other successor sells or exchanges its entire interest in the partnership, or if its entire interest is liquidated, the partnership taxable year with respect to the estate or other successor in interest shall close on the date of such sale or exchange, or the date of completion of the liquidation.

(ii) The last return of a decedent partner shall include only his share of partnership taxable income for any partnership taxable year or years ending within or with the last taxable year for such decedent partner (i. e., the year ending with the date of his death). The distributive share of partnership taxable income for a partnership taxable year ending after the decedent's last taxable year is includible in the return of his estate or other successor in interest. If the estate or other successor in interest of a partner continues to share in the profits or losses of the partnership business, the distributives share thereof is includible in the taxable year of the estate or other successor in interest within or with which the taxable year of the partnership ends. See also paragraph (a)(1)(ii) of §1.736–1. Where the estate or other successor in interest receives distributions, any gain or loss on such distributions is includible in its gross income for its taxable year in which the distribution is made.

(iii) If a partner (or a retiring partner), in accordance with the terms of the partnership agreement, designates a person to succeed to his interest in the partnership after his death, such designated person shall be regarded as a successor in interest of the deceased for purposes of this chapter. Thus, where a partner designates his widow as the successor in interest, her distributive share of income for the taxable year of the partnership ending within or with her taxable year may be included in a joint return in accordance with the provisions of sections 2 and 6013(a) (2) and (3).

(iv) If, under the terms of an agreement existing at the date of death of a partner, a sale or exchange of the decedent partner's interest in the partnership occurs upon that date, then the taxable year of the partnership with respect to such decedent partner shall close upon the date of death. See section 706(c)(2)(A)(i). The sale or exchange of a partnership interest does not, for the purpose of this rule, include any transfer of a partnership interest which occurs at death as a result of inheritance or any testamentary disposition.

(v) To the extent that any part of a distributive share of partnership income of the estate or other successor in interest of a deceased partner is attributable to the decedent for the period ending with the date of his death, such part of the distributive share is income in respect of the decedent under section 691. See section 691 and the regulations thereunder.

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

Example 1. B has a taxable year ending December 31 and is a member of partnership ABC, the taxable year of which ends on June 30. B dies on October 31, 1955. His estate (which as a new taxpayer may, under section 441 and the regulations thereunder, adopt any taxable year) adopts a taxable year ending October 31. The return of the decedent for the period January 1 to October 31, 1955, will include only his distributive share of taxable income of the partnership for its taxable year ending June 30, 1955. The distributive share of taxable income of the partnership for its taxable year ending June 30, 1956, arising from the interest of the decedent, will be includible in the return of the estate for its taxable year ending October 31, 1956. That part of the distributive share attributable to the decedent for the period ending with the date of his death (July 1 through October 31, 1955) is income in respect of a decedent under section 691.

Example 2. Assume the same facts as in example 1 of this subdivision, except that, prior to B's death, B and D had agreed that, upon B's death, D would purchase B's interest for $10,000. When B dies on October 31, 1955, the partnership taxable year beginning July 1, 1955, closes with respect to him. Therefore, the return for B's last taxable year (January 1 to October 31, 1955) will include his distributive share of taxable income of the partnership for its taxable year ending June 30, 1955, plus his distributive share of partnership taxable income for the period July 1 to October 31, 1955. See subdivision (iv) of this subparagraph.

Example 3. H is a member of a partnership having a taxable year ending December 31. Both H and his wife W are on a calendar year and file joint returns. H dies on March 31, 1955. Administration of the estate is completed and the estate, including the partnership interest, is distributed to W as legatee on November 30, 1955. Such distribution by the estate is not a sale or exchange of H's partnership interest. No part of the taxable income of the partnership for the taxable year ending December 31, 1955, which is allocable to H, will be included in H's taxable income for his last taxable year (January 1 through March 31, 1955) or in the taxable income of H's estate for the taxable year April 1 through November 30, 1955. The distributive share of partnership taxable income for the full calendar year that is allocable to H will be includible in the taxable income of W for her taxable year ending December 31, 1955, and she may file a joint return under sections 2 and 6013(a)(3). That part of the distributive share attributable to the decedent for the period ending with the date of his death (January 1 through March 31, 1955) is income in respect of a decedent under section 691.

Example 4. M is a member of partnership JKM which operates on a calendar year. M and his wife S file joint returns for calendar years. In accordance with the partnership agreement, M designated S to succeed to his interest in the partnership upon his death. M, who had withdrawn $10,000 from the partnership before his death, dies on October 20, 1955. S's distributive share of income for the taxable year 1955 is $15,000 ($10,000 of which represents the amount withdrawn by M). S shall include $15,000 in her income, even though M received $10,000 of this amount before his death. S may file a joint return with M for the year 1955 under sections 2 and 6013(a). That part of the $15,000 distributive share attributable to the decedent for the period ending with the date of his death (January 1 through October 20, 1955) is income in respect of a decedent under section 691.

(4) *Disposition of less than entire interest.* If a partner sells or exchanges a part of his interest in a partnership, or if the interest of a partner is reduced, the partnership taxable year shall continue to its normal end. In such case, the partner's distributive share of items which he is required to include in his taxable income under the provisions of section 702(a) shall be determined by taking into account his varying interests in the partnership during the partnership taxable year in which such sale, exchange, or reduction of interest occurred.

(5) *Transfer of interest by gift.* The transfer of a partnership interest by gift does not close the partnership taxable year with respect to the donor. However, the income up to the date of gift attributable to the donor's interest shall be allocated to him under section 704(e)(2).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7286, 38 FR 26912, Sept. 27, 1973; T.D. 8123, 52 FR 3623, Feb. 5, 1987]

§ 1.706–1T Taxable years of certain partnerships (temporary).

(a) *Taxable year determined by reference to the partners*—(1) *In general.* If for any taxable year a partnership's taxable year cannot be determined by reference to the taxable year of its partners owning a majority interest in partnership profits and capital (as described in section 706(b)(1)(B)(i)) or by reference to the taxable year of all its principal partners (as described in section 706(b)(1)(B)(ii)), then the partnership must determine its taxable year under section 706(b)(1)(B)(iii). Under section 706(b)(1)(B)(iii), the taxable year of the partnership, except as provided in paragraph (b) of this section, shall be the taxable year that results in the least aggregate deferral of income to the partners (as determined under paragraph (a)(2) of this section). See § 1.706–3T(a) for special rules which provide that certain tax-exempt partners are disregarded.

(2) *Taxable year that results in the least aggregate deferral of income.* The taxable year that results in the least aggregate deferral of income will be the taxable year of one or more of the partners in the partnership which will result in the least aggregate deferral of income to the partners. The aggregate deferral for a particular year is equal to the sum of the products determined by multiplying the month(s) of deferral for each partner that would be generated by that year and each partner's interest in partnership profits for that year. The partner's taxable year that produces the lowest sum when compared to the other partner's taxable years is the taxable year that results in the least aggregate deferral of income to the partners. If the calculation results in more than one taxable year qualifying as the taxable year with the least aggregate deferral, the partnership may select any one of those taxable years as its taxable year. However, if one of the qualifying taxable years is also the partnership's existing taxable year, the partnership must maintain its existing taxable year. The determination of the taxable year that results in the least aggregate deferral of income shall generally be made as of the beginning of the partnership's current taxable year. The district director, however, may determine that the first day of the current taxable year is not the appropriate testing day and require the use of some other day or period that will more accurately reflect the ownership of the partnership and thereby the actual aggregate deferral to the partners where the partners engage in a transaction that has as its principal purpose the avoidance of the principles of this section. Thus, for example the preceding sentence would apply where there is a transfer of an interest in the partnership that results in a temporary transfer of that interest

principally for purposes of qualifying for a specific taxable year under the principles of this section. For purposes of this section, deferral to each partner is measured in terms of months from the end of the partnership's taxable year forward to the end of the partner's taxable year.

(3) *Determination of the taxable year of a partner or partnership that uses a 52–53 week taxable year.* For purposes of the calculation described in paragraph (a)(2) of this section, the taxable year of a partner or partnership that uses a 52–53 week taxable year shall be the same year determined under the rules of section 441(f) and the regulations thereunder with respect to the inclusion of income by the partner or partnership.

(4) *Special de minimis rule.* If the taxable year that results in the least aggregate deferral produces an aggregate deferral that is less than .5 when compared to the aggregate deferral of the current taxable year, the partnership's current taxable year shall be treated as the taxable year with the least aggregate deferral. Thus, the partnership will not be permitted to change its taxable year. However, this de minimis rule will not apply to the first taxable period beginning after December 31, 1986.

(b) *Business purpose.* A partnership may have a taxable year other than the year described in paragraph (a) of this section if it establishes, to the satisfaction of the Commissioner of Internal Revenue, a business purpose for such taxable year in accordance with and under the procedures established in §1.442–1(b)(1). For purposes of this paragraph (b), any deferral of income to partners shall not be treated as a business purpose.

(c) *Procedural requirements and effective date*—(1) *In general.* The change in accounting period required by paragraph (a) of this section shall be treated as initiated by the partnership and made with the consent of the Commissioner. To effect the change, a partnership must show that the requirements of this section are satisfied in a statement setting forth the computations required to establish the taxable year that results in the least aggregate deferral of income to the partners under paragraph (a) of this section. The partnership must attach the statement to the income tax return for the short period involved in the changes and must indicate the following at the top of page 1 of the return: ''FILED UNDER §1.706–1T.''

(2) *Effective date*—(i) *In general.* Except as provided in paragraph (c)(2)(ii) of this section, the rules of this section are effective for partnership taxable years beginning after December 31, 1986.

(ii) *Special rule for first taxable year beginning after December 31, 1986.* A partnership otherwise required to change its accounting period for its first taxable year beginning after December 31, 1986 to a year resulting in the least aggregate deferral of income to its partners under paragraph (a) of this section, may, at its option, delay the application of the rules of that paragraph until its first taxable year beginning after December 31, 1987. In such a case, the partnership must conform its first taxable year beginning after December 31, 1986 to the calendar year and must apply the rules of paragraph (a) of this section to its first taxable year beginning after December 31, 1987. See §1.702–3T(a)(1) regarding the availability of a 4-year spread provision with respect to a partnership required to change its taxable year for its first taxable year beginning after December 31, 1986.

(iii) *Special eligibility for 4-year spread; years beginning after December 31, 1987.* Notwithstanding the provisions of §1.702–3T(a)(1) limiting the availability of the 4-year spread provisions to a partnership's first taxable year beginning after December 31, 1986, if—

(A) A partnership is required under section 706(b)(1)(B)(iii) and paragraph (a) of this section to change to a taxable year that results in the least aggregate deferral of income to the partners for a partnership's first taxable year beginning after December 31, 1987,

(B) The partnership did exercise its option, as provided in paragraph (c)(2)(ii) of this section, to delay the application of the rules of paragraph (a) of this section until the partnership's first taxable year beginning after December 31, 1987, and

(C) The partnership would have been required to change its accounting period under section 706(b)(1)(B)(iii) and paragraph (a) of this section for its first taxable year beginning after December 31, 1986, if paragraph (a) of this section had been applicable to such taxable year, the partners in the partnership will be eligible to utilize the 4-year spread provision provided in § 1.702–3T (subject to the other requirements of that section) with respect to the partnership's change in accounting period required under section 706(b)(1)(B)(iii) and paragraph (a) of this section for the partnership's first taxable year beginning after December 31, 1987.

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

Example 1. Partnership P is on a fiscal year ending June 30. Partner A reports income on the fiscal year ending June 30 and Partner B reports income on the fiscal year ending July 31. A and B each have a 50 percent interest in partnership profits. For its taxable year beginning July 1, 1987, the partnership will be required to retain its taxable year since the fiscal year ending June 30 results in the least aggregate deferral of income to the partners. This determination is made as follows:

Test 6/30	Year End	Interest in Partnership Profits	Months of Deferral for 6/30 Year End	Interest x Deferral
Partner A	6/30	.5	0	0
Partner B	7/31	.5	1	.5
Aggregate deferral				.5

Test 7/31	Year End	Interest in Partnership Profits	Months of Deferral for 7/31 Year End	Interest x Deferral
Partner A	6/30	.5	11	5.5
Partner B	7/31	.5	0	0
Aggregate deferral				5.5

Example 2. The facts are the same as in *Example 1* except that A reports income on the calendar year and B reports on the fiscal year ending November 30. For the partnership's taxable year beginning July 1, 1987, the partnership is required to change its taxable year to a fiscal year ending November 30 because such year results in the least aggregate deferral of income to the partners. This determination is made as follows:

Test 12/31	Year End	Interest in Partnership Profits	Months of Deferral for 12/31 Year End	Interest x Deferral
Partner A	12/31	.5	0	0
Partner B	11/30	.5	11	5.5
Aggregate deferral				5.5

Test 11/30	Year End	Interest in Partnership Profits	Months of Deferral for 11/30 Year End	Interest x Deferral
Partner A	12/31	.5	1	.5
Partner B	11/30	.5	0	0
Aggregate deferral				.5

Example 3. The facts are the same as in *Example 2* except that B reports income on the fiscal year ending June 30. For the partnership's taxable year beginning July 1, 1987, each partner's taxable year will result in identical aggregate deferral of income. If the partnership's current taxable year was neither a fiscal year ending June 30 nor the calendar year, the partnership would select either the fiscal year ending June 30 or the calendar year as its taxable year. However, since the partnership's current taxable year ends June 30, it must retain its current taxable year.

Test 12/31	Year End	Interest in Partnership Profits	Months of Deferral for 12/31 Year End	Interest x Deferral
Partner A	12/31	.5	0	0
Partner B	6/30	.5	6	3.0
Aggregate deferral				3.0

Test 6/30	Year End	Interest in Partnership Profits	Months of Deferral for 6/30 Year End	Interest x Deferral
Partner A	12/31	.5	6	3.0
Partner B	6/30	.5	0	0
Aggregate deferral				3.0

Example 4. The facts are the same as in *Example 1* except that on December 31, 1987, partner A sells a 4 percent interest in the partnership to Partner C, who reports income on the fiscal year ending June 30, and a 40 percent interest in the partnership to Partner D, who also reports income on the fiscal year ending June 30. The taxable year beginning July 1, 1987, is unaffected by the sale. However, for the taxable year beginning July 31, 1988, the partnership must determine the taxable year resulting in the least aggregate deferral as of July 1, 1988. In this case, the partnership will be required to retain its taxable year since the fiscal year ending June 30 continues to be the taxable year that

results in the least aggregate deferral of income to the partners.

Example 5. The facts are the same as in *Example 4* except that Partner D reports income on the fiscal year ending April 30. As in Example 4, the taxable year during which the sale took place is unaffected by the shifts in interests. However, for its taxable year beginning July 1, 1988, the partnership will be required to change its taxable year to the fiscal year ending April 30. This determination is made as follows:

Test 7/31	Year End	Interest in Partnership Profits	Months of Deferral for 7/31 Year End	Interest x Deferral.
Partner A	6/30	.06	11	.66
Partner B	7/31	.5	0	0
Partner C	6/30	.04	11	.44
Partner D	4/30	.4	9	3.60
Aggregate deferral				4.70

Test 6/30	Year End	Interest in Partnership Profits	Months of Deferral for 6/30 Year End	Interest x Deferral.
Partner A	6/30	.06	0	0
Partner B	7/31	.5	1	.5
Partner C	6/30	.04	0	0
Partner D	4/30	.4	10	4.0
Aggregate deferral				4.5

Test 4/30	Year End	Interest in Partnership Profits	Months of Deferral for 4/30 Year End	Interest x Deferral.
Partner A	6/30	.06	2	.12
Partner B	7/31	.5	3	1.50
Partner C	6/30	.04	2	.08
Partner D	4/30	.4	0	0
Aggregate deferral				1.70

§ 1.706-1T(a)(4) Test:	
Current taxable year (June 30)	4.5
Less: Taxable year producing the least aggregate deferral (April 30)	1.7
Additional aggregate deferral (greater than .5)	2.8

Example 6. Partnership P has two partners, A who reports income on the fiscal year ending March 31, and B who reports income on the fiscal year ending July 31. A and B share profits equally. P has determined its taxable year under § 1.706–1T(a)(2) to be the fiscal year ending March 31 as follows:

Test 3/31	Year End	Interest in Partnership Profits	Deferral for 3/31 Year End	Interest x Deferral.
Partner A	3/31	.5	0	0
Partner B	7/31	.5	4	2
Aggregate deferral				2

Test 7/31	Year End	Interest in Partnership Profits	Deferral for 7/31 Year End	Interest x Deferral.
Partner A	3/31	.5	8	4
Partner B	7/31	.5	0	0
Aggregate deferral				4

In May 1988, Partner A sells a 45 percent interest in the partnership to C, who reports income on the fiscal year ending April 30. For the taxable period beginning April 1, 1989, the fiscal year ending April 30 is the taxable year that produces the least aggregate deferral of income to the partners. However, under paragraph (a)(4) of this section the partnership is required to retain its fiscal year ending March 31. This determination is made as follows:

Test 3/31	Year End	Interest in Partnership Profits	Deferral for 3/31 Year End	Interest x Deferral.
Partner A	3/31	.05	0	0
Partner B	7/31	.5	4	2.0
Partner C	4/30	.45	1	.45
Aggregate deferral				2.45

Test 7/31	Year End	Interest in Partnership Profits	Deferral for 7/31 year end	Interest Deferral
Partner A	3/31	.05	8	.40
Partner B	7/31	.5	0	0
Partner C	4/30	.45	9	4.05
Aggregate deferral				4.45

Test 4/30	Year End	Interest in Partnership Profits	Deferral for 4/30 year end	Interest Deferral
Partner A	3/31	.05	11	.55
Partner B	7/31	.5	3	1.50
Partner C	4/30	.45	0	0
Aggregate deferral				2.05

§ 1.706-1T(a)(4) Test:	
Current taxable year (3/31)	2.45
Less: Taxable year producing the least aggregate deferral (4/30).	2.05
Additional aggregate deferral (less than .5)	.40

[T.D. 8169, 52 FR 48995, Dec. 29, 1987; 53 FR 1441, Jan. 19, 1988, as amended by T.D. 8205, 53 FR 19711, May 27, 1988]

§ 1.706–2T Temporary regulations; question and answer under the Tax Reform Act of 1984.

Question 1: For purposes of section 706(d), how is an otherwise deductible amount that is deferred under section 267(a)(2) treated?

Answer 1: In the year the deduction is allowed, the deduction will constitute an allocable cash basis item under section 706(d)(2)(B)(iv).

(Secs. 267(f)(2)(B), 706(d)(2)(B)(iv), 1502, and 7805, Internal Revenue Code of 1954 (98 Stat. 704, 26 U.S.C. 267; 98 Stat. 589, 26 U.S.C. 706; 68A Stat. 367, 26 U.S.C. 1502; 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7991, 49 FR 47001, Nov. 30, 1984]

§ 1.706–3T Temporary regulations under the Tax Reform Act of 1986 and the Revenue Act of 1987 (temporary).

(a) *Certain tax-exempt partners disregarded*—(1) *General rule.* In determining the taxable year (the ‘‘current year’’) of a partnership under section 706(b) and the regulations thereunder, a partner that is tax-exempt under section 501(a) shall be disregarded if such partner was not subject to tax, under chapter 1 of the Code, on any income attributable to its investment in the partnership during the partnership's taxable year immediately preceding the current year. However, if a partner that is tax-exempt under section 501(a) was not a partner during the partnership's immediately preceding taxable year, such partner will be disregarded for the current year if the partnership reasonably believes that the partner will not be subject to tax, under chapter 1 of the Code, on any income attributable to such partner's investment in the partnership during the current year.

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

Example. Assume that partnership A has historically used the calendar year as its taxable year. In addition, assume that A is owned by 5 partners, 4 calendar year individuals (each owning 10 percent of A's profits and capital) and a tax-exempt organization (owning 60 percent of A's profits and capital). The tax-exempt organization has never had unrelated business taxable income with respect to A and has historically used a June 30 fiscal year. Finally, assume that A desires to retain the calendar year for its taxable year beginning January 1, 1987. Under these facts and but for the special rule in paragraph (a)(1) of this section, A would be required under section 706(b)(1)(B)(i) to change to a year ending June 30, for its taxable year beginning January 1, 1987. However, under the special rule provided in paragraph (a)(1) of this section, and assuming the optional effective date provided in paragraph (c) of this section is chosen, the partner that is tax-exempt is disregarded, and A must retain the calendar year, under section 706(b)(1)(B)(i), for its taxable year beginning January 1, 1987.

(b) *Effect of partner elections under section 444.* For purposes of section 706(b)(1)(B), any section 444 election by a partner in a partnership shall be taken into account in determining the taxable year of the partnership. See example 4 of § 1.7519–1T(d).

(c) *Effective date.* The provisions of this section are generally effective for taxable years beginning after December 31, 1987. However, a partnership may, at its option, apply the provisions of this section for taxable years beginning after December 31, 1986.

[T.D. 8205, 53 FR 19710, May 27, 1988]

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[T.D. 8439, 57 FR 44978, Sept. 30, 1992]

§1.707–1 Transactions between partner and partnership.

(a) *Partner not acting in capacity as partner.* A partner who engages in a transaction with a partnership other than in his capacity as a partner shall be treated as if he were not a member of the partnership with respect to such transaction. Such transactions include, for example, loans of money or property by the partnership to the partner or by the partner to the partnership, the sale of property by the partner to the partnership, the purchase of property by the partner from the partnership, and the rendering of services by the partnership to the partner or by the partner to the partnership. Where a partner retains the ownership of property but allows the partnership to use such separately owned property for partnership purposes (for example, to obtain credit or to secure firm creditors by guaranty, pledge, or other agreement) the transaction is treated as one between a partnership and a partner not acting in his capacity as a partner. However, transfers of money or property by a partner to a partnership as contributions, or transfers of money or property by a partnership to a partner as distributions, are not transactions included within the provisions of this section. In all cases, the substance of the transaction will govern rather than its form. See paragraph(c)(3) of § 1.731–1.

(b) *Certain sales or exchanges of property with respect to controlled partnerships*—(1) *Losses disallowed.* (i) No deduction shall be allowed for a loss on a sale or exchange of property (other than an interest in the partnership, directly or indirectly, between a partnership and a partner who owns, directly or indirectly, more than 50 percent of the capital interest or profits interest in such partnership. A loss on a sale or exchange of property, directly or indirectly, between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interest or profits interest in each partnership shall not be allowed.

(ii) If a gain is realized upon the subsequent sale or exchange by a transferee of property with respect to which a loss was disallowed under the provisions of subdivision (i) of this subparagraph, section 267(d) (relating to amount of gain where loss previously disallowed) shall apply as though the loss were disallowed under section 267(a)(1).

(2) *Gains treated as ordinary income.* Any gain recognized upon the sale or exchange, directly or indirectly, of property which, in the hands of the transferee immediately after the transfer, is property other than a capital asset, as defined in section 1221, shall be ordinary income if the transaction is between a partnership and a partner who owns, directly or indirectly, more than 80 percent of the capital interest or profits interest in the partnership. This rule also applies where such a transaction is between partnerships in which the same persons own, directly or indirectly, more than 80 percent of the capital interest or profits interest in each partnership. The term *property other than a capital asset* includes (but is not limited to) trade accounts receivable, inventory, stock in trade, and depreciable or real property used in the trade or business.

(3) *Ownership of a capital or profits interest.* In determining the extent of the ownership by a partner, as defined in section 761(b), of his capital interest or profits interest in a partnership, the rules for constructive ownership of stock provided in section 267(c) (1), (2), (4), and (5) shall be applied for the purpose of section 707(b) and this paragraph. Under these rules, ownership of a capital or profits interest in a partnership may be attributed to a person who is not a partner as defined in section 761(b) in order that another partner may be considered the constructive owner of such interest under section 267(c). However, section 707(b)(1)(A) does not apply to a constructive owner of a partnership interest since he is not a partner as defined in section 761(b). For example, where trust T is a partner in the partnership ABT, and AW, A's wife, is the sole beneficiary of the trust, the ownership of a capital and profits interest in the partnership by T will be attributed to AW only for the purpose of further attributing the ownership of such interest to A. See section 267(c) (1) and (5). If A, B, and T are equal partners, then A will be considered as owning more than 50 percent of the capital and profits interest in the partnership, and losses on transactions between him and the partnership will be disallowed by section 707(b)(1)(A). However, a loss sustained by AW on a sale or exchange of property with the partnership would not be disallowed by section 707, but will be disallowed to the extent provided in paragraph (b) of § 1.267(b)–1. See section 267 (a) and (b), and the regulations thereunder.

(c) *Guaranteed payments.* Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership. However, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. See section 706(a) and paragraph (a) of §1.706–1. Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses). For a guaranteed payment to be a partnership deduction, it must meet the same tests under section 162(a) as it would if the payment had been made to a person who is not a member of the partnership, and the rules of section 263 (relating to capital expenditures) must be taken into account. This rule does not affect the deductibility to the partnership of a payment described in section 736(a)(2) to a retiring partner or to a deceased partner's successor in interest. Guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of $10,000 for services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed payment, the partnership has $50,000 ordinary income. A must include $15,000 as ordinary income for his taxable year within or with which the partnership taxable year ends ($10,000 guaranteed payment plus $5,000 distributive share).

Example 2. Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.

Example 3. Partner X in the XY partnership is to receive a payment of $10,000 for services, plus 30 percent of the taxable income or loss of the partnership. After deducting the payment of $10,000 to partner X, the XY partnership has a loss of $9,000. Of this amount, $2,700 (30 percent of the loss) is X's distributive share of partnership loss and, subject to section 704(d), is to be taken into account by him in his return. In addition, he must report as ordinary income the guaranteed payment of $10,000 made to him by the partnership.

Example 4. Assume the same facts as in example 3 of this paragraph, except that, instead of a $9,000 loss, the partnership has $30,000 in capital gains and no other items of income or deduction except the $10,000 paid X as a guaranteed payment. Since the items of partnership income or loss must be segregated under section 702(a), the partnership has a $10,000 ordinary loss and $30,000 in capital gains. X's 30 percent distributive shares of these amounts are $3,000 ordinary loss and $9,000 capital gain. In addition, X has received a $10,000 guaranteed payment which is ordinary income to him.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7891, 48 FR 20049, May 4, 1983]

§1.707–2 Disguised payments for services. [Reserved]

§1.707–3 Disguised sales of property to partnership; general rules.

(a) *Treatment of transfers as a sale*—(1) *In general.* Except as otherwise provided in this section, if a transfer of property by a partner to a partnership and one or more transfers of money or other consideration by the partnership to that partner are described in paragraph (b)(1) of this section, the transfers are treated as a sale of property, in whole or in part, to the partnership.

(2) *Definition and timing of sale.* For purposes of §§1.707–3 through 1.707–5, the use of the term sale (or any variation of that word) to refer to a transfer of property by a partner to a partnership and a transfer of consideration by a partnership to a partner means a sale or exchange of that property, in whole or in part, to the partnership by the partner acting in a capacity other than as a member of the partnership, rather than a contribution and distribution to which sections 721 and 731,

respectively, apply. A transfer that is treated as a sale under paragraph (a)(1) this section is treated as a sale for all purposes of the Internal Revenue Code (*e.g.*, sections 453, 483, 1001, 1012, 1031 and 1274). The sale is considered to take place on the date that, under general principles of Federal tax law, the partnership is considered the owner of the property. If the transfer of money or other consideration from the partnership to the partner occurs after the transfer of property to the partnership; the partner and the partnership are treated as if, on the date of the sale, the partnership transferred to the partner an obligation to transfer to the partner money or other consideration.

(3) *Application of disguised sale rules.* If a person purports to transfer property to a partnership in a capacity as a partner, the rules of this section apply for purposes of determining whether the property was transferred in a disguised sale, even if it is determined after the application of the rules of this section that such person is not a partner. If after the application of the rules of this section to a purported transfer of property to a partnership, it is determined that no partnership exists because the property was actually sold, or it is otherwise determined that the contributed property is not owned by the partnership for tax purposes, the transferor of the property is treated as having sold the property to the person (or persons) that acquired ownership of the property for tax purposes.

(4) *Deemed terminations under section 708.* In applying the rules of this section, transfers resulting from a termination of a partnership under section 708(b)(1)(B) are disregarded.

(b) *Transfers treated as a sale*—(1) *In general.* A transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances—

(i) The transfer of money or other consideration would not have been made but for the transfer of property; and

(ii) In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

(2) *Facts and circumstances.* The determination of whether a transfer of property by a partner to the partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale, in whole or in part, under paragraph (b)(1) of this section is made based on all the facts and circumstances in each case. The weight to be given each of the facts and circumstances will depend on the particular case. Generally, the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists under paragraph (b)(1) of this section. Among the facts and circumstances that may tend to prove the existence of a sale under paragraph (b)(1) of this section are the following:

(i) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(ii) That the transferor has a legally enforceable right to the subsequent transfer;

(iii) That the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;

(iv) That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;

(v) That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;

(vi) That a partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

(vii) That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);

(viii) That partnership distributions, allocation or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

(ix) That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

(x) That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

(c) *Transfers made within two years presumed to be a sale*—(1) *In general.* For purposes of this section, if within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale.

(2) *Disclosure of transfers made within two years.* Disclosure to the Internal Revenue Service in accordance with §1.707–8 is required if—

(i) A partner transfers property to a partnership and the partnership transfers money or other consideration to the partner with a two-year period (without regard to the order of the transfers);

(ii) The partner treats the transfers other than as a sale for tax purposes; and

(iii) The transfer of money or other consideration to the partner is not presumed to be a guaranteed payment for capital under §1.707–4(a)(1)(ii), is not a reasonable preferred return within the meaning of §1.707–4(a)(3), and is not an operating cash flow distribution within the meaning of §1.707–4(b)(2).

(d) *Transfers made more than two years apart presumed not to be a sale.* For purposes of this section, if a transfer of money or other consideration to a partner by a partnership and the transfer of property to the partnership by that partner are more than two years apart, the transfers are presumed not to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers constitute a sale.

(e) *Scope.* This section and §§1.707–4 through 1.707–9 apply to contributions and distributions of property described in section 707(a)(2)(A) and transfers described in section 707(a)(2)(B) of the Internal Revenue Code.

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

Example 1. Treatment of simultaneous transfers as a sale. A transfers property X to partnership AB on April 9, 1992, in exchange for an interest in the partnership. At the time of the transfer, property X has a fair market value of $4,000,000 and an adjusted tax basis of $1,200,000. Immediately after the transfer, the partnership transfers $3,000,000 in cash to A. Assume that, under this section, the partnership's transfer of cash to A is treated as part of a sale of property X to the partnership. Because the amount of cash A receives on April 9, 1992, does not equal the fair market value of the property, A is considered to have sold a portion of property X with a value of $3,000,000 to the partnership in exchange for the cash. Accordingly, A must recognize $2,100,000 of gain ($3,000,000 amount realized less $900,000 adjusted tax basis ($1,200,000 multiplied by $3,000,000/$4,000,000)). Assuming A receives no other transfers that are treated as consideration for the sale of the property under this section, A is considered to have contributed to the partnership, in A's capacity as a partner, $1,000,000 of the fair market value of the property with an adjusted tax basis of $300,000.

Example 2. Treatment of transfers at different times as a sale. (i) The facts are the same as in *Example 1,* except that the $3,000,000 is transferred to A one year after A's transfer of property X to the partnership. Assume that under this section the partnership's transfer of cash to A is treated as part of a sale of property X to the partnership. Assume also that the applicable Federal short-term rate for April, 1992, is 10 percent, compounded semiannually.

(ii) Under paragraph (a)(2) of this section, A and the partnership are treated as if, on April 9, 1992, A sold a portion of property X to the partnership in exchange for an obligation to transfer $3,000,000 to A one year later. Section 1274 applies to this obligation because it does not bear interest and is payable more than six months after the date of the sale. As a result, A's amount realized from the receipt of the partnership's obligation will be the imputed principal amount of the partnership's obligation to transfer $3,000,000 to A, which equals $2,721,088 (the present value on April 9, 1992, of a $3,000,000 payment due one year later, determined using a discount rate of 10 percent, compounded semiannually). Therefore, A's amount realized from the receipt of the partnership's obligation is $2,721,088 (without regard to whether the sale is reported under the installment method). A is therefore considered to have sold only $2,721,088 of the fair market value of property X. The remainder of the $3,000,000 payment ($278,912) is characterized in accordance with the provisions of section 1272. Accordingly, A must recognize $1,904,761 of gain ($2,721,088 amount realized less $816,327 adjusted tax basis ($1,200,000 multiplied by $2,721,088/$4,000,000)) on the sale of property X to the partnership. The gain is reportable under the installment method of section 453 if the sale is otherwise eligible. Assuming A receives no other transfers that are treated as consideration for the sale of property under this section, A is considered to have contributed to the partnership, in A's capacity as a partner, $1,278,912 of the fair market value of property X with an adjusted tax basis of $383,673.

Example 3. Operation of presumption for transfers within two years. (i) C transfers undeveloped land to the CD partnership in exchange for an interest in the partnership. The partnership intends to construct a building on the land. At the time the land is transferred to the partnership, it is unencumbered and has an adjusted tax basis of $500,000 and a fair market value of $1,000,000. The partnership agreement provides that upon completing construction of the building the partnership will distribute $900,000 to C.

(ii) If, within two years of C's transfer of land to the partnership, a transfer is made to C pursuant to the provision requiring a distribution upon completion of the building, the transfer is presumed to be, under paragraph (c) of this section, part of a sale of the land to the partnership. C may rebut the presumption that the transfer is part of a sale if the facts and circumstances clearly establish that—

(A) The transfer to C would have been made without regard to C's transfer of land to the partnership; or

(B) The partnership's obligation or ability to make this transfer to C depends, at the time of the transfer to the partnership, on the entrepreneurial risks of partnership operations.

(iii) For example, if the partnership will be able to fund the transfer of cash to C only to the extent that permanent loan proceeds exceed the cost of constructing the building, the fact that excess permanent loan proceeds will be available only if the cost to complete the building is significantly less than the amount projected by a reasonable budget would be evidence that the transfer to C is not part of a sale. Similarly, a condition that limits the amount of the permanent loan to the cost of constructing the building (and thereby limits the partnership's ability to make a transfer to C) unless all or a substantial portion of the building is leased would be evidence that the transfer to C is not part of a sale, if a significant risk exists that the partnership may not be able to lease the building to that extent. Another factor that may prove that the transfer of cash to C is not part of a sale would be that, at the time the land is transferred to the partnership, no lender has committed to make a permanent loan to fund the transfer of cash to C.

(iv) Facts indicating that the transfer of cash to C is not part of a sale, however, may be offset by other factors. An offsetting factor to restrictions on the permanent loan proceeds may be that the permanent loan is to be a recourse loan and certain conditions to the loan are likely to be waived by the lender because of the creditworthiness of the partners or the value of the partnership's other assets. Similarly, the factor that no lender has committed to fund the transfer of cash to C may be offset by facts establishing that the partnership is obligated to attempt to obtain such a loan and that its ability to obtain such a loan is not significantly dependent on the value that will be added by successful completion of the building, or that the partnership reasonably anticipates that it will have (and will utilize) an alternative source to fund the transfer of cash to C if the permanent loan proceeds are inadequate.

Example 4. Operation of presumption for transfers within two years. E is a partner in the equal EF partnership. The partnership owns two parcels of unimproved real property (*parcels 1 and 2*). Parcels 1 and 2 are unencumbered. Parcel 1 has a fair market value of $500,000, and parcel 2 has a fair market value of $1,500,000. E transfers additional unencumbered, unimproved real property (*parcel 3*) with a fair market value of

$1,000,000 to the partnership in exchange for an increased interest in partnership profits of 66⅔ percent. Immediately after this transfer, the partnership sells parcel 1 for $500,000 in a transaction not in the ordinary course of business. The partnership transfers the proceeds of the sale $333,333 to E and $166,667 to F in accordance with their respective partnership interests. The transfer of $333,333 to E is presumed to be, in accordance with paragraph (c) of this section, a sale, in part, of parcel 3 to the partnership. However, the facts of this example clearly establish that $250,000 of the transfer to E is not part of a sale of parcel 3 to the partnership because E would have been distributed $250,000 from the sale of parcel 1 whether or not E had transferred parcel 3 to the partnership. The transfer to E exceeds by $83,333 ($333,333 minus $250,000) the amount of the distribution that would have been made to E if E had not transferred parcel 3 to the partnership. Therefore, $83,333 of the transfer is presumed to be part of a sale of a portion of parcel 3 to the partnership by E.

Example 5. Operation of presumption for transfers more than two years apart. (i) G transfers undeveloped land to the GH partnership in exchange for an interest in the partnership. At the time the land is transferred to the partnership, it is unencumbered and has an adjusted tax basis of $500,000 and a fair market value of $1,000,000. H contributes $1,000,000 in cash in exchange for an interest in the partnership. Under the partnership agreement, the partnership is obligated to construct a building on the land. The projected construction cost is $5,000,000, which the partnership plans to fund with its $1,000,000 in cash and the proceeds of a construction loan secured by the land and improvements.

(ii) Shortly before G’s transfer of the land to the partnership, the partnership secures commitments from lending institutions for construction and permanent financing. To obtain the construction loan, H guarantees completion of the building for a cost of $5,000,000. The partnership is not obligated to reimburse or indemnify H if H must make payment on the completion guarantee. The permanent loan will be funded upon completion of the building, which is expected to occur two years after G’s transfer of the land. The amount of the permanent loan is to equal the lesser of $5,000,000 or 80 percent of the appraised value of the improved property at the time the permanent loan is closed. Under the partnership agreement, the partnership is obligated to apply the proceeds of the permanent loan to retire the construction loan and to hold any excess proceeds for transfer to G 25 months after G’s transfer of the land to the partnership. The appraised value of the improved property at the time the permanent loan is closed is expected to exceed $5,000,000 only if the partnership is able to lease a substantial portion of the improvements by that time, and there is a significant risk that the partnership will not be able to achieve a satisfactory occupancy level. The partnership completes construction of the building for the projected cost of $5,000,000 approximately two years after G’s transfer of the land. Shortly thereafter, the permanent loan is funded in the amount of $5,000,000. At the time of funding the land and building have an appraised value of $7,000,000. The partnership transfers the $1,000,000 excess permanent loan proceeds to G 25 months after G’s transfer of the land to the partnership.

(iii) G’s transfer of the land to the partnership and the partnership’s transfer of $1,000,000 to G occurred more than two years apart. In accordance with paragraph (d) of this section, those transfers are presumed not to be a sale unless the facts and circumstances clearly establish that the transfers constitute a sale of the property, in whole or part, to the partnership. The transfer of $1,000,000 to G would not have been made but for G’s transfer of the land to the partnership. In addition, at the time G transferred the land to the partnership, G had a legally enforceable right to receive a transfer from the partnership at a specified time an amount that equals the excess of the permanent loan proceeds over $4,000,000. In this case, however, there was a significant risk that the appraised value of the property would be insufficient to support a permanent loan in excess of $4,000,000 because of the risk that the partnership would not be able to achieve a sufficient occupancy level. Therefore, the facts of this example indicate that at the time G transferred the land to the partnership the subsequent transfer of $1,000,000 to G depended on the entrepreneurial risks of partnership operations. Accordingly, G’s transfer of the land to the partnership is not treated as part of a sale.

Example 6. Rebuttal of presumption for transfers more than two years apart. The facts are the same as in *Example 5,* except that the partnership is able to secure a commitment for a permanent loan in the amount of $5,000,000 without regard to the appraised value of the improved property at the time the permanent loan is funded. Under these facts, at the time that G transferred the land to the partnership the subsequent transfer of $1,000,000 to G was not dependent on the entrepreneurial risks of partnership operations, because during the period before the permanent loan is funded, the permanent lender’s obligation to make a loan in the amount necessary to fund the transfer is not subject to the contingencies related to the risks of partnership operations, and after the permanent loan is funded, the partnership holds liquid assets sufficient to make the transfer. Therefore, the facts and circumstances clearly establish that G's transfer of the land to the partnership is part of a sale.

Example 7. Operation of presumption for transfers more than two years apart. The facts are the same as in *Example 6,* except that H does not guarantee either that the improvements will be completed or that the cost to the partnership of completing the improvements will not exceed $5,000,000. Under these facts, if there is a significant risk that the improvements will not be completed, G's transfer of the land to the partnership will not be treated as part of a sale because the lender is required to make the permanent loan if the improvements are not completed. Similarly, the transfers will not be treated as a sale to the extent that there is a significant risk that the cost of constructing the improvements will exceed $5,000,000, because, in the absence of a guarantee of the cost of the improvements by H, the $5,000,000 proceeds of the permanent loan might not be sufficient to retire the construction loan and fund the transfer to G. In either case, the transfer of cash to G would be dependent on the entrepreneurial risks of partnership operations.

Example 8. Rebuttal of presumption for transfers more than two years apart. (i) On February 1, 1992, I, J, and K form partnership IJK. On formation of the partnership, I transfers an unencumbered office building with a fair market value of $50,000,000 and an adjusted tax basis of $20,000,000 to the partnership, and J and K each transfer United States government securities with a fair market value and an adjusted tax basis of $25,000,000 to the partnership. Substantially all of the rentable space in the office building is leased on a long-term basis. The partnership agreement provides that all items of income, gain, loss, and deduction from the office building are to be allocated 45 percent to J, 45 percent to K, and 10 percent to I. The partnership agreement also provides that all items of income, gain, loss, and deduction from the government securities are to be allocated 90 percent to I, 5 percent to J, and 5 percent to K. The partnership agreement requires that cash flow from the office building and government securities be allocated between partners in the same manner as the items of income, gain, loss, and deduction from those properties are allocated between them. The partnership agreement complies with the requirements of §1.704–1(b)(2)(ii)(*b*). It is not expected that the partnership will need to resort to the government securities or the cash flow therefrom to operate the office building. At the time the partnership is formed, I, J, and K contemplated that I's interest in the partnership would be liquidated sometime after January 31, 1994, in exchange for a transfer of the government securities and cash (if necessary). On March 1, 1995, the partnership transfers cash and the government securities to I in liquidation of I's interest in the partnership. The cash transferred to I represents the excess of I's share of the appreciation in the office building since the formation of the partnership over J's and K's share of the appreciation in the government securities since they are acquired by the partnership.

(ii) I's transfer of the office building to the partnership and the partnership's transfer of the government securities and cash to I occurred more than two years apart. Therefore, those transfers are presumed not to be a sale unless the facts and circumstances clearly establish that the transfers constitute a sale. Absent I's transfer of the office building to the (partnership, I would not have received the government securities from the partnership. The facts including the amount and nature of partnership assets) indicate that, at the time that I transferred the office building to the partnership, the timing of the transfer of the government securities to I was anticipated and was not dependent on the entrepreneurial risks of partnership operations. Moreover, the facts indicate that the partnership allocations were designed to effect an exchange of the burdens and benefits of ownership of the government securities in anticipation of the transfer of those securities to I and those burdens and benefits were effectively shifted to I on formation of the partnership. Accordingly, the facts and circumstances clearly establish that I sold the office building to the partnership on February 1, 1992, in exchange for the partnership's obligation to transfer the government securities to I and to make certain other cash transfers to I.

[T.D. 8439, 57 FR 44978, Sept. 30, 1992]

§1.707–4 Disguised sales of property to partnership; special rules applicable to guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures.

(a) *Guaranteed payments and preferred returns*—(1) *Guaranteed payment not treated as part of a sale*—(i) *In general.* A guaranteed payment for capital made to a partner is not treated as part of a sale of property under §1.707–3(a) (relating to treatment of transfers as a sale). A party's characterization of a payment as a guaranteed payment for capital will not control in determining whether a payment is, in fact, a guaranteed payment for capital. The term *guaranteed payment for capital* means any payment to a partner by a partnership that is determined without regard to partnership income and is for the use of that partner's capital. See section 707(c). For this purpose, one or more payments are not made for the use of a partner's capital if the payments are designed to liquidate all or part of the partner's interest in property contributed to the partnership rather than to provide the partner with a return on an investment in the partnership.

(ii) *Reasonable guaranteed payments.* Notwithstanding the presumption set forth in §1.707–3(c) (relating to transfers made within two years of each other), for purposes of section 707(a)(2) and the regulations thereunder a transfer of money to a partner that is characterized by the parties as a guaranteed payment for capital, is determined without regard to the income of the partnership and is reasonable (within the meaning of paragraph (a)(3) of this section) is presumed to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale.

(iii) *Unreasonable guaranteed payments.* A transfer of money to a partner that is characterized by the parties as a guaranteed payment for capital but that is not reasonable (within the meaning of paragraph (a)(3) of this section) is presumed not to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is a guaranteed payment for capital. A transfer that is not a guaranteed payment for capital is subject to the rules of §1.707–3.

(2) *Presumption regarding reasonable preferred returns.* Notwithstanding the presumption set forth in §1.707–3(c) (relating to transfers made within two years of each other), a transfer of money to a partner that is characterized by the parties as a preferred return and that is reasonable (within the meaning of paragraph (a)(3) of this section) is presumed not to be part of a sale of property to the partnership unless the facts and circumstances (including the likelihood and expected timing of the subsequent allocation of income or gain to support the preferred return) clearly establish that the transfer is part of a sale. The term *preferred return* means a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain.

(3) *Definition of reasonable preferred returns and guaranteed payments*—(i) *In general.* A transfer of money to a partner that is characterized as a preferred return or guaranteed payment for capital is reasonable only to the extent that the transfer is made to the partner pursuant to a written provision of a partnership agreement that provides for payment for the use of capital in a reasonable amount, and only to the extent that the payment is made for the use of capital after the date on which that provision is added to the partnership agreement.

(ii) *Reasonable amount.* A transfer of money that is made to a partner during any partnership taxable year and is characterized as a preferred return or guaranteed payment for capital is reasonable in amount if the sum of any preferred return and any guaranteed payment for capital that is payable for that year does not exceed the amount determined by multiplying either the partner's unreturned capital at the beginning of the year or, at the partner's option, the partner's weighted average capital balance for the year (with either amount appropriately adjusted, taking into account the relevant compounding periods, to reflect any unpaid preferred return or guaranteed payment for capital that is payable to the partner) by the safe harbor interest rate for that year. The safe harbor interest rate for a partnership's taxable year equals 150 percent of the highest applicable Federal rate, at the appropriate compounding period or periods, in effect at any time from the time that the right to the preferred return or guaranteed payment for capital is first established pursuant to a binding, written agreement among the partners through the end of the taxable year. A partner's unreturned capital equals the excess of the aggregate amount of money and the fair market value of other consideration (net of liabilities) contributed by the partner to the partnership over the aggregate amount of money and the fair market value of other consideration (net of liabilities) distributed by the partnership to the partner other than transfers of money that are presumed to be guaranteed payments for capital under paragraph (a)(1)(ii) of this section, transfers of money that are reasonable preferred returns within the meaning of this paragraph (a)(3), and operating cash flow distributions within the meaning of paragraph (b)(2) of this section.

(4) *Examples.* The following examples illustrate the application of paragraph (a) of this section:

Example 1. Transfer presumed to be a guaranteed payment. (i) A transfers property with a fair market value of $100,000 to partnership AB. At the time of A's transfer, the partnership agreement is amended to provide that A is to receive a guaranteed payment for the use of A's capital of 10 percent (compounded annually) of the fair market value of the transferred property in each of the three years following the transfer. The partnership agreement provides that partnership net taxable income and loss will be allocated equally between partners A and B, and that partnership cash flow will be distributed in accordance with the allocation of partnership net taxable income and loss. The partnership would be allowed a deduction in the year paid if the transfers made to A are treated as guaranteed payments under section 707(c). Under the partnership agreement, that deduction would be allocated in the same manner as any other item of partnership deduction. The partnership agreement complies with the requirements of § 1.704–1(b)(2)(ii)(*b*). The partnership agreement does not provide for the payment of a preferred return and, other than the guaranteed payment to be paid to A, no transfer is expected to be made during the three year period following A's transfer that is not an operating cash flow distribution (within the meaning of paragraph (b)(2) of this section). Assume that the highest applicable Federal rate in effect at the time of A's transfer is eight percent compounded annually.

(ii) The transfer of money to be made to A under the partnership agreement is characterized by the parties as a guaranteed payment for capital and is determined without regard to the income of the partnership. The transfer is also reasonable within the meaning of § 1.707–4(a)(3). The transfer, therefore, is presumed to be a guaranteed payment for capital. The presumption set forth in § 1.707–3(c) (relating to transfers made within two years of each other) thus does not apply to this transfer. The transfer will not be treated as part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital but is part of a sale.

(iii) The presumption that the transfer is a guaranteed payment for capital is not rebutted, because there are no facts indicating that the transfer is not a guaranteed payment for the use of capital.

Example 2. Transfers characterized as guaranteed payments treated as part of a sale. (i) C and D form partnership CD. C transfers property with a fair market value of $100,000 and an adjusted tax basis of $20,000 in exchange for a partnership interest. D is responsible for managing the day-to-day operations of the partnership and makes no capital contribution to the partnership upon its formation. The partnership agreement provides that C is to receive payments characterized as guaranteed payments and determined without regard to partnership income of $8,333 per year for the first four years of partnership operations for the use of C's capital. In addition, the partnership agreement provides that—

(A) Partnership net taxable income and loss will be allocated 75 percent to C and 25 percent to D; and

(B) All partnership cash flow (determined prior to consideration of the guaranteed payment) will be distributed 75 percent to C and 25 percent to D except that guaranteed payments that the partnership is obligated to make to C are payable solely out of D's share of the partnership's cash flow.

(ii) If D's share of the partnership's cash flow is not sufficient to make the guaranteed payment to C, then D is obligated to contribute any shortfall to the partnership, even in the event the partnership is liquidated. Thus, the effect of the guaranteed payment arrangement is that the guaranteed payment to C is funded entirely by D. The partnership agreement complies with the requirements of § 1.704–1(b)(2)(ii)(*b*). Assume that, at the time the partnership is formed, the partnership or D could borrow $25,000 pursuant to a loan requiring equal payments of principal and interest over a four-year term at the current market interest rate of approximately 12 percent (compounded annually). Assume that the highest applicable Federal rate in effect at the time the partnership is formed is 10 percent compounded annually.

(iii) The transfer of money to be made to C under the partnership agreement is characterized by the parties as a guaranteed payment for capital and is determined without regard to the income of the partnership. The transfer is also reasonable within the meaning of § 1.707–4(a)(3). The transfer, therefore, is presumed to be a guaranteed payment for capital. The presumption set forth in § 1.707–3(c) (relating to transfers made within two years of each other) thus does not apply to this transfer. The transfer will not be treated as part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale.

(iv) For the first four years of partnership operations, the total guaranteed payments made to C under the partnership agreement will equal $33,332. If the characterization of those payments as guaranteed payments for capital within the meaning of section 707(c) were respected, C would be allocated $24,999 of the deductions that would be claimed by the partnership for those payments, thereby leaving the balance in C's capital account approximately $25,000 less than it would have been if the guaranteed payments had not been made. The guaranteed payments thus have the effect of offsetting approximately $25,000 of the credit made to C's capital account for the property transferred to the partnership by C. C's resulting capital account is approximately equivalent to the capital account C would have had if C had only contributed 75 percent of the property to the partnership. Furthermore, the effect of D's funding the guaranteed payment to C (either through reduced distributions of cash flow to D or additional contributions) is that D's capital account is approximately equivalent to the capital account D would have had if D had contributed 25 percent of the property (or contributed cash so that the partnership could purchase the 25 percent). Moreover, a $25,000 loan requiring equal payments of principal and interest over a four-year term at the current market interest rate of 12 percent (compounded annually), would have resulted in annual payments of principal and interest of $8,230.86. Consequently, the guaranteed payments effectively place the partners in the same economic position that they would have been in had D purchased a one-quarter interest in the property from C financed at the current market rate of interest, and then C and D each contributed their share of the property to the partnership. In view of the burden the guaranteed payments place on D's right to transfers of partnership cash flow and D's legal obligation to make contributions to the partnership to the extent necessary to fund the guaranteed payments, D has effectively purchased through the partnership a one-quarter interest in the property from C.

(v) Under these facts, the presumption that the transfers to C are guaranteed payments for capital is rebutted, because the facts and circumstances clearly establish that the transfers are part of a sale and not guaranteed payments for capital. Under §1.707–3(a), C and the partnership are treated as if C sold a one-quarter interest in the property to the partnership in exchange for a promissory note evidencing the partnership's obligation to make the guaranteed payments.

(b) *Presumption regarding operating cash flow distributions*—(1) *In general.* Notwithstanding the presumption set forth in §1.707–3(c) (relating to transfers made within two years of each other), an operating cash flow distribution is presumed not to be part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is part of a sale.

(2) *Operating cash flow distributions*—(i) *In general.* One or more transfers of money by the partnership to a partner during a taxable year of the partnership are operating cash flow distributions for purposes of paragraph (b)(1) of this section to the extent that those transfers are not presumed to be guaranteed payments for capital under paragraph (a)(1)(ii) of this section, are not reasonable preferred returns within the meaning of paragraph (a)(3) of this section, are not characterized by the parties as distributions to the partner acting in a capacity other than as a partner, and to the extent they do not exceed the product of the net cash flow of the partnership from operations for the year multiplied by the lesser of the partner's percentage interest in overall partnership profits for that year or the partner's percentage interest in overall partnership profits for the life of the partnership. For purposes of the preceding sentence, the net cash flow of the partnership from operations for a taxable year is an amount equal to the taxable income or loss of the partnership arising in the ordinary course of the partnership's business and investment activities, increased by tax exempt interest, depreciation, amortization, cost recovery allowances and other noncash charges deducted in determining such taxable income and decreased by—

(A) Principal payments made on any partnership indebtedness;

(B) Property replacement or contingency reserves actually established by the partnership;

(C) Capital expenditures when made other than from reserves or from borrowings the proceeds of which are not included in operating cash flow; and

(D) Any other cash expenditures (including preferred returns) not deducted in determining such taxable income or loss.

(ii) *Operating cash flow safe harbor.* For any taxable year, in determining a partner's operating cash flow distributions for the year, the partner may use the partner's smallest percentage interest under the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with such taxable year. This provision is merely intended to provide taxpayers with a safe harbor and is not intended to preclude a taxpayer from using a different percentage under the rules of paragraph (b)(2)(i) of this section.

(iii) *Tiered partnerships.* In the case of tiered partnerships, the upper-tier partnership must take into account its share of the net cash flow from operations of the lower-tier partnership applying principles similar to those described in paragraph (b)(2)(i) of this section, so that the amount of the upper-tier partnership's operating cash flow distributions is neither overstated nor understated.

(c) *Accumulation of guaranteed payments, preferred returns, and operating cash flow distributions.* Guaranteed payments for capital, preferred returns, and operating cash flow distributions presumed not to be part of a sale under the rules of paragraphs (a) and (b) of this section do not lose the benefit of the presumption by reason of being retained for distribution in a later year.

(d) *Exception for reimbursements of preformation expenditures.* A transfer of money or other consideration by the partnership to a partner is not treated as part of a sale of property by the partner to the partnership under § 1.707–3(a) (relating to treatment of transfers as a sale) to the extent that the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, capital expenditures that—

(1) Are incurred during the two-year period preceding the transfer by the partner to the partnership; and

(2) Are incurred by the partner with respect to—

(i) Partnership organization and syndication costs described in section 709; or

(ii) Property contributed to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20 percent of the fair market value of such property at the time of the contribution. However, the 20 percent of fair market value limitation of this paragraph (d)(2)(ii) does not apply if the fair market value of the contributed property does not exceed 120 percent of the partner's adjusted basis in the contributed property at the time of contribution.

(e) *Other exceptions.* The Commissioner may provide by guidance published in the Internal Revenue Bulletin that other payments or transfers to a partner are not treated as part of a sale for purposes of section 707(a)(2) and the regulations thereunder.

[T.D. 8439, 57 FR 44981, Sept. 30, 1992; 57 FR 56444, Nov. 30, 1992]

§ 1.707–5 Disguised sales of property to partnership; special rules relating to liabilities.

(a) *Liability assumed or taken subject to by partnership*—(1) *In general.* For purposes of this section and §§ 1.707–3 and 1.707–4, if a partnership assumes or takes property subject to a qualified liability (as defined in paragraph (a)(6) of this section) of a partner, the partnership is treated as transferring consideration to the partner only to the extent provided in paragraph (a)(5) of this section. By contrast, if the partnership assumes or takes property subject to a liability of the partner other than a qualified liability, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability as provided in paragraphs (a) (2), (3) and (4) of this section.

(2) *Partner's share of liability.* A partner's share of any liability of the partnership is determined under the following rules:

(i) *Recourse liability.* A partner's share of a recourse liability of the partnership equals the partner's share of the liability under the rules of section 752 and the regulations thereunder. A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under § 1.752–1(a)(1) or would be treated as a recourse liability under that section if it were treated as a partnership liability for purposes of that section.

(ii) *Nonrecourse liability.* A partner's share of a nonrecourse liability of the partnership is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under §1.752–3(a)(3). A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability under §1.752–1(a)(2) or would be a nonrecourse liability of the partnership under §1.752–1(a)(2) if it were treated as a partnership liability for purposes of that section.

(3) *Reduction of partner's share of liability.* For purposes of this section, a partner's share of a liability, immediately after a partnership assumes or takes subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if—

(i) At the time that the partnership assumes or takes subject to a liability, it is anticipated that the transferring partner's share of the liability will be subsequently reduced; and

(ii) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the assumption of or taking subject to the liability is treated as part of a sale under §1.707–3.

(4) *Special rule applicable to transfers of encumbered property to a partnership by more than one partner pursuant to a plan.* For purposes of paragraph (a)(1) of this section, if the partnership assumes or takes property or properties subject to the liabilities of more than one partner pursuant to a plan, a partner's share of the liabilities assumed or taken subject to by the partnership pursuant to that plan immediately after the transfers equals the sum of that partner's shares of the liabilities (other than that partner's qualified liabilities, as defined in paragraph (a)(6) of this section) assumed or taken subject to by the partnership pursuant to the plan. This paragraph (a)(4) does not apply to any liability assumed or taken subject to by the partnership with a principal purpose of reducing the extent to which any other liability assumed or taken subject to by the partnership is treated as a transfer of consideration under paragraph (a)(1) of this section.

(5) *Special rule applicable to qualified liabilities.* (i) If a transfer of property by a partner to a partnership is not otherwise treated as part of a sale, the partnership's assumption of or taking subject to a qualified liability in connection with a transfer of property is not treated as part of a sale. If a transfer of property by a partner to the partnership is treated as part of a sale without regard to the partnership's assumption of or taking subject to a qualified liability (as defined in paragraph (a)(6) of this section) in connection with the transfer of property, the partnership's assumption of or taking subject to that liability is treated as a transfer of consideration made pursuant to a sale of such property to the partnership only to the extent of the lesser of—

(A) The amount of consideration that the partnership would be treated as transferring to the partner under paragraph (a)(1) of this section if the liability were not a qualified liability; or

(B) The amount obtained by multiplying the amount of the qualified liability by the partner's net equity percentage with respect to that property.

(ii) A partner's net equity percentage with respect to an item of property equals the percentage determined by dividing—

(A) The aggregate transfers of money or other consideration to the partner by the partnership (other than any transfer described in this paragraph (a)(5)) that are treated as proceeds realized from the sale of the transferred property; by

(B) The excess of the fair market value of the property at the time it is transferred to the partnership over any qualified liability encumbering the property or, in the case of any qualified liability described in paragraph (a)(6)(i)(C) or (D) of this section, that is properly allocable to the property.

(6) *Qualified liability of a partner defined.* A liability assumed or taken subject to by a partnership in connection with a transfer of property to the partnership by a partner is qualified liability of the partner only to the extend—

(i) The liability is—

(A) A liability that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfers the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that two-year period;

(B) A liability that was not incurred in anticipation of the transfer of the property to a partnership, buy that was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property since it was incurred (see paragraph (a)(7) of this section for further rules regarding a liability incurred within two years of a property transfer or of a written agreement to transfer);

(C) A liability that is allocable under the rules of § 1.163–8T to capital expenditures with respect to the property; or

(D) A liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business; and

(ii) If the liability is a recourse liability, the amount of the liability does not exceed the fair market value of the transferred property (less the amount of any other liabilities that are senior in priority and that either encumber such property or are liabilities described in paragraph (a)(6)(i) (C) or (D) of this section) at the time of the transfer.

(7) *Liability incurred within two years of transfer presumed to be in anticipation of the transfer*—(i) *In general.* For purposes of this section, if within a two-year period a partner incurs a liability (other than a liability described in paragraph (a)(6)(i) (C) or (D) of this section) and transfers property to a partnership or agrees in writing to transfer the property, and in connection with the transfer the partnership assumes or takes the property subject to the liability, the liability is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish that the liability was not incurred in anticipation of the transfer.

(ii) *Disclosure of transfers of property subject to liabilities incurred within two years of the transfer.* If a partner treats a liability assumed or taken subject to by a partnership as a qualified liability under paragraph (a)(6)(i)(B) of this section, such treatment is to be disclosed to the Internal Revenue Service in accordance with § 1.707–8.

(b) *Treatment of debt-financed transfers of consideration by partnerships*—(1) *In general.* For purposes of § 1.707–3, if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under § 1.163–8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner's allocable share of the partnership liability.

(2) *Partner's allocable share of liability*—(i) *In general.* A partner's allocable share of a partnership liability for purposes of paragraph (b)(1) of this section equals the amount obtained by multiplying the partner's share of the liability as described in paragraph (a)(2) of this section by the fraction determined by dividing—

(A) The portion of the liability that is allocable under § 1.163–8T to the money or other property transferred to the partner; by

(B) The total amount of the liability.

(ii) *Debt-financed transfers made pursuant to a plan*—(A) *In general.* Except as provided in paragraph (b)(2)(iii) of this section, if a partnership transfers to more than one partner pursuant to a plan all or a portion of the proceeds of one or more partnership liabilities, paragraph (b)(1) of this section is applied by treating all of the liabilities incurred pursuant to the plan as one liability, and each partner's allocable share of those liabilities equals the amount obtained by multiplying the sum of the partner's shares of each of the respective liabilities (as defined in paragraph (a)(2) of this section) by the fraction obtained by dividing—

(*1*) The portion of those liabilities that is allocable under § 1.163–8T to the money or other consideration transferred to the partners pursuant to the plan; by

(*2*) The total amount of those liabilities.

(B) *Special rule.* Paragraph (b)(2)(ii)(A) of this section does not apply to any transfer of money or other property to a partner that is made with a principal purpose of reducing the extent to which any transfer is taken into account under paragraph (b)(1) of this section.

(iii) *Reduction of partner's share of liability.* For purposes of paragraph (b)(2) of this section, a partner's share of a liability, immediately after the partnership assumes or takes subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if—

(A) It is anticipated that the partner's share of the liability that is allocable to a transfer of money or other consideration to the partner will be reduced subsequent to the transfer; and

(B) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the partnership's distribution of the proceeds of the borrowing is treated as part of a sale.

(c) *Refinancings.* To the extent that the proceeds of a partner or partnership liability (the *refinancing debt*) are allocable under the rules of § 1.163–8T to payments discharging all or part of any other liability of that partner or of the partnership, as the case may be, the refinancing debt is treated as the other liability for purposes of applying the rules of this section.

(d) *Share of liability where assumption accompanied by transfer of money.* For purposes of §§ 1.707–3 through 1.707–5, if pursuant to a plan a partner pays or contributes money to the partnership and the partnership assumes or takes subject to one or more liabilities (other than qualified liabilities) of the partner, the amount of those liabilities that the partnership is treated as assuming or taking subject to is reduced (but not below zero) by the money transferred.

(e) *Tiered partnerships and other related persons.* If a lower-tier partnership succeeds to a liability of an upper-tier partnership, the liability in the lower-tier partnership retains the characterization as qualified or nonqualified that it had under these rules in the upper-tier partnership. A similar rule applies to other related party transactions involving liabilities to the extent provided by guidance published in the Internal Revenue Bulletin.

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

Example 1. Partnership's assumption of nonrecourse liability encumbering transferred property. (i) A and B form partnership AB, which will engage in renting office space. A transfers $500,000 in cash to the partnership, and B transfers an office building to the partnership. At the time it is transferred to the partnership, the office building has a fair market value of $1,000,000, an adjusted basis of $400,000, and is encumbered by a $500,000 liability, which B incurred 12 months earlier to finance the acquisition of other property. No facts rebut the presumption that the liability was incurred in anticipation of the transfer of the property to the partnership. Assume that this liability is a nonrecourse liability of the partnership within the meaning of section 752 and the regulations thereunder. The partnership agreement provides that partnership items will be allocated equally between A and B, including excess nonrecourse deductions under § 1.752–3(a)(3). The partnership agreement complies with the requirements of § 1.704–1(b)(2)(ii)(*b*).

(ii) The nonrecourse liability secured by the office building is not a qualified liability within the meaning of paragraph (a)(6) of this section. B would be allocated 50 percent of the excess nonrecourse liability under the partnership agreement. Accordingly, immediately after the partnership's assumption of that liability, B's share of the liability equals $250,000, which is equal to B's 50 percent share of the excess nonrecourse liability of the partnership as determined in accordance with B's share of partnership profits under § 1.752–3(a)(3).

(iii) The partnership's taking subject to the liability encumbering the office building is treated as a transfer of $250,000 of consideration to B (the amount by which the liability ($500,000) exceeds B's share of that liability immediately after taking subject to $250,000)). B is treated as having sold $250,000 of the fair market value of the office building to the partnership in exchange for the partnership's taking subject to a $250,000 liability. This results in a gain of $150,000 ($250,000 minus ($250,000/$1,000,000 multiplied by $400,000)).

Example 2. Partnership's assumption of recourse liability encumbering transferred property. (i) C transfers property Y to a partnership. At the time of its transfer to the partnership, property Y has a fair market value of $10,000,000 and is subject to an $8,000,000 liability that C incurred, immediately before transferring property Y to the partnership, in order to finance other expenditures. Upon the transfer of property Y to the partnership, the partnership assumed the liability encumbering that property. The partnership assumed this liability solely to acquire property Y. Under section 752 and the regulations thereunder, immediately after the partnership's assumption of the liability encumbering property Y, the liability is a recourse liability of the partnership and C's share of that liability is $7,000,000.

(ii) Under the facts of this example, the liability encumbering property Y is not a qualified liability.

Accordingly, the partnership's assumption of the liability results in a transfer of consideration to C in connection with C's transfer of property Y to the partnership in the amount of $1,000,000 (the excess of the liability assumed by the partnership ($8,000,000) over C's share of the liability immediately after the assumption ($7,000,000)). See paragraphs (a) (1) and (2) of this section.

Example 3. Subsequent reduction of transferring partner's share of liability. (i) The facts are the same as in Example 2. In addition, property Y is a fully leased office building, the rental income from property Y is sufficient to meet debt service, and the remaining term of the liability is ten years. It is anticipated that, three years after the partnership's assumption of the liability, C's share of the liability under section 752 will be reduced to zero because of a shift in the allocation of partnership losses pursuant to the terms of the partnership agreement. Under the partnership agreement, this shift in the allocation of partnership losses is dependent solely on the passage of time.

(ii) Under paragraph (a)(3) of this section, if the reduction in C's share of the liability was anticipated at the time of C's transfer, and the reduction was part of a plan that has as one of its principal purposes minimizing the extent of sale treatment under § 1.707–3 (*i.e.*, a principal purpose of allocating a large percentage of losses to C in the first three years when losses were not likely to be realized was to minimize the extent to which C's transfer would be treated as part of a sale), C's share of the liability immediately after the assumption is treated as equal to C's reduced share.

Example 4. Trade payables as qualified liabilities. (i) D and E form partnership DE which will engage in a consulting business that requires no overhead and minimal cash on hand for daily operating expenses. Previously, D and E, as individual sole proprietors, operated separate consulting businesses. D and E each transfer to the partnership sufficient cash to cover daily operating expenses together with the goodwill and trade payables related to each sole proprietorship. Due to uncertainty over the collection rate on the trade receivables related to their sole proprietorships, D and E agree that none of the trade receivables will be transferred to the partnership.

(ii) Under the facts of this example, all the assets related to the consulting business (other than the trade receivables) together with the trade payables were transferred to partnership DE. The trade receivables retained by D and E are not material to a continuation of the trade or business by the partnership because D and E contributed sufficient cash to cover daily operating expenses. Accordingly, the trade payables transferred to the partnership constitute qualified liability under paragraph (a)(6) of this section.

Example 5. Partnership's assumption of a qualified liability as sole consideration. (i) F transfers property Z to a partnership. At the time of its transfer to the partnership, property Z has a fair market value of $165,000 and an adjusted tax basis of $75,000. Also, at the time of the transfer, property Z is subject to a $75,000 liability that F incurred more than two years before transferring property Z to the partnership. The liability has been secured by property Z since it was incurred by F. Upon the transfer of property Z to the partnership, the partnership assumed the liability encumbering that property. The partnership made no other transfers to F in consideration for the transfer of property Z to the partnership. Assume that, under section 752 and the regulations thereunder, immediately after the partnership's assumption of the liability encumbering property Z, the liability is a recourse liability of the partnership and F's share of that liability is $25,000.

(ii) The $75,000 liability secured by property Z is a qualified liability of F because F incurred the liability more than two years prior to the assumption of the liability by the partnership and the liability has encumbered property Z for more than two years prior to that assumption. *See* paragraph (a)(6) of this section. Therefore, since no other transfer to F was made as consideration for the transfer of property Z, under paragraph (a)(5) of this section, the partnership's assumption of the qualified liability of F encumbering property Z is not treated as part of a sale.

Example 6. Partnership's assumption of a qualified liability in addition to other consideration. (i) The facts are the same as in *Example 5,* except that the partnership makes a transfer to D of $30,000 in money that is consideration for F's transfer of property Z to the partnership under §1.707–3.

(ii) As in *Example 5,* the $75,000 liability secured by property Z is a qualified liability of F. Since the partnership transferred $30,000 to F in addition to assuming the qualified liability under paragraph (a)(5) of this section, the partnership's assumption of this qualified liability is treated as a transfer of additional consideration to F to the extent of the lesser of—

(A) The amount that the partnership would be treated as transferring to F if the liability were not a qualified liability ($50,000 (*i.e.,* the excess of the $75,000 qualified liability over F's $25,000 share of that liability)); or

(B) The amount obtained by multiplying the qualified liability ($75,000) by F's net equity percentage with respect to property Z (one-third).

(iii) F's net equity percentage with respect to property Z equals the fraction determined by dividing—

(A) The aggregate amount of money or other consideration (other than the qualified liability) transferred to F and treated as part of a sale of property Z under §1.707–3(a) ($30,000 transfer of money); by

(B) F's net equity in property Z ($90,000 (*i.e.,* the excess of the $165,000 fair market value over the $75,000 qualified liability)).

(iv) Accordingly, the partnership's assumption of the qualified liability of F encumbering property Z is treated as a transfer of $25,000 (one-third of $75,000) of consideration to F pursuant to a sale. Therefore, F is treated as having sold $55,000 of the fair market value of property Z to the partnership in exchange for $30,000 in money and the partnership's assumption of $25,000 of the qualified liability. Accordingly, F must recognize $30,000 of gain on the sale (the excess of the $55,000 amount realized over $25,000 of F's adjusted basis for property, Z (i.e., one-third of F's adjusted basis for the property, because F is treated as having sold one-third of the property to the partnership)).

Example 7. Partnership's assumptions of liabilities encumbering properties transferred pursuant to a plan. (i) Pursuant to a plan, G and H transfer property 1 and property 2, respectively, to an existing partnership in exchange for interests in the partnership. At the time the properties are transferred to the partnership, property 1 has a fair market value of $10,000 and an adjusted tax basis of $6,000, and property 2 has a fair market value of $10,000 and an adjusted tax basis of $4,000. At the time properties 1 and 2 are transferred to the partnership, a $6,000 nonrecourse liability (*liability 1*) is secured by property 1 and a $7,000 recourse liability of F (*liability 2*) is secured by property 2. Properties 1 and 2 are transferred to the partnership, and the partnership takes subject to liability 1 and assumes liability 2. G and H incurred liabilities 1 and 2 immediately prior to transferring properties 1 and 2 to the partnership and used the proceeds for personal expenditures. The liabilities are not qualified liabilities. Assume that G and H are each allocated $2,000 of liability 1 in accordance with §1.707–5(a)(2)(ii) (which determines a partner's share of a nonrecourse liability). Assume further that G's share of liability 2 is $3,500 and H's share is $0 in accordance with §1.707–5(a)(2)(i) (which determines a partner's share of a recourse liability).

(ii) G and H transferred properties 1 and 2 to the partnership pursuant to a plan. Accordingly, the partnership's taking subject to liability 1 is treated as a transfer of only $500 of consideration to G, (the amount by which liability 1 ($6,000) exceeds G's share of liabilities 1 and 2 ($5,500)), and the partnership's assumption of liability 2 is treated as a transfer of only $5,000 of consideration to H (the amount by which liability 2 ($7,000) exceeds H's share of liabilities 1 and 2 ($2,000)). G is treated under the rule in §1.707–3 as having sold $500 of the fair market value of property 1 in exchange for the partnership's taking subject to liability 1 and H is treated as having sold $5,000 of the fair market value of property 2 in exchange for the assumption of liability 2.

Example 8. Partnership's assumption of liability pursuant to a plan to avoid sale treatment of partnership assumption of another liability. (i) The facts are the same as in *Example 7,* except that—

(A) H transferred the proceeds of liability 2 to the partnership; and

(B) H incurred liability 2 in an attempt to reduce the extent to which the partnership's taking subject to liability 1 would be treated as a transfer of consideration to G (and thereby reduce the portion of G's transfer of property 1 to the partnership that would be treated as part of a sale).

(ii) Because the partnership assumed liability 2 with a principal purpose of reducing the extent to which the partnership's taking subject to liability 1 would be treated as a transfer of consideration to G, liability 2 is ignored in applying paragraph (a)(3) of this section. Accordingly, the partnership's taking subject to liability 1 is treated as a transfer of $4,000 of consideration to G (the amount by which liability 1 ($6,000) exceeds G's share of liability 1 ($2,000)). On the other hand, the partnership's assumption of liability 2 is not treated as a transfer of any consideration to H because H's share of that liability equals $7,000 as a result of H's transfer of $7,000 in money to the partnership.

Example 9. Partnership's assumptions of qualified liabilities encumbering properties transferred pursuant to a plan in addition to other consideration. (i) Pursuant to a plan, I transfers property 1 and J transfers property 2 plus $10,000 in cash to partnership IJ in exchange for equal interests in the partnership.

At the time the properties are transferred to the partnership, property 1 has a fair market value of $100,000, an adjusted tax basis of $5,000, and is encumbered by a qualified liability of $50,000 (*liability 1).* Property 2 has a fair market value of $100,000, an adjusted tax basis of $5,000, and is encumbered by a qualified liability of $70,000 (*liability 2).* Pursuant to the plan, the partnership transferred to I $10,000 in cash. That amount is consideration for I's transfer of property 1 to the partnership under § 1.707–3. In accordance with § 1.707–5(a)(2), I and J are each allocated $25,000 of liability 1 and $35,000 of liability 2.

(ii) Because the partnership transferred $10,000 to I as consideration for the transfer of property, under § 1.707–5(a)(5), the partnership's assumption of liability 1 is treated as a transfer of additional consideration to I, even though liability 1 is a qualified liability, to the extent of the lesser of—

(A) The amount that the partnership would be treated as transferring to I if the liability were not a qualified liability; or

(B) The amount obtained by multiplying the qualified liability by I's net equity percentage with respect to property 1.

(iii) Because I and J transferred properties 1 and 2 to the partnership pursuant to a plan, treating I's qualified liability as a nonqualified liability under § 1.707–5(a)(5)(i)(A) enables I to apply the special rule applicable to transfers of encumbered property to a partnership by more than one partner pursuant to a plan under § 1.707–5(a)(4). Under this alternative test, the partnership's assumption of liability 1 encumbering property 1 is treated as a transfer of zero ($0) additional consideration to I pursuant to a sale. This is because the amount of liability 1 ($50,000) does not exceed the sum of I's share of liability 1 treated as a nonqualified liability ($25,000) and I's share of liability 2 ($35,000)).

(iv) The alternative under § 1.707–5(a)(5)(i)(B) is the amount obtained by multiplying the qualified liability ($50,000) by I's net equity percentage with respect to property 1. I's net equity percentage with respect to property 1 equals one-fifth, the fraction determined by dividing—

(A) The aggregate amount of money or other consideration (other than the qualified liability) transferred to I and treated as part of a sale of property 1 under § 1.707–3(a) (the $10,000 transfer of money; by

(B) I's net equity in property 1 ($50,000 *i.e.*, the excess of the $100,000 fair market value over the $50,000 qualified liability).

(v) Under this alternative test, the partnership's assumption of the qualified liability encumbering property 1 is treated as a transfer of $10,000 (one-fifth of the $50,000 qualified liability) of additional consideration to I pursuant to a sale.

(vi) Applying § 1.707–5(a)(5) to these facts, the partnership's assumption of liability 1 is treated as a transfer of additional consideration to I to the extent of the lesser of—

(A) zero; or

(B) $10,000.

(vii) Therefore, the partnership's assumption of I's qualified liability encumbering property 1 is not treated as a transfer of any additional consideration to I pursuant to a sale, and I is treated as having only received $10,000 of the fair market value of property 1 to the partnership in exchange for $10,000 in cash. Accordingly, I must recognize $9,500 of gain on the sale, that is, the excess of the $10,000 amount realized over $500 of I's adjusted tax basis for property 1 (one-tenth of I's adjusted tax basis for the property, because I is treated as having sold one-tenth of the property to the partnership). Since no other transfer to J was made as consideration for the transfer of property 2, the partnership's assumption of the qualified liability of J encumbering property 2 is not treated as part of a sale.

Example 10. Treatment of debt-financed transfers of consideration by partnership. (i) K transfers property Z to partnership KL in exchange for an interest therein on April 9, 1992. On September 13, 1992, the partnership incurs a liability of $20,000. On November 17, 1992, the partnership transfers $20,000 to K, and $10,000 of this transfer is allocable under the rules of § 1.163–8T to proceeds of the partnership liability incurred on September 13, 1992. The remaining $10,000 is paid from other partnership funds. Assume that, under section 752 and the corresponding regulations, the $20,000 liability incurred on September 13, 1992, is a recourse liability of the partnership and K's share of that liability is $10,000 on November 17, 1992.

(ii) Because a portion of the transfer made to K on November 17, 1992, is allocable under § 1.163–8T to proceeds of a partnership liability that was incurred by the partnership within 90 days of that transfer, K is required to take the transfer into account in applying the rules of this section and § 1.707–3 only to the extent that the amount of the transfer exceeds K's allocable share of the liability used to fund the transfer. K's allocable share of the $20,000 liability used to fund $10,000 of the transfer to K is $5,000 (K's share of the liability ($10,000) multiplied by the fraction obtained by dividing—

(A) The amount of the liability that is allocable to the distribution to K ($10,000); by

(B) The total amount of such liability ($20,000)).

(iii) Therefore, K is required to take into account only $15,000 of the $20,000 partnership transfer to K for purposes of this section and § 1.707–3. Under these facts, assuming the within-two-year presumption is not rebutted, this $15,000 transfer will be treated under the rule in § 1.707–3 as part of a sale by K of property Z to the partnership.

Example 11. Borrowing against pool of receivables. (i) M generates receivables which have an adjusted basis of zero in the ordinary course of its business. For M to use receivables as security for a loan, a commercial lender requires M to transfer the receivables to a partnership in which M has a 90 percent interest. In January, 1992, M transfers to the partnership receivables with a face value of $100,000. N (who is not related to M) transfers $10,000 cash to the partnership in exchange for a 10 percent interest. The partnership borrows $80,000, secured by the receivables, and makes a distribution of $72,000 of the proceeds to M and $8,000 of the proceeds to N within 90 days of incurring the liability. M's share of the liability under §1.707–5(a)(2) is $72,000 (90 percent × $80,000).

(ii) Because the transfer of the loan proceeds to M is allocable under §1.163–8T to proceeds of a partnership loan that was incurred by the partnership within 90 days of that transfer, M is required to take the transfer into account in applying the rules of this section and §1.707–3 only to the extent that the amount of the transfer ($72,000) exceeds M's allocable share of the liability used to fund the transfer. Because the distribution was a debt-financed transfer pursuant to a plan, M's allocable share of the liability is $72,000 ($72,000 × $80,000/80,000) under §1.707–5(b)(2)(ii). Therefore, M is not required to take into account any of the loan proceeds for purposes of this section and §1.707–3.

(iii) When the receivables are collected, M must be allocated the gain on the contributed receivables under section 704(c). However, the lender permits the partnership to distribute cash to the partners only to the extent of the value of new receivables contributed to the partnership. In 1993, M contributes additional receivables and receives a distribution of cash. The taxable income recognized by the partnership on the receivables is taxable income of the partnership arising in the ordinary course of the partnership's activities. To the extent the distribution does not exceed 90 percent (M's percentage interest in overall partnership profits) of the partnership's operating cash flow under §1.707–4(b), the distribution to M is presumed not to be a part of a sale of receivables by M to the partnership, and the presumption is not rebutted under these facts.

[T.D. 8439, 57 FR 44983, Sept. 30, 1992]

§1.707–6 Disguised sales of property by partnership to partner; general rules.

(a) *In general.* Rules similar to those provided in §1.707–3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a sale of property, in whole or in part, to the partner.

(b) *Special rules relating to liabilities*—(1) *In general.* Rules similar to those provided in §1.707–5 apply to determine the extent to which an assumption of or taking subject to a liability by a partner, in connection with a transfer of property by a partnership, is considered part of a sale. Accordingly, if a partner assumes or takes property subject to a qualified liability (as defined in paragraph (b)(2) of this section) of a partnership, the partner is treated as transferring consideration to the partnership only to the extent provided in paragraph (b). If the partner assumes or takes subject to a liability that is not a qualified liability, the amount treated as consideration transferred to the partnership is the amount that the liability assumed or taken subject to by the partner exceeds the partner's share of that liability (determined under the rules of §1.707–5(a)(2)) immediately before the transfer. Similar to the rules provided in §1.707–5(a)(4), if more than one partner assumes or takes subject to a liability pursuant to a plan, the amount that is treated as a transfer of consideration by each partner is the amount by which all of the liabilities (other than qualified liabilities) assumed or taken subject to by the partner pursuant to the plan exceed the partner's share of all of those liabilities immediately before the assumption or taking subject to. This paragraph (b)(1) does not apply to any liability assumed or taken subject to by a partner with a principal purpose of reducing the extent to which any other liability assumed or taken subject to by a partner is treated as a transfer of consideration under this paragraph (b).

(2) *Qualified liabilities.* (i) If a transfer of property by a partnership to a partner is not otherwise treated as part of a sale, the partner's assumption of or taking subject to a qualified liability is not treated as part of a sale. If a transfer of property by a partnership to the partner is treated as part of a sale without regard to the partner's assumption of or taking subject to a

qualified liability, the partner's assumption of or taking subject to that liability is treated as a transfer of consideration made pursuant to a sale of such property to the partner only to the extent of the lesser of—

(A) The amount of consideration that the partner would be treated as transferring to the partnership under paragraph (b) of this section if the liability were not a qualified liability; or

(B) The amount obtained by multiplying the amount of the liability at the time of its assumption or taking subject to by the partnership's net equity percentage with respect to that property.

(ii) A partnership's net equity percentage with respect to an item of property encumbered by a qualified liability equals the percentage determined by dividing—

(A) The aggregate transfers to the partnership from the partner (other than any transfer described in this paragraph (b)(2)) that are treated as the proceeds realized from the sale of the transferred property to the partner; by

(B) The excess of the fair market value of the property at the time it is transferred to the partner over any qualified liabilities of the partnership that are assumed or taken subject to by the partner at that time.

(iii) For purposes of this section, the definition of a qualified liability is that provided in § 1.707–5(a)(6) with the following exceptions—

(A) In applying the definition, the qualified liability is one that is originally an obligation of the partnership and is assumed or taken subject to by the partner in connection with a transfer of property to the partner; and

(B) If the liability was incurred by the partnership more than two years prior to the earlier of the date the partnership agrees in writing to transfer the property or the date the partnership transfers the property to the partner, that liability is a qualified liability whether or not it has encumbered the transferred property throughout the two-year period.

(c) *Disclosure rules.* Similar to the rules provided in §§ 1.707–3(c)(2) and 1.707–5(a)(7)(ii), a partnership is to disclose to the Internal Revenue Service, in accordance with § 1.707–8, the facts in the following circumstances:

(1) When a partnership transfers property to a partner and the partner transfers money or other consideration to the partnership within a two-year period (without regard to the order of the transfers) and the partnership treats the transfers as other than a sale for tax purposes; and

(2) When a partner assumes or takes subject to a liability of a partnership in connection with a transfer of property by the partnership to the partner, and the partnership incurred the liability within the two-year period prior to the earlier of the date the partnership agrees in writing to the transfer of property or the date the partnership transfers the property, and the partnership treats the liability as a qualified liability under rules similar to § 1.707–5(a)(6)(i)(B).

(d) *Examples.* The following examples illustrate the rules of this section.

Example 1. Sale of property by partnership to partner. (i) A is a member of a partnership. The partnership transfers property X to A. At the time of the transfer, property X has a fair market value of $1,000,000. One year after the transfer, A transfers $1,100,000 to the partnership. Assume that under the rules of section 1274 the imputed principal amount of an obligation to transfer $1,100,000 one year after the transfer of property X is $1,000,000 on the date of the transfer.

(ii) Since the transfer of $1,100,000 to the partnership by A is made within two years of the transfer of property X to A, under rules similar to those provided in § 1.707–3(c), the transfers are presumed to be a sale unless the facts and circumstances clearly establish otherwise. If no facts exist that would rebut this presumption, on the date that the partnership transfers property X to A, the partnership is treated as having sold property X to A in exchange for A's obligation to transfer $1,100,000 to the partnership one year later.

Example 2. Assumption of liability by partner. (i) B is a member of an existing partnership. The partnership transfers property Y to B. On the date of the transfer, property Y has a fair market value of $1,000,000 and is encumbered by a nonrecourse liability of $600,000. B takes the property subject to the liability. The partnership incurred the nonrecourse liability six months prior to the transfer of property Y to B and used the proceeds to purchase an unrelated asset. Assume that, under rule of §1.707–5(a)(2)(ii) (which determines a partner's share of a nonrecourse liability), B's share of the nonrecourse liability immediately before the transfer of property Y was $100,000.

(ii) The liability is not allocable under the rules of §1.163–8T to capital expenditures with respect to the property transferred to B and was not incurred in the ordinary course of the trade or business in which the property transferred to the partner was used or held. Since the partnership incurred the nonrecourse liability within two years of the transfer to B, under rules similar to those provided in §1.707–5(a)(5), the liability is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish the contrary. Assuming no facts exist to rebut this presumption, the liability taken subject to by B is not a qualified liability. The partnership is treated as having received, on the date of the transfer of property Y to B, $500,000 ($600,000 liability assumed by B less B's share of the $100,000 liability immediately prior to the transfer) as consideration for the sale of one-half ($500,000/$1,000,000) of property Y to B. The partnership is also treated as having distributed to B, in B's capacity as a partner, the other one-half of property Y.

[T.D. 8439, 57 FR 44987, Sept. 30, 1992]

§1.707–7 Disguised sales of partnership interests. [Reserved]

§1.707–8 Disclosure of certain information.

(a) *In general.* The disclosure referred to in §1.707–3(c)(2) (regarding certain transfers made within two years of each other), §1.707–5(a)(7)(ii) (regarding a liability incurred within two years prior to a transfer of property), and §1.707–6(c) (relating to transfers of property from a partnership to a partner in situations analogous to those listed above) is to be made in accordance with paragraph (b) of this section.

(b) *Method of providing disclosure.* Disclosure is to be made on a completed Form 8275 or on a statement attached to the return of the transferor of property for the taxable year of the transfer that includes the following:

(1) A caption identifying the statement as disclosure under section 707;

(2) An identification of the item (or group of items) with respect to which disclosure is made;

(3) The amount of each item; and

(4) The facts affecting the potential tax treatment of the item (or items) under section 707.

(c) *Disclosure by certain partnerships.* If more than one partner transfers property to a partnership pursuant to a plan, the disclosure required by this section may be made by the partnership on behalf of all the transferors rather than by each transferor separately.

[T.D. 8439, 57 FR 44988, Sept. 30, 1992]

§1.707–9 Effective dates and transitional rules.

(a) *Sections 1.707–3 through 1.707–6*—(1) *In general.* Except as provided in paragraph (a)(3) of this section, §§1.707–3 through 1.707–6 apply to any transaction with respect to which all transfers that are part of a sale of an item of property occur after April 24, 1991.

(2) *Transfers occurring on or before April 24, 1991.* Except as otherwise provided in paragraph (a)(3) of this section, in the case of any transaction with respect to which one or more of the transfers occurs on or before April 24, 1991, the determination of whether the transaction is a disguised sale of property (including a partnership interest) under section 707(a)(2) is to be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 73 of the Tax Reform Act of 1984 (Pub. L. 98–369, 98 Stat. 494). See H.R. Rep. No. 861, 98th Cong., 2d Sess. 859–62 (1984); S. Prt. No. 169 (Vol. I), 98th Cong., 2d Sess. 223–32 (1984); H.R. Rep. No. 432 (Pt. 2), 98th Cong., 2d Sess. 1216–21 (1984).

(3) *Effective date of section 73 of the Tax Reform Act of 1984.* Sections 1.707–3 through 1.707–6 do not apply to any transfer of money or other consideration to which section 73(a) of the Tax Reform Act of 1984 (Pub. L. 98–369, 98 Stat. 494) does not apply pursuant to section 73(b) of that Act.

(b) *Section 1.707–8 disclosure of certain information.* The disclosure provisions described in §1.707–8 apply to transactions with respect to which all transfers that are part of a sale of property occur after September 30, 1992.

[T.D. 8439, 57 FR 44989, Sept. 30, 1992]

§ 1.708–1 Continuation of partnership.

(a) *General rule.* For purposes of subchapter K, chapter 1 of the Code, an existing partnership shall be considered as continuing if it is not terminated.

(b) *Termination*—(1) *General rule.* (i) A partnership shall terminate when the operations of the partnership are discontinued and no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. For example, on November 20, 1956, A and B, each of whom is a 20-percent partner in partnership ABC, sell their interests to C, who is a 60-percent partner. Since the business is no longer carried on by any of its partners in a partnership, the ABC partnership is terminated as of November 20, 1956. However, where partners DEF agree on April 30, 1957, to dissolve their partnership, but carry on the business through a winding up period ending September 30, 1957, when all remaining assets, consisting only of cash, are distributed to the partners, the partnership does not terminate because of cessation of business until September 30, 1957.

(a) Upon the death of one partner in a 2-member partnership, the partnership shall not be considered as terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership business.

(b) For the continuation of a partnership where payments are being made under section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest), see paragraph (a)(6) of § 1.736–1.

(ii) A partnership shall terminate when 50 percent or more of the total interest in partnership capital and profits is sold or exchanged within a period of 12 consecutive months. Such sale or exchange includes a sale or exchange to another member of the partnership. However, a disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest, is not a sale or exchange for purposes of this subparagraph. Moreover, if the sale or exchange of an interest in a partnership (upper-tier partnership) that holds an interest in another partnership (lower-tier partnership) results in a termination of the upper-tier partnership, the upper-tier partnership is treated as exchanging its entire interest in the capital and profits of the lower-tier partnership. If the sale or exchange of an interest in an upper-tier partnership does not terminate the upper-tier partnership, the sale or exchange of an interest in the upper-tier partnership is not treated as a sale or exchange of a proportionate share of the upper-tier partnership's interest in the capital and profits of the lower-tier partnership. The previous two sentences apply to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, the sentences may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply the sentences to the termination in a consistent manner. Furthermore, the contribution of property to a partnership does not constitute such a sale or exchange. See, however, paragraph (c)(3) of § 1.731–1. Fifty percent or more of the total interest in partnership capital and profits means 50 percent or more of the total interest in partnership capital plus 50 percent or more of the total interest in partnership profits. Thus, the sale of a 30-percent interest in partnership capital and a 60-percent interest in partnership profits is not the sale or exchange of 50 percent or more of the total interest in partnership capital and profits. If one or more partners sell or exchange interests aggregating 50 percent or more of the total interest in partnership capital and 50 percent or more of the total interest in partnership profits within a period of 12 consecutive months, such sale or exchange is considered as being within the provisions of this subparagraph. When interests are sold or exchanged on different dates, the percentages to be added are determined as of the date of each sale. For example, with respect to the ABC partnership, the sale by A on May 12, 1956, of a 30-percent interest in capital and profits to D, and the sale by B on March 27, 1957, of a 30-percent interest in capital and profits to E, is a sale of a 50-percent or more interest. Accordingly, the partnership is terminated as of March 27, 1957. However, if, on March 27, 1957, D instead of B, sold his 30-percent interest in capital and profits to E, there would be no termination since only one 30-percent interest would have been sold or exchanged within a 12-month period.

(iii) For purposes of subchapter K, chapter 1 of the Code, a partnership taxable year closes with respect to all partners on the date on which the partnership terminates. See section 706(c)(1) and paragraph (c)(1) of §1.706–1. The date of termination is:

(a) For purposes of section 708(b)(1)(A), the date on which the winding up of the partnership affairs is completed.

(b) For purposes of section 708(b)(1)(B), the date of the sale or exchange of a partnership interest which, of itself or together with sales or exchanges in the preceding 12 months, transfers an interest of 50 percent or more in both partnership capital and profits.

(iv) If a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur: The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up. In the latter case, the new partnership terminates in accordance with (b)(1)(i) of this section. This paragraph (b)(1)(iv) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (b)(1)(iv) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (b)(1)(iv) to the termination in a consistent manner. The provisions of this paragraph (b)(1)(iv) are illustrated by the following example:

Example. (i) A and B each contribute $10,000 cash to form AB, a general partnership, as equal partners. AB purchases depreciable Property X for $20,000. Property X increases in value to $30,000, at which time A sells its entire 50 percent interest to C for $15,000 in a transfer that terminates the partnership under section 708(b)(1)(B). At the time of the sale, Property X had an adjusted tax basis of $16,000 and a book value of $16,000 (original $20,000 tax basis and book value reduced by $4,000 of depreciation). In addition, A and B each had a capital account balance of $8,000 (original $10,000 capital account reduced by $2,000 of depreciation allocations with respect to Property X).

(ii) Following the deemed contribution of assets and liabilities by the terminated AB partnership to a new partnership (new AB) and the liquidation of the terminated AB partnership, the adjusted tax basis of Property X in the hands of new AB is $16,000. See Section 723. The book value of Property X in the hands of new partnership AB is also $16,000 (the book value of Property X immediately before the termination) and B and C each have a capital account of $8,000 in new AB (the balance of their capital accounts in AB prior to the termination). See §1.704–1(b)(2)(iv)(*l*) (providing that the deemed contribution and liquidation with regard to the terminated partnership are disregarded in determining the capital accounts of the partners and the books of the new partnership). Additionally, under §301.6109–1(d)(2)(iii) of this chapter, new AB retains the taxpayer identification number of the terminated AB partnership.

(iii) Property X was not section 704(c) property in the hands of terminated AB and is therefore not treated as section 704(c) property in the hands of new AB, even though Property X is deemed contributed to new AB at a time when the fair market value of Property X ($30,000) was different from its adjusted tax basis ($16,000). See §1.704–3(a)(3)(i) (providing that property contributed to a new partnership under §1.708–1(b)(1)(iv) is treated as section 704(c) property only to the extent that the property was section 704(c) property in the hands of the terminated partnership immediately prior to the termination).

(v) If a partnership is terminated by a sale or exchange of an interest in the partnership, a section 754 election (including a section 754 election made by the terminated partnership on its final return) that is in effect for the taxable year of the terminated partnership in which the sale occurs, applies with respect to the incoming partner. Therefore, the bases of partnership assets are adjusted pursuant to sections 743 and 755 prior to their deemed contribution to the new partnership. This paragraph (b)(1)(v) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (b)(1)(v) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (b)(1)(v) to the termination in a consistent manner.

(2) *Special rules*—(i) *Merger or consolidation.* If two or more partnerships merge or consolidate into one partnership, the resulting partnership shall be considered a continuation of the merging or consolidating partnership the members of which own an interest of more than 50 percent in the capital and profits of the resulting partnership. If the resulting partnership can, under the preceding sentence, be considered a continuation of more than one of the merging or consolidating partnerships, it shall, unless the Commissioner permits otherwise, be considered the continuation of that partnership which is credited with the contribution of the greatest dollar value of assets to the resulting partnership. Any other merging or consolidating partnerships shall be considered as terminated. If the members of none of the merging or consolidating partnerships have an interest of more than 50 percent in the capital and profits of the resulting partnership, all of the merged or consolidated partnerships are terminated, and a new partnership results. The taxable years of such merging or consolidating partnerships which are considered terminated shall be closed in accordance with the provisions of section 706(c), and such partnerships shall file their returns for a taxable year ending upon the date of termination, i.e., the date of merger or consolidation. The resulting partnership shall file a return for the taxable year of the merging or consolidating partnership that is considered as continuing. The return shall state that the resulting partnership is a continuation of such merging or consolidating partnership and shall include the names and addresses of the merged or consolidated partnerships. The respective distributive shares of the partners for the periods prior to and subsequent to the date of merger or consolidation shall be shown as a part of the return. The provisions of this subdivision may be illustrated by the following example:

Example. Partnership AB, in whose capital and profits A and B each own a 50-percent interest, and partnership CD, in whose capital and profits C and D each own a 50-percent interest, merge on September 30, 1955, and form partnership ABCD. Partners A, B, C, and D are on a calendar year; partnership AB is also on a calendar year; and partnership CD is on a fiscal year ending June 30th. After the merger, the partners have capital and profits interests as follows: A, 30 percent; B, 30 percent; C, 20 percent; and D, 20 percent. Since A and B together own an interest of more than 50 percent in the capital and profits of partnership ABCD, such partnership shall be considered a continuation of partnership AB and shall continue to file returns on a calendar year basis. Since C and D own an interest of less than 50 percent in the capital and profits of partnership ABCD, the taxable year of partnership CD closes as of September 30, 1955, the date of the merger, and CD partnership is terminated as of that date. Partnership ABCD is required to file a return for the taxable year January 1 to December 31, 1955, indicating thereon that, until September 30, 1955, it was partnership AB. Partnership CD is required to file a return for its final taxable year, July 1 through September 30, 1955.

(ii) *Division of a partnership.* Upon the division of a partnership into two or more partnerships, any resulting partnership or partnerships shall be considered a continuation of the prior partnership if its members had an interest of more than 50 percent in the capital and profits of the prior partnership. Any other resulting partnership will not be considered a continuation of the prior partnership but will be considered a new partnership. If the members of none of the resulting partnerships owned an interest of more than 50 percent in the capital and profits of the divided partnership, the divided partnership is terminated. Where members of a partnership which has been divided into two or more partnerships do not become members of a resulting partnership which is considered a continuation of the prior partnership, such partner's interests shall be considered liquidated as of the date of the division. The resulting partnership that is regarded as continuing shall file a return for the taxable year of the partnership that has been divided. The return shall state that the partnership is a continuation of the divided partnership and shall set forth separately the respective distributive shares of the partners for the periods prior to and subsequent to the date of division. The provisions of this subdivision may be illustrated by the following example:

Example. Partnership ABCD is in the real estate and insurance business. A owns a 40-percent interest, and B, C, and D each owns a 20-percent interest, in the capital and profits of the partnership. The partnership and the partners report their income on a calendar year. They agree to separate the real estate and insurance business as of November 1, 1955, and to form two partnerships; partnership AB to take over the real estate business, and partnership CD to take over the insurance business. Since members of resulting partnership AB owned more than a 50-percent interest in the capital and profits of partnership ABCD (A, 40 percent, and B, 20 percent), partnership AB shall be considered a continuation of partnership ABCD. Partnership AB is required to file a return for the taxable year January 1 to December 31, 1955, indicating thereon that until November 1, 1955, it was partnership ABCD. In forming partnership CD, partners C and D may contribute the property distributed to them in liquidation of their entire interests in divided partnership ABCD. Partnership CD will be required to file a return for the taxable year it adopts pursuant to section 706(b) and paragraph (b) of §1.706–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8717, 62 FR 25500, May 9, 1997]

§1.709–1 Treatment of organization and syndication costs.

(a) *General rule.* Except as provided in paragraph (b) of this section, no deduction shall be allowed under chapter 1 of the Code to a partnership or to any partner for any amounts paid or incurred, directly or indirectly, in partnership taxable years beginning after December 31, 1975, to organize a partnership, or to promote the sale of, or to sell, an interest in the partnership.

(b) *Amortization of organization expenses.* (1) Under section 709(b) of the Code, a partnership may elect to treat its organizational expenses (as defined in section 709(b)(2) and in §1.709–2(a)) paid or incurred in partnership taxable years beginning after December 31, 1976, as deferred expenses. If a partnership elects to amortize organizational expenses, it must select a period of not less than 60 months, over which the partnership will amortize all such expenses on a straight line basis. This period must begin with the month in which the partnership begins business (as determined under §1.709–2(c)). However, in the case of a partnership on the cash receipts and disbursements method of accounting, no deduction shall be allowed for a taxable year with respect to any such expenses that have not been paid by the end of that taxable year. Portions of such expenses which would have been deductible under section 709(b) in a prior taxable year if the expenses had been paid are deductible in the year of payment. The election is irrevocable and the period selected by the partnership in making its election may not be subsequently changed.

(2) If there is a winding up and complete liquidation of the partnership prior to the end of the amortization period, the unamortized amount of organizational expenses is a partnership deduction in its final taxable year to the extent provided under section 165 (relating to losses). However, there is no partnership deduction with respect to its capitalized syndication expenses.

(c) *Time and manner of making election.* The election to amortize organizational expenses provided by section 709(b) shall be made by attaching a statement to the partnership's return of income for the taxable year in which the partnership begins business. The statement shall set forth a description of each organizational expense incurred (whether or not paid) with the amount of the expense, the date each expense was incurred, the month in which the partnership began business, and the number of months (not less than 60) over which the expenses are to be amortized. A taxpayer on the cash receipts and disbursements method of accounting shall also indicate the amount paid before the end of the taxable year with respect to each such expense. Expenses less than $10 need not be separately listed, provided the total amount of these expenses is listed with the dates on which the first and last of such expenses were incurred, and, in the case of a taxpayer on the cash receipts and disbursements method of accounting, the aggregate amount of such expenses that was paid by the end of the taxable year is stated. In the case of a partnership which begins business in a taxable year that ends after March 31, 1983, the original return and statement must be filed (and the election made) not later than the date prescribed by law for filing the return (including any extensions of time) for that taxable year. Once an election has been made, an amended return (or returns) and statement (or statements) may be filed to include any organizational expenses not included in the partnership's original return and statement.

[T.D. 7891, 48 FR 20048, May 4, 1983]

§ 1.709–2 Definitions.

(a) *Organizational expenses.* Section 709(b)(2) of the Internal Revenue Code defines organizational expenses as expenses which:

(1) Are incident to the creation of the partnership;

(2) Are chargeable to capital account; and

(3) Are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would (but for section 709(a)) be amortized over such life.

An expenditure which fails to meet one or more of these three tests does not qualify as an organizational expense for purposes of section 709(b) and this section. To satisfy the statutory requirement described in paragraph (a)(1) of this section, the expense must be incurred during the period beginning at a point which is a reasonable time before the partnership begins business and ending with the date prescribed by law for filing the partnership return (determined without regard to any extensions of time) for the taxable year the partnership begins business. In addition, the expenses must be for creation of the partnership and not for operation or starting operation of the partnership trade or business. To satisfy the statutory requirement described in paragraph (a)(3) of this section, the expense must be for an item of a nature normally expected to benefit the partnership throughout the entire life of the partnership. The following are examples of organizational expenses within the meaning of section 709 and this section: Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement; accounting fees for services incident to the organization of the partnership; and filing fees. The following are examples of expenses that are not organizational expenses within the meaning of section 709 and this section (regardless of how the partnership characterizes them): Expenses connected with acquiring assets for the partnership or transferring assets to the partnership; expenses connected with the admission or removal of partners other than at the time the partnership is first organized; expenses connected with a contract relating to the operation of the partnership trade or business (even where the contract is between the partnership and one of its members); and syndication expenses.

(b) *Syndication expenses.* Syndication expenses are expenses connected with the issuing and marketing of interests in the partnership. Examples of syndication expenses are brokerage fees; registration fees; legal fees of the underwriter or placement agent and the issuer (the general partner or the partnership) for securities advice and for advice pertaining to the adequacy of tax disclosures in the prospectus or placement memorandum for securities law purposes; accounting fees for preparation of representations to be included in the offering materials; and printing costs of the prospectus, placement memorandum, and other selling and promotional material. These expenses are not subject to the election under section 709(b) and must be capitalized.

(c) *Beginning business.* The determination of the date a partnership begins business for purposes of section 709 presents a question of fact that must be determined in each case in light of all the circumstances of the particular case. Ordinarily, a partnership begins business when it starts the business operations for which it was organized. The mere signing of a partnership agreement is not alone sufficient to show the beginning of business.

If the activities of the partnership have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have begun business. Accordingly, the acquisition of operating assets which are necessary to the type of business contemplated may constitute beginning business for these purposes. The term *operating assets,* as used herein, means assets that are in a state of readiness to be placed in service within a reasonable period following their acquisition.

[T.D. 7891, 48 FR 20049, May 4, 1983]

CONTRIBUTIONS, DISTRIBUTIONS, AND TRANSFERS

CONTRIBUTIONS TO A PARTNERSHIP

§1.721–1 Nonrecognition of gain or loss on contribution.

(a) No gain or loss shall be recognized either to the partnership or to any of its partners upon a contribution of property, including installment obligations, to the partnership in exchange for a partnership interest. This rule applies whether the contribution is made to a partnership in the process of formation or to a partnership which is already formed and operating. Section 721 shall not apply to a transaction between a partnership and a partner not acting in his capacity as a partner since such a transaction is governed by section 707. Rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it. In all cases, the substance of the transaction will govern, rather than its form. See paragraph (c)(3) of §1.731–1. Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721. For the rules governing the treatment of liabilities to which contributed property is subject, see section 752 and §1.752–1.

(b)(1) Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest. To the extent that an interest in capital representing compensation for services rendered by the decedent prior to his death is transferred after his death to the decedent's successor in interest, the fair market value of such interest is income in respect of a decedent under section 691.

(2) To the extent that the value of such interest is: (i) Compensation for services rendered to the partnership, it is a guaranteed payment for services under section 707(c); (ii) compensation for services rendered to a partner, it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under this chapter.

(c) *Underwritings of partnership interests*—(1) *In general.* For the purpose of section 721, if a person acquires a partnership interest from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires the partnership interest is treated as transferring cash directly to the partnership in exchange for the partnership interest and the underwriter is disregarded. A qualified underwriting transaction is a transaction in which a partnership issues partnership interests for cash in an underwriting in which either the underwriter is an agent of the partnership or the underwriter's ownership of the partnership interests is transitory.

(2) *Effective date.* This paragraph (c) is effective for qualified underwriting transactions occurring on or after May 1, 1996.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8665, 61 FR 19189, May 1, 1996]

§ 1.722–1 Basis of contributing partner's interest.

The basis to a partner of a partnership interest acquired by a contribution of property, including money, to the partnership shall be the amount of money contributed plus the adjusted basis at the time of contribution of any property contributed. If the acquisition of an interest in partnership capital results in taxable income to a partner, such income shall constitute an addition to the basis of the partner's interest. See paragraph (b) of § 1.721–1. If the contributed property is subject to indebtedness or if liabilities of the partner are assumed by the partnership, the basis of the contributing partner's interest shall be reduced by the portion of the indebtedness assumed by the other partners, since the partnership's assumption of his indebtedness is treated as a distribution of money to the partner. Conversely, the assumption by the other partners of a portion of the contributor's indebtedness is treated as a contribution of money by them. See section 752 and § 1.752–1. The provisions of this section may be illustrated by the following examples:

Example 1. A acquired a 20-percent interest in a partnership by contributing property. At the time of A's contribution, the property had a fair market value of $10,000, an adjusted basis to A of $4,000, and was subject to a mortgage of $2,000. Payment of the mortgage was assumed by the partnership. The basis of A's interest in the partnership is $2,400, computed as follows:

Adjusted basis to A of property contributed	$4,000
Less portion of mortgage assumed by other partners which must be treated as a distribution (80 percent of $2,000)	1,600
Basis of A's interest	2,400

Example 2. If, in example 1 of this section, the property contributed by A was subject to a mortgage of $6,000, the basis of A's interest would be zero, computed as follows:

Adjusted basis to A of property contributed	$4,000
Less portion of mortgage assumed by other partners which must be treated as a distribution (80 percent of $6,000)	4,800
	(800)

Since A's basis cannot be less than zero, the $800 in excess of basis, which is considered as a distribution of money under section 752(b), is treated as capital gain from the sale or exchange or a partnership interest. See section 731(a).

§ 1.723–1 Basis of property contributed to partnership.

The basis to the partnership of property contributed to it by a partner is the adjusted basis of such property to the contributing partner at the time of the contribution. Since such property has the same basis in the hands of the partnership as it had in the hands of the contributing partner, the holding period of such property for the partnership includes the period during which it was held by the partner. See section 1223(2). For elective adjustments to the basis of partnership property arising from distributions or transfers of partnership interests, see sections 732(d), 734(b), and 743(b).

DISTRIBUTIONS BY A PARTNERSHIP

§ 1.731–1 Extent of recognition of gain or loss on distribution.

(a) *Recognition of gain or loss to partner*—(1) *Recognition of gain.* (i) Where money is distributed by a partnership to a partner, no gain shall be recognized to the partner except to the extent that the amount of money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. This rule is applicable both to current distributions (i.e., distributions other than in liquidation of an entire interest) and to distributions in liquidation of a partner's entire interest in a partnership. Thus, if a partner with a basis for his interest of $10,000 receives a distribution of cash of $8,000 and property with a fair market value of $3,000, no gain is recognized to him. If $11,000 cash were distributed, gain would be recognized to the extent of $1,000. No gain shall be recognized to a distributee partner with respect to a distribution of property (other than money) until he sells or otherwise disposes of such property, except to the extent otherwise provided by section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest) and section 751 (relating to unrealized receivables and inventory items). See section 731(c) and paragraph (c) of this section.

(ii) For the purposes of sections 731 and 705, advances or drawings of money or property against a partner's distributive share of income shall be treated as current distributions made on the last day of the partnership taxable year with respect to such partner.

(2) *Recognition of loss.* Loss is recognized to a partner only upon liquidation of his entire interest in the partnership, and only if the property distributed to him consists solely of money, unrealized receivables (as defined in section 751(c)), and inventory items (as defined in section 751(d)(2)). The term *liquidation of a partner's interest,* as defined in section 761(d), is the termination of the partner's entire interest in the partnership by means of a distribution or a series of distributions. Loss is recognized to the distributee partner in such cases to the extent of the excess of the adjusted basis of such partner's interest in the partnership at the time of the distribution over the sum of:

(i) Any money distributed to him, and

(ii) The basis to the distributee, as determined under section 732, of any unrealized receivables and inventory items that are distributed to him.

If the partner whose interest is liquidated receives any property other than money, unrealized receivables, or inventory items, then no loss will be recognized. Application of the provisions of this subparagraph may be illustrated by the following examples:

Example 1. Partner A has a partnership interest in partnership ABC with an adjusted basis to him of $10,000. He retires from the partnership and receives, as a distribution in liquidation of his entire interest, his share of partnership property. This share is $5,000 cash and inventory with a basis to him (under section 732) of $3,000. Partner A realizes a capital loss of $2,000, which is recognized under section 731(a)(2).

Example 2. Partner B has a partnership interest in partnership BCD with an adjusted basis to him of $10,000. He retires from the partnership and receives, as a distribution in liquidation of his entire interest, his share of partnership property. This share is $4,000 cash, real property (used in the trade or business) with an adjusted basis to the partnership of $2,000, and unrealized receivables having a basis to him (under section 732) of $3,000. No loss will be recognized to B on the transaction because he received property other than money, unrealized receivables, and inventory items. As determined under section 732, the basis to B for the real property received is $3,000.

(3) *Character of gain or loss.* Gain or loss recognized under section 731(a) on a distribution is considered gain or loss from the sale or exchange of the partnership interest of the distributee partner, that is, capital gain or loss.

(b) *Gain or loss recognized by partnership.* A distribution of property (including money) by a partnership to a partner does not result in recognized gain or loss to the partnership under section 731. However, recognized gain or loss may result to the partnership from certain distributions which, under section 751(b), must be treated as a sale or exchange of property between the distributee partner and the partnership.

(c) *Exceptions.* (1) Section 731 does not apply to the extent otherwise provided by:

(i) Section 736 (relating to payments to a retiring partner or to a deceased partner's successor in interest) and

(ii) Section 751 (relating to unrealized receivables and inventory items).

For example, payments under section 736(a), which are considered as a distributive share or guaranteed payment, are taxable as such under that section.

(2) The receipt by a partner from the partnership of money or property under an obligation to repay the amount of such money or to return such property does not constitute a distribution subject to section 731 but is a loan governed by section 707(a). To the extent that such an obligation is canceled, the obligor partner will be considered to have received a distribution of money or property at the time of cancellation.

(3) If there is a contribution of property to a partnership and within a short period:

(i) Before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or

(ii) After such contribution the contributed property is distributed to another partner,

such distribution may not fall within the scope of section 731. Section 731 does not apply to a distribution of property, if, in fact, the distribution was made in order to effect an exchange of property between two or more of the partners or between the partnership and a partner. Such a transaction shall be treated as an exchange of property.

§1.731–2 Partnership distributions of marketable securities.

(a) *Marketable securities treated as money*. Except as otherwise provided in section 731(c) and this section, for purposes of sections 731(a)(1) and 737, the term money includes marketable securities and such securities are taken into account at their fair market value as of the date of the distribution.

(b) *Reduction of amount treated as money*—(1) *Aggregation of securities.* For purposes of section 731(c)(3)(B) and this paragraph (b), all marketable securities held by a partnership are treated as marketable securities of the same class and issuer as the distributed security.

(2) *Amount of reduction*. The amount of the distribution of marketable securities that is treated as a distribution of money under section 731(c) and paragraph (a) of this section is reduced (but not below zero) by the excess, if any, of—

(i) The distributee partner's distributive share of the net gain, if any, which would be recognized if all the marketable securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value; over

(ii) The distributee partner's distributive share of the net gain, if any, which is attributable to the marketable securities held by the partnership immediately after the transaction, determined by using the same fair market value as used under paragraph (b)(2)(i) of this section.

(3) *Distributee partner's share of net gain*. For purposes of section 731(c)(3)(B) and paragraph (b)(2) of this section, a partner's distributive share of net gain is determined—

(i) By taking into account any basis adjustments under section 743(b) with respect to that partner;

(ii) Without taking into account any special allocations adopted with a principal purpose of avoiding the effect of section 731(c) and this section; and

(iii) Without taking into account any gain or loss attributable to a distributed security to which paragraph (d)(1) of this section applies.

(c) *Marketable securities*—(1) *In general.* For purposes of section 731(c) and this section, the term *marketable securities* is defined in section 731(c)(2).

(2) *Actively traded.* For purposes of section 731(c) and this section, a financial instrument is actively traded (and thus is a marketable security) if it is of a type that is, as of the date of distribution, actively traded within the meaning of section 1092(d)(1). Thus, for example, if *XYZ* common stock is listed on a national securities exchange, particular shares of *XYZ* common stock that are distributed by a partnership are marketable securities even if those particular shares cannot be resold by the distributee partner for a designated period of time.

(3) *Interests in an entity*—(i) *Substantially all.* For purposes of section 731(c)(2)(B)(v) and this section, substantially all of the assets of an entity consist (directly or indirectly) of marketable securities, money, or both only if 90 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

(ii) *Less than substantially all.* For purposes of section 731(c)(2)(B)(vi) and this section, an interest in an entity is a marketable security to the extent that the value of the interest is attributable (directly or indirectly) to marketable securities, money, or both, if less than 90 percent but 20 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

(4) *Value of assets.* For purposes of section 731(c) and this section, the value of the assets of an entity is determined without regard to any debt that may encumber or otherwise be allocable to those assets, other than debt that is incurred to acquire an asset with a principal purpose of avoiding or reducing the effect of section 731(c) and this section.

(d) *Exceptions*—(1) *In general.* Except as otherwise provided in paragraph (d)(2) of this section, section 731(c) and this section do not apply to the distribution of a marketable security if—

(i) The security was contributed to the partnership by the distributee partner;

(ii) The security was acquired by the partnership in a nonrecognition transaction, and the following conditions are satisfied—

(A) The value of any marketable securities and money exchanged by the partnership in the nonrecognition transaction is less than 20 percent of the value of all the assets exchanged by the partnership in the nonrecognition transaction; and

(B) The partnership distributed the security within five years of either the date the security was acquired by the partnership or, if later, the date the security became marketable; or

(iii) The security was not a marketable security on the date acquired by the partnership, and the following conditions are satisfied—

(A) The entity that issued the security had no outstanding marketable securities at the time the security was acquired by the partnership;

(B) The security was held by the partnership for at least six months before the date the security became marketable; and

(C) The partnership distributed the security within five years of the date the security became marketable.

(2) *Anti-stuffing rule.* Paragraph (d)(1) of this section does not apply to the extent that 20 percent or more of the value of the distributed security is attributable to marketable securities or money contributed (directly or indirectly) by the partnership to the entity to which the distributed security relates after the security was acquired by the partnership (other than marketable securities contributed by the partnership that were originally contributed to the partnership by the distributee partner). For purposes of this paragraph (d)(2), money contributed by the distributing partnership does not include any money deemed contributed by the partnership as a result of section 752.

(3) *Successor security.* Section 731(c) and this section apply to the distribution of a marketable security acquired by the partnership in a nonrecognition transaction in exchange for a security the distribution of which immediately prior to the exchange would have been excepted under this paragraph (d) only to the extent that section 731(c) and this section otherwise would have applied to the exchanged security.

(e) *Investment partnerships*—(1) *In general.* Section 731(c) and this section do not apply to the distribution of marketable securities by an investment partnership (as defined in section 731(c)(3)(C)(i)) to an eligible partner (as defined in section 731(c)(3)(C)(iii)).

(2) *Eligible partner*—(i) *Contributed services.* For purposes of section 731(c)(3)(C)(iii) and this section, a partner is not treated as a partner other than an eligible partner solely because the partner contributed services to the partnership.

(ii) *Contributed partnership interests.* For purposes of determining whether a partner is an eligible partner under section 731(c)(3)(C), if the partner has contributed to the investment partnership an interest in another partnership that meets the requirements of paragraph (e)(4)(i) of this section after the contribution, the contributed interest is treated as property specified in section 731(c)(3)(C)(i).

(3) *Trade or business activities.* For purposes of section 731(c)(3)(C) and this section, a partnership is not treated as engaged in a trade or business by reason of——

(i) Any activity undertaken as an investor, trader, or dealer in any asset described in section 731(c)(3)(C)(i), including the receipt of commitment fees, break-up fees, guarantee fees, director's fees, or similar fees that are customary in and incidental to any activities of the partnership as an investor, trader, or dealer in such assets;

(ii) Reasonable and customary management services (including the receipt of reasonable and customary fees in exchange for such management services) provided to an investment partnership (within the meaning of section 731(c)(3)(C)(i)) in which the partnership holds a partnership interest; or

(iii) Reasonable and customary services provided by the partnership in assisting the formation, capitalization, expansion, or offering of interests in a corporation (or other entity) in which the partnership holds or acquires a significant equity interest (including the provision of advice or consulting services, bridge loans, guarantees of obligations, or service on a company's board of directors), provided that the anticipated receipt of compensation for the services, if any, does not represent a significant purpose for the partnership's investment in the entity and is incidental to the investment in the entity.

(4) *Partnership tiers.* For purposes of section 731(c)(3)(C)(iv) and this section, a partnership (upper-tier partnership) is not treated as engaged in a trade or business engaged in by, or as holding (instead of a partnership interest) a proportionate share of the assets of, a partnership (lower-tier partnership) in which the partnership holds a partnership interest if——

(i) The upper-tier partnership does not actively and substantially participate in the management of the lower-tier partnership; and

(ii) The interest held by the upper-tier partnership is less than 20 percent of the total profits and capital interests in the lower-tier partnership.

(f) *Basis rules*—(1) *Partner's basis*—(i) *Partner's basis in distributed securities.* The distributee partner's basis in distributed marketable securities with respect to which gain is recognized by reason of section 731(c) and this section is the basis of the security determined under section 732, increased by the amount of such gain. Any increase in the basis of the marketable securities attributable to gain recognized by reason of section 731(c) and this section is allocated to marketable securities in proportion to their respective amounts of unrealized appreciation in the hands of the partner before such increase.

(ii) *Partner's basis in partnership interest.* The basis of the distributee partner's interest in the partnership is determined under section 733 as if no gain were recognized by the partner on the distribution by reason of section 731(c) and this section.

(2) *Basis of partnership property.* No adjustment is made to the basis of partnership property under section 734 as a result of any gain recognized by a partner, or any step-up in the basis in the distributed marketable securities in the hands of the distributee partner, by reason of section 731(c) and this section.

(g) *Coordination with other sections*—(1) *Sections 704(c)(1)(B) and 737*—(i) *In general.* If a distribution results in the application of sections 731(c) and one or both of sections 704(c)(1)(B) and 737, the effect of the distribution is determined by applying section 704(c)(1)(B) first, section 731(c) second, and finally section 737.

(ii) *Section 704(c)(1)(B).* The basis of the distributee partner's interest in the partnership for purposes of determining the amount of gain, if any, recognized by reason of section 731(c) (and for determining the basis of the marketable securities in the hands of the distributee partner) includes the increase or decrease, if any, in the partner's basis that occurs under section 704(c)(1)(B)(iii) as a result of a distribution to another partner of property contributed by the distributee partner in a distribution that is part of the same distribution as the marketable securities.

(iii) *Section 737*—(A) *Marketable securities as other property.* A distribution of marketable securities is treated as a distribution of property other than money for purposes of section 737 to the extent that the marketable securities are not treated as money under section 731(c). In addition, marketable securities contributed to the partnership are treated as property other than money in determining the contributing partner's net precontribution gain under section 737(b).

(B) *Basis increase under section 737.* The basis of the distributee partner's interest in the partnership for purposes of determining the amount of gain, if any, recognized by reason of section 731(c) (and for determining the basis of the marketable securities in the hands of the distributee partner) does not include the increase, if any, in the partner's basis that occurs under section 737(c)(1) as a result of a distribution of property to the distributee partner in a distribution that is part of the same distribution as the marketable securities.

(2) *Section 708(b)(1)(B).* If a partnership termination occurs under section 708(b)(1)(B), the successor partnership will be treated as if there had been no termination for purposes of section 731(c) and this section. Accordingly, a section 708(b)(1)(B) termination will not affect whether a partnership qualifies for any of the exceptions in paragraphs (d) and (e) of this section. In addition, a deemed distribution that may occur as a result of a section 708(b)(1)(B) termination will not be subject to section 731(c) and this section.

(h) *Anti-abuse rule.* The provisions of section 731(c) and this section must be applied in a manner consistent with the purpose of section 731(c) and the substance of the transaction. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 731(c) and this section, the Commissioner can recast the transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 731(c) and this section. Whether a tax result is inconsistent with the purpose of section 731(c) and this section must be determined based on all the facts and circumstances. For example, under the provisions of this paragraph (h)—

(1) A change in partnership allocations or distribution rights with respect to marketable securities may be treated as a distribution of the marketable securities subject to section 731(c) if the change in allocations or distribution rights is, in substance, a distribution of the securities;

(2) A distribution of substantially all of the assets of the partnership other than marketable securities and money to some partners may also be treated as a distribution of marketable securities to the remaining partners if the distribution of the other property and the withdrawal of the other partners is, in substance, equivalent to a distribution of the securities to the remaining partners; and

(3) The distribution of multiple properties to one or more partners at different times may also be treated as part of a single distribution if the distributions are part of a single plan of distribution.

(i) [Reserved]

(j) *Examples.* The following examples illustrate the rules of this section. Unless otherwise specified, all securities held by a partnership are marketable securities within the meaning of section 731(c); the partnership holds no marketable securities other than the securities described in the example; all distributions by the partnership are subject to section 731(a) and are not subject to sections 704(c)(1)(B), 707(a)(2)(B), 751(b), or 737; and no securities are eligible for an exception to section 731(c). The examples are as follows:

Example 1. Recognition of gain. (i) *A* and *B* form partnership *AB* as equal partners. *A* contributes property with a fair market value of $1,000 and an adjusted tax basis of $250. *B* contributes $1,000 cash. *AB* subsequently purchases Security *X* for $500 and immediately distributes the security to *A* in a current distribution. The basis in *A*'s interest in the partnership at the time of distribution is $250.

(ii) The distribution of Security *X* is treated as a distribution of money in an amount equal to the fair market value of Security *X* on the date of distribution ($500). (The amount of the distribution that is treated as money is not reduced under section 731(c)(3)(B) and paragraph (b) of this section because, if Security *X* had been sold immediately before the distribution, there would have been no gain recognized by *AB* and *A*'s distributive share of the gain would therefore have been zero.) As a result, *A* recognizes $250 of gain under section 731(a)(1) on the distribution ($500 distribution of money less $250 adjusted tax basis in *A*'s partnership interest).

Example 2. Reduction in amount treated as money—in general. (i) *A* and *B* form partnership *AB* as equal partners. *AB* subsequently distributes Security *X* to *A* in a current distribution. Immediately before the distribution, *AB* held securities with the following fair market values, adjusted tax bases, and unrecognized gain or loss:

	Value	Basis	Gain (Loss)
Security X	100	70	30
Security Y	100	80	20
Security Z	100	110	(10)

(ii) If *AB* had sold the securities for fair market value immediately before the distribution to *A*, the partnership would have recognized $40 of net gain ($30 gain on Security *X* plus $20 gain on Security *Y* minus $10 loss on Security *Z*). *A*'s distributive share of this gain would have been $20 (one-half of $40 net gain). If *AB* had sold the remaining securities immediately after the distribution of Security *X* to *A*, the partnership would have $10 of net gain ($20 of gain on Security *Y* minus $10 loss on Security *Z*). *A*'s distributive share of this gain would have been $5 (one-half of $10 net gain). As a result, the distribution resulted in a decrease of $15 in *A*'s distributive share of the net gain in *AB*'s securities ($20 net gain before distribution minus $5 net gain after distribution).

(iii) Under paragraph (b) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by $15. The distribution of Security *X* is therefore treated as a distribution of $85 of money to *A* ($100 fair market value of Security *X* minus $15 reduction).

Example 3. Reduction in amount treated as money—carried interest. (i) *A* and *B* form partnership *AB*. *A* contributes $1,000 and provides substantial services to the partnership in exchange for a 60 percent interest in partnership profits. *B* contributes $1,000 in exchange for a 40 percent interest in partnership profits. *AB* subsequently distributes Security *X* to *A* in a current distribution. Immediately before the distribution, *AB* held securities with the following fair market values, adjusted tax bases, and unrecognized gain:

	Value	Basis	Gain
Security *X*	100	80	20
Security *Y*	100	90	10

(ii) If *AB* had sold the securities for fair market value immediately before the distribution to *A*, the partnership would have recognized $30 of net gain ($20 gain on Security *X* plus $10 gain on Security *Y*). *A*'s distributive share of this gain would have been $18 (60 percent of $30 net gain). If *AB* had sold the remaining securities immediately after the distribution of Security *X* to *A*, the partnership would have $10 of net gain ($10 gain on Security *Y*). *A*'s distributive share of this gain would have been $6 (60 percent of $10 net gain). As a result, the distribution resulted in a decrease of $12 in *A*'s distributive share of the net gain in *AB*'s securities ($18 net gain before distribution minus $6 net gain after distribution).

(iii) Under paragraph (b) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by $12. The distribution of Security *X* is therefore treated as a distribution of $88 of money to *A* ($100 fair market value of Security *X* minus $12 reduction).

Example 4. Reduction in amount treated as money—change in partnership allocations. (i) *A* is admitted to partnership *ABC* as a partner with a 1 percent interest in partnership profits. At the time of *A*'s admission, *ABC* held no securities. *ABC* subsequently acquires Security *X*. *A*'s interest in partnership profits is subsequently increased to 2 percent for securities acquired after the increase. *A* retains a 1 percent interest in all securities acquired before the increase. *ABC* then acquires Securities *Y* and *Z* and later distributes Security *X* to *A* in a current distribution. Immediately before the distribution, the securities held by *ABC* had the following fair market values, adjusted tax bases, and unrecognized gain or loss:

	Value	Basis	Gain (Loss)
Security *X*	1,000	500	500
Security *Y*	1,000	800	200
Security *Z*	1,000	1,100	(100)

(ii) If *ABC* had sold the securities for fair market value immediately before the distribution to *A*, the partnership would have recognized $600 of net gain ($500 gain on Security *X* plus $200 gain on Security *Y* minus $100 loss on Security *Z*). *A*'s distributive share of this gain would have been $7 (1 percent of $500 gain on Security *X* plus 2 percent of $200 gain on Security *Y* minus 2 percent of $100 loss on Security *Z*).

(iii) If *ABC* had sold the remaining securities immediately after the distribution of Security *X* to *A*, the partnership would have $100 of net gain ($200 gain on Security *Y* minus $100 loss on Security *Z*). *A*'s distributive share of this gain would have been $2 (2 percent of $200 gain on Security *Y* minus 2 percent of $100 loss on Security *Z*). As a result, the distribution resulted in a decrease of $5 in *A*'s distributive share of the net gain in *ABC*'s securities ($7 net gain before distribution minus $2 net gain after distribution).

(iv) Under paragraph (b) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by $5. The distribution of Security *X* is therefore treated as a distribution of $995 of money to *A* ($1000 fair market value of Security *X* minus $5 reduction).

Example 5. Basis consequences—distribution of marketable security. (i) *A* and *B* form partnership *AB* as equal partners. *A* contributes nondepreciable real property with a fair market value and adjusted tax basis of $100.

(ii) *AB* subsequently distributes Security *X* with a fair market value of $120 and an adjusted tax basis of $90 to *A* in a current distribution. At the time of distribution, the basis in *A*'s interest in the partnership is $100. The amount of the distribution that is treated as money is reduced under section 731(c)(3)(B) and paragraph (b)(2) of this section by $15 (one-half of $30 net gain in Security *X*). As a result, *A* recognizes $5 of gain under section 731(a) on the distribution (excess of $105 distribution of money over $100 adjusted tax basis in *A*'s partnership interest).

(iii) *A*'s adjusted tax basis in Security *X* is $95 ($90 adjusted basis of Security *X* determined under section 732(a)(1) plus $5 of gain recognized by *A* by reason of section 731(c)). The basis in *A*'s interest in the partnership is $10 as determined under section 733 ($100 predistribution basis minus $90 basis allocated to Security *X* under section 732).

Example 6. Basis consequences—distribution of marketable security and other property. (i) *A* and *B* form partnership *AB* as equal partners. *A* contributes nondepreciable real property, with a fair market value of $100 and an adjusted tax basis of $10.

(ii) *AB* subsequently distributes Security *X* with a fair market value and adjusted tax basis of $40 to *A* in a current distribution and, as part of the same distribution, *AB* distributes Property *Z* to *A* with an adjusted tax basis and fair market value of $40. At the time of distribution, the basis in *A*'s interest in the partnership is $10. *A* recognizes $30 of gain under section 731(a) on the distribution (excess of $40 distribution of money over $10 adjusted tax basis in *A*'s partnership interest).

(iii) *A*'s adjusted tax basis in Security *X* is $35 ($5 adjusted basis determined under section 732(a)(2) plus $30 of gain recognized by *A* by reason of section 731(c)). *A*'s basis in Property *Z* is $5, as determined under section 732(a)(2). The basis in *A*'s interest in the partnership is $0 as determined under section 733 ($10 pre-distribution basis minus $10 basis allocated between Security *X* and Property *Z* under section 732).

(iv) *AB*'s adjusted tax basis in the remaining partnership assets is unchanged unless the partnership has a section 754 election in effect. If *AB* made such an election, the aggregate basis of *AB*'s assets would be increased by $70 (the difference between the $80 combined basis of Security *X* and Property *Z* in the hands of the partnership before the distribution and the $10 combined basis of the distributed property in the hands of *A* under section 732 after the distribution). Under section 731(c)(5), no adjustment is made to partnership property under section 734 as a result of any gain recognized by *A* by reason of section 731(c) or as a result of any step-up in basis in the distributed marketable securities in the hands of *A* by reason of section 731(c).

Example 7. Coordination with section 737. (i) *A* and *B* form partnership *AB*. *A* contributes Property *A*, nondepreciable real property with a fair market value of $200 and an adjusted basis of $100 in exchange for a 25 percent interest in partnership capital and profits. *AB* owns marketable Security *X*.

(ii) Within five years of the contribution of Property *A*, *AB* subsequently distributes Security *X*, with a fair market value of $120 and an adjusted tax basis of $100, to *A* in a current distribution that is subject to section 737. As part of the same distribution, *AB* distributes Property *Y* to *A* with a fair market value of $20 and an adjusted tax basis of $0. At the time of distribution, there has been no change in the fair market value of Property *A* or the adjusted tax basis in *A*'s interest in the partnership.

(iii) If *AB* had sold Security *X* for fair market value immediately before the distribution to *A*, the partnership would have recognized $20 of gain. *A*'s distributive share of this gain would have been $5 (25 percent of $20 gain). Because *AB* has no other marketable securities, *A*'s distributive share of gain in partnership securities after the distribution would have been $0. As a result, the distribution resulted in a decrease of $5 in *A*'s share of the net gain in *AB*'s securities ($5 net gain before distribution minus $0 net gain after distribution). Under paragraph (b)(2) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by $5. The distribution of Security *X* is therefore treated as a distribution of $115 of money to *A* ($120 fair market value of Security *X* minus $5 reduction). The portion of the distribution of the marketable security that is not treated as a distribution of money ($5) is treated as other property for purposes of section 737.

(iv) *A* recognizes total gain of $40 on the distribution. *A* recognizes $15 of gain under section 731(a)(1) on the distribution of the portion of Security *X* treated as money ($115 distribution of money less $100 adjusted tax basis in *A*'s partnership interest). *A* recognizes $25 of gain under section 737 on the distribution of Property *Y* and the portion of Security *X* that is not treated as money. *A*'s section 737 gain is equal to the lesser of (i) *A*'s precontribution gain ($100) or (ii) the excess of the fair market value of property received ($20 fair market value of Property *Y* plus $5 portion of Security *X* not treated as money) over the adjusted basis in *A*'s interest in the partnership immediately before the distribution ($100) reduced (but not below zero) by the amount of money received in the distribution ($115).

(v) *A*'s adjusted tax basis in Security *X* is $115 ($100 basis of Security *X* determined under section 732(a) plus $15 of gain recognized by reason of section 731(c)). *A*'s adjusted tax basis in Property *Y* is $0 under section 732(a). The basis in *A*'s interest in the partnership is $25 ($100 basis before distribution minus $100 basis allocated to Security *X* under section 732(a) plus $25 gain recognized under section 737).

(k) *Effective date.* This section applies to distributions made on or after December 26, 1996. However, taxpayers may apply the rules of this section to distributions made after December 8, 1994, and before December 26, 1996.

[T.D. 8707, 61 FR 67938, Dec. 26, 1996; 62 FR 8086, Feb. 21, 1997]

§ 1.732–1 Basis of distributed property other than money.

(a) *Distributions other than in liquidation of a partner's interest.* The basis of property (other than money) received by a partner in a distribution from a partnership, other than in liquidation of his entire interest, shall be its adjusted basis to the partnership immediately before such distribution. However, the basis of the property to the partner shall not exceed the adjusted basis of the partner's interest in the partnership, reduced by the amount of any money distributed to him in the same transaction. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Partner A, with an adjusted basis of $15,000 for his partnership interest, receives in a current distribution property having an adjusted basis of $10,000 to the partnership immediately before distribution, and $2,000 cash. The basis of the property in A's hands will be $10,000. Under sections 733 and 705, the basis of A's partnership interest will be reduced by the distribution to $3,000 ($15,000 less $2,000 cash, less $10,000, the basis of the distributed property to A).

Example 2. Partner R has an adjusted basis of $10,000 for his partnership interest. He receives a current distribution of $4,000 cash and property with an adjusted basis to the partnership of $8,000. The basis of the distributed property to partner R is limited to $6,000 ($10,000, the adjusted basis of his interest, reduced by $4,000, the cash distributed).

(b) *Distribution in liquidation.* Where a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership, the basis of such property to the partner shall be an amount equal to the adjusted basis of his interest in the partnership reduced by the amount of any money distributed to him in the same transaction. Application of this rule may be illustrated by the following example:

Example. Partner B, with a partnership interest having an adjusted basis to him of $12,000, retires from the partnership and receives cash of $2,000, and real property with an adjusted basis to the partnership of $6,000 and a fair market value of $14,000. The basis of the real property to B is $10,000 (B's basis for his partnership interest, $12,000, reduced by $2,000, the cash distributed).

(c) *Allocation of basis among properties distributed to a partner.* (1) Under section 732 (a)(2) or (b), the basis to be allocated to properties distributed to a partner shall be allocated first to any unrealized receivables (as defined in section 751(c)) and inventory items (as defined in section 751(d)(2)) included in the distribution. However, such receivables or inventory items may not take a higher basis in the hands of the partner than their common adjusted basis to the partnership immediately before the distribution, unless such distribution is treated as a sale or exchange under section 751(b), or unless the distributee partner has a special basis adjustment for the distributed property under section 732(d) or 743(b). Any basis not allocated to unrealized receivable or inventory items shall be allocated to any other properties distributed to the partner in the same transaction, in proportion to the bases of such other properties in the hands of the partnership before distribution. The provisions of this subparagraph may be illustrated by the following example:

Example. Partner A, whose partnership interest in partnership ABC has an adjusted basis of $15,000, receives as a distribution in liquidation of his entire interest inventory items having a basis to the partnership of $6,000. In addition, he receives cash of $5,000, and two parcels of real property with adjusted bases to the partnership of $6,000 and $2,000, respectively. Basis in the amount of $10,000 ($15,000 basis, less $5,000 cash received) is allocated $6,000 to inventory items, and $3,000 (6,000/8,000×$4,000) and $1,000 (2,000/8,000×$4,000), respectively, to the two parcels of real property.

(2) If the adjusted basis to the partnership of the unrealized receivables

and inventory items distributed to a partner is greater than the partner's adjusted basis of his interest (reduced by the amount of money distributed to him in the same transaction), the amount of the basis to be allocated to such unrealized receivables and inventory items shall be allocated in proportion to the adjusted bases of such properties in the hands of the partnership. If the basis of the partner's interest to be allocated upon a distribution in liquidation of his entire interest is in excess of the adjusted basis to the partnership of the unrealized receivables and inventory items distributed, and if there is no other property distributed to which such excess can be allocated, the distributee partner sustains a capital loss under section 731(a)(2) to the extent of the unallocated basis of his partnership interest. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Partner C, whose interest in partnership ABC has an adjusted basis to him of $9,000, receives as a distribution in liquidation cash of $6,000, inventory items having an adjusted basis to the partnership of $6,000, and real property having a basis to the partnership of $4,000. The cash payment reduces C's basis to $3,000, which is allocated entirely to inventory items. The real property has a zero basis in C's hands. The partnership bases not carried over to C for the distributed properties are lost unless an election under section 754 is in effect requiring the partnership to adjust the bases of remaining partnership properties under section 734(b).

Example 2. Partner B, whose interest in partnership ABC has an adjusted basis to him of $9,000, receives as a distribution in liquidation cash of $1,000 and inventory items having a basis to the partnership of $6,000. The cash payment reduces B's basis to $8,000, which can be allocated only to the extent of $6,000 to the inventory items. The remaining $2,000 basis, not allocable to distributed property, constitutes a capital loss in that amount to partner B under section 731(a)(2). If the election under section 754 is in effect, see section 734(b) for adjustment of the basis of undistributed partnership property.

(d) *Special partnership basis to transferee under section 732(d).* (1)(i) A transfer of a partnership interest occurs upon a sale or exchange of an interest or upon the death of a partner. Section 732(d) provides a special rule for the determination of the basis of property distributed to a transferee partner who acquired any part of his partnership interest in a transfer with respect to which the election under section 754 (relating to the optional adjustment to basis of partnership property) was not in effect.

(ii) Where an election under section 754 is in effect, see section 743(b) and paragraph (b) of §1.743–1 and §1.732–2.

(iii) If a transferee partner receives a distribution of property (other than money) from the partnership within 2 years after he acquired his interest or part thereof in the partnership by a transfer with respect to which the election under section 754 was not in effect, he may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in section 743(b) were in effect.

(iv) If an election under section 732(d) is made upon a distribution of property to a transferee partner, the amount of the adjustment with respect to the transferee partner is not diminished by any depletion or depreciation of that portion of the basis of partnership property which arises from the special basis adjustment under section 732(d), since depletion or depreciation on such portion for the period prior to distribution is allowed or allowable only if the optional adjustment under section 743(b) is in effect.

(v) If property is distributed to a transferee partner who elects under section 732(d), and if such property is not the same property which would have had a special basis adjustment, then such special basis adjustment shall apply to any like property received in the distribution, provided that the transferee, in exchange for the property distributed, has relinquished his interest in the property with respect to which he would have had a special basis adjustment. This rule applies whether the property in which the transferee has relinquished his interest is retained or disposed or by the partnership. (For shift of transferee's special basis adjustment to like property, see paragraph (b)(2)(ii) of §1.743–1.)

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

Example. The basis to transferee partner K of his one-fourth interest in partnership WJKS is $17,000. At the time he acquired such interest by purchase, the election under section 754 was not in effect and the partnership inventory had a basis to the partnership of $14,000 and a value of $16,000. K's purchase price reflected $500 of this difference. Thus, $4,000 of the $17,000 paid by K for his one-fourth interest was attributable to his share of partnership inventory with a basis of $3,500. Within 2 years after acquiring his interest, K retired from the partnership and received in liquidation of his entire interest cash of $1,500, inventory with a basis to the partnership of $3,500, property X (a capital asset), with an adjusted basis to the partnership of $2,000, and property Y (a depreciable asset), with an adjusted basis to the partnership of $4,000. The value of the inventory received by K was one-fourth of the value of all partnership inventory and was his share of such property. It is immaterial whether the inventory K received was on hand when K acquired his interest. In accordance with K's election under section 732(d), the amount of his share of partnership basis which is attributable to partnership inventory is increased by $500 (one-fourth of the $2,000 difference between the value of such property, $16,000, and its $14,000 basis to the partnership at the time K acquired his interest). This adjustment under section 732(d) applies only for purposes of distributions to partner K, and not for purposes of partnership depreciation, depletion, or gain or loss on disposition. Thus, the amount to be allocated among the properties received by K in the liquidating distribution is $15,500 ($17,000, K's basis for his interest, reduced by the amount of cash received, $1,500). This amount is allocated as follows: The basis of the inventory items received is $4,000, consisting of the $3,500 common partnership basis for such items, plus the special basis adjustment of $500 which K would have had under section 743(b). The remaining basis of $11,500 ($15,500 minus $4,000) is to be allocated to the remaining property distributed to K in proportion to their adjusted bases to the partnership. Since the adjusted basis to the partnership of property X is $2,000, and that of property Y is $4,000, the $11,500 is allocated $3,833 (2,000/6,000×$11,500) to X, and $7,667 (4,000/6,000×$11,500) to Y.

(2) A transferee partner who wishes to elect under section 732(d) shall make the election with his tax return:

(i) For the year of the distribution, if the distribution includes any property subject to the allowance for depreciation, depletion, or amortization, or

(ii) For any taxable year no later than the first taxable year in which the basis of any of the distributed property is pertinent in determining his income tax, if the distribution does not include any such property subject to the allowance for depreciation, depletion or amortization.

(3) A taxpayer making an election under section 732(d) shall submit with the return in which the election is made a schedule setting forth the following:

(i) That under section 732(d) he elects to adjust the basis of property received in a distribution; and

(ii) The computation of the special basis adjustment for the property distributed and the properties to which the adjustment has been allocated. For rules of allocation, see section 755.

(4) A partner who acquired any part of his partnership interest in a transfer to which the election provided in section 754 was not in effect, is required to apply the special basis rule contained in section 732(d) to a distribution to him, whether or not made within 2 years after the transfer, if at the time of his acquisition of the transferred interest:

(i) The fair market value of all partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership.

(ii) An allocation of basis under section 732(c) upon a liquidation of his interest immediately after the transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance, and

(iii) A special basis adjustment under section 743(b) would change the basis to the transferee partner of the property actually distributed.

The application of the rule presented in this subparagraph may be illustrated by the following examples:

Example 1. Partnership ABC owns three parcels of land, each of which has an adjusted basis to the partnership of $5,000 and is worth $55,000, and depreciable property with an adjusted basis and value of $150,000. D purchases A's partnership interest for $105,000 when the election under section 754 is not in effect. At the time of D's purchase, the fair market value of all partnership property (other than money) is $315,000, which exceeds 110 percent of $165,000, its adjusted basis to the partnership. Four years later, the partnership is dissolved. D receives one of the three parcels of land which has a basis to the partnership of $5,000, and one-third of the depreciable property with an adjusted basis to the partnership at that time of $45,000, one-third of $135,000 ($150,000 basis, minus $15,000 depreciation computed on the partnership basis. See subparagraph (1)(iv) of this paragraph.) If D's adjusted basis for his interest at the time of the distribution was $100,000 and was allocated under section 732(c) to the property received by him in proportion to their respective bases to the partnership, the basis to him for the distributed land would be $10,000 (5,000/50,000×$100,000) and the basis of the depreciable property would be $90,000 (45,000/50,000×$100,000). In effect, D would be attributing to the basis of the depreciable property a portion of the cost of his partnership interest properly attributable to appreciation in nondepreciable property. The application of section 743(b) to the transfer of the interest would have resulted in a different basis to D for the property actually distributed. Therefore, the special basis adjustment under section 732(d) must be made so that D must increase the basis of the land by a special basis adjustment of $50,000 ($55,000 fair market value less $5,000 partnership basis), making the basis of his interest therein $55,000 (55,000/100,000× $100,000). D's basis for the depreciable property will then be $45,000 (45,000/100,000 ×$100,000).

Example 2. Assume the same facts as in example 1 of this subparagraph, except that the partnership does not dissolve but distributes one parcel of land to each of the partners in a current distribution. Since the conditions of this subparagraph have been met, D's basis for the distributed land is the adjusted basis such land would have if the adjustment provided in section 743(b) were in effect with respect to the partnership property. Therefore, D's basis for the land is $55,000 ($5,000 basis of the land to the partnership, plus $50,000 special basis adjustment under section 732(d)). D's basis for his partnership interest is reduced by $55,000, his basis for the property distributed.

(e) *Exception.* When a partnership distributes unrealized receivables (as defined in section 751(c)) or substantially appreciated inventory items (as defined in section 751(d)) in exchange for any part of a partner's interest in other partnership property (including money), or, conversely, partnership property (including money) other than unrealized receivables or substantially appreciated inventory items in exchange for any part of a partner's interest in the partnership's unrealized receivables or substantially appreciated inventory items, the distribution will be treated as a sale or exchange of property under the provisions of section 751(b). In such case, section 732 (including subsection(d) thereof) applies in determining the partner's basis of the property which he is treated as having sold to or exchanged with the partnership (as constituted after the distribution). The partner is considered as having received such property in a current distribution and, immediately thereafter, as having sold or exchanged it. See section 751(b) and paragraph (b) of §1.751–1. However, section 732 does not apply in determining the basis of that part of property actually distributed to a partner which is treated as received by him in a sale or exchange under section 751(b). Consequently, the basis of such property shall be its cost to the partner.

§1.732–2 Special partnership basis of distributed property.

(a) *Adjustments under section 734(b).* In the case of a distribution of property to a partner, the partnership bases of the distributed properties shall reflect any increases or decreases to the basis of partnership property which have been made previously under section 734(b) (relating to the optional adjustment to basis of undistributed partnership property) in connection with previous distributions.

(b) *Adjustments under section 743(b).* In the case of a distribution of property to a partner who acquired any part of his interest in a transfer as to which an election under section 754 was in effect, then, for the purposes of section 732 (other than subsection (d) thereof), the adjusted partnership bases of the distributed property shall take into account, in addition to any adjustments under section 734(b), the transferee's special basis adjustment for the distributed property under section 743(b). The application of this paragraph may be illustrated by the following example:

Example. Partner D acquired his interest in partnership ABD from a previous partner. Since the partnership had made an election under section 754, a special basis adjustment with respect to D is applicable to the basis of partnership property in accordance with section 743(b). One of the assets of the partnership at the time D acquired his interest was property X, which is later distributed to D in a current distribution. Property X has an adjusted basis to the partnership of $1,000 and with respect to D it has a special basis adjustment of $500. Therefore, for purposes of section 732(a)(1), the adjusted basis of such property to the partnership with respect to D immediately before its distribution is $1,500. However, if property X is distributed to partner A, a nontransferee partner, its adjusted basis to the partnership for purposes of section 732(a)(1) is only $1,000. In such case, D's $500 special basis adjustment may shift over to other property. See paragraph (b)(2)(ii) of § 1.743–1.

(c) *Adjustments to basis of distributed inventory and unrealized receivables.* Under section 732, the basis to be allocated to distributed properties shall be allocated first to any unrealized receivables and inventory items. If the distributee partner is a transferee of a partnership interest and has a special basis adjustment for unrealized receivables or inventory items under either section 743(b) or section 732(d), then the partnership adjusted basis immediately prior to distribution of any unrealized receivables or inventory items distributed to such partner shall be determined as follows: If the distributee partner receives his entire share of the fair market value of the inventory items or unrealized receivables of the partnership, the adjusted basis of such distributed property to the partnership, for the purposes of section 732, shall take into account the entire amount of any special basis adjustment which the distributee partner may have for such assets. If the distributee partner receives less than his entire share of the fair market value of partnership inventory items or unrealized receivables, then, for purposes of section 732, the adjusted basis of such distributed property to the partnership shall take into account the same proportion of the distributee's special basis adjustment for unrealized receivables or inventory items as the value of such items distributed to him bears to his entire share of the total value of all such items of the partnership. The provisions of this paragraph may be illustrated by the following example:

Example. Partner C acquired his 40-percent interest in partnership AC from a previous partner. Since the partnership had made an election under section 754, C has a special basis adjustment to partnership property under section 743(b). C retires from the partnership when the adjusted basis of his partnership interest is $3,000. He receives from the partnership in liquidation of his entire interest, $1,000 cash, certain capital assets, depreciable property, and certain inventory items and unrealized receivables. C has a special basis adjustment of $800 with respect to partnership inventory items and of $200 with respect to unrealized receivables. The common partnership basis for the inventory items distributed to him is $500 and for the unrealized receivables is zero. If the value of inventory items and the unrealized receivables distributed to C in his 40 percent share of the total value of all partnership inventory items and unrealized receivables, then, for purposes of section 732, the adjusted basis of such property in C's hands will be $1,300 for the inventory items ($500 plus $800) and $200 for the unrealized receivables (zero plus $200). The remaining basis of $500, which constitutes the basis of the capital assets and depreciable property distributed to C, is determined as follows: $3,000 (total basis) less $1,000 cash, or $2,000 (the amount to be allocated to the basis of all distributed property), less $1,500 ($800 and $200 special basis adjustments, plus $500 common partnership basis, the amount allocated to inventory items and unrealized receivables). However, if the value of the inventory items and unrealized receivables distributed to C consisted of only 20 percent of the total fair market value of such property (i. e., only one-half of C's 40-percent share), then only one-half of C's special basis adjustment of $800 for partnership inventory items and $200 for unrealized receivables would be taken into account. In that case, the basis of the inventory items in C's hands would be $650 ($250, the common partnership basis for inventory items distributed to him, plus $400, one-half of C's special basis adjustment for inventory items). The basis of the unrealized receivables in C's hands would be $100 (zero plus $100, one-half of C's special basis adjustment for unrealized receivables).

§ 1.733–1 Basis of distributee partner's interest.

In the case of a distribution by a partnership to a partner other than in liquidation of a partner's entire interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by the amount of any money distributed to such partner and by the amount of the basis to him of distributed property other than money as determined under section 732 and §§ 1.732–1 and 1.732–2.

§1.734–1 Optional adjustment to basis of undistributed partnership property.

(a) *General rule.* A partnership shall not adjust the basis of partnership property as the result of a distribution of property to a partner, unless the election provided in section 754 (relating to optional adjustment to basis of partnership property) is in effect.

(b) *Method of adjustment*—(1) *Increase in basis.* Where an election under section 754 is in effect and a distribution of partnership property is made, whether or not in liquidation of the partner's entire interest in the partnership, the adjusted basis of the remaining partnership assets shall be increased by:

(i) The amount of any gain recognized under section 731(a)(1) to the distributee partner, or

(ii) The excess of the adjusted basis to the partnership immediately before the distribution of any property distributed (including adjustments under section 743(b) or section 732(d) when applied) over the basis under section 732 (including such special basis adjustments) of such property to the distributee partner.

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

Example 1. Partner A has a basis of $10,000 for his one-third interest in partnership ABC. The partnership has no liabilities and has assets consisting of cash of $11,000 and property with a partnership basis of $19,000 and a value of $22,000. A receives $11,000 in cash in liquidation of his entire interest in the partnership. He has a gain of $1,000 under section 731(a)(1). If the election under section 754 is in effect, the partnership basis for the property becomes $20,000 ($19,000 plus $1,000).

Example 2. Partner D has a basis of $10,000 for his one-third interest in partnership DEF. The partnership balance sheet before the distribution shows the following:

ASSETS

	Adjusted basis	Value
Cash	$4,000	$4,000
Property X	11,000	11,000
Property Y	15,000	18,000
Total	30,000	33,000

LIABILITIES AND CAPITAL

	Adjusted basis	Value
Liabilities	$0	$0
Capital:		
D	10,000	11,000
E	10,000	11,000
F	10,000	11,000
Total	30,000	33,000

In liquidation of his entire interest in the partnership, D received property X with a partnership basis of $11,000. D's basis for property X is $10,000 under section 732(b). Where the election under section 754 is in effect, the excess of $1,000 (the partnership basis before the distribution less D's basis for property X after distribution) is added to the basis of property Y. The basis of property Y becomes $16,000 ($15,000 plus $1,000). If the distribution is made to a transferee partner who elects under section 732(d), see §1.734–2.

(2) *Decrease in basis.* Where the election provided in section 754 is in effect and a distribution is made in liquidation of a partner's entire interest, the partnership shall decrease the adjusted basis of the remaining partnership property by:

(i) The amount of loss, if any, recognized under section 731(a)(2) to the distributee partner, or

(ii) The excess of the basis of the distributed property to the distributee, as determined under section 732 (including adjustments under section 743(b) or section 732(d) when applied) over the adjusted basis of such property to the partnership (including such special basis adjustments) immediately before such distribution.

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

Example 1. Partner G has a basis of $11,000 for his one-third interest in partnership GHI. Partnership assets consist of cash of $10,000 and property with a basis of $23,000 and a value of $20,000. There are no partnership liabilities. In liquidation of his entire interest in the partnership, G receives $10,000 in cash. He has a loss of $1,000 under section 731(a)(2). If the election under section 754 is in effect, the partnership basis for the property becomes $22,000 ($23,000 less $1,000).

Example 2. Partner J has a basis of $11,000 for his one-third interest in partnership JKL. The partnership balance sheet before the distribution shows the following:

ASSETS

	Adjusted basis	Value
Cash	$5,000	$5,000
Property X	10,000	10,000
Property Y	18,000	15,000
Total	33,000	30,000

LIABILITIES AND CAPITAL

	Adjusted basis	Value
Liabilities	$0	$0
Capital:		
J	11,000	10,000
K	11,000	10,000
L	11,000	10,000
Total	33,000	30,000

In liquidation of his entire interest in the partnership, J receives property X with a partnership basis of $10,000. J's basis for property X under section 732(b) is $11,000. Where the election under section 754 is in effect, the excess of $1,000 ($11,000 basis of property X to J, the distributee, less its $10,000 adjusted basis to the partnership immediately before the distribution) decreases the basis of property Y in the partnership. Thus, the basis of property Y becomes $17,000 ($18,000 less $1,000). If the distribution is made to a transferee partner who elects uunder section 732(d), see § 1.734–2.

(c) *Allocation of basis.* For allocation among the partnership properties of basis adjustments under section 734(b) and paragraph (b) of this section, see section 755 and § 1.755–1.

(d) *Returns.* A partnership which must adjust the bases of partnership properties under section 734 shall attach a statement to the partnership return for the year of the distribution setting forth the computation of the adjustment and the partnership properties to which the adjustment has been allocated.

§ 1.734–2 Adjustment after distribution to transferee partner.

(a) In the case of a distribution of property by the partnership to a partner who has obtained all or part of his partnership interest by transfer, the adjustments to basis provided in section 743(b) and section 732(d) shall be taken into account in applying the rules under section 734(b). For determining the adjusted basis of distributed property to the partnership immediately before the distribution where there has been a prior transfer of a partnership interest with respect to which the election provided in section 754 or section 732(d) is in effect, see §§ 1.732–1 and 1.732–2.

(b)(1) If a transferee partner, in liquidation of his entire partnership interest, receives a distribution of property (including money) with respect to which he has no special basis adjustment, in exchange for his interest in property with respect to which he has a special basis adjustment, and does not utilize his entire special basis adjustment in determining the basis of the distributed property to him under section 732, the unused special basis adjustment of the distributee shall be applied as an adjustment to the partnership basis of the property retained by the partnership and as to which the distributee did not use his special basis adjustment. The provisions of this subparagraph may be illustrated by the following example:

Example. Upon the death of his father, partner S acquires by inheritance a half-interest in partnership ACS. Partners A and C each have a one-quarter interest. The assets of the partnership consist of $10,000 cash and land used in farming worth $10,000 with a basis of $1,000 to the partnership. Since the partnership had made the election under section 754 at the time of transfer, partner S had a special basis adjustment of $4,500 under section 743(b) with respect to his undivided half-interest in the real estate. The basis of S's partnership interest, in accordance with section 742, is $10,000. S retires from the partnership and receives $10,000 in cash in exchange for his entire interest. Since S has received no part of the real estate, his special basis adjustment of $4,500 will be allocated to the real estate, the remaining partnership property, and will increase its basis to the partnership to $5,500.

(2) The provisions of this paragraph do not apply to the extent that certain distributions are treated as sales or exchanges under section 751(b) (relating to unrealized receivables and substantially appreciated inventory items). See section 751(b) and paragraph (b) of § 1.751–1.

§ 1.735–1 Character of gain or loss on disposition of distributed property.

(a) *Sale or exchange of distributed property*—(1) *Unrealized receivables.* Any gain realized or loss sustained by a partner on a sale or exchange or other disposition of unrealized receivables (as defined in paragraph (c)(1) of §1.751–1) received by him in a distribution from a partnership shall be considered gain or loss from the sale or exchange of property other than a capital asset.

(2) *Inventory items.* Any gain realized or loss sustained by a partner on a sale or exchange of inventory items (as defined in section 751(d)(2)) received in a distribution from a partnership shall be considered gain or loss from the sale or exchange of property other than a capital asset if such inventory items are sold or exchanged within 5 years from the date of the distribution by the partnership. The character of any gain or loss from a sale or exchange by the distributee partner of such inventory items after 5 years from the date of distribution shall be determined as of the date of such sale or exchange by reference to the character of the assets in his hands at that date (inventory items, capital assets, property used in a trade or business, etc.).

(b) *Holding period for distributed property.* A partner's holding period for property distributed to him by a partnership shall include the period such property was held by the partnership. The provisions of this paragraph do not apply for the purpose of determining the 5-year period described in section 735(a)(2) and paragraph (a)(2) of this section. If the property has been contributed to the partnership by a partner, then the period that the property was held by such partner shall also be included. See section 1223(2). For a partnership's holding period for contributed property, see §1.723–1.

(c) *Effective date.* Section 735(a) applies to any property distributed by a partnership to a partner after March 9, 1954. See section 771(b)(2) and paragraph (b)(2) of §1.771–1. However, see section 771(c).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8574, July 7, 1965]

§1.736–1 Payments to a retiring partner or a deceased partner's successor in interest.

(a) *Payments considered as distributive share or guaranteed payment.* (1)(i) Section 736 and this section apply only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership. See section 761(d). Section 736 and this section do not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. Section 736 and this section apply only to payments made by the partnership and not to transactions between the partners. Thus, a sale by partner A to partner B of his entire one-fourth interest in partnership ABCD would not come within the scope of section 736.

(ii) A partner retires when he ceases to be a partner under local law. However, for the purposes of subchapter K, chapter 1 of the Code, a retired partner or a deceased partner's successor will be treated as a partner until his interest in the partnership has been completely liquidated.

(2) When payments (including assumption of liabilities treated as a distribution of money under section 752) are made to a withdrawing partner, that is, a retiring partner or the estate or other successor in interest of a deceased partner, the amounts paid may represent several items. In part, they may represent the fair market value at the time of his death or retirement of the withdrawing partner's interest in all the assets of the partnership (including inventory) unreduced by partnership liabilities. Also, part of such payments may be attributable to his interest in unrealized receivables and part to an arrangement among the partners in the nature of mutual insurance. When a partnership makes such payments, whether or not related to partnership income, to retire the withdrawing partner's entire interest in the partnership, the payments must be allocated between (i) payments for the value of his interest in assets, except unrealized receivables and, under some circumstances, good will (section 736(b)), and (ii) other payments (section 736(a)). The amounts paid for his interest in assets are treated in the same manner as a distribution in complete liquidation under sections 731, 732, and, where applicable, 751. See paragraph (b)(4)(ii) of §1.751–1. The remaining partners are allowed no deduction for

these payments since they represent either a distribution or a purchase of the withdrawing partner's capital interest by the partnership (composed of the remaining partners).

(3) Under section 736(a), the portion of the payments made to a withdrawing partner for his share of unrealized receivables, good will (in the absence of an agreement to the contrary), or otherwise not in exchange for his interest in assets under the rules contained in paragraph (b) of this section will be considered either:

(i) A distributive share of partnership income, if the amount of payment is determined with regard to income of the partnership; or

(ii) A guaranteed payment under section 707(c), if the amount of the payment is determined without regard to income of the partnership.

(4) Payments, to the extent considered as a distributive share of partnership income under section 736(a)(1), are taken into account under section 702 in the income of the withdrawing partner and thus reduce the amount of the distributive shares of the remaining partners. Payments, to the extent considered as guaranteed payments under section 736(a)(2), are deductible by the partnership under section 162(a) and are taxable as ordinary income to the recipient under section 61(a). See section 707(c).

(5) The amount of any payments under section 736(a) shall be included in the income of the recipient for his taxable year with or within which ends the partnership taxable year for which the payment is a distributive share, or in which the partnership is entitled to deduct such amount as a guaranteed payment. On the other hand, payments under section 736(b) shall be taken into account by the recipient for his taxable year in which such payments are made. See paragraph (b)(4) of this section.

(6) A retiring partner or a deceased partner's successor in interest receiving payments under section 736 is regarded as a partner until the entire interest of the retiring or deceased partner is liquidated. Therefore, if one of the members of a 2-man partnership retires under a plan whereby he is to receive payments under section 736, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's entire interest is liquidated, since the retiring partner continues to hold a partnership interest in the partnership until that time. Similarly, if a partner in a 2-man partnership dies, and his estate or other successor in interest receives payments under section 736, the partnership shall not be considered to have terminated upon the death of the partner but shall terminate as to both partners only when the entire interest of the decedent is liquidated. See section 708(b).

(b) *Payments for interest in partnership.* (1) Payments made in liquidation of the entire interest of a retiring partner or deceased partner shall, to the extent made in exchange for such partner's interest in partnership property (except for unrealized receivables and good will as provided in subparagraphs (2) and (3) of this paragraph), be considered as a distribution by the partnership (and not as a distributive share or guaranteed payment under section 736(a)). Generally, the valuation placed by the partners upon a partner's interest in partnership property in an arm's length agreement will be regarded as correct. If such valuation reflects only the partner's net interest in the property (i.e., total assets less liabilities), it must be adjusted so that both the value of the partner's interest in property and the basis for his interest take into account the partner's share of partnership liabilities. Gain or loss with respect to distributions under section 736(b) and this paragraph will be recognized to the distributee to the extent provided in section 731 and, where applicable, section 751.

(2) Payments made to a retiring partner or to the successor in interest of a deceased partner for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, shall not be considered as made in exchange for such partner's interest in partnership property. Such payments shall be treated as payments under section 736(a) and paragraph (a) of this section. For definition of unrealized receivables, see section 751(c).

(3) For the purposes of section 736(b) and this paragraph, payments made to a retiring partner or to a successor in interest of a deceased partner in exchange for the interest of such partner in partnership property shall not include any amount paid for the partner's share of good will of the partnership in excess of its partnership basis, including any special basis adjustments for it to which such partner is entitled, except to the extent that the partnership agreement provides for a reasonable payment with respect to such good will. Such payments shall be considered as payments under section 736(a). To the extent that the partnership agreement provides for a reasonable payment with respect to good will, such payments shall be treated under section 736(b) and this paragraph. Generally, the valuation placed upon good will by an arm's length agreement of the partners, whether specific in amount or determined by a formula, shall be regarded as correct.

(4) Payments made to a retiring partner or to a successor in interest of a deceased partner for his interest in inventory shall be considered as made in exchange for such partner's interest in partnership property for the purposes of section 736(b) and this paragraph. However, payments for an interest in substantially appreciated inventory items, as defined in section 751(d), are subject to the rules provided in section 751(b) and paragraph (b) of §1.751–1. The partnership basis in inventory items as to a deceased partner's successor in interest does not change because of the death of the partner unless the partnership has elected the optional basis adjustment under section 754. But see paragraph (b)(3)(iii) of §1.751–1.

(5) Where payments made under section 736 are received during the taxable year, the recipient must segregate that portion of each such payment which is determined to be in exchange for the partner's interest in partnership property and treated as a distribution under section 736(b) from that portion treated as a distributive share or guaranteed payment under section 736(a). Such allocation shall be made as follows:

(i) If a fixed amount (whether or not supplemented by any additional amounts) is to be received over a fixed number of years, the portion of each payment to be treated as a distribution under section 736(b) for the taxable year shall bear the same ratio to the total fixed agreed payments for such year (as distinguished from the amount actually received) as the total fixed agreed payments under section 736(b) bear to the total fixed agreed payments under section 736 (a) and (b). The balance, if any, of such amount received in the same taxable year shall be treated as a distributive share or a guaranteed payment under section 736(a) (1) or (2). However, if the total amount received in any one year is less than the amount considered as a distribution under section 736(b) for that year, then any unapplied portion shall be added to the portion of the payments for the following year or years which are to be treated as a distribution under section 736(b). For example, retiring partner W who is entitled to an annual payment of $6,000 for 10 years for his interest in partnership property, receives only $3,500 in 1955. In 1956, he receives $10,000. Of this amount, $8,500 ($6,000 plus $2,500 from 1955) is treated as a distribution under section 736 (b) for 1956; $1,500, as a payment under section 736(a).

(ii) If the retiring partner or deceased partner's successor in interest receives payments which are not fixed in amount, such payments shall first be treated as payments in exchange for his interest in partnership property under section 736(b) to the extent of the value of that interest and, thereafter, as payments under section 736(a).

(iii) In lieu of the rules provided in subdivisions (i) and (ii) of this subparagraph, the allocation of each annual payment between section 736 (a) and (b) may be made in any manner to which all the remaining partners and the withdrawing partner or his successor in interest agree, provided that the total amount allocated to property under section 736(b) does not exceed the fair market value of such property at the date of death or retirement.

(6) Except to the extent section 751(b) applies, the amount of any gain or loss with respect to payments under section 736(b) for a retiring or deceased partner's interest in property for each year

of payment shall be determined under section 731. However, where the total of section 736(b) payments is a fixed sum, a retiring partner or a deceased partner's successor in interest may elect (in his tax return for the first taxable year for which he receives such payments), to report and to measure the amount of any gain or loss by the difference between:

(i) The amount treated as a distribution under section 736(b) in that year, and

(ii) The portion of the adjusted basis of the partner for his partnership interest attributable to such distribution (i.e., the amount which bears the same proportion to the partner's total adjusted basis for his partnership interest as the amount distributed under section 736(b) in that year bears to the total amount to be distributed under section 736(b)).

A recipient who elects under this subparagraph shall attach a statement to his tax return for the first taxable year for which he receives such payments, indicating his election and showing the computation of the gain included in gross income.

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

Example 1. Partnership ABC is a personal service partnership and its balance sheet is as follows:

ASSETS

	Adjusted basis per books	Market value
Cash	$13,000	$13,000
Unrealized receivables	0	30,000
Capital and section 1231 assets	20,000	23,000
Total	33,000	66,000

LIABILITIES AND CAPITAL

	Per books	Value
Liabilities	$3,000	$3,000
Capital:		
A	10,000	21,000
B	10,000	21,000
C	10,000	21,000
Total	33,000	66,000

Partner A retires from the partnership in accordance with an agreement whereby his share of liabilities ($1,000) is assumed. In addition he is to receive $9,000 in the year of retirement plus $10,000 in each of the two succeeding years. Thus, the total that A receives for his partnership interest is $30,000 ($29,000 in cash and $1,000 in liabilities assumed). Under the agreement terminating A's interest, the value of A's interest in section 736(b) partnership property is $12,000 (one-third of $36,000, the sum of $13,000 cash and $23,000, the fair market value of capital and section 1231 assets). A's share in unrealized receivables is not included in his interest in partnership property described in section 736(b). Since the basis of A's interest is $11,000 ($10,000 plus $1,000, his share of partnership liabilities), he will realize a capital gain of $1,000 ($12,000 minus $11,000) from the disposition of his interest in partnership property. The remaining $18,000 ($30,000 minus $12,000) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c). The payment for the first year is $10,000, consisting of $9,000 in cash, plus $1,000 in liability assumed (section 752(b)). Thus, unless the partners agree otherwise under subparagraph (5)(iii) of this paragraph, each annual payment of $10,000 will be allocated as follows: $6,000 (18,000/30,000 of $10,000) is a section 736(a)(2) payment and $4,000 (12,000/30,000 of $10,000) is a payment for an interest in section 736(b) partnership property. (The partnership may deduct the $6,000 guaranteed payment made to A in each of the 3 years.) The gain on the payments for partnership property will be determined under section 731, as provided in subparagraph (6) of this paragraph. A will treat only $4,000 of each payment as a distribution in a series in liquidation of his entire interest and, under section 731, will have a capital gain of $1,000 when the last payment is made. However, if A so elects, as provided in subparagraph (6) of this paragraph, he may treat such gain as follows: Of each $4,000 payment attributable to A's interest in partnership property, $333 is capital gain (one-third of the total capital gain of $1,000), and $3,667 is a return of capital.

Example 2. Assume the same facts as in example 1 of this subparagraph except that the agreement between the partners provides for payments to A for 3 years of a percentage of annual income instead of a fixed amount. Unless the partners agree otherwise under subparagraph (5)(iii) of this paragraph, all payments received by A up to $12,000 shall be treated under section 736(b) as payments for A's interest in partnership property. His gain of $1,000 will be taxed only after he has received his full basis under section 731. Since the payments are not fixed in amount, the election provided in subparagraph (6) of this paragraph is not available. Any payments in excess of $12,000 shall be treated as a distributive share of partnership income to A under section 736(a)(1).

Example 3. Assume the same facts as in example 1 of this subparagraph except that the partnership agreement provides that the payment for A's interest in partnership property shall include payment for his interest in the good will of the partnership. At the time of A's retirement, the partners determine the value of partnership good will to be $9,000. The value of A's interest in partnership property described in section 736(b) is thus $15,000 (one-third of $45,000, the sum of $13,000 cash, plus $23,000, the value of capital and section 1231 assets, plus $9,000 good will). From the disposition of his interest in partnership property, A will realize a capital gain of $4,000 ($15,000, minus $11,000) the basis of his interest. The remaining $15,000 ($30,000 minus $15,000) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c).

Example 4. Assume the same facts as in example 1 of this subparagraph except that the capital and section 1231 assets consist of an item of section 1245 property (as defined in section 1245(a)(3)). Assume further that under paragraph (c)(4) of §1.751–1 the section 1245 property is an unrealized receivable to the extent of $2,000. Therefore, the value of A's interest in section 736(b) partnership property is only $11,333 (one-third of $34,000, the sum of $13,000 cash and $21,000, the fair market value of section 1245 property to the extent not an unrealized receivable). From the disposition of his interest in partnership property, A will realize a capital gain of $333 ($11,333 minus $11,000, the basis of his interest). The remaining $18,667 ($30,000 minus $11,333) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c).

(c) *Cross reference.* See section 753 for treatment of payments under section 736(a) as income in respect of a decedent under section 691.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8574, July 7, 1965]

§1.737–1 Recognition of precontribution gain.

(a) *Determination of gain*—(1) *In general.* A partner that receives a distribution of property (other than money) must recognize gain under section 737 and this section in an amount equal to the lesser of the excess distribution (as defined in paragraph (b) of this section) or the partner's net precontribution gain (as defined in paragraph (c) of this section). Gain recognized under section 737 and this section is in addition to any gain recognized under section 731.

(2) *Transactions to which section 737 applies.* Section 737 and this section apply only to the extent that a distribution by a partnership is a distribution to a partner acting in the capacity of a partner within the meaning of section 731, except that section 737 and this section do not apply to the extent that section 751(b) applies to the distribution.

(b) *Excess distribution*—(1) *Definition.* The excess distribution is the amount (if any) by which the fair market value of the distributed property (other than money) exceeds the distributee partner's adjusted tax basis in the partner's partnership interest.

(2) *Fair market value of property.* The fair market value of the distributed property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value that a partnership assigns to distributed property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.

(3) *Distributee partner's adjusted tax basis*—(i) *General rule.* In determining the amount of the excess distribution, the distributee partner's adjusted tax basis in the partnership interest includes any basis adjustment resulting from the distribution that is subject to section 737 (for example, adjustments required under section 752) and from any other distribution or transaction that is part of the same distribution, except for—

(A) The increase required under section 737(c)(1) for the gain recognized by the partner under section 737; and

(B) The decrease required under section 733(2) for any property distributed to the partner other than property previously contributed to the partnership by the distributee partner. See §1.704–4(e)(1) for a rule in the context of section 704(c)(1)(B). See also §1.737–3(b)(2) for a special rule for determining a partner's adjusted tax basis in distributed property previously contributed by the partner to the partnership.

(ii) *Advances or drawings.* The distributee partner's adjusted tax basis in the partnership interest is determined as of the last day of the partnership's taxable year if the distribution to which section 737 applies is properly characterized as an advance or drawing against the partner's distributive share of income. See § 1.731–1(a)(1)(ii).

(c) *Net precontribution gain*—(1) *General rule.* The distributee partner's net precontribution gain is the net gain (if any) that would have been recognized by the distributee partner under section 704(c)(1)(B) and § 1.704–4 if all property that had been contributed to the partnership by the distributee partner within five years of the distribution and is held by the partnership immediately before the distribution had been distributed by the partnership to another partner other than a partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership. See § 1.704–4 for provisions determining a contributing partner's gain or loss under section 704(c)(1)(B) on an actual distribution of contributed section 704(c) property to another partner.

(2) *Special rules*—(i) *Property contributed on or before October 3, 1989.* Property contributed to the partnership on or before October 3, 1989, is not taken into account in determining a partner's net precontribution gain. See § 1.704–4(c)(1) for a similar rule in the context of section 704(c)(1)(B).

(ii) *Section 734(b)(1)(A) adjustments.* For distributions to a distributee partner of money by a partnership with a section 754 election in effect that are part of the same distribution as the distribution of property subject to section 737, for purposes of paragraph (a) and (c)(1) of this section the distributee partner's net precontribution gain is reduced by the basis adjustments (if any) made to section 704(c) property contributed by the distributee partner under section 734(b)(1)(A). See § 1.737–3(c)(4) for rules regarding basis adjustments for partnerships with a section 754 election in effect.

(iii) *Transfers of a partnership interest.* The transferee of all or a portion of a contributing partner's partnership interest succeeds to the transferor's net precontribution gain, if any, in an amount proportionate to the interest transferred. See § 1.704–3(a)(7) and § 1.704–4(d)(2) for similar provisions in the context of section 704(c)(1)(A) and section 704(c)(1)(B).

(iv) *Section 704(c)(1)(B) gain recognized in related distribution.* A distributee partner's net precontribution gain is determined after taking into account any gain or loss recognized by the partner under section 704(c)(1)(B) and § 1.704–4 (or that would have been recognized by the partner except for the like-kind exception in section 704(c)(2) and § 1.704–4(d)(3)) on an actual distribution to another partner of section 704(c) property contributed by the distributee partner that is part of the same distribution as the distribution to the distributee partner.

(v) *Section 704(c)(2) disregarded.* A distributee partner's net precontribution gain is determined without regard to the provisions of section 704(c)(2) and § 1.704–4(d)(3) in situations in which the property contributed by the distributee partner is not actually distributed to another partner in a distribution related to the section 737 distribution.

(d) *Character of gain.* The character of the gain recognized by the distributee partner under section 737 and this section is determined by, and is proportionate to, the character of the partner's net precontribution gain. For this purpose, all gains and losses on section 704(c) property taken into account in determining the partner's net precontribution gain are netted according to their character. Character is determined at the partnership level for this purpose, and any character with a net negative amount is disregarded. The character of the partner's gain under section 737 is the same as, and in proportion to, any character with a net positive amount. Character for this purpose is determined as if the section 704(c) property had been sold by the partnership to an unrelated third party at the time of the distribution and includes any item that would have been taken into account separately by the contributing partner under section 702(a) and § 1.702–1(a).

(e) *Examples.* The following examples illustrate the provisions of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

Example 1. Calculation of excess distribution and net precontribution gain. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, depreciable real property with a fair market value of $30,000 and an adjusted tax basis of $20,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $30,000. C contributes $30,000 cash.

(ii) Property A has 10 years remaining on its cost recovery schedule and is depreciated using the straight-line method. The partnership uses the traditional method for allocating items under section 704(c) described in §1.704–3(b)(1) for Property A. The partnership has book depreciation of $3,000 per year (10 percent of the $30,000 book basis in Property A) and each partner is allocated $1,000 of book depreciation per year (one-third of the total annual book depreciation of $3,000). The partnership also has tax depreciation of $2,000 per year (10 percent of the $20,000 adjusted tax basis in Property A). This $2,000 tax depreciation is allocated equally between B and C, the noncontributing partners with respect to Property A.

(iii) At the end of 1997, the book value of Property A is $21,000 ($30,000 initial book value less $9,000 aggregate book depreciation) and its adjusted tax basis is $14,000 ($20,000 initial tax basis less $6,000 aggregate tax depreciation).

(iv) On December 31, 1997, Property B is distributed to A in complete liquidation of A's partnership interest. The adjusted tax basis of A's partnership interest at that time is $20,000. The amount of the excess distribution is $10,000, the difference between the fair market value of the distributed Property B ($30,000) and A's adjusted tax basis in A's partnership interest ($20,000). A's net precontribution gain is $7,000, the difference between the book value of Property A ($21,000) and its adjusted tax basis at the time of the distribution ($14,000). A recognizes gain of $7,000 on the distribution, the lesser of the excess distribution and the net precontribution gain.

Example 2. Determination of distributee partner's basis. (i) On January 1, 1995, A, B, and C form general partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $4,000. B and C each contributes $10,000 cash.

(ii) The partnership purchases Property B, nondepreciable real property with a fair market value of $9,000, subject to a $9,000 nonrecourse liability. This nonrecourse liability is allocated equally among the partners under section 752, increasing A's adjusted tax basis in A's partnership interest from $4,000 to $7,000.

(iii) On December 31, 1998, A receives $2,000 cash and Property B, subject to the $9,000 liability, in a current distribution.

(iv) In determining the amount of the excess distribution, the adjusted tax basis of A's partnership interest is adjusted to take into account the distribution of money and the shift in liabilities. A's adjusted tax basis is therefore increased to $11,000 for this purpose ($7,000 initial adjusted tax basis, less $2,000 distribution of money, less $3,000 (decrease in A's share of the $9,000 partnership liability), plus $9,000 (increase in A's individual liabilities)). As a result of this basis adjustment, the adjusted tax basis of A's partnership interest ($11,000) is greater than the fair market value of the distributed property ($9,000) and therefore, there is no excess distribution. A recognizes no gain under section 737.

Example 3. Net precontribution gain reduced for gain recognized under section 704(c)(1)(B). (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Properties A1 and A2, nondepreciable real properties located in the United States each with a fair market value of $10,000 and an adjusted tax basis of $6,000. B contributes Property B, nondepreciable real property located outside the United States, with a fair market value and adjusted tax basis of $20,000. C contributes $20,000 cash.

(ii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest and, as part of the same distribution, Property A1 is distributed to B in a current distribution.

(iii) A's net precontribution gain before the distribution is $8,000 ($20,000 fair market value of Properties A1 and A2 less $12,000 adjusted tax basis of such properties). A recognizes $4,000 of gain under section 704(c)(1)(B) and §1.704–4 on the distribution of Property A1 to B ($10,000 fair market value of Property A1 less $6,000 adjusted tax basis of Property A1). This gain is taken into account in determining A's excess distribution and net precontribution gain. As a result, A's net precontribution gain is reduced from $8,000 to $4,000, and the adjusted tax basis in A's partnership interest is increased by $4,000 to $16,000.

(iv) A recognizes gain of $4,000 on the receipt of Property B under section 737, an amount equal to the lesser of the excess distribution of $4,000 ($20,000 fair market value of Property B less $16,000 adjusted tax basis of A's interest in the partnership) and A's remaining net precontribution gain of $4,000.

Example 4. Character of gain. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable property to the partnership:

	Fair market value	Adjusted tax basis
Property A1	$30,000	$20,000
Property A2	30,000	38,000
Property A3	10,000	9,000

(ii) The character of gain or loss on Property A1 and Property A2 is long-term, U.S.-source capital gain or loss. The character of gain on Property A3 is long-term, foreign-source capital gain. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $70,000. C contributes $70,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes $3,000 of gain under section 737, an amount equal to the excess distribution of $3,000 ($70,000 fair market value of Property B less $67,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of $3,000 ($70,000 aggregate fair market value of properties contributed by A less $67,000 aggregate adjusted tax basis of such properties).

(iv) In determining the character of A's gain, all gains and losses on property taken into account in determining A's net precontribution gain are netted according to their character and allocated to A's recognized gain under section 737 based on the relative proportions of the net positive amounts. U.S.-source and foreign-source gains must be netted separately because A would have been required to take such gains into account separately under section 702. As a result, A's net precontribution gain of $3,000 consists of $2,000 of net long-term, U.S.-source capital gain ($10,000 gain on Property A1 and $8,000 loss on Property A2) and $1,000 of net long-term, foreign-source capital gain ($1,000 gain on Property A3).

(v) The character of A's gain under paragraph (d) of this section is therefore $2,000 long-term, U.S.-source capital gain ($3,000 gain recognized under section 737 × $2,000 net long-term, U.S.-source capital gain/$3,000 total net precontribution gain) and $1,000 long-term, foreign-source capital gain ($3,000 gain recognized under section 737 × $1,000 net long-term, foreign-source capital gain/$3,000 total net precontribution gain).

[T.D. 8642, 60 FR 66733, Dec. 26, 1995]

§ 1.737–2 Exceptions and special rules.

(a) *Section 708(b)(1)(B) terminations.* Section 737 and this section do not apply to the deemed distribution of interests in a new partnership caused by the termination of a partnership under section 708(b)(1)(B). A subsequent distribution of property by the new partnership to a partner of the new partnership that was formerly a partner of the terminated partnership is subject to section 737 to the same extent that a distribution from the terminated partnership would have been subject to section 737. See also § 1.704–4(c)(3) for a similar rule in the context of section 704(c)(1)(B). This paragraph (a) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (a) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (a) to the termination in a consistent manner.

(b) *Transfers to another partnership*—(1) *Complete transfer.* Section 737 and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement. See § 1.704–4(c)(4) for a similar rule in the context of section 704(c)(1)(B).

(2) *Certain divisive transactions.* Section 737 and this section do not apply to a transfer by a partnership (transferor partnership) of all of the section 704(c) property contributed by a partner to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution as part of the same plan or arrangement of an interest in the transferee partnership (and no other property) in complete liquidation of the interest of the partner that originally contributed the section 704(c) property to the transferor partnership.

(3) *Subsequent distributions.* A subsequent distribution of property by the transferee partnership to a partner of the transferee partnership that was formerly a partner of the transferor partnership is subject to section 737 to the same extent that a distribution

from the transferor partnership would have been subject to section 737.

(c) *Incorporation of a partnership.* Section 737 and this section do not apply to an incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction. See §1.704–4(c)(5) for a similar rule in the context of section 704(c)(1)(B).

(d) *Distribution of previously contributed property*—(1) *General rule.* Any portion of the distributed property that consists of property previously contributed by the distributee partner (previously contributed property) is not taken into account in determining the amount of the excess distribution or the partner's net precontribution gain. The previous sentence applies on or after May 9, 1997. See §1.737–3(b)(2) for a special rule for determining the basis of previously contributed property in the hands of a distributee partner who contributed the property to the partnership.

(2) *Limitation for distribution of previously contributed interest in an entity.* An interest in an entity previously contributed to the partnership is not treated as previously contributed property to the extent that the value of the interest is attributable to property contributed to the entity after the interest was contributed to the partnership. The preceding sentence does not apply to the extent that the property contributed to the entity was contributed to the partnership by the partner that also contributed the interest in the entity to the partnership.

(3) *Nonrecognition transactions.* Property received by the partnership in exchange for contributed section 704(c) property in a nonrecognition transaction is treated as the contributed property with regard to the contributing partner for purposes of section 737 to the extent that the property received is treated as section 704(c) property under §1.704–3(a)(8). See §1.704–4(d)(1) for a similar rule in the context of section 704(c)(1)(B).

(4) *Undivided interests.* The distribution of an undivided interest in property is treated as the distribution of previously contributed property to the extent that the undivided interest does not exceed the undivided interest, if any, contributed by the distributee partner in the same property. See §1.704–4(c)(6) for the application of section 704(c)(1)(B) in a similar context. The portion of the undivided interest in property retained by the partnership after the distribution, if any, that is treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee partner.

(e) *Examples.* The following examples illustrate the rules of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

Example 1. Distribution of previously contributed property. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable real property to the partnership:

	Fair market value	Adjusted tax basis
Property A1	$20,000	$10,000
Property A2	10,000	6,000

(ii) A's total net precontribution gain on the contributed property is $14,000 ($10,000 on Property A1 plus $4,000 on Property A2). B contributes $10,000 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of $20,000. C contributes $30,000 cash.

(iii) On December 31, 1998, Property A2 and Property B are distributed to A in complete liquidation of A's interest in the partnership. Property A2 was previously contributed by A and is therefore not taken into account in determining the amount of the excess distribution or A's net precontribution gain. The adjusted tax basis of Property A2 in the hands of A is also determined under section 732 as if that property were the only property distributed to A.

(iv) As a result of excluding Property A2 from these determinations, the amount of the excess distribution is $10,000 ($20,000 fair market value of distributed Property B less $10,000 adjusted tax basis in A's partnership interest). A's net precontribution gain is also $10,000 ($14,000 total net precontribution gain less $4,000 gain with respect to previously contributed Property A2). A therefore recognizes $10,000 of gain on the distribution, the lesser of the excess distribution and the net precontribution gain.

Example 2. Distribution of a previously contributed interest in an entity. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $5,000, and all of the stock of Corporation X with a fair market value and adjusted tax basis of $500. B contributes $500 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. Partner C contributes $10,500 cash. On December 31, 1996, ABC contributes Property B to Corporation X in a nonrecognition transaction under section 351.

(ii) On December 31, 1998, all of the stock of Corporation X is distributed to A in complete liquidation of A's interest in the partnership. The stock is treated as previously contributed property with respect to A only to the extent of the $500 fair market value of the Corporation X stock contributed by A. The fair market value of the distributed stock for purposes of determining the amount of the excess distribution is therefore $10,000 ($10,500 total fair market value of Corporation X stock less $500 portion treated as previously contributed property). The $500 fair market value and adjusted tax basis of the Corporation X stock is also not taken into account in determining the amount of the excess distribution and the net precontribution gain.

(iii) A recognizes $5,000 of gain under section 737, the amount of the excess distribution ($10,000 fair market value of distributed property less $5,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain ($10,000 fair market value of Property A less $5,000 adjusted tax basis in Property A).

Example 3. Distribution of undivided interest in property. (i) On January 1, 1995, A and B form partnership AB as equal partners. A contributes $500 cash and an undivided one-half interest in Property X. B contributes $500 cash and an undivided one-half interest in Property X.

(ii) On December 31, 1998, an undivided one-half interest in Property X is distributed to A in a current distribution. The distribution of the undivided one-half interest in Property X is treated as a distribution of previously contributed property because A contributed an undivided one-half interest in Property X. As a result, A does not recognize any gain under section 737 on the distribution.

[T.D. 8642, 60 FR 66735, Dec. 26, 1995, as amended by T.D. 8717, 62 FR 25501, May 9, 1997]

§ 1.737–3 Basis adjustments; Recovery rules.

(a) *Distributee partner's adjusted tax basis in the partnership interest.* The distributee partner's adjusted tax basis in the partnership interest is increased by the amount of gain recognized by the distributee partner under section 737 and this section. This increase is not taken into account in determining the amount of gain recognized by the partner under section 737(a)(1) and this section or in determining the amount of gain recognized by the partner under section 731(a) on the distribution of money in the same distribution or any related distribution. See § 1.704–4(e)(1) for a determination of the distributee partner's adjusted tax basis in a distribution subject to section 704(c)(1)(B).

(b) *Distributee partner's adjusted tax basis in distributed property*—(1) *In general.* The distributee partner's adjusted tax basis in the distributed property is determined under section 732 (a) or (b) as applicable. The increase in the distributee partner's adjusted tax basis in the partnership interest under paragraph (a) of this section is taken into account in determining the distributee partner's adjusted tax basis in the distributed property other than property previously contributed by the partner. See § 1.704–4(e)(2) for a determination of basis in a distribution subject to section 704(c)(1)(B).

(2) *Previously contributed property.* The distributee partner's adjusted tax basis in distributed property that the partner previously contributed to the partnership is determined as if it were distributed in a separate and independent distribution prior to the distribution that is subject to section 737 and § 1.737–1.

(c) *Partnership's adjusted tax basis in partnership property*—(1) *Increase in basis.* The partnership's adjusted tax basis in eligible property is increased by the amount of gain recognized by the distributee partner under section 737.

(2) *Eligible property.* Eligible property is property that——

(i) Entered into the calculation of the distributee partner's net precontribution gain;

(ii) Has an adjusted tax basis to the partnership less than the property's fair market value at the time of the distribution;

(iii) Would have the same character of gain on a sale by the partnership to an unrelated party as the character of any of the gain recognized by the distributee partner under section 737; and

(iv) Was not distributed to another partner in a distribution subject to section 704(c)(1)(B) and §1.704–4 that was part of the same distribution as the distribution subject to section 737.

(3) *Method of adjustment.* For the purpose of allocating the basis increase under paragraph (c)(2) of this section among the eligible property, all eligible property of the same character is treated as a single group. Character for this purpose is determined in the same manner as the character of the recognized gain is determined under §1.737–1(d). The basis increase is allocated among the separate groups of eligible property in proportion to the character of the gain recognized under section 737. The basis increase is then allocated among property within each group in the order in which the property was contributed to the partnership by the partner, starting with the property contributed first, in an amount equal to the difference between the property's fair market value and its adjusted tax basis to the partnership at the time of the distribution. For property that has the same character and was contributed in the same (or a related) transaction, the basis increase is allocated based on the respective amounts of unrealized appreciation in such properties at the time of the distribution.

(4) *Section 754 adjustments.* The basis adjustments to partnership property made pursuant to paragraph (c)(1) of this section are not elective and must be made regardless of whether the partnership has an election in effect under section 754. Any adjustments to the bases of partnership property (including eligible property as defined in paragraph (c)(2) of this section) under section 734(b) pursuant to a section 754 election (other than basis adjustments under section 734(b)(1)(A) described in the following sentence) must be made after (and must take into account) the adjustments to basis made under paragraph (a) and paragraph (c)(1) of this section. Basis adjustments under section 734(b)(1)(A) that are attributable to distributions of money to the distributee partner that are part of the same distribution as the distribution of property subject to section 737 are made before the adjustments to basis under paragraph (a) and paragraph (c)(1) of this section. See §1.737–1(c)(2)(ii) for the effect, if any, of basis adjustments under section 734(b)(1)(A) on a partner's net precontribution gain. See also §1.704–4(e)(3) for a similar rule regarding basis adjustments pursuant to a section 754 election in the context of section 704(c)(1)(B).

(d) *Recovery of increase to adjusted tax basis.* Any increase to the adjusted tax basis of partnership property under paragraph (c)(1) of this section is recovered using any applicable recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the type adjusted) placed in service at the time of the distribution.

(e) *Examples.* The following examples illustrate the rules of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

Example 1. Partner's basis in distributed property. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $5,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. C contributes $10,000 cash.

(ii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes $5,000 of gain under section 737, an amount equal to the excess distribution of $5,000

($10,000 fair market value of Property B less $5,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of $5,000 ($10,000 fair market value of Property A less $5,000 adjusted tax basis of such property).

(iii) A's adjusted tax basis in A's partnership interest is increased by the $5,000 of gain recognized under section 737. This increase is taken into account in determining A's basis in the distributed property. Therefore, A's adjusted tax basis in distributed Property B is $10,000 under section 732(b).

Example 2. Partner's basis in distributed property in connection with gain recognized under section 704(c)(1)(B). (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable real property located in the United States to the partnership:

	Fair market value	Adjusted tax basis
Property A1	$10,000	5,000
Property A2	10,000	2,000

(ii) B contributes $10,000 cash and Property B, nondepreciable real property located outside the United States, with a fair market value and adjusted tax basis of $10,000. C contributes $20,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in a current distribution and Property A1 is distributed to B in a current distribution. A recognizes $5,000 of gain under section 704(c)(1)(B) and § 1.704–4 on the distribution of Property A1 to B, the difference between the fair market value of such property ($10,000) and the adjusted tax basis in distributed Property A1 ($5,000). The adjusted tax basis of A's partnership interest is increased by this $5,000 of gain under section 704(c)(1)(B) and § 1.704–4(e)(1).

(iv) The increase in the adjusted tax basis of A's partnership interest is taken into account in determining the amount of the excess distribution. As a result, there is no excess distribution because the fair market value of Property B ($10,000) is less than the adjusted tax basis of A's interest in the partnership at the time of distribution ($12,000). A therefore recognizes no gain under section 737 on the receipt of Property B. A's adjusted tax basis in Property B is $10,000 under section 732(a)(1). The adjusted tax basis of A's partnership interest is reduced from $12,000 to $2,000 under section 733. See *Example 3* of § 1.737–1(e).

Example 3. Partnership's basis in partnership property after a distribution with section 737 gain. (i) On January 31, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable property to the partnership:

	Fair market value	Adjusted tax basis
Property A1	$1,000	$500
Property A2	4,000	1,500
Property A3	4,000	6,000
Property A4	6,000	4,000

(ii) The character of gain or loss on Properties A1, A2, and A3 is long-term, U.S.-source capital gain or loss. The character of gain on Property A4 is long-term, foreign-source capital gain. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $15,000. C contributes $15,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes gain of $3,000 under section 737, an amount equal to the excess distribution of $3,000 ($15,000 fair market value of Property B less $12,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of $3,000 ($15,000 aggregate fair market value of the property contributed by A less $12,000 aggregate adjusted tax basis of such property).

(iv) $2,000 of A's gain is long-term, foreign-source capital gain ($3,000 total gain under section 737 x $2,000 net long-term, foreign-source capital gain/$3,000 total net precontribution gain). $1,000 of A's gain is long-term, U.S.-source capital gain ($3,000 total gain under section 737 x $1,000 net long-term, U.S.-source capital gain/$3,000 total net precontribution gain).

(v) The partnership must increase the adjusted tax basis of the property contributed by A by $3,000. All property contributed by A is eligible property. Properties A1, A2, and A3 have the same character and are grouped into a single group for purposes of allocating this basis increase. Property A4 is in a separate character group.

(vi) $2,000 of the basis increase must be allocated to long-term, foreign-source capital assets because $2,000 of the gain recognized by A was long-term, foreign-source capital gain. The adjusted tax basis of Property A4 is therefore increased from $4,000 to $6,000. $1,000 of the increase must be allocated to Properties A1 and A2 because $1,000 of the gain recognized by A is long-term, U.S.-source capital gain. No basis increase is allocated to Property A3 because its fair market value is less than its adjusted tax basis. The $1,000 basis increase is allocated between Properties A1 and A2 based on the unrealized appreciation in each asset before such basis adjustment. As a result, the adjusted tax basis of Property A1 is increased by $167 ($1,000 x $500/$3,000) and the adjusted tax basis of Property A2 is increased by $833 ($1,000 x $2,500/3,000).

[T.D. 8642, 60 FR 66736, Dec. 26, 1995; 61 FR 7214, Feb. 27, 1996]

§1.737–4 Anti-abuse rule.

(a) *In general.* The rules of section 737 and §§1.737–1, 1.737–2, and 1.737–3 must be applied in a manner consistent with the purpose of section 737. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 737, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 737. Whether a tax result is inconsistent with the purpose of section 737 must be determined based on all the facts and circumstances. See §1.704–4(f) for an anti-abuse rule and examples in the context of section 704(c)(1)(B). The anti-abuse rule and examples under section 704(c)(1)(B) and §1.704–4(f) are relevant to section 737 and §§1.737–1, 1.737–2, and 1.737–3 to the extent that the net precontribution gain for purposes of section 737 is determined by reference to section 704(c)(1)(B).

(b) *Examples.* The following examples illustrate the rules of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

Example 1. Increase in distributee partner's basis by temporary contribution; results inconsistent with the purpose of section 737. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A1, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $1,000. B contributes Property B, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $10,000. C contributes $10,000 cash.

(ii) On January 1, 1999, pursuant to a plan a principal purpose of which is to avoid gain under section 737, A transfers to the partnership Property A2, nondepreciable real property with a fair market value and adjusted tax basis of $9,000. A treats the transfer as a contribution to the partnership pursuant to section 721 and increases the adjusted tax basis of A's partnership interest from $1,000 to $10,000. On January 1, 1999, the partnership agreement is amended and all other necessary steps are taken so that substantially all of the economic risks and benefits of Property A2 are retained by A. On February 1, 1999, Property B is distributed to A in a current distribution. If the contribution of Property A2 is treated as a contribution to the partnership for purposes of section 737, there is no excess distribution because the fair market value of distributed Property B ($10,000) does not exceed the adjusted tax basis of A's interest in the partnership ($10,000), and therefore section 737 does not apply. A's adjusted tax basis in distributed Property B is $10,000 under section 732(a)(1) and the adjusted tax basis of A's partnership interest is reduced to zero under section 733.

(iii) On March 1, 2000, A receives Property A2 from the partnership in complete liquidation of A's interest in the partnership. A recognizes no gain on the distribution of Property A2 because the property was previously contributed property. See §1.737–2(d).

(iv) Although A has treated the transfer of Property A2 as a contribution to the partnership that increased the adjusted tax basis of A's interest in the partnership, it would be inconsistent with the purpose of section 737 to recognize the transfer as a contribution to the partnership. Section 737 requires recognition of gain when the value of distributed property exceeds the distributee partner's adjusted tax basis in the partnership interest. Section 737 assumes that any contribution or other transaction that affects a partner's adjusted tax basis in the partnership interest is a contribution or transaction in substance and is not engaged in with a principal purpose of avoiding recognition of gain under section 737. Because the transfer of Property A2 to the partnership was not a contribution in substance and was made with a principal purpose of avoiding recognition of gain under section 737, the Commissioner can disregard the contribution of Property A2 for this purpose. As a result, A recognizes gain of $9,000 under section 737 on the receipt of Property B, an amount equal to the lesser of the excess distribution of $9,000 ($10,000 fair market value of distributed Property B less the $1,000 adjusted tax basis of A's partnership interest, determined without regard to the transitory contribution of Property A2) or A's net precontribution gain of $9,000 on Property A1.

Example 2. Increase in distributee partner's basis; section 752 liability shift; results consistent with the purpose of section 737. (i) On January 1, 1995, A and B form general partnership AB as equal partners. A contributes

Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $1,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. The partnership also borrows $10,000 on a recourse basis and purchases Property C. The $10,000 liability is allocated equally between A and B under section 752, thereby increasing the adjusted tax basis in A's partnership interest to $6,000.

(ii) On December 31, 1998, the partners agree that A is to receive Property B in a current distribution. If A were to receive Property B at that time, A would recognize $4,000 of gain under section 737, an amount equal to the lesser of the excess distribution of $4,000 ($10,000 fair market value of Property B less $6,000 adjusted tax basis in A's partnership interest) or A's net precontribution gain of $9,000 ($10,000 fair market value of Property A less $1,000 adjusted tax basis of Property A).

(iii) With a principal purpose of avoiding such gain, A and B agree that A will be solely liable for the repayment of the $10,000 partnership liability and take the steps necessary so that the entire amount of the liability is allocated to A under section 752. The adjusted tax basis in A's partnership interest is thereby increased from $6,000 to $11,000 to reflect A's share of the $5,000 of liability previously allocated to B. As a result of this increase in A's adjusted tax basis, there is no excess distribution because the fair market value of distributed Property B ($10,000) is less than the adjusted tax basis of A's partnership interest. Recognizing A's increased adjusted tax basis as a result of the shift in liabilities is consistent with the purpose of section 737 and this section. Section 737 requires recognition of gain only when the value of the distributed property exceeds the distributee partner's adjusted tax basis in the partnership interest. The $10,000 recourse liability is a bona fide liability of the partnership that was undertaken for a substantial business purpose and A's and B's agreement that A will assume responsibility for repayment of that debt has substance. Therefore, the increase in A's adjusted tax basis in A's interest in the partnership due to the shift in partnership liabilities under section 752 is respected, and A recognizes no gain under section 737.

[T.D. 8642, 60 FR 66738, Dec. 26, 1995]

§ 1.737–5 Effective date.

Sections 1.737–1, 1.737–2, 1.737–3, and 1.737–4 apply to distributions by a partnership to a partner on or after January 9, 1995.

[T.D. 8642, 60 FR 66739, Dec. 26, 1995]

TRANSFERS OF INTERESTS IN A PARTNERSHIP

§ 1.741–1 Recognition and character of gain or loss on sale or exchange.

(a) The sale or exchange of an interest in a partnership shall, except to the extent section 751(a) applies, be treated as the sale or exchange of a capital asset, resulting in capital gain or loss measured by the difference between the amount realized and the adjusted basis of the partnership interest, as determined under section 705. For treatment of selling partner's distributive share up to date of sale, see section 706(c)(2). Where the provisions of section 751 require the recognition of ordinary income or loss with respect to a portion of the amount realized from such sale or exchange, the amount realized shall be reduced by the amount attributable under section 751 to unrealized receivables and substantially appreciated inventory items, and the adjusted basis of the transferor partner's interest in the partnership shall be reduced by the portion of such basis attributable to such unrealized receivables and substantially appreciated inventory items. See section 751 and § 1.751–1.

(b) Section 741 shall apply whether the partnership interest is sold to one or more members of the partnership or to one or more persons who are not members of the partnership. Section 741 shall also apply even though the sale of the partnership interest results in a termination of the partnership under section 708(b). Thus, the provisions of section 741 shall be applicable (1) to the transferor partner in a 2-man partnership when he sells his interest to the other partner, and (2) to all the members of a partnership when they sell their interests to one or more persons outside the partnership.

(c) See section 351 for nonrecognition of gain or loss upon transfer of a partnership interest to a corporation controlled by the transferor.

(d) For rules relating to the treatment of liabilities on the sale or exchange of interests in a partnership see §§ 1.752–1 and 1.1001–2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7741, 45 FR 81745, Dec. 12, 1980]

§1.742–1 Basis of transferee partner's interest.

The basis to a transferee partner of an interest in a partnership shall be determined under the general basis rules for property provided by part II (section 1011 and following), subchapter O, chapter 1 of the Code. Thus, the basis of a purchased interest will be its cost. The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and paragraph (c)(3)(v) of §1.706–1 and paragraph (b) of §1.753–1) under section 691. See section 1014(c). For basis of contributing partner's interest, see section 722. The basis so determined is then subject to the adjustments provided in section 705.

§1.743–1 Optional adjustment to basis of partnership property.

(a) *General rule.* The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership, either by sale or exchange or as a result of the death of a partner, unless the election provided by section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to the partnership. However, whether or not the election provided in section 754 is in effect, the basis of partnership property shall not be adjusted as the result of a contribution of property, including money, to the partnership.

(b) *Adjustment to basis of partnership property*—(1) *Determination of adjustment.* In the case of a transfer of an interest in a partnership, either by sale or exchange or as a result of the death of a partner, a partnership as to which the election under section 754 is in effect shall:

(i) Increase the adjusted basis of partnership property by the excess of the transferee's basis for his partnership interest over his share of the adjusted basis to the partnership of all partnership property, or

(ii) Decrease the adjusted basis of partnership property by the excess of the transferee partner's share of the adjusted basis of all partnership property over his basis for his partnership interest.

The amount of the increase or decrease constitutes an adjustment affecting the basis of partnership property with respect to the transferee partner only. Thus, for purposes of depreciation, depletion, gain or loss, and distributions, the transferee partner will have a special basis for those partnership properties which are adjusted under section 743(b) and this paragraph. This special basis is his share of the common partnership basis (i.e., the adjusted basis of such properties to the partnership without regard to any special basis adjustments of any transferee) plus or minus his special basis adjustments. A partner's share of the adjusted basis of partnership property is equal to the sum of his interest as a partner in partnership capital and surplus, plus his share of partnership liabilities. Where an agreement with respect to contributed property is in effect under section 704(c)(2), such agreement shall be taken into account in determining a partner's share of the adjusted basis of partnership property. Generally, if a partner's interest in partnership capital and profits is one-third, his share of the adjusted basis of partnership property will be one-third of such basis. The provisions of this paragraph may be illustrated by the following examples:

Example 1. A is a member of partnership ABC in which the partners have equal interests in capital and profits. The partnership has made the election under section 754, relating to the optional adjustment to the basis of partnership property. A sells his interest to P for $22,000. The balance sheet of the partnership at the date of sale shows the following:

ASSETS

	Adjusted basis per books	Market value
Cash	$5,000	$5,000
Accounts receivable	10,000	10,000
Inventory	20,000	21,000
Depreciable assets	20,000	40,000
Total	55,000	76,000

LIABILITIES AND CAPITAL

	Adjusted basis per books	Value
Liabilities	$10,000	$10,000
Capital:		
A	15,000	22,000
B	15,000	22,000
C	15,000	22,000
Total	55,000	76,000

The amount of the adjustment under section 743(b) is the difference between the basis of the transferee's interest in the partnership and his share of the adjusted basis of partnership property. Under section 742, the basis of P's interest is $25,333 (the cash paid for A's interest, $22,000, plus $3,333, P's share of partnership liabilities). P's share of the adjusted basis of partnership property is $18,333, i.e., $15,000 plus $3,333. The amount to be added to the basis of partnership property is, therefore, $7,000, the difference between $25,333 and $18,333. This amount will be allocated to partnership properties in accordance with the rules set forth in section 755 and § 1.755–1.

Example 2. D is a member of partnership DEF in which the partners have equal interests in profits, but not in capital. The partnership has made the election under section 754. D dies and his interest passes to W, his widow. The balance sheet of the partnership at the date of D's death shows the following:

ASSETS

	Adjusted basis per books	Market value
Cash	$7,000	$7,000
Accounts receivable	10,000	10,000
Inventory	20,000	24,000
Depreciable assets	20,000	40,000
Total	57,000	81,000

LIABILITIES AND CAPITAL

	Adjusted basis per books	Value
Liabilities	$10,000	$10,000
Capital:		
D	18,000	26,000
E	15,000	23,000
F	14,000	22,000
Total	57,000	81,000

The amount of the adjustment under section 743(b) is the difference between the basis of the transferee's interest in the partnership and her share of the adjusted basis of partnership property. Under section 742, the basis of W's interest is $29,333 (the fair market value of D's interest at his death, $26,000, plus $3,333, his share of partnership liabilities). W's share of the adjusted basis of partnership property is $21,333 (i.e., $18,000 plus $3,333, her share of partnership liabilities). The amount to be added to the basis of partnership property is, therefore, $8,000, the difference between $29,333 and $21,333. This amount will be allocated to partnership properties in accordance with the rules set forth in section 755 and § 1.755–1.

Note that in examples 1 and 2 of this subparagraph the amount of the adjustment does not depend upon the adjusted basis to the transferor for his interest in partnership capital.

(2) *Determination of partner's share of adjusted basis of partnership property.* (i) Under the provisions of section 743(b), a partner's share of the adjusted basis of partnership property shall be determined by taking into account the effect of any partnership agreement with respect to contributed property as described in section 704(c)(2), or the effect of the contribution of undivided interests under section 704(c)(3). This rule may be illustrated by the following examples:

Example 1. A, B, and C form partnership ABC, to which A contributes land worth $1,000 (property X) with an adjusted basis to him of $400, and B and C each contributes $1,000 cash. Each partner has $1,000 credited to him on the books of the partnership as his capital contribution. The partners share in profits equally. During the partnership's first taxable year, property X appreciates in value to $1,300. A sells his one-third interest in the partnership to D for $1,100, when the election under section 754 is in effect. No agreement under section 704(c)(2) is in effect. The adjusted basis of the partnership property is increased with respect to D by the excess of his basis for his partnership interest, $1,100, over his share of the adjusted basis of partnership property, $800 (1/3 of $2,400, the total adjusted basis of partnership property). The amount of the adjustment, therefore, is $300 ($1,100 minus $800), which is an increase in the basis of partnership property with respect to D only. This special basis adjustment will be allocated to property X. (See section 755 and § 1.755–1.) If property X is sold for $1,600, the gain to the partnership is $1,200 ($1,600 received, less the adjusted common partnership basis of $400 for property X). Thus, each partner's distributive share of the gain on the sale is $400. However, D's recognized gain is only $100 (his $400 distributive share of the gain, reduced by $300, his special basis adjustment with respect to property X). If D purchased his interest from B or C, the partners who contributed cash, D's adjustment under section 743(b) would also be $300, computed in exactly the same manner as in the case of a purchase from A.

Example 2. Assume that partnership ABC described in example 1 of this subdivision has an agreement under section 704(c)(2) with respect to property X, stating that upon the sale of that property any gain, to the extent attributable to the precontribution appreciation of $600 (the difference between its value, $1,000, and its basis, $400, at the time of the contribution) is to be allocated entirely to A, who contributed property X. Upon the purchase of A's interest by D for $1,100, the computation of D's special basis would differ from that indicated in example 1 of this subdivision as follows: Under the partnership agreement, A's share of the $2,400 adjusted basis of partnership property is only $400 (his basis for property X prior to its contribution to the partnership), and B's and C's share is $1,000 each (the amount of the cash investment of each). The amount of the increase to D in the adjusted basis of partnership property under section 743(b)(1) is $700 (the excess of $1,100, D's cost basis for his interest, over $400, A's share of the adjusted basis of partnership property to which D succeeds). This amount constitutes an adjustment to the basis of partnership property with respect to D only. If X is sold by the partnership for $1,600, the gain is $1,200 ($1,600 received less the adjusted common partnership basis of $400). Under the partnership agreement, $600 of this gain, which is attributable to precontribution appreciation in value, is allocable to D, who is A's successor. The remaining $600 gain is not subject to the agreement and is allocable to the partners equally, $200 each. D's distributive share of the partnership gain is thus $600 plus $200, or $800. However, D has a special basis adjustment of $700 under section 743(b)(1), which reduces his gain from $800 to $100. B and C each has a gain of $200, which is unaffected by the transfer of A's interest to D.

Example 3. Assume the same facts as in example 2 of this subdivision, except that D has purchased his interest from B instead of from A. His special basis adjustment for partnership property in this case differs from that where he had purchased his interest from A, because of the effect of the agreement under section 704(c)(2). In this case, D is a successor to B, whose share of the adjusted basis of partnership property is $1,000, instead of A, whose share is only $400. As a result, the adjustment under section 743(b)(1) is the excess of D's cost basis for his interest, $1,100, over his share of the adjusted basis of partnership property, $1,000, or $100. In this case, if property X is sold for $1,600, the partnership gain is $1,200 ($1,600 less the adjusted partnership basis of $400). Of this gain, $600, representing precontribution appreciation, is allocable to A under the partnership agreement. The remaining $600 is allocable in the amount of $200 to each partner. Since D as a transferee has a special basis adjustment of $100 under section 743(b)(1), his gain is reduced from $200 to $100.

(ii) If a partner receives a distribution of property with respect to which another partner has a special basis adjustment, the distributee shall not take into account the special basis adjustment of the other partner. However, the partner with the special basis adjustment will reallocate it under section 755 to remaining partnership property of a like kind or, if he receives a distribution of like property, to such distributed property. If a partner receives a distribution of property with respect to which he has a special basis adjustment, such basis adjustment will be taken into account when relevant under section 732. See paragraph (b) of §1.732–2. If, at the time a partner receives property (whether or not he has a special basis adjustment with respect to such property), he relinquishes his interest in other property of a like kind with respect to which he has a special basis adjustment, the adjusted basis to the partnership of the distributed property shall include his special basis adjustment for the property in which he relinquished his interest. For the purposes of the preceding sentence, a partner will be considered as having relinquished his interest in any remaining partnership properties when his interest has been completely liquidated; however, when a partner receives a distribution not in liquidation, he will be considered as relinquishing his interest only in property distributed to other partners. For the purposes of this subdivision, like property means property of the same class, that is, stock in trade, property used in the trade or business, capital assets, etc. For certain adjustments to the basis of remaining partnership property after a distribution to a transferee partner, see paragraph (b) of §1.734–2. The provisions of this subdivision may be illustrated by the following examples:

Example 1. C is a transferee partner in partnership BC. The partnership owns, among other assets, X, a depreciable asset with a common basis to the partnership of $1,000 and a special basis adjustment to C of $200, and Y, another depreciable asset with a common basis of $800 and a special basis adjustment to C of $300. B and C agree that B will receive a distribution of property Y, and C will receive a distribution of property X, with all other property to remain in the partnership. With respect to B, the partnership basis of property Y is $800, the common partnership basis. Y will, therefore, have a basis of $800 in B's hands under section 732(a) which provides for the use of a carryover basis in the case of current distributions. With respect to C, however, the partnership basis of property X is $1,500, the common partnership basis of $1,000, plus C's special basis adjustment of $200 for property X, plus C's additional special basis adjustment of $300 for property Y, in which he has relinquished his interest.

Example 2. (a) Partner D acquired his one-third interest in partnership BCD for $14,000 from a previous partner when an election under section 754 was in effect. Therefore, under section 743(b), D has a special basis adjustment for certain partnership property. Assume that at the time of the distribution in paragraph (b) of this example, the partnership assets consist of cash and rental property and that such assets and D's special basis adjustments under section 743(b) are as follows:

Item	Fair market value	Common partnership basis	D's share	D's special basis adjustment	Partnership basis to D
Cash	$12,000	$12,000	$4,000	....	$4,000
House:					
U	9,000	1,200	400	....	400
V	6,000	4,500	1,500	....	1,500
W	8,000	1,500	500	....	500
X	9,000	4,800	1,600	$2,000	3,600
Y	9,000	6,000	2,000	....	2,000
Z	7,000	3,000	1,000	1,000	2,000
Total	60,000	33,000	11,000	3,000	14,000

(b) Assume further that D receives $4,000 in cash and houses Y and Z in complete liquidation of his interest in partnership BCD. In determining the basis to D of houses Y and Z under section 732 (b) and (c), D must allocate $10,000 basis ($14,000 basis for his interest, less $4,000 cash received) to houses Y and Z in proportion to their adjusted basis to the partnership. For purposes of section 732(c), the adjusted basis of house Y is $7,200. ($6,000 common partnership basis, plus $1,200, allocated share of D's special basis adjustment of $2,000 for house X, in which D relinquished his interest). The adjusted basis of house Z is $4,800 ($3,000 common partnership basis, plus $1,000, D's special basis for house Z, plus $800, allocated share of D's special basis of $2,000 for house X, in which D relinquished his interest). Under the rule of this subdivision, 6,000/10,000 of the $2,000 special basis adjustment for X is allocated to Y and 4,000/10,000 of such amount to Z. Therefore, $6,000 basis (7,200/12,000 of $10,000) is allocated to house Y and $4,000 basis (4,800/12,000 of $10,000) to house Z.

(c) Since houses Y and Z had $12,000 basis to the partnership, as computed in paragraph (b) of this example, and only $10,000 basis to D, as determined under section 732, the partnership, under section 734(b)(1)(B), must increase the basis of remaining partnership property (houses U, V, W, and X) by $2,000 (excess of $12,000 over $10,000). For allocation of this amount, see section 755 and § 1.755–1.

(iii) Where an adjustment is made under section 743(b) to the basis of partnership property subject to depletion, any depletion allowable shall be determined separately for each partner, including the transferee partner, based on his interest in such property. See paragraph (a)(8) of § 1.702–1. This rule may be illustrated by the following example:

Example. A, B, and C each contributes $5,000 cash to form partnership ABC, which purchases oil property for $15,000. C subsequently sells his partnership interest to D for $100,000 when the election under section 754 is in effect. D has a special basis adjustment for the oil property of $95,000 (the difference between D's basis, $100,000, and his share of the basis of partnership property, $5,000). Assume that the depletion allowance computed under the percentage method would be $21,000 for the taxable year so that each partner would be entitled to $7,000 as his share of the deduction for depletion. However, under the cost depletion method, at an assumed rate of 10 percent, the allowance with respect to D's one-third interest which has a basis to him of $100,000 ($5,000, plus his special basis adjustment of $95,000) is $10,000, although the cost depletion allowance with respect to the one-third interest of A and B in the oil property, each of which has a basis of $5,000, is only $500. For partners A and B, the percentage depletion is greater than cost depletion and each will deduct $7,000 based on the percentage depletion method. However, as to D, the transferee partner, the cost depletion method results in a greater allowance and D will, therefore, deduct $10,000 based on cost depletion. See section 613(a).

(iv) Where there has been more than one transfer of partnership interests, the last transferee's special basis adjustment, if any, under section 743(b) shall be determined by reference to the partnership common basis for its property without regard to any prior transferee's special basis adjustment. For example, A, B, and C form a partnership. A and B each contributes $1,000 cash and C contributes land with a basis and value of $1,000. When the land has appreciated in value to $1,300, A sells his interest to D for $1,100 (1/3 of $3,300, the value of the partnership property). The election under section 754 is in effect; therefore, D has a special basis adjustment of $100 with respect to the land under section 743(b). After the land has further appreciated in value to $1,600, D sells his interest to E for $1,200 (1/3 of $3,600, the value of the partnership property). Under section 743(b), E has a special basis adjustment of $200. This amount is determined without regard to any special basis adjustment that D may have had in the partnership assets.

(3) *Returns.* A transferee partner who has a special basis adjustment under section 743(b) shall attach a statement to his income tax return for the first taxable year in which the basis of any partnership property subject to the adjustment is pertinent in determining his income tax, showing the computation of the adjustment and the partnership properties to which the adjustment has been allocated.

(c) *Allocation of basis.* For the allocation of basis among partnership properties where section 743 (b) applies, see section 755 and §1.755–1.

(d) *Section 708(b)(1)(B) terminations.* A partner with a special basis adjustment in property held by a partnership that terminates under section 708(b)(1)(B) will continue to have the same special basis adjustment with respect to property deemed contributed by the terminated partnership to the new partnership under §1.708–1(b)(1)(iv), regardless of whether the new partnership makes a section 754 election. This paragraph (d) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (d) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (d) to the termination in a consistent manner.

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PROVISIONS COMMON TO PART II, SUBCHAPTER K, CHAPTER 1 OF THE CODE

§1.751–1 Unrealized receivables and inventory items.

(a) *Sale or exchange of interest in a partnership*—(1) *Character of amount realized.* To the extent that money or property received by a partner in exchange for all or part of his partnership interest is attributable to his share of the value of partnership unrealized receivables or substantially appreciated inventory items, the money or fair market value of the property received shall be considered as an amount realized from the sale or exchange of property other than a capital asset. The remainder of the total amount realized on the sale or exchange of the partnership interest is realized from the sale or exchange of a capital asset under section 741. For definition of ‘‘unrealized receivables'' and ‘‘inventory items which have appreciated substantially in value'', see section 751 (c) and (d). Unrealized receivables and substantially appreciated inventory items are hereafter in this section referred to as ‘‘section 751 property''. See paragraph (e) of this section.

(2) *Determination of gain or loss.* The income or loss realized by a partner upon the sale or exchange of his interest in section 751 property is the difference between (i) the portion of the total amount realized for the partnership interest allocated to section 751 property, and (ii) the portion of the selling partner's basis for his entire interest allocated to such property. Generally, the portion of the total amount

realized which the seller and the purchaser allocate to section 751 property in an arm's length agreement will be regarded as correct. The portion of the partner's adjusted basis for his partnership interest to be allocated to section 751 property shall be an amount equal to the basis such property would have had under section 732 (including subsection (d) thereof) if the selling partner had received his share of such properties in a current distribution made immediately before the sale. See §§ 1.732–1 and 1.732–2. Such basis shall reflect the rules of section 704(c)(3), if applicable, or any agreement under section 704(c)(2). Any gain or loss recognized which is attributable to section 751 property will be ordinary gain or loss. The difference between the remainder, if any, of the partner's adjusted basis for his partnership interest and the balance, if any, of the amount realized is the transferor's capital gain or loss on the sale of his partnership interest.

(3) *Statement required.* A transferor partner selling or exchanging any part of his interest in a partnership which has any section 751 property at the time of sale or exchange shall submit with his income tax return for the taxable year in which the sale or exchange occurs a statement setting forth separately the following information:

(i) The date of the sale or exchange, the amount of the transferor partner's adjusted basis for his partnership interest, and the portion thereof attributable to section 751 property under section 732; and

(ii) The amount of any money and the fair market value of any other property received or to be received for the transferred interest in the partnership, and the portion thereof attributable to section 751 property.

(iii) If the transferor partner computes his adjusted basis for section 751 property under the provisions of section 732(d), he must also include in the statement the information required byp-paragraph (d)(3) of§ 1.732–1.

(iv) If the transferor partner has a special basis adjustment under section 743(b), he must also include in the statement the computation of his special basis adjustment and the partnership properties to which the adjustment has been allocated.

(b) *Certain distributions treated as sales or exchanges*—(1) *In general.* (i) Certain distributions to which section 751(b) applies are treated in part as sales or exchanges of property between the partnership and the distributee partner, and not as distributions to which sections 731 through 736 apply. A distribution treated as a sale or exchange under section 751(b) is not subject to the provisions of section 707(b). Section 751(b) applies whether or not the distribution is in liquidation of the distributee partner's entire interest in the partnership. However, section 751(b) applies only to the extent that a partner either receives section 751 property in exchange for his relinquishing any part of his interest in other property, or receives other property in exchange for his relinquishing any part of his interest in section 751 property.

(ii) Section 751(b) does not apply to a distribution to a partner which is not in exchange for his interest in other partnership property. Thus, section 751(b) does not apply to the extent that a distribution consists of the distributee partner's share of section 751 property or his share of other property. Similarly, section 751(b) does not apply to current drawings or to advances against the partner's distributive share, or to a distribution which is, in fact, a gift or payment for services or for the use of capital. In determining whether a partner has received only his share of either section 751 property or of other property, his interest in such property remaining in the partnership immediately after a distribution must be taken into account. For example, the section 751 property in partnership ABC has a fair market value of $100,000 in which partner A has an interest of 30 percent, or $30,000. If A receives $20,000 of section 751 property in a distribution, and continues to have a 30-percent interest in the $80,000 of section 751 property remaining in the partnership after the distribution, only $6,000 ($30,000 minus $24,000 (30 percent of $80,000)) of the section 751 property received by him will be considered to be his share of such property. The remaining $14,000 ($20,000 minus $6,000) received is in excess of his share.

(iii) If a distribution is, in part, a distribution of the distributee partner's share of section 751 property, or of other property (including money) and, in part, a distribution in exchange of such properties, the distribution shall be divided for the purpose of applying section 751(b). The rules of section 751(b) shall first apply to the part of the distribution treated as a sale or exchange of such properties, and then the rules of sections 731 through 736 shall apply to the part of the distribution not treated as a sale or exchange. See paragraph (b)(4)(ii) of this section for treatment of payments under section 736(a).

(2) *Distribution of section 751 property (unrealized receivables or substantially appreciated inventory items).* (i) To the extent that a partner receives section 751 property in a distribution in exchange for any part of his interest in partnership property (including money) other than section 751 property, the transaction shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the income or loss to the partnership will be measured by the difference between the adjusted basis to the partnership of the section 751 property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in other partnership property which he relinquished in the exchange. In computing the partners' distributive shares of such ordinary income or loss, the income or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702(a)(8).

(iii) At the time of the distribution, the distributee partner realizes gain or loss measured by the difference between his adjusted basis for the property relinquished in the exchange (including any special basis adjustment which he may have) and the fair market value of the section 751 property received by him in exchange for his interest in other property which he has relinquished. The distributee's adjusted basis for the property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b). The character of the gain or loss to the distributee partner shall be determined by the character of the property in which he relinquished his interest.

(3) *Distribution of partnership property other than section 751 property.* (i) To the extent that a partner receives a distribution of partnership property (including money) other than section 751 property in exchange for any part of his interest in section 751 property of the partnership, the distribution shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes gain or loss on the sale or exchange of the property other than section 751 property. The amount of the gain to the partnership will be measured by the difference between the adjusted basis to the partnership of the distributed property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in section 751 property which he relinquished in the exchange. The character of the gain or loss to the partnership is determined by the character of the distributed property treated as sold or exchanged by the partnership. In computing the partners' distributive shares of such gain or loss, the gain or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702(a)(8).

(iii) At the time of the distribution, the distributee partner realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the distributee partner's income or loss shall be measured by the difference between his adjusted basis for the section 751 property relinquished in the exchange (including any special basis adjustment which he may have), and the fair market value of other property (including money) received by him in exchange for his interest in the section 751 property which he has relinquished. The distributee partner's adjusted basis for the section 751 property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b).

(4) *Exceptions.* (i) Section 751(b) does not apply to the distribution to a partner of property which the distributee partner contributed to the partnership. The distribution of such property is governed by the rules set forth in sections 731 through 736, relating to distributions by a partnership.

(ii) Section 751(b) does not apply to payments made to a retiring partner or to a deceased partner's successor in interest to the extent that, under section 736(a), such payments constitute a distributive share of partnership income or guaranteed payments. Payments to a retiring partner or to a deceased partner's successor in interest for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, constitute payments under section 736(a) and, therefore, are not subject to section 751(b). However, payments under section 736(b) which are considered as made in exchange for an interest in partnership property are subject to section 751(b) to the extent that they involve an exchange of substantially appreciated inventory items for other property. Thus, payments to a retiring partner or to a deceased partner's successor in interest under section 736 must first be divided between payments under section 736(a) and section 736(b). The section 736(b) payments must then be divided, if there is an exchange of substantially appreciated inventory items for other property, between the payments treated as a sale or exchange under section 751(b) and payments treated as a distribution under sections 731 through 736. See subparagraph (1)(iii) of this paragraph, and section 736 and § 1.736–1.

(5) *Statement required.* A partnership which distributes section 751 property to a partner in exchange for his interest in other partnership property, or which distributes other property in exchange for any part of the partner's interest in section 751 property, shall submit with its return for the year of the distribution a statement showing the computation of any income, gain, or loss to the partnership under the provisions of section 751(b) and this paragraph. The distributee partner shall submit with his return a statement showing the computation of any income, gain, or loss to him. Such statement shall contain information similar to that required under paragraph (a)(3) of this section.

(c) *Unrealized receivables.* (1) The term *unrealized receivables,* as used in subchapter K, chapter 1 of the Code, means any rights (contractual or otherwise) to payment for:

(i) Goods delivered or to be delivered (to the extent that such payment would be treated as received for property other than a capital asset), or

(ii) Services rendered or to be rendered,

to the extent that income arising from such rights to payment was not previously includible in income under the method of accounting employed by the partnership. Such rights must have arisen under contracts or agreements in existence at the time of sale or distribution, although the partnership may not be able to enforce payment until a later time. For example, the term includes trade accounts receivable of a cash method taxpayer, and rights to payment for work or goods begun but incomplete at the time of the sale or distribution.

(2) The basis for such unrealized receivables shall include all costs or expenses attributable thereto paid or accrued but not previously taken into account under the partnership method of accounting.

(3) In determining the amount of the sale price attributable to such unrealized receivables, or their value in a distribution treated as a sale or exchange, any arm's length agreement between the buyer and the seller, or between the partnership and the distributee partner, will generally establish the amount or value. In the absence of such an agreement, full account shall be taken not only of the estimated cost of completing performance of the contract or agreement, but also of the time between the sale or distribution and the time of payment.

(4)(i) With respect to any taxable year of a partnership ending after September 12, 1966 (but only in respect of expenditures paid or incurred after that date), the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from mining property defined in section 617(f)(2). With respect to each item of partnership mining property so defined, the potential gain is the amount that would be treated as gain to which section 617(d)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(ii) With respect to sales, exchanges, or other dispositions after December 31, 1975, in any taxable year of a partnership ending after that date, the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from stock in a DISC as described in section 992(a). With respect to stock in such a DISC, the potential gain is the amount that would be treated as gain to which section 995(c) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the stock were sold by the partnership at its fair market value.

(iii) With respect to any taxable year of a partnership beginning after December 31, 1962, the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from section 1245 property. With respect to each item of partnership section 1245 property (as defined in section 1245(a)(3)), potential gain from section 1245 property is the amount that would be treated as gain to which section 1245(a)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item of section 1245 property were sold by the partnership at its fair market value. See §1.1245–1(e)(1). For example, if a partnership would recognize under section 1245(a)(1) gain of $600 upon a sale of one item of section 1245 property and gain of $300 upon a sale of its only other item of such property, the potential section 1245 income of the partnership would be $900.

(iv) With respect to transfers after October 9, 1975, and to sales, exchanges, and distributions taking place after that date, the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from stock in certain foreign corporations as described in section 1248. With respect to stock in such a foreign corporation, the potential gain is the amount that would be treated as gain to which section 1248(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the stock were sold by the partnership at its fair market value.

(v) With respect to any taxable year of a partnership ending after December 31, 1963, the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from section 1250 property. With respect to each item of partnership section 1250 property (as defined in section 1250(c)), potential gain from section 1250 property is the amount that would be treated as gain to which section 1250(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item of section 1250 property were sold by the partnership at its fair market value. See §1.1250–1(f)(1).

(vi) With respect to any taxable year of a partnership beginning after December 31, 1969, the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from farm recapture property as defined in section 1251(e)(1) (as in effect before enactment of the Tax Reform Act of 1984). With respect to each item of partnership farm recapture property so defined, the potential gain is the amount which would be treated as gain to which section 1251(c) (as in effect before enactment of the Tax Reform Act of 1984) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(vii) With respect to any taxable year of a partnership beginning after December 31, 1969, the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from farm land as defined in section 1252(a)(2). With respect to each item of partnership farm land so defined, the potential gain is the amount that would be treated as gain to which section 1252(a)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(viii) With respect to transactions which occur after December 31, 1976, in any taxable year of a partnership ending after that date, the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from franchises, trademarks, or trade names referred to in section 1253(a). With respect to each such item so referred to in section 1253(a), the potential gain is the amount that would be treated as gain to which section 1253(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the items were sold by the partnership at its fair market value.

(ix) With respect to any taxable year of a partnership ending after December 31, 1975, the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain under section 1254(a) from natural resource recapture property as defined in § 1.1254–1(b)(2). With respect to each separate partnership natural resource recapture property so described, the potential gain is the amount that would be treated as gain to which section 1254(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the property were sold by the partnership at its fair market value.

(x) For purposes of section 751(c) and this paragraph (c)(4), any arm's-length agreement between the buyer and seller, or between the partnership and distributee partner, will generally establish the fair market value of the property described in this paragraph (c)(4).

(5) For purposes of subtitle A of the Internal Revenue Code, the basis of any potential gain described in paragraph (c)(4) of this section is zero.

(6)(i) If (at the time of any transaction referred to in paragraph (c)(4) of this section) a partnership holds property described in paragraph (c)(4) of this section and if—

(A) A partner had a special basis adjustment under section 743(b) in respect of the property;

(B) The basis under section 732 of the property if distributed to the partner would reflect a special basis adjustment under section 732(d); or

(C) On the date a partner acquired a partnership interest by way of a sale or exchange (or upon the death of another partner) the partnership owned the property and an election under section 754 was in effect with respect to the partnership, the partner's share of any potential gain described in paragraph (c)(4) of this section is determined under paragraph (c)(6)(ii) of this section.

(ii) The partner's share of the potential gain described in paragraph (c)(4) of this section in respect of the property to which this paragraph (c)(6)(ii) applies is that amount of gain that the partner would recognize under section 617(d)(1), 995(c), 1245(a), 1248(a), 1250(a), 1251(c) (as in effect before the Tax Reform Act of 1984), 1252(a), 1253(a), or 1254(a) (as the case may be) upon a sale of the property by the partnership, except that, for purposes of this paragraph (c)(6) the partner's share of such gain is determined in a manner that is consistent with the manner in which the partner's share of partnership property is determined; and the amount of a potential special basis adjustment under section 732(d) is treated as if it were the amount of a special basis adjustment under section 743(b). For example, in determining, for purposes of this paragraph (c)(6), the amount of gain that a partner would recognize under section 1245 upon a sale of partnership property, the items allocated under §1.1245–1(e)(3)(ii) are allocated to the partner in the same manner as the partner's share of partnership property is determined. See §1.1250–1(f) for rules similar to those contained in §1.1245–1(e)(3)(ii).

(d) *Inventory items which have substantially appreciated in value*—(1) *Substantial appreciation.* Partnership inventory items shall be considered to have appreciated substantially in value if, at the time of the sale or distribution, the total fair market value of all the inventory items of the partnership exceeds 120 percent of the aggregate adjusted basis for such property in the hands of the partnership (without regard to any special basis adjustment of any partner) and, in addition, exceeds 10 percent of the fair market value of all partnership property other than money. The terms ''inventory items which have appreciated substantially in value'' or ''substantially appreciated inventory items'' refer to the aggregate of all partnership inventory items. These terms do not refer to specific partnership inventory items or to specific groups of such items. For example, any distribution of inventory items by a partnership the inventory items of which as a whole are substantially appreciated in value shall be a distribution of substantially appreciated inventory items for the purposes of section 751(b), even though the specific inventory items distributed may not be appreciated in value. Similarly, if the aggregate of partnership inventory items are not substantially appreciated in value, a distribution of specific inventory items, the value of which is more than 120 percent of their adjusted basis, will not constitute a distribution of substantially appreciated inventory items. For the purpose of this paragraph, the ''fair market value'' of inventory items has the same meaning as ''market'' value in the regulations under section 471, relating to general rule for inventories.

(2) *Inventory items.* The term *inventory items* as used in subchapter K, chapter 1 of the Code, includes the following types of property:

(i) Stock in trade of the partnership, or other property of a kind which would properly be included in the inventory of the partnership if on hand at the close of the taxable year, or property held by the partnership primarily for sale to customers in the ordinary course of its trade or business. See section 1221(1).

(ii) Any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231. Thus, accounts receivable acquired in the ordinary course of business for services or from the sale of stock in trade constitute inventory items (see section 1221(4)), as do any unrealized receivables.

(iii) Any other property retained by the partnership which, if held by the partner selling his partnership interest or receiving a distribution described in section 751(b), would be considered property described in subdivision (i) or (ii) of this subparagraph. Property actually distributed to the partner does not come within the provisions of section 751(d)(2)(C) and this subdivision.

(e) *Section 751 property and other property.* For the purposes of this section, *section 751 property* means unrealized receivables or substantially appreciated inventory items, and *other property* means all property (including money) except section 751 property.

(f) *Effective date.* Section 751 applies to gain or loss to a seller, distributee, or partnership in the case of a sale, exchange, or distribution occurring after March 9, 1954. For the purpose of applying this paragraph in the case of a taxable year beginning before January 1, 1955, a partnership or a partner may elect to treat as applicable any other section of subchapter K, chapter 1 of the Code. Any such election shall be made by a statement submitted not later than the time prescribed by law for the filing of the return for such taxable year, or August 21, 1956, whichever date is later (but not later than 6 months after the time prescribed by law for the filing of the return for such year). See section 771(b)(3) and paragraph (b)(3) of §1.771–1. See also section 771(c) and paragraph (c) of §1.771–1.

(g) *Examples.* Application of the provisions of section 751 may be illustrated by the following examples:

Example 1. C buys B's interest in personal service partnership AB for $15,000, when the balance sheet of the firm (reflecting a cash receipts and disbursements method of accounting) is as follows:

ASSETS

	Adjusted basis per books	Market value
Cash	$3,000	$3,000
Loans receivable	10,000	10,000
Other assets	7,000	7,000
Unrealized receivables	0	12,000
Total	20,000	32,000

LIABILITIES AND CAPITAL

	Per books	Value
Liabilities	$2,000	$2,000
Capital:		
A	9,000	15,000
B	9,000	15,000
Total	20,000	32,000

Section 751(a) applies to the sale. The total amount realized by B is $16,000, consisting of the cash received, $15,000, plus $1,000, B's share of the partnership liabilities assumed by C. See section 752. B's undivided half interest in the partnership property includes a half-interest in the partnership's unrealized receivables which are worth $12,000. Consequently, $6,000 of the $16,000 realized by B shall be considered received in exchange for B's interest in the partnership attributable to its unrealized receivables. The remaining $10,000 realized by B is in exchange for a capital asset. B's basis for his partnership interest is $10,000 ($9,000, plus $1,000, B's share of partnership liabilities). No portion of this basis is attributable to B's share of the unrealized receivables of the partnership since such property has a zero basis in the hands of the partnership; therefore, B has a basis of zero for the unrealized receivables because the partnership basis for such receivables would have carried over to him under section 732 had they been distributed to him. The difference between the zero basis and the $6,000 B realized for the unrealized receivables is ordinary income to him. The entire $10,000 of B's basis is the basis for his interest in partnership property other than unrealized receivables and is applied against the remaining $10,000 ($16,000 minus $6,000) received from the sale of his interest. Therefore, B has no capital gain or loss. (If B's basis for his interest in partnership property, other than unrealized receivables, were $9,000, he would realize capital gain of $1,000. If his basis were $11,000, he would sustain a capital loss of $1,000).

Example 2. (a) *Facts.* Partnership ABC makes a distribution to partner C in liquidation of his entire one-third interest in the partnership. At the time of the distribution, the balance sheet of the partnership, which uses the accrual method of accounting, is as follows:

ASSETS

	Adjusted basis per books	Market value
Cash	$15,000	$15,000
Accounts receivable	9,000	9,000
Inventory	21,000	30,000
Depreciable property	42,000	48,000
Land	9,000	9,000
Total	96,000	11,000

LIABILITIES AND CAPITAL

	Per books	Value
Current liabilities	$15,000	$15,000
Mortgage payable	21,000	21,000
Capital:		
A	20,000	25,000
B	20,000	25,000
C	20,000	25,000
Total	96,000	111,000

The distribution received by C consists of $10,000 cash and depreciable property with a fair market value of $15,000 and an adjusted basis to the partnership of $15,000.

(b) *Presence of section 751 property.* The partnership has no unrealized receivables, but the dual test provided in section 751(d)(1) must be applied to determine whether the inventory items of the partnership, in the aggregate, have appreciated substantially in value. The fair market value of all partnership inventory items, $39,000 (inventory $30,000, and accounts receivable $9,000), exceeds 120 percent of the $30,000 adjusted basis of such items to the partnership. The fair market value of the inventory items, $39,000, also exceeds 10 percent of the fair market value of all partnership property other than money (10 percent of $96,000 or $9,600). Therefore, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* Since C's entire partnership interest is to be liquidated, the provisions of section 736 are applicable. No part of the payment, however, is considered as a distributive share or as a guaranteed payment under section 736(a) because the entire payment is made for C's interest in partnership property. Therefore, the entire payment is for an interest in partnership property under section 736(b), and, to the extent applicable, subject to the rules of section 751. In the distribution, C received his share of cash ($5,000) and $15,000 in depreciable property ($1,000 less than his $16,000 share). In addition, he received other partnership property ($5,000 cash and $12,000 liabilities assumed, treated as money distributed under section 752(b)) in exchange for his interest in accounts receivable ($3,000), inventory ($10,000), land ($3,000), and the balance of his interest in depreciable property ($1,000). Section 751(b) applies only to the extent of the exchange of other property for section 751 property (i.e., inventory items, which include trade accounts receivable). The section 751 property exchanged has a fair market value of $13,000 ($3,000 in accounts receivable and $10,000 in inventory). Thus, $13,000 of the total amount C received is considered as received for the sale of section 751 property.

(d) *Distributee partner's tax consequences.* C's tax consequences on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* C's share of the inventory items is treated as if he received them in a current distribution, and his basis for such items is $10,000 ($7,000 for inventory and $3,000 for accounts receivable) as determined under paragraph (b)(3)(iii) of this section. Then C is considered as having sold his share of inventory items to the partnership for $13,000. Thus, on the sale of his share of inventory items, C realizes $3,000 of ordinary income.

(2) *The part of the distribution not under section 751(b).* Section 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was $32,000 ($20,000 plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $10,000, the basis attributed to the section 751 property treated as distributed to C and sold by him to the partnership. Thus, C has a basis of $22,000 for the remainder of his partnership interest. The total distribution to C was $37,000 ($22,000 in cash and liabilities assumed, and $15,000 in depreciable property). Since C received no more than his share of the depreciable property, none of the depreciable property constitutes proceeds of the sale under section 751(b). C did receive more than his share of money. Therefore, the sale proceeds, treated separately in subparagraph (1) of this paragraph of this example, must consist of money and therefore must be deducted from the money distribution. Consequently, in liquidation of the balance of C's interest, he receives depreciable property and $9,000 in money ($22,000 less $13,000). Therefore, no gain or loss is recognized to C on the distribution. Under section 732(b), C's basis for the depreciable property is $13,000 (the remaining basis of his partnership interest, $22,000, reduced by $9,000, the money received in the distribution).

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* The partnership consisting of the remaining members has no ordinary income on the distribution since it did not give up any section 751 property in the exchange. Of the $22,000 money distributed (in cash and the assumption of C's share of liabilities), $13,000 was paid to acquire C's interest in inventory ($10,000 fair market value) and in accounts receivable ($3,000). Since under section 751(b) the partnership is treated as buying these properties, it has a new cost basis for the inventory and accounts receivable acquired from C. Its basis for C's share of inventory and accounts receivable is $13,000, the amount which the partnership is considered as having paid C in the exchange. Since the partnership is treated as having distributed C's share of inventory and accounts receivable to him, the partnership must decrease its basis for inventory and accounts receivable ($30,000) by $10,000, the basis of C's share treated as distributed to him, and then increase the basis for inventory and accounts receivable by $13,000 to reflect the purchase prices of the items acquired. Thus, the basis of the partnership inventory is increased from $21,000 to $24,000 in the transaction. (Note that the basis of property acquired in a section 751(b) exchange is determined under section 1012 without regard to any elections of the partnership. See paragraph (e) of § 1.732–1.) Further, the partnership realizes no capital gain or loss on the portion of the distribution treated as a sale under section 751(b) since, to acquire C's interest in the inventory and accounts receivable, it gave up money and assumed C's share of liabilities.

(2) *The part of the distribution not under section 751(b).* In the remainder of the distribution to C which was not in exchange for C's interest in section 751 property, C received only other property as follows: $15,000 in depreciable property (with a basis to the partnership of $15,000) and $9,000 in money ($22,000 less $13,000 treated under subparagraph (1) of this paragraph of this example). Since this part of the distribution is not an exchange of section 751 property for other property, section 751(b) does not apply. Instead, the provisions which apply are sections 731 through 736, relating to distributions by a partnership. No gain or loss is recognized to the partnership on the distribution. (See section 731(b).) Further, the partnership makes no adjustment to the basis of remaining depreciable property unless an election under section 754 is in effect. (See section 734(a).) Thus, the basis of the depreciable property before the distribution, $42,000, is reduced by

the basis of the depreciable property distributed, $15,000, leaving a basis for the depreciable property in the partnership of $27,000. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) as follows: Since the adjusted basis of the distributed property to the partnership had been $15,000, and is only $13,000 in C's hands (see paragraph (d)(2) of this example), the partnership will increase the basis of the depreciable property remaining in the partnership by $2,000 (the excess of the adjusted basis to the partnership of the distributed depreciable property immediately before the distribution over its basis to the distributee). Whether or not an election under section 754 is in effect, the basis for each of the remaining partner's partnership interests will be $38,000 ($20,000 original contribution, plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities each assumed).

(f) *Partnership trial balance.* A trial balance of the AB partnership after the distribution in liquidation of C's entire interest would reflect the results set forth in the schedule below. Column I shows the amounts to be reflected in the records if an election is in effect under section 754 with respect to an optional adjustment under section 734(b) to the basis of undistributed partnership property. Column II shows the amounts to be reflected in the records where an election under section 754 is not in effect. Note that in column II, the total bases for the partnership assets do not equal the total of the bases for the partnership interests.

Example 3. (a) *Facts.* Assume that the distribution to partner C in example 2 of this paragraph in liquidation of his entire interest in partnership ABC consists of $5,000 in cash and $20,000 worth of partnership inventory with a basis of $14,000.

	I		II	
	Sec.754, Election in effect		Sec.754, Election not in effect	
	Basis	Fair market value	Basis	Fair market value
Cash	$5,000	$5,000	$5,000	$5,000
Accounts receivable	9,000	9,000	9,000	9,000
Inventory	24,000	30,000	24,000	30,000
Depreciable property	29,000	33,000	27,000	33,000
Land	9,000	9,000	9,000	9,000
	76,000	86,000	74,000	86,000
Current liabilities	15,000	15,000	15,000	15,000
Mortgage	21,000	21,000	21,000	21,000
Capital:				
	20,000	25,000	20,000	25,000
	20,000	25,000	20,000	25,000
	76,000	86,000	76,000	86,000

(b) *Presence of section 751 property.* For the same reason as stated in paragraph (b) of example 2, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* In the distribution, C received his share of cash ($5,000) and his share of appreciated inventory items ($13,000). In addition, he received appreciated inventory with a fair market value of $7,000 (and with an adjusted basis to the partnership of $4,900) and $12,000 in money (liabilities assumed). C has relinquished his interest in $16,000 of depreciable property and $3,000 of land. Although C relinquished his interest in $3,000 of accounts receivable, such accounts receivable are inventory items and, therefore, that exchange was not an exchange of section 751 property for other property. Section 751(b) applies only to the extent of the exchange of other property for section 751 property (i.e., depreciable property or land for inventory items). Assume that the partners agree that the $7,000 of inventory in excess of C's share was received by him in exchange for $7,000 of depreciable property.

(d) *Distributee partner's tax consequences.* C's tax consequence on the distributions are as follows:

(1) *The section 751(b) sale or exchange.* C is treated as if he had received his 7/16ths share of the depreciable property in a current distribution. His basis for that share is $6,125 (42,000/48,000 of $7,000), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his 7/16ths share of depreciable property to the partnership for $7,000, realizing a gain of $875.

(2) *The part of the distribution not under section 751(b).* Section 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was $32,000 ($20,000, plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $6,125, the basis of property treated as distributed to C and sold by him to the partnership. Thus, C will have a basis of $25,875 for the remainder of his partnership interest. Of the $37,000 total distribution to C, $30,000 ($17,000 in money, including liabilities assumed, and $13,000 in inventory) is not within section 751(b). Under section 732(b), C's basis for the inventory with a fair market value of $13,000 (which had an adjusted basis to the partnership of $9,100) is limited to $8,875, the amount of the remaining basis for his partnership interest, $25,875, reduced by $17,000, the money received. Thus, C's total aggregate basis for the inventory received is $15,875 ($7,000 plus $8,875), and not its $14,000 basis in the hands of the partnership.

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* The partnership consisting of the remaining

members has $2,100 of ordinary income on the sale of the $7,000 of inventory which had a basis to the partnership of $4,900 (21,000/30,000 of $7,000). This $7,000 of inventory was paid to acquire 7/16ths of C's interest in the depreciable property. Since, under section 751(b), the partnership is treated as buying this property from C, it has a new cost basis for such property. Its basis for the depreciable property is $42,875 ($42,000 less $6,125, the basis of the 7/16ths share considered as distributed to C, plus $7,000, the partnership purchase price for this share).

(2) *The part of the distribution not under section 751 (b).* In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731(b). Further, under section 734(a), the partnership makes no adjustment to the basis of the accounts receivable or the 9/16ths interest in depreciable property which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) since the adjusted basis to the partnership of the inventory distributed had been $9,100, and C's basis for such inventory after distribution is only $8,875. The basis of the inventory remaining in the partnership must be increased by $225. Whether or not an election under section 754 is in effect, the basis for each of the remaining partnership interests will be $39,050 ($20,000 original contribution, plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities now assumed, plus $1,050, each partner's share of ordinary income realized by the partnership upon that part of the distribution treated as a sale or exchange).

Example 4. (a) *Facts.* Assume the same facts as in example 3 of this paragraph, except that the partners did not identify the property which C relinquished in exchange for the $7,000 of inventory which he received in excess of his share.

(b) *Presence of section 751 property.* For the same reasons stated in paragraph (b) of example 2 of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* The analysis stated in paragraph (c) of example 3 of this paragraph is the same in this example, except that, in the absence of a specific agreement among the partners as to the properties exchanged, C will be presumed to have sold to the partnership a proportionate amount of each property in which he relinquished an interest. Thus, in the absence of an agreement, C has received $7,000 of inventory in exchange for his release of 7/19ths of the depreciable property and 7/19ths of the land. ($7,000, fair market value of property released, over $19,000, the sum of the fair market values of C's interest in the land and C's interest in the depreciable property.)

(d) *Distributee partner's tax consequences.* C's tax consequences on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* C is treated as if he had received his 7/19ths shares of the depreciable property and land in a current distribution. His basis for those shares is $6,263 (51,000/57,000 of $7,000, their fair market value), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his 7/19ths shares of depreciable property and land to the partnership for $7,000, realizing a gain of $737.

(2) *The part of the distribution not under section 751(b).* Section 751(b) does not apply to the balance of the distribution. Before the distribution C's basis for his partnership interest was $32,000 ($20,000 plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $6,263, the bases of C's shares of depreciable property and land treated as distributed to him and sold by him to the partnership. Thus, C will have a basis of $25,737 for the remainder of his partnership interest. Of the total $37,000 distributed to C, $30,000 ($17,000 in money, including liabilities assumed, and $13,000 in inventory) is not within section 751(b). Under section 732(b), C's basis for the inventory (with a fair market value of $13,000 and an adjusted basis to the partnership of $9,100) is limited to $8,737, the amount of the remaining basis for his partnership interest ($25,737 less $17,000, money received. Thus, C's total aggregate basis for the inventory he received is $15,737 ($7,000 plus $8,737), and not the $14,000 basis it had in the hands of the partnership.

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* The partnership consisting of the remaining members has $2,100 of ordinary income on the sale of $7,000 of inventory which had a basis to the partnership of $4,900 (21,000/30,000 of $7,000). This $7,000 of inventory was paid to acquire 7/19ths of C's interest in the depreciable property and land. Since, under section 751(b), the partnership is treated as buying this property from C, it has a new cost basis for such property. The bases of the depreciable property and land would be $42,737 and $9,000, respectively. The basis for the depreciable property is computed as follows: The common partnership basis of $42,000 is reduced by the $5,158 basis (42,000/48,000 of $5,895) for C's 7/19ths interest constructively distributed and increased by $5,895 (16,000/19,000 of $7,000), the part of the purchase price allocated to the depreciable property. The basis of the land would be computed in the same way. The $9,000 original partnership basis is reduced by $1,105 basis ($9,000/9,000 of $1,105) of land constructively distributed to C, and increased by $1,105 (3,000/19,000

of $7,000), the portion of the purchase price allocated to the land.

(2) *The part of the distribution not under section 751(b).* In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731(b). Further, under section 734(a), the partnership makes no adjustment to the basis of the accounts receivable or the 12/19ths interests in depreciable property and land which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) since the adjusted basis to the partnership of the inventory distributed had been $9,100 and C's basis for such inventory after the distribution is only $8,737. The basis of the inventory remaining in the partnership must be increased by the difference of $363. Whether or not an election under section 754 is in effect, the basis for each of the remaining partnership interests will be $39,050 ($20,000 original contribution plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities assumed, plus $1,050, each partner's share of ordinary income realized by the partnership upon the part of the distribution treated as a sale or exchange).

Example 5. (a) *Facts.* Assume that partner C in example 2 of this paragraph agrees to reduce his interest in capital and profits from one-third to one-fifth for a current distribution consisting of $5,000 in cash, and $7,500 of accounts receivable with a basis to the partnership of $7,500. At the same time, the total liabilities of the partnership are not reduced. Therefore, after the distribution, C's share of the partnership liabilities has been reduced by $4,800 from $12,000 (1/3 of $36,000) to $7,200 (1/5 of $36,000).

(b) *Presence of section 751 property.* For the same reasons as stated in paragraph (b) of example 2 of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* C's interest in the fair market value of the partnership properties before and after the distribution can be illustrated by the following table:

Item	C's interest Fair Market Value		C received		C relinquished
	One-third before	One-fifth after	Distribution of share	In excess of share	
Cash	$5,000	$2,000	$3,000	$2,000	
Liabilities assumed	(12,000)	(7,200)		4,800	
Inventory items:					
Accounts receivable	3,000	300	2,700	4,800	
Inventory	10,000	6,000			$4,000
Depreciable property	16,000	9,600			6,400
Land	3,000	1,800			1,200
Total	25,000	12,500	5,700	11,600	11,600

Although C relinquished his interest in $4,000 of inventory and received $4,800 of accounts receivable, both items constitute section 751 property and C has received only $800 of accounts receivable for $800 worth of depreciable property or for an $800 undivided interest in land. In the absence of an agreement identifying the properties exchanged, it is presumed C received $800 for proportionate shares of his interests in both depreciable property and land. To the extent that inventory was exchanged for accounts receivable, or to the extent cash was distributed for the release of C's interest in the balance of the depreciable property and land, the transaction does not fall within section 751(b) and is a current distribution under section 732(a). Thus, the remaining $6,700 of accounts receivable are received in a current distribution.

(d) *Distributee partner's tax consequences.* C's tax consequences on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* Assuming that the partners paid $800 worth of accounts receivable for $800 worth of depreciable property, C is treated as if he received the depreciable property in a current distribution, and his basis for the $800 worth of depreciable property is $700 (42,000/48,000 of $800, its fair market value), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his $800 share of depreciable property to the partnership for $800. On the sale of the depreciable property, C realizes a gain of $100. If, on the other hand, the partners had agreed that C exchanged an $800 interest in the land for $800 worth of accounts receivable, C would realize no gain or loss, because under paragraph (b)(2)(iii) of this section his basis for the land sold would be $800. In the absence of an agreement, the basis for the depreciable property and land (which C is considered as having received in a current distribution and then sold back to the partnership) would be $716 (51,000/57,000 of $800). In that case, on the sale of the balance of the $800 share of depreciable property and land, C would realize $84 of gain ($800 less $716).

(2) *The part of the distribution not under section 751(b).* Section 751(b) does not apply to the balance of the distribution. Under section 731, C does not realize either gain or loss on the balance of the distribution. The adjustments to the basis of C's interest are illustrated in the following table:

	If accounts receivable received for depreciable property	If accounts receivable received for land	If there is no agreement
Original basis for C's interest	$32,000	$32,000	$32,000
Less basis of property distributed prior to sec. 751 (b) sale or exchange	−700	−800	−716
	31,300	31,200	31,284
Less money received in distribution	−9,800	−9,800	−9,800
	21,500	21,400	21,484
Less basis of property received in a current distribution under sec. 732	−6,700	−6,700	−6,700
Resulting basis for C's interest	14,800	14,700	14,784

C's basis for the $1,500 worth of accounts receivable which he received in the distribution will be $7,500, composed of $800 for the portion purchased in the section 751(b) exchange, plus $6,700, the basis carried over under section 732(a) for the portion received in the current distribution.

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* The partnership realizes no gain or loss in the section 751 sale or exchange because it had a basis of $800 for the accounts receivable for which it received $800 worth of other property. If the partnership agreed to purchase $800 worth of depreciable property, the partnership basis of depreciable property becomes $42,100 ($42,000 less $700 basis of property constructively distributed to C, plus $800, price of property purchased). If the partnership purchased land with the accounts receivable, there would be no change in the basis of the land to the partnership because the basis of land distributed was equal to its purchase price. If there were no agreement, the basis of the depreciable property and land would be $51,084 (depreciable property, $42,084 and land $9,000). The basis for the depreciable property is computed as follows: The common partnership basis of $42,000 is reduced by the $590 basis (42,000/48,000 of $674) for C's $674 interest constructively distributed, and increased by $674 (6,400/7,600 of $800), the part of the purchase price allocated to the depreciable property. The basis of the land would be computed in the same way. The $9,000 original partnership basis is reduced by $126 basis (9,000/9,000 of $126) of the land constructively distributed to C, and increased by $126 (1,200/7,600 of $800), the portion of the purchase price allocated to the land.

(2) *The part of the distribution not under section 751(b).* The partnership will realize no gain or loss in the balance of the distribution under section 731. Since the property in C's hands after the distribution will have the same basis it had in the partnership, the basis of partnership property remaining in the partnership after the distribution will not be adjusted (whether or not an election under 754 is in effect).

Example 6. (a) *Facts.* Partnership ABC distributes to partner C, in liquidation of his entire one-third interest in the partnership, a machine which is section 1245 property with a recomputed basis (as defined in section 1245(a)(2)) of $18,000. At the time of the distribution, the balance sheet of the partnership is as follows:

ASSETS

	Adjusted basis per books	Market value
Cash	$3,000	$3,000
Machine (section 1245 property)	9,000	15,000
Land	18,000	27,000
Total	30,000	45,000

LIABILITIES AND CAPITAL

	Per books	Value
Liabilities	$0	$0
Capital:		
A	10,000	15,000
B	10,000	15,000
C	10,000	15,000
Total	30,000	45,000

(b) *Presence of section 751 property.* The section 1245 property is an unrealized receivable of the partnership to the extent of the potential section 1245 income in respect of the property. Since the fair market value of the property ($15,000) is lower than its recomputed basis ($18,000), the excess of the fair market value over its adjusted basis ($9,000), or $6,000, is the potential section 1245 income of the partnership in respect of the property. The partnership has no other section 751 property.

(c) *The properties exchanged.* In the distribution C received his share of section 751 property (potential section 1245 income of $2,000, i.e., 1/3 of $6,000) and his share of section 1245 property (other than potential section 1245 income) with a fair market value of $3,000, i.e., 1/3 of ($15,000 minus $6,000), and an adjusted basis of $3,000, i.e., 1/3 of $9,000. In addition he received $4,000 of section 751 property (consisting of $4,000 ($6,000 minus $2,000) of potential section 1245 income) and section 1245 property (other than potential section 1245 income) with a fair market value of $6,000 ($9,000 minus $3,000) and an adjusted basis of $6,000 ($9,000 minus $3,000). C relinquished his interest in $1,000 of cash and $9,000 of land. Assume that the partners agree that the $4,000 of section 751 property in excess of C's share was received by him in exchange for $4,000 of land.

(d) *Distributee partner's tax consequences.* C's tax consequences on the distributions are as follows:

(1) *The section 751(b) sale or exchange.* C is treated as if he received in a current distribution 4/9ths of his share of the land with a basis of $2,667 (18,000/27,000×$4,000). Then C is considered as having sold his 4/9ths share of the land to the partnership for $4,000, realizing a gain of $1,333. C's basis for the remainder of his partnership interest after the current distribution is $7,333, i.e., the basis of his partnership interest before the current distribution ($10,000) minus the basis of the land treated as distributed to him ($2,667).

(2) *The part of the distribution not under section 751(b).* Of the $15,000 total distribution to C, $11,000 ($2,000 of potential section 1245 income and $9,000 section 1245 property other than potential section 1245 income) is not within section 751(b). Under section 732(b) and (c), C's basis for his share of potential section 1245 income is zero (see paragraph (c)(5) of this section) and his basis for $9,000 of section 1245 property (other than potential section 1245 income) is $7,333, i.e., the amount of the remaining basis for his partnership interest ($7,333) reduced by the basis for his share of potential section 1245 income (zero). Thus C's total aggregate basis for the section 1245 property (fair market value of $15,000) distributed to him is $11,333 ($4,000 plus $7,333). For an illustration of the computation of his recomputed basis for the section 1245 property immediately after the distribution, see example 2 of paragraph (f)(3) of § 1.1245–4.

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* Upon the sale of $4,000 potential section 1245 income, with a basis of zero, for 4/9ths of C's interest in the land, the partnership consisting of the remaining members has $4,000 ordinary income under sections 751(b) and 1245(a)(1). See section 1245(b)(3) and (6)(A). The partnership's new basis for the land is $19,333, i.e., $18,000, less the basis of the 4/9ths share considered as distributed to C ($2,667), plus the partnership purchase price for this share ($4,000).

(2) *The part of the distribution not under section 751(b).* The analysis under this subparagraph should be made in accordance with the principles illustrated in paragraph (e)(2) of examples 3, 4, and 5 of this paragraph.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8575, July 7, 1965; T.D. 7084, 36 FR 268, Jan. 8, 1971; T.D. 8586, 60 FR 2500, Jan. 10, 1995]

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[T.D. 8380, 56 FR 66350, Dec. 23, 1991]

§1.752–1 Treatment of partnership liabilities.

(a) *Definitions.* For purposes of section 752, the following definitions apply:

(1) *Recourse liability defined.* A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability under §1.752–2.

(2) *Nonrecourse liability defined.* A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under §1.752–2.

(3) *Related person.* Related person means a person having a relationship to a partner that is described in §1.752–4(b).

(b) *Increase in partner's share of liabilities.* Any increase in a partner's share of partnership liabilities, or any increase in a partner's individual liabilities by reason of the partner's assumption of partnership liabilities, is treated as a contribution of money by that partner to the partnership.

(c) *Decrease in partner's share of liabilities.* Any decrease in a partner's share of partnership liabilities, or any decrease in a partner's individual liabilities by reason of the partnership's assumption of the individual liabilities of the partner, is treated as a distribution of money by the partnership to that partner.

(d) *Assumption of liability.* Except as otherwise provided in paragraph (e) of this section, a person is considered to assume a liability only to the extent that:

(1) The assuming person is personally obligated to pay the liability; and

(2) If a partner or related person assumes a partnership liability, the person to whom the liability is owed knows of the assumption and can directly enforce the partner's or related person's obligation for the liability, and no other partner or person that is a related person to another partner would bear the economic risk of loss for the liability immediately after the assumption.

(e) *Property subject to a liability.* If property is contributed by a partner to the partnership or distributed by the partnership to a partner and the property is subject to a liability of the transferor, the transferee is treated as having assumed the liability, to the extent that the amount of the liability does not exceed the fair market value of the property at the time of the contribution or distribution.

(f) *Netting of increases and decreases in liabilities resulting from same transaction.* If, as a result of a single transaction, a partner incurs both an increase in the partner's share of the partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of the partnership liabilities (or the partner's individual liabilities), only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership. Generally, the contribution to or distribution from a partnership of property subject to a liability or the termination of the partnership under section 708(b) will require that increases and decreases in liabilities associated with the transaction be netted to determine if a partner will be deemed to have made a contribution or received a distribution as a result of the transaction.

(g) *Example.* The following example illustrates the principles of paragraphs (b), (c), (e), and (f) of this section.

Example. Property contributed subject to a liability; netting of increase and decrease in partner's share of liability. B contributes property with an adjusted basis of $1,000 to a general partnership in exchange for a one-third interest in the partnership. At the time of the contribution, the partnership does not have any liabilities outstanding and the property is subject to a recourse debt of $150 and has a fair market value in excess of $150. After the contribution, B remains personally liable to the creditor and none of the other partners bears any of the economic risk of loss for the liability under state law or otherwise. Under paragraph (e) of this section, the partnership is treated as having assumed the $150 liability. As a result, B's individual liabilities decrease by $150. At the same time, however, B's share of liabilities of the partnership increases by $150. Only the net increase or decrease in B's share of the liabilities of the partnership and B's individual liabilities is taken into account in applying section 752. Because there is no net change, B is not treated as having contributed money to the partnership or as having received a distribution of money from the partnership under paragraph (b) or (c) of this section. Therefore B's basis for B's partnership interest is $1,000 (B's basis for the contributed property).

(h) *Sale or exchange of a partnership interest.* If a partnership interest is sold or exchanged, the reduction in the transferor partner's share of partnership liabilities is treated as an amount realized under section 1001 and the regulations thereunder. For example, if a partner sells an interest in a partnership for $750 cash and transfers to the purchaser the partner's share of partnership liabilities in the amount of $250, the seller realizes $1,000 on the transaction.

(i) *Bifurcation of partnership liabilities.* If one or more partners bears the economic risk of loss as to part, but not all, of a partnership liability represented by a single contractual obligation, that liability is treated as two or more separate liabilities for purposes of section 752. The portion of the liability as to which one or more partners bear the economic risk of loss is a recourse liability and the remainder of the liability, if any, is a nonrecourse liability.

[T.D. 8380, 56 FR 66351, Dec. 23, 1991]

§ 1.752–2 Partner's share of resource liabilities.

(a) *In general.* A partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss. The determination of the extent to which a partner bears the economic risk of loss for a partnership liability is made under the rules in paragraphs (b) through (j) of this section.

(b) *Obligation to make a payment.* (1) *In general.* Except as otherwise provided in this section, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner. Upon a constructive liquidation, all of the following events are deemed to occur simultaneously:

(i) All of the partnership's liabilities become payable in full;

(ii) With the exception of property contributed to secure a partnership liability (see §1.752–2(h)(2)), all of the partnership's assets, including cash, have a value of zero;

(iii) The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditors's right to repayment is limited solely to one or more assets of the partnership);

(iv) All items of income, gain, loss, or deduction are allocated among the partners; and

(v) The partnership liquidates.

(2) *Treatment upon deemed disposition.* For purposes of paragraph (b)(1) of this section, gain or loss on the deemed disposition of the partnership's assets is computed in accordance with the following:

(i) If the creditor's right to repayment of a partnership liability is limited solely to one or more assets of the partnership, gain or loss is recognized in an amount equal to the difference between the amount of the liability that is extinguished by the deemed disposition and the tax basis (or book value to the extent section 704(c) or §1.704–1(b)(4)(i) applies) in those assets.

(ii) A loss is recognized equal to the remaining tax basis (or book value to the extent section 704(c) or §1.704–1(b)(4)(i) applies) of all the partnership's assets not taken into account in paragraph (b)(2)(i) of this section.

(3) *Obligations recognized.* The determination of the extent to which a partner or related person has an obligation to make a payment under paragraph (b)(1) of this section is based on the facts and circumstances at the time of the determination. All statutory and contractual obligations relating to the partnership liability are taken into account for purposes of applying this section, including:

(i) Contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership;

(ii) Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership; and

(iii) Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law, including the governing state partnership statute.

To the extent that the obligation of a partner to make a payment with respect to a partnership liability is not recognized under this paragraph (b)(3), paragraph (b) of this section is applied as if the obligation did not exist.

(4) *Contingent obligations.* A payment obligation is disregarded if, taking into account all the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligation will ever be discharged. If a payment obligation would arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs.

(5) *Reimbursement rights.* A partner's or related person's obligation to make a payment with respect to a partnership liability is reduced to the extent that the partner or related person is entitled to reimbursement from another partner or a person who is a related person to another partner.

(6) *Deemed satisfaction of obligation.* For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. See §1.752–2(j).

(c) *Partner or related person as lender*—(1) *In general.* A partner bears the economic risk of loss for a partnership liability to the extent that the partner or a related person makes (or acquires an interest in) a nonrecourse loan to the partnership and the economic risk of loss for the liability is not borne by another partner.

(2) *Wrapped debt.* If a partnership liability is owed to a partner or related person and that liability includes (*i.e.,*

is ‘‘wrapped’’ around) a nonrecourse obligation encumbering partnership property that is owed to another person, the partnership liability will be treated as two separate liabilities. The portion of the partnership liability corresponding to the wrapped debt is treated as a liability owed to another person.

(d) *De minimis exceptions*—(1) *Partner as lender.* The general rule contained in paragraph (c)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, makes a loan to the partnership which constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed).

(2) *Partner as guarantor.* The general rule contained in paragraph (b)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, guarantees a loan that would otherwise be a nonrecourse loan of the partnership and which would constitute qualified nonrecourse financing within the meaning of section 465(b)(6) (without regard to the type of activity financed) if the guarantor had made the loan to the partnership.

(e) *Special rule for nonrecourse liability with interest guaranteed by a partner*—(1) *In general.* For purposes of this section, if one or more partners or related persons have guaranteed the payment of more than 25 percent of the total interest that will accrue on a partnership nonrecourse liability over its remaining term, and it is reasonable to expect that the guarantor will be required to pay substantially all of the guaranteed future interest if the partnership fails to do so, then the liability is treated as two separate partnership liabilities. If this rule applies, the partner or related person that has guaranteed the payment of interest is treated as bearing the economic risk of loss for the partnership liability to the extent of the present value of the guaranteed future interest payments. The remainder of the stated principal amount of the partnership liability constitutes a nonrecourse liability. Generally, in applying this rule, it is reasonable to expect that the guarantor will be required to pay substantially all of the guaranteed future interest if, upon a default in payment by the partnership, the lender can enforce the interest guaranty without foreclosing on the property and thereby extinguishing the underlying debt. The guarantee of interest rule continues to apply even after the point at which the amount of guaranteed interest that will accrue is less than 25 percent of the total interest that will accrue on the liability.

(2) *Computation of present value.* The present value of the guaranteed future interest payments is computed using a discount rate equal to either the interest rate stated in the loan documents, or if interest is imputed under either section 483 or section 1274, the applicable federal rate, compounded semi-annually. The computation takes into account any payment of interest that the partner or related person may be required to make only to the extent that the interest will accrue economically (determined in accordance with section 446 and the regulations thereunder) after the date of the interest guarantee. If the loan document contains a variable rate of interest that is an interest rate based on current values of an objective interest index, the present value is computed on the assumption that the interest determined under the objective interest index on the date of the computation will remain constant over the term of the loan. The term ‘‘objective interest index’’ has the meaning given to it in section 1275 and the regulations thereunder (relating to variable rate debt instruments). Examples of an objective interest index include the prime rate of a designated financial institution, LIBOR (London Interbank Offered Rate), and the applicable federal rate under section 1274(d).

(3) *Safe harbor.* The general rule contained in paragraph (e)(1) of this section does not apply to a partnership nonrecourse liability if the guarantee of interest by the partner or related person is for a period not in excess of the lesser of five years or one-third of the term of the liability.

(4) *De minimis exception.* The general rule contained in paragraph (e)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent of less, guarantees the interest on a loan to that partnership which constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed). An allocation of interest to the extent paid by the guarantor is not treated as a partnership item of deduction or loss subject to the 10 percent or less rule.

(f) *Examples.* The following examples illustrate the principles of paragraphs (a) through (e) of this section.

Example 1. Determining when a partner bears the economic risk of loss. A and B form a general partnership with each contributing $100 in cash. The partnership purchases an office building on leased land for $1,000 from an unrelated seller, paying $200 in cash and executing a note to the seller for the balance of $800. The note is a general obligation of the partnership, *i.e.*, no partner has been relieved from personal liability. The partnership agreement provides that all items are allocated equally except that tax losses are specially allocated 90% to A and 10% to B and that capital accounts will be maintained in accordance with the regulations under section 704(b), including a deficit capital account restoration obligation on liquidation. In a constructive liquidation, the $800 liability becomes due and payable. All of the partnership's assets, including the building, are deemed to be worthless. The building is deemed sold for a value of zero. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

	A	B
Initial contribution	$100	$100
Loss on hypothetical sale	(900)	(100)
	($800)	$0

Other than the partners' obligation to fund negative capital accounts on liquidation, there are no other contractual or statutory payment obligations existing between the partners, the partnership and the lender. Therefore, $800 of the partnership liability is classified as a recourse liability because one or more partners bears the economic risk of loss for non-payment. B has no share of the $800 liability since the constructive liquidation produces no payment obligation for B. A's share of the partnership liability is $800 because A would have an obligation in that amount to make a contribution to the partnership.

Example 2. Recourse liability; deficit restoration obligation. C and D each contribute $500 in cash to the capital of a new general partnership, CD. CD purchases property from an unrelated seller for $1,000 in cash and a $9,000 mortgage note. The note is a general obligation of the partnership, *i.e.*, no partner has been relieved from personal liability. The partnership agreement provides that profits and losses are to be divided 40% to C and 60% to D. C and D are required to make up any deficit in their capital accounts. In a constructive liquidation, all partnership assets are deemed to become worthless and all partnership liabilities become due and payable in full. The partnership is deemed to dispose of all its assets in a fully taxable transaction for no consideration. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

	C	D
Initial contribution	$500	$500
Loss on hypothetical sale	(4,000) ($3,500)	(6,000) ($5,500)

C's capital account reflects a deficit that C would have to make up to $3,500 and D's capital account reflects a deficit that D would have to make up of $5,500. Therefore, the $9,000 mortgage note is a recourse liability because one or more partners bear the economic risk of loss for the liability. C's share of the recourse liability is $3,500 and D's share is $5,500.

Example 3. Guarantee by limited partner; partner deemed to satisfy obligation. E and F form a limited partnership. E, the general partner, contributes $2,000 and F, the limited partner, contributes $8,000 in cash to the partnership. The partnership agreement allocates losses 20% to E and 80% to F until F's capital account is reduced to zero, after which all losses are allocated to E. The partnership purchases depreciable property for $25,000 using its $10,000 cash and a $15,000 recourse loan from a bank. F guarantees payment of the $15,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership.

In a constructive liquidation, the $15,000 liability becomes due and payable. All of the partnership's assets, including the depreciable property, are deemed to be worthless. The depreciable property is deemed sold for a value of zero. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

	E	F
Initial contribution	$2,000	$8,000
Loss on hypothetical sale	(17,000)	(8,000)
	($15,000)	$0

E, as a general partner, would be obligated by operation of law to make a net contribution to the partnership of $15,000. Because E is assumed to satisfy that obligation, it is also assumed that F would not have to satisfy F's guarantee. The $15,000 mortgage is treated as a recourse liability because one or more partners bear the economic risk of loss. E's share of the liability is $15,000, and F's share is zero. This would be so even if E's net worth at the time of the determination is less than $15,000, unless the facts and circumstances indicate a plan to circumvent or avoid E's obligation to contribute to the partnership.

Example 4. Partner guarantee with right of subrogation. G, a limited partner in the GH partnership, guarantees a portion of a partnership liability. The liability is a general obligation of the partnership, *i.e.*, no partner has been relieved from personal liability. If under state law G is subrogated to the rights of the lender, G would have the right to recover the amount G paid to the recourse lender from the general partner. Therefore, G does not bear the economic risk of loss for the partnership liability.

Example 5. Bifurcation of partnership liability; guarantee of part of nonrecourse liability. A partnership borrows $10,000, secured by a mortgage on real property. The mortgage note contains an exoneration clause which provides that in the event of default, the holder's only remedy is to foreclose on the property. The holder may not look to any other partnership asset or to any partner to pay the liability. However, to induce the lender to make the loan, a partner guarantees payment of $200 of the loan principal. The exoneration clause does not apply to the partner's guarantee. If the partner paid pursuant to the guarantee, the partner would be subrogated to the rights of the lender with respect to $200 of the mortgage debt, but the partner is not otherwise entitled to reimbursement from the partnership or any partner. For purposes of section 752, $200 of the $10,000 mortgage liability is treated as a recourse liability of the partnership and $9,800 is treated as a nonrecourse liability of the partnership. The partner's share of the recourse liability of the partnership is $200.

Example 6. Wrapped debt. I, an individual, purchases real estate from an unrelated seller for $10,000, paying $1,000 in cash and giving a $9,000 purchase mortgage note on which I has no personal liability and as to which the seller can look only to the property for satisfaction. At a time when the property is worth $15,000, I sells the property to a partnership in which I is a general partner. The partnership pays for the property with a partnership purchase money mortgage note of $15,000 on which neither the partnership nor any partner (or person related to a partner) has personal liability. The $15,000 mortgage note is a wrapped debt that includes the $9,000 obligation to the original seller. The liability is a recourse liability to the extent of $6,000 because I is the creditor with respect to the loan and I bears the economic risk of loss for $6,000. I's share of the recourse liability is $6,000. The remaining $9,000 is treated as a partnership nonrecourse liability that is owed to the unrelated seller.

Example 7. Guarantee of interest by partner treated as part recourse and part nonrecourse. On January 1, 1992, a partnership obtains a $4,000,000 loan secured by a shopping center owned by the partnership. Neither the partnership nor any partner has any personal liability under the loan documents for repayment of the stated principal amount. Interest accrues at a 15 percent annual rate and is payable on December 31 of each year. The principal is payable in a lump sum on December 31, 2006. A partner guarantees payment of 50 percent of each interest payment required by the loan. The guarantee can be enforced without first foreclosing on the property. When the partnership obtains the loan, the present value (discounted at 15 percent, compounded annually) of the future interest payments is $3,508,422, and of the future principal payment is $491,578. If tested on that date, the loan would be treated as a partnership liability of $1,754,211 ($3,508,422 × .5) for which the guaranteeing partner bears the economic risk of loss and a partnership nonrecourse liability of $2,245,789 ($1,754,211 + $491,578).

Example 8. Contingent obligation not recognized. J and K form a general partnership with cash contributions of $2,500 each. J and K share partnership profits and losses equally. The partnership purchases an apartment building for its $5,000 of cash and a $20,000 nonrecourse loan from a commercial bank. The nonrecourse loan is secured by a mortgage on the building. The loan documents provide that the partnership will be liable for the outstanding balance of the loan on a recourse basis to the extent of any decrease in the value of the apartment building resulting from the partnership's failure properly to maintain the property. There are no facts that establish with reasonable certainty the existence of any liability on the part of the partnership (and its partners) for damages resulting from the partnership's failure properly to maintain the building. Therefore, no partner bears the economic risk of loss, and the liability constitutes a nonrecourse liability. Under §1.752–3, J and K share this nonrecourse liability equally because they share all profits and losses equally.

(g) *Time-value-of-money considerations*—(1) *In general.* The extent to which a partner or related person bears the economic risk of loss is determined by taking into account any delay in the time when a payment or contribution obligation with respect to a partnership liability is to be satisfied. If a payment obligation with respect to a partnership liability is not required to be satisfied within a reasonable time after the liability becomes due and payable, or if the obligation to make a contribution to the partnership is not required to be satisfied before the later of—

(i) The end of the year in which the partner's interest is liquidated, or

(ii) 90 days after the liquidation,

the obligation is recognized only to the extent of the value of the obligation.

(2) *Valuation of an obligation.* The value of a payment or contribution obligation that is not required to be satisfied within the time period specified in paragraph (g)(1) of this section equals the entire principal balance of the obligation only if the obligation bears interest equal to or greater than the applicable federal rate under section 1274(d) at the time of valuation, commencing on—

(i) In the case of a payment obligation, the date that the partnership liability to a creditor or other person to whom the obligation relates becomes due and payable, or

(ii) In the case of a contribution obligation, the date of the liquidation of the partner's interest in the partnership. If the obligation does not bear interest at a rate at least equal to the applicable federal rate at the time of valuation, the value of the obligation is discounted to the present value of all payments due from the partner or related person (*i.e.*, the imputed principal amount computed under section 1274(b)). For purposes of making this present value determination, the partnership is deemed to have constructively liquidated as of the date on which the payment obligation is valued and the payment obligation is assumed to be a debt instrument subject to the rules of section 1274 (*i.e.*, the debt instrument is treated as if it were issued for property at the time of the valuation).

(3) *Satisfaction of obligation with partner's promissory note.* An obligation is not satisfied by the transfer to the obligee of a promissory note by a partner or related person unless the note is readily tradeable on an established securities market.

(4) *Example.* The following example illustrates the principle of paragraph (g) of this section.

Example. Value of obligation not required to be satisfied within specified time period. A, the general partner, and B, the limited partner, each contributes $10,000 to partnership AB. AB purchases property from an unrelated seller for $20,000 in cash and a $70,000 recourse purchase money note. The partnership agreement provides that profits and losses are to be divided equally. A and B are required to make up any deficit in their capital accounts. While A is required to restore any deficit balance in A's capital account within 90 days after the date of liquidation of the partnership, B is not required to restore any deficit for two years following the date of liquidation. The deficit in B's capital account will not bear interest during that two-year period. In a constructive liquidation, all partnership assets are deemed to become worthless and all partnership liabilities become due and payable in full. The partnership is deemed to dispose of all its assets in a fully taxable transaction for no consideration. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

	A	B
Initial contribution	$10,000	$10,000
Loss on hypothetical sale	(45,000)	(45,000)
	(35,000)	(35,000)

A's and B's capital accounts each reflect deficits of $35,000. B's obligation to make a contribution pursuant to B's deficit restoration obligation is recognized only to the extent of the fair market value of that obligation at the time of the constructive liquidation because B is not required to satisfy that obligation by the later of the end of the partnership taxable year in which B's interest is liquidated or within 90 days after the date of the liquidation. Because B's obligation does not bear interest, the fair market value is deemed to equal the imputed principal amount under section 1274(b). Under section 1274(b), the imputed principal amount of a debt instrument equals the present value of all payments due under the debt instrument. Assume the applicable federal rate with respect to B's obligation is 10 percent compounded semiannually. Using this discount rate, the present value of the $35,000 payment that B would be required to make two years after the constructive liquidation to restore the deficit balance in B's capital account equals $28,795. To the extent that B's deficit restoration obligation is not recognized, it is assumed that B's obligation does not exist. Therefore, A, as the sole general partner, would be obligated by operation of law to contribute an additional $6,205 of capital to the partnership. Accordingly, under paragraph (g) of this section, B bears the economic risk of loss for $28,795 and A bears the economic risk of loss for $41,205 ($35,000 + $6,205).

(h) *Partner providing property as security for partnership liability*—(1) *Direct pledge.* A partner is considered to bear the economic risk of loss for a partnership liability to the extent of the value of any the partner's or related person's separate property (other than a direct or indirect interest in the partnership) that is pledged as security for the partnership liability.

(2) *Indirect pledge.* A partner is considered to bear the economic risk of loss for a partnership liability to the extent of the value of any property that the partner contributes to the partnership solely for the purpose of securing a partnership liability. Contributed property is not treated as contributed solely for the purpose of securing a partnership liability unless substantially all of the items of income, gain, loss, and deduction attributable to the contributed property are allocated to the contributing partner, and this allocation is generally greater than the partner's share of other significant items of partnership income, gain, loss, or deduction.

(3) *Valuation*. The extent to which a partner bears the economic risk of loss as a result of a direct pledge described in paragraph (h)(1) of this section or an indirect pledge described in paragraph (h)(2) of this section is limited to the fair market value of the property at the time of the pledge or contribution.

(4) *Partner's promissory note.* For purposes of paragraph (h)(2) of this section, a promissory note of the partner or related person that is contributed to the partnership shall not be taken into account unless the note is readily tradeable on an established securities market.

(i) *Treatment of recourse liabilities in tiered partnerships.* If a partnership (the ''upper-tier partnership'') owns (directly or indirectly through one or more partnerships) an interest in another partnership (the ''lower-tier partnership''), the liabilities of the lower-tier partnership are allocated to the upper-tier partnership in an amount equal to the sum of the following—

(1) The amount of the economic risk of loss that the upper-tier partnership bears with respect to the liabilities; and

(2) Any other amount of the liabilities with respect to which partners of the upper-tier partnership bear the economic risk of loss.

(j) *Anti-abuse rules*—(1) *In general.* An obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person for purposes of this section if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Circumstances with respect to which a payment obligation may be disregarded include, but are not limited to, the situations described in paragraphs (j)(2) and (j)(3) of this section.

(2) *Arrangements tantamount to a guarantee.* Irrespective of the form of a contractual obligation, a partner is considered to bear the economic risk of loss with respect to a partnership liability, or a portion thereof, to the extent that:

(i) The partner or related person undertakes one or more contractual obligations so that the partnership may obtain a loan;

(ii) The contractual obligations of the partner or related person eliminate substantially all the risk to the lender that the partnership will not satisfy its obligations under the loan; and

(iii) One of the principal purposes of using the contractual obligations is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests.

The partners are considered to bear the economic risk of loss for the liability in accordance with their relative economic burdens for the liability pursuant to the contractual obligations. For example, a lease between a partner and a partnership which is not on commercially reasonable terms may be tantamount to a guarantee by the partner of a partnership liability.

(3) *Plan to circumvent or avoid the obligation.* An obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation.

(4) *Example.* The following example illustrates the principle of paragraph (j)(3) of this section.

Example. Plan to circumvent or avoid obligation. A and B form a general partnership. A, a corporation, contributes $20,000 and B contributes $80,000 to the partnership. A is obligated to restore any deficit in its partnership capital account. The partnership agreement allocates losses 20% to A and 80% to B until B's capital account is reduced to zero, after which all losses are allocated to A. The partnership purchases depreciable property for $250,000 using its $100,000 cash and a $150,000 recourse loan from a bank. B guarantees payment of the $150,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership. A is a subsidiary, formed by a parent of a consolidated group, with capital limited to $20,000 to allow the consolidated group to enjoy the tax losses generated by the property while at the same time limiting its monetary exposure for such losses. These facts, when considered together with B's guarantee, indicate a plan to circumvent or avoid A's obligation to contribute to the partnership. The rules of section 752 must be applied as if A's obligation to contribute did not exist. Accordingly, the $150,000 liability is a recourse liability that is allocated entirely to B.

[T.D. 8380, 56 FR 66351, Dec. 23, 1991; 57 FR 4913, Feb. 10, 1992; 57 FR 5054, Feb. 12, 1992; 57 FR 5511, Feb. 14, 1992]

§1.752–3 Partner's share of nonrecourse liabilities.

(a) *In general.* A partner's share of the nonrecourse liabilities of a partnership equals the sum of paragraphs (a)(1) through (a)(3) of this section as follows—

(1) The partner's share of partnership minimum gain determined in accordance with the rules of section 704(b) and the regulations thereunder;

(2) The amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration; and

(3) The partner's share of the excess nonrecourse liabilities (those not allocated under paragraphs (a)(1) and (a)(2) of this section) of the partnership as determined in accordance with the partner's share of partnership profits. The partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain. Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Excess nonrecourse liabilities are not required to be allocated under the same method each year.

(b) *Examples.* The following examples illustrate the principles of paragraph (a) of this section.

Example 1. Partner's share of nonrecourse liabilities. The AB partnership purchases depreciable property for a $1,000 purchase money note that is nonrecourse liability under the rules of this section. Assume that this is the only nonrecourse liability of the partnership, and that no principal payments are due on the purchase money note for a year. The partnership agreement provides that all items of income, gain, loss, and deduction are allocated equally. Immediately after purchasing the depreciable property, the partners share the nonrecourse liability equally because they have equal interests in partnership profits. A and B are each treated as if they contributed $500 to the partnership to reflect each partner's increase in his or her share of partnership liabilities (from $0 to $500). The minimum gain with respect to an item of partnership property subject to a nonrecourse liability equals the amount of gain that would be recognized if the partnership disposed of the property in full satisfaction of the nonrecourse liability and for no other consideration. Therefore, if the partnership claims a depreciation deduction of $200 for the depreciable property for the year it acquires that property, partnership minimum gain for the year will increase by $200 (the excess of the $1,000 nonrecourse liability over the $800 adjusted tax basis of the property). See section 704(b) and the regulations thereunder. A and B each have a $100 share of partnership minimum gain at the end of that year because the depreciation deduction is treated as a nonrecourse deduction. See section 704(b) and the regulation thereunder. Accordingly, at the end of that year, A and B are allocated $100 each of the nonrecourse liability to match their shares of partnership minimum gain. The remaining $800 of the nonrecourse liability will be allocated equally between A and B ($400 each).

Example 2. Excess nonrecourse liabilities allocated consistently with reasonably expected deductions. The facts are the same as in *Example 1* except that the partnership agreement provides that depreciation deductions will be allocated to A. The partners agree to allocate excess nonrecourse liabilities in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Assuming that the allocation of all of the depreciation deductions to A is valid under section 704(b), immediately after purchasing the depreciable property, A's share of the nonrecourse liability is $1,000. Accordingly, A is treated as if A contributed $1,000 to the partnership.

[T.D. 8380, 56 FR 66355, Dec. 23, 1991]

§ 1.752–4 Special rules.

(a) *Tiered partnerships.* An upper-tier partnership's share of the liabilities of a lower-tier partnership (other than any liability of the lower-tier partnership that is owed to the upper-tier partnership) is treated as a liability of the upper-tier partnership for purposes of applying section 752 and the regulations thereunder to the partners of the upper-tier partnership.

(b) *Related person definition*—(1) *In general.* A person is related to a partner if the person and the partner bear a relationship to each other that is specified in section 267(b) or 707(b)(1), subject to the following modifications:

(i) Substitute ''80 percent or more'' for ''more than 50 percent'' each place it appears in those sections;

(ii) A person's family is determined by excluding brothers and sisters; and

(iii) Disregard sections 267(e)(1) and 267(f)(1)(A).

(2) *Person related to more than one partner*—(i) *In general.* If, in applying the related person rules in paragraph (b)(1) of this section, a person is related to more than one partner, paragraph (b)(1) of this section is applied by treating the person as related only to the partner with whom there is the highest percentage of related ownership. If two or more partners have the same percentage of related ownership and no other partner has a greater percentage, the liability is allocated equally among the partners having the equal percentages of related ownership.

(ii) *Natural persons.* For purposes of determining the percentage of related ownership between a person and a partner, natural persons who are related by virtue of being members of the same family are treated as having a percentage relationship of 100 percent with respect to each other.

(iii) *Related partner exception.* Notwithstanding paragraph (b)(1) of this section (which defines related person), persons owning interests directly or indirectly in the same partnership are not treated as related persons for purposes of determining the economic risk of loss borne by each of them for the liabilities of the partnership. This paragraph (iii) does not apply when determining a partner's interest under the de minimis rules in §§ 1.752–2 (d) and (e).

(iv) *Special rule where entity structured to avoid related person status*—(A) *In general.* If—

(*1*) A partnership liability is owed to or guaranteed by another entity that is a partnership, an S corporation, a C corporation, or a trust;

(*2*) A partner or related person owns (directly or indirectly) a 20 percent or more ownership interest in the other entity; and

(*3*) A principal purpose of having the other entity act as a lender or guarantor of the liability was to avoid the determination that the partner that owns the interest bears the economic risk of loss for federal income tax purposes for all or part of the liability;

then the partner is treated as holding the other entity's interest as a creditor or guarantor to the extent of the partner's or related person's ownership interest in the entity.

(B) *Ownership interest.* For purposes of paragraph (b)(2)(iv)(A) of this section, a person's ownership interest in:

(*1*) A partnership equals the partner's highest percentage interest in any item of partnership loss or deduction for any taxable year;

(*2*) An S corporation equals the percentage of the outstanding stock in the S corporation owned by the shareholder;

(*3*) A C corporation equals the percentage of the fair market value of the issued and outstanding stock owned by the shareholder; and

(*4*) A trust equals the percentage of the actuarial interests owned by the beneficial owner of the trust.

(C) Example. Entity structured to avoid related person status. A, B, and C form a general partnership, ABC. A, B, and C are equal partners, each contributing $1,000 to the partnership. A and B want to loan money to ABC and have the loan treated as nonrecourse for purposes of section 752. A and B form partnership AB to which each contributes $50,000. A and B share losses equally in partnership AB. Partnership AB loans partnership ABC $100,000 on a nonrecourse basis secured by the property ABC buys with the loan. Under these facts and circumstances, A and B bear the economic risk of loss with respect to the partnership liability equally based on their percentage interest in losses of partnership AB.

(c) *Limitation.* The amount of an indebtedness is taken into account only once, even though a partner (in addition to the partner's liability for the indebtedness as a partner) may be separately liable therefor in a capacity other than as a partner.

(d) *Time of determination.* A partner's share of partnership liabilities must be determined whenever the determination is necessary in order to determine the tax liability of the partner or any other person. See §1.705–1(a) for rules regarding when the adjusted basis of a partner's interest in the partnership must be determined.

[T.D. 8380, 56 FR 66356, Dec. 23, 1991]

§1.752–5 Effective dates and transition rules.

(a) *In general.* Unless a partnership makes an election under paragraph (b)(1) of this section to apply the provisions of §§1.752–1 through 1.752–4 earlier, §§1.752–1 through 1.752–4 apply to any liability incurred or assumed by a partnership on or after December 28, 1991, other than a liability incurred or assumed by the partnership pursuant to a written binding contract in effect prior to December 28, 1991 and at all times thereafter. For liabilities incurred or assumed by a partnership prior to December 28, 1991 (or pursuant to a written binding contract in effect prior to December 28, 1991 and at all times thereafter), unless an election to apply these regulations has been made, see §§1.752–0T to 1.752–4T, set forth in 26 CFR 1.752–0T through 1.752–4T as contained in 26 CFR edition revised April 1, 1991, (TD 8237, TD 8274, and TD 8355) and §1.752–1, set forth in 26 CFR 1.752–1 as contained in 26 CFR edition revised April 1, 1988 (TD 6175 and TD 6500).

(b) *Election*—(1) *In general.* A partnership may elect to apply the provisions of §§1.752–1 through 1.752–4 to all of its liabilities to which the provisions of those sections do not otherwise apply as of the beginning of the first taxable year of the partnership ending on or after December 28, 1991.

(2) *Time and manner of election.* An election under this paragraph (b) is made by attaching a written statement to the partnership return for the first taxable year of the partnership ending on or after December 28, 1991. The written statement must include the name, address, and taxpayer identification number of the partnership making the statement and contain a declaration that an election is being made under this paragraph (b).

(c) *Effect of section 708(b)(1)(B) termination on determining date liabilities are* *incurred or assumed.* For purposes of applying this section, a termination of the partnership under section 708(b)(1)(B) will not cause partnership liabilities incurred or assumed prior to the termination to be treated as incurred or assumed on the date of the termination.

[T.D. 8380, 56 FR 66356, Dec. 23, 1991]

§ 1.753–1 Partner receiving income in respect of decedent.

(a) *Income in respect of a decedent under section 736(a).* All payments coming within the provisions of section 736(a) made by a partnership to the estate or other successor in interest of a deceased partner are considered income in respect of the decedent under section 691. The estate or other successor in interest of a deceased partner shall be considered to have received income in respect of a decedent to the extent that amounts are paid by a third person in exchange for rights to future payments from the partnership under section 736(a). When a partner who is receiving payments under section 736(a) dies, section 753 applies to any remaining payments under section 736(a) made to his estate or other successor in interest.

(b) *Other income in respect of a decedent.* When a partner dies, the entire portion of the distributive share which is attributable to the period ending with the date of his death and which is taxable to his estate or other successor constitutes income in respect of a decedent under section 691. This rule applies even though that part of the distributive share for the period before death which the decedent withdrew is not included in the value of the decedent's partnership interest for estate tax purposes. See paragraph (c) (3) of § 1.706–1.

(c) *Example.* The provisions of this section may be illustrated by the following example:

Example. A and the decedent B were equal partners in a business having assets (other than money) worth $40,000 with an adjusted basis of $10,000. Certain partnership business was well advanced towards completion before B's death and, after B's death but before the end of the partnership year, payment of $10,000 was made to the partnership for such work. The partnership agreement provided that, upon the death of one of the partners, all partnership property, including unfinished work, would pass to the surviving partner, and that the surviving partner would pay the estate of the decedent the undrawn balance of his share of partnership earnings to the date of death, plus $10,000 in each of the three years after death. B's share of earnings to the date of his death was $4,000, of which he had withdrawn $3,000. B's distributive share of partnership income of $4,000 to the date of his death is income in respect of a decedent (although only the $1,000 undrawn at B's death will be reflected in the value of B's partnership interest on B's estate tax return). Assume that the value of B's interest in partnership property at the date of his death was $22,000, composed of the following items: B's one-half share of the assets of $40,000, plus $2,000, B's interest in partnership cash. It should be noted that B's $1,000 undrawn share of earnings to the date of his death is not a separate item but will be paid from partnership assets. Under the partnership agreement, A is to pay B's estate a total of $31,000. The difference of $9,000 between the amount to be paid by A ($31,000) and the value of B's interest in partnership property ($22,000) comes within section 736(a) and, thus, also constitutes income in respect of a decedent. (However, the $17,000 difference between the $5,000 basis for B's share of the partnership property and its $22,000 value at the date of his death does not constitute income in respect of a decedent.) If, before the close of the partnership taxable year, A pays B's estate $11,000, of which they agree to allocate $3,000 as the payment under section 736(a), B's estate will include $7,000 in its gross income (B's $4,000 distributive share plus $3,000 payment under section 736(a)). In computing the deduction under section 691(c), this $7,000 will be considered as the value for estate tax purposes of such income in respect of a decedent, even though only $4,000 ($1,000 of distributive share not withdrawn, plus $3,000, payment under section 736(a)) of this amount can be identified on the estate tax return as part of the partnership interest.

(d) *Effective date.* The provisions of section 753 apply only in the case of payments made with respect to decedents whose death occurred after December 31, 1954. See section 771(b)(4) and paragraph (b)(4) of § 1.771–1.

§ 1.754–1 Time and manner of making election to adjust basis of partnership property.

(a) *In general.* A partnership may adjust the basis of partnership property under sections 734(b) and 743(b) if it files an election in accordance with the rules set forth in paragraph (b) of this section. An election may not be filed to make the adjustments provided in either section 734(b) or section 743(b) alone, but such an election must apply to both sections. An election made under the provisions of this section shall apply to all property distributions and transfers of partnership interests taking place in the partnership taxable year for which the election is made and in all subsequent partnership taxable years unless the election is revoked pursuant to paragraph (c) of this section.

(b) *Time and method of making election.* (1) An election under section 754 and this section to adjust the basis of partnership property under sections 734(b) and 743(b), with respect to a distribution of property to a partner or a transfer of an interest in a partnership, shall be made in a written statement filed with the partnership return for the taxable year during which the distribution or transfer occurs. For the election to be valid, the return must be filed not later than the time prescribed by paragraph (e) of §1.6031–1 (including extensions thereof) for filing the return for such taxable year (or before August 23, 1956, whichever is later). Notwithstanding the preceding two sentences, if a valid election has been made under section 754 and this section for a preceding taxable year and not revoked pursuant to paragraph (c) of this section, a new election is not required to be made. The statement required by this subparagraph shall (i) set forth the name and address of the partnership making the election, (ii) be signed by any one of the partners, and (iii) contain a declaration that the partnership elects under section 754 to apply the provisions of section 734(b) and section 743(b). For rules regarding extensions of time for filing elections, see §1.9100–1.

(2) The principles of this paragraph may be illustrated by the following example:

Example. A, a U.S. citizen, is a member of partnership ABC, which has not previously made an election under section 754 to adjust the basis of partnership property. The partnership and the partners use the calendar year as the taxable year. A sells his interest in the partnership to D on January 1, 1971. The partnership may elect under section 754 and this section to adjust the basis of partnership property under sections 734(b) and 743(b). Unless an extension of time to make the election is obtained under the provisions of §1.9100–1, the election must be made in a written statement filed with the partnership return for 1971 and must contain the information specified in subparagraph (1) of this paragraph. Such return must be filed by April 17, 1972 (unless an extension of time for filing the return is obtained). The election will apply to all distributions of property to a partner and transfers of an interest in the partnership occurring in 1971 and subsequent years, unless revoked pursuant to paragraph (c) of this section.

(c) *Revocation of election.* A partnership having an election in effect under this section may revoke such election with the approval of the district director for the internal revenue district in which the partnership return is required to be filed. A partnership which wishes to revoke such an election shall file with the district director for the internal revenue district in which the partnership return is required to be filed an application setting forth the grounds on which the revocation is desired. The application shall be filed not later than 30 days after the close of the partnership taxable year with respect to which revocation is intended to take effect and shall be signed by any one of the partners. Examples of situations which may be considered sufficient reason for approving an application for revocation include a change in the nature of the partnership business, a substantial increase in the assets of the partnership, a change in the character of partnership assets, or an increased frequency of retirements or shifts of partnership interests, so that an increased administrative burden would result to the partnership from the election. However, no application for revocation of an election shall be approved when the purpose of the revocation is primarily to avoid stepping down the basis of partnership assets upon a transfer or distribution.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7208, 37 FR 20686, Oct. 3, 1972]

§1.755–1 Rules for allocation of basis.

(a) *General rule.* (1)(i) A partnership which has elected under section 754 must adjust the basis of partnership property under the provisions of section 734(b) (relating to the optional adjustment to the basis of undistributed partnership property) and section 743(b) (relating to the optional adjustment to the basis of partnership property where a partnership interest is transferred). The amount of the increase or decrease (as determined in those sections) in the adjusted basis of the partnership property shall first be divided, under paragraph (b) of this section, between the two classes of property described in section 755(b). Then, the portion of the increase or decrease allocated to each class shall be further allocated to the bases of the properties within the class in a manner which will reduce the difference between the fair market value and the adjusted basis of partnership properties. In the alternative, any increase or decrease may be allocated in any other manner approved by the district director under subparagraph (2) of this paragraph.

(ii) If there is an increase in basis to be allocated to partnership assets, such increase must be allocated only to assets whose values exceed their bases and in proportion to the difference between the value and basis of each. No increase shall be made to the basis of any asset the adjusted basis of which equals or exceeds its fair market value.

(iii) If there is a decrease in basis to be allocated to partnership assets, such decrease must be allocated to assets whose bases exceed their value and in proportion to the difference between the basis and value of each. No decrease shall be made to the basis of any asset, the fair market value of which equals or exceeds its adjusted basis.

(iv) The application of the rules with respect to the allocation of an adjustment in basis under subdivisions (ii) and (iii) of this subparagraph requires that a portion of such adjustment be allocated to partnership good will, to the extent that good will exists and is reflected in the value of the property distributed, the price at which the partnership interest is sold, or the basis of the partnership interest determined under section 1014, in accordance with the difference between such value of the good will and its adjusted basis at the time of the transaction.

(2) If a partnership (or a partner electing under section 732(d)) desires to adjust the basis of assets under section 734(b) or 743(b) in a manner other than that prescribed in subparagraph (1) of this paragraph, it must file an application for permission to use such method with the district director no later than 30 days after the close of the partnership taxable year in which the proposed adjustment is to be made. The application must describe the proposed adjustments in detail and set forth the reasons for the desired use of the other method. Under section 755(a)(2), the district director may permit the partnership to increase the bases of some partnership properties and decrease the bases of other partnership properties under section 734(b) or 743(b). Each increase or decrease to the basis of an asset must reduce or eliminate the difference between such basis and the value of the asset. The net amount of all such adjustments must equal the amount of the adjustment under section 734(b) or 743(b). Adjustments that both increase and decrease the basis of partnership assets will be permitted by the district director only upon a satisfactory showing of the values for partnership assets used by the parties to determine the price at which a partnership interest was sold, the value of the decedent's partnership interest at date of death (or at the alternate valuation date, if used), or the amount of a distribution.

(b) *Special rules.* For the purposes of applying section 755, all partnership property shall be classified into two categories: Capital assets and property described in section 1231(b) (certain property used in the trade or business), or any other property of the partnership.

(1) *Distributions.* (i) Where there is a distribution of partnership property resulting in an adjustment to the basis of undistributed partnership property under section 734(b)(1)(B) or (b)(2)(B), such adjustment must be allocated to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose. Thus, when the partnership adjusted basis of distributed capital assets and section 1231(b)

property immediately prior to distribution exceeds the basis of such property to the distributee partner (as determined under section 732), the basis of the undistributed capital assets and section 1231(b) property remaining in the partnership shall be increased by an amount equal to such excess. Conversely, when the basis to the distributee partner (as determined under section 732) of distributed capital assets and section 1231(b) property exceeds the partnership adjusted basis of such property immediately prior to the distribution, the basis of the undistributed capital assets and section 1231(b) property remaining in the partnership shall be decreased by an amount equal to such excess. Similarly, where there is a distribution of partnership property other than capital assets and section 1231(b) property, and the basis of such other property to the distributee partner (as determined under section 732) is not the same as the partnership adjusted basis of such property immediately prior to distribution, the adjustment shall be made only to undistributed property of the same category remaining in the partnership.

(ii) Where there is a distribution resulting in an adjustment under section 734(b)(1)(A) or (b)(2)(A) to the basis of undistributed partnership property, such adjustment must be allocated only to capital assets or section 1231(b) property.

(2) *Transfers.* Where there is a basis adjustment under section 743(b) arising from a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, the amount of the adjustment shall be allocated between the two classes of property described in section 755(b) and then the amount allocated to each class shall be further allocated under the rules of paragraph (a)(1) of this section. Thus, to the extent that an amount paid by a purchaser of a partnership interest (or the basis of the partnership interest to the estate or other successor in interest of a deceased partner) is attributable to the value of capital assets and section 1231(b) property, any difference between the amount so attributable and the transferee partner's share of the partnership basis of such property shall constitute a special basis adjustment with respect to partnership capital assets and section 1231 (b) property. Similarly, any such difference attributable to any other property of the partnership shall constitute a special basis adjustment with respect to such property.

(3) *Limitation on decrease of basis.* Where a decrease in the basis of partnership assets is required under section 734(b)(2) and the amount of the decrease exceeds the adjusted basis to the partnership of property of the required character, the basis of such property shall be reduced to zero (but not below zero), and the balance of the decrease in basis shall be made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(4) *Carryover of adjustment.* Where, in the case of a distribution, an increase or decrease required under paragraph (a) of this section in the basis of undistributed partnership property cannot be made because the partnership owns no property of the character required to be adjusted, or because the adjustment has been limited under subparagraph (3) of this paragraph, the adjustment shall be made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

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

Example (1). Assume that partnership ABC has three assets: X, a capital asset with an adjusted basis of $1,000 and a value of $1,500; Y, a depreciable asset with an adjusted basis of $1,000 and a value of $900; and Z, inventory items with an adjusted basis of $700 and a value of $600. A sells his interest to D (when an election under 754 is in effect) for $1,000 (1/3 of $3,000, the total value of partnership assets). D's share of the adjusted basis of partnership property is $900 (1/3 of $2,700). Therefore, under section 743(b), D has a special basis adjustment of $100 ($1,000 minus $900). This adjustment must be allocated entirely to property X, since such allocation will have the effect of reducing the difference between the value and basis of such asset. Therefore, D has a special basis adjustment of $100 with respect to property X, which now has a special basis to him of $1,100. No part of the adjustment is made to depreciable property Y or inventory items Z, since any such adjustment would increase the difference between the basis and value of each such asset.

Example (2). Assume the same facts as in example 1 of this paragraph, except that capital asset X has a value of $1,500, depreciable property Y has a value of $1,100, and inventory items Z have a value of only $400. Therefore, under section 743(b), D has a special basis adjustment of $100, the excess of D's basis for his interest in the partnership ($1,000) over his share of the adjusted basis of partnership property ($900). This $100 adjustment must be allocated entirely to capital asset X and depreciable property Y in proportion to the difference between the value and basis of each since such allocation has the effect of reducing the difference between the value and basis of each such asset. Therefore, D has a special basis adjustment of $83 ($500/$600 of $100) with respect to capital asset X, which now has a special basis to him of $1,083, and of $17 ($100/$600 of $100) with respect to depreciable property Y, which now has a special basis to him of $1,017. No part of the adjustment is made to inventory items Z, since any such adjustment would increase the difference between the basis of such asset and its value.

Example (3). Assume that partnership EFG has three assets: X, a capital asset with an adjusted basis of $1,000 and a value of $1,500; Y, a depreciable asset with an adjusted basis of $1,000 and a value of $700; and Z, inventory items with an adjusted basis of $700 and a value of $800. E sells his interest to H (when an election under section 754 is in effect) for $1,000 (1/3 of $3,000, the total value of the partnership assets). H's share of the adjusted basis of partnership is $900 (1/3 of $2,700). Therefore, H has a special basis adjustment of $100 ($1,000 minus $900) under section 743(b). Since, of the total $300 difference between the value and the adjusted basis of all partnership property, $200 ($500, appreciation in value of X, minus $300, depreciation in value of Y) is attributable to the class of capital assets and depreciable property, and $100 (appreciation in value of inventory items Z) to the class of other property, H's special basis adjustment of $100 must be allocated 2/3 to capital assets and depreciable property and 1/3 to other property (inventory). The $67 increase (2/3 of $100) to be allocated to capital assets and depreciable property must further be allocated so as to reduce the difference between the value and basis of such assets. This can be done only by allocating the entire $67 increase to capital asset X (the basis of which is less than its value), and no part of the increase to depreciable property Y (the basis of which exceeds its value). Therefore, H has a special basis adjustment of $67 for capital asset X, which now has a special basis to him of $1,067; he has no special basis adjustment for depreciable property Y. H also has a special basis adjustment of $33 (1/3 of $100) for inventory items Z, the special basis of which is now $733.

§ 1.755–2T Coordination of sections 755 and 1060 (temporary).

(a) *Coordination with section 1060*—(1) *In general.* If there is a basis adjustment to which this section applies—

(i) The fair market value of each item of partnership property must be determined under this section; and

(ii) The rules of § 1.755–1 must be applied using the values so determined.

(2) *Application of this section.* This section applies to any basis adjustment made under section 743(b) (relating to certain transfers of interests in a partnership) or section 732(d) (relating to certain partnership distributions), if assets of the partnership constitute a trade or business for purposes of section 1060(c).

(b) *Determining the fair market value of partnership property*—(1) *Property other than that in the nature of goodwill or going concern value.* For purposes of this section, the fair market value of each item of partnership property (other than property in the nature of goodwill or going concern value) shall be determined on the basis of all the facts and circumstances.

(2) *Property in the nature of goodwill or going concern value.* For purposes of paragraph (a) of this section, the fair market value of partnership property in the nature of goodwill or going concern value (referred to hereinafter in this section as goodwill) shall be deemed to equal the amount (not below zero) which if assigned to such property would result in a liquidating distribution to the transferee partner equal to such partner's basis for the transferred partnership interest immediately after the transfer (reduced by the amount, if any, of such basis that is attributable to partnership liabilities) if—

(i) All partnership property were sold immediately after such transfer for an amount equal to the fair market value of such property (as determined under this section), and

(ii) The proceeds of that sale were, after the payment of all partnership liabilities (within the meaning of section 752 and the regulations thereunder), distributed to the partners.

(c) *Cross-reference.* See §§1.732–1(d)(3) and 1.743–1(b)(3) for rules requiring a transferee partner to attach a statement to such partner's return showing the computation of the special basis adjustment and the partnership properties to which the adjustment is allocated under section 755.

(d) *Effective date.* This section applies to any basis adjustment under section 743(b) made as a result of any transfer of a partnership interest made after May 6, 1986, unless such transfer is made pursuant to a binding contract that was in effect on May 6, 1986, and at all times thereafter prior to such transfer. However, the requirements of this section shall be deemed to be satisfied with respect to any transfer made on or before July 15, 1988, if the amount of any basis adjustment under section 743(b) or section 732(d) made as a result of such transfer that is allocated to each item of partnership property (other than goodwill) does not exceed the amount equal to the difference between the transferee partner's share of the partnership basis of such property and such partner's share of the fair market value of such property.

(e) *Example.* The provisions of this section may be illustrated by the following example which assumes that the assets of the partnership constitute a trade or business under section 1060 and that the partnership has an election in effect under section 754 at the time of the sale of the partnership interest.

Example (1). A is a member of partnership ABC. ABC has three assets: a building with a fair market value of $2,000,000, equipment with a fair market value of $800,000 and goodwill. ABC has no liabilities. A has a one-third interest in partnership capital and profits. A sells his partnership interest to D for $1,000,000. Under paragraph (b)(2) of this section, the fair market value of goodwill is deemed to equal the value that must be assigned to goodwill in order for the partnership to distribute $1,000,000 to D if it were to sell all of its property at fair market value (in the case of goodwill, its assigned value) and completely liquidate after D's purchase of A's partnership interest. In order for D, a one-third partner, to receive a liquidation distribution of $1,000,000, the partnership would have to sell all partnership property for a total of $3,000,000. The fair market value of partnership property other than goodwill is $2,800,000. Therefore, goodwill must be assigned a value of $200,000 ($3,000,000 − $2,800,000) in order for D to receive a liquidating distribution of $1,000,000. Accordingly, D's section 743(b) basis adjustment must be allocated under §1.755–1 using a fair market value of $200,000 for goodwill.

[T.D. 8215, 53 FR 27044, July 18, 1988]

DEFINITIONS

§1.761–1 Terms defined.

(a) *Partnership.* The term *partnership* means a partnership as determined under §§301.7701–1, 301.7701–2, and 301.7701–3 of this chapter.

(b) *Partner.* The term *partner* means a member of a partnership.

(c) *Partnership agreement.* For the purposes of subchapter K, a partnership agreement includes the original agreement and any modifications thereof agreed to by all the partners or adopted in any other manner provided by the partnership agreement. Such agreement or modifications can be oral or written. A partnership agreement may be modified with respect to a particular taxable year subsequent to the close of such taxable year, but not later than the date (not including any extension of time) prescribed by law for the filing of the partnership return. As to any matter on which the partnership agreement, or any modification thereof, is silent, the provisions of local law shall be considered to constitute a part of the agreement.

(d) *Liquidation of partner's interest.* The term *liquidation of a partner's interest* means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership. A series of distributions will come within the meaning of this term whether they are made in one year or in more than one year. Where a partner's interest is to be liquidated by a series of distributions, the interest will not be considered as liquidated until the final distribution has been made. For the basis of property distributed in one liquidating distribution, or in a series of distributions in liquidation, see section 732(b). A distribution which is not in liquidation of a partner's entire interest, as defined in this paragraph, is a current distribution.

Current distributions, therefore, include distributions in partial liquidation of a partner's interest, and distributions of the partner's distributive share. See paragraph (a)(1)(ii) of § 1.731–1.

(e) *Distribution of partnership interest.* For purposes of section 708(b)(1)(B) and § 1.708–1(b)(1)(iv), the deemed distribution of an interest in a new partnership by a partnership that terminates under section 708(b)(1)(B) is not a sale or exchange of an interest in the new partnership. However, the deemed distribution of an interest in a new partnership by a partnership that terminates under section 708(b)(1)(B) is treated as an exchange of the interest in the new partnership for purposes of section 743. This paragraph (e) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (e) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (e) to the termination in a consistent manner.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7208, 37 FR 20686, Oct. 3, 1972; T.D. 8697, 61 FR 66588, Dec. 18, 1996; T.D. 8717, 62 FR 25501, May 9, 1997]

§ 1.761–2 Exclusion of certain unincorporated organizations from the application of all or part of subchapter K of chapter 1 of the Internal Revenue Code.

(a) *Exclusion of eligible unincorporated organizations*—(1) *In general.* Under conditions set forth in this section, an unincorporated organization described in subparagraph (2) or (3) of this paragraph may be excluded from the application of all or a part of the provisions of subchapter K of chapter 1 of the Code. Such organization must be availed of (i) for investment purposes only and not for the active conduct of a business, or (ii) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted. The members of such organization must be able to compute their income without the necessity of computing partnership taxable income. Any syndicate, group, pool, or joint venture which is classifiable as an association, or any group operating under an agreement which creates an organization classifiable as an association, does not fall within these provisions.

(2) *Investing partnership.* Where the participants in the joint purchase, retention, sale, or exchange of investment property:

(i) Own the property as coowners,

(ii) Reserve the right separately to take or dispose of their shares of any property acquired or retained, and

(iii) Do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year, then

such group may be excluded from the application of the provisions of subchapter K under the rules set forth in paragraph (b) of this section.

(3) *Operating agreements.* Where the participants in the joint production, extraction, or use of property:

(i) Own the property as coowners, either in fee or under lease or other form of contract granting exclusive operating rights, and

(ii) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and

(iii) Do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than 1 year, then

such group may be excluded from the application of the provisions of subchapter K under the rules set forth in paragraph (b) of this section. However, the preceding sentence does not apply to any unincorporated organization one of whose principal purposes is cycling, manufacturing, or processing for persons who are not members of the organization. In addition, except as provided in paragraph (d)(2)(i) of this section, this paragraph (a)(3) does not apply to any unincorporated organization that produces natural gas under a joint operating agreement, unless all members of the unincorporated organization comply with paragraph (d) of this section.

(b) *Complete exclusion from subchapter K*—(1) *Time for making election for exclusion.* Any unincorporated organization described in subparagraph (1) and either (2) or (3) of paragraph (a) of this section which wishes to be excluded from all of subchapter K must make the election provided in section 761(a) not later than the time prescribed by paragraph (e) of §1.6031–1 (including extensions thereof) for filing the partnership return for the first taxable year for which exclusion from subchapter K is desired. Notwithstanding the prior sentence such organization may be deemed to have made the election in the manner prescribed in subparagraph (2)(ii) of this paragraph.

(2) *Method of making election.* (i) Except as provided in subdivision (ii) of this subparagraph, any unincorporated organization described in subparagraphs (1) and either (2) or (3) of paragraph (a) of this section which wishes to be excluded from all of subchapter K must make the election provided in section 761(a) in a statement attached to, or incorporated in, a properly executed partnership return, Form 1065, which shall contain the information required in this subdivision. Such return shall be filed with the internal revenue officer with whom a partnership return, Form 1065, would be required to be filed if no election were made. Where, for the purpose of determining such officer, it is necessary to determine the internal revenue district (or service center serving such district) in which the electing organization has its principal office or place of business, the principal office or place of business of the person filing the return shall be considered the principal office or place of business of the organization. The partnership return must be filed not later than the time prescribed by paragraph (e) of §1.6031–1 (including extensions thereof) for filing the partnership return with respect to the first taxable year for which exclusion from subchapter K is desired. Such partnership return shall contain, in lieu of the information required by Form 1065 and by the instructions relating thereto, only the name or other identification and the address of the organization together with information on the return, or in the statement attached to the return, showing the names, addresses, and identification numbers of all the members of the organization; a statement that the organization qualifies under subparagraphs (1) and either (2) or (3) of paragraph (a) of this section; a statement that all of the members of the organization elect that it be excluded from all of subchapter K; and a statement indicating where a copy of the agreement under which the organization operates is available (or if the agreement is oral, from whom the provisions of the agreement may be obtained).

(ii) If an unincorporated organization described in subparagraphs (1) and either (2) or (3) of paragraph (a) of this section does not make the election provided in section 761(a) in the manner prescribed by subdivision (i) of this subparagraph, it shall nevertheless be deemed to have made the election if it can be shown from all the surrounding facts and circumstances that it was the intention of the members of such organization at the time of its formation to secure exclusion from all of subchapter K beginning with the first taxable year of the organization. Although the following facts are not exclusive, either one of such facts may indicate the requisite intent:

(a) At the time of the formation of the organization there is an agreement among the members that the organization be excluded from subchapter K beginning with the first taxable year of the organization, or

(b) The members of the organization owning substantially all of the capital interests report their respective shares of the items of income, deductions, and credits of the organization on their respective returns (making such elections as to individual items as may be appropriate) in a manner consistent with the exclusion of the organization from subchapter K beginning with the first taxable year of the organization.

(3) *Effect of election*—(i) *In general.* An election under this section to be excluded will be effective unless within 90

days after the formation of the organization (or by October 15, 1956, whichever is later) any member of the organization notifies the Commissioner that the member desires subchapter K to apply to such organization, and also advises the Commissioner that he has so notified all other members of the organization by registered or certified mail. Such election is irrevocable as long as the organization remains qualified under subparagraphs (1) and either (2) or (3) of paragraph (a) of this section, or unless approval of revocation of the election is secured from the Commissioner. Application for permission to revoke the election must be submitted to the Commissioner of Internal Revenue, Attention: T:I, Washington, DC 20224, no later than 30 days after the beginning of the first taxable year to which the revocation is to apply.

(ii) *Special rule.* Notwithstanding subdivision (i) of this subparagraph, an election deemed made pursuant to subparagraph (2)(ii) of this paragraph will not be effective in the case of an organization which had a taxable year ending on or before November 30, 1972, if any member of the organization notifies the Commissioner that the member desires subchapter K to apply to such organization, and also advises the Commissioner that he has so notified all other members of the organization by registered or certified mail. Such notification to the Commissioner must be made on or before January 2, 1973 and must include the names and addresses of all of the members of the organization.

(c) *Partial exclusion from subchapter K.* An unincorporated organization which wishes to be excluded from only certain sections of subchapter K must submit to the Commissioner, no later than 90 days after the beginning of the first taxable year for which partial exclusion is desired, a request for permission to be excluded from certain provisions of subchapter K. The request shall set forth the sections of subchapter K from which exclusion is sought and shall state that such organization qualifies under subparagraphs (1) and either (2) or (3) of paragraph (a) of this section, and that the members of the organization elect to be excluded to the extent indicated. Such exclusion shall be effective only upon approval of the election by the Commissioner and subject to the conditions he may impose.

(d) *Rules for gas producers that produce natural gas under joint operating agreements*—(1) *Joint operating agreements and gas balancing.* Co-owners of a property producing natural gas enter into a joint operating agreement (JOA) to define the rights and obligations of each co- producer of the gas in place. The JOA determines, among other things, each co-producer's proportionate share of the natural gas as it is produced from the reservoir, together with the associated production expenses. A gas imbalance arises when a co-producer does not take its proportionate share of current gas production under the JOA (underproducer) and another co-producer takes more than its proportionate share of current production (overproducer). The co-producers often enter into a gas balancing agreement (GBA) as an addendum to their JOA to establish their rights and obligations when a gas imbalance arises. A GBA typically allows the overproducer to take the amount of the gas imbalance (overproduced gas) and entitles the underproducer to recoup the overproduced gas either from the volume of the gas remaining in the reservoir or by a cash balancing payment.

(2) *Permissible gas balancing methods*—(i) *General requirement.* All co-producers of natural gas operating under the same JOA must use the cumulative gas balancing method, as described in paragraph (d)(3) of this section, unless they use the annual gas balancing method described in paragraph (d)(4) of this section. A co-producer's failure to comply with the provisions of this paragraph (d)(2)(i) generally constitutes the use of an impermissible method of accounting, requiring a change to a permissible method under § 1.446–1(e)(3) with any terms and conditions as may be imposed by the Commissioner. The co-producers' election to be excluded from all or part of subchapter K will not be revoked, unless the Commissioner determines that there was willful failure to comply with the requirements of this paragraph (d)(2)(i).

(ii) *Change in method of accounting; adoption of method of accounting*—(A) *In* *general.* The annual gas balancing method and the cumulative gas balancing method are methods of accounting. Accordingly, a change to or from either of these methods is a change in method of accounting that requires the consent of the Commissioner. See section 446(e) and §1.446–1(e). For purposes of this section, each JOA is treated as a separate trade or business. Paragraph (d)(2)(ii)(B) of this section provides rules for adopting either permissible method of accounting. Paragraph (d)(2)(ii)(C) of this section provides rules on the timing of required changes to either permissible method during the transitional period, and paragraph (d)(5) of this section contains the procedural provisions for making a change in method of accounting required in paragraph (d)(2)(ii)(C) of this section.

(B) *Adoption of method of accounting.* A co-producer must adopt a permissible method for each JOA entered into on or after the start of the co-producer's first taxable year beginning after December 31, 1994 (or, in the case of the use of the annual gas balancing method by co-producers not having the same taxable year, the start of the first taxable year beginning after December 31, 1994, of the co-producer whose taxable year begins latest in the calendar year). If a co-producer is adopting the cumulative method, the co-producer may adopt the method by using the method on its timely filed return for the taxable year of adoption. A co-producer may adopt the annual gas balancing method with the permission of the Commissioner under guidelines set forth in paragraph (d)(4)(ii) of this section.

(C) *Required change in method of accounting for certain joint operating agreements.* This paragraph (d)(2)(ii)(C) applies to certain JOAs entered into prior to 1996. Except in the case of a part-year change in method of accounting or in the case of the cessation of a JOA (both of which are described in this paragraph (d)(2)(ii)(C)), for each JOA entered into prior to a co-producer's first taxable year beginning after December 31, 1994, and in effect as of the beginning of that year, the co-producer must change its method of accounting for sales of gas and its treatment of certain related deductions and credits to a permissible method as of the start of its first taxable year beginning after December 31, 1994. In the case of a JOA of co-producers that do not all have the same taxable year and that choose the annual gas balancing method, if the JOA is entered into prior to the first taxable year beginning after December 31, 1994 of the co-producer whose taxable year begins latest in the calendar year and the JOA is in effect as of January 1, 1996, a change to the annual gas balancing method by each co-producer under that JOA is made as of January 1, 1996 (part-year change in method of accounting). If the co-producers would have made a part-year change to the annual gas balancing method but for the fact that their JOA ceased to be in effect before January 1, 1996 (cessation of a JOA), the co-producers do not change their method of accounting with respect to the JOA. Rather, for their taxable years in which the JOA ceases to be in effect, the co-producers use their current method of accounting with respect to that JOA.

(3) *Cumulative gas balancing method*—(i) *In general.* The cumulative gas balancing method (cumulative method), solely for purposes of reporting income from gas sales and certain related deductions and credits, treats each co-producer under the same JOA as the sole owner of its percentage share of the total gas in the reservoir and disregards the ownership arrangement described in the JOA for gas as it is produced from the reservoir. Each co-producer is considered to be taking only its share of the total gas in the reservoir as long as the gas remaining in the reservoir is sufficient to satisfy the ownership rights of the co-producers in their percentage shares of the total gas in the reservoir. After a co-producer has taken its entire share of the total gas in the reservoir, any additional gas taken by that co-producer (taking co-producer) is treated as having been taken from its other co-producers' shares of the total gas in the reservoir. The effect of being treated as a taking co-producer under the cumulative method is that the taking co-producer generally may not claim an allowance for depletion and a production credit on its sales of its other co-producers'

percentage shares of the total gas in the reservoir.

(ii) *Requirements*—(A) *Reporting of income from sales of gas.* Under the cumulative method, each co-producer must include in gross income under its overall method of accounting the amount of its sales from all gas produced from the reservoir, including sales of gas taken from another co-producer's share of the gas in the reservoir.

(B) *Reporting of deduction of taking co-producer.* A taking co-producer deducts the amount of a payment (in cash or property, other than gas produced under the JOA) made to another co-producer for sales of that co-producer's gas, but only for the taxable year in which the payment is made. Thus, an accrual method taking co-producer is not permitted a deduction for any obligation it has to pay another co-producer for sales of that co-producer's gas until a payment is made. See paragraph (d)(3)(iii)(B) of this section for a rule requiring a reduction of the amount of the deduction described in this paragraph (d)(3)(ii)(B) if the taking co-producer had mistakenly claimed a depletion deduction relating to those sales.

(C) *Reporting of income by other co-producers.* Any co-producer that is entitled to receive a payment from a taking co-producer must include the amount of the payment in gross income as proceeds from the sale of its gas only for the taxable year that the payment is actually received, regardless of its overall method of accounting.

(D) *Reporting of production expenses.* Each co-producer deducts its proportionate share of production expenses, as provided in the JOA, under its regular method of accounting for the expenses.

(iii) *Special rules for production credits and depletion deductions under the cumulative method*—(A) *In general.* Under the cumulative method, a co-producer's depletion allowance and production credit for a taxable year are based on its income from gas sales and production of gas from its percentage share of the total gas in the reservoir, and are not based on its current proportionate share of income and production as determined under the JOA. Thus, in general, a taking co-producer is not allowed a production credit or an allowance for depletion on its sales of gas in excess of its percentage share of the total gas in the reservoir. However, the Service will not disallow depletion deductions or production credits claimed by a taking co-producer on the gas of other co-producers if the taking co-producer had a reasonable but mistaken belief that the deductions or credits were claimed with respect to the taking co-producer's percentage share of total gas in the reservoir and the taking co-producer makes the appropriate reductions and additions to tax required in paragraphs (d)(3)(iii)(B) and (d)(3)(iii)(C) of this section. The reasonableness of the mistaken belief is determined at the time of filing the return claiming the deductions or credits. A co-producer receiving a payment for sales of its gas from a taking co-producer claims a production credit and an allowance for depletion relating to those sales only for the taxable year in which the amount of the payment is included in its gross income.

(B) *Reduction of taking co-producer's payment deduction for depletion claimed on another co-producer's gas.* If a taking co-producer claims an allowance for depletion on another co-producer's gas, the taking co-producer must reduce its deduction claimed in a later year for making a payment to the other co-producer for sales of that co-producer's gas by the amount of any percentage depletion deduction allowed on the gas sales to which the payment relates. If the percentage limitation of section 613A(d)(1) applied to disallow a depletion deduction for a previous year, the taking co-producer must reduce the amount of any carried over depletion deduction allowable in the year of the payment or in a future year by the portion of the carried over depletion deduction, if any, that relates to another co-producer's gas.

(C) *Addition to tax of taking co-producer for production credit claimed on another co-producer's gas.* If a taking co-producer claims a production credit on another co-producer's gas, the taking co-producer must add to its tax for the taxable year that it makes a payment to the other co-producer for sales of that co-producer's gas any production credit allowed in an earlier taxable year on the gas sales to which the payment relates, but only to the extent the credit allowed actually reduced the taking co- producer's tax in any earlier year. The taking co-producer also must reduce the amount of its minimum tax credit allowable by reason of section 53(d)(1)(B)(iii) in the year of the payment or in a future year by the portion of the credit, if any, that relates to another co-producer's gas.

(iv) *Anti-abuse rule.* If the Commissioner determines that co-producers using the cumulative method have arranged or altered their taking of production for a taxable year with a principal purpose of shifting the income, deductions, or credits relating to that production to avoid tax, the co- producers' election to be excluded from all or part of subchapter K will be revoked for that year and for subsequent years. In determining that a principal purpose was to avoid tax, the Commissioner will examine all the facts and circumstances surrounding the use of the cumulative method by the co-producers. See *Examples 3* and *4* of paragraph (d)(6) of this section.

(4) *Annual gas balancing method*—(i) *In general.* The annual gas balancing method (annual method) takes into account each co-producer's ownership rights and obligations, as described in the JOA, with respect to the co-producer's current proportionate share of gas as it is produced from the reservoir. Under the annual method, gas imbalances relating to a JOA must be eliminated annually through a balancing payment, which may be in the form of cash, gas produced under the same JOA, or other property. If all the co-producers under a JOA have the same taxable year, any gas imbalance remaining at the end of a taxable year must be eliminated by a balancing payment from the overproducer to the underproducer by the due date of the overproducer's tax return for that taxable year (including extensions). If all the co-producers under a JOA do not have the same taxable year, any gas imbalance remaining at the end of a calendar year must be eliminated by a balancing payment from the overproducer to the underproducer by September 15 of the following calendar year. The annual method may be used only if the Commissioner's permission is obtained. Paragraph (d)(4)(ii) of this section provides guidelines for applying for this permission. The annual method is not available for a JOA with respect to which any co-producer made an election under paragraph (d)(5)(i)(B)(*3*) of this section (to take an aggregate section 481(a) adjustment for all JOAs of a co-producer into account in the year of change).

(ii) *Obtaining the Commissioner's permission to use the annual method.* A request for the Commissioner's permission to adopt the annual method for a new JOA must be in writing and must set forth the names of all the co-producers under the JOA and the respective taxable year of adoption. See paragraphs (d)(2)(ii) and (d)(5)(ii) of this section for the rules for a change in method of accounting to the annual method. In addition, the request must contain an explanation of how the co-producers will report income from gas sales, the making or receiving of a balancing payment, production expenses, depletion deductions, and production credits. Permission will be granted under appropriate conditions, including, but not limited to, an agreement in writing by all co-producers to use the annual method and to eliminate any gas imbalances annually in accordance with paragraph (d)(4)(i) of this section.

(5) *Transitional rules for making a change in method of accounting required in paragraph (d)(2)(ii)(C) of this section*—(i) *Change in method of accounting to the cumulative method*—(A) *Automatic consent to change in method of accounting to the cumulative method.* A co-producer changing to the cumulative method for any JOA entered into prior to its first taxable year beginning after December 31, 1994, and in effect as of the beginning of that year is granted the consent of the Commissioner to change its method of accounting with respect to each JOA to the cumulative method, provided the co-producer—

(*1*) Makes the change on its timely filed return for its first taxable year beginning after December 31, 1994;

(*2*) Attaches a completed and signed Form 3115 to the co-producer's tax return for the year of change, stating that, pursuant to §1.761–2(d)(2)(ii) of the regulations, the co-producer is changing its method of accounting for sales of gas and its treatment of certain related deductions and credits under each JOA to the cumulative method;

(*3*) In the case of a co-producer making an election under paragraph (d)(5)(i)(B)(*3*) of this section to take the aggregate section 481(a) adjustment into account in the year of change, attaches the statement described in paragraph (d)(5)(i)(B)(*3*)(*ii*) of this section; and

(*4*) In the case of a co-producer not making an election under paragraph (d)(5)(i)(B)(*3*) of this section, attaches a list of each JOA with respect to which there is a section 481(a) adjustment computed in accordance with paragraph (d)(5)(i)(B)(*2*)(*i*) of this section.

(B) *Section 481(a) adjustment*—(*1*) *Application of section 481(a).* A change in method of accounting to the cumulative method under the automatic consent procedure in paragraph (d)(5)(i)(A) of this section is a change in method of accounting to which the provisions of section 481(a) apply. Thus, a section 481(a) adjustment must be taken into account in the manner provided by this paragraph (d)(5)(i)(B) to prevent the omission or duplication of income. Paragraph (d)(5)(i)(B)(*2*) of this section provides the general rules for computing the amount of the section 481(a) adjustment of a co-producer relating to a particular JOA and for taking the section 481(a) adjustment into account. Paragraph (d)(5)(i)(B)(*3*) of this section provides rules for electing to take a co-producer's section 481(a) adjustment computed on an aggregate basis for all JOAs into account in the year of change. Paragraph (d)(5)(i)(C) of this section provides rules to coordinate the taking of a depletion deduction or a production credit with the inclusion of a section 481(a) adjustment arising from a change in method of accounting to the cumulative method under this paragraph (d)(5)(i).

(*2*) *Computation of the section 481(a) adjustment relating to a joint operating agreement*—(*i*) *In general.* The section 481(a) adjustment of a co-producer relating to a JOA is computed as of the first day of the co-producer's year of change and is equal to the difference between the amount of income reported under the co-producer's former method of accounting for all taxable years prior to the year of change and the amount of income that would have been reported if the co-producer's new method had been used in all those taxable years.

(*ii*) *Section 481(a) adjustment period.* Except to the extent that paragraph (d)(5)(i)(B)(*3*) of this section applies, a co-producer's section 481(a) adjustment relating to a JOA, whether positive or negative, is taken into account in computing taxable income ratably over the 6-taxable-year period beginning with the year of change (the section 481(a) adjustment period). If the co-producer has been in existence less than 6 taxable years, the adjustment is taken into account over the number of years the co-producer has been in existence. If the co-producer ceases to engage in the trade or business that gave rise to the section 481(a) adjustment at any time during the section 481(a) adjustment period, the entire remaining balance of the section 481(a) adjustment relating to that trade or business must be taken into account in the year of the cessation. For purposes of this paragraph (d)(5)(i)(B)(*2*)(*ii*), production under each JOA is treated as a separate trade or business. The determination as to whether the co-producer ceases to engage in its trade or business is to be made under the principles of § 1.446-–1(e)(3)(ii) and its underlying administrative procedures. For example, the permanent cessation of production under a co-producer's JOA constitutes the cessation of a trade or business of the co-producer. Accordingly, for the year that production under a JOA permanently ceases, the remaining balance of the section 481(a) adjustment relating to the JOA must be taken into account.

(*3*) *Election to take aggregate section 481(a) adjustment for all joint operating agreements into account in the year of change*—(*i*) *In general.* A co-producer may elect to take into account its section 481(a) adjustment, computed on an aggregate basis for all of its JOAs, whether negative or positive, in the year of change, provided the co-producer uses the cumulative method for all of its JOAs entered into prior to its first taxable year beginning after December 31, 1994, and in effect as of the beginning of that year. The aggregate section 481(a) adjustment of a co-producer is equal to the difference between the amount of income reported under the co-producer's former method of accounting for all taxable years prior to the year of change and the amount of income that would have been reported if the co-producer's new method had been used in all of those taxable years for all JOAs for which the co-producer changes its method of accounting. An election made under this paragraph (d)(5)(i)(B)(*3*) is irrevocable. If any person who, together with another person, would be treated as a single taxpayer under section 41(f)(1) (A) or (B) makes an election under this paragraph (d)(5)(i)(B)(*3*), all persons within that single taxpayer group will be treated as if they had made an election under this paragraph (d)(5)(i)(B)(*3*) and, as such, will be irrevocably bound by that election. If a co-producer does not make an election under this paragraph, each JOA entered into prior to the start of its first taxable year beginning after December 31, 1994, and in effect as of the beginning of that year must be accounted for separately in computing the section 481(a) adjustment and taxable income of the co-producer for any year to which this paragraph (d) applies.

(*ii*) *Time and manner for making the election*. An election under this paragraph (d)(5)(i)(B)(*3*) is made by attaching a statement to the co-producer's timely filed return for its year of change indicating that the co- producer is electing under §1.761–2(d)(5)(i)(B)(*3*) to take its aggregate section 481(a) adjustment into account in the year of change.

(C) *Treatment of section 481(a) adjustment as a sale for purposes of computing a production credit and as gross income from the property for purposes of depletion deductions.* Any positive section 481(a) adjustment arising as a result of a change in method of accounting for gas imbalances under this paragraph (d)(5)(i) and taken into account in computing taxable income under paragraph (d)(5)(i)(B) of this section is considered a sale by the taxpayer for purposes of computing any production credit in the year that the adjustment is taken into account. Similarly, the positive section 481(a) adjustment is considered *gross income from the property* and *taxable income from the property* for purposes of computing depletion deductions in the year the adjustment is taken into account. Sales amounts used in computing any production credit in any year in which a negative section 481(a) adjustment is taken into account in computing taxable income under paragraph (d)(5)(i)(B) of this section must be reduced by the amount of the negative section 481(a) adjustment taken into account in that year. Similarly, gross income from the property and taxable income from the property used in computing any depletion deduction in any year in which the negative section 481(a) adjustment is taken into account must be reduced by the amount of the negative adjustment. For these purposes, any taxpayer that makes an aggregate section 481(a) adjustment election under paragraph (d)(5)(i)(B)(*3*) of this section must allocate the adjustment among its properties in any reasonable manner that prevents a duplication or omission of depletion deductions.

(ii) *Change in method of accounting to the annual method*—(A) *In general.* A co-producer changing to the annual method in accordance with paragraph (d)(2)(ii) of this section must request a change under §1.446–1(e)(3) and will be subject to any terms and conditions as may be imposed by the Commissioner.

(B) *Section 481(a) adjustment.* A change in method of accounting to the annual method is a change in method of accounting to which the provisions of section 481(a) apply. Thus, a section 481(a) adjustment must be taken into account to prevent the omission or duplication of income. If all the co-producers under a JOA have the same taxable year, the section 481(a) adjustment involved in a change to the annual method by a co-producer relating to the JOA is computed as of the first day of the co-producer's year of change. If the co-producers under a JOA do not all have the same taxable year (that is, in the case of a part-year change described in paragraph (d)(2)(ii)(C) of this section), the change in method of accounting occurs on January 1, 1996, and the section 481(a) adjustment is computed on that date.

(iii) *Untimely change in method of accounting to comply with this section.* Unless a co-producer required by this section to change its method of accounting complies with the provisions of this paragraph (d)(5) for its first applicable taxable year within the time prescribed by this paragraph (d)(5), the co-producer must take the section 481(a) adjustment into account under the provisions of any applicable administrative procedure that is prescribed by the Commissioner specifically for purposes of complying with this section. Absent such an administrative procedure, a co-producer must request a change under § 1.446–1(e)(3) and will be subject to any terms and conditions as may be imposed by the Commissioner.

(6) *Examples.* The following examples illustrate the application of the cumulative method described in paragraph (d)(3) of this section.

Example 1. Operation of the cumulative method. (i) L, a corporation using the cash receipts and disbursements method of accounting, and M, a corporation using an accrual method, file returns on a calendar year basis. On January 1, 1995, L and M enter into a JOA to produce natural gas as an unincorporated organization from a reservoir located in State Y. The JOA allocates reservoir production 60 percent to L and 40 percent to M. L and M enter into a GBA as an addendum to the JOA. L and M agree to use the cumulative method to account for gas sales from the reservoir and elect under section 761(a) and this section to exclude the organization from the application of subchapter K. Production from the reservoir is eligible for the section 29 credit for producing fuel from a nonconventional source. L and M produce and sell the following amounts of natural gas (in mmcf) until 2000 during which year production from the reservoir ceases:

	1995	1996	1997	1998	1999	2000
L	720	480	600	–0–	–0–	–0–
M	240	60	120	160	80	40

(ii) By the end of 1996, neither L nor M has fully produced its percentage share of the total gas in the reservoir. In 1997, L produces a total of 600 mmcf of gas at the rate of 50 mmcf per month. Prior to filing its return for 1997, L determines that it fully produced its percentage share of gas in the reservoir as of June 30, 1997. Pursuant to the GBA executed by L and M, L pays M at the end of 2000 for the 300 mmcf of M's gas (as determined under the cumulative method) that L sold in the last half of 1997.

(iii) For 1995, L and M must include in their gross income the amounts relating to gas sales of 720 mmcf and 240 mmcf, respectively. For 1996, L and M must include the amounts relating to gas sales of 480 mmcf and 60 mmcf, respectively. For both 1995 and 1996, L and M compute an allowance for depletion and a section 29 credit based upon gas taken and sold by each from the reservoir for each taxable year.

(iv) For 1997, L and M must include in gross income the amounts relating to their gas sales of 600 mmcf and 120 mmcf, respectively. Under paragraph (d)(3)(iii)(A) of this section, L computes an allowance for depletion and the section 29 credit based only on production from L's proportionate share of gas in the reservoir (that is, based on L's production through June 30, 1997). Accordingly, for 1997, L claims depletion and the section 29 credit only with respect to 300 mmcf of gas (50 mmcf per month x 6 months). For 1997, because M has not fully produced from its percentage share of the total gas in the reservoir as of the end of 1997, M claims depletion and the section 29 credit on the 120 mmcf that M produced in 1997.

(v) In 1998 and 1999, M must include in gross income the amounts relating to M's sales of gas, that is, 160 mmcf for 1998 and 80 mmcf for 1999. For 2000, M must include in gross income the amount relating to sales of 340 mmcf of gas, which consists of its own sales of 40 mmcf plus the payment for 300 mmcf of gas that L made to M for having sold from M's share of the total gas in the reservoir during the last half of 1997. Because M produced from its percentage share of the total gas in the reservoir during 1998, 1999, and 2000, M claims a depletion deduction and a section 29 credit on its income and production for those years, that is, 160 mmcf for 1998, 80 mmcf for 1999, and 40 mmcf for 2000. Additionally, for 2000, M claims depletion and the section 29 credit relating to the payment that M received from L for the 300 mmcf of M's gas that L sold in the last half of 1997. Under paragraph (d)(3)(ii)(B) of this section, L's deduction for its payment to M for the 300 mmcf of M's gas that L sold in 1997 is allowable only for 2000.

Example 2. Adjustments under the cumulative method for depletion deductions and production credits that were claimed for sales in excess of a co-producer's percentage share of total gas in the reservoir. (i) L, a corporation using the cash receipts and disbursements method of accounting, and M, a corporation using an accrual method, file returns on a calendar year basis. On January 1, 1995, L and M enter into a JOA to produce natural gas as an unincorporated organization from a reservoir located in State Y. The JOA allocates reservoir production 60 percent to L and 40 percent to M. L and M enter into a GBA as an addendum to the JOA. L and M agree to use the cumulative method to account for gas sales from the reservoir and elect under section 761(a) and this section to exclude the organization from the application of subchapter K. Production from the reservoir is eligible for the section 29 credit for producing fuel from a nonconventional source. L and M produce and sell the following amounts of natural gas (in mmcf) until 2000 during which year production from the reservoir ceases:

	1995	1996	1997	1998	1999	2000
L	720	480	600	60	60	–0–
M	240	60	120	60	60	40

(ii) In addition, L does not realize until December 31, 1999, that L fully produced its percentage share of the total gas in the reservoir as of June 30, 1997. At the time of filing its returns for 1997 and 1998, L reasonably believes that during 1997 and 1998, respectively, it did not fully produce its percentage share of the total gas in the reservoir. Thus, L claims depletion and the section 29 credit for its total sales of 600 mmcf in 1997 and 60 mmcf in 1998. Pursuant to the GBA executed by L and M, L pays M at the end of 2000 for the 420 mmcf of M's gas (as determined under the cumulative method) that L sold (300 mmcf in the last half of 1997 (assuming that production was at a rate of 50 mmcf per month), 60 mmcf in 1998, and 60 mmcf in 1999).

(iii) In 1997 and 1998, L and M include in gross income the amounts relating to their respective sales of gas, that is, for L 600 mmcf for 1997 and 60 mmcf for 1998, and for M 120 mmcf for 1997 and 60 mmcf for 1998.

(iv) For 1999, L must include in gross income the amount of its sales of 60 mmcf, but may not claim depletion or the section 29 credit on those sales. For 1999, M must include in gross income the amount of its sales of 60 mmcf and claims depletion and the section 29 credit with respect to those 60 mmcf.

(v) For 2000, M must include in gross income the amount relating to gas sales of 460 mmcf, that is, the amount of M's own gas sales of 40 mmcf and the amount of the payment received from L for the 420 mmcf of M's gas that L sold (consisting of 300 mmcf in 1997, 60 mmcf in 1998, and 60 mmcf in 1999). Under paragraph (d)(3)(iii)(A) of this section, M computes a depletion deduction and a production credit relating to the amount of M's actual gas sales for 2000 and the payment received from L, that is, relating to a total of 460 mmcf of gas (M's sales of 40 mmcf for 2000, plus L's payment for 420 mmcf of gas). Under paragraph (d)(3)(ii)(B) of this section, L's deduction for making its payment to M for 420 mmcf of gas is allowable only for 2000. Under paragraph (d)(3)(iii)(B) of this section, L must reduce its deduction by the amount of any percentage depletion deductions allowed on its sales of M's gas, that is, relating to 360 mmcf of gas (300 mmcf for 1997 and 60 mmcf for 1998). In addition, under paragraph (d)(3)(iii)(C) of this section, L must increase its tax for 2000 by the amount of any section 29 credit L claimed on its sales of M's gas, but only to the extent that the credit claimed actually reduced L's tax in any earlier year.

Example 3. Non-abusive altering of the taking of production for a taxable year. (i) C and D enter into a JOA and a GBA on December 1, 1994, for gas production from a reservoir. The JOA allocates production at 50 percent to C and 50 percent to D. C and D agree in writing to use the cumulative method to account for gas sales. Additionally, C and D elect under section 761(a) and this section to exclude their organization from the application of subchapter K. C and D arrange to sell all their production under annually renewable contracts. In 1995, C and D each sell 480 mmcf of gas from the reservoir.

(ii) In November 1995, D is notified that its contract with its purchaser will not be renewed for 1996. D is unable to find a new purchaser for its gas for 1996. In December 1995, D notifies C that it will not be taking production from the reservoir in 1996. Pursuant to the GBA, C then contracts with its current gas purchaser to sell an additional 20 mmcf per month in 1996. Accordingly, C sells 720 mmcf in 1996 (60 mmcf per month x 12 months). Under the facts described in this example, a principal purpose of altering the taking of production is not to avoid tax. Accordingly, the co-producers' election under section 761(a) will not be revoked by reason of altering the taking of production.

Example 4. Abusive altering of the taking of production for a taxable year. The facts are the same as in *Example 3*(i). For 1996, C anticipates that C's regular tax (reduced by the credits allowable under sections 27 and 28) will not exceed C's tentative minimum tax. Accordingly, under section 29(b)(6), C's credit allowed under section 29(a) for sales of its gas will be zero. For 1997, C anticipates that its credit allowed under section 29(a) will not be limited by section 29(b)(6). On the other hand, D anticipates that any credit it may claim under section 29(a) for 1996, even including a credit based on sales of C's share of current production under the JOA, will not be limited by section 29(b)(6). However, for 1997, D anticipates that its credit under section 29(a) will be limited by section 29(b)(6). On January 1, 1996, C and D agree that D will contract with its purchaser to sell the entire 960 mmcf produced from the reservoir in 1996 and that C will contract with its purchaser to sell the entire 960 mmcf produced from the reservoir in 1997. Under these facts, a principal purpose of altering the taking of production is to avoid tax. Accordingly, the co-producers' election under section 761(a) will be revoked for 1996 and for subsequent years.

(7) *Effective date.* Except in the case of a part-year change to the annual method or the cessation of a JOA, both of which are described in paragraph (d)(2)(ii)(C) of this section, the provisions of this paragraph (d) apply to all taxable years beginning after December 31, 1994, of any producer that is a member of an unincorporated organization that produces natural gas under a JOA in effect on or after the start of the producer's first taxable year beginning after December 31, 1994. In the case of a part-year change, the provisions of this paragraph (d) apply on and after January 1, 1996. In the case of the cessation of a JOA, the co-producers use their current method of accounting with respect to that JOA until the JOA ceases to be in effect.

(e) *Cross reference.* For requirements with respect to the filing of a return on Form 1065 by a partnership, see § 1.6031–1.

[T.D. 7208, 37 FR 20687, Oct. 3, 1972; 37 FR 23161, Oct. 31, 1972, as amended by T.D. 8578, 59 FR 66183, Dec. 23, 1994; 60 FR 11028, Mar. 1, 1995]

EFFECTIVE DATE FOR SUBCHAPTER K, CHAPTER 1 OF THE CODE

§ 1.771–1 Effective date.

(a) *General rule.* Except as provided in paragraph (b) or (c) of this section, the provisions of subchapter K, chapter 1 of the Code, shall apply to any taxable year of a partnership beginning after December 31, 1954, and to any part of a partner's taxable year falling within such partnership taxable year. The provisions of the Internal Revenue Code of 1939 relating to partnerships shall apply to any taxable year of a partnership beginning before January 1, 1955, and to any part of a partner's taxable year falling within such partnership taxable year. If a partnership and the partners are on different taxable years, subchapter K shall become effective at the same time both for the partnership and for the partners.

(b) *Special rules.* Certain provisions of section 771 apply after specific dates in 1954, as follows:

(1) *Adoption of taxable year.* Section 706(b) (relating to the adoption of taxable years by partners and partnerships), shall apply to any partnership which adopts or changes to, and any partner who changes to, a taxable year beginning on or after April 2, 1954. For the purpose of applying this subparagraph, the rules of section 708 (relating to the continuation of partnerships) shall apply. For example, if two or more partnerships merge after April 1, 1954, and the new partnership uses the taxable year of the partnership of which it is deemed to be the successor under section 708(b)(2)(A), it will not need prior approval to continue to use such taxable year even though such year may be different from the taxable years of the partners. Such a partnership is not ''adopting'' or ''changing'' its taxable year.

(2) *Property distributed by a partnership.* Section 735(a), relating to the character of gain or loss on disposition of property distributed by a partnership to a partner, shall apply only to property distributed after March 9, 1954. Although a partnership whose taxable year begins before January 1, 1955, generally will be subject to the provisions of the Internal Revenue Code of 1939, any unrealized receivables or inventory items distributed by any such partnership after March 9, 1954, will be subject to the provisions of section 735(a), and the gain or loss on the subsequent disposition of such property will be ordinary gain or loss rather than capital gain or loss. In the case of property distributed before March 10, 1954, section 735(a) will not apply, even though the property is disposed of by the distributee partner after that date, unless the partnership elects under paragraph (c) of this section to apply section 735.

(3) *Unrealized receivables and inventory items.* Section 751 (providing for the realization of ordinary income on certain transfers or distributions of unrealized receivables or substantially appreciated inventory items) shall be applicable to any such transfer or distribution occurring after March 9, 1954. For the purpose of applying section 751 in the case of a taxable year beginning before January 1, 1955, a partnership or partner may elect to treat as applicable any other section of subchapter K. See paragraph (f) of § 1.751–1.

(4) *Partner receiving income in respect of a decedent.* Section 753, which provides that the amount includible in the gross income of a successor in interest of a deceased partner under section 736(a) shall be considered income in respect of a decedent under section 691, shall apply only in the case of payments made with respect to decedents whose death occurred after December 31, 1954.

(c) *Optional treatment of certain distributions.* (1) For a partnership taxable year beginning after December 31, 1953, and before January 1, 1955, a partnership may elect to apply the rules of certain sections of subchapter K with respect to current distributions made by the partnership in such year. These sections are 731, 732 (a), (c), and (e), 733, 735, and 751 (b), (c), and (d). If an election is made, it shall apply to the partnership and all its members for all current distributions made by the partnership during the taxable year. Such distributions shall also be subject to the rules of section 705 (relating to determination of basis of a partner's interest), 752 (relating to treatment of certain liabilities), and 761(d) (relating to the definition of liquidation of a partner's interest), to the extent that such sections apply to current distributions.

(2) An election under this paragraph shall be made by a statement filed with the partnership return for the taxable year to which such election applies, or before August 23, 1956, whichever date is later. The statement shall be signed by all members of the partnership and the election once made shall be binding on the partnership and on all of its members.

INSURANCE COMPANIES

Life Insurance Companies

DEFINITION; TAX IMPOSED

§1.801–1 Definitions.

(a) *Life insurance company.* The term *life insurance company* as used in subtitle A of the Code is defined in section 801. For the purpose of determining whether a company is a ''life insurance company'' within the meaning of that term as used in section 801, it must first be determined whether the company is taxable as an insurance company under the Code. For the definition of an ''insurance company'', see paragraph (b) of this section. In determining whether an insurance company is a life insurance company, the life insurance reserves (as defined in section 803(b)) plus any unearned premiums and unpaid losses on noncancellable life, health, or accident policies, not included in ''life insurance reserves'' must comprise more than 50 percent of its total reserves (as defined in section 801). An insurance company writing only noncancellable life, health, or accident policies and having no ''life insurance reserves'' may qualify as a life insurance company if its unearned premiums and unpaid losses on such policies comprise more than 50 percent of its total reserves. A noncancellable insurance policy means a contract which the insurance company is under an obligation to renew or continue at a specified premium and with respect to which a reserve in addition to the unearned premium must be carried to cover that obligation. For the purpose of the preceding sentence, the term ''unearned premium'' means the amount which will cover the cost of carrying the insurance risk for the period for which the premium has been paid in advance. A burial or funeral benefit insurance company qualifying as a life insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services will be taxable under section 821 or section 831 as an insurance company other than life.

(b) *Insurance companies.* (1) Insurance companies include both stock and mutual companies, as well as mutual benefit insurance companies. A voluntary unincorporated association of employees formed for the purpose of relieving sick and aged members and the dependents of deceased members is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer. A corporation which merely sets aside a fund for the insurance of its employees is not required to file a separate return for such fund, but the income therefrom shall be included in the return of the corporation.

(2) Though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a corporation is authorized and intends to carry on, the character of the business actually done in the taxable year determines whether it is taxable as an insurance company under the Code. For example, during the year 1954 the M Corporation, incorporated under the insurance laws of the State of R, carried on the business of lending money in addition to guaranteeing the payment of principal and interest of mortgage loans. Of its total income for the year, one-third was derived from its insurance business of guaranteeing the payment of principal and interest of mortgage loans and two-thirds was derived from its noninsurance business of lending money. The M Corporation is not an insurance company for the year 1954 within the meaning of the Code and the regulations thereunder.

§ 1.801–2 Taxable years affected.

Section 1.801–1 is applicable only to taxable years beginning after December 31, 1953, and before January 1, 1955, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Sections 1.801–3 through 1.801–7 are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112). Section 1.801–8 is applicable only to taxable years beginning after December 31, 1961, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) and section 3 of the Act of October 23, 1962 (76 Stat. 1134).

[T.D. 6886, 31 FR 8681, June 23, 1966]

§ 1.801–3 Definitions.

For purposes of part I, subchapter L, chapter 1 of the Code, this section defines the following terms, which are to be used in determining if a taxpayer is a life insurance company (as defined in section 801(a) and paragraph (b) of this section):

(a) *Insurance company.* (1) The term *insurance company* means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.

(2) Insurance companies include both stock and mutual companies, as well as mutual benefit insurance companies. For taxable years beginning before January 1, 1970, a voluntary unincorporated association of employees, including an association fulfilling the requirements of section 801(b)(2)(B) (as in effect for such years), formed for the purpose of relieving sick and aged members and the dependents of deceased members, is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer. A corporation which merely sets aside a fund for the insurance of its employees is not an insurance company, and the income from such fund shall be included in the return of the corporation.

(b) *Life insurance company.* (1) The term *life insurance company*, as used in subtitle A of the Code, is defined in section 801(a). For the purpose of determining whether a company is a ‘‘life insurance company’’ within the meaning of that term as used in section 801(a), it must first be determined whether the company is taxable as an insurance company (as defined in paragraph (a) of this section). An insurance company shall be taxed as a life insurance company if it is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, and its life insurance reserves (as defined in section 801(b) and §1.801–4), plus unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves, comprise more than 50 percent of its total reserves (as defined in section 801(c) and §1.801–5). For purposes of determining whether it satisfies the percentage requirements of the preceding sentence, a company shall first make any adjustments to life insurance reserves and total reserves required by section 806(a) (relating to adjustments for certain changes in reserves and assets) and then as required by section 801(d) (relating to adjustments in reserves for policy loans). For examples of the adjustments required under section 806(a), see paragraph (b)(4) of §1.806–3. For an example of the adjustments required under section 801(d), see paragraph (c) of §1.801–6. Furthermore, if an insurance company which computes its life insurance reserves on a preliminary term basis elects to revalue such reserves on a net level premium basis under section 818(c), such revalued basis shall be disregarded for purposes of section 801.

(2) An insurance company writing only noncancellable life, health, or accident policies and having no ‘‘life insurance reserves’’ may qualify as a life insurance company if its unearned premiums, and unpaid losses (whether or not ascertained), on such policies comprise more than 50 percent of its total reserves.

(3) Section 801(f) provides that a burial or funeral benefit insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services shall not be taxable under section 802 but shall be taxable under section 821 or section 831 as an insurance company other than life.

(c) *Noncancellable life, health, or accident insurance policy.* The term *noncancellable life, health, or accident insurance policy* means a health and accident contract, or a health and accident contract combined with a life insurance or annuity contract, which the insurance company is under an obligation to renew or continue at a specified premium and with respect to which a reserve in addition to the unearned premiums (as defined in paragraph (e) of this section) must be carried to cover that obligation. Such a health and accident contract shall be considered noncancellable even though it states a termination date at a stipulated age, if, with respect to the health and accident contract, such age termination date is 60 or over. Such a contract, however, shall not be considered to be noncancellable after the age termination date stipulated in the contract has passed. However, if the age termination date stipulated in the contract occurs during the period covered by a premium received by the life insurance company prior to such date, and the company cannot cancel or modify the contract during such period, the age termination date shall be deemed to occur at the expiration of the period for which the premium has been received.

(d) *Guaranteed renewable life, health, and accident insurance policy.* The term *guaranteed renewable life, health, and accident insurance policy* means a health and accident contract, or a health and accident contract combined with a life insurance or annuity contract, which is not cancellable by the company but under which the company reserves the right to adjust premium rates by classes in accordance with its experience under the type of policy involved, and with respect to which a reserve in addition to the unearned premiums (as defined in paragraph (e) of this section) must be carried to cover that obligation. Section 801(e) provides that such policies shall be treated in the same manner as noncancellable life, health, and accident insurance policies. For example, the age termination date requirements applicable to noncancellable health and accident insurance policies shall also apply to guaranteed renewable life, health, and accident insurance policies. See paragraph (c) of this section.

(e) *Unearned premiums.* The term *unearned premiums* means those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

(f) *Life insurance reserves.* For the definition of the term ''life insurance reserves'', see section 801(b) and § 1.801–4.

(g) *Unpaid losses (whether or not ascertained).* The term *unpaid losses (whether or not ascertained)* means a reasonable estimate of the amount of the losses (based upon the facts in each case and the company's experience with similar cases):

(1) Reported and ascertained by the end of the taxable year but where the amount of the loss has not been paid by the end of the taxable year,

(2) Reported by the end of the taxable year but where the amount thereof has not been either ascertained or paid by the end of the taxable year, or

(3) Which have occurred by the end of the taxable year but which have not been reported or paid by the end of the taxable year.

(h) *Total reserves.* For the definition of the term *total reserves,* see section 801(c) and § 1.801–5.

(i) *Amount of reserves.* For purposes of subsections (a), (b), and (c) of section 801 and this section, section 801(b)(5) provides that the amount of any reserve (or portion thereof) for any taxable year shall be the mean of such reserve (or portion thereof) at the beginning and end of the taxable year.

[T.D. 6513, 25 FR 12655, Dec. 10, 1960, as amended by T.D. 7172, 37 FR 5619, Mar. 17, 1972]

§ 1.801–4 Life insurance reserves.

(a) *Life insurance reserves defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term *life insurance reserves* (as defined in section 801(b)) means those amounts:

(1) Which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest;

(2) Which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies; and

(3) Which, except as otherwise provided by section 801(b)(2) and paragraphs (b) and (c) of this section, are required by law. For the meaning of the term ''reserves required by law'', see paragraph (b) of § 1.801–5.

For purposes of determining life insurance reserves, only those amounts shall be taken into account which must be reserved either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute. Moreover, such amounts must actually be held by the company during the taxable year for which the reserve is claimed. However, reserves held by the company with respect to the net value of risks reinsured in other solvent companies (whether or not authorized) shall be deducted from the company's life insurance reserves. For example, if an ordinary life policy with a reserve of $100 is reinsured in another solvent company on a yearly renewable term basis, and the reserve on such yearly renewable term policy is $10, the reinsured company shall include $90 ($100 minus $10) in determining its life insurance reserves. Generally, life insurance reserves, as in the case of level premium life insurance, are held to supplement the future premium receipts when the latter, alone, are insufficient to cover the increased risk in the later years. For examples of reserves which qualify as life insurance reserves, see paragraph (d) of this section. For examples of reserves which do not qualify as life insurance reserves, see paragraph (e) of this section.

(b) *Certain reserves which need not be required by law.* Section 801(b)(2) sets forth certain reserves which, though not required by law, may still qualify as life insurance reserves, provided, however, that they first satisfy the requirements of section 801(b)(1) (A) and (B) and paragraph (a) (1) and (2) of this section. Thus, reserves need not be required by law:

(1) In the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, and

(2) For taxable years beginning before January 1, 1970, in the case of policies issued by an organization which met the requirements of section 501(c)(9) (as it existed prior to amendment by the Tax Reform Act of 1969) other than the requirement of subparagraph (B) thereof.

(c) *Assessment companies.* Section 801(b)(3) provides that in the case of an assessment life insurance company or association, the term *life insurance reserves* includes:

(1) Sums actually deposited by such company or association with officers of a State or Territory pursuant to law as guaranty or reserve funds, and

(2) Any funds maintained, under the charter or articles of incorporation or association of such company or association (or bylaws approved by the State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

For purposes of part I, subchapter L, chapter 1 of the Code, the reserves described in this paragraph shall be included as life insurance reserves even though such reserves do not meet the requirements of section 801(b) and paragraph (a) of this section. However, for such reserves to be included as life insurance reserves, they must be deposited or maintained to liquidate future unaccrued claims arising from life insurance, annuity, or noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is deposited or maintained, life, health, or accident contingencies. The rate of interest assumed in calculating the reserves described in this paragraph shall be 3 percent, regardless of the rate of interest (if any) specified in the contract in respect of such reserves.

(d) *Reserves which qualify as life insurance reserves.* The following reserves, provided they meet the requirements of section 801(b) and paragraph (a) of this section, are illustrative of reserves which shall be included as life insurance reserves:

(1) Reserves held under life insurance contracts.

(2) Reserves held under annuity contracts (including reserves held under variable annuity contracts as described in section 801(g)(1)).

(3) Reserves held under noncancellable health and accident insurance contracts (as defined in paragraph (c) of §1.801–3) and reserves held under guaranteed renewable health and accident insurance contracts (as defined in paragraph (d) of §1.801–3).

(4) Reserves held either separately or combined under contracts described in subparagraphs (1), (2), or (3) of this paragraph.

(5) Reserves held under deposit administration contracts. Generally, the reserves held by a life insurance company on both the active and retired lives under deposit administration contracts will meet the requirements of section 801(b) and paragraph (a) of this section.

However, reserves held by the company with respect to the net value of risks reinsured in other solvent companies (whether or not authorized) shall be deducted from the company's life insurance reserves. See paragraph (a) of this section.

(e) *Reserves and liabilities which do not qualify as life insurance reserves.* The following are illustrative of reserves and liabilities which do not meet the requirements of section 801(b) and paragraph (a) of this section and, accordingly, shall not be included as life insurance reserves:

(1) Liability for supplementary contracts not involving at the time with respect to which the liability is computed, life, health, or accident contingencies.

(2) In the case of cancellable health and accident policies and similar cancellable contracts, the unearned premiums and unpaid losses (whether or not ascertained).

(3) The unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies (and guaranteed renewable life, health, and accident policies) not included in life insurance reserves. (However, such amounts

shall be taken into account under section 801(a)(2) for purposes of determining whether an insurance company is a life insurance company.)

(4) The deficiency reserve (as defined in section 801(b)(4)) for each individual contract, that is, that portion of the reserve for such contract equal to the amount (if any) by which:

(i) The present value of the future net premiums required for such contract, exceeds

(ii) The present value of the future actual premiums and consideration charged for such contract.

(5) Reserves required to be maintained to provide for the ordinary operating expenses of a business which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, and unpaid brokerage.

(6) Liability for premiums received in advance.

(7) Liability for premium deposit funds.

(8) Liability for annual and deferred dividends declared or apportioned.

(9) Liability for dividends left on deposit at interest.

(10) Liability for accrued but unsettled policy claims whether known or unreported.

(11) A mandatory securities valuation reserve.

(f) *Adjustments to life insurance reserves.* In the event it is determined on the basis of the facts of a particular case that premiums deferred and uncollected and premiums due and unpaid are not properly accruable for the taxable year under section 809 and, accordingly, are not properly includible under assets (as defined in section 805(b)(4)) for the taxable year, appropriate reduction shall be made in the life insurance reserves. This reduction shall be made when the insurance company has calculated life insurance reserves on the assumption that the premiums on all policies are paid annually or that all premiums due on or prior to the date of the annual statement have been paid.

[T.D. 6513, 25 FR 12656, Dec. 10, 1960, as amended by T.D. 7172, 37 FR 5619, Mar. 17, 1972]

§1.801–5 Total reserves.

(a) *Total reserves defined.* For purposes of section 801(a) and §1.801–3, the term ''total reserves'' is defined in section 801(c) as the sum of:

(1) Life insurance reserves (as defined in section 801(b) and §1.801–4),

(2) Unearned premiums (as defined in paragraph (e) of §1.801–3), and unpaid losses (whether or not ascertained) (as defined in paragraph (g) of §1.801–3), not included in life insurance reserves, and

(3) All other insurance reserves required by law.

The term ''total reserves'' does not, however, include deficiency reserves (within the meaning of section 801(b)(4), and paragraph (e)(4) of §1.801–4), even though such deficiency reserves are required by State law. In determining total reserves, a company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held during the taxable year for which the reserve is claimed. For example, during the taxable year 1958 a life insurance company sells life insurance and annuity contracts in States A and B. State A requires reserves of 10 against the life and 5 against the annuity business. State B requires reserves of 9 against the life and 7 against the annuity business. Assuming the company actually holds these reserves during the taxable year 1958, its highest aggregate reserve for such taxable year is the 16 required by State B. Thus, the company is not permitted to compute its highest aggregate reserve by taking State A's requirement of 10 against its life insurance business and adding it to State B's requirement of 7 against its annuity business.

(b) *Reserves required by law defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term *reserves required by law* means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

(c) *Information to be filed.* In any case where reserves are claimed, sufficient information must be filed with the return to enable the district director to determine the validity of the claim. See section 6012 and paragraph (c) of §1.6012–2. If the basis (for Federal income tax purposes) for determining the amount of any of the life insurance reserves as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year then the following information must be filed with respect to all such changes in basis:

(1) The nature of the life insurance reserve (i.e., life, annuity, etc.);

(2) The mortality or morbidity table, assumed rate of interest, method used in computing or estimating such reserve on the old basis, and the amount of such reserve at the beginning and close of the taxable year computed on the old basis;

(3) The mortality or morbidity table, assumed rate of interest, method used in computing or estimating such reserve on the new basis, and the amount of such reserve at the close of the taxable year computed on the new basis;

(4) The deviation, if any, from recognized mortality or morbidity tables, or recognized methods of computation;

(5) The reasons for the change in basis of such reserve; and

(6) Whether such change in the reserve has been approved or accepted by the regulatory authorities of the State of domicile, and if so, a copy of the letter, certificate, or other evidence of such approval or acceptance.

(d) *Illustration of principles.* The provisions of section 801 relating to the percentage requirements for qualification as a life insurance company may be illustrated by the following example:

Example. The books of Y, an insurance company, selling life insurance, noncancellable health and accident insurance, and cancellable accident and health insurance, reflect (after adjustment under sections 806(a) and 801(d)) the following facts for the taxable year 1958:

	Jan. 1	Dec. 31	Mean of year
1. Life insurance reserves	$3,000	$5,000	$4,000
2. Unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable accident and health insurance not included in life insurance reserves	400	600	500
3. Unearned premiums, and unpaid losses (whether or not ascertained), on cancellable accident and health insurance	1,800	2,200	2,000
4. All other insurance reserves required by law	900	1,100	1,000
5. Total reserves	....	....	7,500

The rules provided by section 801 require that the sum of the mean of the year figures in items 1 and 2 comprise more than 50 percent of the mean of the year figure in item 5 for an insurance company to qualify as a life insurance company. Thus, Y would qualify as a life insurance company for the taxable year 1958 as the sum of the mean of the year figures in items 1 and 2 ($4,500) comprise 60 percent of the mean of the year figure in item 5 ($7,500).

[T.D. 6513, 25 FR 12657, Dec. 10, 1960]

§1.801–6 Adjustments in reserves for policy loans.

(a) *In general.* Section 801(d) provides that for purposes only of determining whether or not an insurance company is a life insurance company (as defined in section 801(a) and paragraph (b) of §1.801–3), the life insurance reserves (as defined in section 801(b) and §1.801–4), and the total reserves (as defined in section 801(c) and paragraph (a) of §1.801–5), shall each be reduced by an amount equal to the mean of the aggregates, at the beginning and end of the taxable year, of the policy loans outstanding with respect to contracts for which life insurance reserves are maintained. Such reduction shall be made after any adjustments required under section 806(a) and §1.806–3 have been made.

(b) *Policy loans defined.* The term *policy loans* includes loans made by the insurance company, by whatever name called, for which the reserve on a contract is the collateral.

(c) *Illustration of principles.* The provisions of section 801(d) and this section may be illustrated by the following example:

Example. The books of T, an insurance company, selling only life insurance and cancellable accident and health insurance, reflect (after adjustment under section 806 (a)) the following facts for the taxable year 1958:

	Jan. 1	Dec. 31	Mean of year
1. Life insurance reserves	$1,000	$2,000	$1,500
2. Policy loans	50	850	450
3. Life insurance reserves less policy loans	....	....	1,050
4. Unearned premiums, and unpaid losses (whether or not ascertained), on cancellable accident and health insurance	900	1,600	1,250
5. Total reserves adjusted for policy loans (item 3 plus item 4)	....	....	2,300

As the rules provided by section 801 (a) and (d) require that the figure in item 3 ($1,050) be more than 50 percent of the mean of the year figure in item 5 ($2,300) for an insurance company to qualify as a life insurance company, T would not qualify as a life insurance company for the taxable year 1958.

[T.D. 6513, 25 FR 12657, Dec. 10, 1960]

§ 1.801–7 Variable annuities.

(a) *In general.* (1) Section 801(g)(1) provides that for purposes of part I, subchapter L, chapter 1 of the Code, an annuity contract includes a contract which provides for the payment of a variable annuity computed on the basis of recognized mortality tables and the investment experience of the company issuing such a contract. A variable annuity differs from the ordinary or fixed dollar annuity in that the annuity benefits payable under a variable annuity contract vary with the insurance company's investment experience with respect to such contracts while the annuity benefits paid under a fixed dollar annuity contract are guaranteed irrespective of the company's actual investment earnings.

(2) The reserves held with respect to the annuity contracts described in section 801(g)(1) and subparagraph (1) of this paragraph shall qualify as life insurance reserves within the meaning of section 801(b)(1) and paragraph (a) of § 1.801–4 provided such reserves are required by law (as defined in paragraph (b) of § 1.801–5) and are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from such contracts involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies. Accordingly, a company issuing variable annuity contracts shall qualify as a life insurance company for Federal income tax purposes if it satisfies the requirements of section 801(a) (relating to the definition of a life insurance company) and paragraph (b) of § 1.801–3.

(b) *Special rules for variable annuities*—(1) *Adjusted reserves rate; assumed rate.* The adjusted reserves rate for any taxable year with respect to the annuity contracts described in section 801(g)(1) and paragraph (a)(1) of this section, and the rate of interest assumed by the taxpayer for any taxable year in calculating the reserve on any such contract, shall be a rate equal to the current earnings rate determined under section 801(g)(3) and subparagraph (2) of this paragraph. However, any change in the rate of interest assumed by the taxpayer in calculating the reserve on a variable annuity contract for any taxable year which is attributable to an increase or decrease in the current earnings rate, shall not be treated as a change of basis in computing reserves for purposes of section 806(b) (relating to certain changes in reserves) or section 810 (d)(1) (relating to adjustment for change in computing reserves).

(2) *Current earnings rate.* (i) The current earnings rate for any taxable year with respect to the annuity contracts described in section 801(g)(1) and paragraph (a)(1) of this section shall be the current earnings rate determined under section 805(b)(2) and paragraph (a)(2) of § 1.805–5 with respect to such contracts, reduced by the percentage obtained by dividing *(a)* the amount of the actuarial margin charge on all such variable annuity contracts issued by the taxpayer, by *(b)* the mean of the reserves for such contracts.

(ii) For purposes of section 801(g)(3) and subdivision (i) of this subparagraph, the term *actuarial margin charge* means any amount retained by the company from gross investment income pursuant to the terms of the variable annuity contract in excess of any portion of the investment expenses which is attributable to such contract and which is deductible under section 804(c) and paragraph (b) of § 1.804–4.

(3) *Increases and decreases in reserves.* (i) Section 801(g)(4) provides that for purposes of section 810 (a) and (b) (relating to adjustments for increases or decreases in certain reserves), the sum of the items described in section 810(c) and paragraph (b) of §1.810–2 taken into account as of the close of the taxable year shall be adjusted:

(a) By subtracting therefrom the sum of any amounts added from time to time (for the taxable year) to the reserves for variable annuity contracts described in section 801(g)(1) and paragraph (a)(1) of this section by reason of realized or unrealized appreciation in the value of the assets held in relation thereto, and

(b) By adding thereto the sum of any amounts subtracted from time to time (for the taxable year) from such reserves by reason of realized or unrealized depreciation in the value of such assets.

(ii) The application of section 801(g)(4) and subdivision (i) of this subparagraph may be illustrated by the following example:

Example. Company M, a life insurance company issuing only variable annuity contracts of the type described in section 801(g)(1) and paragraph (a)(1) of this section, increased its life insurance reserves held with respect to such contracts during the taxable year 1959 by $275,000. Of the total increase in the reserves, $100,000 was attributable to premium receipts, $50,000 to dividends and interest, $100,000 to unrealized appreciation in the value of the assets held in relation to such reserves, and $25,000 to realized capital gains on the sale of such assets. As of the close of the taxable year 1959, the reserves held by company M with respect to all variable annuity contracts amounted to $1,275,000. However, under section 801(g)(4) and subdivision (i) of this subparagraph, this amount must be reduced by the $100,000 unrealized asset value appreciation and the $25,000 of realized capital gains. Accordingly, for purposes of section 810 (a) and (b), the amount of these reserves which is to be taken into account as of the close of the taxable year 1959 under section 810(c) is $1,150,000 ($1,275,000 less $125,000).

(c) *Companies issuing variable annuities and other contracts.* (1) In the case of a life insurance company which issues both annuity contracts described in section 801(g)(1) and paragraph (a)(1) of this section and other contracts, the policy and other contract liability requirements (as defined in section 805(a) and paragraph (b) of §1.805–4) of such a company for any taxable year shall be considered to be the sum of:

(i) The policy and other contract liability requirements computed with respect to the items which relate to such variable annuity contracts, and

(ii) The policy and other contract liability requirements computed by excluding the items taken into account under subdivision (i) of this subparagraph.

(2) [Reserved for regulations to be issued under section 801(g)(5)(B).]

(d) *Termination.* Paragraphs (1), (2), (3), (4), and (5) of section 801(g) and paragraphs (a), (b), (c), and (d) of this section shall not apply with respect to any taxable year beginning after December 31, 1962.

[T.D. 6610, 27 FR 8717, Aug. 31, 1962]

§1.801–8 Contracts with reserves based on segregated asset accounts.

(a) *Definitions*—(1) *Annuity contracts include variable annuity contracts.* Section 801(g)(1)(A) provides that for purposes of part I, subchapter L, chapter 1 of the Code, an annuity contract includes a contract which provides for the payment of a variable annuity computed on the basis of recognized mortality tables and the investment experience of the company issuing such a contract. A variable annuity differs from the ordinary or fixed dollar annuity in that the annuity benefits payable under a variable annuity contract vary with the insurance company's investment experience with respect to such contracts while the annuity benefits paid under a fixed dollar annuity contract are guaranteed irrespective of the company's actual investment earnings.

(2) *Contracts with reserves based on a segregated asset account.* (i) For purposes of part I, section 801(g)(1)(B) defines the term *contract with reserves based on a segregated asset account* as a contract (individual or group):

(a) Which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company,

(b) Which provides for the payment of annuities, and

(c) Under which the amounts paid in, or the amount paid as annuities, reflect the investment return and the market value of the segregated asset account.

(ii) The term *contract with reserves based on a segregated asset account* includes a contract such as a variable annuity contract, which reflects the investment return and the market value of the segregated asset account, even though such contract provides for the payment of an annuity computed on the basis of recognized mortality tables, but the term includes such contract only for the period during which it satisfies the requirements of section 801(g)(1)(B) and subdivision (i) of this subparagraph. However, such term does not include a pension contract written on the basis of the so-called new-money concept. Thus, for example, such term does not include a pension contract whereby reserves are credited on the basis of the company's new high yield investments. Furthermore, such term does not include a contract which during the taxable year contains a right to participate in the divisible surplus of the company where such right merely reflects the company's investment return. Nevertheless, the term does include a contract which meets the requirements of section 801(g)(1)(B) and of this subparagraph even if part of the amounts received are, for example, allocated to reserves under provisions of the contract which are written on the basis of the new-money concept. However, such reserves do not qualify as a segregated asset account referred to in section 801(g) and this section.

(iii) If at any time during the taxable year a contract otherwise satisfying the requirements of section 801(g)(1)(B) and subdivision (i) of this subparagraph ceases to reflect current investment return and current market value, such contract shall not be considered as meeting the requirements of section 801(g)(1)(B)(iii) and subdivision (i) *(c)* of this subparagraph after such cessation. Thus, a contract with reserves based on a segregated asset account includes a contract under which the reflection of investment return and market value terminates at the beginning of the annuity payments, but only for the period prior to such termination. For example, if the purchaser of a variable annuity contract which meets such requirements elects an option which provides for the payment of a fixed dollar annuity, then such contract shall be considered as satisfying such requirements only for the period prior to the time such contract ceases to reflect current investment return and current market value. Furthermore, a group annuity contract which satisfies the requirements of section 801(g)(1)(B) and subdivision (i) of this subparagraph shall be considered as continuing to meet such requirements even though a certificate holder under the group contract elects an option which provides for the payment of a fixed dollar annuity. However, the annuity attributable to such certificate holder shall not be considered as satisfying such requirements as of the time such annuity ceases to reflect current investment return and current market value. On the other hand, a group annuity contract which does not reflect current market value shall not be considered as satisfying such requirements even though a certificate holder under the group contract elects an option which provides for the payment of a variable annuity. However, the variable annuity attributable to such certificate holder shall be considered as satisfying such requirements as of the time such variable annuity commences to reflect current investment return and current market value.

(b) *Life insurance reserves.* Section 801(g)(2) provides that for purposes of section 801(b)(1)(A), the reflection of the investment return and the market value of the segregated asset account shall be considered an assumed rate of interest. Thus, the reserves held with respect to contracts described in section 801(g)(1) and paragraph (a) of this section shall qualify as life insurance reserves within the meaning of section 801(b)(1) and paragraph (a) of §1.801–4 provided such reserves are required by law (as defined in paragraph (b) of §1.801–5) and are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from such contracts with reserves based on segregated asset accounts involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies. Accordingly, a company issuing contracts with reserves based on segregated asset accounts shall qualify as a life insurance company for Federal income tax purposes if it satisfies the requirements of section 801(a) (relating to the definition of a life insurance company) and paragraph (b) of §1.801–3.

(c) *Separate accounting.* (1) For purposes of part I, section 801(g)(3) provides that a life insurance company (as defined in section 801(a) and paragraph (b) of §1.801–3) which issues contracts with reserves based on segregated asset accounts (as defined in section 801 (g)(1)(B) and paragraph (a)(2) of this section) shall separately account for each and every income, exclusion, deduction, asset, reserve, and other liability item which is properly attributable to such segregated asset accounts. In those cases where such items are not directly accounted for, separate accounting shall be made:

(i) According to the method regularly employed by the company, if such method is reasonable, and

(ii) In all other cases in a manner which, in the opinion of the district director, is reasonable.

A method of separate accounting for such items as are not accounted for directly will be deemed ‘‘regularly employed’’ by a life insurance company if the method was consistently followed in prior taxable years, or if, in the case of a company which has never before issued contracts with reserves based on segregated asset accounts, the company initiates in the first taxable year for which it issues such contracts a reasonable method of separate accounting for such items and consistently follows such method thereafter. Ordinarily, a company regularly employs a method of accounting in accordance with the statute of the State, Territory, or the District of Columbia, in which it operates.

(2) Every life insurance company issuing contracts with reserves based on segregated asset accounts shall keep such permanent records and other data relating to such contracts as is necessary to enable the district director to determine the correctness of the application of the rules prescribed in section 301(g) and this section and to ascertain the accuracy of the computations involved.

(d) *Investment yield.* (1) For purposes of part I, section 801(g)(4)(A) provides that the policy and other contract liability requirements (as determined under section 805), and the life insurance company’s share of investment yield (as determined under sections 804(a) or 809(b)), shall be separately computed:

(i) With respect to the items separately accounted for in accordance with section 801(g)(3) and paragraph (c) of this section, and

(ii) Excluding the items taken into account under subdivision (i) of this subparagraph.

Thus, for purposes of determining both taxable investment income and gain or loss from operations, a life insurance company shall separately compute the life insurance company’s share of the investment yield on the assets in its segregated asset account without regard to the policy and other contract liability requirements of, and the investment income attributable to, contracts with reserves that are not based on the segregated asset account. Such separate computations shall be made after any allocation required under section 801(g)(4)(B) and subparagraph (2) of this paragraph.

(2)(i) Section 801(g)(4)(B) provides that if the net short-term capital gain (as defined in section 1222(5)) exceeds the net long-term capital loss (as defined in section 1222(8)), determined without regard to any separate computations under section 801(g)(4)(A) and subparagraph (1) of this paragraph, then such excess shall be allocated between section 801(g)(4)(A) (i) and (ii) and subparagraph (1) (i) and (ii) of this paragraph. Such allocation shall be in proportion to the respective contributions to such excess of the items taken into account under each such section and subparagraph. The allocation under this subparagraph shall be made before the separate computations prescribed by section 801(g)(4)(A) and subparagraph (1) of this paragraph.

(ii) The operation of the allocation required under section 801(g)(4)(B) and subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. For the taxable year 1962, T, a life insurance company which issues regular life insurance and annuity contracts and contracts with reserves based on segregated asset accounts, had (without regard to section 801(g)(4)(A)) realized short-term capital gains of $10,000 and short-term capital losses of $10,000 attributable to its general asset accounts and realized short-term capital gains of $12,000 attributable to its segregated asset accounts. For the taxable year 1962, the excess of the net short-term capital gain ($10,000+$12,000−$10,000, or $12,000) over the net long-term capital loss (0) was $12,000. Of the excess of $12,000, 100 percent was contributed by the segregated asset accounts. Applying the provisions of section 801(g)(4)(B), T would allocate the entire $12,000 to its segregated asset accounts for such taxable year.

Example 2. The facts are the same as in example 1 except that for the taxable year 1962, T had (without regard to section 801(g)(4)(A)) realized short-term capital losses of $8,000 attributable to its general asset accounts and realized long-term capital gains of $1,000 and long-term capital losses of $5,000 attributable to its segregated asset accounts. For the taxable year 1962, the excess of the net short-term capital gain ($10,000+$12,000−$8,000, or $14,000) over the net long-term capital loss ($5,000−$1,000, or $4,000) was $10,000. Of the excess of $10,000, the general asset accounts contributed 20 percent ($2,000 ($10,000−$8,000)÷$10,000) and the segregated asset accounts contributed 80 percent ($8,000 ($12,000−$4,000)÷$10,000). Applying the provisions of section 801(g)(4)(B), T would allocate $2,000 ($10,000×20 percent) to its general asset accounts and $8,000 ($10,000×80 percent) to its segregated asset accounts for such taxable year.

Example 3. W is a life insurance company which issues regular life insurance and annuity contracts and contracts with reserves based on either of two segregated asset accounts, Separate Account C or Separate Account D. For the taxable year 1962, W had (without regard to section 801(g)(4)(A)) realized short-term capital gains of $16,000 and long-term capital losses of $15,000 attributable to its general asset accounts, long-term capital gains of $12,000 and short-term capital losses of $6,000 attributable to Separate Account C and long-term capital gains of $7,000 and short-term capital losses of $5,000 attributable to Separate Account D. For the taxable year 1962, the excess of the net short-term capital gain ($16,000−$6,000−$5,000) over the net long-term capital loss (0) was $5,000. Of the $5,000 excess, 20 percent ($16,000−$15,000÷$5,000) was contributed by the general asset accounts, leaving 80 percent as the amount contributed by the segregated asset accounts. Applying the provisions of section 801(g)(4)(B) W would allocate $1,000 (20 percent of $5,000) to the general asset accounts, leaving $4,000 (80 percent of $5,000) to be allocated among the segregated asset accounts, Separate Account C and Separate Account D. W would allocate $3,000 of the $4,000 to Separate Account C computed as follows:

$$\$3{,}000 = \frac{(\$4{,}000)\times(\$12{,}000-\$6{,}000)}{(\$12{,}000-\$6{,}000)+(\$7{,}000-\$5{,}000)}$$

W would allocate $1,000 of the $4,000 to Separate Account D computed as follows:

$$\$1{,}000 = \frac{(\$4{,}000)\times(\$7{,}000-\$5{,}000)}{(\$12{,}000-\$6{,}000)+(\$7{,}000-\$5{,}000)}$$

(e) *Policy and other contract liability requirements.* (1) For purposes of part I, section 801(g)(5)(A) provides that with respect to life insurance reserves based on segregated asset accounts (as defined in section 801(g)(1)(B) and paragraph (a)(2) of this section), the adjusted reserves rate and the current earnings rate for purposes of section 805(b), and the rate of interest assumed by the taxpayer for purposes of sections 805(c) and 809(a)(2), shall be a rate equal to the current earnings rate determined under section 805(b)(2) and paragraph (a)(2) of § 1.805–5 with respect to the items separately accounted for in accordance with section 801(g)(3), reduced by the percentage obtained by dividing:

(i) Any amount retained with respect to all of the reserves based on a segregated asset account by the life insurance company from gross investment income (as defined in section 804(b) and paragraph (a) of § 1.804–3) on segregated assets, to the extent such retained amount exceeds the deductions allowable under section 804(c) which are attributable to such reserves, by

(ii) The means of such reserves.

(2) For purposes of part I, section 801 (g)(5)(B) provides that with respect to reserves based on segregated asset accounts other than life insurance reserves, there shall be included as interest paid within the meaning of section 805(e)(1) and paragraph (b)(1) of § 1.805–8, an amount equal to the product of the means of such reserves multiplied by the rate of interest assumed as defined in section 801(g)(5)(A) and subparagraph (1) of this paragraph.

(3) For purposes of this paragraph, any change in the rate of interest assumed by the taxpayer in calculating the reserve on a contract with reserves based on a segregated asset account for any taxable year beginning after December 31, 1961, which is attributable to an increase or decrease in the current earnings rate, shall not be treated as a change of basis in computing reserves for purposes of section 806(b) (relating to certain changes in reserves) or section 810 (d)(1) (relating to adjustment for change in computing reserves).

(4) The provisions of section 801(g) (3) through (5) may be illustrated by the following example. For purposes of this example, it is assumed that all computations have been carried out to a sufficient number of decimal places to insure substantial accuracy and to eliminate any significant error in the resulting tax liability.

Example. The books of R, a life insurance company, discloses the following facts with respect to items of investment yield, deductions, assets, and reserves for the taxable year 1962:

(a) *Excerpts from Company Financial Statements.*

(1) Investment yield	Company regular account	Separate account A	Separate account B
Interest wholly tax-exempt	$100,000	$3,000	$1,000
Interest—other	10,000,000	8,000	15,000
Dividends received	200,000	25,000	27,000
Other items of investment yield	100,000	2,000	1,000
Gross investment income	10,400,000	38,000	44,000
Less deductions (sec. 804(c))	1,000,000	4,000	4,400
Investment yield	9,400,000	34,000	39,600
(2) Assets and reserves:			
(i) Assets:			
Jan. 1, 1962 ...	190,000,000	....	....
Dec. 31, 1962	210,000,000	1,600,000	1,800,000
Mean	200,000,000	800,000	900,000
(ii) Life insurance reserves:			
Jan. 1, 1962 ...	152,000,000	....	....
Dec. 31, 1962	168,000,000	1,600,000	1,640,000
Mean	160,000,000	800,000	820,000
(iii) Reserves based on segregated asset accounts other than life insurance reserves:			
Jan. 1, 1962 ...	....	....	....
Dec. 31, 1962	....	....	120,000
Mean	....	....	60,000

(b) *Additional facts.* In addition to the facts assumed in (a) above, assume the following: The company retained with respect to reserves based upon segregated asset accounts a total of $4,720 from gross investment income on Separate Account A and $5,720 from gross investment income on Separate Account B. With respect to the Company Regular Account computed without regard to the items in either of the separate accounts, the policy and other contract liability requirement is $6,580,000 and the required interest is $5,640,000. There are no items of interest paid with respect to the separate accounts other than those computed under section 801(g)(5)(B). Based on these facts, the current earnings rate (sec. 805(b)); adjusted reserves rate (sec. 805 (b)); and rate of interest assumed (secs. 805(c) and 809(a)(2)); and the policy and other contract liability requirements are determined for each of the Separate Accounts A and B (and the policy and other contract liability requirements for the Company Regular Account) as set forth in items (c) through (1) below.

(c) *Separate Account A.* The current earnings rate determined under section 805 (b)(2) with respect to the items separately accounted for under Separate Account A, prior to the reduction provided for under section 801(g)(5)(A), is 4.25 percent (the investment yield, $34,000, divided by the mean of the assets, $800,000). The company retained with respect to such reserves from gross investment income on Separate Account A a total of $4,720. The company had deductions allowable under section 804(c) with respect to such account of $4,000. Accordingly, for purposes of section 801(g)(5)(A)(i), the amount retained by the company was $720 (the total amount retained of $4,720 less the deductions allowable under section 804(c) of $4,000). The reduction percentage for purposes of section 801(g)(5)(A) is 0.09 percent (the amount retained of $720 divided by the mean of the life insurance reserves of $800,000). Therefore, the adjusted reserves rate and the current earnings rate for purposes of section 805(b), and the rate of interest assumed for purposes of sections 805(c) and 809(a)(2) is equal to 4.16 percent (the current earnings rate of 4.25 percent less the reduction percentage of 0.09 percent).

The policy and other contract liability requirements with respect to Separate Account A is determined as follows: For purposes of section 805(a) (1) and (2), the amount is $33,280 (the mean of the life insurance reserves, $800,000, multiplied by the current earnings rate, as determined under section 801(g)(5)(A), 4.16 percent). Thus, the policy and other contract liability requirement for Separate Account A is $33,280.

(d) *Separate Account B.* The current earnings rate determined under section 805 (b)(2) with respect to the items separately accounted for under Separate Account B, prior to the reduction provided for under section 801(g)(5)(A), is 4.40 percent (the investment yield, $39,600 divided by the mean of the assets, $900,000). The company retained with respect to such reserves from gross investment income on Separate Account B a total of $5,720. The company had deductions allowable under section 804(c) with respect to such account of $4,400. Accordingly, for purposes of section 801(g)(5)(A)(i) the amount retained by the company was $1,320 (the total amount retained of $5,720 less the deductions allowable under section 804(c) of $4,400). The reduction percentage for purposes of section 801(g)(5)(A) is 0.15 percent (the amount retained of $1,320 divided by the mean of the reserves based on Separate Account B of $880,000 ($820,000 plus $60,000)). Therefore, the adjusted reserves rate and the current earnings rate for purposes of section 805(b), and the rate of interest assumed for purposes of section 805(c) and 809(a)(2) is equal to 4.25 percent (the current earnings rate of 4.40 percent less the reduction percentage of 0.15 percent).

With respect to reserves based on segregated asset accounts other than life insurance reserves, Separate Account B had such reserves at December 31, 1962, of $120,000. The mean of such reserves was $60,000. The rate of interest assumed with respect to such reserves is 4.25 percent, as computed above. Accordingly, there shall be included as interest paid within the meaning of section 805(e)(1) the amount of $2,550 (the mean of such reserves, $60,000 multiplied by the rate of interest assumed of 4.25 percent).

The policy and other contract liability requirements with respect to Separate Account B is determined as follows:

(1) For purposes of section 805(a)(1) and (2), the amount is $34,850 (the mean of the life insurance reserves, $820,000, multiplied by the current earnings rate, as determined under section 801(g)(5)(A), 4.25 percent).

(2) For purposes of section 805(a)(3), the amount is $2,550 (the mean of the reserves based on Separate Account B other than life insurance reserves, $60,000, multiplied by the rate of interest assumed, as determined under section 801(g)(5)(A), 4.25 percent). It has been assumed that there was no other interest paid on Separate Account B within the meaning of section 805(e). If there was other interest paid with respect to Separate Account B that met the requirements of section 805(e), however, then such interest would be included under section 805(a)(3). Thus, the policy and other contract liability requirement for Separate Account B is $37,400 ($34,850+$2,550).

(e) *Company Regular Account.* The policy and other contract liability requirements with respect to the Company Regular Account is $6,580,000 (this amount is determined by the company in the manner provided by section 805 (and the regulations thereunder) without regard to either Separate Account A or Separate Account B).

(f) *Policyholders' share and company's share of investment yield—section 804.* The policyholders' and company's share of investment yield and taxable investment income are computed as follows:

(1) Company Regular Account

Policyholders' share of investment yield.	70% ($6,580,000÷$9,400,000).
Company's share of investment yield (100% less 70%).	30%.

(2) Separate Account A

Policyholders' share of investment yield.	97.8824% ($33,280 ÷$34,000).
Company's share of investment yield (100% less 97.8824%).	2.1176%.

(3) Separate Account B

Policyholders' share of investment yield.	94.444% ($37,400 ÷$39,600).
Company's share of investment yield (100% less 94.444%).	5.556%.

(g) *The company's share of investment yield under section 804 is determined as follows:*

Investment yield (from item (a)(1))	Company regular account (30 percent times each amount in item (a)(1))	Separate account A (2.1176 percent times each amount in item (a)(1))	Separate account B (5.556 percent times each amount in item (a)(1))
Interest wholly tax-exempt	$30,000	$63.53	$55.56
Interest—other	3,000,000	169.41	833.40
Dividends received	60,000	529.40	1,500.12
Other items of gross investment income.	30,000	42.35	55.56
	3,120,000	804.69	2,444.64

Investment yield (from item (a)(1))	Company regular account (30 percent times each amount in item (a)(1))	Separate account A (2.1176 percent times each amount in item (a)(1))	Separate account B (5.556 percent times each amount in item (a)(1))
Less deductions	300,000	84.70	244.46
Investment yield	2,820,000	719.99	2,200.18

(h) *Taxable investment income.* The company's taxable investment income (without regard to any excess of net long-term capital gain over net short-term capital loss) is determined as follows:

Life insurance company's share of investment yield ($2,820,000+$719.99+ $2,200.18)	$2,822,920.17
Less:	
Company's share of interest wholly tax-exempt ($30,000+ $63.53+$55.56)=$30,119.09	
85 percent of company's share of dividends received (but not to exceed 85% of taxable investment income computed without regard to this deduction) (85%×$62,029.52) ($60,000+ $529.40+$1,500.12)=$52,725.09	
Small business deduction (10% of investment yield, $9,473,600, not to exceed $25,000) =$25,000.00	107,844.18
Taxable investment income	2,715,075.99

(i) *Required interest—section 809(a)(2)*— (1) *Separate Account A.* The rate of interest assumed by the company, with respect to Separate Account A is 4.16 percent (see (c) above). The required interest for purposes of section 809(a)(2) is determined as follows:

Life insurance reserves: 4.16% (rate assumed) times $800,000 (mean of life insurance reserves)	$33,280.00

(2) *Separate Account B.* The rate of interest assumed by the company with respect to Separate Account B is 4.25 percent (see (d) above). The required interest for purposes of section 809(a)(2) is determined as follows:

(i) Life insurance reserves: 4.25% (rate assumed) times $820,000 (mean of life insurance reserves)	$34,850.00
(ii) Other section 810(c) reserves: 4.25% (rate assumed) times $60,000 (mean of reserves other than life insurance reserves)	$2,550.00
	$37,400.00

(3) *Company Regular Account.* The required interest with respect to the Company Regular Account is $5,640,000 (this amount is assumed for purposes of this example, but it would be determined by the company in the manner provided by section 809 without regard to either Separate Account A or Separate Account B).

(j) *Policyholders' share and company's share of investment yield—section 809.* The policyholders' share and the company's share of investment yield for purposes of section 809 is determined as follows:

(1) *Company Regular Account:*	
Policyholders' share of investment yield	60% ($5,640,000÷$9,400,000).
Company's share of investment yield (100 percent—60%).	40%.
(2) *Separate Account A:*	
Policyholders' share of investment yield	97.8824% ($33,280÷$34,000).
Company's share of investment yield (100%—97.8824 percent).	2.1176%.
(3) *Separate Account B:*	
Policyholders' share of investment yield	94.444% ($37,400÷$39,600).
Company's share of investment yield (100%—94.444%).	5.556%.

(k) *The company's share of investment yield under section 809 is determined as follows:*

Investment yield (from item (a)(1))	Company regular account (40 percent times each amount in item (a)(1))	Separate account A (2.1176 percent times each amount in item (a)(1))	Separate account B (5.556 percent times each amount in item (a)(1))
Interest wholly tax-exempt	$40,000	$63.53	$55.56
Interest—other	4,000,000	169.41	833.40
Dividends received	80,000	529.40	1,500.12
Other items of gross investment income	40,000	42.35	55.56
	4,160,000	804.69	2,444.64

Investment yield (from item (a)(1))	Company regular account (40 percent times each amount in item (a)(1))	Separate account A (2.1176 percent times each amount in item (a)(1))	Separate account B (5.556 percent times each amount in item (a)(1))
Less deductions	400,000	84.70	244.46
Investment yield	3,760,000	719.99	2,200.18

(1) *Deductions under section 809(d)(8).* For purposes of section 809(d)(8), the life insurance company's share of each of such items is determined as follows:

(1) Wholly tax-exempt interest ($40,000+$63.53+$55.56)	$40,119.09
(2) Dividends received 85%× $82,029.52 ($80,000+$529.40+$1,500.12) (it is assumed for purposes of this example that this amount does not exceed 85% of the gain from operations as computed under sec. 809(d)(8)(B))	69,725.09

(f) *Increases and decreases in reserves.* (1) Section 801(g)(6) provides that for purposes of section 810 (a) and (b) (relating to adjustments for increases or decreases in certain reserves), the sum of the items described in section 810(c) and paragraph (b) of § 1.810–2 taken into account as of the close of the taxable year shall be adjusted:

(i) By subtracting therefrom the sum of any amounts added from time to time (for the taxable year) to the reserves separately accounted for in accordance with section 801(g)(3) and paragraph (c) of this section by reason of realized or unrealized appreciation in value of the assets held in relation thereto, and

(ii) By adding thereto the sum of any amounts subtracted from time to time (for the taxable year) from such reserves by reason of realized or unrealized depreciation in the value of such assets.

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

Example. Company M, a life insurance company issuing only contracts with reserves based on segregated asset accounts as defined in section 801(g)(1)(B) and paragraph (a)(2) of this section (other than contracts described in section 805(d)(1) (A), (B), (C), or (D)), increased its life insurance reserves held with respect to such contracts during the taxable year 1962 by $275,000. Of the total increase in the reserves, $100,000 was attributable to premium receipts, $50,000 to dividends and interest, $100,000 to unrealized appreciation in the value of the assets held in relation to such reserves, and $25,000 to realized capital gains on the sale of such assets. As of the close of the taxable year 1962, the reserves held by company M with respect to all such contracts amounted to $1,275,000. However, under section 801(g)(6) and this subparagraph, this amount must be reduced by the $100,000 unrealized asset value appreciation and the $25,000 of realized capital gains. Accordingly, for purposes of section 810(a) and (b), the amount of these reserves which is to be taken into account as of the close of the taxable year 1962 under section 810(c) is $1,150,000 ($1,275,000 less $125,000). However, for purposes of section 810 (a) and (b), the amount of these reserves which is to be taken into account as of the beginning of the taxable year 1963 under section 810(c) is $1,275,000 (the amount as of the close of the taxable year 1962 before reduction of $125,000 for unrealized appreciation and realized capital gains).

(3)(i) Under section 801(g)(6), the deduction allowable for items described in section 809(d) (1) and (7) (relating to death benefits and assumption reinsurance, respectively) with respect to segregated asset accounts shall be reduced to the extent that the amount of such items is increased for the taxable year by appreciation (or shall be increased to the extent that the amount of such items is decreased for the taxable year by depreciation) not reflected in adjustments required to be made under subparagraph (1) of this paragraph.

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

Example. On June 30, 1962, X, a life insurance company, reinsured a portion of its insurance contracts with reserves based on segregated asset accounts with Y, a life insurance company, under an agreement whereby Y agreed to assume and become solely liable under the contracts reinsured. The reserves on the contracts reinsured by X were $90,000, of which $10,000 was attributable to unrealized appreciation in the value of the assets held in relation to such reserves. However, no amounts had been added to the reserves by reason of the unrealized appreciation of $10,000 and consequently, the $10,000 was not reflected in adjustments to reserves under section 809(g)(6) or subparagraph (1) of this paragraph. Under the reinsurance agreement, X made a payment of $90,000 in cash to

Y for assuming such contracts. Applying the provisions of section 809(d)(7), and assuming no other such reinsurance transactions by X during the taxable year, X would have an allowable deduction of $90,000 as a result of this payment on June 30, 1962. However, applying the provisions of section 801(g)(6) and this subparagraph, the actual deduction allowed would be $80,000 ($90,000 less $10,000). See section 806 (a) and §1.806–3 for the adjustments in reserves and assets to be made by X and Y as a result of this transaction. For the treatment by Y of this $90,000 payment, see section 809(c)(1) and paragraph (a)(1)(i) of §1.809–4.

(g) *Basis of assets held for certain pension plan contracts.* Section 801(g)(7) provides that in the case of contracts described in section 805(d)(1) (A), (B), (C), (D), or (E) (relating to the definition of pension plan reserves), the basis of each asset in a segregated asset account shall (in addition to all other adjustments to basis) be (i) increased by the amount of any appreciation in value, and (ii) decreased by the amount of any depreciation in value; but only to the extent that such appreciation and depreciation are reflected in the increases and decreases in reserves, or other items described in section 801(g)(6), with respect to such contracts. Thus, there shall be no capital gains tax payable by a life insurance company on appreciation realized on assets in a segregated asset account to the extent such appreciation has been reflected in reserves, or other items described in section 801(g)(6), for contracts described in section 805(d)(1) (A), (B), (C), (D), or (E) based on segregated asset accounts.

(h) *Additional separate computation*—(1) *Assets and total insurance liabilities.* A life insurance company which issues contracts with reserves based on segregated asset accounts (as defined in section 801(g)(1)(B) and paragraph (a)(2) of this section) shall separately compute and report with its return the assets and total insurance liabilities which are properly attributable to all of such segregated asset accounts. Each foreign corporation carrying on a life insurance business which issues such contracts shall separately compute and report with its return assets held in the United States and total insurance liabilities on United States business which are properly attributable to all of such segregated asset accounts.

(2) *Foreign life insurance companies.* For adjustment under section 819 in the case of a foreign life insurance company which issues contracts based on segregated asset accounts under section 801(g), see §1.819–2(b)(4).

[T.D. 6886, 31 FR 8681, June 23, 1966, as amended by T.D. 6970, 33 FR 12044, Aug. 24, 1968; T.D. 7501, 42 FR 42341, Aug. 23, 1977]

§1.802(b)–1 Tax on life insurance companies.

(a) For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, section 802(b) imposes a tax on the 1954 life insurance company taxable income of all life insurance companies (including a foreign life insurance company carrying on a life insurance business within the United States if with respect to its United States business it would qualify as a life insurance company under section 801). The tax so imposed is equal to 3 3/4 percent of the amount of such income not in excess of $200,000, plus 6 1/2 percent of the amount of such income in excess of $200,000. For the definition of the term ‘‘1954 life insurance company taxable income’’, see §1.805–1.

(b) The taxable income of life insurance companies differs from the taxable income of other corporations. See section 803. Life insurance companies are entitled, in computing life insurance company taxable income, to the special deductions provided in part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code. The gross income, the deduction under section 803 (g)(1) for wholly tax-exempt interest, and the deduction under section 242 for partially tax-exempt interest, are decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. See section 803 (i) and §1.803–6. Such companies are not subject to the provisions of subchapter P (section 1201 and following), chapter 1 of the Code, relating to capital gains and losses, nor to the provisions of section 171 (amortizable bond premium).

(c) All provisions of the Code and of the regulations in this part not inconsistent with the specific provision of sections 801 to 807, inclusive, are applicable to the assessment and collection of the tax imposed by section 802, and life insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120L.

(d) Foreign life insurance companies not carrying on an insurance business within the United States are not taxable under section 802, but are taxable as other foreign corporations. See section 881.

§ 1.802–2 Taxable years affected.

Section 1.802(b)–1 is applicable only to taxable years beginning after December 31, 1953, and before January 1, 1955, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Sections 1.802–3 through 1.802–5 (other than paragraph (f)(2) of § 1.802–3), except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) and section 235(c)(1) of the Revenue Act of 1964 (78 Stat. 126). Paragraph (f)(2) of § 1.802–3 is applicable only to taxable years beginning after December 31, 1961, and all reference to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112), section 3 of the Act of October 23, 1962 (76 Stat. 1134) and section 235(c)(1) of the Revenue Act of 1964 (78 Stat. 126).

[T.D. 6886, 31 FR 8685, June 23, 1966]

§ 1.802–3 Tax imposed on life insurance companies.

(a) *In general.* For taxable years beginning after December 31, 1957, section 802(a)(1) imposes a tax on the life insurance company taxable income (as defined in section 802(b) and paragraph (a) of § 1.802–4) of every life insurance company (including a foreign life insurance company carrying on a life insurance business within the United States if with respect to its United States business it would qualify as a life insurance company under section 801(a)). The tax imposed by section 802(a)(1) is payable upon the basis of returns rendered by the life insurance companies liable thereto. See subchapter A, chapter 61 (section 6001 and following) of the Code.

(b) *Tax imposed.* The tax imposed by section 802(a)(1) consists of a normal tax and a surtax computed as provided in section 11 as though the life insurance company taxable income (as defined in section 802(b)) were the taxable income referred to in section 11.

(c) *Normal tax.* The normal tax is computed by applying to the life insurance company taxable income the regular corporate normal tax rate (as in effect for the taxable year) provided by section 11(b).

(d) *Surtax.* The surtax is computed by applying the regular corporate surtax rate (as in effect for the taxable year) provided by section 11(c) to the amount by which the life insurance company taxable income exceeds the surtax exemption for the taxable year as determined under section 11(d). See sections 269 and 1551 and the regulations thereunder, for certain circumstances in which the surtax exemption may be disallowed in whole or in part.

(e) *Special rule for 1959 and 1960.* See section 802(a)(3) and paragraph (a) of § 1.802–5 for a transitional rule applicable in certain cases in determining tax liability for the taxable years 1959 and 1960 by reason of the operation of section 802(b)(3).

(f) *Tax imposed in case of certain capital gains*—(1) *Taxable years beginning after December 31, 1958, and before January 1, 1962.* For taxable years beginning after December 31, 1958, and before January 1, 1962, if the net long-term capital gain (as defined in section 1222(7)) of any life insurance company exceeds its net short-term capital loss (as defined in section 1222(6)), section 802(a)(2) imposes a separate tax equal to 25 percent of such excess. This separate 25 percent tax rate applies whether or not there is life insurance company taxable income, taxable investment income, or a gain or loss from operations for the taxable year. For taxable years beginning after December 31, 1958, and before January 1, 1962, only the excess (if any) of net short-term capital gain (as defined in section 1222(5)) over net long-term capital loss (as defined in section 1222(8)) shall be taken into account in computing taxable investment income and gain or loss from operations. See sections 804(b) and 809(b). Except as modified by section 817 (rules relating to certain gains and losses), the general rules of the Code relating to gains and losses (such as the rules for determining the amount, characterization, and treatment thereof) shall apply with respect to life insurance companies.

(2) *Alternative tax in case of capital gains for taxable years beginning after December 31, 1961.* For taxable years beginning after December 31, 1961, if the net long-term capital gain (as defined in section 1222(7)) of any life insurance company exceeds its net short-term capital loss (as defined in section 1222(6)), section 802(a)(2) imposes an alternative tax in lieu of the tax imposed by section 802(a)(1), if and only if such alternative tax is less than the tax imposed by section 802(a)(1). The alternative tax is the sum of:

(i) A partial tax, computed as provided by section 802(a)(1), on the life insurance company taxable income determined by reducing the taxable investment income, and the gain from operations, by the amount of the excess of its net long-term capital gain over its net short-term capital loss, and

(ii)*(a)* In the case of a taxable year beginning before January 1, 1970, an amount equal to 25 percent of such excess, or

(b) In the case of a taxable year beginning after December 31, 1969, an amount determined as provided in section 1201(a) and paragraph (a)(3) of § 1.1201–1 on such excess.

In the computation of the partial tax, the deductions provided by sections 170 (as modified by section 809(a)(3)), 243, 244, 245 (as modified by sections 804 (a)(5) and 809(d)(8)(B)), and the limitation provided by section 809(f), shall not be recomputed as a result of the reduction of taxable investment income, and gain from operations, by the amount of such excess. Except as modified by section 817 (rules relating to certain gains and losses), the general rules of the Code relating to gains and losses (such as the rules for determining the amount, characterization and treatment thereof) shall apply with respect to life insurance companies.

(g) *Foreign life insurance companies.* Foreign life insurance companies not carrying on an insurance business within the United States are not taxable under section 802, but are taxable as other foreign corporations. See section 881.

(h) *Assessment and collection of tax imposed.* All provisions of the Internal Revenue Code and of the regulations in this part not inconsistent with the specific provisions of sections 801 to 820, inclusive, are applicable to the assessment and collection of the tax imposed by section 802(a), and life insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120L.

(i) *Illustration of principles.* The provisions of section 802(a), other than paragraph (3) thereof, and this section may be illustrated by the following example:

Example. For the taxable year 1959, T, a life insurance company, has life insurance company taxable income of $300,000 (including $25,000 of net short-term capital gain) and $80,000 of net long-term capital gain. The tax of T under section 802(a) for 1959 is $170,500 ($90,000 normal tax, $60,500 surtax, and $20,000 capital gains tax) computed as follows:

COMPUTATION OF NORMAL TAX	
Life insurance company taxable income	$300,000
Normal tax (30% of $300,000)	90,000
COMPUTATION OF SURTAX	
Life insurance company taxable income	$300,000
Less: Exemption from surtax	25,000
Excess of life insurance company taxable income subject to surtax	275,000
Surtax (22% of $275,000)	60,500
COMPUTATION OF CAPITAL GAINS TAX	
Excess of net long-term capital gain over net short-term capital loss	$80,000
Capital gains tax (25% of $80,000)	20,000

(j) *Cross reference.* In the case of a taxable year of a life insurance company ending after December 31, 1963, for which an election under section 1562(a)(1) by a controlled group of corporations is effective, the additional tax imposed by section 1562 may apply. See section 1562 and the regulations thereunder.

[T.D. 6513, 25 FR 12658, Dec. 10, 1960, as amended by T.D. 6845, 30 FR 9740, Aug. 5, 1965; T.D. 6886, 31 FR 8685, June 23, 1966; T.D. 7337, 39 FR 44972, Dec. 30, 1974]

§ 1.802–4 Life insurance company taxable income.

(a) *Life insurance company taxable income defined.* Section 802(b) defines the term *life insurance company taxable income,* for purposes of part I, subchapter L, chapter 1 of the Code, as the sum of:

(1) The taxable investment income (as defined in section 804), or, if smaller, the gain from operations (as defined in section 809),

(2) If the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) The amount subtracted from the policyholders surplus account for the taxable year, as determined under section 815.

If for any taxable year there is a loss from operations (as defined in section 809(b)(2)), the amount taken into account under paragraphs (1) and (2) of section 802(b) and subparagraphs (1) and (2) of this paragraph shall be zero. However, even in such a case, there may still be an amount includible in life insurance company taxable income (and hence an amount subject to tax) by reason of an amount includible under section 802(b)(3) and subparagraph (3) of this paragraph.

(b) *Illustration of principles.* The provisions of section 802(b) and this section may be illustrated by the following examples:

Example 1. For the taxable year 1959, Y, a life insurance company, has taxable investment income of $250,000, and a gain from operations of $175,000. Y made no subtractions from the policyholders surplus account during such taxable year. For the taxable year 1959, Y has life insurance company taxable income of $175,000.

Example 2. The facts are the same as in example 1 except that for the taxable year 1959, Y has a gain from operations of $400,000. For the taxable year 1959, Y has life insurance company taxable income of $325,000, computed by adding taxable investment income ($250,000) and 50 percent ($75,000) of the amount ($150,000) by which the gain from operations ($400,000) exceeds the taxable investment income ($250,000).

Example 3. For the taxable year 1959, W, a life insurance company, has taxable investment income of zero (0) and a gain from operations of $90,000. W made no subtractions from the policyholders surplus account during such taxable year. For the taxable year 1959, W has life insurance company taxable income of $45,000, computed by adding taxable investment income (0) and 50 percent ($45,000) of the amount ($90,000) by which the gain from operations ($90,000) exceeds the taxable investment income (0).

Example 4. For the taxable year 1961, Z, a life insurance company, has taxable investment income of $100,000, a policyholders surplus account of $50,000 as of the beginning of such taxable year, a loss from operations (as defined in section 809(b)(2)) of $25,000, and subtractions from the policyholders surplus account in the amount of $20,000. For the taxable year 1961, Z has life insurance company taxable income of $20,000, as only the amount ($20,000) subtracted from the policyholders surplus account is taken into account.

[T.D. 6513, 25 FR 12658, Dec. 10, 1960]

§ 1.802–5 Special rule for 1959 and 1960.

(a) *Transitional rule.* Section 802(a)(3) provides a transitional rule for the determination of the tax liability of a life insurance company for the taxable years 1959 and 1960 by reason of the operation of section 802(b)(3). Except as limited by section 802(a)(3) and paragraph (b) of this section, any increase in a life insurance company's tax that is attributable to the operation of section 802(b)(3) is taken into account only to the extent of one-third and two-thirds for the taxable years 1959 and 1960, respectively. To the extent there is an increase in a life insurance company's tax that is attributable to the operation of section 802(b)(3) which is not taken into account for the taxable years 1959 and 1960 because of the transitional rule provided by section 802(a)(3) and this paragraph, such amounts shall be included in ''other accounts'' under section 815(a)(3). For taxable years commencing after December 31, 1960, the full amount of any increase in tax due to the operation of section 802(b)(3) shall be imposed without any further transitional reduction.

(b) *Limitations.* The transitional rule provided by section 802(a)(3) is limited solely to an increase in tax under section 802(b)(3) that is occasioned by the operation of section 815(c)(3) (relating to subtractions from the policyholders surplus account by reason of distributions to shareholders). This rule is further limited to actual distributions that are made by life insurance companies in 1959 or 1960 and does not extend to other distributions that are treated under section 815(d)(2)(B) as made by life insurance companies in 1959 or 1960. Furthermore, section 802(a)(3) shall not apply to any increase in tax under section 802(b)(3) that is attributable to other subtractions from the policyholders surplus account by reason of the operation of the special rules contained in section 815(d). However, the transitional rule provided by section 802(a)(3) does apply in the case of a distribution to which section 815(e)(1)(B)(ii) applies.

(c) *Illustration of principles.* The provisions of section 802(a)(3) and this section may be illustrated by the following example:

Example. For the taxable year 1960, X, a life insurance company, had taxable investment income of $9,000, gain from operations of $27,000, and subtractions from the policyholders surplus account of $22,000. Based upon these figures, X had life insurance company taxable income of $40,000 for 1960, of which $18,000 was includible under section 802(b) (1) and (2) and $22,000 under section 802(b)(3). Applying the tax imposed by section 802(a)(1) (at rates as in effect for 1960), without regard to the transitional rule of section 802(a)(3), X would have a tax liability of $15,300 ($40,000 multiplied by 52 percent, less $5,500). However, applying the transitional rule of section 802(a)(3), the actual tax liability of X, for 1960, would be $12,000, computed as follows:

(1) Total tax liability (without regard to sec. 802(a)(3))		$15,300
(2) Life insurance company taxable income	$40,000	
(3) Amount subtracted from policyholders surplus account	22,000	
(4) Item (2) less item (3)	18,000	
(5) Tax on amount includible under sec. 802(b) (1) and (2) (30% of $18,000)		5,400
(6) Tax attributable to sec. 802(b)(3) (item (1) less item (5))		9,900
(7) Less: 33 1/3 percent of tax attributable to sec. 802(b)(3) (1/3 of $9,900)		3,300
(8) Tax liability for 1960 after application of sec. 802(a)(3) (item (1) less item (7))		12,000

[T.D. 6513, 25 FR 12659, Dec. 10, 1960]

§1.803–1 Life insurance reserves.

(a) The term ‘‘life insurance reserves’’ is defined in section 803(b). Generally, such reserves, as in the case of level premium life insurance, are held to supplement the future premium receipts when the latter, alone, are insufficient to cover the increased risk in the later years. In the case of cancellable health and accident policies and similar cancellable contracts, the unearned premiums held to cover the risk for the unexpired period covered by the premiums are not included in life insurance reserves. Unpaid loss reserves for noncancellable health and accident policies are included in life insurance reserves if they are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest.

(b) In the case of an assessment life insurance company or association, life insurance reserves include sums actually deposited by such company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation or association of such company or association, or bylaws (approved by the State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

(c) Life insurance reserves, except as otherwise provided in section 803(b), must be required by law either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute but such requirement, without more, is not conclusive; for example, life insurance reserves do not include reserves required to be maintained to provide for the ordinary running expenses of a business which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, and unpaid brokerage; nor do they include the net value of risks reinsured in other solvent companies; liability for premiums paid in advance; liability for annual and deferred dividends declared or apportioned; liability for dividends left on deposit at interest; liability for accrued but unsettled policy claims whether known or unreported; liability for supplementary contracts not involving, at the time with respect to which the liability is computed, life, health, or accident contingencies.

(d) In any case where reserves are claimed, sufficient information must be filed with the return to enable the district director to determine the validity of the claim. Only reserves which are required by law or insurance department ruling, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will, except as otherwise specifically provided in section 803(b), be considered as life insurance reserves. A company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held.

(e) In the case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, it is required that reserve funds thereon be based upon recognized mortality or morbidity tables covering disability benefits of the kind contained in policies issued by this particular class of companies but they need not be required by law.

§1.803–2 Adjusted reserves.

For the purpose of determining ‘‘required interest’’ for taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, certain reserves computed on a preliminary term method are to be adjusted by increasing such reserves by 7 percent. The reserves to be thus adjusted are reserves computed on preliminary term methods, such as the Illinois Standard, or the Select and Ultimate methods. Only reserves on policies in the modification period are to be so adjusted. Where reserves under a preliminary term method are the same as on the level premium method, and in the case of reserves for extended or paid-up insurance, no adjustment is to be made. The reserves are thus adjusted, and the rate of interest on which they are computed, should be reported in Schedule A, Form 1120L.

§1.803–3 Interest paid or accrued.

Interest paid or accrued is one of the elements to be used in computing the amount of ‘‘required interest’’ for purposes of determining the reserve interest credit provided in section 805. See §1.805–1. Interest paid or accrued consists of (a) interest paid or accrued on indebtedness (except indebtedness incurred or continued to purchase or carry tax-exempt securities as set forth in section 803(f)(1)) and (b) amounts in the nature of interest paid or accrued on certain contracts, as provided in section 803(f)(2). Interest on indebtedness includes interest on dividends held on deposit and surrendered during the taxable year but does not include interest paid or accrued on deferred dividends. Life insurance reserves as defined in §1.803–1 are not indebtedness. Dividends left with the company to accumulate at interest are a debt and not a reserve liability. Amounts in the nature of interest include so-called excess-interest dividends as well as guaranteed interest paid or accrued within the taxable year on insurance or annuity contracts (or contracts arising out of insurance or annuity contracts) which, at the time of payment, do not involve life, health, or accident contingencies. It is immaterial whether the optional mode of settlement specified in the insurance or annuity contract arises from an option exercised by the insured during his or her lifetime or from an option exercised by a beneficiary after the policy has matured, frequently referred to as a supplementary contract not involving life contingencies; for example, a contract to pay the insurance benefit in 10 annual installments. No distinction is made based on the person choosing the method of payment, and the full amount of the interest paid or accrued and not merely the guaranteed interest is considered as interest paid or accrued.

§1.803–4 Taxable income and deductions.

(a) *In general.* The taxable income of a life insurance company is its gross amount of income received or accrued during the taxable year from interest, dividends, and rents, less the deductions provided in section 803(g) for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, and the special deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code. In addition to the limitations on deductions relating to real estate owned and occupied by a life insurance company provided in section 803(h), the limitations on the adjustment for amortization of premium and accrual of discount provided in section 803(i), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 803(g)(2), life insurance companies are subject to the limitations on deductions relating to wholly tax-exempt income provided in section 265. Life insurance companies are not entitled to the net operating loss deduction provided in section 172.

(b) *Wholly tax-exempt interest.* Interest which in the case of other taxpayers is excluded from gross income by section 103 but included in the gross income of a life insurance company by section 803(a)(2) is allowed as a deduction from gross income by section 803(g)(1).

(c) *Investment expenses.* (1) As used in the Code, the term *general expenses* means any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. Any assignment of such expense to the investment department of the company for which a deduction is claimed under section 803(g)(2) subjects the entire deduction for investment expenses to the limitation provided in that section. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes.

(2) If no general expenses are assigned to or included in investment expenses the deduction may consist of investment expenses paid or incurred during the taxable year in which case an itemized schedule of such expenses must be appended to the return.

(3) Invested assets for the purpose of section 803(g)(2) and this section are those which are owned and used, and to the extent used, for the purpose of producing the income specified in section 803(a)(2). They do not include real estate owned and occupied, and to the extent owned and occupied, by the company. If general expenses are assigned to or included in investment expenses, the maximum allowance will not be granted unless it is shown to the satisfaction of the district director that such allowance is justified by a reasonable assignment of actual expenses.

(d) *Taxes and expenses with respect to real estate.* The deduction for taxes and expenses under section 803(g)(3) includes taxes and expenses paid or accrued during the taxable year exclusively upon or with respect to real estate owned by the company and any sum representing taxes imposed upon a shareholder of the company upon his interest as shareholder which is paid or accrued by the company without reimbursement from the shareholder. No deduction shall be allowed, however, for taxes, expenses, and depreciation upon or with respect to any real estate owned by the company except to the extent used for the purpose of producing investment income. See paragraph (c) of this section. As to real estate owned and occupied by the company, see §1.803–5.

(e) *Depreciation.* The deduction allowed for depreciation is, except as provided in section 803(h), identical with that allowed other corporations by section 167. The amount allowed by section 167 in the case of life insurance companies is limited to depreciation sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 803(a)(2).

§ 1.803–5 Real estate owned and occupied.

The amount allowable as a deduction for taxes, expenses, and depreciation upon or with respect to any real estate owned and occupied in whole or in part by a life insurance company is limited to an amount which bears the same ratio to such deduction (computed without regard to this limitation) as the rental value of the space not so occupied bears to the rental value of the entire property. For example, if the rental value of the space not occupied by the company is equal to one-half of the rental value of the entire property, the deduction for taxes, expenses, and depreciation is one-half of the taxes, expenses, and depreciation on account of the entire property. Where a deduction is claimed as provided in this section, the parts of the property occupied and the parts not occupied by the company, together with the respective rental values thereof, must be shown in a statement accompanying the return.

§ 1.803–6 Amortization of premium and accrual of discount.

(a) Section 803(i) provides for certain adjustments on account of amortization of premium and accrual of discount on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such adjustments are limited to the amount of appropriate amortization or accrual attributable to the taxable year with respect to such securities which are not in default as to principal or interest and which are amply secured. The question of ample security will be resolved according to the rules laid down from time to time by the National Association of Insurance Commissioners. The adjustment for amortization of premium decreases, and for accrual of discount increases, (1) the gross income, (2) the deduction for wholly tax-exempt interest, and (3) the deduction for partially tax-exempt interest.

(b) The premium for any such security is the excess of its acquisition value over its maturity value and the discount is the excess of its maturity value over its acquisition value. The acquisition value of any such security is its cost (including buying commissions or brokerage but excluding any amounts paid for accrued interest) if purchased for cash, or if not purchased for cash, then its fair market value. The maturity value of any such security is the amount payable thereunder either at the maturity date or an earlier call date. The earlier call date of any such security may be the earliest call date specified therein as a day certain, the earliest interest payment date if it is callable or payable at such date, the earliest date at which it is callable at par, or such other call or payment date, prior to maturity, specified in the security as may be selected by the life insurance company. A life insurance company which adjusts amortization of premium or accrual of discount with reference to a particular call or payment date must make the adjustments with reference to the value on such date and may not, after selecting such date, use a different call or payment date, or value, in the calculation of such amortization or discount with respect to such security unless the security was not in fact called or paid on such selected date.

(c) The adjustments for amortization of premium and accrual of discount will be determined:

(1) According to the method regularly employed by the company, if such method is reasonable, or

(2) According to the method prescribed by this section.

A method of amortization of premium or accrual of discount will be deemed ‘‘regularly employed’’ by a life insurance company if the method was consistently followed in prior taxable years, or if, in the case of a company which has never before made such adjustments, the company initiates in the first taxable year for which the adjustments are made a reasonable method of amortization of premium or accrual of discount and consistently follows such method thereafter. Ordinarily, a company regularly employs a method in accordance with the statute of some State, Territory, or the District of Columbia, in which it operates.

(d) The method of amortization and accrual prescribed by this section is as follows:

(1) The premium (or discount) shall be determined in accordance with this section; and

(2) The appropriate amortization of premium (or accrual of discount) attributable to the taxable year shall be an amount which bears the same ratio to the premium (or discount) as the number of months in the taxable year during which the security was owned by the life insurance company bears to the number of months between the date of acquisition of the security and its maturity or earlier call date, determined in accordance with this section. For the purpose of this section, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered as a month.

§1.803–7 Taxable years affected.

Sections 1.803–1 through 1.803–6 are applicable only to taxable years beginning after December 31, 1953, and before January 1, 1955, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments.

[T.D. 6513, 25 FR 12660, Dec. 10, 1960]

INVESTMENT INCOME

§1.804–3 Gross investment income of a life insurance company.

(a) *Gross investment income defined.* For purposes of part I, subchapter L, chapter 1 of the Code, section 804(b) defines the term *gross investment income* of a life insurance company as the sum of the following:

(1) The gross amount of income from:

(i) Interest (including tax-exempt interest and partially tax-exempt interest), as described in §1.61–7. Interest shall be adjusted for amortization of premium and accrual of discount in accordance with the rules prescribed in section 818(b) and the regulations thereunder.

(ii) Dividends, as described in §1.61–9.

(iii) Rents and royalties, as described in §1.61–8.

(iv) The entering into of any lease, mortgage, or other instrument or agreement from which the life insurance company may derive interest, rents, or royalties.

(v) The alteration or termination of any instrument or agreement described in subdivision (iv) of this subparagraph.

For example, gross investment income includes amounts received as commitment fees, as a bonus for the entering into of a lease, or as a penalty for the early payment of a mortgage.

(2) In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net short-term capital gain (as defined in section 1222(5)) exceeds the net long-term capital loss (as defined in section 1222(8)), and

(3) The gross income from any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner.

(b) *No double inclusion of income.* In computing the gross income from any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner, any item described in section 804(b)(1) and paragraph (a)(1) of this section shall not be considered as gross income arising from the conduct of such trade or business or partnership, but shall be taken into account under section 804(b)(1) and paragraph (a)(1) of this section.

(c) *Exclusion of net long-term capital gains.* Any net long-term capital gains from the sale or exchange of a capital asset (or any gain considered to be from the sale or exchange of a capital asset under applicable law) shall be excluded from the gross investment income of a life insurance company. However, section 804(b)(2) and paragraph (a)(2) of this section provide that the amount (if any) by which the net short-term capital gain exceeds the net long-term capital loss shall be included in the gross investment income of a life insurance company.

[T.D. 6513, 25 FR 12661, Dec. 10, 1960]

§1.804–4 Investment yield of a life insurance company.

(a) *Investment yield defined.* Section 804(c) defines the term ‘‘investment yield’’ of a life insurance company for purposes of part I, subchapter L, chapter 1 of the Code. Investment yield means gross investment income (as defined in section 804(b) and paragraph (a) of § 1.804–3), less the deductions provided in section 804(c) and paragraph (b) of this section for investment expenses, real estate expenses, depreciation, depletion, and trade or business (other than an insurance business) expenses. However, such expenses are deductible only to the extent that they relate to investment income and the deduction of such expenses is not disallowed by any other provision of subtitle A of the Code. For example, investment expenses are not allowable unless they are ordinary and necessary expenses within the meaning of section 162, and under section 265, no deduction is allowable for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from taxation under chapter 1 of the Code. A deduction shall not be permitted with respect to the same item more than once.

(b) *Deductions from gross investment income*—(1) *Investment expenses.* (i) Section 804(c)(1) provides for the deduction of investment expenses by a life insurance company in determining investment yield. ''Investment expenses'' are those expenses of the taxable year which are fairly chargeable against gross investment income. For example, investment expenses include salaries and expenses paid exclusively for work in looking after investments, and amounts expended for printing, stationery, postage, and stenographic work incident to the collection of interest. An itemized schedule of such expenses shall be attached to the return.

(ii) Any assignment of general expenses to the investment department of a life insurance company for which a deduction is claimed under section 804(c)(1) subjects the entire deduction for investment expenses to the limitation provided in that section and subdivision (iii) of this subparagraph. As used in section 804(c)(1), the term *general expenses* means any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. For example, if real estate taxes, depreciation, or other expenses attributable to office space owned by the company and utilized by it in connection with its investment function are assigned to investment expenses, such items shall be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitation of section 804(c)(1) and subdivision (iii) of this subparagraph. Similarly, if an expense, such as a salary, is attributable to more than one department, including the investment department, such expense may be properly allocated among these departments. If such expenses are allocated, the amount properly allocable to the investment department shall be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitation of section 804(c)(1) and subdivision (iii) of this subparagraph. If general expenses are in part assigned to or included in investment expenses, the maximum allowance (as determined under section 804(c)(1)) shall not be granted unless it is shown to the satisfaction of the district director that such allowance is justified by a reasonable assignment of actual expenses. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes, if any. In cases where the investment expenses allowable as deductions under section 804(c)(1) exceed the limitation contained therein, see section 809(d)(9).

(iii) If any general expenses are in part assigned to or included in investment expenses, the total deduction under section 804(c)(1) shall not exceed the sum of:

(a) One-fourth of one percent of the mean of the assets (as defined in section 805(b)(4) and paragraph (a)(4) of § 1.805–5) held at the beginning and end of the taxable year,

(b) The amount of the mortgage service fees for the taxable year, plus

(c) Whichever of the following is the greater:

(1) One-fourth of the amount by which the investment yield (computed without any deduction for investment expenses allowed by section 804(c)(1)) exceeds 3 3/4 percent of the mean of the assets (as defined in section 805(b)(4)) held at the beginning and end of the

taxable year, reduced by the amount of the mortgage service fees for the taxable year, or

(2) One-fourth of one percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees for the taxable year. For purposes of the preceding sentence, the term *mortgages held* refers to mortgages, and other similar liens, on real property which are held by the company as security for ''mortgage loans''.

For purposes of section 804(c)(1)(B) and (C)(i) and (*b*) and (*c*)(*1*) of this subdivision, the term *mortgage service fees* includes mortgage origination fees. Such mortgage origination fees shall be amortized in accordance with the rules prescribed in section 818(b) and the regulations thereunder.

(iv) The operation of the limitation contained in section 804(c)(1) and subdivision (iii) of this subparagraph may be illustrated by the following example:

Example. The books of S, a life insurance company, reflect the following items for the taxable year 1958:

Investment expenses (including general expenses assigned to or included in investment expenses)	$125,000
Mean of the assets held at the beginning and end of the taxable year	20,000,000
Mortgage service fees	25,000
Investment yield computed without regard to investment expenses	1,200,000
Mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees	6,000,000

In order to determine the limitation on investment expenses, S would make up the following schedule:

1. Mean of the assets held at the beginning and end of the taxable year	$20,000,000	
2. One-fourth of 1 percent of item 1 (1/4 of 1% of $20,000,000)	50,000	
3. Mortgage service fees	25,000	
4. The greater of (a) or (b):		
(a)(i) Investment yield computed without regard to investment expenses	$1,200,000	
(ii) Three and three-fourths percent of item 1 (3 3/4% × $20,000,000)	750,000	
(iii) Excess of (i) over (ii) ($1,200,000 minus $750,000)	450,000	
(iv) One-fourth of (iii) (1/4 × $450,000)	112,500	
(v) Less: Mortgage service fees (item 3)	25,00	
(vi) Excess of (iv) over (v) ($112,500 minus $25,000)	87,500	
(b) One-fourth of 1 percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees (1/4 of 1% × $6,000,000)	15,000	
5. The greater of item 4 (a) or (b)		87,500
6. Limitation on investment expenses (items 2, 3, and 4(a))		162,500

As the investment expenses (including general expenses assigned to or included in investment expenses) of S for the taxable year 1958 ($125,000) do not exceed the limitation on such expenses ($162,500), S would be entitled to deduct the entire $125,000 under section 804(c)(1).

(2) *Real estate expenses and taxes.* The deduction for expenses and taxes under section 804(c)(2) includes taxes (as defined in section 164) and other expenses for the taxable year exclusively on or with respect to real estate owned by the company. For example, no deduction shall be allowed under section 804(c)(2) for amounts allowed as a deduction under section 164(e) (relating to taxes of shareholders paid by a corporation). No deduction shall be allowed under section 804(c)(2) for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. An itemized schedule of such taxes and expenses shall be attached to the return. See subparagraph (4) of this paragraph for limitation of such deduction.

(3) *Depreciation.* The deduction allowed for depreciation is, except as provided in section 804(c)(3) and subparagraph (4) of this paragraph, identical to that allowed other corporations by section 167. Such amount allowed as a deduction from gross investment income in determining investment yield is limited to depreciation sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 804(b). An election with respect to any of the methods of depreciation provided in section 167 shall not be affected in any way by the enactment of the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112). However, in appropriate cases, the method of depreciation may be changed with the

consent of the Commissioner. See section 167(e) and § 1.167(e)–1. See subparagraph (4) of this paragraph for limitation of such deduction. See section 809(d)(12) and the regulations thereunder for the treatment of depreciable property used in the operation of a life insurance business.

(4) *Limitation on deductions allowable under section 804 (c)(2) and (c)(3).* Section 804(c)(3) provides that the amount allowable as a deduction for taxes, expenses, and depreciation on or with respect to any real estate owned and occupied for insurance purposes in whole or in part by a life insurance company shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this limitation) as the rental value of the space not so occupied bears to the rental value of the entire property. For example, T, a life insurance company, owns a twenty-story downtown home office building. The rental value of each floor of the building is identical. T rents nine floors to various tenants, one floor is utilized by it in operating its investment department, and the remaining ten floors are occupied by it in carrying on its insurance business. Since floor space equivalent to eleven-twentieths, or 55 percent, of the rental value of the entire property is owned and occupied for insurance purposes by the company, the deductions allowable under section 804(c)(2) and (3) for taxes, depreciation, and other real estate expenses shall be limited to nine-twentieths, or 45 percent, of the taxes, depreciation, and other real estate expenses on account of the entire property. However, the portion of such allowable deductions attributable to the operation of the investment department (one-twentieth, or 5 percent) may be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitations of section 804(c)(1). Where a deduction is claimed as provided in this section, the parts of the property occupied and the parts not occupied by the company in carrying on its insurance business, together with the respective rental values thereof, must be shown in a schedule accompanying the return.

(5) *Depletion.* The deduction for depletion (and depreciation) provided in section 804(c)(4) is identical to that allowed other corporations by section 611. The amount allowed by section 611 in the case of a life insurance company is limited to depletion (and depreciation) sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 804(b). See section 611 and § 1.611–5 for special rules relating to the depreciation of improvements in the case of mines, oil and gas wells, other natural deposits, and timber.

(6) *Trade or business deductions.* (i) Under section 804(c)(5), the deductions allowed by subtitle A of the Code (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner are, subject to the limitations in subdivisions (ii), (iii), and (iv) of this subparagraph, allowable as deductions from the gross investment income of a life insurance company in determining its investment yield. Such deductions are allowable, however, only to the extent that they are attributable to the production of income which is included in the life insurance company's gross investment income by reason of section 804(b)(3). However, since any interest, dividends, rents, and royalties received by any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner, is included in the life insurance company's gross investment income by reason of section 804(b)(1) and paragraph (b) of § 1.804–3, any expenses fairly chargeable against the production of such income may be deductible under section 804(c) (1), (2), (3), or (4). The allowable deductions may exceed the gross income from such business.

(ii) In computing the deductions under section 804(c)(5), there shall be excluded losses:

(a) From (or considered as from) sales or exchanges of capital assets,

(b) From sales or exchanges of property used in the trade or business (as defined in section 1231(b)), and

(c) From the compulsory or involuntary conversion (as a result of destruction, in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business (as so defined).

(iii) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account. For example, if a life insurance company operates a radio station primarily to advertise its own insurance services, a portion of the expenses of the radio station shall not be allowed as a deduction. The portion disallowed shall be an amount which bears the same ratio to the total expenses of the station as the value of advertising furnished to the insurance company bears to the total value of services rendered by the station.

(iv) The deduction for net operating losses provided in section 172, and the special deductions for corporations provided in part VIII, subchapter B, chapter 1 of the Code, shall not be allowed.

[T.D. 6513, 25 FR 12662, Dec. 10, 1960]

§1.806–1 Adjustment for certain reserves.

(a) For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, a life insurance company writing contracts other than life insurance or annuity contracts (either separately or combined with noncancellable health and accident insurance contracts) must add to its life insurance company taxable income (as a factor in determining 1954 adjusted taxable income) an amount equal to eight times the amount of the adjustment for certain reserves provided in paragraph (b) of this section.

(b) The adjustment for certain reserves referred to in paragraph (a) of this section shall be an amount equal to 3 1/4 percent of the mean of the unearned premiums and unpaid losses at the beginning and end of the taxable year on such other contracts as are not included in life insurance reserves. If such unearned premiums, however, are less than 25 percent of the net premiums written during the taxable year on such other contracts, then the adjustment shall be 3 1/4 percent of 25 percent of the net premiums written during the taxable year on such other contracts plus 3 1/4 percent of the mean of the unpaid losses at the beginning and end of the taxable year on such other contracts. As used in this section, the term ‘‘unearned premiums’’ has the same meaning as in section 832(b)(4) and§1.832–1.

§1.806–2 Taxable years affected.

Section 1.806–1 is applicable only to taxable years beginning after December 31, 1953, and before January 1, 1955, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Sections 1.806–3 and 1.806–4 are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6513, 25 FR 12668, Dec. 10, 1960]

§1.806–3 Certain changes in reserves and assets.

(a) *In general.* For purposes of part I, subchapter L, chapter 1 of the Code, section 806(a) provides that if there is a change in life insurance reserves (as defined in section 801(b)), during the taxable year, which is attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such life insurance reserves, then the means of such reserves, and the mean of the assets, shall be appropriately adjusted to reflect the amounts involved in such transfer. For example, the adjustments required under section 806(a) are applicable to transfers in which one life insurance company purchases or acquires a part or all of the business of another life insurance company under an arrangement whereby the purchaser or transferee becomes solely liable on the contracts transferred. This provision shall apply in the case of assumption reinsurance but not in the case of indemnity reinsurance or reinsurance ceded. Thus, no adjustments shall be required under section 806(a) when, in the ordinary course of business, an indemnity reinsurance contract is entered into with another company (on a yearly renewable term basis, on a coinsurance basis, or otherwise) whereby there is a sharing of risks under one or more individual contracts. It will be necessary for each life insurance company participating in a transfer described in section 806(a) to make the adjustments required by such section. Such adjustments shall be made without regard to whether or not the transferor of the liabilities was the original insurer.

(b) *Manner in which adjustments shall be made*—(1) *Daily basis.* The means of the life insurance reserves, and the mean of the assets, shall be appropriately adjusted, on a daily basis, to reflect the amounts involved in a transfer described in section 806(a) and paragraph (a) of this section. The transferor and the transferee shall be treated as having held such life insurance reserves and assets for a fraction of the year in which the transfer occurs.

(2) *Determination of period held.* In determining the fraction which represents the fractional year that such reserves and assets were held, the numerator shall be the number of days during the taxable year which such reserves and assets were actually held, and the denominator shall be the number of days in the calendar year of the transfer. In computing the period held for purposes of the numerator, the day on which such reserves and assets are transferred is included by the transferor and excluded by the transferee.

(3) *Adjustments to the means of life insurance reserves and assets not transferred.* All life insurance reserves and assets transferred during the taxable year, within the meaning of section 806(a), shall be excluded from the beginning and end of the taxable year balances of the transferor and transferee, respectively. The amount of assets to be excluded from the beginning of the taxable year balance of the transferor shall be an amount equal to the value of such reserves at the beginning of the taxable year. The amount of assets to be excluded from the end of the taxable year balance of the transferee shall be an amount equal to the value of such reserves at the end of the taxable year. The means of the life insurance reserves and assets not so transferred shall be determined in the ordinary manner, that is, the arithmetic means. There shall be added to these means an amount to appropriately adjust them, on a daily basis, for the life insurance reserves and assets that were transferred during the taxable year. This adjustment shall be determined by multiplying (i) the mean of the transferred life insurance reserves (or assets, as the case may be) at the beginning of the taxable year (or, if acquired later, at the beginning of the period held as defined in subparagraph (2) of this paragraph) and the end of the period held as defined in subparagraph (2) of this paragraph (or at the end of the taxable year, if held at such time) by (ii) the fraction determined under subparagraph (2) of this paragraph.

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

Example 1. On March 14, 1958, the M Company, a life insurance company, transferred to the N Company, a life insurance company, pursuant to an assumption reinsurance agreement, all of its life insurance reserves, and related assets, on one block of policies. The reserves (and assets) for this block were held by the M Company on January 1, 1958, and totaled $60,000; on March 14, the reserves (and assets) totaled $64,000. The M Company had life insurance reserves of $1,000,000 at the beginning of 1958 (including those subsequently transferred) and $1,040,000 at the end of 1958. The M Company had assets of $1,300,000 at the beginning of 1958 (including those subsequently transferred) and $1,380,000 at the end of 1958. The mean of M's life insurance reserves for the taxable year 1958 is computed as follows:

Reserves at 1–1–58	$1,000,000	
Exclude reserves (at beginning of year) on contracts transferred to N	60,000	
Recomputed amount at 1–1–58		$940,000
Reserves at 12–31–58		1,040,000
Sum		1,980,000
Mean		990,000
Adjustment for reserves transferred on 8–14–58:		
Reserves at 1–1–58 on contracts transferred to N	$60,000	
Reserves at 3–14–58 on such contracts	64,000	

Sum	124,000	
Mean	62,000	
Fraction taken into account	73/365	
Adjustment (73/365×$62,000)		$12,400
Mean of M's life insurance reserves after section 806(a) adjustment		1,002,400

Example 2. Assuming the facts to be the same as in example 1, the mean of M's assets for the taxable year 1958 is computed as follows:

Assets at 1–1–58	$1,300,000	
Exclude assets (at beginning of year) on contracts transferred to N	60,000	
Recomputed amount at 1–1–58		$1,240,000
Assets at 12–31–58		1,380,000
Sum		2,620,000
Mean		1,310,000
Adjustments for assets transferred on 3–14–58:		
Assets at 1–1–58 on contracts transferred to N	$60,000	
Assets at 3–14–58 on such contracts	64,000	
Sum	124,000	
Mean	62,000	
Fraction taken into account	73/365	
Adjustment (73/365×$62,000)–		$12,400
Mean of M's assets after section 806(a) adjustment		1,322,400

Example 3. Assume the facts are the same as in example 1. At the end of 1958, N Company had life insurance reserves (and assets) of $80,000 on the contracts transferred on March 14, 1958. The N Company had life insurance reserves of $6,000,000 at the beginning of 1958 and $6,400,000 at the end of 1958 (including those transferred). The N Company had assets of $6,800,000 at the beginning of 1958 and $7,300,000 at the end of 1958 (including those on the contracts transferred). The mean of N's life insurance reserves for the taxable year 1958 is computed as follows:

Reserves at 1–1–58		$6,000,000
Reserves at 12–31–58	$6,400,000	
Exclude reserves (at end of year) on contracts transferred from M	80,000	
Recomputed amount at 12–31–58		6,320,000
Sum		12,320,000
Mean		6,160,000
Adjustment for reserves transferred on 3–14–58:		
Reserves at 3–14–58 on contracts transferred from M	$64,000	
Reserves at 12–31–58 on such contracts	80,000	
Sum	144,000	
Mean	72,000	
Fraction taken into account	292/365	
Adjustment (292/365×$72,000)		57,600
Mean of N's life insurance reserves after section 806(a) adjustment		6,217,600

Example 4. Assuming the facts to be the same as in example 3, the mean of N's assets for the taxable year 1958 is computed as follows:

Assets at 1–1–58		$6,800,000
Assets at 12–31–58	$7,300,000	
Exclude assets (at end of year) on contracts transferred from M	80,000	
Recomputed amount at 12–31–58		7,220,000
Sum		14,020,000
Mean		7,010,000
Adjustments for assets transferred on 3–14–58:		
Assets at 3–14–58 on contracts transferred from M	$64,000	
Assets at 12–31–58 on such contracts	80,000	
Sum	144,000	
Mean	72,000	
Fraction taken into account	292/365	
Adjustment (292/365×$72,000)		$57,600
Mean of N's assets after section 806(a) adjustment		7,067,600

Example 5. The facts are the same as in example 1, except that on October 19, 1958, company N transfers to company P, a life insurance company, all of the life insurance reserves, and related assets, on the block of policies it had received from company M on March 14, 1958. The reserves (and assets) for this block totaled $76,000 on October 19, 1958. The means of company M's life insurance reserves and assets, as computed in examples 1 and (2), respectively, would be unchanged by the transfer of October 19, 1958. Since company N did not own this block of policies at either the beginning or end of the taxable year, it would not have to recompute its beginning or end of the taxable year reserves or assets. Company N will, however, have to adjust (or increase) the mean of its life insurance reserves and assets on account of the policies it received from company M. This adjustment will be $42,000, which is determined by multiplying the means of the life insurance reserves (or assets) on these policies as of March 15, 1958, and October 19, 1958, $70,000 ($64,000+$76,000=$140,000÷2) by the fraction 219/365 (the numerator of 219 is determined by excluding the day of the transfer to N, March 14, 1958, and including the day of the transfer from N to P, October 19, 1958). Company P will have to recompute its end of the year life insurance reserves and assets (in the same manner as illustrated in examples 3 and 4). Assuming the end of the year

reserves (and assets) on this block of policies is $80,000, company P will have an adjustment under section 806 (a) of $15,600, which is determined by multiplying the means of the reserves on these policies as of October 20, 1958, and December 31, 1958, $78,000 ($76,000+$80,000= $156,000÷2) by the fraction 73/365.

[T.D. 6513, 25 FR 12663, Dec. 10, 1960]

§ 1.806–4 Change of basis in computing reserves.

(a) *In general.* For purposes of subpart B, part I, subchapter L, chapter 1 of the Code, section 806(b) provides that if the basis for determining the amount of any item referred to in section 810(c) (relating to items taken into account) as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year, then in determining taxable investment income the amount of the item as of the close of the taxable year shall be the amount computed on the old basis, and the amount of the item as of the beginning of the next taxable year shall be the amount computed on the new basis. For purposes of the preceding sentence, an election under section 818(c) shall not be treated as a change in basis for determining the amount of an item referred to in section 810(c). A change of basis in computing any of the items referred to in section 810(c) is not a change of accounting method requiring the consent of the Secretary or his delegate under section 446(e).

(b) *Illustration of change of basis in computing reserves.* The application of section 806(b) and paragraph (a) of this section may be illustrated by the following examples:

Example 1. Assume that the life insurance reserves of Y, a life insurance company, at the beginning of the taxable year 1959 are $100 and that during such taxable year a portion of the reserves is strengthened (by reason of a change in mortality or interest assumptions, or otherwise), so that at the end of the taxable year 1959 the reserves (computed on the new basis) are $130 but computed on the old basis would be $120. Assume further that at the close of the next taxable year, 1960, the reserves (computed on the new basis) are $142. Under the provisions of section 806(b) and paragraph (a) of this section, the mean of such reserves for the taxable year of the reserve strengthening, namely 1959, is $110 (the mean of $100, the balance at the beginning of the taxable year 1959, and $120, the balance at the end of the taxable year 1959 computed on the old basis). The mean of such reserves for the next taxable year, 1960, is $136 (the mean of $130, the balance at the beginning of the taxable year 1960 computed on the new basis, and $142, the balance at the end of the taxable year 1960 computed on the new basis).

Example 2. The life insurance reserves of S, a life insurance company, computed with respect to contracts for which such reserves are determined on a recognized preliminary term basis amount to $50 on January 1, 1959, and $80 on December 31, 1959. For the taxable year 1959, S elects to revalue such reserves on a net level premium basis under section 818(c). Such reserves computed under section 818(c) amount to $60 on January 1, 1959, and $96 on December 31, 1959. Under the provisions of paragraph (a) of this section, the mean of such reserves for the taxable year 1959 is $78 (the mean of $60, the balance at the beginning of the taxable year 1959 computed under section 818(c), and $96, the balance at the end of the taxable year 1959 computed under section 818(c).

[T.D. 6513, 25 FR 12669, Dec. 10, 1960]

§ 1.807–1 Mortality and morbidity tables.

(a) *Tables to be used.* If there are no commissioners' standard tables applicable to an insurance contract when the contract is issued, then the mortality and morbidity tables set forth in this subsection are used to compute reserves under section 807(d)(2) for the contract.

Type of Contract	Table
1. Group term life insurance (active life reserves).	1960 Commissioners' Standard Group Mortality Table.
2. Group life insurance (active life reserves); accidental death benefits.	1959 Accidental Death Benefits Table.
3. Permanent and paid-up group life insurance (active life reserves).	Same table as are applicable to males for ordinary life insurance.
4a. Group life insurance disability income benefits (active life reserves).	The tables of period 2 disablement rates and the 1930 to 1950 termination rates of the 1952 Disability Study of the Society of Actuaries.
4b. Group life insurance disability income benefits (disabled life reserves).	The 1930 to 1950 termination rates of the 1952 Disability study of the Society of Actuaries.
5. Group life insurance; survivor income benefits insurance.	Same tables as are applicable to group annuities.
6. Group life insurance; extended death benefits for disabled lives.	1970 Intercompany Group life Disability Valuation Table.
7. Credit life insurance	1958 Commissions' Extended Term Table.

Type of Contract	Table
8. Supplementary contracts involving life contingencies.	Same tables as are applicable to individual immediate annuities.
9. Noncancellable accident and health insurance (active life reserves); benefits issued before 1984.	Tables used for NAIC annual statement reserves as of December 31, 1983.
10a. Noncancellable accident and health insurance (active life reserves); group disability benefits issued after 1983 and individual disability benefits issued after 1983 and before 1989.	1964 Commissioners' Disability Tables.
10b. Noncancellable accident and health insurance (active life reserves); individual disability benefits issued after 1988.	1985 Commissioners' Individual Disability Table A or Commissioners' Individual Disability Table B.
11. Noncancellable accident and health insurance (active life reserves); accidental death benefits issued after 1983.	1959 Accidental Death Benefits Tables.
12. Noncancellable accident and health insurance (active life reserves); all benefits issued after 1983 other than disability and accidental death.	Tables used for NAIC annual statement reserves.
13a. Noncancellable accident and health insurance (claim reserves); group disability benefits for all years of issue and individual disability benefits for years before 1989.	1964 Commissioners' Disability Tables.
13b. Noncancellable accident and health insurance (claim reserves); individual disability benefits for years after 1988.	1985 Commissioners' Individual Disability Table A or Commissioners' Individual Disability Table B.
14. Noncancellable accident and health insurance (claim reserves); all benefits other than disability for all years of issue.	Tables used for annual statement reserves.

(b) *Adjustments.* An appropriate adjustment may be made to the tables in paragraph (a) of this section to reflect risks (such as substandard risks) incurred under the contract which are not otherwise taken into account.

(c) *Special rule where more than 1 table or option applicable.* If, with respect to any category of risks, there are 2 or more tables (or options under 1 or more tables) in paragraph (a) of this section, the table (and option thereunder) which generally yields the lowest reserves shall be used to compute reserves under section 807(d)(2) for the contract.

(d) *Effective date.* This section is effective for taxable years beginning after December 31, 1983, except that the 1985 Commissioners' Individual Disability Tables A and B shall be treated (for purposes of section 807(d)(5)(B) and for purposes of determining the issue dates of contracts for which they shall be used) as if the tables were new prevailing commissioners' standard tables adopted by the twenty-sixth State on December 26, 1989.

[T.D. 8278, 54 FR 52934, Dec. 26, 1989; 55 FR 1768, Jan. 18, 1990]

GAIN AND LOSS FROM OPERATIONS

§1.809–1 Taxable years affected.

Sections 1.809 through 1.809–8, except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all reference to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112), the Act of June 27, 1961 (75 Stat. 120), the Act of October 10, 1962 (76 Stat. 808); the Act of October 23, 1962 (76 Stat. 1134), and section 214(b)(4) of the Revenue Act of 1964 (78 Stat. 55).

[T.D. 6992, 34 FR 827, Jan. 18, 1969]

§1.809–2 Exclusion of share of investment yield set aside for policyholders.

(a) *In general.* Section 809 provides the rules for determining the gain or loss from operations of a life insurance company, which amount is necessary to determine life insurance company taxable income. In order to determine gain or loss from operations, a life insurance company must first determine the share of each and every item of its investment yield (as defined in section 804(c) and paragraph (a) of §1.804–4) set aside for policyholders (as computed under section 809(a)(1) and paragraph (b) of this section), as this share is excluded from gain or loss from operations (as defined in section 809(b) (1) and (2) and paragraphs (a) and (b) of §1.809–3, respectively). The life insurance company shall then add its share of each and every item of its investment yield to the sum of the items comprising gross amount (as described in section 809(c) and paragraph (a) of §1.809–4). In addition, the life insurance company shall, for taxable years beginning after December 31, 1961, add the amount (if any) by which its net long-term capital gain exceeds its net short-term loss. From the sum so computed (which includes the capital gains item only for taxable years beginning after December 31, 1961) there shall then be subtracted the deductions provided in section 809(d) and paragraph (a) of § 1.809–5. The amount thus obtained is the gain or loss from operations for the taxable year.

(b) *Computation of share of investment yield set aside for policyholders.* Section 809(a)(1) provides that the share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. For this purpose, the percentage used in determining the share of each of these items comprising the investment yield set aside for policyholders shall be determined by dividing the required interest (as defined in section 809(a)(2) and paragraph (d) of this section) by the investment yield (as defined in section 804(c) and paragraph (a) of § 1.804–4). The percentage thus obtained is then applied to each and every item of the investment yield so that the share of each and every item of investment yield set aside for policyholders shall be excluded from gain or loss from operations. However, if in any case the required interest exceeds the investment yield, then the share of any item set aside for policyholders shall be 100 percent.

(c) *Computation of life insurance company's share of investment yield.* For purposes of subpart C, part I, subchapter L, chapter 1 of the Code, section 809(b)(3) provides that the percentage used in determining the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) shall be obtained by subtracting the percentage obtained under paragraph (b) of this section from 100 percent. For example, if the policyholders' percentage (as determined under section 809(a)(1) and paragraph (b) of this section) is 72.38 percent, then the life insurance company's share is 27.62 percent (100 percent minus 72.38 percent). In such a case, if the amount of a particular item is $200, then the life insurance company's share of such item included in determining gain or loss from operations is $55.24 ($200 multiplied by 27.62 percent) and the share of such item set aside for policyholders (which is excluded from gain or loss from operations) is $144.76 ($200 multiplied by 72.38 percent). For purposes of determining gain or loss from operations, the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) shall be added to the sum of the items comprising gross amount (as described in section 809(c) and paragraph (a) of § 1.809–4).

(d) *Required interest defined.* (1) For purposes of part I, section 809(a)(2) defines the term *required interest* for any taxable year as the sum of the products obtained by multiplying (i) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by (ii) the means of the amount of such reserves computed at that rate at the beginning and end of the taxable year. In the case of the reserves described in section 810(c)(1), such rate of interest shall be the same as that used by the taxpayer for purposes of paragraph (b) of § 1.801–5 (relating to the definition of reserves required by law) with respect to such reserves. In the case of the reserves described in section 810(c)(2) through (5), such rate of interest shall be the same as that actually paid, credited, or accrued by the taxpayer with respect to such reserves. Thus, the required interest for any taxable year includes the elements of interest paid (as defined in section 805(e)) with respect to the reserves described in section 810(c).

(2) For purposes of computing required interest under section 809(a)(2) and subparagraph (1) of this paragraph, the amount of life insurance reserves taken into account shall be adjusted first as required by section 818(c) (relating to an election with respect to life insurance reserves computed on a preliminary term basis) and then as required by section 806(a) (relating to adjustments for certain changes in reserves and assets) before applying the rate of interest required, or assumed by

the taxpayer, thereto. However, in the case of the adjustments required by section 810(d) as a result of a change in the basis of computing reserves, the adjustments to any of the reserves described in section 810(c) shall be taken into account in accordance with the rules prescribed in section 810(d) and §1.810–3.

[T.D. 6535, 26 FR 525, Jan. 20, 1961, as amended by T.D. 6886, 31 FR 8687, June 23, 1966]

§1.809–3 Gain and loss from operations defined.

(a) *Gain from operations.* For purposes of part I, subchapter L, chapter 1 of the Code, section 809(b)(1) defines the term *gain from operations* as the excess of the sum of (1) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), (2) the items of gross amount taken into account under section 809(c) and paragraph (a) of §1.809–4, and (3) for taxable years beginning after December 31, 1961, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss, over the sum of the deductions provided by section 809(d) and §1.809–5.

(b) *Loss from operations.* For purposes of part I, section 809(b)(2) defines the term *loss from operations* as the excess of the sum of the deductions provided by section 809(d) and §1.809–5 over the sum of (1) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), (2) the items of gross amount taken into account under section 809(c) and paragraph (a) of §1.809–4, and (3) for taxable years beginning after December 31, 1961, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss.

(c) *Illustration of principles.* The provisions of section 809(b) (1) through (3) and paragraphs (a) and (b) of this section may be illustrated by the following example:

Example. For the taxable year 1958, T, a life insurance company, had investment yield of $900,000, including $150,000 of dividends received from domestic corporations subject to taxation under chapter 1 of the Code, $10,000 of wholly tax-exempt interest, and $78,000 of partially tax-exempt interest. T also had items of gross amount under section 809(c) in the amount of $12,000,000 and deductions under section 809(d) of $6,963,500 (exclusive of any deductions for wholly tax-exempt interest, partially tax-exempt interest, and dividends received). For such taxable year, the share of each and every item of investment yield set aside for policyholders was 80 percent and the company's share of each and every item of investment yield was 20 percent. Based upon these figures, T had a gain from operations of $5,180,000 for the taxable year 1958, computed as follows:

	Col. 1	Col. 2 (80%×Col. 1) exclusion of policyholder's share	Col. 3 (20%×Col. 1) company's share
Interest wholly tax-exempt	$10,000	$8,000	$2,000
Interest partially tax-exempt	78,000	62,400	15,600
Dividends received ...	50,000	120,000	30,000
Other items of investment yield	662,000	529,600	132,400
Investment yield	900,000	720,000	180,000
Gross amount (sum of items under sec. 809(c))			$12,000,000
Total			12,180,000
Less:			
Deductions under sec. 809(d)(8):			
Company's share of interest wholly tax-exempt		$2,000	
30/52 of company's share of interest partially tax-exempt (30/52 ×$15,600)		9,000	
85% of company's share of dividends received (but not to exceed 85% of gain from operations as computed under sec. 809(d)(8)(B)) (85%×$30,000)		25,500	
All other deductions under sec. 809(d)		6,963,500	
			7,000,000
Gain from operations			5,180,000

(d) *Exception.* (1) In accordance with section 809(b)(4), if it is established in any case to the satisfaction of the Commissioner, or by a determination of The Tax Court of the United States, or of any other court of competent jurisdiction, which has become final, that the application of the definition of gain from operations contained in section 809(b)(1) results in the imposition of tax on:

(i) Any interest which under section 103 is excluded from gross income,

(ii) Any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

(iii) Any amount of dividends received which under sections 243, 244, and 245 (as modified by section 809(d)(8)(B)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(2) For the date upon which a decision by the Tax Court becomes final, see section 7481. For the date upon which a judgment of any other court becomes final, see paragraph (c) of § 1.1313(a)–1.

[T.D. 6535, 26 FR 526, Jan. 20, 1961, as amended by T.D. 6886, 31 FR 8687, June 28, 1966]

§ 1.809–4 Gross amount.

(a) *Items taken into account.* For purposes of determining gain or loss from operations under section 809(b) (1) and (2), respectively, section 809(c) specifies three categories of items which shall be taken into account. Such items are in addition to the life insurance company's share of the investment yield (as determined under section 809(a)(1) and paragraph (c) of § 1.809–2), and the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss (such capital gains item is included in determining gain or loss from operations only for taxable years beginning after December 31, 1961). The additional three categories of items taken into account are:

(1) *Premiums.* (i) The gross amount of all premiums and other consideration on insurance and annuity contracts (including contracts supplementary thereto); less return premiums and premiums and other consideration arising out of reinsurance ceded. The term *gross amount of all premiums* means the premiums and other consideration provided in the insurance or annuity contract. Thus, the amount to be taken into account shall be the total of the premiums and other consideration provided in the insurance or annuity contract without any deduction for commissions, return premiums, reinsurance, dividends to policyholders, dividends left on deposit with the company, discounts on premiums paid in advance, interest applied in reduction of premiums (whether or not required to be credited in reduction of premiums under the terms of the contract), or any other item of similar nature. Such term includes advance premiums, premiums deferred and uncollected and premiums due and unpaid, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction as defined in paragraph (a)(7)(ii) of § 1.809–5). The term also includes amounts a life insurance company charges itself representing premiums with respect to liability for insurance and annuity benefits for its employees (including full-time life insurance salesmen within the meaning of section 7701(a)(20)).

(ii) The term *return premiums* means amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Thus, such term includes amounts refunded due to policy cancellations or erroneously computed premiums. Furthermore, amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums. For the treatment of amounts which do not meet the requirements of return premiums, see section 811 (relating to dividends to policyholders).

(iii) For purposes of section 809(c)(1) and this subparagraph, the term *reinsurance ceded* means an arrangement whereby the taxpayer (the reinsured) remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. Such term includes indemnity reinsurance transactions but does not include assumption reinsurance transactions. See paragraph (a)(7)(ii) of §1.809–5 for the definition of assumption reinsurance.

(2) *Decreases in certain reserves.* Each net decrease in reserves which is required by section 810 (a) and (d)(1) or 811(b)(2) to be taken into account for the taxable year as a net decrease for purposes of section 809(c)(2).

(3) *Other amounts.* All amounts, not included in computing investment yield and not otherwise taken into account under section 809(c) (1) or (2), shall be taken into account under section 809(c)(3) to the extent that such amounts are includible in gross income under subtitle A of the Code. See section 61 (relating to gross income defined) and the regulations thereunder.

(b) *Treatment of net long-term capital gains.* For taxable years beginning before January 1, 1962, any net long-term capital gains (as defined in section 1222(7)) from the sale or exchange of a capital asset (or any gain considered to be from the sale or exchange of a capital asset under applicable law) shall be excluded from the determination of gain or loss from operations of a life insurance company. On the other hand, with respect to taxable years beginning after December 31, 1961, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss (as defined in section 1222(6)) shall be taken into account in determining gain or loss from operations under section 809. However, for any taxable year beginning after December 31, 1958, the excess of net short-term capital gain (as defined in section 1222(5)) over net long-term capital loss (as defined in section 1222(8)) is included in computing investment yield (as defined in section 804(c)) and, to that extent, is taken into account in determining gain or loss from operations under section 809.

[T.D. 6535, 26 FR 527, Jan. 20, 1961, as amended by T.D. 6610, 27 FR 8718, Aug. 31, 1962, T.D. 6886, 31 FR 8687, June 23, 1966]

§1.809–5 Deductions.

(a) *Deductions allowed.* Section 809(d) provides the following deductions for purposes of determining gain or loss from operations under section 809(b) (1) and (2), respectively:

(1) *Death benefits, etc.* All claims and benefits accrued (less reinsurance recoverable), and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts (including contracts supplementary thereto). The term *all claims and benefits accrued* includes, for example, matured endowments and amounts allowed on surrender. The term *losses incurred (whether or not ascertained)* includes a reasonable estimate of the amount of the losses (based upon the facts in each case and the company's experience with similar cases) incurred but not reported by the end of the taxable year as well as losses reported but where the amount thereof cannot be ascertained by the end of the taxable year.

(2) *Increases in certain reserves.* The net increase in reserves which is required by section 810 (b) and (d)(1) to be taken into account for the taxable year as a net increase for purposes of section 809(d)(2).

(3) *Dividends to policyholders.* The deduction for dividends to policyholders as determined under section 811(b) and §1.811–2. Except as provided in section 809(d)(3) and this subparagraph, no amount shall be allowed as a deduction in respect of dividends to policyholders under section 809(d). See section 809(f) and §1.809–7 for limitation of such deduction.

(4) *Operations loss deduction.* The operations loss deduction as determined under section 812.

(5) *Certain nonparticipating contracts.* (i) An amount equal to the greater of:

(a) 10 percent of the increase for the taxable year in certain life insurance reserves for nonparticipating contracts (other than group contracts); or

(b) 3 percent of the premiums for the taxable year attributable to nonparticipating contracts (other than group contracts) which are issued or renewed for periods of 5 years or more.

(ii) For purposes of section 809(d)(5) and this subparagraph, the term *nonparticipating contracts* means those contracts which during the taxable year contain no right to participate in the divisible surplus of the company. For example, if at any time during the taxable year for which the deduction allowed under section 809(d)(5) and this subparagraph is claimed such contracts have rights to dividends or similar distributions (as defined in section 811(a) and paragraph (a) of § 1.811–2), such contracts shall no longer be deemed nonparticipating contracts and, therefore, no deduction shall be allowed. Thus, if a class of contracts having no right to participate in the divisible surplus of the company is in force for nine years and on March 10, 1958, it is announced that such contracts shall be accorded dividend rights as of August 1, 1958, no deduction shall be allowed under section 809(d)(5) and this subparagraph for the taxable year 1958 or any succeeding taxable year, whether or not dividends are actually paid on such contracts. However, if the announcement of March 10, 1958, states that such contracts shall be accorded dividend rights as of January 1, 1959, a deduction under section 809(d)(5) and this subparagraph shall be allowed for the taxable year 1958 but not for any succeeding taxable year.

(iii) For purposes of section 809(d)(5) and this subparagraph, the term *reserves for nonparticipating contracts* means such part of the life insurance reserves (as defined in section 801(b) and § 1.801–4), other than that portion of such reserves which is allocable to annuity features, as relates to nonparticipating contracts (as defined in subdivision (ii) of this subparagraph). The amount of life insurance reserves taken into account shall be adjusted first as required by section 818(c) (relating to an election with respect to life insurance reserves computed on a preliminary term basis) and then as required by section 806(a) (relating to adjustments for certain changes in reserves and assets). In the case of the adjustments required by section 810(d) (relating to adjustment for change in computing reserves), the increase in life insurance reserves attributable to reserve strengthening shall be taken into account in accordance with the rules prescribed in section 810(d) and § 1.810–3.

(iv) For purposes of section 809(d)(5) and this subparagraph, the term *premiums* means the net amount of the premiums and other consideration attributable to nonparticipating contracts (as defined in subdivision (ii) of this subparagraph) which are taken into account under section 809(c)(1). For this purpose, premiums include only such amounts attributable to such contracts which are issued or renewed for periods of 5 years or more, but does not include that portion of the premiums which is allocable to annuity features. No portion of a premium shall be deemed allocable to annuity features solely because a contract, such as an endowment contract, provides that at maturity the insured shall have an option to take an annuity. The determination of whether a contract meets the 5-year requirement shall be made as of the date the contract is issued, or as of the date it is renewed, whichever is applicable. Thus, a 20-year nonparticipating endowment policy shall qualify for the deduction under section 809(d)(5), even though the insured subsequently dies at the end of the second year, since the policy is issued for a period of 5 years or more. However, a 1-year renewable term contract shall not qualify, since as of the date it is issued (or of any renewal date) it is not issued (or renewed) for a period of 5 years or more. In like manner, a policy originally issued for a 3-year period and subsequently renewed for an additional 3-year period shall not qualify. However, if this policy is renewed for a period of 5 years or more, the policy shall qualify for the deduction under section 809(d)(5) from the date it is renewed.

(v) The provisions of section 809(d)(5) and this subparagraph may be illustrated by the following example:

Example. Assume the following facts with respect to X, a life insurance company, for the taxable year 1958:

Life insurance reserves on nonparticipating contracts without annuity features (other than group contracts) at 1–1–58	$150,000
Life insurance reserves on nonparticipating contracts without annuity features (other than group contracts) at 12–31–58	225,000
Annuity reserves on nonparticipating contracts (other than group contracts) at 1–1–58	48,000
Annuity reserves on nonparticipating contracts (other than group contracts) at 12–31–58	57,000
Premiums on nonparticipating contracts without annuity features (other than group contracts) issued or renewed for 5 years or more	85,000

Premiums on nonparticipating contracts allocable to annuity features (other than group contracts) issued or renewed for 5 years or more	14,000
Return premiums on nonparticipating contracts without annuity features (other than group contracts)	5,000

In order to determine the deduction under section 809(d)(5) (without regard to the limitation of section 809(f)), X would make up the following schedule:

(1) Life insurance reserves on nonparticipating contracts without annuity features (other than group contracts) at 12–31–58	$225,000	
(2) Life insurance reserves on nonparticipating contracts without annuity features (other than group contracts) at 1–1–58	150,000	
(3) Excess of item (1) over item (2) ($225,000 minus $150,000)	75,000	
(4) 10 percent of item (3) (10%×$75,000)		7,500
(5) Net premiums on nonparticipating contracts without annuity features issued or renewed for 5 years or more (other than group contracts) (gross premiums on such contracts ($85,000) minus return premiums ($5,000) on such contracts)	80,000	
(6) 3 percent of item (5) (3%×$80,000)		2,400
(7) The greater of item (4) or item (6)		7,500
(8) Tentative deduction under sec. 809(d)(5) (computed without regard to the limitation of sec. 809(f))		7,500

(vi) See section 809(f) and §1.809–7 for limitation of the deduction provided by this subparagraph.

(6) *Certain accident and health insurance and group life insurance.* (i) For taxable years beginning before January 1, 1963, an amount equal to two percent of the premiums for the taxable year attributable to group life insurance contracts, group accident and health insurance contracts, or group accident and health insurance contracts with a life feature. For taxable years beginning after December 31, 1962, the deduction shall be an amount equal to two percent of the premiums for the taxable year attributable to group life insurance contracts, accident and health insurance contracts (other than those to which section 809(d)(5) applies), or accident and health insurance contracts with a life feature (other than those to which section 809(d)(5) applies). For purposes of section 809(d)(6) and this subparagraph, the term ‘‘premiums’’ means the net amount of the premiums and other consideration attributable to such contracts taken into account under section 809(c)(1). The deduction allowed by section 809(d)(6) and this subparagraph for the taxable year and all preceding taxable years shall not exceed 50 percent of the net amount of the premiums attributable to such contracts for the taxable year. For example, assume that premiums attributable to group life insurance and group accident and health insurance contracts are $103,000 for the taxable year 1962. Assume further that there are $3,000 of return premiums attributable to such contracts for the taxable year. Under the provisions of section 809(d)(6) and this subparagraph, a deduction (determined without regard to section 809(f) of $2,000 (2 percent of $100,000 ($103,000−$3,000)) is allowed. Assuming that the company continues to receive net premiums of $100,000 attributable to such contracts for 15 years, the cumulative amount of these deductions is $30,000 ($2,000 for 15 years). If, in the sixteenth year, net premiums attributable to such contracts amount to $60,000, no deduction shall be allowed under section 809(d)(6) and this subparagraph since the cumulative amount of these deductions ($30,000) equals 50 percent of the current year’s premiums ($60,000) from such contracts.

(ii) In computing the deduction under section 809(d)(6), the determination as to when the 50 percent limitation on such deduction has been reached shall be based upon the amount allowed as a deduction for the taxable year and all preceding taxable years after the application of the limitation provided in section 809(f) and §1.809–7. Thus, if in the example set forth in paragraph (c) of §1.809–7 the application of the limitation provided by section 809(f) limited the deduction allowed for the taxable year under section 809(d)(6) to $3,250,000, then for purposes of determining the 50 percent limitation on such deduction, only $3,250,000 (the amount allowed) shall be taken into account.

(iii) For purposes of determining whether the 50 percent limitation applies to any taxable year, the deduction provided by section 809(d)(6) for all preceding taxable years shall be taken into account, irrespective of whether or not the life insurance company claimed a deduction for these amounts for such preceding taxable years.

(iv) See section 809(f) and § 1.809–7 for limitation of the deduction provided by this subparagraph.

(7) *Assumption by another person of liabilities under insurance, etc., contracts.* (i) The consideration (other than consideration arising out of reinsurance ceded as defined in paragraph (a)(1)(iii) of § 1.809–4) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto) of the taxpayer.

(ii) For purposes of section 809(d)(7) and this subparagraph, the term *assumption reinsurance* means an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the taxpayer. Such term does not include indemnity reinsurance or reinsurance ceded (as defined in paragraph (a)(1)(iii) of § 1.809–4).

(iii) The provisions of section 809(d)(7) and this subparagraph may be illustrated by the following example:

Example. During the taxable year 1958, T, a life insurance company, transferred a block of insurance policies and made a payment of $50,000 to R, a life insurance company, under an arrangement whereby R became solely liable to the policyholders on the policies transferred by T. Under the provisions of section 809(d)(7) and this subparagraph, T is allowed a deduction of $50,000 for the taxable year 1958. For the treatment by R of this $50,000 payment, see section 809(c)(1) and paragraph (a)(1)(i) of § 1.809–4. See section 806(a) and § 1.806–3 for the adjustments in reserves and assets to be made by T and R as a result of this transaction.

(8) *Tax-exempt interest, dividends, etc.* (i) Each of the following items:

(a) The life insurance company's share of interest which under section 103 is excluded from gross income;

(b) The deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3) and paragraph (d)(2)(i) of § 1.804–2) computed with respect to the life insurance company's share of such interest; and

(c) The deductions for dividends received provided by sections 243, 244, and 245 (as modified by section 809(d)(8)(B) and subdivision (ii) of this subparagraph) computed with respect to the life insurance company's share of the dividends received.

(ii) The modification contained in section 809(d)(8)(B) provides the method for applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of section 809(d)(8)(A)(iii) and subdivision (i)*(c)* of this subparagraph. Under this method, the sum of the deductions allowed by sections 243(a)(1) (relating to dividends received by corporations), 244(a) (relating to dividends received on certain preferred stock), and 245 (relating to dividends received from certain foreign corporations) shall be limited to 85 percent of the gain from operations computed without regard to:

(a) The deductions provided by section 809(d) (3), (5), and (6);

(b) The operations loss deductions provided by section 812; and

(c) The deductions allowed by sections 243(a)(1), 244(a), and 245.

If a life insurance company has a loss from operations (as determined under sec. 812) for the taxable year, the limitation provided in section 809(d)(8)(B) and this subdivision shall not be applicable for such taxable year. In that event, the deductions provided by sections 243(a)(1), 244(a), and 245 shall be allowable for all tax purposes to the life insurance company for such taxable year without regard to such limitation. If the life insurance company does not have a loss from operations for the taxable year, however, the limitation shall be applicable for all tax purposes for such taxable year. In determining whether a life insurance company has a loss from operations for the taxable year under section 812, the deductions allowed by sections 243(a)(1), 244(a), and 245 shall be computed without regard to the limitation provided in section 809(d)(8)(B) and this subdivision.

(9) *Investment expenses, etc.* (i) The amount of investment expenses to the extent not allowed as a deduction under section 804(c)(1) in computing investment yield. For example, if a deduction in the amount of $100,000 is claimed for investment expenses,

which amount includes general expenses assigned to or included in investment expenses, and due to the operation of the limitation provided by section 804(c)(1) only $85,000 is allowed, then the excess ($15,000) shall be allowed as a deduction under section 809(d)(9) and this subparagraph.

(ii) The amount (if any) by which the sum of the deductions allowable under section 804(c) exceeds the gross investment income. For example, if gross investment income under section 804(b) equals $400,000, and the sum of the deductions allowable under section 804(c) equals $425,000, then the excess ($25,000) shall be allowed as a deduction under section 809(d)(9) and this subparagraph.

(iii) In determining the amount of the deductions allowed under subdivisions (i) and (ii) of this subparagraph, a life insurance company shall first take such deductions to the full extent allowable under section 804(c)(1), and any amount which is allowed as a deduction under section 804(c) shall not again be allowed as a deduction under section 809(d)(9).

(10) *Small business deduction.* The small business deduction as determined under section 804(a)(4).

(11) *Certain mutualization distributions.* The amount of distributions to shareholders actually made by the life insurance company in 1958, 1959, 1960, and 1961 in acquisition of stock pursuant to a plan of mutualization adopted by the company before January 1, 1958. If such deduction is claimed, there must be attached to the return of the company claiming such deduction a certified copy of the plan of mutualization and proof that such plan was adopted prior to January 1, 1958. See section 809(g) and §1.809–8 for limitation of such deduction.

(12) *Other deductions.* Except as modified by section 809(e) and §1.809–6, all other deductions allowed under subtitle A of the Code for purposes of computing taxable income to the extent not allowed as a deduction in computing investment yield. For example, a life insurance company shall be allowed a deduction under section 809(d)(12) and this subparagraph for amounts representing premiums charged itself with respect to liability for insurance and annuity benefits for its employees (including full-time life insurance salesmen within the meaning of section 7701(a)(20)) in accordance with the rules prescribed in sections 162 and 404 and the regulations thereunder, to the extent that a deduction for such amounts is not allowed under section 804(c)(1) and paragraph (b)(1) of §1.804–4 or section 809(d)(9) and subparagraph (9) of this paragraph.

(b) *Denial of double deduction.* Nothing in section 809(d) shall permit the same item to be deducted more than once in determining gain or loss from operations. For example, if an item is allowed as a deduction for the taxable year by reason of its being a loss incurred within such taxable year (whether or not ascertained) under section 809(d)(1), such item, or any portion thereof, shall not also be allowed as a deduction for such taxable year under section 809(d)(2).

[T.D. 6535, 26 FR 527, Jan. 20, 1961, as amended by T.D. 6610, 27 FR 8718, Aug. 31, 1962; T.D. 6886, 31 FR 8687, June 23, 1966; T.D. 6992, 34 FR 827, Jan. 18, 1969]

§1.809–6 Modifications.

Under section 809(e), the deductions allowed under section 809(d)(12) and paragraph (a)(12) of §1.809–5 (relating to other deductions) are subject to the following modifications:

(a) *Interest.* No deduction shall be allowed under section 163 for interest in respect of items described in section 810(c) since such interest is taken into account in the determination of required interest under section 809.

(b) *Bad debts.* No deduction shall be allowed for an addition to reserves for bad debts under section 166(c). However, a deduction for specific bad debts shall be allowed to the extent that such deduction is allowed under section 166 and the regulations thereunder. In the case of a loss incurred on the sale of mortgaged or pledged property, see §1.166–6 of this chapter.

(c) *Charitable, etc., contributions and gifts.* (1) The deduction by a life insurance company in any taxable year for a charitable contribution (as defined in section 170(c)) shall be limited to 5 percent of the gain from operations (as determined under section 809(b)(1)), computed without regard to any deductions for:

(i) Charitable contributions under section 170;

(ii) Dividends to policyholders under section 811(b);

(iii) Certain nonparticipating contracts under section 809(d)(5);

(iv) Group life insurance contracts and group accident and health insurance contracts under section 809(d)(6);

(v) Tax-exempt interest, dividends, etc., under section 809(d)(8); and

(vi) Any operations loss carryback to the taxable year under section 812.

(2) In applying the first sentence of section 170(b)(2) as contained in section 170 or, in the case of taxable years beginning after December 31, 1969, section 170(d)(2)(B) as contained in section 170A, any excess of the charitable contributions made by a life insurance company in a taxable year over the amount deductible in such year under the limitation contained in subparagraph (1) of this paragraph, shall be reduced to the extent that such excess:

(i) Reduces life insurance company taxable income (computed without regard to section 802(b)(3)) for the purpose of determining the offsets referred to in section 812(b)(2); and

(ii) Increases an operations loss carryover under section 812 for a succeeding taxable year.

(3) The application of the rules provided in section 809(e)(3) and this paragraph may be illustrated by the following example:

Example. Assume that life insurance company P is organized on January 1, 1958, and has a loss from operations for that year in the amount of $100,000 which is an operations loss carryover to 1959. In 1959, company P has a gain from operations and tax base (computed without regard to section 802(b)(3)) of $100,000 before the allowance of a deduction for a $5,000 charitable contribution made in 1959 and before the application of the operations loss carryover from 1958. Under section 170(b)(2), the operations loss carryover from 1958 is first applied to eliminate the $100,000 gain from operations and tax base in 1959 and the $5,000 charitable contribution carryover would (except for the limitation contained in this paragraph) become a charitable contribution carryover to 1960. However, for the purpose of computing the offsets referred to in section 812(b)(2), the $5,000 charitable contribution is applied to reduce the gain from operations and tax base for 1959 to $95,000 before the application of the operations carryover from 1958. Since only $95,000 of the $100,000 loss from operations in 1958 is an offset for 1959, the remaining $5,000 becomes an operations loss carryover to 1960. Accordingly, under the limitation contained in this paragraph, the charitable contributions carryover provided under the second sentence of section 170(b)(2) is eliminated.

(d) *Amortizable bond premium.* No deduction shall be allowed under section 171 for the amortization of bond premiums since a special deduction for such premiums is specifically taken into account under section 818(b).

(e) *Net operating loss deduction.* No deduction shall be allowed under section 172 since section 812 allows an ‘‘operations loss deduction’’.

(f) *Partially tax-exempt interest.* No deduction shall be allowed under section 242 for partially tax-exempt interest since section 809(d)(8) allows a deduction for such interest.

(g) *Dividends received.* No deduction shall be allowed under sections 243, 244, and 245 for dividends received since section 809(d)(8) allows a deduction for such dividends.

[T.D. 6535, 26 FR 529, Jan. 20, 1961, as amended by T.D. 7207, 37 FR 20797, Oct. 5, 1972]

§ 1.809–7 Limitation on certain deductions.

(a) *In general.* Section 809(f)(1) limits the deductions under section 809(d) (3), (5), and (6), relating to deductions for dividends to policyholders, certain nonparticipating contracts, and group life, accident, and health insurance contracts, respectively. This limitation provides that the amount of such deductions shall not exceed the sum of (1) the amount (if any) by which the gain from operations for the taxable year (determined without regard to such deductions) exceeds the taxpayer’s taxable investment income for such year, plus (2) $250,000.

(b) *Application of limitation.* Section 809(f)(2) provides a priority system for applying the limitation contained in section 809(f)(1) and paragraph (a) of this section. Under this priortity system, the limitation shall be applied in the following order:

(1) For taxable years beginning before January 1, 1962:

(i) First to the amount of the deduction under section 809(d)(6) (relating to group life, accident, and health insurance);

(ii) Then to the amount of the deduction under section 809(d)(5) (relating to certain nonparticipating contracts); and

(iii) Finally to the amount of the deduction under section 809(d)(3) (relating to dividends to policyholders).

(2) For taxable years beginning after December 31, 1961, the limitation shall be applied in the following order:

(i) First to the amount of the deduction under section 809(d)(3);

(ii) Then to the amount of the deduction under section 809(d)(6); and

(iii) Finally to the amount of the deduction under section 809(d)(5).

Thus, for taxable years beginning after December 31, 1961, the limitation and priority system would operate first to disallow a deduction under section 809(d)(5), then a deduction under section 809(d)(6), and finally a deduction under section 809(d)(3). For purposes of applying the 50 percent limitation contained in section 809(d)(6) with respect to a taxable year beginning after December 31, 1961, the amount of the deductions for taxable years beginning before January 1, 1962, shall be determined by applying the priortity system contained in subparagraph (1) of this paragraph.

(c) *Illustration of principles.* The operation of the limitation and priority system provided by section 809(f) and this section may be illustrated by the following examples:

Example 1. Assume the following facts with respect to M, a life insurance company, for the taxable year 1958:

Gain from operations computed without regard to the deductions under sec. 809(d) (3), (5), and (6)	$100,000,000
Taxable investment income	83,000,000
Tentative deduction for group life, accident, and health insurance under sec. 809(d)(6)	4,000,000
Tentative deduction for certain nonparticipating contracts under sec. 809(d)(5)	6,000,000
Tentative deduction for dividends to policyholders under sec. 809(d)(3)	10,000,000

In order to determine the limitation on the deductions under section 809(d) (3), (5), and (6), M would make up the following schedule:

(1) Statutory amount provided under sec. 809(f)(1)		$250,000
(2) Gain from operations computed without regard to the deductions under sec. 809(d) (3), (5), and (6)	$100,000,000	
(3) Taxable investment income	83,000,000	
(4) Excess of item (2) over item (3)		17,000,000
(5) Limitation on deductions under sec. 809(d) (3), (5), and (6) (item (1) plus item (4))		17,250,000

Since the total tentative deductions under section 809(d) (3), (5), and (6) ($20,000,000) exceeds the limitation on such deductions ($17,250,000), M would make up the following schedule to determine the application of the priority system:

(6) Maximum possible deduction under sec. 809(d) (3), (5), and (6) (item (5))	$17,250,000
(7) Deduction for group life, accident, and health insurance under sec. 809(d)(6) (not in excess of item (6))	4,000,000
(8) Maximum possible deduction under sec. 809(d)(5) (item (6) less item (7))	13,250,000
(9) Deduction for certain nonparticipating contracts under sec. 809(d)(5) (not in excess of item (8))	6,000,000
(10) Maximum possible deduction under sec. 809(d)(3) (item (8) less item (9))	7,250,000
(11) Deduction for dividends to policyholders under sec. 809(d)(3) (not in excess of item (10))	7,250,000

Thus, as a result of the application of the limitation and priority system for the taxable year 1958, M shall be allowed a deduction of $4,000,000 under section 809(d)(6), $6,000,000 under section 809(d)(5), and only $7,250,000 of the $10,000,000 tentative deduction under section 809(d)(3).

Example 2. The facts are the same as in example 1, except that the taxable year is 1962. Since the total tentative deductions under section 809(d) (3), (5), and (6) ($20,000,000) exceeds the limitation on such deductions ($17,250,000), M would make up the following schedule to determine the application of the priority system:

(1) Maximum possible deductions under sec. 809(d) (3), (5), and (6) (item (5) in example 1)	$17,250,000

(2) Deduction for dividends to policyholders under sec. 809(d)(3) (not in excess of item (1))	10,000,000
(3) Maximum possible deduction under sec. 809(d)(6) (item (1) less item (2))	7,250,000
(4) Deduction for certain accident, health, and group life insurance under sec. 809(d)(6) (not in excess of item (3))	4,000,000
(5) Maximum possible deduction under sec. 809(d)(5) (item (4) less item (5))	3,250,000
(6) Deduction for certain nonparticipating contracts under sec. 809(d)(5) (not in excess of item (5))	3,250,000

Thus, as a result of the application of the limitation and priority system for the taxable year 1962, M shall be allowed a deduction of $10,000,000 under section 809(d)(3), $4,000,000 under section 809(d)(6), and only $3,250,000 of the $6,000,000 tentative deduction under section 809(d)(5).

[T.D. 6535, 26 FR 530, Jan. 20, 1961, as amended by T.D. 6886, 31 FR 8688, June 23, 1966]

§ 1.809–8 Limitation on deductions for certain mutualization distributions.

(a) *Deduction not to reduce taxable investment income.* Section 809(g)(1) limits the deduction under section 809(d)(11) for certain mutualization distributions. This limitation provides that such deduction shall not exceed the amount (if any) by which the gain from operations for the taxable year, computed without regard to such deduction (but after the application of the limitation contained in section 809(f) and § 1.809–7), exceeds the taxpayer's taxable investment income for such year.

(b) *Deduction not to reduce tax below that imposed by 1957 law.* Section 809(g)(2) further limits the deduction under section 809(d)(11). Under section 809(g)(2), such deduction shall be allowed only to the extent that it (after the application of all other deductions) does not reduce the tax imposed by section 802(a)(1) for the taxable year below the amount of tax which would have been imposed for such taxable year if the law in effect for 1957 applied for such taxable year. If such deduction is claimed for 1958 (or 1959), the company shall attach to its return a schedule showing what its tax for 1958 (or 1959) would have been had such tax been computed under the law in effect for 1957.

(c) *Application of section 815.* Section 809(g)(3) provides that any portion of a distribution which is allowed as a deduction under section 809(d)(11) shall not be treated as a distribution to shareholders for purposes of section 815; except that in the case of any distributions made in 1959, such portion shall be treated as a distribution with respect to which a reduction is required under section 815(e)(2)(B) (relating to adjustment in allocation ratio for certain distributions after December 31, 1958).

[T.D. 6535, 26 FR 530, Jan. 20, 1961]

§ 1.809–9 Computation of the differential earnings rate and the recomputed differential earnings rate.

(a) *In general.* Neither the differential earnings rate under section 809(c) nor the recomputed differential earnings rate that is used in computing the recomputed differential earnings amount under section 809(f)(3) may be less than zero.

(b) *Definitions*—(1) *Recomputed differential earnings amount.* The recomputed differential earnings amount, with respect to any taxable year, is the amount equal to the product of—

(i) The life insurance company's average equity base for the taxable year; multiplied by

(ii) The recomputed differential earnings rate for that taxable year.

(2) *Recomputed differential earnings rate.* The recomputed differential earnings rate for any taxable year equals the excess of—

(i) The imputed earnings rate for the taxable year; over

(ii) The average mutual earning rate for the calendar year in which the taxable year begins.

(c) *Effective date.* The regulations are effective for all taxable years beginning after December 31, 1986.

[T.D. 8499, 58 FR 64899, Dec. 10, 1993]

§ 1.809–10 Computation of equity base.

(a) *In general.* For purposes of section 809, the equity base of a life insurance company includes the amount of any asset valuation reserve and the amount of any interest maintenance reserve.

(b) *Effective date.* This section is effective for taxable years ending after December 31, 1991.

[T.D. 8484, 58 FR 47061, Sept. 7, 1993, as amended by T.D. 8564, 59 FR 49579, Sept. 29, 1994]

§1.810–1 Taxable years affected.

Sections 1.810–2 through 1.810–4 are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6535, 26 FR 531, Jan. 20, 1961]

§1.810–2 Rules for certain reserves.

(a) *Adjustment for decrease or increase in certain reserve items*—(1) *Adjustment for decrease.* Section 810(a) provides that if the sum of the items described in section 810(c) and paragraph (b) of this section at the beginning of the taxable year exceeds the sum of such items at the end of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)), the amount of such excess shall be taken into account as a net decrease referred to in section 809(c)(2) and paragraph (a)(2) of §1.809–4 in determining gain or loss from operations.

(2) *Adjustment for increase.* Section 810(b) provides that if the sum of the items described in section 810(c) and paragraph (b) of this section at the end of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)) exceeds the sum of such items at the beginning of the taxable year, the amount of such excess shall be taken into account as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of §1.809–5 in determining gain or loss from operations.

(b) *Items taken into account.* The items described in section 810(c) and referred to in section 810 (a) and (b) and paragraph (a) of this section are:

(1) The life insurance reserves (as defined in section 801(b) and §1.801–4);

(2) The unearned premiums and unpaid losses included in total reserves under section 801(c)(2) and §1.801–5;

(3) The amounts (discounted at the rates of interest assumed by the company) necessary to satisfy the obligations under insurance or annuity contracts (including contracts supplementary thereto), but only if such obligations do not involve (at the time with respect to which the computation is made under this subparagraph) life, health, or accident contingencies;

(4) Dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts (including contracts supplementary thereto); and

(5) Premiums received in advance, and liabilities for premium deposit funds.

(6) Special contingency reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof.

For purposes of this paragraph, the same item shall be counted only once and deficiency reserves (as defined in section 801(b)(4) and paragraph (e)(4) of §1.801–4) shall not be taken into account.

(c) *Special rules.* For purposes of section 810 (a) and (b) and paragraph (a) of this section, in determining whether there is a net increase or decrease in the sum of the items described in section 810(c) and paragraph (b) of this section for the taxable year, the following rules shall apply:

(1) *Computation of net increase or decrease in reserves.* The sum of the items described in section 810(c) and paragraph (b) of this section at the beginning of the taxable year shall be the aggregate of the sums of each of such items at the beginning of the taxable year. The sum of the items described in section 810(c) and paragraph (b) of this section at the end of the taxable year shall be the aggregate of the sums of each of such items at the end of the taxable year. However, in order to determine whether there is a net increase or decrease in such items for the taxable year, the aggregate of the sums of

the items at the end of the taxable year must first be reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1).

(2) *Effect of change in basis in computing reserves.* Any increase or decrease in the sum of the items described in section 810(c) and paragraph (b) of this section for the taxable year which is attributable to a change in the basis used in computing such items during the taxable year shall not be taken into account under section 810 (a) or (b) and paragraph (a) of this section but shall be taken into account in the manner prescribed in section 810(d) and paragraph (a) of § 1.810–3.

(3) *Effect of section 818(c) election.* If a company which computes its life insurance reserves on a preliminary term basis elects to revalue such reserves on a net level premium basis under section 818(c), the sum of such reserves at the beginning and end of all taxable years (including the first taxable year) for which the election applies shall be the sum of such reserves computed on such net level premium basis.

(4) *Cross references.* For taxable years beginning before January 1, 1970, see section 810(e) (as in effect for such years) and § 1.810–4 for special rules for determining the net increase or decrease in the sum of the items described in section 810(c) and paragraph (b) of this section in the case of certain voluntary employees' beneficiary associations. For similar special rules in the case of life insurance companies issuing variable annuity contracts, see section 801(g)(4) and the regulations thereunder.

(d) *Illustration of principles.* The provisions of section 810 (a) and (b) and this section may be illustrated by the following examples:

Example 1. Assume the following facts with respect to R, a life insurance company:

Sum of items described in section 810(c) (1) through (6) at beginning of taxable year	$940
Sum of items described in section 810(c) (1) through (6) at end of taxable year	1,060
Required interest (as defined in section 809(a)(2))	70
Investment yield (as defined in section 804(c)) ..	100
Amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)	70

In order to determine the adjustment for decrease or increase in the sum of the items described in section 810(c) for the taxable year, R must first reduce the sum of such items at the end of the taxable year ($1,060) by the amount of investment yield ($70) not included in gain or loss from operations for the taxable year by reason of section 809(a)(1). Since the adjusted sum of such items at the end of the taxable year, $990 ($1,060 minus $70), exceeds the sum of such items at the beginning of the taxable year, $940, the excess of $50 ($990 minus $940) shall be taken into account as a net increase under section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations.

Example 2. Assume the facts are the same as in example 1, except that the sum of the items described in section 810(c) at the beginning of the taxable year is $1000. Since the sum of the items described in section 810(c) at the beginning of taxable year, $1000, exceeds the sum of such items at the end of the taxable year after adjustment for the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1), $990 ($1060 minus $70), the excess of $10 ($1000 minus $990) shall be taken into account as a net decrease under section 809 (c)(2) and paragraph (a)(2) of § 1.809–4 in determining gain or loss from operations.

Example 3. Assume the following facts with respect to S, a life insurance company:

Sum of items described in section 810(c) (1) through (6) at beginning of taxable year	$1,970
Sum of items described in section 810(c) (1) through (6) at the end of taxable year	2,040
Required interest (as defined in section 809(a)(2))	60
Investment yield (as defined in section 804(c)) ..	40
Amount of investment yield not included in gain or loss from operations by reason of section 809(a)(1)	40

Under the provisions of section 809(a)(1), since the required interest ($60) exceeds the investment yield ($40), the share of each and every item of investment yield set aside for policyholders and not included in gain or loss from operations for the taxable year shall be 100 percent. Thus, applying the provisions of section 810 (a) and (b), the sum of the items described in section 810(c) at the end of the taxable year ($2,040) must first be reduced by the entire amount of the investment yield ($40) in order to determine the net increase or decrease in the sum of such items for the taxable year. Since the adjusted sum of such items at the end of the taxable year, $2,000 ($2,040 minus $40), is greater than the sum of such items at the beginning of the taxable year, $1,970, the excess of $30 ($2,000 minus $1,970) shall be taken into account as a net increase under section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations. No additional deduction is allowed under section 809(d) for the amount ($20) by which the required interest exceeds the investment yield for the taxable year.

Example 4. Assume the facts are the same as in example 1, except that as a result of a change in the basis used in computing an item described in section 810(c) during the taxable year, the sum of such items at the end of the taxable year is $1,200. Under the provisions of paragraph (c)(2) of this section, any increase or decrease in the sum of the section 810(c) items for the taxable year which is attributable to a change in the basis used in computing such items during the taxable year shall not be taken into account under section 810 (a) and (b). Thus, for purposes of section 810 (a) and (b), the sum of the items described in section 810(c) at the end of the taxable year shall be $1,060 (the amount computed without regard to the change in basis) and S shall treat the $50 computed in the manner described in example 1 as a net increase under section 809(d)(2) and paragraph (a)(2) of §1.809–5 in determining its gain or loss from operations for the taxable year. The amount of the increase in the section 810(c) items which is attributable to the change in basis during the taxable year, $140 ($1,200 minus $1,060), shall be taken into account in the manner prescribed in section 810(d) and paragraph (a) of §1.810–3.

Example 5. The life insurance reserves of M, a life insurance company, computed with respect to contracts for which such reserves are determined on a recognized preliminary term basis amount to $100 on January 1, 1960, and $110 on December 31, 1960. For the taxable year 1960, M elects to revalue such reserves on a net level premium basis under section 818(c). Such reserves computed under section 818(c) amount to $115 on January 1, 1960, and $127 on December 31, 1960. Under the provisions of paragraph (c)(3) of this section, a company which makes the section 818(c) election must use the net level premium basis in computing the sum of its life insurance reserves at the beginning and end of all taxable years for which the election applies. Thus, for purposes of section 810 (a) and (b), in determining whether there is a net increase or decrease in the sum of the section 810(c) items for the taxable year 1960, M shall include $115 as its reserves with respect to such contracts under section 810(c)(1) at the beginning of the taxable year and $127 as its reserves with respect to such contracts under section 810(c)(1) at the end of the taxable year.

[T.D. 6535, 26 FR 531, Jan. 20, 1961, as amended by T.D. 7163, 37 FR 4189, Feb. 29, 1972; T.D. 7172, 37 FR 5619, Mar. 17, 1972]

§1.810–3 Adjustment for change in computing reserves.

(a) *Reserve strengthening or weakening.* Section 810(d)(1) provides that if the basis for determining any item referred to in section 810(c) and paragraph (b) of §1.810–2 at the end of any taxable year differs from the basis for such determination at the end of the preceding taxable year, then so much of the difference between:

(1) The amount of the item at the end of the taxable year, computed on the new basis, and

(2) The amount of the item at the end of the taxable year, computed on the old basis,

as is attributable to contracts issued before the taxable year shall be taken into account as follows:

(i) If the amount of the item at the end of the taxable year computed on the new basis exceeds the amount of the item at the end of the taxable year computed on the old basis, 1/10 of such excess shall be taken into account, for each of the succeeding 10 taxable years as a net increase to which section 809(d)(2) and paragraph (a)(2) of §1.809–5 applies; or

(ii) If the amount of the item at the end of the taxable year computed on the old basis exceeds the amount of the item at the end of the taxable year computed on the new basis, 1/10 of such excess shall be taken into account, for each of the 10 succeeding taxable years, as a net decrease to which section 809 (c)(2) and paragraph (a)(2) of §1.809–4 applies.

(b) *Illustration of principles.* The provisions of section 810(d)(1) and paragraph (a) of this section may be illustrated by the following examples:

Example 1. Assume that the amount of an item described in section 810(c) of L, a life insurance company, at the beginning of the taxable year 1959 is $100. Assume that at the end of the taxable year 1959, as a result of a change in the basis used in computing such item during the taxable year, the amount of the item (computed on the new basis) is $200 but computed on the old basis would have been $150. Since the amount of the item at the end of the taxable year computed on the new basis, $200, exceeds the amount of the item at the end of the taxable year computed on the old basis, $150, by $50, 1/10 of the amount of such excess, or $5, shall be taken into account as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations for each of the 10 taxable years immediately following the taxable year 1959. Any increase (or decrease) in the sum of the section 810(c) items computed on the old basis at the end of the taxable year 1959 ($150) after adjustment for investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1), over the sum of such items computed on the old basis at the beginning of the taxable year 1959 ($100), shall be taken into account in the manner prescribed in section 810 (a) or (b) and § 1.810–2 for purposes of determining L's gain or loss from operations for 1959.

Example 2. Assume the facts are the same as in example 1, and that the sum of the items described in section 810(c) (computed on the new basis) is $200 on January 1, 1960, and $260 on December 31, 1960. Under the provisions of section 810(d)(1), as a result of the reserve strengthening attributable to the change in basis which occurred in 1959, L would include $5 (computed in the manner described in example 1) as a net increase under section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining its gain or loss from operations for 1960. In addition to this amount, any increase (or decrease) in the sum of the items described in section 810(c) at the end of the taxable year 1960 ($260) after adjustment for investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1), over the sum of such items at the beginning of the taxable year 1960 ($200), shall be taken into account in the manner prescribed in section 810 (a) or (b) and § 1.810–2 for purposes of determining L's gain or loss from operations for 1960.

(c) *Termination as life insurance company.* Section 810(d)(2) provides, subject to the provisions of section 381(c)(22) and the regulations thereunder (relating to carryovers in certain corporate readjustments), that if for any taxable year a company which previously was a life insurance company no longer meets the requirements of section 801(a) and paragraph (b) of § 1.801–3 (relating to the definition of a life insurance company), the balance of any adjustments remaining to be made under section 810(d)(1) and paragraph (a) of this section shall be taken into account for the preceding taxable year.

(d) *Illustration of principles.* The provisions of section 810(d)(2) and paragraph (c) of this section may be illustrated by the following example:

Example. Assume the facts are the same as in example 1 of paragraph (b) of this section, except that for the taxable year 1962, L no longer meets the requirements of section 801(a) (relating to the definition of a life insurance company) and that the provisions of section 381(c)(22) are not applicable. Under the provisions of section 810 (d)(2), the entire balance of the adjustment remaining to be made with respect to the change in basis which occurred in 1959, 8/10 of $50, or $40, shall be taken into account for the taxable year 1961, the last year L was a life insurance company. Thus, for the taxable year 1961, the total amount to be taken into account by L as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining its gain or loss from operations shall be $45. Of this amount, $5 (1/10 of $50) represents the amount determined under the provisions of section 810(d)(1), and $40 represents the amount determined under the provisions of section 810(d)(2).

(e) *Effect of preliminary term election.* (1) Section 810(d)(3) provides that if a company which computes its life insurance reserves on a preliminary term basis elects to revalue such reserves on a net level premium basis under section 818(c), such election shall not be treated as a change in basis within the meaning of section 810(d)(1) and paragraph (a) of this section. Thus, any increase or decrease in reserves attributable to such election shall not be taken into account under section 810(d)(1) and paragraph (a) of this section but shall be taken into account in the manner prescribed in section 810 (a) and (b) and paragraph (a) of § 1.810–2. See paragraph (c)(3) of § 1.810–2.

(2) Section 810(d)(3) further provides that where an election under section 818(c) would apply to an item referred to in section 810(c) but for the fact that the basis used in computing such item has actually been changed, any increase or decrease in such item attributable to such actual change in basis shall be subject to the adjustment required under section 810(d)(1) and paragraph (a) of this section. In such a case, however, for purposes of section 810(d)(1)(B) and paragraph (a)(2) of this section, the amount of such item at the end of the taxable year computed on the old basis shall be the amount of such item at the end of the taxable year computed as if the election under section 818(c) applied in respect of such item for the taxable year.

(f) *Illustration of principles.* The provisions of section 810(d)(3) and paragraph (e) of this section may be illustrated by the following examples:

Example 1. Assume that S, a life insurance company which computes its life insurance reserves on a 3-percent assumed rate and the Commissioner's reserve valuation method (one of the recognized preliminary term reserve methods), elects to revalue such reserves on a net level premium method under section 818(c) and that the significant facts are as follows:

	Jan. 1, 1958	Dec. 31, 1958
Book reserves at 3-percent assumed rate, Commissioner's reserve valuation method	100	118
Reserves at 3-percent assumed rate, after restatement under section 818(c)	110	131

Under the provisions of section 810(d)(3), an election under section 818(c) is not treated as a change in basis for purposes of section 810(d)(1). Accordingly, the increase of $21 ($131 minus $110) attributable to such election shall not be subject to the adjustment provided by section 810(d)(1) but shall be taken into account in the manner prescribed in section 810(b). For purposes of determining the amount to be taken into account under section 810(b), the reserves with respect to the contracts subject to the section 818(c) election shall be $110 at the beginning of the taxable year 1958 and $131 at the end of the taxable year 1958. However, as a result of making the election under section 818(c), the difference ($10) between the reserves computed on the preliminary term basis on January 1, 1958 ($100) and the reserves restated on the net level premium basis on January 1, 1958 ($110) shall not be taken into account under section 809(d) for the year 1958, or for any subsequent taxable year.

Example 2. Assume the facts are the same as in example 1, except that during the taxable year 1959, S actually changed from the preliminary term basis to a net level premium basis which was identical with the net level premium basis used under the section 818(c) election and that the significant facts are as follows:

	Jan. 1, 1959	Dec. 31, 1959
Book reserves at 3-percent assumed rate, Commissioner's reserve valuation method	118	127
Reserves at 3-percent assumed rate, after restatement under section 818(c)	131	142
Strengthened reserves at 3-percent assumed rate and net level premium method	…………	142

Under the provisions of section 810(d)(3), if a company which has made an election under section 818(c) which has not been revoked actually changes the basis used by it in computing the reserves subject to such election, any increase or decrease in reserves attributable to such change in basis shall be taken into account in the manner prescribed in section 810(d)(1). Since S actually changed to the same basis which it used in computing its reserves under section 818(c), the reserves at the end of the taxable year computed on the new basis ($142) are the same as the reserves at the end of the taxable year computed on the old basis ($142), i.e., the basis which would have applied under section 818(c) if the election applied for 1959. Accordingly, no adjustment under section 810(d)(1) is required.

Example 3. Assume the facts are the same as in example 1, except that during the taxable year 1960, S actually changed the basis used by it in computing its reserves on a certain block of contracts subject to the election under section 818(c) and that the significant facts with respect to this block of contracts are as follows:

	Jan. 1, 1960	Dec. 31, 1960
Book reserves at 3-percent assumed rate, Commissioner's reserve valuation method	50	63
Reserves at 3-percent assumed rate, after restatement under section 818(c)	60	75
Strengthened reserves at 2-percent assumed rate and net level premium method	…………	95

Under the provisions of section 810(d)(3), the amount of the reserves subject to the section 818(c) election at the end of the taxable year computed on the old basis shall be the amount of such reserves at the end of the taxable year determined under section 818(c) ($75). Since the reserves at the end of the taxable year computed on the new basis, $95, exceed the reserves at the end of the taxable year computed on the old basis, $75, by $20, 1/10 of the excess of $20, or $2, shall be taken into account as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of §1.809–5 in determining gain or loss from operations for each of the 10 taxable years immediately following the taxable year 1960. For purposes of determining whether there is a net increase or decrease in the sum of the items described in section 810(c) for the taxable year 1960 under section 810 (a) or (b), the sum of the reserves with respect to such block of contracts shall be $60 at the beginning of the taxable year and $75 at the end of the taxable year (the amount of such reserves computed under section 818(c) at the beginning and end of the taxable year). The difference ($10) between the reserves computed on the preliminary term basis on January 1, 1960 ($50) and the reserves restated on the net level premium basis on January 1, 1960 ($60) shall not be taken into account under section 809(d) for the year 1960, or for any subsequent taxable year.

[T.D. 6535, 26 FR 532, Jan. 20, 1961]

§ 1.810–4 Certain decreases in reserves of voluntary employees' beneficiary associations.

(a) *Decreases due to voluntary lapses of policies issued before January 1, 1958.* (1) Section 810(e) provides that if for any taxable year a life insurance company which meets the requirements of section 501(c)(9), other than the requirement of subparagraph (B) thereof, makes an election in the manner provided in section 810(e)(3) and paragraph (b) of this section, only 11½ percent of any decrease in life insurance reserves (as defined in section 801(b) and § 1.801–4) attributable to the voluntary lapse on or after January 1, 1958, of any policy issued prior to that date shall be taken into account under section 810 (a) or (b) and paragraph (a) of § 1.810–2 in determining the net increase or decrease in the sum of the items described in section 810(c) during the taxable year. In applying the preceding sentence, the decrease in the reserve for any policy shall be determined by reference to the amount of such reserve at the beginning of the taxable year, reduced by any amount allowable as a deduction under section 809(d)(1) and paragraph (a)(1) of § 1.809–5 in respect of such policy by reason of such lapse. The election under section 810(e) shall be adhered to in computing the company's gain or loss from operation for the taxable year for which the election is made and for all subsequent taxable years, unless consent to revoke such election is obtained from the Commissioner.

(2) The application of the election provided under section 810(e) and subparagraph (1) of this paragraph may be illustrated by the following example:

Example. For the taxable year 1960, M, a life insurance company which meets the requirements of section 501(c)(9), other than the requirement of subparagraph (B) thereof, makes the election under section 810(e). Assume the following facts with respect to a policy issued in 1955 which voluntarily lapsed during the taxable year:

(1) Life insurance reserve on January 1, 1960	$600
(2) Amount allowable as a deduction under sec. 809(d)(1)	200
(3) Decrease in life insurance reserves for sec. 810(e) purposes (item (1) minus item (2))	400
(4) Amount taken into account under sec. 810 (a) and (b) by reason of sec. 810(e) election (11 1/2%×$400)	46

Under the provisions of section 810(e) and subparagraph (1) of this paragraph, M would include $46 as its life insurance reserve with respect to such policy under section 810(c)(1) at the beginning of the taxable year 1960 for purposes of determining the net increase or decrease in the sum of the items described in section 810(c) for the taxable year under section 810 (a) or (b).

(b) *Time and manner of making election.* The election provided by section 810(e)(3) shall be made in a statement attached to the life insurance company's income tax return for the first taxable year for which the company desires the election to apply. The return and statement must be filed not later than the date prescribed by law (including extensions thereof) for filing the return for such taxable year. However, if the last day prescribed by law (including extensions thereof) for filing a return for the first taxable year for which the company desires the election to apply falls before January 20, 1961, the election provided by section 810(e)(3) may be made for such year by filing the statement and an amended return for such taxable year (and all subsequent taxable years for which returns have been filed) before April 21, 1961. The statement shall indicate that the company meets the requirements of section 501(c)(9), other than the requirement of subparagraph (B) thereof, and has made the election provided under section 810(e) and paragraph (a) of this section. The statement shall set forth the following information with respect to each policy described in paragraph (a) of this section which has voluntarily lapsed during such year:

(1) Type of policy.

(2) Date issued.

(3) Date lapsed.

(4) Reason for lapse.

(5) Policy reserve as of beginning of taxable year.

(6) Deduction allowable under section 809(d)(1) and paragraph (a)(1) of § 1.809–

5 during taxable year by reason of lapse.

(7) Decrease in policy reserve for section 810(e) purposes (excess of (5) over (6)).

In addition, the statement shall set forth the total of the amounts referred to in subparagraph (7) of this paragraph with respect to all policies described in paragraph (a) of this section which have voluntarily lapsed during the taxable year.

(c) *Scope of election.* An election made under section 810(e)(3) and paragraph (a) of this section shall be effective for the taxable year for which made and for all succeeding taxable years, unless consent to revoke the election is obtained from the Commissioner. However, for taxable years beginning prior to January 20, 1961, a company may revoke the election provided by section 810(e)(3) without obtaining consent from the Commissioner by filing, before April 21, 1961, a statement that the company desires to revoke such election. An amended return reflecting such revocation must accompany the statement for all taxable years for which returns have been filed with respect to such election.

(d) *Disallowance of carryovers from pre-1958 losses from operations.* For any taxable year for which the election provided under section 810(e)(3) and paragraph (b) of this section is effective, the provisions of section 812(b)(1) and §1.812–4 shall not apply with respect to any loss from operations for any taxable year beginning before January 1, 1958.

(e) *Effective date; cross reference.* The provisions of section 810(e) (as in effect for such years) and this section apply only with respect to taxable years beginning before January 1, 1970. For provisions relating to certain funded pension trusts applicable to taxable years beginning after December 31, 1969, see section 501(c)(18) and the regulations thereunder.

[T.D. 6535, 26 FR 533, Jan. 20, 1961, as amended by T.D. 7172, 37 FR 5619, Mar. 17, 1972]

§1.811–1 Taxable years affected.

Section 1.811–2, except as otherwise provided therein, is applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6535, 26 FR 534, Jan. 20, 1961]

§1.811–2 Dividends to policyholders.

(a) *Dividends to policyholders defined.* Section 811(a) defines the term *dividends to policyholders,* for purposes of part I, subchapter L, chapter 1 of the Code, to mean dividends and similar distributions to policyholders in their capacity as such. The term includes amounts returned to policyholders where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management. In general, any payment not fixed in the contract which is made with respect to a participating contract (that is, a contract which during the taxable year contains a right to participate in the divisible surplus of the company) shall be treated as a dividend to policyholders. Similarly, any amount refunded or allowed as a rate credit with respect to either a participating or a nonparticipating contract shall be treated as a dividend to policyholders if such amount depends on the experience of the company. However, the term does not include interest paid (as defined in section 805(e) and paragraph (b) of §1.805–8) or return premiums (as defined in section 809(c) and paragraph (a)(1)(ii) of §1.809–4). Thus, so-called excess-interest dividends and amounts returned by one life insurance company to another in respect of reinsurance ceded shall not be treated as dividends to policyholders even though such amounts are not fixed in the contract but depend upon the experience of the company or the discretion of the management.

(b) *Amount of deduction*—(1) *In general.* Section 811(b)(1) provides, subject to the limitation of section 809(f), that the deduction for dividends to policyholders for any taxable year shall be an amount equal to the dividends to policyholders paid during the taxable year:

(i) Increased by the excess of the amounts held as reserves for dividends to policyholders at the end of the taxable year for payment during the year following the taxable year, over the amounts held as reserves for dividends to policyholders at the end of the preceding taxable year for payment during the taxable year, or

(ii) Decreased by the excess of the amounts held as reserves for dividends to policyholders at the end of the preceding taxable year for payment during the taxable year, over the amounts held as reserves for dividends to policyholders at the end of the taxable year for payment during the year following the taxable year.

For the rule as to when dividends are considered paid, see section 561 and the regulations thereunder. For the determination of the amounts held as reserves for dividends to policyholders, see paragraph (c) of this section. For special provisions relating to the treatment of dividends to policyholders paid with respect to policies reinsured under modified coinsurance contracts, see section 820(c)(5) and the regulations thereunder.

(2) *Certain amounts to be treated as net decreases.* Section 811(b)(2) provides that if the amount determined under subparagraph (1)(ii) of this paragraph exceeds the dividends to policyholders paid during the taxable year, the amount of such excess shall be a net decrease referred to in section 809(c)(2).

(c) *Reserves for dividends to policyholders defined*—(1) *In general.* The term *reserves for dividends to policyholders,* as used in section 811(b)(1) (A) and (B) and paragraph (b)(1) of this section, means only those amounts:

(i) Actually held, or set aside as provided in subparagraph (2) of this paragraph and thus treated as actually held, by the company at the end of the taxable year, and

(ii) With respect to which, at the end of the taxable year or, if set aside, within the period prescribed in subparagraph (2) of this paragraph, the company is under an obligation, which is either fixed or determined according to a formula which is fixed and not subject to change by the company, to pay such amounts as dividends to policyholders (as defined in section 811(a) and paragraph (a) of this section) during the year following the taxable year.

(2) *Amounts set aside.* (i) In the case of a life insurance company (as defined in section 801(a) and paragraph (b) of § 1.801–3), all amounts set aside before the 16th day of the 3d month of the year following the taxable year for payment as dividends to policyholders (as defined in section 811(a) and paragraph (a) of this section) during the year following such taxable year shall be treated as amounts actually held at the end of the taxable year.

(ii) In the case of a mutual savings bank subject to the tax imposed by section 594, all amounts set aside before the 16th day of the 4th month of the year following the taxable year for payment as dividends to policyholders (as defined in section 811(a) and paragraph (a) of this section) during the year following such taxable year shall be treated as amounts actually held at the end of the taxable year.

(3) *1958 reserve for dividends to policyholders.* For purposes of section 811(b) and paragraph (b) of this section, the amounts held at the end of 1957 as reserves for dividends to policyholders payable during 1958 shall be determined as if part I, subchapter L, chapter 1 of the Code (as in effect for 1958) applied for 1957. Any adjustment in the reserves for dividends to policyholders at the beginning of 1957 required as a result of an understatement or overstatement of such reserves by the company shall be made to the balance of such reserves as of the beginning of 1957. For example, if at the beginning of 1957 the reserves for dividends to policyholders are stated to be $100 and it is subsequently determined that such reserves should have been $90, the reserves at the beginning of 1957 shall be reduced by $10. Under no circumstances shall an adjustment required with regard to the beginning 1957 reserves be made to the reserves at the end of 1957.

(4) *Information to be filed.* Every company claiming a deduction for dividends to policyholders shall keep such permanent records as are necessary to establish the amount of dividends actually paid during the taxable year. Such company shall also keep a copy of the dividend resolution and any necessary supporting data relating to the amounts of dividends declared and to the amounts held or set aside as reserves for dividends to policyholders during the taxable year. The company

shall file with its return a concise statement of the pertinent facts relating to its dividend policy for the year, the amount of dividends actually paid during the taxable year, and the amounts held or set aside as reserves for dividends to policyholders during the taxable year.

(d) *Illustration of principles.* The provisions of section 811(b) and this section may be illustrated by the following examples:

Example 1. On December 31, 1959, M, a life insurance company, held $200 as reserves for dividends to policyholders due and payable in 1960. On March 10, 1960, M set aside an additional $50 as reserves for dividends to policyholders due and payable in 1960. During the taxable year 1960, M paid $240 as dividends to its policyholders and at the end of the taxable year 1960, held $175 as reserves for dividends to policyholders due and payable in 1961. No additional amount was set aside before March 16, 1961, as reserves for dividends to policyholders due and payable in 1961. For the taxable year 1960, subject to the limitation of section 809(f), M's deduction for dividends to policyholders is $165, computed as follows:

(1) Dividends paid to policyholders during the taxable year 1960		$240
(2) Decreased by the excess of item (a) over item (b):		
(a) Reserves for dividends to policyholders as of 12–31–59 (including amounts set aside as provided in paragraph (c)(2) of this section)	$250	
(b) Reserves for dividends to policyholders as of 12–31–60 –	175	
		75
(3) Deduction for dividends to policyholders under sec. 811(b) (computed without regard to the limitation of sec. 809(f))		$165

Example 2. On December 31, 1960, S, a life insurance company, held $100 as reserves for dividends to policyholders due and payable in 1961. During the taxable year 1961, S paid $125 as dividends to its policyholders and at the end of the taxable year 1961, held $110 as reserves for dividends to policyholders due and payable in 1962. No additional amount was set aside for dividends to policyholders as provided in paragraph (c)(2) of this section before March 16, 1961, or March 16, 1962. For the taxable year 1961, subject to the limitation of section 809(f), S's deduction for dividends to policyholders is $135, computed as follows:

(1) Dividends paid to policyholders during the taxable year 1961		$125
(2) Increased by the excess of item (a) over item (b):		
(a) Reserves for dividends to policyholders as of 12–31–61	$110	
(b) Reserves for dividends to policyholders as of 12–31–60	100	
		10
(3) Deduction for dividends to policyholders under sec. 811(b) (computed without regard to the limitation of sec. 809(f))		$135

Example 3. Assume the facts are the same as in example 2, except that on December 31, 1960, the amount held as reserves for dividends to policyholders due and payable in 1961 is $250. For the taxable year 1961, S's deduction for dividends to policyholders is zero, computed as follows:

(1) Dividends paid to policyholders during the taxable year 1961		$125
(2) Decreased by the excess of item (a) over item (b):		
(a) Reserves for dividends to policyholders as of 12–31–60	$250	
(b) Reserves for dividends to policyholders as of 12–31–61	110	
		140
(3) Deduction for dividends to policyholders under sec. 811(b) (computed without regard to the limitation of sec. 809(f))		$0

Under the provisions of section 811(b)(2) and paragraph (b)(2) of this section, since the decrease in the reserves for dividends to policyholders during the taxable year, $140 ($250 minus $110), exceeds the dividends to policyholders paid during the taxable year 1961, $125, S shall include $15 (the amount of such excess) as a net decrease under section 809(c)(2) and paragraph (a)(2) of §1.809–4 in determining its gain or loss from operations for 1961.

[T.D. 6535, 26 FR 534, Jan. 20, 1961]

§1.812–1 Taxable years affected.

Sections 1.812–2 through 1.812–8, except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) and the Act of October 23, 1962 (76 Stat. 1134).

[T.D. 6886, 31 FR 8689, June 23, 1966]

§1.812–2 Operations loss deduction.

(a) *Allowance of deduction.* Section 812 provides that a life insurance company shall be allowed a deduction in computing gain or loss from operations for any taxable year beginning after December 31, 1957, in an amount equal to the aggregate of the operations loss carryovers and operations loss carrybacks to such taxable year. This deduction is referred to as the operations loss deduction. The loss from operations (computed under section 809), is the basis for the computation of the operations loss carryovers and operations loss carrybacks and ultimately for the operations loss deduction itself. Section 809(e)(5) provides that the net operating loss deduction provided in section 172 shall not be allowed a life insurance company since the operations loss deduction provided in section 812 and this paragraph shall be allowed in lieu thereof.

(b) *Steps in computation of operations loss deduction.* The three steps to be taken in the ascertainment of the operations loss deduction for any taxable year beginning after December 31, 1957, are as follows:

(1) Compute the loss from operations for any preceding or succeeding taxable year from which a loss from operations may be carried over or carried back to such taxable year.

(2) Compute the operations loss carryovers to such taxable year from such preceding taxable years and the operations loss carrybacks to such taxable year from such succeeding taxable years.

(3) Add such operations loss carryovers and carrybacks in order to determine the operations loss deduction for such taxable year.

(c) *Statement with tax return.* Every life insurance company claiming an operations loss deduction for any taxable year shall file with its return for such year a concise statement setting forth the amount of the operations loss deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the operations loss deduction.

(d) *Ascertainment of deduction dependent upon operations loss carryback.* If a life insurance company is entitled in computing its operations loss deduction to a carryback which it is not able to ascertain at the time its return is due, it shall compute the operations loss deduction on its return without regard to such operations loss carryback. When the life insurance company ascertains the operations loss carryback, it may within the applicable period of limitations file a claim for credit or refund of the overpayment, if any, resulting from the failure to compute the operations loss deduction for the taxable year with the inclusion of such carryback; or it may file an application under the provisions of section 6411 for a tentative carryback adjustment.

(e) *Law applicable to computations.* The following rules shall apply to all taxable years beginning after December 31, 1957:

(1) In determining the amount of any operations loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year.

(2) The loss from operations for any taxable year shall be determined under the law applicable to that year without regard to the year to which it is to be carried and in which, in effect, it is to be deducted as part of the operations loss deduction.

(3) The amount of the operations loss deduction which shall be allowed for any taxable year shall be determined under the law applicable for that year.

(f) *Special rules.* For purposes of taxable years beginning after December 31, 1954, and before January 1, 1958:

(1) The amount of any:

(i) Loss from operations;

(ii) Operations loss carryback; and

(iii) Operations loss carryover

shall be computed as if part I, subchapter L, chapter 1 of the Code (as in effect for 1958) and section 381(c)(22) applied to such taxable years.

(2) A loss from operations (determined in accordance with the provisions of section 812(b)(1)(C) and this paragraph) for such taxable years shall in no way affect the tax liability of any life insurance company for such taxable years. However, such loss may, to the extent allowed as an operations loss carryover under section 812, affect the tax liability of a life insurance company for a taxable year beginning after December 31, 1957. For example, for the taxable year 1956, X, a life insurance company, has a loss from operations (determined in accordance with the provisions of section 812(b)(1)(C) and this paragraph). Such loss shall in no way affect X's tax liability for the taxable years 1956 (the year of the

loss), 1955 (a year to which such loss shall be carried back), or 1957 (a year to which such loss shall be carried forward). However, to the extent allowed under section 812, any amount of the loss for 1956 remaining after such carryback and carryforward shall be taken into account in determining X's tax liability for taxable years beginning after December 31, 1957.

[T.D. 6535, 26 FR 536, Jan. 20, 1961]

§1.812–3 Computation of loss from operations.

(a) *Modification of deductions.* A loss from operations is sustained by a life insurance company in any taxable year, if and to the extent that, for such year, there is an excess of the sum of the deductions provided by section 809(d) over the sum of (1) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) as determined under section 809(b)(3), and (2) the sum of the items of gross amount taken into account under section 809(c). In determining the loss from operations for purposes of section 812:

(i) No deduction shall be allowed under section 812 for the operations loss deduction.

(ii) The 85 percent limitation on dividends received provided by section 246 (b) as modified by section 809(d)(8)(B) shall not apply to the deductions otherwise allowed under:

(a) Section 243(a) in respect to dividends received by corporations,

(b) Section 244 in respect of dividends received on certain preferred stock of public utilities, and

(c) Section 245 in respect of dividends received from certain foreign corporations.

(b) *Illustration of principles.* The application of paragraph (a) of this section may be illustrated by the following example:

Example. For the taxable year 1960, X, a life insurance company, has items taken into account under section 809(c) amounting to $150,000, its share of the investment yield amounts to $250,000, and total deductions allowed by section 809(d) of $375,000, exclusive of any operations loss deduction and exclusive of any deduction for dividends received. In 1960, X received as its share of dividends entitled to the benefits of section 243(a) the amount of $100,000. These dividends are included in X's share of the investment yield. X has no other deductions to which section 812(c) applies. On the basis of these facts, X has a loss from operations for the taxable year 1960 of $60,000, computed as follows:

Deductions for 1960	$375,000
Plus: Deduction for dividends received computed without regard to the limitation provided by sec. 246(b), as modified by sec. 809(d)(8)(B) (85% of $100,000)	85,000
Total deductions as modified by sec. 812(c)	460,000
Less: Sum of sec. 809(c) items and X's share of investment yield (including $100,000 of dividends)	400,000
Loss from operations for 1960	(60,000)

[T.D. 6535, 26 FR 536, Jan. 20, 1961]

§1.812–4 Operations loss carrybacks and operations loss carryovers.

(a) *In general*—(1) *Years to which loss may be carried.* In order to compute the operations loss deduction of a life insurance company the company must first determine the part of any losses from operations for any preceding or succeeding taxable years which are carryovers or carrybacks to the taxable year in issue. Except as otherwise provided by this paragraph, a loss from operations for taxable years beginning after December 31, 1954, shall be carried back to each of the 3 taxable years preceding the loss year and shall be carried forward to each of the 5 taxable years succeeding the loss year. Except as limited by section 812(e)(2) and paragraph (b) of §1.812–6, if the life insurance company is a new company (as defined in section 812(e)(1)) for the loss year, the loss from operations shall be carried back to each of the 3 taxable years preceding the loss year and shall be carried forward to each of the 8 taxable years succeeding the loss year. In determining the span of years for which a loss from operations may be carried, taxable years in which a company does not qualify as a life insurance company (as defined in section 801(a)), or is not treated as a new company, shall be taken into account.

(2) *Special transitional rules.* (i) A loss from operations for any taxable year beginning before January 1, 1958, shall not be carried back to any taxable year

beginning before January 1, 1955. Furthermore, a loss from operations for any taxable year beginning after December 31, 1957, shall not be carried back to any taxable year beginning before January 1, 1958.

(ii) If for any taxable year a life insurance company has made an election under section 810(e) (relating to certain decreases in reserves for voluntary employees' beneficiary associations) which is effective for such taxable year, the provisions of section 812(b)(1) and subparagraph (1) of this paragraph shall not apply with respect to any loss from operations for any taxable year beginning before January 1, 1958.

(3) *Illustration of principles.* The provisions of section 812(b)(1) and of this paragraph may be illustrated by the following examples:

Example 1. P, a life insurance company, organized in 1940, has a loss from operations of $1,000 in 1958. This loss cannot be carried back, but shall be carried forward to each of the 5 taxable years following 1958.

Example 2. Q, a life insurance company, organized in 1940, has a loss from operations of $1,200 in 1959. This loss shall be carried back to the taxable year 1958 and then shall be carried forward to each of the 5 taxable years following 1959.

Example 3. R, a life insurance company, organized in 1940, has a loss from operations of $1,300 for the taxable year 1956. This loss shall first be carried back to the taxable year 1955 and then shall be carried forward to each of the 5 taxable years following 1956. The loss for 1956, carryback to 1955, and carryover to 1957 shall each be computed as if part I, subchapter L, chapter 1 of the Code (as in effect for 1958) applied to such taxable years.

Example 4. S, a life insurance company, organized in 1958 and meeting the provisions of section 812(e) (rules relating to new companies), has a loss from operations of $1,400 for the taxable year 1958. This loss cannot be carried back, but shall be carried forward to each of the 8 taxable years following 1958, provided, however, S is not a nonqualified corporation at any time during the loss year (1958) or any taxable year thereafter.

Example 5. T, a life insurance company, organized in 1954 and meeting the provisions of section 812(e) (rules relating to new companies), has a loss from operations of $1,500 for the taxable year 1956. This loss shall first be carried back to the taxable year 1955 and then carried forward to each of the 8 taxable years following 1956, provided, however, T is not a nonqualified corporation at any time during the loss year (1956) or any taxable year thereafter. The loss for 1956, carryback to 1955, and carryover to 1957 shall each be computed as if part I of subchapter L (as in effect for 1958) applied to such taxable years.

(4) *Periods of less than 12 months.* A fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) is a preceding or a succeeding taxable year for the purpose of determining under section 812 the first, second, etc., preceding or succeeding taxable year. For the determination of the loss from operations for periods of less than 12 months, see section 818(d) and the regulations thereunder.

(5) *Amount of loss to be carried.* The amount which is carried back or carried over to any taxable year is the loss from operations to the extent it was not absorbed in the computation of gain from operations for other taxable years, preceding such taxable year, to which it may be carried back or carried over. For the purpose of determining the gain from operations for any such preceding taxable year, the various operations loss carryovers and carrybacks to such taxable year are considered to be applied in reduction of the gain from operations in the order of the taxable years from which such losses are carried over or carried back, beginning with the loss for the earliest taxable year.

(6) *Corporate acquisitions.* For the computation of the operations loss carryovers in the case of certain acquisitions of the assets of a life insurance company by another life insurance company, see section 381(c)(22) and the regulations thereunder.

(b) *Portion of loss from operations which is a carryback or a carryover to the taxable year in issue*—(1) *Manner of computation.* (i) A loss from operations shall first be carried back to the earliest taxable year permissible under section 812(b) and paragraph (a) of this section for which such loss is allowable as a carryback or a carryover. The entire amount of the loss from operation shall be carried back to such earliest year.

(ii) Section 812(b)(2) provides that the portion of the loss from operations which shall be carried to each of the taxable years subsequent to the earliest taxable year shall be the excess (if any) of the amount of the loss from operations over the sum of the offsets (as defined in section 812(d) and paragraph (a) of §1.812–5) for all prior taxable years to which the loss from operations may be carried.

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

Example. T, a life insurance company (which is not a new company as defined in section 812(e)(1)), has a loss from operations for 1960. The entire amount of the loss from operations for 1960 shall first be carried back to 1958. The amount of the carryback to 1959 is the excess (if any) of the 1960 loss over the offset for 1958. The amount of the carryover to 1961 is the excess (if any) of the 1960 loss over the sum of the offsets for 1958 and 1959. The amount of the 1960 loss remaining (if any) to be carried over to 1962, 1963, or 1964 shall be computed in a like manner.

[T.D. 6535, 26 FR 537, Jan. 20, 1961]

§1.812–5 Offset.

(a) *Offset defined.* Section 812(d) defines the term ''offset'' for purposes of section 812(b)(2) and paragraph (b)(1)(ii) of §1.812–4. For any taxable year the offset is only that portion of the increase in the operations loss deduction for the taxable year which is necessary to reduce the life insurance company taxable income (computed without regard to section 802(b)(3)) for such year to zero. For purposes of the preceding sentence, the offset shall be determined with the modifications prescribed in paragraph (b) of this section. Such modifications shall be made independently of, and without reference to, the modifications required by paragraph (a) of §1.812–3 for purposes of computing the loss from operations itself.

(b) *Modifications*—(1) *Operations loss deduction*—(i) *In general.* Section 812(d)(2) provides that for purposes of section 812(d)(1) (relating to the definition of offset), the operations loss deduction for any taxable year shall be computed by taking into account only such losses from operations otherwise allowable as carryovers or as carrybacks to such taxable year as were sustained in taxable years preceding the taxable year in which the life insurance company sustained the loss from operations from which the offset is to be deducted. Thus, for such purposes the loss from operations for the loss year or for any taxable year thereafter shall not be taken into account.

(ii) *Illustration of principles.* The provisions of this subparagraph may be illustrated by the following example:

Example. In computing the operations loss deduction for 1960, Y, a life insurance company, has a carryover from 1958 of $9,000, a carryover from 1959 of $6,000, a carryback from 1961 of $18,000, and a carryback from 1962 of $10,000, or an aggregate of $43,000 in carryovers and carrybacks. Thus, the operations loss deduction for 1960, for purposes of determining the tax liability for 1960, is $43,000. However, in computing the offset for 1960 which is subtracted from the loss from operations for 1961 for the purpose of determining the portion of such loss which may be carried over to subsequent taxable years, the operations loss deduction for 1960 is $15,000, that is, the aggregate of the $9,000 carryover from 1958 and the $6,000 carryover from 1959. In computing the operations loss deduction for such purpose, the $18,000 carryback from 1961 and the $10,000 carryback from 1962 are disregarded. In computing the offset for 1960, however, which is subtracted from the loss from operations for 1962 for the purpose of determining the portion of such 1962 loss which may be carried over for subsequent taxable years, the operations loss deduction for 1960 is $33,000, that is, the aggregate of the $9,000 carryover from 1958, the $6,000 carryover from 1959, and the $18,000 carryback from 1961. In computing the operations loss deduction for such purpose, the $10,000 carryback from 1962 is disregarded.

(2) *Recomputation of deductions limited by section 809(f)*—(i) *In general.* If in any taxable year a life insurance company has deductions under section 809(d) (3), (5), and (6), as limited by section 809(f), and sustains a loss from operations in a succeeding taxable year which may be carried back as an operations loss deduction, such limitation and deductions shall be recomputed. This recomputation is required since the carryback must be taken into account for purposes of determining such limitation and deductions.

(ii) *Illustration of principles.* The provisions of this subparagraph may be illustrated by the following example:

(a) Facts. The books of P, a life insurance company, reveal the following facts:

Taxable year	Taxable investment income	Gain from operations	Loss from operations
1959	$9,000,000	$10,000,000	....

Taxable year	Taxable investment income	Gain from operations	Loss from operations
1960	....	....	($9,800,000)

The gain from operations thus shown is computed without regard to any operations loss deduction or deductions under section 809(d) (3), (5), and (6), as limited by section 809(f). Assume that for the taxable year 1959, P has (without regard to the limitation of section 809(f) or the operations loss deduction for 1959) a deduction under section 809(d)(3) of $2,500,000 for dividends to policyholders and no deductions under section 809(d) (5) or (6).

(*b*) *Determination of section 809(f) limitation and deduction for dividends to policyholders without regard to the operations loss deduction for 1959.* In order to determine gain or loss from operations for 1959, P must determine the deduction for dividends to policyholders for such year. Under the provisions of section 809(f), the amount of such deduction shall not exceed the sum of *(1)* the amount (if any) by which the gain from operations for such year (determined without regard to such deduction) exceeds P's taxable investment income for such year, plus *(2)* $250,000. Since the gain from operations as thus determined ($10,000,000) exceeds the taxable investment income ($9,000,000) by $1,000,000, the limitation on such deduction is $1,250,000 ($1,000,000 plus $250,000). Accordingly, only $1,250,000 of the $2,500,000 deduction for dividends to policyholders shall be allowed. The gain from operations for such year is $8,750,000 ($10,000,000 minus $1,250,000).

(c) Recomputation of section 809(f) limitation and deduction for dividends to policyholders after application of the operations loss deduction for 1959. Since P has sustained a loss from operations for 1960 which shall be carried back to 1959 as an operations loss deduction, it must recompute the section 809(f) limitation and deduction for dividends to policyholders. Taking into account the $9,800,000 operations loss deduction for 1959 reduces gain from operations for such year to $200,000 ($10,000,000 minus $9,800,000). Since the gain from operations as thus determined ($200,000) is less than the taxable investment income ($9,000,000), the limitation on the deduction for dividends to policyholders is $250,000. Thus, only $250,000 of the $2,500,000 deduction for dividends to policyholders shall be allowed. The gain from operations for such year as thus determined is $9,750,000 ($10,000,000 minus $250,000) since for purposes of this determination the operations loss deduction for 1959 is not taken into account (see section 812(c)(1)). Accordingly, the offset for 1959 is $9,750,000 (the increase in the operations loss deduction for 1959, computed without regard to the carryback for 1960, which reduces life insurance company taxable income for 1959 to zero); thus, the portion of the 1960 loss from operations which shall be carried forward to 1961 is $50,000 (the excess of the 1960 loss ($9,800,000) over the offset for 1959 ($9,750,000)).

(3) *Minimum limitation.* The life insurance company taxable income, as modified under this paragraph, shall in no case be considered less than zero.

[T.D. 6535, 26 FR 537, Jan. 20, 1961]

§ 1.812–6 New company defined.

Section 812(e) provides that for purposes of part I, subchapter L, chapter 1 of the Code, a life insurance company is a ''new company'' for any taxable year only if such taxable year begins not more than 5 years after the first day on which it (or any predecessor if section 381(c)(22) applies or would have applied if in effect) was authorized to do business as an insurance company.

[T.D. 7326, 39 FR 35354, Oct. 1, 1974]

§ 1.812–7 Application of subtitle A and subtitle F.

Section 812(f) provides that except as modified by section 809(e) (relating to modifications of deduction items otherwise allowable under subtitle A of the Code) subtitles A and F of the Code shall apply to operations loss carrybacks and carryovers, and to the operations loss deduction, in the same manner and to the same extent that such subtitles apply in respect of net operation loss carrybacks, net operating loss carryovers, and the net operating loss deduction of corporations generally. For the computation of the operations loss carrybacks and carryovers, and of the operations loss deduction in the case of certain acquisitions of the assets of a life insurance company by another life insurance company, see section 381(c)(22) and the regulations thereunder.

[T.D. 6535, 26 FR 539, Jan. 20, 1961]

§ 1.812–8 Illustration of operations loss carrybacks and carryovers.

The application of § 1.812–4 may be illustrated by the following example:

(a) *Facts.* The books of M, a life insurance company, organized in 1940, reveal the following facts:

Taxable year	Taxable investment income	Gain from operations	Loss from operations
1958	$11,000	$15,000	
1959	23,000	30,000	
1960			($75,000)
1961	25,000	20,000	
1962			(150,000)
1963	22,000	30,000	
1964	40,000	35,000	
1965	62,000	75,000	
1966	25,000	17,000	
1967	39,000	53,000	

The gain from operations thus shown is computed without regard to any operations loss deduction. The assumption is also made that none of the other modifications prescribed in paragraph (b) of § 1.812–5 apply. There are no losses from operations for 1955, 1956, 1957, 1968, 1969, 1970.

(b) *Loss sustained in 1960.* The portions of the $75,000 loss from operations for 1960 which shall be used as carrybacks to 1958 and 1959 and as carryovers to 1961, 1962, 1963, 1964, and 1965 are computed as follows:

(1) *Carryback to 1958.* The carryback to this year is $75,000, that is, the amount of the loss from operations.

(2) *Carryback to 1959.* The carryback to this year is $60,000 (the excess of the loss for 1960 over the offset for 1958), computed as follows:

Loss from operations	$75,000
Less:	
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	15,000
Carryback	60,000

(3) *Carryover to 1961.* The carryover to this year is $30,000 (the excess, if any, of the loss for 1960 over the sum of the offsets for 1958 and 1959), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction of the carryback from 1960 or the carryback from 1962)	30,000	
Sum of offsets		45,000
Carryover		30,000

(4) *Carryover to 1962.* The carryover to this year is $10,000 (the excess, if any, of the loss for 1960 over the sum of the offsets for 1958, 1959, and 1961), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction of the carryback from 1960 or the carryback from 1962)	80,000	
Offset for 1961 (the $20,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryback from 1962)	20,000	
Sum of offsets		65,000
Carryover		10,000

(5) *Carryover to 1963.* The carryover to this year is $10,000 (the excess, if any, of the loss for 1960 over the sum of the offsets for 1958, 1959, 1961, and 1962), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction of the carryback from 1960 or the carryback from 1962)	30,000	
Offset for 1961 (the $20,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryback from 1962)	20,000	
Offset for 1962 (a year in which a loss from operations was sustained)	0	
Sum of offsets		65,000
Carryover		10,000

(6) *Carryover to 1964.* The carryover to this year is $0 (the excess, if any, of the loss from 1960 over the sum of the offsets for 1958, 1959, 1961, 1962, and 1963), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction of the carryback from 1960 or the carryback from 1962)	30,000	

Offset for 1961 (the $20,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryback from 1962)	20,000	
Offset for 1962 (a year in which a loss from operations was sustained)	0	
Offset for 1963 (the $30,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryover from 1962)	30,000	
Sum of offsets		95,000
Carryover		0

(7) *Carryover to 1965.* The carryover to this year is $0 (the excess, if any, of the loss from 1960 over the sum of the offsets for 1958, 1959, 1961, 1962, 1963, and 1964), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction for the carryback from 1960 or the carryback from 1962)	30,000	
Offset for 1961 (the $20,000 gain from operations for such year computed without the deduction for the carryover from 1960 or the carryback from 1962)	20,000	
Offset for 1962 (a year in which a loss from operations was sustained)	0	
Offset for 1963 (the $30,000 gain from operations for such year computed without the deduction for the carryover from 1960 or the carryover from 1962)	30,000	
Offset for 1964 (the $35,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryover from 1962)	35,000	
Sum of offsets		130,000
Carryover		0

(c) *Loss sustained in 1962.* The portions of the $150,000 loss from operations for 1962 which shall be used as carrybacks to 1959, 1960, and 1961 and as carryovers to 1963, 1964, 1965, 1966, and 1967 are computed as follows:

(1) *Carryback to 1959.* The carryback to this year is $150,000, that is, the amount of the loss from operations.

(2) *Carryback to 1960.* The carryback to this year is $150,000 (the excess, if any, of the loss from 1962 over the offset for 1959), computed as follows:

Loss from operations	$150,000
Less:	
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0
Carryback	150,000

(3) *Carryback to 1961.* The carryback to this year is $150,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959 and 1960), computed as follows:

Loss from operations	$150,000
Less:	
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0
Offset for 1960 (a year in which a loss from operations was sustained)	0
Sum of offsets	0
Carryback	150,000

(4) *Carryover to 1963.* The carryover to this year is $150,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, and 1961), computed as follows:

Loss from operations		$150,000
Less:		
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0	
Offset for 1960 (a year in which a loss from operations was sustained)	0	
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	0	
Sum of offsets		0
Carryover		150,000

(5) *Carryover to 1964.* The carryover to this year is $130,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, 1961, and 1963), computed as follows:

Loss from operations		$150,000
Less:		
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0	

Offset for 1960 (a year in which a loss from operations was sustained)	0	
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	0	
Offset for 1963 (the $30,000 gain from operations for such year reduced by the carryover to such year of $10,000 from 1960, the carryover from 1962 to 1963 not being taken into account)	20,000	
Sum of offsets		20,000
Carryover		130,000

(6) *Carryover to 1965.* The carryover to this year is $95,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, 1961, 1963, and 1964), computed as follows:

Loss from operations		$150,000
Less:		
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0	
Offset for 1960 (a year in which a loss from operations was sustained)	0	
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960 the carryback from 1962 to 1961 not being taken into account)	0	
Offset for 1963 (the $30,000 gain from operations for such year reduced by the carryover to such year of $10,000 from 1960, the carryover from 1962 to 1963 not being taken into account)	20,000	
Offset for 1964 (the $35,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the carryover from 1962 to 1964 not being taken into account)	35,000	
Sum of offsets		55,000
Carryover		95,000

(7) *Carryover to 1966.* The carryover to this year is $20,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, 1961, 1963, 1964, and 1965), computed as follows:

Loss from operations		$150,000
Less:		
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0	
Offset for 1960 (a year in which a loss from operations was sustained)	0	
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	0	
Offset for 1963 (the $30,000 gain from operations for such year reduced by the carryover for such year of $10,000 from 1960, the carryover from 1962 to 1963 not being taken into account)	20,000	
Offset for 1964 (the $35,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the carryover from 1962 to 1964 not being taken into account)	35,000	
Offset for 1965 (the $75,000 gain from operations for such year reduced by the carryover to such year of $0 to 1960, the carryover from 1962 to 1965 not being taken into account)	$75,000	
Sum of offsets		$130,000
Carryover		20,000

(8) *Carryover to 1967.* The carryover to this year is $3,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, 1961, 1963, 1964, 1965, and 1966), computed as follows:

Loss from operations		$150,000
Less:		
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0	
Offset for 1960 (a year in which a loss from operations was sustained)	0	
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	0	

Offset for 1963 (the $30,000 gain from operations for such year reduced by the carryover to such year of $10,000 from 1960, the carryover from 1962 to 1963 not being taken into account)	20,000	
Offset for 1964 (the $35,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the carryover from 1962 to 1964 not being taken into account)	35,000	
Offset for 1965 (the $75,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the carryover from 1962 to 1965 not being taken into account)	75,000	
Offset for 1966 (the $17,000 gain from operations for such year computed without the deduction of the carryover from 1962)	17,000	
Sum of offsets		147,000
Carryover		3,000

(d) *Determination of operations loss deduction for each year.* The carryovers and carrybacks computed under paragraphs (b) and (c) of this section are used as a basis for the computation of the operations loss deduction in the following manner:

Taxable year	Carryover		Carryback		Operations loss deductions
	From 1960	From 1962	From 1960	From 1962	
1958			$75,000		$75,000
1959			60,000	$150,000	210,000
1961	$30,000			150,000	180,000
1963	10,000	$150,000			160,000
1964		130,000			130,000
1965		95,000			95,000
1966		20,000			20,000
1967		3,000			3,000

[T.D. 6535, 26 FR 539, Jan. 20, 1961]

DISTRIBUTIONS TO SHAREHOLDERS

§ 1.815–1 Taxable years affected.

Sections 1.815–2 through 1.815–6, except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112), the Act of October 10, 1962 (76 Stat. 808), and the Act of October 23, 1962 (76 Stat. 1134).

[T.D. 6886, 31 FR 8689, June 23, 1966]

§ 1.815–2 Distributions to shareholders.

(a) *In general.* Section 815 provides that every stock life insurance company subject to the tax imposed by section 802 shall establish and maintain two special surplus accounts for Federal income tax purposes. These special accounts are the shareholders surplus account (as defined in section 815(b) and § 1.815–3) and the policyholders surplus account (as defined in section 815(c) and § 1.815–4). To the extent that a distribution to shareholders (as defined in paragraph (c) of this section) is treated as being made out of the shareholders surplus account, no tax is imposed on the company with respect to such distribution. However, to the extent that a distribution to shareholders is treated as being made out of the policyholders surplus account, the amount subtracted from the policyholders surplus account by reason of such distribution shall be taken into account in determining life insurance company taxable income under section 802(b).

(b) *Priority system for distributions to shareholders.* (1) For purposes of section 815 (other than subsection (e) thereof relating to certain mutualizations) and section 802(b)(3) (relating to the determination of life insurance company taxable income), any distribution made to shareholders after December 31, 1958, shall be treated in the following manner:

(i) Distributions shall be treated as first being made out of the shareholders surplus account (as defined in section 815(b) and §1.815–3);

(ii) Once the shareholders surplus account has been reduced to zero, distributions shall then be treated as being made out of the policyholders surplus account (as defined in section 815(c) and §1.815–4) until that account has been reduced to zero; and

(iii) Finally, any distributions in excess of the amounts in the shareholders surplus account and the policyholders surplus account shall be treated as being made out of other accounts (as defined in §1.815–5).

(2) For purposes of subparagraph (1) of this paragraph, in order to determine whether a distribution (or any portion thereof) shall be treated as being made out of the shareholders surplus account, policyholders surplus account, or other accounts, the amount in such accounts at the end of any taxable year shall be the cumulative balance in such accounts at the end of the taxable year, computed without diminution by reason of a distribution (or any portion thereof) during the taxable year which is treated as being made out of such accounts. For example, on January 1, 1960, S, a stock life insurance company, had $1,000 in its shareholders surplus account and $3,000 in its policyholders surplus account. On November 1, 1960, S distributed $4,000 to its shareholders. Under the provisions of section 815(b)(2) and paragraph (b) of §1.815–3, S added $5,000 to its shareholders surplus account for the taxable year 1960. Since the distributions to shareholders during the taxable year 1960, $4,000, does not exceed the cumulative balance in the shareholders surplus account at the end of the taxable year, computed without diminution by reason of distributions treated as made out of such account during the taxable year, $6,000 ($1,000 plus $5,000), the entire distribution is treated as being made out of the shareholders surplus account.

(3) Except in the case of a distribution in cash and as otherwise provided herein, the amount to be charged to the special surplus accounts referred to in subparagraph (1) of this paragraph with respect to any distributions to shareholders (as defined in section 815(a) and paragraph (c) of this section) shall be the fair market value of the property distributed, determined as of the date of distribution. However, for the amount of the adjustment to earnings and profits reflecting such distributions, see section 312 and the regulations thereunder. For a special rule relating to the determination of the amount to be charged to such special surplus accounts in the case of a distribution by a foreign life insurance company carrying on a life insurance business within the United States, see section 819(c)(1) and the regulations thereunder.

(c) *Distributions to shareholders defined.* (1) Except as otherwise provided in section 815(f) and subparagraph (2) of this paragraph, the term *distribution*, as used in section 815(a) and paragraph (b) of this section, means any distribution of property made by a life insurance company to its shareholders. For purposes of the preceding sentence, the term *property* means any property (including money, securities, and indebtedness to the company) other than stock, or rights to acquire stock, in the company making the distribution. Thus, for example, the term includes a distribution which is considered a dividend under section 316, but is not limited to the extent that such distribution must be made out of the accumulated or current earnings and profits of the company making the distribution. For example, except as otherwise provided in section 815(f) and subparagraph (2) of this paragraph, there is a distribution within the meaning of this paragraph in any case in which a corporation acquires the stock of a shareholder in exchange for property in a redemption treated as a distribution in exchange for stock under section 302(a) or treated as a distribution of property under section 302(d). For special rules relating to distributions to shareholders in acquisition of stock pursuant to a plan of mutualization, see section 815(e) and paragraph (e) of §1.815–6.

(2) The term *distribution*, as used in section 815(a) and paragraph (b) of this section, does not (except for purposes of section 815(a)(3) and (e)(2)(B)) include any distribution in redemption of

stock issued prior to January 1, 1958, where such stock was at all times on and after the date of its issuance and on and before the date of its redemption limited as to the amount of dividends payable and was callable, at the option of the issuer, at a price not in excess of 105 percent of the sum of its issue price plus the amount of contribution to surplus (if any) made by the original purchaser at the time of his purchase.

[T.D. 6535, 26 FR 542, Jan. 20, 1961, as amended by T.D. 7189, 37 FR 12793, June 29, 1972]

§ 1.815–3 Shareholders surplus account.

(a) *In general.* Every stock life insurance company subject to the tax imposed by section 802 shall establish and maintain a shareholders surplus account. This account shall be established as of January 1, 1958, and the beginning or opening balance of the shareholders surplus account on that date shall be zero.

(b) *Additions to shareholders surplus account.* (1) The amount added to the shareholders surplus account for any taxable year beginning after December 31, 1957, shall be the amount by which the sum of:

(i) The life insurance company taxable income (computed without regard to section 802(b)(3)),

(ii) In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss, reduced (in the case of a taxable year beginning after December 31, 1961) by the amount referred to in subdivision (i) of this subparagraph,

(iii) The deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3)), the deductions for dividends received provided by sections 243, 244, and 245 (as modified by section 809(d)(8)(B)), and the amount of interest excluded from gross income under section 103, and

(iv) The small business deduction provided by section 809(d)(10). Exceeds the taxes imposed for the taxable year by section 802(a), computed without regard to section 802(b)(3).

(c) *Subtractions from shareholders surplus account*—(1) *In general.* There shall be subtracted from the cumulative balance in the shareholders surplus account at the end of any taxable year, computed without diminution by reason of distributions made during the taxable year, the amount which is treated as being distributed out of such account under section 815(a) and paragraph (b) of § 1.815–2.

(2) *Special rule; distributions in 1958.* There shall be subtracted from the shareholders surplus account (to the extent thereof) for any taxable year beginning in 1958 the amount of the distributions to shareholders made by the company during 1958. For example, assume S, a stock life insurance company, had additions to its shareholders surplus account (as determined under section 815(b)(2) and paragraph (b) of this section) for the taxable year 1958 of $10,000, and actually distributed as dividends to its shareholders $8,000 during the year 1958. The balance in S's shareholders surplus account as of January 1, 1959, shall be $2,000. If S had distributed $12,000 as dividends in 1958, the balance in its shareholders surplus account as of January 1, 1959, would be zero and the other accounts referred to in section 815(a)(3) and paragraph (b)(1)(iii) of § 1.815–2 would be reduced by $2,000.

(d) *Illustration of principles.* The application of section 815(b) and this section may be illustrated by the following example:

Example. The books of S, a stock life insurance company, reflect the following items for the taxable year 1960.

Balance in shareholders surplus account as of 1–1–60	$5,000
Life insurance company taxable income computed without regard to sec. 802(b)(3)	4,000
Excess of net long-term capital gain over net short-term capital loss	1,700
Tax-exempt interest included in gross investment income under sec. 804(b)	100
Small business deduction (determined under sec. 809(d)(10))	200
Tax liability under sec. 802(a) (1) and (2) computed without regard to sec. 802(b)(3)	1,625
Amount distributed to shareholders	9,000

For purposes of determining the amount to be subtracted from its shareholders surplus account for the taxable year, S would first make up the following schedule in order to determine the cumulative balance in the shareholders surplus account at the end of the taxable year, computed without diminution by reason of distributions made during the taxable year:

(1) Balance in shareholders surplus account as of 1–1–60		$5,000
(2) Additions to account:		
(a) Life insurance company taxable income computed without regard to sec. 802(b)(3)	$4,000	
(b) Excess of net long-term capital gain over net short-term capital loss	1,700	
(c) Tax-exempt interest included in gross investment income under sec. 804(b)	100	
(d) Small business deduction (determined under sec. 809(d)(10))	200	
Total	6,000	
Less:		
Tax liability under sec. 802(a)(1) and (2) computed without regard to sec. 802(b)(3)	1,625	
		4,375
(3) Cumulative balance in shareholders surplus account as of 12–31–60 (item (1) plus item (2))		9,375

Since the amount distributed to shareholders during the taxable year, $9,000, does not exceed the cumulative balance in the shareholders surplus account at the end of the taxable year, computed without diminution by reason of distributions made during the taxable year, $9,375, under the provisions of section 815(a), the entire distribution shall be treated as being made out of the shareholders surplus account. Thus, $9,000 shall be subtracted from the shareholders surplus account (leaving a balance of $375 in such account at the end of the taxable year) and S shall incur no additional tax liability by reason of the distribution to its shareholders during the taxable year 1960.

[T.D. 6535, 26 FR 542, Jan. 20, 1961, as amended by T.D. 7189, 37 FR 12793, June 29, 1972]

§1.815–4 Policyholders surplus account.

(a) *In general.* Every stock life insurance company subject to the tax imposed by section 802 shall establish and maintain a policyholders surplus account. This account shall be established as of January 1, 1959, and the beginning or opening balance of the policyholders surplus account on that date shall be zero.

(b) *Additions to policyholders surplus account.* The amount added to the policyholders surplus account for any taxable year beginning after December 31, 1958, shall be the sum of:

(1) An amount equal to 50 percent of the amount by which the gain from operations for the taxable year exceeds the taxable investment income,

(2) The deduction allowed or allowable under section 809(d)(5) (as limited by section 809(f)) for certain nonparticipating contracts, and

(3) The deduction allowed or allowable under section 809(d)(6) (as limited by section 809(f)) for taxable years beginning before January 1, 1963, for group life and group accident and health insurance contracts, and for taxable years beginning after December 31, 1962, for accident and health insurance and group life insurance contracts.

(c) *Subtractions from policyholders surplus account*—(1) *In general.* There shall be subtracted from the cumulative balance in the policyholders surplus account at the end of any taxable year, computed without diminution by reason of distributions made during the taxable year, an amount equal to the sum of:

(i) The amount which (without regard to subdivision (ii) of this subparagraph) is treated under section 815(a) as distributed out of the policyholders surplus account for the taxable year, plus

(ii) The amount (determined without regard to section 802(a)(3)) by which the tax imposed for taxable years beginning before January 1, 1962, by section 802(a)(1), and for taxable years beginning after December 31, 1961, by section 802(a), is increased by reason of section 802(b)(3).

In addition, there shall be subtracted from the policyholders surplus account for the taxable year those amounts which, at the close of the taxable year, are subtracted or treated as subtracted from the policyholders surplus account under section 815(d) (1) and (4) and paragraphs (a) and (d) of §1.815–6. For purposes of this paragraph, the subtractions from the policyholders surplus account shall be treated as made in the following order:

(a) First the amount determined under section 815(c)(3) by reason of distributions to shareholders during the taxable year which are treated as being made out of the policyholders surplus account;

(b) Next the amount elected to be subtracted from the policyholders surplus account for the taxable year under section 815(d)(1);

(c) Then the amount which is treated as a subtraction from the policyholders surplus account for the taxable year by reason of the limitation provided in section 815(d)(4); and

(d) Finally the amount taken into account upon termination as a life insurance company as provided in section 815(d)(2).

(2) *Method of computing amount subtracted from policyholders surplus account*—(i) *Where life insurance company taxable income, computed without regard to section 802(b)(3), exceeds $25,000.* If the life insurance company taxable income for any taxable year computed under section 802(b), computed without regard to section 802(b)(3), exceeds $25,000, the amount subtracted from the policyholders surplus account shall be determined by multiplying the amount treated as distributed out of such account by a ratio, the numerator of which is 100 percent and the denominator of which is 100 percent minus the sum of the normal tax rate and the surtax rate for the taxable year.

(ii) *Where life insurance company taxable income does not exceed $25,000.* If the life insurance company taxable income for any taxable year, computed under section 802(b), does not exceed $25,000, the amount subtracted from the policyholders surplus account shall be determined by multiplying the amount treated as distributed out of such account by a ratio, the numerator of which is 100 percent and the denominator of which is 100 percent minus the normal tax rate for the taxable year.

(iii) *Where life insurance company taxable income, computed without regard to section 802(b)(3) does not exceed $25,000, but computed with regard to section 802(b)(3) does exceed $25,000.* If the life insurance company taxable income for any taxable year, computed without regard to section 802(b)(3) does not exceed $25,000, but computed with regard to section 802(b)(3) does exceed $25,000, the amount subtracted from the policyholders surplus account shall be determined in the following manner:

(a) First, determine the amount by which $25,000 exceeds the amount determined under section 802(b) (1) and (2);

(b) Then, multiply the amount determined under *(a)* by a ratio, the numerator of which is 100 percent minus the normal tax rate and the denominator of which is 100 percent;

(c) Next, determine the amount by which the amount treated as distributed out of the policyholders surplus account exceeds the amount determined under *(b)* and multiply such excess by a ratio, the numerator of which is 100 percent and the denominator of which is 100 percent minus the sum of the normal tax rate and the surtax rate; and

(d) Finally, add the amounts determined under *(a)* and *(c)*.

(3) *Illustration of principles.* The application of section 815(c)(3) and subparagraph (2) of this paragraph may be illustrated by the following examples:

Example 1. The life insurance company taxable income of S, a stock life insurance company, computed without regard to section 802(b)(3), exceeds $25,000 for the taxable year 1959. Assume that of the amount distributed by S to its shareholders during the taxable year, $9,600 (as determined under section 815(a) and without regard to section 815(c)(3)(B)) is treated as distributed out of the policyholders surplus account. Since the sum of the normal tax rate (30%) and the surtax rate (22%) in effect for 1959 is 52 percent. S shall subtract $20,000 from its policyholders surplus account for the taxable year 1959, computed as follows:

$$\$9{,}600\times100/(100-52)=\$9{,}600\times100/48=\$20{,}000$$

Of this amount, $9,600 is due to the application of section 815(c)(3)(A) and $10,400 to the application of section 815(c)(3)(B).

Example 2. Assume that for the taxable year 1960, S, a stock life insurance company, has taxable investment income of $1,000 and a gain from operations of $2,000. Assume further that of the amount distributed by S to its shareholders during the taxable year, $3,500 (as determined under section 815(a) and without regard to section 815(c)(3)(B)) is treated as distributed out of the policyholders surplus account. Since S's life insurance company taxable income does not exceed $25,000 for the taxable year and the normal tax rate in effect for 1960 is 30 percent, S shall subtract $5,000 from its policyholders surplus account for the taxable year 1960, computed as follows:

$$\$3{,}500\times100/(100-30)=\$3{,}500\times100/70=\$5{,}000$$

Of this amount, $3,500 is due to the application of section 815(c)(3)(A), and $1,500 to the application of section 815(c)(3)(B).

Example 3. For the taxable year 1960, the life insurance company taxable income of S, a stock life insurance company, computed without regard to section 802(b)(3), is $10,000. Assume that of the amount distributed by S to its shareholders during the taxable year, $12,000 (as determined under section 815(a) and without regard to section 815(c)(3)(B)) is treated as distributed out of the policyholders surplus account. Since the life insurance company taxable income of S, computed with regard to section 802(b)(3), exceeds $25,000, in order to determine the amount to be subtracted from its policyholders surplus account, S would make up the following schedule:

(1) $25,000 minus life insurance company taxable income, computed without regard to sec. 802(b)(3) ($25,000 minus $10,000	$15,000
(2) Item (1) multiplied by 100 percent minus the normal tax rate as in effect for 1960, over 100 percent ($15,000×(100−30)÷100)	10,500
(3) Amount by which the amount treated as distributed out of policyholders surplus account ($12,000) exceeds item (2) ($10,500), multiplied by 100 percent over 100 percent minus the sum of the normal tax rate and the surtax rate as in effect for 1960 ($1,500×100÷(100−52))	3,125
(4) Item (1) plus item (3) ($15,000 plus $3,125)	18,125

For the taxable year 1960, S shall subtract $18,125 from its policyholders surplus account. Of this amount, $10,500 represents the distribution from the policyholders surplus account which is taxed at a 30 percent tax rate and $1,500 the distribution from the policyholders surplus account which is taxed at a 52 percent tax rate. Thus, of the amount subtracted from the policyholders surplus account for the taxable year 1960, $12,000 is due to the application of section 815(c)(3) (A), and $6,125 to the application of section 815(c)(3)(B).

(d) *Illustration of principles.* The application of section 815(c) and this section may be illustrated by the following example:

Example. The books of S, a stock life insurance company, reflect the following items for the taxable year 1960:

Taxable investment income	$25,000
Gain from operations	30,000
Tax base (sec. 802(b)(1) and (2))	27,500
Deduction for certain nonparticipating policies provided by sec. 809(d)(5) (as limited by sec. 809(f))	600
Deduction for group policies provided by sec. 809(d)(6) (as limited by sec. 809(f))	400
Amount distributed to shareholders	60,000
Cumulative balance in shareholders surplus account as of 12–31–60	36,000
Balance in policyholders surplus account as of 1–1–60	48,000

For purposes of determining the amount to be subtracted from its policyholders surplus account for the taxable year, S would first make up the following schedule in order to determine the cumulative balance in the policyholders surplus account at the end of the taxable year, computed without diminution by reason of distributions made during the taxable year:

(1) Balance in policyholders surplus account as of 1–1–60		$48,000
(2) Additions to account:		
(a) 50 percent of the amount by which the gain from operations ($30,000) exceeds the taxable investment income ($25,000) (1/2 ×$5,000)	$2,500	
(b) The deduction for certain nonparticipating contracts provided by sec. 809(d)(5) (as limited by sec. 809(f))	600	
(c) The deduction for group contracts provided by sec. 809(d)(6) (as limited by sec. 809(f))	400	
		3,500
(3) Cumulative balance in policyholders account as of 12–31–60 (item (1) plus item (2))		51,500

Under the provisions of section 815(a), since the amount distributed to shareholders during the taxable year, $60,000, exceeds the cumulative balance in the shareholders surplus at the end of the taxable year, computed without diminution by reason of distributions during the taxable year, $36,000, the shareholders surplus account shall first be reduced to zero. The remaining $24,000 ($60,000 minus $36,000) of the distribution shall then be treated as made out of the policyholders surplus account. Thus, since the tax base under section 802(b)(1) and (2) is in excess of $25,000, the total amount to be subtracted from the policyholders surplus account at the end of the taxable year would be $50,000 ($24,000×100÷(100−52)). Of this amount $26,000 ($50,000 minus $24,000) represents the tax on the portion of the distribution to shareholders which is treated as being out of the policyholders surplus account.

(e) *Special rule for 1959 and 1960.* For a special transitional rule applicable to any increase in tax liability under section 802(b)(3) for the taxable years 1959 and 1960 which is due solely to the operation of section 815(c)(3) and this section, see section 802(a)(3) and §1.802–5.

[T.D. 6535, 26 FR 543, Jan. 20, 1961, as amended by T.D. 6886, 31 FR 8689, June 23, 1966]

§1.815–5 Other accounts defined.

The term *other accounts*, as used in section 815(a)(3) and paragraph (b) of §1.815–2, means all amounts which are not specifically included in the shareholders surplus account under section 815(b) and paragraph (b) of §1.815–3, or in the policyholders surplus account under section 815(c) and paragraph (b) of §1.815–4. Thus, for example, other accounts includes amounts representing the increase in tax due to the operation of section 802(b)(3) which is not taken into account for the taxable years 1959 and 1960 because of the special transitional rule provided in section 802(a)(3) and § 1.802–5, earnings and profits accumulated prior to January 1, 1958, paid-in surplus, capital, etc. To the extent that a distribution (or any portion thereof) is treated as being made out of other accounts, no tax is imposed on the company with respect to such distribution.

[T.D. 6535, 26 FR 544, Jan. 20, 1961]

§ 1.815–6 Special rules.

(a) *Election to transfer amounts from policyholders surplus account to shareholders surplus account*—(1) *In general.* Section 815(d)(1) permits a life insurance company to elect, after the close of any taxable year for which it is a life insurance company, to subtract any amount (or any portion thereof) in its policyholders surplus account as of the close of the taxable year. The effect of such election is to subject the company to tax on the amounts elected to be subtracted for the taxable year for which the election applies. The amount so subtracted, less the amount of tax imposed with respect to such amount by reason of section 802(b)(3), shall be added to the shareholders surplus account as of the beginning of the taxable year following the taxable year for which the election applies and no further tax shall be imposed upon the company if the amount elected to be transferred to the shareholders surplus account is subsequently distributed to shareholders.

(2) *Manner and effect of election.* (i) The election provided by section 815(d)(1) and this section shall be made in a statement attached to the life insurance company's income tax return for any taxable year for which the company desires the election to apply. The statement shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the return for such taxable year. In addition, the statement shall indicate that the company has made the election provided under section 815(d)(1) for the taxable year and the amount elected to be subtracted from the policyholders surplus account.

(ii) An election made under section 815(d)(1)(B) and subdivision (i) of this subparagraph shall be effective only with respect to the taxable year for which the election is made. Thus, the company must make a new election for each taxable year for which it desires the election to apply. Once such an election has been made for any taxable year it may not be revoked.

(3) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. For the taxable year 1960, the life insurance company taxable income of S, a stock life insurance company, computed without regard to section 802(b)(3), exceeds $25,000. Assume that S elects to subtract $20,000 from its policyholders surplus account under section 815(d)(1) for the taxable year. Since S is subject to a 52 percent tax rate, the tax on the amount elected to be subtracted from the policyholders surplus account (as of the close of the taxable year 1960) is $10,400 ($20,000×52 percent). Thus, the amount to be added to the shareholders surplus account as of January 1, 1961, is $9,600 (the amount subtracted from the policyholders surplus account by virtue of the section 815(d)(1) election, less the tax imposed upon such amount by reason of section 802(b)(3), or $20,000 minus $10,400).

(b) *Termination as life insurance company*—(1) *Effect of termination.* Except as provided in section 381(c)(22) (relating to carryovers in certain corporate readjustments), section 815(d)(2)(A) provides that if for any taxable year the taxpayer is not an insurance company (as defined in paragraph (a) of § 1.801–3), or if for any two successive taxable years the taxpayer is not a life insurance company (as defined in section 801(a) and paragraph (b) of § 1.801–3), the amount taken into account under section 802(b)(3) for the last preceding year for which the company was a life insurance company shall be increased (after the application of section 815(d)(2)(B)) by the entire balance in the policyholders surplus account at the close of such last preceding taxable year.

(2) *Effect of certain distributions.* If for any taxable year the taxpayer is an insurance company (as defined in paragraph (a) of § 1.801–3) but is not a life

insurance company (as defined in section 801(a) and paragraph (b) of §1.801–3), section 815(d)(2)(B) provides that any distribution to shareholders during such taxable year shall be treated as having been made on the last day of the last preceding taxable year for which the company was a life insurance company.

(3) *Examples.* The application of section 815(d)(2) and this paragraph may be illustrated by the following examples:

Example 1. At the end of the taxable year 1959, the balance in the policyholders surplus account of S, a life insurance company within the meaning of section 801(a) and paragraph (b) of §1.801–3, is $12,000. If S fails to qualify as an insurance company (as defined in paragraph (a) of §1.801–3) for the taxable year 1960, and section 381(c)(22) does not apply, under the provisions of section 815(d)(2)(A), the entire balance of $12,000 in the policyholders surplus account at the end of 1959, the last year S was a life insurance company, shall be taken into account under section 802(b)(3) for purposes of determining S's tax liability for the taxable year 1959.

Example 2. Assume the facts are the same as in example 1, except that for the taxable years 1960 and 1961, S qualifies as an insurance company (as defined in paragraph (a) of §1.801–3) but does not qualify as a life insurance company within the meaning of section 801(a) and paragraph (b) of §1.801–3. Assume further that as a result of a distribution by S to its shareholders in 1960, $4,800 (as determined under section 815(a) and without regard to section 815(c)(3)(B)) is treated as distributed out of the policyholders surplus account. Under the provisions of section 815(d)(2)(B), if section 381(c)(22) does not apply, any distribution to shareholders during the taxable years 1960 and 1961 shall be treated as having been made on December 31, 1959 (the last day of the last preceding taxable year for which S was a life insurance company). Thus, assuming S is subject to a 52 percent tax rate on additions to life insurance company taxable income, $10,000 ($4,800 plus $5,200, the tax on the portion of the distribution treated as made out of the policyholders surplus account) shall be treated as being subtracted from the policyholders surplus account at the end of 1959 and shall be taken into account under section 802(b)(3) for purposes of determining S's tax liability for the taxable year 1959. Under the provisions of section 815(d)(2)(A), the entire balance of $2,000 ($12,000 minus $10,000) in the policyholders surplus account at the end of 1959 (after the application of section 815(d)(2)(B)), shall also be taken into account under section 802(b)(3) for purposes of determining S's tax liability for the taxable year 1959.

(c) *Treatment of certain indebtedness.* Section 815(d)(3) provides that if a taxpayer makes any payment in discharge of its indebtedness and such indebtedness is attributable to a distribution by the taxpayer to its shareholders after February 9, 1959, the amount of such payment shall be treated as a distribution in cash to shareholders both for purposes of section 802(b)(3) and section 815. However, this paragraph shall only apply to the extent that the distribution of such indebtedness to shareholders was treated as being out of accounts other than the shareholders and policyholders surplus accounts at the time of distribution.

(d) *Limitation on amount in policyholders surplus account*—(1) *In general.* Section 815(d)(4) provides a limitation on the amount that any life insurance company may accumulate in its policyholders surplus account. If the policyholders surplus account at the end of any taxable year (computed without regard to this paragraph) exceeds whichever of the following is the greatest:

(i) 15 percent of life insurance reserves (as defined in section 801(b) and paragraph (a) of §1.801–4) at the end of the taxable year.

(ii) 25 percent of the amount by which the life insurance reserves at the end of the taxable year exceed the life insurance reserves at the end of 1958, or

(iii) 50 percent of the net amount of the premiums and other consideration taken into account for the taxable year under section 809(c)(1),

then such excess shall be treated as a subtraction from the policyholders surplus account as of the end of such taxable year. The amount so treated as subtracted, less the amount of tax imposed with respect to such amount by reason of section 802(b)(3), shall be added to the shareholders surplus account at the beginning of the succeeding taxable year.

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

Example. The books of S, a stock life insurance company, reflect the following items for the taxable year 1960:

Balance in policyholders surplus account, computed without regard to sec. 815(d)(4), as of 12–31–60	$175
Life insurance reserves (as defined in sec. 801(b)) as of 12–31–60	4,500
Life insurance reserves (as defined in sec. 801(b)) as of 12–31–58	3,900
Premiums and other consideration taken into account for the taxable year under sec. 809(c)(1)	310

In order to determine the limitations on the amount that it may accumulate in its policyholders surplus account at the end of the taxable year under section 815(d)(4), S would make up the following schedule:

(1) 15 percent of life insurance reserves at the end of the taxable year (15%×$4,500)	$675
(2) 25 percent of amount by which life insurance reserves at the end of the taxable year ($4,500) exceed life insurance reserves as of 12–31–58 ($3,900) (25%×$600)	150
(3) 50 percent of premiums and other consideration taken into account under sec. 809(c)(1) for the taxable year (50%×$310)	155
(4) Limitation on policyholders surplus account (the greatest of items (1), (2), or (3))	675

Since the balance in the policyholders surplus account at the end of the taxable year 1960, $175, does not exceed the limitation provided by section 815(d)(4), $675, S is not required to make any further adjustment to its policyholders surplus account at the end of the taxable year.

(e) *Special rule for certain mutualizations*—(1) *In general.* Section 815(e) provides a rule for determining priorities which shall operate in place of section 815(a) and paragraph (b) of § 1.815–2 where a life insurance company makes any distribution to its shareholders after December 31, 1958, in acquisition of stock pursuant to a plan of mutualization. Section 815(e)(1) provides that such a distribution shall first be treated as being made out of paid-in capital and paid-in surplus, and, to the extent thereof, no tax shall be imposed on the company with respect to such distribution. Thereafter, distributions made pursuant to such plan of mutualization shall be treated as made in two allocable parts. One part shall be treated as being made out of other accounts (as defined in § 1.815–5) and the company shall incur no tax with respect to such portion of the distribution. The other part shall be treated as a distribution to which section 815(a) and paragraph (b) of § 1.815–2 applies. Thus, such portion of the distribution shall be treated as first being made out of the shareholders surplus account (as defined in section 815(b) and § 1.815–3), to the extent thereof, and then out of the policyholders surplus account (as defined in section 815(c) and § 1.815–4), to the extent thereof. See paragraph (a) of § 1.815–2. For purposes of this paragraph, a distribution shall be considered as being made pursuant to a plan of mutualization only if the requirements of applicable State law for the adoption of such plan (as, for example, approval by the requisite majority of the board of directors, shareholders, and policyholders) have been fulfilled.

(2) *Allocation ratio.* Section 815(e)(2)(A) provides an allocation ratio which when applied to the amount distributed under a plan of mutualization in excess of the balance in the paid-in capital and paid-in surplus accounts determines the portion of such excess to be treated as distributed out of the shareholders surplus account, policyholders surplus account, or other accounts. The numerator of this ratio is the excess of the assets of the company (as defined in section 805(b)(4) and paragraph (a)(4) of § 1.805–5) over the total liabilities (including reserves), both determined as of December 31, 1958, and adjusted in the manner provided in subparagraph (3) of this paragraph. The denominator of this ratio is the amount included in the numerator plus the amounts in the shareholders surplus account and policyholders surplus account, all determined as of the beginning of the year of the distribution.

(3) *Adjustment for certain distributions.* Section 815(e)(2)(B) provides that if between 1958 and the year of distribution the taxpayer has been treated as having made a distribution (under a plan of mutualization or otherwise) which is treated as a return of paid-in capital and paid-in surplus or as out of other accounts (as defined in § 1.815–5), the aggregate amount of any such prior distributions must be subtracted from the numerator and denominator in all cases where the allocation ratio provided by subparagraph (2) of this paragraph applies.

(f) *Recomputation required as a result of a subsequent loss from operations under section 812*—(1) *In general.* Any amounts added to or subtracted from the special surplus accounts referred to in section 815(a) and paragraph (b) of

§ 1.815–2 for any taxable year shall be adjusted to the extent necessary to properly reflect a subsequent loss from operations which under section 812 is carried back to the taxable year for which such additions or subtractions were made.

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

Example. Assume that for the taxable years 1959 through 1961, the books of S, a stock life insurance company subject to a 30 percent tax rate for all taxable years involved, reflect the following items:

	1959	1960	1961
Taxable investment income	$40.00	$40.00	$40.00
Gain from operations	60.00	60.00	60.00
Tax base (sec. 802(b)(1) and (2))	50.00	50.00	50.00
Tax (sec. 802(b)(1) and (2) base)	15.00	15.00	15.00
Shareholders surplus account—			
At beginning of year	0	35.00	37.00
Added at beginning of year by reason of election under sec. 815(d)(1)	0	7.00	0
Added for year (without regard to election under sec. 815(d)(1))	35.00	35.00	35.00
Subtracted (distributions)	0	40.00	40.00
Policyholders surplus account—			
At beginning of year	0	0	10.00
Added for year	10.00	10.00	10.00
Subtracted (distributions)	0	0	0
Subtracted (by reason of election under sec. 815(d)(1))	10.00	0	0
Tax base (sec. 802(b)(3))	10.00	0	0
Tax (sec. 802(b)(3) base)	3.00	0	0

Assume further that S has a loss from operations for the taxable year 1962 of $25. Under the provisions of section 812, the $25 loss from operations would be carried back to the taxable year 1959 and would reduce the 1959 tax base under section 802(b)(1) and (2) to $35 ($60 minus $25). After adjustments reflecting the 1962 loss from operations, the results for the taxable years 1959 through the beginning of 1962 would be as follows:

	1959	1960	1961	1962
Taxable investment income	$40.00	$40.00	$40.00	....
Gain from operations	35.00	60.00	60.00	....
Tax base (sec. 802(b)(1) and (2))	35.00	50.00	50.00	....
Tax (sec. 802(b)(1) and (2) base)	10.50	15.00	15.00	....
Shareholders surplus account—				
At beginning of year	0	24.50	19.50	$14.50
Added for year (without regard to election under sec. 815(d)(1))	24.50	35.00	35.00	....
Added by reason of election under sec. 815(d)(1	0	0	0	....
Subtracted (distributions)	0	40.00	40.00	....
Policyholders surplus account—				
At beginning of year	0	0	10.00	20.00
Added for year	0	10.00	10.00	....
Subtracted (distributions)	0	0	0	....
Subtracted (by reason of election under sec. 815(d)(1))	0	0	0	....
Tax base (sec. 802(b)(3))	0	0	0	....
Tax (sec. 802(b)(3) base)	0	0	0	....

As a result of the loss from operations for 1962, the election under section 815(d)(1) for the taxable year 1959 has become inapplicable in its entirety since the balance in the policyholders surplus account at the end of 1959, as recomputed, is zero. Thus, S would be entitled to a total refund of $7.50 for the taxable year 1959. Of this amount, $4.50 is due to the recomputation of the section 802(b)(1) and (2) tax base and $3 to the amount of tax paid by reason of the election under section 815(d)(1).

[T.D. 6535, 26 FR 545, Jan. 20, 1961]

MISCELLANEOUS PROVISIONS

§ 1.817–1 Taxable years affected.

Except as otherwise provided therein, §§ 1.817–2 through 1.817–4 are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) and section 3 of the Act of October 23, 1962 (76 Stat. 1134).

[T.D. 6886, 31 FR 8689, June 23, 1966]

§ 1.817–2 Treatment of capital gains and losses.

(a) *In general.* For taxable years beginning after December 31, 1958, and before January 1, 1962, if the net long-term capital gain (as defined in section 1222(7)) of any life insurance company exceeds its net short-term capital loss (as defined in section 1222(6)), section 802(a)(2) prior to its amendment by section 3 of the Act of October 23, 1962 (76 Stat. 1134), imposes a separate tax equal to 25 percent of such excess. For taxable years beginning after December 31, 1961, if the net long-term capital gain of any life insurance company exceeds its net short-term capital loss, section 802(a)(2) imposes an alternative tax in lieu of the tax imposed by section 802(a)(1), if and only if such alternative tax is less than the tax imposed by section 802(a)(1). Except as modified by section 817 (rules relating to certain gains and losses), the general rules of the Code relating to gains and losses, such as subchapter O (relating to gain or loss on disposition of property), subchapter P (relating to capital gains and losses), etc., shall apply with respect to life insurance companies.

(b) *Modification of section 1221 and 1231.* (1) In the case of a life insurance company, section 817(a)(1) provides that for purposes of applying section 1231(a) (relating to property used in the trade or business and involuntary conversions), the term *property used in the trade or business* shall be treated as including only:

(i) Property used in carrying on an insurance business, of a character subject to the allowance for depreciation under section 167 (even though fully depreciated), held for more than 1 year (6 months for taxable years beginning before 1977; 9 months taxable years beginning in 1977), and real property used in carrying on an insurance business, held for more than 1 year (6 months for taxable years beginning before 1977; 9 months taxable years beginning in 1977), and which is not:

(a) Property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year;

(b) Property held by the taxpayer primarily for sale to customers in the ordinary course of business; or

(c) A copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property held by a taxpayer described in section 1221(3). In the case of a letter, memorandum, or property similar to a letter or memorandum, this subdivision *(c)* applies only to sales and other dispositions occurring after July 25, 1969.

(ii) The cutting or disposal of timber, or the disposal of coal or iron ore, to the extent considered arising from a sale or exchange by reason of the provisions of section 631 and the regulations thereunder.

(2) In the case of a life insurance company, section 817(a)(2) provides that for purposes of applying section 1221(2) (relating to the exclusion of certain property from the term capital asset), the reference to property used in trade or business shall be treated as including only property used in carrying on an insurance business.

(3) Section 1231(a), as modified by section 817(a)(1) and subparagraph (1) of this paragraph, shall apply to recognized gains and losses from the following:

(i) The sale, exchange, or involuntary conversion of the following property, if held for more than 1 year (6 months for taxable years beginning before 1977; 9 months taxable years beginning in 1977):

(a) The home office and branch office buildings (including land) owned and occupied by the life insurance company;

(b) Furniture and equipment owned by the life insurance company and used in the home office and branch office buildings occupied by the life insurance company; and

(c) Automobiles and other depreciable personal property used in connection with the operations conducted in the home office and branch office buildings occupied by the life insurance company.

(ii) The involuntary conversion of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months taxable years beginning in 1977).

(iii) The cutting or disposal of timber, or the disposal of coal or iron ore, to the extent considered arising from a sale or exchange by reason of the provisions of section 631 and the regulations thereunder.

(4) Section 1221(2), as modified by section 817(a)(2) and subparagraph (2) of

this paragraph, shall include only the following property;

(i) The home office and branch office buildings (including land) owned and occupied by the life insurance company;

(ii) Furniture and equipment owned by the life insurance company and used in the home office and branch office buildings occupied by the life insurance company; and

(iii) Automobiles and other depreciable personal property used in connection with the operations conducted in the home office and branch office buildings occupied by the life insurance company.

(5) If an asset described in subparagraph (3) (i)(*a*), (*b*), or (*c*) or subparagraph (4) of this paragraph, or any portion thereof, is also an ''investment asset'' (an asset from which gross investment income, as defined in section 804(b), is derived), such asset, or portion thereof, shall not be treated as an asset used in carrying on an insurance business. Accordingly, the gains or losses from the sale or exchange (or considered as from the sale or exchange) of depreciable assets attributable to any trade or business, other than the insurance trade or business, carried on by the life insurance company, such as operating a radio station, housing development, or a farm, or renting various pieces of real estate shall be treated as gains or losses from the sale or exchange of a capital asset unless such asset is involuntarily converted (within the meaning of paragraph (e) of §1.123–1).

(c) *Illustration of principles.* The provisions of section 817(a) and this section may be illustrated by the following examples:

Example 1. L, a life insurance company, has recognized gains and losses for the taxable year 1959 from the sale or involuntary conversion of the following items:

	Gains	*Losses*
Stocks, held for more than 6 months	$100,000	....
Bonds, held for more than 6 months	....	$5,000
Housing development, held for more than 6 months	....	400,000
Branch office building owned and occupied by L, held for more than 6 months	....	115,000
Furniture and equipment used in the investment department, held for more than 6 months	30,000	....
Radio station, held for more than 6 months	200,000	....
Involuntary conversion of apartment building, held for more than 6 months	7,000	....

The recognized gains and losses from the sale of the stocks, bonds, housing development, and radio station shall be treated as gains and losses from the sale of capital assets since such items are capital assets within the meaning of section 1221 (as modified by section 817(a)(2)). Accordingly, the provisions of section 1231 shall not apply to the sale of such capital assets. However, the provisions of section 1231 (as modified by section 817(a)(1)) shall apply to the sale of the branch office building and the furniture and equipment, and the apartment building involuntarily converted. Since the aggregate of the recognized losses ($115,000) exceeds the aggregate of the recognized gains ($37,000), the gains and losses are treated as ordinary gains and losses.

Example 2. Y, a life insurance company, owns a twenty-story home office building, having an adjusted basis of $15,000,000, ten floors of which it rents to various tenants, one floor of which is utilized by it in operating its investment department, and the remaining nine floors of which are occupied by it in carrying on its insurance business. If in 1960, Y sells the building for $10,000,000, Y must first apportion its basis between that portion of the building (one-half) used in carrying on an insurance business, and that portion of the building (one-half) classified as an ''investment asset'', before it can determine the character of the loss attributable to each portion of the building. For such purpose, the one floor utilized by Y in operating its investment department is treated as used in carrying on an insurance business. Assuming that each portion of the building bears an equal (one-half) relation to the basis of the entire building, Y (without regard to section 817(b)) would have a $2,500,000 ordinary loss on that portion used in carrying on an insurance business (assuming that Y had no gains subject to section 1231), and a $2,500,000 capital loss on that portion of the building classified as an investment asset.

[T.D. 6558, 26 FR 2782, Apr. 4, 1961, as amended by T.D. 6841, 30 FR 9308, July 27, 1965; T.D. 6886, 31 FR 8689, June 23, 1966; T.D. 7369, 40 FR 29840, July 16, 1975; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.817–3 Gain on property held on December 31, 1958, and certain substituted property acquired after 1958.

(a) *Limitation on gain recognized on property held on December 31, 1958.* (1) Section 817(b)(1) limits the amount of gain that shall be recognized on the sale or other disposition of property other than insurance and annuity contracts (and contracts supplementary thereto) and property described in section 1221(1) (relating to stock in trade or inventory-type property) if:

(i) The property was held (or treated as held within the meaning of paragraph (c)(1) of this section) by a life insurance company on December 31, 1958;

(ii) The taxpayer has been a life insurance company at all times on and after December 31, 1958, including the date of the sale or other disposition of the property; and

(iii) The fair market value of the property on December 31, 1958, exceeds the adjusted basis for determining gain as of such date.

The gain on the sale or other disposition of such property shall be limited to an amount (but not less than zero) equal to the amount by which the gain (determined without regard to section 817(b)(1)) exceeds the difference between fair market value of such property on December 31, 1958, and the adjusted basis for determining gain as of such date. Accordingly, the tax imposed under section 802(a) shall apply with respect to the amount of gain so limited. In addition, in the case of a stock life insurance company, the amount of such gain shall be taken into account under section 815(b)(2)(A)(ii) for purposes of determining the amount to be added to the shareholders surplus account (as defined in section 815(b) and § 1.815–3) for the taxable year. Furthermore, the amount of the gain (determined without regard to section 817(b)(1) and this paragraph) which is not taken into account under section 802(a) and under paragraph (f) of § 1.802–3 by reason of the application of section 817(b)(1) shall be included in other accounts (as defined in § 1.815–5) by such a company for the taxable year.

(2) Section 817(b)(1) and subparagraph (1) of this paragraph shall not apply for purposes of determining loss with respect to property held on December 31, 1958.

(b) *Illustration of principles.* The application of section 817(b)(1) and paragraph (a) of this section may be illustrated by the following examples:

Example 1. On December 31, 1958, J, a stock life insurance company, owned stock of Z Corporation and on such date the stock had an adjusted basis for determining gain of $5,000 and a fair market value of $6,000. On August 1, 1959, the company sells such stock for $8,000. Assuming J qualifies as a life insurance company for the taxable year 1959, and applying the provisions of section 817(b)(1) and paragraph (a) of this section, the gain recognized (assuming no adjustment to basis for the period since December 31, 1958) on the sale shall be limited to $2,000 (the amount by which the gain realized, $3,000, exceeds the difference, $1,000, between the fair market value, $6,000, and the adjusted basis, $5,000, for determining gain on December 31, 1958). Thus, J shall take into account $2,000 under section 815(b)(2)(A)(ii) for purposes of determining the amount to be added to its shareholders surplus account for the taxable year and shall include $1,000 in other accounts for the taxable year.

Example 2. The facts are the same as in example 1, except that the selling price is $5,800. In such case, no gain shall be recognized even though there is a realized gain of $800 since such realized gain does not exceed the difference ($1,000) between the fair market value ($6,000) and the adjusted basis ($5,000) for determining gain on December 31, 1958. Furthermore, no loss shall be realized or recognized as a result of this transaction. Thus, J shall include $800 in other accounts for the taxable year and shall not take into account any amount under section 815(b)(2)(A)(ii).

Example 3. The facts are the same as in example 1, except that the adjusted basis for determining loss is $5,000 and the selling price is $4,500. In such case, since J has sustained a loss, section 817(b)(1) does not apply.

(c) *Certain substituted property acquired after December 31, 1958.* Section 817(b)(2) provides that if a life insurance company acquires property after December 31, 1958, in exchange for property actually held by the company on December 31, 1958, and the property acquired has a substituted basis within the meaning of section 1016(b) and § 1.1016–10, the following rules shall apply:

(1) For purposes of section 817(b)(1), such acquired property shall be deemed as having been held continuously by

the taxpayer since the beginning of the holding period thereof as determined under section 1223;

(2) The fair market value and adjusted basis referred to in section 817(b)(1) shall be that of that property for which the holding period taken into account includes December 31, 1958;

(3) Section 817(b)(1) shall apply only if the property or properties, the holding periods of which are taken into account, were held only by life insurance companies after December 31, 1958, during the holding periods so taken into account;

(4) The difference between the fair market value and adjusted basis referred to in section 817(b)(1) shall be reduced (but not below zero) by the excess of (i) the gain that would have been recognized but for section 817(b) on all prior sales or other dispositions after December 31, 1958, of properties referred to in section 817(b)(2)(C) over (ii) the gain that was recognized on such sales or other dispositions; and

(5) The basis of such acquired property shall be determined as if the gain which would have been recognized but for section 817(b) were recognized gain.

For purposes of section 817(b)(2) and this paragraph, the term *property* does not include insurance and annuity contracts (and contracts supplementary thereto) and property described in section 1221(1) (relating to stock in trade or inventory-type property). Furthermore, the provisions of section 817(b)(1) and paragraph (a)(1) of this section shall not apply for purposes of determining loss with respect to property described in section 817(b)(2) and this paragraph.

(d) *Illustration of principles.* The application of section 817(b)(2) and paragraph (c) of this section may be illustrated by the following example:

Example. Assume that W, a life insurance company, owns property B on December 31, 1958, at which time its adjusted basis was $1,000 and its fair market value was $1,800. On January 31, 1960, in a transaction to which section 1031 (relating to exchange of property held for productive use or investment) applies, W receives property H having a fair market value of $1,700 plus $300 in cash in exchange for property B. The gain realized on the transaction, without regard to section 817(b) is $1,000 (assuming no adjustments to basis for the period since December 31, 1958). Under the provisions of section 817(b)(1) the gain is limited to $200. The entire $200 shall be recognized since such amount is less than the amount of gain ($300) which would be recognized under section 1031. Applying the provisions of section 817(b)(2) and paragraph (c) of this section, the basis of property H shall be determined as if the entire $300 of cash received is recognized gain. Thus, the basis of property H under section 1031 is $1,000 ($1,000 (the basis of property B) minus $300 (the amount of money received) plus $300 (the recognized gain of $200 plus $100 which would have been recognized but for section 817(b)). If W later sells property H for $2,200 cash, and assuming no further adjustments to its basis of $1,000, the gain realized is $1,200, but due to the application of section 817(b)(2) the amount of gain recognized is $500, computed as follows:

Selling price		$2,200
Less: Adjusted basis as of date of sale		1,000
Gain realized		1,200
Fair market value as of 12–31–58	$1,800	
Adjusted basis as of 12–31–58	1,000	
Excess of fair market value over adjusted basis	800	
Less: Excess of gain which would have been recognized on all prior dispositions but for sec. 817(b) over gain recognized on all prior dispositions ($300 minus $200)	100	
		$700
Gain recognized	500	

[T.D. 6558, 26 FR 2783, Apr. 4, 1961, as amended by T.D. 6886, 31 FR 8689, June 23, 1966]

§ 1.817–4 Special rules.

(a) *Limitation on capital loss carryovers.* Section 817(c) provides that a net capital loss (as defined in section 1222(10)) for any taxable year beginning before January 1, 1959, shall not be taken into account. For any taxable year beginning after December 31, 1958, the provisions of part II, subchapter P, chapter 1 of the Code (relating to the treatment of capital losses) shall be applicable to life insurance companies for purposes of determining the tax imposed by section 802(a) and § 1.802–3 (relating to the imposition of tax in case of capital gains).

(b) *Gain on transactions occurring prior to January 1, 1959.* For purposes of part I, subchapter L, chapter 1 of the Code, section 817(d) provides that:

(1) There shall be excluded from tax any gain from the sale or exchange of a capital asset, and any gain considered as gain from sale or exchange of a

capital asset, which results from sales or other dispositions of property prior to January 1, 1959; and

(2) Any gain after December 31, 1958, resulting from the sale or other disposition of property prior to January 1, 1959, which, but for this subparagraph would be taken into account under section 1231, shall not be taken into account under section 1231.

For example, if a life insurance company makes an installment sale of a capital asset prior to January 1, 1959, and payments are received after such date, any capital gain attributable to such sale shall not be taken into account for purposes of section 802(a). Furthermore, any gain referred to in subparagraphs (1) and (2) and the preceding sentence shall not be taken into account in determining the excess of the net short-term capital gain over the net long-term capital loss (and for taxable years beginning after December 31, 1961, the excess of the net long-term capital gain over the net short-term capital loss) for purposes of computing taxable investment income under section 804(a)(2) or gain or loss from operations under section 809(b).

(c) *Certain reinsurance transactions in 1958.* For purposes of part I, section 817(e) provides that where a life insurance company reinsures (or sells) all of its insurance contracts of a particular type, such as an entire industrial department, in either a single transaction, or in a series of related transactions, all of which occurred during 1958, and the reinsuring (or purchasing) company or companies assume all liabilities under such contracts, such reinsurance (or sale) shall be treated as the sale of a capital asset. However, such transaction shall be subject to the provisions of section 806(a) and § 1.806–3 (relating to adjustments for certain changes in reserves and assets).

(d) *Certain other reinsurance transactions.* (1) For any taxable year beginning after December 31, 1958, the reinsurance of all or a part of the insurance contracts of a particular type by a life insurance company, in either a single transaction, or in a series of related transactions, occurring in any such taxable year, whereby the reinsuring company or companies assume all liabilities under such contracts, shall not be treated as the sale or exchange of a capital asset but shall be subject to the provisions of section 806(a) and 809 and the regulations thereunder. However, if in connection with a transaction described in the preceding sentence the reinsured or reinsurer transfers an asset which is a capital asset within the meaning of section 1221 (as modified by section 817(a)(2)), such transfer shall be treated as the sale or exchange of a capital asset by the transferor.

(2)(i) The consideration paid by the reinsured to the reinsurer in connection with a transaction described in subparagraph (1) of this paragraph shall be treated as an item of deduction under section 809(d)(7). However any amount received by the reinsured from the reinsurer shall be applied against and reduce (but not below zero) the amount of such consideration, and to the extent that it exceeds such consideration, shall be treated as an item of gross amount under section 809(c)(3).

(ii) In connection with an assumption reinsurance (as defined in paragraph (a)(7)(ii) of § 1.809–5) transaction, a reinsurer shall in any taxable year beginning after December 31, 1957:

(A) Treat the consideration received from the reinsured in any such taxable year as an item of gross amount under section 809(c)(1), and

(B) Treat any amount paid to the reinsured for the purchase of such contracts, to the extent such amount meets the requirements of section 162, as a deferred expense that may be amortized over the reasonably estimated life (as defined in paragraph (d)(2)(iv) of this section) of the contracts reinsured and treat the portion of the expense so amortized in each taxable year as a deduction under section 809(d)(12) irrespective of the taxable year in which such amount was paid to the reinsured.

(iii) For purposes of paragraph (d)(2)(ii) of this section where the reinsured transfers to the reinsurer in connection with the assumption reinsurance transaction a net amount which is less than the increase in the reinsurer's reserves resulting from the transaction, the reinsurer shall be treated as:

(A) Having received from the reinsured consideration in an amount equal to the net amount of the increase in the reinsurer's reserves resulting from the transaction, and

(B) Having paid the reinsured an amount for the purchase of the contracts equal to the excess of the amount of such increase in the reinsurer's reserves over the net amount received from the reinsured.

(iv) For purposes of this subparagraph, the term *reasonably estimated life* means the period during which the contract reinsured remains in force. Such period shall be based on the facts in each case (such as age, health, and sex of the insured, type of contract reinsured, etc.) and the assuming company's experience (such as mortality, lapse rate, etc.) with similar risks.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example 1. On June 30, 1959, X, a life insurance company, reinsured a portion of its insurance contracts with Y, a life insurance company, under an agreement whereby Y agreed to assume and to become solely liable under the contracts reinsured. The reserves on the contracts reinsured by X were $100,000. Under the reinsurance agreement X agreed to pay Y $100,000 for assuming such contracts and Y agreed to pay X $17,000 for the right to receive future premium payments under this block of contracts. Rather than exchange payments of money, X agreed to pay Y a net amount of $83,000 in cash. Assuming that the reasonably estimated life of the contracts reinsured is 17 years, that there are no other insurance transactions by X or Y during the taxable year, and assuming that X and Y compute the reserves on the contracts reinsured on the same basis, X has income of $100,000 under section 809(c)(2) as a result of the net decrease in its reserves. X has a net deduction of $83,000 ($100,000−$17,000) under section 809(d)(7). For the taxable year 1959, Y has income of $100,000 under section 809(c)(1) as a result of the consideration received from X and a deduction of $100,000 under section 809(d)(2) for the net increase in reserves and $1,000 ($17,000 divided by 17, the reasonably estimated life of the contracts reinsured), under section 809(d)(12). The remaining $16,000 shall be amortized over the next 16 succeeding taxable years (16×$1,000=$16,000) under section 809(d)(12) at the rate of $1,000 for each such taxable year.

Example 2. The facts are the same as in example 1, except X agreed to pay Y a consideration of $100,000 in cash for assuming these contracts and Y paid X a bonus of $17,000 in cash and that this bonus meets the requirements of section 162. Assuming that the reasonably estimated life of the contracts reinsured is 17 years, X has income of $100,000 under section 809(c)(2) as a result of this net decrease in its reserves and a deduction of $83,000 under section 809(d)(7) for the amount of the consideration ($100,000) paid to Y for assuming these contracts, reduced by the bonus ($17,000) received from Y. For the taxable year 1959, Y has income of $100,000 under section 809(c)(1) as a result of the consideration received from X and deductions of $100,000 under section 809(d)(2) for the net increase in reserves and $1,000 (the bonus of $17,000 divided by 17, the reasonably estimated life of the contracts reinsured), under section 809(d)(12). The remaining amount of the bonus ($16,000) shall be amortized over the next 16 succeeding taxable years (16×$1,000=$16,000) under section 809(d)(12) at the rate of $1,000 for each such taxable year.

Example 3. The facts are the same as in Example 1, except that the reinsurance agreement does not specifically provide that X agreed to pay Y $100,000 for assuming the contracts reinsured and Y agreed to pay X $17,000 for the right to receive future premium payments under such contracts. Instead, X agreed to pay Y a net amount of $83,000 in cash for assuming such contracts. Nevertheless, Y is treated as having received from X consideration equal to $100,000, the amount of the increase in Y's reserves, and as having paid $17,000 ($100,000 less $83,000) for the purchase of such contracts. Therefore, for the taxable year 1959, Y has income of $100,000 under section 809(c)(1). Y also has a deduction of $100,000 under section 809(d)(2) for the net increase in its reserves and an amortization deduction under section 809(d)(12) of $1,000 ($17,000 divided by 17, the reasonably estimated life of the contracts reinsured). The remaining $16,000 shall be amortized by Y over the next 16 succeeding years at the rate of $1,000 for each such year. For 1959, X has income of $100,000 under section 809(c)(2) as a result of the net decrease in its reserves and a deduction of $83,000 under section 809(d)(7) for the net amount of consideration paid to Y for assuming the contracts reinsured.

Example 4. The facts are the same as in example 1, except that X agreed to pay Y a consideration of $130,000 in cash for assuming such contracts. Based upon these facts, X has income of $100,000 under section 809(c)(2) as a result of this net decrease in its reserves and a deduction of $130,000 under section 809(d)(7) for the amount of the consideration paid to Y for assuming these contracts. Y has income of $130,000 under section 809(c)(1) as a result of the consideration received from X and a deduction of $100,000 under section 809(d)(2) for the net increase in its reserves.

Example 5. On August 1, 1960, R, a life insurance company, reinsured all of its insurance policies with S, a life insurance company, under an agreement whereby S agreed to assume and become solely liable under the contracts reinsured. The reserves on the contracts reinsured by R were $3,000,000. Under the reinsurance agreement, R agreed to pay S a consideration of $3,000,000 in stocks and bonds for assuming such contracts. Assuming no other insurance transactions by R or S during the taxable year, that R and S compute the reserves on the contracts reinsured on the same basis, and that R has a recognized gain (after the application of the limitation of section 817(b)(1)) of $20,000 due to appreciation in value of the assets transferred, the results to each company are as follows:

Company R (reinsured)	
Net decrease in reserves (sec. 809(c) (2))	$3,000,000
Capital gain (as limited by sec. 817(b) (1)) to be taxed separately under sec. 802(a)(2)	20,000
Consideration paid by R to S in respect of S's assuming liabilities under contracts issued by R (sec. 809(d)(7))	$3,000,000
INCOME	
Company S (reinsurer)	
Consideration received by S in respect of assuming liabilities under contracts issued by R (sec. 809(c)(1))	$3,000,000
DEDUCTIONS	
Net increase in reserves (sec.809(d)(2))	$3,000,000

[T.D. 6558, 26 FR 2783, Apr. 4, 1961, as amended by T.D. 6625, 27 FR 12543, Dec. 19, 1962; T.D. 6886, 31 FR 8689, June 23, 1966; T.D. 41 FR 5100, Feb. 4, 1976]

§ 1.817–5 Diversification requirements for variable annuity, endowment, and life insurance contracts.

(a) *Consequences of nondiversification*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, for purposes of subchapter L, section 72, and section 7702(a), a variable contract (as defined in section 817(d)), other than a pension plan contract (as defined in section 818(a)), which is based on one or more segregated asset accounts shall not be treated as an annuity, endowment, or life insurance contract for any calendar quarter period for which the investments of any such account are not adequately diversified. For this purpose, a variable contract shall be treated as based on a segregated asset account for a calendar quarter period if amounts received under the contract (or earnings thereon) are allocated to the segregated asset account at any time during the period. In addition, a variable contract that is not treated as an annuity, endowment, or life insurance contract for any period by reason of this paragraph (a)(1) shall not be treated as an annuity, endowment, or life insurance contract for any subsequent period even if the investments are adequately diversified for such subsequent period. If a variable contract which is a life insurance or endowment contract under other applicable (e.g., State or foreign) law is not treated as a life insurance or endowment contract under section 7702(a), the income on the contract for any taxable year of the policyholder is treated as ordinary income received or accrued by the policyholder during such year in accordance with section 7702 (g) and (h). Likewise, if a variable contract is not treated as an annuity contract under section 72, the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year in the same manner as a life insurance or endowment contract under section 7702 (g) and (h).

(2) *Inadvertent failure to diversify.* The investments of a segregated asset account shall be treated as satisfying the requirements of paragraph (b) of this section for one or more periods, provided the following conditions are satisfied—

(i) The issuer or holder must show the Commissioner that the failure of the investments to satisfy the requirements of paragraph (b) of this section for such period or periods was inadvertent,

(ii) The investments of the account must satisfy the requirements of paragraph (b) of this section within a reasonable time after the discovery of such failure, and

(iii) The issuer or holder of the variable contract must agree to make such adjustments or pay such amounts as may be required by the Commissioner with respect to the period or periods during which the investments of the account did not satisfy the requirements of paragraph (b) of this section. The amount required by the Commissioner to be paid shall be an amount based upon the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract (as defined in section

7702(g)(1)(B), without regard to section 7702(g)(1)(C)) for such period or periods.

(b) *Diversification of investments*—(1) *In general.* (i) Except as otherwise provided in this paragraph and paragraph (c) of this section, the investments of a segregated asset account shall be considered adequately diversified for purposes of this section and section 817(h) only if—

(A) No more than 55% of the value of the total assets of the account is represented by any one investment;

(B) No more than 70% of the value of the total assets of the account is represented by any two investments;

(C) No more than 80% of the value of the total assets of the account is represented by any three investments; and

(D) No more than 90% of the value of the total assets of the account is represented by any four investments.

(ii) For purposes of this section—

(A) All securities of the same issuer, all interests in the same real property project, and all interests in the same commodity are each treated as a single investment; and

(B) In the case of government securities, each government agency or instrumentality shall be treated as a separate issuer.

(iii) See paragraph (f) of this section for circumstances in which a segregated asset account is treated as the owner of assets held indirectly through certain pass-through entities and corporations taxed under subchapter M, chapter 1 of the Code.

(2) *Safe harbor.* A segregated asset account will be considered adequately diversified for purposes of this section and section 817(h) if—

(i) The account meets the requirements of section 851 (b)(4) and the regulations thereunder; and

(ii) No more than 55% of the value of the total assets of the account is attributable to cash, cash items (including receivables), government securities, and securities of other regulated investment companies.

(3) *Alternative diversification requirements for variable life insurance contracts.* (i) A segregated asset account with respect to variable life insurance contracts will be considered adequately diversified for purposes of this section and section 817(h) if the requirements of paragraph (b)(1) or (b)(2) of this section are satisfied or if the assets of such account, other than Treasury securities, satisfy the percentage limitations prescribed in paragraph (b)(1) of this section increased by the product of (A) .5 and (B) the percentage of the value of the total assets of the account that is represented by Treasury securities. In determining whether the assets of an account, other than Treasury securities, satisfy the increased percentage limitations, such limitations are applied as if the Treasury securities were not included in the account (*i.e.*, the increased percentage limitations are not applied to Treasury securities and the value of the total assets of the account is reduced by the value of the Treasury securities).

(ii) The provisions of this paragraph (b)(3) may be illustrated by the following examples:

Example 1. On the last day of a quarter of a calendar year, a segregated asset account with respect to variable life insurance contracts holds assets having a total value of $100,000. The assets of the account are represented by Treasury securities having a total value of $90,000 and securities of Corporation A having a total value of $10,000. The 55% limit described in paragraph (b)(1)(i) of this section would be increased by 45% (0.5×90%) to 100%, and would then be applied to the assets of the account other than Treasury securities. Because no more than 100% of the value of the assets other than Treasury securities is represented by securities of Corporation A, the investments of the account will be considered adequately diversified.

Example 2. On the last day of a quarter of a calendar year, a segregated asset account with respect to variable life insurance contracts holds assets having a total value of $100,000. The assets of the account are represented by Treasury securities having a total value of $60,000, securities of Corporation A having a total value of $30,000, and securities of Corporation B having a total value of $10,000. The 55% and 70% limits described in paragraph (b)(1)(i) of this section would be increased by 30% (0.5×60%) to 85% and 100%, respectively, and would then be applied to the assets of the account other than Treasury securities. Securities of Corporation A represent 75%, and securities of Corporation B represent 25%, of the value of the assets of the account other than Treasury securities. Because no more than 85% of the value of the assets other than Treasury securities is represented by securities of Corporation A or B and no more than 100% of the value of the assets other than Treasury securities is represented by securities of Corporations A and B, the investments of the account will be considered adequately diversified.

(c) *Periods for which an account is adequately diversified*—(1) *In general.* A segregated asset account that satisfies the requirements of paragraph (b) of this section on the last day of a quarter of a calendar year (*i.e.,* March 31, June 30, September 30, and December 31) or within 30 days after such last day shall be considered adequately diversified for such quarter.

(2) *Start-up period.* (i) Except as provided in paragraph (c)(2)(iv) of this section, a segregated asset account that is not a real property account on its first anniversary shall be considered adequately diversified until such first anniversary.

(ii) Except as provided in paragraph (c)(2)(iv) of this section, a segregated asset account that is a real property account on its first anniversary shall be considered adequately diversified until the earlier of its fifth anniversary or the anniversary on which the account ceases to be a real property account.

(iii) For purposes of paragraph (c)(2) (i) and (ii) of this section, the anniversary of a segregated asset account is the anniversary of the date on which any amount received under a life insurance or annuity contract, other than a pension plan contract (as defined in section 818 (a)), is first allocated to the account.

(iv) If more than 30 percent of the amount allocated to a segregated asset account as of the last day of a calendar quarter is attributable to contracts entered into more than one year before such date, paragraph (c)(2)(i) of this section shall not apply to the segregated asset account for any period after such date. Similarly, if more than 30 percent of the amount allocated to a segregated asset account as of the last day of a calendar quarter is attributable to contracts entered into more than 5 years before such date, paragraph (c)(2)(ii) of this section shall not apply to the segregated asset account for any period after such date. For purposes of this paragraph (c)(2), amounts transferred to the account from a diversified account (determined without regard to this paragraph (c)(2)) or as a result of an exchange pursuant to section 1035 in which the issuer of the contract received in the exchange is not related in a manner specified in section 267(b) to the issuer of the contract transferred in the exchange are not treated as—

(A) Amounts attributable to contracts entered into more than one year before such date, in the case of accounts subject to paragraph (c)(2)(i) of this section, or

(B) Amounts attributable to contracts entered into more than five years before such date, in the case of accounts subject to paragraph (c)(2)(ii) of this section.

(3) *Liquidation period.* A segregated asset account that satisfies the requirements of paragraph (b) of this section on the date a plan of liquidation is adopted shall be considered adequately diversified for—

(i) The one-year period beginning on the date the plan of liquidation is adopted if the account is not a real property account on such date; or

(ii) The two-year period beginning on the date the plan of liquidation is adopted if the account is a real property account on such date.

(d) *Market fluctuations.* A segregated asset account that satisfies the requirements of paragraph (b) of this section at the end of any calendar quarter (or within 30 days after the end of such calendar quarter) shall not be considered nondiversified in a subsequent quarter because of a discrepancy between the value of its assets and the diversification requirements unless such discrepancy exists immediately after the acquisition of any asset and such discrepancy is wholly or partly the result of such acquisition.

(e) *Segregated asset account.* For purposes of section 817(h) and this section, a segregated asset account shall consist of all assets the investment return and market value of each of which must be allocated in an identical manner to any variable contract invested in any of such assets. See paragraph (g) for examples illustrating the application of this paragraph (e).

(f) *Look-through rule for assets held through certain investment companies, partnerships, or trusts*—(1) *In general.* If this paragraph (f) applies, a beneficial interest in a regulated investment company, a real estate investment trust, a partnership, or a trust that is treated under sections 671 through 679 as owned by the grantor or another person (''investment company, partnership, or trust'') shall not be treated as a single investment of a segregated asset account. Instead, a pro rata portion of each asset of the investment company, partnership, or trust shall be treated, for purposes of this section, as an asset of the segregated asset account. For purposes of this section, the ratable interest of a partner in a partnership's assets shall be determined in accordance with the partner's capital interest in the partnership.

(2) *Applicability*—(i) *Certain investment companies, partnerships, and trusts.* This paragraph (f) shall apply to an investment company, partnership, or trust if—

(A) All the beneficial interests in the investment company, partnership, or trust (other than those described in paragraph (f)(3) of this section) are held by one or more segregated asset accounts of one or more insurance companies; and

(B) Public access to such investment company, partnership, or trust is available exclusively (except as otherwise permitted in paragraph (f)(3) of this section) through the purchase of a variable contract. Solely for this purpose, the status of a contract as a variable contract will be determined without regard to section 817(h) and this section.

(ii) *Nonregistered partnerships.* This paragraph (f) shall also apply to a partnership interest if the partnership interest is not registered under a Federal or State law regulating the offering or sale of securities.

(iii) *Trusts holding Treasury securities.* This paragraph (f) shall also apply to a trust that is treated under section 671 through 679 as owned by the grantor or another person if substantially all of the assets of the trust are represented by Treasury securities.

(3) *Interests not held by segregated asset accounts.* Satisfaction of the requirements of paragraph (f)(2)(i) of this section shall not be prevented by reason of beneficial interests in the investment company, partnership, or trust that are—

(i) Held by the general account of a life insurance company or a corporation related in a manner specified in section 267(b) to a life insurance company, but only if the return on such interests is computed in the same manner as the return on an interest held by a segregated asset account is computed (determined without regard to expenses attributable to variable contracts), there is no intent to sell such interests to the public, and a segregated asset account of such life insurance company also holds or will hold a beneficial interest in the investment company, partnership, or trust;

(ii) Held by the manager, or a corporation related in a manner specified in section 267(b) to the manager, of the investment company, partnership, or trust, but only if the holding of the interests is in connection with the creation or management of the investment company, partnership, or trust, the return on such interest is computed in the same manner as the return on an interest held by a segregated asset account is computed (determined without regard to expenses attributable to variable contracts), and there is no intent to sell such interests to the public;

(iii) Held by the trustee of a qualified pension or retirement plan; or

(iv) Held by the public, or treated as owned by policyholders pursuant to Rev. Rul. 81–225, 1981–2 C.B. 12, but only if (A) the investment company, partnership, or trust was closed to the public in accordance with Rev. Rul. 82–55, 1982–1 C.B. 12, or (B) all the assets of the segregated asset account are attributable to premium payments made by policyholders prior to September 26, 1981, to premium payments made in connection with a qualified pension or retirement plan, or to any combination of such premium payments.

(g) *Examples.* The provisions of paragraphs (e) and (f) of this section may be illustrated by the following examples.

Example 1. (i) The assets underlying variable contracts issued by a life insurance company consist of two groups of assets: (a) a diversified portfolio of debt securities and

(b) interests in P, a partnership that is publicly registered. All of the beneficial interests in P are held by one or more segregated asset accounts of one or more insurance companies and public access to P is available exclusively through the purchase of a variable contract. The variable contracts provide that policyholders may specify which portion of each premium is to be invested in the debt securities and which portion is to be invested in P interests. The portfolio of debt securities and the assets of P, considered separately, each satisfy the diversification requirements of paragraph (b) of this section.

(ii) As a result of the ability of policyholders to allocate premiums among the two groups of assets, the investment return and market value of the interests in P and the debt securities may be allocated to different variable contracts in a non-identical manner. Accordingly, under paragraph (e) of this section, the interests in P are treated as part of a single segregated asset account (''Account 1'') and the debt securities are treated as part of a different segregated asset account (''Account 2'').

(iii) Since P is described in paragraph (f)(2)(i) of this section, interests in P will not be treated as a single investment of Account 1. Rather, Account 1 is treated as owning a pro rata portion of the assets of P.

(iv) Since Account 1 and Account 2 each satisfy the requirements of paragraph (b) of this section, variable contracts that are based on either or both accounts are treated as annuity, endowment, or life insurance contracts.

Example 2. The facts are the same as in example 1 except that some of the beneficial interests in P are held by persons not described in paragraph (f)(3) of this section. Since P is not described in paragraph (f)(2) of this section, interests in P will be treated as a single investment of Account 1. As a result, Account 1 does not satisfy the requirements of paragraph (b) of this section. Variable contracts based in whole or in part on Account 1 are not treated as annuity, endowment, or life insurance contracts. Variable contracts that are not based on Account 1 at any time during the period in which such account fails to satisfy the requirements of paragraph (b) of this section (*i.e.*, contracts based entirely on Account 2), are treated as annuity, endowment, or life insurance contracts. See paragraph (a)(1).

Example 3. The facts are the same as in example 2 except that P is not publicly registered. Since P is described in paragraph (e)(2)(ii) of this section, the result is the same as in example 1.

Example 4. The facts are the same as in example 2 except that the variable contracts do not permit policyholders to allocate premiums between or among the debt securities and interests in P. Thus, the investment return and market value of the interests in P and the debt securities must be allocated to the same variable contracts and in an identical manner. Under paragraph (e) of this section, the interests in P and the debt securities are treated as part of a single segregated asset account. If the interests in P and the debt securities, considered together, satisfy the requirements of paragraph (b) of this section, contracts based on this segregated asset account will be treated as annuity, endowment, or life insurance contracts.

(h) *Definitions.* The terms defined below shall, for purposes of this section, have the meanings set forth in such definitions:

(1) *Government security*—(i) *General rule.* The term *government security* shall mean any security issued or guaranteed or insured by the United States or an instrumentality of the United States; or any certificate of deposit for any of the foregoing. Any security or certificate or deposit insured or guaranteed only in part by the United States or an instrumentality thereof is treated as issued by the United States or its instrumentality only to the extent so insured or guaranteed, and as issued by the direct obligor to the extent not so insured or guaranteed. For purposes of this paragraph (h)(1), an instrumentality of the United States shall mean any person that is treated for purposes of 15 U.S.C. 80a–2 (16), as amended, as a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States.

(ii) *Example.* A segregated asset account purchases a certificate of deposit in the amount of $150,000 from bank A. Deposits in bank A are insured by the Federal Deposit Insurance Corporation, an instrumentality of the United States, to the extent of $100,000 per depositor. The certificate of deposit is treated as a government security to the extent of the $100,000 insured amount and is treated as a security issued by bank A to the extent of the $50,000 excess of the value of the certificate of deposit over the insured amount.

(2) *Treasury security*—(i) *General rule.* For purposes of paragraph (b)(3) of this section and section 817(h)(3), the term *Treasury security* shall mean a security

the direct obligor of which is the United States Treasury.

(ii) *Example.* A segregated asset account purchases put and call options on U.S. Treasury securities issued by the Options Clearing Corporation. The options are not Treasury securities for purposes of paragraph (b)(3) and section 817(h)(3) because the direct obligor of the options is not the United States Treasury.

(3) *Real property.* The term *real property* shall mean any property that is treated as real property under 1.856–3 (d) except that it shall not include interests in real property.

(4) *Real property account.* A segregated asset account is a real property account on an anniversary of the account (within the meaning of paragraph (c)(2)(iii) of this section) or on the date a plan of liquidation is adopted if not less than the applicable percentage of the total assets of the account is represented by real property or interests in real property on such anniversary or date. For this purpose, the applicable percentage is 40% for the period ending on the first anniversary of the date on which premium income is first received, 50% for the year ending on the second anniversary, 60% for the year ending on the third anniversary, 70% for the year ending on the fourth anniversary, and 80% thereafter. A segregated asset account will also be treated as a real property account on its first anniversary if on or before such first anniversary the issuer has stated in the contract or prospectus or in a submission to a regulatory agency, an intention that the assets of the account will be primarily invested in real property or interests in real property, provided that at least 40% of the total assets of the account are so invested within six months after such first anniversary.

(5) *Commodity.* The term *commodity* shall mean any type of personal property other than a security.

(6) *Security.* The term *security* shall include a cash item and any partnership interest registered under a Federal or State law regulating the offering or sale of securities. The term shall not include any other partnership interest, any interest in real property, or any interest in a commodity.

(7) *Interest in real property.* The term *interest in real property* shall include the ownership and co-ownership of land or improvements thereon and leaseholds of land or improvements thereon. Such term shall not, however, include mineral, oil, or gas royalty interests, such as a retained economic interest in coal or iron ore with respect to which the special provisions of section 631(c) apply. The term ‘‘interest in real property’’ also shall include options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

(8) *Interest in a commodity.* The term *interest in a commodity* shall include the ownership and co-ownership of any type of personal property other than a security, and any leaseholds thereof. Such term shall include mineral, oil, and gas royalty interests, including any fractional undivided interest therein. Such term also shall include any put, call, straddle, option, or privilege on any type of personal property other than a security.

(9) *Value.* The term *value* shall mean, with respect to investments for which market quotations are readily available, the market value of such investments; and with respect to other investments, fair value as determined in good faith by the managers of the segregated asset account.

(10) *Terms used in section 851.* To the extent not inconsistent with this paragraph (h) all terms used in this section shall have the same meaning as when used in section 851.

(i) *Effective date*—(1) *In general.* This section is effective for taxable years beginning after December 31, 1983.

(2) *Exceptions.* (i) If, at all times after December 31, 1983, an insurance company would be considered the owner of the assets of a segregated asset account under the principles of Rev. Rul. 81–225, 1981–2 C.B. 12, this section will not apply to such account until December 15, 1986.

(ii) This section will not apply to any variable contract to which Rev. Rul. 77–85, 1977–1 C.B. 12, or Rev. Rul. 81–225, 1981–2 C.B. 12, did not apply by reason of the limited retroactive effect of such rulings.

(iii) In determining whether a segregated asset account is adequately diversified for any calendar quarter ending before July 1, 1988, debt instruments that are issued, guaranteed, or insured by the United States or an instrumentality of the United States shall not be treated as government securities if such debt instruments are secured by a mortgage on real property (other than real property owned by the United States or an instrumentality of the United States) or represent an interest in a pool of debt instruments secured by such mortgages.

(iv) This section shall not apply until January 1, 1989, with respect to a variable contract (as defined in section 817(d)) that (1) provides for the payment of an immediate annuity (as defined in section 72(u)(4)); (2) was outstanding on September 12, 1986; and (3) the segregated asset account on which it was based was, on September 12, 1986, wholly invested in deposits insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation.

[T.D. 8242, 54 FR 8730, Mar. 2, 1989; T.D. 8242, 54 FR 11866, Mar. 22, 1989]

§ 1.818–1 Taxable years affected.

Sections 1.818–2 through 1.818–8, except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6558, 26 FR 2785, Apr. 4, 1961 as amended by T.D. 7469, 42 FR 12181, Mar. 3, 1977]

§ 1.818–2 Accounting provisions.

(a) *Method of accounting.* (1) Section 818(a)(1) provides the general rule that all computations entering into the determination of taxes imposed by part I, subchapter L, chapter 1 of the Code, shall be made under an accrual method of accounting. Thus, the over-all method of accounting for life insurance companies shall be the accrual method. Except as otherwise provided in part I, the term ‘‘accrual method’’ shall have the same meaning and application in section 818 as it does under section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For general rules relating to the taxable year for inclusion of income and deduction of expenses under an accrual method of accounting, see sections 451 and 461 and the regulations thereunder.

(2) Section 818(a)(2) provides that, to the extent permitted under this section, a life insurance company's method of accounting may be a combination of the accrual method with any other method of accounting permitted by chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. Thus, section 818(a)(2) specifically prohibits the use by a life insurance company of the cash receipts and disbursements method either separately or in combination with a permissible method of accounting. The term ‘‘method of accounting’’ includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. For purposes of section 818(a)(2), a life insurance company may elect to compute its taxable income under an over-all method of accounting consisting of the accrual method combined with the special methods of accounting for particular items of income and expense provided under other sections of chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. These methods of accounting for special items include the accounting treatment provided for depreciation (section 167), research and experimental expenditures (section 174), soil and water conservation expenditures (section 175), organizational expenditures (section 248), etc. In addition, a life insurance company may, where applicable, use the crop method of accounting (as provided in the regulations under sections 61 and 162), and the installment method of accounting for sales of realty and casual sales of personalty (as provided in section 453(b)). To the extent not inconsistent with the provisions of the Internal Revenue Code of 1954 or the regulations thereunder and the method of accounting adopted by the taxpayer pursuant

to this section, all computations entering into the determination of taxes imposed by part I shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

(3)(i) An election to use any of the special methods of accounting referred to in subparagraph (2) of this paragraph which was made pursuant to any provisions of the Internal Revenue Code of 1954 or prior revenue laws for purposes of determining a company's tax liabilities for prior years, shall have the same force and effect in determining the items of gross investment income under section 804(b) and the items of deduction under section 804(c) of the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) as if such Act had not been enacted.

(ii) For purposes of determining gain or loss from operations under section 809(b), in computing the life insurance company's share of investment yield under section 809(b) (1)(A) and (2)(A), an election with respect to any of the special methods of accounting referred to in subparagraph (2) of this paragraph which was made pursuant to any provision of the Internal Revenue Code of 1954 or prior revenue laws, shall not be affected in any way by the enactment of the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

(iii) For purposes of determining gain or loss from operations under section 809(b), in computing the items of gross amount under section 809(c) and the deduction items under section 809(d), an election to use any of the special methods of accounting referred to in subparagraph (2) of this paragraph must be made in accordance with the specific statutory provisions of the sections containing such elections and the regulations thereunder. However, where a particular election may be made only with the consent of the Commissioner (either because the time for making the election without the consent of the Commissioner has expired or because the particular section contained no provision for making an election without consent), and the time prescribed by the applicable regulations for submitting a request for permission to make such an election for the taxable year 1958 has expired, a life insurance company may make such an election for the year 1958 at the time of filing its return for that year (including extensions thereof). For example, a life insurance company may elect any of the methods of depreciation prescribed in section 167 (to the extent permitted under that section and the regulations thereunder) with respect to those assets, or any portion thereof, for which no depreciation was allowable under prior revenue laws, for example, furniture and fixtures used in the underwriting department. Similarly, a life insurance company shall be permitted to make an election under section 461(c) (relating to the accrual of real property taxes) with respect to real property for which no deduction was allowable under prior revenue laws. Any such election shall be made in the manner and form prescribed in the applicable regulations.

(iv) For purposes of subdivision (ii) of this subparagraph, the method used under section 1016(a)(3)(C) (relating to adjustments to basis) in determining the amount of exhaustion, wear and tear, obsolescence, and amortization actually sustained shall not preclude a taxpayer from electing any of the methods prescribed in section 167 in accordance with the provisions of that section and the regulations thereunder for determining the amount of such exhaustion, wear and tear, obsolescence, and amortization for the year 1958. For example, if the amount of depreciation actually sustained, under section 1016(a)(3)(C), on a life insurance company's home office building (other than that portion for which depreciation was allowable under prior revenue laws) is determined on the straight line method, the life insurance company may elect for the year 1958 to use any of the methods prescribed in section 167 for determining its depreciation allowance for 1958. However, such election shall be binding for 1958, and for all subsequent taxable years, unless consent to change such election, if required, is obtained from the Commissioner in accordance with the provisions of section 167 and the regulations thereunder.

(4)(i) For purposes of section 805(b)(3)(B)(i) (relating to the determination of the current earnings rate for any taxable year beginning before January 1, 1958), the determination for any year of the investment yield and the assets shall be made as though the taxpayer had been on the accrual method prescribed in subparagraph (1) of this paragraph for such year, or the accrual method in combination with the other methods of accounting prescribed in subparagraph (2) of this paragraph, if these other methods of accounting are used by the taxpayer in determining the investment yield and assets for the taxable year 1958. However, where the method used for determining the deduction under section 167 for the year 1958 differs from the method used in prior years, the amount of the deduction actually allowed or allowable for such prior years for purposes of section 1016(a)(2) (relating to adjustments to basis) shall be the amount to be taken into account in determining the current earnings rate under section 805(b)(3)(B)(i).

(ii) For purposes of section 812(b)(1)(C) (relating to operations loss carrybacks and carryovers for years prior to 1958), the determination for those years of the gain or loss from operations shall be made as though the taxpayer had been on the accrual method of accounting prescribed in subparagraph (1) of this paragraph for such year, or the accrual method in combination with the other methods of accounting prescribed in subparagraph (2) of this paragraph, if these other methods of accounting are used by the taxpayer in the determination of gain or loss from operations for the taxable year 1958. However, where any adjustment to basis is required under section 1016(a)(3)(C) on account of exhaustion, wear and tear, obsolescence, amortization, and depletion sustained, the amount actually sustained as determined under section 1016(a)(3)(C) for each of the years involved shall be the amount allowed in the determination of gain or loss from operations for purposes of section 812(b)(1)(C).

(b) *Adjustments required if accrual method of accounting was not used in 1957.* The items of gross amount taken into account under section 809(c) and the items of deductions allowed under section 809(d) for the taxable year 1958 shall be determined as though the taxpayer had been on the accrual method of accounting prescribed in paragraph (a) of this section for all prior years. Thus, life insurance companies not on the accrual method for the year 1957 shall accrue, as of December 31, 1957, those items of gross amount which would have been properly taken into account for the year 1957 if the company had been on the accrual method described in section 818(a). Likewise, life insurance companies not on the accrual method for the year 1957 shall accrue, as of December 31, 1957, those items of deductions which would have been properly allowed for the year 1957 if the company had been on the accrual method described in section 818(a). For example, if certain premium amounts were received during the year 1958 but such amounts would have been properly taken into account for the year 1957 if the taxpayer had been on the accrual method for the year 1957, then the taxpayer will not be required to take such premium amounts into account for the year 1958. If, for example, certain claims, benefits, and losses were paid during the year 1958 but such items would have been properly taken into account for the year 1957 if the taxpayer had been on the accrual method for the year 1957, then the taxpayer will not be permitted to deduct such expense items for the year 1958. For a special transitional rule applicable with respect to changes in method of accounting required by section 818(a) and paragraph (a) of this section, see section 818(e) and § 1.818–6.

(c) *Change of basis in computing reserves.* (1) Section 806(b) provides that if the basis for determining the amount of any item referred to in section 810(c) as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year, then for purposes of subpart B, part I, subchapter L, chapter 1 of the Code (relating to the determination of taxable investment income), the amount of such item shall be the amount computed on the old basis as of the close of the taxable year and the amount computed on the new basis as of the beginning of the next taxable year. Similarly, section 810(d)(1) provides rules for determining the amount of the adjustment to be made for purposes of subpart C, part I, subchapter L, chapter 1 of the Code (relating to the determination of gain or loss from operations), if the basis for determining any item referred to in section 810(c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year. Under an accrual method of accounting, a change in the basis or method of computing the amount of liability of any item referred to in section 810(c) occurs in the taxable year in which all the events have occurred which determine the change in the basis or method of computing the amount of such liability and, in which, the amount thereof (whether increased or decreased) can be determined with reasonable accuracy.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. Assume that during the taxable year 1960, M, a life insurance company, determines that the amount of its life insurance reserves held with respect to a particular block of contracts is understated on the present basis being used in valuing such liability and that such liability can be more accurately reflected by changing from the present basis to a particular new basis. Assume that M uses such new basis in computing its reserves under such contracts at the end of the taxable year 1960. Under the provisions of section 818(a) and subparagraph (1) of this paragraph, the change in basis for purposes of sections 806(b) and 810(d) occurs during the taxable year 1960, the year in which all the events have occurred which determine the change in basis and the amount of any increase (or decrease) attributable to such change can be determined with reasonable accuracy. Such change shall be treated as having occurred during the taxable year 1960 whether M determines that its liability under such contracts was understated for the first time during 1960, or that its liability under such contracts has, in fact, been understated for a number of prior years.

Example 2. Assume the facts are the same as in example 1, except that during the taxable year 1960 the insurance department of State X issues a ruling, pursuant to authority conferred by statute, requiring M to use the particular new basis which more accurately reflects its liability with respect to such contracts and that as a result of such ruling, M uses the new basis in computing its reserves under such contracts for the taxable years 1958, 1959, and 1960. Under the provisions of section 818(a) and subparagraph (1) of this paragraph, the change in basis for purposes of sections 806(b) and 810(d) occurs during the taxable year 1960, the year in which all the events have occurred which determine that a change in basis should be made and the amount of any increase (or decrease) attributable to such change can be determined with reasonable accuracy.

[T.D. 6558, 26 FR 2785, Apr. 4, 1961]

§1.818–3 Amortization of premium and accrual of discount.

(a) *In general.* Section 818(b) provides that the appropriate items of income, deductions, and adjustments under part I, subchapter L, chapter 1 of the Code, shall be adjusted to reflect the appropriate amortization of premium and the appropriate accrual of discount on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such adjustments are limited to the amount of appropriate amortization or accrual attributable to the taxable year with respect to such securities which are not in default as to principal or interest and which are amply secured. The question of ample security will be resolved according to the rules laid down from time to time by the National Association of Insurance Commissioners. The adjustment for amortization of premium decreases the gross investment income, the exclusion and reduction for wholly tax-exempt interest, the exclusion and deduction for partially tax-exempt interest, and the basis or adjusted basis of such securities. The adjustment for accrual of discount increases the gross investment income, the exclusion and reduction for wholly tax-exempt interest, the exclusion and deduction for partially tax-exempt interest, and the basis or adjusted basis of such securities. However, for taxable years beginning after May 31, 1960, only the accrual of discount relating to issue discount will increase the exclusion and reduction for wholly tax-exempt interest. See section 103.

(b) *Acquisitions before January 1, 1958.* (1) In the case of any such security acquired before January 1, 1958, the premium is the excess of its acquisition value over its maturity value and the discount is the excess of its maturity value over its acquisition value. The acquisition value of any such security is its cost (including buying commissions or brokerage but excluding any amounts paid for accrued interest) if purchased for cash, or if not purchased for cash, its then fair market value. The maturity value of any such security is the amount payable thereunder either at the maturity date or an earlier call date. The earlier call date of any such security may be the earliest interest payment date if it is callable or payable at such date, the earliest date at which it is callable at par, or such other call or payment date, prior to maturity, specified in the security as may be selected by the life insurance company. A life insurance company which adjusts amortization of premium or accrual of discount with reference to a particular call or payment date must make the adjustments with reference to the value on such date and may not, after selecting such date, use a different call or payment date, or value, in the calculation of such amortization or discount with respect to such security unless the security was not in fact called or paid on such selected date.

(2) The adjustments for amortization of premium and accrual of discount will be determined:

(i) According to the method regularly employed by the company, if such method is reasonable, or

(ii) According to the method prescribed by this section.

A method of amortization of premium or accrual of discount will be deemed ''regularly employed'' by a life insurance company if the method was consistently followed in prior taxable years, or if, in the case of a company which has never before made such adjustments, the company initiates in the first taxable year for which the adjustments are made a reasonable method of amortization of premium or accrual of discount and consistently follows such method thereafter. Ordinarily, a company regularly employs a method in accordance with the statute of some State, Territory, or the District of Columbia, in which it operates.

(3) The method of amortization and accrual prescribed by this section is as follows:

(i) The premium (or discount) shall be determined in accordance with this section; and

(ii) The appropriate amortization of premium (or accrual of discount) attributable to the taxable year shall be an amount which bears the same ratio to the premium (or discount) as the number of months in the taxable year during which the security was owned by the life insurance company bears to the number of months between the date of acquisition of the security and its maturity or earlier call date, determined in accordance with this section. For purposes of this section, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered a month.

(c) *Acquisitions after December 31, 1957.* (1) In the case of:

(i) Any bond, as defined in section 171(d), acquired after December 31, 1957, the amount of the premium and the amortizable premium for the taxable year, shall be determined under section 171(b) and the regulations thereunder, as if the election set forth in section 171(c) had been made, and

(ii) Any bond, note, debenture, or other evidence of indebtedness not described in subdivision (i) of this subparagraph and acquired after December 31, 1957, the amount of the premium and the amortizable premium for the taxable year, shall be determined under paragraph (b) of this section.

(2) In the case of any bond, note, debenture, or other evidence of indebtedness acquired after December 31, 1957, the amount of the discount and the accrual of discount attributable to the taxable year shall be determined under paragraph (b) of this section.

(d) *Convertible evidences of indebtedness.* Section 818(b)(2)(B) provides that in no case shall the amount of premium on a convertible evidence of indebtedness (including any bond, note, or debenture) include any amount attributable to the conversion features of the evidence of indebtedness. This provision is the same as the one contained in section 171(b), and the rules prescribed in paragraph (c) of § 1.171–2 shall be applicable for purposes of section 818(b)(2)(B). This provision is to be applied without regard to the date upon which the evidence of indebtedness was acquired. Thus, where a convertible evidence of indebtedness was acquired before January 1, 1958, and a portion or all of the premium attributable to the conversion features of the evidence of indebtedness has been amortized for taxable years beginning before January 1, 1958, no adjustment for such amortization will be required by reason of section 818(b)(2)(B). Such amortization will, however, require an adjustment to the basis of the evidence of indebtedness under section 1016(a)(17). For taxable years beginning after December 31, 1957, no further amortization of the premium attributable to the conversion features of such an evidence of indebtedness will be taken into account.

(e) *Adjustments to basis.* Section 1016(a)(17) (relating to adjustments to basis) provides that in the case of any evidence of indebtedness referred to in section 818(b) and this section, the basis shall be adjusted to the extent of the adjustments required under section 818(b) (or the corresponding provisions of prior income tax laws) for the taxable year and all prior taxable years. The basis of any evidence of indebtedness shall be reduced by the amount of the adjustment required under section 818(b) (or the corresponding provision of prior income tax laws) on account of amortizable premium and shall be increased by the amount of the adjustment required under section 818(b) on account of accruable discounts.

(f) *Denial of double inclusion.* Any amount which is includible in gross investment income by reason of section 818(b) and paragraph (a) of this section shall not be includible in gross income under section 1232(a) (relating to the taxation of bonds and other evidences of indebtedness). See section 1232(a)(2)(C) and the regulations thereunder.

[T.D. 6558, 26 FR 2786, Apr. 4, 1961]

§1.818–4 Election with respect to life insurance reserves computed on preliminary term basis.

(a) *In general.* Section 818(c) permits a life insurance company issuing contracts with respect to which the life insurance reserves are computed on one of the recognized preliminary term bases to elect to revalue such reserves on a net level premium basis for the purpose of determining the amount which may be taken into account as life insurance reserves for purposes of part I, subchapter L, chapter 1 of the Code, other than section 801 (relating to the definition of a life insurance company). If such an election is made, the method to be used in making this revaluation of reserves shall be either the exact revaluation method (as described in section 818(c)(1) and paragraph (b)(1) of this section) or the approximate revaluation method (as described in section 818(c)(2) and paragraph (b)(2) of this section).

(b) *Revaluation of reserves computed on preliminary term basis.* If a life insurance company makes an election under section 818(c) in the manner provided in paragraph (e) of this section, the amount to be taken into account as life insurance reserves with respect to contracts for which such reserves are computed on a preliminary term basis may be determined on either of the following bases:

(1) *Exact revaluation method.* As if the reserves for all such contracts had been computed on a net level premium basis (using the same mortality or morbidity assumptions and interest rates for both the preliminary term basis and the net level premium basis).

(2) *Approximate revaluation method.* The amount computed without regard to section 818(c):

(i) Increased by $21 per $1,000 of insurance in force (other than term insurance) under such contracts, less 2.1 percent of reserves under such contracts, and

(ii) Increased by $5 per $1,000 of term insurance in force under such contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of reserves under such contracts.

(c) *Exception.* If a life insurance company which makes an election under section 818(c)(2) and paragraph (b)(2) of this section has life insurance reserves with respect to both life insurance and noncancellable accident and health contracts for which such reserves are computed on a preliminary term basis, it shall use the approximate revaluation method for all its life insurance reserves other than that portion of such reserves held with respect to its noncancellable accident and health contracts, and shall use the exact revaluation method for all its life insurance reserves held with respect to such noncancellable accident and health contracts.

(d) *Reserves subject to recomputation.* (1) For the first taxable year for which the election under section 818(c) and paragraph (b) of this section applies, a company making such election must revalue all its life insurance reserves held with respect to contracts for which such reserves are computed on a preliminary term basis at the end of such taxable year on the basis elected under section 818(c) and paragraph (b) of this section. However, for purposes of the preceding sentence, an election under section 818(c) shall not apply with respect to such reserves which would not be treated as being computed on the preliminary term basis at the end of such taxable year except for the provisions of section 810 (a) or (b). See paragraph (c)(2) of §1.810–2. For example, if S, a life insurance company which computes its life insurance reserves on a recognized preliminary term basis at the beginning of the taxable year 1958, strengthens a portion of such reserves during the taxable year by actually changing to a net level premium basis in computing such reserves, and then makes the election under section 818(c) and paragraph (b) of this section for 1958, such election shall not apply with respect to the strengthened contracts.

(2) For any taxable year other than the first taxable year for which the election under section 818(c) and paragraph (b) of this section applies, a company making such election must revalue all its life insurance reserves held with respect to contracts for which such reserves are computed on a preliminary term basis at the beginning or end of the taxable year on the basis elected under section 818(c) and paragraph (b) of this section. For example, if M, a life insurance company which made a valid outstanding election under section 818(c) in the manner provided in paragraph (e) of this section for the taxable year 1959, sells a block of contracts subject to such election on September 1, 1960, M would value such contracts on the basis elected under section 818(c) and paragraph (b) of this section on January 1, 1960, for purposes of determining the net decrease or increase in the sum of the items described in section 810(c) for the taxable year under section 810 (a) or (b).

(3) For the effect of an election under section 818(c) and paragraph (b) of this section in determining gain or loss from operations for the taxable year, see paragraph (c)(3) of §1.810–2 and paragraph (e) of §1.810–3.

(e) *Time and manner of making election.* The election provided by section 818(c) shall be made in a statement attached to the life insurance company's income tax return for the first taxable year for which the company desires the election to apply. The return and statement must be filed not later than the date prescribed by law (including extensions thereof) for filing the return for such taxable year. However, if the last day prescribed by law (including extensions thereof) for filing a return for the first taxable year for which the company desires the election to apply falls before April 4, 1961, the election provided by section 818(c) may be made for such year by filing the statement and an amended return for such taxable year (and all subsequent taxable years for which returns have been filed) before July 4, 1961. The statement shall indicate whether the exact or the approximate method of revaluation has been adopted. The statement shall also set forth sufficient information as to mortality and morbidity asumptions; interest rates; the valuation method used; the amount of the reserves and the amount and type of insurance in force under all contracts for which reserves are computed on a preliminary term basis; and such other pertinent data as will enable the Commissioner to determine the correctness of the application of the revaluation method adopted and the accuracy of the computations involved in revaluing the reserves. The election to use either the exact revaluation method or the approximate revaluation method shall, except for the purposes of section 801, be adhered to in making the computations under part I for the taxable year for which such election is made and for all subsequent taxable years.

(f) *Scope of election.* An election made under section 818(c) and paragraph (b) of this section to use either the exact or the approximate method of revaluing the company's life insurance reserves shall be binding for the taxable year for which made, and, except as provided in paragraph (g) of this section, shall be binding for all succeeding taxable years, unless consent to revoke the election is obtained from the Commissioner. However, for taxable years beginning prior to April 4, 1961, a company may revoke the election provided by section 818(c) without obtaining consent from the Commissioner by filing, before July 4, 1961, a statement that the company desires to revoke such election. An amended return reflecting such revocation must accompany the statement for all taxable years for which returns have been filed with respect to such election.

(g) *Special rule for 1958.* If an election is made for a taxable year beginning in 1958 to use the approximate revaluation method described in section 818(c)(2) and paragraph (b)(2) of this section the company may, for its first taxable year beginning after 1958, elect to change to the exact revaluation method described in section 818(c)(1) and paragraph (b)(1) of this section without obtaining the consent of the Commissioner. In such case, the election to change shall be made in a statement attached to the company's income tax return for such taxable year and filed not later than the date prescribed by law (including extensions thereof) for filing the return for such year. The statement shall indicate that the company has elected to change from the approximate to the exact revaluation method for such taxable year and shall include such information and data referred to in paragraph (e) of this section as will enable the Commissioner to determine the correctness and accuracy of the computations involved.

[T.D. 6558, 26 FR 2787, Apr. 4, 1961; 26 FR 3276, Apr. 18, 1961]

§1.818–5 Short taxable years.

(a) *In general.* Section 818(d) provides that if any return of a corporation made under part I, subchapter L, chapter 1 of the Code, is for a period of less than the entire calendar year, then section 443 (relating to returns for a period of less than 12 months) shall not apply. This section further provides certain rules to be used in determining the life insurance company taxable income for a period of less than the entire calendar year.

(b) *Returns for periods of less than the entire calendar year.* A return for a short period, that is, for a taxable year consisting of a period of less than the entire calendar year, shall be made only under the following circumstances:

(1) If a company which qualifies as a life insurance company is not in existence for the entire taxable year, a return is required for the short period during which the taxpayer was in existence. For example, a life insurance company organized on August 1, is required to file a return for the short period from August 1 to December 31, and returns for each calendar year thereafter. Similarly, if a company which qualifies as a life insurance company completely dissolves during the taxable year it is required to file a return for the short period from January 1 to the date it goes out of existence. All items entering into the computation of taxable investment income and gain or loss from operations for the short period shall be determined on a consistent basis and in the manner provided in paragraph (c) of this section.

(2) A return must be filed for a short period resulting from the termination by the district director of a taxpayer's taxable year for jeopardy. See section 6851 and the regulations thereunder.

A company which was an insurance company for the preceding taxable year (but not a life insurance company as defined in section 801(a) and paragraph (b) of §1.801–3) and which for the current taxable year qualifies as a life insurance company shall not file a return for the short period from the time during the taxable year that it first qualifies as a life insurance company to the end of the taxable year. Similarly, an insurance company which was a life insurance company for the preceding taxable year but which for the current taxable year does not qualify as a life insurance company shall not file a return for the short period from the beginning of the taxable year to the time during the taxable year that it no longer qualifies as a life insurance company.

(c) *Computation of life insurance company taxable income for short period.* (1) If a return is made for a short period, section 818(d)(1) provides that the taxable investment income and the gain or loss from operations shall be determined on an annual basis by a ratable daily projection of the appropriate figures for the short period. The appropriate figures for the short period shall be determined on an annual basis by multiplying such figures by a fraction, the numerator of which is the number of days in the calendar year in which the short period occurs and the denominator of which is the number of days in the short period.

(2)(i) In computing taxable investment income for a short period, the investment yield, the policy and other contract liability requirements, the policyholders' share of each and every item of investment yield, and the company's share of any item of investment yield shall be determined on an annual basis.

(ii) For purposes of determining the investment yield on an annual basis, each item of gross investment income under section 804(b) and each item of deduction under section 804(c) shall be annualized in the manner provided in subparagraph (1) of this paragraph. In any case in which a limitation is placed on the amount of a deduction provided under section 804(c), the limitation shall apply to the item of deduction computed on an annual basis.

(iii) The policy and other contract liability requirements shall be determined on an annual basis in the following manner:

(a) The interest paid (as defined in section 805(e) and § 1.805–8) for the short period shall be annualized in the manner prescribed in subparagraph (1) of this paragraph.

(b) The current earnings rate for the taxable year in which the short period occurs shall be determined by dividing the taxpayer's investment yield, as determined on an annual basis under subdivision (ii) of this subparagraph, by the mean of the taxpayer's assets at the beginning and end of the short period. For purposes of section 805, any reference to the current earnings rate for the taxable year in which the short period occurs means the current earnings rate as determined under this subdivision.

(c) The adjusted life insurance reserves shall be determined as provided in section 805(c), and the pension plan reserves shall be determined as provided in section 805(d).

(iv) The policyholders' share of each and every item of investment yield (as defined in section 804(a)) shall be that percentage obtained by dividing the policy and other contract liability requirements, determined under subdivision (iii) of this subparagraph, by the investment yield, determined under subdivision (ii) of this subparagraph.

(v) The taxable investment income for the short period shall be an amount (not less than zero) equal to the life insurance company's share of each and every item of investment yield, as determined under subdivision (ii) of this subparagraph, reduced by the items described in section 804(a)(2) (A) and (B). In determining these reductions under section 804(a)(2)(A) the amount of the respective items shall be the amount that is determined on an annual basis under subdivision (ii) of this subparagraph. The small business deduction, under section 804(a)(2)(B) shall be an amount (not to exceed $25,000) equal to 10 percent of the investment yield, determined under subdivision (ii) of this subparagraph, for the short period.

(vi) Except as provided in this paragraph, the determination of taxable investment income under subpart B, part I, subchapter L, chapter 1 of the Code, shall be made in accordance with all the provisions of that subpart.

(3)(i) In computing gain or loss from operations for a short period, the share of each and every item of investment yield set aside for policyholders, the life insurance company's share of each and every item of investment yield, the items of gross amount, and the items of deduction shall, except as modified by this subparagraph, be determined on an annual basis in the manner provided in subparagraph (1) of this paragraph. In any case in which a limitation is placed on the amount of a deduction provided under section 809, the limitation shall apply to the item of deduction computed on an annualized basis.

(ii) For purposes of sections 809 and 810, the investment yield shall be determined in the manner provided in subparagraph (2)(ii) of this paragraph. The share of any item of investment yield set aside for policyholders shall be that percentage obtained by dividing the required interest as determined under section 809(a)(2), by the investment yield, as determined in this subparagraph, except that if the required interest exceeds the investment yield then the share of any item of investment yield set aside for policyholders shall be 100 percent.

(iii) The items of gross amount and the items of deduction, other than the operations loss deduction under section 809(d)(4), shall be determined on an annual basis. See subdivision (iv) of this subparagraph for the manner in which the net decrease or net increase in reserves under section 810 shall be annualized.

(iv) For purposes of determining either a net decrease in reserves under section 810(a) or a net increase in reserves under section 810(b), the sum of the items described in section 810(c) as of the end of the short period shall be reduced by the amount of the investment yield not included in gain or loss from operations for the short period by reason of section 809(a)(1). The amount of investment yield excluded under section 809(a)(1) has been determined upon an annualized basis while the sum of the items described in section 180(c) at the end of the short period has been determined on an actual basis. In order to place these on the same basis, the amount of investment yield not included in gain or loss from operations by reason of section 809(a)(1), determined under subdivision (ii) shall, for purposes of section 810(a) and section 810(b), be reduced to an amount which bears the same ratio to the full amount as the number of days in the short period bears to the number of days in the entire calendar year. The net decrease or the net increase of the items referred to in section 810(c) for the short period shall then be determined, as provided in section 810(a) and section 810(b), respectively, and the result annualized.

(4) The portion of the life insurance company taxable income described in section 802(b) (1) and (2) (relating to taxable investment income and gain or loss from operations) shall be determined on an annual basis by treating the amounts ascertained under subparagraph (2) of this paragraph as the taxable investment income, and the amount ascertained under subparagraph (3) of this paragraph as the gain or loss from operations, for the taxable year.

(5) The portion of the life insurance company taxable income described in section 802(b) (1) and (2) for the short period shall be the amount which bears the same ratio to the amount ascertained under section 818(d) (2) and subparagraph (4) of this paragraph as the number of days in the short period bears to the number of days in the entire year.

(d) *Special rules.* (1) For purposes of determining the average earnings rate (as defined in section 805(b)(3)) for subsequent taxable years, the current earnings rate for the taxable year in which the short period occurs shall be the rate determined under paragraph (c)(2) of this section.

(2) For purposes of determining an operations loss deduction under section 812, the loss from operations for the short period shall be the loss from operations determined under paragraph (c)(5) of this section.

[T.D. 6558, 26 FR 2788, Apr. 4, 1961]

§1.818–6 Transitional rule for change in method of accounting.

(a) *In general.* Section 818(e) prescribes the rules to be followed in recomputing the taxes of a life insurance company for the taxable year 1957 in cases where the method of accounting required to be used in computing the company's taxes for 1958 under section 818(a) and paragraph (a) of §1.818–2 is different from the method used in 1957.

(b) *Recomputation of 1957 taxes.* (1) For purposes of recomputing its taxes for 1957, a life insurance company must ascertain the net amount of those adjustments which are determined (as of the close of 1957) to be necessary solely by reason of the change to the method of accounting required by section 818(a) and paragraph (a) of § 1.818–2 in order to prevent amounts from being duplicated or omitted. Thus, for example, life insurance companies not on the accrual method of accounting for the year 1957 shall accrue, as of December 31, 1957, those items of gross investment income under section 803(b) and those items of deduction under section 803(c), as in effect for 1957, which would have been properly accruable for the year 1957 if the company had been on the accrual method of accounting.

(2) In the case of a change in the over-all method of accounting, the term ''net amount of those adjustments'' means the consolidation of adjustments (whether the amounts thereof represent increases or decreases in items of income or deductions) arising with respect to balances in the various accounts on December 31, 1957. In the case of a change in the treatment of a single material item, the amount of the adjustment shall be determined with reference only to the net dollar balances in that particular account.

(3)(i) The amount of the taxpayer's tax for 1957 shall be recomputed (under the law applicable to 1957, modified as provided in section 818(e) (4) and paragraph (e) of this section) by taking into account an amount equal to one-tenth of the net amount of the adjustments determined under subparagraph (1) of this paragraph. The increase or decrease in tax attributable to the adjustments for such year is the difference between the tax for such year computed with the allocation of one-tenth of the net amount of the adjustments to such taxable year over the tax computed without the allocation of any part of the adjustments to such year.

(ii) The amount of increase or decrease (as the case may be) referred to in section 818(e) (2) or (3) and paragraphs (c) or (d) of this section, shall be the amount of the increase or decrease in tax ascertained in the manner described in subdivision (i) of this subparagraph, multiplied by 10.

(c) *Treatment of decrease.* Section 818(e) (2) provides that for purposes of subtitle F of the Code, if the recomputation under paragraph (b) (3) (ii) of this section results in a decrease, the amount of such decrease shall be treated as a decrease in the tax imposed for 1957; except that for purposes of computing the period of limitation on the making of refunds or the allowance of credits with respect to such overpayments, the amount of such decrease shall be treated as an overpayment of tax for 1959. No interest shall be paid, for any period before March 16, 1960, on any overpayment of the tax imposed for 1957 which is attributable to such decrease.

(d) *Treatment of increase*—(1) *In general.* Section 818(e) (3) (A) provides that for purposes of subtitle F of the Code, other than section 6016 (relating to declarations of estimated income tax by corporations) and section 6655 (relating to failure by corporations to pay estimated income tax), if the recomputation under paragraph (b) (3) (ii) of this section results in an increase, the amount of such increase shall be treated as a tax imposed for 1959. Such tax shall be payable in 10 equal annual installments, beginning with March 15, 1960.

(2) *Special rules.* Section 818(e) (3) (B) provides that for purposes of section 818(e) (3) (A) and subparagraph (1) of this paragraph:

(i) No interest shall be paid on any installment described in section 818(e) (3) (A) and subparagraph (1) of this paragraph before the time prescribed therein for the payment of such installment.

(ii) Section 6152(c) (relating to proration of deficiencies to installments) and the regulations thereunder shall apply. However, section 6152(a) (relating to the election to make installment payments) and the regulations thereunder shall not apply.

(iii) In applying section 6502(a) (1) (relating to collection after assessment) and the regulations thereunder, the assessment of any installment described in section 818(e) (3) (A) and subparagraph (1) of this paragraph shall be treated as made at the time prescribed therein for the payment of such installment.

(iv) If for any taxable year the taxpayer is not a life insurance company, the amount of the increase in tax (as determined under paragraph (b) (3) (ii) of this section), to the extent not taken into account for prior taxable years, shall be payable on the date the return for such taxable year is due (determined without regard to any extensions of time for filing such return), unless such amount is required to be taken into account by the acquiring corporation under section 381(c) (22) and the regulations thereunder.

(e) *Modifications of 1957 tax computation.* Section 818(e) (4) provides that in recomputing the taxpayer's tax for 1957 for purposes of section 818(e) (1) and paragraph (b) of this section:

(1) Section 804(b), as in effect for 1957 (relating to the maximum reserve and other policy liability deduction), shall not apply with respect to any amount required to be taken into account by reason of section 818(e) (1) and paragraph (b) of this section; and

(2) The amount of the deduction allowed by section 805, as in effect for 1957 (relating to the special interest deduction), shall not be reduced by reason of any amount required to be taken into account under section 818(e) (1) and paragraph (b) of this section.

(f) *Illustration of principles.* The application of section 818(e) and this section may be illustrated by the following examples:

Example 1. For the taxable year 1957, the life insurance taxable income of M, a life insurance company, is $200,000 computed on the cash receipts and disbursements method of accounting. The net amount of the adjustments required under section 818(e)(1) by reason of the change to the accrual method of accounting for 1958, increases M's life insurance taxable income for 1957 by $50,000. The increase in tax attributable to the change in method of accounting required by section 818(a) is $26,000, computed as follows:

(1) Life insurance taxable income before adjustments	$200,000
(2) Adjustments required by sec. 818(e) (1) (1/10×$50,000)	5,000
(3) Life insurance taxable income after adjustments (item (1) plus item (2))	205,000
(4) Tax liability after adjustments (52%×$205,000, minus $5,500)	101,100
(5) Tax liability before adjustments (52%×$200,000, minus $5,500)	98,500
(6) Excess of item (4) over item (5)	2,600
(7) Increase in tax for purposes of sec. 818(e) (3) (item (6) multiplied by 10)	26,000

Under the provisions of section 818(e)(3), one-tenth of the increase in tax for 1957 attributable to the change in method of accounting required by section 818(a), $2,600 (1/10×$26,000), was due and payable on March 15, 1960, and the balance, $23,400 (9/10×$26,000), is due and payable in equal installments on March 15th of the nine succeeding taxable years. However, if for the taxable year 1965, M is no longer a life insurance company, and section 381(c)(22) does not apply, the balance of the installments not paid in prior taxable years, $10,400 (4/10×$26,000), shall be due and payable on March 15, 1966.

Example 2. Assume the facts are the same as in example 1, except that the net amount of the adjustments required by section 818(e)(1) decreases M's life insurance taxable income for 1957 by $25,000. The decrease in tax attributable to the change in method of accounting required by section 818(a) is $13,000, computed as follows:

(1) Life insurance taxable income before adjustments	$200,000
(2) Adjustments required by sec. 818(e) (1) (1/10×$25,000)	2,500
(3) Life insurance taxable income after adjustments (item (1) minus item (2))	197,500
(4) Tax liability after adjustments (52%×$197,500, minus $5,500)	97,200
(5) Tax liability before adjustments (52%×$200,000, minus $5,500)	98,500
(6) Excess of item (5) over item (4)	1,300
(7) Decrease in tax for purposes of sec. 818(e)(2) (item (6) multiplied by 10)	13,000

Under the provisions of section 818(e)(2), the entire $13,000 decrease in tax for 1957 attributable to the change in method of accounting required by section 818(a) shall be treated as an overpayment of tax for the taxable year 1959.

[T.D. 6558, 26 FR 2789, Apr. 4, 1961]

§ 1.818–7 Denial of double deductions.

Section 818(f) provides that the same item may not be deducted more than once under subpart B, part I, subchapter L, chapter 1 of the Code (relating to the determination of taxable investment income), and more than once under subpart C, part I, subchapter L, chapter 1 of the Code (relating to the determination of gain or loss from operations).

[T.D. 6558, 26 FR 2790, Apr. 4, 1961]

§ 1.818–8 Special rules relating to consolidated returns and certain capital losses.

Section 818(g) provides that, in the case of a life insurance company filing or required to file a consolidated return under section 1501 for a taxable year, the computations of the policyholders' share of investment yield under subparts B and C, part I, subchapter L, chapter 1 of the Code (including all determinations and computations incident thereto) shall be made as if such company were not filing a consolidated return. Thus, for example, if X and Y are life insurance companies which are entitled to file a consolidated return for 1975 and X has paid dividends to Y during such taxable year, Y must include such dividends in the computation of gross investment income under section 804(b). For other rules relating to the filing of consolidated returns, see sections 1501 through 1504 and the regulations thereunder.

[T.D. 7469, 42 FR 12181, Mar. 3, 1977]

§ 1.819–1 Taxable years affected.

Section 1.819–2 is applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code, are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6558, 26 FR 2791, Apr. 4, 1961]

§ 1.819–2 Foreign life insurance companies.

(a) *Carrying on United States insurance business.* Section 819(a) provides that a foreign life insurance company carrying on a life insurance business within the United States, if with respect to its United States business it would qualify as a life insurance company under section 801, shall be taxable on its United States business under section 802 in the same manner as a domestic life insurance company. Thus, the life insurance company taxable income of such a foreign life insurance company shall not be determined in the manner provided by part I, subchapter N, chapter 1 of the Code (relating to determination of sources of income), but shall be determined in the manner provided by part I, subchapter L, chapter 1 of the Code (relating to life insurance companies). See section 842. Accordingly, in determining its life insurance company taxable income from its United States business, such a foreign life insurance company shall take into account the appropriate items of income irrespective of whether such items of income are from sources within or without the United States. A foreign life insurance company shall take into account the appropriate items of expenses, losses, and other deductions properly allocable to such items of income from its United States business. To the extent not inconsistent with the provisions of this paragraph, section 818(a), and section 819(b), all computations entering into the determination of taxes imposed by part I shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

(b) *Adjustment where surplus held in the United States is less than specified minimum*—(1) *In general.* Section 819(b)(1) provides that if the minimum figure for the taxable year determined under section 819(b)(2) and subparagraph (2)(i) of this paragraph exceeds the surplus held in the United States as of the end of the taxable year (as defined in section 819(b)(2)(B) and subparagraph (2)(ii) of this paragraph) by a foreign life insurance company carrying on a life insurance business within the United States and taxable under section 802, then:

(i) The amount of the policy and other contract liability requirements (determined under section 805 and § 1.805–4 without regard to this subparagraph), and

(ii) The amount of the required interest (determined under section 809(a)(2) and paragraph (d) of § 1.809–2 without regard to this subparagraph),

shall each be reduced by an amount determined by multiplying such excess by the current earnings rate (as defined in section 805(b)(2) and paragraph (a)(2) of § 1.805–5) of such company. Such current earnings rate shall be determined by reference to the assets held by the company in the United States.

(2) *Definitions.* For purposes of section 819(b)(1) and subparagraph (1) of this paragraph:

(i) The term *minimum figure,* in the case of a taxable year beginning after December 31, 1957, but before January 1, 1959, means the amount obtained by multiplying the company's total insurance liabilities on United States business by 9 percent. In the case of any taxable year beginning after December 31, 1958, such term means the amount obtained by multiplying the company's total insurance liabilities on United

States business by the percentage determined and proclaimed by the Secretary as being applicable for such year.

(ii) The term *surplus held in the United States* means the excess of the assets held in the United States (as of the end of the taxable year) over the total insurance liabilities on United States business (as of the end of the taxable year).

(iii) The term *total insurance liabilities* means the sum of the total reserves (as defined in section 801(c) and paragraph (a) of §1.801–5) as of the end of the taxable year plus (to the extent not included in total reserves) the items referred to in section 810(c) (3), (4), and (5) of paragraph (b) (3), (4), and (5) of §1.810–2 as of the end of the taxable year; and

(iv) The term *assets* shall have the same meaning as that contained in section 805(b)(4) and paragraph (a)(4) of §1.805–5.

(3) *Illustration of principles.* The provisions of section 819(b) and this paragraph may be illustrated by the following example:

Example. For the taxable year 1958, P, a foreign life insurance company carrying on a life insurance business within the United States and taxable under section 802, has total insurance liabilities on United States business (as of the end of the taxable year) of $940,000, assets held in the United States of $1,000,000 (as of the end of the taxable year), policy and other contract liability requirements in the amount of $30,000 required interest in the amount of $20,000, and a current earnings rate of 4 percent. In order to determine whether section 819(b) applies for the taxable year 1958, P must first compute its minimum figure, for if the minimum figure is less than the surplus held in the United States (as of the end of the taxable year), no section 819(b) adjustments need be made. Since the minimum figure, $84,600 ($940,000, the total insurance liabilities on United States business multiplied by 9 percent, the percentage applicable for 1958), exceeds the surplus held in the United States, $60,000 (the excess of the assets held in the United States, $1,000,000, over the total insurance liabilities on United States business, $940,000), by $24,600, section 819(b) applies for the taxable year 1958. Thus, the amount of the policy and other contract liability requirements, $30,000, and the amount of the required interest, $20,000, shall each be reduced by $984 ($24,600, the amount of such excess, multiplied by 4 percent, the current earnings rate).

(4) *Segregated asset accounts.* For taxable years beginning after December 31, 1967, pursuant to the provisions of section 801(g):

(i) A foreign corporation carrying on a life insurance business which issues contracts based on segregated asset accounts shall separately compute in a manner consistent with this subparagraph the adjustment (if any) under section 819 to the amount of policy and other contract liability requirements and the amount of required interest properly attributable to each of such segregated asset accounts. The ‘‘minimum figure’’ used in section 819 in making the adjustment with respect to each of the segregated asset accounts shall be computed as provided in subdivision (ii) of this subparagraph in lieu of the manner provided in subparagraphs (1), (2), and (3) of this paragraph.

(ii) The minimum figure applicable to a segregated asset account referred to in subdivision (i) of this subparagraph is the amount determined by multiplying the total insurance liabilities on U.S. business attributable to such a segregated asset account, by 1 percent.

(iii) The minimum figure as computed under subdivision (ii) of this subparagraph shall be compared only with the surplus held in the United States attributable to each segregated asset account referred to in subdivision (i) of this subparagraph. Such surplus is the excess of assets held in the United States properly attributable to such segregated asset account over the total insurance liabilities on U.S. business properly attributable to such account.

(iv) If the minimum figure applicable to accounts other than segregated asset accounts exceeds the surplus held in the United States attributable to such other accounts, for purposes of section 819 and this paragraph, the amount of such excess shall not exceed the company’s overall excess, as defined in this subdivision. No adjustment under section 819 or this paragraph shall be made with respect to any account if there is no such overall excess. For purposes of this subdivision and of subdivision (v) of this subparagraph, the term "overall excess" means the amount, if any, by which the aggregate minimum figures applicable to segregated asset accounts plus the minimum figure applicable to accounts other than segregated asset accounts exceeds the surplus held in the United States with respect to the company's entire U.S. life insurance business, including segregated asset accounts as well as other accounts.

(v) In the case of a company which issues contracts based on one or more than one segregated asset account, if the minimum figure applicable to a segregated asset account exceeds the surplus held in the United States attributable to such account, then for purposes of section 819 and this paragraph, the amount of such excess shall not exceed the account limitation figure, as defined in this subdivision. Therefore, no adjustment under section 819 or under this subparagraph shall be made with respect to any segregated asset account if the aggregate of the account limitation figures is zero, but nothing in this subdivision shall preclude an adjustment under section 819 with respect to accounts other than segregated asset accounts. For purposes of this subdivision, the term "account limitation figure" is a segregated assets account's proportionate share of the aggregate of the account limitation figures. Such aggregate of the account limitation figures is equal to the lesser of either the company's overall excess as defined in subdivision (iv) of this subparagraph, or the amount, if any, by which the aggregate of the minimum figures applicable to segregated asset accounts exceeds the surplus held in the United States with respect to all such segregated asset accounts. For purposes of this subdivision, a segregated asset account's proportionate share of the aggregate of the account limitation figures is determined by multiplying the amount of such aggregate of account limitation figures by a percentage, the numerator of which is the amount by which the minimum figure applicable to such account exceeds the surplus held in the United States attributable to such account, and the denominator of which is the aggregate of the amounts by which the minimum figure applicable to each segregated asset account exceeds the surplus held in the United States attributable to such account.

(vi) Subdivisions (i), (ii), (iii), (iv), and (v) of this subparagraph may be illustrated by the following examples:

Example 1. (a) For the taxable year 1968, T, a foreign life insurance company carrying on a life insurance business within the United States and taxable under section 802, has the following assets and total insurance liabilities with respect to such U.S. business:

	Regular account	Separate account A	Separate account B
Assets	$9,300,000	$1,810,000	$515,000
Total insurance liabilities	8,000,000	1,800,000	500,000

It is further assumed that the percentage determined and proclaimed by the Secretary under section 819(a)(2)(A) for the taxable year 1968 is 15 percent.

(b) In order to determine whether any adjustment under section 819 must be made, T must compute the minimum figure applicable to its Regular Account as well as each of its Separate Accounts. The minimum figure for the Regular Account is $1,200,000 (15 percent of $8,000,000). The minimum figure applicable to Separate Account A is $18,000 (1 percent of $1,800,000). The minimum figure applicable to Separate Account B is $5,000 (1 percent of $500,000). The aggregate of the minimum figures is $1,223,000 ($1,200,000+$18,000+$5,000). The surplus held in the United States with respect to the Regular Account is $1,300,000 ($9,300,000−$8,000,000), with respect to Separate Account A is $10,000 ($1,810,000−$1,800,000) and with respect to Separate Account B is $15,000 ($515,000−$500,000). The surplus held in the United States with respect to T's entire U.S. life insurance business is $1,325,000 ($1,300,000+$10,000+$15,000).

(c) Since the aggregate of the minimum figures ($1,223,000) does not exceed the surplus held in the United States attributable to T's entire U.S. life insurance business ($1,325,000), under subdivision (iv) of this subparagraph no adjustment under section 819 shall be made with respect to the Regular Account or either of the Separate Accounts.

Example 2. (a) The facts are the same as in example 1 except that the assets held in the United States with respect to the Regular Account is $8,300,000 instead of $9,300,000. Thus, the surplus held in the United States with respect to the Regular Account is $300,000 ($8,300,000−$8,000,000), and the surplus held in the United States with respect to T's entire U.S. life insurance business is $325,000 ($300,000+$10,000 +$15,000).

(b) Since the aggregate of the minimum figures with respect to the Separate Accounts, $23,000 ($18,000+$5,000), does not exceed the surplus held in the United States with respect to both of such Separate Accounts, $25,000 ($10,000+$15,000), under subdivision (v) of this subparagraph, no adjustment under section 819 must be made with respect to either of the Separate Accounts.

(c) The excess of the minimum figure for the Regular Account ($1,200,000) over the surplus held in the United States with respect to the Regular Account ($300,000) is equal to $900,000 ($1,200,000−$300,000). However, the company's overall excess as defined in subdivision (iv) of this subparagraph, is $898,000 ($1,223,000−$325,000). Under subdivision (iv) of this subparagraph the excess with respect to the Regular Account ($900,000) is limited to the amount of overall excess ($898,000). Thus, the amount of policy and other contract liability requirements with respect to T's Regular Account and the amount of required interest with respect to T's Regular Account (both computed without regard to section 819) shall each be reduced by an amount equal to the product of $898,000 and the current earnings rate computed only with respect to T's Regular Account.

(c) *Distributions to shareholders*—(1) *In general.* In the case of a foreign life insurance company carrying on a life insurance business within the United States and taxable under section 802, section 819(c)(1) provides alternative methods for determining the amount of distributions to shareholders for purposes of section 815 (relating to distributions to shareholders) and section 802(b)(3) (relating to life insurance company taxable income). Such a foreign life insurance company may elect (in the manner provided by subparagraph (4) of this paragraph) for each taxable year whichever of the alternative methods provided by section 819(c)(1) and this subparagraph it desires, and the method elected for any one taxable year shall be effective only with respect to the taxable year for which the election is made. Such alternative methods are:

(i) The amount of the distributions to shareholders shall be the amount determined by multiplying the total amount of distributions to shareholders by the percentage which the minimum figure for the taxable year is of the excess of the assets of the company over the total insurance liabilities; or

(ii) The amount of the distributions for shareholders shall be the amount determined by multiplying the total amount of distributions for shareholders by the percentage which the total insurance liabilities on United States business for the taxable year is of the total insurance liabilities of the company.

(2) *Definitions.* For purposes of section 819(c)(1) and subparagraph (1) of this paragraph:

(i) The term *total amount of the distributions to shareholders* means all distributions (within the meaning of section 815 and §1.815–2) by a foreign life insurance company to all of its shareholders whether or not in the United States;

(ii) The term *minimum figure for the taxable year* means the amount determined under section 819(b)(2)(A) and paragraph (b)(2) of this section;

(iii) The term *assets of the company* means all of the assets (as defined in section 805(b) (4) and paragraph (a) (4) of §1.805–5) of the foreign life insurance company whether or not in the United States (as of the end of the taxable year); and

(iv) The term *total insurance liabilities of the company* means the total insurance liabilities (as defined in section 819(b)(2) and paragraph (b)(2) of this section) on all of its business whether or not in the United States (as of the end of the taxable year).

(3) *Illustration of principles.* The provisions of section 819(c)(1) and subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. For the taxable year 1958, T, a foreign life insurance company carrying on a life insurance business within the United States and taxable under section 802, has a minimum figure of $40,000, total amount of distributions to all shareholders (within the meaning of section 815) of $5,000, assets (as of the end of the year) of $500,000, total insurance liabilities (as of the end of the year) of $450,000, and total insurance liabilities on United States business (as of the end of the year) of $180,000. Based upon these facts, if T elects the method provided in section 819(c)(1)(A) and subparagraph (1)(i) of this paragraph, the amount of T's distributions to shareholders for the taxable year 1958 is $4,000, that is, $5,000 (the total amount of distributions to shareholders) multiplied by 80 percent (the percentage which the minimum figure for the taxable year, $40,000, is of $50,000, the excess of the assets of the company ($500,000) over the total insurance liabilities ($450,000)).

Example 2. The facts are the same as in example 1, except that for the taxable year 1958, T elects the method provided in section 819(c)(1)(B) and subparagraph (1)(ii) of this paragraph. Based upon these facts, the amount of T's distributions to shareholders for the taxable year 1958 is $2,000, that is, $5,000 (the total amount of distributions to shareholders) multiplied by 40 percent (the percentage which the total insurance liabilities on United States business ($180,000) is of the total insurance liabilities of the company ($450,000)).

(4) *Manner and effect of election.* (i) The election provided by section 819(c)(1) shall be made in a statement attached to the foreign life insurance company's income tax return for any taxable year for which the company desires the election to apply. The return and statement must be filed not later than the date prescribed by law (including extensions thereof) for filing the return for such taxable year. The statement shall indicate the method elected, the name and address of the taxpayer, and shall be signed by the taxpayer (or his duly authorized representative).

(ii) An election made under section 819(c)(1) and this paragraph shall be effective only with respect to the taxable year for which the election is made. Thus, the company must make a new election for each taxable year for which it desires the election to apply. Once such election has been made for any taxable year it may not be revoked. However, for taxable years beginning prior to April 4, 1961, a company may revoke the election provided by section 819(c)(1) without obtaining consent from the Commissioner by filing, before July 4, 1961, a statement that the company desires to revoke such election. An amended return reflecting such revocation and the selection of the other percentage must accompany the statement for all taxable years for which returns have been filed with respect to such election.

(5) *Application of section 815.* Once the amount of distributions to shareholders is determined under the provisions of section 819(c)(1) and this paragraph, the rules of section 815 (relating to distributions to shareholders) shall apply to the shareholders surplus account and the policyholders surplus account of a foreign stock life insurance company in the same manner as they would apply to a domestic stock life insurance company.

(d) *Distributions pursuant to certain mutualizations.* Section 819(c)(2) provides that for purposes of applying section 815(e) and paragraph (e) of § 1.815–6 (relating to a special rule for certain mutualizations) in the case of a foreign life insurance company subject to tax under section 802:

(1) The paid-in capital and paid-in surplus referred to in section 815(e)(1)(A) of a foreign life insurance company is the portion of such capital and surplus determined by multiplying such amounts by the percentage selected for the taxable year under section 819(c)(1) and paragraph (c)(1) of this section; and

(2) The excess referred to in section 815(e)(2)(A)(i) (without the adjustment provided by section 815(e)(2)(B)), is whichever of the following is the greater:

(i) The minimum figure for 1958 determined under section 819(b)(2)(A); or

(ii) The surplus held in the United States (as defined in section 819(b)(2)(B)) determined as of December 31, 1958.

(e) *No United States insurance business.* Foreign life insurance companies not carrying on an insurance business within the United States shall not be taxable under part I, subchapter L, chapter 1 of the Code, but shall be taxable as other foreign corporations. See section 881 and the regulations thereunder.

[T.D. 6558, 26 FR 2791, Apr. 4, 1961; 26 FR 3276, Apr. 18, 1961, as amended by T.D. 6970, 33 FR 12044, Aug. 24, 1968]

EDITORIAL NOTE: For a determination with respect to the percentage to be used by foreign life insurance companies in computing income tax for the taxable year 1984 and the estimated tax for taxable year 1985, see 51 FR 883, Jan. 9, 1986.

MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE AND CERTAIN MARINE INSURANCE COMPANIES AND OTHER THAN FIRE OR FLOOD INSURANCE COMPANIES WHICH OPERATE ON BASIS OF PERPETUAL POLICIES OR PREMIUM DEPOSITS)

§1.821–1 Tax on mutual insurance companies other than life or marine or fire insurance companies subject to the tax imposed by section 831.

(a) *In general.* (1) For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, all mutual insurance companies, including foreign insurance companies carrying on an insurance business within the United States, not taxable under section 801 or 831 and not specifically exempt under the provisions of section 501(c)(15), are subject to the tax imposed by section 821 on their investment income or on their gross income, whichever tax is the greater, except interinsurers and reciprocal underwriters which are taxed only on their investment income. For the alternative tax, in lieu of the tax imposed by section 821 (a) or (b), where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder.

(2) The taxable income of mutual insurance companies subject to the tax imposed by section 821 differs from the taxable income of other corporations. See section 821(a)(2) and section 822. Such companies are entitled, in computing mutual insurance company taxable income, to the deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code. The gross amount of income during the taxable year from interest, the deduction under section 822(c)(1) for wholly tax-exempt interest, and the deduction under section 242 for partially tax-exempt interest, are decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. See section 822(d)(2) and §1.822–3.

(3) All provisions of the Code and of the regulations in this part not inconsistent with the specific provisions of section 821 are applicable to the assessment and collection of the tax imposed by section 821 (a) or (b) and mutual insurance companies subject to the tax imposed by section 821 are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120M.

(4) Foreign mutual insurance companies not carrying on an insurance business within the United States are not taxable under section 821 (a) or (b), but are taxable as other foreign corporations. See section 881.

(5) Mutual insurance companies subject to the tax imposed by section 821, except interinsurers or reciprocal underwriters, with mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) of over $3,000 or with gross amounts of income from interest, dividends, rents, and net premiums (minus dividends to policyholders and wholly tax-exempt interest) in excess of $75,000, are subject to a tax computed under section 821(a)(1) or section 821(a)(2) whichever is the greater. Interinsurers and reciprocal underwriters with mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) of over $50,000 are subject to a tax computed under section 821(b).

(b) *Rates of tax.* (1) The normal tax under section 821(a)(1)(A) and 821(b)(1), except as hereinafter indicated, is computed upon mutual insurance company taxable income for purposes of the normal tax at the rate of 30 percent.

(2) The surtax under section 821(a)(1)(B) and 821(b)(2), except as hereinafter indicated, is computed on that portion of the mutual insurance company taxable income for purposes of the surtax in excess of $25,000 at the rate of 22 percent. The tax under section 821(a)(2), except as hereinafter indicated, is 1 percent of the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest.

(3) Under section 821(a)(1)(A) companies with mutual insurance company taxable income for purposes of the normal tax of over $3,000 and not over $6,000 pay a normal tax, at a specified rate, on that portion of such income in excess of $3,000. The rate applicable in computing the normal tax of such companies is 60 percent. Under section 821(a)(2) companies with gross amounts of income from interest dividends, rents, and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest, of over $75,000 and not over $150,000 pay a tax equal to 2 percent of that portion in excess of $75,000.

(4) Under section 821(b)(1) interinsurers and reciprocal underwriters with mutual insurance company taxable income for purposes of the normal tax of over $50,000 and not over $100,000 pay a normal tax computed on that portion of such income in excess of $50,000 at the rate of 60 percent. Under section 821(b)(2) interinsurers and reciprocal underwriters with mutual insurance company taxable income for purposes of the surtax of over $50,000 and not over $100,000 pay a surtax, at the rate of 33 percent, on that portion of such income in excess of $50,000.

(5) Section 821(c) provides for an adjustment of the amount computed under section 821(a)(1), section 821(a)(2), and section 821(b) where the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) is over $75,000 and less than $125,000. The adjustment reduces the tax otherwise computed under those sections to an amount which bears the same proportion to such tax as the excess over $75,000 bears to $50,000.

(c) *Application.* The application of section 821 (a) to (c) inclusive, may be illustrated by the following examples:

Example 1. The W Company, a mutual casualty insurance company, for the calendar year 1954, has mutual insurance company taxable income for purposes of the surtax of $5,500 and, due to partially tax-exempt interest of $800, has income for purposes of the normal tax of $4,700. The gross amount of income of the W Company from interest, dividends, rents and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $150,000. Its normal tax under section 821(a)(1) for the calendar year 1954 is 60 percent of $1,700 ($4,700 minus $3,000) or $1,020, since its income subject to normal tax is not over $6,000. It is not liable for surtax for the calendar year 1954 as its mutual insurance company taxable income for purposes of the surtax does not exceed $25,000. It has no surtax and, therefore, its total tax under section 821(a)(1)(A) is the normal tax of $1,020. The tax under section 821(a)(2) is 2 percent of $75,000 ($150,000 − $75,000), or $1,500. Since the tax under section 821(a)(2) exceeds the tax under section 821(a)(1), the tax under section 821 is $1,500, namely, that imposed by section 821(a)(2).

Example 2. If in example 1 the income for purposes of the normal tax were not over $3,000, the income for purposes of the surtax were not over $25,000, the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) were $90,000, and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, were $70,000, the W Company would be required to file an income tax return but due to section 821(a) no income tax would be imposed.

Example 3. The X Company, a mutual casualty insurance company, for the calendar year 1954 has mutual insurance company taxable income for surtax purposes of $28,000 and, due to partially tax-exempt interest of $5,000, has income for normal tax purposes of $23,000. The gross amount of income of the X Company from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $1,200,000. Under section 821(a)(1) its normal tax for the calendar year 1954 is 30 percent of $23,000, or $6,900, and the surtax is 22 percent of $3,000 ($28,000 − $25,000), or $660. The combined tax under section 821(a)(1) is $7,560 ($6,900 plus $660). The tax under section 821(a)(2) is 1 percent of $1,200,000, or $12,000. Since the tax under section 821(a)(2) exceeds the tax under section 821(a)(1), the tax under section 821(a) is $12,000, namely, that imposed by section 821(a)(2).

Example 4. The Y Company, a mutual fire insurance company subject to the tax imposed by section 821 for the calendar year 1954, has mutual insurance company taxable income for purposes of the surtax of $35,000 and, due to partially tax-exempt interest of $5,000, has income for purposes of the normal tax of $30,000. The gross amount received from interest, dividends, rents and premiums (including deposits and assessments) is $120,000, and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $100,000. Under section 821(a)(1), without application of section 821(c), the normal tax would be 30 percent of $30,000, or $9,000, since this is less than $16,200, 60 percent of $27,000 (excess of $30,000 over $3,000); and the surtax would be 22 percent of $10,000 (excess of $35,000 over $25,000), or $2,200. The combined tax of $11,200 ($9,000 plus $2,200) would then be reduced by applying section 821(c), since the gross receipts are between $75,000 and $125,000. The tax under section 821(a)(1), as thus adjusted, would be 90 percent of $11,200, or $10,080, since $45,000 (excess of $120,000 over $75,000) is 90 percent of $50,000. Under section 821(a)(2), without reference to section 821(c), the tax is 2 percent of $25,000 (excess of $100,000 over $75,000), or $500, since this is less than $1,000, 1 percent of $100,000. Applying section 821(c) reduces this to $450, or 90 percent of $500. Since $10,080, the tax under section 821(a)(1), as adjusted, exceeds $450, the tax under section 821(a)(2), as adjusted, the tax under section 821(a)(1), as adjusted, is applicable. The Y Company would accordingly pay a combined normal taxing and surtax of $10,080.

Example 5. The Z Exchange, an interinsurer, for the calendar year 1954 has mutual insurance company taxable income for purposes of the surtax of $60,000 and, due to partially tax-exempt interest of $12,000, has income for purposes of the normal tax of $48,000. The gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) is $2,700,000. The Z Exchange is not liable for normal tax under section 821(b)(1) for the calendar year 1954 as its mutual insurance company taxable income for purposes of the normal tax does not exceed $50,000. Its surtax is 33 percent of $10,000 ($60,000 minus $50,000), or $3,300, since that amount is less than $7,700, 22 percent of $35,000 (excess of $60,000 over $25,000). Since the Z Exchange has no normal tax, is not subject to the tax imposed by section 821(a)(2), and is not entitled to the adjustment provided in section 821(c), its total tax under section 821(a) is $3,300.

§1.821–2 Taxable years affected.

Section 1.821–1 is applicable only to taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, and all references to sections of part II, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Section 1.821–3 is applicable only to taxable years beginning after December 31, 1954, but before January 1, 1963, and all references to sections of part II, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Tax Act for 1955 (70 Stat. 36). Sections 1.821–4 and 1.821–5 are applicable only to taxable years beginning after December 31, 1962, and all references to sections of parts II and III, subchapter L, chapter 1 of the Code are to sections of the Internal Revenue Code of 1954 as amended by section 8 of the Revenue Act of 1962 (76 Stat. 989).

[T.D. 6681, 28 FR 11110, Oct. 17, 1963]

§1.821–3 Tax on mutual insurance companies other than life or marine or fire insurance companies subject to the tax imposed by section 831.

(a) *In general.* (1) For taxable years beginning after December 31, 1954, all mutual insurance companies, including foreign insurance companies carrying on an insurance business within the United States, not taxable under section 802 or 831 and not specifically exempt under the provisions of section 501(c)(15), are subject to the tax imposed by section 821 on their investment income or on their gross income, whichever tax is the greater, except interinsurers and reciprocal underwriters which are taxed only on their investment income. For the alternative tax, in lieu of the tax imposed by section 821 (a) or (b), where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder.

(2) The taxable income of mutual insurance companies subject to the tax imposed by section 821 differs from the taxable income of other corporations. See section 821(a)(2) and section 822. Such companies are entitled, in computing mutual insurance company taxable income, to the deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code. The gross amount of income during the taxable year from interest, the deduction under section 822(c)(1) for wholly tax-exempt interest, and the deduction under section 242 for partially tax-exempt interest, are decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. See section 822(d)(2) and §1.822–7. However, for taxable years beginning after May 31, 1960,

only the accrual of discount relating to issue discount will increase the deduction for wholly tax-exempt interest. See section 103. In the case of any such evidence of indebtedness, adjustment shall be made to basis in the same manner as that made by life insurance companies under section 1016(a)(17) and the regulations thereunder.

(3) All provisions of the Internal Revenue Code and of the regulations in this part not inconsistent with the specific provisions of section 821 are applicable to the assessment and collection of the tax imposed by section 821 (a) or (b) and mutual insurance companies subject to the tax imposed by section 821 are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120M.

(4) Foreign mutual insurance companies not carrying on an insurance business within the United States are not taxable under section 821 (a) or (b), but are taxable as other foreign corporations. See section 881.

(5) Mutual insurance companies subject to the tax imposed by section 821, except interinsurers or reciprocal underwriters, with mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) of over $3,000 or with gross amounts of income during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums (minus dividends to policyholders and wholly tax-exempt interest) in excess of $75,000, are subject to a tax computed under section 821(a)(1) or section 821(a)(2) whichever is the greater. Interinsurers and reciprocal underwriters with mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) of over $50,000 are subject to a tax computed under section 821(b).

(b) *Rates of tax.* (1) For taxable years beginning before July 1, 1963, the normal tax under section 821(a)(1)(A) and 821(b)(1), except as hereinafter indicated, is computed upon mutual insurance company taxable income for purposes of the normal tax at the rate of 30 percent.

(2) The surtax under section 821(a)(1)(B) and 821(b)(2), except as hereinafter indicated, is computed on that portion of the mutual insurance company taxable income for the purposes of the surtax in excess of $25,000 at the rate of 22 percent. The tax under section 821(a)(2), except as hereinafter indicated, is 1 percent of the gross amount of income during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest.

(3) For taxable years beginning before July 1, 1963, under section 821(a)(1)(A) companies with mutual insurance company taxable income for purposes of the normal tax of over $3,000 and not over $6,000 pay a normal tax, at a specified rate, on that portion of such income in excess of $3,000. The rate applicable in computing the normal tax of such companies is 60 percent. Under section 821(a)(2) companies with gross amounts of income during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest, of over $75,000 and not over $150,000 pay a tax equal to 2 percent of that portion in excess of $75,000.

(4) For taxable years beginning before July 1, 1963, under section 821(b)(1) interinsurers and reciprocal underwriters with mutual insurance company taxable income for purposes of the normal tax of over $50,000 and not over $100,000 pay a normal tax computed on that portion of such income in excess of $50,000 at the rate of 60 percent. Under section 821(b)(2) interinsurers and reciprocal underwriters with mutual insurance company taxable income for purposes of the surtax of over $50,000 and not over $100,000 pay a surtax, at the rate of 33 percent, on that portion of such income in excess of $50,000.

(5) Section 821(c) provides for an adjustment of the amount computed under section 821(a)(1), section 821(a)(2), and section 821(b) where the gross amount received during the taxable

year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) is over $75,000 and less than $125,000. The adjustment reduces the tax otherwise computed under those sections to an amount which bears the same proportion to such tax as the excess over $75,000 bears to $50,000.

(c) *Application.* The application of section 821 (a) to (c) inclusive, may be illustrated by the following examples:

Example 1. The W Company, a mutual casualty insurance company, for the calendar year 1958, has mutual insurance company taxable income for purposes of the surtax of $5,500 and, due to partially tax-exempt interest of $800, has income for purposes of the normal tax of $4,700. The gross amount of income of the W Company from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $150,000. Its normal tax under section 821(a)(1) for the calendar year 1958 is 60 percent of $1,700 ($4,700 minus $3,000) or $1,020, since its income subject to normal tax is not over $6,000. It is not liable for surtax for the calendar year 1958 as its mutual insurance company taxable income for purposes of the surtax does not exceed $25,000. It has no surtax and, therefore, its total tax under section 821(a)(1)(A) is the normal tax of $1,020. The tax under section 821(a)(2) is 2 percent of $75,000 ($150,000−$75,000), or $1,500. Since the tax under section 821(a)(2) exceeds the tax under section 821(a)(1), the tax under section 821 is $1,500, namely, that imposed by section 821(a)(2).

Example 2. If in the above example the income for purposes of the normal tax were not over $3,000, the income for purposes of the surtax were not over $25,000, the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) were $90,000, and the gross amount of income from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums, minus dividends to policyholders and wholly tax-exempt interest were $70,000, the W Company would be required to file an income tax return but due to section 821(a) no income tax would be imposed.

Example 3. The X Company, a mutual casualty insurance company, for the calendar year 1958, has mutual insurance company taxable income for surtax purposes of $28,000 and, due to partially tax-exempt interest of $5,000, has income for normal tax purposes of $23,000. The gross amount of income of the X Company received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $1,200,000. Under section 821(a)(1) its normal tax for the calendar year 1958 is 30 percent of $23,000, or $6,900, and the surtax is 22 percent of $3,000 ($28,000−$25,000), or $660. The combined tax under section 821(a)(1) is $7,560 ($6,900 plus $660). The tax under section 821(a)(2) is 1 percent of $1,200,000, or $12,000. Since the tax under section 821(a)(2) exceeds the tax under section 821(a)(1), the tax under section 821(a) is $12,000, namely, that imposed by section 821(a)(2).

Example 4. The Y Company, a mutual fire insurance company subject to the tax imposed by section 821 for the calendar year 1958, has mutual insurance company taxable income for purposes of the surtax of $35,000 and, due to partially tax-exempt interest of $5,000, has income for purposes of the normal tax of $30,000. The gross amount received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) is $120,000, and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $100,000. Under section 821(a)(1), without application of section 821(c), the normal tax would be 30 percent of $30,000, or $9,000, since this is less than $16,200, 60 percent of $27,000 (excess of $30,000 over $3,000); and the surtax would be 22 percent of $10,000 (excess of $35,000 over $25,000), or $2,200. The combined tax of $11,200 ($9,000 plus $2,200) would then be reduced by applying section 821(c), since the gross receipts are between $75,000 and $125,000. The tax under section 821(a)(1), as thus adjusted, would be 90 percent of $11,200, or $10,080, since $45,000 (excess of $120,000 over $75,000) is 90 percent of $50,000. Under section 821(a)(2), without reference to section 821(c), the tax is 2 percent of $25,000 (excess of $100,000 over $75,000), or $500, since this is less than $1,000, 1 percent of $100,000. Applying section 821(c) reduces this to $450, or 90 percent of $500. Since $10,080, the tax under section 821(a)(1), as adjusted, exceeds $450, the tax under section 821(a)(2), as adjusted, the tax under section 821(a)(1), as adjusted, is applicable. The Y Company would accordingly pay a combined normal tax and surtax of $10,080.

Example 5. The Z Exchange, an inter-insurer, for the calendar year 1958 has mutual insurance company taxable income for purposes of the surtax of $60,000 and, due to partially tax-exempt interest of $12,000, has income for purposes of the normal tax of $48,000. The gross amount received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) is $2,700,000. The Z Exchange is not liable for normal tax under section 821(b)(1) for the calendar year 1958 as its mutual insurance company taxable income for purposes of the normal tax does not exceed $50,000. Its surtax is 33 percent of $10,000 ($60,000 minus $50,000), or $3,300, since that amount is less than $7,700, 22 percent of $35,000 (excess of $60,000 over $25,000). Since the Z Exchange has no normal tax, is not subject to the tax imposed by section 821(a)(2), and is not entitled to the adjustment provided in section 821(c), its total tax under section 821(b) is $3,300.

[T.D. 6610, 27 FR 8718, Aug. 31, 1962]

§ 1.821–4 Tax on mutual insurance companies other than life insurance companies and other than fire, flood, or marine insurance companies, subject to tax imposed by section 831.

(a) *In general*—(1) *Tax imposed.* (i) For taxable years beginning after December 31, 1962, all mutual insurance companies, including foreign insurance companies carrying on an insurance business within the United States, not taxable under section 802 or 831, and not specifically exempt under the provisions of section 501(c)(15), are subject either to the tax imposed by section 821(a) on mutual insurance company taxable income or, in the case of certain small companies, to the tax imposed by section 821(c) on taxable investment income. The determination of whether a mutual insurance company is taxable under section 821 (a) or (c) for the taxable year is dependent upon the gross amount received by the company during such taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments). If such gross amount received exceeds $150,000, but does not exceed $500,000 for the taxable year, the company is subject to the tax imposed by section 821(c) on taxable investment income, unless (*a*) the company elects under section 821(d) in the manner provided in paragraph (f) of this section to be subject to the tax imposed by section 821(a), or (*b*) there is a balance in its protection against loss account at the beginning of the taxable year. A company having a gross amount received in excess of $500,000 is subject to the tax imposed by section 821(a). For exemption from income tax of companies having a gross amount received not in excess of $150,000, see section 501(c)(15). For the alternative tax, in lieu of the tax imposed by section 821 (a) or (c), where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder. For the definition of an insurance company, see paragraph (a) of § 1.801–3.

(ii) The term ''premiums'' as used in section 821 and this section has the same meaning as in section 501(c)(15) and § 1.501(c)(15)–1, and means the total amount of the premiums and other consideration provided in the insurance contract without any deduction for commissions, return premiums, reinsurance, dividends to policyholders, dividends left on deposit with the company, discounts on premiums paid in advance, interest applied in reduction of premiums (whether or not required to be credited in reduction of premiums under the terms of the contract), or any other item of similar nature. Such term includes advance premiums, premiums deferred and uncollected and premiums due and unpaid, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction), but does not include amounts received from other insurance companies for losses paid under reinsurance contracts.

(2) *Tax base.* The taxable income of mutual insurance companies taxable under section 821 differs from the taxable income of other corporations. See sections 821(b) and 822. Mutual insurance companies have special items of income and special deductions not provided for other corporations. See, for example, sections 821(b)(1)(C), 822(d), 823(b), 824(a), and 825(a). Thus, the computation of mutual insurance company taxable income for a company taxable under section 821(a), and the computation of taxable investment income for a company taxable under section 821(c), must be made in strict accordance with the provisions of part II of subchapter L of the Code.

(3) *Applicability of other provisions.* All provisions of the Code and of the regulations in this part not inconsistent with the specific provisions of part II of

subchapter L of the Code are applicable to the assessment and collection of the tax imposed by section 821 (a) or (c), and mutual insurance companies subject to the tax imposed by section 821 are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120M.

(4) *Certain foreign companies.* Foreign mutual insurance companies (other than a life insurance company and other than a fire, flood, or marine insurance company subject to the tax imposed by section 831) not carrying on an insurance business within the United States are not taxable under section 821 (a) or (c), but are taxable as other foreign corporations. See section 881.

(b) *Rates of tax imposed by section 821(a)*—(1) *Normal tax.* For taxable years beginning before January 1, 1964, the normal tax imposed under section 821(a) is the lesser of 30 percent of mutual insurance company taxable income, or 60 percent of the amount by which mutual insurance company taxable income exceeds $6,000. In the case of taxable years beginning after December 31, 1963, the normal tax is imposed at the rate of 22 percent of mutual insurance company taxable income, or 44 percent of the amount by which mutual insurance company taxable income exceeds $6,000, whichever is the lesser. For example, a company subject to tax under section 821(a) will file a return but will pay no normal tax if mutual insurance company taxable income does not exceed $6,000. When mutual insurance company taxable income exceeds $6,000 but does not exceed $12,000, the company will pay a normal tax equal to 44 percent (60 percent in the case of taxable years beginning before Jan. 1, 1964), of the amount by which mutual insurance company taxable income exceeds $6,000. When mutual insurance company taxable income exceeds $12,000, the company will pay normal tax at the rate of 22 percent (30 percent in the case of taxable years beginning before Jan. 1, 1964), of such income.

(2) *Surtax*—(i) *Taxable years beginning before January 1, 1964.* For taxable years beginning before January 1, 1964, companies taxable under section 821(a) are subject to a surtax equal to 22 percent of so much of their mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) as exceeds $25,000. In the case of an interinsurer or reciprocal underwriter electing to be subject to the limitation provided in section 826(b), the surtax applies to any increase in mutual insurance company taxable income attributable to such election, without regard to the $25,000 surtax exemption otherwise provided by this subparagraph, and without regard to whether the company is liable for any normal tax under subparagraph (1) of this paragraph. See section 826(f) and §1.826–2.

(ii) *Taxable years beginning after December 31, 1963.* For taxable years beginning after December 31, 1963, companies taxable under section 821(a) are subject to a surtax at the rates and with the exemptions provided in section 11(c) on their mutual insurance company taxable income. In the case of an interinsurer or reciprocal underwriter electing to be subject to the limitation provided in section 826(b), the surtax applies to any increase in mutual insurance company taxable income attributable to such election, without regard to the surtax exemption otherwise provided by section 11(d), and without regard to whether the company is liable for any normal tax under section 821(a)(1) and subparagraph (1) of this paragraph. See section 826(f) and §1.826–2.

(c) *Mutual insurance company taxable income defined.* The tax imposed by section 821(a) with respect to any taxable year is computed upon mutual insurance company taxable income for the taxable year. Section 821(b) provides that in the case of a mutual insurance company subject to the tax imposed by section 821(a), mutual insurance company taxable income means the amount by which:

(1) The sum of:

(i) The taxable investment income (as defined in section 822(a)(1) and paragraph (a)(1) of §1.822–8).

(ii) The statutory underwriting income (as defined in section 823(a)(1) and paragraph (b)(1) of §1.823–6), and

(iii) The amounts required by section 824(d) and paragraph (b)(3) of § 1.824–1 to be subtracted from the protection against loss account, exceeds.

(2) The sum of:

(i) The investment loss (as defined in section 822(a)(2) and paragraph (a)(2) of § 1.822–8),

(ii) The statutory underwriting loss (as defined in section 823(a)(2) and paragraph (b)(2) of § 1.823–6), and

(iii) The unused loss deduction provided by section 825(a) and paragraph (a) of § 1.825–1.

If for any taxable year the amount determined under subparagraph (2) of this paragraph equals or exceeds the amount determined under subparagraph (1) of this paragraph, the mutual insurance company taxable income for such year shall be zero.

(d) *Examples.* The application of the tax imposed by section 821(a) may be illustrated by the following examples:

Example 1. (a) M, a mutual casualty insurance company, for the calendar year 1963 has gross receipts from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) in excess of $500,000, and therefore is subject to the tax imposed by section 821(a). M's taxable investment income, computed under section 822, is $30,000 and its statutory underwriting income, computed under section 823, is $15,000. M subtracts $3,000 from its protection against loss account in accordance with the computation made under section 824(d). M has no unused loss deduction. M received no partially tax exempt interest. If M is not subject to section 826, its mutual insurance company taxable income for the taxable year 1963 is $48,000, computed as follows:

(1) Taxable investment income	$30,000
(2) Statutory underwriting income	15,000
(3) Subtractions from protection against loss account	3,000
(4) Total income items	48,000
(5) Investment loss	0
(6) Statutory underwriting loss	0
(7) Unused loss deduction	0
(8) Total loss items	0
(9) Mutual insurance company taxable income (item (4) minus item (8))	48,000

(b) Since M's mutual insurance company taxable income is in excess of $12,000, M will pay normal tax on its mutual insurance company taxable income at a rate of 30 percent. In addition, since M's mutual insurance company taxable income exceeds $25,000, M will pay surtax on such excess at a rate of 22 percent. M's total tax liability for the taxable year 1963 is $19,460, computed as follows:

(1) Mutual insurance company taxable income as computed in item (a)(9)	$48,000
(2) Normal tax; 30 percent of mutual insurance company taxable income	14,400
(3) Surtax exemption	25,000
(4) Mutual insurance company taxable income subject to the surtax (item (1) minus item (3))	23,000
(5) Surtax: 22 percent of mutual insurance company taxable income subject to the surtax	5,060
(6) Total tax (item (2) plus item (5))	19,460

Example 2. If in example 1, M's mutual insurance company taxable income for 1963 had been in excess of $6,000 but not in excess of $12,000, M would pay normal tax in an amount equal to 60 percent of the amount by which such income exceeded $6,000. Thus, if M had mutual insurance company taxable income of $11,000, M's total tax liability for the taxable year 1963 would be $3,000, computed as follows:

(1) Mutual insurance company taxable income	$11,000
(2) Mutual insurance company taxable income in excess of $6,000 ($11,000 minus $6,000)	5,000
(3) 30 percent of item (1)	3,800
(4) 60 percent of item (2)	3,000
(5) Normal tax (lesser of items (3) or (4))	3,000
(6) Surtax exemption	25,000

Since the surtax exemption exceeds the mutual insurance company taxable income for purposes of the surtax, there is no surtax liability. Since the normal tax under section 821(a) is the lesser of 30 percent of mutual insurance company taxable income or 60 percent of the amount by which such income exceeds $6,000, M's normal tax (and total income tax liability) is $3,000. If M's mutual insurance company taxable income was not in excess of $6,000, M would be required to file a return, but would not be liable for any normal tax, since, in such a case, 60 percent of M's mutual insurance company taxable income in excess of $6,000 would be zero.

Example 3. Assume the same income as in example 1 in the 1965 calendar year and that M is not a corporation to which section 1561 (with respect to certain controlled corporations) applies. Since M's mutual insurance company taxable income is in excess of $12,000, M will pay normal tax on its mutual insurance company taxable income at a rate of 22 percent. In addition, since M's mutual insurance company taxable income exceeds the surtax exemption provided in section 11(d) of $25,000, M will pay a surtax on such excess at the rate provided in section 11(c), 26 percent. M's total liability for the taxable year 1964 is $16,540, computed as follows:

(1) Mutual insurance company taxable income as computed in example (1)	$48,000
(2) Normal tax: 22 percent of mutual insurance company taxable income for normal tax purposes	10,560
(3) Surtax exemption provided by section 11(d)	25,000
(4) Mutual insurance company taxable income subject to the surtax (item (1) minus item (3))	23,000
(5) Surtax: at rates provided in section 11(c): 26 percent of mutual insurance company taxable income subject to the surtax	5,980
(6) Total tax (item (2) plus item (5))	16,540

(e) *Alternative tax for certain small mutual insurance companies*—(1) *In general.* (i) Section 821(c) provides an alternative tax for certain small mutual insurance companies. This alternative tax, which is in lieu of the tax imposed by section 821(a), is imposed on taxable investment income (as defined in section 822(a)(1) and paragraph (a)(1) of §1.822–8) and consists of a normal tax and a surtax. The tax provided by section 821(c) is imposed on every mutual insurance company (other than a life insurance company and other than a fire, flood, or marine insurance company subject to the tax imposed by section 831) which received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) a gross amount in excess of $150,000 but not in excess of $500,000, except a company which has properly elected under section 821(d) and paragraph (f) of this section to be subject to the tax imposed by section 821(a), or a company which has a balance in its protection against loss account at the beginning of the taxable year.

(ii) Any company which would be taxable under section 821(c) but for the presence of an amount in its protection against loss account at the beginning of the taxable year may elect to subtract the balance from such account. See section 824(d)(5) and §1.824–3. If such an election is made in such a case, the company shall not be subject to the tax imposed by section 821(a), but shall be subject to the tax imposed by section 821(c).

(2) *Rates of tax imposed by section 821(c)*—(i) *Normal tax.* The normal tax for taxable years beginning before January 1, 1964, is the lesser of 30 percent of taxable investment income or 60 percent of the amount by which taxable investment income exceeds $3,000. For taxable years beginning after December 31, 1963, the normal tax is imposed at the rate of 22 percent of taxable investment income, or 44 percent of the amount by which taxable investment income exceeds $3,000, whichever is the lesser. Thus, a company subject to tax under section 821(c) will file a return but will pay no tax if for the taxable year its taxable investment income does not exceed $3,000; or will pay a normal tax equal to 44 percent (60 percent in the case of taxable years beginning before Jan. 1, 1964), of taxable investment income in excess of $3,000 when such income exceeds $3,000 but does not exceed $6,000. When taxable investment income exceeds $6,000, the normal tax is imposed at the rate of 22 percent (30 percent in the case of taxable years beginning before Jan. 1, 1964) of such income.

(ii) *Surtax.* For taxable years beginning before January 1, 1964, a surtax is imposed at the rate of 22 percent of taxable investment income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) in excess of $25,000. For taxable years beginning after December 31, 1963, a surtax is imposed at the rate provided in section 11(c) on taxable investment income in excess of the surtax exemption provided in section 11(d).

(f) *Election to be taxed under section 821(a)*—(1) *In general.* Section 821(d) provides that any mutual insurance company taxable under section 821(c) may elect, in the manner provided by subparagraph (3) of this paragraph, to be taxed under section 821(a).

(2) *Scope of election.* Except as otherwise provided herein, an election made under section 821(d) and this paragraph to be taxable under section 821(a) shall be binding for the taxable year for which made and for all succeeding taxable years unless the Commissioner consents to a revocation of such election. If for any taxable year the gross

amount received from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) does not exceed $150,000, a company's prior election made under section 821(d) to be taxable under section 821(a) will automatically terminate and any balance in the protection against loss account will be taken into account for the preceding taxable year. (See section 824(d)(4) and § 1.824–2 for automatic termination of protection against loss account if company is not subject to the tax imposed by section 821(a).) If for any taxable year thereafter the gross amount received exceeds $150,000 but does not exceed $500,000, the company shall be taxable under section 821(c) unless it makes a new election to be taxable under section 821(a). If a company subject to tax under section 821(c) for a taxable year elects under section 821(d) and this section to be taxed under section 821(a) and, in a subsequent taxable year, the gross receipts of such company exceed $500,000, the election made for such earlier taxable year shall be considered as continuing in effect. Thus, such a company will continue to be taxable under section 821(a) notwithstanding that its gross receipts subsequently fall below $500,000 (so long as they do not fall below $150,000) unless the Commissioner consents to a revocation of the prior election. Whether revocation is permissible in any case will depend on the facts and circumstances of the particular case, but in no case will revocation be granted in the absence of a showing that the election creates an undue burden or material hardship on the company due to a substantial change in the character of its operations.

(3) *Time and manner of making election.* The election provided by section 821(d) shall be made in a statement attached to the company's income tax return for the first taxable year for which the election is to apply. The statement shall include the name and address of the taxpayer, shall be signed by the taxpayer (or its duly authorized representative), and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the return for such taxable year.

(g) *Examples.* The application of the tax imposed by section 821(c) may be illustrated by the following examples:

Example 1. M, a mutual casualty insurance company, for the calendar year 1963 has a gross amount received from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) of $400,000. Since M's gross amount received exceeds $150,000, but does not exceed $500,000, M is subject to the tax imposed by section 821(c) on taxable investment income unless it elects to be subject to the tax imposed on mutual insurance company taxable income by section 821(a). M computes its taxable investment income under section 822 to be $35,000. In computing taxable investment income, M deducted $2,000 of partially tax-exempt interest under section 242. If M does not make an election to be taxed under section 821(a), its total tax liability for the taxable year 1963 is $13,140 computed as follows:

(1) Taxable investment income as computed under section 822	$35,000
(2) 30 percent of taxable investment income	10,500
(3) 60 percent of taxable investment income in excess of $3,000	19,200
(4) Normal tax (lesser of items (2) or (3))	10,500
(5) Partially tax-exempt interest deducted in computing taxable investment income	2,000
(6) Taxable investment income for purposes of the surtax (item (1) plus item (5))	37,000
(7) Surtax exemption	25,000
(8) Taxable investment income subject to surtax (item (6) minus item (7))	12,000
(9) Surtax (22 percent of item (8))	2,640
(10) Total tax liability (item (4) plus item (9))	13,140

Example 2. N, a mutual casualty insurance company, for the taxable year 1963 has a gross amount received from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) of $210,000. Since N's gross amount received exceeds $150,000 but does not exceed $500,000, N is subject to the tax imposed by section 821(c) on taxable investment income unless it elects to be subject to the tax imposed by section 821(a). Furthermore, since the gross amount received by N does not exceed $250,000, N is entitled to the special tax reduction provided by section 821(c)(2). N computes its taxable investment income under section 822 to be $24,000. In computing taxable investment income, N deducted $2,000 of partially tax-exempt interest under section 242. If N does not make an election to be taxed under section 821(a), its total tax liability for the taxable year 1963 is $4,452 computed as follows:

(1) Taxable investment income as computed under section 822	$24,000
(2) 30 percent of taxable investment income	7,200
(3) 60 percent of taxable investment income in excess of $3,000	12,600
(4) Normal tax (lesser of items (2) or (3))	7,200

(5) Partially tax-exempt interest deducted in computing taxable investment income	2,000
(6) Taxable investment income for purposes of the surtax (item (1) plus item (5))	26,000
(7) Surtax exemption	25,000
(8) Taxable investment income subject to surtax (item (6) minus item (7))	1,000
(9) Surtax 22 percent of item (8)	220
(10) Tax liability computed without regard to special reduction (item (4) plus item (9))	7,420
(11) Amount by which gross receipts exceed $150,000 ($210,000 gross receipts minus $150,000)	60,000
(12) Percentage which item (1) bears to $100,000 ($60,000 over $100,000)	0.60
(13) Tax as adjusted (percentage determined in item (12) applied to item (10))	4,452

If N's taxable investment income for purposes of the surtax did not exceed $3,000, N would file a return but would pay no tax. Had N elected (under section 821(d)) to be subject to tax under section 821(a), N would not be entitled to the special reduction afforded by section 821(c)(2), since that provision applies only to companies taxable under section 821(c).

[T.D. 6681, 28 FR 11110, Oct. 17, 1963, as amended by T.D. 7100, 36 FR 5333, Mar. 20, 1971; 36 FR 5846, Mar. 30, 1971]

§1.821–5 Special transitional underwriting loss.

(a) *In general.* Section 821(f) provides a special reduction in the statutory underwriting income (as defined by section 823(a)(1) and paragraph (b)(1) of §1.823–6) of any company taxable under section 821(a) which was taxable under section 821 for the five taxable years immediately preceding January 1, 1962, and which incurred an underwriting loss (as defined in section 821(f)(3) and paragraph (c) of this section) for each of such five taxable years.

(b) *Amount of reduction.* In the case of a company described in section 821(f)(1) and paragraph (a) of this section the statutory underwriting income for the taxable year (determined without regard to this paragraph) shall be reduced by an amount equal to the amount by which:

(1) The sum of the underwriting losses of such company for the five taxable years immediately preceding January 1, 1962, exceeds

(2) The total amount by which the company's statutory underwriting income was reduced by reason of section 821(f) and this section for prior taxable years.

(c) *Underwriting loss defined.* For purposes of computing the amount of the reduction available under section 821(f) and paragraph (a) of this section, the term underwriting loss means statutory underwriting loss (as defined by section 823(a)(2) and paragraph (b)(2) of §1.823–6) computed without any deduction under section 824(a) and paragraph (a) of §1.824–1 (relating to deduction to provide protection against losses) and without any deduction under section 832(c)(11) (relating to dividends and similar distributions paid or declared to policyholders). For rules relating to the definition of dividends and similar distributions paid or declared to policyholders, see paragraph (a) of §1.832–5.

(d) *Years of applicability.* Section 821(f)(4) provides that the special reduction of statutory underwriting income allowed by section 821(f)(2) and paragraph (b) of this section shall apply to any taxable year beginning after December 31, 1962, and before January 1, 1968, for which the taxpayer is subject to the tax imposed by section 821(a).

[T.D. 6681, 28 FR 11112, Oct. 17, 1963]

§1.822–1 Taxable income and deductions.

(a) *In general.* For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, the taxable income of a mutual insurance company subject to the tax imposed by section 821 is its gross investment income, namely, the gross amount of income during the taxable year from interest, dividends, rents, and gains from sales or exchanges of capital assets, less the deductions provided in section 822(c) for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, interest paid or accrued, capital losses to the extent provided in subchapter P (sec. 1201 and following), chapter 1 of the Code, and the special deductions provided in part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code. In addition to the limitations on deductions relating to real estate owned and occupied by a mutual insurance company subject to the tax imposed by section 821 provided in section

822(d)(1), the adjustment for amortization of premium and accrual of discount provided in section 822(d)(2), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 822(c)(2), mutual insurance companies subject to the tax imposed by section 821 are subject to the limitation on deductions relating to wholly tax-exempt income provided in section 265. Such companies are not entitled to the net operating loss deduction provided in section 172.

(b) *Wholly tax-exempt interest.* Interest which in the case of other taxpayers is excluded from gross income by section 103 but included in the gross investment income by section 822(b) is allowed as a deduction from gross investment income by section 822(c)(1).

(c) *Investment expenses.* The deduction allowed by section 822(c)(2) for investment expenses is the same as that allowed life insurance companies by section 803(g)(2). See paragraph (c) of § 1.803–4.

(d) *Taxes and expenses with respect to real estate.* The deduction allowed by section 822(c)(3) for taxes and expenses with respect to real estate owned by the company is the same as that allowed life insurance companies by section 803(g)(3). See paragraph (d) of § 1.803–4.

(e) *Depreciation.* The deduction allowed by section 822(c)(4) for depreciation is the same as that allowed life insurance companies by section 803(g)(4). See paragraph (e) of § 1.803–4.

(f) *Interest paid or accrued.* The deduction allowed by section 822(c)(5) for interest on indebtedness is the same as that allowed other corporations by section 163. See § 1.163–1.

(g) *Capital losses.* (1) The deduction for capital losses under section 822(c)(6) includes not only capital losses to the extent provided in subchapter P but in addition thereto losses from capital assets sold or exchanged to provide funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Losses in the latter case may be deducted from ordinary income while the deduction for losses under subchapter P is limited to the gains. See section 1211.

(2) Capital assets are considered as sold or exchanged to provide for the funds or payments specified in section 822(c)(6), to the extent that the gross receipts from the sale or exchange of such assets are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, and losses and expenses paid over the sum of interest, dividends, rents, and net premiums received. If, by reason of a particular sale or exchange of a capital asset, gross receipts are greater than such excess, the gross receipts and the resulting loss should be apportioned and the excess included in capital losses subject to the provisions of subchapter P. Capital losses actually used to reduce net income in any taxable year may not again be used in a succeeding taxable year as an offset against capital gains in that year and for that purpose a special rule is set forth for the application of section 1212.

(3) The application of section 822(c)(6) may be illustrated by the following examples:

Example 1. The X Company, a mutual fire insurance company subject to the tax imposed by section 821, in the taxable year 1954 sells capital assets in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. The gross receipts from the sale are $60,000, resulting in losses of $20,000. It pays dividends to policyholders of $150,000. It sustains losses of $25,000, and pays expenses of $25,000. It receives interest of $50,000, dividends of $5,000, rents of $4,000, and net premiums of $66,000. The excess of the sum of dividends, losses, and expenses paid ($200,000) over the sum of interest, dividends, rents, and net premiums received ($125,000) is $75,000. As the gross receipts from the sale of capital assets ($60,000) do not exceed such excess ($75,000), the losses of $20,000 are allowable as a deduction from gross investment income.

Example 2. If in example 1 the gross receipts were $76,000 and the last capital asset sold, for the purpose therein specified, resulted in gross receipts of $2,000 and a loss of $500, the losses allowable as a deduction from gross investment income would be $19,750. The last sale made the gross receipts of $76,000 exceed by $1,000 the excess ($75,000) of the sum of dividends, losses, and expenses paid ($200,000) over the sum of interest, dividends, rents, and net premiums received ($125,000). The gross receipts and the resulting loss from the last sale are apportioned on the basis of the ratio of the excess of $1,000 to the gross receipts of $2,000, or 50 percent. Fifty percent of the loss of $500 is deducted from the total loss of $20,000. The remaining gross receipts of $1,000 and the proportionate loss of $250 should be reported as capital losses under subchapter P.

Example 3. If in example 1 the X Company had mutual insurance company taxable income for purposes of the surtax of $9,750 and, under the provisions of subchapter P, had capital losses of $18,000 and capital gains of $10,000, the net capital loss for the taxable year 1954, in applying section 1212 for the purposes of section 822(c)(6), would be $8,000. This is determined by subtracting from total losses of $38,000 ($18,000 capital losses under subchapter P plus $20,000 other capital losses under section 822(c)(6)) the sum of capital gains of $10,000 and losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders of $20,000. Such losses of $20,000 are added to capital gains of $10,000, since they are less than taxable income for purposes of the surtax, computed without regard to gains or losses from sales or exchanges of capital assets, of $29,750 ($9,750 taxable income for purposes of the surtax plus $20,000 other capital losses under section 822(c)(6) plus the portion of capital losses allowable under subchapter P of $10,000 minus capital gains under subchapter P of $10,000).

(h) *Special deductions.* Section 822(c)(7) allows a mutual insurance company the special deductions provided by part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code, relating to partially tax-exempt interest and to dividends received.

§1.822–2 Real estate owned and occupied.

The limitation in section 822(d)(1) on the amount allowable as a deduction for taxes, expenses, and depreciation upon or with respect to any real estate owned and occupied in whole or in part by a mutual insurance company subject to the tax imposed by section 821 is the same as that provided in the case of life insurance companies by section 803(h). See §1.803–5.

§1.822–3 Amortization of premium and accrual of discount.

Section 822(d)(2) makes provision for the appropriate amortization of premium and the appropriate accrual of discount, attributable to the taxable year, on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. Such amortization and accrual is the same as that provided for life insurance companies by section 803(i) and shall be determined in accordance with §1.803–6, except that in determining the premium and discount of a mutual insurance company subject to the tax imposed by section 821 the basis provided in section 1012 shall be used in lieu of the acquisition value.

§1.822–4 Taxable years affected.

Sections 1.822–1 through 1.822–3 are applicable only to taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, and all references to sections of part II, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Sections 1.822–5 through 1.822–7 are applicable only to taxable years beginning after December 31, 1954, but before January 1, 1963, and all references to sections of part II, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Tax Act for 1955 (70 Stat. 36). Sections 1.822–8 through 1.822–12 are applicable only to taxable years beginning after December 31, 1962, and all references to sections of parts II and III, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954 as amended by section 8 of the Revenue Act of 1962 (76 Stat. 989).

[T.D. 6681, 28 FR 11113, Oct. 17, 1963]

§1.822–5 Mutual insurance company taxable income.

(a) *Mutual insurance company taxable income defined.* Section 822(a) defines the term ‘‘mutual insurance company taxable income’’ for purposes of part II, subchapter L, chapter 1 of the Code. Mutual insurance company taxable income means gross investment income (as defined in section 822(b) and paragraph (b) of this section), less the deductions provided in section 822(c) and paragraph (c) of this section for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, interest paid or accrued, capital losses, special deductions, trade or business (other than in insurance business) expenses, and depletion. However, such expenses are deductible only to the extent that they relate to investment income and the deduction of such expenses is not disallowed by any other provision of subtitle A of the Code. For example, investment expenses are not allowable unless they are ordinary and necessary expenses within the meaning of section 162. In addition to the limitations on deductions relating to real estate owned and occupied by a mutual insurance company subject to the tax imposed by section 821 provided in section 822(d)(1), the adjustment for amortization of premium and accrual of discount provided in section 822(d)(2), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 822(c)(2), mutual insurance companies subject to the tax imposed by section 821 are subject to the limitation on deductions relating to wholly tax-exempt income provided in section 265. Such companies are not entitled to the net operating loss deduction provided in section 172, and a deduction shall not be permitted with respect to the same item more than once.

(b) *Gross investment income defined.* For purposes of part II, subchapter L, chapter 1 of the Code, section 822(b) defines the term ‘‘gross investment income’’ of a mutual insurance company subject to the tax imposed by section 821 as the sum of the following:

(1) The gross amount of income during the taxable year from:

(i) Interest (including tax-exempt interest and partially tax-exempt interest), as described in § 1.61–7. Interest shall be adjusted for amortization of premium and accrual of discount in accordance with the rules prescribed in section 822(d)(2) and § 1.822–7;

(ii) Dividends, as described in § 1.61–9;

(iii) Rents and royalties, as described in § 1.61–8;

(iv) The entering into of any lease, mortgage or other instrument or agreement from which the company may derive interest, rents, or royalties;

(v) The alteration or termination of any instrument or agreement described in subdivision (iv) of this subparagraph;

(vi) Gains from sales or exchanges of capital assets to the extent provided in subchapter P (section 1201 and following, relating to capital gains and losses), chapter 1 of the Code.

(2) The gross income from any trade or business (other than an insurance business) carried on by a mutual insurance company subject to the tax imposed by section 821, or by a partnership of which the insurance company is a partner.

For example, gross investment income includes amounts received as commitment fees, or as a bonus for the entering into of a lease, or as a penalty for the early payment of a mortgage. In computing the gross income from any trade or business (other than an insurance business) carried on by the insurance company, or by a partnership of which the insurance company is a partner, any item described in section 822(b)(1) and paragraph (b)(1) of this section shall not be considered as gross income arising from the conduct of such trade or business, but shall be taken into account under section 822(b)(1) and paragraph (b)(1) of this section.

(c) *Deductions from gross investment income*—(1) *Wholly tax-exempt interest.* Interest which in the case of other taxpayers is excluded from gross income by section 103 but included in the gross investment income by section 822(b) is allowed as a deduction from gross investment income by section 822(c)(1).

(2) *Investment expenses.* (i) The deduction for investment expenses under section 822(c)(2) includes only those expenses of the taxable year which are fairly chargeable against gross investment income. For example, investment expenses include salaries and expenses paid exclusively for work in looking after investments, and amounts expended for printing, stationery, postage, and stenographic work incident to the collection of interest. An itemized

schedule of such expenses shall be attached to the return.

(ii) Any assignment of general expenses to the investment department of a mutual insurance company subject to the tax imposed by section 821 subjects the entire deduction for investment expenses to the limitation provided in section 822(c)(2) and subdivision (iii) of this subparagraph. As used in section 822(c)(2), the term ‘‘general expenses’’ means any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. For example, if an expense, such as a salary, is attributable to more than one department, including the investment department, such expense may be properly allocated among these departments. If such expense is allocated, the amount properly allocable to the investment department shall be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitation of section 822(c)(2) and subdivision (iii) of this subparagraph. However, a company subject to the tax imposed by section 821 shall not deduct under section 822(c)(2) its real estate taxes, depreciation, or other expenses with respect to any portion of the real estate which it owns, irrespective of whether such items are properly allocable to its investment department. For the rules relating to the deductibility of these items, see section 822(c) (3) and (4) and subparagraphs (3) and (4) of this paragraph. If general expenses are in part assigned to or included in investment expenses, the maximum allowance (as determined under section 822(c)(2) shall not be granted unless it is shown to the satisfaction of the district director that such allowance is justified by a reasonable assignment of actual expenses. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes, if any.

(iii) If any general expenses are in part assigned to or included in investment expenses, the total deduction under section 822(c)(2) shall not exceed the sum of:

(a) One-fourth of 1 percent of the mean of the book value of the invested assets held at the beginning and end of the taxable year, plus.

(b) One-fourth of the amount by which mutual insurance company taxable income (computed without any deduction for investment expenses, tax-free interest, partially tax-exempt interest, or dividends received) exceeds 33/4 percent of the book value of the mean of the invested assets held at the beginning and end of the taxable year.

For purposes of section 822(c)(2) and this paragraph, the term ‘‘invested assets’’ means only those assets which are owned and used, and to the extent used, for the purpose of producing the income specified in section 822(b). See paragraph (b) of this section. The term does not include real estate owned and occupied, and to the extent owned and occupied, by the company.

(3) *Real estate expenses and taxes.* The deduction for real estate expenses and taxes under section 822(c)(3) includes taxes (as defined in section 164) and other expenses for the taxable year exclusively on or with respect to real estate owned by the company. For example, no deduction shall be allowed under section 822(c)(3) for amounts allowed as a deduction under section 164(e) (relating to taxes of shareholders paid by a corporation). No deduction shall be allowed under section 822(c)(3) for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. An itemized schedule of such taxes and expenses shall be attached to the return. See §1.822–6 for limitation of such deduction.

(4) *Depreciation.* The deduction allowed by section 822(c)(4) for depreciation is, except as provided in section 822(d)(1) and §1.822–6, identical to that allowed other corporations by section 167. Such amount allowed as a deduction from gross investment income in determining mutual insurance company taxable income is limited to depreciation sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 822(b).

(5) *Interest paid or accrued.* The deduction allowed by section 822(c)(5) for interest on indebtedness is the same as that allowed other corporations by section 163. See § 1.163–1.

(6) *Capital losses.* (i) The deduction for capital losses under section 822(c)(6) includes not only capital losses to the extent provided in subchapter P, chapter 1 of the Code but in addition thereto losses from capital assets sold or exchanged to provide funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Losses in the latter case may be deducted from ordinary income while the deduction for losses under subchapter P is limited to the gains. See section 1211.

(ii) Capital assets are considered as sold or exchanged to provide for the funds or payments specified in section 822(c)(6), to the extent that the gross receipts from the sale or exchange of such assets are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, and losses and expenses paid over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received. If, by reason of a particular sale or exchange of a capital asset, gross receipts are greater than such excess, the gross receipts and the resulting loss should be apportioned and the excess included in capital losses subject to the provisions of subchapter P. Capital losses actually used to reduce net income in any taxable year may not again be used in a succeeding taxable year as an offset against capital gains in that year and for that purpose a special rule is set forth for the application of section 1212.

(iii) The application of section 822(c)(6) may be illustrated by the following examples:

Example 1. The X Company, a mutual fire insurance company subject to the tax imposed by section 821, in the taxable year 1958 sells capital assets in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. The gross receipts from the sale are $60,000, resulting in losses of $20,000. It pays dividends to policyholders of $150,000. It sustains losses of $25,000, and pays expenses of $25,000. It receives interest of $50,000, dividends of $5,000, royalties of $4,000, and net premiums of $66,000. The excess of the sum of dividends, losses, and expenses paid ($200,000) over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received ($125,000) is $75,000. As the gross receipts from the sale of capital assets ($60,000) do not exceed such excess ($75,000), the losses of $20,000 are allowable as a deduction from gross investment income.

Example 2. If in example 1 the gross receipts were $76,000 and the last capital asset sold, for the purpose therein specified, resulted in gross receipts of $2,000 and a loss of $500, the losses allowable as a deduction from gross investment income would be $19,750. The last sale made the gross receipts of $76,000 exceed by $1,000 the excess ($75,000) of the sum of dividends, losses, and expenses paid ($200,000) over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received ($125,000). The gross receipts and the resulting loss from the last sale are apportioned on the basis of the ratio of the excess of $1,000 to the gross receipts of $2,000, or 50 percent. Fifty percent of the loss of $500 is deducted from the total loss of $20,000. The remaining gross receipts of $1,000 and the proportionate loss of $250 should be reported as capital losses under subchapter P.

Example 3. If in example 1 the X Company had mutual insurance company taxable income for purposes of the surtax of $9,750 and, under the provisions of subchapter P, chapter 1 of the Code, had capital losses of $18,000 and capital gains of $10,000, the net capital loss for the taxable year 1958, in applying section 1212 for the purposes of section 822(c)(6), would be $8,000. This is determined by subtracting from total losses of $38,000 ($18,000 capital losses under subchapter P plus $20,000 other capital losses under section 822(c)(6)) the sum of capital gains of $10,000 and losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders of $20,000. Such losses of $20,000 are added to capital gains of $10,000, since they are less than taxable income for purposes of the surtax, computed without regard to gains or losses from sales or exchanges of capital assets, of $29,750 ($9,750 taxable income for purposes of the surtax plus $20,000 other capital losses under section 822(c)(6) plus the portion of capital losses allowable under subchapter P of $10,000 minus capital gains under subchapter P of $10,000).

(7) *Special deductions.* Section 822(c)(7) allows a mutual insurance company the special deductions provided by part VIII (section 241 and following), except

section 248, subchapter B, chapter 1 of the Code, relating to partially tax-exempt interest and to dividends received.

(8) *Trade or business deductions.* (i) Under section 822(c)(8), the deductions allowed by subtitle A of the Code (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the insurance company, or by a partnership of which the company is a partner are, subject to the limitations in subdivision (ii) of this subparagraph, allowable as deductions from gross investment income in computing mutual insurance company taxable income. Such deductions are allowable, however, only to the extent that they relate to income which is included in the company's gross investment income by reason of section 822(b) (2). Thus, a deduction shall not be allowed under section 822(c)(8) with respect to any item described in section 822(b)(1). The allowable deductions may exceed the gross income from such business.

(ii) In computing the deductions under section 822(c)(8):

(a) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account. For example, if the company operates a radio station primarily to advertise its own insurance services, a portion of the expenses of the radio station shall not be allowed as a deduction. The portion disallowed shall be an amount which bears the same ratio to the total expenses of the station as the value of advertising furnished to the insurance company bears to the total value of services rendered by the station.

(b) The deduction for net operating losses provided in section 172 shall not be allowed.

(9) *Depletion.* The deduction allowed by section 822(c)(9) for depletion is the same as that allowed life insurance companies under section 804(c)(4). See paragraph (b)(5) of §1.804–4.

[T.D. 6610, 27 FR 8720, Aug. 31, 1962, as amended by T.D. 6631, 28 FR 219, Jan. 9, 1963]

§1.822–6 Real estate owned and occupied.

Section 822(d)(1) provides that the amount allowable as a deduction for taxes, expenses, and depreciation on or with respect to any real estate owned and occupied in whole or in part by a mutual insurance company subject to the tax imposed by section 821 shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this limitation) as the rental value of the space not so occupied bears to the rental value of the entire property. For example, if the rental value of the space not occupied by the company is equal to one-half of the rental value of the entire property, the deduction for taxes, expenses, and depreciation is one-half of the taxes, expenses, and depreciation on account of the entire property. Where a deduction is claimed as provided in this section, the parts of the property occupied and the parts not occupied by the company, together with the respective rental values thereof, must be shown in a statement accompanying the return.

[T.D. 6610, 27 FR 8722, Aug. 31, 1962]

§1.822–7 Amortization of premium and accrual of discount.

Section 822(d)(2) makes provision for the appropriate amortization of premium and the appropriate accrual of discount, attributable to the taxable year, on bonds, notes, debentures, or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. Such amortization and accrual is the same as that provided for life insurance companies by section 818(b)(1), as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 133), and shall be determined in accordance with paragraphs (a) and (b) of §1.818–3, except in the case of a mutual insurance company subject to the tax imposed by section 821, paragraph (b) of §1.818–3 shall apply without regard to the date of acquisition and the basis provided in section 1012 shall be used in lieu of the acquisition value.

[T.D. 6610, 27 FR 8722, Aug. 31, 1962]

§1.822–8 Determination of taxable investment income.

(a) *In general*—(1) *Taxable investment income defined.* Section 822(a)(1) defines the term ‘‘taxable investment income’’ for purposes of part II, subchapter L, chapter 1 of the Code as the gross investment income (as defined in section 822(b) and paragraph (b) of this section), less the deductions provided in section 822(c) and paragraph (c) of this section for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, interest paid or accrued, capital losses, special deductions, trade or business (other than an insurance business) expenses, and depletion. However, such expenses are deductible only to the extent that they relate to investment income and the deduction of such expenses is not disallowed by any other provision of subtitle A of the Code.

For example, investment expenses are not allowable unless they are ordinary and necessary expenses within the meaning of section 162. In addition to the limitations on deductions relating to real estate owned and occupied by a mutual insurance company subject to the tax imposed by section 821 provided in section 822(d)(1), the adjustment for amortization of premium and accrual of discount provided in section 822(d)(2), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 822(c)(2), mutual insurance companies subject to the tax imposed by section 821 (a) or (c) are subject to the limitation on deductions relating to wholly tax-exempt income provided in section 265. Such companies are not entitled to the net operating loss deduction provided in section 172. See, however, section 825 and paragraph (a) of § 1.825–1 for unused loss deduction allowed companies taxable under section 821(a). A deduction shall not be permitted with respect to the same item more than once.

(2) *Investment loss defined.* The term ''investment loss'' is defined by section 822(a)(2) as the amount by which the deductions allowable under section 822(c) and paragraph (c) of this section exceed the gross investment income (as defined in section 822(b) and paragraph (b) of this section).

(b) *Gross investment income defined.* For purposes of part II, subchapter L, chapter 1 of the Code, section 822(b) defines the term ''gross investment income'' of a mutual insurance company subject to the tax imposed by section 821 (a) or (c) as the sum of the following:

(1) The gross amount of income during the taxable year from:

(i) Interest (including tax-exempt interest and partially tax-exempt interest), as described in § 1.61–7. Interest shall be adjusted for amortization of premium and accrual of discount in accordance with the rules prescribed in section 822(d)(2) and § 1.822–10;

(ii) Dividends, as described in § 1.61–9;

(iii) Rents and royalties, as described in § 1.61–8;

(iv) The entering into of any lease, mortgage or other instrument or agreement from which the company may derive interest, rents, or royalties;

(v) The alteration or termination of any instrument or agreement described in subdivision (iv) of this subparagraph;

(vi) Gains from sales or exchanges of capital assets to the extent provided in subchapter P (section 1201 and following, relating to capital gains and losses) chapter 1 of the Code.

(2) The gross income from any trade or business (other than an insurance business) carried on by a mutual insurance company subject to the tax imposed by section 821 (a) or (c), or by a partnership of which the insurance company is a partner.

For example, gross investment income includes amounts received as commitment fees, or as a bonus for the entering into of a lease, or as a penalty for the early payment of a mortgage. In computing the gross income from any trade or business (other than an insurance business) carried on by the insurance company, or by a partnership of which the insurance company is a partner, any item described in section 822(b)(1) and paragraph (b)(1) of this section shall not be considered as gross income arising from the conduct of such trade or business, but shall be taken into account under section 822(b)(1) and paragraph (b)(1) of this section.

(c) *Deductions from gross investment income—*(1) *Wholly tax-exempt interest.* Interest which in the case of other taxpayers is excluded from gross income by section 103 but included in the gross investment income by section 822(b) is allowed as a deduction from gross investment income by section 822(c)(1).

(2) *Investment expenses.* (i) The deduction for investment expenses under section 822(c)(2) includes only those expenses of the taxable year which are fairly chargeable against gross investment income. For example, investment expenses include salaries and expenses paid exclusively for work in looking after investments, and amounts expended for printing, stationery, postage, and stenographic work incident to the collection of interest. An itemized schedule of such expenses shall be attached to the return.

(ii) Any assignment of general expenses to the investment department of a mutual insurance company subject to the tax imposed by section 821 (a) or (c) subjects the entire deduction for investment expenses to the limitation provided in section 822(c)(2) and subdivision (iii) of this subparagraph. As used in section 822(c)(2), the term ‘‘general expenses’’ means any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. For example, if an expense, such as a salary, is attributable to more than one department, including the investment department, such expense may be properly allocated among these departments. If such expense is allocated, the amount properly allocable to the investment department shall be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitation of section 822(c)(2) and subdivision (iii) of this subparagraph. However, a company subject to the tax imposed by section 821 (a) or (c) shall not deduct under section 822(c)(2) its real estate taxes, depreciation, or other expenses with respect to any portion of the real estate which it owns, irrespective of whether such items are properly allocable to its investment department. For the rules relating to the deductibility of these items, see section 822(c) (3) and (4) and subparagraphs (3) and (4) of this paragraph. If general expenses are in part assigned to or included in investment expenses, the maximum allowance (as determined under section 822(c)(2)) shall not be granted unless it is shown to the satisfaction of the district director that such allowance is justified by a reasonable assignment of actual expenses. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes, if any.

(iii) If any general expenses are in part assigned to or included in investment expenses, the total deduction under section 822(c)(2) shall not exceed the sum of:

(a) One-fourth of 1 percent of the mean of the book value of the invested assets held at the beginning and end of the taxable year, plus

(b) One-fourth of the amount by which taxable investment income (computed without any deduction for investment expenses, tax-free interest, partially tax-exempt interest, or dividends received) exceeds 33/4 percent of the book value of the mean of the invested assets held at the beginning and end of the taxable year.

For purposes of section 822(c)(2) and this paragraph, the term ‘‘invested assets’’ means only those assets which are owned and used, and to the extent used, for the purpose of producing the income specified in section 822(b). See paragraph (b) of this section. The term does not include real estate owned and occupied, and to the extent owned and occupied, by the company.

(3) *Real estate expenses and taxes.* The deduction for real estate expenses and taxes under section 822(c)(3) includes taxes (as defined in section 164) and other expenses for the taxable year exclusively on or with respect to real estate owned by the company. For example, no deduction shall be allowed under section 822(c)(3) for amounts allowed as a deduction under section 164(e) (relating to taxes of shareholders paid by a corporation). No deduction shall be allowed under section 822(c)(3) for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. An itemized schedule of such taxes and expenses shall be attached to the return. See §1.822–9 for limitation of such deduction.

(4) *Depreciation.* The deduction allowed by section 822(c)(4) for depreciation is, except as provided in section 822(d)(1) and § 1.822–9, identical to that allowed other corporations by section 167. Such amount allowed as a deduction from gross investment income in determining taxable investment income is limited to depreciation sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 822(b).

(5) *Interest paid or accrued.* The deduction allowed by section 822(c)(5) for interest on indebtedness is the same as that allowed other corporations by section 163. See § 1.163–1.

(6) *Capital losses.* (i) The deduction for capital losses under section 822(c)(6) includes not only capital losses to the extent provided in subchapter P, chapter 1 of the Code but in addition thereto losses from capital assets sold or exchanged to provide funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Losses in the latter case may be deducted from ordinary income while the deduction for losses under subchapter P is limited to the gains. See section 1211.

(ii) Capital assets are considered as sold or exchanged to provide for the funds or payments specified in section 822(c)(6), to the extent that the gross receipts from the sale or exchange of such assets are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, and losses and expenses paid over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received. If, by reason of a particular sale or exchange of a capital asset, gross receipts are greater than such excess, the gross receipts and the resulting loss should be apportioned and the excess included in capital losses subject to the provisions of subchapter P. Capital losses actually used to reduce net income in any taxable year may not again be used in a succeeding taxable year as an offset against capital gains in that year and for that purpose a special rule is set forth for the application of section 1212.

(iii) The application of section 822(c)(6) may be illustrated by the following examples:

Example 1. The X Company, a mutual fire insurance company subject to tax under section 821, in the taxable year 1963 sells capital assets in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. The gross receipts from the sale are $60,000, resulting in losses of $20,000. It pays dividends to policyholders of $150,000. It sustains losses of $25,000, and pays expenses of $25,000. It receives interest of $50,000, dividends of $5,000, royalties of $4,000, and net premiums of $66,000. The excess of the sum of dividends, losses, and expenses paid ($200,000) over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received ($125,000) is $75,000. Since the gross receipts from the sale of capital assets ($60,000) do not exceed such excess ($75,000), the losses of $20,000 are allowable as a deduction from gross investment income in computing taxable investment income under section 822.

Example 2. If in example 1 the gross receipts were $76,000 and the last capital asset sold, for the purpose therein specified, resulted in gross receipts of $2,000 and a loss of $500, the losses allowable as a deduction from gross investment income would be $19,750. The last sale made the gross receipts of $76,000 exceed by $1,000 the excess ($75,000) of the sum of dividends, losses, and expenses paid ($200,000) over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received ($125,000). The gross receipts and the resulting loss from the last sale are apportioned on the basis of the ratio of the excess of $1,000 to the gross receipts of $2,000, or 50 percent. Fifty percent of the loss of $500 is deducted from the total loss of $20,000. The remaining gross receipts of $1,000 and the proportionate loss of $250 should be reported as capital losses under subchapter P.

Example 3. If in example 1 the X Company had taxable investment income for purposes of the surtax of $9,750 and, under the provisions of subchapter P, chapter 1 of the Code, had capital losses of $18,000 and capital gains of $10,000, the net capital loss for the taxable year 1963, in applying section 1212 for the purposes of section 822(c)(6), would be $8,000. This is determined by subtracting from total losses of $38,000 ($18,000 capital losses under subchapter P plus $20,000 other capital losses under section 822(c)(6)) the sum of capital gains of $10,000 and losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders of $20,000. Such losses of $20,000 are added to capital gains of $10,000, since they are less than taxable investment income for purposes of the surtax, computed without regard to gains or losses from sales or exchanges of capital assets, of $29,750 ($9,750 taxable investment income for purposes of the surtax plus $20,000 other capital losses under section 822(c)(6) plus the portion of capital losses allowable under subchapter P of $10,000 minus capital gains under subchapter P of $10,000).

(7) *Special deductions.* Section 822(c)(7) allows a mutual insurance company the special deductions provided by part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code, relating to partially tax-exempt interest and to dividends received. In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of this subparagraph, the reference in such section to ''taxable income'' shall be treated as a reference to ''taxable investment income''.

(8) *Trade or business deductions.* (i) Under section 822(c)(8), the deductions allowed by subtitle A of the Code (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the insurance company, or by a partnership of which the company is a partner are, subject to the limitations in subdivision (ii) of this subparagraph, allowable as deductions from gross investment income in computing taxable investment income. Such deductions are allowable, however, only to the extent that they relate to income which is included in the company's gross investment income by reason of section 822(b)(2). Thus, a deduction shall not be allowed under section 822(c)(8) with respect to any item described in section 822(b)(1). The allowable deductions may exceed the gross income from such business.

(ii) In computing the deductions under section 822(c)(8):

(a) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account. For example, if the company operates a radio station primarily to advertise its own insurance services, a portion of the expenses of the radio station shall not be allowed as a deduction. The portion disallowed shall be an amount which bears the same ratio to the total expenses of the station as the value of advertising furnished to the insurance company bears to the total value of services rendered by the station.

(b) The deduction for net operating losses provided in section 172 shall not be allowed.

(9) *Depletion.* The deduction allowed by section 822(c)(9) for depletion is the same as that allowed life insurance companies under section 804(c)(4). See paragraph (b)(5) of §1.804–4.

[T.D. 6681, 28 FR 11113, Oct. 17, 1963]

§1.822–9 Real estate owned and occupied.

Section 822(d)(1) provides that the amount allowable as a deduction for taxes, expenses, and depreciation on or with respect to any real estate owned and occupied in whole or in part by a mutual insurance company subject to the tax imposed by section 821 (a) or (c) shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this limitation) as the rental value of the space not so occupied bears to the rental value of the entire property. For example, if the rental value of the space not occupied by the company is equal to one-half of the rental value of the entire property, the deduction for taxes, expenses, and depreciation is one-half of the taxes, expenses, and depreciation on account of the entire property. Where a deduction is claimed as provided in this section, the parts of the property occupied and the parts not occupied by the company, together with the respective rental values thereof, must be shown in a statement accompanying the return.

[T.D. 6681, 28 FR 11115, Oct. 17, 1963]

§1.822–10 Amortization of premium and accrual of discount.

(a) *In general.* In computing taxable investment income for the taxable year, the gross amount of income from interest, the deduction under section 822(c)(1) for wholly tax-exempt interest, and the deduction under section

242 for partially tax-exempt interest, are, under the provisions of section 822(d)(2), each to be decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821 (a) or (c). However, only the accrual of discount relating to issue discount will increase the deduction for wholly tax-exempt interest. See section 103. Such amortization and accrual is the same as that provided for life insurance companies by section 818(b)(1), as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 133), and shall be determined in accordance with paragraphs (a) and (b) of § 1.818–3, except as provided by paragraph (b) of this section.

(b) *Modifications.* (1) Paragraph (b) of § 1.818–3 shall apply to mutual casualty insurance companies subject to the tax imposed by section 821 (a) or (c) without regard to the date of acquisition of the particular securities to which the amortization of premium or accrual of discount is attributable.

(2) In computing the amount of premium or discount for purposes of section 822(d)(2) with respect to securities held by a company taxable under section 821, the basis provided by section 1012 shall be used in lieu of the acquisition value provided by paragraph (b) of § 1.818–3. In the case of a company subject to the tax imposed by section 821(c), adjustments to basis to reflect the accrual of discount and the amortization of premium shall be made in the manner provided by paragraphs (a) and (b) of § 1.818–3. However, for purposes of determining statutory underwriting income or loss for the taxable year under section 823, a company subject to the tax imposed by section 821(a) is not required to accrue discount or to amortize premium in computing its income under section 832 as if it were subject to the tax imposed by section 831. Thus, the accrual of discount and amortization of premium required in the computation of taxable investment income by a company subject to the tax imposed by section 821(a) neither increases nor decreases the mutual insurance company taxable income of such a company and, except to the extent such a company actually accrues discount or amortizes premium for purposes of making the section 832 computation, no adjustment shall be made to the basis of obligations held by it to reflect accrual of discount or amortization of premium.

[T.D. 6681, 28 FR 11115, Oct. 17, 1963]

§ 1.822–11 Net premiums.

The term ‘‘net premiums’’, defined in section 822(f)(1), includes deposits and assessments, but excludes amounts returned to policyholders which are treated as dividends under section 822(f)(2). Net premiums are used in sections 822(c)(6) and 832(c)(5) in determining the limitation on certain capital losses and in the application of section 1212.

[T.D. 6681, 28 FR 11115, Oct. 17, 1963]

§ 1.822–12 Dividends to policyholders.

(a) Dividends to policyholders are used in determining the ‘‘underwriting loss’’ for purposes of the special transitional underwriting loss deduction provided by section 821(f), and the limitation on capital losses under section 822(c)(6); in computing statutory underwriting income or loss under section 823, and the subtractions from the protection against loss account under section 824(d). The term ‘‘dividends to policyholders’’ is defined in section 822(f)(2) as dividends and similar distributions paid or declared to policyholders. It includes amounts returned to policyholders where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management. Such amounts are not to be treated as return premiums under section 822(f)(1). Savings credited to the individual accounts of the subscribers of a reciprocal underwriter or interinsurer under section 823(b)(2) are not dividends paid or declared within the meaning of this paragraph. However, distributions in respect of such credits shall be considered as dividends paid. See section 823(b)(2) and paragraph (c)(2) of § 1.823–6. The term ‘‘paid or declared’’ is to be construed according to the method of accounting regularly employed in keeping the books of the insurance company, and such method shall be consistently followed with respect to all deductions (including dividends and similar distributions to policyholders) and all items of income.

(b) If the method of accounting so employed is the cash receipts and disbursements method, the deduction is limited to the dividends and similar distributions actually paid to policyholders in the taxable year. If, on the other hand, the method of accounting so employed is the accrual method, the deduction, or a reasonably accurate estimate thereof, for dividends and similar distributions declared to policyholders for any taxable year will, in general, be computed by adding the amount of dividends and similar distributions declared but unpaid at the end of the taxable year to dividends and similar distributions paid during the taxable year and deducting dividends and similar distributions declared but unpaid at the beginning of the taxable year. If an insurance company using the accrual method does not compute the deduction for dividends and similar distributions declared to policyholders in the manner stated, it must submit with its return a full and complete explanation of the manner in which the deduction is computed. For the rule as to when dividends are considered paid, see the regulations under section 561.

[T.D. 6681, 28 FR 11115, Oct. 17, 1963]

§1.823–1 Net premiums.

Net premiums are one of the items used, together with interest, dividends, and rents, less dividends to policyholders and wholly tax-exempt interest, in determining tax liability under section 821(a)(2). They are also used in section 822(c)(6) in determining the limitation on certain capital losses and in the application of section 1212. The term ‘‘net premiums’’ is defined in section 823(1) and includes deposits and assessments, but excludes amounts returned to policyholders which are treated as dividends under section 823(2).

§1.823–2 Dividends to policyholders.

(a) Dividends to policyholders is one of the deductions used, together with wholly tax-exempt interest, in determining tax liability under section 821(a)(2). They are also used in section 822(c)(6) in determining the limitation on certain capital losses and in the application of section 1212. The term ‘‘dividends to policyholders’’ is defined in section 823(2) as dividends and similar distributions paid or declared to policyholders. It includes amounts returned to policyholders where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management. Such amounts are not to be treated as return premiums under section 823(1). Similar distributions include such payments as the so-called unabsorbed premium deposits returned to policyholders by factory mutual fire insurance companies. The term ‘‘paid or declared’’ is to be construed according to the method of accounting regularly employed in keeping the books of the insurance company, and such method shall be consistently followed with respect to all deductions (including dividends and similar distributions to policyholders) and all items of income.

(b) If the method of accounting so employed is the cash receipts and disbursements method, the deduction is limited to the dividends and similar distributions actually paid to policyholders in the taxable year. If, on the other hand, the method of accounting so employed is the accrual method, the deduction, or a reasonably accurate estimate thereof, for dividends and similar distributions declared to policyholders for any taxable year will, in general, be computed as follows:

To dividends and similar distributions paid during the taxable year add the amount of dividends and similar distributions declared but unpaid at the end of the taxable year and deduct dividends and similar distributions declared but unpaid at the beginning of the taxable year.

If an insurance company using the accrual method does not compute the deduction for dividends and similar distributions declared to policyholders in the manner stated, it must submit with its return a full and complete explanation of the manner in which the deduction is computed. For the rule as to when dividends are considered paid, see the regulations under section 561.

§ 1.823–3 Taxable years affected.

Sections 1.823–1 and 1.823–2 are applicable only to taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, and all references to sections of part II, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Sections 1.823–4 and 1.823–5 are applicable only to taxable years beginning after December 31, 1954, but before January 1, 1963, and all references to sections of part II, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Tax Act for 1955 (70 Stat. 36). Sections 1.823–6 through 1.823–8 are applicable only to taxable years beginning after December 31, 1962, and all references to sections of parts II and III, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954 as amended by section 8 of the Revenue Act of 1962 (76 Stat. 989).

[T.D. 6681, 28 FR 11116, Oct. 17, 1963]

§ 1.823–4 Net premiums.

Net premiums are one of the items used, together with the gross amount of income during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof), less dividends to policyholders and wholly tax-exempt interest, in determining tax liability under section 821(a)(2). They are also used in section 822(c)(6) in determining the limitation on certain capital losses and in the application of section 1212. The term ''net premiums'' is defined in section 823(1) and includes deposits and assessments, but excludes amounts returned to policyholders which are treated as dividends under section 823(2).

[T.D. 6610, 27 FR 8722, Aug. 31, 1962]

§ 1.823–5 Dividends to policyholders.

(a) Dividends to policyholders is one of the deductions used, together with wholly tax-exempt interest, in determining tax liability under section 821(a)(2). They are also used in section 822(c)(6) in determining the limitation on certain capital losses and in the application of section 1212. The term ''dividends to policyholders'' is defined in section 823(2) as dividends and similar distributions paid or declared to policyholders. It includes amounts returned to policyholders where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management. Such amounts are not to be treated as return premiums under section 823(1). Similar distributions include such payments as the so-called unabsorbed premium deposits returned to policyholders by factory mutual fire insurance companies. The term ''paid or declared'' is to be construed according to the method of accounting regularly employed in keeping the books of the insurance company, and such method shall be consistently followed with respect to all deductions (including dividends and similar distributions to policyholders) and all items of income.

(b) If the method of accounting so employed is the cash receipts and disbursements method, the deduction is limited to the dividends and similar distributions actually paid to policyholders in the taxable year. If, on the other hand, the method of accounting so employed is the accrual method, the deduction, or a reasonably accurate estimate thereof, for dividends and similar distributions declared to policyholders for any taxable year will, in general, be computed as follows: To dividends and similar distributions paid during the taxable year add the amount of dividends and similar distributions declared but unpaid at the end of the taxable year and deduct dividends and similar distributions declared but unpaid at the beginning of the taxable year. If an insurance company using the accrual method does not compute the deduction for dividends and similar distributions declared to policyholders in the manner stated, it must submit with its return a full and complete explanation of the manner in which the deduction is computed. For the rule as to when dividends are considered paid, see the regulations under section 561.

[T.D. 6610, 27 FR 8722, Aug. 31, 1962]

§1.823–6 Determination of statutory underwriting income or loss.

(a) *In general.* Section 823(a) and this section provide that for purposes of determining statutory underwriting income or loss for the taxable year, a mutual insurance company subject to the tax imposed by section 821(a) must first take into account the same gross income and deduction items (except as modified by section 823(b) and paragraph (c) of this section) as a taxpayer subject to tax under section 831 would take into account for purposes of determining its taxable income under section 832. These items are then reduced to the extent that they include amounts which are included in determining taxable investment income or loss under section 822(a) and §1.822–8. In addition, in computing its statutory underwriting income or loss for the taxable year, a company taxable under section 821(a) is allowed to deduct the amount determined under section 824(a) (relating to deduction to provide protection against losses) and, if its gross amount received is less than $1,100,000, is allowed to deduct the amount determined under section 823(c) and paragraph (d) of this section (relating to special deduction for certain small companies), subject to the limitations provided therein.

(b) *Definitions*—(1) *Statutory underwriting income defined.* Section 823(a) (1) defines the term ''statutory underwriting income'' for purposes of part II of subchapter L of the Code. Subject to the modifications provided by section 823(b) and paragraph (c) of this section, statutory underwriting income is defined as the amount by which:

(i) The gross income which would be taken into account in computing taxable income under section 832 if the taxpayer were subject to the tax imposed by section 831, reduced by the gross investment income (as determined under section 822(b)), exceeds

(ii) The sum of:

(a) The deductions which would be taken into account in computing taxable income if the taxpayer were subject to the tax imposed by section 831, reduced by the deductions provided in section 822(c) (relating to deductions allowed in computing taxable investment income), plus

(b) The deductions provided in section 823(c) (relating to special deduction for small company having gross amount of less than $1,100,000) and section 824(a) (relating to deduction to provide protection against losses).

For purposes of subdivision (ii)*(a)* of this subparagraph, the limitations on the amounts deductible under paragraphs (9) (relating to charitable, etc., contributions) and (12) (relating to partially tax-exempt interest and to dividends received) of section 832(c) shall be computed by reference to taxable income as defined by section 832(a), and as modified by section 823(b) and paragraph (c) of this section.

(2) *Statutory underwriting loss defined.* ''Statutory underwriting loss'' is defined in section 823(a)(2) as the amount by which the amount determined under section 823(a)(1)(B) and subparagraph (1)(ii) of this paragraph exceeds the amount determined under section 823(a)(1)(A) and subparagraph (1)(i) of this paragraph.

(c) *Modifications*—(1) *Net operating losses.* In applying section 832 for purposes of determining statutory underwriting income or loss under section 823(a) and paragraph (b) of this section, the deduction for net operating losses provided by section 172 is not allowed. However, see section 825(a) and §1.825–1 for unused loss deduction allowed companies taxable under section 821(a) in computing mutual insurance company taxable income under section 821(b).

(2) *Interinsurers and reciprocal underwriters*—(i) *In general.* Section 823(b)(2) provides that in computing the statutory underwriting income or loss of a mutual insurance company which is an interinsurer or reciprocal underwriter, there shall be allowed as a deduction the increase for the taxable year in savings credited to subscriber accounts, or there shall be included as an item of gross income the decrease for the taxable year in savings credited to subscriber accounts. For purposes of this subparagraph, the term ''savings credited to subscriber accounts'' means such portion of the surplus for the taxable year as is credited to the individual accounts of subscribers before the 16th day of the third month following the close of the taxable year,

but only if the company would be obligated to pay such amount promptly to such subscriber if he terminated his contract at the close of the company's taxable year, and only if the company mails notification to such subscriber of the amount credited to his individual account in the manner provided by subdivision (v) of this subparagraph.

(ii) *Limitations.* Amounts representing return premiums (as defined in paragraph (a)(1)(ii) of § 1.809–4) which the company would be obligated to pay to any subscriber terminating his contract at the close of the company's taxable year are not savings credited to subscriber accounts within the meaning of section 823(b)(2) and subdivision (i) of this subparagraph. The deduction for savings credited to individual subscriber accounts is allowed only in the case of reciprocal underwriters or interinsurers where the subscriber or policyholder has not only a legally enforceable right to receive the amount so credited if he withdraws from the exchange, but where the amounts credited, as a matter of actual practice, are paid to subscribers or policyholders who terminate their contracts. Thus, no deduction shall be allowed for savings credited to subscriber accounts if such savings are not in fact promptly returned to subscribers when they terminate their contracts.

(iii) *Computation of increase or decrease in savings credited to subscriber accounts.* For purposes of determining the increase or decrease for the taxable year in savings credited to subscriber accounts, every reciprocal underwriter or interinsurer claiming a deduction under section 823(b)(2) and this section shall establish and maintain an account for savings credited to subscriber accounts. The opening balance in such account for the first taxable year for which a deduction is claimed under section 823(b)(2) and this section shall be zero. In each taxable year there shall be added to such account the total amount of savings credited to subscriber accounts for the taxable year, and there shall be subtracted from such account the total amount of savings subtracted from subscriber accounts for the taxable year. However, in no case may the amount added to the account exceed the total amount of savings to subscribers for the taxable year, irrespective of the amount of savings credited to subscriber accounts for the taxable year. Credits made to subscriber accounts after the close of the taxable year and before the 16th day of the third month following the close of the taxable year will be taken into account as if such amounts had been credited on the last day of the taxable year to the extent such amounts would have become fixed and determinable legal obligations due subscribers if such subscribers had terminated their contracts on the last day of the company's taxable year unless, at the time the amounts are credited, the company specifically designates such amounts as being from surplus for the taxable year in which the amounts were actually credited. Such a designation, once made, shall be irrevocable. However, if a company credited savings to subscriber accounts after December 31, 1962, and before March 16, 1963, and failed to designate such credits as being from surplus for the taxable year 1963, such company may designate such credits as being from surplus for the taxable year 1963 for purposes of determining the total amount of credits to subscriber accounts for such year. In determining the total amount of savings subtracted from subscriber accounts for the taxable year, only amounts subtracted from savings credited for taxable years beginning with the first taxable year for which a deduction was claimed under section 823(b)(2) and this subparagraph will be taken into account. The method of accounting regularly employed by the taxpayer in keeping its books of account will be used for purposes of determining whether the amounts subtracted from the subscriber accounts are from savings for taxable years beginning before the first taxable year for which a deduction is claimed under section 823(b)(2) and this subparagraph, or from savings for taxable years beginning with such first taxable year. Where the method of accounting regularly employed by the taxpayer in keeping its books of account does not clearly indicate whether an amount was subtracted from savings credited to subscriber accounts for taxable years beginning before the first taxable year for which a deduction is claimed under section 823(b)(2) and this subparagraph, or from savings credited for such first taxable year and subsequent taxable years, the amount subtracted will be deemed to have come from savings credited to subscriber accounts for all taxable years, on a pro rata basis. Where an amount is subtracted from a subscriber's account for record purposes, but such subtraction does not reflect the discharge of the company's legal obligation to pay the amount subtracted promptly to the subscriber if he terminates his contract, then such subtraction shall not be taken into account for purposes of section 823(b)(2) and this subparagraph. On the other hand, where the company ceases to be under a legal obligation to pay promptly to any subscriber the amount credited to his individual account, then such amount shall be considered as having been subtracted from such subscriber's account at the time such obligation ceased to exist. For purposes of section 823(b)(2) and this subparagraph, the increase (if any) for the taxable year in savings credited to subscriber accounts shall be the amount by which the balance in the account for savings credited to subscriber accounts as of the close of the taxable year exceeds the balance in such account as of the close of the preceding taxable year; and the decrease (if any) for the taxable year in savings credited to subscriber accounts shall be the amount by which the balance in the account for savings credited to subscriber accounts as of the close of the preceding taxable year exceeds the balance in such account as of the close of the taxable year.

(iv) *Legal obligation.* For purposes of this subparagraph, the existence of a legal obligation on the part of the company to pay to the subscriber the savings credited to him will be determined under the insurance contract pursuant to which the credits are made. Where it appears that the company is otherwise legally obligated to pay amounts credited to its subscribers, the requisite legal obligation will not be considered absent merely because a subscriber's credits remain subject to absorption by future losses incurred if left on deposit with the company.

(v) *Notification to subscribers.* Every reciprocal underwriter or interinsurer claiming a deduction under section 823(b)(2) and this subparagraph for amounts credited to the individual accounts of its subscribers must mail to each such subscriber written notification of the amount credited to the subscriber's account for the taxable year, the date on which such amount was credited, and the date on which the subscriber's right to such amount first would have become fixed if such subscriber had terminated his contract at the close of the company's taxable year. As an alternative to providing each subscriber with specific information relating to the amount of savings credited to his individual account, the notification required by this subdivision may be provided in the form of a table or formula mailed to the subscribers. However, a table or formula may not be used in lieu of the specific notification required by this subdivision unless such table or formula has been approved by the Commissioner. Generally, a table or formula will be approved if it enables the subscriber to simply and readily ascertain the amount of savings credited to his individual account for the taxable year, the date on which such amount was credited, and the date on which his right to such amount first would have become fixed if he had terminated his contract at the close of the company's taxable year. A reciprocal underwriter or interinsurer which desires to use such a table or formula should direct a written request for approval of such table or formula to the Commissioner of Internal Revenue, Attention: T:R, Washington, DC, 20224. Such request must set forth a copy of the table or formula proposed to be used, together with sufficient information to permit the Commissioner to determine the basis upon which such table or formula was prepared and the manner in which the subscribers will use such table or formula in determining the amounts credited to their individual accounts. Once a table or formula has been approved, the use of such table or formula with respect to savings credited for subsequent taxable years will not require further approval unless the basis upon which such table or formula was prepared, or the manner in which such table or formula is to be applied, is substantially changed. The table or formula method of notification may be used with respect to all or less than all of the company's subscribers. For example, the company might provide the notification required by this subdivision to one class of subscribers in the form of a table or formula mailed to the individual subscribers, while providing another class of subscribers with specific statements of the amounts credited to their individual accounts. The notification required by this subdivision must be mailed before the 16th day of the third month following the close of the reciprocal's taxable year for which the account was credited. Where for any taxable year a reciprocal underwriter or interinsurer claims a deduction under section 823(b) and this subparagraph and fails to give notice as required by this subdivision, such deduction shall not be allowed unless the reciprocal establishes to the satisfaction of the district director that the failure to mail such notice within the prescribed period was due to reasonable cause.

(d) *Special deduction for small company having gross amount of less than $1,100,000*—(1) *In general.* In the case of a taxpayer subject to the tax imposed by section 821(a), section 823(c) provides that if the gross amount received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) is less than $1,100,000, then, subject to the limitation provided in section 823(c)(2) and subparagraph (2) of this paragraph, there shall be allowed an additional deduction for purposes of determining statutory underwriting income or loss under section 823(a) for the taxable year. The amount of the additional deduction is $6,000; except that if the gross amount received for the taxable year exceeds $500,000, the additional deduction is limited to an amount equal to 1 percent of the amount by which $1,100,000 exceeds such gross amount.

(2) *Limitation.* The amount of the deduction provided by section 823(c)(1) may not exceed the statutory underwriting income for the taxable year, computed without regard to the deduction allowed under section 823(c)(1) and subparagraph (1) of this paragraph, and the deduction allowed under section 824(a) (relating to deduction for protection against losses).

(3) *Example.* The application of section 823(c) and this paragraph may be illustrated by the following example:

M, a mutual insurance company subject to the tax imposed by section 821(a), has the following items for the taxable year 1963:

Gross amount for purposes of section 823(c)(1)	$800,000
Gross investment income (including capital gains)	150,000
Capital gains	100,000
Gross income under section 832	900,000
Deductions under section 822(c)	22,000
Deductions under section 832 (as modified by section 823(b)(2))	746,000

Under the provisions of section 823(c), M's special small company deduction for the taxable year 1963 would be $3,000, computed as follows:

(1) Gross amount for purposes of section 823(c)(1)	$800,000
(2) Amount by which $1,100,000 exceeds item (1) ($1,100,000 minus $800,000)	300,000
(3) 1 percent of item (2) (not to exceed $6,000)	3,000
(4) Gross income under section 832, reduced by gross investment income ($900,000 minus $150,000)	750,000
(5) Deductions under section 832 (as modified by section 823(b)), reduced by deductions under section 822(c) ($746,000 minus $22,000)	724,000
(6) Limitation on deduction under section 823(c)(1) (excess, if any, of item (4) over item (5))	26,000
(7) Deduction under section 823(c)(1) (item (3) or item (6), whichever is the lesser)	3,000

[T.D. 6681, 28 FR 11116, Oct. 17, 1963]

§ 1.823–7 Subscribers of reciprocal underwriters and interinsurers.

A subscriber or policyholder of a reciprocal underwriter or interinsurer entitled to the deduction allowed by section 823(b)(2) and paragraph (c)(2) of § 1.823–6 shall treat amounts representing savings credit to his individual account for the taxable year as a dividend paid or declared for purposes of computing his taxable income. If a reciprocal credits savings to subscriber accounts after the close of its taxable year, but before the 16th day of the third month following the close of the taxable year, and the reciprocal takes such credits into account as if they had been made on the last day of its taxable year, the subscribers of such reciprocal must take such savings into account as if they had in fact been credited on the last day of the company's taxable year. The subscriber shall take savings credited to his account into account without regard to whether the amounts credited are actually distributed to him in cash. To the extent the insurance premium constituted a deductible expense when paid or accrued, the subscriber's taxable income for the taxable year will be increased and any loss for the taxable year will be decreased, by the amount credited to his account. Amounts credited to a subscriber's account which are taken into income by him and which subsequently are used to absorb losses of the reciprocal shall be treated by the subscriber as an additional insurance expense for the taxable year in which the amounts are absorbed. Such amounts may be deducted in computing taxable income to the extent insurance constitutes an otherwise properly deductible expense for such taxable year.

[T.D. 6681, 28 FR 11118, Oct. 17, 1963]

§1.823–8 Special transitional underwriting loss; cross reference.

With respect to taxable years beginning after December 31, 1962, and before January 1, 1968, section 821(f) provides, for any company subject to the tax imposed by section 821(a), a special reduction in the statutory underwriting income if such company was subject to tax under section 821 for the five taxable years immediately preceding January 1, 1962, and incurred an underwriting loss in each of such five taxable years. For rules relating to the determination of the amount of such reduction, see section 821(f) and §1.821–5.

[T.D. 6681, 28 FR 11118, Oct. 17, 1963]

§1.825–1 Unused loss deduction; in general.

(a) *Amount of deduction.* Section 825(a) provides that the unused loss deduction of a mutual insurance company subject to the tax imposed by section 821(a) shall be an amount equal to the sum of the unused loss carryovers and carrybacks to the taxable year. The amount so determined is used in the computation of mutual insurance company taxable income for the taxable year. See section 821(b) and §1.821–4.

(b) *Unused loss defined.* Section 825(b) defines the term ''unused loss'' as the amount (if any) by which:

(1) The sum of the statutory underwriting loss (as defined in section 823(a)(2)) and the investment loss (as defined in section 822(a)(2)) exceeds

(2) The sum of:

(i) The taxable investment income (as defined in section 822(a)(1)),

(ii) The statutory underwriting income (as defined in section 823(a)(1)), and

(iii) The amounts required to be subtracted from the protection against loss account under section 824(d).

(c) *Steps in computation of unused loss deduction.* The three steps to be taken in the ascertainment of the unused loss deduction for any taxable year are as follows:

(1) Compute the unused loss for any preceding or succeeding taxable year from which an unused loss may be carried over or carried back to the taxable year.

(2) Compute the unused loss carryovers to the taxable year from such preceding taxable years and the unused loss carrybacks to the taxable year from such succeeding taxable years.

(3) Add such unused loss carryovers and carrybacks in order to determine the unused loss deduction for the taxable year.

(d) *Statement with tax return.* Every mutual insurance company taxable under section 821(a) claiming an unused loss deduction for any taxable year shall file with its return for such year a concise statement setting forth the amount of the unused loss deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the unused loss deduction.

(e) *Ascertainment of deduction dependent upon unused loss carryback.* If a mutual insurance company taxable under section 821(a) is entitled in computing its unused loss deduction to a carryback which it is not able to ascertain at the time its return is due, it shall compute the unused loss deduction on its return without regard to such unused loss carryback. When the company ascertains the unused loss carryback, it may within the applicable period of limitations file a claim for credit or refund of the overpayment, if any, resulting from the failure to compute the unused loss deduction for the taxable year with the inclusion of such carryback; or it may file an application under the provisions of section 6411 for a tentative carryback adjustment.

(f) *Law applicable to computations.* The following rules shall apply to taxable years for which the taxpayer is subject to the tax imposed by section 821(a):

(1) In determining the amount of any unused loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year.

(2) The unused loss for any taxable year shall be determined under the law applicable to that year without regard to the year to which it is to be carried and in which, in effect, it is to be deducted as part of the unused loss deduction.

(3) The amount of the unused loss deduction which shall be allowed for any taxable year shall be determined under the law applicable for that year.

[T.D. 6681, 28 FR 11122, Oct. 17, 1963]

§ 1.825–2 Unused loss carryovers and carrybacks.

(a) *Years to which loss may be carried*—(1) *In general.* In order to determine its unused loss deduction for any taxable year, a mutual insurance company taxable under section 821(a) must first determine the part of any unused losses for any preceding or succeeding taxable years which are carryovers or carrybacks to the taxable year in issue. An unused loss is to be an unused loss carryback to each of the 3 taxable years preceding the loss year, and an unused loss carryover to each of the 5 taxable years following the loss year, subject to the limitations provided in section 825(g) and subparagraph (2) of this paragraph.

(2) *Limitations.* An unused loss may not be carried:

(i) To or from any taxable year beginning before January 1, 1963,

(ii) To or from any taxable year for which the taxpayer is not subject to the tax imposed by section 821(a), nor

(iii) To any taxable year if, between the loss year and such taxable year, there is an intervening taxable year for which the taxpayer was not subject to the tax imposed by section 821(a).

(3) *Periods of less than 12 months.* A fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) is a preceding or a succeeding taxable year for the purpose of determining under section 825 the first, second, etc., preceding or succeeding taxable year.

(b) *Loss year defined.* The term ‘‘loss year’’ as used in this section means any taxable year for which a company subject to the tax imposed by section 821(a) has an unused loss in excess of zero.

(c) *Amount of carrybacks and carryovers.* Section 825(e) provides that in the case of a loss year for a company taxable under section 821(a), the entire amount of the unused loss shall be carried to the earliest taxable year to which such loss may be carried under section 825(d) (subject to the limitations of section 825(g)). The amount of the unused loss carried to each of the other taxable years to which such loss may be carried under section 825(d) following such earliest taxable year shall be the excess (if any) of such loss over the sum of the offsets for each taxable year preceding the taxable year to which the unused loss is carried.

(d) *Offset defined*—(1) *In general.* Section 825(f) defines the term ‘‘offset’’ and provides that the taxable year to which an unused loss is carried shall be referred to as the ‘‘offset year’’. The definition of the term offset in the case of an unused loss carryback to an offset year, differs from the definition of such term in the case of an unused loss carryover to an offset year.

(2) *Offset in case of carryback.* In the case of an unused loss carryback from the loss year to the offset year, the offset is the mutual insurance company taxable income for the offset year, computed without regard to any unused loss carryback from the loss year or any taxable year thereafter.

(3) *Offset in case of carryover.* In the case of an unused loss carryover from the loss year to the offset year, the offset is equal to the sum of:

(i) The amount required to be subtracted from the protection against loss account under section 824(d)(1)(C) (relating to amounts equal to the unused loss carryovers to the offset year), plus

(ii) The mutual insurance company taxable income for the taxable year, computed without regard to any unused loss carryback or carryover from the loss year or any taxable year thereafter.

[T.D. 6681, 28 FR 11123, Oct. 17, 1963]

§1.825–3 Examples.

The application of section 825 may be illustrated by the following examples:

Example 1. For the taxable year 1967, F, a mutual insurance company subject to the tax imposed by section 821(a), has the following items:

Taxable investment income	1
Underwriting loss	59
Addition to protection against loss account	8
Statutory underwriting loss	67

The subtractions from the protection against loss account are as follows:

Amount subtracted from amounts in account with respect to taxable years 1963 through 1966	18
Amount subtracted from amounts in account with respect to taxable year 1967	8
Total subtractions from protection against loss account under section 824(d)	26

The application of section 825 in this case may be illustrated by the facts and results shown in the following table and explained below:

TAXABLE YEAR

	1963	1964	1965	1966	1967	1968
Protection against loss account:						
Addition to account during taxable year	6	2	3	7	8	7
Subtraction from account during taxable year	0	0	0	0	8	7
Protection against loss account (at end of year)	6	2	3	7	0	0
Protection against loss account (at end of taxable year 1968)	0	0	0	0	0	0
Unused loss	0	0	0	0	40	0
Unused loss carryback	0	40	35	25	0	0
Unused loss carryover	0	0	0	0	0	18
Unused loss deduction	0	40	35	25	0	18
Mutual insurance company taxable income (computed without regard to unused loss)	13	5	10	7	0	2
Mutual insurance company taxable income (computed with regard to unused loss)	13	0	0	0	0	0
Offset for year	0	5	10	7	0	9
Offset total	0	5	15	22	22	31

1967: Under the provisions of section 825(b), F's unused loss for 1967 is 40, the amount by which the sum of the statutory underwriting loss and the investment loss, 67 (67 plus 0), exceeds the sum of the taxable investment income, the statutory underwriting income, and the amounts required to be subtracted from the protection against loss account under section 824(d) for the taxable year, 27 (the sum of 1, 0, and 26, respectively).

1967 carryback to 1964: Under the provisions of section 825(e), the entire unused loss for 1967 of 40 is carried back to 1964, the earliest year to which the loss may be carried under section 825(d). Since there are no other amounts carried to 1964, the unused loss deduction for 1964 is 40. Thus, after taking the unused loss deduction into account, the mutual insurance company taxable income for 1964 is zero, and the offset for 1964 is 5 (the mutual insurance company taxable income for 1964 determined without regard to the unused loss carryback from 1967 or any year thereafter).

1967 carryback to 1965: The portion of the unused loss for 1967 which is carried back to 1965 is 35 (40 minus 5, the offset for 1964). After taking the unused loss deduction into account, the mutual insurance company taxable income for 1965 is zero. The offset for 1965 is 10, the mutual insurance company taxable income for 1965 determined without regard to any unused loss carryback from 1967 or any year thereafter.

1967 carryback to 1966: The portion of the unused loss for 1967 which is carried back to 1966 is 25. This amount is the excess of the unused loss for 1967 of 40 over the sum of the offset for 1964 (5) and the offset for 1965 (10). As a result of the unused loss deduction the mutual insurance company taxable income for 1966 is reduced to zero. The offset for 1966 is 7.

1967 carryover to 1968: Under the provisions of section 825(d), the portion of the unused loss for 1967 which is carried forward to 1968 is 18 (40 minus the sum of 5, 10, and 7, the offsets for 1964, 1965, and 1966, respectively).

Under section 825(f)(2), this amount is first applied against any amounts in the protection against loss account at the end of 1968, and is then applied against the mutual insurance company taxable income for 1968 (computed without regard to any unused loss carryovers or carrybacks from 1967 or any taxable year thereafter). Thus, assuming that there are no other subtractions from its protection against loss account under section 824(d) for 1968, F's protection against loss account of 7 is reduced to zero by reason of the subtraction under section 824(d)(1)(C). The remaining portion of the unused loss for 1967 which is carried to 1968, 11 (18 minus 7, the amount of the unused loss carryover to 1968 which is subtracted from the protection against loss account under section 824(d)(1)(C)), is then applied against the mutual insurance company taxable income for 1968 computed without regard to any unused carryback or carryover from the loss year (1967) or any taxable year thereafter. After the application of the unused loss deduction for 1968, the mutual insurance company taxable income for 1968 is zero. The offset for 1968 is 9, the sum of the amount required to be subtracted from the protection against loss account under section 824(d)(1)(C) for 1968 (7), plus the mutual insurance company taxable income for 1968, determined without regard to any unused loss carryover or carryback from 1967 or any year thereafter (2). The remaining 9 of the unused loss for 1967 (40 minus the sum of 5, 10, 7, and 9, the offsets for 1964, 1965, 1966, and 1968, respectively), is carried forward to 1969, and to the extent not used in that year or any year thereafter, may be carried forward to 1970, 1971, and 1972, in that order.

Example 2. If in example 1 F had an unused loss in 1966 of 22, then, with respect to F's 1967 unused loss of 40, the offset for 1964 would be zero; the offset for 1965 would be 6—the 1965 mutual insurance company taxable income of 10 less an unused loss carryback of 4 from 1966 (the 1966 unused loss of 22 minus the 1963 offset of 13 and the 1964 offset of 5); the offset for the loss year 1966 would be zero, and 34 (the 1967 unused loss of 40 minus the offset for 1965 of 6) would remain as an unused loss carryover to 1968, 1969, 1970, 1971, 1972, in that order. Thus, the unused loss carrybacks or carryovers to an offset year are applied against the mutual insurance company taxable income for such year in the order in which the losses occurred, with the earliest loss being offset first.

Example 3. For the taxable year 1963, M, a mutual insurance company subject to tax imposed by section 821(a), has an unused loss (as defined in section 825(b)) of $65,000. Under section 825(g), the loss may not be carried back to any taxable year beginning before 1963. However, the loss may be carried forward to each of the 5 taxable years following 1963 provided that for each of such succeeding taxable years M is subject to the tax imposed by section 821(a).

Example 4. Assume the facts are the same as in example 3, except that for the taxable year 1964, the gross amount received by M from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) exceeds $150,000 but does not exceed $500,000. If M does not make the election under section 821(d) (relating to election to be taxed under section 821(a)) for 1964, M's 1963 unused loss of $65,000 will not be allowed as an unused loss carryover or carryback since, by reason of section 825(g)(3), the unused loss may not be carried to any taxable year if, between the loss year and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by section 821(a), and by reason of section 825(g)(1), the unused loss may not be carried to any taxable year beginning before 1963.

[T.D. 6681, 28 FR 11123, Oct. 17, 1963]

§ 1.826–1 Election by reciprocal underwriters and interinsurers.

(a) *In general.* Except as otherwise provided in section 826(c), any mutual insurance company which is an interinsurer or reciprocal underwriter taxable under section 821(a) may elect under section 826(a) to limit its deductions for amounts paid or incurred to its attorney-in-fact to the deductions of its attorney-in-fact which are allocable to income received by the attorney-in-fact from the reciprocal during the taxable year. See § 1.826–4 for rules relating to allocation of expenses. In no case may such an election increase the amount deductible by the reciprocal for amounts paid or due its attorney-in-fact for the taxable year. The election allowed by section 826(a) and this section in effect increases the income of the reciprocal by the net income of the attorney-in-fact attributable to its business with the reciprocal. A reciprocal making the election is allowed a credit for the amount of tax paid by the attorney-in-fact for the taxable year which is attributable to income received by the attorney-in-fact from the reciprocal. See section 826(e) and § 1.826–5.

(b) *Companies eligible to elect under section 826(a).* Any mutual insurance company which is a reciprocal underwriter or interinsurer subject to the tax imposed by section 821(a) may elect (in the manner prescribed by paragraph (c) of this section) to be subject to the limitation provided by section 826(b) and paragraph (a) of this section provided the attorney-in-fact of the electing reciprocal:

(1) Is subject to the taxes imposed by section 11 (b) and (c) and the regulations thereunder;

(2) Consents (in the manner provided by paragraph (a) of §1.826–3) to provide the information required under paragraph (b) of §1.826–3 during the period in which the election made under section 826(a) and this section is in effect;

(3) Reports the income received from the reciprocal and the deductions allocable thereto under the same method of accounting used by the reciprocal in reporting its deductions for amounts paid or due its attorney-in-fact; and

(4) Files its income tax return on a calendar year basis.

(c) *Manner of making election.* The election provided by section 826(a) and this section shall be made in a statement attached to the taxpayer's income tax return for the first taxable year for which such election is to apply. The statement shall include the name and address of the taxpayer, shall be signed by the taxpayer (or its duly authorized representative), and shall be filed not later than the time prescribed by law for filing the income tax return (including extensions thereof) for the first taxable year for which such election is to apply. For information required of an electing reciprocal, see paragraph (e) of this section.

(d) *Scope of election.* The election allowed by section 826(a) is binding for the taxable year for which made and all succeeding taxable years unless the Commissioner consents to a revocation of such election. Whether revocation will be permitted will depend upon the facts and circumstances of each particular case.

(e) *Information required of an electing company.* Every reciprocal underwriter or interinsurer making the election provided by section 826(a) and this section shall, in the manner provided by paragraph (f) of this section, furnish the following information for each taxable year during which such election is in effect:

(1) The name and address of the attorney-in-fact with respect to which the election allowed by section 826(a) and this section is in effect; the district in which such attorney-in-fact filed its return for the taxable year; and a copy of the consent required by section 826 and §1.826–3 and the date and district in which such consent was filed;

(2) The deductible amount paid or due to such attorney-in-fact from the reciprocal computed without regard to the limitation provided by section 826(b);

(3) The total amount claimed as a deduction by the reciprocal for amounts paid to its attorney-in-fact after giving effect to the limitation provided by section 826(b);

(4) The amount of the increase (if any) in underwriting gain (as defined in section 824(a)) attributable to the election allowed by section 826(a);

(5) The amount of the increase (if any) in the deduction allowed by section 824(a) (relating to deduction to provide protection against losses) attributable to the election allowed by section 826(a);

(6) The amount of any increase or decrease in the statutory underwriting income or loss for the taxable year (as computed under section 823) attributable to the election allowed by section 826(a);

(7) The amount of any increase or decrease in the mutual insurance company taxable income or unused loss for the taxable year attributable to the election allowed by section 826(a);

(8) The amount of the increase (if any) in the tax liability of the reciprocal for the taxable year attributable to the election allowed by section 826(a) before taking into account the credit provided by section 826(e);

(9) The amount of tax attributable to income received by the attorney-in-fact from the reciprocal during the taxable year (as determined under §1.826–5) claimed (under section 826(e) and paragraph (a) of this section) by the reciprocal as a credit for the taxable year; and

(10) The information which the attorney-in-fact is required to submit to the reciprocal under paragraphs (b) and (c) of §1.826–3.

(f) *Manner in which information is to be provided.* The information required by paragraph (e) of this section shall be set forth in a statement attached to the taxpayer's income tax return for each taxable year for which such information is required. Such statement shall include the name and address of the taxpayer; and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the income tax return for the taxable year with respect to which such information is being provided.

[T.D. 6681, 28 FR 11124, Oct. 17, 1963]

§ 1.826–2 Special rules applicable to electing reciprocals.

(a) *Protection against loss account.* Section 826(d) provides that for purposes of determining the amount to be subtracted from the protection against loss account under section 824(d)(1)(D) and the regulations thereunder (relating to amounts added to the account for the fifth preceding taxable year) for any taxable year, any amount which was added to such account by reason of the election under section 826(a) and paragraph (a) of § 1.826–1 shall be treated as having been added by reason of section 824(a)(1)(A) and the regulations thereunder (relating to amounts equal to 1 percent of losses incurred during the taxable year). Thus, no amount added to the protection against loss account by reason of an election made under section 826(a) may remain in such account beyond the end of the fifth taxable year following the taxable year with respect to which such amount was added. See section 824(d)(1)(D) and paragraph (b)(3) of § 1.824–1. The amount added to the protection against loss account by reason of an election under section 826(a) is that amount which is equal to 25 percent (plus, in the case of a reciprocal which qualifies as a concentrated risk company under section 824(a), so much of the concentrated wind-storm, etc., premium percentage as exceeds 40 percent) of the amount by which:

(1) The underwriting gain (as defined by section 824(a)(1)) computed after taking into account the limitation provided by section 826(b) and § 1.826–1, exceeds

(2) The underwriting gain computed without regard to the limitation provided by section 826(b) and § 1.826–1.

(b) *Denial of surtax exemption.* Section 826(f) provides that the tax imposed upon any increase in the mutual insurance company taxable income of a reciprocal which is attributable to the limitation provided by section 826(b) shall be computed without regard to the surtax exemption provided by section 821(a)(2) and the regulations thereunder. Thus, a company making the election provided under section 826(a) will be subject to surtax, as well as normal tax, on the increase in its mutual insurance company taxable income for the taxable year which is attributable to such election. Similarly, any amount which was added to the protection against loss account by reason of an election under section 826(a) and § 1.826–1, and which is subtracted from such account in accordance with section 826(d) and paragraph (a) of this section, will be subject to surtax, as well as normal tax, to the extent such amount increases mutual insurance company taxable income in the year in which the subtraction is made. Furthermore, the company will be subject to surtax on such increases notwithstanding the fact that it may have no normal tax liability for the taxable year, because its mutual insurance company taxable income (after giving effect to the election provided by section 826(a)) does not exceed $6,000.

(c) *Adjustment for refunds.* Section 826(g) provides that if for any taxable year an attorney-in-fact is allowed a credit or refund for taxes paid with respect to which credit or refund to the reciprocal resulted under section 826(e), the taxes of such reciprocal for such taxable year shall be properly adjusted. The reciprocal shall make the adjustment required by section 826(g) by increasing its income tax liability for its taxable year in which the credit or refund is allowed to the attorney-in-fact by the amount of such credit or refund which is attributable to taxes paid by the attorney-in-fact on income received from the reciprocal, as determined under § 1.826–6, but only to the extent that the payment of such amount by the attorney-in-fact resulted in a credit or refund to the reciprocal. However, if the refund or credit to the attorney-in-fact is the result of an error in determining its items of income or deduction for the taxable year with respect to which the refund or credit is allowed, and such error affects the amount of deductions allocable to its reciprocal for such taxable year, then, if the reciprocal's period for filing an amended return has not otherwise expired, the preceding sentence shall not apply and the reciprocal shall make the adjustment required by section 826(g) by filing an amended return for such taxable year and all subsequent taxable years for which an adjustment is required. The reciprocal's amended return or returns shall give effect to the change in the deductions of the attorney-in-fact allocable to income received from the reciprocal and the tax paid by the attorney-in-fact attributable to such income. The amount of any adjustment required by section 826(g) and this section and the computation thereof shall be set forth in a statement attached to and filed with the taxpayer's income tax return for the taxable year for which the adjustment is made. Such statement shall include the name and address of the taxpayer, and a copy of the notification received by the attorney-in-fact indicating that it has been allowed the credit or refund requiring adjustment of the reciprocal's taxes.

[T.D. 6681, 28 FR 11125, Oct. 17, 1963, as amended by T.D. 7100, 36 FR 5334, Mar. 20, 1971]

§1.826–3 Attorney-in-fact of electing reciprocals.

(a) *Manner of making consent.* Section 826(c)(2) provides that a reciprocal may not elect to be subject to the limitation provided by section 826(b) unless its attorney-in-fact consents to make certain information available. See paragraph (b) of this section. The attorney-in-fact of a reciprocal making the election provided by section 826(a) shall signify the consent required by section 826(c) in a statement attached to its income tax return for the first taxable year for which the reciprocal's election is to apply. Such statement shall include the name and address of the consenting taxpayer; the name and address of the reciprocal with respect to which such consent is to apply; shall be signed by the taxpayer (or its duly authorized representative); and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the income tax return for the first taxable year for which such consent is to apply. In addition, such statement shall specify that the taxpayer is subject to the taxes imposed by section 11 (b) and (c); the method of accounting used in reporting income received from its reciprocal and the deductions allocable thereto; and that its return is filed on the calendar year basis. Consent, once given, shall be irrevocable for the period during which the election provided for the reciprocal by section 826(a) is in effect. See paragraph (e) of §1.826–1.

(b) *Information required of consenting attorney-in-fact.* Every attorney-in-fact making the consent provided by section 826(c)(2) and paragraph (a) of this section shall, in the manner prescribed by paragraph (c) of this section, furnish the following information for each taxable year during which the consent provided by section 826(c)(2) and paragraph (a) of this section is in effect:

(1) The name and address of the reciprocal with respect to which the consent required by section 826(c)(2) and paragraph (a) of this section is to apply;

(2) Gross income in total and by sources, adjusted for returns and allowances;

(3) Deductions (itemized to the same extent as on taxpayer's income tax return and accompanying schedules) allocable to each source of gross income and in total (see §1.826–4);

(4) Method of allocation used in subparagraph (3) of this paragraph;

(5) Taxable income (if any) in total and by sources, as in subparagraph (2) of this paragraph (income by sources from subparagraph (2) of this paragraph minus expenses allocable thereto under subparagraph (3) of this paragraph);

(6) Total income tax liability (if any) for the taxable year;

(7) Taxes paid attributable (under §1.826–5) to income earned by the taxpayer in dealing with the reciprocal;

(8) Such other information as may be required by the district director.

(c) *Manner in which information is to be provided.* (1) The information required by paragraph (b) of this section shall be set forth in a statement attached to the taxpayer's income tax return for each taxable year for which the consent provided by section 826(c)(2) and paragraph (a) of this section is in effect. Such statement shall include the name and address of the taxpayer, and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the income tax return for each taxable year for which such information is required.

(2) A copy of the statement containing the information required by paragraph (b) of this section shall be submitted to the board of advisors (or other comparable body) of the reciprocal on whose behalf the consent provided under section 826(c)(2) is given. The copy shall be executed in the same manner as the original and shall be delivered to such board not later than 10 days before the last date prescribed by law (including extensions thereof) for filing the reciprocal's income tax return for the taxable year for which the information is required unless the attorney-in-fact establishes to the satisfaction of the district director that the failure to furnish such copy or the failure to furnish such copy within the prescribed 10 day period was due to circumstances beyond its control. In addition, there shall be attached to and made a part of such copy, a copy of the income tax return of the attorney-in-fact (including accompanying schedules) for each taxable year for which such statement is required.

[T.D. 6681, 28 FR 11125, Oct. 17, 1963]

§ 1.826–4 Allocation of expenses.

An attorney-in-fact allocating expenses as required by section 826(b) and paragraph (b) of § 1.826–3 shall allocate each expense itemized in its income tax return (and accompanying schedules) for the taxable year to each source of gross income (as set forth pursuant to paragraph (b)(2) of § 1.826–3). However, no portion of the net operating loss deduction allowed by section 172 shall be allocated to income received or due from the reciprocal, and no expenses, other than those directly related thereto, shall be allocated to capital gains. Where the method of allocation used by the taxpayer does not reasonably reflect the expenses of the taxpayer allocable to income received or due from the reciprocal, the district director may require the taxpayer to use such other method of allocation as is reasonable under the circumstances.

[T.D. 6681, 28 FR 11126, Oct. 17, 1963]

§ 1.826–5 Attribution of tax.

(a) *In general.* Section 826(e) provides that a reciprocal making the election allowed by section 826(a) shall be credited with so much of the tax paid by the attorney-in-fact as is attributable to the income received by the attorney-in-fact from the reciprocal in such taxable year.

(b) *Computation.* For purposes of section 826(e) and paragraph (a) of this section, the amount of tax attributable to income received by the attorney-in-fact from the reciprocal in the taxable year shall be computed in the following manner:

(1) First, compute the taxable income (if any) from each source of gross income set forth in paragraph (b)(2) of § 1.826–3 by deducting from each such amount the expenses allocable thereto under § 1.826–4;

(2) Second, compute the normal tax on each amount of taxable income computed in subparagraph (1) of this paragraph at the rate provided by section 11(b) of the Code;

(3) Third, deduct from each amount determined in subparagraph (1) of this paragraph an amount which bears the same proportion to the surtax exemption provided by section 11(c) of the Code as each amount computed under subparagraph (1) of this paragraph bears to the total of the amounts computed under subparagraph (1) of this paragraph;

(4) Fourth, compute the surtax on each remainder computed in subparagraph (3) of this paragraph at the rate provided by section 11(c) of the Code;

(5) Fifth, add the normal tax computed under subparagraph (2) of this paragraph to the surtax computed

under subparagraph (4) of this paragraph for each amount computed under subparagraph (1) of this paragraph;

(6) Sixth, deduct from each amount of tax computed under subparagraph (5) of this paragraph any tax credits (other than those arising from payments made with respect to the tax liability for the taxable year or other taxable years) allocable (in the same manner as provided for expenses under §1.826–4) to such amount;

(7) Seventh, compute that amount which bears the same proportion to the tax actually paid with respect to the taxable year as each individual amount computed under subparagraph (6) of this paragraph bears to the total of the amounts computed under subparagraph (6) of this paragraph. The amount so determined with respect to each amount computed under subparagraph (6) of this paragraph is the tax paid which is attributable to the amount computed under subparagraph (1) of this paragraph.

To the extent the amounts determined under subparagraph (1) of this paragraph are attributable to amounts received from the reciprocal for the taxable year, the tax attributable to such amounts (as determined under subparagraph (7) of this paragraph) shall be the amount of tax attributable to income received by the attorney-in-fact from the reciprocal during the taxable year.

(c) *Taxes of attorney-in-fact unaffected.* Nothing in section 826 or the regulations thereunder shall increase or decrease the taxes imposed on the income of the attorney-in-fact.

[T.D. 6681, 28 FR 11126, Oct. 17, 1963]

§1.826–6 Credit or refund.

(a) *Notification required.* In any case where a taxpayer applies for a credit or refund of taxes paid by it in respect of a taxable year for which the taxpayer was the consenting attorney-in-fact of a reciprocal making the election provided by section 826(a), such taxpayer shall give notice to its reciprocal for such taxable year, first, upon applying for the credit or refund; and again, within 10 days from the date on which a final determination is made that such credit or refund has been allowed or denied.

(b) *Notice form.* The notices required by this section shall include the name and address of the taxpayer and shall be signed by the taxpayer or its duly authorized representative. In addition, there shall be attached to and made a part of each first notice a concise statement of the claim upon which the application for refund or credit is based; and there shall be attached to and made a part of each second notice:

(1) A copy of the notification (if any) received by the taxpayer indicating that the credit or refund has been allowed; and

(2) A statement setting forth the amount of such credit or refund attributable to taxes paid by the taxpayer on income received from the reciprocal, and the computation by which such amount was determined.

(c) *Manner of apportioning refund or credit.* The taxpayer shall determine the amount of the refund or credit attributable to taxes paid on income received from its reciprocal by reallocating its income and expense items for the taxable year, with respect to which the refund or credit is allowed, in the manner provided by §§1.826–3 and 1.826–4 so as to reflect the adjustments (if any) in such items which resulted in the credit or refund of tax for the taxable year. The taxpayer shall then recompute the tax attributable to income received from its reciprocal for such taxable year in the manner provided by §1.826–5. The district director may require such additional information as may be necessary in the circumstances to verify the computations required by this paragraph.

[T.D. 6681, 28 FR 11126, Oct. 17, 1963]

§1.826–7 Examples.

The application of section 826 may be illustrated by the following examples:

Example 1. For the taxable year 1963, R, a reciprocal underwriter subject to the taxes imposed by section 821(a), has the following items (determined before applying any election under section 826):

Gross income under sec. 832		$578
Gross investment income		50
Deductions under sec. 832 (as modified by sec. 823(b)):		
Deduction for amounts paid by R to attorney-in-fact A	$100	
All other deductions	500	

Total deductions under sec. 832	600	
Deductions under sec. 822(c)		40
Incurred losses		400
Protection against loss deduction		4
Underwriting gain		0
Mutual insurance company taxable income		0
Unused loss		22
Credit or refund for taxes paid		0

Assume that the deductions of attorney-in-fact A allocable to the income received by A from R are 60 and the tax paid by A allocable to the income received from R is 16. If R elects to be subject to the limitation provided in section 826(b), the results for 1963 would be as follows:

Gross income under sec. 832		$578
Gross investment income		50
Deductions under sec. 832 (as modified by sec. 823(b)):		
Deduction for amounts paid by R to attorney-in-fact A	$60	
All other deductions	500	
Total deduction under sec. 832	560	
Deductions under sec. 822(c)		40
Incurred losses		400
Underwriting gain		8
Protection against loss deduction		6
Mutual insurance company taxable income		12
Unused loss		0
Credit or refund for taxes paid		16

Under the provisions of section 826(b), R's deduction for amounts paid or incurred to the attorney-in-fact in the taxable year 1963 would be limited to the deductions of A allocable to the income received by A from R. Thus, R's deductions under section 832 (as modified by section 823(b)) for 1963 would be 60 (the deductions of A which are allocable to the income received by A from R). As a result of making the election under section 826(a) for the taxable year 1963, R's underwriting gain would be 8, and its statutory underwriting income would be 2 (the underwriting gain of 8 minus the protection against loss deduction of 6—of which 4 represents the amount determined under section 824(a)(1)(A)—and 2 represents the amount determined under section 824(a)(1)(B)—or 8 minus 6). R's mutual insurance company taxable income for 1963 would be 12, consisting of taxable investment income of 10 (gross investment income minus deductions under section 822(c), or 50 minus 40) plus statutory underwriting income of 2. Since all of R's mutual insurance company taxable income of 12 is attributable to the limitation under section 826(b), the entire amount is subject to the surtax under section 821(a)(2) without regard to the $25,000 surtax exemption. The credit of 16, representing that part of the tax paid by A which is allocable to the income received by A from R, may be applied by R against its taxes with respect to its mutual insurance company taxable income of 12 for 1963, and R would be entitled to a refund of any excess of the amount of such credit over its tax liability for 1963.

Under the provisions of section 826(d), no portion of the amount added to the protection against loss account in 1963 by reason of the election under section 826(a), 2 (25 percent of the amount by which the consolidated underwriting gain exceeds 25 percent of the underwriting gain determined without regard to the election under section 826(a), or the amount by which 25 percent of 8 exceeds 25 percent of 0), may remain in such account beyond the taxable year 1968.

Example 2. For the taxable year 1963, F is a corporate attorney-in-fact subject to the taxes imposed by section 11(b) and (c) of the Code. F files its return on the calendar year basis and reports income received from its reciprocal and the deductions allocable thereto under the same method of accounting used by its reciprocal in reporting its deductions for amounts paid to R. F properly consents to provide the information required by paragraph (b) of § 1.826–3. In addition to its attorney-in-fact business, F owns real estate for investment purposes, and operates a real estate management service. For the taxable year 1963, F has gross income from these various sources as follows:

Attorney-in-fact fees	$85,000
Real estate management fees	18,000
Rental income	25,000

F allocates its expenses for the taxable year on the basis of their direct relation to each source of income. During 1963, F acquired property for use in its attorney-in-fact operations which entitled F to an investment credit of $800 under section 38. For 1963, F determines that the tax paid by it which is attributable to its reciprocal is $21,863, computed as follows:

	Attorney-in-fact fees	Real estate management	Rental income	Total
Gross income	$85,000	$18,000	$25,000	$128,000
Allocable expenses	25,000	3,000	35,000	63,000
Taxable income (loss)	60,000	15,000	(10,000)	65,000
Normal tax (30 percent)	18,000	4,500	0	19,500
Surtax exemption	20,000	5,000	0	25,000
Income subject to surtax	40,000	10,000	0	40,000
Surtax (22 percent)	8,800	2,200	0	8,800
Total tax	26,800	6,700	0	28,300
Investment credit	800	0	0	800
1963 tax liability	26,000	6,700	0	27,500

	Attorney-in-fact fees	Real estate management	Rental income	Total
1963 tax paid	....	....	....	27,500
Allocation of tax paid ..	21,863	5,637	0	27,500

Under paragraph (b)(1) of §1.826–5, F computes its taxable income from its attorney-in-fact fees to be $60,000 ($85,000 minus $25,000), and its taxable income from its real estate management to be $15,000 ($18,000 minus $3,000). Since F's rental operations resulted in a $10,000 loss for the taxable year ($25,000 minus $35,000), F's taxable income from its rental operations is zero. Using the 30 percent rate provided by section 11(b), F computes its normal tax to be $18,000 on its attorney-in-fact fees and $4,500 on its real estate management operations. F's normal tax on total income is $19,500. The $3,000 difference between the normal tax on F's total income and the normal taxes on F's profitable operations results from the loss on F's rental operations. Under paragraph (b)(3) of §1.826–5, F allocates its surtax exemption as follows: $20,000 ($60,000/$75,000×$25,000) to its attorney-in-fact fees; and $5,000 ($15,000/$75,000×$25,000) to its real estate management operations. F computes its surtax on its profitable operations at the 22 percent rate provided by section 11(c) as follows: $8,800 (22 percent of $40,000) on attorney-in-fact fees; and $2,200 (22 percent of $10,000) on real estate management income. F adds its normal tax and surtax on its profitable operations and determines its total tax to be $26,800 on its attorney-in-fact operations; $6,700 on its real estate management operations; and $28,300 on its total income. F must allocate its investment credit on the same basis as it used to allocate its expenses. Thus, F's entire investment credit must be allocated to its attorney-in-fact operations. Accordingly, F's 1963 tax liability is $26,000 on its attorney-in-fact fees; $6,700 on its real estate management operations; $0 on its rental operations; and $27,500 on its total income. Under paragraph (b)(7) of §1.826–5, F allocates $21,863 ($26,000/$32,700×$27,500) of its 1963 tax paid to its attorney-in-fact fees; and $5,637 ($6,700/$32,700×$27,500) of its 1963 tax paid to its real estate management business. F's reciprocal will be allowed a credit or refund of $21,863 for taxes paid by F which are attributable to F's income received from its reciprocal.

Example 3. Assume the same facts as in example 2, and assume further that in 1966 F sustains a net operating loss on its overall operations of $5,000. In carrying the loss back to 1963 as a net operating loss deduction under section 172, F must allocate the deduction under the same method it used in allocating its 1963 deductions. Thus, if the loss was entirely attributable to F's rental operations for the taxable year 1966, F would reduce its taxable income attributable to those operations by the entire amount of the loss and would recompute the tax attributable to those operations under paragraph (b) of §1.826–5. As recomputed in the table below, F's 1963 tax liability from attorney-in-fact fees would be $19,800 and F's total tax liability would be $24,900.

	Attorney-in-fact fees	Real estate management	Rental income	Total
Gross income	$85,000	$18,000	$25,000	$128,000
Allocable expenses	25,000	3,000	35,000	63,000
Net operating loss deduction	0	0	5,000	5,000
Taxable income (loss)	60,000	15,000	(15,000)	60,000
Normal tax (30 percent)	18,000	4,500	0	18,000
Surtax exemption ..	20,000	5,000	0	25,000
Income subject to surtax	40,000	10,000	0	35,000
Surtax (22 percent) ..	8,800	2,200	0	7,700
Total tax	26,800	6,700	0	25,700
Investment credit	800	0	0	800
1963 tax liability	26,000	6,700	0	24,900
1963 tax paid	....	....	....	24,900
Allocation of tax paid ..	19,800	5,100	0	24,900

As a result of its 1966 net operating loss, F would be entitled to a refund of $2,600 (1963 taxes paid of $27,500 minus recomputed 1963 taxes of $24,900). Under paragraph (a) of §1.826–6, F would be required to notify its reciprocal of its claim for refund and of the amount of the refund or credit attributable to taxes paid on income received from the reciprocal. Since the 1963 tax paid by F attributable to its reciprocal (as recomputed) is less than the amount claimed in 1963 by F's reciprocal as a credit, F's reciprocal would be required, under section 826(g), to add the difference—$2,063 ($21,863 minus $19,800), to its tax liability for 1966. Thus, F's reciprocal would first compute its tax liability for 1966 without regard to section 826(g) and then would increase such liability by $2,063.

[T.D. 6681, 28 FR 11126, Oct. 17, 1963]

OTHER INSURANCE COMPANIES

§ 1.831–1 Tax on insurance companies (other than life or mutual), mutual marine insurance companies, and mutual fire insurance companies issuing perpetual policies.

(a) All insurance companies, other than life or mutual or foreign insurance companies not carrying on an insurance business within the United States, and all mutual marine insurance companies and mutual fire insurance companies exclusively issuing either perpetual policies, or policies for which the sole premium charged is a single deposit which, except for such deduction of underwriting costs as may be provided, is refundable upon cancellation or expiration of the policy, are subject to the tax imposed by section 831. As used in this section and §§ 1.832–1 and 1.832–2, the term ‘‘insurance companies’’ means only those companies which qualify as insurance companies under the definition provided by paragraph (b) of § 1.801–1 and which are subject to the tax imposed by section 831.

(b) All provisions of the Code and of the regulations in this part not inconsistent with the specific provisions of section 831 are applicable to the assessment and collection of the tax imposed by section 831(a), and insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations.

(c) Since section 832 provides that the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners shall be the basis for computing gross income and since the annual statement is rendered on the calendar year basis, the returns under section 831 shall be made on the basis of the calendar year and shall be on Form 1120. Insurance companies are entitled, in computing insurance company taxable income, to the deductions provided in part VIII (section 241 and following), subchapter B, chapter 1 of the Code.

(d) Foreign insurance companies not carrying on an insurance business within the United States are not taxable under section 831 but are taxable as other foreign corporations. See section 881.

(e) Insurance companies are subject to both normal tax and surtax. The normal tax shall be computed as provided in section 11(b) and the surtax shall be computed as provided in section 11(c). For the circumstances under which the $25,000 exemption from surtax for certain taxable years may be disallowed in whole or in part, see section 1551. For alternative tax where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder.

§ 1.831–2 Taxable years affected.

Section 1.831–1 is applicable only to taxable years beginning after December 31, 1953, but before January 1, 1963, and ending after August 16, 1954, and all references therein to sections of the Code and regulations are to sections of the Internal Revenue Code of 1954 and the regulations thereunder before amendments. Section 1.831–3 is applicable only to taxable years beginning after December 31, 1962, and all references therein to sections of the Code and regulations are to sections of the Internal Revenue Code of 1954 as amended. Section 1.831–4 is applicable only with respect to the companies described therein, and only with respect to taxable years beginning after December 31, 1961.

[T.D. 6681, 28 FR 11128, Oct. 17, 1963]

§ 1.831–3 Tax on insurance companies (other than life or mutual), mutual marine insurance companies, mutual fire insurance companies issuing perpetual policies, and mutual fire or flood insurance companies operating on the basis of premium deposits; taxable years beginning after December 31, 1962.

(a) All insurance companies, other than life or mutual or foreign insurance companies not carrying on an insurance business within the United States, and all mutual marine insurance companies and mutual fire or flood insurance companies exclusively issuing perpetual policies or whose principal business is the issuance of policies for which the premium deposits are the same regardless of the length of the term for which the policies are written, are subject to the tax imposed by section 831 if the unabsorbed portion of such premium deposits not required for losses, expenses or reserves is returned or credited to the policyholder on cancellation or expiration of the policy. For purposes of section 831 and this section, in the case of a mutual flood insurance company, the premium deposits will be considered to be the same if the payment of a premium increases the total insurance under the policy in an amount equal to the amount of such premium and the omission of any annual premium does not result in the reduction or suspension of coverage under the policy. As used in this section and section 832 and the regulations thereunder, the term ''insurance companies'' means only those companies which qualify as insurance companies under the definition provided by paragraph (b) of §1.801–1 and which are subject to the tax imposed by section 831.

(b) All provisions of the Code and of the regulations in this part not inconsistent with the specific provisions of section 831 are applicable to the assessment and collection of the tax imposed by section 831(a), and insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations.

(c) Since section 832 provides that the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners shall be the basis for computing gross income and since the annual statement is rendered on the calendar year basis, the returns under section 831 shall be made on the basis of the calendar year and shall be on Form 1120. Insurance companies are entitled, in computing insurance company taxable income, to the deductions provided in part VIII (section 241 and following), subchapter B, chapter 1 of the Code.

(d) Foreign insurance companies not carrying on an insurance business within the United States are not taxable under section 831 but are taxable as other foreign corporations. See section 881.

(e) Insurance companies are subject to both normal tax and surtax. The normal tax shall be computed as provided in section 11(b) and the surtax shall be computed as provided in section 11(c). For the circumstances under which the $25,000 exemption from surtax for certain taxable years may be disallowed in whole or in part, see section 1551. For alternative tax where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder.

[T.D. 6681, 28 FR 11128, Oct. 17, 1963]

§1.831–4 Election of multiple line companies to be taxed on total income.

(a) *In general.* Section 831(c) provides that any mutual insurance company engaged in writing marine, fire, and casualty insurance which, for any 5-year period beginning after December 31, 1941, and ending before January 1, 1962, was subject to the tax imposed by section 831 (or the tax imposed by corresponding provisions of prior law) may elect, in the manner provided by paragraph (b) of this section, to be subject to the tax imposed by section 831, whether or not marine insurance is its predominant source of premium income. A company making an election under section 831(c) and this section will be subject to the tax imposed by section 831 for taxable years beginning after December 31, 1961, rather than subject to the tax imposed by section 821.

(b) *Time and manner of making election.* The election provided by section 831(c) and paragraph (a) of this section shall be made in a statement attached to the taxpayer's return for the taxable year 1962. The statement shall indicate that the taxpayer has made the election provided by section 831(c) and this section; shall include the name and address of the taxpayer, and shall be signed by the taxpayer or his duly authorized representative. In addition, the statement shall list the 5 consecutive taxable years prior to 1962 for which the taxpayer was subject to tax under section 831 (or the corresponding provisions of prior law); the types of insurance written by the company; and the percentage of marine insurance to total insurance written. The return and statement must be filed not later than the date prescribed by law (including extensions thereof) for filing the return for the taxable year 1962. However, if the last date prescribed by law (including extensions thereof) for filing the income tax return for the taxable year 1962 falls before October 17, 1963, the election provided by section 831(c) and this section may be made for such year by filing the statement and an amended return for such taxable year (and all subsequent taxable years for which returns have been filed) before January 16, 1964.

(c) *Scope of election.* An election made under section 831(c) and paragraph (b) of this section shall be binding for all taxable years beginning after December 31, 1961, unless consent to revoke the election is obtained from the Commissioner. However, if a taxpayer made the election provided by section 831(c) and this section for taxable years beginning prior to October 17, 1963, the taxpayer may revoke such election without obtaining consent from the Commissioner by filing, before January 16, 1964, a statement that the taxpayer desires to revoke such election. Such statement shall be signed by the taxpayer or its duly authorized representative. An amended return reflecting such revocation must accompany the statement for all taxable years for which returns have been filed with respect to such election.

(d) *Limitation on certain net operating loss carryovers and carrybacks.* In the case of a taxpayer making the election allowed under section 831(c) and this section, a net operating loss shall not be carried:

(1) To or from any taxable year for which the insurance company is not subject to the tax imposed by section 831(a) (or predecessor sections); or

(2) To any taxable year if, between the loss year and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by section 831(a) (or predecessor sections).

[T.D. 6681, 28 FR 11128, Oct. 17, 1963]

§ 1.832–1 Gross income.

(a) Gross income as defined in section 832(b)(1) means the gross amount of income earned during the taxable year from interest, dividends, rents, and premium income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, as well as the gain derived from the sale or other disposition of property, and all other items constituting gross income under section 61, except that in the case of a mutual fire insurance company described in § 1.831–1 the amount of single deposit premiums received, but not assessments, shall be excluded from gross income. Gross income does not include increase in liabilities during the year on account of reinsurance treaties, remittances from the home office of a foreign insurance company to the United States branch, borrowed money, or gross increase due to adjustments in book value of capital assets. The underwriting and investment exhibit is presumed to reflect the true net income of the company, and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined in the Code. By reason of the definition of investment income, miscellaneous items which are intended to reflect surplus but do not properly enter into the computation of income, such as dividends declared to shareholders in their capacity as such, home office remittances and receipts, and special deposits, are ignored. Gain or loss from agency balances and bills receivable not admitted as assets on the underwriting and investment exhibit will be ignored, excepting only such agency balances and bills receivable as have been allowed as deductions for worthless debts or, having been previously so allowed, are recovered during the taxable year. In computing ‘‘premiums earned on insurance contracts during the taxable year’’ the amount of the unearned premiums shall include (1) life insurance reserves as defined in section 803(b) and § 1.803–1 pertaining to the life, burial, or funeral insurance, or annuity business of an insurance company subject to the tax imposed by section 831 and not qualifying as a life insurance company under section 801, and (2) liability for return premiums under a rate credit or retrospective rating plan based on experience, such as the ''War Department Insurance Rating Plan,'' and which return premiums are therefore not earned premiums. In computing ''losses incurred'' the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

(b) Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for ''losses incurred'' which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such losses which, in the opinion of the district director are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. The district director may require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for ''losses incurred.''

(c) That part of the deduction for ''losses incurred'' which represents an adjustment to losses paid for salvage and reinsurance recoverable shall, except as hereinafter provided, include all salvage in course of liquidation, and all reinsurance in process of collection not otherwise taken into account as a reduction of losses paid, outstanding at the end of the taxable year. Salvage in course of liquidation includes all property (other than cash), real or personal, tangible or intangible, except that which may not be included by reason of express statutory provisions (or rules and regulations of an insurance department) of any State or Territory or the District of Columbia in which the company transacts business. Such salvage in course of liquidation shall be taken into account to the extent of the value thereof at the end of the taxable year as determined from a fair and reasonable estimate based upon either the facts in each case or the company's experience with similar cases. Cash received during the taxable year with respect to items of salvage or reinsurance shall be taken into account in computing losses paid during such taxable year.

§1.832–2 Deductions.

(a) The deductions allowable are specified in section 832(c) and by reason of the provisions of section 832(c)(10) and (12) include in addition certain deductions provided in sections 161, and 241 and following. The deductions, however, are subject to the limitation provided in section 265, relating to expenses and interest in respect of tax-exempt income. The net operating loss deduction is computed under section 172 and the regulations thereunder. For the purposes of section 172, relating to net operating loss deduction, ''gross income'' shall mean gross income as defined in section 832(b)(1) and the allowable deductions shall be those allowed by section 832(c) with the exceptions and limitations set forth in section 172(d). In addition to the deduction for capital losses provided in subchapter P (section 1201 and following), chapter 1 of the Code, insurance companies are allowed a deduction for losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. A special rule is provided for the application of the capital loss carryover provisions of section 1212. The deduction is the same as that allowed mutual insurance companies subject to the tax imposed by section 821; see section 822(c)(6) and the regulations thereunder. Insurance companies, other than mutual fire insurance companies described in §1.831–1, are also allowed a deduction for dividends and similar distributions paid or declared to policyholders in their capacity as such. The deduction is otherwise the same as that allowed mutual insurance companies subject to the tax imposed by section 821; see section 823(2) and the regulations thereunder.

(b) Among the items which may not be deducted are income and profits taxes imposed by the United States, income and profits taxes imposed by any foreign country or possession of the United States (in cases where the company chooses to claim to any extent a credit for such taxes), taxes assessed against local benefits, decrease during the year due to adjustments in the book value of capital assets, decrease in liabilities during the year on account of reinsurance treaties, dividends paid to shareholders in their capacity as such, remittances to the home office of a foreign insurance company by the United States branch, and borrowed money repaid.

(c) In computing taxable income of insurance companies, losses sustained during the taxable year from the sale or other disposition of property are deductible subject to the limitation contained in section 1211. Insurance companies are entitled to the alternative taxes provided in section 1201.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6867, 30 FR 15094, Dec. 12, 1965]

§1.832–3 Taxable years affected.

Sections 1.832–1 and 1.832–2 are applicable only to taxable years beginning after December 31, 1953, and before January 1, 1963, and ending after August 16, 1954, and all references therein to sections of the Code and regulations are to sections of the Internal Revenue Code of 1954 and the regulations thereunder before amendments. Sections 1.832–4, 1.832–5, and 1.832–6 are applicable only to taxable years beginning after December 31, 1962, and all references therein to sections of the Code and regulations are to sections of the Internal Revenue Code of 1954 as amended.

[T.D. 6681, 28 FR 11129, Oct. 17, 1963]

§1.832–4 Gross income.

(a)(1) Gross income as defined in section 832(b)(1) means the gross amount of income earned during the taxable year from interest, dividends, rents, and premium income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, as well as the gain derived from the sale or other disposition of property, and all other items constituting gross income under section 61, except that in the case of a mutual fire insurance company described in section 831(a)(3)(A) the amount of single deposit premiums received, but not assessments, shall be excluded from gross income. Section 832(b)(1)(D) provides that in the case of a mutual fire or flood insurance company described in section 831(a)(3)(B), there shall be included in gross income an amount equal to 2 percent of the premiums earned during the taxable year on contracts described in section 831(a)(3)(B) after deduction of premium deposits returned or credited during such taxable year with respect to such contracts. Gross income does not include increase in liabilities during the year on account of reinsurance treaties, remittances from the home office of a foreign insurance company to the United States branch, borrowed money, or gross increase due to adjustments in book value of capital assets.

(2) The underwriting and investment exhibit is presumed to reflect the true net income of the company, and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined in the Code. By reason of the definition of investment income, miscellaneous items which are intended to reflect surplus but do not properly enter into the computation of income, such as dividends declared to shareholders in their capacity as such, home office remittances and receipts, and special deposits, are ignored. Gain or loss from agency balances and bills receivable not admitted as assets on the underwriting and investment exhibit will be ignored, excepting only such agency balances and bills receivable as have been allowed as deductions for worthless debts or, having been previously so allowed, are recovered during the taxable year.

(3) In computing ''premiums earned on insurance contracts during the taxable year'' the amount of the unearned premiums shall include:

(i) Life insurance reserves as defined in section 803(b) and §1.803–1 pertaining to the life, burial, or funeral insurance, or annuity business of an insurance company subject to the tax imposed by section 831 and not qualifying as a life insurance company under section 801;

(ii) Liability for return premiums under a rate credit or retrospective rating plan based on experience, such as the ''War Department Insurance Rating Plan,'' and which return premiums are therefore not earned premiums; and

(iii) In the case of a mutual fire or flood insurance company described in section 831(a)(3)(B) (with respect to the contracts described therein), the amount of unabsorbed premium deposits which the company would be obligated to return to its policyholders at the close of the company's taxable year if all of its policies were terminated at such time.

(4) In computing the amount of unabsorbed premium deposits which a mutual fire or flood insurance company described in section 831(a)(3)(B) would be obligated to return to its policyholders at the close of its taxable year, the company must use its own schedule of unabsorbed premium deposit returns then in effect. A copy of the applicable schedule must be filed with the company's income tax return for each taxable year for which a computation based upon such schedule is made. In addition, a taxpayer making such a computation must provide the following information for each taxable year for which the computation is made:

(i) The amount of gross premiums received during the taxable year, and the amount of premiums paid for reinsurance during the taxable year, on the policies described in section 831(a)(3)(B) and on other policies;

(ii) The amount of insurance written during the taxable year under the policies described in section 831(a)(3)(B) and under other policies, and the amount of such insurance written which was reinsured during the taxable year. The information required under this subdivision shall only be submitted upon the specific request of the district director for a statement setting forth such information, and, if required, such statement shall be filed in the manner provided by this subparagraph or in such other manner as is satisfactory to the district director;

(iii) The amount of premiums earned during the taxable year on the policies described in section 831(a)(3)(B) and on other policies and the computations by which such amounts were determined, including sufficient information to support the taxpayer's determination of the amount of unearned premiums on premium deposit plan and other policies at the beginning and end of the taxable year, and the amount of unabsorbed premium deposits at the beginning and end of the taxable year on policies described in section 831(a)(3)(B).

The information required by this subparagraph shall be set forth in a statement attached to the taxpayer's income tax return for the taxable year for which such information is being provided. Such statement shall include the name and address of the taxpayer, and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the income tax return for the taxable year.

(5) In computing ''losses incurred'' the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

(b) *Losses incurred.* Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for ''losses incurred'' which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses. See section 846 for rules relating to the determination of discounted unpaid losses. These losses must be stated in amounts which, based upon the facts in each case and the company's experience with similar cases, represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of unpaid losses which, in the opinion of the district director, are in excess of a fair and reasonable estimate will be disallowed as a deduction. The district director may require any insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for ''losses incurred.''

(c) *Losses incurred are reduced by salvage.* Under section 832(b)(5)(A), losses incurred are computed by taking into account losses paid reduced by salvage and reinsurance recovered, the change in discounted unpaid losses, and the change in estimated salvage and reinsurance recoverable. For purposes of section 832(b)(5)(A)(iii), estimated salvage recoverable includes all anticipated recoveries on account of salvage, whether or not the salvage is treated, or may be treated, as an asset for state statutory accounting purposes. Estimates of salvage recoverable must be based on the facts of each case and the company's experience with similar cases. Except as otherwise provided in guidance published by the Commissioner in the Internal Revenue Bulletin, estimated salvage recoverable must be discounted either—

(1) By using the applicable discount factors published by the Commissioner for estimated salvage recoverable; or

(2) By using the loss payment pattern for a line of business as the salvage recovery pattern for that line of business and by using the applicable interest rate for calculating unpaid losses under section 846(c). For purposes of section 832(b)(5)(A) and the regulations thereunder, the term ''salvage recoverable'' includes anticipated recoveries on account of subrogation claims arising with respect to paid or unpaid losses.

(d) *Increase in unpaid losses shown on annual statement in certain circumstances*—(1) *In general.* An insurance company that takes estimated salvage recoverable into account in determining the amount of its unpaid losses shown on its annual statement is allowed to increase its unpaid losses by the amount of estimated salvage recoverable taken into account if the company complies with the disclosure requirement of paragraph (d)(2) of this section. This adjustment shall not be used in determining under section 846(d) the loss payment pattern for a line of business.

(2) *Disclosure requirement.* (i) *In general.* A company described in paragraph (d)(1) of this section is allowed to increase the unpaid losses shown on its annual statement only if the company either—

(A) Discloses on its annual statement, by line of business and accident year, the extent to which estimated salvage recoverable is taken into account in computing the unpaid losses shown on the annual statement filed by the company for the calendar year ending with or within the taxable year of the company; or

(B) Files a statement on or before the due date of its Federal income tax return (determined without regard to extensions) with the appropriate state regulatory authority of each state to which the company is required to submit an annual statement. The statement must be contained in a separate document captioned ''DISCLOSURE CONCERNING LOSS RESERVES'' and must disclose, by line of business and accident year, the extent to which estimated salvage recoverable is taken into account in computing the unpaid losses shown on the annual statement filed by the company for the calendar year ending with or within the taxable year of the company.

(ii) *Transitional rule.* For a taxable year ending before December 31, 1991, a taxpayer is deemed to satisfy the disclosure requirement of paragraph (d)(2)(i)(B) of this section if the taxpayer files the statement described in paragraph (d)(2)(i)(B) of this section before March 17, 1992.

(3) *Failure to disclose in a subsequent year.* If a company that claims the increase permitted by paragraph (d)(1) of this section fails in a subsequent taxable year to make the disclosure described in paragraph (d)(2) of this section, the company cannot claim an increase under paragraph (d)(1) of this section in any subsequent taxable year without the consent of the Commissioner.

(e) *Treatment of estimated salvage recoverable*—(1) *In general.* An insurance company is required to take estimated salvage recoverable (including that which cannot be treated as an asset for state statutory accounting purposes) into account in computing the deduction for losses incurred. Except as provided in paragraph (e)(2)(iii) of this section, an insurance company must apply this method of accounting to estimated salvage recoverable for all lines of business and for all accident years.

(2) *Change in method of accounting*—(i) If an insurance company did not take estimated salvage recoverable into account as required by paragraph (c) of this section for its last taxable year beginning before January 1, 1990, taking estimated salvage recoverable into account as required by paragraph (c) of this section is a change in method of accounting.

(ii) If a company does not claim the deduction under section 11305(c)(3) of the 1990 Act, the company must take into account 13 percent of the adjustment that would otherwise be required under section 481 for pre-1990 accident years as a result of the change in accounting method. This paragraph (e)(2)(ii) applies only to an insurance company subject to tax under section 831.

(iii) If a company claims the deduction under section 11305(c)(3) of the 1990 Act and paragraph (f) of this section, the company must implement the change in method of accounting for estimated salvage recoverable for post-1989 taxable years pursuant to a ‘‘cut-off’’ method.

(3) *Rule for overestimates.* An insurance company is required under section 11305(c)(4) of the 1990 Act to include in gross income 87 percent of any amount (adjusted for discounting) by which the section 481 adjustment is overestimated. The rule is applied by comparing the amount of the section 481 adjustment (determined without regard to paragraph (e)(2)(ii) of this section and any discounting) to the sum of the actual salvage recoveries and remaining undiscounted estimated salvage recoverable that are attributable to losses incurred in accident years beginning before 1990. For any taxable year beginning after December 31, 1989, any excess of the section 481 adjustment over this sum (reduced by amounts treated as overestimates in prior taxable years pursuant to this paragraph (e)(3)) is an overestimate. To determine the amount to be included in income, it is necessary to discount this excess and multiply the resulting amount by 87 percent.

(f) *Special deduction*—(1) *In general.* Under section 11305(c)(3) of the 1990 Act, an insurance company may deduct an amount equal to 87 percent of the discounted amount of estimated salvage recoverable that the company took into account in determining the deduction for losses incurred under section 832(b)(5) in the last taxable year beginning before January 1, 1990. A company that claims the special deduction must establish to the satisfaction of the district director that the deduction represents only the discounted amount of estimated salvage recoverable that was actually taken into account by the company in computing losses incurred for that taxable year.

(2) *Safe harbor.* The requirements of paragraph (f)(1) of this section are deemed satisfied and the amount that the company reports as bona fide estimated salvage recoverable is not subject to adjustment by the district director, if—

(i) The company files with the insurance regulatory authority of the company’s state of domicile, on or before September 16, 1991, a statement disclosing the extent to which losses incurred for each line of business reported on its 1989 annual statement were reduced by estimated salvage recoverable,

(ii) The company attaches a statement to its Federal income tax return filed for the first taxable year beginning after December 31, 1989, agreeing to apply the special rule for overestimates under section 11305(c)(4) of the 1990 Act to the amount of estimated salvage recoverable for which it has taken the special deduction, and

(iii) In the case of a company that is a member of a consolidated group, each insurance company subject to tax under section 831 that is included in the consolidated group complies with paragraph (f)(2)(ii) of this section with respect to its special deduction, if any.

(3) *Limitations on special deduction*—(i) The special deduction under section 11305(c)(3) of the 1990 Act is available only to an insurance company subject to tax under section 831.

(ii) An insurance company that claimed the benefit of the ‘‘fresh start’’ with respect to estimated salvage recoverable under section 1023(e) of the Tax Reform Act of 1986 may not claim the special deduction allowed by section 11305(c)(3) of the 1990 Act to the extent of the estimated salvage recoverable for which a fresh start benefit was previously claimed.

(iii) A company that claims the special deduction is precluded from also claiming the section 481 adjustment provided in paragraph (e)(2)(ii) of this section for pre-1990 accident years.

(g) *Effective date.* Paragraphs (b) through (f) of this section are effective for taxable years beginning after December 31, 1989.

[T.D. 6681, 28 FR 11129, Oct. 17, 1963, as amended by T.D. 8171, 53 FR 118, Jan. 5, 1988; T.D. 8293, 55 FR 9425, Mar. 14, 1990. Redesignated and amended by T.D. 8390, 57 FR 3132, Jan. 28, 1992; 57 FR 6353, Feb. 24, 1992]

§ 1.832–5 Deductions.

(a) The deductions allowable are specified in section 832(c) and by reason of the provisions of section 832(c)(10) and (12) include in addition certain deductions provided in sections 161, and 241 and following. The deductions, however, are subject to the limitation provided in section 265, relating to expenses and interest in respect of tax-exempt income. The net operating loss deduction is computed under section 172 and the regulations thereunder. For the purposes of section 172, relating to net operating loss deduction, ‘‘gross income’’ shall mean gross income as defined in section 832(b)(1) and the allowable deductions shall be those allowed by section 832(c) with the exceptions and limitations set forth in section 172(d). In addition to the deduction for capital losses provided in subchapter P (section 1201 and following), chapter 1 of the Code, insurance companies are allowed a deduction for losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. A special rule is provided for the application of the capital loss carryover provisions of section 1212. The deduction is the same as that allowed mutual insurance companies subject to the tax imposed by section 821; see section 822(c)(6) and the regulation thereunder. Insurance companies, other than mutual fire insurance companies described in section 831(a)(3)(A) and the regulations thereunder, are also allowed a deduction for dividends and similar distributions paid or declared to policyholders in their capacity as such. Similar distributions include such payments as the so-called unabsorbed premium deposits returned to policyholders by factory mutual insurance companies. The deduction is otherwise the same as that allowed mutual insurance companies subject to the tax imposed by section 821; see section 822(f)(2) and the regulations thereunder.

(b) Among the items which may not be deducted are income and profits taxes imposed by the United States, income and profits taxes imposed by any foreign country or possession of the United States (in cases where the company chooses to claim to any extent a credit for such taxes), taxes assessed against local benefits, decrease during the year due to adjustments in the book value of capital assets, decrease in liabilities during the year on account of reinsurance treaties, dividends paid to shareholders in their capacity as such, remittances to the home office of a foreign insurance company by the United States branch, and borrowed money repaid.

(c) In computing taxable income of insurance companies, losses sustained during the taxable year from the sale or other disposition of property are deductible subject to the limitation contained in section 1211. Insurance companies are entitled to the alternative taxes provided in section 1201.

[T.D. 6681, 28 FR 11130, Oct. 17, 1963, as amended by T.D. 6867, 30 FR 15094, Dec. 7, 1965]

§ 1.832–6 Policyholders of mutual fire or flood insurance companies operating on the basis of premium deposits.

For purposes of determining his taxable income for any taxable year, a taxpayer insured by a mutual fire or flood insurance company under a policy for which the premium deposit is the same regardless of the length of the term for which the policy is written, and who is entitled to have returned or credited to his on the cancellation or expiration of such policy the unabsorbed portion of the premium deposit not required for losses, expenses, or establishment of reserves, may, if such amount is otherwise deductible under this chapter, deduct so much of his premium deposit as was absorbed by the company during the taxpayer's taxable year. The amount of the premium deposit absorbed during the taxpayer's taxable year shall be determined in accordance with the schedule of unabsorbed premium deposit returns in effect for the company during such taxable year. If the taxpayer is unable to determine the applicable rate of absorption in effect during his taxable year, he shall compute his deduction on the basis of the rate of absorption in effect at the end of the company's taxable year which next preceded the end of the taxpayer's taxable year. In such a case, an appropriate adjustment will be made upon the final determination of the rate of absorption applicable to the taxable year.

[T.D. 6681, 28 FR 11130, Oct. 17, 1963]

§1.832–7T Treatment of salvage and reinsurance in computing "losses incurred" deduction, taxable years beginning before January 1, 1990 (temporary).

(a) In computing ''losses incurred'' the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

(b) Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for ''losses incurred'' which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such losses which in the opinion of the district director are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. The district director may require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for ''losses incurred''.

(c) That part of the deduction for ''losses incurred'' which represents an adjustment to losses paid for salvage and reinsurance recoverable shall, except as hereinafter provided, include all salvage in course of liquidation, and all reinsurance in process of collection not otherwise taken into account as a reduction of losses paid, outstanding at the end of the taxable year. Salvage in course of liquidation includes all property (other than cash), real or personal, tangible or intangible, except that which may not be included by reason of express statutory provisions (or rules and regulations of an insurance department) of any State or Territory or the District of Columbia in which the company transacts business. Such salvage in course of liquidation shall be taken into account to the extent of the value thereof at the end of the taxable year as determined from a fair and reasonable estimate based upon either the facts in each case or the company's experience with similar cases. Cash received during the taxable year with respect to items of salvage or reinsurance shall be taken into account in computing losses paid during such taxable year.

(d) This section is effective for taxable years beginning before January 1, 1990.

[T.D. 8266, 54 FR 38970, Sept. 22, 1989; T.D. 8293, 55 FR 9425, Mar. 14, 1990]

§1.846–0 Outline of provisions.

The following is a list of the headings in §§1.846–1 through 1.846–4.

§1.846–1 Application of discount factors.

(a) In general.

(1) Rules.

(2) Examples.

(3) Increase in discounted unpaid losses shown on the annual statement.

(4) Increase in unpaid losses which take into account estimated salvage recoverable.

(b) Applicable discount factors.

(1) In general.

(i) Discount factors published by the Service.

(ii) Composite discount factors.

(iii) Annual statement changes.

(2) Title insurance company reserves.

(3) Reinsurance business.

(i) Proportional reinsurance for accident years after 1987.

(ii) Non-proportional reinsurance.

(A) Accident years after 1991.

(B) Accident years 1988 through 1991.

(iii) Reinsurance for accident years before 1988.

(iv) 90 percent exception.

(4) International business.

(5) Composite discount factors.

§1.846–2 Election by taxpayer to use its own historical loss payment pattern.

(a) In general.

(b) Eligible line of business.

(1) In general.

(2) Other published guidance.

(3) Special rule for 1987 determination year.

(c) Anti-abuse rule.

§1.846–3 Fresh start and reserve strengthening.

(a) In general.

(b) Applicable discount factors.

(1) Calculation of beginning balance.

(2) Example.

(c) Rules for determining the amount of reserve strengthening.

(1) In general.

(2) Accident years after 1985.

(i) In general.

(ii) Hypothetical unpaid loss reserve.

(3) Accident years before 1986.

(i) In general.

(ii) Exceptions.

(iii) Certain transactions deemed to be reinsurance assumed (ceded) in 1986.

(d) Section 845.

(e) Treatment of reserve strengthening.

(f) Examples.

§1.846–4 Effective date.

[T.D. 8433, 57 FR 40843, Sept. 8, 1992; 57 FR 48563, Oct. 27, 1992]

§1.846–1 Application of discount factors.

(a) *In general*—(1) *Rules.* A separate series of discount factors are computed for, and applied, to undiscounted unpaid losses attributable to each accident year of each line of business shown on the annual statement (as defined by section 846(f)(3)) filed by that taxpayer for the calendar year ending with or within the taxable year of the taxpayer. See §1.832–4(b) relating to the determination of unpaid losses. Paragraph (b) of this section provides rules relating to applicable discount factors and §1.846–3(b) contains guidance relating to discount factors applicable to accident years prior to the 1987 accident year. Once a taxpayer applies a series of discount factors to unpaid losses attributable to an accident year of a line of business, that series of discount factors must be applied to discount the unpaid losses for that accident year for that line of business for all future taxable years. The discount factors cannot be changed to reflect a change in the taxpayer's loss payment pattern during a subsequent year or to reflect a different interest rate assumption. However, discount factors may be changed for taxpayers who elect to use their own historical loss payment pattern, if information upon which the pattern is based is adjusted upon examination by the district director.

(2) *Examples.* The following examples illustrate the principles of paragraph (a)(1) of this section:

Example 1. A taxpayer discounts unpaid losses attributable to all accident years prior to 1992 using discount factors published by the Service. In 1992, the taxpayer elects, under §1.846–2, to compute discount factors using its own historical loss payment pattern. The taxpayer must continue to discount unpaid losses attributable to pre-1992 accident years using the discount factors published for those accident years by the Service.

Example 2. On its annual statements through 1987, a taxpayer did not allocate unpaid losses attributable to proportional reinsurance to the line of business associated with the risks being reinsured. Beginning with the 1988 annual statement, the taxpayer allocated those losses for all accident years to the line of business being reinsured. The taxpayer must continue to discount the unpaid losses attributable to proportional reinsurance from pre-1988 accident years using the discount factors that were used in determining tax reserves for the 1987 tax year. (See paragraph (b)(3) of this section for rules relating to the application of discount factors to reinsurance unpaid losses.)

(3) *Increase in discounted unpaid losses shown on the annual statement.* If the amount of unpaid losses shown on the annual statement is determined on a discounted basis, and the extent to which the unpaid losses were discounted can be determined on the basis of information disclosed on or with the annual statement, the amount of the unpaid losses to which the discount factors are applied shall be determined

without regard to any reduction attributable to the discounting reflected on the annual statement.

(4) *Increase in unpaid losses which take into account estimated salvage recoverable.* If the amount of unpaid losses shown on the annual statement reflects a reduction for estimated salvage recoverable and the extent to which the unpaid losses were reduced by estimated salvage recoverable is appropriately disclosed as required by §1.832–4(d)(2), the amount of unpaid losses shall be determined without regard to the reduction for salvage recoverable.

(b) *Applicable discount factors*—(1) *In general.* Except as otherwise provided in section 846(f)(6) (relating to certain accident and health lines of business), in §1.846–2 (relating to a taxpayer's election to use its own historical loss payment pattern), in this paragraph (b), or in other guidance published in the Internal Revenue Bulletin, the following factors must be used—

(i) *Discount factors published by the Service.* If the Service has published discount factors for a line of business, a taxpayer must discount unpaid losses attributable to that line by applying those discount factors; and

(ii) *Composite discount factors.* If the Service has not published discount factors for a line of business, a taxpayer must discount unpaid losses attributable to that line by applying composite discount factors.

(iii) *Annual statement changes.* If the groupings of individual lines of business on the annual statement changes, taxpayers must discount the unpaid losses on the resulting lines of business with the discounting patterns that would have applied to those unpaid losses based on their annual statement classification prior to the change.

(2) *Title insurance company reserves.* A title insurance company may only take into account case reserves (relating to claims which have been reported to the insurance company). Unless the Service publishes other guidance, the reserves must be discounted using the ‘‘Miscellaneous Casualty’’ discount factors published by the Service. Section 832(b)(8) provides rules for determining the discounted unearned premiums of a title insurance company.

(3) *Reinsurance business*—(i) *Proportional reinsurance for accident years after 1987.* For the 1988 accident year and subsequent accident years, unpaid losses for proportional reinsurance must be discounted using discount factors applicable to the line of business to which those unpaid losses are allocated as required on the annual statement.

(ii) *Non-proportional reinsurance*—(A) *Accident years after 1991.* For the 1992 accident year and subsequent accident years, unpaid losses for non-proportional reinsurance must be discounted using the applicable discount factors published by the Service for the appropriate reinsurance line of business.

(B) *Accident years 1988 through 1991.* For the 1988, 1989, 1990, and 1991 accident years unpaid losses for non-proportional reinsurance must be discounted using composite discount factors.

(iii) *Reinsurance for accident years before 1988.* If on its annual statement a taxpayer does not allocate unpaid losses to the applicable line of business for proportional or nonproportional reinsurance attributable to the 1987 accident year or a prior accident year, those losses must be discounted using composite discount factors. If on its annual statement a taxpayer allocates to the underlying line of business reinsurance unpaid losses that are attributable to the 1987 accident year or a prior accident year, those losses must be discounted using discount factors applicable to the underlying line of business.

(iv) *90 percent exception.* For purposes of §1.846–1(b)(3) (ii) and (iii), if more than 90 percent of all the unallocated losses of a taxpayer for an accident year relate to one underlying line of business, the taxpayer must discount all unallocable reinsurance unpaid losses attributable to that accident year using the discount factors published by the Service for the underlying line of business.

(4) *International business.* For any accident year, unpaid losses which are attributable to international business must be discounted using composite discount factors unless more than 90 percent of all losses for that accident year relate to one underlying line of

business. If more than 90 percent of all losses for an accident year relate to one underlying line of business, the taxpayer must discount the losses attributable to that accident year using discount factors published by the Service for the underlying line of business.

(5) *Composite discount factors.* For purposes of the regulations under section 846, ‘‘composite discount factors’’ means the series of discount factors published annually by the Service determined on the basis of the appropriate composite loss payment pattern.

[T.D. 8433, 57 FR 40844, Sept. 8, 1992]

§ 1.846–2 Election by taxpayer to use its own historical loss payment pattern.

(a) *In general.* If a taxpayer has one or more eligible lines of business in a determination year, the taxpayer may elect on the taxpayer's timely filed Federal income tax return for the determination year to discount unpaid losses using its own historical loss payment pattern instead of the industry-wide pattern determined by the Secretary. A taxpayer making the election must use its own historical loss payment pattern in discounting unpaid losses for each line of business that is an eligible line of business in that determination year. The election applies to accident years ending with the determination year and to each of the four succeeding accident years. If a taxpayer makes the election for the 1987 determination year, the taxpayer must use its 1987 loss payment pattern (determined by reference to its 1985 annual statement) to discount unpaid losses attributable to all accident years prior to 1988.

(b) *Eligible line of business*—(1) *In general.* A line of business is an eligible line of business in a determination year if, on the most recent annual statement filed by the taxpayer before the beginning of that determination year, the taxpayer reports losses and loss expenses incurred (in Schedule P, part 1, column 24 of the 1990 annual statement or comparable location in an earlier or subsequently revised blank) for at least the number of accident years for which losses and loss expenses incurred for that line of business are required to be separately reported on that annual statement. For example, for the 1987 determination year, the 1985 annual statement is used. The annual statement to be used to determine eligibility in subsequent determination years is the annual statement for each fifth year after 1985 (e.g., 1990, 1995, etc.).

(2) *Other published guidance.* A line of business is also an eligible line of business for purposes of the election if the line is an eligible line under requirements published for this purpose in the Internal Revenue Bulletin.

(3) *Special rule for 1987 determination year.* A line of business is an eligible line of business in the 1987 determination year if it is eligible under paragraph (b) (1) or (2) of this section, or if on the most recent annual statement filed by the taxpayer before the beginning of the 1987 determination year, the taxpayer reports written premiums for the line of business for at least the number of accident years that unpaid losses for that line of business are required to be separately reported on that annual statement.

(c) *Anti-abuse rule.* To prevent avoidance of the requirement that the election to use historical loss payment patterns apply to all eligible lines of business of a taxpayer, the district director may—

(1) Nullify a taxpayer's election to compute discounted unpaid losses based on its historical loss payment pattern;

(2) Adjust a taxpayer's historical loss payment pattern; or

(3) Make other proper adjustments.

[T.D. 8433, 57 FR 40845, Sept. 8, 1992]

§ 1.846–3 Fresh start and reserve strengthening.

(a) *In general.* Section 1023(e) of the Tax Reform Act of 1986 (‘‘the 1986 Act’’) provides rules relating to fresh start and reserve strengthening. For purposes of section 1023(e) of the 1986 Act, a taxpayer must discount its unpaid losses as of the end of the last taxable year beginning before January 1, 1987. The excess of undiscounted unpaid losses over discounted unpaid losses as of that time is not required to be included in income, except (as provided in paragraph (e) of this section) to the extent of any ‘‘reserve strengthening’’ in a taxable year beginning in 1986. The exclusion from income of this excess is known as ‘‘fresh start.’’ The amount of fresh start is, however, included in earnings and profits for the first taxable year beginning after December 31, 1986.

(b) *Applicable discount factors*—(1) *Calculation of beginning balance.* For purposes of section 1023(e) of the 1986 Act, a taxpayer discounts unpaid losses as of the end of the last taxable year beginning before January 1, 1987—

(i) By using the same discount factors that are used in the succeeding taxable year to discount unpaid losses attributable to the 1987 accident year and prior accident years (see section 1023(e)(2) of the 1986 Act); and

(ii) By applying those discount factors as if the 1986 accident year were the 1987 accident year.

(2) *Example.* The following example illustrates the principles of this paragraph (b):

Example. X, a calendar year taxpayer, does not make an election in 1987 to use its own historical loss payment pattern. When X computes discounted unpaid losses for its last taxable year beginning before January 1, 1987, the discount factor for AY+0 published in Rev. Rul. 87–34, 1987–1 C.B. 168, must be applied to unpaid losses attributable to the 1986 accident year; the discount factor for AY+1 is applied to unpaid losses attributable to the 1985 accident year; etc.

(c) *Rules for determining the amount of reserve strengthening (weakening)*—(1) *In general.* The amount of reserve strengthening (weakening) is the amount that is determined under paragraph (c)(2) or (3) to have been added to (subtracted from) an unpaid loss reserve in a taxable year beginning in 1986. For purposes of section 1023(e)(3)(B) of the 1986 Act, the amount of reserve strengthening (weakening) must be determined separately for each unpaid loss reserve by applying the rules of this paragraph (c). This determination is made without regard to the reasonableness of the amount of the unpaid loss reserve and without regard to the taxpayer’s discretion, or lack thereof, in establishing the amount of the unpaid loss reserve. The amount of reserve strengthening for an unpaid loss reserve may not exceed the amount of the reserve, including any undiscounted strengthening amount, as of the end of the last taxable year beginning before January 1, 1987. For purposes of this section, an ‘‘unpaid loss reserve’’ is the aggregate of the unpaid loss estimate for losses (whether or not reported) incurred in an accident year of a line of business.

(2) *Accident years after 1985*—(i) *In general.* The amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year after 1985 is the amount by which that reserve at the end of the last taxable year beginning in 1986 exceeds (is less than) a hypothetical unpaid loss reserve.

(ii) *Hypothetical unpaid loss reserve.* For purposes of this paragraph (c)(2), the term ‘‘hypothetical unpaid loss reserve’’ means a reserve computed for losses the estimates of which were included, at the end of the last taxable year beginning in 1986, in the unpaid loss reserve for which reserve strengthening (weakening) is being determined. The hypothetical unpaid loss reserve must be computed using the same assumptions, other than the assumed interest rates in the case of reserves determined on a discounted basis for annual statement reporting purposes, that were used to determine the 1985 accident year reserve, if any, for the line of business for which the hypothetical reserve is being computed. If there was no 1985 accident year reserve for that line of business, the hypothetical unpaid loss reserve is the reserve, at the end of the last taxable year beginning in 1986, for which reserve strengthening (weakening) is being determined (and thus there is no reserve strengthening or weakening).

(3) *Accident years before 1986*—(i) *In general.* For each taxable year beginning in 1986, the amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year before 1986 is the amount by which the reserve at the end of that taxable year exceeds (is less than)—

(A) The reserve at the end of the immediately preceding taxable year; reduced by

(B) Claims paid and loss adjustment expenses paid (‘‘loss payments’’) in the taxable year beginning in 1986 with respect to losses that are attributable to the reserve. The amount by which a reserve is reduced as a result of reinsurance ceded during a taxable year beginning in 1986 is treated as a loss payment made in that taxable year.

(ii) *Exceptions.* Notwithstanding paragraph (c)(3)(i) of this section, the amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year before 1986 does not include—

(A) An amount added to the reserve in a taxable year beginning in 1986 as a result of a loss reported to the taxpayer from a mandatory state or federal assigned risk pool if the amount of the loss reported is not discretionary with the taxpayer; or

(B) Payments made with respect to reinsurance assumed during a taxable year beginning in 1986 or amounts added to the reserve to take into account reinsurance assumed for a line of business during a taxable year beginning in 1986, but only to the extent that the amount does not exceed the amount of a hypothetical reserve for the reinsurance assumed. The amount of the hypothetical reserve is determined using the same assumptions (other than the assumed interest rates) that were used to determine a reserve for reinsurance assumed for the line of business in a taxable year beginning in 1985.

(iii) *Certain transactions deemed to be reinsurance assumed (ceded) in 1986.* For purposes of this paragraph (c)(3), reinsurance assumed (ceded) in a taxable year beginning in 1985 is treated as assumed (ceded) during the succeeding taxable year if the appropriate unpaid loss reserve is not adjusted to take into account the reinsurance transaction until that succeeding taxable year.

(d) *Section 845.* Any reinsurance transaction that has as one of its purposes the avoidance of the reserve strengthening limitation is subject to section 845.

(e) *Treatment of reserve strengthening.* The fresh start provision of section 1023(e)(3)(A) of the 1986 Act does not apply to the portion of the taxpayer's unpaid losses attributable to reserve strengthening. Thus, the difference between the undiscounted unpaid losses attributable to reserve strengthening and the discounted unpaid losses attributable to reserve strengthening must be included in income and, therefore, included in earnings and profits for the first taxable year beginning after December 31, 1986. The amount that a taxpayer must include in income for its first taxable year beginning after December 31, 1986, as a result of reserve strengthening is equal to the excess (if any) of—

(*1*) The sum of each amount of reserve strengthening multiplied by the difference between 100 percent and the discount factor that, under paragraph (b) of this section, is applicable to the unpaid loss reserve which was strengthened; over

(*2*) The sum of each reserve weakening multiplied by the difference between 100 percent and the discount factor that, under paragraph (b) of this section, is applicable to the unpaid loss reserve which was weakened.

(f) *Examples.* The following examples illustrate the principles of this section. For purposes of these examples, it is assumed that the taxpayers are property and casualty insurance companies that in 1987 did not elect to use their own historical loss payment patterns.

Example 1. (i) As of the end of 1985, X, a calendar year taxpayer, had undiscounted unpaid losses of $1,000,000 in the workers' compensation line of business for the 1984 accident year. The same reserve had undiscounted unpaid losses of $900,000 at the end of 1986. During 1986, X's loss payments for this reserve were $300,000. Accordingly, under paragraph (c)(3)(i) of this section, X has a reserve strengthening of $200,000 ($900,000–($1,000,000–$300,000)).

(ii) This was X's only reserve strengthening or weakening. Thus, under paragraph (e) of this section, for 1987 X must include in income $54,361.40 ($200,000 × (100%–72.8193%)). The factor of 72.8193% is the AY+2 factor from the workers' compensation series of discount factors published in Rev. Rul. 87–34, 1987–1 C.B. 168.

Example 2. The facts are the same as in *Example 1,* except that X's 1986 loss payments for the reserve were $1,100,000. If only paragraph (c)(3)(i) of this section were applied, X would have a $1,000,000 reserve strengthening ($900,000–($1,000,000–$1,100,000)). Under paragraph (c)(1) of this section, however, the amount of reserve strengthening for the reserve is limited to the amount of the reserve at the end of 1986. Accordingly, X has a reserve strengthening of $900,000 and for 1987 must include in income $244,626.30 ($900,000 × (100%–72.1893%)).

Example 3. (i) As of the end of 1985, Y, a calendar year taxpayer, had undiscounted unpaid losses of $1,000,000 in the auto physical damage line of business for the 1985 accident year. The same reserve included undiscounted unpaid losses of $600,000 at the end of 1986. During 1986, Y had loss payments of $300,000 for this line of business. Under paragraph (c)(3)(i) of this section Y has a $100,000 reserve weakening ($600,000–($1,000,000–$300,000)).

(ii) Under paragraph (e) of this section, the only effect of the reserve weakening is to reduce the amount that Y is required to include in income as a result of any strengthening of another reserve.

Example 4. The facts are the same as in *Example 1* except that X also has a $100,000 reserve weakening for the 1985 accident year in its auto physical damage line of business. Under paragraph (b) of this section, the reserve discount factor for the reserve is 93.3400, the AY+1 factor from the auto physical damage series of discount factors published in Rev. Rul. 87–34. Thus, under paragraph (e) of this section, the amount that X is required to include in income in 1987 is reduced by $6,660 ($100,000 × (100%–93.3400%)), resulting in an amount of $47,761.40 ($54,361.40–$6,660).

Example 5. (i) At the end of 1985, Z, a calendar year taxpayer, had undiscounted unpaid losses of $1,000,000 in the workers' compensation line of business for the 1984 accident year. On May 1, 1986, Z ceded $130,000 of the reserve to an unrelated reinsurer. Z added $250,000 to the 1985 year end reserve to take into account workers' compensation risks for the 1984 accident year that Z assumed in a reinsurance transaction on September 1, 1986. Z had $230,000 of 1986 loss payments related to the 1984 accident year of its workers' compensation line, $60,000 of which was attributable to the reinsurance assumed by Z. At the end of 1986, Z's reserve for the workers' compensation line for the 1984 accident year was $1,100,000.

(ii) If only paragraph (c)(3)(i) of this section were applied, Z would have a $460,000 reserve strengthening ($1,100,000–($1,000,000–$230,000–$130,000)). Under paragraph (c)(3)(ii)(B) of this section, however, reserve strengthening does not include the $250,000 that Z added to the reserve to take into account the reinsurance assumed. Also, none of the $60,000 of loss payments attributable to the reinsurance assumed in 1986 are taken into account. Accordingly, Z has $150,000 of reserve strengthening ($460,000–$250,000–$60,000). If this is Z's only reserve strengthening or weakening, then the amount that Z must include in income for 1987 under paragraph (e) of this section is $40,771.05 ($150,000 × (100%–72.8193%)). The factor of 72.8193% is the AY+2 factor from the workers' compensation series of discount factors published in Rev. Rul. 87–34.

Example 6. (i) X was a calendar year taxpayer before July 1, 1986, the date on which X became a member of an affiliated group of corporations that files a consolidated return with a June 30 year end. Thus, X had two taxable years beginning in 1986: a short taxable year ending June 30, 1986, and a fiscal taxable year ending June 30, 1987.

(ii) As of the end of 1985, X had undiscounted unpaid losses of $800,000 in the automobile liability line of business for the 1983 accident year. At the end of the short taxable year, X had reserves of $700,000 of undiscounted unpaid losses, and on June 30, 1987, had reserves of $600,000 of undiscounted unpaid losses. During the short taxable year, ending June 30, 1986, X's loss payments for this reserve were $120,000. During the taxable year ending June 30, 1987, X's loss payments for this reserve were $180,000. Under paragraph (c)(3)(i) of this section, X has a $100,000 reserve strengthening: of which $20,000 ($700,000–($800,000–$120,000)) is attributable to the short taxable year ending June 30, 1986 and $80,000 ($600,000–($700,000–$180,000)) is attributable to the taxable year ending June 30, 1987.

(iii) The amount of reserve strengthening for this line of business is determined pursuant to the principles of paragraph (c)(2) of this section.

[T.D. 8433, 57 FR 40845, Sept. 8, 1992; 57 FR 48563, Oct. 27, 1992; 57 FR 57531, Dec. 4, 1992]

§1.846–4 Effective date.

Sections 1.846–1 through Sections 1.846–3 apply to taxable years beginning after December 31, 1986.

[T.D. 8433, 57 FR 40847, Sept. 8, 1992]

§1.848–0 Outline of regulations under section 848.

This section lists the paragraphs in §§1.848–1 through 1.848–3.

1.848–1 Definitions and special provisions.

(a) Scope and effective date.

(b) Specified insurance contract.

(1) In general.

(2) Exceptions.

(i) In general.

(ii) Reinsurance of qualified foreign contracts.

(c) Life insurance contract.

(d) Annuity contract.

(e) Noncancellable accident and health insurance contract.

(f) Guaranteed renewable accident and health insurance contract.

(g) Combination contract.

(1) Definition.

(2) Treatment of premiums on a combination contract.

(i) In general.

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1.848–3 Interim rules for certain reinsurance agreements.

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[T.D. 8456, 57 FR 61818, Dec. 29, 1992]

§1.848–1 Definitions and special provisions.

(a) *Scope and effective date.* The definitions and special provisions in this section apply solely for purposes of determining specified policy acquisition expenses under section 848 of the Internal Revenue Code, this section, and §§1.848–2 and 1.848–3. Unless otherwise specified, the rules of this section are effective for the taxable years of an insurance company beginning after November 14, 1991.

(b) *Specified insurance contract*—(1) *In general.* A ‘‘specified insurance contract’’ is any life insurance contract, annuity contract, noncancellable or guaranteed renewable accident and health insurance contract, or combination contract. A reinsurance agreement that reinsures the risks under a specified insurance contract is treated in the same manner as the reinsured contract.

(2) *Exceptions*—(i) *In general.* A ‘‘specified insurance contract’’ does not include any pension plan contract (as defined in section 818(a)), flight insurance or similar contract, or qualified foreign contract (as defined in section 807(e)(4)).

(ii) *Reinsurance of qualified foreign contracts.* The exception for qualified foreign contracts does not apply to reinsurance agreements that reinsure qualified foreign contracts.

(c) *Life insurance contract.* A ‘‘life insurance contract’’ is any contract—

(1) Issued after December 31, 1984, that qualifies as a life insurance contract under section 7702(a) (including an endowment contract as defined in 7702(h)); or

(2) Issued prior to January 1, 1985, if the premiums on the contract are reported as life insurance premiums on the insurance company's annual statement (or could be reported as life insurance premiums if the company were required to file the annual statement for life and accident and health companies).

(d) *Annuity contract.* An ''annuity contract'' is any contract (other than a life insurance contract as defined in paragraph (c) of this section) if amounts received under the contract are subject to the rules in section 72(b) or section 72(e) (determined without regard to section 72(u)). The term ''annuity contract'' also includes a contract that is a qualified funding asset under section 130(d).

(e) *Noncancellable accident and health insurance contract.* The term ''noncancellable accident and health insurance contract'' has the same meaning for purposes of section 848 as the term has for purposes of section 816(b).

(f) *Guaranteed renewable accident and health insurance contract.* The term ''guaranteed renewable accident and health insurance contract'' has the same meaning for purposes of section 848 as the term has for purposes of section 816(e).

(g) *Combination contract*—(1) *Definition.* A ''combination contract'' is a contract (other than a contract described in section 848(e)(3)) that provides two or more types of insurance coverage, at least one of which if offered separately would be a life insurance contract, an annuity contract, or a noncancellable or guaranteed renewable accident and health insurance contract.

(2) *Treatment of premiums on a combination contract*—(i) *In general.* If the premium allocable to each type of insurance coverage is separately stated on the insurance company's annual statement (or could be separately stated if the insurance company were required to file the annual statement for life and accident and health companies), the premium allocable to each type of insurance coverage in a combination contract is subject to the capitalization rate, if any, that would apply if that coverage was provided in a separate contract. If the premium allocable to each type of insurance coverage in a combination contract is not separately stated, the entire premium is subject to the highest capitalization percentage applicable to any of the coverages provided.

(ii) *De minimis premiums.* For purposes of this paragraph (g)(2)—

(A) A de minimis premium is not required to be separately stated;

(B) In determining the highest capitalization percentage applicable to a combination contract, the coverage to which a de minimis premium is allocable is disregarded;

(C) If the separate statement requirement of this paragraph (g)(2) is satisfied, a de minimis premium is treated in accordance with its characterization on the insurance company's annual statement; and

(D) Whether a premium for an insurance coverage is de minimis is determined by comparing that premium with the aggregate of the premiums for the combination contract. A premium that is not more than 2 percent of the premium for the entire contract is considered de minimis. Whether a premium that is more than 2 percent is de minimis is determined based on all the facts and circumstances.

(3) *Example.* The principles of this paragraph (g) are illustrated by the following example.

Example. A life insurance company (L1) issues a contract to an employer (X) which provides cancellable accident and health insurance coverage and group term life insurance coverage to X's employees. L1 charges a premium of $1,000 for the contract, $950 of which is attributable to the cancellable accident and health insurance coverage and $50 of which is attributable to the group term life insurance coverage. On its annual statement, L1 reports the premiums attributable to the accident and health insurance coverage separately from the premiums attributable to the group term life insurance coverage. The contract issued by L1 is a combination contract as defined in paragraph (g)(1) of this section. Pursuant to paragraph (g)(2)(i) of this section, only the premiums attributable to the group term life insurance coverage ($50) are subject to the provisions of section 848. The premiums attributable to the cancellable accident and health insurance coverage ($950) are not subject to the provisions of section 848.

(h) *Group life insurance contract*—(1) *In general*. A life insurance contract (as defined in paragraph (c) of this section) is group life insurance contract if—

(i) The contract is a group life insurance contract under the applicable law;

(ii) The coverage is provided under a master contract issued to the group policyholder, which may be a trust, trustee, or agent;

(iii) The premiums on the contract are reported either as group life insurance premiums or credit life insurance premiums on the insurance company's annual statement (or could be reported as group life insurance premiums or credit life insurance premiums if the company were required to file the annual statement for life and accident and health companies);

(iv) The group affiliation requirement of paragraph (h)(2) of this section is satisfied;

(v) The premiums on the contract are determined on a group basis within the meaning of paragraph (h)(3) of this section; and

(vi) The proceeds of the contract are not payable to or for the benefit of the insured's employer, an organization or association to which the insured belongs, or other similar person. (See paragraph (h)(7) of this section for special rules that apply in determining if this requirement is satisfied.)

(2) *Group affiliation requirement*—(i) *In general*. The group affiliation requirement of section 848(e)(2)(A) and this paragraph (h)(2) is satisfied only if all of the individuals eligible for coverage under the contract constitute a group described in paragraphs (h)(2) (ii) through (viii) of this section.

(ii) *Employee group*. An employee group consists of all of the employees (including statutory employees within the meaning of section 3121(d)(3) and individuals who are treated as employed by a single employer under section 414 (b), (c), or (m)), or any class or classes thereof within the meaning of paragraph (h)(2)(x) of this section, of an employer. For this purpose, the term ‘‘employee’’ includes—

(A) A retired or former employee;

(B) The sole proprietor, if the employer is a sole proprietorship;

(C) A partner of the partnership, if the employer is a partnership;

(D) A director of the corporation, if the employer is a corporation; and

(E) An elected or appointed official of the public body, if the employer is a public body.

(iii) *Debtor group*. A debtor group consists of all of the debtors, or any class or classes thereof within the meaning of paragraph (h)(2)(x) of this section, of a creditor. For this purpose, the term ‘‘debtor’’ includes a borrower of money or purchaser or lessee of goods, services, or property for which payment is arranged through a credit transaction.

(iv) *Labor union group*. A labor union group consists of all of the members, or any class or classes thereof within the meaning of paragraph (h)(2)(x) of this section, of a labor union or similar employee organization.

(v) *Association group*. An association group consists of all of the members, or any class or classes thereof within the meaning of paragraph (h)(2)(x) of this section, of an association that, at the time the master contract is issued—

(A) Is organized and maintained for purposes other than obtaining insurance;

(B) Has been in active existence for at least two years (including, in the case of a merged or successor association, the years of active existence of any predecessor association); and

(C) Has at least 100 members.

(vi) *Credit union group*. A credit union group consists of all of the members or borrowers, or any class or classes thereof within the meaning of paragraph (h)(2)(x) of this section, of a credit union.

(vii) *Multiple group*. A multiple group consists of two or more groups from any single category described in paragraphs (h)(2) (ii) through (vi) of this section. A multiple group may not include two or more groups from different categories described in paragraph (h)(2) (ii) through (vi) of this section.

(viii) *Certain discretionary groups*. Provided that the contract otherwise satisfies the requirements of paragraph (h)(1) of this section, a contract issued to one of the following discretionary groups is treated as satisfying the group affiliation requirement of this paragraph (h)(2)—

(A) A contract issued to a group consisting of students of one or more universities or other educational institutions;

(B) A contract issued to a group consisting of members or former members of the U.S. Armed Forces;

(C) A contract issued to a group of individuas for the payment of future funeral expenses; and

(D) A contract issued to any other discretionary group as specified by the Commissioner in subsequent guidance published in the Internal Revenue Bulletin. (See § 601.601(d)(2)(ii)(*b*) of this chapter.)

(ix) *Employees treated as members.* In determining whether the group affiliation requirement of paragraph (h)(2) of this section is satisfied, the employees of a labor union, credit union, or association may be treated as members of a labor union group, a credit union group, or an association group, respectively.

(x) *Class or classes of a group determined without regard to individual health characteristics*—(A) *In general.* A class or classes of a group described in paragraphs (h)(2) (ii) through (viii) of this section may be determined using any reasonable characteristics (for example, amount of insurance, location, or occupation) other than individual health characteristics. The employees of a single employer covered under a policy issued to a multi-employer trust are considered a class of a group described in paragraph (h)(2)(ii) of this section.

(B) *Limitation of coverage based on certain work and age requirements permissible.* A limitation of coverage under a group contract to persons who are actively at work or of a pre-retirement age (for example, age 65 or younger) is not treated as based on individual health characteristics.

(3) *Premiums determined on a group basis*—(i) *In general.* Premiums for a contract are determined on a group basis for purposes of section 848(e)(2)(B) and this paragraph (h) only if the premium charged by the insurance company for each member of the group (or any class thereof) is determined on the basis of the same rates for the corresponding amount of coverage (for example, per $1,000 of insurance) or on the basis of rates which differ only because of the gender, smoking habits, or age of the member.

(ii) *Exception for substandard premium rates for certain high risk insureds.* Any difference in premium rates is disregarded for purposes of this paragraph (h)(3) if the difference is charged for an individual who was accepted for coverage at a substandard rate prior to January 1, 1993.

(iii) *Flexible premium contracts.* In the case of a group universal life insurance contract, the identical premium requirement is satisfied if the premium rates used by the insurance company in determining the periodic mortality charges applied to the policy account value of any member insured by the contract differ from those of other members (within the same class) only because of the gender, smoking habits, or age of the member.

(iv) *Determination of actual age.* For purposes of this paragraph (h)(3), determinations of actual age may be made using any reasonable method, provided that this method is applied consistently for all members of the group.

(4) *Underwriting practices used by company.* [Reserved]

(5) *Disqualification of group*—(i) *In general.* Except as otherwise provided in this paragraph (h)(5), if the requirements of paragraphs (h)(1), (2), and (3) of this section are not satisfied with respect to one or more members of the group, or of a class within a group (within the meaning of paragraph (h)(2)(x) of this section), the premiums for the entire group (or class) are treated as individual life insurance premiums.

(ii) *Exception for de minimis failures.* If the requirements of paragraphs (h) (1), (2), or (3) of this section are not satisfied with respect to one or more members of the group (or class), but the sum of the premiums charged by the insurance company for those individuals is no more than 5 percent of the aggregate premiums for the group (or class), only the premiums charged for those individuals are treated as premiums for an individual life insurance contract.

(6) *Supplemental life insurance coverage.* For purposes of determining whether the requirement in paragraph (h)(3)(i) of this section is satisfied, any supplemental life insurance coverage (including optional coverage for members of the group, their spouses, or their dependent children) is (or is treated as) a separate contract. In determining whether the group affiliation requirement of paragraph (h)(2) of this section is satisfied for the supplemental coverage, a member's spouse and dependent children are treated as members of the group if they are eligible for coverage.

(7) *Special rules relating to the payment of proceeds.* The following rules apply for purposes of section 848(e)(2) and paragraph (h)(1)(vi) of this section.

(i) *Contracts issued to a welfare benefit fund.* If a contract issued to a welfare benefit fund (as defined in section 419) provides for payment of proceeds to the welfare benefit fund, the proceeds of the contract are not considered payable to or for the benefit of the insured's employer, an organization or association to which the insured belongs, or other similar person, provided the proceeds are paid as benefits to the employee or the employee's beneficiary.

(ii) *Credit life insurance contracts.* If a credit life insurance contract provides for payment of proceeds to the insured's creditor, the proceeds of the contract are not treated as payable to or for the benefit of the insured's employer, an organization or association to which the insured belongs, or other similar person, provided the proceeds are applied against an outstanding indebtedness of the insured.

(iii) *''Organization or association'' limited to the sponsor of the contract or the group policyholder.* The term ''organization or association'' means the organization or association that is either the sponsor of the contract or the group policyholder.

(i) *General deductions.* The term ''general deductions'' is defined in section 848(c)(2). An insurance company determines its general deductions for the taxable year without regard to amounts capitalized or amortized under section 848(a). The amount of a company's general deductions is also determined without regard to the rules of §1.848–2(f), which apply only for purposes of determining net consideration for reinsurance agreements.

[T.D. 8456, 57 FR 61819, Dec. 29, 1992; 58 FR 9245, Feb. 19, 1993]

§1.848–2 Determination of net premiums.

(a) *Net premiums*—(1) *In general.* An insurance company must use the accrual method of accounting (as prescribed by section 811(a)(1)) to determine the net premiums with respect to each category of specified insurance contracts. With respect to any category of contracts, net premiums means—

(i) The gross amount of premiums and other consideration (see paragraph (b) of this section); reduced by

(ii) The sum of—

(A) The return premiums (see paragraph (e) of this section); and

(B) The net negative consideration for a reinsurance agreement (other than an agreement described in paragraph (h)(2) of this section). See paragraphs (f) and (g) of this section for rules relating to the determination of net negative consideration.

(2) *Separate determination of net premiums for certain reinsurance agreements.* Net premiums with respect to reinsurance agreements for which an election under paragraph (h)(3) of this section has been made (certain reinsurance agreements with parties not subject to United States taxation) are treated separately and are subject to the rules of paragraph (h) of this section.

(b) *Gross amount of premiums and other consideration*—(1) *General rule.* The term ''gross amount of premiums and other consideration'' means the sum of—

(i) All premiums and other consideration (other than amounts on reinsurance agreements); and

(ii) The net positive consideration for any reinsurance agreement (other than an agreement for which an election under paragraph (h)(3) of this section has been made).

(2) *Items included.* The gross amount of premiums and other consideration includes—

(i) Advance premiums;

(ii) Amounts in a premium deposit fund or similar account, to the extent provided in paragraph (b)(3) of this section;

(iii) Fees;

(iv) Assessments;

(v) Amounts that the insurance company charges itself representing premiums with respect to benefits for its employees (including full-time life insurance salesmen treated as employees under section 7701(a)(20)); and

(vi) The value of a new contract issued in an exchange described in paragraph (c)(2) or (c)(3) of this section.

(3) *Treatment of premium deposits*—(i) *In general.* An amount in a premium deposit fund or similar account is taken into account in determining the gross amount of premiums and other consideration at the earlier of the time that the amount is applied to, or irrevocably committed to, the payment of a premium on a specified insurance contract. If an amount is irrevocably committed to the payment of a premium on a specified insurance contract, then neither that amount nor any earnings allocable to that amount are included in the gross amount of premiums and other consideration when applied to the payment of a premium on the same contract.

(ii) *Amounts irrevocably committed to the payment of premiums.* Except as provided in paragraph (b)(3)(iii) of this section, an amount in a premium deposit fund or similar account is irrevocably committed to the payment of premiums on a contract only if neither the amount nor any earnings allocable to that amount may be—

(A) Returned to the policyholder or any other person (other than on surrender of the contract); or

(B) Used by the policyholder to fund another contract.

(iii) *Retired lives reserves.* Premiums received by an insurance company under a retired lives reserve arrangement are treated as irrevocably committed to the payment of premiums on a specified insurance contract.

(4) *Deferred and uncollected premiums.* The gross amount of premiums and other consideration does not include deferred and uncollected premiums.

(c) *Policy exchanges*—(1) *General rule.* Except as otherwise provided in this paragraph (c), an exchange of insurance contracts (including a change in the terms of a specified insurance contract) does not result in any amount being included in the gross amount of premiums and other consideration.

(2) *External exchanges.* If a contract is exchanged for a specified insurance contract issued by another insurance company, the company that issues the new contract must include the value of the new contract in the gross amount of premiums and other consideration.

(3) *Internal exchanges resulting in fundamentally different contracts*—(i) *In general.* If a contract is exchanged for a specified insurance contract issued by the same insurance company that issued the original contract, the company must include the value of the new contract in the gross amount of premiums and other consideration if the new contract—

(A) Relates to a different category of specified insurance contract than the original contract;

(B) Does not cover the same insured as the original contract; or

(C) Changes the interest, mortality, morbidity, or expense guarantees with respect to the nonforfeiture benefits provided in the original contract.

(ii) *Certain modifications treated as not changing the mortality, morbidity, interest, or expense guarantees.* For purposes of paragraph (c)(3)(i)(C) of this section, the following items are not treated as changing the interest, mortality, morbidity, or expense guarantees with respect to the nonforfeiture benefits provided in the contract—

(A) A change in a temporary guarantee with respect to the amounts to be credited as interest to the policyholder's account, or charged as mortality, morbidity, or expense charges, if the new guarantee applies for a period of ten years or less;

(B) The determination of benefits on annuitization using rates which are more favorable to the policyholder than the permanently guaranteed rates; and

(C) Other items as specified by the Commissioner in subsequent guidance published in the Internal Revenue Bulletin.

(iii) *Exception for contracts restructured by a court supervised rehabilitation* *or similar proceeding.* No amount is included in the gross amount of premiums and other consideration with respect to any change made to the interest, mortality, morbidity, or expense guarantees with respect to the nonforfeiture benefits of contracts of an insurance company that is the subject of a rehabilitation, conservatorship, insolvency, or similar state proceeding. This treatment applies only if the change—

(A) Occurs as part of the rehabilitation, conservatorship, insolvency, or similar state proceeding; and

(B) Is approved by the state court, the state insurance department, or other state official with authority to act in the rehabilitation, conservatorship, insolvency, or similar state proceeding.

(4) *Value of the contract*—(i) *In general.* For purposes of paragraph (c)(2) or (c)(3) of this section, the value of the new contract is established through the most recent sale by the company of a comparable contract. If the value of the new contract is not readily ascertainable, the value may be approximated by using the interpolated terminal reserve of the original contract as of the date of the exchange.

(ii) *Special rule for group term life insurance contracts.* In the case of any exchange involving a group term life insurance contract without cash value, the value of the new contract is deemed to be zero.

(iii) *Special rule for certain policy enhancement and update programs*—(A) *In general.* If the interest, mortality, morbidity, or expense guarantees with respect to the nonforfeiture benefits of a specified insurance contract are changed pursuant to a policy enhancement or update program, the value of the contract included in the gross amount of premiums and other consideration equals 30 percent of the value determined under paragraph (c)(4) of this section.

(B) *Policy enhancement or update program defined.* For purposes of paragraph (c)(4)(iii)(A) of this section, a policy enhancement or update program means any offer or commitment by the insurance company to all of the policyholders holding a particular policy form to change the interest, mortality, morbidity, or expense guarantees used to determine the contract's nonforfeiture benefits.

(5) *Example.* The principles of this paragraph (c) are illustrated by the following example.

Example. (i) An individual (A) owns a life insurance policy issued by a life insurance company (L1). On January 1, 1993, A purchases additional term insurance for $250, which is added as a rider to A's life insurance policy. The purchase of the additional term insurance does not change the interest mortality, morbidity, or expense guarantees with respect to the nonforfeiture benefits provided by A's life insurance policy.

(ii) A's purchase of the term insurance rider is not considered to result in a fundamentally different contract under paragraph (c)(3) of this section because the addition of the rider did not change the interest, mortality, morbidity, or expense guarantees with respect to the nonforfeiture values of A's original life insurance policy. Therefore, L1 includes only the $250 received from A in the gross amount of premiums and other consideration.

(d) *Amounts excluded from the gross amount of premiums and other consideration*—(1) *In general.* The following items are not included in the gross amount of premiums and other consideration—

(i) Items treated by section 808(e) as policyholder dividends that are paid to the policyholder and immediately returned to the insurance company as a premium on the same contract that generated the dividends, including—

(A) A policyholder dividend applied to pay a premium under the contract that generated the dividend;

(B) Excess interest accumulated within the contract;

(C) A policyholder dividend applied for additional coverage (for example, a paid-up addition, extension of the period for which insurance protection is provided, or reduction of the period for which premiums are paid) on the contract that generated the dividend;

(D) A policyholder dividend applied to reduce premiums otherwise payable on the contract that generated the dividend;

(E) An experience-rated refund applied to pay a premium on the group contract that generated the refund; and

(F) An experience-rated refund applied to a premium stabilization reserve held with respect to the group contract that generated the refund;

(ii) Premiums waived as a result of the disability of an insured or the disability or death of a premium payor;

(iii) Premiums considered to be paid on a contract as the result of a partial surrender or withdrawal from the contract, or as a result of the surrender or withdrawal of a paid-up addition previously issued with respect to the same contract; and

(iv) Amounts treated as premiums upon the selection by a policyholder or by a beneficiary of a settlement option provided in a life insurance contract.

(2) *Amounts received or accrued from a guaranty association.* Amounts received or accrued from a guaranty association relating to an insurance company that is subject to an insolvency, delinquency, conservatorship, rehabilitation, or similar proceeding are not included in the gross amount of premiums and other consideration.

(3) *Exclusion not to apply to dividend accumulations.* For purposes of section 848(d)(3) and paragraph (d)(1) of this section, amounts applied from a dividend accumulation account to pay premiums on a specified insurance contract are not amounts treated as paid to, and immediately returned by, the policyholder.

(e) *Return premiums.* For purposes of section 848(d)(1)(B) and this section, return premiums do not include policyholder dividends (as defined in section 808), claims or benefits payments, or amounts returned to another insurance company under a reinsurance agreement. For the treatment of amounts returned to another insurance company under a reinsurance agreement, see paragraph (f) of this section.

(f) *Net consideration for a reinsurance agreement*—(1) *In general.* For purposes of section 848, the ceding company and the reinsurer must treat amounts arising from the reinsurance of a specified insurance contract consistently in determining their net premiums. See paragraph (g) of this section for restrictions on the amount of the net negative consideration for any reinsurance agreement that may be taken into account. See paragraph (h) of this section for special rules applicable to reinsurance agreements with parties not subject to United States taxation.

(2) *Net consideration determined by a ceding company*—(i) *In general.* The net consideration determined by a ceding company for a reinsurance agreement equals—

(A) The gross amount incurred by the reinsurer with respect to the reinsurance agreement, including any ceding commissions, annual allowances, reimbursements of claims and benefits, modified coinsurance reserve adjustments under paragraph (f)(5) of this section, experience-rated adjustments, and termination payments; less

(B) The gross amount of premiums and other consideration incurred by the ceding company with respect to the reinsurance agreement.

(ii) *Net negative and net positive consideration.* If the net consideration is less than zero, the ceding company has net negative consideration for the reinsurance agreement. If the net consideration is greater than zero, the ceding company has net positive consideration for the reinsurance agreement.

(3) *Net consideration determined by the reinsurer*—(i) *In general.* The net consideration determined by a reinsurer for a reinsurance agreement equals—

(A) The amount described in paragraph (f)(2)(i)(B) of this section; less

(B) The amount described in paragraph (f)(2)(i)(A) of this section.

(ii) *Net negative and net positive consideration.* If the net consideration is less than zero, the reinsurer has net negative consideration for the reinsurance agreement. If the net consideration is greater than zero, the reinsurer has net positive consideration for the reinsurance agreement.

(4) *Timing consistency required.* For purposes of determining the net consideration of a party for a reinsurance agreement, an income or expense item is taken into account for the first taxable year for which the item is required to be taken into account by either party. Thus, the ceding company and the reinsurer must take the item into account for the same taxable year (or for the same period if the parties have different taxable years).

(5) *Modified coinsurance and funds-withheld reinsurance agreements*—(i) *In*

general. In the case of a modified coinsurance or funds-withheld reinsurance agreement, the net consideration for the agreement includes the amount of any payments or reserve adjustments, as well as any related loan transactions between the ceding company and the reinsurer. The amount of any investment income transferred between the parties as the result of a reserve adjustment or loan transaction is treated as an item of consideration under the reinsurance agreement.

(ii) *Special rule for certain funds-withheld reinsurance agreements.* In the case of a funds-withheld reinsurance agreement that is entered into after November 14, 1991, but before the first day of the first taxable year beginning after December 31, 1991, and is terminated before January 1, 1995, the parties' net consideration in the year of termination must include the amount of the original reserve for any reinsured specified insurance contract that, in applying the provisions of subchapter L, was treated as premiums and other consideration incurred for reinsurance for the taxable year in which the agreement became effective.

(6) *Treatment of retrocessions.* For purposes of this paragraph (f), a retrocession agreement is treated as a separate reinsurance agreement. The party that is relieved of liability under a retrocession agreement is treated as the ceding company.

(7) *Mixed reinsurance agreement.* If a reinsurance agreement includes more than one category of specified insurance contracts (or specified insurance contracts and contracts that are not specified insurance contracts), the portion of the agreement relating to each category of reinsured specified insurance contracts is treated as a separate agreement. The portion of the agreement relating to reinsured contracts that are not specified insurance contracts is similarly treated as a separate agreement.

(8) *Treatment of policyholder loans.* For purposes of determining the net consideration under a reinsurance agreement, the transfer of a policyholder loan receivable is treated as an item of consideration under the agreement. The interest credited with respect to a policyholder loan receivable is treated as investment income earned directly by the party holding the receivable. The amounts taken into account as claims and benefit reimbursements under the agreement must be determined without reduction for the policyholder loan.

(9) *Examples.* The principles of this paragraph (f) are illustrated by the following examples.

Example 1. On July 1, 1992, a life insurance company (L1) transfers a block of individual life insurance contracts to an unrelated life insurance company (L2) under an agreement whereby L2 becomes solely liable to the policyholders under the contracts reinsured. L1 and L2 are calendar year taxpayers. Under the assumption reinsurance agreement, L1 agrees to pay L2 $100,000 for assuming the life insurance contracts, and L2 agrees to pay L1 a $17,000 ceding commission. Under paragraph (f)(2) of this section, L1 has net negative consideration of ($83,000) ($17,000 ceding commission incurred by L2—$100,000 incurred by L1 for reinsurance). Under paragraph (f)(3) of this section, L2 has net positive consideration of $83,000. Under paragraph (b)(1)(ii) of this section, L2 includes the net positive consideration in its gross amount of premiums and other consideration.

Example 2. (i) On July 1, 1992, a life insurance company (L1) transfers a block of individual life insurance contracts to an unrelated life insurance company (L2) under an agreement whereby L1 remains liable to the policyholders under the reinsured contracts. L1 and L2 are calendar year taxpayers. Under the indemnity reinsurance agreement, L1 agrees to pay L2 $100,000 for reinsuring the life insurance contracts, and L2 agrees to pay L1 a $17,000 ceding commission. L1 agrees to pay L2 an amount equal to the future premiums on the reinsured contracts. L2 agrees to indemnify L1 for claims and benefits and administrative expenses incurred by L1 while the reinsurance agreement is in effect.

(ii) For the period beginning July 1, 1992, and ending December 31, 1992, the following income and expense items are determined with respect to the reinsured contracts:

Item	Income	Expense
Premiums	$25,000	
Death benefits		$10,000
Surrender benefits		8,000
Premium taxes and other expenses		2,000
Total		20,000

(iii) Under paragraph (f)(2) of this section, L1's net negative consideration equals ($88,000), which is determined by subtracting the $125,000 ($100,000 + $25,000) incurred by L1 from the $37,000 incurred by L2 under the reinsurance agreement ($17,000 + $10,000 + $8,000 + $2,000). L2's net positive consideration is $88,000. Under paragraph (b)(1)(ii) of this section, L2 includes the $88,000 net positive consideration in its gross amount of premiums and other consideration.

Example 3. (i) Assume that the reinsurance agreement referred to in *Example 2* is terminated on December 31, 1993. During the period from January 1, 1993 through December 31, 1993, the following income and expense items are determined with respect to the reinsured contracts:

Item	Income	Expense
Premiums	$45,000	
Death benefits		$18,000
Surrender benefits		6,000
Premium taxes and other expenses		8,000
Total		32,000

(ii) On the termination of the reinsurance agreement, L1 receives a payment of $70,000 from L2 as consideration for releasing L2 from liability with respect to the reinsured contracts.

(iii) L1's net positive consideration equals $57,000, which is the excess of the $102,000 incurred by L2 for the year ($18,000 + $6,000 + $8,000 + $70,000) over the $45,000 incurred by L1. L2's net negative consideration is ($57,000). L1 includes the net positive consideration in its gross amount of premiums and other consideration.

Example 4. (i) On January 1, 1993, an insurance company (L1) enters into a modified coinsurance agreement with another insurance company (L2), covering a block of individual life insurance contracts. Both L1 and L2 are calendar year taxpayers. Under the agreement, L2 is credited with an initial reinsurance premium equal to L1's reserves on the reinsured contracts at the inception of the agreement, any new premiums received with respect to the reinsured contracts, any decrease in L1's reserves on the reinsured contracts, and an amount of investment income determined by reference to L1's reserves on the reinsured contracts. L2 is charged for all claims and expenses incurred with respect to the reinsured contracts plus an amount reflecting any increase in L1's reserves. The agreement further provides that cash settlements between the parties are made at the inception and termination of the agreement, as well as at the end of each calendar year while the agreement is in effect. The cash settlement is determined by netting the sum of the amounts credited to L2 against the sum of the amounts charged to L2 with respect to the reinsured policies. L1's reserves on the reinsured policies at the inception of the reinsurance agreement are $375,000.

(ii) Under the cash settlement formula, L2 is credited with an initial reinsurance premium equal to L1's reserves on the reinsured policies ($375,000), but is charged an amount reflecting L1's policy reserve requirements ($375,000).

(iii) For the period ending December 31, 1993, L2 is also credited and charged the following amounts with respect to the reinsured contracts.

Item	Income	Expense
Premiums	$100,000	
Investment income	39,000	
Death benefits		$65,000
Increase in reserves		75,000

(iv) Under paragraph (f)(5) of this section, L2's net negative consideration for the 1993 taxable year equals ($1,000) which is determined by subtracting the sum of the amounts charged to L2 ($375,000 + $65,000 + $75,000 = $515,000) from the sum of the amounts credited to L2 ($375,000 + $100,000 + $39,000 = $514,000). L1's net positive consideration for calendar year 1993 equals $1,000. Under paragraph (b)(1)(ii) of this section, L1 includes the $1,000 net positive consideration in its gross amount of premiums and other consideration.

Example 5. (i) On January 1, 1993, an insurance company (L1) enters into a coinsurance agreement with another insurance company (L2) covering a block of individual life insurance contracts. Both L1 and L2 are calendar year taxpayers. Under the agreement, L2 is credited with an initial reinsurance premium equal to L1's reserves on the effective date of the agreement, any new premiums received on the reinsured contracts, but must indemnify L1 of all claims and expenses incurred with respect to the contracts. As part of the agreement, L2 makes a loan to L1 equal to the amount of the reserves on the reinsured contracts. L1's reserves on the reinsured contracts on the effective date of the agreement are $375,000. Thus, on the inception date of the reinsurance agreement, L1 transfers to L2 its note for $375,000 as consideration for reinsurance.

(ii) The reinsurance agreement between L1 and L2 is a funds-withheld reinsurance agreement. Under paragraph (f)(5) of this section, the amount of any loan transaction is taken into account in determining the parties' net consideration. At the inception of the reinsurance agreement, L2 is credited with a reinsurance premium equal to L1's reserves on the reinsured contracts ($375,000). L2's $375,000 loan to L1 is treated as an amount returned to L1 under the agreement.

(iii) For the period ending December 31, 1993, L2 is credited and charged the following amounts with respect to the reinsured contracts and the loan transaction with L1.

Item	Income	Expense
Premiums	$100,000	

Item	Income	Expense
Accrued interest	39,000	
Death benefits		$65,000
Increase in loan to L1		75,000

(iv) Under paragraph (f)(5) of this section, L2's net negative consideration for the 1993 taxable year equals ($1,000), which is determined by subtracting the sum of amounts incurred by L2 with respect to death benefits and the loan transaction ($375,000 + $65,000 + $75,000 = $515,000) from the sum of the amounts credited to L2 as reinsurance premiums and interest on the loan transaction ($375,000 + $100,000 + 39,000 = $514,000). L1's net positive consideration for calendar year 1993 equals $1,000. Under paragraph (b)(1)(ii) of this section, L1 includes the $1,000 net positive consideration in its gross amount of premiums and other consideration.

Example 6. (i) On December 31, 1993, an insurance company (L1) enters into a reinsurance agreement with another insurance company (L2) covering a block of individual life insurance contracts. Both L1 and L2 are calendar year taxpayers. Under the agreement, L2 is credited with L1's reserves on the reinsured contracts on the effective date of the agreement, plus any new premiums received on the reinsured contracts, but must indemnify L1 for all claims and expenses incurred with respect to the contracts. Under the agreement, L1 transfers cash of $325,000 to L2 plus rights to its policyholder loan receivables on the reinsured contracts ($50,000). L2 reports the reinsurance agreement by including the transferred policyholder loan receivables as an asset on its books.

(ii) For the period beginning January 1, 1994 and ending December 31, 1994, the following income and expense items are incurred with respect to the reinsured contracts.

Item	Income	Expense
Premiums	$100,000	
Death benefits		$25,000
Surrender benefits		5,000
Premium taxes and other expenses		8,000
Total		38,000

(iii) These amounts are net of the outstanding policyholder loans held by L2 of $20,000 with respect to death benefits and $15,000 with respect to surrender benefits.

(iv) Under paragraph (f)(8) of this section, the transferred policyholder loan receivables are treated as an item of consideration under the reinsurance agreement. In determining the parties' net consideration for the agreement, the transferred policyholder loan receivables ($50,000) are treated as an item of consideration incurred by L1 under paragraph (f)(2)(i)(B) of this section. Therefore, for the 1993 taxable year, L1 has net negative consideration of ($375,000). L2 has net positive consideration of $375,000. Under paragraph (b)(1)(ii) of this section, L2 includes the $375,000 net positive consideration in its gross amount of premiums and other consideration.

(v) For the 1994 taxable year, L2 has net positive consideration for the reinsurance agreement of $62,000 before adjustment for the transferred policyholder loans. Under paragraph (f)(8) of this section, the amounts taken into account as claim and benefit payments must be adjusted by the amount of any transferred policyholder loan receivables which are netted against the reinsurer's claim and benefit reimbursements. Therefore, L2 takes into account $45,000 ($25,000+$20,000=$45,000) as reimbursements for death benefits, and $20,000 ($5,000+$15,000=$20,000) as reimbursements for surrender benefits. After adjustment for these items, L2 has net positive consideration of $27,000, which is determined by subtracting the sum of the amounts charged to L2 ($45,000+$20,000+$8,000=$73,000) from the sum of the amounts credited to L2 ($100,000). L1 has net negative consideration of ($27,000) under the agreement. Under paragraph (b)(1)(ii) of this section, L2 includes the $27,000 net positive consideration in its gross amount of premiums and other consideration. The amount of any interest earned on the policyholder loan receivables after their transfer to L2 is treated as investment income earned directly by L2, and is not taken into account as an item of consideration under the agreement.

(g) *Reduction in the amount of net negative consideration to ensure consistency of capitalization for reinsurance agreements*—(1) *In general.* Paragraph (g)(3) of this section provides for a reduction in the amount of net negative consideration that a party to a reinsurance agreement (other than a reinsurance agreement described in paragraph (h)(2) of this section) may take into account in determining net premiums under paragraph (a)(2)(ii) of this section if the party with net positive consideration has a capitalization shortfall (as defined in paragraph (g)(4) of this section). Unless the party with net negative consideration demonstrates that the party with net positive consideration does not have a capitalization shortfall or demonstrates the amount of the other party's capitalization shortfall which is allocable to the reinsurance agreement, the net negative consideration that may be taken into account under paragraph (a)(2)(ii) of this section is zero. However, the reduction of paragraph (g)(3) of this section does not apply to a reinsurance agreement if the parties make a joint election under paragraph (g)(8) of this section. Under the election, the party with net positive consideration capitalizes specified policy acquisition expenses with respect to the agreement without regard to the general deductions limitation of section 848(c)(1).

(2) *Application to reinsurance agreements subject to the interim rules.* In applying this paragraph (g) to a reinsurance agreement that is subject to the interim rules of §1.848–3, the term ''premiums and other consideration incurred for reinsurance under section 848(d)(1)(B)'' is substituted for ''net negative consideration,'' and the term ''gross amount of premiums and other consideration under section 848(d)(1)(A)'' is substituted for ''net positive consideration.'' If an insurance company has ''premiums and other consideration incurred for reinsurance under section 848(d)(1)(B)'' and a ''gross amount of premiums and other consideration under section 848(d)(1)(A)'' for the same agreement, the net of these amounts is taken into account for purposes of this paragraph (g).

(3) *Amount of reduction.* The reduction required by this paragraph (g)(3) equals the amount obtained by dividing—

(i) The portion of the capitalization shortfall (as defined in paragraph (g)(4) of this section) allocated to the reinsurance agreement under paragraph (g)(7) of this section; by

(ii) The applicable percentage set forth in section 848(c)(1) for the category of specified insurance contracts reinsured by the agreement.

(4) *Capitalization shortfall.* A ''capitalization shortfall'' equals the excess of—

(i) The sum of the required capitalization amounts (as defined in paragraph (g)(5) of this section) for all reinsurance agreements (other than reinsurance agreements for which an election has been made under paragraph (h)(3) of this section); over

(ii) The general deductions allocated to those reinsurance agreements, as determined under paragraph (g)(6) of this section.

(5) *Required capitalization amount*—(i) *In general.* The ''required capitalization amount'' for a reinsurance agreement (other than a reinsurance agreement for which an election has been made under paragraph (h)(3) of this section) equals the amount (either positive or negative) obtained by multiplying—

(A) The net positive or negative consideration for an agreement not described in paragraph (h)(2) of this section, and the net positive consideration for an agreement described in paragraph (h)(2) of this section, but for which an election under paragraph (h)(3) of this section has not been made; by

(B) The applicable percentage set forth in section 848(c)(1) for that category of specified insurance contracts.

(ii) *Special rule with respect to net negative consideration.* Solely for purposes of computing a party's required capitalization amount under this paragraph (g)(5)—

(A) If either party to the reinsurance agreement is the direct issuer of the reinsured contracts, the party computing its required capitalization amount takes into account the full amount of any net negative consideration without regard to any potential reduction under paragraph (g)(3) of this section; and

(B) If neither party to the reinsurance agreement is the direct issuer of the reinsured contracts, any net negative consideration is deemed to equal zero in computing a party's required capitalization amount except to the extent that the party with the net negative consideration establishes that the other party to that reinsurance agreement capitalizes the appropriate amount.

(6) *General deductions allocable to reinsurance agreements.* An insurance company's general deductions allocable to its reinsurance agreements equals the excess, if any, of—

(i) The company's general deductions (excluding additional amounts treated as general deductions under paragraph (g)(8) of this section); over

(ii) The amount determined under section 848(c)(1) on specified insurance contracts that the insurance company has issued directly (determined without regard to any reinsurance agreements).

(7) *Allocation of capitalization shortfall among reinsurance agreements.* The capitalization shortfall is allocated to each reinsurance agreement for which the required capitalization amount (as determined in paragraph (g)(5) of this section) is a positive amount. The portion of the capitalization shortfall allocable to each agreement equals the amount which bears the same ratio to the capitalization shortfall as the required capitalization amount for the reinsurance agreement bears to the sum of the positive required capitalization amounts.

(8) *Election to determine specified policy acquisition expenses for an agreement without regard to general deductions limitation*—(i) *In general.* The reduction specified by paragraph (g)(3) of this section does not apply if the parties to a reinsurance agreement make an election under this paragraph (g)(8). The election requires the party with net positive consideration to capitalize specified policy acquisition expenses with respect to the reinsurance agreement without regard to the general deductions limitation of section 848(c)(1). That party must reduce its deductions under section 805 or section 832(c) by the amount, if any, of the party's capitalization shortfall allocable to the reinsurance agreement. The additional capitalized amounts are treated as specified policy acquisition expenses attributable to premiums and other consideration on the reinsurance agreement, and are deductible in accordance with section 848(a)(2).

(ii) *Manner of making election.* To make an election under paragraph (g)(8) of this section, the ceding company and the reinsurer must include an election statement in the reinsurance agreement, either as part of the original terms of the agreement or by an addendum to the agreement. The parties must each attach a schedule to their federal income tax returns which identifies the reinsurance agreement for which the joint election under this paragraph (g)(8) has been made. The schedule must be attached to each of the parties' federal income tax returns filed for the later of—

(A) The first taxable year ending after the election becomes effective; or

(B) The first taxable year ending on or after December 29, 1992.

(iii) *Election statement.* The election statement in the reinsurance agreement must—

(A) Provide that the party with net positive consideration for the reinsurance agreement for each taxable year will capitalize specified policy acquisition expenses with respect to the reinsurance agreement without regard to the general deductions limitation of section 848(a)(1);

(B) Set forth the agreement of the parties to exchange information pertaining to the amount of net consideration under the reinsurance agreement each year to ensure consistency;

(C) Specify the first taxable year for which the election is effective; and

(D) Be signed by both parties.

(iv) *Effect of election.* An election under this paragraph (g)(8) is effective for the first taxable year specified in the election statement and for all subsequent taxable years for which the reinsurance agreement remains in effect. The election may not be revoked without the consent of the Commissioner.

(9) *Example.* The principles of this paragraph (g) are illustrated by the following examples.

Example 1. (i) On December 31, 1992, a life insurance company (L1) transfers a block of individual life insurance contracts to an unrelated life insurance company (L2) under an agreement in which L2 becomes solely liable to the policyholders on the reinsured contracts. L1 transfers $105,000 to L2 as consideration for the reinsurance of the contracts.

(ii) L1 and L2 do not make an election under paragraph (g)(8) of this section to capitalize specified policy acquisition expenses with respect to the reinsurance agreement without regard to the general deductions limitation. L2 has no other insurance business, and its general deductions for the taxable year are $3,500.

(iii) Under paragraph (f)(2) of this section, L1's net negative consideration is ($105,000). Under paragraph (f)(3) of this section, L2's net positive consideration is $105,000. Pursuant to paragraph (b)(1)(ii) of this section, L2 includes the net positive consideration in its gross amount of premiums and other consideration.

(iv) The required capitalization amount under paragraph (g)(5) of this section for the reinsurance agreement is $8,085 ($105,000 × .077). L2's general deductions, all of which are allocable to the reinsurance agreement with L1, are $3,500. The $4,585 difference between the required capitalization amount ($8,085) and the general deductions allocable to the reinsurance agreement ($3,500) represents L2's capitalization shortfall under paragraph (g)(4) of this section.

(v) Since L2 has a capitalization shortfall allocable to the agreement, the rules of paragraph (g)(1) of this section apply for purposes of determining the amount by which L1 may reduce its net premiums. Under paragraph (g)(3) of this section, L1 must reduce the amount of net negative consideration that it takes into account under paragraph (a)(2)(ii) of this section by $59,545 ($4,585/.077). Thus, of the $105,000 net negative consideration under the reinsurance agreement, L1 may take into account only $45,455 as a reduction of its net premiums.

Example 2. The facts are the same as *Example 1,* except that L1 and L2 make the election under paragraph (g)(8) of this section to capitalize specified policy acquisition expenses with respect to the reinsurance agreement without regard to the general deductions limitation. Pursuant to this election, L2 must capitalize as specified policy acquisition expenses an amount equal to $8,085 ($105,000 × .077). L1 may reduce its net premiums by the $105,000 of net negative consideration.

Example 3. (i) A life insurance company (L1) is both a direct issuer and a reinsurer of life insurance and annuity contracts. For 1993, L1's net premiums under section 848 (d)(1) for directly issued individual life insurance and annuity contracts are as follows:

Category	Net premiums
Life insurance contracts	$17,000,000
Annuity contracts	8,000,000

(ii) L1's general deductions for 1993 are $1,500,000.

(iii) For 1993, L1 is a reinsurer under four separate indemnity reinsurance agreements with unrelated insurance companies (L2, L3, L4, and L5). The agreements with L2, L3, and L4 cover life insurance contracts issued by those companies. The agreement with L5 covers annuity contracts issued by L5, The parties to the reinsurance agreements have not made the election under paragraph (g)(8) of this section to capitalize specified policy acquisition expenses with respect to these agreements without regard to the general deductions limitation.

(iv) L1's net consideration for 1993 with respect to its reinsurance agreements is as follows:

Agreement	Net consideration
L2	$1,200,000
L3	(350,000)
L4	300,000
L5	600,000

(v) To determine whether a reduction under paragraph (g)(3) of this section applies with respect to these reinsurance agreements, L1 must determine the required capitalization amounts for its reinsurance agreements and the amount of its general deductions allocable to these agreements.

(vi) Pursuant to paragraph (g)(5) of this section, the required capitalization amount for each reinsurance agreement is determined as follows:

L2	$1,200,000×.077=$92,400
L3	($350,000)×.077=($26,950)
L4	$300,000×.077=$23,100
L5	$600,000×.0175=$10,500

(vii) Thus, the sum of L1's required capitalization amounts on its reinsurance agreements equals $99,050.

(viii) Pursuant to paragraph (g)(6) of this section, L1 determines its general deductions allocable to its reinsurance agreements. The amount determined under section 848(c)(1) on its directly issued contracts is:

REQUIRED CAPITALIZATION AMOUNT

Category:		
Annuity contracts	$8,000,000×.0175 =	$140,000
Life insurance contracts	$17,000,000×.077 =	1,309,000
		$1,449,000

(ix) L1's general deductions allocable to its reinsurance agreements are $51,000 ($1,500,000 − $1,449,000).

(x) Pursuant to paragraph (g)(4) of this section, L1's capitalization shortfall equals $48,050, reflecting the excess of L1's required capitalization amounts for its reinsurance agreements ($99,050) over the general deductions allocable to its reinsurance agreements ($51,000).

(xi) Pursuant to paragraph (g)(7) of this section, the capitalization shortfall of $48,050 must be allocated between each of L1's reinsurance agreements with net positive consideration in proportion to their respective required capitalization amounts. The allocation of the shortfall between L1's reinsurance agreements is determined as follows:

L2=$35,237 ($48,050×92,400/126,000)
L4=$8,809 ($48,050×23,100/126,000)
L5=$4,004 ($48,050×10,500/126,000)

(xii) Accordingly, the reduction under paragraph (g)(3) of this section that applies to the amount of net negative consideration that may be taken into account by L2, L4, and L5 under paragraph (a)(1)(ii)(B) of this section is determined as follows:

L2=$457,623 ($35,237/.077)
L4=$114,403 ($8,809/.077)

L5=$228,800 ($4,004/.0175)

Example 4. The facts are the same as *Example 3,* except that L1 and L4 make a joint election under paragraph (g)(8) of this section to capitalize specified policy acquisition expenses with respect to the reinsurance agreement without regard to the general deductions limitation. Pursuant to this election, L1 must reduce its deductions under section 805 by an amount equal to the capitalization shortfall allocable to the reinsurance agreement with L4 ($8,809). L1 treats the additional capitalized amounts as specified policy acquisition expenses allocable to premiums and other consideration under the agreement. L4 may reduce its net premiums by the $300,000 net negative consideration. The election by L1 and L4 does not change the amount of the capitalization shortfall allocable under paragraph (g)(7) of this section to the reinsurance agreements with L2 and L5. Thus, the reduction required by paragraph (g)(3) of this section with respect to the amount of the net negative consideration that L2 and L5 may recognize under paragraph (a)(2)(ii) of this section is $457,623 and $228,800, respectively.

(h) *Treatment of reinsurance agreements with parties not subject to U.S. taxation*—(1) *In general.* Unless an election under paragraph (h)(3) of this section is made, an insurance company may not reduce its net premiums by the net negative consideration for the taxable year (or, with respect to a reinsurance agreement that is subject to the interim rules of § 1.848–3, by the premiums and other consideration incurred for reinsurance) under a reinsurance agreement to which this paragraph (h) applies.

(2) *Agreements to which this paragraph (h) applies*—(i) *In general.* This paragraph (h) applies to a reinsurance agreement if, with respect to the premiums and other consideration under the agreement, one party to that agreement is subject to United States taxation and the other party is not.

(ii) *Parties subject to U.S. taxation*—(A) *In general.* A party is subject to United States taxation for this purpose if the party is subject to United States taxation either directly under the provisions of subchapter L of chapter 1 of the Internal Revenue Code (subchapter L), or indirectly under the provisions of subpart F of part III of subchapter N of chapter 1 of the Internal Revenue Code (subpart F).

(B) *Effect of a closing agreement.* If a reinsurer agrees in a closing agreement with the Internal Revenue Service to be subject to tax under rules equivalent to the provisions of subchapter L on its premiums and other consideration from reinsurance agreements with parties subject to United States taxation, the reinsurer is treated as an insurance company subject to tax under subchapter L.

(3) *Election to separately determine the amounts required to be capitalized for reinsurance agreements with parties not subject to U.S. taxation*—(i) *In general.* This paragraph (h)(3) authorizes an insurance company to make an election to separately determine the amounts required to be capitalized for the taxable year with respect to reinsurance agreements with parties that are not subject to United States taxation. If this election is made, an insurance company separately determines a net foreign capitalization amount for the taxable year for all reinsurance agreements to which this paragraph (h) applies.

(ii) *Manner of making the election.* An insurance company makes the election authorized by this paragraph (h)(3) by attaching an election statement to the federal income tax return (including an amended return) for the taxable year for which the election becomes effective. The election applies to that taxable year and all subsequent taxable years unless permission to revoke the election is obtained from the Commissioner.

(4) *Amount taken into account for purposes of determining specified policy acquisition expenses.* If for a taxable year an insurance company has a net positive foreign capitalization amount (as defined in paragraph (h)(5)(i) of this section), any portion of that amount remaining after the reduction described in paragraph (h)(7) of this section is treated as additional specified policy acquisition expenses for the taxable year (determined without regard to amounts taken into account under this paragraph (h)). A net positive capitalization amount is treated as an amount otherwise required to be capitalized for the taxable year for purposes of the reduction under section 848(f)(1)(A).

(5) *Net foreign capitalization amount*—(i) *In general.* An insurance company's net foreign capitalization amount equals the sum of the foreign capitalization amounts (netting positive and negative amounts) determined under paragraph (h)(5)(ii) of this section for each category of specified insurance contracts reinsured by agreements described in paragraph (h)(2) of this section. If the amount is less than zero, the company has a net negative foreign capitalization amount. If the amount is greater than zero, the company has a net positive foreign capitalization amount.

(ii) *Foreign capitalization amounts by category.* The foreign capitalization amount for a category of specified insurance contracts is determined by—

(A) Combining the net positive consideration and the net negative consideration for the taxable year (or, with respect to a reinsurance agreement that is subject to the interim rules of § 1.848–3, by combining the gross amount of premiums and other consideration and the premiums and other consideration incurred for reinsurance) for all agreements described in paragraph (h)(2) of this section which reinsure specified insurance contracts in that category; and

(B) Multiplying the result (either positive or negative) by the percentage for that category specified in section 848(c)(1).

(6) *Treatment of net negative foreign capitalization amount*—(i) *Applied as a reduction to previously capitalized amounts.* If for a taxable year an insurance company has a net negative foreign capitalization amount, the negative amount reduces (but not below zero) the unamortized balances of the amounts previously capitalized (beginning with the amount capitalized for the most recent taxable year) to the extent attributable to prior years' net positive foreign capitalization amounts. The amount by which previously capitalized amounts is reduced is allowed as a deduction for the taxable year.

(ii) *Carryover of remaining net negative foreign capitalization amount.* The net negative foreign capitalization amount, if any, remaining after the reduction described in paragraph (h)(6)(i) of this section is carried over to reduce a future net positive capitalization amount. The remaining net negative foreign capitalization amount may only offset a net positive foreign capitalization amount in a future year, and may not be used to reduce the amounts otherwise required to be capitalized under section 848(a) for the taxable year, or to reduce the unamortized balances of specified policy acquisition expenses from preceding taxable years, with respect to directly written business or reinsurance agreements other than agreements for which the election under paragraph (h)(3) of this section has been made.

(7) *Reduction of net positive foreign capitalization amount by carryover amounts allowed.* If for a taxable year an insurance company has a net positive foreign capitalization amount, that amount is reduced (but not below zero) by any carryover of net negative foreign capitalization amounts from preceding taxable years. Any remaining net positive foreign capitalization amount is taken into account as provided in paragraph (h)(4) of this section.

(8) *Examples.* The principles of this paragraph (h) are illustrated by the following examples.

Example 1. (i) On January 1, 1993, a life insurance company (L1) enters into a reinsurance agreement with a foreign corporation (X) covering a block of annuity contracts issued to residents of the United States. X is not subject to taxation either directly under subchapter L or indirectly under subpart F on the premiums for the reinsurance agreement with L1. L1 makes the election under paragraph (h)(3) of this section to separately determine the amounts required to be capitalized for the taxable year with respect to parties not subject to United States taxation.

(ii) For the taxable year ended December 31, 1993, L1 has net negative consideration of ($25,000) under its reinsurance agreement with X. L1 has no other reinsurance agreements with parties not subject to United States taxation.

(iii) Under paragraph (h)(5) of this section, L1's net negative foreign capitalization amount for the 1993 taxable year equals ($437.50), which is determined by multiplying L1's net negative consideration on the agreement with X ($25,000) by the percentage in section 848(c)(1) for the reinsured specified insurance contracts (1.75%). Under paragraph (h)(6)(ii) of this section, L1 carries over the net negative foreign capitalization amount of $437.50) to future taxable years. The net negative foreign capitalization amount may not be used to reduce the amounts which L1 is required to capitalize on directly written business or reinsurance agreements other than those agreements described in paragraph (h)(2) of this section.

Example 2. (i) The facts are the same as *Example 1* except that L1 terminates its reinsurance agreement with X and receives $35,000 on December 31, 1994. For the 1994 taxable year, L1 has net positive consideration of $35,000 under its agreement with X. L1 has no other reinsurance agreements with parties not subject to United States taxation.

(ii) Under paragraph (h)(5) of this section, L1's net positive net foreign capitalization amount for the 1984 taxable year equals $612.50, which is determined by multiplying the net positive consideration on the agreement with X ($35,000) by the percentage in section 848(c)(1) for the reinsured specified insurance contracts (1.75%). Under paragraph (h)(4) of this section, L1 reduces the net positive foreign capitalization amount for the taxable year by the net negative foreign capitalization amount carried over from preceding taxable years ($437.50). After this reduction, L1 includes $175 ($612.50–$437.50) as specified policy acquisition expenses for the 1994 taxable year.

(i) *Carryover of excess negative capitalization amount*—(1) *In general.* This paragraph (i) authorizes a carryover of an excess negative capitalization amount (as defined in paragraph (i)(2) of this section) to reduce amounts otherwise required to be capitalized under section 848. Paragraph (i)(4) provides special rules for the treatment of excess negative capitalization amounts of insolvent insurance companies.

(2) *Excess negative capitalization amount.* The excess negative capitalization amount with respect to a category of specified insurance contracts for a taxable year is equal to the excess of—

(A) The negative capitalization amount with respect to that category; over

(B) The amount that can be utilized under section 848(f)(1).

(3) *Treatment of excess negative capitalization amount.* The excess negative capitalization amount for a taxable year reduces the amounts that are otherwise required to be capitalized by an insurance company under section 848(c)(1) for future years.

(4) *Special rule for the treatment of an excess negative capitalization amount of an insolvent company*—(i) *When applicable.* This paragraph (i)(4) applies only for the taxable year in which an insolvent insurance company has an excess negative capitalization amount and has net negative consideration under a reinsurance agreement. See paragraph (i)(4)(v) of this section for the definition of ''insolvent.''

(ii) *Election to forego carryover of excess negative capitalization amount.* At the joint election of the insolvent insurance company and the other party to the reinsurance agreement—

(A) The insolvent insurance company reduces the excess negative capitalization amount which would otherwise be carried over under paragraph (i)(1) of this section by the amount determined under paragraph (i)(4)(iii) of this section; and

(B) The other party reduces the amount of its specified policy acquisition expenses for the taxable year by the amount determined under paragraph (i)(4)(iii) of this section.

(iii) *Amount of reduction to the excess negative capitalization amount and specified policy acquisition expenses.* To determine the reduction to the carryover of an insolvent insurance company's excess negative capitalization amount and the specified policy acquisition expenses of the other party with respect to a reinsurance agreement—

(A) Multiply the net negative consideration for each reinsurance agreement of the insolvent insurer for which there is net negative consideration for the taxable year by the appropriate percentage specified in section 848(c)(1) for the category of specified insurance contracts reinsured by the agreement;

(B) Sum the results for each agreement;

(C) Calculate the ratio between the results in paragraphs (i)(4)(iii) (A) and (B) of this section for each agreement; and

(D) Multiply that result by the increase in the excess negative capitalization amount of the insolvent insurer for the taxable year.

(iv) *Manner of making election.* To make an election under paragraph (i)(4) of this section, each party to the reinsurance agreement must attach an election statement to its federal income tax return (including an amended return) for the taxable year for which the election is effective. The election statement must identify the reinsurance agreement for which the joint election under this paragraph (i)(4) has been made, state the amount of the reduction to the insolvent insurance company's excess negative capitalization amount that is attributable to the agreement, and be signed by both parties. An election under this paragraph (i)(4) is effective for the taxable year specified in the election statement, and may not be revoked without the consent of the Commissioner.

(v) *Presumptions relating to the insolvency of an insurance company undergoing a court supervised rehabilitation or similar state proceeding.* For purposes of this paragraph (i)(4), an insurance company which is undergoing a rehabilitation, conservatorship, or similar state proceeding shall be presumed to be insolvent if the state proceeding results in—

(A) An order of the state court finding that the fair market value of the insurance company's assets is less than its liabilities;

(B) The use of funds, guarantees, or reinsurance from a guaranty association;

(C) A reduction of the policyholders' available account balances; or

(D) A substantial limitation on access to funds (for example, a partial or total moratorium on policyholder withdrawals or surrenders that applies for a period of 5 years).

(vi) *Example.* The principles of this paragraph (i)(4) are illustrated by the following example.

Example. (i) An insurance company (L1) is the subject of a rehabilitation proceeding under the supervision of a state court. The state court has made a finding that the fair market value of L1's assets is less than its liabilities. On December 31, 1993, L1 transfers a block of individual life insurance contracts to an unrelated insurance company (L2) under an assumption reinsurance agreement whereby L2 becomes solely liable to the policyholders under the contracts reinsured. Under the agreement, L1 agrees to pay L2 $2,000,000 for assuming the life insurance contracts. This negative net consideration causes L1 to incur an excess negative capitalization amount of $138,600 for the 1993 taxable year. L1 has no other reinsurance agreements for the taxable year.

(ii) As part of the reinsurance agreement, L1 and L2 agree to make an election under paragraph (i)(4) of this section. Under the election, L1 agrees to forgo the carryover of the $138,600 excess negative capitalization amount for future taxable years. L2 must include the $2,000,000 net positive consideration for the reinsurance agreement in its gross amount of premiums and other consideration. L2 reduces its specified policy acquisition expenses for the 1993 taxable year by $138,600.

(j) *Ceding commissions with respect to reinsurance of contracts other than specified insurance contracts.* A ceding commission incurred with respect to the reinsurance of an insurance contract that is not a specified insurance contract is not subject to the provisions of section 848(g).

(k) *Effective dates*—(1) *In general.* Unless otherwise specified in this paragraph, the rules of this section are effective for the taxable years of an insurance company beginning after November 14, 1991.

(2) *Reduction in the amount of net negative consideration to ensure consistency of capitalization for reinsurance agreements.* Section 1.848–2(g) (which provides for an adjustment to ensure consistency) is effective for—

(i) All amounts arising under any reinsurance agreement entered into after November 14, 1991; and

(ii) All amounts arising under any reinsurance agreement for taxable years beginning after December 31, 1991, without regard to the date on which the reinsurance agreement was entered into.

(3) *Net consideration rules.* Section 1.848–2(f) (which provides rules for determining the net consideration for a reinsurance agreement) applies to—

(i) Amounts arising in taxable years beginning after December 31, 1991, under a reinsurance agreement entered into after November 14, 1991; and

(ii) Amounts arising in taxable years beginning after December 31, 1994, under a reinsurance agreement entered into before November 15, 1991.

(4) *Determination of the date on which a reinsurance agreement is entered into.* A reinsurance agreement is considered entered into at the earlier of—

(i) The date of the reinsurance agreement; or

(ii) The date of a binding written agreement to enter into a reinsurance transaction if the written agreement evidences the parties' agreement on substantially all material items relating to the reinsurance transaction.

(5) *Special rule for certain reinsurance agreements with parties not subject to U.S. taxation.* The election and special rules in paragraph (h) of this section relating to the determination of amounts required to be capitalized on reinsurance agreements with parties not subject to United States taxation apply to taxable years ending on or after September 30, 1990.

(6) *Carryover of excess negative capitalization amount.* The provisions of paragraph (i) of this section, including the special rule for the treatment of excess negative capitalization amounts of insolvent insurance companies, are affected with respect to amounts arising in taxable years ending on or after September 30, 1990.

[T.D. 8456, 57 FR 61821, Dec. 29, 1992; 58 FR 7987, Feb. 11, 1993; 59 FR 947, Jan. 7, 1994]

§1.848–3 Interim rules for certain reinsurance agreements.

(a) *Scope and effective dates.* The rules of this section apply in determining net premiums for a reinsurance agreement with respect to—

(1) Amounts arising in taxable years beginning before January 1, 1992, under a reinsurance agreement entered into after November 14, 1991; and

(2) Amounts arising in taxable years beginning before January 1, 1995, under a reinsurance agreement entered into before November 15, 1991.

(b) *Interim rules.* In determining a company's gross amount of premiums and other consideration under section 848(d)(1)(A) and premiums and other consideration incurred for reinsurance under section 848(d)(1)(B), the general rules of subchapter L of the Internal Revenue Code apply with the adjustments and special rules set forth in paragraph (c) of this section. Except as provided in paragraph (c)(5) of this section (which applies to modified coinsurance transactions), the gross amount of premiums and other consideration is determined without any reduction for ceding commissions, annual allowances, reimbursements of claims and benefits, or other amounts incurred by a reinsurer with respect to reinsured contracts.

(c) *Adjustment and special rules.* This paragraph sets forth certain adjustments and special rules that apply for reinsurance agreements in determining the gross amount of premiums and other consideration under section 848(d)(1)(A) and premiums and other considerations incurred for reinsurance under section 848(d)(1)(B).

(1) *Assumption reinsurance.* The ceding company must treat the gross amount of consideration incurred with respect to an assumption reinsurance agreement as premiums and other consideration incurred for reinsurance under section 848(d)(1)(B). The reinsurance must include the same amount in the gross amount of premiums and other consideration under section 848(d)(1)(A). For rules relating to the determination and treatment of ceding commissions, see paragraph (c)(3) of this section.

(2) *Reimbursable dividends.* The reinsurer must treat the amount of policyholder dividends reimbursable to the ceding company (other than under a modified coinsurance agreement covered by paragraph (c)(5) of this section) as a return premium under section 848(d)(1)(B). The ceding company must include the same amount in the gross amount of premiums and other consideration under section 848(d)(1)(A). The amount of any experience-related refund due the ceding company is treated as a policyholder dividend reimbursable to the ceding company.

(3) *Ceding commissions*—(i) *In general.* The reinsurer must treat ceding commissions as a general deduction. The ceding company must treat ceding commissions as non-premium related income under section 803(a)(3). The ceding company may not reduce its general deductions by the amount of the ceding commission.

(ii) *Amount of ceding commission.* For purposes of this section, the amount of a ceding commission equals the excess, if any, of—

(A) The increase in the reinsurer's tax reserves resulting from the reinsurance agreement (computed in accordance with section 807(d)); over

(B) The gross consideration incurred by the ceding company for the reinsurance agreement, less any amount incurred by the reinsurer as part of the reinsurance agreement.

(4) *Termination payments.* The reinsurer must treat the gross amount of premiums and other consideration payable as a termination payment to the ceding company (including the tax reserves on the reinsured contracts) as premiums and other consideration incurred for reinsurance under section 848(d)(1)(B). The ceding company must include the same amount in the gross amount of premiums and other consideration under section 848(d)(1)(A). This paragraph does not apply to modified coinsurance agreements.

(5) *Modified coinsurance agreements.* In the case of a modified coinsurance agreement, the parties must determine their net premiums on a net consideration basis as described in § 1.848–2(f)(5).

(D) *Examples.* The principles of this section are illustrated by the following examples.

Example 1. On July 1, 1991, an insurance company (L1) transfers a block of individual life insurance contracts to an unrelated insurance company (L2) under an arrangement whereby L2 becomes solely liable to the policy holder under the contracts reinsured. The tax reserves on the reinsured contracts are $100,000. Under the assumption reinsurance agreement, L1 pays L2 $83,000 for assuming the life insurance contracts. Under paragraph (c)(3) of this section, since the increase in L2's tax reserves ($100,000) exceeds the net consideration transferred by L1 ($83,000), the reinsurance agreement provides for a ceding commission. The ceding commission equals $17,000 ($100,000-$83,000). Under paragraph (c)(3) of this section, L1 reduces its gross amount of premiums and other consideration for the 1991 taxable year under section 848(d)(1)(B) by the $100,000 premium incurred for reinsurance, and L2 includes the $100,000 premium for reinsurance in its gross amount of premiums and other consideration under section 848(d)(1)(A). L1 treats the $17,000 ceding commission as non-premium related income and section 803 (a)(3).

Example 2. On July 1, 1991, a life insurance company (L1) transfers a block of individual life insurance contracts to an unrelated insurance company (L2) under an arrangement whereby L2 becomes solely liable to the policyholder under the contracts reinsured. The tax reserves on the reinsured contracts are $100,000. Under the assumption reinsurance agreement, L1 pays L2 $100,000 for assuming the contracts, and L2 pays L1 a $17,000 ceding commission. Under paragraph (c)(1) of this section, L1 reduces its gross amount of premiums and other consideration under section 848(d)(1)(B) by $100,000. L2 includes $100,000 in its gross amount of premiums and other consideration under section 848(d)(1)(A). Under paragraph (c)(3) of this section, since the increase in L2's tax reserves ($100,000) exceeds the net consideration transferred by L1, the reinsurance agreement provides for a ceding commission. The ceding commission equals $17,000 ($100,000 increase in L2's tax reserves less $83,000 net consideration transferred by L1). L1 treats the $17,000 ceding commission as non-premium related income under section 803(a)(3).

Example 3. On July 1, 1991, a life insurance company (L1) transfers a block of individual life insurance contracts to an unrelated insurance company (L2) under an arrangement whereby L2 becomes solely liable to the policyholder under the contracts reinsured. Under the assumption reinsurance agreement, L1 transfers assets of $105,000 to L2. The tax reserves on the reinsured contracts are $100,000. Under paragraph (c)(1) of this section, L1 reduces its gross amount of premiums and other consideration under section 848(d)(1)(B) by $105,000, and L2 increases its gross amount of premiums and other consideration under section 848(d)(1)(A) by $105,000. Since the net consideration transferred by L1 exceeds the increase in L2's tax reserves, there is no ceding commission under paragraph (c)(3) of this section.

Example 4. (i) On June 30, 1991, a life insurance company (L1) reinsures 40% of certain individual life insurance contracts to be issued after that date with an unrelated insurance company (L2) under an agreement whereby L1 remains directly liable to the policyholders with respect to the contracts reinsured. The agreement provides that L2 is credited with 40% of any premiums received with respect to the reinsured contracts, but must indemnify L1 for 40% of any claims, expenses, and policyholder dividends. During the period from July 1 through December 31, 1991, L1 has the following income and expense items with respect to the reinsured policies:

Item	Income	Expense
Premiums	$8,000	
Benefits paid		$1,000
Commissions		6,000
Policyholder dividends		500
Total		7,500

(ii) Under paragraphs (b) and (c)(2) of this section, L1 includes $8,200 in its gross amount of premiums and other consideration under section 848(d)(1)(A) ($8,000 gross premiums on the reinsured contracts plus $200 of policyholder dividends reimbursed by L2 ($500 × 40%). L1 reduces its gross amount of premiums and other consideration by $3,200 (40% × $8,000) as premiums and other consideration incurred for reinsurance under section 848(d)(1)(B). The benefits and commissions incurred by L1 with respect to the reinsured contracts do not reduce L1's gross amount of premiums and other consideration under section 848(d)(1)(B). L2 includes $3,200 in its gross amount of premiums and other consideration (40% × $8,000) and is treated as having paid return premiums of $200 (the amount of reimbursable dividends paid to L1). L2 is also treated as having incurred the following expenses with respect to the reinsured contracts: $400 as benefits paid (40% × $1,000) and $2,400 as commissions expense (40% × $6,000). Under paragraph (b) of this section, these expenses do not reduce L2's gross amount of premiums and other consideration under section 848(d)(1)(A).

Example 5. On December 31, 1991, an insurance company (L1) terminates a reinsurance agreement with an unrelated insurance company (L2). The termination applies to a reinsurance agreement under which L1 had ceded 40% of its liability on a block of individual life insurance contracts to L2. Upon termination of the reinsurance agreement, L2 makes a final payment of $116,000 to L1 for assuming full liability under the contracts. The tax reserves attributable to L2's portion of the reinsured contracts are $120,000. Under paragraph (c)(4) of this section, L2 reduces its gross amount of premiums and other consideration under section 848(d)(1)(B) by $120,000. L1 includes $120,000 in its gross amount of premiums and other consideration under section 848(d)(1)(A).

Example 6. (i) On June 30, 1991, an insurance company (L1) reinsures 40% of its existing life insurance contracts with an unrelated life insurance company (L2) under a modified coinsurance agreement. For the period July 1, 1991 through December 31, 1991, L1 reports the following income and expense items with respect to L2's 40% share of the reinsured contracts:

Item	Income	Expense
Premiums	$10,000	
Benefits paid	....	$4,000
Policyholder dividends	....	500
Reserve adjustment	....	1,500
Total	....	6,000

(ii) Pursuant to paragraph (c)(5) of this section, L1 reduces its gross amount of premiums and other consideration under section 848(d)(1)(B) by the $4,000 net consideration for the modified coinsurance agreement ($10,000–$6,000). L2 includes the $4,000 net consideration in its gross amount of premiums and other consideration under section 848(d)(1)(A).

[T.D. 8456, 57 FR 61829, Dec. 29, 1992]

SUBCHAPTER A—INCOME TAX (Continued)

PART 1—INCOME TAXES

Normal Taxes and Surtaxes (Continued)

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1.907(e)–1 [Reserved].
1.907(f)–1 Carryback and carryover of credits disallowed by section 907(a) (for amounts carried between taxable years that each begin after December 31, 1982).

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Section 1.882–5 also issued under 26 U.S.C. 882, 26 U.S.C. 864(e), 26 U.S.C. 988(d), and 26 U.S.C. 7701(l).

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Section 1.884–1 (d) (13) (i) also issued under 26 U.S.C. 884 (c) (2).

Section 1.884–1 (e) also issued under 26 U.S.C. 884 (c) (2) (B).

Section 1.884–2 also issued under 26 U.S.C. 884(g).

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Section 1.884–5 (e) and (f) also issued under 26 U.S.C. 884 (e) (4) (C).

Sections 1.892–1T through 1.892–7T also issued under 26 U.S.C. 892(c).

Section 1.894–1 also issued under 26 U.S.C. 7701(l).

Sections 1.897–5T, 1.897–6T and 1.897–7T also issued under 26 U.S.C. 897 (d), (e), (g) and (j) and 26 U.S.C. 367(e)(2).

Sections 1.902–1 and 902–2 also issued under 26 U.S.C. 902(c)(7).

Sections 1.904–4 through 1.904–7 also issued under 26 U.S.C. 904(d)(5).

Section 1.904(b)–3 also issued under 26 U.S.C. 7701(b)(11).

Section 1.904(f)–(2) also issued under 26 U.S.C. 904 (f)(3)(b).

Sections 1.904–4 through 1.904–7 also issued under 26 U.S.C. 904(d)(5).

Section 1.904(i)–1 also issued under 26 U.S.C. 904(i).

Sections 1.905–3T and 1.905–4T also issued under 26 U.S.C. 989(c)(4).

Section 1.907(b)–1 is also issued under 26 U.S.C. 907(b).

Section 1.907(b)–1T also issued under 26 U.S.C. 907(b).

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Revenue Service, Treasury

REGULATED INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUSTS

§ 1.851–1 Definition of regulated investment company.

(a) *In general.* The term ‘‘regulated investment company’’ is defined to mean any domestic corporation (other than a personal holding company as defined in section 542) which meets (1) the requirements of section 851(a) and paragraph (b) of this section, and (2) the limitations of section 851(b) and § 1.851–2. As to the definition of the term ‘‘corporation’’, see section 7701(a)(3).

(b) *Requirement.* To qualify as a regulated investment company, a corporation must be:

(1) Registered at all times during the taxable year, under the Investment Company Act of 1940, as amended (15 U.S.C. 80a–1 to 80b–2), either as a management company or a unit investment trust, or

(2) A common trust fund or similar fund excluded by section 3(c)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a–3(c)) from the definition of ‘‘investment company’’ and not included in the definition of ‘‘common trust fund’’ by section 584(a).

§ 1.851–2 Limitations.

(a) *Election to be a regulated investment company.* Under the provisions of section 851(b)(1), a corporation, even though it satisfies the other requirements of part I, subchapter M, chapter 1 of the Code, for the taxable year, will not be considered a regulated investment company for such year, within the meaning of such part I, unless it elects to be a regulated investment company for such taxable year, or has made such an election for a previous taxable year which began after December 31, 1941. The election shall be made by the taxpayer by computing taxable income as a regulated investment company in its return for the first taxable year for which the election is applicable. No other method of making such election is permitted. An election once made is irrevocable for such taxable year and all succeeding taxable years.

(b) *Gross income requirement*—(1) *General rule.* Section 851(b) (2) and (3) provides that (i) at least 90 percent of the corporation's gross income for the taxable year must be derived from dividends, interest, and gains from the sale or other disposition of stocks or securities, and (ii) less than 30 percent of its gross income must have been derived from the sale or other disposition of stock or securities held for less than three months. In determining the gross income requirements under section 851(b) (2) and (3), a loss from the sale or other disposition of stock or securities does not enter into the computation. A determination of the period for which stock or securities have been held shall be governed by the provisions of section 1223 insofar as applicable.

(2) *Special rules.* (i) For purposes of section 851(b)(2), there shall be treated as dividends amounts which are included in gross income for the taxable year under section 951(a)(1)(A)(i) to the extent that (*a*) a distribution out of a foreign corporation's earnings and profits of the taxable year is not included in gross income by reason of section 959 (a)(1), and (*b*) the earnings and profits are attributable to the amounts which were so included in gross income under section 951(a)(1)(A)(i). For allocation of distributions to earnings and profits of foreign corporations, see § 1.959–3. The provisions of this subparagraph shall apply with respect to taxable years of controlled foreign corporations beginning after December 31, 1975, and to taxable years of United States shareholders (within the meaning of section 951(b) within which or with which such taxable years of such controlled foreign corporations end.

(ii) For purposes of subdivision (i) of this subparagraph, if by reason of section 959(a)(1) a distribution of a foreign corporation's earnings and profits for a taxable year described in section 959(c)(2) is not included in a shareholder's gross income, then such distribution shall be allocated proportionately between amounts attributable to amounts included under each clause of section 951(a)(1)(A). Thus, for example, M is a United States shareholder in X Corporation, a controlled foreign corporation. M and X each use the calendar year as the taxable year. For 1977, M is required by section 951(a)(1)(a) to include $3,000 in its gross income, $1,000 of which is included under clause (i) thereof. In 1977, M received a distribution described in section 959(c)(2) of $2,700 out of X's earnings and profits for 1977, which is, by reason of section 959(a)(1), excluded from M's gross income. The amount of the distribution attributable to the amount included under section 951(a)(1)(A)(i) is $900, i.e., $2,700 multiplied by ($1,000/$3,000).

(c) *Diversification of investments.* (1) Subparagraph (A) of section 851(b)(4) requires that at the close of each quarter of the taxable year at least 50 percent of the value of the total assets of the taxpayer corporation be represented by one or more of the following:

(i) Cash and cash items, including receivables;

(ii) Government securities;

(iii) Securities of other regulated investment companies; or

(iv) Securities (other than those described in subdivisions (ii) and (iii) of this subparagraph) of any one or more issuers which meet the following limitations: *(a)* The entire amount of the securities of the issuer owned by the taxpayer corporation is not greater in value than 5 percent of the value of the total assets of the taxpayer corporation, and *(b)* the entire amount of the securities of such issuer owned by the taxpayer corporation does not represent more than 10 percent of the outstanding voting securities of such issuer. For the modification of the percentage limitations applicable in the case of certain venture capital investment companies, see section 851(e) and §1.851–6.

Assuming that at least 50 percent of the value of the total assets of the corporation satisfies the requirements specified in this subparagraph, and that the limiting provisions of subparagraph (B) of section 851(b)(4) and subparagraph (2) of this paragraph are not violated, the corporation will satisfy the requirements of section 851(b)(4), notwithstanding that the remaining assets do not satisfy the diversification requirements of subparagraph (A) of section 851(b)(4). For example, a corporation may own all the stock of another corporation, provided it otherwise meets the requirements of subparagraphs (A) and (B) of section 851(b)(4).

(2) Subparagraph (B) of section 851(b)(4) prohibits the investment at the close of each quarter of the taxable year of more than 25 percent of the value of the total assets of the corporation (including the 50 percent or more mentioned in subparagraph (A) of section 851(b)(4)) in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers which the taxpayer company controls and which are engaged in the same or similar trades or businesses or related trades or businesses, including such issuers as are merely a part of a unit contributing to the completion and sale of a product or the rendering of a particular service. Two or more issuers are not considered as being in the same or similar trades or businesses merely because they are engaged in the broad field of manufacturing or of any other general classification of industry, but issuers shall be construed to be engaged in the same or similar trades or businesses if they are engaged in a distinct branch of business, trade, or manufacture in which they render the same kind of service or produce or deal in the same kind of product, and such service or products fulfill the same economic need. If two or more issuers produce more than one product or render more than one type of service, then the chief product or service of each shall be the basis for determining whether they are in the same trade or business.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4090, Apr. 28, 1962; T.D. 7555, 43 FR 32753, July 28, 1978]

§1.851–3 Rules applicable to section 851(b)(4).

In determining the value of the taxpayer's investment in the securities of any one issuer, for the purposes of subparagraph (B) of section 851(b)(4), there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer. See example 4 in §1.851–5. For purposes of §§1.851–2, 1.851–4, 1.851–5, and 1.851–6, the terms ‘‘controls’’, ‘‘controlled group’’, and ‘‘value’’ have the meaning assigned to them by section 851(c). All other terms used in such sections have the same meaning as when used in the Investment Company Act of 1940 (15 U.S.C., chapter 2D) or that act as amended.

§1.851–4 Determination of status.

With respect to the effect which certain discrepancies between the value of its various investments and the requirements of section 851(b)(4) and paragraph (c) of §1.851–2, or the effect that the elimination of such discrepancies will have on the status of a company as a regulated investment company for purposes of part I, subchapter M, chapter 1 of the Code, see section 851(d). A company claiming to be a regulated investment company shall keep sufficient records as to investments so as to be able to show that it has complied with the provisions of section 851 during the taxable year. Such records shall be kept at all times available for inspection by any internal revenue officer or employee and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

[T.D. 6598, 27 FR 4090, Apr. 28, 1962]

§ 1.851–5 Examples.

The provisions of section 851 may be illustrated by the following examples:

Example 1. Investment Company W at the close of its first quarter of the taxable year has its assets invested as follows:

	Percent
Cash	5
Government securities	10
Securities of regulated investment companies	20
Securities of Corporation A	10
Securities of Corporation B	15
Securities of Corporation C	20
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	20
Total	100

Investment Company W owns all of the voting stock of Corporations A and B, 15 percent of the voting stock of Corporation C, and less than 10 percent of the voting stock of the other corporations. None of the corporations is a member of a controlled group. Investment Company W meets the requirements under section 851(b)(4) at the end of its first quarter. It complies with subparagraph (A) of section 851(b)(4) since it has 55 percent of its assets invested as provided in such subparagraph. It complies with subparagraph (B) of section 851(b)(4) since it does not have more than 25 percent of its assets invested in the securities of any one issuer, or of two or more issuers which it controls.

Example 2. Investment Company V at the close of a particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash	10
Government securities	35
Securities of Corporation A	7
Securities of Corporation B	12
Securities of Corporation C	15
Securities of Corporation D	21
Total	100

Investment Company V fails to meet the requirements of subparagraph (A) of section 851(b)(4) since its assets invested in Corporations A, B, C, and D exceed in each case 5 percent of the value of the total assets of the company at the close of the particular quarter.

Example 3. Investment Company X at the close of the particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash and Government securities	20
Securities of Corporation A	5
Securities of Corporation B	10
Securities of Corporation C	25
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	40
Total	100

Investment Company X owns more than 20 percent of the voting power of Corporations B and C and less than 10 percent of the voting power of all of the other corporations. Corporation B manufactures radios and Corporation C acts as its distributor and also distributes radios for other companies. Investment Company X fails to meet the requirements of subparagraph (B) of section 851(b)(4) since it has 35 percent of its assets invested in the securities of two issuers which it controls and which are engaged in related trades or businesses.

Example 4. Investment Company Y at the close of a particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash and Government securities	15
Securities of Corporation K (a regulated investment company)	30
Securities of Corporation A	10
Securities of Corporation B	20
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	25
Total	100

Corporation K has 20 percent of its assets invested in Corporation L and Corporation L has 40 percent of its assets invested in Corporation B. Corporation A also has 30 percent of its assets invested in Corporation B, and owns more than 20 percent of the voting power in Corporation B. Investment Company Y owns more than 20 percent of the voting power of Corporations A and K. Corporation K owns more than 20 percent of the voting power of Corporation L, and Corporation L owns more than 20 percent of the voting power of Corporation L. Investment Company Y is disqualified under subparagraph (B) of section 851(b)(4) since more than 25 percent of its assets are considered invested in Corporation B as shown by the following calculation:

	Percent
Percentage of assets invested directly in Corporation B	20.0
Percentage invested through the controlled group, Y-K-L-B (40 percent of 20 percent of 30 percent)	2.4
Percentage invested in the controlled group, Y-A-B (30 percent of 10 percent)	3.0
Total percentage of assets of investment Company Y invested in Corporation B	25.4

Example 5. Investment Company Z, which keeps its books and makes its returns on the basis of the calendar year, at the close of the first quarter of 1955 meets the requirements of section 851(b)(4) and has 20 percent of its assets invested in Corporation A. Later during the taxable year it makes distributions

to its shareholders and because of such distributions it finds at the close of the taxable year that it has more than 25 percent of its remaining assets invested in Corporation A. Investment Company Z does not lose its status as a regulated investment company for the taxable year 1955 because of such distributions, nor will it lose its status as a regulated investment company for 1956 or any subsequent year solely as a result of such distributions.

Example 6. Investment Company Q, which keeps its books and makes its returns on the basis of a calendar year, at the close of the first quarter of 1955, meets the requirements of section 851(b)(4) and has 20 percent of its assets invested in Corporation P. At the close of the taxable year 1955, it finds that it has more than 25 percent of its assets invested in Corporation P. This situation results entirely from fluctuations in the market values of the securities in Investment Company Q's portfolio and is not due in whole or in part to the acquisition of any security or other property. Corporation Q does not lose its status as a regulated investment company for the taxable year 1955 because of such fluctuations in the market values of the securities in its portfolio, nor will it lose its status as a regulated investment company for 1956 or any subsequent year solely as a result of such market value fluctuations.

§1.851–6 Investment companies furnishing capital to development corporations.

(a) *Qualifying requirements.* (1) In the case of a regulated investment company which furnishes capital to development corporations, section 851 (e) provides an exception to the rule relating to the diversification of investments, made applicable to regulated investment companies by section 851(b)(4)(A). This exception (as provided in paragraph (b) of this section) is available only to registered management investment companies which the Securities and Exchange Commission determines, in accordance with regulations issued by it, and certifies to the Secretary or his delegate, not earlier than 60 days before the close of the taxable year of such investment company, to be principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available.

(2) For the purpose of the aforementioned determination and certification, unless the Securities and Exchange Commission determines otherwise, a corporation shall be considered to be principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, for at least 10 years after the date of the first acquisition of any security in such corporation or any predecessor thereof by such investment company if at the date of such acquisition the corporation or its predecessor was principally so engaged, and an investment company shall be considered at any date to be furnishing capital to any company whose securities it holds if within 10 years before such date it had acquired any of such securities, or any securities surrendered in exchange therefor, from such other company or its predecessor.

(b) *Exception to general rule.* (1) The registered management investment company, which for the taxable year meets the requirements of paragraph (a) of this section, may (subject to the limitations of section 851(e)(2) and paragraph (c) of this section) in the computation of 50 percent of the value of its assets under section 851(b)(4)(A) and paragraph (c)(1) of §1.851–2 for any quarter of such taxable year, include the value of any securities of an issuer (whether or not the investment company owns more than 10 percent of the outstanding voting securities of such issuer) if at the time of the latest acquisition of any securities of such issuer the basis of all such securities in the hands of the investment company does not exceed 5 percent of the value of the total assets of the investment company at that time. The exception provided by section 851(e)(1) and this subparagraph is not applicable to the securities of an issuer if the investment company has continuously held any security of such issuer or of any predecessor company (as defined in paragraph (d) of this section) for 10 or more years preceding such quarter of the taxable year. The rule of section 851(e)(1) with respect to the relationship of the basis of the securities of an issuer to the value of the total assets of the investment company is, in substance, a qualification of the 5-percent limitation in section 851(b)(4)(A)(ii) and paragraph (c)(1)(iv) of § 1.851–2. All other provisions and requirements of section 851 and §§ 1.851–1 through 1.851–6 are applicable in determining whether such registered management investment company qualifies as a regulated investment company.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. (i) The XYZ Corporation, a regulated investment company, qualified under section 851(e) as an investment company furnishing capital to development corporations. On June 30, 1954, the XYZ Corporation purchased 1,000 shares of the stock of the A Corporation at a cost of $30,000. On June 30, 1954, the value of the total assets of the XYZ Corporation was $1,000,000. Its investment in the stock of the A Corporation ($30,000) comprised 3 percent of the value of its total assets, and it therefore met the requirements prescribed by section 851(b)(4)(A)(ii) as modified by section 851(e)(1).

(ii) On June 30, 1955, the value of the total assets of the XYZ Corporation was $1,500,000 and the 1,000 shares of stock of the A Corporation which the XYZ Corporation owned appreciated in value so that they were then worth $60,000. On that date, the XYZ Investment Company increased its investment in the stock of the A Corporation by the purchase of an additional 500 shares of that stock at a total cost of $30,000. The securities of the A Corporation owned by the XYZ Corporation had a value of $90,000 (6 percent of the value of the total assets of the XYZ Corporation) which exceeded the limit provided by section 851(b)(4)(A)(ii). However, the investment of the XYZ Corporation in the A Corporation on June 30, 1955, qualified under section 851(b)(4)(A) as modified by section 851(e)(1), since the basis of those securities to the investment company did not exceed 5 percent of the value of its total assets as of June 30, 1955, illustrated as follows:

Basis to the XYZ Corporation of the A Corporation's stock acquired on June 30, 1954	$30,000
Basis of the 500 shares of the A Corporation's stock acquired by the XYZ Corporation on June 30, 1955	30,000
Basis of all stock of A Corporation	60,000

Basis of stock of A Corporation ($60,000)/ Value of XYZ Corporation's total assets at June 30, 1955, time of the latest acquisition ($1,500,000)=4 percent

Example 2. The same facts existed as in example 1, except that on June 30, 1955, the XYZ Corporation increased its investment in the stock of the A Corporation by the purchase of an additional 1,000 shares of that stock (instead of 500 shares) at a total cost of $60,000. No part of the investment of the XYZ Corporation in the A Corporation qualified under the 5 percent limitation provided by section 851(b)(4)(A) as modified by section 851(e)(1), illustrated as follows:

Basis to the XYZ Corporation of the 1,000 shares of the A Corporation's stock acquired on June 30, 1954	$30,000
Basis of the 1,000 shares of the A Corporation's stock acquired on June 30, 1955	60,000
Total	90,000

Basis of stock of A Corporation ($90,000)/ Value of XYZ Corporation's total assets at June 30, 1955, time of the latest acquisition ($1,500,000)= 6 percent

Example 3. The same facts existed as in example 2 and on June 30, 1956, the XYZ Corporation increased its investment in the stock of the A Corporation by the purchase of an additional 100 shares of that stock at a total cost of $6,000. On June 30, 1956, the value of the total assets of the XYZ Corporation was $2,000,000 and on that date the investment in the A Corporation qualified under section 851(b)(4)(A) as modified by section 851(e)(1) illustrated as follows:

Basis to the XYZ Corporation of investments in the A Corporation's stock:	
1,000 shares acquired June 30, 1954	$30,000
1,000 shares acquired June 30, 1955	60,000
100 shares acquired June 30, 1956	6,000
Total	96,000

Basis of stock of A Corporation ($96,000)/ Value of XYZ Corporation's total assets at June 30, 1956, time of the latest acquisition ($2,000,000)=4.8 percent

(c) *Limitation.* Section 851(e) and this section do not apply in the quarterly computation of 50 percent of the value of the assets of an investment company under subparagraph (A) of section 851(b)(4) and paragraph (c)(1) of § 1.851–2 for any taxable year if at the close of any quarter of such taxable year more than 25 percent of the value of its total assets (including the 50 percent or more mentioned in such subparagraph (A)) is represented by securities (other than Government securities or the securities of other regulated investment companies) of issuers as to each of which such investment company (1) holds more than 10 percent of the outstanding voting securities of such issuer, and (2) has continuously held any security of such issuer (or any security of a predecessor of such issuer) for 10 or more years preceding such quarter, unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close of such quarter.

(d) *Definition of predecessor company.* As used in section 851(e) and this section, the term ‘‘predecessor company’’ means any corporation the basis of whose securities in the hands of the investment company was, under the provisions of section 358 or corresponding provisions of prior law, the same in whole or in part as the basis of any of the securities of the issuer and any corporation with respect to whose securities any of the securities of the issuer were received directly or indirectly by the investment company in a transaction or series of transactions involving nonrecognition of gain or loss in whole or in part. The other terms used in this section have the same meaning as when used in section 851(b)(4). See paragraph (c) of §1.851–2 and §1.851–3.

§1.851–7 Certain unit investment trusts.

(a) *In general.* For purposes of the Internal Revenue Code, a unit investment trust (as defined in paragraph (d) of this section) shall not be treated as a person (as defined in section 7701(a)(1)) except for years ending before January 1, 1969. A holder of an interest in such a trust will be treated as directly owning the assets of such trust for taxable years of such holder which end with or within any year of the trust to which section 851(f) and this section apply.

(b) *Treatment of unit investment trust.* A unit investment trust shall not be treated as an individual, a trust estate, partnership, association, company, or corporation for purposes of the Internal Revenue Code. Accordingly, a unit investment trust is not a taxpayer subject to taxation under the Internal Revenue Code. No gain or loss will be recognized by the unit investment trust if such trust distributes a holder's proportionate share of the trust assets in exchange for his interest in the trust. Also, no gain or loss will be recognized by the unit investment trust if such trust sells the holder's proportionate share of the trust assets and distributes the proceeds from such share to the holder in exchange for his interest in the trust.

(c) *Treatment of holder of interest in unit investment trust.* (1) Each holder of an interest in a unit investment trust shall be treated (to the extent of such interest) as owning a proportionate share of the assets of the trust. Accordingly, if the trust distributes to the holder of an interest in such trust his proportionate share of the trust assets in exchange for his interest in the trust, no gain or loss shall be recognized by such holder (or by any other holder of an interest in such trust). For purposes of this paragraph, each purchase of an interest in the trust by the holder will be considered a separate interest in the trust. Items of income, gain, loss, deduction, or credit received by the trust or a custodian thereof shall be taxed to the holders of interests in the trust (and not to the trust) as though they had received their proportionate share of the items directly on the date such items were received by the trust or custodian.

(2) The basis of the assets of such trust which are treated under subparagraph (1) of this paragraph as being owned by the holder of an interest in such trust shall be the same as the basis of his interest in such trust. Accordingly, the amount of the gain or loss recognized by the holder upon the sale by the unit investment trust of the holder's pro rata share of the trust assets shall be determined with reference the basis, of his interest in the trust. Also, the basis of the assets received by the holder, if the trust distributes a holder's pro rata share of the trust assets in exchange for his interest in the trust, will be the same as the basis of his interest in the trust. If the unit investment trust sells less than all of the holder's pro rata share of the trust assets and the holder retains an interest in the trust, the amount of the gain or loss recognized by the holder upon the sale shall be determined with reference to the basis of his interest in the assets sold by the trust, and the basis of his interest in the trust shall be reduced accordingly. If the trust distributes a portion of the holder's pro rata share of the trust assets in exchange for a portion of his interest in

the trust, the basis of the assets received by the holder shall be determined with reference to the basis of his interest in the assets distributed by the trust, and the basis of his interest in the trust shall be reduced accordingly. For purposes of this subparagraph the basis of the holder's interest in assets sold by the trust or distributed to him shall be an amount which bears the same relationship to the basis of his total interest in the trust that the fair market value of the assets so sold or distributed bears to the fair market value of such total interest in the trust, such fair market value to be determined on the date of such sale or distribution.

(3) The period for which the holder of an interest in such trust has held the assets of the trust which are treated under subparagraph (1) of this paragraph as being owned by him is the same as the period for which such holder has held his interest in such trust. Accordingly, the character of the gain, loss, deduction, or credit recognized by the holder upon the sale by the unit investment trust of the holder's proportionate share of the trust assets shall be determined with reference to the period for which he has held his interest in the trust. Also, the holding period of the assets received by the holder if the trust distributes the holder's proportionate share of the trust assets in exchange for his interest in the trust will include the period for which the holder has held his interest in the trust.

(4) The application of the provisions of this paragraph may be illustrated by the following example:

Example. B entered a periodic payment plan of a unit investment trust (as defined in paragraph (d) of this section) with X Bank as custodian and Z as plan sponsor. Under this plan, upon B's demand, X must either redeem B's interest at a price substantially equal to the fair market value of the number of shares in Y, a management company, which are credited to B's account by X in connection with the unit investment trust, or at B's option distribute such shares of Y to B. B's plan provides for quarterly payments of $1,000. On October 1, 1969, B made his initial quarterly payment of $1,000 and X credited B's account with 110 shares of Y. On December 1, 1969, Y declared and paid a dividend of 25 cents per share, 5 cents of which was designated as a capital gain dividend pursuant to section 852(b)(3) and § 1.852–4. X credited B's account with $27.50 but did not distribute the money to B in 1969. On December 31, 1969, X charged B's account with $1 for custodial fees for calendar year 1969. On January 1, 1970, B paid X $1,000 and X credited B's account with 105 shares of Y. On April 1, 1970, B paid X $1,000 and X credited B's account with 100 shares of Y. B must include in his tax return for 1969 a dividend of $22 and a long-term capital gain of $5.50. In addition, B is entitled to deduct the annual custodial fee of $1 under section 212 of the Code.

(a) On April 4, 1970, at B's request, X sells the shares of Y credited to B's account (315 shares) for $10 per share and distributes the proceeds ($3,150) to B together with the remaining balance of $26.50 in B's account. The receipt of the $26.50 does not result in any tax consequences to B. B recognizes a long-term capital gain of $100 and a short- term capital gain of $50, computed as follows:

(1) B is treated as owning 110 shares of Y as of October 1, 1969. The basis of these shares is $1,000, and they were sold for $1,100 (110 shares at $10 per share). Therefore, B recognizes a gain from the sale or exchange of a capital asset held for more than 6 months in the amount of $100.

(2) B is treated as owning 105 shares of Y as of January 1, 1970, and 100 shares as of April 1, 1970. With respect to the shares acquired on April 1, 1970, there is no gain recognized as the shares were sold for $1,000, which is B's basis of the shares. The shares acquired on January 1, 1970, were sold for $1,050 (105 shares at $10 per share), and B's basis of these shares is $1,000. Therefore, B recognizes a gain of $50 from the sale or exchange of a capital asset held for not more than 6 months.

(b) On April 4, 1970, at B's request, X distributes to B the shares of Y credited to his account and $26.50 in cash. The receipt of the $26.50 does not result in any tax consequences to B. B does not recognize gain or loss on the distribution of the shares of Y to him. The bases and holding periods of B's interests in Y are as follows:

Number of shares	Date acquired	Basis
110	10–1–69	$9.09
105	1–1–70	9.52
100	4–1–70	10.00

(d) *Definition.* A unit investment trust to which this section refers is a business arrangement (other than a segregated asset account, whether or not it holds assets pursuant to a variable annuity contract, under the insurance laws or regulations of a State) which (except for taxable years ending before Jan. 1, 1969)—

(1) Is a unit investment trust (as defined in the Investment Company Act of 1940);

(2) Is registered under such Act;

(3) Issues periodic payment plan certificates (as defined in such Act) in one or more series;

(4) Possesses, as substantially all of its assets, as to all such series, securities issued by—

(i) A single management company (as defined in such Act), and securities acquired pursuant to subparagraph (5) of this paragraph, or

(ii) A single other corporation; and

(5) Has no power to invest in any other securities except securities issued by a single other management company, when permitted by such Act or the rules and regulations of the Securities and Exchange Commission.

(e) *Investment in two single management companies.* (1) A unit investment trust may possess securities issued by two or more separate single management companies (as defined in such Act) if—

(i) The trust issues a separate series of periodic payment plan certificates (as defined in such Act) with respect to the securities of each separate single management company which it possesses; and

(ii) None of the periodic payment plan certificates issued by the trust permits joint acquisition of an interest in each series nor the application of payments in whole or in part first to a series issued by one of the single management companies and then to any other series issued by any other single management company.

(2) If a unit investment trust possesses securities of two or more separate single management companies as described in subparagraph (1) of this paragraph and issues a separate series of periodic payment plan certificates with respect to the securities of each such management company, then the holder of an interest in a series shall be treated as the owner of the securities in the single management company represented by such interest.

(i) A holder of an interest in a series of periodic payment plan certificates of a trust who transfers or sells his interest in the series in exchange for an interest in another series of periodic payment plan certificates of the trust shall recognize the gain or loss realized from the transfer or sale as if the trust had sold the shares credited to his interests in the series at fair market value and distributed the proceeds of the sale to him.

(ii) The basis of the interests in the series so acquired by the holder shall be the fair market value of his interests in the series transferred or sold.

(iii) The period for which the holder has held his interest in the series so acquired shall be measured from the date of his acquisition of his interest in that series.

(f) *Cross references.* (1) For reporting requirements imposed on custodians of unit investment trusts described in this section, see §§1.852–4, 1.852–9, 1.853–3, 1.854–2, and 1.6042–2.

(2) For rules relating to redemptions of certain unit investment trusts not described in this section, see §1.852–10.

[T.D. 7187, 37 FR 13254, July 6, 1972, as amended by T.D. 7187, 37 FR 20688, Oct. 3, 1972]

§1.852–1 Taxation of regulated investment companies.

(a) *Requirements applicable thereto*—(1) *In general.* Section 852(a) denies the application of the provisions of part I, subchapter M, chapter 1 of the Code (other than section 852(c), relating to earnings and profits), to a regulated investment company for a taxable year beginning after February 28, 1958, unless—

(i) The deduction for dividends paid for such taxable year as defined in section 561 (computed without regard to capital gain dividends) is equal to at least 90 percent of its investment company taxable income for such taxable year (determined without regard to the provisions of section 852(b)(2)(D) and paragraph (d) of §1.852–3); and

(ii) The company complies for such taxable year with the provisions of §1.852–6 (relating to records required to be maintained by a regulated investment company).

See section 853(b)(1)(B) and paragraph (a) of §1.853–2 for amounts to be added to the dividends paid deduction, and section 855 and §1.855–1, relating to dividends paid after the close of the taxable year.

(2) *Special rule for taxable years of regulated investment companies beginning before March 1, 1958.* The provisions of part I of subchapter M (including section 852(c)) are not applicable to a regulated investment company for a taxable year beginning before March 1, 1958, unless such company meets the requirements of section 852(a) and subparagraph (1) (i) and (ii) of this paragraph.

(b) *Failure to qualify.* If a regulated investment company does not meet the requirements of section 852(a) and paragraph (a)(1) (i) and (ii) of this section for the taxable year, it will, even though it may otherwise be classified as a regulated investment company, be taxed in such year as an ordinary corporation and not as a regulated investment company. In such case, none of the provisions of part I of subchapter M (other than section 852(c) in the case of taxable years beginning after February 28, 1958) will be applicable to it. For the rules relating to the applicability of section 852(c), see § 1.852–5.

[T.D. 6598, 27 FR 4091, Apr. 28, 1962]

§ 1.852–2 Method of taxation of regulated investment companies.

(a) *Imposition of normal tax and surtax.* Section 852(b)(1) imposes a normal tax and surtax, computed at the rates and in the manner prescribed in section 11, on the investment company taxable income, as defined in section 852(b)(2) and § 1.852–3, for each taxable year of a regulated investment company. The tax is imposed as if the investment company taxable income were the taxable income referred to in section 11. In computing the normal tax under section 11, the regulated investment company's taxable income and the dividends paid deduction (computed without regard to the capital gains dividends) shall both be reduced by the deduction for partially tax-exempt interest provided by section 242.

(b) *Taxation of capital gains*—(1) *In general.* Section 852(b)(3)(A) imposes (i) in the case of a taxable year beginning before January 1, 1970, a tax of 25 percent, or (ii) in the case of a taxable year beginning after December 31, 1969, a tax determined as provided in section 1201(a) and paragraph (a)(3) of § 1.1201–1, on the excess, if any, of the net long-term capital gain of a regulated investment company (subject to tax under part I, subchapter M, chapter 1 of the Code) over the sum of its net short-term capital loss and its deduction for dividends paid (as defined in section 561) determined with reference to capital gain dividends only. For the definition of capital gain dividend paid by a regulated investment company, see section 852(b)(3)(C) and paragraph (c) of § 1.852–4. In the case of a taxable year ending after December 31, 1969, and beginning before January 1, 1975, such deduction for dividends paid shall first be made from the amount subject to tax in accordance with section 1201(a)(1)(B), to the extent thereof, and then from the amount subject to tax in accordance with section 1201(a)(1)(A). See § 1.852–10, relating to certain distributions in redemption of interests in unit investment trusts which, for purposes of the deduction for dividends paid with reference to capital gain dividends only, are not considered preferential dividends under section 562(c). See section 855 and § 1.855–1, relating to dividends paid after the close of the taxable year.

(2) *Undistributed capital gains*—(i) *In general.* A regulated investment company (subject to tax under part I of subchapter M) may, for taxable years beginning after December 31, 1956, designate under section 852(b)(3)(D) an amount of undistributed capital gains to each shareholder of the company. For the definition of the term ''undistributed capital gains'' and for the treatment of such amounts by a shareholder, see paragraph (b)(2) of § 1.852–4. For the rules relating to the method of making such designation, the returns to be filed, and the payment of the tax in such cases, see paragraph (a) of § 1.852–9.

(ii) *Effect on earnings and profits of a regulated investment company.* If a regulated investment company designates an amount as undistributed capital gains for a taxable year, the earnings and profits of such regulated investment company for such taxable year shall be reduced by the total amount of the undistributed capital gains so designated. In such case, its capital account shall be increased—

(a) In the case of a taxable year ending before January 1, 1970, by 75 percent of the total amount designated,

(b) In the case of a taxable year ending after December 31, 1969, and beginning before January 1, 1975, by the total amount designated decreased by the amount of tax imposed by section 852(b)(3)(A) with respect to such amount, or

(c) In the case of a taxable year beginning after December 31, 1974, by 70 percent of the total amount designated. The earnings and profits of a regulated investment company shall not be reduced by the amount of tax which is imposed by section 852(b)(3)(A) on an amount designated as undistributed capital gains and which is paid by the corporation but deemed paid by the shareholder.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4091, Apr. 28, 1962; T.D. 6921, 32 FR 8754, June 20, 1967; T.D. 7337, 39 FR 44972, Dec. 30, 1974]

§1.852–3 Investment company taxable income.

Section 852(b)(2) requires certain adjustments to be made to convert taxable income of the investment company to investment company taxable income, as follows:

(a) The excess, if any, of the net long-term capital gain over the net short-term capital loss shall be excluded;

(b) The net operating loss deduction provided in section 172 shall not be allowed;

(c) The special deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code, shall not be allowed. Those not allowed are the deduction for partially tax-exempt interest provided by section 242, the deductions for dividends received provided by sections 243, 244, and 245, and the deduction for certain dividends paid provided by section 247. However, the deduction provided by section 248 (relating to organizational expenditures), otherwise allowable in computing taxable income, shall likewise be allowed in computing the investment company taxable income. See section 852(b)(1) and paragraph (a) of §1.852–2 for treatment of the deduction for partially tax-exempt interest (provided by section 242) for purposes of computing the normal tax under section 11;

(d) The deduction for dividends paid (as defined in section 561) shall be allowed, but shall be computed without regard to capital gains dividends (as defined in section 852(b)(3)(C) and paragraph (c) of §1.852–4); and

(e) The taxable income shall be computed without regard to section 443(b). Thus, the taxable income for a period of less than 12 months shall not be placed on an annual basis even though such short taxable year results from a change of accounting period.

§1.852–4 Method of taxation of shareholders of regulated investment companies.

(a) *Ordinary income.* (1) Except as otherwise provided in paragraph (b) of this section (relating to capital gains), a shareholder receiving dividends from a regulated investment company shall include such dividends in gross income for the taxable year in which they are received.

(2) See section 853 (b)(2) and (c) and paragraph (b) of §1.853–2 and §1.853–3 for the treatment by shareholders of dividends received from a regulated investment company which has made an election under section 853(a) with respect to the foreign tax credit. See section 854 and §§1.854–1 through 1.854–3 for limitations applicable to dividends received from regulated investment companies for the purpose of the credit under section 34 (for dividends received on or before December 31, 1964), the exclusion from gross income under section 116, and the deduction under section 243. See section 855 (b) and (d) and paragraphs (c) and (f) of §1.855–1 for treatment by shareholders of dividends paid by a regulated investment company after the close of the taxable year in the case of an election under section 855(a).

(b) *Capital gains*—(1) *In general.* Under section 852(b)(3)(B), shareholders of a regulated investment company who receive capital gain dividends (as defined in paragraph (c) of this section), in respect of the capital gains of an investment company for a taxable year for which it is taxable under part I, subchapter M, chapter 1 of the Code, as a regulated investment company, shall treat such capital gain dividends as gains from the sale or exchange of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and realized in the taxable year of the shareholder in which the dividend was received. In the case of dividends with respect to any taxable year of a regulated investment company ending after December 31, 1969, and beginning before January 1, 1975, the portion of a shareholder's capital gain dividend to which section 1201(d) (1) or (2) applies is the portion so designated by the regulated investment company pursuant to paragraph (c)(2) of this section.

(2) *Undistributed capital gains.* (i) A person who is a shareholder of a regulated investment company at the close of a taxable year of such company for which it is taxable under part I of subchapter M shall include in his gross income as a gain from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) any amount of undistributed capital gains. The term ''undistributed capital gains'' means the amount designated as undistributed capital gains in accordance with paragraph (a) of §1.852–9, but the amount so designated shall not exceed the shareholder's proportionate part of the amount subject to tax under section 852(b)(3)(A). Such amount shall be included in gross income for the taxable year of the shareholder in which falls the last day of the taxable year of the regulated investment company in respect of which the undistributed capital gains were designated. The amount of such gains designated under paragraph (a) of §1.852–9 as gain described in section 1201(d) (1) or (2) shall be included in the shareholder's gross income as gain described in section 1201(d) (1) or (2). For certain administrative provisions relating to undistributed capital gains, see §1.852–9.

(ii) Any shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D)(i) and subdivision (i) of this subparagraph shall be deemed to have paid for his taxable year for which such amount is so includible—

(a) In the case of an amount designated with respect to a taxable year of the company ending before January 1, 1970, a tax equal to 25 percent of such amount.

(b) In the case of a taxable year of the company ending after December 31, 1969, and beginning before January 1, 1975, a tax equal to the tax designated under paragraph (a)(1) of §1.852–9 by the regulated investment company as his proportionate share of the capital gains tax paid with respect to such amount, or

(c) In the case of an amount designated with respect to a taxable year of the company beginning after December 31, 1974, a tax equal to 30 percent of such amount.

Such shareholder is entitled to a credit or refund of the tax so deemed paid in accordance with the rules provided in paragraph (c)(2) of §1.852–9.

(iii) Any shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D)(i) and subdivision (i) of this subparagraph shall increase the adjusted basis of the shares of stock with respect to which such amount is so includible—

(a) In the case of an amount designated with respect to a taxable year of the company ending before January 1, 1970, by 75 percent of such amount.

(b) In the case of an amount designated with respect to a taxable year of the company ending after December 31, 1969, and beginning before January 1, 1975, by the amount designated under paragraph (a)(1)(iv) of §1.852–9 by the regulated investment company, or

(c) In the case of an amount designated with respect to a taxable year of the company beginning after December 31, 1974, by 70 percent of such amount.

(iv) For purposes of determining whether the purchaser or seller of a share or regulated investment company stock is the shareholder at the close of such company's taxable year who is required to include an amount of undistributed capital gains in gross income, the amount of the undistributed capital gains shall be treated in the same manner as a cash dividend payable to shareholders of record at the close of the company's taxable year. Thus, if a cash dividend paid to shareholders of record as of the close of the regulated investment company's taxable year would be considered income to the purchaser, then the purchaser is also considered to be the shareholder of such company at the close of its taxable year for purposes of including an amount of undistributed capital gains in gross income. If, in such a case, notice on Form 2439 is, pursuant to paragraph (a)(1) of §1.852–9, mailed by the regulated investment company to the seller, then the seller shall be considered the nominee of the purchaser and, as such, shall be subject to the provisions in paragraph (b) of §1.852–9. For rules for determining whether a dividend is income to the purchaser or seller of a share of stock, see paragraph (c) of §1.61–9.

(3) *Partners and partnerships.* If the shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D) and subparagraph (2) of this paragraph is a partnership, such amount shall be included in the gross income of the partnership for the taxable year of the partnership in which falls the last day of the taxable year of the regulated investment company in respect of which the undistributed capital gains were designated. The amount so includible by the partnership shall be taken into account by the partners as distributive shares of the partnership gains and losses from sales or exchanges of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) pursuant to section 702(a)(2) and paragraph (a)(2) of §1.702–1. The tax with respect to the undistributed capital gains is deemed paid by the partnership (under section 852(b)(3)(D)(ii) and subparagraph (2)(ii) of this paragraph), and the credit or refund of such tax shall be taken into account by the partners in accordance with section 702(a)(8) and paragraph (a)(8)(ii) of §1.702–1 and paragraph (c)(2) of §1.852–9. In accordance with section 705(a), the partners shall increase the basis of their partnership interests under section 705(a)(1) by the distributive shares of such gains, and shall decrease the basis of their partnership interests by the distributive shares of the amount of the tax under section 705(a)(2)(B) (relating to certain nondeductible expenditures) and paragraph (a)(3) of §1.705–1.

(4) *Nonresident alien individuals.* If the shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D) and subparagraph (2) of this paragraph is a nonresident alien individual, such shareholder shall be treated, for purposes of section 871 and the regulations thereunder, as having realized a long-term capital gain in such amount on the last day of the taxable year of the regulated investment company in respect of which the undistributed capital gains were designated.

(5) *Effect on earnings and profits of corporate shareholders of a regulated investment company.* If a shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D) and subparagraph (2) of this paragraph is a corporation, such corporation, in computing its earnings and profits for the taxable year for which such amount is so includible, shall treat such amount as if it had actually been received and the taxes paid shall include any amount of tax liability satisfied by a credit under section 852(b)(3)(D) and subparagraph (2) of this paragraph.

(c) *Definition of capital gain dividend*—(1) *General rule.* A capital gain dividend, as defined in section 852(b)(3)(C), is any dividend or part thereof which is designated by a regulated investment company as a capital gain dividend in a written notice mailed to its shareholders within the period specified in paragraph (c)(4) of this section. If the aggregate amount so designated with respect to the taxable year (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 855) is greater than the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate amount so designated. For example, a regulated investment company making its return on the calendar year basis advised its shareholders by written notice mailed December 30, 1955, that of a distribution of $500,000 made December 15, 1955, $200,000 constituted a capital gain dividend, amounting to $2 per share. It was later discovered that an error had been made in determining the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, and that such excess was $100,000 instead of $200,000. In such case each shareholder would have received a capital gain dividend of $1 per share instead of $2 per share.

(2) *Shareholder of record custodian of certain unit investment trusts.* In any case where a notice is mailed pursuant to subparagraph (1) of this paragraph by a regulated investment company with respect to a taxable year of the regulated investment company ending after December 8, 1970, to a shareholder of record who is a nominee acting as a custodian of a unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851–7, the nominee shall furnish each holder of an interest in such trust with a written notice mailed on or before the 55th day following the close of the regulated investment company's taxable year. The notice shall designate the holder's proportionate share of the capital gain dividend shown on the notice received by the nominee pursuant to subparagraph (1) of this paragraph. The notice shall include the name and address of the nominee identified as such. This subparagraph shall not apply if the regulated investment company agrees with the nominee to satisfy the notice requirements of subparagraph (1) of this paragraph with respect to each holder of an interest in the unit investment trust whose shares are being held by the nominee as custodian and, not later than 45 days following the close of the company's taxable year, files with the Internal Revenue Service office where the company's income tax return is to be filed for the taxable year, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this paragraph shall be deemed met if the regulated investment company transmits a copy of such statement to the nominee within such 45-day period; provided however, if the regulated investment company fails or is unable to satisfy the requirements of this subparagraph with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 45 days following the close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this subparagraph within 30 days of such notice. If a notice under paragraph (c)(1) of this section is mailed within the 120-day period following the date of a determination pursuant to paragraph (c)(4)(ii) of this section, the 120-day period and the 130-day period following the date of the determination shall be substituted for the 45-day period and the 55-day period following the close of the regulated investment company's taxable year prescribed by this subparagraph (2).

(3) *Subsection (d) gain for certain taxable years.* In the case of capital gain dividends with respect to any taxable year of a regulated investment company ending after December 31, 1969, and beginning before January 1, 1975 (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 855), the company must include in its written notice under paragraph (c)(1) of this section a statement showing the shareholder's proportionate share of the capital gain dividend which is gain described in section 1201(d)(1) and his proportionate share of such dividend which is gain described in section 1201(d)(2). In determining the portion of the capital gain dividend which, in the hands of a shareholder, is gain described in section 1201(d) (1) or (2), the regulated investment company shall consider that capital gain dividends for a taxable year are first made from its

long-term capital gains for such year which are not described in section 1201(d) (1) or (2), to the extent thereof, and then from its long-term capital gains for such year which are described in section 1201(d) (1) or (2). A shareholder's proportionate share of gains which are described in section 1201(d)(1) is the amount which bears the same ratio to the amount paid to him as a capital gain dividend in respect of such year as (i) the aggregate amount of the company's gains which are described in section 1201(d)(1) and paid to all shareholders bears to (ii) the aggregate amount of the capital gain dividend paid to all shareholders in respect of such year. A shareholder's proportionate share of gains which are described in section 1201(d)(2) shall be determined in a similar manner. Every regulated investment company shall keep a record of the proportion of each capital gain dividend (to which this paragraph applies) which is gain described in section 1201(d) (1) or (2). If, for his taxable year, a shareholder must include in his gross income a capital gain dividend to which this paragraph applies, he shall attach to his income tax return for such taxable year a statement showing, with respect to the total of such dividends for such taxable year received from each regulated investment company, the name and address of the regulated investment company from which such dividends are received, the amount of such dividends, the portion of such dividends which was designated as gain described in section 1201(d)(1), and the portion of such dividends which was designated as gain described in section 1201(d)(2).

(4) *Mailing of written notice to shareholders.* (i) Except as provided in paragraph (c)(4)(ii) of this section, the written notice designating a dividend or part thereof as a capital gain dividend must be mailed to the shareholders not later than 45 days (30 days for a taxable year ending before February 26, 1964) after the close of the taxable year of the regulated investment company.

(ii) If a determination (as defined in section 860(e)) after November 6, 1978, increases the excess for the taxable year of the net capital gain over the deduction for capital gains dividends paid, then a regulated investment company may designate all or part of any dividend as a capital gain dividend in a written notice mailed to its shareholders at any time during the 120-day period immediately following the date of the determination. The aggregate amount designated during this period may not exceed this increase. A dividend may be designated if it is actually paid during the taxable year, is one paid after the close of the taxable year to which section 855 applies, or is a deficiency dividend (as defined in section 860(f)), including a deficiency dividend paid by an acquiring corporation to which section 381(c)(25) applies. The date of a determination is established under §1.860–2(b)(1).

(d) *Special treatment of loss on the sale or exchange of regulated investment company stock held less than 31 days*—(1) *In general.* Under section 852(b)(4), if any person, with respect to a share of regulated investment company stock acquired by such person after December 31, 1957, and held for a period of less than 31 days, is required by section 852(b)(3) (B) or (D) to include in gross income as a gain from the sale or exchange of a capital asset held for more than six months—

(i) The amount of a capital gain dividend, or

(ii) An amount of undistributed capital gains,

then such person shall, to the extent of such amount, treat any loss on the sale or exchange of such share of stock as a loss from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). Such special treatment with respect to the sale of regulated investment company stock held for a period of less than 31 days is applicable to losses for taxable years ending after December 31, 1957.

(2) *Determination of holding period.* The rules contained in section 246(c)(3) (relating to the determination of holding periods for purposes of the deduction for dividends received) shall be applied in determining whether, for purposes of section 852(b)(4) and this paragraph, a share of regulated investment company stock has been held for a period of less than 31 days. In applying those rules, however, ''30 days'' shall be

substituted for the number of days specified in subparagraph (B) of section 246(c)(3).

(3) *Example.* The application of section 852(b)(4) and this paragraph may be illustrated by the following example:

Example. On December 15, 1958, A purchased a share of stock in the X regulated investment company for $20. The X regulated investment company declared a capital gain dividend of $2 per share to shareholders of record on December 31, 1958. A, therefore, received a capital gain dividend of $2 which, pursuant to section 852(b)(3)(B), he must treat as a gain from the sale or exchange of a capital asset held for more than 6 months. On January 5, 1959, A sold his share of stock in the X regulated investment company for $17.50, which sale resulted in a loss of $2.50. Under section 852(b)(4) and this paragraph, A must treat $2 of such loss (an amount equal to the capital gain dividend received with respect to such share of stock) as a loss from the sale or exchange of a capital asset held for more than 6 months.

(Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805; 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6531, 26 FR 413, Jan. 19, 1961; T.D. 6598, 27 FR 4091, Apr. 28, 1962; T.D. 6777, 29 FR 17809, Dec. 16, 1964; T.D. 6921, 32 FR 8755, June 20, 1967; T.D. 7187, 37 FR 13256, July 6, 1972; T.D. 7337, 39 FR 44972, Dec. 30, 1974; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 7936, 49 FR 2106, Jan. 18, 1984]

§ 1.852–5 Earnings and profits of a regulated investment company.

(a) Any regulated investment company, whether or not such company meets the requirements of section 852(a) and paragraphs (a)(1) (i) and (ii) of § 1.852–1, shall apply paragraph (b) of this section in computing its earnings and profits for a taxable year beginning after February 28, 1958. However, for a taxable year of a regulated investment company beginning before March 1, 1958, paragraph (b) of this section shall apply only if the regulated investment company meets the requirements of section 852(a) and paragraphs (a)(1) (i) and (ii) of § 1.852–1.

(b) In the determination of the earnings and profits of a regulated investment company, section 852(c) provides that such earnings and profits for any taxable year (but not the accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for the taxable year. Thus, if a corporation would have had earnings and profits of $500,000 for the taxable year except for the fact that it had a net capital loss of $100,000, which amount was not deductible in determining its taxable income, its earnings and profits for that year if it is a regulated investment company would be $500,000. If the regulated investment company had no accumulated earnings and profits at the beginning of the taxable year, in determining its accumulated earnings and profits as of the beginning of the following taxable year, the earnings and profits for the taxable year to be considered in such computation would amount to $400,000 assuming that there had been no distribution from such earnings and profits. If distributions had been made in the taxable year in the amount of the earnings and profits then available for distribution, $500,000, the corporation would have as of the beginning of the following taxable year neither accumulated earnings and profits nor a deficit in accumulated earnings and profits, and would begin such year with its paid-in capital reduced by $100,000, an amount equal to the excess of the $500,000 distributed over the $400,000 accumulated earnings and profits which would otherwise have been carried into the following taxable year.

§ 1.852–6 Records to be kept for purpose of determining whether a corporation claiming to be a regulated investment company is a personal holding company.

(a) Every regulated investment company shall maintain in the internal revenue district in which it is required to file its income tax return permanent records showing the information relative to the actual owners of its stock contained in the written statements required by this section to be demanded from the shareholders. The actual owner of stock includes the person who is required to include in gross income in his return the dividends received on the stock. Such records shall be kept at all times available for inspection by any internal revenue officer or employee, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(b) For the purpose of determining whether a domestic corporation claiming to be a regulated investment company is a personal holding company as defined in section 542, the permanent records of the company shall show the maximum number of shares of the corporation (including the number and face value of securities convertible into stock of the corporation) to be considered as actually or constructively owned by each of the actual owners of any of its stock at any time during the last half of the corporation's taxable year, as provided in section 544.

(c) Statements setting forth the information (required by paragraph (b) of this section) shall be demanded not later than 30 days after the close of the corporation's taxable year as follows:

(1) In the case of a corporation having 2,000 or more record owners of its stock on any dividend record date, from each record holder of 5 percent or more of its stock; or

(2) In the case of a corporation having less than 2,000 and more than 200 record owners of its stock, on any dividend record date, from each record holder of 1 percent or more of its stock; or

(3) In the case of a corporation having 200 or less record owners of its stock, on any dividend record date, from each record holder of one-half of 1 percent or more of its stock.

When making demand for the written statements required of each shareholder by this paragraph, the company shall inform each of the shareholders of his duty to submit as a part of his income tax return the statements which are required by §1.852–7 if he fails or refuses to comply with such demand. A list of the persons failing or refusing to comply in whole or in part with a company's demand shall be maintained as a part of its record required by this section. A company which fails to keep such records to show the actual ownership of its outstanding stock as are required by this section shall be taxable as an ordinary corporation and not as a regulated investment company.

§1.852–7 Additional information required in returns of shareholders.

Any person who fails or refuses to comply with the demand of a regulated investment company for the written statements which §1.852–6 requires the company to demand from its shareholders shall submit as a part of his income tax return a statement showing, to the best of his knowledge and belief—

(a) The number of shares actually owned by him at any and all times during the period for which the return is filed in any company claiming to be a regulated investment company;

(b) The dates of acquisition of any such stock during such period and the names and addresses of persons from whom it was acquired;

(c) The dates of disposition of any such stock during such period and the names and addresses of the transferees thereof;

(d) The names and addresses of the members of his family (as defined in section 544(a)(2)); the names and addresses of his partners, if any, in any partnership; and the maximum number of shares, if any, actually owned by each in any corporation claiming to be a regulated investment company, at any time during the last half of the taxable year of such company;

(e) The names and addresses of any corporation, partnership, association, or trust in which he had a beneficial interest to the extent of at least 10 percent at any time during the period for which such return is made, and the number of shares of any corporation claiming to be a regulated investment company actually owned by each;

(f) The maximum number of shares (including the number and face value of securities convertible into stock of the corporation) in any domestic corporation claiming to be a regulated investment company to be considered as constructively owned by such individual at any time during the last half of the corporation's taxable year, as provided in section 544 and the regulations thereunder; and

(g) The amount and date of receipt of each dividend received during such period from every corporation claiming to be a regulated investment company.

§1.852–8 Information returns.

Nothing in §§1.852–6 and 1.852–7 shall be construed to relieve regulated investment companies or their shareholders from the duty of filing information returns required by regulations prescribed under the provisions of subchapter A, chapter 61 of the Code.

§1.852–9 Special procedural requirements applicable to designation under section 852(b)(3)(D).

(a) *Regulated investment company*—(1) *Notice to shareholders.* (i) A designation of undistributed capital gains under section 852(b)(3)(D) and paragraph (b)(2)(i) of §1.852–2 shall be made by notice on Form 2439 mailed by the regulated investment company to each person who is a shareholder of record of the company at the close of the company's taxable year. The notice on Form 2439 shall show the name, address, and employer identification number of the regulated investment company; the taxable year of the company for which the designation is made; the name, address, and identifying number of the shareholder; the amount designated by the company for inclusion by the shareholder in computing his long-term capital gains; and the tax paid with respect thereto by the company which is deemed to have been paid by the shareholder.

(ii) In the case of a designation of undistributed capital gains with respect to a taxable year of the regulated investment company ending after December 31, 1969, and beginning before January 1, 1975, Form 2439 shall also show the shareholder's proportionate share of such gains which is gain described in section 1201(d)(1), his proportionate share of such gains which is gain described in section 1201(d)(2), and the amount (determined pursuant to subdivision (iv) of this subparagraph) by which the shareholder's adjusted basis in his shares shall be increased.

(iii) In determining under subdivision (ii) of this subparagraph the portion of the undistributed capital gains which, in the hands of the shareholder, is gain described in section 1201(d) (1) or (2), the company shall consider that capital gain dividends for a taxable year are made first from its long-term capital gains for such year which are not described in section 1201(d) (1) or (2), to the extent thereof, and then from its long-term capital gains for such year which are described in section 1201(d) (1) or (2). A shareholder's proportionate share of undistributed capital gains for a taxable year which is gain described in section 1201(d)(1) is the amount which bears the same ratio to the amount included in his income as designated undistributed capital gains for such year as *(a)* the aggregate amount of the company's gains for such year which are described in section 1201(d)(1) and designated as undistributed capital gains bears to *(b)* the aggregate amount of the company's gains for such year which are designated as undistributed capital gains. A shareholder's proportionate share of gains which are described in section 1201(d)(2) shall be determined in a similar manner. Every regulated investment company shall keep a record of the proportion of undistributed capital gains (to which this subdivision applies) which is gain described in section 1201(d) (1) or (2).

(iv) In the case of a designation of undistributed capital gains for any taxable year ending after December 31, 1969, and beginning before January 1, 1975, Form 2439 shall also show with respect to the undistributed capital gains of each shareholder the amount by which such shareholder's adjusted basis in his shares shall be increased under section 852(b)(3)(D)(iii). The amount by which each shareholders' adjusted basis in his shares shall be increased is the amount includible in his gross income with respect to such shares under section 852(b)(3)(D)(i) less the tax which the shareholder is deemed to have paid with respect to such shares. The tax which each shareholder is deemed to have paid with respect to such shares is the amount which bears the same ratio to the amount of the tax imposed by section 852(b)(3)(A) for such year with respect to the aggregate amount of the designated undistributed capital gains as the amount of such gains includible in the shareholder's gross income bears to the aggregate amount of such gains so designated.

(v) Form 2439 shall be prepared in triplicate, and copies B and C of the form shall be mailed to the shareholder on or before the 45th day (30th day for a taxable year ending before February 26, 1964) following the close of the company's taxable year. Copy A of each Form 2439 must be associated with the duplicate copy of the undistributed capital gains tax return of the company (Form 2438), as provided in subparagraph (2)(ii) of this paragraph.

(2) *Return of undistributed capital gains tax*—(i) *Form 2438.* Every regulated investment company which designates undistributed capital gains for any taxable year beginning after December 31, 1956, in accordance with subparagraph (1) of this paragraph, shall file for such taxable year an undistributed capital gains tax return on Form 2438 including on such return the total of its undistributed capital gains so designated and the tax with respect thereto. The return on Form 2438 shall be prepared in duplicate and shall set forth fully and clearly the information required to be included therein. The original of Form 2438 shall be filed on or before the 30th day after the close of the company's taxable year with the internal revenue officer designated in instructions applicable to Form 2438. The duplicate copy of form 2438 for the taxable year shall be attached to and filed with the income tax return of the company on Form 1120 for such taxable year.

(ii) *Copies A of Form 2439.* For each taxable year which ends on or before December 31, 1965, there shall be submitted with the company's return on Form 2438 all copies A of Form 2439 furnished by the company to its shareholders in accordance with subparagraph (1) of this paragraph. For each taxable year which ends after December 31, 1965, there shall be submitted with the duplicate copy of the company's return on Form 2438, which is attached to and filed with the income tax return of the company on Form 1120 for the taxable year, all copies A of Form 2439 furnished by the company to its shareholders in accordance with subparagraph (1) of this paragraph. The copies A of Form 2439 shall be accompanied by lists (preferably in the form of adding machine tapes) of the amounts of undistributed capital gains and of the tax paid with respect thereto shown on such forms. The totals of the listed amounts of undistributed capital gains and of tax paid with respect thereto must agree with the corresponding entries on Form 2438.

(3) *Payment of tax.* The tax required to be returned on Form 2438 shall be paid by the regulated investment company on or before the 30th day after the close of the company's taxable year to the internal revenue officer with whom the return on Form 2438 is filed.

(b) *Shareholder of record not actual owner*—(1) *Notice to actual owner.* In any case in which a notice on Form 2439 is mailed pursuant to paragraph (a)(1) of this section by a regulated investment company to a shareholder of record who is a nominee of the actual owner or owners of the shares of stock to which the notice relates, the nominee shall furnish to each such actual owner notice of the owner's proportionate share of the amounts of undistributed capital gains and tax with respect thereto, as shown on the Form 2439 received by the nominee from the regulated investment company. The nominee's notice to the actual owner shall be prepared in triplicate on Form 2439 and shall contain the information prescribed in paragraph (a)(1) of this section, except that the name and address of the nominee, identified as such, shall be entered on the form in addition to, and in the space provided for, the name and address of the regulated investment company, and the amounts of undistributed capital gains and tax with respect thereto entered on the form shall be the actual owner's proportionate share of the corresponding items shown on the nominee's notice from the regulated investment company. Copies B and C of the Form 2439 prepared by the nominee shall be mailed to the actual owner—

(i) For taxable years of regulated investment companies ending after February 25, 1964, on or before the 75th day (55th day in the case of a nominee who is acting as a custodian of a unit investment trust described in section 851(f)(1) and paragraph (d) of §1.851–7 for taxable years of regulated investment companies ending after December 8, 1970, and 135th day if the nominee is a resident of a foreign country) following the close of the regulated investment company's taxable year, or

(ii) For taxable years of regulated investment companies ending before February 26, 1964, on or before the 60th day (120th day if the nominee is a resident of a foreign country) following the close of the regulated investment company's taxable year.

(2) *Transmittal of Form 2439.* The nominee shall enter the word ''Nominee'' in the upper right hand corner of copy B of the notice on Form 2439 received by him from the regulated investment company, and on or before the appropriate day specified in subdivision (i) or (ii) of subparagraph (1) of this paragraph shall transmit such copy B, together with all copies A of Form 2439 prepared by him pursuant to subparagraph (1) of this paragraph, to the internal revenue officer with whom his income tax return is required to be filed.

(3) *Custodian of certain unit investment trusts.* The requirements of this paragraph shall not apply to a nominee who is acting as a custodian of the unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851–7 provided that the regulated investment company agrees with the nominee to satisfy the notice requirements of paragraph (a) of this section with respect to each holder of an interest in the unit investment trust whose shares are being held by such nominee as custodian and on or before the 45th day following the close of the company's taxable year, files with the Internal Revenue Service office where the company's income tax return is to be filed for the taxable year, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this paragraph shall be deemed met if the regulated investment company transmits a copy of such statement to the nominee within such 45-day period; provided however, if the regulated investment company fails or is unable to satisfy the requirements of this paragraph with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 45 days following the close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this paragraph within 30 days of such notice.

(c) *Shareholders*—(1) *Return requirements.* The copy B of the Form 2439 furnished to a shareholder by the regulated investment company or by a nominee, as provided in paragraph (a) or (b), respectively, of this section, shall be attached to the return of income made by the shareholder for his taxable year in which the amount of undistributed capital gains is includible in gross income, as provided in paragraph (b)(2) of § 1.852–4.

(2) *Credit or refund*—(i) *In general.* The amount of the tax paid by the regulated investment company with respect to the undistributed capital gains required under section 852(b)(3)(D) and paragraph (b)(2) of § 1.852–4 to be included by a shareholder in his computation of long-term capital gains for any taxable year is deemed paid by such shareholder under section 852(b)(3)(D)(ii) and such payment constitutes, for purposes of section 6513(a) (relating to time tax considered paid), an advance payment in like amount of the tax imposed under chapter 1 of the Code for such taxable year. In the case of an overpayment of tax within the meaning of section 6401, see section 6402 and the regulations in part 301 of this chapter (Regulations on Procedure and Administration) for rules applicable to the treatment of an overpayment of tax and section 6511 and the regulations in part 301 of this chapter (Regulations on Procedure and Administration) with respect to the limitations applicable to the credit or refund of an overpayment of tax.

(ii) *Form to be used.* Claim for refund or credit of the tax deemed to have been paid by a shareholder with respect to an amount of undistributed capital gains shall be made on the shareholder's income tax return for the taxable year in which such amount of undistributed capital gains is includable in gross income. In the case of a shareholder which is a partnership, claim shall be made by the partners on their income tax returns for refund or credit of their distributive shares of the tax deemed to have been paid by the partnership. In the case of a shareholder which is exempt from tax under section 501(a) and to which section 511 does not apply for the taxable year, claim for refund of the tax deemed to have been paid by such shareholder on an amount of undistributed capital gains for such year shall be made on Form 843 and copy B of Form 2439 furnished to such shareholder shall be attached to its claim. For other rules applicable to the filing of claims for credit or refund of an overpayment of tax, see §301.6402–2 of this chapter (Regulations on Procedure and Administration), relating to claims for credit or refund, and §301.6402–3 of this chapter, relating to special rules applicable to income tax.

(3) *Records.* The shareholder is required to keep copy C of the Form 2439 furnished for the regulated investment company's taxable years ending after December 31, 1969, and beginning before January 1, 1975, as part of his records to show increases in the adjusted basis of his shares in such company.

(d) *Penalties.* For criminal penalties for willful failure to file a return, supply information, or pay tax, and for filing a false or fraudulent return, statement, or other document, see sections 7203, 7206, and 7207.

[T.D. 6500, 25 FR 11710, Nov. 26, 1960, as amended by T.D. 6921, 32 FR 8755, June 20, 1967; T.D. 7012, 34 FR 7688, May 15, 1969; T.D. 7187, 37 FR 13256, July 6, 1972; T.D. 7332, 39 FR 44217, Dec. 23, 1974; T.D. 7337, 39 FR 44973, Dec. 30, 1974]

§1.852–10 Distributions in redemption of interests in unit investment trusts.

(a) *In general.* In computing that part of the excess of its net long-term capital gain over net short-term capital loss on which it must pay a capital gains tax, a regulated investment company is allowed under section 852(b)(3)(A)(ii) a deduction for dividends paid (as defined in section 561) determined with reference to capital gains dividends only. Section 561(b) provides that in determining the deduction for dividends paid, the rules provided in section 562 are applicable. Section 562(c) (relating to preferential dividends) provides that the amount of any distribution shall not be considered as a dividend unless such distribution is pro-rata, with no preference to any share of stock as compared with other shares of the same class except to the extent that the former is entitled to such preference.

(b) *Redemption distributions made by unit investment trust*—(1) *In general.* Where a unit investment trust (as defined in paragraph (c) of this section) liquidates part of its portfolio represented by shares in a management company in order to make a distribution to a holder of an interest in the trust in redemption of part or all of such interest, and by so doing, the trust realizes net long-term capital gain, that portion of the distribution by the trust which is equal to the amount of the net long-term capital gain realized by the trust on the liquidation of the shares in the management company will not be considered a preferential dividend under section 562(c). For example, where the entire amount of net long-term capital gain realized by the trust on such a liquidation is distributed to the redeeming interest holder, the trust will be allowed the entire amount of net long-term capital gain so realized in determining the deduction under section 852(b)(3)(A)(ii) for dividends paid determined with reference to capital gains dividends only. This paragraph and section 852(d) shall apply only with respect to the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) realized by the trust which is attributable to a redemption by a holder of an interest in such trust. Such dividend may be designated as a capital gain dividend by a written notice to the certificate holder. Such designation should clearly indicate to the holder that the holder's gain or loss on the redemption of the certificate may differ from such designated amount, depending upon the holder's basis for the redeemed certificate, and that the holder's own records are to be used in computing the holder's gain or loss on the redemption of the certificate.

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

Example. B entered into a periodic payment plan contract with X as custodian and Z as plan sponsor under which he purchased a plan certificate of X. Under this contract, upon B's demand, X must redeem B's certificate at a price substantially equal to the value of the number of shares in Y, a management company, which are credited to B's account by X in connection with the unit investment trust. Except for a small amount of cash which X is holding to satisfy liabilities and to invest for other plan certificate holders, all of the assets held by X in connection with the trust consist of shares in Y. Pursuant to the terms of the periodic payment plan contract, 100 shares of Y are credited to B's account. Both X and Y have elected to be treated as regulated investment companies. On March 1, 1965, B notified X that he wished to have his entire interest in the unit investment trust redeemed. In order to redeem B's interest, X caused Y to redeem 100 shares of Y which X held. At the time of redemption, each share of Y had a value of $15. X then distributed the $1,500 to B. X's basis for each of the Y shares which was redeemed was $10. Therefore, X realized a long-term capital gain of $500 ($5×100 shares) which is attributable to the redemption by B of his interest in the trust. Under section 852(d), the $500 capital gain distributed to B will not be considered a preferential dividend. Therefore, X is allowed a deduction of $500 under section 852(b)(3)(A)(ii) for dividends paid determined with reference to capital gains dividends only, with the result that X will not pay a capital gains tax with respect to such amount.

(c) *Definition of unit investment trust.* A unit investment trust to which paragraph (a) of this section refers is a business arrangement which—

(1) Is registered under the Investment Company Act of 1940 as a unit investment trust;

(2) Issues periodic payment plan certificates (as defined in such Act);

(3) Possesses, as substantially all of its assets, securities issued by a management company (as defined in such Act);

(4) Qualifies as a regulated investment company under section 851; and

(5) Complies with the requirements provided for by section 852(a).

Paragraph (a) of this section does not apply to a unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851–7.

[T.D. 6921, 32 FR 8755, June 20, 1967, as amended by T.D. 7187, 37 FR 13527, July 6, 1972; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.852–11 Treatment of certain losses attributable to periods after October 31 of a taxable year.

(a) *Outline of provisions.* This paragraph lists the provisions of this section.

(a) Outline of provisions.
(b) Scope.
(1) In general.
(2) Limitation on application of section.
(c) Post-October capital loss defined.
(1) In general.
(2) Methodology.
(3) October 31 treated as last day of taxable year for purpose of determining taxable income under certain circumstances.
(i) In general.
(ii) Effect on gross income.
(d) Post-October currency loss defined.
(1) Post-October currency loss.
(2) Net foreign currency loss.
(3) Foreign currency gain or loss.
(e) Limitation on capital gain dividends.
(1) In general.
(2) Amount taken into account in current year.
(i) Net capital loss.
(ii) Net long-term capital loss.
(3) Amount taken into account in succeeding year.
(f) Regulated investment company may elect to defer certain losses for purposes of determining taxable income.
(1) In general.
(2) Effect of election in current year.
(3) Amount of loss taken into account in current year.
(i) If entire amount of net capital loss deferred.
(ii) If part of net capital loss deferred.
(A) In general.
(B) Character of capital loss not deferred.
(iii) If entire amount of net long-term capital loss deferred.
(iv) If part of net long-term capital loss deferred.
(v) If entire amount of post-October currency loss deferred.
(vi) If part of post-October currency loss deferred.
(4) Amount of loss taken into account in succeeding year and subsequent years.
(5) Effect on gross income.
(g) Earnings and profits.
(1) General rule.
(2) Special rule—treatment of losses that are deferred for purposes of determining taxable income.
(h) Examples.

(i) Procedure for making election.

(1) In general.

(2) When applicable instructions not available.

(j) Transition rules.

(1) In general.

(2) Retroactive election.

(i) In general.

(ii) Deadline for making election.

(3) Amended return required for succeeding year in certain circumstances.

(i) In general.

(ii) Time for filing amended return.

(4) Retroactive dividend.

(i) In general.

(ii) Method of making election.

(iii) Deduction for dividends paid.

(A) In general.

(B) Limitation on ordinary dividends.

(C) Limitation on capital gain dividends.

(D) Effect on other years.

(iv) Earnings and profits.

(v) Receipt by shareholders.

(vi) Foreign tax election.

(vii) Example.

(5) Certain distributions may be designated retroactively as capital gain dividends.

(k) Effective date.

(b) *Scope*—(1) *In general.* This section prescribes the manner in which a regulated investment company must treat a post-October capital loss (as defined in paragraph (c) of this section) or a post-October currency loss (as defined in paragraph (d)(1) of this section) for purposes of determining its taxable income, its earnings and profits, and the amount that it may designate as capital gain dividends for the taxable year in which the loss is incurred and the succeeding taxable year (the ‘‘succeeding year’’).

(2) *Limitation on application of section.* This section shall not apply to any post-October capital loss or post-October currency loss of a regulated investment company attributable to a taxable year for which an election is in effect under section 4982(e)(4) of the Code with respect to the company.

(c) *Post-October capital loss defined*—(1) *In general.* For purposes of this section, the term *post-October capital loss* means—

(i) Any net capital loss attributable to the portion of a regulated investment company's taxable year after October 31; or

(ii) If there is no such net capital loss, any net long-term capital loss attributable to the portion of a regulated investment company's taxable year after October 31.

(2) *Methodology.* The amount of any net capital loss or any net long-term capital loss attributable to the portion of the regulated investment company's taxable year after October 31 shall be determined in accordance with general tax law principles (other than section 1212) by treating the period beginning on November 1 of the taxable year of the regulated investment company and ending on the last day of such taxable year as though it were the taxable year of the regulated investment company. For purposes of this paragraph (c)(2), any item (other than a capital loss carryover) that is required to be taken into account or any rule that must be applied, for purposes of section 4982, on October 31 as if it were the last day of the regulated investment company's taxable year must also be taken into account or applied in the same manner as required under section 4982, both on October 31 and again on the last day of the regulated investment company's taxable year.

(3) *October 31 treated as last day of taxable year for purpose of determining taxable income under certain circumstances*—(i) *In general.* If a regulated investment company has a post-October capital loss for a taxable year, any item that must be marked to market for purposes of section 4982 on October 31 as if it were the last day of the regulated investment company's taxable year must also be marked to market on October 31 and again on the last day of the regulated investment company's taxable year for purposes of determining its taxable income. If the regulated investment company does not have a post-October capital loss for a taxable year, the regulated investment company must treat items that must be marked to market for purposes of section 4982 on October 31 as if it were the last day of the regulated investment company's taxable year as marked to market only on the last day of its taxable year for purposes of determining its taxable income.

(ii) *Effect on gross income.* The marking to market of any item on October 31 of a regulated investment company's taxable year for purposes of determining its taxable income under paragraph (c)(3)(i) of this section shall not affect the amount of the gross income of such company for such taxable year for purposes of section 851(b) (2) or (3).

(d) *Post-October currency loss defined.* For purposes of this section—

(1) *Post-October currency loss.* The term *post-October currency loss* means any net foreign currency loss attributable to the portion of a regulated investment company's taxable year after October 31. For purposes of the preceding sentence, principles similar to those of paragraphs (c)(2) and (c)(3) of this section shall apply.

(2) *Net foreign currency loss.* The term ''net foreign currency loss'' means the excess of foreign currency losses over foreign currency gains.

(3) *Foreign currency gain or loss.* The terms ''foreign currency gain'' and ''foreign currency loss'' have the same meaning as provided in section 988(b).

(e) *Limitation on capital gain dividends*—(1) *In general.* For purposes of determining the amount a regulated investment company may designate as capital gain dividends for a taxable year, the amount of net capital gain for the taxable year shall be determined without regard to any post-October capital loss for such year.

(2) *Amount taken into account in current year*—(i) *Net capital loss.* If the post-October capital loss referred to in paragraph (e)(1) of this section is a post-October capital loss as defined in paragraph (c)(1)(i) of this section, the net capital gain of the company for the taxable year in which the loss arose shall be determined without regard to any capital gains or losses (both long-term and short-term) taken into account in computing the post-October capital loss for the taxable year.

(ii) *Net long-term capital loss.* If the post-October capital loss referred to in paragraph (e)(1) of this section is a post-October capital loss as defined in paragraph (c)(1)(ii) of this section, the net capital gain of the company for the taxable year in which the loss arose shall be determined without regard to any long-term capital gain or loss taken into account in computing the post-October capital loss for the taxable year.

(3) *Amount taken into account in succeeding year.* If a regulated investment company has a post-October capital loss (as defined in paragraph (c)(1)(i) or (c)(1)(ii) of this section) for any taxable year, then, for purposes of determining the amount the company may designate as capital gain dividends for the succeeding year, the net capital gain for the succeeding year shall be determined by treating all gains and losses taken into account in computing the post-October capital loss as arising on the first day of the succeeding year.

(f) *Regulated investment company may elect to defer certain losses for purposes of determining taxable income*—(1) *In general.* A regulated investment company may elect, in accordance with the procedures of paragraph (i) of this section, to compute its taxable income for a taxable year without regard to part or all of any post-October capital loss or post-October currency loss for that year.

(2) *Effect of election in current year.* The taxable income of a regulated investment company for a taxable year to which an election under paragraph (f)(1) of this section applies shall be computed without regard to that part of any post-October capital loss or post-October currency loss to which the election applies.

(3) *Amount of loss taken into account in current year*—(i) *If entire amount of net capital loss deferred.* If a regulated investment company elects, under paragraph (f)(1) of this section, to defer the entire amount of a post-October capital loss as defined in paragraph (c)(1)(i) of this section, the taxable income of the company for the taxable year in which the loss arose shall be determined without regard to any capital gains or losses (both long-term and short-term) taken into account in computing the post-October capital loss for the taxable year.

(ii) *If part of net capital loss deferred*—(A) *In general.* If a regulated investment company elects, under paragraph (f)(1) of this section, to defer less than the entire amount of a post-October capital loss as defined in paragraph (c)(1)(i) of this section, the taxable income of the company for the taxable year in which the loss arose shall be determined by including an amount of capital loss taken into account in computing the post-October capital loss for the taxable year equal to the amount of the post-October capital loss that is not deferred. No amount of capital gain taken into account in computing the post-October capital loss for the taxable year shall be taken into account in the determination.

(B) *Character of capital loss not deferred.* The capital loss includible in the taxable income of the company under this paragraph (f)(3)(ii) for the taxable year in which the loss arose shall consist first of any short-term capital losses to the extent thereof, and then of any long-term capital losses, taken into account in computing the post-October capital loss for the taxable year.

(iii) *If entire amount of net long-term capital loss deferred.* If a regulated investment company elects, under paragraph (f)(1) of this section, to defer the entire amount of a post-October capital loss as defined in paragraph (c)(1)(ii) of this section, the taxable income of the company for the taxable year in which the loss arose shall be determined without regard to any long-term capital gains or losses taken into account in computing the post-October capital loss for the taxable year.

(iv) *If part of net long-term capital loss deferred.* If a regulated investment company elects, under paragraph (f)(1) of this section, to defer less than the entire amount of a post-October capital loss as defined in paragraph (c)(1)(ii) of this section, the taxable income of the company for the taxable year in which the loss arose shall be determined by including an amount of long-term capital loss taken into account in computing the post-October capital loss for the taxable year equal to the amount of the post-October capital loss that is not deferred. No amount of long term capital gain taken into account in computing the post-October capital loss for the taxable year shall be taken into account in the determination.

(v) *If entire amount of post-October currency loss deferred.* If a regulated investment company elects, under paragraph (f)(1) of this section, to defer the entire amount of a post-October currency loss, the taxable income of the company for the taxable year in which the loss arose shall be determined without regard to any foreign currency gains or losses taken into account in computing the post-October currency loss for the taxable year.

(vi) *If part of post-October currency loss deferred.* If a regulated investment company elects, under paragraph (f)(1) of this section, to defer less than the entire amount of a post-October currency loss, the taxable income of the company for the taxable year in which the loss arose shall be determined by including an amount of foreign currency loss taken into account in computing the post-October currency loss for the taxable year equal to the amount of the post-October currency loss that is not deferred. No amount of foreign currency gain taken into account in computing the post-October currency loss for the taxable year shall be taken into account in the determination.

(4) *Amount of loss taken into account in succeeding year and subsequent years.* If a regulated investment company has a post-October capital loss or a post-October currency loss for any taxable year and an election under paragraph (f)(1) is made for that year, then, for purposes of determining the taxable income of the company for the succeeding year and all subsequent years, all capital gains and losses taken into account in determining the post-October capital loss, and all foreign currency gains and losses taken into account in determining the post-October currency loss, that are not taken into account under the rules of paragraph (f)(3) of this section in determining the taxable income of the regulated investment company for the taxable year in which the loss arose shall be treated as arising on the first day of the succeeding year.

(5) *Effect on gross income.* An election by a regulated investment company to defer any post-October capital loss or any post-October currency loss for a taxable year under paragraph (f)(1) of this section shall not affect the amount of the gross income of such company for such taxable year (or the succeeding year) for purposes of section 851(b) (2) or (3).

(g) *Earnings and profits*—(1) *General rule.* The earnings and profits of a regulated investment company for a taxable year are determined without regard to any post-October capital loss or post-October currency loss for that year. If a regulated investment company distributes with respect to a calendar year amounts in excess of the limitation described in the succeeding sentence, then, with respect to those excess amounts, for the taxable year with respect to which the amounts are distributed, the earnings and profits of the company are computed without regard to the preceding sentence. The limitation described in this sentence is the amount that would be the required distribution for that calendar year under section 4982 if ‘‘100 percent’’ were substituted for each percentage set forth in section 4982(b)(1).

(2) *Special Rule—Treatment of losses that are deferred for purposes of determining taxable income.* If a regulated investment company elects to defer, under paragraph (f)(1) of this section, any part of a post-October capital loss or post-October currency loss arising in a taxable year, then, for both the taxable year in which the loss arose and the succeeding year, both the earnings and profits and the accumulated earnings and profits of the company are determined as if the part of the loss so deferred had arisen on the first day of the succeeding year.

(h) *Examples.* The provisions of paragraphs (e), (f), and (g) of this section may be illustrated by the following examples. For each example, assume that X is a regulated investment company that computes its income on a calendar year basis, and that no election is in effect under section 4982(e)(4).

Example 1. X has a $25 net foreign currency gain, a $50 net short-term capital loss, and a $75 net long-term capital gain for the post-October period of 1988. X has no post-October currency loss and no post-October capital loss for 1988, and this section does not apply.

Example 2. X has the following capital gains and losses for the periods indicated:

	Long-term	Short-term
01/01 to 10/31/88	115 (15)	80 (20)
	100	60
11/01 to 12/31/88	75 (150)	150 (50)
	(75)	100
01/01 to 10/31/89	30 (5)	40 (20)
	25	20
11/01 to 12/31/89	35 (0)	100 (50)
	35	50

X has a post-October capital loss of $75 for its 1988 taxable year due to a net long-term capital loss for the post-October period of 1988. X does not make an election under paragraph (f)(1) of this section.

(i) *Capital gain dividends.* X may designate up to $100 as a capital gain dividend for 1988 because X must disregard the $75 long-term capital gain and the $150 long-term capital loss for the post-October period of 1988 in computing its net capital gain for this purpose. In computing its net capital gain for 1989 for the purposes of determining the amount it may designate as a capital gain dividend for 1989, X must take into account the $75 long-term capital gain and the $150 long-term capital loss for the post-October period of 1988 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X may not designate any amount as a capital gain dividend for 1989.

(ii) *Taxable income.* X must include the $75 long-term capital gain and the $150 long-term capital loss for its post-October period of 1988 in its taxable income for 1988 because it did not make an election under paragraph (f)(1) of this section for 1988. Accordingly, X’s taxable income for 1988 will include a net capital gain of $25 and a net short-term capital gain of $160. X’s taxable income for 1989 will include a net capital gain of $60 and a net short-term capital gain of $70.

(iii) *Earnings and profits.* X must determine its earnings and profits for 1988 without regard to the $75 long-term capital gain and the $150 long-term capital loss for the post-October period of 1988. X must, however, include the $75 long-term capital gain and $150 long-term capital loss for the post-October period of 1988 in determining its accumulated earnings and profits for 1988. Thus, X includes $260 of capital gain in its earnings and profits for 1988, includes $185 in its accumulated earnings and profits for 1988, and includes $130 of capital gain in its earnings and profits for 1989.

Example 3. Same facts as example 2, except that X elects to defer the entire $75 post-October capital loss for 1988 under paragraph (f)(1) of this section for purposes of determining its taxable income for 1988.

(i) *Capital gain dividends.* Same result as in example 2.

(ii) *Taxable income.* X must compute its taxable income for 1988 without regard to the $75 long-term capital gain and the $150 long-term capital loss for the post-October period of 1988 because it made an election to defer the entire $75 post-October capital loss for 1988 under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net capital gain of $100 and a net short-term capital gain of $160. X must include the $75 long-term capital gain and the $150 long-term capital loss for the post-October period of 1988 in its taxable income for 1989 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X's taxable income for 1989 will include a net long-term capital loss of $15 and a net short-term capital gain of $70.

(iii) *Earnings and profits.* For 1988, X must determine both its earnings and profits and its accumulated earnings and profits without regard to the $75 long-term capital gain and $150 long-term capital loss for the post-October period of 1988. In determining both its earnings and profits and its accumulated earnings and profits for 1989, X must include (in addition to the long-term and short-term capital gains and losses for 1989) the $75 long-term capital gain and $150 long-term capital loss for the post-October period of 1988 as if those deferred gains and losses arose on January 1, 1989. Thus, X will include $260 of capital gain in its earnings and profits for 1988 and $55 of capital gain in its earnings and profits for 1989.

Example 4. Same facts as example 2, except that X elects to defer only $50 of the post-October capital loss for 1988 under paragraph (f)(1) of this section for purposes of determining its taxable income for 1988.

(i) *Capital gain dividends.* Same results as in example 2.

(ii) *Taxable income.* X must compute its taxable income for 1988 without regard to the $75 long-term capital gain and $125 of the $150 long-term capital loss for the post-October period of 1988 because it made an election to defer $50 of the $75 post-October capital loss for 1988 under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net capital gain of $75 and a net short-term capital gain of $160. X must include the $75 long-term capital gain and $125 of the $150 long-term capital loss for the post-October period of 1988 in its taxable income for 1989 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X's taxable income for 1989 will include a net capital gain of $10 and a net short-term capital gain of $70.

(iii) *Earnings and profits.* X must determine its earnings and profits for 1988 without regard to the $75 long-term capital gain and the $150 long-term capital loss for the post-October period of 1988. X must include $25 of the $150 long-term capital loss for the post-October period of 1988 in determining its accumulated earnings and profits for 1988. In determining both its earnings and profits and its accumulated earnings and profits for 1989, X must include (in addition to the long-term and short-term capital gains and losses for 1989) the $75 long-term capital gain and $125 of the $150 long-term capital loss for the post-October period of 1988 as if those deferred gains and losses arose on January 1, 1989. Thus, X includes $260 of capital gain in its earnings and profits for 1988, includes $235 in its accumulated earnings and profits for 1988, and includes $80 of capital gain in its earnings and profits for 1989.

Example 5. X has the following capital gains and losses for the periods indicated:

	Long-term	Short-term
01/01 to 10/31/88	115 (15)	80 (20)
	100	60
11/01 to 12/31/88	150 (75)	50 (150)
	75	(100)
01/01 to 10/31/89	30 (5)	40 (20)
	25	20
11/01 to 12/31/89	35 (0)	100 (50)
	35	50

X has a post-October capital loss of $25 for its 1988 taxable year due to a net capital loss for the post-October period of 1988. X does not make an election under paragraph (f)(1) of this section.

(i) *Capital gain dividends.* X may designate up to $100 as a capital gain dividend for 1988 because X must disregard the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988 in computing its net capital gain for this purpose. In computing its net capital gain for 1989 for purposes of determining the amount it may designate as a capital gain dividend for 1989, X must take into account the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X may designate up to $105 as a capital gain dividend for 1989.

(ii) *Taxable income.* X must include the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988 in its taxable income for 1988 because it did not make an election under paragraph (f)(1) of this section for 1988. Accordingly, X's taxable income for 1988 will include a net capital gain of $135 (consisting of a net long-term capital gain of $175 and a net short-term capital loss of $40). X's taxable income for 1989 will include a net capital gain of $60 and a net short-term capital gain of $70.

(iii) *Earnings and profits.* X must determine its earnings and profits for 1988 without regard to the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988. X must, however, include the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988 in determining its accumulated earnings and profits for 1988. Thus, X includes $160 of capital gain in its earnings and profits for 1988, includes $135 in its accumulated earnings and profits for 1988, and includes $130 of capital gain in its earnings and profits for 1989.

Example 6. Same facts as example 5, except that X elects to defer the entire $25 post-October capital loss for 1988 under paragraph (f)(1) of this section for purposes of determining its taxable income for 1988.

(i) *Capital gain dividends.* Same result as in example 5.

(ii) *Taxable income.* X must compute its taxable income for 1988 without regard to the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988 because it made an election to defer the entire $25 post-October capital loss for 1988 under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net capital gain of $100 and a net short-term capital gain of $60. X must include the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988 in its taxable income for 1989 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X's taxable income for 1989 will include a net capital gain of $105 (consisting of a net long-term capital gain of $135 and a net short-term capital loss of $30).

(iii) *Earnings and profits.* For 1988, X must determine both its earnings and profits and its accumulated earnings and profits without regard to the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988. In determining both its earnings and profits and its accumulated earnings and profits for 1989, X must include (in addition to the long-term and short-term capital gains and losses for 1989) the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988 as if those deferred gains and losses arose on January 1, 1989. Thus, X will include $160 of capital gain in its earnings and profits for 1988 and $105 of capital gain in its earnings and profits for 1989.

Example 7. Same facts as example 5, except that X elects to defer only $20 of the post-October capital loss for 1988 under paragraph (f)(1) of this section for purposes of determining its taxable income for 1988.

(i) *Capital gain dividends.* Same result as in example 5.

(ii) *Taxable income.* X must compute its taxable income for 1988 by including $5 of the $150 short-term capital loss for the post-October period of 1988, but without regard to the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and $145 of the $150 short-term capital loss for the post-October period of 1988 because it made an election to defer $20 of the $25 post-October capital loss for 1988 under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net capital gain of $100 and a net short-term capital gain of $55. X must include the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and $145 of the $150 short-term capital loss for the post-October period of 1988 in its taxable income for 1989 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X's taxable income for 1989 will include a net capital gain of $110 (consisting of a long-term capital gain of $135 and a net short-term capital loss of $25).

(iii) *Earnings and profits.* X must determine its earnings and profits for 1988 without regard to the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and the $150 short-term capital loss for the post-October period of 1988. In determining its accumulated earnings and profits for 1988, X must include $5 of the $150 short-term capital loss for the post-October period of 1988. In determining its accumulated earnings and profits for 1989, X must include (in addition to the long-term and short-term capital gains and losses for 1989) the $150 long-term capital gain, the $75 long-term capital loss, the $50 short-term capital gain, and $145 of the $150 short-term capital loss for the post-October period of 1988 as if those deferred gains and losses arose on January 1, 1989. Thus, X includes $160 of capital gain in its earnings and profits for 1988, includes $155 in its accumulated earnings and profits for 1988, and includes $110 of capital gain in its earnings and profits for 1989.

Example 8. X has the following capital gains and losses for the periods indicated:

	Long-term	Short-term
01/01 to 10/31/88	115 (15)	80 (20)
	100	60
11/01 to 12/31/88	15 (75)	25 (10)
	(60)	15
01/01 to 10/31/89	80 (5)	50 (100)
	75	(50)
11/01 to 12/31/89	85 (0)	40 (20)
	85	20

X has a post-October capital loss of $45 for its 1988 taxable year due to a net capital loss for the post-October period of 1988. X does not make an election under paragraph (f)(1) of this section.

(i) *Capital gain dividends.* X may designate up to $100 as a capital gain dividend for 1988 because X must disregard the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988 in computing its net capital gain for this purpose. In computing its net capital gain for 1989 for purposes of determining the amount it may designate as a capital gain dividend for 1989, X must take into account the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X may designate up to $85 as a capital gain dividend for 1989.

(ii) *Taxable income.* X must include the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988 in its taxable income for 1988 because it did not make an election under paragraph (f)(1) of this section for 1988. Accordingly, X's taxable income for 1988 will include a net capital gain of $40 and a net short-term capital gain of $75. X's taxable income for 1989 will include a net capital gain of $130 for 1989 (consisting of a net long-term capital gain of $160 and a net short-term capital loss of $30).

(iii) *Earnings and profits.* X must determine its earnings and profits for 1988 without regard to the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988. X must, however, include the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988 in determining its accumulated earnings and profits for 1988. Thus, X includes $160 of capital gain in its earnings and profits for 1988, includes $115 in its accumulated earnings and profits for 1988, and includes $130 of capital gain in its earnings and profits for 1989.

Example 9. Same facts as example 8, except that X elects to defer the entire $45 post-October capital loss for 1988 under paragraph (f)(1) of this section for purposes of determining its taxable income for 1988.

(i) *Capital gain dividends.* Same result as in example 8.

(ii) *Taxable income.* X must compute its taxable income for 1988 without regard to the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988 because it made an election to defer the entire $45 post-October capital loss for 1988 under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net capital gain of $100 and a net short-term capital gain of $60. X must include the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988 in its taxable income for 1989 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X's taxable income for 1989 will include a net capital gain of $85 (consisting of a net long-term capital gain of $100 and a net short-term capital loss of $15).

(iii) *Earnings and profits.* For 1988, X must determine both its earnings and profits and its accumulated earnings and profits without regard to the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988. In determining both its earnings and profits and its accumulated earnings and profits for 1989, X must include (in addition to the long-term and short-term capital gains and losses for 1989) the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988 as if those deferred gains and losses arose on January 1, 1989. Thus, X will include $160 of capital gain in its earnings and profits for 1988 and $85 of capital gain in its earnings and profits for 1989.

Example 10. Same facts as example 8, except that X elects to defer only $30 of the post-October capital loss for 1988 under paragraph (f)(1) of this section for purposes of determining its taxable income for 1988.

(i) *Capital gain dividends.* Same result as in example 8.

(ii) *Taxable income.* X must compute its taxable income for 1988 by including $5 of the $75 long-term capital loss and the $10 short-term capital loss for the post-October period of 1988, but without regard to the $15 long-term capital gain, $70 of the $75 long-term capital loss, and the $25 short-term capital gain for the post-October period of 1988 because it made an election to defer $30 of the $45 post-October capital loss for 1988 under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net capital gain of $95 and a net short-term capital gain of $50. X must include the $15 long-term capital gain, $70 of the $75 long-term capital loss, and the $25 short-term capital gain for the post-October period of 1988 in its taxable income for 1989 in addition to the long-term and short-term capital gains and losses for 1989. Accordingly, X's taxable income for 1989 will include a net capital gain of $100 (consisting of a net long-term capital gain of $105 and a net short-term capital loss of $5).

(iii) *Earnings and profits.* X must determine its earnings and profits for 1988 without regard to the $15 long-term capital gain, the $75 long-term capital loss, the $25 short-term capital gain, and the $10 short-term capital loss for the post-October period of 1988. In determining its accumulated earnings and profits for 1988, X must include $5 of the $75 long-term capital loss and the $10 short-term capital loss for the post-October period of 1988. In determining both its earnings and profits and its accumulated earnings and profits for 1989, X must include (in addition to the long-term and short-term capital gains and losses for 1989) the $15 long-term capital gain, $70 of the $75 long-term capital loss, and the $25 short-term capital gain for the post-October period of 1988 as if those deferred gains and losses arose on January 1, 1989. Thus, X includes $160 of capital gain in its earnings and profits for 1988, includes $145 in its accumulated earnings and profits for 1989, and includes $100 of capital gain in its earnings and profits for 1989 (consisting of a net long-term capital gain of $105 and a net short-term capital loss of $5).

Example 11. X has the following foreign currency gains and losses attributable to the periods indicated:

01/01 to 10/31/88	200
11/01 to 12/31/88	(100)
01/01 to 10/31/89	110
11/01 to 12/31/89	40

X has a $100 post-October currency loss for its 1988 taxable year due to a net foreign currency loss for the post-October period of 1988. X does not make an election under paragraph (f)(1) of this section.

(i) *Taxable income.* X must compute its taxable income for 1988 by including the $100 foreign currency loss for the post-October period of 1988 because it did not make an election under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net foreign currency gain of $100. X's taxable income for 1989 will include a net foreign currency gain of $150.

(ii) *Earnings and profits.* X must determine its earnings and profits for 1988 without regard to the foreign currency loss for the post-October period of 1988. X must, however, include the $100 foreign currency loss for the post-October period 1988 in determining its accumulated earnings and profits for 1988. Thus, X includes $200 of foreign currency gain in its earnings and profits for 1988, includes $100 in its accumulated earnings and profits for 1988, and includes $150 of foreign currency gain in its earnings and profits for 1989.

Example 12. Same facts as example 11, except that X elects to defer the entire $100 post-October currency loss for 1988 under paragraph (f)(1) of this section for purposes of determining its taxable income for 1988.

(i) *Taxable income.* X must compute its taxable income for 1988 without regard to the $100 foreign currency loss for the post-October period of 1988 because it made an election to defer the entire $100 post-October currency loss for 1988 under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net foreign currency gain of $200. X's taxable income for 1989 will include a net foreign currency gain of $50 because X must compute its taxable income for 1989 by including the $100 foreign currency loss for the post-October period of 1988 in addition to the foreign currency gains and losses for 1989.

(ii) *Earnings and profits.* For 1988, X must determine both its earnings and profits and its accumulated earnings and profits without regard to the $100 foreign currency loss for the post-October period of 1988. In determining both its earnings and profits and its accumulated earnings and profits for 1989, X must include (in addition to the foreign currency gains and losses for 1989) the $100 foreign currency loss for the post-October period 1988 as if that deferred loss arose on January 1, 1989. Thus, X will include $200 of foreign currency gain in its earnings and profits for 1988 and $50 of foreign currency gain in its earnings and profits for 1989.

Example 13. Same facts as example 11, except that X elects to defer only $75 of the post-October currency loss under paragraph (f)(1) of this section for purposes of determining its taxable income for 1988.

(i) *Taxable income.* X must compute its taxable income for 1988 by including $25 of the $100 foreign currency loss for the post-October period of 1988, but without regard to $75 of the $100 foreign currency loss for the post-October period of 1988 because it made an election to defer $75 of the $100 post-October currency loss for 1988 under paragraph (f)(1) of this section. Accordingly, X's taxable income for 1988 will include a net foreign currency gain of $175. X's taxable income will include a net foreign currency gain of $75 for

1989 because X must compute its taxable income for 1989 by including $75 of the $100 foreign currency loss for the post-October period of 1988 in addition to the foreign currency gains and losses for 1989.

(ii) *Earnings and profits.* X must determine its earnings and profits for 1988 without regard to the $100 foreign currency loss for the post-October period of 1988. X must, however, inlcude $25 of the $100 foreign currency loss for the post-October period of 1988 in determining its accumulated earnings and profits for 1988. In determining both its earnings and profits and its accumulated earnings and profits for 1989, X must include (in addition to the foreign currency gains and losses for 1989) the $75 of the $100 foreign currency loss for the post-October period of 1988 as if that loss arose on January 1, 1989. Thus, X includes $200 of foreign currency gain in its earnings and profits for 1988, includes $175 in its accumulated earnings and profits for 1988, and includes $75 of foreign currency gain in its earnings and profits for 1989.

(i) *Procedure for making election*—(1) *In general.* Except as provided in paragraph (i)(2) of this section, a regulated investment company may make an election under paragraph (f)(1) of this section for a taxable year to which this section applies by completing its income tax return (including any necessary schedules) for that taxable year in accordance with the instructions for the form that are applicable to the election.

(2) *When applicable instructions not available.* If the instructions for the income tax returns of regulated investment companies for a taxable year to which this section applies do not reflect the provisions of this section, a regulated investment company may make an election under paragraph (f)(1) of this section for that year by entering the appropriate amounts on its income tax return (including any necessary schedules) for that year, and by attaching a written statement to the return that states—

(i) The taxable year for which the election under this section is made;

(ii) The fact that the regulated investment company elects to defer all or a part of its post-October capital loss or post-October currency loss for that taxable year for purposes of computing its taxable income under the terms of this section;

(iii) The amount of the post-October capital loss or post-October currency loss that the regulated investment company elects to defer for that taxable year; and

(iv) The name, address, and employer identification number of the regulated investment company.

(j) *Transition rules*—(1) *In general.* For a taxable year ending before March 2, 1990 in which a regulated investment company incurred a post-October capital loss or post-October currency loss, the company may use any method that is consistently applied and in accordance with reasonable business practice to determine the amounts taken into account in that taxable year for purposes of paragraphs (e)(2), (f)(3), and (g) of this section and to determine the amount taken into account in the succeeding year for purposes of paragraphs (e)(3), (f)(4), and (g) of this section. For example, for purposes of paragraph (e), a taxpayer may use a method that treats as incurred in a taxable year all capital gains taken into account in computing the post–October capital loss for that year and an amount of capital loss for such period equal to the amount of such gains and that treats the remaining amount of capital loss for such period as arising on the first day of the succeeding year.

Similarly, for purposes of paragraph (e)(3), a taxpayer may use a method that treats as arising on the first day of the succeeding year only the excess of the capital losses from sales or exchanges after October 31 over the capital gains for such period (that is, the net capital loss or net long-term capital loss for such period).

(2) *Retroactive election*—(i) *In general.* A regulated investment company may make an election (a ‘‘retroactive election’’) under paragraph (f)(1) for a taxable year with respect to which it has filed an income tax return on or before May 1, 1990 (a ‘‘retroactive election year’’) by filing an amended return (including any necessary schedules) for the retroactive election year reflecting the appropriate amounts and by attaching a written statement to the return that complies with the requirements of paragraph (i)(2) of this section.

(ii) *Deadline for making election.* A retroactive election may be made no later than December 31, 1990.

(3) *Amended return required for succeeding year in certain circumstances*—(i) *In general.* If, at the time a regulated investment company makes a retroactive election under this section, it has already filed an income tax return for the succeeding year, the company must file an amended return for such succeeding year reflecting the appropriate amounts.

(ii) *Time for filing amended return.* An amended return required under paragraph (j)(3)(i) of this section must be filed together with the amended return described in paragraph (j)(2)(i).

(4) *Retroactive dividend*—(i) *In general.* A regulated investment company that makes a retroactive election under this section for a retroactive election year may elect to treat any dividend (or portion thereof) declared and paid (or treated as paid under section 852(b)(7)) by the regulated investment company after the retroactive election year and on or before December 31, 1990 as having been paid during the retroactive election year (a ‘‘retroactive dividend’’). This election shall be irrevocable with respect to the retroactive dividend to which it applies.

(ii) *Method of making election.* The election under this paragraph (j)(4) must be made by the regulated investment company by treating the dividend (or portion thereof) to which the election applies as a dividend paid during the retroactive election year in computing its deduction for dividends paid in its tax returns for all applicable years (including the amended return(s) required to be filed under paragraphs (j)(2) and (3) of this section).

(iii) *Deduction for dividends paid*—(A) *In general.* Subject to the rules of sections 561 and 562, a regulated investment company shall include the amount of any retroactive dividend in computing its deduction for dividends paid for the retroactive election year. No deduction for dividends paid shall be allowed under this paragraph (j)(4)(iii)(A) for any amount not paid (or treated as paid under section 852(b)(7)) on or before December 31, 1990.

(B) *Limitation on ordinary dividends.* The amount of retroactive dividends (other than retroactive dividends qualifying as capital gain dividends) paid for a retroactive election year under this section shall not exceed the increase, if any, in the investment company taxable income of the regulated investment company (determined without regard to the deduction for dividends paid (as defined in section 561)) that is attributable solely to the regulated investment company having made the retroactive election.

(C) *Limitation on capital gain dividends.* The amount of retroactive dividends qualifying as capital gain dividends paid for a retroactive election year under this section shall not exceed the increase, if any, in the amount of the excess described in section 852(b)(3)(A) (relating to the excess of the net capital gain over the deduction for capital gain dividends paid) that is attributable solely to the regulated investment company having made the retroactive election.

(D) *Effect on other years.* A retroactive dividend shall not be includible in computing the deduction for dividends paid for—

(*1*) The taxable year in which such distribution is actually paid (or treated as paid under section 852(b)(7)); or

(*2*) Under section 855(a), the taxable year preceding the retroactive election year.

(iv) *Earnings and profits.* A retroactive dividend shall be considered as paid out of the earnings and profits of the retroactive election year (computed with the application of sections 852(c) and 855, § 1.852–5, § 1.855–1, and this section), and not out of the earnings and profits of the taxable year in which the distribution is actually paid (or treated as paid under section 852(b)(7)).

(v) *Receipt by shareholders.* Except as provided in section 852(b)(7), a retroactive dividend shall be included in the gross income of the shareholders of the regulated investment company for the taxable year in which the dividend is received by them.

(vi) *Foreign tax election.* If a regulated investment company to which section 853 (relating to foreign taxes) is applicable for a retroactive election year elects to treat a dividend paid (or treated as paid under section 852(b)(7)) during the taxable year as a retroactive dividend, the shareholders of the regulated investment company shall consider the amounts described in section 853(b)(2) allocable to such distribution as paid or received, as the case may be, in the shareholder's taxable year in which the distribution is made.

(vii) *Example.* The provisions of this paragraph (j)(4) may be illustrated by the following example:

Example. X is a regulated investment company that computes its income on a calendar year basis. No election is in effect under section 4982(e)(4). X has the following income for 1988:

FOREIGN CURRENCY GAINS AND LOSSES

Gains and Losses

Jan. 1–Oct. 31—100
Nov. 1–Dec. 31—(75)

CAPITAL GAINS AND LOSSES

Jan. 1–Oct. 31—short term, 100; long term, 100
Nov. 1–Dec. 31—short term, 50; long term, (100)

(A) X had investment company taxable income of $175 and no net capital gain for 1988 for taxable income purposes. X distributed $175 of investment company taxable income as an ordinary dividend for 1988.

(B) If X makes a retroactive election under this section to defer the entire $75 post-October currency loss and the entire $50 post-October capital loss for the post-October period of its 1988 taxable year for purposes of computing its taxable income, that deferral increases X's investment company taxable income for 1988 by $25 (due to an increase in foreign currency gain of $75 and a decrease in short-term capital gain of $50) to $200 and increases the excess described in section 852(b)(3)(A) for 1988 by $100 from $0 to $100. The amount that X may treat as a retroactive ordinary dividend is limited to $25, and the amount that X may treat as a retroactive capital gain dividend is limited to $100.

(5) *Certain distributions may be designated retroactively as capital gain dividends.* To the extent that a regulated investment company designated as capital gain dividends for a taxable year less than the maximum amount permitted under paragraph (e) of this section for that taxable year, the regulated investment company may designate an additional amount of dividends paid (or treated as paid under sections 852(b)(7) or 855, or paragraph (j)(4) of this section) for the taxable year as capital gain dividends, notwithstanding that a written notice was not mailed to its shareholders within 60 days after the close of the taxable year in which the distribution was paid (or treated as paid under section 852(b)(7)).

(k) *Effective date.* the provisions of this section shall apply to taxable years ending after October 31, 1987.

[T.D. 8287, 55 FR 3213, Jan. 31, 1990; 55 FR 7891, Mar. 6, 1990; 55 FR 11110, Mar. 26, 1990. Redesignated and amended by T.D. 8320, 55 FR 50176, Dec. 5, 1990; 56 FR 2808, Jan. 24, 1991; 56 FR 8130, Feb. 27, 1991]

§ 1.852–12 Non-RIC earnings and profits.

(a) *Applicability of section 852(a)(2)(A)*—(1) *In general.* An investment company does not satisfy section 852(a)(2)(A) unless—

(i) Part I of subchapter M applied to the company for all its taxable years ending on or after November 8, 1983; and

(ii) For each corporation to whose earnings and profits the investment company succeeded by the operation of section 381, part I of subchapter M applied for all the corporation's taxable years ending on or after November 8, 1983.

(2) *Special rule.* See section 1071(a)(5)(D) of the Tax Reform Act of 1984, Public Law 98–369 (98 Stat. 1051), for a special rule which treats part I of subchapter M as having applied to an investment company's first taxable year ending after November 8, 1983.

(b) *Applicability of section 852(a)(2)(B)*—(1) *In general.* An investment company does not satisfy section 852(a)(2)(B) unless, as of the close of the taxable year, it has no earnings and profits other than earnings and profits that—

(i) Were earned by a corporation in a year for which part I of subchapter M applied to the corporation and, at all times thereafter, were the earnings and profits of a corporation to which part I of subchapter M applied;

(ii) By the operation of section 381 pursuant to a transaction that occurred before December 22, 1992, became the earnings and profits of a corporation to which part I of subchapter M applied and, at all times thereafter, were the earnings and profits of a corporation to which part I of subchapter M applied;

(iii) Were accumulated in a taxable year ending before January 1, 1984, by a corporation to which part I of subchapter M applied for any taxable year ending before November 8, 1983; or

(iv) Were accumulated in the first taxable year of an investment company that began business in 1983 and that was not a successor corporation.

(2) *Prior law.* For purposes of paragraph (b) of this section, a reference to part I of subchapter M includes a reference to the corresponding provisions of prior law.

(c) *Effective date.* This regulation is effective for taxable years ending on or after December 22, 1992.

[T.D. 8483, 58 FR 43798, Aug. 18, 1993; 58 FR 49352, Sept. 22, 1993]

§ 1.853–1 Foreign tax credit allowed to shareholders.

(a) *In general.* Under section 853, a regulated investment company, meeting the requirements set forth in section 853(a) and paragraph (b) of this section, may make an election with respect to the income, war-profits, and excess profits taxes described in section 901(b)(1) which it pays to foreign countries or possessions of the United States during the taxable year, including such taxes as are deemed paid by it under the provisions of any income tax convention to which the United States is a party. If an election is made, the shareholders of the regulated investment company shall apply their proportionate share of such foreign taxes paid, or deemed to have been paid by it pursuant to any income tax convention, as either a credit (under section 901) or as a deduction (under section 164(a)) as provided by section 853(b)(2) and paragraph (b) of § 1.853–2. The election is not applicable with respect to taxes deemed to have been paid under section 902 (relating to the credit allowed to corporate stockholders of a foreign corporation for taxes paid by such foreign corporation).

(b) *Requirements.* To qualify for the election provided in section 853(a), a regulated investment company (1) must have more than 50 percent of the value of its total assets, at the close of the taxable year for which the election is made, invested in stocks and securities of foreign corporations, and (2) must also, for that year, comply with the requirements prescribed in section 852(a) and paragraph (a) of § 1.852–1. The term ‘‘value’’, for purposes of the first requirement, is defined in section 851(c)(4). For the definition of foreign corporation, see section 7701(a).

§ 1.853–2 Effect of election.

(a) *Regulated investment company.* A regulated investment company making a valid election with respect to a taxable year under the provisions of section 853(a) is, for such year, denied both the deduction for foreign taxes provided by section 164(a) and the credit for foreign taxes provided by section 901 with respect to all income, war-profits, and excess profits taxes (described in section 901(b)(1)) which it has paid to any foreign country or possession of the United States. See section 853(b)(1)(A). However, under section 853(b)(1)(B), the regulated investment company is permitted to add the amount of such foreign taxes paid to its dividends paid deduction for that taxable year. See paragraph (a) of § 1.852–1.

(b) *Shareholder.* Under section 853(b)(2), a shareholder of an investment company, which has made the election under section 853, is, in effect, placed in the same position as a person directly owning stock in foreign corporations, in that he must include in his gross income (in addition to taxable dividends actually received) his proportionate share of such foreign taxes paid and must treat such amount as foreign taxes paid by him for the purposes of the deduction under section 164(a) and the credit under section 901. For such purposes he must treat as gross income from a foreign country or possession of the United States (1) his proportionate share of the taxes paid by the regulated investment company to such foreign country or possession and (2) the portion of any dividend paid by the investment company which represents income derived from such sources.

(c) *Dividends paid after the close of the taxable year.* For additional rules applicable to certain distributions made after the close of the taxable year which may be designated as income received from sources within and taxes paid to foreign countries or possessions of the United States, see section 855(d) and paragraph (f) of §1.855–1.

(d) *Example.* This section may be illustrated as follows:

(1) The X Corporation, a regulated investment company, has total assets, at the close of the taxable year, of $10 million invested as follows:

Domestic corporations		$4,000,000
Foreign corporations in:		
Country A	$3,500,000	
Country B	2,500,000	
		6,000,000
Total assets		10,000,000

(2) The dividend income of X Corporation is received from the following sources:

Domestic corporations		$300,000
Foreign corporations:		
Country A	$250,000	
Country B	250,000	
		500,000
Total dividend income		800,000
Operation and management expenses		80,000
Net dividend income		720,000
Taxes withheld by Country B on dividends of $250,000 at a rate of 10 percent	25,000	
Taxes withheld by Country B on dividends of $250,000 at a rate of 20 percent	50,000	
Total foreign taxes withheld		75,000
Income available for distribution		$645,000

(3) X Corporation has 250,000 shares of common stock outstanding and distributes the entire $645,000 as a dividend of $2.58 per share of stock.

(4) The X Corporation meets the 50 percent requirement of section 851(b)(4) and the requirements of section 852(a). It notifies each shareholder by mail, within the time prescribed by section 853(c), that by reason of the election they are to treat as foreign taxes paid $0.30 per share of stock ($75,000 of foreign taxes paid, divided by the 250,000 shares of stock outstanding), of which $0.20 represents taxes paid to Country B and $0.10 taxes paid to Country A. The shareholders must report as income $2.88 per share ($2.58 of dividends actually received plus the $0.30 representing foreign taxes paid). Of the $2.88 per share, $1.80 per share ($450,000 (which represents such part of the net dividend income of $720,000 as the foreign dividend income of $500,000 bears to the total dividend income of $800,000) divided by 250,000 shares) is to be considered as received from foreign sources. Ninety cents is to be considered as received from Country A, and ninety cents from Country B.

§1.853–3 Notice to shareholders.

(a) *General rule.* If a regulated investment company makes an election under section 853(a), in the manner provided in §1.853–4, the investment company is required, under section 853(c), to furnish its shareholders with a written notice mailed not later than 45 days (30 days for taxable years ending before February 26, 1964) after the close of its taxable year. The notice must designate the shareholder's portion of foreign taxes paid to each such country or possession and the portion of the dividend which represents income derived from sources within each such country or possession. For purposes of section 853(b)(2) and paragraph (b) of §1.853–2, the amount that a shareholder may treat as his proportionate share of foreign taxes paid and the amount to be included as gross income derived from any foreign country or possession of the United States shall not exceed the amounts so designated by the company in such written notice. If, however, the amount designated by the company in the notice exceeds the shareholder's proper proportionate share of foreign taxes or gross income from sources within any foreign country or possession, the shareholder is limited to the amount correctly ascertained.

(b) *Shareholder of record custodian of certain unit investment trusts.* In any case where a notice is mailed pursuant to paragraph (a) of this section by a regulated investment company with respect to a taxable year of the regulated investment company ending after December 8, 1970 to a shareholder of record who is a nominee acting as a custodian of a unit investment trust described in section 851(f)(1) and paragraph (b) of §1.851–7, the nominee shall furnish each holder of an interest in such trust with a written notice mailed on or before the 55th day following the close of the regulated investment company's taxable year. The notice shall designate the holder's proportionate share of the amounts of foreign taxes paid to each such country or possession and the holder's proportionate share of the dividend which represents income derived from sources within each country or possession shown on the notice received by the nominee pursuant to paragraph (a) of this section. The notice shall include the name and address of the nominee identified as such. This paragraph shall not apply if the regulated investment company agrees with the nominee to satisfy the notice requirements of paragraph (a) of this section with respect to each holder of an interest in the unit investment trust whose shares are being held by the nominee as custodian and not later than 45 days following the close of the company's taxable year, files with the Internal Revenue Service office where such company's return for the taxable year is to be filed, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this paragraph shall be deemed met if the regulated investment company transmits a copy of such statement to the nominee within such 45-day period: *Provided however,* if the regulated investment company fails or is unable to satisfy the requirements of this paragraph with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 45 days following the close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this paragraph within 30 days of such notice.

[T.D. 7187, 37 FR 13257, July 6, 1972]

§ 1.853–4 Manner of making election.

(a) *General rule.* A regulated investment company, to make a valid election under section 853, must—

(1) File with Form 1099 and Form 1096 a statement as part of its return which sets forth the following information:

(i) The total amount of income received from sources within foreign countries and possessions of the United States;

(ii) The total amount of income, war profits, or excess profits taxes (described in section 901(b)(1)) paid, or deemed to have been paid under the provisions of any treaty to which the United States is a party, to such foreign countries or possessions;

(iii) The date, form, and contents of the notice to its shareholders;

(iv) The proportionate share of such taxes paid during the taxable year and foreign income received during such year attributable to one share of stock of the regulated investment company; and

(2) File as part of its return for the taxable year a Form 1118 modified so that it becomes a statement in support of the election made by a regulated investment company for taxes paid to a foreign country or a possession of the United States.

(b) *Irrevocability of the election.* The election is applicable only with respect to taxable years subject to the Code, shall be made with respect to all such foreign taxes, and must be made not later than the time prescribed for filing the return (including extensions thereof). Such election, if made, shall be irrevocable with respect to the dividend (or portion thereof), and the foreign taxes paid with respect thereto, to which the election applies.

§ 1.854–1 Limitations applicable to dividends received from regulated investment company.

(a) *In general.* Section 854 provides special limitations applicable to dividends received from a regulated investment company for purposes of the exclusion under section 116 for dividends received by individuals, the deduction under section 243 for dividends received by corporations, and, in the case of dividends received by individuals before January 1, 1965, the credit under section 34.

(b) *Capital gain dividend.* Under the provisions of section 854(a) a capital gain dividend as defined in section 852(b)(3) and paragraph (c) of § 1.852–4 shall not be considered a dividend for purposes of the exclusion under section 116, the deduction under section 243, and, in the case of taxable years ending before January 1, 1965, the credit under section 34.

(c) *Rule for dividends other than capital gain dividends.* (1) Section 854(b)(1) limits the amount that may be treated as a dividend (other than a capital gain dividend) by the shareholder of a regulated investment company, for the purposes of the credit, exclusion, and deduction specified in paragraph (b) of this section, where the investment company receives substantial amounts of income (such as interest, etc.) from sources other than dividends from domestic corporations, which dividends qualify for the exclusion under section 116.

(2) Where the ‘‘aggregate dividends received’’ (as defined in section 854(b)(3)(B) and paragraph (b) of §1.854–3) during the taxable year by a regulated investment company (which meets the requirements of section 852(a) and paragraph (a) of §1.852–1 for the taxable year during which it paid such dividend) are less than 75 percent of its gross income for such taxable year (as defined in section 854(b)(3)(A) and paragraph (a) of §1.854–3), only that portion of the dividend paid by the regulated investment company which bears the same ratio to the amount of such dividend paid as the aggregate dividends received by the regulated investment company, during the taxable year, bears to its gross income for such taxable year (computed without regard to gains from the sale or other disposition of stocks or securities) may be treated as a dividend for purposes of such credit, exclusion, and deduction.

(3) Subparagraph (2) of this paragraph may be illustrated by the following example:

Example. The XYZ regulated investment company meets the requirements of section 852(a) for the taxable year and has received income from the following sources:

Capital gains (from the sale of stock or securities)	$100,000
Dividends (from domestic sources other than dividends described in section 116(b))	70,000
Dividend (from foreign corporations)	5,000
Interest	25,000
Total	200,000
Expenses	20,000
Taxable income	180,000

The regulated investment company decides to distribute the entire $180,000. It distributes a capital gain dividend of $100,000 and a dividend of ordinary income of $80,000. The aggregate dividends received by the regulated investment company from domestic corporations ($70,000) is less than 75 percent of its gross income ($100,000) computed without regard to capital gains from sales of securities. Therefore, an apportionment is required. Since $70,000 is 70 percent of $100,000, out of every $1 dividend of ordinary income paid by the regulated investment company only 70 cents would be available for the credit, exclusion, or deduction referred to in section 854(b)(1). The capital gains dividend and the dividend received from foreign corporations are excluded from the computation.

(d) *Dividends received from a regulated investment company during taxable years of shareholders ending after July 31, 1954, and subject to the Internal Revenue Code of 1939.* For the application of section 854 to taxable years of shareholders of a regulated investment company ending after July 31, 1954, and subject to the Internal Revenue Code of 1939, see §1.34–5 and §1.116–2.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6921, 32 FR 8756, June 20, 1967]

§1.854–2 Notice to shareholders.

(a) *General rule.* Section 854(b)(2) provides that the amount that a shareholder may treat as a dividend for purposes of the exclusion under section 116 for dividends received by individuals, the deduction under section 243 for dividends received by corporation, and, in the case of dividends received by individuals before January 1, 1965, the credit under section 34, shall not exceed the amount so designated by the company in a written notice to its shareholders mailed not later than 45 days (30 days for a taxable year ending before Feb. 26, 1964) after the close of the company’s taxable year. If, however, the amount so designated by the company in the notice exceeds the amount which may be treated by the shareholder as a dividend for such purposes, the shareholder is limited to the amount as correctly ascertained under section 854(b)(1) and paragraph (c) of §1.854–1.

(b) *Shareholder of record custodian of certain unit investment trusts.* In any case where a notice is mailed pursuant to paragraph (a) of this section by a regulated investment company with respect to a taxable year of the regulated investment company ending after December 8, 1970 to a shareholder of record who is a nominee acting as a custodian of a unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851–7, the nominee shall furnish each holder of an interest in such trust with a written notice mailed on or before the 55th day following the close of the regulated investment company's taxable year. The notice shall designate the holder's proportionate share of the amounts that may be treated as a dividend for purposes of the exclusion under section 116 for dividends received by individuals and the deduction under section 243 for dividends received by corporations shown on the notice received by the nominee pursuant to paragraph (a) of this section. This notice shall include the name and address of the nominee identified as such. This paragraph shall not apply if the regulated investment company agrees with the nominee to satisfy the notice requirements of paragraph (a) of this section with respect to each holder of an interest in the unit investment trust whose shares are being held by the nominee as custodian and not later than 45 days following the close of the company's taxable year, files with the Internal Revenue Service office where such company's return is to be filed for the taxable year, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this paragraph shall be deemed met if the regulated investment company transmits a copy of such statement to the nominee within such 45-day period; provided however, if the regulated investment company fails or is unable to satisfy the requirements of this paragraph with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 45 days following the close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this paragraph within 30 days of such notice.

[T.D. 7187, 37 FR 13257, July 6, 1972]

§ 1.854–3 Definitions.

(a) For the purpose of computing the limitation prescribed by section 854(b)(1)(B) and paragraph (c) of § 1.854–1, the term ''gross income'' does not include gain from the sale or other disposition of stock or securities. However, capital gains arising from the sale or other disposition of capital assets, other than stock or securities, shall not be excluded from gross income for this purpose.

(b) The term ''aggregate dividends received'' includes only dividends received from domestic corporations other than dividends described in section 116(b) (relating to dividends not eligible for exclusion from gross income). Accordingly, dividends received from foreign corporations will not be included in the computation of ''aggregate dividends received''. In determining the amount of any dividend for purposes of this section, the rules provided in section 116(c) (relating to certain distributions) shall apply.

§ 1.855–1 Dividends paid by regulated investment company after close of taxable year.

(a) *General rule.* In—

(1) Determining under section 852(a) and paragraph (a) of § 1.852–1 whether the deduction for dividends paid during the taxable year (without regard to capital gain dividends) by a regulated investment company equals or exceeds 90 percent of its investment company taxable income (determined without regard to the provisions of section 852(b)(2)(D)),

(2) Computing its investment company taxable income (under section 852(b)(2) and § 1.852–3), and

(3) Determining the amount of capital gain dividends (as defined in section 852(b)(3) and paragraph (c) of § 1.852–4 paid during the taxable year,

any dividend (or portion thereof) declared by the investment company either before or after the close of the taxable year but in any event before the time prescribed by law for the filing of its return for the taxable year (including the period of any extension of time granted for filing such return) shall, to the extent the company so elects in such return, be treated as having been paid during such taxable year. This rule is applicable only if the entire amount of such dividend is actually distributed to the shareholders in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment made after such declaration.

(b) *Election*—(1) *Method of making election*. The election must be made in the return filed by the company for the taxable year. The election shall be made by the taxpayer (the regulated investment company) by treating the dividend (or portion thereof) to which such election applies as a dividend paid during the taxable year in computing its investment company taxable income, or if the dividend (or portion thereof) to which such election applies is to be designated by the company as a capital gain dividend, in computing the amount of capital gain dividends paid during such taxable year. The election provided in section 855(a) may be made only to the extent that the earnings and profits of the taxable year (computed with the application of section 852(c) and §1.852–5) exceed the total amount of distributions out of such earnings and profits actually made during the taxable year (not including distributions with respect to which an election has been made for a prior year under section 855(a)). The dividend or portion thereof, with respect to which the regulated investment company has made a valid election under section 855(a), shall be considered as paid out of the earnings and profits of the taxable year for which such election is made, and not out of the earnings and profits of the taxable year in which the distribution is actually made.

(2) *Irrevocability of the election*. After the expiration of the time for filing the return for the taxable year for which an election is made under section 855(a), such election shall be irrevocable with respect to the dividend or portion thereof to which it applies.

(c) *Receipt by shareholders*. Under section 855(b), the dividend or portion thereof, with respect to which a valid election has been made, will be includible in the gross income of the shareholders of the regulated investment company for the taxable year in which the dividend is received by them.

(d) *Examples*. The application of paragraphs (a), (b), and (c) of this section may be illustrated by the following examples:

Example 1. The X Company, a regulated investment company, had taxable income (and earnings or profits) for the calendar year 1954 of $100,000. During that year the company distributed to shareholders taxable dividends aggregating $88,000. On March 10, 1955, the company declared a dividend of $37,000 payable to shareholders on March 20, 1955. Such dividend consisted of the first regular quarterly dividend for 1955 of $25,000 plus an additional $12,000 representing that part of the taxable income for 1954 which was not distributed in 1954. On March 15, 1955, the X Company filed its federal income tax return and elected therein to treat $12,000 of the total dividend of $37,000 to be paid to shareholders on March 20, 1955, as having been paid during the taxable year 1954. Assuming that the X Company actually distributed the entire amount of the dividend of $37,000 on March 20, 1955, an amount equal to $12,000 thereof will be treated for the purposes of section 852(a) as having been paid during the taxable year 1954. Such amount ($12,000) will be considered by the X Company as a distribution out of the earnings and profits for the taxable year 1954, and will be treated by the shareholders as a taxable dividend for the taxable year in which such distribution is received by them.

Example 2. The Y Company, a regulated investment company, had taxable income (and earnings or profits) for the calendar year 1954 of $100,000, and for 1955 taxable income (and earnings or profits) of $125,000. On January 1, 1954, the company had a deficit in its earnings and profits accumulated since February 28, 1913, of $115,000. During the year 1954 the company distributed to shareholders taxable dividends aggregating $85,000. On March 5, 1955, the company declared a dividend of $65,000 payable to shareholders on March 31, 1955. On March 15, 1955, the Y Company filed its federal income tax return in which it included $40,000 of the total dividend of $65,000 payable to shareholders on March 31, 1955, as a dividend paid by it during the taxable year 1954. On March 31, 1955, the Y Company distributed the entire amount of the dividend of $65,000 declared on March 5, 1955. The election under section 855(a) is valid only to the extent of $15,000, the amount of the undistributed earnings and profits for 1954 ($100,000 earnings and profits less $85,000 distributed during 1954). The remainder ($50,000) of the $65,000 dividend paid on March 31, 1955, could not be the subject of an election, and such amount will be regarded as a distribution by the Y Company out of earnings and profits for the taxable year 1955. Assuming that the only other distribution by the Y Company during 1955 was a distribution of $75,000 paid as a dividend on October 31, 1955, the total amount of the distribution of $65,000 paid on March 31, 1955, is to be treated by the shareholders as taxable dividends for the taxable year in which such dividend is received. The Y Company will treat the amount of $15,000 as a distribution of the earnings or profits of the company for the taxable year 1954, and the remaining $50,000 as a distribution of the earnings or profits for the year 1955. The distribution of $75,000 on October 31, 1955, is, of course, a taxable dividend out of the earnings and profits for the year 1955.

(e) *Notice to shareholders.* Section 855(c) provides that in the case of dividends, with respect to which a regulated investment company has made an election under section 855(a), any notice to shareholders required under subchapter M, chapter 1 of the Code, with respect to such amounts, shall be made not later than 45 days (30 days for a taxable year ending before February 26, 1964) after the close of the taxable year in which the distribution is made. Thus, the notice requirements of section 852(b)(3)(C) and paragraph (c) of § 1.852–4 with respect to capital gain dividends, section 853(c) and § 1.853–3 with respect to allowance to shareholder of foreign tax credit, and section 854(b)(2) and § 1.854–2 with respect to the amount of a distribution which may be treated as a dividend, may be satisfied with respect to amounts to which section 855(a) and this section apply if the notice relating to such amounts is mailed to the shareholders not later than 45 days (30 days for a taxable year ending before February 26, 1964) after the close of the taxable year in which the distribution is made. If the notice under section 855(c) relates to an election with respect to any capital gain dividends, such capital gain dividends shall be aggregated by the investment company with the designated capital gain dividends actually paid during the taxable year to which the election applies (not including such dividends with respect to which an election has been made for a prior year under section 855) for the purpose of determining whether the aggregate of the designated capital gain dividends with respect to such taxable year of the company is greater than the excess of the net long-term capital gain over the net short-term capital loss of the company. See section 852(b)(3)(C) and paragraph (c) of § 1.852–4.

(f) *Foreign tax election.* Section 855(d) provides that in the case of an election made under section 853 (relating to foreign taxes), the shareholder of the investment company shall consider the foreign income received, and the foreign tax paid, as received and paid, respectively, in the shareholder's taxable year in which distribution is made.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6921, 32 FR 8757, June 20, 1967]

REAL ESTATE INVESTMENT TRUSTS

§ 1.856–0 Revenue Act of 1978 amendments not included.

The regulations under part II of subchapter M of the Code do not reflect the amendments made by the Revenue Act of 1978, other than the changes made by section 362 of the Act, relating to deficiency dividends.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. 856(f)(2)); sec. 856 (g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954; 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 7767, 46 FR 11265, Feb. 6, 1981, as amended by T.D. 7936, 49 FR 2106, Jan. 18, 1984]

§ 1.856–1 Definition of real estate investment trust.

(a) *In general.* The term ''real estate investment trust'' means a corporation, trust, or association which (1) meets the status conditions in section 856(a) and paragraph (b) of this section, and (2) satisfies the gross income and asset diversification requirements under the limitations of section 856(c) and § 1.856–2. (See, however, paragraph

(f) of this section, relating to the requirement that, for taxable years beginning before October 5, 1976, a real estate investment trust must be an unincorporated trust or unincorporated association).

(b) *Qualifying conditions.* To qualify as a ''real estate investment trust'', an organization must be one—

(1) Which is managed by one or more trustees or directors,

(2) The beneficial ownership of which is evidenced by transferable shares or by transferable certificates of beneficial interest,

(3) Which would be taxable as a domestic corporation but for the provisions of part II, subchapter M, chapter 1 of the Code,

(4) Which, in the case of a taxable year beginning before October 5, 1976, does not hold any property (other than foreclosure property) primarily for sale to customers in the ordinary course of its trade or business,

(5) Which is neither (i) a financial institution to which section 585, 586, or 593 applies, nor (ii) an insurance company to which subchapter L applies,

(6) The beneficial ownership of which is held by 100 or more persons, and

(7) Which would not be a personal holding company (as defined in section 542) if all of its gross income constituted personal holding company income (as defined in section 543).

(c) *Determination of status.* The conditions described in subparagraphs (1) through (5) of paragraph (b) of this section must be met during the entire taxable year and the condition described in subparagraph (6) of paragraph (b) of this section must exist during at least 335 days of a taxable year of 12 months or during a proportionate part of a taxable year of less than 12 months. The days during which the latter condition must exist need not be consecutive. In determining the minimum number of days during which the condition described in paragraph (b)(6) of this section is required to exist in a taxable year of less than 12 months, fractional days shall be disregarded. For example, in a taxable year of 310 days, the actual number of days prescribed would be 284 $^{38}/_{73}$ days ($^{310}/_{365}$ of 335). The fractional day is disregarded so that the required condition in such taxable year need exist for only 284 days.

(d) *Rules applicable to status requirements.* For purposes of determining whether an organization meets the conditions and requirements in section 856(a), the following rules shall apply.

(1) *Trustee.* The term ''trustee'' means a person who holds legal title to the property of the real estate investment trust, and has such rights and powers as will meet the requirement of ''centralization of management'' under paragraph (c) of §301.7701–2 of this chapter (Regulations on Procedure and Administration). Thus, the trustee must have continuing exclusive authority over the management of the trust, the conduct of its affairs, and (except as limited by section 856(d)(3) and §1.856–4) the management and disposition of the trust property. For example, such authority will be considered to exist even though the trust instrument grants to the shareholders any or all of the following rights and powers: To elect or remove trustees; to terminate the trust; and to ratify amendments to the trust instrument proposed by the trustee. The existence of a mere fiduciary relationship does not, in itself, make one a trustee for purposes of section 856(a)(1). The trustee will be considered to hold legal title to the property of the trust, for purposes of this subparagraph, whether the title is held in the name of the trust itself, in the name of one or more of the trustees, or in the name of a nominee for the exclusive benefit of the trust.

(2) *Beneficial ownership.* Beneficial ownership shall be evidenced by transferable shares, or by transferable certificates of beneficial interest, and (subject to the provisions of paragraph (c) of this section) must be held by 100 or more persons, determined without reference to any rules of attribution. Provisions in the trust instrument or corporate charter or bylaws which permit the trustee or directors to redeem shares or to refuse to transfer shares in any case where the trustee or directors, in good faith, believe that a failure to redeem shares or that a transfer of shares would result in the loss of status as a real estate investment trust

will not render the shares ‘‘non-transferable.’’ For purposes of the regulations under part II of subchapter M, the terms ‘‘stockholder,’’ ‘‘stockholders,’’ ‘‘shareholder,’’ and ‘‘shareholders’’ include holders of beneficial interest in a real estate investment trust, the terms ‘‘stock,’’ ‘‘shares,’’ and ‘‘shares of stock’’ include certificates of beneficial interest, and the term ‘‘shares’’ includes shares of stock.

(3) *Unincorporated organization taxable as a domestic corporation.* The determination of whether an unincorporated organization would be taxable as a domestic corporation, in the absence of the provisions of part II of subchapter M, shall be made in accordance with the provisions of section 7701(a) (3) and (4) and the regulations thereunder and for such purposes an otherwise qualified real estate investment trust is deemed to satisfy the ‘‘objective to carry on business’’ requirement of paragraph (a) of §301.7701–2 of this chapter. (Regulations on Procedure and Administration).

(4) *Property held for sale to customers.* In the case of a taxable year beginning before October 5, 1976, a real estate investment trust may not hold any property (other than foreclosure property) primarily for sale to customers in the ordinary course of its trade or business. Whether property is held for sale to customers in the ordinary course of the trade or business of a real estate investment trust depends upon the facts and circumstances in each case.

(5) *Personal holding company.* A corporation, trust, or association, even though it may otherwise meet the requirements of part II of subchapter M, will not be a real estate investment trust if, by considering all of its gross income as personal holding company income under section 543, it would be a personal holding company as defined in section 542. Thus, if at any time during the last half of the trust’s taxable year more than 50 percent in value of its outstanding stock is owned (directly or indirectly under the provisions of section 544) by or for not more than 5 individuals, the stock ownership requirement in section 542(a)(2) will be met and the trust would be a personal holding company. See §1.857–8, relating to record requirements for purposes of determining whether the trust is a personal holding company.

(e) *Other rules applicable.* To the extent that other provisions of chapter 1 of the Code are not inconsistent with those under part II of subchapter M there of and the regulations thereunder, such provisions will apply with respect to both the real estate investment trust and its shareholders in the same manner that they would apply to any other organization which would be taxable as a domestic corporation. For example:

(1) Taxable income of a real estate investment trust is computed in the same manner as that of a domestic corporation;

(2) Section 301, relating to distributions of property, applies to distributions by a real estate investment trust in the same manner as it would apply to a domestic corporation;

(3) Sections 302, 303, 304, and 331 are applicable in determining whether distributions by a real estate investment trust are to be treated as in exchange for stock;

(4) Section 305 applies to distributions by a real estate investment trust of its own stock;

(5) Section 311 applies to distributions by a real estate investment trust;

(6) Except as provided in section 857(d), earnings and profits of a real estate investment trust are computed in the same manner as in the case of a domestic corporation;

(7) Section 316, relating to the definition of a dividend, applies to distributions by a real estate investment trust; and

(8) Section 341, relating to collapsible corporations, applies to gain on the sale or exchange of, or a distribution which is in exchange for, stock in a real estate investment trust in the same manner that it would apply to a domestic corporation.

(f) *Unincorporated status required for certain taxable years.* In the case of a taxable year beginning before October 5, 1976, a real estate investment trust must be an unincorporated trust or unincorporated association. Accordingly, in applying the regulations under part II of subchapter M of the Code with respect to such a taxable year, the term ''an unincorporated trust or unincorporated association'' is to be substituted for the term ''a corporation, trust, or association'' each place it appears, and the references to ''directors'' and ''corporate charter or bylaws'' are to be disregarded.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. 856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917, 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 6598, 27 FR 4082, Apr. 28, 1962, as amended by T.D. 6928, 32 FR 13221, Sept. 19, 1967; T.D. 7767, 46 FR 11265, Feb. 6, 1981]

§1.856–2 Limitations.

(a) *Effective date.* The provisions of part II, subchapter M, chapter 1 of the Code, and the regulations thereunder apply only to taxable years of a real estate investment trust beginning after December 31, 1960.

(b) *Election.* Under the provisions of section 856(c)(1), a trust, even though it satisfies the other requirements of part II of subchapter M for the taxable year, will not be considered a ''real estate investment trust'' for such year, within the meaning of such part II, unless it elects to be a real estate investment trust for such taxable year, or has made such an election for a previous taxable year which has not been terminated or revoked under section 856(g)(1) or (2). The election shall be made by the trust by computing taxable income as a real estate investment trust in its return for the first taxable year for which it desires the election to apply, even though it may have otherwise qualified as a real estate investment trust for a prior year. No other method of making such election is permitted. An election cannot be revoked with respect to a taxable year beginning before October 5, 1976. Thus, the failure of an organization to be a qualified real estate investment trust for a taxable year beginning before October 5, 1976, does not have the effect of revoking a prior election by the organization to be a real estate investment trust, even though the organization is not taxable under part II of subchapter M for such taxable year. See section 856(g) and §1.856–8 for rules under which an election may be revoked with respect to taxable years beginning after October 4, 1976.

(c) *Gross income requirements.* Section 856(c) (2), (3), and (4), provides that a corporation, trust, or association is not a ''real estate investment trust'' for a taxable year unless it meets certain requirements with respect to the sources of its gross income for the taxable year. In determining whether the gross income of a real estate investment trust satisfies the percentage requirements of section 856(c) (2), (3), and (4), the following rules shall apply:

(1) *Gross income.* For purposes of both the numerator and denominator in the computation of the specified percentages, the term ''gross income'' has the same meaning as that term has under section 61 and the regulations thereunder. Thus, in determining the gross income requirements under section 856(c) (2), (3), and (4), a loss from the sale or other disposition of stock, securities, real property, etc. does not enter into the computation.

(2) *Lapse of options.* Under section 856(c)(6)(C), the term ''interests in real property'' includes options to acquire land or improvements thereon, and options to acquire leaseholds of land and improvements thereon. However, where a corporation, trust, or association writes an option giving the holder the right to acquire land or improvements thereon, or writes an option giving the holder the right to acquire a leasehold of land or improvements thereon, any income that the corporation, trust, or association recognizes because the option expires unexercised is not considered to be gain from the sale or other disposition of real property (including interests in real property) for purposes of section 856(c) (2)(D) and (3)(C). The rule in the preceding sentence also applies for purposes of section 856(c)(4)(C) in determining gain from the sale or other disposition of real property for the 30-percent-of-gross-income limitation.

(3) *Commitment fees.* For purposes of section 856(c) (2)(G) and (3)(G), if consideration is received or accrued for an agreement to make a loan secured by a mortgage covering both real property and other property, or for an agreement to purchase or lease both real property and other property, an apportionment of the consideration is required. The apportionment of consideration received or accrued for an agreement to make a loan secured by a mortgage covering both real property and other property shall be made under the principles of § 1.856–5(c), relating to the apportionment of interest income.

(4) *Holding period of property.* For purposes of the 30-percent limitation of section 856(c)(4), the determination of the period for which property described in such section has been held is governed by the provisions of section 1223 and the regulations thereunder.

(5) *Rents from real property and interest.* See §§ 1.856–4 and 1.856–5 for rules relating to rents from real property and interest.

(d) *Diversification of investment requirements*—(1) *75-percent test.* Section 856(c)(5)(A) requires that at the close of each quarter of the taxable year at least 75 percent of the value of the total assets of the trust be represented by one or more of the following:

(i) Real estate assets;

(ii) Government securities; and

(iii) Cash and cash items (including receivables).

For purposes of this subparagraph the term ''receivables'' means only those receivables which arise in the ordinary course of the trust's operation and does not include receivables purchased from another person. Subject to the limitations in section 856(c)(5)(B) and subparagraph (2) of this paragraph, the character of the remaining 25 percent (or less) of the value of the total assets is not restricted.

(2) *Limitations on certain securities.* Under section 856(c)(5)(B), not more than 25 percent of the value of the total assets of the trust may be represented by securities other than those described in section 856(c)(5)(A). The ownership of securities under the 25-percent limitation in section 856(c)(5)(B) is further limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the trust and to not more than 10 percent of the outstanding voting securities of such issuer. Thus, if the real estate investment trust meets the 75-percent asset diversification requirement in section 856(c)(5)(A), it will also meet the first test under section 856(c)(5)(B) since it will, of necessity, have not more than 25 percent of its total assets represented by securities other than those described in section 856(c)(5)(A). However, the trust must also meet two additional tests under section 856(c)(5)(B), i.e. it cannot own the securities of any one issuer in an amount (i) greater in value than 5 percent of the value of the trust's total assets, or (ii) representing more than 10 percent of the outstanding voting securities of such issuer.

(3) *Determination of investment status.* The term ''total assets'' means the gross assets of the trust determined in accordance with generally accepted accounting principles. In order to determine the effect, if any, which an acquisition of any security or other property may have with respect to the status of a trust as a real estate investment trust, section 856(c)(5) requires a revaluation of the trust's assets at the end of the quarter in which such acquisition was made. A revaluation of assets is not required at the end of any quarter during which there has been no acquisition of a security or other property since the mere change in market value of property held by the trust does not, of itself, affect the status of the trust as a real estate investment trust. A change in the nature of ''cash items'', for example, the prepayment of insurance or taxes, does not constitute the acquisition of ''other property'' for purposes of this subparagraph. A real estate investment trust shall keep sufficient records as to investments so as to be able to show that it has complied with the provisions of section 856(c)(5) during the taxable year. Such records shall be kept at all times available for inspection by any internal revenue officer or employee and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(4) *Illustrations.* The application of section 856(c)(5) and this paragraph may be illustrated by the following examples:

Example 1. Real Estate Investment Trust M, at the close of the first quarter of its taxable year, has its assets invested as follows:

	Percent
Cash	6
Government securities	7
Real estate assets	63
Securities of various corporations (not exceeding, with respect to any one issuer, 5 percent of the value of the total assets of the trust nor 10 percent of the outstanding voting securities of such issuer)	24
Total	100

Trust M meets the requirements of section 856(c)(5) for that quarter of its taxable year.

Example 2. Real Estate Investment Trust P, at the close of the first quarter of its taxable year, has its assets invested as follows:

	Percent
Cash	6
Government securities	7
Real estate assets	63
Securities of Corporation Z	20
Securities of Corporation X	4
Total	100

Trust P meets the requirement of section 856(c)(5)(A) since at least 75 percent of the value of the total assets is represented by cash, Government securities, and real estate assets. However, Trust P does not meet the diversification requirements of section 856(c)(5)(B) because its investment in the voting securities of Corporation Z exceeds 5 percent of the value of the trust's total assets.

Example 3. Real Estate Investment Trust G, at the close of the first quarter of its taxable year, has its assets invested as follows:

	Percent
Cash	4
Government securities	9
Real estate assets	70
Securities of Corporation S	5
Securities of Corporation L	4
Securities of Corporation U	4
Securities of Corporation M (which equals 25 percent of Corporation M's outstanding voting securities)	4
Total	100

Trust G meets the 75-percent requirement of section 856(c)(5)(A), but does not meet the requirements of section 856(c)(5)(B) because its investment in the voting securities of Corporation M exceeds 10 percent of Corporation M's outstanding voting securities.

Example 4. Real Estate Investment Trust R, at the close of the first quarter of its taxable year (i.e. calendar year), is a qualified real estate investment trust and has its assets invested as follows:

Cash	$5,000
Government securities	4,000
Receivables	4,000
Real estate assets	68,000
Securities of Corporation P	4,000
Securities of Corporation O	5,000
Securities of Corporation U	5,000
Securities of Corporation T	5,000
Total assets	100,000

During the second calendar quarter the stock in Corporation P increases in value to $50,000 while the value of the remaining assets has not changed. If Real Estate Investment Trust R has made no acquisition of stock or other property during such second quarter it will not lose its status as a real estate investment trust merely by reason of the appreciation in the value of P's stock. If, during the third quarter, Trust R acquires stock of Corporation S worth $2,000, such acquisition will necessitate a revaluation of all of the assets of Trust R as follows:

Cash	$3,000
Government securities	4,000
Receivables	4,000
Real estate assets	68,000
Securities in Corporation P	50,000
Securities in Corporation O	5,000
Securities in Corporation U	5,000
Securities in Corporation T	5,000
Securities in Corporation S	2,000
Total assets	146,000

Because of the discrepancy between the value of its various investments and the 25-percent limitation in section 856(c)(5), resulting in part from the acquisition of the stock of Corporation S, Trust R, at the end of the third quarter, loses its status as a real estate investment trust. However, if Trust R, within 30 days after the close of such quarter, eliminates the discrepancy so that it meets the 25-percent limitation, the trust will be considered to have met the requirements of section 856(c)(5) at the close of the third quarter, even though the discrepancy between the value of its investment in Corporation P and the 5-percent limitation in section 856(c)(5) (resulting solely from appreciation) may still exist. If instead of acquiring stock of Corporation S, Trust R had acquired additional stock of Corporation P, then because of the discrepancy between the value of its investments and both the 5-percent and the 25-percent limitations in section 856(c)(5) resulting in part from this acquisition, trust R, at the end of the third quarter, would lose its status as a real estate investment trust, unless within 30 days after the close of such quarter both of the discrepancies are eliminated.

Example 5. If, in the previous example, the stock of Corporation P appreciates only to $10,000 during the second quarter and, in the third quarter, Trust R acquires stock of Corporation S worth $1,000, the assets as of the end of the third quarter would be as follows:

Cash	$4,000
Government securities	4,000
Receivables	4,000
Real estate assets	68,000
Securities in Corporation P	10,000
Securities in Corporation O	5,000
Securities in Corporation U	5,000
Securities in Corporation T	5,000
Securities in Corporation S	1,000
Total assets	106,000

Because the discrepancy between the value of its investment in Corporation P and the 6-percent limitation in section 856(c)(5) results solely from appreciation, and because there is no discrepancy between the value of its various investments and the 25-percent limitation, Trust R, at the end of the third quarter, does not lose its status as a real estate investment trust. If, instead of acquiring stock of Corporation S, Trust R had acquired additional stock of Corporation P worth $1,000, then, because of the discrepancy between the value of its investment in Corporation P and the 5-percent limitation resulting in part from this acquisition, Trust R, at the end of the third quarter, would lose its status as a real estate investment trust, unless within 30 days after the close of such quarter this discrepancy is eliminated.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. 856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001); (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 6598, 27 FR 4083, Apr. 28, 1962 as amended by T.D. 7767, 46 FR 11265, Feb. 6, 1981]

§ 1.856–3 Definitions.

For purposes of the regulations under part II, subchapter M, chapter 1 of the Code, the following definitions shall apply.

(a) *Value.* The term ‘‘value’’ means, with respect to securities for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the trustees of the real estate investment trust. In the case of securities of other qualified real estate investment trusts, fair value shall not exceed market value or asset value, whichever is higher.

(b) *Real estate assets*—(1) *In general.* The term ‘‘real estate assets’’ means real property, interests in mortgages on real property (including interests in mortgages on leaseholds of land or improvements thereon), and shares in other qualified real estate investment trusts. The term ‘‘mortgages on real property’’ includes deeds of trust on real property.

(2) *Treatment of REMIC interests as real estate assets*—(i) *In general.* If, for any calendar quarter, at least 95 percent of a REMIC's assets (as determined in accordance with § 1.860F–4(e)(1)(ii) or § 1.6049–7(f)(3)) are real estate assets (as defined in paragraph (b)(1) of this section), then, for that calendar quarter, all the regular and residual interests in that REMIC are treated as real estate assets and, except as provided in paragraph (b)(2)(iii) of this section, any amount includible in gross income with respect to those interests is treated as interest on obligations secured by mortgages on real property. If less than 95 percent of a REMIC's assets are real estate assets, then the real estate investment trust is treated as holding directly its proportionate share of the assets and as receiving directly its proportionate share of the income of the REMIC. See §§ 1.860F–4(e)(1)(ii)(B) and 1.6049–7(f)(3) for information required to be provided to regular and residual interest holders if the 95-percent test is not met.

(ii) *Treatment of REMIC assets for section 856 purposes*—(A) *Manufactured housing treated as real estate asset.* For purposes of paragraphs (b) (1) and (2) of this section, the term ‘‘real estate asset’’ includes manufactured housing treated as a single family residence under section 25(e)(10).

(B) *Status of cash flow investments.* For purposes of this paragraph (b)(2), cash flow investments (as defined in section 860G(a)(6) and § 1.860G–2(g)(1)) are real estate assets.

(iii) *Certain contingent interest payment obligations held by a REIT.* If a REIT holds a residual interest in a REMIC for a principal purpose of avoiding the limitation set out in section 856(f) (concerning interest based on mortgagor net profits) or section 856(j) (concerning shared appreciation provisions), then, even if the REMIC satisfies the 95-percent test of paragraph (b)(i) of this section, the REIT is treated as receiving directly the REMIC's items of income for purposes of section 856.

(c) *Interests in real property.* The term ''interests in real property'' includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon. The term also includes timeshare interests that represent an undivided fractional fee interest, or undivided leasehold interest, in real property, and that entitle the holders of the interests to the use and enjoyment of the property for a specified period of time each year. The term also includes stock held by a person as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216). Such term does not, however, include mineral, oil, or gas royalty interests, such as a retained economic interest in coal or iron ore with respect to which the special provisions of section 631(c) apply.

(d) *Real property.* The term ''real property'' means land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). In addition, the term ''real property'' includes interests in real property. Local law definitions will not be controlling for purposes of determining the meaning of the term ''real property'' as used in section 856 and the regulations thereunder. The term includes, for example, the wiring in a building, plumbing systems, central heating, or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though such items may be termed fixtures under local law.

(e) *Securities.* The term ''securities'' does not include ''interests in real property'' or ''real estate assets'' as those terms are defined in section 856 and this section.

(f) *Qualified real estate investment trusts.* The term ''qualified real estate investment trust'' means a real estate investment trust within the meaning of part II of subchapter M which is taxable under such part as a real estate investment trust. For purposes of the 75-percent requirement in section 856(c)(5)(A), the trust whose stock has been included by another trust as ''real estate assets'' must be a ''qualified real estate investment trust'' for its full taxable year in which falls the close of each quarter of the trust's taxable year for which the computation is made. For example, Real Estate Investment Trust Z for its taxable year ending December 31, 1963, holds as ''real estate assets'' stock in Real Estate Investment Trust Y, which is also on a calendar year. If Trust Y is not a qualified real estate investment trust for its full taxable year ending December 31, 1963, Trust Z may not include the stock of Trust Y as ''real estate assets'' in computing the 75-percent requirement as of the close of any quarter of its taxable year ending December 31, 1963.

(g) *Partnership interest.* In the case of a real estate investment trust which is a partner in a partnership, as defined in section 7701(a)(2) and the regulations thereunder, the trust will be deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. For purposes of section 856, the interest of a partner in the partnership's assets shall be determined in accordance with his capital interest in the partnership. The character of the various assets in the hands of the partnerhsip and items of gross income of the partnership shall retain the same character in the hands of the partners for all purposes of section 856.

Thus, for example, if the trust owns a 30-percent capital interest in a partnership which owns a piece of rental property the trust will be treated as owning 30 percent of such property and as being entitled to 30 percent of the rent derived from the property by the partnership. Similarly, if the partnership holds any property primarily for sale to customers in the ordinary course of its trade or business, the trust will be treated as holding its proportionate share of such property primarily for such purpose. Also, for example, where a partnership sells real property or a trust sells its interest in a partnership which owns real property, any gross income realized from such sale, to the extent that it is attributable to the real property, shall be deemed gross income from the sale or disposition of real property held for either the period that the partnership has held the real property of the period that the trust was a member of the partnership, whichever is the shorter.

(h) *Net capital gain.* The term ''net capital gain'' means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the taxable year.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. 856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 6598, 27 FR 4084, Apr. 28, 1962, as amended by T.D. 6841, 30 FR 9308, July 27, 1965; T.D. 7767, 46 FR 11266, Feb. 6, 1981; T.D. 8458, 57 FR 61298, Dec. 24, 1992]

§ 1.856–4 Rents from real property.

(a) *In general.* Subject to the exceptions of section 856(d) and paragraph (b) of this section, the term ''rents from real property'' means, generally, the gross amounts received for the use of, or the right to use, real property of the real estate investment trust.

(b) *Amounts specifically included or excluded*—(1) *Charges for customary services.* For taxable years beginning after October 4, 1976, the term ''rents from real property'', for purposes of paragraphs (2) and (3) of section 856(c), includes charges for services customarily furnished or rendered in connection with the rental of real property, whether or not the charges are separately stated. Services furnished to the tenants of a particular building will be considered as customary if, in the geographic market in which the building is located, tenants in buildings which are of a similar class (such as luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air-conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance and of janitorial and cleaning services, the collection of trash, and the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard services, parking facilities, and swimming pool facilities are examples of services which are customarily furnished to the tenants of a particular class of buildings in many geographic marketing areas. Where it is customary, in a particular geographic marketing area, to furnish electricity or other utilities to tenants in buildings of a particular class, the submetering of such utilities to tenants in such buildings will be considered a customary service. To qualify as a service customarily furnished, the service must be furnished or rendered to the tenants of the real estate investment trust or, primarily for the convenience or benefit of the tenant, to the guests, customers, or subtenants of the tenant. The service must be furnished through an independent contractor from whom the trust does not derive or receive any income. See paragraph (b)(5) of this section. For taxable years beginning before October 5, 1976, the rules in paragraph (b)(3) of 26 CFR 1.856–4 (revised as of April 1, 1977), relating to the furnishing of services, shall continue to apply.

(2) *Amounts received with respect to certain personal property*—(i) *In general.* In the case of taxable years beginning after October 4, 1976, rent attributable to personal property that is leased under, or in connection with, the lease

of real property is treated under section 856(d)(1)(C) as ‘‘rents from real property’’ (and thus qualified for purposes of the income source requirements) if the rent attributable to the personal property is not more than 15 percent of the total rent received or accrued under the lease for the taxable year. If, however, the rent attributable to personal property is greater than 15 percent of the total rent received or accrued under the lease for the taxable year, then the portion of the rent from the lease that is attributable to personal property will not qualify as ‘‘rents from real property’’.

(ii) *Application.* In general, the 15-percent test in section 856(d)(1)(C) is applied separately to each lease of real property. However, where the real estate investment trust rents all (or a portion of all) the units in a multiple unit project under substantially similar leases (such as the leasing of apartments in an apartment building or complex to individual tenants), the 15-percent test may be applied with respect to the aggregate rent received or accrued for the taxable year under the similar leases of the property, by using the average of the trust’s aggregate adjusted bases of all of the personal property subject to such leases, and the average of the trust’s aggregate adjusted bases of all real and personal property subject to such leases. A lease of a furnished apartment is not considered to be substantially similar to a lease of an unfurnished apartment (including an apartment where the trust provides only personal property, such as major appliances, that is commonly provided by a landlord in connection with the rental of unfurnished living quarters).

(iii) *Taxable years beginning before October 5, 1976.* In the case of taxable years beginning before October 5, 1976, any amount of rent that is attributable to personal property does not qualify as rent from real property.

(3) *Disqualification of rent which depends on income or profits of any person.* Except as provided in paragraph (b)(6)(ii) of this section, no amount received or accrued, directly or indirectly, with respect to any real property (or personal property leased under, or in connection with, real property) qualifies as ‘‘rents from real property’’ where the determination of the amount depends in whole or in part on the income or profits derived by any person from the property. However, any amount so accured or received shall not be excluded from the term ‘‘rents from real property’’ solely by reason of being based on a fixed percentage or percentages of receipts or sales (whether or not receipts or sales are adjusted for returned merchandise, or Federal, State, or local sales taxes). Thus, for example, ‘‘rents from real property’’ would include rents where the lease provides for differing percentages or receipts or sales from different departments or from separate floors of a retail store so long as each percentage is fixed at the time of entering into the lease and a change in such percentage is not renegotiated during the term of the lease (including any renewal periods of the lease, in a manner which has the effect of basing the rent on income of profits. See paragraph (b)(6) of this section for rules relating to certain amounts received or accrued by a trust which are considered to be based on the income or profits of a sublessee of the prime tenant. The amount received or accrued as rent for the taxable year which is based on a fixed percentage or percentages of the lessee’s receipts or sales reduced by escalation receipts (including those determined under a formula clause) will qualify as ‘‘rents from real property’’. Escalation receipts include amounts received by a prime tenant from subtenants by reason of an agreement that rent shall be increased to reflect all or a portion of an increase in real estate taxes, property insurance, operating costs of the prime tenant, or similar items customarily included in lease escalation clauses. Where in accordance with the terms of an agreement an amount received or accrued as rent for the taxable year includes both a fixed rental and a percentage of all or a portion of the lessee’s income or profits, neither the fixed rental nor the additional amount will qualify as ‘‘rents from real property’’. However, where the amount received or accrued for the taxable year under such an agreement includes only the fixed rental, the determination of which does not depend in whole

or in part on the income or profits derived by the lessee, such amount may qualify as ‘‘rents from real property’’. An amount received or accrued as rent for the taxable year which consists, in whole or in part, of one or more percentages of the lessee's receipts or sales in excess of determinable dollar amounts may qualify as ‘‘rents from real property’’, but only if two conditions exist. First, the determinable amounts must not depend in whole or in part on the income or profits of the lessee. Second, the percentages and, in the case of leases entered into after July 7, 1978, the determinable amounts, must be fixed at the time the lease is entered into and a change in percentages and determinable amounts is not renegotiated during the term of the lease (including any renewal periods of the lease) in a manner which has the effect of basing rent on income or profits. In any event, an amount will not qualify as ‘‘rents from real property’’ if, considering the lease and all the surrounding circumstances, the arrangement does not conform with normal business practice but is in reality used as a means of basing the rent on income or profits. The provisions of this subparagraph may be illustrated by the following example:

Example. A real estate investment trust owns land underlying an office building. On January 1, 1975, the trust leases the land for 50 years to a prime tenant for an annual rental of $100x plus 20 percent of the prime tenant's annual gross receipts from the office building in excess of a fixed base amount of $5,000x and 10 percent of such gross receipts in excess of $10,000x. For this purpose the lease defines gross receipts as all amounts received by the prime tenant from occupancy tenants pursuant to leases of space in the office building reduced by the amount by which real estate taxes, property insurance, and operating costs related to the office building for a particular year exceed the amount of such items for 1974. The exclusion from gross receipts of increases since 1974 in real estate taxes, property insurance, and other expenses relating to the office building reflects the fact that the prime tenant passes on to occupancy tenants by way of a customary lease escalation provision the risk that such expenses might increase during the term of an occupancy lease. The exclusion from gross receipts of these expense escalation items will not cause the rental received by the real estate investment trust from the prime tenant to fail to qualify as ‘‘rents from real property’’ for purposes of section 856(c).

(4) *Disqualification of amounts received from persons owned in whole or in part by the trust.* ‘‘Rents from real property’’ does not include any amount received or accrued, directly or indirectly, from any person in which the real estate investment trust owns, at any time during the taxable year, the specified percentage or number of shares of stock (or interest in the assets or net profits) of that person. Any amount received from such person will not qualify as ‘‘rents from real property’’ if such person is a corporation and the trust owns 10 percent or more of the total combined voting power of all classes of its stock entitled to vote or 10 percent or more of the total number of shares of all classes of its outstanding stock, or if such person is not a corporation and the trust owns a 10-percent-or-more interest in its assets or net profits. For example, a trust leases an office building to a tenant for which it receives rent of $100,000 for the taxable year 1962. The lessee of the building subleases space to various subtenants for which it receives gross rent of $500,000 for the year 1962. The trust owns 15 percent of the total assets of an unincorporated subtenant. The rent paid by this subtenant for the taxable year is $50,000. Therefore, $10,000 (50,000/500,000×$100,000) of the rent paid to the trust does not qualify as ‘‘rents from real property’’. Where the real estate investment trust receives, directly or indirectly, any amount of rent from any person in which it owns any proprietary interest, the trust shall submit, at the time it files its return for the taxable year (or before June 1, 1962, whichever is later), a schedule setting forth—

(i) The name and address of such person and the amount received as rent from such person; and

(ii) If such person is a corporation, the highest percentage of the total combined voting power of all classes of its stock entitled to vote, and the highest percentage of the total number of shares of all classes of its outstanding stock, owned by the trust at any time during the trust's taxable year; or

(iii) If such person is not a corporation, the highest percentage of the trust's interest in the assets or net profits of such person, owned by the trust at any time during its taxable year.

(5) *Furnishing of services or management of property must be through an independent contractor*—(i) *In general.* No amount received or accrued, directly or indirectly, with respect to any real property (or any personal property leased under, or in connection with, the real property) qualifies as ''rents from real property'' if the real estate investment trust furnishes or renders services to the tenants of the property or manages or operates the property, other than through an independent contractor from whom the trust itself does not derive or receive any income. The prohibition against the trust deriving or receiving any income from the independent contractor applies regardless of the source from which the income was derived by the independent contractor. Thus, for example, the trust may not receive any dividends from the independent contractor. The requirement that the trust not receive any income from an independent contractor requires that the relationship between the two be an arm's-length relationship. The independent contractor must be adequately compensated for any services which are performed for the trust. Compensation to an independent contractor determined by reference to an unadjusted percentage of gross rents will generally be considered to be adequate where the percentage is reasonable taking into account the going rate of compensation for managing similar property in the same locality, the services rendered, and other relevant factors. The independent contractor must not be an employee of the trust (*i.e.,* the manner in which he carries out his duties as independent contractor must not be subject to the control of the trust). Although the cost of services which are customarily rendered or furnished in connection with the rental of real property may be borne by the trust, the services must be furnished or rendered through an independent contractor. Furthermore, the facilities through which the services are furnished must be maintained and operated by an independent contractor. For example, if a heating plant is located in the building, it must be maintained and operated by an independent contractor. To the extent that services (other than those customarily furnished or rendered in connection with the rental of real property) are rendered to the tenants of the property by the independent contractor, the cost of the services must be borne by the independent contractor, a separate charge must be made for the services, the amount of the separate charge must be received and retained by the independent contractor, and the independent contractor must be adequately compensated for the services.

(ii) *Trustee or director functions.* The trustees or directors of the real estate investment trust are not required to delegate or contract out their fiduciary duty to manage the trust itself, as distinguished from rendering or furnishing services to the tenants of its property or managing or operating the property. Thus, the trustees or directors may do all those things necessary, in their fiduciary capacities, to manage and conduct the affairs of the trust itself. For example, the trustees or directors may establish rental terms, choose tenants, enter into and renew leases, and deal with taxes, interest, and insurance, relating to the trust's property. The trustees or directors may also make capital expenditures with respect to the trust's property (as defined in section 263) and may make decisions as to repairs of the trust's property (of the type which would be deductible under section 162), the cost of which may be borne by the trust.

(iii) *Independent contractor defined.* The term ''independent contractor'' means—

(a) A person who does not own, directly or indirectly, at any time during the trust's taxable year more than 35 percent of the shares in the real estate investment trust, or

(b) A person—

(1) If a corporation, not more than 35 percent of the total combined voting power of whose stock (or 35 percent of the total shares of all classes of whose stock), or

(2) If not a corporation, not more than 35 percent of the interest in whose assets or net profits is owned, directly or indirectly, at any time during the

trust's taxable year by one or more persons owning at any time during such taxable year 35 percent or more of the shares in the trust.

(iv) *Information required.* The real estate investment trust shall submit with its return for the taxable year (or before June 1, 1962, whichever is later) a statement setting forth the name and address of each independent contractor; and

(a) The highest percentage of the outstanding shares in the trust owned at any time during its taxable year by such independent contractor and by any person owning at any time during such taxable year any shares of stock or interest in the independent contractor.

(b) If the independent contractor is a corporation such statement shall set forth the highest percentage of the total combined voting power of its stock and the highest percentage of the total number of shares of all classes of its stock owned at any time during its taxable year by any person owning shares in the trust at any time during such taxable year.

(c) If the independent contractor is not a corporation such statement shall set forth the highest percentage of any interest in its assets or net profits owned at any time during its taxable year by any person owning shares in the trust at any time during such taxable year.

(6) *Amounts based on income or profits of subtenants.* (i) Except as provided in paragraph (b)(6)(ii) of this section, if a trust leases real property to a tenant under terms other than solely on a fixed sum rental (for example, a percentage of the tenant's gross receipts), and the tenant subleases all or a part of such property under an agreement which provides for a rental based in whole or in part on the income or profits of the sublessee, the entire amount of the rent received by the trust from the prime tenant with respect to such property is disqualified as ‘‘rents from real property’’.

(ii) *Exception.* For taxable years beginning after October 4, 1976, section 856(d)(4) provides an exception to the general rule that amounts received or accrued, directly or indirectly, by a real estate investment trust do not qualify as rents from real property if the determination of the amount depends in whole or in part on the income or profits derived by any person from the property. This exception applies where the trust rents property to a tenant (the prime tenant) for a rental which is based, in whole or in part, on a fixed percentage or percentages of the receipts or sales of the prime tenant, and the rent which the trust receives or accrues from the prime tenant pursuant to the lease would not qualify as ‘‘rents from real property’’ solely because the prime tenant receives or accrues from subtenants (including concessionaires) rents or other amounts based on the income or profits derived by a person from the property. Under the exception, only a proportionate part of the rent received or accrued by the trust does not qualify as ‘‘rents from real property’’. The proportionate part of the rent received or accrued by the trust which is nonqualified is the lesser of the following two amounts:

(A) The rent received or accrued by the trust from the prime tenant pursuant to the lease, that is based on a fixed percentage or percentages of receipts or sales, or

(B) The product determined by multiplying the total rent which the trust receives or accrues from the prime tenant pursuant to the lease by a fraction, the numerator of which is the rent or other amount received by the prime tenant that is based, in whole or in part, on the income or profits derived by any person from the property, and the denominator of which is the total rent or other amount received by the prime tenant from the property. For example, assume that a real estate investment trust owns land underlying a shopping center. The trust rents the land to the owner of the shopping center for an annual rent of $10x plus 2 percent of the gross receipts which the prime tenant receives from subtenants who lease space in the shopping center. Assume further that, for the year in question, the prime tenant derives total rent from the shopping center of $100x and, of that amount, $25x is received from subtenants whose rent is based, in whole or in part, on the income or profits derived from the property. Accordingly, the trust will receive a total rent of $12x, of which $2x is based on a percentage of the gross receipts of the prime tenant. The portion of the rent which is disqualified is the lesser of $2x (the rent received by the trust which is based on a percentage of gross receipts), or $3x, ($12x multiplied by $25x/$100x). Accordingly, $10x of the rent received by the trust qualifies as ''rents from real property'' and $2x does not qualify.

(7) *Attribution rules.* Paragraphs (2) and (3) of section 856(d) relate to direct or indirect ownership of stock, assets, or net profits by the persons described therein. For purposes of determining such direct or indirect ownership, the rules prescribed by section 318(a) (for determining the ownership of stock) shall apply except that ''10 percent'' shall be substituted for ''50 percent'' in section 318(a) (2)(C) and (3)(C).

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4085, Apr. 28, 1962, as amended by T.D. 6969, 33 FR 12000, Aug. 23, 1968; T.D. 7767, 46 FR 11266, Feb. 6, 1981]

§1.856–5 Interest.

(a) *In general.* In computing the percentage requirements in section 856(c) (2)(B) and (3)(B), the term ''interest'' includes only an amount which constitutes compensation for the use or forbearance of money. For example, a fee received or accrued by a lender which is in fact a charge for services performed for a borrower rather than a charge for the use of borrowed money is not includable as interest.

(b) *Where amount depends on income or profits of any person.* Except as provided in paragraph (d) of this section, any amount received or accrued, directly or indirectly, with respect to an obligation is not includable as interest for purposes of section 856(c) (2)(B) and (3)(B) if, under the principles set forth in paragraphs (b)(3) and (6)(i) of §1.856–4, the determination of the amount depends in whole or in part on the income or profits of any person (whether or not derived from property secured by the obligation). Thus, for example, if in accordance with a loan agreement an amount is received or accrued by the trust with respect to an obligation which includes both a fixed amount of interest and a percentage of the borrower's income or profits, neither the fixed interest nor the amount based upon the percentage will qualify as interest for purposes of section 856(c) (2)(B) and (3)(B). This paragraph and paragraph (d) of this section apply only to amounts received or accrued in taxable years beginning after October 4, 1976, pursuant to loans made after May 27, 1976. For purposes of the preceding sentence, a loan is considered to be made before May 28, 1976, if it is made pursuant to a binding commitment entered into before May 28, 1976.

(c) *Apportionment of interest*—(1) *In general.* Where a mortgage covers both real property and other property, an apportionment of the interest income must be made for purposes of the 75-percent requirement of section 856(c)(3). For purposes of the 75-percent requirement, the apportionment shall be made as follows:

(i) If the loan value of the real property is equal to or exceeds the amount of the loan, then the entire interest income shall be apportioned to the real property.

(ii) If the amount of the loan exceeds the loan value of the real property, then the interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction, the numerator of which is the loan value of the real property, and the denominator of which is the amount of the loan. The interest income apportioned to the other property is an amount equal to the excess of the total interest income over the interest income apportioned to the real property.

(2) *Loan value.* For purposes of this paragraph, the loan value of the real property is the fair market value of the property, determined as of the date on

which the commitment by the trust to make the loan becomes binding on the trust. In the case of a loan purchased by the trust, the loan value of the real property is the fair market value of the property, determined as of the date on which the commitment by the trust to purchase the loan becomes binding on the trust. However, in the case of a construction loan or other loan made for purposes of improving or developing real property, the loan value of the real property is the fair market value of the land plus the reasonably estimated cost of the improvements or developments (other than personal property) which will secure the loan and which are to be constructed from the proceeds of the loan. The fair market value of the land and the reasonably estimated cost of improvements or developments shall be determined as of the date on which a commitment to make the loan becomes binding on the trust. If the trust does not make the construction loan but commits itself to provide long-term financing following completion of construction, the loan value of the real property is determined by using the principles for determining the loan value for a construction loan. Moreover, if the mortgage on the real property is given as additional security (or as a substitute for other security) for the loan after the trust's commitment is binding, the real property loan value is its fair market value when it becomes security for the loan (or, if earlier, when the borrower makes a binding commitment to add or substitute the property as security).

(3) *Amount of loan.* For purposes of this paragraph, the amount of the loan means the highest principal amount of the loan outstanding during the taxable year.

(d) *Exception.* Section 856(f)(2) provides an exception to the general rule that amounts received, directly or indirectly, with respect to an obligation do not qualify as ''interest'' where the determination of the amounts depends in whole or in part on the income or profits of any person. The exception applies where the trust receives or accrues, with respect to the obligation of its debtor, an amount that is based in whole or in part on a fixed percentage or percentages of receipts or sales of the debtor, and the amount would not qualify as interest solely because the debtor has receipts or sale proceeds that are based on the income or profits of any person. Under this exception only a proportionate part of the amount received or accrued by the trust fails to qualify as interest for purposes of the percentage-of-income requirements of section 856(c) (2) and (3). The proportionate part of the amount received or accrued by the trust that is non-qualified is the lesser of the following two amounts:

(1) The amount received or accrued by the trust from the debtor with respect to the obligation that is based on a fixed percentage or percentages of receipts or sales, or

(2) The product determined by multiplying by a fraction the total amount received or accrued by the trust from the debtor with respect to the obligation. The numerator of the fraction is the amount of receipts or sales of the debtor that is based, in whole or in part, on the income or profits of any person and the denominator is the total amount of the receipts or sales of the debtor. For purposes of the preceding sentence, the only receipts or sales to be taken into account are those taken into account in determining the payment to the trust pursuant to the loan agreement.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7767, 46 FR 11268, Feb. 6, 1981]

§ 1.856–6 Foreclosure property.

(a) *In general.* Under section 856(e) a real estate investment trust may make an irrevocable election to treat as ''foreclosure property'' certain real property (including interests in real property), and any personal property incident to the real property, acquired by the trust after December 31, 1973.

This section prescribes rules relating to the election, including rules relating to property eligible for the election. This section also prescribes rules relating to extensions of the general two-year period (hereinafter the ‘‘grace period’’) during which property retains its status as foreclosure property, as well as rules relating to early termination of the grace period under section 856(e)(4). The election to treat property as foreclosure property does not alter the character of the income derived therefrom (other than for purposes of section 856(c)(2)(F) and (3)(F)). For example, if foreclosure property is sold, the determination of whether it is property described in section 1221(1) will not be affected by the fact that it is foreclosure property.

(b) *Property eligible for the election*—(1) *Rules relating to acquisitions.* In general, the trust must acquire the property after December 31, 1973, as the result of having bid in the property at foreclosure, or having otherwise reduced the property to ownership or possession by agreement or process of law, after there was default (or default was imminent) on a lease of the property (where the trust was the lessor) or on an indebtedness owed to the trust which the property secured. Foreclosure property which secured an indebtedness owed to the trust is acquired for purposes of section 856(e) on the date on which the trust acquires ownership of the property for Federal income tax purposes. Foreclosure property which a trust owned and leased to another is acquired for purposes of section 856(e) on the date on which the trust acquires possession of the property from its lessee. A trust will not be considered to have acquired ownership of property for purposes of section 856(e) where it takes control of the property as a mortgagee-in-possession and cannot receive any profit or sustain any loss with respect to the property except as a creditor of the mortgagor. A trust may be considered to have acquired ownership of property for purposes of section 856(e) even through legal title to the property is held by another person. For example, where, upon foreclosure of a mortgage held by the trust, legal title to the property is acquired in the name of a nominee for the exclusive benefit of the trust and the trust is the equitable owner of the property, the trust will be considered to have acquired ownership of the property for purposes of section 856(e). Generally, the fact that under local law the mortgagor has a right of redemption after foreclosure is not relevant in determining whether the trust has acquired ownership of the property for purposes of section 856(e). Property is not ineligible for the election solely because the property, in addition to securing an indebtedness owed to the trust, also secures debts owed to other creditors. Property eligible for the election includes a building or other improvement which has been constructed on land owned by the trust and which is acquired by the trust upon default of a lease of the land.

(2) *Personal property.* Personal property (including personal property not subject to a mortgage or lease of the real property) will be considered incident to a particular item of real property if the personal property is used in a trade or business conducted on the property or the use of the personal property is otherwise an ordinary and necessary corollary of the use to which the real property is put. In the case of a hotel, such items as furniture, appliances, linens, china, food, etc. would be examples of incidental personal property. Personal property incident to the real property is eligible for the election even though it is acquired after the real property is acquired or is placed in the building or other improvement in the course of the completion of construction.

(3) *Property with respect to which default is anticipated.* Property is not eligible for the election to be treated as foreclosure property if the loan or lease with respect to which the default occurs (or is imminent) was made or entered into (or the lease or indebtedness was acquired) by the trust with an intent to evict or foreclose, or when the trust knew or had reason to know that default would occur (‘‘improper knowledge’’). For purposes of the preceding sentence, a trust will not be considered to have improper knowledge with respect to a particular lease or loan, if the lease or loan was made pursuant to a binding commitment entered into by

the trust at a time when it did not have improper knowledge. Moreover, if the trust, in an attempt to avoid default or foreclosure, advances additional amounts to the borrower in excess of amounts contemplated in the original loan commitment or modifies the lease or loan, such advance or modification will be considered not to have been made with an intent to evict or foreclose, or with improper knowledge, unless the original loan or lease was entered into with that intent or knowledge.

(c) *Election*—(1) *In general.* (i) An election to treat property as foreclosure property applies to all of the eligible real property acquired in the same taxable year by the trust upon the default (or as a result of the imminence of default) on a particular lease (where the trust is the lessor) or on a particular indebtedness owed to the trust. For example, if a loan made by a trust is secured by two separate tracts of land located in different cities, and in the same taxable year the trust acquires both tracts on foreclosure upon the default (or imminence of default) of the loan, the trust must include both tracts in the election. For a further example, the trust may choose to make a separate election for only one of the tracts if they are acquired in different taxable years or were not security for the same loan. If real property subject to the same election is acquired at different times in the same taxable year, the grace period for a particular property begins when that property is acquired.

(ii) If the trust acquires separate pieces of real property that secure the same indebtedness (or are under the same lease) in different taxable years because the trust delays acquiring one of them until a later taxable year, and the primary purpose for the delay is to include only one of them in an election, then if the trust makes an election for one piece it must also make an election for the other piece. A trust will not be considered to have delayed the acquisition of property for this purpose if there is a legitimate business reason for the delay (such as an attempt to avoid foreclosure by further negotiations with the debtor or lessee).

(iii) All of the eligible personal property incident to the real property must also be included in the election.

(2) *Time for making election.* The election to treat property as foreclosure property must be made on or before the due date (including extensions of time) for filing the trust's income tax return for the taxable year in which the trust acquires the property with respect to which the election is being made, or April 3, 1975, whichever is later.

(3) *Manner of making the election.* An election made after February 6, 1981, shall be made by a statement attached to the income tax return for the taxable year in which the trust acquired the property with respect to which the election is being made. The statement shall indicate that the election is made under section 856(e) and shall identify the property to which the election applies. The statement shall also set forth—

(i) The name, address, and taxpayer identification number of the trust,

(ii) The date the property was acquired by the trust, and

(iii) A brief description of how the real property was acquired, including the name of the person or persons from whom the real property was acquired and a description of the lease or indebtedness with respect to which default occurred or was imminent.

An election made on or before February 6, 1981 shall be filed in the manner prescribed in 26 CFR 10.1(f) (revised as of April 1, 1977) (temporary regulations relating to the election to treat property as foreclosure property) as in effect when the election is made.

(4) *Status of taxpayer.* In general, a taxpayer may make an election with respect to an acquisition of property only if the taxpayer is a qualified real estate investment trust for the taxable year in which the acquisition occurs. If, however, the taxpayer establishes, to the satisfaction of the district director for the internal revenue district in which the taxpayer maintains its principal place of business or principal office or agency, that its failure to be a qualified real estate investment trust for a taxable year was to due to reasonable cause and not due to willful neglect, the taxpayer may make the election with respect to property acquired

in such taxable year. The principles of §§1.856.7(c) and 1.856.8(d) (including the principles relating to expert advice) will apply in determining whether, for purposes of this subparagraph, the failure of the taxpayer to be a qualified real estate investment trust for the taxable year in which the property is acquired was due to reasonable cause and not due to willful neglect. If a taxpayer makes a valid election to treat property as foreclosure property, the property will not lose its status as foreclosure property solely because the taxpayer is not a qualified real estate investment trust for a subsequent taxable year (including a taxable year which encompasses an extension of the grace period). However, the rules relating to the termination of foreclosure property status in section 856(e)(4) (but not the tax on income from foreclosure property imposed by section 857(b)(4)) apply to the year in which the property is acquired and all subsequent years, even though the taxpayer is not a qualified real estate investment trust for such year.

(d) *Termination of 2-year grace period; subsequent leases*—(1) *In general.* Under section 856(e)(4)(A), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring on or after the day on which the trust acquired the property) on which the trust either—

(i) Enters into a lease with respect to any of the property which, by its terms, will give rise to income of the trust which is not described in section 856(c)(3) (other than section 856(c)(3)(F)), or

(ii) Receives or accrues, directly or indirectly, any amount which is not described in section 856(c)(3) (other than section 856(c)(3)(F)) pursuant to a lease with respect to any of the real property entered into by the trust on or after the day the trust acquired the property.

For example, assume the trust acquires, in a particular taxable year, a shopping center upon the default of an indebtedness owed to the trust. Also assume that the trust subsequently enters into a lease with respect to one of several stores in the shopping center that requires the lessee to pay rent to the trust which is not income described in section 856(c)(3) (other than section 856(c)(3)(F)). In such case, the entire shopping center will cease to be foreclosure property on the day the trust enters into the lease.

(2) *Extensions or renewals of leases.* Generally, the extension or renewal of a lease of foreclosure property will be treated as the entering into of a new lease only if the trust has a right to renegotiate the terms of the lease. If, however, by operation of law or by contract, the acquisition of the foreclosure property by the trust terminates a preexisting lease of the property, or gives the trust a right to terminate the lease, then for purposes of section 856(e)(4)(A), a trust, in such circumstances, will not be considered to have entered into a lease with respect to the property solely because the terms of the preexisting lease are continued in effect after foreclosure without substantial modification. The letting of rooms in a hotel or motel does not constitute the entering into a lease for purposes of section 856(e)(4)(A).

(3) *Rent attributable to personal property.* Solely for the purposes of section 856(e)(4)(A), if a trust enters into a lease with respect to real property on or after the day upon which the trust acquires such real property by foreclosure, and a portion of the rent from such lease is attributable to personal property which is foreclosure property incident to such real property, such rent attributable to the incidental personal property will not be considered to terminate the status of such real property (or such incidental personal property) as foreclosure property.

(e) *Termination of 2-year grace period; completion of construction*—(1) *In general.* Under section 856(e)(4)(B), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring on or after the day on which the trust acquired the property) on which any construction takes place on the property, other than completion of a building (or completion of any other improvement) where more than 10 percent of the construction of the building (or other improvement) was completed before default became imminent. If more than one default occurred with respect to an indebtedness or lease in respect of which there is an acquisition, the more-than-10-percent test (including the rule prescribed in this paragraph relating to the test) will not be applied at the time a particular default became imminent if it is clear that the acquisition did not occur as the result of such default. For example, if the debtor fails to make four consecutive payments of principal and interest on the due dates, and the trust takes action to acquire the property securing the debt only after the fourth default becomes imminent, the 10-percent test is applied at the time the fourth default became imminent (even though the trust would not have foreclosed on the property had not all four defaults occurred).

(2) *Determination of percentage of completion.* The determination of whether the construction of a building or other improvement was more than 10 percent complete when default became imminent shall be made by comparing the total direct costs of construction incurred with respect to the building or other improvement as of the date default became imminent with the estimated total direct costs of construction as of such date. If the building or other improvement qualifies as more than 10 percent complete under this method, the building or other improvement shall be considered to be more than 10 percent complete. For purposes of this subparagraph, direct costs of construction include the cost of labor and materials which are directly connected with the construction of the building or improvement.

Thus, for example, direct costs of construction incurred as of the date default became imminent would include amounts paid, or for which liability has been incurred, for labor which has been performed as of such date that is directly connected with the construction of the building or other improvement and for building materials and supplies used or consumed in connection with the construction as of such date. For purposes of applying the 10-percent test the trust may also take into account the cost of building materials and supplies which have been delivered to the construction site as of the date default became imminent and which are to be used or consumed in connection with the construction. On the other hand, architect's fees, administrative costs of the developer or builder, lawyers' fees, and expenses incurred in connection with obtaining zoning approval or building permits are not considerd to be direct costs of construction. Any construction by the trust as mortgagee-in-possession is considered to have taken place after default resulting in acquisition of the property became imminent. Generally, the trust's estimate of the total direct costs of completing construction as of the date the default became imminent will be accepted, provided that the estimate is reasonable, in good faith, and is based on all of the data reasonably available to the trust when the trust undertakes completion of construction of the building or other improvement. Appropriate documentation which shows that construction was more than 10 percent complete when default became imminent must be available at the principal place of business of the trust for inspection in connection with an examination of the income tax return. Construction includes the renovation of a building, such as the remodeling of apartments, or the renovation of an apartment building to convert rental units to a condominium. The renovation must be more than 10 percent complete (determined by comparing the total direct cost of the physical renovation which has been incurred when default became imminent with the estimated total direct cost of renovation as of such date) when default became immiment in order for the property not to lose its status as foreclosure property if the trust undertakes the renovation.

(3) *Modification of a building or improvement.* Generally, the terms ''building'' and ''improvement'' in section 856(e)(4)(B) mean the building or improvement (including any intergral part thereof) as planned by the mortgagor or lessee (or other person in possession of the property, if appropriate)

as of the date default became imminent. The trust, however, may estimate the total direct costs of construction and complete the construction of the building or other improvement by modifying the building or other improvement as planned as of the date default became imminent so as to reduce the estimated direct cost of construction of the building or improvement. If the trust does so modify the planned construction of the building or improvement, the 10-percent test is to be applied by comparing the direct costs of construction incurred as of the date default became imminent that are attributable to the building or improvement as modified, with the estimated total direct costs (as of such date) of construction of the building or other improvement as modified. The trust, in order to meet the 10-percent test, may not, however, modify the planned building or improvement by reducing the estimated direct cost of construction to such an extent that the building or improvement is not functional.

Also, the trust may make subsequent modifications which increase the direct cost of construction of the building or improvement if such modifications—

(i) Are required by a Federal, State, or local agency, or

(ii) Are alterations that are either required by a prospective lessee or purchaser as a condition of leasing or buying the property or are necessary for the property to be used for the purpose planned at the time default became imminent.

Subdivision (ii) of the preceding sentence applies, however, only if the building or improvement, as modified, was more than 10 percent complete when default became imminent. A building completed by the trust will not cease to be foreclosure property solely because the building is used in a manner other than that planed by the defaulting mortgagor or lessee. Thus, for example, assume a trust acquired on foreclosure a planned apartment building which was 20 percent complete when default became imminent and that the trust completes the building without modifications which increase the direct cost of construction. The property will not cease to be foreclosure property by reason of section 856(e)(4)(B) solely because the trust sells the dwelling units in the building as condominium units, rather than holding them for rent as planned by the defaulting mortgagor. (See, however, section 856(e)(4)(C) and paragraph (f)(2) of this section for rules relating to the requirement that where foreclosure property is used in a trade or business (including a trade or business of selling the foreclosure property), the trade or business must be conducted through an independent contractor after 90 days after the property is acquired.)

(4) *Application on building-by-building basis.* Generally the more than 10 percent test is to be applied on a building-by-building basis. Thus, for example, if a trust has foreclosed on land held by a developer building a housing subdivision, the trust may complete construction of the houses which were more than 10 percent complete when default became imminent. The trust, however, may not complete construction of houses which were only 10 percent (or less) complete, nor may the trust begin construction of other houses planned for the subdivision on which construction has not begun. The trust, however, may construct an additional building or improvement (whether or not the construction thereof has begun) which is an integral part of another building or other improvement that was more than 10 percent complete when default became imminent if the additional building or improvement and the other building or improvement, taken together as a unit, meet the more than 10 percent test. For purposes of this paragraph, an additional building or other improvement will be considered to be an integral part of another building or improvement if—

(i) It is ancillary to the other building or improvement and its principal intended use is to furnish services or facilities which either supplement the use of such other building or improvement or are necessary for such other building or improvement to be utilized in the manner or for the purpose for which it is intended, or

(ii) The buildings or improvements are intended to comprise constituent parts of an interdependent group of buildings or other improvements.

However, a building or other improvement will not be considered to be an integral part of another building or improvement unless the buildings or improvements were planned as part of the same overall construction plan or project before default became imminent. An additional building or other improvement (such as, for example, an outdoor swimming pool or a parking garage) may be considered to be an integral part of another building or improvement, even though the additional building or improvement was also intended to be used to provide facilities or services for use in connection with several other buildings or improvements which will not be completed. If the trust chooses not to undertake the construction of an additional building or other improvement which qualifies as an integral part of another building or improvement, so much of the costs of construction (including both the direct costs of construction incurred before the default became imminent and the estimated costs of completion) as are attributable to that ''integral part'' shall not be taken into account in determining whether any other building or improvement was more than 10 percent complete when default became imminent. For example, assume the trust acquires on foreclosure a property on which the defaulting mortgagor has begun construction of a motel. The motel, as planned by the mortgagor, was to consist of a two-story building containing 30 units, and two detached one-story wings, each of which was to contain 20 units. At the time default became imminent, the defaulting mortgagor had completed more than 10 percent of the construction of the two-story structure but the two wings, an access road, a parking lot, and an outdoor swimming pool planned for the motel were each less than 10 percent complete. The trust may construct the two wings of the motel, the access road, the parking lot, and the swimming pool: *Provided,* That the motel and the other improvements which the trust undertakes to construct, taken together as a unit, were more than 10 percent complete when default became imminent. If, however, the trust chooses not to undertake construction of the swimming pool, the cost of construction attributable to the swimming pool, whether incurred before default became imminent or estimated as the cost of completion, shall not be taken into account in determining whether the trust can complete construction of the other buildings and improvements. For another example, assume that the trust acquires a planned shopping center on foreclosure. At the time default became imminent several large buildings intended to house shops and stores in the shopping center were more than 10 percent complete. Less than 10 percent of the construction, however, had been completed on a separate structure intended to house a bank. The bank was planned as a component of the shopping center in order to provide, in conjunction with the other shops and stores, a specific range and variety of goods and services with which to attract customers to the shopping center. The trust may complete construction of the bank: *Provided,* That the bank and the other buildings and improvements which the trust undertakes to complete, taken together as a unit, were more than 10 percent complete when default became imminent. If the trust chooses not to construct the bank, no actual or estimated construction costs attributable to the bank are to be taken into account in applying the 10-percent test with respect to the other buildings and improvements in the shopping center. For a third example, assume that a defaulting mortgagor had planned to construct two identical apartment buildings, A and B, on the same tract of land, that neither building is to provide substantial facilities or services to be used in connection with the other, and that only building A was more than 10 percent complete when default became imminent. The trust, in this case, may not complete building B. On the other hand, if the facts are the same except that pursuant to the plans of the defaulting mortgagor, one of the buildings is to contain the furnace and central air conditioning machinery for both buildings A and B, the trust may complete both buildings A and B: *Provided,* That, taken together as a unit, the two buildings meet the more-than-10-percent test.

(5) *Repair and maintenance.* Under this paragraph (e), ‘‘construction’’ does not include—

(i) The repair or maintenance of a building or other improvement (such as the replacement of worn or obsolete furniture and appliances) to offset normal wear and tear or obsolescence, and the restoration of property required because of damage from fire, storm, vandalism or other casualty,

(ii) The preparation of leased space for a new tenant which does not substantially extend the useful life of the building or other improvement or significantly increase its value, even though, in the case of commercial space, this preparation includes adapting the property to the conduct of a different business, or

(iii) The performing of repair or maintenance described in paragraph (e)(5)(i) of this section after property is acquired that was deferred by the defaulting party and that does not constitute renovation under paragraph (e)(2) of this section.

(6) *Independent contractor required.* If any construction takes place on the foreclosure property more than 90 days after the day on which such property was acquired by the trust, such construction must be performed by an independent contractor (as defined in section 856(d)(3) and §1.856–4(b)(5)(iii)) from whom the trust does not derive or receive any income. Otherwise, the property will cease to be foreclosure property.

(7) *Failure to complete construction.* Property will not cease to be foreclosure property solely because a trust which undertakes the completion of construction of a building or other improvement on the property that was more than 10 percent complete when default became imminent does not complete the construction. Thus, for example, if a trust continues construction of a building that was 20 percent complete when default became imminent, and the trust constructs an additional 40 percent of the building and then sells the property, the property will not lose its status as foreclosure property solely because the trust fails to complete construction of the building.

(f) *Termination of 2-year grace period; use of foreclosure property in a trade or business*—(1) *In general.* Under section 856(e)(4)(C), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring more than 90 days after the day on which the trust acquired the property) on which the property is used in a trade or business conducted by the trust, other than a trade or business conducted by the trust through an independent contractor from whom the trust itself does not derive or receive any income. (See section 856(d)(3) for the definition of independent contractor.)

(2) *Property held primarily for sale to customers.* For the purposes of section 856(e)(4)(C), foreclosure property held by the trust primarily for sale to customers in the ordinary course of a trade or business is considered to be property used in a trade or business conducted by the trust. Thus, if a trust holds foreclosure property (whether real property or personal property incident to real property) for sale to customers in the ordinary course of a trade or business more than 90 days after the day on which the trust acquired the real property, the trade or business of selling the property must be conducted by the trust through an independent contractor from whom the trust does not derive or receive any income. Otherwise, after such 90th day the property will cease to be foreclosure property.

(3) *Change in use.* Foreclosure property will not cease to be foreclosure property solely because the use of the property in a trade or business by the trust differs from the use to which the property was put by the person from whom it was acquired. Thus, for example, if a trust acquires a rental apartment building on foreclosure, the property will not cease to be foreclosure property solely because the trust converts the building to a condominium apartment building and, through an independent contractor from whom the trust derives no income, engages in the trade or business of selling the individual condominium units.

(g) *Extension of 2-year grace period*—(1) *In general.* A real estate investment trust may apply to the district director of the internal revenue district in which is located the principal place of business (or principal office or agency) of the trust for an extension of the 2-year grace period. If the trust establishes to the satisfaction of the district director that an extension of the grace period is necessary for the orderly liquidation of the trust's interest in foreclosure property, or for an orderly renegotiation of a lease or leases of the property, the district director may extend the 2-year grace period. See section 856(e)(3) (as in effect with respect to the particular extension) for rules relating to the maximum length of an extension, and the number of extensions which may be granted. An extension of the grace period may be granted by the district director either before or after the date on which the grace period, but for the extension, would expire. The extension shall be effective as of the date on which the grace period, but for the extension, would expire.

(2) *Showing required.* Generally, in order to establish the necessity of an extension, the trust must demonstrate that it has made good faith efforts to renegotiate leases with respect to, or dispose of, the foreclosure property. In certain cases, however, the trust may establish the necessity of an extension even though it has not made such efforts. For example, if the trust demonstrates that, for valid business reasons, construction of the foreclosure property could not be completed before the expiration of the grace period, the necessity of the extension could be established even though the trust had made no effort to sell the property. For another example, if the trust demonstrates that due to a depressed real estate market, it could not sell the foreclosure property before the expiration of the grace period except at a distress price, the necessity of an extension could be established even though the trust had made no effort to sell the property. The fact that property was acquired as foreclosure property prior to January 3, 1975 (the date of enactment of section 856(e)), generally will be considered as a factor (but not a controlling factor) which tends to establish that an extension of the grace period is necessary.

(3) *Time for requesting an extension of the grace period.* A request for an extension of the grace period must be filed with the appropriate district director more than 60 days before the day on which the grace period would otherwise expire. In the case of a grace period which would otherwise expire before August 6, 1976, a request for an extension will be considered to be timely filed if filed on or before June 7, 1976.

(4) *Information required.* The request for an extension of the grace period shall identify the property with respect to which the request is being made and shall also include the following information:

(i) The name, address, and taxpayer identification number of the trust,

(ii) The date the property was acquired as foreclosure property by the trust,

(iii) The taxable year of the trust in which the property was acquired,

(iv) If the trust has been previously granted an extension of the grace period with respect to the property, a statement to that effect (which shall include the date on which the grace period, as extended, expires) and a copy of the information which accompanied the request for the previous extension,

(v) A statement of the reasons why the grace period should be extended,

(vi) A description of any efforts made by the trust after the acquisition of the property to dispose of the property or to renegotiate any lease with respect to the property, and

(vii) A description of any other factors which tend to establish that an extension of the grace period is necessary for the orderly liquidation of the trust's interest in the property, or for an orderly renegotiation of a lease or leases of the property.

The trust shall also furnish any additional information requested by the district director after the request for extension is filed.

(5) *Automatic extension.* If a real estate investment trust files a request for an extension with the district director more than 60 days before the expiration of the grace period, the grace period shall be considered to be extended until the end of the 30th day after the

date on which the district director notifies the trust by certified mail sent to its last known address that the period of extension requested by the trust is not granted. In no event, however, shall the rule in the preceding sentence extend the grace period beyond the expiration of (i) the period of extension requested by the trust, or (ii) the 1-year period following the date that the grace period (but for the automatic extension) would expire. The date of the postmark on the sender's receipt is considered to be the date of the certified mail for purposes of this subparagraph. This subparagraph does not apply, however, if the date of the notification by certified mail described in the first sentence is more than 30 days before the date that the grace period (determined without regard to this subparagraph) expires. Moreover, this subparagraph shall not operate to allow any period of extension that is prohibited by the last sentence of section 856(e)(3) (as in effect with respect to the particular extension).

(6) *Extension of time for filing.* If a real estate investment trust fails to file the request for an extension of the grace period within the time provided in paragraph (g)(3) of this section, then the district director shall grant a reasonable extension of time for filing such request, provided (i) it is established to the satisfaction of the district director that there was reasonable cause for failure to file the request within the prescribed time and (ii) a request for such extension is filed within such time as the district director considers reasonable under the circumstances.

(7) *Status of taxpayer.* The reference to "real estate investment trust" or "trust" in this paragraph (g) shall be considered to include a taxpayer that is not a qualified real estate investment trust, if the taxpayer establishes to the satisfaction of the district director that its failure to be a qualified real estate investment trust for the taxable year was due to reasonable cause and not due to willful neglect. The principles of §1.856–7(c) and §1.856–8(d) (including the principles relating to expert advice) shall apply for determining reasonable cause (and absence of willful neglect) for this purpose.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11269, Feb. 6, 1981; 46 FR 15263, Mar. 5, 1981]

§1.856–7 Certain corporations, etc., that are considered to meet the gross income requirements.

(a) *In general.* A corporation, trust, or association which fails to meet the requirements of paragraph (2) or (3) of section 856(c), or of both such paragraphs, for any taxable year nevertheless is considered to have satisfied these requirements if the corporation, trust, or association meets the requirements of subparagraphs (A), (B), and (C) of section 856(c)(7) (relating to a schedule attached to the return, the absence of fraud, and reasonable cause).

(b) *Contents of the schedule.* The schedule required by subparagraph (A) of section 856(c)(7) must contain a breakdown, or listing, of the total amount of gross income falling under each of the separate subparagraphs of section 856(c) (2) and (3). Thus, for example, the real estate investment trust, for purposes of listing its income from the sources described in section 856(c)(2), would list separately the total amount of dividends, the total amount of interest, the total amount of rents from real property, etc. The listing is not required to be on a lease-by-lease, loan-by-loan, or project-by-project basis, but the real estate investment trust must maintain adequate records on such a basis with which to substantiate each total amount listed in the schedule.

(c) *Reasonable cause*—(1) *In general.* The failure to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs) will be considered due to reasonable cause and not due to willful neglect if the real estate investment trust exercised ordinary business care and prudence in attempting to satisfy the requirements. Such care and prudence must be exercised at the time each transaction is entered into by the trust. However, even if the trust exercised ordinary business care and prudence in entering into a transaction, if the trust later determines that the transaction results in the receipt or accrual of nonqualified income and that the amounts of such nonqualified income, in the context of the trust's overall portfolio, reasonably can be expected to cause a source-of-income requirement to be failed, the trust must use ordinary business care and prudence in an effort to renegotiate the terms of the transaction, dispose of property acquired or leased in the transaction, or alter other elements of its portfolio. In any case, failure to meet an income source requirement will be considered due to willful neglect and not due to reasonable cause if the failure is willful and the trust could have avoided such failure by taking actions not inconsistent with ordinary business care and prudence. For example, if the trust enters into a lease knowing that it will produce nonqualified income which reasonably can be expected to cause a source-of-income requirement to be failed, the failure is due to willful neglect even if the trust has a legitimate business purpose for entering into the lease.

(2) *Expert advice*—(i) *In general.* The reasonable reliance on a reasoned, written opinion as to the characterization for purposes of section 856 of gross income to be derived (or being derived) from a transaction generally constitutes ''reasonable cause'' if income from that transaction causes the trust to fail to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs). The absence of such a reasoned, written opinion with respect to a transaction does not, by itself, give rise to any inference that the failure to meet a percentage of income requirement was without reasonable cause. An opinion as to the character of income from a transaction includes an opinion pertaining to the use of a standard form of transaction or standard operating procedure in a case where such standard form or procedure is in fact used or followed.

(ii) If the opinion indicates that a portion of the income from a transaction will be nonqualifed income, the trust must still exercise ordinary business care and prudence with respect to the nonqualified income and determine that the amount of that income, in the context of its overall portfolio, reasonably cannot be expected to cause a source-of-income requirement to be failed. Reliance on an opinion is not reasonable if the trust has reason to believe that the opinion is incorrect (for example, because the trust withholds facts from the person rendering the opinion).

(iii) *Reasoned written opinion.* For purposes of this subparagraph (2), a written opinion means an opinion, in writing, rendered by a tax advisor (including house counsel) whose opinion would be relied on by a person exercising ordinary business care and prudence in the circumstances of the particular transaction. A written opinion is considered ''reasoned'' even if it reaches a conclusion which is subsequently determined to be incorrect, so long as the opinion is based on a full disclosure of the factual situation by the real estate investment trust and is addressed to the facts and law which the person rendering the opinion believes to be applicable. However, an opinion is not considered ''reasoned'' if it does nothing more than recite the facts and express a conclusion.

(d) *Application of section 856(c)(7) to taxable years beginning before October 5, 1976.* Pursuant to section 1608(b) of the Tax Reform Act of 1976, paragraph (7) of section 856(c) and this section apply to a taxable year of a real estate investment trust which begins before October 5, 1976, only if as the result of a determination occurring after October 4, 1976, the trust does not meet the requirements of paragraph (2) or (3) of section 856(c), or both paragraphs, as in effect for the taxable year. The requirement that the schedule described in subparagraph (A) of section 856(c)(7) be attached to the income tax return of a real estate investment trust in order for section 856(c)(7) to apply is not applicable to taxable years beginning before October 5, 1976. For purposes of section 1608(b) of the Tax Reform Act of 1976 and this paragraph, the rules relating to determinations prescribed in section 860(e) and §1.860–2(b)(1) (other than the second, third, and last sentences of §1.860–2(b)(1)(ii)) shall apply. However, a determination consisting of an agreement between the taxpayer and the district director (or other official to whom authority to sign the agreement is delegated) shall set forth the amount of gross income for the taxable year to which the determination applies, the amount of the 90 percent and 75 percent source-of-income requirements for the taxable year to which the determination applies, and the amount by which the real estate investment trust failed to meet either or both of the requirements. The agreement shall also set forth the amount of tax for which the trust is liable pursuant to section 857(b)(5). The agreement shall also contain a finding as to whether the failure to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs) was due to reasonable cause and not due to willful neglect.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954); sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 7767, 46 FR 11274, Feb. 6, 1981, as amended by T.D. 7936, 49 FR 2106, Jan. 18, 1984]

§1.856–8 Revocation or termination of election.

(a) *Revocation of an election to be a real estate investment trust.* A corporation, trust, or association that has made an election under section 856(c)(1) to be a real estate investment trust may revoke the election for any taxable year after the first taxable year for which the election is effective. The revocation must be made by filing a statement with the district director for the internal revenue district in which the taxpayer maintains its principal place of business or principal office or agency. The statement must be filed on or before the 90th day after the first day of the first taxable year for which the revocation is to be effective. The statement must be signed by an official authorized to sign the income tax return of the taxpayer and must—

(1) Contain the name, address, and taxpayer identification number of the taxpayer,

(2) Specify the taxable year for which the election was made, and

(3) Include a statement that the taxpayer, pursuant to section 856(g)(2), revokes its election under section 856(c)(1) to be a real estate investment trust.

The revocation may be made only with respect to a taxable year beginning after October 4, 1976, and is effective for the taxable year in which made and for all succeeding taxable years. A revocation with respect to a taxable year beginning after October 4, 1976, that is filed before February 6, 1981, in the time and manner prescribed in §7.856(g)–1 of this chapter (as in effect when the revocation was filed) is considered to meet the requirements of this paragraph.

(b) *Termination of election to be a real estate investment trust.* An election of a corporation, trust, or association under section 856(c)(1) to be a real estate investment trust shall terminate if the corporation, trust, or association is not a qualified real estate investment trust for any taxable year (including the taxable year with respect to which the election is made) beginning after October 4, 1976. (This election terminates whether the failure to be a qualified real estate investment trust is intentional or inadvertent.) The term ‘‘taxable year’’ includes a taxable year of less than 12 months for which a return is made under section 443. The termination of the election is effective for the first taxable year beginning after October 4, 1976, for which the corporation, trust, or association is not a qualified real estate investment trust and for all succeeding taxable years.

(c) *Restrictions on election after termination or revocation*—(1) *General rule.* Except as provided in paragraph (d) of this section, if a corporation, trust, or association has made an election under section 856(c)(1) to be a real estate investment trust and the election has been terminated or revoked under section 856(g)(1) or (2), the corporation, trust, or association (and any successor corporation, trust, or association) is not eligible to make a new election under section 856(c)(1) for any taxable year prior to the fifth taxable year which begins after the first taxable year for which the termination or revocation is effective.

(2) *Successor corporation.* The term ‘‘successor corporation, trust, or association'', as used in section 856(g)(3), means a corporation, trust, or association which meets both a continuity of ownership requirement and a continuity of assets requirement with respect to the corporation, trust, or association whose election has been terminated under section 856(g)(1) or revoked under section 856(g)(2). A corporation, trust, or association meets the continuity of ownership requirement only if at any time during the taxable year the persons who own, directly or indirectly, 50 percent or more in value of its outstanding shares owned, at any time during the first taxable year for which the termination or revocation was effective, 50 percent or more in value of the outstanding shares of the corporation, trust, or association whose election has been terminated or revoked. A corporation, trust, or association meets the continuity of assets requirement only if either (i) a substantial portion of its assets were assets of the corporation, trust, or association whose election has been revoked or terminated, or (ii) it acquires a substantial portion of the assets of the corporation, trust, or association whose election has been terminated or revoked.

(3) *Effective date.* Section 856(g)(3) does not apply to the termination of an election that was made by a taxpayer pursuant to section 856(c)(1) on or before October 4, 1976, unless the taxpayer is a qualified real estate investment trust for a taxable year ending after October 4, 1976, for which the pre-October 5, 1976, election is in effect. For example, assume that Trust X, a calendar year taxpayer, files a timely election under section 856(c)(1) with respect to its taxable year 1974, and is a qualified real estate investment trust for calendar years 1974 and 1975. Assume further that Trust X is not a qualified real estate investment trust for 1976 and 1977 because it willfully fails to meet the asset diversification requirements of section 856(c)(5) for both years. The failure (whether or not willful) to meet these requirements in 1977 terminates the election to be a real estate investment trust made with respect to 1974. (See paragraph (b) of this section.) The termination is effective for 1977 and all succeeding taxable years. However, under section 1608(d)(3) of the Tax Reform Act of 1976, Trust X is not prohibited by section 856(g)(3) from making a new election under section 856(c)(1) with respect to 1978.

(d) *Exceptions*— Section 856(g)(4) provides an exception to the general rule of section 856(g)(3) that the termination of an election to be a real estate investment trust disqualifies the corporation, trust, or association from making a new election for the 4 taxable years following the first taxable year for which the termination is effective. This exception applies where the corporation, trust, or association meets the requirements of section 856(g)(4)(A), (B) and (C) (relating to the timely filing of a return, the absence of fraud, and reasonable cause, respectively) for the taxable year with respect to which the termination of election occurs. In order to meet the requirements of section 856(g)(4)(C), the corporation, trust, or association must establish, to the satisfaction of the district director for the internal revenue district in which the corporation, trust, or association maintains its principal place of business or principal office or agency, that its failure to be a qualified real estate investment trust for the taxable year in question was due to reasonable cause and not due to willful neglect. The principles of § 1.856–7(c) (including the principles relating to expert advice) will apply in determining whether, for purposes of section 856(g)(4), the failure of a corporation, trust, or association to be a qualified real estate investment trust for a taxable year was due to reasonable cause and not due to willful neglect. Thus, for example, the corporation, trust, or association must exercise ordinary business care and prudence in attempting to meet the status conditions of section 856(a) and the distribution and recordkeeping requirements of section 857(a), as well as the gross income requirements of section 856(c). The provisions of section 856(g)(4) do not apply to a taxable year in which the corporation, trust, or association makes a valid revocation, under section 856(g)(2), of an election to be a real estate investment trust.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11275, Feb. 6, 1981; 46 FR 15263, Mar. 5, 1981]

§1.857–1 Taxation of real estate investment trusts.

(a) *Requirements applicable thereto.* Section 857(a) denies the application of the provisions of part II, subchapter M, chapter 1 of the Code (other than sections 856(g), relating to the revocation or termination of an election, and 857(d), relating to earnings and profits) to a real estate investment trust for a taxable year unless—

(1) The deduction for dividends paid for the taxable year as defined in section 561 (computed without regard to capital gain dividends) equals or exceeds the amount specified in section 857(a)(1), as in effect for the taxable year; and

(2) The trust complies for such taxable year with the provisions of §1.857–8 (relating to records required to be maintained by a real estate investment trust).

See section 858 and §1.858–1, relating to dividends paid after the close of the taxable year.

(b) *Failure to qualify.* If a real estate investment trust does not meet the requirements of section 857(a) and paragraph (a) of this section for the taxable year, it will, even though it may otherwise be classified as a real estate investment trust, be taxed in such year as an ordinary corporation and not as a real estate investment trust. In such case, none of the provisions of part II of subchapter M (other than sections 856(g) and 857(d)) will be applicable to it. For the rules relating to the applicability of sections 856(g) and 857(d), see §1.857–7.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4087, Apr. 28, 1962, as amended by T.D. 7767, 46 FR 11277, Feb. 6, 1981]

§1.857–2 Real estate investment trust taxable income and net capital gain.

(a) *Real estate investment trust taxable income.* Section 857(b)(1) imposes a nominal tax and surtax, computed at the rates and in the manner prescribed in section 11, on the ‘‘real estate investment trust taxable income’’, as defined in section 857(b)(2). Section 857(b)(2) requires certain adjustments to be made to convert taxable income of the real estate investment trust to ‘‘real estate investment trust taxable income’’. The adjustments are as follows:

(1) *Net capital gain.* In the case of taxable years ending before October 5, 1976, the net capital gain, if any, is excluded.

(2) *Special deductions disallowed.* The special deductions provided in part VIII, subchapter B, chapter 1 of the Code (except the deduction under section 248) are not allowed.

(3) *Deduction for dividends paid*—(i) *General rule.* The deduction for dividends paid (as defined in section 561) is allowed. In the case of taxable years

ending before October 5, 1976, the deduction for dividends paid is computed without regard to capital gains dividends.

(ii) *Deduction for dividends paid if there is net income from foreclosure property.* If for any taxable year the trust has net income from foreclosure property (as defined in section 857(b)(4)(B) and § 1.857–3), the deduction for dividends paid is an amount equal to the amount which bears the same proportion to the total dividends paid or considered as paid during the taxable year that otherwise meet the requirements for the deduction for dividends paid (as defined in section 561) as the real estate investment trust taxable income (determined without regard to the deduction for dividends paid) bears to the sum of—

(A) The real estate investment trust taxable income (determined without regard to the deduction for dividends paid), and

(B) The amount by which the net income from foreclosure property exceeds the tax imposed on such income by section 857(b)(4)(A).

For purposes of the preceding sentence, the term ‘‘total dividends paid or considered as paid during the taxable year’’ includes deficiency dividends paid with respect to the taxable year that are not otherwise excluded under this subdivision or section 857(b)(3)(A). The term, however, does not include either deficiency dividends paid during the taxable year with respect to a preceding taxable year ending before October 5, 1976, capital gains dividends.

(iii) *Deduction for dividends paid for purposes of the alternative tax.* The rules in section 857(b)(3)(A) apply in determining the amount of the deduction for dividends paid that is taken into account in computing the alternative tax. Thus, for example, if a real estate investment trust has net income from foreclosure property for a taxable year ending after October 4, 1976, then for purposes of determining the partial tax described in section 857(b)(3)(A)(i), the amount of the deduction for dividends paid is computed pursuant to paragraph (a)(3)(ii) of this section, except that capital gains dividends are excluded from the dividends paid or considered as paid during the taxable year, and the net capital gain is excluded in computing real estate investment trust taxable income.

(4) *Section 443(b) disregarded.* The taxable income is computed without regard to seciton 443(b). Thus, the taxable income for a period of less than 12 months is not placed on an annual basis even though the short taxable year results from a change of accounting period.

(5) *Net operating loss deduction.* In the case of a taxable year ending before October 5, 1976, the net operating loss deduction provided in section 172 is not allowed.

(6) *Net income from foreclosure property.* An amount equal to the net income from foreclosure property (as defined in section 857(b)(4)(B) and paragraph (a) of § 1.857–3), if any, is excluded.

(7) *Tax imposed by section 857(b)(5).* An amount equal to the tax (if any) imposed on the trust by section 857(b)(5) for the taxble year is excluded.

(8) *Net income or loss from prohibited transactions.* An amount equal to the amount of any net income derived from prohibited transactions (as defined in section 857(b)(6)(B)(i)) is excluded. On the other hand, an amount equal to amount of any net loss derived from prohibited transactions (as defined in section 857(b)(6)(B)(ii)) is included. Because the amount of the net loss derived from prohibited transactions is taken into account in computing taxable income before the adjustments required by section 857(b)(2) and this section are made, the effect of including an amount equal to the amount of the loss is to disallow a deduction for the loss.

(b) *Net capital gain in taxable years ending October 5, 1976.* The rules relating to the taxation of capital gains in 26 CFR 1.857–2(b) (revised as of April 1,

1977) apply to taxable years ending before October 5, 1976.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11277, Feb. 6, 1981]

§1.857–3 Net income from foreclosure property.

(a) *In general.* For purposes of section 857(b)(40(B), net income from foreclosure property means the aggregate of—

(1) All gains and losses from sales or other dispositions of foreclosure property described in section 1221(1), and,

(2) The difference (hereinafter called ‘‘net gain or loss from operations’’) between (i) the gross income derived from foreclosure property (as defined in section 856(e)) to the extent such gross income is not described in subparagraph (A), (B), (C), (D), (E), or (G) of section 856(c)(3), and (ii) the deductions allowed by chapter 1 of the Code which are directly connected with the production of such gross income.

Thus, the sum of the gains and losses from sales or other dispositions of foreclosure property described in section 1221(1) is aggregated with the net gain or loss from operations in arriving at net income from foreclosure property. For example, if for a taxable year a real estate investment trust has gain of $100 from the sale of an item of foreclosure property described in section 1221(1), a loss of $50 from the sale of an item of foreclosure property described in section 1221(1), gross income of $25 from the rental of foreclosure property that is not gross income described in subparagraph (A), (B), (C), (D), or (G) of section 856(c)(3), and deductions of $35 allowed by chapter 1 of the Code which are directly connected with the production of the rental income, the net income from foreclosure property for the taxable years is $40 (($100−$50)+($25−$35)).

(b) *Directly connected deductions.* A deduction which is otherwise allowed by chapter 1 of the Code is ‘‘directly connected’’ with the production of gross income from the foreclosure property if it has a proximate and primary relationship to the earning of the income. Thus, in the case of gross income from real property that is foreclosure property, ‘‘directly connected’’ deductions would include depreciation on the property, interest paid or accrued on the indebtedness of the trust (whether or not secured by the property) to the extent attributable to the carrying of the property, real estate taxes, and fees paid to an independent contractor hired to manage the property. On the other hand, general overhead and administrative expenses of the trust are not ‘‘directly connected’’ deductions. Thus, salaries of officers and other administrative employees of the trust are not ‘‘directly connected’’ deductions. The net operating loss deduction provided by section 172 is not allowed in computing net income from foreclosure property.

(c) *Net loss from foreclosure property.* The tax imposed by section 857(b)(4) applies only if there is net income from foreclosure property. If there is a net loss from foreclosure property (that is, if the aggregate computed under paragraph (a) of this section results in a negative amount) the loss is taken into account in computing real estate investment trust taxable income under section 857(b)(2).

(d) *Gross income not subject to tax on foreclosure property.* If the gross income derived from foreclosure property consists of two classes, a deduction directly connected with the production of both classes (including interest attributable to the carrying of the property) must be apportioned between them. The two classes are:

(1) Gross income which is taken into account in computing net income from foreclosure property and

(2) Other income (such as income described in subparagraph (A), (B), (C), (D), or (G) of section 856(c)(3)).

The apportionment may be made on any reasonable basis.

(e) *Allocation and apportionment of interest.* For purposes of determining the amount of interest attributable to the carrying of foreclosure property under paragraph (b) of this section, the following rules apply:

(1) *Deductible interest.* Interest is taken into account under this paragraph (e) only if it is otherwise deductible under chapter 1 of the Code.

(2) *Interest specifically allocated to property.* Interest that is specifically allocated to an item of property is attributable only to the carrying of that property. Interest is specifically allocated to an item of property if (i) the indebtedness on which the interest is paid or accrued is secured only by that property, (ii) such indebtedness was specifically incurred for the purpose of purchasing, constructing, maintaining, or improving that property, and (iii) the proceeds of the borrowing were applied for that purpose.

(3) *Other interest.* Interest which is not specifically allocated to property is apportioned between foreclosure property and other property under the principles of § 1.861–8(e)(2)(v).

(4) *Effective date.* The rules in this paragraph (e) are mandatory for all taxable years ending after February 6, 1981.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11277, Feb. 6, 1981]

§ 1.857–4 Tax imposed by reason of the failure to meet certain source-of-income requirements.

Section 857(b)(5) imposes a tax on a real estate investment trust that is considered, by reason of section 856(c)(7), as meeting the source-of-income requirements of paragraph (2) or (3) of section 856(c) (or both such paragraphs). The amount of the tax is determined in the manner prescribed in section 857(b)(5).

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11278, Feb. 2, 1981]

§ 1.857–5 Net income and loss from prohibited transactions.

(a) *In general.* Section 857(b)(6) imposes, for each taxable year, a tax equal to 100 percent of the net income derived from prohibited transactions. A prohibited transaction is a sale or other disposition of property described in section 1221(1) that is not foreclosure property. The 100-percent tax is imposed to preclude a real estate investment trust from retaining any profit from ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development tract. In order to prevent a trust from receiving any tax benefit from such activities, a net loss from prohibited transactions effectively is disallowed in compting real estate investment trust taxable income. See § 1.857–2(a)(8). Such loss, however, does reduce the amount which a trust is required to distribute as dividends. For purposes of applying the provisions of the Code, other than those provisions of part II of subchapter M which relate to prohibited transactions, no inference is to be drawn from the fact that a type of transaction does not constitute a prohibited transaction.

(b) *Special rules.* In determining whether a particular transaction constitutes a prohibited transaction, the activities of a real estate investment trust with respect to foreclosure property and its sales of such property are disregarded. Also, if a real estate investment trust enters into a purchase and leaseback of real property with an option in the seller-lessee to repurchase the property at the end of the lease period, and the seller exercises the option pursuant to its terms, income from the sale generally will not be considered to be income from a prohibited transaction solely because the purchase and leaseback was entered into with an option in the seller to repurchase and because the option was exercised pursuant to its terms. Other facts and circumstances, however, may require a conclusion that the property is held primarily for sale to customers in the ordinary course of a trade or business. Gain from the sale or other disposition of property described in section 1221(1) (other than foreclosure property) that is included in gross income for a taxable year of a qualified real estate investment trust constitutes income from a prohibited transaction, even though the sale or other disposition from which the gain is derived occurred in a prior taxable year. For example, if a corporation that is a qualified real estate investment trust for the current taxable year elected to report the income from the sale of an item of section 1221(1) property (other than foreclosure property) on the installment method of reporting income, the gain from the sale that is taken into income by the real estate investment trust for the current taxable year is income from a prohibited transaction. This result follows even though the sale occurred in a prior taxable year for which the corporation did not qualify as a real estate investment trust. On the other hand, if the gain is taken into income in a taxable year for which the taxpayer is not a qualifed real estate investment trust, the 100-percent tax does not apply.

(c) *Net income or loss from prohibited transactions.* Net income or net loss from prohibited transactions is determined by aggregating all gains from the sale or other disposition of property (other than foreclosure property) described in section 1221(1) with all losses from the sale or other disposition of such property. Thus, for example, if a real estate investment trust sells two items of property described in section 1221(1) (other than foreclosure property) and recognizes a gain of $100 on the sale of one item and a loss of $40 on the sale of the second item, the net income from prohibited transactions will be $60.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11278, Feb. 6, 1981]

§1.857–6 Method of taxation of shareholders of real estate investment trusts.

(a) *Ordinary income.* Except as otherwise provided in paragraph (b) of this section (relating to capital gains), a shareholder receiving dividends from a real estate investment trust shall include such dividends in gross income for the taxable year in which they are received. See section 858(b) and paragraph (c) of §1.858–1 for treatment by shareholders of dividends paid by a real estate investment trust after the close of its taxable year in the case of an election under section 858(a).

(b) *Capital gains.* Under section 857(b)(3)(B), shareholders of a real estate investment trust who receive capital gain dividends (as defined in paragraph (e) of this section), in respect of the capital gains of a corporation, trust, or association for a taxable year for which it is taxable under part II of subchapter M as a real estate investment trust, shall treat such capital gain dividends as gains from the sale or exchange of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and realized in the taxable year of the shareholder in which the dividend was received. In the case of dividends with respect to any taxable year of a real estate investment trust ending after December 31, 1969, and beginning before January 1, 1975, the portion of a shareholder's capital gain dividend which in his hands is gain to which section 1201(d) (1) or (2) applies is the portion so designated by the real estate investment trust pursuant to paragraph (e)(2) of this section.

(c) *Special treatment of loss on the sale or exchange of real estate investment trust stock held less than 31 days*—(1) *In general.* Under section 857(b)(7), if any person with respect to a share of real estate investment trust stock held for a period of less than 31 days, is required by section 857(b)(3)(B) to include in gross income as a gain from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) the amount of a capital gains dividend, then such person shall, to the extent of such amount, treat any loss on the sale or exchange of such share as a loss from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(2) *Determination of holding period.* The rules contained in section 246(c)(3) (relating to the determination of holding periods for purposes of the deduction for dividends received) shall be applied in determining whether, for purposes of section 857(b)(7)(B) and this paragraph, a share of real estate investment trust stock has been held for a period of less than 31 days. In applying those rules, however, ‘‘30 days’’ shall be substituted for the number of days specified in subparagraph (B) of such section.

(3) *Illustration.* The application of section 857(b)(7) and this paragraph may be illustrated by the following example:

Example. On December 15, 1961, A purchased a share of stock in the S Real Estate Investment Trust for $20. The S trust declared a capital gains dividend of $2 per share to shareholders of record on December 31, 1961. A, therefore, received a capital gain dividend of $2 which, pursuant to section 857(b)(3)(B), he must treat as a gain from the sale or exchange of a capital asset held for more than six months. On January 5, 1962, A sold his share of stock in the S trust for $17.50, which sale resulted in a loss of $2.50. Under section 857(b)(4) and this paragraph, A must treat $2 of such loss (an amount equal to the capital gain dividend received with respect to such share of stock) as a loss from the sale or exchange of a capital asset held for more than six months.

(d) *Dividend received credit, exclusion, and deduction not allowed.* Any dividend received from a real estate investment trust which, for the taxable year to which the dividend relates, is a qualified real estate investment trust, shall not be eligible for the dividend received credit (for dividends received on or before December 31, 1964) under section 34(a), the dividend received exclusion under section 116, or the dividend received deduction under section 243.

(e) *Definition of capital gain dividend.* (1)(i) A capital gain dividend, as defined in section 857(b)(3)(C), is any dividend or part thereof which is designated by a real estate investment trust as a capital gain dividend in a written notice mailed to its shareholders within the period specified in section 857(b)(3)(C) and paragraph (f) of this section. If the aggregate amount so designated with respect to the taxable year (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 858) is greater than the net capital gain of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate of the amount so designated. For example, a real estate investment trust making its return on the calendar year basis advised its shareholders by written notice mailed December 30, 1961, that $200,000 of a distribution of $500,000 made December 15, 1961, constituted a capital gain dividend, amounting to $2 per share. It was later discovered that an error had been made in determining the net capital gain of the taxable year and the net capital gain was $100,000 instead of $200,000. In such case, each shareholder would have received a capital gain dividend of $1 per share instead of $2 per share.

(ii) For purposes of section 857(b)(3)(C) and this paragraph, the net capital gain for a taxable year ending after October 4, 1976, is deemed not to exceed the real estate investment trust taxable income determined by taking into account the net operating loss deduction for the taxable year but not the deduction for dividends paid. See example 2 in §1.172–5(a)(4).

(2) In the case of capital gain dividends designated with respect to any taxable year of a real estate investment trust ending after December 31, 1969, and beginning before January 1, 1975 (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 858), the real estate investment trust must include in its written notice designating the capital gain dividend a statement showing the shareholder's proportionate share of such dividend which is gain described in section 1201(d)(1) and his proportionate share of such dividend which is gain described in section 1201(d)(2). In determining the portion of the capital gain dividend which, in the hands of a shareholder, is gain described in section 1201(d) (1) or (2), the real estate investment trust shall consider that capital gain dividends for a taxable year are first made from its long-term capital gains which are not described in section 1201(d) (1) or (2), to the extent thereof, and then from its long-term capital gains for such year which are described in section 1201(d) (1) or (2). A shareholder's proportionate share of gains which are described in section 1201(d)(1) is the amount which bears the same ratio to the amount paid to him as a capital gain dividend in respect of such year as (i) the aggregate amount of the trust's gains which are described in section 1201(d)(1) and paid to all shareholders bears to (ii) the aggregate amount of the capital gain dividend paid to all shareholders in respect of such year. A shareholder's proportionate share of gains which are described in section 1201(d)(2) shall be determined in a similar manner. Every real estate investment trust shall keep a record of the proportion of each capital gain divided (to which this subparagraph applies) which is gain described in section 1201(d) (1) or (2).

(f) *Mailing of written notice to shareholders*—(1) *General rule.* Except as provided in paragraph (f)(2) of this section, the written notice designating a dividend or part thereof as a capital gain dividend must be mailed to the shareholders not later than 30 days after the close of the taxable year of the real estate investment trust.

(2) *Net capital gain resulting from a determination.* If, as a result of a determination (as defined in section 860(e)), occurring after October 4, 1976, there is an increase in the amount by which the net capital gain exceeds the deduction for dividends paid (determined with reference to capital gains dividends only) for the taxable year, then a real estate investment trust may designate a dividend (or part thereof) as a capital gain dividend in a written notice mailed to its shareholders at any time during the 120-day period immediately following the date of the determination. The designation may be made with respect to a dividend (or part thereof) paid during the taxable year to which the determination applies (including a dividend considered as paid during the taxable year pursuant to section 858). A deficiency dividend (as defined in section 860(f)), or a part thereof, that is paid with respect to the taxable year also may be designated as a capital gain dividend by the real estate investment trust (or by the acquiring corporation to which section 381(c)(25) applies) before the expiration of the 120-day period immediately following the determination. However, the aggregate amount of the dividends (or parts thereof) that may be designated as capital gain dividends after the date of the determination shall not exceed the amount of the increase in the excess of the net capital gain over the deduction for dividends paid (determined with reference to capital gains dividends only) that results from the

determination. The date of a determination shall be established in accordance with §1.860–2(b)(1).

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954); sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 6598, 27 FR 4088, Apr. 28, 1962, as amended by T.D. 6777, 29 FR 17809, Dec. 16, 1964; T.D. 7337, 39 FR 44974, Dec. 30, 1974; T.D. 7728, 45 FR 72650, Nov. 3, 1980. Redesignated and amended by T.D. 7767, 46 FR 11277, 11279, and 11283, Feb. 6, 1981; T.D. 7936, 49 FR 2107, Jan. 18, 1984; T.D. 8107, 51 FR 43347, Dec. 2, 1986]

§1.857–7 Earnings and profits of a real estate investment trust.

(a) Any real estate investment trust whether or not such trust meets the requirements of section 857(a) and paragraph (a) of §1.857–1 for any taxable year beginning after December 31, 1960 shall apply paragraph (b) of this section in computing its earnings and profits for such taxable year.

(b) In the determination of the earnings and profits of a real estate investment trust, section 857(d) provides that such earnings and profits for any taxable year (but not the accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for the taxable year. Thus, if a trust would have had earnings and profits of $500,000 for the taxable year except for the fact that it had a net capital loss of $100,000, which amount was not deductible in determining its taxable income, its earnings and profits for that year if it is a real estate investment trust would be $500,000. If the real estate investment trust had no accumulated earnings and profits at the beginning of the taxable year, in determining its accumulated earnings and profits as of the beginning of the following taxable year, the earnings and profits for the taxable year to be considered in such computation would amount to $400,000 assuming that there had been no distribution from such earnings and profits. If distributions had been made in the taxable year in the amount of the earnings and profits then available for distribution, $500,000, the trust would have as of the beginning of the following taxable year neither accumulated earnings and profits nor a deficit in accumulated earnings and profits, and would begin such year with its paid-in capital reduced by $100,000, an amount equal to the excess of the $500,000 distributed over the $400,000 accumulated earnings and profits which would otherwise have been carried into the following taxable year. For purposes of section 857(d) and this section, if an amount equal to any net loss derived from prohibited transactions is included in real estate investment trust taxable income pursuant to section 857(b)(2)(F), that amount shall be considered to be an amount which is not allowable as a deduction in computing taxable income for the taxable year. The earnings and profits for the taxable year (but not the accumulated earnings and profits) shall not be considered to be less than (i) in the case of a taxable year ending before October 5, 1976, the amount (if any) of the net capital gain for the taxable year, or (ii) in the case of a taxable year ending after December 31, 1973, the amount (if any), of the excess of the net income from foreclosure property for the taxable year over the tax imposed thereon by section 857(b)(4)(A).

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4088, Apr. 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277 and 11279, Feb. 6, 1981]

§1.857–8 Records to be kept by a real estate investment trust.

(a) *In general.* Under section 857(a)(2) a real estate investment trust is required to keep such records as will disclose the actual ownership of its outstanding stock. Thus, every real estate investment trust shall maintain in the internal revenue district in which it is required to file its income tax return permanent records showing the information relative to the actual owners of its stock contained in the written statements required by this section to be demanded from its shareholders. Such records shall be kept at all times available for inspection by any internal revenue officer or employee, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(b) *Actual owner of stock.* The actual owner of stock of a real estate investment trust is the person who is required to include in gross income in his return the dividends received on the stock. Generally, such person is the shareholder of record of the real estate investment trust. However, where the shareholder of record is not the actual owner of the stock, the stockholding record of the real estate investment trust may not disclose the actual ownership of such stock. Accordingly, the real estate investment trust shall demand written statements from shareholders of record disclosing the actual owners of stock as required in paragraph (d) of this section.

(c) *Stock ownership for personal holding company determination.* For the purpose of determining under section 856(a)(6) whether a trust, claiming to be a real estate investment trust, is a personal holding company, the permanent records of the trust shall show the maximum number of shares of the trust (including the number and face value of securities convertible into stock of the trust) to be considered as actually or constructively owned by each of the actual owners of any of its stock at any time during the last half of the trust's taxable year, as provided in section 544.

(d) *Statements to be demanded from shareholders.* The information required by paragraphs (b) and (c) of this section shall be set forth in written statements which shall be demanded from shareholders of record as follows:

(1) In the case of a trust having 2,000 or more shareholders of record of its stock on any dividend record date, from each record holder of 5 percent or more of its stock; or

(2) In the case of a trust having less than 2,000 and more than 200 shareholders of record of its stock on any dividend record date, from each record holder of 1 percent or more of its stock; or

(3) In the case of a trust having 200 or less shareholders of record of its stock on any dividend record date, from each record holder of one-half of 1 percent or more of its stock.

(e) *Demands for statements.* The written statements from shareholders of record shall be demanded by the real estate investment trust in accordance with paragraph (d) of this section within 30 days after the close of the real estate investment trust's taxable year (or before June 1, 1962, whichever is later). When making demand for such written statements, the trust shall inform each such shareholder of his duty to submit at the time he files his income tax return (or before July 1, 1962, whichever is later) the statements which are required by §1.857–9 if he fails or refuses to comply with such demand. A list of the persons failing or refusing to comply in whole or in part with the trust's demand for statements under this section shall be maintained as a part of the trust's records required by this section. A trust which fails to keep such records to show, to the extent required by this section, the actual ownership of its outstanding stock shall be taxable as an ordinary corporation and not as a real estate investment trust.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4088, Apr. 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277 and 11279, Feb. 6, 1981]

§ 1.857–9 Information required in returns of shareholders.

(a) *In general.* Any person who fails or refuses to submit to a real estate investment trust the written statements required under § 1.857–8 to be demanded by such trust from its shareholders of record shall submit at the time he files his income tax return for his taxable year which ends with, or includes, the last day of the trust's taxable year (or before July 1, 1962, whichever is later) a statement setting forth the information required by this section.

(b) *Information required*—(1) *Shareholder of record not actual owner.* In the case of any person holding shares of stock in any trust claiming to be a real estate investment trust who is not the actual owner of such stock, the name and address of each actual owner, the number of shares owned by each actual owner at any time during such person's taxable year, and the amount of dividends belonging to each actual owner.

(2) *Actual owner of shares.* In the case of an actual owner of shares of stock in any trust claiming to be a real estate investment trust—

(i) The name and address of each such trust, the number of shares actually owned by him at any and all times during his taxable year, and the amount of dividends from each such trust received during his taxable year;

(ii) If shares of any such trust were acquired or disposed of during such person's taxable year, the name and address of the trust, the number of shares acquired or disposed of, the dates of acquisition or disposition, and the names and addresses of the persons from whom such shares were acquired or to whom they were transferred;

(iii) If any shares of stock (including securities convertible into stock) of any such trust are also owned by any member of such person's family (as defined in section 544(a)(2)), or by any of his partners, the name and address of the trust, the names and addresses of such members of his family and his partners, and the number of shares owned by each such member of his family or partner at any and all times during such person's taxable year; and

(iv) The names and addresses of any corporation, partnership, association, or trust, in which such person had a beneficial interest of 10 percent or more at any time during his taxable year.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4089, Apr. 28, 1962, as amended by T.D. 6628, 27 FR 12794, Dec. 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277 and 11279, Feb. 6, 1981]

§ 1.857–10 Information returns.

Nothing in §§ 1.857–8 and 1.857–9 shall be construed to relieve a real estate investment trust or its shareholders from the duty of filing information returns required by regulations prescribed under the provisions of subchapter A, chapter 61 of the Code.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4089, Apr. 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277 and 11279, Feb. 6, 1981]

§1.857–11 Non-REIT earnings and profits.

(a) *Applicability of section 857(a)(3)(A).* A real estate investment trust does not satisfy section 857(a)(3)(A) unless—

(1) Part II of subchapter M applied to the trust for all its taxable years beginning after February 28, 1986; and

(2) For each corporation to whose earnings and profits the trust succeeded by the operation of section 381, part II of subchapter M applied for all the corporation's taxable years beginning after February 28, 1986.

(b) *Applicability of section 857(a)(3)(B); in general.* A real estate investment trust does not satisfy section 857(a)(3)(B) unless, as of the close of the taxable year, it has no earnings and profits other than earnings and profits that—

(1) Were earned by a corporation in a year for which part II of subchapter M applied to the corporation and, at all times thereafter, were the earnings and profits of a corporation to which part II of subchapter M applied; or

(2) By the operation of section 381 pursuant to a transaction that occurred before December 22, 1992, became the earnings and profits of a corporation to which part II of subchapter M applied and, at all times thereafter, were the earnings and profits of a corporation to which part II of subchapter M applied.

(c) *Distribution procedures similar to those for regulated investment companies to apply.* Distribution procedures similar to those in section 852(e) for regulated investment companies apply to non-REIT earnings and profits of real estate investment trusts.

(d) *Effective date.* This regulation is effective for taxable years ending on or after December 22, 1992.

[T.D. 8483, 58 FR 43798, Aug. 18, 1993]

§1.858–1 Dividends paid by a real estate investment trust after close of taxable year.

(a) *General rule.* Under section 858, a real estate investment trust may elect to treat certain dividends that are distributed within a specified period after the close of a taxable year as having been paid during the taxable year. The dividend is taken into account in determining the deduction for dividends paid for the taxable year in which it is treated as paid. The dividend may be an ordinary dividend or, subject to the requirements of sections 857(b)(3)(C) and 858(c), a capital gain dividend. The trust may make the dividend declaration required by section 858(a)(1) either before or after the close of the taxable year as long as the declaration is made before the time prescribed by law for filing its return for the taxable year (including the period of any extension of time granted for filing the return).

(b) *Election*—(1) *Method of making election.* The election must be made in the return filed by the trust for the taxable year. The election shall be made by treating the dividend (or portion thereof) to which the election applies as a dividend paid during the taxable year of the trust in computing its real estate investment trust taxable income and, if applicable, the alternative tax imposed by section 857(b)(3)(A). (In the case of an election with respect to a taxable year ending before October 5, 1976, if the dividend (or portion thereof) to which the election is to apply is a capital gain dividend, the trust shall treat the dividend as paid during such taxable year in computing the amount of capital gains dividends paid during the taxable year.) In the case of an election with respect to a taxable year beginning after October 4, 1976, the trust must also specify in its return (or in a statement attached to its return) the exact dollar amount that is to be treated as having been paid during the taxable year.

(2) *Limitation based on earnings and profits.* The election provided in section 858(a) may be made only to the extent that the earnings and profits of the taxable year (computed with the application of sections 857(d) and § 1.857–7) exceed the total amount of distributions out of such earnings and profits actually made during the taxable year. For purposes of the preceding sentence, deficiency dividends and distributions with respect to which an election has been made for a prior year under section 858(a) are disregarded in determining the total amount of distributions out of earnings and profits actually made during the taxable year. The dividend or portion thereof, with respect to which the real estate investment trust has made a valid election under section 858(a), shall be considered as paid out of the earnings and profits of the taxable year for which such election is made, and not out of the earnings and profits of the taxable year in which the distribution is actually made.

(3) *Additional limitation based on amount specified.* The amount treated under section 858(a) as having been paid in a taxable year beginning after October 4, 1976, cannot exceed the lesser of (i) the dollar amount specified by the trust in its return (or a statement attached thereto) in making the election or (ii) the amount allowable under the limitation prescribed in paragraph (b)(2) of this section.

(4) *Irrevocability of the election.* After the expiration of the time for filing the return for the taxable year for which an election is made under section 858(a), such election shall be irrevocable with respect to the dividend or portion thereof to which it applies.

(c) *Receipt by shareholders.* Under section 858(b), the dividend or portion thereof, with respect to which a valid election has been made, will be includable in the gross income of the shareholders of the real estate investment trust for the taxable year in which the dividend is received by them.

(d) *Illustrations.* The application of paragraphs (a), (b), and (c) of this section may be illustrated by the following examples:

Example 1. The X Trust, a real estate investment trust, had taxable income (and earnings and profits) for the calendar year 1961 of $100,000. During that year the trust distributed to shareholders taxable dividends aggregating $88,000. On March 10, 1962, the trust declared a dividend of $37,000 payable to shareholders on March 20, 1962. Such dividend consisted of the first regular quarterly dividend for 1962 of $25,000 plus an additional $12,000 representing that part of the taxable income for 1961 which was not distributed in 1961. On March 15, 1962, the X Trust filed its Federal income tax return and elected therein to treat $12,000 of the total dividend of $37,000 to be paid to shareholders on March 20, 1962, as having been paid during the taxable year 1961. Assuming that the X Trust actually distributed the entire amount of the dividend of $37,000 on March 20, 1962, an amount equal to $12,000 thereof will be treated for the purposes of section 857(a) as having been paid during the taxable year 1961. Upon distribution of such dividend the trust becomes a qualified real estate investment trust for the taxable year 1961. Such amount ($12,000) will be considered by the X Trust as a distribution out of the earnings and profits for the taxable year 1961, and will be treated by the shareholders as a taxable dividend for the taxable year in which such distribution is received by them. However, assuming that the X Trust is not a qualified real estate investment trust for the calendar year 1962, nevertheless, the $12,000 portion of the dividend (paid on March 20, 1962) which the trust elected to relate to the calendar year 1961, will not qualify as a dividend for purposes of section 34, 116, or 243.

Example 2. The Y Trust, a real estate investment trust, had taxable income (and earnings and profits) for the calendar year 1964 of $100,000, and for 1965 taxable income (and earnings and profits) of $125,000. On January 1, 1964, the trust had a deficit in its earnings and profits accumulated since February 28, 1913, of $115,000. During the year 1964 the trust distributed to shareholders taxable dividends aggregating $85,000. On March 5, 1965, the trust declared a dividend of $65,000 payable to shareholders on March 31, 1965. On March 15, 1965, the Y Trust filed its Federal income tax return in which it included $40,000 of the total dividend of $65,000 payable to shareholders on March 31, 1965, as a dividend paid by it during the taxable year 1964. On March 31, 1965, the Y Trust distributed the entire amount of the dividend of $65,000 declared on March 5, 1965. The election under section 858(a) is valid only to the extent of $15,000, the amount of the undistributed earnings and profits for 1964 ($100,000 earnings and profits less $85,000 distributed during 1964). The remainder ($50,000) of the $65,000 dividend paid on March 31, 1965, could not be the subject of an election, and such amount will be regarded as a distribution by the Y Trust out of earnings and profits for the taxable year 1965. Assuming that the only other distribution by the Y Trust during 1965 was a distribution of $75,000 paid as a dividend on October 31, 1965, the total amount of the distribution of $65,000 paid on March 31, 1965, is to be treated by the shareholders as taxable dividends for the taxable year in which such dividend is received. The Y Trust will treat the amount of $15,000 as a distribution of the earnings or profits of the trust for the taxable year 1964, and the remaining $50,000 as a distribution of the earnings or profits for the year 1965. The distribution of $75,000 on October 31, 1966, is, of course, a taxable dividend out of the earnings and profits for the year 1965.

Example 3. Assume the facts are the same as in example 2, except that the taxable years involved are calendar years 1977 and 1978, and Y Trust specified in its Federal income tax return for 1977 that the dollar amount of $40,000 of the $65,000 distribution payable to shareholders on March 31, 1978, is to be treated as having been paid in 1977. The result will be the same as in example 2, since the amount of the undistributed earnings and profits for 1977 is less than the $40,000 amount specified by Y Trust in making its election. Accordingly, the election is valid only to the extent of $15,000. Y Trust will treat the amount of $15,000 as a distribution, in 1977, of earnings and profits of the trust for the taxable year 1977 and the remaining $50,000 as a distribution, in 1978, of the earnings and profits for 1978.

(e) *Notice to shareholders.* Section 858(c) provides that, in the case of dividends with respect to which a real estate investment trust has made an election under section 858(a), any notice to shareholders required under part II, subchapter M, chapter 1 of the Code, with respect to such amounts, shall be made not later than 30 days after the close of the taxable year in which the distribution is made. Thus, the notice requirement of section 857(b)(3)(C) and paragraph (f) of §1.857–6 with respect to capital gains dividends may be satisfied with respect to amounts to which section 858(a) and this section apply if the notice relating to such amounts is mailed to the shareholders not later than 30 days after the close of the taxable year in which the distribution is made. If the notice under section 858(c) reltes to an election with respect to any capital gains dividends, such capital gains dividends shall be aggregated by the real estate investment trust with the designated capital gains dividends actually paid during the taxable year to which the election applies (not including deficiency dividends or dividends with respect to which an election has been made for a prior taxable year under section 858) to determine whether the aggregate of the designated capital gains dividends with respect to such taxable year exceeds the net capital gain of the trust. See section 857(b)(3)(C) and paragraph (f) of §1.857–6.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4089, Apr. 28, 1962, as amended by T.D. 7767, 46 FR 11279, Feb. 6, 1981]

§1.860–1 Deficiency dividends.

Section 860 allows a qualified investment entity to be relieved from the payment of a deficiency in (or to be allowed a credit or refund of) certain taxes. ‘‘Qualified investment entity’’ is defined in section 860(b). The taxes referred to are those imposed by sections 852(b) (1) and (3), 857(b) (1) or (3), the minimum tax on tax preferences imposed by section 56 and, if the entity fails the distribution requirements of section 852(a)(1)(A) or 857(a)(1) (as applicable), the corporate income tax imposed by section 11(a) or 1201(a). The method provided by section 860 is to allow an additional deduction for a dividend distribution (that meets the requirements of section 860 and §1.860–2) in computing the deduction for dividends paid for the taxable year for which the deficiency is determined. A deficiency divided may be an ordinary dividend or, subject to the limitations of sections 852(b)(3)(C), 857(b)(3)(C), and 860(f)(2)(B), may be a capital gain dividend.

(Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805; sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 7936, 49 FR 2107, Jan. 18, 1984]

§ 1.860–2 Requirements for deficiency dividends.

(a) *In general*—(1) *Determination, etc.* A qualified investment entity is allowed a deduction for a deficiency dividend only if there is a determination (as defined in section 860(e) and paragraph (b)(1) of this section) that results in an adjustment (as defined in section 860(d) (1) or (2)) for the taxable year for which the deficiency dividend is paid. An adjustment does not include an increase in the excess of (i) the taxpayer's interest income excludable from gross income under section 103(a) over (ii) its deductions disallowed under sections 265 and 171(a)(2).

(2) *Payment date and claim.* The deficiency dividend must be paid on, or within 90 days after, the date of the determination and before the filing of a claim under section 860(g) and paragraph (b)(2) of this section. This claim must be filed within 120 days after the date of the determination.

(3) *Nature and amount of distribution.* (i) The deficiency dividend must be a distribution of property (including money) that would have been properly taken into account in computing the dividends paid deduction under section 561 for the taxable year for which tax liability resulting from the determination exists if the property had been distributed during that year. Thus, if the distribution would have been a dividend under section 316(a) if it had been made during the taxable year for which the determination applies, and the distribution may qualify under sections 316(b)(3), 562(a), and 860(f)(1), even though the distributing corporation, trust, or association has no current or accumulated earnings and profits for the taxable year in which the distribution is actually made. The amount of the distribution is determined under section 301 as of the date of the distribution.

The amount of the deduction is subject to the applicable limitations under sections 562 and 860(f)(2). Thus, if the entity distributes to an individual shareholder property (other than money) which on the date of the distribution has a fair market value in excess of its adjusted basis in the hands of the entity, the amount of the deficiency dividend in the individual's hands for purposes of section 316(b)(3) is determined by using the property's fair market value on that date. Nevertheless, the amount of the deficiency dividend the entity may deduct is limited, under § 1.562–1(a), to the adjusted basis of the property and the amount taxable to the individual as a dividend is determined by reference to the current and accumulated earnings and profits for the year to which the determination applies.

(ii) The qualified investment entity does not have to distribute the full amount of the adjustment in order to pay a deficiency dividend. For example, assume that in 1983 a determination with respect to a calendar year regulated investment company results in an increase of $100 in investment company taxable income (computed without the dividends paid deduction) for 1981 and no other change. The regulated investment company may choose to pay a deficiency dividend of $100 or of any lesser amount and be allowed a dividends paid deduction for 1981 for the amount of that deficiency dividend.

(4) *Status of distributor.* The corporation, trust, or association that pays the deficiency dividend does not have to be a qualified investment entity at the time of payment.

(5) *Certain definitions to apply.* For purposes of sections 860(d) (defining adjustment) and (f)(2) (limitations) the definitions of the terms ''investment company taxable income,'' ''real estate investment trust taxable income,'' and ''capital gains dividends'' in sections 852(b)(2), 857(b)(2), 852(b)(3)(C), and 857(b)(3)(C) apply, as appropriate to the particular entity.

(b) *Determination and claim for deduction*—(1) *Determination.* For purposes of applying section 860(e), the following rules apply:

(i) The date of determination by a decision of the United States Tax Court, the date upon which a judgment of a court becomes final, and the date of determination by a closing agreement shall be determined under the rules in § 1.547–2(b)(1) (ii), (iii), and (iv).

(ii) A determination under section 860(e)(3) may be made by an agreement signed by the district director or another official to whom authority to sign the agreement is delegated, and by or on behalf of the taxpayer. The agreement shall set forth the amount, if any, of each adjustment described in subparagraphs (A), (B), and (C) of section 860(d) (1) or (2) (as appropriate) for the taxable year and the amount of the liability for any tax imposed by section 11(a), 56(a), 852(b)(1), 852(b)(3)(A), 857(b)(1), 857(b)(3)(A), or 1201(a) for the taxable year. The agreement shall also set forth the amount of the limitation (determined under section 860(f)(2)) on the amount of deficiency dividends that can qualify as capital gain dividends and ordinary dividends, respectively, for the taxable year. An agreement under this subdivision (ii) which is signed by the district director (or other delegate) shall be sent to the taxpayer at its last known address by either registered or certified mail. If registered mail is used, the date of registration is the date of determination. If certified mail is used, the date of the postmark on the sender's receipt is the date of determination. However, if a dividend is paid by the taxpayer before the registration or postmark date, but on or after the date the agreement is signed by the district director (or other delegate), the date of determination is the date of signing.

(2) *Claim for deduction.* A claim for deduction for a deficiency dividend shall be made, with the requisite declaration, on Form 976 and shall contain the following information and have the following attachments:

(i) The name, address, and taxpayer identification number of the corporation, trust, or association;

(ii) The amount of the deficiency and the taxable year or years involved;

(iii) The amount of the unpaid deficiency or, if the deficiency has been paid in whole or in part, the date of payment and the amount thereof;

(iv) A statement as to how the deficiency was established (*i.e.*, by an agreement under section 860(e)(3), by a closing agreement under section 7121, or by a decision of the Tax Court or court judgment);

(v) Any date or other information with respect to the determination that is required by Form 976;

(vi) The amount and date of payment of the dividend with respect to which the claim for the deduction for deficiency dividends is filed;

(vii) The amount claimed as a deduction for deficiency dividends;

(viii) If the amount claimed as a deduction for deficiency dividends includes any amount designated (or to be designated) as capital gain dividends, the amount of capital gain dividends for which a deficiency dividend deduction is claimed;

(ix) Any other information required by the claim form;

(x) A certified copy of the resolution of the trustees, directors, or other authority authorizing the payment of the dividend with respect to which the claim is filed; and

(xi) A copy of any court decision, judgment, agreement, or other document required by Form 976.

(3) *Filing claim.* The claim, together with the accompanying documents, shall be filed with the district director, or director of the internal revenue service center, with whom the income tax return for the taxable year for which the determination applies was filed. In the event that the determination is an agreement with the district director (or other delegate) described in section 860(e)(3) and paragraph (b)(1)(ii) of this section, the claim may be filed with the district director with whom (or pursuant to whose delegation) the agreement was made.

(The reporting requirements of this section were approved by the Office of Management and Budget under control number 1545–0045)

(Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805; sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 7936, 49 FR 2107, Jan. 18, 1984; 49 FR 3177, Jan. 26, 1984]

§1.860–3 Interest and additions to tax.

(a) *In general.* If a qualified investment entity is allowed a deduction for deficiency dividends with respect to a taxable year, under section 860(c)(1) the tax imposed on the entity by chapter 1 of the Code (computed by taking into account the deduction) for that year is deemed to be increased by the amount of the deduction. This deemed increase in tax, however, applies solely for purposes of determining the liability of the entity for interest under subchapter A of chapter 67 of the Code and for additions to tax and additional amounts under chapter 68 of the Code. For purposes of applying subchapter A of chapter 67 and 68, the last date prescribed for payment of the deemed increase in tax is considered to be the last date prescribed for the payment of tax (determined in the manner provided in section 6601(b)) for the taxable year for which the deduction for deficiency dividends is allowed. The deemed increase in tax is considered to be paid as of the date that the claim for the deficiency dividend deduction described in section 860(g) is filed.

(b) *Overpayments of tax.* If a qualified investment entity is entitled to a credit or refund of an overpayment of the tax imposed by chapter 1 of the Code for the taxable year for which the deficiency dividend deduction is allowed, then, for purposes of computing interest, additions to tax, and additional amounts, the payment (or payments) that result in the overpayment and that precede the filing of the claim described in section 860(g) will be applied against and reduce the increase in tax that is deemed to occur under section 860(c)(1).

(c) *Examples.* This section is illustrated by the following examples:

Example 1. Corporation X is a real estate investment trust that files its income tax return on a calendar year basis. X receives an extension of time until June 15, 1978, to file its 1977 income tax return and files the return on May 15, 1978. X does not elect to pay any tax due in installments. For 1977, X reports real estate investment trust taxable income (computed without the dividends paid deduction) of $100, a dividends paid deduction of $100, and no tax liability. Following an examination of X's 1977 return, the district director and X enter into an agreement which is a determination under section 860(e)(3). The determination is dated November 1, 1979, and increases X's real estate investment trust taxable income (computed without the dividends paid deduction) by $20 to $120. Thus, taking into account the $100 of dividends paid in 1977, X has undistributed real estate investment trust taxable income of $20 as a result of the determination. X pays a dividend of $20 on November 10, 1979, files a claim for a deficiency dividend deduction of this $20 pursuant to section 860(g) on November 15, 1979, and is allowed a deficiency dividend deduction of $20 for 1977. After taking into account this deduction, X has no real estate investment trust taxable income and meets the distribution requirements of section 857(a)(1). However, for purposes of section 6601 (relating to interest on underpayment of tax), the tax imposed by chapter 1 of the Code on X for 1977 is deemed increased by this $20, and the last date prescribed for payment of the tax is March 15, 1978 (the due date of the 1977 return determined without any extension of time). The tax of $20 is deemed paid on November 15, 1979, the date the claim for the deficiency dividend deduction is filed. Thus, X is liable for interest on $20, at the rate established under section 6621, for the period from March 15, 1978, to November 15, 1979. Also, for purposes of determining whether X is liable for any addition to tax or additional amount imposed by chapter 68 of the Code (including the penalty prescribed by section 6697), the amount of tax imposed on X by chapter 1 of the Code is deemed to be increased by $20 (the amount of the deficiency dividend deduction allowed), the last date prescribed for payment of such tax is March 15, 1978, and the tax of $20 is deemed to be paid on November 15, 1979. X, however, is not subject to interest and penalties for the amount of any tax for which it would have been liable under section 11(a), 56(a), 1201(a), or 857(b) had it not been allowed the $20 deduction for deficiency dividends.

Example 2. Assume the facts are the same as in example (1) except that the district director, upon examining X's income tax return, asserts an income tax deficiency of $4, based on an asserted increase of $10 in real estate investment trust taxable income, and no agreement is entered into between the parties. X pays the $4 on June 1, 1979, and files suit for refund in the United States District Court. The District Court, in a decision which becomes final on November 1, 1980, holds that X did fail to report $10 of real estate investment trust taxable income and is not entitled to any refund. (No other item of income or deduction is in issue.) X pays a dividend of $10 on November 10, 1980, files a claim for a deficiency dividend deduction of this $10 on November 15, 1980, and is allowed a deficiency dividend deduction of $10 for 1977. Assume further that $4 is refunded to X on December 31, 1980, as the result of the $10 deficiency dividend deduction being allowed. Also assume that any assessable penalties, additional amounts, and additions to tax (including the penalty imposed by section 6697) for which X is liable are paid within 10 days of notice and demand, so that no interest is imposed on such penalties, etc. X's liability for interest for the period March 15, 1978, to June 1, 1979, is determined with respect to $10 (the amount of the deficiency dividend deduction allowed). X's liability for interest for the period June 1, 1979, to November 15, 1980, is determined with respect to $6, *i.e.*, $10 minus the $4 payment. X is entitled to interest on the $4 overpayment for the period described in section 6611(b)(2), beginning on November 15, 1980.

(Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805; sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 7936, 49 FR 2108, Jan. 18, 1984]

§1.860–4 Claim for credit or refund.

If the allowance of a deduction for a deficiency dividend results in an overpayment of tax, the taxpayer, in order to secure credit or refund of the overpayment, must file a claim on Form 1120X in addition to the claim for the deficiency dividend deduction required under section 860(g). The credit or refund will be allowed as if on the date of the determination (as defined in section 860(e)) two years remained before the expiration of the period of limitations on the filing of claim for refund for the taxable year to which the overpayment relates.

(The reporting requirements of this section were approved by the Office of Management and Budget under control number 1545–0045)

(Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805; sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 7936, 49 FR 2109, Jan. 18, 1984]

§1.860–5 Effective date.

(a) *In general.* Section 860 and §§1.860–1 through 1.860–4 apply with respect to determinations after November 6, 1978.

(b) *Prior determination of real estate investments trusts.* Section 859 (as in effect before the enactment of the Revenue Act of 1978) applies to determinations with respect to real estate investment trusts occurring after October 4, 1976, and before November 7, 1978. In the case of such a determination, the rules in §§1.860–1 through 1.860–4 apply, a reference in this chapter 1 to section 860 (or to a particular provision of section 860) shall be considered to be a reference to section 859 (or to the corresponding substantive provision of section 859), as in effect before enactment of the Revenue Act of 1978, and "qualified investment entity" in §§1.381(c)25–1(a) and 1.860–1 through 1.860–3 means a real estate investment trust.

(Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805; sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)))

[T.D. 7936, 49 FR 2109, Jan. 18, 1984]

§1.860A–0 Outline of REMIC provisions.

This section lists the paragraphs contained in §§1.860A–1 through 1.860G–3.

Section 1.860A–1 Effective dates and transition rules.

(a) In general.
(b) Exceptions.
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(2) Tax avoidance rules.
(i) Transfers of certain residual interests.
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(iii) Residual interests that lack significant value.
(3) Excise taxes.
(4) Rate based on current interest rate.
(i) In general.
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Section 1.860C–1 Taxation of holders of residual interests.

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(b) Adjustments to basis of residual interests.
(1) Increase in basis.
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(3) Adjustments made before disposition.
(c) Counting conventions.

Section 1.860C–2 Determination of REMIC taxable income or net loss.

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(b) Deductions allowable to a REMIC.
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(2) Deduction allowable under section 163.
(3) Deduction allowable under section 166.
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Section 1.860D–1 Definition of a REMIC.

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(3) Asset test.
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Section 1.860E–1 Treatment of taxable income of a residual interest holder in excess of daily accruals.

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(2) Affiliated groups.
(3) Special rule for certain financial institutions.
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(B) Example.
(iii) Significant value.
(iv) Determining anticipated weighted average life.
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(D) Anticipated payments.
(b) Treatment of a residual interest held by REITs, RICs, common trust funds, and subchapter T cooperatives. [Reserved]
(c) Transfers of noneconomic residual interests.
(1) In general.
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(3) Computations.
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Section 1.860E–2 Tax on transfers of residual interest to certain organizations.

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(b) [Reserved]

[T.D. 8458, 57 FR 61299, Dec. 24, 1992; 58 FR 15089, Mar. 19, 1993, as amended by T.D. 8614, 60 FR 42787, Aug. 17, 1995]

§ 1.860A–1 Effective dates and transition rules.

(a) *In general.* Except as otherwise provided in paragraph (b) of this section, the regulations under sections 860A through 860G are effective only for a qualified entity (as defined in § 1.860D–1(c)(3)) whose startup day (as defined in section 860G(a)(9) and § 1.860G–2(k)) is on or after November 12, 1991.

(b) *Exceptions*—(1) *Reporting regulations*—(i) Sections 1.860D–1(c) (1) and (3), and § 1.860D–1(d) (1) through (3) are effective after December 31, 1986.

(ii) Sections 1.860F–4 (a) through (e) are effective after December 31, 1986 and are applicable after that date except as follows:

(A) Section 1.860F–4(c)(1) is effective for REMICs with a startup day on or after November 10, 1988.

(B) Sections 1.860F–4(e)(1)(ii) (A) and (B) are effective for calendar quarters and calendar years beginning after December 31, 1988.

(C) Section 1.860F–4(e)(1)(ii)(C) is effective for calendar quarters and calendar years beginning after December 31, 1986 and ending before January 1, 1988.

(D) Section 1.860F–4(e)(1)(ii)(D) is effective for calendar quarters and calendar years beginning after December 31, 1987 and ending before January 1, 1990.

(2) *Tax avoidance rules*—(i) *Transfers of certain residual interests.* Section 1.860E–1(c) (concerning transfers of noneconomic residual interests) and § 1.860G–3(a)(4) (concerning transfers by a foreign holder to a United States person) are effective for transfers of residual interests on or after September 27, 1991.

(ii) *Transfers to foreign holders.* Generally, § 1.860G–3(a) (concerning transfers of residual interests to foreign holders) is effective for transfers of residual interests after April 20, 1992. However, § 1.860G–3(a) does not apply to a transfer of a residual interest in a REMIC by the REMIC's sponsor (or by another transferor contemporaneously with formation of the REMIC) on or before June 30, 1992, if—

(A) The terms of the regular interests and the prices at which regular interests were offered had been fixed on or before April 20, 1992;

(B) On or before June 30, 1992, a substantial portion of the regular interests in the REMIC were transferred, with the terms and at the prices that were fixed on or before April 20, 1992, to investors who were unrelated to the REMIC's sponsor at the time of the transfer; and

(C) At the time of the transfer of the residual interest, the expected future distributions on the residual interest were equal to at least 30 percent of the anticipated excess inclusions (as defined in § 1.860E–2(a)(3)), and the transferor reasonably expected that the transferee would receive sufficient distributions from the REMIC at or after the time at which the excess inclusions accrue in an amount sufficient to satisfy the taxes on the excess inclusions.

(iii) *Residual interests that lack significant value.* The significant value requirement in § 1.860E–1(a) (1) and (3) (concerning excess inclusions accruing to organizations to which section 593 applies) generally is effective for residual interests acquired on or after September 27, 1991. The significant value requirement in §1.860E–1(a) (1) and (3) does not apply, however, to residual interests acquired by an organization to which section 593 applies as a sponsor at formation of a REMIC in a transaction described in §1.860F–2(a)(1) if more than 50 percent of the interests in the REMIC (determined by reference to issue price) were sold to unrelated investors before November 12, 1991. The exception from the significant value requirement provided by the preceding sentence applies only so long as the sponsor owns the residual interests.

(3) *Excise taxes.* Section 1.860E–2(a)(1) is effective for transfers of residual interests to disqualified organizations after March 31, 1988. Section 1.860E–2(b)(1) is effective for excess inclusions accruing to pass-thru entities after March 31, 1988.

(4) *Rate based on current interest rate*—(i) *In general.* Section 1.860G–1(a)(3)(i) applies to obligations (other than transition obligations described in paragraph (b)(4)(iii) of this section) intended to qualify as regular interests that are issued on or after April 4, 1994.

(ii) *Rate based on index.* Section 1.860G–1(a)(3)(i) (as contained in 26 CFR part 1 revised as of April 1, 1994) applies to obligations intended to qualify as regular interests that—

(A) Are issued by a qualified entity (as defined in §1.860D–1(c)(3)) whose startup date (as defined in section 860G(a)(9) and §1.860G–2(k)) is on or after November 12, 1991; and

(B) Are either—

(*1*) Issued before April 4, 1994; or

(*2*) Transition obligations described in paragraph (b)(4)(iii) of this section.

(iii) *Transition obligations.* Obligations are described in this paragraph (b)(4)(iii) if—

(A) The terms of the obligations and the prices at which the obligations are offered are fixed before April 4, 1994; and

(B) On or before June 1, 1994, a substantial portion of the obligations are transferred, with the terms and at the prices that are fixed before April 4, 1994, to investors who are unrelated to the REMIC's sponsor at the time of the transfer.

[T.D. 8458, 57 FR 61300, Dec. 24, 1992; 58 FR 8098, Feb. 11, 1993; 58 FR 15089, Mar. 19, 1993; T.D. 8614, 60 FR 42787, Aug. 17, 1995]

§1.860C–1 Taxation of holders of residual interests.

(a) *Pass-thru of income or loss.* Any holder of a residual interest in a REMIC must take into account the holder's daily portion of the taxable income or net loss of the REMIC for each day during the taxable year on which the holder owned the residual interest.

(b) *Adjustments to basis of residual interests*—(1) *Increase in basis.* A holder's basis in a residual interest is increased by—

(i) The daily portions of taxable income taken into account by that holder under section 860C(a) with respect to that interest; and

(ii) The amount of any contribution described in section 860G(d)(2) made by that holder.

(2) *Decrease in basis.* A holder's basis in a residual interest is reduced (but not below zero) by—

(i) First, the amount of any cash or the fair market value of any property distributed to that holder with respect to that interest; and

(ii) Second, the daily portions of net loss of the REMIC taken into account under section 860C(a) by that holder with respect to that interest.

(3) *Adjustments made before disposition.* If any person disposes of a residual interest, the adjustments to basis prescribed in paragraph (b) (1) and (2) of this section are deemed to occur immediately before the disposition.

(c) *Counting conventions.* For purposes of determining the daily portion of REMIC taxable income or net loss under section 860C(a)(2), any reasonable convention may be used. An example of a reasonable convention is ''30 days per month/90 days per quarter/360 days per year.''

[T.D. 8458, 57 FR 61301, Dec. 24, 1992]

§1.860C–2 Determination of REMIC taxable income or net loss.

(a) *Treatment of gain or loss.* For purposes of determining the taxable income or net loss of a REMIC under section 860C(b), any gain or loss from the disposition of any asset, including a qualified mortgage (as defined in section 860G(a)(3)) or a permitted investment (as defined in section 860G(a)(5) and § 1.860G–2(g)), is treated as gain or loss from the sale or exchange of property that is not a capital asset.

(b) *Deductions allowable to a REMIC*—(1) *In general.* Except as otherwise provided in section 860C(b) and in paragraph (b) (2) through (5) of this section, the deductions allowable to a REMIC for purposes of determining its taxable income or net loss are those deductions that would be allowable to an individual, determined by taking into account the same limitations that apply to an individual.

(2) *Deduction allowable under section 163.* A REMIC is allowed a deduction, determined without regard to section 163(d), for any interest expense accrued during the taxable year.

(3) *Deduction allowable under section 166.* For purposes of determining a REMIC's bad debt deduction under section 166, debt owed to the REMIC is not treated as nonbusiness debt under section 166(d).

(4) *Deduction allowable under section 212.* A REMIC is not treated as carrying on a trade or business for purposes of section 162. Ordinary and necessary operating expenses paid or incurred by the REMIC during the taxable year are deductible under section 212, without regard to section 67. Any expenses that are incurred in connection with the formation of the REMIC and that relate to the organization of the REMIC and the issuance of regular and residual interests are not treated as expenses of the REMIC for which a deduction is allowable under section 212. See § 1.860F–2(b)(3)(ii) for treatment of those expenses.

(5) *Expenses and interest relating to tax-exempt income.* Pursuant to section 265(a), a REMIC is not allowed a deduction for expenses and interest allocable to tax-exempt income. The portion of a REMIC's interest expense that is allocable to tax-exempt interest is determined in the manner prescribed in section 265(b)(2), without regard to section 265(b)(3).

[T.D. 8458, 57 FR 61301, Dec. 24, 1992]

§ 1.860D–1 Definition of a REMIC.

(a) *In general.* A real estate mortgage investment conduit (or REMIC) is a qualified entity, as defined in paragraph (c)(3) of this section, that satisfies the requirements of section 860D(a). See paragraph (d)(1) of this section for the manner of electing REMIC status.

(b) *Specific requirements*—(1) *Interests in a REMIC*—(i) *In general.* A REMIC must have one class, and only one class, of residual interests. Except as provided in paragraph (b)(1)(ii) of this section, every interest in a REMIC must be either a regular interest (as defined in section 860G(a)(1) and § 1.860G–1(a)) or a residual interest (as defined in section 860G(a)(2) and § 1.860G–1(c)).

(ii) *De minimis interests.* If, to facilitate the creation of an entity that elects REMIC status, an interest in the entity is created and, as of the startup day (as defined in section 860G(a)(9) and § 1.860G–2(k)), the fair market value of that interest is less than the lesser of $1,000 or 1/1,000 of one percent of the aggregate fair market value of all the regular and residual interests in the REMIC, then, unless that interest is specifically designated as an interest in the REMIC, the interest is not treated as an interest in the REMIC for purposes of section 860D(a) (2) and (3) and paragraph (B)(1)(i) of this section.

(2) *Certain rights not treated as interests.* Certain rights are not treated as interests in a REMIC. Although not an exclusive list, the following rights are not interests in a REMIC.

(i) *Payments for services.* The right to receive from the REMIC payments that represent reasonable compensation for services provided to the REMIC in the ordinary course of its operation is not an interest in the REMIC. Payments made by the REMIC in exchange for services may be expressed as a specified percentage of interest payments due on qualified mortgages or as a specified percentage of earnings from permitted investments. For example, a mortgage servicer's right to receive reasonable compensation for servicing the mortgages owned by the REMIC is not an interest in the REMIC.

(ii) *Stripped interests.* Stripped bonds or stripped coupons not held by the

REMIC are not interests in the REMIC even if, in a transaction preceding or contemporaneous with the formation of the REMIC, they and the REMIC's qualified mortgages were created from the same mortgage obligation. For example, the right of a mortgage servicer to receive a servicing fee in excess of reasonable compensation from payments it receives on mortgages held by a REMIC is not an interest in the REMIC. Further, if an obligation with a fixed principal amount provides for interest at a fixed or variable rate and for certain contingent payment rights (*e.g.*, a shared appreciation provision or a percentage of mortgagor profits provision), and the owner of the obligation contributes the fixed payment rights to a REMIC and retains the contingent payment rights, the retained contingent payment rights are not an interest in the REMIC.

(iii) *Reimbursement rights under credit enhancement contracts.* A credit enhancer's right to be reimbursed for amounts advanced to a REMIC pursuant to the terms of a credit enhancement contract (as defined in §1.860G–2 (c)(2)) is not an interest in the REMIC even if the credit enhancer is entitled to receive interest on the amounts advanced.

(iv) *Rights to acquire mortgages.* The right to acquire or the obligation to purchase mortgages and other assets from a REMIC pursuant to a clean-up call (as defined in §1.860G–2(j)) or a qualified liquidation (as defined in section 860F(a)(4)), or on conversion of a convertible mortgage (as defined in §1.860G–2(d)(5)), is not an interest in the REMIC.

(3) *Asset test*—(i) *In general.* For purposes of the asset test of section 860D(a)(4), substantially all of a qualified entity's assets are qualified mortgages and permitted investments if the qualified entity owns no more than a de minimis amount of other assets.

(ii) *Safe harbor.* The amount of assets other than qualified mortgages and permitted investments is de minimis if the aggregate of the adjusted bases of those assets is less than one percent of the aggregate of the adjusted bases of all of the REMIC's assets. Nonetheless, a qualified entity that does not meet this safe harbor may demonstrate that it owns no more than a de minimis amount of other assets.

(4) *Arrangements test.* Generally, a qualified entity must adopt reasonable arrangements designed to ensure that—

(i) Disqualified organizations (as defined in section 860E(e)(5)) do not hold residual interests in the qualified entity; and

(ii) If a residual interest is acquired by a disqualified organization, the qualified entity will provide to the Internal Revenue Service, and to the persons specified in section 860E(e)(3), information needed to compute the tax imposed under section 860E(e) on transfers of residual interests to disqualified organizations.

(5) *Reasonable arrangements*—(i) *Arrangements to prevent disqualified organizations from holding residual interests.* A qualified entity is considered to have adopted reasonable arrangements to ensure that a disqualified organization (as defined in section 860E(e)(5)) will not hold a residual interest if—

(A) The residual interest is in registered form (as defined in §5f.103–1(c) of this chapter); and

(B) The qualified entity's organizational documents clearly and expressly prohibit a disqualified organization from acquiring beneficial ownership of a residual interest, and notice of the prohibition is provided through a legend on the document that evidences ownership of the residual interest or through a conspicuous statement in a prospectus or private offering document used to offer the residual interest for sale.

(ii) *Arrangements to ensure that information will be provided.* A qualified entity is considered to have made reasonable arrangements to ensure that the Internal Revenue Service and persons specified in section 860E(e)(3) as liable for the tax imposed under section 860E(e) receive the information needed to compute the tax if the qualified entity's organizational documents require that it provide to the Internal Revenue Service and those persons a computation showing the present value of the total anticipated excess inclusions with respect to the residual interest for periods after the transfer. See

§ 1.860E–2(a)(5) for the obligation to furnish information on request.

(6) *Calendar year requirement.* A REMIC's taxable year is the calendar year. The first taxable year of a REMIC begins on the startup day and ends on December 31 of the same year. If the startup day is other than January 1, the REMIC has a short first taxable year.

(c) *Segregated pool of assets*—(1) *Formation of REMIC.* A REMIC may be formed as a segregated pool of assets rather than as a separate entity. To constitute a REMIC, the assets identified as part of the segregated pool must be treated for all Federal income tax purposes as assets of the REMIC and interests in the REMIC must be based solely on assets of the REMIC.

(2) *Identification of assets.* Formation of the REMIC does not occur until—

(i) The sponsor identifies the assets of the REMIC, such as through execution of an indenture with respect to the assets; and

(ii) The REMIC issues the regular and residual interests in the REMIC.

(3) *Qualified entity defined.* For purposes of this section, the term ''qualified entity'' includes an entity or a segregated pool of assets within an entity.

(d) *Election to be treated as a real estate mortgage investment conduit*—(1) *In general.* A qualified entity, as defined in paragraph (c)(3) of this section, elects to be treated as a REMIC by timely filing, for the first taxable year of its existence, a Form 1066, U.S. Real Estate Mortgage Investment Conduit Income Tax Return, signed by a person authorized to sign that return under § 1.860F–4(c). See § 1.9100–1 for rules regarding extensions of time for making elections. Once made, this election is irrevocable for that taxable year and all succeeding taxable years.

(2) *Information required to be reported in the REMIC's first taxable year.* For the first taxable year of the REMIC's existence, the qualified entity, as defined in paragraph (c)(3) of this section, must provide either on its return or in a separate statement attached to its return—

(i) The REMIC's employer identification number, which must not be the same as the identification number of any other entity,

(ii) Information concerning the terms and conditions of the regular interests and the residual interest of the REMIC, or a copy of the offering circular or prospectus containing such information,

(iii) A description of the prepayment and reinvestment assumptions that are made pursuant to section 1272(a)(6) and the regulations thereunder, including a statement supporting the selection of the prepayment assumption,

(iv) The form of the electing qualified entity under State law or, if an election is being made with respect to a segregated pool of assets within an entity, the form of the entity that holds the segregated pool of assets, and

(v) Any other information required by the form.

(3) *Requirement to keep sufficient records.* A qualified entity, as defined in paragraph (c)(3) of this section, that elects to be a REMIC must keep sufficient records concerning its investments to show that it has complied with the provisions of sections 860A through 860G and the regulations thereunder during each taxable year.

[T.D. 8366, 56 FR 49516, Sept. 30, 1991; T.D. 8458, 57 FR 61301, Dec. 24, 1992]

§ 1.860E–1 Treatment of taxable income of a residual interest holder in excess of daily accruals.

(a) *Excess inclusion cannot be offset by otherwise allowable deductions*—(1) *In general.* Except as provided in paragraph (a)(3) of this section, the taxable income of any holder of a residual interest for any taxable year is in no event less than the sum of the excess inclusions attributable to that holder's residual interests for that taxable year. In computing the amount of a net operating loss (as defined in section 172(c)) or the amount of any net operating loss carryover (as defined in section 172(b)(2)), the amount of any excess inclusion is not included in gross income or taxable income. Thus, for example, if a residual interest holder has $100 of gross income, $25 of which is an excess inclusion, and $90 of business deductions, the holder has taxable income of $25, the amount of the excess inclusion, and a net operating loss of $15 ($75 of other income – $90 of business deductions).

(2) *Affiliated groups.* If a holder of a REMIC residual interest is a member of an affiliated group filing a consolidated income tax return, the taxable income of the affiliated group cannot be less than the sum of the excess inclusions attributable to all residual interests held by members of the affiliated group.

(3) *Special rule for certain financial institutions*—(i) *In general.* If an organization to which section 593 applies holds a residual interest that has significant value (as defined in paragraph (a)(3)(iii) of this section), section 860E(a)(1) and paragraph (a)(1) of this section do not apply to that organization with respect to that interest. Consequently, an organization to which section 593 applies may use its allowable deductions to offset an excess inclusion attributable to a residual interest that has significant value, but, except as provided in section 860E(a)(4)(A), may not use its allowable deductions to offset an excess inclusion attributable to a residual interest held by any other member of an affiliated group, if any, of which the organization is a member. Further, a net operating loss of any other member of an affiliated group of which the organization is a member may not be used to offset an excess inclusion attributable to a residual interest held by that organization.

(ii) *Ordering rule*—(A) *In general.* In computing taxable income for any year, an organization to which section 593 applies is treated as having applied its allowable deductions for the year first to offset that portion of its gross income that is not an excess inclusion and then to offset that portion of its income that is an excess inclusion.

(B) *Example.* The following example illustrates the provisions of paragraph (a)(3)(ii) of this section:

Example. Corp. *X,* a corporation to which section 593 applies, is a member of an affiliated group that files a consolidated return. For a particular taxable year, Corp. *X* has gross income of $1,000, and of this amount, $150 is an excess inclusion attributable to a residual interest that has significant value. Corp. *X* has $975 of allowable deductions for the taxable year. Corp. *X* must apply its allowable deductions first to offset the $850 of gross income that is not an excess inclusion, and then to offset the portion of its gross income that is an excess inclusion. Thus, Corp. *X* has $25 of taxable income ($1,000 − $975), and that $25 is an excess inclusion that may not be offset by losses sustained by other members of the affiliated group.

(iii) *Significant value.* A residual interest has significant value if—

(A) The aggregate of the issue prices of the residual interests in the REMIC is at least 2 percent of the aggregate of the issue prices of all residual and regular interests in the REMIC; and

(B) The anticipated weighted average life of the residual interests is at least 20 percent of the anticipated weighted average life of the REMIC.

(iv) *Determining anticipated weighted average life*—(A) *Anticipated weighted average life of the REMIC.* The anticipated weighted average life of a REMIC is the weighted average of the anticipated weighted average lives of all classes of interests in the REMIC. This weighted average is determined under the formula in paragraph (a)(3)(iv)(B) of this section, applied by treating all payments taken into account in computing the anticipated weighted average lives of regular and residual interests in the REMIC as principal payments on a single regular interest.

(B) *Regular interests that have a specified principal amount.* Generally, the anticipated weighted average life of a regular interest is determined by—

(*1*) Multiplying the amount of each anticipated principal payment to be made on the interest by the number of years (including fractions thereof) from the startup day (as defined in section 860G(a)(9) and §1.860G–2(k)) to the related principal payment date;

(*2*) Adding the results; and

(*3*) Dividing the sum by the total principal paid on the regular interest.

(C) *Regular interests that have no specified principal amount or that have only a nominal principal amount, and all residual interests.* If a regular interest has no specified principal amount, or if the interest payments to be made on a regular interest are disproportionately high relative to its specified principal amount (as determined by reference to §1.860G–1(b)(5)(i)), then, for purposes of computing the anticipated weighted average life of the interest, all anticipated payments on that interest, regardless of their designation as principal or interest, must be taken into account in applying the formula set out in paragraph (a)(3)(iv)(B) of this section. Moreover, for purposes of computing the weighted average life of a residual interest, all anticipated payments on that interest, regardless of their designation as principal or interest, must be taken into account in applying the formula set out in paragraph (a)(3)(iv)(B) of this section.

(D) *Anticipated payments.* The anticipated principal payments to be made on a regular interest subject to paragraph (a)(3)(iv)(B) of this section, and the anticipated payments to be made on a regular interest subject to paragraph (a)(3)(iv)(C) of this section or on a residual interest, must be determined based on—

(*1*) The prepayment and reinvestment assumptions adopted under section 1272(a)(6), or that would have been adopted had the REMIC's regular interests been issued with original issue discount; and

(*2*) Any required or permitted clean up calls or any required qualified liquidation provided for in the REMIC's organizational documents.

(b) *Treatment of residual interests held by REITs, RICs, common trust funds, and subchapter T cooperatives.* [Reserved]

(c) *Transfers of noneconomic residual interests*—(1) *In general.* A transfer of a noneconomic residual interest is disregarded for all Federal tax purposes if a significant purpose of the transfer was to enable the transferor to impede the assessment or collection of tax. A significant purpose to impede the assessment or collection of tax exists if the transferor, at the time of the transfer, either knew or should have known (had ''improper knowledge'') that the transferee would be unwilling or unable to pay taxes due on its share of the taxable income of the REMIC.

(2) *Noneconomic residual interest.* A residual interest is a noneconomic residual interest unless, at the time of the transfer—

(i) The present value of the expected future distributions on the residual interest at least equals the product of the present value of the anticipated excess inclusions and the highest rate of tax specified in section 11(b)(1) for the year in which the transfer occurs; and

(ii) The transferor reasonably expects that, for each anticipated excess inclusion, the transferee will receive distributions from the REMIC at or after the time at which the taxes accrue on the anticipated excess inclusion in an amount sufficient to satisfy the accrued taxes.

(3) *Computations.* The present value of the expected future distributions and the present value of the anticipated excess inclusions must be computed under the procedure specified in § 1.860E–2(a)(4) for determining the present value of anticipated excess inclusions in connection with the transfer of a residual interest to a disqualified organization.

(4) *Safe harbor for establishing lack of improper knowledge.* A transferor is presumed not to have improper knowledge if—

(i) The transferor conducted, at the time of the transfer, a reasonable investigation of the financial condition of the transferee and, as a result of the investigation, the transferor found that the transferee had historically paid its debts as they came due and found no significant evidence to indicate that the transferee will not continue to pay its debts as they come due in the future; and

(ii) The transferee represents to the transferor that it understands that, as the holder of the noneconomic residual interest, the transferee may incur tax liabilities in excess of any cash flows generated by the interest and that the transferee intends to pay taxes associated with holding the residual interest as they become due.

(d) *Transfers to foreign persons.* Paragraph (c) of this section does not apply to transfers of residual interests to which § 1.860G–3(a)(1), concerning transfers to certain foreign persons, applies.

[T.D. 8458, 57 FR 61302, Dec. 24, 1992; 58 FR 8098, Feb. 11, 1993]

§ 1.860E–2 Tax on transfers of residual interests to certain organizations.

(a) *Transfers to disqualified organizations*—(1) *Payment of tax.* Any excise tax due under section 860E(e)(1) must be paid by the later of March 24, 1993, or April 15th of the year following the calendar year in which the residual interest is transferred to a disqualified organization. The Commissioner may prescribe rules for the manner and method of collecting the tax.

(2) *Transitory ownership.* For purposes of section 860E (e) and this section, a transfer of a residual interest to a disqualified organization in connection with the formation of a REMIC is disregarded if the disqualified organization has a binding contract to sell the interest and the sale occurs within 7 days of the startup day (as defined in section 860G(a)(9) and § 1.860G–2(k)).

(3) *Anticipated excess inclusions.* The anticipated excess inclusions are the excess inclusions that are expected to accrue in each calendar quarter (or portion thereof) following the transfer of the residual interest. The anticipated excess inclusions must be determined as of the date the residual interest is transferred and must be based on—

(i) Events that have occurred up to the time of the transfer;

(ii) The prepayment and reinvestment assumptions adopted under section 1272(a)(6), or that would have been adopted had the REMIC's regular interests been issued with original issue discount; and

(iii) Any required or permitted clean up calls, or required qualified liquidation provided for in the REMIC's organizational documents.

(4) *Present value computation.* The present value of the anticipated excess inclusions is determined by discounting the anticipated excess inclusions from the end of each remaining calendar quarter in which those excess inclusions are expected to accrue to the date the disqualified organization acquires the residual interest. The discount rate to be used for this present value computation is the applicable Federal rate (as specified in section 1274(d)(1)) that would apply to a debt instrument that was issued on the date the disqualified organization acquired the residual interest and whose term ended on the close of the last quarter in which excess inclusions were expected to accrue with respect to the residual interest.

(5) *Obligation of REMIC to furnish information.* A REMIC is not obligated to determine if its residual interests have been transferred to a disqualified organization. However, upon request of a person designated in section 860E(e)(3), the REMIC must furnish information sufficient to compute the present value of the anticipated excess inclusions. The information must be furnished to the requesting party and to the Internal Revenue Service within 60 days of the request. A reasonable fee charged to the requestor is not income derived from a prohibited transaction within the meaning of section 860F(a).

(6) *Agent.* For purposes of section 860E(e)(3), the term ''agent'' includes a broker (as defined in section 6045(c) and § 1.6045–1(a)(1)), nominee, or other middleman.

(7) *Relief from liability*—(i) *Transferee furnishes information under penalties of perjury.* For purposes of section 860E(e)(4), a transferee is treated as having furnished an affidavit if the transferee furnishes—

(A) A social security number, and states under penalties of perjury that the social security number is that of the transferee; or

(B) A statement under penalties of perjury that it is not a disqualified organization.

(ii) *Amount required to be paid.* The amount required to be paid under section 860E(e)(7)(B) is equal to the product of the highest rate specified in section 11(b)(1) for the taxable year in which the transfer described in section 860E(e)(1) occurs and the amount of excess inclusions that accrued and were allocable to the residual interest during the period that the disqualified organization held the interest.

(b) *Tax on pass-thru entities*—(1) *Tax on excess inclusions.* Any tax due under section 860E(e)(6) must be paid by the later of March 24, 1993, or by the fifteenth day of the fourth month following the close of the taxable year of the pass-thru entity in which the disqualified person is a record holder. The Commissioner may prescribe rules for the manner and method of collecting the tax.

(2) *Record holder furnishes information under penalties of perjury.* For purposes of section 860E(e)(6)(D), a record holder is treated as having furnished an affidavit if the record holder furnishes—

(i) A social security number and states, under penalties of perjury, that the social security number is that of the record holder; or

(ii) A statement under penalties of perjury that it is not a disqualified organization.

(3) *Deductibility of tax.* Any tax imposed on a pass-thru entity pursuant to section 860E(e)(6)(A) is deductible against the gross amount of ordinary income of the pass-thru entity. For example, in the case of a REIT, the tax is deductible in determining real estate investment trust taxable income under section 857(b)(2).

(4) *Allocation of tax.* Dividends paid by a RIC or by a REIT are not preferential dividends within the meaning of section 562(c) solely because the tax expense incurred by the RIC or REIT under section 860E(e)(6) is allocated solely to the shares held by disqualified organizations.

[T.D. 8458, 57 FR 61304, Dec. 24, 1992]

§ 1.860F–1 Qualified liquidations.

A plan of liquidation need not be in any special form. If a REMIC specifies the first day in the 90-day liquidation period in a statement attached to its final return, then the REMIC will be considered to have adopted a plan of liquidation on the specified date.

[T.D. 8458, 57 FR 61304, Dec. 24, 1992]

§ 1.860F–2 Transfers to a REMIC.

(a) *Formation of a REMIC*—(1) *In general.* For Federal income tax purposes, a REMIC formation is characterized as the contribution of assets by a sponsor (as defined in paragraph (b)(1) of this section) to a REMIC in exchange for REMIC regular and residual interests. If, instead of exchanging its interest in mortgages and related assets for regular and residual interests, the sponsor arranges to have the REMIC issue some or all of the regular and residual interests for cash, after which the sponsor sells its interests in mortgages and related assets to the REMIC, the transaction is, nevertheless, viewed for Federal income tax purposes as the sponsor's exchange of mortgages and related assets for regular and residual interests, followed by a sale of some or all of those interests. The purpose of this rule is to ensure that the tax consequences associated with the formation of a REMIC are not affected by the actual sequence of steps taken by the sponsor.

(2) *Tiered arrangements*—(i) *Two or more REMICs formed pursuant to a single set of organizational documents.* Two or more REMICs can be created pursuant to a single set of organizational documents even if for state law purposes or for Federal securities law purposes those documents create only one organization. The organizational documents must, however, clearly and expressly identify the assets of, and the interests in, each REMIC, and each REMIC must satisfy all of the requirements of section 860D and the related regulations.

(ii) *A REMIC and one or more investment trusts formed pursuant to a single set of documents.* A REMIC (or two or more REMICs) and one or more investment trusts can be created pursuant to a single set of organizational documents and the separate existence of the REMIC(s) and the investment trust(s) will be respected for Federal income tax purposes even if for state law purposes or for Federal securities law purposes those documents create only one organization. The organizational documents for the REMIC(s) and the investment trust(s) must, however, require both the REMIC(s) and the investment trust(s) to account for items of income and ownership of assets for Federal tax purposes in a manner that respects the separate existence of the multiple entities. See § 1.860G–2(i) concerning issuance of regular interests coupled with other contractual rights for an illustration of the provisions of this paragraph.

(b) *Treatment of sponsor*—(1) *Sponsor defined.* A sponsor is a person who directly or indirectly exchanges qualified mortgages and related assets for regular and residual interests in a REMIC. A person indirectly exchanges interests in qualified mortgages and related assets for regular and residual interests in a REMIC if the person transfers, other than in a nonrecognition transaction, the mortgages and related assets to another person who acquires a transitory ownership interest in those assets before exchanging them for interests in the REMIC, after which the transitory owner then transfers some or all of the interests in the REMIC to the first person.

(2) *Nonrecognition of gain or loss.* The sponsor does not recognize gain or loss on the direct or indirect transfer of any property to a REMIC in exchange for regular or residual interests in the REMIC. However, the sponsor, upon a subsequent sale of the REMIC regular or residual interests, may recognize gain or loss with respect to those interests.

(3) *Basis of contributed assets allocated among interests*—(i) *In general.* The aggregate of the adjusted bases of the regular and residual interests received by the sponsor in the exchange described in paragraph (a) of this section is equal to the aggregate of the adjusted bases of the property transferred by the sponsor in the exchange, increased by the amount of organizational expenses (as described in paragraph (b)(3)(ii) of this section). That total is allocated among all the interests received in proportion to their fair market values on the pricing date (as defined in paragraph (b)(3)(iii) of this section) if any, or, if none, the startup day (as defined in section 860G(a)(9) and §1.860G–2(k)).

(ii) *Organizational expenses*—(A) *Organizational expense defined.* An organizational expense is an expense that is incurred by the sponsor or by the REMIC and that is directly related to the creation of the REMIC. Further, the organizational expense must be incurred during a period beginning a reasonable time before the startup day and ending before the date prescribed by law for filing the first REMIC tax return (determined without regard to any extensions of time to file). The following are examples of organizational expenses: legal fees for services related to the formation of the REMIC, such as preparation of a pooling and servicing agreement and trust indenture; accounting fees related to the formation of the REMIC; and other administrative costs related to the formation of the REMIC.

(B) *Syndication expenses.* Syndication expenses are not organizational expenses. Syndication expenses are those expenses incurred by the sponsor or other person to market the interests in a REMIC, and, thus, are applied to reduce the amount realized on the sale of the interests. Examples of syndication expenses are brokerage fees, registration fees, fees of an underwriter or placement agent, and printing costs of the prospectus or placement memorandum and other selling or promotional material.

(iii) *Pricing date.* The term ‘‘pricing date’’ means the date on which the terms of the regular and residual interests are fixed and the prices at which a substantial portion of the regular interests will be sold are fixed.

(4) *Treatment of unrecognized gain or loss*—(i) *Unrecognized gain on regular interests.* For purposes of section 860F(b)(1)(C)(i), the sponsor must include in gross income the excess of the issue price of a regular interest over the sponsor’s basis in the interest as if the excess were market discount (as defined in section 1278(a)(2)) on a bond and the sponsor had made an election under section 1278(b) to include this market discount currently in gross income. The sponsor is not, however, by reason of this paragraph (b)(4)(i), deemed to have made an election under section 1278(b) with respect to any other bonds.

(ii) *Unrecognized loss on regular interests.* For purposes of section 860F(b)(1)(D)(i), the sponsor treats the excess of the sponsor’s basis in a regular interest over the issue price of the interest as if that excess were amortizable bond premium (as defined in section 171(b)) on a taxable bond and the sponsor had made an election under section 171(c). The sponsor is not, however, by reason of this paragraph (b)(4)(ii), deemed to have made an election under section 171(c) with respect to any other bonds.

(iii) *Unrecognized gain on residual interests.* For purposes of section 860F(b)(1)(C)(ii), the sponsor must include in gross income the excess of the issue price of a residual interest over the sponsor’s basis in the interest ratably over the anticipated weighted average life of the REMIC (as defined in §1.860E–1(a)(3)(iv)).

(iv) *Unrecognized loss on residual interests.* For purposes of section 860F(b)(1)(D)(ii), the sponsor deducts the excess of the sponsor’s basis in a residual interest over the issue price of the interest ratably over the anticipated weighted average life of the REMIC.

(5) *Additions to or reductions of the sponsor's basis.* The sponsor's basis in a regular or residual interest is increased by any amount included in the sponsor's gross income under paragraph (b)(4) of this section. The sponsor's basis in a regular or residual interest is decreased by any amount allowed as a deduction and by any amount applied to reduce interest payments to the sponsor under paragraph (b)(4)(ii) of this section.

(6) *Transferred basis property.* For purposes of paragraph (b)(4) of this section, a transferee of a regular or residual interest is treated in the same manner as the sponsor to the extent that the basis of the transferee in the interest is determined in whole or in part by reference to the basis of the interest in the hands of the sponsor.

(c) *REMIC's basis in contributed assets.* For purposes of section 860F(b)(2), the aggregate of the REMIC's bases in the assets contributed by the sponsor to the REMIC in a transaction described in paragraph (a) of this section is equal to the aggregate of the issue prices (determined under section 860G(a)(10) and § 1.86G–1(d)) of all regular and residual interests in the REMIC.

[T.D. 8458, 57 FR 61304, Dec. 24, 1992; 58 FR 8098, Feb. 11, 1993]

§ 1.860F–4 REMIC reporting requirements and other administrative rules.

(a) *In general.* Except as provided in paragraph (c) of this section, for purposes of subtitle F of the Internal Revenue Code, a REMIC is treated as a partnership and any holder of a residual interest in the REMIC is treated as a partner. A REMIC is not subject, however, to the rules of subchapter C of chapter 63 of the Internal Revenue Code, relating to the treatment of partnership items, for a taxable year if there is at no time during the taxable year more than one holder of a residual interest in the REMIC.

(b) *REMIC tax return*—(1) *In general.* To satisfy the requirement under section 6031 to make a return of income for each taxable year, a REMIC must file the return required by paragraph (b)(2) of this section. The due date and any extensions for filing the REMIC's annual return are determined as if the REMIC were a partnership.

(2) *Income tax return.* The REMIC must make a return, as required by section 6011(a), for each taxable year on Form 1066, U.S. Real Estate Mortgage Investment Conduit Income Tax Return. The return must include—

(i) The amount of principal outstanding on each class of regular interests as of the close of the taxable year,

(ii) The amount of the daily accruals determined under section 860E(c), and

(iii) The information specified in § 1.860D–1(d)(2) (i), (iv), and (v).

(c) *Signing of REMIC return*—(1) *In general.* Although a REMIC is generally treated as a partnership for purposes of subtitle F, for purposes of determining who is authorized to sign a REMIC's income tax return for any taxable year, the REMIC is not treated as a partnership and the holders of residual interests in the REMIC are not treated as partners. Rather, the REMIC return must be signed by a person who could sign the return of the entity absent the REMIC election. Thus, the return of a REMIC that is a corporation or trust under applicable State law must be signed by a corporate officer or a trustee, respectively. The return of a REMIC that consists of a segregated pool of assets must be signed by a person who could sign the return of the entity that owns the assets of the REMIC under applicable State law.

(2) *REMIC whose startup day is before November 10, 1988*—(i) *In general.* The income tax return of a REMIC whose startup day is before November 10, 1988, may be signed by any person who held a residual interest during the taxable year to which the return relates, or, as provided in section 6903, by a fiduciary, as defined in section 7701(a)(6), who is acting for the REMIC and who has furnished adequate notice in the manner prescribed in § 301.6903–1(b) of this chapter.

(ii) *Startup day.* For purposes of paragraph (c)(2) of this section, startup day means any day selected by a REMIC that is on or before the first day on which interests in such REMIC are issued.

(iii) *Exception.* A REMIC whose startup day is before November 10, 1988, may elect to have paragraph (c)(1) of this section apply, instead of paragraph (c)(2) of this section, in determining who is authorized to sign the REMIC return. See section 1006(t)(18)(B) of the Technical and Miscellaneous Revenue Act of 1988 (102 Stat. 3426) and §5h.6(a)(1) of this chapter for the time and manner for making this election.

(d) *Designation of tax matters person.* A REMIC may designate a tax matters person in the same manner in which a partnership may designate a tax matters partner under §301.6231(a)(7)–1T of this chapter. For purposes of applying that section, all holders of residual interests in the REMIC are treated as general partners.

(e) *Notice to holders of residual interests*—(1) *Information required.* As of the close of each calendar quarter, a REMIC must provide to each person who held a residual interest in the REMIC during that quarter notice on Schedule Q (Form 1066) of information specified in paragraphs (e)(1) (i) and (ii) of this section.

(i) *In general.* Each REMIC must provide to each of its residual interest holders the following information—

(A) That person's share of the taxable income or net loss of the REMIC for the calendar quarter;

(B) The amount of the excess inclusion (as defined in section 860E and the regulations thereunder), if any, with respect to that person's residual interest for the calendar quarter;

(C) If the holder of a residual interest is also a pass-through interest holder (as defined in §1.67–3T(a)(2)), the allocable investment expenses (as defined in §1.67–3T(a)(4)) for the calendar quarter, and

(D) Any other information required by Schedule Q (Form 1066).

(ii) *Information with respect to REMIC assets*—(A) *95 percent asset test.* For calendar quarters after 1988, each REMIC must provide to each of its residual interest holders the following information—

(*1*) The percentage of REMIC assets that are qualifying real property loans under section 593,

(*2*) The percentage of REMIC assets that are assets described in section 7701(a)(19), and

(*3*) The percentage of REMIC assets that are real estate assets defined in section 856(c)(6)(B), computed by reference to the average adjusted basis (as defined in section 1011) of the REMIC assets during the calendar quarter (as described in paragraph (e)(1)(iii) of this section). If the percentage of REMIC assets represented by a category is at least 95 percent, then the REMIC need only specify that the percentage for that category was at least 95 percent.

(B) *Additional information required if the 95 percent test not met.* If, for any calendar quarter after 1988, less than 95 percent of the assets of the REMIC are real estate assets defined in section 856(c)(6)(B), then, for that calendar quarter, the REMIC must also provide to any real estate investment trust (REIT) that holds a residual interest the following information—

(*1*) The percentage of REMIC assets described in section 856(c)(5)(A), computed by reference to the average adjusted basis of the REMIC assets during the calendar quarter (as described in paragraph (e)(1)(iii) of this section),

(*2*) The percentage of REMIC gross income (other than gross income from prohibited transactions defined in section 860F(a)(2)) described in section 856(c)(3)(A) through (E), computed as of the close of the calendar quarter, and

(*3*) The percentage of REMIC gross income (other than gross income from prohibited transactions defined in section 860F(a)(2)) described in section 856(c)(3)(F), computed as of the close of the calendar quarter. For purposes of this paragraph (e)(1)(ii)(B)(*3*), the term ''foreclosure property'' contained in section 856(c)(3)(F) has the meaning specified in section 860G(a)(8).

In determining whether a REIT satisfies the limitations of section 856(c)(2), all REMIC gross income is deemed to be derived from a source specified in section 856(c)(2).

(C) *For calendar quarters in 1987.* For calendar quarters in 1987, the percentages of assets required in paragraphs (e)(1)(ii) (A) and (B) of this section may be computed by reference to the fair market value of the assets of the REMIC as of the close of the calendar quarter (as described in paragraph (e)(1)(iii) of this section), instead of by reference to the average adjusted basis during the calendar quarter.

(D) *For calendar quarters in 1988 and 1989.* For calendar quarters in 1988 and 1989, the percentages of assets required in paragraphs (e)(1)(ii) (A) and (B) of this section may be computed by reference to the average fair market value of the assets of the REMIC during the calendar quarter (as described in paragraph (e)(1)(iii) of this section), instead of by reference to the average adjusted basis of the assets of the REMIC during the calendar quarter.

(iii) *Special provisions.* For purposes of paragraph (e)(1)(ii) of this section, the percentage of REMIC assets represented by a specified category computed by reference to average adjusted basis (or fair market value) of the assets during a calendar quarter is determined by dividing the average adjusted bases (or for calendar quarters before 1990, fair market value) of the assets in the specified category by the average adjusted basis (or, for calendar quarters before 1990, fair market value) of all the assets of the REMIC as of the close of each month, week, or day during that calendar quarter. The monthly, weekly, or daily computation period must be applied uniformly during the calendar quarter to all categories of assets and may not be changed in succeeding calendar quarters without the consent of the Commissioner.

(2) *Quarterly notice required*—(i) *In general.* Schedule Q must be mailed (or otherwise delivered) to each holder of a residual interest during a calendar quarter no later than the last day of the month following the close of the calendar quarter.

(ii) *Special rule for 1987.* Notice to any holder of a REMIC residual interest of the information required in paragraph (e)(1) of this section for any of the four calendar quarters of 1987 must be mailed (or otherwise delivered) to each holder no later than March 28, 1988.

(3) *Nominee reporting*—(i) *In general.* If a REMIC is required under paragraphs (e) (1) and (2) of this section to provide notice to an interest holder who is a nominee of another person with respect to an interest in the REMIC, the nominee must furnish that notice to the person for whom it is a nominee.

(ii) *Time for furnishing statement.* The nominee must furnish the notice required under paragraph (e)(3)(i) of this section to the person for whom it is a nominee no later than 30 days after receiving this information.

(4) *Reports to the Internal Revenue Service.* For each person who was a residual interest holder at any time during a REMIC's taxable year, the REMIC must attach a copy of Schedule Q to its income tax return for that year for each quarter in which that person was a residual interest holder. Quarterly notice to the Internal Revenue Service is not required.

(f) *Information returns for persons engaged in a trade or business.* See §1.6041–1(b)(2) for the treatment of a REMIC under sections 6041 and 6041A.

[T.D. 8366, 56 FR 49516, Sept. 30, 1991, as amended by T.D. 8458, 57 FR 61306, Dec. 24, 1992; 58 FR 8098, Feb. 11, 1993]

§1.860G–1 Definition of regular and residual interests.

(a) *Regular interest*—(1) *Designation as a regular interest.* For purposes of section 860G(a)(1), a REMIC designates an interest as a regular interest by providing to the Internal Revenue Service the information specified in §1.860D–1(d)(2)(ii) in the time and manner specified in §1.860D–1(d)(2).

(2) *Specified portion of the interest payments on qualified mortgages*—(i) *In general.* For purposes of section 860G(a)(1)(B)(ii), a specified portion of the interest payments on qualified mortgages means a portion of the interest payable on qualified mortgages, but only if the portion can be expressed as—

(A) A fixed percentage of the interest that is payable at either a fixed rate or at a variable rate described in paragraph (a)(3) of this section on some or all of the qualified mortgages;

(B) A fixed number of basis points of the interest payable on some or all of the qualified mortgages; or

(C) The interest payable at either a fixed rate or at a variable rate described in paragraph (a)(3) of this section on some or all of the qualified mortgages in excess of a fixed number of basis points or in excess of a variable rate described in paragraph (a)(3) of this section.

(ii) *Specified portion cannot vary.* The portion must be established as of the startup day (as defined in section 860G(a)(9) and §1.860G–2(k)) and, except as provided in paragraph (a)(2)(iii) of this section, it cannot vary over the period that begins on the startup day and ends on the day that the interest holder is no longer entitled to receive payments.

(iii) *Defaulted or delinquent mortgages.* A portion is not treated as varying over time if an interest holder's entitlement to a portion of the interest on some or all of the qualified mortgages is dependent on the absence of defaults or delinquencies on those mortgages.

(iv) *No minimum specified principal amount is required.* If an interest in a REMIC consists of a specified portion of the interest payments on the REMIC's qualified mortgages, no minimum specified principal amount need be assigned to that interest. The specified principal amount can be zero.

(v) *Specified portion includes portion of interest payable on regular interest.* (A) The specified portions that meet the requirements of paragraph (a)(2)(i) of this section include a specified portion that can be expressed as a fixed percentage of the interest that is payable on some or all of the qualified mortgages where—

(*1*) Each of those qualified mortgages is a regular interest issued by another REMIC; and

(*2*) With respect to that REMIC in which it is a regular interest, each of those regular interests bears interest that can be expressed as a specified portion as described in paragraph (a)(2)(i)(A), (B), or (C) of this section.

(B) See §1.860A–1(a) for the effective date of this paragraph (a)(2)(v).

(vi) *Examples.* The following examples, each of which describes a pass-thru trust that is intended to qualify as a REMIC, illustrate the provisions of this paragraph (a)(2).

Example 1. (i) A sponsor transferred a pool of fixed rate mortgages to a trustee in exchange for two classes of certificates. The Class A certificate holders are entitled to all principal payments on the mortgages and to interest on outstanding principal at a variable rate based on the current value of One-Month LIBOR, subject to a lifetime cap equal to the weighted average rate payable on the mortgages. The Class B certificate holders are entitled to all interest payable on the mortgages in excess of the interest paid on the Class A certificates. The Class B certificates are subordinate to the Class A certificates so that cash flow shortfalls due to defaults or delinquencies on the mortgages will be borne first by the Class B certificate holders.

(ii) The Class B certificate holders are entitled to all interest payable on the pooled mortgages in excess of a variable rate described in paragraph (a)(3)(vi) of this section. Moreover, the portion of the interest payable to the Class B certificate holders is not treated as varying over time solely because payments on the Class B certificates may be reduced as a result of defaults or delinquencies on the pooled mortgages. Thus, the Class B certificates provide for interest payments that consist of a specified portion of the interest payable on the pooled mortgages under paragraph (a)(2)(i)(C) of this section.

Example 2. (i) A sponsor transferred a pool of variable rate mortgages to a trustee in exchange for two classes of certificates. The mortgages call for interest payments at a variable rate based on the current value of the One-Year Constant Maturity Treasury Index (hereinafter "CMTI") plus 200 basis points, subject to a lifetime cap of 12 percent. Class C certificate holders are entitled to all principal payments on the mortgages and interest on the outstanding principal at a variable rate based on the One-Year CMTI plus 100 basis points, subject to a lifetime cap of 12 percent. The interest rate on the Class C certificates is reset at the same time the rate is reset on the pooled mortgages.

(ii) The Class D certificate holders are entitled to all interest payments on the mortgages in excess of the interest paid on the Class C certificates. So long as the One-Year CMTI is at 10 percent or lower, the Class D certificate holders are entitled to 100 basis points of interest on the pooled mortgages. If, however, the index exceeds 10 percent on a reset date, the Class D certificate holders' entitlement shrinks, and it disappears if the index is at 11 percent or higher.

(iii) The Class D certificate holders are entitled to all interest payable on the pooled mortgages in excess of a qualified variable rate described in paragraph (a)(3) of this section. Thus, the Class D certificates provide for interest payments that consist of a specified portion of the interest payable on the qualified mortgages under paragraph (a)(2)(i)(C) of this section.

Example 3. (i) A sponsor transferred a pool of fixed rate mortgages to a trustee in exchange for two classes of certificates. The fixed interest rate payable on the mortgages varies from mortgage to mortgage, but all rates are between 8 and 10 percent. The Class E certificate holders are entitled to receive all principal payments on the mortgages and interest on outstanding principal at 7 percent. The Class F certificate holders are entitled to receive all interest on the mortgages in excess of the interest paid on the Class E certificates.

(ii) The Class F certificates provide for interest payments that consist of a specified portion of the interest payable on the mortgages under paragraph (a)(2)(i) of this section. Although the portion of the interest payable to the Class F certificate holders varies from mortgage to mortgage, the interest payable can be expressed as a fixed percentage of the interest payable on each particular mortgage.

(3) *Variable rate.* A regular interest may bear interest at a variable rate. For purposes of section 860G(a)(1)(B)(i), a variable rate of interest is a rate described in this paragraph (a)(3).

(i) *Rate based on current interest rate.* A qualified floating rate as defined in § 1.1275–5(b)(1) (but without the application of paragraph (b)(2) or (3) of that section) set at a current value, as defined in § 1.1275–5(a)(4), is a variable rate. In addition, a rate equal to the highest, lowest, or average of two or more qualified floating rates is a variable rate. For example, a rate based on the average cost of funds of one or more financial institutions is a variable rate.

(ii) *Weighted average rate*—(A) *In general.* A rate based on a weighted average of the interest rates on some or all of the qualified mortgages held by a REMIC is a variable rate. The qualified mortgages taken into account must, however, bear interest at a fixed rate or at a rate described in this paragraph (a)(3). Generally, a weighted average interest rate is a rate that, if applied to the aggregate outstanding principal balance of a pool of mortgage loans for an accrual period, produces an amount of interest that equals the sum of the interest payable on the pooled loans for that accrual period. Thus, for an accrual period in which a pool of mortgage loans comprises $300,000 of loans bearing a 7 percent interest rate and $700,000 of loans bearing a 9.5 percent interest rate, the weighted average rate for the pool of loans is 8.75 percent.

(B) *Reduction in underlying rate.* For purposes of paragraph (a)(3)(ii)(A) of this section, an interest rate is considered to be based on a weighted average rate even if, in determining that rate, the interest rate on some or all of the qualified mortgages is first subject to a cap or a floor, or is first reduced by a number of basis points or a fixed percentage. A rate determined by taking a weighted average of the interest rates on the qualified mortgage loans net of any servicing spread, credit enhancement fees, or other expenses of the REMIC is a rate based on a weighted average rate for the qualified mortgages. Further, the amount of any rate reduction described above may vary from mortgage to mortgage.

(iii) *Additions, subtractions, and multiplications.* A rate is a variable rate if it is—

(A) Expressed as the product of a rate described in paragraph (a)(3)(i) or (ii) of this section and a fixed multiplier;

(B) Expressed as a constant number of basis points more or less than a rate described in paragraph (a)(3)(i) or (ii) of this section; or

(C) Expressed as the product, plus or minus a constant number of basis points, of a rate described in paragraph (a)(3)(i) or (ii) of this section and a fixed multiplier (which may be either a positive or a negative number).

(iv) *Caps and floors.* A rate is a variable rate if it is a rate that would be described in paragraph (a)(3)(i) through (iii) of this section except that it is—

(A) Limited by a cap or ceiling that establishes either a maximum rate or a maximum number of basis points by which the rate may increase from one accrual or payment period to another or over the term of the interest; or

(B) Limited by a floor that establishes either a minimum rate or a maximum number of basis points by which the rate may decrease from one accrual or payment period to another or over the term of the interest.

(v) *Funds-available caps*—(A) *In general.* A rate is a variable rate if it is a rate that would be described in paragraph (a)(3)(i) through (iv) of this section except that it is subject to a ‘‘funds-available’’ cap. A funds-available cap is a limit on the amount of interest to be paid on an instrument in any accrual or payment period that is based on the total amount available for the distribution, including both principal and interest received by an issuing entity on some or all of its qualified mortgages as well as amounts held in a reserve fund. The term ‘‘funds-available cap’’ does not, however, include any cap or limit on interest payments used as a device to avoid the standards of paragraph (a)(3)(i) through (iv) of this section.

(B) *Facts and circumstances test.* In determining whether a cap or limit on interest payments is a funds-available cap within the meaning of this section and not a device used to avoid the standards of paragraph (a)(3)(i) through (iv) of this section, one must consider all of the facts and circumstances. Facts and circumstances that must be taken into consideration are—

(*1*) Whether the rate of the interest payable to the regular interest holders is below the rate payable on the REMIC's qualified mortgages on the start-up day; and

(*2*) Whether, historically, the rate of interest payable to the regular interest holders has been consistently below that payable on the qualified mortgages.

(C) *Examples.* The following examples, both of which describe a pass-thru trust that is intended to qualify as a REMIC, illustrate the provisions of this paragraph (a)(3)(v).

Example 1. (i) A sponsor transferred a pool of mortgages to a trustee in exchange for two classes of certificates. The pool of mortgages has an aggregate principal balance of $100*x*. Each mortgage in the pool provides for interest payments based on the eleventh district cost of funds index (hereinafter COFI) plus a margin. The initial weighted average rate for the pool is COFI plus 200 basis points. The trust issued a Class X certificate that has a principal amount of $100*x* and that provides for interest payments at a rate equal to One-Year LIBOR plus 100 basis points, subject to a cap described below. The Class R certificate, which the sponsor designated as the residual interest, entitles its holder to all funds left in the trust after the Class X certificates have been retired. The Class R certificate holder is not entitled to current distributions.

(ii) At the time the certificates were issued, COFI equalled 4.874 percent and One-Year LIBOR equalled 3.375 percent. Thus, the initial weighted average pool rate was 6.874 percent and the Class X certificate rate was 4.375 percent. Based on historical data, the sponsor does not expect the rate paid on the Class X certificate to exceed the weighted average rate on the pool.

(iii) Initially, under the terms of the trust instrument, the excess of COFI plus 200 over One-Year LIBOR plus 100 (excess interest) will be applied to pay expenses of the trust, to fund any required reserves, and then to reduce the principal balance on the Class X certificate. Consequently, although the aggregate principal balance of the mortgages initially matched the principal balance of the Class X certificate, the principal balance on the Class X certificate will pay down faster than the principal balance on the mortgages as long as the weighted average rate on the mortgages is greater than One-Year LIBOR plus 100. If, however, the rate on the Class X certificate (One-Year LIBOR plus 100) ever exceeds the weighted average rate on the mortgages, then the Class X certificate holders will receive One-Year LIBOR plus 100 subject to a cap based on the current funds that are available for distribution.

(iv) The funds available cap here is not a device used to avoid the standards of paragraph (a)(3) (i) through (iv) of this section. First, on the date the Class X certificates were issued, a significant spread existed between the weighted average rate payable on the mortgages and the rate payable on the Class X certificate. Second, historical data suggest that the weighted average rate payable on the mortgages will continue to exceed the rate payable on the Class X certificate. Finally, because the excess interest will be applied to reduce the outstanding principal balance of the Class X certificate more rapidly than the outstanding principal balance on the mortgages is reduced, One-Year LIBOR plus 100 basis points would have to exceed the weighted average rate on the mortgages by an increasingly larger amount before the funds available cap would be triggered. Accordingly, the rate paid on the Class X certificates is a variable rate.

Example 2. (i) The facts are the same as those in *Example 1,* except that the pooled mortgages are commercial mortgages that provide for interest payments based on the gross profits of the mortgagors, and the rate on the Class X certificates is 400 percent on One-Year LIBOR (a variable rate under paragraph (a)(3)(iii) of this section), subject to a cap equal to current funds available to the trustee for distribution.

(ii) Initially, 400 percent of One-Year LIBOR exceeds the weighted average rate payable on the mortgages. Furthermore, historical data suggest that there is a significant possibility that, in the future, 400 percent of One-Year LIBOR will exceed the weighted average rate on the mortgages.

(iii) The facts and circumstances here indicate that the use of 400 percent of One-Year LIBOR with the above-described cap is a device to pass through to the Class X certificate holder contingent interest based on mortgagor profits. Consequently, the rate paid on the Class X certificate here is not a variable rate.

(vi) *Combination of rates.* A rate is a variable rate if it is based on—

(A) One fixed rate during one or more accrual or payment periods and a different fixed rate or rates, or a rate or rates described in paragraph (a)(3) (i) through (v) of this section, during other accrual or payment periods; or

(B) A rate described in paragraph (a)(3) (i) through (v) of this section during one or more accrual or payment periods and a fixed rate or rates, or a different rate or rates described in paragraph (a)(3) (i) through (v) of this section in other periods.

(4) *Fixed terms on the startup day.* For purposes of section 860G(a)(1), a regular interest in a REMIC has fixed terms on the startup day if, on the startup day, the REMIC's organizational documents irrevocably specify—

(i) The principal amount (or other similar amount) of the regular interest;

(ii) The interest rate or rates used to compute any interest payments (or other similar amounts) on the regular interest; and

(iii) The latest possible maturity date of the interest.

(5) *Contingencies prohibited.* Except for the contingencies specified in paragraph (b)(3) of this section, the principal amount (or other similar amount) and the latest possible maturity date of the interest must not be contingent.

(b) *Special rules for regular interests*—(1) *Call premium.* An interest in a REMIC does not qualify as a regular interest if the terms of the interest entitle the holder of that interest to the payment of any premium that is determined with reference to the length of time that the regular interest is outstanding and is not described in paragraph (b)(2) of this section.

(2) *Customary prepayment penalties received with respect to qualified mortgages.* An interest in a REMIC does not fail to qualify as a regular interest solely because the REMIC's organizational documents provide that the REMIC must allocate among and pay to its regular interest holders any customary prepayment penalties that the REMIC receives with respect to its qualified mortgages. Moreover, a REMIC may allocate prepayment penalties among its classes of interests in any manner specified in the REMIC's organizational documents. For example, a REMIC could allocate all or substantially all of a prepayment penalty that it receives to holders of an interest-only class of interests because that class would be most significantly affected by prepayments.

(3) *Certain contingencies disregarded.* An interest in a REMIC does not fail to qualify as a regular interest solely because it is issued subject to some or all of the contingencies described in paragraph (b)(3) (i) through (vi) of this section.

(i) *Prepayments, income, and expenses.* An interest does not fail to qualify as a regular interest solely because—

(A) The timing of (but not the right to or amount of) principal payments (or other similar amounts) is affected by the extent of prepayments on some or all of the qualified mortgages held by the REMIC or the amount of income from permitted investments (as defined in § 1.860G–2(g)); or

(B) The timing of interest and principal payments is affected by the payment of expenses incurred by the REMIC.

(ii) *Credit losses.* An interest does not fail to qualify as a regular interest solely because the amount or the timing of payments of principal or interest (or other similar amounts) with respect to a regular interest is affected by defaults on qualified mortgages and permitted investments, unanticipated expenses incurred by the REMIC, or lower than expected returns on permitted investments.

(iii) *Subordinated interests.* An interest does not fail to qualify as a regular interest solely because that interest bears all, or a disproportionate share, of the losses stemming from cash flow shortfalls due to defaults or delinquencies on qualified mortgages or permitted investments, unanticipated expenses incurred by the REMIC, lower than expected returns on permitted investments, or prepayment interest shortfalls before other regular interests or the residual interest bear losses occasioned by those shortfalls.

(iv) *Deferral of interest.* An interest does not fail to qualify as a regular interest solely because that interest, by its terms, provides for deferral of interest payments.

(v) *Prepayment interest shortfalls.* An interest does not fail to qualify as a regular interest solely because the amount of interest payments is affected by prepayments of the underlying mortgages.

(vi) *Remote and incidental contingencies.* An interest does not fail to qualify as a regular interest solely because the amount or timing of payments of principal or interest (or other similar amounts) with respect to the interest is subject to a contingency if there is only a remote likelihood that the contingency will occur. For example, an interest could qualify as a regular interest even though full payment of principal and interest on that interest is contingent upon the absence of significant cash flow shortfalls due to the operation of the Soldiers and Sailors Civil Relief Act, 50 U.S.C. app. 526 (1988).

(4) *Form of regular interest.* A regular interest in a REMIC may be issued in the form of debt, stock, an interest in a partnership or trust, or any other form permitted by state law. If a regular interest in a REMIC is not in the form of debt, it must, except as provided in paragraph (a)(2)(iv) of this section, entitle the holder to a specified amount that would, were the interest issued in debt form, be identified as the principal amount of the debt.

(5) *Interest disproportionate to principal*—(i) *In general.* An interest in a REMIC does not qualify as a regular interest if the amount of interest (or other similar amount) payable to the holder is disproportionately high relative to the principal amount or other specified amount described in paragraph (b)(4) of this section (specified principal amount). Interest payments (or other similar amounts) are considered disproportionately high if the issue price (as determined under paragraph (d) of this section) of the interest in the REMIC exceeds 125 percent of its specified principal amount.

(ii) *Exception.* A regular interest in a REMIC that entitles the holder to interest payments consisting of a specified portion of interest payments on qualified mortgages qualifies as a regular interest even if the amount of interest is disproportionately high relative to the specified principal amount.

(6) *Regular interest treated as a debt instrument for all Federal income tax purposes.* In determining the tax under chapter 1 of the Internal Revenue Code, a REMIC regular interest (as defined in section 860G(a)(1)) is treated as a debt instrument that is an obligation of the REMIC. Thus, sections 1271 through 1288, relating to bonds and other debt instruments, apply to a regular interest. For special rules relating to the accrual of original issue discount on regular interests, see section 1272(a)(6).

(c) *Residual interest.* A residual interest is an interest in a REMIC that is issued on the startup day and that is designated as a residual interest by providing the information specified in §1.860D–1(d)(2)(ii) at the time and in the manner provided in §1.860D–1(d)(2). A residual interest need not entitle the holder to any distributions from the REMIC.

(d) *Issue price of regular and residual interests*—(1) *In general.* The issue price of any REMIC regular or residual interest is determined under section 1273(b) as if the interest were a debt instrument and, if issued for property, as if the requirements of section 1273(b)(3) were met. Thus, if a class of interests is publicly offered, then the issue price of an interest in that class is the initial offering price to the public at which a substantial amount of the class is sold. If the interest is in a class that is not publicly offered, the issue price is the price paid by the first buyer of that interest regardless of the price paid for the remainder of the class. If the interest is in a class that is retained by the sponsor, the issue price is its fair market value on the pricing date (as defined in §1.860F–2(b)(3)(iii)), if any, or, if none, the startup day, regardless of whether the property exchanged therefor is publicly traded.

(2) *The public.* The term ‘‘the public’’ for purposes of this section does not include brokers or other middlemen, nor does it include the sponsor who acquires all of the regular and residual

interests from the REMIC on the startup day in a transaction described in § 1.860F–2(a).

[T.D. 8458, 57 FR 61306, Dec. 24, 1992; 58 FR 8098, Feb. 11, 1993; 58 FR 15089, Mar. 19, 1993; T.D. 8614, 60 FR 42787, Aug. 17, 1995]

§ 1.860G–2 Other rules.

(a) *Obligations principally secured by an interest in real property*—(1) *Tests for determining whether an obligation is principally secured.* For purposes of section 860G(a)(3)(A), an obligation is principally secured by an interest in real property only if it satisfies either the test set out in paragraph (a)(1)(i) or the test set out in paragraph (a)(1)(ii) of this section.

(i) *The 80-percent test.* An obligation is principally secured by an interest in real property if the fair market value of the interest in real property securing the obligation—

(A) Was at least equal to 80 percent of the adjusted issue price of the obligation at the time the obligation was originated (see paragraph (b)(1) of this section concerning the origination date for obligations that have been significantly modified); or

(B) Is at least equal to 80 percent of the adjusted issue price of the obligation at the time the sponsor contributes the obligation to the REMIC.

(ii) *Alternative test.* For purposes of section 860G(a)(3)(A), an obligation is principally secured by an interest in real property if substantially all of the proceeds of the obligation were used to acquire or to improve or protect an interest in real property that, at the origination date, is the only security for the obligation. For purposes of this test, loan guarantees made by the United States or any state (or any political subdivision, agency, or instrumentality of the United States or of any state), or other third party credit enhancement are not viewed as additional security for a loan. An obligation is not considered to be secured by property other than real property solely because the obligor is personally liable on the obligation.

(2) *Treatment of liens.* For purposes of paragraph (a)(1)(i) of this section, the fair market value of the real property interest must be first reduced by the amount of any lien on the real property interest that is senior to the obligation being tested, and must be further reduced by a proportionate amount of any lien that is in parity with the obligation being tested.

(3) *Safe harbor*—(i) *Reasonable belief that an obligation is principally secured.* If, at the time the sponsor contributes an obligation to a REMIC, the sponsor reasonably believes that the obligation is principally secured by an interest in real property within the meaning of paragraph (a)(1) of this section, then the obligation is deemed to be so secured for purposes of section 860G(a)(3). A sponsor cannot avail itself of this safe harbor with respect to an obligation if the sponsor actually knows or has reason to know that the obligation fails both of the tests set out in paragraph (a)(1) of this section.

(ii) *Basis for reasonable belief.* For purposes of paragraph (a)(3)(i) of this section, a sponsor may base a reasonable belief concerning any obligation on—

(A) Representations and warranties made by the originator of the obligation; or

(B) Evidence indicating that the originator of the obligation typically made mortgage loans in accordance with an established set of parameters, and that any mortgage loan originated in accordance with those parameters would satisfy at least one of the tests set out in paragraph (a)(1) of this section.

(iii) *Later discovery that an obligation is not principally secured.* If, despite the sponsor's reasonable belief concerning an obligation at the time it contributed the obligation to the REMIC, the REMIC later discovers that the obligation is not principally secured by an interest in real property, the obligation is a defective obligation and loses its status as a qualified mortgage 90 days after the date of discovery. See paragraph (f) of this section, relating to defective obligations.

(4) *Interests in real property; real property.* The definition of ''interests in real property'' set out in § 1.856–3(c), and the definition of ''real property'' set out in § 1.856–3(d), apply to define those terms for purposes of section 860G(a)(3) and paragraph (a) of this section.

(5) *Obligations secured by an interest in real property*. Obligations secured by interests in real property include the following: mortgages, deeds of trust, and installment land contracts; mortgage pass-thru certificates guaranteed by GNMA, FNMA, FHLMC, or CMHC (Canada Mortgage and Housing Corporation); other investment trust interests that represent undivided beneficial ownership in a pool of obligations principally secured by interests in real property and related assets that would be considered to be permitted investments if the investment trust were a REMIC, and provided the investment trust is classified as a trust under §301.7701–4(c) of this chapter; and obligations secured by manufactured housing treated as single family residences under section 25(e)(10) (without regard to the treatment of the obligations or the properties under state law).

(6) *Obligations secured by other obligations; residual interests*. Obligations (other than regular interests in a REMIC) that are secured by other obligations are not principally secured by interests in real property even if the underlying obligations are secured by interests in real property. Thus, for example, a collateralized mortgage obligation issued by an issuer that is not a REMIC is not an obligation principally secured by an interest in real property. A residual interest (as defined in section 860G(a)(2)) is not an obligation principally secured by an interest in real property.

(7) *Certain instruments that call for contingent payments are obligations*. For purposes of section 860G(a)(3) and (4), the term ''obligation'' includes any instrument that provides for total noncontingent principal payments that at least equal the instrument's issue price even if that instrument also provides for contingent payments. Thus, for example, an instrument that was issued for $100*x* and that provides for noncontingent principal payments of $100*x*, interest payments at a fixed rate, and contingent payments based on a percentage of the mortgagor's gross receipts, is an obligation.

(8) *Defeasance*. If a REMIC releases its lien on real property that secures a qualified mortgage, that mortgage ceases to be a qualified mortgage on the date the lien is released unless—

(i) The mortgagor pledges substitute collateral that consists solely of government securities (as defined in section 2(a)(16) of the Investment Company Act of 1940 as amended (15 U.S.C. 80a–1));

(ii) The mortgage documents allow such a substitution;

(iii) The lien is released to facilitate the disposition of the property or any other customary commercial transaction, and not as part of an arrangement to collateralize a REMIC offering with obligations that are not real estate mortgages; and

(iv) The release is not within 2 years of the startup day.

(9) *Stripped bonds and coupons*. The term ''qualified mortgage'' includes stripped bonds and stripped coupons (as defined in section 1286(e) (2) and (3)) if the bonds (as defined in section 1286(e)(1)) from which such stripped bonds or stripped coupons arose would have been qualified mortgages.

(b) *Assumptions and modifications*—(1) *Significant modifications are treated as exchanges of obligations*. If an obligation is significantly modified in a manner or under circumstances other than those described in paragraph (b)(3) of this section, then the modified obligation is treated as one that was newly issued in exchange for the unmodified obligation that it replaced. Consequently—

(i) If such a significant modification occurs after the obligation has been contributed to the REMIC and the modified obligation is not a qualified replacement mortgage, the modified obligation will not be a qualified mortgage and the deemed disposition of the unmodified obligation will be a prohibited transaction under section 860F(a)(2); and

(ii) If such a significant modification occurs before the obligation is contributed to the REMIC, the modified obligation will be viewed as having been originated on the date the modification occurs for purposes of the tests set out in paragraph (a)(1) of this section.

(2) *Significant modification defined*. For purposes of paragraph (b)(1) of this section, a ''significant modification'' is

any change in the terms of an obligation that would be treated as an exchange of obligations under section 1001 and the related regulations.

(3) *Exceptions.* For purposes of paragraph (b)(1) of this section, the following changes in the terms of an obligation are not significant modifications regardless of whether they would be significant modifications under paragraph (b)(2) of this section—

(i) Changes in the terms of the obligation occasioned by default or a reasonably foreseeable default;

(ii) Assumption of the obligation;

(iii) Waiver of a due-on-sale clause or a due on encumbrance clause; and

(iv) Conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage.

(4) *Modifications that are not significant modifications.* If an obligation is modified and the modification is not a significant modification for purposes of paragraph (b)(1) of this section, then the modified obligation is not treated as one that was newly originated on the date of modification.

(5) *Assumption defined.* For purposes of paragraph (b)(3) of this section, a mortgage has been assumed if—

(i) The buyer of the mortgaged property acquires the property subject to the mortgage, without assuming any personal liability;

(ii) The buyer becomes liable for the debt but the seller also remains liable; or

(iii) The buyer becomes liable for the debt and the seller is released by the lender.

(6) *Pass-thru certificates.* If a REMIC holds as a qualified mortgage a pass-thru certificate or other investment trust interest of the type described in paragraph (a)(5) of this section, the modification of a mortgage loan that backs the pass-thru certificate or other interest is not a modification of the pass-thru certificate or other interest unless the investment trust structure was created to avoid the prohibited transaction rules of section 860F(a).

(c) *Treatment of certain credit enhancement contracts*—(1) *In general.* A credit enhancement contract (as defined in paragraph (c) (2) and (3) of this section) is not treated as a separate asset of the REMIC for purposes of the asset test set out in section 860D(a)(4) and § 1.860D–1(b)(3), but instead is treated as part of the mortgage or pool of mortgages to which it relates. Furthermore, any collateral supporting a credit enhancement contract is not treated as an asset of the REMIC solely because it supports the guarantee represented by that contract. See paragraph (g)(1)(ii) of this section for the treatment of payments made pursuant to credit enhancement contracts as payments received under a qualified mortgage.

(2) *Credit enhancement contracts.* For purposes of this section, a credit enhancement contract is any arrangement whereby a person agrees to guarantee full or partial payment of the principal or interest payable on a qualified mortgage or on a pool of such mortgages, or full or partial payment on one or more classes of regular interests or on the class of residual interests, in the event of defaults or delinquencies on qualified mortgages, unanticipated losses or expenses incurred by the REMIC, or lower than expected returns on cash flow investments. Types of credit enhancement contracts may include, but are not limited to, pool insurance contracts, certificate guarantee insurance contracts, letters of credit, guarantees, or agreements whereby the REMIC sponsor, a mortgage servicer, or other third party agrees to make advances described in paragraph (c)(3) of this section.

(3) *Arrangements to make certain advances.* The arrangements described in this paragraph (c)(3) are credit enhancement contracts regardless of whether, under the terms of the arrangement, the payor is obligated, or merely permitted, to advance funds to the REMIC.

(i) *Advances of delinquent principal and interest.* An arrangement by a REMIC sponsor, mortgage servicer, or other third party to advance to the REMIC out of its own funds an amount to make up for delinquent payments on qualified mortgages is a credit enhancement contract.

(ii) *Advances of taxes, insurance payments, and expenses.* An arrangement by a REMIC sponsor, mortgage servicer, or other third party to pay taxes and hazard insurance premiums on, or other expenses incurred to protect the

REMIC's security interest in, property securing a qualified mortgage in the event that the mortgagor fails to pay such taxes, insurance premiums, or other expenses is a credit enhancement contract.

(iii) *Advances to ease REMIC administration.* An agreement by a REMIC sponsor, mortgage servicer, or other third party to advance temporarily to a REMIC amounts payable on qualified mortgages before such amounts are actually due to level out the stream of cash flows to the REMIC or to provide for orderly administration of the REMIC is a credit enhancement contract. For example, if two mortgages in a pool have payment due dates on the twentieth of the month, and all the other mortgages have payment due dates on the first of each month, an agreement by the mortgage servicer to advance to the REMIC on the fifteenth of each month the payments not yet received on the two mortgages together with the amounts received on the other mortgages is a credit enhancement contract.

(4) *Deferred payment under a guarantee arrangement.* A guarantee arrangement does not fail to qualify as a credit enhancement contract solely because the guarantor, in the event of a default on a qualified mortgage, has the option of immediately paying to the REMIC the full amount of mortgage principal due on acceleration of the defaulted mortgage, or paying principal and interest to the REMIC according to the original payment schedule for the defaulted mortgage, or according to some other deferred payment schedule. Any deferred payments are payments pursuant to a credit enhancement contract even if the mortgage is foreclosed upon and the guarantor, pursuant to subrogation rights set out in the guarantee arrangement, is entitled to receive immediately the proceeds of foreclosure.

(d) *Treatment of certain purchase agreements with respect to convertible mortgages*—(1) *In general.* For purposes of sections 860D(a)(4) and 860G(a)(3), a purchase agreement (as described in paragraph (d)(3) of this section) with respect to a convertible mortgage (as described in paragraph (d)(5) of this section) is treated as incidental to the convertible mortgage to which it relates. Consequently, the purchase agreement is part of the mortgage or pool of mortgages and is not a separate asset of the REMIC.

(2) *Treatment of amounts received under purchase agreements.* For purposes of sections 860A through 860G and for purposes of determining the accrual of original issue discount and market discount under sections 1272(a)(6) and 1276, respectively, a payment under a purchase agreement described in paragraph (d)(3) of this section is treated as a prepayment in full of the mortgage to which it relates. Thus, for example, a payment under a purchase agreement with respect to a qualified mortgage is considered a payment received under a qualified mortgage within the meaning of section 860G(a)(6) and the transfer of the mortgage is not a disposition of the mortgage within the meaning of section 860F(a)(2)(A).

(3) *Purchase agreement.* A purchase agreement is a contract between the holder of a convertible mortgage and a third party under which the holder agrees to sell and the third party agrees to buy the mortgage for an amount equal to its current principal balance plus accrued but unpaid interest if and when the mortgagor elects to convert the terms of the mortgage.

(4) *Default by the person obligated to purchase a convertible mortgage.* If the person required to purchase a convertible mortgage defaults on its obligation to purchase the mortgage upon conversion, the REMIC may sell the mortgage in a market transaction and the proceeds of the sale will be treated as amounts paid pursuant to a purchase agreement.

(5) *Convertible mortgage.* A convertible mortgage is a mortgage that gives the obligor the right at one or more times during the term of the mortgage to elect to convert from one interest rate to another. The new rate of interest must be determined pursuant to the terms of the instrument and must be intended to approximate a market rate of interest for newly originated mortgages at the time of the conversion.

(e) *Prepayment interest shortfalls.* An agreement by a mortgage servicer or other third party to make payments to the REMIC to make up prepayment interest shortfalls is not treated as a separate asset of the REMIC and payments made pursuant to such an agreement are treated as payments on the qualified mortgages. With respect to any mortgage that prepays, the prepayment interest shortfall for the accrual period in which the mortgage prepays is an amount equal to the excess of the interest that would have accrued on the mortgage during that accrual period had it not prepaid, over the interest that accrued from the beginning of that accrual period up to the date of the prepayment.

(f) *Defective obligations*—(1) *Defective obligation defined.* For purposes of sections 860G(a)(4)(B)(ii) and 860F(a)(2), a defective obligation is a mortgage subject to any of the following defects.

(i) The mortgage is in default, or a default with respect to the mortgage is reasonably foreseeable.

(ii) The mortgage was fraudulently procured by the mortgagor.

(iii) The mortgage was not in fact principally secured by an interest in real property within the meaning of paragraph (a)(1) of this section.

(iv) The mortgage does not conform to a customary representation or warranty given by the sponsor or prior owner of the mortgage regarding the characteristics of the mortgage, or the characteristics of the pool of mortgages of which the mortgage is a part. A representation that payments on a qualified mortgage will be received at a rate no less than a specified minimum or no greater than a specified maximum is not customary for this purpose.

(2) *Effect of discovery of defect.* If a REMIC discovers that an obligation is a defective obligation, and if the defect is one that, had it been discovered before the startup day, would have prevented the obligation from being a qualified mortgage, then, unless the REMIC either causes the defect to be cured or disposes of the defective obligation within 90 days of discovering the defect, the obligation ceases to be a qualified mortgage at the end of that 90 day period. Even if the defect is not cured, the defective obligation is, nevertheless, a qualified mortgage from the startup day through the end of the 90 day period. Moreover, even if the REMIC holds the defective obligation beyond the 90 day period, the REMIC may, nevertheless, exchange the defective obligation for a qualified replacement mortgage so long as the requirements of section 860G(a)(4)(B) are satisfied. If the defect is one that does not affect the status of an obligation as a qualified mortgage, then the obligation is always a qualified mortgage regardless of whether the defect is or can be cured. For example, if a sponsor represented that all mortgages transferred to a REMIC had a 10 percent interest rate, but it was later discovered that one mortgage had a 9 percent interest rate, the 9 percent mortgage is defective, but the defect does not affect the status of that obligation as a qualified mortgage.

(g) *Permitted investments*—(1) *Cash flow investment*—(i) *In general.* For purposes of section 860G(a)(6) and this section, a cash flow investment is an investment of payments received on qualified mortgages for a temporary period between receipt of those payments and the regularly scheduled date for distribution of those payments to REMIC interest holders. Cash flow investments must be passive investments earning a return in the nature of interest.

(ii) *Payments received on qualified mortgages.* For purposes of paragraph (g)(1) of this section, the term ‘‘payments received on qualified mortgages’’ includes—

(A) Payments of interest and principal on qualified mortgages, including prepayments of principal and payments under credit enhancement contracts described in paragraph (c)(2) of this section;

(B) Proceeds from the disposition of qualified mortgages;

(C) Cash flows from foreclosure property and proceeds from the disposition of such property;

(D) A payment by a sponsor or prior owner in lieu of the sponsor's or prior owner's repurchase of a defective obligation, as defined in paragraph (f) of this section, that was transferred to the REMIC in breach of a customary warranty; and

(E) Prepayment penalties required to be paid under the terms of a qualified mortgage when the mortgagor prepays the obligation.

(iii) *Temporary period.* For purposes of section 860G(a)(6) and this paragraph (g)(1), a temporary period generally is that period from the time a REMIC receives payments on qualified mortgages and permitted investments to the time the REMIC distributes the payments to interest holders. A temporary period may not exceed 13 months. Thus, an investment held by a REMIC for more than 13 months is not a cash flow investment. In determining the length of time that a REMIC has held an investment that is part of a commingled fund or account, the REMIC may employ any reasonable method of accounting. For example, if a REMIC holds mortgage cash flows in a commingled account pending distribution, the first-in, first-out method of accounting is a reasonable method for determining whether all or part of the account satisfies the 13 month limitation.

(2) *Qualified reserve funds.* The term qualified reserve fund means any reasonably required reserve to provide for full payment of expenses of the REMIC or amounts due on regular or residual interests in the event of defaults on qualified mortgages, prepayment interest shortfalls (as defined in paragraph (e) of this section), lower than expected returns on cash flow investments, or any other contingency that could be provided for under a credit enhancement contract (as defined in paragraph (c) (2) and (3) of this section).

(3) *Qualified reserve asset*—(i) *In general.* The term ''qualified reserve asset'' means any intangible property (other than a REMIC residual interest) that is held both for investment and as part of a qualified reserve fund. An asset need not generate any income to be a qualified reserve asset.

(ii) *Reasonably required reserve*—(A) *In general.* In determining whether the amount of a reserve is reasonable, it is appropriate to consider the credit quality of the qualified mortgages, the extent and nature of any guarantees relating to either the qualified mortgages or the regular and residual interests, the expected amount of expenses of the REMIC, and the expected availability of proceeds from qualified mortgages to pay the expenses. To the extent that a reserve exceeds a reasonably required amount, the amount of the reserve must be promptly and appropriately reduced. If at any time, however, the amount of the reserve fund is less than is reasonably required, the amount of the reserve fund may be increased by the addition of payments received on qualified mortgages or by contributions from holders of residual interests.

(B) *Presumption that a reserve is reasonably required.* The amount of a reserve fund is presumed to be reasonable (and an excessive reserve is presumed to have been promptly and appropriately reduced) if it does not exceed—

(*1*) The amount required by a nationally recognized independent rating agency as a condition of providing the rating for REMIC interests desired by the sponsor; or

(*2*) The amount required by a third party insurer or guarantor, who does not own directly or indirectly (within the meaning of section 267(c)) an interest in the REMIC (as defined in §1.860D–1(b)(1)), as a condition of providing credit enhancement.

(C) *Presumption may be rebutted.* The presumption in paragraph (g)(3)(ii)(B) of this section may be rebutted if the amounts required by the rating agency or by the third party insurer are not commercially reasonable considering the factors described in paragraph (g)(3)(ii)(A) of this section.

(h) *Outside reserve funds.* A reserve fund that is maintained to pay expenses of the REMIC, or to make payments to REMIC interest holders is an outside reserve fund and not an asset of the REMIC only if the REMIC's organizational documents clearly and expressly—

(1) Provide that the reserve fund is an outside reserve fund and not an asset of the REMIC;

(2) Identify the owner(s) of the reserve fund, either by name, or by description of the class (*e.g.*, subordinated regular interest holders) whose membership comprises the owners of the fund; and

(3) Provide that, for all Federal tax purposes, amounts transferred by the REMIC to the fund are treated as amounts distributed by the REMIC to

the designated owner(s) or transferees of the designated owner(s).

(i) *Contractual rights coupled with regular interests in tiered arrangements*—(1) *In general.* If a REMIC issues a regular interest to a trustee of an investment trust for the benefit of the trust certificate holders and the trustee also holds for the benefit of those certificate holders certain other contractual rights, those other rights are not treated as assets of the REMIC even if the investment trust and the REMIC were created contemporaneously pursuant to a single set of organizational documents. The organizational documents must, however, require that the trustee account for the contractual rights as property that the trustee holds separate and apart from the regular interest.

(2) *Example.* The following example, which describes a tiered arrangement involving a pass-thru trust that is intended to qualify as a REMIC and a pass-thru trust that is intended to be classified as a trust under §301.7701–4(c) of this chapter, illustrates the provisions of paragraph (i)(1) of this section.

Example. (i) A sponsor transferred a pool of mortgages to a trustee in exchange for two classes of certificates. The pool of mortgages has an aggregate principal balance of $100*x*. Each mortgage in the pool provides for interest payments based on the eleventh district cost of funds index (hereinafter COFI) plus a margin. The trust (hereinafter REMIC trust) issued a Class N bond, which the sponsor designates as a regular interest, that has a principal amount of $100*x* and that provides for interest payments at a rate equal to One-Year LIBOR plus 100 basis points, subject to a cap equal to the weighted average pool rate. The Class R interest, which the sponsor designated as the residual interest, entitles its holder to all funds left in the trust after the Class N bond has been retired. The Class R interest holder is not entitled to current distributions.

(ii) On the same day, and under the same set of documents, the sponsor also created an investment trust. The sponsor contributed to the investment trust the Class N bond together with an interest rate cap contract. Under the interest rate cap contract, the issuer of the cap contract agrees to pay to the trustee for the benefit of the investment trust certificate holders the excess of One-Year LIBOR plus 100 basis points over the weighted average pool rate (COFI plus a margin) times the outstanding principal balance of the Class N bond in the event One-Year LIBOR plus 100 basis points ever exceeds the weighted average pool rate. The trustee (the same institution that serves as REMIC trust trustee), in exchange for the contributed assets, gave the sponsor certificates representing undivided beneficial ownership interests in the Class N bond and the interest rate cap contract. The organizational documents require the trustee to account for the regular interest and the cap contract as discrete property rights.

(iii) The separate existence of the REMIC trust and the investment trust are respected for all Federal income tax purposes. Thus, the interest rate cap contract is an asset beneficially owned by the several certificate holders and is not an asset of the REMIC trust. Consequently, each certificate holder must allocate its purchase price for the certificate between its undivided interest in the Class N bond and its undivided interest in the interest rate cap contract in accordance with the relative fair market values of those two property rights.

(j) *Clean-up call*—(1) *In general.* For purposes of section 860F(a)(5)(B), a clean-up call is the redemption of a class of regular interests when, by reason of prior payments with respect to those interests, the administrative costs associated with servicing that class outweigh the benefits of maintaining the class. Factors to consider in making this determination include—

(i) The number of holders of that class of regular interests;

(ii) The frequency of payments to holders of that class;

(iii) The effect the redemption will have on the yield of that class of regular interests;

(iv) The outstanding principal balance of that class; and

(v) The percentage of the original principal balance of that class still outstanding.

(2) *Interest rate changes.* The redemption of a class of regular interests undertaken to profit from a change in interest rates is not a clean-up call.

(3) *Safe harbor.* Although the outstanding principal balance is only one factor to consider, the redemption of a class of regular interests with an outstanding principal balance of no more than 10 percent of its original principal balance is always a clean-up call.

(k) *Startup day.* The term ‘‘startup day’’ means the day on which the REMIC issues all of its regular and residual interests. A sponsor may, however, contribute property to a REMIC in exchange for regular and residual interests over any period of 10 consecutive days and the REMIC may designate any one of those 10 days as its startup day. The day so designated is then the startup day, and all interests are treated as issued on that day.

[T.D. 8458, 57 FR 61309, Dec. 24, 1992; 58 FR 8098, Feb. 11, 1993]

§1.860G–3 Treatment of foreign persons.

(a) *Transfer of a residual interest with tax avoidance potential*—(1) *In general.* A transfer of a residual interest that has tax avoidance potential is disregarded for all Federal tax purposes if the transferee is a foreign person. Thus, if a residual interest with tax avoidance potential is transferred to a foreign holder at formation of the REMIC, the sponsor is liable for the tax on any excess inclusion that accrues with respect to that residual interest.

(2) *Tax avoidance potential*—(i) *Defined.* A residual interest has tax avoidance potential for purposes of this section unless, at the time of the transfer, the transferor reasonably expects that, for each excess inclusion, the REMIC will distribute to the transferee residual interest holder an amount that will equal at least 30 percent of the excess inclusion, and that each such amount will be distributed at or after the time at which the excess inclusion accrues and not later than the close of the calendar year following the calendar year of accrual.

(ii) *Safe harbor.* For purposes of paragraph (a)(2)(i) of this section, a transferor has a reasonable expectation if the 30-percent test would be satisfied were the REMIC's qualified mortgages to prepay at each rate within a range of rates from 50 percent to 200 percent of the rate assumed under section 1272(a)(6) with respect to the qualified mortgages (or the rate that would have been assumed had the mortgages been issued with original issue discount).

(3) *Effectively connected income.* Paragraph (a)(1) of this section will not apply if the transferee's income from the residual interest is subject to tax under section 871(b) or section 882.

(4) *Transfer by a foreign holder.* If a foreign person transfers a residual interest to a United States person or a foreign holder in whose hands the income from a residual interest would be effectively connected income, and if the transfer has the effect of allowing the transferor to avoid tax on accrued excess inclusions, then the transfer is disregarded and the transferor continues to be treated as the owner of the residual interest for purposes of section 871(a), 881, 1441, or 1442.

(b) [Reserved]

[T.D. 8458, 57 FR 61313, Dec. 24, 1992]

TAX BASED ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES

DETERMINATION OF SOURCES OF INCOME

§1.861–1 Income from sources within the United States.

(a) *Categories of income.* Part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder determine the sources of income for purposes of the income tax. These sections explicitly allocate certain important sources of income to the United States or to areas outside the United States, as the case may be; and, with respect to the remaining income (particularly that derived partly from sources within and partly from sources without the United States), authorize the Secretary or his delegate to determine the income derived from sources within the United States, either by rules of separate allocation or by processes or formulas of general apportionment. The statute provides for the following three categories of income:

(1) *Within the United States.* The gross income from sources within the United States, consisting of the items of gross income specified in section 861(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See §§1.861–2 to 1.861–7, inclusive, and §1.863–1. The taxable income from sources within the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 861(b) and 863(a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely

be allocated to some item or class of gross income. See §§ 1.861–8 and 1.863–1.

(2) *Without the United States.* The gross income from sources without the United States, consisting of the items of gross income specified in section 862(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See §§ 1.862–1 and 1.863–1. The taxable income from sources without the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 862(b) and 863(a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. See §§ 1.862–1 and 1.863–1.

(3) *Partly within and partly without the United States.* The gross income derived from sources partly within and partly without the United States, consisting of the items specified in section 863(b) (1), (2), and (3). The taxable income allocated or apportioned to sources within the United States, in the case of such income, shall be determined in accordance with section 863 (a) or (b). See §§ 1.863–2 to 1.863–5, inclusive.

(4) *Exceptions.* An owner of certain aircraft or vessels first leased on or before December 28, 1980, may elect to treat income in respect of these aircraft or vessels as income from sources within the United States for purposes of sections 861(a) and 862(a). See § 1.861–9. An owner of certain aircraft, vessels, or spacecraft first leased after December 28, 1980, must treat income in respect of these craft as income from sources within the United States for purposes of sections 861(a) and 862(a). See § 1.861–9A.

(b) *Taxable income from sources within the United States.* The taxable income from sources within the United States shall consist of the taxable income described in paragraph (a)(1) of this section plus the taxable income allocated or apportioned to such sources, as indicated in paragraph (a)(3) of this section.

(c) *Computation of income.* If a taxpayer has gross income from sources within or without the United States, together with gross income derived partly from sources within and partly from sources without the United States, the amounts thereof, together with the expenses and investment applicable thereto, shall be segregated; and the taxable income from sources within the United States shall be separately computed therefrom.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7928, 48 FR 55845, Dec. 16, 1983]

§ 1.861–2 Interest.

(a) *In general.* (1) Gross income consisting of interest from the United States or any agency or instrumentality thereof (other than a possession of the United States or an agency or instrumentality of a possession), a State or any political subdivision thereof, or the District of Columbia, and interest from a resident of the United States on a bond, note, or other interest-bearing obligation issued, assumed or incurred by such person shall be treated as income from sources within the United States. Thus, for example, income from sources within the United States includes interest received on any refund of income tax imposed by the United States, a State or any political subdivision thereof, or the District of Columbia. Interest other than that described in this paragraph is not to be treated as income from sources within the United States. See paragraph (a)(7) of this section for special rules concerning substitute interest paid or accrued pursuant to a securities lending transaction.

(2) The term ‘‘resident of the United States’’, as used in this paragraph, includes (i) an individual who at the time of payment of the interest is a resident of the United States, (ii) a domestic corporation, (iii) a domestic partnership which at any time during its taxable year is engaged in trade or business in the United States, or (iv) a foreign corporation or a foreign partnership, which at any time during its taxable year is engaged in trade or business in the United States.

(3) The method by which, or the place where, payment of the interest is made is immaterial in determining whether interest is derived from sources within the United States.

(4) For purposes of this section, the term ‘‘interest’’ includes all amounts treated as interest under section 483, and the regulations thereunder. It also includes original issue discount, as defined in section 1232(b)(1), whether or not the underlying bond, debenture, note, certificate, or other evidence of indebtedness is a capital asset in the hands of the taxpayer within the meaning of section 1221.

(5) If interest is paid on an obligation of a resident of the United States by a nonresident of the United States acting in the nonresident's capacity as a guarantor of the obligation of the resident, the interest will be treated as income from sources within the United States.

(6) In the case of interest received by a nonresident alien individual or foreign corporation this paragraph (a) applies whether or not the interest is effectively connected for the taxable year with the conduct of a trade or business in the United States by such individual or corporation.

(7) A substitute interest payment is a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to an interest payment which the owner of the transferred security is entitled to receive during the term of the transaction. A securities lending transaction is a transfer of one or more securities that is described in section 1058(a) or a substantially similar transaction. A sale-repurchase transaction is an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive a substantially identical securities from the transferee in the future in exchange for cash. A substitute interest payment shall be sourced in the same manner as the interest accruing on the transferred security for purposes of this section and §1.862–1. See also §§1.864–5(b)(2)(iii), 1.871–7(b)(2), 1.881–2(b)(2) and for the character of such payments and §1.894–1(c) for the application tax treaties to these transactions.

(b) *Interest not derived from U.S. sources.* Notwithstanding paragraph (a) of this section, interest shall be treated as income from sources without the United States to the extent provided by subparagraphs (A) through (H), of section 861(a)(1) and by the following subparagraphs of this paragraph.

(1) *Interest on bank deposits and on similar amounts.* (i) Interest paid or credited before January 1, 1977, to a nonresident alien individual or foreign corporation on—

(a) Deposits with persons, including citizens of the United States or alien individuals and foreign or domestic partnerships or corporations, carrying on the banking business in the United States,

(b) Deposits or withdrawable accounts with savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law, or

(c) Amounts held by an insurance company under an agreement to pay interest thereon, shall be treated as income from sources without the United States if such interest is not effectively connected for the taxable year with the conduct of a trade or business in the United States by such nonresident alien individual or foreign corporation. If such interest is effectively connected for the taxable year with the conduct of a trade or business in the United States by such nonresident alien individual or foreign corporation, it shall be treated as income from sources within the United States under paragraph (a) of this section unless it is treated as income from sources without the United States under another subparagraph of this paragraph. For a special rule for determining whether such interest is effectively connected for the taxable year with the conduct of a trade or business in the United States, see paragraph (c)(1)(ii) or §1.864–4.

(ii) Paragraph (b)(1)(i)*(b)* of this section applies to interest on deposits or withdrawable accounts described therein only to the extent that the interest paid or credited by the savings institution described therein is deductible under section 591 in determining the taxable income of such institution; and, for this purpose, whether an amount is deductible under section 591 shall be determined without regard to section 265, relating to deductions allocable to tax-exempt income. Thus, for example, such subdivision does not apply to amounts paid by a savings and loan or similar association on or with respect to its nonwithdrawable capital stock or on or with respect to funds held in restricted accounts which represent a proprietary interest in such association. Paragraph (b)(1)(i)*(b)* of this section also applies to so-called dividends paid or credited on deposits or withdrawable accounts if such dividends are deductible under section 591 without reference to section 265.

(iii) For purposes of paragraph (b)(1)(i)*(c)* of this section, amounts held by an insurance company under an agreement to pay interest thereon include policyholder dividends left with the company to accumulate, prepaid insurance premiums, proceeds of policies left on deposit with the company, and overcharges of premiums. Such subdivision does not apply to *(a)* the so-called ''interest element'' in the case of annuity or installment payments under life insurance or endowment contracts or *(b)* interest paid by an insurance company to its creditors on notes, bonds, or similar evidences of indebtedness, if the debtor-creditor relationship does not arise by virtue of a contract of insurance with the insurance company.

(iv) For purposes of paragraph (b)(1)(i) of this section, interest received by a partnership shall be treated as received by each partner of such partnership to the extent of his distributive share of such item.

(2) *Interest from a resident alien individual or domestic corporation deriving substantial income from sources without the United States.* Interest received from a resident alien individual or a domestic corporation shall be treated as income from sources without the United States when it is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) that less than 20 percent of the gross income from all sources of such individual or corporation has been derived from sources within the United States, as determined under the provisions of sections 861 to 863, inclusive, and the regulations thereunder, for the 3-year period ending with the close of the taxable year of such individual or corporation preceding its taxable year in which such interest is paid or credited, or for such part of such period as may be applicable. If 20 percent or more of the gross income from all sources of such individual or corporation has been derived from sources within the United States, as so determined, for such 3-year period (or part thereof), the entire amount of the interest from such individual or corporation shall be treated as income from sources within the United States.

(3) *Interest from a foreign corporation not deriving major portion of its income from a U.S. business.* (i) Interest from a foreign corporation which, at any time during the taxable year, is engaged in trade or business in the United States shall be treated as income from sources without the United States when it is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) that *(a)* less than 50 percent of the gross income from all sources of such foreign corporation for the 3-year period ending with the close of its taxable year preceding its taxable year in which such interest is paid or credited (or for such part of such period as the corporation has been in existence) was effectively connected with the conduct by such corporation of a trade or business in the United States, as determined under section 864(c) and § 1.864–3, or *(b)* such foreign corporation had gross income for such 3-year period (or part thereof) but none was effectively connected with the conduct of a trade or business in the United States.

(ii) If 50 percent or more of the gross income from all sources of such foreign corporation for such 3-year period (or part thereof) was effectively connected with the conduct by such corporation of a trade or business in the United States, see section 861(a)(1)(D) and paragraph (c)(1) of this section for determining the portion of interest from such corporation which is treated as income from sources within the United States.

(iii) For purposes of this paragraph the gross income which is effectively connected with the conduct of a trade or business in the United States includes the gross income which, pursuant to section 882 (d) or (e) and the regulations thereunder, is treated as income which is effectively connected with the conduct of a trade or business in the United States.

(iv) This paragraph does not apply to interest paid or credited after December 31, 1969, by a branch in the United States of a foreign corporation if, at the time of payment or crediting, such branch is engaged in the commercial banking business in the United States; furthermore, such interest is treated under paragraph (a) of this section as income from sources within the United States unless it is treated as income from sources without the United States under paragraph (b) (1) or (4) of this section.

(4) *Bankers' acceptances.* Interest derived by a foreign central bank of issue from bankers' acceptances shall be treated as income from sources without the United States. For this purpose, a foreign central bank of issue is a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency. Such a bank is generally the custodian of the banking reserves of the country under whose laws it is organized.

(5) *Foreign banking branch of a domestic corporation or partnership.* Interest paid or credited on deposits with a branch outside the United States (as defined in section 7701(a)(9)) of a domestic corporation or of a domestic partnership shall be treated as income from sources without the United States, if, at the time of payment or crediting, such branch is engaged in the commercial banking business. For purposes of applying this paragraph, it is immaterial (i) whether the domestic corporation or domestic partnership is carrying on a banking business in the United States, (ii) whether the recipient of the interest is a citizen or resident of the United States, a foreign corporation, or a foreign partnership, (iii) whether the interest is effectively connected with the conduct of a trade or business in the United States by the recipient, or (iv) whether the deposits with the branch located outside the United States are payable in the currency of a foreign country. Notwithstanding the provisions of §1.863–6, interest to which this paragraph applies shall be treated as income from sources within the foreign country, possession of the United States, or other territory in which the branch is located.

(6) *Section 4912(c) debt obligations*— (i) *In general.* Under section 861(a)(1)(G), interest on a debt obligation shall not be treated as income from sources within the United States if—

(a) The debt obligation was part of an issue of debt obligations with respect to which an election has been made under section 4912(c) (relating to the treatment of such debt obligations as debt obligations of a foreign obligor for purposes of the interest equalization tax),

(b) The debt obligation had a maturity not exceeding 15 years (within the meaning of paragraph (b)(6)(ii) of this section) on the date it is originally issued or on the date it is treated under section 4912(c)(2) as issued by reason of being assumed by a certain domestic corporation,

(c) The debt obligation, when originally issued, was purchased by one or more underwriters (within the meaning of paragraph (b)(6)(iii) of this section) with a view to distribution through resale (within the meaning of paragraph (b)(6)(iv) of this section), and

(d) The interest on the debt obligation is attributable to periods after the effective date of an election under section 4912(c) to treat such debt obligations as debt obligations of a foreign obligor for purposes of the interest equalization tax.

(ii) *Maturity not exceeding 15 years.* The date the debt obligation is issued or treated as issued is not included in the 15 year computation, but the date of maturity of the debt, obligation is included in such computation.

(iii) *Purchased by one or more underwriters.* For purposes of this paragraph, the debt obligation when originally issued will not be treated as purchased by one or more underwriters unless the underwriter purchases the debt obligation for his own account and bears the risk of gain or loss on resale. Thus, for example, a debt obligation, when originally issued, will not be treated as purchased by one or more underwriters if the underwriter acts only in the capacity of an agent of the issuer. Neither will a debt obligation, when originally issued, be treated as purchased by one or more underwriters if the agreement between the underwriter and issuer is merely for a ‘‘best efforts’’ underwriting, for the purchase by the underwriter of all or a portion of the debt obligations remaining unsold at the expiration of a fixed period of time, or for any other arrangement under the terms of which the debt obligations are not purchased by the underwriter with a view to distribution through resale. The fact that an underwriter is related to the issuer will not prevent the underwriter from meeting the requirements of this paragraph. In determining whether a related underwriter meets the requirements of this paragraph consideration shall be given to whether the purchase by the underwriter of the debt obligation from the issuer for resale was effected by a transaction subject to conditions similar to those which would have been imposed between independent persons.

(iv) *With a view to distribution through resale. (a)* An underwriter who purchased a debt obligation shall be deemed to have purchased it with a view to distribution through resale if the requirements of paragraph (b)(6)(iv) *(b)* or *(c)* of this section are met.

(b) The requirements of this paragraph *(b)* is that—

(1) The debt obligation is registered, approved, or listed for trading on one or more foreign securities exchanges or foreign established securities markets within 4 months after the date on which the underwriter purchases the debt obligation, or by the date of the first interest payment on the debt obligation, whichever is later, or

(2) The debt obligation, or any substantial portion of the issue of which the debt obligation is a part, is actually traded on one or more foreign securities markets on or within 15 calendar days after the date on which the underwriter purchases the debt obligation.

For purposes of this paragraph (b)(6)(iv), a foreign established securities market includes any foreign over-the-counter market as reflected by the existence of an inter-dealer quotation system for regularly disseminating to brokers and dealers quotations of obligations by identified brokers or dealers, other than quotations prepared and distributed by a broker or dealer in the regular course of his business and containing only quotations of such broker or dealer.

(c) The requirements of this paragraph *(c)* are that, except as provided in paragraph (b)(6)(iv)*(d)* of this section, the underwriter is under no written or implied restriction imposed by the issuer with respect to whom he may resell the debt obligation and either—

(1) Within 30 calendar days after he purchased the debt obligation the underwriter or underwriters either *(i)* sold it or *(ii)* sold at least 95 percent of the face amount of the issue of which the debt obligation is a part, or

(2)(i) The debt obligation is evidenced by an instrument which, under the laws of the jurisdiction in which it is issued, is either negotiable or transferable by assignment (whether or not it is registered for trading), and *(ii)* it appears from all the relevant facts and circumstances, including any written statements or assurances made by the purchasing underwriter or underwriters, that such debt obligation was purchased with a view to distribution through resale.

(d) The requirements of paragraph (b)(6)(iv)*(c)* of this paragraph may be met whether or not the underwriter is restricted from reselling the debt obligations—

(1) To a United States person (as defined in section 7701(a)(30)) or

(2) To any particular person or persons pursuant to a restriction imposed by, or required to be met in order to comply with, United States or foreign securities or other law.

(v) *Statement with return.* Any taxpayer who is required to file a tax return and who excludes from gross income interest of the type specified in this subparagraph must comply with the requirements of paragraph (d) of this section.

(vi) *Effect of termination of IET.* If the interest equalization tax expires, the provisions of section 861(a)(1)(G) and this subparagraph shall apply to interest paid on debt obligations only with respect to which a section 4912(c) election was made.

(vii) *Definition of term underwriter.* For purposes of section 861(a)(1)(G) and this paragraph, the term ''underwriter'' shall mean any underwriter as defined in section 4919(c)(1).

(c) *Special rules*—(1) *Proration of interest from a foreign corporation deriving major portion of its income from a U.S. business.* If, after applying the first sentence of paragraph (b)(3) of this section to interest to which that paragraph applies, it is determined that the interest may not be treated as income from sources without the United States, the amount of the interest from the foreign corporation which at some time during the taxable year is engaged in trade or business in the United States which is to be treated as income from sources within the United States shall be the amount that bears the same ratio to such interest as the gross income of such foreign corporation for the 3-year period ending with the close of its taxable year preceding its taxable year in which such interest is paid or credited (or for such part of such period as the corporation has been in existence) which was effectively connected with the conduct by such corporation of a trade or business in the United States bears to its gross income from all sources for such period.

(2) *Payors having no gross income for period preceding taxable year of payment.* If the resident alien individual, domestic corporation, or foreign corporation, as the case may be, paying interest has no gross income from any source for the 3-year period (or part thereof) specified in paragraph (b) (2) or (3) of this section, or paragraph (c)(1) of this section, the 20-percent test or the 50-percent test, or the apportionment formula, as the case may be, described in such paragraph shall be applied solely with respect to the taxable year of the payor in which the interest is paid or credited. This paragraph applies whether the lack of gross income for the 3-year period (or part thereof) stems from the business inactivity of the payor, from the fact that the payor is a corporation which is newly created or organized, or from any other cause.

(3) *Transitional rule.* For purposes of applying paragraph (b)(3) of this section, and paragraph (c)(1) of this section, the gross income of the foreign corporation for any period before the first taxable year beginning after December 31, 1966, which is from sources within the United States (determined as provided by sections 861 through 863, and the regulations thereunder, as in effect immediately before amendment by section 102 of the Foreign Investors Tax Act of 1966 (Pub. L. 89–809, 80 Stat. 1541)) shall be treated as gross income for such period which is effectively connected with the conduct of a trade or business in the United States by such foreign corporation.

(4) *Gross income determinations.* In making determinations under paragraph (b) (2) or (3) of this section, or paragraph (c) (1) or (3) of this section—

(i) The gross income of a domestic corporation or a resident alien individual is to be determined by excluding any items specifically excluded from gross income under chapter 1 of the Code, and

(ii) The gross income of a foreign corporation which is effectively connected with the conduct of a trade or business in the United States is to be determined under section 882(b)(2) and by excluding any items specifically excluded from gross income under chapter 1 of the Code, and

(iii) The gross income from all sources of a foreign corporation is to be determined without regard to section 882(b) and without excluding any items otherwise specifically excluded from gross income under chapter 1 of the Code.

(d) *Statement with return.* Any taxpayer who is required to file a return and applies any provision of this section to exclude an amount of interest from his gross income must file with his return a statement setting forth the amount so excluded, the date of its receipt, the name and address of the obligor of the interest, and, if known, the location of the records which substantiate the amount of the exclusion. A statement from the obligor setting forth such information and indicating the amount of interest to be treated as income from sources without the United States may be used for this purpose. See §§1.6012–1(b)(1)(i) and 1.6012–2(g)(1)(i).

(e) *Effective dates.* Except as otherwise provided, this section applies with respect to taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, (see 26 CFR part 1 revised April 1, 1971). Paragraph (a)(7) of this section is applicable to payments made after November 13, 1997.

[T.D. 7378, 40 FR 45429, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975, as amended by T.D. 8257, 54 FR 31819, Aug. 2, 1989; T.D. 8735, 62 FR 53500, Oct. 14, 1997]

§ 1.861–3 Dividends.

(a) *General*—(1) *Dividends included in gross income.* Gross income from sources within the United States includes a dividend described in subparagraph (2), (3), (4), or (5) of this paragraph. For purposes of subparagraphs (2), (3), and (4) of this paragraph, the term ''dividend'' shall have the same meaning as set forth in section 316 and the regulations thereunder. See subparagraph (5) of this paragraph for special rules with respect to certain dividends from a DISC or former DISC. See also paragraph (a)(6) of this section for special rules concerning substitute dividend payments received pursuant to a securities lending transaction.

(2) *Dividend from a domestic corporation.* A dividend described in this subparagraph is a dividend from a domestic corporation other than a domestic corporation entitled to the benefits of section 931, and other than a domestic corporation less than 20 percent of the gross income of which is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) to have been derived from sources within the United States, as determined under the provisions of sections 861 to 864, inclusive, and the regulations thereunder, for the 3-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividend, or for such part of such period as the corporation has been in existence. See subparagraph (5) of this paragraph for the treatment of certain dividends from a DISC or former DISC.

(3) *Dividend from a foreign corporation*—(i) *In general. (a)* A dividend described in this subparagraph is a dividend from a foreign corporation (other than a dividend to which subparagraph (4) of this paragraph applies) unless less than 50 percent of the gross income from all sources of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the taxable year in which occurs the declaration of such dividend (or for such part of such period as the corporation has been in existence) was effectively connected with the conduct by such corporation of a trade or business in the United States, as determined under section 864(c) and § 1.864–3. Thus, no portion of a dividend from a foreign corporation shall be treated as income from sources within the United States under section 861(a)(2)(B) if less than 50 percent of the gross income of such foreign corporation from all sources for such 3-year period (or part thereof) was effectively connected with the conduct by such corporation of a trade or business in the United States or if such foreign corporation had gross income for such 3-year period (or part thereof) but none was effectively connected with the conduct by such corporation of a trade or business in the United States.

(b) If 50 percent or more of the gross income from all sources of such foreign corporation for such 3-year period (or part thereof) was effectively connected with the conduct by such corporation of a trade or business in the United States, the amount of the dividend which is to be treated as income from sources within the United States under section 861(a)(2)(B) shall be the amount that bears the same ratio to such dividend as the gross income of such foreign corporation for such 3-year period (or part thereof) which was effectively connected with the conduct by such corporation of a trade or business in the United States bears to its gross income from all sources for such period.

(c) For purposes of this subdivision (i), the gross income which is effectively connected with the conduct of a trade or business in the United States includes the gross income which, pursuant to section 882 (d) or (e), is treated as income which is effectively connected with the conduct of a trade or business in the United States.

(ii) *Rule applicable in applying limitation on amount of foreign tax credit.* For purposes of determining under section 904 the limitation upon the amount of the foreign tax credit—

(a) So much of a dividend from a foreign corporation as exceeds (and only to the extent it so exceeds) the amount which is 100/85ths of the amount of the deduction allowable under section 245(a) in respect of such dividend, plus

(b) An amount which bears the same proportion to any section 78 dividend to which the dividend from the foreign corporation gives rise as the amount of the excess determined under *(a)* of this subdivision bears to the total amount of the dividend from the foreign corporation, shall, notwithstanding subdivision (i) of this subparagraph, be treated as income from sources without the United States. This subdivision applies to a dividend for which no dividends-received deduction is allowed under section 245 or for which the 85 percent dividends-received deduction is allowed under section 245(a) but does not apply to a dividend for which a deduction is allowable under section 245(b). All of a dividend for which the 100 percent dividends-received deduction is allowed under section 245(b) shall be treated as income from sources within the United States for purposes of determining under section 904 the limitation upon the amount of the foreign tax credit. If the amount of a distribution of property other than money (constituting a dividend under section 316) is determined by applying section 301(b)(1)(C), such amount must be used as the dividend for purposes of applying *(a)* of this subdivision even though the amount used for purposes of section 245(a) is determined by applying section 301(b)(1)(D). In making determinations under this subdivision, a dividend (other than a section 78 dividend referred to in *(b)* of this subdivision) shall be determined without regard to section 78.

(iii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example 1. D, a domestic corporation, owns 80 percent of the outstanding stock of M, a foreign manufacturing corporation. M, which makes its returns on the basis of the calendar year, has earnings and profits of $200,000 for 1971 and 60 percent of its gross income for that year is effectively connected for 1971 with the conduct of a trade or business in the United States. For an uninterrupted period of 36 months ending on December 31, 1970, M has been engaged in trade or business in the United States and has received gross income effectively connected with the conduct of a trade or business in the United States amounting to 60 percent of its gross income from all sources for such period. The only distribution by M to D for 1971 is a cash dividend of $100,000; of this amount, $60,000 ($100,000×60%) is treated under subdivision (i) of this subparagraph as income from sources within the United States, and $40,000 ($100,000−$60,000) is treated under §1.862–1(a)(2) as income from sources without the United States. Accordingly, under section 245(a), D is entitled to a dividends-received deduction of $51,000 ($60,000×85%), and under subdivision (ii) of this subparagraph $40,000 ($100,000−[$51,000×100/85]) is treated as income from sources without the United States for purposes of determining under section 904(a) (1) or (2) the limitation upon the amount of the foreign tax credit.

Example 2. (a) The facts are the same as in example (1) except that the distribution for 1971 consists of property which has a fair market value of $100,000 and an adjusted basis of $30,000 in M's hands immediately before the distribution. The amount of the dividend under section 316 is $58,000, determined by applying secton 301(b)(1)(C) as follows:

Portion of adjusted basis of property attributable to gross income of M effectively connected for 1971 with conduct of trade or business in United States ($30,000×60%)	$18,000
Portion of fair market value of property attributable to gross income of M not effectively connected for 1971 with conduct of trade or business in United States ($100,000×40%)	40,000
Total dividend	58,000

(b) Of the total dividend, $34,800 ($58,000×60% (percentage applicable to 3-year period)) is treated under subdivision (i) of this subparagraph as income from sources within the United States, and $23,200 ($58,000×40%) is treated under §1.862–1(a)(2) as income from sources without the United States. However, by reason of section 245(c) the adjusted basis of the property ($30,000) is used under section 245(a) in determining the dividends-received deduction. Thus, under section 245(a), D is entitled to a dividends-received deduction of $15,300 ($30,000×60%×85%).

(c) Under subdivision (ii) of this subparagraph, the amount of the dividend for purposes of applying *(a)* of that subdivision is the amount ($58,000) determined by applying section 301(b)(1)(C) rather than the amount ($30,000) determined by applying section 301(b)(1)(B). Accordingly, under subdivision (ii) of this subparagraph $40,000 ($58,000−[$15,300×100/85]) is treated as income from sources without the United States for purposes of determining under section 904(a) (1) or (2) the limitation upon the amount of the foreign tax credit.

Example 3. (a) D, a domestic corporation which makes its returns on the basis of the calendar year, owns 100 percent of the outstanding stock of N, a foreign corporation which is not a less developed country corporation under section 902(d). N, which makes its returns on the basis of the calendar year, has total gross income for 1971 of $100,000, of which $80,000 (including $60,000 from sources within foreign country X) is effectively connected for that year with the conduct of a trade or business in the United States. For 1971 N is assumed to have paid $27,000 of income taxes to country X and to have accumulated profits of $81,000 for purposes of section 902(c)(1)(A). N's accumulated profits in excess of foreign income taxes amount to $54,000. For 1971 D receives a cash dividend of $42,000 from N, which is D's only income for that year.

(b) For 1971 D chooses the benefits of the foreign tax credit under section 901, and as a result is required under section 78 to include in gross income an amount equal to the foreign income taxes of $21,000 ($27,000×$42,000/$54,000) it is deemed to have paid under section 902(a)(1). Thus, assuming no other deductions for the taxable year, D has gross income of $63,000 ($42,000+$21,000) for 1971 less a dividends-received deduction under section 245(a) of $28,560 ([$42,000×$80,000/$100,000]×85%), or taxable income for 1971 of $34,440.

(c) Under subdivision (ii) of this subparagraph, for purposes of determining under section 904(a) (1) or (2) the limitation upon the amount of the foreign tax credit, $12,600 is treated as income from sources without the United States, determined as follows:

Excess of dividend from N over amount which is 100/85ths of amount of sec. 245(a) deduction ($42,000 − [$28,560× 100/85])	$8,400
Proportionate part of sec. 78 dividend ($21,000×$8,400/$42,000)	4,200
Taxable income from sources without the United States	12,600

Example 4. A, an individual citizen of the United States who makes his return on the basis of the calendar year, receives in 1971 a cash dividend of $10,000 from M, a foreign corporation, which makes its return on the basis of the calendar year. For the 3-year period ending with 1970 M has been engaged in trade or business in the United States and has received gross income effectively connected with the conduct of a trade or business in the United States amounting to 80 percent of its gross income from all sources for such period. Of the total dividend, $8,000 ($10,000×80%) is treated under subdivision (i) of this subparagraph as income from sources within the United States and $2,000 ($10,000 − $8,000) is treated under § 1.862–1(a)(2) as income from sources without the United States. Since under section 245 no dividends received-deduction is allowable to an individual, A is entitled under subdivision (ii) of this subparagraph to treat the entire dividend of $10,000 ($10,000 − [$0×100/85]) as income from sources without the United States for purposes of determining under section 904(a) (1) or (2) the limitation upon the amount of the foreign tax credit.

(4) *Dividend from a foreign corporation succeeding to earnings of a domestic corporation.* A dividend described in this subparagraph is a dividend from a foreign corporation, if such dividend is received by a corporation after December 31, 1959, but only to the extent that such dividend is treated by such recipient corporation under the provisions of § 1.243–3 as a dividend from a domestic corporation subject to taxation under chapter 1 of the Code. To the extent that this subparagraph applies to a dividend received from a foreign corporation, subparagraph (3) of this paragraph shall not apply to such dividend.

(5) *Certain dividends from a DISC or former DISC*—(i) *General rule.* A dividend described in this subparagraph is a dividend from a corporation that is a DISC or former DISC (as defined in section 992(a)) other than a dividend that—

(*a*) Is deemed paid by a DISC, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) to the extent provided in subdivision (iii) of this subparagraph or

(b) Reduces under § 1.996–3(b)(3) accumulated DISC income (as defined in subdivision (ii)*(b)* of this subparagraph) to the extend provided in subdivision (iv) of this subparagraph.

Thus, a dividend deemed paid under section 995(b)(1) (A), (B), or (C) (relating to certain deemed distributions in qualified years) will be treated in full as gross income from sources within the United States. To the extent that a dividend from a DISC or former DISC is paid out of other earnings and profits (as defined in § 1.996–3(d)), subparagraph (2) of this paragraph shall apply. To the extent that a dividend from a DISC or former DISC is paid out of previously taxed income (as defined in § 1.996–3(c)), see section 996(a)(3) (relating to the exclusion from gross income of amounts distributed out of previously taxed income). In determining the source of income of certain dividends from a DISC or former DISC, the source of income from any transaction which gives rise to gross receipts (as defined in §1.993–6), in the hands of the DISC or former DISC, is immaterial.

(ii) *Definitions.* For purposes of this subparagraph, the term—

(a) ''Dividend from'' means any amount actually distributed which is a dividend within the meaning of section 316 (including distributions to meet qualification requirements under section 992(c)) and any amount treated as a distribution taxable as a dividend pursuant to section 995(b) (relating to deemed distributions in qualified years or upon disqualification) or included in gross income as a dividend pursuant to section 995(c) (relating to gain on certain dispositions of stock in a DISC or former DISC), and

(b) ''Accumulated DISC income'' means the amount of accumulated DISC income as of the close of the taxable year immediately preceding the taxable year in which the dividend was made increased by the amount of DISC income for the taxable year in which the dividend was made (as determined under §1.996–3(b)(2)).

(*c*) ''Nonqualified export taxable income'' means the taxable income of a DISC from any transaction which gives rise to gross receipts (as defined in §1.993–6) which are not qualified export receipts (as defined in §1.993–1) other than a transaction giving rise to gain described in section 995(b)(1) (B) or (C). For purposes of subdivisions (i)*(b)* and (iv) of this subparagraph, if by reason of section 995(c), gain is included in the shareholder's gross income as a dividend, accumulated DISC income shall be treated as if it were reduced under §1.996–3(b)(3).

(iii) *Determination of source of income for deemed distributions, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F). (a*) If for its taxable year a DISC does not have any nonqualified export taxable income, then for such year the entire amount treated, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) as a deemed distribution taxable as a dividend will be treated as gross income from sources without the United States.

(*b*) If for its taxable year a DISC has any nonqualified export taxable income, then for such year the portion of the amount treated, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) as a deemed distribution taxable as a dividend that will be treated as income from sources within the United States shall be equal to the amount of such nonqualified export taxable income multiplied by the following fraction. The numerator of the fraction is the sum of the amounts treated, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) as deemed distributions taxable as dividends. The denominator of the fraction is the taxable income of the DISC for the taxable year, reduced by the amounts treated under section 995(b)(1) (A), (B), and (C) as deemed distributions taxable as dividends. However, in no event shall the numerator exceed the denominator. The remainder of such dividend will be treated as gross income from sources without the United States.

(iv) *Determination of source of income for dividends that reduce accumulated DISC income. (a)* If no portion of the accumulated DISC income of a DISC or former DISC is attributable to nonqualified export taxable income from any transaction during a year for which it is (or is treated as) a DISC, then the entire amount of any dividend that reduces under §1.996–3(b)(3) accumulated DISC income will be treated as income from sources without the United States.

(*b*) If any portion of the accumulated DISC income of a DISC or former DISC is attributable to nonqualified export taxable income from any transaction during a year for which it is (or is treated as) a DISC, then the portion of any dividend during its taxable year that reduces under § 1.996–3(b)(3) accumulated DISC income that will be treated as income from sources within the United States shall be equal to the amount of such dividend multiplied by a fraction (determined as of the close of such year) the numerator of which is the amount of accumulated DISC income attributable to nonqualified export taxable income, and the denominator of which is the total amount of accumulated DISC income. The remainder of such dividend will be treated as gross income from sources without the United States.

(v) *Special rules.* For purposes of subdivisions (iii) and (iv) of this subparagraph—

(a) Taxable income shall be determined under § 1.992–3(b)(2)(i) (relating to the computation of deficiency distribution), and

(*b*) The portion of any deemed distribution taxable as a dividend, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1)(D), (E), and (F) or amount under § 1.996–3(b)(3) (i) through (iv) that is treated as gross income from sources within the United States during the taxable year shall be considered to reduce the amount of nonqualified export taxable income as of the close of such year.

(vi) *Illustrations.* This subparagraph may be illustrated by the following examples:

Example 1. (a) Y is a corporation which uses the calendar year as its taxable year and which elects to be treated as a DISC beginning with 1972. X is its sole shareholder. In 1973, Y has $18,000 of taxable income from qualified export receipts (none of which are interest and gains described in section 995(b)(1)(A), (B), and (C)) and $1,000 of nonqualified export taxable income. Under these facts, X is deemed to have received a distribution under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, of $9,500, *i.e.*, $19,000 X ½. X is treated under subdivision (iii)(*b*) of this subparagraph as having $500, *i.e.*, $1,000 X $9,500/ $19,000, from sources within the United States and $9,000 from sources without the United States.

(b) For 1972, assume that Y did not have any nonqualified export taxable income. Pursuant to subdivision (v)*(b)* of this subparagraph, at the beginning of 1974, $500 of Y's accumulated DISC income is attributable to nonqualified export taxable income (iii)*(a)* of this subparagraph), i.e., $1,000—$500.

Example 2. The facts are the same as in example (1) except that in 1973, in addition to the taxable income described in such example, Y has $450 of taxable income from gross interest from producer's loans described in section 995(b)(1)(A). Under these facts, the deemed distribution of $450 under section 995(b)(1)(A) is treated in full under subdivision (i) of this subparagraph as gross income from sources within the United States. The deemed distribution under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, of $9,500 will be treated in the same manner as in example (1), *i.e.*, $1,000 X $9,500/($19,450 − $450).

Example 3. (a) The facts are the same as in example (1) except that in 1973, in addition to the distribution described in such example, Y makes a deemed distribution taxable as a dividend of $100 under section 995(b)(1)(G) (relating to foreign investment attributable to producer's loans) and actual distributions of all of its previously taxed income and of $2,000 taxable as a dividend which reduces accumulated DISC income (as defined in subdivision (ii)(*b*) of this subparagraph). Under § 1.996–3(b)(3), accumulated DISC income is first reduced by the deemed distribution of $100 and then by the actual distribution taxable as a dividend of $2,000. As indicated in example (1), for 1972 Y did not have any nonqualified export taxable income. Assume that Y had accumulated DISC income of $12,000 at the end of 1973, $500 of which under example (1) is attributable to nonqualified export taxable income.

(b) The distribution from previously taxed income is excluded from gross income pursuant to section 996(a)(3).

(c) Of the deemed distribution of $100, X is treated under subdivision (iv)*(b)* as having $4.17, i.e., $100×500/12,000, from sources within the United States and $95.83, i.e., $100—$4.17, from sources without the United States.

(d) Of the actual distribution taxable as a dividend of $2,000, X is treated under subdivision (iv)*(b)* as having $83.33, i.e., $2,000×500/ 12,000, from sources within the United States and $1,916.67, i.e., $2,000—$83.33, from sources without the United States.

(e) The sum of the amounts deemed and actually distributed as dividends for 1973 that are treated as gross income from sources within the United States is as follows:

	Total dividend	Amount of dividend from sources within the United States
Deemed distribution under sec. 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976	$9,500	$500.00
Deemed distribution under section 995(b)(1)(G)	100	4.17
Actual distribution that reduces accumulated DISC income	2,000	83.33
Totals	$11,600	$587.50

Thus, pursuant to subdivision (v)(*b*) of this subparagraph, at the beginning of 1974 Y has $412.50, *i.e.*, $1,000—$587.50, of nonqualified export taxable income.

(f) The result would be the same if Y made an actual distribution taxable as a dividend of $1,500 on March 30, 1973, and another distribution of $500 on December 31, 1973.

Example 4. (a) Z is a corporation which uses the calendar year as its taxable year and which elects to be treated as a DISC beginning with 1972. W is its sole shareholder. At the end of the 1976 Z has previously taxed income of $12,000 and accumulated DISC income of $4,000, $900 of which is attributable to nonqualified export taxable income. In 1977, Z has $20,050 of taxable income from qualified export receipts, of which $550 is from gross income from producer's loans described in section 995(b)(1)(A); Z has $950 of taxable income giving rise to gross receipts which are not qualified export receipts, of which $450 is gain described in section 995(b)(1)(B). Of its total taxable income of $21,000 (which is equal to its earnings and profits for 1977), $1,000 is attributable to sales of military property. Z has an international boycott factor (determined under section 999) of .10, and made an illegal bribe (within the meaning of section 162(c)) of $1,265. The proportion which the amount of Z's adjusted base period export receipts bears to Z's export gross receipts for 1977 is .40 (see section 995(e)(1)). Z makes a deemed distribution taxable as a dividend of $1,000 under section 995(b)(1)(G) (relating to foreign investment attributable to producer's loans) and actual distributions of $32,000.

(b) The deemed distributions of $550 under section 995(b)(1)(A) and $450 under section 995(b)(1)(B) are treated in full under subdivision (i) of this subparagraph as gross income from sources within the United States.

(c) Under these facts, Z has also made the following deemed distributions taxable as dividends to W under the following subdivisions of section 995(b)(1):

(D)	$500,	*i.e.*, ½×$1,000.
(E)	7,800,	*i.e.*,.40×[$21,000–$(550+450+500)].
(F)(i)	5,850,	*i.e.*, ½×[$21,000–$550+450+500+ 7,800)].
(ii)	585,	*i.e.*, $5,850×.10
(iii)	1,265	
Total	16,000	

(d) The portion of the total amount of these deemed distributions ($16,000 that is treated under the subdivision (iii)(*b*) as gross income from sources within the United States is computed as follows:

(1) The amount of nonqualified export taxable income is $500, i.e., taxable income giving rise to gross receipts which are not qualified export receipts ($950) minus gain described in section 995(b)(1) (B) or (C) ($450).

(2) $500×($16,000/$[21,000–(550+450)]) =$400.

The remainder of these distributions, $15,600 ($16,000 minus $400), is treated under subdivision (iii)(*b*) of this subparagraph as gross income from sources without the United States.

(e) The earnings and profits accounts of Z at the end of 1977 are computed as follows:

	Total earnings and profits	Previously taxed income	Accumulated DISC income attributable to taxable income from translations which give rise to gross receipts which—	
			Are qualified export receipts	Are not qualified export receipts
(1) Balance: January 1, 1977	$16,000	$12,000	$3,100	$900
(2) Earnings and profits for 1977, before actual and section 955(b)(1)(G) distributions	21,000	17,000	3,900	[1] 100
(3) Balance: December 31, 1977	37,000	29,000	7,000	1,000
(4) Distribution under section 995(b)(1)(G)		1,000	(875)	[2] (125)
(5) Balance	37,000	30,000	6,125	875
(6) Actual distribution	(32,000)	(30,000)	(1,750)	[3] (250)
(7) Balance: January 1, 1978	5,000		4,375	625

[1] The total of nonqualified export taxable income ($500) minus the portion of such income, under subdivision (iii)(*b*) of this subparagraph, deemed distributed pursuant to section 995(b)(1)(D), (E), and (F) ($400), as computed under (d)(2) of this example.

[2] Under subdivision (iv)(*b*) of this subparagraph, $1,000/$8,000×$1,000.

[3] Under subdivision (iv)(*b*) of this subparagraph, $1,000/$8,000×$2,000 (amount of actual distribution that reduces accumulated DISC income).

(6) *Substitute dividend payments.* A substitute dividend payment is a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction. A securities lending transaction is a transfer of one or more securities that is described in section 1058(a) or a substantially similar transaction. A sale-repurchase transaction is an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive substantially identical securities from the transferee in the future in exchange for cash. A substitute dividend payment shall be sourced in the same manner as the distributions with respect to the transferred security for purposes of this section and § 1.862–1. See also §§ 1.864–5(b)(2)(iii), 1.871–7(b)(2) and 1.881–2(b)(2) for the character of such payments and § 1.894–1(c) for the application of tax treaties to these transactions.

(b) *Special rules*—(1) *Foreign corporation having no gross income for period preceding declaration of dividend.* If the foreign corporation has no gross income from any source for the 3-year period (or part thereof) specified in paragraph (a)(3)(i) of this section, the 50-percent test, or the apportionment formula, as the case may be, described in such paragraph shall be applied solely with respect to the taxable year of such corporation in which the declaration of the dividend occurs. This subparagraph applies whether the lack of gross income for the 3-year period (or part thereof) stems from the business inactivity of the foreign corporation, from the fact that such corporation is newly created or organized, or from any other cause.

(2) *Transitional rule.* For purposes of applying paragraph (a)(3)(i) of this section, the gross income of the foreign corporation for any period before the first taxable year beginning after December 31, 1966, which is from sources within the United States (determined as provided by sections 861 through 863, and the regulations thereunder, as in effect immediately before amendment by section 102 of the Foreign Investors Tax Act of 1966 (Pub. L. 89–809, 80 Stat. 1541)) shall be treated as gross income for such period which is effectively connected with the conduct of a trade or business within the United States by such foreign corporation.

(3) *Gross income determinations.* In making determinations under subparagraph (2) or (3) of paragraph (a) of this section, or subparagraph (2) of this paragraph—

(i) The gross income of a domestic corporation is to be determined by excluding any items specifically excluded from gross income under chapter 1 of the Code.

(ii) The gross income of a foreign corporation which is effectively connected with the conduct of a trade or business in the United States is to be determined under section 882(b)(2) and by excluding any items specifically excluded from gross income under chapter 1 of the Code, and

(iii) The gross income from all sources of a foreign corporation is to be determined without regard to section 882(b) and without excluding any items otherwise specifically excluded from gross income under chapter 1 of the Code.

(c) *Statement with return.* Any taxpayer who is required to file a return and applies any provision of this section to exclude any dividend from his gross income must file with his return a statement setting forth the amount so excluded, the date of its receipt, the name and address of the corporation paying the dividend, and, if known, the location of the records which substantiate the amount of the exclusion. A statement from the paying corporation setting forth such information and indicating the amount of the dividend to be treated as income from sources within the United States may be used for this purpose. See §§ 1.6012–1(b)(1)(i) and 1.6012–2 (g)(1)(i).

(d) *Effective date.* Except as otherwise provided in this paragraph this section applies with respect to dividends received or accrued after December 31,

1966. Paragraph (a)(5) of this section applies to certain dividends from a DISC or former DISC in taxable years ending after December 31, 1971. Paragraph (a)(6) of this section is applicable to payments made after November 13, 1997. For purposes of paragraph (a)(5) of this section, any reference to a distribution taxable as a dividend under section 995(b)(1)(F) (ii) and (iii) for taxable years beginning after December 31, 1975, shall also constitute a reference to any distribution taxable as a dividend under section 995(b)(1)(F) (ii) and (iii) for taxable years beginning after November 30, 1975, but before January 1, 1976. For corresponding rules applicable with respect to dividends received or accrued before January 1, 1967, see 26 CFR 1.861–3 (Revised as of January 1, 1972).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6830, 30 FR 8046, June 23, 1965; T.D. 7378, 40 FR 45432, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975; T.D. 7472, 42 FR 12179, Mar. 3, 1977; T.D. 7591, 44 FR 5116, Jan. 25, 1979; T.D. 7854, 47 FR 51738, Nov. 17, 1982; T.D. 8735, 62 FR 53501, Oct. 14, 1997]

§1.861–4 Compensation for labor or personal services.

(a) *In general.* (1) Gross income from sources within the United States includes compensation for labor or personal services performed in the United States irrespective of the residence of the payer, the place in which the contract for service was made, or the place or time of payment; except that such compensation shall be deemed not to be income from sources within the United States, if—

(i) The labor or services are performed by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during his taxable year,

(ii) The compensation for such labor or services does not exceed in the aggregate a gross amount of $3,000, and

(iii) The compensation is for labor or services performed as an employee of, or under any form of contract with—

(a) A nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

(b) An individual who is a citizen or resident of the United States, a domestic partnership, or a domestic corporation, if such labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by such individual, partnership, or corporation.

(2) As a general rule, the term ‘‘day’’, as used in subparagraph (1)(i) of this paragraph, means a calendar day during any portion of which the nonresident alien individual is physically present in the United States.

(3) Solely for purposes of applying this paragraph, the nonresident alien individual, foreign partnership, or foreign corporation for which the nonresident alien individual is performing personal services in the United States shall not be considered to be engaged in trade or business in the United States by reason of the performance of such services by such individual.

(4) In determining for purposes of subparagraph (1)(ii) of this paragraph whether compensation received by the nonresident alien individual exceeds in the aggregate a gross amount of $3,000, any amounts received by the individual from an employer as advances or reimbursements for travel expenses incurred on behalf of the employer shall be omitted from the compensation received by the individual, to the extent of expenses incurred, where he was required to account and did account to his employer for such expenses and has met the tests for such accounting provided in §1.162–17 and paragraph (e)(4) of §1.274–5. If advances or reimbursements exceed such expenses, the amount of the excess shall be included as compensation for personal services for purposes of such subparagraph. Pensions and retirement pay attributable to labor or personal services performed in the United States are not to be taken into account for purposes of subparagraph (1)(ii) of this paragraph. (5) For definition of the term ‘‘United States’’, when used in a geographical sense, see sections 638 and 7701(a)(9).

(b) *Amount includible in gross income—* (1) *Taxable years beginning after December 31, 1975.* (i) If a specific amount is paid for labor or personal services performed in the United States, that amount (if income from sources within the United States) shall be included in the gross income. If no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case. In many cases the facts and circumstances will be such that an apportionment on the time basis will be acceptable, that is, the amount to be included in gross income will be that amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made. In other cases, the facts and circumstances will be such that another method of apportionment will be acceptable.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example 1. B, a nonresident alien individual, was employed by M from March 1, 1976, to June 12, 1976, a total of 104 days, for which he received compensation in the amount of $12,240. During that period B was present in the United States 59 days. Under his contract B was subject to call at all times by his employer and was in a payment status on a 7-day week basis. There was no specific agreement as to the amount of pay for services performed within the United States; moreover, he received his stipulated salary payments regardless of the number of days per week he actually performed services. Under these circumstances the amount of compensation to be included in gross income as income from sources within the United States will be $6,943.85 ($12,240 × 59/104).

Example 2. C, a citizen of the United States, was a resident of a foreign country during his entire taxable year. He is employed by N, a domestic corporation, and paid a salary of $17,600 per annum. Under his contract C is required to work only on a 5-day week basis, Monday through Friday. During 1976 he was in the United States for 6 weeks, performing services therein for N for 30 work days. During the year he worked 240 days for N for which payment was made, determined by eliminating his vacation period for which no payment was made. Under these circumstances the amount of compensation for personal services performed in the United States is $2,200 ($17,600×30/240).

(2) *Taxable years beginning before January 1, 1976.* If a specific amount is paid for labor or personal services performed in the United States, that amount (if income from sources within the United States) shall be included in the gross income. If no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis; that is, there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made.

(c) *Coastwise travel.* Except as to income excluded by paragraph (a) of this section, wages received for services rendered inside the territorial limits of the United States and wages of an alien seaman earned on a coastwise vessel are to be regarded as from sources within the United States.

(d) *Effective date.* This section applies with respect to taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.861–4 (Revised as of January 1, 1972).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7378, 40 FR 45433, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975]

§ 1.861–5 Rentals and royalties.

Gross income from sources within the United States includes rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, in the United States, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property. The income arising from the rental of property, whether tangible or intangible, located within the United States, or from the use of property, whether tangible or intangible, within the United States, is from sources within the United States. For taxable years beginning after December 31, 1966, gains described in section 871(a)(1)(D) and section 881(a)(4) from the sale or exchange after October 4, 1966, of patents, copyrights, and other like property shall be treated, as provided in section 871(e)(2), as rentals or royalties for the use of, or privilege of using, property or an interest in property. See paragraph (e) of §1.871–11.

[T.D. 7378, 40 FR 45434, Oct. 2, 1975]

§1.861–6 Sale of real property.

Gross income from sources within the United States includes gain, computed under the provisions of section 1001 and the regulations thereunder, derived from the sale or other disposition of real property located in the United States. For the treatment of capital gains and losses, see subchapter P (section 1201 and following), chapter 1 of the Code, and the regulations thereunder.

§1.861–7 Sale of personal property.

(a) *General.* Gains, profits, and income derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which the property is sold. Thus, gross income from sources within the United States includes gains, profits, and income derived from the purchase of personal property without the United States and its sale within the United States.

(b) *Purchase within a possession.* Notwithstanding paragraph (a) of this section, income derived from the purchase of personal property within a possession of the United States and its sale within the United States shall be treated as derived partly from sources within and partly from sources without the United States. See section 863(b)(3) and §1.863–2.

(c) *Country in which sold.* For the purposes of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss. However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

(d) *Production and sale.* For provisions respecting the source of income derived from the sale of personal property produced by the taxpayer, see section 863(b)(2) and paragraphs (b) of §§1.863–1 and 1.863–2.

(e) *Section 306 stock.* For determining the source of gain on the disposition of section 306 stock, see section 306(f) and the regulations thereunder.

§1.861–8 Computation of taxable income from sources within the United States and from other sources and activities.

(a) *In general*—(1) *Scope.* Sections 861(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources within the United States after gross income from sources within the United States has been determined. Sections 862(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources without the United States after gross income from sources without the United States has been determined. This section provides specific guidance for applying the cited Code sections by prescribing rules for the allocation and apportionment of expenses, losses, and other deductions (referred to collectively in this section as ‘‘deductions’’) of the taxpayer. The rules contained in this section apply in determining taxable income of the taxpayer from specific sources and activities under other sections of the Code, referred to in this section as operative sections. See paragraph (f)(1) of this section for a list and description of operative sections. The operative sections include, among others, sections 871(b) and 882 (relating to taxable income of a nonresident alien individual or a foreign corporation which is effectively connected with the conduct of a trade or business in the United States), section 904(a)(1) (as in effect before enactment of the Tax Reform Act of 1976, relating to taxable income from sources within specific foreign countries), and section 904(a)(2) (as in effect before enactment of the Tax Reform Act of 1976, or section 904(a) after such enactment, relating to taxable income from all sources without the United States).

(2) *Allocation and apportionment of deductions in general.* A taxpayer to which this section applies is required to allocate deductions to a class of gross income and, then, if necessary to make the determination required by the operative section of the Code, to apportion deductions within the class of gross income between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income. Except for deductions, if any, which are not definitely related to gross income (see paragraphs (c)(2) and (e)(9) of this section) and which, therefore, are ratably apportioned to all gross income, all deductions of the taxpayer (except the deductions for personal exemptions enumerated in paragraph (e)(11) of this section) must be so allocated and apportioned. As further detailed below, allocations and apportionments are made on the basis of the factual relationship of deductions to gross income.

(3) *Class of gross income.* For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a ''class of gross income'' and may consist of one or more items (or subdivisions of these items) of gross income enumerated in section 61, namely:

(i) Compensation for services, including fees, commissions, and similar items;

(ii) Gross income derived from business;

(iii) Gains derived from dealings in property;

(iv) Interest;

(v) Rents;

(vi) Royalties;

(vii) Dividends;

(viii) Alimony and separate maintenance payments;

(ix) Annuities;

(x) Income from life insurance and endowment contracts;

(xi) Pensions;

(xii) Income from discharge of indebtedness;

(xiii) Distributive share of partnership gross income;

(xiv) Income in respect of a decedent;

(xv) Income from an interest in an estate or trust.

(4) *Statutory grouping of gross income and residual grouping of gross income.* For purposes of this section, the term ''statutory grouping of gross income'' or ''statutory grouping'' means the gross income from a specific source or activity which must first be determined in order to arrive at ''taxable income'' from which specific source or activity under an operative section. (See paragraph (f)(1) of this section.) Gross income from other sources or activities is referred to as the ''residual grouping of gross income'' or ''residual grouping.'' For example, for purposes of determining taxable income from sources within specific foreign countries and possessions of the United States, in order to apply the per-country limitation to the foreign tax credit (as in effect before enactment of the Tax Reform Act of 1976), the statutory groupings are the separate gross incomes from sources within each country and possession. Moreover, if the taxpayer has income subject to section 904(d) (as in effect after enactment of the Tax Reform Act of 1976), such income constitutes one or more separate statutory groupings. In the case of the per-country limitation, the residual grouping is the aggregate of gross income from sources within the United States. In some instances, where the operative section so requires, the statutory grouping or the residual grouping may include, or consist entirely of, excluded income. See paragraph (d)(2)

of this section with respect to the allocation and apportionment of deductions to excluded income.

(5) *Effective date*—(i) *Taxable years beginning after December 31, 1976.* The provisions of this section apply to taxable years beginning after December 31, 1976.

(ii) *Taxable years beginning before January 1, 1977.* For taxable years beginning before January 1, 1977, §1.861–8 applies as in effect on October 23, 1957 (T.D. 6258), as amended on August 22, 1966 (T.D. 6892) and on September 29, 1975 (T.D. 7378). The specific rules for allocation and apportionment of deductions set forth in this section may, at the option of the taxpayer, apply to those taxable years on a deduction-by-deduction basis if the rules are applied consistently to all taxable years with respect to which action by the Internal Revenue Service is not barred by any statute of limitations. Thus, for example, a calendar year taxpayer may choose to have the rules of paragraph (e)(2) of this section apply for the allocation and apportionment of all interest expenses for the two taxable years ending December 31, 1975 and 1976, which are open years under examination, and may justify the allocation and apportionment of all research and development expenses for those years on a basis supportable under §1.861–8 as in effect for 1975 and 1976 without regard to the rules of paragraph (e)(3) of this section.

(b) *Allocation*—(1) *In general.* For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a ‘‘class of gross income’’ and may consist of one or more items of gross income. The rules emphasize the factual relationship between the deduction and a class of gross income. See paragraph (d)(1) of this section which provides that in a taxable year there may be no item of gross income in a class or less gross income than deductions allocated to the class, and paragraph (d)(2) of this section which provides that a class of gross income may include excluded income. Allocation is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income (without regard to the taxpayable year in which such gross income is received or accrued or is expected to be received or accrued). The classes of gross income are not predetermined but must be determined on the basis of the deductions to be allocated. Although most deductions will be definitely related to some class of a taxpayer’s total gross income, some deductions are related to all gross income. In addition, some deductions are treated as not definitely related to any gross income and are ratably apportioned to all gross income. (See paragraph (e)(9) of this section.) In allocating deductions it is not necessary to differentiate between deductions related to one item of gross income and deductions related to another item of gross income where both items of gross income are exclusively within the same statutory grouping or exclusively within the residual grouping.

(2) *Relationship to activity or property.* A deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. Where a deduction is incurred as a result of, or incident to, an activity or in connection with property, which activity or property generates, has generated, or could reasonably have been expected to generate gross income, such deduction shall be considered definitely related to such gross income as a class whether or not there is any item of gross income in such class which is received or accrued during the taxable year and whether or not the amount of deductions exceeds the amount of the gross income in such class. See paragraph (d)(1) of this section and example 17 of paragraph (g) of this section with respect to cases in which there is an excess of deductions. In some cases, it will be found that this subparagraph can most readily be applied by determining, with respect to a deduction, the categories of gross income to which it is not related and concluding that it is definitely related to a class consisting of all other gross income.

(3) *Supportive functions.* [Reserved] For guidance, see § 1.861–8T(b)(3).

(4) *Deductions related to a class of gross income.* See paragraph (e) of this section for rules relating to the allocation and apportionment of certain specific deductions definitely related to a class of gross income. See paragraph (c)(1) of this section for rules relating to the apportionment of deductions.

(5) *Deductions related to all gross income.* If a deduction does not bear a definite relationship to a class of gross income constituting less than all of gross income, it shall ordinarily be treated as definitely related and allocable to all of the taxpayer's gross income except where provided to the contrary under paragraph (e) of this section. Paragraph (e)(9) of this section lists various deductions which generally are not definitely related to any gross income and are ratably apportioned to all gross income.

(c) *Apportionment of deductions*—(1) *Deductions definitely related to a class of gross income.* [Reserved] For guidance, see § 1.861–8T(c)(1).

(2) *Apportionment based on assets.* [Reserved] For guidance, see § 1.861–8T(c)(2).

(3) *Deductions not definitely related to any gross income.* If a deduction is not definitely related to any gross income (see paragraph (e)(9) of this section), the deduction must be apportioned ratably between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping. Thus, the amount apportioned to each statutory grouping shall be equal to the same proportion of the deduction which the amount of gross income in the statutory grouping bears to the total amount of gross income. The amount apportioned to the residual grouping shall be equal to the same proportion of the deduction which the amount of the gross income in the residual grouping bears to the total amount of gross income.

(d) *Excess of deductions and excluded and eliminated income*—(1) *Excess of deductions.* Each deduction which bears a definite relationship to a class of gross income shall be allocated to that class in accordance with paragraph (b)(1) of this section even though, for the taxable year, no gross income in such class is received or accrued or the amount of the deduction exceeds the amount of such class of gross income. In apportioning deductions, it may be that, for the taxable year, there is no gross income in the statutory grouping (or residual grouping), or that deductions exceed the amount of gross income in the statutory grouping (or residual grouping). If there is no gross income in a statutory grouping or the amount of deductions allocated and apportioned to a statutory grouping exceeds the amount of gross income in the statutory grouping, the effects are determined under the operative section. If the taxpayer is a member of a group filing a consolidated return, such excess of deductions allocated or apportioned to a statutory grouping of income of such member is taken into account in determining the consolidated taxable income from such statutory grouping, and such excess of deductions allocated or apportioned to the residual grouping of income is taken into account in determining the consolidated taxable income from the residual grouping. See § 1.1502–4(d)(1) and the last sentence of § 1.1502–12. For an illustration of the principles of this paragraph (d)(1), see example 17 of paragraph (g) of this section.

(2) *Allocation and apportionment to exempt, excluded, or eliminated income.* [Reserved] For guidance, see § 1.861–8T(d)(2).

(e) *Allocation and apportionment of certain deductions*—(1) *In general.* Subparagraphs (2) and (3) of this paragraph contain rules with respect to the allocation and apportionment of interest expense and research and development expenditures, respectively. Subparagraphs (4) through (8) of this paragraph contain rules with respect to the allocation of certain other deductions. Subparagraph (9) of this paragraph lists those deductions which are ordinarily considered as not being definitely related to any class of gross income. Subparagraph (10) of this paragraph lists special deductions of corporations which must be allocated and apportioned. Subparagraph (11) of this paragraph lists personal exemptions which are neither allocated nor apportioned. Examples of allocation and apportionment are contained in paragraph (g) of this section.

(2) *Interest.* [Reserved] For guidance, see §1.861–8T(e)(2).

(3) *Research and experimental expenditures.* For rules regarding the allocation and apportionment of research and experimental expenditures, see §1.861–17.

(4) *Stewardship expenses attributable to dividends received.* If a corporation renders services for the benefit of a related corporation and the corporation charges the related corporation for such services (see section 482 and the regulations thereunder which provide for an allocation where the charge is not on an arm's length basis as determined therein), the deductions for expenses of the corporation attributable to the rendering of such services are considered definitely related to the amounts so charged and are to be allocated to such amounts. However, the regulations under section 482 (§1.482–2(b)(2)(ii) recognize a type of activity which is not considered to be for the benefit of a related corporation but is considered to constitute ‘‘stewardship’’ or ‘‘overseeing’’ functions undertaken for the corporation's own benefit as an investor in the related corporation, and therefore, a charge to the related corporation for such stewardship or overseeing functions is not provided for. Services undertaken by a corporation of a stewardship or overseeing character generally represent a duplication of services which the related corporation has independently performed for itself. For example, assume that a related corporation, which has a qualified financial staff, makes an analysis to determine the amount and source of its borrowing needs and submits a report of its findings and a plan of borrowing to the parent corporation, and the parent corporation's financial staff reviews the findings and plans to determine whether to advise the related corporation to reconsider its plan. The services of review performed by the parent corporation for its own benefit are of a stewardship or overseeing character. The deductions resulting from stewardship or overseeing functions are incurred as a result of, or incident to, the ownership of the related corporation and, thus, shall be considered definitely related and allocable to dividends received or to be received from the related corporation. If a corporation has a foreign or international department which exercises stewardship or overseeing functions with respect to related foreign corporations and, in addition, the department has other functions which are attributable to other foreign-source income (such as fees for services rendered outside of the United States for the benefit of foreign related corporations, foreign royalties, and gross income of foreign branches) to which its deductions are also to be allocated, some part of the deductions with respect to that department are considered definitely related to the other foreign-source income. In some instances, the operations of a foreign or international department will also be attributable to United States source income (such as fees for services performed in the United States) to which its deductions are to be allocated. Methods of apportionment which could possibly be utilized with respect to stewardship expenses include comparisons of time spent by employees weighted to take into account differences in compensation, or comparisons of each related corporation's gross receipts, gross income, or unit sales volume, assuming that stewardship activities are not substantially disproportionate to such factors. See paragraph (f)(5) of this section for the type of verification that may be required in this respect. See examples 17 and (18) of paragraph (g) of this section for the allocation and apportionment of stewardship expenses. See paragraph (b)(3) of this section for the allocation and apportionment of deductions attributable to supportive functions other than stewardship activities.

(5) *Legal and accounting fees and expenses.* Fees and other expenses for legal and accounting services are ordinarily definitely related and allocable to specific classes of gross income or to all the taxpayer's gross income, depending on the nature of the services rendered (and are apportioned as provided in paragraph (c)(1) of this section). For example, accounting fees for the preparation of a study of the costs

involved in manufacturing a specific product will ordinarily be definitely related to the class of gross income derived from (or which could reasonably have been expected to be derived from) that specific product. The taxpayer is not relieved from his responsibility to make a proper allocation and apportionment of fees on the grounds that the statement of services rendered does not identify the services performed beyond a generalized designation such as ''professional,'' or does not provide any type of allocation, or does not properly allocate the fees involved.

(6) *Income taxes*—(i) *In general.* The deduction for state, local, and foreign income, war profits and excess profits taxes (''state income taxes'') allowed by section 164 shall be considered definitely related and allocable to the gross income with respect to which such state income taxes are imposed. For example, if a domestic corporation is subject to state income taxation and the state income tax is imposed in part on an amount of foreign source income, then that part of the taxpayer's deduction for state income tax that is attributable to foreign source income is definitely related and allocable to foreign source income. In allocating and apportioning the deduction for state income tax for purposes including (but not limited to) the computation of the foreign tax credit limitation under section 904 of the Code and the consolidated foreign tax credit under § 1.1502–4 of the regulations, the income upon which the state income tax is imposed is determined by reference to the law of the jurisdiction imposing the tax. Thus, if a state attributes taxable income to a corporate taxpayer by applying an apportionment formula that takes into consideration the income and factors of one or more corporations related by ownership to the corporate taxpayer and engaging in activities related to the business of the corporate taxpayer, then the income so attributed is the income upon which the state income tax is imposed. If the income so attributed to the corporate taxpayer includes foreign source income, then, in computing the taxpayer's foreign tax credit limitation under section 904, for example, the taxpayer's deduction for state income tax will be considered definitely related and allocable to a class of gross income that includes the statutory grouping of foreign source income. When the law of the state includes dividends that are treated under section 862(a)(2) as income from sources without the United States in taxable income apportionable to the state, but does not include factors of the corporation paying such dividends in the apportionment formula used to determine state taxable income, an appropriate portion of the deduction for state income tax will be considered definitely related and allocable to a class of gross income consisting solely of foreign source dividend income. A deduction for state income tax will not be considered definitely related to a hypothetical amount of income calculated under federal tax principles when the jurisdiction imposing the tax computes taxable income under different principles. A corporate taxpayer's deduction for a state franchise tax that is computed on the basis of income attributable to business activities conducted within the state must be allocated and apportioned in the same manner as the deduction for state income taxes. In determining, for example, both the foreign tax credit under section 904 of the Code and the consolidated foreign tax credit limitation under § 1.1502–4 of the regulations, the deduction for state income tax may be allocable and apportionable to foreign source income in a statutory grouping described in section 904(d) in a taxable year in which the taxpayer has no foreign source income in such statutory grouping. Alternatively, such an allocation or apportionment may be appropriate if a taxpayer corporation has no foreign source income in a statutory grouping, but its deduction is attributable to foreign source income in such grouping that is attributed to the taxpayer corporation under the law of a state which attributes taxable income to a corporation by applying an apportionment formula that takes into consideration the income and factors of one or more corporations related by ownership to the taxpayer corporation and engaging in activities related to the business of the taxpayer corporation. Example 30 of paragraph (g) of

this section illustrates the application of this last rule.

(ii) *Methods of allocation and apportionment*—(A) *In general.* A taxpayer's deduction for a state income tax is to be allocated (and then apportioned, if necessary, subject to the rules of §1.861–8(d)) by reference to the taxable income that the law of the taxing jurisdiction attributes to the taxpayer (''state taxable income'').

(B) *Effect of subsequent recomputations of state income tax.* [Reserved]

(C) *Illustrations*—(*1*) *In general.* Examples 25 through 32 of paragraph (g) of §1.861–8 illustrate, in the given factual situations, the application of this paragraph (e)(6) and the general rule of paragraph (b)(1) of this section that a deduction must be allocated to the class of gross income to which the deduction is factually related. In general, these examples employ a presumption that state income taxes are allocable to a class of gross income that includes the statutory grouping of income from sources without the United States when the total amount of taxable income determined under state law exceeds the amount of taxable income determined under the Code (without taking into account the deduction for state income taxes) in the residual grouping of income from sources within the United States. A taxpayer that allocates and apportions the deduction for state income tax in accordance with the methodology of Example 25 of paragraph (g) of this section must also apply the modifications illustrated in Examples 26 and 27 of paragraph (g) of this section, when applicable. The modification illustrated in *Example 26* is applicable when the deduction for state income tax is attributable in part to taxes imposed by a state which factually excludes foreign source income (as determined for federal income tax purposes) from state taxable income. The modification illustrated in *Example 27* is applicable when the taxpayer has income-producing activities in a state which does not impose a corporate income tax. The specific allocation of state income tax illustrated in Example 28 follows the rule in paragraph (e)(6)(i) of this section, and must be applied whenever a taxpayer's state taxable income includes dividends apportioned to the state under a formula that does not take into account the factors of the corporations paying those dividends, regardless of whether the taxpayer uses the methodology of Example 25 with respect to the remainder of the deduction for state income taxes.

(*2*) *Modifications.* Before applying a method of allocation and apportionment illustrated in the examples, the computation of state taxable income under state law may be modified, subject to the approval of the District Director, to reflect more accurately the income with respect to which the state income tax is imposed. Any modification to the state law computation of state taxable income must yield an allocation and apportionment of the deduction for state income taxes that is consistent with the rules contained in this paragraph (e)(6), and that accurately reflects the factual relationship between the state income tax and the income on which that tax is imposed. For example, a modification to the computation of taxable income under state law might be appropriate to compensate for differences between the state law definition of taxable income and the federal definition of taxable income, due to a difference in the rate of allowable depreciation or the amount of another deduction that is allowable under both systems. This rule is illustrated in Example 31 of paragraph (g) of this section. However, a modification to the computation of taxable income under state law will not be appropriate, and will not more accurately reflect the factual relationship between the state tax and the income on which the tax is imposed, to the extent such modification reflects the fact that the state does not follow federal tax principles in attributing income to the taxpayer's activities in the state. This rule is illustrated in Example 32 of paragraph (g) of this section. A taxpayer may not modify the methods illustrated in the examples, or use an alternative method of allocation and apportionment of the deduction for state income taxes, if the modification or alternative method would be inconsistent with the rules of paragraph (e)(6)(i) of this section. A taxpayer that uses a method of allocation and apportionment other than one illustrated in Example 25 (as modified by Examples 26 and 27), or 29 with respect to a factual situation similar to those of the examples, must describe the alternative method on an attachment to its federal income tax return and establish to the satisfaction of the District Director, upon examination, that the result of the alternative method more accurately reflects the factual relationship between the state income tax and the income on which the tax is imposed.

(D) *Elective safe harbor methods.* (*1*) *In general.* In lieu of applying the rules set forth in paragraphs (e)(6)(ii) (A) through (C) of this section, a taxpayer may elect to allocate and apportion the deduction for state income tax in accordance with one of the two safe harbor methods described in paragraph (e)(6)(ii)(D) (*2*) and (*3*) of this section. A taxpayer shall make this election for a taxable year by filing a timely tax return for that year that reflects an allocation and apportionment of the deduction for state income tax under one of the safe harbor methods and attaching to such return a statement that the taxpayer has elected to use the safe harbor method provided in either paragraph (e)(6)(ii)(D) (*2*) or (*3*) of this section, as appropriate. Once made, this election is effective for the taxable year for which made and all subsequent taxable years, and may be revoked only with the consent of the Commissioner. Example 33 of paragraph (g) of this section illustrates the application of these safe harbor methods.

(*2*) *Method One.* (*i*) *Step One—Specific allocation to foreign source portfolio dividends and other income.* If any portion of the deduction for state income tax is attributable to tax imposed by a state which includes in a corporate taxpayer's taxable income apportionable to the state, portfolio dividends (as defined in paragraph (i) of Example 28 of paragraph (g) of this section) that are treated under section 862(a)(2) as income from sources without the United States, but does not include factors of the corporations paying the portfolio dividends in the apportionment formula used to determine state taxable income, the taxpayer shall allocate an appropriate portion of the deduction to a class of gross income consisting solely of foreign source portfolio dividends. The portion of the deduction so allocated, and the amount of foreign source portfolio dividends included in such class, shall be determined in accordance with the methodology illustrated in paragraph (ii) of Example 28 of paragraph (g). If a state income tax is determined based upon formulary apportionment of the total taxable income attributable to the taxpayer's unitary business, the taxpayer must also apply the methodology illustrated in paragraph (ii) (C) through (G) of Example 29 of paragraph (g) of this section to make specific allocations of appropriate portions of the deduction for state income tax on the basis of income that, under separate accounting, would have been attributed to other members of the unitary group. The taxpayer shall reduce its aggregate state taxable income by the amount of foreign source portfolio dividends and other income to which a specific allocation is made (the reduced amount being referred to hereinafter as ‘‘adjusted state taxable income’’).

(*ii*) *Step Two—Adjustment of U.S. source federal taxable income.* If the taxpayer has significant income-producing activities in a state which does not impose a corporate income tax or other state tax measured by income derived from business activities in the state, the taxpayer shall reduce its U.S. source federal taxable income (solely for purposes of this safe harbor method) by the amount of federal taxable income attributable to its activities in such state. This amount shall be determined in accordance with the methodology illustrated in paragraph (ii) of Example 27 of paragraph (g) of this section, provided that the taxpayer shall be required to use the rules of the Uniform Division of Income for Tax Purposes Act to attribute income to the relevant state. The taxpayer's U.S. source federal taxable income, as so reduced, is referred to hereinafter as ‘‘adjusted U.S. source federal taxable income.’’

(*iii*) *Step Three—Allocation.* The taxpayer shall allocate the remainder of the deduction for state income tax (after reduction by the portion allocated to foreign source portfolio dividends and other income under Step One) in accordance with the methodology illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section. However, the taxpayer shall substitute for the comparison of aggregate state taxable income to U.S. source federal taxable income, illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section, a comparison of its adjusted state taxable income to an amount equal to 110% of its adjusted U.S. source federal taxable income.

(*iv*) *Step Four—Apportionment.* In the event that apportionment of the remainder of the deduction for state income tax is required, the taxpayer shall apportion that remaining deduction to U.S. source income in accordance with the methodology illustrated in paragraph (iii) of Example 25 of paragraph (g) of this section, substituting for domestic source income in that paragraph an amount equal to 110% of the taxpayer's adjusted U.S. source federal taxable income. The remaining portion of the deduction shall be apportioned to the statutory groupings of foreign source income described in section 904(d) of the Code in accordance with the proportion of the income in each statutory grouping of foreign source income described in section 904(d) to the taxpayer's total foreign source federal taxable income (after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One, above).

(*3*) *Method Two.* (*i*) *Step One—Specific allocation to foreign source portfolio dividends and other income.* Step One of this method is the same as Step One of Method One (as described in paragraph (e)(6)(ii)(D)(*2*)(*i*) of this section).

(*ii*) *Step Two—Adjustment of U.S. source federal taxable income.* Step Two of this method is the same as Step Two of Method One (as described in paragraph (e)(6)(ii)(D)(*2*)(*ii*) of this section).

(*iii*) *Step Three—Allocation.* The taxpayer shall allocate the remainder of the deduction for state income tax (after reduction by the portion allocated to foreign source portfolio dividends and other income under Step One) in accordance with the methodology illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section. However, the taxpayer shall substitute for the comparison of aggregate state taxable income to U.S. source federal taxable income, illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section, a comparison of its adjusted state taxable income to its adjusted U.S. source federal taxable income.

(*iv*) *Step Four—Apportionment.* In the event that apportionment of the deduction is required, the taxpayer shall apportion to U.S. source income that portion of the deduction that is attributable to state income taxes imposed upon an amount of state taxable income equal to adjusted U.S. source federal taxable income. The taxpayer shall apportion the remaining amount of the deduction to U.S. and foreign source income in the same proportions that the taxpayer's adjusted U.S. source federal taxable income and foreign source federal taxable income (after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One, above) bear to its total federal taxable income (taking into account the adjustment of U.S. source federal taxable income under Step Two and after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One). The portion of the deduction apportioned to foreign source income shall be apportioned among the statutory groupings described in section 904(d) of the Code in accordance with the proportions of the taxpayer's total foreign source federal taxable income (after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One, above) in each grouping.

(iii) *Effective dates.* The rules of §1.861–8(e)(6)(i) and the language preceding the examples in §1.861–8(g) are effective for taxable years beginning after December 31, 1976. The rules of §1.861–8(e)(6)(ii) (other than §1.861–8(e)(6)(ii)(D)) and Examples 25 through 32 of §1.861–8(g) are effective for taxable years beginning on or after January 1, 1988. The rules of §1.861–8(e)(6)(ii)(D) and Example 33 of § 1.861–8(g) are effective for taxable years ending after March 12, 1991. At the option of the taxpayer, however, the rules of § 1.861–8(e)(6)(ii) (other than § 1.861–8(e)(6)(ii)(D)) and Examples 25 through 32 of § 1.861–8(g) may be applied with respect to deductions for state taxes incurred in taxable years beginning before January 1, 1988.

(7) *Losses on the sale, exchange, or other disposition of property*—(i) *Allocation.* The deduction allowed for loss recognized on the sale, exchange, or other disposition of a capital asset or property described in section 1231(b) shall be considered a deduction which is definitely related and allocable to the class of gross income to which such asset or property ordinarily gives rise in the hands of the taxpayer. Where the nature of gross income generated from the asset or property has varied significantly over several taxable years of the taxpayer, such class of gross income shall generally be determined by reference to gross income generated from the asset or property during the taxable year or years immediately preceding the sale, exchange, or other dispostion of such asset or property. Thus, for example, where an asset generates primarily sales income from domestic sources in the early years of its operation and then is leased by the taxpayer to a foreign subsidiary in later years, the class of gross income to which the asset gives rise will be considered to be the rental income derived from the lease and will not include sales income from domestic sources.

(ii) *Apportionment of losses.* Where in the unusual circumstances that an apportionment of a deduction for losses on the sale, exchange, or other disposition of a capital asset or property described in section 1231(b) is necessary, the amount of such deduction shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income (within the class of gross income) and the residual grouping (within the class of gross income) in the same proportion that the amount of gross income within such statutory grouping (or statutory groupings) and such residual grouping bear, respectively, to the total amount of gross income within the class of gross income. Apportionment will be necessary where, for example, the class of gross income to which the deduction is allocated consists of gross income (such as royalties) attributable to an intangible asset used both within and without the United States, or gross income (such as from sales or services) attributable to a tangible asset used both within and without the United States.

(iii) *Allocation of loss recognized in taxable years after 1986.* See §§ 1.865–1T, 1.865–2, and 1.865–2T for rules regarding the allocation of certain loss recognized in taxable years beginning after December 31, 1986.

(8) *Net operating loss deduction.* [Reserved] For guidance, see § 1.861–8T(e)(8).

(9) *Deductions which are not definitely related.* Deductions which shall generally be considered as not definitely related to any gross income, and therefore are ratably apportioned as provided in paragraph (c)(2) of this section, are—

(i) The deduction allowed by section 163 for interest described in subparagraph (2)(iii) of this paragraph (e);

(ii) The deduction allowed by section 164 for real estate taxes on a personal residence or for sales tax on the purchase of items for personal use;

(iii) The deduction for medical expenses allowed by section 213;

(iv) The deduction for charitable contributions allowed by sections 170, 873(b)(2), and 882(c)(1)(B); and

(v) The deduction for alimony payments allowed by section 215.

(10) *Special deductions.* The special deductions allowed in the case of a corporation by section 241 (relating to the deductions for partially tax exempt interest, dividends received, etc.), section 922 (relating to Western Hemisphere trade corporations), and section 941 (relating to China Trade Act corporations) shall be allocated and apportioned consistent with the principles of this section.

(11) *Personal exemptions.* The deductions for the personal exemptions allowed by section 151, 642(b), or 873(b)(3) shall not be taken into account for purpose of allocation and apportionment under this section.

(f) *Miscellaneous matters*—(1) *Operative sections.* The operative sections of the Code which require the determination of taxable income of the taxpayer from specific sources or activities and which give rise to statutory groupings to which this section is applicable include the sections described below.

(i) *Overall limitation to the foreign tax credit.* Under the overall limitation to the foreign tax credit, as provided in section 904(a)(2) (as in effect before enactment of the Tax Reform Act of 1976, or section 904(a) after such enactment) the amount of the foreign tax credit may not exceed the tentative U.S. tax (i.e., the U.S. tax before application of the foreign tax credit) multiplied by a fraction, the numerator of which is the taxable income from sources without the United States and the denominator of which is the entire taxable income. Accordingly, in this case, the statutory grouping is foreign source income (including, for example, interest received from a domestic corporation which meets the tests of section 861(a)(1)(B), dividends received from a domestic corporation which has an election in effect under section 936, and other types of income specified in section 862). Pursuant to sections 862(b) and 863(a) and §§1.862–1 and 1.863–1, this section provides rules for identifying the deductions to be taken into account in determining taxable income from sources without the United States. See section 904(d) (as in effect after enactment of the Tax Reform Act of 1976) and the regulations thereunder which require separate treatment of certain types of income. See example 3 of paragraph (g) of this section for one example of the application of this section to the overall limitation.

(ii) [Reserved]

(iii) *DISC and FSC taxable income.* Sections 925 and 994 provide rules for determining the taxable income of a FSC and DISC, respectively, with respect to qualified sales and leases of export property and qualified services. The combined taxable income method available for determining a DISC's taxable income provides, without consideration of export promotion expenses, that the taxable income of the DISC shall be 50 percent of the combined taxable income of the DISC and the related supplier derived from sales and leases of export property and from services. In the FSC context, the taxable income of the FSC equals 23 percent of the combined taxable income of the FSC and the related supplier. Pursuant to regulations under section 925 and 994, this section provides rules for determining the deductions to be taken into account in determining combined taxable income, except to the extent modified by the marginal costing rules set forth in the regulations under sections 925(b)(2) and 994(b)(2) if used by the taxpayer. See *Examples* (22) and (23) of paragraph (g) of this section. In addition, the computation of combined taxable income is necessary to determine the applicability of the section 925(d) limitation and the ''no loss'' rules of the regulations under sections 925 and 994.

(iv) *Effectively connected taxable income.* Nonresident alien individuals and foreign corporations engaged in trade or business within the United States, under sections 871(b)(1) and 882(a)(1), on taxable income which is effectively connected with the conduct of a trade or business within the United States. Such taxable income is determined in most instances by initially determining, under section 864(c), the amount of gross income which is effectively connected with the conduct of a trade or business within the United States. Pursuant to sections 873 and 882(c), this section is applicable for purposes of determining the deductions from such gross income (other than the deduction for interest expense allowed to foreign corporations (see §1.882–5)) which are to be taken into account in determining taxable income. See example 21 of paragraph (g) of this section.

(v) *Foreign base company income.* Section 954 defines the term ''foreign base company income'' with respect to controlled foreign corporations. Section 954(b)(5) provides that in determining foreign base company income the gross income shall be reduced by the deductions of the controlled foreign corporation ''properly allocable to such income''. This section provides rules for identifying which deductions are properly allocable to foreign base company income.

(vi) *Other operative sections.* The rules provided in this section also apply in determining—

(A) The amount of foreign source items of tax preference under section 58(g) determined for purposes of the minimum tax;

(B) The amount of foreign mineral income under section 901(e);

(C) [Reserved]

(D) The amount of foreign oil and gas extraction income and the amount of foreign oil related income under section 907;

(E) The tax base for citizens entitled to the benefits of section 931 and the section 936 tax credit of a domestic corporation which has an election in effect under section 936;

(F) The exclusion for income from Puerto Rico for residents of Puerto Rico under section 933;

(G) The limitation under section 934 on the maximum reduction in income tax liability incurred to the Virgin Islands;

(H) The income derived from Guam by an individual who is subject to section 935;

(I) The special deduction granted to China Trade Act corporations under section 941;

(J) The amount of certain U.S. source income excluded from the subpart F income of a controlled foreign corporation under section 952(b);

(K) The amount of income from the insurance of U.S. risks under section 953(b)(5);

(L) The international boycott factor and the specifically attributable taxes and income under section 999; and

(M) The taxable income attributable to the operation of an agreement vessel under section 607 of the Merchant Marine Act of 1936, as amended, and the Capital Construction Fund Regulations thereunder (26 CFR, part 3). See 26 CFR 3.2(b)(3).

(2) *Application to more than one operative section.* (i) Where more than one operative section applies, it may be necessary for the taxpayer to apply this section separately for each applicable operative section. In such a case, the taxpayer is required to use the same method of allocation and the same principles of apportionment for all operative sections.

(ii) When expenses, losses, and other deductions that have been properly allocated and apportioned between combined gross income of a related supplier and a DISC or former DISC and residual gross income, regardless of which of the administrative pricing methods of section 994 has been applied, such deductions are not also allocated and apportioned to gross income consisting of distributions from the DISC or former DISC attributable to income of the DISC or former DISC as determined under the administrative pricing methods with respect to DISC or former DISC taxable years beginning after December 31, 1986. Accordingly, *Example* (22) of paragraph (g) of this section does not apply to distributions from a DISC or former DISC with respect to DISC or former DISC taxable years beginning after December 31, 1986. This rule does not apply to the extent that the taxable income of the DISC or former DISC is determined under the section 994(a)(3) transfer pricing method. In addition, for taxable years beginning after December 31, 1986, in the case of expenses, losses, and other deductions that have been properly allocated and apportioned between combined gross income of a related supplier and a FSC and residual gross income, regardless of which of the administrative pricing methods of section 925 has been applied, such deductions are not also allocated and apportioned to gross income consisting of distributions from the FSC or former FSC which are attributable to the foreign trade income of the FSC or former FSC as determined under the administrative pricing methods. This rule does not apply to the extent that the foreign trade income of the FSC or former FSC is determined under the section 925(a)(3) transfer pricing method. See *Example* (23) of paragraph (g) of this section.

(3) *Special rules of section 863(b)*—(i) *In general.* Special rules under section 863(b) provide for the application of rules of general apportionment provided in §§ 1.863–3 to 1.863–5, to worldwide taxable income in order to attribute part of such worldwide taxable income to U.S. sources and the remainder of such worldwide taxable income

to foreign sources. The activities specified in section 863(b) are—

(A) Transportation or other services rendered partly within and partly without the United States,

(B) Sales of personal property produced by the taxpayer within and sold without the United States, or produced by the taxpayer without and sold within the United States, and

(C) Sales within the United States of personal property purchased within a possession of the United States.

In the instances provided in §§1.863–3 and 1.863–4 with respect to the activities described in (A), (B), and (C) of this subdivision, this section is applicable only in determining worldwide taxable income attributable to these activities.

(ii) *Relationship of sections 861, 862, 863(a), and 863(b).* Sections 861, 862, 863(a), and 863(b) are the four provisions applicable in determining taxable income from specific sources. Each of these four provisions applies independently. Where a deduction has been allocated and apportioned to income under one of these four provisions, the deduction shall not again be allocated and apportioned to gross income under any of the other three provisions. However, two or more of these provisions may have to be applied at the same time to determine the proper allocation and apportionment of a deduction. The special rules under section 863(b) take precedence over the general rules of Code sections 861, 862 and 863(a). For example, where a deduction is allocable in whole or in part to gross income to which section 863(b) applies, such deduction or part thereof shall not otherwise be allocated under section 861, 862, or 863(a). However, where the gross income to which the deduction is allocable includes both gross income to which section 863(b) applies and gross income to which section 861, 862, or 863(a) applies, more than one section must be applied at the same time in order to determine the proper allocation and apportionment of the deduction.

(4) *Adjustments made under other provisions of the Code*—(i) *In general.* If an adjustment which affects the taxpayer is made under section 482 or any other provision of the Code, it may be necessary to recompute the allocations and apportionments required by this section in order to reflect changes resulting from the adjustment. The recomputation made by the District Director shall be made using the same method of allocation and apportionment as was originally used by the taxpayer, provided such method as originally used conformed with paragraph (a)(5) of this section and, in light of the adjustment, such method does not result in a material distortion. In addition to adjustments which would be made aside from this section, adjustments to the taxpayer’s income and deductions which would not otherwise be made may be required before applying this section in order to prevent a distortion in determining taxable income from a particular source of activity. For example, if an item included as a part of the cost of goods sold has been improperly attributed to specific sales, and, as a result, gross income under one of the operative sections referred to in paragraph (f)(1) of this section is improperly determined, it may be necessary for the District Director to make an adjustment to the cost of goods sold, consistent with the principles of this section, before applying this section. Similarly, if a domestic corporation transfers the stock in its foreign subsidiaries to a domestic subsidiary and the parent continues to incur expenses in connection with the supervision of the foreign subsidiaries (see paragraph (e)(4) of this section), it may be necessary for the District Director to make an allocation under section 482 with respect to such expenses before making allocations and apportionments required by this section, even though the section 482 allocation might not otherwise be made.

(ii) *Example.* X, a domestic corporation, purchases and sells consumer items in the United States and foreign markets. Its sales in foreign markets are made to related foreign subsidiaries. X reported $1,500,000 as sales during the taxable year of which $1,000,000 was domestic sales and $500,000 was foreign sales. X took a deduction for expenses incurred by its marketing department during the taxable year in the amount of $150,000. These expenses were determined to be allocable to both domestic and foreign sales and are apportionable between such sales. Thus, X allocated and apportioned the marketing department deduction as follows:

To gross income from domestic sales: $150,000×($1,000,000/$1,500,000)	$100,000
To gross income from foreign sales: $150,000×($500,000/$1,500,000)	50,000
Total	150,000

On audit of X's return for the taxable year, the District Director adjusted, under section 482, X's sales to related foreign subsidiaries by increasing the sales price by a total of $100,000, thereby increasing X's foreign sales and total sales by the same amount. As a result of the section 482 adjustment, the apportionment of the deduction for the marketing department expenses is redetermined as follows:

To gross income from domestic sales: $150,000×($1,000,000/$1,600,000)	$93,750
To gross income from foreign sales: $150,000×($600,000/$1,600,000)	56,250
Total	150,000

(5) *Verification of allocations and apportionments.* Since, under this section, allocations and apportionments are made on the basis of the factual relationship between deductions and gross income, the taxpayer is required to furnish, at the request of the District Director, information from which such factual relationships can be determined. In reviewing the overall limitation to the foreign tax credit of a domestic corporation, for example, the District Director should consider information which would enable him to determine the extent to which deductions attributable to functions performed in the United States are related to earning foreign source income, United States source income, or income from both sources. In addition to functions with a specific international purpose, consideration should be given to the functions of management, the direction and results of an acquisition program, the functions of operating units and personnel located at the head office, the functions of support units (including but not limited to engineering, legal, budget, accounting, and industrial relations), the functions of selling and advertising units and personnel, the direction and uses of research and development and the direction and uses of services furnished by independent contractors. Thus, for example when requested by the District Director, the taxpayer shall make available any of its organization charts, manuals, and other writings which relate to the manner in which its gross income arises and to the functions of organizational units, employees, and assets of the taxpayer and arrange for the interview of such of its employees as the District Director deems desirable in order to determine the gross income to which deductions relate. See section 7602 and the regulations thereunder which generally provide for the examination of books and witnesses. See also section 905(b) and the regulations thereunder which require proof of foreign tax credits to the satisfaction of the Secretary or his delegate.

(g) *General examples.* The following examples illustrate the principles of this section. In each example, unless otherwise specified, the operative section which is applied and gives rise to the statutory grouping of gross income is the overall limitation to the foreign tax credit under section 904(a). In addition, in each example, where a method of allocation or apportionment is illustrated as an acceptable method, it is assumed that such method is used by the taxpayer on a consistent basis from year to year (except in the case of the optional method for apportioning research and development expense under paragraph (e)(3)(iii) of § 1.861–8). Further, it is assumed that each party named in each example operates on a calendar year accounting basis and, where the party is a U.S. taxpayer, files returns on a calendar year basis.

Examples 1—16 —[Reserved]

Example 17— Stewardship Expenses (Consolidation)—(i) *Facts.* X, a domestic corporation, wholly owns M, N, and O, also domestic corporations. X, M, N, and O file a consolidated income tax return. All the income of X and O is from sources within the United States, all of M's income is from sources within South America, and all of N's income is from sources within Africa. X receives no dividends from M, N, or O. During the taxable year, the consolidated group of corporations earned consolidated gross income of $550,000 and incurred total deductions of $370,000 as follows:

	Gross income	Deductions
Corporations:		
X	$100,000	$50,000
M	250,000	100,000
N	150,000	200,000

	Gross income	Deductions
O	50,000	20,000
Total	550,000	370,000

Of the $50,000 of deductions incurred by X, $15,000 relates to X's ownership of M; $10,000 relates to X's ownership of N; $5,000 relates to X's ownership of O; and the entire $30,000 constitute stewardship expenses. The remainder of X's deductions ($20,000) relates to production of income from its plant in the United States.

(ii) *Allocation.* In accordance with §1.1502–4, each corporation must first compute its separate taxable income for purposes of computing the limitation on the foreign tax credit. X's deductions of $50,000 are definitely related and thus allocable to the types of gross income to which they give rise, namely $25,000 wholly to income from sources outside the United States ($15,000 for stewardship of M and $10,000 for stewardship of N) and the remainder ($25,000) wholly to gross income from sources within the United States. Expenses incurred by M and N are entirely related and thus wholly allocable to income earned from sources without the United States and expenses incurred by O are entirely related and thus wholly allocable to income earned within the United States. Hence, no apportionment of expenses of X, M, N, or O is necessary. For purposes of applying the overall limitation, the statutory grouping is gross income from sources without the United States and the residual grouping is gross income from sources within the United States. As a result of the allocation of deductions, X, M, and N have separate taxable income (losses) from sources without the United States in the amounts of ($25,000), $150,000, and ($50,000), respectively, computed as follows:

	X	M	N
Foreign gross income	....	$250,000	$150,000
Less: Deductions allocable to foreign gross income	$25,000	100,000	200,000
Total, taxable income (loss)	(25,000)	150,000	(50,000)

Thus, in the combined computation of the overall limitation, the numerator of the limiting fraction (taxable income from sources outside the United States) is $75,000 ($150,000 of separate taxable income of M less $50,000 of losses of N and less $25,000 of losses of X).

Example 18— Stewardship and Supportive Expenses—(i) *Facts.* X, a domestic corporation, manufactures and sells pharmaceuticals in the United States. X's domestic subsidiary S, and X's foreign subsidiaries T, U, and V perform similar functions in the United States and foreign countries T, U, and V, respectively. Each corporation derives substantial net income during the taxable year. X's gross income for the taxable year consists of:

Domestic sales income	$32,000,000
Dividends from S (before dividends received deduction)	3,000,000
Dividends from T	2,000,000
Dividends from U	1,000,000
Dividends from V	0
Royalties from T and U	1,000,000
Fees from U for services performed in the United States	1,000,000
Total gross income	40,000,000
Among other deductions, X incurs the following:	
Expenses of supervision department	1,600,000
Charitable contributions	100,000

X's Supervision Department (the Department) is responsible for the supervision of its four subsidiaries and for rendering certain services to the subsidiaries, and this Department provides all the supportive functions necessary for X's foreign activities. The Department performs three principal types of activities. The first type consists of services for the direct benefit of U for which a fee is paid by U to X. The cost of the services for U is $1,000,000. The second type consists of stewardship activities which are in the nature of a management review and generally duplicate functions performed by the subsidiaries' own employees (and are, therefore, of a type described in §1.482–2(b)(2)(ii) which would not be subject to an allocation under section 482). For example, a team of auditors from X's accounting department periodically audits the subsidiaries' books and prepares internal reports for use by X's management. Similarly, X's treasurer periodically reviews for the board of directors of X the subsidiaries' financial policies. The cost of the duplicative services and related supportive expenses is $540,000. The third type of activity consists of providing services which are ancillary to the license agreements which X maintains with subsidiaries T and U. The cost of the ancillary services is $60,000.

(ii) *Allocation.* The Department's outlay of $1,000,000 is the basis for the charge to U for services rendered, and therefore $1,000,000 is allocated to the fees paid by U. The remaining $600,000 in the Department's deductions are definitely related to the types of gross income to which they give rise, namely dividends from subsidiaries S, T, U and V and royalties from t and U. However, $60,000 of the $600,000 in deductions are found to be attributable to the ancillary serivces and are definitely related (and therefore allocable) solely to royalties received from T and U, while the remaining $540,000 in deductions are definitely related (and therefore allocable) to dividends received from all the subsidiaries.

(iii) *Apportionment.* For purposes of applying the overall limitation, the statutory grouping is gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deduction of $540,000 for the Supervision Department expenses and related supportive expenses which is allocable to dividends received from the subsidiaries must be apportioned between the statutory and residual groupings before the overall limitation may be applied. In determining an appropriate method for apportioning the $540,000, a basis other than X's gross income must be used since the dividend payment policies of the subsidiaries bear no relationship either to the activities of the Department or to the amount of income earned by each subsidiary. This is evidenced by the fact that V paid no dividends during the year, whereas S, T, and U paid dividends of $1 million or more each. In the absence of facts that would indicate a material distortion resulting from the use of such method, the stewardship expenses ($540,000) may be apportioned on the basis of the gross receipts of each subsidiary.

The gross receipts of the subsidiaries were as follows:	
S	$4,000,000
T	3,000,000
U	500,000
V	1,500,000
Total	9,000,000

Thus, the expenses of the Department are apportioned for purposes of the overall limitation as follows:

Apportionment of stewardship expenses to the statutory grouping of gross income: 540,000×[($3,000,000+$500,000+ $1,500,000)/ $9,000,000]	$300,000
Apportionment of supervisory expenses to the residual grouping of gross income: $540,000×$4,000,000/9,000,000	240,000
Total: Apportioned stewardship expense	$540,000

(iv) *Allocation and apportionment of charitable contributions.* Pursuant to paragraph (e)(9) of this section, charitable contributions are generally treated as deductions which are not definitely related to any gross income and are, accordingly, apportioned ratably on the basis of gross income for purposes of the overall limitation as follows:

Apportionment of charitable contributions to the statutory grouping of gross income: $100,000×[($2,000,000 + $1,000,000 + $1,000,000)/$40,000,000]	$10,000
Apportionment of charitable contributions to the residual grouping of gross income: $100,000×[($32,000,000 + $3,000,000 + $1,000,000)/$40,000,000]	90,000
Total apportioned charitable contributions	100,000

Example 19— Supportive Expense—(i) *Facts.* X, a domestic corporation, purchases and sells products both in the United States and in foreign countries. X has no foreign subsidiary and no international department. During the taxable year, X incurs the following expenses with respect to its worldwide activities:

Personnel department expenses	$50,000
Training department expenses	35,000
General and administrative expenses	55,000
President's salary	40,000
Sales manager's salary	20,000
Total	200,000

X has domestic gross receipts from sales of $750,000 and foreign gross receipts from sales of $500,000 and has gross income from such sales in the same ratio, namely $300,000 from domestic sources and $200,000 from foreign sources.

(ii) *Allocation.* The above expenses are definitely related and allocable to all of X's gross income derived from both domestic and foreign markets.

(iii) *Apportionment.* For purposes of applying the overall limitation, the statutory grouping is gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deductions for its worldwide sales activities must be apportioned between these groupings. Company X in this example (unlike Company X in example 18) does not have a separate international division which performs essentially all of the functions required to manage and oversee its foreign activities. The president and sales manager do not maintain time records. The division of their time between domestic and foreign activities varies from day to day and cannot be estimated on an annual basis with any reasonable degree of accuracy. Similarly, there are no facts which would justify a method of apportionment of their salaries or of one of the other listed deductions based on more specific factors than gross receipts or gross income. An acceptable method of apportionment would be on the basis of gross receipts. The apportionment of the $200,000 deduction is as follows:

Apportionment of the $200,000 expense to the statutory grouping of gross income: $200,000×[$500,000/($500,000+$750,000)]	$80,000
Apportionment of the $200,000 expense to the residual grouping of gross income: $200,000×[$750,000/($500,000+$750,000)]	120,000
Total apportioned supportive expense	200,000

Example 20— Supportive Expense—(i) *Facts.* Assume the same facts as above except that X's president devotes only 5 percent of his time to the foreign operations and 95 percent of his time to the domestic operations and that X's sales manager devotes approximately 10 percent of his time to foreign sales and 90 percent of his time to domestic sales.

(ii) *Allocation.* The expenses incurred by X with respect to its worldwide activities are definitely related, and therefore allocable to

X's gross income from both its foreign and domestic markets.

(iii) *Apportionment.* On the basis of the additional facts it is not acceptable to apportion the salaries of the president and the sales manager on the basis of gross receipts. It is acceptable to apportion such salaries between the statutory grouping (gross income from sources without the United States) and residual grouping (gross income from sources within the United States) on the basis of time devoted to each sales activity. Remaining expenses may still be apportioned on the basis of gross receipts. The apportionment is as follows:

Apportionment of the $200,000 expense to the statutory grouping of gross income:	
President's salary: $40,000×5 pct	$2,000
Sales manager's salary: $20,000×10 pct	2,000
Remaining expenses: $140,000×[$500,000/($500,000+$750,000)]	56,000
Subtotal: Apportionment of expense to statutory grouping	60,000
Apportionment of the $200,000 expense to the residual grouping of gross income:	
President's salary: $40,000×95 pct	38,000
Sales manager's salary: $20,000×90 pct	18,000
Remaining expenses: $140,000×[$750,000/($500,000+$750,000)]	84,000
Subtotal: Apportionment of expense to residual grouping	140,000
Total: Apportioned general and administrative expense	200,000

Example 21— Supportive Expense—(i) *Facts.* X, a foreign corporation doing business in the United States, is a manufacturer of metal stamping machines. X has no United States subsidiaries and no separate division to manage and oversee its business in the United States. X manufactures and sells these machines in the United States and in foreign countries A and B and has a separate manufacturing facility in each country. Sales of these machines are X's only source of income. In 1977, X incurs general and administrative expenses related to both its U.S. and foreign operations of $100,000. It has machine sales of $500,000, $1,000,000 and $1,000,000 on which it earns gross income of $200,000, $400,000 and $400,000 in the United States, country A, and country B, respectively. The income from the manufacture and sale of the machines in countries A and B is not effectively connected with X's business in the United States.

(ii) *Allocation.* The $100,000 of general and administrative expense is definitely related to the income to which it gives rise, namely a part of the gross income from sales of machines in the United States, in country A, and in country B. The expenses are allocable to this class of income, even though X's gross income from sources outside the United States is excluded income since it is not effectively connected with a U.S. trade or business.

(iii) *Apportionment* Since X is a foreign corporation, the statutory grouping is gross income effectively connected with X's trade of business in the United States, namely gross income from sources within the United States, and the residual grouping is gross income not effectively connected with a trade or business in the United States, namely gross income from countries A and B. Since there are no facts which would require a method of apportionment other than on the basis of sales or gross income, the amount may be apportioned between the two groupings on the basis of amounts of gross income as follows:

Apportionment of general and administrative expense to the statutory grouping, gross income from sources within the United States: $100,000×[$200,000/($200,000 + $400,000 + $400,000)]	$20,000
Apportionment of general and administrative expense to the residual grouping, gross income from sources without the United States: $100,000×[($400,000 + $400,000)/($200,000 + $400,000 + $400,000)]	80,000
Total apportioned general and administrative expense	100,000

Example 22— Domestic International Sales Corporations—(i) *Facts.* X, a domestic corporation, manufactures a line of kitchenware and sells it to retailers in the United States, France, and the United Kingdom. After the Domestic International Sales Corporation (DISC) legislation was passed in 1971, X established, as of January 1, 1972, a DISC and thereafter did all of its foreign marketing through sales by the DISC. In 1977 the DISC has total sales of $7,700,000 for which X's cost of goods sold is $6,000,000. Thus, the gross income attributable to exports through the DISC is $1,700,000 ($7,700,000−$6,000,000). Moreover, X has U.S. domestic sales of kitchenware of $12,000,000 on which it earned gross income of $900,000, and X receives royalty income from the foreign license of its kitchenware technology in the amount of $800,000. The DISC's expenses attributable to the resale of export property are $400,000 of which $300,000 qualify as export promotion expenses. X also incurs $125,000 of general and administrative expenses in connection with its domestic and foreign sales activities, and its foreign licensing activities. X and the DISC determine transfer prices charged on the basis of a single product grouping and the ''50–50'' combined taxable income method (without marginal costing) which permits the DISC to have a taxable income equal to 50 percent of the combined taxable income attributable to the production and sales of the export property, plus 10 percent of the DISC's export promotion expenses.

(ii) *Allocation.* For purposes of determining combined taxable income of X and the DISC from export sales, general and administrative expenses of $125,000 must be allocated to and apportioned between gross income resulting from the production and sale of kitchenware for export, and from the production and sale of kitchenware for the domestic market. The deduction of $400,000 for expenses attributable to the resale of export property is allocated solely to gross income from the production and sale of kitchenware in foreign markets.

(iii) *Apportionment.* Apportionment of expense takes place in two stages. In the first stage, for computing conbined taxable income from the production and sale of export property, the general and administrative expense should be apportioned between the statutory grouping of gross income from the export of kitchenware and the residual grouping of gross income from domestic sales and foreign licenses. In the second stage, since the limitation on the foreign tax credit requires the use of a separate limitation with respect to dividends from a DISC (section 904(d)), the general and administrative expense should be apportioned between two statutory groupings, DISC dividends and foreign royalty income (for which the overall limitation is used), and the residual grouping of gross income from sales within the United States. In the first stage, in the absence of more specific or contrary information, the general and administrative expense may be apportioned on the basis of gross income in the respective groupings, as follows:

Apportionment of general and administrative expense to the statutory grouping, gross income from exports of kitchenware: $125,000×[$1,700,000/($1,700,000 + $900,000 + $800,000)]	$62,500
Apportionment of general and administrative expense to the residual grouping, gross income from domestic sales of kitchenware and foreign royalty income from licensing kitchenware technology: $125,000×[($900,000 + $800,000)/($1,700,000 + $900,000 + $800,000)]	62,500
Total apportionment of general and administrative expense	125,000

On the basis of this apportionment, the combined taxable income, and the DISC portion of taxable income may be calculated as follows:

Gross income from exports	$1,700,000	
Less:		
DISC expense for resale of export property	400,000	
Apportioned general and administrative expense	62,500	
		$462,500
Combined taxable income from production and export of kitchenware		1,237,500
DISC income:		
50 pct of combined taxable income		618,750
10 pct of export promotion expense of $300,000		30,000
Total DISC income		648,750
DISC income as a percentage of combined taxable income		52.4

In the second stage, in the absence of more specific or contrary information, the general and administrative expense may also be apportioned on the basis of gross income in the respective groupings. Since DISC taxable income is 52.4 percent of combined taxable income, DISC gross income is treated as 52.4 percent of the gross income from exports $1,700,000. The apportionment follows:

Apportionment of general and administrative expense to the statutory grouping, DISC dividends: $125,000×[(0.524×$1,700,000)/($1,700,000 + $900,000 + $800,000)]	$32,750
Apportionment of general and administrative expense to the statutory grouping, foreign royalty income: $125,000×[$800,000/($1,700,000 + 900,000 + $800,000)]	29,412
Apportionment of general and administrative expense to the residual grouping, gross income from sources within the United States: $125,000×[($900,000 + (0.476 ×$1,700,000))/($1,700,000 + $900,000 + $800,000)]	62,838
Total apportioned general and administrative expense	125,000

(iv) This *Example* 22 applies only to DISC taxable years ending before January 1, 1987, and to distributions from a DISC or former DISC with respect to DISC or former DISC taxable years ending before January 1, 1987.

Example 23— [Reserved]

Example 24— [Reserved] For guidance, see § 1.861–8T(g) *Example* 24.

Example 25— Income Taxes—(i) *Facts.* X, a domestic corporation, is a manufacturer and distributor of electronic equipment with operations in states A, B, and C. X also has a branch in country Y which manufactures and distributes the same type of electronic equipment. In 1988, X has taxable income from these activities, as described under the Code (without taking into account the deduction for state income taxes), of $1,000,000, of which $200,000 is foreign source general limitation income subject to a separate limitation under section 904(d)(1)(I) (''general limitation income'') and $800,000 is domestic source income. States A, B, and C each determine X's income subject to tax within their state by making adjustments to X's taxable income as determined under the Code, and then apportioning the adjusted taxable income on the basis of the relative amounts of X's payroll, property, and sales within each state as compared to X's worldwide payroll, property, and sales. The adjustments made by states A, B, and C all involve adding and subtracting enumerated items from taxable income as determined under the Code. However, in making these adjustments to taxable income, none of the states specifically exempts foreign source income as determined under the Code. On this basis, it is determined that X has taxable income of $550,000, $200,000, and $200,000 in states A, B, and C, respectively. The corporate tax rates in states A, B, and C are 10 percent, 5 percent, and 2 percent, respectively, and X has total state income tax liabilities of $69,000 ($55,000 + $10,000 + $4,000), which it deducts as an expense for federal income tax purposes.

(ii) *Allocation.* X's deduction of $69,000 for state income taxes is definitely related and thus allocable to the gross income with respect to which the taxes are imposed. Since the statutes of states A, B, and C do not specifically exempt foreign source income (as determined under the Code) from taxation and since, in the aggregate, states A, B, and C tax $950,000 of X's income while only $800,000 is domestic source income under the Code, it is presumed that state income taxes are imposed on $150,000 of foreign source income. The deduction for state income taxes is therefore related and allocable to both X's foreign source and domestic source income.

(iii) *Apportionment.* For purposes of computing the foreign tax credit limitation, X's income is comprised of one statutory grouping, foreign source general limitation gross income, and one residual grouping, gross income from sources within the United States. The state income tax deduction of $69,000 must be apportioned between these two groupings. Corporation X calculates the apportionment on the basis of the relative amounts of foreign source general limitation taxable income and U.S. source taxable income subject to state taxation. In this case, state income taxes are presumed to be imposed on $800,000 of domestic source income and $150,000 of foreign source general limitation income.

State income tax deduction apportioned to foreign source general limitation income (statutory grouping): $69,000 × ($150,000/$950,000)	$10,895
State income tax deduction apportioned to income from sources within the United States (residual grouping): $69,000 × ($800,000/$950,000)	58,105
Total apportioned state income tax deduction	$69,000

Example 26— Income Taxes—(i) *Facts.* Assume the same facts as in Example 25 except that the language of state A's statute and the statute's operation exempt from taxation all foreign source income, as determined under the Code, so that foreign source income is not included in adjusted taxable income subject to apportionment in state A (and factors relating to X's country Y branch are not taken into account in computing the state A apportionment fraction).

(ii) *Allocation.* X's deduction of $69,000 for state income taxes is definitely related and thus allocable to the gross income with respect to which the taxes are imposed. Since state A exempts all foreign source income by statute, state A is presumed to impose tax on $550,000 of X's $800,000 of domestic source income. X's state A tax of $55,000 is allocable, therefore, solely to domestic source income. Since the statutes of states B and C do not specifically exclude all foreign source income as determined under the Code, and since states B and C impose tax on $400,000 ($200,000 + $200,000) of X's income of which only $250,000 ($800,000 − $550,000) is presumed to be domestic source, the deduction for the $14,000 of income taxes imposed by states B and C is related and allocable to both foreign source and domestic source income.

(iii) *Apportionment.* (A) For purposes of computing the foreign tax credit limitation, X's income is comprised of one statutory grouping, foreign source general limitation gross income, and one residual grouping, gross income from sources within the United States. The deduction of $14,000 for income taxes of states B and C must be apportioned between these two groupings.

(B) Corporation X calculates the apportionment on the basis of the relative amounts of foreign source general limitation income and U.S. source income subject to state taxation.

States B and C income tax deduction apportioned to foreign source general limitation income (statutory grouping): $14,000 × ($150,000/$400,000)	$5,250
States B and C income tax deduction apportioned to income from sources within the United States (residual grouping): $14,000 × ($250,000/$400,000)	8,750
Total apportioned state income tax deduction	$14,000

(C) Of X's total income taxes of $69,000, the amount allocated and apportioned to foreign source general limitation income equals $5,250. The total amount of state income taxes allocated and apportioned to U.S. source income equals $63,750 ($55,000 + $8,750).

Example 27— Income Tax—(i) *Facts.* Assume the same facts as in Example 25 except that state A, in which X has significant income-producing activities, does not impose a corporate income tax or other state tax computed on the basis of income derived from business activities conducted in state A. X therefore has a total state income tax liability in 1988 of $14,000 ($10,000 paid to state B plus $4,000 paid to state C), all of which is subject to allocation and apportionment under paragraph (b) of this section.

(ii) *Allocation.* (A) X's deduction of $14,000 for state income taxes is definitely related and allocable to the gross income with respect to which the taxes are imposed. However, in these facts, an adjustment is necessary before the aggregate state taxable incomes can be compared with U.S. source income on the federal income tax return in the manner described in Examples 25 and 26. Unlike the facts in Examples 25 and 26, state A imposes no income tax and does not define taxable income attributable to activities in state A. The total amount of X's income subject to state taxation is, therefore, $400,000 ($200,000 in state B and $200,000 in state C). This total presumptively does not include any income attributable to activities performed in state A and therefore can not properly be compared to total U.S. source taxable income reported by X for federal income tax purposes, which does include income attributable to state A activities.

(B)(*1*) Accordingly, before applying the method used in Examples 25 and 26 to the facts of this example, it is necessary first to estimate the amount of taxable income that state A could reasonably attribute to X's activities in state A, and then to reduce federal taxable income by that amount.

(*2*) Any reasonable method may be used to attribute taxable income to X's activities in state A. For example, the rules of the Uniform Division of Income for Tax Purposes Act (''UDITPA'') attribute income to a state on the basis of the average of three ratios that are based upon the taxpayer's facts—property within the state over total property, payroll within the state over total payroll, and sales within the state over total sales—and, with adjustments, provide a reasonable method for this purpose. When applying the rules of UDITPA to estimate U.S. source income derived from state A activities, the taxpayer's UDITPA factors must be adjusted to eliminate both taxable income and factors attributable to a foreign branch. Therefore, in this example all taxable income as well as UDITPA apportionment factors (property, payroll, and sales) attributable to X's country Y branch must be eliminated.

(C)(*1*) Since it is presumed that, if state A had had an income tax, state A would not attempt to tax the income derived by X's country Y branch, any reasonable estimate of the income that would be taxed by state A must exclude any foreign source income.

(*2*) When using the rules of UDITPA to estimate the income that would have been taxable by state A in these facts, foreign source income is excluded by starting with federally defined taxable income (before deduction for state income taxes) and subtracting any income derived by X's country Y branch. The hypothetical state A taxable income is then determined by multiplying the resulting difference by the average of X's state A property, payroll, and sales ratios, determined using the principles of UDITPA (after adjustment by eliminating the country Y branch factors). The resulting product is presumed to be exclusively U.S. source income, and the allocation and apportionment method described in Example 26 must then be applied.

(*3*) If, for example, state A taxable income were determined to equal $550,000, then $550,000 of U.S. source income for federal income tax purposes would be presumed to constitute state A taxable income. Under Example 26, the remaining $250,000 ($800,000 − $550,000) of U.S. source income for federal income tax purposes would be presumed to be subject to tax in states B and C. Since states B and C impose tax on $400,000, the application of Example 25 would result in a presumption that $150,000 is foreign source income and $250,000 is domestic source income. The deduction for the $14,000 of income taxes of states B and C would therefore be related and allocable to both foreign source and domestic source income and would be subject to apportionment.

(iii) *Apportionment.* The deduction of $14,000 for income taxes of states B and C is apportioned in the same manner as in Example 26. As a result, $5,250 of the $14,000 of state B and state C income taxes is apportioned to foreign source general limitation income ($14,000 × $150,000/$400,000), and $8,750 ($14,000 × $250,000/$400,000) of the $14,000 of state B and state C income taxes is apportioned to U.S. source income.

Example 28— Income Tax—(i) *Facts.* (A) Assume the same facts as in Example 25 (X has $1,000,000 of taxable income for federal income tax purposes, $800,000 of which is U.S. source income and $200,000 of which is foreign source general limitation income), except that $100,000 of X's $200,000 of foreign source general limitation income consists of dividends from first-tier controlled foreign corporations (''CFCs'') (as defined in section 957(a) of the Code) which derive exclusively foreign source general limitation income. X owns stock representing 10 to 50 percent of the vote and value in such CFCs.

(B) State A taxable income is computed by first making adjustments to X's federal taxable income. These adjustments result in X having a total of $1,100,000 of apportionable taxable income for state A tax purposes. None of the $100,000 of adjustments made by state A relate to the dividends paid by the CFCs. As in Example 25, the amount of apportionable taxable income attributable to business activities conducted in state A is determined by multiplying apportionable taxable income by a fraction (the ''state apportionment fraction'') that compares the relative amounts of X's payroll, property, and sales within state A with X's worldwide payroll, property and sales. An analysis of state A law indicates that state A law includes in its definition of the taxable business income of X which is apportionable to X's state A activities, dividends paid to X by its subsidiaries that are in the same business as X, but are less than 50 percent owned by X (‘‘portfolio dividends’’). The dividends received by X from the 10 to 50 percent owned first-tier CFCs, therefore, are considered to be portfolio dividends includable in apportionable business income for state A tax purposes. However, the factors of these CFCs are not included in the state A apportionment fraction for purposes of apportioning income to X’s activities in the state. The comparison of X’s state A factors with X’s worldwide factors results in a state apportionment fraction of 50 percent. Applying this fraction to apportionable taxable income of $1,100,000, as determined under state law, results in attributing 50 percent of apportionable taxable income to state A, and produces total state A taxable income of $550,000. State A imposes an income tax at a rate of 10 percent on the amount of income that is attributed to state A, which results in $55,000 of tax imposed by state A.

(ii) *Allocation*. (A) States A, B, and C impose income taxes of $69,000 which must be allocated to the classes of gross income upon which the taxes are imposed. A portion of X’s federal income tax dedution of $55,000 for state A income tax is definitely related and thus allocable to the class of gross income consisting of foreign source portfolio dividends. A definite relationship exists between a deduction for state income tax and portfolio dividends when a state includes portfolio dividends in state taxable income apportionable to the state, but determines state taxable income by applying an apportionment fraction that excludes the factors of the corporations paying those dividends. By applying a state apportionment fraction that excludes factors of the corporations paying portfolio dividends to apportionable taxable income that includes the $100,000 of foreign source portfolio dividends, $50,000 (50 percent of the $100,000) of the portfolio dividends is attributed to X’s activities in state A and subjected to state A income tax. Applying the state A income tax rate of 10 percent to the $50,000 of foreign source portfolio dividends subjected to state A income tax, $5,000 of X’s $55,000 total state A income tax liability is definitely related and allocable to a class of gross income consisting of the foreign source portfolio dividends. Since under the look-through rules of section 904(d)(3) the foreign source portfolio dividends from the first-tier CFCs are included within the general limitation described in section 904(d)(1)(I), the $5,000 of state A tax on foreign source portfolio dividends is allocated entirely to foreign source general limitation income and, therefore, is not apportioned. (If the total amount of state A tax imposed on foreign source portfolio dividends were to exceed the actual amount of X’s state A income tax liability (for example, due to net operating losses), the actual amount of state A tax would be allocated entirely to those foreign source portfolio dividends.) After allocation of a portion of the state A tax to portfolio dividends, $50,000 ($55,000 − $5,000) of state A tax remains to be allocated.

(B) A total of $64,000 (the aggregate of the $50,000 remaining state A tax, and the $10,000 and $4,000 of taxes imposed by states B and C, respectively) is to be allocated (as provided in Example 25) by comparing U.S. source taxable income (as determined under the Code) with the aggregate of the state taxable incomes determined by states A, B, and C (after reducing state apportionable taxable incomes by the amount of any portfolio dividends included in apportionable taxable income to which tax has been specifically allocated). X’s state A taxable income, after reduction by the $50,000 of portfolio dividends taxed by state A, equals $500,000. X also has taxable income of $200,000 and $200,000 in states B and C, respectively. In the aggregate, therefore, states A, B, and C tax $900,000 of X’s income, after excluding state taxable income attributable to portfolio dividends. Since X has only $800,000 of U.S. source taxable income for federal income tax purposes, it is presumed that state income taxes are imposed on $100,000 of foreign source income. The remaining deduction of $64,000 for state income taxes is therefore related and allocable to both foreign source and domestic source income and is subject to apportionment.

(iii) *Apportionment*. For purposes of computing the foreign tax credit limitation, X’s income is comprised of one statutory grouping, foreign source general limitation income, and one residual grouping, gross income from sources within the United States. The remaining state income tax deduction of $64,000 must be apportioned between these two groupings on the basis of relative amounts of foreign source general limitation taxable income and U.S. source taxable income subject to state taxation. In this case, the $64,000 of state income taxes is considered to be imposed on $800,000 of domestic source income and $100,000 of foreign source general limitation income and is apportioned as follows:

State income tax deduction apportioned to foreign source general limitation income (statutory grouping): $64,000 × ($100,000/$900,000)	$7,111
State income tax deduction apportioned to income from sources within the United States (residual grouping): $64,000 × ($800,000/$900,000)	56,889
Total apportioned state income tax deduction	$64,000

Of the total state income taxes of $69,000, the amount allocated and apportioned to foreign source general limitation income equals $12,111 ($5,000 + $7,111). The total amount of state income taxes allocated and apportioned to U.S. source income equals $56,889.

Example 29— Income Taxes—(i) *Facts.* (A) P, a domestic corporation, is a manufacturer and distributor of electronic equipment with operations in states F, G, and H. P also has a branch in country Y which manufactures and distributes the same type of electronic equipment. In addition, P has three wholly owned subsidiaries, US1, US2, and FS, the latter a controlled foreign corporation (''CFC'') as defined in section 957(a) of the Code. P also owns stock representing 10 to 50 percent of the vote and value of various other first-tier CFCs that derive exclusively foreign source general limitation income.

(B) In 1988, P derives $1,000,000 of federal taxable income (without taking into account the deduction for state income taxes), which consists of $250,000 of foreign source general limitation income and $750,000 of U.S. source income. The foreign source general limitation income consists of a $25,000 subpart F inclusion with respect to FS, $150,000 of dividends from the other first-tier CFCs deriving exclusively foreign source general limitation income, in which P owns stock representing 10 to 50 percent of the vote and value, and $75,000 of manufacturing and sales income derived by P's U.S. operations and country Y branch. The $750,000 of U.S. source income consists of manufacturing and sales income derived by P's U.S. operations.

(C) For federal income tax purposes, US1 derives $75,000 of taxable income, before deduction for state income taxes, which consists entirely of U.S. source income. US2, a so-called ''80/20'' corporation described in section 861(c)(1), derives $250,000 of federal taxable income before deduction for state or foreign income taxes, all of which is derived from foreign operations and consists entirely of foreign source general limitation income. FS is not engaged in a U.S. trade or business and derives $550,000 of foreign source general limitation income before deduction for foreign income taxes.

(D) State F imposes a corporate income tax of 10 percent of P's state F taxable income, which is determined by formulary apportionment of the total taxable income attributable to P's worldwide unitary business. State F determines P's taxable income for state F tax purposes by first making adjustments to the taxable income, as determined for federal income tax purposes, of the members of the unitary business group to determine the total taxable income of the group. State F then computes P's state taxable income by attributing a portion of that unitary business taxable income to activities of P that are conducted in state F. State F does this by multiplying the unitary business taxable income (federal taxable income with state adjustments) by a fraction (the ''state apportionment fraction'') that compares the relative amounts of the unitary business group's payroll, property, and sales (the ''factors'') in state F with the payroll, property, and sales of the unitary business group. P is the only member of its unitary business group that has state F factors and that is thereby subject to state F income tax and filing requirements. State F defines the unitary business group to include any corporation more than 50 percent of which is directly or indirectly owned by a state F taxpayer and is engaged in the same unitary business. P's unitary business group, therefore, includes P, US1, US2, and FS, but does not include the 10 to 50 percent owned CFCs. The income of the unitary business group excludes intercompany dividends between members of the unitary business group and subpart F inclusions with respect to a member of the unitary business group. Dividends paid from nonmembers of the unitary group (the 10 to 50 percent owned CFCs) for state F tax purposes are referred to as ''portfolio dividends'' and are included in taxable income of the unitary business. None of the factors (in state F or worldwide) of the corporations paying portfolio dividends are included in the state F apportionment fraction for purposes of apportioning total taxable income of the unitary business to P's state F activities.

(E) After state adjustments to the taxable income of the unitary business group, as determined under federal tax principles, the total taxable income of P's unitary business group equals $2,000,000, consisting of $1,050,000 of P's income ($100,000 of foreign source manufacturing and sales income, $150,000 of foreign source portfolio dividends, and $800,000 of U.S. source manufacturing and sales income, but excluding the $25,000 subpart F inclusion attributable to FS since FS is a member of the unitary business group), $100,000 of US1's income (from sales made in the United States), $275,000 of US2's income (from an active business outside the United States), and $575,000 of FS's income. The differences between taxable income under federal tax principles and state F apportionable taxable income for P, US1, US2, and FS represent adjustments to taxable income under federal tax principles that are made pursuant to the tax laws of state F.

(F) The taxable income for each member of the unitary business group under federal tax principles and state law principles is summarized in the following table. (The items of income listed in the ''Federal'' column of the table refer to taxable income before deduction for state income tax.)

	Federal	State F
P		
U.S. source income	$750,000	$800,000
Foreign source general limitation income:		
Portfolio dividends	150,000	150,000
Subpart F income	25,000	0
Manufacturing and sales income	75,000	100,000
Total taxable income	1,000,000	1,050,000
US1		
U.S. source income	75,000	100,000
US2		
Foreign source general limitation income	250,000	275,000
FS		
Foreign source general limitation income	550,000	575,000
Taxable income of the unitary business group	....	2,000,000

(G) State F deems P to have state F taxable income of $500,000, which is determined by multiplying the total taxable income of the unitary business group ($2,000,000) by the group's state F apportionment fraction, which is assumed to be 25 percent in these facts. P's state F taxable income is then multiplied by the state F tax rate of 10 percent, resulting in a state F tax liability of $50,000. State G and state H, unlike state F, do not tax portfolio dividends. Although state G and state H apportion taxable income, respectively, on the basis of an apportionment fraction that compares state factors to total factors, state G and state H, unlike state F, do not apply a unitary business theory and consider only P's taxable income and factors in computing P's taxable income. P's taxable income under state G law equals $300,000, which is subject to a 5 percent tax rate resulting in a state G tax liability of $15,000. P's taxable income under state H law is $300,000, which is subject to a tax rate of 2 percent resulting in a state H tax liability of $6,000. P has a total federal income tax deduction for state income taxes of $71,000 ($50,000 + 15,000 + 6,000).

(ii) *Allocation.* (A) P's deduction of $71,000 for state income taxes is definitely related and allocable to the gross income with respect to which the taxes are imposed. Adjustments may be necessary, however, before aggregate state taxable incomes can be compared with U.S. source taxable income on the federal income tax return in the manner described in Examples 25 and 26. In allocating P's deduction for state income taxes, it is necessary first to determine the portion, if any, of the deduction that is definitely related and allocable to a particular class of gross income. A definite relationship exists between a deduction for state income tax and dividend income when a state includes portfolio dividends in state taxable income apportionable to the taxpayer's activities in the state, but determines state taxable income by applying an apportionment formula that excludes the factors of the corporations paying portfolio dividends.

(B) In this case, $150,000 of foreign source portfolio dividends are subject to a state F apportionment fraction of 25 percent, which results in a total of $37,500 of state F taxable income attributable to such dividends. As illustrated in Example 28, $3,750 ($150,000 × 25 percent state F apportionment percentage × 10 percent state F tax rate) of P's state F income tax is definitely related and allocable to a class of gross income consisting entirely of the foreign source portfolio dividends. Since under the look-through rules of section 904(d)(3) the foreign source portfolio dividends paid by first-tier CFCs are included within the general limitation described in section 904(d)(1)(I), the $3,750 of state F tax on foreign source portfolio dividends is allocated entirely to foreign source general limitation income and, therefore, is not apportioned.

(C) After reducing state F taxable income of the unitary business group by the taxable income attributable to portfolio dividends, P's remaining state F taxable income equals $462,500 ($500,000 − $37,500), the portion of the taxable income of the unitary business that state F attributes to P's activities in state F. Accordingly, in order to allocate and apportion the remaining $46,250 of state F tax ($50,000 of state F tax minus the $3,750 of state F tax allocated to foreign source portfolio dividends), it is necessary first to determine if state F is taxing only P's non-unitary taxable income (as defined below) or is imposing its tax partly on other unitary business income that is attributed under state F law to P's activities in state F. P's state F non-unitary taxable income is computed by applying the state F apportionment formula, solely on the basis of P's income (excluding portfolio dividends) and state F apportionment factors. If the state F taxable income (after reduction by the portfolio dividends attributed to state F) attributed to P under state F law exceeds P's non-unitary taxable income, a portion of the state F tax must be allocated and apportioned on the basis of the other unitary business income that is attributed to and taxable to P under state F law. If P's non-unitary taxable income equals or exceeds the $462,500 of remaining state F taxable income, it is presumed that state F is only taxing P's non-unitary taxable income, so that the entire amount of the remaining state F tax should be allocated and apportioned in the manner described in Example 25.

(D) If P's non-unitary taxable income is less than the $462,500 of remaining state F taxable income (after reduction for the

$37,500 of state F taxable income attributable to portfolio dividends), it is presumed that state F is attributing to P, and taxing P upon, other unitary business income. In such a case, it is necessary to determine if state F is attributing to P, and imposing its income tax on, a part of the foreign source income that would be generally presumed under separate accounting to be the income of foreign affiliates and 80/20 companies included in the unitary group, or whether state F is limiting the income it attributes to P, and its taxation of P, to the U.S. source income that would be generally presumed under separate accounting to be the income of domestic members of the unitary group.

(E) Assume for purposes of this example that the non-unitary taxable income attributable to P equals $396,000, computed by multiplying P's state F taxable income of $900,000 (P's state F taxable income (before state F apportionment) of $1,050,000 less the $150,000 of foreign source portfolio dividends) by P's non-unitary state F apportionment fraction, which is assumed to be 44 percent. Because P's non-unitary taxable income of $396,000 is less than the $462,500 of remaining state F taxable income, state F is presumed to be attributing to P and taxing the income that would have been generally attributed under separate accounting to P's affiliates in the unitary group. To determine if state F tax is being imposed on members of the unitary group (other that P) that produce foreign source income, it is necessary to compute a hypothetical state F taxable income for all companies in the unitary group with significant U.S. operations. (For this purpose, the hypothetical group of companies with significant domestic operations is referred to as the ''water's edge group.'') State F is presumed to be attributing to P and taxing income that would have been generally attributable under separate accounting to foreign corporations and 80/20 companies to the extent that the remaining state F taxable income ($462,500) of P exceeds the hypothetical state F taxable income that would have been attributed under state F law to P if state F had defined the unitary group to be the water's edge group.

(F) The members of the water's edge group would have been P and US1. The unitary business income of this water's edge group is $1,000,000, the sum of $900,000 (P's state F taxable income (before state F apportionment) of $1,050,000 less the $150,000 of foreign source portfolio dividends) and $100,000 (US1's state F taxable income). For purposes of this example, the state F apportionment fraction determined on a unitary basis for this water's edge group is assumed to equal 40 percent, the average of P and US1's state F payroll, property, and sales factor ratios (the water's edge group's state F factors over its worldwide factors). Applying this apportionment fraction to the $1,000,000 of unitary business income of the water's edge group yields state F water's edge taxable income of $400,000. The excess of the remaining $462,500 of P's state F taxable income over the $400,000 of P's state F water's edge taxable income equals $62,500, and is attributable to the inclusion of US2 and FS in the unitary group. The state F tax attributable to the $62,500 of taxable income attributed to P under state F law, and that would have generally been attributed to US2 and FS under non-unitary accounting, equals $6,250 and is allocated entirely to a class of gross income consisting of foreign source general limitation income, because the income of FS and US2 consists entirely of such income. After the $6,250 of state F tax attributable to US2 and FS is subtracted from the remaining $46,250 of net state F tax, P has $40,000 of state F tax remaining to be allocated and apportioned.

(G) To the extent that the remainder of P's state F taxable income ($400,000) exceeds P's non-unitary state F taxable income ($396,000), it is presumed that state F is attributing to and imposing on P a tax on U.S. source income that would have been attributed under separate accounting to members of the water's edge group other than P. In these facts, the $4,000 difference in P's state F taxable income results from the inclusion of US1 in the unitary group. The $400 of P's state F tax attributable to this $4,000 is allocated entirely to P's U.S. source income. P's remaining $39,600 of state F tax ($40,000 of P's state F tax resulting from the attribution of P of income that would have been attributed under non-unitary accounting to other members of the water's edge group, minus $400 of state F tax attributable to US1 and allocated to P's U.S. source income) is the state F tax attributable to P's non-unitary state F taxable income that is to be allocated and apportioned together with P's state G tax of $15,000 and state H tax of $6,000 as illustrated in Example 25.

(H) In allocating the $60,600 of state tax liabilities ($39,600 state F tax attributable to P's non-unitary state F income + $15,000 state G tax + $6,000 state H tax) under Example 25, P's state taxable income in state G and state H ($300,000 + $300,000) must be added to P's non-unitary state F taxable income ($396,000). The resulting $996,000 of combined state taxable incomes is compared with $750,000 of U.S. source income on P's federal income tax return. Because P's combined state taxable incomes exceeds P's federal U.S. source taxable income, it is presumed that the remaining $60,600 of P's total state income taxes is imposed in part on foreign source income. Accordingly, P's remaining deduction of $60,600 ($39,600 + $15,000 + $6,000) for state income taxes is related and allocable to both P's foreign source and domestic source income and is subject to apportionment.

(iii) *Apportionment.* The $60,600 of state taxes (the remaining $39,600 of state F tax + $15,000 of state G tax + $6,000 of state H tax) must be apportioned between foreign source general limitation income and U.S. source income for federal income tax purposes. This apportionment is based upon the relative amounts of foreign source general limitation taxable income and U.S. source taxable income comprising the $996,000 of income subject to tax by the states, after reducing the total amount of income subject to tax by the portfolio dividends and the income attributed to P under state F law that would have been attributed under arm's length principles to other members of P's state F unitary business group. The deduction for the $60,600 of state income taxes is apportioned as follows:

State income tax deduction apportioned to foreign source general limitation income (statutory grouping): $60,600 x ($246,000/$996,000)	$14,967
State income tax deduction apportioned to income from sources within the United States (residual grouping): $60,600 x ($750,000/$996,000)	45,633
Total apportioned state income tax deduction	60,600

Of the total state income taxes of $71,000, the amount allocated and apportioned to foreign source general limitation income is $24,967—the sum of $14,967 of state F, state G, and state H taxes apportioned to foreign source general limitation income, $3,750 of state F tax allocated to foreign source apportionable dividend income, and the $6,250 of state F tax allocated to foreign source general limitation income as the result of state F's worldwide unitary business theory of taxation. The total amount of state income taxes allocated and apportioned to U.S. source income equals $46,033—the sum of the $400 of state F tax attributable to the inclusion of US1 in the state F unitary business group and $45,633 of combined state F, G, and H tax apportioned under the method provided in Example 25.

Example 30— Income Taxes—(i) *Facts.* (A) As in Example 17 of §1.861–8(g), X is a domestic corporation that wholly owns M, N, and O, also domestic corporations. X, M, N, and O file a consolidated income tax return. All the income of X and O is from sources within the United States, all of M's income is from sources within South America, and all of N's income is from sources within Africa. X receives no dividends from M, N, or O. During the taxable year, the consolidated group of corporations earned consolidated gross income of $550,000 and incurred total deductions of $370,000. X has gross income of $100,000 and deductions of $50,000, without regard to its deduction for state income tax. Of the $50,000 of deductions incurred by X, $15,000 relates to X's ownership of M; $10,000 relates to X's ownership of N; $5,000 relates to X's ownership of O; and the entire $30,000 constitutes stewardship expenses. The remainder of X's $20,000 of deductions (which is assumed not to include state income tax) relates to production of income from its plant in the United States. M has gross income of $250,000 and deductions of $100,000, which yield foreign source taxable income of $150,000. N has gross income of $150,000 and deductions of $200,000, which yield a foreign source loss of $50,000. O has gross income of $50,000 and deductions of $20,000, which yield U.S. source taxable income of $30,000.

(B) Unlike Example 17 of §1.861–8(g), however, X also has a deduction of $1,800 for state A income taxes. X's state A taxable income is computed by first making adjustments to the federal taxable income of X to derive apportionable taxable income for state A tax purposes. An analysis of state A law indicates that state A law also includes in its definition of the taxable business income of X which is apportionable to X's state A activities, the taxable income of M, N, and O, which is related to X's business. As in Example 25, the amount of apportionable taxable income attributable to business activities conducted in state A is determined by multiplying apportionable taxable income by a fraction (the ''state apportionment fraction'') that compares the relative amounts of payroll, property, and sales within state A with worldwide payroll, property and sales. Assuming that X's apportionable taxable income equals $180,000, $100,000 of which is from sources without the United States, and $80,000 is from sources within the United States, and that the state apportionment fraction is equal to 10 percent, X has state A taxable income of $18,000. The state A income tax of $1,800 is then derived by applying the state A income tax rate of 10 percent to the $18,000 of state A taxable income.

(ii) *Allocation and apportionment.* In accordance with §1.1502–4, each corporation must first compute its separate taxable income for purposes of computing the consolidated limitation on the foreign tax credit. Assume that under Example 29, it is determined that X's deduction for state A income tax is definitely related to a class of gross income consisting of income from sources both within and without the United States, and that the state A tax is apportioned $1,000 to sources without the United States, and $800 to sources within the United States. Under Example 17, without regard to the deduction for X's state A income tax, X has a separate loss of ($25,000) from sources without the United States. After taking into account the deduction for state A income tax, X's separate loss from sources without the United States is increased by the $1,000 state A tax apportioned to sources without the United States, and equals a loss of ($26,000), for purposes of computing the numerator of the consolidated foreign tax credit limitation.

Example 31— Income Taxes—(i) *Facts.* Assume that the facts are the same as in Example 29, except that state G requires P to adjust its federal taxable income by depreciating an asset at a different rate than is allowed P under the Internal Revenue Code for the same asset. Before using the methodology of Example 25 to determine whether a portion of its deduction for state income taxes is allocable to a class of gross income that includes foreign source income, P recomputes its taxable income under state G law by using the rate of depreciation that it is entitled to use under the Code, and uses this recomputed amount in applying the methodology of Example 25.

(ii) *Allocation.* P's modification of its state G taxable income is permissible. Under the methdology of Example 25, this modification of state G taxable income will produce a reasonable determination of the portion (if any) of P's state income taxes that is allocable to a class of gross income that includes foreign sources income.

Example 32— Income Taxes—(i) *Facts.* Assume the facts are the same as Example 29, except that P's state F taxable income differs from the amount of its U.S. source income under federal income tax principles solely because state F determines P's state taxable income under a worldwide unitary business theory instead of the arm's length principles applied in the Code. Before using the methodology of Example 25 to determine whether a portion of its deduction for state income taxes is allocable to a class of gross income that includes foreign source income, P recomputes state F taxable income under the arm's length principles applied in the Code. P substitutes that recomputed amount for the amount of taxable income actually determined under state F law in applying the methodology of Example 25.

(ii) *Allocation.* P's modification of state F taxable income does not accurately reflect the factual relationship between the deduction for state F income tax and the income on which the tax is imposed, because there is no factual relationship between the state F income tax and the state F taxable income as recomputed under Code principles. State F does not impose its income tax upon P's income as it might have been defined under the Internal Revenue Code. Consequently, P's modification of state F taxable income is impermissible because it will not produce a reasonable determination of the portion (if any) of P's state income taxes that is allocable to a class of gross income that includes foreign source income.

Example 33— Income Taxes—(i) *Facts.* Assume the same facts as in Example 29, except that state G does not impose an income tax on corporations, and P's non-unitary state F taxable income equals $462,500. Thus only $56,000 of state income taxes ($50,000 of state F income tax and $6,000 of state H income tax) are deductible and required to be allocated and (if necessary) apportioned. As in Example 29, P has $800,000 of aggregate state taxable income ($500,000 of state F taxable income and $300,000 of state H taxable income).

(ii) *Method One.* Assume that P has elected to allocate and apportion its deduction for state income tax under the safe harbor method provided in § 1.861–8 (e)(6)(ii)(D)(*2*) (''Method One'').

(A) *Step One—Specific allocation to foreign source portfolio dividends.* P applies the methodology of paragraph (ii) of *Example 28* to determine the portion of the deduction that must be allocated to a class of gross income consisting solely of foreign source portfolio dividends. As illustrated in paragraphs (ii)(A) and (B) of Example 29, $3,750 of the deduction for state F income tax is attributable to the $37,500 of foreign source portfolio dividends attributed under state F law to P's activities in state F. Thus $3,750 of P's deduction for state income tax must be specifically allocated to a class of gross income consisting solely of $37,500 of foreign source portfolio dividends. No apportionment of the $3,750 is necessary. P's adjusted state taxable income is $762,500 (aggregate state taxable income of $800,000 reduced by $37,500 of foreign source portfolio dividends). Because the remaining amount of state F taxable income ($462,500) equals P's non-unitary state F taxable income, no further specific allocation of state tax is required.

(B) *Step Two—Adjustment of U.S. source federal taxable income.* P applies the methodology illustrated in paragraph (ii) of Example 27 (including the rules of UDITPA described therein) to determine the amount of its federal taxable income attributable to its activities in state G. Assume that P determines under this methodology that $300,000 of its federal taxable income is attributable to activities in state G. P's adjusted U.S. source federal taxable income equals $450,000 ($750,000 minus the $300,000 attributed to P's activities in state G).

(C) *Step Three—Allocation.* The portion of P's deduction for state income tax remaining to be allocated equals $52,250 ($56,000 minus the $3,750 specifically allocated to foreign source portfolio dividends). P allocates this portion by applying the methodology illustrated in paragraph (ii) of Example 25, as modified by paragraph (e)(6)(ii)(D)(*2*)(*iii*) of this section. Thus, P compares its adjusted state taxable inocme (as determined under Step One in paragraph (A) above) with an amount equal to 110% of its adjusted U.S.

source federal taxable income (as determined under Step Two in paragraph (B) above). Because P's adjusted state taxable income ($762,500) exceeds 110% of P's adjusted U.S. source federal taxable income ($495,000, or 110% of $450,000), the remaining portion of P's deduction for state income tax ($52,500) must be allocated to a class of gross income that includes both U.S. and foreign source income.

(D) *Step Four—Apportionment.* P must apportion to U.S. source income the portion of the deduction that is attributable to state income tax imposed upon state taxable income in an amount equal to 110% of P's adjusted U.S. source federal taxable income. The remainder of the deduction must be apportioned to foreign source general limitation income.

Amount of deduction to be apportioned	$52,250.00
Less portion of deduction to be apportioned to income from sources within the United States (residual grouping): ($52,250 × ($495,000/$762,500)	$33,919.67
Equals Portion of deduction to be apportioned to foreign source general limitation income (statutory grouping):	$18,330.33

(iii) *Method Two.* Assume that P has elected to allocate and apportion its deduction for state income tax under the safe harbor method provided in §1.861–8(e)(6)(ii)(D)(*3*) ("Method Two").

(A) *Step One—Specific allocation.* Step One of Method Two is the same as Step One of Method One. Therefore, as described in paragraph (A) of paragraph (ii) above, $3,750 of P's deduction for state income tax must be specifically allocated to a class of gross income consisting solely of $37,500 of foreign source portfolio dividends. No apportionment of the $3,750 is necessary. P's adjusted state taxable income is $762,500 (aggregate state taxable income of $800,000 reduced by $37,500 of foreign source portfolio dividends).

(B) *Step Two—Adjustment of U.S. source federal taxable income.* Step Two of Method Two is the same as Step Two of Method One. Therefore, as described in paragraph (B) of paragraph (ii) above, assume that P determines that $300,000 of its federal taxable income is attributable to activities in state G. P's adjusted U.S. source federal taxable income equals $450,000 ($750,000 minus the $300,000 attributed to P's activities in state G).

(C) *Step Three—Allocation.* The portion of P's deduction for state income tax remaining to be allocated equals $52,250 ($56,000 minus the $3,750 of state F income tax specifically allocated to foreign source portfolio dividends). P allocates this portion by applying the methodology illustrated in paragraph (ii) of Example 25, as modified by paragraph (e)(6)(ii)(D)(*3*)(*iii*) of this section. Thus, P compares its adjusted state taxable income (as determined under Step One in paragraph (A) above) with its adjusted U.S. source federal taxable income (as determined under Step Two in paragraph (B) above). Because P's adjusted state taxable income ($762,500) exceeds P's adjusted U.S. source federal taxable income ($450,000), the remaining portion of P's deduction for state income tax ($52,500) must be allocated to a class of gross income that includes both U.S. and foreign source income.

(D) *Step Four—Apportionment.* P must apportion to U.S. source income the portion of the deduction that is attributable to state income tax imposed upon state taxable income in an amount equal to P's adjusted U.S. source federal taxable income.

Amount of deduction to be apportioned	$52,250.00
Less portion of deduction initially apportioned to income from sources within the United States (residual grouping): $52,250 × ($450,000/$762,500)	30,836.07
Remainder requiring further apportionment: $52,250 × ($312,500/ $762,500)	21,413.93

The remainder of $21,413.93 must be further apportioned between foreign source general limitation income and U.S. source federal taxable income in the same proportions that P's adjusted U.S. source federal taxable income and foreign source general limitation income bear to P's total federal taxable income (taking into account the adjustment of U.S. source federal taxable income and reduced by the amount of foreign source portfolio dividends to which the tax has been specifically allocated).

Portion of remainder apportioned to foreign source general limitation income (statutory grouping): $21,413.93 X ($212,500/$662,500)	$6,868.62
Remaining state income tax deduction to be apportioned to income from sources within the United States (residual grouping): $21,413.93 X ($450,000/$662,500)	$14,545.31

Of P's total deduction of $56,000 for state income tax, the portion allocated and apportioned to foreign source general limitation income equals $10,618.62—the sum of $6,868.62 apportioned under Step Four and the $3,750.00 specifically allocated to foreign source portfolio dividend income under Step One. The portion of the deduction allocated and apportioned to U.S. source income equals $45,381.38—the sum of the $30,836.07

and the $14,545.31 apportioned under Step Four.

(Secs. 882(c) and 7805 of the Internal Revenue Code of 1954 (80 Stat. 1556; 26 U.S.C. 882(c) and 68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7456, 42 FR 1195, Jan. 6, 1977, as amended by T.D. 7749, 46 FR 1683, Jan. 7, 1981; T.D. 7939, 49 FR 4207, Feb. 3, 1984; T.D. 8228, 53 FR 35474, Sept. 14, 1988; T.D. 8286, 55 FR 3052, Jan. 30, 1990; T.D. 8337, 56 FR 10369, Mar. 12, 1991; 56 FR 22760, May 16, 1991; 56 FR 24001, May 28, 1991; T.D. 8228, 60 FR 36669, July 18, 1995; T.D. 8646, 60 FR 66503, Dec. 22, 1995; T.D. 8805, 64 FR 1509, Jan 11, 1999]

§ 1.861–8T Computation of taxable income from sources within the United States and from other sources and activities (temporary).

(a) *In general.*

(1) [Reserved]

(2) *Allocation and apportionment of deductions in general.* If an affiliated group of corporations joins in filing a consolidated return under section 1501, the provisions of this section are to be applied separately to each member in that affiliated group for purposes of determining such member's taxable income, except to the extent that expenses, losses, and other deductions are allocated and apportioned as if all domestic members of an affiliated group were a single corporation under section 864(e) and the regulations thereunder. See § 1.861–9T through § 1.861–11T for rules regarding the affiliated group allocation and apportionment of interest expense, and § 1.861–14T for rules regarding the affiliated group allocation and apportionment of expenses other than interest.

(3)–(5) [Reserved]

(b) *Allocation.*

(1)–(2) [Reserved]

(3) *Supportive functions.* Deductions which are supportive in nature (such as overhead, general and administrative, and supervisory expenses) may relate to other deductions which can more readily be allocated to gross income. In such instance, such supportive deductions may be allocated and apportioned along with the deductions to which they relate. On the other hand, it would be equally acceptable to attribute supportive deductions on some reasonable basis directly to activities or property which generate, have generated, or could be reasonably expected to generate gross income. This would ordinarily be accomplished by allocating the supportive expenses to all gross income or to another broad class of gross income and apportioning the expenses in accordance with paragraph (c)(1) of this section. For this purpose, reasonable departmental overhead rates may be utilized. For examples of the application of the principles of this paragraph (b)(3) other than to expenses attributable to stewardship activities, see examples 19 through 21 of paragraph (g) of this section. See paragraph (e)(4) of this section for the allocation and apportionment of deductions attributable to stewardship activities. However, supportive deductions that are described in § 1.861–14T(e)(3) shall be allocated and apportioned in accordance with the rules of § 1.1861–14T and shall not be allocated and apportioned by reference only to the gross income of a single member of an affiliated group of corporations as defined in § 1.861–14T(d).

(4)–(5) [Reserved]

(c) *Apportionment of deductions*—(1) *Deductions definitely related to a class of gross income.* Where a deduction has been allocated in accordance with paragraph (b) of this section to a class of gross income which is included in one statutory grouping and the residual grouping, the deduction must be apportioned between the statutory grouping and the residual grouping. Where a deduction has been allocated to a class of gross income which is included in more than one statutory grouping, such deduction must be apportioned among the statutory groupings and, where necessary, the residual grouping. Thus, in determining the separate limitations on the foreign tax credit imposed by section 904(d)(1) or by section 907, the income within a separate limitation category constitutes a statutory grouping of income and all other income not within that separate limitation category (whether domestic or within a different separate limitation category) constitutes the residual grouping. In this regard, the same method of apportionment must be used in apportioning a deduction to each separate limitation category. Also, see paragraph (f)(1)(iii) of this section with respect to the apportionment of deductions among the statutory groupings designated in section 904(d)(1). If the class of gross income to which a deduction has been allocated consists entirely of a single statutory grouping or the residual grouping, there is no need to apportion that deduction. If a deduction is not definitely related to any gross income, it must be apportioned ratably as provided in paragraph (c)(3) of this section. A deduction is apportioned by attributing the deduction to gross income (within the class to which the deduction has been allocated) which is in one or more statutory groupings and to gross income (within the class) which is in the residual grouping. Such attribution must be accomplished in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. In apportioning deductions, it may be that for the taxable year there is no gross income in the statutory grouping or that deductions will exceed the amount of gross income in the statutory grouping. See paragraph (d)(1) of this section with respect to cases in which deductions exceed gross income. In determining the method of apportionment for a specific deduction, examples of bases and factors which should be considered include, but are not limited to—

(i) Comparison of units sold,

(ii) Comparison of the amount of gross sales or receipts,

(iii) Comparison of costs of goods sold,

(iv) Comparison of profit contribution,

(v) Comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent which are attributable to the activities or properties giving rise to the class of gross income, and

(iv) Comparison of the amount of gross income.

Paragraph (e) (2) through (8) of this section provides the applicable rules for allocation and apportionment of deductions for interest, research and development expenses, and certain other deductions. The effects on tax liability of the apportionment of deductions and the burden of maintaining records not otherwise maintained and making computations not otherwise made shall be taken into consideration in determining whether a method of apportionment and its application are sufficiently precise. A method of apportionment described in this paragraph (c)(1) may not be used when it does not reflect, to a reasonably close extent, the factual relationship between the deduction and the groupings of income. Furthermore, certain methods of apportionment described in this paragraph (c)(1) may not be used in connection with any deduction for which another method is prescribed. The principles set forth above are applicable in apportioning both deductions definitely related to a class which constitutes less than all of the taxpayer's gross income and to deductions related to all of the taxpayer's gross income. If a deduction is not related to any class of gross income, it must be apportioned ratably as provided in paragraph (c)(3) of this section.

(2) *Apportionment based on assets.* Certain taxpayers are required by paragraph (e)(2) of this section and § 1.861–9T to apportion interest expense on the basis of assets. A taxpayer may apportion other deductions based on the comparative value of assets that generate income within each grouping, provided that such method reflects the factual relationship between the deduction and the groupings of income and is applied in accordance with the rules of § 1.861–9T(g). In general, such apportionments must be made either on the basis of the tax book value of those assets or on their fair market value. However, once the taxpayer uses fair market value, the taxpayer and all related persons must continue to use such method unless expressly authorized by the Commissioner to change methods. For purposes of this paragraph (c)(2) the term *related persons* means two or more persons in a relationship described in section 267(b). In determining whether two or more corporations are members of same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section

1563(e)(1), and stock owned by the application of section 267(c). In determining whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3). In the case of any corporate taxpayer that—

(i) Uses tax book value, and

(ii) Owns directly or indirectly (within the meaning of § 1.861–11T(b)(2)(ii)) 10 percent or more of the total combined voting power of all classes of stock entitled to vote in any other corporation (domestic or foreign) that is not a member of the affiliated group (as defined in section 864(e)(5)), such taxpayer shall adjust its basis in that stock in the manner described in § 1.861–11T(b).

(3) [Reserved]

(d) *Excess of deductions and excluded and eliminated items of income.*

(1) [Reserved]

(2) *Allocation and apportionment to exempt, excluded or eliminated income*—(i) *In general.* In the case of taxable years beginning after December 31, 1986, except to the extent otherwise permitted by § 1.861–13T, the following rules shall apply to take account of income that is exempt or excluded, or assets generating such income, with respect to allocation and apportionment of deductions.

(A) *Allocation of deductions.* In allocating deductions that are definitely related to one or more classes of gross income, exempt income (as defined in paragraph (d)(2)(ii) of this section) shall be taken into account.

(B) *Apportionment of deductions.* In apportioning deductions that are definitely related either to a class of gross income consisting of multiple groupings of income (whether statutory or residual) or to all gross income, exempt income and exempt assets (as defined in paragraph (d)(2)(ii) of this section) shall not be taken into account.

For purposes of apportioning deductions which are not taken into account under § 1.1502–13 in determining gain or loss from intercompany transactions, as defined in § 1.1502–13, income from such transactions shall be taken into account in the year such income is ultimately included in gross income.

(ii) *Exempt income and exempt asset defined*—(A) *In general.* For purposes of this section, the term *exempt income* means any income that is, in whole or in part, exempt, excluded, or eliminated for federal income tax purposes. The term *exempt asset* means any asset the income from which is, in whole or in part, exempt, excluded, or eliminated for federal tax purposes.

(B) *Certain stock and dividends.* The term ‘‘exempt income’’ includes the portion of the dividends that are deductible under—

(*1*) Section 243(a) (1) or (2) (relating to the dividends received deduction),

(*2*) Section 245(a) (relating to the dividends received deduction for dividends from certain foreign corporations).

Thus, for purposes of apportioning deductions using a gross income method, gross income would not include a dividend to the extent that it gives rise to a dividend received deduction under either section 243(a)(1), section 243(a)(2), or section 245(a). In the case of a life insurance company taxable under section 801, the amount of such stock that is treated as tax exempt shall not be reduced because a portion of the dividends received deduction is disallowed as attributable to the policyholder’s share of such dividends. See § 1.861–14T(h) for a special rule concerning the allocation of reserve expenses of a life insurance company. In addition, for purposes of apportioning deductions using an asset method, assets would not include that portion of stock equal to the portion of dividends paid thereon that would be deductible under either section 243(a)(1), section 243(a)(2), or section 245(a). In the case of stock which generates, has generated, or can reasonably be expected to generate qualifying dividends deductible under section 243(a)(3), such stock shall not constitute a tax exempt asset. Such stock and the dividends thereon will, however, be eliminated from consideration in the apportionment of interest expense under the consolidation rule set forth in § 1.861–10T(c), and in the apportionment of other expenses under the consolidation rules set forth in § 1.861–14T.

(iii) *Income that is not considered tax exempt.* The following items are not considered to be exempt, eliminated, or excluded income and, thus, may have expenses, losses, or other deductions allocated and apportioned to them:

(A) In the case of a foreign taxpayer (including a foreign sales corporation (FSC)) computing its effectively connected income, gross income (whether domestic or foreign source) which is not effectively connected to the conduct of a United States trade or business;

(B) In computing the combined taxable income of a DISC or FSC and its related supplier, the gross income of a DISC or a FSC;

(C) For all purposes under subchapter N of the Code, including the computation of combined taxable income of a possessions corporation and its affiliates under section 936(h), the gross income of a possessions corporation for which a credit is allowed under section 936(a); and

(D) Foreign earned income as defined in section 911 and the regulations thereunder (however, the rules of § 1.911–6 do not require the allocation and apportionment of certain deductions, including home mortgage interest, to foreign earned income for purposes of determining the deductions disallowed under section 911(d)(6)).

(iv) *Prior years.* For expense allocation and apportionment rules applicable to taxable years beginning before January 1, 1987, and for later years to the extent permitted by § 1.861–13T, see § 1.861–8(d)(2) (Revised as of April 1, 1986).

(e) *Allocation and apportionment of certain deductions.*

(1) [Reserved]

(2) *Interest.* The rules concerning the allocation and apportionment of interest expense and certain interest equivalents are set forth in §§ 1.861–9T through § 1.861–13T.

(3)–(7) [Reserved]

(8) *Net operating loss deduction.* A net operating loss deduction allowed under section 172 shall be allocated and apportioned in the same manner as the deductions giving rise to the net operating loss deduction.

(9)–(11) [Reserved]

(f) *Miscellaneous matters*—(1) *Operative sections.*

(i) [Reserved]

(ii) *Separate limitations to the foreign tax credit.* Section 904(d)(1) requires that the foreign tax credit limitation be determined separately in the case of the types of income specified therein. Accordingly, the income within each separate limitation category constitutes a statutory grouping of income and all other income not within that separate limitation category (whether domestic or within a different separate limitation category) constitutes the residual groups.

(iii) [Reserved]

(2)—(5) [Reserved]

(g) [Reserved]

Examples (1)— (23). [Reserved]

Example (24)— Exempt, excluded, or eliminated income—(i) *Income method*—(A) *Facts.* X, a domestic corporation organized on January 1, 1987, is engaged in a number of businesses worldwide. X owns a 25-percent voting interest in each of five corporations engaged in the business A, two of which are domestic and three of which are foreign. X incurs stewardship expenses in connection with these five stock investments in the amount of $100. X apportions its stewardship expenses using a gross income method. Each of the five companies pays a dividend in the amount of $100. X is entitled to claim the 80-percent dividends received deduction on dividends paid by the two domestic companies. Because tax exempt income is considered in the allocation of deductions, X's $100 stewardship expense is allocated to the class of income consisting of dividends from business A companies. However, because tax exempt income is not considered in the apportionment of deductions within a class of gross income, the gross income of the two domestic companies must be reduced to reflect the availability of the dividends received deduction. Thus, for purposes of apportionment, the gross income paid by the three foreign companies is considered to be $100 each, while the gross income paid by the domestic companies is considered to be $20 each. Accordingly, X has total gross income from business A companies, for purposes of apportionment, of $340. As a result, $29.41 of X's stewardship expense is apportioned to each of the foreign companies and $5.88 of X's stewardship expense is apportioned to each of the domestic companies.

(ii) *Asset method*—(A) *Facts.* X, a domestic corporation organized on January 1, 1987, carries on a trade or business in the United States. X has deductible interest expense incurred in 1987 of $60,000. X owns all the stock of Y, a foreign corporation. X also owns 49 percent of the voting stock of Z, a domestic corporation. Neither Y nor Z has retained earnings and profits at the end of 1987. X apportions its interest expense on the basis of the fair market value of its assets. X has assets worth $1,500,000 that generate domestic source income, among which are tax exempt municipal bonds worth $100,000, and the stock of Z, which has a value of $500,000. The Y stock owned by X has a fair market value of $2,000,000 and generates solely foreign source general limitation income.

(B) *Allocation.* No portion of X's interest expense is directly allocable solely to identified property within the meaning of § 1.861–10T. Thus, X's deduction for interest is definitely related to all its gross income as a class.

(C) *Apportionment.* For purposes of apportioning expenses, assets that generate exempt, eliminated, or excluded income are not taken into account. Because X's municipal bonds are tax exempt, they are not taken into account in apportioning interest expense. Since X is entitled to claim under section 243 to 80-percent dividends received deduction with respect to the dividend it received from Z, 80 percent of the value of that stock is not taken into account as an asset for purposes of apportionment under the asset method. X apportions its interest deduction between the statutory grouping of foreign source general limitation income and the residual grouping of domestic source income as follows:

To foreign source general limitation income:

$$\text{Interest expense} \times \frac{\text{General limitation assets that are not tax exempt}}{\text{Worldwide assets that are not tax exempt}}$$

$$\$60{,}000 \times \frac{\$2{,}000{,}000}{(\$100{,}000 + \$900{,}000 + \$2{,}000{,}000)} = \$40{,}000$$

$$\frac{\text{Nonexempt foreign assets}}{\text{20 percent of Z stock value} + \text{Nonexempt domestic assets} + \text{Nonexempt foreign assets}}$$

To domestic source income:

$$\text{Interest expense} \times \frac{\text{Domestic assets that are not tax exempt}}{\text{Worldwide assets that are not tax exempt}}$$

$$\$60{,}000 \times \frac{\$100{,}000 + \$900{,}000}{(\$100{,}000 + \$900{,}000 + \$2{,}000{,}000)} = \$20{,}000$$

$$\frac{\text{20 percent of Z stock value} + \text{nonexempt domestic assets}}{\text{20 percent of Z stock value} + \text{Nonexempt domestic assets} + \text{Nonexempt foreign assets}}$$

(h) *Effective dates.* In general, the rules of this section, as well as the rules of §§ 1.861–9T, 1.861–10T, 1.861–11T, 1.861–12T, and 1.861–14T shall apply for taxable years beginning after December 31, 1986. In the case of corporate taxpayers, transition rules set forth in § 1.861–13T provide for the gradual phase-in of certain the provisions of this and the foregoing sections. However, the following rules are effective for taxable years commencing after December 31, 1988:

(1) Section 1.861–9T(b)(2) (concerning the treatment of certain foreign currency borrowings),

(2) Section 1.861–9T(d)(2) (concerning the treatment of interest incurred by nonresident aliens),

(3) Section 1.861–10T(b)(3)(ii) (providing an operating costs test for purposes of the nonrecourse indebtedness exception), and

(4) Section 1.861–10T(b)(6) (concerning excess collaterilization of nonrecourse borrowings).

In addition, §1.861–10T(e) (concerning the treatment of related controlled foreign corporation indebtedness) is effective for taxable years commencing after December 31, 1987. For rules for taxable years beginning before January 1, 1987, and for later years to the extent permitted by §1.861–13T, see §1.861–8 (Revised as of April 1, 1986). Paragraph (e)(8) of this section shall cease to be effective January 8, 2002.

[T.D. 8228, 53 FR 35474, Sept. 14, 1988, as amended by T.D. 8286, 55 FR 3054, Jan. 30, 1990; T.D. 8337, 56 FR 10369, Mar. 12, 1991; T.D.8597, 60 FR 36679, July 18, 1995; T.D. 8805, 64 FR 1509, Jan. 11, 1999]

§1.861–9T Allocation and apportionment of interest expense (temporary regulations).

(a) *In general.* Any expense that is deductible under section 163 (including original issue discount) constitutes interest expense for purposes of this section, as well as for purposes of §§1.861–10T, 1.861–11T, 1.861–12T, and 1.861–13T. The term interest refers to the gross amount of interest expense incurred by a taxpayer in a given tax year. The method of allocation and apportionment for interest set forth in this section is based on the approach that, in general, money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. Exceptions to the fungibility rule are set forth in §1.861–10T. The fungibility approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. When borrowing will generally free other funds for other purposes, and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes. Consistent with the principles of fungibility, except as otherwise provided, the aggregate of deductions for interest in all cases shall be considered related to all income producing activities and assets of the taxpayer and, thus, allocable to all the gross income which the assets of the taxpayer generate, have generated, or could reasonably have been expected to generate. In the case of the interest expense of members of an affiliated group, interest expense shall be considered to be allocable to all gross income of the members of the group under §1.861–11T. That section requires the members of an affiliated group to allocate and apportion the interest expense of each member of the group as if all members of such group were a single corporation. For the method of determining the interest deduction allowed to foreign corporations under section 882(c), see §1.882–5.

(b) *Interest equivalents*—(1) *Certain expenses and losses*—(i) *General rule.* Any expense or loss (to the extent deductible) incurred in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time shall be subject to allocation and apportionment under the rules of this section if such expense or loss is substantially incurred in consideration of the time value of money. However, the allocation and apportionment of a loss under this paragraph (b) shall not affect the characterization of such loss as capital or ordinary for other purposes of the Code and the regulations thereunder.

(ii) Examples. The rule of this paragraph (b)(1) may be illustrated by the following examples.

Example 1. W, a domestic corporation, borrows from X two ounces of gold at a time when the spot price for gold is $500 per ounce. W agrees to return the two ounces of gold in six months. W sells the two ounces of gold to Y for $1000. W then enters into a contract with Z to purchase two ounces of gold six months in the future for $1,050. In exchange for the use of $1,000 in cash, W has sustained a loss of $50 on related transactions. This loss is subject to allocation and apportionment under the rules of this section in the same manner as interest expense.

Example 2. X, a domestic corporation with a dollar functional currency, borrows 100 pounds on January 1, 1987 for a three-year term at an interest rate greater than the applicable federal rate for dollar loans. At this time, the interest rate on the pound was approximately equal to the interest rate on dollar borrowings and the forward price on the pound, vis-a-vis the dollar, was approximately equal to the spot price. On January 1, 1987, X converted 100 pounds into dollars and entered into a currency swap that substantially hedged X’s foreign currency exposure on the pound borrowing, both with respect to interest and principal. The borrowing, coupled with the swap, represents a series of related transactions in which the taxpayer secures the use of funds in its functional currency. Any net foreign currency loss on this series of transactions constitutes a loss incurred substantially in consideration of the time value of money and shall be apportioned in the same manner as interest expense. Thus, if the pound depreciates against the dollar, such that when the first payment on the pound borrowing is due the taxpayer has a currency loss on the swap payment hedging its first interest payment, such loss shall, even if the transaction is not integrated under section 988(d), be allocated and apportioned in the same manner as interest expense under the authority of this paragraph (b)(1).

Example 3. On January 1, 1987, X, a domestic corporation with a dollar functional currency, enters into a dollar interest rate swap contract with Y, a domestic counterparty. Under the terms of this agreement, X agrees to pay Y floating rate interest with respect to a notional principal amount of $100 for five years. In return, Y agrees to pay X fixed rate interest at 10 percent with respect to a notional principal amount of $100 for five years. On the same day, Y prepays the fixed leg of the swap by making a lump sum payment of $37 to X. This lump sum payment represents the present value of five $10 swap payments. Because X secures the use of $37 in this transaction, any net swap expense arising from the transaction represents an expense incurred substantially in consideration of the time value of money. Assuming this lump sum payment is not otherwise characterized as a loan from Y to X, and that X must amortize the $37 lump sum payment under the principles of Notice 89–21, any net swap expense incurred by X with respect to this transaction (*i.e.*, the excess, if any, of X's annual swap payment to Y over the annual amortization of the $37 lump sum payment that is taken into income by X) represents an expense equivalent to interest expense. The result would be the same if X sold the fixed leg to a third party for $37. While this example presents the case of a lump sum payment, the rules of paragraph (b)(1) would also apply to any transaction in which the swap payments are not substantially contemporaneous if the pricing of the transaction is materially affected by the time value of money. Thus, expenses and losses will be subject to apportionment under the rules of this section to the extent that such expenses or losses were incurred in consideration of the time value of money.

(2) *Certain foreign currency borrowings*—(i) *Rule.* If a taxpayer borrows in a nonfunctional currency at a rate of interest that is less than the applicable federal rate (or its equivalent in functional currency if the functional currency is not the dollar), any swap, forward, future, option, or similar financial arrangement (or any combination thereof) entered into by the taxpayer or by a related person (as defined in § 1.861–8T(c)(2)) that exists during the term of the borrowing and that substantially diminishes currency risk with respect to the borrowing or interest expense thereon will be presumed to constitute a hedge of such borrowing, unless the taxpayer can demonstrate on the basis of facts and circumstances that the two transactions are in fact unrelated. Under this presumption, the currency loss incurred on the borrowing during taxable years beginning after December 31, 1988, in connection with hedged nonfunctional currency borrowings, reduced or increased by the gain or loss on the hedge, will be apportioned in the same manner as interest expense. This presumption can be rebutted by a showing that the financial arrangement was entered into in connection with hedging currency exposure arising in the ordinary course of a trade or business (other than with respect to the borrowing).

(ii) *Examples.* The principles of this paragraph (b)(2) may be illustrated by the following examples.

Example 1. Taxpayer has a dollar functional currency and does not have any qualified business units with a functional currency other than the dollar. On January 1, 1989, when the unit of foreign currency is worth $1, taxpayer borrows 100 units of foreign currency for a three-year period bearing interest at the annual rate of 3 percent and immediately converts the proceeds of the borrowing into dollars for use in its business. In the ordinary course of its business, taxpayer has no foreign currency exposure in this currency. In March 1989, taxpayer enters into a three-year swap agreement that covers most, but not all, of the payment of interest and principal. Because the swap substantially diminishes currency risk with respect to the borrowing, it is presumed to hedge the loan. Since taxpayer cannot demonstrate that it was hedging currency exposure arising in the ordinary course of its business (other than currency exposure with respect to the borrowing), the net currency loss on the borrowing adjusted for any gain or loss on the swap must be apportioned in the same manner as interest expense.

Example 2. Assume the same facts as in Example 1, except that the taxpayer borrows in two separate foreign currencies on terms described in Example 1 and enters into a swap agreement in a single currency that substantially diminishes the taxpayer's aggregate foreign currency risk. The net currency loss on the borrowings adjusted for any gain or loss on the swap must be apportioned in the same manner as interest expense.

(3) *Losses on sale of certain receivables*—(1) *General rule.* Any loss on the sale of a trade receivable (as defined in § 1.954–2(h)) shall be allocated and apportioned, solely for purposes of this section and §§ 1.861–10T, 1.861–11T, 1.861–12T, and 1.861–13T, in the same manner as interest expense, unless at the time of sale of the receivable, it bears interest at a rate which is at least 120 percent of the short term applicable federal rate (as determined under section 1274(d) of the Code), or its equivalent in foreign currency in the case of receivables denominated in foreign currency, determined at the time the receivable arises. This treatment shall not affect the characterization of such expense as interest for other purposes of the Internal Revenue Code.

(ii) *Exceptions.* To the extent that a loss on the sale of a trade receivable exceeds the discount on the receivable that would be computed applying to the amount received on the sale of the receivable 120 percent of the applicable federal rate (or its equivalent in foreign currency in the case of receivables denominated in foreign currency) for the period commencing with the date on which the receivable is sold and ending with the earlier of the date on which the receivable begins to bear interest at such rate or the anticipated payment date of the receivable, such excess shall not be allocated and apportioned in the same manner as interest expense but rather shall be allocated and apportioned to the gross income generated by the receivable. In cases of transfers of receivables to a domestic international sales corporation described § 1.994–1(c)(6)(v), the rule of this paragraph (b)(3) shall not apply for purposes of computing combined taxable income. In computing the combined taxable income of a foreign sales corporation and its related supplier, loss on the sale of receivables to a third party incurred either by the foreign sales corporation or its related supplier shall offset combined taxable income, notwithstanding the provisions of this paragraph (b)(3). See § 1.924(a)–1T(g)(7).

Example. On October 1, X sells a widget to Y for $100 payable in 30 days, after which the receivable will bear stated interest at 13 percent. On October 4, X sells Y's obligation to Z for $98. Assume that the applicable federal rate for the month of October is 10 percent. Applying 120 percent of the applicable federal rate to the $98 received on the sale of the receivable, the obligation is discounted at a 12 percent rate for a period of 27 days. At this discount rate, the obligation would have sold for $99.22. Thus, 88 cents of the $2 loss on the sale is apportioned in the same manner as interest expense, and $1.22 of the $2 loss on the sale is directly allocated to the income generated on the widget sale.

(4) *Rent in certain leasing transactions.* [Reserved]

(5) *Treatment of bond premium*—(i) *Treatment by the issuer.* If a bond or other debt obligation is issued at a premium, an amount of interest expense incurred by the issuer on that bond or other debt obligation equal to the amortized portion of that premium that is included in gross income for the year shall be allocated and apportioned solely to the amortized portion of premium derived by the issuer for the year.

(ii) *Treatment by the holder.* If a bond or debt obligation is purchased at a premium, the portion of that premium amortized during the year by the holder under section 171 and the regulations thereunder shall be allocated and apportioned solely to interest income derived from the bond by the holder for the year.

(6) *Financial products that alter effective cost of borrowing*—(i) *In general.* Various derivative financial products can be part of transactions or series of transactions described in paragraph (b)(1) of this section. Such derivative financial products, including interest rate swaps, options, forwards, caps, and collars, potentially alter a taxpayer's effective cost of borrowing with respect to an actual liability of the taxpayer. For example, a taxpayer that is obligated to pay interest at a fixed rate may, in effect, pay interest at a floating rate by entering into an interest rate swap. Similarly, a taxpayer that is obligated to pay interest at a floating rate may, in effect, limit its exposure to rising interest rates by purchasing a cap. Such a taxpayer may have gains

or losses associated with such derivative financial products. This paragraph (b)(6) provides rules for the treatment of gains and losses from such derivative financial products (''financial products'') that are part of transactions described in paragraph (b)(1) of this section and that are used by the taxpayer to alter its effective cost of borrowing with respect to an actual liability. This paragraph (b)(6) shall only apply where the hedge and the borrowing are in the same currency and shall not apply to the extent otherwise provided in section 988 and the regulations thereunder. The allocation and apportionment of a loss under this paragraph (b) shall not affect the characterization of such loss as capital or ordinary for other purposes of the Code and the regulations thereunder.

(ii) *Definition of gain and loss.* For purposes of this paragraph (b)(6), the term ''gain'' refers to the excess of the amounts properly taken into income under a financial product that alters the effective cost of borrowing over the amounts properly allowed as a deduction thereunder within a given taxable year. See. *e.g.,* Notice 89–21. The term ''loss'' refers to the excess of the amounts properly allowed as a deduction under such a financial product over the amounts properly taken into income thereunder within a given taxable year.

(iii) *Treatment of gain or loss on the disposition of a financial product.* [Reserved]

(iv) *Entities that are not financial services entities.* An entity that does not constitute a financial services entity within the meaning of § 1.904–4(e)(3) shall treat gains and losses on financial products described in paragraph (b)(6)(i) of this section as follows.

(A) *Losses.* Losses on any financial product described in paragraph (b)(6)(i) of this section shall be apportioned in the same manner as interest expense whether or not such financial product is identified by the taxpayer under paragraph (b)(6)(iv)(C) of this section as a liability hedge.

(B) *Gains.* Gains on any financial product described in paragraph (b)(6)(i) of this section shall reduce the taxpayer's total interest expense that is subject to apportionment, but only if such financial product is identified by the taxpayer under paragraph (b)(6)(iv)(C) of this section as a liability hedge. Such reduction is accomplished by directly allocating interest expense to the income derived from such a financial product.

(C) *Identification of financial products.* A taxpayer can identify a financial product described in paragraph (b)(6)(i) of this section as hedging a particular interest-bearing liability (or any group of such liabilities) by clearly identifying on its books and records on the same day that it becomes a party to such arrangement that such arrangement hedges a given liability (or group of liabilities). In the case of a partial hedge, such identification shall apply to only that part of the liability that is hedged. If the taxpayer clearly identifies on its books and records a financial product as a hedge of an interest-bearing asset (or any group of such assets), it will create a rebuttable presumption that such financial product is not described in paragraph (b)(6)(i) of this section. A taxpayer may identify a hedge as relating to an anticipated liability, provided that such liability is in fact incurred within 120 days following the date of such identification. Gains and losses on such an anticipatory arrangement accruing prior to the time at which the liability is incurred shall constitute an adjustment to interest expense.

(v) *Financial services entities.* [Reserved]

(vi) *Dealers.* The rule of paragraph (b)(6)(iv) of this section shall not apply to a person acting in its capacity as a regular dealer in the financial products described in paragraph (b)(6)(i) of this section. Instead, losses sustained by a regular dealer in connection with such financial products shall be allocated to the class of gross income from such arrangements. Gains of a regular dealer in notional principal contracts are governed by the rules of § 1.863–7T(b). Amounts received or accrued by any person from any financial product that is integrated as specified in Notice 89–90 with an asset shall not be treated as amounts received or accrued by a person acting in its capacity as a regular dealer in financial products.

(vii) *Examples.* The principles of this paragraph (b)(6) may be illustrated by the following examples.

Example 1. X is not a financial services entity or regular dealer in the financial products described in paragraph (b)(6)(i) of this section and has a dollar functional currency. In 1990, X incurred a total of $200 of interest expense. On January 1, 1990, X entered into an interest rate swap agreement with Y, in order to hedge its interest rate exposure with respect to a pre-existing floating rate liability. On the same day, X properly identified the agreement as a hedge of such liability. Under the agreement, X is required to pay Y an amount equal to a fixed rate of 10 percent on a notional principal amount of $1,000. Y is required to pay X an amount equal to a floating rate of interest on the same notional principal amount. Under the agreement, X received from Y during 1990 a net payment of $25. Because X identified the swap agreement as a liability hedge under the rules of paragraph (b)(6)(iv)(C), X may effectively reduce its total allocable interest expense for 1990 to $175 by directly allocating $25 of interest expense to the swap income. Had X not properly identified the swap as a liability hedge, this swap payment would have been treated as domestic source income in accordance with the rule of §1.863–7T(b).

Example 2. Assume the same facts as Example (1), except that X did not properly identify the agreement as a liability hedge on January 1, l990. In 1990, X made a net payment of $25 to Y under the swap agreement. This swap payment is allocated and apportioned in the same manner as interest expense under the rules of paragraph (b)(6)(iv)(A).

(viii) *Effective dates*—(A) *Losses.* The rules of this paragraph (b)(6) shall apply to losses on any transaction described in paragraph (b)(6)(i) of this section that was entered into after September 14, 1988.

(B) *Gains.* Except as provided in paragraph (b)(6)(viii)(C) of this section, the rules of this paragraph (b)(6) shall apply to any gain that was realized on any transaction described in paragraph (b)(6)(i) of this section that was entered into after August 14, 1989.

(C) *Exception for interim gains.* Taxpayers shall be permitted to apply the rules of this paragraph (b)(6) to any gain that was realized on any transaction described in paragraph (b)(6)(i) of this section that was entered into after September 14, 1988 and on or before August 14, 1989, if the taxpayer can demonstrate to the satisfaction of the Commissioner that substantially all of the arrangements described in paragraph (b)(6)(i) of this section to which the taxpayer became a party during that interim period were identified on the taxpayer's books and records with the liabilities of the taxpayer in a substantially contemporaneous manner and that all losses and expenses that are subject to the rules of this paragraph (b)(6) were treated in the same manner as interest expense. For this purpose, arrangements that were identified in a substantially contemporaneous manner with the taxpayer's assets shall be ignored.

(7) *Foreign currency gain or loss.* In addition to the rules of paragraph (b)(1), (b)(2), and (b)(6) of this section, any foreign currency loss that is treated as an adjustment to interest expense under regulations issued under section 988 shall be allocated and apportioned in the same manner as interest expense. Any foreign currency gain that is treated as an adjustment to interest expense under regulations issued under section 988 shall offset apportionable interest expense.

(c) *Allowable deductions.* In order for an interest expense to be allocated and apportioned, it must first be determined that the interest expense is currently deductible. A number of provisions in the Code disallow or suspend deductions of interest expense or require the capitalization thereof.

(1) *Disallowed deductions.* A taxpayer does not allocate and apportion interest expense under this section that is permanently disallowed as a deduction by operation of section 163(h), section 265, or any other provision or rule that permanently disallows the deduction of interest expense.

(2) *Section 263A.* Section 263A requires the capitalization of interest expense that is allocable to designated types of property. Any interest expense that is capitalized under section 263A does not constitute deductible interest expense for purposes of this section. Furthermore, interest expense capitalized in inventory or depreciable property is not separately allocated and apportioned when the inventory is sold or depreciation is allowed. Capitalized interest expense is effectively allocated and apportioned as part of, and in the

same manner as, the cost of goods sold, amortization, or depreciation deduction.

(3) *Section 163(d).* Section 163(d) suspends the deduction for interest expense to the extent that it exceeds net investment income. In the year that suspended investment interest expense becomes allowable under the rules of section 163(d), that interest expense is apportioned under rules set forth in paragraph (d)(1) of this section as though it were incurred in the taxable year in which the expense is deducted.

(4) *Section 469*—(i) *General rule.* Section 469 suspends the deduction of passive activity losses to the extent that they exceed passive activity income for the year. Passive activity losses may consist in part of interest expense properly allocable to passive activity. In the year that suspended interest expense becomes allowable as a deduction under the rules of section 469, that interest expense is apportioned under rules set forth in paragraph (d)(1) of this section as though it were incurred in the taxable year in which the expense is deducted.

(ii) *Identification of the interest component of a suspended passive loss.* A suspended passive loss may consist of a variety of items of expense other than interest expense. Suspended interest expense for any taxable year is computed by multiplying the total suspended passive loss for the year by a fraction, the numerator of which is passive interest expense for the year (determined under regulations issued under section 163) and the denominator of which is total passive expenses for the year. The amount of the suspended interest expense that is considered to be deductible in a subsequent taxable year is computed by multiplying the amount of any cumulative suspended interest expense (reduced by suspended interest expense allowed as a deduction in prior taxable years) times a fraction, the numerator of which is the portion of cumulative suspended passive losses that become deductible in the taxable year and the denominator of which is the cumulative suspended passive losses for prior taxable years (reduced by suspended passive losses allowed as deductions in prior taxable years).

(iii) *Example.* The rules of this paragraph (c)(4) may be illustrated by the following example.

Example. On January 1, 1987, A, a United States citizen, invested in a passive activity. In 1987, the passive activity generated no passive income and $100 in passive losses, all of which were suspended by operation of section 469. The suspended loss included $10 of suspended interest expense. In 1988, the passive activity generated $50 in passive income and $150 in passive expenses which included $30 of interest expense. The entire $100 passive loss was suspended in 1988 and included $20 of interest expense ($100 suspended passive loss × $30 passive interest expense/$150 total passive expenses). Thus, at the end of 1988, A had total suspended passive losses of $200, including $30 of suspended interest expense. In 1989, the passive activity generated $100 in passive income and no passive expenses. Thus, $100 of A's cumulative suspended passive loss was therefore allowed in 1989. The $100 of deductible passive loss includes $15 of suspended interest expense ($30 cumulative suspended interest expense × $100 of cumulative suspended passive losses allowable in 1989/$200 of total cumulative suspended passive losses). The $15 of interest expense is apportioned under the rules of paragraph (d) of this section as though it were incurred in 1989.

(d) *Apportionment rules for individuals, estates, and certain trusts*—(1) *United States individuals.* In the case of taxable years beginning after December 31, 1986, individuals generally shall apportion interest expense under different rules according to the type of interest expense incurred. The interest expense of individuals shall be characterized under the regulations issued under section 163. However, in the case of an individual whose foreign source income (including income that is excluded under section 911) does not exceed a gross amount of $5,000, the apportionment of interest expense under this section is not required. Such an individual's interest expense may be allocated entirely to domestic source income.

(i) *Interest incurred in the conduct of a trade or business.* An individual who incurs business interest described in section 163(h)(2)(A) shall apportion such interest expense using an asset method by reference to the individual's business assets.

(ii) *Investment interest.* An individual who incurs investment interest described in section 163(h)(2)(B) shall apportion that interest expense on the basis of the individual's investment assets.

(iii) *Interest incurred in a passive activity.* An individual who incurs passive activity interest described in section 163(h)(2)(C) shall apportion that interest expense on the basis of the individual's passive activity assets. Individuals who receive a distributive share of interest expense incurred in a partnership are subject to special rules set forth in paragraph (e) of this section.

(iv) *Qualified residence and deductible personal interest.* Individuals who incur qualified residence interest described in section 163(h)(2)(D) shall apportion that interest expense under a gross income method, taking into account all income (including business, passive activity, and investment income) but excluding income that is exempt under section 911. For purposes of this section, any qualified residence that is rented shall be considered to be a business asset for the period in which it is rented, with the result that the interest on such a residence is not apportioned under this subdivision (iv) but instead under subdivisions (i) or (iii) of this paragraph (d)(1). To the extent that personal interest described in section 163(h)(2) remains deductible under transitional rules, individuals shall apportion such interest expense in the same manner as qualified residence interest.

(v) *Example.* The following example illustrates the principles of this section.

Example —(i) *Facts.* A is a resident individual taxpayer engaged in the active conduct of a trade or business, which A operates as a sole proprietor. A's business generates only domestic source income. A's investment portfolio consists of several less than 10 percent stock investments. Certain stocks in which A's adjusted basis is $40,000 generate domestic source income and other stocks in which A's adjusted basis is $60,000 generate foreign source passive income. In addition, A owns his personal residence, which is subject to a mortgage in the amount of $100,000. All interest expense incurred with respect to A's mortgage is qualified residence interest for purposes of section 163(h)(2)(D). A's other indebtedness consists of a bank loan in the amount of $40,000. Under the regulations issued under section 163(h), it is determined that the proceeds of the $40,000 loan were divided equally between A's business and his investment portfolio. In 1987, the gross income of A's business, before the apportionment of interest expense, was $50,000. A's investment portfolio generated $4,000 in domestic source income and $6,000 in foreign source passive income. All of A's debt obligations bear interest at the annual rate of 10 percent.

(ii) *Analysis of business interest.* Under section 163(h) of the Code, $2,000 of A's interest expense is attributable to his business. Under the rules of paragraph (d)(1)(i), such interest must be apportioned on the basis of the business assets. Applying the asset method described in paragraph (g) of this section, it is determined that all of A's business assets generate domestic income and, therefore, constitute domestic assets. Thus, the $2,000 in interest expense on the business loan is allocable to domestic source income.

(iii) *Analysis of investment interest.* Under section 163(h) of the Code, $2,000 of A's interest expense is investment interest. Under the rules of paragraph (d)(1)(ii) of this section, such interest must be apportioned on the basis of investment assets. Applying the asset method, A's investment assets consist of stock generating domestic source income with an adjusted basis of $40,000 and stock generating foreign source passive income with an adjusted basis of $60,000. Thus, 40 percent ($800) of A's investment interest is apportioned to domestic source income and 60 percent ($1,200) of A's investment interest is apportioned to foreign source passive income for purposes of section 904.

(iv) *Analysis of qualified residence interest.* The $10,000 of qualified residence interest expense is apportioned under the rules of paragraph (d)(1)(iv) of this section on the basis of all of A's gross income. A's gross income consists of $60,000, $54,000 of which is domestic source and $6,000 of which is foreign source passive income. Thus, $9,000 of A's qualified residence interest is apportioned to domestic source income and $1,000 of A's qualified residence interest is apportioned to foreign source passive income.

(2) *Nonresident aliens*—(i) *General rule.* For taxable years beginning on or after January 1, 1988, interest expense incurred by a nonresident alien shall be considered to be connected with income effectively connected with a United States trade or business only to the extent that interest expense is incurred with respect to liabilities that—

(A) Are entered on the books and records of the United States trade or business when incurred, or

(B) Are secured by assets that generate such effectively connected income.

(ii) *Limitations*—(A) *Maximum debt capitalization.* Interest expense incurred by a nonresident alien is not considered to be connected with effectively connected income to the extent that it is incurred with respect to liabilities that exceed 80 percent of the gross assets of the United States trade or business.

(B) *Collateralization by other assets.* Interest expense on indebtedness that is secured by specific assets (not including the general credit of the nonresident alien) other than the assets of the United States trade or business shall not be considered to be connected with effectively connected income.

(3) *Estates and trusts.* Estates shall be treated in the same manner as individuals. In the case of a trust that is beneficially owned by individuals and is a complex trust, the trust shall be treated in the same manner as individuals under the rules of paragraph (d) of this section, except that no de minimis amount shall apply. In the case of a trust that is beneficially owned by one or more corporations, the trust shall be treated either as a partnership or as a corporation depending on how the trust is characterized under the rules of section 7701 and the regulations thereunder.

(e) *Partnerships*—(1) *In general—aggregate rule.* A partner's distributive share of the interest expense of a partnership that is directly allocable under §1.861–10T to income from specific partnership property shall be treated as directly allocable to the income generated by such partnership property. Subject to the exceptions set forth in paragraph (e)(4), a partner's distributive share of the interest expense of a partnership that is not directly allocable under §1.861–10T generally is considered related to all income producing activities and assets of the partner and shall be subject to apportionment under the rules described in this paragraph. For purposes of this section, a partner's percentage interest in a partnership shall be determined by reference to the partner's interest in partnership income for the year. Similarly, a partner's pro rata share of partnership assets shall be determined by reference to the partner's interest in partnership income for the year.

(2) *Corporate partners whose interest in the partnership is 10 percent or more.* A corporate partner shall apportion its distributive share of partnership interest expense by reference to the partner's assets, including the partner's pro rata share of partnership assets, under the rules of paragraph (f) of this section if the corporate partner's direct and indirect interest in the partnership (as determined under the attribution rules of section 318) is 10 percent or more. A corporation using the tax book value method of apportionment shall use the partnership's inside basis in its assets, adjusted to the extent required under §1.861–10T(d)(2). A corporation using the fair market value method of apportionment shall use the fair market value of the partnership's assets, adjusted to the extent required under §1.861–10T(d)(2).

(3) *Individual partners who are general partners or who are limited partners with an interest in the partnership of 10 percent or more.* An individual partner is subject to the rules of this paragraph (e)(3) if either the individual is a general partner or the individual's direct and indirect interest (as determined under the attribution rules of section 318) in the partnership is 10 percent or more. The individual shall first classify his or her distributive share of partnership interest expense as interest incurred in the active conduct of a trade or business, as passive activity interest, or as investment interest under regulations issued under sections 163 and 469. The individual must then apportion his or her interest expense (including the partner's distributive share of partnership interest expense) under the rules of paragraph (d) of this section. Each such individual partner shall take into account his or her distributive share of partnership gross income or pro rata share of the partnership assets in applying such rules. An individual using the tax book value method of apportionment shall use the partnership's inside basis in its assets, adjusted to the extent required under §1.861–10T(d)(2). An individual using the fair market value method of apportionment shall use the fair market

value of the partnership's assets, adjusted to the extent required under § 1.861–10T(d)(2).

(4) *Less than 10 percent limited partners and less than 10 percent corporate general partners—entity rule*—(i) *Partnership interest expense.* A limited partner (whether individual or corporate) or corporate general partner whose direct and indirect interest (as determined under the attribution rules of section 318) in the partnership is less than 10 percent shall directly allocate its distributive share of partnership interest expense to its distributive share of partnership gross income. Under § 1.904–7(i)(2) of the regulations, such a partner's distributive share of foreign source income of the partnership is treated as passive income (subject to the high taxed income exception of section 904(d)(2)(F)), except in the case of high withholding tax interest or income from a partnership interest held in the ordinary course of the partner's active trade or business, as defined in § 1.904–7(i)(2). A partner's distributive share of partnership interest expense (other than partnership interest expense that is directly allocated to identified property under § 1.861–10T) shall be apportioned in accordance with the partner's relative distributive share of gross foreign source income in each limitation category and of domestic source income from the partnership. To the extent that partnership interest expense is directly allocated under § 1.861–10T, a comparable portion of the income to which such interest expense is allocated shall be disregarded in determining the partner's relative distributive share of gross foreign source income in each limitation category and domestic source income. The partner's distributive share of the interest expense of the partnership that is directly allocable under § 1.861–10T shall be allocated according to the treatment, after application of § 1.904–7(i)(2), of the partner's distributive share of the income to which the expense is allocated.

(ii) *Other interest expense of the partner.* For purposes of apportioning other interest expense of the partner on an asset basis, the partner's interest in the partnership, and not the partner's pro rata share of partnership assets, is considered to be the relevant asset. The value of this asset for apportionment purposes is either the tax book value or fair market value of the partner's partnership interest, depending on the method of apportionment used by the taxpayer. This amount of a partner's interest in the partnership is allocated among various limitation categories in the same manner as partnership interest expense (that is not directly allocable under § 1.861–10T) is apportioned in subdivision (i) of this paragraph (e)(4). If the partner uses the tax book value method of apportionment, the partner's interest in the partnership must be reduced, for this purpose, to the extent that the partner's basis consists of liabilities that are taken into account under section 752. Under either the tax book value or fair market value method of apportionment, for purposes of this section only, the value of the partner's interest in the partnership must be reduced by the principal amount of any indebtedness of the partner the interest on which is directly allocated to its partnership interest under § 1.861–10T.

(5) *Tiered partnerships.* If a partnership is a partner in another partnership, the distributive share of interest expense of a lower-tier partnership that is subject to the rules of paragraph (e)(4) shall not be reapportioned in the hands of any higher-tier partner. However, the distributive share of interest expense of lower-tier partnership that is subject to the rules of paragraph (e) (2) or (3) shall be apportioned by the partner of the higher-tier partnership or by any higher-tier partnership to which the rules of paragraph (e)(4) apply, taking into account the partner's indirect pro rata share of the lower-tier partnership's income or assets.

Example —(i) *Facts.* X is a domestic

(6) Example—(i) Facts. A, B, and C are partners in a limited partnership. A is a corporate general partner, owns a 5 percent interest in the partnership, and has an adjusted basis in its partnership interest, determined without regard to section 752 of the Code, of $5. A's investment in the partnership is not held in the ordinary course of the taxpayer's active trade or business, as defined in § 1.904–7(i)(2). B, a corporate limited partner, owns a 70 percent interest in the partnership, and has an adjusted basis in its

partnership interest, determined without regard to section 752 of the Code, of $70. C is an individual limited partner, owns a 25 percent interest in the partnership, and has an adjusted basis in the partnership interest, determined without regard to section 752 of the Code, of $25. The partners' interests in the profits and losses of the partnership conform to their respective interests. None of the interest expense incurred directly by any of the partners is directly allocable to their partnership interest under § 1.861–10T. The ABC partnership's sole assets are two apartment buildings, one domestic and the other foreign. The domestic building has an adjusted inside basis of $600 and the foreign building has an adjusted inside basis of $500. Each of the buildings is subject to a nonrecourse liability in the amount of $500. The ABC partnership's total interest expense for the taxable year is $120, both nonrecourse liabilities bearing interest at the rate of 12 percent. The indebtedness on the domestic building qualifies for direct allocation under the rules of § 1.861–10T. The indebtedness on the foreign building does not so qualify. The partnership incurred no foreign taxes. The partnership's gross income for the taxable year is $360, consisting of $100 in foreign source income and $260 in domestic source income. Under § 1.752–1(e), the nonrecourse liabilities of the partnership are allocated among the partners according to their share of the partnership profits. Accordingly, the adjusted basis of A, B, and C in their respective partnership interests (for other than apportionment purposes) is, respectively, $55, $770, and $275.

(ii) *Determination of the amount of partnership interest expense that is subject to allocation and apportionment.* Interest on the nonrecourse loan on the domestic building is, under § 1.861–10T, directly allocable to income from that investment. The interest expense is therefore directly allocable to domestic income. Interest on the nonrecourse loan on the foreign building is not directly allocable. The interest expense is therefore subject to allocation and apportionment. Thus, $60 of interest expense is directly allocable to domestic income and $60 of interest expense is subject to allocation and apportionment.

(iii) *Analysis for Partner A.* A's distributive share of the partnership's gross income is $18, which consists of $5 in foreign source income and $13 in domestic source income. A's distributive share of the ABC interest expense is $6, $3 of which is directly allocable to domestic income and $3 of which is subject to apportionment. After direct allocation of qualifying interest expense, A's distributive share of the partnership's gross income consists of $5 in foreign source income and $10 in domestic source income. Because A is a less than 10 percent corporate partner, A's distributive share of any foreign source partnership income is considered to be passive income. Accordingly, in apportioning the $3 of partnership interest expense that is subject to apportionment on a gross income method, one-third ($1) is apportioned to foreign source passive income and two-thirds ($2) is apportioned to domestic source income. In apportioning its other interest expense, A uses the tax book value method. A's adjusted basis in A's partnership interest ($55) includes A's share of the partnership's liabilities ($50), which are included in basis under section 752. For purposes of apportioning other interest expense, A's adjusted basis in the partnership must be reduced to the extent of such liabilities. Thus, A's adjusted basis in the partnership, for purposes of apportionment, is $5. For the purpose of apportioning A's other interest expense, this $5 in basis is characterized one-third as a foreign passive asset and two-thirds as a domestic asset, which is the ratio determined in paragraph (e)(4)(i).

(iv) *Analysis for Partner B.* B's distributive share of the ABC interest expense is $84, $42 of which is directly allocable to domestic income and $42 of which is subject to apportionment. As a corporate limited partner whose interest in the partnership is 10 percent or more, B is subject to the rules of paragraph (e)(2) and paragraph (f) of this section. These rules require that a corporate partner apportion its distributive share of partnership interest expense at the partner level on the asset method described in paragraph (g) of this section by reference to its corporate assets, which include, for this purpose, 70 percent of the partnership's assets, adjusted in the manner described in § 1.861–10T(e) to reflect directly allocable interest expense.

(v) *Analysis for Partner C.* C's distributive share of the ABC interest expense is $30, $15 of which is directly allocable to domestic income and $15 of which is subject to apportionment. As an individual limited partner whose interest in the partnership is 10 percent or more, C is subject to the rules of paragraph (e)(3) of this section. These rules require that an individual's share of partnership interest expense be classified under regulations issued under section 163(h) and then apportioned under the rules applicable to individuals, which are set forth in paragraph (d) of this section.

(7) *Foreign partners.* The distributive share of partnership interest expense of a nonresident alien who is a partner in a partnership shall be considered to be connected with effectively connected income based on the percentage of the assets of the partnership that generate effectively connected income. No interest expense directly incurred by the

partner may be allocated and apportioned to effectively connected income derived by the partnership.

(f) *Corporations*—(1) *Domestic corporations.* Domestic corporations shall apportion interest expense using the asset method described in paragraph (g) of this section and the applicable rules of §§ 1.861–10T through 1.861–13T.

(2) *Foreign branches of domestic corporations.* In the application of the asset method described in paragraph (g) of this section, a domestic corporation shall—

(i) Take into account the assets of any foreign branch, translated according to the rules set forth in paragraph (g) of this section, and

(ii) Combine with its own interest expense any deductible interest expense incurred by a branch, translated according to the rules of section 987 and the regulations thereunder.

For purposes of computing currency gain or loss on any remittance from a branch or other qualified business unit (as defined in § 1.989(a)–1T) under section 987, the rules of this paragraph (f) shall not apply. The branch shall compute its currency gain or loss on remittances by taking into account only its separate expenses and its separate income.

Example —(i) *Facts.* X is a domestic corporation which operates B, a branch doing business in a foreign country. In 1988, without regard to branch B, X has gross domestic source income of $1,000 and gross foreign source general limitation income of $500 and incurs $200 of interest expense. Using the tax book value method of apportionment, X, without regard to branch B, determines the value of its assets that generate domestic source income to be $6,000 and the value of its assets that generate foreign source general limitation income to be $1,000. B constitutes a qualified business unit within the meaning of section 989 with a functional currency other than the U.S. dollar and uses the profit and loss method prescribed by section 987. Applying the translation rules of section 987, B earned $500 of gross foreign general limitation income and incurred $100 of interest expense. B incurred no other expenses. For 1988, the average functional currency book value of B's assets that generate foreign general limitation income translated at the year-end rate for 1988 is $3,000.

(ii) *Computation of net income.* The combined assets of X and B for 1988 (averaged under the rules of § 1.861–9T(g)(3)) consist 60 percent of assets generating domestic source income and 40 percent of assets generating foreign source general limitation income. The combined interest expense of both X and B is $300. Thus, $180 of the combined interest expense is apportioned to domestic source income and $120 is apportioned to the foreign source income, yielding net domestic source income of $820 and net foreign source general limitation income of $880.

(iii) *Computation of currency gain or loss.* For purposes of computing currency gain or loss on branch remittances, B takes into account only its gross income and its separate expenses. In 1988, B therefore has a net amount of income in foreign currency units equal in value to $400. Gain or loss on remittances shall be computed by reference to this amount.

(3) *Controlled foreign corporations*—(i) *In general.* For purposes of computing subpart F income and computing earnings and profits for all other federal tax purposes, the interest expense of a controlled foreign corporation may be apportioned either using the asset method described in paragraph (g) of this section or using the modified gross income method described in paragraph (j) of this section, subject to the rules of subdivisions (ii) and (iii) of this paragraph (f)(2). However, the gross income method described in paragraph (j) of this section is not available to any controlled foreign corporation if a United States shareholder and the members of its affiliated group (as defined in § 1.861–11T(d)) constitute controlling shareholders of such controlled foreign corporation and such affiliated group elects the fair market value method of apportionment under paragraph (g) of this section.

(ii) *Manner of election.* The election to use the asset method described in paragraph (g) of this section or the modified gross income method described in paragraph (j) of this section may be made either by the controlled foreign corporation or by the controlling United States shareholders on behalf of the controlled foreign corporation. The term ‘‘controlling United States shareholders’’ means those United States shareholders (as defined in section 951(b)) who, in aggregate, own (within the meaning of section 958(a)) greater than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote. In the case of a controlled foreign corporation in which the United States shareholders own stock representing more than 50 percent of the value of the stock in such corporation, but less than 50 percent of the combined voting power of all classes of stock in such corporation, the term ''controlling United States shareholders'' means all the United States shareholders (as defined in section 951(b)) who own (within the meaning of section 958(a)) stock of the controlled foreign corporation. All United States shareholders are bound by the election of either the controlled foreign corporation or the controlling United States shareholders. The election shall be made by filing a written statement described in § 1.964–1(c)(3)(ii) at the time and in the manner described therein and providing a written notice described in § 1.964–1(c)(3)(iii), except that no such written statement or notice is required to be filed or sent before March 13, 1989.

(iii) *Consistency requirement.* The same method of apportionment must be employed by all controlled foreign corporations in which a United States taxpayer and the members of its affiliated group (as defined in § 1.861–11T(d)) constitute controlling United States shareholders. A controlled foreign corporation that is required by this paragraph (f)(3)(iii) to utilize a particular method of apportionment must do so with respect to all United States shareholders.

(iv) *Stock characterization.* Pursuant to § 1.861–12T(c)(2), the stock of a controlled foreign corporation shall be characterized in the hands of any United States shareholder using the same method that the controlled foreign corporation uses to apportion its interest expense.

(4) *Other relevant provisions.* Affiliated groups of corporations are subject to special rules set forth in § 1.861–11T. Section 1.861–12T sets forth rules relating to basis adjustments for stock in nonaffiliated 10 percent owned corporations, special rules relating to the consideration and characterization of certain assets in the apportionment of interest expense, and to other special rules pertaining to the apportionment of interest expense. Section 1.861–13T contains transition rules limiting the application of the rules of §§ 1.861–8T through 1.861–12T, which are otherwise applicable to taxable years beginning after 1986. In the case of an affiliated group of corporations as defined in § 1.861–11T(d), any reference in §§ 1.861–8T through 1.861–13T to the ''taxpayer'' with respect to the allocation and apportionment of interest expense generally denotes the entire affiliated group of corporations and not the separate members thereof, unless the context otherwise requires.

(g) *Asset method*—(1) *In general.* (i) Under the asset method, the taxpayer apportions interest expense to the various statutory groupings based on the average total value of assets within each such grouping for the taxable year, as determined under the asset valuation rules of this paragraph (g)(1) and paragraph (g)(2) of this section and the asset characterization rules of paragraph (g)(3) of this section and § 1.861–12T. Except to the extent otherwise provided (*see, e.g.,* paragraph (d)(1)(iv) of this section), taxpayers must apportion interest expense only on the basis of asset values and may not apportion any interest deduction on the basis of gross income.

(ii) A taxpayer may elect to determine the value of its assets on the basis of either the tax book value or the fair market value of its assets. For rules concerning the application of the fair market value method, see paragraph (h) of this section. In the case of an affiliated group—

(A) The parent of which used the fair market value method prior to 1987, or

(B) A substantial portion of which used the fair market value method prior to 1987, such a taxpayer may use either the fair market value method or the tax book value method for its tax year commencing in 1987 and may use either such method in its tax year commencing in 1988 without regard to which method was used in its tax year commencing in 1987 and without securing the Commissioner's consent. The use of the fair market value method in 1988, however, shall operate as a binding election as described in § 1.861–8T(c)(2). For rules requiring consistency in the use of the tax book value or fair market value method, see § 1.861–8T(c)(2).

(iii) A taxpayer electing to apportion its interest expense on the basis of the fair market value of its assets must establish the fair market value to the satisfaction of the Commissioner. If a taxpayer fails to establish the fair market value of an asset to the satisfaction of the Commissioner, the Commissioner may determine the appropriate asset value. If a taxpayer fails to establish the value of a substantial portion of its assets to the satisfaction of the Commissioner, the Commissioner may require the taxpayer to use the tax book value method of apportionment.

(iv) For rules relating to earnings and profits adjustments by taxpayers using the tax book value method for the stock in certain nonaffiliated 10 percent owned corporations, see § 1.861–12T(b).

(v) The provisions of this paragraph (g)(1) may be illustrated by the following examples.

Example 1 —(i) *Facts.* X, a domestic corporation organized on January 1, 1987, has deductible interest expense in 1987 in the amount of $150,000. X apportions its expenses according to the tax book value method. The adjusted basis of X's assets is $3,600,000, $3,000,000 of which generate domestic source income and $600,000 of which generate foreign source general limitation income.

(ii) *Allocation.* No portion of the $150,000 deduction is directly allocable solely to identified property within the meaning of § 1.861–10T. Thus, X's deduction for interest is related to all its activities and assets.

(iii) *Apportionment.* X apportions its interest expense as follows:

To foreign source general limitation income:

$$\$150{,}000 \times \frac{\$600{,}000}{\$3{,}600{,}000} \,.\,.\,.\,.\,.\,\$25{,}000$$

To domestic source income:

$$\$150{,}000 \times \frac{\$300{,}000}{\$3{,}600{,}000} \,.\,.\,.\,.\,.\,\$125{,}000$$

Example 2 —(i) *Facts.* Assume the same facts as in Example 1, except that X apportions its interest expense on the basis of the fair market value of its assets. X's total assets have a fair market value of $4,000,000, $3,200,000 of which generate domestic source income and $800,000 of which generate foreign source general limitation income.

(ii) *Allocation.* No portion of the $150,000 deduction is directly allocable solely to identified property within the meaning of § 1.861–10T. Thus, X's deduction for interest is related to all its activities and properties.

(iii) *Apportionment.* If it establishes the fair market value of its assets to the satisfaction of the Commissioner, X may apportion its interest expense as follows:

To foreign source general limitation income:

$$\$150{,}000 \times \frac{\$800{,}000}{\$4{,}000{,}000} \,.\,.\,.\,.\,.\,\$30{,}000$$

To domestic source income:

$$\$150{,}000 \times \frac{\$3{,}200{,}000}{\$4{,}000{,}000} \,.\,.\,.\,.\,.\,\$120{,}000$$

(2) *Asset values*—(i) *General rule.* For purposes of determining the value of assets under this section, an average of values (book or market) within each statutory grouping and the residual grouping shall be computed for the year on the basis of values of assets at the beginning and end of the year. For the first taxable year beginning after 1986, a taxpayer may choose to determine asset values solely by reference to the year-end value of its assets, provided that all the members of an affiliated group as defined in § 1.861–11T(d) make the same choice. Thus, no averaging is required for the first taxable year beginning after 1986. Where a substantial distortion of asset values would result from averaging beginning-of-year and year-end values, as might be the case in the event of a major corporate acquisition or disposition, the taxpayer must use a different method of asset valuation that more clearly reflects the average value of assets weighted to reflect the time such assets are held by the taxpayer during the taxable year.

(ii) *Special rule for qualified business units of domestic corporations with functional currency other than the U.S. dollar*—(A) *Tax book value method.* In the case of taxpayers using the tax book value method of apportionment, the following rules shall apply to determine the value of the assets of a qualified business unit (as defined in section 989(a)) of a domestic corporation with a functional currency other than the dollar.

(*1*) *Profit and loss branch.* In the case of a branch for which an election is not effective under § 1.985–2T to use the dollar approximate separate transactions method of computing currency gain or loss, the tax book value shall be determined by applying the rules of paragraph (g)(2)(i) and (3) of this section with respect to beginning-of-year and end-of-year tax book value in units of functional currency that are translated into dollars at the end-of-year exchange rate between the functional currency and the U.S. dollar.

Example. At the end of 1987, a profit and loss branch has assets that generate foreign source general limitation income with a tax book value in units of functional currency of 100. At the end of 1987, the unit is worth $1. At the end of 1988, the branch has assets that generate foreign source general limitation income with a tax book value in units of functional currency of 80. At the end of 1988, the unit is worth $2. The average value of foreign source general limitation assets for 1988 is 90 units, which is worth $180.

(*2*) *Approximate separate transactions method.* In the case of a branch for which an election is effective under § 1.985–2T to use the dollar approximate separate transactions method to compute currency gain or loss, the beginning-of-year dollar amount of the assets shall be determined by reference to the end-of-year balance sheet of the branch for the immediately preceding taxable year, adjusted for United States generally accepted accounting principles and United States tax accounting principles, and translated into U.S. dollars as provided in § 1.985–3T. The year-end dollar amount of the assets of the branch shall be determined in the same manner by reference to the end-of-year balance sheet for the current taxable year. The beginning-of-year and end-of-year dollar tax book value of assets, as so determined, within each grouping must then be averaged as provided in paragraph (g)(2)(i) of this section.

(B) *Fair market value method.* In the case of taxpayers using the fair market value method of apportionment, the beginning-of-year and end-of-year fair market values of branch assets within each grouping shall be computed in dollars and averaged as provided in this paragraph (g)(2).

(iii) *Adjustment for directly allocated interest.* Prior to averaging, the year-end value of any asset to which interest expense is directly allocated during the current taxable year under the rules of § 1.861–10T (b) or (c) shall be reduced (but not below zero) by the percentage of the principal amount of indebtedness outstanding at year-end equal to the percentage of all interest on the debt for the taxable year that is directly allocated.

(iv) *Assets in intercompany transactions.* In the application of the asset method described in this paragraph (g), the tax book value of assets transferred between affiliated corporations in intercompany transactions shall be determined without regard to the gain or loss that is deferred under the regulations issued under section 1502.

(v) Example. X is a domestic corporation that uses the fair market value method of apportionment. X is a calendar year taxpayer. X owns 25 percent of the stock of A, a noncontrolled section 902 corporation. At the end of 1987, the fair market value of X's assets by income grouping are as follows:

Domestic	$1,000,000
Foreign general limitation	500,000
Foreign passive	500,000
Noncontrolled section 902 corporation	50,000

For its 1987 tax year, X apportions its interest expense by reference to the 1987 year-end values. In July of 1988, X sells a portion of its investment in A and in an asset acquisition purchases a shipping business, the assets of which generate exclusively foreign shipping income. At the end of 1988, the fair market values of X's assets by income grouping are as follows:

Domestic	$800,000
Foreign general limitation	900,000
Foreign passive	300,000
Noncontrolled section 902 corporation	40,000
Foreign shipping	100,000

For its 1988 tax year, X shall apportion its interest expense by reference to the average of the 1988 beginning-of-year values (the 1987 year-end values) and the 1988 year-end values, assuming that the averaging of beginning-of-year and end-of-year values does not cause a substantial distortion of asset values. These averages are as follows:

Domestic	$900,000
Foreign general limitation	700,000
Foreign passive	400,000
Foreign shipping	50,000
Noncontrolled section 902 corporation	45,000

(3) *Characterization of assets.* Assets are charactrized for purposes of this section according to the source and type of the income that they generate, have generated, or may reasonably be

expected to generate. The physical location of assets is not relevant to this determination. Subject to the special rules of paragraph (h) concerning the application of the fair market value method of apportionment, the value of assets within each statutory grouping and the residual grouping at the beginning and end of each year shall be determined by dividing the taxpayer's assets into three types—

(i) *Single category assets.* Assets that generate income that is exclusively within a single statutory grouping or the residual grouping;

(ii) *Multiple category assets.* Assets that generate income within more than one grouping of income (statutory or residual); and

(iii) *Assets without directly identifiable yield.* Assets that produce no directly identifiable income yield or that contribute equally to the generation of all the income of the taxpayer (such as assets used in general and administrative functions).

Single category assets are directly attributable to the relevant statutory or residual grouping of income. In order to attribute multiple category assets to the relevant groupings of income, the income yield of each such asset for the taxable year must be analyzed to determine the proportion of gross income generated by it within each relevant grouping. The value of each asset is then prorated among the relevant groupings of income according to their respective proportions of gross income. The value of each asset without directly identifiable income yield must be identified. However, because prorating the value of such assets cannot alter the ratio of assets within the various groupings of income (as determined by reference to the single and multiple category assets), they are not taken into account in determining that ratio. Special asset characterization rules that are set forth in § 1.861–12T. An example demonstrating the application of the asset method is set forth in § 1.861–12T(d).

(h) *The fair market value method.* An affiliated group (as defined in § 1.861–11T(d)) or other taxpayer (the ‘‘taxpayer'') that elects to use the fair market value method of apportionment shall value its assets according to the following methodology.

(1) *Determination of values*—(i) *Valuation of group assets.* The taxpayer shall first determine the aggregate value of the assets of the taxpayer on the last day of its taxable year without excluding the value of stock in foreign subsidiaries or any other asset. In the case of a publicly traded corporation, this determination shall be equal to the aggregate trading value of the taxpayer's stock traded on established securities markets at year-end increased by the taxpayer's year-end liabilities to unrelated persons and its pro rata share of year-end liabilities of all related persons owed to unrelated persons. In determining whether persons are related, § 1.861–8T(c)(2) shall apply. In the case of a corporation that is not publicly traded, this determination shall be made by reference to the capitalization of corporate earnings, in accordance with the rules of Rev. Rul. 68–609. In either case, control premium shall not be taken into account.

(ii) *Valuation of tangible assets.* The taxpayer shall determine the value of all assets held by the taxpayer and its pro rata share of assets held by other related persons on the last day of its taxable year, excluding stock or indebtedness in such persons, any intangible property as defined in section 936(h)(3)(B), or goodwill or going concern value intangibles. Such valuations shall be made using generally accepted valuation techniques. For this purpose, assets may be combined into reasonable groupings. Statistical methods of valuation may only be used in connection with fungible property, such as commodities. The value of stock in any corporation that is not a related person shall be determined under the rules of paragraph (h)(1)(i) of this section, except that no liabilities shall be taken into account.

(iii) *Computation of intangible asset value.* The value of the intangible assets of the taxpayer and of intangible assets of all related persons attributable to the taxpayer's ownership in related persons is equal to the amount obtained by subtracting the amount determined under paragraph (h)(1)(ii) of this section from the amount determined under paragraph (h)(1)(i) of this section.

(2) *Apportionment of intangible asset value.* The value of the intangible assets determined under paragraph (h)(1)(iii) of this section is apportioned among the taxpayer and all related persons in proportion to the net income before interest expense of the taxpayer and the taxpayer's pro rata share of the net income before interest expense of each ralated person held by the taxpayer, excluding income that is passive under § 1.904–4(b). For this purpose, net income is determined before reduction for income taxes. Net income of the taxpayer and of related persons shall be computed without regard to dividends or interest received from any person that is related to the taxpayer.

(3) *Characterization of affiliated group's portion of intangible asset value.* The portion of the value of intangible assets of the taxpayer and related persons that is apportioned to the taxpayer under paragraph (h)(2) of this section is characterized on the basis of net income before interest expense, as determined under paragraph (h)(2) of this section, of the taxpayer within each statutory or residual grouping of income.

(4) *Valuing stock in related persons held by the taxpayer.* The value of stock in a related person held by the taxpayer equals the sum of the following amounts reduced by the taxpayer's pro rata share of liabilities of such related person:

(i) The portion of the value of intangible assets of the taxpayer and related persons that is apportioned to such related person under paragraph (h)(2) of this section;

(ii) The taxpayer's pro rata share of tangible assets held by the related person (as determined under paragraph (h)(1)(ii) of this section); and

(iii) The total value of stock in all related person held by the related person as determined under this paragraph (h)(4).

(5) *Characterizing stock in related persons.* Stock in a related person held by the taxpayer or by another related person shall be characterized on the basis of the fair market value of the taxpayer's pro rata share of assets held by the related person attributed to each statutory grouping and the residual grouping under the stock characterization rules of § 1.861–12T(c)(3)(ii), except that the portion of the value of intangible assets of the taxpayer and related persons that is apportioned to the related person under paragraph (h)(2) of this section shall be characterized on the basis of the net income before interest expense of the related person within each statutory grouping or residual grouping (excluding income that is passive under § 1.904–4(b)).

(6) *Adjustments for apportioning related person expenses.* For purposes of apportioning expenses of a related person, the value of stock in a second related person as otherwise determined under paragraph (h)(4) of this section (which is determined on the basis of the taxpayer's percentage ownership interest in the second related person) shall be increased to reflect the first related person's percentage ownership interest in the second related person to the extent it is larger.

Example. Assume that a taxpayer owns 80 percent of CFC1, which owns 100 percent of CFC2. The value of CFC1 is determined generally under paragraph (h)(4) on the basis of the taxpayer's 80 percent indirect interest in CFC2. For purposes of apportioning expenses of CFC1, 100 percent of the stock of CFC1 must be taken into account. Therefore, the value of CFC2 stock in the hands of CFC1 shall equal the value of CFC2 stock in the hands of CFC1 as determined under paragraph (h)(4) of this section, increased by 25 percent of such amount to reflect the fact that CFC1 owns 100 percent and not 80 percent of CFC2.

(i) [Reserved]

(j) *Modified gross income method.* Subject to rules set forth in paragraph (f)(3) of this section, the interest expense of a controlled foreign corporation may be allocated according to the following rules.

(1) *Single-tier controlled foreign corporation.* In the case of a controlled foreign corporation that does not hold stock in any lower-tier controlled foreign corporation, the interest expense of the controlled foreign corporation shall be apportioned based on its gross income.

(2) *Multiple vertically owned controlled foreign corporations.* In the case of a controlled foreign corporation that

holds stock in any lower-tier controlled foreign corporation, the interest expense of that controlled foreign corporation and such upper-tier controlled foreign corporation shall be apportioned based on the following methodology:

(i) *Step 1.* Commencing with the lowest-tier controlled foreign corporation in the chain, allocate and apportion its interest expense based on its gross income as provided in paragraph (j)(1) of this section, yielding gross income in each grouping net of interest expense.

(ii) *Step 2.* Moving to the next higher-tier controlled foreign corporation, combine the gross income of such corporation within each grouping with its pro rata share of the gross income net of interest expense of all lower-tier controlled foreign corporations held by such higher-tier corporation within the same grouping adjusted as follows:

(A) Exclude from the gross income of the upper-tier corporation any dividends or other payments received from the lower-tier corporation other than interest subject to look-through under section 904(d)(3); and

(B) Exclude from the gross income net of interest expense of any lower-tier corporation any subpart F income (net of interest expense apportioned to such income).

Then apportion the interest expense of the higher-tier controlled foreign corporation based on the adjusted combined gross income amounts. Repeat this step 2 for each next higher-tier controlled foreign corporation in the chain. For purposes of this paragraph (j)(2)(ii), pro rata share shall be determined under principles similar to section 951(a)(2).

[T.D. 8228, 53 FR 35477, Sept. 14, 1988, as amended by T.D. 8257, 54 FR 31819, Aug. 2, 1989; T.D. 8597, 60 FR 36679, July 18, 1995; T.D. 8658, 61 FR 9329, Mar. 8, 1996]

§1.861–10 Special allocations of interest expense.

(a)–(d) [Reserved]

(e) *Treatment of certain related group indebtedness*—(1) *In general.* If, for any taxable year beginning after December 31, 1991, a U.S. shareholder (as defined in paragraph (e)(5)(i) of this section) has both—

(i) Excess related group indebtedness (as determined under Step One in paragraph (e)(2) of this section) and

(ii) Excess U.S. shareholder indebtedness (as determined under Step Two in paragraph (e)(3) of this section),

the U.S. shareholder shall allocate, to its gross income in the various separate limitation categories described in section 904(d)(1), a portion of its interest expense paid or accrued to any obligee who is not a member of the affiliated group (as defined in §1.861–11T(d)) of the U.S. shareholder (‘‘third party interest expense’’), excluding amounts allocated under paragraphs (b) and (c) of §1.861–10T. The amount of third party interest expense so allocated shall equal the total amount of interest income derived by the U.S. shareholder during the year from related group indebtedness, multiplied by the ratio of the lesser of the foregoing two amounts of excess indebtedness for the year to related group indebtedness for the year. This amount of third party interest expense is allocated as described in Step Three in paragraph (e)(4) of this section.

(2) *Step One: Excess related group indebtedness.* (i) The excess related group indebtedness of a U.S. shareholder for the year equals the amount by which its related group indebtedness for the year exceeds its allowable related group indebtedness for the year.

(ii) The ‘‘related group indebtedness’’ of the U.S. shareholder is the average of the aggregate amounts at the beginning and end of the year of indebtedness owed to the U.S. shareholder by each controlled foreign corporation which is a related person (as defined in paragraph (e)(5)(ii) of this section) with respect to the U.S. shareholder.

(iii) The ‘‘allowable related group indebtedness’’ of a U.S. shareholder for the year equals—

(A) The average of the aggregate values at the beginning and end of the year of the assets (including stock holdings in and obligations of related persons, other than related controlled foreign corporations) of each related controlled foreign corporation, multiplied by

(B) The foreign base period ratio of the U.S. shareholder for the year.

(iv) The ‘‘foreign base period ratio’’ of the U.S. shareholder for the year is the average of the related group debt-to-asset ratios of the U.S. shareholder for each taxable year comprising the foreign base period for the current year (each a ‘‘base year’’). For this purpose, however, the related group debt-to-asset ratio of the U.S. shareholder for any base year may not exceed 110 percent of the foreign base period ratio for that base year. This limitation shall not apply with respect to any of the five taxable years chosen as initial base years by the U.S. shareholder under paragraph (e)(2)(v) of this section or with respect to any base year for which the related group debt-to-asset ratio does not exceed 0.10.

(v)(A) The foreign base period for any current taxable year (except as described in paragraphs (e)(2)(v) (B) and (C) of this section) shall consist of the five taxable years immediately preceding the current year.

(B) The U.S. shareholder may choose as foreign base periods for all of its first five taxable years for which this paragraph (e) is effective the following alternative base periods:

(*1*) For the first effective taxable year, the 1982, 1983, 1984, 1985 and 1986 taxable years;

(*2*) For the second effective taxable year, the 1983, 1984, 1985 and 1986 taxable years and the first effective taxable year;

(*3*) For the third effective taxable year, the 1984, 1985 and 1986 taxable years and the first and second effective taxable years;

(*4*) For the fourth effective taxable year, the 1985 and 1986 taxable years and the first, second and third effective taxable years; and

(*5*) For the fifth effective taxable year, the 1986 taxable year and the first, second, third and fourth effective taxable years.

(C) If, however, the U.S. shareholder does not choose, under paragraph (e)(10)(ii) of this section, to apply this paragraph (e) to one or more taxable years beginning before January 1, 1992, the U.S. shareholder may not include within any foreign base period the taxable year immediately preceding the first effective taxable year. Thus, for example, a U.S. shareholder for which the first effective taxable year is the taxable year beginning on October 1, 1992, may not include the taxable year beginning on October 1, 1991, in any foreign base period. Assuming that the U.S. shareholder does not elect the alternative base periods described in paragraph (e)(2)(v)(B) of this section, the initial foreign base period for the U.S. shareholder will consist of the taxable years beginning on October 1 of 1986, 1987, 1988, 1989, and 1990. The foreign base period for the U.S. shareholder for the following taxable year, beginning on October 1, 1993, will consist of the taxable years beginning on October 1 of 1987, 1988, 1989, 1990, and 1992.

(D) If the U.S. shareholder chooses the base periods described in paragraph (e)(2)(v)(B) of this section as foreign base periods, it must make a similar election under paragraph (e)(3)(v)(B) of this section with respect to its U.S. base periods.

(vi) The ‘‘related group debt-to-asset ratio’’ of a U.S. shareholder for a year is the ratio between—

(A) The related group indebtedness of the U.S. shareholder for the year (as determined under paragraph (e)(2)(ii) of this section); and

(B) The average of the aggregate values at the beginning and end of the year of the assets (including stock holdings in and obligations of related persons, other than related controlled foreign corporations) of each related controlled foreign corporation.

(vii) Notwithstanding paragraph (e)(2)(i) of this section, a U.S. shareholder is considered to have no excess related group indebtedness for the year if—

(A) Its related group indebtedness for the year does not exceed its allowable related group indebtedness for the immediately preceding year (as determined under paragraph (e)(2)(iii) of this section); or

(B) Its related group debt-to-asset ratio (as determined under paragraph (e)(2)(vi) of this section) for the year does not exceed 0.10.

(3) *Step Two: Excess U.S. shareholder indebtedness.* (i) The excess indebtedness of a U.S. shareholder for the year

equals the amount by which its unaffiliated indebtedness for the year exceeds its allowable indebtedness for the year.

(ii) The ‘‘unaffiliated indebtedness’’ of the U.S. shareholder is the average of the aggregate amounts at the beginning and end of the year of indebtedness owed by the U.S. shareholder to any obligee, other than a member of the affiliated group (as defined in §1.861–11T(d)) of the U.S shareholder.

(iii) The ‘‘allowable indebtedness’’ of a U.S. shareholder for the year equals—

(A) The average of the aggregate values at the beginning and end of the year of the assets of the U.S. shareholder (including stock holdings in and obligations of related controlled foreign corporations, but excluding stock holdings in and obligations of members of the affiliated group (as defined in §1.861–11T(d)) of the U.S. shareholder), reduced by the amount of the excess related group indebtedness of the U.S. shareholder for the year (as determined under Step One in paragraph (e)(2) of this section), multiplied by

(B) The U.S. base period ratio of the U.S. shareholder for the year.

(iv) The ‘‘U.S. base period ratio’’ of the U.S. shareholder for the year is the average of the debt-to-asset ratios of the U.S. shareholder for each taxable year comprising the U.S. base period for the current year (each a ‘‘base year’’). For this purpose, however, the debt-to-asset ratio of the U.S. shareholder for any base year may not exceed 110 percent of the U.S. base period ratio for that base year. This limitation shall not apply with respect to any of the five taxable years chosen as initial base years by the U.S. shareholder under paragraph (e)(3)(v) of this section or with respect to any base year for which of the debt-to-asset ratio does not exceed 0.10.

(v)(A) The U.S. base period for any current taxable year (except as described in paragraphs (e)(3)(v) (B) and (C) of this section) shall consist of the five taxable years immediately preceding the current year.

(B) The U.S. shareholder may choose as U.S. base periods for all of its first five taxable years for which this paragraph (e) is effective the following alternative base periods:

(*1*) For the first effective taxable year, the 1982, 1983, 1984, 1985 and 1986 taxable years;

(*2*) For the second effective taxable year, the 1983, 1984, 1985 and 1986 taxable years and the first effective taxable year;

(*3*) For the third effective taxable year, the 1984, 1985 and 1986 taxable years and the first and second effective taxable years;

(*4*) For the fourth effective taxable year, the 1985 and 1986 taxable years and the first, second and third effective taxable years; and

(*5*) For the fifth effective taxable year, the 1986 taxable year and the first, second, third and fourth effective taxable years.

(C) If, however, the U.S. shareholder does not choose, under paragraph (e)(10)(ii) of this section, to apply this paragraph (e) to one or more taxable years beginning before January 1, 1992, the U.S. shareholder may not include within any U.S. base period the taxable year immediately preceding the first effective taxable year. Thus, for example, a U.S. shareholder for which the first effective taxable year is the taxable year beginning on October 1, 1992, may not include the taxable year beginning on October 1, 1991, in any U.S. base period. Assuming that the U.S. shareholder does not elect the alternative base periods described in paragraph (e)(3)(v)(B) of this section, the initial U.S. base period for the U.S. shareholder will consist of the taxable years beginning on October 1, of 1986, 1987, 1988, 1989, and 1990. The U.S. base period for the U.S. shareholder for the following taxable year, beginning on October 1, 1993, will consist of the taxable years beginning on October 1, 1987, 1988, 1989, 1990, and 1992.

(D) If the U.S. shareholder chooses the base periods described in paragraph (e)(3)(v)(B) of this section as U.S. base periods, it must make a similar election under paragraph (e)(2)(v)(B) of this section with respect to its foreign base periods.

(vi) The ‘‘debt-to-asset ratio’’ of a U.S. shareholder for a year is the ratio between—

(A) The unaffiliated indebtedness of the U.S. shareholder for the year (as determined under paragraph (e)(3)(ii) of this section); and

(B) The average of the aggregate values at the beginning and end of the year of the assets of the U.S. shareholder. For this purpose, the assets of the U.S. shareholder include stock holdings in and obligations of related controlled foreign corporations but do not include stock holdings in and obligations of members of the affiliated group (as defined in § 1.861–11T(d)).

(vii) A U.S. shareholder is considered to have no excess indebtedness for the year if its debt-to-asset ratio (as determined under paragraph (e)(3)(vi) of this section) for the year does not exceed 0.10.

(4) *Step Three: Allocation of third party interest expense.* (i) A U.S. shareholder shall allocate to its gross income in the various separate limitation categories described in section 904(d)(1) a portion of its third party interest expense incurred during the year equal in amount to the interest income derived by the U.S. shareholder during the year from allocable related group indebtedness.

(ii) The ''allocable related group indebtedness'' of a U.S. shareholder for any year is an amount of related group indebtedness equal to the lesser of—

(A) The excess related group indebtedness of the U.S. shareholder for the year (determined under Step One in paragraph (e)(2) of this section); or

(B) The excess U.S. shareholder indebtedness for the year (determined under Step Two in paragraph (e)(3) of this section).

(iii) The amount of interest income derived by a U.S. shareholder from allocable related group indebtedness during the year equals the total amount of interest income derived by the U.S. shareholder during the year with respect to related group indebtedness, multiplied by the ratio of allocable related group indebtedness for the year to the aggregate amount of related group indebtedness for the year.

(iv) The portion of third party interest expense described in paragraph (e)(4)(i) of this section shall be allocated in proportion to the relative average amounts of related group indebtedness held by the U.S. shareholder in each separate limitation category during the year. The remaining portion of third party interest expense of the U.S. shareholder for the year shall be apportioned as provided in §§ 1.861–8T through 1.861–13T, excluding paragraph (e) of § 1.861–10T and this paragraph (e).

(v) The average amount of related group indebtedness held by the U.S. shareholder in each separate limitation category during the year equals the average of the aggregate amounts of such indebtedness in each separate limitation category at the beginning and end of the year. Solely for purposes of this paragraph (e)(4), each debt obligation of a related controlled foreign corporation held by the U.S. shareholder at the beginning or end of the year is attributed to separate limitation categories in the same manner as the stock of the obligor would be attributed under the rules of § 1.861–12T(c)(3), whether or not such stock is held directly by the U.S. shareholder.

(vi) The amount of third party interest expense of a U.S. shareholder allocated pursuant to this paragraph (e)(4) shall not exceed the total amount of the third party interest expense of the U.S. shareholder for the year (excluding any third party interest expense allocated under paragraphs (b) and (c) of § 1.861–10T).

(5) *Definitions.* For purposes of this paragraph (e), the following terms shall have the following meanings.

(i) *U.S. shareholder.* The term ''U.S. shareholder'' has the same meaning as the term ''United States shareholder'' when used in section 957, except that, in the case of a United States shareholder that is a member of an affiliated group (as defined in § 1.861–11T(d)), the entire affiliated group is considered to constitute a single U.S. shareholder.

(ii) *Related person.* For the definition of the term ''related person'', see § 1.861–8T(c)(2). A controlled foreign corporation is considered ''related'' to a U.S. shareholder if it is a related person with respect to the U.S. shareholder.

(6) *Determination of asset values.* A U.S. shareholder shall determine the values of the assets of each related controlled foreign corporation (for purposes of Step One in paragraph (e)(2) of this section) and the assets of the U.S. shareholder (for purposes of Step Two in paragraph (e)(3) of this section) for

any year in accordance with the valuation method (tax book value or fair market value) elected for that year pursuant to §1.861–9T(g). However, solely for purposes of this paragraph (e), a U.S. shareholder may instead choose to determine the values of the assets of all related controlled foreign corporations by reference to their values as reflected on Forms 5471 (the annual information return with respect to each related controlled foreign corporation), subject to the translation rules of paragraph (e)(8)(i) of this section. This method of valuation may be used only if the taxable years of each of the related controlled foreign corporations begin with, or no more than one month earlier than, the taxable year of the U.S. shareholder. Once chosen for a taxable year, this method of valuation must be used in each subsequent taxable year and may be changed only with the consent of the Commissioner.

(7) *Adjustments to asset value.* For purposes of apportioning remaining interest expense under §1.861–9T, a U.S. shareholder shall reduce (but not below zero) the value of its assets for the year (as determined under §1.861–9T (g) (3) or (h)) by an amount equal to the allocable related group indebtedness of the U.S. shareholder for the year (as determined under Step Three in paragraph (e)(4)(ii) of this section). This reduction is allocated among assets in each separate limitation category in proportion to the average amount of related group indebtedness held by the U.S. shareholder in each separate limitation category during the year (as determined under Step Three in paragraph (e)(4)(v) of this section).

(8) *Special rules*—(i) *Exchange rates.* All indebtedness amounts and asset values (including current year and base year amounts and values) denominated in a foreign currency shall be translated into U.S. dollars at the exchange rate for the current year. The exchange rate for the current year may be determined under any reasonable method (*e.g.*, average of month-end exchange rates for each month in the current year) if it is consistently applied to the current year and all base years. Once chosen for a taxable year, a method for determining an exchange rate must be used in each subsequent taxable year and will be treated as a method of accounting for purposes of section 446. A taxpayer may apply a different translation rule only with the prior consent of the Commissioner. In this regard, the Commissioner will be guided by the extent to which a different rule would reduce the comparability of dollar amounts of indebtedness and dollar asset values for the base years and the current year.

(ii) *Exempt assets.* Solely for purposes of this paragraph (e), any exempt assets otherwise excluded under section 864(e)(3) and §1.861–8T(d) shall be included as assets of the U.S. shareholder or related controlled foreign corporation.

(iii) *Exclusion of certain directly allocated indebtedness and assets.* Qualified nonrecourse indebtedness (as defined in §1.861–10T(b)(2)) and indebtedness incurred in connection with an integrated financial transaction (as defined in §1.861–10T(c)(2)) shall be excluded from U.S. shareholder indebtedness and related group indebtedness. In addition, assets which are the subject of qualified nonrecourse indebtedness or integrated financial transactions shall be excluded from the assets of the U.S. shareholder and each related controlled foreign corporation.

(iv) *Exclusion of certain receivables.* Receivables between related controlled foreign corporations (or between members of the affiliated group constituting the U.S. shareholder) shall be excluded from the assets of the related controlled foreign corporation (or affiliated group member) holding such receivables. See also §1.861–11T(e)(1).

(v) *Classification of certain loans as related group indebtedness.* If—

(A) A U.S. shareholder owns stock in a related controlled foreign corporation which is a resident of a country that—

(*1*) Does not impose a withholding tax of 5 percent or more upon payments of dividends to a U.S. shareholder; and

(*2*) Does not, for the taxable year of the controlled foreign corporation, subject the income of the controlled foreign corporation to an income tax which is greater than that percentage specified under §1.954–1T(d)(1)(i) of the maximum rate of tax specified under section 11 of the Code, and

(B) The controlled foreign corporation has outstanding a loan or loans to one or more other related controlled foreign corporations, or the controlled foreign corporation has made a direct or indirect capital contribution to one or more other related controlled foreign corporations which have outstanding a loan or loans to one or more other related controlled foreign corporations, then, to the extent of the aggregate amount of its capital contributions in taxable years beginning after December 31, 1986, to the related controlled foreign corporation that made such loans or additional contributions, the U.S. shareholder itself shall be treated as having made the loans decribed in paragraph (e)(8)(v)(B) of this section and, thus, such loan amounts shall be considered related group indebtedness. However, for purposes of paragraph (e)(4) of this section, interest income derived by the U.S. shareholder during the year from related group indebtedness shall not include any income derived with respect to the U.S. shareholder's ownership of stock in the related controlled foreign corporation that made such loans or additional contributions.

(vi) *Classification of certain stock as related person indebtedness.* In determining the amount of its related group indebtedness for any taxable year, a U.S. shareholder must treat as related group indebtedness its holding of stock in a related controlled foreign corporation if, during such taxable year, such related controlled foreign corporation claims a deduction for interest under foreign law for distributions on such stock. However, for purposes of paragraph (e)(4) of this section, interest income derived by the U.S. shareholder during the year from related group indebtedness shall not include any income derived with respect to the U.S. shareholder's ownership of stock in the related controlled foreign corporation.

(9) *Corporate events*—(i) *Initial acquisition of a controlled foreign corporation.* If the foreign base period of the U.S. shareholder for any year includes a base year in which the U.S. shareholder did not hold stock in any related controlled foreign corporation, then, in computing the foreign base period ratio, the related group debt-to-asset ratio of the U.S. shareholder for any such base year shall be deemed to be 0.10.

(ii) *Incorporation of U.S. shareholder*—(A) *Nonapplication.* This paragraph (e) does not apply to the first taxable year of the U.S. shareholder. However, this paragraph (e) does apply to all following years, including years in which later members of the affiliated group may be incorporated.

(B) *Foreign and U.S. base period ratios.* In computing the foreign and U.S. base period ratios, the foreign and U.S. base periods of the U.S. shareholder shall be considered to be only the period prior to the current year that the U.S. shareholder was in existence if this prior period is less than five taxable years.

(iii) *Acquisition of additional corporations.* (A) If a U.S. shareholder acquires (directly or indirectly) stock of a foreign or domestic corporation which, by reason of the acquisition, then becomes a related controlled foreign corporation or a member of the affiliated group, then in determining excess related group indebtedness or excess U.S. shareholder indebtedness, the indebtedness and assets of the acquired corporation shall be taken into account only at the end of the acquisition year and in following years. Thus, amounts of indebtedness and assets and the various debt-to-asset ratios of the U.S. shareholder existing at the beginning of the acquisition year or relating to preceding years are not recalculated to take account of indebtedness and assets of the acquired corporation existing as of dates before the end of the year. If, however, a major acquisition is made within the last three months of the year and a substantial distortion of values for the year would otherwise result, the taxpaper must take into account the average values of the acquired indebtedness and assets weighted to reflect the time such indebtedness is owed and such assets are held by the taxpayer during the year.

(B) In the case of a reverse acquisition subject to this paragraph (e)(9), the rules of § 1.1502–75(d)(3) apply in determining which corporations are the acquiring and acquired corporations. For this purpose, whether corporations are affiliated is determined under § 1.861–11T(d).

(C) If the stock of a U.S. shareholder is acquired by (and, by reason of such acquisition, the U.S. shareholder becomes affiliated with) a corporation described below, then such U.S. shareholder shall be considered to have acquired such corporation for purposes of the application of the rules of this paragraph (e). A corporation to which this paragraph (e)(9)(iii)(C) applies is—

(*1*) A corporation which is not affiliated with any other corporation (other than other similarly described corporation); and

(*2*) Substantially all of the assets of which consist of cash, securities and stock.

(iv) *Election to compute base period ratios by including acquired corporations.* A U.S. shareholder may choose, solely for purposes of paragraph (e)(9) (i) and (iii) of this section, to compute its foreign and U.S. base period ratios for the acquisition year and all subsequent years by taking into account the indebtedness and asset values of the acquired corporation or corporations (including related group indebtedness owed to a former U.S. shareholder) at the beginning of the acquisition year and in each of the five base years preceding the acquisition year. This election, if made for an acquisition, must be made for all other acquisitions occurring during the same taxable year or initiated in that year and concluded in the following year.

(v) *Dispositions.* If a U.S. shareholder disposes of stock of a foreign or domestic corporation which, by reason of the disposition, then ceases to be a related controlled foreign corporation or a member of the affiliated group (unless liquidated or merged into a related corporation), in determining excess related group indebtedness or excess U.S. shareholder indebtedness, the indebtedness and assets of the divested corporation shall be taken into account only at the beginning of the disposition year and for the relevant preceding years. Thus, amounts of indebtedness and assets and the various debt-to-asset ratios of the U.S. shareholder existing at the end of the year or relating to following years are not affected by indebtedness and assets of the divested corporation existing as of dates after the beginning of the year. If, however, a major disposition is made within the first three months of the year and a substantial distortion of values for the year would otherwise result, the taxpayer must take into account the average values of the divested indebtedness and assets weighted to reflect the time such indebtedness is owed and such assets are held by the taxpayer during the year.

(vi) *Election to compute base period ratios by excluding divested corporations.* A U.S. shareholder may choose, solely for purposes of paragraph (e) (9) (v) and (vii) of this section, to compute its foreign and U.S. base period ratios for the disposition year and all subsequent years without taking into account the indebtedness and asset values of the divested corporation or corporations at the beginning of the disposition year and in each of the five base years preceding the disposition year. This election, if made for a disposition, must be made for all other dispositions occurring during the same taxable year or initiated in that year and concluded in the following year.

(vii) *Section 355 transactions.* A U.S. corporation which becomes a separate U.S. shareholder as a result of a distribution of its stock to which section 355 applies shall be considered—

(A) As disposed of by the U.S. shareholder of the affiliated group of which the distributing corporation is a member, with this disposition subject to the rules of paragraphs (e) (9) (v) and (vi) of this section; and

(B) As having the same related group debt-to-asset ratio and debt-to-asset ratio as the distributing U.S. shareholder in each year preceding the year of distribution for purposes of applying this paragraph (e) to the year of distibution and subsequent years of the distributed corporation.

(10) *Effective date*—(i) *Taxable years beginning after December 31, 1991.* The provisions of this paragraph (e) apply to all taxable years beginning after December 31,1991.

(ii) *Taxable years beginning after December 31, 1987 and before January 1, 1992.* The provisions of § 1.861–10T (e) apply to taxable years beginning after December 31, 1987, and before January 1, 1992. The taxpayer may elect to apply the provisions of this paragraph

(e) (in lieu of the provisions of § 1.861–10T (e)) for any taxable year beginning after December 31, 1987, but this paragraph (e) must then be applied to all subsequent taxable years.

(11) The following example illustrates the provisions of this paragraph (e):

Example. (i) *Facts.* X, a domestic corporation, elects to apply this paragraph (e) to its 1990 tax year. X has a calendar taxable year and apportions its interest expense on the basis of the tax book value of its assets. In 1990, X incurred deductible third-party interest expense of $24,960 on an average amount of indebtedness (determined on the basis of beginning-of-year and end-of-year amounts) of $249,600. X manufactures widgets, all of which are sold in the United States. X owns all of the stock of Y, a controlled foreign corporation that also has a calendar taxable year and is also engaged in the manufacture and sale of widgets. Y has no earnings and profits or deficit of earnings and profits attributable to taxable years prior to 1987. X's total assets and their average tax book values (determined on the basis of beginning-of-year and end-of-year tax book values) for 1990 are:

Asset	Average tax book value
Plant and equipment	$315,000
Corporate headquarters	60,000
Y stock	75,000
Y note	50,000
Total	500,000

Y had $25,000 of income before the deduction of any interest expense. Of this total, $5,000 is high withholding tax interest income. The remaining $20,000 is derived from widget sales, and constitutes foreign source general limitation income. Assume that Y has no deductions from gross income other than interest expense. During 1990, Y paid $5,000 of interest expense to X on the Y note and $10,000 of interest expense to third parties, giving Y total interest expense of $15,000. X elects pursuant to § 1.861–9T to apportion Y's interest expense under the gross income method prescribed in section 1.861–9T (j).

(ii) *Step 1:* Using a beginning and end of year average, X (the U.S. shareholder) held the following average amounts of indebtedness of Y and Y had the following average asset values:

	1985	1986–88	1989	1990
(A) Related group indebtedness	$11,000	24,000	26,000	50,000
(B) Average Value of Assets of Related CFC	100,000	200,000	200,000	250,000
(C) Related Group Debt-to-Asset Ratio	.11	.12	.13	.20

(*1*) X's ''foreign base period ratio'' for 1990, an average of its ratios of related group indebtedness to related group assets for 1985 through 1989, is:

(.11+.12+.12+.12+.13)/5=.12

(*2*) X's ''allowable related group indebtedness'' for 1990 is:

$250,000×.12=$30,000.

(*3*) X's ''excess related group indebtedness'' for 1990 is:

$50,000 − $30,000=$20,000

X's related group indebtedness of $50,000 for 1990 is greater than its allowable related group indebtedness of $24,000 for 1989 (assuming a foreign base period ratio in 1989 of .12), and X's related group debt-to-asset ratio for 1990 is .20, which is greater than the ratio of .10 described in paragraph (e)(2)(vii)(B) of this section. Therefore, X's excess related group indebtedness for 1990 remains at $20,000.

(iii) *Step 2:* Using a beginning and end of year average, X has the following average amounts of U.S. and foreign indebtedness and average asset values:

	1985	1986	1987	1988	1989	1990
(1)	$231,400	225,000	225,000	225,000	220,800	249,600
(2)	445,000	450,000	450,000	450,000	460,000	480,000 (a)
(3)	.52	.50	.50	.50	.48	.52

(1) U.S. and foreign indebtedness

(2) Average value of assets of U.S. shareholder

(3) Debt-to-Asset ratio of U.S. shareholder

(a) [500,000–20,000 (excess related group indebtedness determined in Step 1)]

X's ''U.S. base period ratio'' for 1990 is:

(.52+.50+.50+.50+.48)/5=.50

X's ''allowable indebtedness'' for 1990 is:

$480,000×.50=$240,000

X’s ‘‘excess U.S. shareholder indebtedness’’ for 1990 is:

$249,000 – $240,000=$9,600

X’s debt-to-asset ratio for 1990 is .52, which is greater than the ratio of .10 described in paragraph (e)(3)(vii) of this section. Therefore, X’s excess U.S. shareholder indebtedness for 1990 remains at $9,600.

(iv) *Step 3:* (a) Since X’s excess U.S. shareholder indebtedness of $9,600 is less than its excess related group indebtedness of $20,000, X’s allocable related group indebtedness for 1990 is $9,600. The amount of interest received by X during 1990 on allocable related group indebtedness is:

$5,000×$9,600/$50,000=$960

(b) Therefore, $960 of X’s third party interest expense ($24,960) shall be allocated among various separate limitation categories in proportion to the relative average amounts of Y obligations held by X in each such category. The amount of Y obligations in each limitation category is determined in the same manner as the stock of Y would be attributed under the rules of §1.861–12T(c)(3). Since Y’s interest expense is apportioned under the gross income method prescribed in §1.861–9T (j), the Y stock must be characterized under the gross income method described in §1.861–12T(c)(3)(iii). Y’s gross income net of interest expense is determined as follows:

Foreign source high withholding tax interest income
=$5,000–[($15,000) multiplied by ($5,000)/($5,000+$20,000)]
=$2,000

and

Foreign source general limitation income
=$20,000–[($15,000) multiplied by ($20,000)/($5,000+$20,000)]
=$8,000.

(c) Therefore, $192 [($960×$2,000/($2,000+$8,000)] of X’s third party interest expense is allocated to foreign source high withholding tax interest income and $768 [$960×$8,000/($2,000+$8,000)] is allocated to foreign source general limitation income.

(v) As a result of these direct allocations, for purposes of apportioning X’s remaining interest expense under §1.861–9T, the value of X’s assets generating foreign source general limitation income is reduced by the principal amount of indebtedness the interest on which is directly allocated to foreign source general limitation income ($7,680), and the value of X’s assets generating foreign source high withholding tax interest income is reduced by the principal amount of indebtedness the interest on which is directly allocated to foreign source high withholding tax interest income ($1,920), determined as follows:

Reduction of X’s assets generating foreign source general limitation income:

$$\text{X's allocable related group indebtedness} \times \frac{\text{Y's Foreign source general limitation income}}{\text{Y's Foreign source income}}$$

$$\$9{,}600 \times \$8{,}000/(\$8{,}000 + \$2{,}000) = \$7{,}680$$

Reduction of X’s assets generating foreign source high withholding tax interest income:

$$\text{X's allocable related group indebtedness} \times \frac{\begin{array}{c}\text{Y's Foreign source high withholding tax}\\ \text{interest income}\end{array}}{\text{Y's Foreign source income}}$$

$$\$9{,}600 \times \$2{,}000/(\$8{,}000 + \$2{,}000) = \$1{,}920$$

[T.D. 8410, 57 FR 13022, Apr. 15, 1992; 57 FR 28012, June 23, 1992]

§ 1.861–10T Special allocations of interest expense (temporary regulations).

(a) *In general.* This section applies to all taxpayers and provides three exceptions to the rules of § 1.861–9T that require the allocation and apportionment of interest expense on the basis of all assets of all members of the affiliated group. Paragraph (b) of this section describes the direct allocation of interest expense to the income generated by certain assets that are subject to qualified nonrecourse indebtedness. Paragraph (c) of this section describes the direct allocation of interest expense to income generated by certain assets that are acquired in integrated financial transaction. Paragraph (d) of this section provides special rules that are applicable to all transactions described in paragraphs (b) and (c) of this section. Paragraph (e) of this section requires the direct allocation of third party interest of an affiliated group to such group's investment in related controlled foreign corporations in cases involving excess related person indebtedness (as defined therein). See also § 1.861–9T(b)(5), which requires direct allocation of amortizable bond premium.

(b) *Qualified nonrecourse indebtedness*—(1) *In general.* In the case of qualified nonrecourse indebtedness (as defined in paragraph (b)(2) of this section), the deduction for interest shall be considered directly allocable solely to the gross income which the property acquired, constructed, or improved with the proceeds of the indebtedness generates, has generated, or could reasonably be expected to generate.

(2) *Qualified nonrecourse indebtedness defined.* The term ''qualified nonrecourse indebtedness'' means any borrowing that is not excluded by paragraph (b)(4) of this section if:

(i) The borrowing is specifically incurred for the purpose of purchasing, constructing, or improving identified property that is either depreciable tangible personal property or real property with a useful life of more than one year or for the purpose of purchasing amortizable intangible personal property with a useful life of more than one year;

(ii) The proceeds are actually applied to purchase, construct, or improve the identified property;

(iii) Except as provided in paragraph (b)(7)(ii) (relating to certain third party guarantees in leveraged lease transactions), the creditor can look only to the identified property (or any lease or other interest therein) as security for payment of the principal and interest on the loan and, thus, cannot look to any other property, the borrower, or any third party with respect to repayment of principal or interest on the loan;

(iv) The cash flow from the property, as defined in paragraph (b)(3) of this section, is reasonably expected to be sufficient in the first year of ownership as well as in each subsequent year of ownership to fulfill the terms and conditions of the loan agreement with respect to the amount and timing of payments of interest and original issue discount and periodic payments of principal in each such year; and

(v) There are restrictions in the loan agreement on the disposal or use of the property consistent with the assumptions described in subdivisions (iii) and (iv) of this paragraph (b)(2).

(3) *Cash flow defined*—(i) *In general.* The term ''cash flow from the property'' as used in paragraph (b)(2)(iv) of this section means a stream of revenue (as computed under paragraph (b)(3)(ii) of this section) substantially all of which derives directly from the property. The phrase ''cash flow from the property'' does not include revenue if a significant portion thereof is derived from activities such as sales, labor, services, or the use of other property. Thus, revenue derived from the sale or lease of inventory or of similar property does not constitute cash flow from the property, including plant or equipment used in the manufacture and sale or lease, or purchase and sale or lease, of such inventory or similar property. In addition, revenue derived in part from the performance of services that are not ancillary and subsidiary to the use of property does not constitute cash flow from the property.

(ii) *Self-constructed assets.* The activities associated with self-construction of assets shall be considered to constitute labor or services for purposes of paragraph (b)(3)(i) only if the self-constructed asset—

(A) Is constructed for the purpose of resale, or

(B) Without regard to purpose, is sold to an unrelated person within one year from the date that the property is placed in service for purposes of section 167.

(iii) *Computation of cash flow.* Cash flow is computed by subtracting cash disbursements excluding debt service from cash receipts.

(iv) *Analysis of operating costs.* [Reserved]

(v) *Examples.* The principles of this paragraph may be demonstrated by the following examples.

Example 1. In 1987, X borrows $100,000 in order to purchase an apartment building, which X then purchases. The loan is secured only by the building and the leases thereon. Annual debt service on the loan is $12,000. Annual gross rents from the building are $20,000. Annual taxes on the building are $2,000. Other expenses deductible under section 162 are $2,000. Rents are reasonably expected to remain stable or increase in subsequent years, and taxes and expenses are reasonably expected to remain proportional to gross rents in subsequent years. X provides security, maintenance, and utilities to the tenants of the building. Based on facts and circumstances, it is determined that, although services are provided to tenants, these services are ancillary and subsidiary to the occupancy of the apartments. Accordingly, the case flow of $16,000 is considered to constitute a return from the property. Furthermore, such cash flow is sufficient to fulfill the terms and conditions of the loan agreement as required by paragraph (b)(2)(iii).

Example 2. In 1987, X borrows funds in order to purchase a hotel, which X then purchases and operates. The loan is secured only by the hotel. Based on facts and circumstances, it is determined that the operation of the hotel involves services the value of which is significant in relation to amounts paid to occupy the rooms. Thus, a significant portion of the cash flow is derived from the performance of services incidental to the occupancy of hotel rooms. Accordingly, the cash flow from the hotel is considered not to constitute a return on or from the property.

Example 3. In 1987, X borrows funds in order to build a factory, which X then builds and operates. The loan is secured only by the factory and the equipment therein. Based on the facts and circumstances, it is determined that the operation of the factory involves significant expenditures for labor and raw materials. Thus, a significant portion of the cash flow is derived from labor and the processing of raw materials. Accordingly, the cash flow from the factory is considered not to constitute a return on or from the property.

(4) *Exclusions.* The term ‘‘qualified nonrecourse indebtedness’ shall not include any transaction that—

(i) Lacks economic significance within the meaning of paragraph (b)(5) of this section;

(ii) Involves cross collateralization within the meaning of paragraph (b)(6) of this section;

(iii) Except in the case of a leveraged lease described in paragraph (b)(7)(ii) of this section, involves credit enhancement within the meaning of paragraph (b)(7) of this section or, with respect to loans made on or after October 14, 1988, does not under the terms of the loan documents, prohibit the acquisition by the holder of bond insurance or similar forms of credit enhancement;

(iv) Involves the purchase of inventory;

(v) Involves the purchase of any financial asset, including stock in a corporation, an interest in a partnership or a trust, or the debt obligation of any obligor (although interest incurred in order to purchase certain financial instruments may qualify for direct allocation under paragraph (c) of this section);

(vi) Involves interest expense that constitutes qualified residence interest as defined in section 163(h)(3); or

(vii) [Reserved]

(5) *Economic significance.* Indebtedness that otherwise qualifies under paragraph (b)(2) shall nonetheless be subject to apportionment under §1.861–9T if, taking into account all the facts and circumstances, the transaction (including the security arrangement) lacks economic significance.

(6) *Cross collateralization.* The term ‘‘cross collateralization’’ refers to the pledge as security for a loan of—

(i) Any asset of the borrower other than the identified property described in paragraph (b)(2) of this section, or

(ii) Any asset belonging to any related person, as defined in §1.861–8T(c)(2).

(7) *Credit enhancement*—(i) *In general.* Except as provided in paragraph

(b)(7)(ii) of this section, the term ‘‘credit enhancement’’ refers to any device, including a contract, letter of credit, or guaranty, that expands the creditor's rights, directly or indirectly, beyond the identified property purchased, constructed, or improved with the funds advanced and, thus effectively provides as security for a loan the assets of any person other than the borrower. The acquisition of bond insurance or any other contract of suretyship by an initial or subsequent holder of an obligation shall constitute credit enhancement.

(ii) *Special rule for leveraged leases.* For purposes of this paragraph (b), the term ‘‘credit enhancement’’ shall not include any device under which any person that is not a related person within the meaning of § 1.861–8T(c)(2) agrees to guarantee, without recourse to the lessor or any person related to the lessor, a lessor's payment of principal and interest on indebtedness that was incurred in order to purchase or improve an asset that is depreciable tangible personal property or depreciable tangible real property (and the land on which such real property is situated) that is leased to a lessee that is not a related person in a transaction that constitutes a lease for federal income tax purposes.

(iii) *Syndication of credit risk and sale of loan participations.* The term ‘‘syndication of credit risk’’ refers to an arrangement in which one primary lender secures the promise of a secondary lender to bear a portion of the primary lender's credit risk on a loan. The term ‘‘sale of loan participations’’ refers to an arrangement in which one primary lender divides a loan into several portions, sells and assigns all rights with respect to one or more portions to participating secondary lenders, and does not remain at risk in any manner with respect to the portion assigned. For purposes of this paragraph (b), the syndication of credit risk shall constitute credit enhancement because the primary lender can look to secondary lenders for payment of the loan, notwithstanding limitations on the amount of the secondary lender's liability. Conversely, the sale of loan participations does not constitute credit enhancement, because the holder of each portion of the loan can look solely to the asset securing the loan and not to the credit or other assets of any person.

(8) *Other arrangements that do not constitute cross collateralization or credit enhancement.* For purposes of paragraphs (b) (6) and (7) of this section, the following arrangements do not constitute cross collateralization or credit enhancement:

(i) *Integrated projects.* A taxpayer's pledge of multiple assets of an integrated project, provided that the integrated project. An integrated project consists of functionally related and geographically contiguous assets that, as to the taxpayer, are used in the same trade or business.

(ii) Insurance. A taxpayer's purchase of third-party casualty and liability insurance on the collateral or, by contract, bearing the risk of loss associated with destruction of the collateral or with respect to the attachment of third party liability claims.

(iii) *After-acquired property.* Extension of a creditor's security interest to improvements made to the collateral, provided that the extension does not constitute excess collateralization under paragraph (b)(6), determined by taking into account the value of improvements at the time the improvements are made and the value of the original property at the time the loan was made.

(iv) *Warranties of completion and maintenance.* A taxpayer's warranty to a creditor that it will complete construction or manufacture of the collateral or that it will maintain the collateral in good condition.

(v) *Substitution of collateral.* A taxpayer's right to substitute collateral under any loan contract. However, after the right is exercised, the loan shall no longer constitute qualified nonrecourse indebtedness.

(9) *Refinancings.* If a taxpayer refinances qualified nonrecourse indebtedness (as defined in paragraph (b)(2) of this section) with new indebtedness, such new indebtedness shall continue to qualify only if—

(i) The principal amount of the new indebtedness does not exceed by more than five percent the remaining principal amount of the original indebtedness,

(ii) The term of the new indebtedness does not exceed by more than six months the remaining term of the original indebtedness, and

(iii) The requirements of this paragraph (other than those of paragraph (b)(2) (i) and (ii) of this section) are satisfied at the time of the refinancing, and the exclusions contained in this paragraph (b)(4) do not apply.

(10) *Post-construction permanent financing.* Financing that is obtained after the completion of constructed property will be deemed to satisfy the requirements of paragraph (b)(2) (i) and (ii) of this section if—

(i) The financing is obtained within one year after the constructed property or substantially all of a constructed integrated project (as defined in paragraph (b)(9)(i) of this section) is placed in service for purposes of section 167; and

(ii) The financing does not exceed the cost of construction (including construction period interest).

(11) *Assumptions of pre-existing qualified nonrecourse indebtedness.* If a transferee of property that is subject to qualified nonrecourse indebtedness assumes such indebtedness, the indebtedness shall continue to constitute qualified nonrecourse indebtedness, provided that the assumption in no way alters the qualified status of the debt.

(12) *Excess collateralization.* [Reserved]

(c) *Direct allocations in the case of certain integrated financial transactions*—(1) *General rule.* Interest expense incurred on funds borrowed in connection with an integrated financial transaction (as defined in paragraph (c)(2) of this section) shall be directly allocated to the income generated by the investment funded with the borrowed amounts.

(2) *Definition.* The term ‘‘integrated financial transaction’’ refers to any transaction in which—

(i) The taxpayer—

(A) Incurs indebtedness for the purpose of making an identified term investment,

(B) Identifies the indebtedness as incurred for such purpose at the time the indebtedness is incurred, and

(C) Makes the identified term investment within ten business days after incurring the indebtedness;

(ii) The return on the investment is reasonably expected to be sufficient throughout the term of the investment to fulfill the terms and conditions of the loan agreement with respect to the amount and timing of payments of principal and interest or original issue discount;

(iii) The income constitutes interest or original issue discount or would constitute income equivalent to interest if earned by a controlled foreign corporation (as described in §1.954–2T(h));

(iv) The debt incurred and the investment mature within ten business days of each other;

(v) The investment does not relate in any way to the operation of, and is not made in the normal course of, the trade or business of the taxpayer or any related person, including the financing of the sale of goods or the performance of services by the taxpayer or any related person, or the compensation of the taxpayer’s employees (including any contribution or loan to an employee stock ownership plan (as defined in section 4975(e)(7)) or other plan that is qualified under section 401(a)); and

(vi) The borrower does not constitute a financial services entity (as defined in section 904 and the regulations thereunder).

(3) *Rollovers.* In the event that a taxpayer sells of otherwise liquidates an investment described in paragraph (c)(2) of this section, the interest expense incurred on the borrowing shall, subsequent to that liquidation, no longer qualify for direct allocation under this paragraph (c).

(4) *Examples.* The principles of this paragraph (c) may be demonstrated by the following examples.

Example 1. X is a manufacturer and does not constitute a financial services entity as defined in the regulations under section 904. On January 1, 1988, X borrows $100 for 6 months at an annual interest rate of 10 percent. X identifies on its books and records by the close of that day that the indebtedness is being incurred for the purpose of making an investment that is intended to qualify as an integrated financial transaction. On January 5, 1988, X uses the proceeds to purchase a portfolio of stock that approximates the composition of the Standard & Poor’s 500

Index. On that day, X also enters into a forward sale contract that requires X to sell the stock on June 1, 1988 for $110. X identifies on its books and records by the close of January 5, 1988, that the portfolio stock purchases and the forward sale contract constitute part of the integrated financial transaction with respect to which the identified borrowing was incurred. Under § 1.954–2T(h), the income derived from the transaction would constitute income equivalent to interest. Assuming that the return on the investment to be derived on June 1, 1988, will be sufficient to pay the interest due on June 1, 1988, the interest on the borrowing is directly allocated to the gain from the investment.

Example 2. X does not constitute a financial services entity as defined in the regulations under section 904. X is in the business of, among other things, issuing credit cards to consumers and purchasing from merchants who accept the X card the receivables of consumers who make purchases with the X card. X borrows from Y in order to purchase X credit card receivables from Z, a merchant. Assuming that the Y borrowing satisfies the other requirements of paragraph (c)(2) of this section, the transaction nonetheless cannot constitute an integrated financial transaction because the purchase relates to the operation of X's trade or business.

Example 3. Assume the same facts as in Example 2, except that X borrows in order to purchase the receivables of A, a merchant who does not accept the X card and is not otherwise engaged directly or indirectly in any business transaction with X. Because the borrowing is not related to the operation of X's trade or business, the borrowing may qualify as an integrated financial transaction if the other requirements of paragraph (c)(2) of this section are satisfied.

(d) *Special rules.* In applying paragraphs (b) and (c) of this section, the following special rules shall apply.

(1) *Related person transactions.* The rules of this section shall not apply to the extent that any transaction—

(i) Involves either indebtedness between related persons (as defined in section § 1.861–8T(c)(2)) or indebtedness incurred from unrelated persons for the purpose of purchasing property from a related person; or

(ii) Involves the purchase of property that is leased to a related person (as defined in § 1.861–8T(c)(2)) in a transaction described in paragraph (b) of this section. If a taxpayer purchases property and leases such property in whole or in part to a related person, a portion of the interest incurred in connection with such an acquisition, based on the ratio that the value of the property leased to the related person bears to the total value of the property, shall not qualify for direct allocation under this section.

(2) *Consideration of assets or income to which interest is directly allocated in apportioning other interest expense.* In apportioning interest expense under § 1.861–9T, the year-end value of any asset to which interest expense is directly allocated under this section during the current taxable year shall be reduced to the extent provided in § 1.861–9T(g)(2)(iii) to reflect the portion of the principal amount of the indebtedness outstanding at year-end relating to the interest which is directly allocated. A similar adjustment shall be made to the end-of-year value of assets for the prior year for purposes of determining the beginning-of-year value of assets for the current year. These adjustments shall be made prior to averaging beginning-of-year and end-of-year values pursuant to § 1.861–9T(g)(2). In apportioning interest expense under the modified gross income method, gross income shall be reduced by the amount of income to which interest expense is directly allocated under this section.

(e) *Treatment of certain related controlled foreign corporation indebtedness*—(1) *In general.* In taxable years beginning after 1987, if a United States shareholder has incurred substantially disproportionate indebtedness in relation to the indebtedness of its related controlled foreign corporations so that such corporations have excess related person indebtedness (as determined under step 4 in subdivision (iv) of this paragraph (e)(1), the third party interest expense of the related United States shareholder (excluding amounts allocated under paragraphs (b) and (c)) in an amount equal to the interest income received on such excess related person indebtedness shall be allocated to gross income in the various separate limitation categories described in section 904(d)(1) in the manner prescribed in step 6 in subdivision (vi) of this paragraph (e)(1). This computation shall be performed as follows.

(i) *Step 1: Compute the debt-to-asset ratio of the related United States shareholder.* The debt-to-asset ratio of the related United States shareholder is the ratio between—

(A) The average month-end debt level of the related United States shareholder taking into account debt owing to any obligee who is not a related person as defined in section §1.861–8T(c)(2), and

(B) The value of assets (tax book or fair market) of the related United States shareholder including stockholdings and obligations of related controlled foreign corporations but excluding stockholdings and obligations of members of the affiliated group (as defined in §1.861–11T(d)).

(ii) *Step 2: Compute aggregate debt-to-asset ratio of all related controlled foreign corporations.* The aggregate debt-to-asset ratio of all related controlled foreign corporations is the ratio between—

(A) The average aggregate month-end debt level of all related controlled foreign corporations for their taxable years ending during the related United States shareholder's taxable year taking into account only indebtedness owing to persons other than the related United States shareholder or the related United States shareholder's other related controlled foreign corporations (''third party indebtedness''), and

(B) The aggregate value (tax book or fair market) of the assets of all related controlled foreign corporations for their taxable years ending during the related United States shareholder's taxable year excluding stockholdings in and obligations of the related United States shareholder or the related United States shareholder's other related controlled foreign corporations.

(iii) *Step 3: Compute aggregate related person debt of all related controlled foreign corporations.* This amount equals the average aggregate month-end debt level of all related controlled foreign corporations for their taxable years ending with or within the related United States shareholder's taxable year, taking into account only debt which is owned to the related United States shareholder (''related person indebtedness'').

(iv) *Step 4: Computation of excess related person indebtedness and computation of the income therefrom*—(A) *General rule.* If the ratio computed under step 2 is less than applicable percentage of the ratio computed under step 1, the taxpayer shall add to the aggregate third party indebtedness of all related controlled foreign corporations determined under paragraph (e)(1)(ii)(A) of this section that portion of the related person indebtedness computed under step 3 that, when combined with the aggregate third party indebtedness of all controlled foreign corporations, makes the ratio computed under step 2 equal to applicable percentage of the ratio computed under step 1. The amount of aggregate related person debt that is so added to the aggregate third party debt of related controlled foreign corporations is considered to constitute excess related person indebtedness. For purposes of this paragraph (e)(1)(iv)(A), the term ''applicable percentage'' means the designated percentages for taxable years beginning during the following calendar years:

Taxable years beginning in	Applicable percentage
1988	50
1989	65
1990 and thereafter	80

(B) *Elective quadratic formula.* In calculating the amount of excess related party indebtedness of related controlled foreign corporations, the United States shareholder's debt-to-asset ratio may be adjusted to reflect the amount by which its debt and assets would be reduced had the related controlled foreign corporations incurred the excess related party indebtedness directly to third parties. In such case, the ratio computed in Step 1 is adjusted to reflect a reduction of both portions of the ratio by the amount of excess related person indebtedness as computed under this paragraph (e)(1)(ii)(A). Excess related person indebtedness may be computed under the following formula, under which excess related person indebtedness equals the smallest positive amount (not exceeding the aggregate amount of related controlled foreign corporation indebtedness) that is a solution to the following formula (with X equalling the amount of excess related person indebtedness):

$$\frac{\text{Aggregate third party debt of related US shareholder} - X}{\text{US shareholder assets} - X} \times \text{Applicable percentage for year} = \frac{\text{Aggregate third party debt of related CFCs} + X}{\text{Related CFC assets}}$$

Guidance concerning the solution of this equation is set forth in *Example* (2) of § 1.861–12(k).

(C) *Computation of interest income received on excess related party indebtedness.* The amount of interest income received on excess related person indebtedness equals the total interest income on related person indebtedness derived by the related United States shareholder during the taxable year multiplied by the ratio of excess related person indebtedness over the aggregate related person indebtedness for the taxable year.

(v) *Step 5: Determine the aggregate amount of related controlled foreign corporation obligations held by the related United States shareholder in each limitation category.* The aggregate amount of related controlled foreign corporation obligations held by the related United States shareholder in each limitation category equals the sum of the value of all such obligations in each limitation category. Solely for purposes of this paragraph (e)(1)(v), each debt obligation in a related controlled foreign corporation held by a related United States shareholder shall be attributed to separate limitation categories in the same manner as the stock of the obligor would be attributed under the rules of § 1.861–12T(c)(3), whether or nor such stock is held directly by such related United States shareholder.

(vi) *Step 6: Direct allocation of United States shareholder third party interest expense.* Third party interest expense of the related United States shareholder equal to the amount of interest income received on excess related person indebtedness as determined in step 4 shall be allocated among the various separate limitation categories in proportion to the relative aggregate amount of related controlled foreign corporation obligations held by the related United States shareholder in each such category, as determined under step 5. The remaining portion of third party interest expense will be apportioned as provided in §§ 1.861–8T through 1.861–13T, excluding this paragraph.

(2) *Definitions*—(i) *United States shareholder.* For purposes of this paragraph, the term ‘‘United States shareholder’’ has the same meaning as defined by section 957, except that, in the case of a United States shareholder that is a member an affiliated group (as defined in § 1.861–11T(d)), the entire affiliated group shall be considered to constitute a single United States shareholder. The term ‘‘related United States shareholder’’ is the United States shareholder (as defined in this paragraph (e)(2)(i)) with respect to which related controlled foreign corporations (as defined in paragraph (e)(2)(ii) of this section) are related within the meaning of that paragraph.

(ii) *Related controlled foreign corporation.* For purposes of this section, the term ‘‘related controlled foreign corporation’’ means any controlled foreign corporation which is a related person (as defined in § 1.861–8T(c)(2)) to a United States shareholder (as defined paragraph (e)(2)(i) of this section).

(iii) *Value of assets and amount of liabilities.* For purposes of this section, the value of assets is determined under § 1.861–9T(g). Thus, in the case of assets that are denominated in foreign currency, the average of the beginning-of-year and end-of-year values is determined in foreign currency and translated into dollars using exchange rates on the last day of the related United States shareholder’s taxable year. In the case of liabilities that are denominated in foreign currency, the average month-end debt level of such liabilities is determined in foreign currency and then translated into dollars using exchange rates on the last day of the related United States shareholder’s taxable year.

(3) *Treatment of certain stock.* To the extent that there is insufficient related person indebtedness of all related controlled foreign corporations under step 3 in paragraph (e)(1)(iii) of this section to achieve as equal ratio in step 4 of

paragraph (e)(1)(iv) of this section, certain stock held by the related United States shareholder will be treated as related person indebtedness. Such stock includes—

(i) Any stock in the related controlled foreign corporation that is treated in the same manner as debt under the law of any foreign country that grants a deduction for interest or original issue discount relating to such stock, and

(ii) Any stock in a related controlled foreign corporation that has made loans to, or held stock described in this paragraph (e)(3) in, another related controlled foreign corporation. However, such stock shall be treated as related person indebtedness only to the extent of the principal amount of such loans.

For purposes of computing income from excess related person indebtedness in step 4 of paragraph (e)(1)(iv) of this section, stock that is treated under this paragraph as related person indebtedness shall be considered to yield interest in an amount equal to the interest that would be computed on an equal amount of indebtedness under section 1274. Only dividends actually paid thereon shall be included in gross income for other purposes.

(4) *Adjustments to assets in apportioning other interest expense.* In apportioning interest expense under §1.861–9T, the value of assets in each separate limitation category for the taxable year as determined under §1.861–9T(g)(3) shall be reduced (but not below zero) by the principal amount of third party indebtedness of the related United States shareholder the interest expense on which is allocated to each such category under paragraph (e)(1) of this section.

(5) *Exceptions*—(i) *Per company rule.* If—

(A) A related controlled foreign corporation with obligations owing to a related United States shareholder has a greater proportion of passive assets than the proportion of passive assets held by the related United States shareholder,

(B) Such passive assets are held in liquid or short term investments, and

(C) There are frequent cash transfers between the related controlled foreign corporation and the related United States shareholder,

the Commissioner, in his discretion, may choose to exclude such a corporation from other related controlled foreign corporations in the application of the rules of this paragraph (e).

(ii) *Aggregate rule.* If it is determined that, in aggregate, the application of the rules of this paragraph (e) increases a taxpayer's foreign tax credit as determined under section 901(a), the Commissioner, in his discretion, may choose not to apply the rules of this paragraph. If the Commissioner exercises discretion under this paragraph (e)(5)(ii), then paragraph (e) shall not apply to any extent to any interest expense of the taxpayer.

[T.D. 8228, 53 FR 35485, Sept. 14, 1988]

§1.861–11T Special rules for allocating and apportioning interest expense of an affiliated group of corporations (temporary regulations.)

(a) *In general.* Sections 1.861–9T, 1.861–10T, 1.861–12T, and 1.861–13T provide rules that are generally applicable in apportioning interest expense. The rules of this section relate to affiliated groups of corporations and implement section 864(e) (1) and (5), which requires affiliated group allocation and apportionment of interest expense. The rules of this section apply to taxable years beginning after December 31, 1986, except as otherwise provided in §1.861–13T. Paragraph (b) of this section describes the scope of the application of the rule for the allocation and apportionment of interest expense of affiliated groups of corporations, which is contained in paragraph (c) of this section. Paragraph (d) of this section sets forth the definition of the term ‘‘affiliated group’’ for purposes of this section. Paragraph (e) describes the treatment of loans between members of an affiliated group. Paragraph (f) of this section provides rules concerning the affiliated group allocation and apportionment of interest expense in computing the combined taxable income of a FSC or DISC and its related supplier. Paragraph (g) of this section describes the treatment of losses caused by apportionment of interest expense in the case of an affiliated group that does not file a consolidated return.

(b) *Scope of application*—(1) *Application of section 864(e) (1) and (5) (concerning the definition and treatment of affiliated groups).* Section 864(e) (1) and (5) and the portions of this section implementing section 864(e) (1) and (5) apply to the computation of foreign source taxable income for purposes of section 904 (relating to various limitations on the foreign tax credit). Section 904 imposes separate foreign tax credit limitations on passive income, high withholding interest income, financial services income, shipping income, income consisting of dividends from each noncontrolled section 902 corporation, income consisting of dividends from a DISC or former DISC, taxable income attributable to foreign trade income within the meaning of section 923(b), distributions from a FSC or former FSC, and all other forms of foreign source income not enumerated above (''general limitation income''). Section 864(e) (1) and (5) and the portions of this section implementing section 864(e) (1) and (5) also apply in connection with section 907 to determine reductions in the amount allowed as a foreign tax credit under section 901. Section 864(e) (1) and (5) and the portions of this section implementing section 864(e) (1) and (5) also apply to the computation of the combined taxable income of the related supplier and a foreign sales corporation (FSC) (under sections 921 through 927) as well as the combined taxable income of the related supplier and a domestic international sales corporation (DISC) (under sections 991 through 997).

(2) *Nonapplication of section 864(e) (1) and (5) (concerning the definition and treatment of affiliated groups).* Section 864(e) (1) and (5) and the portions of this section implementing section 864(e) (1) and (5) do not apply to the computation of subpart F income of controlled foreign corporations (under sections 951 through 964), the computation of combined taxable income of a possessions corporation and its affiliates (under section 936), or the computation of effectively connected taxable income of foreign corporations. For the rules with respect to the allocation and apportionment of interest expenses of foreign corporations other than controlled foreign corporations, see §§ 1.882–4 and 1.882–5.

(c) *General rule for affiliated corporations.* Except as otherwise provided in this section, the taxable income of each member of an affiliated group within each statutory grouping shall be determined by allocating and apportioning the interest expense of each member according to apportionment fractions which are computed as if all members of such group were a single corporation. For purposes of determining these apportionment fractions, stock in corporations within the affiliated group (as defined in section 864(e)(5) and the rules of this section) shall not be taken into account. In the case of an affiliated group of corporations that files a consolidated return, consolidated foreign tax credit limitations are computed for the group in accordance with the rules of § 1.1502–4. Except as otherwise provided, all the interest expense of all members of the group will be treated as definitely related and therefore allocable to all the gross income of the members of the group and all the assets of all the members of the group shall be taken into account in apportioning this interest expense. For purposes of this section, the term ''taxpayer'' refers to the affiliated group (regardless of whether the group files a consolidated return), rather than to the separate members thereof.

(d) *Definition of affiliated group*—(1) *General rule.* For purposes of the section, in general, the term ''affiliated group'' has the same meaning as is given that term by section 1504, except that section 936 companies are also included within the affiliated group. Section 1504(a) defines an affiliated group as one or more chains of includible corporations connected through 80-percent stock ownership with a common parent corporation which is an includible corporation (as defined in section 1504(b)). In the case of a corporation that either becomes or ceases to be a member of the group during the course of the corporation's taxable year, only the interest expense incurred by the group member during the period of membership shall be allocated and apportioned as if all members of the group were a single corporation. In this regard, assets held during the period of membership shall be taken into account. Other interest expense incurred by the group member during its taxable year but not during the period of membership shall be allocated and apportioned without regard to other members of the group.

(2) *Inclusion of section 936 corporations*—(i) The exclusion from the affiliated group of section 936 corporations under section 1504(b)(4) is inoperative for purposes of this section. Thus, a possessions corporation meeting the ownership requirements of section 1504(a) with respect to which an election under section 936 is in effect for the taxable year is a member of the affiliated group.

(ii) Example— (A) Facts. X is the common parent of Y and Z. XY constitutes an affiliated group of corporations within the meaning of section 1504(a) and uses the tax book value method of apportionment. Y owns all the stock of Z, a possessions corporation with respect to which an election under section 936 is in effect for the taxable year. Z manufactures widgets in Puerto Rico. Y purchases these widgets and markets them exclusively in the United States. Of the three corporations, only Z has foreign source income, which includes both qualified possessions source investment income and general limitation income. For purposes of section 904, Z's qualified possessions source investment income constitutes foreign source passive income. In computing the section 936 benefit, Y and Z have elected the cost sharing method. Of the three corporations, only X has debt and, thus, only X incurs interest expense.

(B) *Analysis.* As provided in paragraph (b)(2) of this section, sections 864(e)(1) and (5) do not apply in the computation of benefits under section 936(h). The effect of including Z in the affiliated group relates to the fact that X, the only debtor corporation in the group, must, under the asset method described in §1.861–9T(g), apportion a part of its interest expense to foreign source passive income and foreign source general limitation income. This is because the assets of Z that generate qualified possessions source investment income and general limitation income are included in computing the group apportionment fractions. The result is that, under section 904(f), X has an overall foreign loss in both the passive and general limitation categories, which currently offsets domestic income and must be recaptured against any subsequent years' foreign passive income and general limitation income, respectively, under the rules of that section.

(3) *Treatment of life insurance companies subject to taxation under section 801*—(i) *General rule.* A life insurance company that is subject to taxation under section 801 shall be considered to constitute a member of the affiliated group composed of companies not taxable under section 801 only if a parent corporation so elects under section 1504(c)(2)(A) of the Code. If a parent does not so elect, no adjustments shall be required with respect to such an insurance company under paragraph (g) of this section.

(ii) *Treatment of stock.* Stock of a life insurance company that is subject to taxation under section 801 that is not included in an affiliated group shall be disregarded in the allocation and apportionment of the interest expense of such affiliated group.

(4) *Treatment of certain financial corporations*—(i) *In general.* In the case of an affiliated group (as defined in paragraph (d)(1) of this section), any member that constitutes financial corporations as defined in paragraph (d)(4)(ii) of this section shall be treated as a separate affiliated group consisting of financial corporations (the ''financial group''). The members of the group that do not constitute financial corporations shall be treated as members of a separate affiliated group consisting of nonfinancial corporations (''the nonfinancial group'').

(ii) *Financial corporation defined.* The term ''financial corporation'' means any corporation which meets all of the following conditions:

(A) It is described in section 581 (relating to the definition of a bank) or section 591 (relating to the deduction for dividends paid on deposits by mutual savings banks, cooperative banks, domestic building and loan associations, and other savings institutions chartered and supervised as savings and loan or similar associations);

(B) Its business is predominantly with persons other than related persons (within the meaning of section 864(d)(4) and the regulations thereunder) or their customers; and

(C) It is required by state or Federal law to be operated separately from any other entity which is not such an institution.

(iii) *Treatment of bank holding companies.* The total aggregate interest expense of any member of an affiliated group that constitutes a bank holding company subject to regulation under the Bank Holding Company Act of 1956 shall be prorated between the financial group and the nonfinancial group on the basis of the assets in the financial and nonfinancial groups. For purposes of making this proration, the assets of each member of each group, and not the stock basis in each member, shall be taken into account. Any direct or indirect subsidiary of a bank holding company that is predominantly engaged in the active conduct of a banking, financing, or similar business shall be considered to be a financial corporation for purposes of this paragraph (d)(4). The interest expense of the bank holding company must be further apportioned in accordance with § 1.861–9T(f) to the various section 904(d) categories of income contained in both the financial group and the nonfinancial group on the basis of the assets owned by each group. For purposes of computing the apportionment fractions for each group, the assets owned directly by a bank holding company within each limitation category described in section 904(d)(1) (other than stock in affiliates or assets described in § 1.861–9T(f)) shall be treated as owned pro rata by the nonfinancial group and the financial group based on the relative amounts of investments of the bank holding company in the nonfinancial group and financial group.

(iv) *Consideration of stock of the members of one group held by members of the other group.* In apportioning interest expense, the nonfinancial group shall not take into account the stock of any lower-tier corporation that is treated as a member of the financial group under paragraph (d)(4)(i) of this section. Conversely, in apportioning interest expense, the financial group shall not take into account the stock of any lower-tier corporation that is treated as a member of the nonfinancial group under paragraph (d)(4)(i) of this section. For the treatment of loans between members of the financial group and members of the nonfinancial group, see paragraph (e)(1) of this section.

(5) Example— (i) Facts. X, a domestic corporation which is not a bank holding company, is the parent of domestic corporations Y and Z. Z owns 100 percent of the stock Z1, which is also a domestic corporation. X, Y, Z, and Z1 were organized after January 1, 1987, and constitute an affiliated group within the meaning of paragraph (d)(1) of this section. Y and Z are financial corporations described in paragraph (d)(4) of this section. X also owns 25 percent of the stock of A, a domestic corporation. Y owns 25 percent of the voting stock of B, a foreign corporation that is not a controlled foreign corporation. Z owns less than 10 percent of the voting stock of C, another foreign corporation. The foreign source income generated by Y's or Z's direct assets is exclusively financial services income. The foreign source income generated by X's or Z1's direct assets is exclusively general limitation income. X and Z1 are not financial corporations described in paragraph (d)(4)(ii) of this section. Y and Z, therefore, constitute a separate affiliated group apart from X and Z1 for purposes of section 864(e). The combined interest expense of Y and Z of $100,000 ($50,000 each) is apportioned separately on the basis of their assets. The combined interest expense of X and Z1 of $50,000 ($25,000 each) is allocated on the basis of the assets of the XZ1 group.

Analysis of the YZ group assets

Adjusted basis of assets of the YZ group that generate foreign source financial services income (excluding stock of foreign subsidiaries not included in the YZ affiliated group)	$200,000
Z's basis in the C stock (not adjusted by the allocable amount of C's earnings and profits because Z owns less than 10 percent of the stock) which would be considered to generate passive income in the hands of a nonfinancial services entity but is considered to generate financial services income when in the hands of Z, a financial services entity	$100,000
Y's basis in the B stock (adjusted by the allocable amount of B's earnings and profits) which generates dividends subject to a separate limitation for B dividends	$100,000
Adjusted basis of assets of the YZ group that generate U.S. source income	$600,000
Total assets	$1,000,000

Analysis of the XZ1 group assets

Adjusted basis of assets of the XZ1 group that generate foreign source general limitation income	$500,000
Adjusted basis of assets of the XZ1 group other than A stock that generate domestic source income	$1,900,000
X's basis in the A stock adjusted by the allocable amount of A's earnings and profits	$100,000
Total domestic assets	$2,000,000
Total assets	$2,500,000

(ii) *Allocation.* No portion of the $50,000 deduction of the YZ group is definitely related solely to specific property within the meaning of §1.861–10T. Thus, the YZ group's deduction for interest is related to all its activities and properties. Similarly, no portion of the $50,000 deduction of the XZ1 group is definitely related solely to specific property within the meaning of §1.861–10T. Thus, the XZ1 group's deduction for interest is related to all its activities and properties.

(iii) *Apportionment.* The YZ group would apportion its interest expense as follows:

To gross financial services income from sources outside the United States:

$$\$50{,}000\times\frac{\$300{,}000}{\$1{,}000{,}000}\ldots\ldots\$15{,}000$$

To gross income subject to a separate limitation for dividends from B:

$$\$50{,}000\times\frac{\$100{,}000}{\$1{,}000{,}000}\ldots\ldots\$5{,}000$$

To gross income from sources inside the United States:

$$\$50{,}000\times\frac{\$600{,}000}{\$1{,}000{,}000}\ldots\ldots\$30{,}000$$

The XZ1 group would apportion its interest expense as follows:

To gross general limitation income from sources outside the United States:

$$\$50{,}000\times\frac{\$500{,}000}{\$2{,}500{,}000}\ldots\ldots\$10{,}000$$

To gross income from sources inside the United States:

$$\$50{,}000\times\frac{\$2{,}000{,}000}{\$2{,}500{,}000}\ldots\ldots\$40{,}000$$

(6) *Certain unaffiliated corporations.* Certain corporations that are not described in paragraph (d)(1) of this section will nonetheless be considered to constitute affiliated corporations for purposes of §§1.861–9T through 1.861–13T. These corporations include:

(i) Any includible corporation (as defined in section 1504(b) without regard to section 1504(b)(4)) if 80 percent of either the vote or value of all outstanding stock of such corporation is owned directly or indirectly by an includible corporation or by members of an affiliated group, and

(ii) Any foreign corporation if 80 percent of either the vote or value of all outstanding stock of such corporation is owned directly or indirectly by members of an affiliated group, and if more than 50 percent of the gross income of such corporation for the taxable year is effectively connected with the conduct of a United States trade or business. If 80 percent or more of the gross income of such corporation is effectively connected income, then all the assets of such corporation and all of its interest expense shall be taken into account. If between 50 and 80 percent of the gross income of such corporation is effectively connected income, then only the assets of such corporation that generate effectively connected income and a percentage of its interest expense equal to the percentage of its assets that generate effectively connected income shall be taken into account.

The attribution rules of section 318 shall apply in determining indirect ownership under this paragraph (d)(6). The Commissioner shall have the authority to disregard trusts, partnerships, and pass-through entities that break affiliated status. Corporations described in this paragraph (d)(6) shall be considered to constitute members of an affiliated group that does not file a consolidated return and shall therefore be subject to the limitations imposed under paragraph (g) of this section. The affiliated group filing a consolidated return shall be considered to constitute a single corporation for purposes of applying the rules of paragraph (g) of this section.

(e) *Loans between members of an affiliated group*—(1) *General rule.* In the case of loans (including any receivable) between members of an affiliated group, as defined in paragraph (d) of this section, for purposes of apportioning interest expense, the indebtedness of the member borrower shall not be considered an asset of the member lender. However, in the case of members of separate financial and nonfinancial groups under paragraph (d)(4) of this section, the indebtedness of the member borrower shall be considered an asset of the member lender and such asset shall be characterized by reference to the member lender's income from the asset as determined under paragraph (e)(2)(ii) of this section. For purposes of this paragraph (e), the terms ''related person interest income'' and ''related person interest payment'' refer to interest paid and received by members of the same affiliated group as defined in paragraph (d) of this section.

(2) *Treatment of interest expense within the affiliated group*—(i) *General rule.* A member borrower shall deduct related person interest payments in the same manner as unrelated person interest expense using group apportionment fractions computed under § 1.861–9T(f). A member lender shall include related person interest income in the same class of gross income as the class of gross income from which the member borrower deducts the related person interest payment.

(ii) *Special rule for loans between financial and nonfinancial affiliated corporations.* In the case of a loan between two affiliated corporations only one of which constitutes a financial corporation under paragraph (d)(4) of this section, the member borrower shall allocate and apportion related person interest payments in the same manner as unrelated person interest expense using group apportionment fractions computed under § 1.861–9T(f). The source of the related person interest income to the member lender shall be determined under section 861(a)(1).

(iii) *Special rule for high withholding tax interest.* In the case of an affiliated corporation that pays interest that is high withholding tax interest under § 1.904–5(f)(1) to another affiliated corporation, the interest expense of the payor shall be allocated to high withholding tax interest.

(3) *Back-to-back loans.* If a member of the affiliated group makes a loan to a nonmember who makes a loan to a member borrower, the rule of paragraphs (e) (1) and (2) of this section shall apply, in the Commissioner's discretion, as if the member lender made the loan directly to the member borrower, provided that the loans constitute a back-to-back loan transaction. Such loans will constitute a back-to-back loan for purposes of this paragraph (e) if the loan by the nonmember would not have been made or maintained on substantially the same terms irrespective of the loan of funds by the lending member to the nonmember or other intermediary party.

(4) *Examples.* The rules of this paragraph (e) may be illustrated by the following examples.

Example 1. X, a domestic corporation, is the parent of Y, a domestic corporation. X and Y were organized after January 1, 1987, and constitute an affiliated group within the meaning of paragraph (d)(1) of this section. Among X's assets is the note of Y for the amount of $100,000. Because X and Y are members of an affiliated group, Y's note does not constitute an asset for purposes of apportionment. The apportionment fractions for the relevant tax year of the XY group are 50 percent domestic, 40 percent foreign general, and 10 percent foreign passive. Y deducts its related person interest payment using those apportionment fractions. Of the $10,000 in related person interest income received by X, $5,000 consists of domestic source income, $4,000 consists of foreign general limitation income, and $1,000 consists of foreign passive income.

Example 2. X is a domestic corporation organized after January 1, 1987. X owns all the stock of Y, a domestic corporation. On June 1, 1987, X loans $100,000 to Z, an unrelated person. On June 2, 1987, Z makes a loan to Y with terms substantially similar to those of the loan from X to Z. Based on the facts and circumstances of the transaction, it is determined that Z would not have made the loan to Y on the same terms if X had not made the loan to Z. Because the transaction constitutes a back-to-back loan, as defined in paragraph (e)(3) of this section, the Commissioner may require, in his discretion, that neither the note of Y nor the note of Z may be considered an asset of X for purposes of this section.

(f) *Computations of combined taxable income.* In the computation of the combined taxable income of any FSC or DISC and its related supplier which is a member of an affiliated group under the pricing rules of sections 925 or 994, the combined taxable income of such FSC or DISC and its related supplier shall be reduced by the portion of the total interest expense of the affiliated group that is incurred in connection with those assets of the group used in connection with export sales involving that FSC or DISC. This amount shall be computed by multiplying the total interest expense of the affiliated group and interest expense of the FSC or DISC by a fraction the numerator of which is the assets of the affiliated group and of the FSC or DISC generating foreign trade income or gross income attributable to qualified export receipts, as the case may be, and the denominator of which is the total assets of the affiliated group and the FSC or DISC. Under this rule, interest of other group members may be attributed to the combined taxable income of a FSC or DISC and its related supplier without affecting the amount of interest otherwise deductible by the FSC or DISC, the related supplier or other member of the affiliated group. The FSC or DISC is entitled to only the statutory portion of the combined taxable income, net of any deemed interest expense, which determines the commission paid to the FSC or DISC or the transfer price of qualifying export property sold to the FSC or DISC.

(g) *Losses created through apportionment*—(1) *General rules.* In the case of an affiliated group that is eligible to file, but does not file, a consolidated return and in the case of any corporation described in paragraph (d)(6) of this section, the foreign tax credits in any separate limitation category are limited to the credits computed under the rules of this paragraph (g). As a consequence of the affiliated group allocation and apportionment of interest expense required by section 864(e)(1) and this section, interest expense of a group member may be apportioned for section 904 purposes to a limitation category in which that member has no gross income, resulting in a loss in that limitation category. The same is true in connection with any expense other than interest that is subject to apportionment under the rules of section 864(e)(6) of the Code. Any reference to ‘‘interest expense’’ in this paragraph (g) shall be treated as including such expenses. For purposes of this paragraph, the term ‘‘limitation category’’ includes domestic source income, as well as the types of income described in section 904(d)(1) (A) through (I). A loss of one affiliate in a limitation category will reduce the income of another member in the same limitation category if a consolidated return is filed. (See §1.1502–4.) If a consolidated return is not filed, this netting does not occur. Accordingly, in such a case, the following adjustments among members are required in order to give effect to the group allocation of interest expense:

(i) Losses created through group apportionment of interest expense in one or more limitation categories within a given member must be eliminated; and

(ii) A corresponding amount of income of other members in the same limitation category must be recharacterized.

Such adjustments shall be accomplished, in accordance with paragraph (g)(2) of this section, without changing the total taxable income of any member and before the application of section 904(f). Section 904(f) (including section 904(f)(5)) does not apply to a loss created through the apportionment of interest expense to the extent that the loss is eliminated pursuant to paragraph (g)(2)(ii) of this section. For purposes of this section, the terms ‘‘limitation adjustment’’ and ‘‘recharacterization’’ mean the recharacterization of income in one limitation category as income in another limitation category.

(2) *Mechanics of computation*—(i) *Step 1: Computation of consolidated taxable income.* The members of an affiliated group must first allocate and apportion

all other deductible expenses other than interest. The members must then deduct from their respective gross incomes within each limitation category interest expense apportioned under the rules of § 1.861–9T(f). The taxable income of the entire affiliated group within each limitation category is then totalled.

(ii) *Step 2: Loss offset adjustments.* If, after step 1, a member has losses in a given limitation category or limitation categories created through apportionment of interest expense, any such loss (*i.e.*, the portion of such loss equal to interest expense) shall be eliminated by offsetting that loss against taxable income in other limitation categories of that member to the extent of the taxable income of other members within the same limitation category as the loss. If the member has taxable income in more than one limitation category, then the loss shall offset taxable income in all such limitation categories on a pro rata basis. If there is insufficient domestic income of the member to offset the net losses in all foreign limitation categories caused by the apportionment of interest expense, the losses in each limitation category shall be recharacterized as domestic losses to the extent of the taxable income of other members in the same respective limitation categories. After these adjustments are made, the income of the entire affiliated group within each limitation category is totalled again.

(iii) *Step 3: Determination of amount subject to recharacterization.* In order to determine the amount of income to be recharacterized in step 4, the income totals computed under step 1 in each limitation category shall be subtracted from the income totals computed under step 2 in each limitation category.

(iv) *Step 4: Recharacterization.* Because any differences determined under step 3 represent deviations from the consolidated totals computed under Step 1, such differences (in any limitation category) must be eliminated.

(A) *Limitation categories to be reduced.* In the case of any limitation category in which there is a positive change, the income of group members with income in that limitation category must be reduced on a pro rata basis (by reference to net income figures as determined under Step 2) to the extent of such positive change (“limitation reductions”). Each member shall separately compute the sum of the limitation reductions.

(B) *Limitation categories to be increased.* In any case in which only one limitation category has a negative change in Step 3, the sum of the limitation reductions within each member is added to that limitation category. In the case in which multiple limitation categories have negative changes in Step 3, the sum of the limitation reductions within each member is prorated among the negative change limitation categories based on the ratio that the negative change for the entire group in each limitation category bears to the total of all negative changes for the entire group in all limitation categories.

(3) *Examples.* The following examples illustrate the principles of this paragraph.

Example 1 —(i) *Facts.* X, a domestic corporation, is the parent of domestic corporations Y and Z. X, Y, and Z were organized after Janaury 1, 1987, constitute an affiliated group within the meaning of paragraph (d)(1) of this section, but do not file a consolidated return. The XYZ group apportions its interest expense on the basis of the fair market value of its assets. X, Y, and Z have the following assets, interest expense, and taxable income before apportioning interest expense:

Assets	X	Y	Z	Total
Domestic	2,000.00	0	1,000.00	3,000.00
Foreign Passive	0	50.00	50.00	100.00
Foreign General	0	700.00	200.00	900.00
Interest expense	48.00	12.00	80.00	140.00
Taxable Income (pre-interest):				
Domestic	100.00	0	63.00	163.00
Foreign Passive	0	5.00	5.00	10.00
Foreign General	0	60.00	35.00	95.00

(ii) *Step 1: Computation of consolidated taxable income.* Each member of the XYZ group apportions its interest expense according to group apportionment ratios determined under the asset method decribed in § 1.861–9T(f), yielding the following results:

Apportioned interest expense	X	Y	Z	Total
Domestic	36.00	9.00	60.00	105.00
Foreign Passive	1.20	0.30	2.00	3.50
Foreign General	10.80	2.70	18.00	31.50
Total	48.00	12.00	80.00	140.00

The members of the group then compute taxable income within each category by deducting the apportioned interest expense from the amounts of pre-interest taxable income specified in the facts in paragraph (i), yielding the following results:

Taxable income	X	Y	Z	Total
Domestic	64.00	9.00	3.00	58.00
Foreign Passive	−1.20	4.70	3.00	6.50
Foreign General	−10.80	57.30	17.00	63.50
Total	52.00	53.00	23.00	128.00

(iii) *Step 2: Loss offset adjustments.* Because X and Y have losses created through apportionment, these losses must be eliminated by reducing taxable income of the member in other limitation categories. Because X has a total of $12 in apportionment losses and because it has only one limitation category with income (*i.e.*, domestic), domestic income must be reduced by $12, thus eliminating its apportionment losses. Because Y has a total of $9 in apportionment losses and because it has two limitation categories with income (*i.e.*, foreign passive and foreign general limitation), the income in these two limitation categories must be reduced on a pro rata basis in order to eliminate its apportionment losses. In summary, the following adjustments are required:

Loss offset adjustments	X	Y	Z	Total
Domestic	−12.00	+9.00	0	−3.00
Foreign Passive	+1.20	−0.68	0	+0.52
Foreign General	+10.80	−8.32	0	+2.48

These adjustments yield the following adjusted taxable income figures:

Adjusted taxable income	X	Y	Z	Total
Domestic	52.00	0	3.00	55.00
Foreign Passive	0	4.02	3.00	7.02
Foreign General	0	48.98	17.00	65.98
Total	52.00	53.00	23.00	128.00

(iv) *Step 3: Determination of amount subject to recharacterization.* The adjustments performed under Step 2 led to a change in the group's taxable income within each limitation category. The total loss offset adjustments column shown in paragraph (iii) above shows the net deviations between Step 1 and 2.

(v) *Step 4: Recharacterization.* The loss offset adjustments yield a positive change in the foreign passive and the foreign general limitation categories. Y and Z both have income in these limitation categories. Accordingly, the income of Y and Z in each of these limitation categories must be reduced on a pro rata basis (by reference to the adjusted taxable income figures) to the extent of the positive change in each limitation category. The total positive change in the foreign passive limitation category is $0.52. The adjusted taxable income of Y in the foreign passive limitation category is $4.02 and the adjusted taxable income of Z in the foreign passive limitation category is $3. Therefore, $0.30 is drawn from Y and $0.22 is drawn from Z. The total positive change in the foreign general limitation category is $2.48. The adjusted taxable income of Y in the foreign general limitation category is $48.98, and the adjusted taxable income of Z in the foreign general limitation category is $17. Therefore, $1.84 is drawn from Y and $.64 is drawn from Z.

The members must then separately compute the sum of the limitation reductions. Y has limitation reductions of $0.30 in the foreign passive limitation category and $1.84 in the foreign general limitation category, yielding total limitation reduction of $2.14. Under these facts, domestic income is the only limitation category requiring a positive adjustment. Accordingly, Y's domestic income is increased by $2.14. Z has limitation reductions of $0.22 in the foreign passive limitation category and $0.64 in the foreign general limitation category, yielding total limitation reductions of $0.86. Under these facts, domestic income is the only limitation category of Z requiring a positive adjustment. Accordingly, Z's domestic income is increased by $0.86.

Recharacterization adjustments	X	Y	Z	Total
Domestic	0	+2.14	+0.86	+3.00
Foreign Passive	0	−0.30	−0.22	−0.52
Foreign General	0	−1.84	−0.64	−2.48

These recharacterization adjustments yield the following final taxable income figures:

Final taxable income	X	Y	Z	Total
Domestic	52.00	2.14	3.86	58.00
Foreign Passive	0	3.72	2.78	6.50
Foreign General	0	47.14	16.36	63.50
Total	52.00	53.00	23.00	128.00

Example 2 —(i) *Facts.* X, a domestic corporation, is the parent of domestic corporations Y and Z. X, Y, and Z were organized after January 1, 1987, constitute an affiliated group within the meaning of paragraph (d)(1) of this section, but do not file a consolidated return. Moreover, X has served as the sole borrower in the group and, as a result, has sustained an overall loss. The XYZ group apportions its interest expense on the basis of the fair market value of its assets. X, Y, and Z have the following assets, interest expense, and taxable income before interest expense:

Assets	X	Y	Z	Total
Domestic	2,000	0	1,000	3,000
Foreign Passive	0	50	50	100
Foreign General	0	700	200	900
Interest Expense	140	0	0	140
Taxable Income (pre-interest):				
Domestic	100	0	100	200
Foreign Passive	0	5	5	10
Foreign General	0	70	35	105

(ii) *Step 1: Computation of consolidated taxable income.* Each member of the XYZ group apportions its interest expense according to group apportionment ratios determined under the asset method described in § 1.861–9T(g), yielding the following results:

Apportioned interest expense	X	Y	Z	Total
Domestic	105.00	0	0	105.00
Foreign Passive	3.50	0	0	3.50
Foreign General	31.50	0	0	31.50
Total	140.00	0	0	140.00

The members of the group then compute taxable income within each category by deducting the apportioned interest expense from the amounts of pre-interest taxable income specified in the facts in paragraph (i), yielding the following results:

Taxable income	X	Y	Z	Total
Domestic	−5.00	0	100.00	95.00
Foreign Passive	−3.50	5.00	5.00	6.50
Foreign General	−31.50	70.00	35.00	73.50
Total	−40.00	75.00	140.00	175.00

(iii) *Step 2: Loss offset adjustment.* Because X has insufficient domestic income to offset the sum of the losses in the foreign limitation categories caused by apportionment, the amount of apportionment losses in each limitation category shall be recharacterized as domestic losses to the extent of taxable income of other members in the same limitation category. This is accomplished by adding to each foreign limitation categories an amount equal to the loss therein and by subtracting the sum of such foreign losses from domestic income, as follows:

Loss offset adjustments	X	Y	Z	Total
Domestic	−35.00	0	0	−35.00
Foreign Passive	+3.50	0	0	+3.50
Foreign General	+31.50	0	0	+31.50

These adjustments yield the following adjusted taxable income figures:

Adjusted taxable income	X	Y	Z	Total
Domestic	−40	0	100	60
Foreign Passive	0	5	5	10
Foreign General	0	70	35	105
Total	−40	75	140	175

(iv) *Step 3: Determination of amount subject to recharacterization.* The adjustments performed under Step 2 led to a change in the group's taxable income within each limitation category. The total loss offset adjustment column shown in paragraph (iii) above shows the net deviations between Steps 1 and 2.

(v) *Step 4: Recharacterization.* The loss offset adjustments yield a positive change in the foreign passive and the foreign general limitation categories. Y and Z both have income in these limitation categories. Accordingly, the income of Y and Z in each of these limitation categories must be reduced on a pro rata basis (by reference to the adjusted taxable income figures) to the extent of the positive change in each limitation category. The total positive change in the foreign passive limitation category is $3.50. The adjusted taxable income of Y in the foreign passive limitation category is $5, and the adjusted taxable income of Z in the foreign passive limitation category is $5. Therefore, $1.75 is drawn from Y and $1.75 is drawn from Z. The total positive change in the foreign general limitation category is $31.50. The adjusted taxable income of Y in the foreign general limitation category is $70, and the adjusted taxable income of Z in the foreign general limitation category is $35. Therefore, $21 is drawn from Y and $10.50 is drawn from Z.

The members must then separately compute the sum of the limitation reductions. Y has limitation reductions of $1.75 in the foreign passive limitation category and $21 in the foreign general limitation category, yielding total limitation reductions of $22.75. Under these facts, domestic income is the only limitation category requiring a positive adjustment. Accordingly, Y's domestic income is increased by $22.75. Z has limitation reductions of $1.75 in the foreign passive limitation category and $10.50 in the foreign general limitation category, yielding total limitation reductions of $12.25. Under these facts, domestic income is the only limitation category requiring a positive adjustment. Accordingly, Z's domestic income is increased by $12.25.

Recharacterization adjustments	X	Y	Z	Total
Domestic	0	+22.75	+12.25	+35.00
Foreign Passive	0	−1.75	−1.75	−3.50
Foreign General	0	−21.00	−10.50	−31.50

These recharacterization adjustments yield the following final taxable income figures:

Final taxable income	X	Y	Z	Total
Domestic	−40.00	22.75	112.25	95.00
Foreign Passive	0	3.25	3.25	6.50
Foreign General	0	49.00	24.50	73.50
Total	−40.00	75.00	140.00	175.00

[T.D. 8228, 53 FR 35490, Sept. 14, 1988]

§1.861–12T Characterization rules and adjustments for certain assets (temporary regulations.)

(a) *In general.* These rules are applicable to taxpayers in apportioning expenses under an asset method to income in various separate limitation categories under section 904(d), and supplement other rules provided in §§1.861–9T, 1.861–10T, and 1.861–11T. The rules of this section apply to taxable years beginning after December 31, 1986, except as otherwise provided in §1.861–13T. Paragraph (b) of this section describes the treatment of inventories. Paragraph (c)(1) of this section concerns the treatment of various stock assets. Paragraph (c)(2) of this section describes a basis adjustment for stock in nonaffiliated 10 percent owned corporations. Paragraph (c)(3) of this section sets forth rules for characterizing the stock in controlled foreign corporations. Paragraph (c)(4) of this section describes the treatment of stock of noncontrolled section 902 corporations. Paragraph (d)(1) of this section concerns the treatment of notes. Paragraph (d)(2) of this section concerns the treatment of the notes of controlled foreign corporations. Paragraph (e) of this section describes the treatment of certain portfolio securities that constitute inventory or generate income primarily in the form of gains. Paragraph (f) of this section describes the treatment of assets that are subject to the capitalization rules of section 263A. Paragraph (g) of this section concerns the treatment of FSC stock and of assets of the related supplier generating foreign trade income. Paragraph (h) of this section concerns the treatment of DISC stock and of assets of the related supplier generating qualified export receipts. Paragraph (i) of this section is reserved. Paragraph (j) of this section sets forth an example illustrating the rules of this section, as well as the rules of §1.861–9T(g).

(b) *Inventories.* Inventory must be characterized by reference to the source and character of sales income, or sales receipts in the case of LIFO inventory, from that inventory during the taxable year. If a taxpayer maintains separate inventories for any federal tax purpose, including the rules for establishing pools of inventory items under sections 472 and 474 of the Code, each separate inventory shall be separately characterized in accordance with the previous sentence.

(c) *Treatment of stock*—(1) *In general.* Subject to the adjustment and special rules of paragraphs (c) and (e) of this section, stock in a corporation is taken into account in the application of the asset method described in §1.861–9T(g). However, an affiliated group (as defined in §1.861–11T(d)) does not take into account the stock of any member in the application of the asset method.

(2) *Basis adjustment for stock in nonaffiliated 10 percent owned corporations*—(i) *Taxpayers using the tax book value method.* For purposes of apportioning expenses on the basis of the tax book value of assets, the adjusted basis of any stock in a 10 percent owned corporation owned directly by the taxpayer shall be—

(A) Increased by the amount of the earnings and profits of such corporation (and of lower-tier 10 percent owned corporations) attributable to such stock and accumulated during the period the taxpayer or other members of its affiliated group held 10 percent or more of such stock, or

(B) Reduced (but not below zero) by any deficit in earnings and profits of such corporation (and of lower-tier 10 percent owned corporations) attributable to such stock for such period.

Solely for purposes of this section, a taxpayer's basis in the stock of a controlled foreign corporation shall not include any amount included in basis under section 961 or 1293(d) of the Code. For purposes of this paragraph (c)(2), earnings and profits and deficits are computed under the rules of section 312 and, in the case of a foreign corporation, section 902 and the regulations thereunder for taxable years of the 10 percent owned corporation ending on or before the close of the taxable year of the taxpayer. The rules of section 1248 and the regulations thereunder shall apply to determine the amount of earnings and profits that is attributable to stock without regard to whether earned and profits (or deficits) were derived (or incurred) during taxable years beginning before or after December 31, 1962. This adjustment is to be made annually and is noncumulative. Thus, the adjusted basis of the stock (determined without prior years' adjustments under this section) is to be adjusted annually by the amount of accumulated earnings and profits (or any deficit) attributable to such stock as of the end of each year. Earnings and profits or deficits of a qualified business unit that has a functional currency other than the dollar must be computed under this paragraph (c)(2) in functional currency and translated into dollars using the exchange rate at the end of the taxpayer's current taxable year with respect to which interest is being allocated (and not the exchange rates for the years in which the earnings and profits or deficits were derived or incurred).

(ii) *10 percent owned corporation defined*—(A) *In general.* The term ''10 percent owned corporation'' means any corporation (domestic or foreign)—

(*1*) Which is not included within the taxpayer's affiliated group as defined in §1.861–11T(d) (1) or (6).

(*2*) In which the members of the taxpayer's affiliated group own directly or indirectly 10 percent or more of the total combined voting power of all classes of the stock entitled to vote, and

(*3*) Which is taken into account for purposes of apportionment.

(B) *Rule of attribution.* Stock that is owned by a corporation, partnership, or trust shall be treated as being indirectly owned proportionately by its shareholders, partners, or beneficiaries. For this purpose, a partner's interest in stock held by a partnership shall be determined by reference to the partner's distributive share of partnership income.

(iii) *Earnings and profits of lower-tier corporations taken into account.* For purposes of the adjustment to the basis of the stock of the 10 percent owned corporation owned by the taxpayer under paragraph (c)(2)(i) of this section, the earnings and profits of that corporation shall include its pro rata share of the earnings and profits (or any deficit therein) of each succeeding lower-tier 10 percent owned corporation. Thus, a first-tier 10 percent owned corporation shall combine with its own earnings and profits its pro rata share of the earnings and profits of all such lower-tier corporations. The affiliated group shall then adjust its basis in the stock of the first-tier corporation by its pro rata share of the total combined earnings and profits of the first-tier and the lower-tier corporations. In the case of a 10 percent owned corporation whose tax year does not conform to that of the taxpayer, the taxpayer shall include the annual earnings and profits of such 10 percent owned corporation for the tax year ending within the tax year of the taxpayer, whether or not such 10 percent owned corporation is owned directly by the taxpayer.

(iv) *Special rules for foreign corporations in pre-effective date tax years.* Solely for purposes of determining the adjustment required under paragraph (c)(2)(i) of this section, for tax years beginning after 1912 and before 1987, financial earnings (or losses) of a foreign corporation computed using United States generally accepted accounting principles may be substituted for earnings and profits in making the adjustment required by paragraph (c)(2)(i) of this section. A taxpayer is not required to isolate the financial earnings of a foreign corporation derived or incurred during its period of 10 percent ownership or during the post-1912 taxable years and determine earnings and profits (or deficits) attributable under section 1248 principles to the taxpayer's stock in a 10 percent owned corporation. Instead, the taxpayer may include all historic financial earnings for purposes of this adjustment. If the affiliated group elects to use financial earnings with respect to any foreign corporation, financial earnings must be used by that group with respect to all foreign corporations, except that earnings and profits may in any event be used for controlled foreign corporations for taxable years beginning after

1962 and before 1987. However, if the affiliated group elects to use earnings and profits with respect to any single controlled foreign corporation for the 1963 through 1986 period, such election shall apply with respect to all its controlled foreign corporations.

(v) *Taxpayers using the fair market value method.* Because the fair market value of any asset which is stock will reflect retained earnings and profits, taxpayers who use the fair market value method shall not adjust stock basis by the amount of retained earnings and profits, as otherwise required by paragraph (c)(2)(i) of this section.

(vi) *Examples.* Certain of the rules of this paragraph (c)(2) may be illustrated by the following examples.

Example 1. X, an affiliated group that uses the tax book value method of apportionment, owns 20 percent of the stock of Y, which owns 50 percent of the stock of Z. X's basis in the Y stock is $1,000. X, Y, and Z have calendar taxable years. The undistributed earnings and profits of Y and Z at year-end attributable to X's period of ownership are $80 and $40, respectively. Because Y owns half of the Z stock, X's pro rata share of Z's earnings and profits attributable to X's Y stock is $4. X's pro rata share of Y's earnings attributable to X's Y stock is $16. For purposes of apportionment, the tax book value of the Y stock is, therefore, considered to be $1,020.

Example 2. X, an unaffiliated domestic corporation that was organized on January 1, 1987, has owned all the stock of Y, a foreign corporation with a functional currency other than the U.S. dollar, since January 1, 1987. Both X and Y have calendar taxable years. All of Y's assets generate general limitation income. X has a deductible interest expense incurred in 1987 of $160,000. X apportions its interest expense using the tax book value method. The adjusted basis of its assets that generate domestic income is $7,500,000. The adjusted basis of its assets that generate foreign source general limitation income (other than the stock of Y) is $400,000. X's adjusted basis in the Y stock is $2,000,000. Y has undistributed earnings and profits for 1987 of $100,000, translated into dollars from Y's functional currency at the exchange rate on the last day of X's taxable year. Because X is required under paragraph (b)(1) of this §1.861–10T to increase its basis in the Y stock by the computed amount of earnings and profits, X's adjusted basis in the Y stock is considered to be $2,100,000, and its adjusted basis of assets that generate foreign source general limitation income is, thus, considered to be $2,500,000. X would apportion its interest expense as follows:

To foreign source general limitation income:

$$\text{Interest expense} \times \frac{\text{Adjusted basis of foreign general limitation assets}}{\begin{array}{c}\text{Adjusted basis of foreign}\\ \text{general limitation assets}\end{array} + \text{Adjusted basis of domestic assets}}$$

$$\$160{,}000 \times \frac{\$2{,}500{,}000}{\$2{,}500{,}000 + \$7{,}500{,}000} = \$40{,}000$$

To domestic source income:

$$\text{Interest expense} \times \frac{\text{Adjusted basis of domestic assets}}{\begin{array}{c}\text{Adjusted basis of foreign}\\ \text{general limitation assets}\end{array} + \text{Adjusted basis of domestic assets}}$$

$$\$160{,}000 \times \frac{\$7{,}500{,}000}{\$2{,}500{,}000 + \$7{,}500{,}000} = \$120{,}000$$

(3) *Characterization of stock of controlled foreign corporations*—(i) *In general.* Stock in a controlled foreign corporation (as defined in section 957)

shall be characterized as an asset in the various separate limitation categories either on the basis of:

(A) The asset method described in paragraph (c)(3)(ii) of this section, or

(B) The modified gross income method described in paragraph (c)(3)(iii) of this section.

Stock in a controlled foreign corporation whose interest expense is apportioned on the basis of assets shall be characterized in the hands of its United States shareholders under the asset method described in paragraph (c)(3)(ii). Stock in a controlled foreign corporation whose interest expense is apportioned on the basis of gross income shall be characterized in the hands of its United States shareholders under the gross income method described in paragraph (c)(3)(iii).

(ii) *Asset method.* Under the asset method, the taxpayer characterizes the tax book value or fair market value of the stock of a controlled foreign corporation based on an analysis of the assets owned by the controlled foreign corporation during the foreign corporation's taxable year that ends with or within the taxpayer's taxable year. This process is based on the application of §1.861–9T(g) at the level of the controlled foreign corporation. In the case of a controlled foreign corporation that owns stock in one or more lower-tier controlled foreign corporations in which the United States taxpayer is a United States shareholder, the characterization of the tax book value of the fair market value of the stock of the first-tier controlled foreign corporation to the various separate limitation categories of the affiliated group must take into account the stock in lower-tier corporations. For this purpose, the stock of each such lower-tier corporation shall be characterized by reference to the assets owned during the lower-tier corporation's taxable year that ends during the taxpayer's taxable year. The analysis of assets within a chain of controlled foreign corporations must begin at the lowest-tier controlled foreign corporation and proceed up the chain to the first-tier controlled foreign corporation. For purposes of this paragraph (c), the value of any passive asset to which related person interest is allocated under § 1.904–5(c)(2)(ii) must be reduced by the principal amount of indebtedness on which such interest is incurred. Furthermore, the value of any asset to which interest expense is directly allocated under § 1.861–10T must be reduced as provided in § 1.861–9T(g)(2)(iii). See § 1.861–9T(h)(5) for further guidance concerning characterization of stock in a related person under the fair market value method.

(iii) *Modified gross income method.* Under the gross income method, the taxpayer characterizes the tax book value of the stock of the first-tier controlled foreign corporation based on the gross income net of interest expense of the controlled foreign corporation (as computed under § 1.861–9T(j)) within each relevant category for the taxable year of the controlled foreign corporation ending with or within the taxable year of the taxpayer. For this purpose, however, the gross income of the first-tier controlled foreign corporation shall include the total amount of net subpart F income of any lower-tier controlled foreign corporation that was excluded under the rules of § 1.861–9T(j)(2)(ii)(B).

(4) *Stock of noncontrolled section 902 corporations*—(i) *General rule.* Because each noncontrolled section 902 corporation constitutes a separate limitation category, the value of such stock, increased to the extent required under paragraph (c)(2) of this section, is attributable solely to each such category.

(ii) *Special rule for separate limitation losses*—(A) *Election.* If, as a result of the allocation and apportionment of interest expense using the asset method described in § 1.861–9T(g), the taxpayer has a loss in the separate limitation category for a given noncontrolled section 902 corporation, the taxpayer may elect to reallocate interest expense equal to such loss to any other separate limitation category that is in excess credit (without regard to carryovers from other years), to the extent that the reallocation of such interest to such other category does not create a loss in that category. For this purpose, the term ''category in excess credit'' means any category of income with respect to which the foreign income taxes paid or accrued for the current taxable year exceed the limitation computed under section 904 with respect to such category. The election to reallocate interest expense under this paragraph shall be made in the manner prescribed in § 1.861–9T(f)(3) (relating to the election to use a gross income method for controlled foreign corporations). Furthermore, such election is irrevocable and, thus, cannot be amended by an amended return.

(B) Example. X, a domestic corporation organized on January 1, 1987, incurred deductible interest expense in 1987 in the amount of $1,000,000. X uses the tax book value method of apportionment. X owns 25 percent of the stock of A, a noncontrolled section 902 corporation. At the end of 1987, the tax book value of X's assets by income grouping are as follows:

Domestic	$3,500,000
Foreign general limitation	1,000,000
Noncontrolled section 902 corporation	500,000

In 1987, A paid no dividends. X received $100,000 of foreign general limitation income, on which it incurred $50,000 of tax to foreign governments.

The stock of A constitutes ten percent of X's assets. Therefore, ten percent of X's interest expense ($100,000) is allocated and apportioned to the separate limitation category for dividends on the A stock. Since A paid no dividends, this amount would constitute a separate limitation loss under the rules of section 904(f)(5).

Because X incurred more tax to foreign governments on its foreign general limitation income than it can credit against its U.S. tax liability, for the current tax year, and because the reallocation of interest expense allocated and apportioned to dividends from A to foreign general limitation income would not create a loss in that category, X may elect to reallocate such interest expense to the foreign general limitation category to the extent of the loss in the separate limitation category for dividends received from A.

(d) *Treatment of notes*—(1) *General rule.* Subject to the adjustments and special rules of this paragraph (d) and paragraph (e) of this section, all notes held by a taxpayer are taken into account in the application of the asset method described in § 1.861–9T(g). However, the notes of an affiliated corporation are subject to special rules set forth in § 1.861–11T(e). For purposes of this section, the term ''notes'' means all interest bearing debt, including debt bearing original issue discount.

(2) *Characterization of related controlled foreign corporation notes.* The debt of a controlled foreign corporation shall be characterized according to the taxpayer's treatment of the interest income derived from that debt obligation after application of the look-through rule of section 904(d)(3)(C). Thus, a United States shareholder includes interest income from a controlled foreign corporation in the same category of income as the category of income from which the controlled foreign corporation deducts the interest expense. See section 954(b)(5) and § 1.904–5(c)(2) for rules concerning the allocation of related person interest payments to the foreign personal holding company income of a controlled foreign corporation.

(e) *Portfolio securities that constitute inventory or generate primarily gains.* Because gain on the sale of securities is sourced by reference to the residence of the seller, a resident of the United States will generally receive domestic source income (and a foreign resident will generally receive foreign source income) upon sale or disposition of securities that otherwise generate foreign source dividends and interest (or domestic source dividends and interest in the case of a foreign resident). Although under paragraphs (c) and (d) of this section securities are characterized by reference to the source and character of dividends and interest, the source and character of income on gain or disposition must also be taken into account for purposes of characterizing portfolio securities if:

(1) The securities constitute inventory in the hands of the holder, or

(2) 80 percent or more of the gross income generated by a taxpayer's entire portfolio of such securities during a taxable year consists of gains.

For this purpose, a portfolio security is a security in any entity other than a controlled foreign corporation with respect to which the taxpayer is a United States shareholder under section 957, a noncontrolled section 902 corporation with respect to the taxpayer, or a 10 percent owned corporation as defined in § 1.861–12(c)(2)(ii). In taking gains into account, a taxpayer must treat all portfolio securities generating foreign source dividends and interest as a single asset and all portfolio securities generating domestic source dividends as a single asset and shall characterize the total value of that asset based on the source of all income and gain generated by those securities in the taxable year.

(f) *Assets funded by disallowed interest*—(1) *Rule.* In the case of any asset in connection with which interest expense accruing at the end of the taxable year is capitalized, deferred, or disallowed under any provision of the Code, the adjusted basis or fair market value (depending on the taxpayer's choice of apportionment methods) of such an asset shall be reduced by the principal amount of indebtedness the interest on which is so capitalized, deferred, or disallowed.

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

Example. X is a domestic corporation which uses the tax book value method of apportionment. X has $1000 of indebtedness and $100 of interest expense. X constructs an asset with an adjusted basis of $800 before interest capitalization and is required under the rules of section 263A to capitalize $80 in interest expense. Because interest on $800 of debt is capitalized and because the production period is in progress at the end of X's taxable year, $800 of the principal amount of X's debt is allocable to the building. The $800 of debt allocable to the building reduces its adjusted basis for purposes of apportioning the balance of X's interest expense ($20).

(g) *Special rules for FSCs*—(1) *Treatment of FSC stock.* No interest expense shall be allocated or apportioned to stock of a foreign sales corporation ("FSC") to the extent that the FSC stock is attributable to the separate limitation for certain FSC distributions described in section 904(d)(1)(H). FSC stock is considered to be attributable solely to the separate limitation category described in section 904(d)(1)(H) unless the taxpayer can demonstrate that more than 20 percent of the FSC's gross income for the taxable year consists of income other than foreign trading income.

(2) *Treatment of assets that generate foreign trade income.* Assets of the related supplier that generate foreign trade income must be prorated between assets attributable to foreign source general limitation income and assets attributable to domestic source income in proportion to foreign source general limitation income and domestic source income derived from transactions generating foreign trade income.

(i) *Value of assets attributable to foreign source income.* The value of assets attributable to foreign source general limitation income is computed by multiplying the value of assets for the taxable year generating foreign trading gross receipts by a fraction:

(A) The numerator of which is foreign source general limitation income for the taxable year derived from transactions giving rise to foreign trading gross receipts, after the application of the limitation provided in section 927(e)(1), and

(B) The denominator of which is total income for the taxable year derived from the transaction giving rise to foreign trading gross receipts.

(ii) *Value of assets attributable to domestic source income.* The value of assets attributable to domestic source income is computed by subtracting from the total value of assets for the taxable year generating foreign trading gross receipts the value of assets attributable to foreign source general limitation income as computed under paragraph (g)(2)(i) of this section.

(h) *Special rules for DISCs*—(1) *Treatment of DISC stock.* No interest shall be allocated or apportioned to stock in a DISC (or stock in a former DISC to the extent that the stock in the former DISC is attributable to the separate limitation category described in section 904(d)(1)(F)).

(2) *Treatment of assets that generate qualified export receipts.* Assets of the related supplier that generate qualified export receipts must be prorated between assets attributable to foreign source general limitation income and assets attributable to domestic source income in proportion to foreign source general limitation income and domestic source income derived from transactions during the taxable year from transactions generating qualified export receipts.

(i) [Reserved]

(j) *Examples.* Certain of the rules in this section and §§ 1.861–9T(g) and 1.861–

10(e) are illustrated by the following example.

Example 1 —(1) *Facts.* X, a domestic corporation organized on January 1, 1987, has a calendar taxable year and apportions its interest expense on the basis of the tax book value of its assets. In 1987, X incurred a deductible third-party interest expense of $100,000 on an average month-end debt amount of $1 million. The total tax book value of X's assets (adjusted as required under paragraph (b) of this section for retained earnings and profits) is $2 million. X manufactures widgets. One-half of the widgets are sold in the United States and one-half are exported and sold through a foreign branch with title passing outside the United States.

X owns all the stock of Y, a controlled foreign corporation that also has a calendar taxable year and is also engaged in the manufacture and sale of widgets. Y has no earnings and profits or deficits in earnings and profits prior to 1987. For 1987, Y has taxable income and earnings and profits of $50,000 before the deductible for related person interest expense. Half of the $50,000 is foreign source personal holding company income and the other half is derived from widget sales and constitutes foreign source general limitation income. Assume that Y has no deductibles from gross income other than interest expense. Y's foreign personal holding company taxable income is included in X's gross income under section 951. Y paid no dividends in 1987. Prior to 1987, Y did not borrow any funds from X. The average month-end level of borrowings by Y from X in 1987 is $100,000, on which Y paid a total of $10,000 in interest. The total tax book value of Y's assets in 1987 is $500,000. Y has no liabilities to third parties. X elects pursuant to §1.861–9T for Y to apportion Y's interest expense under the gross income method prescribed in §1.861–9T(g).

In addition to its stock in Y, X owns 20 percent of the stock of Z, a noncontrolled section 902 corporation.

X's total assets and their tax book values are:

Asset	Tax book value
Plant & equipment	$1,000,000
Corporate headquarters	500,000
Inventory	200,000
Automobiles	20,000
Patents	50,000
Trademarks	10,000
Y stock (including paragraph (c)(2) adjustment)	80,000
Y note	100,000
Z stock	40,000

(2) *Categorization of Assets.*

Single Category Assets

1. Automobiles: X's automobiles are used exclusively by its domestic sales force in the generation of United States source income. Thus, these assets are attributable solely to the grouping of domestic income.

2. Y Note: Under paragraph (d)(2) of this section, the Y note in the hands of X is characterized according to X's treatment of the interest income received on the Y note. In determining the source and character of the interest income on the Y note, the look-through rules of sections 904(d)(3)(C) and 904(g) apply. Under section 954(b)(5) and §1.904–5(c)(2)(ii), Y's $10,000 interest payment to X is allocated directly to, and thus reduces, Y's foreign personal holding company income of $25,000 (yielding foregin personal holding company taxable income of $15,000). Therefore, the Y note is attributable solely to the statutory grouping of foreign source passive income.

3. Z stock: Because Z is a noncontrolled section 902 corporation, the dividends paid by Z are subject to a separate limitation under section 904(d)(1)(E). Thus, this asset is attributable solely to the statutory grouping consisting of Z dividends.

Multiple Category Assets

1. Plant & equipment, inventory, patents, and trademarks: In 1987, X sold half its widgets in the United States and exported half outside the United States. A portion of the taxable income from export sales will be foreign source income, since the export sales were accomplished through a foreign branch and title passed outside the United States. Thus, these assets are attributable both to the statutory grouping of foreign general limitation and the grouping of domestic income.

2. Y Stock: Since Y's interest expense is apportioned under the gross income method prescribed in §1.861–9T(j), the Y stock must be characterized under the gross income method described in paragraph (c)(3)(iii) of this section.

Assets without Directly Identifiable Yield

1. Corporate headquarters: This asset generates no directly identifiable income yield. The value of the asset is disregarded.

(3) *Analysis of Income Yield for Multiple Category Assets.*

1. Plant & Equipment, inventory, patents, and trademarks: As noted above, X's 1987 widget sales were half domestic and half foreign. Assume that Example 2 of §1.863–3(b)(2) applies in sourcing the export income from the export sales. Under Example 2, the income generated by the export sales is sourced half domestic and half foreign. The income gnerated by the domestic sales is entirely domestic source. Accordingly, three-quarters of the income generated on all sales

is domestic source and one-quarter of the income is foreign source. Thus, three-quarters of the fair market value of these assets are attributed to the grouping of domestic source income and one-quarter of the fair market value of these assets is attributed to the statutory grouping of foreign source general limitation income.

2. Y Stock: Under the gross income method described in paragraph (c)(3)(iii) of this section, Y's gross income net of interest expenses in each limitation category must be determined—$25,000 foreign source general limitation income and $15,000 of foreign source passive income. Of X's adjusted basis of $80,000 in Y stock, $50,000 is attributable to foreign source general limitation income and $30,000 is attributable to foreign source passive income.

(4) *Application of the Special Allocation Rule of § 1.861–10T(e).* Assume that the taxable year in question is 1990 and that the appliable percentage prescribed by § 1.861–10T(e)(1)(iv)(A) is 80 percent. Assume that X has elected to use the quadratic formula provided in § 1.861–10T(e)(1)(iv)(B).

Step 1. X's average month-end level of debt owning to unrelated persons is $1 million. The tax book value of X's assets is $2 million. Thus, X's debt-to-asset ratio computed under § 1.861–10T(e)(1)(i) is 1 to 2.

Step 2. The tax book value of Y's assets is $500,000. Because Y has no debt to persons other than X, Y's debt-to-asset ratio computed under § 1.861–10T(e)(1)(ii) is $0 to $500,000.

Step 3. Y's average month-end liabilities to X, as computed under § 1.861–10T(e)(1)(iii) for 1987 are $100,000.

Step 4. Adding the $100,000 of Y's liabilities owed to X as computed under Step 3 to Y's third party liabilities ($0) would be insufficient to make Y's debt-to-asset ratio computed in Step 2 ($100,000-to-$500,000, or 1:5) equal to at least 80 percent of X's debt-to-asset ratio computed under Step 1, as adjusted to reflect a reduction in X's debt and assets by the $100,000 of excess related person indebtedness (.80 x $900,000/$1,900,000 or 1:2.6). Therefore, the entire amount of Y's liabilities to X ($100,000) constitute excess related person indebtedness under § 1.861–10T(e)(1)(ii). Thus, the entire $10,000 of interest received by X from Y during 1987 constitutes interest received on excess related person indebtedness.

Step 5. The Y note held by X has a tax book value of $100,000. Solely for purposes of § 1.861–10(e)(1)(v), the Y note is attributed to separate limitation categories in the same manner as the Y stock. Under paragraph (c)(3)(iii) of this section, of the $80,000 of Y stock held by X, $50,000 is attributable to foreign source general limitation income, and $30,000 is attributable to foreign source passive income. Thus, for purposes of $1.861–10T(e)(1)(v), $62,500 of the $100,000 Y note is considered to be a foreign source general limitation asset and $37,500 of the $100,000 Y note is considered to be a foreign source passive asset.

Step 6. Since $8,000 of the $10,000 in related person interest income received by Y constitutes interest received on excessive related person indebtedness, $10,000 of X's third party interest expense is allocated to X's debt investment in Y. Under § 1.861–10T(e)(1)(vi), 62.5 percent of the $10,000 of X's third party interest expense ($6,250) is allocated to foreign source general limitation income and 37.5 percent of the $10,000 of X's third party interest expense ($3,750) is allocated to foreign source passive income. As a result of this direct allocation, the value of X's assets generating foreign source general limitation income shall be reduced by the principal amount of indebtedness the interest on which is directly allocated to foreign source general limitation income ($62,500), and X's assets generating foreign general limitation income shall be reduced by the principal amount of indebtedness the interest on which is directly allocated to foreign passive income ($37,500).

(5) *Totals.*

Having allocated $10,000 of its third party interest expense to its debt investment in Y, X would apportion the $90,000 balance of its interest according to the following apportionment fractions:

Asset	Domestic source	Foreign general	Foreign passive	Noncontrolled section 902
Plant and equipment	$750,000	$250,000		
Inventory	$150,000	$50,000		
Automobiles	$20,000			
Patents	$37,500	$12,500		
Trademarks	$7,500	$2,500		
Y stock		$50,000	$30,000	
Y note			$100,000	
Z stock				$40,000
Totals	$965,000	$365,000	$130,000	$40,000
Adjustments for directly allocable interest		($62,250)	($37,750)	

Asset	Domestic source	Foreign general	Foreign passive	Noncontrolled section 902
Adjusted totals	$965,000	$302,750	$92,250	$40,000
Percentage	69	22	6	3

Example 2 —Assume the same facts as in *Example* 1, except that Y has $100,000 of third party indebtedness. Further, assume for purposes of the application of the special allocation rule of §1.861–10T(e) that the taxable year is 1990 and that the applicable percentage prescribed by §1.861–10T(e)(1)(iv)(A) is 80 percent. The application of the §1.861–10(e) would be modified as follows.

Step 1. X's debt-to-asset ratio computed under §1.861–10T(e)(1)(i) remains 1 to 2 (or 0.5).

Step 2. The tax book value of Y's assets is $500,000. Y has $100,000 of indebtedness to third parties. Y's debt-to-asset ratio computed under §1.861–10T(e)(1)(ii) is $100,000 to $500,000 (1:5 or 0.2).

Step 3. Y's average month-end liabilities to X, as computed under §1.861–10T(e)(1)(iii) remain $100,000.

Step 4. X's debt-to-asset ratio is 0.5 and 80 percent of 0.5 is 0.4. Because Y's debt-to-asset ratio is 0.2, there is excess related person indebtedness, the amount of which can be computed based on the following formula:

$$\frac{\text{Aggregate third party debt of related U.S. shareholder} - X}{\text{U.S. shareholder assets} - X} \times \begin{matrix}\text{Applicable percentage}\\ \text{for year (0.8)}\end{matrix} = \frac{\text{Aggregate third party debt of related CFCs} + X}{\text{Related CFC assets}}$$

Supplying the facts as given, this equation is as follows:

$$\frac{1{,}000{,}000 - X}{2{,}000{,}000 - X} \times .8 = \frac{100{,}000 + X}{500{,}000}$$

Multiply both sides by 500,000 and (2,000,000 − X), yielding:

$$4 \times 10^{11} - 400{,}000X = 2 \times 10^{11} + 2{,}000{,}000X - 100{,}000X - X^{2}$$

Since there is an X^2 in this equation, a quadratic formula must be utilized to solve for X. Group the components in this equation, segregating the X and the $X^{2\leqq}$

$$X^{2} + (-2{,}300{,}000)X + (2 \times 10^{11}) = 0$$

Apply the quadratic formula:

$$X = \frac{-b \pm \sqrt{b^{2} - 4(a)(c)}}{2(a)}$$

a=1 (coefficient of X^2)
b=−2,300,000 (coefficient of X)
c=2×10^{11} (remaining element of equation)

Therefore, X equals either 90,519 or (2.21×10^{11}). for purposes of computing excess related person indebtedness, X is the lowest positive amount derived from this equation, which is 90,519.

Steps 5 and 6 are unchanged from *Example* 1, except that the total amount of interest on excess related party indebtedness is $9,051.

[T.D. 8228, 53 FR 35495, Sept. 14, 1988]

§1.861–13T Transition rules for interest expenses (temporary regulations).

(a) *In general*—(1) *Optional application.* The rules of this section may be applied at the choice of a corporate taxpayer. In the case of an affiliated group, however, the choice must be made on a consistent basis for all members. Therefore, a corporate taxpayer (or affiliated group) may allocate and apportion its interest expense entirely on the basis of the rules contained in §§1.861–8T through 1.861–12T and without regard to the rules of this section. The choice is made on an annual basis and, thus, is not binding with respect to subsequent tax years.

(2) *Transition relief.* This section contains transitional rules that limit the application of the rules for allocating and apportioning interest expense of corporate taxpayers contained in

§§ 1.861–8T through 1.861–12T, which are applicable in allocating and apportioning the interest expense of corporate taxpayers generally for taxable years beginning after 1986. Sections 1.861–9(d) (relating to individuals, estates, and certain trusts) and 1.861–9(e) (relating to partnerships) are effective for taxable years beginning after 1986. Thus, the taxpayers to whom those sections apply do not qualify for transition relief under this section.

(3) *Indebtedness defined.* For purposes of this section, the term ''indebtedness'' means any obligation or other evidence of indebtedness that qenerates an expense that constitutes interest expense within the meaning of § 1.861–9T(a). In the case of an obligation that does not bear interest initially, but becomes interest bearing with the lapse of time or upon the occurrence of an event, such obligation shall only be considered to constitute indebtedness when it first bears interest. Obligations that are outstanding as of November 16, 1985 shal1 only qualify for transition relief under this section if they bear interest-bearing as of that date. For this purpose, any obligation that has original issue discount within the meaning of section 1273(a)(1) of the Code shall be considered to be interest-bearing.

(4) *Exceptions.* The term ''indebtedness'' shall not include any obligation existing between affiliated corporations, as defined in § 1.861–llT(d). Moreover, the term ''indebtedness'' shall not include any obligation the interest on which is directly allocable under §§ 1.861–10T(b) and 1.861–10T(c). Under § 1.861–9T(b)(6)(iv)(B), certain interest expense is directly allocated to the gain derived from an appropriately identified financial product. When interest expense on a liability is reduced by such gain, the principal amount of such liability shall be reduced pro rata by the relative amount of interest expense that is directly allocated.

(b) *General phase-in*—(1) *In general.* In the case of each of the first three taxable years of the taxpayer beginning after December 31, 1986, the rules of §§ 1.861–8T through 1.861–12T shall not apply to interest expenses paid or accrued by the taxpayer during the taxable year with respect to an aggregate amount of indebtedness which does not exceed the general phase-in amount, as defined in paragraph (b)(2) of this section.

(2) *General phase-in amount defined.* Subject to the limitation imposed by paragraph (b)(3) of this section, the general phase-in amount means the amount which is the applicable percentage (determined under the following table) of the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985:

Taxable year beginning after December 31, 1986	Percentage
First	75
Second	50
Third	25

(3) *Reductions in indebtedness.* The general phase-in amount shall not exceed the taxpayer's historic lowest month-end debt level taking into account all months after October 1985. However, for the taxable year ln which a taxpayer attains a new historic lowest month-end debt level (but not for subsequent taxable years), the general phase-in amount shall not exceed the average of month-end debt levels within that taxable year (without taking into account any increase in month-end debt levels occurring in such taxable Year after the new historic lowest month-end debt level is attained).

Example. X is a calendar year taxpayer that had $100 of indebtedness outstanding on November 16, 1985. X's month-end debt level remained $100 for all subsequent months until July 1987, when X's month-end debt level fell to $50. In computing transition relief for 1987, X's general phase-in amount cannot exceed $75 (900 divided by 12), which is the average of month-end debt levels in 1987. Assuming that X's month-end debt level for any subsequent month does not fall below $50, the limitation on its general phase-in amount for all taxable years after 1987 will be $50, its historic lowest month-end debt level after October 1985.

(c) *Nonapplication of the consolidation rule*—(1) *General rule.* In the case of each of the first five taxable years of the taxpayer beginning after December 31, 1986, the consolidation rule contained in § 1.861–11T(c) shall not apply to interest expenses paid or accrued by the taxpayer during the taxable year with respect to an aggregate amount of indebtedness which does not exceed the special phase-in amount, as defined in paragraph (c)(2) of this section.

(2) *Special phase-in amount.* The special phase-in amount is the sum of—

(i) The general phase-in amount,

(ii) The five-year phase-in amount, and

(iii) The four-year phase-in amount.

(3) *Five-year phase-in amount.* The five-year phase-in amount is the lesser of—

(i) The applicable percentage (the ‘‘unreduced percentage’’ in the following table) of the five-year debt amount, or

(ii) The applicable percentage (the ‘‘reduced percentage’’ in the following table) of the five-year debt amount reduced by paydowns (if any):

Transition year	Unreduced percentage	Reduced percentage
Year 1	8⅓	10
Year 2	16⅔	25
Year 3	25	50
Year 4	33⅓	100
Year 5	16⅔	100

(4) *Four-year phase-in amount.* The four-year phase-in amount is the lesser of—

(i) The applicable percentage (the ‘‘unreduced percentage’’ in the following table) of the four-year debt amount, or

(ii) The applicable percentage (the ‘‘reduced percentage’’ in the following table) of the four-year debt amount reduced by paydowns (if any) to the extent that such paydowns exceed the five-year debt amount:

Transition year	Unreduced percentage	Reduced percentage
Year 1	5	6¼
Year 2	10	16⅔
Year 3	15	37½
Year 4	20	100

(5) *Five-year debt amount.* The ‘‘five-year debt amount’’ means the excess (if any) of—

(i) The amount of the outstanding indebtedness of the taxpayer on May 29, 1985, over

(ii) The amount of the outstanding indebtedness of the taxpayer on December 31, 1983. The five-year debt amount shall not exceed the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985.

(6) *Four-year debt amount.* The ‘‘four-year debt amount’’ means the excess (if any) of—

(i) The amount of the outstanding indebtedness of the taxpayer on December 31, 1983, over

(ii) The amount of the outstanding indebtedness of the taxpayer on December 31, 1982.

The four-year debt amount shall not exceed the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985, reduced by the five-year debt amount.

(7) *Paydowns.* The term ‘‘paydowns’’ means the excess (if any) of—

(i) The aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985, over

(ii) The limitation on the general phase-in amount described in paragraph (b)(3) of this section.

Paydowns are first applied to the five-year debt amount to the extent thereof and then to the four-year debt amount for purposes of computing the five-year and the four-year phase-in amounts.

(d) *Treatment of affiliated group.* For purposes of this section, all members of the same affiliated group of corporations (as defined in §1.861–11(d)) shall be treated as one taxpayer whether or not such members filed a consolidated return. Interaffiliate debt is not taken into account in computing transition relief. Moreover, any reduction in the amount of interaffiliate debt is not taken into account in determining the amount of paydowns.

(e) *Mechanics of computation*—(1) *Step 1: Determination of the amounts within the various categories of debt.* Each separate member of an affiliated group must determine each of its following amounts:

(i) *November 16, 1985 amount.* The amount of its debt outstanding on November 16, 1985 (after the elimination of interaffiliate indebtedness),

(ii) *Unreduced five-year debt.* The amount of any net increase in the amount of its indebtedness on May 29, 1985 (after elimination of interaffiliate indebtedness) over the amount of its indebtedness on December 31, 1983 (after elimination of interaffiliate indebtedness),

(iii) *Unreduced four-year debt.* The amount of any net increase in the amount of its indebtedness on December 31, 1983 (after elimination of interaffiliate indebtedness) over the amount of its indebtedness on December 31, 1982 (after elimination of interaffiliate indebtedness), and

(iv) *Month-end debt.* The amount of its month-end debt level for all months after October 1985 (after elimination of interaffiliate indebtedness).

(2) *Step 2: Aggregation of the separate company amounts.* Each of the designated amounts for the separate companies identified in Step 1 must be aggregated in order to compute consolidated transition relief. Paragraph (e)(10)(iv) of this section (Step 10) requires the use of the taxpayer's current year average debt level for the purpose of computing the percentages of debt that are subject to the three sets of rules that are identified in Step 10. For use in that computation, the taxpayer should compute the current year average debt level by aggregating separate company month-end debt levels and then by averaging those aggregate amounts.

(3) *Step 3: Calculation of the lowest historic month-end debt level of the taxpayer.* In order to calculate the lowest historic month-end debt level of the taxpayer, determine the month-end debt level of each separate company for each month ending after October 1985 and aggregate these amounts on a month-by-month basis. On such aggregate basis, in any taxable year in which the taxpayer attains an aggregate new lowest historic month-end debt level, add together all the aggregate month-end debt levels within the taxable year (without taking into account any increase in aggregate debt level subsequent to the attainment of such lowest historic month-end debt level) and divide by the number of months in that taxable year, yielding the average of month-end debt levels for such year. Such average shall constitute the taxpayer's lowest historic month-end debt level for that taxable year in which the aggregate new lowest historic month-end debt level was attained. Unless otherwise specified, all subsequent references to any amount refer to the aggregate amount for all members of the same affiliated group of corporations.

(4) *Step 4: Computation of paydowns.* Paydowns equal the amount by which the November 16, 1985 amount exceeds the taxpayer's lowest historic month-end debt level, determined under Step 3.

(5) *Step 5: Computation of limitations on unreduced five-year debt and unreduced four-year debt.* (i) The unreduced five-year debt cannot exceed the November 16, 1985 amount.

(ii) The unreduced four-year debt cannot exceed the November 16, 1985 amount less the unreduced five-year debt.

(6) *Step 6: Computation of reduced five-year and reduced four-year debt*—(i) *Reduced five-year debt.* Compute the amount of reduced five-year debt by subtracting from the unreduced five-year debt (see Step 5) the amount of paydowns (see Step 4).

(ii) *Reduced four-year debt.* To the extent that the amount of paydowns (see step 4) exceeds the amount of unreduced five-year debt (see Step 5), compute the amount of reduced four-year debt by subtracting such excess from the unreduced four-year debt (see Step 1).

(iii) To the extent that paydowns do not offset either the unreduced five-year amount or the unreduced four-year amount, the reduced and the unreduced amounts are the same.

(7) *Step 7: Computation of the general phase-in amount.* The general phase-in amount is the lesser of—

(i) The percentage of the November 16, 1985 amount designated for the relevant transition year in the table below, or

(ii) The lowest group month-end debt level (see Step 3).

GENERAL PHASE-IN TABLE

Transition year	Percentage
Year 1	75
Year 2	50
Year 3	25

(8) *Step 8: Computation of Five-Year Phase-in Amount.* The five-year phase-in amount is the lesser of—

(i) The percentage of the unreduced five-year debt designated for the relevant transition year in the table below, or

(ii) The percentage of the reduced five-year debt designated for the relevant transition year in the table below.

FIVE-YEAR PHASE-IN TABLE

Transition year	Unreduced percentage	Reduced percentage
Year 1	8⅓	10
Year 2	16⅔	25
Year 3	25	50
Year 4	33⅓	100
Year 5	16⅔	100

(9) *Step 9: Computation of Four-year Phase-in Amount.* The four-year phase-in amount is the lesser of—

(i) The percentage of the unreduced four-year debt designated for the relevant transition year in the table below, or

(ii) The percentage of the reduced four-year debt designated for the relevant transition year in the table below.

FOUR-YEAR PHASE-IN TABLE

Transition year	Unreduced percentage	Reduced percentage
Year 1	5	6¼
Year 2	10	16⅔
Year 3	15	37½
Year 4	20	100

(10) *Step 10: Determination of group debt ratio and application of transition relief to separate company interest expense.* (i) The general phase-in amount consists of the amount computed under Step 7. Interest expense on this amount is subject to pre-1987 rules of allocation and apportionment.

(ii) The post-1986 separate company amount consists of the sum of the amounts determined under Steps 8 and 9. Interest expense on this amount is subject to post-1986 rules of allocation and apportionment as applied on a separate company basis. Thus, §1.861–11T(c) does not apply with respect to this amount of indebtedness. Because the consolidation rule does not apply, stock in affiliated corporations shall be taken into account in computing the apportionment fractions for each separate company in the same manner as under pre-1987 rules.

(iii) The post-1986 one-taxpayer amount consists of any indebtedness that does not qualify for transition relief under Steps 7, 8, and 9. Interest expense on this amount is subject to post-1986 rules as applied on a consolidated basis.

(iv) To determine the extent to which the interest expense of each separate company is subject to any of these sets of allocation and apportionment rules, each company shall prorate its own interest expense using two fractions. The general phase-in fraction is the general phase-in amount over the current year average debt level of the affiliated group (see Step 2). The post-1986 separate company fraction is the post-1986 separate company amount over the current year average debt level of the affiliated group. The balance of each separate company's interest expense is subject to post-1986 one-taxpayer rules.

(f) *Example.* XYZ form an affiliate group.

(1) *Step 1:* Determination of the amounts within the various debt categories.

	Historic 3rd party debt	Increase
Company X:		
Nov. 16, 1985	$100,000	
May 29, 1983 (5-year)	90,000	$10,000
Dec. 31, 1983 (4-year)	80,000	10,000
Dec. 31, 1982	70,000	
Current Interest Expense	10,000	
Company Y:		
Nov. 16, 1985	200,000	
May 29, 1985 (5-year)	170,000	120,000
Dec. 31, 1983 (4-year)	50,000	10,000
Dec. 31, 1982	40,000	
Current Interest Expense	30,000	
Company Z:		
Nov. 16, 1985	300,000	
May 29, 1985 (5-year)	300,000	50,000
Dec. 31, 1983 (4-year)	250,000	100,000
Dec. 31, 1982	150,000	
Current Interest Expense	30,000	

(2) *Step 2:* Aggregation of the separate company amounts.

Aggregate Nov. 16, 1985	$600,000
Aggregate 5-year debt	180,000
Aggregate 4-year debt	120,000
Current year average debt level	700,000

(3) *Step 3:* Calculation of lowest historic month-end debt level.

An analysis of historic month-end debt levels indicates that in 1986, XYZ's aggregate month-end debt level fell to $500,000, which represents the lowest sum for all years under consideration. Because this historic low occurred in a prior tax year, there is no averaging of month-end debt levels in the current taxable year.

(4) *Step 4:* Computation of paydowns. The aggregate November 16, 1985 amount ($600,000), less the lowest historic month-end debt level ($500,000), yields a total paydown in the amount of $100,000.

(5) *Step 5:* Computation of limitations on aggregate unreduced five-year debt and aggregate unreduced four-year debt.

Aggregate Nov. 16, 1985 amount	$600,000
Aggregate unreduced 5-year debt	180,000
Aggregate unreduced 4-year debt	120,000

Because the November 16, 1985 amount exceeds the unreduced 4- and 5-year debt, the full amount of the 4- and 5-year debt qualify for transition relief. In cases where the November 16, 1985 amount is less than the 4- or 5-year debt (or the sum of both), the latter amounts are limited to the November 16, 1985 amount. See the limitations on the 4-year and 5-year debt amounts in paragraphs (c)(6) and (c)(5), respectively, of this section.

(6) *Step 6:* Computation of reduced five-year and four-year debt. The paydowns computed under Step 4 are deemed to first offset the aggregate unreduced five-year debt. Accordingly, the reduced amount of five-year debt is $80,000. Since the paydowns are less than the aggregate unreduced five-year debt, there is no paydown in connection with aggregate unreduced four-year debt. Accordingly, the unreduced four-year debt and the reduced four-year debt are both considered to be $120,000.

(7) *Step 7:* Computation of the general phase-in amount. In transition year 1, the general transition amount is the lesser of:

(i) 75 percent of the aggregate November 16, 1985 amount (75% of $600,000 = $450,000); or

(ii) the lowest month-end debt level since November 16, 1985 ($500,000).

Therefore, the general transition amount is $450,000.

(8) *Step 8:* Computation of the five-year phase-in amount. In transition year 1, the five-year phase-in amount is the lesser of:

(i) 8⅓ percent of the unreduced five-year amount (8⅓% of $180,000=$15,000); or

(ii) 10 percent of the reduced five-year amount (10% of $80,000=$8,000).

Therefore, the five-year phase-in amount is $8,000.

(9) *Step 9:* Computation of the four-year phase-in amount. In transition year 1, the four-year phase-in amount is the lesser of:

(i) 5 percent of the unreduced four-year amount (5% of $120,000=$6,000); or

(ii) 6¼ percent of the reduced four-year amount (6¼% of $120,000=$7,500).

Therefore, the four-year phase-in amount is $6,000.

(10) *Step 10:* Determination of group debt ratio and application of relief to separate company interest expense.

(i) As determined under Step 7, interest expense on a total of $450,000 of the XYZ debt in the first transition year is computed under pre-1987 rules of allocation and apportionment.

(ii) The sum of Steps 8 ($8,000) and 9 ($6,000) is $14,000. Interest expense on a total of $14,000 of XYZ debt is computed under post-1986 rules of allocation and apportionment as applied on a separate company basis.

(iii) The balance of XYZ's current year interest expense is computed under post-1986 rules of allocation and apportionment as applied on a consolidated basis. X, Y, and Z, respectively, have current interest expense of $10,000, $30,000, and $30,000. Thus, 64.3 percent (450,000/700,000) of the interest expense of each separate company is subject to pre-1987 rules. Two percent (14,000/700,000) of the interest expense of each separate company is subject to post-1986 rules applied on a separate company basis. Finally, the balance of each separate company's current year interest expense (33.7 percent) is subject to post-1986 rules applied on a consolidated basis.

(g) *Corporate transfers*—(1) *Effect on transferee*—(i) *General rule.* Except as provided in paragraph (g)(1)(ii) of this section, if a domestic corporation or an affiliated group acquires stock in a domestic corporation that was not a member of the transferee's affiliated group before the acquisition, but becomes a member of the transferee's affiliated group after the acquisition, the transferee group shall take into account the following transition attributes of the acquired corporation in computing its transition relief:

(A) November 16, 1985 amount;

(B) Unreduced five-year amount;

(C) Unreduced four-year amount; and

(D) The amount of any transferor paydowns attributed to the acquired corporation under the rules of paragraph (h)(1) of this section.

(ii) *Special rule for year of acquisition.* To compute the amount of the transition attributes described in paragraph (g)(1)(i) of this section that a transferee takes into account in the transferee's taxable year of the acquisition, such transition attributes shall be multiplied by a fraction, the numerator of which is the number of months within the taxable year that the transferee held the acquired corporation and the denominator of which is the number of months in such taxable year. In order for the transferee to assert ownership of a subsidiary for a given month, the transferee and the acquired corporation must be affiliated corporations as of the last day of the month. In addition, the transferor and the transferee shall take account of the month-end debt level of the transferred corporation only for those months at the end of which the transferred corporation was a member of the transferor's or the transferee's respective affiliated group.

(iii) *Aggregation of transition attributes.* The transition attributes of the acquired corporation shall be aggregated with the respective amounts of the transferee group.

(iv) *Conveyance of transferor paydowns.* The total paydowns of the transferee group shall include the amount of any paydown of the transferor group that was attributed to the acquired corporation under the rules of paragraph (h)(1) of this section.

(v) *Effect of certain elections.* If an election—

(A) Is made under section 338(g) (whether or not an election under 338(h)(10) is made),

(B) Is deemed to be made under section 338(e) (other than (e)(2)), or section 338(f), or,

(C) Is made under section 336(e), no indebtedness of the acquired corporation shall qualify for transition relief for the year such election first becomes effective and for subsequent taxable years, and no other transition attributes of the acquired corporation shall be taken into account by the transferee group.

(2) *Effect on transferor*—(i) *General rule.* Except as provided in paragraph (g)(2)(ii) of this section, in the case of an acquisition of a member of an affiliated group by a nonmember of the group, the transferor shall not take into account the transition attributes of the acquired corporation in computing the transition relief of the transferor group in subsequent taxable years. Thus, the November 16, 1985 amount, the unreduced five-year and four-year debt amounts, and the end-of-month debt levels of the transferor group shall be computed without regard to the acquired corporation's respective amounts for purposes of computing transition relief of the tranferor group for years thereafter.

(ii) *Special rule for the year of disposition.* To compute the amount of the transition attributes described in paragraph (g)(2)(i) of this section that a transferor shall take into account in the transferor's taxable year of the disposition, such transition attributes shall be multiplied by a fraction, the numerator of which is the number of months within the taxable year that the transferor held the acquired corporation and the denominator of which is the number of months in such taxable year. In order for the transferor to assert ownership of a subsidiary for a given month, the transferor and the acquired corporation must be affiliated corporations as of the last day of the month.

(iii) *Effect of prior paydowns.* Any paydowns of the acquired corporation that are considered to reduce the debt of other members of the transferor group under the rules of paragraph (h)(1) of this section (whether incurred in a prior taxable year or in that portion of a year of disposition that is taken into account by the transferor) shall continue to be taken into account by the transferor group after the disposition.

(3) *Special rule for assumptions of indebtedness.* In connection with the transfer of a corporation, if the indebtedness of an acquired corporation is assumed by any party other than the transferee or another member of the transferee's affiliated group, the transition attributes of the acquired corporation shall not be taken into account in computing the transition relief of the transferee group. See paragraph (g)(2) of this section concerning the treatment of the transferor group. Also in connection with the transfer of a corporation, if the transferee or another member of the transferee's affiliated group assumes the indebtedness of an acquired corporation, such assumed indebtedness shall only qualify for transition relief during the period in which the acquired corporation remains a member of the transferee group. Further, if the transferee group subsequently disposes of the acquired corporation, the indebtedness of the acquired corporation will continue to qualify for transition relief only if the indebtedness is assumed by the new purchaser as of the time such corporation is acquired.

(4) *Effect of asset sales.* If substantially all of the assets of a corporation are sold, the indebtedness of such corporation shall cease to be qualified for transition relief. Thus, the transition attributes of such corporation shall not be taken into account in computing transition relief.

(h) *Rules for attributing paydowns among separate companies*—(1) *General rule.* In the case of a corporate transfer under paragraph (g) of this section, it is necessary to determine the amount of paydowns attributable to the acquired corporation. Under paragraph (c)(7) of this section, paydowns are deemed to reduce first the five-year phase-in amount, then the four-year phase-in amount, and then the general phase-in amount. Thus, for example, a reduction in indebtedness of the group caused by a reduction in the debt of a group member that has no five-year debt will nevertheless be deemed under this ordering rule to reduce the indebtedness of those group members that do have five-year debt. In order to preserve the effect of paydowns caused by a reduction, each member must determine on a separate company basis at the time of any transfer of any member of the affiliated group the impact of paydowns (including those paydowns occurring in the year of transfer prior to the time of the transfer) on the various categories of indebtedness.

(2) *Mechanics of computation.* Separate company accounts of paydowns are determined by prorating any paydown among all group members with five-year debt to the extent thereof on the basis of the relative amounts of five-year debt. Paydowns in excess of five-year debt are prorated on a similar basis among all group members with four-year debt to the extent thereof on the basis of the relative amounts of four-year debt. Paydowns in excess of four-year and five-year debt are prorated among all group members with general phase-in debt to the extent thereof on the basis of the relative amounts of general phase-in debt. After an initial paydown has been prorated among the members of an affiliated group, any further reduction in the amount of aggregate month-end debt level as compared to the November 16, 1985 amount is prorated among all members of the affiliated group based on the remaining net amounts of four-year and five-year debt.

(3) *Examples.* The rules of paragraphs (g) and (h) of this section may be illustrated by the following examples.

Example 1— Computing separate company accounts of reductions—(i) *Facts.* XYZ constitutes an affiliated group of corporations that has a calendar taxable year and the following transition attributes:

	Historic 3rd party debt	Increase
Company X:		
Nov. 16, 1985	$100,000	
May 29, 1985 (5-year)	80,000	$0
Dec. 31, 1983 (4-year)	80,000	10,000
Dec. 31, 1982	70,000	
Company Y:		
Nov. 16, 1985	200,000	
May 29, 1985 (5-year)	170,000	120,000
Dec. 31, 1983 (4-year)	50,000	10,000
Dec. 31, 1982	40,000	
Company Z:		
Nov. 16, 1985	300,000	
May 29, 1985 (5-year)	290,000	40,000
Dec. 31, 1983 (4-year)	250,000	100,000
Dec. 31, 1982	150,000	

In 1986, the XYZ group attained its lowest historic month-end debt level of $500,000. Because the November 16, 1985 amount is

$600,000 the XYZ group therefore has a paydown in the amount of $100,000. This paydown partially offsets the $160,000 of five-year debt in the XYZ group.

(ii) *Analysis.* Applying the rule of paragraph (h)(1) of this section, separate company accounts of paydowns are computed by prorating the $100,000 paydown among those members of the group that have five-year debt. Accordingly, the paydown is prorated between Y and Z as follows:

To Y:

$$\$100{,}000 \times \frac{\$120{,}000}{\$160{,}000} = \$75{,}000$$

To Z:

$$\$100{,}000 \times \frac{\$40{,}000}{\$160{,}000} = \$25{,}000$$

Example 2— Corporate acquisitions—(i) *Facts.* The facts are the same as in example 1. On July 15, 1987, the XYZ group sells all the stock of Y to A. Having held the stock of Y for six months in 1987, the XZ group computes its transition relief for that year taking into account half of the transition attributes of Y. AY constitutes an affiliated group of corporations after the acquisition. Having held the stock of Y for six months in 1987, the AY group computes its transition relief for that year taking into account half of the transition attributes of Y. In 1987, the AY group attained a new lowest month-end debt level that yields an average lowest month-end debt level for 1987 of $150,000.

(ii) *Transferee group.* The following analysis applies in determining transition relief for purposes of apportioning the interest expense of the transferee group for 1987. The AY group has the following transition attributes for 1987:

	Historic 3rd party debt	Increase
Company A:		
Nov. 16, 1985	$100,000	
May 29, 1985 (5-year)	250,000	$5,000
Dec. 31, 1983 (4-year)	245,000	10,000
Dec. 31, 1982	235,000	
Company Y (half-year amounts):		
Nov. 16, 1985	100,000	
May 29, 1985 (5-year)	85,000	60,000
Dec. 31, 1983 (4-year)	25,000	5,000
Dec. 31, 1982	20,000	
Pre-acquisition year paydown by another member of the transferor group that reduced Y's five-year debt (one half of $75,000)	37,500	

Because the November 16, 1985 amount of the AY group in 1987 is $200,000 and because the 1987 average of historic month-end debt levels was $150,000, the AY group has a paydown in the amount of $50,000. In addition, the 1986 paydown by the XYZ group that was deemed to reduce Y debt is added to the paydown computed above, yielding a total paydown of $87,500. This amount is prorated between members, eliminating the four and five year debt of the AY group. Note that Y is only a member of the AY group for half of the 1987 taxable year. In 1988, Y's entire transition indebtedness and a $75,000 paydown must be taken into account in computing the amount of interest expense eligible for transition relief.

(iii) *Transferor group.* The following analysis applies in determining transition relief for purposes of apportioning the interest expense of the transferor group for 1987. The XZ group has the transition attributes stated below for 1987. In 1987, the XZ group attained a new lowest month-end debt level that yields an average lowest month-end debt level for 1987 of $250,000.

	Historic 3rd party debt	Increase
Company X:		
Nov. 16, 1985	$100,000	
May 29, 1985 (5-year)	80,000	$0
Dec. 31, 1983 (4-year)	80,000	10,000
Dec. 31, 1982	70,000	
Pre-disposition paydown that reduced X's debt	0	
Company Y (half-year amounts):		
Nov. 16, 1985	100,000	
May 29, 1985 (5-year)	85,000	60,000
Dec. 31, 1983 (4-year)	25,000	5,000
Dec. 31, 1982	20,000	
Pre-disposition paydown that reduced Y's debt	37,500	
Company Z:		
Nov. 16, 1985	300,000	
May 29, 1985 (5-year)	290,000	40,000
Dec. 31, 1983 (4-year)	250,000	100,000
Dec. 31, 1982	150,000	
Pre-disposition paydown that reduced Z's debt	25,000	

Because the revised November 16, 1985 amount of the XZ group is $500,000 and because the 1987 average of lowest historic month-end debt levels of the XZ group was $250,000, the XZ group has a paydown in the amount of $250,000. This paydown offsets the total five and four year debt of the XZ group. Had the 1987 paydown of the XZ group been an amount less than the five-year amount, the paydown would have been prorated based on Y's adjusted 5-year amount of $22,500 and Z's adjusted 5-year amount of $15,000.

[T.D. 8257, 54 FR 31820, Aug. 2, 1989]

§ 1.861–14T Special rules for allocating and apportioning certain expenses (other than interest expense) of an affiliated group of corporations (temporary regulations.)

(a) *In general.* Section 1.861–11T provides special rules for allocating and apportioning interest expense of an affiliated group of corporations. The rules of this § 1.861–14T also relate to affiliated groups of corporations and implement section 864(e)(6), which requires affiliated group allocation and apportionment of expenses other than interest which are not directly allocable and apportionable to any specific income producing activity or property. In general, the rules of this section apply to taxable years beginning after December 31, 1986. Paragraph (b) of this section describes the scope of the application of the rule for the allocation and apportionment of such expenses of affiliated groups of corporations. Such rule is then set forth in paragraph (c) of this section. Paragraph (d) of this section contains the definition of the term ''affiliated group'' for purposes of this section. Paragraph (e) of this section describes the expenses subject to allocation and apportionment under the rules of this section. Paragraph (f) of this section provides rules concerning the affiliated group allocation and apportionment of such expenses in computing the combined taxable income of a FSC or DISC and its related supplier. Paragraph (g) of this section describes the treatment of losses caused by apportionment of such expenses in the case of an affiliated group that does not file a consolidated return. Paragraph (h) of this section provides rules concerning the treatment of the reserve expenses of a life insurance company. Paragraph (j) of this section provides examples illustrating the application of this section.

(b) *Scope*—(1) *Application of section 864(e)(6).* Section 864(e)(6) and this section apply to the computation of taxable income for purposes of computing separate limitations on the foreign tax credit under section 904. Section 864(e)(6) and this section also apply in connection with section 907 to determine reductions in the amount allowed as a foreign tax credit under section 901. Section 864(e)(6) and this section also apply to the computation of the combined taxable income of the related supplier and a foreign sales corporation (FSC) (under sections 921 through 927) as well as the combined taxable income of the related supplier and a domestic international sales corporation (DISC) (under sections 991 through 997).

(2) *Nonapplication of section 864(e)(6).* Section 864(e)(6) and this section do not apply to the computation of subpart F income of controlled foreign corporations (under sections 951 through 964) or the computation of effectively connected taxable income of foreign corporations.

(3) *Application of section 864(e)(6) to the computation of combined taxable income of a possessions corporation and its affiliates.* [Reserved]

(c) *General rule for affiliated corporations*—(1) *General rule.* (i) Except as otherwise provided in paragraph (c)(2) of this section, the taxable income of each member of an affiliated group within each statutory grouping shall be determined by allocating and apportioning the expenses described in paragraph (e) of this section of each member according to apportionment fractions which are computed as if all members of such group were a single corporation. For purposes of determining these apportionment fractions, any interaffiliate transactions or property that are duplicative with respect to the measure of apportionment chosen shall be eliminated. For example, in the application of an asset method of apportionment, stock in affiliated corporations shall not be taken into account, and loans between members of an affiliated group shall be treated in accordance with the rules of § 1.861–11T(e). Similarly, in the application of a gross income method of apportionment, interaffiliate dividends and interest, gross income from sales or services, and other interaffiliate gross income shall be eliminated. Likewise, in the application of a method of apportionment based on units sold or sales receipts, interaffiliate sales shall be eliminated.

(ii) Except as otherwise provided in this section, the rules of § 1.861–8T apply to the allocation and apportionment of the expenses described in paragraph (e) of this section. Thus, allocation under this paragraph (c) is accomplished by determining, with respect to each expense described in paragraph (e), the class of gross income to which the expense is definitely related and then allocating the deduction to such class of gross income. For this purpose, the gross income of all members of the affiliated group must be taken in account. Then, the expense is apportioned by attributing the expense to gross income (within the class to which the expense has been allocated) which is in the statutory grouping and to gross income (within the class) which is in the residual grouping. Section 1.861–8T(c)(1) identifies a number of factors upon which apportionment may be based, such as comparison of units sold, gross sales or receipts, assets used, or gross income. The apportionment method chosen must be applied consistently by each member of the affiliated group in apportioning the expense when more than one member incurred the expense or when members incurred separate portions of the expense. The apportionment fraction must take into account the apportionment factors contributed by all members of the affiliated group. In the case of an affiliated group of corporations that files a consolidated return, consolidated foreign tax credit limitations are computed for the group in accordance with the rules of §1.1502–4. For purposes of this section the term ''taxpayer'' refers to the affiliated group (regardless of whether the group files a consolidated return), rather than to the separate members thereof.

(2) *Expenses relating to fewer than all members.* An expense relates to fewer than all members of an affiliated group if the expense is allocable under paragraph (e)(1) of this section to gross income of at least one member other than the member that incurred the expense but fewer than all members of the affiliated group. The taxable income of the member that incurred the expense shall be determined by apportioning that expense under the rules of paragraph (c)(1) of this section as if the members of the affiliated group that derive gross income to which such expense is allocable under paragraph (e)(1) were treated as a single corporation.

(3) *Prior application of section 482.* The rules of this section do not supersede the application of section 482 and the regulations thereunder. Section 482 may be applied effectively to deny a deduction for an expense to one member of an affiliated group and to allow a deduction for that expense to another member of the affiliated group. In cases to which section 482 is applied, expenses shall be reallocated and reapportioned under section 864(e)(6) and this section after taking into account the application of section 482.

(d) *Definition of affiliated group*—(1) *General rule.* For purposes of this section, the term ''affiliated group'' has the same meaning as is given that term by section 1504, except that section 936 companies are also included within the affiliated group. Section 1504(a) defines an affiliated group as one or more chains of includible corporations connected through 80% stock ownership with a common parent corporation which is an includible corporation (as defined in section 1504(b)). In the case of a corporation that either becomes or ceases to be a member of the group during the course of the corporation's taxable year, only the expenses incurred by the group member during the period of membership shall be allocated and apportioned as if all members of the group were a single corporation. In this regard, the apportionment factor chosen shall relate only to the period of membership. For example, if apportionment on the basis of assets is chosen, the average amount of assets (tax book value or fair market value) for the taxable year shall be multiplied by a fraction, the numerator of which is the number of months of the corporation's taxable year during which the corporation was a member of the affiliated group, and the denominator of which is the number of months within the corporation's taxable year. If apportionment on the basis of gross income is chosen, account shall be taken of gross income generated only during the period of membership. If apportionment on the basis of units sold or sales receipts is chosen, account shall be taken of units sold or sales receipts only during the period of membership. Expenses incurred by the group member during its taxable year, but not during the period of membership, shall be allocated and apportioned without regard to other members of the group.

(2) *Inclusion of section 936 corporations.* The exclusion from the affiliated group of section 936 corporations under section 1504(b)(4) does not apply for purposes of this section. Thus, a possessions corporation meeting the ownership requirements of section 1504(a) with respect to which an election under section 936 is in effect for the taxable year is a member of the affiliated group.

(3) *Inclusion of financial corporations.* For purposes of this section, in the case of an affiliated group (as defined in paragraph (d)(1) of this section), any members that constitute financial corporations as defined in § 1.861–11T(d)(4)(ii) shall be treated as members of the affiliated group. The rule of § 1.861–11T(d)(4)(i), which treats such financial corporations as a separate affiliated group, applies only for purposes of allocation and apportionment of interest expense and does not apply to the allocation and apportionment of other expenses under this section.

(4) *Treatment of life insurance companies subject to taxation under section 801.* A life insurance company that is subject to taxation under section 801 shall be considered to constitute a member of the affiliated group composed of companies not taxable under section 801 only if a parent corporation so elects under section 1504(c)(2)(A) of the Code.

(e) *Expenses to be allocated and apportioned under this section*—(1) *Expenses not directly traceable to specific income producing activities or property.* (i) The expenses that are required to be allocated and apportioned under the rules of this section are expenses related to certain supportive functions, research and experimental expenses, stewardship expenses, and legal and accounting expenses, to the extent that such expenses are not directly allocable to specific income producing activities or property solely of the member of the affiliated group that incurred the expense. Interest expense of members of an affiliated group of corporations is allocated and apportioned under § 1.861–11T and not under the rules of this section. Expenses that are included in inventory costs or that are capitalized are not subject to allocation and apportionment under the rules of this section.

(ii) An item of expense is not considered to be directly allocable to specific income producing activities or property solely of the member incurring the expense if, were all members of the affiliated group treated as a single corporation, the expense would not be considered definitely related, within the meaning of § 1.861–8T(b)(2), only to a class of gross income derived solely by the member which actually incurred the expense. Furthermore, the expense is presumed not to be definitely related only to a class of gross income derived solely by the member incurring the expense (and is, therefore, presumed not to be directly allocable to specific income producing activities or property of that member) unless the taxpayer is able affirmatively to establish otherwise. As provided in paragraph (c)(1) of this section, expenses described in this paragraph (e)(1) generally shall be apportioned by the member incurring the expense according to apportionment fractions computed as if all members of the affiliated group were a single corporation. Under paragraph (c)(2) of this section, however, an expense shall be apportioned according to apportionment fractions computed as if only some (but fewer than all) members of the affiliated group were a single corporation, if the expense is considered allocable to gross income of at least one member other than the member incurring the expense but fewer than all members of the affiliated group. An item of expense shall be considered to be allocable to gross income of fewer than all members of the group if, were all members of the affiliated group treated as a single corporation, the expense would not be considered definitely related within the meaning of § 1.861–8T(b)(2) to gross income derived by all members of the group. In such case, the expense shall be considered allocable, for purposes of paragraph (c)(2) of this section, to gross income of those members of the group that generated (or could reasonably be expected to generate) the gross income to which the expense would be considered definitely related if the group were treated as a single corporation.

(2) *Research and experimental expenses*—(i) *In general.* The allocation and apportionment of research and experimental expenses is governed by the rules of §1.861–8T(e)(3). In the case of research and experimental expenses incurred by a member of an affiliated group, the rules of §1.861–8T(e)(3) shall be applied as if all members of the affiliated group were a single taxpayer. Thus, research and experimental expenses shall be allocated to all income of all members of the affiliated group reasonably connected with the relevant broad product category to which such expenses are definitely related under §1.861–8T(e)(3)(i). If fewer than all members of the affiliated group derive gross income reasonably connected with that relevant broad product cagetory, then such expenses shall be apportioned under the rules of this paragraph (c)(2) only among those members, as if those members were a single corporation. See *Example* (1) of paragraph (j) of this section. Such expenses shall then be apportioned, if the sales method is used, in accordance with the rules of §1.861–8T(e)(3)(ii) between the statutory grouping (within the class of gross income) and the residual grouping (within the class of gross income) taking into account the amount of sales of all members of the affiliated group from the product category which resulted in such gross income. Section 1.861–8T(e)(3)(ii)(D), relating to sales of controlled parties, shall be applied as if all members of the affiliated group were the ‘‘taxpayer’’ referred to therein. If either of the optional gross income methods of apportionment is used, gross income of all members of the affiliated group that generate, have generated, or could reasonably have been expected to generate gross income within the relevant class of gross income must be taken into account.

(ii) *Expenses subject to the statutory moratorium.* The rules of this section do not apply to research and experimental expenses allocated under section 126 of Pub. L. 98–368.

(3) *Expenses related to supportive functions.* Expenses which are supportive in nature (such as overhead, general and administrative, supervisory expenses, advertising, marketing, and other sales expenses) are to be allocated and apportioned in accordance with the rules of §1.861–8T(b)(3). To the extent that such expenses are not directly allocable under paragraph (e)(1)(ii) of this section to specific income producing activities or property of the member of the affiliated group that incurred the expense, such expenses must be allocated and apportioned as if all members of the affiliated group were a single corporation in accordance with the rules of paragraph (c) of this section. Specifically, such expenses must be allocated to a class of gross income that take into account gross income that is generated, has been generated, or could reasonably have been expected to have been generated by the members of the affiliated group. If the expenses relate to the gross income of fewer than all members of the affiliated group as determined under paragraph (c)(2) of this section, then those expenses must be apportioned under the rules of paragraph (c)(2) of this section, as if those fewer members were a single corporation. See *Example* (3) of paragraph (j) of this section. Such expenses must be apportioned between statutory and residual groupings of income within the appropriate class of gross income by reference to the apportionment factors contributed by the members of the affiliated group that are treated as a single corporation.

(4) *Stewardship expenses.* Stewardship expenses are to be allocated and apportioned in accordance with the rules of §1.861–8T(e)(4). In general, stewardship expenses are considered definitely related and allocable to dividends received or to be received from a related corporation. If members of the affiliated group, other than the member that incurred the stewardship expense, receive or may receive dividends from the related corporation, such expense must be allocated and apportioned in accordance with the rules of paragraph (c) of this section as if all such members of the affiliated group that receive or may receive dividends were a single

corporation. See *Example* (4) of paragraph (j) of this section. Such expenses must be apportioned between statutory and residual groupings of income within the appropriate class of gross income by reference to the apportionment factors contributed by the members of the affiliated group treated as a single corporation.

(5) *Legal and accounting fees and expenses.* Legal and accounting fees and expenses are to be allocated and apportioned under the rules of § 1.861–8T (e)(5). To the extent that such expenses are not directly allocable under paragraph (e)(1)(ii) of this section to specific income producing activities or property of the member of the affiliated group that incurred the expense, such expenses must be allocated and apportioned as if all members of the affiliated group were a single corporation. Specifically, such expenses must be allocated to a class of gross income that takes into account the gross income which is generated, has been generated, or could reasonably have been expected to have been generated by the other members of the affiliated group. If the expenses relate to the gross income of fewer than all members of the affiliated group as determined under paragraph (c)(2) of this section, then those expenses must be apportioned under the rules of paragraph (c)(2) of this section, as if those fewer members were a single corporation. See *Example* (5) of paragraph (j) of this section. Such expenses must be apportioned taking into account the apportionment factors contributed by the members of the group that are treated as a single corporation.

(f) *Computation of FSC or DISC combined taxable income.* In the computation under the pricing rules of sections 925 and 994 of the combined taxable income of any FSC or DISC and its related supplier which are members of an affiliated group, the combined taxable income of such FSC or DISC and its related supplier shall be reduced by the portion of the expenses of the affiliated group described in paragraph (e) of this section that is incurred in connection with export sales involving that FSC or DISC. In order to determine the portion of the expenses of the affiliated group that is incurred in connection with export sales by or through a FSC or DISC, the portion of the total of the apportionment factor chosen that relates to the generation of that export income must be determined. Thus, if gross income is the apportionment factor chosen, the portion of total gross income of the affiliated group that consists of combined gross income derived from transactions involving the FSC or DISC and related supplier must be determined. Similarly, if units sold or sales receipts is the apportionment factor chosen, the portion of total units sold or sales receipts that generated export income of the FSC or DISC and related supplier must be determined. The amount of the expense shall then be multiplied by a fraction, the numerator of which is the export related apportionment factor as determined above, and the denominator of which is the total apportionment factor. Thus, if gross income is the apportionment factor chosen, apportionment is based on a fraction, the numerator of which is export related combined gross income of the FSC or DISC and related supplier and the denominator of which is the total gross income of the affiliated group. Similarly, if units sold or sales receipts is the apportionment factor chosen, the fraction is the units sold or sales receipts that generated export income of the FSC or DISC and related supplier over the total units sold or sales receipts of the affiliated group. Under this rule, expenses of other group members may be attributed to the combined gross income of a FSC of DISC and its related supplier without affecting the amount of expenses (other than any commission payable by the related supplier to the FSC or DISC) otherwise deductible by the FSC or DISC, the related supplier, or other members of the affiliated group. The FSC or DISC must calculate combined taxable income, taking into account any reduction by expenses attributed from other members of the affiliated group to determine the commission derived by the FSC or DISC or the transfer price of qualifying export property sold to the FSC or DISC.

(g) *Losses created through apportionment.* In the case of an affiliated group that does not file a consolidated return, the taxable income in any separate limitation category must be adjusted under this paragraph (g) for purposes of computing the separate foreign tax credit limitations under section 904(d). As a consequence of the affiliated group allocation and apportionment of expenses required by section 864(e)(6) and this section, expenses of a group member may be apportioned for section 904 purposes to a limitation category with a consequent loss in that limitation category. For purposes of this paragraph, the term ''limitation category'' includes domestic source income, as well as the types of income described in section 904(d)(1) (A) through (I). A loss of one affiliate in a limitation category will reduce the income of another member in the same limitation category if a consolidated return is filed. (*See* §1.1502–4.) If a consolidated return is not filed, this netting does not occur. Accordingly, in such a case, the following adjustments among members are required, in order to give effect to the group allocation of expense:

(1) Losses created through group apportionment of expense in one or more limitation categories within a given member must be eliminated; and

(2) A corresponding amount of income of other members in the same limitation category must be recharacterized.

Such adjustments shall be accomplished in accordance with the rules of §1.861–11T(g).

(h) *Special rule for the allocation of reserve expenses of a life insurance company.* An amount of reserve expenses of a life insurance company equal to the dividends received deduction that is disallowed because it is attributable to the policyholders' share of dividends received shall be treated as definitely related to such dividends. The remaining reserve expenses of such company shall be allocated and apportioned under the rules of §1.861–8 and this section.

(i) [Reserved]

(j) *Examples.* The rules of this section may be illustrated by the following examples. All of these examples assume that section 482 has not been applied by the Commissioner.

Example 1— (i) *Facts.* P owns all of the stock of X and all of the stock of Y. P, X and Y are domestic corporations. P is a holding company for the stock of X and Y. Both X and Y manufacture and sell a product which is included in a broad product category listed in §1.861–8(e)(3)(i). During 1988, X incurred $100,000 on research connected with that product. All of the research was performed in the United States. In 1988, the domestic sales by X of the product totalled $400,000 and the foreign sales of the product totalled $200,000; Y's domestic sales of the product totalled $200,000 and Y's foreign sales of the product totalled $200,000. In 1988, X's gross income is $300,000, of which $200,000 is from domestic sales and $100,000 is from foreign sales; Y's gross income is $200,000 of which $100,000 is from domestic sales and $100,000 is from foreign sales.

(ii) P, X and Y are affiliated corporations within the meaning of section 864(e)(5) and this section. The research expenses incurred by X are allocable to all income connected with the relevant broad category listed in §1.861–8T(e)(3)(i). Both X and Y have gross income includible within the class of gross income related to that product category. Accordingly, the research and experimental expenses incurred by X are to be allocated and apportioned as if X and Y were a single corporation. The apportionment for 1988 is as follows:

Tentative Apportionment on the Basis of Sales

Research expenses to be apportioned	$100,000
Exclusive apportionment to United States source gross income	$30,000
Research expense to be apportioned on the basis of sales	$70,000

Apportionment of research expense to foreign source general limitation income:

$$\$70{,}000 \times \frac{\$200{,}000 + \$200{,}000}{\$600{,}000 + \$400{,}000} = \$28{,}000$$

Apportionment of research expense to United States source gross income:

$$\$70{,}000 \times \frac{\$400{,}000 + \$200{,}000}{\$600{,}000 + \$400{,}000} = \$42{,}000$$

Total apportioned deduction for research $100,000

Of which—

Apportioned to foreign source gross income $28,000

Apportioned to U.S. source gross income ($30,000+$42,000) $72,000

Tentative Apportionment on the Basis of Gross Income

Research expense apportioned to foreign source gross income:

$$\$100{,}000 \times \frac{\$100{,}000 + \$100{,}000}{\$300{,}000 + \$200{,}000} = \$40{,}000$$

Research expense apportioned to United States income:

$$\$100{,}000 \times \frac{\$200{,}000 + \$100{,}000}{\$300{,}000 + \$200{,}000} = \$60{,}000$$

Example 2—(i) *Facts.* P owns all of the stock of X, which owns all of the stock of Y. P, X and Y are all domestic corporations. P has incurred general training program expenses of $100,000 in 1987. Employees of P, X and Y participate in the training program. In 1987, P had United States source gross income of $200,000 and foreign source general limitation income of $200,000; X had U.S. source gross income of $100,000 and foreign source general limitation income of $100,000; and Y had U.S. source gross income of $300,000 and foreign source general limitation income of $100,000.

(ii) *Analysis.* P, X and Y are an affiliated group of corporations within the meaning of section 864(e)(5). The training expenses incurred by P are not definitely related solely to specific income producing activities or property of P. The employees of X and Y also participate in the training program. Thus, this expense relates to gross income generated by P, X and Y. This expense is definitely related and allocable to all of the gross income from foreign and domestic sources of P, X and Y. It is assumed that apportionment on the basis of gross income is reasonable. The apportionment of the expense is as follows:

Apportionment of $100,000 expense to foreign source general limitation income:

$$\$100{,}000 \times \frac{\$200{,}000 + \$100{,}000 + \$100{,}000}{\$400{,}000 + \$200{,}000 + \$400{,}000} = \$40{,}000$$

Apportionment of $100,000 expense to United States source gross income:

$$\$100{,}000 \times \frac{\$200{,}000 + \$100{,}000 + \$300{,}000}{\$400{,}000 + \$200{,}000 + \$400{,}000} = \$60{,}000$$

Total apportioned expense $100,000

Example 3—(i) *Facts.* The facts are the same as in *Example* (2) above, except that only employees of P and X participate in the training program.

(ii) *Analysis.* Because only the employees of P and X participate in the training program and they perform no services for Y, the expense relates only to gross income generated by P and X. Accordingly, the $100,000 expense must be allocated and apportioned as if P and X were a single corporation. The apportionment of the $100,000 expense is as follows:

Apportionment of $100,000 expense to foreign source general limitation income:

$$\$100{,}000 \times \frac{\$200{,}000 + \$100{,}000}{\$400{,}000 + \$200{,}000} = \$50{,}000$$

Apportionment of $100,000 expense to U.S. source gross income:

$$\$100{,}000 \times \frac{\$200{,}000 + \$100{,}000}{\$400{,}000 + \$200{,}000} = \$50{,}000$$

Example 4—(i) *Facts.* P owns all of the stock of X which owns all of the stock of Y. P and X are domestic corporations; Y is a foreign corporation. In 1987 P incurred $10,000 of stewardship expenses relating to an audit of Y.

(ii) *Analysis.* The stewardship expenses incurred by P are not directly allocable to specific income producing activities or property of P. The expense is definitely related and allocable to dividends received or to be received by X. Accordingly, the expense of P is allocated and apportioned as if P and X were a single corporation. The expense is definitely related to dividends received or to be received by X from Y, a foreign corporation. Such dividends are foreign source general limitation income. Thus, the entire amount of the expense must be allocated to foreign source dividend income.

Example 5—(i) *Facts.* P owns all of the stock of X which owns all of the stock of Y. P, X and Y are all domestic corporations. In 1987, P incurred $10,000 legal expense relating to the testimony of certain employees of P in connection with litigation to which Y is a party. This expense is not allocable to specific income of Y. In 1987, Y had $100,000 foreign source general limitation income and $300,000 U.S. source gross income.

(ii) *Analysis.* The legal expenses incurred by P are not definitely related solely to specific income producing activities or property of P. The expense is definitely related and allocable to the class of gross income which includes only gross income generated by Y. Accordingly, the expense of P is allocated and apportioned as if Y were the only member of the affiliated group, as follows:

Apportionment of legal expenses to foreign source general limitation income:

$$\$10{,}000 \times \frac{\$100{,}000}{\$400{,}000} \ldots\ldots \$2{,}500$$

Apportionment of legal expenses to U.S. source gross income:

$$\$10{,}000 \times \frac{\$300{,}000}{\$400{,}000} \ldots\ldots \$7{,}500$$

Example 6—(i) *Facts.* P owns all of the stock of R, which owns all of the stock of F. P and R are domestic corporations, and F is a foreign sales corporation under section 922 of the Code. R and F have entered into an agreement whereby F is paid a commission with respect to sales of product A. In 1987, P had gross receipts of $1,000,000 from domestic sales of product A, and gross receipts of $1,000,000 from foreign sales of product A. R had gross receipts of $1,000,000 from domestic sales of product A, and $1,000,000 from export sales of product A. R's cost of goods sold attributable to export sales is $500,000. R has deductible expenses of $100,000 directly related to its export sales, and F has such deductible expenses of $100,000. During 1987, P incurred an expense of $100,000 for marketing studies involving the worldwide market for product A.

(ii) *Analysis.* P and R are an affiliated group of corporations within the meaning of section 864(e)(5) and this section. The expense incurred by P for marketing studies regarding the worldwide market for product A is an expense that is not directly related solely to the activities of P, but also to the activities of R. This expense must be allocated and apportioned under the rules of paragraph (c)(1) of this section, as if P and R were a single corporation. The expense is allocable to the class of gross income that includes all gross income generated by sales of product A. Apportionment on the basis of gross receipts is reasonable under these facts. F, a foreign corporation, is not a member of the affiliated group. However, for purposes of determining F's commission on its sales, the combined gross income of F and R must be reduced by the portion of the marketing studies expense of P that is incurred in connection with export sales involving F under the rules of paragraph (f) of this section. The computation of the combined taxable income of R and F is as follows:

Combined Taxable Income of R and F

R's gross receipts from export sales	$1,000,000
R's cost of goods sold	$500,000
Combined Gross Income	$500,000
Less:	
R's other deductible expenses	$100,000
F's other deductible expenses	100,000
Apportionment of P's expense:	

$$\$100{,}000 \times \frac{\$1{,}000{,}000}{\$200{,}000 + \$2{,}000{,}000} \ldots\ldots \$25{,}000$$

Total	$225,000
Combined Taxable Income	$275,000

[T.D. 8228, 53 FR 35501, Sept. 14, 1988]

§ 1.861–15 Income from certain aircraft or vessels first leased on or before December 28, 1980.

(a) *General rule.* A taxpayer who owns an aircraft or vessel described in paragraph (b) of this section and who leases the aircraft or vessel to a United States person (other than a member of the same controlled group of corporations (as defined in section 1563) as the taxpayer) may elect under paragraph (f) of this section to treat all amounts includible in gross income with respect to the aircraft or vessel as income from sources within the United States for any taxable year ending after the commencement of the lease. This paragraph (a) applies only with respect to taxable years ending after August 15, 1971, and only with respect to leases entered into after that date of aircraft or vessels first leased by the taxpayer on or before December 28, 1980. An election once made applies to the taxable year for which made and to all subsequent taxable years unless it is revoked or terminated in accordance with paragraph (g) of this section. A taxpayer need not be a United States person to be eligible to make the election under this section, unless otherwise required by a provision of law not contained in the Internal Revenue Code of 1954. In addition, the taxpayer need not be a bank or other financial institution to be eligible to make this election. The term ''United States person'' as used in this section has the meaning assigned to it by section 7701(a)(30).

(b) *Property to which the election applies*—(1) *section 38 property.* An election made under this section may be made only if the aircraft or vessel is section 38 property, or property which would be section 38 property but for section 48(a)(5) (relating to property used by governmental units), at the time the election is made and for all taxable years to which the election applies. The aircraft or vessel must be property which qualifies for the investment credit under section 38 unless the property does not qualify because it is described in section 48(a)(5). If an aircraft is used predominantly outside the United States (determined under § 1.48–1(g)(1)), it must qualify under the provisions of section 48(a)(2)(B)(i) and § 1.48–1(g)(2)(i). If a vessel is used predominantly outside the United States, it must qualify under the provisions of section 48(a)(2)(B)(iii) and § 1.48–1(g)(2)(iii). The aircraft or vessel may not be suspension or termination period property described in section 48(h) or section 49(a) (as in effect before the enactment of the Revenue Act of 1978). See paragraph (g) (3) and (4) of this section for rules which apply if the property ceases to be section 38 property.

(2) *United States manufacture or construction.* An election under this section may be made only if the aircraft or vessel is manufactured or constructed in the United States. The aircraft or vessel will be considered to be manufactured or constructed in the United States if 50 percent or more of the basis of the aircraft or vessel is attributable to value added within the United States.

(3) *Exclusion of certain property used outside the United States.* The term ''aircraft or vessel'' as used in this paragraph (b) does not include any property which is used predominantly outside the United States and which qualifies as section 38 property under—

(i) Section 48(a)(2)(B)(v), relating to containers used in the transportation of property to and from the United States,

(ii) Section 48(a)(2)(B)(vi), relating to certain property used for the purpose of exploring for, developing, removing, or transporting resources from the Outer Continental Shelf, or

(iii) Section 48(a)(2)(B)(x), relating to certain property used in international or territorial waters.

(c) *Leases or subleases to which the election applies.* At the time the election under this section is made and for all taxable years for which the election applies, the lessee of the aircraft or vessel must be a United States person. In addition, the aircraft or vessel may not be subleased to a person who is not a United States person unless the sublease is a short-term sublease. For purposes of this section, a short-term sublease is a sublease for a period of time (including any period for which the sublease may be renewed or extended) which is less than 30 percent of the asset guideline period of the aircraft or vessel leased (determined under section 167(m)). See paragraphs (g) (3) and (4) of this section for rules which apply if the requirements of this paragraph (c) are not met.

(d) *Income to which the election applies.* An election under this section applies to all amounts derived by the taxpayer with respect to the aircraft or vessel which is subject to the election. The election applies to all amounts which are includible in the taxpayer's gross income whether or not includible during or after the period of a lease to which the election applies. Amounts derived by the taxpayer with respect to the aircraft or vessel include any gain from the sale, exchange, or other disposition of the aircraft or vessel. If by reason of the allowance of expenses and other deductions, there is a loss with respect to an aircraft or vessel, the election applies to treat the loss as having a source within the United States. Similarly, if the sale, exchange or other disposition of the aircraft or vessel which is subject to an election results in a loss, it is treated as having a source within the United States. See paragraph (e)(2) of this section for the application of an election under this section to the income of certain transferees or distributees.

(e) *Effect of election*—(1) *In general.* An election under this section applies to the taxable year for which it is made and to all subsequent taxable years for which amounts in respect of the aircraft or vessel to which the election relates are includible in gross income. However, the election may be revoked under paragraph (g) (1) or (2) of this section or terminated under paragraph (g)(3) of this section.

(2) *Certain transfers involving carryover of basis.* (i) If an electing taxpayer transfers or distributes an aircraft or vessel which is subject to the election under this section, the transferee or distributee will be treated as having made an election under this section with respect to the aircraft or vessel if the basis of the aircraft or vessel in the hands of the transferee or distributee is determined by reference to its basis in the hands of the transferor or distributor. This paragraph (e)(2)(i) applies even though the transferor or distributor recognizes an amount of gain which increases basis in the hands of the transferee or distributee and even though the transferee of distributee is a nonresident alien individual or foreign corporation. For example, if a corporation distributes a vessel which is subject to an election under this section to its parent corporation in a complete liquidation described in section 332(b), the parent corporation will be required to treat all amounts includible in its gross income with respect to the vessel as income from source within the United States if, unless the election is revoked or terminated under paragraph (g) of this section, the basis of the property in the hands of the parent is determined under section 334(b)(1) (relating to the general rule on carryover of basis). In further illustration, if a corporation distributes a vessel (subject to an election) in a distribution to which section 301(a) applies, the distributee will be treated as having made the election with respect to the vessel if its basis is determined under section 301(d)(2) (relating to basis of corporate distributees) even though the basis is the fair market value of the vessel under section 301(d)(2)(A).

(ii) If a member of an affiliated group which files a consolidated return transfers an aircraft or vessel subject to an election to another member of that group, the transferee will be treated as having made the election with respect to the aircraft or vessel. In addition, if a partnership distributes an aircraft or vessel subject to an election to a partner, the partner will be treated as having made the election with respect to the aircraft or vessel.

(iii) If paragraph (e)(2) (i) and (ii) of this section do not apply, the election under this section with respect to an aircraft or vessel will not be considered as made by a transferee or distributee.

(f) *Election*—(1) *Time for making the election.* The election under this section must be made before the expiration of the period prescribed by section 6511(a) (or section 6511(c) if the period is extended by agreement) for making a claim for credit or refund of the tax imposed by chapter 1 for the first taxable year for which the election is to apply. The period for that first taxable year is determined without regard to the special periods prescribed by section 6511(d).

(2) *Manner of making the election.* An election under this section must be made by filing with the income tax return (or an amended return) for the first taxable year for which the election is to apply a statement, signed by the taxpayer, to the effect that the election under section 861(e) is being made. The statement must—

(i) Set forth sufficient facts to identify the aircraft or vessel which is the subject of the election,

(ii) State that the aircraft or vessel was manufactured or constructed in the United States,

(iii) State that the aircraft or vessel is section 38 property described in § 1.861–9(b) which was leased to a United States person (as defined in section 7701(a)(30) of the Code) pursuant to a lease entered into after August 15, 1971,

(iv) State that the electing taxpayer is the owner of the aircraft or vessel,

(v) State the lessee of the aircraft or vessel is not a member of a controlled group of corporations (as defined in section 1563) of which the taxpayer is a member,

(vi) Give the name and taxpayer identification number of the lessee of the aircraft or vessel, and

(vii) State that the aircraft or vessel is not subject to a sublease (other than a short-term sublease) to any person who is not a United States person.

(3) *Election by partnership.* Any election under this section with respect to an aircraft or vessel owned by a partnership shall be made by the partnership. Any partnership election is applicable to each partner's partnership interest in the aircraft or vessel. However, an election made by a partner before August 8, 1979 will be recognized where the partnership made no election and the election can no longer be revoked without the consent of the Commissioner under paragraph (g)(1) of this section.

(g) *Termination of election*—(1) *Revocation without consent.* A taxpayer may revoke an election within the time prescribed in paragraph (f)(1) of this section without the consent of the Commissioner. In such a case, the taxpayer must file an amended income tax return for any taxable year to which the election applied.

(2) *Revocation with consent.* Except as provided in paragraph (g) (1) or (3) of this section, an election made under this section is binding unless consent to revoke is obtained from the Commissioner. A request to revoke the election must be made in writing and addressed to the Assistant Commissioner of Internal Revenue (Technical), Attention: T:C:C:3, Washington, DC 20224. The request must include the name and address of the taxpayer and be signed by the taxpayer or his duly authorized representative. It must specify the taxable year or years for which the revocation is to be effective and must be filed at least 90 days prior to the time (not including extensions) prescribed by law for filing the income tax return for the first taxable year for which the revocation of the election is to be effective or by November 6, 1979 whichever is later. The request must specify the grounds which are considered to justify the revocation. The Commissioner may require such additional information as may be necessary in order to determine whether the proposed revocation will be permitted. Consent will generally not be given to revoke an election where the revocation would result in treating gross income with respect to the aircraft or vessel (including any gain from the sale, exchange, or other disposition of such aircraft or vessel) as income from sources without the United States where, during the period the election was in effect, there were losses from sources within the United States. A copy of the consent of the Commissioner to revoke must be attached to the taxpayer's income tax return (or amended return) for each taxable year affected by the revocation.

(3) *Automatic termination.* If an aircraft or vessel subject to an election

under section 861(e) ceases to be section 38 property, ceases to be leased by its owner directly to a United States person, or is subleased (other than a short-term sublease) to a person who is not a United States person, within the period set forth in section 6511(a) (or section 6511(c) if the period is extended by agreement) for making a claim for credit or refund of the tax imposed by chapter 1 for the first taxable year for which the election applied, then the election with respect to such aircraft or vessel will automatically terminate. If the election terminates, the taxpayer who made the election must file an amended tax return or claim for credit or refund, as the case may be, for any taxable year to which the election applied.

(4) *Factors not causing revocation or termination.* The fact that an aircraft or vessel ceases to be section 38 property, ceases to be leased by its owner directly to a United States person, or is leased or subleased for any period of time to a person who is not a United States person, after expiration of the period set forth in section 6511(a) (or section 6511(c) if the period is extended by agreement) for making a claim for credit or refund of the tax imposed by chapter 1 for the first taxable year for which the election applied, will not cause a termination of the election made under this section with respect to the aircraft or vessel. For example, the electing taxpayer is not relieved from any of the consequences of making the election merely because the aircraft or vessel is subleased to a person who is not a United States person for a period in excess of that allowed for short-term subleases under paragraph (c) of this section after expiration of the later of 3 years from the time the return was filed for the first taxable year to which the election applied or 2 years from the time the tax was paid for that year where the period set forth in section 6511(a) has not been extended by agreement.

(5) *Effect of revocation or termination.* If an election is revoked or terminated under this paragraph (g), the taxpayer is required to recompute the tax for the appropriate taxable years without reference to section 861(e)(1).

(6) *Revocation or termination after December 28, 1980.* The rules in paragraph (g)(1) through (g)(5) continue to apply with respect to any election made pursuant to this section even though the revocation or termination may occur after December 28, 1980.

[T.D. 7635, 44 FR 46457, Aug. 8, 1979, as amended by T.D. 7928, 48 FR 55846, Dec. 16, 1983. Redesignated at 53 FR 35477, Sept. 14, 1988]

§1.861–16 Income from certain craft first leased after December 28, 1980.

(a) *General rule.* If a taxpayer—

(1) Owns a qualified craft (as defined in paragraph (b) of this section).

(2) Leases such qualified craft after December 28, 1980, to a United States person that is not a member of the same controlled group of corporations as the taxpayer, and

(3) The lease is the taxpayer's first lease of the craft and the taxpayer is not considered to have made an election with respect to the craft under §1.861–9(e)(2),

then the taxpayer shall treat all amounts includible in gross income with respect to the qualified craft as income from sources within the United States for each taxable year ending after commencement of the lease. If this section applies to income with respect to a craft, it applies to all such amounts that are includible in the taxpayer's gross income, whether or not includible during or after the period of a lease to a United States person. Amounts derived by the taxpayer with respect to the qualified craft include any gain from the sale, exchange, or other disposition of the qualified craft. If this section applies to income with respect to a craft and there is a loss with respect to that craft (either due to the allowance of expenses and other deductions or due to a sale, exchange, or other disposition of the qualified craft), such loss is treated as allocable or apportionable to sources within the United States. The fact that a craft ceases to be section 38 property, ceases to be leased by the taxpayer to a United States person, or is leased or subleased for any period of time to a person who is not a United States person will not terminate the application of this section.

(b) *Qualified craft*—(1) *In general.* A qualified craft is a vessel, aircraft, or spacecraft that—

(i) Is section 38 property (or would be section 38 property but for section 48(a)(5), relating to use by governmental units), and

(ii) Is manufactured or constructed in the United States.

(2) *Vessel.* The term ''vessel'' includes every type of watercraft capable of being used as a means of transportation on water, and any items of property that are affixed in a permanent fashion or are integral to the vessel. A vessel that is used predominately outside the United States must be described in section 48(a)(2)(B)(iii) and § 1.48–1(g)(2)(iii), relating to vessels documented for use in the foreign or domestic commerce of the United States, to be a qualified craft.

(3) *Aircraft.* An aircraft used predominantly outside the United States must be described in section 48(a)(2)(B)(i) and § 1.48–1(g)(2)(i), relating to aircraft registered by the Administrator of the Federal Aviation Agency, and operated to and from the United States or operated under contract with the United States, to be a qualified craft.

(4) *Spacecraft.* A spacecraft must be described in section 48(a)(2)(B)(viii) and § 1.48–1(g)(2)(viii), relating to communications satellites, or any interest therein, of a United States person, to be a qualified craft.

(5) *United States manufacture or construction.* A craft will be considered to be manufactured or constructed in the United States if 50 percent or more of the basis of the craft on the date of the lease to a United States person is attributable to value added within the United States.

(c) *United States person.* For purposes of this section, the term ''United States person'' includes those persons described in section 7701(a)(30) and individuals with respect to whom an election under section 6013 (g) or (h) (relating to nonresident alien individuals married to United States citizens or residents) is in effect.

(d) *Controlled group.* For purposes of paragraph (a)(2) of this section, whether a taxpayer and a United States person are members of the same controlled group of corporations is determined under section 1563. Solely for purposes of this section, if at least 80% of the capital interest, or the profits interest, in a partnership is owned, directly or indirectly, by a member or members of a controlled group of corporations, then the partnership shall be considered a member of that controlled group of corporations. In addition, if at least 80% of the capital interest, or the profits interest, in a partnership is owned, directly or indirectly, by a corporation, then the partnership and that corporation shall be considered members of a controlled group of corporations.

(e) *Certain transfers and distributions*—(1) *Transfers and distributions involving carryover of basis.* If—

(i) The income with respect to a craft is subject to this section,

(ii) The taxpayer transfers or distributes such craft, and

(iii) The basis of such craft in the hands of the transferee or distributee is determined by reference to its basis in the hands of the transferor or distributor,

then this section will apply to the income with respect to the craft includible in the gross income of the transferee or distributee. This paragraph (e)(1) applies even though the transferor or distributor recognizes an amount of gain that increases basis in the hands of the transferee or distributee and even though the transferee or distributee is a nonresident alien or foreign corporation. For example, if a corporation distributes a craft the income of which is subject to this section to its parent corporation in a complete liquidation described in section 332(b), the parent corporation will be treated as if it satisified the requirements of paragraph (a) of this section with respect to such craft if the basis of the property in the hands of the parent corporation is determined under section 334(b) (relating to the general rule on carryover of basis in liquidations). In further illustration, if a corporation distributes a craft the income of which is subject to this section, in a distribution to which section 301(a) applies, the distributee will be treated as if it satisfied the requirements of paragraph (a) of this section with respect to such craft if its basis is determined under section 301(d)(2) (relating to basis of corporate distributees) even though the basis may be the fair market value of the craft under section 301(d)(2)(A).

(2) *Partnerships.* If a partnership satisfies the requirements of paragraph (a) (1), (2), and (3) of this section, each partner shall treat all amounts includible in gross income with respect to the craft as income from sources within the United States for any taxable year of the partnership ending after commencement of the lease. In addition, if a partnership distributes a craft the income of which is subject to this section, to a partner, the partner will be treated as if he or she satisfied the requirements of paragraph (a) of this section with respect to such craft.

(3) *Affiliated groups.* If a member of a group of corporations that files a consolidated return transfers a craft, the income of which is subject to this section, to another member of that same group, the transferee will be treated as if it satisfied the requirements of paragraph (a) of this section with respect to the craft.

[T.D. 7928, 48 FR 55846, Dec. 16, 1983. Redesignated by T.D. 8228, 53 FR 35477, Sept. 14, 1988]

§1.861–17 Allocation and apportionment of research and experimental expenditures.

(a) *Allocation*—(1) *In general.* The methods of allocation and apportionment of research and experimental expenditures set forth in this section recognize that research and experimentation is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and experimentation must bear the cost of unsuccessful research and experimentation. Expenditures for research and experimentation that a taxpayer deducts under section 174 ordinarily shall be considered deductions that are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories). For purposes of this allocation, the product category (or categories) that a taxpayer may be considered to have shall be determined in accordance with the provisions of paragraph (a)(2) of this section.

(2) *Product categories*—(i) *Allocation based on product categories.* Ordinarily, a taxpayer's research and experimental expenditures may be divided between the relevant product categories. Where research and experimentation is conducted with respect to more than one product category, the taxpayer may aggregate the categories for purposes of allocation and apportionment; however, the taxpayer may not subdivide the categories. Where research and experimentation is not clearly identified with any product category (or categories), it will be considered conducted with respect to all the taxpayer's product categories.

(ii) *Use of three digit standard industrial classification codes.* A taxpayer shall determine the relevant product categories by reference to the three digit classification of the Standard Industrial Classification Manual (SIC code). A copy may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. The individual products included within each category are enumerated in Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual, 1987 (or later edition, as available).

(iii) *Consistency.* Once a taxpayer selects a product category for the first taxable year for which this section is effective with respect to the taxpayer, it must continue to use that product category in following years, unless the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in the product category is appropriate. For this purpose, a change in the taxpayer's selection of a product category shall include a change from a three digit SIC code category to a two digit SIC code category, a change from a two digit SIC code category to a three digit SIC code category, or any other aggregation, disaggregation or change of a previously selected SIC code category.

(iv) *Wholesale trade category.* The two digit SIC code category ‘‘Wholesale trade'' is not applicable with respect to sales by the taxpayer of goods and services from any other of the taxpayer's product categories and is not applicable with respect to a domestic international sales corporation (DISC) or foreign sales corporation (FSC) for which the taxpayer is a related supplier of goods and services from any of the taxpayer's product categories.

(v) *Retail trade category.* The two digit SIC code category ''Retail trade'' is not applicable with respect to sales by the taxpayer of goods and services from any other of the taxpayer's product categories, except wholesale trade, and is not applicable with respect to a DISC or FSC for which the taxpayer is a related supplier of goods and services from any other of the taxpayer's product categories, except wholesale trade.

(3) *Affiliated Groups*—(i) *In general.* Except as provided in paragraph (a)(3)(ii) of this section, the allocation and apportionment required by this section shall be determined as if all members of the affiliated group (as defined in § 1.861–14T(d)) were a single corporation. See § 1.861–14T.

(ii) *Possessions corporations.* (A) For purposes of the allocation and apportionment required by this section, sales and gross income from products produced in whole or in part in a possession by an electing corporation (within the meaning of section 936(h)(5)(E)), and dividends from an electing corporation, shall not be taken into account, except that this paragraph (a)(3)(ii) shall not apply to sales of (and gross income and dividends attributable to sales of) products with respect to which an election under section 936(h)(5)(F) is not in effect.

(B) The research and experimental expenditures taken into account for purposes of this section shall be reduced by the amount of such expenditures included in computing the cost-sharing amount (determined under section 936(h)(5)(C)(i)).

(4) *Legally mandated research and experimentation.* Where research and experimentation is undertaken solely to meet legal requirements imposed by a political entity with respect to improvement or marketing of specific products or processes, and the results cannot reasonably be expected to generate amounts of gross income (beyond de minimis amounts) outside a single geographic source, the deduction for such research and experimentation shall be considered definitely related and therefore allocable only to the grouping (or groupings) of gross income within that geographic source as a class (and apportioned, if necessary, between such groupings as set forth in paragraphs (c) and (d) of this section). For example, where a taxpayer performs tests on a product in response to a requirement imposed by the U.S. Food and Drug Administration, and the test results cannot reasonably be expected to generate amounts of gross income (beyond de minimis amounts) outside the United States, the costs of testing shall be allocated solely to gross income from sources within the United States.

(b) *Exclusive apportionment*—(1) *In general.* An exclusive apportionment shall be made under this paragraph (b), where an apportionment based upon geographic sources of income of a deduction for research and experimentation is necessary (after applying the exception in paragraph (a)(4) of this section).

(i) *Exclusive apportionment under the sales method.* If the taxpayer apportions on the sales method under paragraph (c) of this section, an amount equal to fifty percent of such deduction for research and experimentation shall be apportioned exclusively to the statutory grouping of gross income or the residual grouping of gross income, as the case may be, arising from the geographic source where the research and experimental activities which account for more than fifty percent of the amount of such deduction were performed.

(ii) *Exclusive apportionment under the optional gross income methods.* If the taxpayer apportions on the optional gross income methods under paragraph (d) of this section, an amount equal to twenty-five percent of such deduction for research and experimentation shall be apportioned exclusively to the statutory grouping or the residual grouping of gross income, as the case may be, arising from the geographic source where the research and experimental activities which account for more than fifty percent of the amount of such deduction were performed.

(iii) *Exception.* If the applicable fifty percent geographic source test of the preceding paragraph (b)(1)(i) or (ii) is not met, then no part of the deduction shall be apportioned under this paragraph (b)(1).

(2) *Facts and circumstances supporting an increased exclusive apportionment*—(i) *In general.* The exclusive apportionment provided for in paragraph (b)(1) of this section reflects the view that research and experimentation is often most valuable in the country where it is performed, for two reasons. First, research and experimentation often benefits a broad product category, consisting of many individual products, all of which may be sold in the nearest market but only some of which may be sold in foreign markets. Second, research and experimentation often is utilized in the nearest market before it is used in other markets, and in such cases, has a lower value per unit of sales when used in foreign markets. The taxpayer may establish to the satisfaction of the Commissioner that, in its case, one or both of the conditions mentioned in the preceding sentences warrant a significantly greater exclusive allocation percentage than allowed by paragraph (b)(1) of this section because the research and experimentation is reasonably expected to have very limited or long delayed application outside the geographic source where it was performed. Past experience with research and experimentation may be considered in determining reasonable expectations.

(ii) *Not all products sold in foreign markets.* For purposes of establishing that only some products within the product category (or categories) are sold in foreign markets, the taxpayer shall compare the commercial production of individual products in domestic and foreign markets made by itself, by uncontrolled parties (as defined under paragraph (c)(2)(i) of this section) of products involving intangible property which was licensed or sold by the taxpayer, and by those controlled corporations (as defined under paragraph (c)(3)(ii) of this section) that can reasonably be expected to benefit directly or indirectly from any of the taxpayer's research expense connected with the product category (or categories). The individual products compared for this purpose shall be limited, for nonmanufactured categories, solely to those enumerated in Executive Office of the President, Office of Management and Budget Standard Industrial Classification Manual, 1987 (or later edition, as available), and, for manufactured categories, solely to those enumerated at a 7-digit level in the U.S. Bureau of the Census, Census of Manufacturers: 1992, Numerical List of Manufactured Products, 1993, (or later edition, as available). Copies of both of these documents may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402.

(iii) *Delayed application of research findings abroad.* For purposes of establishing the delayed application of research findings abroad, the taxpayer shall compare the commercial introduction of its own particular products and processes (not limited by those listed in the Standard Industrial Classification Manual or the Numerical List of Manufactured Products) in the United States and foreign markets, made by itself, by uncontrolled parties (as defined under paragraph (c)(2)(i) of this section) of products involving intangible property that was licensed or sold by the taxpayer, and by those controlled corporations (as defined under paragraph (c)(3)(i) of this section) that can reasonably be expected to benefit, directly or indirectly, from the taxpayer's research expense. For purposes of evaluating the delay in the application of research findings in foreign markets, the taxpayer shall use a safe haven discount rate of 10 percent per year of delay unless he is able to establish to the satisfaction of the Commissioner, by reference to the cost of money and the number of years during which economic benefit can be directly attributable to the results of the taxpayer's research, that another discount rate is more appropriate.

(c) *Sales method*—(1) *In general.* The amount equal to the remaining portion of such deduction for research and experimentation, not apportioned under paragraph (a)(4) or (b)(1)(i) of this section, shall be apportioned between the statutory grouping (or among the statutory groupings) within the class of gross income and the residual grouping within such class in the same proportions that the amount of sales from the product category (or categories) that resulted in such gross income within the statutory grouping (or statutory groupings) and in the residual grouping bear, respectively, to the total amount of sales from the product category (or categories).

(i) *Apportionment in excess of gross income.* Amounts apportioned under this section may exceed the amount of gross income related to the product category within the statutory grouping. In such case, the excess shall be applied against other gross income within the statutory grouping. See § 1.861–8(d)(1) for instances where the apportionment leads to an excess of deductions over gross income within the statutory grouping.

(ii) *Leased property.* For purposes of this paragraph (c), amounts received from the lease of equipment during a taxable year shall be regarded as sales receipts for such taxable year.

(2) *Sales of uncontrolled parties.* For purposes of the apportionment under paragraph (c)(1) of this section, the sales from the product category (or categories) by each party uncontrolled by the taxpayer, of particular products involving intangible property that was licensed or sold by the taxpayer to such uncontrolled party shall be taken fully into account both for determining the taxpayer's apportionment and for determining the apportionment of any other member of a controlled group of corporations to which the taxpayer belongs if the uncontrolled party can reasonably be expected to benefit directly or indirectly (through any member of the controlled group of corporations to which the taxpayer belongs) from the research expense connected with the product category (or categories) of such other member. An uncontrolled party can reasonably be expected to benefit from the research expense of a member of a controlled group of corporations to which the taxpayer belongs if such member can reasonably be expected to license, sell, or transfer intangible property to that uncontrolled party or transfer secret processes to that uncontrolled party, directly or indirectly through a member of the controlled group of corporations to which the taxpayer belongs. Past experience with research and experimentation shall be considered in determining reasonable expectations.

(i) *Definition of uncontrolled party.* For purposes of this paragraph (c)(2) the term *uncontrolled party* means a party that is not a person with a relationship to the taxpayer specified in section 267(b), or is not a member of a controlled group of corporations to which the taxpayer belongs (within the meaning of section 993(a)(3) or 927(d)(4)).

(ii) *Licensed products.* In the case of licensed products, if the amount of sales of such products is unknown (for example, where the licensed product is a component of a large machine), a reasonable estimate based on the principles of section 482 should be made.

(iii) *Sales of intangible property.* In the case of sales of intangible property, regardless of whether the consideration received in exchange for the intangible is a fixed amount or is contingent on the productivity, use, or disposition of the intangible, if the amount of sales of products utilizing the intangible property is unknown, a reasonable estimate of sales shall be made annually. If necessary, appropriate economic analyses shall be used to estimate sales.

(3) *Sales of controlled parties.* For purposes of the apportionment under paragraph (c)(1) of this section, the sales from the product category (or categories) of the taxpayer shall be taken fully into account and the sales from the product category (or categories) of a corporation controlled by the taxpayer shall be taken into account to the extent provided in this paragraph (c)(3) for determining the taxpayer's apportionment, if such corporation can reasonably be expected to benefit directly or indirectly (through another member of the controlled group of corporations to which the taxpayer belongs) from the taxpayer's research expense connected with the product category (or categories). A corporation controlled by the taxpayer can reasonably be expected to benefit from the taxpayer's research expense if the taxpayer can be expected to license, sell, or transfer intangible property to that

corporation or transfer secret processes to that corporation, either directly or indirectly through a member of the controlled group of corporations to which the taxpayer belongs. Past experience with research and experimentation shall be considered in determining reasonable expectations.

(i) *Definition of a corporation controlled by the taxpayer.* For purposes of this paragraph (c)(3), the term *a corporation controlled by the taxpayer* means any corporation that has a relationship to the taxpayer specified in section 267(b) or is a member of a controlled group of corporations to which the taxpayer belongs (within the meaning of section 993(a)(3) or 927(d)(4).

(ii) *Sales to be taken into account.* The sales from the product category (or categories) of a corporation controlled by the taxpayer taken into account shall be equal to the amount of sales that bear the same proportion to the total sales of the controlled corporation as the total value of all classes of the stock of such corporation owned directly or indirectly by the taxpayer, within the meaning of section 1563, bears to the total value of all classes of stock of such corporation.

(iii) *Sales not to be taken into account more than once.* Sales from the product category (or categories) between or among such controlled corporations or the taxpayer shall not be taken into account more than once; in such a situation, the amount sold by the selling corporation to the buying corporation shall be subtracted from the sales of the buying corporation.

(iv) *Effect of cost-sharing arrangements.* If the corporation controlled by the taxpayer has entered into a bona fide cost-sharing arrangement, in accordance with the provisions of §1.482–7, with the taxpayer for the purpose of developing intangible property, then that corporation shall not reasonably be expected to benefit from the taxpayer's share of the research expense.

(d) *Gross income methods*—(1)(i) *In general.* In lieu of applying the sales method of paragraph (c) of this section, the remaining amount of the deduction for research and experimentation, not apportioned under paragraph (a)(4) or (b)(1)(ii) of this section, shall be apportioned as prescribed in paragraphs (d)(2) and (3) of this section, between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income.

(ii) *Optional methods to be applied to all research and experimental expenditures.* These optional methods must be applied to the taxpayer's entire deduction for research and experimental expense remaining after applying the exception in paragraph (a)(4) of this section, and may not be applied on a product category basis. Thus, after the allocation of the taxpayer's entire deduction for research and experimental expense under paragraph (a)(2) of this section (by attribution to SIC code categories), the taxpayer must then apportion as necessary the entire deduction as allocated by separate amounts to various product categories, using only the sales method under paragraph (c) of this section or only the optional gross income methods under this paragraph (d). The taxpayer may not use the sales method for a portion of the deduction and optional gross income methods for the remainder of the deduction separately allocated.

(2) *Option one.* The taxpayer may apportion its research and experimental expenditures ratably on the basis of gross income between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income in the same proportions that the amount of gross income in the statutory grouping (or groupings) and the amount of gross income in the residual grouping bear, respectively, to the total amount of gross income, if the conditions described in paragraph (d)(2)(i) and (ii) of this section are both met.

(i) The amount of research and experimental expense ratably apportioned to the statutory grouping (or groupings in the aggregate) is not less than fifty percent of the amount that would have been so apportioned if the taxpayer had used the method described in paragraph (c) of this section; and

(ii) The amount of research and experimental expense ratably apportioned to the residual grouping is not less than fifty percent of the amount that would have been so apportioned if the taxpayer had used the method described in paragraph (c) of this section.

(3) *Option two.* If, when the amount of research and experimental expense is apportioned ratably on the basis of gross income, either of the conditions described in paragraph (d)(2)(i) or (ii) of this section is not met, the taxpayer may either—

(i) Where the condition of paragraph (d)(2)(i) of this section is not met, apportion fifty percent of the amount of research and experimental expense that would have been apportioned to the statutory grouping (or groupings in the aggregate) under paragraph (c) of this section to such statutory grouping (or to such statutory groupings in the aggregate and then among such groupings on the basis of gross income within each grouping), and apportion the balance of the amount of research and experimental expenses to the residual grouping; or

(ii) Where the condition of paragraph (d)(2)(ii) of this section is not met, apportion fifty percent of the amount of research and experimental expense that would have been apportioned to the residual grouping under paragraph (c) of this section to such residual grouping, and apportion the balance of the amount of research and experimental expenses to the statutory grouping (or to the statutory groupings in the aggregate and then among such groupings ratably on the basis of gross income within each grouping).

(e) *Binding election*—(1) *In general.* A taxpayer may choose to use either the sales method under paragraph (c) of this section or the optional gross income methods under paragraph (d) of this section for its original return for its first taxable year to which this section applies. The taxpayer's use of either the sales method or the optional gross income methods for its return filed for its first taxable year to which this section applies shall constitute a binding election to use the method chosen for that year and for four taxable years thereafter.

(2) *Change of method.* The taxpayer's election of a method may not be revoked during the period referred to in paragraph (e)(1) of this section without the prior consent of the Commissioner. After the expiration of that period, the taxpayer may change methods without the prior consent of the Commissioner. However, the taxpayer's use of the new method shall constitute a binding election to use the new method for its return filed for the first year for which the taxpayer uses the new method and for four taxable years thereafter. The taxpayer's election of the new method may not be revoked during that period without the prior consent of the Commissioner.

(i) *Short taxable years.* For purposes of this paragraph (e), the term *taxable year* includes a taxable year of less than twelve months.

(ii) *Affiliated groups.* In the case of an affiliated group, the period referred to in paragraph (e)(1) of this section shall commence as of the latest taxable year in which any member of the group has changed methods.

(f) *Special rules for partnerships*—(1) *Research and experimental expenditures.* For purposes of applying this section, if research and experimental expenditures are incurred by a partnership in which the taxpayer is a partner, the taxpayer's research and experimental expenditures shall include the taxpayer's distributive share of the partnership's research and experimental expenditures.

(2) *Purpose and location of expenditures.* In applying the exception for expenditures undertaken to meet legal requirements under paragraph (a)(4) of this section and the exclusive apportionment for the sales method and the optional gross income methods under paragraph (b) of this section, a partner's distributive share of research and experimental expenditures incurred by a partnership shall be treated as incurred by the partner for the same purpose and in the same location as incurred by the partnership.

(3) *Apportionment under the sales method.* In applying the remaining apportionment for the sales method under paragraph (c) of this section, a taxpayer's sales from a product category shall include the taxpayer's share of any sales from the product category of any partnership in which the taxpayer is a partner. For purposes of the preceding sentence, a taxpayer's share of

sales shall be proportionate to the taxpayer's distributive share of the partnership's gross income in the product category.

(g) *Effective date.* This section applies to taxable years beginning after December 31, 1995. However, a taxpayer may at his or her option, apply this section in its entirety to all taxable years beginning after August 1, 1994.

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

Example 1 —(i) *Facts.* X, a domestic corporation, is a manufacturer and distributor of small gasoline engines for lawn mowers. Gasoline engines are a product within the category, Engines and Turbines (SIC Industry Group 351). Y, a wholly owned foreign subsidiary of X, also manufactures and sells these engines abroad. During 1996, X incurred expenditures of $60,000 on research and experimentation, which it deducts as a current expense, to invent and patent a new and improved gasoline engine. All of the research and experimentation was performed in the United States. In 1996, the domestic sales by X of the new engine total $500,000 and foreign sales by Y total $300,000. X provides technology for the manufacture of engines to Y via a license that requires the payment of an arm's length royalty. In 1996, X's gross income is $160,000, of which $140,000 is U.S. source income from domestic sales of gasoline engines and $10,000 is foreign source royalties from Y, and $10,000 is U.S. source interest income.

(ii) *Allocation.* The research and experimental expenditures were incurred in connection with small gasoline engines and they are definitely related to the items of gross income to which the research gives rise, namely gross income from the sale of small gasoline engines in the United States and royalties received from subsidiary Y, a foreign manufacturer of gasoline engines. Accordingly, the expenses are allocable to this class of gross income. The U.S. source interest income is not within this class of gross income and, therefore, is not taken into account.

(iii) *Apportionment.* (A) For purposes of applying the foreign tax credit limitation, the statutory grouping is general limitation gross income from sources without the United States and the residual grouping is gross income from sources within the United States. Since the related class of gross income derived from the use of engine technology consists of both gross income from sources without the United States (royalties from Y) and gross income from sources within the United States (gross income from engine sales), X's deduction of $60,000 for its research and experimental expenditure must be apportioned between the statutory and residual grouping before the foreign tax credit limitation may be determined. Because more than 50 percent of X's research and experimental activity was performed in the United States, 50 percent of that deduction can be apportioned exclusively to the residual grouping of gross income, gross income from sources within the United States. The remaining 50 percent of the deduction can then be apportioned between the residual and statutory groupings on the basis of sales of small gasoline engines by X and Y. Alternatively, X's deduction for research and experimentation can be apportioned under the optional gross income method. The apportionment for 1996 is as follows:

(1) Tentative Apportionment on the Basis of Sales

(*i*) Research and experimental expense to be apportioned between residual and statutory groupings of gross income:	$60,000
(*ii*) Less: Exclusive apportionment of research and experimental expense to the residual grouping of gross income ($60,000×50 percent): ...	$30,000
(*iii*) Research and experimental expense to be apportioned between residual and statutory groupings of gross income on the basis of sales:	$30,000
(*iv*) Apportionment of research and experimental expense to the residual grouping of gross income ($30,000×$500,000/($500,000+$300,000)):	$18,750
(*v*) Apportionment of research and experimental expense to the statutory grouping of gross income ($30,000×$300,000/($500,000+$300,000)):	$11,250
(*vi*) Total apportioned deduction for research and experimentation:	$60,000
(*vii*) Amount apportioned to the residual grouping ($30,000+$18,750):	$48,750
(*viii*) Amount apportioned to the statutory grouping:	$11,250

(2) Tentative Apportionment on the Basis of Gross Income.

(*i*) Exclusive apportionment of research and experimental expense to the residual grouping of gross income ($60,000×25 percent): ...	$15,000
(*ii*) Research and experimental expense apportioned to sources within the United States (residual grouping) ($45,000×$140,000/($140,000+$10,000)):	$42,000
(*iii*) Research and experimental expense apportioned to sources within country Y (statutory grouping) ($45,000×$10,000/($140,000+$10,000)):	$3,000
(*iv*) Amount apportioned to the residual grouping:	$57,000
(*v*) Amount apportioned to the statutory grouping:	$3,000

(B) The total research and experimental expense apportioned to the statutory grouping ($3,000) under the gross income method is approximately 26 percent of the amount apportioned to the statutory grouping under the sales method. Thus, X may use option two of the gross income method (paragraph (d)(3) of this section) and apportion to the statutory grouping fifty percent (50%) of the $11,250 apportioned to that grouping under the sales method. Thus, X apportions $5,625 of research and experimental expense to the statutory grouping. X's use of the optional gross income methods will constitute a binding election to use the optional gross income methods for 1996 and four taxable years thereafter.

Example 2 —(i) *Facts.* Assume the same facts as in *Example 1* except that X also spends $30,000 in 1996 for research on steam turbines, all of which is performed in the United States, and X has steam turbine sales in the United States of $400,000. X's foreign subsidiary Y neither manufactures nor sells steam turbines. The steam turbine research is in addition to the $60,000 in research which X does on gasoline engines for lawnmowers. X thus has a deduction of $90,000 for its research activity. X's gross income is $200,000, of which $140,000 is U.S. source income from domestic sales of gasoline engines, $50,000 is U.S. source income from domestic sales of steam turbines, and $10,000 is foreign source royalties from Y.

(ii) *Allocation.* X's research expenses generate income from sales of small gasoline engines and steam turbines. Both of these products are in the same three digit SIC code category, Engines and Turbines (SIC Industry Group 351). Therefore, the deduction is definitely related to this product category and allocable to all items of income attributable to it. These items of X's income are gross income from the sale of small gasoline engines and steam turbines in the United States and royalties from foreign subsidiary Y, a foreign manufacturer and seller of small gasoline engines.

(iii) *Apportionment.* (A) For purposes of applying the foreign tax credit limitation, the statutory grouping is general limitation gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deduction of $90,000 must be apportioned between the statutory and residual groupings. Because more than 50 percent of X's research and experimental activity was performed in the United States, 50 percent of that deduction can be apportioned exclusively to the residual grouping, gross income from sources within the United States. The remaining 50 percent of the deduction can then be apportioned between the residual and statutory groupings on the basis of total sales of small gasoline engines and steam turbines by X and Y. Alternatively, X's deduction for research and experimentation can be apportioned under the optional gross income methods. The apportionment for 1996 is as follows:

(1) Tentative Apportionment on the Basis of Sales

(*i*) Research and experimental expense to be apportioned between residual and statutory groupings of gross income:	$90,000
(*ii*) Less: Exclusive apportionment of the research and experimental expense to the residual grouping of gross income ($90,000×50 percent):	$45,000
(*iii*) Research and experimental expense to be apportioned between the residual and statutory groupings of gross income on the basis of sales:	$45,000
(*iv*) Apportionment of research and experimental expense to the residual grouping of gross income ($45,000×($500,000+$400,000)/($500,000+$400,000+$300,000)):	$33,750
(*v*) Apportionment of research and experimental expense to the statutory grouping of gross income ($45,000×$300,000/($500,000+$400,000+$300,000)):	$11,250

(*vi*) Total apportioned deduction for research and experimentation:	$90,000
(*vii*) Amount apportioned to the residual grouping ($45,000+$33,750):	$78,750
(*viii*) Amount apportioned to the statutory grouping:	$11,250

(2) Tentative Apportionment on the Basis of Gross Income

(*i*) Exclusive apportionment of research and experimental expense to the residual grouping of gross income ($90,000×25 percent):	$22,500
(*ii*) Research and experimental expense apportioned to sources within the United States (residual grouping) ($67,500×$190,000/($140,000+$50,000+$10,000)):	$64,125
(*iii*) Research and experimental expense apportioned to sources within country Y (statutory grouping) ($67,500×$10,000/($140,000+$50,000+$10,000)):	$3,375
(*iv*) Amount apportioned to the residual grouping:	$86,625
(*v*) Amount apportioned to the statutory grouping:	$3,375

(B) The total research and experimental expense apportioned to the statutory grouping ($3,375) under the gross income method is 30 percent of the amount apportioned to the statutory grouping under the sales method. Thus, X may use option two of the gross income method (paragraph (d)(3) of this section) and apportion to the statutory grouping fifty percent (50%) of the $11,250 apportioned to that grouping under the sales method. Thus, X apportions $5,625 of research and experimental expense to the statutory grouping. X's use of the optional gross income methods will constitute a binding election to use the optional gross income methods for 1996 and four taxable years thereafter.

Example 3 —(i) *Facts.* Assume the same facts as in *Example 1* except that in 1997 X continues its sales of the new engines, with sales of $600,000 in the United States and $400,000 abroad by subsidiary Y. X also acquires a 60 percent (by value) ownership interest in foreign corporation Z and a 100 percent ownership interest in foreign corporation C. X transfers its engine technology to Z for a royalty equal to 5 percent of sales, and X enters into an arm's length cost-sharing arrangement with C to share the funding of all of X's research activity. In 1997, corporation Z has sales in country Z equal to $1,000,000. X incurs expense of $80,000 on research and experimentation in 1997, and in addition, X performs $15,000 of research on gasoline engines which was funded by the cost-sharing arrangement with C. All of Z's sales are from the product category, Engines and Turbines (SIC Industry Group 351). X performs all of its research in the United States and $20,000 of its expenditure of $80,000 is made solely to meet pollution standards mandated by law. X establishes, to the satisfaction of the Commissioner, that the expenditure in response to pollution standards is not expected to generate gross income (beyond *de minimis* amounts) outside the United States.

(ii) *Allocation.* The $20,000 of research expense which X incurred in connection with pollution standards is definitely related and thus allocable to the residual grouping, gross income from sources within the United States. The remaining $60,000 in research and experimental expenditure incurred by X is definitely related to all gasoline engines and is therefore allocable to the class of gross income to which the engines give rise, gross income from sales of gasoline engines in the United States, royalties from country Y, and royalties from country Z. No part of the $60,000 research expense is allocable to dividends from country C, because corporation C has already paid, through its cost-sharing arrangement, for research activity performed by X which may benefit C.

(iii) *Apportionment.* For purposes of applying the foreign tax credit limitation, the statutory grouping is general limitation gross income from sources without the United States, and the residual grouping is gross income from sources within the United States. X's deduction of $60,000 for its research and experimental expenditure must be apportioned between these groupings. Because more than 50 percent of the research and experimentation was performed in the United States, 50 percent of the $60,000 deduction can be apportioned exclusively to the residual grouping. The remaining 50 percent of the deduction can then be apportioned between the residual and the statutory grouping on the basis of sales of gasoline engines by X, Y, and Z. (If X utilized the optional gross income methods in 1996, then its use of such methods constituted a binding election to use the optional gross income methods in 1996 and for four taxable years thereafter. If X utilized the sales method in 1996, then its use of such method constituted a binding election to use the sales method in 1996 and for four taxable years thereafter.) The optional gross income methods are not illustrated in this *Example 3* (see instead *Examples 1* and *2*). Since X has only a 60 percent ownership interest in corporation Z, only 60 percent of Z's sales (60% of $1,000,000, or

$600,000) are included for purposes of apportionment. The allocation and apportionment for 1997 is as follows:

(A) X's total research expense:	$80,000
(B) Less: Legally mandated research directly allocated to the residual grouping of gross income:	$20,000
(C) Tentative apportionment on the basis of sales.	
(*1*) Research and experimental expense to be apportioned between residual and statutory groupings of gross income:	$60,000
(*2*) Less: Exclusive apportionment of research and experimental expense to the residual grouping of gross income ($60,000×50 percent):	$30,000
(*3*) Research and experimental expense to be apportioned between the residual and the statutory groupings on the basis of sales:	$30,000
(*4*) Apportionment of research and experimental expense to gross income from sources within the United States (residual grouping) ($30,000×$600,000/ ($600,000+$400,000+$600,000)):	$11,250
(*5*) Apportionment of research and experimental expense to general limitation gross income from countries Y and Z (statutory grouping) ($30,000×$400,000+$600,000/ ($600,000+$400,000+$600,000)):	$18,750
(*6*) Total apportioned deduction for research and experimentation ($30,000+$30,000):	$60,000
(*7*) Amount apportioned to the residual grouping ($30,000+$11,250):	$41,250
(*8*) Amount apportioned to the statutory grouping of gross income from sources within countries Y and Z:	$18,750

Example 4 —*Research and Experimentation*—(i) *Facts.* X, a domestic corporation, manufactures and sells forklift trucks and other types of materials handling equipment in the United States. The manufacture and sale of forklift trucks and other materials handling equipment belongs to the product category, Construction, Mining, and Materials Handling Machinery and Equipment (SIC Industry Group 353). X also sells its forklift trucks to a wholesaling subsidiary located in foreign country Y (but title passes in the United States), and X manufactures forklift trucks in foreign country Z. The wholesaling of forklift trucks to country Y also belongs to X's product category Transportation equipment and, therefore, may not belong to the product category, Wholesale trade (SIC Major Group 50 and 51). In 1997, X sold $7,000,000 of forklift trucks to purchasers in the United States, $3,000,000 of forklift trucks to the wholesaling subsidiary in Y, and transferred forklift truck components with an FOB export value of $2,000,000 to its branch in Z. The branch's sales of finished forklift trucks were $5,000,000. In response to legally mandated emission control requirements, X's United States research department has been engaged in a research project to improve the performance and quality of engine exhaust systems used on its products in the United States. It incurs expenses of $100,000 for this purpose in 1997. In the past, X has customarily adapted the product improvements developed originally for the domestic market to its forklift trucks manufactured abroad. During the taxable year 1997, development of an improved engine exhaust system is completed and X begins installing the new system during the latter part of the taxable year in products manufactured and sold in the United States. X continues to manufacture and sell forklift trucks in foreign countries without the improved engine exhaust systems.

(ii) *Allocation.* X's deduction for its research expense is definitely related to the income to which it gives rise, namely income from the manufacture and sale of forklift trucks within the United States and in country Z. Although the research is undertaken in response to a legal mandate, it can reasonably be expected to generate gross income from the manufacture and sale of trucks by the branch in Z. Therefore, the deduction is not allocable solely to income from X's domestic sales of forklift trucks. It is allocable to income from such sales and income from the sales of X's branch in Z.

(iii) *Apportionment.* For the method of apportionment on the basis of either sales or gross income, see *Example 3.* However, in determining the amount of research apportioned to income from foreign and domestic sources, the net sales of the branch in Z are $3,000,000 ($5,000,000 less $2,000,000) and the sales within the United States are $12,000,000 ($7,000,000 plus $3,000,000 plus $2,000,000). See § 1.861–17(c)(3)(iii).

Example 5 —(i) *Facts.* X, a domestic corporation, is a drug company that manufactures a wide variety of pharmaceutical products for sale in the United States. Pharmaceutical products belong to the product category, Drugs (SIC Industry Group 283). X exports its pharmaceutical products through a foreign sales corporation (FSC). X's wholly owned foreign subsidiary Y also manufactures pharmaceutical products. In 1997, X has domestic sales of pharmaceutical products of $10,000,000, the FSC has sales of pharmaceutical products of $3,000,000, and Y has sales of pharmaceutical products of $5,000,000. In that same year, 1997, X incurs expense of $200,000 on research to test a product in response to requirements imposed by the United States Food and Drug Administration (FDA). X is able to show that, even though country Y imposes certain testing requirements on pharmaceutical products, the research performed in the United States is not accepted by country Y for purposes of its own licensing requirements, and the research has minimal use abroad. X is further able to show that FSC sells goods to countries that do not accept or do not require research performed in the United States for purposes of their own licensing standards.

(ii) *Allocation*. Since X's research expense of $200,000 is undertaken to meet the requirements of the United States Food and Drug Administration, and since it is reasonable to expect that the expenditure will not generate gross income (beyond *de minimis* amounts) outside the United States, the deduction is definitely related and thus allocable to the residual grouping.

(iii) *Apportionment*. No apportionment is necessary since the entire expense is allocated to the residual grouping, gross income from sales within the United States.

Example 6 —(i) *Facts*. X, a domestic corporation, is engaged in continuous research and experimentation to improve the quality of the products that it manufactures and sells, which are floodlights, flashlights, fuse boxes, and solderless connectors. X incurs and deducts $100,000 of expenditure for research and experimentation in 1997 that was performed exclusively in the United States. As a result of this research activity, X acquires patents that it uses in its own manufacturing activity. X licenses its floodlight patent to Y and Z, uncontrolled foreign corporations, for use in their own territories, countries Y and Z, respectively. Corporation Y pays X an arm's length royalty of $3,000 plus $0.20 for each floodlight sold. Sales of floodlights by Y for the taxable year are $135,000 (at $4.50 per unit) or 30,000 units, and the royalty is $9,000 ($3,000 + $0.20 x 30,000). Y has sales of other products of $500,000. Z pays X an arm's length royalty of $3,000 plus $0.30 for each unit sold. Z manufactures 30,000 floodlights in the taxable year, and the royalty is $12,000 ($3,000 + $0.30 x 30,000). The dollar value of Z's floodlight sales is not known and cannot be reasonably estimated because, in this case, the floodlights are not sold separately by Z but are instead used as a component in Z's manufacture of lighting equipment for theaters. The sales of all Z's products, including the lighting equipment for theaters, are $1,000,000. Y and Z each sell the floodlights exclusively within their respective countries. X's sales of floodlights for the taxable year are $500,000 and its sales of its other products, flashlights, fuse boxes, and solderless connectors, are $400,000. X has gross income of $500,000, consisting of gross income from domestic sources from sales of floodlights, flashlights, fuse boxes, and solderless connectors of $479,000, and royalty income of $9,000 and $12,000 from foreign corporations Y and Z respectively. X utilized the optional gross income methods of apportionment for its return filed for its first taxable year to which this section applies.

(ii) *Allocation*. X's research and experimental expenses are definitely related to all of the products that it produces, which are floodlights, flashlights, fuse boxes, and solderless connectors. All of these products are in the same three digit SIC Code category, Electric Lighting and Wiring Equipment (SIC Industry Group 364). Thus, X's research and experimental expenses are allocable to all items of income attributable to this product category, domestic sales income and royalty income from the foreign countries in which corporations Y and Z operate.

(iii) *Apportionment*. (A) The statutory grouping of gross income is general limitation income from sources without the United States. The residual grouping is gross income from sources within the United States. X's deduction of $100,000 for its research expenditures must be apportioned between the groupings. For apportionment on the basis of sales in accordance with paragraph (c) of this section, X is entitled to an exclusive apportionment of 50 percent of its research and experimental expense to the residual grouping, gross income from sources within the United States, since more than 50 percent of the research activity was performed in the United States. The remaining 50 percent of the deduction can then be apportioned between the residual and statutory groupings on the basis of sales. Since Y and Z are unrelated licensees of X, only their sales of the licensed product, floodlights, are included for purposes of apportionment. Floodlight sales of Z are unknown, but are estimated at ten times royalties from Z, or $120,000. All of X's sales from the entire product category are included for purposes of apportionment on the basis of sales. Alternatively, X may apportion its deduction on the basis of gross income, in accordance with paragraph (d) of this section. The apportionment is as follows:

(1) Tentative Apportionment on the Basis of Sales

(*i*) Research and experimental expense to be apportioned between statutory and residual groupings of gross income:	$100,000
(*ii*) Less: Exclusive apportionment of research and experimental expense to the residual groupings of gross income ($100,000×50 percent):	$50,000
(*iii*) Research and experimental expense to be apportioned between the statutory and residual groupings of gross income on the basis of sales:	$50,000
(*iv*) Apportionment of research and experimental expense to the residual groupings of gross income ($50,000×$900,000/ ($900,000+$135,000+$120,000)):	$38,961
(*v*) Apportionment of research and experimental expense to the statutory grouping, royalty income from countries Y and Z ($50,000×$135,000+$120,000/ ($900,000+$135,000+$120,000)):	$11,039
(*vi*) Total apportioned deduction for research and experimentation:	$100,000
(*vii*) Amount apportioned to the residual grouping ($50,000+$38,961):	$88,961
(*viii*) Amount apportioned to the statutory grouping of sources within countries Y and Z:	$11,039

(2) Tentative Apportionment on Gross Income Basis

(*i*) Exclusive apportionment of research and experimental expense to the residual grouping of gross income ($100,000×25 percent): ..	$25,000
(*ii*) Apportionment of research and experimental expense to the residual grouping of gross income ($75,000×$479,000/$500,000):	$71,850
(*iii*) Apportionment of research and experimental expense to the statutory grouping of gross income ($75,000×$9,000+$12,000/ $500,000):	$3,150
(*iv*) Amount apportioned to the residual grouping:	$96,850
(*v*) Amount apportioned to the statutory grouping of general limitation income from sources without the United States:	$3,150

(B) Since X has elected to use the optional gross income methods of apportionment and its apportionment on the basis of gross income to the statutory grouping, $3,150, is less than 50 percent of its apportionment on the basis of sales to the statutory grouping, $11,039, it must use Option two of paragraph (d)(3) of this section and apportion $5,520 (50 percent of $11,039) to the statutory grouping.

[T.D. 8646, 60 FR 66503, Dec. 22, 1995]

§ 1.861–18 Classification of transactions involving computer programs.

(a) *General*—(1) *Scope.* This section provides rules for classifying transactions relating to computer programs for purposes of subchapter N of chapter 1 of the Internal Revenue Code, sections 367, 404A, 482, 551, 679, 1059A, chapter 3, chapter 5, sections 842 and 845 (to the extent involving a foreign person), and transfers to foreign trusts not covered by section 679.

(2) *Categories of transactions.* This section generally requires that such transactions be treated as being solely within one of four categories (described in paragraph (b)(1) of this section) and provides certain rules for categorizing such transactions. In the case of a transfer of a copyright right, this section provides rules for determining whether the transaction should be classified as either a sale or exchange, or a license generating royalty income. In the case of a transfer of a copyrighted article, this section provides rules for determining whether the transaction should be classified as either a sale or exchange, or a lease generating rental income.

(3) *Computer program.* For purposes of this section, a computer program is a set of statements or instructions to be

used directly or indirectly in a computer in order to bring about a certain result. For purposes of this paragraph (a)(3), a computer program includes any media, user manuals, documentation, data base or similar item if the media, user manuals, documentation, data base or similar item is incidental to the operation of the computer program.

(b) *Categories of transactions*—(1) *General.* Except as provided in paragraph (b)(2) of this section, a transaction involving the transfer of a computer program, or the provision of services or of know-how with respect to a computer program (collectively, a transfer of a computer program) is treated as being solely one of the following—

(i) A transfer of a copyright right in the computer program;

(ii) A transfer of a copy of the computer program (a copyrighted article);

(iii) The provision of services for the development or modification of the computer program; or

(iv) The provision of know-how relating to computer programming techniques.

(2) *Transactions consisting of more than one category.* Any transaction involving computer programs which consists of more than one of the transactions described in paragraph (b)(1) of this section shall be treated as separate transactions, with the appropriate provisions of this section being applied to each such transaction. However, any transaction that is de minimis, taking into account the overall transaction and the surrounding facts and circumstances, shall not be treated as a separate transaction, but as part of another transaction.

(c) *Transfers involving copyright rights and copyrighted articles*—(1) *Classification*—(i) *Transfers treated as transfers of copyright rights.* A transfer of a computer program is classified as a transfer of a copyright right if, as a result of the transaction, a person acquires any one or more of the rights described in paragraphs (c)(2)(i) through (iv) of this section. Whether the transaction is treated as being solely the transfer of a copyright right or is treated as separate transactions is determined pursuant to paragraph (b)(1) and (b)(2) of this section. For example, if a person receives a disk containing a copy of a computer program which enables it to exercise, in relation to that program, a non-de minimis right described in paragraphs (c)(2)(i) through (iv) of this section (and the transaction does not involve, or involves only a de minimis provision of services as described in paragraph (d) of this section or of know-how as described in paragraph (e) of this section), then, under paragraph (b)(2) of this section, the transfer is classified solely as a transfer of a copyright right.

(ii) *Transfers treated solely as transfers of copyrighted articles.* If a person acquires a copy of a computer program but does not acquire any of the rights described in paragraphs (c)(2)(i) through (iv) of this section (or only acquires a de minimis grant of such rights), and the transaction does not involve, or involves only a de minimis, provision of services as described in paragraph (d) of this section or of know-how as described in paragraph (e) of this section, the transfer of the copy of the computer program is classified solely as a transfer of a copyrighted article.

(2) *Copyright rights.* The copyright rights referred to in paragraph (c)(1) of this section are as follows—

(i) The right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;

(ii) The right to prepare derivative computer programs based upon the copyrighted computer program;

(iii) The right to make a public performance of the computer program; or

(iv) The right to publicly display the computer program.

(3) *Copyrighted article.* A copyrighted article includes a copy of a computer program from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. The copy of the program may be fixed in the magnetic medium of a floppy disk, or in the main memory or hard drive of a computer, or in any other medium.

(d) *Provision of services.* The determination of whether a transaction involving a newly developed or modified computer program is treated as either the provision of services or another transaction described in paragraph (b)(1) of this section is based on all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties.

(e) *Provision of know-how.* The provision of information with respect to a computer program will be treated as the provision of know-how for purposes of this section only if the information is—

(1) Information relating to computer programming techniques;

(2) Furnished under conditions preventing unauthorized disclosure, specifically contracted for between the parties; and

(3) Considered property subject to trade secret protection.

(f) *Further classification of transfers involving copyright rights and copyrighted articles*—(1) *Transfers of copyright rights.* The determination of whether a transfer of a copyright right is a sale or exchange of property is made on the basis of whether, taking into account all facts and circumstances, there has been a transfer of all substantial rights in the copyright. A transaction that does not constitute a sale or exchange because not all substantial rights have been transferred will be classified as a license generating royalty income. For this purpose, the principles of sections 1222 and 1235 may be applied. Income derived from the sale or exchange of a copyright right will be sourced under section 865(a), (c), (d), (e), or (h), as appropriate. Income derived from the licensing of a copyright right will be sourced under section 861(a)(4) or 862(a)(4), as appropriate.

(2) *Transfers of copyrighted articles.* The determination of whether a transfer of a copyrighted article is a sale or exchange is made on the basis of whether, taking into account all facts and circumstances, the benefits and burdens of ownership have been transferred. A transaction that does not constitute a sale or exchange because insufficient benefits and burdens of ownership of the copyrighted article have been transferred, such that a person other than the transferee is properly treated as the owner of the copyrighted article, will be classified as a lease generating rental income. Income from transactions that are classified as sales or exchanges of copyrighted articles will be sourced under sections 861(a)(6), 862(a)(6), 863, 865(a), (b), (c), or (e), as appropriate. Income derived from the leasing of a copyrighted article will be sourced under section 861(a)(4) or section 862(a)(4), as appropriate.

(3) *Special circumstances of computer programs.* In connection with determinations under this paragraph (f), consideration must be given as appropriate to the special characteristics of computer programs in transactions that take advantage of these characteristics (such as the ability to make perfect copies at minimal cost). For example, a transaction in which a person acquires a copy of a computer program on disk subject to a requirement that the disk be destroyed after a specified period is generally the equivalent of a transaction subject to a requirement that the disk be returned after such period. Similarly, a transaction in which the program deactivates itself after a specified period is generally the equivalent of returning the copy.

(g) *Rules of operation*—(1) *Term applied to transaction by parties.* Neither the form adopted by the parties to a transaction, nor the classification of the transaction under copyright law, shall be determinative. Therefore, for example, if there is a transfer of a computer program on a single disk for a one-time payment with restrictions on transfer and reverse engineering, which the parties characterize as a license (including, but not limited to, agreements commonly referred to as shrink-wrap licenses), application of the rules of paragraphs (c) and (f) of this section may nevertheless result in the transaction being classified as the sale of a copyrighted article.

(2) *Means of transfer not to be taken into account.* The rules of this section shall be applied irrespective of the physical or electronic or other medium used to effectuate a transfer of a computer program.

(3) *To the public*—(i) *In general.* For purposes of paragraph (c)(2)(i) of this section, a transferee of a computer program shall not be considered to have the right to distribute copies of the program to the public if it is permitted to distribute copies of the software to only either a related person, or to identified persons who may be identified by either name or by legal relationship to the original transferee. For purposes of this subparagraph, a related person is a person who bears a relationship to the transferee specified in section 267(b)(3), (10), (11), or (12), or section 707(b)(1)(B). In applying section 267(b), 267(f), 707(b)(1)(B), or 1563(a), ''10 percent'' shall be substituted for ''50 percent.''

(ii) *Use by individuals.* The number of employees of a transferee of a computer program who are permitted to use the program in connection with their employment is not relevant for purposes of this paragraph (g)(3). In addition, the number of individuals with a contractual agreement to provide services to the transferee of a computer program who are permitted to use the program in connection with the performance of those services is not relevant for purposes of this paragraph (g)(3).

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

Example 1. (i) *Facts.* Corp A, a U.S. corporation, owns the copyright in a computer program, Program X. It copies Program X onto disks. The disks are placed in boxes covered with a wrapper on which is printed what is generally referred to as a shrink-wrap license. The license is stated to be perpetual. Under the license no reverse engineering, decompilation, or disassembly of the computer program is permitted. The transferee receives, first, the right to use the program on two of its own computers (for example, a laptop and a desktop) provided that only one copy is in use at any one time, and, second, the right to make one copy of the program on each machine as an essential step in the utilization of the program. The transferee is permitted by the shrink-wrap license to sell the copy so long as it destroys any other copies it has made and imposes the same terms and conditions of the license on the purchaser of its copy. These disks are made available for sale to the general public in Country Z. In return for valuable consideration, P, a Country Z resident, receives one such disk.

(ii) *Analysis.* (A) Under paragraph (g)(1) of this section, the label license is not determinative. None of the copyright rights described in paragraph (c)(2) of this section have been transferred in this transaction. P has received a copy of the program, however, and, therefore, under paragraph (c)(1)(ii) of this section, P has acquired solely a copyrighted article.

(B) Taking into account all of the facts and circumstances, P is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a sale of a copyrighted article rather than the grant of a lease.

Example 2. (i) *Facts.* The facts are the same as those in *Example 1,* except that instead of selling disks, Corp A, the U.S. corporation, decides to make Program X available, for a fee, on a World Wide Web home page on the Internet. P, the Country Z resident, in return for payment made to Corp A, downloads Program X (via modem) onto the hard drive of his computer. As part of the electronic communication, P signifies his assent to a license agreement with terms identical to those in *Example 1,* except that in this case P may make a back-up copy of the program on to a disk.

(ii) *Analysis.* (A) None of the copyright rights described in paragraph (c)(2) of this section have passed to P. Although P did not buy a physical copy of the disk with the program on it, paragraph (g)(2) of this section provides that the means of transferring the program is irrelevant. Therefore, P has acquired a copyrighted article.

(B) As in *Example 1,* P is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a sale of a copyrighted article rather than the grant of a lease.

Example 3. (i) *Facts.* The facts are the same as those in *Example 1,* except that Corp A only allows P, the Country Z resident, to use Program X for one week. At the end of that week, P must return the disk with Program X on it to Corp A. P must also destroy any copies made of Program X. If P wishes to use Program X for a further period he must enter into a new agreement to use the program for an additional charge.

(ii) *Analysis.* (A) Under paragraph (c)(2) of this section, P has received no copyright rights. Because P has received a copy of the program under paragraph (c)(1)(ii) of this section, he has, therefore, received a copyrighted article.

(B) Taking into account all of the facts and circumstances, P is not properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a lease of a copyrighted article rather than a sale. Taking into account the special characteristics of computer programs as provided in paragraph (f)(3) of this section, the result would be the same if P were required to destroy the disk at the end of the one week period instead of returning it since Corp A can make additional copies of the program at minimal cost.

Example 4. (i) *Facts.* The facts are the same as those in *Example 2,* where P, the Country Z resident, receives Program X from Corp A's home page on the Internet, except that P may only use Program X for a period of one week at the end of which an electronic lock is activated and the program can no longer be accessed. Thereafter, if P wishes to use Program X, it must return to the home page and pay Corp A to send an electronic key to reactivate the program for another week.

(ii) *Analysis.* (A) As in *Example 3,* under paragraph (c)(2) of this section, P has not received any copyright rights. P has received a copy of the program, and under paragraph (g)(2) of this section, the means of transmission is irrelevant. P has, therefore, under paragraph (c)(1)(ii) of this section, received a copyrighted article.

(B) As in *Example 3,* P is not properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a lease of a copyrighted article rather than a sale. While P does retain Program X on its computer at the end of the one week period, as a legal matter P no longer has the right to use the program (without further payment) and, indeed, cannot use the program without the electronic key. Functionally, Program X is no longer on the hard drive of P's computer. Instead, the hard drive contains only a series of numbers which no longer perform the function of Program X. Although in *Example 3,* P was required to physically return the disk, taking into account the special characteristics of computer programs as provided in paragraph (f)(3) of this section, the result in this *Example 4* is the same as in *Example 3.*

Example 5. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program X to Corp B, a Country Z corporation, and grants Corp B an exclusive license for the remaining term of the copyright to copy and distribute an unlimited number of copies of Program X in the geographic area of Country Z, prepare derivative works based upon Program X, make public performances of Program X, and publicly display Program X. Corp B will pay Corp A a royalty of $y a year for three years, which is the expected period during which Program X will have commercially exploitable value.

(ii) *Analysis.* (A) Although Corp A has transferred a disk with a copy of Program X on it to Corp B, under paragraph (c)(1)(i) of this section because this transfer is accompanied by a copyright right identified in paragraph (c)(2)(i) of this section, this transaction is a transfer solely of copyright rights, not of copyrighted articles. For purposes of paragraph (b)(2) of this section, the disk containing a copy of Program X is a de minimis component of the transaction.

(B) Applying the all substantial rights test under paragraph (f)(1) of this section, Corp A will be treated as having sold copyright rights to Corp B. Corp B has acquired all of the copyright rights in Program X, has received the right to use them exclusively within Country Z, and has received the rights for the remaining life of the copyright in Program X. The fact the payments cease before the copyright term expires is not controlling. Under paragraph (g)(1) of this section, the fact that the agreement is labelled a license is not controlling (nor is the fact that Corp A receives a sum labelled a royalty). (The result in this case would be the same if the copy of Program X to be used for the purposes of reproduction were transmitted electronically to Corp B, as a result of the application of the rule of paragraph (g)(2) of this section.)

Example 6. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program X to Corp B, a Country Z corporation, and grants Corp B the non exclusive right to reproduce (either directly or by contracting with either Corp A or another person to do so) and distribute for sale to the public an unlimited number of disks at its factory in Country Z in return for a payment related to the number of disks copied and sold. The term of the agreement is two years, which is less than the remaining life of the copyright.

(ii) *Analysis.* (A) As in *Example 5,* the transfer of the disk containing the copy of the program does not constitute the transfer of a copyrighted article under paragraph (c)(1) of this section because Corp B has also acquired a copyright right under paragraph (c)(2)(i) of this section, the right to reproduce and distribute to the public. For purposes of paragraph (b)(2) of this section, the disk containing Program X is a de minimis component of the transaction.

(B) Taking into account all of the facts and circumstances, there has been a license of Program X to Corp B, and the payments made by Corp B are royalties. Under paragraph (f)(1) of this section, there has not been a transfer of all substantial rights in the copyright to Program X because Corp A has the right to enter into other licenses with respect to the copyright of Program X, including licenses in Country Z (or even to sell that copyright, subject to Corp B's interest). Corp B has acquired no right itself to license the copyright rights in Program X. Finally, the term of the license is for less than the remaining life of the copyright in Program X.

Example 7. (i) *Facts.* Corp C, a distributor in Country Z, enters into an agreement with Corp A, a U.S. corporation, to purchase as many copies of Program X on disk as it may from time-to-time request. Corp C will then sell these disks to retailers. The disks are shipped in boxes covered by shrink-wrap licenses (identical to the license described in Example 1).

(ii) *Analysis.* (A) Corp C has not acquired any copyright rights under paragraph (c)(2) of this section with respect to Program X. It has acquired individual copies of Program X, which it may sell to others. The use of the term license is not dispositive under paragraph (g)(1) of this section. Under paragraph (c)(1)(ii) of this section, Corp C has acquired copyrighted articles.

(B) Taking into account all of the facts and circumstances, Corp C is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been a sale of copyrighted articles.

Example 8. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program X to Corp D, a foreign corporation engaged in the manufacture and sale of personal computers in Country Z. Corp A grants Corp D the non-exclusive right to copy Program X onto the hard drive of an unlimited number of computers, which Corp D manufactures, and to distribute those copies (on the hard drive) to the public. The term of the agreement is two years, which is less than the remaining life of the copyright in Program X. Corp D pays Corp A an amount based on the number of copies of Program X it loads on to computers.

(ii) *Analysis.* The analysis is the same as in *Example 6.* Under paragraph (c)(2)(i) of this section, Corp D has acquired a copyright right enabling it to exploit Program X by copying it on to the hard drives of the computers that it manufactures and then sells. For purposes of paragraph (b)(2) of this section, the disk containing Program X is a de minimis component of the transaction. Taking into account all of the facts and circumstances, Corp D has not, however, acquired all substantial rights in the copyright to Program X (for example, the term of the agreement is less than the remaining life of the copyright). Under paragraph (f)(1) of this section, this transaction is, therefore, a license of Program X to Corp D rather than a sale and the payments made by Corp D are royalties. (The result would be the same if Corp D included with the computers it sells an archival copy of Program X on a floppy disk.)

Example 9. (i) *Facts.* The facts are the same as in *Example 8,* except that Corp D, the Country Z corporation, receives physical disks. The disks are shipped in boxes covered by shrink-wrap licenses (identical to the licenses described in *Example 1*). The terms of these licenses do not permit Corp D to make additional copies of Program X. Corp D uses each individual disk only once to load a single copy of Program X onto each separate computer. Corp D transfers the disk with the computer when it is sold.

(ii) *Analysis.* (A) As in *Example 7* (unlike *Example 8*) no copyright right identified in paragraph (c)(2) of this section has been transferred. Corp D acquires the disks without the right to reproduce and distribute publicly further copies of Program X. This is therefore the transfer of copyrighted articles under paragraph (c)(1)(ii) of this section.

(B) Taking into account all of the facts and circumstances, Corp D is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, the transaction is classified as the sale of a copyrighted article. (The result would be the same if Corp D used a single physical disk to copy Program X onto each computer, and transferred an unopened box containing Program X with each computer, if Corp D were not permitted to copy Program X onto more computers than the number of individual copies purchased.)

Example 10. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program X to Corp E, a Country Z corporation, and grants Corp E the right to load Program X onto 50 individual workstations for use only by Corp E employees at one location in return for a one-time per-user fee (generally referred to as a site license or enterprise license). If additional workstations are subsequently introduced, Program X may be loaded onto those machines for additional one-time per-user fees. The license which grants the rights to operate Program X on 50 workstations also prohibits Corp E from selling the disk (or any of the 50 copies) or reverse engineering the program. The term of the license is stated to be perpetual.

(ii) *Analysis.* (A) The grant of a right to copy, unaccompanied by the right to distribute those copies to the public, is not the transfer of a copyright right under paragraph (c)(2) of this section. Therefore, under paragraph (c)(1)(ii) of this section, this transaction is a transfer of copyrighted articles (50 copies of Program X).

(B) Taking into account all of the facts and circumstances, P is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been a sale of copyrighted articles rather than the grant of a lease. Notwithstanding the restriction on sale, other factors such as, for example, the risk of loss and the right to use the copies in perpetuity outweigh, in this case, the restrictions placed on the right of alienation.

(C) The result would be the same if Corp E were permitted to copy Program X onto an unlimited number of workstations used by employees of either Corp E or corporations that had a relationship to Corp E specified in paragraph (g)(3) of this section.

Example 11. (i) *Facts.* The facts are the same as in *Example 10,* except that Corp E, the Country Z corporation, acquires the right to make Program X available to workstation users who are Corp E employees by way of a local area network (LAN). The number of users that can use Program X on the LAN at any one time is limited to 50. Corp E pays a one-time fee for the right to have up to 50 employees use the program at the same time.

(ii) *Analysis.* Under paragraph (g)(2) of this section the mode of utilization is irrelevant. Therefore, as in *Example 10,* under paragraph (c)(2) of this section, no copyright right has been transferred, and, thus, under paragraph (c)(1)(ii) of this section, this transaction will be classified as the transfer of a copyrighted article. Under the benefits and burdens test of paragraph (f)(2) of this section, this transaction is a sale of copyrighted articles. The result would be the same if an unlimited number of Corp E employees were permitted to use Program X on the LAN or if Corp E were permitted to copy Program X onto LANs maintained by corporations that had a relationship to Corp E specified in paragraph (g)(3) of this section.

Example 12. (i) *Facts.* The facts are the same as in *Example 11,* except that Corp E pays a monthly fee to Corp A, the U.S. corporation, calculated with reference to the permitted maximum number of users (which can be changed) and the computing power of Corp E's server. In return for this monthly fee, Corp E receives the right to receive upgrades of Program X when they become available. The agreement may be terminated by either party at the end of any month. When the disk containing the upgrade is received, Corp E must return the disk containing the earlier version of Program X to Corp A. If the contract is terminated, Corp E must delete (or otherwise destroy) all copies made of the current version of Program X. The agreement also requires Corp A to provide technical support to Corp E but the agreement does not allocate the monthly fee between the right to receive upgrades of Program X and the technical support services. The amount of technical support that Corp A will provide to Corp E is not foreseeable at the time the contract is entered into but is expected to be de minimis. The agreement specifically provides that Corp E has not thereby been granted an option to purchase Program X.

(ii) *Analysis.* (A) Corp E has received no copyright rights under paragraph (c)(2) of this section. Corp A has not provided any services described in paragraph (d) of this section. Based on all the facts and circumstances of the transaction, Corp A has provided de minimis technical services to Corp E. Therefore, under paragraph (c)(1)(ii) of this section, the transaction is a transfer of a copyrighted article.

(B) Taking into account all facts and circumstances, under the benefits and burdens test Corp E is not properly treated as the owner of the copyrighted article. Corp E does not receive the right to use Program X in perpetuity, but only for so long as it continues to make payments. Corp E does not have the right to purchase Program X on advantageous (or, indeed, any) terms once a certain amount of money has been paid to Corp A or a certain period of time has elapsed (which might indicate a sale). Once the agreement is terminated, Corp E will no longer possess any copies of Program X, current or superseded. Therefore under paragraph (f)(2) of this section there has been a lease of a copyrighted article.

Example 13. (i) *Facts.* The facts are the same as in *Example 12,* except that, while Corp E must return copies of Program X as new upgrades are received, if the agreement terminates, Corp E may keep the latest version of Program X (although Corp E is still prohibited from selling or otherwise transferring any copy of Program X).

(ii) *Analysis.* For the reasons stated in *Example 10,* paragraph (ii)(B), the transfer of the program will be treated as a sale of a copyrighted article rather than as a lease.

Example 14. (i) *Facts.* Corp G, a Country Z corporation, enters into a contract with Corp A, a U.S. corporation, for Corp A to modify Program X so that it can be used at Corp G's facility in Country Z. Under the contract, Corp G is to acquire one copy of the program on a disk and the right to use the program on 5,000 workstations. The contract requires Corp A to rewrite elements of Program X so that it will conform to Country Z accounting standards and states that Corp A retains all copyright rights in the modified Program X. The agreement between Corp A and Corp G is otherwise identical as to rights and payment terms as the agreement described in *Example 10.*

(ii) *Analysis.* (A) As in *Example 10,* no copyright rights are being transferred under paragraph (c)(2) of this section. In addition, since no copyright rights are being transferred to Corp G, this transaction does not involve the provision of services by Corp A under paragraph (d) of this section. This transaction will be classified, therefore, as a transfer of copyrighted articles under paragraph (c)(1)(ii) of this section.

(B) Taking into account all facts and circumstances, Corp G is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been the sale of a copyrighted article rather than the grant of a lease.

Example 15. (i) *Facts.* Corp H, a Country Z corporation, enters into a license agreement for a new computer program. Program Q is to be written by Corp A, a U.S. corporation. Corp A and Corp H agree that Corp A is writing Program Q for Corp H and that, when Program Q is completed, the copyright in Program Q will belong to Corp H. Corp H gives instructions to Corp A programmers regarding program specifications. Corp H agrees to pay Corp A a fixed monthly sum during development of the program. If Corp H is dissatisfied with the development of the program, it may cancel the contract at the end of any month. In the event of termination, Corp A will retain all payments, while any procedures, techniques or copyrightable interests will be the property of Corp H. All of the payments are labelled royalties. There is no provision in the agreement for any continuing relationship between Corp A and Corp H, such as the furnishing of updates of the program, after completion of the modification work.

(ii) *Analysis.* Taking into account all of the facts and circumstances, Corp A is treated as providing services to Corp H. Under paragraph (d) of this section, Corp A is treated as providing services to Corp H because Corp H bears all of the risks of loss associated with the development of Program Q and is the owner of all copyright rights in Program Q. Under paragraph (g)(1) of this section, the fact that the agreement is labelled a license is not controlling (nor is the fact that Corp A receives a sum labelled a royalty).

Example 16. (i) *Facts.* Corp A, a U.S. corporation, and Corp I, a Country Z corporation, agree that a development engineer employed by Corp A will travel to Country Z to provide know-how relating to certain techniques not generally known to computer programmers, which will enable Corp I to more efficiently create computer programs. These techniques represent the product of experience gained by Corp A from working on many computer programming projects, and are furnished to Corp I under nondisclosure conditions. Such information is property subject to trade secret protection.

(ii) *Analysis.* This transaction contains the elements of know-how specified in paragraph (e) of this section. Therefore, this transaction will be treated as the provision of know-how.

Example 17 (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program Y to Corp E, a Country Z corporation, in exchange for a single fixed payment. Program Y is a computer program development program, which is used to create other computer programs, consisting of several components, including libraries of reusable software components that serve as general building blocks in new software applications. No element of these libraries is a significant component of any overall new program. Because a computer program created with the use of Program Y will not operate unless the libraries are also present, the license agreement between Corp A and Corp E grants Corp E the right to distribute copies of the libraries with any program developed using Program Y. The license agreement is otherwise identical to the license agreement in *Example 1.*

(ii) *Analysis.* (A) No non-de minimis copyright rights described in paragraph (c)(2) of this section have passed to Corp E. For purposes of paragraph (b)(2) of this section, the right to distribute the libraries in conjunction with the programs created using Program Y is a de minimis component of the transaction. Because Corp E has received a copy of the program under paragraph (c)(1)(ii) of this section, it has received a copyrighted article.

(B) Taking into account all the facts and circumstances, Corp E is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been the sale of a copyrighted article rather than the grant of a lease.

Example 18 (i) *Facts.* (A) Corp A, a U.S. corporation, transfers a disk containing Program X to Corp E, a country Z Corporation. The disk contains both the object code and the source code to Program X and the license agreement grants Corp E the right to—

(*1*) Modify the source code in order to correct minor errors and make minor adaptations to Program X so it will function on Corp E's computer; and

(*2*) Recompile the modified source code.

(B) The license does not grant Corp E the right to distribute the modified Program X to the public. The license is otherwise identical to the license agreement in *Example 1.*

(ii) *Analysis.* (A) No non-de minimis copyright rights described in paragraph (c)(2) of this section have passed to Corp E. For purposes of paragraph (b)(2) of this section, the right to modify the source code and recompile the source code in order to create new code to correct minor errors and make minor adaptations is a de minimis component of the transaction. Because Corp E has received a copy of the program under paragraph (c)(1)(ii) of this section, it has received a copyrighted article.

(B) Taking into account all the facts and circumstances, Corp E is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been the sale of a copyrighted article rather than the grant of a lease.

(i) *Effective date*—(1) *General.* This section applies to transactions occurring pursuant to contracts entered into on or after December 1, 1998.

(2) *Elective transition rules*—(i) *Contracts entered into in taxable years ending on or after October 2, 1998.* A taxpayer may elect to apply this section to transactions occurring pursuant to contracts entered into in taxable years ending on or after October 2, 1998. A taxpayer that makes an election under this paragraph (i)(2)(i) must apply this section to all contracts entered into in

taxable years ending on or after October 2, 1998.

(ii) *Contracts entered into before October 2, 1998.* A taxpayer may elect to apply this section to transactions occurring in taxable years ending on or after October 2, 1998 pursuant to contracts entered into before October 2, 1998 provided the taxpayer would not be required under this section to change its method of accounting as a result of such election, or the taxpayer would be required to change its method of accounting but the resulting section 481(a) adjustment would be zero. A taxpayer that makes an election under this paragraph (i)(2)(ii) must apply this section to all transactions occurring in taxable years ending on or after October 2, 1998 pursuant to contracts entered into before October 2, 1998.

(3) *Manner of making election.* Taxpayers may elect, under paragraph (i)(2)(i) or (i)(2)(ii) of this section, to apply this section, by treating the transactions in accordance with these regulations on their original tax return.

(4) *Examples.* The following examples illustrate application of the transition rule of paragraph (i)(2)(ii) of this section:

Example 1. Corp A develops computer programs for sale to third parties. Corp A uses an overall accrual method of accounting and files its tax return on a calendar-year basis. In year 1, Corp A enters into a contract to deliver a computer program in that year, and to provide updates for each of the following four years. Under the contract, the computer program and the updates are priced separately, and Corp A is entitled to receive payments for the computer program and each of the updates upon delivery. Assume Corp A properly accounts for the contract as a contract for the provision of services. Corp A properly includes the payments under the contract in gross income in the taxable year the payments are received and the computer program or updates are delivered. Corp A properly deducts the cost of developing the computer program and updates when the costs are incurred. Year 3 includes ctober 2, 1998. Assume under the rules of this section, the provision of updates would properly be accounted for as the transfer of copyrighted articles. If Corp A made an election under paragraph (i)(2)(ii) of this section, Corp A would not be required to change its method of accounting for income under the contract as a result of the election. Corp A would also not be required to change its method of accounting for the cost of developing the computer program and the updates under the contract as a result of the election. Therefore, under paragraph (i)(2)(ii) of this section, Corp A may elect to apply the provisions of this section to the updates provided in years 3, 4, and 5, because Corp A is not required to change from its method of accounting for the contract as a result of the election.

Example 2. Corp A develops computer programs for sale to third parties. Corp A uses an overall accrual method of accounting and files its tax return on a calendar-year basis. In year 1, Corp A enters into a contract to deliver a computer program and to provide one update the following year. Under the contract, the computer program and the update are priced separately, and Corp A is entitled to receive payment for the computer program and the update upon delivery of the computer program. Assume Corp A properly accounts for the contract as a contract for the provision of services. Corp A properly includes the portion of the payment relating to the computer program in gross income in year 1, the taxable year the payment is received and the program delivered. Corp A properly includes the portion of the payment relating to the update in gross income in year 2, the taxable year the update is provided, under Rev. Proc. 71–21, 1971–2 CB 549 (see § 601.601 (d)(2) of this chapter). Corp A properly deducts the cost of developing the computer program and update when the costs are incurred. Year 2 includes October 2, 1998. Assume under the rules of this section, provision of the update would properly be accounted for as the transfer of a copyrighted article. If Corp A made an election under paragraph (i)(2)(ii) of this section, Corp A would be required to change its method of accounting for deferring income under its contract as a result of the election. However, the section 481(a) adjustment would be zero because the portion of the payment relating to the update would be includible in gross income in year 2, the taxable year the update is provided, under both Rev. Proc. 71–21 and § 1.451–5. Corp A would not be required to change its method of accounting for the cost of developing the computer program and the update under the contract as a result of the election. Therefore, under paragraph (i)(2)(ii) of this section, Corp A may elect to apply the provisions of this section to the update in year 2, because the section 481(a) adjustment resulting from the change in method of accounting for deferring advance payments under the contract is zero, and because Corp A is not required to change from its method of accounting for the cost of developing the computer program and updates under the contract as a result of the election.

Example 3. Assume the same facts as in *Example 1* except that Corp A is entitled to receive payments for the computer program and each of the updates 30 days after delivery. Corp A properly includes the amounts due under the contract in gross income in the taxable year the computer program or updates are provided. Assume that Corp A properly uses the nonaccrual-experience method described in section 448(d)(5) and §1.448–2T to account for income on its contracts. If Corp A made an election under paragraph (i)(2)(ii) of this section, Corp A would be required to change from the nonaccrual-experience method for income as a result of the election, because the method is only available with respect to amounts to be received for the performance of services. Therefore, Corp A may not elect to apply the provisions of this section to the updates provided in years 3, 4, and 5, under paragraph (i)(2)(ii) of this section, because Corp A would be required to change from the nonaccrual-experience method of accounting for income on the contract as a result of the election.

(j) *Change in method of accounting required by this section*—(1) *Consent.* A taxpayer is granted consent to change its method of accounting for contracts involving computer programs, to conform with the classification prescribed in this section. The consent is granted for contracts entered into on or after December 1, 1998, or in the case of a taxpayer making an election under paragraph (i)(2)(i) of this section, the consent is granted for contracts entered into in taxable years ending on or after October 2, 1998. In addition, a taxpayer that makes an election under paragraph (i)(2)(ii) of this section is granted consent to change its method of accounting for any contract with transactions subject to the election, if the taxpayer is required to change its method of accounting as a result of the election.

(2) *Year of change.* The year of change is the taxable year that includes December 1, 1998, or in the case of a taxpayer making an election under paragraph (i)(2)(i) or (i)(2)(ii) of this section, the taxable year that includes October 2, 1998.

(k) *Time and manner of making change in method of accounting*—(1) *General.* A taxpayer changing its method of accounting in accordance with this section must file a Form 3115, Application for Change in Method of Accounting, in duplicate. The taxpayer must type or print the following statement at the top of page 1 of the Form 3115: ‘‘FILED UNDER TREASURY REGULATION §1.861–18.’’ The original Form 3115 must be attached to the taxpayers original return for the year of change. A copy of the Form 3115 must be filed with the National Office no later than when the original Form 3115 is filed for the year of change.

(2) *Copy of Form 3115.* The copy required by this paragraph (k)(l) to be sent to the national office should be sent to the Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, P.O. Box 7604, Benjamin Franklin Station, Washington DC 20044 (or in the case of a designated private delivery service: Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, 1111 Constitution Avenue, NW., Washington, DC 20224).

(3) *Effect of consent and Internal Revenue Service review.* A change in method of accounting granted under this section is subject to review by the district director and the national office and may be modified or revoked in accordance with the provisions of Rev. Proc. 97–37 (1997–33 IRB 18) (or its successors) (see §601.601(d)(2) of this chapter).

[T.D. 8785, 63 FR 52977, Oct. 2, 1998; 63 FR 64868, Nov. 24, 1998]

§1.862–1 Income specifically from sources without the United States.

(a) *Gross income.* (1) The following items of gross income shall be treated as income from sources without the United States:

(i) Interest other than that specified in section 861(a)(1) and §1.861–2 as being derived from sources within the United States;

(ii) Dividends other than those derived from sources within the United States as provided in section 861(a)(2) and §1.861–3;

(iii) Compensation for labor or personal services performed without the United States;

(iv) Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, without the United States, patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property;

(v) Gains, profits, and income from the sale of real property located without the United States; and

(vi) Gains, profits, and income derived from the purchase of personal property within the United States and its sale without the United States.

(2) In applying subparagraph (1)(iv) of this paragraph for taxable years beginning after December 31, 1966, gains described in section 871(a)(1)(D) and section 881(a)(4) from the sale or exchange after October 4, 1966, of patents, copyrights, and other like property shall be treated, as provided in section 871(e)(2), as rentals or royalties for the use of, or privilege of using, property or an interest in property. See paragraph (e) of § 1.871–11.

(3) For determining the time and place of sale of personal property for purposes of subparagraph (1)(vi) of this paragraph, see paragraph (c) of § 1.861–7.

(4) Income derived from the purchase of personal property within the United States and its sale within a possession of the United States shall be treated as derived entirely from within that possession.

(5) If interest is paid on an obligation of a nonresident of the United States by a resident of the United States acting in the resident's capacity as a guarantor of the obligation of the nonresident, the interest will be treated as income from sources without the United States.

(6) For rules treating certain interest as income from sources without the United States, see paragraph (b) of § 1.861–2.

(7) For the treatment of compensation for labor or personal services performed partly within the United States and partly without the United States, see paragraph (b) of § 1.861–4.

(b) *Taxable income.* The taxable income from sources without the United States, in the case of the items of gross income specified in paragraph (a) of this section, shall be determined on the same basis as that used in § 1.861–8 for determining the taxable income from sources within the United States.

(c) *Income from certain property.* For provisions permitting a taxpayer to elect to treat amounts of gross income attributable to certain aircraft or vessels first leased on or before December 28, 1980, as income from sources within the United States which would otherwise be treated as income from sources without the United States under paragraph (a) of this section, see § 1.861–9. For provisions requiring amounts of gross income attributable to certain aircraft, vessels, or spacecraft first leased by the taxpayer after December 28, 1980, to be treated as income from sources within the United States which would otherwise be treated as income from sources without the United States under paragraph (a) of this section, see § 1.861–9A.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7378, 40 FR 45434, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975; T.D. 7928, 48 FR 55847, Dec. 16, 1983]

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[T.D. 8687, 61 FR 60545, Nov. 29, 1996]

§1.863–1 Allocation of gross income under section 863(a).

(a) *In general.* Items of gross income other than those specified in section 861(a) and section 862(a) will generally be separately allocated to sources within or without the United States. See §1.863–2 for alternate methods to determine the income from sources within or without the United States in the case of items specified in §1.863–2(a). See also sections 865(b) and (e)(2). In the case of sales of property involving partners and partnerships, the rules of §1.863–3(g) apply.

(b) *Natural resources*—(1) *In general.* Notwithstanding any other provision, except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale outside the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber within the United States, must be allocated between sources within and without the United States based on the fair market value of the product at the export terminal (as defined in paragraph (b)(3)(iii) of this section). Notwithstanding any other provision, except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale within the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber outside the United States must be allocated between sources within and without the United States based on the fair market value of the product at the export terminal. For place of sale, see §§1.861–7(c) and 1.863–3(c)(2). The source of gross receipts equal to the fair market value of the product at the export terminal will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of its fair market value at the export terminal (excess gross receipts) will be determined as follows—

(i) If the taxpayer engages in additional production activities subsequent to shipment from the export terminal and outside the country of sale, the source of excess gross receipts must be determined under §1.863–3. For purposes of applying §1.863–3, only production assets used in additional production activity subsequent to the export terminal are taken into account.

(ii) In all other cases, excess gross receipts will be from sources within the country of sale. This paragraph (b)(1)(ii) applies to a taxpayer that engages in additional production activities in the country of sale, as well as to a taxpayer that does not engage in additional production activities at all.

(2) *Additional production prior to export terminal.* Notwithstanding any other provision of this section, gross receipts from the sale of products derived by a taxpayer who performs additional production activities as defined in paragraph (b)(3)(ii) of this section before the relevant product is shipped from the export terminal are allocated between sources within and without the United States based on the fair market value of the product immediately prior to the additional production activities. The source of gross receipts equal to the fair market value of the product immediately prior to the additional production activities will be from sources where the farm, mine,

well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of the fair market value immediately prior to the additional production activities must be determined under § 1.863–3. For purposes of applying § 1.863–3, only production assets used in the additional production activities are taken into account.

(3) *Definitions*—(i) *Production activity.* For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See § 1.864–1. Except as otherwise provided in §§ 1.1502–13 or 1.863–3(g)(2), only production activities conducted directly by the taxpayer are taken into account.

(ii) *Additional production activities.* For purposes of this section, additional production activities are substantial production activities performed directly by the taxpayer in addition to activities from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber. Whether a taxpayer's activities constitute additional production activities will be determined under the principles of § 1.954–3(a)(4). However, in no case will activities that prepare the natural resource itself for export, including those that are designed to facilitate the transportation of the natural resource to or from the export terminal, be considered additional production activities for purposes of this section.

(iii) *Export terminal.* Where the farm, mine, well, deposit, or uncut timber is located without the United States, the export terminal will be the final point in a foreign country from which goods are shipped to the United States. If there is no such final point in a foreign country (e.g., the property is extracted and produced on the high seas), the export terminal will be the place of production. Where the farm, mine, well, deposit, or uncut timber is located within the United States, the export terminal will be the final point in the United States from which goods are shipped from the United States to a foreign country. The location of the export terminal is determined without regard to any contractual terms agreed to by the taxpayer and without regard to whether there is an actual sale of the products at the export terminal.

(4) *Determination of fair market value.* For purposes of this section, fair market value depends on all of the facts and circumstances as they exist relative to a party in any particular case. Where the products are sold to a related party in a transaction subject to section 482, the determination of fair market value under this section must be consistent with the arm's length price determined under section 482.

(5) *Determination of gross income.* To determine the amount of a taxpayer's gross income from sources within or without the United States, the taxpayer's gross receipts from sources within or without the United States determined under this paragraph (b) must be reduced by the cost of goods sold properly attributable to gross receipts from sources within or without the United States.

(6) *Tax return disclosure.* A taxpayer that determines the source of its income under this paragraph (b) shall attach a statement to its return explaining the methodology used to determine fair market value under paragraph (b)(4) of this section, and explaining any additional production activities (as defined in paragraph (b)(3)(ii) of this section) performed by the taxpayer. In addition, the taxpayer must provide such other information as is required by § 1.863–3.

(7) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. No additional production. U.S. Mines, a U.S. corporation, operates a copper mine and mill in country X. U.S. Mines extracts copper-bearing rocks from the ground and transports the rocks to the mill where the rocks are ground and processed to produce copper-bearing concentrate. The concentrate is transported to a port where it is dried in preparation for export, stored and then shipped to purchasers in the United States. Because title to the property is passed in the United States and, under the facts and circumstances, none of U.S. Mine's activities constitutes additional production prior to the export terminal within the meaning of paragraph (b)(3)(ii) of this section, under paragraph (b)(1) and (b)(1)(ii) of this section, gross receipts equal to the fair market value of the concentrate at the export terminal will be from sources without the United States, and excess gross receipts will be from sources within the United States.

Example 2. No additional production. US Gas, a U.S. corporation, extracts natural gas within the United States, and transports the natural gas to a U.S. port where it is liquified in preparation for shipment. The liquified natural gas is then transported via freighter and sold without additional production activities in a foreign country. Liquefaction of natural gas is not an additional production activity because liquefaction prepares the natural gas for transportation from the export terminal. Therefore, under paragraph (b)(1) and (b)(1)(ii) of this section, gross receipts equal to the fair market value of the liquefied natural gas at the export terminal will be from sources within the United States, and excess gross receipts will be from sources without the United States.

Example 3. Sale in third country. US Gold, a U.S. corporation, mines gold in country X, produces gold jewelry in the United States, and sells the jewelry in country Y. Assume that the fair market value of the gold at the export terminal in country X is $40, and that US Gold ultimately sells the gold jewelry in country Y for $100. Under §1.863–1(b), $40 of US Gold's gross receipts will be allocated to sources without the United States. Under paragraph (b)(1)(i) of this section, the source of the remaining $60 of gross receipts will be determined under §1.863–3. If US Gold applies the 50/50 method described in §1.863–3, $20 of cost of goods sold is properly attributable to activities subsequent to the export terminal, and all of US Gold's production assets subsequent to the export terminal are located in the United States, then $20 of gross income will be allocated to sources within the United States and $20 of gross income will be allocated to sources without the United States.

Example 4. Production in country of sale. US Oil, a U.S. corporation, extracts oil in country X, transports the oil via pipeline to the export terminal in country Y, refines the oil in the United States, and sells the refined product in the United States to unrelated persons. Assume that the fair market value of the oil at the export terminal in country Y is $80, and that US Oil ultimately sells the refined product for $100. Under paragraph (b)(1) of this section, $80 of US Oil's gross receipts will be allocated to sources without the United States, and under paragraph (b)(1)(ii) of this section the remaining $20 of gross receipts will be allocated to sources within the United States.

Example 5. Additional production prior to export. The facts are the same as in *Example 1,* except that U.S. Mines also operates a smelter in country X. The concentrate output from the mill is transported to the smelter where it is transformed into smelted copper. The smelted copper is exported to purchasers in the United States. Under the facts and circumstances, all of the processes applied to make copper concentrate are considered mining. Therefore, under paragraph (b)(2) of this section, gross receipts equal to the fair market value of the concentrate at the smelter will be from sources without the United States. Under the facts and circumstances, the conversion of the concentrate into smelted copper is an additional production activity in a foreign country within the meaning of paragraph (b)(3)(ii) of this section. Therefore, the source of U.S. Mine's excess gross receipts will be determined pursuant to paragraph (b)(2) of this section.

(c) *Determination of taxable income.* The taxpayer's taxable income from sources within or without the United States will be determined under the rules of §§1.861–8 through 1.861–14T for determining taxable income from sources within the United States.

(d) *Scholarships, fellowship grants, grants, prizes and awards*—(1) *In general.* This paragraph (d) applies to scholarships, fellowship grants, grants, prizes and awards. The provisions of this paragraph (d) do not apply to amounts paid as salary or other compensation for services.

(2) *Source of income.* The source of income from scholarships, fellowship grants, grants, prizes and awards is determined as follows:

(i) *United States source income.* Except as provided in paragraph (d)(2)(iii) of this section, scholarships, fellowship grants, grants, prizes and awards made by a U.S. citizen or resident, a domestic partnership, a domestic corporation, an estate or trust (other than a foreign estate or trust within the meaning of section 7701(a)(31)), the United States (or an instrumentality or agency thereof), a State (or any political subdivision thereof), or the District of Columbia shall be treated as income from sources within the United States.

(ii) *Foreign source income.* Scholarships, fellowship grants, grants, prizes and awards made by a foreign government (or an instrumentality, agency, or any political subdivision thereof), an international organization (as defined in section 7701(a)(18)), or a person other than a U.S. person (as defined in section 7701(a)(30)) shall be treated as income from sources without the United States.

(iii) *Certain activities conducted outside the United States.* Scholarships, fellowship grants, targeted grants, and achievement awards received by a person other than a U.S. person (as defined in section 7701(a)(30)) with respect to activities previously conducted (in the case of achievement awards) or to be conducted (in the case of scholarships, fellowships grants, and targeted grants) outside the United States shall be treated as income from sources without the United States.

(3) *Definitions.* The following definitions apply for purposes of this paragraph (d):

(i) *Scholarships* are defined in section 117 and the regulations thereunder.

(ii) *Fellowship grants* are defined in section 117 and the regulations thereunder.

(iii) *Prizes and awards* are defined in section 74 and the regulations thereunder.

(iv) *Grants* are amounts described in subparagraph (3) of section 4945(g) and the regulations thereunder, and are not amounts otherwise described in paragraphs (d)(3) (i), (ii), or (iii) of this section. For purposes of this paragraph (d), the reference to section 4945(g)(3) is applied without regard to the identity of the payor or recipient and without the application of the objective and nondiscriminatory basis test and the requirement of a procedure approved in advance.

(v) *Targeted grants* are grants—

(A) Issued by an organization described in section 501(c)(3), the United States (or an instrumentality or agency thereof), a State (or any political subdivision thereof), or the District of Columbia; and

(B) For an activity undertaken in the public interest and not primarily for the private financial benefit of a specific person or persons or organization.

(vi) *Achievement awards* are awards—

(A) Issued by an organization described in section 501(c)(3), the United States (or an instrumentality or agency thereof), a State (or political subdivision thereof), or the District of Columbia; and

(B) For a past activity undertaken in the public interest and not primarily for the private financial benefit of a specific person or persons or organization.

(4) *Effective dates.* The following are the effective dates concerning this paragraph (d):

(i) *Scholarships and fellowship grants.* This paragraph (d) is effective for scholarship and fellowship grant payments made after December 31, 1986. However, for scholarship and fellowship grant payments made after May 14, 1989, and before June 16, 1993, the residence of the payor rule of paragraph (d)(2) (i) and (ii) of this section may be applied without applying paragraph (d)(2)(iii) of this section.

(ii) *Grants, prizes and awards.* This paragraph (d) is effective for payments made for grants, prizes and awards, targeted grants, and achievement awards after September 25, 1995. However, the taxpayer may elect to apply the provisions of this paragraph (d) to payments made for grants, prizes and awards, targeted grants, and achievement awards after December 31, 1986, and before September 26, 1995.

(e) *Effective dates.* The rules of paragraphs (a), (b) and (c) of this section will apply to taxable years beginning after December 30, 1996. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and on or before December 30, 1996. For years beginning before December 30, 1996, see §1.863–1 (as contained in 26 CFR part 1 revised as of April 1, 1996).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 8615, 60 FR 44275, Aug. 25, 1995; T.D. 8687, 61 FR 60545, Nov. 29, 1996; 61 FR 65323, Dec. 12, 1996]

§ 1.863–2 Allocation and apportionment of taxable income.

(a) *Determination of taxable income.* Section 863(b) provides an alternate method for determining taxable income from sources within the United States in the case of gross income derived from sources partly within and partly without the United States. Under this method, taxable income is determined by deducting from such gross income the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions that cannot definitely be allocated to some item or class of gross income. The income to which this section applies (and that is treated as derived partly from sources within and partly from sources without the United States) will consist of gains, profits, and income

(1) From certain transportation or other services rendered partly within and partly without the United States to the extent not within the scope of section 863(c) or other specific provisions of this title;

(2) From the sale of inventory property (within the meaning of section 865(i)) produced (in whole or in part) by the taxpayer in the United States and sold outside the United States or produced (in whole or in part) by the taxpayer outside the United States and sold in the United States; or

(3) Derived from the purchase of personal property within a possession of the United States and its sale within the United States, to the extent not excluded from the scope of these regulations under §1.936–6(a)(5),

Q&A 7.

(b) *Determination of source of taxable income.* Income treated as derived from sources partly within and partly without the United States under paragraph (a) of this section may be allocated to sources within and without the United States pursuant to §1.863–1 or apportioned to such sources in accordance with the methods described in other regulations under section 863. To determine the source of certain types of income described in paragraph (a)(1) of this section, see §1.863–4. To determine the source of gross income described in paragraph (a)(2) of this section, see §1.863–1 for natural resources and see §1.863–3 for other inventory. Taxpayers, at their election, may apply the principles of §1.863–3 (b)(1) and (c) to determine the source of taxable income (rather than gross income) from sales of inventory property (other than natural resources). To determine the source of income partly from sources within a possession of the United States, including income described in paragraph (a)(3) of this section, see §1.863–3(f).

(c) *Effective dates.* This section will apply to taxable years beginning after December 30, 1996. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and on or before December 30, 1996. For years beginning before December 30, 1996, see §1.863–2 (as contained in 26 CFR part 1 revised as of April 1, 1996).

[T.D. 8687, 61 FR 60546, Nov. 29, 1996; 61 FR 65323, Dec. 12, 1996]

§1.863–3 Allocation and apportionment of income from certain sales of inventory.

(a) *In general*—(1) *Scope.* Paragraphs (a) through (e) of this section apply to determine the source of income derived from the sale of inventory property (inventory), which a taxpayer produces (in whole or in part) within the United States and sells outside the United States, or which a taxpayer produces (in whole or in part) outside the United States and sells within the United States (Section 863 Sales). A taxpayer must divide gross income from Section 863 Sales between production activity and sales activity using one of the methods described in paragraph (b) of this section. The source of gross income from production activity and from sales activity must then be determined under paragraph (c) of this section. Taxable income from Section 863 Sales is determined under paragraph (d) of this section. Paragraph (e) of this section describes the rules for electing the methods described in paragraph (b) of this section and the information that a taxpayer must disclose on a tax return. Paragraph (f) of this section applies to determine the source of certain income derived from a possession of the United States. Paragraph (g) of this section provides special rules for partnerships for all sales subject to §§1.863–1 through 1.863–3. Paragraph (h) of this section provides effective dates for the rules in this section.

(2) *Rules of application for Section 863 Sales.* Once a taxpayer has elected a method described in paragraph (b) of this section, the taxpayer must separately apply that method to Section 863 Sales in the United States and to Section 863 Sales outside the United States. In addition, the taxpayer must

apply the rules of paragraphs (c) and (d) of this section by aggregating all Section 863 Sales to which a method described in paragraph (b) of this section applies, after separately applying that method to Section 863 Sales in the United States and to Section 863 Sales outside the United States. See section 865(i)(1) for the definition of inventory property. See also section 865(e)(2). See § 1.861–7(c) and paragraph (c)(2) of this section for the time and place of sale.

(b) *Methods to determine income attributable to production activity and sales activity*—(1) *50/50 method*—(i) *Determination of gross income.* Generally, gross income from Section 863 Sales will be apportioned between production activity and sales activity under the 50/50 method as described in this paragraph (b)(1). Under the 50/50 method, one-half of the taxpayer's gross income will be considered income attributable to production activity and the source of that income will be determined under the rules of paragraph (c)(1) of this section. The remaining one-half of such gross income will be considered income attributable to sales activity and the source of that income will be determined under the rules of paragraph (c)(2) of this section. In lieu of the 50/50 method, the taxpayer may elect to determine the source of income from Section 863 Sales under the IFP method described in paragraph (b)(2) of this section or, with the consent of the District Director, the books and records method described in paragraph (b)(3) of this section.

(ii) *Example.* The following example illustrates the rules of this paragraph (b)(1):

Example. 50/50 method. (i) P, a U.S. corporation, produces widgets in the United States. P sells the widgets for $100 to D, an unrelated foreign distributor, in another country. P's cost of goods sold is $40. Thus, P's gross income is $60.

(ii) Pursuant to the 50/50 method, one-half of P's gross income, or $30, is considered income attributable to production activity, and one-half of P's gross income, or $30, is considered income attributable to sales activity.

(2) *IFP method*—(i) *Establishing an IFP.* A taxpayer may elect to allocate gross income earned from production activity and sales activity using the independent factory price (IFP) method described in this paragraph (b)(2) if an IFP is fairly established. An IFP is fairly established based on a sale by the taxpayer only if the taxpayer regularly sells part of its output to wholly independent distributors or other selling concerns in such a way as to reasonably reflect the income earned from production activity. A sale will not be considered to fairly establish an IFP if sales activity by the taxpayer with respect to that sale is significant in relation to all of the activities with respect to that product.

(ii) *Applying the IFP method.* If the taxpayer elects to use the IFP method, the amount of the gross sales price equal to the IFP will be treated as attributable to production activity, and the excess of the gross sales price over the IFP will be treated as attributable to sales activity. If a taxpayer elects to use the IFP method, the IFP must be applied to all Section 863 Sales of inventory that are substantially similar in physical characteristics and function, and are sold at a similar level of distribution as the inventory sold in the sale fairly establishing an IFP. The IFP will only be applied to sales that are reasonably contemporaneous with the sale fairly establishing the IFP. An IFP cannot be applied to sales in other geographic markets if the markets are substantially different. If the taxpayer elects the IFP method, the rules of this paragraph will also apply to determine the division of gross receipts between production activity and sales activity in a Section 863 Sale that itself fairly establishes an IFP. If the taxpayer elects to apply the IFP method, the IFP method must be applied to all sales for which an IFP may be fairly established and applied for that taxable year and each subsequent taxable year. The taxpayer will apply either the 50/50 method described in paragraph (b)(1) of this section or the books and records method described in paragraph (b)(3) of this section to any other Section 863 Sale for which an IFP cannot be established or applied for each taxable year.

(iii) *Determination of gross income.* The amount of a taxpayer's gross income from production activity is determined by reducing the amount of gross receipts from production activity by the cost of goods sold properly attributable to production activity. The amount of a taxpayer's gross income from sales activity is determined by reducing the amount of gross receipts from sales activity by the cost of goods sold (if any) properly attributable to sales activity. The source of gross income from production activity is determined under the rules of paragraph (c)(1) of this section, and the source of gross income from sales activity will be determined under the rules of paragraph (c)(2) of this section.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (b)(2):

Example 1. IFP method. (i) P, a U.S. producer, purchases cotton and produces cloth in the United States. P sells cloth in country X to D, an unrelated foreign clothing manufacturer, for $100. Cost of goods sold for cloth is $80, entirely attributable to production activity. P does not engage in significant sales activity in relation to its other activities in the sales to D. Under these facts, the sale to D fairly establishes an IFP of $100. Assume that P elects to use the IFP method. Accordingly, $100 of the gross sales price is treated as attributable to production activity, and no amount of income from this sale is attributable to sales activity. After reducing the gross sales price by cost of goods sold, $20 of the gross income is treated as attributable to production activity ($100–$80).

(ii) P also sells cloth in country X to A, an unrelated foreign retail outlet, for $110. Because P elected the IFP method and the cloth is substantially similar to the cloth sold to D, the IFP fairly established in the sales to D must be used to determine the amount attributable to production activity in the sale to A. Accordingly, $100 of the gross sales price is treated as attributable to production activity and $10 ($110–$100) is attributable to sales activity. After reducing the gross sales price by cost of goods sold, $20 of the gross income is treated as attributable to production activity ($100–$80) and $10 is attributable to sales activity.

Example 2. Scope of IFP Method. (i) USCo manufactures three dissimilar products. USCo elects to apply the IFP method. In year 1, an IFP can be established for sales of product X, but not for products Y and Z. In year 2, an IFP cannot be established for any of USCo's products. In year 3, an IFP can be established for products X and Y, but not for product Z.

(ii) In year 1, USCo must apply the IFP method to sales of product X. In year 2, although USCo's IFP election remains in effect, USCo is not required to apply the IFP election to any products. In year 3, USCo is required to apply the IFP method to sales of products X and Y.

(3) *Books and records method.* A taxpayer may elect to determine the amount of its gross income from Section 863 Sales that is attributable to production and sales activities for the taxable year based upon its books of account if it has received in advance the permission of the District Director having audit responsibility over its tax return. The taxpayer must establish to the satisfaction of the District Director that the taxpayer, in good faith and unaffected by considerations of tax liability, will regularly employ in its books of account a detailed allocation of receipts and expenditures which clearly reflects the amount of the taxpayer's income from production and sales activities. If a taxpayer receives permission to apply the books and records method, but does not comply with a material condition set forth by the District Director, the District Director may, in its discretion, revoke permission to use the books and records method. The source of gross income treated as attributable to production activity under this method may be determined under the rules of paragraph (c)(1) of this section, and the source of gross income attributable to sales activity will be determined under the rules of paragraph (c)(2) of this section.

(c) *Determination of the source of gross income from production activity and sales activity*—(1) *Income attributable to production activity*—(i) *Production only within the United States or only within foreign countries*—(A) *Source of income.* For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See §1.864–1. Subject to the provisions in §1.1502–13 or paragraph (g)(2)(ii) of this section, the only production activities that are taken into account for purposes of §§1.863–1, 1.863–2, and this section are those conducted directly by the taxpayer. Where the taxpayer's production assets are located only within the United States or only outside the United States, the income attributable to production activity is sourced where the taxpayer's production assets are located. For rules regarding the source of income when production assets are located both within the United States and without the United States, see paragraph (c)(1)(ii) of this section.

(B) *Definition of production assets.* Subject to the provisions of § 1.1502–13 and paragraph (g)(2)(ii) of this section, production assets include only tangible and intangible assets owned directly by the taxpayer that are directly used by the taxpayer to produce inventory described in paragraph (a) of this section. Production assets do not include assets that are not directly used to produce inventory described in paragraph (a) of this section. Thus, production assets do not include such assets as accounts receivables, intangibles not related to production of inventory (e.g., marketing intangibles, including trademarks and customer lists), transportation assets, warehouses, the inventory itself, raw materials, or work-in-process. In addition, production assets do not include cash or other liquid assets (including working capital), investment assets, prepaid expenses, or stock of a subsidiary.

(C) *Location of production assets.* For purposes of this section, a tangible production asset will be considered located where the asset is physically located. An intangible production asset will be considered located where the tangible production assets owned by the taxpayer to which it relates are located.

(ii) *Production both within the United States and within foreign countries*—(A) *Source of income.* Where the taxpayer's production assets are located both within and without the United States, income from sources without the United States will be determined by multiplying the income attributable to the taxpayer's production activity by a fraction, the numerator of which is the average adjusted basis of production assets that are located outside the United States and the denominator of which is the average adjusted basis of all production assets within and without the United States. The remaining income is treated as from sources within the United States.

(B) *Adjusted basis of production assets.* For purposes of paragraph (c)(1)(ii)(A) of this section, the adjusted basis of an asset is determined under section 1011. The average adjusted basis is computed by averaging the adjusted basis of the asset at the beginning and end of the taxable year, unless by reason of material changes during the taxable year such average does not fairly represent the average for such year. In this event, the average adjusted basis will be determined upon a more appropriate basis. If production assets are used to produce inventory sold in Section 863 Sales and are also used to produce other property during the taxable year, the portion of its adjusted basis that is included in the fraction described in paragraph (c)(1)(ii)(A) of this section will be determined under any method that reasonably reflects the portion of the assets that produces inventory sold in Section 863 Sales. For example, the portion of such an asset that is included in the formula may be determined by multiplying the asset's average adjusted basis by a fraction, the numerator of which is the gross receipts from sales of inventory from Section 863 Sales produced by the asset, and the denominator of which is the gross receipts from all property produced by that asset.

(iii) *Anti-abuse rule.* The purpose of this paragraph (c)(1) is to attribute the source of the taxpayer's production income to the location of the taxpayer's production activity. Therefore, if the taxpayer has entered into or structured one or more transactions with a principal purpose of reducing its U.S. tax liability by manipulating the formula described in paragraph (c)(1)(ii)(A) of this section in a manner inconsistent with the purpose of this paragraph (c)(1), the District Director may make appropriate adjustments so that the source of the taxpayer's income from production activity more clearly reflects the source of that income.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (c)(1):

Example 1. Source of production income. (i) A, a U.S. corporation, produces widgets that are sold both within the United States and within a foreign country. The initial manufacture of all widgets occurs in the United States. The second stage of production of widgets that are sold within a foreign country is completed within the country of sale.

A's U.S. plant and machinery which is involved in the initial manufacture of the widgets has an average adjusted basis of $200. A also owns warehouses used to store work-in-process. A owns foreign equipment with an average adjusted basis of $25. A's gross receipts from all sales of widgets is $100, and its gross receipts from export sales of widgets is $25. Assume that apportioning average adjusted basis using gross receipts is reasonable. Assume A's cost of goods sold from the sale of widgets in the foreign countries is $13 and thus, its gross income from widgets sold in foreign countries is $12. A uses the 50/50 method to divide its gross income between production activity and sales activity.

(ii) A determines its production gross income from sources without the United States by multiplying one-half of A's $12 of gross income from sales of widgets in foreign countries, or $6, by a fraction, the numerator of which is all relevant foreign production assets, or $25, and the denominator of which is all relevant production assets, or $75 ($25 foreign assets + ($200 U.S. assets × $25 gross receipts from export sales/$100 gross receipts from all sales)). Therefore, A's gross production income from sources without the United States is $2 ($6 × ($25/$75)).

Example 2. Location of intangible property. Assume the same facts as *Example 1,* except that A employs a patented process that applies only to the initial production of widgets. In computing the formula used to determine the source of income from production activity, A's patent, if it has an average adjusted basis, would be located in the United States.

Example 3. Anti-abuse rule. (i) Assume the same facts as *Example 1.* A sells its U.S. assets to B, an unrelated U.S. corporation, with a principal purpose of reducing its U.S. tax liability by manipulating the property fraction. A then leases these assets from B. After this transaction, under the general rule of paragraph (c)(1)(ii) of this section, all of A's production income would be considered from sources without the United States, because all of A's relevant production assets are located within a foreign country. Since the leased property is not owned by the taxpayer, it is not included in the fraction.

(ii) Because A has entered into a transaction with a principal purpose of reducing its U.S. tax liability by manipulating the formula described in paragraph (c)(1)(ii)(A) of this section, A's income must be adjusted to more clearly reflect the source of that income. In this case, the District Director may redetermine the source of A's production income by ignoring the sale-leaseback transactions.

(2) *Income attributable to sales activity.* The source of the taxpayer's income that is attributable to sales activity will be determined under the provisions of §1.861–7(c). However, notwithstanding any other provision, for purposes of section 863, the place of sale will be presumed to be the United States if personal property is wholly produced in the United States and the property is sold for use, consumption, or disposition in the United States. See §1.864–6(b)(3)(ii) to determine the country of use, consumption, or disposition. Also, in applying this paragraph, property will be treated as wholly produced in the United States if it is subject to no more than packaging, repackaging, labeling, or other minor assembly operations outside the United States, within the meaning of §1.954–3(a)(4)(iii) (property manufactured or produced by a controlled foreign corporation).

(d) *Determination of source of taxable income.* Once the source of gross income has been determined under paragraph (c) of this section, the taxpayer must properly allocate and apportion separately under §§1.861–8 through 1.861–14T the amounts of its expenses, losses, and other deductions to its respective amounts of gross income from Section 863 Sales determined separately under each method described in paragraph (b) of this section. In addition, if the taxpayer deducts expenses for research and development under section 174 that may be attributed to its Section 863 Sales under §1.861–8(e)(3), the taxpayer must separately allocate or apportion expenses, losses, and other deductions to its respective amounts of gross income from each relevant product category that the taxpayer uses in applying the rules of §1.861–8(e)(3)(i)(A). In the case of gross income from Section 863 Sales determined under the IFP method or the books and records method, the rules of §§1.861–8 through 1.861–14T must apply to properly allocate or apportion amounts of expenses, losses and other deductions allocated and apportioned to such gross income between gross income from sources within and without the United States. In the case of gross income from Section 863 Sales determined under the 50/50 method, the amounts of expenses, losses, and other deductions allocated and apportioned to such gross income must be apportioned between sources within and without the United States pro rata based on the relative amounts of gross income from sources within and without the United States determined under the 50/50 method. Research and experimental expenditures qualifying under § 1.861–17 are allocated under that section, and are not allocated and apportioned pro rata under the 50/50 method.

(e) *Election and reporting rules*—(1) *Elections under paragraph (b) of this section.* If a taxpayer does not elect a method specified in paragraph (b) (2) or (3) of this section, the taxpayer must apply the method specified in paragraph (b)(1) of this section. The taxpayer may elect to apply the method specified in paragraph (b)(2) of this section by using the method on a timely filed original return (including extensions). A taxpayer may elect to apply the method specified in paragraph (b)(3) of this section by using the method on a timely filed original return (including extensions), but only if the taxpayer has received permission from the District Director to apply that method. Once a method under paragraph (b) of this section has been used, that method must be used in later taxable years unless the Commissioner consents to a change. However, if a taxpayer elects to change to or from the method specified in paragraph (b)(3) of this section, the taxpayer must obtain permission from the District Director instead of the Commissioner. Permission to change methods from one year to another year will not be withheld unless the change would result in a substantial distortion of the source of the taxpayer's income.

(2) *Disclosure on tax return.* A taxpayer who uses one of the methods described in paragraph (b) of this section must fully explain in a statement attached to the return the methodology used, the circumstances justifying use of that methodology, the extent that sales are aggregated, and the amount of income so allocated.

(f) *Income partly from sources within a possession of the United States*—(1) *In general.* This paragraph (f) relates to gains, profits, and income, which are treated as derived partly from sources within the United States and partly from sources within a possession of the United States (Section 863 Possession Sales). This paragraph (f) applies to determine the source of income derived from the sale of inventory produced (in whole or in part) by the taxpayer within the United States and sold within a possession, or produced (in whole or in part) by a taxpayer in a possession and sold within the United States (Possession Production Sales). It also applies to determine the source of income derived from the purchase of personal property within a possession of the United States and its sale within the United States (Possession Purchase Sales). A taxpayer subject to this paragraph (f) must divide gross income from Section 863 Possession Sales using one of the methods described in either paragraph (f)(2)(i) of this section (in the case of Possession Production Sales) or paragraph (f)(3)(i) of this section (in the case of Possession Purchase Sales). Once a taxpayer has elected a method, the taxpayer must separately apply that method to the applicable category of Section 863 Possession Sales in the United States and to those in a possession. The source of gross income from each type of activity must then be determined under either paragraph (f)(2)(ii) or (3)(ii) of this section, as appropriate. The source of taxable income from Section 863 Possession Sales is determined under paragraph (f)(4) of this section. The taxpayer must apply the rules for computing gross and taxable income by aggregating all Section 863 Possession Sales to which a method in this section applies after separately applying that method to Section 863 Possession Sales in the United States and to Section 863 Possession Sales in a possession. This section does not apply to determine the source of a taxpayer's gross income derived from a sale of inventory purchased from a corporation that has an election in effect under section 936, if the taxpayer's income from sales of that inventory is taken into account to determine benefits under section 936 for the section 936 corporation. For rules to be applied to determine the source of such income, see § 1.936–6(a)(5) Q&A 7a and 1.936–6(b)(1) Q&A 13.

(2) *Allocation or apportionment for Possession Production Sales*—(i) *Methods for determining the source of gross income for Possession Production Sales*—(A) *Possession 50/50 method.* Under the possession

50/50 method, gross income from Possession Production Sales is allocated between production activity and business sales activity as described in this paragraph (f)(2)(i)(A). Under the possession 50/50 method, one-half of the taxpayer's gross income will be considered income attributable to production activity and the source of that income will be determined under the rules of paragraph (f)(2)(ii)(A) of this section. The remaining one-half of such gross income will be considered income attributable to business sales activity and the source of that income will be determined under the rules of paragraph (f)(2)(ii)(B) of this section.

(B) *IFP method.* In lieu of the possession 50/50 method, a taxpayer may elect the independent factory price (IFP) method. Under the IFP method, gross income from Possession Production Sales is allocated to production activity or sales activity using the IFP method, as described in paragraph (b)(2) of this section, if an IFP is fairly established under the rules of paragraph (b)(2) of this section. See paragraphs (f)(2)(ii)(A) and (C) of this section for rules for determining the source of gross income attributable to production activity and sales activity.

(C) *Books and records method.* A taxpayer may elect to allocate gross income using the books and records method described in paragraph (b)(3) of this section, if it has received in advance the permission of the District Director having audit responsibility over its return. See paragraph (f)(2)(ii) of this section for rules for determining the source of gross income.

(ii) *Determination of source of gross income from production, business sales, and sales activity*—(A) *Gross income attributable to production activity.* The source of gross income from production activity is determined under the rules of paragraph (c)(1) of this section, except that the term possession is substituted for foreign country wherever it appears.

(B) *Gross income attributable to business sales activity*—(*1*) *Source of gross income.* Gross income from the taxpayer's business sales activity is sourced in the possession in the same proportion that the amount of the taxpayer's business sales activity for the taxable year within the possession bears to the amount of the taxpayer's business sales activity for the taxable year both within the possession and outside the possession, with respect to Possession Production Sales. The remaining income is sourced in the United States.

(*2*) *Business sales activity.* For purposes of this paragraph (f)(2)(ii)(B), the taxpayer's business sales activity is equal to the sum of—

(*i*) The amounts for the taxable period paid for wages, salaries, and other compensation of employees, and other expenses attributable to Possession Production Sales (other than amounts that are nondeductible under section 263A, interest, and research and development); and

(*ii*) Possession Production Sales for the taxable period.

(*3*) *Location of business sales activity.* For purposes of determining the location of the taxpayer's business activity within a possession, the following rules apply:

(*i*) *Sales.* Receipts from gross sales will be attributed to a possession under the provisions of paragraph (c)(2) of this section.

(*ii*) *Expenses.* Expenses will be attributed to a possession under the rules of §§1.861–8 through 1.861–14T.

(C) *Gross income attributable to sales activity.* The source of the taxpayer's income that is attributable to sales activity, as determined under the IFP method or the books and records method, will be determined under the provisions of paragraph (c)(2) of this section.

(3) *Allocation or apportionment for Possession Purchase Sales*—(i) *Methods for determining the source of gross income for Possession Purchase Sales*—(A) *Business activity method.* Gross income from Possession Purchase Sales is allocated in its entirety to the taxpayer's business activity, and is then apportioned between U.S. and possession sources under paragraph (f)(3)(ii) of this section.

(B) *Books and records method.* A taxpayer may elect to allocate gross income using the books and records method described in paragraph (b)(3) of this section, subject to the conditions set forth in paragraph (b)(3) of this section. See paragraph (f)(2)(ii) of this section for rules for determining the source of gross income.

(ii) *Determination of source of gross income from business activity*—(A) *Source of gross income.* Gross income from the taxpayer's business activity is sourced in the possession in the same proportion that the amount of the taxpayer's business activity for the taxable year within the possession bears to the amount of the taxpayer's business activity for the taxable year both within the possession and outside the possession, with respect to Possession Purchase Sales. The remaining income is sourced in the United States.

(B) *Business activity.* For purposes of this paragraph (f)(3)(ii), the taxpayer's business activity is equal to the sum of—

(*1*) The amounts for the taxable period paid for wages, salaries, and other compensation of employees, and other expenses attributable to Possession Purchase Sales (other than amounts that are nondeductible under section 263A, interest, and research and development);

(*2*) Cost of goods sold attributable to Possession Purchase Sales during the taxable period; and

(*3*) Possession Purchase Sales for the taxable period.

(C) *Location of business activity.* For purposes of determining the location of the taxpayer's business activity within a possession, the following rules apply:

(*1*) *Sales.* Receipts from gross sales will be attributed to a possession under the provisions of paragraph (c)(2) of this section.

(*2*) *Cost of goods sold.* Payments for cost of goods sold will be properly attributable to gross receipts from sources within the possession only to the extent that the property purchased was manufactured, produced, grown, or extracted in the possession (within the meaning of section 954(d)(1)(A)).

(*3*) *Expenses.* Expenses will be attributed to a possession under the rules of §§ 1.861–8 through 1.861–14T.

(iii) *Examples.* The following examples illustrate the rules of paragraph (f)(3)(ii) of this section relating to the determination of source of gross income from business activity:

Example 1. (i) U.S. Co. purchases in a possession product X for $80 from A. A manufactures X in the possession. Without further production, U.S. Co. sells X in the United States for $100. Assume U.S. Co. has sales and administrative expenses in the possession of $10.

(ii) To determine the source of U.S. Co.'s gross income, the $100 gross income from sales of X is allocated entirely to U.S. Co.'s business activity. Forty-seven dollars of U.S. Co.'s gross income is sourced in the possession. [Possession expenses ($10) plus possession purchases (i.e., cost of goods sold) ($80) plus possessions sales ($0), divided by total expenses ($10) plus total purchases ($80) plus total sales ($100).] The remaining $53 is sourced in the United States.

Example 2. (i) Assume the same facts as in *Example 1,* except that A manufactures X outside the possession.

(ii) To determine the source of U.S. Co.'s gross income, the $100 gross income is allocated entirely to U.S. Co.'s business activity. Five dollars of U.S. Co.'s gross income is sourced in the possession. [Possession expenses ($10) plus possession purchases ($0) plus possession sales ($0), divided by total expenses ($10) plus total purchases ($80) plus total sales ($100).] The $80 purchase is not included in the numerator used to determine U.S. Co.'s business activity in the possession, since product X was not manufactured in the possession. The remaining $95 is sourced in the United States.

(4) *Determination of source of taxable income.* Once the source of gross income has been determined under paragraph (f)(2) or (3) of this section, the taxpayer must properly allocate and apportion separately under §§ 1.861–8 through 1.861–14T the amounts of its expenses, losses, and other deductions to its respective amounts of gross income from Section 863 Possession Sales determined separately under each method described in paragraph (f)(2) or (3) of this section. In addition, if the taxpayer deducts expenses for research and development under section 174 that may be attributed to its Section 863 Possession Sales under § 1.861–17, the taxpayer must separately allocate or apportion expenses, losses, and other deductions to its respective amounts of gross income from each relevant product category that the taxpayer uses in applying the rules of § 1.861–17. Thus, in the case of gross income from Section 863 Possession Sales determined under the IFP method or books and records method, a taxpayer must apply the rules of §§ 1.861–8 through 1.861–14T to

properly allocate or apportion amounts of expenses, losses and other deductions, allocated and apportioned to such gross income, between gross income from sources within and without the United States. However, in the case of gross income from Possession Production Sales determined under the possessions 50/50 method or gross income from Possession Purchase Sales computed under the business activity method, the amounts of expenses, losses, and other deductions allocated and apportioned to such gross income must be apportioned between sources within and without the United States pro rata based on the relative amounts of gross income from sources within and without the United States determined under those methods, except that the rules regarding the allocation and apportionment of research and experimental expenditures in §1.861–17 shall apply to such expenditures of taxpayers using the 50/50 method.

(5) *Special rules for partnerships.* In applying the rules of this paragraph (f) to transactions involving partners and partnerships, the rules of paragraph (g) of this section apply.

(6) *Election and reporting rules*—(i) *Elections under paragraph (f)(2) or (3) of this section.* If a taxpayer does not elect one of the methods specified in paragraph (f)(2) or (3) of this section, the taxpayer must apply the possession 50/50 method in the case of Possession Production Sales or the business activity method in the case of Possession Purchase Sales. The taxpayer may elect to apply a method specified in either paragraph (f)(2) or (3) of this section by using the method on a timely filed original return (including extensions). Once a method has been used, that method must be used in later taxable years unless the Commissioner consents to a change. Permission to change methods from one year to another year will be granted unless the change would result in a substantial distortion of the source of the taxpayer's income.

(ii) *Disclosure on tax return.* A taxpayer who uses one of the methods described in paragraph (f)(2) or (3) of this section must fully explain in a statement attached to the tax return the methodology used, the circumstances justifying use of that methodology, the extent that sales are aggregated, and the amount of income so allocated.

(g) *Special rules for partnerships*—(1) *General rule.* For purposes of §1.863–1 and this section, a taxpayer's production or sales activity does not include production and sales activities conducted by a partnership of which the taxpayer is a partner either directly or through one or more partnerships, except as otherwise provided in paragraph (g)(2) of this section.

(2) *Exceptions*—(i) *In general.* For purposes of determining the source of the partner's distributive share of partnership income or determining the source of the partner's income from the sale of inventory property which the partnership distributes to the partner in kind, the partner's production or sales activity includes an activity conducted by the partnership. In addition, the production activity of a partnership includes the production activity of a taxpayer that is a partner either directly or through one or more partnerships, to the extent that the partner's production activity is related to inventory that the partner contributes to the partnership in a transaction described under section 721.

(ii) *Attribution of production assets to or from a partnership.* A partner will be treated as owning its proportionate share of the partnership's production assets only to the extent that, under paragraph (g)(2)(i) of this section, the partner's activity includes production activity conducted through a partnership. A partner's share of partnership assets will be determined by reference to the partner's distributive share of partnership income for the year attributable to such production assets. Similarly, to the extent a partnership's activities include the production activities of a partner, the partnership will be treated as owning the partner's production assets related to the inventory that is contributed in kind to the partnership. See paragraph (c)(1)(ii)(B) of this section for rules apportioning the basis of assets to Section 863 Sales.

(iii) *Basis.* For purposes of this section, in those cases where the partner is treated as owning its proportionate share of the partnership's production assets, the partner's basis in production assets held through a partnership shall be determined by reference to the partnership's adjusted basis in its assets (including a partner's special basis adjustment, if any, under section 743). Similarly, a partnership's basis in a partner's production assets is determined with reference to the partner's adjusted basis in its assets.

(iv) *Separate application of methods.* If, under paragraph (g)(2) of this section, a partner is treated as conducting the activity of a partnership, and is treated as owning its proportionate share of a partnership's production assets, a partner must apply the method it has elected under paragraph (b) of this section separately to Section 863 Sales described in this paragraph (g) and all other Section 863 Sales.

(3) *Examples.* The following examples illustrate the rules of this paragraph (g):

Example 1. Distributive share of partnership income. A, a U.S. corporation, forms a partnership in the United States with B, a country X corporation. A and B each have a 50 percent interest in the income, gains, losses, deductions and credits of the partnership. The partnership is engaged in the manufacture and sale of widgets. The widgets are manufactured in the partnership's plant located in the United States and are sold by the partnership outside the United States. The partnership owns the manufacturing facility and all other production assets used to produce the widgets. A's distributive share of partnership income includes 50 percent of the sales income from these sales. In applying the rules of section 863 to determine the source of its distributive share of partnership income from the export sales of widgets, A is treated as carrying on the activity of the partnership related to production of these widgets and as owning a proportionate share of the partnership's assets related to production of the widgets, based upon its distributive share of partnership income.

Example 2. Distribution in kind. Assume the same facts as in *Example 1* except that the partnership, instead of selling the widgets, distributes the widgets to A and B. A then further processes the widgets and then sells them outside the United States. In determining the source of the income earned by A on the sales outside the United States, A is treated as conducting the activities of the partnership related to production of the distributed widgets. Thus, the source of gross income on the sale of the widgets is determined under section 863 and these regulations. A applies the 50/50 method described in paragraph (b)(1) of this section to determine the source of income from the sales. In applying paragraph (c)(1) of this section, A is treated as owning its proportionate share of the partnership's production assets based upon its distributive share of partnership income.

(h) *Effective dates.* The rules of this section apply to taxable years beginning after December 30, 1996. However, taxpayers may apply these regulations for taxable years beginning after July 11, 1995, and on or before December 30, 1996. For years beginning before December 30, 1996, see §§ 1.863–3A and 1.863–3AT. However, the rules of paragraph (f) of this section apply to taxable years beginning on or after November 13, 1998.

[T.D. 8687, 61 FR 60547, Nov. 29, 1996; 61 FR 65323, Dec. 12, 1996, as amended by T.D. 8786, 63 FR 55023, Oct. 14, 1998]

REGULATIONS APPLICABLE TO TAXABLE YEARS PRIOR TO DECEMBER 30, 1996

§ 1.863–3A Income from the sale of personal property derived partly from within and partly from without the United States.

(a) *General*—(1) *Classes of income.* Income from the sale of property to which paragraph (b) (2) and (3) of § 1.863–2 applies is divided into two classes for purposes of this section, namely, income which is treated as derived partly from sources within the United States and partly from sources within a foreign country, and income which is treated as derived partly from sources within the United States and partly from sources within a possession of the United States.

(2) *Definition.* For purposes of this section, the word ''produced'' includes created, fabricated, manufactured, extracted, processed, cured, or aged. For determining the time and place of sale of personal property for purposes of this section, see paragraph (c) of § 1.861–7.

(b) *Income partly from sources within a foreign country*—(1) *General.* This paragraph relates to gains, profits, and income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country, or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States. Pursuant to section 863(b) such items shall be treated as derived partly from sources within the United States and partly from sources within a foreign country.

(2) *Allocation or apportionment.* The taxable income from sources within the United States, in the case of the items to which this paragraph applies, shall be determined according to the examples set forth in this subparagraph. For such purposes, the deductions for the personal exemptions shall not be taken into account, but the special deductions described in paragraph (c) of §1.861–8 shall be taken into account.

Example 1. Where the manufacturer or producer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish fairly an independent factory or production price—or shows to the satisfaction of the district director (or, if applicable, the Director of International Operations) that such an independent factory or production price has been otherwise established—unaffected by considerations of tax liability and the selling or distributing branch or department of the business is located in a different country from that in which the factory is located or the production carried on, the taxable income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling department at the independent factory price so established. In all such cases the basis of the accounting shall be fully explained in a statement attached to the return for the taxable year.

Example 2. (i) and (ii) [Reserved] For guidance, see §863–3T(b)(2) *Example* (2)(i) and (ii).

(iii) The term ‘‘gross sales’’, as used in this example, refers only to the sales of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States.

(iv) The term ‘‘property’’, as used in this example, includes only the property held or used to produce income which is derived from such sales. Such property should be taken at its actual value, which in the case of property valued or appraised for purposes of inventory, depreciation, depletion, or other purposes of taxation shall be the highest amount at which so valued or appraised, and which in other cases shall be deemed to be its book value in the absence of affirmative evidence showing such value to be greater or less than the actual value. The average value during the taxable year or period shall be employed. The average value of property as above prescribed at the beginning and end of the taxable year or period ordinarily may be used, unless by reason of material changes during the taxable year or period such average does not fairly represent the average for such year or period, in which event the average shall be determined upon a monthly or daily basis.

(v) Bills and accounts receivable shall (unless satisfactory reason for a different treatment is shown) be assigned or allocated to the United States when the debtor resides in the United States, unless the taxpayer has no office, branch, or agent in the United States.

Example 3. Application for permission to base the return upon the taxpayer’s books of account will be considered by the district director (or, if applicable, the Director of International Operations) in the case of any taxpayer who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the processes or formulas herein prescribed the taxable income derived from sources within the United States.

(c) *Income partly from sources within a possession of the United States*—(1) *General.* This paragraph relates to gains, profits, and income which, pursuant to section 863(b), are treated as derived partly from sources within the United States and partly from sources within a possession of the United States. The items so treated are described in subparagraphs (3) and (4) of this paragraph.

(2) *Allocation or apportionment.* The taxable income from sources within the United States, in the case of the items to which this paragraph applies, shall be determined according to the examples set forth in subparagraphs (3) and (4) of this paragraph. For such purposes, the deductions for the personal exemptions shall not be taken into account, but the special deductions described in paragraph (c) of §1.861–8 shall be taken into account.

(3) *Personal property produced and sold.* This subparagraph relates to gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced

(in whole or in part) by the taxpayer within a possession of the United States and sold within the United States.

Example 1. Same as example 1 under paragraph (b)(2) of this section.

Example 2. (i) Where an independent factory or production price has not been established as provided under example 1, the taxable income shall first be computed by deducting from the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States, the expenses, losses, or other deductions properly allocated and apportioned thereto in accordance with the rules set forth in § 1.861–8.

(ii) Of the amount of taxable income so determined, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the possession of the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States, and the denominator of which consists of the value of the taxpayer's property both within the United States and within the possession of the United States. The remaining one-half of such taxable income shall be apportioned in accordance with the total business of the taxpayer within the United States and within the possession of the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the amount of the taxpayer's business for the taxable year or period within the United States, and the denominator of which consists of the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States.

(iii) ''The business of the taxpayer'', as used in this example, shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies consumed in the regular course of business, plus the amounts received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the production (in whole or in part) of personal property within the United States and its sale within a possession of the United States or to the production (in whole or in part) of personal property within a possession of the United States and its sale within the United States. The term ''property'', as used in this example, includes only the property held or used to produce income which is derived from such sales.

Example 3. Same as example 3 under paragraph (b)(2) of this section.

(4) *Personal property purchased and sold.* This subparagraph relates to gross income derived from the purchase of personal property within a possession of the United States and its sale within the United States.

Example 1. (i) The taxable income shall first be computed by deducting from such gross income the expenses, losses, or other deductions properly allocated or apportioned thereto in accordance with the rules set forth in § 1.861–8.

(ii) The amount of taxable income so determined shall be apportioned in accordance with the total business of the taxpayer within the United States and within the possession of the United States, the portion attributable to sources within the United States being that percentage of such taxable income which the amount of the taxpayer's business for the taxable year or period within the United States bears to the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States.

(iii) The ''business of the taxpayer'', as that term is used in this example, shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies sold or consumed in the regular course of business, plus the amount received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the purchase of personal property within a possession of the United States and its sale within the United States.

Example 2. Same as example 3 under paragraph (b)(2) of this section.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7456, 42 FR 1214, Jan. 6, 1977; T.D. 8228, 53 FR 35506, Sept. 14, 1988. Redesignated by T.D. 8687, 61 FR 60545, Nov. 29, 1996]

§ 1.863–3AT Income from the sale of personal property derived partly from within and partly from without the United States (temporary regulations).

(a) [Reserved]

(b) *Income partly from sources within a foreign country.*

(1) [Reserved]

(2) *Allocation or apportionment.*

Example 1. [Reserved]

Example 2. (i) Where an independent factory or production price has not been established as provided under *Example* (1), the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States shall be computed.

(ii) Of this gross amount, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction, the numerator of which consists of the value of the taxpayer's property within the United States and the denominator of which consists of the value of the taxpayer's property both within the United States and within the foreign country. The remaining one-half of such gross income shall be apportioned in accordance with the gross sales of the taxpayer within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the taxpayer's gross sales for the taxable year or period within the United States, and the denominator of which consists of the taxpayer's gross sales for the taxable year or period both within the United States and within the foreign country. Deductions from gross income that are allocable and apportionable to gross income described in paragraph (i) of this *Example* 2 shall be apportioned between the United States and foreign source portions of such income, as determined under this paragraph (ii), on a pro rata basis, without regard to whether the deduction relates primarily or exclusively to the production of property or to the sale of property.

(b)(2) *Example* (2)(iii) through (c)(4) [Reserved]

[T.D. 8228, 53 FR 35506, Sept. 14, 1988. Redesignated by T.D. 8687, 61 FR 60545, Nov. 29, 1996]

§1.863–4 Certain transportation services.

(a) *General.* A taxpayer carrying on the business of transportation service (other than an activity giving rise to transportation income described in section 863(c) or to income subject to other specific provisions of this title) between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(b) *Gross income.* The gross income from sources within the United States derived from such services shall be determined by taking such a portion of the total gross revenues therefrom as (1) the sum of the costs or expenses of such transportation business carried on by the taxpayer within the United States and a reasonable return upon the property used in its transportation business while within the United States bears to (2) the sum of the total costs or expenses of such transportation business carried on by the taxpayer and a reasonable return upon the total property used in such transportation business. Revenues from operations incidental to transportation services, such as the sale of money orders, shall be apportioned on the same basis as direct revenues from transportation services.

(c) *Allocation of costs or expenses.* In allocating the total costs or expenses incurred in such transportation business, costs or expenses incurred in connection with that part of the services which was wholly rendered in the United States shall be assigned to the cost of transportation business within the United States. For example, expenses of loading and unloading in the United States, rentals, office expenses, salaries, and wages wholly incurred for services rendered to the taxpayer in the United States belong to this class. Costs and expenses incurred in connection with services rendered partly within and partly without the United States may be prorated on a reasonable basis between such services. For example, ship wages, charter money, insurance, and supplies chargeable to voyage expenses shall ordinarily be prorated for each voyage on the basis of the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days on the voyage; and fuel consumed on each voyage may be prorated on the basis of the proportion which the number of miles sailed within the territorial limits of the United States bears to the total number of miles sailed on the voyage. For other expenses entering into the cost of services, only such expenses as are allowable deductions under the internal revenue laws shall be taken into account.

(d) *Items not included as costs or expenses*—(1) *Taxes and interest.* Income, war profits, and excess profits taxes shall not be regarded as costs or expenses for the purpose of determining the proportion of gross income from sources within the United States; and, for such purpose, interest and other expenses for the use of borrowed capital shall not be taken into the cost of services rendered, for the reason that the return upon the property used measures the extent to which such borrowed capital is the source of the income. See paragraph (f)(2) of this section.

(2) *Other business activity and general expenses.* If a taxpayer subject to this section is also engaged in a business other than that of providing transportation service between points in the United States and points outside the United States, the costs and expenses, including taxes, properly apportioned or allocated to such other business shall be excluded both from the deductions and from the apportionment process prescribed in paragraph (c) of this section; but, for the purpose of determining taxable income, a ratable part of any general expenses, losses, or deductions, which cannot definitely be allocated to some item or class of gross income, may be deducted from the gross income from sources within the United States after the amount of such gross income has been determined. Such ratable part shall ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income. See paragraph (f)(3) of this section.

(3) *Personal exemptions and special deductions.* The deductions for the personal exemptions, and the special deductions described in paragraph (c) of § 1.861–8, shall not be taken into account for purposes of paragraph (c) of this section.

(e) *Property used while within the United States*—(1) *General.* The value of the property used shall be determined upon the basis of cost less depreciation. Eight percent may ordinarily be taken as a reasonable rate of return to apply to such property. The property taken shall be the average property employed in the transportation service between points in the United States and points outside the United States during the taxable year.

(2) *Average property.* For ships, the average shall be determined upon a daily basis for each ship, and the amount to be apportioned for each ship as assets employed within the United States shall be computed upon the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days the ship was in service during the taxable period. For other assets employed in the transportation business, the average of the assets at the beginning and end of the taxable period ordinarily may be taken, but if the average so obtained does not, by reason of material changes during the taxable year, fairly represent the average for such year either for the assets employed in the transportation business in the United States or in total, the average must be determined upon a monthly or daily basis.

(3) *Current assets.* Current assets shall be decreased by current liabilities and allocated to services between the United States and foreign countries and to other services. The part allocated to services between the United States and foreign countries shall be based on the proportion which the gross receipts from such services bear to the gross receipts from all services. The amount so allocated to services between the United States and foreign countries shall be further allocated to services rendered within the United States and to services rendered without the United States. The portion allocable to services rendered within the United States shall be based on the proportion which the expenses incurred within the territorial limits of the United States bear to the total expenses incurred in services between the United States and foreign countries.

(f) *Taxable income*—(1) *General.* In computing taxable income from sources within the United States there shall be allowed as deductions from the gross income from such sources, determined in accordance with paragraph (b) of this section, (i) the expenses of the transportation business carried on within the United States (as determined under paragraphs (c) and (d) of this section) and (ii) the expenses and deductions determined in accordance with this paragraph.

(2) *Interest and taxes.* Interest and income, war-profits, and excess profits taxes shall be excluded from the apportionment process, as indicated in paragraph (d) of this section; but, for the purpose of computing taxable income there may be deducted from the gross income from sources within the United States, after the amount of such gross income has been determined, a ratable part of all interest deductible under section 163 and of all income, war-profits, and excess profits taxes deductible under section 164, paid or accrued in respect of the business of transportation service between points in the United States and points outside the United States. The ratable part shall ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income, from such transportation service.

(3) *General expenses.* General expenses, losses, or deductions shall be deducted under this paragraph to the extent indicated in paragraph (d)(2) of this section.

(4) *Personal exemptions.* The deductions for the personal exemptions shall be allowed under this paragraph to the same extent as provided by paragraph (b) of §1.861–8.

(5) *Special deductions.* The special deductions allowed in the case of a corporation by sections 241, 922, and 941 shall be allowed under this paragraph to the same extent as provided by paragraph (c) of §1.861–8.

(g) *Allocation based on books of account.* Application for permission to base the return upon the taxpayer's books of account will be considered by the district director (or, if applicable, the Director of International Operations) in the case of any taxpayer subject to this section, who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which more clearly reflects the income derived from sources within the United States than does the process prescribed by paragraphs (b) to (f), inclusive, of this section.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 8687, 61 FR 60550, Nov. 29, 1996]

§1.863–6 Income from sources within a foreign country or possession of the United States.

The principles applied in §§1.861–1 to 1.863–5, inclusive, for determining the gross and the taxable income from sources within and without the United States shall generally be applied, for purposes of the income tax, in determining the gross and the taxable income from sources within and without a foreign country, or within and without a possession of the United States. This section shall not apply, however, to the extent it is determined by applying §1.863–3 that a portion of the taxable income is from sources within the United States and the balance of the taxable income is from sources within a foreign country or possession of the United States. In the application of this section the name of the particular foreign country or possession of the United States shall be substituted for the term ''United States'', and the term ''domestic'' shall be construed to mean created or organized in such foreign country or possession. In applying section 861 and the regulations thereunder for purposes of this section, references to sections 243, 245, and 931 shall be excluded, and the exception in section 861(a)(3) shall not apply. In the case of any item of income, the income from sources within a foreign country or possession of the United States shall not exceed the amount which, by applying any provision of §§1.861–1 to 1.863–5, inclusive, without reference to this section, is treated as income from sources without the United States.

[T.D. 7378, 40 FR 45435, Oct. 2, 1975]

§1.863–7 Allocation of income attributable to certain notional principal contracts under section 863(a).

(a) *Scope*—(1) *Introduction.* This section provides rules relating to the source and, in certain cases, the character of notional principal contract income. However, this section does not apply to income from a section 988 transaction within the meaning of section 988 and the regulations thereunder, relating to the treatment of certain nonfunctional currency transactions. Notional principal contract income is income attributable to a notional principal contract. A notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract, because a taxpayer cannot enter into a contract with itself.

(2) *Effective date.* This section applies to notional principal contract income includible in income on or after February 13, 1991. However, any taxpayer desiring to apply paragraph (b)(2)(iv) of this section to notional principal contract income includible in income prior to February 13, 1991, in lieu of temporary Income Tax Regulations § 1.863–7T(b)(2)(iv) may (on a consistent basis) so choose. See paragraph (c) of this section for an election to apply the rules of this section to notional principal contract income includible in income before December 24, 1986.

(b) *Source of notional principal contract income*—(1) *General rule.* Unless paragraph (b) (2) or (3) of this section applies, the source of notional principal contract income shall be determined by reference to the residence of the taxpayer as determined under section 988(a)(3)(B)(i).

(2) *Qualified business unit exception.* The source of notional principal contract income shall be determined by reference to the residence of a qualified business unit of a taxpayer if—

(i) The taxpayer's residence, determined under section 988(a)(3)(B)(i), is the United States;

(ii) The qualified business unit's residence, determined under section 988(a)(3)(B)(ii), is outside the United States;

(iii) The qualified business unit is engaged in the conduct of a trade or business where it is a resident as determined under section 988(a)(3)(B)(ii); and

(iv) The notional principal contract is properly reflected on the books of the qualified business unit. Whether a notional principal contract is properly reflected on the books of such qualified business unit is a question of fact. The degree of participation in the negotiation and acquisition of a notional principal contract shall be considered in this determination. Participation in connection with the negotiation or acquisition of a notional principal contract may be disregarded if the district director determines that a purpose for such participation was to affect the source of notional principal contract income.

(3) *Effectively connected notional principal contract income.* Notional principal contract income that under principles similar to those set forth in § 1.864–4(c) arises from the conduct of a United States trade or business shall be sourced in the United States and such income shall be treated as effectively connected to the conduct of a United States trade or business for purposes of sections 871(b) and 882(a)(1).

(c) *Election*—(1) *Eligibility and effect.* A taxpayer described in paragraph (b)(2)(i) of this section may make an election to apply the rules of this section to all, but not part, of the taxpayer's income attributable to notional principal contracts for all taxable years (or portion thereof) beginning before December 24, 1986, for which the period of limitations for filing a claim for refund under section 6511(a) has not expired. A taxpayer not described in paragraph (b)(2)(i) of this section that is engaged in trade or business within the United States may make an election to apply the rules of this section to all, but not part, of the taxpayer's income described in paragraph (b)(3) of this section for all taxable years (or portion thereof) beginning before December 24, 1986, for which the period of limitations for filing a claim for refund under section 6511(a) has not expired. If a taxpayer makes an election pursuant to this paragraph (c)(1) in the time and manner provided in paragraph (c) (2) and (3) of this section, then, with respect to such taxable years (or portion thereof), no tax shall be deducted or withheld under sections 1441 and 1442 with respect to payments made by the taxpayer pursuant to a notional principal contract the income attributable to which is subject to such election. The election may be revoked only with the consent of the Commissioner.

(2) *Time for making election.* The election specified in paragraph (c)(1) of this section shall be made by May 14, 1991.

(3) *Manner of making election.* The election described in paragraph (c)(1) of this section shall be made by attaching a statement to the tax return or an amended tax return for each taxable year beginning before December 24, 1986, in which the taxpayer accrued or received notional principal contract income. The statement shall—

(i) Contain the name, address, and taxpayer identifying number of the electing taxpayer;

(ii) Identify the election as a ‘‘Notional Principal Contract Election under §1.863–7’’; and

(iii) Specify each taxable year described in paragraph (c)(1) of this section in which payments were made.

(d) *Example.* The operation of this section is illustrated by the following example:

(1) On January 1, 1990, X, a calendar year domestic corporation, entered into an interest rate swap contract with FZ, an unrelated foreign corporation. X does not have a qualified business unit outside the United States. Under the contract, X is required to pay FZ fixed rate dollar amounts, and FZ is required to pay X floating rate dollar amounts, each determined solely by reference to a notional dollar denominated principal amount specified under the contract. The contract is a notional principal contract under §1.863–7(a) because the contract provides for the payment of amounts at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for a promise to pay similar amounts.

(2) Assume that during 1990 X had notional principal contract income of $100 in connection with the notional principal contract described in (1) above. Also assume that the contract provides that payments more than 30 days late give rise to a $5 fee, and that X receives such a fee in 1990. Under paragraph (b)(1) of this section, the source of X’s $100 of income attributable to the swap agreement is domestic. The $5 fee is not notional principal contract income.

(e) *Cross references.* See §1.861–9T(b) for the allocation of expense to certain notional principal contracts. For rules relating to the source of income from nonfunctional currency notional principal contracts, see §1.9 88–4T. For rules relating to the taxable amount of notional principal contract income allocable under this section to sources inside or outside the United States, see §1.863–1(c).

[T.D. 8330, 56 FR 1362, Jan. 14, 1991]

§1.864–1 Meaning of sale, etc.

For purposes of §§1.861 through 1.864–7, the word ‘‘sale’’ includes ‘‘exchange’’; the word ‘‘sold’’ includes ‘‘exchanged’’; the word ‘‘produced’’ includes ‘‘created’’, ‘‘fabricated’’, ‘‘manufactured’’, ‘‘extracted’’, ‘‘processed’’, ‘‘cured’’, and ‘‘aged’’.

[T.D. 6948, 33 FR 5090, Mar. 28, 1968]

§1.864–2 Trade or business within the United States.

(a) *In general.* As used in part I (section 861 and following) and part II (section 871 and following), subchapter N, chapter 1 of the Code, and chapter 3 (section 1441 and following) of the Code, and the regulations thereunder, the term ‘‘engaged in trade or business within the United States’’ does not include the activities described in paragraphs (c) and (d) of this section, but includes the performance of personal services within the United States at any time within the taxable year except to the extent otherwise provided in this section.

(b) *Performance of personal services for foreign employer*—(1) *Excepted services.* For purposes of paragraph (a) of this section, the term ‘‘engaged in trade or business within the United States’’ does not include the performance of personal services—

(i) For a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States at any time during the taxable year, or

(ii) For an office or place of business maintained in a foreign country or in a possession of the United States by an individual who is a citizen or resident of the United States or by a domestic partnership or a domestic corporation, by a nonresident alien individual who is temporarily present in the United

States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate gross amount of $3,000.

(2) *Rules of application.* (i) As a general rule, the term ''day'', as used in subparagraph (1) of this paragraph, means a calendar day during any portion of which the nonresident alien individual is physically present in the United States.

(ii) Solely for purposes of applying this paragraph, the nonresident alien individual, foreign partnership, or foreign corporation for which the nonresident alien individual is performing personal services in the United States shall not be considered to be engaged in trade or business in the United States by reason of the performance of such services by such individual.

(iii) In applying subparagraph (1) of this paragraph it is immaterial whether the services performed by the nonresident alien individual are performed as an employee for his employer or under any form of contract with the person for whom the services are performed.

(iv) In determining for purposes of subparagraph (1) of this paragraph whether compensation received by the nonresident alien individual exceeds in the aggregate a gross amount of $3,000, any amounts received by the individual from an employer as advances or reimbursements for travel expenses incurred on behalf of the employer shall be omitted from the compensation received by the individual, to the extent of expenses incurred, where he was required to account and did account to his employer for such expenses and has met the tests for such accounting provided in § 1.162–17 and paragraph (e)(4) of § 1.274–5. If advances or reimbursements exceed such expenses, the amount of the excess shall be included as compensation for personal services for purposes of such subparagraph. Pensions and retirement pay attributable to personal services performed in the United States are not to be taken into account for purposes of subparagraph (1) of this paragraph.

(v) See section 7701(a)(5) and § 301.7701–5 of this chapter (Procedure and Administration Regulations) for the meaning of ''foreign'' when applied to a corporation or partnership.

(vi) As to the source of compensation for personal services, see §§ 1.861–4 and 1.862–1.

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

Example 1. During 1967, A, a nonresident alien individual, is employed by the London office of a domestic partnership. A, who uses the calendar year as his taxable year, is temporarily present in the United States during 1967 for 60 days performing personal service in the United States for the London office of the partnership and is paid by that office a total gross salary of $2,600 for such services. During 1967, A is not engaged in trade or business in the United States solely by reason of his performing such personal services for the London office of the domestic partnership.

Example 2. The facts are the same as in example 1, except that A's total gross salary for the services performed in the United States during 1967 amounts to $3,500, of which $2,625 is received in 1967 and $875 is received in 1968. During 1967, is engaged in trade or business in the United States by reason of his performance of personal services in the United States.

(c) *Trading in stocks or securities.* For purposes of paragraph (a) of this section—

(1) *In general.* The term ''engaged in trade or business within the United States'' does not include the effecting of transactions in the United States in stocks or securities through a resident broker, commission agent, custodian, or other independent agent. This subparagraph shall apply to any taxpayer, including a broker or dealer in stocks or securities, except that it shall not apply if at any time during the taxable year the taxpayer has an office or other fixed place of business in the United States through which, or by the direction of which, the transactions in stocks or securities are effected. The volume of stock or security transactions effected during the taxable year shall not be taken into account in determining under this subparagraph whether the taxpayer is engaged in trade or business within the United States.

(2) *Trading for taxpayer's own account*—(i) *In general.* The term ''engaged in trade or business within the

United States'' does not include the effecting of transactions in the United States in stocks or securities for the taxpayer's own account, irrespective of whether such transactions are effected by or through—

(a) The taxpayer himself while present in the United States,

(b) Employees of the taxpayer, whether or not such employees are present in the United States while effecting the transactions, or

(c) A broker, commission agent, custodian, or other agent of the taxpayer, whether or not such agent while effecting the transactions is *(1)* dependent or independent, or *(2)* resident, nonresident, or present, in the United States, and irrespective of whether any such employee or agent has discretionary authority to make decisions in effecting such transactions. For purposes of this paragraph, the term ''securities'' means any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing; and the effecting of transactions in stocks or securities includes buying, selling (whether or not by entering into short sales), or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise, for the account and risk of the taxpayer, and any other activity closely related thereto (such as obtaining credit for the purpose of effectuating such buying, selling, or trading). The volume of stock of security transactions effected during the taxable year shall not be taken into account in determining under this subparagraph whether the taxpayer is engaged in trade or business within the United States. The application of this subdivision may be illustrated by the following example:

Example. A, a nonresident alien individual who is not a dealer in stocks or securities, authorizes B, an individual resident of the United States, as his agent to effect transactions in the United States in stocks and securities for the account of A. B is empowered with complete authority to trade in stocks and securities for the account of A and to use his own discretion as to when to buy or sell for A's account. This grant of discretionary authority from A to B is also communicated in writing by A to various domestic brokerage firms through which A ordinarily effects transactions in the United States in stocks or securities. Under the agency arrangement B has the authority to place orders with the brokers, and all confirmations are to be made by the brokers to B, subject to his approval. The brokers are authorized by A to make payments to B and to charge such payments to the account of A. In addition, B is authorized to obtain and advance the necessary funds, if any, to maintain credits with the brokerage firms. Pursuant to his authority B carries on extensive trading transactions in the United States during the taxable year through the various brokerage firms for the account of A. During the taxable year A makes several visits to the United States in order to discuss with B various aspects of his trading activities and to make necessary changes in his trading policy. A is not engaged in trade or business within the United States during the taxable year solely because of the effecting by B of transactions in the United States in stocks or securities during such year for the account of A.

(ii) *Partnerships.* A nonresident alien individual, foreign partnership, foreign estate, foreign trust, or foreign corporation shall not be considered to be engaged in trade or business within the United States solely because such person is a member of a partnership (whether domestic or foreign) which, pursuant to discretionary authority granted to such partnership by such person, effects transactions in the United States in stocks or securities for the partnership's own account or solely because an employee of such partnership, or a broker, commission agent, custodian, or other agent, pursuant to discretionary authority granted by such partnership, effects transactions in the United States in stocks or securities for the account of such partnership. This subdivision shall not apply, however, to any member of *(a)* a partnership which is a dealer in stocks or securities or *(b)* a partnership (other than a partnership in which, at any time during the last half of its taxable year, more than 50 percent of either the capital interest or the profits interest is owned, directly or indirectly, by five or fewer partners who are individuals) the principal business of which is trading in stocks or securities for its own account, if the principal office of such partnership is in the United States at any time during the taxable year. The principles of subdivision (iii) of this subparagraph for determining whether a foreign corporation has its principal office in the United States shall apply in determining under this subdivision whether a partnership has its principal office in the United States. See section 707(b)(3) and paragraph (b)(3) of § 1.707–1 for rules for determining the extent of the ownership by a partner of a capital interest or profits interest in a partnership. The application of this subdivision may be illustrated by the following examples:

Example 1. B, a nonresident alien individual, is a member of partnership X, the members of which are U.S. citizens, nonresident alien individuals, and foreign corporations. The principal business of partnership X is trading in stocks or securities for its own account. Pursuant to discretionary authority granted by B, partnership X effects transactions in the United States in stocks or securities for its own account. Partnership X is not a dealer in stocks or securities, and more than 50 percent of either the capital interest or the profits interest in partnership X is owned throughout its taxable year by five or fewer partners who are individuals. B is not engaged in trade or business within the United States solely by reason of such effecting of transactions in the United States in stocks or securities by partnership X for its own account.

Example 2. The facts are the same as in example 1, except that not more than 50 percent of either the capital interest or the profits interest in partnership X is owned throughout the taxable year by five or fewer partners who are individuals. However, partnership X does not maintain its principal office in the United States at any time during the taxable year. B is not engaged in trade or business within the United States solely by reason of the trading in stocks or securities by partnership X for its own account.

Example 3. The facts are the same as in example 1, except that, pursuant to discretionary authority granted by partnership X, domestic broker D effects transactions in the United States in stocks or securities for the account of partnership X. B is not engaged in trade or business in the United States solely by reason of such trading in stocks or securities for the account of partnership X.

(iii) *Dealers in stocks or securities and certain foreign corporations.* This subparagraph shall not apply to the effecting of transactions in the United States for the account of *(a)* a dealer in stocks or securities or *(b)* a foreign corporation (other than a corporation which is, or but for section 542(c)(7) or 543(b)(1)(C) would be, a personal holding company) the principal business of which is trading in stocks or securities for its own account, if the principal office of such corporation is in the United States at any time during the taxable year. Whether a foreign corporation's principal office is in the United States for this purpose is to be determined by comparing the activities (other than trading in stocks or securities) which the corporation conducts from its office or other fixed place of business located in the United States with the activities it conducts from its offices or other fixed places of business located outside the United States. For purposes of this subdivision, a foreign corporation is considered to have only one principal office, and an office of such corporation will not be considered to be its principal office merely because it is a statutory office of such corporation. For example, a foreign corporation which carries on most or all of its investment activities in the United States but maintains a general business office or offices outside the United States in which its management is located will not be considered as having its principal office in the United States if all or a substantial portion of the following functions is carried on at or from an office or offices located outside the United States:

(1) Communicating with its shareholders (including the furnishing of financial reports),

(2) Communicating with the general public,

(3) Soliciting sales of its own stock,

(4) Accepting the subscriptions of new stockholders,

(5) Maintaining its principal corporate records and books of account,

(6) Auditing its books of account,

(7) Disbursing payments of dividends, legal fees, accounting fees, and officers' and directors' salaries,

(8) Publishing or furnishing the offering and redemption price of the shares of stock issued by it,

(9) Conducting meetings of its shareholders and board of directors, and

(10) Making redemptions of its own stock.

The application of this subdivision may be illustrated by the following examples:

Example 1. (a) Foreign corporation X (not a corporation which is, or but for section

542(c)(7) or 543(b)(1)(C) would be, a personal holding company) was organized to sell its shares to nonresident alien individuals and foreign corporations and to invest the proceeds from the sale of such shares in stocks or securities in the United States. Foreign corporation X is engaged primarily in the business of investing, reinvesting, and trading in stocks or securities for its own account.

(b) For a period of three years, foreign corporation X irrevocably authorizes domestic corporation Y to exercise its discretion in effecting transactions in the United States in stocks or securities for the account and risk of foreign corporation X. Foreign corporation X issues a prospectus in which it is stated that its funds will be invested pursuant to an investment advisory contract with domestic corporation Y and otherwise advertises its services. Shares of foreign corporation X are sold to nonresident aliens and foreign corporations who are customers of the United States brokerage firms unrelated to domestic corporation Y or foreign corporation X. The principal functions performed for foreign corporation X by domestic corporation Y are the rendering of investment advice and the effecting of transactions in the United States in stocks or securities for the account of foreign corporation X. Moreover, domestic corporation Y occasionally communicates with prospective foreign investors in foreign corporation X (through speaking engagements abroad by management of domestic corporation Y, and otherwise) for the purpose of explaining the investment techniques and policies used by domestic corporation Y in investing the funds of foreign corporation X. However, domestic corporation Y does not participate in the day-to-day conduct of other business activities of foreign corporation X.

(c) Foreign corporation X maintains a general business office or offices outside the United States in which its management is permanently located and from which it carries on, except to the extent noted heretofore, the functions enumerated in *(b)(1)* through *(10)* of this subdivision. The management of foreign corporation X at all times retains the independent power to cancel the investment advisory contract with domestic corporation Y subject to the contractual limitations contained therein and is in all other respects independent of the management of domestic corporation Y. The managing personnel of foreign corporation X communicate on a regular basis with domestic corporation Y, and periodically visit the offices of domestic corporation Y, in connection with the business activities of foreign corporation X.

(d) The principal office of foreign corporation X will not be considered to be in the United States; and, therefore, foreign corporation X is not engaged in trade or business within the United States solely by reason of its relationship with domestic corporation Y.

Example 2. The facts are the same as in example 1 except that, in lieu of having the investment advisory contract with domestic corporation Y, foreign corporation X has an office in the United States in which its employees perform the same functions as are performed by domestic corporation Y in example 1. Foreign corporation X is not engaged in trade or business within the United States during the taxable year solely because the employees located in its United States office effect transactions in the United States in stocks or securities for the account of that corporation.

(iv) *Definition of dealer in stocks or securities*—(*a*) *In general.* For purposes of this subparagraph, a dealer in stocks or securities is a merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom. Persons who buy and sell, or hold, stocks or securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations, members of partnerships, or fiduciaries, who in their individual capacities buy and sell, or hold, stocks or securities for investment or speculation are not dealers in stocks or securities within the meaning of this subparagraph solely by reason of that activity. In determining under this subdivision whether a person is a dealer in stocks or securities such person's transactions in stocks or securities effected both in and outside the United States shall be taken into account.

(b) Underwriting syndicates and dealers trading for others. A foreign person who otherwise may be considered a dealer in stocks or securities under (a) of this subdivision shall not be considered a dealer in stocks or securities for purposes of this subparagraph—

(1) Solely because he acts as an underwriter, or as a selling group member, for the purpose of making a distribution of stocks or securities of a domestic issuer to foreign purchasers of such stocks or securities, irrespective of whether other members of the selling group distribute the stocks or

securities of the domestic issuer to domestic purchasers, or

(2) Solely because of transactions effected in the United States in stocks or securities pursuant to his grant of discretionary authority to make decisions in effecting those transactions, if he can demonstrate to the satisfaction of the Commissioner that the broker, commission agent, custodian, or other agent through whom the transactions were effected acted pursuant to his written representation that the funds in respect of which such discretion was granted were the funds of a customer who is neither a dealer in stocks or securities, a partnership described in subdivision (ii)*(b)* of this subparagraph, or a foreign corporation described in subdivision (iii)*(b)* of this subparagraph.

For purposes of this *(b),* a foreign person includes a nonresident alien individual, a foreign corporation, or a partnership any member of which is a nonresident alien individual or a foreign corporation. This *(b)* shall apply only if the foreign person at no time during the taxable year has an office or other fixed place of business in the United States through which, or by the direction of which, the transactions in stocks or securities are effected.

(c) Illustrations. The application of this subdivision may be illustrated by the following examples:

Example 1. Foreign corporation X is a member of an underwriting syndicate organized to distribute stock issued by domestic corporation Y. Foreign corporation X distributes the stock of domestic corporation Y to foreign purchasers only. Domestic corporation M is syndicate manager of the underwriting syndicate and, pursuant to the terms of the underwriting agreement, reserves the right to sell certain quantities of the underwritten stock on behalf of all the members of the syndicate so as to engage in stabilizing transactions and to take certain other actions which may result in the realization of profit by all members of the underwriting syndicate. Foreign corporation X is not engaged in trade or business within the United States solely by reason of its participation as a member of such underwriting syndicate for the purpose of distributing the stock of domestic corporation Y to foreign purchasers or by reason of the exercise by M corporation of its discretionary authority as manager of such syndicate.

Example 2. Foreign corporation Y, a calendar year taxpayer, is a bank which trades in stocks or securities both for its own account and for the account of others. During 1967 foreign corporation Y authorizes domestic corporation M, a broker, to exercise its discretion in effecting transactions in the United States in stocks or securities for the account of B, a nonresident alien individual who has a trading account with foreign corporation Y. Foreign corporation Y furnishes a written representation to domestic corporation M to the effect that the funds in respect of which foreign corporation Y has authorized domestic corporation M to use its discretion in trading in the United States in stocks or securities are not funds in respect of which foreign corporation Y is trading for its own account but are the funds of one of its customers who is neither a dealer in stocks or securities, a partnership described in subdivision (ii)*(b)* of this subparagraph, or a foreign corporation described in subdivision (iii)*(b)* of this subparagraph. Pursuant to the discretionary authority so granted, domestic corporation M effects transactions in the United States during 1967 in stocks or securities for the account of the customer of foreign corporation Y. At no time during 1967 does foreign corporation Y have an office or other fixed place of business in the United States through which, or by the direction of which, such transactions in stocks or securities are effected by domestic corporation M. During 1967 foreign corporation Y is not engaged in trade or business within the United States solely by reason of such trading in stocks or securities during such year by domestic corporation M for the account of the customer of foreign corporation Y. Copies of the written representations furnished to domestic corporation M should be retained by foreign corporation Y for inspection by the Commissioner, if inspection is requested.

(d) *Trading in commodities.* For purposes of paragraph (a) of this section—

(1) *In general.* The term ''engaged in trade or business within the United States'' does not include the effecting of transactions in the United States in commodities (including hedging transactions) through a resident broker, commission agent, custodian, or other independent agent if (i) the commodities are of a kind customarily dealt in on an organized commodity exchange, such as a grain futures or a cotton futures market, (ii) the transaction is of a kind customarily consummated at such place, and (iii) the taxpayer at no time during the taxable year has an office or other fixed place of business in the United States through which, or by the direction of which, the transactions in commodities are effected.

The volume of commodity transactions effected during the taxable year shall not be taken into account in determining under this subparagraph whether the taxpayer is engaged in trade or business in the United States.

(2) *Trading for taxpayer's own account*—(i) *In general.* The term ''engaged in trade or business within the United States'' does not include the effecting of transactions in the United States in commodities (including hedging transactions) for the taxpayer's own account if the commodities are of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind customarily consummated at such place. This rule shall apply irrespective of whether such transactions are effected by or through—

(a) The taxpayer himself while present in the United States,

(b) Employees of the taxpayer, whether or not such employees are present in the United States while effecting the transactions, or

(c) A broker, commission, agent, custodian, or other agent of the taxpayer, whether or not such agent while effecting the transactions is *(1)* dependent or independent, or *(2)* resident, nonresident, or present, in the United States, and irrespective of whether any such employee or agent has discretionary authority to make decisions in effecting such transactions. The volume of commodity transactions effected during the taxable year shall not be taken into account in determining under this subparagraph whether the taxpayer is engaged in trade or business within the United States. This subparagraph shall not apply to the effecting of transactions in the United States for the account of a dealer in commodities.

(ii) *Partnerships.* A nonresident alien individual, foreign partnership, foreign estate, foreign trust, or foreign corporation shall not be considered to be engaged in trade or business within the United States solely because such person is a member of a partnership (whether domestic or foreign) which, pursuant to discretionary authority granted to such partnership by such person, effects transactions in the United States in commodities for the partnership's account or solely because an employee of such partnership, or a broker, commission agent, custodian, or other agent, pursuant to discretionary authority granted by such partnership, effects transactions in the United States in commodities for the account of such partnership. This subdivision shall not apply to any member of a partnership which is a dealer in commodities.

(iii) *Illustration.* The application of this subparagraph may be illustrated by the following example:

Example. Foreign corporation X, a calendar year taxpayer, is engaged as a merchant in the business of purchasing grain in South America and selling such cash grain outside the United States under long-term contracts for delivery in foreign countries. Foreign corporation X consummates a sale of 100,000 bushels of cash grain in February 1967 for July delivery to Sweden. Because foreign corporation X does not actually own such grain at the time of the sales transaction, such corporation buys as a hedge a July ''futures contract'' for delivery of 100,000 bushels of grain, in order to protect itself from loss by reason of a possible rise in the price of grain between February and July. The ''futures contract'' is ordered through domestic corporation Y, a futures commission merchant registered under the Commodity Exchange Act. Foreign corporation X is not engaged in trade or business within the United States during 1967 solely by reason of its effecting of such futures contract for its own account through domestic corporation Y.

(3) *Definition of commodity.* For purposes of section 864(b)(2)(B) and this paragraph the term ''commodities'' does not include goods or merchandise in the ordinary channels of commerce.

(e) *Other rules.* The fact that a person is not determined by reason of this section to be not engaged in trade or business with the United States is not to be considered a determination that such person is engaged in trade or business within the United States. Whether or not such person is engaged in trade or business within the United States shall be determined on the basis of the facts and circumstances in each case. For other rules relating to the determination of whether a taxpayer is engaged in trade or business in the United States see section 875 and the regulations thereunder.

(f) *Effective date.* The provisions of this section shall apply only in the case of taxable years beginning after December 31, 1966.

[T.D. 6948, 33 FR 5090, Mar. 28, 1968, as amended by T.D. 7378, 40 FR 45435, Oct. 2, 1975]

§ 1.864–3 Rules for determining income effectively connected with U.S. business of nonresident aliens or foreign corporations.

(a) *In general.* For purposes of the Internal Revenue Code, in the case of a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at any time during the taxable year, the rules set forth in §§ 1.864–4 through 1.864–7 and this section shall apply in determining whether income, gain, or loss shall be treated as effectively connected for a taxable year beginning after December 31, 1966, with the conduct of a trade or business in the United States. Except as provided in sections 871 (c) and (d) and 882 (d) and (e), and the regulations thereunder, in the case of a nonresident alien individual or a foreign corporation that is at no time during the taxable year engaged in a trade or business in the United States, no income, gain, or loss shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States. The general rule prescribed by the preceding sentence shall apply even though the income, gain, or loss would have been treated as effectively connected with the conduct of a trade or business in the United States if such income or gain had been received or accrued, or such loss had been sustained, in an earlier taxable year when the taxpayer was engaged in a trade or business in the United States. In applying §§ 1.864–4 through 1.864–7 and this section, the determination whether an item of income, gain, or loss is effectively connected with the conduct of a trade or business in the United States shall not be controlled by any administrative, judicial, or other interpretation made under the laws of any foreign country.

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

Example 1. During 1967 foreign corporation N, which uses the calendar year as the taxable year, is engaged in the business of purchasing and selling household equipment on the installment plan. During 1967 N is engaged in business in the United States by reason of the sales activities it carries on in the United States for the purpose of selling therein some of the equipment which it has purchased. During 1967 N receives installment payments of $800,000 on sales it makes that year in the United States, and the income from sources within the United States for 1967 attributable to such payments is $200,000. By reason of section 864(c)(3) and paragraph (b) of § 1.864–4 this income of $200,000 is effectively connected for 1967 with the conduct of a trade or business in the United States by N. In December of 1967, N discontinues its efforts to make any further sales of household equipment in the United States, and at no time during 1968 is N engaged in a trade or business in the United States. During 1968 N receives installment payments of $500,000 on the sales it made in the United States during 1967, and the income from sources within the United States for 1968 attributable to such payments is $125,000. By reason of section 864(c)(1)(B) and this section, this income of $125,000 is not effectively connected for 1968 with the conduct of a trade or business in the United States by N, even though such amount, if it had been received by N during 1967, would have been effectively connected for 1967 with the conduct of a trade or business in the United States by that corporation.

Example 2. R, a foreign holding company, owns all of the voting stock in five corporations, two of which are domestic corporations. All of the subsidiary corporations are engaged in the active conduct of a trade or business. R has an office in the United States where its chief executive officer, who is also the chief executive officer of one of the domestic corporations, spends a substantial portion of the taxable year supervising R's investment in its operating subsidiaries and performing his function as chief executive officer of the domestic operating subsidiary. R is not considered to be engaged in a trade or business in the United States during the taxable year by reason of the activities carried on in the United States by its chief executive officer in the supervision of its investment in its operating subsidiary corporations. Accordingly, the dividends from sources within the United States received by R during the taxable year from its domestic subsidiary corporations are not effectively connected for that year with the conduct of a trade or business in the United States by R.

Example 3. During the months of June through December 1971, B, a nonresident alien individual who uses the calendar year as the taxable year and the cash receipts and disbursements method of accounting, is employed in the United States by domestic corporation M for a salary of $2,000 per month, payable semimonthly. During 1971, B receives from M salary payments totaling $13,000, all of which income by reason of section 864(c)(2) and paragraph (c)(6)(ii) of §1.864–4, is effectively connected for 1971 with the conduct of a trade or business in the United States by B. On December 31, 1971, B terminates his employment with M and departs from the United States. At no time during 1972 is B engaged in a trade or business in the United States. In January of 1972, B receives from M salary of $1,000 for the last half of December 1971, and a bonus of $1,000 in consideration of the services B performed in the United States during 1971 for that corporation. By reason of section 864(c)(1)(B) and this section, the $2,000 received by B during 1972 from sources within the United States is not effectively connected for that year with the conduct of a trade or business in the United States, even though such amount, if it had been received by B during 1971, would have been effectively connected for 1971 with the conduct of a trade or business in the United States by B.

[T.D. 7216, 37 FR 23424, Nov. 3, 1972]

§1.864–4 U.S. source income effectively connected with U.S. business.

(a) *In general.* This section applies only to a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, and to the income, gain, or loss of such person from sources within the United States. If the income, gain, or loss of such person for the taxable year from sources within the United States consists of (1) gain or loss from the sale or exchange of capital assets or (2) fixed or determinable annual or periodical gains, profits, and income or certain other gains described in section 871(a)(1) or 881(a), certain factors must be taken into account, as prescribed by section 864(c)(2) and paragraph (c) of this section, in order to determine whether the income, gain, or loss is effectively connected for the taxable year with the conduct of a trade or business in the United States by that person. All other income, gain, or loss of such person for the taxable year from sources within the United States shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that person, as prescribed by section 864(c)(3) and paragraph (b) of this section.

(b) *Income other than fixed or determinable income and capital gains.* All income, gain, or loss for the taxable year derived by a nonresident alien individual or foreign corporation engaged in a trade or business in the United States from sources within the United States which does not consist of income, gain, or loss described in section 871(a)(1) or 881(a), or of gain or loss from the sale or exchange of capital assets, shall, for purposes of paragraph (a) of this section, be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States. This income, gain, or loss shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States, whether or not the income, gain, or loss is derived from the trade or business being carried on in the United States during the taxable year. The application of this paragraph may be illustrated by the following examples:

Example 1. M, a foreign corporation which uses the calendar year as the taxable year, is engaged in the business of manufacturing machine tools in a foreign country. It establishes a branch office in the United States during 1968 which solicits orders from customers in the United States for the machine tools manufactured by that corporation. All negotiations with respect to such sales are carried on in the United States. By reason of its activity in the United States M is engaged in business in the United States during 1968. The income or loss from sources within the United States from such sales during 1968 is treated as effectively connected for that year with the conduct of a business in the United States by M. Occasionally, during 1968 the customers in the United States write directly to the home office of M, and the home office makes sales directly to such customers without routing the transactions through its branch office in the United States. The income or loss from sources within the United States for 1968 from these occasional direct sales by the home office is also treated as effectively connected for that year with the conduct of a business in the United States by M.

Example 2. The facts are the same as in example 1 except that during 1967 M was also engaged in the business of purchasing and selling office machines and that it used the installment method of accounting for the sales made in this separate business. During 1967 M was engaged in business in the United States by reason of the sales activities it carried on in the United States for the purpose of selling therein a number of the office machines which it had purchased. Although M discontinued this business activity in the United States in December of 1967, it received in 1968 some installment payments on the sales which it had made in the United States during 1967. The income of M for 1968 from sources within the United States which is attributable to such installment payments is effectively connected for 1968 with the conduct of a business in the United States, even though such income is not connected with the business carried on in the United States during 1968 through its sales office located in the United States for the solicitation of orders for the machine tools it manufactures.

Example 3. Foreign corporation S, which uses the calendar year as the taxable year, is engaged in the business of purchasing and selling electronic equipment. The home office of such corporation is also engaged in the business of purchasing and selling vintage wines. During 1968, S establishes a branch office in the United States to sell electronic equipment to customers, some of whom are located in the United States and the balance, in foreign countries. This branch office is not equipped to sell, and does not participate in sales of, wine purchased by the home office. Negotiations for the sales of the electronic equipment take place in the United States. By reason of the activity of its branch office in the United States, S is engaged in business in the United States during 1968. As a result of advertisements which the home office of S places in periodicals sold in the United States, customers in the United States frequently place orders for the purchase of wines with the home office in the foreign country, and the home office makes sales of wine in 1968 directly to such customers without routing the transactions through its branch office in the United States. The income or loss from sources within the United States for 1968 from sales of electronic equipment by the branch office, together with the income or loss from sources within the United States for that year from sales of wine by the home office, is treated as effectively connected for that year with the conduct of a business in the United States by S.

(c) *Fixed or determinable income and capital gains*—(1) *Principal factors to be taken into account*—(i) *In general.* In determining for purposes of paragraph (a) of this section whether any income for the taxable year from sources within the United States which is described in section 871(a)(1) or 881(a), relating to fixed or determinable annual or periodical gains, profits, and income and certain other gains, or whether gain or loss from sources within the United States for the taxable year from the sale or exchange of capital assets, is effectively connected for the taxable year with the conduct of a trade or business in the United States, the principal tests to be applied are (a) the asset-use test, that is, whether the income, gain, or loss is derived from assets used in, or held for use in, the conduct of the trade or business in the United States, and (b) the business-activities test, that is, whether the activities of the trade or business conducted in the United States were a material factor in the realization of the income, gain, or loss.

(ii) *Special rule relating to interest on certain deposits.* For purposes of determining under section 861(a)(1)(A) (relating to interest on deposits with banks, savings and loan associations, and insurance companies paid or credited before January 1, 1976) whether the interest described therein is effectively connected for the taxable year with the conduct of a trade or business in the United States, such interest shall be treated as income from sources within the United States for purposes of applying this paragraph and §1.864–5. If by reason of the application of this paragraph such interest is determined to be income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States, it shall then be treated as interest from sources without the United States which is not subject to the application of §1.864–5.

(2) *Application of the asset-use test*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, the asset-use test ordinarily shall apply in making a determination with respect to income, gain, or loss of a passive type where the trade or business activities as such do not give rise directly to the realization of the income, gain, or loss. However, even in the case of such income, gain, or loss, any activities of the trade or business which materially contribute to the realization of such income, gain, or loss shall also be taken into account as a factor in determining whether the income, gain, or loss is effectively connected with the conduct of a trade or business in the United States. The asset-use test is of

primary significance where, for example, interest income is derived from sources within the United States by a nonresident alien individual or foreign corporation that is engaged in the business of manufacturing or selling goods in the United States. See also subparagraph (5) of this paragraph for rules applicable to taxpayers conducting a banking, financing, or similar business in the United States.

(ii) *Cases where applicable.* Ordinarily, an asset shall be treated as used in, or held for use in, the conduct of a trade or business in the United States if the asset is—

(*a*) Held for the principal purpose of promoting the present conduct of the trade or business in the United States; or

(*b*) Acquired and held in the ordinary course of the trade or business conducted in the United States, as, for example, in the case of an account or note receivable arising from that trade or business; or

(*c*) Otherwise held in a direct relationship to the trade or business conducted in the United States, as determined under paragraph (c)(2)(iv) of this section.

(iii) *Application of asset-use test to stock*—(*a*) *In general.* Except as provided in paragraph (c)(2)(iii)(*b*) of this section, stock of a corporation (whether domestic or foreign) shall not be treated as an asset used in, or held for use in, the conduct of a trade or business in the United States.

(*b*) *Stock held by foreign insurance companies.* [Reserved]

(iv) *Direct relationship between holding of asset and trade or business—(a) In general.* In determining whether an asset is held in a direct relationship to the trade or business conducted in the United States, principal consideration shall be given to whether the asset is needed in that trade or buisness. An asset shall be considered needed in a trade or business, for this purpose, only if the asset is held to meet the present needs of that trade or business and not its anticipated future needs. An asset shall be considered as needed in the trade or business conducted in the United States if, for example, the asset is held to meet the operating expenses of that trade or business. Conversely, an asset shall be considered as not needed in the trade or business conducted in the United States if, for example, the asset is held for the purpose of providing for *(1)* future diversification into a new trade or business, *(2)* expansion of trade or business activities conducted outside of the United States, *(3)* future plant replacement, or *(4)* future business contingencies.

(b) Presumption of direct relationship. Generally, an asset will be treated as held in a direct relationship to the trade or business if *(1)* the asset was acquired with funds generated by that trade or business, *(2)* the income from the asset is retained or reinvested in that trade or business, and *(3)* personnel who are present in the United States and actively involved in the conduct of that trade or business exercise significant management and control over the investment of such asset.

(v) *Illustration.* The application of paragraph (iv) may be illustrated by the following examples:

Example 1. M, a foreign corporation which uses the calendar year as the taxable year, is engaged in industrial manufacturing in a foreign country. M maintains a branch in the United States which acts as importer and distributor of the merchandise it manufactures abroad; by reason of these branch activities. M is engaged in business in the United States during 1968. The branch in the United States is required to hold a large current cash balance for business purposes, but the amount of the cash balance so required varies because of the fluctuating seasonal nature of the branch's business. During 1968 at a time when large cash balances are not required the branch invests the surplus amount in U.S. Treasury bills. Since these Treasury bills are held to meet the present needs of the business conducted in the United States they are held in a direct relationship to that business, and the interest for 1968 on these bills is effectively connected for that year with the conduct of the business in the United States by M.

Example 2. Foreign corporation M, which uses the calendar year as the taxable year, has a branch office in the United States where it sells to customers located in the United States various products which are manufactured by that corporation in a foreign country. By reason of this activity M is engaged in business in the United States during 1997. The U.S. branch establishes in 1997 a fund to which are periodically credited various amounts which are derived from the business carried on at such branch. The amounts in this fund are invested in various securities issued by domestic corporations by the managing officers of the U.S. branch, who have the responsibility for maintaining proper investment diversification and investment of the fund. During 1997, the branch office derives from sources within the United States interest on these securities, and gains and losses resulting from the sale or exchange of such securities. Since the securities were acquired with amounts generated by the business conducted in the United States, the interest is retained in that business, and the portfolio is managed by personnel actively involved in the conduct of that business, the securities are presumed under paragraph (c)(2)(iv)(*b*) of this section to be held in a direct relationship to that business. However, M is able to rebut this presumption by demonstrating that the fund was established to carry out a program of future expansion and not to meet the present needs of the business conducted in the United States. Consequently, the income, gains, and losses from the securities for 1997 are not effectively connected for that year with the conduct of a trade or business in the United States by M.

(3) *Application of the business-activities test*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, the business-activities test shall ordinarily apply in making a determination with respect to income, gain, or loss which, even though generally of the passive type, arises directly from the active conduct of the taxpayer's trade or business in the United States. The business-activities test is of primary significance, for example, where *(a)* dividends or interest are derived by a dealer in stocks or securities, *(b)* gain or loss is derived from the sale or exchange of capital assets in the active conduct of a trade or business by an investment company, *(c)* royalties are derived in the active conduct of a business consisting of the licensing of patents or similar intangible property, or *(d)* service fees are derived in the active conduct of a servicing business. In applying the business-activities test, activities relating to the management of investment portfolios shall not be treated as activities of the trade or business conducted in the United States unless the maintenance of the investments constitutes the principal activity of that trade or business. See also subparagraph (5) of this paragraph for rules applicable to taxpayers conducting a banking, financing, or similar business in the United States.

(ii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example 1. Foreign corporation S is a foreign investment company organized for the purpose of investing in stocks and securities. S is not a personal holding company or a corporation which would be a personal holding company but for section 542(c)(7) or 543(b)(1)(C). Its investment portfolios consist of common stocks issued by both foreign and domestic corporations and a substantial amount of high grade bonds. The business activity of S consists of the management of its portfolios for the purpose of investing, reinvesting, or trading in stocks and securities. During the taxable year 1968, S has its principal office in the United States within the meaning of paragraph (c)(2)(iii) of § 1.864–2 and, by reason of its trading in the United States in stocks and securities, is engaged in business in the United States. The dividends and interest derived by S during 1968 from sources within the United States, and the gains and losses from sources within the United States for such year from the sale of stocks and securities from its investment portfolios, are effectively connected for 1968 with the conduct of the business in the United States by that corporation, since its activities in connection with the management of its investment portfolios are activities of that business and such activities are a material factor in the realization of such income, gains, and losses.

Example 2. N, a foreign corporation which uses the calendar year as the taxable year, has a branch in the United States which acts as an importer and distributor of merchandise; by reason of the activities of that branch, N is engaged in business in the United States during 1968. N also carries on a business in which it licenses patents to unrelated persons in the United States for use in the United States. The businesses of the licensees in which these patents are used have no direct relationship to the business carried on in N's branch in the United States, although the merchandise marketed by the branch is similar in type to that manufactured under the patents. The negotiations and other activities leading up to the consummation of these licenses are conducted by employees of N who are not connected with the U.S. branch of that corporation, and the U.S. branch does not otherwise participate in arranging for the licenses. Royalties received by N during 1968 from these licenses are not effectively connected for that year with the conduct of its business in the United States because the activities of that business are not a material factor in the realization of such income.

(4) *Method of accounting as a factor.* In applying the asset-use test or the business-activities test described in subparagraph (1) of this paragraph, due regard shall be given to whether or not the asset, or the income, gain, or loss, is accounted for through the trade or business conducted in the United States, that is, whether or not the asset, or the income, gain, or loss, is carried on books of account separately kept for that trade or business, but this accounting test shall not by itself be controlling. In applying this subparagraph, consideration shall be given to whether the accounting treatment of an item reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business and whether there is a consistent accounting treatment of that item from year to year by the taxpayer.

(5) *Special rules relating to banking, financing, or similar business activity*—(i) *Definition of banking, financing, or similar business.* A nonresident alien individual or a foreign corporation shall be considered for purposes of this section and paragraph (b)(2) of §1.864–5 to be engaged in the active conduct of a banking, financing, or similar business in the United States if at some time during the taxable year the taxpayer is engaged in business in the United States and the activities of such business consist of any one or more of the following activities carried on, in whole or in part, in the United States in transactions with persons situated within or without the United States:

(a) Receiving deposits of funds from the public,

(b) Making personal, mortgage, industrial, or other loans to the public,

(c) Purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness,

(d) Issuing letters of credit to the public and negotiating drafts drawn thereunder,

(e) Providing trust services for the public, or

(f) Financing foreign exchange transactions for the public.

Although the fact that the taxpayer is subjected to the banking and credit laws of a foreign country shall be taken into account in determining whether he is engaged in the active conduct of a banking, financing, or similar business, the character of the business actually carried on during the taxable year in the United States shall determine whether the taxpayer is actively conducting a banking, financing, or similar business in the United States. A foreign corporation which acts merely as a financing vehicle for borrowing funds for its parent corporation or any other person who would be a related person within the meaning of section 954(d)(3) if such foreign corporation were a controlled foreign corporation shall not be considered to be engaged in the active conduct of a banking, financing, or similar business in the United States.

(ii) *Effective connection of income from stocks or securities with active conduct of a banking, financing, or similar business.* Notwithstanding the rules in subparagraphs (2) and (3) of this paragraph with respect to the asset-use test and the business-activities test, any dividends or interest from stocks or securities, or any gain or loss from the sale or exchange of stocks or securities which are capital assets, which is from sources within the United States and derived by a nonresident alien individual or a foreign corporation in the active conduct during the taxable year of a banking, financing, or similar business in the United States shall be treated as effectively connected for such year with the conduct of that business only if the stocks or securities giving rise to such income, gain, or loss are attributable to the U.S. office through which such business is carried on and—

(a) Were acquired—

(1) As a result of, or in the course of making loans to the public,

(2) In the course of distributing such stocks or securities to the public, or

(3) For the purpose of being used to satisfy the reserve requirements, or other requirements similar to reserve requirements, established by a duly constituted banking authority in the United States, or

(b) Consist of securities (as defined in subdivision (v) of this subparagraph) which are—

(1) Payable on demand or at a fixed maturity date not exceeding 1 year from the date of acquisition,

(2) Issued by the United States, or any agency or instrumentality thereof, or

(3) Not described in *(a)* or in *(1)* or *(2)* of this *(b)*.

However, the amount of interest from securities described in *(b)(3)* of this subdivision (ii) which shall be treated as effectively connected for the taxable year with the active conduct of a banking, financing, or similar business in the United States shall be an amount (but not in excess of the entire interest for the taxable year from sources within the United States from such securities) determined by multiplying the entire interest for the taxable year from sources within the United States from such securities by a fraction the numerator of which is 10 percent and the denominator of which is the same percentage, determined on the basis of a monthly average for the taxable year, as the book value of the total of such securities held by the U.S. office through which such business is carried on bears to the book value of the total assets of such office. The amount of gain or loss, if any, for the taxable year from the sale or exchange of such securities which shall be treated as effectively connected for the taxable year with the active conduct of a banking, financing, or similar business in the United States shall be an amount (but not in excess of the entire gain or loss for the taxable year from sources within the United States from the sale or exchange of such securities) determined by multiplying the entire gain or loss for the taxable year from sources within the United States from the sale or exchange of such securities by the fraction described in the immediately preceding sentence. The percentage of the denominator of the limiting fraction for such purposes shall be the percentage obtained by separately adding the book value of such securities and such total assets held at the close of each month in the taxable year, dividing each such sum by 12, and then dividing the amount of securities so obtained by the amount of assets so obtained. This subdivision does not apply to dividends from stock owned by a foreign corporation in a domestic corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned by such foreign corporation and which is engaged in the active conduct of a banking business in the United States. The application of this subdivision may be illustrated by the following example:

Example. Foreign corporation M, created under the laws of foreign country Y, has in the United States a branch, B, which during the taxable year is engaged in the active conduct of the banking business in the United States within the meaning of subdivision (i) of this subparagraph. During the taxable year M derives from sources within the United States through the activities carried on through B, $7,500,000 interest from securities described in subdivision *(b)(3)* of this subdivision (ii) and $7,500,000 gain from the sale or exchange of such securities. The monthly average, determined as of the last day of each month in the taxable year, of such securities held by B divided by the monthly average, as so determined, of the total assets held by B equals 15 percent. Under this subdivision, the amount of interest income from such securities that shall be treated as effectively connected for the taxable year with the active conduct by M of a banking business in the United States is $5 million ($7,500,000 interest × 10%/15%), and the amount of gain from the sale or exchange of such securities that shall be treated as effectively connected for such year with the active conduct of such business is $5 million ($7,500,000 gain × 10%/15%).

(iii) *Stocks or securities attributable to U.S. office*—(*a*) *In general.* For purposes of paragraph (c)(5)(ii) of this section, a stock or security shall be deemed to be attributable to a U.S. office only if such office actively and materially participated in soliciting, negotiating, or performing other activities required to arrange the acquisition of the stock or security. The U.S. office need not have been the only active participant in arranging the acquisition of the stock or security.

(*b*) *Exceptions.* A stock or security shall not be deemed to be attributable to a U.S. office merely because such office conducts one or more of the following activities:

(*1*) Collects or accounts for the dividends, interest, gain, or loss from such stock or security,

(*2*) Exercises general supervision over the activities of the persons directly responsible for carrying on the activities described in paragraph (c)(5)(iii)(*a*) of this section,

(*3*) Performs merely clerical functions incident to the acquisition of such stock or security,

(*4*) Exercises final approval over the execution of the acquisition of such stock or security, or

(*5*) Holds such stock or security in the United States or records such stock or security on its books or records as having been acquired by such office or for its account.

(*c*) *Effective date.* This paragraph (c)(5)(iii) shall be effective for income includible in taxable years beginning on or after June 18, 1984, except that 26 CFR 1.864–4 (c)(5)(iii) as it appeared in the Code of Federal Regulations revised as of April 1, 1983, shall apply to income received or accured under a loan made by the taxpayer on or before May 18, 1984, or pursuant to a written binding commitment entered into on or before May 18, 1984.

(iv) *Acquisitions in course of making loans to the public.* For purposes of subdivision (ii) of this subparagraph—

(a) A stock or security shall be considered to have been acquired in the course of making a loan to the public where, for example, such stock or security was acquired as additional consideration for the making of the loan,

(b) A stock or security shall be considered to have been acquired as a result of making a loan to the public if, for example, such stock or security was acquired by foreclosure upon a bona fide default of the loan and is held as an ordinary and necessary incident to the active conduct of the banking, financing, or similar business in the United States, and

(c) A stock or security acquired on a stock exchange or organized over-the-counter market shall be considered not to have been acquired as a result of, or in the course of, making loans to the public.

(v) *Security defined.* For purposes of this subparagraph, a security is any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items.

(vi) *Limitations on application of subparagraph—(a) Other business activity.* This subparagraph provides rules for determining when certain income from stocks or securities is effectively connected with the active conduct of a banking, financing, or similar business in the United States. Any dividends, interest, gain, or loss from sources within the United States which by reason of the application of subdivision (ii) of this subparagraph is not effectively connected with the active conduct by a nonresident alien individual or a foreign corporation of a banking, financing, or similar business in the United States may be effectively connected for the taxable year, under subparagraph (2) or (3) of this paragraph with the conduct by such taxpayer of another trade or business in the United States, such as, for example, the business of selling or manufacturing goods or merchandise or of trading in stocks or securities for the taxpayer's own account.

(b) Other income. For rules relating to income, gain, or loss from sources within the United States (other than dividends or interest from, or gain or loss from the sale or exchange of, stocks or securities referred to in subdivision (ii) of this subparagraph) derived in the active conduct of a banking, financing, or similar business in the United States, see subparagraphs (2) and (3) of this paragraph and paragraph (b) of this section.

(vii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example 1. Foreign corporation F, which is created under the laws of foreign country X and engaged in the active conduct of the banking business in country X and a number of other foreign countries, has in the United States a branch, B, which during the taxable year is engaged in the active conduct of the banking business in the United States within the meaning of subdivision (i) of this subparagraph. In the course of its banking business in foreign countries, F receives at its branches located in country X and other foreign countries substantial deposits in U.S. dollars which are transferred to the accounts of B in the United States. During the taxable year, B actively participates in negotiating loans to residents of the United States, such as call loans to U.S. brokers, which are financed from the U.S. dollar deposits transferred to B by F. In addition, B actively participates in purchasing on the New York Stock Exchange and over-the-counter markets long-term bonds and notes issued by the U.S. Government, U.S. Treasury bills, and long-term interest-bearing bonds issued by domestic corporations and having a maturity date of less than 1 year from the date of acquisition, all of which are purchased from the deposits transferred to B by F. All of the securities so acquired are held by B and recorded on its books in the United States. Pursuant to subdivision (ii) of this subparagraph, the interest received by F during the taxable year on these loans, bonds, notes, and bills is effectively connected for such year with the active conduct by F of a banking business in the United States.

Example 2. The facts are the same as in example 1 except that B also actively participates in using part of the U.S. dollar deposits, which are transferred to it by F, to purchase on the New York Stock Exchange shares of common stock issued by various domestic corporations. All of the shares so purchased are considered to be capital assets within the meaning of section 1221 and are recorded on B's books in the United States. None of the shares so purchased were acquired for the purpose of meeting reserve or other similar requirements. During the taxable year some of the shares are sold by B on the stock exchange. Pursuant to subdivision (ii) of this subparagraph, the dividends and gains received by F during the taxable year on these shares of stock are not effectively connected with the active conduct by F of a banking, financing, or similar business in the United States.

Example 3. The facts are the same as in example 1 except that B also uses part of the U.S. dollar deposits, which are transferred to it by F, to make a loan to domestic corporation M. As part of the consideration for the loan, M gives to B a number of shares of common stock issued by M. All of these shares of stock are considered to be capital assets within the meaning of section 1221 and are recorded on B's books in the United States. During the taxable year one-half of these shares of stock is sold by B on the New York Stock Exchange. Pursuant to subdivision (ii) of this subparagraph, the dividends and gains received by F during the taxable year on these shares of stock are effectively connected for such year with the active conduct by F of a banking business in the United States.

Example 4. The facts are the same as in example 1 except that during the taxable year the home office of F in country X actively participates in negotiating loans to residents of the United States, such as call loans to U.S. brokers, which are financed by the U.S. dollar deposits received at the home office and are recorded on the books of the home office. B does not participate in negotiating these loans. Pursuant to subdivision (ii) of this subparagraph the interest received by F during the taxable year on these loans made by the home office in country X is not effectively connected with the active conduct by F of a banking, financing, or similar business in the United States.

Example 5. Foreign corporation *Y,* which is created under the laws of foreign country X and is engaged in the active conduct of a banking business in country X and other foreign countries, has a branch, *C,* in the United States that is engaged in the active conduct of a banking business in the United States, within the meaning of paragraph (c)(5)(i) of this section, during the taxable year. *C* handles the negotiation and acquisition of securities involved in loans made by *Y* to U.S. persons. *C* also presents interest coupons with respect to such securities for payment, presents all such securities for payment at maturity, and maintains compete photocopy files with respect to such securities. The activities of the office of *Y* in country X with respect to these securities consist of giving pro forma approval of the loans, storing the original securities, and recording the securities on the books of the country X office. Pursuant to paragraphs (c)(5)(ii) and (c)(5)(iii) of this section, the U.S. source interest income received by *Y* during the taxable year on these securities is effectively connected for such year with the active conduct by *Y* of a banking business in the United States.

(6) *Income related to personal services of an individual*—(i) *Income, gain, or loss from assets.* Income or gains from sources within the United States described in section 871(a)(1) and derived from an asset, and gain or loss from sources within the United States from the sale or exchange of capital assets, realized by a nonresident alien individual engaged in a trade or business in the United States during the taxable year solely by reason of his performing personal services in the United States shall not be treated as income, gain, or loss which is effectively connected for the taxable year with the conduct of a trade or business in the United States, unless there is a direct economic relationship between his holding of the asset from which the income, gain, or loss results and his trade or business of performing the personal services.

(ii) *Wages, salaries, and pensions.* Wages, salaries, fees, compensations, emoluments, or other remunerations, including bonuses, received by a nonresident alien individual for performing personal services in the United States which, under paragraph (a) of §1.864–2, constitute engaging in a trade or business in the United States, and pensions and retirement pay attributable to such personal services, constitute income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual if he is engaged in a trade or business in the United States at some time during the taxable year in which such income is received.

(7) *Effective date.* Paragraphs (c)(2) and (c)(6)(i) of this section are effective for taxable years beginning on or after June 6, 1996.

[T.D. 7216, 37 FR 23425, Nov. 3, 1972, as amended by T.D. 7332, 39 FR 44232, Dec. 23, 1974; T.D. 79–58, 49 FR 21052, May 18, 1984; T.D.8657, 61 FR 9337, Mar. 8, 1996]

§1.864–5 Foreign source income effectively connected with U.S. business.

(a) *In general.* This section applies only to a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, and to the income, gain, or loss of such person from sources without the United States. The income, gain, or loss of such person for the taxable year from sources without the United States which is specified in paragraph (b) of this section shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States, only if he also has in the United States at some time during the taxable year, but not necessarily at the time the income, gain, or loss is realized, an office or other fixed place of business, as defined in §1.864–7, to which such income, gain, or loss is attributable in accordance with §1.864–6. The income of such person for the taxable year from sources without the United States which is specified in paragraph (c) of this section shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States when derived by a foreign corporation carrying on a life insurance business in the United States. Except as provided in paragraphs (b) and (c) of this section, no income, gain, or loss of a nonresident alien individual or a foreign corporation for the taxable year from sources without the United States shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that person. Any income, gain, or loss described in paragraph (b) or (c) of this section which, if it were derived by the taxpayer from sources within the United States for the taxable year, would not be treated under §1.864–4 as effectively connected for the taxable year with the conduct of a trade or business in the United States shall not be treated under this section as effectively connected for the taxable year with the conduct of a trade or business in the United States.

(b) *Income other than income attributable to U.S. life insurance business.* Income, gain, or loss from sources without the United States other than income described in paragraph (c) of this section shall be taken into account pursuant to paragraph (a) of this section in applying §§1.864–6 and 1.864–7 only if it consists of—

(1) *Rents, royalties, or gains on sales of intangible property.* (i) Rents or royalties for the use of, or for the privilege of using, intangible personal property located outside the United States or from any interest in such property, including rents or royalties for the use, or for the privilege of using, outside the United States, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like properties, if such rents or royalties are derived in the active conduct of the trade or business in the United States.

(ii) Gains or losses on the sale or exchange of intangible personal property located outside the United States or from any interest in such property, including gains or losses on the sale or exchange of the privilege of using, outside the United States, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like properties, if such gains or losses are derived in the active conduct of the trade or business in the United States.

(iii) Whether or not such an item of income, gain, or loss is derived in the active conduct of a trade or business in the United States shall be determined from the facts and circumstances of each case. The frequency with which a nonresident alien individual or a foreign corporation enters into transactions of the type from which the income, gain, or loss is derived shall not of itself determine that the income, gain, or loss is derived in the active conduct of a trade or business.

(iv) This subparagraph shall not apply to rents or royalties for the use of, or for the privilege of using, real property or tangible personal property, or to gain or loss from the sale or exchange of such property.

(2) *Dividends or interest, or gains or loss from sales of stocks or securities*—(i) *In general.* Dividends or interests from any transaction, or gains or losses on the sale or exchange of stocks or securities, realized by *(a)* a nonresident alien individual or a foreign corporation in the active conduct of a banking, financing, or similar business in the United States or *(b)* a foreign corporation engaged in business in the United States whose principal business is trading in stocks or securities for its own account. Whether the taxpayer is engaged in the active conduct of a banking, financing, or similar business in the United States for purposes of this subparagraph shall be determined in accordance with the principles of paragraph (c)(5)(i) of § 1.864–4.

(ii) *Substitute payments.* For purposes of this paragraph (b)92), a substitute interest payment (as defined in § 1.861–2(a)(7)) received by a foreign person subject to tax under this paragraph (b) pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in § 1.861–2(a)(7)) with respect to a security (as defined in § 1.864–6(b)(2)(ii)(c)) shall have the same character as interest income paid or accrued with respect to the terms of the transferred security. Similarly, for purposes of this paragraph (b)(2), a substitute dividend payment (as defined in § 1.861–3(a)(6)) received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in § 1.861–3(a)(6)) with respect to a stock shall have the same character as a distribution with respect to the transferred security. This paragraph (b)(2)(ii) is applicable to payments made after November 13, 1997.

(iii) *Incidental investment activity.* This subparagraph shall not apply to income, gain, or loss realized by a nonresident alien individual or foreign corporation on stocks or securities held, sold, or exchanged in connection with incidental investment activities carried on by that person. Thus, a foreign corporation which is primarily a holding company owning significant percentages of the stocks or securities issued by other corporations shall not be treated under this subparagraph as a corporation the principal business of which is trading in stocks or securities for its own account, solely because it engages in sporadic purchases or sales of stocks or securities to adjust its portfolio. The application of this subdivision may be illustrated by the following example:

Example. F, a foreign corporation, owns voting stock in foreign corporations M, N, and P, its holdings in such corporations constituting 15, 20, and 100 percent, respectively, of all classes of their outstanding voting stock. Each of such stock holdings by F represents approximately 20 percent of its total assets. The remaining 40 percent of F's assets consist of other investments, 20 percent being invested in securities issued by foreign governments and in stocks and bonds issued by other corporations in which F does not own a significant percentage of their outstanding voting stock, and 20 percent being invested in bonds issued by N. None of the assets of F are held primarily for sale; but if the officers of that corporation were to decide that other investments would be preferable to its holding of such assets, F would sell the stocks and securities and reinvest the proceeds therefrom in other holdings. Any income, gain, or loss which F may derive from this investment activity is not considered to be realized by a foreign corporation described in subdivision (i) of this subparagraph.

(3) *Sale of goods or merchandise through U.S. office.* (i) Income, gain, or loss from the sale of inventory items or of property held primarily for sale to customers in the ordinary course of business, as described in section 1221(1), where the sale is outside the United States but through the office or other

fixed place of business which the nonresident alien or foreign corporation has in the United States, irrespective of the destination to which such property is sent for use, consumption, or disposition.

(ii) This subparagraph shall not apply to income, gain, or loss resulting from a sales contract entered into on or before February 24, 1966. See section 102(e)(1) of the Foreign Investors Tax Act of 1966 (80 Stat. 1547). Thus, for example, the sales office in the United States of a foreign corporation enters into negotiations for the sale of 500,000 industrial bearings which the corporation produces in a foreign country for consumption in the Western Hemisphere. These negotiations culminate in a binding agreement entered into on January 1, 1966. By its terms delivery under the contract is to be made over a period of 3 years beginning in March of 1966. Payment is due upon delivery. The income from sources without the United States resulting from this sale negotiated by the U.S. sales office of the foreign corporation shall not be taken into account under this subparagraph for any taxable year.

(iii) This subparagraph shall not apply to gains or losses on the sale or exchange of intangible personal property to which subparagraph (1) of this paragraph applies or of stocks or securities to which subparagraph (2) of this paragraph applies.

(c) *Income attributable to U.S. life insurance business.* (1) All of the income for the taxable year of a foreign corporation described in subparagraph (2) of this paragraph from sources without the United States, which is attributable to its U.S. life insurance business, shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. Thus, in determining its life insurance company taxable income from its U.S. business for purposes of section 802, the foreign corporation shall include all of its items of income from sources without the United States which would appropriately be taken into account in determining the life insurance company taxable income of a domestic corporation. The income to which this subparagraph applies shall be taken into account for purposes of paragraph (a) of this section without reference to §§1.864–6 and 1.864–7.

(2) A foreign corporation to which subparagraph (1) of this paragraph applies is a foreign corporation carrying on an insurance business in the United States during the taxable year which—

(i) Without taking into account its income not effectively connected for that year with the conduct of any trade or business in the United States, would qualify as a life insurance company under part I (section 801 and following) of subchapter L, chapter 1 of the Code, if it were a domestic corporation, and

(ii) By reason of section 842 is taxable under that part on its income which is effectively connected for that year with its conduct of any trade or business in the United States.

(d) *Excluded foreign source income.* Notwithstanding paragraphs (b) and (c) of this section, no income from sources without the United States shall be treated as effectively connected for any taxable year with the conduct of a trade or business in the United States by a nonresident alien individual or a foreign corporation if the income consists of—

(1) *Dividends, interest, or royalties paid by a related foreign corporation.* Dividends, interest, or royalties paid by a foreign corporation in which the nonresident alien individual or the foreign corporation described in paragraph (a) of this section owns, within the meaning of section 958(a), or is considered as owning, by applying the ownership rules of section 958(b), at the time such items are paid more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(2) *Subpart F income of a controlled foreign corporation.* Any income of the foreign corporation described in paragraph (a) of this section which is subpart F income for the taxable year, as determined under section 952(a), even though part of the income is attributable to amounts which, if distributed by the foreign corporation, would be distributed with respect to its stock which is owned by shareholders who are not U.S. shareholders within the meaning of section 951(b). This subparagraph shall not apply to any income of the foreign corporation which

is excluded in determining its subpart F income for the taxable year for purposes of section 952(a). Thus, for example, this subparagraph shall not apply to—

(i) Foreign base company shipping income which is excluded under section 954(b)(2),

(ii) Foreign base company income amounting to less than 10 percent (30 percent in the case of taxable years of foreign corporations ending before January 1, 1976) of gross income which by reason of section 954(b)(3)(A) does not become subpart F income for the taxable year,

(iii) Any income excluded from foreign base company income under section 954(b)(4), relating to exception for foreign corporations not availed of to reduce taxes,

(iv) Any income derived in the active conduct of a trade or business which is excluded under section 954(c)(3), or

(v) Any income received from related persons which is excluded under section 954(c)(4).

This subparagraph shall apply to the foreign corporation's entire subpart F income for the taxable year determined under section 952(a), even though no amount is included in the gross income of a U.S. shareholder under section 951(a) with respect to that subpart F income because of the minimum distribution provisions of section 963(a) or because of the reduction under section 970(a) with respect to an export trade corporation. This subparagraph shall apply only to a foreign corporation which is a controlled foreign corporation within the meaning of section 957 and the regulations thereunder. The application of this subparagraph may be illustrated by the following examples:

Example 1. Controlled foreign corporation M, incorporated under the laws of foreign country X, is engaged in the business of purchasing and selling merchandise manufactured in foreign country Y by an unrelated person. M negotiates sales, through its sales office in the United States, of its merchandise for use outside of country X. These sales are made outside the United States, and the merchandise is sold for use outside the United States. No office maintained by M outside the United States participates materially in the sales made through its U.S. sales office. These activities constitute the only activities of M. During the taxable year M derives $100,000 income from these sales made through its U.S. sales office, and all of such income is foreign base company sales income by reason of section 954(d)(2) and paragraph (b) of § 1.954–3. The entire $100,000 is also subpart F income, determined under section 952(a). In addition, all of this income would, without reference to section 864(c)(4)(D)(ii) and this subparagraph, be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by M. Through its entire taxable year 60 percent of the one class of stock of M is owned within the meaning of section 958(a) by U.S. shareholders, as defined in section 951(b), and 40 percent of its one class of stock is owned within the meaning of section 958(a) by persons who are not U.S. shareholders, as defined in section 951(b). Although only $60,000 of the subpart F income of M for the taxable year is includible in the income of the U.S. shareholders under section 951(a), the entire subpart F income of $100,000 constitutes income which, by reason of section 864(c)(4)(D)(ii) and this subparagraph, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by M.

Example 2. The facts are the same as in example 1 except that the foreign base company sales income amounts to $150,000 determined in accordance with paragraph (d)(3)(i) of § 1.954–1, and that M also has gross income from sources without the United States of $50,000 from sales, through its sales office in the United States, of merchandise for use in country X. These sales are made outside the United States. All of this income would, without reference to section 864(c)(4)(D)(ii) and this subparagraph, be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by M. Since the foreign base company income of $150,000 amounts to 75 percent of the entire gross income of $200,000, determined as provided in paragraph (d)(3)(ii) of § 1.954–1, the entire $200,000 constitutes foreign base company income under section 954(b)(3)(B). Assuming that M has no amounts to be taken into account under paragraphs (1), (2), (4), and (5) of section 954(b), the $200,000 is also subpart F income, determined under section 952(a). This subpart F income of $200,000 constitutes income which, by reason of section 864(c)(4)(D)(ii) and this subparagraph, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by M.

(3) *Interest on certain deposits.* Interest which, by reason of section 861(a)(1)(A) (relating to interest on deposits with banks, savings and loan associations,

and insurance companies paid or credited before January 1, 1976) and paragraph (c) of §1.864–4, is determined to be income from sources without the United States because it is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the nonresident alien individual or foreign corporation.

[T.D. 7216, 37 FR 23429, Nov. 3, 1972, as amended by T.D. 7893, 48 FR 22507, May 19, 1983; T.D. 8735, 62 FR 53501, Oct. 14, 1997]

§1.864–6 Income, gain, or loss attributable to an office or other fixed place of business in the United States.

(a) *In general.* Income, gain, or loss from sources without the United States which is specified in paragraph (b) of §1.864–5 and received by a nonresident alien individual or a foreign corporation engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States only if the income, gain, or loss is attributable under paragraphs (b) and (c) of this section to an office or other fixed place of business, as defined in §1.864–7, which the taxpayer has in the United States at some time during the taxable year.

(b) *Material factor test*—(1) *In general.* For purposes of paragraph (a) of this section, income, gain, or loss is attributable to an office or other fixed place of business which a nonresident alien individual or a foreign corporation has in the United States only if such office or other fixed place of business is a material factor in the realization of the income, gain, or loss, and if the income, gain, or loss is realized in the ordinary course of the trade or business carried on through that office or other fixed place of business. For this purpose, the activities of the office or other fixed place of business shall not be considered to be a material factor in the realization of the income, gain, or loss unless they provide a significant contribution to, by being an essential economic element in, the realization of the income, gain, or loss. Thus, for example, meetings in the United States of the board of directors of a foreign corporation do not of themselves constitute a material factor in the realization of income, gain, or loss. It is not necessary that the activities of the office or other fixed place of business in the United States be a major factor in the realization of the income, gain, or loss. An office or other fixed place of business located in the United States at some time during a taxable year may be a material factor in the realization of an item of income, gain, or loss for that year even though the office or other fixed place of business is not present in the United States when the income, gain, or loss is realized.

(2) *Application of material factor test to specific classes of income.* For purposes of paragraph (a) of this section, an office or other fixed place of business which a nonresident alien individual or a foreign corporation, engaged in a trade or business in the United States at some time during the taxable year, had in the United States, shall be considered a material factor in the realization of income, gain, or loss consisting of—

(i) *Rents, royalties, or gains on sales of intangible property.* Rents, royalties, or gains or losses, from intangible personal property specified in paragraph (b)(1) of §1.864–5, if the office or other fixed place of business either actively participates in soliciting, negotiating, or performing other activities required to arrange, the lease, license, sale, or exchange from which such income, gain, or loss is derived or performs significant services incident to such lease, license, sale, or exchange. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because the office or other fixed place of business conducts one or more of the following activities: *(a)* Develops, creates, produces, or acquires and adds substantial value to, the property which is leased, licensed, or sold, or exchanged, *(b)* collects or accounts for the rents, royalties, gains, or losses, *(c)* exercises general supervision over the activities of the persons directly responsible for carrying on the activities or services described in the immediately preceding sentence, *(d)* performs merely clerical functions incident to the lease, license, sale, or exchange or *(e)* exercises final approval over the execution of the lease, license, sale, or exchange. The application of this subdivision may be illustrated by the following examples:

Example 1. F, a foreign corporation, is engaged in the active conduct of the business of licensing patents which it has either purchased or developed in the United States. F has a business office in the United States. Licenses for the use of such patents outside the United States are negotiated by offices of F located outside the United States, subject to approval by an officer of such corporation located in the U.S. office. All services which are rendered to F's foreign licensees are performed by employees of F's offices located outside the United States. None of the income, gain, or loss resulting from the foreign licenses so negotiated by F is attributable to its business office in the United States.

Example 2. N, a foreign corporation, is engaged in the active conduct of the business of distributing motion picture films and television programs. N does not distribute such films or programs in the United States. The foreign distribution rights to these films and programs are acquired by N's U.S. business office from the U.S. owners of these films and programs. Employees of N's offices located in various foreign countries carry on in such countries all the solicitations and negotiations for the licensing of these films and programs to licensees located in such countries and provide the necessary incidental services to the licensees. N's U.S. office collects the rentals from the foreign licensees and maintains the necessary records of income and expense. Officers of N located in the United States also maintain general supervision over the employees of the foreign offices, but the foreign employees conduct the day to day business of N outside the United States of soliciting, negotiating, or performing other activities required to arrange the foreign licenses. None of the income, gain, or loss resulting from the foreign licenses so negotiated by N is attributable to N's U.S. office.

(ii) *Dividends or interest, or gains or losses from sales of stock or securities—(a) In general.* Dividends or interest from any transaction, or gains or losses on the sale or exchange of stocks or securities, specified in paragraph (b)(2) of § 1.864–5, if the office or other fixed place of business either actively participates in soliciting, negotiating, or performing other activities required to arrange, the issue, acquisition, sale, or exchange, of the asset from which such income, gain, or loss is derived or performs significant services incident to such issue, acquisition, sale, or exchange. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because the office or other fixed place of business conducts one or more of the following activities: *(1)* Collects or accounts for the dividends, interest, gains, or losses, *(2)* exercises general supervision over the activities of the persons directly responsible for carrying on the activities or services described in the immediately preceding sentence, *(3)* performs merely clerical functions incident to the issue, acquisition, sale, or exchange, or *(4)* exercises final approval over the execution of the issue, acquisition, sale, or exchange.

(b) Effective connection of income from stocks or securities with active conduct of a banking, financing, or similar business. Notwithstanding *(a)* of this subdivision (ii), the determination as to whether any dividends or interest from stocks or securities, or gain or loss from the sale or exchange of stocks or securities which are capital assets, which is from sources without the United States and derived by a nonresident alien individual or a foreign corporation in the active conduct during the taxable year of a banking, financing, or similar business in the United States, shall be treated as effectively connected for such year with the active conduct of that business shall be made by applying the principles of paragraph (c)(5)(ii) of § 1.864–4 for determining whether income, gain, or loss of such type from sources within the United States is effectively connected for such year with the active conduct of that business.

(c) Security defined. For purposes of this subdivision (ii), a security is any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe or to purchase, any of the foregoing items.

(d) Limitations on application of rules on banking, financing, or similar business—(1) Trading for taxpayer's own account. The provisions of *(b)* of this subdivision (ii) apply for purposes of determining when certain income, gain, or loss from stocks or securities is effectively connected with the active conduct of a banking, financing, or similar business in the United States. Any dividends, interest, gain, or loss from sources without the United States which by reason of the application of *(b)* of this subdivision (ii) is not effectively connected with the active conduct by a foreign corporation of a banking, financing, or similar business in the United States may be effectively connected for the taxable year, under *(a)* of this subdivision (ii), with the conduct by such taxpayer of a trade or business in the United States which consists of trading in stocks or securities for the taxpayer's own account.

(2) Other income. For rules relating to dividends or interest from sources without the United States (other than dividends or interest from, or gain or loss from the sale or exchange of, stocks or securities referred to in *(b)* of this subdivision (ii)) derived in the active conduct of a banking, financing, or similar business in the United States, see *(a)* of this subdivision (ii).

(iii) *Sale of goods or merchandise through U.S. office.* Income, gain, or loss from sales of goods or merchandise specified in paragraph (b)(3) of § 1.864–5, if the office or other fixed place of business actively participates in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale which are not the subject of a separate agreement between the seller and the buyer. The office or other fixed place of business in the United States shall be considered a material factor in the realization of income, gain, or loss from a sale made as a result of a sales order received in such office or other fixed place of business except where the sales order is received unsolicited and that office or other fixed place of business is not held out to potential customers as the place to which such sales orders should be sent. The income, gain, or loss must be realized in the ordinary course of the trade or business carried on through the office or other fixed place of business in the United States. Thus, if a foreign corporation is engaged solely in a manufacturing business in the United States, the income derived by its office in the United States as a result of an occasional sale outside the United States is not attributable to the U.S. office if the sales office of the manufacturing business is located outside the United States. On the other hand, if a foreign corporation establishes a sales office in the United States to sell for consumption in the Western Hemisphere merchandise which the corporation produces in Africa, the income derived by the sales office in the United States as a result of an occasional sale made by it in Europe shall be attributable to the U.S. sales office. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because of one or more of the following activities: *(a)* The sale is made subject to the final approval of such office or other fixed place of business, *(b)* the property sold is held in, and distributed from, such office or other fixed place of business, *(c)* samples of the property sold are displayed (but not otherwise promoted or sold) in such office or other fixed place of business, or *(d)* such office or other fixed place of business performs merely clerical functions incident to the sale. Activities carried on by employees of an office or other fixed place of business constitute activities of that office or other fixed place of business.

(3) *Limitation where foreign office is a material factor in realization of income*—(i) *Goods or merchandise destined for foreign use, consumption, or disposition.* Notwithstanding subparagraphs (1) and (2) of this paragraph, an office or other fixed place of business which a nonresident alien individual or a foreign corporation has in the United States shall not be considered, for purposes of paragraph (a) of this section, to be a material factor in the realization of income, gain, or loss from sales of goods or merchandise specified in paragraph (b)(3) of § 1.864–5 if the property is sold for use, consumption, or disposition

outside the United States and an office or other fixed place of business, as defined in §1.864–7, which such nonresident alien individual or foreign corporation has outside the United States participates materially in the sale. For this purpose an office or other fixed place of business which the taxpayer has outside the United States shall be considered to have participated materially in a sale made through the office or other fixed place of business in the United States if the office or other fixed place of business outside the United States actively participates in soliciting the order resulting in the sale, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale which are not the subject of a separate agreement between the seller and buyer. An office or other fixed place of business which the taxpayer has outside the United States shall not be considered to have participated materially in a sale merely because of one or more of the following activities: *(a)* The sale is made subject to the final approval of such office or other fixed place of business, *(b)* the property sold is held in, and distributed from, such office or other fixed place of business, *(c)* samples of the property sold are displayed (but not otherwise promoted or sold) in such office or other fixed place of business, *(d)* such office or other fixed place of business is used for purposes of having title to the property pass outside the United States, or *(e)* such office or other fixed place of business performs merely clerical functions incident to the sale.

(ii) *Rules for determining country of use, consumption, or disposition—(a) In general.* As a general rule, personal property which is sold to an unrelated person shall be presumed for purposes of this subparagraph to have been sold for use, consumption, or disposition in the country of destination of the property sold; for such purpose, the occurrence in a country of a temporary interruption in shipment of property shall not cause that country to be considered the country of destination. However, if at the time of a sale of personal property to an unrelated person the taxpayer knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed, or disposed of in the country of destination, the taxpayer must determine the country of ultimate use, consumption, or disposition of the property or the property shall be presumed to have been sold for use, consumption, or disposition in the United States. A taxpayer who sells personal property to a related person shall be presumed to have sold the property for use, consumption, or disposition in the United States unless the taxpayer establishes the use made of the property by the related person; once he has established that the related person has disposed of the property, the rules in the two immediately preceding sentences relating to sales to an unrelated person shall apply at the first stage in the chain of distribution at which a sale is made by a related person to an unrelated person. Notwithstanding the preceding provisions of this subdivision *(a)*, a taxpayer who sells personal property to any person whose principal business consists of selling from inventory to retail customers at retail outlets outside the United States may assume at the time of the sale to that person that the property will be used, consumed, or disposed of outside the United States. For purposes of this *(a)*, a person is related to another person if either person owns or controls directly or indirectly the other, or if any third person or persons own or control directly or indirectly both. For this purpose, the term ‘‘control’’ includes any kind of control, whether or not legally enforceable, and however, exercised or exercisable. For illustrations of the principles of this subdivision, see paragraph (a)(3)(iv) of §1.954–3.

(b) Fungible goods. For purposes of this subparagraph, a taxpayer who sells to a purchaser personal property which because of its fungible nature cannot reasonably be specifically traced to other purchasers and to the countries of ultimate use, consumption, or disposition shall, unless the taxpayer establishes a different disposition as being proper, treat that property as being sold, for ultimate use, consumption, or disposition in those countries, and to those other purchasers, in the

same proportions in which property from the fungible mass of the first purchaser is sold in the ordinary course of business by such first purchaser. No apportionment is required to be made, however, on the basis of sporadic sales by the first purchaser. This *(b)* shall apply only in a case where the taxpayer knew, or should have known from the facts and circumstances surrounding the transaction, the manner in which the first purchaser disposes of property from the fungible mass.

(iii) *Illustration.* The application of this subparagraph may be illustrated by the following example:

Example. Foreign corporation M has a sales office in the United States during the taxable year through which it sells outside the United States for use in foreign countries industrial electrical generators which such corporation manufactures in a foreign country. M is not a controlled foreign corporation within the meaning of section 957 and the regulations thereunder, and, by reason of its activities in the United States, is engaged in business in the United States during the taxable year. The generators require specialized installation and continuous adjustment and maintenance services. M has an office in foreign country X which is the only organization qualified to perform these installation, adjustment, and maintenance services. During the taxable year M sells several generators through its U.S. office for use in foreign country Y under sales contracts which also provide for installation, adjustment, and maintenance by its office in country X. The generators are installed in country Y by employees of M's office in country X, who also are responsible for the servicing of the equipment. Since the office of M in country X performs significant services incident to these sales which are necessary for their consummation and are not the subject of a separate agreement between M and the purchaser, the U.S. office of M is not considered to be a material factor in the realization of the income from the sales and, for purposes of paragraph (a) of this section, such income is not attributable to the U.S. office of that corporation.

(c) *Amount of income, gain, or loss allocable to U.S. office*—(1) *In general.* If, in accordance with paragraph (b) of this section, an office or other fixed place of business which a nonresident alien individual or a foreign corporation has in the United States at some time during the taxable year is a material factor in the realization for that year of an item of income, gain, or loss specified in paragraph (b) of §1.864–5, such item of income, gain, or loss shall be considered to be allocable in its entirety to that office or other fixed place of business. In no case may any income, gain, or loss for the taxable year from sources without the United States, or part thereof, be allocable under this paragraph to an office or other fixed place of business which a nonresident alien individual or a foreign corporation has in the United States if the taxpayer is at no time during the taxable year engaged in a trade or business in the United States.

(2) *Special limitation in case of sales of goods or merchandise through U.S. office.* Notwithstanding subparagraph (1) of this paragraph, in the case of a sale of goods or merchandise specified in paragraph (b)(3) of §1.864–5, which is not a sale to which paragraph (b)(3)(i) of this section applies, the amount of income which shall be considered to be allocable to the office or other fixed place of business which the nonresident alien individual or foreign corporation has in the United States shall not exceed the amount which would be treated as income from sources within the United States if the taxpayer had sold the goods or merchandise in the United States. See, for example, section 863(b)(2) and paragraph (b) of §1.863–3, which prescribes, as available methods for determining the income from sources within the United States, the independent factory or production price method, the gross sales and property apportionment method, and any other method regularly employed by the taxpayer which more clearly reflects taxable income from such sources than those specifically authorized.

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

Example 1. Foreign corporation M, which is not a controlled foreign corporation within the meaning of section 957 and the regulations thereunder, manufactures machinery in a foreign country and sells the machinery outside the United States through its sales office in the United States for use in foreign countries. Title to the property which is sold is transferred to the foreign purchaser outside the United States, but no office or other fixed place of business of M in a foreign country participates materially in the sale made through its U.S. office. During the taxable year M derives a total taxable income (determined as though M were a domestic corporation) of $250,000 from these sales. If the sales made through the U.S. office for the taxable year had been made in the United States and the property had been sold for use in the United States, the taxable income from sources within the United States from such sales would have been $100,000, determined as provided in section 863 and 882(c) and the regulations thereunder. The taxable income which is allocable to M's U.S. sales office pursuant to this paragraph and which is effectively connected for the taxable year with the conduct of a trade or business within the United States by that corporation is $100,000.

Example 2. Foreign corporation N, which is not a controlled foreign corporation within the meaning of section 957 and the regulations thereunder, has an office in a foreign country which purchases merchandise and sells it through its sales office in the United States for use in various foreign countries, such sales being made outside the United States and title to the property passing outside the United States. No other office of N participates materially in these sales made through its U.S. office. By reason of its sales activities in the United States, N is engaged in business in the United States during the taxable year. During the taxable year N derives taxable income (determined as though N were a domestic corporation) of $300,000 from these sales made through its U.S. sales office. If the sales made through the U.S. office for the taxable year had been made in the United States and the property had been sold for use in the United States, the taxable income from sources within the United States from such sales would also have been $300,000, determined as provided in sections 861 and 882(c) and the regulations thereunder. The taxable income which is allocable to N's U.S. sales office pursuant to this paragraph and which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation is $300,000.

Example 3. The facts are the same as in example 2, except that N has an office in a foreign country which participates materially in the sales which are made through its U.S. office. The taxable income which is allocable to N's U.S. sales office is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation.

[T.D. 7216, 37 FR 23431, Nov. 3, 1972]

§ 1.864–7 Definition of office or other fixed place of business.

(a) *In general.* (1) This section applies for purposes of determining whether a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, has an office or other fixed place of business in the United States for purposes of applying section 864(c)(4)(B) and § 1. 864–6 to income, gain, or loss specified in paragraph (b) of § 1.864–5 from sources without the United States or has an office or other fixed place of business outside the United States for purposes of applying section 864(c)(4)(B)(iii) and paragraph (b)(3)(i) of § 1.864–6 to sales of goods or merchandise for use, consumption, or disposition outside the United States.

(2) In making a determination under this section due regard shall be given to the facts and circumstances of each case, particularly to the nature of the taxpayer's trade or business and the physical facilities actually required by the taxpayer in the ordinary course of the conduct of his trade or business.

(3) The law of a foreign country shall not be controlling in determining whether a nonresident alien individual or a foreign corporation has an office or other fixed place of business.

(b) *Fixed facilities*—(1) *In general.* As a general rule, an office or other fixed place of business is a fixed facility, that is, a place, site, structure, or other similar facility, through which a nonresident alien individual or a foreign corporation engages in a trade or business. For this purpose an office or other fixed place of business shall include, but shall not be limited to, a factory; a store or other sales outlet; a workshop; or a mine, quarry, or other place of extraction of natural resources. A fixed facility may be considered an office or other fixed place of business whether or not the facility is continuously used by a nonresident alien individual or foreign corporation.

(2) *Use of another person's office or other fixed place of business.* A nonresident alien individual or a foreign corporation shall not be considered to have an office or other fixed place of business merely because such alien individual or foreign corporation uses another person's office or other fixed place of business, whether or not the office or place of business of a related

person, through which to transact a trade or business, if the trade or business activities of the alien individual or foreign corporation in that office or other fixed place of business are relatively sporadic or infrequent, taking into account the overall needs and conduct of that trade or business.

(c) *Management activity.* A foreign corporation shall not be considered to have an office or other fixed place of business merely because a person controlling that corporation has an office or other fixed place of business from which general supervision and control over the policies of the foreign corporation are exercised. The fact that top management decisions affecting the foreign corporation are made in a country shall not of itself mean that the foreign corporation has an office or other fixed place of business in that country. For example, a foreign sales corporation which is a wholly owned subsidiary of a domestic corporation shall not be considered to have an office or other fixed place of business in the United States merely because of the presence in the United States of officers of the domestic parent corporation who are generally responsible only for the policy decisions affecting the foreign sales corporation, provided that the foreign corporation has a chief executive officer, whether or not he is also an officer of the domestic parent corporation, who conducts the day-to-day trade or business of the foreign corporation from a foreign office. The result in this example would be the same even if the executive officer should (1) regularly confer with the officers of the domestic parent corporation, (2) occasionally visit the U.S. office of the domestic parent corporation, and (3) during such visits to the United States temporarily conduct the business of the foreign subsidiary corporation out of the domestic parent corporation's office in the United States.

(d) *Agent activity*—(1) *Dependent agents*—(i) *In general.* In determining whether a nonresident alien individual or a foreign corporation has an office or other fixed place of business, the office or other fixed place of business of an agent who is not an independent agent, as defined in subparagraph (3) of this paragraph, shall be disregarded unless such agent *(a)* has the authority to negotiate and conclude contracts in the name of the nonresident alien individual or foreign corporation, and regularly exercises that authority, or *(b)* has a stock of merchandise belonging to the nonresident alien individual or foreign corporation from which orders are regularly filed on behalf of such alien individual or foreign corporation. A person who purchases goods from a nonresident alien individual or a foreign corporation shall not be considered to be an agent for such alien individual or foreign corporation for purposes of this paragraph where such person is carrying on such purchasing activities in the ordinary course of its own business, even though such person is related in some manner to the nonresident alien individual or foreign corporation. For example, a wholly owned domestic subsidiary corporation of a foreign corporation shall not be treated as an agent of the foreign parent corporation merely because the subsidiary corporation purchases goods from the foreign parent corporation and resells them in its own name. However, if the domestic subsidiary corporation regularly negotiates and concludes contracts in the name of its foreign parent corporation or maintains a stock of merchandise from which it regularly fills orders on behalf of the foreign parent corporation, the office or other fixed place of business of the domestic subsidiary corporation shall be treated as the office or other fixed place of business of the foreign parent corporation unless the domestic subsidiary corporation is an independent agent within the meaning of subparagraph (3) of this paragraph.

(ii) *Authority to conclude contracts or fill orders.* For purposes of subdivision (i) of this subparagraph, an agent shall be considered regularly to exercise authority to negotiate and conclude contracts or regularly to fill orders on behalf of his foreign principal only if the authority is exercised, or the orders are filled, with some frequency over a continuous period of time. This determination shall be made on the basis of the facts and circumstances in each case, taking into account the nature of the business of the principal; but, in all cases, the frequency and continuity tests are to be applied conjunctively. Regularity shall not be evidenced by occasional or incidental activity. An agent shall not be considered regularly to negotiate and conclude contracts on behalf of his foreign principal if the agent's authority to negotiate and conclude contracts is limited only to unusual cases or such authority must be separately secured by the agent from his principal with respect to each transaction effected.

(2) *Independent agents.* The office or other fixed place of business of an independent agent, as defined in subparagraph (3) of this paragraph, shall not be treated as the office or other fixed place of business of his principal who is a nonresident alien individual or a foreign corporation, irrespective of whether such agent has authority to negotiate and conclude contracts in the name of his principal, and regularly exercises that authority, or maintains a stock of goods from which he regularly fills orders on behalf of his principal.

(3) *Definition of independent agent*—(i) *In general.* For purposes of this paragraph, the term ''independent agent'' means a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity. Thus, for example, an agent who, in pursuance of his usual trade or business, and for compensation, sells goods or merchandise consigned or entrusted to his possession, management, and control for that purpose by or for the owner of such goods or merchandise is an independent agent.

(ii) *Related persons.* The determination of whether an agent is an independent agent for purposes of this paragraph shall be made without regard to facts indicating that either the agent or the principal owns or controls directly or indirectly the other or that a third person or persons own or control directly or indirectly both. For example, a wholly owned domestic subsidiary corporation of a foreign corporation which acts an an agent for the foreign parent corporation may be treated as acting in the capacity of independent agent for the foreign parent corporation. The facts and circumstances of a specific case shall determine whether the agent, while acting for his principal, is acting in pursuance of his usual trade or business and in such manner as to constitute him an independent agent in his relations with the nonresident alien individual or foreign corporation.

(iii) *Exclusive agents.* Where an agent who is otherwise an independent agent within the meaning of subdivision (i) of this subparagraph acts in such capacity exclusively, or almost exclusively, for one principal who is a nonresident alien individual or a foreign corporation, the facts and circumstances of a particular case shall be taken into account in determining whether the agent, while acting in that capacity, may be classified as an independent agent.

(e) *Employee activity.* Ordinarily, an employee of a nonresident alien individual or a foreign corporation shall be treated as a dependent agent to whom the rules of paragraph (d)(1) of this section apply if such employer does not in and of itself have a fixed facility (as defined in paragraph (b) of this section) in the United States or outside the United States, as the case may be. However, where the employee, in the ordinary course of his duties, carries on the trade or business of his employer in or through a fixed facility of such employer which is regularly used by the employee in the course of carrying out such duties, such fixed facility shall be considered the office or other fixed place of business of the employer, irrespective of the rules of paragraph (d)(1) of this section. The application of this paragraph may be illustrated by the following example:

Example. M, a foreign corporation, opens a showroom office in the United States for the purpose of promoting its sales of merchandise which it purchases in foreign country X. The employees of the U.S. office, consisting of salesmen and general clerks, are empowered only to run the office, to arrange for the appointment of distributing agents for the merchandise offered by M, and to solicit orders generally. These employees do not have the authority to negotiate and conclude contracts in the name of M, nor do they have a stock of merchandise from which to fill orders on behalf of M. Any negotiations entered into by these employees are under M's instructions and subject to its approval as to any decision reached. The only independent authority which the employees have is in the appointment of distributors to whom M is to sell merchandise, but even this authority is subject to the right of M to approve or disapprove these buyers on receipt of information as to their business standing. Under the circumstances, this office used by a group of salesmen for sales promotion is a fixed place of business which M has in the United States.

(f) *Office or other fixed place of business of a related person.* The fact that a nonresident alien individual or a foreign corporation is related in some manner to another person who has an office or other fixed place of business shall not of itself mean that such office or other fixed place of business of the other person is the office or other fixed place of business of the nonresident alien individual or foreign corporation. Thus, for example, the U.S. office of foreign corporation M, a wholly owned subsidiary corporation of foreign corporation N, shall not be considered the office or other fixed place of business of N unless the facts and circumstances show that N is engaged in trade or business in the United States through that office or other fixed place of business. However, see paragraph (b)(2) of this section.

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

Example 1. S, a foreign corporation, is engaged in the business of buying and selling tangible personal property. S is a wholly owned subsidiary of P, a domestic corporation engaged in the business of buying and selling similar property, which has an office in the United States. Officers of P are generally responsible for the policies followed by S and are directors of S, but S has an independent group of officers, none of whom are regularly employed in the United States. In addition to this group of officers, S has a chief executive officer, D, who is also an officer of P but who is permanently stationed outside the United States. The day-to-day conduct of S's business is handled by D and the other officers of such corporation, but they regularly confer with the officers of P and on occasion temporarily visit P's offices in the United States, at which time they continue to conduct the business of S. S does not have an office or other fixed place of business in the United States for purposes of this section.

Example 2. The facts are the same as in example 1 except that, on rare occasions, an employee of P receives an order which he, after consultation with officials of S and because P cannot fill the order, accepts on behalf of S rather than on behalf of P. P does not hold itself out as a person which those wishing to do business with S should contact. Assuming that orders for S are seldom handled in this manner and that they do not constitute a significant part of that corporation's business, S shall not be considered to have an office or other fixed place of business in the United States because of these activities of an employee of P.

Example 3. The facts are the same as in example 1 except that all orders received by S are subject to review by an officer of P before acceptance. S has a business office in the United States.

Example 4. S, a foreign corporation organized under the laws of Puerto Rico, is engaged in the business of manufacturing dresses in Puerto Rico and is entitled to an income tax exemption under the Puerto Rico Industrial Incentive Act of 1963. S is a wholly owned subsidiary of P, a domestic corporation engaged in the business of buying and selling dresses to customers in the United States. S sells most of the dresses it produces to P, the assumption being made that the income from these sales is derived from sources without the United States. P in turn sells these dresses in the United States in its name and through the efforts of its own employees and of distributors appointed by it. S does not have a fixed facility in the United States, and none of its employees are stationed in the United States. On occasion, employees of S visit the office of P in the United States, and executives of P visit the office of S in Puerto Rico, to discuss with one another matters of mutual business interest involving both corporations, including the strategy for marketing the dresses produced by S. These matters are also regularly discussed by such persons by telephone calls between the United States and Puerto Rico. S's employees do not otherwise participate in P's marketing activities. Officers of P are generally responsible for the policies followed by S and are directors of S, but S has a chief executive officer in Puerto Rico who, from its office therein, handles the day-to-day conduct of S's business. Based upon the facts presented, and assuming there are no other facts which would lead to a different determination, S shall not be considered to have an office or other fixed place of business in the United States for purposes of this section.

Example 5. The facts are the same as in example 4 except that the dresses are manufactured by S in styles and designs furnished by P and out of goods and raw materials purchased by P and sold to S. Based upon the facts presented, and assuming there are no other facts which would lead to a different determination, S shall not be considered to have an office or other fixed place of business in the United States for purposes of this section.

Example 6. The facts are the same as in example 5 except that, pursuant to the instructions of P, the dresses sold by P are shipped by S directly to P's customers in the United States. Based upon the facts presented, and assuming there are no other facts which would lead to a different determination, S shall not be considered to have an office or other fixed place of business in the United States for purposes of this section.

[T.D. 7216, 37 FR 23433, Nov. 3, 1972]

§ 1.864–8T Treatment of related person factoring income (temporary).

(a) *Applicability*—(1) *General rule.* This section applies for purposes of determining the treatment of income derived by a person from a trade or service receivable acquired from a related person. Except as provided in paragraph (d) of this section, if a person acquires (directly or indirectly) a trade or service receivable from a related person, any income (including any stated interest, discount or service fee) derived from the trade or service receivable shall be treated as if it were interest received on a loan to the obligor under the receivable. The characterization of income as interest pursuant to this section shall apply only for purposes of sections 551–558 (relating to foreign personal holding companies), sections 951–964 (relating to controlled foreign corporations), and section 904 (relating to the limitation on the foreign tax credit) of the Code and the regulations thereunder. The principles of sections 861 through 863 and the regulations thereunder shall be applied to determine the source of such interest income for purposes of section 904.

(2) *Override.* With respect to income characterized as interest under this section, the special rules of section 864(d) and this section override any conflicting provisions of the Code and regulations relating to foreign personal holding companies, controlled foreign corporations, and the foreign tax credit limitation. Thus, for example, pursuant to section 864(d)(5) and paragraph (e) of this section, stated interest derived from a factored trade or service receivable is not eligible for the subpart F de minimis rule of section 954(b)(3), the same country exception of section 954(c)(3)(A)(i), or the special rules for export financing interest of sections 904(d)(2) and 954(c)(2)(B), even if in the absence of this section the treatment of such stated interest would be governed by those sections.

(3) *Limitation.* Section 864(d) and this section apply only with respect to the tax treatment of income derived from a trade or service receivable acquired from a related person. Therefore, neither section 864(d) nor this section affects the characterization of an expense or loss of either the seller of a receivable or the obligor under a receivable. Accordingly, the obligor under a trade or service receivable shall not be allowed to treat any part of the purchase price of property or services as interest (other than amounts treated as interest under provisions other than section 864(d)).

(b) *Definitions.* The following definitions apply for purposes of this section and § 1.956–3T.

(1) *Trade or service receivable.* The term ''trade or service receivable'' means any account receivable or evidence of indebtedness, whether or not issued at a discount and whether or not bearing stated interest, arising out of the disposition by a related person of property described in section 1221(l) (hereinafter referred to as ''inventory property'') or the performance of services by a related person.

(2) *Related person.* A ''related person'' is:

(i) A person who is a related person within the meaning of section 267(b) and the regulations thereunder;

(ii) A United States shareholder (as defined in section 951(b)); or

(iii) A person who is related (within the meaning of section 267(b) and the regulations thereunder) to a United States shareholder.

(c) *Acquisition of a trade or service receivable*—(1) *General rule.* A trade or service receivable is considered to be acquired by a person at the time when that person is entitled to receive all or a portion of the income from the trade or service receivable. A person who acquires a trade or service receivable (hereinafter referred to as the ''factor'') is considered to have acquired a trade or service receivable regardless of whether:

(i) The acquisition is characterized for federal income tax purposes as a sale, a pledge of collateral for a loan, an assignment, a capital contribution, or otherwise;

(ii) The factor takes title to or obtains physical possession of the trade or service receivable;

(iii) The related person assigns the trade or service receivable with or without recourse:

(iv) The factor or some other person is obligated to collect the payments due under the trade or service receivable;

(v) The factor is liable for all property, excise, sales, or similar taxes due upon collection of the receivable;

(vi) The factor advances the entire face amount of the trade or service receivable transferred;

(vii) All trade or service receivables assigned by the related person are assigned to one factor; and

(viii) The obligor under the trade or service receivable is notified of the assignment.

(2) *Example.* The following example illustrates the application of paragraphs (a), (b), and (c)(1) of this section.

Example. P, a domestic corporation, owns all of the outstanding stock of FS, a controlled foreign corporation. P manufactures and sells paper products to customers, including X, an unrelated domestic corporation. As part of a sales transaction, P takes back a trade receivable from X and sells the receivable to FS. Because FS has acquired a trade or service receivable from a related person, the income derived by FS from P's receivable is interest income described in paragraph (a)(1) of this section.

(3) *Indirect acquisitions*—(i) *Acquisition through unrelated person.* A trade or service receivable will be considered to be acquired from a related person if it is acquired from an unrelated person who acquired (directly or indirectly) such receivable from a person who is a related person to the factor. The following example illustrates the application of this paragraph (c)(3)(i).

Example. A, a United States citizen, owns all of the outstanding stock of FPHC, a foreign personal holding company. A performs engineering services within and without the United States for customers, including X, an unrelated corporation. A performs engineering services for X and takes back a service receivable. A sells the receivable to Y, an unrelated corporation engaged in the factoring business. Y resells the receivable to FPHC. Because FPHC has indirectly acquired a service receivable from a related person, the income derived by FPHC from A's receivable is interest income described in paragraph (a)(1) of this section.

(ii) *Acquisition by nominee or pass-through entity.* A factor will be considered to have acquired a trade or service receivable held on its behalf by a nominee or by a partnership, simple trust, S corporation or other pass-through entity to the extent the factor owns (directly or indirectly) a beneficial interest in such partnership or other pass-through entity. The rule of this paragraph (c)(3)(ii) does not limit the application of paragraph (c)(3)(iii) of this section regarding the characterization of trade or service receivables of unrelated persons acquired pursuant to certain swap or pooling arrangements. The following example illustrates the application of this paragraph (c)(3)(ii).

Example. FS1, a controlled foreign corporation, acquires a 20 percent limited partnership interest in PS, a partnership. PS purchases trade or service receivables resulting from the sale of inventory property by FS1's domestic parent, P. PS does not purchase receivables of any person who is related to any other partner in PS. FS1 is considered to have acquired a 20 percent interest in the receivables acquired by PS. Thus, FS1's distributive share of the income derived by PS from the receivables of P is considered to be interest income described in paragraph (a)(1) of this section.

(iii) *Swap or pooling arrangements.* A trade or service receivable of a person unrelated to the factor will be considered to be a trade or service receivable acquired from a related person and subject to the rules of this section if it is acquired in accordance with an arrangement that involves two or more groups of related persons that are unrelated to each other and the effect of the arrangement is that one or more related persons in each group acquire (directly or indirectly) trade or service receivables of one or more unrelated persons who are also parties to the arrangement, in exchange for reciprocal purchases of the first group's receivables. The following example illustrates the application of this paragraph (c)(3)(iii).

Example. Controlled foreign corporations A, B, C, and D are wholly-owned subsidiaries of domestic corporations M, N, O, and P, respectively. M, N, O, and P are not related persons. According to a prearranged plan, A, B, C, and D each acquire trade or service receivables of M, N, O, and/or P, except that neither A, B, C nor D acquires receivables of its own parent corporation. Because the effect of this arrangement is that the unrelated groups acquire each other's trade or service receivables pursuant to the arrangement, income derived by A, B, C, and D from the receivables acquired from M, N, O, and P is interest income described in paragraph (a)(1) of this section.

(iv) *Financing arrangements.* If a controlled foreign corporation (as defined in section 957(a)) participates (directly or indirectly) in a lending transaction that results in a loan to the purchaser of inventory property, services, or trade or service receivables of a related person (or a loan to a person who is related to the purchaser), and if the loan would not have been made or maintained on the same terms but for the corresponding purchase, then the controlled foreign corporation shall be considered to have indirectly acquired a trade or service receivable, and income derived by the controlled foreign corporation from such a loan shall be considered to be income described in paragraph (a)(1) of this section. For purposes of this paragraph (c)(3)(iv), it is immaterial that the sums lent are not, in fact, the sums used to finance the purchase of a related person's inventory property, services, or trade or service receivables. The amount of income derived by the controlled foreign corporation to be taken into account shall be the total amount of income derived from a lending transaction described in this paragraph (c)(3)(iv), if the amount lent is less than or equal to the purchase price of the inventory property, services, or trade or service receivables. If the amount lent is greater than the purchase price of the inventory property, services or receivables, the amount to be taken into account shall be the proportion of the interest charge (including original issue discount) that the purchase price bears to the total amount lent pursuant to the lending transaction. The following examples illustrate the application of this paragraph (c)(3)(iv).

Example 1. P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation engaged in the financing business in Country X. P manufactures and sells toys, including sales to C, an unrelated corporation. Prior to P's sale of toys to C for $2,000, D, a wholly-owned Country X subsidiary of C, borrows $3,000 from FS1. The loan from FS1 to D would not have been made or maintained on the same terms but for C's purchase of toys from P. Two-thirds of the income derived by FS1 from the loan to D is interest income described in paragraph (a)(1) of this section.

Example 2. P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation organized under the laws of Country X. FS1 has accumulated cash reserves. P has uncollected trade and service receivables of foreign obligors. FS1 makes a $1,000 loan to U, a foreign corporation that is unrelated to P or FS1. U purchases P's trade and service receivables for $2,000. The loan would not have been made or maintained on the same terms but for U's purchase of P's receivables. The income derived by U from the receivables is not interest income within the meaning of paragraph (a) of this section. However, the interest paid by U to FS1 is interest income described in paragraph (a)(1) of this section.

Example 3. The facts are the same as in Example (2), except that U is a wholly-owned Country Y subsidiary of FS1. Because U is related to P within the meaning of paragraph (b)(2) of this section, under paragraph (c)(1) of this section, income derived by U from P's receivables is interest income described in paragraph (a)(1) of this section. In addition, the income derived by FS1 from the loan to U is interest income described in paragraph (a)(1) of this section.

(d) *Same country exception*—(1) *Income from trade or service receivables.* Income derived from a trade or service receivable acquired from a related person shall not be treated as interest income described in paragraph (a)(1) of this section if:

(i) The person acquiring the trade or service receivable and the related person are created or organized under the laws of the same foreign country;

(ii) The related person has a substantial part of its assets used in its trade or business located in such foreign country; and

(iii) The related person would not have derived foreign base company income, as defined in section 954(a) and the regulations thereunder, or income effectively connected with a United

States trade or business from such receivable if the related person had collected the receivable.

For purposes of paragraph (d)(1)(ii) of this section, the standards contained in §1.954–2(e) shall apply in determining the location of a substantial part of the assets of a related person. For purposes of paragraph (d)(1)(iii) of this section, a determination of whether the related person would have derived foreign base company income shall be made without regard to the de minimis test described in section 954(b)(3)(A). The following examples illustrate the application of this paragraph (d)(1).

Example 1. FS1, a controlled foreign corporation incorporated under the laws of Country X, owns all of the outstanding stock of FS2, which is also incorporated under the laws of Country X. FS1 has a substantial part of its assets used in its business in Country X. FS1 manufactures and sells toys for use in Country Y. The toys sold are considered to be manufactured in Country X under §1.954–3(a)(2). FS1 is not considered to have a branch or similar establishment in Country Y that is treated as a separate corporation under section 954(d)(2) and §1.954–3(b). Thus, gross income derived by FS1 from the toy sales is not foreign base company sales income. FS1 takes back receivables without stated interest from its customers. FS1 assigns those receivables to FS2. The income derived by FS2 from the receivables of FS1 is not interest income described in paragraph (a)(1) of this section, because it satisfies the same country exception under paragraph (d)(1) of this section.

Example 2. The facts are the same as in Example 1, except that the toys sold by FS1 are purchased from FS1's U.S. parent and are sold for use outside of Country X. Thus, any income derived by FS1 from the sale of the toys would be foreign base company sales income. Therefore, income derived by FS2 from the receivables of FS1 is interest income described in paragraph (a)(1) of this section. FS2 is considered to derive interest income from the receivable even if, solely by reason of the de minimis rule of section 954(b)(3)(A), FS1 would not have derived foreign base company income if FS1 had collected the receivable.

(2) *Income from financing arrangements.* Income derived by a controlled foreign corporation from a loan to a person that purchases inventory property or services of a person that is related to the controlled foreign corporation, or from other loans described in paragraph (c)(3)(iv) of this section, shall not be treated as interest income described in paragraph (a)(1) of this section if:

(i) The person providing the financing and the related person are created or organized under the laws of the same foreign country;

(ii) The related person has a substantial part of its assets used in its trade or business located in such foreign country; and

(iii) The related person would not have derived foreign base company income or income effectively connected with a United States trade or business:

(A) From the sale of inventory property or services to the borrower or from financing the borrower's purchase of inventory property or services, in the case of a loan to the purchaser of inventory property or services of a related person; or

(B) From collecting amounts due under the receivable or from financing the purchase of the receivable, in the case of a loan to the purchaser of a trade or service receivable of a related person.

For purposes of paragraph (d)(2)(ii) of this section, the standards contained in §1.954–2(e) shall apply in determining the location of a substantial part of the assets of a related person. For purposes of paragraph (d)(2)(iii) of this section, a determination of whether the related person would have derived foreign base company income shall be made without regard to the de minimis test described in section 954(b)(3)(A). The following examples illustrate the application of this paragraph (d)(2).

Example 1. FS1, a controlled foreign corporation incorporated under the laws of Country X, owns all of the outstanding stock of FS2, which is also incorporated under the laws of Country X. FS1, which has a substantial part of its assets used in its business located in Country X, manufactures and sells toys for use in Country Y. The toys sold are considered to be manufactured in Country X under §1.954–3(a)(2). FS1 is not considered to have a branch or similar establishment in Country Y that is treated as a separate corporation under section 954(d)(2) and §1.954–3(b). Thus, the gross income derived by FS1 from the toy sales is not foreign base company sales income. FS2 makes a loan to FS3, a wholly-owned subsidiary of FS1 which is also incorporated under the laws of Country X, in connection with FS3's purchase of toys from FS1. FS3 does not earn any subpart F gross income. Thus, FS1 would not have derived foreign personal holding company interest income if FS1 had made the loan to FS3, because the interest would be covered by the same country exception of section 954(c)(3). Therefore, the income derived by FS2 from its loan to FS3 is not treated as interest income described in paragraph (a)(1) of this section, because it satisfies the same country exception under paragraph (d)(2) of this section. Such income is also not treated as foreign personal holding company income described in section 954(c)(1)(A) because the same country exception of section 954(c)(3) also applies to the interest actually derived by FS2 from its loan to FS3.

Example 2. FS1, a controlled foreign corporation incorporated under the laws of Country X, owns all of the outstanding stock of FS2, which is also incorporated under the laws of Country X. FS1 purchases toys from its U.S. parent and resells them for use outside of Country X. As part of a sales transaction, FS1 takes back trade receivables. FS2 makes a loan to U, an unrelated corporation, to finance U's purchase of FS1's trade receivables. Because FS1 would have derived foreign base company income if FS1 had collected the receivables or made the loan itself, the same country exception of paragraph (d)(2) of this section does not apply. Accordingly, under paragraph (c)(3)(iv) of this section, the income derived by FS2 from its loan to U is treated as interest income described in paragraph (a)(1) of this section.

(e) *Special rules*—(1) *Foreign personal holding companies and controlled foreign corporations.* For purposes of sections 551–558 (relating to foreign personal holding companies), the exclusion provided by section 552(c) for interest described in section 954(c)(3)(A) shall not apply to income described in paragraph (a)(1) of this section. For purposes of the sections 951–964 (relating to controlled foreign corporations), income described in paragraph (a)(1) of this section shall be included in a United States shareholder's pro rata share of a controlled foreign corporation's subpart F income without regard to the de minimis rule under section 954(b)(3)(A). However, income described in paragraph (a)(1) of this section shall be included in the computation of a controlled foreign corporation's foreign base company income for purposes of applying the de minimis rule under section 954(b)(3)(A) and the more than 70 percent of gross income test under section 954(b)(3)(B). In addition, income described in paragraph (a)(1) of this section shall be considered to be subpart F income without regard to the exclusions from foreign base company income provided by section 954(c)(2)(B) (relating to export financing interest derived in the conduct of a banking business) and section 954(c)(3)(A)(i) (relating to certain interest income received from related persons).

(2) *Foreign tax credit.* Income described in paragraph (a)(1) of this section shall be considered to be interest income for purposes of the section 904 foreign tax credit limitation and is not eligible for the exceptions for export financing interest provided in section 904(d)(2) (A)(iii)(II), (B)(ii), and (C)(iii). In addition, such income will be subject to the look-through rule for subpart F income set forth in section 904(d)(3) without regard to the de minimis exception provided in section 904(d)(3)(E).

(3) *Possessions corporations*—(i) *Limitation on credit.* Income described in paragraph (a)(1) of this section shall not be treated as income described in section 936(a)(1) (A) or (B) unless the income is considered under the principles of § 1.863–6 to be derived from sources within the possessions. Thus, the credit provided by section 936 is not available for income described in paragraph (a)(1) of this section unless the obligor under the receivable is a resident of a possession. In the case of a loan described in section 864(d)(6), the credit provided by section 936 is not available for income described in paragraph (a)(1) of this section unless the purchaser of the inventory property or services is a resident of a possession.

(ii) *Eligibility determination.* Notwithstanding the limitation on the availability of the section 936 credit for income described in paragraph (a)(1) of this section, if income treated as interest income under paragraph (a)(1) of this section is derived from sources within a possession (determined without regard to this section), such income shall be eligible for inclusion in a corporation's gross income for purposes of section 936(a)(2)(A). If such income is derived from the active conduct of a trade or business within a possession (determined without regard to this section), such income shall be eligible for inclusion in a corporation's gross income for purposes of section 936(a)(2)(B). (These rules apply for purposes of determining whether a corporation is eligible to elect the credit provided under section 936(a).)

(iii) *Example.* The following example illustrates the application of paragraph (e)(3) of this section.

Example. Corporation X is operating in a possession as a possessions corporation. In 1985, X earned $50,000 from the active conduct of a business in the possession, including $5,000 from trade or service receivables acquired from a related party. Obligors under the receivables acquired by X are not residents of the possession. Corporation X also earned $20,000 from activities other than its active conduct of business in the possession. The $5,000 derived by X from the receivables is not eligible for the section 936 credit. However, the $5,000 may be used by X to meet the percentage tests under section 936(a)(2) to the extent that such income is considered to be derived from sources within the possession (for purposes of section 936(a)(2)(A)) or is considered to be derived from the active conduct of a trade or business in the possession (for purposes of section 936(a)(2)(B)), in either case determined without regard to the characterization of such income under this section.

(f) *Effective date.* The provisions of this section shall apply with respect to accounts receivable and evidences of indebtedness transferred after March 1, 1984 and are effective June 14, 1988.

[T.D. 8209, 53 FR 22166, June 14, 1988]

§1.865–1T Loss with respect to personal property other than stock (temporary).

(a) *General rules for allocation of loss*—(1) *Allocation against gain.* Except as otherwise provided in §§1.865–2 and 1.865–2T and paragraph (c) of this section, loss recognized with respect to personal property shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain from a sale of such property would give rise in the hands of the seller. Thus, for example, loss recognized by a United States resident on the sale of a bond generally is allocated to reduce United States source income.

(2) *Loss attributable to foreign office.* Except as otherwise provided in §§1.865–2 and 1.865–2T and paragraph (c) of this section, and except with respect to loss subject to paragraph (b) of this section, in the case of loss recognized by a United States resident with respect to property that is attributable to an office or other fixed place of business in a foreign country within the meaning of section 865(e)(3), the loss shall be allocated to reduce foreign source income if a gain on the sale of the property would have been taxable by the foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent. However, paragraph (a)(1) of this section and not this paragraph (a)(2) will apply if gain on the sale of such property would be sourced under section 865(c), (d)(1)(B), or (d)(3).

(3) *Loss recognized by United States citizen or resident alien with foreign tax home.* Except as otherwise provided in §§1.865–2 and 1.865–2T and paragraph (c) of this section, and except with respect to loss subject to paragraph (b) of this section, in the case of loss with respect to property recognized by a United States citizen or resident alien that has a tax home (as defined in section 911(d)(3)) in a foreign country, the loss shall be allocated to reduce foreign source income if a gain on the sale of such property would have been taxable by a foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(4) *Allocation for purposes of section 904.* For purposes of section 904, loss recognized with respect to property that is allocated to foreign source income under this paragraph (a) shall be allocated to the separate category under section 904(d) to which gain on the sale of the property would have been assigned (without regard to section 904(d)(2)(A)(iii)(III)). For purposes of §1.904–4(c)(2)(ii)(A), any such loss allocated to passive income shall be allocated (prior to the application of §1.904–4(c)(2)(ii)(B)) to the group of passive income to which gain on a sale of the property would have been assigned had a sale of the property resulted in the recognition of a gain under the law

of the relevant foreign jurisdiction or jurisdictions.

(5) *Loss recognized by partnership.* A partner's distributive share of loss recognized by a partnership with respect to personal property shall be allocated and apportioned in accordance with this section as if the partner had recognized the loss. If loss is attributable to an office or other fixed place of business of the partnership within the meaning of section 865(e)(3), such office or fixed place of business shall be considered to be an office of the partner for purposes of this section.

(b) *Special rules of application*—(1) *Depreciable property.* In the case of a loss recognized with respect to depreciable personal property, the gain referred to in paragraph (a)(1) of this section is the gain that would be sourced under section 865(c)(1) (depreciation recapture).

(2) *Contingent payment debt instrument.* Except to the extent provided in § 1.1275–4(b)(9)(iv), loss recognized with respect to a contingent payment debt instrument to which § 1.1275–4(b) applies (instruments issued for money or publicly traded property) shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the instrument (in the amount of the loss subject to this paragraph (b)(2)) would give rise.

(c) *Exceptions*—(1) *Foreign currency and certain financial instruments.* This section does not apply to loss governed by section 988 and loss recognized with respect to options contracts or derivative financial instruments, including futures contracts, forward contracts, notional principal contracts, or evidence of an interest in any of the foregoing.

(2) *Inventory.* This section does not apply to loss recognized with respect to property described in section 1221(1).

(3) *Interest equivalents and trade receivables.* Loss subject to § 1.861–9T(b) (loss equivalent to interest expense and loss on trade receivables) shall be allocated and apportioned under the rules of § 1.861–9T and not under the rules of this section.

(4) *Unamortized bond premium.* To the extent a taxpayer recognizing loss with respect to a bond (within the meaning of § 1.171–1(b)) did not amortize bond premium to the full extent permitted by §§ 1.171–2 or 1.171–3 (or § 1.171–1, as contained in the 26 CFR part 1 edition revised as of April 1, 1997) (as applicable), loss recognized with respect to the bond shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the bond was assigned.

(5) *Accrued interest.* Loss attributable to accrued but unpaid interest on a debt obligation shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the obligation was assigned. For purposes of this section, whether loss is attributable to accrued but unpaid interest (rather than to principal) shall be determined under the principles of §§ 1.61–7(d) and 1.446–2(e).

(6) *Anti-abuse rules*—(i) *Transactions involving built-in losses.* If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to personal property by transferring the property to another person, qualified business unit, office or other fixed place of business, or branch that subsequently recognizes the loss, the loss shall be allocated by the transferee as if it were recognized by the transferor immediately prior to the transaction. If one of the principal purposes of a change of residence is to change the allocation of a built-in loss with respect to personal property, the loss shall be allocated as if the change of residence had not occurred. If one of the principal purposes of a transaction is to change the allocation of a built-in loss on the disposition of personal property by converting the original property into other property and subsequently recognizing loss with respect to such other property, the loss shall be allocated as if it were recognized with respect to the original property

immediately prior to the transaction. Transactions subject to this paragraph shall include, without limitation, reorganizations within the meaning of section 368(a), liquidations under section 332, transfers to a corporation under section 351, transfers to a partnership under section 721, transfers to a trust, distributions by a partnership, distributions by a trust, transfers to or from a qualified business unit, office or other fixed place of business, or branch, or exchanges under section 1031. A person may have a principal purpose of affecting loss allocation even though this purpose is outweighed by other purposes (taken together or separately).

(ii) *Offsetting positions.* If a taxpayer recognizes loss with respect to personal property and the taxpayer (or any person described in section 267(b) (after application of section 267(c), 267(e), 318 or 482 with respect to the taxpayer) holds (or held) offsetting positions with respect to such property with a principal purpose of recognizing foreign source income and United States source loss, the loss shall be allocated and apportioned against such foreign source income. For purposes of this paragraph (c)(6)(ii), positions are offsetting if the risk of loss of holding one or more positions is substantially diminished by holding one or more other positions.

(iii) *Matching rule.* To the extent a taxpayer (or a person described in section 1059(c)(3)(C) with respect to the taxpayer) recognizes foreign source income for tax purposes that results in the creation of a corresponding loss with respect to personal property, the loss shall be allocated and apportioned against such income. For examples illustrating a similar rule with respect to stock loss, see Examples 3 through 6 of § 1.865–2T(b)(4)(iv).

(d) *Definitions*—(1) *Contingent payment debt instrument.* A contingent payment debt instrument is any debt instrument that is subject to § 1.1275–4.

(2) *Depreciable personal property.* Depreciable personal property is any property described in section 865(c)(4)(A).

(3) *Terms defined in § 1.861–8.* See § 1.861–8 for the meaning of *class of gross income, statutory grouping of gross income,* and *residual grouping of gross income.*

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

Example 1. On January 1, 1997, *A*, a domestic corporation, purchases for $1,000 a machine that produces widgets, which *A* sells in the United States and throughout the world. Throughout *A*'s holding period, the machine is located and used in Country *X*. During *A*'s holding period, *A* incurs depreciation deductions of $400 with respect to the machine. Under § 1.861–8, *A* allocates and apportions depreciation deductions of $250 against foreign source general limitation income and $150 against U.S. source income. On December 12, 1999, *A* sells the machine and recognizes a loss of $500. Because the machine was used predominantly outside the United States, under section 865(c)(1)(B) and (c)(3)(B)(ii), gain on the disposition of the machine would be foreign source general limitation income to the extent of the depreciation adjustments. Therefore, under paragraph (b)(1) of this section, the entire $500 loss is allocated against foreign source general limitation income.

Example 2. On January 1, 1997, *A*, a domestic corporation, loans $2,000 to *N*, its wholly-owned controlled foreign corporation, in exchange for a contingent payment debt instrument subject to § 1.1275–4(b). During 1997 through 1999, *A* accrues and receives interest income of $630, $150 of which is foreign source general limitation income and $480 of which is foreign source passive income under section 904(d)(3). Assume there are no positive or negative adjustments pursuant to § 1.1275–4(b)(6) in 1997 through 1999. On January 1, 2000, *A* disposes of the debt instrument and recognizes a $770 loss. Under § 1.1275–4(b)(8)(ii), $630 of the loss is treated as ordinary loss and $140 is treated as capital loss. Assume that $140 of interest income earned in 2000 with respect to the debt instrument would be foreign source passive income under section 904(d)(3). Under § 1.1275–4(b)(9)(iv), $150 of the ordinary loss is allocated against foreign source general limitation income and $480 of the ordinary loss is allocated against foreign source passive income. Under paragraph (b)(2) of this section, the $140 capital loss is allocated against foreign source passive income.

Example 3. On January 1, 1997, *A*, a domestic corporation, purchases for $1,000 a bond maturing January 1, 2009, with a stated principal amount of $1,000, payable at maturity. The bond provides for unconditional payments of interest of $100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. Between 1997 and 2001, *A* accrues and receives foreign source interest income of $500 with respect to the bond. On January 1, 2002, *A* sells the bond and recognizes a $500 loss. Under paragraph (a)(1) of this section, the $500 loss is allocated against U.S. source income. Paragraph (c)(6)(iii) of this section is not applicable because *A*'s recognition of the foreign source income did not result in the creation of a corresponding loss with respect to the bond.

Example 4. On January 1, 1999, *A*, a domestic corporation on the accrual method of accounting, purchases for $1,000 a bond maturing January 1, 2009, with a stated principal amount of $1,000, payable at maturity. The bond provides for unconditional payments of interest of $100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. On June 10, 1999, after *A* has accrued $44 of interest income, but before any interest has been paid, the issuer suddenly becomes insolvent and declares bankruptcy. *A* sells the bond (including the accrued interest) for $20. Assuming that *A* properly accrued $44 interest income, *A* treats the $20 proceeds from the sale of the bond as payment of interest previously accrued and recognizes a $1000 loss with respect to the bond principal and a $24 loss with respect to the accrued interest. See § 1.61–7(d). Under paragraph (a)(1) of this section, the $1000 loss with respect to the principal is allocated against U.S. source income. Under paragraph (c)(5) of this section, the $24 loss with respect to accrued but unpaid interest is allocated against foreign source interest income.

(f) *Effective date*—(1) *In general.* Except as provided in paragraph (f)(2) of this section, this section is effective for loss recognized on or after January 11, 1999. For purposes of this paragraph (f), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account. This section shall cease to be effective January 8, 2002.

(2) *Application to prior periods.* A taxpayer may apply the rules of this section to losses recognized in any taxable year beginning on or after January 1, 1987, and all subsequent years, provided that—

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 1999; and

(ii) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

(3) *Examples.* See § 1.865–2(e)(3) for examples illustrating an effective date provision similar to the effective date provided in this paragraph (f).

[T.D. 8805, 64 FR 1509, Jan. 11, 1999]

§ 1.865–2 Loss with respect to stock.

(a) *General rules for allocation of loss with respect to stock*—(1) *Allocation against gain.* Except as otherwise provided in paragraph (b) of this section, loss recognized with respect to stock shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain (other than gain treated as a dividend under section 964(e)(1) or 1248) from a sale of such stock would give rise in the hands of the seller (without regard to section 865(f)). Thus, for example, loss recognized by a United States resident on the sale of stock generally is allocated to reduce United States source income.

(2) *Stock attributable to foreign office.* Except as otherwise provided in paragraph (b) of this section, in the case of loss recognized by a United States resident with respect to stock that is attributable to an office or other fixed place of business in a foreign country within the meaning of section 865(e)(3), the loss shall be allocated to reduce foreign source income if a gain on the sale of the stock would have been taxable by the foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(3) *Loss recognized by United States citizen or resident alien with foreign tax home*—(i) *In general.* Except as otherwise provided in paragraph (b) of this section, in the case of loss with respect to stock that is recognized by a United States citizen or resident alien that has a tax home (as defined in section 911(d)(3)) in a foreign country, the loss shall be allocated to reduce foreign source income if a gain on the sale of the stock would have been taxable by a foreign country and the highest marginal rate of tax imposed on such gains

in the foreign country is at least 10 percent.

(ii) *Bona fide residents of Puerto Rico.* Except as otherwise provided in paragraph (b) of this section, in the case of loss with respect to stock in a corporation described in section 865(g)(3) recognized by a United States citizen or resident alien that is a bona fide resident of Puerto Rico during the entire taxable year, the loss shall be allocated to reduce foreign source income.

(4) *Stock constituting a United States real property interest.* Loss recognized by a nonresident alien individual or a foreign corporation with respect to stock that constitutes a United States real property interest shall be allocated to reduce United States source income. For additional rules governing the treatment of such loss, see section 897 and the regulations thereunder.

(5) *Allocation for purposes of section 904.* For purposes of section 904, loss recognized with respect to stock that is allocated to foreign source income under this paragraph (a) shall be allocated to the separate category under section 904(d) to which gain on a sale of the stock would have been assigned (without regard to section 904(d)(2)(A)(iii)(III)). For purposes of § 1.904–4(c)(2)(ii)(A), any such loss allocated to passive income shall be allocated (prior to the application of § 1.904–4(c)(2)(ii)(B)) to the group of passive income to which gain on a sale of the stock would have been assigned had a sale of the stock resulted in the recognition of a gain under the law of the relevant foreign jurisdiction or jurisdictions.

(b) *Exceptions*—(1) *Dividend recapture exception*—(i) *In general.* If a taxpayer recognizes a loss with respect to shares of stock, and the taxpayer (or a person described in section 1059(c)(3)(C) with respect to such shares) included in income a dividend recapture amount (or amounts) with respect to such shares at any time during the recapture period, then, to the extent of the dividend recapture amount (or amounts), the loss shall be allocated and apportioned on a proportionate basis to the class or classes of gross income or the statutory or residual grouping or groupings of gross income to which the dividend recapture amount was assigned.

(ii) *Exception for de minimis amounts.* Paragraph (b)(1)(i) of this section shall not apply to a loss recognized by a taxpayer on the disposition of stock if the sum of all dividend recapture amounts (other than dividend recapture amounts eligible for the exception described in paragraph (b)(1)(iii) of this section (passive limitation dividends)) included in income by the taxpayer (or a person described in section 1059(c)(3)(C)) with respect to such stock during the recapture period is less than 10 percent of the recognized loss.

(iii) *Exception for passive limitation dividends.* Paragraph (b)(1)(i) of this section shall not apply to the extent of a dividend recapture amount that is treated as income in the separate category for passive income described in section 904(d)(2)(A) (without regard to section 904(d)(2)(A)(iii)(III)). The exception provided for in this paragraph (b)(1)(iii) shall not apply to any dividend recapture amount that is treated as income in the separate category for financial services income described in section 904(d)(2)(C).

(iv) *Examples.* The application of this paragraph (b)(1) may be illustrated by the following examples:

Example 1. (i) *P*, a domestic corporation, is a United States shareholder of *N*, a controlled foreign corporation. *N* has never had any subpart F income and all of its earnings and profits are described in section 959(c)(3). On May 5, 1998, *N* distributes a dividend to *P* in the amount of $100. The dividend gives rise to a $5 foreign withholding tax, and *P* is deemed to have paid an additional $45 of foreign income tax with respect to the dividend under section 902. Under the look-through rules of section 904(d)(3) the dividend is general limitation income described in section 904(d)(1)(I).

(ii) On February 6, 2000, *P* sells its shares of *N* and recognizes a $110 loss. In 2000, *P* has the following taxable income, excluding the loss on the sale of *N*:

(A) $1,000 of foreign source income that is general limitation income described in section 904(d)(1)(I);

(B) $1,000 of foreign source capital gain from the sale of stock in a foreign affiliate that is sourced under section 865(f) and is passive income described in section 904(d)(1)(A); and

(C) $1,000 of U.S. source income.

(iii) The $100 dividend paid in 1998 is a dividend recapture amount that was included in *P*'s income within the recapture period preceding the disposition of the *N* stock. The *de* *minimis* exception of paragraph (b)(1)(ii) of this section does not apply because the $100 dividend recapture amount exceeds 10 percent of the $110 loss. Therefore, to the extent of the $100 dividend recapture amount, the loss must be allocated under paragraph (b)(1)(i) of this section to the separate limitation category to which the dividend was assigned (general limitation income).

(iv) *P*'s remaining $10 loss on the disposition of the *N* stock is allocated to U.S. source income under paragraph (a)(1) of this section.

(v) After allocation of the stock loss, *P*'s foreign source taxable income in 2000 consists of $900 of foreign source general limitation income and $1,000 of foreign source passive income.

Example 2. (i) *P*, a domestic corporation, owns all of the stock of *N1*, which owns all of the stock of *N2*, which owns all of the stock of *N3*. *N1*, *N2*, and *N3* are controlled foreign corporations. All of the corporations use the calendar year as their taxable year. On February 5, 1997, *N3* distributes a dividend to *N2*. The dividend is foreign personal holding company income of *N2* under section 954(c)(1)(A) that results in an inclusion of $100 in *P*'s income under section 951(a)(1)(A)(i) as of December 31, 1997. Under section 904(d)(3)(B) the inclusion is general limitation income described in section 904(d)(1)(I). The income inclusion to *P* results in a corresponding increase in *P*'s basis in the stock of *N1* under section 961(a).

(ii) On March 5, 1999, *P* sells its shares of *N1* and recognizes a $110 loss. The $100 1997 subpart F inclusion is a dividend recapture amount that was included in *P*'s income within the recapture period preceding the disposition of the *N1* stock. The de minimis exception of paragraph (b)(1)(ii) of this section does not apply because the $100 dividend recapture amount exceeds 10 percent of the $110 loss. Therefore, to the extent of the $100 dividend recapture amount, the loss must be allocated under paragraph (b)(1)(i) of this section to the separate limitation category to which the dividend recapture amount was assigned (general limitation income). The remaining $10 loss is allocated to U.S. source income under paragraph (a)(1) of this section.

Example 3. (i) *P*, a domestic corporation, owns all of the stock of *N1*, which owns all of the stock of *N2*. *N1* and *N2* are controlled foreign corporations. All the corporations use the calendar year as their taxable year and the U.S. dollar as their functional currency. On May 5, 1998, *N2* pays a dividend of $100 to *N1* out of general limitation earnings and profits.

(ii) On February 5, 2000, *N1* sells its *N2* stock to an unrelated purchaser. The sale results in a loss to *N1* of $110 for U.S. tax purposes. In 2000, *N1* has the following current earnings and profits, excluding the loss on the sale of *N2*:

(A) $1,000 of non-subpart F foreign source general limitation earnings and profits described in section 904(d)(1)(I);

(B) $1,000 of foreign source gain from the sale of stock that is taken into account in determining foreign personal holding company income under section 954(c)(1)(B)(i) and which is passive limitation earnings and profits described in section 904(d)(1)(A);

(C) $1,000 of foreign source interest income received from an unrelated person that is foreign personal holding company income under section 954(c)(1)(A) and which is passive limitation earnings and profits described in section 904(d)(1)(A).

(iii) The $100 dividend paid in 1998 is a dividend recapture amount that was included in *N1*'s income within the recapture period preceding the disposition of the *N2* stock. The *de minimis* exception of paragraph (b)(1)(ii) of this section does not apply because the $100 dividend recapture amount exceeds 10 percent of the $110 loss. Therefore, to the extent of the $100 dividend recapture amount, the loss must be allocated under paragraph (b)(1)(i) of this section to the separate limitation category to which the dividend was assigned (general limitation earnings and profits).

(iv) *N1*'s remaining $10 loss on the disposition of the *N2* stock is allocated to foreign source passive limitation earnings and profits under paragraph (a)(1) of this section.

(v) After allocation of the stock loss, *N1*'s current earnings and profits for 1998 consist of $900 of foreign source general limitation earnings and profits and $1,990 of foreign source passive limitation earnings and profits.

(vi) After allocation of the stock loss, *N1*'s subpart F income for 2000 consists of $1,000 of foreign source interest income that is foreign personal holding company income under section 954(c)(1)(A) and $890 of foreign source net gain that is foreign personal holding company income under section 954(c)(1)(B)(i). *P* includes $1,890 in income under section 951(a)(1)(A)(i) as passive income under sections 904(d)(1)(A) and 904(d)(3)(B).

Example 4. P, a foreign corporation, has two wholly-owned subsidiaries, *S*, a domestic corporation, and *B*, a foreign corporation. On January 1, 2000, *S* purchases a one-percent interest in *N*, a foreign corporation, for $100. On January 2, 2000, *N* distributes a $20 dividend to *S*. The $20 dividend is foreign source financial services income. On January 3, 2000, *S* sells its *N* stock to *B* for $80 and recognizes a $20 loss that is deferred under section 267(f). On June 10, 2008, *B* sells its *N* stock to an unrelated person for $55. Under section 267(f) and § 1.267(f)–1(c)(1), *S*'s $20 loss is deferred until 2008. Under this paragraph (b)(1), the $20 loss is allocated to reduce foreign source financial services income in 2008 because the loss was recognized (albeit deferred) within the 24-month recapture period following the receipt of the dividend. See §§1.267(f)–1(a)(2)(i)(B) and 1.267(f)–1(c)(2).

Example 5. The facts are the same as in *Example 4,* except *P, S,* and *B* are domestic corporations and members of the *P* consolidated group. Under the matching rule of §1.1502–13(c)(1), the separate entity attributes of *S*'s intercompany items and *B*'s corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income as if *S* and *B* were divisions of a single corporation and the intercompany transaction was a transaction between divisions. If *S* and *B* were divisions of a single corporation, the transfer of *N* stock on January 3, 2000 would be ignored for tax purposes, and the corporation would be treated as selling that stock only in 2008. Thus, the corporation's entire $45 loss would have been allocated against U.S. source income under paragraph (a)(1) of this section because a dividend recapture amount was not received during the corporation's recapture period. Accordingly, *S*'s $20 loss and *B*'s $25 loss are allocated to reduce U.S. source income.

(2) *Exception for inventory.* This section does not apply to loss recognized with respect to stock described in section 1221(1).

(3) *Exception for stock in an S corporation.* This section does not apply to loss recognized with respect to stock in an S corporation (as defined in section 1361).

(4) *Anti-abuse rules*—(i) *Transactions involving built-in losses.* If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to stock by transferring the stock to another person, qualified business unit (within the meaning of section 989(a)), office or other fixed place of business, or branch that subsequently recognizes the loss, the loss shall be allocated by the transferee as if it were recognized with respect to the stock by the transferor immediately prior to the transaction. If one of the principal purposes of a change of residence is to change the allocation of a built-in loss with respect to stock, the loss shall be allocated as if the change of residence had not occurred. If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to stock (or other personal property) by converting the original property into other property and subsequently recognizing loss with respect to such other property, the loss shall be allocated as if it were recognized with respect to the original property immediately prior to the transaction. Transactions subject to this paragraph shall include, without limitation, reorganizations within the meaning of section 368(a), liquidations under section 332, transfers to a corporation under section 351, transfers to a partnership under section 721, transfers to a trust, distributions by a partnership, distributions by a trust, or transfers to or from a qualified business unit, office or other fixed place of business. A person may have a principal purpose of affecting loss allocation even though this purpose is outweighed by other purposes (taken together or separately).

(ii) *Offsetting positions.* If a taxpayer recognizes loss with respect to stock and the taxpayer (or any person described in section 267(b) (after application of section 267(c)), 267(e), 318 or 482 with respect to the taxpayer) holds (or held) offsetting positions with respect to such stock with a principal purpose of recognizing foreign source income and United States source loss, the loss will be allocated and apportioned against such foreign source income. For purposes of this paragraph (b)(4)(ii), positions are offsetting if the risk of loss of holding one or more positions is substantially diminished by holding one or more other positions.

(iii) *Matching rule.* [Reserved] For further guidance, see §1.865–2T(b)(4)(iii).

(iv) *Examples.* The application of this paragraph (b)(4) may be illustrated by the following examples. No inference is intended regarding the application of any other Internal Revenue Code section or judicial doctrine that may apply to disallow or defer the recognition of loss. The examples are as follows:

Example 1. (i) *Facts.* On January 1, 2000, *P,* a domestic corporation, owns all of the stock of *N1,* a controlled foreign corporation, which owns all of the stock of *N2,* a controlled foreign corporation. *N1*'s basis in the stock of *N2* exceeds its fair market value, and any loss recognized by *N1* on the sale of *N2* would be allocated under paragraph (a)(1) of this section to reduce foreign source passive limitation earnings and profits of *N1.* In contemplation of the sale of *N2* to an unrelated purchaser, *P* causes *N1* to liquidate with principal purposes of recognizing the loss on the *N2* stock and allocating the loss against U.S. source income. *P* sells the *N2* stock and *P* recognizes a loss.

(ii) *Loss allocation.* Because one of the principal purposes of the liquidation was to transfer the stock to *P* in order to change the allocation of the built-in loss on the *N2* stock, under paragraph (b)(4)(i) of this section the loss is allocated against *P*'s foreign source passive limitation income.

Example 2. (i) *Facts.* On January 1, 2000, *P*, a domestic corporation, forms *N* and *F*, foreign corporations, and contributes $1,000 to the capital of each. *N* and *F* enter into offsetting positions in financial instruments that produce financial services income. Holding the *N* stock substantially diminishes *P*'s risk of loss with respect to the *F* stock (and vice versa). *P* holds *N* and *F* with a principal purpose of recognizing foreign source income and U.S. source loss. On March 31, 2000, when the financial instrument held by *N* is worth $1,200 and the financial instrument held by *F* is worth $800, *P* sells its *F* stock and recognizes a $200 loss.

(ii) *Loss allocation.* Because *P* held an offsetting position with respect to the *F* stock with a principal purpose of recognizing foreign source income and U.S. source loss, the $200 loss is allocated against foreign source financial services income under paragraph (b)(4)(ii) of this section.

(c) *Loss recognized by partnership.* A partner's distributive share of loss recognized by a partnership shall be allocated and apportioned in accordance with this section as if the partner had recognized the loss. If loss is attributable to an office or other fixed place of business of the partnership within the meaning of section 865(e)(3), such office or fixed place of business shall be considered to be an office of the partner for purposes of this section.

(d) *Definitions*—(1) *Terms defined in §1.861–8.* See §1.861–8 for the meaning of *class of gross income, statutory grouping of gross income,* and *residual grouping of gross income.*

(2) *Dividend recapture amount.* A dividend recapture amount is a dividend (except for an amount treated as a dividend under section 78), an inclusion described in section 951(a)(1)(A)(i) (but only to the extent attributable to a dividend (including a dividend under section 964(e)(1)) included in the earnings of a controlled foreign corporation (held directly or indirectly by the person recognizing the loss) that is included in foreign personal holding company income under section 954(c)(1)(A)) and an inclusion described in section 951(a)(1)(B).

(3) *Recapture period.* A recapture period is the 24-month period preceding the date on which a taxpayer recognizes a loss with respect to stock, increased by any period of time in which the taxpayer has diminished its risk of loss in a manner described in section 246(c)(4) and the regulations thereunder and by any period in which the assets of the corporation are hedged against risk of loss with a principal purpose of enabling the taxpayer to hold the stock without significant risk of loss until the recapture period has expired.

(4) *United States resident.* See section 865(g) and the regulations thereunder for the definition of United States resident.

(e) *Effective date*—(1) *In general.* This section is effective for loss recognized on or after January 11, 1999. For purposes of this paragraph (e), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account.

(2) *Application to prior periods.* A taxpayer may apply the rules of this section to losses recognized in any taxable year beginning on or after January 1, 1987, and all subsequent years, provided that—

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section and §1.865–2T for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 1999; and

(ii) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

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

Example 1. (i) *P*, a domestic corporation, has a calendar taxable year. On March 10, 1985, *P* recognizes a $100 capital loss on the sale of *N*, a foreign corporation. Pursuant to sections 1211(a) and 1212(a), the loss is not allowed in 1985 and is carried over to the 1990 taxable year. The loss is allocated against foreign source income under §1.861–8(e)(7). In 1999, *P* chooses to apply this section to all losses recognized in its 1987 taxable year and in all subsequent years.

(ii) Allocation of the loss on the sale of *N* is not affected by the rules of this section because the loss was recognized in a taxable year that did not begin after December 31, 1986.

Example 2. (i) *P*, a domestic corporation, has a calendar taxable year. On March 10, 1988, *P* recognizes a $100 capital loss on the sale of *N*, a foreign corporation. Pursuant to sections 1211(a) and 1212(a), the loss is not allowed in 1988 and is carried back to the 1985 taxable year. The loss is allocated against foreign source income under §1.861–8(e)(7) on *P*'s federal income tax return for 1985 and increases an overall foreign loss account under §1.904(f)-1.

(ii) In 1999, *P* chooses to apply this section to all losses recognized in its 1987 taxable year and in all subsequent years. Consequently, the loss on the sale of *N* is allocated against U.S. source income under paragraph (a)(1) of this section. Allocation of the loss against U.S. source income reduces *P's* overall foreign loss account and increases *P's* tax liability in 2 years: 1990, a year that will not be open for assessment on June 30, 1999, and 1997, a year that will be open for assessment on June 30, 1999. Pursuant to paragraph (e)(2)(i) of this section, *P* must file an amended federal income tax return that reflects the rules of this section for 1997, but not for 1990.

Example 3. (i) *P*, a domestic corporation, has a calendar taxable year. On March 10, 1989, *P* recognizes a $100 capital loss on the sale of *N*, a foreign corporation. The loss is allocated against foreign source income under §1.861–8(e)(7) on *P's* federal income tax return for 1989 and results in excess foreign tax credits for that year. The excess credit is carried back to 1988, pursuant to section 904(c). In 1999, *P* chooses to apply this section to all losses recognized in its 1989 taxable year and in all subsequent years. On June 30, 1999, *P's* 1988 taxable year is closed for assessment, but *P's* 1989 taxable year is open with respect to claims for refund.

(ii) Because *P* chooses to apply this section to its 1989 taxable year, the loss on the sale of *N* is allocated against U.S. source income under paragraph (a)(1) of this section. Allocation of the loss against U.S. source income would have permitted the foreign tax credit to be used in 1989, reducing *P's* tax liability in 1989. Nevertheless, under paragraph (e)(2)(ii) of this section, because the credit was carried back to 1988, *P* may not claim the foreign tax credit in 1989.

[T.D. 8805, 64 FR 1511, Jan. 11, 1999]

§1.865–2T Loss with respect to stock (temporary).

(a)–(b)(4)(ii) [Reserved] For further guidance, see §1.865–2(a) through (b)(4)(ii).

(iii) *Matching rule.* To the extent a taxpayer (or a person described in section 1059(c)(3)(C) with respect to the taxpayer) recognizes foreign source income for tax purposes that results in the creation of a corresponding loss with respect to stock, the loss shall be allocated and apportioned against such income. This paragraph (b)(4)(iii) shall not apply to the extent a loss is related to a dividend recapture amount and §1.865–2(b)(1)(ii) (de minimis exception) or (b)(1)(iii) (passive dividend exception) exempts the loss from §1.865–2(b)(1)(i) (dividend recapture rule), unless the stock is held with a principal purpose of producing foreign source income and corresponding loss.

(iv) *Examples.* The application of this paragraph (b)(4) may be illustrated by the following examples. No inference is intended regarding the application of any other Internal Revenue Code section or judicial doctrine that may apply to disallow or defer the recognition of loss. The examples are as follows:

Examples 1 and 2. [Reserved] For further guidance, see §1.865–2(b)(4)(iv).

Example 3. (i) *Facts.* On January 1, 1999, *P* and *Q*, domestic corporations, form *R*, a domestic partnership. The corporations and partnership use the calendar year as their taxable year. *P* contributes $900 to *R* in exchange for a 90-percent partnership interest and *Q* contributes $100 to *R* in exchange for a 10-percent partnership interest. *R* purchases a dance studio in country *X* for $1,000. On January 2, 1999, *R* enters into contracts to provide dance lessons in Country *X* for a 5-year period beginning January 1, 2000. These contracts are prepaid by the dance studio customers on December 31, 1999, and *R* recognizes foreign source taxable income of $500 from the prepayments (*R's* only income in 1999). *P* takes into income its $450 distributive share of partnership taxable income. On January 1, 2000, *P's* basis in its partnership interest is $1,350 ($900 from its contribution under section 722, increased by its $450 distributive share of partnership income under section 705). On September 22, 2000, *P* contributes its *R* partnership interest to *S*, a newly-formed domestic corporation, in exchange for all the stock of *S*. Under section 358, *P's* basis in *S* is $1,350. On December 1, 2000, *P* sells *S* to an unrelated party for $1050 and recognizes a $300 loss.

(ii) *Loss allocation.* Because *P* recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the *S* stock, the $300 loss is allocated against foreign source income under paragraph (b)(4)(iii) of this section.

Example 4. (i) *Facts.* On January 1, 2000, *P*, a domestic corporation that uses the calendar year as its taxable year forms *N*, a foreign corporation. *P* contributes $1,000 to the capital of *N* in exchange for 100 shares of common stock. *P* contributes an additional $1,000 to the capital of *N* in exchange for 100 shares of preferred stock. Each preferred share is entitled to 15-percent dividend but is redeemable by *N* on or after January 1, 2010, for $1. Prior to January 10, 2005, *P* receives a total of $750 of distributions from *N* with respect to its preferred shares, which *P* treats as foreign source general limitation dividends. On January 10, 2005, *P* sells its 100 preferred shares in *N* to an unrelated purchaser for $600. Assume that this arrangement is not recharacterized under Notice 97–21 (1997–1 C.B. 407).

(ii) *Loss allocation.* Because *P* recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the *N* stock, the $400 loss is allocated against foreign source general limitation income under paragraph (b)(4)(iii) of this section.

Example 5. (i) *Facts.* On January 1, 2000, *P*, a domestic corporation that uses the calendar year as its taxable year, and *F*, a newly-formed controlled foreign corporation wholly-owned by *P*, form *N*, a foreign corporation. *P* contributes $1,000 to the capital of *N* in exchange for 100 shares of common stock and $1,000 to the capital of *F* in exchange for 100 shares of common stock. *F* contributes LC1,000 to the capital of *N* in exchange for 100 shares of preferred stock. Each preferred share is entitled to a 65-percent LC dividend. At the time of the contributions, $1=LC1. The LC is expected to depreciate significantly in relation to the U.S. dollar. Prior to June 10, 2005, *P* receives a total of $1,900 of distributions from *F*, which it treats as foreign source general limitation dividends. On June 10, 2005, the *N* preferred stock has a fair market value of $25 and *P* sells *F* for $25 to an unrelated person. Assume that this arrangement is not recharacterized under Notice 97–21 (1997–1 C.B. 407).

(ii) *Loss allocation.* Because *P* recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the *F* stock, the $975 loss is allocated against foreign source general limitation income under paragraph (b)(4)(iii) of this section.

Example 6. (i) *Facts.* On January 1, 1998, *P*, a domestic corporation, purchases *N*, a foreign corporation, for $1000. On March 1, 1998, *N* sells its operating assets, distributes a $400 general limitation dividend to *P*, and invests its remaining $600 in short term government securities. *N* earns interest income from the securities. The income constitutes subpart F income that is included in *P*'s income under section 951, increasing *P*'s basis in the *N* stock under section 961(a). On March 1, 2002, *P* sells *N* and recognizes a $400 loss.

(ii) *Loss allocation.* The $400 dividend received by *P* resulted in a $400 built-in loss in the *N* stock, which was locked in for *P*'s four-year holding period. Because *P* recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the *N* stock, under paragraph (b)(4)(iii) of this section the $400 loss is allocated against foreign source general limitation income.

(c)–(d) [Reserved]

(e) *Effective date*—(1) *In general.* This section is effective for loss recognized on or after January 11, 1999. For purposes of this paragraph (e), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account. This section shall cease to be effective January 8, 2002.

(2) *Application to prior periods.* A taxpayer may apply the rules of this section to losses recognized in any taxable year beginning on or after January 1, 1987, and all subsequent years, provided that—

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section and § 1.865–2 for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 1999; and

(ii) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

[T.D. 8805, 64 FR 1514, Jan. 11, 1999]

NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

NONRESIDENT ALIEN INDIVIDUALS

§ 1.871–1 Classification and manner of taxing alien individuals.

(a) *Classes of aliens.* For purposes of the income tax, alien individuals are divided generally into two classes, namely, resident aliens and nonresident aliens. Resident alien individuals are, in general, taxable the same as citizens of the United States; that is, a resident alien is taxable on income derived from all sources, including sources without the United States. See §1.1–1(b). Nonresident alien individuals are taxable only on certain income from sources within the United States and on the income described in section 864(c)(4) from sources without the United States which is effectively connected for the taxable year with the conduct of a trade or business in the United States. However, nonresident alien individuals may elect, under section 6013 (g) or (h), to be treated as U.S. residents for purposes of determining their income tax liability under Chapters 1, 5, and 24 of the code. Accordingly, any reference in §§1.1–1 through 1.1388–1 and §§1.1491–1 through 1.1494–1 of this part to non-resident alien individuals does not include those with respect to whom an election under section 6013 (g) or (h) is in effect, unless otherwise specifically provided. Similarly, any reference to resident aliens or U.S. residents includes those with respect to whom an election is in effect, unless otherwise specifically provided.

(b) *Classes of nonresident aliens*—(1) *In general.* For purposes of the income tax, nonresident alien individuals are divided into the following three classes:

(i) Nonresident alien individuals who at no time during the taxable year are engaged in a trade or business in the United States,

(ii) Nonresident alien individuals who at any time during the taxable year are, or are deemed under §1.871–9 to be, engaged in a trade or business in the United States, and

(iii) Nonresident alien individuals who are bona fide residents of Puerto Rico during the entire taxable year.

An individual described in subdivision (i) or (ii) of this subparagraph is subject to tax pursuant to the provisions of subpart A (section 871 and following), part II, subchapter N, chapter 1 of the Code, and the regulations thereunder. See §§1.871–7 and 1.871–8. The provisions of subpart A do not apply to individuals described in subdivision (iii) of this subparagraph, but such individuals, except as provided in section 933 with respect to Puerto Rican source income, are subject to the tax imposed by section 1 or section 1201(b). See §1.876–1.

(2) *Treaty income.* If the gross income of a nonresident alien individual described in subparagraph (1) (i) or (ii) of this paragraph includes income on which the tax is limited by tax convention, see §1.871–12.

(3) *Exclusions from gross income.* For rules relating to the exclusion of certain items from the gross income of a nonresident alien individual, including annuities excluded under section 871(f), see §§1.872–2 and 1.894–1.

(4) *Expatriation to avoid tax.* For special rules applicable in determining the tax of a nonresident alien individual who has lost U.S. citizenship with a principal purpose of avoiding certain taxes, see section 877.

(5) *Adjustment of tax of certain nonresident aliens.* For the application of pre-1967 income tax provisions to residents of a foreign country which imposes a more burdensome income tax than the United States, and for the adjustment of the income tax of a national or resident of a foreign country which imposes a discriminatory income tax on the income of citizens of the United States or domestic corporations, see section 896.

(6) *Citizens of certain U.S. possessions.* For rules for treating as nonresident alien individuals certain citizens of possessions of the United States who are not otherwise citizens of the United States, see section 932 and §1.932–1.

(7) *Conduit financing arrangements.* For rules regarding conduit financing arrangements, see §§1.881–3 and 1.881–4.

(c) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871–1 and 1.871–7(a) (Revised as of January 1, 1971).

[T.D. 7332, 39 FR 44218, Dec. 23, 1974, as amended by T.D. 7670, 45 FR 6928, Jan. 31, 1980; T.D. 8611, 60 FR 41004, Aug. 11, 1995]

§ 1.871–2 Determining residence of alien individuals.

(a) *General.* The term *nonresident alien individual* means an individual whose residence is not within the United States, and who is not a citizen of the United States. The term includes a nonresident alien fiduciary. For such purpose the term fiduciary shall have the meaning assigned to it by section 7701(a)(6) and the regulations in part 301 of this chapter (Regulations on Procedure and Administration). For presumption as to an alien's nonresidence, see paragraph (b) of § 1.871–4.

(b) *Residence defined.* An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances.

(c) *Application and effective dates.* Unless the context indicates otherwise, §§ 1.871–2 through 1.871–5 apply to determine the residence of aliens for taxable years beginning before January 1, 1985. To determine the residence of aliens for taxable years beginning after December 31, 1984, see section 7701(b) and §§ 301.7701(b)–1 through 301.7701(b)–9 of this chapter. However, for purposes of determining whether an individual is a qualified individual under section 911(d)(1)(A), the rules of §§ 1.871–2 and 1.871–5 shall continue to apply for taxable years beginning after December 31, 1984. For purposes of determining whether an individual is a resident of the United States for estate and gift tax purposes, see § 20.0–1(b) (1) and (2) and § 25.2501–1(b) of this chapter, respectively.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8411, 57 FR 15241, Apr. 27, 1992]

§ 1.871–3 Residence of alien seamen.

In order to determine whether an alien seaman is a resident of the United States for purposes of the income tax, it is necessary to decide whether the presumption of nonresidence (as prescribed by paragraph (b) of § 1.871–4) is overcome by facts showing that he has established a residence in the United States. Residence may be established on a vessel regularly engaged in coastwise trade, but the mere fact that a sailor makes his home on a vessel which is flying the United States flag and is engaged in foreign trade is not sufficient to establish residence in the United States, even though the vessel, while carrying on foreign trade, touches at American ports. An alien seaman may acquire an actual residence in the United States within the rules laid down in § 1.871–4, although the nature of his calling requires him to be absent for a long period from the place where his residence is established. An alien seaman may acquire such a residence at a sailors' boarding house or hotel, but such a claim should be carefully scrutinized in order to make sure that such residence is bona fide. The filing of Form 1078 or taking out first citizenship papers is proof of residence in the United States from the time the form is filed or the papers taken out, unless rebutted by other evidence showing an intention to be a transient.

§ 1.871–4 Proof of residence of aliens.

(a) *Rules of evidence.* The following rules of evidence shall govern in determining whether or not an alien within the United States has acquired residence therein for purposes of the income tax.

(b) *Nonresidence presumed.* An alien by reason of his alienage, is presumed to be a nonresident alien.

(c) *Presumption rebutted*—(1) *Departing alien.* In the case of an alien who presents himself for determination of tax liability before departure from the United States, the presumption as to the alien's nonresidence may be overcome by proof—

(i) That the alien, at least six months before the date he so presents himself, has filed a declaration of his intention to become a citizen of the United States under the naturalization laws; or

(ii) That the alien, at least six months before the date he so presents himself, has filed Form 1078 or its equivalent; or

(iii) Of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident.

(2) *Other aliens.* In the case of other aliens, the presumption as to the alien's nonresidence may be overcome by proof—

(i) That the alien has filed a declaration of his intention to become a citizen of the United States under the naturalization laws; or

(ii) That the alien has filed Form 1078 or its equivalent; or

(iii) Of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident.

(d) *Certificate.* If, in the application of paragraph (c)(1)(iii) or (2)(iii) of this section, the internal revenue officer or employee who examines the alien is in doubt as to the facts, such officer or employee may, to assist him in determining the facts, require a certificate or certificates setting forth the facts relied upon by the alien seeking to overcome the presumption. Each such certificate, which shall contain, or be verified by, a written declaration that it is made under the penalties of perjury, shall be executed by some credible person or persons, other than the alien and members of his family, who have known the alien at least six months before the date of execution of the certificate or certificates.

§1.871–5 Loss of residence by an alien.

An alien who has acquired residence in the United States retains his status as a resident until he abandons the same and actually departs from the United States. An intention to change his residence does not change his status as a resident alien to that of a nonresident alien. Thus, an alien who has acquired a residence in the United States is taxable as a resident for the remainder of his stay in the United States.

§1.871–6 Duty of withholding agent to determine status of alien employees.

(a) *Proof of status required.* If income is paid to an alien individual without withholding the tax under chapter 3 of the Code, except insofar as the regulations thereunder permit exemption from withholding, then the withholding agent must be prepared to justify the failure to withhold.

(b) *Evidence of residence.* A withholding agent may rely upon the evidence of residence afforded by the fact that the alien individual has filed Form 1078 or an equivalent written statement. This statement or form shall be filed in the manner prescribed in §1.1441–5.

(c) *Cross reference.* For definition of the term ''withholding agent,'' see §1.1441–7.

(d) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871–6 (Revised as of January 1, 1971).

(Sec. 1441(c)(4), (80 Stat. l553; 26 U.S.C. 1441(c)(4)), 3401(a)(6) (80 Stat. 1554; 26 U.S.C. 3401(a)(6)), and 7805 (68A Stat.917; 26 U.S.C. 7805) of the Internal Revenue Code of l954)

[T.D. 7332, 39 FR 44218, Dec. 23, 1974, as amended by T.D. 7977, 49 FR 36831, Sept. 20, l984]

EFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53416, Oct. 14, 1997, §1.871–6 was revised, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effective date was delayed to Jan. 1, 2000. For the convenience of the user, the revised text is set forth as follows:

§ 1.871–6 Duty of witholding agent to determine status of alien payees.

For the obligation of a witholding agent to withold the tax imposed by this section, see chapter 3 of the Internal Revenue Code and the regulations thereunder.

[T.D. 8734, 62 FR 53416, Oct. 14, 1997]

§ 1.871–7 Taxation of nonresident alien individuals not engaged in U.S. business.

(a) *Imposition of tax.* (1) This section applies for purposes of determining the tax of a nonresident alien individual who at no time during the taxable year is engaged in trade or business in the United States. However, see also § 1.871–8 where such individual is a student or trainee deemed to be engaged in trade or business in the United States or where he has an election in effect for the taxable year in respect to real property income. Except as otherwise provided in § 1.871–12, a nonresident alien individual to whom this section applies is not subject to the tax imposed by section 1 or section 1201(b) but, pursuant to the provision of section 871(a), is liable to a flat tax of 30 percent upon the aggregate of the amounts determined under paragraphs (b), (c), and (d) of this section which are received during the taxable year from sources within the United States. Except as specifically provided in such paragraphs, such amounts do not include gains from the sale or exchange of property. To determine the source of such amounts, see sections 861 through 863, and the regulations thereunder.

(2) The tax of 30 percent is imposed by section 871(a) upon an amount only to the extent the amount constitutes gross income. Thus, for example, the amount of an annuity which is subject to such tax shall be determined in accordance with section 72.

(3) Deductions shall not be allowed in determining the amount subject to tax under this section except that losses from sales or exchanges of capital assets shall be allowed to the extent provided in section 871(a)(2) and paragraph (d) of this section.

(4) Except as provided in §§ 1.871–9 and 1.871–10, a nonresident alien individual not engaged in trade or business in the United States during the taxable year has no income, gain, or loss for the taxable year which is effectively connected for the taxable year with the conduct of a trade or business in the United States. See section 864(c)(1)(B) and § 1.864–3.

(5) Gains and losses which, by reason of section 871(d) and § 1.871–10, are treated as gains or losses which are effectively connected for the taxable year with the conduct of a trade or business in the United States by the nonresident alien individual shall not be taken into account in determining the tax under this section. See, for example, paragraph (c)(2) of § 1.871–10.

(6) For special rules applicable in determining the tax of certain nonresident alien individuals, see paragraph (b) of § 1.871–1.

(b)*Fixed or determinable annual or periodical income*—(1) *General rule.* The tax of 30 percent imposed by section 871(a)(1) applies to the gross amount received from sources within the United States as fixed or determinable annual or periodical gains, profits, or income. Specific items of fixed or determinable annual or periodical income are enumerated in section 871(a)(1)(A) as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments, but other items of fixed or determinable annual or periodical gains, profits, or income are also subject to the tax, as, for instance, royalties, including royalties for the use of patents, copyrights, secret processes and formulas, and other like property. As to the determination of fixed or determinable annual or periodical income see § 1.1441–2(b). For special rules treating gain on the disposition of section 306 stock as fixed or determinable annual or periodical income for purposes of section 871(a), see section 306(f) and paragraph (h) of § 1.306–3.

(2) *Substitute payments.* For purposes of this section, a substitute interest payment (as defined in § 1.861–2(a)(7)) received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in § 1.861–2(a)(7)) shall have the same character as interest income paid or accrued with respect to the terms of the transferred security. Similarly, for purposes of this section, a substitute dividend payment (as defined in § 1.861–3(a)(6)) received by a foreign person

pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in §1.861–3(a)(6)) shall have the same character as a distribution received with respect to the transferred security. Where, pursuant to a securities lending transaction or a sale-repurchase transaction, a foreign person transfers to another person a security the interest on which would qualify as portfolio interest under section 871(h) in the hands of the lender, substitute interest payments made with respect to the transferred security will be treated as portfolio interest, provided that in the case of interest on an obligation in registered form (as defined in §1.871–14(c)(1)(i)), the transferor complies with the documentation requirement described in §1.871–14(c)(1)(ii)(C) with respect to the payment of the substitute interest and none of the exceptions to the portfolio interest exemption in sections 871(h) (3) and (4) apply. See also §§1.861–2(b)(2) and 1.894–1(c).

(c) *Other income and gains*—(1) *Items subject to tax.* The tax of 30 percent imposed by section 871(a)(1) also applies to the following gains received during the taxable year from sources within the United States:

(i) Gains described in section 402(a)(2), relating to the treatment of total distributions from certain employees' trusts; section 403(a)(2), relating to treatment of certain payments under certain employee annuity plans; and section 631 (b) or (c), relating to treatment of gain on the disposal of timber, coal, or iron ore with a retained economic interest;

(ii) [Reserved]

(iii) Gains on transfers described in section 1235, relating to certain transfers of patent rights, made on or before October 4, 1966; and

(iv) Gains from the sale or exchange after October 4, 1966, of patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, or other like property, or of any interest in any such property, to the extent the gains are from payments (whether in a lump sum or in installments) which are contingent on the productivity, use or disposition of the property or interest sold or exchanged, or from payments which are treated under section 871(e) and §1.871–11 as being so contingent.

(2) *Nonapplication of 183-day rule.* The provisions of section 871(a)(2), relating to gains from the sale or exchange of capital assets, and paragraph (d)(2) of this section do not apply to the gains described in this paragraph; as a consequence, the taxpayer receiving gains described in subparagraph (1) of this paragraph during a taxable year is subject to the tax of 30 percent thereon without regard to the 183-day rule contained in such provisions.

(3) *Determination of amount of gain.* The tax of 30 percent imposed upon the gains described in subparagraph (1) of this paragraph applies to the full amount of the gains and is determined (i) without regard to the alternative tax imposed by section 1201(b) upon the excess of the net long-term capital gain over the net short-term capital loss; (ii) without regard to the deduction allowed by section 1202 in respect of capital gains; (iii) without regard to section 1231, relating to property used in the trade or business and involuntary conversions; and (iv), except in the case of gains described in subparagraph (1)(ii) of this paragraph, whether or not the gains are considered to be gains from the sale or exchange of property which is a capital asset.

(d) *Gains from sale or exchange of capital assets*—(1) *Gains subject to tax.* The tax of 30 percent imposed by section 871(a)(2) applies to the excess of gains derived from sources within the United States over losses allocable to sources within the United States, which are derived from the sale or exchange of capital assets, determined in accordance with the provisions of subparagraphs (2) through (4) of this paragraph.

(2) *Presence in the United States 183 days or more.* (i) If the nonresident alien individual has been present in the United States for a period or periods aggregating 183 days or more during the taxable year, he is liable to a tax of 30 percent upon the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected at any time during the year exceed his losses, allocable to sources within the United States, from sales or exchanges of capital assets effected at any time

during that year. Gains and losses from sales or exchanges effected at any time during such taxable year are to be taken into account for this purpose even though the nonresident alien individual is not present in the United States at the time the sales or exchanges are effected. In addition, if the nonresident alien individual has been present in the United States for a period or periods aggregating 183 days or more during the taxable year, gains and losses for such taxable year from sales or exchanges of capital assets effected during a previous taxable year beginning after December 31, 1966, are to be taken into account, but only if he was also present in the United States during such previous taxable year for a period or periods aggregating 183 days or more.

(ii) If the nonresident alien individual has not been present in the United States during the taxable year, or if he has been present in the United States for a period or periods aggregating less than 183 days during the taxable year, gains and losses from sales or exchanges of capital assets effected during the year are not to be taken into account, except as required by paragraph (c) of this section, in determining the tax of such individual even though the sales or exchanges are effected during his presence in the United States. Moreover, gains and losses for such taxable year from sales or exchanges of capital assets effected during a previous taxable year beginning after December 31, 1966, are not to be taken into account, even though the nonresident alien individual was present in the United States during such previous year for a period or periods aggregating 183 days or more.

(iii) For purposes of this subparagraph, a nonresident alien individual is not considered to be present in the United States by reason of the presence in the United States of a person who is an agent or partner of such individual or who is a fiduciary of an estate or trust of which such individual is a beneficiary or a grantor-owner to whom section 671 applies.

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

Example 1. B, a nonresident alien individual not engaged in trade or business in the United States and using the calendar year as the taxable year, is present in the United States from May 1, 1971, to November 15, 1971, a period of more than 182 days. While present in the United States, B effects for his own account on various dates a number of transactions in stocks and securities on the stock exchange, as a result of which he has recognized capital gains of $10,000. During the period from January 1, 1971, to April 30, 1971, he carries out similar transactions through an agent in the United States, as a result of which B has recognized capital gains of $5,000. On December 15, 1971, through an agent in the United States B sells a capital asset on the installment plan, no payments being made by the purchaser in 1971. During 1972, B receives installment payments of $50,000 on the installment sale made in 1971, and the capital gain from sources within the United States for 1972 attributable to such payments is $12,500. In addition, during the period from January 1, 1972, to May 31, 1972, B effects for his own account, through an agent in the United States, a number of transactions in stocks and securities on the stock exchange, as a result of which B has recognized capital gains of $20,000. At no time during 1972 is B present in the United States or engaged in trade or business in the United States. Accordingly, for 1971, B is subject to tax under section 871(a)(2) on his capital gains of $15,000 from the transactions in that year on the stock exchange. For 1972, B is not subject to tax on the capital gain of $12,500 from the installment sale in 1971 or on the capital gains of $20,000 from the transactions in 1972 on the stock exchange.

Example 2. The facts are the same as in example 1 except that B is present in the United States from June 15, 1972, to December 31, 1972, a period of more than 182 days. Accordingly, B is subject to tax under section 871(a)(2) for 1971 on his capital gains of $15,000 from the transactions in that year on the stock exchange. He is also subject to tax under section 871(a)(2) for 1972 on his capital gains of $32,500 ($12,500 from the installment sale in 1971 plus $20,000 from the transactions in 1972 on the stock exchange).

Example 3. D, a nonresident alien individual not engaged in trade or business in the United States and using the calendar year as the taxable year, is present in the United States from April 1, 1971, to August 31, 1971, a period of less than 183 days. While present in the United States, D effects for his own account on various dates a number of transactions in stocks and securities on the stock exchange, as a result of which he has recognized capital gains of $15,000. During the period from January 1, 1971, to March 31, 1971, he carries out similar transactions through an agent in the United States, as a result of which D has recognized capital gains of $8,000. On December 20, 1971, through an agent in the United States D sells a capital asset on the installment plan, no payments being made by the purchaser in 1971. During 1972, D receives installment payments of $200,000 on the installment sale made in 1971, and the capital gain from sources within the United States for 1972 attributable to such payments is $50,000. In addition, during the period from February 1, 1972, to August 15, 1972, a period of more than 182 days. D effects for his own account, through an agent in the United States, a number of transactions in stocks and securities on the stock exchange, as a result of which D has recognized capital gains of $25,000. At no time during 1972 is D present in the United States or engaged in trade or business in the United States. Accordingly, D is not subject to tax for 1971 or 1972 on any of his recognized capital gains.

Example 4. The facts are the same as in example 3 except that D is present in the United States from February 1, 1972, to August 15, 1972, a period of more than 182 days. Accordingly, D is not subject to tax for 1971 on his capital gains of $23,000 from the transactions in that year on the stock exchange. For 1972 he is subject to tax under section 871(a)(2) on his capital gains of $25,000 from the transactions in that year on the stock exchange, but he is not subject to the tax on the capital gain of $50,000 from the installment sale in 1971.

(3) *Determination of 183-day period*—(i) *In general.* In determining the total period of presence in the United States for a taxable year for purposes of subparagraph (2) of this paragraph, all separate periods of presence in the United States during the taxable year are to be aggregated. If the nonresident alien individual has not previously established a taxable year, as defined in section 441(b), he shall be treated as having a taxable year which is the calendar year, as defined in section 441(d). Subsequent adoption by such individual of a fiscal year as the taxable year will be treated as a change in the taxpayer's annual accounting period to which section 442 applies, and the change must be authorized under this part (Income Tax Regulations) or prior approval must be obtained by filing an application on Form 1128 in accordance with paragraph (b) of §1.442–1. If in the course of his taxable year the nonresident alien individual changes his status from that of a citizen or resident of the United States to that of a nonresident alien individual, or vice versa, the determination of whether the individual has been present in the United States for 183 days or more during the taxable year shall be made by taking into account the entire taxable year, and not just that part of the taxable year during which he has the status of a nonresident alien individual.

(ii) *Definition of ''day''.* The term ''day'', as used in subparagraph (2) of this paragraph, means a calendar day during any portion of which the nonresident alien individual is physically present in the United States (within the meaning of sections 7701(a)(9) and 638) except that, in the case of an individual who is a resident of Canada or Mexico and, in the normal course of his employment in transportation service touching points within both Canada or Mexico and the United States, performs personal services in both the foreign country and the United States, the following rules shall apply:

(a) The performance of labor or personal services during 8 hours or more in any 1 day within the United States shall be considered as 1 day in the United States, except that if a period of more or less than 8 hours is considered a full workday in the transportation job involved, such period shall be considered as 1 day within the United States.

(b) The performance of labor or personal services during less than 8 hours in any day in the United States shall, except as provided in *(a)* of this subdivision, be considered as a fractional part of a day in the United States. The total number of hours during which such services are performed in the United States during the taxable year, when divided by eight, shall be the number of days during which such individual shall be considered present in the United States during the taxable year.

(c) The aggregate number of days determined under *(a)* and *(b)* of this subdivision shall be considered the total number of days during which such individual is present in the United States during the taxable year.

(4) *Determination of amount of excess gains*—(i) *In general.* For the purpose of determining the excess of gains over losses subject to tax under this paragraph, gains and losses shall be taken

into account only if, and to the extent that, they would be recognized and taken into account if the nonresident alien individual were engaged in trade or business in the United States during the taxable year and such gains and losses were effectively connected for such year with the conduct of a trade or business in the United States by such individual. However, in determining such excess of gains over losses no deduction may be taken under section 1202, relating to the deduction for capital gains, or section 1212, relating to the capital loss carryover. Thus, for example, in determining such excess gains all amounts considered under chapter 1 of the Code as gains or losses from the sale or exchange of capital assets shall be taken into account, except those gains which are described in section 871(a)(1) (B) or (D) and taken into account under paragraph (c) of this section and are considered to be gains from the sale or exchange of capital assets. Also, for example, a loss described in section 631 (b) or (c) which is considered to be a loss from the sale of a capital asset shall be taken into account in determining the excess gains which are subject to tax under this paragraph. In further illustration, in determining such excess gains no deduction shall be allowed, pursuant to the provisions of section 267, for losses from sales or exchanges of property between related taxpayers. Any gains which are taken into account under section 871(a)(1) and paragraph (c) of this section shall not be taken into account in applying section 1231 for purposes of this paragraph. Gains and losses are to be taken into account under this paragraph whether they are short-term or long-term capital gains or losses within the meaning of section 1222.

(ii) *Gains not included.* The provisions of this paragraph do not apply to any gains described in section 871(a)(1) (B) or (D), and in subdivision (i), (iii), or (iv) of paragraph (c)(1) of this section, which are considered to be gains from the sale or exchange of capital assets.

(iii) *Allowance of losses.* In determining the excess of gains over losses subject to tax under this paragraph losses shall be allowed only to the extent provided by section 165(c). Losses from sales or exchanges of capital assets in excess of gains from sales or exchanges of capital assets shall not be taken into account.

(e) *Credits against tax.* The credits allowed by section 31 (relating to tax withheld on wages), by section 32 (relating to tax withheld at source on nonresident aliens), by section 39 (relating to certain uses of gasoline and lubricating oil), and by section 6402 (relating to overpayments of tax) shall be allowed against the tax of a nonresident alien individual determined in accordance with this section.

(f) *Effective date.* Except as otherwise provided in this paragraph, this section shall apply for taxable years beginning after December 31, 1966. Paragraph (b)(2) of this section is applicable to payments made after November 13, 1997. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871–7 (b) and (c) (Revised as of January 1, 1971).

[T.D. 7332, 39 FR 44219, Dec. 23, 1974, as amended by T.D. 8734, 62 FR 53416, Oct. 14, 1997; T.D. 8735, 62 FR 53501, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53416, Oct. 14, 1997, §1.871–7 was amended in the third sentence of paragraph (b)(1) by removing the words ''see paragraph (a) of §1.1441–2'' and adding in its place ''see §1.1441–2(b)'', effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effective date was delayed to Jan. 1, 2000.

§1.871–8 Taxation of nonresident alien individuals engaged in U.S. business or treated as having effectively connected income.

(a) *Segregation of income.* This section applies for purposes of determining the tax of a nonresident alien individual who at any time during the taxable year is engaged in trade or business in the United States. It also applies for purposes of determining the tax of a nonresident alien student or trainee who is deemed under section 871(c) and §1.871–9 to be engaged in trade or business in the United States or of a nonresident alien individual who at no time during the taxable year is engaged in trade or business in the United States but has an election in effect for the taxable year under section 871(d) and §1.871–10 in respect to real property income. A nonresident alien individual to whom this section applies must segregate his gross income for the taxable year into two categories, namely (1) the income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, and (2) the income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual. A separate tax shall then be determined upon each such category of income, as provided in paragraph (b) of this section. The determination of whether income or gain is or is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the nonresident alien individual shall be made in accordance with section 864*(c)* and §§1.864–3 through 1.864–7. For purposes of this section income which is effectively connected for the taxable year with the conduct of a trade or business in the United States includes all income which is treated under section 871 (c) or (d) and §1.871–9 or §1.871–10 as income which is effectively connected for such year with the conduct of a trade or business in the United States by the nonresident alien individual.

(b) *Imposition of tax*—(1) *Income not effectively connected with the conduct of a trade or business in the United States.* If a nonresident alien individual who is engaged in trade or business in the United States at any time during the taxable year derives during such year from sources within the United States income or gains described in section 871(a)(1), and paragraph (b) or (c) of §1.871–7 or gains from the sale or exchange of capital assets determined as provided in section 871(a)(2) and paragraph (d) of §1.871–7, which are not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, such income or gains shall be subject to a flat tax of 30 percent of the aggregate amount of such items. This tax shall be determined in the manner, and subject to the same conditions, set forth in §1.871–7 as though the income or gains were derived by a nonresident alien individual not engaged in trade or business in the United States during the taxable year, except that (i) the rule in paragraph (d)(3) of such section for treating the calendar year as the taxable year shall not apply and (ii) in applying paragraph (c) and (d)(4) of such section, there shall not be taken into account any gains or losses which are taken into account in determining the tax under section 871(b) and subparagraph (2) of this paragraph. A nonresident alien individual who has an election in effect for the taxable year under section 871(d) and §1.871–10 and who at no time during the taxable year is engaged in trade or business in the United States must determine his tax under §1.871–7 on his income which is not treated as effectively connected with the conduct of a trade or business in the United States, subject to the exception contained in subdivision (ii) of this subparagraph.

(2) *Income effectively connected with the conduct of a trade or business in the United States*—(i) *In general.* If a nonresident alien to whom this section applies derives income or gains which are effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, the taxable income or gains shall, except as provided in §1.871–12, be taxed in accordance with section 1 or, in the alternative, section 1201(b). See section 871(b)(1). Any income of the nonresident alien individual which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual shall not be taken into account in determining either the rate or amount of such tax. See paragraph (b) of §1.872–1.

(ii) *Determination of taxable income.* The taxable income for any taxable year for purposes of this subparagraph consists only of the nonresident alien individual's taxable income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual; and, for this purpose, it is immaterial that the trade or business with which that income is effectively connected is not the same as the trade or business carried on in the United States by that individual during the taxable year. See example 2 in §1.864–

4(b). In determining such taxable income all amounts constituting, or considered to be, gains or losses for the taxable year from the sale or exchange of capital assets shall be taken into account if such gains or losses are effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, and, for such purpose, the 183-day rule set forth in section 871(a)(2) and paragraph (d)(2) of § 1.871–7 shall not apply. Losses which are not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual shall not be taken into account in determining taxable income under this subdivision, except as provided in section 873(b)(1).

(iii) *Cross references.* For rules for determining the gross income and deductions for the taxable year, see sections 872 and 873, and the regulations thereunder.

(c) *Change in trade or business status*—(1) *In general.* The determination as to whether a nonresident alien individual is engaged in trade or business within the United States during the taxable year is to be made for each taxable year. If at any time during the taxable year he is engaged in a trade or business in the United States, he is considered to be engaged in trade or business within the United States during the taxable year for purposes of sections 864(c)(1) and 871(b), and the regulations thereunder. Income, gain, or loss of a nonresident alien individual is not treated as being effectively connected for the taxable year with the conduct of a trade or business in the United States if he is not engaged in trade or business within the United States during such year, even though such income, gain, or loss may have been effectively connected for a previous taxable year with the conduct of a trade or business in the United States. See § 1.864–3. However, income, gain, or loss which is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by a nonresident alien individual will generally be treated as effectively connected for a subsequent taxable year if he is engaged in a trade or business in the United States during such subsequent year, even though such income, gain, or loss is not effectively connected with the conduct of the trade or business carried on in the United States during such subsequent year. This subparagraph does not apply to income described in section 871 (c) or (d). It may not apply to a nonresident alien individual who for the taxable year uses an accrual method of accounting or to income which is constructively received in the taxable year within the meaning of § 1.451–2.

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

Example 1. B, a nonresident alien individual using the calendar year as the taxable year and the cash receipts and disbursements method of accounting, is engaged in business (business R) in the United States from January 1, 1971, to August 31, 1971. During the period of September 1, 1971, to December 31, 1971, B receives installment payments of $30,000 on sales made in the United States by business R during that year, and the income from sources within the United States for that year attributable to such payments is $7,509. On September 15, 1971, another business (business S), which is carried on by B only in a foreign country sells to U.S. customers on the installment plan several pieces of equipment from inventory. During the period of September 16, 1971, to December 31, 1971, B receives installment payments of $50,000 on these sales by business S, and the income from sources within the United States for that year attributable to such payments is $10,000. Under section 864(c)(3) and paragraph (b) of § 1.864–4 the entire income of $17,500 is effectively connected for 1971 with the conduct of a business in the United States by B. Accordingly, such income is taxable to B under paragraph (b)(2) of this section.

Example 2. Assume the same facts as in example 1, except that during 1972 B receives installment payments of $20,000 from the sales made during 1971 in the United States by business R, and of $80,000 from the sales made in 1971 to U.S. customers by business S, the total income from sources within the United States for 1972 attributable to such payments being $13,000. At no time during 1972 is B engaged in a trade or business in the United States. Under section 864(c)(1)(B) the income of $13,000 for 1972 is not effectively connected with the conduct of a trade or business in the United States by B. Moreover, such income is not fixed or determinable annual or periodical income. Accordingly, no amount of such income is taxable to B under section 871.

Example 3. Assume the same facts as in example 2, except that during 1972 B is engaged in a new business (business T) in the United States from July 1, 1972, to December 31, 1972. Under section 864(c)(3) and paragraph (b) of §1.864–4, the income of $13,000 is effectively connected for 1972 with the conduct of a business in the United States by B. Accordingly, such income is taxable to B under paragraph (b)(2) of this section.

Example 4. Assume the same facts as in example 2, except that the installment payments of $20,000 from the sales made during 1971 in the United States by business R and not received by B until 1972 could have been received by B in 1971 if he had so desired. Under §1.451–2, B is deemed to have constructively received the payments of $20,000 in 1971. Accordingly, the income attributable to such payments is effectively connected for 1971 with the conduct of a business in the United States by B and is taxable to B in 1971 under paragraph (b)(2) of this section.

(d) *Credits against tax.* The credits allowed by section 31 (relating to tax withheld on wages), section 32 (relating to tax withheld at source on nonresident aliens), section 33 (relating to the foreign tax credit), section 35 (relating to partially tax-exempt interest), section 38 (relating to investment in certain depreciable property), section 39 (relating to certain uses of gasoline and lubricating oil), section 40 (relating to expenses of work incentive programs), and section 6402 (relating to overpayments of tax) shall be allowed against the tax determined in accordance with this section. However, the credits allowed by sections 33, 38, and 40 shall not be allowed against the flat tax of 30 percent imposed by section 871(a) and paragraph (b)(1) of this section. Moreover, no credit shall be allowed under section 35 to a non- resident alien individual with respect to whom a tax is imposed for the taxable year under section 871(a) and paragraph (b)(1) of this section, even though such individual has income for such year upon which tax is imposed under section 871(b) and paragraph (b)(2) of this section. For special rules applicable in determining the foreign tax credit, see section 906(b) and the regulations thereunder. For the disallowance of certain credits where a return is not filed for the taxable year, see section 874 and §1.874–1.

(e) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871–7(d) (Revised as of January 1, 1971).

[T.D. 7332, 39 FR 44221, Dec. 23, 1974]

§1.871–9 Nonresident alien students or trainees deemed to be engaged in U.S. business.

(a) *Participants in certain exchange or training programs.* For purposes of §§1.871–7 and 1.871–8 a nonresident alien individual who is temporarily present in the United States during the taxable year as a nonimmigrant under subparagraph (F) (relating to the admission of students into the United States) or subparagraph (J) (relating to the admission of teachers, trainees, specialists, etc., into the United States) of section 101(a)(15) of the Immigration and Nationality Act (8 U.S.C. 1101(a)(15) (F) or (J)), and who without regard to this paragraph is not engaged in trade or business in the United States during such year, shall be deemed to be engaged in trade or business in the United States during the taxable year. For purposes of determining whether an alien who is present in the United States on an F visa or a J visa is a resident of the United States, see §§301.7701(b)–1 through 301.7701(b)–9 of this chapter.

(b) *Income treated as effectively connected with U.S. business.* Any income described in paragraph (1) (relating to the nonexcluded portion of certain scholarship or fellowship grants) or paragraph (2) (relating to certain nonexcluded expenses incident to such grants) of section 1441(b) which is received during the taxable year from sources within the United States by a nonresident alien individual described in paragraph (a) of this section is to be treated for purposes of §§1.871–7, 1.871–8, 1.872–1, and 1.873–1 as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual. However, such income is not to be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States for purposes of section 1441(c)(1) and paragraph (a) of §1.1441–4. For exclusion relating to compensation paid to such individual by a foreign employer, see paragraph (b) of §1.872–2.

(c) *Exchange visitors.* For purposes of paragraph (a) of this section a nonresident alien individual who is temporarily present in the United States during the taxable year as a nonimmigrant under subparagraph (J) of section 101(a)(15) of the Immigration and Nationality Act includes a nonresident alien individual admitted to the United States as an ‘‘exchange visitor’’ under section 201 of the U.S. Information and Educational Exchange Act of 1948 (22 U.S.C. 1446), which section was repealed by section 111 of the Mutual Educational and Cultural Exchange Act of 1961 (75 Stat. 538).

(d) *Mandatory application of rule.* The application of this section is mandatory and not subject to an election by the taxpayer.

(e) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871–7(a)(3) (Revised as of January 1, 1971).

[T.D. 7332, 39 FR 44222, Dec. 23, 1974, as amended by T.D. 8411, 57 FR 15241, Apr. 27, 1992]

§1.871–10 Election to treat real property income as effectively connected with U.S. business.

(a) *When election may be made.* A nonresident alien individual or foreign corporation which during the taxable year derives any income from real property which is located in the United States and, in the case of a nonresident alien individual, held for the production of income, or derives income from any interest in any such property, may elect, pursuant to section 871(d) or 882(d) and this section, to treat all such income as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that taxpayer. The election may be made whether or not the taxpayer is engaged in trade or business in the United States during the taxable year for which the election is made or whether or not the taxpayer has income from real property which for the taxable year is effectively connected with the conduct of a trade or business in the United States, but it may be made only with respect to that income from sources within the United States which, without regard to this section, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the taxpayer. If for the taxable year the taxpayer has no income from real property located in the United States, or from any interest in such property, which is subject to the tax imposed by section 871(a) or 881(a), the election may not be made. But if an election has been properly made under this section for a taxable year, the election remains in effect, unless properly revoked, for subsequent taxable years even though during any such subsequent taxable year there is no income from the real property, or interest therein, in respect of which the election applies.

(b) *Income to which the election applies*—(1) *Included income.* An election under this section shall apply to all income from real property which is located in the United States and, in the case of a nonresident alien individual, held for the production of income, and to all income derived from any interest in such property, including (i) gains from the sale or exchange of such property or an interest therein, (ii) rents or royalties from mines, oil or gas wells, or other natural resources, and (iii) gains described in section 631 (b) or (c), relating to treatment of gain on the disposal of timber, coal, or iron ore with a retained economic interest. The election may not be made with respect to only one class of such income. For purposes of the election, income from real property, or from any interest in real property, includes any amount included under section 652 or 662 in the gross income of a nonresident alien individual or foreign corporation that is the beneficiary of an estate or trust if, by reason of the application of section 652(b) or 662(b), and the regulations thereunder, such amount has the character in the hands of that beneficiary of income from real property, or from any interest in real property. It is immaterial that no tax would be imposed on the income by section 871(a) and paragraph (a) of §1.871–7, or by section 881(a) and paragraph (a) of §1.881–2, if the election were not in effect. Thus, for example, if an election under this section has been made by a nonresident alien individual not engaged in trade or business in the United States during the taxable year, the tax imposed by section 871(b)(1) and paragraph (b)(2) of §1.871–8 applies to his gains derived from the sale of real property located in the United States and held for the production of income, even though such income would not be subject to tax under section 871(a) if the election had not been made. In further illustration, assume that a nonresident alien individual not engaged in trade or business, or present, in the United States during the taxable year has income from sources within the United States consisting of oil royalties, rentals from a former personal residence, and capital gain from the sale of another residence held for the production of income. If he makes an election under this section, it will apply with respect to his royalties, rentals, and capital gain, even though such capital gain would not be subject to tax under section 871(a) if the election had not been made.

(2) *Income not included.* For purposes of subparagraph (1) of this paragraph, income from real property, or from any interest in real property, does not include (i) interest on a debt obligation secured by a mortgage of real property, (ii) any portion of a dividend, within the meaning of section 316, which is paid by a corporation or a trust, such as a real estate investment trust described in section 857, which derives income from real property, (iii) in the case of a nonresident alien individual, income from real property, such as a personal residence, which is not held for the production of income or from any transaction in such property which was not entered into for profit, (iv) rentals from personal property, or royalties from intangible personal property, within the meaning of subparagraph (3) of this paragraph, or (v) income which, without regard to section 871(d) or 882(d) and this section, is treated as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States.

(3) *Rules applicable to personal property.* For purposes of subparagraph (2) of this paragraph, in the case of a sales agreement, or rental or royalty agreement, affecting both real and personal property, the income from the transaction is to be allocated between the real property and the personal property in proportion to their respective fair market values unless the agreement specifically provides otherwise. In the case of such a rental or royalty agreement, the respective fair market values are to be determined as of the time the agreement is signed. In making determinations of this subparagraph, the principles of paragraph (c) of §1.48–1, relating to the definition of ‘‘section 38 property,’’ apply for purposes of determining whether property is tangible or intangible personal property and of paragraph (a)(5) of §1.1245–1 apply for purposes of making the allocation of income between real and personal property.

(c) *Effect of the election*—(1) *Determination of tax.* The income to which, in accordance with paragraph (b) of this section, an election under this section applies shall be subject to tax in the manner, and subject to the same conditions, provided by section 871(b)(1) and paragraph (b)(2) of §1.871–8, or by section 882(a)(1) and paragraph (b)(2) of §1.882–1. For purposes of determining such tax for the taxable year, income to which the election applies shall be aggregated with all other income of the nonresident alien individual or foreign corporation which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that taxpayer. To the extent that deductions are connected with income from real property to which the election applies, they shall be treated for purposes of section 873(a) or section 882(c)(1) as connected with income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by the nonresident alien individual or foreign corporation. An election under this section does not cause a nonresident alien individual or foreign corporation, which is not engaged in trade or business in the United States during the taxable year, to be treated as though such taxpayer were engaged in trade or business in the United States during the taxable year. Thus, for example, the compensation received during the taxable year for services performed in the United States in a previous taxable year by a nonresident alien individual, who has an election in effect for the taxable year under this section but is engaged in trade or business in the United States at no time during the taxable year, is not effectively connected for the taxable year with the conduct of a trade or business in the United States. In further illustration, gain for the taxable year from the casual sale of personal property described in section 1221(I) derived by a nonresident alien individual who is not engaged in trade or business in the United States during the taxable year but has an election in effect for such year under this section is not effectively connected with the conduct of a trade or business in the United States. See § 1.864–3. If an election under this section is in effect for the taxable year, the income to which the election applies shall be treated, for purposes of section 871(b)(1) or section 882(a)(1), section 1441(c)(1), and paragraph (a) of § 1.1441–4, as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by the taxpayer.

(2) *Treatment of property to which election applies.* Any real property, or interest in real property, with respect to which an election under this section applies shall be treated as a capital asset which, if depreciable, is subject to the allowance for depreciation provided in section 167 and the regulations thereunder. Such property, or interest in property, shall be treated as property not used in a trade or business for purposes of applying any provisions of the Code, such as section 172(d)(4)(A), relating to gain or loss attributable to a trade or business for purposes of determining a net operating loss; section 1221(2), relating to property not constituting a capital asset; or section 1231(b), relating to special rules for treatment of gains and losses. For example, if a nonresident alien individual makes the election under this section and, while the election is in effect, sells unimproved land which is located in the United States and held for investment purposes, any gain or loss from the sale shall be considered gain or loss from the sale of a capital asset and shall be treated, for purposes of determining the tax under section 871(b)(1) and paragraph (b)(2) of § 1.871–8, as a gain or loss which is effectively connected for the taxable year with the conduct of a trade or business in the United States.

(d) *Manner of making or revoking an election*—(1) *Election, or revocation, without consent of Commissioner*—(i) *In general.* A nonresident alien individual or foreign corporation may, for the first taxable year for which the election under this section is to apply, make the initial election at any time before the expiration of the period prescribed by section 6511(a), or by section 6511(c) if the period for assessment is extended by agreement, for filing a claim for credit or refund of the tax imposed by chapter 1 of the Code for such taxable year. This election may be made without the consent of the Commissioner. Having made the initial election, the taxpayer may, within the time prescribed for making the election for such taxable year, revoke the election without the consent of the Commissioner. If the revocation is timely and properly made, the taxpayer may make his initial election under this section for a later taxable year without the consent of the Commissioner. If the taxpayer revokes the initial election without the consent of the Commissioner he must file amended income tax returns, or claims for credit or refund, where applicable, for the taxable years to which the revocation applies.

(ii) *Statement to be filed with return.* An election made under this section without the consent of the Commissioner shall be made for a taxable year by filing with the income tax return required under section 6012 and the regulations thereunder for such taxable year a statement to the effect that the election is being made. This statement shall include *(a)* a complete schedule of all real property, or any interest in real property, of which the taxpayer is titular or beneficial owner, which is located in the United States, *(b)* an indication of the extent to which the taxpayer has direct or beneficial ownership in each such item of real property, or interest in real property, *(c)* the location of the real property or interest therein, *(d)* a description of any substantial improvements on any such property, and *(e)* an identification of any taxable year or years in respect of which a revocation or new election under this section has previously occurred. This statement may not be filed with any return under section 6851 and the regulations thereunder.

(iii) *Exemption from withholding of tax.* For statement to be filed with a withholding agent at the beginning of a taxable year in respect of which an election under this section is to be made, see paragraph (a) of §1.1441–4.

(2) *Revocation, or election, with consent of Commissioner*—(i) *In general.* If the nonresident alien individual or foreign corporation makes the initial election under this section for any taxable year and the period prescribed by subparagraph (1)(i) of this paragraph for making the election for such taxable year has expired, the election shall remain in effect for all subsequent taxable years, including taxable years for which the taxpayer realizes no income from real property, or from any interest therein, or for which he is not required under section 6012 and the regulations thereunder to file an income tax return. However, the election may be revoked in accordance with subdivision (iii) of this subparagraph for any subsequent taxable year with the consent of the Commissioner. If the election for any such taxable year is revoked with the consent of the Commissioner, the taxpayer may not make a new election before his fifth taxable year which begins after the first taxable year for which the revocation is effective unless consent is given to such new election by the Commissioner in accordance with subdivision (iii) of this subparagraph.

(ii) *Effect of new election.* A new election made for the fifth taxable year, or taxable year thereafter, without the consent of the Commissioner, and a new election made with the consent of the Commissioner, shall be treated as an initial election to which subparagraph (1) of this paragraph applies.

(iii) *Written request required.* A request to revoke an election made under this section when such revocation requires the consent of the Commissioner, or to make a new election when such election requires the consent of the Commissioner, shall be made in writing and shall be addressed to the Director of International Operations, Internal Revenue Service, Washington, DC 20225. The request shall include the name and address of the taxpayer and shall be signed by the taxpayer or his duly authorized representative. It must specify the taxable year for which the revocation or new election is to be effective and shall be filed within 75 days after the close of the first taxable year for which it is desired to make the change. The request must specify the grounds which are considered to justify the revocation or new election. The Director of International Operations may require such other information as may be necessary in order to determine whether the proposed change will be permitted. A copy of the consent by the Director of International Operations shall be attached to the taxpayer's return required under section 6012 and the regulations thereunder for the taxable year for which the revocation or new election is effective. A copy of such consent may not be filed with any return under section 6851 and the regulations thereunder.

(3) *Election by partnership.* If a nonresident alien individual or foreign corporation is a member of a partnership which has income described in paragraph (b)(1) of this section from real property, any election to be made under this section in respect of such income shall be made by the partners and not by the partnership.

(e) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. There are no corresponding rules in this part for taxable years beginning before January 1, 1967.

[T.D. 7332, 39 FR 44222, Dec. 23, 1974]

§1.871–11 Gains from sale or exchange of patents, copyrights, or similar property.

(a) *Contingent payment defined.* For purposes of section 871(a)(1)(D), section 881(a)(4), §1.871–7(c)(1)(iv), §1.881–2(c)(1)(iii), and this section, payments which are contingent on the productivity, use, or disposition of property or of an interest therein include continuing payments measured by a percentage of the selling price of the products marketed, or based on the number of units manufactured or sold, or based in a similar manner upon production, sale or use, or disposition of the property or interest transferred. A payment which is certain as to the amount to be received, but contingent as to the time of payment, or an installment payment of a principal sum agreed upon in a transfer agreement, shall not be treated as a contingent payment for purposes of this paragraph. For the inapplication of section 1253 to certain amounts described in this paragraph, see paragraph (a) of §1.1253–1.

(b) *Payments treated as contingent on use.* Pursuant to section 871(e), if more than 50 percent of the gain of a nonresident alien individual or foreign corporation for any taxable year from the sale or exchange after October 4, 1966, of any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other like property, or of any interest in any such property, is from payments which are contingent on the productivity, use, or disposition of such property or interest, all of the gain of such individual or corporation for the taxable year from the sale or exchange of such property or interest are, for purposes of section 871(a)(1)(D), section 881(a)(4), section 1441(b), or section 1442(a), and the regulations thereunder, to be treated as being from payments which are contingent on the productivity, use, or disposition of such property or interest. This paragraph does not apply for purposes of determining under section 871(b)(1) or 882(a)(1) the tax of a nonresident alien individual or foreign corporation on income which is effectively connected for the taxable year with the conduct of a trade or business in the United States.

(c) *Sale or exchange.* A sale or exchange for purposes of this section includes, but is not limited to, a transfer by an individual which by reason of section 1235, relating to the sale or exchange of patents, is considered the sale or exchange of a capital asset. The provisions of section 1253, relating to transfers of franchises, trademarks, and trade names, do not apply in determining whether a transfer is a sale or exchange for purposes of this section.

(d) *Recovery of adjusted basis.* For purposes of determining for any taxable year the amount of gains which are subject to tax under section 871(a)(1)(D) or 881(a)(4), payments received by the nonresident alien individual or foreign corporation during such year must be reduced by amounts representing recovery of the taxpayer's adjusted basis of the property or interest which is sold or exchanged. Where the taxpayer receives in the same taxable year payments which, without reference to section 871(e) and this section, are not contingent on the productivity, use, or disposition of the property or interest which is sold or exchanged and payments which are contingent on the productivity, use, or disposition of the property or interest which is sold or exchanged, the taxpayer's unrecovered adjusted basis in the property or interest which is sold or exchanged must be allocated for the taxable year between such payments on the basis of the gross amount of each such type of payments. Where the taxpayer receives in the taxable year only payments which are not so contingent or only payments which are so contingent, the taxpayer's unrecovered basis must be allocated in its entirety to such payments for the taxable year.

(e) *Source rule.* In determining whether gains described in section 871(a)(1)(D) or 881(a)(4) and paragraph (b) of this section are received from sources within the United States, such gains shall be treated, for purposes of section 871(a)(1)(D), section 881(a)(4), section 1441(b), and section 1442(a), as rentals or royalties for the use of, or privilege of using, property or an interest in property. See section 861(a)(4), §1.861–5, and paragraph (a) of §1.862–1.

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

Example 1. (a) A, a nonresident alien individual who uses the cash receipts and disbursements method of accounting and the calendar year as the taxable year, holds a U.S. patent which he developed through his own effort. On December 15, 1967, A enters into an agreement of sale with M Corporation, a domestic corporation, whereby A assigns to M Corporation all of his U.S. rights in the patent. In consideration of the sale, M Corporation is obligated to pay a fixed sum of $60,000, $20,000 being payable on execution of the contract and the balance payable in four annual installments of $10,000 each. As additional consideration, M Corporation agrees to pay to A a royalty in the amount of 2 percent of the gross sales of the products manufactured by M Corporation under the patent. A is not engaged in trade or business in the United States at any time during 1967 and 1968. His adjusted basis in the patent at the time of sale is $28,800.

(b) In 1967, A receives only the $20,000 paid by M Corporation on the execution of the contract of sale. No gain is realized by A upon receipt of this amount, and his unrecovered adjusted basis in the patent is reduced to $8,800 ($28,800 less $20,000).

(c) In 1968, M Corporation has gross sales of $600,000 from products manufactured under the patent. Consequently, for 1968, M Corporation pays $22,000 to A, $10,000 being the annual installment on the fixed payment and $12,000 being payments under the terms of the royalty provision. A's recognized gain for 1968 is $13,200 ($22,000 reduced by the unrecovered adjusted basis of $8,800). Of the total gain of $13,200, gain in the amount of $6,000 ($10,000− [$8,800×$10,000/$22,000]) is considered to be from the fixed installment payment and of $7,200 ($12,000 − [$8,800 × $12,000/ $22,000]) is considered to be from the royalty payment. Since 54.5 percent ($7,200/$13,200) of the gain recognized in 1968 from the sale of the patent is from payments which are contingent on the productivity, use, or disposition of the patent, all of the $13,200 gain recognized in 1968 is treated, for purposes of section 871(a)(1)(D) and section 1441(b), as being from payments which are contingent on the productivity, use, or disposition of the patent.

Example 2. (a) F, a foreign corporation using the calendar year as the taxable year and not engaged in trade or business in the United States, holds a U.S. patent on certain property which it developed through its own efforts. Corporation F uses the cash receipts and disbursements method of accounting. On December 1, 1966, F Corporation enters into an agreement of sale with D Corporation, a domestic corporation, whereby D Corporation purchases the exclusive right and license, and the right to sublicense to others, to manufacture, use, and/or sell certain devices under the patent in the United States during the term of the patent. The agreement grants D Corporation the right to dispose, anywhere in the world, of machinery manufactured in the United States and equipped with such devices. Corporation D is granted the right, at its own expense, to prosecute infringers in its own name or in the name of F Corporation, or both, and to retain any damages recovered.

(b) Corporation D agrees to pay to F Corporation annually $5 for each device manufactured under the patent during the year but in no case less than $5,000 per year. In 1967, D Corporation manufactures 2,500 devices under the patent; and, in 1968, 1,500 devices. Under the terms of the contract D Corporation pays to F Corporation in 1967 $12,500 with respect to production in that year and $7,500 in 1968 with respect to production in that year. F Corporation's basis in the patent at the time of the sale is $17,000.

(c) With respect to the payments received by F Corporation in 1967, no gain is realized by that corporation and its unrecovered adjusted basis in the patent is reduced to $4,500 ($17,000 less $12,500).

(d) With respect to the payments received by F Corporation in 1968, such corporation has recognized gain of $3,000 ($7,500 reduced by unrecovered adjusted basis of $4,500). Of the total gain of $3,000, gain in the amount of $2,000 ($5,000− [$4,500×$5,000/$7,500]) is considered to be from the fixed installment payment and of $1,000 ($2,500−[$4,500× $2,500/ $7,500]) is considered to be from payments which are contingent on the productivity, use, or disposition of the patent. Since 33.3 percent ($1,000/$3,000) of the gain recognized in 1968 from the sale of the patent is from payments which are contingent on the productivity, use, or disposition of the patent, only $1,000 of the $3,000 gain for that year constitutes gains which, for purposes of section 881(a)(4) and section 1442(a), are from payments which are contingent on the productivity, use, or disposition of the patent. The balance of $2,000 is gain from the sale of property and is not subject to tax under section 881(a).

(g) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966, but only in respect of gains from sales or exchanges occurring after October 4, 1966. There are no corresponding rules in this part for taxable years beginning before January 1, 1967.

[T.D. 7332, 39 FR 44224, Dec. 23, 1974]

§ 1.871–12 Determination of tax on treaty income.

(a) *In general.* This section applies for purposes of determining under § 1.871–7 or § 1.871–8 the tax of a nonresident alien individual, or under § 1.881–2 or § 1.882–1 the tax of a foreign corporation, which for the taxable year has income described in section 872(a) or 882(b) upon which the tax is limited by an income tax convention to which the United States is a party. Income for such purposes does not include income of any kind which is exempt from tax under the provisions of an income tax convention to which the United States is a party. See §§ 1.872– 2(c) and 1.883–1(b). This section shall not apply to a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year.

(b) *Definition of treaty and nontreaty income*—(1) *In general.* (i) For purposes of this section the term ''treaty income'' shall be construed to mean the gross income of a nonresident alien individual or foreign corporation, as the case may be, the tax on which is limited by a tax convention. The term ''non-treaty income'' shall be construed, for such purposes, to mean the gross income of the nonresident alien individual or foreign corporation other than the treaty income. Neither term includes income of any kind which is exempt from the tax imposed by chapter 1 of the Code.

(ii) In determining either the treaty or nontreaty income the gross income shall be determined in accordance with §§ 1.872–1 and 1.872–2, or with §§ 1.882–3 and 1.883–1, except that in determining the treaty income the exclusion granted by section 116(a) for dividends shall not be taken into account. Thus, for example, treaty income includes the total amount of dividends paid by a domestic corporation not disqualified by section 116(b) and received from sources within the United States if, in accordance with a tax convention, the dividends are subject to the income tax at a rate not to exceed 15 percent but does not include interest which, in accordance with a tax convention, is exempt from the income tax. In further illustration, neither the treaty nor the nontreaty income includes interest on certain governmental obligations which by reason of section 103 is excluded from gross income, or interest which by reason of a tax convention is exempt from the tax imposed by chapter 1 of the Code.

(iii) For purposes of applying any income tax convention to which the United States is a party, original issue discount which is subject to tax under section 871(a)(1)(C) or 881(a)(3) is to be treated as interest, and gains which are subject to tax under section 871(a)(1)(D) or 881(a)(4) are to be treated as royalty income. This subdivision shall not apply, however, where its application would be contrary to any treaty obligation of the United States.

(2) *Application of permanent establishment rule of treaties.* In applying this section with respect to income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by a nonresident alien individual or foreign corporation, see section 894(b), which provides that with respect to such income the nonresident alien individual or foreign corporation shall be deemed not to have a permanent establishment in the United States at any time during the taxable year for purposes of applying any exemption from, or reduction in rate of, tax provided by any tax convention.

(c) *Determination of tax*—(1) *In general.* If the gross income of a nonresident alien individual or foreign corporation, as the case may be, consists of both treaty and nontreaty income, the tax liability for the taxable year shall be the sum of the amounts determined in accordance with subparagraphs (2) and (3) of this paragraph. In no case, however, may the tax liability so determined exceed the tax liability (tax reduced by allowable credits) with respect to the taxpayer's entire income, determined in accordance with § 1.871–7 or § 1.871–8, or with § 1.881–2 or § 1.882–1, as though the tax convention had not come into effect and without reference to the provisions of this section. Determinations under this paragraph shall be made without taking into account any credits allowed by sections 31, 32, 39, and 6402, but such credits shall be allowed against the tax liability determined in accordance with this subparagraph.

(2) *Tax on nontreaty income.* For purposes of subparagraph (1) of this paragraph, compute a partial tax (determined without the allowance of any credit) upon only the nontreaty income in accordance with §1.871–7 or §1.871–8, or with §1.881–2 or §1.882–1, whichever applies, as though the tax convention had not come into effect. To the extent allowed by paragraph (d) of §1.871–8, or paragraph (c) of §1.882–1, the credits allowed by sections 33, 35, 38, and 40 shall then be allowed, without taking into account any item included in the treaty income, against the tax determined under this subparagraph.

(3) *Tax on treaty income.* For purposes of subparagraph (1) of this paragraph, compute a tax upon the gross amount, determined without the allowance of any deduction, of each separate item of treaty income at the reduced rate applicable to that item under the tax convention. No credits shall be allowed against the tax determined under this subparagraph.

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

Example. (a) A nonresident alien individual who is a resident of a foreign country with which the United States has entered into a tax convention receives during the taxable year 1967 from sources within the United States total gross income of $22,000, consisting of the following items:

Compensation for personal services the tax on which is not limited by the tax convention (effectively connected income under §1.864–4(c)(6)(ii))	$20,000
Oil royalties the tax on which is limited by the tax convention to 15 percent of the gross amount thereof (effectively connected income by reason of election under §1.871–10)	2,000
Total gross income	22,000

(b) The taxpayer is engaged in business in the United States during the taxable year but does not have a permanent establishment therein. There are no allowable deductions, other than the deductions allowed by sections 613 and 873(b)(3).

(c) The tax liability for the taxable year is $6,100, determined as follows:

Nontreaty gross income	$20,000
Less: Deduction for personal exemption	600
Nontreaty taxable income	19,400
Tax under section 1 of the Code on nontreaty taxable income ($5,170 plus 45 percent of $1,400)	5,800
Plus: Tax on treaty income (Gross oil royalties) ($2,000×15 percent)	300
Total tax (determined as provided in paragraph (c) (2) and (3) of this section)	6,100

(d) If the tax had been determined under paragraph (b)(2) of §1.871–8 as though the tax liability would have been $6,478, determined as follows and by taking into account the election under §1.871–10:

Total gross income		$22,000
Less: Deduction under section 613 for percentage depletion ($2000×27½ percent)	$550	
Deduction for personal exemption	600	1,150
Taxable income	20,850	
Tax under section 1 of the Code on taxable income ($6,070 plus 48 percent of $850)		6,478

(e) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871–7(e) (Revised as of January 1, 1971).

[T.D. 7332, 39 FR 44225, Dec. 23, 1974; as amended at T.D. 8657, 61 FR 9338, Mar. 8, 1996]

§1.871–13 Taxation of individuals for taxable year of change of U.S. citizenship or residence.

(a) *In general.* (1) An individual who is a citizen or resident of the United States at the beginning of the taxable year but a nonresident alien at the end of the taxable year, or a nonresident alien at the beginning of the taxable year but a citizen or resident of the United States at the end of the taxable year, is taxable for such year as though his taxable year were comprised of two separate periods, one consisting of the time during which he is a citizen or resident of the United States and the other consisting of the time during which he is not a citizen or resident of the United States. Thus, for example, the income tax liability of an alien individual under chapter 1 of the Code for the taxable year in which he changes his residence will be computed under two different sets of rules, one relating to resident aliens for the period of residence and the other relating to nonresident aliens for the period of nonresidence. However, in determining the taxable income for such year which is subject to the graduated rate of tax imposed by section 1 or 1201 of the Code, all income for the period of U.S. citizenship or residence must be aggregated with the income for the period of nonresidence which is effectively connected for such year with the conduct of a trade or business in the United States. This section does not apply to alien individuals treated as residents for the entire taxable year under section 6013 (g) or (h). These individuals are taxed under the rules in § 1.1–1(b).

(2) For purposes of this section, an individual is deemed to be a citizen or resident of the United States for the day on which he becomes a citizen or resident of the United States, a nonresident of the United States for the day on which he abandons his U.S. residence, and an alien for the day on which he gives up his U.S. citizenship.

(b) *Acquisition of U.S. citizenship or residence.* Income from sources without the United States which is not effectively connected with the conduct by the taxpayer of a trade or business in the United States is not taxable if received by an alien individual while he is not a resident of the United States even though he becomes a citizen or resident of the United States after its receipt and before the close of the taxable year. However, income from sources without the United States which is not effectively connected with the conduct by the taxpayer of a trade or business in the United States is taxable if received by an individual while he is a citizen or resident of the United States, even though he earns the income earlier in the taxable year while he is neither a citizen nor resident of the United States.

(c) *Abandonment of U.S. citizenship or residence.* Income from sources without the United States which is not effectively connected with the conduct by the taxpayer of a trade or business in the United States is not taxable if received by an alien individual while he is not a resident of the United States, even though he earns the income earlier in the taxable year while he is a citizen or resident of the United States. However, income from sources without the United States which is not effectively connected with the conduct by the taxpayer of a trade or business in the United States is taxable if received by an individual while he is a citizen or resident of the United States, even though he abandons his U.S. citizenship or residence after its receipt and before the close of the taxable year.

(d) *Special rules*—(1) *Method of accounting.* Paragraphs (b) and (c) of this section may not apply to an individual who for the taxable year uses an accrual method of accounting.

(2) *Deductions for personal exemptions.* An alien individual to whom this section applies is entitled to deduct one personal exemption for the taxable year under section 151. In addition, he is entitled to such additional exemptions as are allowed as a deduction under section 151 but only to the extent the amount of such additional exemptions do not exceed his taxable income (determined without regard to any deduction for personal exemptions) for the period in the taxable year during which he is a citizen or resident of the United States. This subparagraph does not apply to the extent it is inconsistent with section 873, and the regulations thereunder, or with the provisions of an income tax convention to which the United States is a party.

(3) *Exclusion of dividends received.* In determining the $100 exclusion for the taxable year provided by section 116 in respect of certain dividends, only those dividends for the period during which the individual is neither a citizen nor resident of the United States may be taken into account as are effectively connected for the taxable year with the conduct of a trade or business in the United States. See § 1.116–1(e)(1).

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

Example 1. A, a married alien individual who uses the calendar year as the taxable year and the cash receipts and disbursements method of accounting, becomes a resident of the United States on June 1, 1971. During the period of nonresidence from January 1, 1971, to May 31, 1971, inclusive, A receives $15,000 income from sources without the United States which is not effectively connected with the conduct of a trade or business in the United States. During the period of residence from June 1, 1971, to December 31, 1971, A receives wages of $10,000, dividends of $200 from a foreign corporation, and dividends of $75 from a domestic corporation qualifying under section 116(a). Of the amount of wages so received, $2,000 is for services performed by A outside the United States during the period of nonresidence. Total allowable deductions (other than for personal exemptions) amount to $700, none of which are deductible under section 62 in computing adjusted gross income. For 1971 A's spouse has no gross income and is not the dependent of another taxpayer. For 1971, A's taxable income is $8,200, all of which is subject to tax under section 1, as follows:

Wages		$10,000
Dividends from foreign corporation		200
Dividends from domestic corporation ($75 less $75 exclusion)		0
Adjusted gross income		10,200
Less deductions:		
Personal exemptions (2×$650)	$1,300	
Other allowable deductions	700	2,000
Taxable income		8,200

Example 2. The facts are the same as in example 1 except that during the period of nonresidence from January 1, 1971, to May 31, 1971, A receives from sources within the United States income of $1,850 which is effectively connected with the conduct by A of a business in the United States and $350 in dividends from domestic corporations qualifying under section 116(a). Only $50 of these dividends are effectively connected with the conduct by A of a business in the United States. The assumption is made that there are no allowable deductions connected with such effectively connected income. For 1971, A has taxable income of $10,075 subject to tax under section 1 and $300 income subject to tax under section 871(a)(1)(A), as follows:

Wages		$10,000
Business income		1,850
Dividends from foreign corporation		200
Dividends from domestic corporation ($125 less $100 exclusion)		25
Adjusted gross income		12,075
Less deductions:		
Personal exemptions (2×$650)	$1,300	
Other allowable deductions	700	2,000
Taxable income subject to tax under section 1		10,075
Income subject to tax under section 871(a)(1)(A)		300

Example 3. A, a married alien individual with three children, uses the calendar year as the taxable year and the cash receipts and disbursements method of accounting. On October 1, 1971, A and his family become residents of the United States. During the period of nonresidence from January 1, 1971, to September 30, 1971, A receives income of $18,000 from sources without the United States which is not effectively connected with the conduct of a trade or business in the United States and of $2,500 from sources within the United States which is effectively connected with the conduct of a business in the United States. It is assumed there are no allowable deductions connected with such effectively connected income. During the period of residence from October 1, 1971, to December 31, 1971, A receives wages of $2,000, of which $400 is for services performed outside the United States during the period of nonresidence. Total allowable deductions (other than for personal exemptions) amount to $250, none of which are deductible under section 62 in computing adjusted gross income. Neither the spouse nor any of the children has any gross income for 1971, and the spouse is not the dependent of another taxpayer for such year. For 1971, A's taxable income is $1,850, all of which is subject to tax under section 1, as follows:

Wages (residence period)	$2,000	
Less: Allowable deductions	250	
Taxable income (without deduction for personal exemptions) (residence period)		$1,750
Business income (nonresidence period)		2,500
Total taxable income (without deduction for personal exemptions)		4,250
Less deduction for personal exemptions:		
Taxpayer	650	
Wife and 3 children (4×$650, but not to exceed $1,750)	1,750	2,400
Taxable income		1,850

(f) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. There are no corresponding rules in this part for taxable years beginning before January 1, 1967.

[T.D. 7332, 39 FR 44226, Dec. 23, 1974, as amended by T.D. 7670, 45 FR 6928, Jan. 31, 1980]

§ 1.871–14 Rules relating to repeal of tax on interest of nonresident alien individuals and foreign corporations received from certain portfolio debt investments.

(a) *General rule.* No tax shall be imposed under section 871(a)(1)(A), 871(a)(1)(C), 881(a)(1) or 881(a)(3) on any portfolio interest as defined in sections 871(h)(2) and 881(c)(2) received by a foreign person. But see section 871(b) or 882(a) if such interest is effectively connected with the conduct of a trade or business within the United States.

(b) *Rules concerning obligations in bearer form*—(1) *In general.* Interest (including original issue discount) with respect to an obligation in bearer form is portfolio interest within the meaning of section 871(h)(2)(A) or 881(c)(2)(A) only if it is paid with respect to an obligation issued after July 18, 1984, that is described in section 163(f)(2)(B) and the regulations under that section and an exception under section 871(h) or 881(c) does not apply. Any obligation that is not in registered form as defined in paragraph (c)(1)(i) of this section is an obligation in bearer form.

(2) *Coordination with withholding and reporting rules.* For an exemption from withholding under section 1441 with respect to obligations described in this paragraph (b), see §1.1441–1(b)(4)(i). For rules relating to an exemption from Form 1099 reporting and backup withholding under section 3406, see section 6049 and §1.6049–5(b)(8) for the payment of interest and §1.6045–1(g)(1)(ii) for the redemption, retirement, or sale of an obligation in bearer form.

(c) *Rules concerning obligations in registered form*—(1) *In general*—(i) *Obligation in registered form.* For purposes of this section, an obligation is in registered form only as provided in this paragraph (c)(1)(i). The conditions for an obligation to be considered in registered form are identical to the conditions described in §5f.103–1 of this chapter. Therefore, an obligation that would be an obligation in registered form except for the fact that it can be converted at any time in the future into an obligation that is not in registered form shall not be an obligation in registered form. An obligation that is not in registered form by reason of the preceding sentence may nevertheless be in registered form, but only after the possibility of conversion is terminated. An obligation that is not in registered form and can be converted into an obligation that would meet the requirements of this paragraph (c)(1)(i) for being in registered form shall be considered in registered form only after the conversion is effected. For purposes of this section, an obligation is convertible if the obligation can be transferred by any means not described in §5f.103–1(c) of this chapter. An obligation is treated as an obligation in registered form if—

(A) The obligation is registered as to both principal and any stated interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument, and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder;

(B) The right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system maintained by the issuer (or its agent) described in this paragraph (c)(1)(i)(B). An obligation shall be considered transferable through a book entry system if the ownership of an interest in the obligation, is required to be reflected in a book entry, whether or not physical securities are issued. A book entry is a record of ownership that identifies the owner of an in interest in the obligation; or

(C) It is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred by way of either of the methods described in paragraph (c)(1)(i) (A) or (B) of this section.

(ii) *Requirements for portfolio interest qualification in the case of an obligation in registered form.* Interest (including original issue discount) received on an obligation that is in registered form qualifies as portfolio interest only if—

(A) The interest is paid on an obligation issued after July 18, 1984;

(B) The interest would be subject to tax under section 871(a)(1)(A), 871(a)(1)(C), 881(a)(1) or 881(a)(3) but for section 871(h) or 881(c);

(C) A United States (U.S.) person otherwise required to deduct and withhold tax under chapter 3 of the Internal Revenue Code (Code) receives a statement that meets the requirements of section 871(h)(5) that the beneficial owner of the obligation is not a U.S. person; and

(D) An exception under section 871(h) or 881(c) does not apply.

(2) *Required statement.* For purposes of paragraph (c)(1)(ii)(C) of this section, a U.S. person will be considered to have received a statement that meets the requirements of section 871(h)(5) if either it complies with one of the procedures described in this paragraph (c)(2) and does not have actual knowledge or reason to know that the beneficial owner is a U.S. person or it complies with the procedures described in paragraph (d) or (e) of this section.

(i) The U.S. person (or its authorized foreign agent described in §1.1441–

7(c)(2)) can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii). See §1.1441–1(b)(2)(vii) for rules regarding reliable association with documentation.

(ii) The U.S. person (or its authorized foreign agent described in §1.1441–7(c)(2)) can reliably associate the payment with a withholding certificate described in §1.1441–5(c)(2)(iv) from a person claiming to be withholding foreign partnership and the foreign partnership can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii).

(iii) The U.S. person (or its authorized foreign agent described in §1.1441–7(c)(2)) can reliably associate the payment with a withholding certificate described in §1.1441–1(e)(3)(ii) from a person representing to be a qualified intermediary that has assumed primary withholding responsibility in accordance with §1.1441–1(e)(5)(iv) and the qualified intermediary can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a foreign beneficial owner in accordance with its agreement with the Internal Revenue Service (IRS).

(iv) The U.S. person (or its authorized foreign agent described in §1.1441–7(c)(2)) can reliably associate the payment with a withholding certificate described in §1.1441–1(e)(3)(v) from a person claiming to be a U.S. branch of a foreign bank or of a foreign insurance company that is described in §1.1441–1(b)(2)(iv)(A) or a U.S. branch designated in accordance with §1.1441–1(b)(2)(iv)(E) and the U.S. branch can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii).

(v) The U.S. person receives a statement from a securities clearing organization, a bank, or another financial institution that holds customers' securities in the ordinary course of its trade or business. In such case the statement must be signed under penalties of perjury by an authorized representative of the financial institution and must state that the institution has received from the beneficial owner a withholding certificate described in §1.1441–1(e)(2)(i) (a Form W–8 or an acceptable substitute form as defined §1.1441–1(e)(4)(vi)) or that it has received from another financial institution a similar statement that it, or another financial institution acting on behalf of the beneficial owner, has received the Form W–8 from the beneficial owner. In the case of multiple financial institutions between the beneficial owner and the U.S. person, this statement must be given by each financial institution to the one above it in the chain. No particular form is required for the statement provided by the financial institutions. However, the statement must provide the name and address of the beneficial owner, and a copy of the Form W–8 provided by the beneficial owner must be attached. The statement is subject to the same rules described in §1.1441–1(e)(4) that apply to intermediary Forms W–8 described in §1.1441–1(e)(3)(iii). If the information on the Form W–8 changes, the beneficial owner must so notify the financial institution acting on its behalf within 30 days of such changes, and the financial institution must promptly so inform the U.S. person. This notice also must be given if the financial institution has actual knowledge that the information has changed but has not been so informed by the beneficial owner. In the case of multiple financial institutions between the beneficial owner and the U.S. person, this notice must be given by each financial institution to the institution above it in the chain.

(vi) The U.S. person complies with procedures that the U.S. competent authority may agree to with the competent authority of a country with which the United States has an income tax treaty in effect.

(3) *Time for providing certificate or documentary evidence*—(i) *General rule.* Interest on a registered obligation shall qualify as portfolio interest if the withholding certificate or documentary evidence that must be provided is furnished before expiration of the beneficial owner's period of limitation for claiming a refund of tax with respect

to such interest. See, however, § 1.1441–1(b)(7) for consequences to a withholding agent that makes a payment without withholding even though it cannot reliably associate the payment with the documentation prior to the payment. If a withholding agent withholds an amount under chapter 3 of the Code because it cannot reliably associate the payment with the documentation for the beneficial owner on the date of payment, the beneficial owner may nevertheless claim the benefit of an exemption from tax under this section by claiming a refund or credit for the amount withheld based upon the procedures described in §§ 1.1464–1 and 301.6402–3(e) of this chapter. For this purpose, the taxpayer must attach a withholding certificate described in § 1.1441–1(e)(2)(i) to the income tax filed for claiming a refund of tax. In the alternative, adjustments to any amount of overwithheld tax may be made under the procedures described in § 1.1461–2(a) (for example, if the beneficial owner furnishes documentation to the withholding agent before the due date for filing the return required under § 1.1461–1(b) with respect to that payment).

(ii) *Example.* The following example illustrates the rules of this paragraph (c)(3) and their coordination with § 1.1441–1(b)(7):

Example. A is a withholding agent who, on October 12, 2000, pays interest on a registered obligation to B, a foreign corporation. B is a calendar year taxpayer, engaged in the conduct of a trade or business in the United States, and is, therefore, required to file an annual income tax return on Form 1120F. The interest, however, is not effectively connected with B's U.S. trade or business. On the date of payment, B has not furnished, and A cannot associate the payment with documentation for B. However, A does not withhold under section 1442, even though, under § 1.1441–1(b)(3)(iii)(A), A should presume that B is a foreign person, because A's communications with B are mailed to an address in a foreign country. Assuming that B files a return for its taxable year ending December 31, 2000, and that its statute of limitations period with regard to that year expires on June 15, 2004, the interest paid on October 12, 2000, may qualify as portfolio interest only if B provides appropriate documentation to A on or before June 15, 2004. If B does not provide the documentation on or before June 15, 2004, and does not pay the tax, A is liable for the tax under section 1463, even if B provides the documentation to A after June 15, 2004. Therefore, the provisions in § 1.1441–1(b)(7), regarding late-received documentation would not help A avoid liability for tax under section 1463 even if the documentation is furnished within the statute of limitations period of A. This is because, in a case involving interest, the documentation received within the limitations period of the beneficial owner serves as a condition for the interest to qualify as portfolio interest. When documentation is received after the expiration of the beneficial owner's limitations period, the interest can no longer qualify as portfolio interest. On the other hand, A could rely on documentation that it receives after the expiration of B's limitations period to establish B's right to a reduced rate of withholding under an applicable income tax treaty (since, in such a case, a claim of treaty benefits is not conditioned upon providing documentation prior to the expiration of the beneficial owner's limitations period).

(4) *Coordination with withholding and reporting rules.* For an exemption from withholding under section 1441 with respect to obligations described in this paragraph (c), see § 1.1441–1(b)(4)(i). For rules applicable to withholding certificates, see § 1.1441–1(e)(4). For rules regarding documentary evidence, see § 1.6049–5(c)(1). For application of presumptions when the U.S. person cannot reliably associate the payment with documentation, see § 1.1441–1(b)(3). For standards of knowledge applicable to withholding agents, see § 1.1441–7(b). For rules relating to an exemption from Form 1099 reporting and backup withholding under section 3406, see section 6049 and § 1.6049–5(b)(8) for the payment of interest and § 1.6045–1(g)(1)(i) for the redemption, retirement, or sale of an obligation in registered form. For rules relating to reporting on Forms 1042 and 1042–S, see § 1.1461–1 (b) and (c).

(d) *Application of repeal of 30-percent withholding to pass-through certificates*—(1) *In general.* Interest received on a pass-through certificate qualifies as portfolio interest under section 871(h)(2) or 881(c)(2) if the interest satisfies the conditions described in paragraph (b)(1), (c)(1), or (e) of this section without regard to whether any obligation held by the fund or trust to which the pass-through certificate relates is described in paragraph (b)(1), (c)(1)(ii), or (e) of this section. This paragraph (d)(1) applies only to payments made to the holder of the pass-through certificate from the trustee of the pass-through trust and does not apply to payments made to the trustee of the pass-through trust. For example, a mortgage pass-through certificate in bearer form must meet the requirements set forth in paragraph (b)(1) of this section, but the obligations held by the fund or trust to which the mortgage pass-through certificate relates need not meet the requirements set forth in paragraph (b)(1), (c)(1)(ii), or (e) of this section. However, for purposes of paragraphs (b)(1), (c)(1)(ii), and (e) of this section and section 127 of the Tax Reform Act of 1984, a pass-through certificate will be considered as issued after July 18, 1984, only to the extent that the obligations held by the fund or trust to which the pass-through certificate relates are issued after July 18, 1984.

(2) *Interest in REMICs.* Interest received on a regular or residual interest in a REMIC qualifies as portfolio interest under section 871(h)(2) or 881(c)(2) if the interest satisfies the conditions described in paragraph (b)(1), (c)(1)(ii), or (e) of this section. For purposes of paragraph (b)(1), (c)(1)(ii), or (e) of this section, interest on a regular interest in a REMIC is not considered interest on any mortgage obligations held by the REMIC. The foregoing rule, however, applies only to payments made to the holder of the regular interest from the REMIC and does not apply to payments made to the REMIC. For purposes of paragraph (b)(1), (c)(1)(ii), or (e) of this section, interest on a residual interest in a REMIC is considered to be interest on or with respect to the obligations held by the REMIC, and not on or with respect to the residual interest. For purposes of paragraphs (b)(1), (c)(1)(ii), and (e) of this section and section 127 of the Tax Reform Act of 1984, a residual interest in a REMIC will be considered as issued after July 18, 1984, only to the extent that the obligations held by the REMIC are issued after July 18, 1984, but a regular interest in a REMIC will be considered as issued after July 18, 1984, if the regular interest was issued after July 18, 1984, without regard to the date on which the mortgage obligations held by the REMIC were issued.

(3) *Date of issuance.* In general, a mortgage pass-through certificate will be considered to have been issued after July 18, 1984, if all of the mortgages held by the fund or trust were issued after July 18, 1984. If some of the mortgages held by the fund or trust were issued before July 19, 1984, then the portion of any interest payment which represents interest on those mortgages shall not be considered to be portfolio interest. The preceding sentence shall not apply, however, if all of the following conditions are satisfied:

(i) The mortgage pass-through certificate is issued after December 31, 1986;

(ii) Payment of the mortgage pass-through certificate is guaranteed by, and a guarantee commitment has been issued by, an entity that is independent from the issuer of the underlying obligation;

(iii) The guarantee commitment with respect to the mortgage pass-through certificate cannot have been issued more than 14 months prior to the date on which the mortgage pass-through certificate is issued; and

(iv) The fund or trust to which the mortgage pass-through certificate relates cannot contain mortgage obligations on which the first scheduled monthly payment of principal and interest was made more than twelve months before the date on which the guarantee commitment was made.

(e) *Foreign-targeted registered obligations*—(1) *General rule.* The statement described in paragraph (c)(1)(ii)(C) of this section is not required with respect to interest paid on a registered obligation that is targeted to foreign markets in accordance with the provisions of paragraph (e)(2) of this section if the interest is paid by a U.S. person, a withholding foreign partnership, or a U.S. branch described in §1.1441–1(b)(2)(iv) (A) or (E) to a registered owner at an address outside the United States, provided that the registered owner is a financial institution described in section 871(h)(5)(B). In that case, the U.S. person otherwise required to deduct and withhold tax may treat the interest as portfolio interest if it does not have actual knowledge that the beneficial owner is a United

States person and if it receives the certificate described in paragraph (e)(3)(i) of this section from a financial institution or member of a clearing organization, which member is the beneficial owner of the obligation, or the documentary evidence or statement described in paragraph (e)(3)(ii) of this section from the beneficial owner, in accordance with the procedures described in paragraph (e)(4) of this section.

(2) *Definition of a foreign-targeted registered obligation.* An obligation is considered to be targeted to foreign markets for purposes of paragraph (e)(1) of this section if it is sold (or resold in connection with its original issuance) only to foreign persons (or to foreign branches of United States financial institutions described in section 871(h)(5)(B)) in accordance with procedures similar to those prescribed in §1.163–5(c)(2)(i) (A), (B), or (D). However, the provisions of that section that require an obligation to be offered for sale or resale in connection with its original issuance only outside the United States do not apply with respect to registered obligations offered for sale through a public auction. Similarly, the provisions of that section that require delivery to be made outside the United States do not apply to registered obligations offered for sale through a public auction if the obligations are considered to be in registered form by virtue of the fact that they may be transferred only through a book entry system. The obligation, if evidenced by a physical document other than a confirmation receipt, must contain on its face a legend indicating that it has been sold (or resold in connection with its original issuance) in accordance with those procedures.

(3) *Documentation.* A certificate described in paragraph (e)(3)(i) of this section is required if the United States person otherwise required to deduct and withhold tax (the withholding agent) pays interest to a financial institution described in section 871(h)(5)(B) or to a member of a clearing organization, which member is the beneficial owner of the obligation. The documentation described in paragraph (e)(3)(ii) of this section is required if a withholding agent pays interest to a beneficial owner that is neither a financial institution described in section 871(h)(5)(B) nor a member of a clearing organization.

(i) *Interest paid to a financial institution or a member of a clearing organization*—(A) *Requirement of a certificate*—(*1*) If the withholding agent pays interest to a financial institution described in section 871(h)(5)(B) or to a member of a clearing organization, which member is the beneficial owner of the obligation, the withholding agent must receive a certificate which states that, beginning at the time the last preceding certificate under this paragraph (e)(3)(i) was provided and while the financial institution or clearing organization member has held the obligation, with respect to each foreign-targeted registered obligation which has been held by the person providing the certificate at any time since the provision of such last preceding certificate, either—

(*i*) The beneficial owner of the obligation has not been a United States person on each interest payment date; or

(*ii*) If the person providing the certificate is a financial institution which is holding or has held an obligation on behalf of the beneficial owner, the beneficial owner of the obligation has been a United States person on one or more interest payment dates (identifying such date or dates), and the person making the certification has forwarded or will forward the appropriate United States beneficial ownership notification to the withholding agent in accordance with the provisions of paragraph (e)(4) of this section.

(*2*) The person providing the certificate need not state the foregoing where no previous certificate has been required to be provided by the payee to the withholding agent under this paragraph (e)(3)(i).

(B) *Additional representations.* Whether or not a previous certificate has been required to be provided with respect to the obligation, each certificate furnished pursuant to the provisions in this paragraph (e)(3)(i) must further state that, for each foreign-targeted registered obligation held and every other such obligation to be acquired and held by the person providing the certificate during the period beginning on the date of the certificate and ending on the date the next certificate is required to be provided, the beneficial owner of the obligation will not be a United States person on each interest payment date while the financial institution or clearing organization member holds the obligation and that, if the person providing the certificate is a financial institution which is holding or will be holding the obligation on behalf of a beneficial owner, such person will provide a United States beneficial ownership notification to the withholding agent (and a clearing organization that is not a withholding agent where a member organization is required by this paragraph (e)(3) to furnish the clearing organization with a statement) in accordance with paragraph (e)(4) of this section in the event such certificate (or statement in the case of a statement provided by a member organization to a clearing organization that is not a withholding agent) is or becomes untrue with respect to any obligation. A clearing organization is an entity which is in the business of holding obligations for member organizations and transferring obligations among such members by credit or debit to the account of a member without the necessity of physical delivery of the obligation.

(C) *Obligation must be identified.* The certificate described in paragraph (e)(3)(ii)(A) of this section must identify the obligation or obligations with respect to which it is given, except where the certification is given with respect to an obligation that has not been acquired at the time the certification is made. An obligation is identified if it or the larger issuance of which it is a part is described on a list (e.g., $5 million principal amount of 12% debentures of ABC Savings and Loan Association due February 25, 1995, $3 million principal amount of 10% U.S. Treasury notes due May 28, 1990) of all registered obligations targeted to foreign markets held by or on behalf of the person providing the certificate and the list is attached to, and incorporated by reference into, the certificate. The certificate must identify and provide the address of the person furnishing the certificate.

(D) *Payment to a depository of a clearing organization.* If the withholding agent pays interest to a depository of a clearing organization, then the clearing organization must provide the certificate described in this paragraph (e)(3)(i) to the withholding agent. Any certificate that is provided by a clearing organization must state that the clearing organization has received a statement from each member which complies with the provisions of this paragraph (e)(3)(i) and of paragraph (e)(4) of this section (as if the clearing organization were the withholding agent and regardless of whether the member is a financial institution described in section 871(h)(5)(B)).

(E) *Statement in lieu of Form W–8.* Subject to the requirements set out in paragraph (e)(4) of this section, a certificate or statement in the form described in this paragraph (e)(3)(i), in conjunction with the next annual certificate or statement, will serve as the certificate that may be provided in lieu of a Form W–8 with respect to interest on all foreign-targeted registered obligations held by the person making the certification or statement and which is paid to such person within the period beginning on the date of the certificate and ending on the date the next certificate is required to be provided.

(F) *Electronic transmission.* The certificate described in this paragraph (e)(3)(i) may be provided electronically under the terms and conditions of §1.163–5(c)(2)(i)(D)(*3*)(*ii*).

(ii) *Payment to a person other than a financial institution or member of a clearing organization.* If the withholding agent pays interest to the beneficial owner of an obligation that is neither a financial institution described in section 871(h)(5)(B) nor a member of a clearing organization, then such owner must provide the withholding agent a statement described in paragraph (c)(1)(ii)(C) of this section.

(4) *Applicable procedures regarding documentation*—(i) *Procedures applicable to certificates required under paragraph (e)(3)(i) of this section*—(A) *Time for providing certificate.* Where no previous certificate for foreign-targeted registered obligations has been provided to the withholding agent by the person

providing the certificate under paragraph (e)(3)(i) of this section, such certificate must be provided within the period beginning 90 days prior to the first interest payment date on which the person holds a foreign-targeted registered obligation. The withholding agent may, in its discretion, withhold under section 1441(a), 1442(a), or 1443 if the certificate is not received by the date 30 days prior to the interest payment. Thereafter the certificate must be filed within the period beginning on January 15 and ending January 31 of each year. If a certificate provided pursuant to the first sentence of this paragraph (e)(4)(i)(A) is provided during the period beginning on January 15 and ending on January 31 of any year, then no other certificate need be provided during such period in such year.

(B) *Change of status notification on Form W–9.* If, on any interest payment date after the obligation was acquired by the person making the certification, the beneficial owner of the obligation is a U.S. person, then the person to whom the withholding agent pays interest must furnish the withholding agent with a U.S. beneficial ownership notification within 30 days after such interest payment date. A U.S. beneficial ownership notification must include a statement that the beneficial owner of the obligation has been a U.S. person on an interest payment date (identifying such date), that such owner has provided to the person providing the notification a Form W–9 (or a substitute form that is substantially similar to Form W–9 and completed under penalties of perjury), and that the person providing the notification has been and will be complying with the information reporting requirements of section 6049, if applicable.

(C) *Alternative notification statement.* Where the person providing the notification described in paragraph (e)(4)(i)(B) of this section is neither a controlled foreign corporation within the meaning of section 957(a), nor a foreign corporation 50-percent or more of the gross income of which from all sources for the three-year period ending with the close of the taxable year preceding the date of the statement was effectively connected with the conduct of trade or business in the United States, such person must attach to the notification a copy of the Form W–9 (or substitute form that is substantially similar to Form W–9 and completed under penalties of perjury) provided by the beneficial owner. When a person that provides the U.S. beneficial ownership notification does not attach to it a copy of such Form W–9 (or substitute form that is substantially similar to Form W–9 and completed under penalties of perjury), such person must state that it is either a controlled foreign corporation within the meaning of section 957(a), or a foreign corporation 50-percent or more of the gross income of which from all sources for the three-year period ending with the close of its taxable year preceding the date of the statement was effectively connected with the conduct of a trade or business in the United States. A withholding agent that receives a Form W–9 (or a substitute form that is substantially similar to Form W–9 and completed under penalties of perjury) must send a copy of such form to the IRS, at such address as the IRS shall indicate, within 30 days after receiving it and must attach a statement that the Form W–9 or substitute form was provided pursuant to this paragraph (e)(4) with respect to a U.S. person that has owned a foreign-targeted registered obligation on one or more interest payment dates.

(D) *Failure to provide notification.* If either a Form W–9 (or a substitute form that is substantially similar to a Form W–9 and completed under penalties of perjury) or the statement described in paragraph (e)(4)(i)(C) of this section is not attached to the U.S. beneficial ownership notification provided pursuant to paragraph (e)(4)(i)(B) of this section, the withholding agent is required to withhold under section 1441, 1442, or 1443 on a payment of interest made after the withholding agent has received the notification unless such form or statement (or a statement that the beneficial owner of the obligation is no longer a U.S. person) is received before the interest payment date from the person who provided the notification (or transferee). If, during the period beginning on the next January 15 and ending on the next January 31, such person certifies as set out in paragraph (e)(3)(i) of this section (subject to paragraph (e)(3)(i)(A)(*2*) of this section) then the withholding agent is not required to withhold during the year following such certification (unless such person again provides a U.S. beneficial ownership notification without attaching a Form W–9 or substitute form that is substantially similar to Form W–9 and completed under penalties of perjury or the statement described in paragraph (e)(4)(i)(C) of this section).

(E) *Procedures for clearing organizations.* Within the period beginning 10 days before the end of the calendar quarter and ending on the last day of each calendar quarter, any clearing organization (including a clearing organization that is a withholding agent) relying on annual certificates or statements from its member organizations, as set forth in paragraph (e)(3)(i) of this section, must send each member organization having submitted such certificate or statement a reminder that the member organization must give the clearing organization a U.S. beneficial ownership notification in the circumstances described in paragraph (e)(4)(i)(B) of this section.

(F) *Retention of certificates.* The certificate described in paragraph (e)(3)(i) of this section must be retained in the records of the withholding agent for four years from the end of the calendar year in which it was received. The statement described in paragraph (e)(3)(i) of this section that is received by a clearing organization from a member organization must be retained in the records of the clearing organization for four years from the end of the calendar year in which it was received.

(G) *No reporting requirement.* The withholding agent who receives the certificate described in paragraph (e)(3)(i) of this section is not required to file Form 1042S to report payments under §1.1461–1 (b) or (c) of interest that are made with respect to foreign-targeted registered obligations held by the person providing the certificate and are made within the period beginning with the certificate date and ending on the last date for filing the next certificate.

(ii) *Procedures regarding certificates required under paragraph (e)(3)(ii) of this section*—(A) *Time for providing certificate.* The statement described in paragraph (e)(3)(ii) of this section must be provided to the withholding agent within the period beginning 90 days prior to and ending on the first interest payment date on which the withholding agent pays interest to the beneficial owner. The withholding agent may, in its discretion, withhold under section 1441(a), 1442(a), or 1443 if the statement is not received by the date 30 days prior to the interest payment. The beneficial owner must confirm to the withholding agent the continuing validity of the documentary evidence within the period beginning 90 days prior to the first day of the third calendar year following the provision of such evidence and during the same period every three years thereafter while the owner still owns the obligation. The withholding agent who receives the statement described in paragraph (e)(3)(ii) of this section is not required to report payments of interest under §1.1461–1(b) or (c) if the payments are made with respect to foreign-targeted registered obligations held by the person who provides the statement and are made within the period beginning with the date on which the statement is provided and ending on the last date for confirming the validity of the statement. The statement received for purposes of paragraph (e)(3)(ii) of this section is subject to the applicable procedures set forth in §1.1441–1(e)(4).

(B) *Change of status notification on Form W–9.* If on any interest payment date after the obligation was acquired by the person providing the statement described in paragraph (e)(3)(ii) of this section, the beneficial owner of the obligation is a U.S. person, then the beneficial owner must so inform the withholding agent within 30 days after such interest payment date and must provide a Form W–9 (or substitute form that is substantially similar completed under penalties of perjury) to the withholding agent. However, the beneficial owner is not required to provide another Form W–9 (or substitute form that is substantially similar and completed under penalties of perjury) if such person has already provided it to the withholding agent within the same calendar year.

(iii) *Disqualification of documentation.* In accordance with the provisions of section 871(h)(4), the Secretary may make a determination in appropriate cases that a certificate or statement by any person, or class of persons, does not satisfy the requirements of that section. Should that determination be made, all payments of interest that otherwise qualify as portfolio interest to that person would become subject to 30-percent withholding under section 1441(a), 1442(a), or 1443.

(iv) *Special effective date.* Notwithstanding the foregoing requirements of this section—

(A) Any certificate that is required to be filed with the withholding agent during the period beginning on January 15 and ending on January 31, 1986, is not required to state that the beneficial owner of an obligation, prior to the date of the certificate, either was not a United States person or was a United States person if the obligation was acquired by the person providing the certificate on or before September 19, 1985; and

(B) All of the requirements of this paragraph (e), as in effect prior to the effective date of these amendments, shall remain effective with respect to each interest payment prior to the filing of the certificate described in paragraph (e)(4)(iv)(A) of this section, except that the provisions of paragraph (e)(3) of this section relating to which persons are required to receive certificates or statements and paragraph (e)(3)(ii) or (4)(ii) of this section shall become effective with respect to each interest payment after September 20, 1985.

(5) *Information reporting.* See § 1.6049–5(b)(7) for special information reporting rules applicable to interest on foreign-targeted registered obligations. See § 1.6045–1(g)(1)(ii) for information reporting rules applicable to the redemption, retirement, or sale of foreign-targeted registered obligations.

(f) *Securities lending transactions.* For applicable rules regarding substitute interest payments received pursuant to a securities lending transaction or a sale-repurchase transaction, see §§ 1.871–7(b)(2) and 1.881–2(b)(2).

(g) *Definitions.* For purposes of this section, the terms *U.S. person* and *foreign person* have the meaning set forth in § 1.1441–1(c)(2), the term *beneficial owner* has the meaning set forth in § 1.1441–1(c)(6), the term *withholding agent* has the meaning set forth in § 1.1441–7(a); the term *payee* has the meaning set forth in § 1.1441–1(b)(2); and the term *payment* has the meaning set forth in § 1.1441–2(e).

(h) *Effective date*—(1) *In general.* This section shall apply to payments of interest made after December 31, 1999.

(2) *Transition rule.* For purposes of this section, the validity of a Form W–8 that was valid on January 1, 1998, under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) and expired, or will expire, at any time during 1998, is extended until December 31, 1998. The validity of a Form W–8 that is valid on or after January 1, 1999, remains valid until its validity expires under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) or, if earlier, until December 31, 2000. The rule in this paragraph (h)(2), however, does not apply to extend the validity period of a Form W–8 that expires solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the first three sentences of this paragraph (h)(2), a withholding agent or payor may choose to not take advantage of the transition rule in this paragraph (h)(2) with respect to one or more withholding certificates valid under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) and, therefore, may choose to obtain withholding certificates conforming to the requirements described in this section (new withholding certificates). For purposes of this section, a new withholding certificate is deemed to satisfy the documentation requirement under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998). Further, a new withholding certificate remains valid for the period specified in § 1.1441–1(e)(4)(ii), regardless of when the certificate is obtained.

[T.D. 8734, 62 FR 53416, Oct. 14, 1997, as amended by T.D. 8804, 63 FR 72184, 72187, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53416, Oct. 14, 1997, §1.871–14 was added, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effective date was delayed to Jan. 1, 2000.

§1.872–1 Gross income of nonresident alien individuals.

(a) *In general*—(1) *Inclusions.* The gross income of a nonresident alien individual for any taxable year includes only (i) the gross income which is derived from sources within the United States and which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual and (ii) the gross income, irrespective of whether such income is derived from sources within or without the United States, which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual. For the determination of the sources of income, see sections 861 through 863 and the regulations thereunder. For the determination of whether income from sources within or without the United States is effectively connected for the taxable year with the conduct of a trade or business in the United States, see sections 864(c) and 871 (c) and (d), §§1.864–3 through 1.864–7, and §§1.871–9 and 1.871–10. For special rules for determining the income of an alien individual who changes his residence during the taxable year, see §1.871–13.

(2) *Exchange transactions.* Even though a nonresident alien individual who effects certain transactions in the United States in stocks, securities, or commodities during the taxable year may not, by reason of section 864(b)(2) and paragraph (c) or (d) of §1.864–2, be engaged in trade or business in the United States during the taxable year through the effecting of such transactions, nevertheless he shall be required to include in gross income for the taxable year the gains and profits from those transactions to the extent required by §1.871–7 or §1.871–8.

(3) *Exclusions.* For exclusions from gross income, see §1.872–2.

(b) *Individuals not engaged in U.S. business.* In the case of a nonresident alien individual who at no time during the taxable year is engaged in trade or business in the United States, the gross income shall include only (1) the gross income from sources within the United States which is described in section 871(a) and paragraphs (b), (c), and (d) of §1.871–7, and (2) the gross income from sources within the United States which, by reason of section 871 (c) or (d) and §1.871–9 or §1.871–10, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual.

(c) *Individuals engaged in U.S. business.* In the case of a nonresident alien individual who is engaged in trade or business in the United States at any time during the taxable year, the gross income shall include (1) the gross income from sources within and without the United States which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, (2) the gross income from sources within the United States which, by reason of the election provided in section 871(d) and §1.871–10, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, and (3) the gross income from sources within the United States which is described in section 871(a) and paragraphs (b), (c), and (d) of §1.871–7 and is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual.

(d) *Special rules applicable to certain expatriates.* For special rules for determining the gross income of a nonresident alien individual who has lost U.S. citizenship with a principal purpose of avoiding certain taxes, see section 877(b)(1).

(e) *Alien resident of Puerto Rico.* This section shall not apply in the case of a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year. See section 876 and §1.876–1.

(f) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.872–1 (Revised as of January 1, 1971).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7332, 39 FR 44228, Dec. 23, 1974]

§1.872–2 Exclusions from gross income of nonresident alien individuals.

(a) *Earnings of foreign ships or aircraft*—(1) *Basic rule.* So much of the income from sources within the United States of a nonresident alien individual as consists of earnings derived from the operation of a ship or ships documented, or of aircraft registered, under the laws of a foreign country which grants an equivalent exemption to citizens of the United States nonresident in that foreign country and to corporations organized in the United States shall not be included in gross income.

(2) *Equivalent exemption*—(i) *Ships.* A foreign country which either imposes no income tax, or, in imposing an income tax, exempts from taxation so much of the income of a citizen of the U.S. nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of a foreign ship or ships.

(ii) *Aircraft.* A foreign country which either imposes no income tax, or, in imposing an income tax, exempts from taxation so much of the income of a citizen of the U.S. nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of aircraft registered under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of foreign aircraft.

(3) *Definition of earnings.* For purposes of subparagraphs (1) and (2) of this paragraph, compensation for personal services performed by an individual aboard a ship or aircraft does not constitute earnings derived by such individual from the operation of ships or aircraft.

(b) *Compensation paid by foreign employer to participants in certain exchange or training programs*—(1) *Exclusion from income.* Compensation paid to a nonresident alien individual for the period that the nonresident alien individual is temporarily present in the United States as a nonimmigrant under subparagraph (F) (relating to the admission of students into the United States) or subparagraph (J) (relating to the admission of teachers, trainees, specialists, etc., into the United States) of section 101(a)(15) of the Immigration and Nationality Act (8 U.S.C. 1101(a)(15) (F) or (J)) shall be excluded from gross income if the compensation is paid to such alien by his foreign employer. Compensation paid to a nonresident alien individual by the U.S. office of a domestic bank which is acting as paymaster on behalf of a foreign employer constitutes compensation paid by a foreign employer for purposes of this paragraph if the domestic bank is reimbursed by the foreign employer for such payment. A nonresident alien individual who is temporarily present in the United States as a nonimmigrant under such subparagraph (J) includes a nonresident alien individual admitted to the United States as an ‘‘exchange visitor’’ under section 201 of the U.S. Information and Educational Exchange Act of 1948 (22 U.S.C. 1446), which section was repealed by section 111 of the Mutual Education and Cultural Exchange Act of 1961 (75 Stat. 538).

(2) *Definition of foreign employer.* For purposes of this paragraph, the term ‘‘foreign employer’’ means a nonresident alien individual, a foreign partnership, a foreign corporation, or an office or place of business maintained in a foreign country or in a possession of the United States by a domestic corporation, a domestic partnership, or an individual who is a citizen or resident of the United States. The term does not include a foreign government. However, see section 893 and §1.893–1. Thus, if a French citizen employed in the Paris branch of a banking company incorporated in the State of New York were admitted to the United States under section 101(a)(15)(J) of the Immigration and Nationality Act to study monetary theory and continued to receive a salary from such foreign branch while studying in the United States, such salary would not be includable in his gross income.

(c) *Tax convention.* Income of any kind which is exempt from tax under the provisions of a tax convention or treaty to which the United States is a party shall not be included in the gross income of a nonresident alien individual. Income on which the tax is limited by tax convention shall be included in the gross income of a nonresident alien individual if it is not otherwise excluded from gross income. See §§1.871–12 and 1.894–1.

(d) *Certain bond income of residents of the Ryukyu Islands or the Trust Territory of the Pacific Islands.* Income derived by a nonresident alien individual from a series E or series H U.S. savings bond shall not be included in gross income if such individual acquired the bond while he was a resident of the Ryukyu Islands or the Trust Territory of the Pacific Islands. It is not necessary that the individual continue to be a resident of such Islands or Trust Territory for the period when, without regard to section 872(b)(4) and this paragraph, the income from the bond would otherwise be includible in his gross income under the provisions of section 446 or 454.

(e) *Certain annuities received under qualified plans.* Pursuant to section 871(f), income received by a nonresident alien individual as an annuity under a qualified annuity plan described in section 403(a)(1) (relating to taxation of employee annuities), or from a qualified trust described in section 401(a) (relating to qualified pension, profit-sharing, and stock bonus plans) which is exempt from tax under section 501(a) (relating to exemption from tax on corporations, certain trusts, etc.), shall not be included in gross income, and shall be exempt from tax, for purposes of section 871 and §§1.871–7 and 1.871–8, if—

(1) All of the personal services by reason of which the annuity is payable were either—

(i) Personal services performed outside the United States by an individual (whether or not the annuitant) who, at the time of performance of the services, was a nonresident alien individual, or

(ii) Personal services performed in the United States by a nonresident alien individual (whether or not the annuitant) which, by reason of section 864(b)(1) (or corresponding provision of any prior law), were not personal services causing such individual to be engaged in trade or business in the United States during the taxable year, and

(2) At the time the first amount is paid (even though paid in a taxable year beginning before January 1, 1967) as such annuity under such annuity plan, or by such trust, to (i) the individual described in subparagraph (1) of this paragraph, or (ii) his nonresident alien beneficiary if such beneficiary is entitled to receive such first amount, 90 percent or more of the employees or annuitants for whom contributions or benefits are provided under the annuity plan, or under the plan or plans of which the trust is a part, are citizens or residents of the United States.

This paragraph shall apply whether or not the taxpayer is engaged in trade or business in the United States at any time during the taxable year in which the annuity is received. This paragraph shall not apply to distributions by an employees' trust or from an annuity plan which give rise to gains described in section 402(a)(2) or 403(a)(2), whichever applies. See section 871(a)(1)(B) and paragraph (c)(1)(i) of §1.871–7. For exemption from withholding of tax at source on an annuity which is exempt from tax under section 871(f) and this paragraph, see paragraph (g) of §1.1441–4.

(f) *Other exclusions.* Income which is from sources without the United States, as determined under the provisions of sections 861 through 863, and the regulations thereunder, is not included in the gross income of a nonresident alien individual unless such income is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual. To determine specific exclusions in the case of other items which are from sources within the United States, see the applicable sections of the Code. For special rules under a tax convention for determining the sources of income and for excluding, from gross income, income from sources without the United States which is effectively connected with the conduct of a trade or business in the United States, see the applicable tax convention. For determining which income from sources without the United States is effectively connected with the conduct of a trade or business in the United States, see section 864(c)(4) and § 1.864–5.

(g) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 4, 1967 see 26 CFR 1.872–2 (Revised as of January 1, 1971).

[T.D. 7332, 39 FR 44228, Dec. 23, 1974]

§ 1.873–1 Deductions allowed nonresident alien individuals.

(a) *General provisions*—(1) *Allocation of deductions.* In computing the taxable income of a nonresident alien individual the deductions otherwise allowable shall be allowed only if, and to the extent that, they are connected with income from sources within the United States. No deduction shall be allowed in respect of any item, or portion thereof, which is not connected with income from such sources. For this purpose, the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, except as may otherwise be provided by tax convention. Thus, from the items of gross income specifically from sources within the United States and from the items allocated thereto under the provisions of section 863(a), there shall be deducted (i) the expenses, losses, and other deductions which are connected with those items of income and are properly apportioned or allocated thereto, and (ii) a ratable part of any other expenses, losses, or deductions which are connected with those items of income but cannot definitely be allocated to some item or class of gross income. The ratable part shall be based upon the ratio of gross income from sources within the United States to the total gross income. See §§ 1.861–8 and 1.863–1. In the case of income partly from within and partly from without the United States the expenses, losses, and other deductions connected with income from sources within the United States shall also be deducted in the manner prescribed by §§ 1.863–2 through 1.863–5 in order to ascertain under section 863 the portion of the taxable income attributable to sources within the United States.

(2) *Personal exemptions.* The deductions for the personal exemptions allowed by section 151 or 642(b) shall not be taken into account for purposes of subparagraph (1) of this paragraph but shall be allowed to the extent provided by paragraphs (b) and (c) of this section.

(3) *Adjusted gross income.* The adjusted gross income of a nonresident alien individual shall be the gross income from sources within the United States, determined in accordance with § 1.871–7, minus the deductions prescribed by section 62 to the extent such deductions are allowed under this section in computing taxable income.

(4) *Standard deduction.* The standard deduction shall not be allowed in computing the taxable income of a nonresident alien individual. See section 142(b)(1) and the regulations thereunder.

(5) *Exempt income.* No deduction shall be allowed under this section for the amount of any item or part thereof allocable to a class or classes of exempt income, including income exempt by tax convention. See section 265 and the regulations thereunder.

(b) *No United States business*—(1) *Income of not more than $15,400*—(i) *Deduction for losses only.* A nonresident alien individual within class 1 shall not be allowed any deductions other than the deduction for losses from sales or exchanges of capital assets determined in the manner prescribed by paragraph (b)(4)(vii) of § 1.871–7. Thus, an individual within this class shall not be allowed any deductions for the personal exemptions otherwise allowed by section 151 or 642(b).

(ii) *Source of losses.* Notwithstanding the provisions of section 873(b)(1), losses from sales or exchanges of capital assets shall be allowed under this subparagraph only if allocable to sources within the United States. See paragraph (b)(4)(i) of § 1.871–7.

(2) *Aggregate more than $15,400*—(i) *Deductions allowed.* In computing the income subject to tax under section 1 or section 1201(b), a nonresident alien individual within class 2 shall be allowed deductions to the extent prescribed by paragraph (c)(3) of § 1.871–7, but subject

to the limitations of this section. For this purpose, the deduction for the personal exemptions shall be allowed in accordance with subdivision (iii) of this subparagraph.

(ii) *Deductions disallowed.* In computing the minimum tax prescribed by section 871(b)(3), that individual shall not be allowed any deductions other than the deduction for losses from sales or exchanges of capital assets determined in the manner prescribed by paragraph (b)(4)(vii) of §1.871–7. For this purpose, the deductions for the personal exemptions shall not be allowed. See paragraph (c)(4) of §1.871–7.

(iii) *Personal exemptions.* When the deductions for personal exemptions are allowed under this subparagraph, only one exemption under section 151 shall be allowed in the case of an individual who is not a resident of Canada or Mexico. A resident of either of those countries shall be allowed all the exemptions granted by section 151 to the extent prescribed therein. An estate or trust, whether or not a resident of Canada or Mexico, shall determine its deduction for the personal exemption in accordance with section 642(b) and the regulations thereunder.

(iv) *Source of losses.* Notwithstanding the provisions of section 873(b), losses from sales or exchanges of capital assets shall be allowed under this subparagraph only if allocable to sources within the United States. See paragraph (c)(3)(i) of §1.871–7.

(3) *Election to be taxed on a net basis.* Notwithstanding the other provisions of this paragraph, a nonresident alien individual within class 1 or 2 shall be allowed the deductions allowed by paragraph (c) of this section, if pursuant to a tax convention he is entitled, and does elect, to be subject to United States tax on a net basis as though he were engaged in trade or business within the United States through a permanent establishment situated therein.

(c) *United States business*—(1) *Deductions in general.* For purposes of computing the income subject to tax, a nonresident alien individual within class 3 shall be allowed deductions to the extent prescribed by paragraph (d) of §1.871–7, but subject to the limitations of this section. For this purpose, the deductions for the personal exemptions shall be allowed in accordance with subparagraph (3) of this paragraph.

(2) *Special deductions.* Notwithstanding the rule of source prescribed in paragraph (a) of this section, an individual within class 3 shall be allowed the following deductions whether or not they are connected with income from sources within the United States:

(i) *Losses on transactions for profit.* Any loss sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with a trade or business, shall be allowed to the extent allowed by section 165(c)(2), but only if and to the extent that the profit, if the transaction had resulted in a profit, would be taxable to such individual. Losses allowed under this subdivision shall be deducted in full, as provided in §§1.861–8 and 1.863–1, when the profit from the transaction, if it had resulted in a profit, would, under the provisions of section 861(a) or 863(a), have been taxable in full as income from sources within the United States; but shall be deducted under the provisions of §1.863–3 when the profit from the transaction, if it had resulted in profit, would have been taxable only in part.

(ii) *Casualty losses.* Any loss of property not connected with a trade or business, sustained during the taxable year and not compensated for by insurance or otherwise, if the loss arises from fire, storm, shipwreck, or other casualty, or from theft, shall be allowed to the extent allowed by section 165(c)(3), but only if the loss is of property within the United States. Losses allowed under this subdivision shall be deducted in full, as provided in §§1.861–8 and 1.863–1, from the items of gross income specified under sections 861(a) and 863(a) as being derived in full from sources within the United States; but, if greater than the sum of those items, the unabsorbed loss shall be deducted from the income apportioned under the provisions of §1.863–3 to sources within the United States.

(iii) *Charitable contributions.* The deduction for charitable contributions and gifts, to the extent allowed by section 170, shall be allowed under this subparagraph, but only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations, created in the United States.

(3) *Personal exemptions.* Only one exemption under section 151 shall be allowed in the case of an individual who is not a resident of Canada or Mexico. A resident of either of those countries shall be allowed all the exemptions granted by section 151 to the extent prescribed therein. An estate or trust, whether or not a resident of Canada or Mexico, shall determine its deduction for the personal exemption in accordance with section 642(b) and the regulations thereunder.

§ 1.874–1 Allowance of deductions and credits to nonresident alien individuals.

(a) *Return required.* A nonresident alien individual shall receive the benefit of the deductions and credits otherwise allowable with respect to the income tax, only if the nonresident alien individual timely files or causes to be filed with the Philadelphia Service Center, in the manner prescribed in subtitle F, a true and accurate return of the income which is effectively connected, or treated as effectively connected, with the conduct of a trade or business within the United States by the nonresident alien individual. No provision of this section (other than paragraph (c)(2)) shall be construed, however, to deny the credits provided by sections 31, 32, 33, 34 and 852(b)(3)(D)(ii). In addition, notwithstanding the requirement that a nonresident alien must file a timely return in order to receive the benefit of the deductions and credits otherwise allowable with respect to the income tax, the nonresident alien individual may, for purposes of determining the amount of tax to be withheld under section 1441 from remuneration paid for labor or personal services performed within the United States, receive the benefit of the deduction for personal exemptions provided in section 151, to the extent allowable under section 873(b)(3) and paragraph (c)(3) of § 1.873–1, or in any applicable tax convention, by filing a claim therefore with the withholding agent. The amount of the deduction for the personal exemptions and the amount of the tax to be withheld under those circumstances shall be determined in accordance with paragraph (e)(2) of § 1.1441–3. The deductions and credits allowed such a nonresident alien individual electing under a tax convention to be subject to tax on a net basis may be obtained by filing a return of income in the manner prescribed in the regulations (if any) under the tax convention or under any other guidance issued by the Commissioner.

(b) *Filing deadline for return*—(1) *General rule.* As provided in paragraph (a) of this section, for purposes of computing the nonresident alien individual's taxable income for any taxable year, otherwise allowable deductions and credits will be allowed only if a true and accurate return for that taxable year is filed by the nonresident alien individual on a timely basis. For taxable years of a nonresident alien individual ending after July 31, 1990, whether a return for the current taxable year has been filed on a timely basis is dependent upon whether the nonresident alien individual filed a return for the taxable year immediately preceding the current taxable year. If a return was filed for that immediately preceding taxable year, or if the current taxable year is the first taxable year of the nonresident alien individual for which a return is required to be filed, the required return for the current taxable year must be filed within 16 months of the due date, as set forth in section 6072 and the regulations under that section, for filing the return for the current taxable year. If no return for the taxable year immediately preceding the current taxable year has been filed, the required return for the current taxable year (other than the first taxable year of the nonresident alien individual for which a return is required to be filed) must have been filed no later than the earlier of the date which is 16 months after the due date, as set forth in section 6072, for filing the return for the current taxable year or the date the Internal Revenue Service mails a notice to the nonresident alien individual advising the nonresident alien individual that the current year tax return has not been filed and that no deductions or credits (other than those provided in sections 31, 32, 33, 34 and 852(b)(3)(D)(ii)) may be claimed by the nonresident alien individual.

(2) *Waiver.* The filing deadlines set forth in paragraph (b)(1) of this section may be waived by the District Director or Assistant Commissioner (International) in rare and unusual circumstances if good cause for such waiver, based on the facts and circumstances, is established by the nonresident alien individual.

(3) *Income tax treaties.* A nonresident alien individual who has a permanent establishment or fixed base, as defined in an income tax treaty between the United States and the country of residence of the nonresident alien individual, in the United States is subject to the filing deadlines as set forth in paragraph (b)(1) of this section.

(4) *Protective return.* If a nonresident alien individual conducts limited activities in the United States in a taxable year which the nonresident alien individual determines does not give rise to gross income which is effectively connected with the conduct of a trade or business within the United States as defined in sections 871(b) and 864 (b) and (c) and the regulations under those sections, the nonresident alien individual may nonetheless file a return for that taxable year on a timely basis under paragraph (b)(1) of this section and thereby protect the right to receive the benefit of the deductions and credits attributable to that gross income if it is later determined, after the return was filed, that the original determination was incorrect. On that timely filed return, the nonresident alien individual is not required to report any gross income as effectively connected with a United States trade or business or any deductions or credits but should attach a statement indicating that the return is being filed for the reason set forth in this paragraph (b)(4). If the nonresident alien individual determines that part of the activities which he or she conducts in the United States in a taxable year gives rise to gross income which is effectively connected with the conduct of a trade or business and part does not, the nonresident alien individual must timely file a return for that taxable year to report the gross income determined to be effectively connected, or treated as effectively connected, with the conduct of that trade or business within the United States and the deductions and credits attributable to the gross income. In addition, the nonresident alien individual should attach to that return the statement described in this paragraph (b)(4) with regard to the other activities. The nonresident alien individual may follow the same procedure if the nonresident alien individual determines initially that he or she has no United States tax liability under the provisions of an applicable income tax treaty. In the event the nonresident alien individual relies on the provisions of an income tax treaty to reduce or eliminate the income subject to taxation, or to reduce the rate of tax to which that income is subject, disclosure may be required pursuant to section 6114.

(c) *Allowed deductions and credits*—(1) *In general.* Except for losses of property located within the United States, charitable contributions and personal exemptions (see section 873(b)), deductions are allowed to a nonresident alien individual only to the extent they are connected with gross income which is effectively connected, or treated as effectively connected, with the conduct of the nonresident alien individual's trade or business in the United States. Other than credits allowed by sections 31, 32, 33, 34, and 852(b)(3)(D)(ii), the nonresident alien individual is entitled to credits only if they are attributable to effectively connected income. See paragraph (a) of this section for the requirement that a return be timely filed. Except as provided by section 906, a nonresident alien individual shall not be allowed the credit against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

(2) *Verification.* At the request of the Internal Revenue Service, a nonresident alien individual claiming deductions from gross income which is effectively connected or treated as effectively connected, with the conduct of a trade or business in the United States and credits attributable to that income must furnish at the place designated

pursuant to § 301.7605–1(a) information sufficient to establish that the nonresident alien individual is entitled to the deductions and credits in the amounts claimed. All information must be furnished in a form suitable to permit verification of the claimed deductions and credits. The Internal Revenue Service may require, as appropriate, that an English translation be provided with any information in a foreign language. If a nonresident alien individual fails to furnish sufficient information, the Internal Revenue Service may in its discretion disallow any claimed deductions and credits in full or in part.

(d) *Return by Internal Revenue Service.* If a nonresident alien individual has various sources of income within the United States, so that from any one source, or from all sources combined, the amount of income shall call for the assessment of a tax greater than that withheld at the source in the case of that individual, and a return of income has not been filed in the manner prescribed by subtitle F, including the filing deadlines set forth in paragraph (b)(1) of this section, the Internal Revenue Service shall:

(1) Cause a return of income to be made,

(2) Include on the return the income described in § 1.871–7 or § 1.871–8 of that individual from all sources concerning which it has information, and

(3) *Assess the tax.* If the nonresident alien individual is not engaged in, or does not receive income that is treated as being effectively connected with, a United States trade or business and § 1.871–7 is applicable, the tax shall be assessed on the basis of gross income without allowance for deductions or credits (other than the credits provided by sections 31, 32, 33, 34 and 852(b)(3)(D)(ii)) and collected from one or more sources of income within the United States. If the nonresident alien individual is engaged in a United States trade or business or is treated as having effectively connected income and § 1.871–8 applies, the tax on the income of the nonresident alien individual that is not effectively connected, or treated as effectively connected with the conduct of a United States trade or business shall be assessed on the basis of gross income, determined in accordance with the rules of § 1.871–7, without allowance for deductions or credits (other than the credits provided by sections 31, 32, 33, 34 and 852(b)(3)(D)(ii)) and collected from one or more of the sources of income within the United States. Tax on income that is effectively connected, or treated as effectively connected, with the conduct of a United States trade or business shall be assessed in accordance with either section 1, 55 or 402(e)(1) without allowance for deductions or credits (other than the credits provided by sections 31, 32, 33, 34 and 852(b)(3)(D)(ii)) and collected from one or more of the sources of income within the United States.

(e) *Alien resident of Puerto Rico, Guam, American Samoa, or the Commonwealth of the Northern Mariana Islands.* This section shall not apply to a nonresident alien individual who is a bona fide resident of Puerto Rico, Guam, American Samoa, or the Commonwealth of the Northern Mariana Islands during the entire taxable year. *See* section 876 and § 1.876–1.

[T.D. 8322, 55 FR 50828, Dec. 11, 1990; 56 FR 1361, Jan. 14, 1991]

§ 1.875–1 Partnerships.

Whether a nonresident alien individual who is a member of a partnership is taxable in accordance with subsection (a), (b), or (c) of section 871 may depend on the status of the partnership. A nonresident alien individual who is a member of a partnership which is not engaged in trade or business within the United States is subject to the provisions of section 871 (a) or (b), as the case may be, depending on whether or not he receives during the taxable year an aggregate of more than $15,400 gross income described in section 871(a), if he is not otherwise engaged in trade or business within the United States. A nonresident alien individual who is a member of a partnership which at any time within the taxable year is engaged in trade or business within the United States is considered as being engaged in trade or business within the United States and is therefore taxable under section 871(c). For definition of what the term ‘‘partnership’’ includes, see section

7701(a)(2) and the regulations in part 301 of this chapter (Regulations on Procedure and Administration). The test of whether a partnership is engaged in trade or business within the United States is the same as in the case of a nonresident alien individual. See §1.871–8.

§1.875–2 Beneficiaries of estates or trusts.

(a) [Reserved]

(b) *Exception for certain taxable years.* Notwithstanding paragraph (a) of this section, for any taxable year beginning before January 1, 1975, the grantor of a trust, whether revocable or irrevocable, is not deemed to be engaged in trade or business within the United States merely because the trustee is engaged in trade or business within the United States.

(c) [Reserved]

[T.D. 7332, 39 FR 44233, Dec. 23, 1974]

§1.876–1 Alien residents of Puerto Rico.

(a) *General.* A nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year is, in accordance with the provisions of section 876, subject to tax under section 1 or, in the alternative, under section 1201(b) in generally the same manner as in the case of an alien resident of the United States. See paragraph (b) of §1.1–1 and §1.871–1. The tax is imposed upon the taxable income of such a resident of Puerto Rico, determined in accordance with section 63(a) and the regulations thereunder, from sources both within and without the United States, except that under the provisions of section 933 income derived from sources within Puerto Rico (other than amounts received for services performed as an employee of the United States or any agency thereof) is excluded from gross income. For determining the form of return to be used by such an individual, see section 6012 and the regulations thereunder.

(b) *Exceptions.* Though subject to the tax imposed by section 1, a nonresident alien individual who is a bona fide resident of Puerto Rico during his entire taxable year shall nevertheless be treated as a nonresident alien individual for the purpose of many provisions of the Code relating to nonresident alien individuals. Thus, for example, such a resident of Puerto Rico is not allowed to determine his tax in accordance with the optional tax table (section 4(d)(1)); is not allowed the standard deduction (section 142(b)(1); is not allowed a deduction for a ‘‘dependent’’ who is a resident of Puerto Rico unless the dependent is a citizen of the United States (section 152 (b)(3)); is subject to withholding of tax at source under chapter 3 of the Code (sections 1441(e) and 1451(e)); is generally excepted from the collection of income tax at source on wages (paragraph (d)(1) of §31.3401(a)(6)–1 of this chapter (Employment Tax Regulations)); is not allowed to make a joint return or a joint declaration of estimated tax (sections 6013(a)(1) and 6015(b)); must pay his estimated income tax on or before the 15th day of the 4th month of the taxable year (sections 6015(i)(3), 6073(a), and 6153(a)(1)); and generally must pay his income tax on or before the 15th day of the 6th month following the close of the taxable year (sections 6072(c) and 6151(a)).

(c) *Credits against tax.* The credits allowed by section 31 (relating to tax withheld on wages), section 32 (relating to tax withheld at source on nonresident aliens), section 33 (relating to taxes of foreign countries), section 35 (relating to partially tax-exempt interest), section 38 (relating to investment in certain depreciable property), section 39 (relating to certain uses of gasoline and lubricating oil), and section 40 (relating to expenses of work incentive programs) shall be allowed against the tax determined in accordance with this section. No credit shall be allowed under section 37 in respect of retirement income.

(d) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.876–1 (Revised as of January 1, 1971).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6777, 29 FR 17819, Dec. 16, 1964; T.D. 7332, 39 FR 44229, Dec. 23, 1974]

§ 1.879–1 Treatment of community income.

(a) *Treatment of community income*—(1) *In general.* For taxable years beginning after December 31, 1976, community income of a citizen or resident of the United States who is married to a nonresident alien individual, and the deductions properly allocable to that income, shall be divided between the U.S. citizen or resident spouse in accordance with the rules in section 879 and paragraph (a)(2) through (a)(6) of this section. This section does not apply for any taxable year with respect to which an election under section 6013 (g) or (h) is in effect. Community income for this purpose includes all gross income, whether derived from sources within or without the United States, which is treated as community income of the spouses under the community property laws of the State, foreign country, or possession of the United States in which the recipient of the income is domiciled. Income from real property also may be community income if so treated under the laws of the jurisdiction in which the real property is located.

(2) *Earned income.* Wages, salaries, or professional fees, and other amounts received as compensation for personal services actually performed, which are community income for the taxable year, shall be treated as the income of the spouse who actually performed the personal services. This paragraph (a)(2) does not apply, however, to the following items of community income:

(i) Community income derived from any trade or business carried on by the husband or the wife.

(ii) Community income attributable to a spouse's distributive share of the income of a partnership to which paragraph (a)(4) of this section applies.

(iii) Community income consisting of compensation for personal services rendered to a corporation which represents a distribution of the earnings and profits of the corporation rather than a reasonable allowance as compensation for the personal services actually performed, but not including any income that would be treated as earned income under the second sentence of section 911(b).

(iv) Community income derived from property which is acquired as consideration for personal services performed.

These items of community income are divided in accordance with the rules in paragraph (a)(3) through (a)(6) of this section.

(3) *Trade or business income.* If any income derived from a trade or business carried on by the husband or wife is community income for the taxable year, all of the gross income, and the deductions attributable to that income, shall be treated as the gross income and deductions of the husband. However, if the wife exercises substantially all of the management and control of the trade or business, all of the gross income and deductions shall be treated as the gross income and deductions of the wife. This paragraph (a)(3) does not apply to any income derived from a trade or business carried on by a partnership of which both or one of the spouses is a member (see paragraph (a)(4) of this section). For purposes of this paragraph (a)(3), income derived from a trade or business includes any income derived from a trade or business in which both personal services and capital are material income producing factors. The term ''management and control'' means management and control in fact, not the management and control imputed to the husband under the community property laws of a State, foreign country or possession of the United States. For example, a wife who operates a pharmacy without any appreciable collaboration on the part of a husband is considered as having substantially all of the management and control of the business despite the provisions of any community property laws of a State, foreign country, or possession of the United States, vesting in the husband the right of management and control of community property. The income and deductions attributable to the operation of the pharmacy are considered the income and deductions of the wife.

(4) *Partnership income.* If any portion of a spouse's distributive share of the income of a partnership, of which the spouse is a member, is community income for the taxable year, all of that distributive share shall be treated as the income of that spouse and shall not

be taken into account in determining the income of the other spouse. If both spouses are members of the same partnership, the distributive share of the income of each spouse which is community income shall be treated as the income of that spouse. A spouse's distributive share of the income of a partnership that is community income shall be determined as provided in section 704 and the regulations thereunder.

(5) *Income from separate property.* Any community income for the taxable year, other than income described in section 879(a) (1) or (2) and paragraph (a) (2), (3), or (4) of this section, which is derived from the separate property of one of the spouses shall be treated as the income of that spouse. The determination of what property is separate property for this purpose shall be made in accordance with the laws of the State, foreign country, or possession of the United States in which, in accordance with paragraph (a)(1) of this section, the recipient of the income is domiciled or, in the case of income from real property, in which the real property is located.

(6) *Other community income.* Any community income for the taxable year, other than income described in section 879(a) (1), (2), or (3), and paragraph (a) (2), (3), (4), or (5) of this section, shall be treated as income of that spouse who has a proprietary vested interest in that income under the laws of the state, foreign country, or possession of the United States in which, in accordance with paragraph (a)(1) of this section, the recipient of the income is domiciled or, in the case of income from real property, in which the real property is located. Thus, for example, this paragraph (a)(6) applies to community income not described in paragraph (a) (2), (3), (4), or (5) of this section which consists of dividends, interest, rents, royalties, or gains, from community property or of the earnings of unemancipated minor children.

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

Example 1. H, a U.S. citizen, and W, a nonresident alien individual, each of whose taxable years is the calendar year, were married throughout 1977. H and W were residents of, and domiciled in, foreign country Z during the entire taxable year. No election under section 6013 (g) or (h) is in effect for 1977. During 1977, H earned $10,000 from the performance of personal services as an employee. H also received $500 in dividend income from stock which under the community property laws of country Z is considered to be the separate property of H. W had no separate income for 1977. Under the community property laws of country Z all income earned by either spouse is considered to be community income, and one-half of this income is considered to belong to the other spouse. In addition, the laws of country Z provide that all income derived from property held separately by either spouse is to be treated as community income and treated as belonging one-half to each spouse. Thus, under the community property laws of country Z, H and W are both considered to have realized income of $5,250 during 1977, even though Z's laws recognize the stock as the separate property of H. Under the rules of paragraph (a) (2) and (5) of this section all of the income of $10,500 derived during 1977 is treated, for U.S. income tax purposes, as the income of H.

Example 2. (a) The facts are the same as in example 1, except that H is the sole proprietor of a retail merchandising company, which has a $10,000 profit during 1977. W exercises no management and control over the business. In addition, H is a partner in a wholesale distributing company, and his distributive share of the partnership profit is $5,000. Both of these amounts of income are treated as community income under the community property laws of country Z, and under these laws both H and W are treated as realizing $7,500 of the income. Under the rule of paragraph (a) (3) and (4) of this section all $15,000 of the income is treated as the income of H for U.S. income tax purposes.

(b) If W exercises substantially all of the management and control over the retail merchandising company, then for U.S. income tax purposes the $10,000 profit is treated as the income of W.

Example 3. The facts are the same as in example 1, except that H also received $1,000 in dividends on stock held separately in his name. Under the community property laws of country Z the stock is considered to be community property, the dividends to be community income, and one-half of the income to be the income of each spouse. Under the rule of paragraph (a)(6) of this section, $500 of the dividend income is treated, for U.S. income tax purposes, as the income of each spouse.

(b) *Definitions and other special rules*—(1) *Spouses with different taxable years.* A special rule applies if the nonresident alien and the United States citizen or resident spouse of the alien do not have the same taxable years, as defined in section 441(b) and the regulations thereunder. The special rule is as follows. With respect to the U.S. citizen or resident spouse, section 879 and this section shall apply to each taxable year of the U.S. citizen or resident spouse for which no election under section 6013 (g) or (h) is in effect. With respect to the nonresident alien spouse, section 879 and this section apply to each period falling within the consecutive taxable years of the nonresident alien spouse which coincides with a taxable year of the U.S. citizen or resident spouse to which section 879 and this section apply.

(2) *Determination of marital status.* For purposes of this section, marital status shall be determined under section 143(a).

[T.D. 7670, 45 FR 6928, Jan. 31, 1980]

FOREIGN CORPORATIONS

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[T.D. 8611, 60 FR 41005, Aug. 11, 1995]

§1.881–1 Manner of taxing foreign corporations.

(a) *Classes of foreign corporations.* For purposes of the income tax, foreign corporations are divided into two classes, namely, foreign corporations which at no time during the taxable year are engaged in trade or business in the United States and foreign corporations which, at any time during the taxable year, are engaged in trade or business in the United States.

(b) *Manner of taxing*—(1) *Foreign corporations not engaged in U.S. business.* A foreign corporation which at no time during the taxable year is engaged in trade or business in the United States is taxable, as provided in §1.881–2, on all income received from sources within the United States which is fixed or determinable annual or periodical income and on other items of income enumerated under section 881(a). Such a foreign corporation is also taxable on certain income from sources within the United States which, pursuant to §1.882–2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States.

(2) *Foreign corporations engaged in U.S. business.* A foreign corporation which at any time during the taxable year is engaged in trade or business in the United States is taxable, as provided in §1.882–1, on all income from whatever source derived, whether or not fixed or determinable annual or periodical income, which is effectively connected for the taxable year with the conduct of a trade or business in the United States. Such a foreign corporation is also taxable, as provided in §1.882–1, on income received from sources within the United States which is not effectively connected for the taxable year with the conduct of a trade or business in the United States and consists of (i) fixed or determinable annual or periodical income, or (ii) other items of income enumerated in section 881(a). A foreign corporation which at any time during the taxable year is engaged in trade or business in the United States is also taxable on certain income from sources within the United States which, pursuant to §1.882–2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States.

(c) *Meaning of terms.* For the meaning of the term “engaged in trade or business within the United States”, as used in section 881 and this section, see section 864(b) and the regulations thereunder. For determining when income, gain, or loss of a foreign corporation for a taxable year is effectively connected for that year with the conduct of a trade or business in the United States, see section 864(c), the regulations thereunder, and §1.882–2. The term “foreign corporation” has the meaning assigned to it by section 7701(a) (3) and (5) and §301.7701–5 of this chapter (Regulations on Procedure and Administration), except that, for purposes of section 881 and §1.881–2, in the case of taxable years beginning after December 31, 1971, the term “foreign corporation” does not include a corporation created or organized in Guam or under the law of Guam. Thus, for example, for such a taxable year the first sentence of paragraph (b)(1), and the second sentence of paragraph (b)(2), of this section do not apply to a Guamanian corporation.

(d) *Rules applicable to foreign insurance companies*—(1) *Corporations qualifying under subchapter L.* A foreign corporation carrying on an insurance business in the United States at any time during the taxable year, which, without taking into account its income not effectively connected for the taxable year with the conduct of a trade or business in the United States, would qualify for the taxable year under part I, II, or III of subchapter L if it were a domestic corporation, shall be taxable for such year under that part on its entire taxable income (whether derived from sources within or without the United States) which is, or which pursuant to section 882 (d) or (e) and § 1.882–2 is treated as, effectively connected for the taxable year with the conduct of a trade or business (whether or not its insurance business) in the United States. Any income derived by that foreign corporation from sources within the United States which is not effectively connected for the taxable year with the conduct of a trade or business in the United States is taxable as provided in section 881(a) and § 1.882–1. See sections 842 and 861 through 864, and the regulations thereunder.

(2) *Corporations not qualifying under subchapter L.* A foreign corporation which carries on an insurance business in the United States at any time during the taxable year, and which, without taking into account its income not effectively connected for the taxable year with the conduct of a trade or business in the United States, would not qualify for the taxable year under part I, II, or III of subchapter L if it were a domestic corporation, and a foreign insurance company which does not carry on an insurance business in the United States at any time during the taxable year, shall be taxable—

(i) Under section 881(a) and § 1.881–2 or § 1.882–1 on its income from sources within the United States which is not effectively connected for the taxable year with the conduct of a trade or business in the United States,

(ii) Under section 882(a)(1) and § 1.882–1 on its income (whether derived from sources within or without the United States) which is effectively connected for the taxable year with the conduct of a trade or business in the United States, and

(iii) Under section 882(a)(1) and § 1.882–1 on its income from sources within the United States which pursuant to section 882 (d) or (e) and § 1.882–2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States.

(e) *Other provisions applicable to foreign corporations*—(1) *Accumulated earnings tax.* For the imposition of the accumulated earnings tax upon the accumulated taxable income of a foreign corporation formed or availed of for tax avoidance purposes, whether or not such corporation is engaged in trade or business in the United States, see section 532 and the regulations thereunder.

(2) *Personal holding company tax.* For the imposition of the personal holding company tax upon the undistributed personal holding company income of a foreign corporation which is a personal holding company, whether or not such corporation is engaged in trade or business in the United States, see sections 541 through 547, and the regulations thereunder. Except in the case of a foreign corporation having personal service contract income to which section 543(a)(7) applies, a foreign corporation is not a personal holding company if all of its stock outstanding during the last half of the taxable year is owned by nonresident alien individuals, whether directly or indirectly through foreign estates, foreign trusts, foreign partnerships, or other foreign corporations. See section 542(c)(7).

(3) *Foreign personal holding companies.* For the mandatory inclusion in the gross income of the United States shareholders of the undistributed foreign personal holding company income of a foreign personal holding company, see section 551 and the regulations thereunder.

(4) *Controlled foreign corporations*—(i) *Subpart F income and increase of earnings invested in U.S. Property.* For the mandatory inclusion in the gross income of the U.S. shareholders of the subpart F income, of the previously excluded subpart F income withdrawn from investment in less developed countries, of the previously excluded

subpart F income withdrawn from investment in foreign base company shipping operations, and of the increase in earnings invested in U.S. property, of a controlled foreign corporation, see sections 951 through 964, and the regulations thereunder.

(ii) *Certain accumulations of earnings and profits.* For the inclusion in the gross income of U.S. persons as a dividend of the gain recognized on certain sales or exchanges of stock in a foreign corporation, to the extent of certain earnings and profits attributable to the stock which were accumulated while the corporation was a controlled foreign corporation, see section 1248 and the regulations thereunder.

(5) *Changes in tax rate.* For provisions respecting the effect of any change in rate of tax during the taxable year on the income of a foreign corporation, see section 21 and the regulations thereunder.

(6) *Consolidated returns.* Except in the case of certain corporations organized under the laws of Canada or Mexico and maintained solely for the purpose of complying with the laws of that country as to title and operation of property, a foreign corporation is not an includible corporation for purposes of the privilege of making a consolidated return by an affiliated group of corporations. See section 1504 and the regulations thereunder.

(7) *Adjustment of tax of certain foreign corporations.* For the application of pre-1967 income tax provisions to corporations of a foreign country which imposes a more burdensome income tax than the United States, and for the adjustment of the income tax of a corporation of a foreign country which imposes a discriminatory income tax on the income of citizens of the United States or domestic corporations, see section 896.

(f) *Effective date.* This section applies for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.881–1 (Revised as of January 1, 1971).

(Secs. 7805 (68A Stat. 917; 26 U.S.C. 7805) and 7654(e) (86 Stat. 1496; 26 U.S.C. 7654(e)) of the Internal Revenue Code of 1954)

[T.D. 7293, 38 FR 32795, Nov. 28, 1973, as amended by T.D. 7385, 40 FR 50260, Oct. 29, 1975; T.D. 7893, 48 FR 22507, May 19, 1983]

§1.881–2 Taxation of foreign corporations not engaged in U.S. business.

(a) *Imposition of tax.* (1) This section applies for purposes of determining the tax of a foreign corporation which at no time during the taxable year is engaged in trade or business in the United States. However, see also §1.882–2 where such corporation has an election in effect for the taxable year in respect to real property income or receives interest on obligations of the United States. Except as otherwise provided in §1.871–12, a foreign corporation to which this section applies is not subject to the tax imposed by section 11 or section 1201(a) but, pursuant to the provisions of section 881(a), is liable to a flat tax of 30 percent upon the aggregate of the amounts determined under paragraphs (b) and (c) of this section which are received during the taxable year from sources within the United States. Except as specifically provided in such paragraphs, such amounts do not include gains from the sale or exchange of property. To determine the source of such amounts, see sections 861 through 863, and the regulations thereunder.

(2) The tax of 30 percent is imposed by section 881(a) upon an amount only to the extent the amount constitutes gross income.

(3) Deductions shall not be allowed in determining the amount subject to tax under this section.

(4) Except as provided in §1.882–2, a foreign corporation which at no time during the taxable year is engaged in trade or business in the United States has no income, gain, or loss for the taxable year which is effectively connected for the taxable year with the conduct of a trade or business in the

United States. See section 864(c)(1)(B) and § 1.864–3.

(5) Gains and losses which, by reason of section 882(d) and § 1.882–2, are treated as gains or losses which are effectively connected for the taxable year with the conduct of a trade or business in the United States by such a foreign corporation shall not be taken into account in determining the tax under this section. See, for example, paragraph (c)(2) of § 1.871–10.

(b) *Fixed or determinable annual or periodical income.*— (1) General rule. The tax of 30 percent imposed by section 881(a) applies to the gross amount received from sources within the United States as fixed or determinable annual or periodical gains, profits, or income. Specific items of fixed or determinable annual or periodical income are enumerated in section 881(a)(1) as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments, but other items of fixed or determinable annual or periodical gains, profits, or income are also subject to the tax as, for instance, royalties, including royalties for the use of patents, copyrights, secret processes and formulas, and other like property. As to the determination of fixed or determinable annual or periodical income, see paragraph (a) of § 1.1441–2. For special rules treating gain on the disposition of section 306 stock as fixed or determinable annual or periodical income for purposes of section 881(a), see section 306(f) and paragraph (h) of § 1.306–3.

(2) *Substitute payments.* For purposes of this section, a substitute interest payment (as defined in § 1.861–2(a)(7)) received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in § 1.861–2(a)(7)) shall have the same character as interest income received pursuant to the terms of the transferred security. Similarly, for purposes of this section, a substitute dividend payment (as defined in § 1.861–3(a)(6)) received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in § 1.861–2(a)(7)) shall have the same character as a distribution received with respect to the transferred security. Where, pursuant to a securities lending transaction or a sale-repurchase transaction, a foreign person transfers to another person a security the interest on which would qualify as portfolio interest under section 881(c) in the hands of the lender, substitute interest payments made with respect to the transferred security will be treated as portfolio interest, provided that in the case of interest on an obligation in registered form (as defined in § 1.871–14(c)(1)(i)), the transferor complies with the documentation requirement described in § 1.871–14(c)(1)(ii)(C) with respect to the payment of substitute interest and none of the exceptions to the portfolio interest exemption in sections 881(c) (3) and (4) apply. See also §§ 1.871–7(b)(2) and 1.894–1(c).

(c) *Other income and gains*—(1) *Items subject to tax.* The tax of 30 percent imposed by section 881(a) also applies to the following gains received during the taxable year from sources within the United States:

(i) Gains described in section 631 (b) or (c), relating to the treatment of gain on the disposal of timber, coal, or iron ore with a retained economic interest;

(ii) [Reserved]

(iii) Gains from the sale or exchange after October 4, 1966, of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, or other like property, or of any interest in any such property, to the extent the gains are from payments (whether in a lump sum or in installments) which are contingent on the productivity, use, or disposition of the property or interest sold or exchanged, or from payments which are treated under section 871(e) and § 1.871–11 as being so contingent.

(2) *Determination of amount of gain.* The tax of 30 percent imposed upon the gains described in subparagraph (1) of this paragraph applies to the full amount of the gains and is determined (i) without regard to the alternative tax imposed by section 1201(a) upon the excess of net long-term capital gain over the net short-term capital loss; (ii) without regard to section 1231, relating to property used in the trade or business and involuntary conversions; and (iii) except in the case of gains described in subparagraph (1)(ii) of this

paragraph, whether or not the gains are considered to be gains from the sale or exchange of property which is a capital asset.

(d) *Credits against tax.* The credits allowed by section 32 (relating to tax withheld at source on foreign corporations), by section 39 (relating to certain uses of gasoline and lubricating oil), and by section 6402 (relating to overpayments of tax) shall be allowed against the tax of a foreign corporation determined in accordance with this section.

(e) *Effective date.* Except as otherwise provided in this paragraph, this section applies for taxable years beginning after December 31, 1966. Paragraph (b)(2) of this section is applicable to payments made after November 13, 1997. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.881–2 (Revised as of January 1, 1971).

[T.D. 7293, 38 FR 32796, Nov. 28, 1973, as amended by T.D. 8735, 62 FR 53502, Oct. 14, 1997]

§1.881–3 Conduit financing arrangements.

(a) *General rules and definitions*—(1) *Purpose and scope.* Pursuant to the authority of section 7701(l), this section provides rules that permit the district director to disregard, for purposes of section 881, the participation of one or more intermediate entities in a financing arrangement where such entities are acting as conduit entities. For purposes of this section, any reference to tax imposed under section 881 includes, except as otherwise provided and as the context may require, a reference to tax imposed under sections 871 or 884(f)(1)(A) or required to be withheld under section 1441 or 1442. See §1.881–4 for recordkeeping requirements concerning financing arrangements. See §§1.1441–3(j) and 1.1441–7(d) for withholding rules applicable to conduit financing arrangements.

(2) *Definitions.* The following definitions apply for purposes of this section and §§1.881–4, 1.1441–3(j) and 1.1441–7(d).

(i) *Financing arrangement*—(A) *In general.* Financing arrangement means a series of transactions by which one person (the financing entity) advances money or other property, or grants rights to use property, and another person (the financed entity) receives money or other property, or rights to use property, if the advance and receipt are effected through one or more other persons (intermediate entities) and, except in cases to which paragraph (a)(2)(i)(B) of this section applies, there are financing transactions linking the financing entity, each of the intermediate entities, and the financed entity. A transfer of money or other property in satisfaction of a repayment obligation is not an advance of money or other property. A financing arrangement exists regardless of the order in which the transactions are entered into, but only for the period during which all of the financing transactions coexist. See *Examples 1, 2,* and *3* of paragraph (e) of this section for illustrations of the term financing arrangement.

(B) *Special rule for related parties.* If two (or more) financing transactions involving two (or more) related persons would form part of a financing arrangement but for the absence of a financing transaction between the related persons, the district director may treat the related persons as a single intermediate entity if he determines that one of the principal purposes for the structure of the financing transactions is to prevent the characterization of such arrangement as a financing arrangement. This determination shall be based upon all of the facts and circumstances, including, without limitation, the factors set forth in paragraph (b)(2) of this section. See *Examples 4* and *5* of paragraph (e) of this section for illustrations of this paragraph (a)(2)(i)(B).

(ii) *Financing transaction*—(A) *In general.* Financing transaction means—

(*1*) Debt;

(*2*) Stock in a corporation (or a similar interest in a partnership or trust) that meets the requirements of paragraph (a)(2)(ii)(B) of this section;

(*3*) Any lease or license; or

(*4*) Any other transaction (including an interest in a trust described in sections 671 through 679) pursuant to which a person makes an advance of money or other property or grants rights to use property to a transferee who is obligated to repay or return a substantial portion of the money or other property advanced, or the equivalent in value. This paragraph (a)(2)(ii)(A)(*4*) shall not apply to the posting of collateral unless the collateral consists of cash or the person holding the collateral is permitted to reduce the collateral to cash (through a transfer, grant of a security interest or similar transaction) prior to default on the financing transaction secured by the collateral.

(B) *Limitation on inclusion of stock or similar interests*—(*1*) *In general.* Stock in a corporation (or a similar interest in a partnership or trust) will constitute a financing transaction only if one of the following conditions is satisfied—

(*i*) The issuer is required to redeem the stock or similar interest at a specified time or the holder has the right to require the issuer to redeem the stock or similar interest or to make any other payment with respect to the stock or similar interest;

(*ii*) The issuer has the right to redeem the stock or similar interest, but only if, based on all of the facts and circumstances as of the issue date, redemption pursuant to that right is more likely than not to occur; or

(*iii*) The owner of the stock or similar interest has the right to require a person related to the issuer (or any other person who is acting pursuant to a plan or arrangement with the issuer) to acquire the stock or similar interest or make a payment with respect to the stock or similar interest.

(*2*) *Rules of special application*—(*i*) *Existence of a right.* For purposes of this paragraph (a)(2)(ii)(B), a person will be considered to have a right to cause a redemption or payment if the person has the right (other than rights arising, in the ordinary course, between the date that a payment is declared and the date that a payment is made) to enforce the payment through a legal proceeding or to cause the issuer to be liquidated if it fails to redeem the interest or to make a payment. A person will not be considered to have a right to force a redemption or a payment if the right is derived solely from ownership of a controlling interest in the issuer in cases where the control does not arise from a default or similar contingency under the instrument. The person is considered to have such a right if the person has the right as of the issue date or, as of the issue date, it is more likely than not that the person will receive such a right, whether through the occurrence of a contingency or otherwise.

(*ii*) *Restrictions on payment.* The fact that the issuer does not have the legally available funds to redeem the stock or similar interest, or that the payments are to be made in a blocked currency, will not affect the determinations made pursuant to this paragraph (a)(2)(ii)(B).

(*iii*) *Conduit entity* means an intermediate entity whose participation in the financing arrangement may be disregarded in whole or in part pursuant to this section, whether or not the district director has made a determination that the intermediate entity should be disregarded under paragraph (a)(3)(i) of this section.

(*iv*) *Conduit financing arrangement* means a financing arrangement that is effected through one or more conduit entities.

(*v*) *Related* means related within the meaning of sections 267(b) or 707(b)(1), or controlled within the meaning of section 482, and the regulations under those sections. For purposes of determining whether a person is related to another person, the constructive ownership rules of section 318 shall apply, and the attribution rules of section 267(c) also shall apply to the extent they attribute ownership to persons to whom section 318 does not attribute ownership.

(3) *Disregard of participation of conduit entity*—(i) *Authority of district director.* The district director may determine that the participation of a conduit entity in a conduit financing arrangement should be disregarded for purposes of section 881. For this purpose, an intermediate entity will constitute a conduit entity if it meets the standards of paragraph (a)(4) of this section. The district director has discretion to determine the manner in which the standards of paragraph (a)(4) of this section apply, including the financing transactions and parties composing the financing arrangement.

(ii) *Effect of disregarding conduit entity*—(A) *In general.* If the district director determines that the participation of a conduit entity in a financing arrangement should be disregarded, the financing arrangement is recharacterized as a transaction directly between the remaining parties to the financing arrangement (in most cases, the financed entity and the financing entity) for purposes of section 881. To the extent that a disregarded conduit entity actually receives or makes payments pursuant to a conduit financing arrangement, it is treated as an agent of the financing entity. Except as otherwise provided, the recharacterization of the conduit financing arrangement also applies for purposes of sections 871, 884(f)(1)(A), 1441, and 1442 and other procedural provisions relating to those sections. This recharacterization will not otherwise affect a taxpayer's Federal income tax liability under any substantive provisions of the Internal Revenue Code. Thus, for example, the recharacterization generally applies for purposes of section 1461, in order to impose liability on a withholding agent who fails to withhold as required under §1.1441–3(j), but not for purposes of §1.882–5.

(B) *Character of payments made by the financed entity.* If the participation of a conduit financing arrangement is disregarded under this paragraph (a)(3), payments made by the financed entity generally shall be characterized by reference to the character (e.g., interest or rent) of the payments made to the financing entity. However, if the financing transaction to which the financing entity is a party is a transaction described in paragraph (a)(2)(ii)(A)(*2*) or (*4*) of this section that gives rise to payments that would not be deductible if paid by the financed entity, the character of the payments made by the financed entity will not be affected by the disregard of the participation of a conduit entity. The characterization provided by this paragraph (a)(3)(ii)(B) does not, however, extend to qualification of a payment for any exemption from withholding tax under the Internal Revenue Code or a provision of any applicable tax treaty if such qualification depends on the terms of, or other similar facts or circumstances relating to, the financing transaction to which the financing entity is a party that do not apply to the financing transaction to which the financed entity is a party. Thus, for example, payments made by a financed entity that is not a bank cannot qualify for the exemption provided by section 881(i) of the Code even if the loan between the financed entity and the conduit entity is a bank deposit.

(C) *Effect of income tax treaties.* Where the participation of a conduit entity in a conduit financing arrangement is disregarded pursuant to this section, it is disregarded for all purposes of section 881, including for purposes of applying any relevant income tax treaties. Accordingly, the conduit entity may not claim the benefits of a tax treaty between its country of residence and the United States to reduce the amount of tax due under section 881 with respect to payments made pursuant to the conduit financing arrangement. The financing entity may, however, claim the benefits of any income tax treaty under which it is entitled to benefits in order to reduce the rate of tax on payments made pursuant to the conduit financing arrangement that are recharacterized in accordance with paragraph (a)(3)(ii)(B) of this section.

(D) *Effect on withholding tax.* For the effect of recharacterization on withholding obligations, see §§1.1441–3(j) and 1.1441–7(d).

(E) *Special rule for a financing entity that is unrelated to both intermediate entity and financed entity—(1) Liability of financing entity.* Notwithstanding the fact that a financing arrangement is a conduit financing arrangement, a financing entity that is unrelated to the financed entity and the conduit entity (or entities) shall not itself be liable for tax under section 881 unless the financing entity knows or has reason to know that the financing arrangement is a conduit financing arrangement. But see §1.1441–3(j) for the withholding agent's withholding obligations.

(*2*) *Financing entity's knowledge*—(*i*) *In general.* A financing entity knows or has reason to know that the financing arrangement is a conduit financing arrangement only if the financing entity knows or has reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement, including facts sufficient to establish that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan. A person that knows only of the financing transactions that comprise the financing arrangement will not be considered to know or have reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement.

(*ii*) *Presumption regarding financing entity's knowledge.* It shall be presumed that the financing entity does not know or have reason to know that the financing arrangement is a conduit financing arrangement if the financing entity is unrelated to all other parties to the financing arrangement and the financing entity establishes that the intermediate entity who is a party to the financing transaction with the financing entity is actively engaged in a substantial trade or business. An intermediate entity will not be considered to be engaged in a trade or business if its business is making or managing investments, unless the intermediate entity is actively engaged in a banking, insurance, financing or similar trade or business and such business consists predominantly of transactions with customers who are not related persons. An intermediate entity's trade or business is substantial if it is reasonable for the financing entity to expect that the intermediate entity will be able to make payments under the financing transaction out of the cash flow of that trade or business. This presumption may be rebutted if the district director establishes that the financing entity knew or had reason to know that the financing arrangement is a conduit financing arrangement. See *Example 6* of paragraph (e) of this section for an illustration of the rules of this paragraph (a)(3)(ii)(E).

(iii) *Limitation on taxpayer's use of this section.* A taxpayer may not apply this section to reduce the amount of its Federal income tax liability by disregarding the form of its financing transactions for Federal income tax purposes or by compelling the district director to do so. See, however, paragraph (b)(2)(i) of this section for rules regarding the taxpayer's ability to show that the participation of one or more intermediate entities results in no significant reduction in tax.

(4) *Standard for treatment as a conduit entity*—(i) *In general.* An intermediate entity is a conduit entity with respect to a financing arrangement if—

(A) The participation of the intermediate entity (or entities) in the financing arrangement reduces the tax imposed by section 881 (determined by comparing the aggregate tax imposed under section 881 on payments made on financing transactions making up the financing arrangement with the tax that would have been imposed under paragraph (d) of this section);

(B) The participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan; and

(C) Either—

(*1*) The intermediate entity is related to the financing entity or the financed entity; or

(*2*) The intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity.

(ii) *Multiple intermediate entities*—(A) *In general.* If a financing arrangement involves multiple intermediate entities, the district director will determine whether each of the intermediate entities is a conduit entity. The district director will make the determination by applying the special rules for multiple intermediate entities provided in this section or, if no special rules are provided, applying principles consistent with those of paragraph (a)(4)(i) of this section to each of the intermediate entities in the financing arrangement.

(B) *Special rule for related persons.* The district director may treat related intermediate entities as a single intermediate entity if he determines that one of the principal purposes for the involvement of multiple intermediate entities in the financing arrangement is to prevent the characterization of an intermediate entity as a conduit entity, to reduce the portion of a payment that is subject to withholding tax or otherwise to circumvent the provisions of this section. This determination shall be based upon all of the facts and circumstances, including, but not limited to, the factors set forth in paragraph (b)(2) of this section. If a district director determines that related persons are to be treated as a single intermediate entity, financing transactions between such related parties that are part of the conduit financing arrangement shall be disregarded for purposes of applying this section. *See Examples 7* and *8* of paragraph (e) of this section for illustrations of the rules of this paragraph (a)(4)(ii).

(b) *Determination of whether participation of intermediate entity is pursuant to a tax avoidance plan*—(1) *In general.* A tax avoidance plan is a plan one of the principal purposes of which is the avoidance of tax imposed by section 881. Avoidance of the tax imposed by section 881 may be one of the principal purposes for such a plan even though it is outweighed by other purposes (taken together or separately). In this regard, the only relevant purposes are those pertaining to the participation of the intermediate entity in the financing arrangement and not those pertaining to the existence of a financing arrangement as a whole. The plan may be formal or informal, written or oral, and may involve any one or more of the parties to the financing arrangement. The plan must be in existence no later than the last date that any of the financing transactions comprising the financing arrangement is entered into. The district director may infer the existence of a tax avoidance plan from the facts and circumstances. In determining whether there is a tax avoidance plan, the district director will weigh all relevant evidence regarding the purposes for the intermediate entity's participation in the financing arrangement. See *Examples 11* and *12* of paragraph (e) of this section for illustrations of the rule of this paragraph (b)(1).

(2) *Factors taken into account in determining the presence or absence of a tax avoidance purpose.* The factors described in paragraphs (b)(2)(i) through (iv) of this section are among the facts and circumstances taken into account in determining whether the participation of an intermediate entity in a financing arrangement has as one of its principal purposes the avoidance of tax imposed by section 881.

(i) *Significant reduction in tax.* The district director will consider whether the participation of the intermediate entity (or entities) in the financing arrangement significantly reduces the tax that otherwise would have been imposed under section 881. The fact that an intermediate entity is a resident of a country that has an income tax treaty with the United States that significantly reduces the tax that otherwise would have been imposed under section 881 is not sufficient, by itself, to establish the existence of a tax avoidance plan. The determination of whether the participation of an intermediate entity significantly reduces the tax generally is made by comparing the aggregate tax imposed under section 881 on payments made on financing transactions making up the financing arrangement with the tax that would be imposed under paragraph (d) of this section. However, the taxpayer is not barred from presenting evidence that the financing entity, as determined by the district director, was itself an intermediate entity and another entity should be treated as the financing entity for purposes of applying this test. A reduction in the absolute amount of tax may be significant even if the reduction in rate is not. A reduction in the amount of tax may be significant if the reduction is large in absolute terms or in relative terms. See *Examples 13, 14* and *15* of paragraph (e) of this section for illustrations of this factor.

(ii) *Ability to make the advance.* The district director will consider whether the intermediate entity had sufficient available money or other property of its own to have made the advance to the financed entity without the advance of money or other property to it by the financing entity (or in the case of multiple intermediate entities, whether each of the intermediate entities had sufficient available money or other property of its own to have made the advance to either the financed entity or another intermediate entity without the advance of money or other property to it by either the financing entity or another intermediate entity).

(iii) *Time period between financing transactions.* The district director will consider the length of the period of time that separates the advances of money or other property, or the grants of rights to use property, by the financing entity to the intermediate entity (in the case of multiple intermediate entities, from one intermediate entity to another), and ultimately by the intermediate entity to the financed entity. A short period of time is evidence of the existence of a tax avoidance plan while a long period of time is evidence that there is not a tax avoidance plan. See *Example 16* of paragraph (e) of this section for an illustration of this factor.

(iv) *Financing transactions in the ordinary course of business.* If the parties to the financing transaction are related, the district director will consider whether the financing transaction occurs in the ordinary course of the active conduct of complementary or integrated trades or businesses engaged in by these entities. The fact that a financing transaction is described in this paragraph (b)(2)(iv) is evidence that the participation of the parties to that transaction in the financing arrangement is not pursuant to a tax avoidance plan. A loan will not be considered to occur in the ordinary course of the active conduct of complementary or integrated trades or businesses unless the loan is a trade receivable or the parties to the transaction are actively engaged in a banking, insurance, financing or similar trade or business and such business consists predominantly of transactions with customers who are not related persons. See *Example 17* of paragraph (e) of this section for an illustration of this factor.

(3) *Presumption if significant financing activities performed by a related intermediate entity*—(i) *General rule.* It shall be presumed that the participation of an intermediate entity (or entities) in a financing arrangement is not pursuant to a tax avoidance plan if the intermediate entity is related to either or both the financing entity or the financed entity and the intermediate entity performs significant financing activities with respect to the financing transactions forming part of the financing arrangement to which it is a party. This presumption may be rebutted if the district director establishes that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan. See *Examples 21*, *22* and *23* of paragraph (e) of this section for illustrations of this presumption.

(ii) *Significant financing activities.* For purposes of this paragraph (b)(3), an intermediate entity performs significant financing activities with respect to such financing transactions only if the financing transactions satisfy the requirements of either paragraph (b)(3)(ii)(A) or (B) of this section.

(A) *Active rents or royalties.* An intermediate entity performs significant financing activities with respect to leases or licenses if rents or royalties earned with respect to such leases or licenses are derived in the active conduct of a trade or business within the meaning of section 954(c)(2)(A), to be applied by substituting the term *intermediate* entity for the term *controlled foreign corporation.*

(B) *Active risk management*—(*1*) *In general.* An intermediate entity is considered to perform significant financing activities with respect to financing transactions only if officers and employees of the intermediate entity participate actively and materially in arranging the intermediate entity's participation in such financing transactions (other than financing transactions described in paragraph (b)(3)(ii)(*B*)(*3*) of this section) and perform the business activity and risk management activities described in paragraph (b)(3)(ii)(*B*)(*2*) of this section with respect to such financing transactions, and the participation of the intermediate entity in the financing transactions produces (or reasonably can be expected to produce) efficiency savings by reducing transaction costs and overhead and other fixed costs.

(*2*) *Business activity and risk management requirements.* An intermediate entity will be considered to perform significant financing activities only if, within the country in which the intermediate entity is organized (or, if different, within the country with respect to which the intermediate entity is claiming the benefits of a tax treaty), its officers and employees—

(*i*) Exercise management over, and actively conduct, the day-to-day operations of the intermediate entity. Such operations must consist of a substantial trade or business or the supervision, administration and financing for a substantial group of related persons; and

(*ii*) Actively manage, on an ongoing basis, material market risks arising from such financing transactions as an integral part of the management of the intermediate entity's financial and capital requirements (including management of risks of currency and interest rate fluctuations) and management of the intermediate entity's short-term investments of working capital by entering into transactions with unrelated persons.

(*3*) *Special rule for trade receivables and payables entered into in the ordinary course of business.* If the activities of the intermediate entity consist in whole or in part of cash management for a controlled group of which the intermediate entity is a member, then employees of the intermediate entity need not have participated in arranging any such financing transactions that arise in the ordinary course of a substantial trade or business of either the financed entity or the financing entity. Officers or employees of the financing entity or financed entity, however, must have participated actively and materially in arranging the transaction that gave rise to the trade receivable or trade payable. Cash management includes the operation of a sweep account whereby the intermediate entity nets intercompany trade payables and receivables arising from transactions among the other members of the controlled group and between members of the controlled group and unrelated persons.

(*4*) *Activities of officers and employees of related persons.* Except as provided in paragraph (b)(3)(ii)(B)(*3*) of this section, in applying this paragraph (b)(3)(ii)(B), the activities of an officer or employee of an intermediate entity will not constitute significant financing activities if any officer or employee of a related person participated materially in any of the activities described in this paragraph, other than to approve any guarantee of a financing transaction or to exercise general supervision and control over the policies of the intermediate entity.

(c) *Determination of whether an unrelated intermediate entity would not have participated in financing arrangement on substantially the same terms*—(1) *In general.* The determination of whether an intermediate entity would not have participated in a financing arrangement on substantially the same terms but for the financing transaction between the financing entity and the intermediate entity shall be based upon all of the facts and circumstances.

(2) *Effect of guarantee*—(i) *In general.* The district director may presume that the intermediate entity would not have participated in the financing arrangement on substantially the same terms if there is a guarantee of the financed entity's liability to the intermediate entity (or in the case of multiple intermediate entities, a guarantee of the intermediate entity's liability to the intermediate entity that advanced money or property, or granted rights to use other property). However, a guarantee that was neither in existence nor contemplated on the last date that any of the financing transactions comprising the financing arrangement is entered into does not give rise to this presumption. A taxpayer may rebut this presumption by producing clear and convincing evidence that the intermediate entity would have participated in the financing transaction with the financed entity on substantially the same terms even if the financing entity had not entered into a financing transaction with the intermediate entity.

(ii) *Definition of guarantee.* For the purposes of this paragraph (c)(2), a guarantee is any arrangement under which a person, directly or indirectly, assures, on a conditional or unconditional basis, the payment of another person's obligation with respect to a financing transaction. The term shall be interpreted in accordance with the definition of the term in section 163(j)(6)(D)(iii).

(d) *Determination of amount of tax liability*—(1) *Amount of payment subject to recharacterization*—(i) *In general.* If a financing arrangement is a conduit financing arrangement, a portion of each payment made by the financed entity with respect to the financing transactions that comprise the conduit financing arrangement shall be recharacterized as a transaction directly between the financed entity and the financing entity. If the aggregate principal amount of the financing transaction(s) to which the financed entity is a party is less than or equal to the aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement, the entire amount of the payment shall be so recharacterized. If the aggregate principal amount of the financing transaction(s) to which the financed entity is a party is greater than the aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement, then the recharacterized portion shall be determined by multiplying the payment by a fraction the numerator of which is equal to the lowest aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement (other than financing transactions that are disregarded pursuant to paragraphs (a)(2)(i)(B) and (a)(4)(ii)(B) of this section) and the denominator of which is the aggregate principal amount of the financing transaction(s) to which the financed entity is a party. In the case of financing transactions the principal amount of which is subject to adjustment, the fraction shall be determined using the average outstanding principal amounts for the period to which the payment relates. The average principal amount may be computed using any method applied consistently that reflects with reasonable accuracy the amount outstanding for the period. See *Example 24* of paragraph (e) of this section for an illustration of the calculation of the amount of tax liability.

(ii) *Determination of principal amount*—(A) *In general.* Unless otherwise provided in this paragraph (d)(1)(ii), the principal amount equals the amount of money advanced, or the fair market value of other property advanced or subject to a lease or license, in the financing transaction. In general, fair market value is calculated in U.S. dollars as of the close of business on the day on which the financing transaction is entered into. However, if the property advanced, or the right to use property granted, by the financing entity is the same as the property or rights received by the financed entity, the fair market value of the property or right shall be determined as of the close of business on the last date that any of the financing transactions comprising the financing arrangement is entered into. In the case of fungible property, property of the same type shall be considered to be the same property. See *Example 25* of paragraph (e) for an illustration of the calculation of the principal amount in the case of financing transactions involving fungible property. The principal amount of a financing transaction shall be subject to adjustments, as set forth in this paragraph (d)(1)(ii).

(B) *Debt instruments and certain stock.* In the case of a debt instrument or of stock that is subject to the current inclusion rules of sections 305(c)(3) or (e), the principal amount generally will be equal to the issue price. However, if the fair market value on the issue date differs materially from the issue price, the fair market value of the debt instrument shall be used in lieu of the instrument's issue price. Appropriate adjustments will be made for accruals of original issue discount and repayments of principal (including accrued original issue discount).

(C) *Partnership and trust interests.* In the case of a partnership interest or an interest in a trust, the principal amount is equal to the fair market value of the money or property contributed to the partnership or trust in return for that partnership or trust interest.

(D) *Leases or licenses.* In the case of a lease or license, the principal amount is equal to the fair market value of the property subject to the lease or license on the date on which the lease or license is entered into. The principal amount shall be adjusted for depreciation or amortization, calculated on a basis that accurately reflects the anticipated decline in the value of the property over its life.

(2) *Rate of tax.* The rate at which tax is imposed under section 881 on the portion of the payment that is recharacterized pursuant to paragraph

(d)(1) of this section is determined by reference to the nature of the recharacterized transaction, as determined under paragraphs (a)(3)(ii)(B) and (C) of this section.

(e) *Examples.* The following examples illustrate this section. For purposes of these examples, unless otherwise indicated, it is assumed that FP, a corporation organized in country N, owns all of the stock of FS, a corporation organized in country T, and DS, a corporation organized in the United States. Country T, but not country N, has an income tax treaty with the United States. The treaty exempts interest, rents and royalties paid by a resident of one state (the source state) to a resident of the other state from tax in the source state.

Example 1. Financing arrangement. (i) On January 1, 1996, BK, a bank organized in country T, lends $1,000,000 to DS in exchange for a note issued by DS. FP guarantees to BK that DS will satisfy its repayment obligation on the loan. There are no other transactions between FP and BK.

(ii) BK's loan to DS is a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section. FP's guarantee of DS's repayment obligation is not a financing transaction as described in paragraphs (a)(2)(ii)(A)(*1*) through (*4*) of this section. Therefore, these transactions do not constitute a financing arrangement as defined in paragraph (a)(2)(i) of this section.

Example 2. Financing arrangement. (i) On January 1, 1996, FP lends $1,000,000 to DS in exchange for a note issued by DS. On January 1, 1997, FP assigns the DS note to FS in exchange for a note issued by FS. After receiving notice of the assignment, DS remits payments due under its note to FS.

(ii) The DS note held by FS and the FS note held by FP are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section, and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section.

Example 3. Financing arrangement. (i) On December 1, 1994 FP creates a special purposes subsidiary, FS. On that date FP capitalizes FS with $1,000,000 in cash and $10,000,000 in debt from BK, a Country N bank. On January 1, 1995, C, a U.S. person, purchases an automobile from DS in return for an installment note. On August 1, 1995, DS sells a number of installment notes, including C's, to FS in exchange for $10,000,000. DS continues to service the installment notes for FS.

(ii) The C installment note now held by FS (as well as all of the other installment notes now held by FS) and the FS note held by BK are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section, and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section.

Example 4. Related persons treated as a single intermediate entity. (i) On January 1, 1996, FP deposits $1,000,000 with BK, a bank that is organized in country N and is unrelated to FP and its subsidiaries. M, a corporation also organized in country N, is wholly-owned by the sole shareholder of BK but is not a bank within the meaning of section 881(c)(3)(A). On July 1, 1996, M lends $1,000,000 to DS in exchange for a note maturing on July 1, 2006. The note is in registered form within the meaning of section 881(c)(2)(B)(i) and DS has received from M the statement required by section 881(c)(2)(B)(ii). One of the principal purposes for the absence of a financing transaction between BK and M is the avoidance of the application of this section.

(ii) The transactions described above would form a financing arrangement but for the absence of a financing transaction between BK and M. However, because one of the principal purposes for the structuring of these financing transactions is to prevent characterization of such arrangement as a financing arrangement, the district director may treat the financing transactions between FP and BK, and between M and DS as a financing arrangement under paragraphs (a)(2)(i)(B) of this section. In such a case, BK and M would be considered a single intermediate entity for purposes of this section. See also paragraph (a)(4)(ii)(B) of this section for the authority to treat BK and M as a single intermediate entity.

Example 5. Related persons treated as a single intermediate entity. (i) On January 1, 1995, FP lends $10,000,000 to FS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. On January 2, 1995, FS contributes $10,000,000 to FS2, a wholly-owned subsidiary of FS organized in country T, in exchange for common stock of FS2. On January 1, 1996, FS2 lends $10,000,000 to DS in exchange for an 8-year note that pays interest annually at a rate of 10 percent per annum. FS is a holding company whose most significant asset is the stock of FS2. Throughout the period that the FP–FS loan is outstanding, FS causes FS2 to make distributions to FS, most of which are used to make interest and principal payments on the FP–FS loan. Without the distributions from FS2, FS would not have had the funds with which to make payments on the FP–FS loan. One of the principal purposes for the absence of a financing transaction between FS and FS2 is the avoidance of the application of this section.

(ii) The conditions of paragraph (a)(4)(i)(A) of this section would be satisfied with respect to the financing transactions between

FP, FS, FS2 and DS but for the absence of a financing transaction between FS and FS2. However, because one of the principal purposes for the structuring of these financing transactions is to prevent characterization of an entity as a conduit, the district director may treat the financing transactions between FP and FS, and between FS2 and DS as a financing arrangement. See paragraph (a)(4)(ii)(B) of this section. In such a case, FS and FS2 would be considered a single intermediate entity for purposes of this section. See also paragraph (a)(2)(i)(B) of this section for the authority to treat FS and FS2 as a single intermediate entity.

Example 6. Presumption with respect to unrelated financing entity. (i) FP is a corporation organized in country T that is actively engaged in a substantial manufacturing business. FP has a revolving credit facility with a syndicate of banks, none of which is related to FP and FP's subsidiaries, which provides that FP may borrow up to a maximum of $100,000,000 at a time. The revolving credit facility provides that DS and certain other subsidiaries of FP may borrow directly from the syndicate at the same interest rates as FP, but each subsidiary is required to indemnify the syndicate banks for any withholding taxes imposed on interest payments by the country in which the subsidiary is organized. BK, a bank that is organized in country N, is the agent for the syndicate. Some of the syndicate banks are organized in country N, but others are residents of country O, a country that has an income tax treaty with the United States which allows the United States to impose a tax on interest at a maximum rate of 10 percent. It is reasonable for BK and the syndicate banks to have determined that FP will be able to meet its payment obligations on a maximum principal amount of $100,000,000 out of the cash flow of its manufacturing business. At various times throughout 1995, FP borrows under the revolving credit facility until the outstanding principal amount reaches the maximum amount of $100,000,000. On December 31, 1995, FP receives $100,000,000 from a public offering of its equity. On January 1, 1996, FP pays BK $90,000,000 to reduce the outstanding principal amount under the revolving credit facility and lends $10,000,000 to DS. FP would have repaid the entire principal amount, and DS would have borrowed directly from the syndicate, but for the fact that DS did not want to incur the U.S. withholding tax that would have applied to payments made directly by DS to the syndicate banks.

(ii) Pursuant to paragraph (a)(3)(ii)(E)(*1*) of this section, even though the financing arrangement is a conduit financing arrangement (because the financing arrangement meets the standards for recharacterization in paragraph (a)(4)(i)), BK and the other syndicate banks have no section 881 liability unless they know or have reason to know that the financing arrangement is a conduit financing arrangement. Moreover, pursuant to paragraph (a)(3)(ii)(E)(*2*)(*ii*) of this section, BK and the syndicate banks are presumed not to know that the financing arrangement is a conduit financing arrangement. The syndicate banks are unrelated to both FP and DS, and FP is actively engaged in a substantial trade or business—that is, the cash flow from FP's manufacturing business is sufficient for the banks to expect that FP will be able to make the payments required under the financing transaction. See § 1.1441–3(j) for the withholding obligations of the withholding agents.

Example 7. Multiple intermediate entities—special rule for related persons. (i) On January 1, 1995, FP lends $10,000,000 to FS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. On January 2, 1995, FS contributes $9,900,000 to FS2, a wholly-owned subsidiary of FS organized in country T, in exchange for common stock and lends $100,000 to FS2. On January 1, 1996, FS2 lends $10,000,000 to DS in exchange for an 8-year note that pays interest annually at a rate of 10 percent per annum. FS is a holding company that has no significant assets other than the stock of FS2. Throughout the period that the FP–FS loan is outstanding, FS causes FS2 to make distributions to FS, most of which are used to make interest and principal payments on the FP–FS loan. Without the distributions from FS2, FS would not have had the funds with which to make payments on the FP–FS loan. One of the principal purposes for structuring the transactions between FS and FS2 as primarily a contribution of capital is to reduce the amount of the payment that would be recharacterized under paragraph (d) of this section.

(ii) Pursuant to paragraph (a)(4)(ii)(B) of this section, the district director may treat FS and FS2 as a single intermediate entity for purposes of this section since one of the principal purposes for the participation of multiple intermediate entities is to reduce the amount of the tax liability on any recharacterized payment by inserting a financing transaction with a low principal amount.

Example 8. Multiple intermediate entities. (i) On January 1, 1995, FP deposits $1,000,000 with BK, a bank that is organized in country T and is unrelated to FP and its subsidiaries, FS and DS. On January 1, 1996, at a time when the FP–BK deposit is still outstanding, BK lends $500,000 to BK2, a bank that is wholly-owned by BK and is organized in country T. On the same date, BK2 lends $500,000 to FS. On July 1, 1996, FS lends $500,000 to DS. FP pledges its deposit with BK to BK2 in support of FS' obligation to repay the BK2 loan. FS', BK's and BK2's participation in the financing arrangement is pursuant to a tax avoidance plan.

(ii) The conditions of paragraphs (a)(4)(i)(A) and (B) of this section are satisfied because the participation of BK, BK2 and FS in the financing arrangement reduces the tax imposed by section 881, and FS', BK's and BK2's participation in the financing arrangement is pursuant to a tax avoidance plan. However, since BK and BK2 are unrelated to FP and DS, under paragraph (a)(4)(i)(C)(*2*) of this section, BK and BK2 will be treated as conduit entities only if BK and BK2 would not have participated in the financing arrangement on substantially the same terms but for the financing transaction between FP and BK.

(iii) It is presumed that BK2 would not have participated in the financing arrangement on substantially the same terms but for the BK–BK2 financing transaction because FP's pledge of an asset in support of FS' obligation to repay the BK2 loan is a guarantee within the meaning of paragraph (c)(2)(ii) of this section. If the taxpayer does not rebut this presumption by clear and convincing evidence, then BK2 will be a conduit entity.

(iv) Because BK and BK2 are related intermediate entities, the district director must determine whether one of the principal purposes for the involvement of multiple intermediate entities was to prevent characterization of an entity as a conduit entity. In making this determination, the district director may consider the fact that the involvement of two related intermediate entities prevents the presumption regarding guarantees from applying to BK. In the absence of evidence showing a business purpose for the involvement of both BK and BK2, the district director may treat BK and BK2 as a single intermediate entity for purposes of determining whether they would have participated in the financing arrangement on substantially the same terms but for the financing transaction between FP and BK. The presumption that applies to BK2 therefore will apply to BK. If the taxpayer does not rebut this presumption by clear and convincing evidence, then BK will be a conduit entity.

Example 9. Reduction of tax. (i) On February 1, 1995, FP issues debt to the public that would satisfy the requirements of section 871(h)(2)(A) (relating to obligations that are not in registered form) if issued by a U.S. person. FP lends the proceeds of the debt offering to DS in exchange for a note.

(ii) The debt issued by FP and the DS note are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. The holders of the FP debt are the financing entities, FP is the intermediate entity and DS is the financed entity. Because interest payments on the debt issued by FP would not have been subject to withholding tax if the debt had been issued by DS, there is no reduction in tax under paragraph (a)(4)(i)(A) of this section. Accordingly, FP is not a conduit entity.

Example 10. Reduction of tax. (i) On January 1, 1995, FP licenses to FS the rights to use a patent in the United States to manufacture product A. FS agrees to pay FP a fixed amount in royalties each year under the license. On January 1, 1996, FS sublicenses to DS the rights to use the patent in the United States. Under the sublicense, DS agrees to pay FS royalties based upon the units of product A manufactured by DS each year. Although the formula for computing the amount of royalties paid by DS to FS differs from the formula for computing the amount of royalties paid by FS to FP, each represents an arm's length rate.

(ii) Although the royalties paid by DS to FS are exempt from U.S. withholding tax, the royalty payments between FS and FP are income from U.S. sources under section 861(a)(4) subject to the 30 percent gross tax imposed by §1.881–2(b) and subject to withholding under §1.1441–2(a). Because the rate of tax imposed on royalties paid by FS to FP is the same as the rate that would have been imposed on royalties paid by DS to FP, the participation of FS in the FP–FS–DS financing arrangement does not reduce the tax imposed by section 881 within the meaning of paragraph (a)(4)(i)(A) of this section. Accordingly, FP is not a conduit entity.

Example 11. A principal purpose. (i) On January 1, 1995, FS lends $10,000,000 to DS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. As was intended at the time of the loan from FS to DS, on July 1, 1995, FP makes an interest-free demand loan of $10,000,000 to FS. A principal purpose for FS' participation in the FP–FS–DS financing arrangement is that FS generally coordinates the financing for all of FP's subsidiaries (although FS does not engage in significant financing activities with respect to such financing transactions). However, another principal purpose for FS' participation is to allow the parties to benefit from the lower withholding tax rate provided under the income tax treaty between country T and the United States.

(ii) The financing arrangement satisfies the tax avoidance purpose requirement of paragraph (a)(4)(i)(B) of this section because FS participated in the financing arrangement pursuant to a plan one of the principal purposes of which is to allow the parties to benefit from the country T-U.S. treaty.

Example 12. A principal purpose. (i) DX is a U.S. corporation that intends to purchase property to use in its manufacturing business. FX is a partnership organized in country N that is owned in equal parts by LC1 and LC2, leasing companies that are unrelated to DX. BK, a bank organized in country N and unrelated to DX, LC1 and LC2, lends $100,000,000 to FX to enable FX to purchase the property. On the same day, FX purchases the property and engages in a transaction with DX which is treated as a lease of the property for country N tax purposes but a loan for U.S. tax purposes. Accordingly, DX is treated as the owner of the property for U.S. tax purposes. The parties comply with the requirements of section 881(c) with respect to the debt obligation of DX to FX. FX and DX structured these transactions in this manner so that LC1 and LC2 would be entitled to accelerated depreciation deductions with respect to the property in country N and DX would be entitled to accelerated depreciation deductions in the United States. None of the parties would have participated in the transaction if the payments made by DX were subject to U.S. withholding tax.

(ii) The loan from BK to FX and from FX to DX are financing transactions and, together constitute a financing arrangement. The participation of FX in the financing arrangement reduces the tax imposed by section 881 because payments made to FX, but not BK, qualify for the portfolio interest exemption of section 881(c) because BK is a bank making an extension of credit in the ordinary course of its trade or business within the meaning of section 881(c)(3)(A). Moreover, because DX borrowed the money from FX instead of borrowing the money directly from BK to avoid the tax imposed by section 881, one of the principal purposes of the participation of FX was to avoid that tax (even though another principal purpose of the participation of FX was to allow LC1 and LC2 to take advantage of accelerated depreciation deductions in country N). Assuming that FX would not have participated in the financing arrangement on substantially the same terms but for the fact that BK loaned it $100,000,000, FX is a conduit entity and the financing arrangement is a conduit financing arrangement.

Example 13. Significant reduction of tax. (i) FS owns all of the stock of FS1, which also is a resident of country T. FS1 owns all of the stock of DS. On January 1, 1995, FP contributes $10,000,000 to the capital of FS in return for perpetual preferred stock. On July 1, 1995, FS lends $10,000,000 to FS1. On January 1, 1996, FS1 lends $10,000,000 to DS. Under the terms of the country T-U.S. income tax treaty, a country T resident is not entitled to the reduced withholding rate on interest income provided by the treaty if the resident is entitled to specified tax benefits under country T law. Although FS1 may deduct interest paid on the loan from FS, these deductions are not pursuant to any special tax benefits provided by country T law. However, FS qualifies for one of the enumerated tax benefits pursuant to which it may deduct dividends paid with respect to the stock held by FP. Therefore, if FS had made a loan directly to DS, FS would not have been entitled to the benefits of the country T-U.S. tax treaty with respect to payments it received from DS, and such payments would have been subject to tax under section 881 at a 30 percent rate.

(ii) The FS–FS1 loan and the FS1–DS loan are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. Pursuant to paragraph (b)(2)(i) of this section, the significant reduction in tax resulting from the participation of FS1 in the financing arrangement is evidence that the participation of FS1 in the financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account.

Example 14. Significant reduction of tax. (i) FP owns 90 percent of the voting stock of FX, an unlimited liability company organized in country T. The other 10 percent of the common stock of FX is owned by FP1, a subsidiary of FP that is organized in country N. Although FX is a partnership for U.S. tax purposes, FX is entitled to the benefits of the U.S.-country T income tax treaty because FX is subject to tax in country T as a resident corporation. On January 1, 1996, FP contributes $10,000,000 to FX in exchange for an instrument denominated as preferred stock that pays a dividend of 7 percent and that must be redeemed by FX in seven years. For U.S. tax purposes, the preferred stock is a partnership interest. On July 1, 1996, FX makes a loan of $10,000,000 to DS in exchange for a 7-year note paying interest at 6 percent.

(ii) Because FX is required to redeem the partnership interest at a specified time, the partnership interest constitutes a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(*2*) of this section. Moreover, because the FX-DS note is a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section, together the transactions constitute a financing arrangement within the meaning of (a)(2)(i) of this section. Payments of interest made directly by DS to FP and FP1 would not be eligible for the portfolio interest exemption and would not be entitled to a reduction in withholding tax pursuant to a tax treaty. Therefore, there is a significant reduction in tax resulting from the participation of FX in the financing arrangement, which is evidence that the participation of FX in the financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the existence of such a plan must also be taken into account.

Example 15. Significant reduction of tax. (i) FP owns a 10 percent interest in the profits and capital of FX, a partnership organized in country N. The other 90 percent interest in FX is owned by G, an unrelated corporation that is organized in country T. FX is not engaged in business in the United States. On January 1, 1996, FP contributes $10,000,000 to FX in exchange for an instrument documented as perpetual subordinated debt that provides for quarterly interest payments at 9 percent per annum. Under the terms of the instrument, payments on the perpetual subordinated debt do not otherwise affect the allocation of income between the partners. FP has the right to require the liquidation of FX if FX fails to make an interest payment. For U.S. tax purposes, the perpetual subordinated debt is treated as a partnership interest in FX and the payments on the perpetual subordinated debt constitute guaranteed payments within the meaning of section 707(c). On July 1, 1996, FX makes a loan of $10,000,000 to DS in exchange for a 7-year note paying interest at 8 percent per annum.

(ii) Because FP has the effective right to force payment of the ''interest'' on the perpetual subordinated debt, the instrument constitutes a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(*2*) of this section. Moreover, because the note between FX and DS is a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section, together the transactions are a financing arrangement within the meaning of (a)(2)(i) of this section. Without regard to this section, 90 percent of each interest payment received by FX would be treated as exempt from U.S. withholding tax because it is beneficially owned by G, while 10 percent would be subject to a 30 percent withholding tax because beneficially owned by FP. If FP held directly the note issued by DS, 100 percent of the interest payments on the note would have been subject to the 30 percent withholding tax. The significant reduction in the tax imposed by section 881 resulting from the participation of FX in the financing arrangement is evidence that the participation of FX in the financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account.

Example 16. Time period between transactions. (i) On January 1, 1995, FP lends $10,000,000 to FS in exchange for a 10-year note that pays no interest annually. When the note matures, FS is obligated to pay $24,000,000 to FP. On January 1, 1996, FS lends $10,000,000 to DS in exchange for a 10-year note that pays interest annually at a rate of 10 percent per annum.

(ii) The FS note held by FP and the DS note held by FS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of (a)(2)(i) of this section. Pursuant to paragraph (b)(2)(iii) of this section, the short period of time (twelve months) between the loan by FP to FS and the loan by FS to DS is evidence that the participation of FS in the financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account.

Example 17. Financing transactions in the ordinary course of business. (i) FP is a holding company. FS is actively engaged in country T in the business of manufacturing and selling product A. DS manufactures product B, a principal component in which is product A. FS' business activity is substantial. On January 1, 1995, FP lends $100,000,000 to FS to finance FS' business operations. On January 1, 1996, FS ships $30,000,000 of product A to DS. In return, FS creates an interest-bearing account receivable on its books. FS' shipment is in the ordinary course of the active conduct of its trade or business (which is complementary to DS' trade or business.)

(ii) The loan from FP to FS and the accounts receivable opened by FS for a payment owed by DS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. Pursuant to paragraph (b)(2)(iv) of this section, the fact that DS' liability to FS is created in the ordinary course of the active conduct of DS' trade or business that is complementary to a business actively engaged in by DS is evidence that the participation of FS in the financing arrangement is not pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account.

Example 18. Tax avoidance plan—other factors. (i) On February 1, 1995, FP issues debt in Country N that is in registered form within the meaning of section 881(c)(3)(A). The FP debt would satisfy the requirements of section 881(c) if the debt were issued by a U.S. person and the withholding agent received the certification required by section 871(h)(2)(B)(ii). The purchasers of the debt are financial institutions and there is no reason to believe that they would not furnish Forms W–8. On March 1, 1995, FP lends a portion of the proceeds of the offering to DS.

(ii) The FP debt and the loan to DS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. The owners of the FP debt are the financing entities, FP is the intermediate entity and DS is the financed entity. Interest payments on the debt issued by FP would be subject to withholding tax if the debt were issued by DS, unless DS received all necessary Forms W–8. Therefore, the participation of FP in the financing arrangement potentially reduces the tax imposed by section 881(a). However, because it is reasonable to assume that the purchasers of the FP debt would have provided certifications in order to avoid the withholding tax imposed by section 881, there is not a tax avoidance plan. Accordingly, FP is not a conduit entity.

Example 19. Tax avoidance plan—other factors. (i) Over a period of years, FP has maintained a deposit with BK, a bank organized in the United States, that is unrelated to FP and its subsidiaries. FP often sells goods and purchases raw materials in the United States. FP opened the bank account with BK in order to facilitate this business and the amounts it maintains in the account are reasonably related to its dollar-denominated working capital needs. On January 1, 1995, BK lends $5,000,000 to DS. After the loan is made, the balance in FP's bank account remains within a range appropriate to meet FP's working capital needs.

(ii) FP's deposit with BK and BK's loan to DS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. Pursuant to section 881(i), interest paid by BK to FP with respect to the bank deposit is exempt from withholding tax. Interest paid directly by DS to FP would not be exempt from withholding tax under section 881(i) and therefore would be subject to a 30% withholding tax. Accordingly, there is a significant reduction in the tax imposed by section 881, which is evidence of the existence of a tax avoidance plan. See paragraph (b)(2)(i) of this section. However, the district director also will consider the fact that FP historically has maintained an account with BK to meet its working capital needs and that, prior to and after BK's loan to DS, the balance within the account remains within a range appropriate to meet those business needs as evidence that the participation of BK in the FP–BK–DS financing arrangement is not pursuant to a tax avoidance plan. In determining the presence or absence of a tax avoidance plan, all relevant facts will be taken into account.

Example 20. Tax avoidance plan—other factors. (i) Assume the same facts as in *Example 19,* except that on January 1, 2000, FP's deposit with BK substantially exceeds FP's expected working capital needs and on January 2, 2000, BK lends additional funds to DS. Assume also that BK's loan to DS provides BK with a right of offset against FP's deposit. Finally, assume that FP would have lent the funds to DS directly but for the imposition of the withholding tax on payments made directly to FP by DS.

(ii) As in *Example 19,* the transactions in paragraph (i) of this *Example 20* are a financing arrangement within the meaning of paragraph (a)(2)(i) and the participation of the BK reduces the section 881 tax. In this case, the presence of funds substantially in excess of FP's working capital needs and the fact that FP would have been willing to lend funds directly to DS if not for the withholding tax are evidence that the participation of BK in the FP-BK-FS financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account. Even if the district director determines that the participation of BK in the financing arrangement is pursuant to a tax avoidance plan, BK may not be treated as a conduit entity unless BK would not have participated in the financing arrangement on substantially the same terms in the absence of FP's deposit with BK. BK's right of offset against FP's deposit (a form of guarantee of BK's loan to DS) creates a presumption that BK would not have made the loan to DS on substantially the same terms in the absence of FP's deposit with BK. If the taxpayer overcomes the presumption by clear and convincing evidence, BK will not be a conduit entity.

Example 21. Significant financing activities. (i) FS is responsible for coordinating the financing of all of the subsidiaries of FP, which are engaged in substantial trades or businesses and are located in country T, country N, and the United States. FS maintains a centralized cash management accounting system for FP and its subsidiaries in which it records all intercompany payables and receivables; these payables and receivables ultimately are reduced to a single balance either due from or owing to FS and each of FP's subsidiaries. FS is responsible for disbursing or receiving any cash payments required by transactions between its affiliates and unrelated parties. FS must borrow any cash necessary to meet those external obligations and invests any excess cash for the benefit of the FP group. FS enters into interest rate and foreign exchange contracts as necessary to manage the risks arising from mismatches in incoming and outgoing cash flows. The activities of FS are intended (and reasonably can be expected) to reduce transaction costs and overhead and other fixed costs. FS has 50 employees, including clerical and other back office personnel, located in country T. At the request of DS, on January 1, 1995, FS pays a supplier $1,000,000 for materials delivered to DS and charges DS an open account receivable for this amount. On February 3, 1995, FS reverses the account receivable from DS to FS when DS delivers to FP goods with a value of $1,000,000.

(ii) The accounts payable from DS to FS and from FS to other subsidiaries of FP constitute financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section, and the transactions together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. FS's activities constitute significant financing activities with respect to the financing transactions even though FS did not actively and materially participate in arranging the financing transactions because the financing transactions consisted of trade receivables and trade payables that were ordinary and necessary to carry on the trades or businesses of DS and the other subsidiaries of FP. Accordingly, pursuant to paragraph (b)(3)(i) of this section, FS' participation in the financing arrangement is presumed not to be pursuant to a tax avoidance plan.

Example 22. Significant financing activities—active risk management. (i) The facts are the same as in Example 21, except that, in addition to its short-term funding needs, DS needs long-term financing to fund an acquisition of another U.S. company; the acquisition is scheduled to close on January 15, 1995. FS has a revolving credit agreement with a syndicate of banks located in Country N. On January 14, 1995, FS borrows ¥10 billion for 10 years under the revolving credit agreement, paying yen LIBOR plus 50 basis points on a quarterly basis. FS enters into a currency swap with BK, an unrelated bank that is not a member of the syndicate, under which FS will pay BK ¥10 billion and will receive $100 million on January 15, 1995; these payments will be reversed on January 15, 2004. FS will pay BK U.S. dollar LIBOR plus 50 basis points on a notional principal amount of $100 million semi-annually and will receive yen LIBOR plus 50 basis points on a notional principal amount of ¥10 billion quarterly. Upon the closing of the acquisition on January 15, 1995, DS borrows $100 million from FS for 10 years, paying U.S. dollar LIBOR plus 50 basis points semiannually.

(ii) Although FS performs significant financing activities with respect to certain financing transactions to which it is a party, FS does not perform significant financing activities with respect to the financing transactions between FS and the syndicate of banks and between FS and DS because FS has eliminated all material market risks arising from those financing transactions through its currency swap with BK. Accordingly, the financing arrangement does not benefit from the presumption of paragraph (b)(3)(i) of this section and the district director must determine whether the participation of FS in the financing arrangement is pursuant to a tax avoidance plan on the basis of all the facts and circumstances. However, if additional facts indicated that FS reviews its currency swaps daily to determine whether they are the most cost efficient way of managing their currency risk and, as a result, frequently terminates swaps in favor of entering into more cost efficient hedging arrangements with unrelated parties, FS would be considered to perform significant financing activities and FS' participation in the financing arrangements would not be pursuant to a tax avoidance plan.

Example 23. Significant financing activities—presumption rebutted. (i) The facts are the same as in *Example 21*, except that, on January 1, 1995, FP lends to FS DM 15,000,000 (worth $10,000,000) in exchange for a 10 year note that pays interest annually at a rate of 5 percent per annum. Also, on March 15, 1995, FS lends $10,000,000 to DS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. FS would not have had sufficient funds to make the loan to DS without the loan from FP. FS does not enter into any long-term hedging transaction with respect to these financing transactions, but manages the interest rate and currency risk arising from the transactions on a daily, weekly or quarterly basis by entering into forward currency contracts.

(ii) Because FS performs significant financing activities with respect to the financing transactions between FS, DS and FP, the participation of FS in the financing arrangement is presumed not to be pursuant to a tax avoidance plan. The district director may rebut this presumption by establishing that the participation of FS is pursuant to a tax avoidance plan, based on all the facts and circumstances. The mere fact that FS is a resident of country T is not sufficient to establish the existence of a tax avoidance plan. However, the existence of a plan can be inferred from other factors in addition to the fact that FS is a resident of country T. For example, the loans are made within a short time period and FS would not have been able to make the loan to DS without the loan from FP.

Example 24. Determination of amount of tax liability. (i) On January 1, 1996, FP makes two three-year installment loans of $250,000 each to FS that pay interest at a rate of 9 percent per annum. The loans are self-amortizing with payments on each loan of $7,950 per month. On the same date, FS lends $1,000,000 to DS in exchange for a two-year note that pays interest semi-annually at a rate of 10 percent per annum, beginning on June 30, 1996. The FS-DS loan is not self-amortizing. Assume that for the period of January 1, 1996 through June 30, 1996, the average principal amount of the financing transactions between FP and FS that comprise the financing arrangement is $469,319. Further, assume that for the period of July 1, 1996 through December 31, 1996, the average principal amount of the financing transactions between FP and FS is $393,632. The average principal amount of the financing transaction between FS and DS for the same periods is $1,000,000. The district director determines that the financing transactions between FP and FS, and FS and DS, are a conduit financing arrangement.

(ii) Pursuant to paragraph (d)(1)(i) of this section, the portion of the $50,000 interest payment made by DS to FS on June 30, 1996, that is recharacterized as a payment to FP is

$23,450 computed as follows: ($50,000 x $469,319/$1,000,000) = $23,450. The portion of the interest payment made on December 31, 1996 that is recharacterized as a payment to FP is $19,650, computed as follows: ($50,000 x $393,632/$1,000,000) = $19,650. Furthermore, under § 1.1441–3(j), DS is liable for withholding tax at a 30 percent rate on the portion of the $50,000 payment to FS that is recharacterized as a payment to FP, i.e., $7,035 with respect to the June 30, 1996 payment and $5,895 with respect to the December 31, 1996 payment.

Example 25. Determination of principal amount. (i) FP lends DM 5,000,000 to FS in exchange for a ten year note that pays interest semi-annually at a rate of 8 percent per annum. Six months later, pursuant to a tax avoidance plan, FS lends DM 10,000,000 to DS in exchange for a 10 year note that pays interest semi-annually at a rate of 10 percent per annum. At the time FP make its loan to FS, the exchange rate is DM 1.5/$1. At the time FS makes its loan to DS the exchange rate is DM 1.4/$1.

(ii) FP's loan to FS and FS' loan to DS are financing transactions and together constitute a financing arrangement. Furthermore, because the participation of FS reduces the tax imposed under section 881 and FS' participation is pursuant to a tax avoidance plan, the financing arrangement is a conduit financing arrangement.

(iii) Pursuant to paragraph (d)(1)(i) of this section, the amount subject to recharacterization is a fraction the numerator of which is the lowest aggregate principal amount advanced and the denominator of which is the principal amount advanced from FS to DS. Because the property advanced in these financing transactions is the same type of fungible property, under paragraph (d)(1)(ii)(A) of this section, both are valued on the date of the last financing transaction. Accordingly, the portion of the payments of interest that is recharacterized is ((DM 5,000,000×DM 1.4/$1)/(DM 10,000,000×DM 1.4/$1) or 0.5.

(f) *Effective date.* This section is effective for payments made by financed entities on or after September 11, 1995. This section shall not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest payments with respect to other debt obligations issued prior to October 15, 1984 (whether or not such debt was issued by a Netherlands Antilles corporation).

[T.D. 8611, 60 FR 41005, Aug. 11, 1995; 60 FR 55312, Oct. 31, 1995; 63 FR 67578, Dec. 8, 1998]

§ 1.881–4 Recordkeeping requirements concerning conduit financing arrangements.

(a) *Scope.* This section provides rules for the maintenance of records concerning certain financing arrangements to which the provisions of § 1.881–3 apply.

(b) *Recordkeeping requirements*—(1) *In general.* Any person subject to the general recordkeeping requirements of section 6001 must keep the permanent books of account or records, as required by section 6001, that may be relevant to determining whether that person is a party to a financing arrangement and whether that financing arrangement is a conduit financing arrangement.

(2) *Application of Sections 6038 and 6038A.* A financed entity that is a reporting corporation within the meaning of section 6038A(a) and the regulations under that section, and any other person that is subject to the recordkeeping requirements of § 1.6038A–3, must comply with those recordkeeping requirements with respect to records that may be relevant to determining whether the financed entity is a party to a financing arrangement and whether that financing arrangement is a conduit financing arrangement. Such records, including records that a person is required to maintain pursuant to paragraph (c) of this section, shall be considered records that are required to be maintained pursuant to section 6038 or 6038A. Accordingly, the provisions of sections 6038 and 6038A (including, without limitation, the penalty provisions thereof), and the regulations under those sections, shall apply to any records required to be maintained pursuant to this section.

(c) *Records to be maintained*—(1) *In general.* An entity described in paragraph (b) of this section shall be required to retain any records containing the following information concerning each financing transaction that the entity knows or has reason to know comprises the financing arrangement—

(i) The nature (e.g., loan, stock, lease, license) of each financing transaction;

(ii) The name, address, taxpayer identification number (if any) and country of residence of—

(A) Each person that advanced money or other property, or granted rights to use property;

(B) Each person that was the recipient of the advance or rights; and

(C) Each person to whom a payment was made pursuant to the financing transaction (to the extent that person is a different person than the person who made the advance or granted the rights);

(iii) The date and amount of—

(A) Each advance of money or other property or grant of rights; and

(B) Each payment made in return for the advance or grant of rights;

(iv) The terms of any guarantee provided in conjunction with a financing transaction, including the name of the guarantor; and

(v) In cases where one or both of the parties to a financing transaction are related to each other or another entity in the financing arrangement, the manner in which these persons are related.

(2) *Additional documents.* An entity described in paragraph (b) of this section must also retain all records relating to the circumstances surrounding its participation in the financing transactions and financing arrangements. Such documents may include, but are not limited to—

(i) Minutes of board of directors meetings;

(ii) Board resolutions or other authorizations for the financing transactions;

(iii) Private letter rulings;

(iv) Financial reports (audited or unaudited);

(v) Notes to financial statements;

(vi) Bank statements;

(vii) Copies of wire transfers;

(viii) Offering documents;

(ix) Materials from investment advisors, bankers and tax advisors; and

(x) Evidences of indebtedness.

(3) *Effect of record maintenance requirement.* Record maintenance in accordance with paragraph (b) of this section generally does not require the original creation of records that are ordinarily not created by affected entities. If, however, a document that is actually created is described in this paragraph (c), it is to be retained even if the document is not of a type ordinarily created by the affected entity.

(d) *Effective date.* This section is effective September 11, 1995. This section shall not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest payments with respect to other debt obligations issued prior to October 15, 1984 (whether or not such debt was issued by a Netherlands Antilles corporation).

[T.D. 8611, 60 FR 41014, Aug. 11, 1995]

§1.882–0 Table of contents.

This section lists captions contained in §§1.882–1, 1.882–2, 1.882–3, 1.882–4 and 1.882–5.

§1.882–1 Taxation of foreign corporations engaged in U.S. business or of foreign corporations treated as having effectively connected income.

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(b) Imposition of tax.
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(c) Change in trade or business status.
(d) Credits against tax.
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§1.882–2 Income of foreign corporation treated as effectively connected with U.S. business.

(a) Election as to real property income.
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§1.882–3 Gross income of a foreign corporation.

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[T.D. 8658, 61 FR 9329, Mar. 8, 1996; 61 FR 15891, Apr. 10, 1996]

§1.882–1 Taxation of foreign corporations engaged in U.S. business or of foreign corporations treated as having effectively connected income.

(a) *Segregation of income.* This section applies for purposes of determining the tax of a foreign corporation which at any time during the taxable year is engaged in trade or business in the United States. It also applies for purposes of determining the tax of a foreign corporation which at no time during the taxable year is engaged in trade or business in the United States but has for the taxable year real property income or interest on obligations of the United States which, by reason of section 882 (d) or (e) and §1.882–2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. A foreign corporation to which this section applies must segregate its gross income for the taxable year into two categories, namely, the income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation and the income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. A separate tax shall then be determined upon each such category of income, as provided in paragraph (b) of this section. The determination of whether income or gain is or is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the foreign corporation shall be made in accordance with section 864(c) and §§1.864–3 through 1.864–7. For purposes of this section income which is effectively connected for the taxable year with the conduct of a trade or business in the United States includes all income which is treated under section 882 (d) or (e) and §1.882–2 as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by the foreign corporation.

(b) *Imposition of tax*—(1) *Income not effectively connected with the conduct of a trade or business in the United States.* If a foreign corporation to which this section applies derives during the taxable year from sources within the United States income or gains described in section 881(a) and paragraph (b) or (c) of §1.881–2 which are not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation, such income or gains shall be subject to a flat tax of 30 percent of the aggregate amount of such items. This tax shall be determined in the manner, and subject to the same conditions, set forth in §1.881–2 as though the income or gains were derived by a foreign corporation not engaged in trade or business in the United States during the taxable year, except that in applying paragraph (c) of such section there shall not be taken into account any gains which are taken into account in determining the tax under section 882(a)(1) and subparagraph (2) of this paragraph.

(2) *Income effectively connected with the conduct of a trade or business in the United States*—(i) *In general.* If a foreign corporation to which this section applies derives income or gains which are effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation, the taxable income or gains shall, except as provided in §1.871–12, be taxed in accordance with section 11 or, in the alternative, section 1201(a). See sections 11(f) and 882(a)(1). Any income of the foreign corporation which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation shall not be taken into account in determining either the rate or amount of such tax.

(ii) *Determination of taxable income.* The taxable income for any taxable year for purposes of this subparagraph consists only of the foreign corporation's taxable income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation; and, for this purpose, it is immaterial that the trade or business with which that income is effectively connected is not the same as the trade or business carried on in the United States by that corporation during the taxable year. See example 2 in §1.864–

4(b). In determining such taxable income all amounts constituting, or considered to be, gains or losses for the taxable year from the sale or exchange of capital assets shall be taken into account if such gains or losses are effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation.

(iii) *Cross references.* For rules for determining the gross income and deductions for the taxable year, see section 882 (b) and (c)(1) and the regulations thereunder.

(c) *Change in trade or business status.* The principles of paragraph (c) of § 1.871–8 shall apply to cases where there has been a change in the trade or business status of a foreign corporation.

(d) *Credits against tax.* The credits allowed by section 32 (relating to tax withheld at source on foreign corporations), section 33 (relating to the foreign tax credit), section 38 (relating to investment in certain depreciable property), section 39 (relating to certain uses of gasoline and lubricating oil), section 40 (relating to expenses of work incentive programs), and section 6042 (relating to overpayments of a tax) shall be allowed against the tax determined in accordance with this section. However, the credits allowed by sections 33, 38, and 40 shall not be allowed against the flat tax of 30 percent imposed by section 881(a) and paragraph (b)(1) of this section. For special rules applicable in determining the foreign tax credit, see section 906(b) and the regulations thereunder. For the disallowance of certain credits where a return is not filed for the taxable year see section 882(c)(2) and the regulations thereunder.

(e) *Payment of estimated tax.* Every foreign corporation which for the taxable year is subject to tax under section 11 or 1201(a) and this section must make payment of its estimated tax in accordance with section 6154 and the regulations thereunder. In determining the amount of the estimated tax the foreign corporation must treat the tax imposed by section 881(a) and paragraph (b)(1) of this section as though it were a tax imposed by section 11.

(f) *Effective date.* This section applies for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.882–1 (Revised as of January 1, 1971).

[T.D. 7293, 38 FR 32797, Nov. 28, 1973]

§ 1.882–2 Income of foreign corporations treated as effectively connected with U.S. business.

(a) *Election as to real property income.* A foreign corporation which during the taxable year derives any income from real property which is located in the United States, or derives income from any interest in any such real property, may elect, pursuant to section 882(d) and § 1.871–10, to treat all such income as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. The election may be made whether or not the foreign corporation is engaged in trade or business in the United States during the taxable year for which the election is made or whether or not the corporation has income from real property which for the taxable year is effectively connected with the conduct of a trade or business in the United States, but it may be made only with respect to income from sources within the United States which, without regard to section 882(d) and § 1.871–10, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. The income to which the election applies shall be determined as provided in paragraph (b) of § 1.871–10 and shall be subject to tax in the manner, and subject to the same conditions, provided by section 882(a)(1) and paragraph (b)(2) of § 1.882–1. Section 871(d) (2) and (3) and the provisions of § 1.871–10 thereunder shall apply in respect of an election under section 882(d) in the same manner and to the same extent as they apply in respect of elections under section 871(d).

(b) *Interest on U.S. obligations received by banks organized in possessions.* Interest received from sources within the United States during the taxable year on obligations of the United States by a foreign corporation created or organized in, or under the law of, a possession of the United States and carrying on the banking business in a possession of the United States during the taxable year shall be treated, pursuant to section 882(e) and this paragraph, as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. This paragraph applies whether or not the foreign corporation is engaged in trade or business in the United States at any time during the taxable year but only with respect to income which, without regard to this paragraph, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. Any interest to which this paragraph applies shall be subject to tax in the manner, and subject to the same conditions, provided by section 882(a)(1) and paragraph (b)(2) of §1.882–1. To the extent that deductions are connected with interest to which this paragraph applies, they shall be treated for purposes of section 882(c)(1) and the regulations thereunder as connected with income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by the foreign corporation. An election by the taxpayer is not required in respect of the income to which this paragraph applies. For purposes of this paragraph the term ‘‘possession of the United States’’ includes Guam, the Midway Islands, the Panama Canal Zone, the Commonwealth of Puerto Rico, American Samoa, the Virgin Islands, and Wake Island.

(c) *Treatment of income.* Any income in respect of which an election described in paragraph (a) of this section is in effect, and any interest to which paragraph (b) of this section applies, shall be treated, for purposes of paragraph (b)(2) of §1.882–1 and paragraph (a) of §1.1441–4, as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by the foreign corporation. A foreign corporation shall not be treated as being engaged in trade or business in the United States merely by reason of having such income for the taxable year.

(d) *Effective date.* This section applies for taxable years beginning after December 31, 1966. There are no corresponding rules in this part for taxable years beginning before January 1, 1967.

[T.D. 7293, 38 FR 32798, Nov. 28, 1973]

§1.882–3 Gross income of a foreign corporation.

(a) *In general*—(1) *Inclusions.* The gross income of a foreign corporation for any taxable year includes only (i) the gross income which is derived from sources within the United States and which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation and (ii) the gross income, irrespective of whether such income is derived from sources within or without the United States, which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. For the determination of the sources of income, see sections 861 through 863, and the regulations thereunder. For the determination of whether income from sources within or without the United States is effectively connected for the taxable year with the conduct of a trade or business in the United States, see sections 864(c) and 882 (d) and (e), §§1.864–3 through 1.864–7, and §1.882–2.

(2) *Exchange transactions.* Even though a foreign corporation which effects certain transactions in the United States in stocks, securities, or commodities during the taxable year may not, by reason of section 864(b)(2) and paragraph (c) or (d) of §1.864–2, be engaged in trade or business in the United States during the taxable year through the effecting of such transactions, nevertheless it shall be required to include in gross income for the taxable year the gains and profits from those transactions to the extent required by paragraph (c) of §1.881–2 or by paragraph (a) of §1.882–1.

(3) *Exclusions.* For exclusions from gross income of a foreign corporation, see §1.883–1.

(b) *Foreign corporations not engaged in U.S. business.* In the case of a foreign corporation which at no time during the taxable year is engaged in trade or business in the United States the gross income shall include only (1) the gross income from sources within the United States which is described in section 881(a) and paragraphs (b) and (c) of §1.881–2, and (2) the gross income from sources within the United States which, by reason of section 882 (d) or (e) and §1.882–2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation.

(c) *Foreign corporations engaged in U.S. business.* In the case of a foreign corporation which is engaged in trade or business in the United States at any time during the taxable year, the gross income shall include (1) the gross income from sources within and without the United States which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation, (2) the gross income from sources within the United States which, by reason of section 882 (d) or (e) and §1.882–2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation, and (3) the gross income from sources within the United States which is described in section 881(a) and paragraphs (b) and (c) of §1.881–2 and is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation.

(d) *Effective date.* This section applies for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.882–2 (Revised as of January 1, 1971).

[T.D. 7293, 38 FR 32799, Nov. 28, 1973]

§1.882–4 Allowance of deductions and credits to foreign corporations.

(a) *Foreign corporations*—(1) *In general.* A foreign corporation that is engaged in, or receives income treated as effectively connected with, a trade or business within the United States is allowed the deductions which are properly allocated and apportioned to the foreign corporation's gross income which is effectively connected, or treated as effectively connected, with its conduct of a trade or business within the United States. The foreign corporation is entitled to credits which are attributable to that effectively connected income. No provision of this section (other than paragraph (b)(2)) shall be construed to deny the credits provided by sections 33, 34 and 852(b)(3)(D)(ii) or the deduction allowed by section 170.

(2) *Return necessary.* A foreign corporation shall receive the benefit of the deductions and credits otherwise allowed to it with respect to the income tax, only if it timely files or causes to be filed with the Philadelphia Service Center, in the manner prescribed in subtitle F, a true and accurate return of its taxable income which is effectively connected, or treated as effectively connected, for the taxable year with the conduct of a trade or business in the United States by that corporation. The deductions and credits allowed such a corporation electing under a tax convention to be subject to tax on a net basis may be obtained by filing a return of income in the manner prescribed in the regulations (if any) under the tax convention or under any other guidance issued by the Commissioner.

(3) *Filing deadline for return.* (i) As provided in paragraph (a)(2) of this section, for purposes of computing the foreign corporation's taxable income for any taxable year, otherwise allowable deductions (other than that allowed by section 170) and credits (other than those allowed by sections 33, 34 and 852(b)(3)(D)(ii)) will be allowed only if a return for that taxable year is filed by the foreign corporation on a timely basis. For taxable years of a foreign corporation ending after July 31, 1990, whether a return for the current taxable year has been filed on a timely basis is dependent upon whether the foreign corporation filed a return for the taxable year immediately preceding the current taxable year. If a return was filed for that immediately preceding taxable year, or if the current taxable year is the first taxable year of the foreign corporation for which a return is required to be filed, the required return for the current taxable year must be filed within 18 months of the due date as set forth in section 6072 and the regulations under that section, for filing the return for

the current taxable year. If no return for the taxable year immediately preceding the current taxable year has been filed, the required return for the current taxable year (other than the first taxable year of the foreign corporation for which a return is required to be filed) must have been filed no later than the earlier of the date which is 18 months after the due date, as set forth in section 6072, for filing the return for the current taxable year or the date the Internal Revenue Service mails a notice to the foreign corporation advising the corporation that the current year tax return has not been filed and that no deductions (other than that allowed under section 170) or credits (other than those allowed under sections 33, 34 and 852(b)(3)(D)(ii)) may be claimed by the taxpayer.

(ii) The filing deadlines set forth in paragraph (a)(3)(i) of this section may be waived by the District Director or Assistant Commissioner (International), in rare and unusual circumstances if good cause for such waiver, based on the facts and circumstances, is established by the foreign corporation.

(iii) A foreign corporation which has a permanent establishment, as defined in an income tax treaty between the United States and the foreign corporation's country of residence, in the United States is subject to the filing deadlines set forth in paragraph (a)(3)(i) of this section.

(iv) If a foreign corporation conducts limited activities in the United States in a taxable year which the foreign corporation determines does not give rise to gross income which is effectively connected with the conduct of a trade or business within the United States as defined in sections 882(b) and 864 (b) and (c) and the regulations under those sections, the foreign corporation may nonetheless file a return for that taxable year on a timely basis under paragraph (a)(3)(i) of this section and thereby protect the right to receive the benefit of the deductions and credits attributable to that gross income if it is later determined, after the return was filed, that the original determination was incorrect. On that timely filed return, the foreign corporation is not required to report any gross income as effectively connected with a United States trade or business or any deductions or credits but should attach a statement indicating that the return is being filed for the reason set forth in this paragraph (a)(3). If the foreign corporation determines that part of the activities which it conducts in the United States in a taxable year gives rise to gross income which is effectively connected with the conduct of a trade or business and part does not, the foreign corporation must timely file a return for that taxable year to report the gross income determined to be effectively connected, or treated as effectively connected, with the conduct of the trade or business within the United States and the deductions and credits attributable to the gross income. In addition, the foreign corporation should attach to that return the statement described in this paragraph (b)(3) with regard to the other activities. The foreign corporation may follow the same procedure if it determines initially that it has no United States tax liability under the provisions of an applicable income tax treaty. In the event the foreign corporation relies on the provisions of an income tax treaty to reduce or eliminate the income subject to taxation, or to reduce the rate of tax, disclosure may be required pursuant to section 6114.

(v) In order to be eligible for any deductions and credits for purposes of computing the accumulated earnings tax of section 531, a foreign corporation must file a true and accurate return; on a timely basis, in the manner as set forth in paragraph (a) (2) and (3) of this section.

(4) *Return by Internal Revenue Service.* If a foreign corporation has various sources of income within the United States and a return of income has not been filed, in the manner prescribed by subtitle F, including the filing deadlines set forth in paragraph (a)(3) of this section, the Internal Revenue Service shall:

(i) Cause a return of income to be made,

(ii) Include on the return the income described in §1.882–1 of that corporation from all sources concerning which it has information, and

(iii) Assess the tax and collect it from one or more of those sources of income within the United States, without allowance for any deductions (other than that allowed by section 170) or credits (other than those allowed by sections 33, 34 and 852(b)(3)(D)(ii)).

If the income of the corporation is not effectively connected with, or if the corporation did not receive income that is treated as being effectively connected with, the conduct of a United States trade or business, the tax will be assessed under § 1.882–1(b)(1) on a gross basis, without allowance for any deduction (other than that allowed by section 170) or credit (other than the credits allowed by sections 33, 34 and 852(b)(3)(D)(ii)). If the income is effectively connected, or treated as effectively connected, with the conduct of a United States trade on business, tax will be assessed in accordance with either section 11, 55 or 1201(a) without allowance for any deduction (other than that allowed by section 170) or credit (other than the credits allowed by sections 33, 34 and 852(b)(3)(D)(ii)).

(b) *Allowed deductions and credits*—(1) *In general.* Except for the deduction allowed under section 170 for charitable contributions and gifts (see section 882(c)(1)(B)), deductions are allowed to a foreign corporation only to the extent they are connected with gross income which is effectively connected, or treated as effectively connected, with the conduct of a trade or business in the United States. Deductible expenses (other than interest expense) are properly allocated and apportioned to effectively connected gross income in accordance with the rules of § 1.861–8. For the method of determining the interest deduction allowed to a foreign corporation, see § 1.882–5. Other than the credits allowed by sections 33, 34 and 852(b)(3)(D)(ii), the foreign corporation is entitled to credits only if they are attributable to effectively connected income. See paragraph (a)(2) of this section for the requirement that a return be filed. Except as provided by section 906, a foreign corporation shall not be allowed the credit against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

(2) *Verification.* At the request of the Internal Revenue Service, a foreign corporation claiming deductions from gross income which is effectively connected, or treated as effectively connected, with the conduct of a trade or business in the United States or credits which are attributable to that income must furnish at the place designated pursuant to § 301.7605–1(a) information sufficient to establish that the corporation is entitled to the deductions and credits in the amounts claimed. All information must be furnished in a form suitable to permit verification of claimed deductions and credits. The Internal Revenue Service may require, as appropriate, that an English translation be provided with any information in a foreign language. If a foreign corporation fails to furnish sufficient information, the Internal Revenue Service may in its discretion disallow any claimed deductions and credits in full or in part. For additional filing requirements and for penalties for failure to provide information, see also section 6038A.

[T.D. 8322, 55 FR 50830, Dec. 11, 1990]

§ 1.882–5 Determination of interest deduction.

(a) *Rules of general application*—(1) *Overview*—(i) *In general.* The amount of interest expense of a foreign corporation that is allocable under section 882(c) to income which is (or is treated as) effectively connected with the conduct of a trade or business within the United States (ECI) is the sum of the interest paid or accrued by the foreign corporation on its liabilities booked in the United States, as adjusted under the three-step process set forth in paragraphs (b), (c), and (d) of this section and the specially allocated interest expense determined under section (a)(1)(ii) of this section. The provisions of this section provide the exclusive rules for allocating interest expense to the ECI of a foreign corporation. Under the three-step process, the total value of the U.S. assets of a foreign corporation is first determined under paragraph (b) of this section (Step 1). Next, the amount of U.S.-connected liabilities is determined under paragraph (c) of this section (Step 2). Finally, the amount of interest paid or accrued on liabilities booked in the United States, as determined under paragraph (d)(2) of this section, is adjusted for interest expense attributable to the difference between U.S.-connected liabilities and U.S.-booked liabilities (Step 3). Alternatively, a foreign corporation may elect to determine its interest rate on U.S.-connected liabilities by reference to its U.S. assets, using the separate currency pools method described in paragraph (e) of this section.

(ii) *Direct allocations*—(A) *In general.* A foreign corporation that has a U.S. asset and indebtedness that meet the requirements of § 1.861–10T (b) and (c), as limited by § 1.861–10T(d)(1), may directly allocate interest expense from such indebtedness to income from such asset in the manner and to the extent provided in § 1.861–10T. For purposes of paragraph (b)(1) or (c)(2) of this section, a foreign corporation that allocates its interest expense under the direct allocation rule of this paragraph (a)(1)(ii)(A) shall reduce the basis of the asset that meets the requirements of § 1.861–10T (b) and (c) by the principal amount of the indebtedness that meets the requirements of § 1.861– 10T (b) and (c). The foreign corporation shall also disregard any indebtedness that meets the requirements of § 1.861–10T (b) and (c) in determining the amount of the foreign corporation's liabilities under paragraphs (c)(2) and (d)(2) of this section, and shall not take into account any interest expense paid or accrued with respect to such a liability for purposes of paragraph (d) or (e) of this section.

(B) *Partnership interest.* A foreign corporation that is a partner in a partnership that has a U.S. asset and indebtedness that meet the requirements of § 1.861–10T (b) and (c), as limited by § 1.861–10T(d)(1), may directly allocate its distributive share of interest expense from that indebtedness to its distributive share of income from that asset in the manner and to the extent provided in § 1.861–10T. A foreign corporation that allocates its distributive share of interest expense under the direct allocation rule of this paragraph (a)(1)(ii)(B) shall disregard any partnership indebtedness that meets the requirements of § 1.861–10T (b) and (c) in determining the amount of its distributive share of partnership liabilities for purposes of paragraphs (b)(1), (c)(2)(vi), and (d)(2)(vii) or (e)(1)(ii) of this section, and shall not take into account any partnership interest expense paid or accrued with respect to such a liability for purposes of paragraph (d) or (e) of this section. For purposes of paragraph (b)(1) of this section, a foreign corporation that directly allocates its distributive share of interest expense under this paragraph (a)(1)(ii)(B) shall—

(*1*) Reduce the partnership's basis in such asset by the amount of such indebtedness in allocating its basis in the partnership under § 1.884–1(d)(3)(ii); or

(*2*) Reduce the partnership's income from such asset by the partnership's interest expense from such indebtedness under § 1.884–1(d)(3)(iii).

(2) *Coordination with tax treaties.* The provisions of this section provide the exclusive rules for determining the interest expense attributable to the business profits of a permanent establishment under a U.S. income tax treaty.

(3) *Limitation on interest expense.* In no event may the amount of interest expense computed under this section exceed the amount of interest on indebtedness paid or accrued by the taxpayer within the taxable year (translated into U.S. dollars at the weighted average exchange rate for each currency prescribed by § 1.989(b)–1 for the taxable year).

(4) *Translation convention for foreign currency.* For each computation required by this section, the taxpayer shall translate values and amounts into the relevant currency at a spot rate or a weighted average exchange rate consistent with the method such taxpayer uses for financial reporting purposes, provided such method is applied consistently from year to year. Interest expense paid or accrued, however, shall be translated under the rules of § 1.988–2. The district director or the Assistant Commissioner (International) may require that any or all computations required by this section be made in U.S. dollars if the functional currency of the taxpayer's home office is a hyperinflationary currency, as defined in § 1.985–1, and the computation in U.S. dollars is necessary to prevent distortions.

(5) *Coordination with other sections.* Any provision that disallows, defers, or capitalizes interest expense applies after determining the amount of interest expense allocated to ECI under this section. For example, in determining the amount of interest expense that is disallowed as a deduction under section 265 or 163(j), deferred under section 163(e)(3) or 267(a)(3), or capitalized under section 263A with respect to a United States trade or business, a taxpayer takes into account only the amount of interest expense allocable to ECI under this section.

(6) *Special rule for foreign governments.* The amount of interest expense of a foreign government, as defined in § 1.892–2T(a), that is allocable to ECI is the total amount of interest paid or accrued within the taxable year by the United States trade or business on U.S. booked liabilities (as defined in paragraph (d)(2) of this section). Interest expense of a foreign government, however, is not allocable to ECI to the extent that it is incurred with respect to U.S. booked liabilities that exceed 80 percent of the total value of U.S. assets for the taxable year (determined under paragraph (b) of this section). This paragraph (a)(6) does not apply to controlled commercial entities within the meaning of § 1.892–5T.

(7) *Elections under § 1.882–5*—(i) *In general.* A corporation must make each election provided in this section on the corporation's Federal income tax return for the first taxable year beginning on or after the effective date of this section. An amended return does not qualify for this purpose, nor shall the provisions of § 301.9100–1 of this chapter and any guidance promulgated thereunder apply. Each election under this section, whether an election for the first taxable year or a subsequent change of election, shall be made by the corporation calculating its interest expense deduction in accordance with the methods elected. An elected method must be used for a minimum period of five years before the taxpayer may elect a different method. To change an election before the end of the requisite five-year period, a taxpayer must obtain the consent of the Commissioner or her delegate. The Commissioner or her delegate will generally consent to a taxpayer's request to change its election only in rare and unusual circumstances.

(ii) *Failure to make the proper election.* If a taxpayer, for any reason, fails to make an election provided in this section in a timely fashion, the district director or the Assistant Commissioner (International) may make any or all of the elections provided in this section on behalf of the taxpayer, and such elections shall be binding as if made by the taxpayer.

(8) *Examples.* The following examples illustrate the application of paragraph (a) of this section:

Example 1. Direct allocations. (i) *Facts: FC* is a foreign corporation that conducts business through a branch, *B*, in the United States. Among *B*'s U.S. assets is an interest in a partnership, *P*, that is engaged in airplane leasing solely in the U.S. *FC* contributes 200× to *P* in exchange for its partnership interest. *P* incurs qualified nonrecourse indebtedness within the meaning of § 1.861–10T to purchase an airplane. *FC*'s share of the liability of *P*, as determined under section 752, is 800×.

(ii) *Analysis:* Pursuant to paragraph (a)(1)(ii)(B) of this section, *FC* is permitted to directly allocate its distributive share of the interest incurred with respect to the qualified nonrecourse indebtedness to *FC*'s distributive share of the rental income generated by the airplane. A liability the interest on which is allocated directly to the income from a particular asset under paragraph (a)(1)(ii)(B) of this section is disregarded for purposes of paragraphs (b)(1), (c)(2)(vi), and (d)(2)(vii) or (e)(1)(ii) of this section. Consequently, for purposes of determining the value of *FC*'s assets under paragraphs (b)(1) and (c)(2)(vi) of this section, *FC*'s basis in *P* is reduced by the 800× liability as determined under section 752, but is not increased by the 800× liability that is directly allocated under paragraph (a)(1)(ii)(B) of this section. Similarly, pursuant to paragraph (a)(1)(ii)(B) of this section, the 800× liability is disregarded for purposes of determining *FC*'s liabilities under paragraphs (c)(2)(vi) and (d)(2)(vii) of this section.

Example 2. Limitation on interest expense—(i) *FC* is a foreign corporation that conducts a real estate business in the United States. In its 1997 tax year, *FC* has no outstanding indebtedness, and therefore incurs no interest expense. *FC* elects to use the 50% fixed ratio under paragraph (c)(4) of this section.

(ii) Under paragraph (a)(3) of this section, *FC* is not allowed to deduct any interest expense that exceeds the amount of interest on indebtedness paid or accrued in that taxable year. Since *FC* incurred no interest expense in taxable year 1997, *FC* will not be entitled to any interest deduction for that year under §1.882–5, notwithstanding the fact that *FC* has elected to use the 50% fixed ratio.

Example 3. Coordination with other sections—(i) *FC* is a foreign corporation that is a bank under section 585(a)(2) and a financial institution under section 265(b)(5). *FC* is a calendar year taxpayer, and operates a U.S. branch, *B*. Throughout its taxable year 1997, *B* holds only two assets that are U.S. assets within the meaning of paragraph (b)(1) of this section. *FC* does not make a fair-market value election under paragraph (b)(2)(ii) of this section, and, therefore, values its U.S. assets according to their bases under paragraph (b)(2)(i) of this section. The first asset is a taxable security with an adjusted basis of $100. The second asset is an obligation the interest on which is exempt from federal taxation under section 103, with an adjusted basis of $50. The tax-exempt obligation is not a qualified tax-exempt obligation as defined by section 265(b)(3)(B).

(ii) *FC* calculates its interest expense under §1.882–5 to be $12. Under paragraph (a)(5) of this section, however, a portion of the interest expense that is allocated to *FC*'s effectively connected income under §1.882–5 is disallowed in accordance with the provisions of section 265(b). Using the methodology prescribed under section 265, the amount of disallowed interest expense is $4, calculated as follows:

$$\$12 \times \frac{\$50\text{ Tax-exempt U.S. assets}}{\$150\text{ Total U.S. assets}} = \$4$$

(iii) Therefore, *FC* deducts a total of $8 ($12–$4) of interest expense attributable to its effectively connected income in 1997.

Example 4. Treaty exempt asset—(i) *FC* is a foreign corporation, resident in Country X, that is actively engaged in the banking business in the United States through a permanent establishment, *B*. The income tax treaty in effect between Country X and the United States provides that *FC* is not taxable on foreign source income earned by its U.S. permanent establishment. In its 1997 tax year, *B* earns $90 of U.S. source income from U.S. assets with an adjusted tax basis of $900, and $12 of foreign source interest income from U.S. assets with an adjusted tax basis of $100. *FC*'s U.S. interest expense deduction, computed in accordance with §1.882–5, is $500.

(ii) Under paragraph (a)(5) of this section, *FC* is required to apply any provision that disallows, defers, or capitalizes interest expense after determining the interest expense allocated to ECI under §1.882–5. Section 265(a)(2) disallows interest expense that is allocable to one or more classes of income that are wholly exempt from taxation under subtitle A of the Internal Revenue Code. Section 1.265–1(b) provides that income wholly exempt from taxes includes both income excluded from tax under any provision of subtitle A and income wholly exempt from taxes under any other law. Section 894 specifies that the provisions of subtitle A are applied with due regard to any relevant treaty obligation of the United States. Because the treaty between the United States and Country X exempts foreign source income earned by B from U.S. tax, *FC* has assets that produce income wholly exempt from taxes under subtitle A, and must therefore allocate a portion of its §1.882–5 interest expense to its exempt income. Using the methodology prescribed under section 265, the amount of disallowed interest expense is $50, calculated as follows:

$$\$500 \times \frac{\$100\text{ Treaty-exempt U.S. assets}}{\$1000\text{ Total U.S. assets}} = \$50$$

(iii) Therefore, *FC* deducts a total of $450 ($500–$50) of interest expense attributable to its effectively connected income in 1997.

(b) *Step 1: Determination of total value of U.S. assets for the taxable year*—(1) *Classification of an asset as a U.S. asset*—(i) *General rule.* Except as otherwise provided in this paragraph (b)(1), an asset is a U.S. asset for purposes of this section to the extent that it is a U.S. asset under §1.884–1(d). For purposes of this section, the term *determination date,* as used in §1.884–1(d), means each day for which the total value of U.S. assets is computed under paragraph (b)(3) of this section.

(ii) *Items excluded from the definition of U.S. asset.* For purposes of this section, the term *U.S. asset* excludes an asset to the extent it produces income or gain described in sections 883 (a)(3) and (b).

(iii) *Items included in the definition of U.S. asset.* For purposes of this section, the term *U.S. asset* includes—

(A) U.S. real property held in a wholly-owned domestic subsidiary of a foreign corporation that qualifies as a bank under section 585(a)(2)(B) (without regard to the second sentence thereof), provided that the real property would qualify as used in the foreign corporation's trade or business within the meaning of § 1.864–4(c) (2) or (3) if held directly by the foreign corporation and either was initially acquired through foreclosure or similar proceedings or is U.S. real property occupied by the foreign corporation (the value of which shall be adjusted by the amount of any indebtedness that is reflected in the value of the property);

(B) An asset that produces income treated as ECI under section 921(d) or 926(b) (relating to certain income of a FSC and certain dividends paid by a FSC to a foreign corporation);

(C) An asset that produces income treated as ECI under section 953(c)(3)(C) (relating to certain income of a captive insurance company that a corporation elects to treat as ECI) that is not otherwise ECI; and

(D) An asset that produces income treated as ECI under section 882(e) (relating to certain interest income of possessions banks).

(iv) *Interbranch transactions.* A transaction of any type between separate offices or branches of the same taxpayer does not create a U.S. asset.

(v) *Assets acquired to increase U.S. assets artificially.* An asset shall not be treated as a U.S. asset if one of the principal purposes for acquiring or using that asset is to increase artificially the U.S. assets of a foreign corporation on the determination date. Whether an asset is acquired or used for such purpose will depend upon all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes in acquiring or using an asset is to increase artificially the U.S. assets of a foreign corporation include the length of time during which the asset was used in a U.S. trade or business, whether the asset was acquired from a related person, and whether the aggregate value of the U.S. assets of the foreign corporation increased temporarily on or around the determination date. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(2) *Determination of the value of a U.S. asset*—(i) *General rule.* The value of a U.S. asset is the adjusted basis of the asset for determining gain or loss from the sale or other disposition of that item, further adjusted as provided in paragraph (b)(2)(iii) of this section.

(ii) *Fair-market value election*—(A) *In general.* A taxpayer may elect to value all of its U.S. assets on the basis of fair market value, subject to the requirements of § 1.861–9T(g)(1)(iii), and provided the taxpayer uses the methodology prescribed in § 1.861–9T(h). Once elected, the fair market value must be used by the taxpayer for both Step 1 and Step 2 described in paragraphs (b) and (c) of this section, and must be used in all subsequent taxable years unless the Commissioner or her delegate consents to a change.

(B) *Adjustment to partnership basis.* If a partner makes a fair market value election under paragraph (b)(2)(ii) of this section, the value of the partner's interest in a partnership that is treated as an asset shall be the fair market value of his partnership interest, increased by the fair market value of the partner's share of the liabilities determined under paragraph (c)(2)(vi) of this section. See § 1.884–1(d)(3).

(iii) *Reduction of total value of U.S. assets by amount of bad debt reserves under section 585*—(A) *In general.* The total value of loans that qualify as U.S. assets shall be reduced by the amount of any reserve for bad debts additions to which are allowed as deductions under section 585.

(B) *Example.* The following example illustrates the provisions of paragraph (b)(2)(iii)(A) of this section:

Example. Foreign banks; bad debt reserves. FC is a foreign corporation that qualifies as a bank under section 585(a)(2)(B) (without regard to the second sentence thereof), but is not a large bank as defined in section 585(c)(2). *FC* conducts business through a branch, *B*, in the United States. Among *B*'s U.S. assets are a portfolio of loans with an adjusted basis of $500. *FC* accounts for its bad debts for U.S. federal income tax purposes under the reserve method, and *B* maintains a deductible reserve for bad debts of $50. Under paragraph (b)(2)(iii) of this section, the total value of *FC*'s portfolio of loans is $450 ($500 − $50).

(iv) *Adjustment to basis of financial instruments.* [Reserved]

(3) *Computation of total value of U.S. assets.* The total value of U.S. assets for the taxable year is the average of the sums of the values (determined under paragraph (b)(2) of this section) of U.S. assets. For each U.S. asset, value shall be computed at the most frequent, regular intervals for which data are reasonably available. In no event shall the value of any U.S. asset be computed less frequently than monthly (beginning of taxable year and monthly thereafter) by a large bank (as defined in section 585(c)(2)) and semi-annually (beginning, middle and end of taxable year) by any other taxpayer.

(c) *Step 2: Determination of total amount of U.S.-connected liabilities for the taxable year*—(1) *General rule.* The amount of U.S.-connected liabilities for the taxable year equals the total value of U.S. assets for the taxable year (as determined under paragraph (b)(3) of this section) multiplied by the actual ratio for the taxable year (as determined under paragraph (c)(2) of this section) or, if the taxpayer has made an election in accordance with paragraph (c)(4) of this section, by the fixed ratio.

(2) *Computation of the actual ratio*—(i) *In general.* A taxpayer's actual ratio for the taxable year is the total amount of its worldwide liabilities for the taxable year divided by the total value of its worldwide assets for the taxable year. The total amount of worldwide liabilities and the total value of worldwide assets for the taxable year is the average of the sums of the amounts of the taxpayer's worldwide liabilities and the values of its worldwide assets (determined under paragraphs (c)(2) (iii) and (iv) of this section). In each case, the sums must be computed semi-annually (beginning, middle and end of taxable year) by a large bank (as defined in section 585(c)(2)) and annually (beginning and end of taxable year) by any other taxpayer.

(ii) *Classification of items.* The classification of an item as a liability or an asset must be consistent from year to year and in accordance with U.S. tax principles.

(iii) *Determination of amount of worldwide liabilities.* The amount of a liability must be determined consistently from year to year and must be substantially in accordance with U.S. tax principles. To be substantially in accordance with U.S. tax principles, the principles used to determine the amount of a liability must not differ from U.S. tax principles to a degree that will materially affect the value of taxpayer's worldwide liabilities or the taxpayer's actual ratio.

(iv) *Determination of value of worldwide assets.* The value of an asset must be determined consistently from year to year and must be substantially in accordance with U.S. tax principles. To be substantially in accordance with U.S. tax principles, the principles used to determine the value of an asset must not differ from U.S. tax principles to a degree that will materially affect the value of the taxpayer's worldwide assets or the taxpayer's actual ratio. The value of an asset is the adjusted basis of that asset for determining the gain or loss from the sale or other disposition of that asset, adjusted in the same manner as the basis of U.S. assets are adjusted under paragraphs (b)(2) (ii) through (iv) of this section.

(v) *Hedging transactions.* [Reserved]

(vi) *Treatment of partnership interests and liabilities.* For purposes of computing the actual ratio, the value of a partner's interest in a partnership that will be treated as an asset is the partner's adjusted basis in its partnership interest, reduced by the partner's share of liabilities of the partnership as determined under section 752 and increased by the partner's share of liabilities determined under this paragraph (c)(2)(vi). If the partner has made a fair market value election under paragraph (b)(2)(ii) of this section, the value of its interest in the partnership shall be increased by the fair market value of the partner's share of the liabilities determined under this paragraph (c)(2)(vi). For purposes of this section a partner shares in any liability of a partnership in the same proportion that it shares, for income tax purposes, in the expense attributable to that liability for the taxable year. A partner's adjusted basis in a partnership interest cannot be less than zero.

(vii) *Computation of actual ratio of insurance companies.* [Reserved]

(viii) *Interbranch transactions.* A transaction of any type between separate offices or branches of the same taxpayer does not create an asset or a liability.

(ix) *Amounts must be expressed in a single currency.* The actual ratio must be computed in either U.S. dollars or the functional currency of the home office of the taxpayer, and that currency must be used consistently from year to year. For example, a taxpayer that determines the actual ratio annually using British pounds converted at the spot rate for financial reporting purposes must translate the U.S. dollar values of assets and amounts of liabilities of the U.S. trade or business into pounds using the spot rate on the last day of its taxable year. The district director or the Assistant Commissioner (International) may require that the actual ratio be computed in dollars if the functional currency of the taxpayer's home office is a hyperinflationary currency, as defined in § 1.985–1, that materially distorts the actual ratio.

(3) *Adjustments.* The district director or the Assistant Commissioner (International) may make appropriate adjustments to prevent a foreign corporation from intentionally and artificially increasing its actual ratio. For example, the district director or the Assistant Commissioner (International) may offset a loan made from or to one person with a loan made to or from another person if any of the parties to the loans are related persons, within the meaning of section 267(b) or 707(b)(1), and one of the principal purposes for entering into the loans was to increase artificially the actual ratio of a foreign corporation. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(4) *Elective fixed ratio method of determining U.S. liabilities.* A taxpayer that is a bank as defined in section 585(a)(2)(B)(without regard to the second sentence thereof) may elect to use a fixed ratio of 93 percent in lieu of the actual ratio. A taxpayer that is neither a bank nor an insurance company may elect to use a fixed ratio of 50 percent in lieu of the actual ratio.

(5) *Examples.* The following examples illustrate the application of paragraph (c) of this section:

Example 1. Classification of item not in accordance with U.S. tax principles. Bank *Z*, a resident of country *X*, has a branch in the United States through which it conducts its banking business. In preparing its financial statements in country *X*, *Z* treats an instrument documented as perpetual subordinated debt as a liability. Under U.S. tax principles, however, this instrument is treated as equity. Consequently, the classification of this instrument as a liability for purposes of paragraph (c)(2)(iii) of this section is not in accordance with U.S. tax principles.

Example 2. Valuation of item not substantially in accordance with U.S. tax principles. Bank *Z*, a resident of country *X*, has a branch in the United States through which it conducts its banking business. Bank *Z* is a large bank as defined in section 585(c)(2). The tax rules of country *X* allow Bank *Z* to take deductions for additions to certain reserves. Bank *Z* decreases the value of the assets on its financial statements by the amounts of the reserves. The additions to the reserves under country *X* tax rules cause the value of Bank *Z*'s assets to differ from the value of those assets determined under U.S. tax principles to a degree that materially affects the value of taxpayer's worldwide assets. Consequently, the valuation of Bank *Z*'s worldwide assets under country *X* tax principles is not substantially in accordance with U.S. tax principles. Bank *Z* must increase the value of its worldwide assets under paragraph (c)(2)(iii) of this section by the amount of its country *X* reserves.

Example 3. Valuation of item substantially in accordance with U.S. tax principles. Bank *Z*, a resident of country *X*, has a branch in the United States through which it conducts its banking business. In determining the value of its worldwide assets, Bank *Z* computes the adjusted basis of certain non-U.S. assets according to the depreciation methodology provided under country *X* tax laws, which is different than the depreciation methodology provided under U.S. tax law. If the depreciation methodology provided under country *X* tax laws does not differ from U.S. tax principles to a degree that materially affects the value of Bank *Z*'s worldwide assets or Bank *Z*'s actual ratio as computed under paragraph (c)(2) of this section, then the valuation of Bank *Z*'s worldwide assets under paragraph (c)(2)(iv) of this section is substantially in accordance with U.S. tax principles.

Example 4. [Reserved]

Example 5. Adjustments. FC is a foreign corporation engaged in the active conduct of a banking business through a branch, *B*, in the

United States. *P,* an unrelated foreign corporation, deposits $100,000 in the home office of *FC.* Shortly thereafter, in a transaction arranged by the home office of *FC, B* lends $80,000 bearing interest at an arm's length rate to *S,* a wholly owned U.S. subsidiary of *P.* The district director or the Assistant Commissioner (International) determines that one of the principal purposes for making and incurring such loans is to increase *FC*'s actual ratio. For purposes of this section, therefore, *P* is treated as having directly lent $80,000 to S. Thus, for purposes of paragraph (c) of this section (Step 2), the district director or the Assistant Commissioner (International) may offset *FC*'s liability and asset arising from this transaction, resulting in a net liability of $20,000 that is not a booked liability of *B.* Because the loan to *S* from *B* was initiated and arranged by the home office of *FC,* with no material participation by *B,* the loan to *S* will not be treated as a U.S. asset.

(d) *Step 3: Determination of amount of interest expense allocable to ECI under the adjusted U.S. booked liabilities method*—(1) *General rule.* The adjustment to the amount of interest expense paid or accrued on U.S. booked liabilities is determined by comparing the amount of U.S.-connected liabilities for the taxable year, as determined under paragraph (c) of this section, with the average total amount of U.S. booked liabilities, as determined under paragraphs (d)(2) and (3) of this section. If the average total amount of U.S. booked liabilities equals or exceeds the amount of U.S.-connected liabilities, the adjustment to the interest expense on U.S. booked liabilities is determined under paragraph (d)(4) of this section. If the amount of U.S.-connected liabilities exceeds the average total amount of U.S. booked liabilities, the adjustment to the amount of interest expense paid or accrued on U.S. booked liabilities is determined under paragraph (d)(5) of this section.

(2) *U.S. booked liabilities*—(i) *In general.* A liability is a *U.S. booked liability* if it is properly reflected on the books of the U.S. trade or business, within the meaning of paragraph (d)(2)(ii) or (iii) of this section.

(ii) *Properly reflected on the books of the U.S. trade or business of a foreign corporation that is not a bank*—(A) *In general.* A liability, whether interest bearing or non-interest bearing, is properly reflected on the books of the U.S. trade or business of a foreign corporation that is not a bank as described in section 585(a)(2)(B) (without regard to the second sentence thereof) if—

(*1*) The liability is secured predominantly by a U.S. asset of the foreign corporation;

(*2*) The foreign corporation enters the liability on a set of books relating to an activity that produces ECI at a time reasonably contemporaneous with the time at which the liability is incurred; or

(*3*) The foreign corporation maintains a set of books and records relating to an activity that produces ECI and the District Director or Assistant Commissioner (International) determines that there is a direct connection or relationship between the liability and that activity. Whether there is a direct connection between the liability and an activity that produces ECI depends on the facts and circumstances of each case.

(B) *Identified liabilities not properly reflected.* A liability is not properly reflected on the books of the U.S. trade or business merely because a foreign corporation identifies the liability pursuant to §1.884–4(b)(1)(ii) and (b)(3).

(iii) *Properly reflected on the books of the U.S. trade or business of a foreign corporation that is a bank*—(A) *In general.* A liability, whether interest bearing or non-interest bearing, is properly reflected on the books of the U.S. trade or business of a foreign corporation that is a bank as described in section 585(a)(2)(B) (without regard to the second sentence thereof) if—

(*1*) The bank enters the liability on a set of books relating to an activity that produces ECI before the close of the day on which the liability is incurred; and

(*2*) There is a direct connection or relationship between the liability and that activity. Whether there is a direct connection between the liability and an activity that produces ECI depends on the facts and circumstances of each case.

(B) *Inadvertent error.* If a bank fails to enter a liability in the books of the activity that produces ECI before the close of the day on which the liability was incurred, the liability may be treated as a U.S. booked liability only if, under the facts and circumstances, the taxpayer demonstrates a direct connection or relationship between the liability and the activity that produces ECI and the failure to enter the liability in those books was due to inadvertent error.

(iv) *Liabilities of insurance companies.* [Reserved]

(v) *Liabilities used to increase artificially interest expense on U.S. booked liabilities.* U.S. booked liabilities shall not include a liability if one of the principal purposes for incurring or holding the liability is to increase artificially the interest expense on the U.S. booked liabilities of a foreign corporation. Whether a liability is incurred or held for the purpose of artificially increasing interest expense will depend upon all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes for incurring or holding a liability is to increase artificially the interest expense on U.S. booked liabilities of a foreign corporation include whether the interest expense on the liability is excessive when compared to other liabilities of the foreign corporation denominated in the same currency and whether the currency denomination of the liabilities of the U.S. branch substantially matches the currency denomination of the U.S. branch's assets. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(vi) *Hedging transactions.* [Reserved]

(vii) *Amount of U.S. booked liabilities of a partner.* A partner's share of liabilities of a partnership is considered a booked liability of the partner provided that it is properly reflected on the books (within the meaning of paragraph (d)(2)(ii) of this section) of the U.S. trade or business of the partnership.

(viii) *Interbranch transactions.* A transaction of any type between separate offices or branches of the same taxpayer does not result in the creation of a liability.

(3) *Average total amount of U.S. booked liabilities.* The *average total amount* of U.S. booked liabilities for the taxable year is the average of the sums of the amounts (determined under paragraph (d)(2) of this section) of U.S. booked liabilities. The amount of U.S. booked liabilities shall be computed at the most frequent, regular intervals for which data are reasonably available. In no event shall the amount of U.S. booked liabilities be computed less frequently than monthly by a large bank (as defined in section 585(c)(2)) and semi-annually by any other taxpayer.

(4) *Interest expense where U.S. booked liabilities equal or exceed U.S. liabilities*—(i) *In general.* If the average total amount of U.S. booked liabilities (as determined in paragraphs (d)(2) and (3) of this section) exceeds the amount of U.S.-connected liabilities (as determined under paragraph (c) of this section (Step 2)), the interest expense allocable to ECI is the product of the total amount of interest paid or accrued within the taxable year by the U.S. trade or business on U.S. booked liabilities and the scaling ratio set out in paragraph (d)(4)(ii) of this section. For purposes of this section, the reduction resulting from the application of the scaling ratio is applied pro-rata to all interest expense paid or accrued by the foreign corporation. A similar reduction in income, expense, gain, or loss from a hedging transaction (as described in paragraph (d)(2)(vi) of this section) must also be determined by multiplying such income, expense, gain, or loss by the scaling ratio. If the average total amount of U.S. booked liabilities (as determined in paragraph (d)(3) of this section) equals the amount of U.S.-connected liabilities (as determined under *Step 2*), the interest expense allocable to ECI is the total amount of interest paid or accrued within the taxable year by the U.S. trade or business on U.S. booked liabilities.

(ii) *Scaling ratio.* For purposes of this section, the scaling ratio is a fraction the numerator of which is the amount of U.S.-connected liabilities and the denominator of which is the average total amount of U.S. booked liabilities.

(iii) *Special rules for insurance companies.* [Reserved]

(5) *U.S.-connected interest rate where U.S. booked liabilities are less than U.S.-connected liabilities*—(i) *In general.* If the amount of U.S.-connected liabilities (as determined under paragraph (c) of

this section (Step 2)) exceeds the average total amount of U.S. booked liabilities, the interest expense allocable to ECI is the total amount of interest paid or accrued within the taxable year by the U.S. trade or business on U.S. booked liabilities, plus the excess of the amount of U.S.-connected liabilities over the average total amount of U.S. booked liabilities multiplied by the interest rate determined under paragraph (d)(5)(ii) of this section.

(ii) *Interest rate on excess U.S.-connected liabilities.* The applicable interest rate on excess U.S.-connected liabilities is determined by dividing the total interest expense paid or accrued for the taxable year on U.S.-dollar liabilities shown on the books of the offices or branches of the foreign corporation outside the United States by the average U.S.-dollar denominated liabilities (whether interest-bearing or not) shown on the books of the offices or branches of the foreign corporation outside the United States for the taxable year.

(6) *Examples.* The following examples illustrate the rules of this section:

Example 1. Computation of interest expense; actual ratio—(i) *Facts.* (A) *FC* is a foreign corporation that is not a bank and that actively conducts a real estate business through a branch, *B*, in the United States. For the taxable year, *FC*'s balance sheet and income statement is as follows (assume amounts are in U.S. dollars and computed in accordance with paragraphs (b)(2) and (b)(3) of this section):

	Value	
Asset 1	$2,000	
Asset 2	2,500	
Asset 3	5,500	
	Amount	Interest Expense
Liability 1	$800	56
Liability 2	3,200	256
Capital	6,000	0

(B) Asset 1 is the stock of *FC*'s wholly-owned domestic subsidiary that is also actively engaged in the real estate business. Asset 2 is a building in the United States producing rental income that is entirely ECI to *FC*. Asset 3 is a building in the home country of *FC* that produces rental income. Liabilities 1 and 2 are loans that bear interest at the rates of 7% and 8%, respectively. Liability 1 is a booked liability of B, and Liability 2 is booked in *FC*'s home country. Assume that *FC* has not elected to use the fixed ratio in Step 2.

(ii) *Step 1.* Under paragraph (b)(1) of this section, Assets 1 and 3 are not U.S. assets, while Asset 2 qualifies as a U.S. asset. Thus, under paragraph (b)(3) of this section, the total value of U.S. assets for the taxable year is $2,500, the value of Asset 2.

(iii) *Step 2.* Under paragraph (c)(1) of this section, the amount of *FC*'s U.S.-connected liabilities for the taxable year is determined by multiplying $2,500 (the value of U.S. assets determined under Step 1) by the actual ratio for the taxable year. The actual ratio is the average amount of *FC*'s worldwide liabilities divided by the average value of *FC*'s worldwide assets. The amount of Liability 1 is $800, and the amount of Liability 2 is $3,200. Thus, the numerator of the actual ratio is $4,000. The average value of worldwide assets is $10,000 (Asset 1 + Asset 2 + Asset 3). The actual ratio, therefore, is 40% ($4,000/$10,000), and the amount of U.S.-connected liabilities for the taxable year is $1,000 ($2,500 U.S. assets × 40%).

(iv) *Step 3.* Because the amount of *FC*'s U.S.-connected liabilities ($1,000) exceeds the average total amount of U.S. booked liabilities of *B* ($800), *FC* determines its interest expense in accordance with paragraph (d)(5) of this section by adding the interest paid or accrued on U.S. booked liabilities, and the interest expense associated with the excess of its U.S.-connected liabilities over its average total amount of U.S. booked liabilities. Under paragraph (d)(5)(ii) of this section, *FC* determines the interest rate attributable to its excess U.S.-connected liabilities by dividing the interest expense paid or accrued by the average amount of U.S.-dollar denominated liabilities, which produces an interest rate of 8% ($256/$3200). Therefore, *FC*'s allocable interest expense is $72 ($56 of interest expense from U.S. booked liabilities plus $16 ($200 × 8%) of interest expense attributable to its excess U.S.-connected liabilities).

Example 2. Computation of interest expense; fixed ratio—(i) The facts are the same as in *Example 1,* except that *FC* makes a fixed ratio election under paragraph (c)(4) of this section. The conclusions under Step 1 are the same as in *Example 1.*

(ii) *Step 2.* Under paragraph (c)(1) of this section, the amount of U.S.-connected liabilities for the taxable year is determined by multiplying $2,500 (the value of U.S. assets determined under Step 1) by the fixed ratio for the taxable year, which, under paragraph (c)(4) of this section is 50 percent. Thus, the amount of U.S.-connected liabilities for the taxable year is $1,250 ($2,500 U.S. assets × 50%).

(iii) *Step 3.* As in *Example 1,* the amount of *FC*'s U.S.-connected liabilities exceed the average total amount of U.S. booked liabilities of *B*, requiring *FC* to determine its interest expense under paragraph (d)(5) of this section. In this case, however, *FC* has excess U.S.-connected liabilities of $450 ($1,250 of

U.S.-connected liabilities—$800 U.S. booked liabilities). *FC* therefore has allocable interest expense of $92 ($56 of interest expense from U.S. booked liabilities plus $36 ($450 x 8%) of interest expense attributable to its excess U.S.-connected liabilities).

Example 3. Scaling ratio.—(i) *Facts.* Bank *Z*, a resident of country *X*, has a branch in the United States through which it conducts its banking business. For the taxable year, *Z* has U.S.-connected liabilities, determined under paragraph (c) of this section, equal to $300. *Z*, however, has U.S. booked liabilities of $300 and *U*500. Therefore, assuming an exchange rate of the *U* to the U.S. dollar of 5:1, *Z* has U.S. booked liabilities of $400 ($300 + (*U*500 ÷ 5)).

(ii) *U.S.-connected liabilities.* Because *Z*'s U.S. booked liabilities of $400 exceed its U.S.-connected liabilities by $100, all of *Z*'s interest expense allocable to its U.S. trade or business must be scaled back pro-rata. To determine the scaling ratio, *Z* divides its U.S.-connected liabilities by its U.S. booked liabilities, as required by paragraph (d)(4) of this section. *Z*'s interest expense is scaled back pro rata by the resulting ratio of ¾ ($300 ÷ $400). *Z*'s income, expense, gain or loss from hedging transactions described in paragraph (d)(2)(vi) of this section must be similarly reduced.

Example 4. [Reserved]

(e) *Separate currency pools method*—(1) *General rule.* If a foreign corporation elects to use the method in this paragraph, its total interest expense allocable to ECI is the sum of the separate interest deductions for each of the currencies in which the foreign corporation has U.S. assets. The separate interest deductions are determined under the following three-step process.

(i) *Determine the value of U.S. assets in each currency pool.* First, the foreign corporation must determine the amount of its U.S. assets, using the methodology in paragraph (b) of this section, in each currency pool. The foreign corporation may convert into U.S. dollars any currency pool in which the foreign corporation holds less than 3% of its U.S. assets. A transaction (or transactions) that hedges a U.S. asset shall be taken into account for purposes of determining the currency denomination and the value of the U.S. asset.

(ii) *Determine the U.S.-connected liabilities in each currency pool.* Second, the foreign corporation must determine the amount of its U.S.-connected liabilities in each currency pool by multiplying the amount of U.S. assets (as determined under paragraph (b)(3) of this section) in the currency pool by the foreign corporation's actual ratio (as determined under paragraph (c)(2) of this section) for the taxable year or, if the taxpayer has made an election in accordance with paragraph (c)(4) of this section, by the fixed ratio.

(iii) *Determine the interest expense attributable to each currency pool.* Third, the foreign corporation must determine the interest expense attributable to each currency pool by multiplying the U.S.-connected liabilities in each currency pool by the prescribed interest rate as defined in paragraph (e)(2) of this section.

(2) *Prescribed interest rate.* For each currency pool, the prescribed interest rate is determined by dividing the total interest expense that is paid or accrued for the taxable year with respect to the foreign corporation's worldwide liabilities denominated in that currency, by the foreign corporation's average worldwide liabilities (whether interest bearing or not) denominated in that currency. The interest expense and liabilities are to be stated in that currency.

(3) *Hedging transactions.* [Reserved]

(4) *Election not available if excessive hyperinflationary assets.* The election to use the separate currency pools method of this paragraph (e) is not available if the value of the foreign corporation's U.S. assets denominated in a hyperinflationary currency, as defined in § 1.985–1, exceeds ten percent of the value of the foreign corporation's total U.S. assets. If a foreign corporation made a valid election to use the separate currency pools method in a prior year but no longer qualifies to use such method pursuant to this paragraph (e)(4), the taxpayer must use the method provided by paragraphs (b) through (d) of this section.

(5) *Examples.* The separate currency pools method of this paragraph (e) is illustrated by the following examples:

Example 1. Separate currency pools method—(i) *Facts.* (A) Bank *Z*, a resident of country *X*, has a branch in the United States through which it conducts its banking business. For its 1997 taxable year, *Z* has U.S. assets, as defined in paragraph (b) of this section, that are denominated in U.S. dollars and in *U*, the country *X* currency. Accordingly, *Z*'s U.S. assets are as follows:

	Average value
U.S. Dollar Assets	$20,000
U Assets	*U* 5,000

(B) *Z*'s worldwide liabilities are also denominated in U.S. Dollars and in *U*. The average interest rates on *Z*'s worldwide liabilities, including those in the United States, are 6% on its U.S. dollar liabilities, and 12% on its liabilities denominated in *U*. Assume that *Z* has properly elected to use its actual ratio of 95% to determine its U.S.-connected liabilities in Step 2, and has also properly elected to use the separate currency pools method provided in paragraph (e) of this section.

(ii) *Determination of interest expense. Z* determines the interest expense attributable to its U.S.-connected liabilities according to the steps described below.

(A) First, *Z* separates its U.S. assets into two currency pools, one denominated in U.S. dollars ($20,000) and the other denominated in *U* (*U*5,000).

(B) Second, *Z* multiplies each pool of assets by the applicable ratio of worldwide liabilities to assets, which in this case is 95%. Thus, Z has U.S.-connected liabilities of $19,000 ($20,000 x 95%), and *U*4750 (*U*5000 x 95%).

(C) Third, *Z* calculates its interest expense by multiplying each pool of its U.S.-connected liabilities by the relevant interest rates. Accordingly, *Z*'s allocable interest expense for the year is $1140 ($19,000 x 6%), the sum of the expense associated with its U.S. dollar liabilities, plus *U*570 (*U*4750 x 12%), the interest expense associated with its liabilities denominated in *U. Z* must translate its interest expense denominated in *U* in accordance with the rules provided in section 988, and then must determine whether it is subject to any other provision of the Code that would disallow or defer any portion of its interest expense so determined.

Example 2. [Reserved]

(f) *Effective date*—(1) *General rule.* This section is effective for taxable years beginning on or after June 6, 1996.

(2) *Special rules for financial products.* [Reserved]

[T.D. 8658, 61 FR 9329, Mar. 8, 1996; 61 FR 15891, Apr. 10, 1996]

§1.883–1 Exclusions from gross income of foreign corporations.

(a) *Earnings of foreign ships or aircraft*—(1) *Basic rule.* So much of the income from sources within the United States of a foreign corporation as consists of earnings derived from the operation of a ship or ships documented, or of aircraft registered, under the laws of a foreign country which grants an equivalent exemption to citizens of the United States nonresident in that foreign country and to corporations organized in the United States shall not be included in gross income.

(2) *Equivalent exemption*—(i) *Ships.* A foreign country which either imposes no income tax, or, in imposing that tax, exempts from taxation so much of the income of a citizen of the United States nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of a foreign ship or ships.

(ii) *Aircraft.* A foreign country which either imposes no income tax, or, in imposing that tax, exempts from taxation so much of the income of a citizen of the United States nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of aircraft registered under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of foreign aircraft.

(b) *Income tax conventions.* Generally, income of any kind which is exempt, under the provisions of an income tax convention to which the United States is a party, from any tax imposed by subtitle A (relating to income taxes) is not included in the gross income of a foreign corporation. However, see paragraph (a) of §1.894–1 for certain exceptions to this rule. Income on any tax which imposed by such subtitle is limited by an income tax convention is included in the gross income of a foreign corporation if it is not otherwise excluded from gross income. For the determination of the tax when the taxpayer has income upon which the tax is limited by an income tax convention, see §1.871–12.

(c) *Other exclusions.* Income which is from sources without the United States, as determined under the provisions of sections 861 through 863 and the regulations thereunder, is not included in the gross income of a foreign corporation unless such income is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. To determine specific exclusions in the case of other items which are from sources within the United States, see the applicable sections of the Code. For special rules under a tax convention for determining the sources of income and for excluding, from gross income, income from sources without the United States which is effectively connected with the conduct of a trade or business in the United States, see the applicable tax convention. For determining which income from sources without the United States is effectively connected with the conduct of a trade or business within the United States see section 864(c)(4) and § 1.864–5.

(d) *Effective date.* This section applies for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.883–1 (Revised as of January 1, 1971).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7293, 38 FR 32799, Nov. 28, 1973; 38 FR 34203, Dec. 12, 1973]

§ 1.884–0 Overview of regulation provisions for section 884.

(a) *Introduction.* Section 884 consists of three main parts: a branch profits tax on certain earnings of a foreign corporation's U.S. trade or business; a branch-level interest tax on interest paid, or deemed paid, by a foreign corporation's U.S. trade or business; and an anti-treaty shopping rule. A foreign corporation is subject to section 884 by virtue of owning an interest in a partnership, trust, or estate that is engaged in a U.S. trade or business or has income treated as effectively connected with the conduct of a trade or business in the United States. An international organization (as defined in section 7701(a)(18)) is not subject to the branch profits tax by reason of section 884(e)(5). A foreign government treated as a corporate resident of its country of residence under section 892(a)(3) shall be treated as a corporation for purposes of section 884. The preceding sentence shall be effective for taxable years ending on or after September 11, 1992, except that, for the first taxable year ending on or after that date, the branch profits tax shall not apply to effectively connected earnings and profits of the foreign government earned prior to that date nor to decreases in the U.S. net equity of a foreign government occurring after the close of the preceding taxable year and before that date. Similarly, § 1.884–4 shall apply, in the case of branch interest, only with respect to amounts of interest accrued and paid by a foreign government on or after that date, or, in the case of excess interest, only with respect to amounts attributable to interest accrued by a foreign government on or after that date and apportioned to ECI, as defined in § 1.884–1(d)(1)(iii). Except as otherwise provided, for purposes of the regulations under section 884, the term ''U.S. trade or business'' includes all the U.S. trades or businesses of a foreign corporation.

(1) *The branch profits tax.* Section 1.884–1 provides rules for computing the branch profits tax and defines various terms that affect the computation of the tax. In general, section 884(a) imposes a 30-percent branch profits tax on the after-tax earnings of a foreign corporation's U.S. trade or business that are not reinvested in a U.S. trade or business by the close of the taxable year, or are disinvested in a later taxable year. Changes in the value of the equity of the foreign corporation's U.S. trade or business are used as the measure of whether earnings have been reinvested in, or disinvested form, a U.S. trade or business. An increase in the equity during the taxable year is generally treated as a reinvestment of the earnings for the current taxable year; a decrease in the equity during the taxable year is generally treated as a disinvestment of prior years' earnings that have not previously been subject to the branch profits tax. The amount subject to the branch profits tax for the taxable year is the dividend equivalent amount. Section 1.884–2T contains special rules relating to the effect on

the branch profits tax of the termination or incorporation of a U.S. trade or business or the liquidation or reorganization of a foreign corporation or its domestic subsidiary.

(2) *The branch-level interest tax.* Section 1.884–4 provides rules for computing the branch-level interest tax. In general, interest paid by a U.S. trade or business of a foreign corporation (''branch interest'', as defined in §1.884–4(b)) is treated as if it were paid by a domestic corporation and may be subject to tax under section 871(a) or 881, and to withholding under section 1441 or 1442. In addition, if the interest apportioned to ECI exceeds branch interest, the excess is treated as interest paid to the foreign corporation by a wholly-owned domestic corporation and is subject to tax under section 881(a).

(3) *Qualified resident.* Section 1.884–5 provides rules for determining whether a foreign corporation is a qualified resident of a foreign country. In general, a foreign corporation must be a qualified resident of a foreign country with which the United States has an income tax treaty in order to claim an exemption or rate reduction with respect to the branch profits tax, the branch-level interest tax, and the tax on dividends paid by the foreign corporation.

(b) *Outline of major topics in §§1.884–1 through 1.884–5.*

§1.884–1 Branch profits tax.

(a) General rule.
(b) Dividend equivalent amount.
(1) Definition.
(2) Adjustment for increase in U.S. net equity.
(3) Adjustment for decrease in U.S. net equity.
(4) Examples.
(c) U.S. net equity.
(1) Definition.
(2) Definition of amount of a U.S. asset.
(3) Definition of determination date.
(d) U.S. assets.
(1) Definition of a U.S. asset.
(2) Special rules for certain assets.
(3) Interest in a partnership.
(4) Interest in a trust or estate.
(5) Property that is not a U.S. asset.
(6) E&P basis of a U.S. asset.
(e) U.S. liabilities.
(1) Liabilities based on §1.882–5.
(2) Insurance reserves.
(3) Election to reduce liabilities.
(4) Artificial decrease in U.S. liabilities.
(5) Examples.
(f) Effectively connected earnings and profits.
(1) In general.
(2) Income that does not produce ECEP.
(3) Allocation of deductions attributable to income that does not produce ECEP.
(4) Examples.
(g) Corporations resident in countries with which the United States has an income tax treaty.
(1) General rule.
(2) Special rules for foreign corporations that are qualified residents on the basis of their ownership.
(3) Exemptions for foreign corporations resident in certain countries with income tax treaties in effect on January 1, 1987.
(4) Modifications with respect to other income tax treaties.
(5) Benefits under treaties other than income tax treaties.
(h) Stapled entities.
(i) Effective date.
(1) General rule.
(2) Election to reduce liabilities.
(3) Separate election for installment obligations.
(4) Special rule for certain U.S. assets and liabilities.
(j) Transition rules.
(1) General rule.
(2) Installment obligations.

§1.884–2T Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (temporary).

(a) Complete termination of a U.S. trade or business.
(1) General rule.
(2) Operating rules.
(3) Complete termination in the case of a section 338 election.
(4) Complete termination in the case of a foreign corporation with income under section 864(c)(6) or 864(c)(7).
(5) Special rule if a foreign corporation terminates an interest in a trust. [Reserved]
(6) Coordination with second-level withholding tax.
(b) Election to remain engaged in a U.S. trade or business.
(1) General rule.
(2) Marketable security.
(3) Identification requirements.
(4) Treatment of income from deemed U.S. assets.
(5) Method of election.
(6) Effective date.
(c) Liquidation, reorganization, etc., of a foreign corporation.
(1) Inapplicability of paragraph (a)(1) to section 381 (a) transactions.

(2) Transferor's dividend equivalent amount for the taxable year in which a section 381 (a) transaction occurs.

(3) Transferor's dividend equivalent amount for any taxable year succeeding the taxable year in which the section 381 (a) transaction occurs.

(4) Earnings and profits of the transferor carried over to the transferee pursuant to the section 381 (a) transaction.

(5) Determination of U.S. net equity of a transferee that is a foreign corporation.

(6) Special rules in the case of the disposition of stock or securities in a domestic transferee or in the transferor.

(d) Incorporation under section 351.

(1) In general.

(2) Inapplicability of paragraph (a)(1) of this section to section 351 transactions.

(3) Transferor's dividend equivalent amount for the taxable year in which a section 351 transaction occurs.

(4) Election to increase earnings and profits.

(5) Dispositions of stock or securities of the transferee by the transferor.

(6) Example.

(e) Certain transactions with respect to a domestic subsidiary.

(f) Effective date.

§1.884–3T Coordination of branch profits tax with second–tier withholding (temporary). [Reserved]

§1.884–4 Branch-level interest tax.

(a) General rule.

(1) Tax on branch interest.

(2) Tax on excess interest.

(3) Original issue discount.

(4) Examples.

(b) Branch interest.

(1) Definition of branch interest.

(2) [Reserved]

(3) Requirements relating to specifically identified liabilities.

(4) [Reserved]

(5) Increase in branch interest where U.S. assets constitute 80 percent or more of a foreign corporation's assets.

(6) Special rule where branch interest exceeds interest apportioned to ECI of a foreign corporation.

(7) Effect of election under paragraph (c)(1) of this section to treat interest as if paid in year of accrual.

(8) Effect of treaties.

(c) Rules relating to excess interest.

(1) Election to compute excess interest by treating branch interest that is paid and accrued in different years as if paid in year of accrual.

(2) Interest paid by a partnership.

(3) Effect of treaties.

(4) Examples.

(d) Stapled entities.

(e) Effective dates.

(1) General rule.

(2) Special rule.

(f) Transition rules.

(1) Election under paragraph (c)(1) of this section.

(2) Waiver of notification requirement for non–banks under Notice 89–80.

(3) Waiver of legending requirement for certain debt issued prior to January 3, 1989.

§1.884–5 Qualified resident.

(a) Definition of qualified resident.

(b) Stock ownership requirement.

(1) General rule.

(2) Rules for determining constructive ownership.

(3) Required documentation.

(4) Ownership statements from qualifying shareholders.

(5) Certificate of residency.

(6) Intermediary ownership statement.

(7) Intermediary verification statement.

(8) Special rules for pension funds.

(9) Availability of documents for inspection.

(10) Examples.

(c) Base erosion.

(d) Publicly-traded corporations.

(1) General rule.

(2) Established securities market.

(3) Primary traded.

(4) Regularly traded.

(5) Burden of proof for publicly-traded corporations.

(e) Active trade or business.

(1) General rule.

(2) Active conduct of a trade or business.

(3) Substantial presence test.

(4) Integral part of an active trade or business in the foreign corporation's country of residence.

(f) Qualified resident ruling.

(1) Basis for ruling.

(2) Factors.

(3) Procedural requirements.

(g) Effective dates.

(h) Transition rule.

[T.D. 8432, 57 FR 41649, Sept. 11, 1992; 57 FR 49117, Oct. 29, 1992; 57 FR 60126, Dec. 18, 1992, as amended by T.D. 8657, 61 FR 9338, Mar. 8, 1996]

§1.884–1 Branch profits tax.

(a) *General rule.* A foreign corporation shall be liable for a branch profits tax in an amount equal to 30 percent of the foreign corporation's dividend equivalent amount for the taxable year. The branch profits tax shall be in addition to the tax imposed by section 882 and shall be reported on a foreign corporation's income tax return for the taxable year. The tax shall be due and payable as provided in section 6151 and such other provisions of Subtitle F of the Internal Revenue Code as apply to the income tax liability of corporations. However, no estimated tax payments shall be due with respect to a foreign corporation's liability for the branch profits tax. See paragraph (g) of this section for the application of the branch profits tax to corporations that are residents of countries with which the United States has an income tax treaty, and §1.884–2T for the effect on the branch profits tax of the termination or incorporation of a U.S. trade or business, or the liquidation or reorganization of a foreign corporation or its domestic subsidiary.

(b) *Dividend equivalent amount*—(1) *Definition.* The term ''dividend equivalent amount'' means a foreign corporation's effectively connected earnings and profits (''ECEP'', as defined in paragraph (f)(1) of this section) for the taxable year, adjusted pursuant to paragraph (b) (2) or (3) of this section, as applicable. The dividend equivalent amount cannot be less than zero.

(2) *Adjustment for increase in U.S. net equity.* If a foreign corporation's U.S. net equity (as defined in paragraph (c) of this section) as of the close of the taxable year exceeds the foreign corporation's U.S. net equity as of the close of the preceding taxable year, then, for purposes of computing the foreign corporation's dividend equivalent amount for the taxable year, the foreign corporation's ECEP for the taxable year shall be reduced (but not below zero) by the amount of such excess.

(3) *Adjustment for decrease in U.S. net equity*—(i) *In general.* Except as provided in paragraph (b)(3)(ii) of this section, if a foreign corporation's U.S. net equity as of the close of the taxable year is less than the foreign corporation's U.S. net equity as of the close of the preceding taxable year, then, for purposes of computing the foreign corporation's dividend equivalent amount for the taxable year, the foreign corporation's ECEP for the taxable year shall be increased by the amount of such difference.

(ii) *Limitation based on accumulated ECEP.* The increase of a foreign corporation's ECEP under paragraph (b)(3)(i) of this section shall not exceed the accumulated ECEP of the foreign corporation as of the beginning of the taxable year. The term ''accumulated ECEP'' means the aggregate amount of ECEP of a foreign corporation for preceding taxable years beginning after December 31, 1986, minus the aggregate dividend equivalent amounts for such preceding taxable years. Accumulated ECEP may be less than zero.

(4) *Examples.* The principles of paragraph (b) (2) and (3) of this section are illustrated by the following examples.

Example 1. Reinvestment of all ECEP. Foreign corporation A, a calender year taxpayer, had $1,000 U.S. net equity as of the close of 1986 and $100 of ECEP for 1987. A acquires $100 of additional U.S. assets during 1987 and its U.S. net equity as of the close of 1987 is $1,100. In computing A's dividend equivalent amount for 1987, A's ECEP of $100 is reduced under paragraph (b)(2) of this section by the $100 increase in U.S. net equity between the close of 1986 and the close of 1987. A has no dividend equivalent amount for 1987.

Example 2. Partial reinvestment of ECEP. Assume the same facts as in *Example 1* except that A acquires $40 (rather than $100) of U.S. assets during 1987 and its U.S. net equity as of the close of 1987 is $1,040. In computing A's dividend equivalent amount for 1987, A's ECEP of $100 is reduced under paragraph (b)(2) of this section by the $40 increase in U.S. net equity between the close of 1986 and the close of 1987. A has a dividend equivalent amount of $60 for 1987.

Example 3. Disinvestment of prior year's ECEP. Assume the same facts as in *Example 1* for 1987. A has no ECEP for 1988. A's U.S. net equity decreases by $40 (to $1,060) as of the close of 1988. A has a dividend equivalent amount of $40 for 1988, even though it has no ECEP for 1988. A's ECEP of $0 for 1988 is increased under paragraph (b)(3)(i) of this section by the $40 reduction in U.S. net equity (subject to the limitation in paragraph (b)(3)(ii) of this section of $100 of accumulated ECEP).

Example 4. Accumulated ECEP limitation. Assume the same facts as in *Example 2* for 1987. For 1988, A has $125 of ECEP and its U.S. net equity decreases by $50. A's U.S. net equity as of the close of 1988 is $990 ($1,040–$50). In computing A's dividend equivalent amount for 1988, the $125 of ECEP for 1988 is not increased under paragraph (b)(3)(i) of this section by the full amount of the $50 decrease in U.S. net equity during 1988. Rather, the increase in ECEP resulting from the decrease in U.S. net equity is limited to A's accumulated ECEP as of the beginning of 1988. A had $100 of ECEP for 1987 and a dividend equivalent amount of $60 for that year, so A had $40 of accumulated ECEP as of the beginning of 1988. The increase in ECEP resulting from a decrease in U.S. net equity is thus limited to $40, and the dividend equivalent amount for 1988 is $165 ($125 ECEP + $40 decrease in U.S. net equity).

Example 5. Effect of deficits in ECEP. Foreign corporation A, a calendar year taxpayer, has $150 of accumulated ECEP as of the beginning of 1991 ($200 aggregate ECEP less $50 aggregate dividend equivalent amounts for years preceding 1991). A has U.S. net equity of $450 as of the close of 1990, U.S. net equity of $350 as of the close of 1991 (i.e., a $100 decrease in U.S. net equity) and a $90 deficit in ECEP for 1991. A's dividend equivalent amount is $10 for 1991, i.e., A's deficit of $90 in ECEP for 1991 increased by $100, the decrease in A's U.S. net equity during 1991. A portion of the reduction in U.S. net equity in 1991 ($90) is attributable to A's deficit in ECEP for that year. The reduction in U.S. net equity in 1991 ($100) triggers a dividend equivalent amount only to the extent it exceeds the $90 current year deficit in ECEP for 1991. As of the beginning of 1992, A has $50 of accumulated ECEP (i.e., $110 aggregate ECEP less $60 aggregate dividend equivalent amounts for years preceding 1992).

Example 6. Nimble dividend equivalent amount. Foreign corporation A, a calendar year taxpayer, had a deficit in ECEP of $100 for 1987 and $100 for 1988, and has $90 of ECEP for 1989. A had $2,000 U.S. net equity as of the close of 1988 and has $2,000 U.S. net equity as of the close of 1989. A has a dividend equivalent amount of $90 for 1989, its ECEP for the year, even though it has a net deficit of $110 in ECEP for the period 1987–1989.

(c) *U.S. net equity*—(1) *Definition.* The term ''U.S. net equity'' means the aggregate amount of the U.S. assets (as defined in paragraphs (c)(2) and (d)(1) of this section) of a foreign corporation as of the determination date (as defined in paragraph (c)(3) of this section), reduced (including below zero) by the U.S. liabilities (as defined in paragraph (e) of this section) of the foreign corporation as of the determination date.

(2) *Definition of the amount of a U.S. asset*—(i) *In general.* For purposes of this section, the term ''amount of a U.S. asset'' means the U.S. asset's adjusted basis for purposes of computing earnings and profits (''E&P basis'') multiplied by the proportion of the asset that is treated as a U.S. asset under paragraphs (d) (1) through (4) of this section. The amount of a U.S. asset that is money shall be its face value. See paragraph (d)(6) of this section for rules concerning the computation of the E&P basis of a U.S. asset.

(ii) *Bad debt reserves.* A bank described in section 585(a)(2)(B) (without regard to the second sentence thereof) that uses the reserve method of accounting for bad debts for U.S. federal income tax purposes shall decrease the amount of loans that qualify as U.S. assets by any reserve that is permitted under section 585.

(3) *Definition of determination date.* For purposes of this section, the term ''determination date'' means the close of the day on which the amount of U.S. net equity is required to be determined. Unless otherwise provided, the U.S. net equity of a foreign corporation is required to be determined as of the close of the foreign corporation's taxable year.

(d) *U.S. assets*—(1) *Definition of a U.S. asset*—(i) *General rule.* Except as provided in paragraph (d)(5) of this section, the term ''U.S. asset'' means an asset of a foreign corporation (other than an interest in a partnership, trust, or estate) that is held by the corporation as of the determination date if—

(A) All income produced by the asset on the determination date is ECI (as defined in paragraph (d)(1)(iii) of this section) (or would be ECI if the asset produced income on that date); and

(B) All gain from the disposition of the asset would be ECI if the asset were disposed of on that date and the disposition produced gain.

For purposes of determining whether income or gain from an asset would be ECI under this paragraph (d)(1)(i), it is immaterial whether the asset is of a type that is unlikely to, or cannot, produce income or gain. For example, money may be a U.S. asset although it does not produce income or gain. In the case of an asset that does not produce income, however, the determination of whether income from the asset would be ECI shall be made under the principles of section 864 and the regulations thereunder, but without regard to § 1.864–4(c)(2)(iii)(*b*). For purposes of determining whether an asset is a U.S. asset under this paragraph (d)(1), a foreign corporation may presume, unless it has reason to know otherwise, that gain from the sale of personal property (including inventory property) would be U.S. source if gain from the sale of that type of property would ordinarily be attributable to an office or other fixed place of business of the foreign corporation within the United States (within the meaning of section 865(e)(2)).

(ii) *Special rules for assets not described in paragraph (d)(1)(i) of this section.* An asset of a foreign corporation that is held by the corporation as of the determination date and is not described in paragraph (d)(1)(i) of this section shall be treated as a U.S. asset to the extent provided in paragraph (d)(2) of this section (relating to special rules for certain assets, including assets that produce income or gain at least a portion of which is ECI), and in paragraphs (d) (3) and (4) of this section (relating to special rules for interests in a partnership, trust, and estate).

(iii) *Definition of ECI.* For purposes of the regulations under section 884, the term ''ECI'' means income that is effectively connected with the conduct of a trade or business in the United States and income that is treated as effectively connected with the conduct of a trade or business in the United States under any provision of the Code. The term ''ECI'' also includes all income that is or is treated as effectively connected with the conduct of a U.S. trade or business whether or not the income is included in gross income (for example, interest income earned with respect to tax-exempt bonds).

(2) *Special rules for certain assets*—(i) *Depreciable and amortizable property.* An item of depreciable personal property or an item of amortizable intangible property shall be treated as a U.S. asset of a foreign corporation in the same proportion that the amount of the depreciation or amortization with respect to the item of property that is allowable as a deduction, or is includible in cost of goods sold, for the taxable year in computing the effectively connected taxable income of the foreign corporation bears to the total amount of depreciation or amortization computed for the taxable year with respect to the item of property.

(ii) *Inventory.* An item or pool of inventory property (as defined in section 865(i)(1)) shall be treated as a U.S. asset in the same proportion as the amount of gross receipts from the sale or exchange of such property for the three preceding taxable years (or for such part of the three-year period as the corporation has been in existence) that is effectively connected with the conduct of a U.S. trade or business bears to the total amount of gross receipts from the sale or exchange of such property during such period (or part thereof). If a foreign corporation has not sold or exchanged such property during such three-year period (or part thereof), then the property shall be treated as a U.S. asset in the same proportion that the anticipated amount of gross receipts from the sale or exchange of the property that is reasonably anticipated to be ECI bears to the anticipated total amount of gross receipts from the sale or exchange of the property.

(iii) *Installment obligations.* An installment obligation received in connection with an installment sale (as defined in section 453(b)) for which an election under section 453(d) has not been made shall be treated as a U.S. asset to the extent that it is received in connection with the sale of a U.S. asset. If an obligation is received in connection with the sale of an asset that is wholly a U.S. asset, it shall be treated as a U.S. asset in its entirety. If a single obligation is received in connection with the sale of an asset that is in part a U.S. asset under the rules of paragraphs (d) (2) through (4) of this section, or in connection with the sale of several assets including one or more non-U.S. assets, the obligation shall be treated as a U.S. asset in the same proportion as—

(A) The sum of the amount of gain from the installment sale that would be ECI if the obligation were satisfied in full on the determination date and the adjusted basis of the obligation on such date (as determined under section 453B) attributable to the amount of gain that would be ECI bears to

(B) The sum of the total amount of gain from the sale if the obligation were satisfied in full and the adjusted basis of the obligation on such date (as determined under section 453B).

However, the obligation will only be treated as a U.S. asset if the interest income or original issue discount with respect to the obligation is ECI or the foreign corporation elects to treat the interest or original issue discount as ECI in the same proportion that the obligation is treated as a U.S. asset. A foreign corporation may elect to treat interest income or original issue discount as ECI by reporting such interest income or original issue discount as ECI on its income tax return or an amended return for the taxable year. See paragraph (d)(6)(ii) of this section to determine the E&P basis of an installment obligation for purposes of this paragraph (d)(2)(iii).

(iv) *Receivables*—(A) *Receivables arising from the sale or exchange of inventory property.* An account or note receivable (whether or not bearing stated interest) with a maturity not exceeding six months that arises from the sale or exchange of inventory property (as defined in section 865(i)(1)) shall be treated as a U.S. asset in the proportion determined under paragraph (d)(2)(iii) of this section as if the receivable were an installment obligation.

(B) *Receivables arising from the performance of services or leasing of property.* An account or note receivable (whether or not bearing stated interest) with a maturity not exceeding six months that arises from the performance of services or the leasing of property in the ordinary course of a foreign corporation's trade or business shall be treated as a U.S. asset in the same proportion that the amount of gross income represented by the receivable that is ECI bears to the total amount of gross income represented by the receivable. For purposes of this paragraph (d)(2)(iv)(B), the amount of income represented by a receivable shall not include interest income or original issue discount.

(v) *Bank and other deposits.* A deposit or credit balance with a person described in section 871(i)(3) or a Federal Reserve Bank that is interest-bearing shall be treated as a U.S. asset if all income derived by the foreign corporation with respect to the deposit or credit balance during the taxable year is ECI. Any other deposit or credit balance shall only be treated as a U.S. asset if the deposit or credit balance is needed in a U.S. trade or business within the meaning of § 1.864–4(c)(2)(iii)(*a*).

(vi) *Debt instruments.* A debt instrument, as defined in section 1275(a)(1) (other than an asset treated as a U.S. asset under any other subdivision of this paragraph (d)) shall be treated as a U.S. asset, notwithstanding the fact that gain from the sale or exchange of the obligation on the determination date would not be ECI, if—

(A) All income derived by the foreign corporation from such obligation during the taxable year is ECI; and

(B) The yield for the period that the instrument was held during the taxable year equals or exceeds the Applicable Federal Rate for instruments of similar type and maturity.

Shares in a regulated investment company that purchases solely instruments that, under this paragraph (d)(2)(vi), would be U.S. assets if held directly by the foreign corporation shall also be treated as a U.S. asset.

(vii) *Securities held by a foreign corporation engaged in a banking, financing or similar business.* Securities described in § 1.864–4(c)(5)(ii)(*b*)(*3*) held by a foreign corporation engaged in the active conduct of a banking, financing, or similar business in the United States during the taxable year shall be treated as U.S. assets in the same proportion that income, gain, or loss from such securities is ECI for the taxable year under § 1.864–4(c)(5)(ii).

(viii) *Federal income taxes.* An overpayment of Federal income taxes shall be treated as a U.S. asset to the extent that the tax would reduce a foreign corporation's ECEP for the taxable year but for the fact that the tax does not accrue during the taxable year.

(ix) *Losses involving U.S. assets.* A foreign corporation that sustains, with respect to a U.S. asset, a loss for which a deduction is not allowed under section 165 (in whole or in part) because there exists a reasonable prospect of recovering compensation for the loss shall be treated as having a U.S. asset (“loss property”) from the date of the loss in the same proportion that the asset was treated as a U.S. asset immediately before the loss. See paragraph (d)(6)(iv) of this section to determine the E&P basis of the loss property.

(x) *Ruling for involuntary conversion.* If property that is a U.S. asset of a foreign corporation is compulsorily or involuntarily converted into property not similar or related in service or use (within the meaning of section 1033), the foreign corporation may apply to the Commissioner for a ruling to determine its U.S. assets for the taxable year of the involuntary conversion.

(xi) *Examples.* The principles of paragraphs (c) and (d) (1) and (2) of this section are illustrated by the following examples.

Example 1. Depreciable property. Foreign corporation A, a calendar year taxpayer, is engaged in a trade or business in the United States. A owns equipment that is used in its manufacturing business in country X and in the United States. Under §1.861–8, A's depreciation deduction with respect to the equipment is allocated to sales income and is apportioned 70 percent to ECI and 30 percent to income that is not ECI. Under paragraph (d)(2)(ii) of this section, the equipment is 70 percent a U.S. asset. The equipment has an E&P basis of $100 at the beginning of 1993. A's depreciation deduction (for purposes of computing earnings and profits) with respect to the equipment is $10 for 1993. To determine the amount of A's U.S. asset at the close of 1993, the equipment's $90 E&P basis at the close of 1993 is multiplied by 70 percent (the proportion of the asset that is a U.S. asset). The amount of the U.S. asset as of the close of 1993 is $63.

Example 2. U.S. real property interest connected to a U.S. business. FC is a foreign corporation that is a bank, within the meaning of section 585(a)(2)(B) (without regard to the second sentence thereof), and is engaged in the business of taking deposits and making loans through its branch in the United States. In 1996, FC makes a loan in the ordinary course of its lending business in the United States, securing the loan with a mortgage on the U.S. real property being financed by the borrower. In 1997, after the borrower has defaulted on the loan, FC takes title to the real property that secures the loan. On December 31, 1997, FC continues to hold the property, classifying it on its financial statement as *Other Real Estate Owned*. Because all income and gain from the property would be ECI to FC under the principles of section 864(c)(2), the U.S. real property constitutes a U.S. asset within the meaning of paragraph (d) of this section.

Example 3. U.S. real property interest not connected to a U.S. business. Foreign corporation A owns a condominium apartment in the United States. Assume that holding the apartment does not constitute a U.S. trade or business and the foreign corporation has not made an election under section 882(d) to treat income with respect to the property as ECI. The condominium apartment is not a U.S. asset of A because the income, if any, from the asset would not be ECI. However, the disposition by A of the condominium apartment at a gain will give rise to ECEP.

Example 4. Stock in a domestically-controlled REIT. As an investment, foreign corporation A owns stock in a domestically-controlled REIT, within the meaning of section 897(h)(4)(B). Under section 897(h)(2), gain on disposition of stock in the REIT is not treated as ECI. For this reason the stock does not qualify as a U.S. asset under paragraph (d)(1) of this section even if dividend distributions from the REIT are treated as ECI. Thus, A will have a dividend equivalent amount based on the ECEP attributable to a distribution of ECI from the REIT, even if A invests the proceeds from the dividend in additional stock of the REIT. (Stock in a REIT that is not a domestically-controlled REIT is also not a U.S. asset. See §1.884–1(d)(5)).

Example 5. Section 864(c)(7) property. Foreign corporation A is engaged in the equipment leasing business in the United States and Canada. A transfers the equipment leased by its U.S. trade or business to its Canadian business after the equipment is fully depreciated in the United States. The Canadian business sells the equipment two years later. Section 864(c)(7) would treat the gain on the disposition of the equipment by A as taxable under section 882 as if the sale occurred immediately before the equipment was transferred to the Canadian business. The equipment would not be treated as a U.S. asset even if the gain was ECI because the income from the equipment in the year of the sale in Canada would not be ECI.

(3) *Interest in a partnership*—(i) *In general.* A foreign corporation that is a partner in a partnership must take into account its interest in the partnership (and not the partnership assets) in determining its U.S. assets. For purposes of determining the proportion of the partnership interest that is a U.S. asset, a foreign corporation may elect to use either the asset method described in paragraph (d)(3)(ii) of this section or the income method described in paragraph (d)(3)(iii) of this section.

(ii) *Asset method*—(A) *In general.* A partner's interest in a partnership shall be treated as a U.S. asset in the same proportion that the sum of the partner's proportionate share of the adjusted bases of all partnership assets as of the determination date, to the extent that the assets would be treated as U.S. assets if the partnership were a foreign corporation, bears to the sum of the partner's proportionate share of the adjusted bases of all partnership assets as of the determination date. Generally a partner's proportionate share of a partnership asset is the same as its proportionate share of all items of income, gain, loss, and deduction that may be generated by the asset.

(B) *Non-uniform proportionate shares.* If a partner's proportionate share of all items of income, gain, loss, and deduction that may be generated by a single asset of the partnership throughout the period that includes the taxable year of the partner is not uniform, then, for purposes of determining the partner's proportionate share of the adjusted basis of that asset, a partner must take into account the portion of the adjusted basis of the asset that reflects the partner's economic interest in that asset. A partner's economic interest in an asset of the partnership must be determined by applying the following presumptions. These presumptions may, however, be rebutted if the partner or the Internal Revenue Service shows that the presumption is inconsistent with the partner's true economic interest in the asset during the corporation's taxable year.

(*1*) If a partnership asset ordinarily generates directly identifiable income, a partner's economic interest in the asset is determined by reference to its proportionate share of income that may be generated by the asset for the partnership's taxable year ending with or within the partner's taxable year.

(*2*) If a partnership asset ordinarily generates current deductions and ordinarily generates no directly identifiable income, for example because the asset contributes equally to the generation of all the income of the partnership (such as an asset used in general and administrative functions), a partner's economic interest in the asset is determined by reference to its proportionate share of the total deductions that may be generated by the asset for the partnership's taxable year ending with or within the partner's taxable year.

(*3*) For other partnership assets not described in paragraph (d)(3)(ii)(B) (*1*) or (*2*) of this section, a partner's economic interest in the asset is determined by reference to its proportionate share of the total gain or loss to which it would be entitled if the asset were sold at a gain or loss in the partnership's taxable year ending with or within the partner's taxable year.

(C) *Partnership election under section 754.* If a partnership files an election in accordance with section 754, then for purposes of this paragraph (d)(3)(ii), the basis of partnership property shall reflect adjustments made pursuant to sections 734 (relating to distributions of property to a partner) and 743 (relating to the transfer of an interest in a partnership). However, adjustments made pursuant to section 743 may be made with respect to a transferee partner only.

(iii) *Income method.* Under the income method, a partner's interest in a partnership shall be treated as a U.S. asset in the same proportion that its distributive share of partnership ECI for the partnership's taxable year that ends with or within the partner's taxable year bears to its distributive share of all partnership income for that taxable year.

(iv) *Manner of election*—(A) *In general.* In determining the proportion of a foreign corporation's interest in a partnership that is a U.S. asset, a foreign corporation must elect one of the methods described in paragraph (d)(3) of this section on a timely filed return for the first taxable year beginning on or after the effective date of this section. An amended return does not qualify for this purpose, nor shall the provisions of § 301.9100–1 of this chapter and any guidance promulgated thereunder apply. An election shall be made by the foreign corporation calculating its U.S. assets in accordance with the method elected. An elected method must be used for a minimum period of five years before the foreign corporation may elect a different method. To change an election before the end of the requisite five-year period, a foreign corporation must obtain the consent of the Commissioner or her delegate. The Commissioner or her delegate will generally consent to a foreign corporation's request to change its election only in rare and unusual circumstances. A foreign corporation that is a partner in more than one partnership is not required to elect to use the same method for each partnership interest.

(B) *Elections with tiered partnerships.* If a foreign corporation elects to use the asset method with respect to an interest in a partnership, and that partnership is a partner in a lower-tier partnership, the foreign corporation may apply either the asset method or the income method to determine the proportion of the upper-tier partnership's interest in the lower-tier partnership that is a U.S. asset.

(v) *Failure to make proper election.* If a foreign corporation, for any reason, fails to make an election to use one of the methods required by paragraph (d)(3) of this section in a timely fashion, the district director or the Assistant Commissioner (International) may make the election on behalf of the foreign corporation and such election shall be binding as if made by that corporation.

(vi) *Special rule for determining a partner's adjusted basis in a partnership interest.* For purposes of paragraphs (d)(3) and (6) of this section, a partner's adjusted basis in a partnership interest shall be the partner's basis in such interest (determined under section 705) reduced by the partner's share of the liabilities of the partnership determined under section 752 and increased by a proportionate share of each liability of the partnership equal to the partner's proportionate share of the expense, for income tax purposes, attributable to such liability for the taxable year. A partner's adjusted basis in a partnership interest cannot be less than zero.

(vii) *E&P basis of a partnership interest.* See paragraph (d)(6)(iii) of this section for special rules governing the calculation of a foreign corporation's E&P basis in a partnership interest.

(viii) The application of this paragraph (d)(3) is illustrated by the following examples:

Example 1. General rule—(i) *Facts.* Foreign corporation, FC, is a partner in partnership ABC, which is engaged in a trade or business within the United States. FC and ABC are both calendar year taxpayers. ABC owns and manages two office buildings located in the United States, each with an adjusted basis of $50. ABC also owns a non-U.S. asset with an adjusted basis of $100. ABC has no liabilities. Under the partnership agreement, FC has a 50 percent interest in the capital of ABC and a 50 percent interest in all items of income, gain, loss, and deduction that may be generated by the partnership's assets. FC's adjusted basis in ABC is $100. In determining the proportion of its interest in ABC that is a U.S. asset, FC elects to use the asset method described in paragraph (d)(3)(ii) of this section.

(ii) *Analysis.* FC's interest in ABC is treated as a U.S. asset in the same proportion that the sum of FC's proportionate share of the adjusted bases of all ABC's U.S. assets (50% of $100), bears to the sum of FC's proportionate share of the adjusted bases of all of ABC's assets (50% of $200). Under the asset method, the amount of FC's interest in ABC that is a U.S. asset is $50 ($100 × $50/$100).

Example 2. Special allocation of gain with respect to real property—(i) *Facts.* The facts are the same as in *Example 1,* except that under the partnership agreement, FC is allocated 20 percent of the income from the partnership property but 80 percent of the gain on disposition of the partnership property.

(ii) *Analysis.* Assuming that the buildings ordinarily generate directly identifiable income, there is a rebuttable presumption under paragraph (d)(3)(ii)(B)(*1*) of this section that FC's proportionate share of the adjusted basis of the buildings is FC's proportionate share of the income generated by the buildings (20%) rather than the total gain that it would be entitled to under the partnership agreement (80%) if the buildings were sold at a gain on the determination date. Thus, the sum of FC's proportionate share of the adjusted bases in ABC's U.S. assets (the buildings) is presumed to be $20 [(20% of $50) + (20% of $50)]. Assuming that the non-U.S. asset is not income-producing and does not generate current deductions, there is a rebuttable presumption under paragraph (d)(3)(ii)(B)(*3*) of this section that FC's proportionate share of the adjusted basis of that asset is FC's interest in the gain on the disposition of the asset (80%) rather than its proportionate share of the income that may be generated by the asset (20%). Thus, FC's proportionate share of the adjusted basis of ABC's non-U.S. asset is presumed to be $80 (80% of $100). FC's proportionate share of the adjusted bases of all of the assets of ABC is $100 ($20 + $80). The amount of FC's interest in ABC that is a U.S. asset is $20 ($100 × $20/$100).

Example 3. Tiered partnerships (asset method)—(i) *Facts.* The facts are the same as in *Example 1,* except that FC's adjusted basis in ABC is $175 and ABC also has a 50 percent interest in the capital of partnership DEF. DEF owns and operates a commercial shopping center in the United States with an adjusted basis of $200 and also owns non-U.S. assets with an adjusted basis of $100. DEF has no liabilities. ABC's adjusted basis in its interest in DEF is $150 and ABC has a 50 percent interest in all the items of income, gain, loss and deduction that may be generated by the assets of DEF.

(ii) *Analysis.* Because FC has elected to use the asset method described in paragraph (d)(3)(ii) of this section, it must determine what proportion of ABC's partnership interest in DEF is a U.S. asset. As permitted by paragraph (d)(3)(iv)(B) of this section, FC also elects to use the asset method with respect to ABC's interest in DEF. ABC's interest in DEF is treated as a U.S. asset in the same proportion that the sum of ABC's proportionate share of the adjusted bases of all DEF's U.S. assets (50% of $200), bears to the sum of ABC's proportionate share of the adjusted bases of all of DEF's assets (50% of $300). Thus, the amount of ABC's interest in DEF that is a U.S. asset is $100 ($150 x $100/ $150). FC must then apply the rules of paragraph (d)(3)(ii) of this section to all the assets of ABC, including ABC's interest in DEF that is treated in part as a U.S. asset ($100) and in part as a non-U.S. asset ($50). FC's interest in ABC is treated as a U.S. asset in the same proportion that the sum of FC's proportionate share of the adjusted bases of the U.S. assets of ABC (including ABC's interest in DEF), bears to the sum of FC's proportionate share of the adjusted bases of all ABC's assets (including ABC's interest in DEF). Thus, the amount of FC's interest in ABC that is a U.S. asset is $100 (FC's adjusted basis in ABC ($175) multiplied by FC's proportionate share of the sum of the adjusted bases of ABC's U.S. assets ($100)) over FC's proportionate share of the sum of the adjusted bases of ABC's assets ($175)).

Example 4. Tiered partnerships (income method)—(i) *Facts.* The facts are the same as in *Example 3,* except that FC has elected to use the income method described in paragraph (d)(3)(iii) of this section to determine the proportion of its interest in ABC that is a U.S. asset. The two office buildings located in the United States generate $60 of income that is ECI for the taxable year. The non-U.S. asset is not-income producing. In addition ABC's distributive share of income from DEF consists of $40 of income that is ECI and $140 of income that is not ECI.

(ii) *Analysis.* Because FC has elected to use the income method it does need to determine what proportion of ABC's partnership interest in DEF is a U.S. asset. FC's interest in ABC is treated as a U.S. asset in the same proportion that its distributive share of ABC's income for the taxable year that is ECI ($50) ($30 earned directly by ABC + $20 distributive share from DEF) bears to its distributive share of all ABC's income for the taxable year ($55) ($30 earned directly by ABC + $25 distributive share from DEF). Thus, FC's interest in ABC that is a U.S. asset is $159 ($175 x $50/$55).

(4) *Interest in a trust or estate*—(i) *Estates and non-grantor trusts.* A foreign corporation that is a beneficiary of a trust or estate shall not be treated as having a U.S. asset by virtue of its interest in the trust or estate.

(ii) *Grantor trusts.* If, under sections 671 through 678, a foreign corporation is treated as owning a portion of a trust that includes all the income and gain that may be generated by a trust asset (or pro rata portion of a trust asset), the foreign corporation will be treated as owning the trust asset (or pro rata portion thereof) for purposes of determining its U.S. assets under this section.

(5) *Property that is not a U.S. asset*—(i) *Property that does not give rise to ECEP.* Property described in paragraphs (d) (1) through (4) of this section shall not be treated as a U.S. asset of a foreign corporation if, on the determination date, income from the use of the property, or gain or loss from the disposition of the property, would be described in paragraph (f)(2) of this section (relating to certain income that does not produce ECEP).

(ii) *Assets acquired to increase U.S. net equity artificially.* U.S. assets shall not include assets acquired or used by a foreign corporation if one of the principal purposes of such acquisition or use is to increase artificially the U.S. assets of a foreign corporation on the determination date. Whether assets are acquired or used for such purpose will depend upon all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes in acquiring or using an asset is to increase artificially the U.S. assets of a foreign corporation include the length of time during which the asset was used in a U.S. trade or business, whether the asset was acquired from, or disposed of to, a related person, and whether the aggregate value of the U.S. assets of the foreign corporation increased temporarily on the determination date. For purposes of this paragraph (d)(5)(ii), to be one of the principal purposes, a purpose must be important, but it is not necessary that it be the primary purpose.

(iii) *Interbranch transactions.* A transaction of any type between separate offices or branches of the same taxpayer does not create a U.S. asset.

(6) *E&P basis of a U.S. asset*—(i) *General rule.* The E&P basis of a U.S. asset for purposes of this section is its adjusted basis for purposes of computing the foreign corporation's earnings and profits. In determining the E&P basis of a U.S. asset, the adjusted basis of the asset (for purposes of computing taxable income) must be increased or decreased to take into account inclusions of income or gain, and deductions or similar charges, that affect the basis of the asset where such items are taken into account in a different manner for purposes of computing earnings and profits than for purposes of computing taxable income. For example, if section 312 (k) requires that depreciation with respect to a U.S. asset be determined using the straight line method for purposes of computing earnings and profits, but depreciation with respect to the asset is determined using a different method for purposes of computing taxable income, the E&P basis of the property for purposes of this section must be computed using the straight line method of depreciation.

(ii) *Installment obligations*—(A) *Sales in taxable year beginning on or after January 1, 1987.* For purposes of this section, the E&P basis of an installment obligation described in paragraph (d)(2)(iii) of this section that arises in connection with an installment sale occurring in a taxable year beginning on or after January 1, 1987, shall equal the sum of the total amount of gain from the sale if the obligation were satisfied in full and the adjusted basis of the property sold as of the date of sale, reduced by payments received with respect to the obligation that are not interest or original issue discount. See paragraph (j)(2)(ii) of this section, however, for a special E&P basis rule for an installment obligation arising in connection with a sale of a U.S. asset by a foreign corporation described in section 312(k)(4), where such sale occurs in a taxable year beginning in 1987.

(B) *Sales in taxable year prior to January 1, 1987.* For purposes of this section, the E&P basis of an installment obligation described in paragraph (d)(2)(iii) of this section that arises in connection with an installment sale occurring in a taxable year beginning before January 1, 1987, shall equal zero.

(iii) *Computation of E&P basis in a partnership.* For purposes of this section, a foreign corporation's E&P basis in a partnership interest shall be the foreign corporation's adjusted basis in such interest (as determined under paragraph (d)(3)(vi) of this section), further adjusted to take into account any differences between the foreign corporation's distributive share of items of partnership income, gain, loss, and deduction for purposes of computing the taxable income of the foreign corporation and the foreign corporation's distributive share of items of partnership income, gain, loss, and deductions for purposes of computing the earnings and profits of the foreign corporation.

(iv) *Computation of E&P basis of a loss property.* The E&P basis of a loss property (as defined in paragraph (d)(2)(ix) of this section) shall equal the E&P basis, immediately before the loss, of the U.S. asset with respect to which the loss was sustained, reduced (but not below zero) by—

(A) The amount of any deduction claimed under section 165 by the foreign corporation with respect to the loss for earnings and profits purposes; and

(B) Any compensation received with respect to the loss.

(v) *Computation of E&P basis of financial instruments.* [Reserved]

(vi) *Example.* The application of paragraph (d)(6)(ii) of this section is illustrated by the following example.

Example. Sale in taxable year beginning on or after January 1, 1987. Foreign corporation A, a calendar year taxpayer, sells a U.S. asset on the installment method in 1993. Under the terms of the sale, A is to receive $100, payable in ten annual installments of $10 beginning in 1994, plus an arm's-length rate of interest on the unpaid balance of the sales price. A's adjusted basis in the property sold is $70. The obligation received in connection with the installment sale is treated as a U.S. asset with an E&P basis of $100 ($30 (the amount of gain from the sale if the obligation were satisfied in full) + $70 (the adjusted basis of the property sold)). If A receives a payment of $10 (not including interest) in 1994 with respect to the obligation, the obligation is treated as a U.S. asset with an E&P basis of $90 ($100 − $10) as of the close of 1994.

(e) *U.S. liabilities.* The term *U.S. liabilities* means the amount of liabilities determined under paragraph (e)(1) of this section decreased by the amount of liabilities determined under paragraph (e)(3) of this section, and increased by the amount of liabilities determined under paragraph (e)(2) of this section.

(1) *Liabilities based on §1.882–5.* The amount of liabilities determined under this paragraph (e)(1) is the amount of U.S.-connected liabilities of a foreign corporation under §1.882–5 if the U.S.-connected liabilities were computed using the assets and liabilities of the foreign corporation as of the determination date (rather than the average of such assets and liabilities for the taxable year) and without regard to paragraph (e)(3) of this section.

(2) *Additional liabilities*—(i) *Insurance reserves.* The amount of liabilities determined under this paragraph (e)(2)(i) is the amount (as of the determination date) of the total insurance liabilities on United States business (within the meaning of section 842(b)(2)(B)) of a foreign corporation described in section 842(a) (relating to foreign corporations carrying on an insurance business in the United States) to the extent that such liabilities are not otherwise treated as U.S. liabilities by reason of paragraph (e)(1) of this section.

(ii) *Liabilities described in §1.882–5(a)(1)(ii).* The amount of liabilities determined under this paragraph (e)(2)(ii) is the amount (as of the determination date) of liabilities described in §1.882–5(a)(1)(ii) (relating to liabilities giving rise to interest expense that is directly allocated to income from a U.S. asset).

(3) *Election to reduce liabilities*—(i) *General rule.* The amount of liabilities determined under this paragraph (e)(3) is the amount by which a foreign corporation elects to reduce its liabilities under paragraph (e)(1) of this section.

(ii) *Limitation.* For any taxable year, a foreign corporation may elect to reduce the amount of its liabilities determined under paragraph (e)(1) of this section by an amount that does not exceed the excess, if any, of the amount of liabilities in paragraph (e)(1) of this section over the amount, as of the determination date, of U.S. booked liabilities (determined under §1.882–5(d)(2)) and liabilities described in paragraph (e)(2) of this section.

(iii) *Effect of election on interest deduction and branch-level interest tax.* A foreign corporation that elects to reduce its liabilities under this paragraph (e)(3) must, for purposes of computing the amount of its interest apportioned to ECI under §1.882–5, reduce its U.S.-connected liabilities for the taxable year of the election by the amount of the reduction in liabilities under this paragraph (e)(3). The reduction of its U.S.-connected liabilities will also require a corresponding decrease in the amount of its interest apportioned to ECI under §1.882–5 for purposes of §1.884–4(a) and for all other Code sections for which the amount of interest apportioned under §1.882–5 is relevant.

(iv) *Method of election.* A foreign corporation that elects the benefits of this paragraph (e)(3) for a taxable year shall state on its return for the taxable year (or on a statement attached to the return) that it has elected to reduce its liabilities for the taxable year under this paragraph (e)(3) and that it has reduced the amount of its U.S.-connected liabilities as provided in paragraph (e)(3)(iii) of this section, and shall indicate the amount of such reductions on the return or attachment. An election under this paragraph (e)(3) must be made before the due date (including extensions) for the foreign corporation's income tax return for the taxable year.

(v) *Effect of election on complete termination.* If a foreign corporation completely terminates its U.S. trade or business (within the meaning of §1.884–2T (a)(2)), notwithstanding §1.884–2T(a), the foreign corporation will be subject to tax on a dividend equivalent amount that equals the lesser of—

(A) The foreign corporation's accumulated ECEP that is attributable to an election to reduce liabilities; or

(B) The amount by which the corporation elected to reduce liabilities at the end of the taxable year preceding the year of complete termination.

For purposes of the preceding sentence, accumulated ECEP is attributable to an election to reduce liabilities to the extent that the ECEP was accumulated because of such an election rather than because of an increase in U.S. assets.

For example, if a foreign corporation did not have positive ECEP in any year for which an election was made, it would not be required to include an amount as a dividend equivalent amount under this paragraph (e)(3)(v) because any accumulated ECEP that it may have is not attributable to an election to reduce liabilities.

(4) *Artificial decrease in U.S. liabilities.* If a foreign corporation repays or otherwise decreases its U.S. liabilities and one of the principal purposes of such decrease is to decrease artificially its U.S. liabilities on the determination date, then such decrease shall not be taken into account for purposes of computing the foreign corporation's U.S. net equity. Whether the U.S. liabilities of a foreign corporation are artificially decreased will depend on all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes for the repayment or decrease of the liabilities is to decrease artificially the U.S. liabilities of a foreign corporation shall include whether the aggregate liabilities are temporarily decreased on or before the determination date by, for example, the repayment of liabilities, or U.S. liabilities are temporarily decreased on or before the determination date by the acquisition with contributed funds of passive-type assets that are not U.S. assets. For purposes of this paragraph (e)(4), to be one of the principal purposes, a purpose must be important, but it is not necessary that it be the primary purpose.

(5) *Examples.* The application of this paragraph (e) is illustrated by the following examples.

Example 1. General rule for computation of U.S. liabilities. As of the close of 1997, foreign corporation A, a calendar year taxpayer computes its U.S.-connected liabilities under §1.882–5(c) using its actual ratio of liabilities to assets. For purposes of computing its U.S.- connected liabilities under §1.882–5(c), A must determine the average total value of its assets that are U.S. assets. Assume that the average value of such assets is $100, while the amount of such assets as of the close of 1997 is $125. For purposes of §1.882–5(c)(2), A must determine the ratio of the average of its worldwide liabilities for the year to the average total value of worldwide assets for the taxable year. Assume that A's average liabilities-to-assets ratio under §1.882–5(c)(2) is 55 percent, while its liabilities-to-assets ratio at the close of 1997 is only 50 percent. Thus, assuming no further adjustments under paragraph (e)(3) of this section, A's U.S.-connected liabilities for purposes of §1.882–5 are $55 ($100×55%). However, A's U.S. liabilities are $62.50 for purposes of this section, the value of its assets determined under §1.882–5(b)(2) as of the close of December ($125) multiplied by the liabilities-to-assets ratio of (50%) as of such date.

Example 2. Election made to reduce liabilities. (i) As of the close of 1997, foreign corporation A, a real estate company, owns U.S. assets with an E&P basis of $1000. A has $800 of liabilities under paragraph (e)(1) of this section and $300 of liabilities properly reflected on the books of its U.S. trade or business under §1.882–5(d)(2). A has accumulated ECEP of $500 and in 1998, A has $60 of ECEP that it intends to retain for future expansion of its U.S. trade or business. A elects under paragraph (e)(3) of this section to reduce its liabilities by $60 from $800 to $740. As a result of the election, assuming A's U.S. assets and U.S. liabilities would otherwise have remained constant, A's U.S. net equity as of the close of 1998 will increase by the amount of the decrease in liabilities ($60) from $200 to $260 and its ECEP will be reduced to zero. Under paragraph (e)(3)(iii) of this section, A's interest expense for the taxable year is reduced by the amount of interest attributable to $60 of liabilities and A's excess interest is reduced by the same amount. A's taxable income and ECEP are increased by the amount of the reduction in interest expense attributable to the liabilities, and A may make an election under paragraph (e)(3) of this section to further reduce its liabilities, thus increasing its U.S. net equity and reducing the amount of additional ECEP created for the election.

(ii) In 1999, assuming A again has $60 of ECEP, A may again make the election under paragraph (e)(3) to reduce its liabilities. However, assuming A's U.S. assets and liabilities under paragraph (e)(1) of this section remain constant, A will need to make an election to reduce its liabilities by $120 to reduce to zero its ECEP in 1999 and to continue to retain for expansion (without the payment of the branch profits tax) the $60 of ECEP earned in 1998. Without an election to reduce liabilities, A's dividend equivalent amount for 1999 would be $120 ($60 of ECEP plus the $60 reduction in U.S. net equity from $260 to $200). If A makes the election to reduce liabilities by $120 (from $800 to $680), A's U.S. net equity will increase by $60 (from $260 at the end of the previous year to $320), the amount necessary to reduce its ECEP to $0. However, the reduction of liabilities will itself create additional ECEP subject to section 884 because of the reduction in interest expense attributable to the $120 of liabilities. A can make the election to reduce liabilities by $120 without exceeding the limitation on the election provided in paragraph (e)(3)(ii) of this section because $120 does not exceed the excess of $800 (the amount of A's liabilities under paragraph (e)(1) of this section) over $300 (the amount of liabilities on A's books).

(iii) If A terminates its U.S. trade or business in 1999 in accordance with the rules in § 1.884–2T(a), A would not be subject to the branch profits tax on the $60 of ECEP earned in that year. Under paragraph (e)(3)(v) of this section, however, it would be subject to the branch profits tax on the portion of the $60 of ECEP that it earned in 1998 that became accumulated ECEP because of an election to reduce liabilities.

(f) *Effectively connected earnings and profits*—(1) *In general.* Except as provided in paragraph (f)(2) of this section and as modified by § 1.884–2T (relating to the incorporation or complete termination of a U.S. trade or business or the reorganization or liquidation of a foreign corporation or its domestic subsidiary), the term "effectively connected earnings and profits" ("ECEP") means the earnings and profits (or deficits therein) determined under section 312 and this paragraph (f) that are attributable to ECI (within the meaning of paragraph (d)(1)(iii) of this section). Because the term "ECI" includes income treated as effectively connected, income that is ECI under section 842(b) (relating to minimum net investment income of an insurance business) or 864(c)(7) (relating to gain from property formerly held for use in a U.S. trade or business) gives rise to ECEP. ECEP also includes earnings and profits attributable to ECI of a foreign corporation earned through a partnership, and through a trust or estate. For purposes of section 884, gain on the sale of a U.S. real property interest by a foreign corporation that has made an election to be treated as a domestic corporation under section 897(i) will also give rise to ECEP. ECEP is not reduced by distributions made by the foreign corporation during any taxable year or by the amount of branch profits tax or tax on excess interest (as defined in § 1.884–4(a)(2)) paid by the foreign corporation. Earnings and profits are treated as attributable to ECI even if the earnings and profits are taken into account under section 312 in an earlier or later taxable year than the taxable year in which the ECI is taken into account.

(2) *Income that does not produce ECEP.* The term "ECEP" does not include any earnings and profits attributable to—

(i) Income excluded from gross income under section 883(a)(1) or 883(a)(2) (relating to certain income derived from the operation of ships or aircraft);

(ii) Income that is ECI by reason of section 921(d) or 926(b) (relating to certain income of a FSC and certain dividends paid by a FSC to a foreign corporation or nonresident alien) that is not otherwise ECI;

(iii) Gain on the disposition of a U.S. real property interest described in section 897(c)(1)(A)(ii) (relating to certain interests in a domestic corporation);

(iv) Income that is ECI by reason of section 953(c)(3)(C) (relating to certain income of a captive insurance company that a corporation elects to treat as ECI) that is not otherwise ECI;

(v) Income that is exempt from tax under section 892 (relating to certain income of foreign governments); and

(vi) Income that is ECI by reason of section 882(e) (relating to certain interest income of banks organized under the laws of a possession of the United States) that is not otherwise ECI.

(3) *Allocation of deductions attributable to income that does not produce ECEP.* In determining the amount of a foreign corporation's ECEP for the taxable year, deductions and other adjustments shall be allocated and apportioned under the principles of § 1.861–8 between ECI that gives rise to ECEP and income described in paragraph (f)(2) of this section (relating to income that is ECI but does not give rise to ECEP).

(4) *Examples.* The principles of paragraph (f) of this section are illustrated by the following examples.

Example 1. Tax-exempt income. Foreign corporation A owns a tax-exempt municipal bond that is a U.S. asset as of the close of its 1989 taxable year. The municipal bond gives rise in 1989 to ECI (even though the income is excluded from gross income under section 103(a) and is not gross income of a foreign corporation by reason of section 882(b)), and therefore gives rise to ECEP in 1989.

Example 2. Income exempt under a treaty. Foreign corporation A derives ECI that constitutes business profits that are not attributable to a permanent establishment maintained by A in the United States. The ECI is exempt from taxation under section 882(a) by reason of an income tax treaty and section 894(a). The income nevertheless gives rise to

ECEP under this paragraph (f). However, a dividend equivalent amount attributable to such ECEP may be exempt from the branch profits tax by reason of paragraph (g) of this section (relating to the application of the branch profits tax to corporations that are residents of countries with which the United States has an income tax treaty).

(g) *Corporations resident in countries with which the United States has an income tax treaty*—(1) *General rule.* Except as provided in paragraph (g)(2) of this section, a foreign corporation that is a resident of a country with which the United States has an income tax treaty in effect for a taxable year in which it has a dividend equivalent amount and that meets the requirements, if any, of the limitation on benefits provisions of such treaty with respect to the dividend equivalent amount shall not be subject to the branch profits tax on such amount (or will qualify for a reduction in the amount of tax with respect to such amount) only if—

(i) The foreign corporation is a qualified resident of such country for the taxable year, within the meaning of §1.884–5(a); or

(ii) The limitation on benefits provision, or an amendment to that provision, entered into force after December 31, 1986.

If, after application of §1.884–5(e)(4)(iv), a foreign corporation is a qualified resident under §1.884–5(e) (relating to the active trade or business test) only with respect to one of its trades or businesses in the United States, i.e., the trade or business that is an integral part of its business conducted in its country of residence, and not with respect to another, the rules of this paragraph shall apply only to that portion of its dividend equivalent amount attributable to the trade or business for which the foreign corporation is a qualified resident.

(2) *Special rules for foreign corporations that are qualified residents on the basis of their ownership*—(i) *General rule.* A foreign corporation that, in any taxable year, is a qualified resident of a country with which the United States has an income tax treaty in effect solely by reason of meeting the requirements of §1.884–5 (b) and (c) (relating, respectively, to stock ownership and base erosion) shall be exempt from the branch profits tax or subject to a reduced rate of branch profits tax under paragraph (g)(1) of this section with respect to the portion of its dividend equivalent amount for the taxable year attributable to accumulated ECEP only if the foreign corporation is a qualified resident of such country within the meaning of §1.884–5(a) for the taxable years includable, in whole or in part, in a consecutive 36-month period that includes the taxable year of the dividend equivalent amount. A foreign corporation that fails the 36-month test described in the preceding sentence shall be exempt from the branch profits tax or subject to the branch profits tax at a reduced rate under paragraph (g)(1) of this section with respect to accumulated ECEP (determined on a last-in-first-out basis) accumulated only during prior years in which the foreign corporation was a qualified resident of such country within the meaning of §1.884–5(a).

(ii) *Rules of application.* A foreign corporation that has not satisfied the 36-month test as of the close of the taxable year of the dividend equivalent amount but satisfies the test with respect to such dividend equivalent amount by meeting the 36-month test by the close of the second taxable year succeeding the taxable year of the dividend equivalent amount shall be subject to the branch profits tax for the year of the dividend equivalent amount without regard to paragraph (g)(1) of this section on the portion of the dividend equivalent amount attributable to accumulated ECEP derived in a taxable year in which the foreign corporation was not a qualified resident within the meaning of §1.884–5(a). Upon meeting the 36-month test, the foreign corporation shall be entitled to claim by amended return a refund of the tax paid with respect to the dividend equivalent amount in excess of the branch profits tax calculated by taking into account paragraph (g)(2)(i) of this section, provided the foreign corporation establishes in the amended return for the taxable year that it has met the requirements of such paragraph. For purposes of section 6611 (dealing with interest on overpayments), any overpayment of branch profits tax by reason of this paragraph (g)(2)(ii) shall be deemed not to have been made before the filing date for the taxable year in which the foreign corporation establishes that it has met the 36-month test.

(iii) *Example.* The application of this paragraph (g)(2) is illustrated by the following example.

Example. (i) Foreign corporation A, a calendar year taxpayer, is a resident of the United Kingdom. A has a dividend equivalent amount for its taxable year 1991 of $300, of which $100 is attributable to 1991 ECEP and $200 to accumulated ECEP. A is a qualified resident for its taxable year 1991 because for that year it meets the requirements of § 1.884–5 (b) and (c), relating, respectively, to stock ownership and base erosion. For 1991 A does not meet the requirements of § 1.884–5 (d), (e), or (f) for qualified residence. A is not a qualified resident of the United Kingdom for any taxable year prior to 1990 but is a qualified resident for its taxable years 1990 and 1992.

(ii) Because A is a qualified resident for the 3-year period (1990, 1991, and 1992) that includes the taxable year of the dividend equivalent amount (1991), A satisfies the 36-month test of this paragraph (g)(2) and no branch profits tax is imposed on the total $300 dividend equivalent amount. However, since A was not a qualified resident for any taxable year prior to 1990 and therefore cannot establish that it has satisfied the 36-month test until the taxable year following the year of the dividend equivalent amount, A must pay the branch profits tax for its taxable year 1991 with respect to the portion of the dividend equivalent amount attributable to accumulated ECEP relating to years prior to 1990 without regard to paragraph (g)(1) of this section. A may file for a refund of the branch profits tax paid with respect to its 1991 taxable year at any time after it establishes that it is a qualified resident for its 1992 taxable year.

(3) *Exemptions for foreign corporations resident in certain countries with income tax treaties in effect on January 1, 1987.* The branch profits tax shall not be imposed on the portion of the dividend equivalent amount with respect to which a foreign corporation satisfies the requirements of paragraphs (g) (1) and (2) of this section for a country listed below, so long as the income tax treaty between the United States and that country, as in effect on January 1, 1987, remains in effect, except to the extent the treaty is modified on or after January 1, 1987, to expressly provide for the imposition of the branch profits tax:

Aruba
Austria
Belgium
People's Republic of China
Cyprus
Denmark
Egypt
Finland
Germany
Greece
Hungary
Iceland
Ireland
Italy
Jamaica
Japan
Korea
Luxembourg
Malta
Morocco
Netherlands
Netherlands Antilles
Norway
Pakistan
Philippines
Sweden
Switzerland
United Kingdom

(4) *Modifications with respect to other income tax treaties*—(i) *Limitation on rate of tax*—(A) *General rule.* If, under paragraphs (g) (1) and (2) of this section, a corporation qualifies for a reduction in the amount of the branch profits tax and paragraph (g)(3) of this section does not apply, the rate of tax shall be the rate of tax on branch profits specified in the treaty between the United States and the corporation's country of residence or, if no rate of tax on branch profits is specified, the rate of tax that would apply under such treaty to dividends paid to the foreign corporation by a wholly-owned domestic corporation.

(B) *Certain treaties in effect on January 1, 1987.* The branch profits tax shall generally be imposed at the following rates on the portion of the dividend equivalent amount with respect to which a foreign corporation satisfies the requirements of paragraphs (g) (1) and (2) of this section for a country listed below, for as long as the relevant provisions of those income tax treaties remain in effect and are not modified or superseded by subsequent agreement:

Australia (15%)
Barbados (5%)
Canada (10%)
France (5%)
New Zealand (5%)
Poland (5%)
Romania (10%)
South Africa (30%)
Trinidad & Tobago (10%)
U.S.S.R.

However, for special rates imposed on corporations resident in France and Trinidad & Tobago that have certain amounts of dividend and interest income, see the dividend articles of the income tax treaties with those countries.

(ii) *Limitations other than rate of tax.* If, under paragraphs (g) (1) and (2) of this section, a foreign corporation qualifies for a reduction in the amount of branch profits tax and paragraph (g) (3) of this section does not apply, then—

(A) The foreign corporation shall be entitled to the benefit of any limitations on imposition of a tax on branch profits (in addition to any limitations on the rate of tax) contained in the treaty; and

(B) No branch profits tax shall be imposed with respect to a dividend equivalent amount out of ECEP or accumulated ECEP of the foreign corporation unless the ECEP or accumulated ECEP is attributable to a permanent establishment in the United States or, if not otherwise prohibited under the treaty, to gain from the disposition of a U.S. real property interest described in section 897(c)(1)(A)(i), except to the extent the treaty specifically permits the imposition of the branch profits tax on such earnings and profits.

No article in such treaty shall be construed to provide any limitations on imposition of the branch profits tax other than as provided in this paragraph (g)(4).

(iii) *Computation of the dividend equivalent amount if a foreign corporation has both ECEP attributable to a permanent establishment and not attributable to a permanent establishment.* To determine the dividend equivalent amount of a foreign corporation out of ECEP that is attributable to a permanent establishment, the foreign corporation may only take into account its U.S. assets, U.S. liabilities, U.S. net equity and ECEP attributable to its permanent establishment. Thus, a foreign corporation may not reduce the amount of its ECEP attributable to its permanent establishment by reinvesting all or a portion of that amount in U.S. assets not attributable to the permanent establishment.

(iv) *Limitations under the Canadian treaty.* The limitations on the imposition of the branch profits tax under the Canadian treaty include, but are not limited to, those described in paragraphs (g)(4)(iv) (A) and (B).

(A) *Effect of deficits in earnings and profits.* In the case of a foreign corporation that is a qualified resident of Canada, the dividend equivalent amount for any taxable year shall not exceed the foreign corporation's accumulated ECEP as of the beginning of the taxable year plus the corporation's ECEP for the taxable year. Thus, for example, if a foreign corporation that is a qualified resident of Canada has a deficit in accumulated ECEP of $200 as of the beginning of the taxable year and ECEP of $100 for the taxable year, it will have no dividend equivalent amount for the taxable year because it would have a cumulative deficit in ECEP of $100 as of the close of the taxable year. For purposes of this paragraph (g)(4)(iii)(A), any net deficit in accumulated earnings and profits attributable to taxable years beginning before January 1, 1987, shall be includible in determining accumulated ECEP.

(B) *One-time exemption of Canadian $500,000*—(*1*) *General rule.* In the case of a foreign corporation that is a qualified resident of Canada, the branch profits tax shall be imposed only with respect to that portion of the dividend equivalent amount for the taxable year that, when translated into Canadian dollars and added to the dividend equivalent amounts for preceding taxable years translated into Canadian dollars, exceeds Canadian $500,000. The value of the dividend equivalent amount in Canadian currency shall be determined by translating the ECEP for each taxable year that is includible in the dividend equivalent amount (as determined in U.S. dollars under the currency translation method used in determining the foreign corporation's taxable income for U.S. tax purposes) by the weighted average exchange rate for the taxable year (determined under the rules of section 989(b)(3)) during which the earnings and profits were derived.

(*2*) *Reduction in amount of exemption in the case of related corporations.* The amount of a foreign corporation's exemption under this paragraph (g)(4)(iii)(B) shall be reduced by the amount of any exemption that reduced the dividend equivalent amount of an associated foreign corporation with respect to the same or a similar business. For purposes of this paragraph (g)(4)(iii)(B), a foreign corporation is an associated foreign corporation if it is related to the foreign corporation for purposes of sectional 267(b) or it and the foreign corporation are stapled entities (within the meaning of section 269B(c)(2)) or are effectively stapled entities. A business is the same as or similar to another business if it involves the sale, lease, or manufacture of the same or a similar type of property or the provision of the same or a similar type of services. A U.S. real property interest described in section 897(c)(1)(A)(i) shall be treated as a business and all such U.S. real property interests shall be treated as businesses that are the same or similar.

(*3*) *Coordination with second-tier withholding tax.* The value of the dividend equivalent amount that is exempt from the branch profits tax by reason of paragraph (g)(4)(iii)(B)(*1*) of this section shall not be subject to tax under section 871(a) or 881, or to withholding under section 1441 or 1442, when distributed by the foreign corporation.

(5) *Benefits under treaties other than income tax treaties.* A treaty that is not an income tax treaty does not exempt a foreign corporation from the branch profits tax or reduce the amount of the tax.

(h) *Stapled entities.* Any foreign corporation that is treated as a domestic corporation by reason of section 269B (relating to stapled entities) shall continue to be treated as a foreign corporation for purposes of section 884 and the regulations thereunder, notwithstanding section 269B or the regulations thereunder. Dividends paid by such foreign corporation shall be treated as paid by a domestic corporation and shall be subject to the tax imposed by section 871(a) or 881(a), and to withholding under section 1441 or 1442, as applicable, to the extent paid out of earnings and profits that are not subject to tax under section 884(a). Dividends paid by such foreign corporation out of earnings and profits subject to tax under section 884(a) shall be exempt from the tax imposed by sections 871(a) and 881(a) and shall not be subject to withholding under section 1441 or 1442. Whether dividends are paid out of earnings and profits that are subject to tax under section 884(a) shall be determined under section 884(e)(3)(A) and the regulations thereunder. The limitation on the application of treaty benefits in section 884(e)(3)(B) (relating to qualified residents) shall apply to a foreign corporation described in this paragraph (h).

(i) *Effective date*—(1) *General rule.* This section is effective for taxable years beginning on or after October 13, 1992. With respect to a taxable year beginning before October 13, 1992 and after December 31, 1986, a foreign corporation may elect to apply this section in lieu of § 1.884–1T of the temporary regulations (as contained in the CFR edition revised as of April 1, 1992), but only if the foreign corporation also makes an election under § 1.884–4 (e) to apply § 1.884.4 in lieu of § 1.884–4T (as contained in the CFR edition revised as of April 1, 1992) for that taxable year, and the statute of limitations for assessment of a deficiency has not expired for that taxable year. Once an election has been made, an election under this section shall apply to all subsequent taxable years. However, paragraph (f)(2)(vi) of this section (relating to certain interest income of Possessions banks) shall not apply for taxable years beginning before January 1, 1990.

(2) *Election to reduce liabilities.* A foreign corporation may make an election to reduce its liabilities under paragraph (e)(3) of this section with respect to a taxable year for which an election under paragraph (i)(1) of this section is in effect by filing an amended return for the taxable year and recomputing its interest deduction and any other item affected by the election on an amended Form 1120F to take into account the reduction in liabilities for such year.

(3) *Separate election for installment obligations.* A foreign corporation may make a separate election to apply paragraphs (d)(2)(iii) and (d)(6)(ii) of this section (relating to installment obligations treated as U.S. assets) to any prior taxable year without making an election under paragraph (i)(1) of this section, provided the statute of limitations for assessment of a deficiency has not expired for that taxable year and each succeeding taxable year. Once an election under this paragraph (i)(3) has been made, it shall apply to all subsequent taxable years.

(4) *Special rules for certain U.S. assets and liabilities.* Paragraphs (c)(2) (i) and (ii), (d)(3), (d)(4), (d)(5)(iii), (d)(6)(iii), (d)(6)(vi), (e)(2), and (e)(3)(ii), of this section are effective for taxable years beginning on or after June 6, 1996.

(j) *Transition rules*—(1) *General rule.* Except as provided in paragraph (j)(2) of this section, in order to compute its dividend equivalent amount in the first taxable year to which this section applies (whether or not such year begins before October 13, 1992, a foreign corporation must recompute its U.S. net equity as of close of the preceding taxable year using the rules of this section and use such recomputed amount, rather than the amount computed under §1.884–1T (as contained in the CFR edition revised as of April 1, 1992), to determine the amount of any increase or decrease in the U.S. net equity as of the close of that taxable year.

(2) *Installment obligations*—(i) *Interest election.* In recomputing its U.S. net equity as of the close of the preceding taxable year, a foreign corporation that holds an installment obligation treated as a U.S. asset under §1.884–1T(d)(7) (as contained in the CFR edition revised as of April 1, 1992) as of such date may apply the rules of paragraph (d)(2)(iii) of this section without regard to the rule in that paragraph that requires interest or original issue discount on the obligation to be treated as ECI in order for such obligation to be treated as a U.S. asset.

(ii) *1987 sales by certain foreign corporations.* The E&P basis of an installment obligation arising in connection with a sale of property by a foreign corporation described in section 312(k)(4), where such sale occurs in a taxable year beginning in 1987, shall equal the E&P basis of the property sold as of the determination date reduced by payments received with respect to the obligation that do not represent gain for earnings and profits purposes, interest or original issue discount.

[T.D. 8432, 57 FR 41651, Sept. 11, 1992; 57 FR 49117, Oct. 29, 1992; 57 FR 60126, Dec. 18, 1992; 58 FR 17166, Apr. 1, 1993, as amended by T.D. 8657, 61 FR 9338, Mar. 8, 1996; 61 FR 14247, Apr. 1, 1996]

§1.884–2 Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary.

(a) through (a)(2)(i) [Reserved] For further information, see §1.884–2T(a) through (a)(2)(ii).

(a)(2)(ii) *Waiver of period of limitations.* The waiver referred to in §1.884–2T(a)(2)(i)(D) shall be executed on Form 8848, or substitute form, and shall extend the period for assessment of the branch profits tax for the year of complete termination to a date not earlier than the close of the sixth taxable year following that taxable year. This form shall include such information as is required by the form and accompanying instructions. The waiver must be signed by the person authorized to sign the income tax returns for the foreign corporation (including an agent authorized to do so under a general or specific power of attorney). The waiver must be filed on or before the date (including extensions) prescribed for filing the foreign corporation's income tax return for the year of complete termination. With respect to a complete termination occurring in a taxable year ending prior to June 6, 1996 a foreign corporation may also satisfy the requirements of this paragraph (a)(2)(ii) by applying §1.884–2T(a)(2)(ii) of the temporary regulations (as contained in the CFR edition revised as of April 1, 1995). A properly executed Form 8848, substitute form, or other form of waiver authorized by this paragraph (a)(2)(ii) shall be deemed to be consented to and signed by a Service Center Director or the Assistant Commissioner (International) for purposes of §301.6501(c)–1(d) of this chapter.

(a)(3) through (a)(4) [Reserved] For further information, see §1.884–2T(a)(3) through (a)(4).

(a)(5) *Special rule if a foreign corporation terminates an interest in a trust.* A foreign corporation whose beneficial interest in a trust terminates (by disposition or otherwise) in any taxable year shall be subject to the branch profits tax on ECEP attributable to amounts (including distributions of accumulated income or gain) treated as ECI to such beneficiary in such taxable year notwithstanding any other provision of § 1.884–2T(a).

(b) through (c)(2)(ii) [Reserved] For further information, see § 1.884–2T (b) through (c)(2)(ii).

(c)(2)(iii) *Waiver of period of limitations and transferee agreement.* In the case of a transferee that is a domestic corporation, the provisions of § 1.884–2T(c)(2)(i) shall not apply unless, as part of the section 381(a) transaction, the transferee executes a Form 2045 (Transferee Agreement) and a waiver of period of limitations as described in this paragraph (c)(2)(iii), and files both documents with its timely filed (including extensions) income tax return for the taxable year in which the section 381(a) transaction occurs. The waiver shall be executed on Form 8848, or substitute form, and shall extend the period for assessment of any additional branch profits tax for the taxable year in which the section 381(a) transaction occurs to a date not earlier than the close of the sixth taxable year following the taxable year in which such transaction occurs. This form shall include such information as is required by the form and accompanying instructions. The waiver must be signed by the person authorized to sign Form 2045. With respect to a complete termination occurring in a taxable year ending prior to June 6, 1996 a foreign corporation may also satisfy the requirements of this paragraph (c)(2)(iii) by applying § 1.884–2T(c)(2)(iii) of the temporary regulations (as contained in the CFR edition revised as of April 1, 1995). A properly executed Form 8848, substitute form, or other form of waiver authorized by this paragraph (c)(2)(iii) shall be deemed to be consented to and signed by a Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)–1(d) of this chapter.

(c)(3) through (f) [Reserved] For further information, see § 1.884–2T (c)(3) through (f).

(g) *Effective dates.* Paragraphs (a)(2)(ii) and (c)(2)(iii) of this section are effective for taxable years beginning after December 31, 1986. Paragraph (a)(5) of this section is effective for taxable years beginning on or after June 6, 1996.

[T.D. 8657, 61 FR 9341, Mar. 8, 1996]

§ 1.884–2T Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (temporary).

(a) *Complete termination of a U.S. trade or business*—(1) *General rule.* A foreign corporation shall not be subject to the branch profits tax for the taxable year in which it completely terminates all of its U.S. trade or business within the meaning of paragraph (a)(2) of this section. A foreign corporation's non-previously taxed accumulated effectively connected earnings and profits as of the close of the taxable year of complete termination shall be extinguished for purposes of section 884 and the regulations thereunder, but not for other purposes (for example, sections 312, 316 and 381).

(2) *Operating rules*—(i) *Definition of complete termination.* A foreign corporation shall have completely terminated all of its U.S. trade or business for any taxable year (''the year of complete termination'') only if—

(A) As of the close of that taxable year, the foreign corporation either has no U.S. assets, or its shareholders have adopted an irrevocable resolution in that taxable year to completely liquidate and dissolve the corporation and, before the close of the immediately succeeding taxable year (also a ''year of complete termination'' for purposes of applying this paragraph (a)(2)), all of its U.S. assets are either distributed, used to pay off liabilities, or cease to be U.S. assets;

(B) Neither the foreign corporation nor a related corporation uses, directly or indirectly, any of the U.S. assets of the terminated U.S. trade or business, or property attributable thereto or to effectively connected earnings and profits earned by the foreign corporation in the year of complete termination, in the conduct of a trade or business in the United States at any time during a period of three years from the close of the year of complete termination;

(C) The foreign corporation has no income that is, or is treated as, effectively connected with the conduct of a trade or business in the United States (other than solely by reason of section

864 (c)(6) or (c)(7)) during the period of three years from the close of the year of complete termination; and

(D) The foreign corporation attaches to its income tax return for each year of complete termination a waiver of the period of limitations, as described in paragraph (a)(2)(ii) of this section.

If a foreign corporation fails to completely terminate all of its U.S. trade or business because of the failure to meet any of the requirements of this paragraph (a)(2), then its branch profits tax liability for the taxable year and all subsequent taxable years shall be determined under the provisions of §1.884–1, without regard to any provisions in this paragraph (a), taking into account any reduction in U.S. net equity that results from a U.S. trade or business of the foreign corporation ceasing to have U.S. assets. Any additional branch profits tax liability that may result, together with interest thereon (charged at the underpayment rates determined under section 6621(a)(2) with respect to the period between the date that was prescribed for filing the foreign corporation's income tax return for the taxable year with respect to which the branch profits tax liability arises and the date on which the additional tax for that year is paid), and applicable penalties, if any, shall be the liability of the foreign corporation (or of any person who is a transferee of the foreign corporation within the meaning of section 6901).

(ii) *Waiver of period of limitations.* [Reserved] See §1.884–2(a)(2)(ii) for rules relating to this paragraph.

(iii) *Property subject to reinvestment prohibition rule.* For purposes of paragraph (a)(2)(i)(B) of this section—

(A) The term *U.S. assets of the terminated U.S. trade or business* shall mean all the money and other property that qualified as U.S. assets of the foreign corporation as of the close of the taxable year immediately preceding the year of complete termination; and

(B) Property attributable to U.S. assets or to effectively connected earnings and profits earned by the foreign corporation in the year of complete termination shall mean money or other property into which any part or all of such assets or effectively connected earnings and profits are converted at any time before the expiration of the three-year period specified in paragraph (a)(2)(i)(B) of this section by way of sale, exchange, or other disposition, as well as any money or other property attributable to the sale by a shareholder of the foreign corporation of its interest in the foreign corporation (or a successor corporation) at any time after a date which is 12 months before the close of the year of complete termination (24 months in the case of a foreign corporation that makes an election under paragraph (b) of this section).

(iv) *Related corporation.* For purposes of paragraph (a)(2)(i)(B) of this section, a corporation shall be related to a foreign corporation if either corporation is a 10-percent shareholder of the other corporation or, where the foreign corporation completely liquidates, if either corporation would have been a 10-percent shareholder of the other corporation had the foreign corporation remained in existence. For this purpose, the term *10-percent shareholder* means any person described in section 871(h)(3)(B) as well as any person who owns 10 percent or more of the total value of the stock of the corporation, and stock ownership shall be determined on the basis of the attribution rules described in section 871(h)(3)(C).

(v) *Direct or indirect use of U.S. assets.* The use of any part or all of the property referred to in paragraph (a)(2)(i)(B) of this section shall include the loan thereof to a related corporation or the use thereof as security (as a pledge, mortgage, or otherwise) for any indebtedness of a related corporation.

(3) *Complete termination in the case of a section 338 election.* A foreign corporation whose stock is acquired by another corporation that makes (or is deemed to make) an election under section 338 with respect to the stock of the foreign corporation shall be treated as having completely liquidated as of the close of the acquisition date (as defined in section 338(h)(2)) and to have completely terminated all of its U.S. trade or business with respect to the taxable year ending on such acquisition date provided the foreign corporation that exists prior to the section 338

transaction complies with the requirements of paragraph (a)(2)(i) (B) and (D) of this section. For purposes of the preceding sentence, any of the money or other property paid as consideration for the acquisition of the stock in the foreign corporation (and for any debt claim against the foreign corporation) shall be treated as property attributable to the U.S. assets of the terminated U.S. trade or business and to the effectively connected earnings and profits of the foreign corporation earned in the year of complete termination.

(4) *Complete termination in the case of a foreign corporation with income under section 864(c)(6) or 864(c)(7).* No branch profits tax shall be imposed on effectively connected earnings and profits attributable to income that is treated as effectively connected with the conduct of a trade or business in the United States solely by reason of section 864(c)(6) or 864(c)(7) if—

(i) No income of the foreign corporation for the taxable year is, or is treated as, effectively connected with the conduct of a trade or business in the United States, without regard to section 864(c)(6) or 864(c)(7),

(ii) The foreign corporation has no U.S. assets as of the close of the taxable year, and

(iii) Such effectively connected earnings and profits would not have been subject to branch profits tax pursuant to the complete termination provisions of paragraph (a)(1) of this section if income or gain subject to section 864(c)(6) had not been deferred or if property subject to section 864(c)(7) had been sold immediately prior to the date the property ceased to have been used in the conduct of a trade or business in the United States.

(5) *Special rule if a foreign corporation terminates an interest in a trust.* [Reserved] See § 1.884–2(a)(5) for rules relating to this paragraph.

(6) *Coordination with second-level withholding tax.* Effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits of a foreign corporation that are exempt from branch profits tax by reason of the provisions of paragraph (a)(1) of this section shall not be subject to tax under section 871(a), 881(a), 1441 or 1442 when paid as a dividend by such foreign corporation (or a successor-in-interest).

(b) *Election to remain engaged in a U.S. trade or business*—(1) *General rule.* A foreign corporation that would be considered to have completely terminated all of its U.S. trade or business for the taxable year under the provisions of paragraph (a)(2)(i) of this section, but for the provisions of paragraph (a)(2)(i)(B) of this section that prohibit reinvestment within a three-year period, may make an election under this paragraph (b) for the taxable year in which it completely terminates all its U.S. trade or business (as determined without regard to paragraph (a)(2)(i)(B) of this section) and, if it so chooses, for the following taxable year (but not for any succeeding taxable year). The election under this paragraph (b) is an election by the foreign corporation to designate an amount of marketable securities as U.S. assets for purposes of § 1.884–1. The marketable securities identified pursuant to the election under paragraph (b)(3) of this section shall be treated as being U.S. assets in an amount equal, in the aggregate, to the lesser of the adjusted basis of the U.S. assets that ceased to be U.S. assets during the taxable year in which the election is made (determined on the date or dates the U.S. assets ceased to be U.S. assets) or the adjusted basis of the marketable securities as of the end of the taxable year. The securities must be held from the date that they are identified until the end of the taxable year for which the election is made, or if disposed of during the taxable year, must be replaced on the date of disposition with other marketable securities that are acquired on or before that date and that have a fair market value as of the date of substitution not less than their adjusted basis.

(2) *Marketable security.* For purposes of this paragraph (b), the term *marketable security* means a security (including stock) that is part of an issue any portion of which is regularly traded on an established securities market (within the meaning of § 1.884–5(d)(2) and (4)) and a deposit described in section 871(i)(3) (A) or (B).

(3) *Identification requirements.* In order to qualify for this election—

(i) The marketable securities must be identified on the books and records of the U.S. trade or business within 30 days of the date an equivalent amount of U.S. assets ceases to be U.S. assets; and

(ii) On the date a marketable security is identified, its adjusted basis must not exceed its fair market value.

(4) *Treatment of income from deemed U.S. assets.* The income or gain from the marketable securities (or replacement securities) subject to an election under this paragraph (b) that arises in a taxable year for which an election is made shall be treated as ECI (other than for purposes of section 864(c)(7)), and losses from the disposition of such marketable securities shall be allocated entirely to income that is ECI. In addition, all such securities shall be treated as if they had been sold for their fair market value on the earlier of the last business day of a taxable year for which an election is in effect or the day immediately prior to the date of substitution by the foreign corporation of a U.S. asset for the marketable security, and any gain (but not loss) and accrued interest on the securities shall also be treated as ECI. The adjusted basis of such property shall be increased by the amount of any gain recognized by reason of this paragraph (b).

(5) *Method of election.* A foreign corporation may make an election under this paragraph (b) by attaching to its income tax return for the taxable year a statement—

(i) Identifying the marketable securities treated as U.S. assets under this paragraph (b);

(ii) Setting forth the E&P bases of such securities; and

(iii) Agreeing to treat any income, gain or loss as provided in paragraph (b)(4) of this section.

Such statement must be filed on or before the due date (including extensions) of the foreign corporation's income tax return for the taxable year. A foreign corporation shall not be permitted to make an election under this paragraph (b) more than once.

(6) *Effective date.* This paragraph (b) is effective for taxable years beginning on or after October 13, 1992. However, if a foreign corporation has made a valid election under §1.884–1(i) to apply that section with respect to a taxable year beginning before October 13, 1992 and after December 31 1986, this paragraph (b) shall be effective beginning with such taxable year.

(c) *Liquidation, reorganization, etc. of a foreign corporation.* The following rules apply to the transfer by a foreign corporation engaged (or deemed engaged) in the conduct of a U.S. trade or business (the ‘‘transferor’’) of its U.S. assets to another corporation (the ‘‘transferee’’) in a complete liquidation or reorganization described in section 381(a) (a ‘‘section 381(a) transaction’’) if the transferor is engaged (or deemed engaged) in the conduct of a U.S. trade or business immediately prior to the section 381(a) transaction. For purposes of this paragraph (c), a section 381(a) transaction is considered to occur in the taxable year that ends on the date of distribution or transfer (as defined in §1.381(b)–1(b)) pursuant to the section 381(a) transaction.

(1) *Inapplicability of paragraph (a)(1) of this section to section 381(a) transactions.* Paragraph (a)(1) of this section (relating to the complete termination of a U.S. trade or business of a foreign corporation) does not apply to exempt the transferor from branch profits tax liability for the taxable year in which the section 381(a) transaction occurs or in any succeeding taxable year.

(2) *Transferor's dividend equivalent amount for the taxable year in which a section 381(a) transaction occurs.* The dividend equivalent amount for the taxable year, including a short taxable year, in which a section 381(a) transaction occurs shall be determined under the provisions of §1.884–1, as modified under the provisions of this paragraph (c)(2).

(i) *U.S. net equity.* The transferor's U.S. net equity as of the close of the taxable year shall be determined without regard to any transfer in that taxable year of U.S. assets to or from the transferee pursuant to a section 381(a) transaction, and without regard to any U.S. liabilities assumed or acquired by the transferee from the transferor in that taxable year pursuant to a section 381(a) transaction. The transferor's adjusted basis (for earnings and profits purposes) in U.S. assets transferred to the transferee pursuant to a section 381(a) transaction shall be the adjusted basis of those assets (for earnings and profits purposes) immediately prior to the section 381(a) transaction, adjusted as provided under section 362(b), treating the transferor, for that purpose, as though it were the transferee and treating the gain taken into account for earnings and profits purposes as gain recognized.

(ii) *Effectively connected earnings and profits.* The transferor's effectively connected earnings and profits for the taxable year in which the section 381(a) transaction occurs and its non-previously taxed accumulated effectively connected earnings and profits shall be determined without regard to the carryover to the transferee of the transferor's earnings and profits under section 381 (a) and (c)(2) and paragraph (c)(4) of this section. Effectively connected earnings and profits for the taxable year in which a section 381(a) transaction occurs shall be adjusted by the amount of any gain recognized to the transferor in that year pursuant to the section 381(a) transaction (to the extent taken into account for earnings and profits purposes).

(iii) *Waiver of period of limitations and transferee agreement.* [Reserved] See § 1.884–2(c)(2)(iii) for rules relating to this paragraph.

(3) *Transferor's dividend equivalent amount for any taxable year succeeding the taxable year in which the section 381(a) transaction occurs.* Any decrease in U.S. net equity in any taxable year succeeding the taxable year in which the section 381(a) transaction occurs shall increase the transferor's dividend equivalent amount for those years without regard to the limitation in § 1.884–1(b)(3)(ii), to the extent such decrease in U.S. net equity does not exceed the balance of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits carried over to the transferee pursuant to section 381 (a) and (c)(2), as determined under paragraph (c)(4) of this section.

(4) *Earnings and profits of the transferor carried over to the transferee pursuant to the section 381(a) transaction*—(i) *Amount.* The amount of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits of the transferor that carry over to the transferee under section 381 (a) and (c)(2) shall be the effectively connected earnings and profits and the non-previously taxed accumulated effectively connected earnings and profits of the transferor immediately before the close of the taxable year in which the section 381(a) transaction occurs. For this purpose, the provisions in § 1.381(c)(2)–1 shall generally apply with proper adjustments to reflect the fact that effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits are not affected by distributions to shareholders but, rather, by dividend equivalent amounts. Therefore, the amounts of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits that carry over to the transferee pursuant to those provisions are reduced by the transferor's dividend equivalent amount for the taxable year in which the section 381(a) transaction occurs. Such amounts are also reduced to the extent of any dividend equivalent amount determined for any succeeding taxable year solely as a result of the provisions of paragraph (c)(3) of this section. For purposes of this paragraph (c)(4)(i), if the transferor accumulates non-previously taxed effectively connected earnings and profits, or incurs a deficit in effectively connected earnings and profits, attributable to a period that is after the close of the taxable year in which the section 381(a) transaction occurs and before the liquidation of the transferor, then such effectively connected earnings and profits, or deficits therein, shall be deemed to have been accumulated or incurred on or before the close of the taxable year in which the section 381(a) transaction occurs.

(ii) *Retention of character.* All of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits that carry over to the transferee shall constitute non-previously taxed accumulated effectively connected earnings and profits of the transferee. In the case of a domestic transferee, such non-previously taxed accumulated effectively connected earnings and profits shall also constitute accumulated earnings and profits of the transferee for purposes of section 316(a)(2).

(iii) *Treatment of distributions by a domestic transferee out of non-previously taxed accumulated effectively connected earnings and profits.* In the event the transferee is a domestic corporation, distributions out of the transferee's non-previously taxed accumulated effectively connected earnings and profits that are received by a foreign distributee shall qualify for benefits under an applicable income tax treaty only (A) if the distributee qualifies for the benefits under such treaty and (B) to the extent that the transferor foreign corporation would have qualified under the principles of §1.884–1(g) (1) and (2)(i) for an exemption or reduction in rate with respect to the branch profits tax if the non-previously taxed accumulated effectively connected earnings and profits had been reflected in a dividend equivalent amount for the taxable year in which the section 381(a) transaction occurs. (The tax rate on dividends specified in the treaty between the distributee's country of residence and the United States shall apply to any dividends received by a distributee who qualifies for a treaty benefit under the preceding sentence.) In addition, distributions out of such non-previously taxed accumulated effectively connected earnings and profits shall retain their character in the hands of any domestic distributee up a chain of corporate shareholders for purposes of applying this paragraph (c)(4)(iii) to distributions made by any such person to a foreign distributee. If a domestic transferee has non-previously taxed accumulated effectively connected earnings and profits carried over from the transferor as well as accumulated earnings and profits, then each category of earnings and profits shall be accounted for in two separate pools, and any distribution of earnings and profits shall be treated as a distribution out of each pool in proportion to the respective amount of undistributed earnings and profits in each pool. Section 871(i) (relating, in part, to dividends paid by a domestic corporation meeting the 80-percent foreign business requirements of section 861(c)(1)) shall not apply to any dividends paid by a domestic transferee out of its non-previously taxed accumulated effectively connected earnings and profits.

(5) *Determination of U.S. net equity of a transferee that is a foreign corporation.* In the event the transferee is a foreign corporation, then for purposes of determining the transferee's increase or decrease in U.S. net equity under §1.884–1 for its taxable year during which the section 381(a) transaction occurs, its U.S. net equity as of the close of its immediately preceding taxable year shall be increased by the amount of U.S. net equity acquired by the transferee from the transferor pursuant to the section 381(a) transaction, taking into account the adjustments to the basis (for earnings and profits purposes) of U.S. assets under the principles of section 362(b).

(6) *Special rules in the case of the disposition of stock or securities in a domestic transferee or in the transferor*—(i) *General rule.* This paragraph (c)(6)(i) shall apply where the transferee is a domestic corporation, subdivision (A), (B), or (C) of this paragraph applies and subdivision (D) of this paragraph applies.

(A) Shareholders of the transferor sell, exchange or otherwise dispose of stock in the transferor at any time during a 12-month period before the date of distribution or transfer (as defined in §1.381(b)–1(b)) and the aggregate amount of such stock sold, exchanged or otherwise disposed of exceeds 25 percent of the value of the stock of the transferor, determined on a date that is 12 months before the date of distribution or transfer.

(B) Shareholders of the transferee (or of the transferee's parent in the case of a reorganization described in the parenthetical clause in section 368(a)(1)(C)) who in the aggregate owned more than 25 percent of the value of the stock of the transferor at any time within the 12 month period preceding the close of the year in which the section 381(a) transaction occurs sell, exchange or otherwise dispose of their stock or securities in the transferee at any time during a period of three years from the close of the taxable year in which the section 381(a) transaction occurs.

(C) In the case of a reorganization described in the parenthetical clause in section 368(a)(1)(C), the transferee's parent sells, exchanges or otherwise disposes of its stock or securities in the transferee at any time during a period of three years from the close of the taxable year in which the section 381(a) transaction occurs.

(D) A corporation related to any such shareholder or the shareholder itself if it is a corporation (subsequent to an event described in subdivision (A) or (B) of this paragraph (c)(6)(i)), or the transferee's parent (subsequent to an event described in subdivision (C) of this paragraph (c)(6)(i)), uses, directly or indirectly, the proceeds or property received in such sale, exchange or disposition, or property attributable thereto, in the conduct of a trade or business in the United States at any time during a period of three years from the date of sale in the case of a disposition of stock in the transferor, or from the close of the taxable year in which the section 381(a) transaction occurs in the case of a disposition of the stock or securities in the transferee (or the transferee's parent in the case of a reorganization described in the parenthetical clause in section 368(a)(1)(C)).

Where this paragraph (c)(6)(i) applies, the transferor's branch profits tax liability for the taxable year in which the section 381(a) transaction occurs shall be determined under §1.884–1, taking into account all the adjustments in U.S. net equity that result from the transfer of U.S. assets and liabilities to the transferee pursuant to the section 381(a) transaction, without regard to any provisions in this paragraph (c). If an event described in paragraph (c)(6)(i) (A), (B), or (C) of this section occurs after the close of the taxable year in which the section 381(a) transaction occurs, and if additional branch profits tax is required to be paid by reason of the application of this paragraph (c)(6)(i), then interest must be paid on that amount at the underpayment rates determined under section 6621(a)(2), with respect to the period between the date that was prescribed for filing the transferor's income tax return for the year in which the section 381(a) transaction occurs and the date on which the additional tax for that year is paid. Any such additional tax liability together with interest thereon shall be the liability of the transferee within the meaning of section 6901 pursuant to section 6901 and the regulations thereunder.

(ii) *Operating rule.* For purposes of paragraph (c)(6)(i) of this section paragraphs (a)(2) (iii)(B), (iv) and (v) of this section shall apply for purposes of making the determinations under paragraph (c)(6)(i)(D) of this section.

(d) *Incorporation under section 351*—(1) *In general.* The following rules apply to the transfer by a foreign corporation engaged (or deemed engaged) in the conduct of a U.S. trade or business (the ‘‘transferor’’) of part or all of its U.S. assets to a U.S. corporation (the ‘‘transferee’’) in exchange for stock or securities in the transferee in a transaction that qualifies under section 351(a) (a ‘‘section 351 transaction’’), provided that immediately after the transaction, the transferor is in control (as defined in section 368(c)) of the transferee, without regard to other transferors.

(2) *Inapplicability of paragraph (a)(1) of this section to section 351 transactions.* Paragraph (a)(1) of this section does not apply to exempt the transferor from branch profits tax liability for the taxable year in which a section 351 transaction described in paragraph (d)(1) of this section occurs and shall not apply for any subsequent taxable year of the transferor in which it, or a successor-in-interest, owns stock or securities of a transferee as of the close of the transferor's taxable year.

(3) *Transferor's dividend equivalent amount for the taxable year in which a section 351 transaction occurs.* The dividend equivalent amount of the transferor for the taxable year in which a section 351 transaction described in paragraph (d)(1) of this section occurs shall be determined under the provisions of §1.884–1, as modified by the provisions of this paragraph (d)(3) provided that the transferee elects under

paragraph (d)(4) of this section to be allocated a proportionate amount of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits and the foreign corporation files a statement as provided in paragraph (d)(5)(i) of this section and complies with the agreement included in such statement with respect to a subsequent disposition of the transferee's stock.

(i) *U.S. net equity.* The transferor's U.S. net equity as of the close of the taxable year shall be determined without regard to any transfer in that taxable year of U.S. assets to or from the transferee pursuant to a section 351 transaction, and without regard to any U.S. liabilities assumed or acquired by the transferee from the transferor in that taxable year pursuant to a section 351 transaction. The transferor's adjusted basis for earnings and profits purposes in U.S. assets transferred to the transferee pursuant to a section 351 transaction shall be the adjusted basis of those assets for earnings and profits purposes immediately prior to the section 351 transaction, increased by the amount of any gain recognized by the transferor on the transfer of such assets in the section 351 transaction to the extent taken into account for earnings and profits purposes.

(ii) *Effectively connected earnings and profits.* Subject to the limitation in paragraph (d)(3)(iii) of this section, the calculation of the transferor's dividend equivalent amount shall take into account the transferor's effectively connected earnings and profits for the taxable year in which a section 351 transaction occurs (including any amount of gain recognized to the transferor pursuant to the section 351 transaction to the extent the gain is taken into account for earnings and profits purposes) and, for purposes of applying the limitation of §1.884–1(b)(3)(ii), its non-previously taxed accumulated effectively connected earnings and profits, determined without regard to the allocation to the transferee of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits pursuant to the election under paragraph (d)(4)(i) of this section.

(iii) *Limitation on dividend equivalent amount.* The dividend equivalent amount determined under this paragraph (d)(3) shall not exceed the sum of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits determined after taking into account the allocation to the transferee of the transferor's earnings pursuant to an election under paragraph (d)(4)(i) of this section.

(4) *Election to increase earnings and profits*—(i) *General rule.* The election referred to in paragraph (d)(3) of this section is an election by the transferee to increase its earnings and profits by the amount determined under paragraph (d)(4)(ii) of this section. An election under this paragraph (d)(4)(i) shall be effective only if the transferee attaches a statement to its timely filed (including extensions) income tax return for the taxable year in which the section 351 transaction occurs, in which—

(A) It agrees to be subject to the rules of paragraph (c)(4) (ii) and (iii) of this section with respect to the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to the transferee pursuant to the election under this paragraph (d)(4)(i) in the same manner as if such earnings and profits had been carried over to the transferee pursuant to section 381 (a) and (c)(2), and

(B) It identifies the amount of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits that are allocated from the transferor.

An election with respect to a taxable year ending on or before December 1, 1988, may be made by filing an amended Form 1120F on or before January 3, 1988, to which the statement described in this paragraph (d)(4)(i) shall be attached.

(ii) *Amount of the transferor's effectively connected earnings and profits and* *non-previously taxed accumulated effectively connected earnings and profits allocated to the transferee.* The amount referred to in paragraph (d)(4)(i) of this section is equal to the same proportion of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits (determined immediately prior to the section 351 transaction and without regard to this paragraph (d)(4) or any dividend equivalent amount for the taxable year) that the adjusted bases for purposes of computing earnings and profits in all the U.S. assets transferred to the transferee by the transferor pursuant to the section 351 transaction bear to the adjusted bases for purposes of computing earnings and profits in all the U.S. assets of the transferor, determined immediately prior to the section 351 transaction.

(iii) *Effect of election on transferor.* For purposes of computing the transferor's dividend equivalent amount for the taxable year succeeding the taxable year in which a section 351 transaction occurs, the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits as of the close of the taxable year in which the section 351 transaction occurs shall be reduced by the amount of its effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to the transferee pursuant to the election under paragraph (d)(4)(i) of this section (and by its dividend equivalent amount for the taxable year in which the section 351 transaction occurs).

(5) *Dispositions of stock or securities of the transferee by the transferor*—(i) *General rule.* The statement referred to in paragraph (d)(3) of this section is a statement executed by the transferor stating the transferor's agreement that, upon the disposition of part or all of the stock or securities it owns in the transferee (or a successor-in-interest), it shall treat as a dividend equivalent amount for the taxable year in which the disposition occurs an amount equal to the lesser of (A) the amount realized upon such disposition or (B) the total amount of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits that was allocated from the transferor to that transferee pursuant to an election under paragraph (d)(4)(i) of this section, which amount shall be reduced to the extent previously taken into account by the transferor as dividends or dividend equivalent amounts for tax or branch profits, tax purposes. The extent and manner in which such dividend equivalent amount may be subject to the branch profits tax in the taxable year of disposition shall be determined under the provisions of section 884 and the regulations thereunder, including the provisions of paragraph (a) of this section (relating to complete terminations), as limited under paragraph (d)(2) of this section. Except as otherwise provided in paragraph (d)(5)(ii) of this section, the term *disposition* means any transfer that would constitute a disposition by the transferor for any purpose of the Internal Revenue Code and the regulations thereunder. This paragraph (d)(5)(i) shall apply regardless of whether the stock or securities of the transferee are U.S. assets in the hands of the transferor at the time of sale, exchange or disposition.

(ii) *Exception for certain tax-free dispositions.* For purposes of paragraph (d)(5)(i) of this section, a disposition does not include a transfer of stock or securities of the transferee by the transferor in a transaction that qualifies as a transfer pursuant to a complete liquidation described in section 332(b) or a transfer pursuant to a reorganization described in section 368(a)(1)(F). Any other transfer that qualifies for non-recognition of gain or loss shall be treated as a disposition for purposes of paragraph (d)(5)(i) of this section, unless the Commissioner has, by published guidance or by prior ruling issued to the taxpayer upon its request, determined such transfer not to be a disposition for purposes of paragraph (d)(5)(i) of this section.

(iii) *Distributions governed by section 355.* In the case of a distribution or exchange of stock or securities of a transferee to which section 355 applies (or so much of section 356 as relates to section 355) and that is not in pursuance of a plan meeting the requirements of a reorganization as defined in section 368(a)(1)(D), § 1.3l2–10(b) (relating to the allocation of earnings and profits in certain corporate separations) shall not apply to reduce the transferor's effectively connected earnings and profits or non-previously taxed accumulated effectively connected earnings and profits.

(iv) *Filing of statement.* The statement referred to in paragraph (d)(5)(i) of this section shall be attached to a timely filed (including extensions) income tax return of the transferor for the taxable year in which the section 351 transaction occurs. An election with respect to a taxable year ending on or before December 1, 1988, may be made by filing an amended Form 1120F on or before January 3, 1988, to which the statement described in this paragraph (d)(5)(iv) shall be attached.

(6) *Example.* The provisions of this paragraph (d) are illustrated by the following example.

Example. Foreign corporation X has a calendar taxable year. X's only assets are U.S. assets and X computes its interest deduction using the actual ratio of liabilities to assets under § 1.882–5(b)(2)(ii). X's U.S. net equity as of the close of its 1988 taxable year is $2,000, resulting from the following amounts of U.S. assets and liabilities:

U.S. assets		U.S. liabilities	
U.S. building A	$l,000	Mortgage A	800
U.S. building B	2,500	Mortgage B	1,500
Other U.S. assets	800		
Total	4,300		2,300

Assume that X's adjusted basis in its assets is equal to X's adjusted basis in its assets for earnings and profits purposes. On September 30, 1989, X transfers building A, which has a fair market value of $1,800, to a newly created U.S. corporation Y under section 351 in exchange for 100% of the stock of Y with a fair market value of $800, other property with a fair market value of $200, and the assumption of Mortgage A. Assume that under sections 11 and 351(b), tax of $30 is imposed with respect to the $200 of other property received by X. X's non-previously taxed accumulated effectively connected earnings and profits as of the close of its 1988 taxable year are $200 and its effectively connected earnings and profits for its 1989 taxable year are $330, including $170 of gain recognized to X on the transfer as adjusted for earnings and profits purposes (*i.e.,* $200 of gain recognized minus $30 of tax paid with respect to the gain). Y takes a $1,200 basis in the building transferred from X, equal to the basis in the hands of X ($1,000) increased by the amount of gain recognized to X in the section 351 transaction ($200). Y makes an election in the manner described in paragraph (d)(4)(i) of this section to increase its earnings and profits by the amount described in paragraph (d)(4)(ii) of this section and X files a statement as provided in paragraph (d)(5)(i) of this section. The branch profits tax consequences to X and Y in the taxable year in which the section 351 transaction occurs and in subsequent taxable years are as follows:

(i) *X's dividend equivalent amount for 1989.* The determination of X's dividend equivalent amount for 1989 is a three-step process: determining X's U.S. net equity as of the close of its 1989 taxable year under paragraph (d)(3)(i) of this section; determining the amount of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits for its 1989 taxable year under paragraph (d)(3)(ii) of this section; and applying the limitation in paragraph (d)(3)(iii) of this section.

Step one: Pursuant to paragraph (d)(3)(i) of this section, X's U.S. net equity as of the close of its 1989 taxable year is calculated without regard to the section 351 transaction except that X's basis in its U.S. assets is increased by the $170 amount of gain it has recognized for earnings and profits purposes in connection with the section 351 transaction. Thus, X's U.S. net equity as of the close of its 1989 taxable year is $1,870, consisting of the following U.S. assets and liabilities, taking into account the fact that X's other U.S. assets have decreased to $500:

U.S. assets		U.S. liabilities	
Building A	$l,170	Mortgage A	800
Building B	2,500	Mortgage B	1,500
Other U.S. assets	500		
Total	4,170		2,300

Thus, X's U.S. net equity as of the close of its 1989 taxable year has decreased by $130 relative to its U.S. net equity as of the close of its 1988 taxable year.

Step two: Pursuant to paragraph (d)(3)(ii) of this section, X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits for the taxable year are determined without taking into account the allocation to Y of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits pursuant to the election under paragraph (d)(4)(i) of this section. Thus, X's effectively connected earnings and profits for its 1989 taxable year are $330 and X's non-previously taxed accumulated effectively connected earnings and profits are $200. Thus, but for the limitation in paragraph (d)(3)(iii) of this section, X's dividend equivalent amount for the taxable year would be $460, equal to X's effectively connected earnings and profits for the taxable year ($330), increased by the decrease in X's U.S. net equity ($130).

Step three: Pursuant to paragraph (d)(3)(iii) of this section, X's dividend equivalent amount for its 1989 taxable year may not exceed the sum of the transferor's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits, determined as of the close of its 1989 taxable year, after taking into account the allocation of the transferor's earnings and profits pursuant to the election under paragraph (d)(4)(i) of this section. Based upon subdivision (ii) of this example, X's dividend equivalent amount for 1989 cannot exceed $423, which is equal to the total amount of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits, determined as of the close of its 1989 taxable year without regard to the allocation of earnings and profits to Y pursuant to Y's election under paragraph (d)(4)(i) of this section ($530), reduced by the amount of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to Y pursuant to Y's election under paragraph (d)(4)(i) of this section ($107). Thus, X's dividend equivalent amount for its 1989 taxable year is limited to $423.

(ii) *Amount of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits transferred to Y.* Pursuant to Y's election under paragraph (d)(4)(i) of this section, Y increases its earnings and profits by the amount prescribed in paragraph (d)(4)(ii) of this section. This amount is equal to the sum of X's effectively connected earnings and profits and non previously taxed accumulated effectively connected earnings and profits determined immediately before the section 351 transaction, without regard to X's dividend equivalent amount for the year, allocated in the same proportion that X's basis in the U.S. assets transferred to Y bears to the bases of all of X's U.S. assets, which bases are determined immediately prior to the section 351(a) transaction. The amount of X's effectively connected earnings and profits immediately before the section 351 transaction is assumed to be $260. The total amount of effectively connected earnings and profits ($260) and non-previously taxed accumulated effectively connected earnings and profits ($200) determined immediately before the section 351 transaction is, therefore, $460. The portion of $460 that is allocated to Y pursuant to Y's election under paragraph (d)(4)(i) of this section is $107, calculated as $46? multiplied by a fraction, the numerator of which is the basis of the U.S. assets transferred to Y pursuant to the section 351 transaction ($1,000), and the denominator of which is the basis of X's U.S. assets determined immediately before the section 351 transaction ($4,300). Pursuant to paragraph (d)(4)(i) of this section, the amount of $107 of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to Y pursuant to paragraph (d)(4)(i) of this section constitutes non-previously taxed accumulated effectively connected earnings and profits of Y.

(iii) *X's non-previously taxed accumulated effectively connected earnings and profits for 1990.* Pursuant to paragraph (d)(4)(iii) of this section, X's non-previously taxed accumulated effectively connected earnings and profits as of the close of its 1989 taxable year for purposes of computing its dividend equivalent amount for its taxable year 1990 are zero, *i.e.*, $530 of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits reduced by $107 of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to Y, and further reduced by X's $423 dividend equivalent amount for its 1989 taxable year.

(iv) *X's U.S. net equity for purposes of determining the dividend equivalent amount for succeeding taxable years.* For 1990, X must determine its U.S. net equity as of December 31, 1989, in order to determine whether there has been an increase or decrease in its U.S. net equity as of December 31, 1990. For this purpose, X's U.S. net equity as of December 31, 1989 is determined under the provisions of § 1.884–1 without regard to the special rules in paragraph (d)(3)(i) of this section. Thus, X.'s U.S. net equity as of December 31, 1989 is $1,500, consisting of the following. U.S. assets and liabilities:

U.S. assets		U.S. liabilities	
Building B .... Other U.S. assets	$2,500 500	Mortgage B	1,500
Total	$3,000		1,500

(e) *Certain transactions with respect to a domestic subsidiary.* In the case of a section 381(a) transaction in which a domestic subsidiary of a foreign corporation transfers assets to that foreign corporation or to another foreign corporation with respect to which the first foreign corporation owns stock (directly or indirectly) meeting the requirements of section 1504(a)(2), the transferee's non-previously taxed accumulated effectively connected earnings and profits for the taxable year in which the section 381(a) transaction occurs shall be increased by all of the domestic subsidiary's current earnings and profits and earnings and profits accumulated after December 31, 1986, that carry over to the transferee under sections 381(a) and (c)(1) (including non-previously taxed accumulated effectively connected earnings and profits, if any, transferred to the domestic subsidiary under paragraphs (c)(4) and (d)(4) of this section and treated as earnings and profits under paragraphs (c)(4)(ii) and (d)(4)(ii) of this section). For purposes of determining the transferee's dividend equivalent amount for the taxable year in which the section 381(a) transaction occurs, the transferee's U.S. net equity as of the close of its taxable year immediately preceding the taxable year during which the section 381(a) transaction occurs shall be increased by the greater of

(1) The amount by which the transferee's U.S. net equity computed immediately prior to the transfer would have increased due to the transfer of the subsidiary's assets and liabilities if U.S. net equity were computed immediately prior to the transfer and immediately after the transfer (taking into account in the earnings and profits basis of the assets transferred any gain recognized on the transfer to the extent reflected in earnings and profits), or

(2) The total amount of U.S net equity transferred (directly or indirectly) by the foreign parent to the domestic subsidiary in one or more prior section 351 or 381(a) transactions.

(f) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

[T.D. 8223, 53 FR 34059, Sept. 2, 1988, as amended by T.D. 8432, 57 FR 41659, Sept. 11, 1992; 57 FR 49117, Oct. 29, 1993; 57 FR 60126, Dec. 18, 1992; T.D. 8657, 61 FR 9341, Mar. 8, 1996]

§1.884–3T Coordination of branch profits tax with second-tier withholding (temporary). [Reserved]

§1.884–4 Branch-level interest tax.

(a) *General rule*—(1) *Tax on branch interest.* In the case of a foreign corporation that, during the taxable year, is engaged in trade or business in the United States or has gross income that is ECI (as defined in §1.884–1(d)(1)(iii)), any interest paid by such trade or business (hereinafter "branch interest," as defined in paragraph (b) of this section) shall, for purposes of subtitle A (Income Taxes), be treated as if it were paid by a domestic corporation (other than a corporation described in section 861(c)(1), relating to a domestic corporation that meets the 80 percent foreign business requirement). Thus, for example, whether such interest is treated as income from sources within the United States by the person who receives the interest shall be determined in the same manner as if such interest were paid by a domestic corporation (other than a corporation described in section 861(c)(1)). Such interest shall be subject to tax under section 871(a) or 881, and to withholding under section 1441 or 1442, in the same manner as interest paid by a domestic corporation (other than a corporation described in section 861(c)(1)) if received by a foreign person and not effectively connected with the conduct by the foreign person of a trade or business in the United States, unless the interest, if paid by a domestic corporation, would be exempt under section 871(h) or 881(c) (relating to exemption for certain portfolio interest received by a foreign person), section 871(i) or 881(d) (relating, in part, to exemption for certain bank deposit interest received by a foreign person), or another provision of the Code. Such interest shall also be treated as interest paid by a domestic corporation (other than a corporation described in section 861(c)(1)) for purposes of sections 864(c), 871(b) and 882(a) (relating to income that is effectively connected with the conduct of a trade or business within the United States) and section 904 (relating to the limitation on the foreign tax credit). For purposes of this section, a foreign corporation also shall be treated as engaged in trade or business in the United States if, at any time during the taxable year, it owns an asset taken into account under §1.882–5(a)(1)(ii) or (b)(1) for purposes of determining the amount of the foreign corporation's interest expense allocated or apportioned to ECI. See paragraph (b)(8) of this section for the effect of income tax treaties on branch interest.

(2) *Tax on excess interest*—(i) Definition of excess interest. For purposes of this section, the term ‘‘excess interest’’ means—

(A) The amount of interest allocated or apportioned to ECI of the foreign corporation under § 1.882–5 for the taxable year, after application of § 1.884–1(e)(3); minus

(B) The foreign corporation's branch interest (as defined in paragraph (b) of this section) for the taxable year, but not including interest accruing in a taxable year beginning before January 1, 1987; minus

(C) The amount of interest determined under paragraph (c)(2) of this section (relating to interest paid by a partnership).

(ii) *Imposition of tax.* A foreign corporation shall be liable for tax on excess interest under section 881(a) in the same manner as if such excess interest were interest paid to the foreign corporation by a wholly-owned domestic corporation (other than a corporation described in section 861(c)(1)) on the last day of the foreign corporation's taxable year. Excess interest shall be exempt from tax under section 881(a) only as provided in paragraph (a)(2)(iii) of this section (relating to treatment of certain excess interest of banks as interest on deposits) or paragraph (c)(3) of this section (relating to income tax treaties).

(iii) *Treatment of a portion of the excess interest of banks as interest on deposits.* A portion of the excess interest of a foreign corporation that is a bank (as defined in section 585(a)(2)(B) without regard to the second sentence thereof) provided that a substantial part of its business in the United States, as well as all other countries in which it operates, consists of receiving deposits and making loans and discounts, shall be treated as interest on deposits (as described in section 871(i)(3)), and shall be exempt from the tax imposed by section 881(a) as provided in such section. The portion of the excess interest of the foreign corporation that is treated as interest on deposits shall equal the product of the foreign corporation's excess interest and the greater of—

(A) The ratio of the amount of interest bearing deposits, within the meaning of section 871(i)(3)(A), of the foreign corporation as of the close of the taxable year to the amount of all interest bearing liabilities of the foreign corporation on such date; or

(B) 85 percent.

(iv) *Reporting and payment of tax on excess interest.* The amount of tax due under section 884(f) and this section with respect to excess interest of a foreign corporation shall be reported on the foreign corporation's income tax return for the taxable year in which the excess interest is treated as paid to the foreign corporation under section 884(f)(1)(B) and paragraph(a)(2) of this section, and shall not be subject to withholding under section 1441 or 1442. The tax shall be due and payable as provided in section 6151 and such other sections of Subtitle F of the Internal Revenue Code as apply, and estimated tax payments shall be due with respect to a foreign corporation's liability for the tax on excess interest as provided in section 6655.

(3) *Original issue discount.* For purposes of this section, the term ‘‘interest’’ includes original issue discount, as defined in section 1273(a)(1).

(4) *Examples.* The application of this paragraph (a) is illustrated by the following examples.

Example 1. Taxation of branch interest and excess interest. Foreign corporation A, a calendar year taxpayer that is not a corporation described in paragraph (a)(2)(iii) of this section (relating to banks), has $120 of interest allocated or apportioned to ECI under § 1.882–5 for 1997. A's branch interest (as defined in paragraph (b) of this section) for 1997 is as follows: $55 of portfolio interest (as defined in section 871(h)(2)) to B, a nonresident alien; $25 of interest to foreign corporation C, which owns 15 percent of the combined voting power of A's stock, with respect to bonds issued by A; and $20 to D, a domestic corporation. B and C are not engaged in the conduct of a trade or business in the United States. A, B and C are residents of countries with which the United States does not have an income tax treaty. The interest payments made to B and D are not subject to tax under section 871(a) or 881 and are not subject to withholding under section 1441 or 1442. The payment to C, which does not qualify as portfolio interest because C owns at least 10 percent of the combined voting power of A's stock, is subject to withholding of $7.50 ($25

× 30%). In addition, because A's interest allocated or apportioned to ECI under §1.882–5 ($120) exceeds its branch interest ($100), A has excess interest of $20, which is subject to a tax of $6 ($20 × 30%) under section 881. The tax on A's excess interest must be reported on A's income tax return for 1997.

Example 2. Taxation of excess interest of a bank. Foreign corporation A, a calendar year taxpayer, is a corporation described in paragraph (a)(2)(iii) of this section (relating to banks) and is a resident of a country with which the United States does not have an income tax treaty. A has excess interest of $100 for 1997. At the close of 1997, A has $10,000 of interest-bearing liabilities (including liabilities that give rise to branch interest), of which $8,700 are interest-bearing deposits. For purposes of computing the tax on A's excess interest, $87 of the excess interest ($100 excess interest x ($8,700 interest-bearing deposits/$10,000 interest-bearing liabilities)) is treated as interest on deposits. Thus, $87 of A's excess interest is exempt from tax under section 881(a) and the remaining $13 of excess interest is subject to a tax of $3.90 ($13 × 30%) under section 881(a).

(b) *Branch interest*—(1) *Definition of branch interest.* For purposes of this section, the term ''branch interest'' means interest that is—

(i) Paid by a foreign corporation with respect to a liability that is—

(A) A U.S. booked liability within the meaning of §1.882–5(d)(2) (other than a U.S. booked liability of a partner within the meaning of §1.882–5(d)(2)(vii)); or

(B) Described in §1.884–1(e)(2) (relating to insurance liabilities on U.S. business and liabilities giving rise to interest expense that is directly allocated to income from a U.S. asset); or

(ii) In the case of a foreign corporation other than a corporation described in paragraph (a)(2)(iii) of this section, a liability specifically identified (as provided in paragraph (b)(3)(i) of this section) as a liability of a U.S. trade or business of the foreign corporation on or before the earlier of the date on which the first payment of interest is made with respect to the liability or the due date (including extensions) of the foreign corporation's income tax return for the taxable year, provided that—

(A) The amount of such interest does not exceed 85 percent of the amount of interest of the foreign corporation that would be excess interest before taking into account interest treated as branch interest by reason of this paragraph (b)(1)(ii);

(B) The requirements of paragraph (b)(3)(ii) of this section (relating to notification of recipient of interest) are satisfied; and

(C) The liability is not described in paragraph (b)(3)(iii) of this section (relating to liabilities incurred in the ordinary course of a foreign business or secured by foreign assets) or paragraph (b)(1)(i) of this section.

(2) [Reserved]

(3) *Requirements relating to specifically identified liabilities*—(i) *Method of identification.* A liability described in paragraph (b)(1)(ii) of this section is identified as a liability of a U.S. trade or business only if the liability is shown on the records of the U.S. trade or business, or is identified as a liability of the U.S. trade or business on other records of the foreign corporation or on a schedule established for the purpose of identifying the liabilities of the U.S. trade or business. Each such liability must be identified with sufficient specificity so that the amount of branch interest attributable to the liability, and the name and address of the recipient, can be readily identified from such records or schedule. However, with respect to liabilities that give rise to portfolio interest (as defined in sections 871(h) and 881(c)) or that are payable 183 days or less from the date of original issue, and form part of a larger debt issue, such liabilities may be identified by reference to the issue and maturity date, principal amount and interest payable with respect to the entire debt issue. Records or schedules described in this paragraph that identify liabilities that give rise to branch interest must be maintained in the United States by the foreign corporation or an agent of the foreign corporation for the entire period commencing with the due date (including extensions) of the income tax return for the taxable year to which the records or schedules relate and ending with the expiration of the period of limitations for assessment of tax for such taxable year. A foreign corporation that is subject to this section may identify a liability under paragraph (b)(1)(ii) of this section whether or not it is actually

engaged in the conduct of a trade or business in the United States.

(ii) *Notification to recipient.* Interest with respect to a liability described in paragraph (b)(1)(ii) of this section shall not be treated as branch interest unless the foreign corporation paying the interest either—

(A) Makes a return, pursuant to section 6049, with respect to the interest payment; or

(B) Sends a notice to the person who receives such interest in a confirmation of the transaction, a statement of account, or a separate notice, within two months of the end of the calendar year in which the interest was paid, stating that the interest paid with respect to the liability is from sources within the United States.

(iii) *Liabilities that do not give rise to branch interest under paragraph (b)(1)(ii) of this section.* A liability is described in this paragraph (b)(3)(iii) (and interest with respect to the liability may not be treated as branch interest of a foreign corporation by reason of paragraph (b)(1)(ii) of this section) if—

(A) The liability is directly incurred in the ordinary course of the profit-making activities of a trade or business of the foreign corporation conducted outside the United States, as, for example, an account or note payable arising from the purchase of inventory or receipt of services by such trade or business; or

(B) The liability is secured (during more than half the days during the portion of the taxable year in which the interest accrues) predominantly by property that is not a U.S. asset (as defined in § 1.884–1(d)) unless such liability is secured by substantially all the property of the foreign corporation.

(4) [Reserved]

(5) *Increase in branch interest where U.S. assets constitute 80 percent or more of a foreign corporation's assets*—(i) *General rule.* If a foreign corporation would have excess interest before application of this paragraph (b) (5) and the amount of the foreign corporation's U.S. assets as of the close of the taxable year equals or exceeds 80 percent of all money and the aggregate E&P basis of all property of the foreign corporation on such date, then all interest paid and accrued by the foreign corporation during the taxable year that was not treated as branch interest before application of this paragraph (b)(5) and that is not paid with respect to a liability described in paragraph (b)(3)(iii) of this section (relating to liabilities incurred in the ordinary course of a foreign business or secured by non-U.S. assets) shall be treated as branch interest. However, if application of the preceding sentence would cause the amount of the foreign corporation's branch interest to exceed the amount permitted by paragraph (b)(6)(i) of this section (relating to branch interest in excess of a foreign corporation's interest allocated or apportioned to ECI under § 1.882–5) the amount of branch interest arising by reason of this paragraph shall be reduced as provided in paragraphs (b)(6) (ii) and (iii) of this section, as applicable.

(ii) *Example.* The application of this paragraph (b)(5) is illustrated by the following example.

Example. Application of 80 percent test. Foreign corporation A, a calendar year taxpayer, has $90 of interest allocated or apportioned to ECI under § 1.882–5 for 1993. Before application of this paragraph (b)(5), A has $40 of branch interest in 1993. A pays $60 of other interest during 1993, none of which is attributable to a liability described in paragraph (b)(3)(iii) of this section (relating to liabilities incurred in the ordinary course of a foreign business and liabilities predominantly secured by foreign assets). As of the close of 1993, A has an amount of U.S. assets that exceeds 80 percent of the money and E&P bases of all A's property. Before application of this paragraph (b)(5), A would have $50 of excess interest (i.e., the $90 interest allocated or apportioned to its ECI under § 1.882–5 less $40 of branch interest). Under this paragraph (b)(5), the $60 of additional interest paid by A is also treated as branch interest. However, to the extent that treating the $60 of additional interest as branch interest would create an amount of branch interest that would exceed the amount of branch interest permitted under paragraph (b)(6) of this section (relating to branch interest that exceeds a foreign corporation's interest allocated or apportioned to ECI under § 1.882–5) the amount of the additional branch interest is reduced under paragraph (b)(6)(iii) of this section, which generally allows a foreign corporation to specify certain liabilities that do not give rise to branch interest or paragraph (b) (6) (ii) of this section, which generally specifies liabilities that do not give rise to branch interest beginning with the most-recently incurred liability.

(6) *Special rule where branch interest exceeds interest allocated or apportioned to ECI of a foreign corporation*—(i) *General rule.* If the amount of branch interest that is both paid and accrued by a foreign corporation during the taxable year (including interest that the foreign corporation elects under paragraph (c)(1) of this section to treat as paid during the taxable year) exceeds the amount of interest allocated or apportioned to ECI of a foreign corporation under §1.882–5 for the taxable year, then the amount of the foreign corporation's branch interest shall be reduced by the amount of such excess as provided in paragraphs (b)(6)(ii) and (iii) of this section, as applicable. The rules of paragraphs (b)(6)(ii) and (iii) of this section shall also apply where the amount of branch interest with respect to liabilities identified under paragraph (b)(1)(ii) of this section exceeds the maximum amount that may be treated as branch interest under that paragraph. This paragraph (b)(6) shall apply whether or not a reduction in the amount of branch interest occurs as a result of adjustments made during the examination of the foreign corporation's income tax return, such as a reduction in the amount of interest allocated or apportioned to ECI of the foreign corporation under §1.882–5.

(ii) *Reduction of branch interest beginning with most-recently incurred liability.* Except as provided in paragraph (b)(6)(iii) of this section (relating to an election to specify liabilities that do not give rise to branch interest), the amount of the excess in paragraph (b)(6)(i) of this section shall first reduce branch interest attributable to liabilities described in paragraph (b)(1)(ii) of this section (relating to liabilities identified as giving rise to branch interest) and then, if such excess has not been reduced to zero, branch interest attributable to the group of liabilities described in paragraph (b)(1)(i) of this section. The reduction of branch interest attributable to each group of liabilities (i.e., liabilities described in paragraph (b)(1)(ii) of this section and liabilities described in paragraph (b)(1)(i) of this section) shall be made beginning with interest attributable to the latest-incurred liability and continuing, in reverse chronological order, with branch interest attributable to the next-latest incurred liability. The branch interest attributable to a liability must be reduced to zero before a reduction is made with respect to branch interest attributable to the next-latest incurred liability. Where only a portion of the branch interest attributable to a liability is reduced by reason of this paragraph (b)(6)(ii), the reduction shall be made beginning with the last interest payment made with respect to the liability during the taxable year and continuing, in reverse chronological order, with the next–latest payment until the amount of branch interest has been reduced by the amount specified in paragraph (b)(6)(i) of this section. The amount of interest that is not treated as branch interest by reason of this paragraph (b)(6)(ii) shall not be treated as paid by a domestic corporation and thus shall not be subject to tax under section 871(a) or 881(a).

(iii) *Election to specify liabilities that do not give rise to branch interest.* For purposes of reducing the amount of branch interest under paragraph (b)(6)(i) of this section, a foreign corporation may, instead of using the method described in paragraph (b)(6)(ii) of this section, elect for any taxable year to specify which liabilities will not be treated as giving rise to branch interest or will be treated as giving rise only in part to branch interest. Branch interest paid during the taxable year with respect to a liability specified under this paragraph (b)(6)(iii) must be reduced to zero before a reduction is made with respect to branch interest attributable to the next-specified liability. If all interest payments with respect to a specified liability, when added to all interest payments with respect to other liabilities specified under this paragraph (b)(6)(iii), would exceed the amount of the reduction under paragraph (b)(6)(i) of this section, then only a portion of the branch interest attributable to that specified liability shall be reduced under this paragraph (b)(6)(iii), and the reduction shall be made beginning with the last interest payment made with respect to the liability during the taxable year and continuing, in reverse chronological order, with the next-latest payment until the amount of branch interest has been reduced by the amount of the reduction under paragraph (b)(6)(i) of this section. A foreign corporation that elects to have this paragraph (b)(6)(iii) apply shall note on its books and records maintained in the United States that the liability is not to be treated as giving rise to branch interest, or is to be treated as giving rise to branch interest only in part. Such notation must be made after the close of the taxable year in which the foreign corporation pays the interest and prior to the due date (with extensions) of the foreign corporation's income tax return for the taxable year. However, if the excess interest in paragraph (b)(6)(i) of this section occurs as a result of adjustments made during the examination of the foreign corporation's income tax return, the election and notation may be made at the time of examination. The amount of interest that is not treated as branch interest by reason of this paragraph (b)(6)(iii) shall not be treated as paid by a domestic corporation and thus shall not be subject to tax under section 871 (a) or 881 (a).

(iv) *Examples.* The application of this paragraph (b)(6) is illustrated by the following examples.

Example 1. Branch interest exceeds interest apportioned to ECI with no election in effect. Foreign corporation A, a calendar year, accrual method taxpayer, has interest expense apportioned to ECI under § 1.882–5 of $230 for 1997. A's branch interest for 1997 is as follows:

(i) $130 paid to B, a domestic corporation, with respect to a note issued on March 10, 1997, and secured by real property located in the United States;

(ii) $60 paid to C, an individual resident of country X who is entitled to a 10 percent rate of withholding on interest payments under the income tax treaty between the United States and X, with respect to a note issued on October 15, 1996, which gives rise to interest subject to tax under section 871(a);

(iii) $80 paid to D, an individual resident of country Y who is entitled to a 15 percent rate of withholding on interest payments under the income tax treaty between the United States and Y, with respect to a note issued on February 15, 1997, which gives rise to interest subject to tax under section 871(a); and

(iv) $70 of portfolio interest (as defined in section 871(h) (2)) paid to E, a nonresident alien, with respect to a bond issued on March 1, 1997.

A's branch interest accrues during 1997 for purposes of calculating the amount of A's interest apportioned to ECI under § 1.882–5. A has identified under paragraph (b)(1)(ii) of this section the liabilities described in paragraphs (ii), (iii) and (iv) of this example. A has not made an election under paragraph (b)(6)(iii) of this section to specify liabilities that do not give rise to branch interest. The amount of A's branch interest in 1997 is limited under paragraph (b)(6)(i) of this section to $230, the amount of the interest apportioned to A's ECI for 1997. The amount of A's branch interest must thus be reduced by $110 ($340–$230) under paragraph (b)(6)(ii) of this section. The reduction is first made with respect to interest attributable to liabilities described in paragraph (b)(1)(ii) of this section (i.e., liabilities identified as giving rise to branch interest) and, within the group of liabilities described in paragraph (b)(1)(ii) of this section, is first made with respect to the latest-incurred liability. Thus, the $70 of interest paid to E with respect to the bond issued on March 1, 1997, and $40 of the $80 of interest paid to D with respect to the note issued on February 15, 1997, are not treated as branch interest. The interest paid to D is no longer subject to tax under section 871(a), and D may claim a refund of amounts withheld with respect to the interest payments. There is no change in the tax consequences to E because the interest received by E was portfolio interest and was not subject to tax when it was treated as branch interest.

Example 2. Effect of election to specify liabilities. Assume the same facts as in *Example 1* except that A makes an election under paragraph (b)(6)(iii) of this section to specify which liabilities are not to be treated as giving rise to branch interest. A specifies the liability to D, who would be taxable at a rate of 15 percent on interest paid with respect to the liability, as a liability that does not give rise to branch interest, and D is therefore not subject to tax under section 871 (a) and is entitled to a refund of amounts withheld with respect to the interest payments. A also specifies the liability to C as a liability that gives rise to branch interest only in part. As a result, $30 of the $60 of interest paid to C is not treated as branch interest, and C is entitled to a refund with respect to the $30 of interest that is not treated as branch interest.

(7) *Effect of election under paragraph (c)(1) of this section to treat interest as if paid in year of accrual.* If a foreign corporation accrues an interest expense in

a taxable year earlier than the taxable year of payment and elects under paragraph (c)(1) of this section to compute its excess interest as if the interest expense were branch interest paid in the year of accrual, the interest expense shall be treated as branch interest that is paid at the close of such year (and not in the actual year of payment) for all purposes of this section. Such interest shall thus be subject to tax under section 871(a) or 881(a) and withholding under section 1441 or section 1442, as if paid on the last day of the taxable year of accrual. Interest that is treated under paragraph (c)(1) of this section as paid in a later year for purposes of computing excess interest shall be treated as paid only in the actual year of payment for all purposes of this section other than paragraphs (a)(2) and (c)(1) of this section (relating to excess interest).

(8) *Effect of treaties*—(i) *Payor's treaty.* In the case of a foreign corporation's branch interest, relief shall be available under an article of an income tax treaty between the United States and the foreign corporation's country of residence relating to interest paid by the foreign corporation only if, for the taxable year in which the branch interest is paid (or if the branch interest is treated as paid in an earlier taxable year under paragraph (b)(7) of this section, for the earlier taxable year)—

(A) The foreign corporation meets the requirements of the limitation on benefits provision, if any, in the treaty, and either—

(*1*) The corporation is a qualified resident (as defined in §1.884–5(a)) of that foreign country in such year; or

(*2*) The corporation meets the requirements of paragraph (b)(8)(iii) of this section in such year; or

(B) The limitation on benefits provision, or an amendment to that provision, entered into force after December 31, 1986.

(ii) *Recipient's treaty.* A foreign person (other than a foreign corporation) that derives branch interest is entitled to claim benefits under provisions of an income tax treaty between the United States and its country of residence relating to interest derived by the foreign person. A foreign corporation may claim such benefits if it meets, with respect to the branch interest, the requirements of the limitation on benefits provision, if any, in the treaty and—

(A) The foreign corporation meets the requirements of paragraphs (b)(8)(i)(A) or (B) of this section; and

(B) In the case of interest paid in a taxable year beginning after December 31, 1988, with respect to an obligation with a maturity not exceeding one year, each foreign corporation that beneficially owned the obligation prior to maturity was a qualified resident (for the period specified in paragraph (b)(8)(i) of this section) of a foreign country with which the United States has an income tax treaty or met the requirements of the limitation on benefits provision in a treaty with respect to the interest payment and such provision entered into force after December 31, 1986.

(iii) *Presumption that a foreign corporation continues to be a qualified resident.* For purposes of this paragraph (b)(8), a foreign corporation that was a qualified resident for the prior taxable year because it fulfills the requirements of §1.884–5 shall be considered a qualified resident with respect to branch interest that is paid or received during the current taxable year if—

(A) In the case of a foreign corporation that met the stock ownership and base erosion tests in §1.884–5(b) and (c) for the preceding taxable year, the foreign corporation does not know, or have reason to know, that either 50 percent of its stock (by value) is not beneficially owned (or treated as beneficially owned by reason of §1.884–5(b)(2)) by qualifying shareholders at any time during the portion of the taxable year that ends with the date on which the interest is paid, or that the base erosion test is not met during the portion of the taxable year that ends with the date on which the interest is paid;

(B) In the case of a foreign corporation that met the requirements of §1.884–5(d) (relating to publicly-traded corporations) for the preceding taxable year, the foreign corporation is listed on an established securities exchange in the United States or its country of residence at all times during the portion of the taxable year that ends with the date on which the interest is paid and does not fail the requirements of § 1.884–5(d)(4)(iii) (relating to certain closely-held corporations) at any time during such period; or

(C) In the case of a foreign corporation that met the requirements of § 1.884–5(e) (relating to the active trade or business test) for the preceding taxable year, the foreign corporation continues to operate (other than in a nominal degree), at all times during the portion of the taxable year that ends with the date on which the interest is paid, the same business in the U.S. and its country of residence that caused it to meet such requirements for the preceding taxable year.

(iv) *Treaties other than income tax treaties.* A treaty that is not an income tax treaty does not provide any benefits with respect to branch interest.

(v) *Effect of income tax treaties on interest paid by a partnership.* If a foreign corporation is a partner (directly or indirectly) in a partnership that is engaged in a trade or business in the United States and owns an interest of 10 percent or more (as determined under the attribution rules of section 318) in the capital, profits, or losses of the partnership at any time during the partner's taxable year, the relief that may be claimed under an income tax treaty with respect to the foreign corporation distributive share of interest paid or treated as paid by the partnership shall not exceed the relief that would be available under paragraphs (b)(8) (i) and (ii) of this section if such interest were branch interest of the foreign corporation. See paragraph (c)(2) of this section for the effect on a foreign corporation's excess interest of interest paid by a partnership of which the foreign corporation is a partner.

(vi) *Examples.* The following examples illustrate the application of this paragraph (b)(8).

Example 1. Payor's treaty. The income tax treaty between the United States and country X provides that the United States may not impose a tax on interest paid by a corporation that is a resident of that country (and that is not a domestic corporation) if the recipient of the interest is a nonresident alien or a foreign corporation. Corp A is a qualified resident of country X and meets the limitation on benefits provision in the treaty. A's branch interest is not subject to tax under section 871(a) or 881(a) regardless of whether the recipient is entitled to benefits under an income tax treaty.

Example 2. Recipient's treaty and interest received from a partnership. A, a foreign corporation, and B, a nonresident alien, are partners in a partnership that owns and operates U.S. real estate and each has a distributive share of partnership interest deductions equal to 50 percent of the interest deductions of the partnership. There is no income tax treaty between the United States and the countries of residence of A and B. The partnership pays $1,000 of interest to a bank that is a resident of a foreign country, Y, and that qualifies under an income tax treaty in effect with the United States for a 5 percent rate of tax on U.S. source interest paid to a resident of country Y. However, the bank is not a qualified resident of country Y and the limitation on benefits provision of the treaty has not been amended since December 31, 1986. The partnership is required to withhold at a rate of 30 percent on $500 of the interest paid to the bank (i.e., A's 50 percent distributive share of interest paid by the partnership) because the bank cannot, under paragraph (b)(8)(iv) of this section, claim greater treaty benefits by lending money to the partnership than it could claim, if it lent money to A directly and the $500 were branch interest of A.

(c) *Rules relating to excess interest*—(1) *Election to compute excess interest by treating branch interest that is paid and accrued in different years as if paid in year of accrual*—(i) *General rule.* If branch interest is paid in one or more taxable years before or after the year in which the interest accrues, a foreign corporation may elect to compute its excess interest as if such branch interest were paid on the last day of the taxable year in which it accrues, and not in the taxable year in which it is actually paid. The interest expense will thus reduce the amount of the foreign corporation's excess interest in the year of accrual rather than in the year of actual payment. Except as provided in paragraph (c)(1)(ii) of this section, if an election is made for a taxable year, this paragraph (c)(1)(i) shall apply to all branch interest that is paid or accrued during that year. See paragraph (b)(7) of this section for the effect of an election under this paragraph (c)(1) on branch interest that accrues in a taxable year after the year of payment.

(ii) *Election not to apply in certain cases.* An election under this paragraph (c)(1) shall not apply to an interest expense that accrued in a taxable year beginning before January 1, 1987, and shall not apply to an interest expense that was paid in a taxable year beginning before such date unless the interest was income from sources within the United States. An election under this paragraph (c)(1) shall not apply to branch interest that accrues during the taxable year and is paid in an earlier taxable year if the branch interest reduced excess interest in such earlier year. However, a foreign corporation may amend its income tax return for such earlier taxable year so that the branch interest does not reduce excess interest in such year.

(iii) *Requirements for election.* A foreign corporation that elects to apply this paragraph (c)(1) shall attach to its income tax return (or to an amended income tax return) a statement that it elects to have the provisions of this paragraph (c)(1) apply, or shall provide written notice to the Commissioner during an examination that it elects to apply this paragraph (c)(1). The election shall be effective for the taxable year to which the return relates and for all subsequent taxable years unless the Commissioner consents to revocation of the election.

(iv) *Examples.* The following examples illustrate the application of this paragraph (c)(1).

Example 1. Interest accrued before paid. Foreign corporation A, a calendar year, accrual method taxpayer, has $100 of interest allocated or apportioned to ECI under §1.882–5 for 1997. A has $60 of branch interest in 1997 before application of this paragraph (c)(1). A has an interest expense of $20 that properly accrues for tax purposes in 1997 but is not paid until 1998. When the interest is paid in 1998 it will meet the requirements for branch interest under paragraph (b)(1) of this section. A makes a timely election under this paragraph (c)(1) to treat the accrued interest as if it were paid in 1997. A will be treated as having branch interest of $80 for 1997 and excess interest of $20 in 1997. The $20 of interest treated as branch interest of A in 1997 will not again be treated as branch interest in 1998.

Example 2. Interest paid before accrued. Foreign corporation A, a calendar year, accrual method taxpayer, has $60 of branch interest in 1997. The interest expense does not accrue until 1994 and the amount of interest allocated or apportioned to A's ECI under §1.882–5 is zero for 1997 and $60 for 1998. A makes an election under this paragraph (c)(1) with respect to 1997. As a result of the election, A's $60 of branch interest in 1997 reduces the amount of A's excess interest for 1994 rather than in 1998.

(2) *Interest paid by a partnership*—(i) *General rule.* Except as otherwise provided in paragraphs (c)(2) (i) and (ii) of this section, if a foreign corporation is a partner in a partnership that is engaged in trade or business in the United States, the amount of the foreign corporation's distributive share of interest paid or accrued by the partnership shall reduce (but not below zero) the amount of the foreign corporation's excess interest for the year to the extent such interest is taken into account by the foreign corporation in that year for purposes of calculating the interest allocated or apportioned to the ECI of the foreign corporation under §1.882–5. A foreign corporation's excess interest shall not be reduced by its distributive share of partnership interest that is attributable to a liability described in paragraph (b)(3)(iii) of this section (relating to interest on liabilities incurred in the ordinary course of a foreign business or secured predominantly by assets that are not U.S. assets) or would be described in paragraph (b)(3)(iii) of this section if entered on the partner's books. See paragraph (b)(8)(v) of this section for the effect of income tax treaties on interest paid by a partnership.

(ii) *Special rule for interest that is paid and accrued in different years.* Paragraph (c)(2)(i) of this section shall not apply to any portion of a foreign corporation's distributive share of partnership interest that is paid and accrued in different taxable years unless the foreign corporation has an election in effect under paragraph (c)(1) of this section that is effective with respect to such interest and any tax due under section 871(a) or 881(a) with respect to such interest has been deducted and withheld at source in the earlier of the taxable year of payment or accrual.

(3) *Effect of treaties*—(i) *General rule.* The rate of tax imposed on the excess interest of a foreign corporation that is a resident of a country with which the United States has an income tax treaty shall not exceed the rate provided under such treaty that would apply

with respect to interest paid by a domestic corporation to that foreign corporation if the foreign corporation meets, with respect to the excess interest, the requirements of the limitation on benefits provision, if any, in the treaty and either—

(A) The corporation is a qualified resident (as defined in § 1.884–5(a)) of that foreign country for the taxable year in which the excess interest is subject to tax; or

(B) The limitation on benefits provision, or an amendment to that provision, entered into force after December 31, 1986.

(ii) *Provisions relating to interest paid by a foreign corporation.* Any provision in an income tax treaty that exempts or reduces the rate of tax on interest paid by a foreign corporation does not prevent imposition of the tax on excess interest or reduce the rate of such tax.

(4) *Example.* The application of paragraphs (c)(2) and (3) of this section is illustrated by the following example.

Example. Interest paid by a partnership. Foreign corporation A, a calendar year taxpayer, is not a resident of a foreign country with which the United States has an income tax treaty. A is engaged in the conduct of a trade or business both in the United States and in foreign countries, and owns a 50 percent interest in X, a calendar year partnership engaged in the conduct of a trade or business in the United States. For 1997, all of X's liabilities are of a type described in paragraph (b)(1) of this section (relating to liabilities on U.S. books) and none are described in paragraph (b)(3)(iii) of this section (relating to liabilities that may not give rise to branch interest). A's distributive share of interest paid by X in 1997 is $20. For 1997, A has $150 of interest allocated or apportioned to its ECI under § 1.882–5, $120 of which is attributable to branch interest. Thus, the amount of A's excess interest for 1997, before application of paragraph (c)(2)(i) of this section, is $30. Under paragraph (c)(2)(i) of this section, A's $30 of excess interest is reduced by $20, representing A's share of interest paid by X. Thus, the amount of A's excess interest for 1997 is reduced to $10. A is subject to a tax of 30 percent on its $10 of excess interest.

(d) *Stapled entities.* A foreign corporation that is treated as a domestic corporation by reason of section 269B (relating to stapled entities) shall continue to be treated as a foreign corporation for purposes of section 884 (f) and this section, notwithstanding section 269B and the regulations thereunder. Interest paid by such foreign corporation shall be treated as paid by a domestic corporation and shall be subject to the tax imposed by section 871 (a) or 881 (a), and to withholding under section 1441 and 1442, as applicable, to the extent such interest is not subject to tax by reason of section 884(f) and this section.

(e) *Effective dates*—(1) *General rule.* Except as provided in paragraph (e)(2) of this section, this section is effective for taxable years beginning October 13, 1992, and for payments of interest described in section 884(f)(1)(A) made (or treated as made under paragraph (b)(7) of this section) during taxable years of the payor beginning after such date. With respect to taxable years beginning before October 13, 1992, and after December 31, 1986, a foreign corporation may elect to apply this section in lieu of § 1.884–4T of the temporary regulations (as contained in the CFR edition revised as of April 1, 1992) as they applied to the foreign corporation after issuance of Notice 89–80, 1989–2 C.B. 394, but only if the foreign corporation has made an election under § 1.884–1 (i) to apply § 1.884–1 in lieu of § 1.884–1T (as contained in the CFR edition revised as of April 1, 1992) for that year, and the statute of limitations for assessment of a deficiency has not expired for that taxable year. Once an election has been made, an election under this section shall apply to all subsequent taxable years.

(2) *Special rule.* Paragraphs (a)(1), (a)(2)(i)(A), (a)(2)(iii), (b)(1), (b)(3), (b)(5)(i), (b)(6)(i), (b)(6)(ii), and (c)(2)(i) of this section are effective for taxable years beginning on or after June 6, 1996.

(f) *Transition rules*—(1) *Election under paragraph (c)(1) of this section.* If a foreign corporation has made an election described in § 1.884–4T(b)(7) (as contained in the CFR edition revised as of April 1, 1992) with respect to interest that has accrued and been paid in different taxable years, such election shall be effective for purposes of paragraph (c)(1) of this section as if the corporation had made the election under paragraph (c)(1) of this section of these regulations.

(2) *Waiver of notification requirement for non-banks under Notice 89–80.* If a foreign corporation that is not a bank has made an election under Notice 89–80 to apply the rules in part 2 of section I of the Notice in lieu of the rules in §1.884–4T(b) (as contained in the CFR edition revised as of April 1, 1992) to determine the amount of its interest paid and excess interest in taxable years beginning prior to 1990, the requirement that the foreign corporation satisfy the notification requirements described in paragraph (b)(3)(ii) of this section is waived with respect to interest paid in taxable years ending on or before the date the Notice was issued.

(3) *Waiver of legending requirement for certain debt issued prior to January 3, 1989.* For purposes of sections 871(h), 881(c), and this section, branch interest of a foreign corporation that would be treated as portfolio interest under section 871(h) or 881(c) but for the fact that it fails to meet the requirements of section 163(f)(2)(B)(ii)(II) (relating to the legend requirement), shall nevertheless be treated as portfolio interest provided the interest arises with respect to a liability incurred by the foreign corporation before January 3, 1989, and interest with respect to the liability was treated as branch interest in a taxable year beginning before January 1, 1990.

[T.D. 8432, 57 FR 41660, Sept. 11, 1992; 57 FR 49117, Oct. 29, 1992; 57 FR 60126, Dec. 18, 1992, as amended by T.D. 8657, 61 FR 9341, Mar. 8, 1996]

§1.884–5 Qualified resident.

(a) *Definition of qualified resident.* A foreign corporation is a qualified resident of a foreign country with which the United States has an income tax treaty in effect if, for the taxable year, the foreign corporation is a resident of that country (within the meaning of such treaty) and either—

(1) Meets the requirements of paragraphs (b) and (c) of this section (relating to stock ownership and base erosion);

(2) Meets the requirements of paragraph (d) of this section (relating to publicly-traded corporations);

(3) Meets the requirements of paragraph (e) of this section (relating to the conduct of an active trade or business); or

(4) Obtains a ruling as provided in paragraph (f) of this section that it shall be treated as a qualified resident of its country of residence.

(b) *Stock ownership requirement*—(1) *General rule*—(i) *Ownership by qualifying shareholders.* A foreign corporation satisfies the stock ownership requirement of this paragraph (b) for the taxable year if more than 50 percent of its stock (by value) is beneficially owned (or is treated as beneficially owned by reason of paragraph (b)(2) of this section) during at least half of the number of days in the foreign corporation's taxable year by one or more qualifying shareholders. A person shall be treated as a qualifying shareholder only if such person meets the requirements of paragraph (b)(3) of this section and is either—

(A) An individual who is either a resident of the foreign country of which the foreign corporation is a resident or a citizen or resident of the United States;

(B) The government of the country of which the foreign corporation is a resident (or a political subdivision or local authority of such country), or the United States, a State, the District of Columbia, or a political subdivision or local authority of a State;

(C) A corporation that is a resident of the foreign country of which the foreign corporation is a resident and whose stock is primarily and regularly traded on an established securities market (within the meaning of paragraph (d) of this section) in that country or the United States or a domestic corporation whose stock is primarily and regularly traded on an established securities market (within the meaning of paragraph (d) of this section) in the United States;

(D) A not-for profit organization described in paragraph (b)(1)(iv) of this section that is not a pension fund as defined in paragraph (b)(8)(i)(A) of this section and that is organized under the laws of the foreign country of which the foreign corporation is a resident or the United States; or

(E) A beneficiary of certain pension funds (as defined in paragraph (b)(8)(i)(A) of this section) administered in or by the country in which the foreign corporation is a resident to the extent provided in paragraph (b)(8) of this section.

Beneficial owners of an association taxable as a corporation shall be treated as shareholders of such association for purposes of this paragraph (b)(1). If stock of a foreign corporation is owned by a corporation that is treated as a qualifying shareholder under paragraph (b)(1)(i)(C) of this section, such stock shall not also be treated as owned, directly or indirectly, by any qualifying shareholders of such corporation for purposes of this paragraph (b). Notwithstanding the above, a foreign corporation will not be treated as a qualified resident unless it obtains the documentation described in paragraph (b)(3) of this section to show that the requirements of this paragraph (b)(1)(i) have been met and maintains the documentation as provided in paragraph (b)(9) of this section. See also paragraph (b)(1)(iii) of this section, which treats certain publicly-traded classes of stock as owned by qualifying shareholders.

(ii) *Special rules relating to qualifying shareholders.* For purposes of applying paragraph (b)(1)(i) of this section—

(A) Stock owned on any day shall be taken into account only if the beneficial owner is a qualifying shareholder on that day or, in the case of a corporation or not-for-profit organization that is a qualifying shareholder under paragraph (b)(1)(i) (C) or (D) of this section, for a one-year period that includes such day; and

(B) An individual, corporation or not-for-profit organization is a resident of a foreign country if it is a resident of that country for purposes of the income tax treaty between the United States and that country.

(iii) *Publicly-traded class of stock treated as owned by qualifying shareholders.* A class of stock of a foreign corporation shall be treated as owned by qualifying shareholders if—

(A) The class of stock is listed on an established securities market in the United States or in the country of residence of the foreign corporation seeking qualified resident status; and

(B) The class of stock is primarily and regularly traded on such market (within the meaning of paragraphs (d)(3) and (4) of this section, applied as if the class of stock were the sole class of stock relied on to meet the requirements of paragraph (d)(4)(i)(A)).

For purposes of this paragraph (b), stock in such class shall not also be treated as owned by any qualifying shareholders who own such stock, either directly or indirectly.

(iv) *Special rule for not-for-profit organizations.* A not-for-profit organization is described in paragraph (b)(1)(iv) of this section if it meets the following requirements—

(A) It is a corporation, association taxable as a corporation, trust, fund, foundation, league or other entity operated exclusively for religious, charitable, educational, or recreational purposes, and it is not organized for profit;

(B) It is generally exempt from tax in its country of organization by virtue of its not-for-profit status; and

(C) Either—

(*1*) More than 50 percent of its annual support is expended on behalf of persons described in paragraphs (b)(1)(i)(A) through (E) of this section or on qualified residents of the country in which the organization is organized; or

(*2*) More than 50 percent of its annual support is derived from persons described in paragraphs (b)(1)(i) (A) through (E) of this section or from persons who are qualified residents of the country in which the organization is organized.

For purposes of meeting the requirements of paragraph (b)(1)(iv)(C) of this section, a not-for-profit organization may rely on the addresses of record of its individual beneficiaries and supporters to determine if such persons are resident in the country in which the not-for-profit organization is organized, provided that the addresses of record are not nonresidential addresses such as a post office box or in care of a financial intermediary, and the officers, directors or administrators of the organization do not know or have reason to know that the individual beneficiaries or supporters do not reside at that address.

(2) *Rules for determining constructive ownership*—(i) *General rules for attribution.* For purposes of this section, stock owned by a corporation, partnership, trust, estate, or mutual insurance company or similar entity shall be treated as owned proportionately by its shareholders, partners, beneficiaries, grantors or other interest holders as provided in paragraph (b)(2)(ii) through (v) of this section. The proportionate interest rules of this paragraph (b)(2) shall apply successively upward through a chain of ownership, and a person's proportionate interest shall be computed for the relevant days or period that is taken into account in determining whether a foreign corporation is a qualified resident. Except as otherwise provided, stock treated as owned by a person by reason of this paragraph (b)(2) shall, for purposes of applying this paragraph (b)(2), be treated as actually owned by such person.

(ii) *Partnerships.* A partner shall be treated as having an interest in stock of a foreign corporation owned by a partnership in proportion to the least of—

(A) The partner's percentage distributive share of the partnership's dividend income from the stock;

(B) The partner's percentage distributive share of gain from disposition of the stock by the partnership;

(C) The partner's percentage distributive share of the stock (or proceeds from the disposition of the stock) upon liquidation of the partnership.

For purposes of this paragraph (b)(2)(ii), however, all qualifying shareholders that are partners of a partnership shall be treated as one partner. Thus, the percentage distributive shares of dividend income, gain and liquidation rights of all qualifying shareholders that are partners in a partnership are aggregated prior to determining the least of the three percentages.

(iii) *Trusts and estates*—(A) *Beneficiaries.* In general, a person shall be treated as having an interest in stock of a foreign corporation owned by a trust or estate in proportion to the person's actuarial interest in the trust or estate, as provided in section 318(a)(2)(B)(i), except that an income beneficiary's actuarial interest in the trust will be determined as if the trust's only asset were the stock. The interest of a remainder beneficiary in stock will be equal to 100 percent minus the sum of the percentages of any interest in the stock held by income beneficiaries. The ownership of an interest in stock owned by a trust shall not be attributed to any beneficiary whose interest cannot be determined under the preceding sentence, and any such interest, to the extent not attributed by reason of this paragraph (b)(2)(iii)(A), shall not be considered owned by a beneficiary unless all potential beneficiaries with respect to the stock are qualifying shareholders. In addition, a beneficiary's actuarial interest will be treated as zero to extent that a grantor is treated as owning the stock under paragraph (b)(2)(iii)(B) of this section. A substantially separate and independent share of a trust, within the meaning of section 663(c), shall be treated as a separate trust for purposes of this paragraph (b)(2)(iii)(A), provided that payment of income, accumulated income or corpus of a share of one beneficiary (or group of beneficiaries) cannot affect the proportionate share of income, accumulated income or corpus of another beneficiary (or group of beneficiaries).

(B) *Grantor trusts.* A person is treated as the owner of stock of a foreign corporation owned by a trust to the extent that the stock is included in the portion of the trust that is treated as owned by the person under sections 671 to 679 (relating to grantors and others treated as substantial owners).

(iv) *Corporations that issue stock.* A shareholder of a corporation that issues stock shall be treated as owning stock of a foreign corporation that is owned by such corporation on any day in a proportion that equals the value of the stock owned by such shareholder to the value of all stock of such corporation. If there is an agreement, express or implied, that a shareholder of a corporation will not receive distributions from the earnings of stock owned by the corporation, the shareholder will not be treated as owning that stock owned by the corporation.

(v) *Mutual insurance companies and similar entities.* Stock held by a mutual insurance company, mutual savings bank, or similar entity (including an association taxable as a corporation that does not issue stock interests) shall be considered owned proportionately by the policy holders, depositors, or other owners in the same proportion that such persons share in the surplus of such entity upon liquidation or dissolution.

(vi) *Pension funds.* See paragraphs (b)(8) (ii) and (iii) of this section for the attribution of stock owned by a pension fund (as defined in paragraph (b)(8)(i)(A)) to beneficiaries of the fund.

(vii) *Examples.* The rules of paragraph (b)(2)(ii) of this section are illustrated by the following examples.

Example 1. Stock held solely by qualifying shareholders through a partnership. A and B, residents of country X, are qualifying shareholders, within the meaning of paragraphs (b)(1)(i) (A) through (E) of this section, and the sole partners of partnership P. P's only asset is the stock of foreign corporation Z, a country X corporation seeking qualified resident status under this section. A's distributive share of P's income and gain on the disposition of P's assets is 80 percent, but A's distributive share of P's assets (or the proceeds therefrom) on P's liquidation is 20 percent. B's distributive share of P's income and gain is 20 percent and B is entitled to 80 percent of the assets (or proceeds therefrom) on P's liquidation. Under the attribution rules of paragraph (b)(2)(ii) of this section, A and B will be treated as a single partner owning in the aggregate 100 percent of the stock of Z owned by P.

Example 2. Stock held by both qualifying and non-qualifying shareholders through a partnership. Assume the same facts as in *Example 1* except that C, an individual who is not a qualifying shareholder, is also a partner in P and that C's distributive share of P's income is 60 percent. The distributive shares of A and B are the same as in *Example 1* except that A's distributive share of income is 20 percent. Under the attribution rules of paragraph (b)(2)(ii) of this section, A and B will be treated as a single partner owning in the aggregate 40 percent of the stock of Z owned by P (i.e., the least of A and B's aggregate distributive shares of dividend income (40 percent), gain (100 percent), and liquidation rights (100 percent) with respect to the Z stock).

Example 3. Stock held through tiered partnerships. Assume the same facts as in *Example 1,* except that P does not own the stock of Z directly, but rather is a partner in partnership P1, which owns the stock of Z. Assume that P's distributive share of the dividend income, gain and liquidation rights with respect to the Z stock held by P1 is 40 percent. Assume that of the remaining partners of P1 only D is a qualifying shareholder. D's distributive share of P1's dividend income and gain is 15 percent; D's distributive share of P1's assets on liquidation is 25 percent. Under the attribution rules of paragraph (b)(2)(ii) of this section, A and B, treated as a single partner, will own 40 percent of the Z stock owned by P1 (100 percent X 40 percent) and D will be treated as owning 15 percent of the Z stock owned by P1 (the least of D's dividend income (15 percent), gain (15 percent), and liquidation rights (25 percent) with respect to the Z stock). Thus, 55 percent of the Z stock owned by P1 is treated as owned by qualifying shareholders under paragraph (b)(2)(ii) of this section.

(3) *Required documentation*—(i) *Ownership statements, certificates of residency and intermediary ownership statements.* Except as provided in paragraphs (b)(3)(ii), (iii) and (iv) and paragraph (b)(8) of this section, a person shall only be treated as a qualifying shareholder of a foreign corporation if—

(A) For the relevant period, the person completes an ownership statement described in paragraph (b)(4) of this section and, in the case of an individual who is not a U.S. citizen or resident, also obtains a certificate of residency described in paragraph (b)(5) of this section;

(B) In the case of a person owning stock in the foreign corporation indirectly through one or more intermediaries (including mere legal owners or recordholders acting as nominees), each intermediary completes an intermediary ownership statement described in paragraph (b)(6) of this section; and

(C) Such ownership statements and certificates of residency are received by the foreign corporation on or before the earlier of the date it files its income tax return for the taxable year to which the statements relate or the due date (including extensions) for filing such return or, in the case of a foreign corporation claiming treaty benefits under §1.884–4(b)(8) (i) or (ii) (relating to branch interest) on or before the date on which such interest is paid.

(ii) *Substitution of intermediary verification statement for ownership statements and certificates of residency.* If a qualifying shareholder owns stock through an intermediary that is either a domestic corporation, a resident of the United States, or a resident (for treaty purposes) of a country with which the United States has an income tax treaty in effect, the intermediary may provide an intermediary verification statement (as described in paragraph (b)(7) of this section) in place of any relevant ownership statements and certificates of residency from qualifying shareholders, and in place of intermediary ownership statements (or, where applicable, intermediary verification statements) from all intermediaries standing in the chain of ownership between the qualifying shareholders and the intermediary issuing the intermediary verification statement. An intermediary verification statement generally certifies that the verifying intermediary holds the documentation described in the preceding sentence and agrees to make it available to the District Director on request. Such intermediary verification statements, along with an intermediary ownership statement from the verifying intermediary, must be received by the foreign corporation on or before the earlier of the date if files its income tax return for the taxable year to which the statements relate or the due date (including extensions) for filing such return. An indirect owner of a foreign corporation is thus treated as a qualifying shareholder of a foreign corporation if the foreign corporation receives, on or before the time specified above, an intermediary verification statement and an intermediary ownership statement from the verifying intermediary and an intermediary ownership statement from all intermediaries standing in the chain of the verifying intermediary's ownership of its interest in the foreign corporation.

(iii) *Special rule for registered shareholders of widely-held corporations.* An ownership statement and a certificate of residency shall not be required in the case of an individual who is a shareholder of record of a corporation that has at least 250 shareholders if—

(A) The individual owns less than one percent of the stock (by value) (applying the attribution rules of section 318) of the corporation at all times during the taxable year;

(B) The individual's address of record is in the corporation's country of residence and is not a nonresidential address such as a post office box or in care of a financial intermediary or stock transfer agent; and

(C) The officers and directors of the corporation do not know or have reason to know that the individual does not reside at that address.

The rule in this paragraph (b)(3)(iii) may also be applied with respect to individual owners of mutual insurance companies, mutual savings banks or similar entities, provided that the same conditions set forth in this paragraph (b)(3)(iii) are met with respect to such individuals.

(iv) *Special rule for pension funds.* See paragraphs (b)(8) (ii) through (v) of this section for special documentation rules applicable to pension funds (as defined in paragraph (b)(8)(i)(A) of this section).

(v) *Reasonable cause exception.* If a foreign corporation does not obtain the documentation described in this paragraph (b)(3) or (b)(8) of this section in a timely manner but is able to show prior to notification of an examination of the return for the taxable year that the failure was due to reasonable cause and not willful neglect, the foreign corporation may perfect the documentation after the deadlines specified in this paragraph (b)(3) or (b)(8) of this section. It may make such a showing by providing a written statement to the District Director having jurisdiction over the taxpayer's return or the Office of the Assistant Commissioner (International), as applicable, setting forth the reasons for the failure to obtain the documentation in a timely manner and describing the documentation that was received after the deadline had passed. Whether a failure to obtain the documentation in a timely manner was due to reasonable cause shall be determined by the District Director or the Office of the Assistant Commissioner (International), as applicable, under all the facts and circumstances.

(4) *Ownership statements from qualifying shareholders*—(i) *Ownership statements from individuals.* An ownership statement from an individual is a written statement signed by the individual under penalties of perjury stating—

(A) The name, permanent address, and country of residence of the individual and, if the individual was not a resident of the country for the entire taxable year of the foreign corporation seeking qualified resident status, the period during which it was a resident of the foreign corporation's country of residence;

(B) If the individual is a direct beneficial owner of stock in the foreign corporation, the name of the corporation, the number of shares in each class of stock of the corporation that are so owned, and the period of time during the taxable year of the foreign corporation during which the individual owned the stock (or, in the case of an association taxable as a corporation, the amount and nature of the owner's interest in such association);

(C) If the individual directly owns an interest in a corporation, partnership, trust, estate or other intermediary that owns (directly or indirectly) stock in the foreign corporation, the name of the intermediary, the number and class of shares or amount and nature of the interest of the individual in such intermediary (that is relevant for purposes of attributing ownership in paragraph (b)(2) of this section), and the period of time during the taxable year of the foreign corporation during which the individual held such interest; and

(D) To the extent known by the individual, a description of the chain of ownership through which the individual owns stock in the foreign corporation, including the name and address of each intermediary standing between the intermediary described in paragraph (b)(4)(i)(C) of this section and the foreign corporation.

(ii) *Ownership statements from governments.* An ownership statement from a government that is a qualifying shareholder is a written statement signed by either—

(A) An official of the governmental authority, agency or office that has supervisory authority with respect to the government's ownership interest who is authorized to sign such a statement on behalf of the authority, agency or office; or

(B) The competent authority of the foreign country (as defined in the income tax treaty between the United States and the foreign country).

Such statement shall provide the title of the official signing the statement and the name and address of the government agency, and shall provide the information described in paragraphs (b)(4)(i) (B) through (D) of this section (substituting ''government'' for ''individual'') with respect to the government's direct or indirect ownership of stock in the foreign corporation seeking qualified resident status.

(iii) *Ownership statements from publicly-traded corporations.* An ownership statement from a corporation that is a qualifying shareholder under paragraph (b)(1)(i)(C) of this section is a written statement signed by a person authorized to sign a tax return on behalf of the corporation under penalties of perjury stating—

(A) The name, permanent address, and principal place of business of the corporation (if different from its permanent address);

(B) The information described in paragraphs (b)(4)(i) (B) through (D) of this section (substituting ''corporation'' for ''individual''); and

(C) That the corporation's stock is primarily and regularly traded on an established securities exchange (within the meaning of paragraph (d) of this section) in the United States or its country of residence.

(iv) *Ownership statements from not-for-profit organizations.* An ownership statement from a not-for-profit organization (other than a pension fund as defined in paragraph (b)(8)(i)(A) of this section) is a written statement signed by a person authorized to sign a tax return on behalf of the organization under penalties of perjury stating—

(A) The name, permanent address, and principal location of the activities of the organization (if different from its permanent address);

(B) The information described in paragraphs (b)(4)(i) (B) through (D) of this section (substituting ''not-for-profit organization'' for ''individual'') with respect to the not-for-profit organization's direct or indirect ownership of stock in the foreign corporation seeking qualified resident status; and

(C) That the not-for-profit organization satisfies the requirements of paragraph (b)(1)(iv) of this section.

(v) *Ownership through a nominee.* For purposes of this paragraph (b)(4) and paragraph (b)(6) of this section, a person who owns either stock in a foreign corporation seeking qualified resident status or an interest in an intermediary described in paragraph (b)(4)(i)(C) of this section through a nominee shall be treated as owning such stock or interest directly and must, therefore, provide the information described in paragraphs (b)(4) (i) through (iv) of this section, as applicable. Such person must also provide the name and address of the nominee.

(5) *Certificate of residency.* A certificate of residency must be signed by the relevant authorities (as described below) of the country of residence of the individual shareholder and must state that the individual is a resident of that country for purposes of its income tax laws or, if the authorities do not customarily make such a determination, that the individual has filed a tax return claiming resident status and subjecting the individual's income to tax on a resident basis for the taxable year or period that ends with or within the taxable year for which the corporation is seeking qualified resident status. In the case of an individual who is not legally required to file a tax return in his or her country of residence or in any other country, a certificate of residency of a parent or guardian residing at such individual's address shall be considered sufficient to meet that individual's obligation under this paragraph (b)(5). The relevant authorities shall be the competent authority of the foreign country of which the foreign corporation is a resident, as defined in the income tax treaty between the foreign country and the United States, or such other governmental office of the foreign country (or political subdivision thereof) that customarily provides statements of residence. Notwithstanding the foregoing, the Commissioner may consult with the competent authority of a country regarding the procedures set forth in this paragraph (b)(5) and if necessary agree on additional or alternative procedures under which these certificates may be issued.

(6) *Intermediary ownership statement.* An intermediary ownership statement is a written statement signed under penalties of perjury by the intermediary (if the intermediary is an individual) or a person that would be authorized to sign a tax return on behalf of the intermediary (if the intermediary is not an individual) containing the following information:

(i) The name, address, country of residence, and principal place of business (in the case of a corporation or partnership) of the intermediary and, if the intermediary is a trust or estate, the name and permanent address of all trustees or executors (or equivalent under foreign law);

(ii) The information described in paragraphs (b)(4)(i) (B) through (D) (substituting ‘‘intermediary making the ownership statement’’ for ‘‘individual’’) with respect to the intermediary's direct or indirect ownership in the stock in the foreign corporation seeking qualified resident status;

(iii) If the intermediary is a nominee for a qualifying shareholder or another intermediary, the name and permanent address of the qualifying shareholder, or the name and principal place of business of such other intermediary;

(iv) If the intermediary is not a nominee for a qualifying shareholder or another intermediary, the proportionate interest in the intermediary of each direct shareholder, partner, beneficiary, grantor, or other interest holder (or if the direct holder is a nominee, of its beneficial shareholder, partner, beneficiary, grantor, or other interest holder) from which the intermediary received an ownership statement and the period of time during the taxable year for which the interest in the intermediary was owned by such shareholder, partner, beneficiary, grantor or other interest holder. For purposes of this paragraph (b)(6)(iv), the proportionate interest of a person in an intermediary is the percentage interest (by value) held by such person, determined using the principles for attributing ownership in paragraph (b)(2) of this section. If an intermediary is not required to receive an ownership statement from its individual registered shareholders or other interest holders by reason of paragraph (b)(3)(iii) of this section, then it must provide a list of the names and addresses of such registered shareholders or other interest holders and the aggregate proportionate interest in the intermediary of such registered shareholders or other interest holders.

(7) *Intermediary verification statement.* An intermediary verification statement that may be substituted for certain documentation under paragraph (b)(3)(ii) of this section is a written statement signed under penalties of perjury by the intermediary (if the intermediary is an individual) or by a person that would be authorized to sign a tax return on behalf of the intermediary (if the verifying intermediary is not an individual) containing the following information—

(i) The name, principal place of business, and country of residence of the verifying intermediary;

(ii) A statement that the verifying intermediary has obtained either—

(A) An ownership statement and, if applicable, a certificate of residency from a qualifying shareholder with respect to the foreign corporation seeking qualified resident status, and an intermediary ownership statement from each intermediary standing in the chain of ownership between the verifying intermediary and the qualifying shareholder; or

(B) An intermediary verification statement substituting for the documentation described in paragraph (b)(7)(ii)(A) and an intermediary ownership statement from such intermediary and each intermediary standing in the chain of ownership between such intermediary and the verifying intermediary;

(iii) The proportionate interest (as computed using the documentation described in paragraph (b)(7)(ii) of this section) in the intermediary owned directly or indirectly by qualifying shareholders;

(iv) An agreement to make available to the Commissioner at such time and place as the Commissioner may request the underlying documentation described in paragraph (b)(7)(ii) of this section; and

(v) A specific and valid waiver of any right to bank secrecy or other secrecy under the laws of the country in which the verifying intermediary is located, with respect to any qualifying shareholder ownership statements, certificates of residency, intermediary ownership statements or intermediary verification statements that the verifying intermediary has obtained pursuant to paragraph (b)(7)(ii) of this section.

A foreign corporation may combine, in a single statement, the information in an intermediary ownership statement and the information in an intermediary verification statement.

(8) *Special rules for pension funds*—(i) *Definitions*—(A) *Pension fund.* For purposes of this section, the term ‘‘pension fund’’ shall mean a trust, fund, foundation, or other entity that is established exclusively for the benefit of employees or former employees of one or more employers, the principal purpose of which is to provide retirement, disability, and death benefits to beneficiaries of such entity and persons designated by such beneficiaries in consideration for prior services rendered.

(B) *Beneficiary.* For purposes of this section, the term ‘‘beneficiary’’ of a pension fund shall mean any person who has made contributions to the pension fund, or on whose behalf contributions have been made, and who is currently receiving retirement, disability, or death benefits from the pension fund or can reasonably be expected to receive such benefits in the future, whether or not the person’s right to receive benefits from the fund has vested.

(ii) *Government pension funds.* An individual who is a beneficiary of a pension fund that would be a controlled entity of a foreign sovereign within the principles of § 1.892–2T(c)(1) of the regulations (relating to pension funds established for the benefit of employees or former employees of a foreign government) shall be treated as a qualifying shareholder of a foreign corporation in which the pension fund owns a direct or indirect interest without having to meet the documentation requirements under paragraph (b)(3)(i)(A) of this section, if the foreign corporation is resident in the country of the foreign sovereign and the trustees, directors, or other administrators of the pension fund provide, with the pension fund's intermediary ownership statement described in paragraph (b)(6) of this section, a written statement that the fund is a controlled entity described in this paragraphs (b)(8)(ii). See paragraph (b)(4)(ii) of this section regarding an ownership statement from a pension fund that is an integral part of a foreign government.

(iii) *Non-government pension funds.* For purposes of this section, an individual who is a beneficiary of a pension fund not described in paragraph (b)(8)(ii) of this section shall be treated as a qualifying shareholder of a foreign corporation owned directly or indirectly by such pension fund without having to meet the documentation requirements under paragraph (b)(3)(i)(A) of this section, if—

(A) The pension fund is administered in the foreign corporation's country of residence and is subject to supervision or regulation by a governmental authority (or other authority delegated to perform such supervision or regulation by a governmental authority) in such country;

(B) The pension fund is generally exempt from income taxation in its country of administration;

(C) The pension fund has 100 or more beneficiaries;

(D) The beneficiary's address, as it appears on the records of the fund, is in the foreign corporation's country of residence or the United States and is not a nonresidential address, such as a post office box or in care of a financial intermediary, and none of the trustees, directors or other administrators of the pension fund know, or have reason to know, that the beneficiary is not an individual resident of such foreign country or the United States;

(E) In the case of a pension fund that has fewer than 500 beneficiaries, the beneficiary's employer provides (if the beneficiary is currently contributing to the fund) to the trustees, directors or other administrators a written statement that the beneficiary is currently employed in the country in which the fund is administered or is usually employed in such country but is temporarily employed by the company outside of the country; and

(F) The trustees, directors or other administrators of the pension fund provide, with the pension fund's intermediary ownership statement described in paragraph (b)(6) of this section, a written statement signed under penalties of perjury declaring that the pension fund meets the requirements in paragraphs (b)(8)(iii) (A), (B), and (C) of this section and giving the number of beneficiaries who meet the requirements of paragraph (b)(8)(iii)(D) of this section, and, if applicable, paragraph (b)(8)(iii)(E) of this section.

(iv) *Computation of beneficial interests in non-government pension funds.* The number of shares in a foreign corporation that are held indirectly by beneficiaries of a pension fund who are qualifying shareholders may be computed based on the ratio of the number of such beneficiaries to all beneficiaries of the pension fund (rather than on the basis of the rules in paragraph (b)(2) of this section) if—

(A) The pension fund meets the requirements of paragraphs (b)(8)(iii) (A), (B), and (C) of this section;

(B) The trustees, directors or other administrators of the pension fund have no knowledge, and no reason to know, that the ratio of the pension fund's beneficiaries who are residents of either the country in which the pension fund is administered or of the United States to all beneficiaries of the pension fund would differ significantly from the ratio of the sum of the actuarial interests of such residents in the pension fund to the actuarial interests of all beneficiaries in the pension fund (or, if the beneficiaries' actuarial interest in the stock held directly or indirectly by the pension fund differs from the beneficiaries' actuarial interest in the pension fund, the ratio of actuarial interests computed by reference to the beneficiaries' actuarial interest in the stock);

(C) Either—

(*1*) Any overfunding of the pension fund would be payable, pursuant to the governing instrument or the laws of the foreign country in which the pension fund is administered, only to, or for the benefit of, one or more corporations that are qualified residents of the country in which the pension fund is administered, individual beneficiaries of the pension fund or their designated beneficiaries, or social or charitable causes (the reduction of the obligation of the sponsoring company or companies to make future contributions to the pension fund by reason of overfunding shall not itself result in such overfunding being deemed to be payable to or for the benefit of such company or companies); or

(*2*) The foreign country in which the pension fund is administered has laws that are designed to prevent overfunding of a pension fund and the funding of the pension fund is within the guidelines of such laws; or

(*3*) The pension fund is maintained to provide benefits to employees in a particular industry, profession, or group of industries or professions and employees of at least 10 companies (other than companies that are owned or controlled, directly or indirectly, by the same interests) contribute to the pension fund or receive benefits from the pension fund; and

(D) The trustees, directors or other administrators provide, with the pension fund's intermediary ownership statement described in paragraph (b)(6) of this section, a written statement signed under penalties of perjury certifying that the requirements in paragraphs (b)(8)(iv) (A), (B), and either (C)(*1*), (C)(*2*) or (C)(*3*) of this section have been met.

The statement described in paragraph (b)(8)(iv) (D) of this section may be combined, in a single statement, with the information required in paragraph (b)(8)(iv) (F) of this section.

(v) *Time for making determinations.* The determinations required to be made under this paragraph (b)(8) shall be made using information shown on the records of the pension fund for a date on or after the beginning of the foreign corporation's taxable year to which the determination is relevant.

(9) *Availability of documents for inspection*—(i) *Retention of documents by the foreign corporation.* The documentation described in paragraphs (b)(3) and (b)(8) of this section must be retained by the foreign corporation until expiration of the period of limitations for the taxable year to which the documentation relates and must be made available for inspection by the District Director at such time and place as the District Director may request.

(ii) *Retention of documents by an intermediary issuing an intermediary verification statement.* The documentation upon which an intermediary relies to issue an intermediary verification statement under paragraph (b)(7) of this section must be retained by the intermediary for a period of six years from the date of issuance of the intermediary verification statement and must be made available for inspection by the District Director at such time and place as the District Director may request.

(10) *Examples.* The application of this paragraph (b) is illustrated by the following examples.

Example 1. Foreign corporation A is a resident of country L, which has an income tax treaty in effect with the United States. Foreign corporation A has one class of stock issued and outstanding consisting of 1,000 shares, which are beneficially owned by the following alien individuals, directly or by application of paragraph (b)(2) of this section:

Individual	Shares owned, directly or indirectly by application of paragraph (b)(2) of this section	Percentage
T—resident of the U.S	200	20
U—resident of country L	400	40
V—resident of country M	100	10
W—resident of country L	210	21
X—resident of country N	90	9
Total	1,000	100

(i) T owns his 200 shares directly and is a beneficial owner.

(ii) U and V own, respectively, an 80 percent and a 20 percent actuarial interest in foreign trust FT, (which interest does not differ from their respective interests in the stock owned by FT), which beneficially owns 100 percent of the stock of a foreign corporation B with bearer shares, which beneficially owns 500 shares of foreign corporation A. Foreign corporation B is incorporated in a country that does not have an income tax treaty with the United States. The foreign trust has deposited the bearer shares it owns in B with a bank in a foreign country that has an income tax treaty with the United States.

(iii) W beneficially owns all the shares of foreign corporation C, which are registered in the name of individual Z, a nominee, who resides in country L; foreign corporation C beneficially owns a 70 percent interest in foreign corporation D, which beneficially owns 300 shares of A. D's shares are bearer shares that C (not a resident of a country with which the United States has an income tax treaty) has deposited with a bank in a foreign country that has an income tax treaty with the United States.

(iv) X beneficially owns a 30 percent interest in foreign corporation D.

(v) A is a qualified resident of country L if it obtains the applicable documentation described in paragraph (b)(3) of this section either with respect to ownership by individuals U and W or with respect to ownership by individuals T and U, since either combination of qualifying shareholders of foreign corporation A will exceed 50 percent.

Example 2. Assume the same facts as in *Example 1* and assume that foreign corporation A chooses to obtain documentation with respect to individuals T and U.

(i) A must obtain, pursuant to paragraph (b)(3)(i) of this section, an ownership statement (as described in paragraph (b)(4)(i) of this section) signed by T. T is not required to furnish a certificate of residency because T is a U.S. resident.

(ii) U must provide foreign trust FT with an ownership statement and certificate of residency, as described in paragraphs (b)(4) and (b)(5) of this section. The trustees of FT must provide the depository bank holding foreign corporation B's bearer shares with an intermediary ownership statement concerning its beneficial ownership of B's shares and must attach to it the documentation provided by U. The depository bank must provide B with an intermediary ownership statement regarding its holding of B shares on behalf of FT and has the choice of attaching—

(A) The documentation from U and the intermediary ownership statement from FT; or

(B) An intermediary verification statement described in paragraph (b)(7) of this section, in which case foreign corporation B would not be provided with U's individual documentation or FT's intermediary ownership statement, both of which are retained by the depository bank.

(iii) In either case, B must then provide foreign corporation A with an intermediary ownership statement regarding its direct beneficial ownership of shares in A and, as the case may be, either—

(A) U's documentation and the intermediary ownership statements by FT and the depository bank; or

(B) The depository bank's intermediary ownership and verification statements.

(iv) Thus, with respect to U, A must obtain under paragraph (b)(3)(i) of this section the individual documentation regarding U and an intermediary ownership statement from each intermediary standing in the chain of U's indirect beneficial ownership of shares in A, i.e., from FT, the depository bank and B. In the alternative, A must obtain under paragraph (b)(3)(ii) of this section an intermediary verification statement issued by the depository bank and an intermediary ownership statement from the bank and from B, which, in this example, are the only intermediaries standing in the chain of ownership of the verifying intermediary (i.e., the depository bank).

Example 3. Assume the same facts as in *Example 1.* In addition, assume that foreign corporation A chooses to obtain documentation with respect to individuals U and W. With respect to U, A must obtain the same documentation that is described in *Example 2.* With respect to W, A must obtain, under paragraph (b)(3)(i) of this section, individual documentation regarding W and an intermediary ownership statement from each intermediary standing in the chain of W's indirect beneficial ownership of shares in A, i.e., from individual Z, foreign corporation C, the depository bank in the foreign treaty country, and foreign corporation D. In the alternative, A must obtain, under paragraph (b)(3)(ii) of this section, either—

(i) An intermediary verification statement by the depository bank in the foreign treaty country and an intermediary ownership statement from the bank and from D; or

(ii) An intermediary verification statement from Z and an intermediary ownership statement from Z and from each intermediary standing in the chain of ownership of shares in foreign corporation A, i.e., from C, the depository bank in the foreign treaty country and D. C may not issue an intermediary verification statement because it is not a resident of a country with which the United States has an income tax treaty.

(c) *Base erosion.* A foreign corporation satisfies the requirement relating to base erosion for a taxable year if it establishes that less than 50 percent of its income for the taxable year is used (directly or indirectly) to make deductible payments in the current taxable year to persons who are not residents (or, in the case of foreign corporations, qualified residents) of the foreign country of which the foreign corporation is a resident and who are not citizens or residents (or, in the case of domestic corporations, qualified residents) of the United States. Whether a domestic corporation is a qualified resident of the United States shall be determined under the principles of this section. For purposes of this paragraph (c), the term ‘‘deductible payments’’ includes payments that would be ordinarily deductible under U.S. income tax principles without regard to other provisions of the Code that may require the capitalization of the expense, or disallow or defer the deduction. Such payments include, for example, interest, rents, royalties and reinsurance premiums. For purposes of this paragraph (c), the income of a foreign corporation means the corporation's gross income for the taxable year (or, if the foreign corporation has no gross income for the taxable year, the average of its gross income for the three previous taxable years) under U.S. tax principles, but not excluding items of income otherwise excluded from gross income under U.S. tax principles.

(d) *Publicly-traded corporations*—(1) *General rule.* A foreign corporation that is a resident of a foreign country shall be treated as a qualified resident of that country for any taxable year in which—

(i) Its stock is primarily and regularly traded (as defined in paragraphs (d) (3) and (4) of this section) on one or more established securities markets (as defined in paragraph (d)(2) of this section) in that country, or in the United States, or both; or

(ii) At least 90 percent of the total combined voting power of all classes of stock of such foreign corporation entitled to vote and at least 90 percent of the total value of the stock of such foreign corporation is owned, directly or by application of paragraph (b)(2) of this section, by a foreign corporation that is a resident of the same foreign country or a domestic corporation and the stock of such parent corporation is primarily and regularly traded on an established securities market in that foreign country or in the United States, or both.

(2) *Established securities market*—(i) *General rule.* For purposes of section 884, the term ‘‘established securities market'' means, for any taxable year—

(A) A foreign securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority of the country in which the market is located, is the principal exchange in that country, and has an annual value of shares traded on the exchange exceeding $1 billion during each of the three calendar years immediately preceding the beginning of the taxable year;

(B) A national securities exchange that is registered under section 6 of the Securities Act of 1934 (15 U.S.C. 78f); and

(C) A domestic over-the-counter market (as defined in paragraph (d)(2)(iv) of this section).

(ii) *Exchanges with multiple tiers.* If a principal exchange in a foreign country has more than one tier or market level on which stock may be separately listed or traded, each such tier shall be treated as a separate exchange.

(iii) *Computation of dollar value of stock traded.* For purposes of paragraph (d)(2)(i)(A) of this section, the value in U.S. dollars of shares traded during a calendar year shall be determined on the basis of the dollar value of such shares traded as reported by the International Federation of Stock Exchanges, located in Paris, or, if not so reported, then by converting into U.S. dollars the aggregate value in local currency of the shares traded using an exchange rate equal to the average of the spot rates on the last day of each month of the calendar year.

(iv) *Definition of over-the-counter market.* An over-the-counter market is any market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers that regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets that are prepared and distributed by a broker or dealer in the regular course of business and that contain only quotations of such broker or dealer.

(v) *Discretion to determine that an exchange qualifies as an established securities market.* The Commissioner may, in his sole discretion, determine in a published document that a securities exchange that does not meet the requirements of paragraph (d)(2)(i)(A) of this section qualifies as an established securities market. Such a determination will be made only if it is established that—

(A) The exchange, in substance, has the attributes of an established securities market (including adequate trading volume, and comparable listing and financial disclosure requirements);

(B) The rules of the exchange ensure active trading of listed stocks; and

(C) The exchange is a member of the International Federation of Stock Exchanges.

(vi) *Discretion to determine that an exchange does not qualify as an established securities market.* The Commissioner may, in his sole discretion, determine in a published document that a securities exchange that meets the requirements of paragraph (d)(2)(i) of this section does not qualify as an established securities market. Such determination shall be made if, in the view of the Commissioner—

(A) The exchange does not have adequate listing, financial disclosure, or trading requirements (or does not adequately enforce such requirements); or

(B) There is not clear and convincing evidence that the exchange ensures the active trading of listed stocks.

(3) *Primarily traded.* For purposes of this section, stock of a corporation is ‘‘primarily traded’’ on one or more established securities markets in the corporation’s country of residence or in the United States in any taxable year if, with respect to each class described in paragraph (d)(4)(l)(i)(A) of this section (relating to classes of stock relied on to meet the regularly traded test)—

(i) The number of shares in each class that are traded during the taxable year on all established securities markets in the corporation’s country of residence or in the United States during the taxable year exceeds

(ii) The number of shares in each such class that are traded during that year on established securities markets in any other single foreign country.

(4) *Regularly traded*—(i) *General rule.* For purposes of this section, stock of a corporation is ‘‘regularly traded’’ on one or more established securities markets in the foreign corporation’s country of residence or in the United States for the taxable year if—

(A) One or more classes of stock of the corporation that, in the aggregate, represent 80 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote and of the total value of the stock of such corporation are listed on such market or markets during the taxable year;

(B) With respect to each class relied on to meet the 80 percent requirement of paragraph (d)(4)(i)(A) of this section—

(*1*) Trades in each such class are effected, other than in *de minimis* quantities, on such market or markets on at least 60 days during the taxable year (or 1/6 of the number of days in a short taxable year); and

(*2*) The aggregate number of shares in each such class that is traded on such market or markets during the taxable year is at least 10 percent of the average number of shares outstanding in that class during the taxable year (or, in the case of a short taxable year, a percentage that equals at least 10 percent of the number of days in the short taxable year divided by 365).

If stock of a foreign corporation fails the 80 percent requirement of paragraph (d)(4)(i)(A) of this section, but a class of such stock meets the trading requirements of paragraph (d)(4)(i)(B) of this section, such class of stock may be taken into account under paragraph (b)(1)(iii) of this section as owned by qualifying shareholders for purposes of meeting the ownership test of paragraph (b)(1) of this section.

(ii) *Classes of stock traded on a domestic established securities market treated as meeting trading requirements.* A class of stock that is traded during the taxable year on an established securities market located in the United States shall be treated as meeting the trading requirements of paragraph (d)(4)(i)(B) of this section if the stock is regularly quoted by brokers or dealers making a market in the stock. A broker or dealer makes a market in a stock only if the broker or dealer holds himself out to buy or sell the stock at the quoted price.

(iii) *Closely-held classes of stock not treated as meeting trading requirement*—(A) *General rule.* A class of stock shall not be treated as meeting the trading requirements of paragraph (d)(4)(i)(B) of this section (or the requirements of paragraph (d)(4)(ii) of this section) for a taxable year if, at any time during the taxable year, one or more persons who are not qualifying shareholders (as defined in paragraph (b)(1) of this section) and who each beneficially own 5 percent or more of the value of the outstanding shares of the class of stock own, in the aggregate, 50 percent or more of the outstanding shares of the class of stock for more than 30 days during the taxable year. For purposes of the preceding sentence, shares shall not be treated as owned by a qualifying shareholder unless such shareholder provides to the foreign corporation, by the time prescribed in paragraph (b)(3) of this section, the documentation described in paragraph (b)(3) of this section necessary to establish that it is a qualifying shareholder. For purposes of this paragraph (d)(4)(iii)(A), shares of stock owned by a pension fund, as defined in paragraph (b)(8)(i)(A) of this section, shall be treated as beneficially owned by the beneficiaries of such fund, as defined in paragraph (b)(8)(i)(B) of this section.

(B) *Treatment of related persons.* Persons related within the meaning of section 267(b) shall be treated as one person for purposes of this paragraph (d)(4)(iii). In determining whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c). Further, in determining whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3).

(iv) *Anti-abuse rule.* Trades between persons described in section 267(b) (as modified in paragraph (d)(4)(iii)(B) of this section) and trades conducted in order to meet the requirements of paragraph (d)(4)(i)(B) of this section shall be disregarded. A class of stock shall not be treated as meeting the trading requirements of paragraph (d)(4)(i)(B) of this section if there is a pattern of trades conducted to meet the requirements of that paragraph. For example, trades between two persons that occur several times during the taxable year my be treated as an arrangement or a pattern of trades conducted to meet the trading requirements of paragraph (d)(4)(i)(B) of this section.

(5) *Burden of proof for publicly-traded corporations.* A foreign corporation that relies on this paragraph (d) to establish that it is a qualified resident of a country with which the United States has an income tax treaty shall have the burden of proving all the facts necessary for the corporation to be treated as a qualified resident, except that with respect to paragraphs (d)(4) (iii) and (iv) of this section, a foreign corporation, with either registered or bearer shares, will meet the burden of proof if it has no reason to know and no actual knowledge of facts that would cause the corporation's stock not to be treated as regularly traded under such paragraphs. A foreign corporation that has shareholders of record must also maintain a list of such shareholders and, on request, make available to the District Director such list and any other relevant information known to the foreign corporation.

(e) *Active trade or business*—(1) *General rule.* A foreign corporation that is a resident of a foreign country shall be treated as a qualified resident of that country with respect to any U.S. trade or business if, during the taxable year—

(i) It is engaged in the active conduct of a trade or business (as defined in paragraph (e)(2) of this section) in its country of residence;

(ii) It has a substantial presence (within the meaning of paragraph (e)(3) of this section) in its country of residence; and

(iii) Either—

(A) Such U.S. trade or business is an integral part (as defined in paragraph (e)(4) of this section) of an active trade or business conducted by the foreign corporation in its country of residence; or

(B) In the case of interest received by the foreign corporation for which a treaty exemption or rate reduction is claimed pursuant to § 1.884–4(b)(8)(ii), the interest is derived in connection with, or is incidental to, a trade or business described in paragraph (e)(1)(i) of this section.

A foreign corporation may determine whether it is a qualified resident under this paragraph (e) by applying the rules of this paragraph (e) to the entire affiliated group (as defined in section 1504 (a) without regard to section 1504(b) (2) or (3)) of which the foreign corporation is a member rather than to the foreign corporation separately. If a foreign corporation chooses to apply the rules of this paragraph (e) to its entire affiliated group as provided in the preceding sentence, then it must apply such rules consistently to all of its U.S. trades or businesses conducted during the taxable year.

(2) *Active conduct of a trade or business.* A foreign corporation is engaged in the active conduct of a trade or business only if either—

(i) It is engaged in the active conduct of a trade or business within the meaning of section 367(a)(3) and the regulations thereunder; or

(ii) It qualifies as a banking or financing institution under the laws of the foreign country of which it is a resident, it is licensed to do business with residents of its country of residence, and it is engaged in the active conduct of a banking, financing, or similar business within the meaning of §1.864–4(c)(5)(i) in its country of residence.

A foreign corporation that is an insurance company within the meaning of §1.801–3 (a) or (b) is engaged in the active conduct of a trade or business only if it is predominantly engaged in the active conduct of an insurance business within the meaning of section 952(c)(1)(B)(v) and the regulations thereunder.

(3) *Substantial presence test*—(i) *General rule.* Except as provided in paragraph (e)(3)(ii) of this section, a foreign corporation that is engaged in the active conduct of a trade or business in its country of residence has a substantial presence in that country if, for the taxable year, the average of the following three ratios exceeds 25 percent and each ratio is at least equal to 20 percent—

(A) The ratio of the value of the assets of the foreign corporation used or held for use in the active conduct of a trade or business in its country of residence at the close of the taxable year to the value of all assets of the foreign corporation at the close of the taxable year;

(B) The ratio of gross income from the active conduct of the foreign corporation's trade or business in its country of residence that is derived from sources within such country for the taxable year to the worldwide gross income of the foreign corporation for the taxable year; and

(C) The ratio of the payroll expenses in the foreign corporation's country of residence for the taxable year to the foreign corporation's worldwide payroll expenses for the taxable year.

(ii) *Special rules*—(A) *Asset ratio.* For purposes of paragraph (e)(3)(i)(A) of this section, the value of an asset shall be determined using the method used by the taxpayer in keeping its books for purposes of financial reporting in its country of residence. An asset shall be treated as used or held for use in a foreign corporation's trade or business if it meets the requirements of §1.367(a)–2T(b)(5). Stock held by a foreign corporation shall not be treated as an asset of the foreign corporation for purposes of paragraph (e)(3)i)(A) of this section if the foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote. The rules of §1.954–2T(b)(3) (other than §1.954–2T(b)(3)(x)) shall apply to determine the location of assets used or held for use in a trade or business. Loans originated or acquired in the course of the normal customer loan activities of a banking, financing or similar institution, and securities and derivative financial instruments held by dealers, traders and insurance companies for use in a trade or business shall be treated as located in the country in which an office or other fixed place of business is primarily responsible for the acquisition of the asset and the realization of income, gain or loss with respect to the asset.

(B) *Gross income ratio*—(*1*) *General rule.* For purposes of paragraph (e)(3)(i)(B) of this section, the term ''gross income'' means the gross income of a foreign corporation for purposes of financial reporting in its country of residence. Gross income shall not include, however, dividends, interest, rent, or royalties unless such corporation derives such dividends, interest, rents, or royalties in the active conduct of its trade or business. Gross income shall also not include gain from the disposition of stock if the foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote. Except as provided in this paragraph (e)(3)(ii)(B), the principles of sections 861 through 865 shall apply to determine the amount of gross income of a foreign corporation derived within its country of residence.

(*2*) *Banks, dealers and traders.* Dividend income and gain from the sale of securities, or from entering into or disposing of derivative financial instruments by dealers and traders in such securities or derivative financial instruments shall be treated as derived within the country where the assets are located under paragraph (e)(3)(ii)(A) of this section. Other income, including interest and fees, earned in the active conduct of a banking, financing or similar business shall be treated as derived within the country where the payor of such interest or other income resides. For purposes of the preceding sentence, if a branch or similar establishment outside the country in which the payor resides makes a payment of interest or other income, such amounts shall be treated as derived within the country in which the branch or similar establishment is located.

(*3*) *Insurance companies.* The gross income of a foreign insurance company shall include only gross premiums received by the country.

(*4*) *Other corporations.* Gross income from the performance of services, including transportation services, shall be treated as derived within the country of residence of the person for whom the services are performed. Gross income from the sale of property by a foreign corporation shall be treated as derived within the country in which the purchaser resides.

(*5*) *Anti-abuse rule.* The Commissioner may disregard the source of income from a transaction determined under this paragraph (e)(3)(ii)(B) if it is determined that one of the principal purposes of the transaction was to increase the source of income derived within the country of residence of the foreign corporation for purposes of this section.

(C) *Payroll ratio.* For purposes of paragraph (e)(3)(i)(C) of this section, the payroll expenses of a foreign corporation shall include expenses for ''leased employees'' (within the meaning of section 414(n)(2) but without regard to subdivision (B) of that section) and commission expenses paid to employees and agents for services performed for or on behalf of the corporation. Payroll expense for an employee, agent or a ''leased employee'' shall be treated as incurred where the employee, agent or ''leased employee'' performs services on behalf of the corporation.

(iii) *Exception to gross income test for foreign corporations engaged in certain trades or businesses.* In determining whether a foreign corporation engaged primarily in selling tangible property or in manufacturing, producing, growing, or extracting tangible property has a substantial presence in its country of residence for purposes of paragraph (e)(3)(i) of this section, the foreign corporation may apply the ratio provided in this paragraph (e)(3)(iii) instead of the ratio described in paragraph (e)(3)(i)(B) of this section (relating to the ratio of gross income derived from its country of residence). This ratio shall be the ratio of the direct material costs of the foreign corporation with respect to tangible property manufactured, produced, grown, or extracted in the foreign corporation's country of residence to the total direct material costs of the foreign corporation.

(4) *Integral part of an active trade or business in a foreign corporation's country of residence*—(i) *In general.* A U.S. trade or business of a foreign corporation is an integral part of an active trade or business conducted by a foreign corporation in its country of residence if the active trade or business conducted by the foreign corporation

in both its country of residence and in the United States comprise, in principal part, complementary and mutually interdependent steps in the United States and its country of residence in the production and sale or lease of goods or in the provision of services. Subject to the presumption and de minimis rule in paragraphs (e)(4) (iii) and (iv) of this section, if a U.S. trade or business of a foreign corporation sells goods that are not, in principal part, manufactured, produced, grown, or extracted by the foreign corporation in its country of residence, such business shall not be treated as an integral part of an active trade or business conducted in the foreign corporation's country of residence unless the foreign corporation takes physical possession of the goods in a warehouse or other storage facility that is located in its country of residence and in which goods of such type are normally stored prior to sale to customers in such country.

(ii) *Presumption for banks.* A U.S. trade or business of a foreign corporation that is described in §1.884–4(a)(2)(iii) shall be presumed to be an integral part of an active banking business conducted by the foreign corporation in its country of residence provided that a substantial part of the business of the foreign corporation in both its country of residence and the United States consists of receiving deposits and making loans and discounts. This paragraph shall be effective for taxable years beginning on or after June 6, 1996.

(iii) *Presumption if business principally conducted in country of residence.* A U.S. trade or business of a foreign corporation shall be treated as an integral part of an active trade or business of a foreign corporation in its country or residence with respect to the sale or lease of property (or the performance of services) if at least 50 percent of the foreign corporation's worldwide gross income from the sale or lease of property of the type sold in the United States (or from the performance of services of the type performed in the United States) is derived from the sale or lease of such property for consumption, use, or disposition in the foreign corporation's country of residence (or from the performance of such services in the foreign corporation's country of residence). In determining whether property or services are of the same type, a foreign corporation shall follow recognized industry or trade usage or the three-digit major groups (or any narrower classification) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President. The determination of whether income is of the same kind must be made in a consistent manner from year to year.

(iv) *De minimis rule.* If a foreign corporation is engaged in more than one U.S. trade or business and if at least 80 percent of the sum of the ECEP from the current year and the preceding two years is attributable to one or more trades or businesses that meet the integral part test of this paragraph (e)(4), all of the U.S. trades or businesses of the foreign corporation shall be treated as an integral part of an active or business conducted by the foreign corporation. If a foreign corporation has more than one U.S. trade or business and does not meet the requirements of the preceding sentence but otherwise meets the requirements of this paragraph (e)(4) with regard to one or more trade or business, see §1.884–1(g)(1) to determine the extent to which treaty benefits apply to such corporation.

(f) *Qualified resident ruling*—(1) *Basis for ruling.* In his or her sole discretion, the Commissioner may rule that a foreign corporation is a qualified resident of its country or residence if the Commissioner determines that individuals who are not residents of the foreign country of which the foreign corporation is a resident do not use the treaty between that country and the United States in a manner inconsistent with the purposes of section 884. The purposes of section 884 include, but are not limited to, the prevention of treaty shopping by an individual with respect to any article of an income tax treaty between the country of residence of the foreign corporation and the United States.

(2) *Factors.* In order to make this determination, the Commissioner may take into account the following factors, including, but not limited to:

(i) The business reasons for establishing and maintaining the foreign corporation in its country of residence;

(ii) The date of incorporation of the foreign corporation in relation to the date that an income tax treaty between the United States and the foreign corporation's country of residence entered into force;

(iii) The continuity of the historical business and ownership of the foreign corporation;

(iv) The extent to which the foreign corporation meets the requirements of one or more of the tests described in paragraphs (b) through (e) of this section;

(v) The extent to which the U.S. trade or business is dependent on capital, assets, or personnel of the foreign trade or business;

(vi) The extent to which the foreign corporation receives special tax benefits in its country of residence;

(vii) Whether the foreign corporation is a member of an affiliated group (as defined in section 1504(a) without regard to section 1504(b) (2) or (3)), that has no members resident outside the country of residence of the foreign corporation; and

(viii) The extent to which the foreign corporation would be entitled to comparable treaty benefits with respect to all articles of an income tax treaty that would apply to that corporation if it had been incorporated in the country or countries of residence of the majority of its shareholders. For purposes of the preceding sentence, shareholders taken into account shall generally be limited to persons described in paragraph (b)(1)(i) of this section but for the fact that they are not residents of the foreign corporation's country of residence.

(3) *Procedural requirements.* A request for a ruling under this paragraph (f) must be submitted on or before the due date (including extensions) of the foreign corporation's income tax return for the taxable year for which the ruling is requested. A foreign corporation receiving a ruling will be treated as a qualified resident of its country of residence for the taxable year for which the ruling is requested and for the succeeding two taxable years. If there is a material change in any fact that formed the basis of the ruling, such as the ownership or the nature of the trade or business of the foreign corporation, the foreign corporation must notify the Secretary within 90 days of such change and submit a new private letter ruling request. The Commissioner will then rule whether the change affects the foreign corporation's status as a qualified resident, and such ruling will be valid for the taxable year in which the material change occurred and the two succeeding taxable years, subject to the requirement in the preceding sentence to notify the Commissioner of a material change.

(g) *Effective dates.* Except as provided in paragraph (e)(4)(ii) of this section, this section is effective for taxable years beginning on or after October 13, 1992. With respect to a taxable year beginning before October 13, 1992, and after December 31, 1986, a foreign corporation may elect to apply this section in lieu of the temporary regulations under 1.884–5T (as contained in the CFR edition revised as of April 1, 1992), but only if the statute of limitations for assessment of a deficiency has not expired for that taxable year. Once an election has been made, an election shall apply to all subsequent taxable years.

(h) *Transition rule.* If a foreign corporation elects to apply this section in lieu of § 1.884–5T (as contained in the CFR edition revised as of April 1, 1992) as provided in paragraph (g) of this section, and the application of paragraph (b) of this section results in additional documentation requirements in order for the foreign corporation to be treated as a qualified resident, the foreign corporation must obtain the documentation required under that paragraph on or before March 11, 1993.

[T.D. 8432, 57 FR 41666, Sept. 11, 1992; 57 FR 49117, Oct. 29, 1992; 57 FR 60126, Dec. 18, 1992, as amended by T.D. 8657, 61 FR 9343, Mar. 8, 1996; 61 FR 14248, Apr. 1, 1996]

MISCELLANEOUS PROVISIONS

§1.891 Statutory provisions; doubling of rates of tax on citizens and corporations of certain foreign countries.

SEC. 891. *Doubling of rates of tax on citizens and corporations of certain foreign countries.* Whenever the President finds that, under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes, the President shall so proclaim and the rates of tax imposed by sections 1, 3, 11, 802, 821, 831, 852, 871, and 881 shall, for the taxable year during which such proclamation is made and for each taxable year thereafter, be doubled in the case of each citizen and corporation of such foreign country; but the tax at such doubled rate shall be considered as imposed by such sections as the case may be. In no case shall this section operate to increase the taxes imposed by such sections (computed without regard to this section) to an amount in excess of 80 percent of the taxable income of the taxpayer (computed without regard to the deductions allowable under section 151 and under part VIII of subchapter B). Whenever the President finds that the laws of any foreign country with respect to which the President has made a proclamation under the preceding provisions of this section have been modified so that discriminatory and extraterritorial taxes applicable to citizens and corporations of the United States have been removed, he shall so proclaim, and the provisions of this section providing for doubled rates of tax shall not apply to any citizen or corporation of such foreign country with respect to any taxable year beginning after such proclamation is made.

(Sec. 891 as amended by sec. 5(6), Life Insurance Company Tax Act 1955 (70 Stat. 49); sec. 3(f)(1), Life Insurance Company Income Tax Act 1959 (73 Stat. 140))

[T.D. 6610, 27 FR 8723, Aug. 31, 1962]

§1.892–1T Purpose and scope of regulations (temporary regulations).

(a) *In general.* These regulations provide guidance with respect to the taxation of income derived by foreign governments and international organizations from sources within the United States. Under section 892, certain specific types of income received by foreign governments are excluded from gross income and are exempt, unless derived from the conduct of a commercial activity or received from or by a controlled commercial entity. This section sets forth the effective date of the regulations. Section 1.892–2T defines a foreign government. In particular it describes the extent to which either an integral part of a foreign sovereign or an entity which is not an integral part of a foreign sovereign will be treated as a foreign government for purposes of section 892. Section 1.892–3T describes the types of income that generally qualify for exemption and certain limitations on the exemption. Section 1.892–4T provides rules concerning the characterization of activities as commercial activities. Section 1.892–5T defines a controlled commercial entity. Section 1.892–6T sets forth the extent to which income of international organizations from sources within the United States is excluded from gross income and is exempt from taxation. Section 1.892–7T sets forth the relationship of section 892 to other Internal Revenue Code sections.

(b) *Effective date.* The regulations set forth in §§1.892–1T through 1.892–7T apply to income received by a foreign government on or after July 1, 1986. No amount of income shall be required to be deducted and withheld, by reason of the amendment of section 892 by section 1247 of the Tax Reform Act of 1986 (Pub. L. 99–514, 100 Stat. 2085, 2583) from any payment made before October 22, 1986.

[T.D. 8211, 53 FR 24061, June 27, 1988; 53 FR 27595, July 21, 1988]

§1.892–2T Foreign government defined (temporary regulations).

(a) *Foreign government*—(1) *Definition.* The term ‘‘foreign government’’ means only the integral parts or controlled entities of a foreign sovereign.

(2) *Integral part.* An ‘‘integral part’’ of a foreign sovereign is any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country. The net earnings of the governing authority must be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person. An integral part does not include any individual who is a sovereign, official, or administrator acting

in a private or personal capacity. Consideration of all the facts and circumstances will determine whether an individual is acting in a private or personal capacity.

(3) *Controlled entity.* The term ''controlled entity'' means an entity that is separate in form from a foreign sovereign or otherwise constitute a separate juridical entity if it satisfies the following requirements:

(i) It is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities;

(ii) It is organized under the laws of the foreign sovereign by which owned;

(iii) Its net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and

(iv) Its assets vest in the foreign sovereign upon dissolution.

A controlled entity does not include partnerships or any other entity owned and controlled by more than one foreign sovereign. Thus, a foreign financial organization organized and wholly owned and controlled by several foreign sovereigns to foster economic, financial, and technical cooperation between various foreign nations is not a controlled entity for purposes of this section.

(b) *Inurement to the benefit of private persons.* For purposes of this section, income will be presumed not to inure to the benefit of private persons if such persons (within the meaning of section 7701(a)(1)) are the intended beneficiaries of a governmental program which is carried on by the foreign sovereign and the activities of which constitute governmental functions (within the meaning of § 1.892–4T(c)(4)). Income will be considered to inure to the benefit of private persons if such income benefits:

(1) Private persons through the use of a governmental entity as a conduit for personal investment; or

(2) Private persons who divert such income from its intended use by the exertion of influence or control through means explicitly or implicitly approved of by the foreign sovereign.

(c) *Pension trusts*—(1) *In general.* A controlled entity includes a separately organized pension trust if it meets the following requirements:

(i) The trust is established exclusively for the benefit of (A) employees or former employees of a foreign government or (B) employees or former employees of a foreign government and non-governmental employees or former employees that perform or performed governmental or social services;

(ii) The funds that comprise the trust are managed by trustees who are employees of, or persons appointed by, the foreign government;

(iii) The trust forming a part of the pension plan provides for retirement, disability, or death benefits in consideration for prior services rendered; and

(iv) Income of the trust satisfies the obligations of the foreign government to participants under the plan, rather than inuring to the benefit of a private person.

Income of a pension trust is subject to the rules of § 1.892–5T(b)(3) regarding the application of the rules for controlled commercial entities to pension trusts. Income of a superannuation or similar pension fund of an integral part or controlled entity (which is not a separate pension trust as defined in this paragraph (c)(1)) is subject to the rules that generally apply to a foreign sovereign. Such a pension fund may also benefit non-governmental employees or former employees that perform or performed governmental or social services.

(2) *Illustrations.* The following examples illustrate the application of paragraph (c)(1).

Example 1. The Ministry of Welfare (MW), an integral part of foreign sovereign FC, instituted a retirement plan for FC's employees and former employees. Retirement benefits under the plan are based on a percentage of the final year's salary paid to an individual, times the number of years of government service. Pursuant to the plan, contributions are made by MW to a pension trust managed by persons appointed by MW to the extent actuarially necessary to fund accrued pension liabilities. The pension trust in turn invests such contributions partially in United States Treasury obligations. The income of the trust is credited to the trust's account and subsequently used to satisfy the pension plan's obligations to retired employees. Under these circumstances, the income of the trust is not deemed to inure to the benefit of private persons. Accordingly, the trust is considered a controlled entity of FC.

Example 2. The facts are the same as in *Example* 1, except that the retirement plan also benefits employees performing governmental or social services for the following non-government institutions: (i) A university in a local jurisdiction; (ii) a harbor commission; and (iii) a library system. The retirement benefits under the plan are based on the total amounts credited to an individual's account over the term of his or her employment. MW makes annual contributions to each covered employee's account equal to a percentage of annual compensation. In addition, the income derived from investment of the annual contributions is credited annually to individual accounts. The annual contributions do not exceed an amount that is determined to be actuarially necessary to provide the employee with reasonable retirement benefits. Notwithstanding that retirement benefits vary depending upon the investment experience of the trust, no portion of the income of the trust is deemed to inure to the benefit of private persons. Accordingly, the trust is considered a controlled entity of FC.

Example 3. The facts are the same as in *Example* 1, except that employees are allowed to make unlimited contributions to the trust, and such contributions are credited to the employee's account as well as interest accrued on such contributions. Retirement benefits will reflect the amounts credited to the individual accounts in addition to the usual annuity computation based on the final year's salary and years of service. A pension plan established under these rules is in part acting as an investment conduit. As a result, the income of the trust is deemed to inure to the benefit of private persons. Accordingly, the trust is not considered a controlled entity of FC.

Example 4. (a) The facts are the same as in *Example* 2, except that MW establishes a pension fund rather than a separate pension trust. A pension fund is merely assets of an integral part or controlled entity allocated to a separate account and held and invested for purposes of providing retirement benefits. Under these circumstances, the income of the pension fund is not deemed to inure to the benefit of private persons. Accordingly, income earned from the United States Treasury obligations by the pension fund is considered to be received by a foreign government and is exempt from taxation under section 892.

(b) The facts are the same as in *Example* 4(a), except that MW is a controlled entity of foreign sovereign FC. The result is the same as in *Example* 4(a). However, should MW engage in commercial activities (whether within or outside the United States), the income from the Treasury obligations earned by the pension fund will not be exempt from taxation under section 892 since MW will be considered a controlled commercial entity within the meaning of § 1.892–5T(a).

(d) *Political subdivision and transnational entity.* The rules that apply to a foreign sovereign apply to political subdivisions of a foreign country and to transnational entities. A transnational entity is an organization created by more than one foreign sovereign that has broad powers over external and domestic affairs of all participating foreign countries stretching beyond economic subjects to those concerning legal relations and transcending state or political boundaries.

[T.D. 8211, 53 FR 24061, June 27, 1988; 53 FR 27595, July 21, 1988]

§ 1.892–3T Income of foreign governments (temporary regulations).

(a) *Types of income exempt*—(1) *In general.* Subject to the exceptions contained in §§ 1.892–4T and 1.892–5T for income derived from the conduct of a commercial activity or received from or by a controlled commercial entity, the following types of income derived by a foreign government (as defined in § 1.892–2T) are not included in gross income and are exempt:

(i) Income from investments in the United States in stocks, bonds, or other securities;

(ii) Income from investments in the United States in financial instruments held in the execution of governmental financial or monetary policy; and

(iii) Interest on deposits in banks in the United States of moneys belonging to such foreign government.

Income derived from sources other than described in this paragraph (such as income earned from a U.S. real property interest described in section 897(c)(1)(A)(i)) is not exempt from taxation under section 892. Furthermore, any gain derived from the disposition a U.S. real property interest defined in section 897(c)(1)(A)(i) shall in no event qualify for exemption under section 892.

(2) *Income from investments.* For purposes of paragraph (a) of this section, income from investments in stocks, bonds or other securities includes gain from their disposition and income earned from engaging in section 1058 securities lending transactions. Gain

on the disposition of an interest in a partnership or a trust is not exempt from taxation under section 892.

(3) *Securities.* For purposes of paragraph (a) of this section, the term ''other securities'' includes any note or other evidence of indebtedness. Thus, an annuity contract, a mortgage, a banker's acceptance or a loan are securities for purposes of this section.

However, the term ''other securities'' does not include partnership interests (with the exception of publicly traded partnerships within the meaning of section 7704) or trust interests. The term also does not include commodity forward or futures contracts and commodity options unless they constitute securities for purposes of section 864(b)(2)(A).

(4) *Financial instrument.* For purposes of paragraph (a) of this section, the term ''financial instrument'' includes any forward, futures, options contract, swap agreement or similar instrument in a functional or nonfunctional currency (see section 985(b) for the definition of functional currency) or in precious metals when held by a foreign government or central bank of issue (as defined in § 1.895–1(b)). Nonfunctional currency or gold shall be considered a ''financial instrument'' also when physically held by a central bank of issue.

(5) *Execution of financial or monetary policy*—(i) *Rule.* A financial instrument shall be deemed held in the execution of governmental financial or monetary policy if the primary purpose for holding the instrument is to implement or effectuate such policy.

(ii) *Illustration.* The following example illustrates the application of this paragraph (a)(5).

Example. In order to ensure sufficient currency reserves, the monetary authority of foreign country FC issues short-term government obligations. The amount received from the obligations is invested in U.S. financial instruments. Since the primary purpose for obtaining the U.S. financial instruments is to implement FC's monetary policy, the income received from the financial instruments is exempt from taxation under section 892.

(b) *Illustrations.* The principles of paragraph (a) of this section may be illustrated by the following examples.

Example 1. X, a foreign corporation not engaged in commercial activity anywhere in the world, is a controlled entity of a foreign sovereign within the meaning of § 1.892–2T(a)(3). X is not a Central bank of issue as defined in § 1.895–1(b). In 1987, X received the following items of income from investments in the United States: (i) Dividends from a portfolio of publicly traded stocks in U.S. corporations in which X owns less than 50 percent of the stock; (ii) dividends from BTB Corporation, an automobile manufacturer, in which X owns 50 percent of the stock; (iii) interest from bonds issued by noncontrolled entities and from interest-bearing bank deposits in noncontrolled entities; (iv) rents from a net lease on real property; (v) gains from silver futures contracts; (vi) gains from wheat futures contracts; (vii) gains from spot sales of nonfunctional foreign currency in X's possession; (viii) gains from the disposition of a publicly traded partnership interest, and (ix) gains from the disposition of the stock of Z Corporation, a United States real property holding company as defined in section 897, of which X owns 12 percent of the stock. Only income derived from sources described in paragraph (a)(1) of this section is treated as income of a foreign government eligible for exemption from taxation. Accordingly, only income received by X from items (i), (iii), (v) provided that the silver futures contracts are held in the execution of governmental financial or monetary policy, and (ix) is exempt from taxation under section 892.

Example 2. The facts are the same as in *Example* 1, except that X is also a central bank of issue within the meaning of section 895. Since physical possession of nonfunctional foreign currency when held by a central bank of issue is considered a financial instrument, the item (vii) gains from spot sales of nonfunctional foreign currency are exempt from taxation under paragraph (a)(1) of this section, if physical possession of the currency was an essential part of X's reserve policy in the execution of its governmental financial or monetary policy.

Example 3. State Concert Bureau, an integral part of a foreign sovereign within the meaning of § 1.892–2T(a)(2), entered into an agreement with a U.S. corporation engaged in the business of promoting international cultural programs. Under the agreement the State Concert Bureau agreed to send a ballet troupe on tour for 5 weeks in the United States. The Bureau received approximately $60,000 from the performances. Regardless of whether the performances themselves constitute commercial activities under § 1.892–4T, the income received by the Bureau is not exempt from taxation under section 892 since the income is from sources other than described in paragraph (a)(1) of this section.

[T.D. 8211, 53 FR 24062, June 27, 1988]

§1.892–4T Commercial activities (temporary regulations).

(a) *Purpose.* The exemption generally applicable to a foreign government (as defined in §1.892–2T) for income described in §1.892–3T does not apply to income derived from the conduct of a commercial activity or income received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity. This section provides rules for determining whether income is derived from the conduct of a commercial activity. These rules also apply in determining under §1.892–5T whether an entity is a controlled commercial entity.

(b) *In general.* Except as provided in paragraph (c) of this section, all activities (whether conducted within or outside the United States) which are ordinarily conducted by the taxpayer or by other persons with a view towards the current or future production of income or gain are commercial activities. An activity may be considered a commercial activity even if such activity does not constitute the conduct of a trade or business in the United States under section 864(b).

(c) *Activities that are not commercial*—(1) *Investments*—(i) *In general.* Subject to the provisions of paragraphs (ii) and (iii) of this paragraph (c)(1), the following are not commercial activities: Investments in stocks, bonds, and other securities; loans; investments in financial instruments held in the execution of governmental financial or monetary policy; the holding of net leases on real property or land which is not producing income (other than on its sale or from an investment in net leases on real property); and the holding of bank deposits in banks. Transferring securities under a loan agreement which meets the requirements of section 1058 is an investment for purposes of this paragraph (c)(1)(i). An activity will not cease to be an investment solely because of the volume of transactions of that activity or because of other unrelated activities.

(ii) *Trading.* Effecting transactions in stocks, securities, or commodities for a foreign government's own account does not constitute a commercial activity regardless of whether such activities constitute a trade or business for purposes of section 162 or a U.S. trade or business for purposes of section 864. Such transactions are not commercial activities regardless of whether they are effected by the foreign government through its employees or through a broker, commission agent, custodian, or other independent agent and regardless of whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions. An activity undertaken as a dealer, however, as defined in §1.864–2(c)(2)(iv)(*a*) will not be an investment for purposes of this paragraph (c)(1)(i). For purposes of this paragraph (c)(1)(ii), the term ''commodities'' means commodities of a kind customarily dealt in on an organized commodity exchange but only if the transaction is of a kind customarily consummated at such place.

(iii) *Banking, financing, etc.* Investments (including loans) made by a banking, financing, or similar business constitute commercial activities, even if the income derived from such investments is not considered to be income effectively connected to the active conduct of a banking, financing, or similar business in the U.S. by reason of the application of §1.864–4(c)(5).

(2) *Cultural events.* Performances and exhibitions within or outside the United States of amateur athletic events and events devoted to the promotion of the arts by cultural organizations are not commercial activities.

(3) *Non-profit activities.* Activities that are not customarily attributable to or carried on by private enterprise for profit are not commercial activities. The fact that in some instances Federal, State, or local governments of the United States also are engaged in the same or similar activity does not mean necessarily that it is a non-profit activity. For example, even though the United States Government may be engaged in the activity of operating a railroad, operating a railroad is not a non-profit activity.

(4) *Governmental functions.* Governmental functions are not commercial activities. The term ''governmental functions'' shall be determined under U.S. standards. In general, activities performed for the general public with respect to the common welfare or

which relate to the administration of some phase of government will be considered governmental functions. For example, the operation of libraries, toll bridges, or local transportation services and activities substantially equivalent to the Federal Aviation Authority, Interstate Commerce Commission, or United States Postal Service will all be considered governmental functions for purposes of this section.

(5) *Purchasing.* The mere purchasing of goods for the use of a foreign government is not a commercial activity.

[T.D. 8211, 53 FR 24063, June 27, 1988]

§ 1.892–5T Controlled commercial entity (temporary regulations).

(a) *In general.* The exemption generally applicable to a foreign government (as defined in § 1.892–2T) for income described in § 1.892–3T does not apply to income received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity. The term ''controlled commercial entity'' means any entity engaged in commercial activities as defined in § 1.892–4T (whether conducted within or outside the United States) if the government—

(1) Holds (directly or indirectly) any interest in such entity which (by value or voting power) is 50 percent or more of the total of such interests in such entity, or

(2) Holds (directly or indirectly) a sufficient interest (by value or voting power) or any other interest in such entity which provides the foreign government with effective practical control of such entity.

For purposes of this paragraph, the term ''entity'' encompasses corporations and trusts (including pension trusts described in § 1.892–2T(c)) and estates.

(b) Entities treated as engaged in commercial activity—(1) *U.S. real property holding corporations.* A United States real property holding corporation, as defined in section 897(c)(2) or a foreign corporation that would be a United States real property holding corporation if it was a United States corporation, shall be treated as engaged in commercial activity and, therefore, is a controlled commercial entity if the requirements of paragraph (a)(1) or (a)(2) of this section are satisfied.

(2) *Central banks.* Notwithstanding paragraph (a) of this section, a central bank of issue (as defined in § 1.895–1(b)) shall be treated as a controlled commercial entity only if it engages in commercial activities within the United States.

(3) *Pension trusts.* A pension trust, described in § 1.892–2T(c), which engages in commercial activities within or outside the United States, shall be treated as a controlled commercial entity. Income derived by such a pension trust is not income of a foreign government for purposes of the exemption from taxation provided in section 892. A pension trust described in § 1.892–2T(c) shall not be treated as a controlled commercial entity if such trust solely earns income which would not be unrelated business taxable income (as defined in section 512(a)(1)) if the trust were a qualified trust described in section 401(a). However, only income derived by a pension trust that is described in § 1.892–3T and which is not from commercial activities as defined in § 1.892–4T is exempt from taxation under section 892.

(c) *Control*—(1) *Attribution*—(i) *Rule.* In determining for purposes of paragraph (a) of this section the interest held by a foreign government, any interest in an entity (whether or not engaged in commercial activity) owned directly or indirectly by an integral part or controlled entity of a foreign sovereign shall be treated as actually owned by such foreign sovereign.

(ii) *Illustration.* The following example illustrates the application of paragraph (c)(1)(i) of this section.

Example. FX, a controlled entity of foreign sovereign FC, owns 20 percent of the stock of Corp 1. Neither FX nor Corp 1 is engaged in commercial activity anywhere in the world. Corp 1 owns 60 percent of the stock of Corp 2, which is engaged in commercial activity. The remaining 40 percent of Corp 2's stock is owned by Bureau, an integral part of foreign sovereign FC. For purposes of determining whether Corp 2 is a controlled commercial entity of FC, Bureau will be treated as actually owning the 12 percent of Corp 2's stock indirectly owned by FX. Therefore, since Bureau directly and indirectly owns 52 percent of the stock of Corp 2, Corp 2 is a controlled commercial entity of FC within the meaning of paragraph (a) of this section. Accordingly, dividends or other income received, directly or indirectly, from Corp 2 by either Bureau or FX will not be exempt from taxation under section 892. Furthermore, dividends from Corp 1 to the extent attributable to dividends from Corp 2 will not be exempt from taxation. Thus, a distribution from Corp 1 to FX shall be exempt only to the extent such distribution exceeds Corp 1's earnings and profits attributable to the Corp 2 dividend amount received by Corp 1.

(2) *Effective practical control.* An entity engaged in commercial activity may be treated as a controlled commercial entity if a foreign government holds sufficient interests in such entity to give it ''effective practical control'' over the entity. Effective practical control may be achieved through a minority interest which is sufficiently large to achieve effective control, or through creditor, contractual, or regulatory relationships which, together with ownership interests held by the foreign government, achieve effective control. For example, an entity engaged in commercial activity may be treated as a controlled commercial entity if a foreign government, in addition to holding a small minority interest (by value or voting power), is also a substantial creditor of the entity or controls a strategic natural resource which such entity uses in the conduct of its trade or business, giving the foreign government effective practical control over the entity.

(d) *Related controlled entities*—(1) *Brother/sister entities.* Commercial activities of a controlled entity are not attributed to such entity's other brother/sister related entities. Thus, investment income described in § 1.892–2T that is derived by a controlled entity that is not itself engaged in commercial activity within or outside the United States is exempt from taxation notwithstanding the fact that such entity's brother/sister related entity is a controlled commercial entity.

(2) *Parent/subsidiary entities*—(i) *Subsidiary to parent attribution.* Commercial activities of a subsidiary controlled entity are not attributed to its parent. Thus, investment income described in § 1.892–3T that is derived by a parent controlled entity that is not itself engaged in commercial activity within or outside the United States is exempt from taxation notwithstanding the fact that its subsidiary is a controlled commercial entity. Dividends or other payments of income received by the parent controlled entity from the subsidiary are not exempt under section 892, because it constitutes income received from a controlled commercial entity. Furthermore, dividends paid by the parent are not exempt to the extent attributable to the dividends received by the parent from the subsidiary. Thus, a distribution by the parent shall be exempt only to the extent such distribution exceeds earnings and profits attributable to the dividend received from its subsidiary.

(ii) *Parent to subsidiary attribution.* Commercial activities of a parent controlled entity are attributed to its subsidiary. Thus, investment income described in § 1.892–3T that is derived by a subsidiary controlled entity (not engaged in commercial activity within or outside the United States) is not exempt from taxation under section 892 if its parent is a controlled commercial entity.

(3) *Partnerships.* Except for partners of publicly traded partnerships, commercial activities of a partnership are attributable to its general and limited partners for purposes of section 892. For example, where a controlled entity is a general partner in a partnership engaged in commercial activities, the controlled entity's distributive share of partnership income (including income described in § 1.892–3T) will not be exempt from taxation under section 892.

(4) *Illustrations.* The principles of this section may be illustrated by the following examples.

Example 1. (a) The Ministry of Industry and Development is an integral part of a foreign sovereign under § 1.892–2T(a)(2). The Ministry is engaged in commercial activity within the United States. In addition, the Ministry receives income from various publicly traded stocks and bonds, soybean futures contracts and net leases on U.S. real property. Since the Ministry is an integral part, and not a controlled entity, of a foreign sovereign, it is not a controlled commercial entity within the meaning of paragraph (a) of this section. Therefore, income described in § 1.892–3T is ineligible for exemption under section 892 only to the extent derived from the conduct of commercial activities. Accordingly, the Ministry's income from the stocks and bonds is exempt from U.S. tax.

(b) The facts are the same as in *Example* (1)(a), except that the Ministry also owns 75 percent of the stock of R, a U.S. holding company that owns all the stock of S, a U.S. operating company engaged in commercial activity. Ministry's dividend income from R is income received indirectly from a controlled commercial entity. The Ministry's income from the stocks and bonds, with the exception of dividend income from R, is exempt from U.S. tax.

(c) The facts are the same as in *Example* (1)(a), except that the Ministry is a controlled entity of a foreign sovereign. Since the Ministry is a controlled entity and is engaged in commercial activity, it is a controlled commercial entity within the meaning of paragraph (a) of this section, and none of its income is eligible for exemption.

Example 2. (a) Z, a controlled entity of a foreign sovereign, has established a pension trust as part of a pension plan for the benefit of its employees and former employees. The pension trust (T), which meets the requirements of § 1.892–2T(c), has investments in the U.S. in various stocks, bonds, annuity contracts, and a shopping center which is leased and managed by an independent real estate management firm. T also makes securities loans in transactions that qualify under section 1058. T's investment in the shopping center is not considered an unrelated trade or business within the meaning of section 513(b). Accordingly, T will not be treated as engaged in commercial activity. Since T is not a controlled commercial entity, its investment income described in § 1.892–3T, with the exception of income received from the operations of the shopping center, is exempt from taxation under section 892.

(b) The facts are the same as *Example* (2)(a), except that T has an interest in a limited partnership which owns the shopping center. The shopping center is leased and managed by the partnership rather than by an independent management firm. Managing a shopping center, directly or indirectly through a partnership of which a trust is a member, would be considered an unrelated trade or business within the meaning of section 513(b) giving rise to unrelated business taxable income. Since the commercial activities of a partnership are attributable to its partners, T will be treated as engaged in commercial activity and thus will be considered a controlled commercial entity. Accordingly, none of T's income will be exempt from taxation under section 892.

(c) The facts are the same as *Example* (2)(a), except that Z is a controlled commercial entity. The result is the same as in *Example* (2)(a).

Example 3. (a) The Department of Interior, an integral part of foreign sovereign FC, wholly owns corporations G and H. G, in turn, wholly owns S. G, H and S are each controlled entities. G, which is not engaged in commercial activity anywhere in the world, receives interest income from deposits in banks in the United States. Both H and S do not have any investments in the U.S. but are both engaged in commercial activities. However, only S is engaged in commercial activities within the United States. Because neither the commercial activities of H nor the commercial activities of S are attributable to the Department of Interior or G, G's interest income is exempt from taxation under section 892.

(b) The facts are the same as *Example* (3)(a), except that G rather than S is engaged in commercial activities and S rather than G receives the interest income from the United States. Since the commercial activities of G are attributable to S, S's interest income is not exempt from taxation.

Example 4. (a) K, a controlled entity of a foreign sovereign, is a general partner in the Daj partnership. The Daj partnership has investments in the U.S. in various stocks and bonds and also owns and manages an office building in New York. K will be deemed to be engaged in commercial activity by being a general partner in Daj even if K does not actually make management decisions with regard to the partnership's commercial activity, the operation of the office building. Accordingly K's distributive share of partnership income (including income derived from stocks and bonds) will not be exempt from taxation under section 892.

(b) The facts are the same as in *Example* (4)(a), except that the Daj partnership has hired a real estate management firm to lease offices and manage the building. Notwithstanding the fact that an independent contractor is performing the activities, the partnership shall still be deemed to be engaged in commercial activity. Accordingly, K's distributive share of partnership income (including income derived from stocks and bonds) will not be exempt from taxation under section 892.

(c) The facts are the same as in *Example* (4)(a), except that K is a partner whose partnership interest is considered a publicly traded partnership interest within the meaning of section 7704. Under paragraph (d)(3) of this section, the partnership's commercial activity will not be attributed to K. Since K will not be deemed to be engaged in commercial activity, K's distributive share of partnership income derived from stocks and bonds will be exempt from taxation under section 892.

[T.D. 8211, 53 FR 24064, June 27, 1988]

§ 1.892–6T Income of international organizations (temporary regulations).

(a) *Exempt from tax.* Subject to the provisions of section 1 of the International Organizations Immunities Act (22 U.S.C. 288) (the provisions of which are set forth in paragraph (b)(3) of §1.893–1), the income of an international organization (as defined in section 7701(a)(18)) received from investments in the United States in stocks, bonds, or other domestic securities, owned by such international organization, or from interest on deposits in banks in the United States of moneys belonging to such international organization, or from any other source within the United States, is exempt from Federal income tax.

(b) *Income received prior to Presidential designation.* An organization designated by the President through appropriate Executive order as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act may enjoy the benefits of the exemption with respect to income of the prescribed character received by such organization prior to the date of the issuance of such Executive order, if (i) the Executive order does not provide otherwise and (ii) the organization is a public international organization in which the United States participates, pursuant to a treaty or under the authority of an act of Congress authorizing such participation or making an appropriation for such participation, at the time such income is received.

[T.D. 8211, 53 FR 24065, June 27, 1988]

§1.892–7T Relationship to other Internal Revenue Code sections (temporary regulations).

(a) *Section 893.* The term ''foreign government'' referred to in section 893 (relating to the exemption for compensation of employees of foreign governments) has the same meaning as given such term in §1.892–2T.

(b) *Section 895.* A foreign central bank of issue (as defined in §1.895–1(b)) that fails to qualify for the exemption from tax provided by this section (for example, it is not wholly owned by a foreign sovereign) may nevertheless be exempt from tax on the items of income described in section 895.

(c) *Section 883(b).* Nothing in section 892 or these regulations shall limit the exemption provided under section 883(b) relating generally to the exemption of earnings derived by foreign participants from the ownership or operation of communications satellite systems.

(d) *Section 884.* Earnings and profits attributable to income of a controlled entity of a foreign sovereign which is exempt from taxation under section 892 shall not be subject to the tax imposed by section 884(a).

(e) *Sections 1441 and 1442.* No withholding is required under sections 1441 and 1442 in the case of income exempt from taxation under section 892.

[T.D. 8211, 53 FR 24066, June 27, 1988]

§1.893–1 Compensation of employees of foreign governments or international organizations.

(a) *Employees of foreign governments*—(1) *Exempt from tax.* Except to the extent that the exemption is limited by the execution and filing of the waiver provided for in section 247(b) of the Immigration and Nationality Act (8 U.S.C. 1257(b)), all employees of a foreign government (including consular or other officers, or nondiplomatic representatives) who are not citizens of the United States, or are citizens of the Republic of the Philippines (whether or not citizens of the United States), are exempt from Federal income tax with respect to wages, fees, or salaries received by them as compensation for official services rendered to such foreign government, provided (i) the services are of a character similar to those performed by employees of the Government of the United States in that foreign country and (ii) the foreign government whose employees are claiming exemption grants an equivalent exemption to employees of the Government of the United States performing similar services in that foreign country.

(2) *Certificate by Secretary of State.* Section 893(b) provides that the Secretary of State shall certify to the Secretary of the Treasury the names of the foreign countries which grant an equivalent exemption to the employees of the Government of the United States performing services in such foreign countries, and the character of the services performed by employees of the Government of the United States in foreign countries.

(3) *Items not exempt.* The income received by employees of foreign governments from sources other than their

salaries, fees, or wages, referred to in subparagraph (1) of this paragraph, is subject to Federal income tax.

(4) *Immigration and Nationality Act.* Section 247(b) of the Immigration and Nationality Act provides as follows:

> Sec. 247. Adjustment of status of certain resident aliens.* * *
>
> (b) The adjustment of status required by subsection (a) [of section 247 of the Immigration and Nationality Act] shall not be applicable in the case of any alien who requests that he be permitted to retain his status as an immigrant and who, in such form as the Attorney General may require, executes and files with the Attorney General a written waiver of all rights, privileges, exemptions, and immunities under any law or any executive order which would otherwise accrue to him because of the acquisition of an occupational status entitling him to a non-immigrant status under paragraph (15)(A), (15)(E), or (15)(G) of section 101(a).

(5) *Effect of waiver.* An employee of a foreign government who executes and files with the Attorney General the waiver provided for in section 247(b) of the Immigration and Nationality Act thereby waives the exemption conferred by section 893 of the Code. As a consequence, that exemption does not apply to income received by that alien after the date of filing of the waiver.

(6) *Citizens of the United States.* The compensation of citizens of the United States (other than those who are also citizens of the Republic of the Philippines) who are officers or employees of a foreign government is not exempt from income tax pursuant to this paragraph. But see section 911 and the regulations thereunder.

(b) *Employees of international organizations*—(1) *Exempt from tax.* Except to the extent that the exemption is limited by the execution and filing of the waiver provided for in section 247(b) of the Immigration and Nationality Act and subject to the provisions of sections 1, 8, and 9 of the International Organizations Immunities Act (22 U.S.C. 288, 288e, 288f), wages, fees, or salary of any officer or employee of an international organization (as defined in section 7701(a)(18)) received as compensation for official services to that international organization is exempt from Federal income tax, if that officer or employee (i) is not a citizen of the United States or (ii) is a citizen of the Republic of the Philippines (whether or not a citizen of the United States).

(2) *Income earned prior to executive action.* An individual of the prescribed class who receives wages, fees, or salary as compensation for official services to an organization designated by the President through appropriate Executive order as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act and who has been duly notified to, and accepted by, the Secretary of State as an officer or employee of that organization, or who has been designated by the Secretary of State, prior to formal notification and acceptance, as a prospective officer or employee of that organization, may enjoy the benefits of the exemption with respect to compensation of the prescribed character earned by that individual, either prior to the date of the Issuance of the Executive order, or prior to the date of the acceptance or designation by the Secretary of State, for official services to that organization, if (i) the Executive order does not provide otherwise, (ii) the organization is a public international organization in which the United States participates, pursuant to a treaty or under the authority of an act of Congress authorizing such participation or making an appropriation for such participation, at the time the compensation is earned, and (iii) the individual is an officer or employee of that organization at that time.

(3) *International Organizations Immunities Act.* Sections 1, 8, and 9 of the International Organizations Immunities Act (22 U.S.C. 288, 288e, 288f) provide in part as follows:

> SECTION 1. For the purposes of this title [International Organizations Immunities Act], the term ‘‘international organization’’ means a public international organization in which the United States participates pursuant to any treaty or under the authority of any Act of Congress authorizing such participation or making an appropriation for such participation, and which shall have been designated by the President through appropriate Executive order as being entitled to enjoy the privileges, exemptions, and immunities herein provided. The President shall be authorized, in the light of the functions performed by any such international organization, by appropriate Executive order

to withhold or withdraw from any such organization or its officers or employees any of the privileges, exemptions, and immunities provided for in this title (including the amendments made by this title) or to condition or limit the enjoyment by any such organization or its officers or employees of any such privilege, exemption, or immunity. The President shall be authorized, if in his judgment such action should be justified by reason of the abuse by an international organization or its officers and employees of the privileges, exemptions, and immunities herein provided or for any other reason, at any time to revoke the designation of any international organization under this section, whereupon the international organization in question shall cease to be classed as an international organization for the purposes of this title.

* * * * *

SEC. 8. (a) No person shall be entitled to the benefits of this title [International Organizations Immunities Act] unless he (1) shall have been duly notified to and accepted by the Secretary of State as a * * * officer, or employee; or (2) shall have been designated by the Secretary of State, prior to formal notification and acceptance, as a prospective * * * officer, or employee; * * *.

(b) Should the Secretary of State determine that the continued presence in the United States of any person entitled to the benefits of this title is not desirable, he shall so inform the * * * international organization concerned * * *, and after such person shall have had a reasonable length of time, to be determined by the Secretary of State, to depart from the United States, he shall cease to be entitled to such benefits.

(c) No person shall, by reason of the provisions of this title, be considered as receiving diplomatic status or as receiving any of the privileges incident thereto other than such as are specifically set forth herein.

SEC. 9. The privileges, exemptions, and immunities of international organizations and of their officers and employees * * * provided for in this title [International Organizations Immunities Act], shall be granted notwithstanding the fact that the similar privileges, exemptions, and immunities granted to a foreign government, its officers, or employees, may be conditioned upon the existence of reciprocity by that foreign government: *Provided,* That nothing contained in this title shall be construed as precluding the Secretary of State from withdrawing the privileges, exemptions, and immunities herein provided from persons who are nationals of any foreign country on the ground that such country is failing to accord corresponding privileges, exemptions, and immunities to citizens of the United States.

(4) *Effect of waiver.* An officer or employee of an international organization who executes and files with the Attorney General the waiver provided for in section 247(b) of the Immigration and Nationality Act (8 U.S.C. 1257(b)) thereby waives the exemption conferred by section 893 of the Code. As a consequence, that exemption does not apply to income received by that individual after the date of filing of the waiver.

(5) *Citizens of the United States.* The compensation of citizens of the United States (other than those who are also citizens of the Republic of the Philippines) who are officers or employees of an international organization is not exempt from income tax pursuant to this paragraph. But see section 911 and the regulations thereunder.

(c) *Tax conventions, consular conventions, and international agreements*—(1) *Exemption dependent upon internal revenue laws.* A tax convention or consular convention between the United States and a foreign country, which provides that the United States may include in the tax base of its residents all income taxable under the internal revenue laws, and which makes no specific exception for the income of the employees of that foreign government, does not provide any exemption (with respect to residents of the United States) beyond that which is provided by the internal revenue laws. Accordingly, the effect of the execution and filing of a waiver under section 247(b) of the Immigration and Nationality Act by an employee of a foreign government which is a party to such a convention is to subject the employee to tax to the same extent as provided in paragraph (a)(5) of this section with respect to the waiver of exemption under section 893.

(2) *Exemption not dependent upon internal revenue laws.* If a tax convention, consular convention, or international agreement provides that compensation paid by the foreign government or international organization to its employees is exempt from Federal income tax, and the application of this exemption is not dependent upon the provisions of the internal revenue laws, the exemption so conferred is not affected by the execution and filing of a waiver under section 247(b) of the Immigration

and Nationality Act. For examples of exemptions which are not affected by the Immigration and Nationality Act, see article X of the income tax convention between the United States and the United Kingdom (60 Stat. 1383); article IX, section 9(b), of the Articles of Agreement of the International Monetary Fund (60 Stat. 1414); and article VII, section 9(b), of the Articles of Agreement of the International Bank for Reconstruction and Development (60 Stat. 1458).

§ 1.894–1 Income affected by treaty.

(a) *Income exempt under treaty.* Income of any kind is not included in gross income and is exempt from tax under Subtitle A (relating to income taxes), to the extent required by any income tax convention to which the United States is a party. However, unless otherwise provided by an income tax convention, the exclusion from gross income under section 894(a) and this paragraph does not apply in determining the accumulated taxable income of a foreign corporation under section 535 and the regulations thereunder or the undistributed personal holding company income of a foreign corporation under section 545 and the regulations thereunder. Moreover, the distributable net income of a foreign trust is determined without regard to section 894 and this paragraph, to the extent provided by section 643(a)(6)(B). Further, the compensating tax adjustment required by section 819(a)(3) in the case of a foreign life insurance company is to be determined without regard to section 894 and this paragraph, to the extent required by section 819(a)(3)(A). See § 1.871–12 for the manner of determining the tax liability of a nonresident alien individual or foreign corporation whose gross income includes income on which the tax is reduced under a tax convention.

(b) *Taxpayer treated as having no permanent establishment in the United States*—(1) *In general.* A nonresident alien individual or a foreign corporation, that is engaged in trade or business in the United States through a permanent establishment located therein at any time during a taxable year beginning after December 31, 1966, shall be deemed not to have a permanent establishment in the United States at any time during that year for purposes of applying any exemption from, or reduction in the rate of, any tax under Subtitle A of the Code which is provided by any income tax convention with respect to income which is not effectively connected for that year with the conduct of a trade or business in the United States by the taxpayer. This paragraph applies to all treaties or conventions entered into by the United States, whether entered into before, on, or after November 13, 1966, the date of enactment of the Foreign Investors Tax Act of 1966 (80 Stat. 1539). This paragraph is not considered to be contrary to any obligation of the United States under an income tax convention to which it is a party. The benefit granted under section 894(b) and this paragraph applies only to those items of income derived from sources within the United States which are subject to the tax imposed by section 871(a) or 881(a), and section 1441, 1442, or 1451, on the noneffectively connected income received from sources within the United States by a nonresident alien individual or a foreign corporation. The benefit does not apply to any income from real property in respect of which an election is in effect for the taxable year under § 1.871–10 or in determining under section 877(b) the tax of a nonresident alien individual who has lost United States citizenship at any time after March 8, 1965. The benefit granted by section 894(b) and this paragraph is not elective.

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

Example 1. M, a corporation organized in foreign country X, uses the calendar year as the taxable year. The United States and country X are parties to an income tax convention which provides in part that dividends received from sources within the United States by a corporation of country X not having a permanent establishment in the United States are subject to tax under Chapter 1 of the Code at a rate not to exceed 15 percent. During 1967, M is engaged in business in the United States through a permanent establishment located therein and receives $100,000 in dividends from domestic corporation B, which under section 861(a)(2)(A) constitute income from sources within the United States. Under section

864(c)(2) and §1.864–4(c), the dividends received from B are not effectively connected for 1967 with the conduct of a trade or business in the United States by M. Although M has a permanent establishment in the United States during 1967, it is deemed, under section 894(b) and this paragraph, not to have a permanent establishment in the United States during that year with respect to the dividends. Accordingly, in accordance with paragraph (c)(3) of §1.871–12 the tax on the dividends is $15,000, that is, 15 percent of $100,000, determined without the allowance of any deductions.

Example 2. T, a corporation organized in foreign country X, uses the calendar year as the taxable year. The United States and country X are parties to an income tax convention which provides in part that an enterprise of country X is not subject to tax under chapter 1 of the Code in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States during the taxable year through a permanent establishment located therein and that, if it is so engaged, the tax may be imposed upon the entire income of that enterprise from sources within the United States. The convention also provides that the tax imposed by Chapter 1 of the Code on dividends received from sources within the United States by a corporation of X which is not engaged in trade or business in the United States through a permanent establishment located therein shall not exceed 15 percent of the dividend. During 1967, T is engaged in a business (business A) in the United States which is carried on through a permanent establishment in the United States; in addition, T is engaged in a business (business B) in the United States which is not carried on through a permanent establishment. During 1967, T receives from sources within the United States $60,000 in service fees through the operation of business A and $10,000 in dividends through the operation of business B, both of which amounts are, under section 864(c)(2)(B) and §1.864–4(c)(3), effectively connected for that year with the conduct of a trade or business in the United States by that corporation. The service fees are considered to be industrial or commercial profits under the tax convention with country X. Since T has no income for 1967 which is not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, section 894(b), this paragraph, and §1.871–12 do not apply. Accordingly, for 1967 T's entire income of $70,000 from sources within the United States is subject to tax, after allowance of deductions, in accordance with section 882(a)(1) and paragraph (b)(2) of §1.882–1.

Example 3. S, a corporation organized in foreign country W, uses the calendar year as the taxable year. The United States and country W are parties to an income tax convention which provides in part that a corporation of country W is not subject to tax under Chapter 1 of the Code in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States during the taxable year through a permanent establishment located therein and that, if it is so engaged, the tax may be imposed upon the entire income of that corporation from sources within the United States. The convention also provides that the tax imposed by Chapter 1 of the Code on dividends received from sources within the United States by a corporation of country W which is not engaged in trade or business in the United States through a permanent establishment located therein shall not exceed 15 percent of the dividend. During 1967, S is engaged in business in the United States through a permanent establishment located therein and derives from sources within the United States $100,000 in service fees which, under section 864(c)(2)(B) and §1.864–4(c)(3), are effectively connected for that year with the conduct of a trade or business in the United States by S and which are considered to be industrial or commercial profits under the tax convention with country W. During 1967, S also derives from sources within the United States, through another business it carries on in foreign country X, $10,000 in sales income which, under section 864(c)(3) and §1.864–4(b), is effectively connected for that year with the conduct of a trade or business in the United States by S and $5,000 in dividends which, under section 864(c)(2)(A) and §1.864–4(c)(2), are not effectively connected for that year with the conduct of a trade or business in the United States by S. The sales income is considered to be industrial or commercial profits under the tax convention with country W. Although S is engaged in a trade or business in the United States during 1967 through a permanent establishment located therein, it is deemed, under section 894(b) and this paragraph, not to have a permanent establishment therein with respect to the $5,000 in dividends. Accordingly, in accordance with paragraph (c) of §1.871–12, for 1967 S is subject to a tax of $750 on the dividends ($5,000×.15) and a tax, determined under section 882(a) and §1.882–1, on its $110,000 industrial or commercial profits.

Example 4. (a) N, a corporation organized in foreign country Z, uses the calendar year as the taxable year. The United States and country Z are parties to an income tax convention which provides in part that the tax imposed by Chapter 1 of the Code on dividends received from sources within the United States by a corporation of country Z shall not exceed 15 percent of the amount distributed if the recipient does not have a permanent establishment in the United States or, where the recipient does have a permanent establishment in the United States, if the shares giving rise to the dividends are not effectively connected with the permanent establishment. The tax convention also provides that if a corporation of country Z is engaged in industrial or commercial activity in the United States through a permanent establishment in the United States, income tax may be imposed by the United States on so much of the industrial or commercial profits of such corporation as are attributable to the permanent establishment in the United States.

(b) During 1967, N is engaged in a business (business A) in the United States which is not carried on through a permanent establishment in the United States. In addition, N has a permanent establishment in the United States through which it carries on another business (business B) in the United States. During 1967, N holds shares of stock in domestic corporation D which are not effectively connected with N's permanent establishment in the United States. During 1967, N receives $100,000 in dividends from D which, pursuant to section 864(c)(2)(A) and § 1.864–4(c)(2), are effectively connected for that year with the conduct of business A. Under section 861(a)(2)(A) these dividends are treated as income from sources within the United States. In addition, during 1967, N receives from sources within the United States $150,000 in sales income which, pursuant to section 864(c)(3) and § 1.864–4(b), is effectively connected with the conduct of a trade or business in the United States and which is considered to be industrial or commercial profits under the tax convention with country Z. Of these total profits, $70,000 is from business A and $80,000 is from business B. Only the $80,000 of industrial or commercial profits is attributable to N's permanent establishment in the United States.

(c) Since N has no income for 1967 which is not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, section 894(b) and this paragraph do not apply. However, N is entitled to the reduced rate of tax under the tax convention with country Z with respect to the dividends because the shares of stock are not effectively connected with N's permanent establishment in the United States. Accordingly, assuming that there are no deductions connected with N's industrial or commercial profits, the tax for 1967, determined as provided in paragraph (c) of § 1.871–12, is $46,900 as follows:

Tax on nontreaty income:	
$80,000×.48	$38,400
Less $25,000×.26	6,500
	31,900
Tax on treaty income:	
$100,000 (gross dividends)×.15	15,000
Total tax	46,900

Example 5. M, a corporation organized in foreign country Z, uses the calendar year as the taxable year. The United States and country Z are parties to an income tax convention which provides in part that a corporation of country Z is not subject to tax under Chapter 1 of the Code in respect of its commercial and industrial profits except such profits as are allocable to its permanent establishment in the United States. The regulations in this chapter under the tax convention with country Z provide that a corporation of country Z having a permanent establishment in the United States is subject to U.S. tax upon its industrial and commercial profits from sources within the United States and that its industrial and commercial profits from such sources are deemed to be allocable to the permanent establishment in the United States. During 1967, M is engaged in a business (business A) in the United States which is carried on through a permanent establishment in the United States; in addition, M is engaged in a business (business B) in foreign country X and none of such business is carried on in the United States. During 1967, M receives from sources within the United States $40,000 in sales income through the operation of business A and $10,000 in sales income through the operation of business B, both of which amounts are, under section 864(c)(3) and § 1.864–4(b), effectively connected for that year with the conduct of a trade or business in the United States by that corporation. The sales income is considered to be industrial and commercial profits under the tax convention with country Z. Since M has no income for 1967 which is not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, section 894(b) and this paragraph do not apply. Accordingly, for 1967 M's entire income of $50,000 from sources within the United States is subject to tax, after allowance of deductions, in accordance with section 882(a)(1) and paragraph (b)(2) of § 1.882–1.

(c) *Substitute interest and dividend payments.* The provisions of an income tax convention dealing with interest or dividends paid to or derived by a foreign person include substitute interest or dividend payments that have the same character as interest or dividends under § 1.864–5(b)92)(ii), 1.871–7(b)(2) or 1.881–2(b)(2). The provisions of this paragraph (c) shall apply for purposes of securities lending transactions or sale-repurchase transactions as defined in § 1.861–2(a)(7) and § 1.861–3(a)(6).

(d) *Effective Date.* Paragraphs (a) and (b) of this section apply for taxable years beginning after December 31,

1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, (see 26 CFR part 1 revised April 1, 1971). Paragraph (c) of this section is applicable to payments made after November 1, 1997.

[T.D. 7293, 38 FR 32800, Nov. 28, 1973, as amended by T.D. 8735, 62 FR 53502, Oct. 14, 1997]

§1.894–1T Income affected by treaty (temporary).

(a) through (c) [Reserved]. For further guidance, see §1.894–1(a) through (c).

(d) *Determination of tax on income paid to entities*—(1) *In general.* The tax imposed by sections 871(a), 881(a), 1461, and 4948(a) on a payment received by an entity organized in any country (including the United States) shall be eligible for reduction under the terms of an income tax treaty to which the United States is a party if such payment is treated as derived by a resident of an applicable treaty jurisdiction, such resident is a beneficial owner of the payment, and all other applicable requirements for benefits under the treaty are satisfied. A payment received by an entity is treated as derived by a resident of an applicable treaty jurisdiction to the extent the payment is subject to tax in the hands of a resident of such jurisdiction. For this purpose, a payment received by an entity that is treated as fiscally transparent by the applicable treaty jurisdiction shall be considered a payment subject to tax in the hands of a resident of the jurisdiction only to the extent that the interest holders in the entity are residents of the jurisdiction. For purposes of the preceding sentence, interest holders shall not include any direct or indirect interest holders that are themselves treated as fiscally transparent entities by the applicable treaty jurisdiction. A payment received by an entity that is not treated as fiscally transparent by the applicable treaty jurisdiction shall be considered a payment subject to tax in the hands of a resident of such jurisdiction if the entity is itself a resident of that jurisdiction.

(2) *Application of beneficial ownership requirement in respect of certain payments received by entities*—(i) *Entities treated as fiscally transparent for U.S. tax purposes.* An entity that is treated as fiscally transparent under the laws of the United States and that is resident in an applicable treaty jurisdiction shall be treated as the beneficial owner of a payment if the entity would be treated as the beneficial owner if it were treated as nonfiscally transparent by the United States.

(ii) *Entity's owners as beneficial owners*—(A) A resident of an applicable treaty jurisdiction that derives a payment received by an entity that is fiscally transparent under the laws of the applicable tax jurisdiction shall be treated as the beneficial owner of the payment unless—

(*1*) Such resident would not have been treated as the beneficial owner of the payment had such payment been received directly by the resident; or

(*2*) The entity receiving the payment is not treated as a beneficial owner of the payment.

(B) For example, persons residing in treaty Country X and treated under the laws of Country X as interest holders in a fiscally transparent entity created under the laws of Country Y are treated as the beneficial owners of the payments received by the entity from sources within the United States unless the interest holders would not have been treated as beneficial owners had they received the payment directly (e.g., the partners act as nominees or conduits for other persons). However, if the entity itself is acting as a nominee or conduit for another person and, therefore, is not itself a beneficial owner, then none of the interest holders can be treated as beneficial owners, even if the interest holders own their interests in the entity as beneficial owners. For this purpose, the determination of whether a person is a beneficial owner of a payment shall be made under U.S. tax laws.

(3) *Application to certain domestic entities.* Notwithstanding paragraph (d)(1) of this section, an income tax treaty may not apply to reduce the amount of tax on income received by an entity that is treated as a domestic corporation for U.S. tax purposes. Therefore, neither the domestic corporation nor its shareholders are entitled to the benefits of a reduction of U.S. income

tax on income received from U.S. sources by the corporation.

(4) *Definitions*—(i) *Entity.* For purposes of this paragraph (d), the term *entity* shall mean any person that is treated by the United States or the applicable treaty jurisdiction as other than an individual.

(ii) *Fiscally transparent.* For purposes of this paragraph (d), an entity is treated as *fiscally transparent* by a jurisdiction to the extent the jurisdiction requires interest holders in the entity to take into account separately on a current basis their respective shares of the items of income paid to the entity and to determine the character of such items as if such items were realized directly from the source from which realized by the entity (for purposes of the tax laws of the jurisdiction). Entities that are fiscally transparent for U.S. federal income tax purposes include partnerships, common trust funds described under section 584, simple trusts, grantor trusts, as well as certain other entities (including entities that have a single interest holder) that are treated as partnerships or as disregarded entities for U.S. federal income tax purposes.

(iii) *Applicable treaty jurisdiction.* The term *applicable treaty jurisdiction* means the jurisdiction whose income tax treaty with the United States is invoked for purposes of reducing the rate of tax imposed under section 871(a), 881(a), 1461, and 4948(a).

(iv) *Resident.* The term *resident* shall have the meaning assigned to such term in the applicable income tax treaty.

(5) *Application to all income tax treaties.* Unless otherwise explicitly agreed upon in the text of an income tax treaty, the rules contained in this paragraph (d) shall apply in respect of all income tax treaties to which the United States is a party. However, a reduced rate under a tax treaty for a payment of U.S. source income will not be available irrespective of the provisions in this paragraph (d) to the extent that the applicable treaty partner would not grant a reduced rate under the tax treaty to a U.S. resident in similar circumstances, as evidenced by a mutual agreement between the relevant competent authorities or by a public notice of the treaty partner. The Internal Revenue Service shall announce the terms of any such mutual agreement or treaty partner's position. Any denial of tax treaty benefits as a consequence of such a mutual agreement or treaty partner's position shall affect only U.S. source payments made after announcement of the terms of the agreement or of the position.

(6) *Examples.* This paragraph (d) is illustrated by the following examples. Unless stated otherwise, each example assumes that all conditions for claiming a treaty-reduced tax rate under a U.S. income tax treaty with respect to a payment of U.S. source income are satisfied (other than the condition that the income is treated as derived by a resident of the applicable treaty jurisdiction), including the beneficial ownership requirement and all requirements relating to applicable limitation on benefits provisions. The examples are as follows:

Example 1. (i) *Facts.* Entity A is a business organization formed under the laws of Country X that has an income tax treaty with the United States. Under the laws of Country X, A is liable to tax at the entity level. A is treated as a partnership for U.S. income tax purposes and receives royalties from U.S. sources that are not effectively connected with the conduct of a trade or business in the United States. Some of A's partners are resident in Country X and the other partners are resident in Country Y. Country Y has no income tax treaty in effect with the United States. Article 12 of the U.S.–X tax treaty provides that ''royalties derived from sources within a Contracting State by a resident of the other Contracting State shall not exceed 5 percent of the gross amount thereof * * *''. Article 4.1 of the treaty provides that for purposes of the treaty, ''a 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature * * *''. Article 4.2 of the treaty provides that in the case of income ''derived or paid by a partnership * * *'', the term *resident* applies only to the extent that the income derived by such partnership is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners.

(ii) *Analysis.* Under the U.S.–X income tax treaty, A is a *resident* of Country X within the meaning of Article 4.1 of the treaty. Also, as a resident of Country X taxable on the U.S. source royalty under the tax laws of Country X, A meets the condition under Article 12 of the treaty that it derive the income from sources within the United States. Accordingly, the U.S. source royalty income is treated as derived by a resident of X. Further, A is a beneficial owner of the royalty income, as determined under paragraph (d)(2)(i) of this section. The fact that A's interest holders are also beneficial owners of the royalty income under U.S. tax principles (as partners of A) does not preclude A from qualifying as a beneficial owner for purposes of the treaty. In addition, A may claim benefits under the U.S.–X income tax treaty even though some of its interest holders do not reside in X or reside in a country that does not have an income tax treaty in effect with the United States.

Example 2. (i) *Facts.* The facts are the same as under *Example 1* except that Article 12 of the U.S.–X income tax treaty provides that royalties ''paid'' to a resident of a treaty country from sources within the other may be taxed in both countries but the tax is limited to 10 percent of the gross amount of the royalties in the source country. Further the U.S.–X income tax treaty includes no provision relating to income paid or derived through a partnership.

(ii) *Analysis.* As in *Example 1,* A is entitled to claim the benefit of the U.S.–X income tax treaty with respect to the U.S. source royalty income paid to A. The term *paid* and the term *derived* are used interchangeably in U.S. income tax treaties. Accordingly, the U.S. source royalty income is treated as derived by a resident of X. It is irrelevant that the U.S.–X treaty does not include a provision relating to income paid or derived through a partnership.

Example 3. (i) *Facts.* The facts are the same as under *Example 2,* except that Country Y has an income tax treaty in effect with the United States. Article 12 of the U.S.–Y income tax treaty reduces the rate on U.S. source royalty income to zero if the income is paid to a resident of Country Y who beneficially owns the income. Article 4.1 of the U.S.–Y treaty provides that for purposes of the treaty, ''a 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature * * *''. The U.S.–Y treaty does not include a provision relating to income paid or derived through a partnership. Under the laws of Country Y, A is treated as fiscally transparent entity. Thus, A's partner, T, a corporation organized in Country Y is required to include in income on a current basis its allocable share of A's income. T is a beneficial owner of the income paid to A, as determined under paragraph (d)(2)(ii) of this section.

(ii) *Analysis.* As in *Example 2,* A is entitled to claim the benefit of the U.S.–X income tax treaty with respect to the U.S. source royalty income paid to A. However, T is also entitled to claim the benefit of the exemption under the U.S.–Y treaty for its allocable share of the U.S. source royalty income. T meets the conditions of Article 12 because it is a resident of Country Y within the meaning of Article 4.1 of the treaty. Also, as a resident of Country Y taxable on the U.S. source royalty under the tax laws of Country Y, it meets the condition under Article 12 of the treaty that income from sources within the United States be paid to a resident. Accordingly, T's allocable share of the U.S. source royalty income is treated as derived by a resident of Y. It is irrelevant that the U.S.–Y treaty does not include a provision relating to income paid or derived through a partnership.

Example 4. (i) *Facts.* Entity A is a business organization organized under the laws of Country V that has no income tax treaty with the United States. A is treated as a partnership for U.S. tax purposes and receives royalty income from U.S. sources that is not effectively connected with the conduct of a trade or business in the

United States. G, one of A's interest holders, is a corporation organized under the laws of Country X. X treats A as an entity taxable at the entity level and not as a fiscally transparent entity. Therefore, G is not required to include in income on a current basis its share of A's income. Instead, G is taxed in X on its share of A's profits when distributed by A and such distribution is taxed to G as a dividend. H, A's other interest holder, is a corporation organized in Country Y. Y treats A as a fiscally transparent entity and requires H to include in income on a current basis its allocable share of A's income. Both X and Y have an income tax treaty in effect with the United States. Article 12 of the U.S.–X income tax treaty provides that royalties paid to a resident of a treaty country from sources within the other may be taxed in both countries but the tax is limited to 5 percent of the gross amount of the royalties in the source country. Article 4.1 of the U.S.–X treaty provides that for purposes of the treaty, ''a 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature * * *''. The U.S.–X treaty does not include a provision relating to income paid or derived through a partnership. Article 12 of the U.S.–Y treaty provides that ''royalties derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State''. Article 4.1 of the U.S.–Y treaty provides that, for purposes of the treaty, ''a 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature * * *''. Article 4.2 of the U.S.–Y treaty provides that in the case of income ''derived or paid by a partnership * * *'', the term resident applies only to the extent that the income derived by such partnership is subject to tax in that State as the income of a resident, either, in its hands or in the hands of its partners.

(ii) *Analysis.* A may not claim the benefit of any income tax treaty since it is not a resident of a country with which the United States has such a treaty. This result occurs regardless of how A is treated for U.S. tax purposes or for purposes of the tax laws of Country V. G may not claim the benefits of Article 12 of the U.S.–X treaty. Under the tax laws of X, G's share of the U.S. source royalty income paid to A is not treated as derived by a resident of X since, under X's tax laws, A, rather than G, is required to account for income received by A. This result occurs even if A distributes the royalty amount immediately after receiving it because, in such a case, G would be taxable on an amount treated as a profit distribution from A and not on royalty income received from sources within the United States. The fact that, for U.S. tax purposes, G is treated as the taxpayer for its allocable share of A's income is not relevant for purposes of determining whether, for purposes of Article 12 of the U.S.–X income tax treaty, G's share of the income paid to A is treated as derived by a resident of X. For this purpose, the laws of Country X govern the determination of whether G meets this condition. On the other hand, H may claim an exemption from U.S. tax on its share of the royalty income received by A under Article 12 of the U.S.–Y treaty because, under the tax laws of Y, H rather than A, is required to account for income received by A. Accordingly, H's share of the U.S. source royalty income paid to A is treated as derived by a resident of Y.

Example 5. The facts are the same as in *Example 4*, except that A is a business organization formed under the laws of a U.S. State as a limited liability company. The consequences are the same as described in *Example 4.* G is not eligible for benefits under Article 12 of the U.S.–X income tax treaty since, under X's tax laws, A, rather than G, is required to account for income received by A. Under section 881(a), G is liable for U.S. income tax on its allocable share of A's U.S. source royalty income at a 30 percent rate and A must withhold 30 percent from G's allocable share under section 1442. Similarly, H may claim an exemption from U.S. tax on its share of the royalty income received by A under Article 12 of the

U.S.–Y treaty because, under the tax laws of Y, H rather than A, is required to account for income received by A.

Example 6. The facts are the same as in *Example 4,* except that A is a so–called dual organized entity. In addition to being organized under the laws of Country V, A has also been organized under the laws of the United States pursuant to the State Z domestication statute. Accordingly, both Country V and the United States regard entity A as a domestic entity existing only in that jurisdiction. Further, Country X and Country Y regard A as a Country V entity. A is treated as a partnership for U.S. tax purposes. The fact that A is a dual organized entity that is regarded differently in Countries X or Y and the United States does not impact the relevant tax treaty analysis. As in *Example 4,* A may not claim the benefit of any income tax treaty since it is not a resident of a country with which the United States has such a treaty. Similarly, G is not eligible for benefits under Article 12 of the U.S.–X income tax treaty since, under X's tax laws, A, rather than G, is required to account for income received by A. Under section 881(a), G is liable for U.S. income tax on its allocable share of A's U.S. source royalty income at a 30 percent rate. Because A is treated as a U.S. partnership for U.S. tax purposes, A must withhold 30 percent from G's allocable share under section 1442. H may claim an exemption from U.S. tax on its share of the royalty income received by A under Article 12 of the U.S.–Y income tax treaty because, under the tax laws of Y, H rather than A, is required to account for the income received by A.

Example 7. The facts are the same as in *Example 5,* except that A distributes all U.S. source royalty income to its interest holders immediately following A's receipt of such income. The consequences are the same as described in *Example 5.* G remains ineligible for benefits under Article 12 of the U.S.–X income tax treaty since, under X's tax laws, A, rather than G, is required to account for the royalty income received by A. The fact that A distributes income on a current basis to G is irrelevant even if Country X taxes G on such distributions on a current basis. Country X regards such distributions to G as a distribution of profits from A to G rather than an item of U.S. source royalty income of G. H remains eligible for benefits under Article 12 of the U.S.–Y income tax treaty with respect to H's allocable share of the U.S. source royalty treatment received by A.

Example 8. The facts are the same as in *Example 5,* except that Country X pursuant to a Country X anti-deferral regime requires that G account for on a current basis as a deemed distribution G's pro rata share of A's net passive income. For purposes of the anti-deferral regime, the U.S. source royalty income of G is regarded as passive income. The consequences are the same as described in *Example 5.* G remains ineligible for benefits under Article 12 of the U.S.–X income tax treaty because, under X's tax laws, A, rather than G, is required to account for the royalty income received by A. The fact that G receives a current deemed distribution of net passive income is irrelevant even if Country X taxes G on such deemed distributions on a current basis. Country X regards such deemed distributions to G as a distribution of profits from A to G rather than an allocation to G of G's share of A's U.S. source royalty income. H remains eligible for benefits under Article 12 of the U.S.–Y income tax treaty with respect to H's allocable share of the U.S. source royalty treatment received by A.

Example 9. (i) *Facts.* Entity A is a business organization formed under the laws of Country X that has an income tax treaty with the United States. A has made a valid election under §301.7701–3(c) of this chapter to be treated as a corporation for U.S. tax purposes and receives royalty income from sources within the United States that is not effectively connected with the conduct of a trade or business in the United States. G, A's sole shareholder, is a corporation organized under the laws of Country X. Under the tax laws of X, A is treated as a fiscally transparent entity and, therefore, G is required to include in income on a current basis its share of A's income. Article 12 of the U.S.–X tax treaty provides that ‘‘royalties derived from sources within a Contracting State by a resident of the other Contracting State shall not exceed 5 percent of the gross amount thereof * * *''. Article 4.1 of the treaty provides that for purposes of the treaty, a ''' resident' of a Contracting State means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature * * * ''. Article 4.2 of the treaty provides that in the case of income derived or paid by a partnership * * *'' the term *resident* applies only to the extent that the income derived by such partnership is subject to tax in that State as the income of a resident, either, in its hands or in the hands of its partners.

(ii) *Analysis.* A does not qualify for benefits under the U.S.–X income tax treaty because A is treated as a fiscally transparent entity under the tax laws of X and thus is not a resident of X for purposes of the treaty. G, on the other hand, qualifies for benefits under the U.S.–X treaty with respect to the U.S. source royalty income received by A because, under the tax laws of X, G is required to account for the income received by A on a current basis. This result applies even though, for U.S. tax purposes, A is treated as a corporate entity. Accordingly, the U.S. royalty income paid to A is treated as derived by G, a resident of X, as determined under the tax laws of X. Based on G's qualification for treaty benefits with respect to the U.S. source royalty income, A, as the taxpayer under U.S. tax laws, may claim that the income that it receives for U.S. tax purposes is eligible for benefit under the U.S.–X treaty.

Example 10. The facts are the same as in *Example 9,* except that A is a corporation organized under the laws of a U.S. State and is, therefore, a domestic corporation. A may not claim under the U.S.–X income tax treaty a reduction of the rate of U.S. tax otherwise imposed on its income under section 11. A reduced rate of tax is unavailable under the U.S.–X treaty based upon the savings clause in Article 1 of the U.S.–X treaty. Thus, A remains fully taxable under U.S. tax laws as a domestic corporation.

Example 11. (i) *Facts.* Entity A is a business organization organized under the laws of Country V that has no income tax treaty with the United States. A is treated as a partnership for U.S. tax purposes and receives royalty income from U.S. sources that is not effectively connected with the conduct of a trade or business in the United States. A is directly owned by H and J. J is a corporation organized in Country Z which treats A as fiscally transparent and J as an entity taxable at the entity level. Accordingly, Country Z requires J to include in income on a current basis J's share of A's U.S. source royalty income. H, A's other direct interest holder, is a business organization organized in Country Y. H, in turn is owned by E and F, both of which are entities organized in Country X. E and F are each wholly owned by C which is a corporation organized in Country V. Y treats both A and H as fiscally transparent entities. X treats A, H, and E as fiscally transparent entities. X treats F as an entity taxable at the entity level. Accordingly, X requires F to include in income on a current basis F's indirect share of A's U.S. source royalty income. H and J are treated as corporations for U.S. federal income tax purposes while E, F, and C are treated as partnerships for U.S. federal tax purposes. X, Y and Z each have in effect an income tax treaty with the United States. Article 12 of the U.S.–X and the U.S.–Z income tax treaty provides that royalties paid to a resident of a treaty country from sources within the other may be taxed in both countries but the tax is limited to 5 percent of the gross amount of the royalties in the source country. Article 4.1 of the U.S.–Z and the U.S.–Z treaty provides that for purposes of the treaty, a '''resident' of a Contracting state means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature . . .''. Article 4.2 of the U.S.–X and the U.S.–Z treaty provides that in the case of income ''derived or paid by a partnership . . .'', the term *resident* applies only to the extent that the income derived by such partnership is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners. Article 12 of the U.S.–Y treaty provides that ''royalties derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State.'' Article 4.1 of the U.S.–Y treaty provides that, for purposes of the treaty, a '''resident' of a Contracting State means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature . . .''. The U.S.–Y treaty does not include a provision relating to income paid or derived through a partnership.

(ii) *Analysis.* A may not claim, based on its own status, the benefit of any income tax treaty since it is not a resident of a country with which the United States has such a treaty. This result occurs regardless of how A is treated for U.S. tax purposes or for purposes of the tax laws of Country V. H may not claim the benefits of any treaty, including the benefits of Article 12 of the U.S.–Y treaty, because H does not qualify as a resident of Y or any other treaty jurisdiction. Similarly, neither E nor C may claim the benefits of any income tax treaty, since neither entity qualifies as a resident of X or any other treaty jurisdiction. F, however, is entitled to the benefit of Article 12 of the U.S.–X treaty with respect to F's indirect share of the U.S. source royalty income received by A. Such income is treated as derived by F, a resident of X, because F qualifies as a resident of X and, under the tax laws of X, F is the first entity in the A, H, F chain that is not itself treated as fiscally transparent in X. J may claim the benefits of Article 12 of the U.S.–Z treaty with respect to J's indirect share of the U.S. source royalty income paid to A because, under the tax laws of Z, J rather than A, is required to account for income received by A. Accordingly, J's share of the U.S. source royalty income paid to A is treated as derived by a resident of Z. As illustrated in this example, the U.S. federal income tax treatment of A, J, H, E, F and C is irrelevant for purposes of determining the extent to which U.S. source royalty income paid to A is eligible for treaty-reduced tax rates under the U.S. income tax treaty with X, Y or Z.

Example 12. (i) *Facts.* Entity A is a business organization formed under the laws of Country X that has an income tax treaty in effect with the United States. A owns all of the stock of a U.S. corporation B. Under the tax laws of X, A is subject to tax at the entity level. For U.S. tax purposes, A is treated as a branch of its single owner, G. G is a corporation organized under the laws of X. A receives dividends from B that are from U.S. sources and are not effectively connected with the conduct of a trade or business in the United States. Article 10 of the U.S.–X tax treaty provides that ''dividends derived from sources within a Contracting state by a resident of the other Contracting State shall not exceed 5 percent of the gross amount thereof . . .''. Article 4.1 of the treaty provides that for purposes of the treaty, a '''resident' of a Contracting State means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature . . .''. The U.S.–X treaty contains no provision regarding income paid or derived through a partnership.

(ii) *Analysis.* For U.S. tax purposes, A is treated as a wholly-owned business entity that is disregarded for federal income tax purposes. However, because, under the laws of X and under X's application of the treaty, A is treated as deriving the dividend income as a resident of X, A qualifies for benefits under the treaty with respect to the U.S. source dividend. Thus, G, as the taxable person for U.S. tax purposes, may claim the benefit of a reduced rate under Article 10 of the U.S.–X treaty based on A's eligibility for tax treaty benefits.

(7) *Effective date.* This paragraph (d) applies to amounts paid on or after January 1, 1998.

[T.D. 8722, 62 FR 35676, July 2, 1997; T.D. 8722, 62 FR 46877, Sept. 5, 1997]

§ 1.895–1 Income derived by a foreign central bank of issue, or by Bank for International Settlements, from obligations of the United States or from bank deposits.

(a) *In general.* Income derived by a foreign central bank of issue from obligations of the United States or of any agency or instrumentality thereof, or from interest on deposits with persons carrying on the banking business, is excluded from the gross income of such bank and is exempt from income tax if the bank is the owner of the obligations or deposits and does not hold the obligations or deposits for, or use them in connection with, the conduct of a commercial banking function or other commercial activity by such bank. For purposes of this section and paragraph (i) of § 1.1441–4, obligations of the United States or of any agency or instrumentality thereof include beneficial interests, participations, and other instruments issued under section 302(c) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1717). See 24 CFR part 1600 *et seq.*

(b) *Foreign central bank of issue.* (1) A foreign central bank of issue is a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency. Such a bank is generally the custodian of the banking reserves of the country under whose law it is organized. See also paragraph (b)(5) of § 1.861–2.

(2) The exclusion granted by section 895 applies to an instrumentality that is separate from a foreign government, whether or not owned in whole or in part by a foreign government. For example, foreign banks organized along the lines of, and performing functions similar to, the Federal Reserve System qualify as foreign central banks of issue for purposes of this section.

(3) The Bank for International Settlements shall be treated as though it were a foreign central bank of issue for purposes of obtaining the exclusion granted by section 895.

(c) *Ownership of United States obligations or bank deposits.* The exclusion does not apply if the obligations or bank deposits from which the income is derived are not owned by the foreign central bank of issue. Obligations held, or deposits made, by a foreign central bank of issue as agent, custodian, trustee, or in any other fiduciary capacity, shall be considered as not owned by such bank for purposes of this section.

(d) *Commercial banking function or other commercial activity.* The exclusion applies only to obligations of the United States or of any agency or instrumentality thereof, or to bank deposits, held for, or used in connection with, the conduct of a central banking function and not to obligations or deposits held for, or used in connection with, the conduct of commercial banking functions or other commercial activities by the foreign central bank.

(e) *Other exclusions.* See section 861(a)(1) (A) and (E) and § 1.861–2(b) (1) and (4), for special rules relating to interest paid or credited before January 1, 1977, on deposits and on similar amounts and for rules on interest derived from bankers' acceptances. For exemption from withholding under § 1.1441–1 on income derived by a foreign central bank of issue, or by the Bank of International Settlements, from obligations of the United States or of any agency or instrumentality thereof, or from bank deposits, see § 1.1441–4(i).

(f) *Effective date.* This section shall apply with respect to taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.85–1 (Revised as of January 1, 1972).

[T.D. 7378, 40 FR 45435, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975]

§ 1.897–1 Taxation of foreign investment in United States real property interests, definition of terms.

(a) *In general*—(1) *Purpose and scope of regulations.* These regulations provide guidance with respect to the taxation of foreign investments in U.S. real property interests and related matters. This section defines various terms for purposes of sections 897, 1445, and 6039C and the regulations thereunder. Section 1.897–2 provides rules regarding the definition of, and consequences of, U.S. real property holding corporation status. Section 1.897–3 sets forth rules pursuant to which certain foreign corporations may elect under section 897(i) to be treated as domestic corporations for purposes of sections 897 and 6039C. Finally, §1.987–4 provides rules concerning the similar election under section 897(k) for certain foreign corporations in the process of liquidation.

(2) *Effective date.* The regulations set forth in §§1.897–1 through 1.897–4 are effective for transactions occurring after June 18, 1980. However, with respect to all transactions occurring after June 18, 1980 and before January 30, 1985, taxpayers may at their option choose to apply the Temporary Regulations under section 897 (in their entirety). The Temporary Regulations are located at 26 CFR 6a.897–1 through 6a.897–4 (Revised as of April 1, 1983), and were originally published in the FEDERAL REGISTER for September 21, 1982 (47 FR 41532) and amended by T.D. 7890, published in the FEDERAL REGISTER on April 28, 1983 (48 FR 19163).

(b) *Real property*—(1) *In general.* The term ‘‘real property’’ includes the following three categories of property: Land and unserved natural products of the land, improvements, and personal property associated with the use of real property. The three categories of real property are defined in subparagraphs (2), (3), and (4) of this paragraph (b). Local law definitions will not be controlling for purposes of determining the meaning of the term ‘‘real property’’ as it is used in sections 897, 1445, and 6039C and the regulations thereunder.

(2) *Land and unserved natural products of the land.* The term ‘‘real property’’ includes land, growing crops and timber, and mines, wells, and other natural deposits. Crops and timber cease to be real property at the time that they are served from the land. Ores, minerals, and other natural deposits cease to be real property when they are extracted from the ground. The storage of severed or extracted crops, timber, or minerals in or upon real property will not cause such property to be recharacterized as real property.

(3) *Improvements*—(i) *In general.* The term ‘‘real property’’ includes improvements on land. An improvement is a building, any other inherently permanent structure, or the structural components of either, as defined in subdivisions (ii) through (iv) of this paragraph (b)(3).

(ii) *Building.* The term ‘‘building’’ generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. Any structure that is classified as a building for purposes of section 48(a)(1)(B) and §1.48–1 shall be treated as such for purposes of this section.

(iii) *Inherently permanent structure*—(A) *In general.* The term ‘‘inherently permanent structure’’ means any property not otherwise described in this paragraph (b)(3) that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time. Property that is not classified as a building for purposes of section 48(a)(1)(B) and §1.48–1 may nevertheless constitute an inherently permanent structure. For purposes of this section, affixation to real property may be accomplished by weight alone.

(B) *Use of precedents under section 48.* Any property not otherwise described in this paragraph (b)(3) that constitutes ‘‘other tangible property’’ under the principles of section 48(a)(1)(B) and §1.48–1 (c) and (d) shall be treated for purposes of this section as an inherently permanent structure. Thus, for example, the term includes swimming pools, paved parking areas and other pavements, special foundations for heavy equipment, wharves and docks, bridges, fences, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, railroad tracks and signals, telephone poles, permanently installed telephone and television cables, broadcasting towers, oil derricks, oil and gas pipelines, oil and gas storage tanks, grain storage bins, and silos. However, property that is determined to be either property in the nature of machinery under §1.48–1(c) or property which is essentially an item of machinery or equipment under §1.48–1(e)(1)(i) shall not be treated as an inherently permanent structure.

(C) *Absence of precedents under section 48.* Where precedents developed under the principles of section 48 fail to provide adequate guidance with respect to the classification of particular property, the determination of whether such property constitutes an inherently permanent structure shall be made in view of all the facts and circumstances. In particular, the following factors must be taken into account:

(*1*) The manner in which the property is affixed to real property;

(*2*) Whether the property was designed to be easily removable or to remain in place indefinitely;

(*3*) Whether the property has been moved since its initial installation;

(*4*) Any circumstances that suggest the expected period of affixation (e.g., a lease that requires removal of the property upon its expiration);

(*5*) The amount of damage that removal of the property would cause to the property itself or to the real property to which it is affixed; and

(*6*) The extent of the effort that would be required to remove the property, in terms of time and expense.

(iv) *Structural components of buildings and other inherently permanent structures.* Structural components of buildings and other inherently permanent structures, as defined in §1.48–1 (e)(2), themselves constitute improvements. Structural components include walls, partitions, floors, ceilings, windows, doors, wiring, plumbing, central heating and central air conditioning systems, lighting fixtures, pipes, ducts, elevators, escalators, sprinkler systems, fire escapes and other components relating to the operation or maintenance of a building. However, the term ‘‘structural components’’ does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the ‘‘sole justification’’ test provided by the preceding sentence even though it incidentally provides for the comfort of employees or serves to an insubstantial degree areas where such temperature or humidity requirements are not essential.

(4) *Personal property associated with the use of the real property*—(i) *In general.* The term ‘‘real property’’ includes movable walls, furnishings, and other personal property associated with the use of the real property. Personal property is associated with the use of real property only if it is described in one of the categories set forth in subdivisions (A) through (D) of this paragraph (b)(4)(i). ‘‘Personal property’’ for purposes of this section means any property that constitutes ‘‘tangible personal property’’ under the principles of §1.48–1(c), without regard to whether such property qualifies as section 38 property. Such property will be associated with the use of the real property only where both the personal property and the United States real property interest with which it is associated are held by the same person or by related persons within the meaning of §1.897–1(i). For purposes of this paragraph (b)(4)(i), property is used ‘‘predominantly’’ in a named activity if it is devoted to that activity during at least half of the time in which it is in use during a calendar year.

(A) *Property used in mining, farming, and forestry.* Personal property is associated with the use of real property if it is predominantly used to exploit unsevered natural products in or upon the land. Such property includes mining equipment used to extract ores, minerals, and other natural deposits from the ground. It also includes any property used to cultivate the soil and harvest its products, such as farm machinery, draft animals, and equipment used in the growing and cutting of timber. However, personal property used to process or transport minerals, crops, or timber after they are severed from the land is not associated personal property.

(B) *Property used in the improvement of real property.* Personal property is associated with the use of real property if it is predominantly used to construct or otherwise carry out improvements to real property. Such property includes equipment used to alter the natural contours of the land, equipment used to clear and prepare raw land for construction, and equipment used to carry out the construction of improvements.

(C) *Property used in the operation of a lodging facility.* Personal property is associated with the use of real property if it is predominantly used in connection with the operation of a lodging facility. Property that is used in connection with the operation of a lodging facility includes property used in the living quarters of such facility, such as beds and other furniture, refrigerators, ranges and other equipment, as well as property used in the common areas of such facility, such as lobby furniture and laundry equipment. Such property constitutes personal property associated with the use of real property in the hands of the owner or operator of the facility, not of the tenant or guest. A lodging facility is an apartment house or apartment, hotel, motel, dormitory, residence, or any other facility (or part of a facility) predominantly used to provide, at a charge, living and/or sleeping accommodations, whether on daily, weekly, monthly, annual, or other basis. The term ‘‘lodging facility’’ does not include a personal residence occupied solely by its owner, or a facility used primarily as a means of transportation (such as an aircraft, vessel, or a railroad car) or used primarily to provide medical or convalescent services, even though sleeping accommodations are provided. Nor does the term include temporary living quarters provided by an employer due to the unavailability of lodgings within a reasonable distance of a work-site (such as a mine or construction project). The term ‘‘lodging facility’’ does not include any portion of a facility that constitutes a nonlodging commercial facility and that is available to persons not using the lodging facility on the same basis that it is available to tenants of the lodging facility. Examples of nonlodging commercial facilities include restaurants, drug stores, and grocery stores located in a lodging facility.

(D) *Property used in the rental of furnished office and other work space.* Personal property is associated with the use of real property if it is predominantly used by a lessor to provide furnished office or other work space to lessees. Property that is so used includes office furniture and equipment included in the rental of furnished space. Such property constitutes personal property associated with the use of real property in the hands of the lessor, not of the lessee.

(ii) *Dispositions of associated personal property*—(A) *In general.* Personal property that has become associated with the use of a real property interest shall itself be treated as a real property interest upon its disposition, unless either:

(*1*) The personal property is disposed of more than one year before the disposition of any present right to use or occupy the real property with which it was associated (and subject to the provisions of subdivision (B) of this paragraph (b)(4)(ii));

(*2*) The personal property is disposed of more than one year after the disposition of all present rights to use or occupy the real property with which it was associated (and subject to the provisions of subdivision (C) of this paragraph (b)(4)(ii)); or

(*3*) The personal property and the real property with which it was associated are separately sold to persons that are related neither to the transferor nor to one another (and subject to the provisions of subdivision (D) of this paragraph (b)(4)(ii)).

(B) *Personalty property disposed of one year before realty.* A transferor of personal property associated with the use of real property need not treat such property as a real property interest upon disposition if on the date of disposition the transferor does not expect or intend to dispose of the real property until more than one year later.

However, if the real property is in fact disposed of within the following year, the transferor must treat the personal property as having been a real property interest as of the date on which the personalty was disposed of. If the transferor had not previously filed an income tax return, a return must be filed and tax paid, together with any interest due thereon, by the later of the date on which a tax return or payment is actually due (with extensions), or the 60th day following the date of disposition. If the transferor had previously filed an income tax return, an amended return must be filed and tax paid, together with any interest due thereon, by the later of the dates specified above. Such a transferor may be liable to penalties for failure to file, for late payment of tax, or for understatement of liability, but only if the transferor knew or had reason to anticipate that the real property would be disposed of within one year of the disposition of the associated personal property.

(C) *Personalty disposed of one year after realty.* A disposition of real property shall be disregarded for purposes of subdivision (A)(*2*) of this paragraph (b) (4)(ii) if any right to use or occupy the real property is reacquired within the one-year period referred to in that subdivision. However, the disposition shall not be disregarded if such reacquisition is made in foreclosure of a mortgage or other security interest, in the exercise of a contractual remedy, or in the enforcement of a judgment. If, however, the reacquisition of the porperty is made pursuant to a plan the principal purpose of which is the avoidance of the provisions of section 897, 1445, or 6039C and the regulations thereunder, then the initial disposition shall be disregarded for purposes of subdivision (A)(*2*) of this paragraph (b)(4)(ii).

(D) *Separate dispositions of personalty and realty.* A transferor of personal property associated with the use of real property need not treat such property as a real property interest upon disposition if within 90 days before or after such disposition the transferor separately disposes of the real property interest to persons that are related neither to the transferor nor to the purchaser of the personal property. A transferor may rely upon this rule unless the transferor knows or has reason to know that the purchasers of the real property and the personal property—

(*1*) Are related persons; or

(*2*) Intend to reassociate the personal property with the use of the real property within one year of the date of disposition of the personal property.

(E) *Status of property in hands of transferee.* Personal property that has been associated with the use of real property and that is sold to an unrelated party will be treated as real property in the hands of the transferee only if the personal property becomes associated with the use of real property held or acquired by the transferee, in the manner described in paragraph (b)(4)(i) of this section.

(iii) *Determination dates.* The determination of whether personal property is personal property associated with the use of real property as defined in this paragraph (b)(4) is to be made on the date the personal property is disposed of and on each applicable determination date. See § 1.897–2(c).

(c) *United States real property interest*—(1) *In general.* The term ''United States real property interest'' means any interest, other than an interest solely as a creditor, in either:

(i) Real property located in the United States or the Virgin Islands, or

(ii) A domestic corporation unless it is established that the corporation was not a U.S. real property holding corporation within the period described in section 897(c)(1)(A)(ii).

In addition, for the limited purpose of determining whether any corporation is a U.S. real property holding corporation, the term ''United States real property interest'' means an interest, other than an interest solely as a creditor, in a foreign corporation unless it is established that the foreign corporation is not a U.S. real property holding corporation within the period prescribed in section 897(c)(1)(A)(ii). See § 1.897–2 for rules regarding the manner of establishing that a corporation is not a United States real property holding corporation.

(2) *Exceptions and special rules*—(i) *Domestically-controlled REIT.* An interest in a domestically-controlled real estate investment trust (REIT) is not a U.S. real property interest. A domestically-controlled REIT is one in which less than 50 percent of the fair market value of the outstanding stock was directly or indirectly held by foreign persons during the five-year period ending on the applicable determination date (or the period since June 18, 1980, if

shorter). For purposes of this determination the actual owners of stock, as determined under §1.857–8, must be taken into account.

(ii) *Corporation that has disposed of all U.S. real property interests.* The term ‘‘United States real property interest’’ does not include an interest in a corporation which has disposed of all its U.S. real property interests in transactions in which the full amount of gain, if any, was recognized, as provided by section 897(c)(1)(B). See §1.897–2(f) for rules regarding the requirements of section 897(c)(1)(B).

(iii) *Publicly-traded corporations.* If, at any time during the calendar year, any class of stock of a domestic corporation is regularly traded on an established securities market, an interest in such corporation shall be treated as a U.S. real property interest only in the case of:

(A) A regularly traded interest owned by a person who beneficially owned more than 5 percent of the total fair market value of that class of interests at any time during the five-year period ending either on the date of disposition of such interest or other applicable determination date (or the period since June 18, 1980, in shorter), or

(B) [Reserved]

Separate non-regularly traded interests that were acquired in transactions more than three years apart shall not be cumulated pursuant to this rule. In determining whether a shareholder holds 5 percent of a class of stock in a corporation (or any other interest of an equivalent fair market value), section 318(a) shall apply (except that sections 318(a) (2)(C) and (3)(C) are applied by substituting the phrase ‘‘5 percent’’ for ‘‘50 percent’’).

(iv) *Publicly traded partnerships and trusts.* If any class of interests in a partnership or trust is, within the meaning of §1.897–1(m) and (n), regularly traded on an established securities market, then for purposes of sections 897(g) and 1445 and §1.897–2 (d) and (e) an interest in the entity shall not be treated as an interest in a partnership or trust. Instead, such an interest shall be subject to the rules applicable to interests in publicly traded corporations pursuant to paragraph (c)(2)(iii) of this section. Such interests can be real property interests in the hands of a person that holds a greater than 5 percent interest. Therefore, solely for purposes of determining whether greater than 5 percent interests in such an entity constitute U.S. real property interests the disposition of which is subject to tax, the entity is required to determine pursuant to the provisions of §1.897–2 whether the assets it holds would cause it to be classified as a U.S. real property holding corporation if it were a corporation. The treatment of dispositions of U.S. real property interests by publicly traded partnerships and trusts is not affected by the rules of this paragraph (c)(2)(iv); by reason of the operation of section 897(a), foreign partners or beneficiaries are subject to tax upon their distributive share of any gain recognized upon such dispositions by the partnership or trust. The rules of this paragraph (c)(2)(iv) are illustrated by the following example.

Example. PTP is a partnership one class of interests in which is regularly traded on an established securities market. A is a nonresident alien individual who owns 1 percent of a class of limited partnership interests in PTP. B is a nonresident alien individual who owns 10 percent of the same class of limited partnership interests in PTP. On July 1, 1986, A and B sell their interests in PTP. Pursuant to the rules of this paragraph (c)(2)(iv), neither disposition is treated as the disposition of a partnership interest subject to the provisions of section 897(g). Instead, A and B are treated as having disposed of interests in a publicly traded corporation. Therefore, pursuant to the rule of paragraph (c)(2)(iii) of this section, A’s disposition of a 1 percent interest has no consequences under section 897. However, B’s disposition of a 10 percent interest will constitute the disposition of a U.S. real property interest subject to tax by reason of the operation of section 897 unless it is established pursuant to the rules of §1.897–2 that the interest is not a U.S. real property interest.

(d) *Interest other than an interest solely as a creditor*—(1) *In general.* This paragraph defines an interest other than an interest solely as a creditor, with respect to real property, and with respect to corporations, partnerships, trusts, and estates. An interest solely as a creditor either in real property or in a domestic corporation does not constitute a United States real property interest. Similarly, where one corporation holds an interest solely as a creditor in a second corporation or in a partnership, trust, or estate, that interest will be disregarded for purposes of determining whether the first corporation is a U.S. real property holding corporation (except to the extent that such interest constitutes an asset used or held for use in a trade or business, in accordance with rules of § 1.897–1(f)). In addition, the disposition of an interest solely as a creditor in a parnership, trust, or estate is not subject to sections 897, 1445, and 6039C. Whether an interest is considered debt under any provisions of the Code is not determinative of whether it constitutes an interest solely as a creditor for purpose of sections 897, 1445, and 6039C and the regulations thereunder.

(2) *Interests in real property other than solely as creditor*—(i) *In general.* An interest in real property other than an interest solely as a creditor includes a fee ownership, co-ownership, or leasehold interest in real property, a time sharing interest in real property, and a life estate, remainder, or reversionary interest in such property. The term also includes any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property.

A loan to an individual or entity under the terms of which a holder of the indebtedness has any direct or indirect right to share in the appreciation in value of, or the gross or net proceeds or profits generated by, an interest in real property of the debtor or of a related person is, in its entirety, an interest in real property other than solely as a creditor. An interest in production payments described in section 636 does not generally constitute an interest in real property other than solely as a creditor. However, a right to production payments shall constitute an interest in real property other than solely as a creditor if it conveys a right to share in the appreciation in value of the mineral property. A production payment that is limited to a quantum of mineral (including a percentage of recoverable reserves produced) or a period of time will be considered to convey a right to share in the appreciation in value of the mineral property. The rules of this paragraph (d)(2)(i) are illustrated by the following example.

Example. A, a U.S. citizen, purchases a condominium unit located in the United States for $500,000. A makes a $100,000 down payment and borrows $400,000 from B, a foreign person, to pay the balance of the purchase price. Under the terms of the loan. A is to pay B 13 percent annual interest each year for 10 years and 35 percent of the appreciation in the fair market value of the condominum at the end of the 10-year period. Because B has a right to share in the appreciation in value of the condominium, B has an interest other than solely as a creditor in the condominium. B's entire interest in the obligation from A, therefore, is a United States real property interest.

(ii) *Special rule*—(A) *Installment obligations.* A right to installment or other deferred payments from the disposition of an interest in real property will constitute an interest solely as a creditor if the transferor elects not to have the installment method of section 453(a) apply, any gain or loss is recognized in the year of disposition, and all tax due is timely paid. See section 1445 and regulations thereunder for further guidance concerning the availability of installment sale treatment under section 453. If an agreement for the payment of tax with respect to an installment sale is entered into with the Internal Revenue Service pursuant to section 1445, that agreement may specify whether or not the installment obligation will constitute an interest solely as a creditor. If an installment obligation constitutes an interest other than solely as a creditor then the receipt of each payment shall be treated as the disposition of an interest in real property that is subject to section 897(a) to the extent of any gain required to be taken into account pursuant to section 453.

If the original holder of an installment obligation that constitutes an interest other than solely as a creditor subsequently disposes of the obligation to an unrelated party and recognizes gain or loss pursuant to section 453B, the obligation will constitute an interest in real property solely as a creditor in the hands of the subsequent holder. However, if the obligation is disposed of to a related person and the full amount of gain realized upon the disposition of the real property has not been recognized upon such disposition of the installment obligation, then the obligation shall continue to be an interest in real property other than solely as a creditor in the hands of the subsequent holder subject to the rules of this paragraph (d)(2)(ii)(A).

In addition, if the obligation is disposed of to any person for a principal purpose of avoiding the provisions of sections 897, 1445, or 6039C, then the obligation shall continue to be an interest in real property other than solely as a creditor in the hands of the subsequent holder subject to the rules of this paragraph (d)(2)(ii)(A). However, rights to payments arising from dispositions that took place before June 19, 1980, shall in no event constitute interests in real property other than solely as a creditor, even if such payments are received after June 18, 1980. In addition, rights to payments arising from dispositions to unrelated parties that took place before January 1, 1985, and that were not subject to U.S. tax pursuant to the provisions of a U.S. income tax treaty, shall not constitute interests in real property other than solely as a creditor, even if such payments are received after December 31, 1984.

(B) *Options.* An option, a contract or a right of first refusal to acquire any interest in real property (other than an interest solely as a creditor) will itself constitute an interest in real property other than solely as a creditor.

(C) *Security interests.* A right to repossess or foreclose on real property under a mortgage, security agreement, financing statement, or other collateral instrument securing a debt will not be considered a reversionary interest in, or a right to share in the appreciation in value of or gross or net proceeds or profits generated by, an interest in real property. Thus, no such right of repossession or foreclosure will of itself cause an interest in real property which is otherwise an interest solely as a creditor to become an interest other than solely as a creditor. In addition, a person acting as mortgagee in possession shall not be considered to hold an interest in real property other than solely as a creditor, if the mortgagee's interest in the property otherwise constitutes an interest solely as a creditor.

(D) *Indexed interest rates.* An interest will not constitute a right to share in the appreciation in the value of, or gross or net proceeds or profits generated by, real property solely because it bears a rate of interest that is tied to an index of any kind that is intended to reflect general inflation or deflation of prices and interest rates (e.g., the Consumer Price Index). However, where an interest in real property bears a rate of interest that is tied to an index the principal purpose of which is to reflect changes in real property values, the real property interest will be considered an indirect right to share in the appreciation in value of, or gross or net proceeds or profits generated by, real property. Such an indirect right constitutes an interest in real property other than solely as a creditor.

(E) *Commissions.* A right to payment of a commission, brokerage fee, or similar charge for professional services rendered in connection with the arrangement or financing of a purchase, sale, or lease of real property does not constitute a right to share in the appreciation in value of, or gross or net proceeds or profits of, real property solely because it is based upon a percentage of the purchase price or rent. Thus, a right to a commission earned by a real estate agent based on a percentage of the sales price does not constitute an interest in real property other than solely as a creditor.

However, a right to a commission, brokerage fee, or similar charge will constitute an interest other than solely as a creditor if the total amount of the payment is contingent upon appreciation, proceeds, or profits of the real property occurring or arising after the date of the transaction with respect to which the professional services were rendered. For example, a commission earned in connection with the purchase of a real property interest that is contingent upon the amount of gain ultimately realized by the purchaser will constitute an interest in real property other than solely as a creditor.

(F) *Trustees' fees, etc.* A right to payment of reasonable compensation for services rendered as a trustee, as an administrator of an estate, or in a similar capacity does not constitute a right to share in the appreciation in the value of, or gross or net proceeds or profits of, real property solely because the assets of the trust or estate include U.S. real property interests.

(3) *Interest in an entity other than solely as a creditor*—(i) In general. For purposes of sections 897, 1445, and 6039C, an interest in an entity other than an interest solely as a creditor is—

(A) Stock of a corporation;

(B) An interest in a partnership as a partner within the meaning of section 761(b) and the regulations thereunder;

(C) An interest in a trust or estate as a beneficiary within the meaning of section 643(c) and the regulations thereunder or an ownership interest in any portion of a trust as provided in sections 671 through 679 and the regulations thereunder;

(D) An interest which is, in whole or in part, a direct or indirect right to share in the appreciation in value of an interest in an entity described in subdivision (A), (B), or (C) of this paragraph (d)(3)(i) or a direct or indirect right to share in the appreciation in value of assets of, or gross or net proceeds or profits derived by, the entity; or

(E) A right (whether or not presently exercisable) directly or indirectly to acquire, by purchase, conversion, exchange, or in any other manner, an interest described in subdivision (A), (B), (C), or (D) of this paragraph (d)(3) (i).

(ii) *Special rules*—(A) *Installment obligations.* A right to installment or other deferred payments from the disposition of an interest in an entity will constitute an interest solely as a creditor if the transferor elects not to have the installment method of section 453(a) apply, any gain or loss is recognized in the year of disposition, and tax due is timely paid. See section 1445 and regulations thereunder for further guidance concerning the availability of installment sale treatment under section 453. If an agreement for the payment of tax with respect to an installment sale is entered into with the Internal Revenue Service pursuant to section 1445, that agreement may specify whether or not the installment obligation will constitute an interest solely as a creditor. If an installment obligation constitutes an interest other than solely as a creditor then the receipt of each payment shall be treated as the disposition of such an interest and shall be subject to section 897(a) to the extent that:

(*1*) It constitutes the disposition of a U.S. real property interest and

(*2*) Gain or loss is required to be taken into account pursuant to section 453. Such treatment shall apply to payments arising from dispositions of interests in a corporation any class of the stock of which is regularly traded on an established securities market, but only in the case of a disposition of any portion of an interest described in paragraph (c)(2)(iii)(A) or (B) of this section. If the original holder of an installment obligation that constitutes an interest other than solely as a creditor subsequently disposes of the obligation to an unrelated party and recognizes gain or loss pursuant to section 453B, the obligation will constitute an interest in the entity solely as a creditor in the hands of the subsequent holder. However, if the obligation is disposed of to a related person and the full amount of gain realized upon the disposition of the interest in the entity has not been recognized upon such disposition of the installment obligation, then the obligation shall continue to be an interest in the entity other than solely as a creditor in the hands of the subsequent holder subject to the rules of this paragraph (d)(3)(ii)(A). In addition, if the obligation is disposed of to any person for a principal purpose of avoiding the provisions of section 897, 1445, or 6039C, then the obligation shall continue to be an interest in the entity other than solely as a creditor in the hands of the subsequent holder subject to the rules of this paragraph (d)(3)(ii)(A). However, rights to payments arising from dispositions that took place before June 19, 1980, shall in no event constitute interests in an entity other than solely as a creditor, even if such payments are received after June 18, 1980. In addition, such treatment shall not apply to payments arising from dispositions to unrelated parties that took place before January 1, 1985, and that were not subject to U.S. tax pursuant to the provisions of a

U.S. income tax treaty, regardless of when such payments are received.

(B) *Contingent interests.* The interests described in subdivision (D) of paragraph (d)(3)(i) of this section include any right to a payment from an entity the amount of which is contingent on the appreciation in value of an interest described in subdivision (A), (B), or (C) of paragraph (d)(3)(i) of this section or which is contingent on the appreciation in value of assets of, or the general gross or net proceeds or profits derived by, such entity. The right to such a payment is itself an interest in the entity other than solely as a creditor, regardless of whether the holder of such right actually holds an interest in the entity described in subdivision (A), (B), or (C) of paragraph (d)(3)(i) of this section. For example, a stock appreciation right constitutes an interest in a corporation other than solely as a creditor even if the holder of such right actually holds no stock in the corporation. However, the interests described in subdivision (D) of paragraph (d)(3)(i) of this section do not include any right to a payment that is (*1*) exclusively contingent upon and exclusively paid out of revenues from sales of personal property (whether tangible or intangible) or from services, or (*2*) exclusively contingent upon the resolution of a claim asserted against the entity by a person related neither to the entity nor to the holder of the interest.

(C) *Security interests.* A right to repossess or foreclose on an interest in an entity under a mortgage, security agreement, financing statement, or other collateral instrument securing a debt will not of itself cause an interest in an entity which is otherwise an interest solely as a creditor to become an interest other than solely as a creditor.

(D) *Royalties.* The interests described in subdivision (D) of paragraph (d)(3)(i) of this section do not include rights to payments representing royalties, license fees, or similar charges for the use of patents, inventions, formulas, copyrights, literary, musical or artistic compositions, trademarks, trade names, franchises, licenses, or similar intangible property.

(E) *Commissions.* The interests described in subdivision (D) of paragraph (d)(3)(i) of this section do not include a right to a commission, brokerage fee or similar charge for professional services rendered in connection with the purchase or sale of an interest in an entity. However, a right to such a payment will constitute an interest other than solely as a creditor if the total amount of the payment is contingent upon appreciation in value of assets of, or proceeds or profits derived by, the entity after the date of the transaction with respect to which the payment was earned.

(F) *Trustee's fees.* The interests described in subdivision (D) of paragraph (d)(3)(i) of this section do not include a right to payment representing reasonable compensation for services rendered as a trustee, as an administrator of an estate, or in a similar capacity.

(4) *Aggregation of interests.* If a person holds both interests solely as a creditor and interests other than solely as a creditor in real property or in an entity, those interests will generally be treated as separate and distinct interests. However, such interests shall be aggregated and treated as interests other than solely as a creditor in their entirety if the interest solely as a creditor has been separated from, or acquired separately from, the interest other than solely as a creditor, for a principal purpose of avoiding the provisions of section 897, 1445, or 6039C by causing one or more of such interests to be an interest solely as a creditor. The existence of such a purpose will be determined with reference to all the facts and circumstances. Where an interest solely as a creditor has arm's-length interest and repayment terms it shall in no event be aggregated with and treated as an interest other than solely as a creditor. For purposes of this paragraph (d)(4), an interest rate that does not exceed 120 percent of the applicable Federal rate (as defined in section 1274(d)) shall be presumed to be an arm's-length interest rate. For purposes of applying the rules of this paragraph (d)(4), a person shall be treated as holding any interests held by a related person within the meaning of §1.897–1(i).

(5) *''Interest'' means ''interest other than solely as a creditor.''* Unless otherwise stated, the term ''interest'' as used with regard to real property or

with regard to an entity hereafter in the regulations under sections 897, 1445, and 6039C, means an interest in such real property or entity other than an interest solely as a creditor.

(e) *Proportionate share of assets held by an entity*—(1) *In general.* A person that holds an interest in an entity is for certain purposes treated as holding a proportionate or pro rata share of the assets held by the entity. Such proportionate share must be calculated, in accordance with the rules of this paragraph, for the following purposes.

(i) In determining whether a corporation is a U.S. real property holding corporation—

(A) A person holding an interest in a partnership, trust, or estate is treated as holding a proportionate share of the assets held by the partnership, trust, or estate (see section 897–2(e)(2)), and

(B) A corporation that holds a controlling interest in a second corporation is treated as holding a proportionate share of the assets held by the second corporation (see § 1.897–2(e)(3)).

(ii) In determining reporting obligations that may be imposed under section 6039C, the holder of an interest in a partnership, trust, or estate is treated as owning a proportionate share of the U.S. real property interests held by the partnership, trust, or estate.

(2) *Proportionate share of assets held by a corporation or partnership*—(i) *In general.* A person's proportionate or pro rata share of assets held by a corporation or partnership is determined by multiplying—

(A) The person's percentage ownership interest in the entity, by

(B) The fair market value of the assets held by the entity (or the book value of such assets, in the case of a determination pursuant to § 1.897–2(b)(2)).

(ii) *Percentage ownership interest.* A person's percentage ownership interest in a corporation or partnership is the percentage equal to the ratio of (A) the sum of the liquidation values of all interests in the entity held by the person to (B) the sum of the liquidation values of all outstanding interest in the entity. The liquidation value of an interest in an entity is the amount of cash and the fair market value of any property that would be distributed with respect to such interest upon the liquidation of the entity after satisfaction of liabilities to persons having interests in the entity solely as creditors. With respect to an entity that has interests outstanding that grant a presently-exercisable option to acquire or right to convert into or otherwise acquire an interest in the entity other than solely as a creditor, the liquidation value of all interests in such entity shall be calculated as though such option or right had been exercised, giving effect both to the payment of any consideration required to exercise the option or right and to the issuance of the additional interest.

The fair market value of the assets of the entity, the amount of cash held by the entity, and the amount of liabilities to persons having interests solely as creditors if determined for this purpose on the date with respect to which the percentage ownership interest is determined.

(iii) *Examples.* The rules of this paragraph (e)(2) are illustrated by the following examples.

Example 1. Corporation K's only assets are stock and securities with a fair market value as of the applicable determination date of $20,000,000 K's assets are subject to liabilities of $10,000,000. Among K's liabilities are a $1,000,000 loan from L, under the terms of which L is entitled, upon payment of the loan principal, to a profit share equal to 10 percent of the excess of the fair market value of K's assets over $18,000,000, but only if all other corporate liabilities have been paid. K has two classes of stock, common and preferred. PS1 and PS2 each own 100 of the 200 outstanding shares of preferred stock. CS1 and CS2 each own 500 of the 1,000 outstanding shares of common stock. Each preferred shareholder is entitled to $10,000 per share of preferred stock upon liquidation, subject to payment of all corporate liabilities and to any amount owed to L, but before any common shareholder is paid. The liquidation value of L's interest in K, which constitutes an interest other than an interest solely as a creditor, is $1,200 ($1,000,000 principal of the loan to K plus $200,000 (10 percent of the excess of $20,000,000 over $18,000,000). The liquidation value of each of PS1's and PS2's blocks of preferred stock is $1,000,000 ($10,000 times 100 shares each). The liquidation value of each of CS1's and CS2's blocks of common stock is $3,900,000 [$20,000,000 (the total fair market value of K's assets)—$9,000,000 (liabilities to creditors other than L)—$1,200,000 (L's liquidation value)—$2,000,000 (PS1's and PS2's liquidation value)) times 50 percent (the percentage of common stock owned by each)]. The sum of the liquidation values of all of the outstanding interests in K (i.e., interests other than solely as a creditor) is $11,000,000 [$1,200,000 (L's liquidation value)+$2,000,000 (PS1's and PS2's liquidation values)+$7,800,000 (CS1's and CS2's liquidation values)]. Each of CS1's and CS2's percentage ownership interests in K is 35.5 percent ($3,900,000 divided by $11,000,000). Each of PS1's and PS2's percentage ownership interests in K is 9 percent ($1,000,000 divided by $11,000,000). L's percentage ownership interest in K is 11 percent ($1,200,000 divided by $11,000,000).

Example 2. A, a U.S. person, and B, a foreign person are partners in a partnership the only asset of which is a parcel of undeveloped land located in the United States that was purchased by the partnership in 1980 for $300,000. The partnership has no liabilities, and its capital is $300,000. A's and B's interests in the capital of the partnership are 25 percent and 75 percent, respectively, and A and B each has a 50 percent profit interest in the partnership. The partnership agreement provides that upon liquidation any unrealized gain will be distributed in accordance with the partners' profit interest. In 1984 the partnership has no items of income or deduction, and the fair market value of its parcel of undeveloped land is $500,000. In 1984 the percentage ownership interest of A in the partnership is 35 percent [the ratio of $100,000 (the liquidation value of A's profit interest in 1984) plus $75,000 (the liquidation value of A's 25 percent interest in the partnership's $300,000 capital) to $500,000 (the sum of the liquidation values of all outstanding interests in the partnership)]. The percentage ownership interest of B in the partnership in 1984 is 65 percent [the ratio of $325,000 (B's $100,000 profit interest plus his $225,000 capital interest) to $500,000]

(3) *Proportionate share of assets held by trusts and estates*—(i) *In general.* A person's proportionate or pro rata share of assets held by a trust or estate is determined by multiplying—

(A) The person's percentage ownership interest in the trust or estate, by

(B) The fair market value of the assets held by the trust or estate (or the book value of such assets, in the case of a determination pursuant to §1.897–2(b)(2)).

(ii) *Percentage ownership interest*—(A) *General rule.* A person's percentage ownership interest in a trust or an estate—is the percentage equal to the ratio of:

(*1*) The sum of the actuarial values of such person's interests in the cash and other assets held by the trust or estate after satisfaction of the liabilities of the trust or estate to persons holding interests in the trust or estate solely as creditors, to (*2*) the entire amount of such cash and other assets after satisfaction of liabilities to persons holding interests in the trust or estate solely as creditors. For purposes of calculating this ratio, the fair market value of the trust's or estate's assets, the amount of cash held by the trust or estate, and the amount of the liabilities to persons having interests solely as creditors is determined on the date with respect to which the percentage ownership interest is determined. With respect to a trust or estate that has interests outstanding that grant a presently-exercisable option to acquire or right to convert into or otherwise acquire an interest in the trust or estate other than solely as a creditor, the liquidation value of all interests in such entity shall be calculated as though such option or right had been exercised, giving effect both to the payment of any consideration required to exercise the option or right and to the issuance of the additional interest. With respect to a trust or estate that has interests outstanding that entitle any person to a distribution of U.S. real property interests upon liquidation that is disproportionate to such person's interest in the total assets of the trust or estate, such disproportionate right shall be disregarded in the calculation of the interest-holders' proportionate share of the U.S. real property interests held by the entity. For purposes of determining his own percentage ownership interest in a trust, a grantor or other person will be treated as owning any portion of the trust's cash and other assets which such person is treated as owning under sections 671 through 679.

(B) *Discretionary trusts and estates.* In determining percentage ownership interest in a trust or an estate, the sum of the definitely ascertainable actuarial values of interests in the cash and the other assets of the trust or estate held by persons in existence on the date with respect to which such determination is made must equal the amount in paragraph (e)(3)(ii)(A)(*2*) of this section. If the amount in paragraph (e)(3)(ii)(A)(*2*) of this section exceeds the sum of the definitely ascertainable actuarial values of the interests held by persons in existence on the determination date, the excess will be considered to be owned in total by each beneficiary who is in existence on such date, whose interest in the excess is not definitely ascertainable and who is potentially entitled to such excess. However, such excess shall not be considered to be owned in total by each beneficiary if the discretionary terms of the trust or estate were included for a principal purpose of avoiding the provisions of section 897, 1445, or 6039C by causing assets other than U.S. real property interests to be attributed in total to each beneficiary. The rules of this paragraph (e)(3) are illustrated by the following example.

Example. A, a U.S. person, established a trust on December 31, 1984, and contributed real property with a fair market value of $10,000 to the trust. The terms of that trust provided that the trustee, a bank that is unrelated to A, at its discretion may retain trust income or may distribute it to X, a foreign person, or to the head of state of any country other than the United States. The remainder upon the death of X is to go in equal shares to such of Y and Z, both foreign persons, as survive X. On December 31, 1984, the total value of the trust's assets is $10,000. On the same date, the actuarial values of the remainder interests of Y and Z in the corpus of the trust are definitely ascertainable. They are $1,000 and $500, respectively. Neither the income interest of X nor of the head of state of any country other than the United States has a definitely ascertainable actuarial value on December 31, 1984. The interests of Y and Z in the income portion of the trust similarly have no definitely ascertainable actuarial values on such date since the income may be distributed rather than retained by the trust. Since the sum of the actuarial values of definitely ascertainable interests of persons in existence ($1,500) is less than $10,000, the difference ($8,500) is treated as owned by each beneficiary who is in existence on December 31, 1984, and who is potentially entitled to such excess. Therefore, X, Y, Z, and the head of state of any country other than the United States are each considered as owning the entire $8,500 income interest in the trust. On December 31, 1984, the total actuarial value of X's interest is $8,500, and his percentage ownership interest is 85 percent. The total actuarial value of Y's interest in the trust is $9,500 ($1,000 plus $8,500), and his percentage ownership interest is 95 percent. The total actuarial value of Z's interest is $9,000 ($500 plus $8,500), and his percentage ownership interest is 90 percent. The actuarial value of the interest of the head of state of each country other than the United States is $8,500, and his percentage ownership interest is 85 percent.

(4) *Dates with respect to which percentage ownership interests are determined.* The dates with respect to which percentage ownership interests are determined are the applicable determination dates outlined in § 1.897–2 or in regulations under section 6039C.

(f) *Asset used or held for use in a trade or business*—(1) *In general.* The term ''asset used or held for use in a trade or business'' means—

(i) Property, other than a U.S. real property interest, that is—

(A) Stock in trade of an entity or other property of a kind which would properly be included in the inventory of the entity if on hand at the close of the taxable year, or property held by the entity primarily for sale to customers in the ordinary course of its trade or business, or

(B) Depreciable property used or held for use in the trade or business, as described in section 1231(b)(1) but without regard to the holding period limitations of section 1231(b), or

(C) Livestock, including poultry, used or held for use in a trade or business for draft, breeding, dairy, or sporting purposes, and

(ii) Goodwill and going concern value, patents, inventions, formulas copyrights, literary, musical, or artistic compositions, trademarks, trade names, franchises, licenses, customer lists, and similar intangible property, but only to the extent that such property is used or held for use in the entity's trade or business and subject to the valuation rules of § 1.897–1(o)(4), and

(iii) Cash, stock, securities, receivables of all kinds, options or contracts to acquire any of the foregoing, and options or contracts to acquire commodities, but only to the extent that such assets are used or held for use in the corporation's trade or business and do not constitute U.S. real property interests.

(2) *Used or held for use in a trade or business.* An asset is used or held for

use in an entity's trade or business if it is, under the principles of §1.864–4(c)(2)—

(i) Held for the principal purpose of promoting the present conduct of the trade or business,

(ii) Acquired and held in the ordinary course of the trade or business, as, for example, in the case of an account or note receivable arising from that trade or business (including the performance of services), or

(iii) Otherwise held in a direct relationship to the trade or business.

In determining whether an asset is held in a direct relationship to the trade or business, consideration shall be given to whether the asset is needed in that trade or business. An asset shall be considered to be needed in a trade or business only if the asset is held to meet the present needs of that trade or business and not its anticipated future needs. An asset shall be considered as needed in the trade or business if, for example, the asset is held to meet the operating expenses of that trade or business. Conversely, an asset shall be considered as not needed in the trade or business if, for example, the asset is held for the purpose of providing for future diversification into a new trade or business, future expansion of trade or business activities, future plant replacement, or future business contingencies. An asset that is held to meet reserve or capitalization requirements imposed by applicable law shall be presumed to be held in a direct relationship to the trade or business.

(3) *Special rules concerning liquid assets*—(i) *Safe harbor amount.* Assets described in paragraph (f)(1)(iii) of this section shall be presumed to be used or held for use in a trade or business, in an amount up to 5 percent of the fair market value of other assets used or held for use in the trade or business. However, the rule of this paragraph (f)(3)(i) shall not apply with respect to any assets described in paragraph (f)(1)(iii) of this section that are held or acquired for the principal purpose of avoiding the provisions of section 897 or 1445.

(ii) *Investment companies.* Assets described in paragraph (f)(1)(iii) of this section shall be presumed to be used or held for use in an entity's trade or business if the principal business of the entity is trading or investing in such asssets for its own account. An entity's principal business shall be presumed to be trading or investing in assets described in paragraph (f)(1)(iii) of this section if the fair market value of such assets held by the entity equals or exceeds 90 percent of the sum of the fair market values of the entity's U.S. real property interests, interests in real property located outside the United States, assets otherwise used or held for use in trade or business, and assets described in paragraph (f)(1)(iii) of this section.

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

Example 1. M, a domestic corporation engaged in industrial manufacturing, is required to hold a large current cash balance for the purposes of purchasing materials and meeting its payroll. The amount of the cash balance so required varies because of the fluctuating seasonal nature of the corporation's business. In months when large cash balances are not required, the corpration invests the surplus amount in U.S. Treasury bills. Since both the cash and the Treasury bills are held to meet the present needs of the business, they are held in a direct relationship to that business, and, therefore, constitute assets used or held for use in the trade or business.

Example 2. R, a domestic corporation engaged in the manufacture of goods, engages a stock brockerage firm to manage securities which were purchased with funds from R's general surplus reserves. The funds invested in these securities are intended to provide for the future expansion of R into a new trade or business. Thus, the funds are not necessary for the present needs of the business; they are accordingly not held in a direct relationshp to the business and do not constitute assets used or held for use in the trade or business.

Example 3. B, a federally chartered and regulated bank, is required by law to hold substantial reserves of cash, stock, and securities. Pursuant to the rule of paragraph (f)(2) of this section, such assets are presumed to be held in a direct relationship to B's business, and thus constitute assets used or held for use in the trade or business. In addition, B holds substantial loan receivables which are acquired and held in the ordinary course of its banking business. Pursuant to the rule of paragraph (f)(1)(iii) of this section, such receivables constitute assets used or held for use in the trade or business.

(g) *Disposition.* For purposes of sections 897, 1445, and 6039C, the term ''disposition'' means any transfer that would constitute a disposition by the transferor for any purpose of the Internal Revenue Code and regulations thereunder. The severance of crops or timber and the extracion of minerals do not alone constitute the disposition of a U.S. real property interest.

(h) *Gain or loss.* The amount of gain or loss arising from the disposition of the U.S. real property interest shall be determined as provided in section 1001 (a) and (b). Such gain or loss shall be subject to the provisions of section 897 (a) and (b), unless a nonrecognition provision is applicable pursuant to section 897 (d) or (e) and regulations thereunder. Amounts otherwise treated for Federal income tax purposes as principal and interest payments on debt obligations of all kinds (including obligations that are interests other than solely as a creditor) do not give rise to gain or loss that is subject to section 897(a). However, principal payments on installment obligations described in §§ 1.897–1(d)(2)(ii)(A) and 1.897–1(d)(3)(ii)(A) do give rise to gain or loss that is subject to section 897(a), to the extent such gain or loss is required to be recognized pursuant to section 453. The rules of paragraphs (g) and (h) are illustrated by the following examples.

Example 1. Foreign individual C has an undivided fee interest in a parcel of real property located in the United States. The fair market value of C's interest is $70,000, and C's basis in such interest is $50,000. The only liability to which the real property is subject is the liability of $65,000 secured by a mortgage in the same amount. C transfers his fee interest in the property subject to the mortgage by gift to D. C realizes $15,000 of gain upon such transfer. As a transfer by gift constitutes a disposition for purposes of the Code, and as gain is realized upon that transfer, the gift is a disposition for purposes of sections 897, 1445, and 6039C and is subject to section 897(a) to the extent of the gain realized. However, section 897(a) would not be applicable to the transfer if the mortgage on the U.S. real property were equal to or less than C's $50,000 basis, since the transfer then would not give rise to the realization of gain or loss under the Internal Revenue Code.

Example 2. Foreign corporation Y makes a loan of $1 million to domestic individual Z, secured by a mortgage on residential real property purchased with the loan proceeds. The loan agreement provides that Y is entitled to receive fixed monthly payments from Z, constituting repayment of principal plus interest at a fixed rate. In addition, the agreement provides that Y is entitled to receive a percentage of the appreciation value of the real property as of the time that the loan is retired. The obligation in its entirety is considered debt for Federal income tax purposes. However, because of Y's right to share in the appreciation in value of the real property, the debt obligation gives Y an interest in the real property other than solely as a creditor. Nevertheless, as principal and interest payments do not constitute gain under section 1001 and paragraph (h) of this section, and both the monthly and final payments received by Y are considered to consist solely of principal and interest for Federal income tax purposes, section 897(a) shall not apply to Y's receipt of such payments. However, Y's sale of the debt obligation to foreign corporation A would give rise to gain that is subject to section 897(a).

(i) *Related person.* For purposes of sections 897, 1445, and 6039C, persons are considered to be related if they are partners or partnerships described in section 707(b)(1) of the Code or if they are related within the meaning of section 267 (b) and (c) of the Code (except that section 267(f) shall apply without regard to section 1563(b)(2)).

(j) *Domestic corporation.* The term ''domestic corporation'' has the same meaning as set forth in section 7701(a) (3) and (4) and § 301.7701–5. For purposes of sections 897 and 6039C, it also includes a foreign corporation with respect to which an election under section 897(i) and § 1.897–3 or section 897(k) and § 1.897–4 to be treated as domestic corporation is in effect.

(k) [Reserved]

(l) *Foreign corporation.* The term ''foreign corporation'' has the meaning ascribed to such term in section 7701(a) (3) and (5) and § 301.7701–5. For purposes of sections 897 and 6039C, however, the term does not include a foreign corporation with respect to which there is in effect an election under section 897(i) and § 1.897–3 or section 897(k) and § 1.897–4 to be treated as a domestic corporation.

(m) *Established securities market.* For purposes of sections 897, 1445, and 6039C, the term ''established securities market'' means—

(1) A national securities exchange which is registered under section 6 of

the Securities Exchange Act of 1934 (15 U.S.C. 78f),

(2) A foreign national securities exchange which is officially recognized, sanctioned, or supervised by governmental authority, and

(3) Any over-the-counter market. An over-the-counter market is any market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets which are prepared and distributed by a broker or dealer in the regular course of business and which contain only quotations of such broker or dealer.

(n) [Reserved]

(o) *Fair market value*—(1) *In general.* For purposes of sections 897, 1445, and 6039C only, the term ''fair market value'' means the value of the property determined in accordance with the rules, contained in this paragraph (o). The definition of fair market value provided herein is not to be used in the calculation of gain or loss from the disposition of a U.S. real property interest pursuant to section 1001. An independent professional appraisal of the value of property must be submitted only if such an appraisal is specifically requested in connection with the negotiation of a security agreement pursuant to section 1445.

(2) *Method of calculating fair market value*—(i) *In general.* The fair market value of property is its gross value (as defined in paragraph (o)(2)(ii) of this section) reduced by the outstanding balance of any debts secured by the property which are described in paragraph (o)(2)(iii) of this section. See §1.897–2(b) for the alternative use of book values in certain limited circumstances.

(ii) *Gross value.* Gross value is the price at which the property would change hands between an unrelated willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts. Generally, with respect to trade or business assets, going concern value should be used as it will provide the most accurate reflection of such a price. However, taxpayers may use other methods of valuation if they can establish that such method will provide a more accurate determination of gross value and if they consistently apply such method to all assets to be valued. See subdivisions (3) and (4) of this paragraph (o) for special rules with respect to the valuation of leases and of intangible assets.

(iii) Debts secured by the property. The gross value of property shall be reduced by the outstanding balance of debts that are:

(A) Secured by a mortgage or other security interest in the property that is valid and enforceable under the law of the jurisdiction in which the property is located, and

(B) Either (*1*) Incurred to acquire the property (including long-term financing obtained in replacement of construction loans or other short-term debt within one year of the acquisition or completion of the property), or (*2*) otherwise incurred in direct connection with the property, such as property tax liens upon real property or debts incurred to maintain or improve property.

In addition, if any debt described in this paragraph (o)(2)(iii) is refinanced for a valid business purpose (such as obtaining a more favorable rate of interest), the principal amount of the replacement debt does not exceed the outstanding balance of the original debt, and the replacement debt is secured by the property, then the gross value of the property shall be reduced by the replacement debt. Obligations to related persons shall not be taken into account for purposes of this paragraph (o)(2)(iii) unless such obligations constitute interests solely as a creditor pursuant to the provisions of paragraph (d)(4) of this section and unless the related person has made similar loans to unrelated persons on similar terms and conditions.

(iv) *Anti-abuse rule.* The gross value of real property located outside the United States and of assets used or held for use in a trade or business shall be reduced by the outstanding balance of any debt that was entered into for the principal purpose of avoiding the provisions of section 897, 1445, or 6039C by enabling the corporation to acquire such assets. The existence of such a purpose shall be determined with reference to all the facts and circumstances. Debts that a particular corporation routinely enters into in the ordinary course of its acquisition of assets used or held for use in its trade or business will not be considered to be entered into for the principal purpose of avoiding the provisions of section 897, 1445, or 6039C.

(3) *Fair market value of leases and options.* For purposes of sections 897, 1445, and 6039C, the fair market value of a leasehold interest in real property is the price at which the lease could be assigned or the property sublet, neither party to such transaction being under any compulsion to enter into the transaction and both having reasonable knowledge of all relevant facts. Thus, the value of a leasehold interest will generally consist of the present value, over the period of the lease remaining, of the difference between the rental provided for in the lease and the current rental value of the real property. A leasehold interest bearing restrictions on its assignment or sublease has a fair market value of zero, but only if those restrictions in practical effect preclude (rather than merely condition) the lessee's ability to transfer, at a gain, the benefits of a favorable lease. The normal commercial practice of lessors may be used to determine whether restrictions in a lease have the practical effect of precluding transfer at a gain. The fair market value of an option to purchase any property is, similarly, the price at which the option could be sold, consisting generally of the difference between the option price and the fair market value of the property, taking proper account of any restrictions upon the transfer of the option.

(4) *Fair market value of intangible assets.* For purposes of determining whether a corporation is a U.S. real property holding corporation, the fair market value of intangible assets described in § 1.897–1(f)(1)(ii) may be determined in accordance with the following rules.

(i) *Purchase price.* Intangible assets described in § 1.897–1(f)(1)(ii) that were acquired by purchase from a person not related to the purchaser within the meaning of § 1.897–1(i) may be valued at their purchase price. However, such purchase price must be adjusted to reflect any amortization required by generally accepted accounting principles applied in the United States. Intangible assets acquired by purchase shall include any amounts allocated to goodwill or going concern valued pursuant to section 338(b)(3) and regulations thereunder. Intangible assets acquired by purchase shall not include assets that were acquired indirectly through an acquisition of stock to which section 338 does not apply. Such assets must be value pursuant to a method described in subdivision (ii) or (iii) of this paragraph (o)(4).

(ii) *Book value.* Intangible assets described in § 1.897–1(f)(1)(ii) (other than good will and going concern value) may be valued at the amount at which such assets are carried on the financial accounting records of the holder of such assets, provided that such amount is determined in accordance with generally accepted accounting principles applied in the United States. However, this method may not be used with respect to assets acquired by purchase from a related person within the meaning of § 1.897–1(i).

(iii) *Other methods.* Intangible assets described in § 1.897–1(f)(1)(ii) may be valued pursuant to any other reasonable method at an amount reflecting the price at which the asset would change hands between an unrelated willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts. However, a corporation that uses a method of valuation other than the purchase price or book value methods may be required to comply with the special notification requirements of § 1.897–2(h)(1)(iii)(A).

(p) *Identifying number.* The ''identifying number'' of an individual is the individual's United States social security number. The ''identifying number'' of any other person is its United States employer identification number.

(Approved by the Office of Management and Budget under control number l545–0123)

(Sec. 897 (94 Stat. 2683; 26 U.S.C. 897), sec. 6011 (68A Stat. 732; 26 U.S.C. 6011) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 7999, 49 FR 50693, Dec. 31, 1984; 50 FR 12530, Mar. 29, 1985, as amended by T.D. 8113, 51 FR 46626, Dec. 24, 1986; T.D. 8198, 53 FR 16217, May 5, 1988; T.D. 8657, 61 FR 9343, Mar. 8, 1996; 61 FR 14248, Apr. 1, 1996]

§1.897–2 United States real property holding corporations.

(a) *Purpose and scope.* This section provides rules regarding the definition and consequences of U.S. real property holding corporation status. U.S. real property holding corporation status is important for determining whether gain from the disposition by a foreign person of an interest in a domestic corporation is taxable. Such status is also important for purposes of the withholding and reporting requirements of sections 1445 and 6039C. For example, a person that buys stock of a U.S. real property holding corporation from a foreign person is required to withhold under section 1445. In addition, for purposes of determining whether another corporation is a U.S. real property holding corporation, an interest in a foreign corporation is a U.S. real property interest unless it is established that the foreign corporation is not a U.S. real property holding corporation. The general definition of a U.S. real property holding corporation is provided in paragraph (b) of this section. Paragraph (c) provides rules regarding the dates on which U.S. real property holding corporation status must be determined. The assets that must be included in making the determination of a corporation's status are set forth in paragraph (d), while paragraph (e) provides special rules regarding the treatment of interests held by a corporation in partnerships, trusts, estates, and other corporations. Rules regarding the termination of U.S. real property holding corporation status are set forth in paragraph (f). Paragraph (g) explains the manner in which an interest-holder can establish that a corporation is not a U.S. real property holding corporation, and paragraph (h) provides rules regarding certain notification requirements applicable to corporations.

(b) *U.S. real property holding corporation*—(1) *In general.* A corporation is a U.S. real property holding corporation if the fair market value of the U.S. real property interests held by the corporation on any applicable determination date equals or exceeds 50 percent of the sum of the fair market values of its—

(i) U.S. real property interests;

(ii) Interests in real property located outside the United States; and

(iii) Assets other than those described in subdivision (i) or (ii) of this paragraph (b)(1) that are used or held for use in its trade or business.

See paragraphs (d) and (e) of this section for rules regarding the directly and indirectly held assets that must be included in the determination of whether a corporation is a U.S. real property holding corporation. The term ''interest in real property located outside the United States'' means an interest other than solely as a creditor (as defined in §1.897–1(d)) in real property (as defined in §1.897–(b)) that is located outside the United States or the Virgin Islands. If a corporation qualifies as a U.S. real property holding corporation on any applicable determination date after June 18, 1980, any interest in it shall be treated as a U.S. real property interest for a period of five years from that date, unless the provisions of paragraph (f)(2) of this section are applicable.

(2) *Alternative test*—(i) *In general.* The fair market value of a corporation's U.S. real property interests shall be presumed to be less than 50 percent of the fair market value of the aggregate of its assets described in paragraphs (d) and (e) of this section if on an applicable determination date the total book value of the U.S. real property interests held by the corporation is 25 percent or less of the book value of the aggregate of the corporation's assets described in paragraphs (d) and (e) of this section.

(ii) *Definition of book value.* For purposes of this section and §1.897–1(e) the term ''book value'' shall be defined as follows. In the case of assets that are held directly by the corporation, the term means the value at which an item is carried on the financial accounting records of the corporation, if such value is determined in accordance with generally accepted accounting principles applied in the United States. In the case of assets of which a corporation is treated as holding a pro rata share pursuant to paragraphs (e) (2) and (3) of this section and § 1.897–1(e), the term ''book value'' means the corporation's share of the value at which the asset is carried on the financial accounting records of the entity that directly holds the asset, if such value is determined in accordance with generally accepted accounting principles applied in the United States. For purposes of this paragraph (b)(2)(ii), an entity need not keep all of its books in accordance with U.S. accounting principles, so long as the value of the relevant assets is determined in accordance therewith.

(iii) *Denial of presumption.* If the Internal Revenue Service determines, on the basis of information as to the fair market values of a corporation's assets, that the presumption allowed by this paragraph (b)(2) may not accurately reflect the status of the corporation, the Service will notify the corporation that it may not rely upon the presumption. The Service will provide a written notice to the corporation that sets forth the general grounds for the Service's conclusion that the presumption may be inaccurate. By the 90th day following the date on which the corporation receives the Service's notification, the corporation must determine whether on its most recent determination date it was a U.S. real property holding corporation pursuant to the general rule set forth in paragraph (b)(1) of this section and must notify the Service of its determination. If the corporation determines that it was not a U.S. real property holding corporation pursuant to the general rule, then the corporation may upon future determination dates rely upon the presumption allowed by this paragraph (b)(2), unless on the basis of additional information the Service again requests that the determination be made pursuant to the general rule. If the corporation determines that it was a U.S. real property holding corporation on its most recent determination date, then by the 180th day following the date on which the corporation received the Service's notification the corporation (if a domestic corporation) must notify each holder of an interest in it that contrary to any prior representations it was a U.S. real property holding corporation as of its most recent determination date.

(iv) *Applicability of penalties.* A corporation that had previously relied upon the presumption allowed by this paragraph (b)(2) but that is determined to be a U.S. real property holding corporation shall not be subject to penalties for any incorrect notice previously given pursuant to the requirements of paragraph (h) of this section, if:

(A) The corporation in fact carried out the necessary calculations enabling it to rely upon the presumption allowed by this paragraph (b)(2); and

(B) The corporation complies with the provisions of paragraph (b)(2)(iii) of this section. However, a corporation shall remain subject to any applicable penalties if at the time of its reliance on the presumption allowed by this paragraph (b)(2) the corporation knew that the book value of relevant assets was substantially higher or lower than the fair market value of those assets and therefore had reason to believe that under the general test of paragraph (b)(1) of this section the corporation would probably be a U.S. real property holding corporation. Information with respect to the fair market value of its assets is known by a corporation if such information is included on any books and records of the corporation or its agent, is known by its directors or officers, or is known by employees who in the course of their employment have reason to know such information. A corporation relying upon the presumption allowed by this paragraph (b)(2) has no affirmative duty to determine the fair market values of assets if such values are not otherwise known to it in accordance with the preceding sentence. The rules of this paragraph (b)(2)(iv) may be illustrated by the following examples.

Example 1. DC is a domestic corporation engaged in light manufacturing that knows that it has foreign shareholders. On its December 31, 1985 determination date DC held assets used in its trade or business, consisting largely of recently-purchased equipment, with a book value of $500,000. DC's only real property interest was a factory that it had occupied for over 50 years, which had a book value of $200,000. The factory was located in a deteriorated downtown area, and DC had no knowledge of any facts indicating that the fair market value of the property was substantially higher than its book value. Therefore, DC was entitled to rely upon the presumption allowed by §1.897–2(b)(2) and any incorrect statement pursuant to §1.897–2(h) that arose out of such reliance would not give rise to penalties.

Example 2. The facts are the same as in Example 1, except as follows. By the time of DC's December 31, 1989 determination date, the downtown area in which DC's factory was located had become the subject of an extensive urban renewal program. On December 1, 1989, the president of DC was offered $750,000 for the factory by a developer who planned to convert the property into condominiums. Because DC thus had knowledge of the fair market value of its assets which made it clear that the corporation would probably be a U.S. real property holding corporation under the general rule of §1.897–2(b)(1), DC was not entitled to rely upon the presumption allowed by §1.897–2(b)(2) after December 1, 1989, and any false statements arising out of such reliance thereafter would give rise to penalties.

(v) *Effect on interest-holders and related persons.* For the effect on interest holders and related persons of reliance on a statement issued by a corporation that made a determination as to whether it was a U.S. real property holding corporation under the provisions of §1.897–2(b), see §§1.897–2(g)(1)(ii)(A) and 1.897–2(g)(2)(ii).

(c) *Determination dates for applying U.S. real property holding corporation test*—(1) *In general.* Whether a corporation is a U.S. real property holding corporation is to be determined as of the following dates:

(i) The last day of the corporation's taxable year;

(ii) The date on which the corporation acquires any U.S. real property interest;

(iii) The date on which the corporation disposes of an interest in real property located outside the United States or disposes of other assets used or held for use in a trade or business during the calendar year, subject to the provisions of paragraph (c)(2)(i) of this section; and

(iv) In the case of a corporation that is treated pursuant to paragraph (d)(4) or (5) of this section as owning a portion of the assets held by an entity in which the corporation directly or indirectly holds an interest, the date on which that entity either (A) acquires a U.S. real property interest, (B) disposes of an interest in real property located outside the United States or (C) disposes of other assets used or held for use in a trade or business during the calendar year, subject to the provisions of paragraph (c)(2)(ii) of this section. A determination that is triggered by a transaction described in subdivision (ii), (iii), or (iv) of this paragraph (c)(1) must take such transaction into account. However, the first determination of a corporation's status need not be made until the 120th day after the later of the date of incorporation or of the date on which the corporation first acquires a shareholder. In addition, no determination of a corporation's status need be made during the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, provided that all the assets of the corporation (other than assets retained to meet claims) are distributed within such period.

(2) *Transactions not requiring a determination*—(i) *Transactions by corporation.* Notwithstanding the provisions of paragraph (c)(1) of this section, a determination of U.S. real property holding corporation status need not be made on the date of:

(A) A corporation's disposition of inventory or livestock (as described in §1.897–1(f)(1)(i) (A) and (C));

(B) The satisfaction of accounts receivable arising from the disposition of inventory or livestock or from the performance of services;

(C) The disbursement of cash to meet the regular operating needs of the business (e.g., to acquire inventory or to pay wages and salaries);

(D) A corporation's disposition of assets used or held for use in a trade or business (other than inventory or livestock) not in excess of a limitation amount determined in accordance with the rules of subdivision (iii) of this paragraph (c)(2); or

(E) A corporation's acquisition of U.S. real property interests not in excess of a limitation amount determined in accordance with the rules of subdivision (iii) of this paragraph (c)(2).

(ii) *Transactions by entity other than corporation.* Notwithstanding the provisions of paragraph (c)(1)(iv) or (c)(2)(v) of this section, in the case of a corporation that is treated as owning a portion of the assets held by an entity in which the corporation directly or indirectly holds an interest, a determination of U.S. real property holding corporation status need not be made on the date of:

(A) The entity's disposition of inventory or livestock (as described in § 1.897–1(f)(1)(i) (A) and (C));

(B) The satisfaction of accounts receivable arising from the entity's disposition of inventory or livestock or from the performance of personal services;

(C) The entity's disbursement of cash to meet the regular operating needs of its business (e.g. to acquire inventory or to pay wages and salaries);

(D) The entity's disposition of assets used or held for use in a trade or business (other than inventory or livestock) not in excess of a limitation amount determined in accordance with the rules of subdivision (iii) of this paragraph (c)(2); or

(E) The entity's acquisition of U.S. real property interests not in excess of a limitation amount determined in accordance with the rules of subdivision (iii) of this paragraph (c)(2).

(iii) *Calculation of limitation amount.* The amount of assets used or held for use in a trade or business that may be disposed of, and the amount of U.S. real property interests that may be acquired, by a corporation or other entity without triggering a determination date shall be calculated in accordance with the following rules:

(A) If, in accordance with the provisions of paragaphs (d) and (e) of this section, a corporation on its most recent determination date was considered to hold U.S. real property interests having a fair market value that was less than 25 percent of the aggregate fair market value of all the assets it was considered to hold, then the applicable limitation amount shall be 10 percent of the fair market value of all trade or business assets or all U.S. real property interests (as applicable) held directly by the corporation or by another entity described in paragraph (c)(1)(iv) of this section on that determination date.

(B) If, in accordance with the provisions of paragraphs (d) and (e) of this section, a corporation on its most recent determination date was considered to hold U.S. real property interests having a fair market value that was equal to or greater than 25 and less than 35 percent of the aggregate fair market value of all the assets it was considered to hold, then the applicable limitation amount shall be 5 percent of the fair market value of all trade or bussiness assets or all U.S. real property interests (as applicable) held directly by the corporation or by another entity described in paragraph (c)(1)(iv) of this section on that determination date.

(C) If, in accordance with the provisions of paragraphs (d) and (e) of this section, a corporation on its most recent determination date was considered to hold U.S. real property interests having a fair market value that was equal to or greater than 35 percent of the aggregate fair market value of all the assets it was considered to hold, then the applicable limitation amount shall be 2 percent of the fair market value of all trade or business assets or all U.S. real property interests (as applicable) held directly by the corporation or by another entity described in paragraph (c)(1)(iv) of this section on that determination date.

(D) If a corporation is not a U.S. real property holding corporation under the alternative test of paragraph (b)(2) of this section (relating to the book value of the corporation's assets), then the applicable limitation shall be 10 percent of the book value of all trade or business assets or all U.S. real property interests (as applicable) held directly by the corporation or by another entity described in paragraph (c)(1)(iv) of this section on the most recent determination date.

Dispositions or acquisitions by the corporation or other entity of assets having a value less than the applicable limitation amount must be cumulated by the corporation or entity making such dispositions or acquisitions, and a determination must be made on the date of a transaction that causes the total of either type to exceed the applicable limitation. Once a determination is triggered by a transaction that causes the applicable limitation to be exceeded, the computation of the amount of trade or business assets disposed of or real property interests acquired after that date shall begin again at zero.

The rules of this paragraph (c)(2) may be illustrated by the following examples.

Example 1. DC is a domestic corporation, no class of stock of which is regularly traded on an established securities market, that knows that it has several foreign shareholders. As of December 31, 1984, DC holds U.S. real property interests with a fair market value of $500,000, no real property interests located outside the U.S. and other assets used in its trade or business with a fair market value of $1,600,000. Thus, the fair market value of DC's U.S. real property interests ($500,000) is less than 25% ($525,000) of the total ($2,100,000) of DC's U.S. real property interests ($500,000), interests in real property located outside the United States (zero), and assets used or held for use in a trade or business ($1,600,000). DC is not a U.S. real property holding corporation, and under the rule of paragraph (c)(2)(i) of this section it may dispose of trade or business assets with a fair market value equal to 10 percent ($160,000) of the total fair market value ($1,600,000) of such assets held by it on its most recent determination date (December 31, 1984), without triggering a determination of its U.S. real property holding corporation status. Therefore, when DC disposes of $60,000 worth of trade or business assets (other than inventory or livestock) on March 1, 1985, and again on April 1, 1985, no determination of its status is required on either date. However, when DC disposes of a further $60,000 worth of such trade or business assets on May 1, its total dispositions of such assets ($180,000) exceeds its applicable limitation amount, and DC is therefore required to determine its U.S. real property holding corporation status. On May 1, 1985, the fair market value of DC's U.S. real property interests ($500,000) is greater than 25 percent ($480,000) and less than 35 percent ($672,000) of the total ($1,920,000) of DC's U.S. real property interests ($500,000), interests in real property located outside the United States (zero), and assets used or held for use in a trade or business ($1,420,000). DC is still not a U.S. real property holding corporation, but must now compute its applicable limitation amount as of the May 1 determination date. Under the rule of paragraph (c)(2)(iii)(B) of this section. DC could now dispose of trade or business assets other than inventory or livestock with a total fair market value equal to 5 percent of the fair market value of all trade or business assets held by DC on the May 1 determination date. Therefore, disposition of such trade or business assets with a fair market value of more than $71,000 (5 percent of $1,420,000) will trigger a further determination date for DC.

Example 2. DC is a domestic corporation, no class of stock of which is regularly traded on an established securities market, that knows that it has several foreign shareholders. As of December 31, 1986, DC's only assets are a U.S. real property interest with a fair market value of $300,000 other assets used or held for use in its trade or business with a fair market value of $600,000, and a 50 percent partnership interest in domestic partnership DP. DC's interest in DP constitutes a percentage ownership interest in the partnership of 50 percent, and pursuant to the rules of paragraph (e)(2) of this section DC is treated as owning a portion of the assets of DP determined by multiplying that percentage by the fair market value of DP's assets. As of December 31, 1986, DP's only assets are U.S. real property interests with a fair market value of $120,000 and other assets used in its trade or business with a fair market value of $380,000. As of its December 31, 1986, determination date, the fair market value ($360,000) of the U.S. real property interests DC holds ($300,000) and is treated as holding ($80,000 [The fair market value of DP's U.S. real property interest ($120,000) multiplied by DC's percentage ownership interest in DP (50 percent)]), is equal to 31 percent of the sum of the fair market values ($1,150,000) of the U.S. real property interests DC holds and is treated as holding ($360,000) DC's interest in real property located outside the United States (zero), and assets used or held for use in a trade or business that DC holds or is treated as holding ($790,000 [$600,000 (held directly) plus $190,000 (DC's 50 percent share of assets used or held for use in a trade or business by DP)]). Thus, under the rules of paragraph (c)(2) (i) and (iii)(B) of this section DC may dispose of assets used or held for use in its trade or business with a fair market value equal to 5 percent ($30,000) of the total fair market value ($600,000) of such assets held directly by it on its most recent determination date (December 31, 1986), without triggering a determination of its U.S. real property holding corporation status. In addition, under the rules of paragraph (c)(2) (ii) and (iii)(A) of this section, a determination date for DC would not be triggered by DP's disposition of trade or business assets (other than inventory or livestock) with a fair market value equal to 5 percent ($19,000) of the total fair market value ($380,000) of such assets held by it as of DC's most recent determination date (December 31, 1986). However, any disposition of such assets by DP exceeding that limitation would trigger a determination of DC's U.S. real property holding corporation status. In addition under the rule of paragraph (c)(1)(iv) of this section, any disposition of a U.S. real property interest by DP would trigger a determination date for DC, while under the rule of paragraph (c)(2)(ii) of this section no disposition of inventory or livestock by DP would trigger a determination for DC.

(3) *Alternative monthly determination dates*—(i) *In general.* Notwithstanding the provisions of paragraphs (c) (1) and (2) of this section, a corporation may choose to determine its U.S. real property holding corporation status in accordance with the rules of this paragraph (c)(3). In the case of a corporation that has determined that it is not a U.S. real property holding corporation pursuant to the alternative test of paragraph (b)(2) of this section (relating to the book value of the corporation's assets), the rules of this paragraph (c)(3) may be applied by using book values rather than fair market values in all relevant calculations.

(ii) *Monthly determinations.* A corporation that determines its U.S. real property holding corporation status in accordance with the rules of this paragraph (c)(3) must make a determination at the end of each calendar month.

(iii) *Transactional determinations.* A corporation that determines its U.S. real property holding corporation status in accordance with the rules of this paragraph (c)(3) must make a determination as of the date on which, pursuant to a single transaction (consisting of one or more transfers):

(A) U.S. real property interests are acquired, and/or

(B) Interests in real property located outside the U.S. and/or assets used or held for use in a trade or business are disposed of,

if the total fair market value of the assets acquired and/or disposed of exceeds 5 percent of the sum of the fair market values of the U.S. real property interests, interests in real property located outside the U.S., and assets used or held for use in a trade or business held by the corporation.

(iv) *Exceptions.* Notwithstanding any other provision of this paragraph (c)(3), the first determination of a corporation's status need not be made until the 120th day after the later of the date of incorporation or the date on which the corporation first acquires a shareholder. In addition, no determination of a corporation's status need be made during the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, if all the assets of the corporation (other than assets retained to meet claims) are distributed within such period.

(4) *Valuation date methods*—(i) *In general.* For purposes of determining whether a corporation is a U.S. real property holding corporation on any applicable determination date, the fair market value of the assets held by the corporation (in accordance with § 1.897–2(d)) as of that determination date must be used.

(ii) *Alternative valuation date method for determination dates other than the last day of the taxable year.* For purposes of paragraph (c)(4)(i) of this section, if an applicable determination date under paragraph (c) (1), (2), or (3) of this section is other than the last day of the taxable year, property may be valued as of the later of the last day of the previous taxable year or the date such property was acquired. For purposes of the determination date that falls on the last day of the taxable year, fair market value as of that date must always be used.

(iii) *Consistent methods.* The valuation date method selected under this paragraph (c)(4) for the first determination date in a taxable year must be used for all subsequent determination dates for such year. In addition, the valuation date method selected must be used for all property with respect to which the determination is made. The use of one method for one taxable year does not preclude the use of the other method for any other taxable year.

(5) *Illustrations.* The rules of this paragraph (c) are illustrated by the following examples:

Example 1. Nonresident alien individual C purchased 100 shares of stock of domestic corporation K on July 26, 1985. Although K has additional shares of common stock outstanding, its stock has never been traded on an established securities market. At all times during calendar year 1985, K's only assets were a parcel of U.S. real estate (parcel

A) and a parcel of country Z real estate (parcel B). On December 31, 1985, the fair market value of parcel A was $1,000,000 and the fair market value of parcel B was $2,000,000. For purposes of determining whether K was a U.S. real property holding corporation during 1985, the only applicable determination date was December 31, 1985, because K did not make any acquisitions or dispositions described in paragraph (c)(1) of this section during the year. The test of paragraph (b) of this section is applied using the fair market value of the property held on that date. K was not a U.S. real property holding corporation during 1985 because as of December 31, 1985, the fair market value ($1,000,000) of the U.S. real property interests held by K did not equal or exceed 50 percent ($1,500,000) of the sum ($3,000,000) of the fair market value of K's U.S. real property interest ($1,000,000), the interests in real property located outside the United States ($2,000,000), plus other assets used or held for use by K in a trade or business (zero).

Example 2. The facts are the same as in example 1, except that on April 7, 1986, K purchased another parcel of U.S. real estate for $2,000,000. K's purchase of real property on April 7 triggered a determination on that date. As provided in paragraph (c)(3)(ii) of this section, K chooses to use the value of parcels A and B as of the previous December 31, while newly acquired parcel C must be valued as of its acquisition on April 7, 1986. On that date, K qualifies as a U.S. real property holding corporation, since the fair market value of its U.S. real property interests ($3,000,000) exceeds 50 percent ($2,500,000) of the sum ($5,000,000) of the fair market value of K's U.S. real property interests ($3,000,000), its interests in real property located outside the U.S. ($2,000,000), and its other assets used or held for use in a trade or business (zero).

(d) *Assets held by a corporation.* The assets that must be included in the determination of whether a corporation is a U.S. real property holding corporation are the following:

(1) U.S. real property interests that are held directly by the corporation (including directly-held interests in foreign corporations that are treated as U.S. real property interests pursuant to the rules of paragraph (e)(1) of this section);

(2) Interests in real property located outside the United States that are held directly by the corporation;

(3) Assets used or held for use in a trade or business that are held directly by the corporation;

(4) A proportionate share of assets held through a partnership, trust, or estate pursuant to the rules of paragraph (e)(2) of this section; and

(5) A proportionate share of assets held through a domestic or foreign corporation in which a corporation holds a controlling interest, pursuant to the rules of paragraph (e)(3) of this section.

(e) *Special rules regarding assets held by a corporation*—(1) *Interests in foreign corporations.* For purposes only of determining whether any corporation is a U.S. real property holding corporation, an interest in a foreign corporation shall be treated as a U.S. real property interest unless it is established that the interest was not a U.S. real property interest under the rules of this section on the applicable determination date. The rules of paragraph (g)(2) of this section must be complied with to establish that the interest is not a U.S. real property interest. However, regardless of whether an interest in a foreign corporation is treated as a U.S. real property interest for this purpose, gain or loss from the disposition of an interest in such corporation will not be treated as effectively connected with the conduct of a U.S. trade or business by reason of section 897(a). The rules of this paragraph (e)(1) are illustrated by the following examples. In each example, fair market value is determined as of the applicable determination dates under paragraph (c)(4)(i) of this section.

Example 1. Nonresident alien individual F holds all of the stock of domestic corporation DC. DC's only assets are 40 percent of the stock of foreign corporation FC, with a fair market value of $500,000, and a parcel of country W real estate, with a fair market value of $400,000. Foreign corporation FP, unrelated to DC, holds the other 60 percent of the stock of FC. FC's only asset is a parcel of U.S. real estate with a fair market value of $1,250,000. FC is a U.S. real property holding corporation because the fair market value of its U.S. real property interests ($1,250,000) exceeds 50 percent ($625,000) of the sum of the fair market values of its U.S. real property interests ($1,250,000), its interests in real property located outside the United States (zero), plus its other assets used or held for use in a trade or business (zero). Consequently DC's interest in FC is treated as a U.S. real property interest under the rules of this paragraph (e)(1). DC is a U.S. real property holding corporation because the fair market value ($500,000) of its U.S. real property interest (the stock of FC) exceeds 50 percent ($450,000) of the sum

($900,000) of the fair market value of its U.S. real property interests ($500,000), its interests in real property located outside the United States ($400,000), plus its other assets used or held for use in a trade or business (zero). If F disposes of her stock within 5 years of the current determination date, her gain or loss on the disposition of her stock in DC will be treated as effectively connected with a U.S. trade or business under section 897(a). However, FP's gain on the disposition of its FC stock would not be subject to the provisions of section 897(a) because the stock of FC is a U.S. real property interest only for purposes of determining whether DC is a U.S. real property holding corporation.

Example 2. Nonresident alien individual B holds all of the stock of domestic corporation US. US's only assets are 40 percent of the stock of foreign corporation FC1. Nonresident alien individual N, unrelated to US, holds the other 60 percent of FC1's stock. FC1's only assets are 40 percent of the stock of foreign corporation FC2. The remaining 60 percent of the stock of FC2 is owned by nonresident alien individual X, who is unrelated to FC1. FC2's only asset is a parcel of U.S. real estate with fair market value of $1,000,000. FC2, therefore, is a U.S. real property holding corporation, and the stock of FC2 held by FC1 is a U.S. real property interest for purposes of determining whether FC1 is a U.S. real property holding corporation (but not for purposes of treating FC1's gain from the disposition of FC2 stock as effectively connected with a U.S. trade or business under section 897(a)). As all of FC1's assets are U.S. real property interests, the stock of FC1 held by US is a U.S. real property interest for purposes of determining whether US is a U.S. real property holding corporation (but not for purposes of subjecting N's gain on the dispositon of FC1 stock to the provisions of section 897(a)). As US is a domestic corporation and as all of its assets are U.S. real property interests, US is a U.S. real property holding corporation, and the stock of US held by B is a U.S. real property interest for purposes of section 897(a)). Therefore, B's gain or loss upon the disposition of the stock of US within 5 years of the most recent determination date is subject to the provisions of section 897(a).

(2) Proportionate ownership of assets held by partnerships, trusts, and estates. For purposes of determining whether a corporation is a U.S. real property holding corporation, a holder of an interest in a partnership, a trust, or an estate (whether domestic or foreign) shall be treated pursuant to section 897(c)(4)(B) as holding a proportionate share of the assets held by the entity. However, a holder of an interest shall not be treated as holding a proportionate share of assets that in the hands of the entity are subject to the rule of § 1.897–1(f)(3)(ii) (concerning the trade or business assets of investment companies). Such proportionate share is to be determined in acordance with the rules of § 1.897–1(e) on each applicable determination date. The interest in the entity shall itself be disregarded when a proportionate share of the entity's assets is attributed to the interest-holder pursuant to the rule of this paragraph (e)(2). Any asset treated as held by a holder of an interest by reason of this paragraph (e)(2) which is used or held for use in a trade or business by the partnership, trust, or estate shall be treated as so used or held for use by the holder of the interest. The proportionate ownership rule of this paragraph (e)(2) applies successively upward through a chain of ownership. The proportionate ownership rule of this paragraph (e)(2) is illustrated by the following examples. In each example fair market value is determined as of the applicable determination date under paragraph (c)(4)(i) of this section.

Example 1. Nonresident alien individual F holds all of the stock of domestic corporation DC. DC is a partner in foreign partnership FP, and DC's percentage ownership interest in FP is 50 percent. DC's other assets are a parcel of country F real estate with a fair market value of $500,000 and other assets which it uses in its business with a fair market value of $100,000, FP's assets are a parcel of country Z real estate with a fair market value of $300,000 and a parcel of U.S. real estate with a fair market value of $2,000,000. For purposes of determining whether DC is a U.S. real property holding corporation, DC is treated as holding its pro rata share of the assets held by FP. DC's pro rata share of the U.S. real estate held by FP is $1,000,000, determined by multiplying the fair market value ($2,000,000) of the U.S. real property interests held by FP by DC's percentage ownership interest in FP (50 percent). DC's pro rata share of the country Z real estate held by FP is $150,000, determined in the same manner. DC is a U.S. real property holding corporation because the fair market value ($1,000,000) of its U.S. real property interests (the U.S. real estate it is treated as holding proportionately) exceeds 50 percent ($875,000) of the sum ($1,750,000) of the fair market value of its U.S. real property interests

($1,000,000), its interests in real property located outside the United States [($650,000) (its country F real estate and its pro rata share of the country Z real estate)], plus its other assets which are used or held for use in a trade or business ($100,000). Because DC is a domestic U.S. real property holding corporation, the stock of DC is a U.S. real property interest and F's gain or loss on the disposition of this DC stock within 5 years of the current determination date will be treated as effectively connected with a U.S. trade or business under section 897(a).

Example 2. Nonresident alien individual B holds all of the stock of domestic corporation US. US is a beneficiary of foreign trust FT. US's percentage ownership interest in FT is 90 percent. US has no other assets. FT is a partner in domestic partnership DP. FT's percentage ownership interest in DP is 30 percent. FT has no other assets. DP's only asset is a parcel of U.S. real estate with a fair market value of $1,000,000. FT is treated as holding U.S. real estate with a fair market value of $300,000 (30 percent of the U.S. real estate held by DP with a fair market value of $1,000,000). For purposes of determining whether US is a U.S. real property holding corporation, the proportionate ownership rule is applied successively upward through the chain of ownership. Thus, US is treated as holding 90 percent of FT's $300,000 pro rata share of the U.S. real estate held by DP. US is a U.S. real property holding corporation because the fair market value ($270,000) of its U.S. real property interests (its pro rata share of the U.S. real estate held by DP) exceeds 50 percent ($135,000) of the sum of the fair market values of its U.S. real property interests ($270,000), its interests in real property located outside the United States (zero), plus its other assets used or held for use in a trade or business (zero). Because US is a domestic U.S. real property holding corporation, the stock of US is a U.S. real property interest, and B's gain or loss from the disposition of US stock within 5 years of the current determination date will be treated as effectively connected with a U.S. trade or business under section 807(a).

(3) *Controlling interests in corporations.* For purposes only of determining whether a corporation is a U.S. real property holding corporation, if the corporation (the ''first corporation'') holds a controlling interest in a second corporation—

(i) The first corporation is treated as holding a proportionate share of each asset (i.e., U.S. real property interests, interests in real property located outside the United States, and assets used or held for use in a trade or business) held by the second corporation, determined in accordance with the rules of §1.897–1(e);

(ii) Any asset so treated as held proportionately by the first corporation which is used or held for use by the second corporation in a trade or business shall be treated as so used or held for use by the first corporation; and

(iii) Interests in the second corporation held by the first corporation are not themselves taken into account as U.S. real property interests (regardless of whether the second corporation is a U.S. real property holding corporation) or as trade or business assets. However, the first corporation shall not be treated as holding a proportionate share of assets that in the hands of the second corporation are subject to the rules of §1.897–1(f)(3)(ii) (concerning the trade or business assets of investment companies). A determination of what portion of the assets of the second corporation are considered to be held by the first corporation shall be made as of the applicable dates for determining whether the first corporation is a U.S. real property holding corporation.

A ''controlling interest'' means 50 percent or more of the fair market value of all classes of stock of the corporation, determined as of the applicable determination date. In determining whether a corporation holds a controlling interest in another corporation, section 318(a) shall apply (except that sections 318(a)(2)(C) and (3)(C) are applied by substituting the phrase ''5 percent'' for ''50 percent''). However, a corporation that does not directly hold any interest in a second corporation shall not be treated as holding a controlling interest in the second corporation by reason of the application of section 318(a)(3)(C). The rules of this paragraph (e)(3) apply successively upward through a chain of ownership. For example, if the second corporation owns a controlling interest in a third corporation, the rules of this paragraph shall be applied first to determine the portion of the assets of the third corporation that is considered to be held by the second corporation and then to determine the portion of the assets held and considered to be held by the second corporation that is considered to be held by the first corporation. The controlling interest rules of this paragraph (e)(3) apply, regardless of whether a corporation is domestic or foreign, whenever it is necessary to determine whether a corporation is a U.S. real property holding corporation. The rules of this paragraph (e)(3) are illustrated by the following examples. In each example fair market value is determined as of the applicable determination date under paragraph (c)(4)(i) of this section and no corporation holds constructively any interest not specified in the example.

Example 1. Nonresident alien individual N owns all of the stock of domestic corporation DC. DC's only assets are 60 percent of the fair market value of all classes of stock of foreign corporation FS and 60 percent of the fair market value of all classes of stock of domestic corporation DS. The percentage ownership interest of DC in each of FS and DS is 60 percent. The balance of the stock in FS and DS is held by nonresident alien individual B, who is unrelated to DC. FS's only asset is a parcel of country F real estate with a fair market value of $1,000,000. DS's only asset is a parcel of U.S. real estate with a fair market value of $2,000,000. The value of DC stock in FS and DS is not taken into account for purposes of determining whether DC is a U.S. real property holding corporation. Rather, because DC holds a controlling interest (60 percent) in each of FS and DS, DC is treated as holding a portion of each asset held by FS and DS. DC's portion of the country F real estate held by FS is $600,000, determined by multiplying the fair market value ($1,000,000) of the country F real estate by DC's percentage ownership interest (60 percent). Similarly, DC's portion of the U.S. real estate held by DS is $1,200,000 (60 percent of $2,000,000). DC is a U.S. real property holding corporation, because the fair market value ($1,200,000) of its U.S. real property interests (its portion of the U.S. real estate) exceeds 50 percent ($900,000) of the sum ($1,800,000) of the fair market values of its U.S. real property interests ($1,200,000), its interests in real property located outside the United States (the $600,000 portion of country F real estate), plus its other assets used or held for use in a trade or business (zero). Because DC is a domestic U.S. real property holding corporation, the stock of DC is a U.S. real property interest, and N's gain or loss on the disposition of DC stock within 5 years of the current determination date would be treated as effectively connected with a U.S. trade or business under section 897(a).

Example 2. (i) Nonresident alien individual F owns all of the stock of domestic corporation US1. US1's only asset is 85 percent of the fair market value of all classes of stock of domestic corporation US2. US2's only assets are 60 percent of the fair market value of all classes of stock of domestic corporation US3, with a fair market value of $600,000, and a parcel of country D real estate with a fair market value of $800,000. US3's only asset is a parcel of U.S. real estate with a fair market value of $2,000,000. The percentage ownership interest of F in US1 is 100 percent.

Although US1 owns 85 percent of the stock of US2, US1's percentage ownership interest in US2 is 75 percent, because US2 has other interests other than solely as a creditor outstanding. US2's percentage ownership interest in US3 is 60 percent.

(ii) US2 holds a controlling interest in US3, since it holds more than 50 percent of the fair market value of all classes of stock of US3. Consequently, the value of US2's stock in US3 is not taken into account in determining whether US2 is a U.S. real property holding corporation, even though US3 is a U.S. real property holding corporation. Instead, US2 is treated as holding a portion of the U.S. real estate held by US3. US2's portion of the U.S. real estate is $1,200,000, determined by multiplying US2's percentage ownership interest (60 percent) by the fair market value ($2,000,000) of the U.S. real estate. US1 holds a controlling interest in US2 (75 percent.). By reapplying the rules of paragraph (e)(3) of this section successively upward through the chain of ownership, US1's stock in US2 is not taken into account, and US1 is treated as holding a portion of the country D real estate held by US2 and the U.S. real estate which US2 is treated as holding proportionately. US1's portion of the country D real estate is $600,000, determined by multiplying US1's percentage ownership interest (75 percent) by the fair market value ($800,000) of the country D real estate. US1's portion of the U.S. real estate which US2 is treated as owning is $900,000, determined by multiplying US1's percentage ownership interest (75 percent) by the fair market value ($1,200,000) of US2's portion of U.S. real estate held by US3. US1 is a U.S. real property holding corporation, because the fair market value ($900,000) of its U.S. real property interests (its portion of US2's portion of U.S. real estate) is more than 50 percent ($750,000) of the sum ($1,500,000) of fair market values of its U.S. real property interests ($900,000), its interests in real property located outside the United States ($800,000), plus its other assets need or held for use in a trade or business (zero). Because US1 is a U.S. real property holding corporation and is a domestic corporation, the stock of US1 is a U.S. real property interest, and F's gain or loss on the disposition of US1 stock within 5 years of the current determination date will be treated as effectively connected with a U.S. trade or business under section 897(a).

Example 3. Nonresident alien individual B holds all of the stock of domestic corporation DC. DC's only assets are 40 percent of the fair market value of all classes of stock of foreign corporation FC and a parcel of country R real estate with a fair market value of $100,000. FC's only asset is one parcel of U.S. real estate with a fair market value of $1,000,000. The fair market value of the FC stock held by DC is $200,000. FC is a U.S. real property holding corporation. Since DC does not hold a controlling interest in FC, the controlling interest rules of paragraph (e)(3) of this section do not apply to treat DC as holding a portion of the U.S. real estate held by FC. However, because FC is a U.S. real property holding corporation, the stock of FC is a U.S. real property interest for purposes of determining whether DC is a U.S. real property holding corporation. DC is a U.S. real property holding corporation because the fair market value ($200,000) of its U.S. real property interest (the stock of FC) exceeds 50 percent ($150,000) of the sum ($300,000) of the fair market values of its U.S. real property interest ($200,000), its interests in real property located outside the United States ($100,000), plus its other assets used or held for use in a trade or business (zero). Because DC is a U.S. real property holding corporation and is a domestic corporation, its stock is a U.S. real property interest, and B's gain or loss on the disposition of DC stock within 5 years of the current determination date would be subject to the provisions of section 897(a).

Example 4. Nonresident alien individual C owns all of the stock of domestic corporation DC1. DC1's only assets are 25 percent of the fair market value of all classes of stock of domestic corporation DC2, and a parcel of U.S. real estate with a fair market value of $100,000. The stock of DC2 is not an asset used or held for use in DC1's trade or business. DC2's only assets are a building located in the U.S. with a fair market value of $100,000 and manufacturing equipment and inventory with a fair market value of $200,000, DC2 is not a U.S. real property holding corporation. Since DC1 does not hold a controlling interest in DC2, the rules of this paragraph (e)(3) do not apply to treat DC1 as holding a portion of the assets held by DC2. In addition, since DC2 is not a U.S. real property corporation, its stock does not constitute a U.S. real property interest. Therefore, for purposes of determining whether DC1 is a real property holding corporation, its interest in DC2 is not taken into account. Since DC1's only other asset is a parcel of U.S. real estate, DC1 is a U.S. real property holding corporation, and C's gain or loss on the disposition of DC1 stock within 5 years of the current determination date would be subject to the provisions of section 897(a).

(4) *Co-application of rules of this paragraph (e).* The rules of this paragraph (e) apply in conjunction with one another for purposes of determining whether a corporation is a U.S. real property holding corporation. The rule of this paragraph (e)(4) is illustrated by the following example. In the example fair market value is determined as of the applicable determination date in accordance with paragraph (c)(4)(i) of this section.

Example. Nonresident alien individual B holds 100 percent of the stock of domestic corporation US. US's only asset is 10 percent of the stock of foreign corporation FC1. FC1's only asset is 100 percent of the stock of foreign corporation FC2. FC2's only asset is a 50 percent interest in domestic partnership DP. FC2's percentage ownership interest in DP is 50 percent. DP's only asset is a parcel of U.S. real estate with a fair market value of $10,000,000. In determining whether US is a U.S. real property holding corporation, the rules of this paragraph (e) apply in conjunction with one another. Consequently, under paragraph (e)(2) of the section FC2 is treated as holding U.S. real estate with a fair market value of $5,000,000 (50 percent of $10,000,000, its pro rata share of real estate held by DP). Under paragraph (e)(3) of this section, FC1 is treated as holding 100 percent of the assets of FC2 (U.S. real estate with a fair market value of $5,000,000). FC1, therefore, is a U.S. real property holding corporation. Under paragraph (e)(1) of this section, the stock of FC1 is treated as U.S. real property interest. US is a U.S. real property holding corporation because 100 percent of its assets (the stock of FC1) are U.S. real property interests. As US is a U.S. real property holding corporation and is a domestic corporation, the stock of US is a U.S. real property interest, and B's gain or loss from the disposition of stock of US within 5 years of the current determination date will be subject to the provisions of section 897(a).

(f) *Termination of U.S. real property holding corporation status*—(1) *In general.* A U.S. real property holding corporation may voluntarily determine its status as of the date of any acquisition or dispositon of assets. If the fair market value of its U.S. real property interests on such date no longer equals or exceeds 50 percent of the fair market value of all assets described in paragraphs (d) and (e) of this section, such corporation shall cease to be U.S. real property holding corporation as of such date, and on the day that is five years after such date interests in such corporation shall cease to be treated as U.S. real property interests (unless subsequent transactions within the five-year period have caused the fair market value of the corporation's U.S. real property interests to equal or exceed 50 percent of the fair market value of assets described in paragraphs (d) and (e) of this section). A corporation that determines that interests in it have ceased to be U.S. real property interests pursuant to the rules of this paragraph (f) may so inform the Internal Revenue Service, as provided in paragraph (h) of this section.

(2) *Early termination.* Interests in a U.S. real property holding corporation shall immediately cease to be U.S. real property interests as of the first date on which the following conditions are met—

(i) The corporation does not hold any U.S. real property interests, and

(ii) All of the U.S. real property interests directly or indirectly held by such corporation at any time during the previous five years (but disregarding any disposed of before June 19, 1980) either (A) were directly of indirectly disposed of in transactions in which the full amount of the gain (if any) was recognized or (B) ceased to be U.S. real property interests by reason of the application of this paragraph (f) to one or more other corporations.

For purposes of this paragraph (f)(2), a corporation that disposes of all U.S. real property interests other than a lease that has a fair market value of zero will be considered to have disposed of all of its U.S. real property interests, provided that the leased property is used in the conduct by the corporation of a trade or business in the United States. Such a lease may include an option to renew, but only if such option is for a renewal at fair market rental rates prevailing at the time of renewal.

(g) *Establishing that a corporation is not a U.S. real property holding corporation*—(1) *Foreign persons disposing of interests*—(i) *In general.* A foreign person disposing of an interest in a domestic corporation (other than an interest solely as a creditor) must establish that the interest was not a U.S. real property interest as of the date of disposition, either by:

(A) Obtaining a statement from the corporation pursuant to the provisions of subdivision (ii) of this paragraph (g)(1), or

(B) Obtaining a determination by the Director, Foreign Operations District (''Director'') pursuant to the provisions of subdivision (iii) of this paragraph (g)(1).

If the foreign person does not establish by either method that the interest disposed of was not a U.S. real property interest then the interest shall be presumed to have been a U.S. real property interest the disposition of which is subject to section 897(a). See paragraph (g)(3) of this section for certain exceptions to this rule. It should be noted that the rules of this section relate solely to interests in a corporation that are interests other than solely as a creditor. Therefore, a statement by a corporation or a determination by the Director (under paragraphs (g) or (h) of this section) that an interest is not a U.S. real property interest depends solely upon whether or not the corporation was a U.S. real property holding corporation during the period described in section 897(c)(1)(A)(ii) (subject to certain special rules). The determination of whether an interest is one solely as a creditor is made under the rules of § 1.897–1(d).

(ii) *Statement from corporation*—(A) *In general.* A foreign person disposing of an interest in a domestic corporation may establish that the interest was not a U.S. real property interest as of the date of the disposition by requesting and obtaining from the corporation a statement that the interest was not a U.S. real property interest as of that date. However, a corporation's statement shall not be valid for purposes of this rule, and thus may not be relied upon for purposes of establishing that an interest was not a U.S. real property interest, unless the corporation complies with the notice requirements of paragraph (h) (2) or (h)(4) of this section.

A foreign person that requests and obtains such a statement is not required to forward the statement to the Internal Revenue Service and is not required to take any further action to establish that the interest disposed of was not a U.S. real property interest. To qualify under this rule, the foreign person must obtain the corporation's statement no later than the date, including any extensions, on which a tax return would otherwise be due with respect to a disposition. A foreign person that relies in good faith upon a statement from the corporation is not thereby excused from filing a return and paying any taxes and interest due thereon if the corporation's statement is later found to have been incorrect. However, such reliance shall be taken into account in determining whether the foreign person shall be subject to any penalty for the previous failure to file. However, a foreign person that knew or had reason to know that a corporation's statement was incorrect is not entitled to rely upon such statement and shall remain liable for all applicable penalties.

(B) *Coordination with section 1445.* Pursuant to section 1445 and regulations thereunder, withholding of tax is not required with respect to a foreign person's disposition of an interest in a domestic corporation, if the transferee is furnished with a statement by the corporation under paragraph (h) of this section that the interest is not a U.S. real property interest. A foreign person that obtains a corporation's statement for that purpose prior to the date of disposition may also rely upon the statement for purposes of this paragraph (g)(1)(ii), unless the corporation informs the foreign person (pursuant to paragraph (h)(1)(iv)(C) of this section) that it became a U.S. real property holding corporation after the date of the notice but prior to the actual date of disposition.

(iii) *Determination by Director*—(A) *In general.* A foreign person disposing of an interest in a domestic corporation may establish that the interest was not a U.S. real property interest as of the date of disposition by requesting and obtaining a determination to that effect from the Director. Such a determination may be requested pursuant to the provisions of subdivision (B) or (C) of this paragraph (g)(1)(iii). A request for a determination should be addressed to: Director, Foreign Operations District, 1325 K St. NW, Washington, DC 20225. A foreign transferor who has requested a determination by the Director pursuant to the rules of this paragraph (g)(1)(iii) is not thereby excused from filing a return and paying any tax due by the date, including any extensions, on which such return and payment would otherwise be due with respect to a disposition. If the Director subsequently determines and notifies the foreign transferor that the interest was not a U.S. real property interest, the foreign transferor shall be entitled to a refund of any taxes, penalties, and interest paid by reason of the application of section 897(a) pursuant to the rules of paragraph (g)(1)(i) of this section, together with any interest otherwise due on such refund, if a claim for refund is made within the applicable time limits.

(B) *Determination based on Director's information.* A foreign person may request that the Director make a determination based on information contained in the Director's records, if:

(1) The foreign person made a request to the corporation for information as to the status of its interest no later than the 90th day before the date, including any extensions, on which a tax return would otherwise be due with respect to a disposition, and

(2) The corporation failed to respond to such request by the 30th day following the date the request was delivered to the corporation.

If the Director is unable to make a determination based on information available to him, he shall inform the foreign person that the interest must be treated as a U.S. real property interest unless the person subsequently obtains either the necessary statement from the corporation or a determination pursuant to subdivision (C) of this paragraph (g)(1)(iii).

(C) *Determination based on information supplied by foreign person.* A foreign person may request that the Director make a determination based on information supplied by the foreign person. Such information may be drawn, for example, from annual reports, financial statements, or records of the corporation, and must establish to the satisfaction of the Director that the foreign person's interest was not a U.S. real property interest as of the date of disposition.

(D) *Determination by Director on his own motion.* Notwithstanding any other provision of this section, a foreign person shall not treat the disposition of an interest in a domestic corporation as a disposition of a U.S. real property interest if such person is notified that the Director has upon his own motion determined that the interest was not a U.S. real property interest as of the date of disposition.

(2) *Corporations determining U.S. real property holding corporation status*—(i) *In general.* A corporation that must determine whether it is a U.S. real property holding corporation, and that holds an interest in another corporation (other than a controlling interest as defined in paragraph (e)(3) of this section), must determine whether or not that interest was a U.S. real property interest as of its own determination date, by either:

(A) Obtaining a statement from the second corporation pursuant to the provisions of subdivision (ii) of this paragraph (g)(2);

(B) Obtaining a determination by the Director pursuant to the provisions of subdivision (iii) of this paragraph (g)(2); or

(C) Making an independent determination pursuant to the provisions of subdivision (iv) of this paragraph (g)(2).

A corporation that is unable to determine by any of the above methods whether its interest in a second corporation is a U.S. real property interest must presume that such interest is a U.S. real property interest.

(ii) *Statement from corporation.* A corporation may determine whether or not an interest in a second corporation was a U.S. real property interest as of its own determination date by obtaining from the second corporation a statement that the interest was not a U.S. real property interest as of that date. However, the second corporation's statement shall not be valid for purposes of this rule, and thus may not be relied upon for purposes of establishing that an interest was not a U.S. real property interest, unless such corporation complies with the notice requirements of paragraph (h)(2) or (h)(4) of this section.

A corporation that requests and obtains such a statement is not required to forward the statement to the Internal Revenue Service and is not required to take any further action to establish that the interest in the second corporation was not a U.S. real property interest. If the second corporation's statement is later found to have been incorrect, the first corporation shall not be subject to penalties arising out of past failures to comply with the requirements of section 897 or 1445, if such failures were attributable to reliance upon the second corporation's statement. By the 90th day following receipt of a notification from the Service or from the second corporation that a prior statement was incorrect, the first corporation must redetermine its status (as of its most recent determination date) and if appropriate notify the Internal Revenue Service that it is a U.S. real property holding corporation in accordance with paragraph (h)(1)(ii)(C) of this section. However, a corporation that knew or had reason to know that a second corporation's statement was incorrect is not entitled to rely upon such statement and shall remain liable for all applicable taxes, penalties, and interest arising out of the second corporation's status as a U.S. real property holding corporation.

(iii) *Determination by Director*—(A) *In general.* A corporation may determine whether or not an interest in a second corporation was a U.S. real property interest as of its own determination date by requesting and obtaining a determination to that effect from the Director. Such a determination may be requested pursuant to the provisions of subdivision (B) or (C) of this paragraph (g)(2)(iii). A request for a determination must be addressed to: Director, Foreign Operations District, 1325 K St. NW.; Washington, DC 20225. A corporation that has requested a determination by the Director pursuant to the provisions of this paragraph is not thereby excused from taking any action required by section 897 or 1445 by the date on which such action would otherwise be due. However, the Director may grant a reasonable extension of time for the satisfaction of any requirement if the Director is satisfied that the corporation has not sought a determination pursuant to this paragraph (g)(2)(iii) for a principal purpose of delay.

(B) *Determination based on Director's information.* A corporation may request that the Director make a determination based on information contained in the Director's records, if:

(*1*) The corporation made a request to the second corporation for information as to the status of its interest no later than the fifth day following the first corporation's determination date, and

(*2*) The second corporation failed to respond to such request by the 30th day following the date the request was delivered to the second corporation.

Pending his resolution of such a request, the Director will generally grant an extension with respect to the change-of-status notification that may otherwise be required pursuant to paragraph (h)(1)(ii) of this section. If the Director is unable to make a determination based on information available to him, he shall inform the corporation that the interest must be treated as a U.S. real property interest unless the corporation subsequently obtains either the necessary statement from the second corporation or a determination pursuant to paragraph (g)(2)(iii)(C) or (g)(2)(iv) of this section.

(C) *Determination based on information supplied by corporation.* A corporation may request that the Director make a determination based on information supplied by the corporation. Such information may be drawn, for example, from annual reports, financial statements, or records of the second corporation, and must establish to the satisfaction of the Director that the interest in the second corporation was not a U.S. real property interest as of the first corporation's determination date.

(D) *Determination by Director on his own motion.* Notwithstanding any other provision of this section, a corporation shall not treat an interest in a second corporation as a U.S. real property interest if the corporation is notified that the Director has upon his own motion determined that the interest in the second corporation is not a U.S. real property interest.

(iv) *Independent determination by corporation.* A corporation may independently determine whether or not an interest in a second corporation was a U.S. real property interest as of the first corporation's own determination date. Such determination must be based upon the best evidence available, drawn from annual reports, financial statements, records of the second corporation, or from any other source, that demonstrates to a reasonable certainty that the interest in the second corporation was not a U.S. real property interest. A corporation that makes an independent determination pursuant to this paragraph (g)(2)(iv) shall be subject to the special notification rule of paragraph (h)(1)(iii)(D) of the section. If the Director subsequently determines that the corporation's independent determination was incorrect, the corporation shall be subject to penalties for any past failure to comply with the requirements of section 897 or 1445 only if the corporation's determination was unreasonable in view of facts that the corporation knew or had reason to know.

(3) *Requirements not applicable.* If at any time during the calendar year any class of stock of a corporation is regularly traded on an established securities market, the requirements of this paragraph (g) shall not apply with respect to any holder of an interest in such corporation other than a person who holds an interest described in § 1.897–1(c)(2)(iii) (A) or (B). For example, a corporation determining whether it is a U.S. real property holding corporation need not ascertain from a regularly traded corporation in which it neither holds, nor has held during the period described in section 897(c)(1)(A)(ii), more than a 5 percent interest whether that regularly traded corporation is itself a U.S. real property holding corporation.

In addition, the requirements of this paragraph (g) do not apply to any holder of an interest in a domestically-controlled RETT, as defined in section 897(h)(4)(B).

(h) *Notice requirements applicable to corporations*—(1) *Statement to foreign interest-holder*—(i) *In general.* A domestic corporation must, within a reasonable period after receipt of a request from a foreign person holding an interest in it, inform that person whether the interest constitutes a U.S. real property interest. No particular form is required for this statement, which need only indicate the corporation's determination. The statement must be dated and signed by a responsible corporate officer who must verify under penalties of perjury that the statement is correct to his knowledge and belief.

(ii) *Required determination.* For purposes of the statement required by paragraph (h)(1)(i) of this section, an interest in a corporation is a U.S. real property interest if the corporation was a U.S. real property holding corporation on any determination date during the 5-year period ending on the date specified in the interest-holder's request, or on the date such request was received if no date is specified (or during such shorter period ending on the date that is applicable pursuant to section 897(c)(1)(A)(ii). However, an interest in a corporation is not a U.S. real property interest if such interest is excluded under section 897(c)(1)(B).

(2) *Notice to the Internal Revenue Service.* If a foreign interest holder requests that a domestic corporation provide a statement described in paragraph (h)(1) of this section, then such corporation must provide a notice to the Internal Revenue Service in accordance with this paragraph (h)(2). No particular form is required for such notice, but the following must be provided:

(i) A statement that the notice is provided pursuant to the requirements of § 1.897–2(h)(2);

(ii) The name, address, and identifying number of the corporation providing the notice;

(iii) The name, address, and identifying number (if any) of the foreign interest holder that requested the statement (this information may be omitted from the notice if fully set forth in the statement to the foreign interest holder attached to the notice).

(iv) Whether the interest in quesiton is a U.S. real property interest;

(v) A statement signed by a responsible corporate officer verifying under penalties of perjury that the notice (including any attachments thereto) is correct to his knowledge and belief. A copy of any statement provided to the foreign interest holder must be attached to the notice. The notice must be mailed to the Assistant Commissioner (International), Director, Office of Compliance, OP:I:C:E:666, 950 L'Enfant Plaza South, SW , COMSAT Building, Washington, DC 20024 on or before the 30th day after the statement referred to in § 1.897–2(h)(1) is mailed to the interest holder that requested it. Failure to mail such notice within the time period set forth in the preceding sentence will cause the statement provided pursuant to § 1.897–2(h)(1) to become an invalid statement.

(3) *Requirements not applicable.* The requirements of this paragraph (h) do not apply to domestically-controlled REITS, as defined in section 897(h)(4)(B). These requirements also do not apply to a corporation any class of stock in which is regularly traded on an established securities market at any time during the calendar year. However, such a corporation may voluntarily choose to comply with the requirements of paragraph (h)(4) of this section.

(4) *Voluntary notice to Internal Revenue Service*—(i) *In general.* A domestic corporation which determines that it is not a U.S. real property holding corporation—

(A) On each of the applicable determination dates in a taxable year, or

(B) Pursuant to section 897(c)(1)(B), may attach to its income tax return for that year a statement informing the Internal Revenue Service of its determination. A corporation that has provided a voluntary notice described in this § 1.897–2(h)(4)(i) for the immediately preceding taxable year and that does not have an event described in § 1.897–2(c)(1) (ii), (iii) or (iv) prior to receiving a request from a foreign person under § 1.897–2(h)(1), is exempt from the notice requirement of § 1.897–2(h)(2).

(ii) *Early termination of real property holding corporation status.* A corporation that determines during the course of its taxable year that interests in it have ceased to be U.S. real property interests pursuant to the rules of section 897(c)(1)(B) may, on the day of its determination or thereafter, provide a statement to the Assistant Commissioner (International); Director, Office of Compliance, OP:I:C:E: 666; 950 L'Enfant Plaza South, SW.; COMSAT Building; Washington, DC 20024, informing the Service of its determination. No particular form is required but the statement must set forth the corporation's name, address, identification number, a brief statement regarding its determination and the date such determination was made. Such statement will enable foreign interest-holders to dispose of their interests without being subject to section 897(a), as provided in paragraph (g) of this section.

(5) *Supplemental statements*—(i) *By corporations with substantial intangible assets.* A corporation that is subject to the requirements of paragraph (h)(2) of this section (or that voluntarily complies with the requirements of paragraph (h)(4) of this section) must submit a supplemental statement to the Internal Revenue Service if—

(A) Such corporation values any of the intangible assets described in §1.897–1(f)(1)(ii) (other than goodwill or going concern value) by a method other than the purchase price or book value methods described in §1.897–1(o)(4); and

(B) The fair market value of such intangible assets equals or exceeds 25 percent of the total of the fair market values of the assets the corporation is considered to hold in accordance with the provisions of paragraphs (d) and (e) of this section.

The supplemental statement must inform the Internal Revenue Service that the corporation meets the criteria of subdivisions (A) and (B) of this paragraph (h)(5)(i), and must summarize the methods and calculations upon which the corporation's determination of the fair market value of its intangible assets is based. In addition, the supplemental statement must list any intangible assets that were purchased from any person that have been valued by the corporation at an amount other than their purchase price, and must provide a justification for such a departure from the purchase price. The supplemental statement must be attached to or incorporated in the statement provided under paragraph (h)(2) or (h)(4) of this section.

(ii) *Corporation not valuing goodwill or going concern value at purchase price.* A corporation that is subject to the requirements of paragraph (h)(2) of this section (or that voluntarily complies with the requirements of paragraph (h)(4) of this section) must submit a supplemental statement to the Internal Revenue Service if such corporation values goodwill or going concern value pursuant to §1.897–1(o)(4)(iii). The supplemental statement must set forth that it is made pursuant to this paragraph (h)(5)(ii), and must summarize the methods and calculations upon which the corporation's determination of the fair market value of such intangible assets is based. In addition, the supplemental statement must list any such assets that were purchased from any person that have been valued by the corporation at an amount other than their purchase price, and must provide a justification for such a departure from the purchase price. The supplemental statement must be attached to or incorporated in the statement provided under paragraph (h)(2) or (h)(4) of this section.

(iii) *Corporation using alternative U.S. real property holding corporation test.* A corporation that is subject to the requirements of paragraph (h)(2) of this section (or that voluntarily complies with the requirements of paragraph (h)(4) of this section) must submit a supplemental statement to the Internal Revenue Service if—

(A) Such corporation utilizes the rule of paragraph (b)(2) of this section (regarding the book values of assets held by the corporation) to presume that it is not a U.S. real property holding corporation; and

(B) Such corporation is engaged in or is planning to engage in a trade or business of mining, farming, or forestry, or of buying and selling or developing real property, or of leasing real property to tenants.

The supplemental statement must inform the Internal Revenue Service that the corporation meets the criteria of subdivisions (A) and (B) of this paragraph (h)(5)(iii), and must be attached to or incorporated in the statement provided under paragraph (h)(2) or (h)(4) of this section.

(iv) *Corporation determining real property holding corporation status of second corporation.* A corporation that is subject to the requirements of paragraph (h)(2) of this section (or that voluntarily complies with the requirements of paragraph (h)(4) of this section) must submit a supplemental statement to the Internal Revenue Service if such corporation independently determines whether or not an interest in a second corporation is a U.S. real property interest, pursuant to paragraph (g)(2)(iv) of this section. The supplemental statement must set forth that it is made pursuant to this paragraph (h)(5)(iv) and must briefly summarize the facts upon which the corporation's determination is based and the sources of the information relied upon by the corporation. The supplemental statement must be attached to or incorporated in the statement provided under paragraph (h)(2) or (h)(4) of this section.

(i) *Transition Rules*—(1) *General waiver of penalties for failure to file.* If a foreign person disposed of an interest in a domestic corporation between June 18, 1980 and January 23, 1987, and such person establishes under the rules of paragraph (g) of this section at any time that the interest disposed of was not a U.S. real property interest, then such person shall not be subject to tax under section 897 and shall not be subject to penalties (or interest) for failure to file an income tax return with respect to such disposition.

(2) *Foreign persons that met the requirements of prior regulations.* A foreign person that disposed of an interest in a domestic corporation between June 18, 1980 and January 23, 1987, shall be deemed to have satisfied the requirements of paragraph (g) of this section with respect to such disposition if such person established under prior temporary or prior final regulations issued under section 897 that the interest disposed of was not a U.S. real property interest.

(Sec. 897 (94 Stat. 2683; 26 U.S.C. 897), sec. 6011 (68A Stat. 732; 26 U.S.C. 6011) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

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§ 1.897–3 Election by foreign corporation to be treated as a domestic corporation under section 897(i).

(a) *Purpose and scope.* This section provides rules pursuant to which a foreign corporation may elect under section 897(i) to be treated as a domestic corporation for purposes of sections 897, 1445, and 6039C and the regulations thereunder. A foreign corporation with respect to which an election under section 897(i) is in effect is subject to all rules under sections 897 and 1445 that apply to domestic corporations. Thus, for example, if a foreign corporation that has made an election under section 897(i) is a U.S. real property holding corporation, interests in it are U.S. real property interests that are subject to withholding under section 1445, and any gain or loss from the disposition of such interests by a foreign person will be treated as effectively connected with a U.S. trade or business under section 897(a). Similarly, if a foreign corporation makes an election under section 897(i), its distribution of a U.S. real property interest pursuant to section 301 will be subject to the carryover basis rule of section 897(f). However, an interest in an electing corporation is not a U.S. real property interest if following the election the interest is described in section 897(c)(1)(B) or § 1.897–1(c)(2) (subject to the exceptions of subdivisions (i) and (ii) of that section). In addition, section 897(d) will not apply to any distribution of a U.S. real property interest by such corporation or to any sale or exchange of such interest pursuant to a plan of complete liquidation under section 337. A foreign corporation that makes an election under section 897(i) shall not be treated as a domestic corporation for purposes of any other provision of the Code or regulations, except to the extent that it is required to consent to such treatment as a condition to making the election. For further information concerning the effect of an election under section 897(i) upon the withholding requirements of section 1445, see § 1.1445–7. An election under section 897(i) is the exclusive remedy of any foreign person claiming discriminatory treatment under any treaty with respect to the application of sections 897, 1445, and

6039C to a foreign corporation. Therefore, if a corporation does not make an effective election, relief under a nondiscrimination article of any treaty shall not be otherwise available with respect to the application of sections 897, 1445, and 6039C to such corporation.

(b) *General conditions.* A foreign corporation may make an election under section 897(i) only if it meets all three of the following conditions.

(1) *Holding a U.S. real property interest.* The foreign corporation must hold a U.S. real property interest at the time of the election. This condition is satisfied when a U.S. real property interest is acquired simultaneously with the effective date of an election. For example, this condition is satisfied when real property is acquired in an exchange described in section 351 that is carried out simultaneously with the effective date of the election. This condition is also satisfied by a corporation that indirectly holds a U.S. real property interest through a partnership, trust, or estate.

(2) *Entitlement to nondiscriminatory treatment.* The foreign corporation must be entitled to nondiscriminatory treatment with respect to its U.S. real property interest under any treaty to which the United States is a party. Where the corporation indirectly holds a U.S. real property interest through a partnership, trust, or estate, the corporation itself must be entitled to nondiscriminatory treatment with respect to such property interest.

(3) *Submission of election in proper form.* The foreign corporation must comply with the requirements of paragraph (c) of this section respecting the manner and form in which an election must be submitted.

(c) *Manner and form of election.* An election under section 897(i) is made by filing the materials described in subparagraphs (1) through (5) of this paragraph (c) with the Director Foreign Operations District, 1325 K St., NW., Washington, DC 20225. The required items may be incorporated in a single document.

(1) *General statement.* The foreign corporation must supply a general statement indicating that an election under section 897(i) is being made. The general statement must be signed by a responsible corporate officer, who must verify under penalty of perjury that the statement and all other documents submitted pursuant to the requirements of this paragraph (c) are true and correct to his knowledge and belief. No particular form is required for the statement, which must set forth—

(i) The name, address, identifying number (if any), and place and date of incorporation of the foreign corporation;

(ii) The treaty and article under which the foreign corporation is seeking nondiscriminatory treatment;

(iii) A description of the U.S. real property interests held by the corporation, either directly or through a partnership, trust, or estate, including the dates such interests were acquired, the corporation's adjusted bases in such interests, and their fair market values as of the date of the election (or book values if the corporation is not a U.S. real property holding corporation under the alternative test of §1.897–2(b)(2)); and

(iv) A list of all dispositions of any interests in the foreign corporation after December 31, 1979, and before June 19, 1980, between related persons (as defined in section 453(f)(1)), giving the type and the amount of any interest transferred, the name and address of the related person to whom the interest was transferred, the transferor's basis in the interest transferred, and the amount of any nontaxed gain as defined in section 1125(d) of Pub. L. 96–499.

(2) *Waiver of treaty benefits.* The foreign corporation must submit a binding waiver of the benefits of any U.S. treaty with respect to any gain or loss from the disposition of a U.S. real property interest during the period in which the election is in effect.

(3) *Consent to be taxed.* The foreign corporation must submit a binding agreement to treat as though it were a domestic corporation any gain or loss that is recognized upon—

(i) The disposition of any U.S. real property interest during the period in which the election is in effect, and

(ii) The disposition of any property that it acquired in exchange for a U.S.

real property interest in a nonrecognition transaction (as defined under section 897(e)) during the period in which the election is in effect.

(4) *Interest-holders' consent to election*—(i) *In general.* The foreign corporation must submit both a signed consent to the making of the election and a waiver of U.S. treaty benefits with respect to any gain or loss from the disposition of an interest in the corporation from each person who holds an interest in the corporation on the date the election is made. In the case of a corporation any class of stock of which is regularly traded on an established securities market at any time during the calendar year, the signed consent and waiver need only be provided by a person who holds an interest described in § 1.897–1(c)(2)(iii)(A) or (B) (determined after application of the constructive ownership rules of section 897(c)(6)(C). The foreign corporation must also include with the signed consents and waivers a list that identifies and describes the interest in the corporation held by each interest holder, including the type and amount of such interest and its fair market value as of the date of the election.

(ii) *Corporation's retention of interest-holders' consents.* A corporation need not file the consents and waivers of its interest-holders as required by paragraph (c)(4)(i) of this section, if it instead complies with the requirements of subdivisions (A) through (D) of this paragraph (c)(4)(ii).

(A) The corporation must place a legend on each outstanding certificate for shares of its stock that reads substantially as follows: ''(Name of corporation) has made an election under section 897(i) of the United States Internal Revenue Code to be treated as a U.S. corporation for certain tax purposes, and any purchaser of this interest may therefore be required to withhold tax at the time of the purchase.'' The corporation must certify that the foregoing requirement has been met and that it will place an equivalent legend on every stock certificate that is issued while the election under section 897(i) is in effect and the corporation retains the consents and waivers of its interest-holders under the rules of this paragraph (c)(4)(ii). However, with respect to any registered certificate issued prior to January 30, 1985, in lieu of placing a legend on the certificate the corporation may certify that it will provide the purchaser of the interest with a copy of the legend at the time the certificate is surrendered for issuance of a new certificate.

(B) The corporation must include with its election a statement that the corporation has received both a signed consent to the making of the election and a waiver of U.S. treaty benefits with respect to any gain or loss from the disposition of an interest in the corporation from each person who holds an interest in the corporation on the date the election is made. In the case of a corporation any class of stock of which is regularly traded on an established securities market at any time during the calendar year, the signed consent and waiver need only be provided by a person who holds or has held an interest described in § 1.897–1(c)(2)(iii) (A) or (B) (determined after application of the constructive ownership rules of section 897(c)(6)(C).

(C) The corporation must include with its election a list that describes the interests in the corporation held by each interest-holder. The list need not identify the interest-holders by name, but must set forth the type, amount, and fair market value of the interests held by each.

(D) The corporation must include with its election an agreement that the corporation will retain all signed consents and waivers for a period of three years from the date of the election and supply such documents to the Director within 30 days of his request for production thereof. The Director's review of the signed consents and waivers pursuant to this provision shall not constitute an examination for purposes of section 7605(b).

(5) *Statement regarding prior dispositions.* The foreign corporation must state that no interest in the corporation was disposed of during the shortest of (A) the period from June 19, 1980, through the date of the election, (B) the period from the date on which the corporation first holds a U.S. real property interest through the date of the election or (C) the five-year period ending on the date of the election. If the

corporation cannot state that no such dispositions have been made, it may make the section 897(i) election only if it states that it has complied with the requirements of paragraph (d)(2) of this section.

(d) *Time and duration of election*—(1) *In general.* A foreign corporation that meets the conditions of paragraph (b) of this section may make an election under section 897(i) at any time before the first disposition of an interest in the corporation which would be subject to section 897(a) if the election had been made before that disposition, except as otherwise provided in paragraph (d)(2) of this section. The period to which the election applies begins on the date on which the election is made, or such earlier date as is specified in the election, but not earlier than June 19, 1980. Unless revoked, an election applies for the duration of the time for which the corporation remains in existence. An election is made on the date that the statements described in paragraph (c) of this section are delivered to the Foreign Operations District. If the election is delivered by United States mail, the provisions of section 7502 and the regulations thereunder shall apply in determining the date of delivery.

(2) *Election after disposition of stock.* An election under section 897(i) may be made after any disposition of an interest in the corporation which would have been subject to section 897(a) if the election had been made before that disposition, but only if the requirements of either subdivision (i) or (ii) of this paragraph (d)(2) are met with respect to all dispositions of interests during the period described in paragraph (c)(5) of this section.

(i) There is a payment of an amount equal to any taxes which would have been imposed by reason of the application of section 897 upon all persons who had disposed of interests in the corporation during the period described in paragraph (c)(5) of this section had the corporation made the election prior to such dispositions. Such payment must be made by the later of the date the election is made, or the date on which payment of such taxes would otherwise have been due, and must include any interest that would have accrued had tax actually been due with respect to the disposition. As an election made prior to any disposition of interests in the corporation would have been conditioned on a waiver of treaty benefits by the interest-holders, payment of an amount equal to tax and any interest with respect to such prior disposition is required as a condition to making a subsequent election under this subdivision (i) irrespective of the application of any treaty provision. For this purpose, it is not necessary that the payment be made by the person who would have owed the tax if the election under this section had been made prior to the disposition, and that person is under no obligation to supply any information to the present holders of interests in the electing corporation. The payment shall be made to the Director, Foreign Operations District. Where the payment is made by a present holder of an interest, the basis of the person's interest in the corporation shall be increased to the extent of the amount paid.

(ii) Each person that acquired an interest in the electing corporation took a basis in the interest that was equal to the basis of the interest in the hands of the person from which the interest was acquired, increased by the sum of any gain recognized by the transferor of the interest and any tax paid under chapter 1 by the person that acquired the interest, if such interest was acquired after June 18, 1980.

(3) *Adequate proof of basis.* For purposes of meeting the conditions of paragraph (d)(2) (i) or (ii) of this section, a corporation must establish the bases of and amount of gain realized by all persons who disposed of interests in the corporation during the period described in paragraph (c)(5) of this section. See paragraph (g)(3) of this section for an exception to this rule.

(4) *Acknowledgement of receipt.* Within 60 days after its receipt of an election udner section 897(i), the Internal Revenue Service will acknowledge receipt of the election. Such acknowledgement either will indicate that the information submitted with the election is complete or will specify any documents that remain to be submitted pursuant to the requirements of paragraph (c) of this section respecting the manner and

form in which an election must be made.

(e) *Anti-abuse rule*—(1) *In general.* A corporation that is otherwise eligible to make an election under section 897(i) may do so only by complying with the requirements of subdivision (2) of this paragraph, if during the period described in paragraph (c)(5) of this section—

(i) Prior to receipt of a U.S. real property interest by the corporation seeking to make the election, stock in such corporation (or in any corporation controlled by such corporation) was acquired in a transaction in which the person acquiring such stock obtained an increase in basis in the stock over the adjusted basis of the stock in the hands of the person from whom it was acquired;

(ii) The full amount of gain realized by the person from whom the stock was acquired was not subject to U.S. tax; and

(iii) The corporation seeking to make the election received the U.S. real property interest in a transaction or series of transactions to which section 897 (d)(1)(B) or (e)(1) applies to allow for nonrecognition of gain.

(2) *Recognition of gain.* A corporation described in subparagraph (1) of this paragraph (e) may make an election under section 897(i) only if it pays an amount equal to the tax on the full amount of gain realized by the transferors of the stock of such corporation (or of any corporation controlled by it) in the transaction described in paragraph (e)(1)(i) of this section. However, such amount must be paid only if the stock of the corporation seeking to make the election (or the stock of a corporation controlled by it) would have constituted a U.S. real property interest had it (or a corporation controlled by it) made the election before that acquisition. Such amount must be paid by the later of the date of the election or the date on which such tax would otherwise be due, and must include any interest that would have accrued had tax actually been due with respect to the disposition.

(3) *Definition of control.* For purposes of this paragraph, a corporation controls a second corporation if it holds 80 percent or more of the total combined voting power of all classes of stock entitled to vote, and 80 percent or more of the total number of shares of all other classes of stock of the second corporation. In a chain of corporations where each succeeding corporation is controlled within the meaning of this subparagraph (3) by the corporation immediately above it in the chain, each corporation in the chain shall be considered to be controlled by all corporations that preceded it in the chain.

(4) *Examples.* The rules of this paragraph (e) are illustrated by the following examples.

Example 1. Nonresident alien individual X owns 100 percent of the stock of foreign corporation L which was organized in 1981. L's only asset is a parcel of U.S. real property which it has held since 1981. The fair market value of the U.S. real property held by L on January 1, 1984, is $1,000,000. L's basis in the property is $200,000. X's basis in the L stock is $500,000. On June 1, 1984, M corporation, a foreign corporation owned by foreign persons who are unrelated to X, purchases the stock of L from X for $1,000,000 with title passing outside of the United States. Since the stock of L is not a U.S. real property interest, X's gain from the disposition of the L stock ($500,000) is not treated as effectively connected with a U.S. trade or business under section 897(a). In addition, since X was neither engaged in a U.S. trade or business nor present in the U.S. at any time during 1984, such gain is not subject to U.S. tax under section 871. On January 1, 1987, M liquidates L under a plan of liquidation adopted on that same date. Under section 332 of the Code M recognizes no gain on receipt of the parcel of U.S. real property distributed by L in liquidation. Under section 334(b)(1) M takes $200,000 as its basis in the U.S. real property received from L. Under section 897(d)(1)(B) no gain would be recognized to L under section 897(d)(1)(A) on the liquidating distribution. As a consequence, no gain is recognized to L under section 336 of the Code. After its receipt of the U.S. real property from L, M seeks to make an election to be treated as a domestic corporation. Thus, M acquired the L stock in a transaction in which it obtained a basis in such stock in excess of the adjusted basis of X in the stock, U.S. tax was not paid on the full amount of the gain realized by X, and M has received the property in a distribution to which section 897(d)(1)(B) applied to provide for nonrecognition of gain to L. Therefore, M may make the election only if it pays an amount equal to the tax on the full amount of X's gain, pursuant to the rule of subparagraph (e)(2) of this section.

Example 2. Nonresident alien individual X owns 100 percent of the stock of foreign corporation A which owns 100 percent of the stock of foreign corporation B. X's basis in the A stock is $500,000. A's basis in the B stock is $500,000. B owns U.S. real property with a fair market value of $1,000,000. B's basis in the U.S. real property is $500,000. On January 1, 1985, X sells the stock of A to Y, an unrelated individual, for $1,000,000 with title passing outside of the United States. In addition, X was neither engaged in a U.S. trade or business nor present in the U.S. at any time during 1985. Since the A stock is not a U.S. real property interest, X's gain on such disposition is not treated as effectively connected with a U.S. trade or business under section 897(a) and is therefore not subject to U.S. tax under section 871. On July 1, 1987, a plan of liquidation is adopted, and B is liquidated into A. Under sections 332, 334(b)(1), 336, and 897(d)(1)(B), there is no tax to A on receipt of U.S. real property from B and no tax to B on the distribution of the U.S. real property interest to A. After receipt of the property A seeks to make an election under section 897(i). Under the rules of paragraph (e) of this section, A may make the election only if it pays an amount equal to the tax on the full amount of X's gain. (Assuming that A is a U.S. real property holding corporation, the same result would be required by the rule of paragraph (d)(2) of this section.)

(f) *Revocation of election*—(1) *In general.* An election under section 897(i) may be revoked only with the consent of the Commissioner. A request for revocation shall be in writing and shall be addressed to the Director, Foreign Operations District, 1325 K St. NW., Washington, DC 20225. The request shall include the name, address, and identifying number of the corporation seeking to revoke the election, and a description of all U.S. real property interests held by the corporation on the date of the request for revocation, including the dates such interests were acquired, the corporation's adjusted bases in such interests, and their fair market values as of the date of the request (or book value if the corporation is not a U.S. real property holding corporation under the alternative test of §1.897–2(b)(2)). The request shall be signed by a responsible officer of the corporation under penalty of perjury and shall contain a statement either that the corporation has made no distributions described in subparagraph (2) of this paragraph (f) or that the conditions of that subparagraph have been satisifed. A revocation will be effective as of the date the request is delivered to the Foreign Operations District, unless the Commissioner provides otherwise in his consent to the revocation. If the request is delivered by United States mail, the provisions of section 7502 and the regulations thereunder shall apply in determining the date of delivery. The Commissioner will generally consent to a revocation, provided either that there have been no distributions described in subparagraph (2) of this paragraph (f), or that the conditions of that subparagraph have been satisfied. Within 90 days after its receipt of a request to revoke an election under section 897(i), the Internal Revenue Service will acknowledge receipt of the request. Such acknowledgement either will indicate that the information submitted with the request is complete or will specify any information that remains to be submtted pursuant to the requirements of this paragraph (f).

(2) *Revocation after distribution.* If there have been any distributions of U.S. real property interests by the corporation during the period to which an election made under section 897(i) applies, the Commissioner shall consent to the revocation of such election only if one of the following conditions is met.

(i) The full amount of gain realized by the corporation upon the distribution was subject to U.S. income tax.

(ii) There is a payment of an amount equal to the taxes that would have been imposed upon the corporation by reason of the application of section 897 if the election had not been in effect on the date of the distribution. Such payment must be made by the later of the date of the request for revocation or the date on which payment of such tax would otherwise have been due, and must include any interest that would have accrued had tax actually been due with respect to the distribution. If under the terms of any treaty to which the United States is a party such distribution would not have been subject to U.S. income tax notwithstanding the provisions of section 897, then this condition may be satisfied by providing a statement with the request for revocation setting forth the treaty and article which would have exempted the distribution from U.S. tax had the election under section 897(i) not been in effect on the date thereof.

(iii) At the time of the receipt of the distributed property, the distributee would be subject to taxation under chapter 1 of the Code on a subsequent disposition of the distributed property, and the basis of the distributed property in the hands of the distributee is no greater than the adjusted basis of such property before the distribution, increased by the amount of gain (if any) recognized by the distributing corporation. For purposes of this paragraph (f)(2)(i)(C), a distributee shall be considered to be subject to taxation upon a subsequent disposition of distributed property only if such distributee waives the benefits of any U.S. treaty that would otherwise render such disposition not taxable by the United States. Such waiver must be attached to the corporation's request for revocation.

(g) *Transitional rules*—(1) *In general.* An election under section 897(i) that was made at any time after June 18, 1980, must be amended to comply with the requirements of paragraphs (b), (c), and (d) of this section. Such amendment must be delivered in writing to the Director of the Foreign Operations District by April 1, 1985. If the amendment is delivered by United States mail, the provisions of section 7502 and the regulations thereunder shall apply in determining the date of delivery. An election that is properly amended pursuant to the requirements of this section shall be effective as of the date of the original election.

(2) *Corporations previously entitled to make election.* A foreign corporation that would have been entitled under the rules of this section to make a section 897(i) election at any time between June 19, 1980, and January 30, 1985, may retroactively make such an election pursuant to the requirements of this section. Such election must be delivered to the Director, Foreign Operations District, by March 1, 1985.

(3) *Interests in corporation disposed of prior to publication.* Where interests in a corporation were disposed of before January 3, 1984, the requirement of paragraph (d)(2) of this section may be met, notwithstanding the requirement of paragraph (d)(3), by paying a tax that is based upon a reasonable estimate of the gain upon the prior dispositions. Such estimate must be based on all facts and circumstances known to, and ascertainable through the exercise of reasonable diligence by, the corporation seeking to make the election.

(Sec. 897 (94 Stat. 2683; 26 U.S.C. 897), sec. 6011 (68A Stat. 732; 26 U.S.C. 6011) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

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(1) Exceptions to the general rule.

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(4) Examples.

(5) Contribution of property.

(c) Denial of nonrecognition with respect to certain tax avoidance transfers.

(1) In general.

(2) Certain transfers to domestic corporations.

(i) General rule.

(ii) Example.

(3) Basis adjustment for certain related person transactions.

(4) Rearrangement of ownership to gain treaty benefit.

(d) Effective date.

§1.897–7T Treatment of certain partnership interests as entirely U.S. real property interests under section 897(g) (temporary).

(a) Rule.

(b) Effective date.

§1.897–8T Status as a U.S. real property holding corporation as a condition for electing section 897(i) pursuant to §1.897–3 (temporary).

(a) Purpose and scope.

(b) General conditions.

(c) Effective date.

§1.897–9T Treatment of certain interests in publicly traded corporations, definition of foreign person, and foreign governments and international organizations (temporary).

(a) Purpose and scope.

(b)

(c) Foreign person.

(d) Regularly traded.

(e) Foreign governments and international organizations.

(f) Effective date.

[T.D. 8198, 53 FR 16217, May 5, 1988]

§1.897–5T Corporate distributions (temporary).

(a) *Purpose and scope.* This section provides rules concerning the recognition of gain or loss and adjustments to basis required with respect to certain corporate distributions that are subject to section 897. Paragraph (b) of this section provides rules concerning such distributions by domestic corporations, including distributions under section 301, distributions in redemption of stock, and distributions in liquidation. Paragraph (c) sets forth rules concerning distributions by foreign corporations, including distributions under sections 301 and 355, distributions in redemption of stock, and distributions in liquidation. Finally, various rules generally applicable to distributions subject to this section, as well as to transfers subject to §1.897–6T, are set forth in paragraph (d). The rules contained in this section are also subject to the tax avoidance rules of §1.897–6T(c).

(b) *Distributions by domestic corporations*—(1) *Limitation of basis upon dividend distribution of U.S. real property interest.* Under section 897(f), if any domestic corporation (distributing corporation) distributes a U.S. real property interest to a shareholder that is a foreign person (distributee) in a distribution to which section 301 applies, then the basis of the distributed U.S. real property interest in the hands of the foreign distributee shall be determined in accordance with the provisions of section 301(d), and shall not exceed—

(i) The adjusted basis of the property before the distribution in the hands of the distributing corporation, increased by

(ii) The sum of—

(A) Any gain recognized by the distributing corporation on the distribution, and

(B) Any U.S. tax paid by or on behalf of the distributee with respect to the distribution.

(2) *Distributions by U.S. real property holding corporations which are taxable exchanges of stock under generally applicable rules.* If a domestic corporation, stock in which is treated as a U.S. real property interest, distributes property with respect to such stock to a foreign shareholder, the distributee shall be treated as having disposed of a U.S. real property interest, and shall recognize gain or loss on the stock of such domestic corporation to the extent that, with respect to the distributees—

(i) Part of all of the distribution is treated pursuant to section 301(c)(3)(A) as a sale or exchange of stock;

(ii) Part or all of the distribution is treated pursuant to section 302(a) as made in part or full payment in exchange for stock; or

(iii) Part or all of the distribution is treated pursuant to section 331(a) as made in full payment in exchange for stock.

Stock in a domestic corporation shall not be considered a U.S. real property interest pursuant to the provisions of § 1.897–2(f)(2) if the corporation does not hold any U.S. real property interests and has disposed of all of its U.S. real property interests owned within the previous five years in transactions in which the full amount of gain was recognized under the rules of § 1.897–2(f)(2). If gain is recognized at the corporate level on either a distribution of a U.S. real property interest or a sale of a U.S. real property interest in a liquidation, such distribution or sale shall be considered a disposition for purposes of § 1.897–2(f)(2). With regard to the consequences of a distribution from a U.S. real property holding corporation under section 355(a), see § 1.897–6T(a) (1) and (4).

(3) *Section 332 liquidations of U.S. real property holding corporations*—(i) *General rules.* Exchanges that are subject to section 897(e) are normally covered by § 1.897–6T(a) (1), (2) and (3). This paragraph (b)(3) provides rules concerning the application of section 897(e) and the general principles of § 1.897–6T(a) (1), (2) and (3) to section 332 liquidations of U.S real property holding corporations.

(ii) *Distribution to a foreign corporation under section 332 after June 18, 1980, and before the repeal of the General Utilities doctrine.* Except for distributions under paragraph (b)(3)(iii) of this section (relating to section 332 and former section 334(b)(2)), the rules of this paragraph (b)(3)(ii) shall apply to section 332 distributions after June 18, 1980, and before January 1, 1990, pursuant to section 336(a) as in effect prior to the effective dates of the amendments made by section 631 of the Tax Reform Act of 1986. A foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in a domestic corporation that is a U.S. real property interest shall not, after December 31, 1984, be subject to taxation by reason of section 367(a). The foreign corporation shall recognize gain pursuant to section 897(e)(1) on such stock upon the receipt of property in a section 332(a) liquidation from such domestic corporation, but only to the extent that the property received constitutes property other than a U.S. real property interest. The gain on the stock in the domestic corporation to be recognized by the foreign corporation pursuant to section 897(e)(1) shall be determined by multiplying the gain realized on the distribution by a fraction. The numerator of the fraction shall be the fair market value of the property other than U.S. real property interests received by the foreign corporation on the distribution, and the denominator shall be the fair market value of all property received by the foreign corporation on the distribution. The bases of the distributed U.S. real property interests in the hands of the foreign corporation shall be the same as the bases in the hands of the domestic corporation. The bases of the property other than U.S. real property interests in the hands of the foreign corporation shall be the same as the bases in the hands of the domestic corporation, plus any gain recognized by the foreign corporation on the distribution allocated among such assets in proportion to the potential gain inherent in each such asset at the time of distribution. However, the basis of each asset is limited to its fair market value. Property, other than a U.S. real property interest that is distributed by the domestic corporation, shall not be considered to be distributed by the domestic corporation pursuant to a section 332 liquidation (that is, the foreign corporation shall not be considered to be a corporation for purposes of section 332) if the requirements of section 367(a) are not satisfied. *See,* for example, sections 1245(b)(3) and 1250(d)(3) regarding the consequences to the distributing domestic corporation if the requirements of section 367(a) are not satisfied.

(iii) *Distribution to a foreign corporation under section 332 and former section 334(b)(2) after June 18, 1980.* The rules of this paragraph (b)(2)(iii) shall apply to section 332 distributions after June 18, 1980 where the basis of the distributed property in the hands of the foreign corporation is determined under section 334(b)(2) as in effect prior to the Tax Equity and Fiscal Responsibility Act of 1982. A foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in a domestic corporation that is a U.S. real property interest shall recognize gain on the reciept of property in a section 332(a) liquidation where section 334(b)(2) applies to the extent that the fair market value of the distributed assets that are not U.S real property interests exceeds the basis of such assets determined under section 334(b)(2) (for example, if the liquidation does not occur immediately upon the purchase of stock in the domestic corporation). The gain recognized shall not exceed the excess of the fair market value of the stock of the domestic corporation in the hands of the foreign corporation at the time of the distribution over the shareholder's adjusted basis in such stock. The basis of the distributed U.S. real property interests in the hands of the foreign corporation shall be determined under section 334(b)(2), by reference to the adjusted basis of the stock with respect to which the distribution was made. The basis of such property other than U.S. real property interests shall be tentatively determined under section 334(b)(2), and then increased by any gain recognized by the foreign corporation on the distribution allocated among such assets in proportion to the potential gain inherent in each such asset at the time of distribution (computed using the tentative basis as determined under section 334(b)(2)). The basis of each asset is limited, however, to its fair market value.

(iv) *Distribution to a foreign corporation under section 332 after July 31, 1986 and after the repeal of the General Utilities doctrine.* The rules of this subdivision (iv) shall apply to section 332 distributions after July 31, 1986, pursuant to section 337(a) as in effect after the effectivie dates of the amendments of section 631 of the Tax Reform Act of 1986.

(A) *Liquidation of domestic corporation.* A foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in a domestic corporation that is a U.S. real property interest (except a foreign corporation that has made an effective election under section 897(i) and the stock of which is treated as a U.S. real property interest) shall not recognize any gain under sections 367(a) or 897(e)(1) on the receipt of property in a section 332(a) liquidation. The domestic corporation shall not recognize gain under section 367(e)(2) on the distribution of U.S. real property interests (other than stock in a former U.S. real property holding corporation which is treated as a U.S. real property interest) to the foreign corporation. The domestic corporation shall recognize gain under section 367(e)(2) on the distribution of stock in a former U.S. real property holding corporation which is treated as a U.S. real property interest. With respect to the recognition of gain or loss by the domestic corporation under section 367(e)(2) on the distribution of property other than U.S. real property interests, see the regulations under section 367(e)(2). The basis of the distributed U.S. real property interests (other than stock in a former U.S. real property holding corporation) in the hands of the foreign corporation shall be the same as it was in the hands of the domestic corporation. The basis of any property (other than U.S. real property interests) and stock in a former U.S. real property holding corporation that is a U.S. real property interest in the hands of the foreign corporation shall be the same as it was in the hands of the domestic corporation increased by any gain recognized by the distributing corporation on the distribution that was subject to U.S. taxation.

(B) *Liquidation of certain foreign corporations making a section 897(i) election.* A foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in another foreign corporation, that has made an effective election under section 897(i) and the stock of which is treated as a U.S. real property interest, shall recognize gain pursuant to section 897(e)(1) on such stock upon the receipt from the distributing foreign corporation of property that is not a U.S. real property interest, and that is not used by the distributee foreign corporation in the conduct of a trade or business within the United States (if the distributee foreign corporation is not a resident of a country with which the United States maintains an income tax treaty) or in a permanent establishment within the United States (if the distributee foreign corporation is a resident of a country with which the United States maintains an income tax treaty). The gain on the stock in the foreign corporation (making an effective election under section 897(i)) to be recognized by the distributee foreign corporation pursuant to section 897(e)(1) shall be determined by multiplying the gain realized on the distribution by a fraction. The numerator of the fraction shall be the fair market value of the property received by the distributee foreign corporation upon which it must recognize gain, and the denominator of the fraction shall be the fair market value of all property received by the distributee foreign corporation on the distribution. The distributing foreign corporation shall not recognize gain under section 367(e)(2) on the distribution of U.S. real property interests to the distributee foreign corporation. With respect to the recognition of gain or loss under section 367(e)(2) on the distribution of property other than U.S. real property interests, see the regulations under section 367(e)(2). The basis of the distributed U.S. real property interests in the hands of the distributee foreign corporation shall be the same as it was in the hands of the distributing foreign corporation. The basis of the property upon which the distributee foreign corporation recognized gain in the hands of the distributee foreign corporation shall be the same as the basis in the hands of the distributing foreign corporation, plus any gain recognized by the distributee foreign corporation on the receipt of such property allocated among such property in proportion to the potential gain inherent in each such property at the time of the distribution. In regard to the basis of any other property received by the distributee foreign corporation in the liquidation, see the regulations under section 367(e)(2). However, the basis of each asset is limited to its fair market value.

(v) *Transfer of foreign corporation stock followed by a section 332 liquidation treated as a reorganization.* If a nonresident alien or foreign corporation transfers the stock of a foreign-corporation that owns a U.S. real property interest to a domestic corporation in exchange for stock of the domestic corporation (or its domestic or foreign parent corporation) in a reorganization under section 368(a)(1)(B) or in an exchange under section 351(a), and if the foreign corporation then distributes the U.S. real property interest to the domestic corporation in a liquidation described in section 332(a) within five years of the transfer of the stock of the foreign corporation to the domestic corporation, then the transfer of the foreign corporation stock and the liquidation shall be treated as a reorganization described in section 368(a)(1) (C) or (D). The rules of §1.897–6T(a)(1) shall apply to the transfer of the U.S. real property interest to the domestic corporation in exchange for domestic corporation stock, and the rules of §1.897–5T(c)(4) shall apply to the distribution of domestic corporation stock by the foreign corporation. However, the rules of this paragraph (b)(3)(v) shall not apply if the transfer of the foreign corporation stock and the liquidation under section 332(a) are separate and independent transactions justified by substantial and verifiable business purposes.

(4) *Section 897(i) companies.* Except as otherwise provided herein for purposes of this section and §1.897–6T, a foreign corporation that has made a valid election under section 897(i) shall be treated as a domestic corporation and not as a foreign corporation in determining the application of section 897. For rules concerning the making of a section 897(i) election, see §§1.897–3 and 1.897–8T. In regard to section 367(e)(2) and foreign corporations that have made an effective election under section 897(i), see paragraph (b)(3)(iv) of this section.

(5) *Examples.* The following examples illustrate the rules of this paragraph (b). In each example there is no applicable income tax treaty to which the United States is a party.

Example 1. (i) A is a nonresident alien who owns 100 percent of the stock of DC, a U.S. real property holding corporation. DC's only asset is Parcel P, a U.S. real property interest, with a fair market value of $500,000 and an adjusted basis of $300,000. DC completely liquidates in 1987 and distributes Parcel P to A in exchange for the DC stock held by A.

(ii) Under section 336(a), DC must recognize gain to the extent of the excess of the fair market value ($500,000) over the adjusted basis ($300,000), or $200,000.

(iii) A does not recognize any gain under section 897(a) because the DC stock in the hands of A is no longer a U.S. real property interest under paragraph (b)(2) of this section and paragraph 2(f) of §1.897–2. A does recognize gain (if any) under section 331(a); however, the gain is not subject to taxation under section 871(a). A's adjusted basis in Parcel P is $500,000.

(iv) If DC did not recognize all of the gain on the disposition under a transitional rule to section 631 of the Tax Reform Act of 1986, then paragraph (b)(2) of this section and paragraph 2(f) of §1.897–2 would not apply to A. A would recognize gain (if any) under paragraph (b)(2) because the distribution is treated as in full payment in exchange for the DC stock under section 897(a).

Example 2. (i) FC, a Country F corporation, owns 100 percent of the stock of DC, a U.S. real property holding corporation. FC's basis in the stock of DC is $400,000, and the fair market value of the DC stock is $800,000. DC owns a U.S. real property interest with an adjusted basis of $350,000 and a fair market value of $600,000. DC also owns other assets that are not U.S. real property interests that have an adjusted basis of $125,000 and a fair market value of $200,000. DC completely liquidates in 1985 and distributes all of its property to FC in exchange for the DC stock held by FC.

(ii) Under paragraph (b)(3)(ii) of this section, FC recognizes $100,000 of gain under section 897(a) on the disposition of the DC stock. This is determined by multiplying FC's gain realized ($400,000) by a fraction. The numerator of the fraction is the fair market value of the property other than U.S. real property interests ($200,000), and the denominator of the fraction is the fair market value of all property received ($800,000). FC takes a carryover adjusted basis in the U.S. real property interest ($350,000). FC's adjusted basis in the assets that are not U.S. real property interests ($200,000) is the basis of those assets in the hands of DC ($125,000) plus the gain recognized by FC on the distribution ($100,000) not to exceed the fair market value ($200,000).

Example 3. (i) FC, a Country F corporation, owns 100 percent of the stock of DC, a U.S. real property holding corporation. FC's basis in the stock of DC is $300,000, and the fair market value of the DC stock is $500,000. DC owns Parcel P, a U.S. real property interest, with an adjusted basis of $250,000 and a fair market value of $400,000. DC also owns all of the stock of DX, a former U.S. real property holding corporation whose stock is a U.S. real property interest, with an adjusted basis of $50,000 and a fair market value of $100,000. DC completely liquidates in 1987 and distributes all of its property to FC in exchange for the DC stock held by FC.

(ii) Under paragraph (b)(3)(iv)(A) of this section, DC recognizes $50,000 of gain on the distribution to FC of the DX stock. DC does not recognize any gain for purposes of section 367(e)(2) on the distribution to FC of Parcel P.

(iii) Under paragraph (b)(3)(iv)(A) of this section, FC's disposition of its DC stock is not treated as a disposition of a U.S. real property interest. Under section 334(b)(1), FC takes a carryover adjusted basis of $250,000 in

Parcel P. FC takes an increased basis of $100,000 in the DX stock which is equal to DC's basis ($50,000) increased by the gain recognized by DC ($50,000).

(iv) The result would be the same if FC had made an effective election under section 897(i).

(6) *Section 333 elections*—(i) *General rule.* A foreign shareholder that elects section 333 as in effect prior to its repeal by the Tax Reform Act of 1986 upon the distribution of property in a liquidation by a domestic corporation whose stock is treated as a U.S. real property interest shall recognize gain on such stock to the extent that—

(A) The property received by the foreign shareholder constitutes property other than U.S. real property interests subject to U.S. taxation upon its disposition as specified by paragraph (a)(1) of this section, or

(B) The basis of a U.S. real property interest subject to U.S. taxation upon its disposition in the hands of the recipient foreign shareholder exceeds the basis of the U.S. real property interest in the hands of the liquidating domestic corporation.

In determining the amount of gain recognized by the foreign shareholder, the foreign shareholder shall be considered to have exchanged the domestic corporation stock for all the property distributed on a proportionate fair market value basis. The gain recognized on a respective portion of domestic corporation stock shall not exceed the gain realized on that portion. Property other than U.S. real property interests subject to U.S. taxation upon disposition shall have a fair market value basis in the hands of the foreign shareholder. The basis of U.S. real property interests subject to U.S. taxation upon disposition shall be the basis of the proportionate part of the domestic corporation stock cancelled or redeemed in the liquidation, increased in the amount of gain recognized (other than gain recognized under this section) by the shareholder in respect to that proportionate part of the domestic corporation stock.

(ii) *Example.* The rules of paragraph (b)(6)(i) of this section may be illustrated by the following example.

Example. (i) A is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. A owns all of the stock of DC, a U.S. real property holding corporation. The DC stock has a fair market value of $1,000,000. A acquired the DC stock in two purchases. The basis of one lot of the DC stock is $150,000, and the basis of the other lot is $650,000.

(ii) DC owns Parcel P, a U.S. real property interest, with a fair market value of $750,000 and an adjusted basis of $400,000. DC's only other property is equipment with a fair market value of $250,000 and an adjusted basis of $100,000. DC does not have any earnings and profits.

(iii) DC completely liquidates in 1985 in accordance with section 333 by distributing Parcel P and the equipment to A. A elects section 333 treatment.

(iv) A is considered as having exchanged 75 percent (fair market value of Parcel P/fair market value of all property distributed) of the DC stock for Parcel P. A realized gain of $150,000 on that portion of the DC stock ($750,000–$600,000). All of the gain of $150,000 is recognized under section 897 (a) because A's basis in Parcel P under section 334 (c) ($600,000) would exceed DC's basis in Parcel P ($400,000) by at least the amount of realized gain. A takes a basis of $750,000 in Parcel P.

(v) A is considered as having exchanged 25 percent (fair market value of equipment/fair market value of all property distributed) of the DC stock for the equipment. A realized gain of $50,000 on that portion of the DC stock ($250,000–$200,000). All of the gain of $50,000 is recognized under section 897 (a). A takes a basis of $250,000 in the equipment.

(c) *Distributions of U.S. real property interests by foreign corporations*—(1) *Recognition of gain required.* If a foreign corporation makes a distribution (including a distribution in liquidation or redemption) of a U.S. real property interest to a shareholder (whether foreign or domestic), then, except as provided in paragraph (c) (2), (3), or (4) of this section, the distributing corporation shall recognize gain (but not loss) on the distribution under section 897 (d) (1). The gain recognized shall be equal to the excess of the fair market value of the U.S. real property interest (as of the time of the distribution) over its adjusted basis. Except as otherwise provided, the distributee's basis in the distributed U.S. real property interest shall be determined under the otherwise applicable sections of the Code. The distributee (whether domestic or foreign) of a foreign corporation in a liquidation under section 332 shall take the foreign corporation's basis in the distributed U.S. real property interest increased by any gain recognized (and subject to U.S. income taxation) by the foreign corporation on the distribution of such U.S. real property interest.

(2) *Recognition of gain not required*—(i) *Statutory exception rule.* Under section 897(d)(2)(A), gain shall not be recognized by a distributing foreign corporation if—

(A) At the time of the receipt of the distributed U.S. real property interest, the distributee would be subject to U.S. income taxation on a subsequent disposition of the U.S. real property interest, determined in accordance with the rules of paragraph (d)(1) of this section;

(B) The basis of the distributed U.S. real property interest in the hands of the distributee is no greater than the adjusted basis of such property before the distribution, increased by the amount of gain (if any) recognized by the distributing corporation upon the distribution and added to the adjusted basis under the otherwise applicable provisions; and

(C) The distributing corporation complies with the filing requirements of paragraph (d)(1)(iii) of this section.

(ii) *Section 332 liquidations*—(A) *In general.* A distributing foreign corporation that meets the requirements of paragraph (c)(2)(i) in a section 332(a) liquidation shall not recognize gain on the distribution of U.S. real property interests to a foreign corporation meeting the stock ownership requirements of section 332(b) if the distributing corporation complies with the procedural requirements of paragraph (d)(1)(iii). Whether a foreign corporation recognizes gain on the distribution of U.S. real property interests to a U.S. corporation meeting the stock ownership requirements of section 332(b) depends upon whether the U.S. corporation satisfies the subject to tax requirement provided in paragraph (d)(1)(i) (in addition to the procedural requirements of paragraph (d)(1)(iii)). With respect to section 332 distributions by a foreign corporation occurring after July 31, 1986, section 367(e)(2) shall not affect the application of section 337(a) (as in effect after the Tax Reform Act of 1986) and paragraph (c)(2)(i) of this section to the distribution of a U.S. real property interest.

(B) *Recognition of gain required in certain section 332 liquidations.* Notwithstanding the other rules of this paragraph (c), a foreign corporation shall, pursuant to the authority conferred by section 897(e)(2), recognize gain on its distribution after May 5, 1988 of a U.S. real property interest to a domestic corporation meeting the stock ownership requirements of section 332(b) if—

(*1*) The foreign corporation has not made an election under section 897(i), and any gain on the stock in the foreign corporation would be subject to U.S. taxation if an election were made on the date of the liquidation; and

(*2*) The distribution of the U.S. real property interest by the foreign corporation to the domestic corporation pursuant to section 332(a) occurs less than five years after the date of the last gain from the disposition of stock of the foreign corporation that would be subject to payment of tax under § 1.897–3(d)(2)(i) if an election under section 897(i) were made by the foreign corporation on the date of its liquidation.

With regard to the treatment of certain foreign corporations as domestic corporations under section 897(i), however, see §§ 1.897–3 and 1.897–8T.

(iii) *Examples.* The rules of this paragraph (c)(2) may be illustrated by the following examples.

Example 1. (i) DC, a domestic corporation, owns 100 percent of the stock of FC, a Country F corporation, FC's only asset is Parcel P, a U.S. real property interest, with a fair market value of $500x and an adjusted basis of $100x. In September 1987, FC liquidates under section 332(a) and transfers Parcel P to DC. The transitional rules contained in section 633 of the Tax Reform Act of 1986 concerning the repeal of the *General Utilities* doctrine would not be applicable to a subsequent distribution or disposition of assets by DC.

(ii) Assume that FC complies with the filing requirements of paragraph (d)(1)(iii). DC will be subject to U.S. income taxation on a subsequent disposition of Parcel P under the rules of paragraph (d)(1). The basis of Parcel P in the hands of DC will be $100x under section 334(b)(1), and thus no greater than the basis of Parcel P in the hands of FC. FC does not recognize any gain under the rules of paragraph (c)(1) of this section on the distribution because the exception of paragraph (d)(2)(i) applies.

Example 2. If in *Example* (1) the distribution by FC to DC occurred in September 1985, and

DC sold or exchanged Parcel P under scctions 336(a) or 337(a) as in effect prior to the Tax Reform Act of 1986, then FC must recognize gain of $400x on the distribution of Parcel P. The gain must be recognized because Parcel P in the hands of DC is not considered subject to U.S. income taxation on a subsequent disposition under the rules of paragraph (d)(1) of this section.

(3) *Limitation of gain recognized under paragraph (c)(1) of this section for certain section 355 distributions*—(i) *In general.* Under paragraph (c)(1) of this section, a foreign corporation that distributes stock in a domestic corporation that constitutes a U.S. real property interest in a distribution to which section 355 applies shall recognize gain on the distribution to the extent that the fair market value of the distributed stock exceeds its adjusted basis in the hands of the distributing foreign corporation. The gain recognized shall be limited under this paragraph (c)(3), however, to the amount by which the aggregate basis of the distributed stock in the hands of the distributees exceeds the aggregate adjusted basis of the distributed stock in the hands of the distributing corporation. The distributees' basis in the distributed U.S. real property interest shall be determined under the otherwise applicable provisions of section 358. (Thus, the distributees' basis in the distributed U.S. real property interest shall be determined without any increase for any gain recognized by the foreign corporation).

(ii) *Example.* The rules of paragraph (c)(3)(i) of this section may be illustrated by the following example.

Example. (i) C is a citizen and resident of Country F. C owns all of the stock of FC, a Country F corporation. The fair market value of the FC stock is 1000x, and C has a basis of 600x in the FC stock. Country F does not have an income tax treaty with the United States.

(ii) In a transaction qualifying as a distribution of stock of a controlled corporation under section 355(a), FC distributes to C all of the stock of DC, a U.S. real property holding corporation. C does not surrender any of the FC stock. The DC stock has a fair market value of 600x, and FC has an adjusted basis of 200x in the DC stock. After the distribution, the FC stock has a fair market value of 400x.

(iii) Under paragraph (c)(3)(i) of this section, FC must recognize gain on the distribution of the DC stock to C equal to the difference between the fair market value of the DC stock (600x) and FC's adjusted basis in the DC stock (200x). This results in a potential gain of 400x. Under section 358, C takes a 360x adjusted basis in the DC stock. Provided that FC complies with the filing requirements of paragraph (d)(1)(iii) of this section, the gain recognized by FC is limited under paragraph (c)(3)(i) to 160x because (A) this is the amount by which the basis of the DC stock in the hands of C (360x) exceeds the adjusted basis of the DC stock in the hands of FC (200x), and (B) at the time of receipt of the DC stock, C would be subject to U.S. taxation on a subsequent disposition of the stock.

(iv) C's adjusted basis in the DC stock is not increased by the 160x recognized by FC.

(4) *Distribution by a foreign corporation in certain reorganizations*—(i) *In general.* Under paragraph (c)(1) of this section, a foreign corporation that transfers property to another corporation in an exchange under section 361(a) for stock of a domestic corporation which is a United States real property holding corporation immediately after the transfer in a reorganization under section 368(a)(1) (C), (D), or (F) shall recognize gain under section 897(d)(1) on the distribution (whether actual or deemed) of the stock of the domestic corporation received by the foreign corporation to its shareholders (whether domestic or foreign). See §1.897–6T(a) of the regulations for the consequences to the foreign corporation of the exchange of its property for the domestic corporation stock.

(ii) *Statutory exception.* Pursuant to the exception provided in section 897(d)(2)(A), no gain shall be recognized by the foreign corporation on its distribution of the domestic corporation stock if—

(A) At the time of the distribution, the distributee (*i.e.,* the exchanging shareholder in the section 354 exchange) would be subject to U.S. taxation on a subsequent disposition of the stock of the domestic corporation, determined in accordance with the rules of paragraph (d)(1) of this section;

(B) The distributee's adjusted basis in the stock of the foreign corporation immediately before the distribution was no greater than the foreign corporation's basis in the stock of the domestic corporation determined under section 358; and

(C) The distributing corporation complies with the filing requirements of paragraph (d)(1)(iii) of this section.

(iii) *Regulatory limitation on gain recognized.* If the requirements of subdivisions (A) and (C) of paragraph (c)(4)(ii) are met, the amount of any gain recognized by the foreign corporation shall not exceed the excess of the distributee's adjusted basis in the stock of the foreign corporation immediately before the distribution over the foreign corporation's basis in the stock of the domestic corporation immediately before the distribution as determined under section 358.

(iv) *Examples.* The rules of paragraph (c)(4) of this section may be illustrated by the following examples.

Example 1. (i) A, a nonresident alien, organized FC, a Country W corporation, in September 1980 to invest in U.S. real estate. In 1986, FC's only asset is Parcel P, a U.S. real property interest with a fair market value of $600,000 and an adjusted basis to FC of $200,000. Parcel P is subject to a mortgage with an outstanding balance of $100,000. The fair market value of the FC stock is $500,000, and A's adjusted basis in the stock is $100,000. FC does not have liabilities in excess of the adjusted basis in Parcel P. The United States does not have a treaty with Country W that entitles FC to nondiscriminatory treatment as described in section 1.897–3(b)(2) of the regulations.

(ii) Pursuant to a plan of reorganization under section 368(a)(1)(D), FC transfers Parcel P to DC, a newly formed domestic corporation, in exchange for DC stock. FC distributes the DC stock to A in exchange for A's FC stock.

(iii) FC's exchange of Parcel P for the DC stock is a disposition of a U.S. real property interest. Under § 1.897–6T(a)(1), there is an exchange of a U.S. real property interest (Parcel P) for another U.S. real property interest (DC stock) so that no gain is recognized on the exchange under section 897(e). DC takes FC's basis of $200,000 in Parcel P under section 362(b). Under section 358(a)(1), FC takes a $100,000 basis in the DC stock because FC's substituted basis of $200,000 in the DC stock is reduced by the $100,000 of liabilities to which Parcel P is subject.

(iv) Under section 897(d)(1) and paragraph (c)(4)(i) of this section, FC generally must recognize gain on the distribution of the DC stock received in exchange for FC's assets equal to the difference between the fair market value of the DC stock ($500,000) and FC's adjusted basis in the DC stock prior to the distribution ($100,000). This results in a potential gain of $400,000. Under section 358(a)(1), A takes a basis in the DC stock equal to its basis in the FC stock of $100,000. Provided that FC complies with the filing requirements of paragraph (d)(1)(iii) of this section, no gain is recognized by FC on the distribution of the DC stock under the statutory exception to the general rule of section 897(d)(1) provided in section 897(d)(2)(A) and paragraph (c)(4)(ii) of this section because (*1*) A's basis in the DC stock ($100,000) does not exceed FC's adjusted basis in the DC stock ($100,000) immediately prior to the distribution and (*2*) A, at the time of receipt of the DC stock, would be subject to U.S. taxation on a subsequent disposition of the stock.

(v) The FC stock in the hands of A is not a U.S. real property interest because FC is a foreign corporation that has not elected to be treated as a domestic corporation under section 897(i). Accordingly, the exchange of the FC stock by A for DC stock is not a disposition of a U.S. real property interest under section 897(a).

Example 2. The facts are the same as in Example 1, except that A purchased the FC stock in September 1983 for $100,000 from S, a nonresident alien, and that S had a basis of $40,000 in the FC stock at the time of the sale to A. The results are the same as in Example 1.

Example 3. (i) The facts are the same as in *Example* 1, except that A's adjusted basis in the FC stock prior to the reorganization is $300,000. Following the distribution, A takes its basis of $300,000 in the FC stock as its basis in the DC stock pursuant to section 358(a)(1).

(ii) FC does not qualify under the statutory exception of paragraph (c)(4)(ii) to the general recognition rule of section 897(d)(1) and paragraph (c)(4)(i) of this section because A's basis in the DC stock ($300,000) exceeds FC's adjusted basis in the DC stock ($100,000) immediately prior to the distribution. However, provided that FC complies with the filing requirements of paragraph (d)(1)(iii) of this section, the gain recognized by FC is limited to $200,000 under the regulatory limitation of gain provided by paragraph (c)(4)(iii). This is the excess of A's basis in the FC stock immediately before the distribution ($300,000) over A's adjusted basis in the DC stock immediately before the distribution ($100,000).

(iii) A takes a basis of $300,000 in the DC stock under section 358(a)(1). A's basis in the DC stock is not increased by the gain recognized by FC. DC takes a basis of $200,000 in Parcel P under section 362(b).

Example 4. (i) The facts are the same as in *Example* 3, except that the United States has an income tax treaty with Country W entitling FC to nondiscriminatory treatment under section 1.897–3(b)(2) of the regulations. A valid election under section 897(i) is made to treat FC as a U.S. corporation.

(ii) FC is treated as a domestic corporation for purposes of section 897 and is not required to recognize gain under section 897(d)(1) and paragraph (c)(4)(i) of this section on the distribution of the DC stock as described in *Example* 3. (If a valid section 897(i) election were not made, the result would be same as in *Example* 3.)

(iii) The FC stock in the hands of A is a U.S. real property interest because an election was made under section 897(i) to treat FC as a U.S. corporation. The exchange of the FC stock for DC stock by A is a disposition of a U.S. real property interest. Under section 897(e)(1) and paragraph (a) of § 1.897–6T, A does not recognize gain on the exchange because there is an exchange of a U.S. real property interest (the FC stock) for another U.S. real property interest (the DC stock). Under section 358(a)(1), A takes as its basis in the DC stock A's basis in the FC stock ($300,000).

(5) *Sales of U.S. real property interests by foreign corporations under section 337.* Section 337 as in effect prior to the Tax Reform Act of 1986 shall not apply to any sale or exchange (including a deemed section 337 sale pursuant to an election under section 338(a) to treat a stock purchase as an asset acquisition) of a U.S. real property interest by a foreign corporation.

(6) *Section 897(l) credit.* If a foreign corporation adopts a plan of complete liquidation and if, solely by reason of section 897(d) and this section, section 337(a) (as in effect before the Tax Reform Act of 1986) does not apply to sales or exchanges of, or section 336 (as in effect before the Tax Reform Act of 1986) does not apply to distributions of, United States real property interests by the liquidating corporation, then—

(i) The amount realized by the shareholder on the distribution shall be increased by its proportionate share of the amount by which the tax imposed by chapter 1 of the Code, as modified by the provisions of any applicable U.S. income tax treaty, on the liquidating corporation would have been reduced if section 897(d) and this section had not been applicable, and

(ii) For purposes of the Code, the shareholder shall be deemed to have paid, on the last day prescribed by law for the payment of the tax imposed by subtitle A of the Code on the shareholder for the taxable year, an amount of tax equal to the amount of increase in the amount realized described in subdivison (i) of this paragraph (c).

The special rule provided by this paragraph (c)(5) applies only to shareholders who are United States citizens or residents, and who have held stock in the liquidating corporation continuously since June 18, 1980. This special rule also only applies for the first taxable year of any such shareholder in which the shareholder receives a distribution in complete liquidation from the foreign corporation.

(7) *Other applicable rules.* For rules concerning exemption of gain pursuant to a U.S. income tax treaty, withholding of tax from distributions, and other applicable rules, see paragraph (d) of this section. For the treatment of liquidations described in section 334(b)(2)(A) of certain foreign corporations acquired before November 6, 1980, see § 1.897–4.

(d) *Rules of general application*—(1) *Interests subject to taxation upon later disposition*—(i) *In general.* Pursuant to the otherwise applicable rules of this section and § 1.897–6T, nonrecognition of gain or loss may apply with respect to certain distribution or exchanges of U.S. real property interests if any gain from a subsequent disposition of the interests that are distributed or received by the transferor in the exchange would be included in the gross income of the distributee or transferor and be subject to U.S. taxation. Gain is considered subject to U.S. taxation if the gain is included on the income tax return of a U.S. tax paying entity even if there is no U.S. tax liability (for example, because of net operating losses or an investment tax credit). Gain is not considered subject to U.S. taxation if the gain is derived by a tax exempt entity. A real estate investment trust is considered to be a pass-through entity for purposes of the rule of taxability of this paragraph (d)(1)(i). Thus, for example, a tax exempt entity holding an interest in a real estate investment trust is not subject to tax. A domestic corporation (including a foreign corporation that makes an effective section 897(i) election after receipt of the U.S. real property interest) shall not be considered subject to U.S. taxation on a subsequent disposition of a U.S. real property interest if it received the U.S.

real property interest prior to the effective date of the repeal of section 336(a) or 337(a) as in effect prior to the Tax Reform Act of 1986, unless the U.S. real property interest has not been sold or exchanged by the domestic corporation prior to such effective date in a transaction to which either section 336(a) or section 337(a) (as in effect prior to such effective date) applied. In addition, an interest shall be considered to be subject to U.S. taxation upon its subsequent disposition only if the requirements set forth in subdivision (iii) of this paragraph (d)(1) are met.

(ii) *Effects of income tax treaties*—(A) *Effect of treaty exemption from tax.* Except as otherwise provided in subdivision (C) of this paragraph (d)(1)(ii), a U.S. real property interest shall not be considered to be subject to U.S. taxation upon a subsequent disposition if, at the time of its distribution or exchange, the recipient is entitled pursuant to the provisions of a U.S. income tax treaty to an exemption from U.S. taxation upon a disposition of the interest.

(B) *Effect of treaty reduction of tax.* If, at the time of a distribution or exchange, a distributee of a U.S. real property interest in a distribution or a transferor who receives a U.S. real property interest in an exchange would be entitled pursuant to the provisions of a U.S. income tax treaty to reduced U.S. taxation upon the disposition of the interest, then a portion of the interest received shall be treated as an interest subject to U.S. taxation upon its disposition, and, therefore, that portion shall be entitled to nonrecognition treatment under the rules of this section or § 1.897–6T. The portion of the interest that is treated as subject to U.S. taxation is determined by multiplying the fair market value of the interest by a fraction. The numerator of the fraction is the amount of tax that would be due pursuant to the provisions of the applicable U.S. income tax treaty upon the recipient's disposition of the interest, determined as of the date of the distribution or transfer. The denominator of the fraction is the amount of tax that would be due upon such disposition but for the provisions of the treaty. However, nonrecognition treatment may be preserved in accordance with the provisions of subdivision (C) of this paragraph (d)(1)(ii). With regard to the provisions of this paragraph, see Article XIII (9) of the United States-Canada Income Tax Convention.

(C) *Waiver of treaty benefits to preserve nonrecognition.* Notwithstanding the provisions of subdivisions (A) and (B) of this paragraph (d)(1)(ii), an interest shall be considered to be subject to U.S. taxation upon its subsequent disposition if, in accordance with paragraph (d)(1)(iii)(F) of this section, the recipient waives the benefits of a U.S. income tax treaty that would otherwise entitle the recipient to an exemption from (or reduction of) U.S. tax upon a disposition of the interest.

(iii) *Procedural requirements.* If a U.S. real property interest is distributed or transferred after December 31, 1987, the transferor or distributor (that is a nonresident alien individual or a foreign corporation) shall file an income tax return for the taxable year of the distribution or transfer. Also, if a U.S. real property interest is distributed or transferred in a transaction before January 1, 1988, with respect to which nonrecognition treatment would not have been available under the express provisions of section 897 (d) or (e) of the Code but is available under the provisions of this section or § 1.897–6T, then the person that would otherwise be subject to tax by reason of the operation of section 897 must file an income tax return for the taxable year of the distribution or transfer. This requirement is satisfied by filing a tax return or an amended tax return for the year of the distribution or transfer by May 5, 1989, or by the date that the filing of the return is otherwise required. The person filing the return must attach thereto a document setting forth the following:

(A) A statement that the distribution or transfer is one to which section 897 applies;

(B) A description of the U.S. real property interest distributed or transferred, including its location, its adjusted basis in the hands of the distributor or tranferor immediately before the distribution or transfer, and the date of the distribution or transfer;

(C) A description of the U.S. real property interest received in an exchange;

(D) A declaration signed by an officer of the corporation that the distributing foreign corporation has substantiated the adjusted basis of the shareholder in its stock if the distributing corporation has nonrecognition or recognition limitation under paragraph (c) (3) or (4) of this section;

(E) The amount of any gain recognized and tax withheld by any person with respect to the distribution or transfer;

(F) Identification by name and address of the distributee or transferee, including the distributee's or transferee's taxpayer identification number (if any);

(G) The treaty and article (if any) under which the distributee or transferor would be exempt from U.S. taxation on a sale of the distributed U.S. real property interest or the U.S. real property interest received in the transfer; and

(H) A declaration, signed by the distributee or transferor or its authorized legal representative, that the distributee or transferor shall treat any subsequent sale, exchange, or other disposition of the U.S. real property interest as a disposition that is subject to U.S. taxation, notwithstanding the provisions of any U.S. income tax treaty or intervening change in circumstances.

A person who has provided or filed a notice described in § 1.1445–2(d)(2)(iii) or § 1.1445–5(b)(2)(ii) in connection with a transaction may satisfy the requirement of this paragraph (d)(1)(iii) by attaching to his return a copy of that notice together with any information or declaration required by this subdivision not contained in that notice.

(2) *Treaty exception to imposition of tax.* If gain that would be currently recognized pursuant to the provisions of this section or § 1.897–6T is subject to an exemption from (or reduction of) U.S. tax pursuant to a U.S. income tax treaty, then gain shall be recognized only as provided by that treaty, for dispositions occurring before January 1, 1985. For dispositions occurring after December 31, 1984, all gain shall be recognized as provided in section 897 and the regulations thereunder, except as provided by Articles XIII (9) and XXX (5) of the United States-Canada Income Tax Convention or other income tax treaty entered into force after June 6, 1988.

With regard to Article XXX (5) of the Income Tax Treaty with Canada, see, Rev. Rul. 85–76, 1985–1 C.B. 409. With regard to basis adjustments for certain related person transactions, see, § 1.897–6T(c)(3).

(3) *Withholding.* Under sections 1441 and 1442, as modified by the provisions of any applicable U.S. income tax treaty, a corporation must withhold tax from a dividend distribution to which section 301 applies to a shareholder that is a foreign person, if the dividend is considered to be from sources inside the United States. For a description of dividends that are considered to be from sources inside the United States, see section 861(a)(2). Under section 1445, withholding is required with respect to certain dispositions and distributions of U.S. real property interests.

(4) *Effect on earnings and profits.* With respect to adjustments to earnings and profits for gain recognized to a distributing corporation on a distribution, see section 312 and the regulations thereunder.

(e) *Effective date.* Except as otherwise specifically provided in the text of these regulations, this section shall be effective for transfers, exchanges, distributions and other dispositions occurring after June 18, 1980.

[T.D. 8198, 53 FR 16217, May 5, 1988; 53 FR 18022, May 19, 1988]

§ 1.897–6T Nonrecognition exchanges applicable to corporations, their shareholders, and other taxpayers, and certain transfers of property in corporate reorganizations (temporary).

(a) *Nonrecognition exchanges*—(1) *In general.* Except as otherwise provided in this section and in § 1.897–5T, for purposes of section 897(e) any nonrecognition provision shall apply to a transfer by a foreign person of a U.S. real property interest on which gain is realized only to the extent that the transferred U.S. real property interest is exchanged for a U.S. real property interest which, immediately following the exchange, would be subject to U.S. taxation upon its disposition, and the transferor complies with the filing requirements of paragraph (d)(1)(iii) of § 1.897–5T. No loss shall be recognized pursuant to section 897(e) or the rules of this section unless such loss is otherwise permitted to be recognized. In the case of an exchange of a U.S. real property interest for stock in a domestic corporation (that is otherwise treated as a U.S. real property interest), such stock shall not be considered a U.S. real property interest unless the domestic corporation is a U.S. real property holding corporation immediately after the exchange. Whether an interest would be subject to U.S. taxation in the hands of the transferor upon its disposition shall be determined in accordance with the rules of § 1.897–5T(d)(1).

(2) *Definition of ''nonrecognition'' provision.* A ''nonrecognition provision'' is any provision of the Code which provides that gain or loss shall not be recognized if the requirements of that provision are met. Nonrecognition provisions relevant to this section include, but are not limited to, sections 332, 351, 354, 355, 361, 721, 731, 1031, 1033, 1034 and 1036. For purposes of section 897(e), sections 121 and 453 are not nonrecognition provisions.

(3) *Consequence of nonapplication of nonrecognition provisions.* If a nonrecognition provision does not apply to a transaction, then the U.S. real property interest transferred shall be considered exchanged pursuant to a transaction that is subject to U.S. taxation by reason of the operation of section 897. See, however, § 1.897–5T (d)(2) with respect to the treaty exceptions to the imposition of tax. If a U.S. real property interest is exchanged for an interest the disposition of which is only partially subject to taxation under chapter 1 of the Code (as modified by the provisions of any applicable U.S. income tax treaty), then any nonrecognition provision shall apply only to the extent that the interest received in the exchange would be subject to taxation under chapter 1 of the Code, as modified. For example, the exchange of a U.S. real property interest for an interest in a partnership will receive nonrecognition treatment pursuant to section 721 only to the extent that a disposition of the partnership interest will be subject to U.S. taxation by reason of the operation of section 897(g).

(4) *Section 355 distributions treated as exchanges.* If a domestic corporation, stock in which is treated as a U.S. real property interest, distributes stock in a foreign corporation or stock in a domestic corporation that is not a U.S. real property holding corporation to a foreign person under section 355(a), then the foreign person shall be considered as having exchanged a proportionate part of the stock in the domestic corporation that is treated as a U.S. real property interest for stock that is not treated as a U.S. real property interest.

(5) *Section 1034 rollover of gain*—(i) *Purchase of foreign principal residence.* A nonresident alien individual shall not be entitled to nonrecognition under section 1034 on the sale of a principal residence when the new principal residence acquired is not a U.S. real property interest.

(ii) *Purchase of U.S. principal residence.* A nonresident alien individual who sells his principal residence that is a U.S. real property interest and, within a period beginning two years before the date of such sale and ending on the date (with extensions) of filing his income tax return for the taxable year of the sale of the principal residence, purchases and uses another U.S. real property interest as a principal residence, shall, to the extent provided by section 1034, not recognize gain on the sale of the principal residence. If the individual has not purchased another U.S. real property interest as a principal residence at the time of the filing of the return for the year of sale, the individual must file a timely income tax return for the year of sale without claiming the benefit of section 1034. If the individual subsequently purchases another U.S. property interest as a principal residence that otherwise qualifies under section 1034 after the due date of the income tax return for the year of the sale of the principal residence and before a date that is two years after the sale of the principal residence, the individual may then apply section 1034 by filing an amended income tax return for the year of the sale of the principal residence and claim a refund. A nonresident alien may not claim the benefits of section 1034 unless such individual files a complete and timely income tax return with the appropriate forms for the year of the sale of the principal residence. The rules of this paragraph (a)(5)(ii) shall first apply to the sale of principal residences after June 6, 1988.

A nonresident alien individual who sells his principal residence that is a U.S. real property interest on or before June 6, 1988 shall, to the extent provided by section 1034, not recognize gain on the sale of the principal residence if the new principal residence is a U.S. real property interest.

(6) *Determination of basis.* If a nonrecognition provision applies to the transfer of a U.S. real property interest pursuant to the provisions of this section, then the basis of the property received in the exchange shall be determined in accordance with the rules generally applicable with respect to such nonrecognition provision. Similarly, the basis of the exchanged property in the hands of the transferee shall be determined in accordance with the rules that generally apply to such transfer.

(7) *Examples.* The rules of paragraphs (a) (1) through (6) of this section may be illustrated by the following examples. In each instance, the filing requirements of paragraph (d)(1)(iii) of § 1.897–5T have been satisfied.

Example 1. (i) A is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. A owns Parcel P, a U.S. real property interest, with a fair market value of $500,000 and an adjusted basis of $300,000. A transfers Parcel P to DC, a newly formed U.S. real property holding corporation wholly owned by A, in exchange for DC stock.

(ii) Under paragraph (a)(1) of this section, A has exchanged a U.S. real property interest (Parcel P) for another U.S. real property interest (DC stock) which is subject to U.S. taxation upon its disposition. The nonrecognition provisions of section 351(a) apply to A's transfer of Parcel P.

(iii) Under paragraph (a)(6) of this section, the basis of the DC stock received by A is determined in accordance with the rules generally applicable to the transfer. A takes a $300,000 adjusted basis in the DC stock under the rules of section 358(a)(1).

Example 2. (i) A is a citizen and resident of Country F who is stationed in Washington, DC as a full-time employee of an international organization. A sells his principal residence in Washington, and in the same taxable year A purchases another principal residence in Washington. The cost of the new residence exceeds the adjusted sales price of the old residence.

(ii) Under section 7701(b), A is a nonresident alien for U.S. tax purposes, and is subject to taxation under section 897(a). Under paragraphs (a)(1) and (5)(ii) of this section, A is considered to have exchanged a U.S. real property interest (the old principal residence) for another U.S. real property interest (the new principal residence) which is subject to U.S. taxation upon its disposition. The nonrecognition and basis provisions of section 1034(a) apply to A.

Example 3. If in *Example* 2. A had instead purchased a new principal residence in Country F, there would be an exchange of a U.S. real property interest for property that is not a U.S. real property interest. Under paragraph (a)(5)(i) of this section, A would recognize gain under section 897(a) on the disposition of the old principal residence.

Example 4. (i) B is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. B owns stock in DC1, a U.S. real property holding corporation. In a reorganization qualifying for nonrecognition under section 368(a)(1)(B), B exchanges the DC1 stock under section 354(a) for stock in DC2, a U.S. real property holding corporation.

(ii) A does not recognize any gain under paragraph (a)(1) of this section on the exchange of the DC1 stock for DC2 stock because there is an exchange of a U.S. real property interest (the DC1 stock) for another U.S. real property interest (the DC2 stock) which is subject to U.S. taxation upon its disposition.

Example 5. (i) C is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. C owns all of the stock of DC, a U.S. real property holding corporation. The fair market value of the DC stock is 500x, and C has a basis of 100x in the DC stock.

(ii) In a transaction qualifying as a distribution of stock of a controlled corporation under section 355(a), DC distributes to C all of the stock of FC, a foreign corporation that has not made a section 897(i) election. C does not surrender any of the DC stock. The FC stock has a fair market value of 200x. After the distribution, the DC stock has a fair market value of 300x.

(iii) Under the rules of paragraph (a)(4) of this section, C is considered to have exchanged DC stock with a fair market value of 200x and an adjusted basis of 40x for FC stock with a fair market value of 200x. Because the FC stock is not a U.S. real property interest, C must recognize gain of 160x under section 897(a) on the distribution. C takes a basis of 200x in the FC stock. C's basis in the DC stock is reduced to 60x pursuant to section 358(c).

Example. (i) A is an individual citizen and resident of Country F. F has an income tax treaty with the United States that exempts gain from the sale of stock, but not real property, by a resident of F from U.S. taxation. In 1981, A transferred Parcel P, an appreciated U.S. real property interest, to DC, a U.S. real property holding corporation, in exchange for DC stock. A owned all of the stock of DC.

(ii) Under the rules of paragraph (a)(1) of this section, A must recognize gain on the transfer of Parcel P. Even though there is an exchange of a U.S. real property interest for another U.S. real property interest, there is gain recognition because the U.S. real property interest received (the DC stock) would not have been subject to U.S. taxation upon a disposition immediately following the exchange. A may not convert a U.S. real property interest that was subject to taxation under section 897 into a U.S. real property interest that could be sold without taxation under section 897 due to a treaty exemption.

Example 7. (i) A, a nonresident alien, organized FC1, a Country W corporation in September 1980 to invest in U.S. real property. FC1's only asset is Parcel P, a U.S. real property interest with a fair market value of $500,000 and an adjusted basis of $200,000. The FCI stock has a fair market value of $500,000 and A's basis in the FC1 stock is $100,000. The United States does not have a treaty with Country W.

(ii) A, organized FC2, a Country W corporation in July 1987. FC2 organized DC in August 1987. Pursuant to a plan of reorganization under section 368 (a)(1)(C), FC1 transfers Parcel P to DC in exchange for FC2 voting stock. As a result of the transfer, DC is a U.S. real property holding corporation wholly owned by FC2. The FC2 stock used by DC in the acquisition had been transferred by FC2 to DC as part of the plan of reorganization. FC1 distributes the FC2 stock to A in exchange for A's FC1 stock.

(iii) FC1's exchange of Parcel P for the FC2 stock under section 361(a) is a disposition of a U.S. real property interest. FC1 must recognize gain of $300,000 under section 897(e) and paragraph (a)(1) of this section on the exchange because the FC2 stock received in exchange for Parcel P is not a U.S. real property interest.

(iv) Under section 362(b), DC takes a basis of $500,000 in Parcel P. FC2 takes a basis of $500,000 in the DC stock. A takes a basis of $100,000 in the FC2 stock under section 358(a)(1). Section 897(d) and paragraph (c)(1) of § 1.897–5T do not apply to FC1's distribution of the FC2 stock because the FC2 stock is not a U.S. real property interest.

Example 8. (i) The facts are the same as in *Example 7,* except that the United States has a treaty with Country W that entitles FC1 and FC2 to nondiscriminatory treatment as described in § 1.897–3(b)(2). FC1, but not FC2, makes a valid section 897(i) election prior to the transaction.

(ii) FC1's transfer of Parcel P to DC in exchange for FC2 stock is not subject to section 897(e) and paragraph (a)(1) of this section because FC1 made an election under section 897(i). DC takes a basis of $200,000 in Parcel P under section 362(b).

(iii) FC1's distribution of the FC2 stock to A in exchange for the FC1 stock is not subject to the section 897(d) and paragraph (c)(1) of § 1.897–5T because FC1 made an election under section 897(i).

(iv) A must recognize gain on the exchange under section 354(a) of the FC1 stock for the FC2 stock. A exchanged a U.S. real property interest (the FC1 stock) for an interest which is not a U.S. real property interest (the FC2 stock). A recognizes gain of $400,000. Under section 1012, A takes a $500,000 basis in the FC2 stock.

Example 9. (i) The facts are the same as in *Example 7* except that the United States has a treaty with Country W that entitles FC1 and FC2 to nondiscriminatory treatment as described in § 1.897–3(b)(2). FC2, but not FC1, makes a valid section 897(i) election prior to the transaction.

(ii) FC1's exchange of Parcel P for the FC2 stock under section 361(a) is a disposition of a U.S. real property interest. FC1 does not recognize any gain under section 897(e) and paragraph (a)(1) of this section because there is an exchange of a U.S. real property interest (Parcel P) for another U.S. real property interest (the FC2 stock). DC takes a basis of $200,000 in Parcel P under section 362(b). FC2 takes a basis of $200,000 in the DC stock.

(iii) FC1's distribution of the FC2 stock to A in exchange for the FC1 stock is subject to section 897(d) and paragraph (c)(1) of § 1.897–5T. Because A takes a basis of $100,000 in the FC2 stock under section 358(a) (which is less than the $200,000 basis of the FC2 stock in the hands of FC1), and A would be subject to U.S. taxation under section 897(a) on a subsequent disposition of the FC2 stock, FC1 does not recognize any gain under paragraph (c)(1) of § 1.897–5T due to the statutory exception of paragraph (c)(2)(i) of that section, provided that FC1 complies with the filing requirements of paragraph (d)(1)(C) of § 1.897–5T.

(iv) Since, the FC1 stock was not a U.S. real property interest, its disposition by A in the section 354(a) exchange for FC2 stock is not subject to section 897(e) and paragraph (a)(1) of this section.

Example 10. (i) The facts are the same as in *Example 7,* except that the United States has a treaty with Country W that entitles FC1 and FC2 to nondiscriminatory treatment as described in § 1.897–3(b)(2). FC1 and FC2 made valid section 897(i) elections prior to the transactions.

(ii) FC1's transfer of Parcel P to DC in exchange for FC2 stock is not subject to section 897(e) and paragraph (a)(1) of this section because FC1 made an election under section 897(i). DC takes a basis of $200,000 in Parcel P under section 362(a). FC2 takes a basis of $200,000 in the DC stock.

(iii) FC1's distribution of the FC2 stock to A in exchange for the FC1 stock is not subject to section 897(d) and paragraph (c)(1) of § 1.897–5T because FC1 made an election under section 897(i).

(iv) A does not recognize any gain on the exchange of the FC1 stock for the FC2 stock under section 354(a). Under paragraph (a)(1) of this section, there is an exchange of a U.S. real property interest (FC1 stock) for another U.S. real property interest (FC2 stock). A takes a basis of $100,000 in the FC2 stock under section 358(a).

(8) *Treatment of nonqualifying property*—(i) *In general.* If, under paragraph (a)(1) of this section, a nonrecognition provision would apply to an exchange but for the fact that nonqualifying property (cash or property other than U.S. real property interests) is received in addition to property (U.S. real property interests) that is permitted to be received under paragraph (a)(1) of this section, then the transferor shall recognize gain under this section equal to the lesser of—

(A) The sum of the cash received plus the fair market value of the nonqualifying property received, or

(B) The gain realized with respect to the U.S. real property interest transferred. However, no loss shall be recognized pursuant to this paragraph (a)(8) unless such loss is otherwise permitted to be recognized.

(ii) *Treatment of mixed exchanges.* In a mixed exchange where both a U.S. real property interest and other property (including cash) is transferred in exchange both for property the receipt of which would qualify for nonrecognition treatment pursuant to paragraph (a)(1) of this section and for other property (including cash) which would not so qualify, the transferor will recognize gain in accordance with the rules set forth in subdivisions (A) through (C) of this paragraph (a)(8)(ii).

(A) *Allocation of nonqualifying property.* The amount of nonqualifying property (including cash) considered to be received in exchange for U.S. real property interests shall be determined by multiplying the fair market value of the nonqualifying property received by a fraction (''real property fraction''). The numerator of the fraction is the fair market value of the U.S. real property interest transferred in the exchange. The denominator of the fraction is the fair market value of all property transferred in the exchange.

(B) *Recognition of gain.* The amount of gain that must be recognized, and that shall be subject to U.S. taxation by reason of the operation of section 897, shall be equal to the lesser of:

(*1*) The amount determined under subdivision (A) of this paragraph (a)(8)(ii), or

(*2*) The gain or loss realized with respect to the U.S. real property interest exchanged.

(C) *Treatment of other amounts.* The treatment of other amounts received in a mixed exchange shall be determined as follows:

(*1*) The amount of nonqualifying property (including cash) considered to be received in exchange for property (including cash) other than U.S. real property interests shall be treated in the manner provided in the relevant nonrecognition provision. Such amounts shall be determined by subtracting the amount determined under subdivision (A) of this paragraph (a)(8)(ii) from the total amount of nonqualifying property received in the exchange.

(*2*) The amount of qualifying property considered to be received in exchange for U.S. real property interests shall be treated in the manner provided in paragraph (a)(1) of this section. Such amount shall be determined by multiplying the total fair market value of qualifying property received in the exchange by the real property fraction described in subdivision (A) of this paragraph (a)(8)(ii).

(*3*) The amount of qualifying property considered to be received in exchange for property other than U.S. real property interests shall be treated in the manner provided in the relevant nonrecognition provision. Such amount shall be determined by subtracting the amount determined under subdivision

(*2*) of this paragraph (a)(8)(ii)(C) from the total fair market value of qualifying property received in the exchange.

(iii) *Example.* The rules of paragraph (a)(8)(ii) of this section may be illustrated by the following example.

Example. (i) A is an individual citizen and resident of country F. Country F does not have an income tax treaty with the United States. A is the sole proprietor of a business located in the United States, the assets of which consist of a U.S. real property interest with a fair market value of $1,000,000 and an adjusted basis of $700,000, and equipment used in the business with a fair market value of $500,000 and an adjusted basis of $250,000. A decides to incorporate the business, and on January 1, 1987, A transfers his assets to domestic corporation DC in exchange for 100 percent of the stock of DC, with a fair market value of $900,000. In addition, A receives a long term note (constituting a security) from DC for $600,000, bearing arm's length interest and repayment terms. DC has no assets other than those received in the exchange with A. Pursuant to section 897(c)(2) and § 1.897–2, DC is a U.S. real property holding corporation. Therefore, the stock of DC is a U.S. real property interest. Assume that the note from DC constitutes an interest in the corporation solely as a creditor as provided by § 1.897–1(d)(4) of the regulation. A complies with the filing requirements of paragraph (d)(1)(iii) of § 1.897–5T.

(ii) Because the note from DC would not be subject to U.S. taxation upon its disposition, it is nonqualifing property for purposes of determining whether A is entitled to receive nonrecognition treatment pursuant to section 351 with respect to his exchange of the U.S. real property interest. Thus, A must recognize gain in the manner provided in paragraph (a)(8)(ii) of this section. Pursuant to paragraph (a)(8)(ii)(A), the amount of nonqualifying property received in exchange for the real property interests is determined by multiplying the fair market value of such property ($600,000) by the real property fraction. The numerator of the fraction is $1,000,000, the fair market value of the real property transferred by A. The demoninator is $1,500,000, the fair market value of all property transferred by A. Thus, A is considered to have received $400,000 of the note in exchange for the real property ($600,000 X $1,000,000/$1,500,000). Pursuant to paragraph (a)(8)(ii)(B), A must recognize the lesser of the amount initially determined or the gain realized with respect to the U.S. real property interest. Therefore, A must recognize the $300,000 gain realized with respect to the real property.

(iii) Pursuant to paragraph (a)(8)(ii)(C) of this section, A is considered to have received $200,000 of the note in exchange for equipment ($600,000 [total value of note received] minus $400,000 [portion of note received in exchange for real property]), $600,000 of the stock in exchange for real property ($900,000 [total value of stock received] times $1,000,000/1,500,000) [proportion of property exchanged consisting of real property]), and $300,000 of the stock in exchange for equipment ($900,000 [total value of stock received] minus $600,000 [portion of stock received in exchange for real property]). All three amounts are entitled to nonrecognition treatment pursuant to section 351.

(iv) Pursuant to paragraph (a)(2) of this section, A's basis in the stock and note received and DC's basis in the U.S. real property interest and equipment will be determined in accordance with the generally applicable rules. The $400,000 portion of the note received in exchange for the real property interest is other property. Pursuant to section 358(a)(2), A takes a fair market value ($400,000) basis for that portion of the note. Pursuant to section 358(a)(1), A's basis in the property received without the recognition of gain (the DC stock and the other portion of the note) will be equal to the basis of the property transferred ($950,000 [$700,000 basis of U.S. real property interest plus $250,000 basis of equipment]), decreased by the fair market value of the other property received ($400,000 portion of the note), and increased by the amount of gain recognized to A on the transaction ($300,000). Thus, A's basis in the stock and the nonrecognition portion of the note is $850,000 ($950,000–$400,000+$300,000). Under § 1.358–2(b)(2) of the regulations, the $850,000 is allocated between the stock and the nonrecognition portion of the note in proportion to their fair market values. A takes a basis of $697,000 in the DC stock ($850,000×900,000/1,100,000). A takes a basis of $153,000 in the nonrecognition portion of the note ($850,000×200,000/1,100,000). A's basis in the note is $553,000 ($400,000+$153,000). DC's basis in the property received from A will be determined under section 362(a). DC takes a basis of $1,000,000 in the real property interest (A's basis of $700,000 increased by the $300,000 of gain recognized by A on it). DC takes a basis of $250,000 in the equipment (A's basis of $250,000).

(9) *Treaty exception to imposition of tax.* If gain that would be currently recognized pursuant to the provisions of this section is subject to an exemption from, or reduction of, U.S. tax pursuant to a U.S. income tax treaty, then gain shall be recognized only as provided by that treaty for dispositions occurring before January 1, 1985. For dispositions occurring after December 31, 1984, all gain shall be recognized as

provided in section 897 and the regulations thereunder, except as provided by Articles XII (9) and XXX (5) of the United States-Canada Income Tax Convention or other income tax treaty entered into after June 6, 1988. In regard to Article XXX (5) the Income Tax Treaty with Canada, see, Rev. Rul. 85–76, 1985–1 C.B. 409.

(b) *Certain foreign to foreign exchanges*—(1) *Exceptions to the general rule.* Notwithstanding the provisions of paragraph (a)(1) of this section and pursuant to authority conferred by section 897(e)(2), a foreign person shall not recognize gain, in the instances described in paragraph (b)(2) of this section, on the transfer of a U.S. real property interest to a foreign corporation in exchange for stock in a foreign corporation, but only if the transferee's subsequent disposition of the transferred U.S. real property interest would be subject to U.S. taxation, as determined in accordance with the provisions of § 1.897–5T(d)(1), if the filing requirements of paragraph (d)(1)(iii) of § 1.897–5T have been satisfied, if one of the five conditions set forth in paragraph (b)(2) exists, and if one of the following three forms of exchange takes place.

(i) The exchange is made by a foreign corporation pursuant to section 361(a) in a reorganization described in section 368(a)(1) (D) or (F) and there is an exchange of the transferor corporation stock for the transferee corporation stock under section 354(a); or

(ii) The exchange is made by a foreign corporation pursuant to section 361(a) in a reorganization described in section 368(a)(1)(C); there is an exchange of the transferor corporation stock for the transferee corporation stock (or stock of the transferee corporation's parent in the case of a parenthetical C reorganization) under section 354(a); and the transferor corporation's shareholders own more than fifty percent of the voting stock of the transferee corporation (or stock of the transferee corporation's parent in the case of a parenthetical C reorganization) immediately after the reorganization; or

(iii) The U.S. real property interest exchanged is stock in a U.S. real property holding corporation; the exchange qualifies under section 351(a) of section 354(a) in a reorganization described in section 368(a)(1)(B); and immediately after the exchange, all of the outstanding stock of the transferee corporation (or stock of the transferee corporation's parent in the case of a parenthetical B reorganization) is owned in the same proportions by the same nonresident alien individuals and foreign corporations that, immediately before the exchange, owned the stock of the U.S. real property holding corporation.

If, however, a nonresident alien individual or foreign corporation which received stock in an exchange described in subdivision (iii) of this paragraph (b)(1) (or the transferee corporation's parent) disposes of any of such foreign stock within three years from the date of its receipt, then that individual or corporation shall recognize that portion of the gain realized with respect to the stock in the U.S. real property holding corporation for which foreign stock disposed of was received.

(2) *Applicability of exception.* The exception to the provisions of paragraph (a)(1) provided by paragraph (b)(1) shall apply only if one of the following five conditions exists.

(i) Each of the interests exchanged or received in a transferor corporation or transferee corporation would not be a U.S. real property interest as defined in § 1.897–1(c)(1) if such corporations were domestic corporations; or

(ii) The transferee corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) is incorporated in a foreign country that maintains an income tax treaty with the United States that contains an information exchange provision; the transfer occurs after May 5, 1988; and the transferee corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) submit a binding waiver of all benefits of the respective income tax treaty (including the opportunity to make an election under section 897 (i)), which must be attached to each of the transferor and transferee corporation's income tax returns for the year of the transfer; or

(iii) The transferee foreign corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) is a qualified resident as defined in section 884(e) and any regulations thereunder of the foreign country in which it is incorporated; or

(iv) The transferee foreign corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) is incorporated in the same foreign country as the transferor foreign corporation; and there is an income tax treaty in force between that foreign country and the United States at the time of the transfer that contains an exchange of information provision; or

(v) The transferee foreign corporation is incorporated in the same foreign country as the transferor foreign corporation; and the transfer is incident to a mere change in identity, form, or place of organization of one corporation under section 368(a)(1)(F).

For purposes of any election by a transferee foreign corporation (or the transferee corporation's parent in the case of a parenthetical C reorganization) to be treated as a domestic corporation under section 897(i) and § 1.897–3 where the exchange was described in subdivisions (i) or (ii) of paragraph (b)(1) of this section, any prior dispositions of the transferor foreign corporation stock will be subject to the requirements of § 1.897–3(d)(2) upon an election under section 897(i) by the transferee foreign corporation (or the transferee corporation's parent in the case of a parenthetical C reorganization).

(3) *No exceptions.* No exception to recognition of gain under paragraph (a)(1) of this section is provided for the transfer of a U.S. real property interest by a foreign person to a foreign corporation in exchange for stock in a foreign corporation other than as provided in this paragraph (b). Thus, no exception is provided where—

(i) Such exchange is made pursuant to section 351 and the U.S. real property interest transferred is not stock in a U.S. real property holding corporation; or

(ii) Such exchange is made pursuant to section 361(a) in a reorganization described in section 368(a)(1) that does not qualify for nonrecognition of gain under this paragraph (b). With regard to the treatment of certain foreign corporations as domestic corporations under section 897(i), see §§ 1.897–3 and 1.897–8T.

(4) *Examples.* The rules of paragraph (b)(1) and (2) of this section may be illustrated by the following examples. In each instance, the filing requirements of paragraph (d)(1)(iii) of § 1.897–5T have been satisfied.

Example 1. (i) FC is a Country F corporation that has not made a section 897 (i) election. FC owns Parcel P, a U.S. real property interest, with a fair market value of $450x and an adjusted basis of 100x.

(ii) FC transfers Parcel P to FS, its wholly owned Country F subsidiary, in exchange for FS stock under section 351 (a). FS has not made a section 897(i) election. Under the rules of paragraph (a)(1) of this section, FC must recognize gain of 350x under section 897 (a) because the FS stock received in the exchange is not a U.S. real property interest. No exception to the recognition rule of paragraph (a)(1) is provided under this paragraph (b) for a transfer under section 351 (a) of a U.S. real property interest (that is not stock in a U.S. real property holding corporation) by a foreign corporation to another foreign corporation in exchange for stock to the transferee corporation.

Example 2. (i) FC is a Country F corporation that has not made a section 897(i) election. FC owns several U.S. real property interests that have appreciated in value since FC purchased the interests. FP, a Country F corporation, owns all of the outstanding stock of FC. Country F maintains an income tax treaty with the United States.

(ii) For valid business purposes, FC transferred substantially all of its assets including all of its U.S. real property interests to FS in 1989 under section 361(a) in a reorganization in exchange for FS stock. FS is a newly formed Country F corporation that is owned by FC. The transfer qualifies as a reorganization under section 368(a)(1)(D). FC immediately distributes the FS stock to FP in exchange for the FC stock and FC dissolves. FP has no gain or loss on the exchange of the FC stock for the FS stock under section 354(a).

(iii) Under the rules of paragraph (b)(1)(i) of this section, FC does not recognize any gain on the transfer of the U.S. real property interests to FS under section 361(a) in the reorganization under section 368(a)(1)(D) because FS would be subject to U.S. taxation on a subsequent disposition of the interests, as required by paragraph (b)(1) of this section; there is an exchange of stock under section 354(a), as required by paragraph (b)(1)(i); and FC and FS are incorporated in Country F which maintains an income tax treaty with the United States, as required by paragraph (b)(2)(iv).

(5) *Contributions of property.* A foreign person that contributes a U.S. real property interest to a foreign corporation as paid in surplus or as a contribution to capital (including a contribution provided in section 304(a)) shall be treated, for purposes of section 897(j) and this section, as exchanging the U.S. real property interest for stock in the foreign corporation.

(c) *Denial of nonrecognition with respect to certain tax avoidance transfers*—(1) *In general.* The provisions of § 1.897–5T and paragraphs (a) and (b) of this section are subject to the rules of this paragraph (c).

(2) *Certain transfers to domestic corporations*—

(i) *General rule.* If a foreign person transfers property, that is not a U.S. real property interest, to a domestic corporation in a nonrecognition exchange, where—

(A) The adjusted basis of such property transferred exceeded its fair market value on the date of the transfer to the domestic corporation;

(B) The property transferred will not immediately be used in, or held by the domestic corporation for use in, the conduct of a trade or business as defined in § 1.897–1(f); and

(C) Within two years of the transfer to the domestic corporation, the property transferred is sold at a loss;

then, it will be presumed, absent clear and convincing evidence to the contrary, that the purpose for transferring the loss property was the avoidance of taxation on the disposition of U.S. real property interests by the domestic corporation. Any loss recognized by the domestic corporation on the sale or exchange of such property shall not be used by the domestic corporation, either by direct offset or as part of a net operating loss or capital loss carryback or carryover to offset any gain recognized from the sale or exchange of a U.S. real property interest by the domestic corporation.

(ii) *Example.* The rules of paragraph (c)(2)(i) of this section may be illustrated by the following example.

Example. A is an individual citizen and resident of country F, which does not have an income tax treaty with the U.S. On January 1, 1987, A transfers a U.S. real property interest with a basis of $100,000 and a fair market value of $600,000 to domestic corporation DC in exchange for all of the stock of DC. On October 20, 1987, A transfers stock of a publicly traded domestic corporation with a basis in his hands of $900,000 and a fair market value of $500,000, in exchange for additional stock of DC. The stock of the publicly traded domestic corporation does not constitute an asset used or held for use in DC's trade or business. If DC sells the stock of the publicly traded domestic corporation before October 20, 1989 and recognizes a loss, the loss may not be used to offset any gain recognized on the sale of the U.S. real property interests by DC.

(3) *Basis adjustment for certain related person transactions.* In the case of any disposition after December 31, 1979, of a U.S. real property interest to a related person (within the meaning of section 453(f)(1)), the basis of the interest in the hands of the person acquiring such interest shall be reduced by the amount of any gain which is not subject to taxation under section 871(b)(1) or 882(a)(1) because the disposition occurred before June 19, 1980 or because of any treaty obligation of the United States. If a foreign corporation makes an election under section 897(i), and the stock of such corporation was transferred between related persons after December 31, 1979 and before June 19, 1980, then such stock shall be treated as a U.S. real property interest solely for purposes of this paragraph (c)(3).

(4) *Rearrangement of ownership to gain treaty benefit.* A foreign person who directly or indirectly owns a U.S. real property interest may not directly or indirectly rearrange the incidents of ownership of the U.S. real property interest through the use of nonrecognition provisions in order to gain the benefit of a treaty exemption from taxation. Such nonrecognition will not apply to the foreign transferor. The transferor will recognize gain but not loss on the transfer under section 897(a).

(d) *Effective date.* Except as specifically provided otherwise in the text of the regulations, paragraphs (a) through (c) shall be effective for transfers, exchanges and other dispositions occurring after June 18, 1980. Paragraph (a)(5)(ii) of this section shall be effective for exchanges and elections occurring after June 6, 1988.

[T.D. 8198, 53 FR 16224, May 5, 1988; 53 FR 18022, May 19, 1988]

§ 1.897–7T Treatment of certain partnership interests as entirely U.S. real property interests under sections 897(g) and 1445(e) (temporary).

(a) *Rule.* Pursuant to section 897(g), an interest in a partnership in which, directly or indirectly, fifty percent or more of the value of the gross assets consist of U.S. real property interests, and ninety percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents shall, for purposes of section 1445, be treated as entirely a U.S. real property interest. For purposes of section 897(g), such interest shall be treated as a U.S. real property interest only to the extent that the gain on the disposition is attributable to U.S. real property interests (and not cash, cash equivalents or other property). Consequently, a disposition of any portion of such partnership interest shall be subject to partial taxation under section 897(a) and full withholding under section 1445(a). For purposes of this paragraph, cash equivalent means any asset readily convertible into cash (whether or not denominated in U.S. dollars) including, but not limited to, bank accounts, certificates of deposit, money market accounts, commercial paper, U.S. and foreign treasury obligations and bonds, corporate obligations and bonds, precious metals or commodities, and publicly traded instruments.

(b) *Effective date.* Section 1.897–7T shall be effective for transfers, exchanges, distributions and other dispositions occurring after June 6, 1988.

[T.D. 8198, 53 FR 16228, May 5, 1988]

§ 1.897–8T Status as a U.S. real property holding corporation as a condition for electing section 897(i) pursuant to § 1.897–3 (temporary).

(a) *Purpose and scope.* This section provides a temporary regulation that if and when adopted as a final regulation, will be added to paragraph (b) of § 1.897–3. Paragraph (b) of this section would then appear as paragraph (b)(4) of § 1.897–3.

(b) *General conditions.* The foreign corporation upon making an election under section 897(i) (including any retroactive election) must qualify as a U.S. real property holding corporation as defined in paragraph (b)(1) of § 1.897–2.

(c) *Effective Date.* Section 1.897–8T shall be effective as of June 6, 1988, with respect to foreign corporations making an election under section 897(i) after May 5, 1988.

[T.D. 8198, 53 FR 16229, May 5, 1988]

§ 1.897–9T Treatment of certain interest in publicly traded corporations, definition of foreign person, and foreign governments and international organizations (temporary).

(a) *Purpose and scope.* This section provides a temporary regulation that, if and when adopted as a final regulation will be added as new paragraphs (c)(2)(iii)(B), (k), (n) and (q) of § 1.897–1. Paragraph (b) of this section would then appear as paragraph (c)(2)(iii)(B) of § 1.897–1. Paragraph (c) of this section would then appear as paragraph (k) of § 1.897–1. Paragraph (d) of this section would then appear as paragraph (n) of § 1.897–1. Paragraph (e) of this section would then appear as paragraph (q) of § 1.897–1.

(b) Any other interest in the corporation (other than an interest solely as a creditor) if on the date such interest was acquired by its present holder it had a fair market value greater than the fair market value on that date of 5 percent of the regularly traded class of the corporation's stock with the lowest fair market value. However, if a non-regularly traded class of interests in the corporation is convertible into a regularly traded class of interests in the corporation, an interest in such non-regularly traded class shall be treated as a U.S. real property interest if on the date it was acquired by its present holder it had a fair market value greater than the fair market value on that date of 5 percent of the regularly traded class of the corporation's stock into which it is convertible. If a person holds interests in a corporation of a class that is not regularly traded, and subsequently acquires additional interests of the same class, then all such interests must be aggregated and valued as of the date of the subsequent acquisition. If the subsequent acquisition causes that person's interests to exceed the applicable limitation, then all such interests shall be treated as U.S. real property interests, regardless of when acquired. In addition, if a person holds interests in a corporation of separate classes that are not regularly traded, and if such interests were separately acquired for a principal purpose of avoiding the applicable 5 percent limitation of this paragraph, then such interests shall be aggregated for purposes of applying that limitation. This rule shall not apply to interests of separate classes acquired in transactions more than three years apart. For purposes of paragraph (c)(2)(iii) of § 1.897–1, section 318(a) shall apply (except that section 318(a)(2)(C) and (3)(C) shall each be applied by substituting ''5 percent'' for ''50 percent'').

(c) *Foreign person.* The term ''foreign person'' means a nonresident alien individual (including an individual subject to the provisions of section 877), a foreign corporation as defined in paragraph (1) of this section, a foreign partnership, a foreign trust or a foreign estate, as such persons are defined respectively by § 1.871–2 and by 7701 and the regulations thereunder. A resident alien individual, including a nonresident alien with respect to whom there is in effect an election under section 6013(g) or (h) to be treated as United States resident, is not a foreign person. With respect to the status of foreign governments and international organizations, see paragraph (e) of this section.

(d) *Regularly traded*—(1) *General rule*—(i) *Trading requirements.* A class of interests that is traded on one or more established securities markets is considered to be regularly traded on such market or markets for any calendar quarter during which—

(A) Trades in such class are effected, other than in *de minimis* quantities, on at least 15 days during the calendar quarter;

(B) The aggregate number of the interests in such class traded is at least 7.5 percent or more of the average number of interests in such class outstanding during the calendar quarter; and

(C) The requirements of paragraph (d)(3) of this section are met.

(ii) *Exceptions*—(A) in the case of the class of interests which is held by 2,500 or more record shareholders, the requirements of paragraph (d)(1)(i)(B) of this section shall be applied by substituting ''2.5 percent'' for ''7.5 percent''.

(B) If at any time during the calendar quarter 100 or fewer persons own 50 percent or more of the outstanding shares of a class of interests, such class shall not be considered to be regularly traded for purposes of sections 897, 1445 and 6039C. Related persons shall be treated as one person for purposes of this paragraph (d)(1)(ii)(B).

(iii) *Anti-abuse rule.* Trades between related persons shall be disregarded. In addition, a class of interests shall not be treated as regularly traded if there is an arrangement or a pattern of trades designed to meet the requirements of this paragraph (d)(1). For example, trades between two persons that occur several times during the calendar quarter may be treated as an arrangement or a pattern of trades designed to meet the requirements of this paragraph (d)(1).

(2) *Interests traded on domestic established securities markets.* For purposes of sections 897, 1445 and 6039C, a class of interests that is traded on an established securities market located in the United States is considered to be regularly traded for any calendar quarter during which it is regularly quoted by brokers or dealers making a market in such interests. A broker or dealer makes a market in a class of interests only if the broker or dealer holds himself out to buy or sell interests in such class at the quoted price. Stock of a corporation that is described in section 851(a)(1) and units of a unit investment trust registered under the Investment Company Act of 1940 (15 U.S.C. sections 80a–1 to 80a–2) shall be treated as regularly traded within the meaning of this paragraph.

(3) *Reporting requirement for interests traded on foreign securities markets.* A class of interests in a domestic corporation that is traded on one or more established securities markets located

outside the United States shall not be considered to be regularly traded on such market or markets unless such class is traded in registered form, and—

(i) The corporation registers such class of interests pursuant to section 12 of the Securities Exchange Act of 1934, 15 U.S.C. section 78, or

(ii) The corporation attaches to its Federal income tax return a statement providing the following:

(A) A caption which states ‘‘The following information concerning certain shareholders of this corporation is provided in accordance with the requirements of §1.897–9T.’’

(B) The name under which the corporation is incorporated, the state in which such corporation is incorporated, the principal place of business of the corporation, and its employer identification number, if any;

(C) The identity of each person who, at any time during the corporation's taxable year, was the beneficial owner of more than 5 percent of any class of interests of the corporation to which this paragraph (d)(3) applies;

(D) The title, and the total number of shares issued, of any class of interests so owned; and

(E) With respect to each beneficial owner of more than 5 percent of any class of interests of the corporation, the number of shares owned, the percentage of the class represented thereby, and the nature of the beneficial ownership of each class of shares so owned.

Interests in a domestic corporation which has filed a report pursuant to this paragraph (d)(3)(ii) shall be considered to be regularly traded on an established securities market only for the taxable year of the corporation with respect to which such a report is filed.

(4) *Coordination with section 1445.* For purposes of section 1445, a class of interests in a corporation shall be presumed to be regularly traded during a calendar quarter if such interests were regularly traded within the meaning of this paragraph during the previous calendar quarter.

(e) *Foreign governments and international organizations.* A foreign government shall be treated as a foreign person with respect to U.S. real property interests, and shall be subject to sections 897, 1445, and 6039C on the disposition of a U.S. real property interest except to the extent specifically otherwise provided in the regulations issued under section 892. An international organization (as defined in section 7701(a)(18)) is not a foreign person with respect to U.S. real property interests, and is not subject to sections 897, 1445, and 6039C on the disposition of a U.S. real property interest. Buildings or parts of buildings and the land ancillary thereto (including the residence of the head of the diplomatic mission) used by the foreign government for a diplomatic mission shall not be a U.S. real property interest in the hands of the respective foreign government.

(f) *Effective date.* Section 1.897–9T with the exception of paragraph (e) shall be effective for transfers, exchanges, distributions and other dispositions occurring on or after June 6, 1988. Paragraph (e) of this section shall be effective for transfers, exchanges, distributions and other dispositions occurring on or after July 1, 1986.

[T.D. 8198, 53 FR 16229, May 5, 1988]

INCOME FROM SOURCES WITHOUT THE UNITED STATES

FOREIGN TAX CREDIT

§1.901–1 Allowance of credit for taxes.

(a) *In general.* Citizens of the United States, domestic corporations, and certain aliens resident in the United States, domestic corporations, and certain aliens resident in the United States or Puerto Rico may choose to claim a credit, as provided in section 901, against the tax imposed by chapter 1 of the Code for taxes paid or accrued to foreign countries and possessions of the United States, subject to the conditions prescribed in the following subparagraphs:

(1) *Citizen of the United States.* A citizen of the United States, whether resident or nonresident, may claim a credit for (i) the amount of any income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued under section 905(b)) during the taxable year to any foreign country or to any possession of the United States; and (ii) his share of any such taxes of a partnership of which he is a member,

or of an estate or trust of which he is a beneficiary.

(2) *Domestic corporation.* A domestic corporation may claim a credit for (i) the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country, or to any possession of the United States; and (ii) the taxes deemed to have been paid or accrued under section 902, 905(b), or 960.

(3) *Alien resident of the United States or Puerto Rico.* An alien resident of the United States, or an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, may claim a credit for—

(i) The amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any possession of the United States;

(ii) The amount of any such taxes paid or accrued (or deemed paid or accrued under section 905(b)) during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(iii) His share of any such taxes of a partnership of which he is a member, or of an estate or trust of which he is a beneficiary, paid or accrued (or deemed paid or accrued under section 905(b)) during the taxable year,

(a) To any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country, or

(b) To any possession of the United States, as the case may be.

(4) *Limitation.* Section 907(a) limits the credit against the tax imposed by chapter 1 of the Code for certain foreign taxes paid or accrued with respect to foreign oil or gas extraction income. See § 1.907(a)–1.

(b) *Foreign countries which satisfy the similar credit requirement*—(1) *Taxes of foreign country of which alien resident is citizen or subject.* A foreign country of which an alien resident is a citizen or subject allows a similar credit, within the meaning of section 901(b)(3), to a United States citizen residing in such country either—

(i) If such country allows him a credit against its income taxes for the amount of income taxes paid or accrued to the United States; or

(ii) If, in imposing such taxes, such country exempts from taxation the income received by him from sources within the United States (as determined under part I (section 861 and following), subchapter N, chapter 1 of the Code).

(2) *Taxes of foreign country other than one of which alien resident is citizen or subject.* An alien resident of the United States may claim a credit for income taxes paid or accrued by him to a foreign country other than the one of which he is a citizen or subject if the country of which he is a citizen or subject either—

(i) Allows a credit to a United States citizen residing therein for income taxes paid or accrued by him to such other foreign country; or

(ii) In imposing its income taxes, exempts from taxation the income of a United States citizen residing therein from sources within such other foreign country.

(c) *Deduction denied if credit claimed.* If a taxpayer chooses with respect to any taxable year to claim a credit for taxes to any extent, such choice will be considered to apply to income, war profits, and excess profits taxes paid or accrued in such taxable year to all foreign countries and possessions of the United States, and no portion of any such taxes shall be allowed as a deduction from gross income in such taxable year or any succeeding taxable year. See section 275(a)(4).

(d) *Period during which election can be made or changed.* The taxpayer may, for a particular taxable year, claim the benefits of section 901 (or claim a deduction in lieu of a foreign tax credit) at any time before the expiration of the period prescribed by section 6511(d)(3)(A) (or section 6511(c) if the period is extended by agreement).

(e) *Joint return.* In the case of a husband and wife making a joint return, credit for taxes paid or accrued to any foreign country or to any possession of the United States shall be computed upon the basis of the total taxes so paid by or accrued against the spouses.

(f) *Taxes against which credit not allowed*— The credit for taxes shall be allowed only against the tax imposed by chapter 1 of the Code, but it shall not be allowed against the following taxes imposed under that chapter:

(1) The minimum tax for tax preferences imposed by section 56;

(2) The 10 percent tax on premature distributions to owner-employees imposed by section 72(m)(5)(B);

(3) The tax on lump sum distributions imposed by section 402(e);

(4) The additional tax on income from certain retirement accounts imposed by section 408(f);

(5) The tax on accumulated earnings imposed by section 531;

(6) The personal holding company tax imposed by section 541;

(7) The additional tax relating to war loss recoveries imposed by section 1333; and

(8) The additional tax relating to recoveries of foreign expropriation losses imposed by section 1351.

(g) *Taxpayers to whom credit not allowed.* Among those to whom the credit for taxes is not allowed are the following:

(1) A foreign corporation (see section 882(c)(4));

(2) A China Trade Act corporation (see section 942);

(3) A citizen or domestic corporation entitled to the benefits of the exemption provided by section 931 for income from possessions of the United States (see section 931(g));

(4) A nonresident alien, other than an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year (see sections 874(c) and 901(b)(3));

(5) A citizen of a possession of the United States (except Puerto Rico) who is not otherwise a citizen of the United States and who is not a resident of the United States and persons who are inhabitants of the Virgin Islands (see section 932).

(h) *Taxpayers denied credit in a particular taxable year.* Taxpayers who are denied the credit for taxes for particular taxable years are the following:

(1) An individual who elects to pay the optional tax imposed by section 3, or one who elects under section 144 to take the standard deduction (see section 36);

(2) A taxpayer who elects to deduct taxes paid or accrued to any foreign country or possession of the United States (see sections 164 and 275);

(3) A regulated investment company which has exercised the election under section 853.

(i) *Dividends from a DISC treated as foreign.* For purposes of sections 901 through 906 and the regulations thereunder, any amount treated as a dividend from a corporation which is a DISC or former DISC (as defined in section 992(a) (1) or (3) as the case may be) will be treated as a dividend from a foreign corporation to the extent such dividend is treated under section 861(a)(2)(D) as income from sources without the United States.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6780, 29 FR 18148, Dec. 22, 1964; T.D. 6789, 29 FR 19241, Dec. 31, 1964; T.D. 6795, 30 FR 934, Jan. 29, 1965; T.D. 7283, 38 FR 20824, Aug. 3, 1973; T.D. 7636, 44 FR 47058, Aug. 10, 1979; T.D. 7961, 49 FR 26225, June 27, 1984; T.D. 8160, 52 FR 33932, Sept. 9, 1987]

§1.901–2 Income, war profits, or excess profits tax paid or accrued.

(a) *Definition of income, war profits, or excess profits tax*—(1) *In general.* Section 901 allows a credit for the amount of income, war profits or excess profits tax (referred to as ‘‘income tax’’ for purposes of this section and §§1.901–2A and 1.903–1) paid to any foreign country. Whether a foreign levy is an income tax is determined independently for each separate foreign levy. A foreign levy is an income tax if and only if—

(i) It is a tax; and

(ii) The predominant character of that tax is that of an income tax in the U.S. sense.

Except to the extent otherwise provided in paragraphs (a)(3)(ii) and (c) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Paragraphs (a), (b) and (c) of this section define an income tax for purposes of section 901. Paragraph (d) of this section contains rules describing what constitutes a separate foreign levy. Paragraph (e) of this section contains rules for determining the amount of tax paid by a person. Paragraph (f) of this section contains rules for determining by whom foreign tax is paid. Paragraph (g) of this section contains definitions of the terms ''paid by,'' ''foreign country,'' and ''foreign levy.'' Paragraph (h) of this section states the effective date of this section.

(2) *Tax*—(i) *In general.* A foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. A penalty, fine, interest, or similar obligation is not a tax, nor is a customs duty a tax. Whether a foreign levy requires a compulsory payment pursuant to a foreign country's authority to levy taxes is determined by principles of U.S. law and not by principles of law of the foreign country. Therefore, the assertion by a foreign country that a levy is pursuant to the foreign country's authority to levy taxes is not determinative that, under U.S. principles, it is pursuant thereto. Notwithstanding any assertion of a foreign country to the contrary, a foreign levy is not pursuant to a foreign country's authority to levy taxes, and thus is not a tax, to the extent a person subject to the levy receives (or will receive), directly or indirectly, a specific economic benefit (as defined in paragraph (a)(2)(ii)(B) of this section) from the foreign country in exchange for payment pursuant to the levy. Rather, to that extent, such levy requires a compulsory payment in exchange for such specific economic benefit. If, applying U.S. principles, a foreign levy requires a compulsory payment pursuant to the authority of a foreign country to levy taxes and also requires a compulsory payment in exchange for a specific economic benefit, the levy is considered to have two distinct elements: A tax and a requirement of compulsory payment in exchange for such specific economic benefit. In such a situation, these two distinct elements of the foreign levy (and the amount paid pursuant to each such element) must be separated. No credit is allowable for a payment pursuant to a foreign levy by a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) unless the person claiming such credit establishes the amount that is paid pursuant to the distinct element of the foreign levy that is a tax. See paragraph (a)(2)(ii) of this section and § 1.901–2A.

(ii) *Dual capacity taxpayers*—(A) *In general.* For purposes of this section and §§ 1.901–2A and 1.903–1, a person who is subject to a levy of a foreign state or of a possession of the United States or of a political subdivision of such a state or possession and who also, directly or indirectly (within the meaning of paragraph (a)(2)(ii)(E) of this section) receives (or will receive) a specific economic benefit from the state or possession or from a political subdivision of such state or possession or from an agency or instrumentality of any of the foregoing is referred to as a ''dual capacity taxpayer.'' Dual capacity taxpayers are subject to the special rules of § 1.901–2A.

(B) *Specific economic benefit.* For purposes of this section and §§ 1.901–2A and 1.903–1, the term ''specific economic benefit'' means an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population of the country in general. Thus, a concession to extract government-owned petroleum is a specific economic benefit, but the right to travel or to ship freight on a government-owned airline is not, because the latter, but not the former, is made generally available on substantially the same terms. An economic benefit includes property; a service; a fee or other payment; a right to use, acquire or extract resources, patents or other property that a foreign country owns or controls (within the meaning of paragraph (a)(2)(ii)(D) of this section); or a reduction or discharge of a contractual obligation. It does not include the right or privilege merely to engage in business generally or to engage in business in a particular form.

(C) *Pension, unemployment, and disability fund payments.* A foreign levy imposed on individuals to finance retirement, old-age, death, survivor, unemployment, illness, or disability benefits, or for some substantially similar purpose, is not a requirement of compulsory payment in exchange for a specific economic benefit, as long as the amounts required to be paid by the individuals subject to the levy are not computed on a basis reflecting the respective ages, life expectancies or similar characteristics of such individuals.

(D) *Control of property.* A foreign country controls property that it does not own if the country exhibits substantial indicia of ownership with respect to the property, for example, by both regulating the quantity of property that may be extracted and establishing the minimum price at which it may be disposed of.

(E) *Indirect receipt of a benefit.* A person is considered to receive a specific economic benefit indirectly if another person receives a specific economic benefit and that other person—

(*1*) Owns or controls, directly or indirectly, the first person or is owned or controlled, directly or indirectly, by the first person or by the same persons that own or control, directly or indirectly, the first person; or

(*2*) Engages in a transaction with the first person under terms and conditions such that the first person receives, directly or indirectly, all or part of the value of the specific economic benefit.

(3) *Predominant character.* The predominant character of a foreign tax is that of an income tax in the U.S. sense—

(i) If, within the meaning of paragraph (b)(1) of this section, the foreign tax is likely to reach net gain in the normal circumstances in which it applies,

(ii) But only to the extent that liability for the tax is not dependent, within the meaning of paragraph (c) of this section, by its terms or otherwise, on the availability of a credit for the tax against income tax liability to another country.

(b) *Net gain*—(1) *In general.* A foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements set forth in paragraphs (b)(2), (b)(3) and (b)(4), respectively, of this section.

(2) *Realization*—(i) *In general.* A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed—

(A) Upon or subsequent to the occurrence of events (‘‘realization events’’) that would result in the realization of income under the income tax provisions of the Internal Revenue Code;

(B) Upon the occurrence of an event prior to a realization event (a ‘‘prerealization event’’) provided the consequence of such event is the recapture (in whole or part) of a tax deduction, tax credit or other tax allowance previously accorded to the taxpayer; or

(C) Upon the occurrence of a prerealization event, other than one described in paragraph (b)(2)(i)(B) of this section, but only if the foreign country does not, upon the occurrence of a later event (other than a distribution or a deemed distribution of the income), impose tax (‘‘second tax’’) with respect to the income on which tax is imposed by reason of such prerealization event (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid on the occurrence of the prerealization event) and—

(*1*) The imposition of the tax upon such prerealization event is based on the difference in the values of property at the beginning and end of a period; or

(*2*) The prerealization event is the physical transfer, processing, or export of readily marketable property (as defined in paragraph (b)(2)(iii) of this section).

A foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even if it is also imposed in some situations upon the occurrence of events not described in this paragraph (b)(2)(i). For example, a foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even though the base of that tax also includes imputed rental income from a personal residence used by the owner and receipt of stock dividends of a type described in section

305(a) of the Internal Revenue Code. As provided in paragraph (a)(1) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax; therefore, a foreign tax described in the immediately preceding sentence satisfies the realization requirement even though some persons subject to the tax will on some occasions not be subject to the tax except with respect to such imputed rental income and such stock dividends. However, a foreign tax based only or predominantly on such imputed rental income or only or predominantly on receipt of such stock dividends does not satisfy the realization requirement.

(ii) *Certain deemed distributions.* A foreign tax that does not satisfy the realization requirement under paragraph (b)(2)(i) of this section is nevertheless considered to meet the realization requirement if it is imposed with respect to a deemed distribution (*e.g.*, by a corporation to a shareholder) of amounts that meet the realization requirement in the hands of the person that, under foreign law, is deemed to distribute such amount, but only if the foreign country does not, upon the occurrence of a later event (*e.g.*, an actual distribution), impose tax (‘‘second tax’’) with respect to the income on which tax was imposed by reason of such deemed distribution (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid with respect to the deemed distribution).

(iii) *Readily marketable property.* Property is readily marketable if—

(A) It is stock in trade or other property of a kind that properly would be included in inventory if on hand at the close of the taxable year or if it is held primarily for sale to customers in the ordinary course of business, and

(B) It can be sold on the open market without further processing or it is exported from the foreign country.

(iv) *Examples.* The provisions of paragraph (b)(2) of this section may be illustrated by the following examples:

Example 1. Residents of country X are subject to a tax of 10 percent on the aggregate net appreciation in fair market value during the calendar year of all shares of stock held by them at the end of the year. In addition, all such residents are subject to a country X tax that qualifies as an income tax within the meaning of paragraph (a)(1) of this section. Included in the base of the income tax are gains and losses realized on the sale of stock, and the basis of stock for purposes of determining such gain or loss is its cost. The operation of the stock appreciation tax and the income tax as applied to sales of stock is exemplified as follows: *A*, a resident of country X, purchases stock in June, 1983 for 100u (units of country X currency) and sells it in May, 1985 for 160u. On December 31, 1983, the stock is worth 120u and on December 31, 1984, it is worth 155u. Pursuant to the stock appreciation tax, *A* pays 2u for 1983 (10 percent of (120u − 100u)), 3.5u for 1984 (10 percent of (155u − 120u)), and nothing in 1985 because no stock was held at the end of that year. For purposes of the income tax, *A* must include 60u (160u − 100u) in his income for 1985, the year of sale. Pursuant to paragraph (b)(2)(i)(C) of this section, the stock appreciation tax does not satisfy the realization requirement because country X imposes a second tax upon the occurrence of a later event (*i.e.*, the sale of stock) with respect to the income that was taxed by the stock appreciation tax and no credit or comparable relief is available against such second tax for the stock appreciation tax paid.

Example 2. The facts are the same as in example 1 except that if stock was held on the December 31 last preceding the date of its sale, the basis of such stock for purposes of computing gain or loss under the income tax is the value of the stock on such December 31. Thus, in 1985, *A* includes only 5u (160u—155u) as income from the sale for purposes of the income tax. Because the income tax imposed upon the occurrence of a later event (the sale) does not impose a tax with respect to the income that was taxed by the stock appreciation tax, the stock appreciation tax satisfies the realization requirement. The result would be the same if, instead of a basis adjustment to reflect taxation pursuant to the stock appreciation tax, the country X income tax allowed a credit (or other comparable relief) to take account of the stock appreciation tax. If a credit mechanism is used, see also paragraph (e)(4)(i) of this section.

Example 3. Country X imposes a tax on the realized net income of corporations that do business in country X. Country X also imposes a branch profits tax on corporations organized under the law of a country other than country X that do business in country X. The branch profits tax is imposed when realized net income is remitted or deemed to be remitted by branches in country X to home offices outside of country X. The branch profits tax is imposed subsequent to the occurrence of events that would result in realization of income (*i.e.*, by corporations subject to such tax) under the income tax provisions of the Internal Revenue Code; thus, in accordance with paragraph (b)(2)(i)(A) of this section, the branch profits tax satisfies the realization requirement.

Example 4. Country X imposes a tax on the realized net income of corporations that do business in country X (the ''country X corporate tax''). Country X also imposes a separate tax on shareholders of such corporations (the ''country X shareholder tax''). The country X shareholder tax is imposed on the sum of the actual distributions received during the taxable year by such a shareholder from the corporation's realized net income for that year (*i.e.*, income from past years is not taxed in a later year when it is actually distributed) plus the distributions deemed to be received by such a shareholder. Deemed distributions are defined as (A) a shareholder's pro rata share of the corporation's realized net income for the taxable year, less (B) such shareholder's pro rata share of the corporation's country X corporate tax for that year, less (C) actual distributions made by such corporation to such shareholder from such net income. A shareholder's receipt of actual distributions is a realization event within the meaning of paragraph (b)(2)(i)(A) of this section. The deemed distributions are not realization events, but they are described in paragraph (b)(2)(ii) of this section. Accordingly, the country X shareholder tax satisfies the realization requirement.

(3) *Gross receipts.*—(i) *In general.* A foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of—

(A) Gross receipts; or

(B) Gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value.

A foreign tax that, judged on the basis of its predominant character, is imposed on the basis of amounts described in this paragraph (b)(3)(i) satisfies the gross receipts requirement even if it is also imposed on the basis of some amounts not described in this paragraph (b)(3)(i).

(ii) *Examples.* The provisions of paragraph (b)(3)(i) of this section may be illustrated by the following examples:

Example 1. Country X imposes a ''headquarters company tax'' on country X corporations that serve as regional headquarters for affiliated nonresident corporations, and this tax is a separate tax within the meaning of paragraph (d) of this section. A headquarters company for purposes of this tax is a corporation that performs administrative, management or coordination functions solely for nonresident affiliated entities. Due to the difficulty of determining on a case-by-case basis the arm's length gross receipts that headquarters companies would charge affiliates for such services, gross receipts of a headquarters company are deemed, for purposes of this tax, to equal 110 percent of the business expenses incurred by the headquarters company. It is established that this formula is likely to produce an amount that is not greater than the fair market value of arm's length gross receipts from such transactions with affiliates. Pursuant to paragraph (b)(3)(i)(B) of this section, the headquarters company tax satisfies the gross receipts requirement.

Example 2. The facts are the same as in Example 1, with the added fact that in the case of a particular taxpayer, *A*, the formula actually produces an amount that is substantially greater than the fair market value of arm's length gross receipts from transactions with affiliates. As provided in paragraph (a)(1) of this section, the headquarters company tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Accordingly, the result is the same as in example 1 for all persons subject to the headquarters company tax, including *A*.

Example 3. Country X imposes a separate tax (within the meaning of paragraph (d) of this section) on income from the extraction of petroleum. Under that tax, gross receipts from extraction income are deemed to equal 105 percent of the fair market value of petroleum extracted. This computation is designed to produce an amount that is greater than the fair market value of actual gross receipts; therefore, the tax on extraction income is not likely to produce an amount that is not greater than fair market value. Accordingly, the tax on extraction income does not satisfy the gross receipts requirement. However, if the tax satisfies the criteria of § 1.903–1(a), it is a tax in lieu of an income tax.

(4) *Net income*—(i) *In general.* A foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts (including gross receipts as computed under paragraph (b)(3)(i)(B) of this section) to permit—

(A) Recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts; or

(B) Recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses.

A foreign tax law permits recovery of significant costs and expenses even if such costs and expenses are recovered at a different time than they would be if the Internal Revenue Code applied, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery. For example, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery, the net income requirement is satisfied where items deductible under the Internal Revenue Code are capitalized under the foreign tax system and recovered either on a recurring basis over time or upon the occurrence of some future event or where the recovery of items capitalized under the Internal Revenue Code occurs less rapidly under the foreign tax system. A foreign tax law that does not permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses. Principles used in the foreign tax law to attribute costs and expenses to gross receipts may be reasonable even if they differ from principles that apply under the Internal Revenue Code (e.g., principles that apply under section 265, 465 or 861(b) of the Internal Revenue Code). A foreign tax whose base, judged on the basis of its predominant character, is computed by reducing gross receipts by items described in paragraph (b)(4)(i)(A) or (B) of this section satisfies the net income requirement even if gross receipts are not reduced by some such items. A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income requirement only if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax). In determining whether a foreign tax satisfies the net income requirement, it is immaterial whether gross receipts are reduced, in the base of the tax, by another tax, provided that other tax satisfies the realization, gross receipts and net income requirements.

(ii) *Consolidation of profits and losses.* In determining whether a foreign tax satisfies the net income requirement, one of the factors to be taken into account is whether, in computing the base of the tax, a loss incurred in one activity (e.g., a contract area in the case of oil and gas exploration) in a trade or business is allowed to offset profit earned by the same person in another activity (e.g., a separate contract area) in the same trade or business. If such an offset is allowed, it is immaterial whether the offset may be made in the taxable period in which the loss is incurred or only in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset the loss against profit. In determining whether a foreign tax satisfies the net income requirement, it is immaterial that no such offset is allowed if a loss incurred in one such activity may be applied to offset profit earned in that activity in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset such loss against profit. In determining whether a foreign tax satisfies the net income requirement, it is immaterial whether a person's profits and losses from one trade or business (*e.g.*, oil and gas extraction) are allowed to offset its profits and losses from another trade or business (*e. g.*, oil and gas refining and processing), or whether a person's business profits and losses and its passive investment profits and losses are allowed to offset each other in computing the base of the foreign tax. Moreover, it is immaterial whether foreign law permits or prohibits consolidation of profits and losses of related persons, unless foreign law requires separate entities to be used to carry on separate activities in the same trade or business. If foreign law requires that separate entities carry on such separate activities, the determination whether the net income requirement is satisfied is made by applying the same considerations as if such separate activities were carried on by a single entity.

(iii) *Carryovers.* In determining whether a foreign tax satisfies the net income requirement, it is immaterial, except as otherwise provided in paragraph (b)(4)(ii) of this section, whether losses incurred during one taxable period may be carried over to offset profits incurred in different taxable periods.

(iv) *Examples.* The provisions of this paragraph (b)(4) may be illustrated by the following examples:

Example 1. Country X imposes an income tax on corporations engaged in business in country X; however, that income tax is not applicable to banks. Country X also imposes a tax (the ''bank tax'') of 1 percent on the gross amount of interest income derived by banks from branches in country X; no deductions are allowed. Banks doing business in country X incur very substantial costs and expenses (e.g., interest expense) attributable to their interest income. The bank tax neither provides for recovery of significant costs and expenses nor provides any allowance that significantly compensates for the lack of such recovery. Since such banks are not almost certain never to incur a loss on their interest income from branches in country X, the bank tax does not satisfy the net income requirement. However, if the tax on corporations is generally imposed, the bank tax satisfies the criteria of §1.903–1(a) and therefore is a tax in lieu of an income tax.

Example 2. Country X law imposes an income tax on persons engaged in business in country X. The base of that tax is realized net income attributable under reasonable principles to such business. Under the tax law of country X, a bank is not considered to be engaged in business in country X unless it has a branch in country X and interest income earned by a bank from a loan to a resident of country X is not considered attributable to business conducted by the bank in country X unless a branch of the bank in country X performs certain significant enumerated activities, such as negotiating the loan. Country X also imposes a tax (the ''bank tax'') of 1 percent on the gross amount of interest income earned by banks from loans to residents of country X if such banks do not engage in business in country X or if such interest income is not considered attributable to business conducted in country X. For the same reasons as are set forth in example 1, the bank tax does not satisfy the net income requirement. However, if the tax on persons engaged in business in country X is generally imposed, the bank tax satisfies the criteria of §1.903–1(a) and therefore is a tax in lieu of an income tax.

Example 3. A foreign tax is imposed at the rate of 40 percent on the amount of gross wages realized by an employee; no deductions are allowed. Thus, the tax law neither provides for recovery of costs and expenses nor provides any allowance that effectively compensates for the lack of such recovery. Because costs and expenses of employees attributable to wage income are almost always insignificant compared to the gross wages realized, such costs and expenses will almost always not be so high as to offset the gross wages and the rate of the tax is such that, under the circumstances, after the tax is paid, employees subject to the tax are almost certain to have net gain.

Accordingly, the tax satisfies the net income requirement.

Example 4. Country X imposes a tax at the rate of 48 percent of the ''taxable income'' of nonresidents of country X who furnish specified types of services to customers who are residents of country X. ''Taxable income'' for purposes of the tax is defined as gross receipts received from residents of country X (regardless of whether the services to which the receipts relate are performed within or outside country X) less deductions that permit recovery of the significant costs and expenses (including significant capital expenditures) attributable under reasonable principles to such gross receipts. The country X tax satisfies the net income requirement.

Example 5. Each of country X and province Y (a political subdivision of country X) imposes a tax on corporations, called the ''country X income tax'' and the ''province Y income tax,'' respectively. Each tax has an identical base, which is computed by reducing a corporation's gross receipts by deductions that, based on the predominant character of the tax, permit recovery of the significant costs and expenses (including significant capital expenditures) attributable under reasonable principles to such gross receipts. The country X income tax does not allow a deduction for the province Y income tax for which a taxpayer is liable, nor does the province Y income tax allow a deduction for the country X income tax for which a taxpayer is liable. As provided in paragraph (d)(1) of this section, each of the country X income tax and the province Y income tax is a separate levy. Both of these levies satisfy the net income requirement; the fact that neither levy's base allows a deduction for the other levy is immaterial in reaching that determination.

(c) *Soak-up taxes*—(1) *In general.* Pursuant to paragraph (a)(3)(ii) of this section, the predominant character of a foreign tax that satisfies the requirement of paragraph (a)(3)(i) of this section is that of an income tax in the U.S. sense only to the extent that liability for the foreign tax is not dependent (by its terms or otherwise) on the availability of a credit for the tax against income tax liability to another country. Liability for foreign tax is dependent on the availability of a credit for the foreign tax against income tax liability to another country only if and to the extent that the foreign tax would not be imposed on the taxpayer but for the availability of such a credit. See also § 1.903–1(b)(2).

(2) *Examples.* The provisions of paragraph (c)(1) of this section may be illustrated by the following examples:

Example 1. Country X imposes a tax on the receipt of royalties from sources in country X by nonresidents of country X. The tax is 15 percent of the gross amount of such royalties unless the recipient is a resident of the United States or of country A, B, C, or D, in which case the tax is 20 percent of the gross amount of such royalties. Like the United States, each of countries A, B, C, and D allows its residents a credit against the income tax otherwise payable to it for income taxes paid to other countries. Because the 20 percent rate applies only to residents of countries which allow a credit for taxes paid to other countries and the 15 percent rate applies to residents of countries which do not allow such a credit, one-fourth of the country X tax would not be imposed on residents of the United States but for the availability of such a credit. Accordingly, one-fourth of the country X tax imposed on residents of the United States who receive royalties from sources in country X is dependent on the availability of a credit for the country X tax against income tax liability to another country.

Example 2. Country X imposes a tax on the realized net income derived by all nonresidents from carrying on a trade or business in country X. Although country X law does not prohibit other nonresidents from carrying on business in country X, United States persons are the only nonresidents of country X that carry on business in country X in 1984. The country X tax would be imposed in its entirety on a nonresident of country X irrespective of the availability of a credit for country X tax against income tax liability to another country. Accordingly, no portion of that tax is dependent on the availability of such a credit.

Example 3. Country X imposes tax on the realized net income of all corporations incorporated in country X. Country X allows a tax holiday to qualifying corporations incorporated in country X that are owned by nonresidents of country X, pursuant to which no country X tax is imposed on the net income of a qualifying corporation for the first ten years of its operations in country X. A corporation qualifies for the tax holiday if it meets certain minimum investment criteria and if the development office of country X certifies that in its opinion the operations of the corporation will be consistent with specified development goals of country X. The development office will not so certify to any corporation owned by persons resident in countries that allow a credit (such as that available under section 902 of the Internal Revenue Code) for country X tax paid by a corporation incorporated in country X. In practice, tax holidays are granted to a large number of corporations, but country X tax is imposed on a significant number of other corporations incorporated in country X (*e.g.*, those owned by country X persons and those which have had operations for more than 10 years) in addition to corporations denied a tax holiday because their shareholders qualify for a credit for the country X tax against income tax liability to another country. In the case of corporations denied a tax holiday because they have U.S. shareholders, no portion of the country X tax during the period of the denied 10-year tax holiday is dependent on the availability of a credit for the country X tax against income tax liability to another country.

Example 4. The facts are the same as in example 3, except that corporations owned by persons resident in countries that will allow a credit for country X tax at the time when dividends are distributed by the corporations are granted a provisional tax holiday. Under the provisional tax holiday, instead of relieving such a corporation from country X tax for 10 years, liability for such tax is deferred until the corporation distributes dividends. The result is the same as in example 3.

(d) *Separate levies*—(1) *In general.* For purposes of sections 901 and 903, whether a single levy or separate levies are imposed by a foreign country depends on U.S. principles and not on whether foreign law imposes the levy or levies in a single or separate statutes. A levy imposed by one taxing authority (*e.g.*, the national government of a foreign country) is always separate for purposes of sections 901 and 903 from a levy imposed by another taxing authority (*e.g.*, a political subdivision of that foreign country). Levies are not separate merely because different rates apply to different taxpayers. For example, a foreign levy identical to the tax imposed on U.S. citizens and resident alien individuals by section 1 of the Internal Revenue Code is a single levy notwithstanding the levy has graduated rates and applies different rate schedules to unmarried individuals, married individuals who file separate returns and married individuals who file joint returns. In general, levies are not separate merely because some provisions determining the base of the levy apply, by their terms or in practice, to some, but not all, persons subject to the levy. For example, a foreign levy identical to the tax imposed by section 11 of the Internal Revenue Code is a single levy even though some provisions apply by their terms to some but not all corporations subject to the section 11 tax (*e.g.*, section 465 is by its terms applicable to corporations described in sections 465(a)(1)(B) and 465(a)(1)(C), but not to other corporations), and even though some provisions apply in practice to some but not all corporations subject to the section 11 tax (*e.g.*, section 611 does not, in practice, apply to any corporation that does not have a qualifying interest in the type of property described in section 611(a)). However, where the base of a levy is different in kind, and not merely in degree, for different classes of persons subject to the levy, the levy is considered for purposes of sections 901 and 903 to impose separate levies for such classes of persons. For example, regardless of whether they are contained in a single or separate foreign statutes, a foreign levy identical to the tax imposed by section 871(b) of the Internal Revenue Code is a separate levy from a foreign levy identical to the tax imposed by section 1 of the Internal Revenue Code as it applies to persons other than those described in section 871(b), and foreign levies identical to the taxes imposed by sections 11, 541, 881, 882, 1491 and 3111 of the Internal Revenue Code are each separate levies, because the base of each of those levies differs in kind, and not merely in degree, from the base of each of the others. Accordingly, each such levy must be analyzed separately to determine whether it is an income tax within the meaning of paragraph (a)(1) of this section and whether it is a tax in lieu of an income tax within the meaning of paragraph (a) of §1.903–1. Where foreign law imposes a levy that is the sum of two or more separately computed amounts, and each such amount is computed by reference to a separate base, separate levies are considered, for purposes of sections 901 and 903, to be imposed. A separate base may consist, for example, of a particular type of income or of an amount unrelated to income, *e.g.*, wages paid. Amounts are not separately computed if they are computed separately merely for purposes of a preliminary computation and are then combined as a single base. In the case of levies that apply to dual capacity taxpayers, see also §1.901–2A(a).

(2) *Contractual modifications.* Notwithstanding paragraph (d)(1) of this section, if foreign law imposing a levy is modified for one or more persons subject to the levy by a contract entered into by such person or persons and the foreign country, then foreign law is considered for purposes of sections 901 and 903 to impose a separate levy for all persons to whom such contractual modification of the levy applies, as contrasted to the levy as applied to all persons to whom such contractual modification does not apply. In applying the provisions of paragraph (c) of this section to a tax as modified by such a contract, the provisions of §1.903–1(b)(2) shall apply.

(3) *Examples.* The provisions of paragraph (d)(1) of this section may be illustrated by the following examples:

Example 1. A foreign statute imposes a levy on corporations equal to the sum of 15% of the corporation's realized net income plus 3% of its net worth. As the levy is the sum of two separately computed amounts, each of which is computed by reference to a separate base, each of the portion of the levy based on income and the portion of the levy based on net worth is considered, for purposes of sections 901 and 903, to be a separate levy.

Example 2. A foreign statute imposes a levy on nonresident alien individuals analogous to the taxes imposed by section 871 of the Internal Revenue Code. For the same reasons as set forth in example 1, each of the portion of the foreign levy analogous to the tax imposed by section 871(a) and the portion of the foreign levy analogous to the tax imposed by sections 871 (b) and 1, is considered, for purposes of sections 901 and 903, to be a separate levy.

Example 3. A single foreign statute or separate foreign statutes impose a foreign levy that is the sum of the products of specified rates applied to specified bases, as follows:

Base	Rate (percent)
Net income from mining	45
Net income from manufacturing	50
Net income from technical services	50
Net income from other services	45
Net income from investments	15
All other net income	50

In computing each such base, deductible expenditures are allocated to the type of income they generate. If allocated deductible expenditures exceed the gross amount of a specified type of income, the excess may not be applied against income of a different specified type. Accordingly, the levy is the sum of several separately computed amounts, each of which is computed by reference to a separate base. Each of the levies on mining net income, manufacturing net income, technical services net income, other services net income, investment net income and other net income is, therefore, considered, for purposes of sections 901 and 903, to be a separate levy.

Example 4. The facts are the same as in example 3, except that excess deductible expenditures allocated to one type of income are applied against other types of income to which the same rate applies. The levies on mining net income and other services net income together are considered, for purposes of sections 901 and 903, to be a single levy since, despite a separate preliminary computation of the bases, by reason of the permitted application of excess allocated deductible expenditures, the bases are not separately computed. For the same reason, the levies on manufacturing net income, technical services net income and other net income together are considered, for purposes of sections 901 and 903, to be a single levy. The levy on investment net income is considered, for purposes of sections 901 and 903, to be a separate levy. These results are not dependent on whether the application of excess allocated deductible expenditures to a different type of income, as described above, is permitted in the same taxable period in which the expenditures are taken into account for purposes of the preliminary computation, or only in a different (e.g., later) taxable period.

Example 5. The facts are the same as in example 3, except that excess deductible expenditures allocated to any type of income other than investment income are applied against the other types of income (including investment income) according to a specified set of priorities of application. Excess deductible expenditures allocated to investment income are not applied against any other type of income. For the reason expressed in example 4, all of the levies are together considered, for purposes of sections 901 and 903, to be a single levy.

(e) *Amount of income tax that is creditable*—(1) *In general.* Credit is allowed under section 901 for the amount of income tax (within the meaning of paragraph (a)(1) of this section) that is paid to a foreign country by the taxpayer. The amount of income tax paid by the taxpayer is determined separately for each taxpayer.

(2) *Refunds and credits—(i) In general.* An amount is not tax paid to a foreign country to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven. It is not reasonably certain that an amount will be refunded, credited, rebated, abated, or forgiven if the amount is not greater than a reasonable approximation of final tax liability to the foreign country.

(ii) *Examples.* The provisions of paragraph (e)(2)(i) of this section may be illustrated by the following examples:

Example 1. The internal law of country X imposes a 25 percent tax on the gross amount of interest from sources in country X that is received by a nonresident of country X. Country X law imposes the tax on the nonresident recipient and requires any resident of country X that pays such interest to a nonresident to withhold and pay over to country X 25 percent of such interest, which is applied to offset the recipient's liability for the 25 percent tax. A tax treaty between the United States and country X overrides internal law of country X and provides that country X may not tax interest received by a resident of the United States from a resident of country X at a rate in excess of 10 percent of the gross amount of such interest. A resident of the United States may claim the benefit of the treaty only by applying for a refund of the excess withheld amount (15 percent of the gross amount of interest income) after the end of the taxable year. *A,* a resident of the United States, receives a gross amount of 100u (units of country X currency) of interest income from a resident of country X from sources in country X in the taxable year 1984, from which 25u of country X tax is withheld. *A* files a timely claim for refund of the 15u excess withheld amount. 15u of the amount withheld (25u–10u) is reasonably certain to be refunded; therefore 15u is not considered an amount of tax paid to country X.

Example 2. A's initial income tax liability under country X law is 100u (units of country X currency). However, under country X law *A's* initial income tax liability is reduced in order to compute its final tax liability by an investment credit of 15u and a credit for charitable contributions of 5u. The amount of income tax paid by *A* is 80u.

Example 3. A computes his income tax liability in country X for the taxable year 1984 as 100u (units of country X currency), files a tax return on that basis, and pays 100u of tax. The day after *A* files that return, *A* files a claim for refund of 90u. The difference between the 100u of liability reflected in *A's* original return and the 10u of liability reflected in *A's* refund claim depends on whether a particular expenditure made by *A* is nondeductible or deductible, respectively. Based on an analysis of the country X tax law, *A's* country X tax advisors have advised *A* that it is not clear whether or not that expenditure is deductible. In view of the uncertainty as to the proper treatment of the item in question under country X tax law, no portion of the 100u paid by *A* is reasonably certain to be refunded. If *A* receives a refund, *A* must treat the refund as required by section 905(c) of the Internal Revenue Code.

Example 4. A levy of country X, which qualifies as an income tax within the meaning of paragraph (a)(1) of this section, provides that each person who makes payment to country X pursuant to the levy will receive a bond to be issued by country X with an amount payable at maturity equal to 10 percent of the amount paid pursuant to the levy. *A* pays 38,000u (units of country X currency) to country X and is entitled to receive a bond with an amount payable at maturity of 3800u. It is reasonably certain that a refund in the form of property (the bond) will be made. The amount of that refund is equal to the fair market value of the bond. Therefore, only the portion of the 38,000u payment in excess of the fair market value of the bond is an amount of tax paid.

(3) *Subsidies*—(i) *General rule.* An amount of foreign income tax is not an amount of income tax paid or accrued by a taxpayer to a foreign country to the extent that—

(A) The amount is used, directly or indirectly, by the foreign country imposing the tax to provide a subsidy by any means (including, but not limited to, a rebate, a refund, a credit, a deduction, a payment, a discharge of an obligation, or any other method) to the taxpayer, to a related person (within the meaning of section 482), to any party to the transaction, or to any party to a related transaction; and

(B) The subsidy is determined, directly or indirectly, by reference to the amount of the tax or by reference to the base used to compute the amount of the tax.

(ii) *Subsidy.* The term ''subsidy'' includes any benefit conferred, directly or indirectly, by a foreign country to one of the parties enumerated in paragraph (e)(3)(i)(A) of this section. Substance and not form shall govern in determining whether a subsidy exists. The fact that the U.S. taxpayer may derive no demonstrable benefit from the subsidy is irrelevant in determining whether a subsidy exists.

(iii) *Official exchange rate.* A subsidy described in paragraph (e)(3)(i)(B) of this section does not include the actual use of an official foreign government exchange rate converting foreign currency into dollars where a free exchange rate also exists if—

(A) The economic benefit represented by the use of the official exchange rate is not targeted to or tied to transactions that give rise to a claim for a foreign tax credit;

(B) The economic benefit of the official exchange rate applies to a broad range of international transactions, in all cases based on the total payment to be made without regard to whether the payment is a return of principal, gross income, or net income, and without regard to whether it is subject to tax; and

(C) Any reduction in the overall cost of the transaction is merely coincidental to the broad structure and operation of the official exchange rate.

In regard to foreign taxes paid or accrued in taxable years beginning before January 1, 1987, to which the Mexican Exchange Control Decree, effective as of December 20, 1982, applies, see Rev. Rul. 84–143, 1984–2 C.B. 127.

(iv) *Examples.* The provisions of this paragraph (e)(3) may be illustrated by the following examples:

Example 1. (i) Country X imposes a 30 percent tax on nonresident lenders with respect to interest which the nonresident lenders receive from borrowers who are residents of Country X, and it is established that this tax is a tax in lieu of an income tax within the meaning of §1.903–1(a). Country X provides the nonresident lenders with receipts upon their payment of the 30 percent tax. Country X remits to resident borrowers an incentive payment for engaging in foreign loans, which payment is an amount equal to 20 percent of the interest paid to nonresident lenders.

(ii) Because the incentive payment is based on the interest paid, it is determined by reference to the base used to compute the tax that is imposed on the nonresident lender. The incentive payment is considered a subsidy under this paragraph (e)(3) since it is provided to a party (the borrower) to the transaction and is based on the amount of tax that is imposed on the lender with respect to the transaction. Therefore, two-thirds (20 percent/30 percent) of the amount withheld by the resident borrower from interest payments to the nonresidential lender is not an amount of income tax paid or accrued for purposes of section 901(b).

Example 2. (i) A U.S. bank lends money to a development bank in Country X. The development bank relends the money to companies resident in Country X. A withholding tax is imposed by Country X on the U.S. bank with respect to the interest that the development bank pays to the U.S. bank, and appropriate receipts are provided. On the date that the tax is withheld, fifty percent of the tax is credited by Country X to an account of the development bank. Country X requires the development bank to transfer the amount credited to the borrowing companies.

(ii) The amount successively credited to the account of the development bank and then to the account of the borrowing companies is determined by reference to the amount of the tax and the tax base. Since the amount credited to the borrowing companies is a subsidy provided to a party (the borrowing companies) to a related transaction and is based on the amount of tax and the tax base, it is not an amount paid or accrued as an income tax for purposes of section 901(b).

Example 3. (i) A U.S. bank lends dollars to a Country X borrower. Country X imposes a withholding tax on the lender with respect to the interest. The tax is to be paid in Country X currency, although the interest is payable in dollars. Country X has a dual exchange rate system, comprised of a controlled official exchange rate and a free exchange rate. Priority transactions such as exports of merchandise, imports of merchandise, and payments of principal and interest on foreign currency loans payable abroad to foreign lenders are governed by the official exchange rate which yields more dollars per unit of Country X currency than the free exchange rate. The Country X borrower remits the net amount of dollar interest due to the U.S. bank (interest due less withholding tax), pays the tax withheld in Country X currency to the Country X government, and provides to the U.S. bank a receipt for payment of the Country X taxes.

(ii) The use of the official exchange rate by the U.S. bank to determine foreign taxes with respect to interest is not a subsidy described in paragraph (e)(3)(i)(B) of this section. The official exchange rate is not targeted to or tied to transactions that give rise to a claim for a foreign tax credit. The use of the official exchange rate applies to the interest paid and to the principal paid. Any benefit derived by the U.S. bank through the use of the official exchange rate is merely coincidental to the broad structure and operation of the official exchange rate.

Example 4. (i) B, a U.S. corporation, is engaged in the production of oil and gas in Country X pursuant to a production sharing agreement between B, Country X, and the state petroleum authority of Country X. The agreement is approved and enacted into law by the Legislature of Country X. Both B and the petroleum authority are subject to the Country X income tax. Each entity files an annual income tax return and pays, to the tax authority of Country X, the amount of income tax due on its annual income. B is a dual capacity taxpayer as defined in § 1.901–2(a)(2)(ii)(A). Country X has agreed to return to the petroleum authority one-half of the income taxes paid by B by allowing it a credit in calculating its own tax liability to Country X.

(ii) The petroleum authority is a party to a transaction with B and the amount returned by Country X to the petroleum authority is determined by reference to the amount of the tax imposed on B. Therefore, the amount returned is a subsidy as described in this paragraph (e)(3) and one-half the tax imposed on B is not an amount of income tax paid or accrued.

Example 5. Assume the same facts as in *Example 4,* except that the state petroleum authority of Country X does not receive amounts from Country X related to tax paid by B. Instead, the authority of Country X receives a general appropriation from Country X which is not calculated with reference to the amount of tax paid by B. The general appropriation is therefore not a subsidy described in this paragraph (e)(3).

(v) *Effective Date.* This paragraph (e)(3) shall apply to foreign taxes paid or accrued in taxable years beginning after December 31, 1986.

(4) *Multiple levies*—(i) *In general.* If, under foreign law, a taxpayer's tentative liability for one levy (the ''first levy'') is or can be reduced by the amount of the taxpayer's liability for a different levy (the ''second levy''), then the amount considered paid by the taxpayer to the foreign country pursuant to the second levy is an amount equal to its entire liability for that levy, and the remainder of the amount paid is considered paid pursuant to the first levy. This rule applies regardless of

whether it is or is not likely that liability for one such levy will always exceed liability for the other such levy. For an example of the application of this rule, see example 5 of §1.903–1(b)(3). If, under foreign law, the amount of a taxpayer's liability is the greater or lesser of amounts computed pursuant to two levies, then the entire amount paid to the foreign country by the taxpayer is considered paid pursuant to the levy that imposes such greater or lesser amount, respectively, and no amount is considered paid pursuant to such other levy.

(ii) *Integrated tax systems.* [Reserved]

(5) *Noncompulsory amounts*—(i) *In general.* An amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the extent that the amount paid exceeds the amount of liability under foreign law for tax. An amount paid does not exceed the amount of such liability if the amount paid is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment). Where foreign tax law includes options or elections whereby a taxpayer's tax liability may be shifted, in whole or part, to a different year or years, the taxpayer's use or failure to use such options or elections does not result in a payment in excess of the taxpayer's liability for foreign tax. An interpretation or application of foreign law is not reasonable if there is actual notice or constructive notice (*e.g.,* a published court decision) to the taxpayer that the interpretation or application is likely to be erroneous. In interpreting foreign tax law, a taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts. A remedy is effective and practical only if the cost thereof (including the risk of offsetting or additional tax liability) is reasonable in light of the amount at issue and the likelihood of success. A settlement by a taxpayer of two or more issues will be evaluated on an overall basis, not on an issue-by-issue basis, in determining whether an amount is a compulsory amount. A taxpayer is not required to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for tax.

(ii) *Examples.* The provisions of paragraph (e)(5)(i) of this section may be illustrated by the following examples:

Example 1. A, a corporation organized and doing business solely in the United States, owns all of the stock of *B,* a corporation organized in country X. In 1984 *A* buys merchandise from unrelated persons for $1,000,000, shortly thereafter resells that merchandise to *B* for $600,000, and *B* later in 1984 resells the merchandise to unrelated persons for $1,200,000. Under the country X income tax, which is an income tax within the meaning of paragraph (a)(1) of this section, all corporations organized in country X are subject to a tax equal to 3 percent of their net income. In computing its 1984 country X income tax liability *B* reports $600,000 ($1,200,000—$600,000) of profit from the purchase and resale of the merchandise referred to above. The country X income tax law requires that transactions between related persons be reported at arm's length prices, and a reasonable interpretation of this requirement, as it has been applied in country X, would consider *B' s* arm's length purchase price of the merchandise purchased from *A* to be $1,050,000. When it computes its country X tax liability *B* is aware that $600,000 is not an arm's length price (by country X standards). *B*'s knowing use of a non-arm's length price (by country X standards) of $600,000, instead of a price of $1,050,000 (an arm's length price under country X's law), is not consistent with a reasonable interpretation and application of the law of country X, determined in such a way as to reduce over time *B*'s reasonably expected liability for country X income tax. Accordingly, $13,500 (3 percent of $450,000 ($1,050,000—$600,000)), the amount of country X income tax paid by *B* to country X that is attributable to the purchase of the merchandise from *B*'s parent at less than an arm's length price, is in excess of the amount of *B*'s liability for country X tax, and thus is not an amount of tax.

Example 2. A, a corporation organized and doing business solely in the United States, owns all of the stock of *B,* a corporation organized in country X. Country X has in force an income tax treaty with the United States. The treaty provides that the profits of related persons shall be determined as if the persons were not related. *A* and *B* deal extensively with each other. *A* and *B,* with respect to a series of transactions involving both of them, treat *A* as having $300,000 of income and *B* as having $700,000 of income for purposes of *A*'s United States income tax and *B*'s country X income tax, respectively. *B* has no actual or constructive notice that its treatment of these transactions under country X law is likely to be erroneous. Subsequently, the Internal Revenue Service reallocates $200,000 of this income from *B* to *A* under the authority of section 482 and the treaty. This reallocation constitutes actual notice to *A* and constructive notice to *B* that *B*'s interpretation and application of country X's law and the tax treaty is likely to be erroneous. *B* does not exhaust all effective and practical remedies to obtain a refund of the amount of country X income tax paid by *B* to country X that is attributable to the reallocated $200,000 of income. This amount is in excess of the amount of *B*'s liability for country X tax and thus is not an amount of tax.

Example 3. The facts are the same as in example 2, except that *B* files a claim for refund (an administrative proceeding) of country X tax and *A* or *B* invokes the competent authority procedures of the treaty, the cost of which is reasonable in view of the amount at issue and the likelihood of success, Nevertheless, *B* does not obtain any refund of country X tax. The cost of pursuing any judicial remedy in country X would be unreasonable in light of the amount at issue and the likelihood of *B*'s success, and *B* does not pursue any such remedy. The entire amount paid by *B* to country X is a compulsory payment and thus is an amount of tax paid by *B*.

Example 4. The facts are the same as in example 2, except that, when the Internal Revenue Service makes the reallocation, the country X statute of limitations on refunds has expired; and neither the internal law of country X nor the treaty authorizes the country X tax authorities to pay a refund that is barred by the statute of limitations. *B* does not file a claim for refund, and neither *A* nor *B* invokes the competent authority procedures of the treaty. Because the country X tax authorities would be barred by the statute of limitations from paying a refund, *B* has no effective and practicable remedies. The entire amount paid by *B* to country X is a compulsory payment and thus is an amount of tax paid by *B*.

Example. 5. *A* is a U.S. person doing business in country X. In computing its income tax liability to country X, *A* is permitted, at its election, to recover the cost of machinery used in its business either by deducting that cost in the year of acquisition or by depreciating that cost on the straight line method over a period of 2, 4, 6 or 10 years. *A* elects to depreciate machinery over 10 years. This election merely shifts *A's* tax liability to different years (compared to the timing of *A's* tax liability under a different depreciation period); it does not result in a payment in excess of the amount of *A*'s liability for country X income tax in any year since the amount of country X tax paid by *A* is consistent with a reasonable interpretation of country X law in such a way as to reduce over time *A*'s reasonably expected liability for country X tax. Because the standard of paragraph (e)(5(i) of this section refers to *A*'s reasonably expected liability, not its actual liability, events actually occurring in subsequent years (e.g. whether *A* has sufficient profit in such years so that such depreciation deductions actually reduce *A*'s country X tax liability or whether the country X tax rates change) are immaterial.

Example. 6. The internal law of country X imposes a 25 percent tax on the gross amount of interest from sources in country X that is received by a nonresident of country X. Country X law imposes the tax on the nonresident recipient and requires any resident of country X that pays such interest to a nonresident to withhold and pay over to country X 25 percent of such interest, which is applied to offset the recipient's liability for the 25 percent tax. A tax treaty between the United States and country X overrides internal law of country X and provides that country X may not tax interest received by a resident of the United States from a resident of country X at a rate in excess of 10 percent of the gross amount of such interest. A resident of the United States may claim the benefit of the treaty only by applying for a refund of the excess withheld amount (15 percent of the gross amount of interest income) after the end of the taxable year. A, a resident of the United States, receives a gross amount of 100u (units of country X currency) of interest income from a resident of country X from sources in country X in the taxable year 1984, from which 25u of country X tax is withheld. *A* does not file a timely claim for refund. 15u of the amount withheld (25u–10u) is not a compulsory payment and hence is not an amount of tax.

(f) *Taxpayer*—(1) *In general.* The person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax, even if another person (e.g., a withholding agent) remits such tax. For purposes of this section, § 1.901–2A and § 1.903–1, the person on whom foreign law imposes such liability is referred to as the ‘‘taxpayer.’’ A foreign tax of a type described in paragraph (a)(2)(ii)(C) of this section is considered to be imposed on the recipients of wages if such tax is deducted from such wages under provisions that are comparable to section 3102 (a) and (b) of the Internal Revenue Code.

(2) Party undertaking tax obligation as part of transaction—(i) *In general.* Tax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability. The rules of the foregoing sentence apply notwithstanding anything to the contrary in paragraph (e)(3) of this section. See §1.901–2A for additional rules regarding dual capacity taxpayers.

(ii) *Examples.* The provisions of paragraphs (f)(1) and (2)(i) of this section may be illustrated by the following examples:

Example 1. Under a loan agreement between *A,* a resident of country X, and *B,* a United States person, *A* agrees to pay *B* a certain amount of interest net of any tax that country X may impose on *B* with respect to its interest income. Country X imposes a 10 percent tax on the gross amount of interest income received by nonresidents of country X from sources in country X, and it is established that this tax is a tax in lieu of an income tax within the meaning of §1.903–1(a). Under the law of country X this tax is imposed on the nonresident recipient, and any resident of country X that pays such interest to a nonresident is required to withhold and pay over to country X 10 percent of the amount of such interest, which is applied to offset the recipient's liability for the tax. Because legal liability for the tax is imposed on the recipient of such interest income, *B* is the taxpayer with respect to the country X tax imposed on *B's* interest income from *B*'s loan to *A*. Accordingly, *B*'s interest income for federal income tax purposes includes the amount of country X tax that is imposed on *B* with respect to such interest income and that is paid on *B's* behalf by *A* pursuant to the loan agreement, and, under paragraph (f)(2)(i) of this section, such tax is considered for purposes of section 903 to be paid by *B*.

Example 2. The facts are the same as in example 1, except that in collecting and receiving the interest *B* is acting as a nominee for, or agent of, *C,* who is a United States person. Because *C* (not *B*) is the beneficial owner of the interest, legal liability for the tax is imposed on *C,* not *B* (*C*' s nominee or agent). Thus, *C* is the taxpayer with respect to the country X tax imposed on *C*' s interest income from *C*' s loan to *A*. Accordingly, *C's* interest income for federal income tax purposes includes the amount of country X tax that is imposed on *C* with respect to such interest income and that is paid on *C*' s behalf by *A* pursuant to the loan agreement. Under paragraph (f)(2)(i) of this section, such tax is considered for purposes of section 903 to be paid by *C*. No such tax is considered paid by *B*.

Example 3. Country X imposes a tax called the ‘‘country X income tax.’’ *A,* a United States person engaged in construction activities in country X, is subject to that tax. Country X has contracted with *A* for *A* to construct a naval base. *A* is a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) and, in accordance with paragraphs (a)(1) and (c)(1) of §1.901–2A, *A* has established that the country X income tax as applied to dual capacity persons and the country X income tax as applied to persons other than dual capacity persons together constitute a single levy. *A* has also established that that levy is an income tax within the meaning of paragraph (a)(1) of this section. Pursuant to the terms of the contract, country X has agreed to assume any country X tax liability that *A* may incur with respect to *A*' s income from the contract. For federal income tax purposes, *A*' s income from the contract includes the amount of tax liability that is imposed by country X on *A* with respect to its income from the contract and that is assumed by country X; and for purposes of section 901 the amount of such tax liability assumed by country X is considered to be paid by *A*. By reason of paragraph (f)(2)(i) of this section, country X is not considered to provide a subsidy, within the meaning of paragraph (e)(3) of this section, to *A*.

(3) *Taxes paid on combined income.* If foreign income tax is imposed on the combined income of two or more related persons (for example, a husband and wife or a corporation and one or more of its subsidiaries) and they are jointly and severally liable for the income tax under foreign law, foreign law is considered to impose legal liability on each such person for the amount of the foreign income tax that is attributable to its portion of the base of the tax, regardless of which person actually pays the tax.

(g) *Definitions.* For purposes of this section and §§1.901–2A and 1.903–1, the following definitions apply:

(1) The term *paid* means ‘‘paid or accrued''; the term *payment* means ‘‘payment or accrual''; and the term *paid by*

means ‘‘paid or accrued by or on behalf of.’’

(2) The term *foreign country* means any foreign state, any possession of the United States, and any political subdivision of any foreign state or of any possession of the United States. The term ‘‘possession of the United States’’ includes Puerto Rico, the Virgin Islands, Guam, the Northern Mariana Islands and American Samoa.

(3) The term *foreign levy* means a levy imposed by a foreign country.

(h) *Effective date*—(1) *In general.* This section, § 1.901–2A, and § 1.903–1 apply to taxable years beginning after November 14, 1983. In addition, a person may elect to apply the provisions of this section, § 1.901–2A, and § 1.903–1 to earlier years. See paragraph (h)(2) of this section.

(2) *Election to apply regulations to earlier years*—(i) *Scope of election.* An election to apply the provisions of this section, § 1.901–2A, and § 1.903–1 to taxable years beginning on or before November 14, 1983, is made with respect to one or more foreign states and possessions of the United States with respect to a taxable year of the person making the election beginning on or before November 14, 1983. Such election requires all of the provisions of this section, § 1.901–2A, and § 1.903–1 to be applied to such taxable year and to all subsequent taxable years of the person making the election (‘‘elected years’’). If an election applies to a foreign state or to a possession of the United States (‘‘election country’’), it applies to all taxes of the election country and to all taxes of all political subdivisions of the election country. An election does not apply to foreign taxes carried forward to any elected year from any taxable year to which the election does not apply. Such election does apply to foreign taxes carried back or forward from any elected year to any taxable year.

(ii) *Effect of election.* An election to apply the regulations to earlier years has no effect on the limitations on assessment and collection or on the limitations on credit or refund (see chapter 66 of the Internal Revenue Code).

(iii) *Manner of making election.* An election to apply the regulations to one or more earlier taxable years is made by attaching a statement to a return, amended return, or claim for refund for the earliest taxable year to which the election relates. Such statement shall state that the election is made and, unless the election is to apply to all foreign countries, the statement shall designate the election countries. In the absence of such a designation of the election countries, all foreign countries shall be election countries.

(iv) *Time for making election.* An election to apply the regulations to earlier taxable years must be made by October 12, 1984, except that if a person who has deducted (instead of credited) foreign taxes in its United States income tax return for such an earlier taxable year validly makes an election to credit (instead of deduct) such taxes in a timely filed amended return for such earlier taxable year and such amended return is filed after such date, an election to apply the regulations to such earlier taxable year must be made in such amended return.

(v) *Revocation of election.* An election to apply the regulations to earlier taxable years may not be revoked.

(vi) *Affiliated groups.* A member of an affiliated group that files a consolidated United States income tax return may apply the regulations to earlier years only if an election to so apply them has been made by the common parent of such affiliated group on behalf of all members of the group.

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§ 1.901–2A Dual capacity taxpayers.

(a) *Application of separate levy rules as applied to dual capacity taxpayers*—(1) *In general.* If the application of a foreign levy (as defined in § 1.901–2(g)(3)) is different, either by the terms of the levy or in practice, for dual capacity taxpayers (as defined in § 1.901–2(a)(2)(ii)(A)) from its application to other persons, then, unless the only such difference is that a lower rate (but the same base) applies to dual capacity taxpayers, such difference is considered to be related to the fact that dual capacity taxpayers receive, directly or indirectly, a specific economic benefit (as defined in § 1.901–2(a)(2)(ii)(B)) from the foreign country and thus to be a difference in kind, and not merely of degree. In such a case, notwithstanding any contrary provision of §1.901–2(d), the levy as applicable to such dual capacity taxpayers is a separate levy (within the meaning of §1.901–2(d)) from the levy as applicable to such other persons, regardless of whether such difference is in the base of the levy, in the rate of the levy, or both. In such a case, each of the levy as applied to dual capacity taxpayers and the levy as applied to other persons must be analyzed separately to determine whether it is an income tax within the meaning of §1.901–2(a)(1) and whether it is a tax in lieu of an income tax within the meaning of §1.903–1(a). However, if the application of the levy is neither different by its terms nor different in practice for dual capacity taxpayers from its application to other persons, or if the only difference is that a lower rate (but the same base) applies to dual capacity taxpayers, then, in accordance with §1.901–2(d), such foreign levy as applicable to dual capacity taxpayers and such levy as applicable to other persons together constitute a single levy. In such a case, no amount paid (as defined in §1.901–2(g)(1)) pursuant to such levy by any such dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit, and such levy, as applicable in the aggregate to such dual capacity taxpayers and to such other persons, is analyzed to determine whether it is an income tax within the meaning of §1.901–2(a)(1) or a tax in lieu of an income tax within the meaning of §1.903–1(a). Application of a foreign levy to dual capacity taxpayers will be considered to be different in practice from application of that levy to other persons, even if no such difference is apparent from the terms of the levy, unless it is established that application of that levy to dual capacity taxpayers does not differ in practice from its application to other persons.

(2) *Examples.* The provisions of paragraph (a)(1) of this section may be illustrated by the following examples:

Example 1. Under a levy of country X called the country X income tax, every corporation that does business in country X is required to pay to country X 40 percent of its income from its business in country X. Income for purposes of the country X income tax is computed by subtracting specified deductions from the corporation's gross income derived from its business in country X. The specified deductions include the corporation's expenses attributable to such gross income and allowances for recovery of the cost of capital expenditures attributable to such gross income, except that under the terms of the country X income tax a corporation engaged in the exploitation of minerals K, L or M in country X is not permitted to recover, currently or in the future, expenditures it incurs in exploring for those minerals. In practice, the only corporations that engage in exploitation of the specified minerals in country X are dual capacity taxpayers. Thus, the application of the country X income tax to dual capacity taxpayers is different from its application to other corporations. The country X income tax as applied to corporations that engage in the exploitation of minerals K, L or M (dual capacity taxpayers) is, therefore, a separate levy from the country X income tax as applied to other corporations. Accordingly, each of (i) the country X income tax as applied to such dual capacity taxpayers and (ii) the country X income tax as applied to such other persons, must be analyzed separately to determine whether it is an income tax within the meaning of §1.901–2(a)(1) and whether it is a tax in lieu of an income tax within the meaning of §1.903–1(a).

Example 2. The facts are the same as in example 1, except that it is demonstrated that corporations that engage in exploitation of the specified minerals in country X and that are subject to the levy include both dual capacity taxpayers and other persons. The country X income tax as applied to all corporations is, therefore, a single levy. Accordingly, no amount paid pursuant to the country X income tax by a dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit; and, if the country X income tax is an income tax within the meaning of §1.901–2(a)(1) or a tax in lieu of an income tax within the meaning of §1.903–1(a), it will be so considered in its entirety for all corporations subject to it.

Example 3. Under a levy of country Y called the country Y income tax, each corporation incorporated in country Y is required to pay to country Y a percentage of its worldwide income. The applicable percentage is greater for such corporations that earn more than a specified amount of income than for such corporations that earn less than that amount. Income for purposes of the levy is computed by deducting from gross income specified types of expenses and specified allowances for capital expenditures. The expenses for which deductions are permitted differ depending on the type of business in which the corporation subject to the levy is engaged, *e.g.*, a deduction for interest paid to a related party is not allowed for corporations engaged in enumerated types of activities. In addition, carryover of losses from one taxable period to another is permitted for corporations engaged in specified types of activities, but not for corporations engaged in other activities. By its terms, the foreign levy makes no distinction between dual capacity taxpayers and other persons. It is established that in practice the higher rate of the country Y income tax applies to both dual capacity taxpayers and other persons and that in practice the differences in the base of the country Y income tax (*e.g.*, the lack of a deduction for interest paid to related parties for some corporations subject to the levy and the lack of a carryover provision for some corporations subject to the levy) apply to both dual capacity taxpayers and other persons. The country Y income tax as applied to all corporations incorporated in country Y is therefore a single levy. Accordingly, no amount paid pursuant to the country Y income tax by a dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit; and if the country Y income tax is an income tax within the meaning of § 1.901–2(a)(1) or a tax in lieu of an income tax within the meaning of § 1.903–1(a), it will be so considered in its entirety for all persons subject to it.

Example 4. The facts are the same as in example 3, except that it is not established that in practice the higher rate does not apply only to dual capacity taxpayers. By reason of such higher rate, application of the country Y income tax to dual capacity taxpayers is different in practice from application of the country Y income tax to other persons subject to it. The country Y income tax as applied to dual capacity taxpayers is therefore a separate levy from the country Y income tax as applied to other corporations incorporated in country Y. Accordingly, each of (i) the country Y income tax as applied to dual capacity taxpayers and (ii) the country Y income tax as applied to other corporations incorporated in country Y, must be analyzed separately to determine whether it is an income tax within the meaning of § 1.901–2(a)(1) and whether it is a tax in lieu of an income tax within the meaning of § 1.903–1(a).

Example 5. Under a levy of country X called the country X tax, all persons who do not engage in business in country X and who receive interest income from residents of country X are required to pay to country X 25 percent of the gross amount of such interest income. It is established that the country X tax applies by its terms and in practice to certain banks that are dual capacity taxpayers and to persons who are not dual capacity taxpayers and that application to such dual capacity taxpayers does not differ by its terms or in practice from application to such other persons. The country X tax as applied to all such persons (both the dual capacity taxpayers and the other persons) is, therefore, a single levy. Accordingly, no amount paid pursuant to the country X tax by such a dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit; and, if the country X tax is a tax in lieu of an income tax within the meaning of § 1.903–1(a), it will be so considered in its entirety for all persons subject to it.

Example 6. Under a levy of country X called the country X tax, every corporation incorporated outside of country X (''foreign corporation'') that maintains a branch in country X is required annually to pay to country X 52 percent of its net income attributable to that branch. It is established that the application of the country X tax is neither different by its terms nor different in practice for certain banks that are dual capacity taxpayers from its application to persons (which may, but do not necessarily, include other banks) that are not dual capacity taxpayers. The country X tax as applied to all foreign corporations with branches in country X (*i.e.*, both those banks that are dual capacity taxpayers and the foreign corporations that are not dual capacity taxpayers) is, therefore, a single levy. Accordingly, no amount paid pursuant to the country X tax by a bank that is a dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit; and, if the country X tax is an income tax within the meaning of § 1.901–2(a)(1) or a tax in lieu of an income tax within the meaning of § 1.903–1(a), it will be so considered in its entirety for all persons subject to it.

Example 7. Under a levy of country H called the country H tax, all corporations that are organized outside country H and that do not engage in business in country H are required to pay to country H a percentage of the gross amount of interest income derived from residents of country H. The percentage is 30 percent, except that it is 15 percent for a specified category of corporations. All corporations in that category are dual capacity taxpayers. It is established that the country H tax applies by its terms and in practice to dual capacity taxpayers and to persons that are not dual capacity taxpayers and that the only difference in application between such dual capacity taxpayers and such other persons is that a lower rate (but the same base) applies to such dual capacity taxpayers. The country H tax as applied to all such persons (both the dual capacity taxpayers and the other persons) is, therefore, a single levy. Accordingly, no amount paid pursuant to the country H tax by such a dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit, and if the country H tax is a tax in lieu of an income tax within the meaning of § 1.903–1(a), it will be so considered in its entirety for all persons subject to it.

(b) *Burden of proof for dual capacity taxpayers*—(1) *In general.* For credit to be allowable under section 901 or 903, the person claiming credit must establish that the foreign levy with respect to which credit is claimed is an income tax within the meaning of §1.901–2(a)(1) or a tax in lieu of an income tax within the meaning of §1.903–1(a), respectively. Thus, such person must establish, among other things, that such levy is a tax. See §1.901–2(a)(2)(i) and §1.903–1(a). Where a person claims credit under section 901 or 903 for an amount paid by a dual capacity taxpayer pursuant to a foreign levy, §1.901–2(a)(2)(i) and §1.903–1(a), respectively, require such person to establish the amount, if any, that is paid pursuant to the distinct element of the levy that is a tax. If, pursuant to paragraph (a)(1) of this section and §1.901–2(d), such levy as applicable to dual capacity taxpayers and such levy as applicable to other persons together constitute a single levy, then no amount paid pursuant to that levy by any such dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit. Accordingly, such levy has only one distinct element, and the levy either is or is not, in its entirety, a tax. If, however, such levy as applicable to dual capacity taxpayers is a separate levy from such levy as applicable to other persons, then a person claiming credit under section 901 or 903 for an amount paid by a dual capacity taxpayer pursuant to such separate levy may establish the amount, if any, that is paid pursuant to the distinct element of the levy that is a tax only by the facts and circumstances method or the safe harbor method described in paragraph (c) of this section. If such person fails to so establish such amount, no portion of the amount that is paid pursuant to the separate levy by the dual capacity taxpayer to such foreign country shall be treated as an amount of tax. Any amount that, either by reason of application of the methods of paragraph (c) of this section or by reason of the immediately preceding sentence, is not treated as an amount of tax shall (i) be considered to have been paid in exchange for a specific economic benefit; (ii) be characterized (*e.g.*, as royalty, purchase price, cost of sales, reduction of the proceeds of a sale, or reduction of interest income) according to the nature of the transaction and of the specific economic benefit received; and (iii) be treated according to such characterization for all purposes of chapter 1 of the Internal Revenue Code, except that any determination that an amount is not tax for purposes of section 901 or 903 by reason of application of the safe harbor method shall not be taken into account in determining whether or not such an amount is to be characterized and treated as tax for purposes of computing an allowance for percentage depletion under sections 611 and 613.

(2) *Effect of certain treaties.* If, irrespective of whether such credit would be allowable under section 901 or 903 in the absence of a treaty, the United States has in force a treaty with a foreign country that treats a foreign levy as an income tax for purposes of allowing credit for United States tax and if the person claiming credit is entitled to the benefit of such treaty, then, unless such person claims credit not under the treaty but under section 901 or 903, and except to the extent the treaty provides otherwise and subject to all terms, conditions and limitations provided in the treaty, no portion of an amount paid with respect to such levy by a dual capacity taxpayer shall be considered to be paid in exchange for a specific economic benefit. If, however, such person claims credit not under such treaty but rather under section 901 or 903 (*e.g.*, so as not to be subject to a limitation contained in such treaty), the provisions of this section apply to such levy.

(c) *Satisfaction of burden of proof*—(1) *In general.* This paragraph (c) sets out the methods by which a person who claims credit under section 901 or 903 for an amount paid by a dual capacity taxpayer pursuant to a foreign levy that satisfies all of the criteria of section 901 or 903 other than the determination of the distinct element of the levy that is a tax and of the amount that is paid pursuant to that distinct element (a ‘‘qualifying levy’’) may establish such distinct element and amount. Such person must establish the amount paid pursuant to a qualifying levy that is paid pursuant to the distinct element of the levy that is a tax (which amount therefore is an amount of income tax within the meaning of § 1.901–2(a)(1) or an amount of tax in lieu of income tax within the meaning of § 1.903–1(a) (a ‘‘qualifying amount’’)) only by the facts and circumstances method set forth in paragraph (c)(2) of this section or the safe harbor method set forth in paragraph (c)(3) of this section. A levy is not a qualifying levy, and neither the facts and circumstances method nor the safe harbor method applies to an amount paid by a dual capacity taxpayer pursuant to a foreign levy, if it has been established pursuant to § 1.901–2(d) and paragraph (a)(1) of this section that that levy as applied to that dual capacity taxpayer and that levy as applied to persons other than dual capacity taxpayers together constitute a single levy, or if it has been established in accordance with the first sentence of paragraph (b)(2) of this section that credit is allowable by reason of a treaty for an amount paid with respect to such levy.

(2) *Facts and circumstances method*—(i) *In general.* If the person claiming credit establishes, based on all of the relevant facts and circumstances, the amount, if any, paid by the dual capacity taxpayer pursuant to the qualifying levy that is not paid in exchange for a specific economic benefit, such amount is the qualifying amount with respect to such qualifying levy. In determining the qualifying amount with respect to a qualifying levy under the facts and circumstances method, neither the methodology nor the results that would have obtained if a person had elected to apply the safe harbor method to such qualifying levy is a relevant fact or circumstance. Accordingly, neither such methodology nor such results shall be taken into account in applying the facts and circumstances method.

(ii) *Examples.* The application of the facts and circumstances method is illustrated by the following examples:

Example 1. Country A, which does not have a generally imposed income tax, imposes a levy, called the country A income tax, on corporations that carry on the banking business through a branch in country A. All such corporations lend money to the government of country A, and the consideration (interest) paid by the government of country A for the loans is not made available by the government on substantially the same terms to the population of country A in general. Thus, the country A income tax is imposed only on dual capacity taxpayers. *L,* a corporation that carries on the banking business through a branch in country A and that is a dual capacity taxpayer, establishes that all of the criteria of section 901 are satisfied by the country A income tax, except for the determination of the distinct element of the levy that is a tax and of *L*’s qualifying amount with respect thereto. The country A income tax is, therefore, a qualifying levy. *L* establishes that, although all persons subject to the country A income tax are dual capacity taxpayers, the country A income tax applies in the same manner to income from such persons’ transactions with the government of country A as it does to income from their transactions with private persons; that there are significant transactions (either in volume or in amount) with private persons; and that the portion of such persons’ income that is derived from transactions with the government of country A on the one hand or private persons on the other varies greatly among persons subject to the country A income tax. By making this showing, *L* has demonstrated that no portion of the amount paid by it to country A pursuant to the levy is paid in exchange for a specific economic benefit (the interest income). Accordingly, *L* has demonstrated under the facts and circumstances method that the entire amount it has paid pursuant to the country A income tax is a qualifying amount.

Example 2. A, a domestic corporation that is a dual capacity taxpayer subject to a qualifying levy of country X, pays 1000u (units of country X currency) to country X in 1986 pursuant to the qualifying levy. *A* does not elect to apply the safe harbor method to country X, but if it had so elected, 800u would have been *A’s* qualifying amount with respect to the levy. Based on all of the relevant facts and circumstances (which do not include either the methodology of the safe harbor method or the qualifying amount that would have obtained under that method), *A* establishes that 628u of such 1000u is not paid in exchange for a specific economic benefit. *A* has demonstrated under the facts and circumstances method that 628u is a qualifying amount. Pursuant to paragraph (b)(1) of this section, 372u (1000u–628u) is considered to have been paid by *A* in exchange for a specific economic benefit. That amount is characterized and treated as provided in paragraph (b)(1) of this section.

Example 3. The facts are the same as in example 2 except that under the safe harbor method 580u would have been *A*’s qualifying amount with respect to the levy. That amount is not a relevant fact or circumstance and the result is the same as in example 2.

(3) *Safe harbor method.* Under the safe harbor method, the person claiming credit makes an election as provided in paragraph (d) of this section and, pursuant to such election, applies the safe harbor formula described in paragraph (e) of this section to the qualifying levy or levies to which the election applies.

(d) *Election to use the safe harbor method*—(1) *Scope of election.* An election to use the safe harbor method is made with respect to one or more foreign states and possessions of the United States with respect to a taxable year of the person making the election (the ‘‘electing person’’). Such election applies to such taxable year and to all subsequent taxable years of the electing person (‘‘election years’’), unless the election is revoked in accordance with paragraph (d)(4) of this section. If an election applies to a foreign state or possession of the United States (‘‘elected country’’), it applies to all qualifying levies of the elected country and to all qualifying levies of all political subdivisions of the elected country with respect to which the electing person claims credit for amounts paid (or deemed to be paid) by any dual capacity taxpayer. A member of an affiliated group that files a consolidated United States income tax return may use the safe harbor method for a foreign state or U.S. possession only if an election to use the safe harbor method for that state or possession has been made by the common parent of such affiliated group on behalf of all members of the group. Similarly, a member of an affiliated group that does not file a consolidated United States income tax return may elect to use the safe harbor method for a foreign state or U.S. possession only if an election to use the safe harbor method for that state or possession is made by each member of the affiliated group which claims credit for taxes paid to such state or possession or to any political subdivision thereof. An election to use the safe harbor method for an elected country does not apply to foreign taxes carried back or forward to any election year from any taxable year to which the election does not apply. Such election does apply to foreign taxes carried back or forward from any election year to any taxable year. A person who elects to use the safe harbor method for one or more foreign countries may, in a later taxable year, also elect to use that method for other foreign countries.

(2) *Effect of election.* An election to use the safe harbor method described in paragraph (c)(3) of this section requires the electing person to apply the safe harbor formula of paragraph (e) of this section to all qualifying levies of all elected countries and their political subdivisions, and constitutes a specific waiver by such person of the right to use the facts and circumstances method described in paragraph (c)(2) of this section with respect to any levy of any elected country or any political subdivision thereof.

(3) *Time and manner of making election*—(i) *In general.* To elect to use the safe harbor method, an electing person must attach a statement to its United States income tax return for the taxable year for which the election is made and must file such return by the due date (including extensions) for the filing thereof. Such statement shall state—

(A) That the electing person elects to use the safe harbor method for the foreign states and the possessions of the United States designated in the statement and their political subdivisions, and

(B) That the electing person waives the right, for any election year, to use the facts and circumstances method for any levy of the designated states, possessions and political subdivisions. Notwithstanding the foregoing, a person may, with the consent of the Commissioner, elect to use the safe harbor method for a taxable year for one or more foreign states or possessions of the United States, at a date later than that specified in the first sentence of this paragraph (d)(3)(i), *e.g.,* upon audit of such person’s United States income tax return for such taxable year. The Commissioner will normally consent to such a later election if such person demonstrates that it failed to make a timely election for such a foreign state or possession for such taxable year because such person reasonably believed either that it was not a dual capacity taxpayer with respect to such state or possession or that no levy that it paid to such state or possession or any political subdivision thereof was a qualifying levy (for example, because it reasonably, but incorrectly, believed that the levy it paid was not a separate levy from that applicable to persons other than dual capacity taxpayers). The Commissioner will not, however, consent to such a later election with respect to any state or possession for a taxable year if such person (or any other member of an affiliated group of which such person is a member) applied the facts and circumstances method to any levy of such state or possession or any political subdivision thereof for such taxable year.

(ii) Certain retroactive elections. Notwithstanding the requirements of paragraph (d)(3)(i) of this section relating to the time and manner of making an election, an election may be made for a taxable year beginning on or before November 14, 1983, provided the electing person elects in accordance with §1.901–2(h) to apply all of the provisions of this section, §1.901–2 and §1.903–1 to such taxable year and provided all of the requirements set forth in this paragraph (d)(3)(ii) are satisfied. Such an election shall be made by timely (including extensions) filing a federal income tax return or an amended federal income tax return for such taxable year; by attaching to such return a statement containing the statements and information set forth in paragraph (d)(3)(i) of this section; and by filing amended income tax returns for all subsequent election years for which income tax returns have previously been filed in which credit is claimed under section 901 or 903 and applying the safe harbor method in such amended returns. All amended returns referred to in the immediately preceding sentence must be filed on or before October 12, 1984, (unless the Commissioner consents to a later filing in circumstances similar to those provided in paragraph (d)(3)(i)) and at a time when neither assessment of a deficiency for any of such election years nor the filing of a claim for any refund claimed in any such amended return is barred.

(iii) *Election to credit taxes made in amended return.* If a person has filed a United States income tax return for a taxable year to which this §1.901–2A applies (including application by reason of the election provided in §1.901–2(h)(2)) in which such person has deducted (instead of credited) qualifying foreign taxes and such person validly makes an election to credit (instead of deduct) such taxes in a timely filed amended return for such taxable year, an election to use the safe harbor method may be made in such amended return provided all of the requirements of paragraph (d)(3)(ii) of this section are satisfied other than the requirement that such amended return and the other amended returns referred to in that paragraph be filed on or before October 12, 1984.

(4) *Revocation of election.* An election to use the safe harbor method described in paragraph (c)(3) of this section may not be revoked without the consent of the Commissioner. An application for consent to revoke such election with respect to one or more elected countries shall be made to the Commissioner of Internal Revenue, Washington, DC 20224. Such application shall be made not later than the 30th day before the due date (including extensions) for the filing of the income tax return for the first taxable year for which the revocation is sought to be effective, except in the case of an event described in (i), (ii), (iii) or (iv) below, in which case an application for revocation with retroactive effect may be made within a reasonable time after such event. The Commissioner may make his consent to any revocation conditioned upon adjustments being made in one or more taxable years so as to prevent the revocation from resulting in a distortion of the amount of any item relating to tax liability in any taxable year. The Commissioner will normally consent to a revocation (including, in the case of (i), (ii), (iii) or (iv) below, one with retroactive effect), if—

(i) An amendment to the Internal Revenue Code or the regulations thereunder is made which applies to the taxable year for which the revocation is to be effective and the amendment substantially affects the taxation of income from sources outside the United States under subchapter N of chapter 1 of the Internal Revenue Code; or

(ii) After a safe harbor election is made with respect to a foreign state, a tax treaty between the United States and that state enters into force; that treaty covers a foreign tax to which the safe harbor election applies; and that treaty applies to the taxable year for which the revocation is to be effective; or

(iii) After a safe harbor election is made with respect to a foreign state or possession of the United States, a material change is made in the tax law of that state or possession or of a political subdivision of that state or possession; and the changed law applies to the taxable year for which the revocation is to be effective and has a material effect on the taxpayer; or

(iv) With respect to a foreign country to which a safe harbor election applies, the Internal Revenue Service issues a letter ruling to the electing person and that letter ruling (*A*) relates to the availability or application of the safe harbor method to one or more levies of such foreign country; (*B*) does not relate to the facts and circumstances method described in paragraph (c)(2) of this section; and (*C*) fails to include a ruling requested by the electing person or includes a ruling contrary to one requested by such person (in either case, other than one relating to the facts and circumstances method) and such failure or inclusion has a material adverse effect on the amount of such electing person's credit for taxes paid to such foreign country for the taxable year for which the revocation is to be effective; or

(v) A corporation (''new member'') becomes a member of an affiliated group; the new member and one or more pre-existing members of such group are dual capacity taxpayers with respect to the same foreign country; and, with respect to such country, either the new member or the pre-existing members (but not both) have made a safe harbor election; and the Commissioner in his discretion determines that obtaining the benefit of the right to revoke the safe harbor election with respect to such foreign country was not the principal purpose of the affiliation between such new member and such group; or

(vi) The election has been in effect with respect to at least three taxable years prior to the taxable year for which the revocation is to be effective.

The Commissioner may, in his discretion, consent to a revocation even if none of the foregoing subdivisions (i) through (vi) is applicable. If an election has been revoked with respect to an elected country, a subsequent election to apply the safe harbor method with respect to such elected country may be made only with the consent of the Commissioner and upon such terms and conditions as the Commissioner in his discretion may require.

(e) *Safe harbor formula*—(1) *In general.* The safe harbor formula applies to determine the distinct element of a qualifying levy that is a tax and the amount paid by a dual capacity taxpayer pursuant to such qualifying levy that is the qualifying amount with respect to such levy. Under the safe harbor formula the amount paid in a taxable year pursuant to a qualifying levy that is the qualifying amount with respect to such levy is an amount equal to:

$$(A-B-C)\times D/(1-D)$$

where (except as otherwise provided in paragraph (e)(5) of this section):

A=the amount of gross receipts as determined under paragraph (e)(2) of this section

B=the amount of costs and expenses as determined under paragraph (e)(2) of this section

C=the total amount paid in the taxable year by the dual capacity taxpayer pursuant to the qualifying levy (the ''actual payment amount'')

D=the tax rate as determined under paragraph (e)(3) of this section

In no case, however, shall the qualifying amount exceed the actual payment amount; and the qualifying amount is zero if the safe harbor formula yields a qualifying amount less than zero. The safe harbor formula is intended to yield a qualifying amount that is approximately equal to the amount of generally imposed income tax within the meaning of paragraphs (a) and (b)(1) of §1.903–1 (''general tax'') of the foreign country that would have been required to be paid in the taxable year by the dual capacity taxpayer if it had not been a dual capacity taxpayer and if the base of the general tax had allowed a deduction in such year for the amount (''specific economic benefit amount'') by which the actual payment amount exceeds the qualifying amount. See, however, paragraph (e)(5) of this section if an elected country has no general tax. The specific economic benefit amount is considered to be the portion of the actual payment amount that is paid pursuant to the distinct portion of the qualifying levy that imposes an obligation in exchange for a specific economic benefit. The specific economic benefit amount is therefore considered to be an amount paid by the dual capacity taxpayer in exchange for such specific economic benefit, which amount must be treated for purposes of chapter 1 of the Internal Revenue Code as provided in paragraph (b)(1) of this section.

(2) *Determination of gross receipts and costs and expenses.* For purposes of the safe harbor formula, gross receipts and costs and expenses are, except as otherwise provided in this paragraph (e), the gross receipts and the deductions for costs and expenses, respectively, as determined under the foreign law applicable in computing the actual payment amount of the qualifying levy to which the safe harbor formula applies. However, except as otherwise provided in this paragraph (e), if provisions of the qualifying levy increase or decrease the liability imposed on dual capacity taxpayers compared to the general tax liability of persons other than dual capacity taxpayers by reason of the determination or treatment of gross receipts or of costs or expenses, the provisions generally applicable in computing such other persons' tax base under the general tax shall apply to determine gross receipts and costs and expenses for purposes of computing the qualifying amount. If provisions of the qualifying levy relating to gross receipts meet the requirements of § 1.901–2(b) (3)(i), such provisions shall apply to determine gross receipts for purposes of computing the qualifying amount. If neither the general tax nor the qualifying levy permits recovery of one or more costs or expenses, and by reason of the failure to permit such recovery the qualifying levy does not satisfy the net income requirement of § 1.901–2(b)(4) (even though the general tax does satisfy that requirement), then such cost or expense shall be considered a cost or expense for purposes of computing the qualifying amount. If the qualifying levy does not permit recovery of one or more significant costs or expenses, but provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, then, for purposes of computing the qualifying amount, costs and expenses shall not include the costs and expenses under the general tax whose nonrecovery under the qualifying levy is compensated for by such allowances but shall instead include such allowances. In determining costs and expenses for purposes of computing the qualifying amount with respect to a qualifying levy, the actual payment amount with respect to such levy shall not be considered a cost or expense. For purposes of this paragraph, the following differences in gross receipts and costs and expenses between the qualifying levy and the general tax shall not be considered to increase the liability imposed on dual capacity taxpayers compared to the general tax liability of persons other than dual capacity taxpayers, but only if the general tax would be an income tax within the meaning of § 1.901–2(a)(1) if such different treatment under the qualifying levy had also applied under the general tax:

(i) Differences in the time of realization or recognition of one or more items of income or in the time when recovery of one or more costs and expenses is allowed (unless the period of recovery of such costs and expenses pursuant to the qualifying levy is such that it effectively is a denial of recovery of such costs and expenses, as described in § 1.901–2(b)(4)(i)); and

(ii) Differences in consolidation or carryover provisions of the types described in paragraphs (b)(4)(ii) and (b)(4)(iii) of § 1.901–2.

(3) *Determination of tax rate.* The tax rate for purposes of the safe harbor formula is the tax rate (expressed as a

decimal) that is applicable in computing tax liability under the general tax. If the rate of the general tax varies according to the amount of the base of that tax, the rate to be applied in computing the qualifying amount is the rate that applies under the general tax to a person whose base is, using the terminology of paragraph (e)(1) of this section, ''A'' minus ''B'' minus the specific economic benefit amount paid by the dual capacity taxpayer pursuant to the qualifying levy, provided such rate applies in practice to persons other than dual capacity taxpayers, or, if such rate does not so apply in practice, the next lowest rate of the general tax that does so apply in practice.

(4) *Determination of applicable provisions of general tax*—(i) *In general.* If the general tax is a series of income taxes (*e.g.*, on different types of income), or if the application of the general tax differs by its terms for different classes of persons subject to the general tax (*e.g.*, for persons in different industries), then, except as otherwise provided in this paragraph (e), the qualifying amount small be computed by reference to the income tax contained in such series of income taxes, or in the case of such different applications the application of the general tax, that by its terms and in practice imposes the highest tax burden on persons other than dual capacity taxpayers. Notwithstanding the preceding sentence, the general tax amount shall be computed by reference to the application of the general tax to entities of the same type (as determined under the general tax) as the dual capacity taxpayer and to persons of the same resident or nonresident status (as determined under the general tax) as the dual capacity taxpayer; and, if the general tax treats business income differently from nonbusiness (*e.g.*, investment) income (as determined under the general tax), the dual capacity taxpayer's business and non-business income shall be treated as the general tax treats such income. If, for example, the dual capacity taxpayer would, under the general tax, be treated as a resident (*e.g.*, because the general tax treats an entity that is organized in the foreign country or managed or controlled there as a resident) and as a corporation (*i.e.*, because the rules of the general tax treat an entity like the dual capacity taxpayer as a corporation), and if some of the dual capacity taxpayer's income would, under the general tax, be treated as business income and some as non-business income, the dual capacity taxpayer and its income shall be so treated in computing the qualifying amount.

(ii) *Establishing that provisions apply in practice.* For purposes of the safe harbor formula a provision (including tax rate) shall be considered a provision of the general tax only if it is reasonably likely that that provision applies by its terms and in practice to persons other than dual capacity taxpayers. In general, it will be assumed that a provision (including tax rate) that by its terms applies to persons other than dual capacity taxpayers is reasonably likely to apply in practice to such other persons, unless the person claiming credit knows or has reason to know otherwise. However, in cases of doubt, the person claiming credit may be required to demonstrate that such provision is reasonably likely so to apply in practice.

(5) *No general tax.* If a foreign country does not impose a general tax (and thus a levy, in order to be a qualifying levy must satisfy all of the criteria of section 901 (because section 903 cannot apply), other than the determination of the distinct element of the levy that is a tax and of the amount that is paid pursuant to that distinct element), paragraphs (e)(2), (3) and (4) of this section do not apply to a qualifying levy of such country, and the terms of the safe harbor formula set forth in paragraph (e)(1) of this section are defined with respect to such levy as follows:

A=the amount of gross receipts as determined under the qualifying levy;

B=the amount of deductions for costs and expenses as determined under the qualifying levy;

C=the actual payment amount; and

D=the lower of the rate of the qualifying levy, or the rate of tax specified in section 11(b)(5) (or predecessor or successor section, as the case may be) of the Internal Revenue Code as applicable to the taxable year in which the actual payment amount is paid.

(6) *Certain taxes in lieu of an income tax.* To the extent a tax in lieu of an income tax (within the meaning of § 1.903–1(a)) that applies in practice to persons other than dual capacity taxpayers would actually have been required to be paid in the taxable year by a dual capacity taxpayer if it had not been a dual capacity taxpayer (*e.g.,* in substitution for the general tax with respect to a type of income, such as interest income, dividend income, royalty income, insurance income), such tax in lieu of an income tax shall be treated as if it were an application of the general tax for purposes of applying the safe harbor formula of this paragraph (e) to such dual capacity taxpayer, and such formula shall be applied to yield a qualifying amount that is approximately equal to the general tax (so defined) that would have been required to be paid in the taxable year by such dual capacity taxpayer if the base of such general tax had allowed a deduction in such year for the specific economic benefit amount.

(7) *Multiple levies.* If, in any election year of an electing person, with respect to any elected country and all of its political subdivisions,

(i) Amounts are paid by a dual capacity taxpayer pursuant to more than one qualifying levy or pursuant to one or more levies that are qualifying levies and one or more levies that are not qualifying levies by reason of the last sentence of paragraph (c)(1) of this section but with respect to which credit is allowable, or

(ii) More than one general tax (including a tax treated as if it were an application of the general tax under paragraph (e)(6)) would have been required to be paid by a dual capacity taxpayer (or taxpayers) if it (or they) had not been a dual capacity taxpayer (or taxpayers), or

(iii) Credit is claimed with respect to amounts paid by more than one dual capacity taxpayer,

the provisions of this paragraph (e) shall be applied such that the aggregate qualifying amount with respect to such qualifying levy or levies plus the aggregate amount paid with respect to levies referred to in (e)(7)(i) that are not qualifying levies shall be the aggregate amount that would have been required to be paid in the taxable year by such dual capacity taxpayer (or taxpayers) pursuant to such general tax or taxes if it (or they) had not been a dual capacity taxpayer (or taxpayers) and if the base of such general tax or taxes had allowed a deduction in such year for the aggregate specific economic benefit amount (except that, if paragraph (e)(5) applies to any levy of such elected country or any political subdivision thereof, the aggregate qualifying amount for qualifying levies of such elected country and all of its political subdivisions plus the aggregate amount paid with respect to levies referred to in paragraph (e)(7)(i) that are not qualifying levies shall not exceed the greater of the aggregate amount paid with respect to levies referred to in paragraph (e)(7)(i) that are not qualifying levies and the amount determined in accordance with paragraph (e)(5) where ''D'' is the rate of tax specified in section 11(b)(5) (or predecessor or successor section, as the case may be) of the Internal Revenue Code as applicable to the taxable year in which the actual payment amount is paid). However, in no event shall such aggregate amount exceed the aggregate actual payment amount plus the aggregate amount paid with respect to levies referred to in (e)(7)(i) that are not qualifying levies, nor be less than the aggregate amount paid with respect to levies referred to in (e)(7)(i) that are not qualifying levies. In applying (e)(7)(ii) a person who is not subject to a levy but who is considered to receive a specific economic benefit by reason of § 1.901–2(a)(2)(ii)(E) shall be treated as a dual capacity taxpayer. See example 12 in paragraph (e)(8) of this section.

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

Example 1. Under a levy of country X called the country X income tax, every corporation that does business in country X is required to pay to country X 40% of its income from its business in country X. Income for purposes of the country X income tax is computed by subtracting specified deductions from the corporation's gross income derived from its business in country X. The specified deductions include the corporation's expenses attributable to such gross income and allowances for recovery of the cost of capital expenditures attributable to such gross income, except that under the terms of the country X income tax a corporation engaged in the exploitation of minerals K, L or M in country X is not permitted to recover, currently or in the future, expenditures it incurs in exploring for those minerals. Under the terms of the country X income tax interest is not deductible to the extent it exceeds an arm's length amount (*e.g.*, if the loan to which the interest relates is not in accordance with normal commercial practice or to the extent the interest rate exceeds an arm's length rate). In practice, the only corporations that engage in exploitation of the specified minerals in country X are dual capacity taxpayers. Because no other persons subject to the levy engage in exploitation of minerals K, L or M in country X, the application of the country X income tax to dual capacity taxpayers is different from its application to other corporations. The country X income tax as applied to corporations that engage in the exploitation of minerals K, L or M (dual capacity taxpayers) is, therefore, a separate levy from the country X income tax as applied to other corporations.

A is a U.S. corporation that is engaged in country X in exploitation of mineral K. Natural deposits of mineral K in country X are owned by country X, and *A* has been allowed to extract mineral K in consideration of payment of a bonus and of royalties to an instrumentality of country X. Therefore, *A* is a dual capacity taxpayer. In 1984, *A* does business in country X within the meaning of the levy. *A* has validly elected the safe harbor method for country X for 1984. In 1984, as determined in accordance with the country X income tax as applied to *A, A* has gross receipts of 120u (units of country X currency), deducts 20u of costs and expenses, and pays 40u (40% of (120u–20u)) to country X pursuant to the levy. *A* also incurs in 1984 10u of nondeductible expenditures for exploration for mineral K and 2u of nondeductible interest costs attributable to an advance of funds from a related party to finance an undertaking relating to the exploration for mineral K for which normal commercial financing was unavailable because of the substantial risk inherent in the undertaking. *A* establishes that the country X income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of §1.901–2(a)(1), that it is the generally imposed income tax of country X and hence the general tax, and that all of the criteria of section 903 are satisfied with respect to the country X income tax as applied to dual capacity taxpayers, except for the determination of the distinct element of the levy that is a tax and of *A*'s qualifying amount with respect thereto. (No conclusion is reached whether the country X income tax as applied to dual capacity taxpayers is an income tax within the meaning of §1.901–2(a)(1). Such a determination would require, among other things, that the country X income tax as so applied, judged on the basis of its predominant character, meets the net income requirement of §1.901–2(b)(4) notwithstanding its failure to permit recovery of exploration expenses.) *A* has therefore demonstrated that the country X income tax as applied to dual capacity taxpayers is a qualifying levy.

In applying the safe harbor formula, in accordance with paragraph (e)(2), the amount of *A*'s costs and expenses includes the 10u of nondeductible exploration expenses. The failure to permit recovery of interest in excess of arm's length amounts, a provision of both the general tax and the qualifying levy, does not cause the qualifying levy to fail to satisfy the net income requirement of §1.901–2(b)(4); therefore, the amount of *A*'s costs and expenses does not include the 2u of nondeductible interest costs. Thus, under the safe harbor method, *A*'s qualifying amount with respect to the levy is 33.33u ((120u–30u–40u) x .40/(1–.40)). *A*'s specific economic benefit amount is 6.67u (*A*'s actual payment amount (40u) less *A*'s qualifying amount (33.33u)). Under paragraph (a) of this section, this 6.67u is considered to be consideration paid by *A* for the right to extract mineral K. Pursuant to paragraph (b) of this section, this amount is characterized according to the nature of *A*'s transactions with country X and its instrumentality and of the specific economic benefit received (the right to extract mineral K), as an additional royalty or other business expense paid or accrued by *A* and is so treated for all purposes of chapter 1 of the Internal Revenue Code, except that if an allowance for percentage depletion is allowable to *A* under sections 611 and 613 with respect to *A*'s interest in mineral K, the determination whether this 6.67u is tax or royalty for purposes of computing the amount of such allowance shall be made under sections 611 and 613 without regard to the determination that under the safe harbor formula such 6.67u is not tax for purposes of section 901 or 903.

Example 2. Under a levy of country Y called the country Y income tax, each corporation incorporated in country Y is required to pay to country Y a percentage of its worldwide income. The applicable percentage is 40 percent of the first 1,000u (units of country Y currency) of income and 50 percent of income in excess of 1,000u. Income for purposes of the levy is computed by deducting from gross income specified types of expenses and specified allowances for capital expenditures. The expenses for which deductions are permitted differ depending on the type of business in which the corporation subject to the levy is engaged, *e.g.*, a deduction for interest paid to a related party is not allowed for corporations engaged in enumerated types of activities. In addition, carryover of losses from one taxable period to another is permitted for corporations engaged in specified types of activities, but not for corporations engaged in other activities. By its terms, the foreign levy makes no distinction between dual capacity taxpayers and other persons. In practice the differences in the base of the country Y income tax (*e.g.*, the lack of a deduction for interest paid to related parties for some corporations subject to the levy and the lack of a carryover provision for some corporations subject to the levy) apply to both dual capacity taxpayers and other persons, but the 50 percent rate applies only to dual capacity taxpayers. By reason of such higher rate, application of the country Y income tax to dual capacity taxpayers is different in practice from application of the country Y income tax to other persons subject to it. The country Y income tax as applied to dual capacity taxpayers is therefore a separate levy from the country Y income tax as applied to other corporations incorporated in country Y.

B is a corporation incorporated in country Y that is engaged in construction activities in country Y. *B* has a contract with the government of country Y to build a hospital in country Y for a fee that is not made available on substantially the same terms to substantially all persons who are subject to the general tax of country X. Accordingly, *B* is a dual capacity taxpayer. *B* has validly elected the safe harbor method for country Y for 1985. In 1985, as determined in accordance with the country Y income tax as applied to *B*, *B* has gross receipts of 10,000u, deducts 6,000u of costs and expenses, and pays 1900u ((1,000u×40%) + (3,000u×50%)) to country Y pursuant to the levy.

It is asssumed that *B* has established that the country Y income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of § 1.901–2(a)(1) and is the general tax. It is further assumed that *B* has demonstrated that all of the criteria of section 901 are satisfied with respect to the country Y income tax as applied to dual capacity taxpayers, except for the determination of the distinct element of such levy that is a tax and of *B*'s qualifying amount with respect to that levy, and therefore that the country Y income tax as applied to dual capacity taxpayers is a qualifying levy.

In applying the safe harbor formula, in accordance with paragraph (e)(3), the 50 percent rate is not used because it does not apply in practice to persons other than dual capacity taxpayers. The next lowest rate of the general tax that does apply in practice to such persons, 40 percent, is used. Accordingly, under the safe harbor formula, *B*'s qualifying amount with respect to the levy is 1400u ((10,000u–6000u–1900u) x .40/(1–.40)). *B*'s specific economic benefit amount is 500u (B's actual payment amount (1900u) less *B*'s qualifying amount (1400u)). Pursuant to paragraph (b) of this section, *B*'s specific economic benefit amount is characterized according to the nature of *B*'s transactions with country Y and of the specific economic benefit received, as a reduction of *B*'s proceeds of its contract with country Y; and this amount is so treated for all purposes of chapter 1 of the Code, including the computation of *B*'s accumulated profits for purposes of section 902.

Example 3. The facts are the same as in example 2, with the following additional facts: The contract between *B* and country Y is a cost plus contract. One of the costs of the contract which country Y is required to pay or for which it is required to reimburse *B* is any tax of country Y on *B*'s income or receipts from the contract. Instead of reimbursing *B* therefor, country Y agrees with *B* to assume any such tax liability. Under country Y tax law, *B* is not considered to have additional income or receipts by reason of country Y's assumption of *B*'s country Y tax liability. In 1985, *B*'s gross receipts of 10,000u include 3000u from the contract, and its costs and expenses of 6000u include 2000u attributable to the contract. *B*'s other gross receipts and expenses do not relate to any transaction in which B receives a specific economic benefit. In accordance with the contract, country Y, and not *B*, is required to bear the amount of *B*'s country Y income tax liability on *B*'s 1000u (3000u–2000u) income from the contract. In accordance with the contract *B* computes its country Y income tax without taking this 1000u into account and therefore pays 1400u ((1000u x 40%) + (2000u x 50%)) to country Y pursuant to the levy.

In accordance with § 1.901–2(f)(2)(i), the country Y income tax which country Y is, under the contract, required to bear is considered to be paid by country Y on behalf of *B*. *B*'s proceeds of its contract, for all purposes of chapter 1 of the Code (including the computation of *B*'s accumulated profits for purposes of section 902), therefore, are increased by the additional 500u (1900u computed as in example 2 less 1400u as computed above) of *B's* liability under the country Y income tax that is assumed by country Y and such 500u is considered to be paid pursuant to the levy by country Y on behalf of *B*. In applying the safe harbor formula, therefore, the computation is exactly as in example 2 and the results are the same as in example 2.

Example 4. Country L issues a decree (the ''April 11 decree''), in which it states it is exercising its tax authority to impose a tax on all corporations on their ''net income'' from country L. ''Net income'' is defined as actual gross receipts less all expenses attributable thereto, except that in the case of income from extraction of petroleum, gross receipts are defined as 105 percent of actual gross receipts, and no deduction is allowed for interest incurred on loans whose proceeds are used for exploration for petroleum. Under the April 11 decree, wages paid by corporations subject to the decree are deductible in the year of payment, except that corporations engaged in the extraction of petroleum may deduct such wages only by amortization over a 5-year period and, to the extent such wages are paid to officers, they may be deducted only by amortization over a period of 50 years. The April 11 decree permits related corporations subject to the decree to file consolidated returns in which net income and net losses of related corporations offset each other in computing net income for purposes of the April 11 decree, except that corporations engaged in petroleum exploration or extraction activities are not eligible for inclusion in such a consolidated return. The law of country L does not require separate entities to carry on separate activities in connection with exploring for or extracting petroleum. Net losses of a taxable year may be carried over for 10 years to offset income, except that no more than 25% of net income (before deducting the loss carryover) in any such future year may be offset by a carryover of net loss, and, in the case of any corporation engaged in exploration or extraction of petroleum, losses incurred prior to such a corporation's having net income from production may be carried forward for only 8 years and no more than 15% of net income in any such future year may be offset by such a net loss. The rate to be paid under the April 11 decree is 50% of net income (as defined in the levy), except that if net income exceeds 10,000u (units of country L currency), the rate is 75% of the corporation's net income (including the first 10,000u thereof). In practice, no corporations other than corporations engaged in extraction of petroleum have net income in excess of 10,000u. All petroleum resources of country L are owned by the government of country L, whose petroleum ministry licenses corporations to explore for and extract petroleum in consideration for payment of royalties as petroleum is produced.

J is a U.S. corporation that is engaged in country L in the exploration and extraction of petroleum and therefore is a dual capacity taxpayer. *J* has validly elected the safe harbor method for country L for the year 1983, the year that *J* commenced activities in country L, and has not revoked such election. For the years 1983 through 1986, *J*'s gross receipts, deductions and net income before application of the carryover provisions, determined in accordance with the April 11 decree, are as follows:

Year	Gross receipts (105 percent of actual gross receipts)	Deductions other than wages	Wages paid other than to officers (amortizable at 20 percent)	Wages paid to officers (amortizable at 2 percent)	Nondeductible exploration interest expense	Net income (loss) (B–C–amortization of cumulative D-amortization of cumulative E)
A.	B.	C.	D.	E.	F.	G.
1983	0	13,000u	100u	50u	1,000u	(13,021u)
1984	0	17,000u	100u	50u	2,800u	(17,042u)
1985	42,000u	15,000u	100u	50u	2,800u	26,937u
1986	105,000u	20,000u	100u	50u	2,800u	84,916u

After application of the carryover provisions, *J*'s net income and actual payment amounts pursuant to the April 11 levy are as follows:

Year	Net income (loss)	Actual payment amount (*I* × 75 percent)
H.	*I.*	*J.*
1983	(13,021u)	0
1984	(17,042u)	0
1985	22,896u	17,172u
1986	72,179u	54,134u

Pursuant to paragraph (a)(1) of this section, the April 11 decree as applied to corporations engaged in the exploration or extraction of petroleum in country L is a separate levy from the April 11 decree as applied to all other corporations. *J* establishes that the April 11 decree, as applied to such other corporations, is an income tax within the meaning of § 1.901–2(a)(1) and that the decree as so applied is the general tax.

The April 11 decree as applied to corporations engaged in the exploration or extraction of petroleum in country L does not meet the gross receipts requirement of § 1.901–2(b)(3); therefore, irrespective of whether it meets the other requirements of § 1.901–2(b)(1), it is not an income tax within the meaning of § 1.901–2(a)(1). However, the April 11 decree as applied to such corporations is a qualifying levy because *J* has demonstrated that all of the criteria of section 903 are satisfied with respect to the April 11 decree as applied to such corporations, except for the determination of the distinct element of such levy that imposes a tax and of *J*'s qualifying amount with respect thereto.

In applying the safe harbor formula, in accordance with paragraph (e)(2), gross receipts are computed by reference to the general levy, and thus are 100%, not 105%, of actual gross receipts. Similarly, costs and expenses include exploration interest expense. In accordance with paragraph (e)(2)(i) of this section the difference between the general tax and the qualifying levy in the timing of the deduction for wages, other than wages of officers, is not considered to increase the liability of dual capacity taxpayers because the general tax would not have failed to be an income tax within the meaning of § 1.901–2(a)(1) if it had provided for 5-year amortization of such wages instead of for current deduction. *See* § 1.901–2(b)(4)(i). However, amortization of wages paid to officers over a 50-year period is such a deferred recovery of such wages that it effectively is a denial of the deduction of the excess of such wages paid in any year over the amortization of such cumulative wages permitted in such year. See § 1.901–2(b)(4)(i). The different treatment of wages paid to officers under the general tax and the qualifying levy is thus not merely a difference in timing within the meaning of paragraph(e)(2)(i) of this section. Accordingly, the difference between the amount of wages paid by *J* to officers in any year and *J*'s deduction (in computing the actual payment amount) for amortization of such cumulative wages allowed in such year is, pursuant to paragraph (e)(2) of this section, treated as a cost and expense in computing *J*'s qualifying amount for such year with respect to the April 11 decree. The differences in the consolidation and carryover provisions between the general tax and the qualifying levy are of the types described in paragraph (e)(2)(ii) of this section and, pursuant to paragraphs (b)(4)(ii) and (b)(4)(iii) of § 1.901–2, the general tax would not fail to be an income tax within the meaning of § 1.901–2(a)(i) even if it contained the consolidation and carryover provisions of the qualifying levy. Thus, such differences are not considered to increase the liability of dual capacity taxpayers pursuant to the qualifying levy as compared to the general tax liability of persons other than dual capacity taxpayers.

Accordingly, in applying the safe harbor formula to the qualifying levy for 1985 and 1986, gross receipts and costs and expenses are computed as follows:

Gross receipts

1985: 42,000u × (100/105)=40,000u
1986: 105,000u × (100/105)=100,000u

COSTS AND EXPENSES

Item	1985	1986
1. Deductions other than wages (column C in the preceding chart)	15,000u	20,000u
2. Amortization of cumulative wages paid in 1983 and thereafter other than to officers	60u	80u
3. Deduction of wages to officers paid in current year, instead of amortization allowed in current year of such cumulative wages paid in 1983 and thereafter	50u	50u
4. Deduction of exploration interest expense	2,800u	2,800u
5. Costs and expenses before carryover of net loss (sum of lines 1 through 4)	17,910u	22,930u
6. Recalculation of loss carryover by recalculating 1983 and 1984 net income (loss) to reflect current deduction of wages to officers and exploration interest expense: 1983 adjusted net loss carryover: (13,021u) + (49u) + (1000u)=(14,070u); 1984 adjusted net loss carryover: (17,042u) + (48u) + (2800u)=(19,890u).		
7. Recalculation of limitation on use of net loss carryover deduction:		
Gross receipts	40,000u	100,000u
Less costs and expenses	(17,910u)	(22,930)
Total	22,090u	77,070u
Times 15 percent limitation	3,314u	11,561u
8. Costs and expenses including net loss carryover deduction (line 5 plus line 7)	21,224u	34,491u

In years after 1986, costs and expenses for purposes of determining the qualifying amount would reflect net loss carryforward deductions based on the recomputed losses carried forward from 1983 and 1984 (14,070u and 19,890u, respectively) less the amounts thereof that were utilized in determining costs and expenses for 1985 and 1986 (3,314u and 11,561u, respectively). The 1983 and 1984 loss carryforwards would be considered utilized in accordance with the order of priority in which such losses are utilized under the terms of the qualifying levy.

In applying the safe harbor formula, the tax rate to be used, in accordance with paragraph (e)(3) of this section, is .50.

Accordingly, under the safe harbor method, *J*'s qualifying amounts with respect to the April 11 decree for 1985 and 1986 are computed as follows:

1985: (40,000u–21,224u–17,172u) × .50/(1–.50)=1604u

1986: (100,000u–34,491u–54,134u) × .50/(1–.50)=11,375u

Under the safe harbor method *J*'s qualifying amounts with respect to the April 11 decree for 1985 and 1986 are thus 1604u and 11,375u, respectively; and its specific economic benefit amounts are 15,568u (17,172u–1604u) and 42,759u, (54,134u–11,375u), respectively. Pursuant to paragraph (b) of this section, *J*'s specific economic benefit amounts are characterized according to the nature of *J*'s transactions with country L and of the specific economic benefit received by *J* as additional royalties paid to country L with respect to the petroleum extracted by *J* in country L in 1985 and 1986, and these amounts are so treated for all purposes of chapter 1 of the Code.

Example 5. Country E, which has no generally imposed income tax, imposes a levy called the country E income tax only on corporations carrying on the banking business through a branch in country E and on corporations engaged in the extraction of petroleum in country E. All of the petroleum resources of country E are owned by the government of country E, whose petroleum ministry licenses corporations to explore for and extract petroleum in consideration of payment of royalties as petroleum is extracted. The base of the country E income tax is a corporation's actual gross receipts from sources in country E less all expenses attributable, on reasonable principles, to such gross receipts; the rate of tax is 29 percent.

A is a U.S corporation that carries on the banking business through a branch in country E. *B* is a U.S. corporation (unrelated to *A*) that is engaged in the extraction of petroleum in country E. In 1984 *A* receives interest on loans it has made to 160 borrowers in country E, seven of which are agencies and instrumentalities of the government of country E. The economic benefits received by *A* and *B* (*i.e.*, the interest received by *A* from the government and B's license to extract petroleum owned by the government) are not made available on substantially the same terms to the population of country E in general.

A and *B* are dual capacity taxpayers. Each of them has validly elected the safe harbor method for country E for 1984. *A* demonstrates that the country E income tax as applied to it (a dual capacity taxpayer) is not different by its terms or in practice from the country E income tax as applied to persons (in this case other banks) that are not dual capacity taxpayers. *A* has therefore established pursuant to paragraph (a)(1) of this section and §1.901–2(d) that the country E income tax as applied to it and the country E income tax as applied to persons other than dual capacity taxpayers are together a single levy. *A* establishes that such levy is an income tax within the meaning of §1.901–2(a)(1). In accordance with paragraph (a)(1) of this section, no portion of the amount paid by *A* pursuant to such levy is considered to be paid in exchange for a specific economic benefit. Thus, the entire amount paid by *A* pursuant to this levy is an amount of income tax paid.

B does not demonstrate that the country E income tax as applied to corporations engaged in the extraction of petroleum in country E (dual capacity taxpayers) is not different by its terms or in practice from the country E income tax as applied to persons other than dual capacity taxpayers (*i.e.*, banks that are not dual capacity taxpayers). Accordingly, pursuant to paragraph (a)(1) of this section and §1.901–2(d), the country E income tax as applied to corporations engaged in the extraction of petroleum in country E is a separate levy from the country E income tax as applied to other persons.

B demonstrates that all of the criteria of section 901 are satisfied with respect to the country E income tax as applied to corporations engaged in the exploration of petroleum in country E, except for the determination of the distinct element of such levy that imposes a tax and of *B*' s qualifying amount with respect to the levy. Pursuant to paragraph (e)(5) of this section, in applying the safe harbor formula to *B*, ''A'' is the amount of *B*' s gross receipts as determined under the country E income tax as applied to *B*; ''B'' is the amount of *B*' s costs and expenses as determined thereunder; ''C'' is *B*' s actual payment amount; and ''D'' is .29, the lower of the rate (29 percent) of the qualifying levy (the country E income tax as applied to corporations engaged in the extraction of petroleum in country E) or the rate (46 percent) of tax specified for 1984 in section 11(b)(5) of the Internal Revenue Code. Thus, *B*' s qualifying amount is equal to its actual payment amount.

Example 6. The facts are the same as in example 5, except that the rate of the country E income tax is 55 percent. For the reasons stated in example 5, the results with respect to *A* are the same as in example 5. In applying the safe harbor formula to *B*, ''A,'' ''B,'' and ''C'' are the same as in example 5, but ''D'' is .46, as that rate is less than .55. Thus, *B*' s qualifying amount is less than *B*' s actual payment amount, and the difference is *B*' s specific economic benefit amount.

Example 7. Country E imposes a tax (called the country E income tax) on the realized net income derived by corporations from sources in country E, except that, with respect to interest income received from sources in country E and certain insurance income, nonresident corporations are instead subject to other levies. With respect to such interest income a levy (called the country E interest tax) requires nonresident corporations to pay to country E 20 percent of such gross interest income unless the nonresident corporation falls within a specified category of corporations (''special corporations''), all of which are dual capacity taxpayers, in which case the rate is instead 25 percent. With respect to such insurance income nonresident corporations are subject to a levy (called the country E insurance tax), which is not an income tax within the meaning of § 1.901–2(a)(1).

The country E interest tax applies at the 20 percent rate by its terms and in practice to persons other than dual capacity taxpayers. The country E interest tax as applied at the 25 percent rate to special corporations applies only to dual capacity taxpayers; therefore, the country E interest tax as applied to special corporations is a separate levy from the country E interest tax as applied at the 20 percent rate.

A is a U.S. corporation which is a special corporation subject to the 25 percent rate of the country E interest tax. *A* does not have any insurance income that is subject to the country E insurance tax. *A*, a dual capacity taxpayer, has validly elected the safe harbor formula for 1984. In 1984 *A* receives 100u (units of country E currency) of gross interest income subject to the country E interest tax and pays 25u to country E.

A establishes that the country E income tax is the generally imposed income tax of country E; that all of the criteria of section 903 are satisfied with respect to the country E interest tax as applied to special corporations except for the determination of the distinct element of the levy that is a tax and of *A*' s qualifying amount with respect thereto. *A* has therefore demonstrated that the country E interest tax as applied to special corporations is a qualifying levy. *A* establishes that the country E interest tax at the 20 percent rate is a tax in lieu of an income tax within the meaning of § 1.903–1(a). Pursuant to paragraph (e)(6) of this section the country E interest tax at the 20 percent rate is treated as if it were an application of the general tax for purposes of the safe harbor formula of this paragraph (e), since that tax would actually have been required to have been paid by *A* with respect to its interest income had *A* not been a dual capacity taxpayer (special corporation) instead subject to the qualifying levy (the country E interest tax at the 25 percent rate).

Even if the country E insurance tax is a tax in lieu of an income tax within the meaning of § 1.903–1(a), that tax is not treated as if it were an application of the general tax for purposes of applying the safe harbor formula to *A* since *A* had no insurance income in 1984 and hence such tax would not actually have been required to be paid by *A* had *A* not been a dual capacity taxpayer.

Example 8. Under a levy of country S called the country S income tax, each corporation operating in country S is required to pay country S 50 percent of its income from operations in country S. Income for purposes of the country S income tax is computed by subtracting all attributable costs and expenses from a corporation's gross receipts derived from its business in country S. Among corporations on which the country S income tax is imposed are corporations engaged in the exploitation of mineral K in country S. Natural deposits of mineral K in country S are owned by country S, and all corporations engaged in the exploitation thereof do so under concession agreement with an instrumentality of country S. Such corporations, in addition to the 50 percent country S income tax, are also subject to a levy called a surtax, which is equal to 60 percent of posted price net income less the amount of the contry S income tax. The surtax is not deductible in computing the country S income tax of corporations engaged in the exploitation of mineral K in country S.

A is a U.S. corporation engaged in country S in the exploitation of mineral K, and *A* has been allowed to extract mineral K under a concession agreement with an instrumentality of country S. Therefore, *A* is a dual capacity taxpayer. In accordance with a term of the concession agreement, certain of *A*'s income (net of expenses attributable thereto) is exempted from the income tax and surtax.

The results for *A* in 1984 are as follows:

	Income Tax	Surtax
Gross Receipts:		
Realized—Taxable	120u	—
Realized—Exempt	15u	—
Posted Price-Taxable	—	145u
Costs:		
Attributable to Taxable Receipts	20u	20u
Attributable to Exempt Receipts	5u	—
Taxable Income	100u	125u
Tentative Surtax (60 percent)	—	75u
Petroleum Levy at 50 percent	50u	50u
Surtax	—	25u

Because of the difference (nondeductibility of the surtax) in the country S income tax as applied to dual capacity taxpayers from its application to other persons, the country S income tax as applied to dual capacity taxpayers and the country S income tax as applied to persons other than dual capacity taxpayers are separate levies. Moreover, because *A*'s concession agreement provides for a modification (exemption of certain income) of the country S income tax and surtax as they otherwise apply to other persons engaged in the exploitation of mineral K in country S, those levies (contractual levies) as applied to *A* are separate levies from those levies as applied to other persons engaged in the exploitation of mineral K in country S.

A establishes that the country S income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of § 1.901–2(a)(1) and is the general tax. *A* demonstrates that all the criteria of section 903 are satisfied with respect to the country S income tax as applied to *A* and with respect to the surtax as applied to *A*, except for the determination of the distinct elements of such levies that are taxes and of *A*’s qualifying amounts with respect to such levies. Therefore, both the country S income tax as applied to *A* and the surtax as applied to *A* are qualifying levies.

In applying the safe harbor formula, in accordance with paragraph (e)(2), the amount of *A*’s gross receipts includes the exempt realized income, and the amount of *A*’s costs and expenses includes the costs attributable to such exempt income. In accordance with paragraph (e)(7)(i), the amount of the qualifying levy for purposes of the formula is the sum of *A*’s liability for the country S income tax and *A*’s liability for the surtax. Accordingly, under the safe harbor formula, *A*’s qualifying amount with respect to the country S income tax and the surtax is 35u ((135u − 25u − 75u)×.50/(1 − .50)). *A*’s specific economic benefit amount is 40u (*A*’s actual payment amount (75u) less *A*’s qualifying amount (35u)).

Example 9. Country T imposes a levy on corporations, called the country T income tax. The country T income tax is imposed at a rate of 50 percent on gross receipts less all costs and expenses, and affiliated corporations are allowed to consolidate their results in applying the country T income tax. Corporations engaged in the exploitation of mineral L in country T are subject to a levy that is identical to the country T income tax except that no consolidation among affiliated corporations is allowed. The levy allows unlimited loss carryforwards.

C and *D* are affiliated U.S. corporations engaged in country T in the exploitation of mineral L. Natural deposits of mineral L in country T are owned by country T, and *C* and *D* have been allowed to extract mineral L in consideration of certain payments to an instrumentality of country T. Therefore, *C* and *D* are dual capacity taxpayers.

The results for *C* and *D* in 1984 and 1985 are as follows:

	1984		1985	
	C	*D*	*C*	*D*
Gross Receipts	120u	0	120u	120u
Costs	20u	50u	20u	20u
Loss Carryforward	....	....	....	50u
Net Income (Loss)	100u	(50u)	100u	50u
Income Tax	50u	....	50u	25u

C and *D* establish that the country T income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of §1.901–2(a)(1) and is the general tax. *C* and *D* demonstrate that all of the criteria of section 901 are satisfied with respect to the country T income tax as applied to dual capacity taxpayers, except for the determination of the distinct element of such levy that is a tax and of *C* and *D*’s qualifying amounts with respect to that levy. Therefore, the country T income tax as applied to dual capacity taxpayers is a qualifying levy.

In applying the safe harbor formula, in accordance with paragraphs (e)(2)(ii) and (e)(7)(iii), the gross receipts, costs and expenses, and actual payment amounts of *C* and *D* are aggregated, except that in *D*’s loss year (1984) its gross receipts and costs and expenses are disregarded. The results of any loss year are disregarded since the country T income tax as applied to dual capacity taxpayers does not allow consolidation, and, pursuant to paragraph (e)(2)(ii), differences in consolidation provisions between such levy and the country T income tax as applied to persons that are not dual capacity taxpayers are not considered. Accordingly, in 1984 the qualifying amount with respect to the country T income tax is 50u ((120u − 20u − 50u)×.50/(1 − .50)), all of which is considered paid by *C*. In 1985 the qualifying amount is 75u ((120u+120u − 20u − 20u − 50u (loss carry forward)—50u—25u)×.50/(1 − .50)), of which 50u is considered to be paid by *C* and 25u by *D*.

Example 10. Country W imposes a levy called the country W income tax on corporations doing business in country W. The country W income tax is imposed at a 50 percent rate on gross receipts less all costs and expenses. Corporations engaged in the exploitation of mineral M in country W are subject to a levy that is identical in all respects to the country W income tax except that it is imposed at a rate of 80 percent (the ‘‘80 percent levy’’).

A is a U.S. corporation engaged in country W in exploitation of mineral M and is subject to the 80 percent levy. Natural deposits of mineral M in country W are owned by country W, and *A* has been allowed to extract mineral M in consideration of certain payments to an instrumentality of country W. Therefore, *A* is a dual capacity taxpayer. *B*, a U.S. corporation affiliated with *A*, also is engaged in business in country W, but has no transactions with country W. *B* is subject to the country W income tax. *B* is a dual capacity taxpayer within the meaning of §1.901–2(a)(2)(ii)(A) by virtue of its affiliation with *A*.

The results for *A* and *B* in 1984 are as follows:

	A	*B*
Gross Receipts	120u	100u
Costs	20u	40u
Net Income	100u	60u
Tax Rate	.80	.50
Tax	80u	30u

A and *B* establish that the country W income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of § 1.901–2(a)(1) and is the general tax. It is assumed that *B* has demonstrated that the country W income tax as applied to *B* does not differ by its terms or in practice from the country W income tax as applied to persons other than dual capacity taxpayers and hence that the country W income tax as applied to *B*, a dual capacity taxpayer, and the country W income tax as applied to such other persons is a single levy. Thus, with respect to *B*, the country W income tax is not a qualifying levy by reason of the last sentence of paragraph (c)(1) of this section. *A* demonstrates that all the criteria of section 901 are satisfied with respect to the 80 percent levy, except for the determination of the distinct element of such levy that is a tax and of *A*'s qualifying amount with respect thereto. Accordingly, the 80 percent levy as applied to *A* is a qualifying levy.

In applying the safe harbor formula in accordance with paragraphs (e)(7)(i) and (e)(7)(iii) in the instant case, it is not necessary to incorporate *B*'s results in the safe harbor formula because *B*'s taxation in country W is identical to the taxation of persons other than dual capacity taxpayers and because neither *A*'s and *B*'s results nor their taxation in country W interact in any way to change *A*'s taxation. All of the amount paid by *B*, 30u, is an amount of income tax paid by *B* within the meaning of § 1.901–2(a)(1). Accordingly, under the safe harbor formula, the qualifying amount for *A* with respect to the 80 percent levy is 20u ((120u − 20u − 80u) × .50/(1 − .50)). The remaining 60u paid by *A* (80u − 20u) is *A*'s specific economic benefit amount.

Example 11. The facts are the same as in example 10, except that it is assumed that *B* has not demonstrated that the country W income tax as applied to *B* does not differ by its terms or in practice from the country W income tax as applied to persons other than dual capacity taxpayers. In addition, *A* and *B* demonstrate that all the criteria of section 901 are satisfied with respect to each of the country W income tax and the 80 percent levy as applied to dual capacity taxpayers, except for the determination of the distinct elements of such levies that are taxes of *A* and *B*'s qualifying amounts with respect to such levies. Therefore, the country W income tax and 80 percent levy as applied to dual capacity taxpayers are qualifying levies.

In applying the safe harbor formula in accordance with paragraphs (e)(7)(i) and (e)(7)(iii), the results of *A* and *B* are aggregated. Accordingly, under the safe harbor formula, the aggregate qualifying amount for *A* and *B* with respect to the country W income tax and 80 percent levy is 50u ([(120u + 100u) − (20u + 40u) − (80u + 30u)] × .50/(1 − .50)).

Example 12. Country Y imposes a levy on corporations operating in country Y, called the country Y income tax. Income for purposes of the country Y income tax is computed by subtracting all costs and expenses from a corporation's gross receipts derived from its business in country Y. The rate of the country Y income tax is 50 percent. Country Y also imposes a 20 percent tax (the ''withholding tax'') on the gross amount of certain income, including dividends, received by persons who are not residents of country Y from persons who are residents of country Y and from corporations that operate there. Corporations engaged in the exploitation of mineral K in country Y are subject to a levy (the ''75 percent levy'') that is identical in all respects to the country Y income tax except that it is imposed at a rate of 75 percent. Dividends received from such corporations are not subject to the withholding tax.

C, a wholly-owned country Y subsidiary of *D*, a U.S. corporation, is engaged in country Y in the exploitation of mineral K. Natural deposits of mineral K in country Y are owned by country Y, and *C* has been allowed to extract mineral K in consideration of certain payments to an instrumentality of country Y. Therefore, *C* is a dual capacity taxpayer. *D* has elected the safe harbor method for country Y for 1984. In 1984, *C*'s gross receipts are 120u (units of country Y currency), its costs and expenses are 20u, and its liability under the 75 percent levy is 75u. *C* distributes the amount that remains, 25u, as a dividend to *D*.

D establishes that the country Y income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of § 1.901–2(a)(1) and the general tax, and that all the criteria of section 901 are satisfied with respect to the 75 percent levy, except for the determination of the distinct element of such levy that is tax and of *C*'s qualifying amount with respect thereto. Accordingly, the 75 percent levy is a qualifying levy.

Pursuant to paragraph (e)(7), *D* (which is not subject to a levy of country Y but is considered to receive a specific economic benefit by reason of § 1.901–2(a)(2)(ii)(E)) is treated as a dual capacity taxpayer in applying paragraph (e)(7)(ii). *D* demonstrates that the withholding tax is a tax in lieu of an income tax within the meaning of § 1.903–1, which tax applies in practice to persons other than dual capacity taxpayers, and that such tax actually would have applied to *D* had *D* not been a dual capacity taxpayer (*i.e.*, had *C* not been a dual capacity taxpayer, in which case *D* also would not have been one). Accordingly, the withholding tax is treated for purposes of the safe harbor formula as if it were an application of the general tax.

In applying the safe harbor formula to this situation in accordance with paragraph (e)(7)(ii), the rates of the country Y income tax and the withholding tax are aggregated into a single effective general tax rate. In this case, the rate is .60 $(.50+[(1-.50)\times.20])$. Accordingly, under the safe harbor formula, *C*'s qualifying amount with respect to the 75 percent levy is 37.5u $[(120u-20u-75u)\times.60/(1-.60)]$, the aggregate amount that *C* and *D* would have paid if *C* had been subject to the country Y income tax and had distributed to *D* as a dividend subject to the withholding tax the entire amount that remained for the year after payment of the country Y income tax. Because *C* is in fact the only taxpayer, the entire qualifying amount is paid by *C*.

Example 13. The facts are the same as in example 12, except that dividends received from corporations engaged in the exploitation of mineral K in country Y are subject to the withholding tax. Thus, *C*'s liability under the 75 percent levy is 75u, and *D*'s liability under the withholding tax on the 25u distribution is 5u.

D, which is a dual capacity taxpayer, demonstrates that the withholding tax as applied to *D* does not differ by its terms or in practice from the withholding tax as applied to persons other than dual capacity taxpayers and hence that the withholding tax as applied to *D* and that levy as applied to such other persons is a single levy. *D* demonstrates that all of the criteria of section 903 are satisfied with respect to the withholding tax. The withholding tax is not a qualifying levy by reason of the last sentence of paragraph (c)(1) of this section.

Paragraphs (e)(7)(i), (e)(7)(ii) and (e)(7)(iii) all apply in this situation. As in example 10, it is not necessary to incorporate the withholding tax into the safe harbor formula. All of the amount paid by *D*, 5u, is an amount of tax paid by *D* in lieu of an income tax. In applying the safe harbor formula to *C*, therefore, with respect to the 75 percent levy, "A" is 120, "B" is "20", "C" is 75 and "D" is .50. Accordingly, *C*'s qualifying amount with respect to the 75 percent levy is 25u; the remaining 50u that it paid is its specific economic benefit amount.

Example 14. The facts are the same as in example 12, except that dividends received from corporations engaged in the exploitation of mineral K in country Y are subject to a 10 percent withholding tax (the "10 percent withholding tax"). Thus, *C*'s liability under the 75 percent levy is 75u, and *D*'s liability under the 10 percent withholding tax on the 25u distribution is 2.5u.

The only difference between the withholding tax and the 10 percent withholding tax applicable only to dual capacity taxpayers (including *D*) is that a lower rate (but the same base) applies to dual capacity taxpayers. Although the withholding tax and the 10 percent withholding tax are together a single levy, this difference makes it necessary, when dealing with multiple levies, to incorporate the withholding tax and *D*'s payment pursuant to the 10 percent withholding tax in the safe harbor formula. Accordingly, as in example 12, the safe harbor formula is applied by aggregation.

The aggregate effective rate of the general taxes for purposes of the safe harbor formula is .60 $(.50+[(1-.50)\times.20])$. Pursuant to paragraph (e)(7), the aggregate actual payment amount of the qualifying levies for purposes of the formula is the sum of *C* and *D*'s liability for the 75 percent levy and the 10 percent withholding tax. Accordingly, under the safe harbor formula, the aggregate qualifying amount with respect to the 75 percent levy on *C* and the 10 percent withholding tax on *D* is 33.75u $((120u-20u-[75u+2.5u])\times.60/(1-.60))$, which is the aggregate amount of tax that *C* and *D* would have paid if *C* had been subject to the country Y income tax and had paid out its entire amount remaining after payment of that tax to *D* as a dividend subject to the withholding tax.

Example 15. The facts are the same as in example 5, except that the rate of the country E income tax is 45 percent and a political subdivision of country E also imposes a levy, called the "local tax," on all corporations subject to the country E income tax. The base of the local tax is the same as the base of the country E income tax; the rate is 10 percent.

The reasoning of example 5 with regard to the country E income tax as applied to *A* and *B*, respectively, applies equally with regard to the local tax as applied to *A* and *B*, respectively. Accordingly, the entire amount paid by *A* pursuant to each of the country E income tax and the local tax is an amount of income tax paid, and both the country E income tax as applied to *B* and the local tax as applied to *B* are qualifying levies.

Pursuant to paragraph (e)(7), in applying the safe harbor formula to *B*, "A" is the amount of *B*'s gross receipts as determined under the (identical) country E income tax and local tax as applied to *B*; "B" is the amount of *B*'s costs and expenses thereunder; and "C" is the sum of *B*'s actual payment amounts with respect to the two levies. Pursuant to paragraph (e)(7), in applying the safe harbor formula to *B*, *B*'s aggregate qualifying amount with respect to the two levies is limited to the amount determined in accordance with paragraph (e)(5) where "D" is the rate of tax specified in section 11(b)(5) of the Internal Revenue Code. Accordingly, "D" is .46, which is the lower of the aggregate rate (55 percent) of the qualifying levies or the section 11(b)(5) rate (46 percent). *B*'s aggregate qualifying amount is, therefore, identical to *B*'s qualifying amount in example 6, which is less than its aggregate actual payment amount, and the difference is *B*'s specific economic benefit amount.

(f) *Effective date.* The effective date of this section is as provided in § 1.901–2(h).

(Approved by the Office of Management and Budget under control number 1545–0746)

[T.D. 7918, 48 FR 46284, Oct. 12, 1983]

§ 1.901–3 Reduction in amount of foreign taxes on foreign mineral income allowed as a credit.

(a) *Determination of amount of reduction*—(1) *In general.* For purposes of determining the amount of taxes which are allowed as a credit under section 901(a) for taxable years beginning after December 31, 1969, the amount of any income, war profits, and excess profits taxes paid or accrued, or deemed to be paid under section 902, during the taxable year to any foreign country or possession of the United States with respect to foreign mineral income (as defined in paragraph (b) of this section) from sources within such country or possession shall be reduced by the amount, if any, by which—

(i) The smaller of—

(a) The amount of such foreign income, war profits, and excess profits taxes, or

(b) The amount of the tax which would be computed under chapter 1 of the Code for such year with respect to such foreign mineral income if the deduction for depletion were determined under section 611 without regard to the deduction for percentage depletion under section 613, exceeds

(ii) The amount of the tax computed under chapter 1 of the Code for such year with respect to such foreign mineral income.

The reduction required by this subparagraph must be made on a country-by-country basis whether the taxpayer uses for the taxable year the per-country limitation under section 904(a)(1), or the overall limitation under section 904(a)(2), on the amount of taxes allowed as credit under section 901(a).

(2) *Determination of amount of tax on foreign mineral income*—(i) *Foreign tax.* For purposes of subparagraph (1)(i)*(a)* of this paragraph, the amount of the income, war profits, and excess profits taxes paid or accrued during the taxable year to a foreign country or possession of the United States with respect to foreign mineral income from sources within such country or possession is an amount which is the greater of—

(a) The amount by which the total amount of the income, war profits, and excess profits taxes paid or accrued during the taxable year to such country or possession exceeds the amount of such taxes that would be paid or accrued for such year to such country or possesion without taking into account such foreign mineral income, or

(b) The amount of the income, war profits, and excess profits taxes that would be paid or accrued to such country or possession if such foreign mineral income were the taxpayer's only income for the taxable year, except that in no case shall the amount so determined exceed the total of all income, war profits, and excess profits taxes paid or accrued during the taxable year to such country or possession. For such purposes taxes which are paid or accrued also include taxes which are deemed paid under section 902. In the case of a dividend described in paragraph (b)(2)(i) *(a)* of this section which is from sources within a foreign country or possession of the United States and is attributable in whole or in part to foreign mineral income, the amount of the income, war profits, and excess profits taxes deemed paid under section 902 during the taxable year to such country or possession with respect to foreign mineral income from sources within such country or possession is an amount which bears the same ratio to the amount of the income, war profits, and excess profits taxes deemed paid under section 902 during such year to such country or possession with respect to such dividend as the portion of the dividend which is attributable to foreign mineral income bears to the total dividend. For purposes of *(a)* and *(b)* of this subdivision, foreign mineral income is to be reduced by any credits, expenses, losses, and other deductions which are properly allocable to such income under the law of the foreign country or possession of the United States from which such income is derived.

(ii) *U.S. tax.* For purposes of subparagraph (1)(ii) of this paragraph, the amount of the tax computed under chapter 1 of the Code for the taxable year with respect to foreign mineral income from sources within a foreign country or possession of the United States is the greater of—

(a) The amount by which the tax under chapter 1 of the Code on the taxpayer's taxable income for the taxable year exceeds a tax determined under such chapter on the taxable income for such year determined without regard to such foreign mineral income, or

(b) The amount of tax that would be determined under chapter 1 of the Code if such foreign mineral income were the taxpayer's only income for the taxable year.

For purposes of this subdivision the tax is to be determined without regard to any credits against the tax and without taking into account any tax against which a credit is not allowed under section 901(a). For purposes of *(b)* of this subdivision, the foreign mineral income is to be reduced only by expenses, losses, and other deductions properly allocable under chapter 1 of the Code to such income and is to be computed without any deduction for personal exemptions under section 151 or 642(b).

(iii) *U.S. income tax computed without deduction allowed by section 613.* For purposes of subparagraph (1)(i)*(b)* of this paragraph, the amount of the tax which would be computed under chapter 1 of the Code (without regard to section 613) for the taxable year with respect to foreign mineral income from sources within a foreign country or possession of the United States is the amount of the tax on such income that would be computed under such chapter by using as the allowance for depletion cost depletion computed upon the adjusted depletion basis of the property. For purposes of this subdivision the tax is to be determined without regard to any credits against the tax and without taking into account any tax against which credit is not allowed under section 901(a). If the greater tax with respect to the foreign mineral income under subdivision (ii) of this subparagraph is the tax determined under *(a)* of such subdivision, the tax determined for purposes of subparagraph (1)(i)*(b)* of this paragraph is to be determined by applying the principles of *(a)* (rather than of *(b)*) of subdivision (ii) of this subparagraph. On the other hand, if the greater tax with respect to the foreign mineral income under subdivision (ii) of this subparagraph is the tax determined under *(b)* of such subdivision, the tax determined for purposes of subparagraph (1)(i)*(b)* of this paragraph is to be determined by applying the principles of *(b)* (rather than of *(a)*) of subdivision (ii) of this subparagraph.

(3) *Special rules.* (i) The reduction required by this paragraph in the amount of taxes paid, accrued, or deemed to be paid to a foreign country or possession of the United States applies only where the taxpayer is allowed a deduction for percentage depletion under section 613 with respect to any part of his foreign mineral income for the taxable year from sources within such country or possession, whether or not such deduction is allowed with respect to the entire foreign mineral income from sources within such country or possession for such year.

(ii) For purposes of this section, the term ''foreign country'' or ''possession of the United States'' includes the adjacent continental shelf areas to the extent, and in the manner, provided by section 638(2) and the regulations thereunder.

(iii) The provisions of this section are to be applied before making any reduction required by section 1503(b) in the amount of income, war profits, and excess profits taxes paid or accrued to foreign countries or possessions of the United States by a Western Hemisphere trade corporation.

(iv) If a taxpayer chooses with respect to any taxable year to claim a credit under section 901 and has any foreign mineral income from sources within a foreign country or possession of the United States with respect to which the deduction under section 613 is allowed, he must attach to his return a schedule showing the computations required by subdivisions (i), (ii), and (iii) of subparagraph (2) of this paragraph.

(v) A taxpayer who has elected to use the overall limitation under section 904(a)(2) on the amount of the foreign tax credit for any taxable year beginning before January 1, 1970, may, for his first taxable year beginning after

December 31, 1969, revoke his election without first securing the consent of the Commissioner. See paragraph (d) of §1.904–1.

(b) *Foreign mineral income defined*—(1) *In general.* The term ''foreign mineral income'' means income (determined under chapter 1 of the Code) from sources within a foreign country or possession of the United States derived from—

(i) The extraction of minerals from mines, wells, or other natural deposits,

(ii) The processing of minerals into their primary products, or

(iii) The transportation, distribution, or sale of minerals or of the primary products derived from minerals.

Any income of the taxpayer derived from an activity described in either subdivision (i), (ii), or (iii) of this subparagraph is foreign mineral income, since it is not necessary that the taxpayer extract, process, and transport, distribute, or sell minerals or their primary products for the income derived from any such activity to be foreign mineral income. Thus, for example, an integrated oil company must treat as foreign mineral income from sources within a foreign country or possession of the United States all income from such sources derived from the production of oil, the refining of crude oil into gasoline, the distribution of gasoline to marketing outlets, and the retail sale of gasoline. Similarly, income from such sources from the refining, distribution, or marketing of fuel oil by the taxpayer is foreign mineral income, whether or not the crude oil was extracted by the taxpayer. In further illustration, income from sources within a foreign country or possession of the United States derived from the processing of minerals into their primary products by the taxpayer is foreign mineral income, whether or not the minerals were extracted, or the primary products were sold, by the taxpayer. Section 901(e) and this section apply whether or not the extraction, processing, transportation, distribution, or selling of the minerals or primary products is done by the taxpayer. Thus, for example, an individual who derives royalty income from the extraction of oil from an oil well in a foreign country has foreign mineral income for purposes of this paragraph. Income from the manufacture, distribution, and marketing of petrochemicals is not foreign mineral income. Foreign mineral income is not limited to gross income from the property within the meaning of section 613(c) and §1.613–3.

(2) *Income included in foreign mineral income*—(i) *In general.* Foreign mineral income from sources within a foreign country or possession of the United States includes, but is not limited to—

(a) Dividends from such sources, as determined under §1.902–1(h)(1), received from a foreign corporation in respect of which taxes are deemed paid by the taxpayer under section 902, to the extent such dividends are attributable to foreign mineral income described in subparagraph (1) of this paragraph. The portion of such a dividend which is attributable to such income is that amount which bears the same ratio to the total dividend received as the earnings and profits out of which such dividend is paid that are attributable to foreign mineral income bear to the total earnings and profits out of which such dividend is paid. For such purposes, the foreign mineral income of a foreign corporation is its foreign mineral income described in this paragraph (including any dividends described in this *(a)* which are received from another foreign corporation), whether or not such income is derived from sources within the foreign country or possession of the United States in which, or under the laws of which, the former corporation is created or organized. A foreign corporation is considered to have no foreign mineral income for any taxable year beginning before January 1, 1970.

(b) Any section 78 dividend to which a dividend described in *(a)* of this subdivision gives rise, but only to the extent such section 78 dividend is deemed paid under paragraph (a)(2)(i) of this section with respect to foreign mineral income from sources within such country or possession and to the extent it is treated under of §1.902–1(h)(1) as income from sources within such country or possession.

(c) Any amounts includible in income of the taxpayer under section 702(a) as his distributive share of the income of

a partnership consisting of income described in subparagraph (1) of this paragraph.

(d) Any amounts includible in income of the taxpayer by virtue of section 652(a), 662(a), 671, 682(a), or 691(a), to the extent such amounts consist of income described in subparagraph (1) of this paragraph.

(ii) *Illustration.* The provisions of this subparagraph may be illustrated by the following example:

Example. (a) Throughout 1974, M, a domestic corporation, owns all the one class of stock of N, a foreign corporation which is not a less developed country corporation within the meaning of section 902(d). Both corporations use the calendar year as the taxable year. N is incorporated in foreign country Y. During 1974, N has income from sources within foreign country X, all of which is foreign mineral income. During 1974, N also has income from sources within country Y, none of which is foreign mineral income. N is taxed in each foreign country only on income derived from sources within that country. Neither country X nor country Y allows a credit against its tax for foreign income taxes. N pays a dividend of $40,000 to M for 1974. For purposes of section 902, the dividend is paid from earnings and profits for 1974.

(b) N's earnings and profits and taxes for 1974 are determined as follows:

Foreign mineral income from country X		$100,000
Less:		
Intangible drilling and development costs	$21,000	
Cost depletion	3,000	24,000
Taxable income from country X		76,000
Income tax rate of country X		×50%
Tax paid to country X		38,000
Income from country Y		100,000
Less deductions		25,000
Taxable income from country Y		75,000
Income tax rate of country Y		×60%
Tax paid to country Y		45,000
Total taxable income		151,000
Less total foreign income taxes		83,000
Total earnings and profits		68,000
Taxable income from foreign mineral income		76,000
Less: Tax paid on foreign mineral income		38,000
Earnings and profits from foreign mineral income		38,000

(c) For 1974, M has foreign mineral income from country Y of $49,636.68, determined in the following manner and by applying this section, § 1.78–1, and § 1.902–1(h)(1):

Portion of dividend from country Y attributable to foreign mineral income (subdivision (i)*(a)* of this subparagraph) ($40,000×$38,000/$68,000)	$22,352.94
Foreign income tax deemed paid by M to country Y under section 902(a)(1) ($83,000×$40,000/$68,000)	48,823.53
Foreign income tax deemed paid by M to country Y with respect to foreign mineral income from country Y (paragraph (a)(2)(i) of this section) ($48,823.53×$22,352.94/$40,000)	27,283.74
Foreign mineral income from country Y:	
Dividend attributable to foreign mineral income from country Y	22,352.94
Sec. 78 dividend deemed paid with respect to foreign mineral income (subdivision (i)*(b)* of this subparagraph)	27,283.74
Total foreign mineral income	49,636.68

(c) *Limitations on foreign tax credit*—(1) *In general.* The reduction under section 901(e) and paragraph (a)(1) of this section in the amount of foreign taxes allowed as a credit under section 901(a) is to be made whether the per-country limitation under section 904(a)(1) or the overall limitation under section 904(a)(2) is used for the taxable year, but the reduction in the amount of foreign taxes allowed as a credit under section 901(a) must be made on a country-by-country basis before applying the limitation under section 904(a) to the reduced amount of taxes. If for the taxable year the separate limitation under section 904(f) applies to any foreign mineral income, that limitation must also be applied after making the reduction under section 901(e) and paragraph (a)(1) of this section.

(2) *Carrybacks and carryovers of excess tax paid*—(i) *In general.* Any amount by which *(a)* any income, war profits, and excess profits taxes paid or accrued, or deemed to be paid under section 902, during the taxable year to any foreign country or possession of the United States with respect to foreign mineral income from sources within such country or possession exceed (b) the reduced amount of such taxes as determined under paragraph (a)(1) of this section may not be deemed paid or accrued under section 904(d) in any other taxable year. See § 1.904–2(b)(2)(iii). However, to the extent such reduced amount of taxes exceeds the applicable limitation under section 904(a) for the taxable year it shall be deemed paid or accrued under section 904(d) in another taxable year as a carryback or carryover of an unused foreign tax. The

amount so deemed paid or accrued in another taxable year is not, however, deemed paid or accrued with respect to foreign mineral income in such other taxable year. See § 1.904–2(c)(3).

(ii) *Carryovers to taxable years beginning after December 31, 1969.* Where, under the provisions of section 904(d), taxes paid or accrued, or deemed to be paid under section 902, to any foreign country or possession of the United States in any taxable year beginning before January 1, 1970, are deemed paid or accrued in one or more taxable years beginning after December 31, 1969, the amount of such taxes so deemed paid or accrued shall not be deemed paid or accrued with respect to foreign mineral income and shall not be reduced under section 901(e) and paragraph (a)(1) of this section.

(iii) *Carrybacks to taxable years beginning before January 1, 1970.* Where income, war profits, and excess profits taxes are paid or accrued, or deemed to be paid under section 902, to any foreign country or possession of the United States in any taxable year beginning after December 31, 1969, with respect to foreign mineral income from sources within such country or possession, they must first be reduced under section 901(e) and paragraph (a)(1) of this section before they may be deemed paid or accrued under section 904(d) in one or more taxable years beginning before January 1, 1970.

(d) *Illustrations.* The application of this section may be illustrated by the following examples, in which the surtax exemption provided by section 11(d) and the tax surcharge provided by section 51(a) are disregarded for purposes of simplification:

Example 1. (a) M, a domestic corporation using the calendar year as the taxable year, is an operator drilling for oil in foreign country W. For 1971, M's gross income under chapter 1 of the Code is $100,000, all of which is foreign mineral income from a property in country W and is subject to the allowance for depletion. During 1971, M incurs intangible drilling and development costs of $15,000, which are currently deductible for purposes of the tax of both countries. Cost depletion amounts to $2,000 for purposes of the tax of both countries, and only cost depletion is allowed as a deduction under the law of country W. It is assumed that no other deductions are allowable under the law of either country. Based upon the facts assumed, the income tax paid to country W on such foreign mineral income is $41,500, and the U.S. tax on such income before allowance of the foreign tax credit is $30,240, determined as follows:

	U.S. tax	W tax
Foreign mineral income	$100,000	$100,000
Less:		
Intangible drilling and development costs	15,000	15,000
Cost depletion	....	2,000
Percentage depletion (22% of $100,000, but not to exceed 50% of $85,000)	22,000	....
Taxable income	63,000	83,000
Income tax rate	48%	50%
Tax	30,240	41,500

(b) Without taking this section into account, M would be allowed a foreign tax credit for 1971 of $30,240 ($30,240×$63,000/$63,000), and foreign income tax in the amount of $11,260 ($41,500 less $30,240) would first be carried back to 1969 under section 904(d).

(c) Pursuant to paragraph (a)(1) of this section, however, the foreign income tax allowable as a credit against the U.S. tax is reduced to $31,900, determined as follows:

Foreign income tax paid on foreign mineral income		$41,500
Less reduction under sec. 901(e):		
Smaller of $41,500 (tax paid to country W on foreign mineral income) or $39,840 (U.S. tax on foreign mineral income of $83,000 ($83,000×48%), determined by deducting cost depletion of $2,000 in lieu of percentage depletion of $22,000)	39,840	
Less: U.S. tax on foreign mineral income (before credit)	$30,240	9,600
Foreign income tax allowable as a credit		31,900

(d) After taking this section into account, M is allowed a foreign tax credit for 1971 of $30,240 ($30,240×$63,000/$63,000). The amount of foreign income tax which may be first carried back to 1969 under section 904(d) is reduced from $11,260 to $1,660 ($31,900 less $30,240).

Example 2. (a) M, a domestic corporation using the calendar year as the taxable year, is an operator drilling for oil in foreign country X. For 1972, M has gross income under chapter 1 of the Code of $100,000, all of which is foreign mineral income from a property in country X and is subject to the allowance for depletion. During 1972, M incurs intangible drilling and development costs of $50,000 which are currently deductible for purposes of the U.S. tax but which must be amortized for purposes of the tax of country X. Percentage depletion of $22,000 is allowed as a deduction by both countries. For purposes of the U.S. tax, cost depletion for 1972 amounts to $15,000. It is assumed that no other deductions are allowable under the law of either country. Based upon these facts, the income tax paid to country X on such foreign mineral income is $27,200, and the U.S. tax on such income before allowance of the foreign tax credit is $13,440, determined as follows:

	U.S. tax	X tax
Foreign mineral income	$100,000	$100,000
Less:		
Intangible drilling and development costs	50,000	10,000
Percentage depletion	22,000	22,000
Taxable income	28,000	68,000
Income tax rate	48%	40%
Tax	13,440	27,200

(b) Without taking this section into account, M would be allowed a foreign tax credit for 1972 of $13,440 ($13,440×$28,000/$28,000), and foreign income tax in the amount of $13,760 ($27,200 less $13,440) would first be carried back to 1970 under section 904(d).

(c) Pursuant to paragraph (a)(1) of this section, however, the foreign income tax allowable as a credit against the U.S. tax is reduced to $23,840, determined as follows:

Foreign income tax paid on foreign mineral income		$27,200
Less reduction under sec. 901(e):		
Smaller of $27,200 (tax paid to country X on foreign mineral income) or $16,800 (U.S. tax on foreign mineral income of $35,000 ($35,000×48%), determined by deducting cost depletion of $15,000 in lieu of percentage depletion of $22,000)	$16,800	
Less: U.S. tax on foreign mineral income (before credit)	13,440	3,360
Foreign income tax allowable as a credit		23,840

(d) After taking this section into account, M is allowed a foreign tax credit of $13,440 ($13,440×$28,000/$28,000). The amount of foreign income tax which may be first carried back to 1970 under section 904(d) is reduced from $13,760 to $10,400 ($23,840 less $13,440).

Example 3. (a) N, a domestic corporation using the calendar year as the taxable year, is an operator drilling for oil in foreign country Y. For 1972, N's gross income under chapter 1 of the Code is $100,000, all of which is foreign mineral income from a property in country Y and is subject to the allowance for depletion. During 1972, N incurs intangible drilling and development costs of $15,000, which are currently deductible for purposes of the U.S. tax but are not deductible under the law of country Y. Depreciation of $40,000 is allowed as a deduction for purposes of the U.S. tax; and of $20,000, for purposes of the Y tax. Cost depletion amounts to $10,000 for purposes of the tax of both countries, and only cost depletion is allowed as a deduction under the law of country Y. It is assumed that no other deductions are allowable under the law of either country. Based upon the facts assumed, the income tax paid to country Y on such foreign mineral income is $14,000, and the U.S. tax on such income before allowance of the foreign tax credit is $11,040, determined as follows:

	U.S. tax	Y tax
Foreign mineral income	$100,000	$100,000
Less:		
Intangible drilling and development costs	15,000	....
Depreciation	40,000	20,000
Cost depletion	....	10,000
Percentage depletion (22% of $100,000, but not to exceed 50% of $45,000)	22,000	....
Taxable income	23,000	70,000
Income tax rate	48%	20%
Tax	11,040	14,000

(b) Without taking this section into account, N would be allowed a foreign tax credit for 1972 of $11,040 ($11,040×$23,000/$23,000), and foreign income tax in the amount of $2,960 ($14,000 less $11,040) would first be carried back to 1970 under section 904(d).

(c) Pursuant to paragraph (a)(1) of this section, however, the foreign income tax allowable as a credit against the U.S. tax is reduced to $11,040, determined as follows:

Foreign income tax paid on foreign mineral income		$14,000
Less reduction under sec. 901(e):		
Smaller of $14,000 (tax paid to country Y on foreign mineral income) or $16,800 (U.S. tax on foreign mineral income of $35,000 ($35,000×48%), determined by deducting cost depletion of $10,000 in lieu of percentage depletion of $22,000)	$14,000	
Less: U.S. tax on foreign mineral income (before credit)	11,040	2,960
Foreign income tax allowable as a credit		11,040

(d) After taking this section into account, N is allowed a foreign tax credit for 1972 of $11,040 ($11,040×$23,000/$23,000), but no foreign income tax is carried back to 1970 under section 904(d) since the allowable credit of $11,040 does not exceed the limitation of $11,040.

Example 4. (a) D, a domestic corporation using the calendar year as the taxable year, is an operator drilling for oil in foreign country Z. For 1971, D's gross income under chapter 1 of the Code is $100,000, all of which is foreign mineral income from a property in country Z and is subject to the allowance for depletion. During 1971, D incurs intangible drilling and development costs of $85,000, which are currently deductible for purposes of the U.S. Tax but are not deductible under the law of country Z. Cost depletion in the amount of $10,000 is allowed as a deduction for purposes of both the U.S. tax and the tax of country Z. Percentage depletion is not allowed as a deduction under the law of country Z and is not taken as a deduction for purposes of the U.S. tax. It is assumed that no other deductions are allowable under the law of either country. Based upon the facts assumed, the income tax paid to country Z on such foreign mineral income is $27,000, and the U.S. tax on such income before allowance of the foreign tax credit is $2,400, determined as follows:

	U.S. tax	Z tax
Foreign mineral income	$100,000	$100,000
Less:		
Intangible drilling and development costs	85,000	....
Cost depletion	10,000	10,000
Taxable income	5,000	90,000
Income tax rate	48%	30%
Tax	2,400	27,000

(b) Section 901(e) and this section do not apply to reduce the amount of the foreign income tax paid to country Z with respect to the foreign mineral income since for 1971 D is not allowed the deduction for percentage depletion with respect to any foreign mineral income from sources within country Z. Accordingly, D is allowed a foreign tax credit of $2,400 ($2,400×$5,000/$5,000), and foreign income tax in the amount of $24,600 ($27,000 less $2,400) is first carried back to 1969 under section 904(d).

Example 5. (a) R, a domestic corporation using the calendar year as the taxable year, is an operator drilling for oil in the United States and in foreign country Z. For 1971, R's gross income under chapter 1 of the Code is $250,000, of which $100,000 is foreign mineral income from a property in foreign country Z and $150,000 is from a property in the United States, all being subject to the allowance for depletion. During 1971, R incurs intangible drilling and development costs of $125,000 in the United States and of $25,000 in country Z, all of which are currently deductible for purposes of the U.S. tax. Of these costs of $25,000 incurred in country Z, only $2,500 is currently deductible under the law of country Z. Cost depletion in the case of the U.S. property amounts to $60,000; and in the case of the property in country Z, to $5,000, which is allowed as a deduction under the laws of such country. Percentage depletion is not allowed as a deduction under the law of country Z. In computing the U.S. tax for 1971, R is required to use cost depletion with respect to the mineral income from the U.S. property and percentage depletion with respect to the foreign mineral income from the property in country Z. It is assumed that no other deductions are allowed under the law of either country. Based upon the facts assumed, the income tax paid to country Z on the foreign mineral income from sources therein is $37,000, and the U.S. tax on the entire mineral income before allowance of the foreign tax credit is $8,640, determined as follows:

	U.S. tax	Z tax
Gross income (including foreign mineral income)	$250,000	$100,000
Less:		
Intangible drilling and development costs	150,000	2,500
Cost depletion	60,000	5,000
Percentage depletion on foreign mineral income (22% of $100,000, but not to exceed 50% of [$100,000 − $25,000])	22,000	....
Taxable income	18,000	92,500
Income tax rate	48%	40%
Tax	8,640	37,000

(b) Without taking this section into account, R would be allowed a foreign tax credit for 1971 of $8,640 ($8,640×$18,000/$18,000), and foreign income tax in the amount of $28,360 ($37,000 less $8,640) would first be carried back to 1969 under section 904(d).

(c) Under paragraph (a)(2)(ii) of this section, the amount of the U.S. tax for 1971 with respect to foreign mineral income from country Z is $25,440, which is the greater of the amounts of tax determined under subparagraphs (1) and (2):

(1) U.S. tax on total taxable income in excess of U.S. tax on taxable income excluding foreign mineral income from country Z (determined under paragraph (a)(2)(ii)*(a)* of this section):

U.S. tax on total taxable income	....	$8,640
Less U.S. tax on taxable income other than foreign mineral income from country Z:		
Income from U.S. property	$150,000	
Intangible drilling and development costs	125,000	
Cost depletion	60,000	
Taxable income	0	
Income tax rate	48%	
U.S. tax	0	0
Excess tax	....	8,640

(2) U.S. tax on foreign mineral income from country Z (determined under paragraph (a)(2)(ii) *(b)* of this section):

Foreign mineral income	$100,000
Intangible drilling and development costs	25,000
Percentage depletion (22% of $100,000, but not to exceed 50% of $75,000)	22,000
Taxable income	53,000
Income tax rate	48%
U.S. tax	25,440

(d) Under paragraph (a)(2)(iii) of this section, the amount of the U.S. tax which would be computed for 1971 (without regard to section 613) with respect to foreign mineral income from sources within country Z is $33,600, computed by applying the principles of paragraph (a)(2)(ii)*(b)* of this section:

Foreign mineral income	$100,000
Intangible drilling and development costs	25,000
Cost depletion	5,000
Taxable income	70,000
Income tax rate	48%
U.S. tax	33,600

(e) Pursuant to paragraph (a)(1) of this section, the foreign income tax allowable as a credit against the U.S. tax for 1971 is reduced to $28,840, determined as follows:

Foreign income tax paid on foreign mineral income		$37,000
Less reduction under sec. 901(e):		
Smaller of $37,000 (tax paid to country Z on foreign mineral income) or $33,600 (U.S. tax on foreign mineral income of $70,000, as determined under paragraph (d) of this example	$33,600	
Less: U.S. tax on foreign mineral income of $53,000, as determined under paragraph (c) of this example	25,440	8,160
Foreign income tax allowable as a credit		$28,840

(f) After taking this section into account, R is allowed a foreign tax credit for 1971 of $8,640 ($8,640×$18,000/$18,000). The amount of foreign income tax which may be first carried back to 1969 under section 904(d) is reduced from $28,360 to $20,200 ($28,840 less $8,640).

Example 6. (a) B, a single individual using the calendar year as the taxable year, is an operator drilling for oil in foreign countries X and Y. For 1972, B's gross income under chapter 1 of the Code is $250,000, of which $150,000 is foreign mineral income from a property in country X and $100,000 is foreign mineral income from a property in country Y, all being subject to the allowance for depletion. The assumption is made that B's earned taxable income for 1972 is insufficient to cause section 1348 to apply. During 1972, B incurs intangible drilling and development costs of $16,000 in country X and of $9,000 in country Y, which are currently deductible for purposes of both the U.S. tax and the tax of countries X and Y, respectively. For purposes of both the U.S. tax and the tax of countries X and Y, respectively, cost depletion in the case of the X property amounts to $8,000, and in the case of Y property, to $7,000; and only cost depletion is allowed as a deduction under the law of countries X and Y. For 1972, B uses the overall limitation under section 904(a)(2) on the foreign tax credit. Percentage depletion is not allowed as a deduction under the law of countries X and Y. It is assumed that the only other allowable deductions amount to $2,250. None of these deductions is attributable to the income from the properties in countries X and Y, and none is deductible under the laws of country X or country Y. Based upon the facts assumed, the income tax paid to countries X and Y on the foreign mineral income from each such country is $71,820 and $25,200, respectively, and the U.S. tax on B's total taxable income before allowance of the foreign tax credit is $99,990, determined as follows:

	U.S. Tax	X tax	Y tax
Total income (including foreign mineral income from countries X and Y)	$250,000	$150,000	$100,000
Intangible drilling and development costs	25,000	16,000	9,000
Cost depletion	....	8,000	7,000
Percentage depletion (22% of $150,000, but not to exceed 50% of $134,000; plus 22% of $100,000, but not to exceed 50% of $91,000)	55,000	....	....
Adjusted gross income	170,000	....	....
Other deductions	2,250	....	....
Personal exemption	750	....	....
Taxable income	167,000	126,000	84,000
Income tax rate	....	57%	30%
Foreign tax	....	71,820	25,200
U.S. tax ($53,090 plus 70% of $67,000)	99,990	....	....

(b) Without taking this section into account, B would be allowed a foreign tax credit for 1972 of $97,020 ($71,820+$25,200), but not to exceed the overall limitation under section 904(a)(2) of $99,990 ($99,990 ×$167,750/$167,750). There would be no foreign income tax carried back to 1970 under section 904(d) since the allowable credit of $97,020 does not exceed the limitation of $99,990.

(c) Under paragraph (a)(2)(ii) of this section, the amount of the U.S. tax for 1972 with respect to foreign mineral income from sources within country X is $69,760, which is the greater of the amounts of tax determined under subparagraphs (1) and (2):

(1) U.S. tax on total taxable income in excess of U.S. tax on taxable income excluding foreign mineral income from country X (determined under paragraph (a)(2)(ii)*(a)* of this section):

U.S. tax on total taxable income	....	$99,990
Less U.S. tax on taxable income other than foreign mineral income from country X:		
Foreign mineral income from country Y	$100,000	
Intangible drilling and development costs	9,000	
Percentage depletion (22% of $100,000, but not to exceed 50% of $91,000)	22,000	
Adjusted gross income	69,000	
Other deductions	2,250	
Personal exemption	750	
Taxable income	66,000	
U.S. tax ($26,390 plus 64% of $6,000)	....	30,230
Excess tax	....	69,760

(2) U.S. tax on foreign mineral income from country X (determined under paragraph (a)(2)(ii)*(b)* of this section):

Foreign mineral income from country X	$150,000.00
Intangible drilling and development costs	16,000.00
Percentage depletion (22% of $150,000, but not to exceed 50% of $134,000)	33,000.00
Adjusted gross income	101,000.00

Other deductions	
Taxable income	101,000.00
U.S. tax ($53,090 plus 70% of excess over $100,000)	53,790.00

(d) Under paragraph (a)(2)(iii) of this section, and by applying the principles of paragraph (a)(2)(ii)*(a)* of this section, the amount of the U.S. tax which would be computed for 1972 (without regard to section 613) with respect to foreign mineral income from sources within country X is $87,920, which is the excess of the U.S. tax ($127,990) determined under subparagraph (1) over the U.S. tax ($40,070) determined under subparagraph (2):

(1) U.S. tax on total taxable income determined without regard to section 613:

Total income	$250,000
Intangible drilling and development costs	25,000
Cost depletion	15,000
Adjusted gross income	210,000
Other deductions	2,250
Personal exemption	750
Taxable income	207,000
U.S. tax ($53,090 plus 70% of $107,000)	127,990

(2) U.S. tax on total taxable income other than foreign mineral income from country X, determined without regard to section 613:

Foreign mineral income from country Y	$100,000
Intangible drilling and development costs	9,000
Cost depletion	7,000
Adjusted gross income	84,000
Other deductions	2,250
Personal exemption	750
Taxable income	81,000
U.S. tax ($39,390 plus 68% of $1,000)	40,070

(e) Under paragraph (a)(2)(i) of this section, the amount of income tax paid to country X for 1972 with respect to foreign mineral income from sources within such country is $71,820. This is the amount determined under both *(a)* and *(b)* of paragraph (a)(2)(i) of this section, since, in this case, there is no income from sources within country X other than foreign mineral income, and there are no deductions allowed under the law of country X which are not allocable to such foreign mineral income.

(f) Pursuant to paragraph (a)(1) of this section, the foreign income tax with respect to foreign mineral income from sources within country X which is allowable as a credit against the U.S. tax for 1972 is reduced to $69,760, determined as follows:

Foreign income tax paid to country X on foreign mineral income		$71,820
Less reduction under sec. 901(e):		
Smaller of $71,820 (tax paid to country X on foreign mineral income) or $87,920 (U.S. tax on foreign mineral income from sources within country X, as determined under paragraph (d) of this example)	$71,820	
Less: U.S. tax on foreign mineral income from sources within country X, determined under paragraph (c) of this example	69,760	2,060
Foreign income tax of country X allowable as a credit		69,760

(g) Under paragraph (a)(2)(ii) of this section, the amount of the U.S. tax for 1972 with respect to foreign mineral income from sources within country Y is $48,280, which is the greater of the amounts of tax determined under subparagraphs (1) and (2):

(1) U.S. tax on total taxable income in excess of U.S. tax on taxable income excluding foreign mineral income from country Y (determined under paragraph (a)(2)(ii)*(a)* of this section):

U.S. tax on total taxable income		$99,990
Less U.S. tax on taxable income other than foreign mineral income from country Y:		
Foreign mineral income from country X	$150,000	
Intangible drilling and development costs	16,000	
Percentage depletion (22% of $150,000, but not to exceed 50% of $134,000)	33,000	
Adjusted gross income	101,000	
Other deductions	2,250	
Personal exemption	750	
Taxable income	98,000	
U.S. tax ($46,190 plus 69% of $8,000)		51,710
Excess tax		48,280

(2) U.S. tax on foreign mineral income from country Y (determined under paragraph (a)(2)(ii)*(b)* of this section):

Foreign mineral income from country Y	$100,000
Intangible drilling and development costs	9,000
Percentage depletion (22% of $100,000, but not to exceed 50% of $91,000)	22,000
Adjusted gross income	69,000
Other deductions	
Taxable income	69,000
U.S. tax ($26,390 plus 64% of $9,000)	32,150

(h) Under paragraph (a)(2)(iii) of this section, and by applying the principles of paragraph (a)(2)(ii)*(a)* of this section, the amount of the U.S. tax which would be computed for 1972 (without regard to section 613) with respect to foreign mineral income from sources within country Y is $58,800, which is the excess of the U.S. tax ($127,990) determined under paragraph (d)(1) of this example over the U.S. tax ($69,190) on total taxable income other than foreign mineral income from country Y, determined without regard to section 613, as follows:

Foreign mineral income from country X	$150,000
Intangible drilling and development costs	16,000
Cost depletion	8,000
Adjusted gross income	126,000
Other deductions	2,250
Personal exemption	750
Taxable income	123,000
U.S. tax ($53,090 plus 70% of $23,000)	69,190

(i) Under paragraph (a)(2)(i) of this section, the amount of income tax paid to country Y for 1972 with respect to foreign mineral income from sources within such country is $25,200. This is the amount determined under both *(a)* and *(b)* of paragraph (a)(2)(i) of this section, since, in this case, there is no income from sources within country Y other than foreign mineral income, and there are no deductions allowed under the law of country Y which are not allocable to such foreign mineral income.

(j) Pursuant to paragraph (a)(1) of this section, the foreign income tax with respect to foreign mineral income from sources within country Y which is allowable as a credit against the U.S. tax for 1972 is not reduced from $25,200, as follows:

Foreign income tax paid to country Y on foreign mineral income	....	$25,200
Less reduction under sec. 901(e):		
Smaller of $25,200 (tax paid to country Y on foreign mineral income) or $58,800 (U.S. tax on foreign mineral income from sources within country Y, as determined under paragraph (h) of this example)	$25,200	
Less: U.S. tax on foreign mineral income from sources within country Y, as determined under paragraph (g) of this example	48,280	
Foreign income tax of country Y allowable as a credit	....	25,200

(k) After taking this section into account, B is allowed a foreign tax credit for 1972 of $94,960 ($69,760+$25,200), but not to exceed the overall limitation under section 904 (a)(2) of $99,990 ($99,990×$167,750/$167,750). There would be no foreign income tax carried back to 1970 under section 904(d) since the allowable credit of $94,960 does not exceed the limitation of $99,990.

Example 7. (a) P, a domestic corporation using the calendar year as the taxable year, is an operator mining for iron ore in foreign country X. For 1971, P's gross income under chapter 1 of the Code is $100,000, all of which is foreign mineral income from a property in country X and is subject to the allowance for depletion. For 1971, cost depletion amounts to $5,000 for purposes of the tax of both countries, and only cost depletion is allowed as a deduction under the law of country X. It is assumed that deductions (other than for depletion) attributable to the mineral property in country X amount to $8,000, and these deductions are allowable under the law of both countries. Based upon the facts assumed, the income tax paid to country X on such foreign mineral income is $39,150, and the U.S. tax on such income before allowance of the foreign tax credit is $37,440 determined as follows:

	U.S. tax	X tax
Foreign mineral income	$100,000	$100,000
Less:		
Percentage depletion (14% of $100,000, but not to exceed 50% of $92,000)	14,000	....
Cost depletion	....	5,000
Other deductions	8,000	8,000
Taxable income	78,000	87,000
Income tax rate	48%	45%
Tax	37,440	39,150

(b) Without taking this section into account, P would be allowed a foreign tax credit for 1971 of $37,440 ($37,440×$78,000/ $78,000), and foreign income tax in the amount of $1,710 ($39,150 less $37,440) would first be carried back to 1969 under section 904(d).

(c) Pursuant to paragraph (a)(1) of this section, however, the foreign income tax allowable as a credit against the U.S. tax is reduced to $37,440, determined as follows:

Foreign income tax paid on foreign mineral income		$39,150
Less reduction under sec. 901(e):		
Smaller of $39,150 (tax paid to country X on foreign mineral income) or $41,760 (U.S. tax on foreign mineral income of $87,000 ($87,000×48%), determined by deducting cost depletion of $5,000 in lieu of percentage depletion of $14,000)	$39,150	
Less: U.S. tax on foreign mineral income (before credit)	37,440	1,710
Foreign income tax allowable as a credit		37,440

(d) After taking this section into account, P is allowed a foreign tax credit for 1971 of $37,440 ($37,440×$78,000/$78,000), but no foreign income tax is carried back to 1969 under section 904(d) since the allowable credit of $37,440 does not exceed the limitation of $37,440.

Example 8. (a) The facts are the same as in example 7, except that P is assumed to have received dividends for 1971 of $25,000 from R, a foreign corporation incorporated in country X which is not a less developed country corporation within the meaning of section 902(d). Income tax of $2,500 ($25,000×10%) on such dividends is withheld at the source in country X. It is assumed that P is deemed under section 902(a)(1) and § 1.902–1(h) to have paid income tax of $22,500 to country X in respect of such dividends and that under paragraphs (a)(2)(i) and (b)(2)(i) of this section such dividends are deemed to be attributable to foreign mineral income from sources in country X and that such tax is deemed to be paid with respect to such foreign mineral income. Based upon the facts assumed, the U.S. tax on the foreign mineral income from sources in country X is $60,240 before allowance of the foreign tax credit, determined as follows:

Foreign mineral income from country X:		
Income from mining property	$100,000	
Dividends from R	25,000	
Sec. 78 dividend	22,500	$147,500
Less:		
Percentage depletion (14% of $100,000, but not to exceed 50% of $92,000)		$14,000
Other deductions		8,000
Taxable income		125,500

Income tax rate	48%
U.S. tax	60,240

(b) Without taking this section into account, P would be allowed a foreign tax credit for 1971 of $60,240 ($60,240×$125,500/$125,500), and foreign income tax in the amount of $3,910 ([$39,150+$22,500+$2,500] less $60,240) would first be carried back to 1969 under section 904(d).

(c) Pursuant to paragraph (a)(1) of this section, however, the foreign income tax allowable as a credit against the U.S. tax is reduced from $64,150 to $60,240, determined as follows:

Foreign income tax paid, and deemed to be paid, to country X on foreign mineral income ($39,150+$22,500+$2,500)		$64,150
Less reduction under sec. 901(e):		
Smaller of $64,150 (tax paid and deemed paid to country X on foreign mineral income) or $64,560 (U.S. tax on foreign mineral income of $134,500 ($134,500×48%), determined by deducting cost depletion of $5,000 in lieu of percentage depletion of $14,000)	$64,150	
Less: U.S. tax on foreign mineral income (before credit)	$60,240	$3,910
Foreign income tax allowable as a credit		60,240

(d) After taking this section into account, P is allowed a foreign tax credit for 1971 of $60,240 ($60,240×$125,500/$125,500), but no foreign income tax is carried back to 1969 under section 904(d) since the allowable credit of $60,240 does not exceed the limitation of $60,240.

[T.D. 7294, 38 FR 33074, Nov. 30, 1973, as amended by T.D. 7481, 42 FR 20130, Apr. 18, 1977]

§ 1.902–0 Outline of regulations provisions for section 902.

This section lists the provisions under section 902.

§ 1.902–1 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.

(a) Definitions and special effective date.

(1) Domestic shareholder.

(2) First-tier corporation.

(3) Second-tier corporation.

(4) Third-tier corporation.

(5) Example.

(6) Upper- and lower-tier corporations.

(7) Foreign income taxes.

(8) Post-1986 foreign income taxes.

(i) In general.

(ii) Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986.

(iii) Foreign income taxes paid or accrued with respect to high withholding tax interest.

(9) Post-1986 undistributed earnings.

(i) In general.

(ii) Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986.

(iii) Reduction for foreign income taxes paid or accrued.

(iv) Special allocations.

(10) Pre-1987 accumulated profits.

(i) Definition.

(ii) Computation of pre-1987 accumulated profits.

(iii) Foreign income taxes attributable to pre-1987 accumulated profits.

(11) Dividend.

(12) Dividend received.

(13) Special effective date.

(i) Rule.

(ii) Example.

(b) Computation of foreign income taxes deemed paid by a domestic shareholder, first-tier corporation, and second-tier corporation.

(1) General rule.

(2) Allocation rule for dividends attributable to post-1986 undistributed earnings and pre-1987 accumulated profits.

(i) Portion of dividend out of post-1986 undistributed earnings.

(ii) Portion of dividend out of pre-1987 accumulated profits.

(3) Dividends paid out of pre-1987 accumulated profits.

(4) Deficits in accumulated earnings and profits.

(5) Examples.

(c) Special rules.

(1) Separate computations required for dividends from each first-tier and lower-tier corporation.

(i) Rule.

(ii) Example.

(2) Section 78 gross-up.

(i) Foreign income taxes deemed paid by a domestic shareholder.

(ii) Foreign income taxes deemed paid by an upper-tier corporation.

(iii) Example.

(3) Creditable foreign income taxes.

(4) Foreign mineral income.

(5) Foreign taxes paid or accrued in connection with the purchase or sale of certain oil and gas.

(6) Foreign oil and gas extraction income.

(7) United States shareholders of controlled foreign corporations.

(8) Credit for foreign taxes deemed paid in a section 304 transaction.

(9) Effect of section 482 adjustments on post-1986 foreign income taxes and post-1986 undistributed earnings.
(d) Dividends from controlled foreign corporations.
(1) General rule.
(2) Look-through.
(i) Dividends.
(ii) Coordination with section 960.
(3) Dividends distributed out of earnings accumulated before a controlled foreign corporation became a controlled foreign corporation.
(i) General rule.
(ii) Dividend distributions out of earnings and profits for a year during which a shareholder that is currently a more-than-90-percent United States shareholder of a controlled foreign corporation was not a United States shareholder of the controlled foreign corporation.
(e) Information to be furnished.
(f) Examples.
(g) Effective date.

§ 1.902–2 Treatment of deficits in post-1986 undistributed earnings and pre-1987 accumulated profits of a first-, second-, or third-tier corporation for purposes of computing an amount of foreign taxes deemed paid § 1.902–1.

(a) Carryback of deficits in post-1986 undistributed earnings of a first-, second-, or third-tier corporation to pre-effective date taxable years.
(1) Rule.
(2) Examples.
(b) Carryforward of deficits in pre-1987 accumulated profits of a first-, second-, or third-tier corporation to post-1986 undistributed earnings for purposes of section 902.
(1) General rule.
(2) Effect of pre-effective date deficit.
(3) Examples.

§ 1.902–3 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid with respect to accumulated profits of taxable years of the foreign corporation beginning before January 1, 1987.

(a) Definitions.
(1) Domestic shareholder.
(2) First-tier corporation.
(3) Second-tier corporation.
(4) Third-tier corporation.
(5) Foreign income taxes.
(6) Dividend.
(7) Dividend received.
(b) Domestic shareholder owning stock in a first-tier corporation.
(1) In general.
(2) Amount of foreign taxes deemed paid by a domestic shareholder.
(c) First-tier corporation owning stock in a second-tier corporation.
(1) In general.
(2) Amount of foreign taxes deemed paid by a first-tier corporation.
(d) Second-tier corporation owning stock in a third-tier corporation.
(1) In general.
(2) Amount of foreign taxes deemed paid by a second-tier corporation.
(e) Determination of accumulated profits of a foreign corporation.
(f) Taxes paid on or with respect to accumulated profits of a foreign corporation.
(g) Determination of earnings and profits of a foreign corporation.
(1) Taxable year to which section 963 does not apply.
(2) Taxable year to which section 963 applies.
(3) Time and manner of making choice.
(4) Determination by district director.
(h) Source of income from first-tier corporation and country to which tax is deemed paid.
(1) Source of income.
(2) Country to which taxes deemed paid.
(i) United Kingdom income taxes paid with respect to royalties.
(j) Information to be furnished.
(k) Illustrations.
(l) Effective date.

§ 1.902–4 Rules for distributions attributable to accumulated profits for taxable years in which a first-tier corporation was a less developed country corporation.

(a) In general.
(b) Combined distributions.
(c) Distributions of a first-tier corporation attributable to certain distributions from second- or third-tier corporations.
(d) Illustrations.

[T.D. 8708, 62 FR 927, Jan. 7, 1997]

§ 1.902–1 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.

(a) *Definitions and special effective date.* For purposes of section 902, this section, and § 1.902–2, the definitions provided in paragraphs (a) (1) through (12) of this section and the special effective date of paragraph (a)(13) of this section apply.

(1) *Domestic shareholder.* In the case of dividends received by a domestic corporation from a foreign corporation after December 31, 1986, the term domestic shareholder means a domestic corporation, other than an S corporation as defined in section 1361(a), that owns at least 10 percent of the voting stock of the foreign corporation at the time the domestic corporation receives

a dividend from that foreign corporation.

(2) *First-tier corporation.* In the case of dividends received by a domestic shareholder from a foreign corporation in a taxable year beginning after December 31, 1986, the term first-tier corporation means a foreign corporation, at least 10 percent of the voting stock of which is owned by a domestic shareholder at the time the domestic shareholder receives a dividend from that foreign corporation. The term first-tier corporation also includes a DISC or former DISC, but only with respect to dividends from the DISC or former DISC that are treated under sections 861(a)(2)(D) and 862(a)(2) as income from sources without the United States.

(3) *Second-tier corporation.* In the case of dividends paid to a first-tier corporation by a foreign corporation in a taxable year beginning after December 31, 1986, the foreign corporation is a second-tier corporation if, at the time a first-tier corporation receives a dividend from that foreign corporation, the first-tier corporation owns at least 10 percent of the foreign corporation's voting stock and the product of the following equals at least 5 percent—

(i) The percentage of voting stock owned by the domestic shareholder in the first-tier corporation; multiplied by

(ii) The percentage of voting stock owned by the first-tier corporation in the second-tier corporation.

(4) *Third-tier corporation.* In the case of dividends paid to a second-tier corporation by a foreign corporation in a taxable year beginning after December 31, 1986, a foreign corporation is a third-tier corporation if, at the time a second-tier corporation receives a dividend from that foreign corporation, the second-tier corporation owns at least 10 percent of the foreign corporation's voting stock and the product of the following equals at least 5 percent—

(i) The percentage of voting stock owned by the domestic shareholder in the first-tier corporation; multiplied by

(ii) The percentage of voting stock owned by the first-tier corporation in the second-tier corporation; multiplied by

(iii) The percentage of voting stock owned by the second-tier corporation in the third-tier corporation.

(5) *Example.* The following example illustrates the ownership requirements of paragraphs (a) (1) through (4) of this section:

Example. (i) Domestic corporation M owns 30 percent of the voting stock of foreign corporation A on January 1, 1991, and for all periods thereafter. Corporation A owns 40 percent of the voting stock of foreign corporation B on January 1, 1991, and continues to own that stock until June 1, 1991, when Corporation A sells its stock in Corporation B. Both Corporation A and Corporation B use the calendar year as the taxable year. Corporation B pays a dividend out of its post-1986 undistributed earnings to Corporation A, which Corporation A receives on February 16, 1991. Corporation A pays a dividend out of its post-1986 undistributed earnings to Corporation M, which Corporation M receives on January 20, 1992. Corporation M uses a fiscal year ending on June 30 as the taxable year.

(ii) On February 16, 1991, when Corporation B pays a dividend to Corporation A, Corporation M satisfies the 10 percent stock ownership requirement of paragraphs (a) (1) and (2) of this section with respect to Corporation A. Therefore, Corporation A is a first-tier corporation within the meaning of paragraph (a)(2) of this section and Corporation M is a domestic shareholder of Corporation A within the meaning of paragraph (a)(1) of this section. Also on February 16, 1991, Corporation B is a second-tier corporation within the meaning of paragraph (a)(3) of this section because Corporation A owns at least 10 percent of its voting stock, and the percentage of voting stock owned by Corporation M in Corporation A on February 16, 1991 (30 percent) multiplied by the percentage of voting stock owned by Corporation A in Corporation B on February 16, 1991 (40 percent) equals 12 percent. Corporation A shall be deemed to have paid foreign income taxes of Corporation B with respect to the dividend received from Corporation B on February 16, 1991.

(iii) On January 20, 1992, Corporation M satisfies the 10-percent stock ownership requirement of paragraphs (a)(1) and (2) of this section with respect to Corporation A. Therefore, Corporation A is a first-tier corporation within the meaning of paragraph (a)(2) of this section and Corporation M is a domestic shareholder within the meaning of paragraph (a)(1) of this section. Accordingly, for its taxable year ending on June 30, 1992, Corporation M is deemed to have paid a portion of the post-1986 foreign income taxes paid, accrued, or deemed to be paid, by Corporation A. Those taxes will include taxes paid by Corporation B that were deemed paid by Corporation A with respect to the dividend paid by Corporation B to Corporation A on February 16, 1991, even though Corporation B is no longer a second-tier corporation with respect to Corporations A and M on January 20, 1992, and has not been a second-tier corporation with respect to Corporations A and M at any time during the taxable years of Corporations A and M that include January 20, 1992.

(6) *Upper- and lower-tier corporations.* In the case of a third-tier corporation, the term upper-tier corporation means a first- or second-tier corporation. In the case of a second-tier corporation, the term upper-tier corporation means a first-tier corporation. In the case of a first-tier corporation, the term lower-tier corporation means a second- or third-tier corporation. In the case of a second-tier corporation, the term lower-tier corporation means a third-tier corporation.

(7) *Foreign income taxes.* The term foreign income taxes means income, war profits, and excess profits taxes as defined in §1.901–2(a), and taxes included in the term income, war profits, and excess profits taxes by reason of section 903, that are imposed by a foreign country or a possession of the United States, including any such taxes deemed paid by a foreign corporation under this section. Foreign income, war profits, and excess profits taxes shall not include amounts excluded from the definition of those taxes pursuant to section 901 and the regulations under that section. See also paragraphs (c)(4) and (5) of this section (concerning foreign taxes paid with respect to foreign mineral income and in connection with the purchase or sale of oil and gas).

(8) *Post-1986 foreign income taxes*—(i) *In general.* Except as provided in paragraphs (a)(10) and (13) of this section, the term post-1986 foreign income taxes of a foreign corporation means the sum of the foreign income taxes paid, accrued, or deemed paid in the taxable year of the foreign corporation in which it distributes a dividend plus the foreign income taxes paid, accrued, or deemed paid in the foreign corporation's prior taxable years beginning after December 31, 1986, to the extent the foreign taxes were not paid or deemed paid by the foreign corporation on or with respect to earnings that in prior taxable years were distributed to, or otherwise included (e.g., under sections 304, 367(b), 551, 951(a), 1248 or 1293) in the income of, a foreign or domestic shareholder. Except as provided in paragraph (b)(4) of this section, foreign taxes paid or deemed paid by the foreign corporation on or with respect to earnings that were distributed or otherwise removed from post-1986 undistributed earnings in prior post-1986 taxable years shall be removed from post-1986 foreign income taxes regardless of whether the shareholder is eligible to compute an amount of foreign taxes deemed paid under section 902, and regardless of whether the shareholder in fact chose to credit foreign income taxes under section 901 for the year of the distribution or inclusion. Thus, if an amount is distributed or deemed distributed by a foreign corporation to a United States person that is not a domestic shareholder within the meaning of paragraph (a)(1) of this section (e.g., an individual or a corporation that owns less than 10% of the foreign corporation's voting stock), or to a foreign person that does not meet the definition of a first- or second-tier corporation under paragraph (a)(2) or (3) of this section, then although no foreign income taxes shall be deemed paid under section 902, foreign income taxes attributable to the distribution or deemed distribution that would have been deemed paid had the shareholder met the ownership requirements of paragraphs (a)(1) through (4) of this section shall be removed from post-1986 foreign income taxes. Further, if a domestic shareholder chooses to deduct foreign taxes paid or accrued for the taxable year of the distribution or inclusion, it shall nonetheless be deemed to have paid a proportionate share of the foreign corporation's post-1986 foreign income taxes under section 902(a), and the foreign taxes deemed paid must be removed from post-1986 foreign income taxes. In the case of a foreign corporation the foreign income taxes of which are determined based on an accounting period of less than one year, the term year means that accounting period. See sections 441(b)(3) and 443.

(ii) *Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986.* Post-1986 foreign income taxes shall include foreign income taxes that are deemed paid by an upper-tier corporation with respect to distributions from a lower-tier corporation out of nonpreviously taxed pre-1987 accumulated profits, as defined in paragraph (a)(10) of this section, that are received by an upper-tier corporation in any taxable year of the upper-tier corporation beginning after December 31, 1986, provided the upper-tier corporation's earnings and profits in that year are included in its post-1986 undistributed earnings under paragraph (a)(9) of this section. Foreign income taxes deemed paid with respect to a distribution of pre-1987 accumulated profits shall be translated from the functional currency of the lower-tier corporation into dollars at the spot exchange rate in effect on the date of the distribution. To determine the character of the earnings and profits and associated taxes for foreign tax credit limitation purposes, see section 904 and § 1.904–7(a).

(iii) *Foreign income taxes paid or accrued with respect to high withholding tax interest.* Post-1986 foreign income taxes shall not include foreign income taxes paid or accrued by a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E)(i)) with respect to high withholding tax interest (as defined in section 904(d)(2)(B)) to the extent the foreign tax rate imposed on such interest exceeds 5 percent. See section 904(d)(2)(E)(ii) and § 1.904–4(g)(2)(iii). The reduction in foreign income taxes paid or accrued by the amount of tax in excess of 5 percent imposed on high withholding tax interest income must be computed in functional currency before foreign income taxes are translated into U.S. dollars and included in post-1986 foreign income taxes.

(9) *Post-1986 undistributed earnings*—(i) *In general.* Except as provided in paragraphs (a) (10) and (13) of this section, the term post-1986 undistributed earnings means the amount of the earnings and profits of a foreign corporation (computed in accordance with sections 964(a) and 986) accumulated in taxable years of the foreign corporation beginning after December 31, 1986, determined as of the close of the taxable year of the foreign corporation in which it distributes a dividend. Post-1986 undistributed earnings shall not be reduced by reason of any earnings distributed or otherwise included in income, for example under section 304, 367(b), 551, 951(a), 1248 or 1293, during the taxable year. Post-1986 undistributed earnings shall be reduced to account for distributions or deemed distributions that reduced earnings and profits and inclusions that resulted in previously-taxed amounts described in section 959(c) (1) and (2) or section 1293(c) in prior taxable years beginning after December 31, 1986. Thus, post-1986 undistributed earnings shall not be reduced to the extent of the ratable share of a controlled foreign corporation's subpart F income, as defined in section 952, attributable to a shareholder that is not a United States shareholder within the meaning of section 951(b) or section 953(c)(1)(A), because that amount has not been included in a shareholder's gross income. Post-1986 undistributed earnings shall be reduced as provided herein regardless of whether any shareholder is deemed to have paid any foreign taxes, and regardless of whether any domestic shareholder chose to claim a foreign tax credit under section 901(a) for the year of the distribution. For rules on carrybacks and carryforwards of deficits and their effect on post-1986 undistributed earnings, see § 1.902–2. In the case of a foreign corporation the foreign income taxes of which are computed based on an accounting period of less than one year, the term year means that accounting period. See sections 441(b)(3) and 443.

(ii) *Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986.* Distributions by a lower-tier corporation out of non-previously taxed pre-1987 accumulated profits, as defined in paragraph (a)(10) of this section, that are received by an upper-tier corporation in any taxable year of the upper-tier corporation beginning after December 31, 1986, shall be treated as post-1986 undistributed earnings of the upper-tier corporation, provided the upper-tier corporation's earnings and profits for that year are included in its post-1986 undistributed earnings under paragraph (a)(9)(i) of this section. To determine the character of the earnings and profits and associated taxes for foreign tax credit limitation purposes, see section 904 and §1.904–7(a).

(iii) *Reduction for foreign income taxes paid or accrued.* In computing post-1986 undistributed earnings, earnings and profits shall be reduced by foreign income taxes paid or accrued regardless of whether the taxes are creditable. Thus, earnings and profits shall be reduced by foreign income taxes paid with respect to high withholding tax interest even though a portion of the taxes is not creditable pursuant to section 904(d)(2)(E)(ii) and is not included in post-1986 foreign income taxes under paragraph (a)(8)(iii) of this section. Earnings and profits of an upper-tier corporation, however, shall not be reduced by foreign income taxes paid by a lower-tier corporation and deemed to have been paid by the upper-tier corporation.

(iv) *Special allocations.* The term post-1986 undistributed earnings means the total amount of the earnings of the corporation determined at the corporate level. Special allocations of earnings and taxes to particular shareholders, whether required or permitted by foreign law or a shareholder agreement, shall be disregarded. If, however, the Commissioner establishes that there is an agreement to pay dividends only out of earnings in the separate categories for passive or high withholding tax interest income, then only taxes imposed on passive or high withholding tax interest earnings shall be treated as related to the dividend. See §1.904–6(a)(2).

(10) *Pre-1987 accumulated profits*—(i) *Definition.* The term pre-1987 accumulated profits means the amount of the earnings and profits of a foreign corporation computed in accordance with section 902 and attributable to its taxable years beginning before January 1, 1987. If the special effective date of paragraph (a)(13) of this section applies, pre-1987 accumulated profits also includes any earnings and profits (computed in accordance with sections 964(a) and 986) attributable to the foreign corporation's taxable years beginning after December 31, 1986, but before the first day of the first taxable year of the foreign corporation in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a) (1) through (4) of this section are met with respect to that corporation.

(ii) *Computation of pre-1987 accumulated profits.* Pre-1987 accumulated profits must be computed under United States principles governing the computation of earnings and profits. Pre-1987 accumulated profits are determined at the corporate level. Special allocations of accumulated profits and taxes to particular shareholders with respect to distributions of pre-1987 accumulated profits in taxable years beginning after December 31, 1986, whether required or permitted by foreign law or a shareholder agreement, shall be disregarded. Pre-1987 accumulated profits of a particular year shall be reduced by amounts distributed from those accumulated profits or otherwise included in income from those accumulated profits, for example under sections 304, 367(b), 551, 951(a), 1248 or 1293. If a deficit in post-1986 undistributed earnings is carried back to offset pre-1987 accumulated profits, pre-1987 accumulated profits of a particular taxable year shall be reduced by the amount of the deficit carried back to that year. See §1.902–2. The amount of a distribution out of pre-1987 accumulated profits, and the amount of foreign income taxes deemed paid under section 902, shall be determined and translated into United States dollars by applying the law as in effect prior to the effective date of the Tax Reform Act of 1986. See §§1.902–3, 1.902–4 and 1.964–1.

(iii) *Foreign income taxes attributable to pre-1987 accumulated profits.* The term pre-1987 foreign income taxes means any foreign income taxes paid, accrued, or deemed paid by a foreign corporation on or with respect to its pre-1987 accumulated profits. Pre-1987 foreign income taxes of a particular year shall be reduced by the amount of taxes paid or deemed paid by the foreign corporation on or with respect to amounts distributed or otherwise included in income from pre-1987 accumulated profits of that year. Thus, pre-1987 foreign income taxes shall be reduced by the amount of taxes deemed paid by a domestic shareholder (regardless of whether the shareholder chose to credit foreign income taxes under section 901 for the year of the distribution or inclusion) or a first-tier or second-tier corporation, and by the amount of taxes that would have been deemed paid had any other shareholder been eligible to compute an amount of foreign taxes deemed paid under section 902. Foreign income taxes deemed paid with respect to a distribution of pre-1987 accumulated profits shall be translated from the functional currency of the distributing corporation into United States dollars at the spot exchange rate in effect on the date of the distribution.

(11) *Dividend.* For purposes of section 902, the definition of the term dividend in section 316 and the regulations under that section applies. Thus, for example, distributions and deemed distributions under sections 302, 304, 305(b) and 367(b) that are treated as dividends within the meaning of section 301(c)(1) also are dividends for purposes of section 902. In addition, the term dividend includes deemed dividends under sections 551 and 1248, but not deemed inclusions under sections 951(a) and 1293. For rules concerning excess distributions from section 1291 funds that are treated as dividends solely for foreign tax credit purposes, (see Regulation Project INTL–656–87 published in 1992–1 C.B. 1124; see § 601.601(d)(2)(ii)(*b*) of this chapter).

(12) *Dividend received.* A dividend shall be considered received for purposes of section 902 when the cash or other property is unqualifiedly made subject to the demands of the distributee. See § 1.301–1(b). A dividend also is considered received for purposes of section 902 when it is deemed received under section 304, 367(b), 551, or 1248.

(13) *Special effective date*—(i) *Rule.* If the first day on which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met with respect to a foreign corporation, without regard to whether a dividend is distributed, is in a taxable year of the foreign corporation beginning after December 31, 1986, then—

(A) The post-1986 undistributed earnings and post-1986 foreign income taxes of the foreign corporation shall be determined by taking into account only taxable years beginning on and after the first day of the first taxable year of the foreign corporation in which the ownership requirements are met, including subsequent taxable years in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are not met; and

(B) Earnings and profits accumulated prior to the first day of the first taxable year of the foreign corporation in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met shall be considered pre-1987 accumulated profits.

(ii) *Example.* The following example illustrates the special effective date rules of this paragraph (a)(13):

Example. As of December 31, 1991, and since its incorporation, foreign corporation A has owned 100 percent of the stock of foreign corporation B. Corporation B is not a controlled foreign corporation. Corporation B uses the calendar year as its taxable year, and its functional currency is the u. Assume 1u equals $1 at all relevant times. On April 1, 1992, Corporation B pays a 200u dividend to Corporation A and the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are not met at that time. On July 1, 1992, domestic corporation M purchases 10 percent of the Corporation B stock from Corporation A and, for the first time, Corporation B meets the ownership requirements of section 902(c)(3)(B) and paragraph (a)(2) of this section. Corporation M uses the calendar year as its taxable year. Corporation B does not distribute any dividends to Corporation M during 1992. For its taxable year ending December 31, 1992, Corporation B has 500u of earnings and profits (after foreign taxes but before taking into account the 200u distribution to Corporation A) and pays 100u of foreign income taxes that is equal to $100. Pursuant to paragraph (a)(13)(i) of this section, Corporation B's post-1986 undistributed earnings and post-

1986 foreign income taxes will include earnings and profits and foreign income taxes attributable to Corporation B's entire 1992 taxable year and all taxable years thereafter. Thus, the April 1, 1992, dividend to Corporation A will reduce post-1986 undistributed earnings to 300u (500u–200u) under paragraph (a)(9)(i) of this section. The foreign income taxes attributable to the amount distributed as a dividend to Corporation A will not be creditable because Corporation A is not a domestic shareholder. Post-1986 foreign income taxes, however, will be reduced by the amount of foreign taxes attributable to the dividend. Thus, as of the beginning of 1993, Corporation B has $60 ($100–[$100×40% (200u/500u)]) of post-1986 foreign income taxes. See paragraphs (a)(8)(i) and (b)(1) of this section.

(b) *Computation of foreign income taxes deemed paid by a domestic shareholder, first-tier corporation, and second-tier corporation*—(1) *General rule.* If a foreign corporation pays a dividend in any taxable year out of post-1986 undistributed earnings to a shareholder that is a domestic shareholder or an upper-tier corporation at the time it receives the dividend, the recipient shall be deemed to have paid the same proportion of any post-1986 foreign income taxes paid, accrued or deemed paid by the distributing corporation on or with respect to post-1986 undistributed earnings which the amount of the dividend out of post-1986 undistributed earnings (determined without regard to the gross-up under section 78) bears to the amount of the distributing corporation's post-1986 undistributed earnings. An upper-tier corporation shall not be entitled to compute an amount of foreign taxes deemed paid on a dividend from a lower-tier corporation, however, unless the ownership requirements of paragraphs (a) (1) through (4) of this section are met at each tier at the time the upper-tier corporation receives the dividend. Foreign income taxes deemed paid by a domestic shareholder or an upper-tier corporation must be computed under the following formula:

$$\begin{array}{c}\text{Foreign income taxes}\\ \text{deemed paid by}\\ \text{domestic shareholder}\\ \text{(or upper-tier corporation)}\end{array} = \begin{array}{c}\text{Post-1986 foreign in-}\\ \text{come taxes of first-tier}\\ \text{corporation (or lower-}\\ \text{tier corporation)}\end{array} \times \frac{\begin{array}{c}\text{Dividend paid to domestic}\\ \text{shareholder (or upper-tier cor-}\\ \text{poration) by first-tier corpora-}\\ \text{tion (or lower-tier corporation)}\end{array}}{\begin{array}{c}\text{Post-1986 undistributed}\\ \text{earnings of first-tier corpora-}\\ \text{tion (or lower-tier corporation)}\end{array}}$$

(2) *Allocation rule for dividends attributable to post-1986 undistributed earnings and pre-1987 accumulated profits*—(i) *Portion of dividend out of post-1986 undistributed earnings.* Dividends will be deemed to be paid first out of post-1986 undistributed earnings to the extent thereof. If dividends exceed post-1986 undistributed earnings and dividends are paid to more than one shareholder, then the dividend to each shareholder shall be deemed to be paid pro rata out of post-1986 undistributed earnings, computed as follows:

$$\begin{array}{c}\text{Portion of Dividend to a Share-}\\ \text{holder Attributable to Post-1986}\\ \text{Undistributed Earnings}\end{array} = \begin{array}{c}\text{Post-1986 Un-}\\ \text{distributed Earnings}\end{array} \times \frac{\text{Dividends to Shareholder}}{\begin{array}{c}\text{Total Dividends Paid}\\ \text{To all Shareholders}\end{array}}$$

(ii) *Portion of dividend out of pre-1987 accumulated profits.* After the portion of the dividend attributable to post-1986 undistributed earnings is determined under paragraph (b)(2)(i) of this section, the remainder of the dividend received by a shareholder is attributable to pre-1987 accumulated profits to the extent thereof. That part of the dividend attributable to pre-1987 accumulated profits will be treated as paid first from the most recently accumulated earnings and profits. See § 1.902–3. If dividends paid out of pre-1987 accumulated profits are attributable to more than one pre-1987 taxable year and are paid to more than one shareholder, then the dividend to each shareholder attributable to earnings and profits accumulated in a particular pre-1987 taxable year shall be deemed to be paid pro rata out of accumulated profits of that taxable year, computed as follows:

$$\begin{array}{c}\text{Portion of Dividend to a}\\ \text{Shareholder Attributable}\\ \text{to Accumulated Profits}\\ \text{of a Particular Pre-1987}\\ \text{Taxable Year}\end{array} = \begin{array}{c}\text{Dividend Paid Out of Pre-}\\ \text{1987 Accumulated Profits}\\ \text{with Respect to the}\\ \text{Particular Pre-1987}\\ \text{Taxable Year}\end{array} \times \frac{\text{Dividends to Shareholder}}{\begin{array}{c}\text{Total Dividends Paid}\\ \text{To all Shareholders}\end{array}}$$

(3) *Dividends paid out of pre-1987 accumulated profits.* If dividends are paid by a first-tier corporation or a lower-tier corporation out of pre-1987 accumulated profits, the domestic shareholder or upper-tier corporation that receives the dividends shall be deemed to have paid foreign income taxes to the extent provided under section 902 and the regulations thereunder as in effect prior to the effective date of the Tax Reform Act of 1986. See paragraphs (a) (10) and (13) of this section and §§ 1.902–3 and 1.902–4.

(4) *Deficits in accumulated earnings and profits.* No foreign income taxes shall be deemed paid with respect to a distribution from a foreign corporation out of current earnings and profits that is treated as a dividend under section 316(a)(2), and post-1986 foreign income taxes shall not be reduced, if as of the end of the taxable year in which the dividend is paid or accrued, the corporation has zero or a deficit in post-1986 undistributed earnings and the sum of current plus accumulated earnings and profits is zero or less than zero. The dividend shall reduce post-1986 undistributed earnings and accumulated earnings and profits.

(5) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. Domestic corporation M owns 100 percent of foreign corporation A. Both Corporation M and Corporation A use the calendar year as the taxable year, and Corporation A uses the u as its functional currency. Assume that 1u equals $1 at all relevant times. All of Corporation A's pre-1987 accumulated profits and post-1986 undistributed earnings are non-subpart F general limitation earnings and profits under section 904(d)(1)(I). As of December 31, 1992, Corporation A has 100u of post-1986 undistributed earnings and $40 of post-1986 foreign income taxes. For its 1986 taxable year, Corporation A has accumulated profits of 200u (net of foreign taxes) and paid 60u of foreign income taxes on those earnings. In 1992, Corporation A distributes 150u to Corporation M. Corporation A has 100u of post-1986 undistributed earnings and the dividend, therefore, is treated as paid out of post-1986 undistributed earnings to the extent of 100u. The first 100u distribution is from post-1986 undistributed earnings, and, because the distribution exhausts those earnings, Corporation M is deemed to have paid the entire amount of post-1986 foreign income taxes of Corporation A ($40). The remaining 50u dividend is treated as a dividend out of 1986 accumulated profits under paragraph (b)(2) of this section. Corporation M is deemed to have paid $15 (60u×50u/200u, translated at the appropriate exchange rates) of Corporation A's foreign income taxes for 1986. As of January 1, 1993, Corporation A's post-1986 undistributed earnings and post-1986 foreign income taxes are 0. Corporation A has 150u of accumulated profits and 45u of foreign income taxes remaining in 1986.

Example 2. Domestic corporation M (incorporated on January 1, 1987) owns 100 percent of foreign corporation A (incorporated on January 1, 1987). Both Corporation M and Corporation A use the calendar year as the taxable year, and Corporation A uses the u as its functional currency. Assume that 1u equals $1 at all relevant times. Corporation

A has no pre-1987 accumulated profits. All of Corporation A's post-1986 undistributed earnings are non-subpart F general limitation earnings and profits under section 904(d)(1)(I). On January 1, 1992, Corporation A has a deficit in accumulated earnings and profits and a deficit in post-1986 undistributed earnings of (200u). No foreign taxes have been paid with respect to post-1986 undistributed earnings. During 1992, Corporation A earns 100u (net of foreign taxes), pays $40 of foreign taxes on those earnings and distributes 50u to Corporation M. As of the end of 1992, Corporation A has a deficit of (100u) ((200u) post1986 undistributed earnings + 100u current earnings and profits) in post-1986 undistributed earnings. Corporation A, however, has current earnings and profits of 100u. Therefore, the 50u distribution is treated as a dividend in its entirety under section 316(a)(2). Under paragraph (b)(4) of this section, Corporation M is not deemed to have paid any of the foreign taxes paid by Corporation A because post-1986 undistributed earnings and the sum of current plus accumulated earnings and profits are (100u). The dividend reduces both post-1986 undistributed earnings and accumulated earnings and profits. Therefore, as of January 1, 1993, Corporation A's post-1986 undistributed earnings are (150u) and its accumulated earnings and profits are (150u). Corporation A's post-1986 foreign income taxes at the start of 1993 are $40.

(c) *Special rules*—(1) *Separate computations required for dividends from each first-tier and lower-tier corporation*—(i) *Rule.* If in a taxable year dividends are received by a domestic shareholder or an upper-tier corporation from two or more first-tier corporations or two or more lower-tier corporations, the foreign income taxes deemed paid by the domestic shareholder or the upper-tier corporation under sections 902 (a) and (b) and paragraph (b) of this section shall be computed separately with respect to the dividends received from each first-tier corporation or lower-tier corporation. If a domestic shareholder receives dividend distributions from one or more first-tier corporations and in the same taxable year the first-tier corporation receives dividends from one or more lower-tier corporations, then the amount of foreign income taxes deemed paid shall be computed by starting with the lowest-tier corporation and working upward.

(ii) *Example.* The following example illustrates the application of this paragraph (c)(1):

Example. P, a domestic corporation, owns 40 percent of the voting stock of foreign corporation S. S owns 30 percent of the voting stock of foreign corporation T, and 30 percent of the voting stock of foreign corporation U. Neither S, T, nor U is a controlled foreign corporation. P, S, T and U all use the calendar year as their taxable year. In 1993, T and U both pay dividends to S and S pays a dividend to P. To compute foreign taxes deemed paid, paragraph (c)(1) of this section requires P to start with the lowest tier corporations and to compute foreign taxes deemed paid separately for dividends from each first-tier and lower-tier corporation. Thus, S first will compute foreign taxes deemed paid separately on its dividends from T and U. The deemed paid taxes will be added to S's post-1986 foreign income taxes, and the dividends will be added to S's post-1986 undistributed earnings. Next, P will compute foreign taxes deemed paid with respect to the dividend from S. This computation will take into account the taxes paid by T and U and deemed paid by S.

(2) *Section 78 gross-up*—(i) *Foreign income taxes deemed paid by a domestic shareholder.* Except as provided in section 960(b) and the regulations under that section (relating to amounts excluded from gross income under section 959(b)), any foreign income taxes deemed paid by a domestic shareholder in any taxable year under section 902(a) and paragraph (b) of this section shall be included in the gross income of the domestic shareholder for the year as a dividend under section 78. Amounts included in gross income under section 78 shall, for purposes of section 904, be deemed to be derived from sources within the United States to the extent the earnings and profits on which the taxes were paid are treated under section 904(g) as United States source earnings and profits. Section 1.904–5(m)(6). Amounts included in gross income under section 78 shall be treated for purposes of section 904 as income in a separate category to the extent that the foreign income taxes were allocated and apportioned to income in that separate category. See section 904(d)(3)(G) and §1.904–6(b)(3).

(ii) *Foreign income taxes deemed paid by an upper-tier corporation.* Foreign income taxes deemed paid by an upper-tier corporation on a distribution from a lower-tier corporation are not included in the earnings and profits of the upper-tier corporation. For purposes of section 904, foreign income taxes shall be allocated and apportioned to income in a separate category to the extent those taxes were allocated to the earnings and profits of the lower-tier corporation in that separate category. See section 904(d)(3)(G) and § 1.904–6(b)(3). To the extent that section 904(g) treats the earnings of the lower-tier corporation on which those foreign income taxes were paid as United States source earnings and profits, the foreign income taxes deemed paid by the upper-tier corporation on the distribution from the lower-tier corporation shall be treated as attributable to United States source earnings and profits. See section 904(g) and § 1.904–5(m)(6).

(iii) *Example.* The following example illustrates the rules of this paragraph (c)(2):

Example. P, a domestic corporation, owns 100 percent of the voting stock of controlled foreign corporation S. Corporations P and S use the calendar year as their taxable year, and S uses the u as its functional currency. Assume that 1u equals $1 at all relevant times. As of January 1, 1992, S has –0– post-1986 undistributed earnings and –0– post-1986 foreign income taxes. In 1992, S earns 150u of non-subpart F general limitation income net of foreign taxes and pays 60u of foreign income taxes. As of the end of 1992, but before dividend payments, S has 150u of post-1986 undistributed earnings and $60 of post-1986 foreign income taxes. Assume that 50u of S's earnings for 1992 are from United States sources. S pays P a dividend of 75u which P receives in 1992. Under § 1.904–5(m)(4), one-third of the dividend, or 25u (75u×50u/150u), is United States source income to P. P computes foreign taxes deemed paid on the dividend under paragraph (b)(1) of this section of $30 ($60×50%[75u/150u]) and includes that amount in gross income under section 78 as a dividend. Because 25u of the 75u dividend is United States source income to P, $10 ($30×33.33%[25u/75u]) of the section 78 dividend will be treated as United States source income to P under this paragraph (c)(2).

(3) *Creditable foreign income taxes.* The amount of creditable foreign income taxes under section 901 shall include, subject to the limitations and conditions of sections 902 and 904, foreign income taxes actually paid and deemed paid by a domestic shareholder that receives a dividend from a first-tier corporation. Foreign income taxes deemed paid by a domestic shareholder under paragraph (b) of this section shall be deemed paid by the domestic shareholder only for purposes of computing the foreign tax credit allowed under section 901.

(4) *Foreign mineral income.* Certain foreign income, war profits and excess profits taxes paid or accrued with respect to foreign mineral income will not be considered foreign income taxes for purposes of section 902. See section 901(e) and § 1.901–3.

(5) *Foreign taxes paid or accrued in connection with the purchase or sale of certain oil and gas.* Certain income, war profits, or excess profits taxes paid or accrued to a foreign country in connection with the purchase and sale of oil or gas extracted in that country will not be considered foreign income taxes for purposes of section 902. See section 901(f).

(6) *Foreign oil and gas extraction income.* For rules relating to reduction of the amount of foreign income taxes deemed paid with respect to foreign oil and gas extraction income, see section 907(a) and the regulations under that section.

(7) *United States shareholders of controlled foreign corporations.* See paragraph (d) of this section and sections 960 and 962 and the regulations under those sections for special rules relating to the application of section 902 in computing foreign income taxes deemed paid by United States shareholders of controlled foreign corporations.

(8) *Credit for foreign taxes deemed paid in a section 304 transaction.* [Reserved].

(9) *Effect of section 482 adjustments on post-1986 foreign income taxes and post-1986 undistributed earnings.* [Reserved].

(d) *Dividends from controlled foreign corporations*—(1) *General rule.* Except as provided in paragraph (d)(3) of this section, if a dividend is received by a domestic shareholder that is a United States shareholder (as defined in section 951(b) or section 953(c)(1)(A)) from a first-tier corporation that is a controlled foreign corporation (as defined in section 957(a) or section 953(c)(1)(B)), or by an upper-tier corporation from a lower-tier corporation if the corporations are related look-through entities within the meaning of § 1.904–5(i), the following rule applies. If a dividend is paid out of post-1986 undistributed earnings or pre-1987 accumulated profits of the upper- or lower-tier controlled foreign corporation attributable to more than one separate category under section 904(d), the amount of foreign income taxes deemed paid by the domestic shareholder or the upper-tier corporation under section 902 and paragraph (b) of this section shall be computed separately with respect to the post-1986 undistributed earnings or pre-1987 accumulated profits in each separate category out of which the dividend is paid. See §1.904–5(c)(4) and paragraph (d)(2) of this section. The separately computed deemed paid taxes shall be added to other taxes paid by the U.S. shareholder or upper-tier corporation with respect to income in the appropriate separate category.

(2) *Look-through*—(i) *Dividends.* Except as otherwise provided in paragraph (d)(3) of this section, any dividend distribution out of post-1986 undistributed earnings of a look-through entity to a related look-through entity shall be deemed to be paid pro rata out of each separate category of income. See §§1.904–5(c)(4) and 1.904–7. The portion of the foreign income taxes attributable to a particular separate category that shall be deemed paid by the domestic shareholder or upper-tier corporation must be computed under the following formula:

$$\begin{array}{c}\text{Foreign taxes deemed}\\ \text{paid by domestic share-}\\ \text{holder or upper-tier cor-}\\ \text{poration with respect to a}\\ \text{separate category under}\\ \text{section 904(d)}\end{array} = \begin{array}{c}\text{Post-1986 foreign income}\\ \text{taxes of first-tier or lower-}\\ \text{tier corporation allocated}\\ \text{and apportioned to a sepa-}\\ \text{rate category under}\\ \text{section 1.904–6}\end{array} \times \frac{\begin{array}{c}\text{Dividend amount attrib-}\\ \text{utable to a separate}\\ \text{category}\end{array}}{\begin{array}{c}\text{Post-1986 undistributed}\\ \text{earnings of first-tier or}\\ \text{lower-tier corporation at-}\\ \text{tributable to the separate}\\ \text{category}\end{array}}$$

(ii) *Coordination with section 960.* For rules coordinating the computation of foreign taxes deemed paid with respect to amounts included in gross income under section 951(a) and dividends distributed by a controlled foreign corporation, see section 960 and the regulations under that section.

(3) *Dividends distributed out of earnings accumulated before a controlled foreign corporation became a controlled foreign corporation*—(i) *General rule.* Any dividend distributed by a controlled foreign corporation out of earnings accumulated before the controlled foreign corporation became a controlled foreign corporation shall be treated as a dividend from a noncontrolled section 902 corporation regardless of whether the earnings were accumulated in a taxable year beginning before January 1, 1987, or after December 31, 1986.

(ii) *Dividend distributions out of earnings and profits for a year during which a shareholder that is currently a more-than-90-percent United States shareholder of a controlled foreign corporation was not a United States shareholder of the controlled foreign corporation.* [Reserved]

(e) *Information to be furnished.* If the credit for foreign income taxes claimed under section 901 includes foreign income taxes deemed paid under section 902 and paragraph (b) of this section, the domestic shareholder must furnish the same information with respect to the foreign income taxes deemed paid as it is required to furnish with respect to the foreign income taxes it directly paid or accrued and for which the credit is claimed. See §1.905–2. For other information required to be furnished by the domestic shareholder for the annual accounting period of certain foreign corporations ending with or within the shareholder's taxable year, and for reduction in the amount of foreign income taxes paid, accrued, or deemed paid for failure to furnish the required information, see section 6038 and the regulations under that section.

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

Example 1. Since 1987, domestic corporation M has owned 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Z, a foreign corporation. Corporation A is not a controlled foreign corporation. Corporation A uses the u as its functional currency, and 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. In 1992, Corporation A pays a 30u dividend out of post-1986 undistributed earnings, 3u to Corporation M and 27u to Corporation Z. Corporation M is deemed, under paragraph (b) of this section, to have paid a portion of the post-1986 foreign income taxes paid by Corporation A and includes the amount of foreign taxes deemed paid in gross income under section 78 as a dividend. Both the foreign taxes deemed paid and the dividend would be subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation. Under paragraph (a)(9)(i) of this section, Corporation A must reduce its post-1986 undistributed earnings as of January 1, 1993, by the total amount of dividends paid to Corporation M and Corporation Z in 1992. Under paragraph (a)(8)(i) of this section, Corporation A must reduce its post-1986 foreign income taxes as of January 1, 1993, by the amount of foreign income taxes that were deemed paid by Corporation M and by the amount of foreign income taxes that would have been deemed paid by Corporation Z had Corporation Z been eligible to compute an amount of foreign income taxes deemed paid with respect to the dividend received from Corporation A. Foreign income taxes deemed paid by Corporation M and Corporation A's opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for 1993 are computed as follows:

1. Assumed post-1986 undistributed earnings of Corporation A at start of 1992.	25u
2. Assumed post-1986 foreign income taxes of Corporation A at start of 1992.	$25
3. Assumed pre-tax earnings and profits of Corporation A for 1992	50u
4. Assumed foreign income taxes paid or accrued by Corporation A in 1992.	15u
5. Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4).	60u
6. Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates).	$40
7. Dividends paid out of post-1986 undistributed earnings of Corporation A to Corporation M in 1992.	3u
8. Percentage of Corporation A's post-1986 undistributed earnings paid to Corporation M (Line 7 divided by Line 5).	5%
9. Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) (Line 6 multiplied by Line 8).	$2
10. Total dividends paid out of post-1986 undistributed earnings of Corporation A to all shareholders in 1992.	30u
11. Percentage of Corporation A's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 10 divided by Line 5).	50%
12. Post-1986 foreign income taxes paid with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 6 multiplied by Line 11).	$20
13. Corporation A's post-1986 undistributed earnings at the start of 1993 (Line 5 minus Line 10).	30u
14. Corporation A's post-1986 foreign income taxes at the start of 1993 (Line 6 minus Line 12).	$20

Example 2. (i) The facts are the same as in *Example 1,* except that Corporation M has also owned 10 percent of the one class of stock of foreign corporation B since 1987. Corporation B uses the calendar year as the taxable year. The remaining 90 percent of Corporation B's stock is owned by Corporation Z. Corporation B is not a controlled foreign corporation. Corporation B uses the u as its functional currency, and 1u equals $1 at all relevant times. In 1992, Corporation B has earnings and profits and pays foreign income taxes, a portion of which are attributable to high withholding tax interest, as defined in section 904(d)(2)(B)(i). Corporation B must reduce its pool of post-1986 foreign income

taxes by the amount of tax imposed on high withholding tax interest in excess of 5 percent because that amount is not treated as a tax for purposes of section 902. See section 904(d)(2)(E)(ii) and paragraph (a)(8)(iii) of this section. Corporation B pays 50u in dividends in 1992, 5u to Corporation M and 45u to Corporation Z. Corporation M must compute its section 902(a) deemed paid taxes separately for the dividends it receives in 1992 from Corporation A (as computed in *Example 1*) and from Corporation B. Foreign income taxes of Corporation B deemed paid by Corporation M, and Corporation B's opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for 1993 are computed as follows:

1. Assumed post-1986 undistributed earnings of Corporation B at start of 1992.	(100u)
2. Assumed post-1986 foreign income taxes of Corporation B at start of 1992.	$0
3. Assumed pre-tax earnings and profits of Corporation B for 1992 (including 50u of high withholding tax interest on which 5u of tax is withheld).	302.50u
4. Assumed foreign income taxes paid or accrued by Corporation B in 1992.	102.50u
5. Post-1986 undistributed earnings in Corporation B for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4).	100u
6. Amount of foreign income tax of Corporation B imposed on high withholding tax interest in excess of 5% (5u withholding tax—[5%×50u high withholding tax interest]).	2.50u
7. Post-1986 foreign income taxes in Corporation B for 1992 (pre-dividend) (Line 2 plus [Line 4 minus Line 6 translated at the appropriate exchange rate]).	$100
8. Dividends paid out of post-1986 undistributed earnings to Corporation M in 1992.	5u
9. Percentage of Corporation B's post-1986 undistributed earnings paid to Corporation M (Line 8 divided by Line 5).	5%
10. Foreign income taxes of Corporation B deemed paid by Corporation M under section 902(a) (Line 7 multiplied by Line 9).	$5
11. Total dividends paid out of post-1986 undistributed earnings of Corporation B to all shareholders in 1992.	50u
12. Percentage of Corporation B's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 11 divided by Line 5).	50%
13. Post-1986 foreign income taxes of Corporation B paid on or with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 7 multiplied by Line 12).	$50
14. Corporation B's post-1986 undistributed earnings at start of 1993 (Line 5 minus Line 11).	50u
15. Corporation B's post-1986 foreign income taxes at start of 1993 (Line 7 minus Line 13).	$50

(ii) For 1992, as computed in *Example 1,* Corporation M is deemed to have paid $2 of the post-1986 foreign income taxes paid by Corporation A and includes $2 in gross income as a dividend under section 78. Both the income inclusion and the credit are subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation. Corporation M also is deemed to have paid $5 of the post-1986 foreign income taxes paid by Corporation B and includes $5 in gross income as a deemed dividend under section 78. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from Corporation B, a noncontrolled section 902 corporation.

Example 3. (i) Since 1987, domestic corporation M has owned 50 percent of the one class of stock of foreign corporation A. The remaining 50 percent of Corporation A is owned by foreign corporation Z. For the same time period, Corporation A has owned 40 percent of the one class of stock of foreign corporation B, and Corporation B has owned 30 percent of the one class of stock of foreign corporation C. The remaining 60 percent of Corporation B is owned by foreign corporation Y, and the remaining 70 percent of Corporation C is owned by foreign corporation

X. Corporations A, B, and C are not controlled foreign corporations. Corporations A, B, and C use the u as their functional currency, and 1u equals $1 at all relevant times. Corporation B uses a fiscal year ending June 30 as its taxable year; all other corporations use the calendar year as the taxable year. On February 1, 1992, Corporation C pays a 500u dividend out of post-1986 undistributed earnings, 150u to Corporation B and 350u to Corporation X. On February 15, 1992, Corporation B pays a 300u dividend out of post-1986 undistributed earnings computed as of the close of Corporation B's fiscal year ended June 30, 1992, 120u to Corporation A and 180u to Corporation Y. On August 15, 1992, Corporation A pays a 200u dividend out of post-1986 undistributed earnings, 100u to Corporation M and 100u to Corporation Z. In computing foreign taxes deemed paid by Corporations B and A, section 78 does not apply and Corporations B and A thus do not have to include the foreign taxes deemed paid in earnings and profits. See paragraph (c)(2)(ii) of this section. Foreign income taxes deemed paid by Corporations B, A and M, and the foreign corporations' opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for Corporation B's fiscal year beginning July 1, 1992, and Corporation C's and Corporation A's 1993 calendar years are computed as follows:

A. Corporation C (third-tier corporation):	
1. Assumed post-1986 undistributed earnings in Corporation C at start of 1992.	1300u
2. Assumed post-1986 foreign income taxes in Corporation C at start of 1992.	$500
3. Assumed pre-tax earnings and profits of Corporation C for 1992 ..	500u
4. Assumed foreign income taxes paid or accrued in 1992	300u
5. Post-1986 undistributed earnings in Corporation C for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4).	1500u
6. Post-1986 foreign income taxes in Corporation C for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates).	$800
7. Dividends paid out of post-1986 undistributed earnings of Corporation C to Corporation B in 1992.	150u
8. Percentage of Corporation C's post-1986 undistributed earnings paid to Corporation B (Line 7 divided by Line 5).	10%
9. Foreign income taxes of Corporation C deemed paid by Corporation B under section 902(b)(2) (Line 6 multiplied by Line 8).	$80
10. Total dividends paid out of post-1986 undistributed earnings of Corporation C to all shareholders in 1992.	500u
11. Percentage of Corporation C's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 10 divided by Line 5).	33.33%
12. Post-1986 foreign income taxes paid with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 6 multiplied by Line 11).	$266.66
13. Post-1986 undistributed earnings in Corporation C at start of 1993 (Line 5 minus Line 10).	1000u
14. Post-1986 foreign income taxes in Corporation C at start of 1993 (Line 6 minus Line 12).	$533.34
B. Corporation B (second-tier corporation):	
1. Assumed post-1986 undistributed earnings in Corporation B as of July 1, 1991.	0
2. Assumed post-1986 foreign income taxes in Corporation B as of July 1, 1991.	0
3. Assumed pre-tax earnings and profits of Corporation B for fiscal year ended June 30, 1992, (including 150u dividend from Corporation B).	1000u
4. Assumed foreign income taxes paid or accrued by Corporation B in fiscal year ended June 30, 1992.	200u
5. Foreign income taxes of Corporation C deemed paid by Corporation B in its fiscal year ended June 30, 1992 (Part A, Line 9 of paragraph (i) of this Example 3).	$80

6. Post-1986 undistributed earnings in Corporation B for fiscal year ended June 30, 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4).	800u
7. Post-1986 foreign income taxes in Corporation B for fiscal year ended June 30, 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates plus Line 5).	$280
8. Dividends paid out of post-1986 undistributed earnings of Corporation B to Corporation A on February 15, 1992.	120u
9. Percentage of Corporation B's post-1986 undistributed earnings for fiscal year ended June 30, 1992, paid to Corporation A (Line 8 divided by Line 6).	15%
10. Foreign income taxes paid and deemed paid by Corporation B as of June 30, 1992, deemed paid by Corporation A under section 902(b)(1) (Line 7 multiplied by Line 9).	$42
11. Total dividends paid out of post-1986 undistributed earnings of Corporation B for fiscal year ended June 30, 1992.	300u
12. Percentage of Corporation B's post-1986 undistributed earnings for fiscal year ended June 30, 1992, paid to all shareholders (Line 11 divided by Line 6).	37.5%
13. Post-1986 foreign income taxes paid and deemed paid with respect to post-1986 undistributed earnings distributed to all shareholders during Corporation B's fiscal year ended June 30, 1992 (Line 7 multiplied by Line 12).	$105
14. Post-1986 undistributed earnings in Corporation B as of July 1, 1992 (Line 6 minus Line 11).	500u
15. Post-1986 foreign income taxes in Corporation B as of July 1, 1992 (Line 7 minus Line 13).	$175
C. Corporation A (first-tier corporation):	
1. Assumed post-1986 undistributed earnings in Corporation A at start of 1992.	250u
2. Assumed post-1986 foreign income taxes in Corporation A at start of 1992.	$100
3. Assumed pre-tax earnings and profits of Corporation A for 1992 (including 120u dividend from Corporation B).	250u
4. Assumed foreign income taxes paid or accrued by Corporation A in 1992.	100u
5. Foreign income taxes paid or deemed paid by Corporation B as of June 30, 1992, that are deemed paid by Corporation A in 1992 (Part B, Line 10 of paragraph (i) of this Example 3).	$42
6. Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4).	400u
7. Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates plus Line 5).	$242
8. Dividends paid out of post-1986 undistributed earnings of Corporation A to Corporation M on August 15, 1992.	100u
9. Percentage of Corporation A's post-1986 undistributed earnings paid to Corporation M in 1992 (Line 8 divided by Line 6).	25%
10. Foreign income taxes paid and deemed paid by Corporation A in 1992 that are deemed paid by Corporation M under section 902(a) (Line 7 multiplied by Line 9).	$60.50
11. Total dividends paid out of post-1986 undistributed earnings of Corporation A to all shareholders in 1992.	200u
12. Percentage of Corporation A's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 11 divided by Line 6).	50%
13. Post-1986 foreign income taxes paid and deemed paid by Corporation A with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 7 multiplied by Line 12).	$121

14. Post-1986 undistributed earnings in Corporation A at start of 1993 (Line 6 minus Line 11).	200u
15. Post-1986 foreign income taxes in Corporation A at start of 1993 (Line 7 minus Line 13).	$121

(ii) Corporation M is deemed, under section 902(a) and paragraph (b) of this section, to have paid $60.50 of post-1986 foreign income taxes paid, or deemed paid, by Corporation A on or with respect to its post-1986 undistributed earnings (Part C, Line 10) and Corporation M includes that amount in gross income as a dividend under section 78. Both the income inclusion and the credit are subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation.

Example 4. (i) Since 1987, domestic corporation M has owned 100 percent of the voting stock of controlled foreign corporation A, and Corporation A has owned 100 percent of the voting stock of controlled foreign corporation B. Corporations M, A and B use the calendar year as the taxable year. Corporations A and B are organized in the same foreign country and use the u as their functional currency. 1u equals $1 at all relevant times. Assume that all of the earnings of Corporations A and B are general limitation earnings and profits within the meaning of section 904(d)(2)(I), and that neither Corporation A nor Corporation B has any previously taxed income accounts. In 1992, Corporation B pays a dividend of 150u to Corporation A out of post-1986 undistributed earnings, and Corporation A computes an amount of foreign taxes deemed paid under section 902(b)(1). The dividend is not subpart F income to Corporation A because section 954(c)(3)(B)(i) (the same country dividend exception) applies. Pursuant to paragraph (c)(2)(ii) of this section, Corporation A is not required to include the deemed paid taxes in earnings and profits. Corporation A has no pre-1987 accumulated profits and a deficit in post-1986 undistributed earnings for 1992. In 1992, Corporation A pays a dividend of 100u to Corporation M out of its earnings and profits for 1992 (current earnings and profits). Under paragraph (b)(4) of this section, Corporation M is not deemed to have paid any of the foreign income taxes paid or deemed paid by Corporation A because Corporation A has a deficit in post-1986 undistributed earnings as of December 31, 1992, and the sum of its current plus accumulated profits is less than zero. Note that if instead of paying a dividend to Corporation A in 1992, Corporation B had made an additional investment of $150 in United States property under section 956, that amount would have been included in gross income by Corporation M under section 951(a)(1)(B) and Corporation M would have been deemed to have paid $50 of foreign income taxes paid by Corporation B. See sections 951(a)(1)(B) and 960. Foreign income taxes of Corporation B deemed paid by Corporation A and the opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for Corporation A and Corporation B for 1993 are computed as follows:

A. Corporation B (second-tier corporation):

1. Assumed post-1986 undistributed earnings in Corporation B at start of 1992.	200u
2. Assumed post-1986 foreign income taxes in Corporation B at start of 1992.	$50
3. Assumed pre-tax earnings and profits of Corporation B for 1992 ..	150u
4. Assumed foreign income taxes paid or accrued in 1992	50u
5. Post-1986 undistributed earnings in Corporation B for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4).	300u
6. Post-1986 foreign income taxes in Corporation B for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates).	$100
7. Dividends paid out of post-1986 undistributed earnings of Corporation B to Corporation A in 1992.	150u
8. Percentage of Corporation B’s post-1986 undistributed earnings paid to Corporation A (Line 7 divided by Line 5).	50%
9. Foreign income taxes of Corporation B deemed paid by Corporation A under section 902(b)(1) (Line 6 multiplied by Line 8).	$50
10. Post-1986 undistributed earnings in Corporation B at start of 1993 (Line 5 minus Line 7).	150u
11. Post-1986 foreign income taxes in Corporation B at start of 1993 (Line 6 minus Line 9).	$50

B. Corporation A (first-tier corporation):	
1. Assumed post-1986 undistributed earnings in Corporation A at start of 1992.	(200u)
2. Assumed post-1986 foreign income taxes in Corporation A at start of 1992.	0
3. Assumed pre-tax earnings and profits of Corporation A for 1992 (including 150u dividend from Corporation B).	200u
4. Assumed foreign income taxes paid or accrued by Corporation A in 1992.	40u
5. Foreign income taxes paid by Corporation B in 1992 that are deemed paid by Corporation A (Part A, Line 9 of paragraph (i) of this Example 4).	$50
6. Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4).	(40u)
7. Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates plus Line 5).	$90
8. Dividends paid out of current earnings and profits of Corporation A for 1992.	100u
9. Percentage of post-1986 undistributed earnings of Corporation A paid to Corporation M in 1992 (Line 8 divided by the greater of Line 6 or zero).	0
10. Foreign income taxes paid and deemed paid by Corporation A in 1992 that are deemed paid by Corporation M under section 902(a) (Line 7 multiplied by Line 9).	0
11. Post-1986 undistributed earnings in Corporation A at start of 1993 (line 6 minus line 8).	(140u)
12. Post-1986 foreign income taxes in Corporation A at start of 1993 (Line 7 minus Line 10).	$90

(ii) For 1993, Corporation A has 500u of earnings and profits on which it pays 160u of foreign income taxes. Corporation A receives no dividends from Corporation B, and pays a 100u dividend to Corporation M. The 100u dividend to Corporation M carries with it some of the foreign income taxes paid and deemed paid by Corporation A in 1992, which were not deemed paid by Corporation M in 1992 because Corporation A had no post-1986 undistributed earnings. Thus, for 1993, Corporation M is deemed to have paid $125 of post-1986 foreign income taxes paid and deemed paid by Corporation A and includes that amount in gross income as a dividend under section 78, determined as follows:

1. Post-1986 undistributed earnings in Corporation A at start of 1993	(140u)
2. Post-1986 foreign income taxes in Corporation A at start of 1993	$90
3. Pre-tax earnings and profits of Corporation A for 1993	500u
4. Foreign income taxes paid or accrued by Corporation A in 1993	160u
5. Post-1986 undistributed earnings in Corporation A for 1993 (pre-dividend) (Line 1 plus Line 3 minus Line 4).	200u
6. Post-1986 foreign income taxes in Corporation A for 1993 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates).	$250
7. Dividends paid out of post-1986 undistributed earnings of Corporation A to Corporation M in 1993.	100u
8. Percentage of post-1986 undistributed earnings of Corporation A paid to Corporation M in 1993 (Line 7 divided by Line 5).	50%
9. Foreign income taxes paid and deemed paid by Corporation A that are deemed paid by Corporation M in 1993 (Line 6 multiplied by Line 8).	$125
10. Post-1986 undistributed earnings in Corporation A at start of 1994 (Line 5 minus Line 7).	100u
11. Post-1986 foreign income taxes in Corporation A at start of 1994 (Line 6 minus Line 9).	$125

Example 5. (i) Since 1987, domestic corporation M has owned 100 percent of the voting stock of controlled foreign corporation A. Corporation M also conducts operations through a foreign branch. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A uses the u as its functional currency and 1u equals $1 at all relevant times. Corporation A has no subpart F income, as defined in section 952, and no increase in earnings invested in United States property under section 956 for 1992. Corporation A also has no previously taxed income accounts. Corporation A has general limitation income and high withholding tax interest income that, by operation of section 954(b)(4), does not constitute foreign base company income under section 954(a). Because Corporation A is a controlled foreign corporation, it is not required to reduce post-1986 foreign income taxes by foreign taxes paid or accrued with respect to high withholding tax interest in excess of 5 percent. See § 1.902–1(a)(8)(iii). Corporation A pays a 60u dividend to Corporation M in 1992. For 1992, Corporation M is deemed, under paragraph (b) of this section, to have paid $24 of the post-1986 foreign income taxes paid by Corporation A and includes that amount in gross income under section 78 as a dividend, determined as follows:

1. Assumed post-1986 undistributed earnings in Corporation A at start of 1992 attributable to:	
(a) Section 904(d)(1)(B) high withholding tax interest	20u
(b) Section 904(d)(1)(I) general limitation income	55u
2. Assumed post-1986 foreign income taxes in Corporation A at start of 1992 attributable to:	
(a) Section 904(d)(1)(B) high withholding tax interest	$5
(b) Section 904(d)(1)(I) general limitation income	$20
3. Assumed pre-tax earnings and profits of Corporation A for 1992 attributable to:	
(a) Section 904(d)(1)(B) high withholding tax interest	20u
(b) Section 904(d)(1)(I) general limitation income	20u
4. Assumed foreign income taxes paid or accrued in 1992 on or with respect to:	
(a) Section 904(d)(1)(B) high withholding tax interest	10u
(b) Section 904(d)(1)(I) general limitation income	5u
5. Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) attributable to:	
(a) Section 904(d)(1)(B) high withholding tax interest (Line 1(a) + Line 3(a) minus Line 4(a)).	30u
(b) Section 904(d)(1)(I) general limitation income (Line 1(b) + Line 3(b) minus Line 4(b)).	70u
(c) Total	100u
6. Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) attributable to:	
(a) Section 904(d)(1)(B) high withholding tax interest (Line 2(a) + Line 4(a) translated at the appropriate exchange rates).	$15
(b) Section 904(d)(1)(I) general limitation income (Line 2(b) + Line 4(b) translated at the appropriate exchange rates).	$25
7. Dividends paid to Corporation M in 1992	60u
8. Dividends paid to Corporation M in 1992 attributable to section 904(d) separate categories pursuant to § 1.904–5(d):	
(a) Dividends paid to Corporation M in 1992 attributable to section 904(d)(1)(B) high withholding tax interest (Line 7 multiplied by Line 5(a) divided by Line 5(c)).	18u
(b) Dividends paid to Corporation M in 1992 attributable to section 904(d)(1)(I) general limitation income (Line 7 multiplied by Line 5(b) divided by Line 5(c)).	42u
9. Percentage of Corporation A's post-1986 undistributed earnings for 1992 paid to Corporation M attributable to:	
(a) Section 904(d)(1)(B) high withholding tax interest (Line 8(a) divided by Line 5(a)).	60%

(b) Section 904(d)(1)(I) general limitation income (Line 8(b) divided by Line 5(b)).	60%
10. Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) attributable to:	
(a) Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) with respect to section 904(d)(1)(B) high withholding tax interest (Line 6(a) multiplied by Line 9(a)).	$9
(b) Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) with respect to section 904(d)(1)(I) general limitation income (Line 6(b) multiplied by Line 9(b)).	$15
11. Post-1986 undistributed earnings in Corporation A at start of 1993 attributable to:	
(a) Section 904(d)(1)(B) high withholding tax interest (Line 5(a) minus Line 8(a)).	12u
(b) Section 904(d)(1)(I) general limitation income (Line 5(b) minus Line 8(b)).	28u
12. Post-1986 foreign income taxes in Corporation A at start of 1989 allocable to:	
(a) Section 904(d)(1)(B) high withholding tax interest (Line 6(a) minus Line 10(a)).	$6
(b) Section 904(d)(1)(I) general limitation income (Line 6(b) minus Line 10(b)).	$10

(ii) For purposes of computing Corporation M's foreign tax credit limitation, the post-1986 foreign income taxes of Corporation A deemed paid by Corporation M with respect to income in separate categories will be added to the foreign income taxes paid or accrued by Corporation M associated with income derived from Corporation M's branch operation in the same separate categories. The dividend (and the section 78 inclusion with respect to the dividend) will be treated as income in separate categories and added to Corporation M's other income, if any, attributable to the same separate categories. See section 904(d) and §1.904–6.

(g) *Effective date.* This section applies to any distribution made in and after a foreign corporation's first taxable year beginning on or after January 1, 1987.

[T.D. 8708, 62 FR 928, Jan. 7, 1997]

§1.902–2 Treatment of deficits in post-1986 undistributed earnings and pre-1987 accumulated profits of a first-, second-, or third-tier corporation for purposes of computing an amount of foreign taxes deemed paid under §1.902–1.

(a) *Carryback of deficits in post-1986 undistributed earnings of a first-, second-, or third-tier corporation to pre-effective date taxable years*—(1) *Rule.* For purposes of computing foreign income taxes deemed paid under §1.902–1(b) with respect to dividends paid by a first-, second-, or third-tier corporation, when there is a deficit in the post-1986 undistributed earnings of that corporation and the corporation makes a distribution to shareholders that is a dividend or would be a dividend if there were current or accumulated earnings and profits, then the post-1986 deficit shall be carried back to the most recent pre-effective date taxable year of the first-, second-, or third-tier corporation with positive accumulated profits computed under section 902. See §1.902–3(e). For purposes of this §1.902–2, a pre-effective date taxable year is a taxable year beginning before January 1, 1987, or a taxable year beginning after December 31, 1986, if the special effective date of §1.902–1(a)(13) applies. The deficit shall reduce the section 902 accumulated profits in the most recent pre-effective date year to the extent thereof, and any remaining deficit shall be carried back to the next preceding year or years until the deficit is completely allocated. The amount carried back shall reduce the deficit in post-1986 undistributed earnings. Any foreign income taxes paid in a post-effective date year will not be carried back to pre-effective date taxable years or removed from post-1986 foreign income taxes. See section 960 and the regulations under that section for rules governing the carryback of deficits and the computation of foreign income taxes deemed paid with respect to deemed income inclusions from controlled foreign corporations.

(2) *Examples.* The following examples illustrate the rules of this paragraph (a):

Example 1. (i) From 1985 through 1990, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits and post-1986 undistributed earnings or deficits in post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable year	1985	1986	1987	1988	1989	1990
Current E & P (Deficits) of Corp. A	150u	150u	(100u)	100u	0	0
Current Plus Accumulated E & P of Corp. A	150u	300u	200u	250u	250u	200u
Post-'86 Undistributed Earnings of Corp. A			(100u)	100u	100u	50u
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (increased by deficit carryback).			0	100u	50u	50u
Foreign Income Taxes of Corp. A (Annual)	120u	120u	$10	$50	0	0
Post-'86 Foreign Income Taxes of Corp. A			$10	$60	$60	$30
12/31 Distributions to Corp. M	0	0	5u	0	5u	0
12/31 Distributions to Corp. Z	0	0	45u	0	45u	0

(ii) On December 31, 1987, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has a deficit of (100u) in post-1986 undistributed earnings and $10 of post-1986 foreign income taxes. The (100u) deficit (but not the post-1986 foreign income taxes) is carried back to offset the accumulated profits of 1986 and removed from post-1986 undistributed earnings. The accumulated profits for 1986 are reduced to 50u (150u − 100u). The dividend is paid out of the reduced 1986 accumulated profits. Foreign taxes deemed paid by Corporation M with respect to the 5u dividend are 12u (120u×(5u/50u)). See § 1.902–1(b)(3). Corporation M must include 12u in gross income (translated under the rule applicable to foreign income taxes paid on earnings accumulated in pre-effective date years) under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation. No accumulated profits remain in Corporation A with respect to 1986 after the carryback of the 1987 deficit and the December 31, 1987, dividend distributions to Corporations M and Z.

(iii) On December 31, 1989, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has 100u of post-1986 undistributed earnings and $60 of post-1986 foreign income taxes. Therefore, the dividend is considered paid out of Corporation A's post-1986 undistributed earnings. Foreign taxes deemed paid by Corporation M with respect to the 5u dividend are $3 ($60×5%[5u/100u]). Corporation M must include $3 in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. Corporation A's post-1986 undistributed earnings as of January 1, 1990, are 50u (100u − 50u). Corporation A's post-1986 foreign income taxes must be reduced by the amount of foreign taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes. Section 1.902–1(a)(8)(i). The amount of foreign income taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 50u dividend distributed by Corporation A is $30 ($60×50%[50u/100u]). Thus, post-1986 foreign income taxes as of January 1, 1990, are $30 ($60 − $30).

Example 2. The facts are the same as in *Example 1,* except that Corporation A has a deficit in its post-1986 undistributed earnings of (150u) on December 31, 1987. The deficit is carried back to 1986 and reduces accumulated profits for that year to -0-. Thus, the foreign income taxes paid with respect to the 1986 accumulated profits will never be deemed paid. The 1987 dividend is deemed to be out of Corporation A's 1985 accumulated profits. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend paid on December 31, 1987, are 4u (120u×5u/150u). See § 1.902–1(b)(3). As a result of the December 31, 1987, dividend distributions, 100u (150u − 50u) of accumulated profits and 80u (120u reduced by 40u[120u×50u/150u] of foreign taxes that would have been deemed paid had all of Corporation A's shareholders been eligible to compute an amount of foreign taxes deemed paid with respect to the dividend paid out of 1985 accumulated profits) remain in Corporation A with respect to 1985.

Example 3. (i) From 1986 through 1991, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits and post-1986 undistributed earnings or deficits in post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable year	1986	1987	1988	1989	1990	1991
Current E & P (Deficits) of Corp. A	100u	(50u)	150u	75u	25u	0
Current Plus Accumulated E & P of Corp. A	100u	50u	200u	175u	200u	80u
Post-'86 Undistributed Earnings of Corp. A		(50u)	100u	75u	100u	0
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (increased by deficit carryback).		(50u)	0	75u	0	0
Foreign Income Taxes (Annual) of Corp. A	80u	0	$120	$20	$20	0
Post-'86 Foreign Income Taxes of Corp. A		0	$120	$20	$40	0
12/31 Distributions to Corp. M	0	0	10u	0	12u	0
12/31 Distributions to Corp. Z	0	0	90u	0	108u	0

(ii) On December 31, 1988, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. At that time Corporation A has 100u in its post-1986 undistributed earnings and $120 in its post-1986 foreign income taxes. Corporation M is deemed, under § 1.902–1(b)(1), to have paid $12 ($120×10%[10u/100u]) of the post-1986 foreign income taxes paid by Corporation A and includes that amount in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. Corporation A's post-1986 undistributed earnings as of January 1, 1989, are 0 (100u–100u). Its post-1986 foreign taxes as of January 1, 1989, also are 0, $120 reduced by $120 of foreign income taxes paid that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of foreign taxes deemed paid on the dividend from Corporation A ($120×100%[100u/100u]).

(iii) On December 31, 1990, Corporation A distributes a 12u dividend to Corporation M and a 108u dividend to Corporation Z. At that time Corporation A has 100u in its post-1986 undistributed earnings and $40 in its post-1986 foreign income taxes. The dividend is paid out of post-1986 undistributed earnings to the extent thereof (100u), and the remainder of 20u is paid out of 1986 accumulated profits. Under § 1.902–1(b)(2), the 12u dividend to Corporation M is deemed to be paid out of post-1986 undistributed earnings to the extent of 10u (100u×12u/120u) and the remaining 2u is deemed to be paid out of Corporation A's 1986 accumulated profits. Similarly, the 108u dividend to Corporation Z is deemed to be paid out of post-1986 undistributed earnings to the extent of 90u (100u×108u/120u) and the remaining 18u is deemed to be paid out of Corporation A's 1986 accumulated profits. Foreign income taxes deemed paid by Corporation M under section 902 with respect to the portion of the dividend paid out of post-1986 undistributed earnings are $4 ($40×10%[10u/100u]), and foreign taxes deemed paid by Corporation M with respect to the portion of the dividend deemed paid out of 1986 accumulated profits are 1.6u (80u×2u/100u). Corporation M must include $4 plus 1.6u translated under the rule applicable to foreign income taxes paid on earnings accumulated in taxable years prior to the effective date of the Tax Reform Act of 1986 in gross income as a dividend under section 78. The income inclusion and the foreign income taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 Corporation A. As of January 1, 1991, Corporation A's post-1986 undistributed earnings are 0 (100u–100u). 80u (100u–20u) of accumulated profits remain with respect to 1986. Post-1986 foreign income taxes as of January 1, 1991, are 0, $40 reduced by $40 of foreign income taxes paid that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 100u dividend distributed by Corporation A out of post-1986 undistributed earnings ($40×100%[100u/100u]). Corporation A has 64u of foreign income taxes remaining with respect to 1986, 80u reduced by 16u [80u×20u/100u] of foreign income taxes that would have been deemed paid if Corporations M and Z both were eligible to compute an amount of deemed paid taxes on the 20u dividend distributed by Corporation A out of 1986 accumulated profits.

(b) *Carryforward of deficits in pre-1987 accumulated profits of a first-, second-, or third-tier corporation to post-1986 undistributed earnings for purposes of section 902*—(1) *General rule.* For purposes of computing foreign income taxes deemed paid under § 1.902–1(b) with respect to dividends paid by a first-, second-, or third-tier corporation out of post-1986 undistributed earnings, the amount of a deficit in accumulated profits of the foreign corporation determined under section 902 as of the end of its last pre-effective date taxable year is carried forward and reduces post-1986 undistributed earnings on the first day of the foreign corporation's first taxable year beginning after December 31, 1986, or on the first day of the first taxable year in which the ownership requirements of section 902(c)(3)(B) and § 1.902–1(a)(1) through (4) are met if the special effective date of § 1.902–1(a)(13) applies. Any foreign income taxes paid with respect to a pre-effective date year shall not be carried forward and included in post-1986 foreign income taxes. Post-1986 undistributed earnings may not be reduced by the amount of a pre-1987 deficit in earnings and profits computed under section 964(a). See section 960 and the regulations under that section for rules governing the carryforward of deficits and the computation of foreign income taxes deemed paid with respect to deemed income inclusions from controlled foreign corporations. For translation rules governing carryforwards of deficits in pre-1987 accumulated profits to post-1986 taxable years of a foreign corporation with a dollar functional currency, see § 1.985–6(d)(2).

(2) *Effect of pre-effective date deficit.* If a foreign corporation has a deficit in accumulated profits as of the end of its last pre-effective date taxable year,

then the foreign corporation cannot pay a dividend out of pre-effective date years unless there is an adjustment made (for example, a refund of foreign taxes paid) that restores section 902 accumulated profits to a pre-effective date taxable year or years. Moreover, if a foreign corporation has a deficit in section 902 accumulated profits as of the end of its last pre-effective date taxable year, then no deficit in post-1986 undistributed earnings will be carried back under paragraph (a) of this section. For rules concerning carrybacks of eligible deficits from post-1986 undistributed earnings to reduce pre-1987 earnings and profits computed under section 964(a), see section 960 and the regulations under that section.

(3) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. (i) From 1984 through 1988, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits or deficits in accumulated profits and post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable year	1984	1985	1986	1987	1988
Current E & P (Deficits) of Corp. A.	25u	(100u)	(25u)	200u	100u
Current Plus Accumulated E & P (Deficits) of Corp. A.	25u	(75u)	(100u)	100u	50u
Post-'86 Undistributed Earnings of Corp. A.				100u	50u
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (reduced by deficit carryforward).				(50u)	50u
Foreign Income Taxes (Annual) of Corp. A.	20u	5u	0	$100	$50
Post-'86 Foreign Income Taxes of Corp. A.				$100	$50
12/31 Distributions to Corp. M.	0	0	0	15u	0
12/31 Distributions to Corp. Z.	0	0	0	135u	0

(ii) On December 31, 1987, Corporation A distributes a 150u dividend, 15u to Corporation M and 135u to Corporation Z. Corporation A has 200u of current earnings and profits for 1987, but its post-1986 undistributed earnings are only 100u as a result of the reduction for pre-1987 accumulated deficits required under paragraph (b)(1) of this section. Corporation A has $100 of post-1986 foreign income taxes. Only 100u of the 150u distribution is a dividend out of post-1986 undistributed earnings. Foreign income taxes deemed paid by Corporation M in 1987 with respect to the 10u dividend attributable to post-1986 undistributed earnings, computed under §1.902–1(b), are $10 ($100×10%[10u/100u]). Corporation M includes this amount in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. After the distribution, Corporation A has (50u) of post-1986 undistributed earnings (100u–150u) and -0- post-1986 foreign income taxes, $100 reduced by $100 of foreign income taxes paid that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 100u dividend distributed by Corporation A out of post-1986 undistributed earnings ($100×100%[100u/100u]).

(iii) The remaining 50u of the 150u distribution cannot be deemed paid out of accumulated profits of a pre-1987 year because Corporation A has an accumulated deficit as of the end of 1986 that eliminated all pre-1987 accumulated profits. See paragraph (b)(2) of this section. The 50u is a dividend out of current earnings and profits under section 316(a)(2), but Corporation M is not deemed to have paid any additional foreign income taxes paid by Corporation A with respect to that 50u dividend out of current earnings and profits. See § 1.902–1(b)(4).

Example 2. (i) From 1986 through 1991, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits or deficits in accumulated profits and post-1986 undistributed earnings, pays post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable year	1986	1987	1988	1989	1990
Current E & P (Deficits) of Corp. A.	(100u)	150u	(150u)	100u	250u
Current Plus Accumulated E & P (Deficits) of Corp. A.	(100u)	50u	(200u)	(100u)	50u
Post-'86 Undistributed Earnings of Corp. A.		50u	(200u)	(100u)	50u
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (reduced by deficit carryforward).		(50u)	(200u)	(200u)	0
Foreign Income Taxes (Annual) of Corp. A.	0	$120	0	$50	$100
Post-'86 Foreign Income Taxes of Corp. A.		$120	0	$50	$150
12/31 Distributions to Corp. M.	0	10u	0	10u	5u
12/31 Distributions to Corp. Z.	0	90u	0	90u	45u

(ii) On December 31, 1987, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. At the time of the distribution, Corporation A has 50u of post-1986 undistributed earnings and 150u of current earnings and profits. Thus, 50u of the dividend distribution (5u to Corporation M and 45u to Corporation Z) is a dividend out of post-1986 undistributed earnings. The remaining 50u is a dividend out of current earnings and profits under section 316(a)(2), but Corporation M is not deemed to have paid any additional foreign income taxes paid by Corporation A with respect to that 50u dividend out of current earnings and profits. See § 1.902–1(b)(4). Note that even if there were no current earnings and profits in Corporation A, the remaining 50u of the 100u distribution cannot be deemed paid out of accumulated profits of a pre1987 year because Corporation A has an accumulated deficit as of the end of 1986 that eliminated all pre-1987 accumulated profits. See paragraph (b)(2) of this section. Corporation A has $120 of post-1986 foreign income taxes. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend out of post-1986 undistributed earnings are $12 ($120×10%[5u/50u]). Corporation M includes this amount in gross income as a dividend under section 78. Both the foreign taxes deemed paid and the deemed dividend are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. As of January 1, 1988, Corporation A has (50u) in its post-1986 undistributed earnings (50u − 100u) and -0- in its post-1986 foreign income taxes, $120 reduced by $120 of foreign taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the dividend distributed by Corporation A out of post-1986 undistributed earnings ($120×100%[50u/50u]).

(iii) On December 31, 1989, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. Although the distribution is considered a dividend in its entirety out of 1989 earnings and profits pursuant to section 316(a)(2), post-1986 undistributed earnings are (100u). Accordingly, for purposes of section 902, Corporation M is deemed to have paid no post-1986 foreign income taxes. See §1.902–1(b)(4). Corporation A's post-1986 undistributed earnings as of January 1, 1990, are (200u) ((100u) − 100u). Corporation A's post-1986 foreign income taxes are not reduced because no taxes were deemed paid.

(iv) On December 31, 1990, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has 50u of post-1986 undistributed earnings, and $150 of post-1986 foreign income taxes. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend are $15 ($150×10%[5u/50u]). Post-1986 undistributed earnings as of January 1, 1991, are -0- (50u − 50u). Post-1986 foreign income taxes as of January 1, 1991, also are -0-, $150 reduced by $150 ($150×100%[50u/50u]) of foreign income taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 50u dividend.

[T.D. 8708, 62 FR 937, Jan. 7, 1997]

§1.902–3 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid with respect to accumulated profits of taxable years of the foreign corporation beginning before January 1, 1987.

(a) *Definitions.* For purposes of section 902 and §§1.902–3 and 1.902–4:

(1) *Domestic shareholder.* In the case of dividends received by a domestic corporation after December 31, 1964, from a foreign corporation, the term ''domestic shareholder'' means a domestic corporation which owns at least 10 percent of the voting stock of the foreign corporation at the time it receives a dividend from such foreign corporation.

(2) *First-tier corporation.* In the case of dividends received by a domestic shareholder after December 31, 1964, from a foreign corporation, the term ''first-tier corporation'' means a foreign corporation at least 10 percent of the voting stock of which is owned by a domestic shareholder at the time it receives a dividend from such foreign corporation. The term ''first-tier corporation'' also means a DISC or former DISC, but only with respect to dividends from the DISC or former DISC to the extent they are treated under sections 861(a)(2)(D) and 862(a)(2) as income from sources without the United States.

(3) *Second-tier corporation.* (i) In the case of dividends paid to a first-tier corporation by a foreign corporation after January 12, 1971 (i.e., the date of enactment of Pub. L. 91–684, 84 Stat. 2068), but only for purposes of applying this section for a taxable year of a domestic shareholder ending after that date, the foreign corporation is a ''second-tier corporation'' if at least 10 percent of its voting stock is owned by the first-tier corporation at the time the first-tier corporation receives the dividend.

(ii) In the case of dividends paid to a first-tier corporation by a foreign corporation after January 12, 1971, but only for purposes of applying this section for a taxable year of a domestic shareholder ending before January 13, 1971, or in the case of any dividend paid to a first-tier corporation by a foreign corporation before January 13, 1971, the foreign corporation is a ''second-tier corporation'' if at least 50 percent of its voting stock is owned by the first-tier corporation at the time the first-tier corporation receives the dividend.

(4) *Third-tier corporation.* In the case of dividends paid to a second-tier corporation (as defined in paragraph (a)(3)(i) or (ii) of this section) by a foreign corporation after January 12, 1971, but only for purposes of applying this section for a taxable year of a domestic shareholder ending after that date, the foreign corporation is a ''third-tier corporation'' if at least 10 percent of its voting stock is owned by the second-tier corporation at the time the second-tier corporation receives the dividend.

(5) *Foreign income taxes.* The term ''foreign income taxes'' means income, war profits, and excess profits taxes, and taxes included in the term ''income, war profits, and excess profits taxes'' by reason of section 903, imposed by a foreign country or a possession of the United States.

(6) *Dividend.* For the definition of the term ''dividend'' for purposes of applying section 902 and this section, see section 316 and the regulations thereunder.

(7) *Dividend received.* A dividend shall be considered received for purposes of section 902 and this section when the cash or other property is unqualifiedly made subject to the demands of the distributee. See § 1.301–1(b).

(b) *Domestic shareholder owning stock in a first-tier corporation*—(1) *In general.* (i) If a domestic shareholder receives dividends in any taxable year from its first-tier corporation, the credit for foreign income taxes allowed by section 901 includes, subject to the conditions and limitations of this section, the foreign income taxes deemed, in accordance with paragraph (b)(2) of this section, to be paid by such domestic shareholder for such year.

(ii) If dividends are received by a domestic shareholder from more than one first-tier corporation, the taxes deemed to be paid by such shareholder under section 902(a) and this paragraph (b) shall be computed separately with respect to the dividends received from each of such first-tier corporations.

(iii) Any taxes deemed paid by a domestic shareholder for the taxable year pursuant to section 902(a) and paragraph (b)(2) of this section shall, except as provided in § 1.960–3(b), be included in the gross income of such shareholder for such year as a dividend pursuant to section 78 and § 1.78–1. For the source of such a section 78 dividend, see paragraph (h)(1) of this section.

(iv) Any taxes deemed, under paragraph (b)(2) of this section, to be paid by the domestic shareholder shall be deemed to be paid by such shareholder only for purposes of the foreign tax credit allowed under section 901. See section 904 for other limitations on the amount of the credit.

(v) For rules relating to reduction of the amount of foreign income taxes deemed paid or accrued with respect to foreign mineral income, see section 901(e) and § 1.901–3.

(vi) For the nonrecognition as a foreign income tax for purposes of this section of certain income, profits, or excess profits taxes paid or accrued to a foreign country in connection with the purchase and sale of oil or gas extracted in such country, see section 901(f) and the regulations thereunder.

(vii) For rules relating to reduction of the amount of foreign income taxes deemed paid with respect to foreign oil and gas extraction income, see section 907(a) and the regulations thereunder.

(viii) See the regulations under sections 960, 962, and 963 for special rules relating to the application of section 902 in computing the foreign tax credit of United States shareholders of controlled foreign corporations.

(2) *Amount of foreign taxes deemed paid by a domestic shareholder.* To the extent dividends are paid by a first-tier corporation to its domestic shareholder out of accumulated profits, as defined in paragraph (e) of this section, for any taxable year, the domestic shareholder shall be deemed to have paid the same proportion of any foreign income taxes paid, accrued or deemed, in accordance with paragraph (c)(2) of this section, to be paid by such first-tier corporation on or with respect to such accumulated profits for such year which the amount of such dividends (determined without regard to the gross-up under section 78) bears to the amount by which such accumulated profits exceed the amount of such taxes (other than those deemed, under paragraph (c)(2) of this section, to be paid). For determining the amount of foreign income taxes paid or accrued by such first-tier corporation on or with respect to the accumulated profits for the taxable year of such first-tier corporation, see paragraph (f) of this section.

(c) *First-tier corporation owning stock in a second-tier corporation*—(1) *In general.* For purposes of applying section 902(a) and paragraph (b)(2) of this section, if a first-tier corporation receives dividends in any taxable year from its second-tier corporation, the foreign income taxes deemed to be paid by the first-tier corporation on or with respect to its own accumulated profits for such year shall be the amount determined in accordance with paragraph (c)(2) of this section. This paragraph (c) shall not apply unless the product of—

(i) The percentage of voting stock owned by the domestic shareholder in the first-tier corporation at the time that the domestic shareholder receives dividends from the first-tier corporation in respect of which foreign income taxes are deemed to be paid by the domestic shareholder under paragraph (b)(1) of this section, and

(ii) The percentage of voting stock owned by the first-tier corporation in the second-tier corporation

equals at least 5 percent. The percentage under paragraph (c)(1)(ii) of this section of voting stock owned by the first-tier corporation in the second-tier corporation is determined as of the time that the dividend distributed by the second-tier corporation is received by the first-tier corporation and thus included in accumulated profits of the first-tier corporation out of which dividends referred to in paragraph (c)(1)(i) of this section are distributed by the first-tier corporation to the domestic shareholder.

Example. On February 10, 1976, foreign corporation B pays a dividend out of its accumulated profits for 1975 to foreign corporation A. On February 16, 1976, the date on which it receives the dividend, A Corporation owns 40 percent of the voting stock of B Corporation. Both corporations use the calendar year as the taxable year. On June 1, 1976, A Corporation sells its stock in B Corporation. On January 17, 1977, A Corporation pays a dividend out of its accumulated profits for 1976 to domestic corporation M. M Corporation owns 30 percent of the voting stock of A Corporation on January 20, 1977, the date on which it receives the dividend. M Corporation uses a fiscal year ending on April 30 as the taxable year. On February 16, 1976, A Corporation satisfies the 10-percent stock ownership requirement referred to in paragraph (a)(3) of this section with respect to B Corporation, and on January 20, 1977, M Corporation satisfies the 10-percent stock-ownership requirement referred to in paragraph (a)(2) of this section with respect to A Corporation. The 5-percent requirement of this paragraph (c)(1) is also satisfied since 30 percent (the percentage of voting stock owned by M Corporation in A Corporation on January 20, 1977), when multiplied by 40 percent (the percentage of voting stock owned by A Corporation in B Corporation on February 16, 1976), equals 12 percent. Accordingly, for its taxable year ending on April 30, 1977, M Corporation is entitled to a credit for a portion of the foreign income taxes paid, accrued, or deemed to be paid, by A Corporation for 1976; and for 1976 A Corporation is deemed to have paid a portion of the foreign income taxes paid or accrued by B Corporation for 1975.

(2) *Amount of foreign taxes deemed paid by a first-tier corporation.* A first-tier corporation which receives dividends in any taxable year from its second-tier corporation shall be deemed to have paid for such year the same proportion of any foreign income taxes paid, accrued, or deemed, in accordance with paragraph (d)(2) of this section, to be paid by its second-tier corporation on or with respect to the accumulated profits, as defined in paragraph (e) of this section, for the taxable year of the second-tier corporation from which such dividends are paid which the amount of such dividends bears to the amount by which such accumulated profits of the second-tier corporation exceed the taxes so paid or accrued. For determining the amount of the foreign income taxes paid or accrued by such second-tier corporation on or with respect to the accumulated profits for the taxable year of such second-tier corporation, see paragraph (f) of this section.

(d) *Second-tier corporation owning stock in a third-tier corporation*—(1) *In general.* For purposes of applying section 902(b)(1) and paragraph (c)(2) of this section, if a second-tier corporation receives dividends in any taxable year from its third-tier corporation, the foreign income taxes deemed to be paid by the second-tier corporation on or with respect to its own accumulated profits for such year shall be the amount determined in accordance with paragraph (d)(2) of this section. This paragraph (d) shall not apply unless the product of—

(i) The percentage of voting stock arrived at in applying the 5-percent requirement of paragraph (c)(1) of this section with respect to dividends received by the first-tier corporation from the second-tier corporation, and

(ii) the percentage of voting stock owned by the second-tier corporation in the third-tier corporation equals at least 5 percent. The percentage under paragraph (d)(1)(ii) of this section of voting stock owned by the second-tier corporation in the third-tier corporation is determined as of the time that the dividend distributed by the third-tier corporation is received by the second-tier corporation and thus included in accumulated profits of the second-tier corporation out of which dividends referred to in paragraph (d)(1)(i) of this section are distributed by the second-tier corporation to the first-tier corporation.

Example. On February 27, 1975, foreign corporation C pays a dividend out of its accumulated profits for 1974 to foreign corporation B. On March 3, 1975, the date on which it receives the dividend, B Corporation owns 50 percent of the voting stock of C Corporation. On February 10, 1976, B Corporation pays a dividend out of its accumulated profits for 1975 to foreign corporation A. On February 16, 1976, the date on which it receives the dividend, A Corporation owns 40 percent of the voting stock of B Corporation. All three corporations use the calendar year as the taxable year. On January 17, 1977, A Corporation pays a dividend out of its accumulated profits for 1976 to domestic corporation M. M Corporation owns 30 percent of the voting stock of A Corporation on January 20, 1977, the date on which it receives the dividend. M Corporation uses a fiscal year ending on April 30 as the taxable year. On February 16, 1976, A Corporation satisfies the 10-percent stock ownership requirement referred to in paragraph (a)(3) of this section with respect to B Corporation, and on January 20, 1977, M Corporation satisfies the 10-percent stock-ownership requirement referred to in paragraph (a)(2) of this section with respect to A Corporation. The 5-percent requirement of paragraph (c)(1) of this section is also satisfied since 30 percent (the percentage of voting stock owned by M Corporation in A Corporation on January 20, 1977), when multiplied by 40 percent (the percentage of voting stock owned by A Corporation in B Corporation on February 16, 1976), equals 12 percent. On March 3, 1975, B Corporation satisfies the 10 percent stock ownership requirement referred to in paragraph (a)(4) of this section with respect to C Corporation. The 5-percent requirement of this paragraph (d)(1) is also satisfied since 12 percent (the percentage of voting stock arrived at in applying the 5-percent requirement of paragraph (c)(1) of this section with respect to the dividends received by A Corporation from B Corporation on February 16, 1976), when multiplied by 50 percent (the percentage of voting stock owned by B Corporation in C Corporation on March 3, 1975), equals 6 percent. Accordingly, for its taxable year ending on April 30, 1977, M Corporation is entitled to a credit for a portion of the foreign income taxes paid, accrued, or deemed to be paid, by A Corporation for 1976; for 1976 A Corporation is deemed to have paid a portion of the foreign income taxes paid, accrued, or deemed to be paid, by B Corporation for 1975; and for 1975 B Corporation is deemed to have paid a portion of the foreign income taxes paid or accrued by C Corporation for 1974.

(2) *Amount of foreign taxes deemed paid by a second-tier corporation.* For purposes of applying paragraph (c)(2) of this section to a first-tier corporation, a second-tier corporation which receives dividends in its taxable year from its third-tier corporation shall be deemed to have paid for such year the same proportion of any foreign income taxes paid or accrued by its third-tier corporation on or with respect to the accumulated profits, as defined in paragraph (e) of this section, for the taxable year of the third-tier corporation from which such dividends are paid which the amount of such dividends bears to the amount by which such accumulated profits of the third-tier corporation exceed the taxes so paid or accrued. For determining the amount of the foreign income taxes paid or accrued by such third-tier corporation on or with respect to the accumulated profits for the taxable year of such third-tier corporation, see paragraph (f) of this section.

(e) *Determination of accumulated profits of a foreign corporation.* The accumulated profits for any taxable year of a first-tier corporation and the accumulated profits for any taxable year of a second-tier or third-tier corporation, which are taken into account in applying paragraph (c)(2) or (d)(2) of this section with respect to such first-tier corporation, shall be the sum of—

(1) The earnings and profits of such corporation for such year, and

(2) The foreign income taxes imposed on or with respect to the gains, profits, and income to which such earnings and profits are attributable.

(f) *Taxes paid on or with respect to accumulated profits of a foreign corporation.* For purposes of this section, the amount of foreign income taxes paid or accrued on or with respect to the accumulated profits of a foreign corporation for any taxable year shall be the entire amount of the foreign income taxes paid or accrued for such year on or with respect to such gains, profits, and income. For purposes of this paragraph (f), the gains, profits, and income of a foreign corporation for any taxable year shall be determined after reduction by any income, war profits, or excess profits taxes imposed on or with respect to such gains, profits, and income by the United States.

(g) *Determination of earning and profits of a foreign corporation*—(1) *Taxable year to which section 963 does not apply.* For purposes of this section, the earnings and profits of a foreign corporation for any taxable year beginning after December 31, 1962, other than a taxable year to which paragraph (g)(2) of this section applies, may, if the domestic shareholder chooses, be determined under the rules provided by §1.964–1 exclusive of paragraphs (d) and (e) of such section. The translation of amounts so determined into United States dollars or other foreign currency shall be made at the proper exchange rate for the date of distribution with respect to which the determination is made.

(2) *Taxable year to which section 963 applies.* For any taxable year of a foreign corporation with respect to which there applies under §1.963–1(c)(1) an election by a corporate United States shareholder to exclude from its gross income for the taxable year the subpart F income of a controlled foreign corporation, the earnings and profits of such foreign corporation for such year with respect to such shareholder must be determined, for purposes of this section, under the rules provided by §1.964–1, even though the amount of the minimum distribution required under §1.963–2(a) to be received by such shareholder from such earnings and profits of such foreign corporation, or from the consolidated earnings and profits of the chain or group which includes such foreign corporation, is zero. Effective for taxable years of foreign corporations beginning after December 31, 1975, section 963 is repealed by section 602(a)(1) of the Tax Reduction Act of 1975 (89 Stat. 58); accordingly, this paragraph (g)(2) is inapplicable with respect to computing earnings and profits for such taxable years.

(3) *Time and manner of making choice.* The controlling United States shareholders (as defined in §1.964–1(c)(5)) of a foreign corporation shall make the choice referred to in paragraph (g)(1) of this section (including the elections permitted by §1.964–1 (b) and (c)) by filing a written statement to such effect with the Director of the Internal Revenue Service Center, 11601 Roosevelt Boulevard, Philadelphia, Pennsylvania 19155, within 180 days after the close of the first taxable year of the foreign corporation during which such shareholders receive a distribution of earnings and profits with respect to which the benefits of this section are claimed or on or before November 15, 1965, whichever is later. For purposes of this paragraph (g)(3), the 180-day period shall commence on the date of receipt of any distribution which is considered paid from the accumulated profits of a preceding year or years under paragraph (g)(4) of this section. See §1.964–1(c)(3) (ii) and (iii) for procedures requiring notification of the Director of the Internal Revenue Service Center and noncontrolling shareholders of action taken.

(4) *Determination by district director.* The district director in whose district is filed the income tax return of the domestic shareholder claiming a credit under section 901 for foreign income taxes deemed, under section 902 and this section, to be paid by such shareholder shall have the power to determine, with respect to a foreign corporation, from the accumulated profits of what taxable year or years the dividends were paid. In making such determination the district director shall, unless it is otherwise established to his satisfaction, treat any dividends which are paid in the first 60 days of any taxable year of such a corporation as having been paid from the accumulated profits of the preceding taxable year or years of such corporation and shall, in other respects, treat any dividends as having been paid from the most recently accumulated profits. For purposes of this paragraph (g)(4), in the case of a foreign corporation the foreign income taxes of which are determined on the basis of an accounting period of less than 1 year, the term ‘‘year’’ shall mean such accounting period. See sections 441 (b)(3) and 443.

(h) *Source of income from first-tier corporation and country to which tax is deemed paid*—(1) *Source of income.* For purposes of section 904(a)(1) (relating to the per-country limitation), in the case of a dividend received by a domestic shareholder from a first-tier corporation there shall be deemed to be derived from sources within the foreign country or possession of the United States under the laws of which the first-tier corporation is created or organized the sum of the amounts which under paragraph (a)(3)(ii) of §1.861–3 are treated, with respect to such dividend, as income from sources without the United States.

(2) *Country to which taxes deemed paid.* For purposes of section 904, all foreign income taxes paid, or deemed under paragraph (c) of this section to be paid, by a first-tier corporation shall be deemed to be paid to the foreign country or possession of the United States under the laws of which such first-tier corporation is created or organized.

(i) *United Kingdom income taxes paid with respect to royalties.* A taxpayer shall not be deemed under section 902 and this section to have paid any taxes with respect to which a credit is allowable to such taxpayer or any other taxpayer by virtue of section 905(b).

(j) *Information to be furnished.* If the credit for foreign income taxes claimed under section 901 includes taxes deemed, under paragraph (b)(2) of this section, to be paid, the domestic shareholder must furnish the same information with respect to such taxes as it is required to furnish with respect to the taxes actually paid or accrued by it and for which credit is claimed. See § 1.905–2. For other information required to be furnished by the domestic shareholder for the annual accounting period of certain foreign corporations ending with or within such shareholder's taxable year, and for reduction in the amount of foreign income taxes paid or deemed to be paid for failure to furnish such information, see section 6038 and the regulations thereunder.

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

Example 1. Throughout 1978, domestic corporation M owns all the one class of stock of foreign corporation A. Both corporations use the calendar year as the taxable year. Corporation A has accumulated profits, pays foreign income taxes, and pays dividends for 1978 as summarized below. For 1978, M Corporation is deemed, under paragraph (b)(2) of this section, to have paid $20 of the foreign income taxes paid by A Corporation for 1978 and includes such amount in gross income under section 78 as a dividend, determined as follows:

Gains, profits, and income of A Corp.	$100
Foreign income taxes imposed on or with respect to gains, profits, and income	40
Accumulated profits	100
Foreign income taxes paid on or with respect to accumulated profits (total foreign income taxes)	40
Accumulated profits in excess of foreign income taxes	60
Dividends paid to M Corp	30
Foreign income taxes of A Corp. deemed paid by M Corp. under section 902(a) ($40×$30/$60)	20

Example 2. The facts are the same as in example 1, except that M Corporation also owns all the one class of stock of foreign corporation B which also uses the calendar year as the taxable year. Corporation B has accumulated profits, pays foreign income taxes, and pays dividends for 1978 as summarized below. For 1978, M Corporation is deemed under paragraph (b)(2) of this section, to have paid $20 of the foreign income taxes paid by A Corporation for 1978 and to have paid $50 of the foreign income taxes paid by B Corporation for 1978, and includes $70 in gross income as a dividend under section 78, determined as follows:

B CORPORATION

Gains, profits and income	$200
Foreign income taxes imposed on or with respect to gains, profits, and income	100
Accumulated profits	200
Foreign income taxes paid by B Corp. on or with respect to accumulated profits	100
Accumulated profits in excess of foreign income taxes	100
Dividends paid to M Corp	50
Foreign income taxes of B Corporation deemed paid by M Corporation under section 902(a) ($100×$50/$100)	50

M CORPORATION

Foreign income taxes deemed paid under section 902(a):.	
Taxes of A Corp. (from example 1)	$20
Taxes of B Corp. (as determined above)	50
Total	70
Foreign income taxes included in gross income under section 78 as a dividend:	
Taxes of A Corp. (from example 1)	20
Taxes of B Corp	50
Total	70

Example 3. For 1978, domestic corporation M owns all the one class of stock of foreign corporation A, which in turn owns all the one class of stock of foreign corporation B. All corporations use the calendar year as the taxable year. For 1978, M Corporation is deemed under paragraph (b)(2) of this section to have paid $50 of the foreign income taxes paid, or deemed under paragraph (c)(2) of this section to be paid, by A Corporation for such year and includes such amount in gross income as a dividend under section 78, determined as follows upon the basis of the facts assumed:

B Corp. (second-tier corporation):	
Gains, profits, and income	$300
Foreign income taxes imposed on or with respect to gains, profits, and income	120
Accumulated profits	300
Foreign income taxes paid by B Corp. on or with respect to its accumulated profits (total foreign income taxes)	120

Accumulated profits in excess of foreign income taxes	180
Dividends paid on December 31, 1978 to A Corp.	90
Foreign income taxes of B Corp. deemed paid by A Corp. for 1978 under section 902(b)(1) ($120×$90/$180)	60
A Corp. (first-tier corporation):	
Gains, profits, and income:	
Business operations	200
Dividends from B Corp.	90
Total	290
Foreign income taxes imposed on or with respect to gains, profits, and income	40
Accumulated profits	$290
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits (total foreign income taxes)	40
Accumulated profits in excess of foreign income taxes	250
Foreign income taxes paid, and deemed to be paid, by A Corp. for 1978 on or with respect to its accumulated profits for such year ($60+$40)	100
Dividends paid on Deember. 31, 1978, to M Corp.	125
M Corp. (domestic shareholder):	
Foreign income taxes of A Corp. deemed paid by M Corp. for 1978 under section 902(a) ($100×$125/$250)	50
Foreign income taxes included in gross income of M Corp. under section 78 as a dividend received from A Corp.	50

Example 4. Throughout 1978, domestic corporation M owns 50 percent of the voting stock of foreign corporation A, not a less developed country corporation. A Corporation has owned 40 percent of the voting stock of foreign corporation B, since 1970; B Corporation has owned 30 percent of the voting stock of foreign corporation C, since 1972. B Corporation, uses a fiscal year ending on June 30 as its taxable year; all other corporations use the calendar year as the taxable year. On February 1, 1977, B Corporation receives a dividend from C Corporation out of C Corporation's accumulated profits for 1976. On February 15, 1977, A Corporation receives a dividend from B Corporation out of B Corporation's accumulated profits for its fiscal year ending in 1977. On February 15, 1978, M Corporation receives a dividend from A Corporation out of A Corporation's accumulated profits for 1977. For 1978, M Corporation is deemed under paragraph (b)(2) of this section to have paid $81.67 of the foreign income taxes paid, or deemed under paragraph (c)(2) of this section to be paid, by A Corporation on or with respect to its accumulated profits for 1977, and M Corporation includes that amount in gross income as a dividend under section 78, determined as follows upon the basis of the facts assumed:

C Corp. (third-tier corporation):	
Gains, profits, and income for 1976	$2,000.00
Foreign income taxes imposed on or with respect to such gains, profits, and income	800.00
Accumulated profits	2,000.00
Foreign income taxes paid by C Corp. on or with respect to its accumulated profits (total foreign income taxes)	800.00
Accumulated profits in excess of foreign income taxes	1,200.00
Dividends paid on Feb. 1, 1977 to B Corp	150.00
Foreign income taxes of C Corp. for 1976 deemed paid by B Corp. for its fiscal year ending in 1977 ($800×$150/$1,200)	100.00
B Corp. (second-tier corporation):	
Gains, profits, and income for fiscal year ending in 1977:	
Business operations	850.00
Dividends from C Corp	150.00
Total	1,000.00
Foreign income taxes imposed on or with respect to gains, profits, and income	200.00
Accumulated profits	1,000.00
Foreign income taxes paid by B Corp. on or with respect to its accumulated profits (total foreign income taxes)	$200.00
Accumulated profits in excess of foreign income taxes	800.00
Foreign income taxes paid, and deemed to be paid, by B Corp. for its fiscal year on or with respect to its accumulated profits for such year ($100+$200)	300.00
Dividends paid on February 15, 1977 to A Corp	120.00
Foreign income taxes of B Corp. for its fiscal year deemed paid by A Corp. for 1977 ($300×$120/$800)	45.00
A Corp. (first-tier corporation):	
Gains, profits, and income for 1977:	
Business operations	380.00
Dividends from B Corp	120.00
Total	500.00
Foreign income taxes imposed on or with respect to gains, profits, and income	200.00
Accumulated profits	500.00
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits (total foreign income taxes)	200.00
Accumulated profits in excess of foreign taxes	300.00
Foreign income taxes paid, and deemed to be paid, by A Corp. for 1977 on or with respect to its accumulated profits for such year ($45+$200)	245.00
Dividends paid on Feb. 15, 1978 to M Corp	100.00
M Corp. (domestic shareholder):	
Foreign income taxes of A Corp. for 1977 deemed paid by M Corp. for 1978 under section 902(a)(1) ($245×$100/$300)	81.67
Foreign income taxes included in gross income of M Corp. under section 78 as a dividend received from A Corp	81.67

(l) *Effective date.* Except as provided in §1.902–4, this section applies to any distribution received from a first-tier corporation by its domestic shareholder after December 31, 1964, and before the beginning of the foreign corporation's first taxable year beginning after December 31, 1986. If, however, the first day on which the ownership requirements of section 902(c)(3)(B) and §1.902–1(a)(1) through (4) are met with respect to the foreign corporation is in a taxable year of the foreign corporation beginning after December 31, 1986, then this section shall apply to all taxable years beginning after December 31, 1964, and before the year in which the ownership requirements are first met. See § 1.902–1(a)(13)(i). For corresponding rules applicable to distributions received by the domestic shareholder prior to January 1, 1965, see § 1.902–5 as contained in the 26 CFR part 1 edition revised April 1, 1976.

[T.D. 7481, 42 FR 20125, Apr. 18, 1977, as amended by T.D. 7490, 42 FR 30497, June 15, 1977; T.D. 7649, 44 FR 60086, Oct. 18, 1979. Redesignated and amended by T.D. 8708, 62 FR 927, 940, Jan. 7, 1997; 62 FR 7155, Feb. 18, 1997]

§ 1.902–4 Rules for distributions attributable to accumulated profits for taxable years in which a first-tier corporation was a less developed country corporation.

(a) *In general.* If a domestic shareholder receives a distribution from a first-tier corporation before January 1, 1978, in a taxable year of the domestic shareholder beginning after December 31, 1964, which is attributable to accumulated profits of the first-tier corporation for a taxable year beginning before January 1, 1976, in which the first-tier corporation was a less developed country corporation (as defined in 26 CFR § 1.902–2 revised as of April 1, 1978), then the amount of the credit deemed paid by the domestic shareholder with respect to such distribution shall be calculated under the rules relating to less developed country corporations contained in (26 CFR § 1.902–1 revised as of April 1, 1978).

(b) *Combined distributions.* If a domestic shareholder receives a distribution before January 1, 1978, from a first-tier corporation, a portion of which is described in paragraph (a) of this section, and a portion of which is attributable to accumulated profits of the first-tier corporation for a year in which the first-tier corporation was not a less developed country corporation, then the amount of taxes deemed paid by the domestic shareholder shall be computed separately on each portion of the dividend. The taxes deemed paid on that portion of the dividend described in paragraph (a) shall be computed as specified in paragraph (a). The taxes deemed paid on that portion of the dividend described in this paragraph (b), shall be computed as specified in § 1.902–3.

(c) *Distributions of a first-tier corporation attributable to certain distributions from second- or third-tier corporations.* Paragraph (a) shall apply to a distribution received by a domestic shareholder before January 1, 1978, from a first-tier corporation out of accumulated profits for a taxable year beginning after December 31, 1975, if:

(1) The distribution is attributable to a distribution received by the first-tier corporation from a second- or third-tier corporation in a taxable year beginning after December 31, 1975.

(2) The distribution from the second- or third-tier corporation is made out of accumulated profits of the second- or third-tier corporation for a taxable year beginning before January 1, 1976, and

(3) The first-tier corporation would have qualified as a less developed country corporation under section 902(d) (as in effect on December 31, 1975), in the taxable year in which it received the distribution.

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

Example 1. M, a domestic corporation owns all of the one class of stock of foreign corporation A. Both corporations use the calendar year as the taxable year. A Corporation pays a dividend to M Corporation on January 1, 1977, partly out of its accumulated profits for calendar year 1976 and partly out of its accumulated profits for calendar year 1975. For 1975 A Corporation qualified as a less developed country corporation under the former section 902(d) (as in effect on December 31, 1975). M Corporation is deemed under paragraphs (a) and (b) of this section to have paid $63 of foreign income taxes paid by A Corporation on or with respect to its accumulated profits for 1976 and 1975 and M Corporation includes $36 of that amount in gross income as a dividend under section 78, determined as follows upon the basis of the facts assumed:

1976	
Gains, profits, and income of A Corp. for 1976	$120.00
Foreign income taxes imposed on or with respect to such gains, profits, and income	36.00
Accumulated profits	120.00
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits (total foreign income taxes)	36.00
Accumulated profits in excess of foreign income taxes	84.00
Dividend to M Corp. out of 1976 accumulated profits	84.00
Foreign income taxes of A for 1976 deemed paid by M Corp. ($84/$84×$36)	36.00
Foreign income taxes included in gross income of M Corp. under section 78 as a dividend from A Corp	36.00

1975

Gains, profits, and income of A Corp. for 1975	$257.14
Foreign income taxes imposed on or with respect to such gains, profits, and income	77.14
Accumulated profits (under section 902(c)(1)(B) as in effect prior to amendment by the Tax Reform Act of 1976)	180.00
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits ($77.14×$180/$257.14)	54.00
Dividend to M Corp. out of accumulated profits of A Corp. for 1975	90.00
Foreign income taxes of A Corp. for 1975 deemed paid by M Corp. (under section 902(a)(2) as in effect prior to amendment by the Tax Reform Act of 1976) ($54×$90/$180)	27.00
Foreign income taxes included in gross income of M Corp. under section 78 as a dividend from A Corp	0

Example 2. The facts are the same as in example 1, except that the distribution from A Corporation to M Corporation on January 1, 1977, was from accumulated profits of A Corporation for 1976. A Corporation's accumulated profits for 1976 were made up of income from its trade or business, and a dividend paid by B, a second-tier corporation in 1976. The dividend from B Corporation to A Corporation was from accumulated profits of B Corporation for 1975. A Corporation would have qualified as a less developed country corporation for 1976 under the former section 902(d) (as in effect on December 31, 1975). M Corporation is deemed under paragraphs (b) and (c) of this section to have paid $543 of the foreign taxes paid or deemed paid by A Corporation on or with respect to its accumulated profits for 1976, and M Corporation includes $360 of that amount in gross income as a dividend under section 78, determined as follows upon the basis of the facts assumed:

Total gains, profits, and income of A Corp. for 1976	$1,500
Gains and profits from business operations	1,200
Gains and profits from dividend A Corp. received in 1976 from B Corp. out of accumulated profits of B Corp. for 1975	300
Foreign taxes imposed on or with respect to such profits and income	450
Foreign taxes paid by A Corp. attributable to gains and profits from A Corp.'s business operations	360
Foreign taxes paid by A Corp. attributable to dividend from B Corp. in 1976	90
Dividends from A Corp. to M Corp. on Jan. 1, 1977	1,050
Portion of dividend attributable to gains and profits of A Corp. from business operations. ($1,200/$1,500×$1,050)	840
Portion of dividends attributable to gains on profits of A Corp. from dividend from B Corp. ($300/$1,500×$1,050)	210

(a) *Amount of foreign taxes of A Corp. deemed paid by M Corp. on A Corp.'s gains and profits for 1976 from business operations.*

Gains, profits, and income of A Corp. from business operations	$1,200
Foreign income taxes imposed on or with respect to gains, profits, and income	360
Accumulated profits	1,200
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits (total foreign income taxes)	360
Accumulated profits in excess of foreign income taxes	840
Dividend to M Corp	840
Foreign taxes of A Corp. deemed paid by M Corp. ($360 × $840/$840)	360
Foreign taxes included in gross income of M Corp. under section 78 as a dividend	360

(b) *Amount of foreign taxes of A Corp. deemed paid by M Corp. on portion of the dividend attributable to B Corp.'s accumulated profits for 1975.*

B Corp. (second-tier corporation):	
Gains, profits, and income for calendar year 1975	$1,000
Foreign income taxes imposed on or with respect to gains, profits, and income	400
Accumulated profits (under section 902(c)(1)(B) as in effect prior to amendment by the Tax Reform Act of 1976)	600
Foreign income taxes paid by B Corp. on or with respect to its accumulated profits ($400 × $600/$1,000)	240
Dividend to A Corp. in 1976	300
Foreign taxes of B Corp. for 1975 deemed paid by A Corp. (under section 902(b)(1)(B) as in effect prior to amendment by the Tax Reform Act of 1976) ($240 × $300/$600)	120
A Corp. (first-tier corporation):	
Gains, profits, and income for 1976 attributable to dividend from B Corp.'s accumulated profits for 1975	300
Foreign income taxes imposed on or with respect to such gains, profits, and income	90
Accumulated profits (under section 902(c)(1)(B) as in effect prior to amendment by the Tax Reform Act of 1976)	210
Foreign taxes paid by A Corp. on or with respect to such accumulated profits ($90 × $210/$300)	63
Foreign income taxes paid and deemed to be paid by A Corp. for 1976 on or with respect to such accumulated profits ($120 + $63)	183
Dividend paid to M Corp. attributable to dividend from B Corp. out of accumulated profits for 1975)	210
Foreign taxes of A Corp. deemed paid by M Corp. (under section 902(a)(2) as in effect prior to amendment by the Tax Reform Act of 1976) ($183 × $210/$210)	183
Amount included in gross income of M Corp. under section 78	0

[T.D. 7649, 44 FR 60087, Oct. 18, 1979. Redesignated and amended by T.D. 8708, 62 FR 927, 940, Jan. 7, 1997]

§1.903–1 Taxes in lieu of income taxes.

(a) *In general.* Section 903 provides that the term "income, war profits, and excess profits taxes" shall include a tax paid in lieu of a tax on income, war profits, or excess profits ("income tax") otherwise generally imposed by any foreign country. For purposes of this section and §§1.901–2 and 1.901–2A, such a tax is referred to as a ''tax in lieu of an income tax''; and the terms ''paid'' and ''foreign country'' are defined in §1.901–2(g). A foreign levy (within the meaning of § 1.901–2(g)(3)) is a tax in lieu of an income tax if and only if—

(1) It is a tax within the meaning of § 1.901–2(a)(2); and

(2) It meets the substitution requirement as set forth in paragraph (b) of this section.

The foreign country's purpose in imposing the foreign tax (*e.g.*, whether it imposes the foreign tax because of administrative difficulty in determining the base of the income tax otherwise generally imposed) is immaterial. It is also immaterial whether the base of the foreign tax bears any relation to realized net income. The base of the tax may, for example, be gross income, gross receipts or sales, or the number of units produced or exported. Determinations of the amount of a tax in lieu of an income tax that is paid by a person and determinations of the person by whom such tax is paid are made under § 1.901–2 (e) and (f), respectively, substituting the phrase ''tax in lieu of an income tax'' for the phrase ''income tax'' wherever the latter appears in those sections. Section 1.901–2A contains additional rules applicable to dual capacity taxpayers (as defined in § 1.901–2(a)(2)(ii) (A)). The rules of this section are applied independently to each separate levy (within the meaning of §§ 1.901–2(d) and 1.901–2A (a)) imposed by the foreign country. Except as otherwise provided in paragraph (b)(2) of this section, a foreign tax either is or is not a tax in lieu of an income tax in its entirety for all persons subject to the tax.

(b) *Substitution—(1) In general.* A foreign tax satisfies the substitution requirement if the tax in fact operates as a tax imposed in substitution for, and not in addition to, an income tax or a series of income taxes otherwise generally imposed. However, not all income derived by persons subject to the foreign tax need be exempt from the income tax. If, for example, a taxpayer is subject to a generally imposed income tax except that, pursuant to an agreement with the foreign country, the taxpayer's income from insurance is subject to a gross receipts tax and not to the income tax, then the gross receipts tax meets the substitution requirement notwithstanding the fact that the taxpayer's income from other activities, such as the operation of a hotel, is subject to the generally imposed income tax. A comparison between the tax burden of this insurance gross receipts tax and the tax burden that would have obtained under the generally imposed income tax is irrelevant to this determination.

(2) *Soak-up taxes.* A foreign tax satisfies the substitution requirement only to the extent that liability for the foreign tax is not dependent (by its terms or otherwise) on the availability of a credit for the foreign tax against income tax liability to another country. If, without regard to this paragraph (b)(2), a foreign tax satisfies the requirement of paragraph (b)(1) of this section (including for this purpose any foreign tax that both satisfies such requirement and also is an income tax within the meaning of § 1.901–2(a)(1)), liability for the foreign tax is dependent on the availability of a credit for the foreign tax against income tax liability to another country only to the extent of the lesser of—

(i) The amount of foreign tax that would not be imposed on the taxpayer but for the availability of such a credit to the taxpayer (within the meaning of § 1.901–2(c)), or

(ii) The amount, if any, by which the foreign tax paid by the taxpayer exceeds the amount of foreign income tax that would have been paid by the taxpayer if it had instead been subject to the generally imposed income tax of the foreign country.

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

Example 1. Country X has a tax on realized net income that is generally imposed except that nonresidents are not subject to that tax. Nonresidents are subject to a gross income tax on income from country X that is not attributable to a trade or business carried on in country X. The gross income tax imposed on nonresidents satisfies the substitution requirement set forth in this paragraph (b). See also examples 1 and 2 of § 1.901–2(b)(4)(iv).

Example 2. The facts are the same as in example 1, with the additional fact that payors located in country X are required by country X law to withhold the gross income tax from payments they make to nonresidents, and to remit such withheld tax to the government of country X. The result is the same as in example 1.

Example 3. The facts are the same as in example 2, with the additional fact that the gross income tax on nonresidents applies to payments for technical services performed by them outside of country X. The result is the same as in example 2.

Example 4. Country X has a tax that is generally imposed on the realized net income of nonresident corporations that is attributable to a trade or business carried on in country X. The tax applies to all nonresident corporations that engage in business in country X except for such corporations that engage in contracting activities, each of which is instead subject to two different taxes. The taxes applicable to nonresident corporations that engage in contracting activities satisfy the substitution requirement set forth in this paragraph (b).

Example 5. Country X imposes both an excise tax and an income tax. The excise tax, which is payable independently of the income tax,is allowed as a credit against the income tax. For 1984 *A* has a tentative income tax liability of 100u (units of country X currency) but is allowed a credit for 30u of excise tax that it has paid. Pursuant to paragraph (e)(4)(i) of §1.901–2, the amount of excise tax *A* has paid to country X is 30u and the amount of income tax *A* has paid to country X is 70u. The excise tax paid by *A* does not satisfy the substitution requirement set forth in this paragraph (b) because the excise tax is imposed on *A* in addition to, and not in substitution for, the generally imposed income tax.

Example 6. Pursuant to a contract with country X, *A*, a domestic corporation engaged in manufacturing activities in country X, must pay tax to country X equal to the greater of (i) 5u (units of country X currency) per item produced, or (ii) the maximum amount creditable by *A* against its U.S. income tax liability for that year with respect to income from its country X operations. Also pursuant to the contract, *A* is exempted from country X's otherwise generally imposed income tax. *A* produces 16 items in 1984 and the maximum amount creditable by *A* against its U.S. income tax liability for 1984 is 125u. If *A* had been subject to country X's otherwise generally imposed income tax it would have paid a tax of 150u. Pursuant to paragraph (b)(2) of this section, the amount of tax paid by *A* that is dependent on the availability of a credit against income tax of another country is 0 (lesser of (i) 45u, the amount that would not be imposed but for the availability of a credit (125u–80u), or (ii) 0, the amount by which the contractual tax (125u) exceeds the generally imposed income tax (150u)).

Example 7. The facts are the same as in example 6 except that, of the 150u *A* would have paid if it had been subject to the otherwise generally imposed income tax, 60u is dependent on the availability of a credit against income tax of another country. The amount of tax actually paid by *A* (*i.e.*, 125u) that is dependent on the availability of a credit against income tax of another country is 35u (lesser of (i) 45u, computed as in example , §6, or (ii) 35u, the amount by which the contractual tax (125u) exceeds the amount *A* would have paid as income tax if it had been subject to the otherwise generally imposed income tax (90u, *i.e.*, 150u–60u).

(c) *Effective date.* The effective date of this section is as provided in §1.901–2(h).

[T.D. 7918, 48 FR 46295, Oct. 12, 1983; 48 FR 52033, Nov. 16, 1983]

§1.904–0 Outline of regulation provisions for section 904.

This section lists the regulations under section 904–0 of the Internal Revenue Code of 1986.

§1.904–1 Limitation on credit for foreign taxes.

(a) Per-country limitation.
(1) General.
(2) Illustration of principles.
(b) Overall limitation.
(1) General.
(2) Illustration of principles.
(c) Special computation of taxable income.
(d) Election of overall limitation.
(1) In general.
(i) Manner of making election.
(ii) Revocation for first taxable year beginning after December 31, 1969.
(2) Method of making the initial election.
(3) Method of revoking an election and making a new election.
(e) Joint return.
(1) General.
(2) Electing the overall limitation.

§1.904–2 Carryback and carryover of unused foreign tax.

(a) Credit for foreign tax carryback or carryover.
(b) Years to which carried.
(1) General.
(2) Definitions.
(3) Taxable years beginning before January 1, 1958.
(c) Tax deemed paid or accrued.
(1) Unused foreign tax for per-country limitation year.

(2) Unused foreign tax for overall limitation year.
(3) Unused foreign tax with respect to foreign mineral income.
(d) Determination of excess limitation for certain years.
(e) Periods of less than 12 months.
(f) Statement with tax return.
(g) Illustration of carrybacks and carryovers.

§ 1.904–3 Carryback and carryover of unused foreign tax by husband and wife.

(a) In general.
(b) Joint unused foreign tax and joint excess limitation.
(c) Continuous use of joint return.
(d) From separate to joint return.
(e) Amounts carried from or through a joint return year to or through a separate return year.
(f) Allocation of unused foreign tax and excess limitation.
(1) Limitation.
(i) Per-country limitation.
(ii) Overall limitation.
(2) Unused foreign tax.
(i) Per-country limitation.
(ii) Overall limitation.
(3) Excess limitation.
(i) Per-country limitation taxpayer.
(ii) Overall limitation.
(4) Excess limitation to be applied.
(5) Reduction of excess limitation.
(6) Spouses using different limitations.
(g) Illustrations.

§ 1.904–4 Separate application of section 904 with respect to certain categories of income.

(a) In general.
(b) Passive income.
(1) In general.
(i) Rule.
(ii) Example.
(2) Active rents or royalties.
(i) In general.
(ii) Exception for certain rents and royalties.
(iii) Unrelated person.
(iv) Example.
(c) High-taxed income.
(1) In general.
(2) Grouping of items of income in order to determine whether passive income is high-taxed income.
(i) Effective dates.
(A) In general.
(B) Application to prior periods.
(ii) Grouping rules.
(A) Initial allocation and apportionment of deductions and taxes.
(B) Reallocation of loss groups.
(3) Amounts received or accrued by United States persons.
(4) Income of controlled foreign corporations and foreign QBUs.
(5) Special rules.
(i) Certain rents and royalties.
(ii) Treatment of partnership income.
(iii) Currency gain or loss.
(iv) Certain passive dividends.
(6) Application of this paragraph to additional taxes paid or deemed paid in the year of receipt of previously taxed income.
(i) Determination made in year of inclusion.
(ii) Exception.
(iii) Allocation of foreign taxes imposed on distributions of previously taxed income.
(iv) Increase in taxes paid by successors.
(7) Application of this paragraph to certain reductions of tax on distributions of income.
(i) In general.
(ii) Allocation of reductions of foreign tax.
(iii) Interaction with section 954(b)(4).
(8) Examples.
(d) High withholding tax interest.
(e) Financial services income.
(1) In general.
(2) Active financing income.
(i) Income included.
(3) Financial services entities.
(i) In general.
(ii) Special rule for affiliated groups.
(iii) Treatment of partnerships and other pass-through entities.
(A) Rule.
(B) Examples.
(iv) Examples.
(4) Definition of incidental income.
(i) In general.
(A) Rule.
(B) Examples.
(ii) Income that is not incidental income.
(5) Exceptions.
(f) Shipping income.
(g) Non-controlled section 902 corporations.
(1) Definition.
(2) Treatment of dividends for each separate noncontrolled section 902 corporation.
(i) In general.
(ii) Special rule for dividends received by a controlled foreign corporation.
(iii) Special rule for high withholding tax interest.
(iv) Treatment of inclusions under section 1293.
(3) Special rule for controlled foreign corporations.
(i) General rule.
(ii) Dividend distributions out of earnings and profits for a year during which a shareholder that is currently a more-than-90-percent United States shareholder was not a United States shareholder.
(iii) Ordering rule.
(iv) Examples.
(4) Examples.
(h) Export financing interest.
(1) Definitions.

(i) Export financing.
(ii) Fair market value.
(iii) Related person.
(2) Treatment of export financing interest.
(3) Exceptions.
(i) Export financing interest that is high withholding tax interest.
(ii) Export financing interest that is also related person factoring income.
(iii) Export financing interest that is related person factoring income and is received or accrued by a financial services entity.
(iv) Export financing interest that is related person factoring income and high withholding tax interest.
(4) Examples.
(5) Income eligible for section 864(d)(7) exception (same country exception) from related person factoring treatment.
(i) Income other than interest.
(ii) Interest income.
(iii) Examples.
(i) Interaction of section 907(c) and income described in this section.
(j) Special rule for certain currency gains and losses.
(k) Special rule for alternative minimum tax foreign tax credit.
(l) Priority rules.
(1) In general.
(2) Examples.

§1.904–5 Look-through rules as applied to controlled foreign corporations and other entities.

(a) Definitions.
(b) In general.
(c) Rules for specific types of inclusions and payments.
(1) Subpart F inclusions.
(i) Rule.
(ii) Examples.
(2) Interest.
(i) In general.
(ii) Allocating and apportioning expenses including interest paid to a related person.
(iii) Definitions.
(A) Value of assets and reduction in value of assets and gross income.
(B) Related person debt allocated to passive assets.
(iv) Examples.
(3) Rents and royalties.
(4) Dividends.
(i) Look-through rule.
(ii) Special rule for dividends attributable to certain loans.
(iii) Examples.
(d) Effect of exclusions from Subpart F income.
(1) De minimis amount of Subpart F income.
(2) Exception for certain income subject to high foreign tax.
(3) Examples.
(e) Treatment of Subpart F income in excess of 70 percent of gross income.
(1) Rule.
(2) Example.
(f) Modifications of look-through rules for certain income.
(1) High withholding tax interest.
(2) Dividends from a non-controlled section 902 corporation.
(i) Rule.
(ii) Example.
(3) Distributions from a FSC.
(4) Example.
(g) Application of the look-through rules to certain domestic corporations.
(h) Application of the look-through rules to partnerships and other pass-through entities.
(1) General rule.
(2) Exception for certain partnership interests.
(i) Rule.
(ii) Exceptions.
(3) Income from the sale of a partnership interest.
(4) Value of a partnership interest.
(i) Application of look-through rules to related entities.
(1) In general.
(2) Exception for distributive shares of partnership income.
(3) Special rule for dividends.
(4) Examples.
(j) Look-through rules applied to passive foreign investment company inclusions.
(k) Ordering rules.
(1) In general.
(2) Specific rules.
(l) Examples.
(m) Application of section 904(g).
(1) In general.
(2) Treatment of interest payments.
(3) Examples.
(4) Treatment of dividend payments.
(i) Rule.
(ii) Determination of earnings and profits from United States sources.
(iii) Example.
(5) Treatment of Subpart F inclusions.
(i) Rule.
(ii) Example.
(6) Treatment of section 78 amount.
(7) Coordination with treaties.
(i) Rule.
(ii) Example.
(n) Order of application of sections 904 (d) and (g).
(o) Effective date.

§1.904–6 Allocation and apportionment of taxes.

(a) Allocation and apportionment of taxes to a separate category or categories of income.
(1) Allocation of taxes to a separate category or categories of income.
(i) Taxes related to a separate category of income.

(ii) Apportionment of taxes related to more than one separate category.

(iii) Apportionment of taxes for purposes of applying the high tax income test.

(iv) Special rule for base and timing differences.

(2) Treatment of certain dividends from noncontrolled section 902 corporations.

(b) Application of paragraph (a) to sections 902 and 960.

(1) Determination of foreign taxes deemed paid.

(2) Distributions received from foreign corporations that are excluded from gross income under section 959(b).

(3) Application of section 78.

(4) Increase in limitation.

(c) Examples.

§ 1.904–7 Transition rules.

(a) Characterization of distributions and section 951(a)(1)(A) (ii) and (iii) and (B) inclusions of earnings of a controlled foreign corporation accumulated in taxable years beginning before January 1, 1987, during taxable years of both the payor controlled foreign corporation and the recipient which begin after December 31, 1986.

(1) Distributions and section 951(a)(1)(A) (ii) and (iii) and (B) inclusions.

(2) Limitation on establishing the character of earnings and profits.

(b) Application of look-through rules to distributions (including deemed distributions) and payments by an entity to a recipient when one's taxable year begins before January 1, 1987 and the other's taxable year begins after December 31, 1986.

(1) In general.

(2) Payor of interest, rents, or royalties is subject to the Act and recipient is not subject to the Act.

(3) Recipient of interest, rents, or royalties is subject to the Act and payor is not subject to the Act.

(4) Recipient of dividends and subpart F inclusions is subject to the Act and payor is not subject to the Act.

(5) Examples.

(c) Installment sales.

(d) Special effective date for high withholding tax interest earned by persons with respect to qualified loans described in section 1201(e)(2) of the Act.

(e) Treatment of certain recapture income.

§ 1.904(b)–1 Treatment of capital gains for corporations.

(a) In general.

(1) Inclusion in foreign source taxable income.

(2) Inclusion in entire taxable income.

(3) Treatment of capital losses.

(b) Definitions.

(1) Capital gain net income.

(2) Foreign source capital gain net income.

(3) Net capital gain.

(4) Foreign source net capital gain.

(5) Rate differential portion.

(6) Net capital loss.

(7) Allocation and apportionment.

(8) Computation of net section 1231 gain.

(c) Illustrations.

§ 1.904(b)–2 Treatment of capital gains for other taxpayers.

(a) In general.

(1) Inclusion in foreign source taxable income.

(2) Inclusion in entire taxable income.

(3) Treatment of capital losses.

(b) Definition of net capital loss.

(c) Illustrations.

§ 1.904(b)–3 Sale of personal property.

(a) General rule.

(b) Special rules.

(c) Exception.

(d) Application of source rules.

(e) Gain from liquidation of certain foreign corporations.

(f) Residence defined.

(g) Tax rate applicable to gain.

(h) Country in which gross income derived.

§ 1.904(b)–4 Effective date.

§ 1.904(f)–1 Overall foreign loss and the overall foreign loss account.

(a) Overview of regulations.

(b) Overall foreign loss accounts.

(c) Determination of a taxpayer's overall foreign loss.

(1) Overall foreign loss defined.

(2) Separate limitation defined.

(3) Method of allocation and apportionment of deductions.

(d) Additions to the overall foreign loss account.

(1) General rule.

(2) Overall foreign net capital loss.

(3) Overall foreign losses of another taxpayer.

(4) Additions to overall foreign loss account created by loss carryovers.

(5) Adjustments.

(i) Adjustment due to reduction in foreign source income under section 904(b).

(ii) Adjustment to account for rate differential between ordinary income rate and capital gain rate.

(e) Reductions of overall foreign loss accounts.

(1) Pre-recapture reduction for amounts allocated to other taxpayers.

(2) Reduction for amounts recaptured.

(f) Illustrations.

§1.904(f)–2 Recapture of overall foreign losses.

(a) In general.
(b) Determination of taxable income from sources without the United States for purposes of recapture.
(1) In general.
(c) Section 904(f)(1) recapture.
(1) In general.
(2) Election to recapture more of the overall foreign loss than is required under paragraph (c)(1).
(3) Special rule for recapture of losses incurred prior to section 936 election.
(4) Recapture of pre-1983 overall foreign losses determined on a combined basis.
(5) Illustrations.
(d) Recapture of overall foreign losses from dispositions under section 904(f)(3).
(1) In general.
(2) Treatment of net capital gain.
(3) Dispositions where gain is recognized irrespective of section 904(f)(3).
(4) Dispositions in which gain would not otherwise be recognized.
(i) Recognition of gain to the extent of the overall foreign loss account.
(ii) Basis adjustment.
(iii) Recapture of overall foreign loss to the extent of amount recognized.
(iv) Priorities among dispositions in which gain is deemed to be recognized.
(5) Definitions.
(i) Disposition.
(ii) Property used in a trade or business.
(iii) Property used predominantly outside the United States.
(iv) Property which is a material factor in the realization of income.
(6) Carryover of overall foreign loss accounts in a corporate acquisition to which section 381(a) applies.
(7) Illustrations.

§1.904(f)–3 Allocation of net operating losses and net capital losses.

(a) Allocation of net operating loss carrybacks and carryovers that include overall foreign losses.
(b) Allocation of net capital loss carrybacks and carryovers that include overall foreign losses.
(c) Transitional rule.
(d) Illustrations.

§1.904(f)–4 Recapture of foreign losses out of accumulation distributions from a foreign trust.

(a) In general.
(b) Effect of recapture on foreign tax credit limitation under section 667(d).
(c) Recapture if taxpayer deducts foreign taxes deemed distributed.
(d) Illustrations.

§1.904(f)–5 Special rules for recapture of overall foreign losses of a domestic trust.

(a) In general.
(b) Recapture of trust's overall foreign loss.
(1) Trust accumulates income.
(2) Trust distributes income.
(3) Trust accumulates and distributes income.
(c) Amounts allocated to beneficiaries.
(d) Section 904(f)(3) dispositions to which §1.904(f)–2(d)(4)(i) is applicable.
(e) Illustrations.

§1.904(f)–6 Transitional rule for recapture of FORI and general limitation overall foreign losses incurred in taxable year beginning before January 1, 1983, from foreign source taxable income subject to the general limitation in taxable years beginning after December 31, 1982.

(a) General Rule.
(b) Recapture of pre-1983 FORI and general limitation overall foreign losses from post-1982 income.
(1) Recapture from income subject to the same limitation.
(2) Recapture from income subject to the other limitation.
(c) Coordination of recapture of pre-1983 and post-1982 overall foreign losses.
(d) Illustrations.

§1.904(f)–12 Transition rules.

(a) Recapture in years beginning after December 31, 1986, of overall foreign losses incurred in taxable years beginning before January 1, 1987.
(1) In general.
(2) Rule for general limitation losses.
(i) In general.
(ii) Exception.
(3) Priority of recapture of overall foreign losses incurred in pre-effective date taxable years.
(4) Examples.
(b) Treatment of overall foreign losses that are part of net operating losses incurred in pre-effective date taxable years which are carried forward to post-effective date taxable years.
(1) Rule.
(2) Example.
(c) Treatment of overall foreign losses that are part of net operating losses incurred in post-effective date taxable years which are carried back to pre-effective date taxable years.
(1) Allocation to analogous income category.
(2) Allocation to U.S. source income.
(3) Allocation to other separate limitation categories.
(4) Examples.
(d) Recapture of FORI and general limitation overall foreign losses incurred in taxable years beginning before January 1, 1983.
(e) Recapture of pre-1983 overall foreign losses determined on a combined basis.

(f) Transition rules for taxable years beginning before December 31, 1990.

§ 1.904(i)–1 Limitation on use of deconsolidation to avoid foreign tax credit limitations.

(a) General rule.
(1) Determination of taxable income.
(2) Allocation.
(b) Definitions and special rules.
(1) Affiliate.
(i) Generally.
(ii) Rules for consolidated groups.
(iii) Exception for newly acquired affiliates.
(2) Includible corporation.
(c) Taxable years.
(d) Consistent treatment of foreign taxes paid.
(e) Effective date.

[T.D. 8412, 57 FR 20642, May 14, 1992, as amended by T.D. 8627, 60 FR 56119, Nov. 7, 1995; T.D. 8805, 64 FR 1515, Jan. 11, 1999]

§ 1.904–1 Limitation on credit for foreign taxes.

(a) *Per-country limitation*—(1) *General.* In the case of any taxpayer who does not elect the overall limitation under section 904(a)(2), the amount allowable as a credit for income or profits taxes paid or accrued to a foreign country or a possession of the United States is subject to the per-country limitation prescribed in section 904(a)(1). Such limitation provides that the credit for such taxes paid or accrued (including those deemed to have been paid or accrued other than by reason of section 904(d)) to each foreign country or possession of the United States shall not exceed that proportion of the tax against which credit is taken which the taxpayer's taxable income from sources within such country or possession (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year. For special rules regarding the application of the per-country limitation when the taxpayer has derived section 904(f) interest or section 904(f) dividends, see § 1.904–4 or § 1.904–5.

(2) *Illustration of principles.* The operation of the per-country limitation under section 904(a)(1) on the credit for foreign taxes paid or accrued may be illustrated by the following examples:

Example 1. The credit for foreign taxes allowable for 1954 in the case of X, an unmarried citizen of the United States who in 1954 received the income shown below and had three exemptions under section 151, is $14,904, computed as follows:

Taxable income (computed without deductions for personal exemptions) from sources within the United States	$50,000
Taxable income (computed without deductions for personal exemptions) from sources within Great Britain	25,000
Total taxable income	75,000
United States income tax (based on taxable income computed with the deductions for personal exemptions)	44,712
British income and profits taxes	18,000
Per-country limitation (25,000/75,000 of $44,712)	14,904
Credit for British income and profits taxes (total British income and profits taxes, reduced in accordance with the per-country limitation)	14,904

Example 2. Assume the same facts as in example 1, except that the sources of X's income and taxes paid are as shown below. The credit for foreign taxes allowable to X is $13,442.40, computed as follows:

Taxable income (computed without deductions for personal exemptions) from sources within the United States	$50,000
Taxable income (computed without deductions for personal exemptions) from sources within Great Britain	15,000
Taxable income (computed without deductions for personal exemptions) from sources within Canada	10,000
Total taxable income	75,000
United States income tax (based on taxable income computed with the deductions for personal exemptions)	44,712
British income and profits taxes	10,800
Per-country limitation on British income and profits taxes (15,000/75,000 of $44,712)	8,942.40
Credit for British income and profits taxes as limited by per-country limitation	8,942.40
Canadian income and profits taxes	4,500.00
Per-country limitation on Canadian income and profits taxes (10,000/75,000 of $44,712)	5,961.60
Credit for Canadian income and profits taxes (total Canadian income and profits taxes, since such amount does not exceed the per-country limitation)	4,500.00
Total amount of credit allowable (sum of credits—$8,942.40 plus $4,500)	18,442.40

Example 3. A domestic corporation realized taxable income in 1954 in the amount of $100,000, consisting of $50,000 from United States sources and dividends of $50,000 from a Brazilian corporation, more than 10 percent of whose voting stock it owned. The Brazilian corporation paid income and profits taxes to Brazil on its income and in addition paid a dividend tax for the account of its shareholders on income distributed to them, the latter tax being withheld and paid at the source. The domestic corporation's credit for foreign taxes is $23,250, computed as follows:

Taxable income from sources within the United States	$50,000

Taxable income from sources within Brazil		50,000
Total taxable income		100,000
United States income tax		46,500
Dividend tax paid at source to Brazil		19,000
Income and profits taxes deemed under section 902 to have been paid to Brazil, computed as follows:		
Dividends received from Brazilian corporation during 1954		50,000
Income of Brazilian corporation during 1954		200,000
Income and profits taxes paid to Brazil on $200,000		30,000
Accumulated profits ($200,000 minus $30,000)		170,000
Brazilian taxes applicable to accumulated profits distributed:		
50,000/170,000 of 170,000/200,000 of $30,000		7,500
Total income and profits taxes paid and deemed to have been paid to Brazil	26,500	
Per-country limitation (50,000/100,000 of $46,500)		23,250
Credit for Brazilian income and profits taxes as limited by per-country limitation		23,250

(b) *Overall limitation*—(1) *General.* In the case of any taxpayer who elects the overall limitation provided by section 904(a)(2), the total credit for taxes paid or accrued (including those deemed to have been paid or accrued other than by reason of section 904(d)) shall not exceed that proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year. For special rules regarding the application of the overall limitation when the taxpayer has derived section 904(f) interest or section 904(f) dividends, see §1.904–4 or §1.904–5.

(2) *Illustration of principles.* The operation of the overall limitation under section 904(a)(2) may be illustrated by the following example:

Example. Corporation X, a domestic corporation, for its taxable year beginning January 1, 1961, elects the overall limitation provided by section 904(a)(2). For taxable year 1961 corporation X has taxable income of $275,000 of which $200,000 is from sources without the United States. The United States income tax is $137,500. During the taxable year corporation X pays or accrues to foreign countries $105,000 in income and profits taxes, consisting of $45,000 paid or accrued to foreign country Y and $60,000 to foreign country Z. The credit for such foreign taxes is limited to $100,000, i.e., 200,000÷275,000×$137,500. The limitation would be the same whether or not some portion of the $200,000 of the taxable income from sources without the United States is from sources on the high seas or in a foreign country (other than Y and Z) which imposed no taxes allowable as a credit.

(c) *Special computation of taxable income.* For purposes of computing the limitations under paragraphs (a) and (b) of this section, the taxable income in the case of an individual, estate, or trust shall be computed without any deduction for personal exemptions under section 151 or 642(b).

(d) *Election of overall limitation*—(1) *In general*—(i) *Manner of making election.* The initial election under section 904(b) of the overall limitation provided by section 904(a)(2) may be made by the taxpayer for any taxable year beginning after December 31, 1960, without securing the consent of the Commissioner. The taxpayer may, for the first taxable year for which the election is to be made, make such election at any time before the expiration of the period referred to in paragraph (d) of §1.901–1 for choosing the benefits of section 901 for such taxable year. Having made the initial election, the taxpayer may, within the time prescribed for making such election for such taxable year, revoke such election without the consent of the Commissioner. If such revocation is timely and properly made, the taxpayer may make his initial election of the overall limitation for a later taxable year without the consent of the Commissioner. If, however, the taxpayer makes the initial election for a taxable year and the period prescribed for making such election for such taxable year expires, the taxpayer must continue the election of the overall limitation for all subsequent taxable years (whether or not foreign taxes were paid or accrued for any such year and notwithstanding that a deduction for foreign taxes under section 164 was claimed for any such year) until revoked with the consent of the Commissioner. See section 904(b)(1). If the election for any taxable year is revoked with the consent of the Commissioner, the taxpayer may not make a new election for such taxable year or for any subsequent taxable year without the consent of the Commissioner. If the election of the overall limitation is revoked for a taxable year, the per-country limitation shall apply to such taxable year and to all taxable years thereafter unless a new election of the overall limitation is made, either with or without the consent of the Commissioner in accordance with this section.

(ii) *Revocation for first taxable year beginning after December 31, 1969.* Notwithstanding subdivision (i) of this subparagraph, if the taxpayer has made an initial election under section 904(b) of the overall limitation for a taxable year beginning before January 1, 1970, and the period prescribed for making such election for such taxable year has expired, or if he has made a new election for such a taxable year with the consent of the Commissioner, he may revoke such election effective with respect to his first taxable year beginning after December 31, 1969, without the consent of the Commissioner. Such revocation may be made within the time prescribed for making an initial election for such first taxable year beginning after December 31, 1969. If such revocation is timely and properly made, the taxpayer may make a new election of the overall limitation for a later taxable year without the consent of the Commissioner. Such new election for a later taxable year may be made at any time before the expiration of the period referred to in paragraph (d) of § 1.901–1 for choosing the benefits of section 901 for such taxable year. The revocation of an election, or the making of a new election, pursuant to this subdivision shall be made in the same manner provided in subparagraph (2) of this paragraph for revoking or making an initial election. This subdivision applies even though the taxpayer is not required under section 901(e) and § 1.901–3 to reduce the amount of any foreign taxes paid, accrued, or deemed to be paid with respect to foreign mineral income for any taxable year beginning after December 31, 1969.

(2) *Method of making the initial election.* The initial election of the overall limitation under section 904(b) shall be made on Form 1116 in the case of an individual or on Form 1118 in the case of a corporation. The form shall be attached to the appropriate income tax return for the taxable year to which such election applies. Such election may be made, however, only for a taxable year for which the taxpayer chooses to claim a credit under section 901. If the taxpayer revokes the initial election without the consent of the Commissioner, he must file amended Form 1116 or 1118 and amended income tax returns or claims for refund, where applicable, for the taxable years to which the revocation applies. For rules relating to the filing of such forms, see paragraph (a) of § 1.905–2.

(3) *Method of revoking an election and making a new election.* A request to revoke an election of the overall limitation under section 904(b) when such revocation requires the consent of the Commissioner, or to make a new election when such election requires the consent of the Commissioner, shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Washington, D.C. 20224. The request shall include the name and address of the taxpayer and shall be signed by the taxpayer or his duly authorized representative. It must specify the taxable year for which the revocation or new election is to be effective and shall be mailed within 75 days after the close of the first taxable year for which it is desired to make the change. It must be accompanied by a statement specifying the nature of the taxpayer's business, the countries in which the business is carried on, or expected to be carried on, within the taxable year of the requested change, and grounds considered as justifying the requested revocation or new election. The Commissioner may require such other information as may be necessary in order to determine whether the proposed change will be permitted. Generally, a request for consent to revoke an election or make a new election will be granted if the basic nature of the taxpayer's business changes or if there are changes in conditions in a foreign country which substantially affect the taxpayer's business. For example, a taxpayer who enters substantial operations in a new foreign country or who loses an existing investment due to nationalization, expropriation, or war would be granted consent to revoke an election or make a new election.

(e) *Joint return*—(1) *General.* In the case of a husband and wife making a joint return, the applicable limitation prescribed by section 904(a) on the credit for taxes paid or accrued to foreign countries and possessions of the United States shall be applied with respect to the aggregate taxable income from sources within each such country or possession, or from sources without the United States, as the case may be, and the aggregate taxable income from all sources, of the spouses.

(2) *Electing the overall limitation.* If a husband and wife make a joint return for the current taxable year, but made a separate return for the preceding taxable year and the overall limitation applied for such preceding taxable year to one spouse or to both spouses (whether or not then married), then, unless revoked with the consent of the Commissioner, the overall limitation shall apply for the current taxable year and for subsequent taxable years of both spouses, whether or not they remain married, whether or not joint returns are filed for such subsequent taxable years, and whether or not one of such spouses could have elected the overall limitation for the current taxable year only with the consent of the Commissioner if he had filed a separate return for such year.

[T.D. 6789, 29 FR 19243, Dec. 31, 1964, as amended by T.D. 7294, 38 FR 33080, Nov. 30, 1973; T.D. 7490, 42 FR 30497, June 15, 1977; 42 FR 32536, June 27, 1977]

§1.904–2 Carryback and carryover of unused foreign tax.

(a) *Credit for foreign tax carryback or carryover.* A taxpayer who chooses to claim a credit under section 901 for a taxable year is allowed a credit under that section not only for taxes otherwise allowable as a credit but also for taxes deemed paid or accrued in that year as a result of a carryback or carryover of an unused foreign tax under section 904(d). However, the taxes so deemed paid or accrued shall not be allowed as a deduction under section 164(a). The following paragraphs of this section provide rules for the computation of carryovers and carrybacks under section 904(d). For special rules regarding the application of section 904(d) and this section in the case of taxes paid or accrued with respect to section 904(f) interest see section 904(f) and §1.904–4. For special rules regarding the application of section 904(d) and this section in the case of taxes paid, accrued, or deemed to be paid with respect to section 904(f) dividends see section 904(f) and §1.904–5. For special rules regarding these computations in the case of taxes paid, accrued, or deemed to be paid with respect to foreign oil and gas extraction income or foreign oil related income, see section 907 (b), (e), and (f) and the regulations thereunder.

(b) *Years to which carried*—(1) *General.* If the taxpayer chooses the benefits of section 901 for a taxable year beginning after December 31, 1957, any unused foreign tax (as defined in subparagraph (2) of this paragraph) for such year shall, under section 904(d), be carried to the second preceding taxable year, the first preceding taxable year, and the first, second, third, fourth, and fifth succeeding taxable years, in that order and to the extent not absorbed as taxes deemed paid or accrued, under paragraph (c) of this section, in a prior taxable year. The entire unused foreign tax for any taxable year shall first be carried to the earliest of the taxable years to which, under the preceding sentence, such unused foreign tax may be carried. Any portion of such unused foreign tax not deemed paid or accrued under paragraph (c) of this section in such earliest taxable year shall then be carried to the next earliest taxable year to which such unused foreign tax may be carried, and any portion not absorbed in that year shall then be carried to the next earliest year, and so on.

(2) *Definitions.* (i) When used with reference to a taxable year for which the per-country limitation provided in section 904(a)(1) applies, the term ‘‘unused foreign tax’’ means, with respect to a particular foreign country or possession of the United States, the excess of *(a)* the income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued other than by reason of section 904(d)) in such year to such foreign country or possession, over *(b)* the applicable per-country limitation under section 904(a)(1) for such year.

(ii) When used with reference to a taxable year for which the overall limitation provided in section 904(a)(2) applies, the term ''unused foreign tax'' means the excess of *(a)* the income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued other than by reason of section 904(d)) in such year to all foreign countries and possessions of the United States, over *(b)* the overall limitation under section 904(a)(2) for such year.

(iii) The term ''unused foreign tax'' does not include any amount by which the income, war profits, and excess profits taxes paid or accrued, or deemed to be paid, to any foreign country or possession of the United States with respect to foreign mineral income are reduced under section 901(e)(1) and § 1.901–3(b)(1).

(3) *Taxable years beginning before January 1, 1958.* For purposes of this paragraph, the terms ''second preceding taxable year'' and ''first preceding taxable year'' do not include any taxable year beginning before January 1, 1958.

(c) *Tax deemed paid or accrued*—(1) *Unused foreign tax for per-country limitation year.* (i) The amount of an unused foreign tax with respect to a particular foreign country or possession of the United States, for a taxable year for which the per-country limitation under section 904(a)(1) applies, which shall be deemed paid or accrued in any taxable year to which such unused foreign tax may be carried under paragraph (b) of this section shall, except as provided in subdivision (iii) of this subparagraph, be equal to the smaller of—

(a) The portion of such unused foreign tax which, under paragraph (b) of this section, is carried to such taxable year, or

(b) Any excess limitation for such taxable year with respect to such unused foreign tax (as determined under subdivision (ii) of this subparagraph).

(ii) The excess limitation for any taxable year (hereinafter called the ''excess limitation year'') with respect to an unused foreign tax in respect of a particular foreign country or possession of the United States for another taxable year (hereinafter called the ''year of origin'') shall be the amount, if any, by which the limitation for the excess limitation year with respect to that foreign country or possession (computed under section 904(a)(1)) exceeds the sum of—

(a) The income, war profits, and excess profits taxes actually paid or accrued to such foreign country or possession in the excess limitation year,

(b) The income, war profits, and excess profits taxes deemed paid or accrued in such year to such foreign country or possession other than by reason of section 904(d), and

(c) The portion of the unused foreign tax, with respect to such foreign country or possession for any taxable year earlier than the year of origin, which is absorbed as taxes deemed paid or accrued in the excess limitation year under subdivision (i) of this subparagraph.

(iii) An unused foreign tax for a taxable year for which the per-country limitation provided in section 904(a)(1) applies shall not be deemed paid or accrued in a taxable year for which the overall limitation provided in section 904(a)(2) applies, notwithstanding that under paragraph (b) of this section such overall limitation year is counted as one of the years to which such unused foreign tax may be carried.

(iv) Any portion of an unused foreign tax with respect to a particular foreign country or possession of the United States which is deemed paid or accrued under section 904(d) in the year to which it is carried shall be deemed paid or accrued to the same foreign country or possession to which such foreign tax was paid or accrued (or deemed paid or accrued other than by reason of section 904(d)) for the year in which it originated.

(v) For determination of excess limitation for a year for which the taxpayer does not choose to claim a credit under section 901, see paragraph (d) of this section.

(2) *Unused foreign tax for overall limitation year.* (i) The amount of an unused foreign tax with respect to all foreign countries and possessions of the United States, for a taxable year for which the overall limitation provided in section 904(a)(2) applies, which shall be deemed paid or accrued in any taxable year to which such unused foreign tax may be carried under paragraph (b) of this section shall, except as provided

in subdivision (iii) of this subparagraph, be equal to the smaller of—

(a) The portion of such unused foreign tax which, under paragraph (b) of this section is carried to such taxable year, or

(b) Any excess limitation for such taxable year with respect to such unused foreign tax (as determined under subdivision (ii) of this subparagraph).

(ii) The excess limitation for any taxable year (hereinafter called the ‘‘excess limitation year’’) with respect to an unused foreign tax in respect of all foreign countries and possessions of the United States for another taxable year (hereinafter called the ‘‘year of origin’’) shall be the amount, if any, by which the limitation for the excess limitation year with respect to all foreign countries and possessions of the United States (computed under section 904(a)(2)) exceeds the sum of—

(a) The income, war profits, and excess profits taxes actually paid or accrued to all foreign countries and possessions in the excess limitation year,

(b) The income, war profits, and excess profits taxes deemed paid or accrued in such year to all foreign countries and possessions other than by reason of section 904(d), and

(c) The portion of the unused foreign tax, with respect to all foreign countries and possessions for any taxable year earlier than the year of origin, which is absorbed as taxes deemed paid or accrued in the excess limitation year under subdivision (i) of this subparagraph.

(iii) An unused foreign tax for a taxable year for which the overall limitation provided in section 904(a)(2) applies shall not be deemed paid or accrued in a taxable year for which the per-country limitation provided in section 904(a)(1) applies, notwithstanding that under paragraph (b) of this section such per-country limitation year is counted as one of the years to which such unused foreign tax may be carried.

(iv) For determination of excess limitation for a year for which the taxpayer does not choose to claim a credit under section 901, see paragraph (d) of this section.

(3) *Unused foreign tax with respect to foreign mineral income.* If any portion of an unused foreign tax for any taxable year beginning after December 31, 1969, consists of tax paid or accrued, or deemed to be paid, with respect to foreign mineral income, as defined in §1.901–3(c), such portion shall not be deemed paid or accrued with respect to foreign mineral income in the taxable year to which it is carried under section 904(d).

(d) *Determination of excess limitation for certain years.* An excess limitation for a taxable year may exist, and may absorb all or some portion of an unused foreign tax, even though the taxpayer does not choose to claim a credit under section 901 for such year. In such case, the amount of the excess limitation, if any, for such year (hereinafter called the ‘‘deduction year’’) shall be determined in the same manner as though the taxpayer had chosen to claim a credit under section 901 for that year. For purposes of the preceding sentence—

(1) If the taxpayer has not chosen the benefits of section 901 for any taxable year before the deduction year, the per-country limitation under section 904 (a)(1) shall be considered to be applicable for such year, and

(2) If the taxpayer has chosen the benefits of section 901 for any taxable year before the deduction year, the limitation (per-country or overall) applicable for the last taxable year (preceding such deduction year for) which a credit was claimed under section 901 shall be considered to be applicable for such deduction year.

(e) *Periods of less than 12 months.* A fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) is a preceding or a succeeding taxable year for the purpose of determining under section 904(d) the years to which the unused foreign tax may be carried, and any unused foreign tax or excess limitation for such fractional part of a year is the unused foreign tax or excess limitation for a taxable year.

(f) *Statement with tax return.* Every taxpayer claiming the benefit of a carryback or carryover of the unused foreign tax to any taxable year for which he chooses to claim a credit under section 901 shall file with his return (or with his claim for refund, if appropriate) for that year as an attachment to his Form 1116 or 1118, as the case may be, a statement setting forth the unused foreign tax deemed paid or accrued under this section and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the unused foreign tax so carried back or over.

(g) *Illustration of carrybacks and carryovers.* The application of this section may be illustrated by the following examples:

Example 1. (i) A, a calendar year taxpayer using the cash receipts and disbursements method of accounting, chooses to claim a credit under section 901 for each of the taxable years set forth below. Based upon the taxes actually paid to country X, and the section 904(a)(1) limitation applicable in respect of country X, in each of the taxable years, the unused foreign tax deemed paid under section 904(d) in each of the appropriate taxable years is as follows:

	Taxable years								
	1958	1959	1960	1961	1962	1963	1964	1965	1966
Per-country limitation	$175	$150	$100	$100	$100	$300	$400	$200	$600
Taxes actually paid to country X in taxable year	75	60	830	170	150	100	200	140	400
Unused foreign tax to be carried back or over from year of origin	....	....	730	70	50	....	....	....	....
Excess limitation with respect to unused foreign tax for—									
1960	(100)	(90)	....	....	....	(200)	(200)	(60)	....
1961	....	....	....	....	....	....	....	....	(200)
1962	....	....	....	....	....	....	....	....	(130)
Unused foreign tax absorbed as taxes deemed paid under the carryback and carryover provisions as carried from—									
1960	100	90	....	....	....	200	200	60	....
1961	....	....	....	....	....	....	....	....	70
1962	....	....	....	....	....	....	....	....	50

(ii) The excess limitation for 1958, 1959, 1963, 1964, and 1965, respectively, which is available to absorb the unused foreign tax for 1960 is the amount by which the per-country limitation for each of those years exceeds the taxes actually paid to country X in each such year. The unused foreign tax for 1961 and 1962 are not taken into account, since neither of those years is a year earlier than 1960, the year of origin in respect of which the excess limitation is being determined. Thus, for example, the excess limitation for 1963 is $200, unreduced by the unused foreign tax for 1961 and 1962. There is no excess limitation for 1966 with respect to the unused foreign tax for 1960, since the unused foreign tax may be carried forward only 5 taxable years. The unused foreign tax ($730) for 1960 is thus absorbed as taxes deemed paid to the extent of the excess limitation for each of the taxable years 1958, 1959, 1963, 1964, and 1965, respectively, and in that order, leaving unused foreign tax in the amount of $80 which cannot be absorbed because it cannot be carried beyond 1965.

(iii) The amount of unused foreign tax for 1961 which is deemed paid in 1966 is $70, the smaller of *(a)* that portion of the unused foreign tax carried to 1966 ($70), or *(b)* the excess limitation for 1966 with respect to such unused foreign tax ($200). The unused foreign tax for 1962 ($50) is not taken into account for such purposes, since that year is not a year earlier than 1961, the year of origin in respect of which the excess limitation for 1966 is being determined.

(iv) The excess limitation for 1966 with respect to the unused foreign tax for 1962 is $130, the amount by which the limitation applicable under section 904(a)(1) for 1966 ($600) exceeds the sum of the taxes actually paid ($400) to country X in that year and the unused foreign tax ($70) for 1961 which is absorbed in 1966 as taxes deemed paid and which is carried from a taxable year earlier than 1962, the year of origin in respect of which the excess limitation is being determined. The unabsorbed part ($80) of the unused foreign tax for 1960, a year earlier than 1962, is not taken into account in computing the excess limitation for 1966, since the unused foreign tax for 1960 may not be carried beyond 1965. The unused foreign tax ($50) for 1962 is thus absorbed in full in 1966 as taxes deemed paid, since the unused foreign tax does not exceed the excess limitation ($130) for that year.

Example 2. Assume the same facts as those in example 1 except that the taxpayer does not choose to have the benefits of section 901 for 1961. In that case there is no unused foreign tax for that year to carry back or over to be absorbed in other taxable years as taxes deemed paid. Moreover, the excess limitation for 1966 which is available to absorb the unused foreign tax for 1962 is $200, instead of $130, that is, the amount by which the limitation applicable under section 904(a)(1) for 1966 ($600) exceeds the taxes actually paid ($400) to country X in that year. The amount of the unused foreign tax absorbed in each taxable year as taxes deemed paid is the same as in example 1 except for 1966. In that year only the unused foreign tax ($50) for 1962 is absorbed as taxes deemed paid.

Example 3. Assume the same facts as those in example 1 except that the taxpayer does not choose the benefits of section 901 for 1959. Since the excess limitation for a taxable year for which the taxpayer does not claim a credit under section 901 is determined in the same manner as though the taxpayer had chosen such credit, the excess limitation for 1959 is determined to be $90 just as in example 1. Moreover, even though such excess limitation absorbs a carryback of $90 from the unused tax for 1960, none of such $90 so deemed paid in 1959 is allowed as a deduction under section 164 or as a credit under section 901 for 1959 or for any other taxable year.

Example 4. (i) B, a calendar year taxpayer using the cash receipts and disbursements methods of accounting, chooses the benefits of section 901 for each of the taxable years 1957, 1958, and 1959. Based upon the taxes actually paid to country Y and the per-country limitation applicable with respect to country Y, in each of the taxable years, the unused foreign tax deemed paid under section 904(d) for taxable year 1959 is as follows:

	Taxable years		
	1957	1958	1959
Per-country limitation on credit for taxes paid to Y	$300	$200	$250
Taxes actually paid to Y in taxable year	200	300	150
Unused foreign tax to be carried back or over from year of origin		100	
Excess limitation applicable to unused credit			(100)
Unused foreign tax absorbed as taxes deemed paid			100

(ii) Since a taxable year beginning before January 1, 1958, cannot constitute a preceding taxable year in which the unused foreign tax for 1958 may be absorbed as taxes deemed paid, the entire unused foreign tax ($100) is absorbed as taxes deemed paid in 1959.

Example 5. (i) C, a calendar year taxpayer using an accrual method of accounting, accrues foreign taxes for the first time in 1961. C chooses the benefits of section 901 for each of the taxable years set forth below and for 1962 elects the overall limitation provided by section 904(a)(2) which, with the Commissioner's consent, is revoked for 1966. Based upon the taxes actually accrued with respect to foreign countries X and Y for each of the taxable years, the unused foreign tax deemed accrued under section 904(d) in the appropriate taxable years is as follows:

	Per country	Overall	Overall	Overall	Overall	Per country
Taxable years	1961	1962	1963	1964	1965	1966
Limitation:						
Country X	$175					$290
Country Y	125					95
Overall		$250	$800	$300	$400	
Taxes actually accrued:						
Country X	325					200
Country Y	85					100
Aggregate		350	380	425	450	
Unused foreign tax to be carried back or over from year of origin:						
Country X	150					
Country Y						5
Aggregate		100		125	50	
Excess limitation:						
Country X						90
Country Y	40					
Overall			420			
Unused foreign tax absorbed as taxes deemed accrued under section 904(d) and carried from—						
1961 (Country X)						(90)
1962 (Overall)			(100)			
1964 (Overall)			(125)			
1965 (Overall)			(50)			

(ii) Since the per-country limitation is applicable for 1961 and 1966 only, any unused foreign tax with respect to such years may not be deemed accrued in 1962, 1963, 1964, or 1965, years for which the overall limitation applies. However, the excess limitation for 1966 with respect to country X ($90) is available to absorb a part of the unused foreign tax for 1961 with respect to country X. The difference with respect to country X between the unused foreign tax for 1961 ($150) and the amount absorbed as taxes deemed accrued ($90) in 1966, or $60, may not be carried beyond 1966 since the unused foreign tax may be carried forward only 5 taxable years. There is no excess limitation with respect to country Y for 1961 in respect of the unused foreign tax of country Y for 1966, since the unused foreign tax may be carried back only 2 taxable years.

(iii) Since the overall limitation is applicable for 1962, 1963, 1964, and 1965, any unused foreign tax with respect to such years may not be absorbed as taxes deemed accrued in 1961 or 1966, years for which the per-country limitation applies. However, the excess limitation for 1963 ($420) computed on the basis of the overall limitation is available to absorb the unused foreign tax for 1962 ($100), the unused foreign tax for 1964 ($125), and the unused foreign tax for 1965 ($50), leaving an excess limitation above such absorption of $145 ($420–$275).

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§ 1.904–3 Carryback and carryover of unused foreign tax by husband and wife.

(a) *In General.* This section provides rules, in addition to those prescribed in § 1.904–2, for the carryback and carryover of the unused foreign tax paid or accrued to a foreign country or possession by a husband and wife making a joint return for one or more of the taxable years involved in the computation of the carryback or carryover.

(b) *Joint unused foreign tax and joint excess limitation.* In the case of a husband and wife the joint unused foreign tax or the joint excess limitation for a taxable year for which a joint return is made shall be computed on the basis of the combined income, deductions, taxes, and credit of both spouses as if the combined income, deductions, taxes, and credit were those of one individual.

(c) *Continuous use of joint return.* If a husband and wife make a joint return for the current taxable year, and also make joint returns for each of the other taxable years involved in the computation of the carryback or carryover of the unused foreign tax to the current taxable year, the joint carryback or the joint carryover to the current taxable year shall be computed on the basis of the joint unused foreign tax and the joint excess limitations.

(d) *From separate to joint return.* If a husband and wife make a joint return for the current taxable year, but make separate returns for all of the other taxable years involved in the computation of the carryback or carryover of the unused foreign tax to the current taxable year, the separate carrybacks or separate carryovers shall be a joint carryback or a joint carryover to the current taxable year. If for such current year the per-country limitation applies, then only the unused foreign tax for a taxable year of a spouse for which the per-country limitation applied to such spouse may constitute a carryover or carryback to the current taxable year. If for such current taxable year the overall limitation applies, then only the unused foreign tax for a taxable year of a spouse for which the overall limitation applied to such spouse may constitute a carryover or carryback to the current taxable year.

(e) *Amounts carried from or through a joint return year to or through a separate return year.* It is necessary to allocate to each spouse his share of an unused foreign tax or excess limitation for any taxable year for which the spouses filed a joint return if—

(1) The husband and wife file separate returns for the current taxable year and an unused foreign tax is carried thereto from a taxable year for which they filed a joint return;

(2) The husband and wife file separate returns for the current taxable year and an unused foreign tax is carried to such taxable year from a year for which they filed separate returns but is first carried through a year for which they filed a joint return; or

(3) The husband and wife file a joint return for the current taxable year and an unused foreign tax is carried from a taxable year for which they filed joint

returns but is first carried through a year for which they filed separate returns.

In such cases, the separate carryback or carryover of each spouse to the current taxable year shall be computed in the manner described in §1.904–2 but with the modifications set forth in paragraph (f) of this section. Where applicable, appropriate adjustments shall be made to take into account the fact that, for any taxable year involved in the computation of the carryback or the carryover, either spouse has interest income described in section 904(f)(2) with respect to which the provisions of section 904(f) and §1.904–4 apply, or dividends described in section 904(f)(1)(B) with respect to which the provisions of section 904(f) and §1.904–5 apply, or foreign oil related income described in section 907(c) with respect to which the separate limitation in section 907(b) applies.

(f) *Allocation of unused foreign tax and excess limitation*—(1) *Limitation*—(i) *Per-country limitation.* The per-country limitation of a particular spouse with respect to a foreign country or United States possession for a taxable year for which a joint return is made shall be the portion of the limitation on the joint return which bears the same ratio to such limitation as such spouse's taxable income (with gross income and deductions taken into account to the same extent as taken into account on the joint return) from sources within such country or possession (but not in excess of the joint taxable income from sources within such country or possession) bears to the joint taxable income from such sources.

(ii) *Overall limitation.* The overall limitation of a particular spouse for a taxable year for which a joint return is made shall be the portion of the limitation on the joint return which bears the same ratio to such limitation as such spouse's taxable income (with gross income and deductions taken into account to the same extent as taken into account on the joint return) from sources without the United States (but not in excess of the joint taxable income from such sources) bears to the joint taxable income from such sources.

(2) *Unused foreign tax*—(i) *Per-country limitation.* The unused foreign tax of a particular spouse with respect to a foreign country or United States possession for a taxable year for which a joint return is made shall be the excess of his tax paid or accrued to such country or possession over his limitation determined under subparagraph (1)(i) of this paragraph.

(ii) *Overall limitation.* The unused foreign tax of a particular spouse for a taxable year to which the overall limitation applies and for which a joint return is made shall be the excess of his tax paid or accrued to foreign countries and United States possessions over his limitation determined under subparagraph (1)(ii) of this paragraph.

(3) *Excess limitation*—(i) *Per-country limitation taxpayer.* A spouse's excess limitation with respect to a foreign country or possession for a taxable year for which a joint return is made shall be the excess of his limitation determined under subparagraph (1)(i) of this paragraph over his taxes paid or accrued to such country or possession for such taxable year.

(ii) *Overall limitation.* A spouse's excess limitation for a taxable year to which the overall limitation applies and for which a joint return is made shall be the excess of his limitation determined under subparagraph (1)(ii) of this paragraph over his taxes paid or accrued to foreign countries and United States possessions for such taxable year.

(4) *Excess limitation to be applied.* The excess limitation of the particular spouse for any taxable year which is applied against the unused foreign tax of that spouse for another taxable year in order to determine the amount of the unused foreign tax which shall be carried back or over to a third taxable year shall be, in a case in which the excess limitation is determined on a joint return, the sum of the following amounts:

(i) Such spouse's excess limitation determined under subparagraph (3) of this paragraph reduced as provided in subparagraph (5)(i) of this paragraph, and

(ii) The excess limitation of the other spouse determined under subparagraph (3) of this paragraph for that taxable year reduced as provided in subparagraphs (5) (i) and (ii) of this paragraph.

(5) *Reduction of excess limitation.* (i) The part of the excess limitation which is attributable to each spouse for the taxable year, as determined under subparagraph (3) of this paragraph, shall be reduced by absorbing as taxes deemed paid or accrued under section 904(d) in that year the unabsorbed separate unused foreign tax of such spouse, and the unabsorbed unused foreign tax determined under subparagraph (2) of this paragraph of such spouse, for taxable years which begin before the beginning of the year of origin of the unused foreign tax of the particular spouse against which the excess limitation so determined is being applied.

(ii) In addition, the part of the excess limitation which is attributable to the other spouse for the taxable year, as determined under subparagraph (3) of this paragraph, shall be reduced by absorbing as taxes deemed paid or accrued under section 904(d) in that year the unabsorbed unused foreign tax, if any, of such other spouse for the taxable year which begins on the same date as the beginning of the year of origin of the unused foreign tax of the particular spouse against which the excess limitation so determined is being applied.

(6) *Spouses using different limitations.* If an unused foreign tax is carried through a taxable year for which spouses made a joint return and the credit under section 901 for such taxable year is not claimed, and in the prior taxable year separate returns are made in which the per-country limitation applies to one spouse and the overall limitation applies to the other spouse, the amount treated as absorbed in the taxable year for which a joint return is made—

(i) With respect to the spouse for which the per-country limitation applies shall be determined on the basis of the excess limitation which would be allocated to such spouse under subparagraph (3)(i) of this paragraph had the per-country limitation applied for such year to both spouses;

(ii) With respect to the other spouse for which the overall limitation applies shall be determined on the basis of the excess limitation which would be allocated to such spouse under subparagraph (3)(ii) of this paragraph had the overall limitation applied for such year to both spouses.

This subparagraph shall be applied without regard to subparagraph (4)(ii) of this paragraph.

(g) *Illustrations.* This section may be illustrated by the following examples:

Example 1. (a) H and W, calendar year taxpayers, file joint returns for 1961 and 1963, and separate returns for 1962, 1964, and 1965; and for each of those taxable years they choose to claim a credit under section 901. For the taxable years involved, they had unused foreign tax, excess limitations, and carrybacks and carryovers of unused foreign tax as set forth below. The overall limitation applies to both spouses for all taxable years involved in this example. Neither H nor W had an unused foreign tax or excess limitation for any year before 1961 or after 1965. For purposes of this example, any reference to an excess limitation means such a limitation as determined under paragraph (c)(2)(ii) of § 1.904–2 but without regard to any taxes deemed paid or accrued under section 904(d):

	Taxable year				
	1961	1962	1963	1964	1965
Return	Joint	Separate	Joint	Separate	Separate
H's unused foreign tax to be carried over or back, or excess limitation (enclosed in parentheses)	$500	$250	($650)	$400	($500)
W's unused foreign tax to be carried over or back, or excess limitation (enclosed in parentheses)	300	(200)	(300)	150	(100)
Total	800		(950)		
Carryovers absorbed:					
W's, from 1961		[1]200W	100W		
H's, from 1961			[2]500H		
H's, from 1962			150H		
			100W		
W's, from 1964					50W
H's, from 1964					400H

	Taxable year				
	1961	1962	1963	1964	1965
Carrybacks absorbed:					
W's, from 1964		0	100W		
H's, from 1964			0		

[1] W—absorbed by W's excess limitation.
[2] H—absorbed by H's excess limitation.

(b) Two hundred dollars of the $300 constituting W's part of the joint unused foreign tax for 1961 is absorbed by her separate excess limitation of $200 for 1962, and the remaining $100 of such part is absorbed by her part ($300) of the joint excess limitation for 1963. The excess limitation of $300 for 1963 is not required first to be reduced by any amount, since neither H nor W has any unused foreign tax for taxable years beginning before 1961.

(c) H's part ($500) of the joint unused foreign tax for 1961 is absorbed by his part ($650) of the joint excess limitation for 1963. The excess limitation of $650 for 1963 is not required first to be reduced by any amount, since neither H nor W has any unused foreign tax for taxable years beginning before 1961.

(d) H's unused foreign tax of $250 for 1962 is first absorbed (to the extent of $150) by H's part of the joint excess limitation for 1963, which must first be reduced from $650 to $150 by the absorption as taxes deemed paid or accrued in 1963 of H's unused foreign tax of $500 for 1961, which is a taxable year beginning before 1962. The remaining part ($100) of H's unused foreign tax for 1962 is then absorbed by W's part of the joint excess limitation for 1963, which must first be reduced from $300 to $200 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part $100 of W's unused foreign tax for 1961, which is a taxable year beginning before 1962.

(e) W's unused foreign tax of $150 for 1964 is first absorbed (to the extent of $100) by W's part of the joint excess limitation for 1963, which must first be reduced from $300 to $100 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part ($100) of W's unused foreign tax for 1961 and the unabsorbed part ($100) of H's unused foreign tax for 1962, which are taxable years beginning before 1964. No part of W's unused foreign tax for 1964 is absorbed by H's part of the joint excess limitation for 1963, since H's part of that excess must first be reduced from $650 to $0 by the absorption as taxes deemed paid or accrued in 1963 of H's unused foreign tax of $500 for 1961 and of the unabsorbed part ($150) of H's unused foreign tax for 1962, which are taxable years beginning before 1964. The unabsorbed part ($50) of W's unused foreign tax for 1964 is then absorbed by W's excess limitation of $100 for 1965. No part of W's unused foreign tax for 1964 is absorbed by W's excess limitation for 1962, since that excess limitation must first be reduced from $200 to $0 by W's unused foreign tax for 1961, which is a taxable year beginning before 1964.

(f) No part of H's unused foreign tax of $400 for 1964 is absorbed by H's part of the joint excess limitation for 1963, since H's part of that excess must first be reduced from $650 to $0 by the absorption as taxes deemed paid or accrued in 1963 of H's unused foreign tax of $500 for 1961 and of a part ($150) of H's unused foreign tax for 1962, which are taxable years beginning before 1964. Moreover, no part of H's unused foreign tax of $400 for 1964 is absorbed by W's part of the joint excess limitation for 1963, since W's part of that excess must first be reduced from $300 to $0 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part ($100) of W's unused foreign tax for 1961 and of the unabsorbed part ($100) of H's unused foreign tax for 1962, which are taxable years beginning before 1964, and also by the absorption of a part ($100) of W's unused foreign tax of $150 for 1964, which is a taxable year beginning on the same date as the beginning of H's taxable year 1964. The unabsorbed part ($400) of H's unused foreign tax for 1964 is then absorbed by H's excess limitation of $500 for 1965.

Example 2. (a) Assume the same facts as those in example 1 except that for 1964 W's unused foreign tax is $20, instead of $150. The carrybacks and carryovers absorbed are the same as in example 1 except as indicated in paragraphs (b) and (c) of this example.

(b) No part of W's unused foreign tax of $20 for 1964 is absorbed by W's excess limitation for 1962, since that excess must first be reduced from $200 to $0 by W's unused foreign tax for 1961, which is a taxable year beginning before 1964. W's unused foreign tax of $20 for 1964 is absorbed by W's part of the joint excess limitation for 1963, which must first be reduced from $300 to $100 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part ($100) of W's unused foreign tax for 1961 and the unabsorbed part ($100) of H's unused foreign tax for 1962, which are taxable years beginning before 1964.

(c) For the reason given in paragraph (f) of example 1, no part of H's unused foreign tax of $400 for 1964 is absorbed by H's part of the joint excess limitation for 1963. H's unused foreign tax of $400 for 1964 is first absorbed (to the extent of $80) by W's part of the joint excess limitation for 1963, which must first be reduced from $300 to $80 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part ($100) of W's unused foreign tax for 1961 and of the unabsorbed part ($100) of H's unused foreign tax for 1962, which are taxable years beginning before 1964, and also by the absorption of W's unused foreign tax of $20 for 1964, which is a taxable year beginning on the same date as the beginning of H's taxable year 1964. The unabsorbed part ($320) of H's unused foreign tax for 1964 is then absorbed by H's excess limitation of $500 for 1965.

Example 3. The facts are the same as in example 1 except that the per-country limitation applies to both spouses for all taxable years involved in the example and that excess limitations and the unused foreign taxes relate to a single foreign country. The carryovers and carrybacks are the same as in example 1.

[T.D. 6789, 29 FR 19246, Dec. 31, 1964, as amended by T.D. 7292, 38 FR 33292, Dec. 3, 1973; T.D. 7490, 42 FR 30497, June 15, 1977; T.D. 7961, 49 FR 26225, June 27, l984]

§ 1.904–4 Separate application of section 904 with respect to certain categories of income.

(a) *In general.* A taxpayer is required to compute a separate foreign tax credit limitation for income received or accrued in a taxable year that is described in section 904(d)(1)(A) (passive income), (B) (high withholding tax interest), (C) (financial services income), (D) (shipping income), (E) (dividends from each noncontrolled section 902 corporation), (F) (dividends from a DISC or former DISC), (G) (foreign trade income), (H) (distributions from a FSC or former FSC), or (I) (general limitation income).

(b) *Passive income*—(1) *In general*—(i) *Rule.* The term ''passive income'' means any—

(A) Income received or accrued by any person that is of a kind that would be foreign personal holding company income (as defined in section 954(c)) if the taxpayer were a controlled foreign corporation, including any amount of gain on the sale or exchange of stock in excess of the amount treated as a dividend under section 1248; or

(B) Amount includible in gross income under section 551 or section 1293.

Passive income does not include any income that is also described in section 904(d)(1) (B) through (H), any export financing interest (as defined in section 904(d)(2)(G) and paragraph (h) of this section), any high-taxed income (as defined in section 904(d)(2)(F) and paragraph (c) of this section), or any foreign oil and gas extraction income (as defined in section 907(c)). In addition, passive income does not include any income that would otherwise be passive but is characterized as income in another separate category under the lookthrough rules. In determining whether any income is of a kind that would be foreign personal holding company income, the rules of section 864(d)(5)(A)(i) and (6) (treating related person factoring income of a controlled foreign corporation as foreign personal holding company income that is not eligible for the export financing income exception to the separate limitation for passive income) shall apply only in the case of income of a controlled foreign corporation (as defined in section 957). Thus, income earned directly by a United States person that is related person factoring income may be eligible for the exception for export financing interest.

(ii) *Example.* The following example illustrates the application of paragraph (b)(1)(i) of this section:

P is a domestic corporation with a branch in foreign country X. P does not have any financial services income. For 1988, P has a net foreign currency gain that would not constitute foreign personal holding company income if P were a controlled foreign corporation because the gain is directly related to the business needs of P. The currency gain is, therefore, general limitation income to P because it is not income of a kind that would be foreign personal holding company income.

(2) *Active rents or royalties*—(i) *In general.* Passive income does not include any rents or royalties that are derived in the active conduct of a trade or business and received from a person who is an unrelated person. Except as provided in paragraph (b)(2)(ii) of this section, the principles of section 954(c)(2)(A) and the regulations under that section shall apply in determining whether rents or royalties are derived in the active conduct of a trade or business. For this purpose, the term ''taxpayer'' shall be substituted for the term ''controlled foreign corporation''

if the recipient of the rents or royalties is not a controlled foreign corporation.

(ii) *Exception for certain rents and royalties.* Rents or royalties are considered derived in the active conduct of a trade or business by a United States person or by a controlled foreign corporation (or other entity to which the look-through rules apply) for purposes of section 904 (but not for purposes of section 954) if the requirements of section 954(c)(2)(A) are satisfied by one or more corporations that are members of an affiliated group of corporations (within the meaning of section 1504(a) without regard to section 1504(b)(3)) of which the recipient is a member.

(iii) *Unrelated person.* For purposes of this paragraph (b)(2), a person is considered to be an unrelated person if the person is not a related person within the meaning of section 954(d)(3), without regard to whether the relationship described in section 954(d)(3) is between a controlled foreign corporation and another person or between two persons neither one of which is a controlled foreign corporation.

(iv) *Example.* The following example illustrates the application of paragraph (b)(2)(ii) of this section.

Example. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S is regularly engaged in the restaurant franchise business. P licenses trademarks, tradenames, certain know-how, related services, and certain restaurant designs for which S pays P an arm's length royalty. P is regularly engaged in the development and licensing of such property. The royalties received by P for the use of its property are allocable under the look-through rules of §1.904–5 to the royalties S receives from the franchisees. All of the franchisees are unrelated to S or P and operate in S's country of incorporation. S does not satisfy, but P does satisfy, the active trade or business requirements of section 954(c)(2)(A) and the regulations under that section. The royalty income earned by S with regard to its franchisees is foreign personal holding company income that is general limitation income, and the royalties paid to P are general limitation income to P.

(c) *High-taxed income*——(1) *In general.* Income received or accrued by a United States person that would otherwise be passive income shall not be treated as passive income if the income is determined to be high-taxed income. Income shall be considered to be high-taxed income if, after allocating expenses, losses and other deductions of the United States person to that income under paragraph (c)(2)(ii) of this section, the sum of the foreign income taxes paid or accrued by the United States person with respect to such income and the foreign taxes deemed paid or accrued by the United States person with respect to such income under section 902 or section 960 exceeds the highest rate of tax specified in section 1 or 11, whichever applies (and with reference to section 15 if applicable), multiplied by the amount of such income (including the amount treated as a dividend under section 78). If, after application of this paragraph (c), income that would otherwise be passive income is determined to be high-taxed income, such income shall be treated as general limitation income, and any taxes imposed on that income shall be considered related to general limitation income under §1.904–6. If, after application of this paragraph (c), passive income is zero or less than zero, any taxes imposed on the passive income shall be considered related to general limitation income. For additional rules regarding losses related to passive income, see paragraph (c)(2) of this section. Income and taxes shall be translated at the appropriate rates, as determined under sections 986, 987 and 989 and the regulations under those sections, before application of this paragraph (c). For purposes of allocating taxes to groups of income, United States source passive income is treated as any other passive income. In making the determination whether income is high-taxed, however, only foreign source income, as determined under United States tax principles, is relevant. See paragraph (c)(8) *Examples* 10 through 13 of this section for examples illustrating the application of this paragraph (c)(1) and paragraph (c)(2) of this section.

(2) *Grouping of items of income in order to determine whether passive income is high-taxed income*—(i) *Effective dates*—(A) *In general.* For purposes of determining whether passive income is high-taxed income, the grouping rules of paragraphs (c)(3)(i) and (ii), (c)(4), and (c)(5) of this section apply to taxable years beginning after December 31,

1987. Except as provided in paragraph (c)(2)(i)(B) of this section, the rules of paragraph (c)(3)(iii) apply to taxable years beginning after December 31, 1987, and ending before December 31, 1998, and the rules of paragraph (c)(3)(iv) apply to taxable years ending on or after December 31, 1998. See Notice 87–6 (1987–1 C.B.417) for the grouping rules applicable to taxable years beginning after December 31, 1986 and before January 1, 1988. The fourth sentence of paragraph (c)(2)(ii)(A) and paragraph (c)(2)(ii)(B) of this section are effective for taxable years beginning after March 12, 1999.

(B) *Application to prior periods.* A taxpayer may apply the rules of paragraph (c)(3)(iv) to any taxable year beginning after December 31, 1991, and all subsequent years, provided that—

(*1*) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 1999; and

(*2*) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

(ii) *Grouping rules*—(A) *Initial allocation and apportionment of deductions and taxes.* For purposes of determining whether passive income is high-taxed, expenses, losses and other deductions shall be allocated and apportioned initially to each of the groups of passive income (described in paragraphs (c)(3), (4), and (5) of this section) under the rules of §§1.861–8 through 1.861–14T and 1.865–1T through 1.865–2T. Taxpayers that allocate and apportion interest expense on an asset basis may nevertheless apportion passive interest expense among the groups of passive income on a gross income basis. Foreign taxes are allocated to groups under the rules of §1.904-6(a)(iii). If a loss on a disposition of property gives rise to foreign tax (i.e., the transaction giving rise to the loss is treated under foreign law as having given rise to a gain), the foreign tax shall be allocated to the group of passive income to which gain on the sale would have been assigned under paragraph (c)(3) or (4) of this section. A determination of whether passive income is high-taxed shall be made only after application of paragraph (c)(2)(ii)(B) of this section (if applicable).

(B) *Reallocation of loss groups.* If, after allocation and apportionment of expenses, losses and other deductions under paragraph (c)(2)(ii)(A) of this section, the sum of the allocable deductions exceeds the gross income in one or more groups, the excess deductions shall proportionately reduce income in the other groups (but not below zero).

(3) *Amounts received or accrued by United States persons.* Except as provided in paragraph (c)(5) of this section, all passive inoome received by a United States person shall be subject to the rules of this paragraph (c)(3). However, subpart F inclusions that are passive income and income that is earned by a United States person through a foreign qualified business unit (foreign QBU) that is passive income shall be subject to the rules of this paragraph only to the extent provided in paragraph (c)(4)(ii) of this section. For purposes of this section, a foreign QBU is a QBU (as defined in section 989(a)) other than a controlled foreign corporation, that has its principal place of business outside the United States. These rules shall apply whether the income is received from a controlled foreign corporation of which the United States person is a United States shareholder or from any other person. For purposes of determining whether passive income is high-taxed income, the following rules apply:

(i) All passive income received during the taxable year that is subject to a withholding tax of fifteen percent or greater shall be treated as one item of income.

(ii) All passive income received during the taxable year that is subject to a withholding tax of less than fifteen percent (but greater than zero) shall be treated as one item of income.

(iii) For taxable years ending before December 31, 1998 (except as provided in paragraph (c)(2)(i)(B) of this section), all passive income received during the taxable year that is subject to no withholding tax shall be treated as one item of income.

(iv) For taxable years ending on or after December 31, 1998, all passive income received during the taxable year that is subject to no withholding tax or other foreign tax shall be treated as one item of income, and all passive income received during the taxable year that is subject to no withholding tax but is subject to a foreign tax other than a withholding tax shall be treated as one item of income.

(4) *Income of controlled foreign corporations and foreign QBUs.* Except as provided in paragraph (c)(5) of this section, all amounts included in gross income of a United States shareholder under section 951(a)(1) for a particular year that (after application of the look-through rules of section 904(d)(3) and §1.904–5) are attributable to passive income received or accrued by a controlled foreign corporation and all amounts of passive income received or accrued by a United States person through a foreign QBU shall be subject to the rules of this paragraph (c)(4). This paragraph (c)(4) shall be applied separately to inclusions with respect to each controlled foreign corporation of which the taxpayer is a United States shareholder. This paragraph (c)(4) also shall be applied separately to income attributable to each QBU of a controlled foreign corporation or any other look-through entity as defined in §1.904–5(i), except that if the entity subject to the look-through rules is a United States person, then this paragraph (c)(4) shall be applied separately only to each foreign QBU of that United States person.

(i) *Income from sources within the QBU's country of operation.* Passive income from sources within the QBU's country of operation shall be treated as one item of income.

(ii) *Income from sources without the QBU's country of operation.* Passive income from sources without the QBU's country of operation shall be grouped on the basis of the withholding tax imposed on that income as provided in paragraph (c)(3) (i) through (iii) of this section.

(iii) *Determination of the source of income.* For purposes of this paragraph (c)(4), income will be determined to be from sources within or without the QBU's country of operation under the laws of the foreign country of the payor of the income.

(5) *Special rules*—(i) *Certain rents and royalties.* All items of rent or royalty income to which an item of rent or royalty expense is directly allocable shall be treated as a single item of income and shall not be grouped with other amounts.

(ii) *Treatment of partnership income.* A partner's distributive share of income from a foreign or United States partnership that is not subject to the look-through rules and that is treated as passive income under §1.904–5(h)(2)(i) (generally providing that a less than 10 percent partner's distributive share of partnership income is passive income) shall be treated as a single item of income and shall not be grouped with other amounts. A distributive share of income from a foreign partnership that is treated as passive income under the look-through rules shall be grouped according to the rules in paragraph (c)(4) of this section. A distributive share of income from a United States partnership that is treated as passive income under the look-through rules shall be grouped according to the rules in paragraph (c)(3) of this section, except that the portion, if any, of the distributive share of income attributable to income earned by a United States partnership through a foreign QBU shall be grouped under the rules of paragraph (c)(4) of this section.

(iii) *Currency gain or loss*—(A) *Section 986(c).* Any currency gain or loss with respect to a distribution received by a United States shareholder (other than a foreign QBU of that shareholder) of previously taxed earnings and profits that is recognized under section 986(c) and that is treated as an item of passive income shall be subject to the rules provided in paragraph (c)(3)(iii) of this section. If that item, however, is received or accrued by a foreign QBU of the United States shareholder, it shall be treated as an item of passive income from sources within the QBU's country of operation for purposes of paragraph (c)(4)(i) of this section. This paragraph (c)(5)(iii)(A) shall be applied separately for each foreign QBU of a United States shareholder.

(B) *Section 987(3).* Any currency gain or loss with respect to remittances or transfers of property between QBUs of a United States shareholder that is recognized under section 987(3)(B) and that is treated as an item of passive income shall be subject to the rules provided in paragraph (c)(3)(iii) of this section. If that item, however, is received or accrued by a foreign QBU of the United States shareholder, it shall be treated as an item of passive income from sources within the QBU's country of operation for purposes of paragraph (c)(4)(i) of this section. This paragraph (c)(5)(iii)(B) shall be applied separately for each foreign QBU of a United States shareholder.

(C) *Example.* The following example illustrates the provisions of this paragraph (c)(5)(iii).

Example. P, a domestic corporation, owns all of the stock of S, a controlled foreign corporation that uses x as its functional currency. In 1993, S earns 100x of passive foreign personal holding company income. When included in P's income under subpart F, the exchange rate is 1x equals $1. Therefore, P's subpart F inclusion is $100. At the end of 1993, S has previously taxed earnings and profits of 100x and P's basis in those earnings is $100. In 1994, S has no earnings and distributes 100x to P. The value of the earnings when distributed is $150. Assume that under section 986(c), P must recognize $50 of passive income attributable to the appreciation of the previously taxed income. Country X does not recognize any gain or loss on the distribution. Therefore, the section 986(c) gain is not subject to any foreign withholding tax or other foreign tax. Thus, under paragraph (c)(3)(iii) of this section, the section 986(c) gain shall be grouped with other items of P's income that are subject to no withholding tax or other foreign tax.

(iv) *Certain passive dividends.* A dividend from a controlled foreign corporation that is treated as passive income under the look-through rules shall be grouped according to the rules of paragraph (c)(4) of this section.

(6) *Application of this paragraph to additional taxes paid or deemed paid in the year of receipt of previously taxed income*—(i) *Determination made in year of inclusion.* The determination of whether an amount included in gross income under section 951(a) is high-taxed income shall be made in the taxable year the income is included in the gross income of the United States shareholder under section 951(a) (hereinafter the ''taxable year of inclusion''). Any increase in foreign taxes paid or accrued, or deemed paid or accrued, when the taxpayer receives an amount that is excluded from gross income under section 959(a) and that is attributable to a controlled foreign corporation's earnings and profits relating to the amount previously included in gross income will not be considered in determining whether the amount included in income in the taxable year of inclusion is high-taxed income.

(ii) *Exception.* Paragraph (c)(6)(i) of this section shall not apply to an increase in tax in a case in which the taxpayer is required to adjust its foreign taxes in the year of inclusion under section 905(c).

(iii) *Allocation of foreign taxes imposed on distributions of previously taxed income.* If an item of income is considered high-taxed income in the year of inclusion and paragraph (c)(6)(i) of this section applies, then any increase in foreign income taxes imposed with respect to that item shall be considered to be related to general limitation income. If an item of income is not considered to be high-taxed income in the taxable year of inclusion and paragraph (c)(6)(i) of this section applies, the following rules shall apply. The taxpayer shall treat an increase in taxes paid or accrued, or deemed paid or accrued, on any distribution of the earnings and profits attributable to the amount included in gross income in the taxable year of inclusion as taxes related to passive income to the extent of the excess of the product of (A) the highest rate of tax in section 11 (determined with regard to section 15 and determined as of the year of inclusion) and (B) the amount of the inclusion (after allocation of parent expenses) over (C) the taxes paid or accrued, or deemed paid or accrued, in the year of inclusion. The taxpayer shall treat any taxes paid or accrued, or deemed paid or accrued, on the distribution in excess of this amount as taxes related to general limitation income. If these additional taxes are not creditable in the year of distribution the carryover rules of section 904(c) apply. For purposes of this paragraph, the foreign tax on a subpart F inclusion shall be considered increased on distribution of the earnings and profits associated with that inclusion if the total of taxes paid and deemed paid on the inclusion and the distribution (taking into account any reductions in tax and any withholding taxes) is greater than the total taxes deemed paid in the year of inclusion. Any foreign currency loss associated with the earnings and profits that are distributed with respect to the inclusion is not to be considered as giving rise to an increase in tax.

(iv) *Increase in taxes paid by successors.* [Reserved]

(7) *Application of this paragraph to certain reductions of tax on distributions of income*—(i) *In general.* If the effective rate of tax imposed by a foreign country on income of a foreign corporation that is included in a taxpayer's gross income is reduced under foreign law on distribution of such income, the rules of this paragraph (c) apply at the time that the income is included in the taxpayer's gross income without regard to the possibility of subsequent reduction of foreign tax on the distribution. If the inclusion is considered to be high-taxed income, then the taxpayer shall treat the inclusion as general limitation income. When the foreign corporation distributes the earnings and profits to which the inclusion was attributable and the foreign tax on the inclusion is reduced, then the taxpayer shall redetermine whether the inclusion should be considered to be high-taxed income provided that a redetermination of United States tax liability is required under section 905(c). If, taking into account the reduction in foreign tax, the inclusion would not have been considered high-taxed income, then the taxpayer, in redetermining its United States tax liability for the year or years affected, shall treat the inclusion and the associated taxes (as reduced on the distribution) as passive income and taxes. See section 905(c) and the regulations thereunder regarding the method of adjustment. For this purpose, the foreign tax on a subpart F inclusion shall be considered reduced on distribution of the earnings and profits associated with the inclusion if the total of taxes paid and deemed paid on the inclusion and the distribution (taking into account any reductions in tax and any withholding taxes) is less that the total taxes deemed paid in the year of inclusion. Any foreign currency gain associated with the earnings and profits that are distributed with respect to the inclusion is not to be considered a reduction of tax.

(ii) *Allocation of reductions of foreign tax.* For purposes of paragraph (c)(7)(i) of this section, reductions in foreign tax shall be allocated among the separate categories under the same principles as those of §1.904–6 for allocating taxes among the separate categories. Thus, for purposes of determining to which year's taxes the reduction in taxes relates, foreign law shall apply. If, however, foreign law does not attribute a reduction in taxes to a particular year or years, then the reduction in taxes shall be attributable, on an annual last in-first out (LIFO) basis, to foreign taxes potentially subject to reduction that are associated with previously taxed income, then on a LIFO basis to foreign taxes associated with income that under paragraph (c)(7)(iii) of this section remains as passive income but that was excluded from subpart F income under section 954(b)(4), and finally on a LIFO basis to foreign taxes associated with other earnings and profits. Furthermore, in applying the ordering rules of section 959(c), distributions shall be considered made on a LIFO basis first out of earnings described in section 959(c) (1) and (2), then on a LIFO basis out of earnings and profits associated with income that remains passive income under paragraph (c)(7)(iii) of this section but that was excluded from subpart F under section 954(b)(4), and finally on a LIFO basis out of other earnings and profits.

(iii) *Interaction with section 954(b)(4).* If the effective rate of tax imposed by a foreign country on income of a foreign corporation is reduced under foreign law on distribution of that income, the rules of section 954(b)(4) shall be applied without regard to the possibility of subsequent reduction of foreign tax. If a taxpayer excludes passive income from a controlled foreign corporation's foreign personal holding company income under these circumstances, then the income shall be considered to be passive income until distribution of that income. At that time, the rules of this paragraph shall apply to determine whether the income is high-taxed income and, therefore, general limitation income. For purposes of determining whether a reduction in tax is attributable to taxes on income excluded under section 954(b)(4), the rules of paragraph (c)(7)(ii) of this section apply. The rules of paragraph (c)(7)(ii) of this section shall apply for purposes of ordering distributions to determine whether such distributions are out of earnings and profits associated with such excluded income. For an example illustrating the operation of this paragraph (c)(7)(iii), see paragraph (c)(8) *Example (7)* of this section.

(8) *Examples.* The following examples illustrate the application of this paragraph (c).

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is a single qualified business unit (QBU) operating in foreign country X. In 1988, S earns $130 of gross passive royalty income from country X sources, and incurs $30 of expenses that do not include any payments to P. S's $100 of net passive royalty income is subject to $30 of foreign tax, and is included under section 951 in P's gross income for the taxable year. P allocates $50 of expenses to the $100 (consisting of the $70 section 951 inclusion and $30 section 78 amount), resulting in a net inclusion of $50. After application of the high-tax kick-out rules of paragraph (c)(1) of this section, the $50 inclusion is treated as general limitation income, and the $30 of taxes deemed paid are treated as taxes imposed on general limitation income, because the foreign taxes paid and deemed paid on the income exceed the highest United States tax rate multiplied by the $50 inclusion ($30>$17 (.34×$50)).

Example 2. The facts are the same as in *Example* (1) except that instead of earning $130 of gross passive royalty income, S earns $65 of gross passive royalty income from country X sources and $65 of gross passive interest income from country Y sources. S incurs $15 of expenses and $5 of foreign tax with regard to the royalty income and incurs $15 of expenses and $10 of foreign tax with regard to the interest income. P allocates $50 of expenses pro rata to the $50 inclusion ($45 section 951 inclusion and $5 section 78 amount) attributable to the royalty income earned by S and the $50 inclusion ($40 section 951 inclusion and $10 section 78 amount) attributable to the interest income earned by S. Under paragraph (c)(4) of this section, the high-tax test is applied separately to the section 951 inclusion attributable to the income from X sources and the section 951 inclusion attributable to the income from Y sources. Therefore, after allocation of P's $50 of expenses, the resulting $25 inclusion attributable to the royalty income from X sources is still treated as passive income because the foreign taxes paid and deemed paid on the income do not exceed the highest United States tax rate multiplied by the $25 inclusion ($5<$8.50 (.34×$25)). The $25 inclusion attributable to the interest income from Y sources is treated as general limitation income because the foreign taxes paid and deemed paid exceed the highest United States tax rate multiplied by the $25 inclusion ($10>$8.50 (.34×$25)).

Example 3. Controlled foreign corporation S is a whollyowned subsidiary of domestic corporation P. S is incorporated and operating in country Y and has a branch in country Z. S has two QBUs (QBU Y and QBU Z). In 1988, S earns $65 of gross passive royalty income in country Y through QBU Y and $65 of gross passive royalty income in country Z through QBU Z. S allocates $15 of expenses to the gross passive royalty income earned by each QBU, resulting in net income of $50 in each QBU. Country Y imposes $5 of foreign tax on the royalty income earned in Y, and country Z imposes $10 of tax on royalty income earned in Z. All of S's income constitutes subpart F foreign personal holding company income that is passive income and is included in P's gross income for the taxable year. P allocates $50 of expenses pro rata to the $100 subpart F inclusion attributable to the QBUs (consisting of the $45 section 951 inclusion derived through QBU Y, the $5 section 78 amount attributable to QBU Y, the $40 section 951 inclusion derived through QBU Z, and the $10 section 78 amount attributable to QBU Z), resulting in a net inclusion of $50. Pursuant to paragraph (c)(4) of this section, the high-tax kickout rules must be applied separately to the subpart F inclusion attributable to the income earned by QBU Y and the income earned by QBU Z. After application of the high-tax kickout rules, the $25 inclusion attributable to Y will still be treated as passive income because the foreign taxes paid and deemed paid on the income do not exceed the highest United States tax rate multiplied by the $25 inclusion ($5<$8.50 (.34×$25)). The $25 inclusion attributable to Z will be treated as general limitation income because the foreign taxes paid and deemed paid on the income exceed the highest United States tax rate multiplied by the $25 inclusion ($10≤$8.50 (.34×$25)).

Example 4. Domestic corporation M operates in branch form in foreign countries X and Y. The branches are qualified business units (QBUs), within the meaning of section 989(a). In 1988, QBU X earns passive royalty income, interest income and rental income. All of the QBU X passive income is from Country Z sources. The royalty income is not subject to a withholding tax, and is not taxed by Country X, and the interest and the rental income are subject to a 5 percent and

10 percent withholding tax, respectively. QBU Y earns interest income in Country Y that is not subject to foreign tax. For purposes of determining whether M's foreign source passive income is high-taxed income, the rental income and the interest income earned in QBU X are treated as one item of income pursuant to paragraphs (c) (4)(ii) and (3)(ii) of this section. The interest income earned in QBU Y and the royalty income earned in QBU X are each treated as a separate item of income under paragraphs (c)(4)(i) (with respect to QBU Y's interest income) and (c) (4)(ii) and (3)(iii) (with respect to QBU X's royalty income) of this section.

Example 5. S, a controlled foreign corporation incorporated in foreign country R, is a wholly-owned subsidiary of P, a domestic corporation. For 1988, P is required under section 951(a) to include in gross income $80 (not including the section 78 amount) attributable to the earnings and profits of S for such year, all of which is foreign personal holding company income that is passive rent or royalty income. S does not make any distributions in 1988 or 1989. Foreign income taxes paid by S for 1988 that are deemed paid by P for such year under section 960(a) with respect to the section 951(a) inclusion equal $20. Twenty dollars ($20) of P's expenses are properly allocated to the section 951(a) inclusion. The foreign income tax paid with respect to the section 951(a) inclusion does not exceed the highest United States tax rate multiplied by the amount of income after allocation of parent expenses ($20<$27.20 (.34×$80)). Thus, P's section 951(a) inclusion for 1988 is included in P's passive income and the $20 of taxes attributable to that inclusion are treated as taxes related to passive income. In 1990, S distributes $80 to P, and under section 959 that distribution is treated as attributable to the earnings and profits with respect to the amount included in income by P in 1988 and is excluded from P's gross income. Foreign country R imposes a withholding tax of $15 on the distribution in 1990. Under paragraph (c)(6)(i) of this section, the withholding tax in 1990 does not affect the characterization of the 1988 inclusion as passive income nor does it affect the characterization of the $20 of taxes paid in 1988 as taxes paid with respect to passive income. No further parent expenses are allocable to the receipt of that distribution. In 1990, the foreign taxes paid ($15) exceed the product of the highest United States tax rate and the amount of the inclusion reduced by taxes deemed paid in the year of inclusion ($15>((.34×$80)−$20)). Thus, under paragraph (c)(6)(iii) of this section, $7.20 ((.34×$80)−$20)) of the $15 withholding tax paid in 1990 is treated as taxes related to passive income and the remaining $7.80 ($15–$7.20) of the withholding tax is treated as related to general limitation income.

Example 6. S, a controlled foreign corporation, is a wholly-owned subsidiary of P, a domestic corporation. P and S are calendar year taxpayers. In 1987, S's only earnings consist of $200 of passive income that is foreign personal holding company income that is earned in a foreign country X. Under country X's tax system, the corporate tax on particular earnings is reduced on distribution of those earnings and no withholding tax is imposed. In 1987, S pays $100 of foreign tax. P does not elect to exclude this income from subpart F under section 954(b)(4) and includes $200 in gross income ($100 of net foreign personal holding company income and $100 of the section 78 amount). At the time of the inclusion, the income is considered to be high-taxed income under paragraphs (c)(1) and (c)(6)(i) of this section and is general limitation income to P. S does not distribute any of its earnings in 1987. In 1988, S has no earnings. On December 31, 1988, S distributes the $100 of earnings from 1987. At that time, S receives a $50 refund from X attributable to the reduction of the country X corporate tax imposed on those earnings. Under paragraph (c)(7)(i) of this section, P must redetermine whether the 1987 inclusion should be considered to be high-taxed income. By taking into account the reduction in foreign tax, the inclusion would not have been considered high-taxed income. Therefore, P must redetermine its foreign tax credit for 1987 and treat the inclusion and the taxes associated with the inclusion as passive income and taxes. P must follow the appropriate section 905(c) procedures.

Example 7. The facts are the same as in *Example* 6 except that P elects to apply section 954(b)(4) to S's passive income that is subpart F income. Although the income is not considered to be subpart F income, it remains passive income until distribution. In 1988, S distributes $150 to P. The distribution is a dividend to P because S has $150 of accumulated earnings and profits (the $100 of earnings in 1987 and the $50 refund in 1988). P has no expenses allocable to the dividend from S. In 1988, the income is subject to the high-tax kick-out rules under paragraph (c)(7)(iii) of this section. The income is passive income to P because the foreign taxes paid and deemed paid by P with respect to the income do not exceed the highest United States tax rate on that income.

Example 8. The facts are the same as in *Example* 6 except that the distribution in 1988 is subject to a withholding tax of $25. Under paragraph (c)(7)(i) of this section, P must redetermine whether the 1987 inclusion should be considered to be high-taxed income because there is a net $25 reduction of foreign tax. By taking into account both the reduction in foreign corporate tax and the withholding tax, the inclusion would continue to be considered high-taxed income. P must follow the appropriate section 905(c) procedures. P must redetermine its foreign tax credit for 1987, but the inclusion and the $75 taxes ($50 of deemed paid tax and $25 withholding tax) will continue to be treated as general limitation income and taxes.

Example 9. (i) S, a controlled foreign corporation operating in country G, is a wholly-owned subsidiary of P, a domestic corporation. P and S are calendar year taxpayers. Country G imposes a tax of 50 percent on S's earnings. Under country G's system, the foreign corporate tax on particular earnings is reduced on distribution of those earnings to 30 percent and no withholding tax is imposed. Under country G's law, distributions are treated as made pro rata from each year's earnings. For 1987, S's only earnings consist of passive income that is foreign personal holding company income that is earned in foreign country G. S has taxable income of $110 for United States purposes and $100 for country G purposes. Country G, therefore, imposes a tax of $50 on the 1987 earnings of S. P does not elect to exclude this income from subpart F under section 954(b)(4) and includes $110 in gross income ($60 of net foreign personal holding company income and $50 of the section 78 amount). At the time of the inclusion, the income is considered to be high-taxed income under paragraph (c) of this section and is general limitation income to P. S does not distribute any of its taxable income in 1987.

(ii) In 1988, S earns general limitation income that is not subpart F income. S again has $110 in taxable income for United States purposes and $100 in taxable income for country G purposes, and S pays $50 of tax to foreign country G. In 1989, S has no taxable income or earnings. On December 31, 1989, S distributes $60 of earnings and receives a refund of foreign tax of $24. Country G treats the distribution of earnings as pro rata from the earnings accumulated in 1987 and 1988. However, under paragraph (c)(7)(ii) of this section, the distribution, and, therefore, the reduction of tax is treated as first attributable to the $60 of passive earnings attributable to income previously taxed in 1987. However, because, under foreign law, only 40 percent (the reduction in tax rates from 50 percent to 30 percent is a 40 percent reduction in the tax) of the $50 of foreign taxes on the passive earnings can be refunded, $20 of the $24 foreign tax refund reduces foreign taxes on passive earnings. The other $4 of the tax refund reduces the general limitation taxes from $50 to $46 (even though for United States purposes the $60 distribution is entirely out of passive earnings).

(iii) Under paragraph (c)(7) of this section, P must redetermine whether the 1987 inclusion should be considered to be high-taxed income. By taking into account the reduction in foreign tax, the inclusion would not have been considered high-taxed income ($30<.34×$110). Therefore, P must redetermine its foreign tax credit for 1987 and treat the inclusion and the taxes associated with the inclusion as passive income and taxes. P must follow the appropriate section 905(c) procedures.

Example 10. P, a domestic corporation, earns $100 of passive royalty income from sources within the United States. Under the laws of Country X, however, that royalty is considered to be from sources within Country X and Country X imposes a 10 percent withholding tax on the payment of the royalty. P also earns $100 of passive foreign source dividend income subject to a 10 percent withholding tax to which $15 of expenses are allocated. In determining whether P's passive income is high-taxed, the $10 withholding tax on P's royalty income is allocated to passive income, and within the passive category to the group of income described in paragraph (c)(3)(ii) of this section (passive income subject to a withholding tax of less than 15 percent (but greater than zero)). For purposes of determining whether the income is high-taxed, however, only the foreign source dividend income is taken into account. The foreign source dividend income will still be treated as passive income because the foreign taxes paid on the passive income in the group ($20) do not exceed the highest United States tax rate multiplied by the $85 of net foreign source income in the group ($20 is less than $28.90 ($100 − $15) × .34).

Example 11. In 2001, *P*, a U.S. citizen with a tax home in Country *X*, earns the following items of gross income: $400 of foreign source, passive limitation interest income not subject to foreign withholding tax but subject to Country *X* income tax of $100, $200 of foreign source, passive limitation royalty income subject to a 5 percent foreign withholding tax (foreign tax paid is $10), $1,300 of foreign source, passive limitation rental income subject to a 25 percent foreign withholding tax (foreign tax paid is $325), $500 of foreign source, general limitation income that gives rise to a $250 foreign tax, and $2,000 of U.S. source capital gain that is not subject to any foreign tax. *P* has a $900 deduction allocable to its passive rental income. *P*'s only other deduction is a $700 capital loss on the sale of stock that is allocated to foreign source passive limitation income under § 1.865–2(a)(3)(i). The $700 capital loss is initially allocated to the group of passive income subject to no withholding tax but subject to foreign tax other than withholding tax. The $300 amount by which the capital loss exceeds the income in the group must be reapportioned to the other groups under paragraph (c)(2)(ii)(B) of this section. The royalty income is thus reduced by $100 to $100 ($200 − ($300 × (200/600))) and the rental income is thus reduced by $200 to $200 ($400 − ($300 × (400/600))). The $100 royalty income is not high-taxed and remains passive income because the foreign taxes do not exceed the highest United States rate of tax on that income. Under the high-tax kick-out, the $200 of rental income and the $325 of associated foreign tax are assigned to the general limitation category.

Example 12. The facts are the same as in *Example 11* except the amount of the capital loss that is allocated under §1.865–2(a)(3)(i) and paragraph (c)(2) of this section to the group of foreign source passive income subject to no withholding tax but subject to foreign tax other than withholding tax is $1,200. Under paragraph (c)(2)(ii)(B) of this section, the excess deductions of $800 must be reapportioned to the $200 of net royalty income subject to a 5 percent withholding tax and the $400 of net rental income subject to a 15 percent or greater withholding tax. The income in each of these groups is reduced to zero, and the foreign taxes imposed on the rental and royalty income are considered related to general limitation income. The remaining loss of $200 constitutes a separate limitation loss with respect to passive income.

Example 13. In 2001, *P*, a domestic corporation, earns a $100 dividend that is foreign source passive limitation income subject to a 30-percent withholding tax. A foreign tax credit for the withholding tax on the dividend is disallowed under section 901(k). A deduction for the tax is allowed, however, under sections 164 and 901(k)(7). In determining whether *P*'s passive income is high-taxed, the $100 dividend and the $30 deduction are allocated to the first group of income described in paragraph (c)(3)(iv) of this section (passive income subject to no withholding tax or other foreign tax).

(d) *High withholding tax interest.* The term ''high withholding tax interest'' means any interest if such interest is subject to a withholding tax of a foreign country or a possession of the United States and the rate of tax applicable to such interest is at least 5 percent. For purposes of the preceding sentence, a withholding tax is any tax imposed by a foreign country or possession of the United States that is determined on a gross basis. A withholding tax shall not be considered to be determined on a gross basis if the tax is not the final tax payable on the interest income, but is merely a prepayment or credit against a final foreign tax liability determined on a net basis on the interest alone or on interest and other income. High withholding tax interest does not include any interest described as export financing interest (as defined in section 904(d)(2)(G) and paragraph (h) of this section).

(e) *Financial services income*—(1) *In general.* The term ''financial services income'' means income derived by a financial services entity, as defined in paragraph (e)(3) of this section, that is:

(i) Income derived in the active conduct of a banking, insurance, financing, or similar business (active financing income as defined in paragraph (e)(2) of this section), except income described in paragraph (e)(2)(i)(W) of this section (high withholding tax interest);

(ii) Passive income as defined in section 904(d) (2) (A) and paragraph (b) of this section as determined before the application of the exception for high-taxed income;

(iii) Export financing interest as defined in section 904(d)(2)(G) and paragraph (h) of this section that, but for section 904(d)(2)(B)(ii), would also meet the definition of high withholding tax interest; or

(iv) Incidental income as defined in paragraph (e)(4) of this section.

(2) *Active financing income*—(i) *Income included.* For purposes of paragraph (e)(1) and (e)(3) of this section, income is active financing income only if it is described in any of the following subdivisions.

(A) Income that is of a kind that would be insurance income as defined in section 953(a) (including related party insurance income as defined in section 953(c)(2)) and determined without regard to those provisions of section 953(a)(1)(A) that limit insurance income to income from countries other than the country in which the corporation was created or organized.

(B) Income from the investment by an insurance company of its unearned premiums or reserves ordinary and necessary to the proper conduct of the insurance business, income from providing services as an insurance underwriter, income from insurance brokerage or agency services, and income from loss adjuster and surveyor services.

(C) Income from investing funds in circumstances in which the taxpayer holds itself out as providing a financial service by the acceptance or the investment of such funds, including income from investing deposits of money and income earned investing funds received for the purchase of traveler's checks or face amount certificates.

(D) Income from making personal, mortgage, industrial, or other loans.

(E) Income from purchasing, selling, discounting, or negotiating on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness.

(F) Income from issuing letters of credit and negotiating drafts drawn thereunder.

(G) Income from providing trust services.

(H) Income from arranging foreign exchange transactions, or engaging in foreign exchange transactions.

(I) Income from purchasing stock, debt obligations, or other securities from an issuer or holder with a view to the public distribution thereof or offering or selling stock, debt obligations, or other securities for an issuer or holder in connection with the public distribution thereof, or participating in any such undertaking.

(J) Income earned by broker-dealers in the ordinary course of business (such as commissions) from the purchase or sale of stock, debt obligations, commodities futures, or other securities or financial instruments and dividend and interest income earned by broker dealers on stock, debt obligations, or other financial instruments that are held for sale.

(K) Service fee income from investment and correspondent banking.

(L) Income from interest rate and currency swaps.

(M) Income from providing fiduciary services.

(N) Income from services with respect to the management of funds.

(O) Bank-to-bank participation income.

(P) Income from providing charge and credit card services or for factoring receivables obtained in the course of providing such services.

(Q) Income from financing purchases from third parties.

(R) Income from gains on the disposition of tangible or intangible personal property or real property that was used in the active financing business (as defined in paragraph (e)(3)(i) of this section) but only to the extent that the property was held to generate or generated active financing income prior to its disposition.

(S) Income from hedging gain with respect to other active financing income.

(T) Income from providing traveller's check services.

(U) Income from servicing mortgages.

(V) Income from a finance lease. For this purpose, a finance lease is any lease that is a direct financing lease or a leveraged lease for accounting purposes and is also a lease for tax purposes.

(W) High withholding tax interest that would otherwise be described as active financing income.

(X) Income from providing investment advisory services, custodial services, agency paying services, collection agency services, and stock transfer agency services.

(Y) Any similar item of income that is disclosed in the manner provided in the instructions to the Form 1118 or 1116 or that is designated as a similar item of income in guidance published by the Internal Revenue Service.

(3) *Financial services entities*—(i) *In general.* The term ''financial services entity'' means an individual or entity that is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business (active financing business) for any taxable Year. Except as provided in paragraph (e)(3)(ii) of this section, a determination of whether an entity is a financial services entity shall be done on an entity-by-entity basis. An individual or entity is predominantly engaged in the active financing business for any year if for that year at least 80 percent of its gross income is income described in paragraph (e)(2)(i) of this section. For this purpose, gross income includes all income realized by an individual or entity, whether includible or excludible from gross income under other operative provisions of the Code, but excludes gain from the disposition of stock of a corporation that prior to the disposition of its stock is related to the transferor within the meaning of section 267(b). For this purpose, income received from a related person that is a

financial services entity shall be excluded if such income is characterized under the look-through rules of section 904(d)(3) and §1.904–5. In addition, income received from a related person that is not a financial services entity but that is characterized as financial services income under the look-through rules shall be excluded. *See* paragraph (e)(3)(iv) *Example 5* of this section. Any income received from a related person that is characterized under the look-through rules and that is not otherwise excluded by this paragraph will retain its character either as active financing income or other income in the hands of the recipient for purposes of determining if the recipient is a financial services entity and if the income is financial services income to the recipient. For purposes of this paragraph, related person is defined in §1.904–5(i)(1).

(ii) *Special rule for affiliated groups.* In the case of any corporation that is not a financial services entity under paragraph (e)(3)(i) of this section, but is a member of an affiliated group (as defined in section 1504(a) without regard to section 1504(b)(3)), such corporation will be deemed to be a financial services entity if the affiliated group as a whole meets the requirements of section (e)(3)(i) of this section. For purposes of determining if the affiliated group meets the requirements of paragraph (e)(3)(i) of this section the rules of this paragraph (e)(3)(ii) apply. The income of the group will not include any income from transactions with other members of the group. Passive income will not be considered to be active financing income merely because that income is earned by a member of the group that is a financial services entity without regard to the rule in this paragraph (e)(3)(ii).

(iii) *Treatment of partnerships and other pass-through entities* For purposes of determining whether a partner (including a partnership that is a partner in a second partnership) is a financial services entity, all of the partner's income shall be taken into account, except that income that is excluded under paragraph (e)(3)(i) of this section shall not be taken into account. Thus, if a partnership is determined to be a financial services entity none of the income of the partner received from the partnership that is characterized under the look-through rules shall be included for purpose of determining if the partner is a financial services entity. If a partnership is determined not to be a financial services entity, then income of the partner from the partnership that is characterized under the look-through rules will be taken into account (unless such income is financial services income) and such income will retain its character either as active financing income or as other income in the hands of the partner for purposes of determining if the partner is a financial service entity and if the income is financial services income to the partner. If a partnership is a financial services entity and the partner's income from the partnership is characterized as financial services income under the look-through rules, then, for purposes of determining a partner's foreign tax credit limitation, the income from the partnership shall be considered to be financial services income to the partner regardless of whether the partner is itself a financial services entity. The rules of this paragraph (e)(3)(iii) will appIy for purposes of determining whether an owner of an interest in any other pass-through entity the character of the income of which is preserved when such income is included in the income of the owner of the interest is a financial services entity.

(iv) *Examples.* The principles of paragraph (e)(3) of this section are illustrated by the following examples.

Example 1. P is a domestic corporation that owns 100 percent of the stock of S, a controlled foreign corporation incorporated in Country X. For the 1990 taxable year, 60 percent of S's income is active financing income that consists of income that will be considered general limitation or passive income if S is not a financial services entity. The other 40 percent of S's income is passive non-active financing income. S is not a financial services entity and its active financing income thus retains its character as general limitation and passive income. S makes an interest payment to P in 1990 that is characterized under the look-through rules. Although the interest is not financial services income to S under the look-through rules, it retains its character as active financing income when paid to P and P must take that income into account in determining whether it is a financial services entity under paragraph (e)(3)(i) of this section. If P is determined to be a financial services entity, both the portion of the interest payment characterized as active financing income (whether general limitation or passive income in S's hands) and the portion characterized as passive non-active financing income received from S will be recharacterized as financial services income.

Example 2. [Reserved]

Example 3. PS is a domestic partnership operating in branch form in foreign country X. PS has two equal general partners, A and B. A and B are domestic corporations that each operate in branch form in foreign countries Y and Z. All of A's income, except that derived through PS, is manufacturing income. All of B's income, except that derived through PS, is active financing income. A and B's only income from PS are distributive shares of PS's income. PS is a financial services entity and all of its income is financial services income. The income from PS is excluded in determining if A or B are financial services entities. Thus, A is not a financial services entity because none of A's income is active financing income and B is a financial services entity because all of B's income is active financing income. However, both A and B's distributive shares of PS's taxable income consist of financial services income even though A is not a financial services entity.

Example 4. PS is a domestic partnership operating in foreign country X. A and B are domestic corporations that are equal general partners in PS and, therefore, the look-through rules apply for purposes of characterizing A's and B's distributive shares of PS's income. Fifty (50) percent of PS's gross income is active financing income that is not high withholding tax interest. The active financing income includes income that also meets the definition of passive income and income that meets the definition of general limitation income. The other 50 percent of PS's income is from manufacturing. PS is, therefore, not a financial services entity. A s and B's distributive shares of partnership taxable income consist of general limitation manufacturing income and active financing income. Under paragraph (c)(3)(i) of this section, the active financing income shall be financial services income to A or B if either A or B is determined to be a financial services entity. If A or B is not a financial services entity, the distributive shares of income from PS will not be financial services income to A or B and will consist of passive and general limitation income. All of the income from PS is included in determining if A or B are financial services entities.

Example 5. P is a United States corporation that is not a financial services entity. P owns 100 percent of the stock of S, a controlled foreign corporation that is not a financial services entity. S owns 100 percent of the stock of T, a controlled foreign corporation that is a financial services entity. In 1991, T pays a dividend to S. The dividend from T is characterized under the look-through rules of section 904(d)(3). Pursuant to paragraph (e)(3)(i) of this section, the dividend from T is excluded in determining whether S is a financial services entity. S is determined not to be a financial services entity but the dividend retains its character as financial services income in S's hands. Any subpart F inclusion or dividend to P out of earnings and profits attributable to the dividend from T will be excluded in determining whether P is a financial services entity but the inclusion or dividend will retain its character as financial services income.

(4) *Definition of incidental income*—(i) *In general*—(A) *Rule.* Incidental income is income that is integrally related to active financing income of a financial services entity. Such income includes, for example, income from precious metals trading and commodity trading that is integrally related to futures income. If securities, shares of stock, or other types of property are acquired by a financial services entity as an ordinary and necessary incident to the conduct of a active financing business, the income from such property will be considered to be financial services income but only so long as the retention of such property remains an ordinary or necessary incident to the conduct of such business. Thus property, including stock, acquired as the result of, or in order to prevent, a loss in an active financing business upon a loan held by the taxpayer in the ordinary course of such business will be considered ordinary and necessary to the conduct of such business, but income from such property will be considered financial services income only so long as the holding of such property remains an ordinary and necessary incident to the conduct of such business. If an entity holds such property for five years or less then the property is considered held incident to the financial services business. If an entity holds such property for more than five years, a presumption will be established that the entity is not holding such property incident to its financial services business. An entity will be able to rebut the presumption by demonstrating that under the facts and circumstances

it is not holding the property as an investment. However, the fact that an entity holds the property for more than five years and is not able to rebut the presumption that it is not holding the property incident to its financial services business will not affect the characterization of any income received from the property during the first five years as financial services income.

(B) *Examples.* The following examples illustrate the application of paragraph (e)(4)(i) of this section.

Example 1. X is a financial services entity within the meaning of paragraph (e)(3)(i) of this section. In 1987, X made a loan in the ordinary course of its business to an unrelated foreign corporation, Y. As security for that loan, Y pledged certain operating assets. Those assets generate income of a type that would be subject to the general limitation. In January 1989, Y defaulted on the loan and forfeited the collateral. During the period X held the assets, X earned operating income generated by those assets. This income was applied in partial satisfaction of Y's obligation. In 1993, X sold the forfeited assets. The sales proceeds were in excess of the remainder of Y's obligation. The operating income received in the period from 1989 to 1993 and the income on the sale of the assets in 1993 are financial services income of X.

Example 2. The facts are the same as in *Example* 1, except that instead of pledging its operating assets as collateral for the loan, Y pledged the stock of its operating subsidiary Z. In 1993 X sold the stock of Z in complete satisfaction of Y's obligation. X's income from the sale of Z stock in satisfaction of Y's obligation is financial services income.

Example 3. P, a domestic corporation, is a financial services entity within the meaning of paragraph (e)(3)(i) of this section. P holds a United States dollar denominated debt (the ‘‘obligation’’) of the Central Bank of foreign country X. The obligation evidences a loan of $100 made by P to the Central Bank. In 1988, pursuant to a program of country X, P delivers the obligation to the Central Bank which credits 70 units of country X currency to M, a country X corporation. M issues all of its only class of capital stock to P. M invests the 70 units of country X currency in the construction and operation of a new hotel in X. In 1994, M distributes 10 units of country X currency to P as a dividend. P is not able to rebut the presumption that it is not holding the stock of M incident to its financial services business. The dividend to P is, therefore, not financial services income.

(ii) *Income that is not incidental income.* Income that is attributable to non-financial activity is not incidental income within the meaning of paragraph (e)(4) (i) and (ii) of this section solely because such income represents a relatively small proportion of the taxpayer's total income or that the taxpayer engages in non-financial activity on a sporadic basis. Thus, for example, income from data processing services provided to related or unrelated parties or income from the sale of goods or non-financial services (for example travel services) is not financial services income, even if the recipient is a financial services entity.

(5) *Exceptions.* Financial services income does not include income that is:

(i) Export financing interest as defined in section 904(d)(2)(G) and paragraph (h) of this section unless that income would be high withholding tax interest as defined in section 904(d)(2)(B) but for paragraph (d)(2)(B)(ii) of that section;

(ii) High withholding tax interest as defined in section 904(d)(2)(B) unless that income also meets the definition of export financing interest; and

(iii) Dividends from noncontrolled section 902 corporations as defined in section 904(d)(2)(E) and paragraph (g) of this section.

(f) *Shipping income.* The term ‘‘shipping income’’ means any income received or accrued by any person that is of a kind that would be foreign base company shipping income (as defined in section 954(f) and the regulations thereunder). Shipping income does not include any dividends received or accrued from a noncontrolled section 902 corporation, any income that is financial services income, or any income described in section 904(d)(1)(G) (foreign trade income within the meaning of section 923(b)).

(g) *Noncontrolled section 902 corporation*—(1) *Definition.* Except as otherwise provided, the term ‘‘noncontrolled section 902 corporation’’ means any foreign corporation with respect to which the taxpayer meets the stock ownership requirements of section 902(a) or, for purposes of applying the look-through rules described in section 904(d)(3) and §1.904–5, the taxpayer meets the requirements of section 902(b). Except as provided in section 902 and the regulations under that section and paragraph (g)(3) of this section, a controlled foreign corporation shall not be treated as a noncontrolled section 902 corporation with respect to any distributions out of its earnings and profits for periods during which it was a controlled foreign corporation. In the case of a partnership owning a foreign corporation, the determination of whether a taxpayer meets the ownership requirements of section 902 (a) or (b) will be made with respect to the partner's indirect ownership, and not the partnership's direct ownership, in the foreign corporation.

(2) *Treatment of dividends from each separate noncontrolled section 902 corporation*—(i) *In general.* Except as otherwise provided, a separate foreign tax credit limitation applies to dividends received or accrued by a corporation from each noncontrolled section 902 corporation. Any dividend distribution made by a noncontrolled section 902 corporation out of earnings and profits attributable to periods in which the shareholder did not meet the stock ownership requirements of section 902(a) or section 902(b) shall be treated as distributions made by a noncontrolled section 902 corporation.

(ii) *Special rule for dividends received by a controlled foreign corporation.* If—

(A) Stock in a foreign corporation that it is not a controlled foreign corporation is owned by a controlled foreign corporation, see paragraph (g)(4) *Example 1,*

(B) There are two or more shareholders of that controlled foreign corporation, and

(C) The ownership requirements of section 902(b) with respect to the foreign corporation are met by at least one of the United States shareholders of the controlled foreign corporation,

then any dividends received by the controlled foreign corporation from the foreign corporation shall be treated in their entirety to the controlled foreign corporation as dividends from a noncontrolled section 902 corporation, notwithstanding that all the United States shareholders of the controlled foreign corporation do not meet the requirements of section 902(b). Any income received or accrued by a United States shareholder of a controlled foreign corporation described in the preceding sentence that is attributable to a dividend paid by a foreign corporation shall be considered to be passive income if the shareholder's interest in that foreign corporation does not satisfy the requirements of section 902(b).

(iii) *Special rules for high withholding tax interest.* If a taxpayer receives or accrues a dividend distribution from a noncontrolled section 902 corporation out of earnings and profits attributable to high withholding tax interest earned or accrued by the noncontrolled section 902 corporation, any gross basis foreign tax (as defined in paragraph (d) of this section) imposed on such interest, to the extent that the taxes are imposed at a rate in excess of 5 percent, shall not be treated as foreign taxes for purposes of determining the amount of foreign taxes deemed paid or accrued by the taxpayer under section 902. The preceding sentence shall have no effect upon the determination of the amount of earnings and profits of a noncontrolled section 902 corporation.

(iv) *Treatment of inclusions under section 1293.* If a foreign corporation is a noncontrolled section 902 corporation with respect to a taxpayer, any inclusion in the taxpayer's gross income under section 1293 with respect to that corporation shall be treated as a dividend from a noncontrolled section 902 corporation and thus shall be subject to a separate limitation.

(3) *Special rule for controlled foreign corporations*— (i) *General rule.* Distributions from a controlled foreign corporation shall be treated as dividends from a noncontrolled section 902 corporation, and therefore not subject to the look-through rules of § 1.904–5, to the extent that the distribution is out of earnings and profits for periods during which the controlled foreign corporation was not a controlled foreign corporation.

(ii) *Dividend distributions out of earnings and profits for a year during which a shareholder that is currently a more-than-90-percent United States shareholder was not a United States shareholder.* [Reserved]

(iii) *Ordering rule.* [Reserved]

(iv) *Examples.* [Reserved]

(4) *Examples.* The following examples illustrate the application of this paragraph (g).

Example 1. A and B are domestic corporations. A owns 90 percent of the stock of C, a foreign corporation and B owns the remaining 10 percent of the C stock. C is a controlled foreign corporation. A and B are United States shareholders. C owns 20 percent of the stock of D, a foreign corporation, not a controlled foreign corporation, that is incorporated in a different country than C. D is a noncontrolled section 902 corporation with respect to C and A, but not with respect to B. In 1987, C has foreign personal holding company income of $1000, $100 of which is attributable to a dividend from D. The remainder of the foreign personal holding company income is passive income. Assume that gross income and net income are equal and that C pays no foreign taxes on its foreign personal holding company income. In 1987, A and B have section 951(a)(1)(A) inclusions of $900 and $100, respectively, attributable to the foreign personal holding company income. Under paragraph (g)(2)(ii) of this section, the $900 included by A consists of $810 passive income and $90 of income attributable to a dividend from a noncontrolled section 902 corporation. The $100 included by B in gross income is characterized as passive income in its entirety although $10 of the $100 is attributable to the dividend from D, and, as to C, that dividend is characterized as a dividend from a noncontrolled section 902 corporation. As to B, the $10 is characterized as passive income because B does not meet the ownership requirements of section 902(b) with regard to D.

Example 2. In 1987, A, a domestic corporation, owned 9 percent of the stock of B, a foreign corporation. In 1988, A acquired an additional 20 percent of the stock of B. Thus, in 1988, B is a noncontrolled section 902 corporation with regard to A. In 1989, A acquired an additional 25 percent of the stock of B. A acquired no additional stock in 1990. In 1989 and 1990, A owned 54 percent of the stock of B. For 1989 and 1990, B is a controlled foreign corporation in which A is a United States shareholder. B has no subpart F income in 1989 or 1990. In 1990, B pays a dividend of $3,000 to A. One thousand dollars ($1,000) of the dividend is attributable to earnings and profits from 1987, $1,000 is attributable to earnings and profits from 1988, and $1,000 is attributable to earnings and profits from 1989. Under paragraph (g)(1) of this section, the $1,000 attributable to the earnings and profits from 1989 is subject to the look through rules of section 904(d)(3) and §1.904–5(c)(4) and is characterized in A's hands according to those rules. Under section 904(d)(2)(E)(i) and paragraph (g)(3) of this section, the $2,000 attributable to the 1987 and 1988 earnings and profits is treated as income subject to a separate limitation for dividends from a noncontrolled section 902 corporation (B corporation).

Example 3. M owns 40 percent of the voting stock of foreign corporation N. N is a noncontrolled section 902 corporation. In 1987, N earns $2,000 of gross interest income and incurs $1,700 of interest expense. N incurs no other expenses and earns no other income. One-thousand dollars ($1,000) of the interest income is subject to a 10 percent withholding tax and is, therefore, high withholding tax interest. N's earnings and profits are $200 ($2,000 gross interest income less $1,700 interest expense less $100 withholding tax). N pays the full $200 out as a dividend. M receives $80 (40 percent of the $200). Under paragraph (g)(2)(iii) of this section, $50 ($100−5% ×$1,000) of the $100 withholding tax is not treated as a foreign tax for purposes of determining the amount of foreign taxes deemed paid by M under section 902. M's deemed paid credit with respect to the $80 dividend it receives is, therefore, reduced from $40 ($100×$80/$200) to $20 ($50×$80/$200).

(h) *Export financing interest*—(1) *Definitions*—(i) *Export financing interest.* The term ''export financing interest'' means any interest derived from financing the sale (or other disposition) for use or consumption outside the United States of any property that is manufactured, produced, grown, or extracted in the United States by the taxpayer or a related person, and not more than 50 percent of the fair market value of which is attributable to products imported into the United States. For purposes of this paragraph, the term ''United States'' includes the fifty States, the District of Columbia, and the Commonwealth of Puerto Rico.

(ii) *Fair market value.* For purposes of this paragraph, the fair market value of any property imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation. For purposes of determining the foreign content of an item of property imported into the United States, see section 927 and the regulations thereunder.

(iii) *Related person.* For purposes of this paragraph, the term ''related person'' has the meaning given it by section 954(d)(3) except that such section shall be applied by substituting ''the person with respect to whom the determination is being made'' for ''controlled foreign corporation'' each place it applies.

(2) *Treatment of export financing interest.* Except as provided in paragraph (h)(3) of this section, if a taxpayer (including a financial services entity) receives or accrues export financing interest from an unrelated person, then that interest shall be treated as general limitation income.

(3) *Exceptions*—(i) *Export financing interest that is high withholding tax interest.* If a financial services entity receives or accrues export financing interest that would also be high withholding tax interest but for section 904(d)(2)(B)(ii), that income shall be treated as financial services income.

(ii) *Export financing interest that is also related person factoring income.* Export financing interest shall be treated as passive income if that income is also related person factoring income. For this purpose, related person factoring income is—

(A) Income received or accrued by a controlled foreign corporation that is income described in section 864(d)(6) (income of a controlled foreign corporation from a loan for the purpose of financing the purchase of inventory property of a related person); or

(B) Income received or accrued by any person that is income described in section 864(d)(1) (income from a trade receivable acquired from a related person).

(iii) *Export financing interest that is related person factoring income and is received or accrued by a financial services entity.* If a financial services entity receives or accrues export financing interest that is also related person factoring income, then the income shall be treated as financial services income. See section 864(d)(5)(A)(i).

(iv) *Export financing interest that is related person factoring income and high withholding tax interest.* If any taxpayer (including a financial services entity) receives or accrues export financing interest that is also related person factoring income and high withholding tax interest, then that income shall be treated as high withholding tax interest. See section 864(d)(5)(A)(i).

(4) *Examples.* The following examples illustrate the operation of paragraph (h)(3) of this section:

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is not a financial services entity and has accumulated cash reserves. P has uncollected trade and service receivables of foreign obligors. P sells the receivables at a discount (“factors”) to S. The income derived by S on the receivables is related person factoring income. The income is also export financing interest. Because the income is related person factoring income, the income is passive income to S.

Example 2. The facts are the same as in *Example (1)* except that S is a financial services entity and derives the income in an active financing business. The income derived by S on the receivables is related person factoring income and is also export financing interest. Therefore, pursuant to paragraph (h)(3)(iii) of this section, the income is financial services income to S.

Example 3. Domestic corporation S is a wholly-owned subsidiary of domestic corporation P. S is not a financial services entity and has accumulated cash reserves. P has uncollected trade and service receivables of foreign obligors. P factors the receivables to S. The income derived by S on the receivables is related person factoring income. The income is also export financing interest. The income will be passive income to S.

Example 4. The facts are the same as in *Example* 3 except that instead of factoring P’s receivables, S finances the sales of P’s goods by making loans to the purchasers of P’s goods. The interest derived by S on these loans is export financing interest and is not related person factoring income. The income will be general limitation income to S.

(5) *Income eligible for section 864(d)(7) exception (same country exception) from related person factoring treatment*—(i) *Income other than interest.* If any foreign person that is not a financial services entity receives or accrues income that is described in section 864(d)(7) (income on a trade or service receivable acquired from a related person in the same foreign country as the recipient) and such income would also meet the definition of export financing interest if section 864(d)(1) applied to such income (income on a trade or service receivable acquired from a related person treated as interest), then the income shall be considered to be export financing interest and shall be treated as general limitation income. If a financial services entity receives or accrues that income, the income shall not be considered to be export financing interest and, therefore, shall be treated as financial services income.

(ii) *Interest income.* If export financing interest is received or accrued by any foreign person and that income would otherwise be treated as related person factoring income under section 864(d)(6) if section 864(d)(7) did not apply, section 904(d)(2)(A)(iii)(II) shall apply, and the interest shall be treated as general limitation income unless the interest is received or accrued by a financial services entity. If that interest is received or accrued by a financial services entity, section 904(d)(2)(C)(iii)(III) shall apply and the interest shall be treated as general limitation income. If that interest also would be high withholding tax interest but for section 904(d)(2)(B)(ii), then the interest shall be treated as financial services income.

(iii) *Examples.* The following examples illustrate the operation of this paragraph (h)(5):

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. Controlled foreign corporation T is a wholly-owned subsidiary of controlled foreign corporation S. S and T are incorporated in Country M. In 1987, P sells tractors to T, which T sells to X, an unrelated foreign corporation organized in country M. The tractors are to be used in country M. T uses a substantial part of its assets in its trade or business located in Country M. T has uncollected trade receivables from X that it factors to S. S derived more than 20 percent of its gross income for 1987 other than from an active financing business and the income derived by S from the receivables is not derived in an active financing business. Thus, pursuant to paragraph (e)(3)(i) of this section, S is not a financial services entity. The income is not related person factoring income because it is described in section 864(d)(7) (income eligible for the same country exception). If section 864(d)(1) applied, the income S derived from the receivables would meet the definition of export financing interest. The income, therefore, is considered to be export financing interest and is general limitation income to S.

Example 2. The facts are the same as in *Example (1)* except that S is a financial services entity and derives the income on the receivables from the conduct of an active financing business. The income S derives from the receivables is not related person factoring income because it is described in section 864(d)(7). If the income would be high withholding tax interest but for section 904(d)(2)(B)(ii), then the income will not be considered to be export financing interest and will be financial services income to S. Otherwise, the income will be considered to be export financing interest and will be general limitation income to S.

Example 3. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation, P. Controlled foreign corporation T is a wholly-owned subsidiary of controlled foreign corporation S. S and T are incorporated in country M. S is not a financial services entity. In 1987, P sells tractors to T, which T sells to X, a foreign partnership that is organized in country M and is related to S and T. S makes a loan to X to finance the tractor sales. The interest earned by S from financing the sales is described in section 864(d)(7) and is export financing interest. Therefore, the income shall be general limitation income to S.

Example 4. The facts are the same as in *Example (3)* except that S is a financial services entity and derives the interest on the loan to X in an active financing business. The interest S earns is export financing interest that is not described in section 864(d)(1) because it is described in section 864(d)(7). Because the interest is described in section 864 (d)(7) and is export financing interest, section 904(d)(2)(C)(iii)(III) shall apply and the income shall be general limitation income to S, unless it would also be high withholding tax interest but for section 904(d)(2)(B)(ii), in which case it will be financial services income to S.

(i) *Interaction of section 907(c) and income described in this section.* If a person receives or accrues income that is income described in section 907(c) (relating to oil and gas income), the rules of section 907(c) and the regulations thereunder, as well as the rules of this section, shall apply to the income. Thus, for example, if a taxpayer receives or accrues a dividend distribution from two separate noncontrolled section 902 corporations out of earnings and profits attributable to income received or accrued by the noncontrolled section 902 corporations that is income described in section 907(c), the rules provided in section 907 shall apply separately to the dividends received from each noncontrolled section 902 corporation. The reduction in amount allowed as foreign tax provided by section 907(a) shall therefore be calculated separately for dividends received or accrued by the taxpayer from each separate noncontrolled section 902 corporation.

(j) *Special rule for DASTM gain or loss.* Any DASTM gain or loss computed under §1.985–3(d) must be allocated among the categories of income under the rules of § 1.985–3 (e)(2)(iv) or (e)(3). The rules of § 1.985–3(e) apply before the rules of section 904(d)(2)(A)(iii)(III) (the exception from passive income for high-taxed income).

(k) *Special rule for alternative minimum tax foreign tax credit.* For purposes of computing the alternative minimum tax foreign tax credit under section 59(a), items included in alternative minimum taxable income by reason of section 56(g) (adjustments based on adjusted current earnings) shall be characterized as income described in a separate category under section 904(d) and this section based on the character of the underlying items of income.

(l) *Priority rules*—(1) *In general.* In the case of income that meets the definitions of more than one category of separate limitation income, the following priority rules apply:

(i) Income that meets the definitions of passive income and of any other separate limitation income described in section 904(d)(1) (B) through (H) will be subject to the other separate limitation;

(ii) Income that meets the definitions of financial services income and of either shipping income or passive income will be subject to the separate limitation for financial services income;

(iii) Income that meets the definitions of financial services income and of any separate limitation income other than shipping or passive income will be subject to the other separate limitation;

(iv) Income that meets the definitions of dividends from a noncontrolled section 902 corporation and of any other separate limitation income will be subject to the separate limitation for dividends from a noncontrolled section 902 corporation unless that income is foreign oil and gas extraction income defined in section 907(c), in which case it will be treated as general limitation income pursuant to § 1.907(a)–1(f);

(v) Income that meets the definitions of high withholding tax interest and of any other separate limitation income will be high withholding tax interest; and

(vi) Income that meets the definitions of shipping income and of foreign trade income will be subject to the separate limitation for foreign trade income.

(2) *Examples.* The provisions of this paragraph (l) are illustrated by the following examples:

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S owns 20 percent of the voting stock of T, a foreign corporation that is not a controlled foreign corporation. In 1987, T pays S a dividend that qualifies as foreign base company shipping income to S under § 1.954–6(f)(1). The dividend from T is also a dividend from a noncontrolled section 902 corporation. Therefore, pursuant to section 904(d)(2)(D) and paragraph (l)(1)(iv) of this section, the dividend from T is treated as a dividend from a noncontrolled section 902 corporation.

Example 2. In 1987, domestic corporation P received a dividend from R, a foreign corporation that is not a controlled foreign corporation. P owns 30 percent of the voting stock of R. P is a financial services entity and the dividend from R qualifies as financial services income under paragraph (e)(4)(i)(A) of this section. The dividend from R is also a dividend from a noncontrolled section 902 corporation. Therefore, pursuant to section 904(d)(2)(C) (iii)(II) and paragraphs (l)(1)(iii) and (iv) of this section, the dividend from R is treated as a dividend from a noncontrolled section 902 corporation.

Example 3. P, a domestic corporation, owns 10 percent of foreign corporation S. S is a noncontrolled section 902 corporation. In 1990, S earns foreign oil and gas extraction income which is general limitation income. S pays a dividend to P out of its earnings and profits for 1990. The dividend from S is a dividend from a noncontrolled section 902 corporation that is also foreign oil and gas extraction income. Pursuant to section 907(c)(3)(A), § 1.907(a)–1(f) and paragraph (l)(1)(iv) of this section, P will include the dividend in income as general limitation income.

[T.D. 8214, 53 FR 27011, July 18, 1988, as amended by T.D. 8412, 57 FR 20644, May 14, 1992; 57 FR 45660, Oct. 2, 1992; T.D. 8556, 59 FR 37672, July 25, 1994; T.D. 8805, 64 FR 1515, Jan. 11, 1999]

§ 1.904–5 Look-through rules as applied to controlled foreign corporations and other entities.

(a) *Definitions.* For purposes of section 904(d)(3) and the regulations under section 904, the following definitions apply:

(1) The term *separate category* means, as the context requires, any category of income described in section 904(d)(1) (A), (B), (C), (D), (E), (F), (G), (H), or (I)

and in §1.904–4 (b), (d), (e), (f), and (g), or any category of earnings and profits to which income described in such provisions is attributable.

(2) The term *controlled foreign corporation* has the meaning given such term by section 957 (taking into account the special rule for certain captive insurance companies contained in section 953(c)).

(3) The term *United States shareholder* has the meaning given such term by section 951(b) (taking into account the special rule for certain captive insurance companies contained in section 953(c)), except that for purposes of this section, a United States shareholder shall include any member of the controlled group of the United States shareholder. For this purpose the controlled group is any member of the affiliated group within the meaning of section 1504(a)(1) except that 50 percent shall be substituted for 80 percent wherever it appears in section 1504(a)(2).

(b) *In general.* Except as otherwise provided in section 904(d) (2)(E) and (3) and this section, dividends, interest, rents, and royalties received or accrued by a taxpayer from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as general limitation income.

(c) *Rules for specific types of inclusions and payments*—(1) *Subpart F inclusions*—(i) *Rule.* Any amount included in gross income under section 951(a)(1)(A) shall be treated as income in a separate category to the extent the amount so included is attributable to income received or accrued by the controlled foreign corporation that is described as income in such category. For purposes of this §1.904–5, income shall be characterized under the rules of §1.904–4 prior to the application of the rules of paragraph (c) of this section. For rules concerning inclusions under section 951(a)(1)(B), see paragraph (c)(4)(i) of this section.

(ii) *Examples.* The following examples illustrate the application of this paragraph (c)(1):

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S earns $200 of net income, $85 of which is foreign base company shipping income, $15 of which is foreign personal holding company income, and $100 of which is non-subpart F general limitation income. No foreign tax is imposed on the income. One hundred dollars ($100) of S's income is subpart F income taxed currently to P under section 951(a)(1)(A). Because $85 of the subpart F inclusion is attributable to shipping income of S, $85 of the subpart F inclusion is shipping income to P. Because $15 of the subpart F inclusion is attributable to passive income of S, $15 of the subpart F inclusion is passive income to P.

Example 2. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is a financial services entity. P manufactures cars and is not a financial services entity. In 1987, S earns $200 of interest income unrelated to its banking business and $900 of interest income related to its banking business. Assume that S pays no foreign taxes and has no expenses. All of S's income is included in P's gross income as foreign personal holding company income. Because S is a financial services entity, income that would otherwise be passive income is considered to be financial services income. P, therefore, treats the entire subpart F inclusion as financial services income.

Example 3. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. P is a financial services entity. S manufactures cars and is not a financial services entity. In 1987, S earns $200 of passive income that is subpart F income and $900 of general limitation non-subpart F income. Assume that S pays no foreign taxes on its passive earnings and has no expenses. P includes the $200 of subpart F income in gross income. Because P is a financial services entity, the inclusion will be financial services income to P.

Example 4. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. Neither P nor S is a financial services entity. Controlled foreign corporation T is a wholly-owned subsidiary of controlled foreign corporation S. T is a financial services entity. In 1991, T pays a dividend to S. For purposes of determining whether S is a financial services entity under §1.904–4(e)(3)(i), the dividend from T is ignored. For purposes of characterizing the dividend in S's hands under the look-through rules of paragraph (c)(4) of this section, however, the dividend retains its character as financial services income. Similarly, any subpart F inclusion or dividend to P out of the earnings and profits attributable to the dividend from S is excluded in determining whether P is a financial services entity under §1.904–4(e)(3)(i), but retains its character in P's hands as financial services income under paragraph (c)(4) of this section.

Example 5. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S owns 40 percent of foreign corporation A, 45 percent of foreign corporation B, 30 percent of foreign corporation C and 20 percent of foreign corporation D. A, B, C, and D are noncontrolled section 902 corporations. In 1987, S's only income is a $100 dividend from each foreign corporation. Assume that S pays no foreign taxes and has no expenses. All $400 of the income is foreign personal holding company income and is included in P's gross income. P must include $100 in its separate limitation for dividends from A, $100 in its separate limitation for dividends from B, $100 in its separate limitation for dividends from C, and $100 in its separate limitation for dividends from D.

(2) *Interest*—(i) *In general.* For purposes of this paragraph, related person interest is any interest paid or accrued by a controlled foreign corporation to any United States shareholder in that corporation (or to any other related person) to which the look-through rules of section 904(d)(3) and this section apply. Unrelated person interest is all interest other than related person interest. Related person interest shall be treated as income in a separate category to the extent it is allocable to income of the controlled foreign corporation in that category. If related person interest is received or accrued from a controlled foreign corporation by two or more persons, the amount of interest received or accrued by each person that is allocable to any separate category of income shall be determined by multiplying the amount of related person interest allocable to that separate category of income by a fraction. The numerator of the fraction is the amount of related person interest received or accrued by that person and the denominator is the total amount of related person interest paid or accrued by the controlled foreign corporation.

(ii) *Allocating and apportioning expenses including interest paid to a related person.* Related person interest and other expenses of a controlled foreign corporation shall be allocated and apportioned in the following manner:

(A) Gross income in each separate category shall be determined;

(B) Any expenses that are definitely related to less than all of gross income as a class, including unrelated person interest that is directly allocated to income from a specific property, shall be allocated and apportioned under the principles of §§ 1.861–8 or 1.861-10T, as applicable, to income in each separate category;

(C) Related person interest shall be allocated to and shall reduce (but not below zero) the amount of passive foreign personal holding company income as determined after the application of paragraph (c)(2)(ii)(B) of this section;

(D) To the extent that related person interest exceeds passive foreign personal holding company income as determined after the application of paragraphs (c)(2)(ii) (B) and (C) of this section, the related person interest shall be apportioned under the rules of this paragraph to separate categories other than passive income.

(*1*) If under § 1.861–9T, the modified gross income method of apportioning interest expense is elected, related person interest shall be apportioned as follows:

$$\begin{array}{c}\text{Related person interest minus Related}\\ \text{person interest allocated under}\\ \text{paragraph (c)(2)(ii)(C) of this section}\end{array} \times \frac{\begin{array}{c}\text{Gross income in a separate category}\\ \text{(other than passive)}\end{array}}{\text{Total gross income (other than passive)}}$$

(*2*) If under § 1.861–9T, the asset method of apportioning interest expense is elected, related person interest shall be apportioned according to the following formula:

$$\begin{array}{c}\text{Related person interest minus Related}\\ \text{person interest minus allocated under}\\ \text{paragraph (c)(2)(ii)(C) of this section}\end{array} \times \frac{\begin{array}{c}\text{Value of assets in a separate category}\\ \text{(other than passive)}\end{array}}{\begin{array}{c}\text{Value of total assets}\\ \text{(other than passive)}\end{array}}$$

(E) Any other expenses (including unrelated person interest that is not directly allocated to income from a specific property) that are not definitely related expenses or that are definitely related to all of gross income as a class shall be apportioned under the rules of this paragraph to reduce income in each separate category.

(*1*) If under §1.861–9T, the modified gross income method of apportioning interest expense is elected, the interest expense shall be apportioned as follows:

$$\begin{array}{c}\text{Expense apportionable}\\ \text{to a separate category}\end{array} = \text{Expense} \times \frac{\begin{array}{c}\text{Gross income in a separate category (minus}\\ \text{related person interest allocated under}\\ \text{paragraph (c)(2)(ii)(C) of this section if}\\ \text{the category is passive)}\end{array}}{\begin{array}{c}\text{Total gross income minus related person}\\ \text{interest allocated to passive income}\\ \text{under paragraph (c)(2)(ii)(C) of}\\ \text{this section}\end{array}}$$

(*2*) If under §1.861–9T, the asset method of apportioning interest expense is elected, then the expense shall be apportioned as follows:

$$\begin{array}{c}\text{Expense apportionable}\\ \text{to a separate category}\end{array} = \text{Expense} \times \frac{\begin{array}{c}\text{Value of assets in a separate category}\\ \text{(minus related person debt}\\ \text{allocated to passive assets if}\\ \text{the category is passive)}\end{array}}{\begin{array}{c}\text{Value of total assets minus}\\ \text{related person debt allocated}\\ \text{to passive assets}\end{array}}$$

(*3*) Expenses other than interest shall be apportioned in a similar manner depending on the apportionment method used. *See* §1.861–8T(c)(1) (i)–(vi).

(iii) *Definitions*—(A) *Value of assets and reduction in value of assets and gross income.* For purposes of paragraph (c)(2)(ii) (D) and (E) of this section, the value of total assets is the value of assets in all categories (determined under the principles of §1.861–9T(g)). See §1.861–10T(d)(2) to determine the reduction in value of assets and gross income for purposes of apportioning additional third person interest expense that is not directly allocated when some interest expense has been directly allocated. For purposes of this paragraph and paragraph (c)(2)(ii)(E) of this section, any reduction in the value of assets for indebtedness that relates to interest allocated under paragraph (c)(2)(ii)(C) of this section is made before determining the average of asset values. For rules relating to the averaging of reduced asset values see §1.861–9T(g)(2).

(B) *Related person debt allocated to passive assets.* For purposes of paragraph (c)(2)(ii)(E) of this section, related person debt allocated to passive assets is determined as follows:

$$\text{Related person debt allocated to the passive category} = \text{Total related person debt} \times \frac{\text{Related person interest allocable to passive income under paragraph (c)(2)(ii)(C)}}{\text{All related person interest}}$$

For this purpose, the term *total related person debt* means the sum of the principal amounts of obligations of a controlled foreign corporation owed to any United States shareholder of such corporation or to any related entity (within the meaning of paragraph (g) of this section) determined at the end of the taxable year.

(iv) *Examples.* The following examples illustrate the operation of this paragraph (c)(2).

Example 1. (i) Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S earns $200 of foreign personal holding company income that is passive income. S also earns $100 of foreign base company sales income that is general limitation income. S has $2000 of passive assets and $2000 of general limitation assets. In 1987, S makes a $150 interest payment to P with respect to a $1500 loan from P. S also pays $100 of interest to an unrelated person on a $1000 loan from that person. S has no other expenses. S uses the asset method to apportion interest expense.

(ii) Under paragraph (c)(2)(ii)(C) of this section, the $150 related person interest payment is allocable to S's passive foreign personal holding company income. Therefore, the $150 interest payment is passive income to P. Because the entire related person interest payment is allocated to passive income under paragraph (c)(2)(ii)(C) of this section, none of the related person interest payment is apportioned to general limitation income under paragraph (c)(2)(ii)(D) of this section. Under paragraph (c)(2)(iii)(B) of this section, the entire amount of the related person debt is allocable to passive assets ($1500=$1500×$150/$150). Under paragraph (c)(2)(ii)(E) of this section, $20 of interest expense paid to an unrelated person is apportioned to passive income ($20=$100×($2000 − $1500)/($4000 − $1500)). Eighty dollars ($80) of the interest expense paid to an unrelated person is apportioned to general limitation income ($80=$100×$2000/($4000 − $1500)).

Example 2. The facts are the same as in *Example* 1, except that S uses the gross income method to apportion interest expense. Under paragraph (c)(2)(ii)(E) of this section, the unrelated person interest expense would be apportioned on a gross income method. Therefore, $33 of interest expense paid to unrelated persons would be apportioned to passive income ($33=$100×($200 − $150)/($300 − $150) and $67 of interest expense paid to unrelated persons would be apportioned to general limitation income ($67=$100×$100/($300 − $150).

Example 3. (i) The facts are the same as in *Example* 1, except that S has an additional $50 of third person interest expense that is directly allocated to income from a specific property that produces only passive income. The principal amount of indebtedness to which the interest relates is $500. S also has $50 of additional non-interest expenses that are not definitely related expenses and that are apportioned on an asset basis.

(ii) Under paragraph (c)(2)(ii)(B) of this section, the $50 of directly allocated third person interest is first allocated to reduce the passive income of S. Under paragraph (c)(2)(ii)(C) of this section, the $150 of related person interest is allocated to the remaining $150 of passive income. Under paragraph (c)(2)(iii)(B) of this section, all of the related person debt is allocated to passive assets. ($1500=$1500×$150/$150).

(iii) Under paragraph (c)(2)(ii)(E) of this section, the non-interest expenses that are not definitely related are apportioned on the basis of the asset values reduced by the allocated related person debt. Therefore, $10 of these expenses are apportioned to the passive category ($50×($2000 − $1500)/($4000 − $1500)) and $40 are apportioned to the general limitation category ($50×$2000/($4000 − $1500)).

(iv) In order to apportion third person interest between the categories of assets, the value of assets in a separate category must also be reduced under the principles of § 1.861–8 by the indebtedness relating to the specifically allocated interest. Therefore, under paragraph (c)(2)(iii)(B) of this section, the value of assets in the passive category for purposes of apportioning the additional third person interest=0 ($2000 minus $500 (the principal amount of the debt, the interest payment on which is directly allocated to specific interest producing properties) minus $1500 (the related person debt allocated to passive assets)). Under paragraph (c)(2)(ii)(E) of this section, all $100 of the non-definitely related third person interest is apportioned to the general limitation category ($100=$100×$2000/($4000−$500−$1500)).

Example 4. (i) Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S earns $100 of foreign personal holding company income that is passive income. S also earns $100 of foreign base company sales income that is general limitation income. S has $1000 of general limitation assets and $1000 of passive assets. In 1987, S makes a $150 interest payment to P on a $1500 loan from P and has $20 of general and administrative expenses (G & A) that under the principles of §§1.861–8 through 1.861–14T is treated as directly allocable to all of P's gross income. S also makes a $25 interest payment to an unrelated person on a $250 loan from the unrelated person. S has no other expenses. S uses the asset method to apportion interest expense. S uses the gross income method to apportion G & A.

(ii) Under paragraph (c)(2)(ii)(C) of this section, $100 of the interest payment to P is allocable to S's passive foreign personal holding company income. Under paragraph (c)(2)(ii)(D) of this section, the additional $50 of related person interest expense is apportioned to general limitation income ($50=$50×$1000/$1000). Under paragraph (c)(2)(iii)(B) of this section, related person debt allocated to passive assets equals $1000 ($1000=$1500×$100/$150).

(iii) Under paragraph (c)(2)(ii)(E) of this section, none of the $25 of interest expense paid to an unrelated person is apportioned to passive income ($0=$25×($1000−$1000)/($2000−$1000). Twenty-five dollars ($25) of the interest expense paid to an unrelated person is apportioned to general limitation income ($25=$25×$1000/($2000−$1000). Under paragraph (c)(2)(ii)(E) of this section, none of the G & A is allocable to S's passive foreign personal holding company income ($0=$20×($100−$100)/($200−$100). All $20 of the G & A is apportioned to S's general limitation income ($20=$20×$100/($200−$100).

Example 5. The facts are the same as in *Example* 4, except that S uses the gross income method to apportion interest expense. As in *Example* 4, $100 of the interest payment to P is allocate to passive income under paragraph (c)(2)(ii)(C) of this section. Under paragraph (c)(2)(ii)(D) of this section, the additional $50 of related person interest expense is apportioned to general limitation income ($150−100×$100/$100). Under paragraph (c)(2)(ii)(E) of this section, none of the unrelated person interest expense and none of the G & A is apportioned to passive income, because after the application of paragraph (c)(2)(ii)(C) of this section, no passive income remains in the passive income category.

Example 6. Controlled foreign corporation T is a wholly-owned subsidiary of S, a controlled foreign corporation. S is a wholly-owned subsidiary of P, a domestic corporation. S is not a financial services entity. S and T are incorporated in the same country. In 1987, P sells tractors to T, which T sells to X, a foreign corporation that is related to both S and T and is organized in the same country as S and T. S makes a loan to X to finance the tractor sales. Assume that the interest earned by S from financing the sales is export financing interest that is neither related person factoring income nor foreign personal holding company income. The export financing interest earned by S is, therefore, general limitation income. S earns no other income. S makes a $100 interest payment to P. The $100 of interest paid is allocable under the look-through rules of paragraph (c)(2)(ii) of this section to the general limitation income earned by S and is therefore general limitation income to P.

(3) *Rents and Royalties.* Any rents or royalties received or accrued from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as income in a separate category to the extent they are allocable to income of the controlled foreign corporation in that category under the principles of §§1.861–8 through 1.861–14T.

(4) *Dividends*—(i) *Look-through rule.* Any dividend paid or accrued out of the earnings and profits of any controlled foreign corporation, shall be treated as income in a separate category in proportion to the ratio of the portion of earnings and profits attributable to income in such category to the total amount of earnings and profits of the controlled foreign corporation. For purposes of this paragraph, the term "dividend" includes any amount included in gross income under section 951(a)(1)(B) as a pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.

(ii) *Special rule for dividends attributable to certain loans.* If a dividend is distributed to a taxpayer by a controlled foreign corporation, that controlled foreign corporation is the recipient of loan proceeds from a related look-through entity (within the meaning of §1.904–5(i)), and the purpose of such loan is to alter the characterization of the dividend for purposes of this section, then, to the extent of the principal amount of the loan, the dividend shall be characterized with respect to the earnings and profits of the related person lender rather than with respect to the earnings and profits of the dividend payor. A loan will not be considered made for the purpose of altering the characterization of a dividend if the loan would have been made or maintained on substantially the same terms irrespective of the dividend. The determination of whether a loan would have been made or maintained on substantially the same terms irrespective of the dividend will be made taking into account all the facts and circumstances of the relationship between the lender and the borrower. Thus, for example, a loan by a related party lender to a controlled foreign corporation that arises from the sale of inventory in the ordinary course of business will not be considered a loan made for the purpose of altering the character of any dividend paid by the borrower.

(iii) *Examples.* The following examples illustrate the application of this paragraph (c)(4).

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S has earnings and profits of $1,000, $600 of which is attributable to general limitation income and $400 of which is attributable to dividends received by S from its wholly-owned subsidiary, T. T is a controlled foreign corporation and is incorporated and operates in the same country as S. All of T's income is financial services income. Neither S's general limitation income nor the dividend from T is subpart F income. In December 1987, S pays a dividend to P of $200, all of which is attributable to earnings and profits earned in 1987. Six-tenths of the dividend ($120) is treated as general limitation income because six-tenths of S's earnings and profits are attributable to general limitation income. Four-tenths of the dividend ($80) is treated as financial services income because four-tenths of S's earnings and profits are attributable to dividends from T, and all of T's earnings are financial services income.

Example 2. A, a United States person, has been the sole shareholder in controlled foreign corporation X since its organization on January 1, 1963. Both X and A are calendar year taxpayers. X's earnings and profits for 1963 through the end of 1987 totaled $3,000. A sells his stock in X at the end of 1987 and realizes a gain of $4,000. Of the total $4,000 gain, $3,000 (A's share of the post-1962 earnings and profits) is includible in A's gross income as a dividend and is subject to the look-through rules including the transition rule of § 1.904–7(a) with respect to the portion of the distribution out of pre-87 earnings and profits. The remaining $1,000 of the gain is includible as gain from the sale or exchange of the X stock and is passive income to A.

(d) *Effect of exclusions from subpart F income*—(1) *De minimis amount of subpart F income.* If the sum of a controlled foreign corporation's gross foreign base company income (determined under section 954(a) without regard to section 954(b)(5)) and gross insurance income (determined under section 953(a)) for the taxable year is less than the lesser of 5 percent of gross income or $1,000,000, then all of that income (other than income that would be financial services income without regard to this paragraph (d)(1)) shall be treated as general limitation income. In addition, if the test in the preceding sentence is satisfied, for purposes of paragraphs (c)(2)(ii) (D) and (E) of this section (apportionment of interest expense to passive income using the asset method), any passive limitation assets shall be treated as general limitation assets. The determination in the first sentence shall be made prior to the application of the exception for certain income subject to a high rate of foreign tax described in paragraph (d)(2) of this section.

(2) *Exception for certain income subject to high foreign tax.* For purposes of the dividend look-through rule of paragraph (c)(4)(i) of this section, an item of net income that would otherwise be passive income (after application of the priority rules of § 1.904–4(l)) and that is received or accrued by a controlled foreign corporation shall be treated as general limitation income, and the earnings and profits attributable to such income shall be treated as general limitation earnings and profits, if the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11 (with reference to section 15, if applicable). The preceding sentence has no effect on amounts (other than dividends) paid or accrued by a controlled foreign

corporation to a United States shareholder of such controlled foreign corporation to the extent those amounts are allocable to passive income of the controlled foreign corporation.

(3) *Examples.* The following examples illustrate the application of this paragraph.

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S earns $100 of gross income, $4 of which is interest that is subpart F foreign personal holding company income and $96 of which is gross manufacturing income that is not subpart F income. S has no other earnings for 1987. S has no expenses and pays no foreign taxes. S pays P a $100 dividend. Under the de minimis rule of section 954(b)(3), none of S's income is treated as foreign base company income. All of S's income, therefore, is treated as general limitation income. The entire $100 dividend is general limitation income to P.

Example 2. (i) Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1987, S earns $50 of shipping income of a type that is foreign base company shipping income. S also earns $50 of dividends from T, a foreign corporation in which S owns 45 percent of the voting stock, and receives $50 of dividends from U, a foreign corporation in which S owns 5% of the voting stock. Foreign persons hold the remaining voting stock of both T and U. S, T, and U are all incorporated in different foreign countries. The dividends S receives from T and U are of a type that normally would be subpart F foreign personal holding company income that is passive income. Under §1.904–4(l)(1)(iv), however, the dividends from T are dividends from a noncontrolled section 902 corporation rather than passive income. S has no expenses. The earnings and profits of S are equal to the net income after taxes of S. The dividends and the shipping income are taxed abroad by S's country of incorporation at an effective rate of 40 percent. P establishes to the satisfaction of the Secretary that the effective rate of tax on both the dividends and the shipping income exceeds 90 percent of the maximum United States tax rate. Thus, under section 954(b)(4), neither the shipping income nor the dividends are taxed currently to P under subpart F. S's earnings attributable to shipping income and dividends from a noncontrolled section 902 corporation retain their character as such. Under paragraph (d)(2) of this section, S's earnings attributable to the dividends from U are treated as earnings attributable to general limitation income. See §§1.905–3T and 1.905–4T, however, for rules concerning adjustments to the pools of earnings and profits and foreign taxes and redeterminations of United States tax liability when foreign taxes are refunded in a later year.

(ii) In 1988, S has no earnings and pays a $150 dividend (including gross-up) to P. The dividend is paid out of S's post-1986 pool of earnings and profits. One-third of the dividend ($50) is attributable to S's shipping earnings, one-third ($50) is attributable to the dividend from T, and one-third ($50) is attributable to the dividend from U. Pursuant to section 904(d)(3)(E) and paragraph (c)(4) of this section, one-third of the dividend is shipping income, one-third is a dividend from a noncontrolled section 902 corporation, T, and one-third is general limitation income to P.

(e) *Treatment of subpart F income in excess of 70 percent of gross income*—(1) *Rule.* If the sum of a controlled foreign corporation's gross foreign base company income (determined without regard to section 954(b)(5)) and gross insurance income for the taxable year exceeds 70 percent of the gross income, then all of the controlled foreign corporation's gross income shall be treated as foreign base company income (whichever is appropriate) and, thus, included in a United States shareholder's gross income. However, the inclusion in gross income of an amount that would not otherwise be subpart F income does not affect its character for purposes of determining whether the income is within a separate category. The determination of whether the controlled foreign corporation's gross foreign base company income and gross insurance income exceeds 70 percent of gross income is made before the exception for certain income subject to a high rate of foreign tax.

(2) *Example.* The following example illustrates the application of this paragraph.

Example. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S earns $100, $75 of which is foreign personal holding company income and $25 of which is non-subpart F services income. S is not a financial services entity. S's gross and net income are equal. Under the 70 percent full inclusion rule of section 954(b)(3)(B), the entire $100 is foreign base company income currently taxable to P under section 951. Because $75 of the $100 section 951 inclusion is attributable to S's passive income, $75 of the inclusion is passive income to P. The remaining $25 of the inclusion is treated as general limitation income to P because $25 is attributable to S's general limitation income.

(f) *Modification of look-through rules for certain income*—(1) *High withholding tax interest.* If a taxpayer receives or accrues interest from a controlled foreign corporation that is a financial services entity, and the interest would be described as high withholding tax interest if section 904(d)(3) and paragraph (c)(2) of this section (the look-through rules for interest) did not apply, then the interest shall be treated as high withholding tax interest to the extent that the interest is allocable under section 904(d)(3) and paragraph (c)(2)(i) of this section to financial services income of the controlled foreign corporation. See section 904(d)(3)(H). The amount treated as high-withholding tax interest under this paragraph (f)(1) shall not exceed the interest, or equivalent income, of the payor that would be taken into account in determining the financial services income of the payor if the look-through rules applied.

(2) *Dividends from a noncontrolled section 902 corporation.* (i) *Rule.* If a United States shareholder that is a corporation receives or accrues income from a controlled foreign corporation that is attributable to dividends from a noncontrolled section 902 corporation, such income shall be subject to a separate limitation for such dividends except as provided in § 1.904–4(g)(2)(ii) (relating to dividends from a foreign corporation with respect to which the United States shareholder does not meet the stock ownership requirements of section 902).

(ii) *Example.* The following example illustrates the provisions of this paragraph (f)(2).

Example. P, a domestic corporation, owns 40 percent of S, a controlled foreign corporation. U, an unrelated domestic corporation, owns the remaining 60 percent of S. S owns 10 percent of T, a noncontrolled section 902 corporation. In 1990, T pays S a dividend, which S includes in its gross income as a dividend from a noncontrolled section 902 corporation. S has no other income during 1990. P and U must include S's dividend income from T in their gross income under subpart F. Pursuant to § 1.904–4(g)(2)(ii)(C), the subpart F inclusion to U is characterized as a dividend from a noncontrolled section 902 corporation because U meets the 5 percent ownership requirement of section 902(b) (60%×10%=6%). The subpart F inclusion to P is characterized as passive income because P does not meet the 5 percent ownership requirement of section 902(b) (40%×10%=4%).

(3) *Distributions from a FSC.* Income received or accrued by a taxpayer that, under the rules of paragraph (c)(4) of this section (look-through rules for dividends), would be treated as foreign trade income or as passive income that is interest and carrying charges (as defined in section 927(d)(1)), and that is also a distribution from a FSC (or a former FSC), shall be treated as a distribution from a FSC (or a former FSC).

(4) *Example.* The following example illustrates the operation of paragraph (f)(1) of this section.

Example. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S is a financial services entity. In 1988, S earns $80 of interest that meets the definition of financial services income and $20 of high withholding tax interest. S makes a $100 interest payment to P. The interest payment to P is subject to a withholding tax of 15 percent. Twenty dollars ($20) of the interest payment to P is considered to be high withholding tax interest because, under section 904(d)(3), it is allocable to the high withholding tax interest earned by S. The remaining eighty dollars ($80) of the interest payment is also treated as high withholding tax interest to P because, under paragraph (f)(1) of this section, interest that is subject to a high withholding tax but would not be considered to be high withholding tax interest under the look-through rules of paragraph (c)(2) of this section, shall be treated as high withholding tax interest to the extent that the interest would have been treated as financial services interest income under the look-through rules of paragraph (c)(2)(i) of this section.

(g) *Application of look-through rules to certain domestic corporations.* The principles of section 904(d)(3) and this section shall apply to any foreign source interest, rents and royalties paid by a United States corporation to a related corporation. For this purpose, a United States corporation and another corporation are considered to be related if one owns, directly or indirectly, stock possessing 50 percent or more of the total voting power of all classes of stock of the other corporation or 50 percent or more of the total value of the other corporation. In addition, a United States corporation and another corporation shall be considered to be related if the same United States shareholders own, directly or indirectly, stock possessing 50 percent or more of the total voting power of all classes of stock or 50 percent of the total value of each corporation. For purposes of this paragraph, the constructive stock ownership rules of section 318 and the regulations under that section apply.

(h) *Application of look-through rules to partnerships and other pass-through entities*—(1) *General rule.* Except as provided in paragraph (h)(2) of this section, a partner's distributive share of partnership income shall be characterized as income in a separate category to the extent that the distributive share is a share of income earned or accrued by the partnership in such category. Payments to a partner described in section 707 (*e.g.,* payments to a partner not acting in capacity as a partner) shall be characterized as income in a separate category to the extent that the payment is attributable under the principles of §1.861–8 and this section to income earned or accrued by the partnership in such category, if the payments are interest, rents, or royalties that would be characterized under the look-through rules of this section if the partnership were a foreign corporation, and the partner who receives the payment owns 10 percent or more of the value of the partnership. A payment by a partnership to a member of the controlled group (as defined in paragraph (a)(3) of this section) of the partner shall be characterized under the look-through rules of this section if the payment would be a section 707 payment entitled to look-through treatment if it were made to the partner.

(2) *Exception for certain partnership interests*—(i) *Rule.* Except as otherwise provided, if any limited partner or corporate general partner owns less than 10 percent of the value in a partnership, the partner's distributive share of partnership income from the partnership shall be passive income to the partner, and the partner's distributive share of partnership deductions from the partnership shall be allocated and apportioned under the principles of §1.861–8 only to the partner's passive income from that partnership.

(ii) *Exceptions.* To the extent a partner's distributive share of income from a partnership is a share of high withholding tax interest received or accrued by the partnership, that partner's distributive share of partnership income will be high withholding tax interest regardless of the partner's level of ownership in the partnership. If a partnership interest described in paragraph (h)(2)(i) of this section is held in the ordinary course of a partner's active trade or business, the rules of paragraph (h)(1) of this section shall apply for purposes of characterizing the partner's distributive share of the partnership income. A partnership interest will be considered to be held in the ordinary course of a partner's active trade or business if the partner (or a member of the partner's affiliated group of corporations (within the meaning of section 1504(a) and without regard to section 1504(b)(3))) engages (other than through a less than 10 percent interest in a partnership) in the same or related trade or business as the partnership.

(3) *Income from the sale of a partnership interest.* To the extent a partner recognizes gain on the sale of a partnership interest, that income shall be treated as passive income to the partner, unless the income is considered to be high-taxed under section 904(d)(2)(A)(iii)(III) and §1.904–4(c).

(4) *Value of a partnership interest.* For purposes of paragraphs (i), (h)(1), and (h)(2) of this section, a partner will be considered as owning 10 percent of the value of a partnership for a particular year if the partner has 10 percent of the capital and profits interest of the partnership. Similarly, a partnership (first partnership) is considered as owning 50 percent of the value of another partnership (second partnership) if the first partnership owns 50 percent of the capital and profits interests of another partnership. For this purpose, value will be determined at the end of the partnership's taxable year.

(i) *Application of look-through rules to related entities*—(1) *In General.* Except as provided in paragraphs (i) (2) and (3) of this section, the principles of this section shall apply to distributions and payments that are subject to the look-through rules of section 904(d)(3) and this section from a controlled foreign corporation or other entity otherwise entitled to look-through treatment (a ‘‘look-through entity’’) under this section to a related 1ookthrough entity. Two look-through entities shall be considered to be related to each other if one owns, directly or indirectly, stock possessing more than 50 percent of the total voting power of all classes of voting stock of the other entity or more than 50 percent of the total value of such entity. In addition, two look-through entities are related if the same United States shareholders own, directly or indirectly, stock possessing 50 percent or more of the total voting power of all voting classes of stock (in the case of a corporation) or 50 percent or more of the total value of each look-through entity. In the case of a corporation, value shall be determined by taking into account all classes of stock. In the case of a partnership, value shall be determined under the rules in paragraph (h)(4) of this section. For purposes of this section, indirect ownership shall be determined under section 31B and the regulations thereunder.

(2) *Exception for distributive shares of partnership income.* In the case of tiered partnership arrangements, a distributive share of partnership income will be characterized under the look-through rules of section 904(d)(3) and this section if the partner meets the requirements of paragraph (h)(1) of this section with respect to the partnership (first partnership), whether or not the income is received through another partnership or partnerships (second partnership) and whether or not the first partnership and the second partnership are considered to be related under the rules of paragraph (i)(1) of this section.

(3) *Special rule for dividends.* [Reserved]

(4) *Examples.* The following examples illustrate the provisions of this paragraph (i):

Example 1. P, a domestic corporation, owns all of the stock of S, a controlled foreign corporation. S owns 40 percent of the stock of T, a controlled foreign corporation. The remaining 60 percent of the stock of T is owned by V, a domestic corporation. The percentages of value of T owned by S and V correspond to their percentages of stock ownership. T owns all of the stock of U, a controlled foreign corporation. U earns exclusively general limitation non-subpart F income. In 1992, U makes an interest payment of $100 to T, which is subpart F income to P and V. V and T are related look-through entities, but P and T are not related look-through entities. V, therefore, is entitled to look-through treatment on the interest payment to T and the payment will be treated as general limitation income. P is not entitled to look-through treatment (because P, through 5, owns only 40 percent of T) and the interest payment, therefore, is passive income to P.

Example 2. [Reserved]

(j) *Look-through rules applied to passive foreign investment company inclusions.* If a passive foreign investment company is a controlled foreign corporation and the taxpayer is a United States shareholder in that passive foreign investment company, any amount included in gross income under section 1293 shall be treated as income in a separate category to the extent the amount so included is attributable to income received or accrued by that controlled foreign corporation that is described as income in the separate category. For purposes of this paragraph (j), the priority rules of § 1.904–4(l) shall apply prior to the application of the rules of this paragraph.

(k) *Ordering rules*—(1) *In general.* Income received or accrued by a related person to which the look-through rules apply is characterized before amounts included from, or paid or distributed by that person and received or accrued by a related person. For purposes of determining the character of income received or accrued by a person from a related person if the payor or another related person also receives or accrues income from the recipient and the look-through rules apply to the income in all cases, the rules of paragraph (k)(2) of this section apply.

(2) *Specific rules.* For purposes of characterizing income under this paragraph, the following types of income are characterized in the order stated:

(i) Rents and royalties;

(ii) Interest;

(iii) Subpart F inclusions and distributive shares of partnership income;

(iv) Dividend distributions.

If an entity is both a recipient and a payor of income described in any one of the categories described in (k)(2) (i) through (iv) of this section, the income received will be characterized before the income that is paid. In addition, the amount of interest paid or accrued, directly or indirectly, by a person to a related person shall be offset against and eliminate any interest received or accrued, directly or indirectly, by a person from that related person before application of the ordering rules of this paragraph. In a case in which a person pays or accrues interest to a related person, and also receives or accrues interest indirectly from the related person, the smallest interest payment is eliminated and the amount of all other interest payments are reduced by the amount of the smallest interest payment.

(l) *Examples.* The following examples illustrate the application of paragraphs (g), (h), (i), and (k) of this section.

Example 1. S and T, controlled foreign corporations, are wholly-owned subsidiaries of P, a domestic corporation. S and T are incorporated in two different foreign countries and T is a financial services entity. In 1987, S earns $100 of income that is general limitation foreign base company sales income. After expenses, including a $50 interest payment to T, S's income is subject to foreign tax at an effective rate of 40 percent. P elects to exclude S's $50 of net income from subpart F under section 954(b)(4). T earns $350 of income that consists of $300 of subpart F financial services income and $50 of interest received from S. The $50 of interest is foreign personal holding company income in T's hands because section 954(c)(3)(A)(i) (same country exception for interest payments) does not apply. The $50 of interest is also general limitation income to T because S and T are related look-through entities within the meaning of paragraph (i)(1) of this section and, therefore the look-through rules of paragraph (c)(2)(i) of this section apply to characterize the interest payment. Thus, with respect to T, P includes in its gross income $50 of general limitation foreign personal holding company income and $300 of financial services income.

Example 2. The facts are the same as in *Example (1)* except that instead of earning $100 of general limitation foreign base company sales income, S earns $100 of foreign personal holding company income that is passive income. Although the interest payment to T would otherwise be passive income, T is a financial services entity and, under §1.904–4(e)(1), the income is treated as financial services income in T's hands. Thus, P's entire $350 section 951 inclusion consists of financial services income.

Example 3. P, a domestic corporation, wholly-owns S, a domestic corporation that is a 80/20 corporation. In 1987, S's earnings consist of $100 of foreign source shipping income and $100 of foreign source high withholding tax interest. S makes a $100 foreign source interest payment to P. The interest payment to P is subject to the look-through rules of paragraph (c)(2)(i) of this section, and is characterized as shipping income and high withholding tax interest to the extent that it is allocable to such income in S's hands.

Example 4. PS is a domestic partnership that is the sole shareholder of controlled foreign corporation S. PS has two general partners, A and B. A and B each have a greater than 10 percent interest in PS. PS also has two limited partners, C and D. C has a 50 percent interest in the partnership and D has a 9 percent interest. A, B, C and D are all United States persons. In 1987, S has $100 of general limitation non-subpart F income on which it pays no foreign tax. S pays a $100 dividend to PS. The dividend is the only income of PS. Under the look-through rule of paragraph (c)(4) of this section, the dividend to PS is general limitation income. Under paragraph (h)(1) of this section, A's, B's, and C's distributive shares of PS's income are general limitation income. Under paragraph (h)(2) of this section, because D is a limited partner with a less than 10 percent interest in PS, D's distributive share of PS's income is passive income.

Example 5. P has a 25 percent interest in partnership PS that he sells to X for $110. P's basis in his partnership interest is $35. P recognizes $75 of gain on the sale of its partnership interest and is subject to no foreign tax. Under paragraph (h)(3) of this section, the gain is treated as passive income.

Example 6. P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. S has $100 of passive foreign personal holding company income from unrelated persons and $100 of general limitation income. S also has $50 of interest income from T. S pays T $100 of interest. Under paragraph (k)(2) of this section, the $100 interest payment from S to T is reduced for limitation purposes to the extent of the $50 interest payment from T to S before application of the rules in paragraph (c)(2)(ii) of this section. Therefore, the interest payment from T to S is disregarded. S is treated as if it paid $50 of interest to T, all of which is allocable to S's passive foreign personal holding company income. Therefore the $50 interest payment from S to T is passive income.

Example 7. P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation. S owns 100 percent of the stock of T, a controlled foreign corporation and 100 percent of the stock of U, a controlled foreign corporation. In 1988, T pays S $5 of interest, S pays U $10 of interest and U pays T $20 of interest. Under paragraph (k)(2) of this section, the interest payments from S to U must be offset by the amount of interest that S is considered as receiving indirectly from U and the interest payment from U to T is offset by the amount of the interest payment that U is considered as receiving indirectly from T. The $l0 payment by S to U is reduced by $5, the amount of the interest payment from T to S that is treated as being paid indirectly by U to S. Similarly, the $20 interest payment from U to T is reduced by $5, the amount of the interest payment from S to U that is treated as being paid indirectly by T to U. Therefore, under paragraph (k)(2) of this section, T is treated as having made no interest payment to S, S is treated as having paid $5 of interest to U, and U is treated as having paid $15 to T.

Example 8. (i) P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. In 1987, S earns $100 of passive foreign personal holding company income and $100 of general limitation non-subpart F sales income from unrelated persons and $100 of general limitation non-subpart F interest income from a related person, W. S pays $150 of interest to T. T earns $200 of general limitation sales income from unrelated persons and the $150 interest payment from S. T pays S $100 of interest.

(ii) Under paragraph (k)(2) of this section, the $100 interest payment from T to S reduces the $150 interest payment from S to T. S is treated as though it paid $50 of interest to T. T is treated as though it made no interest payment to S.

(iii) Under paragraph (k)(2)(ii) of this section, the remaining $50 interest payment from S to T is then characterized. The interest payment is first allocable under the rules of paragraph (c)(2)(ii)(C) of this section to S's passive income. Therefore, the $50 interest payment to T is passive income. The interest income is foreign personal holding company income in T's hands. T, therefore, has $50 of subpart F passive income and $200 of non-subpart F general limitation income.

(iv) Under paragraph (k)(2)(iii) of this section, subpart F inclusions are characterized next. P has a subpart F inclusion with respect to S of $50 that is attributable to passive income of S and is treated as passive income to P. P has a subpart F inclusion with respect to T of $50 that is attributable to passive income of T and is treated as passive income to P.

Example 9. (i) P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. P also owns 100 percent of the stock of U, a controlled foreign corporation. In 1987, S earns $100 of passive foreign personal holding company income and $200 of non-subpart F general limitation income from unrelated persons. S also receives $150 of dividend income from T. S pays $100 of interest to T and $100 of interest to U. U earns $300 of non-subpart F general limitation income and the $100 of interest received from S. U pays a $100 royalty to T. T earns the $100 interest payment received from S and the $100 royalty received from U.

(ii) Under paragraph (k)(2)(i) of this section, the royalty paid by U to T is characterized first. Assume that the royalty is directly allocable to U's general limitation income. Also assume that the royalty is not subpart F income to T. With respect to T, the royalty is general limitation income.

(iii) Under paragraph (k)(2)(ii) of this section, the interest payments from S to T and U are characterized next. This characterization is done without regard to any dividend income received by S because, under paragraph (k)(2) of this section, dividends are characterized after interest payments from a related person. The interest payments are first allocable to S's passive income under paragraph (c)(2)(ii)(C) of this section. Therefore, $50 of the interest payment to T is passive and $50 of the interest payment to U is passive. The remaining $50 paid to T is general limitation income and the remaining $50 paid to U is general limitation income. All of the interest payments to T and U are subpart F foreign personal holding company income to both recipients.

(iv) Under paragraph (k)(2)(iii) of this section, P has a $100 subpart F inclusion with respect to T that is characterized next. Fifty dollars ($50) of the subpart F inclusion is passive income to P because it is attributable to the passive income portion of the interest income received by T from S, and $50 of the inclusion is treated as general limitation income to P because it is attributable to the general limitation portion of the interest income received by T from S. Under paragraph (k)(2)(iii) of this section, P also has a $100 subpart F inclusion with respect to U. Fifty dollars ($50) of the subpart F inclusion is passive income to P because it is attributable to the passive portion of the interest income received by U from S, and $50 of the inclusion is general limitation income to P because it is attributable to the general limitation portion of the interest income received by U from S.

(v) Under paragraph (k)(2)(iv) of this section, the $150 distribution from T to S is characterized next. One-hundred dollars ($100) of the distribution is out of earnings and profits attributable to previously taxed income. Therefore, only $50 is a dividend that is subject to the look-through rules of paragraph (d) of this section. The $50 dividend is attributable to T's general limitation income and is general limitation income to S in its entirety.

Example 10. (i) P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. P also owns 100 percent of the stock of U, a controlled foreign corporation. S, T and U are all incorporated in the same foreign country. In 1987, S earns $100 of passive foreign personal holding income and $200 of general limitation non-subpart F income from unrelated persons. S pays $100 of interest to T and $100 of interest to U. U earns $300 of general limitation non-subpart F income and the $100 of interest received from S. T's only income is the $100 interest payment received from S.

(ii) Under paragraph (k)(2)(ii) of this section, the interest payments from S to T and U are characterized first. The interest payments are first allocated under the rule of paragraph (c)(2)(ii)(C) of this section to S's passive income. Therefore, under that provision and paragraph (c)(2)(i) of this section, $50 of the interest payment to T is passive income to T and $50 of the interest payment to U is passive income to U. The remaining $50 paid to T is general limitation income and the remaining $50 paid to U is general limitation income.

(iii) Under paragraph (k)(2)(iii) of this section, any subpart F inclusion of P is determined and characterized next. Under paragraph (c)(1)(i) of this section, paragraphs (c)(2)(i) and (c)(2)(ii) apply not only for purposes of determining the separate category of income of S to which the interest payments from S to T and U are allocable but also for purposes of determining the subpart F income of T and U. Although the interest payments from S to T and U are ''same country'' interest payments that would otherwise be excludible from T's and U's subpart F income under section 954(c)(3)(A)(i), section 954(c)(3)(B) provides that the exception for same country payments between related persons shall not apply to the extent such payments have reduced the subpart F income of the payor. In this case, $50 of the $100 interest payment from S to T reduced S's subpart F income and $50 of the $100 interest payment from S to U reduced the remaining $50 of S's subpart F income. Therefore, T has $50 of subpart F income that is passive income and U has $50 of subpart F income that is passive income. P includes $100 of subpart F income in gross income that is passive income to P.

(iv) The remaining $50 of interest paid by S to T and the remaining $50 of interest paid by S to U is not subpart F income to T or U because it did not reduce S's subpart F income and is therefore eligible for the same country exception.

Example 11. P, a domestic corporation, owns 100 percent of the stock of S, a controlled foreign corporation, and S owns 100 percent of the stock of T, a controlled foreign corporation. P also owns 100 percent of the stock of U, a controlled foreign corporation. In 1991, T earns $100 of general limitation income that is not subpart F income and distributes the entire amount to S as a dividend. S earns $100 of passive foreign personal holding company income and the $100 dividend from T. S pays $100 of interest to U. U earns $200 of general limitation income that is foreign base company income and $100 of interest income from S. This transaction does not involve circular payments and, therefore, the ordering rules of paragraph (k)(2) of this section do not apply. Instead, pursuant to paragraph (k)(1) of this section, income received is characterized first. T's earnings and, thus, the dividend from T to S are characterized first. S includes the $100 dividend from T in gross income as general limitation income because all of T's earnings are general limitation income. S thus has $100 of passive foreign personal holding company income and $100 of general limitation income. The interest payment to U is then characterized as $100 passive income under paragraph (c)(2)(ii)(C) of this section (allocation of related person interest to passive foreign personal holding company income). For 1991, U thus has $200 of general limitation income that is subpart F income, and $100 of passive foreign personal holding company income. For 1991, P includes in its gross income $200 of general limitation subpart F income from U, $100 of passive subpart F income from U (relating to the interest payment from S to U), and $100 of general limitation subpart F income from S (relating to the dividend from T to S).

(m) *Application of section 904(g)*—(1) *In general.* For purposes of determining the portion of an interest payment that is allocable to income earned or accrued by a controlled foreign corporation from sources within the United States under section 904(g)(3), the rules in paragraph (m)(2) of this section apply. For purposes of determining the portion of a dividend paid or accrued by a controlled foreign corporation that is treated as from sources within the United States under section 904(g)(4), the rules in paragraph (m)(4) of this section apply. For purposes of determining the portion of an amount included in gross income under section 951(a) that is attributable to income of the controlled foreign corporation from sources within the United States under section 904(g)(2), the rules in paragraph (m)(5) of this section apply. In order to determine whether section 904(g) applies, section 904(g)(5) (exception if controlled foreign corporation has a de minimis amount of United States source income) shall be applied to the total amount of earnings and profits of a controlled foreign corporation for a taxable year without regard to the characterization of those earnings under section 904(d).

(2) *Treatment of interest payments.* If interest is received or accrued by a United States shareholder or a person related to a United States shareholder (within the meaning of paragraph (c)(2)(ii) of this section) from a controlled foreign corporation, the interest shall be considered to be allocable to income of the controlled foreign corporation from sources within the United States for purposes of section 904(d) to the extent that the interest is allocable under paragraph (c)(2)(ii)(C) of this section to passive income that is from sources within the United States. If related person interest is less than or equal to passive income, the related person interest will be allocable to United States source passive income based on the ratio of United States source passive income to total passive income. To the extent that related person interest exceeds passive income, and, therefore, is allocated under paragraph (c)(2)(ii)(D) of this section to income in a separate category other than passive, the following formulas apply in determining the portion of the interest payment that is from sources within the United States. If the taxpayer uses the gross income method to allocate interest, the portion of the interest payment from sources within the United States is determined as follows:

$$\begin{array}{c}\text{The amount of the interest payment}\\ \text{allocated to the separate category under}\\ \text{paragraph (c)(2)(ii)(D) of this section}\end{array} \times \frac{\begin{array}{c}\text{Gross income from United States sources}\\ \text{in that category}\end{array}}{\begin{array}{c}\text{Gross income from all sources}\\ \text{in that category}\end{array}}$$

If the taxpayer uses the asset method to allocate interest, then the portion of the interest payment from sources within the United States is determined as follows:

$$\begin{array}{c}\text{The amount of the interest payment}\\ \text{allocated to the separate category under}\\ \text{paragraph (c)(2)(ii)(D) of this section}\end{array} \times \frac{\text{Value of domestic assets in that category}}{\text{Value of total assets in that category}}$$

For purposes of this paragraph, the value of assets in a separate category is the value of assets as determined under the principles of § 1.861–9T(g). See § 1.861–10T(d)(2) for purposes of determining the value of assets and gross income in a separate category as reduced for indebtedness the interest on which is directly allocated.

(3) *Examples.* The following examples illustrate the application of this paragraph.

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1988, S pays P $300 of interest. S has no other expenses. In 1988, S has $3000 of assets that generate $650 of foreign source general limitation sales income and a $1000 loan to an unrelated foreign person that generates $20 of foreign source passive interest income. S also has a $4000 loan to an unrelated United States person that generates $70 of United States source passive income and $4000 of inventory that generates $100 of United States source general limitation income. S uses the asset method to allocate interest expense. The following chart summarizes S's assets and income:

	Foreign	U.S.	Totals
Assets:			
Passive	1000	4000	5000
General	3000	4000	7000
Total	4000	8000	12000
Income:			
Passive	20	70	90
General	650	100	750
Total	670	170	840

Under paragraph (c)(2)(ii)(C) of this section, $90 of the related person interest payment is allocable to S's passive income. Under paragraph (m)(2) of this section, $70 is from sources within the United States and $20 is from foreign sources. Under paragraph (c)(2)(ii)(D) of this section, the remaining $210 of the related person interest payment is allocated to general limitation income. Under paragraph (m)(2) of this section, $120 of the remaining $210 is treated as income from sources within the United States ($120=$210×$4000/$7000) and $90 is treated as income from foreign sources. ($90=$210×$3000/$7000).

Example 2. The facts are the same as in *Example* 1 except that S uses the gross income method to allocate interest expense. The first $90 of related person interest expense is allocated to passive income in the same manner as in Example 1. Under paragraph (c)(2)(ii)(D) of this section, the remaining $210 of the related person interest expense is allocated to general limitation income. Under paragraph (m)(2) of this section, $28 of the remaining $210 is treated as income from United States sources ($28=$210×$100/$750) and $182 is treated as income from foreign sources ($182=$210×$650/$750).

Example 3. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. In 1988, S pays $300 of interest to P. S has no other expenses. S uses the asset method to allocate interest expense. In 1988, S has $4000 of assets that generate $650 of foreign source general limitation manufacturing income and a $1000 loan to an unrelated foreign person that generates $100 of foreign source passive interest income. S has $500 of shipping assets that generate $200 of foreign source shipping income and $500 of shipping assets that generate $200 of United States source shipping income. S also has a $1000 loan to an unrelated United States person that generates $100 of United States source passive income. S's passive income is not also described as shipping income. The following chart summarizes S's assets and income:

	Foreign	U.S.	Totals
Assets:			
Passive	1000	1000	2000
Shipping	500	500	1000
General	4000	0	4000
Total	5500	1500	7000
Income:			
Passive	100	100	200
Shipping	200	200	400
General	650	0	650
Total	950	300	1250

Under paragraph (c)(2)(ii)(C) of this section, $200 of the related person interest payment is allocable to S's passive income. Under paragraph (m)(2) of this section, $100 of this amount is from foreign sources and $100 is from sources within the United States.

Under paragraph (c)(2)(ii)(D) of this section, $80 of the remaining $100 of the related person interest payment is allocated to general limitation income ($80=$100×$4000/$5000) and $20 is allocated to shipping income ($20=$100×$1000/$5000).

Under paragraph (m)(2) of this section, none of $80 of the interest payment allocated to general limitation income is treated as income from United States sources ($0=$80×$0/$4000). Therefore, the entire $80 is treated as income from foreign sources.

Under paragraph (m)(2) of this section, $10 of the $20 of the interest payment allocated to the shipping income is treated as income from United States sources ($10=$20×$500/$1000) and $10 of the $20 is treated as income from foreign sources ($10=$20×$500/$1000).

Example 4. The facts are the same as in *Example* 3 except that S uses the gross income method to allocate interest expense. The interest allocated to passive income under paragraph (c)(2)(ii)(C) of this section is the same, $200, $100 from United States sources and $100 from foreign sources.

Under paragraph (c)(2)(ii)(D) of this section, the remaining $100 of related person interest is allocated between the shipping and general limitation categories based on the gross income in those categories. Therefore, $38 of the remaining $100 interest payment is allocated to shipping income ($38=$100×$400/($1250 − $200)) and $62 is treated as allocated to general limitation income ($62=$100×$650/($1250–$200)).

Under paragraph (m)(2) of this section, $19 of the $38 allocable to shipping income is treated as income from United States sources ($19=$38×$200/$400) and $19 is treated as income from foreign sources ($19=$38×$200/$400).

Under paragraph (m)(2) of this section, all of the $62 allocated to general limitation income is treated as income from foreign sources ($62=$62×$650/$650).

(4) *Treatment of dividend payments*—(i) *Rule.* Any dividend or distribution treated as a dividend under this section that is received or accrued by a United States shareholder from a controlled foreign corporation shall be treated as income in a separate category derived from sources within the United States in proportion to the ratio of the portion of the earnings and profits of the controlled foreign corporation in the corresponding separate category from United States sources to the total amount of earnings and profits of the controlled foreign corporation in that separate category.

(ii) *Determination of earnings and profits from United States sources.* In order to determine the portions of earnings and profits from United States sources and from foreign sources within each separate category, related person interest shall be allocated to the United States source portion of income in a separate category by applying the rules of paragraph (m)(2) of this section. Other expenses shall be allocated by applying the rules of paragraph (c)(2)(ii) of this section separately to the United States source income and the foreign source income in each category. For example, unrelated person interest expense that is allocated among categories of income based upon the relative amounts of assets in a category must be allocated between United States and foreign source income within each category by applying the rules of paragraph (c)(2)(ii)(E) of this section separately to United States source and foreign source assets in the separate category.

(iii) *Example.* The following example illustrates the application of this paragraph.

Example. Controlled foreign corporation, S, is a wholly owned subsidiary of P, a domestic corporation. S is a financial services entity. In 1987, S has $100 of non-subpart F general limitation earnings and profits and $100 of non-subpart F financial services income. None of the general limitation earnings and profits are from sources within the United States, and $50 of the financial services earnings and profits are from United States sources. In 1988, S earns $300 of non-subpart F general limitation earnings and profits and $500 of non-subpart F financial services earnings and profits. One hundred dollars ($100) of the general limitation earnings and profits are from sources within the United States. None of the financial services earnings and profits are from United States sources. In 1988, S pays P a $500 dividend. Under paragraph (c)(4) of this section, $200 of the dividend is attributable to general limitation earnings and profits ($200=$500×$400/$1000). Under this paragraph (m)(3), the portion of the dividend that is attributable to general limitation earnings and profits from sources within the United States is $50 ($200×$100/$400). Under paragraph (c)(4) of this section, $300 of the dividend is attributable to financial services earnings and profits ($300=$500×$600/$1000). Under this paragraph (m)(3), the portion of the dividend that is attributable to financial services earnings and profits from sources within the United States is $25 ($300×$50/$600).

(5) *Treatment of subpart F inclusions*—(i) *Rule.* Any amount included in the gross income of a United States shareholder of a controlled foreign corporation under section 951(a) shall be treated as income subject to a separate limitation that is derived from sources within the United States to the extent such amount is attributable to income of the controlled foreign corporation in the corresponding category of income from sources within the United States. In order to determine a controlled foreign corporation's taxable income and earnings and profits from sources within the United States in each separate category, the principles of paragraph (m)(4)(ii) of this section shall apply.

(ii) *Example.* The following example illustrates the application of this paragraph (m)(5).

Example. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation, P. In 1987, S earns $100 of subpart F foreign personal holding company income that is passive income. Of this amount, $40 is derived from sources within the United States. S also earns $50 of subpart F general limitation income. None of this income is from sources within the United States. Assume that S pays no foreign taxes and has no expenses. P is required to include $150 in gross income under section 951(a). Of this amount, $60 will be foreign source passive income to P and $40 will be United States source passive income to P. Fifty dollars ($50) will be foreign source general limitation income to P.

(6) *Treatment of section 78 amount.* For purposes of treating taxes deemed paid by a taxpayer under section 902(a) and section 960(a)(1) as a dividend under section 78, taxes that are paid or accrued with respect to United States source income in a separate category shall be treated as United States source income in that separate category.

(7) *Coordination with treaties*—(i) *Rule.* If any amount of income derived from a United States-owned foreign corporation, as defined in section 904(g)(6), would be treated as derived from sources within the United States under section 904(g) and this paragraph (m) and, pursuant to an income tax convention with the United States, the taxpayer chooses to avail itself of benefits

of the convention that treat that amount as arising from sources outside the United States under a rule explicitly treating the income as foreign source, then that amount will be treated as foreign source income. However, sections 904 (a), (b), (c), (d) and (f), 902, 907, and 960 shall be applied separately to amounts described in the preceding sentence with respect to each treaty under which the taxpayer has claimed benefits and, within each treaty, to each separate category of income.

(ii) *Example.* The following example illustrates the application of this paragraph (m)(7).

Example. Controlled foreign corporation S is incorporated in Country A and is a wholly-owned subsidiary of P, a domestic corporation. In 1990, S earns $80 of foreign base company sales income in Country A which is general limitation income and $40 of U.S. source interest income. S incurs $20 of expenses attributable to its sales business. S pays P $40 of interest that is allocated to U.S. source passive income under paragraphs (c)(2)(ii)(C) and (m)(2) of this section. Assume that earnings and profits equal net income. All of S's net income of $60 is includible in P's gross income under subpart F (section 951(a)(1)). For 1990, P also has $100 of passive income derived from investments in Country B. Pursuant to section 904(g)(3) and paragraph (m)(2) of this section, the $40 interest payment from S is United States source income to P because it is attributable to United States source interest income of S. The United States-Country A income tax treaty, however, treats all interest payments by residents of Country A as Country A sourced and P elects to apply the treaty. Pursuant to section 904(g)(10) and this paragraph (m)(7), the entire interest payment will be treated as foreign source income to P. P thus has $60 of foreign source general limitation income, $40 of foreign source passive income from S, and $100 of other foreign source passive income. In determining P's foreign tax credit limitation on passive income, the passive income from Country A shall be treated separately from any other passive income.

(n) *Order of application of sections 904 (d) and (g).* In order to apply the rules of this section, section 904(d)(1) shall first be applied to the controlled foreign corporation to determine the amount of income and earnings and profits derived by the controlled foreign corporation in each separate category. The income and earnings and profits in each separate category that is from United States sources shall then be determined. Sections 904(d)(3), 904(g), and this section shall then be applied for purposes of characterizing and sourcing income received, accrued, or included by a United States shareholder in the controlled foreign corporation that is attributable or allocable to income or earnings and profits of the controlled foreign corporation.

(o) *Effective date.* Section 904(d)(3) and this section apply to distributions and section 951 inclusions of earnings and profits of a controlled foreign corporation (or other entity to which this section applies) derived during the first taxable year of the controlled foreign corporation (or other entity) beginning after December 31, 1986, and thereafter, and to payments made by a controlled foreign corporation (or other entity) during such taxable years, without regard to whether the corresponding taxable year of the recipient of the distribution or payment or of one or more of the United States shareholders of the controlled foreign corporation begins after December 31, 1986. Paragraph (k)(1) of this section does not apply on or after March 23, 1998. For rules applicable on or after March 23, 1998, see §1.904–5T(k)(1).

[T.D. 8214, 53 FR 27020, July 18, 1988, as amended by T.D. 8412, 57 FR 20648, May 14, 1992; T.D.8767, 63 FR 14615, Mar. 26, 1998]

§1.904–5T Look-through rules as applied to controlled foreign corporations and other entities (temporary).

(a) through (j) [Reserved]. For further guidance, see §1.904–5(a) through (j).

(k) *Ordering rules*—(1) *In general.* Income received or accrued by a related person to which the look-through rules apply is characterized before amounts included from, or paid or distributed by, that person and received or accrued by a related person. For purposes of determining the character of income received or accrued by a person from a related person if the payor or another related person also receives or accrues income from the recipient and the look-through rules apply to the income in all cases, the rules of paragraph (k)(2) of this section apply. Notwithstanding any other provision of this section, the principles of § 1.954–1T(c)(1)(i) will apply to any expense subject to that subparagraph.

(k)(2) through (n) [Reserved]. For further guidance, see § 1.904–5(k)(2) through (n).

(o) *Effective date.* Section 1.904–5T(k)(1) applies on or after March 23, 1998. For rules prior to March 23, 1998, see § 1.904–5(k)(1).

[T.D. 8767, 63 FR 14615, Mar. 26, 1998]

§ 1.904–6 Allocation and apportionment of taxes.

(a) *Allocation and apportionment of taxes to a separate category or categories of income*—(1) *In general*—(i) *Taxes related to a separate category of income.* The amount of foreign taxes paid or accrued with respect to a separate category of income (including United States source income) shall include only those taxes that are related to income in that separate category. Taxes are related to income if the income is included in the base upon which the tax is imposed. If, for example, foreign law exempts certain types of income from foreign taxes, or certain types of income are exempt from foreign tax under an income tax convention, then no taxes are considered to be related to such income for purposes of this paragraph. As another example, if foreign law provides for a specific rate of tax with respect to certain types of income (*e.g.*, capital gains), or certain expenses, deductions, or credits are allowed under foreign law only with respect to a particular type of income, then such provisions shall be taken into account in determining the amount of foreign tax imposed on such income. A withholding tax (unless it is a withholding tax that is not the final tax payable on the income as described in § 1.904–4(d)) is related to the income from which it is withheld. A tax that is imposed on a base that includes more than one separate category of income is considered to be imposed on income in all such categories, and, thus, the taxes are related to all such categories included within the foreign country or possession's taxable income base.

(ii) *Apportionment of taxes related to more than one separate category*. If a tax is related to more than one separate category, then, in order to determine the amount of the tax paid or accrued with respect to each separate category, the tax shall be apportioned on an annual basis among the separate categories on the basis of the following formula:

$$\text{Foreign tax related to more than one separate category} \times \frac{\text{Net income subject to that foreign tax included in a separate category}}{\text{Net income subject to that foreign tax}}$$

For purposes of apportioning foreign taxes among the separate categories, gross income is determined under the law of the foreign country or a possession of the United States to which the foreign income taxes have been paid or accrued. Gross income, as determined under foreign law, in the passive category shall first be reduced by any related person interest expense that is allocated to the income under the principles of section 954(b)(5) and § 1.904–5(c)(2)(ii)(C) (adjusted gross passive income). Gross income in all separate categories (including adjusted gross passive income) is next reduced by deducting any expenses, losses, or other amounts that are deductible under foreign law that are specifically allocable to the gross amount of such income under the laws of that foreign country or possession. If expenses are not specifically allocated under foreign law then the expenses will be apportioned under the principles of foreign law but only after taking into account the reduction of passive income by the application of section 954(b)(5). Thus, for example, if foreign law provides that expenses will be apportioned on a gross income basis, the gross income amounts will be those amounts determined under foreign law except that, in the case of passive income, the amount will be adjusted gross passive income. If foreign law does not provide for the direct allocation or apportionment of expenses, losses, or other deductions to a particular category of income, then the principles of §§1.861–8 through 1.861–14T and section 954(b)(5) shall apply in allocating and apportioning such expenses, losses, or other deductions to gross income as determined under foreign law after reduction of passive income by the amount of related person interest allocated to passive income under section 954(b)(5) and §1.904–5(c)(2)(ii)(C). For example, the principles of §§1.861–8 through 1.861–14T apply to require definitely related expenses to be directly allocated to particular categories of gross income and provide the methods of apportioning expenses that are definitely related to more than one category of gross income or that are not definitely related to any particular category of gross income. For this purpose, the apportionment of expenses required to be made under §§1.861–8 through 1.861–14T need not be made on other than a separate company basis. The rules in this paragraph apply only for purposes of the apportionment of taxes among separate categories of income and do not affect the computation of a taxpayer's foreign tax credit limitation with respect to a specific category of income.

(iii) *Apportionment of taxes for purposes of applying the high-tax income test.* If taxes have been allocated and apportioned to passive income under the rules of paragraph (a)(1) (i) or (ii) of this section, the taxes must further be apportioned to the groups of income described in §1.904–4(c) (3), (4) and (5) for purposes of determining if the group is high-taxed income. Taxes will be related to income in a particular group under the same rules as those in paragraph (a)(1) (i) and (ii) of this section except that those rules shall be applied by substituting the term ''group'' for the term ''category.''

(iv) *Special rule for base and timing differences.* If, under the law of a foreign country or possession of the United States, a tax is imposed on an item of income that does not constitute income under United States tax principles, that tax shall be treated as imposed with respect to general limitation income. If, under the law of a foreign country or possession of the United States, a tax is imposed on an item that would be income under United States tax principles in another year, that tax will be allocated to the appropriate separate category or categories as if the income were recognized under United States tax principles in the year in which the tax was imposed.

(2) *Treatment of certain dividends from noncontrolled section 902 corporations.* If a taxpayer receives or accrues a dividend from a noncontrolled section 902 corporation, and if the Commissioner establishes that there is an agreement, express or implied, that such dividend is paid out of the passive earnings or high withholding tax interest income of the foreign corporation, then only the foreign taxes imposed on passive income or high withholding tax interest income of the noncontrolled section 902 corporation will be considered to be taxes related to the dividend. For an illustration of this rule, see paragraph (c) *Example (7)* of this section.

(b) *Application of paragraph (a) to sections 902 and 960*—(1) *Determination of foreign taxes deemed paid.* If, for the taxable year, there is included in the gross income of a domestic corporation under section 951 an amount attributable to the earnings and profits of a controlled foreign corporation for any taxable year and the amount included consists of income in more than one separate category of the controlled foreign corporation, then the domestic corporation shall be deemed to have paid only a portion of the taxes paid or accrued, or deemed paid or accrued, by the controlled foreign corporation that are allocated to each separate category to which the inclusion is attributable. The portion of the taxes allocated to a particular separate category that shall be deemed paid by the United States shareholder shall be equal to the taxes allocated to that separate category multiplied by the amount of the inclusion with respect to that category (as determined under §1.904–5(c)(1)) and divided by the earnings and profits of the controlled foreign corporation with respect to that separate category (in accordance with § 1.904–5(c)(2)(ii)). The rules of this paragraph (b)(1) also apply for purposes of computing the foreign taxes deemed paid by United States shareholders of controlled foreign corporations under section 902.

(2) *Distributions received from foreign corporations that are excluded from gross income under section 959(b).* The principles of this paragraph shall be applied to—

(i) Any portion of a distribution received from a first-tier corporation by a domestic corporation or individual that is excluded from the domestic corporation's or individual's income under section 959(a) and § 1.959–1; and

(ii) Any portion of a distribution received from an immediately lower-tier corporation by a second- or first-tier corporation that is excluded from such foreign corporation's gross income under section 959(b) and § 1.959–2, if such distribution is treated as a dividend pursuant to § 1.960–2(a).

(3) *Application of section 78.* For purposes of treating taxes deemed paid by a taxpayer under section 902(a) and section 960(a)(1) as a dividend under section 78, taxes that were allocated to income in a separate category shall be treated as income in that same separate category.

(4) *Increase in limitation.* The amount of the increase in the foreign tax credit limitation allowed by section 960(b) and § 1.960–4 shall be determined with regard to the applicable category of income under section 904(d).

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

Example 1. M, a domestic corporation, conducts business in foreign country X. M earns $400 of shipping income, $200 of general limitation income and $200 of passive income as determined under foreign law. Under foreign law, none of M's expenses are directly allocated or apportioned to a particular category of income. Under the principles of §§ 1.861–8 through 1.861–14T, M apportions $75 of directly allocable expenses to shipping income, $10 of directly allocable expenses to general limitation income, and no such expenses to passive income. M also apportions expenses that are not directly allocable to a specific class of gross income—$40 to shipping income, $20 to general limitation income, and $20 to passive income. Therefore, for purposes of paragraph (a) of this section, M has $285 of net shipping income, $170 of net general limitation income, and $180 of net passive income. Country X imposes tax of $100 on a base that includes M's shipping income and general limitation income. Country X exempts passive income from tax. The tax paid by M is related to M's shipping and general limitation income. The $100 tax is apportioned between those limitations. Thus, M is considered to have paid $63 of X tax on its shipping income ($100×$285/$455) and $37 of tax on its general limitation income ($100×$170/$455). None of the X tax is allocated to M's passive income.

Example 2. The facts are the same as in example 1 except that X does not exempt all passive income from tax but only exempts interest income. M's passive income consists of $100 of gross dividend income, to which $10 of expenses that are not directly allocable are apportioned, and $100 of interest income, to which $10 of expenses that are not directly allocable are apportioned. The $90 of net dividend income is subject to X tax, and $90 of net interest income is exempt from X tax. M pays $130 of tax to X. The $130 of tax is related to M's general, shipping, and passive income. The tax is apportioned among those limitations as follows: $68 to shipping income ($130×$285/$545) $41 to general limitation income ($130×$170/$545), and $21 to passive income ($130×$90/$545).

Example 3. P, a domestic corporation, owns 100 percent of S, a controlled foreign corporation organized in country X. S owns l00 percent of T, a controlled foreign corporation that is also organized in country X. Country X grants group relief to S and T. In 1987, S earns $100 of income and T incurs an $80 loss. Under country X's group relief provisions, only $20 of S's income is subject to country X tax. Country X imposes a 30 percent tax on this income ($6). P includes $100 of S's income in gross income under section 951. Six dollars ($6) of foreign tax is related to that income for purposes of section 960.

Example 4. P, a domestic corporation, owns 100 percent of S, a controlled foreign corporation organized in country X and 100 percent of T, a controlled foreign corporation organized in country Y. T has $200 of gross manufacturing general limitation income and $50 of passive income. T also pays S $100 for shipping T's goods, a price that may be justified under section 482. T has no other expenses and S has no other income or expense. T's income and earnings and profits are the same. Foreign country X does not tax S on its shipping income. Foreign country Y taxes all of T's income at a rate of 20 percent. Under the law of foreign country Y, T is only allowed a $50 deduction for the payment to S. Therefore, for foreign law purposes, T has $150 of manufacturing income and earnings and profits and $50 of passive income and earnings and profits upon which it pays $40 of tax. Under the principles of foreign law, $30 of that tax is imposed on the general limitation manufacturing income and $10 of the tax is imposed on passive income. Therefore, the foreign effective rate on the general limitation income is 30 percent and the foreign effective rate on the passive income is 20 percent. T has $100 of general limitation income and $50 of passive income and pays $30 of general limitation taxes and $10 of passive taxes. S has $100 of shipping income and pays no foreign tax.

Example 5. R, a domestic corporation, owns 50 percent of T, a foreign corporation that is not a controlled foreign corporation and that is organized in foreign country X. R licenses certain property to T. T then relicenses this property to a third person. In 1987, T paid R a royalty of $100 all of which is treated as passive income to R because it was not an active royalty as defined in §1.904–4(b)(2). R has $10 of expenses associated with the royalty income and no foreign tax was imposed on the royalty so the high-tax kickout does not apply. In 1988, the Commissioner determined that the correct arm's length royalty was $150 and under the authority of section 482 reallocated an additional $50 of income to R for 1987. Under a closing agreement with the Commissioner, R elected the benefits of Rev. Proc. 65–17 in relation to the income reallocated from R and established an account receivable from T. In 1988, T paid R an additional $50 to reflect the section 482 adjustment and the account receivable that was established because of the adjustment. Foreign country X treats the $50 payment in 1988 as a dividend by T and imposes a $10 withholding tax on the payment. Under paragraph (a)(1) of this section, the $10 of withholding tax is treated as fully allocable to the $50 payment because under foreign law the tax is imposed only on that income. For U.S. purposes, the income is not characterized as a dividend but as a repayment of a bona fide debt and, therefore, the $50 of income is not required to be recognized by R in 1988. The $10 of tax is treated as a tax paid in 1988 on the $50 of passive income included by R in 1987 pursuant to the section 482 adjustment rather than as a tax associated with a dividend from a noncontrolled section 902 corporation. The $10 tax is a tax imposed on passive income under paragraph (a)(1)(iv) of this section.

Example 6. P, a domestic corporation owns all of the stock of S, a controlled foreign corporation that is incorporated in country X. In 1989, S has $100 of passive income, $200 of dividends from a noncontrolled section 902 corporation and $200 of general limitation income. S also has $100 of related person interest expense and $100 of other expenses that under foreign law are directly allocable to the general limitation income of S. S has no other expenses. Country X imposes a tax of 25% on all of the net income of S and S, therefore, pays $75 in foreign tax. Under paragraph (a)(1)(ii) of this section, the passive income of S is first reduced by the amount of related person interest for purposes of determining the net amount for purposes of allocating the $75 of tax. Under paragraph (a)(1)(ii) of this section, the general limitation income of S is reduced by the $100 of other expenses. Therefore, $50 of the foreign tax is allocated to the dividends from a noncontrolled section 902 corporation ($50=$75×$200/$300), $25 is allocated to the general limitation income of S ($25=$75×$100/$300), and no taxes are allocated to S's passive income.

Example 7. R, a domestic corporation owns preferred stock in T, a foreign corporation that is not a controlled foreign corporation, incorporated in foreign country X. R's stock represents 15 percent of the value of T. Dividends on the preferred stock are paid only out of certain designated passive investments of T. Foreign country X does not tax the passive income of T. Under paragraph (a)(2) of this section, no taxes will be considered to be related to any dividend paid by T to R.

Example 8. Domestic corporation P owns all of the stock of controlled foreign corporation S, which owns all of the stock of controlled foreign corporation T. All such corporations use the calendar year as the taxable year. Assume that earnings and profits are equal to net income and that the income amounts are identical under United States and foreign law principles. In 1987, T earns (before foreign taxes) $187.50 of net passive income and $62.50 of net general limitation income and pays $50 of foreign taxes. S earns no income in 1987 and pays no foreign taxes. For 1987, P is required under section 951 to include in gross income $175 attributable to the earnings and profits of T for that year. One hundred and fifty dollars ($150) of the subpart F inclusion is attributable to passive income earned by T, and $25 of the subpart F inclusion is attributable to general limitation income earned by T. In 1988, T earns no income and pays no foreign taxes. T pays a $200 dividend to S, consisting of $175 from its earnings and profits attributable to amounts required to be included in P's gross income with respect to T and $25 from its other earnings and profits. Assume that no withholding tax is imposed with respect to the distribution from T to S. In 1988, S earns $100 of net general limitation income and receives a $200 dividend from T. S pays $30 in foreign taxes. For 1988, P is required under section 951 to include in gross income $22.50 attributable to the earnings and profits of S for such year. The entire subpart F inclusion is attributable to general limitation income earned by S. In 1988, S pays P a dividend of $247.50, consisting of $157.50 from its earnings and profits attributable to the amount required under section 951 to be included in P's gross income with respect to T, $22.50 from its earnings and profits attributable to the amount required under section 951 to be included in P's gross income with respect to S, and $67.50 from its other earnings and profits. Assume the de minimis rule of section 954(b)(3)(A) and the full inclusion rule of section 954(b)(3)(B) do not apply to the gross amounts of income earned by S and T. The foreign income taxes deemed paid by P for 1987 and 1988 under section 960(a)(1) and section 902(a) are determined as follows on the basis of the following facts and computations.

T corporation (second-tier corporation):			
1. Pre-tax earnings and profits:			
(a) Passive income (p.i.)	187.50		
Plus:			
(b) General limitation income (g.l.i.)	62.50		
(c) Total	250.00		
Less:			
(d) Foreign income taxes paid on or with respect to T's earnings and profits (20%)		50.00	
(e) Earnings and profits			200.00
2. Allocation of taxes:			
(a) Foreign income taxes paid by T that are allocable to p.i. earned by T:			
Line 1(d) taxes		50.00	
Multiplied by: foreign law net p.i.		187.50	
Divided by: foreign law total net income		250.00	
Result			37.50
(b) Foreign income taxes paid by T that are allocable to g.l.i. earned by T:			
Line 1(d) taxes		50.00	
Multiplied by: foreign law net g.l.i.		62.50	
Divided by: foreign law total net income		250.00	
Result			12.50
3. T's earnings and profits:			
(a) Earnings and profits attributable to T's p.i.:			
Line (1)(a) e & p		187.50	
Less: line 2(a) taxes		37.50	
Result			150.00
(b) Earnings and profits attributable to T's g.l.i.:			
Line (1)(b) e & p		62.50	
Less: line 2(b) taxes		12.50	
Result			50.00
4. Subpart F inclusion attributable to T:			
(a) Amount required to be included in P's gross income for 1987 under section 951 with respect to T that is attributable to T's p.i.			150.00
(b) Amount required to be included in P's gross income for 1987 under section 951 with respect to T that is attributable to T's g.l.i.			25.00
5. Foreign income taxes deemed paid by P under section 960(a)(1) with respect to T:			
(a) Taxes deemed paid that are attributable to T's subpart F inclusion that are attributable to T's p.i.:			
Line 2(a) taxes		37.50	
Multiplied by: line 4(a) sec. 951 incl.		150.00	
Divided by: line 3(a) e & p		150.00	
Result:			37.50

(b) Taxes deemed paid that are attributable to T's subpart F inclusion that are attributable to T's g.l.i.:			
Line 2(b) taxes	....	12.50	
Multiplied by: line 4(b) sec. 951 incl.	....	25.00	
Divided by: line 3(b) e & p	....	50.00	
Result	....	....	6.25
6. Dividends paid to S:			
(a) Dividends attributable to T's previously taxed p.i.	....	150.00	
Plus:			
(b) Dividends attributable to T's previously taxed g.l.i.	....	25.00	
Plus:			
(c) Dividends from T's non-previously taxed earnings and profits attributable to p.i.	....	0	
Plus:			
(d) Dividends from T's non-previously taxed earnings and profits attributable to g.l.i.	....	....	25.00
(e) Total dividends paid to S	....	....	200.00
7. Taxes deemed paid by S:			
(a) Taxes of T deemed paid by S for 1987 under section 902(b)(1) with regard to T's p.i.:			
Line 2(a) taxes	....	37.50	
Multiplied by: line 6(c) dividend	....	0	
Dividend by: line 3(a) e & p	....	....	150.00
Result	....	....	0
(b) Taxes of T deemed paid by S for 1987 under section 902(b)(1) with regard to T's g.l.i.:			
Line 2(b) taxes	....	12.50	
Multiplied by: line 6(d) dividend	....	25.00	
Dividend by: line 3(b) e & p	....	50.00	
Result	....	....	6.25
S corporation (first-tier corporation):			
8. Pre-tax earnings and profits:			
(a) Dividends from T attributable to T's non-previously taxed p.i.	0		
Plus:			
(b) Dividends from T attributable to T's non-previously taxed g.l.i.	25		
Plus:			
(c) Dividends from T attributable to T's previously taxed p.i.	150		
Plus:			
(d) Dividends from T attributable to T's previously taxed g.l.i.	25		
Plus:			
(e) Passive income other than dividend from T	0		
Plus:			
(f) General limitation income other than dividend from T	100.00		
(g) Total pre-tax earnings and profits	....	300.00	
(h) Foreign income taxes paid on or with respect to S's earnings and profits (10%)	....	30.00	
(i) Earnings and profits	....	....	270.00
9. Allocation of taxes:			
(a) Foreign income taxes paid by S that are allocable to non-previously taxed p.i. earned by S:			
Line 8(h) taxes	....	30.00	
Multiplied by: foreign law line 8(a) & 8(e) p.i. amounts	....	0	

Dividend by: foreign law total net income		300.00	
Result			0
(b) Foreign income taxes paid by S that are allocable to S's previously taxed p.i. received from T:			
Line 8(h) taxes		30.00	
Multiplied by: foreign law line 8(c) p.i. amount		150.00	
Divided by: foreign law total net income		300.00	
Result			15.00
(c) Foreign income taxes paid by S that are allocable to non-previously taxed g.l.i. earned by S:			
Line 8(h) taxes		30.00	
Multiplied by: foreign law line 8(b) & line 8(f) g.l.i. amounts		125.00	
Divided by: foreign law total net income		300.00	
Result			12.50
(d) Foreign income taxes paid by S that are allocable to S's previously taxed g.l.i. received from T:			
Line 8(h) taxes		30.00	
Multiplied by: foreign law line 8(d) amount		25.00	
Divided by: foreign law total net income		300.00	
Result			2.50
10. (a) Non-previously taxed earnings and profits of S:			
Lines 8(a), 8(b), 8(e), & 8(f) e & p		125.00	
Less: lines 9(a) & 9(c) taxes		12.50	
Result			112.50
(b) Portion of result in 10(a) attributable to S's p.i.			0
(c) Portion of result in 10(a) attributable to S's g.l.i.			112.50
11. (a) Previously taxed earnings and profits of S:			
Lines 8(c) and 8(d) e & p		175.00	
Less: lines 9(b) & 9(d) taxes		17.50	
Result			157.50
(b) Portion of result in 11(a) attributable to T's p.i.:			
Line 8(c)		150.00	
Less: line 9(b) taxes		15.00	
Result			135.00
(c) Portion of result in 11(a) attributable to T's g.l.i.:			
Line 8(d)		25.00	
Less: line 9(d) taxes		2.50	
Result			22.50
12. Subpart F inclusion attributable to S:			
(a) Amount required to be included in P's gross income for 1988 under section 951 with respect to S that is attributable to S's p.i.			0
(b) Amount required to be included in P's gross income for 1988 under section 951 with respect to S that is attributable to S's g.l.i.			22.50
13. Foreign income taxes deemed paid by P under section 960(a)(1) with respect to S:			
(a) Taxes deemed paid that are attributable to S's subpart F inclusion that are attributable to S's p.i.:			
Line 9(a) taxes		0	

Multiplied by: line 12(a) sec. 951 incl.		0	
Divided by: line 10(b) e & p		0	
Result			0
(b) Taxes deemed paid that are attributable to S's subpart F inclusion that are attributable to S's g.l.i.:			
Line 9(c) taxes		12.50	
Multiplied by: line 12(b) sec. 951 incl.		22.50	
Divided by: line 10(c) e & p		112.50	
Result			2.50
(c) Foreign income taxes deemed paid by S deemed paid by P that are allocable to S's p.i.:			
Line 7(a) taxes deemed paid by S		0	
Multiplied by: line 12(a) sec. 951 incl.		0	
Divided by: line 10(b) e & p		0	
Result			0
(d) Foreign income taxes deemed paid by S deemed paid by P that are allocable to S's g.l.i.:			
Line 7(b) taxes deemed paid by S		6.25	
Multiplied by: line 12(b) sec. 951 incl.		22.50	
Divided by: line 10(c) e & p		112.50	
Result			1.25
14. Dividends paid to P:			
(a) Dividends from S attributable to S's previously taxed p.i.		0	
Plus:			
(b) Dividends from S attributable to S's previously taxed g.l.i.		22.50	
Plus:			
(c) Dividends to which section 902(a) applies:			
(i) Consisting of S's earnings and profits attributable to T's previously taxed p.i.	135.00		
Plus:			
(ii) Consisting of S's earnings and profits attributable to T's previously taxed g.l.i.	22.50		
Plus:			
(iii) Consisting of S's other p.i. earnings and profits	0		
Plus:			
(iv) Consisting of S's other g.l.i. earnings and profits	67.50		
(v) Total section 902 dividend		225.00	
(d) Total dividends paid to P			247.50
15. Foreign income taxes deemed paid by P under section 902 and section 960(a)(3) with respect to S:			
(a) Taxes paid by S deemed paid by P under section 902(a) with regard to S's p.i.:			
Line 9(a) taxes		0	
Multiplied by: line 14(c)(iii) div.		0	
Divided by: line 10(b) e & p		0	
Result			0
(b) Taxes paid by S deemed paid by P under section 902(a) with regard to S's g.l.i.:			
Line 9(c) taxes		12.50	
Multiplied by: line 14(c)(iv) div.		67.50	
Divided by: line 10(c) e & p		112.50	
Result			7.50

(c) Taxes deemed paid by S deemed paid by P under section 902(a) with regard to S's p.i.:		
Line 7(a) deemed paid taxes	0	
Multiplied by: line 14(c)(iii) div.	0	
Divided by: line 10(b) e & p	0	
Result		0
(d) Taxes deemed paid by S deemed paid by P under section 902(a) with regard to S's g.l.i.:		
Line 7(b) deemed paid taxes	6.25	
Multiplied by: line 14(c)(iv) div.	67.50	
Divided by: line 10(c) e & p	112.50	
Result		3.75
(e) Foreign income taxes paid by S under section 960(a)(3) deemed paid by P with regard to S's previously taxed p.i.:		
Line 9(b) taxes	15.00	
Multiplied by: line 14(c)(i) div.	135.00	
Divided by: line 11(b) e & p	135.00	
Result		15.00
(f) Foreign income taxes paid by S under section 960(a)(3) deemed paid by P with regard to S's previously taxed g.l.i.:		
Line 9(d) taxes	2.50	
Multiplied by: line 14(c)(ii) div.	22.50	
Divided by: line 11(c) e & p	22.50	
Result		2.50

Summary:		
Total taxes deemed paid by P under section 960(a)(1) with respect to—		
Passive income of S and T included under section 951 in income of P:		
Line 5(a)	37.50	
Plus: Line 13(a)	0	
Plus: Line 13(c)	0	
Result	37.50	
General limitation income of S and T included under section 951 in income of P:		
Line 5(b)	6.25	
Plus: Line 13(b)	2.50	
Plus: Line 13(d)	1.25	
Result	10.00	
Total deemed paid taxes under section 960(a)(1)	47.50	
Total taxes deemed paid by P under section 902 and section 960(a)(3) attributable to passive income of S and T (line 15(e))		15.00
Total taxes deemed paid by P under section 902 and section 960(a)(3) attributable to general limitation income of S and T:		
Line 15(b)	7.50	
Plus: Line 15(d)	3.75	
Plus: Line 15(f)	2.50	
Result	13.75	

[T.D. 8214, 53 FR 27029, July 18, 1988, as amended by T.D. 8412, 57 FR 20652, May 14, 1992]

§1.904–7 Transition rules.

(a) *Characterization of distributions and section 951(a)(1) (A) (ii) and (iii) and (B) inclusions of earnings of a controlled foreign corporation accumulated in taxable years beginning before January 1, 1987, during taxable years of both the payor controlled foreign corporation and the recipient which begin after December 31, 1986*—(1) *Distributions and section 951(a)(1) (A) (ii) and (iii) and (B) inclusions.* Earnings accumulated in taxable years beginning before January 1, 1987, by a foreign corporation that was a controlled foreign corporation when such earnings were accumulated are characterized in that foreign corporation's hands under section 904(d)(1)(A) (separate limitation interest income) or section 904(d)(1)(E) (general limitation income) (prior to their amendment by the Tax Reform Act of 1986 (the Act)) after application of the de minimis rule of former section 904(d)(3)(C) (prior to its amendment by the Act). When, in a taxable year after the effective date of the Act, earnings and profits attributable to such income are distributed to, or included in the gross income of, a United States shareholder under section 951(a)(1) (A) (ii) or (iii) or (B) (hereinafter in this section ''inclusions''), the ordering rules of section 904(d)(3)(D) and §1.904–5(c)(4) shall be applied in determining initially the character of the income of the distributee or United States shareholder. Thus, a proportionate amount of a distribution described in this paragraph initially will be characterized as separate limitation interest income in the hands of the distributee based on the ratio of the separate limitation interest earnings and profits out of which the dividend was paid to the total earnings and profits out of which the dividend was paid. The distribution or inclusions must then be recharacterized in the hands of the distributee or United States shareholder on the basis of the following principles:

(i) Distributions and inclusions that initially are characterized as separate limitation interest income shall be treated as passive income;

(ii) Distributions and inclusions that initially are characterized as old general limitation income shall be treated as general limitation income, unless the taxpayer establishes to the satisfaction of the Commissioner that the distribution or inclusion is attributable to:

(A) Earnings and profits accumulated with respect to shipping income, as defined in section 904(d)(2)(D) and §1.904–4(f); or

(B) In the case of a financial services entity, earnings and profits accumulated with respect to financial services income, as defined in section 904(d)(2)(C)(ii) and §1.904–4(e)(1); or

(C) Earnings and profits accumulated with respect to high withholding tax interest, as defined in section 904(d)(2)(B) and §1.904–4(d).

(2) *Limitation on establishing the character of earnings and profits.* In order for a taxpayer to establish that distributions or inclusions that are attributable to general limitation earnings and profits of a particular taxable year beginning before January 1, 1987, are attributable to shipping, financial services or high withholding tax interest earnings and profits, the taxpayer must establish the amounts of foreign taxes paid or accrued with respect to income attributable to those earnings and profits that are to be treated as taxes paid or accrued with respect to shipping, financial services or high withholding tax interest income, as the case may be, under section 904(d)(2)(I). Conversely, in order for a taxpayer to establish the amounts of general limitation taxes paid or accrued in a taxable year beginning before January 1, 1987, that are to be treated as taxes paid or accrued with respect to shipping, financial services or high withholding tax interest income, as the case may be, the taxpayer must establish the amount of any distributions or inclusions that are attributable to shipping, financial services or high withholding tax interest earnings and profits. For purposes of establishing the amounts of general limitation taxes that are to be treated as taxes paid or accrued with respect to shipping, financial services or high withholding tax interest income, the principles of §1.904–6 shall be applied.

(b) *Application of look-through rules to distributions (including deemed distributions) and payments by an entity to a recipient when one's taxable year begins before January 1, 1987 and the other's taxable year begins after December 31, 1986*—(1) *In general.* This paragraph provides rules relating to the application of section 904(d)(3) to payments made by a controlled foreign corporation or other entity to which the look-through rules apply during its taxable year beginning after December 31, 1986, but received in a taxable year of the recipient beginning before January 1, 1987. The paragraph also provides rules relating to distributions (including deemed distributions) or payments made by a controlled foreign corporation to which section 904(d)(3) (as in effect before the Act) applies during its taxable year beginning before January 1, 1987, and received in a taxable year of the recipient beginning after December 31, 1986.

(2) *Payor of interest, rents, or royalties is subject to the Act and recipient is not subject to the Act.* If interest, rents, or royalties are paid or accrued on or after the start of the payor's first taxable year beginning on or after January 1, 1987, but prior to the start of the recipient's first taxable year beginning on or after January 1, 1987, such interest, rents, or royalties shall initially be characterized in accordance with section 904(d)(3) and § 1.904–5. To the extent that interest payments in the hands of the recipient are initially characterized as passive income under these rules, they will be treated as separate limitation interest in the hands of the recipient. To the extent that rents or royalties in the hands of the recipient are initially characterized as passive income under these rules, they will be recharacterized as general limitation income in the hands of the recipient.

(3) *Recipient of interest, rents, or royalties is subject to the Act and payor is not subject to the Act.* If interest, rents, or royalties are paid or accrued before the start of the payor's first taxable year beginning on or after January 1, 1987, but on or after the start of the recipient's first taxable year beginning after January 1, 1987, the income in the recipient's hands shall be initially characterized in accordance with former section 904(d)(3) (prior to its amendment by the Act). To the extent interest income is characterized as separate limitation interest income under these rules, that income shall be recharacterized as passive income in the hands of the recipient. Rents or royalties will be characterized as general limitation income.

(4) *Recipient of dividends and subpart F inclusions is subject to the Act and payor is not subject to the Act.* If dividends are paid or accrued or section 951(a)(1) inclusions occur before the start of the first taxable year of a controlled foreign corporation beginning on or after January 1, 1987, but on or after the start of the first taxable year of the distributee or United States shareholder beginning on or after January 1, 1987, the dividends or section 951(a)(1) inclusions in the hands of the distributee or United States shareholder shall be initially characterized in accordance with former section 904(d)(3) (including the ordering rules of section 904(d)(3)(A). Therefore, under former section 904(d)(3)(A), dividends are considered to be paid or derived first from earnings attributable to separate limitation interest income. To the extent the dividend or section 951(a)(1) inclusion is initially characterized under these rules as separate limitation interest income in the hands of the distributee or United States shareholder, the dividend or section 951(a)(1) inclusion shall be recharacterized as passive income in the hands of the distributee or United States shareholder. The portion, if any, of the dividend or section 951(a)(1) inclusion that is not characterized as passive income shall be characterized according to the rules in paragraph (a) of this section. Therefore, a taxpayer may establish that income that would otherwise be characterized as general limitation income is shipping or financial services income. Rules comparable to the rules contained in section 904(d)(2)(I) shall be applied for purposes of characterizing foreign taxes deemed paid with respect to distributions and section 951(a)(1) inclusions covered by this paragraph (b)(4).

(5) *Examples.* The following examples illustrate the application of this paragraph (b).

Example 1. P is a domestic corporation that is a fiscal year taxpayer (July 1–June 30). S, a controlled foreign corporation, is a wholly-owned subsidiary of P and has a calendar taxable year. On June l, 1987, S makes a $100 interest payment to P. Because the payment is made after January 1, 1987 (the first day of S's first taxable year beginning after December 31, 1986), the look-through rules of section 904(d)(3) apply to characterize the payment made by S. To the extent, however, that the interest payment to P is allocable to passive income earned by S, the payment will be included in P's separate limitation for interest as provided in former section 904(d)(1)(A).

Example 2. P is a domestic corporation that is a calendar year taxpayer. S, a controlled foreign corporation, is a wholly-owned subsidiary of P and has a July 1–June 30 taxable year. On June 1, 1987, S makes a $100 interest payment to P. Because the payment is made prior to July l, 1987 (the first day of S's first taxable year beginning after December 31, 1986), the look-through rules of section 904(d)(3) do not apply. Assume that, under former section 904(d)(3), the interest payment would be characterized as separate limitation interest income. For purposes of determining P's foreign tax credit limitation, the interest payment will be passive income as provided in section 904(d)(1)(A).

Example 3. The facts are the same as in *Example* 2 except that on June 1, 1987, S makes a $100 dividend distribution to P. Because the dividend is paid prior to July l, 1987 (the first day of S's first taxable year beginning after December 31, 1986), the look-through rules of section 904(d)(3) do not apply. Assume that, under former section 904(d)(3), S's earnings and profits for the taxable year ending June 30, 1987, consist of $200 of earnings attributable to general limitation income and $75 of earnings attributable to separate limitation interest income. The portion of the dividend that is attributable to S's separate limitation interest and is treated as separate limitation interest income under former section 904(d)(3) is $75. The remaining $25 of the dividend is treated as general limitation income under former section 904(d)(3). For purposes of determining P's foreign tax credit limitation, $75 of the dividend will be recharacterized as passive income. The remaining $25 of the dividend will be characterized as general limitation income, unless P can establish that the general limitation portion is attributable to shipping or financial services income.

(c) *Installment sales.* If income is received or accrued by any person on or after the effective date of the Act (as applied to such person) that is attributable to a disposition of property by such person with regard to which section 453 or section 453A applies (installment sale treatment), and the disposition occurred prior to the effective date of the Act, that income shall be characterized according to the rules of §§1.904–4 through 1.904–7.

(d) *Special effective date for high withholding tax interest earned by persons with respect to qualified loans described in section 1201(e)(2) of the Act.* For purposes of characterizing interest received or accrued by any person, the definition of high withholding tax interest in §1.904–4(d) shall apply to taxable years beginning after December 31, 1986, except as provided in section 1201(e)(2) of the Act.

(e) *Treatment of certain recapture income.* Except as otherwise provided, if income is subject to recapture under section 585(c), the income shall be general limitation income. If the income is recaptured by a taxpayer that is a financial services entity, the entity may treat the income as financial services income if the taxpayer establishes to the satisfaction of the Secretary that the deduction to which the recapture amount is attributable is allocable to financial services income. If the taxpayer establishes to the satisfaction of the Secretary that the deduction to which the recapture amount is attributable is allocable to high-withholding tax interest income, the taxpayer may treat the income as high-withholding tax interest.

[T.D. 8214, 53 FR 27034, July 18, 1988, as amended by T.D. 8412, 57 FR 20653, May 14, 1992]

§1.904(b)–1 Treatment of capital gains for corporations.

(a) *In general.* For purposes of computing the foreign tax credit limitation of corporations, the following rules apply:

(1) *Inclusion in foreign source taxable income.* The taxable income of a corporation from sources without the United States includes gain from the sale or exchange of capital assets only in an amount equal to—

(i) Foreign source capital gain net income (as defined in paragraph (b)(2) of this section), reduced by

(ii) The rate differential portion (as defined in paragraph (b)(5) of this section) of foreign source net capital gain (as defined in paragraph (b)(4) of this section).

(2) *Inclusion in entire taxable income.* The entire taxable income of a corporation includes gain from the sale or exchange of capital assets only in an amount equal to—

(i) Capital gain net income (as defined in paragraph (b)(1) of this section), reduced by

(ii) The rate differential portion of net capital gain (as defined in paragraph (b)(3) of this section).

(3) *Treatment of capital losses.* The taxable income of a corporation from sources without the United States shall be reduced by an amount equal to—

(i) Any net capital loss (as defined in paragraph (b)(6) of this section) allocable or apportionable to sources without the United States to the extent taken into account in determining capital gain net income for the taxable year, less

(ii) An amount equal to the rate differential portion of the excess of net capital gain from sources within the United States over net capital gain (from all sources).

(b) *Definitions.* For purposes of section 904(b) and §§ 1.904(b)–1 through (b)–3, the following definitions shall apply:

(1) *Capital gain net income.* The term *capital gain net income* means the excess of the gains from the sales or exchanges of capital assets over the losses from such sales or exchanges. Such term shall include net section 1231 gain, but shall not include gains from the sale or exchange of capital assets to the extent that such gains are not treated as capital gains. In determining capital gain net income, gains and losses which are not from the sale or exchange of capital assets but which are treated as capital gains and losses under the Internal Revenue Code are included.

(2) *Foreign source capital gain net income.* The term *foreign source capital gain net income* means the lesser of—

(i) Capital gain net income from sources without the United States, or

(ii) Capital gain net income (from all sources).

(3) *Net capital gain.* The term *net capital gain* means the excess of the net long-term capital gain (including net section 1231 gain) for the taxable year over the net short-term capital loss for such year, but shall not include gains from the sale or exchange of capital assets to the extent that such gains are not treated as capital gains. In determining net capital gain, gains and losses which are not from the sale or exchange of capital assets but which are treated as capital gains and losses under the Internal Revenue Code are included.

(4) *Foreign source net capital gain.* The term *''foreign source net capital gain* means the lesser of—

(i) Net capital gain from sources without the United States, or

(ii) Net capital gain (from all sources).

(5) *Rate differential portion.* The term *rate differential portion* of foreign source net capital gain, net capital gain, or the excess of net capital gain from sources within the United States over net capital gain, as the case may be, is the same proportion of such amount as the excess of the highest rate of tax specified in section 11(b) over the alternative rate of tax under section 1201(a) bears to the highest rate of tax specified in section 11(b).

(6) *Net capital loss.* Except as provided in § 1.904(b)–2(b), the term *net capital loss* means the excess of the losses from sales and exchanges of capital assets over the sum allowed under section 1211. For purposes of paragraph (a) of this section, the term ''net capital loss'' includes any amounts which are short-term capital losses under section 1212(a). Net capital losses do not include losses from the sales or exchanges of capital assets which are not treated as capital losses under the Internal Revenue Code. In determining net capital loss, gains and losses which are not from the sale or exchange of capital assets but which are treated as capital gains and losses under the Internal Revenue Code are included.

(7) *Allocation and apportionment.* For purposes of this section and § 1.904 (b)–2 and (b)–3, the rules under § 1.861–8(e)(7) with respect to the allocation and apportionment of losses are to be applied with respect to losses on the sale, exchange or other disposition of property.

(8) *Computation of net section 1231 gain.* For purposes of this section and §1.904(b)–2, the netting of section 1231 gains and losses is determined by aggregating the gains and loss from sources both within and without the United States. The gain or loss determined by this aggregation determines the character of the section 1231 gains (and losses allocable or apportionable thereto) from sources without the United States and from all sources for purposes of computing the foreign tax credit limitation fraction.

(c) *Illustrations.* The principles of paragraph (a) of this section may be illustrated by the following examples:

Example 1. Corporation A had the following business taxable income, capital gains and capital losses for 1979:

	In thousands		
	Foreign source	U.S. source	All sources
Business income	$1,200	$2,000	$3,200
Long-term capital gain	300	200	500
Long-term capital loss	0	400	400
Short-term capital gain	100	400	500
Short-term capital loss	200	300	500

For purposes of computing the foreign tax credit limitations, the foreign source taxable income and the entire taxable income of A are computed as follows:

Step (1) First compute the net long-term capital gain and net short-term capital gain and the net long-term capital loss and net short-term capital loss allocable or apportionable to such sources, from sources without the United States and from all sources, as follows:

	In thousands	
	Sources without the U.S.	All sources
Net long-term capital gain	$300	$100
Net long-term capital loss	0	0
Net short-term capital gain	0	0
Net short-term capital loss	100	0

Step (2) Next compute capital gain net income and net capital gain from sources without the United States and from all sources as follows:

	In thousands	
	Sources without the U.S.	All sources
Capital gain net income	(a) $200	(b) $100
Net capital gain	(c)200	(d)100

Step (3) Next calculate foreign source capital gain net income and foreign source net capital gain, which is the lesser of (a) or (b) and the lesser of (c) or (d), respectively. Foreign source capital gain net income is $100,000, and foreign source net capital gain is $100,000.

Step (4) Compute taxable income from sources without the United States, using $\frac{18}{46}$ as the rate differential portion, as follows:

Foreign business income + Foreign source capital gain net income $-\frac{18}{46}$ (foreign source net capital gain)

$1,200,000 + $100,000 $-\frac{18}{46}$ ($100,000) (39,130)=$1,260,870

Step (5) Compute the entire taxable income as follows:

Business income + Capital gain net income $-\frac{18}{46}$ (net capital gain)

$3,200,000 + $100,000 $-\frac{18}{46}$ ($100,000) (39,130)=$3,260,870

Example 2. Corporation B had the following business taxable income, capital gains, and capital losses for 1979:

	In thousands		
	Foreign source	U.S. source	All sources
Business income	$1,200	$2,000	$3,200
Long-term capital gain	300	200	500
Long-term capital loss	500	100	600
Short-term capital gain	600	200	800
Short-term capital loss	100	200	300

For purposes of computing the foreign tax credit limitation, the foreign source taxable income and the entire taxable income of B are computed as follows:

Step (1) First compute the net long-term capital gain and net short-term capital gain and the net long-term capital loss and net short-term capital loss allocable or apportionable to such sources, from sources without the United States and from all sources, as follows:

	In thousands	
	Sources without U.S.	All sources
Net long-term capital gain	0	0
Net long-term capital loss	$200	$100
Net short-term capital gain	500	500
Net short-term capital loss	0	0

Step (2) Next compute capital gain net income and net capital gain from sources without the United States and from all sources as follows:

	In thousands	
	Sources without the U.S.	All sources
Capital gain net income	(a) $300	(b) $400
Net capital gain	(c) 0	(d) 0

Step (3) Next calculate foreign source capital gain net income and foreign source net capital gain which is the lesser of (a) or (b) and the lesser of (c) or (d), respectively. Foreign source capital gain net income is $300,000 and foreign source net capital gain is zero.

Step (4) Compute taxable income from sources without the United States, using $\frac{18}{46}$ as the rate differential portion, as follows:

Foreign business income+Foreign source capital gain net income $-\frac{18}{46}$ (foreign source net capital gain)

$1,200,000+300,000—$\frac{18}{46}$ (0)=$1,500,000

Step (5) Compute the entire taxable income as follows:

Business income+Capital gain net income $-\frac{18}{46}$ (net capital gain)

$3,200,000+$400,000 $-\frac{18}{46}$ (0)=$3,600,000

Example 3. Corporation C had the following business taxable income, capital gains, and capital losses for 1979:

	In thousands		
	Foreign source	U.S. source	All sources
Business income	$1,200	$2,000	3,200
Long-term capital gain	200	500	700
Long-term capital loss	600	100	700
Short-term capital gain	300	400	700
Short-term capital loss	500	100	600

For purposes of computing the foreign tax credit limitation, the foreign source taxable income and the entire taxable income of C are computed as follows:

Step (*1*) First compute the net long-term capital gain and net short-term capital gain and the net long-term capital loss and net short-term capital loss allocable or apportionable to such sources, from sources without the United States and from all sources, as follows:

	In thousands	
	Sources without the U.S.	All sources
Net long-term capital gain	0	0
Net long-term capital loss	$400	0
Net short-term capital gain	0	$100
Net short-term capital loss	200	0

Step (*2*) Next compute capital gain net income and net capital gain from sources without the United States and from all sources:

	In thousands	
	Sources without the U.S.	All sources
Capital gain net income	(a) 0	(b) $100
Net capital gain	(c) 0	(d) 0

Step (*3*) Next calculate foreign source capital gain net income and foreign source net capital gain which is the lesser of (a) or (b) and the lesser of (c) or (d) respectively. Foreign source capital gain net income is zero and foreign source net capital gain is zero.

Step (*4*) Under paragraph (a)(3)(i) of this section, the taxable income from sources without the United States is reduced by the amount by which the net capital loss allocable or apportionable to sources without the United States reduces capital gains (long and short-term) from sources within the United States when computing capital gain net income. This is determined by first computing the net capital loss allocable or apportionable to sources without the United States ($600,000) and the capital gain net income from sources within the United States ($700,000). In this case, $600,000 of net capital loss allocable or apportionable to sources without the United States reduces $600,000 of net long and short-term capital gains from sources within the United States in computing capital gain net income.

Step (*5*) Under paragraph (a)(3)(ii) of this section, the adjustment under paragraph (a)(3)(i) of this section is reduced by an amount equal to the rate differential portion of net capital gain from sources within the United States over net capital gain (from all sources). In this case, net capital gain from sources within the United States is $400,000 and net capital gain is zero, so an amount equal to $\frac{18}{46}$ multiplied by $400,000 is added to the numerator of the foreign tax credit limitation fraction in computing taxable income from sources without the United States.

Step (*6*) Computation of foreign tax credit limitation fraction.

(i) Taxable income from sources without the United States is as follows:

Foreign business income + Foreign source capital gain net income $-\frac{18}{46}$ (foreign source net captial gain) − paragraph (a)(3)(i) adjustment − paragraph (a)(3)(ii) adjustment

$$\$1{,}200{,}000 + 0 - 0 - \$600{,}000 + {}^{18}{}_{46}\frac{(\$400{,}000)}{(\$156{,}522)} = \$756{,}522$$

(ii) The entire taxable income is as follows:

Business income+Capital gain net income—
18⁄46 (net capital gain)
$3,200,000 + $100,000 − 0 = $3,300,000

Note that no adjustment under paragraph (a)(3) is made with respect to the denominator.

Example 4. Corporation D had the following business taxable income, capital gains and capital losses in 1979:

	In thousands		
	Foreign source	U.S. source	All sources
Business income	$2,000	$2,500	$4,500
Long-term capital gain	100	200	300
Long-term capital loss	100	100	200
Short-term capital gain	300	400	700
Short-term capital loss	800	....	800

For purposes of computing the foreign tax credit limitation, the foreign source taxable income and the entire taxable income are computed as follows:

Step (1) First compute the net long-term capital gain and net short-term capital gain and the net long-term capital loss and net short-term capital loss allocable or apportionate to such sources, from sources without the United States and from all sources, as follows:

	In thousands	
	Sources without the U.S.	All sources
Net long-term capital gain	0	100
Net long-term capital loss	0	0
Net short-term capital gain	0	0
Net short-term capital loss	500	100

Step (2) Next compute capital gain net income and net capital gain from sources without the United States and from all sources:

	In thousands	
	Sources without the U.S.	All sources
Capital gain net income	(a) 0	(b) 0
Net capital gain	(c) 0	(d) 0

Step (3) Next compute foreign source capital gain net income and foreign source net capital gain, which is the lesser of (a) or (b) and the lesser of (c) or (d), respectively. Foreign source capital gain net income is zero and foreign source net capital gain is zero.

Step (4) Under paragraph (a)(3)(i) of this section, the taxable income from sources without the United States is reduced by the amount by which the net capital loss allocable or apportionable to sources without the United States reduces capital gains (long- and short-term) from sources within the United States when computing capital gain net income. This is determined by first computing the net capital loss allocable or apportionable to sources without the United States ($500,000), and the capital gain net income from sources within the United States ($500,000). In this case, $500,000 of net capital loss allocable or apportionable to sources without the United States reduces $500,000 of net long- and short-term gains from sources within the United States in computing capital gain net income.

Step (5) Under paragraph (a)(3)(ii) of this section, the adjustment under paragraph (a)(3)(i) of this section is reduced by an amount equal to the rate differential portion of net capital gain from sources within the United States over net capital gain (from all sources). In this case, net capital gain from sources within the United States is $100,000 and the net capital gain is zero, so an amount equal to 18⁄46 multiplied by $100,000 is added to the numerator of the foreign tax credit limitation fraction in computing taxable income from sources without the United States.

Step (6) Computation of foreign tax credit limitation fraction.

(i) Taxable income from sources without the United States is as follows:

Foreign business income + Foreign source capital gain net income −18/46 (foreign source net capital gain) − (paragraph (a)(3)(i) adjustment − paragraph (a)(3)(ii) adjustment)

$$\$2{,}000{,}000 + 0 - 0 - \$500{,}000 + {}^{18}{}_{46}\frac{(\$100{,}000)}{(\$39{,}130)} = \$1{,}539{,}130$$

(ii) The entire taxable income is determined as follows:

Business income + Capital gain net income − 18⁄46 (net capital gain)

$4,500,000 + 0 − 0 = $4,500,000

Note that no adjustment under paragraph (a)(3) of this section is made with respect to the denominator.

[T.D. 7914, 48 FR 44520, Sept. 29, 1983]

§ 1.904(b)–2 Treatment of capital gains for other taxpayers.

(a) *In general.* For purposes of computing the foreign tax credit limitation of persons other than corporations, the following rules apply:

(1) *Inclusion in foreign source taxable income.* The taxable income from sources without the United States shall include gain from the sale or exchange of capital assets only to the extent of foreign source capital gain net income (as defined in paragraph (b)(2) of § 1.904(b)–1), reduced by an amount determined by multiplying foreign source net capital gain (as defined in paragraph (b)(4) of § 1.904(b)–1) by the percentage specified under section 1202(a).

(2) *Inclusion in entire taxable income.* The entire taxable income of a taxpayer other than a corporation shall include gains from the sale or exchange of capital assets only to the extent of capital gain net income (as defined in paragraph (b)(1) of § 1.904(b)–1), reduced by an amount determined by multiplying net capital gain (as defined in paragraph (b)(3) of § 1.904(b)–1) by the percentage specified under section 1202(a).

(3) *Treatment of capital losses.* The taxable income from sources without the United States shall be reduced by:

(i) Any net capital loss (as defined in paragraph (b) of this section) allocable or apportionable to sources without the United States to the extent taken into account in determining capital gain net income, less

(ii) An amount equal to the excess of net capital gain from sources within the United States over net capital gain, multiplied by the percentage specified under section 1202(a).

(b) *Definition of net capital loss.* For purposes of paragraph (a) of this section, the term *net capital loss* means the excess of the losses from the sale or exchange of capital assets treated as capital losses under the Internal Revenue Code and any carryforward as determined under section 1212 over the amount allowed under section 1211(b). In determining net capital loss, gains and losses which are not from the sale or exchange of capital assets but which are treated as capital gains and losses under the Internal Revenue Code are included.

(c) *Illustrations.* The principles of paragraph (a) of this section are illustrated by the following examples:

Example 1. X, an individual, has $1,500,000 of foreign source taxable income and $2,500,000 of U.S. source taxable income (exclusive of capital gains and losses) for 1979 and the following capital gains and losses:

	In thousands		
	Foreign source	U.S. source	All sources
Long-term capital gain	$300	$500	$800
Long-term capital loss	100	500	600
Short-term capital gain	100	400	500
Short-term capital loss	100	200	300

For purposes of computing the foreign tax credit limitation, the foreign source taxable income and the entire taxable income of X are computed as follows:

Step (1) First, compute the net long-term capital gain and net short-term capital gain and the net long-term capital loss and net short-term capital loss allocable or apportionable to such sources, from sources without the United States and from all sources, as follows:

	In thousands	
	Sources without the U.S.	All sources
Net long-term capital gain	$200	$200
Net long-term capital loss	0	0
Net short-term capital gain	0	200
Net short-term capital loss	0	0

Step (2) Next compute capital gain net income and net capital gain from sources without United States and from all sources as follows:

	In thousands	
	Sources without the U.S.	All sources
Capital gain net income	(a) $200	(b) $400
Net capital gain	(c) 200	(d) 200

Step (3) Next calculate foreign source capital gain net income and foreign source net capital gain, which is the lesser (a) or (b) and the lesser of (c) or (d), respectively. Foreign source capital gain net income is $200,000 and foreign source net capital gain is $200,000.

Step (4) Compute taxable income from sources without the United States, using 0.60 as the percentage specified in section 1202(a), as follows:

Foreign taxable income (exclusive of capital gains and losses)+Foreign source capital gain net income −0.60 (foreign source net capital gain)

$1,500,000+$200,000−0.60($200,000)=$1,580,000

Step (5) Compute the entire taxable income as follows:

Taxable income (exclusive of capital gains and losses)+Capital gain net income−0.60 (net capital gain)

$4,000,000+$400,000−0.60 ($200,000) ($120,000)=$4,280,000

Example 2. Y, an individual, has $2,000,000 of foreign source taxable income and $3,000,000 of U.S. source taxable income (exclusive of capital gains and losses) for 1979 and the following capital gains and losses:

	In thousands		
	Foreign source	U.S. source	All sources
Long-term capital gain	$200	$800	$1,000
Long-term capital loss	700	100	800
Short-term capital gain	100	300	400
Short-term capital loss	300	200	500

For purposes of computing the foreign tax credit limitation, the foreign source taxable income and the entire taxable income of Y are computed as follows:

Step (1) First, compute the net long-term capital gain and net short-term capital gain and the net long-term capital loss and net short-term capital loss allocable or apportionable to such sources, from sources without the United States and from all sources, as follows:

	In thousands	
	Sources without the United States	All sources
Net long-term capital gain	0	$200
Net lon-term capital loss	$500	0
Net short-term capital gain	0	0
Net short-term capital loss	200	100

Step (2) Next compute the capital gain net income and net capital gain from sources without the United States and from all sources as follows:

	In thousands	
	Sources without the United States	All sources
Capital gain net income	(a) 0	(b) $100
Net capital gain	(c) 0	(d) 100

Step (3) Next calculate foreign source capital gain net income and foreign source net capital gain, which is the lesser of (a) or (b) and the lesser of (c) or (d), respectively. Foreign source capital gain net income is zero and foreign source net capital gain is also zero.

Step (4) Under paragraph (a)(3)(i) of this section, the taxable income from sources without the United States is reduced by the amount by which the net capital loss allocable or apportionable to sources without the United States reduces capital gains (long and short-term) from sources within the United States when computing capital gain net income. This is determined by first computing the net capital loss allocable or apportionable to sources without the United States ($700,000) and the capital gain net income from sources within the United States ($800,000). In this case, $700,000 of net capital loss allocable or apportionable to sources without the United States reduces $700,000 of long and short-term capital gain in computing capital gain net income.

Step (5) Under paragraph (a)(3)(ii) of this section, the adjustment under paragraph (a)(3)(i) of this section is reduced by an amount equal to the difference between net capital gain from sources within the United States and net capital gain (from all sources), multiplied by the percentage specified under section 1202(a). In this case, the net capital gain from sources within the United States is $700,000 the net capital gain is $100,000 and the percentage specified under section 1202(a) is 0.60.

Step (6) Computation of foreign tax credit limitation fraction.

(i) Taxable income from sources without the United States is as follows:

Foreign income (exclusive of capital gains and losses)+Foreign source capital gain net income −0.60 (foreign source net capital gain)−(paragraph (a)(3)(i) adjustment−paragraph (a)(3)(ii) adjustment)

$$\$2{,}000{,}000 + 0 - 0 - \$700{,}000 + 0.60\ (\$600{,}000)\,(\$360{,}000) = \$1{,}660{,}000$$

(ii) The entire taxable income is as follows:

Taxable income (exclusive of capital gains and losses)+Capital gains net income−0.60(net capital gain)

$5,000,000+$100,000−$60,000=$5,040,000

Note that no adjustment under paragraph (a)(3) of this section is made with respect to the denominator.

[T.D. 7914, 48 FR 44523, Sept. 29, 1983]

§ 1.904(b)–3 Sale of personal property.

(a) *General rule.* For purposes of section 904 and the regulations thereunder, there shall be included as gain from sources within the United States any gain from sources without the United States arising from the sale or exchange of a capital asset which is personal property (as defined in § 1.1245–3(b)). For purposes of this paragraph, gain from the sale or exchange of a capital asset shall include net section 1231 gain, but shall not include gain from the sale or exchange of a capital asset which is not treated as capital gain. However, gains and losses which are not from the sale or exchange of capital assets but which are treated as capital gains and losses under the Internal Revenue Code are included. The special source rules provided under this section shall be applied on an item by item basis with respect to the sale of personal property within any taxable year, except that if substantially all the assets of a trade or business (within the meaning of section 368(a)(1)(C) are sold within any one country within any taxable year, the gains and losses from such sales of such assets shall be netted before applying the source rules under this section.

(b) *Special rules.* Paragraph (a) of this section shall not apply in each of the following cases:

(1) In the case of an individual, if the property is sold or exchanged within the country or possession of the individual's residence.

(2) In the case of a corporation if the property is stock in a second corporation, and is sold in a country or possession in which the second corporation derived more than 50 percent of its gross income for the 3-year period ending with the close of such second corporation's taxable year immediately preceding the year during which the sale or exchange occurred (or for such part of such period as the corporation has been in existence, but in no event less than a 12-month period). For purposes of this paragraph (b)(2) of this section the gross income of any foreign corporation shall be computed in the same manner as if the foreign corporation were a domestic corporation. Thus, the gross income of a foreign corporation for this purpose includes income from all sources, which is not specifically excluded from gross income under any other provisions of the Code.

(3) In the case of any taxpayer, if the property is personal property (other than stock in a corporation) which is sold or exchanged in a country or possession in which the property is used in a trade or business of the taxpayer, or in which the taxpayer derived more than 50 percent of its gross income for the 3-year period ending with the close of its taxable year immediately preceding the year during which the sale or exchange occurred (or, in case of a taxpayer other than an individual, for such part of such period as the taxpayer has been in existence, but in no event less than a 12-month period). In the case of property sold or exchanged by a partnership, trust, or estate, the determination required by the preceding sentence shall be made at the level of the partnership, trust (other than a grantor trust), or estate. For purposes of this paragraph (b)(3) of this section, the gross income of any foreign corporation (or other entity) shall be computed in the same manner as if

the foreign corporation were a domestic corporation (or a domestic entity).

(c) *Exception.* Paragraph (a) of this section shall not apply to a sale of personal property if the gain (determined under chapter 1 of the Internal Revenue Code and computed on an item by item basis as provided under paragraph (a) of this section) from the sale or exchange of the personal property is subject to an income, war profits, or excess profits tax (including a tax withheld with respect to nonresident aliens or foreign corporations) with respect to a foreign country or a possession of the United States in which the sale or exchange occurs, and the rate of tax imposed by such country or possession applicable to such gain is 10 percent or more. For purposes of this paragraph, the tax must be 10 percent or more of the total amount of gain (whether ordinary or capital) arising from the sale or exchange of the item of personal property.

(d) *Application of source rules.* In determining the foreign country or possession where property is sold or exchanged for purposes of paragraphs (b) and (c) of this section, and the foreign country or possession where gross income is derived for purposes of paragraphs (b)(2), (3) and (e) of this section, the source of any gain or income shall be determined by applying the principles under sections 861, 862, and 863 and the regulations thereunder.

(e) *Gain from liquidation of certain foreign corporations.* Paragraph (a) shall not apply with respect to a distribution in liquidation of a foreign corporation to which part II of subchapter C applies, if such corporation derived less than 50 percent of its gross income from sources within the United States for the 3-year period ending with the close of such corporation's taxable year immediately preceding the year during which the distribution occurred (or for such part of such period as the corporation has been in existence, but in no event less than a 12-month period). For purposes of paragraph (e) of this section, the gross income of the foreign corporation shall be computed in the same manner as if the foreign corporation were a domestic corporation.

(f) *Residence defined.* For purposes of paragraph (b)(1) of this section, the country of an individual's residence is to be determined by applying the rules under §§301.7701(b)–1 through 301.7701(b)–9 of this chapter.

(g) *Tax rate applicable to gain.* For purposes of paragraph (c) of this section, the tax rate applicable to the gain on the sale or exchange of personal property (as determined under chapter 1 of the Internal Revenue Code 1954) shall be determined by applying the tax laws of the foreign country or possession (and any applicable reduction under a tax treaty) to such gain and by treating the gain from such transaction as if such gain were the only income derived by the taxpayer during the taxable year (and the only deductions allowed are deductions directly attributable to such gain).

(h) *Country in which gross income derived.* Notwithstanding paragraph (d) of this section, for purposes of this section, dividends received by a shareholder who is not a U.S. person from a foreign corporation shall be deemed to be derived from sources within the foreign country under the laws of which the foreign corporation is created or organized.

[T.D. 7914, 48 FR 44524, Sept. 29, 1983, as amended by T.D. 8411, 57 FR 15241, Apr. 27, 1992]

§1.904(b)–4 Effective date.

Sections 1.904(b)–(1) and 1.904(b)–2 shall apply to taxable years beginning after December 31, 1975 and §1.904(b)–3 shall apply to sales and exchanges made after November 12, 1975.

[T.D. 7914, 48 FR 44525, Sept. 29, 1983]

§1.904(f)–1 Overall foreign loss and the overall foreign loss account.

(a) *Overview of regulations.* In general, section 904(f) and these regulations apply to any taxpayer that sustains an overall foreign loss (as defined in paragraph (c)(1) of this section) in a taxable year beginning after December 31, 1975. For taxable years ending after December 31, 1984, and beginning before January 1, 1987, there can be five types of overall foreign losses: a loss under each of the five separate limitations contained in former section 904(d)(1)(A) (passive interest limitation), (d)(1)(B) (DISC dividend limitation), (d)(1)(C) (foreign trade income limitation), (d)(1)(D) (foreign sales corporation (FSC) distributions limitation), and (d)(1)(E) (general limitation). For taxable years beginning after December 31, 1982, and ending before January 1, 1985, there can be three types of overall foreign losses under former section 904(d)(1)(A) (passive interest limitation), former section 904(d)(1)(B) (DISC dividend limitation) and former section 904(d)(1)(C) (general limitation). For taxpayers subject to section 907, the post-1982 general limitation overall foreign loss account may be further subdivided, as provided in § 1.904(f)–6. For taxable years beginning after December 31, 1975, and before January 1, 1983, taxpayers should have computed overall foreign losses separately under the passive interest limitation, the DISC dividend limitation, the general limitation, and the section 907(b) (FORI) limitation. However, for taxable years beginning after December 31, 1975, and before January 1, 1983, taxpayers may have computed only two types of overall foreign losses: A foreign oil related loss under the FORI limitation and an overall foreign loss computed on a combined basis for the passive interest limitation, the DISC dividend limitation, and the general limitation. A taxpayer that computed overall foreign losses for these years on a combined basis will not be required to amend its return to recompute such losses on a separate basis. If a taxpayer computed its overall foreign losses for these years separately under the passive interest limitation, the DISC dividend limitation, and the general limitation, on returns previously filed, a taxpayer may not amend those returns to compute such overall foreign losses on a combined basis. Section 1.904(f)–1 provides rules for determining a taxpayer's overall foreign losses, for establishing overall foreign loss accounts, and for making additions to and reductions of such accounts for purposes of section 904(f). Section 1.904(f)–2 provides rules for recapturing the balance in any overall foreign loss account under the general recapture rule of section 904(f)(1) and under the special recapture rule of section 904(f)(3) when the taxpayer disposes of property used predominantly outside the United States in a trade or business. Section 1.904(f)–3 provides rules for allocating overall foreign losses that are part of net operating losses or net capital losses to foreign source income in years to which such losses are carried. In addition, § 1.904(f)–3 provides transition rules for the treatment of net operating losses incurred in taxable years beginning after December 31, 1982, and carried back to taxable years beginning before January 1, 1983, and of net operating losses incurred in taxable years beginning before January 1, 1983, and carried forward to taxable years beginning after December 31, 1982. Section 1.904(f)–4 provides rules for recapture out of an accumulation distribution of a foreign trust. Section 1.904(f)–5 provides rules for recapture of overall foreign losses of domestic trusts. Section 1.904(f)–6 provides a transition rule for recapturing a taxpayer's pre-1983 overall foreign losses under the general limitation and the FORI limitation out of taxable income subject to the general limitation in taxable years beginning after December 31, 1982. Section § 1.1502–9 provides rules concerning the application of these regulations to corporations filing consolidated returns.

(b) *Overall foreign loss accounts.* Any taxpayer that sustains an overall foreign loss under paragraph (c) of this section must establish an account for such loss. Separate types of overall foreign losses must be kept in separate accounts. For taxable years beginning prior to January 1, 1983, taxpayers that computed losses on a combined basis in accordance with § 1.904(f)–1(c)(1) will keep one overall foreign loss account for such overall foreign loss. The balance in each overall foreign loss account represents the amount of such overall foreign loss subject to recapture by the taxpayer in a given year. From year to year, amounts may be added to or subtracted from the balances in such accounts as provided in paragraphs (d) and (e) of this section. The taxpayer must report the balances (if any) in its overall foreign loss accounts annually on a Form 1116 or 1118. Such forms must be filed for each taxable year ending after September 24, 1987. The balance in each account does not have to be attributed to the year or years in which the loss was incurred.

(c) *Determination of a taxpayer's overall foreign loss*—(1) *Overall foreign loss defined.* For taxable years beginning after December 31, 1982, and before January 1, 1987, a taxpayer sustains an overall foreign loss in any taxable year in which its gross income from sources without the United States subject to a separate limitation (as defined in paragraph (c)(2) of this section) is exceeded by the sum of the deductions properly allocated and apportioned thereto. Such losses are to be determined separately in accordance with the principles of the separate limitations. Accordingly, income and deductions subject to a separate limitation are not to be netted with income and deductions subject to another separate limitation for purposes of determining the amount of an overall foreign loss. A taxpayer may, for example, have an overall foreign loss under the general limitation in the same taxable year in which it has taxable income under the DISC dividend limitation. The same principles of calculating overall foreign losses on a separate limitation basis apply for taxable years beginning before January 1, 1983, except that a taxpayer shall determine its overall foreign losses on a combined basis, except for income subject to the FORI limitation, if the taxpayer filed its pre-1983 returns on such basis. Thus, for taxable years beginning prior to January 1, 1983, a taxpayer can net income and losses among the passive interest limitation, the DISC dividend limitation, and the general limitation if the taxpayer calculated its overall foreign losses that way at the time. Taxpayers that computed overall foreign losses separately under each of the separate limitations on their returns filed for taxable years beginning prior to January 1, 1983, may not amend such returns to compute their overall foreign losses for pre-1983 years on a combined basis.

(2) *Separate limitation defined.* For purposes of paragraph (c)(1) of this section and these regulations, the term separate limitation means any of the separate limitations under former section 904(d)(1)(A) (passive interest limitation), (B) (DISC dividend limitation), (C) (foreign trade income limitation), (D) (FSC distributions limitation), and (E) (general limitation) and the separate limitation under section 907(b) (FORI limitation) (for taxable years ending after December 31, 1975, and beginning before January 1, 1983).

(3) *Method of allocation and apportionment of deductions.* In determining its overall foreign loss, a taxpayer shall allocate and apportion expenses, losses, and other deductions to the appropriate category of gross income in accordance with section 862(b) and §1.861–8 of the regulations. However, the following deductions shall not be taken into account:

(i) The amount of any net operating loss deduction for such year under section 172(a); and

(ii) To the extent such losses are not compensated for by insurance or otherwise, the amount of any—

(A) Expropriation losses for such year (as defined in section 172(h)), or

(B) Losses for such year which arise from fire, storm, shipwreck, or other casualty, or from theft.

(d) *Additions to the overall foreign loss account*—(1) *General rule.* A taxpayer's overall foreign loss as determined under paragraph (c) of this section shall be added to the applicable overall foreign loss account at the end of its taxable year to the extent that the overall foreign loss has reduced United States source income during the taxable year or during a year to which the loss has been carried back. For rules with respect to carryovers see paragraph (d)(4) of this section and §1.904(f)–3.

(2) *Overall foreign net capital loss.* An overall foreign net capital loss shall be added to the applicable overall foreign loss account at the end of the taxable year to the extent that the foreign source capital loss has reduced United States source capital gain net income during the taxable year or during a year to which the loss has been carried back, subject to the adjustments in paragraph (d)(5) of this section. For rules with respect to carryovers, see paragraph (d)(4) of this section and §1.904(f)–3. As provided under section 1211(b), to the extent that a foreign source net capital loss has reduced United States source income other

than United States source capital gain net income, this additional amount would be added to the taxpayer's overall foreign loss account as if the United States source income had been offset by a foreign net operating loss that is not a capital loss.

(3) *Overall foreign losses of another taxpayer.* If any portion of any overall foreign loss of another taxpayer is allocated to the taxpayer in accordance with § 1.904(f)–5 (relating to overall foreign losses of domestic trusts) or § 1.1502–9 (relating to consolidated overall foreign losses), the taxpayer shall add such amount to its applicable overall foreign loss account.

(4) *Additions to overall foreign loss account created by loss carryovers.* Subject to the adjustments under § 1.904(f)–1(d)(5), the taxpayer shall add to each overall foreign loss account—

(i) All net operating loss carryovers to the current taxable year attributable to the same limitation to the extent that overall foreign losses included in the net operating loss carryovers reduced United States source income for the taxable year, and

(ii) All capital loss carryovers to the current taxable year attributable to the same limitation to the extent that foreign source capital loss carryovers reduced United States source capital gain net income for the taxable year.

(5) *Adjustments.* The amount of overall foreign loss determined in paragraph (d)(1) of this section and the amount of overall foreign net capital loss determined in paragraph (d)(2) of this section which shall be added to a taxpayer's overall foreign loss account shall be adjusted as follows prior to being added to an account.

(i) *Adjustment due to reduction in foreign source income under section 904(b).* A taxpayer's overall foreign loss account shall not include any net capital loss from sources without the United States to the extent that the application of section 904(b) would result in a reduction of foreign source taxable income (but not below zero) for purposes of the numerator of the foreign tax credit limitation fraction.

(ii) *Adjustment to account for rate differential between ordinary income rate and capital gain rate.* Subject to the provisions of paragraph (d)(5)(i) of this section, if an overall foreign loss for a taxable year includes an overall foreign net capital loss, such amount shall be reduced as follows, in accordance with the provisions of section 904(b), before being added to the overall foreign loss account:

(A) In the case of a corporate taxpayer, to the extent that the United States source capital gain net income reduced by the foreign source net capital loss consists of United States source net capital gain, by an amount equal to the rate differential portion (as defined in section 904(b)(3)(D) of the Code and the regulations thereunder) of the United States source net capital gain; or

(B) In the case of a taxpayer other than a corporate taxpayer, for taxable years beginning prior to January 1, 1979, an amount equal to the taxpayer's United States source net capital gain that is offset by such foreign source net capital loss reduced by 50 percent of such gain, and for taxable years beginning after December 31, 1978, and before January 1, 1987, reduced by an amount equal to 60 percent of such gain.

(e) *Reductions of overall foreign loss accounts.* The taxpayer shall subtract the following amounts from its overall foreign loss accounts at the end of its taxable year in the following order, if applicable:

(1) *Pre-recapture reduction for amounts allocated to other taxpayers.* An overall foreign loss account is reduced by the amount of any overall foreign loss which is allocated to another taxpayer in accordance with § 1.904(f)–5 (relating to overall foreign losses of domestic trusts) or § 1.1502–9 (relating to consolidated overall foreign losses).

(2) *Reduction for amounts recaptured.* An overall foreign loss account is reduced by the amount of any foreign source income that is subject to the same limitation as the loss that resulted in the account and that is recaptured in accordance with § 1.904(f)–2 (c) (relating to recapture under section 904(f)(1)); § 1.904(f)–2 (d) (relating to recapture when the taxpayer disposes of certain properties under section 904(f)(3)); and § 1.904(f)–4 (relating to recapture when the taxpayer receives an

accumulation distribution from a foreign trust under section 904(f)(4)).

(f) *Illustrations.* The rules of this section are illustrated by the following examples.

Example 1. X Corporation is a domestic corporation with foreign branch operations in country C. X's taxable income and losses for its taxable year 1983 are as follows:

U.S. Source taxable income	$1,000
Foreign source taxable income (loss) subject to the general limitation	($500)
Foreign source taxable income subject to the passive interest limitation	$200

X has a general limitation overall foreign loss of $500 for 1983 in accordance with paragraph (c) (1) of this section. Since the general limitation overall foreign loss is not considered to offset income under the separate limitation for passive interest income, it therefore offsets $500 of United States source taxable income. This amount is added to X's general limitation overall foreign loss account at the end of 1983 in accordance with paragraphs (c) (1) and (d) (1) of this section.

Example 2. Y Corporation is a domestic corporation with foreign branch operations in Country C. Y's taxable income and losses for its taxable year 1982 are as follows:

U.S. source taxable income	$1,000
Foreign source taxable income (loss) subject to the general limitation	($500)
Foreign source taxable income subject to the passive interest limitation	$250

For its pre-1983 taxable years, Y filed its returns determining its overall foreign losses on a combined basis. In accordance with paragraphs (a) and (c) (1) of this section, Y may net the foreign source income and loss before offsetting the United States source income. Y therefore has a section 904(d)(1)(A–C) overall foreign loss account of $250 at the end of 1982.

Example 3. X Corporation is a domestic corporation with foreign branch operations in country C. For its taxable year 1985, X has taxable income (loss) determined as follows:

U.S. source taxable income	$200
Foreign source taxable income (loss) subject to the general limitation	($1,000)
Foreign source taxable income (loss) subject to the passive limitation	$1,800

X has a general limitation overall foreign loss of $1,000 in accordance with paragraph (c)(1) of this section. The overall foreign loss offsets $200 of United States source taxable income in 1985 and, therefore, X has a $200 general limitation overall foreign loss account at the end of 1985. The remaining $800 general limitation loss is offset by the passive interest limitation income in 1985 so that X has no net operating loss carryover that is attributable to the general limitation loss and no additional amount attributable to that loss will be added to the overall foreign loss account in 1985 or in any other year.

Example 4. In 1986, V Corporation has $1000 of general limitation foreign source taxable income and $500 of general limitation foreign source net capital loss which has reduced $500 of United States source capital gain net income (''short term gain'') (none of which is net capital gain). Under section 904(b), the numerator of V's foreign tax credit limitation fraction for income subject to the general limitation is reduced by $500 (see §1.904 (b)–1 (a)(3)). Under paragraph (d)(5)(i) of this section, none of that $500 goes into its general limitation overall foreign loss account.

Example 5. Z Corporation is a domestic corporation with foreign branch operations. For the taxable year 1984, Z's taxable income and (losses) are as follows:

U.S. source taxable ordinary income	$1,000
U.S. source net capital gain	$460
Foreign source taxable ordinary income subject to the general limitation	$200
Foreign source net capital loss subject to the general limitation	($800)

Z had no capital gain net income in any prior taxable year. Under paragraph (d)(2) and (5) of this section, the amount to be added to Z's general limitation overall foreign loss account is the excess of the amount which has reduced United States source capital gain net income for the taxable year ($460), adjusted for the rate differential because it has reduced United States source net capital gain ($460 × 28/46 = $280), over the amount which has reduced the numerator of Z's foreign tax credit limitation fraction under section 904(b)(2), which is $200. (The $200 amount is foreign source net capital loss that has reduced United States source net capital gain in the denominator of the fraction, but not exceeding the amount of foreign source income in the numerator before the section 904(b)(2) adjustment.) Thus, Z must add $80 (the excess of the $280 over $200) to its general limitation overall foreign loss account in 1984.

[T.D. 8153, 52 FR 31994, Aug. 25, 1987; 52 FR 43434, Nov. 12, 1987]

§1.904(f)–2 Recapture of overall foreign losses.

(a) *In general.* A taxpayer shall be required to recapture an overall foreign loss as provided in this section. Recapture is accomplished by treating as United States source income a portion of the taxpayer's foreign source taxable income of the same limitation as the foreign source loss that resulted in an overall foreign loss account. As a result, if the taxpayer elects the benefits of section 901 or section 936, the taxpayer's foreign tax credit limitation with respect to such income is decreased. As provided in § 1.904 (f)–1(e)(2), the balance in a taxpayer's overall foreign loss account is reduced by the amount of loss recaptured. Recapture continues until such time as the amount of foreign source taxable income recharacterized as United States source income equals the amount in the overall foreign loss account. As provided in § 1.904 (f)–1(e)(2), the balance in a overall foreign loss account is reduced at the end of each taxable year by the amount of the loss recaptured during that taxable year. Regardless of whether recapture occurs in a year in which a taxpayer elects the benefits of section 901 or in a year in which a taxpayer deducts its foreign taxes under section 164, the overall foreign loss account is recaptured only to the extent of foreign source taxable income remaining after applying the appropriate section 904(b) adjustments, if any, as provided in paragraph (b) of this section.

(b) *Determination of taxable income from sources without the United States for purposes of recapture*—(1) *In general.* For purposes of determining the amount of an overall foreign loss subject to recapture, the taxpayer's taxable income from sources without the United States shall be computed with respect to each of the separate limitations described in § 1.904 (f)–1(c)(2) in accordance with the rules set forth in § 1.904 (f)–1(c) (1) and (3). This computation is made without taking into account foreign source taxable income (and deductions properly allocated and apportioned thereto) subject to other separate limitations. Before applying the recapture rules to foreign source taxable income, the following provisions shall be applied to such income in the following order:

(i) Former section 904(b)(3)(C) (prior to its removal by the Tax Reform Act of 1986) and the regulations thereunder shall be applied to treat certain foreign source gain as United States source gain; and

(ii) Section 904(b)(2) and the regulations thereunder shall be applied to make adjustments in the foreign tax credit limitation fraction for certain capital gains and losses.

(c) *Section 904(f)(1) recapture*—(1) *In general.* In a year in which a taxpayer elects the benefits of sections 901 or 936, the amount of any foreign source taxable income subject to recapture in a taxable year in which paragraph (a) of this section is applicable is the lesser of the balance in the applicable overall foreign loss account (after reduction of such account in accordance with § 1.904 (f)–1(e)) or fifty percent of the taxpayer's foreign source taxable income of the same limitation as the loss that resulted in the overall foreign loss account (as determined under paragraph (b) of this section). If, in any year, in accordance with sections 164(a) and section 275(a)(4)(A), a taxpayer deducts rather than credits its foreign taxes, recapture is applied to the extent of the lesser of (i) the balance in the applicable overall foreign loss account or (ii) foreign source taxable income of the same limitation type that resulted in the overall foreign loss minus foreign taxes imposed on such income.

(2) *Election to recapture more of the overall foreign loss than is required under paragraph (c)(1).* In a year in which a taxpayer elects the benefits of sections 901 or 936, a taxpayer may make an annual revocable election to recapture a greater portion of the balance in an overall foreign loss account than is required to be recaptured under paragraph (c)(1) of this section. A taxpayer may make such an election or amend a prior election by attaching a statement to its annual Form 1116 or 1118. If an amendment is made to a prior year's election, an amended tax return should be filed. The statement attached to the Form 1116 or 1118 must indicate the percentage and dollar amount of the taxpayer's foreign source taxable income that is being recharacterized as United States source income and the percentage and dollar amount of the

balance (both before and after recapture) in the overall foreign loss account that is being recaptured. Except for the special recapture rules for section 936 corporations and for recapture of pre-1983 overall foreign losses determined on a combined basis, the taxpayer that elects to credit its foreign taxes may not elect to recapture an amount in excess of the taxpayer's foreign source taxable income subject to the same limitation as the loss that resulted in the overall foreign loss account.

(3) *Special rule for recapture of losses incurred prior to section 936 election.* If a corporation elects the application of section 936 and at the time of the election has a balance in any overall foreign loss account, such losses will be recaptured from the possessions source income of the electing section 936 corporation that qualifies for the section 936 credit, including qualified possession source investment income as defined in section 936(d)(2), even though the overall foreign loss to be recaptured may not be attributable to a loss in an income category of a type that would meet the definition of qualified possession source investment income. For purposes of recapturing an overall foreign loss incurred by a consolidated group including a corporation that subsequently elects to use section 936, the electing section 936 corporation's possession source income that qualifies for the section 936 credit, including qualified possession source investment income, shall be used to recapture the section 936 corporation's share of previously incurred overall foreign loss accounts. Rules for determining the section 936 corporation's share of the consolidated groups overall foreign loss accounts are provided in §1.1502–9(c).

(4) *Recapture of pre-1983 overall foreign losses determined on a combined basis.* If a taxpayer computed its overall foreign losses on a combined basis in accordance with §1.904(f)–1(c)(1) for taxable years beginning before January 1, 1983, any losses recaptured in taxable years beginning after December 31, 1982, shall be recaptured from income subject to the general limitation, subject to the rules in §1.904(f)–6 (a) and (b). Ordering rules for recapture of these losses are provided in §1.904(f)–6(c).

(5) *Illustrations.* The rules of this paragraph (c) are illustrated by the following examples, all of which assume a United States corporate tax rate of 50 percent unless otherwise stated.

Example 1. X Corporation is a domestic corporation that does business in the United States and abroad. On December 31, 1983, the balance in X's general limitation overall foreign loss account is $600, all of which is attributable to a loss incurred in 1983. For 1984, X has United States source taxable income of $500 and foreign source taxable income subject to the general limitation of $500. For 1984, X pays $200 in foreign taxes and elects section 901. Under paragraph (c)(1) of this section, X is required to recapture $250 (the lesser of $600 or 50 percent of $500) of its overall foreign loss. As a consequence, X's foreign tax credit limitation under the general limitation is $250/$1,000×$500, or $125, instead of $500/$1,000×$500, or $250. The balance in X's general limitation overall foreign loss account is reduced by $250 in accordance with §1.904(f)–1(e)(2).

Example 2. The facts are the same as in example 1 except that X makes an election to recapture its overall foreign loss to the extent of 80 percent of its foreign source taxable income subject to the general limitation (or $400) in accordance with paragraph (c)(2) of this section. As a result of recapture, X's 1984 foreign tax credit limitation for income subject to the general limitation is $100/$1,000×$500, or $50, instead of $500/$1,000×$500, or $250. X's general limitation overall foreign loss account is reduced by $400 in accordance with §1.904(f)–1(e)(2).

Example 3. The facts are the same as in example 1 except that X does not elect the benefits of section 901 in 1984 and instead deducts its foreign taxes paid. In 1984, X recaptures $300 of its overall foreign loss, the difference between X's foreign source taxable income of $500 and $200 of foreign taxes paid. The balance in X's general limitation overall foreign loss account is reduced by $300 in accordance with §1.904(f)–1(e)(2).

Example 4. The facts are the same as in example 1 except that in 1984, X also has $1,000 of foreign source DISC dividend income subject to the separate limitation for DISC dividends which carries a foreign tax of $50. Under paragraph (c)(1) of this section the amount of X's general limitation overall foreign loss subject to recapture is $250 (the lesser of the balance in the overall foreign loss account or 50 percent of the foreign source taxable income subject to the general limitation). There is no recapture with respect to the DISC dividend income. X's separate limitation for DISC dividend income is $1,000/$2,000×$1,000, or $500. Its general limitation is $250/$2,000×$1,000, or $125, instead of $500/$2,000×$1,000, or $250. The balance in X's general limitation overall foreign loss account is reduced by $250 in accordance with § 1.904(f)–1(e)(2).

Example 5. On December 31, 1980, V, a domestic corporation that does business in the United States and abroad, has a balance in its section 904(d)(1)(A–C) overall foreign loss account of $600. V also has a balance in its FORI limitation overall foreign loss account of $900. For 1981, V has foreign source taxable income subject to the general limitation of $500 and $500 of United States source income. V also has foreign source taxable income subject to the FORI limitation of $800. V is required to recapture $250 of its section 904(d)(1)(A–C) overall foreign loss account (the lesser of $600 or 50% of $500) and its general limitation foreign tax credit limitation is $250/$1,800×$900, or $125 instead of $500/$1,800×$900, or $250. V is also required to recapture $400 of its FORI limitation overall foreign loss account (the lesser of $900 or 50% of $800). V's foreign tax credit limitation for FORI is $400/$1,800×$900, or $200, instead of $800/$1,800×$900, or $400. The balance in V's FORI limitation overall foreign loss account is reduced to $500 and the balance in V's section 904(d)(1)(A–C) account is reduced to $350, in accordance with § 1.904(f)–1(e)(2).

Example 6. This example assumes a United States corporate tax rate of 46 percent (under section 11(b)) and an alternative rate of tax under section 1201(a) of 28 percent. W is a domestic corporation that does business in the United States and abroad. On December 31, 1984, W has $350 in its general limitation overall foreign loss account. For 1985, W has $500 of United States source taxable income, and has foreign source income subject to the general limitation as follows:

Foreign source taxable income other than net capital gain	$720
Foreign source net capital gain	$460

Under paragraph (b)(2) of this section, foreign source taxable income for purposes of recapture includes foreign source capital gain net income, reduced, under section 904(b)(2), by the rate differential portion of foreign source net capital gain, which adjusts for the reduced tax rate for net capital gain under section 1201(a):

Foreign source capital gain net income	$460
Rate differential portion of foreign source net capital gain (18/46 of $460)	−180
Foreign source capital gain included in foreign source taxable income	$280

The total foreign source taxable income of W for purposes of recapture in 1985 is $1,000 ($720+$280). Under paragraph (c)(1) of this section, W is required to recapture $350 (the lesser of $350 or 50 percent of $1,000), and W's general limitation overall foreign loss account is reduced to zero. W's foreign tax credit limitation for income subject to the general limitation is $650/$1,500×$690 ((.46) (500+720)+(.28) (460)), or $299, instead of $1,000/$1,500×$690, or $460.

(d) *Recapture of overall foreign losses from dispositions under section 904(f)(3)*—(1) *In general.* If a taxpayer disposes of property used or held for use predominantly without the United States in a trade or business during a taxable year and that property generates foreign source taxable income subject to a separate limitation to which paragraph (a) of this section is applicable, (i) gain will be recognized on the disposition of such property, (ii) such gain will be treated as foreign source income subject to the same limitation as the income the property generated, and (iii) the applicable overall foreign loss account shall be recaptured as provided in paragraphs (d)(2), (d)(3), and (d)(4) of this section. See paragraph (d)(5) of this section for definitions.

(2) *Treatment of net capital gain.* If the gain from a disposition of property to which this paragraph (d) applies is treated as net capital gain, all references to such gain in paragraphs (d)(3) and (d)(4) of this section shall mean such gain as adjusted under paragraph (b) of this section. The amount by which the overall foreign loss account shall be reduced shall be determined from such adjusted gain.

(3) *Dispositions where gain is recognized irrespective of section 904(f)(3).* If a taxpayer recognizes foreign source gain subject to a separate limitation on the disposition of property described in paragraph (d)(1) of this section, and there is a balance in a taxpayer's overall foreign loss account that is attributable to a loss under such limitation after applying paragraph (c) of this section, an additional portion of such balance shall be recaptured in accordance with paragraphs (a) and (b) of this section. The amount recaptured shall be the lesser of such balance or 100 percent of the foreign source gain recognized on the disposition that was not previously recharacterized.

(4) *Dispositions in which gain would not otherwise be recognized*—(1) *Recognition of gain to the extent of the overall foreign loss account.* If a taxpayer

makes a disposition of property described in paragraph (d)(1) of this section in which any amount of gain otherwise would not be recognized in the year of the disposition, and such property was used or held for use to generate foreign source taxable income subject to a separate limitation under which the taxpayer had a balance in its overall foreign loss account (including a balance that arose in the year of the disposition), the taxpayer shall recognize foreign source taxable income in an amount equal to the lesser of:

(A) The sum of the balance in the applicable overall foreign loss account (but only after such balance has been increased by amounts added to the account for the year of the disposition or has been reduced by amounts recaptured for the year of the disposition under paragraph (c) and paragraph (d)(3) of this section) plus the amount of any overall foreign loss that would be part of a net operating loss for the year of the disposition if gain from the disposition were not recognized under section 904(f)(3), plus the amount of any overall foreign loss that is part of a net operating loss carryover from a prior year, or

(B) The excess of the fair market value of such property over the taxpayer's adjusted basis in such property. The excess of the fair market value of such property over its adjusted basis shall be determined on an asset by asset basis. Losses from the disposition of an asset shall not be recognized. Any foreign source taxable income deemed received and recognized under this paragraph (d)(4)(i) will have the same character as if the property had been sold or exchanged in a taxable transaction and will constitute gain for all purposes.

(ii) *Basis adjustment.* The basis of the property received in an exchange to which this paragraph (d)(4) applies shall be increased by the amount of gain deemed recognized, in accordance with applicable sections of subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), O (relating to gain or loss on the disposition of property), and P (relating to capital gains and losses). If the property to which this paragraph (d)(4) applies was transferred by gift, the basis of such property in the hands of the donor immediately preceding such gift shall be increased by the amount of the gain deemed recognized.

(iii) *Recapture of overall foreign loss to the extent of amount recognized.* The provisions of paragraphs (a) and (b) of this section shall be applied to the extent of 100 percent of the foreign source taxable income which is recognized under paragraph (d)(4)(i) of this section. However, amounts of foreign source gain that would not be recognized except by application of section 904(f)(3) and paragraph (d)(4)(i) of this section, and which are treated as United States source gain by application of section 904(b)(3)(C) (prior to its removal by the Tax Reform Act of 1986) and paragraph (b)(1) of this section, shall reduce the overall foreign loss account (subject to the adjustments described in paragraph (d)(2) of this section) if such gain is net capital gain, notwithstanding the fact that such amounts would otherwise not be recaptured under the ordering rules in paragraph (b) of this section.

(iv) *Priorities among dispositions in which gain is deemed to be recognized.* If, in a single taxable year, a taxpayer makes more than one disposition to which this paragraph (d)(4) is applicable, the rules of this paragraph (d)(4) shall be applied to each disposition in succession starting with the disposition which occurred earliest, until the balance in the applicable overall foreign loss account is reduced to zero. If the taxpayer simultaneously makes more than one disposition to which this paragraph (d)(4) is applicable, the rules of paragraph (d)(4) shall be applied so that the balance in the applicable overall foreign loss account to be recaptured will be allocated pro rata among the assets in proportion to the excess of the fair market value of each asset over the adjusted basis of each asset.

(5) *Definitions*—(i) *Disposition.* A disposition to which this paragraph (d) applies includes a sale; exchange; distribution; gift; transfer upon the foreclosure of a security interest (but not a mere transfer of title to a creditor upon creation of a security interest or to a debtor upon termination of a security interest); involuntary conversion;

contribution to a partnership, trust, or corporation; transfer at death; or any other transfer of property whether or not gain or loss is recognized under other provisions of the Code. However, a disposition to which this paragraph (d) applies does not include:

(A) A distribution or transfer of property to a domestic corporation described in section 381 (a) (provided that paragraph (d)(6) of this section applies);

(B) A disposition of property which is not a material factor in the realization of income by the taxpayer (as defined in paragraph (d)(5)(iv) of this section);

(C) A transaction in which gross income is not realized; or

(D) The entering into of a unitization or pooling agreement (as defined in § 1.614–8(b)(6) of the regulations) containing a valid election under section 761(a)(2), and in which the source of the entire gain from any disposition of the interest created by the agreement would be determined to be foreign source under section 862(a)(5) if the disposition occurred presently.

(ii) *Property used in a trade or business.* Property is used in a trade or business if it is held for the principal purpose of promoting the present or future conduct of the trade or business. This generally includes property acquired and held in the ordinary course of a trade or business or otherwise held in a direct relationship to a trade or business. In determining whether an asset is held in a direct relationship to a trade or business, principal consideration shall be given to whether the asset is used in the trade or business. Property will be treated as held in a direct relationship to a trade or business if the property was acquired with funds generated by that trade or business or if income generated from the asset is available for use in that trade or business. Property used in a trade or business may be tangible or intangible, real or personal property. It includes property, such as equipment, which is subject to an allowance for depreciation under section 167 or cost recovery under section 168. Property may be considered used in a trade or business even if it is a capital asset in the hands of the taxpayer. However, stock of another corporation shall not be considered property used in a trade or business if a substantial investment motive exists for acquiring and holding the stock. On the other hand, stock acquired or held to assure a source of supply for a trade or business shall be considered property used in that trade or business. Inventory is generally not considered property used in a trade or business. However, when disposed of in a manner not in the ordinary course of a trade or business, inventory will be considered property used in the trade or business. A partnership interest will be treated as property used in a trade or business if the underlying assets of the partnership would be property used in a trade or business. For purposes of section 904(f) (3) and § 1.904(f)–2 (d) (1) and (5), a disposition of a partnership interest to which this section applies will be treated as a disposition of a proportionate share of each of the assets of the partnership. For purposes of allocating the purchase price of the interest and the seller's basis in the interest to those assets, the principles of § 1.751–1(a) will apply.

(iii) *Property used predominantly outside the United States.* Property will be considered used predominantly outside the United States if for a 3-year period ending on the date of the disposition (or, if shorter, the period during which the property has been used in the trade or business) such property was located outside the United States more than 50 percent of the time. An aircraft, railroad rolling stock, vessel, motor vehicle, container, or other property used for transportation purposes is deemed to be used predominantly outside the United States if, during the 3-year (or shorter) period, either such property is located outside the United States more than 50 percent of the time or more than 50 percent of the miles traversed in the use of such property are traversed outside the United States.

(iv) *Property which is a material factor in the realization of income.* For purposes of this section, property used in a trade or business will be considered a material factor in the realization of income unless the taxpayer establishes that it is not (or, if the taxpayer did not realize income from the trade or business in the taxable year, would not be expected to be) necessary to the realization of income by the taxpayer.

(6) *Carryover of overall foreign loss accounts in a corporate acquisition to which section 381(a) applies.* In the case of a distribution or transfer described in section 381(a), an overall foreign loss account of the distributing or transferor corporation shall be treated as an overall foreign loss account of the acquiring or transferee corporation as of the close of the date of the distribution or transfer. If the transferee corporation had an overall foreign loss account under the same separate limitation prior to the distribution or transfer, the balance in the transferor's account must be added to the transferee's account. If not, the transferee must adopt the transferor's overall foreign loss account. An overall foreign loss of the transferor will be treated as incurred by the transferee in the year prior to the year of the transfer.

(7) *Illustrations.* The rules of this paragraph (d) are illustrated by the following examples which assume that the United States corporate tax rate is 50 percent (unless otherwise stated). For purposes of these examples, none of the foreign source gains are treated as net capital gains (unless so stated).

Example 1. X Corporation has a balance in its general limitation overall foreign loss account of $600 at the close of its taxable year ending December 31, 1984. In 1985, X sells assets used predominantly outside the United States in a trade or business and recognizes $1,000 of gain on the sale under section 1001. This gain is subject to the general limitation. This sale is a disposition within the meaning of paragraph (d)(5)(i) of this section, and to which this paragraph (d) applies. X has no other foreign source taxable income in 1985 and has $1,000 of United States source taxable income. Under paragraph (c), X is required to recapture $500 (the lesser of the balance in X's general limitation overall foreign loss account ($600) or 50 percent of $1,000) of its overall foreign loss account. The balance in X's general limitation overall foreign loss account is reduced to $100 in accordance with § 1.904(f)–1(e)(2). In addition, under paragraph (d)(3) of this section, X is required to recapture $100 (the lesser of the remaining balance in its general limitation overall foreign loss account ($100) or 100 percent of its foreign source taxable income recognized on such disposition that has not been previously recharacterized ($500)). The total amount recaptured is $600. X's foreign tax credit limitation for income subject to the general limitation in 1985 is $200 ($400/$2,000 x $1,000) instead of $500 ($1,000/$2,000 x $1,000). The balance in X's general limitation overall foreign loss account is reduced to zero in accordance with § 1.904(f)–1(e)(2).

Example 2. On December 31, 1984, Y Corporation has a balance in its general limitation overall foreign loss account of $1,500. In 1985, Y has $500 of United States source taxable income and $200 of foreign source taxable income subject to the general limitation. Y's foreign source taxable income is from the sale of property used predominantly outside of the United States in a trade or business. This sale is a disposition to which this paragraph (d) is applicable. In 1985, Y also transferred property used predominantly outside of the United States in a trade or business to another corporation. Under section 351, no gain was recognized on this transfer. Such property had been used to generate foreign source taxable income subject to the general limitation. The excess of the fair market value of the property transferred over Y's adjusted basis in such property was $2,000. In accordance with paragraph (c) of this section, Y is required to recapture $100 (the lesser of $1,500, the amount in Y's general limitation overall foreign loss account, or 50 percent of $200, the amount of general limitation foreign source taxable income for the current year) of its general limitation overall foreign loss. Y is then required to recapture an additional $100 of its general limitation overall foreign loss account under paragraph (d)(3) of this section out of the remaining gain recognized on the sale of assets, because 100 percent of such gain is subject to recapture. The balance in Y's general limitation overall foreign loss account is reduced to $1,300 in accordance with § 1.904(f)–1(e)(2). Y corporation is then required to recognize $1,300 of foreign source taxable income on its section 351 transfer under paragraph (d)(4) of this section. The remaining $700 of potential gain associated with the section 351 transfer is not recognized. Under paragraph (d)(4), 100 percent of the $1,300 is recharacterized as United States source taxable income, and Y's general limitation overall foreign loss account is reduced to zero. Y's entire taxable income for 1985 is:

U.S. source taxable income	$500
Foreign source taxable income subject to the general limitation that is recharacterized as U.S. source income by paragraphs (c) and (d)(3) of this section	200
Gain recognized under section 904(f)(3) and paragraph (d)(4) of this section, and recharacterized as U.S. source income	1,300
Total	$2,000

Y's foreign tax credit limitation for 1985 for income subject to the general limitation is $0 ($0/$2,000×$1,000) instead of $100 ($200/$700×$350).

Example 3. W Corporation is a calendar year domestic corporation with foreign branch operations in country C. As of December 31, 1984, W has no overall foreign loss accounts and has no net operating loss carryovers. W's entire taxable income in 1985 is:

U.S. source taxable income	$800
Foreign source taxable income (loss) subject to the general limitation	($1,000)

W cannot carry back its 1985 NOL to any earlier year. As of December 31, 1985, W therefore has $800 in its general limitation overall foreign loss account. In 1986, W earns $400 United States source taxable income and has an additional $1,000 loss from the operations of the foreign branch. Income in the loss category would be subject to the general limitation. Also in 1986, W disposes of property used predominately outside the United States in a trade or business. Such property generated income subject to the general limitation. The excess of the property's fair market value over its adjusted basis is $3,000. The disposition is of a type described in § 1.904 (f)–2(d)(4)(i). W has no other income in 1986. Under § 1.904 (f)–2(d)(4)(i), W is required to recognize foreign source taxable income on the disposition in an amount equal to the lesser of $2,000 ($800 (the balance in the general limitation overall foreign loss account as of 1985) + $400 (the increase in the general limitation overall foreign loss account attributable to the disposition year) + $600 (the general limitation overall foreign loss that is part of the NOL from 1986) + $200 (the general limitation overall foreign loss that is part of the NOL from 1985)) or $3,000. The $2,000 foreign source income required to be recognized under section 904(f)(3) is reduced to $1,200 by the remaining $600 loss in 1986 and the $200 net operating loss carried forward from 1985. This $1,200 of income is subject to the general limitation. In computing foreign tax credit limitation for general limitation income, the $1,200 of foreign source income is treated as United States source income and, therefore, W's foreign tax credit limitation for income subject to the general limitation is zero. W's overall foreign loss account is reduced to zero.

Example 4. Z Corporation has a balance in its FORI overall foreign loss account of $1,500 at the end of its taxable year 1980. In 1981, Z has $1,600 of foreign oil related income subject to the separate limitation for FORI income and no United States source income. In addition, in 1981, Z makes two dispositions of property used predominantly outside the United States in a trade or business on which no gain was recognized. Such property generated foreign oil related income. The excess of the fair market value of the property transferred in the first disposition over Z's adjusted basis in such property is $575. The excess of the fair market value of the property transferred in the second disposition over Z's adjusted basis in such property is $1,000. Under paragraph (c) of this section, Z is required to recapture $800 (the lesser of 50 percent of its foreign oil related income of $1,600 or the balance ($1,500) in its FORI overall foreign loss account) of its foreign oil related loss. In accordance with paragraphs (d)(4) (i) and (iv) of this section, Z is required to recognize foreign oil related income in the amount of $575 on the first disposition and, since the foreign oil related loss account is now reduced by $1,375 (the $800 and $575 amounts previously recaptured), Z is required to recognize foreign oil related income in the amount of $125 on the second disposition. In accordance with paragraph (d)(4)(iii) of this section, the entire amount recognized is treated as United States source income and the balance in the FORI overall foreign loss account is reduced to zero under § 1.904 (f)–1 (e)(2). Z's foreign tax credit limitation for FORI is $400 ($800/$2,300×$1,150) instead of $800 ($1,600/$1,600×$800).

Example 5. The facts are the same as in example 4, except that the gain from the two dispositions of property is treated as net capital gain and the United States corporate tax rate is assumed to be 46 percent. As in example 4, Z is required to recapture $800 of its foreign oil related loss from its 1981 ordinary foreign oil related income. In accordance with paragraph (d)(4) (i) and (iv) of this section, Z is first required to recognize foreign oil related income (which is net capital gain) on the first disposition in the amount of $575. Under paragraphs (b) and (d) (2) of this section, this net capital gain is adjusted by subtracting the rate differential portion of such gain from the total amount of such gain to determine the amount by which the foreign oil related loss account is reduced, which is $350 ($575− ($575×18/46)). The balance remaining in Z's foreign oil related loss account after this step is $350. Therefore, this process will be repeated, in accordance with paragraph (d)(4)(iv) of this section, to recapture that remaining balance out of the gain deemed recognized on the second disposition, resulting in reduction of the foreign oil related loss account to zero and net capital gain required to be recognized from the second dispostion in the amount of $575, which must also be adjusted by subtracting the rate differential portion to determine the amount by which the foreign oil related loss account is reduced (which is $350). The $575 of net capital gain from each disposition is recharacterized as United States source net capital gain. Z's section 907 (b) foreign tax credit limitation is the same as in example 4, and Z has $1,150 ($575+$575) of United States source net capital gain.

[T.D. 8153, 52 FR 31997, Aug. 25, 1987; 52 FR 43434, Nov. 12, 1987]

§1.904(f)–3 Allocation of net operating losses and net capital losses.

(a) *Allocation of net operating loss carrybacks and carryovers that include overall foreign losses.* If a taxpayer sustains an overall foreign loss that is part of a net operating loss for the year, then, in carrying such net operating loss back to an earlier year or forward to a later year in accordance with section 172 (or §1.1502–21T(b) (or §§1.1502–21A(b) and 1.1502–79A(a), as appropriate)), the portion, if any, of the net operating loss attributable to a United States source loss shall be allocated first to United States source income and the portion of the net operating loss attributable to an overall foreign loss shall be allocated first to foreign source taxable income subject to the same separate limitation in the carryback or carryover year. To the extent that the overall foreign loss component of the net operating loss exceeds foreign source taxable income subject to the same separate limitation in the year to which it is carried, it shall be allocated next to the taxpayer's United States source income for such year and then to foreign source taxable income subject to another separate limitation. See paragraph §1.904 (f)–1(d) of this section for additions to the applicable overall foreign loss account to the extent that the United States source taxable income is reduced in the taxable year to which the loss is carried.

(b) *Allocation of net capital loss carrybacks and carryovers that include overall foreign losses.* If a taxpayer sustains an overall foreign loss that is part of a net capital loss for the year, then in carrying the net capital loss back to an earlier year or forward to a later year in accordance with section 1212 (or §§1.1502–22T(b) (or §§1.1502–22A and 1.1502–79A(b), as appropriate)), the portion of the net capital loss that is attributable to a foreign source capital loss shall be allocated first to foreign source capital gain net income subject to the same separate limitation in the carryback or carryover year. To the extent that such foreign source capital loss exceeds foreign source capital gain net income subject to the same separate limitation in the year to which it is carried, it shall be allocated first to United States source capital gain net income in such year and then to foreign source capital gain net income subject to another separate limitation. An overall foreign source net capital loss carried over to a later year in accordance with this paragraph (b) shall be taken into consideration in determining the taxpayer's overall foreign loss in the year to which it is carried and shall be added to the applicable overall foreign loss account for such year in accordance with paragraph (c) of this section. An overall foreign source net capital loss carried back to an earlier year in accordance with this paragraph (b) shall be added to the applicable overall foreign loss account in the year in which the loss occurred.

(c) *Transitional rule.* When a taxpayer incurs a net operating loss in a post-1982 taxable year that is carried back to a pre-1983 taxable year and creates an overall foreign loss in the pre-1983 year, for purposes of this section, §1.904(f)–1(c)(1), and §1.904(f)–2(b), that loss will be treated as if it arose in the post-1982 year; thus the loss will first offset United States source income before it offsets foreign source income subject to another limitation. When a taxpayer incurs a net operating loss in a pre-1983 taxable year that is carried forward to a post-1982 taxable year and creates an overall foreign loss in the carryover year, for purposes of this section, §1.904(f)–1(c)(1), and §1.904(f)–2(b), that loss is treated as if it arose in the post-1982 taxable year; thus the loss will first offset United States source income before it offsets foreign source income subject to another limitation.

(d) *Illustrations.* The following examples illustrate the application of this section.

Example 1. X Corporation is a domestic corporation with foreign branch operations in Country C. For its taxable year 1985, X has a net operating loss of ($1250), determined as follows:

U.S. source taxable income (loss)...........($250)
Foreign source taxable income (loss)
subject to the general limitation

	($1,000)

The only prior year to which the net operating loss can be carried under section 172 is 1983. For its taxable year 1983, X had the following taxable income:

U.S. source taxable income	$1,900
Foreign source taxable income subject to the general limitation	$400

X has a general limitation overall foreign loss for 1985 of $1,000. X's overall foreign loss is part of a net operating loss of $1,250 for 1985. In accordance with § 1.904(f)–3(a), the foreign loss carried back to 1983 is first allocated to X's foreign source taxable income subject to the limitation under which the loss arose, the general limitation. This amount is not added to X's overall foreign loss account under paragraph (c)(1)(i). The remaining $600 of 1985 foreign source loss is allocated to and thus reduces 1983 United States source income, and this amount is added to X's general limitation overall foreign loss account in 1985.

Example 2. The facts are the same as in example 1, except that in 1983, X's United States source taxable income was zero. No amount is added to X's overall foreign loss account at the end of 1985. X's income and deductions for 1986 are as follows:

U.S. source taxable income	$1,250
Foreign source taxable income subject to the general limitation	$300

X has a net operating loss carryover to 1986 of $850 ($1,250–$400). The $850 net operating loss carryover is comprised of $600 of foreign losses ($1,000 of 1985 loss, minus $400 offset by foreign source income in the carryback year) and $250 of United States source loss. The $600 foreign source component of the net operating loss is first allocated to X's foreign source taxable income subject to the general limitation in 1986, in accordance with § 1.904(f)–3(a), prior to reducing United States source income. The $250 United States source component of the net operating loss component is also allocated first to United States income in the carryover year before reducing any foreign source income. Thus, $300 of the remaining $600 of foreign source net operating loss carryover is first applied to eliminate foreign source income in the carryover year, leaving $300 of foreign source net operating loss. The $250 United States source component of the net operating loss reduces United States source taxable income to $1,000 in 1986. This $1,000 of United States source income is then further reduced by the remaining $300 of foreign source net operating loss. Therefore, in 1986, X has $700 of United States source income and $300 is added to X's general limitation overall foreign loss account in accordance with § 1.904(f)–1(d)(4) of this section.

Example 3. Z is a domestic corporation that does business in the United States and abroad. For taxable years prior to 1983, Z computed its overall foreign losses on a separate limitation basis. In 1980, Z had $100 of United States source income and ($100) of foreign source loss subject to the general limitation. On December 31, 1980, the balance in Z's general limitation overall foreign loss account was $100. In 1981, Z had $50 of United States source income and $100 of general limitation foreign source income. In 1982, Z also had $50 United States source income and $100 foreign source general limitation income. Therefore, in both 1981 and 1982, Z recaptured $50 and at the end of 1982, Z's general limitation overall foreign loss account was reduced to zero. In 1983, Z had no income. In 1984, Z had a ($150) United States source loss and a ($150) general limitation foreign source loss. The 1984 net operating loss is carried back first to 1981 and then to 1982. Because of the overall foreign loss recapture that occurred in those years, Z is considered to have $100 of United States source income and $50 of foreign source income in each year. Thus, in 1981, ($50) of the ($150) foreign source component of the carryback eliminated the $50 foreign source income in that year and ($100) of the ($150) domestic source component of the carryback eliminated the United States source income in that year. In 1982, ($50) of the remaining domestic source component of the net operating loss reduced the United States source income to $50. The remaining ($100) of the foreign source component of the loss first reduced the foreign source income to zero and then reduced the remaining United States source income to zero, thus creating a $50 overall foreign loss. Therefore, at the end of 1984, Z has $50 in its general limitation overall foreign loss account.

Example 4. In 1985, V Corporation has a general limitation loss of <$1,000> and no other income or loss in that year. The 1985 loss is carried back to 1982. For taxable years prior to 1983, V computed its overall foreign losses on a combined basis for income subject to the passive interest limitation, the DISC dividend limitation, and the general limitation. In 1982, V had $400 of passive interest limitation income and $200 of general limitation income and $1,000 of United States source taxable income. Under paragraph (d) of this section, the $1,000 NOL attributable to the 1985 loss is first offset by the general limitation income in 1982 and then the United States source passive interest limitation income in that year. V therefore adds $800 to its general limitation overall foreign loss account in 1985.

Example 5. In 1982, W Corporation has a general limitation loss of <$500> and $200 of passive interest limitation income. For taxable years prior to 1983, W computed its overall foreign losses on a combined basis. W has no other taxable income or loss. W cannot carry back the $300 NOL and so it carries it forward to 1983, a year in which it has $600 passive interest limitation income and $500 of United States source income and no general limitation income. Under paragraph (d) of this section, the NOL is not offset by the foreign source income in 1984 but first is applied against United States source income. Thus, $300 is added to W's general limitation overall foreign loss account in 1984.

[T.D. 8153, 52 FR 32001, Aug. 25, 1987; 52 FR 43434, Nov. 12, 1987, as amended by T.D. 8677, 61 FR 33323, June 27, 1996]

§1.904(f)–4 Recapture of foreign losses out of accumulation distributions from a foreign trust.

(a) *In general.* If a taxpayer receives a distribution of foreign source taxable income subject to a separate limitation in which the taxpayer had a balance in an overall foreign loss account and that income is treated under section 666 as having been distributed by a foreign trust in a preceding taxable year, a portion of the balance in the taxpayer's applicable overall foreign loss account shall be subject to recapture under this section. The amount subject to recapture shall be the lesser of the balance in the taxpayer's overall foreign loss account (after applying §§1.904(f)–1, 1.904(f)–2, 1.904(f)–3, and 1.904(f)–6 to the taxpayer's other income or loss in the current taxable year) or the entire amount of foreign source taxable income deemed distributed in a preceding year or years under section 666.

(b) *Effect of recapture on foreign tax credit limitation under section 667(d).* If paragraph (a) of this section is applicable, then in applying the separate limitation (in accordance with section 667(d)(1) (A) and (C)) to determine the amount of foreign taxes deemed distributed under section 666 (b) and (c) that can be credited against the increase in tax in a computation year, a portion of the foreign source taxable income deemed distributed in such computation year shall be treated as United States source income. Such portion shall be determined by multiplying the amount of foreign source taxable income deemed distributed in the computation year by a fraction. The numerator of this fraction is the balance in the taxpayer's overall foreign loss account (after application of §§1.904(f)–1, 1.904(f)–2, 1.904(f)–3, and 1.904(f)–6), and the denominator of the fraction is the entire amount of foreign source taxable income deemed distributed under section 666. However, the numerator of this fraction shall not exceed the denominator of the fraction.

(c) *Recapture if taxpayer deducts foreign taxes deemed distributed.* If paragraph (a) of this section is applicable and if, in accordance with section 667(d)(1)(B), the beneficiary deducted rather than credited its taxes in the computation year, the beneficiary shall reduce its overall foreign loss account (but not below zero) by an amount equal to the lesser of the balance in the applicable overall foreign loss account or the amount of the actual distribution deemed distributed in the computation year (without regard to the foreign taxes deemed distributed).

(d) *Illustrations.* The provisions of this section are illustrated by the following examples:

Example 1. X Corporation is a domestic corporation that has a balance of $10,000 in its general limitation overall foreign loss account on December 31, 1980. For its taxable year beginning January 1, 1981, X's only income is an accumulation distribution from a foreign trust of $20,000 of general limitation foreign source taxable income. Under section 666, the amount distributed and the foreign taxes paid on such amount ($4,000) are deemed distributed in two prior taxable years. In determining the partial tax on such distribution under section 667(b), the amount added to each computation year is $12,000 (the sum of the actual distribution plus the taxes deemed distributed ($24,000) divided by the number of accumulation years (2)). Of that amount, $5,000 ($10,000/$24,000×$12,000) is treated as United States source taxable income in accordance with paragraph (b) of this section. Assuming the United States tax rate is 50 percent, X's separate foreign tax credit limitation against the increase in tax in each computation year is $3,500 ($7,000/$12,000×$6,000) instead of $6,000 ($12,000/$12,000×$6,000). X's overall foreign loss account is reduced to zero in accordance with paragraph (a) of this section.

Example 2. Assume the same facts as in Example 1, except that X deducted rather than credited its foreign taxes in the computation years. In 1979, the amount added to X's income is $12,000 under section 667(b), $2,000 of which is deductible under section 667(d)(1)(B). X must reduce its overall foreign loss account by $10,000, the amount of the actual distribution that is deemed distributed in 1979 (without regard to the $2,000 foreign taxes also deemed distributed). The entire overall foreign loss account is therefore reduced to $0 in 1979.

[T.D. 8153, 52 FR 32002, Aug. 25, 1987]

§ 1.904(f)–5 Special rules for recapture of overall foreign losses of a domestic trust.

(a) *In general.* Except as provided in this section, the rules contained in §§ 1.904(f)–1, 1.904(f)–2, 1.904(f)–3, 1.904(f)–4, and 1.904(f)–6 apply to domestic trusts.

(b) *Recapture of trust's overall foreign loss.* In taxable years in which a trust has foreign source taxable income subject to a separate limitation in which the trust has a balance in its overall foreign loss account, the balance in the trust's overall foreign loss account shall be recaptured as follows:

(1) *Trust accumulates income.* If the trust accumulates all of its foreign source taxable income subject to the same limitation as the loss that created the balance in the overall foreign loss account, its overall foreign loss shall be recaptured out of such income in accordance with §§ 1.904(f)–1, 1.904(f)–2, 1.904(f)–3, 1.904(f)–4, and 1.904(f)–6.

(2) *Trust distributes income.* If the trust distributes all of its foreign source taxable income subject to the same limitation as the loss that created the overall foreign loss account, the amount of the overall foreign loss that would be subject to recapture by the trust under paragraph (b)(1) of this section shall be allocated to the beneficiaries in proportion to the amount of such income which is distributed to each beneficiary in that year.

(3) *Trust accumulates and distributes income.* If the trust accumulates part of its foreign source taxable income subject to the same limitation as the loss that created the overall foreign loss account and distributes part of such income, the portion of the overall foreign loss that would be subject to recapture by the trust under paragraph (b)(1) of this section if the distributed income were accumulated shall be allocated to the beneficiaries receiving income distributions. The amount of overall foreign loss to be allocated to such beneficiaries shall be the same portion of the total amount of such overall foreign loss that would be recaptured as the amount of such income which is distributed to each beneficiary bears to the total amount of such income of the trust for such year. That portion of the overall foreign loss subject to recapture in such year that is not allocated to the beneficiaries in accordance with this paragraph (b)(3) shall be recaptured by the trust in accordance with paragraph (b)(1).

(c) *Amounts allocated to beneficiaries.* Amounts of a trust's overall foreign loss allocated to any beneficiary in accordance with paragraph (b)(2) or (3) of this section shall be added to the beneficiary's applicable overall foreign loss account and treated as an overall foreign loss of the beneficiary incurred in the taxable year preceding the year of such allocation. Such amounts shall be recaptured in accordance with §§ 1.904(f)-1, 1.904(f)-2, 1.904(f)-3, 1.904(f)-4, and 1.904(f)-6 out of foreign source taxable income distributed by the trust which is subject to the same separate limitation.

(d) *Section 904(f)(3) dispositions to which § 1.904(f)-2(d)(4)(i) is applicable.* Foreign source taxable income recognized by a trust under § 1.904(f)-2(d)(4) on a disposition of property used in a trade or business outside the United States shall be deemed to be accumulated by the trust. All such income shall be used to recapture the trust's overall foreign loss in accordance with § 1.904(f)-2(d)(4).

(e) *Illustrations.* The provisions of this section are illustrated by the following examples:

Example 1. T, a domestic trust, has a balance of $2,000 in a general limitation overall foreign loss account on December 31, 1983. For its taxable year ending on December 31, 1984, T has foreign source taxable income subject to the general limitation of $1,600, all of which it accumulates. Under paragraph (b)(1) of this section, T is required to recapture $800 in 1984 (the lesser of the overall foreign loss or 50 percent of the foreign source taxable income). This amount is treated as United States source income for purposes of taxing T in 1984 and upon subsequent distribution to T's beneficiaries. At the end of its 1984 taxable year, T has a balance of $1,200 in its overall foreign loss account.

Example 2. The facts are the same as in example 1. In 1985, T has general limitation foreign source taxable income of $1,000, which it distributes to its beneficiaries as follows: $500 to A, $250 to B, and $250 to C. Under paragraph (b)(1) of this section, T would have been required to recapture $500 of its overall foreign loss if it had accumulated all of such income. Therefore, under paragraph (b)(2) of this section, T must allocate $500 of its overall foreign loss to A, B, and C as follows: $250 to A ($500×$500/$1,000), $125 to B ($500×$250/$1,000), and $125 to C ($500×$250/$1,000). Under paragraph (c) of this section and §1.904(f)-1(d)(4), A, B, and C must add the amounts of general limitation overall foreign loss allocated to them from T to their overall foreign loss accounts and treat such amounts as overall foreign losses incurred in 1984. A, B, and C must then apply the rules of §§1.904(f)-1, 1.904(f)-2, 1.904(f)-3, 1.904(f)-4, and 1.904(f)-6 to recapture their overall foreign losses. T's overall foreign loss account is reduced in accordance with §1.904(f)–1(e)(1) by the $500 that is allocated to A, B, and C. At the end of 1985, T's general limitation overall foreign loss account has a balance of $700.

Example 3. The facts are the same as in example 2, including an overall foreign loss account at the end of 1984 of $1,200, except that in 1985 T's general limitation foreign source taxable income is $1,500 instead of $1,000, and T accumulates the additional $500. Under paragraph (b)(1) of this section, T would be required to recapture $750 of its overall foreign loss if it accumulated all of the $1,500. Under paragraph (b)(3) of this section, T must allocate $500 of its overall foreign loss to A, B, and C as follows: $250 to A ($750×$500/$1,500) and $125 each to B and C (750×$250/$1,500). T must also recapture $250 of its overall foreign loss, which is the amount subject to recapture in 1985 that is not allocated to the beneficiaries ($750−$500=$250). Under §1.904(f)-1(e)(1), T reduces its general limitation overall foreign loss account by $500. Under §1.904(f)-1(e)(2), T reduces its general limitation overall foreign loss account by $250. At the end of 1985 there is a balance in the general limitation overall foreign loss account of $450 (($1,200−$500)−$250).

[T.D. 8153, 52 FR 32002, Aug. 25, 1987; 52 FR 43434, Nov. 12, 1987]

§1.904(f)–6 Transitional rule for recapture of FORI and general limitation overall foreign losses incurred in taxable years beginning before January 1, 1983, from foreign source taxable income subject to the general limitation in taxable years beginning after December 31, 1982.

(a) *General rule.* For taxable years beginning after December 31, 1982, foreign source taxable income subject to the general limitation includes foreign oil related income (as defined in section 907(c)(2) prior to its amendment by section 211 of the Tax Equity and Fiscal Responsibility Act of 1982). However, for purposes of recapturing general limitation overall foreign losses incurred in taxable years beginning before January 1, 1983 (pre-1983) out of foreign source taxable income subject to the general limitation in taxable years beginning after December 31, 1982 (post-1982), the taxpayer shall make separate determinations of foreign oil related income and other general limitation income (as if the FORI limitation under ‘‘old section 907(b)’’ (prior to its amendment by section 211 of the Tax Equity and Fiscal Responsibility Act of 1982) were still in effect), and shall apply the rules set forth in this section. The taxpayer shall maintain separate accounts for its pre-1983 FORI limitation overall foreign losses, its pre-1983 general limitation overall foreign losses (or its pre-1983 section 904(d)(1)(A–C) overall foreign losses if such losses were computed on a combined basis), and its post-1982 general limitation overall foreign losses. The taxpayer shall continue to maintain such separate accounts, make such separate determinations, and apply the rules of this section separately to each account until the earlier of—

(1) Such time as the taxpayer's entire pre-1983 FORI limitation overall foreign loss account and pre-1983 general limitation overall foreign loss account (or, if the taxpayer determined pre-1983 overall foreign losses on a combined basis, the section 904(d)(1)(A–C) account) have been recaptured, or

(2) The end of the taxpayer's 8th post-1982 taxable year, at which time the taxpayer shall add any remaining balance in its pre-1983 FORI limitation account and pre-1983 general limitation overall foreign loss account (or the section 904(d)(1)(A-C) account) to its post-1982 general limitation overall foreign loss account.

(b) *Recapture of pre-1983 FORI and general limitation overall foreign losses from post-1982 income.* A taxpayer having a balance in its pre-1983 FORI limitation overall foreign loss account or its pre-1983 general limitation overall foreign loss account (or its pre-1983 section 904(d)(1)(A–C) account) in a post-1982 taxable year shall recapture such overall foreign loss as follows:

(1) *Recapture from income subject to the same limitation.* The taxpayer shall first apply the rules of §§1.904(f)–1 through

1.904(f)–5 to the taxpayer's separately determined foreign oil related income to recapture the pre-1983 FORI limitation overall foreign loss account, and shall apply such rules to the taxpayer's separately determined general limitation income (exclusive of foreign oil related income) to recapture the pre-1983 general limitation overall foreign loss account (or the section 904(d)(1)(A–C) overall foreign loss account. Rules for determining the recapture of the pre-1983 section 904 (d)(1)(A–C) losses are contained in § 1.904(f)–2(c)(4).

(2) *Recapture from income subject to the other limitation.* The taxpayer shall next apply the rules of §§ 1.904(f)–1 through 1.904(f)–5 to the taxpayer's separately determined foreign oil related income to recapture the pre-1983 general limitation overall foreign loss account (or the section 904(d)(1)(A–C) overall foreign loss account) and shall apply such rules to the taxpayer's separately determined general limitation income to recapture foreign oil related losses to the extent that—

(i) The amount recaptured from such separately determined income under paragraph (b)(1) of this section is less than 50 percent (or such larger percentage as the taxpayer elects) of such separately determined income, and

(ii) The amount recaptured from such separately determined income under this paragraph (b)(2) does not exceed an amount equal to 12½ percent of the balance in the taxpayer's pre-1983 FORI limitation overall foreign loss account or the pre-1983 general limitation overall foreign loss account (or the section 904(d)(1)(A-C) overall foreign loss account) at the beginning of the taxpayer's first post-1982 taxable year, multiplied by the number of post-1982 taxable years (including the year to which this rule is being applied) which have elapsed, less the amount (if any) recaptured in prior post-1982 taxable years under this paragraph (b)(2) from such separately determined income.

The taxpayer may elect to recapture a pre-1983 overall foreign loss from post-1982 income subject to the general limitation at a faster rate than is required by this paragraph (b)(2). This election shall be made in the same manner as an election to recapture more than 50 percent of the income subject to recapture under section 904(f)(1), as provided in § 1.904(f)–2(c)(2).

(c) *Coordination of recapture of pre-1983 and post-1982 overall foreign losses.* A taxpayer incurring a general limitation overall foreign loss in any post-1982 taxable year in which the taxpayer has a balance in a pre-1983 FORI limitation or its pre-1983 general limitation overall foreign loss account (or the section 904(d)(1)(A-C) overall foreign loss account) shall establish a separate overall foreign loss account for such loss. The taxpayer shall recapture its overall foreign losses in succeeding taxable years by first applying the rules of this section to recapture its pre-1983 overall foreign losses, and then applying the rules of §§ 1.904(f)–1 through 1.904(f)–5 to recapture its post-1982 general limitation overall foreign loss. A post-1982 general limitation overall foreign loss is required to be recaptured only to the extent that the amount of foreign source taxable income recharacterized under paragraph (b) of this section is less than 50 percent of the taxpayer's total general limitation foreign source taxable income (including foreign oil related income)) for such taxable year (except as required by section 904(f)(3)). However, a taxpayer may elect to recapture at a faster rate.

(d) *Illustrations.* The provisions of this section are illustrated by the following examples:

Example 1. X Corporation is a domestic corporation which has the calendar year as its taxable year. On December 31, 1982, X has a balance of $1,000 in its section 904(d)(1)(A-C) overall foreign loss account. X does not have a balance in a FORI limitation overall foreign loss account. For 1983, X has income of $1,200, which was subject to the general limitation and includes foreign oil related income of $1,000 and other general limitation income of $200. In 1983, X is required to recapture $225 of its pre-1983 section 904(d)(1)(A-C) overall foreign loss account computed as follows:

Amount recaptured under paragraph (b)(1) of this section	$100

The amount recaptured from general limitation income exclusive of foreign oil related income is the lesser of $1,000 (the pre-1983 loss reflected in the section 904(d)(1)(A-C) overall foreign loss account) or 50 pecent of $200 (the separately determined general limitation income (exclusive of foreign oil related income).

Amount recaptured under paragraph (b)(2) of this section $125

The amount recaptured from foreign oil related income is the lesser of $900 (the remaining pre-1983 section 904(d)(1)(A-C) overall foreign loss account after recapture under paragraph (b)(1) of this section) or 50 percent of $1,000 (the separately determined foreign oil related income), but as limited by paragraph (b)(2)(ii) of this section to (12½ percent of $1,000 x 1)—$0, which is $125.

Total amount recaptured in 1983 ....$225

Example 2. The facts are the same as in example 1, except that X has general limitation income of $50 for 1984 and $600 for 1985, all of which is foreign oil related income. X is required to recapture $25 in 1984 and $225 in 1985 of its pre-1983 section 904(d)(1)(A-C) overall foreign loss account computed as follows:

Amount recaptured under paragraph (b)(2) of this section in 1984 ....$25

The amount recaptured from foreign oil related income is the lesser of $775 (the remaining pre-1983 section 904(d)(1)(A-C) overall foreign loss account or 50 percent of $50 (the separately determined foreign oil related income).This amount is within the limitation of paragraph (b)(2)(ii) of this section, (12½ percent of $1,000 x 2)—$125, which is $125.

Amount recaptured under paragraph (b)(2) of this section in 1985.................$225

The amount recaptured from foreign oil related income is the lesser of $750 (the remaining pre-1983 section 904(d)(1)(A–C) overall foreign loss account) or 50 percent of $600 (the separately determined foreign oil related income), but as limited by paragraph (b)(2)(ii) of this section to (12½ percent of $1,000×3)–($125+$25), which is $225. ($125 is the amount recaptured in 1983 under paragraph (b)(2) of this section, and $25 is the amount recaptured in 1984 under paragraph (b)(2) of this section.)

Example 3. Y Corporation is a domestic corporation which has the calendar year as its taxable year. On December 31, 1982, Y has a balance of $400 in its section 904(d)(1)(A–C) overall foreign loss account. Y does not have a balance in a FORI overall foreign loss account. For 1983, Y has a general limitation overall foreign loss of $200. For 1984, Y has general limitation income of $1,200, all of which is foreign oil related income. In 1984, Y is required to recapture a total of $300 computed as follows:

Amount of pre-1983 overall foreign loss recaptured under paragraph (b)(2) of this section $100

The amount of the pre-1983 section 904(d)(1)(A–C) overall foreign loss account attributable to a general limitation loss recaptured from foreign oil related income is the lesser of $400 (the loss) or 50 percent of $1,200 (the separately determined foreign oil related income), but as limited by paragraph (b)(2)(ii) of this section to (12½ percent of $400×2) − $0, which is $100.

Amount of post-1982 overall foreign loss recaptured under paragraph (c) of this section $200

The amount of post-1982 general limitation overall foreign loss recaptured is the amount computed under §1.904 (f)−2(c)(1), which is the lesser of $200 (the post-1982 loss) or 50 percent of $1,200 (the income), but only to the extent that the amount of pre-1983 loss recaptured under paragraph (b) of this section is less than 50 percent of such income ((50 percent of $1,200)—$100 recaptured under paragraph (b) = $500).

Total amount recaptured in 1984 ....$300

At the end of 1984, Y has a balance in its pre-1983 section 904(d)(1)(A–C) overall foreign loss account of $300, and has reduced its post-1982 general limitation overall foreign loss account to zero.

Example 4. Z is a domestic corporation which has the calendar year as its taxable year. On December 31, 1982, Z has a balance of $400 in its section 904 (d)(1)(A–C) overall foreign loss account, and a balance of $1,000 in its FORI limitation overall foreign loss account. For 1983, Z has general limitation income of $2,000, which includes foreign oil related income of $1,000 and other general limitation income of $1,000. Keeping these amounts separate for purposes of this section, Z is required to recapture a total of $1,000 in 1983, computed as follows:

Amount recaptured under paragraph (b)(1) of this section $900

The amount of pre-1983 section 904(d)(1)(A–C) overall foreign loss account recaptured from general limitation income exclusive of foreign oil related income, in accordance with §1.904 (f)−2(c)(1), is the lesser of $400 (the section 904(d)(1)(A–C) overall foreign loss) or 50 percent of $1,000, the general limitation income exclusive of foreign oil related income), which is $400.

The amount of pre-1983 FORI overall foreign loss recaptured from foreign oil related income, in accordance with §1.904(f)–2(c)(1), is the lesser of $1,000 (the FORI overall foreign loss) or 50 percent of $1,000 (the foreign oil related income), which is $500.

Amount recaptured under paragraph (b)(2) of this section $100

The amount of pre-1983 FORI 907(b) overall foreign loss recaptured from section general limitation income exclusive of foreign oil related income is the lesser of $500 (the remaining balance in that loss account) or 50 percent of $1,000 (the general limitation income exclusive of foreign oil related income), but only to the extent that the amount recaptured from such income under paragraph (b)(1) of this section is less than 50 percent of such income, or $100 (50 percent of $1,000)—$400 recaptured due to section 904(d)(1)(A–C) overall foreign loss account, and only up to the amount permitted by paragraph (b)(2)(ii) of this section, which is (12½ percent of $1,000 x 1)—$0, or $125.

Total amount recaptured in 1983............$1,000

At the end of 1983, Z has reduced its pre-1983 section 904(d)(1)(A–C) overall foreign loss account to zero, and has a balance in its pre-1983 FORI overall foreign loss account of $400.

[T.D. 8153, 52 FR 32003, Aug. 25, 1987; 52 FR 43434, Nov. 12, 1987]

§§ 1.904(f)–7—1.904(f)–11 [Reserved]

§ 1.904(f)–12 Transition rules.

(a) *Recapture in years beginning after December 31, 1986, of overall foreign losses incurred in taxable years beginning before January 1, 1987*—(1) *In general.* If a taxpayer has a balance in an overall foreign loss account at the end of its last taxable year beginning before January 1, 1987 (pre-effective date years), the amount of that balance shall be recaptured in subsequent years by recharacterizing income received in the income category described in section 904(d) as in effect for taxable years beginning after December 31, 1986 (post-effective date years), that is analogous to the income category for which the overall foreign loss account was established, as follows:

(i) Interest income as defined in section 904(d)(1)(A) as in effect for pre-effective date taxable years is analogous to passive income as defined in section 904(d)(1)(A) as in effect for post-effective date years;

(ii) Dividends from a DISC or former DISC as defined in section 904(d)(1)(B) as in effect for pre-effective date taxable years is analogous to dividends from a DISC or former DISC as defined in section 904(d)(1)(F) as in effect for post-effective date taxable years;

(iii) Taxable income attributable to foreign trade income as defined in section 904(d)(1)(C) as in effect for pre-effective date taxable years is analogous to taxable income attributable to foreign trade income as defined in section 904(d)(1)(G) as in effect for post-effective date years;

(iv) Distributions from a FSC (or former FSC) as defined in section 904(d)(1)(D) as in effect for pre-effective date taxable years is analogous to distributions from a FSC (or former FSC) as defined in section 904(d)(1)(H) as in effect for post-effective date taxable years;

(v) For general limitation income as described in section 904(d)(1)(E) as in effect for pre-effective date taxable years, see the special rule in paragraph (a)(2) of this section.

(2) *Rule for general limitation losses*—(i) *In general.* Overall foreign losses incurred in the general limitation category of section 904(d)(1)(E), as in effect for pre-effective date taxable years, that are recaptured in post-effective date taxable years shall be recaptured from the taxpayer's general limitation income, financial services income, shipping income, and dividends from each noncontrolled section 902 corporation. If the sum of the taxpayer's general limitation income, financial services income, shipping income and dividends from each noncontrolled section 902 corporation for a taxable year subject to recapture exceeds the overall foreign loss to be recaptured, then the amount of each type of separate limitation income that will be treated as U.S. source income shall be determined as follows:

$$\text{Overall foreign loss subject to recapture} \times \frac{\text{Amount of income in each separate category from which the loss may be recaptured}}{\text{Sum of income in all separate categories from which the loss may be recaptured.}}$$

This recapture shall be made after the allocation of separate limitation losses pursuant to section 904(f)(5)(B) and before the recharacterization of post-effective date separate limitation income pursuant to section 904(f)(5)(C).

(ii) *Exception.* If a taxpayer can demonstrate to the satisfaction of the district director that an overall foreign loss in the general limitation category of section 904(d)(1)(E), as in effect for pre-effective date taxable years, is attributable, in sums certain, to losses in one or more separate categories of section 904(d)(1) (including for this purpose the passive income category and the high withholding tax interest category), as in effect for post-effective date taxable years, then the taxpayer may recapture the loss (in the amounts demonstrated) from those separate categories only.

(3) *Priority of recapture of overall foreign losses incurred in pre-effective date taxable years.* An overall foreign loss incurred by a taxpayer in pre-effective date taxable years shall be recaptured to the extent thereof before the taxpayer recaptures an overall foreign loss incurred in a post-effective date taxable year.

(4) *Examples.* The following examples illustrate the application of this paragraph (a).

Example 1. X corporation is a domestic corporation which operates a branch in Country Y. For its taxable year ending December 31, 1988, X has $800 of financial services income, $100 of general limitation income and $100 of shipping income. X has a balance of $100 in its general limitation overall foreign loss account which resulted from an overall foreign loss incurred during its 1986 taxable year. X is unable to demonstrate to which of the income categories set forth in section 904(d)(1) as in effect for post-effective date taxable years the loss is attributable. In addition, X has a balance of $100 in its shipping overall foreign loss account attributable to a shipping loss incurred during its 1987 taxable year. X has no other overall foreign loss accounts. Pursuant to section 904(f)(1), the full amount in each of X corporation's overall foreign loss accounts is subject to recapture since $200 (the sum of those amounts) is less than 50% of X's foreign source taxable income for its 1988 taxable year, or $500. X's overall foreign loss incurred during its 1986 taxable year is recaptured before the overall foreign loss incurred during its 1987 taxable year, as follows: $80 ($100×800/1000) of X's financial services income, $10 ($100×100/1000) of X's general limitation income, and $10 (100×100/1000) of X's shipping income will be treated as U.S. source income. The remaining $90 of X corporation's 1988 shipping income will be treated as U.S. source income for the purpose of recapturing X's 100 overall foreign loss attributable to the shipping loss incurred in 1987. $10 remains in X's shipping overall foreign loss account for recapture in subsequent taxable years.

Example 2. The facts are the same as in *Example* 1 except that X has $800 of financial services income, $100 of general limitation income, a $100 dividend from a noncontrolled section 902 corporation and a ($100) shipping loss for its taxable year ending December 31, 1988. Separate limitation losses are allocated pursuant to the rules of section 904(f)(5) before the recapture of overall foreign losses. Therefore, the ($100) shipping loss incurred by X will be allocated to its separate limitation income as follows: $80 ($100×800/1000) will be allocated to X's financial services income, $10 ($100×100/1000) will be allocated to its general limitation income and $10 ($100×100/1000) will be allocated to X's dividend from the noncontrolled section 902 corporation. Accordingly, after allocation of the 1988 shipping loss, X has $720 of financial services income, $90 of general limitation income, and a $90 dividend from the noncontrolled section 902 corporation. Pursuant to section 904(f)(1), the full amount in each of X corporation's overall foreign loss accounts is subject to recapture since $200 (the sum of those amounts) is less than 50% of X's net foreign source taxable income for its 1988 taxable year, or $450. X's overall foreign loss incurred during its 1986 taxable year is recaptured as follows: $80 ($100×720/900) of X's financial services income, $10 ($100×90/900) of its general limitation income and $10 ($100×90/900) of its dividend from the noncontrolled section 902 corporation will be treated as U.S. source income. Accordingly, after application of section 904(f), X has $100 of U.S. source income, $640 of financial services income, $80 of general limitation income and a $80 dividend from the noncontrolled section 902 corporation for its 1988 taxable year. X must establish a separate limitation loss account for each portion of the 1988 shipping loss that was allocated to its financial services income, general limitation income and dividends from the noncontrolled section 902 corporation. X's overall foreign loss account for the 1986 general limitation loss is reduced to zero. X still has a $100 balance in its overall foreign loss account that resulted from the 1987 shipping loss.

Example 3. Y is a domestic corporation which has a branch operation in Country Z. For its 1988 taxable year, Y has $5 of shipping income, $15 of general limitation income and $100 of financial services income. Y has a balance of $100 in its general limitation overall foreign loss account attributable to its 1986 taxable year. Y has no other overall foreign loss accounts. Pursuant to section 904(f)(1), $60 of the overall foreign loss is subject to recapture since 50% of Y's foreign source income for 1988 is less than the balance in its overall foreign loss account. Y can demonstrate that the entire $100 overall foreign loss was attributable to a shipping limitation loss incurred in 1986. Accordingly, only Y's $5 of shipping limitation income received in 1988 will be treated as U.S. source income, Because Y can demonstrate that the 1986 loss was entirely attributable to a shipping loss, none of Y's general limitation income or financial services income received in 1988 will be treated as U.S. source income.

Example 4. The facts are the same as in *Example* 3 except that Y can only demonstrate that $50 of the 1986 overall foreign loss account was attributable to a shipping loss incurred in 1986. Accordingly, Y's $5 of shipping limitation income received in 1988 will be treated as U.S. source income. The remaining $50 of the 1986 overall foreign loss that Y cannot trace to a particular separate limitation will be recaptured and treated as U.S. source income as follows: $43 ($50×100/115) of Y's financial services income will be treated as U.S. source income and $7 ($50×15/115) of Y's general limitation income will be treated as U.S. source income. Y has $45 remaining in its overall foreign loss account to be recaptured from shipping income in a future year.

(b) *Treatment of overall foreign losses that are part of net operating losses incurred in pre-effective date taxable years which are carried forward to post-effective date taxable years*—(1) *Rule.* An overall foreign loss that is part of a net operating loss incurred in a pre-effective date taxable year which is carried forward, pursuant to section 172, to a post-effective date taxable year will be carried forward under the rules of section 904(f)(5) and the regulations under that section. *See also* Notice 89–3, 1989–1 C.B. 623. For this purpose the loss must be allocated to income in the category analogous to the income category set forth in section 904(d) as in effect for pre-effective date taxable years in which the loss occurred. The analogous category shall be determined under the rules of paragraph (a) of this section.

(2) *Example.* The following example illustrates the rule of paragraph (b)(1) of this section.

Example. Z is a domestic corporation which has a branch operation in Country D. For its taxable year ending December 31, 1988, Z has $100 of passive income and $200 of general limitation income. Z also has a $60 net operating loss which was carried forward pursuant to section 172 from its 1986 taxable year. The net operating loss resulted from an overall foreign loss attributable to the general limitation income category. Z can demonstrate that the loss is a shipping loss. Therefore, the net operating loss will be treated as a shipping loss for Z's 1988 taxable year. Pursuant to section 904(f)(5), the shipping loss will be allocated as follows: $20 ($60×100/300) will be allocated to Z's passive income and $40 ($60×200/300) will be allocated to Z's general limitation income. Accordingly, after application of section 904(f), Z has $80 of passive income and $160 of general limitation income for its 1988 taxable year. Although no addition to Z's overall foreign loss account for shipping income will result from the NOL carry forward, shipping income earned by Z in subsequent taxable years, will be subject to recharacterization as a passive income and general limitation income pursuant to the rules set forth in section 904(f)(5).

(c) *Treatment of overall foreign losses that are part of net operating losses incurred in post-effective date taxable years which are carried back to pre-effective date taxable years*—(1) *Allocation to analogous income category.* An overall foreign loss that is part of a net operating loss incurred by the taxpayer in a post-effective date taxable year which is carried back, pursuant to section 172, to a pre-effective date taxable year shall be allocated first to income in the pre-effective date income category analogous to the income category set forth in section 904(d) as in effect for post-effective date taxable years in which the loss occurred. Except for the general limitation income category, the pre-effective date income category that is analogous to a post-effective date income category shall be determined under paragraphs (a)(1) (i) through (iv) of this section. The general limitation income category for pre-effective date years shall be treated as the income category that is analogous to the post-effective date categories for general limitation income, financial services income, shipping income, dividends from each noncontrolled section 902 corporation and high withholding tax interest income. If the net operating loss resulted from separate limitation losses in more than one post-effective date income category and more than one loss is carried back to pre-effective date general limitation income, then the losses shall be allocated to the pre-effective date general limitation income based on the following formula:

$$\text{Pre-effective date general limitation income} \times \frac{\text{Loss in each post-effective date separate limitation category that is analogous to pre-effective date general limitation income}}{\text{Losses in all post-effective categories that are analogous to pre-effective date general limitation income}}$$

(2) *Allocation to U.S. source income.* If an overall foreign loss is carried back to a pre-effective date taxable year and the loss exceeds the foreign source income in the analogous category for the carry back year, the remaining loss shall be allocated against U.S. source income as set forth in § 1.904(f)–3. The amount of the loss that offsets U.S. source income must be added to the taxpayer's overall foreign loss account. An addition to an overall foreign loss account resulting from the carry back of a net operating loss incurred by a taxpayer in a post-effective date taxable year shall be treated as having been incurred by the taxpayer in the year in which the loss arose and shall be subject to recapture pursuant to section 904(f) as in effect for post-effective date taxable years.

(3) *Allocation to other separate limitation categories.* To the extent that an overall foreign loss that is carried back as part of a net operating loss exceeds the separate limitation income to which it is allocated and the U.S. source income of the taxpayer for the taxable year to which the loss is carried, the loss shall be allocated pro rata to other separate limitation income of the taxpayer for the taxable year. However, there shall be no recharacterization of separate limitation income pursuant to section 904(f)(5) as a result of the alloction of such a net operating loss to other separate limitation income of the taxpayer.

(4) *Examples.* The following examples illustrate the rules of paragraph (c) of this section.

Example 1. X is a domestic corporation which has a branch operation in Country A. For its taxable year ending December 31, 1987, X has a $60 net operating loss which is carried back pursuant to section 172 to its taxable year ending December 31, 1985. The net operating loss resulted from a shipping loss; X had no U.S. source income in 1987. X had $20 of general limitation income, $40 of DISC limitation income and $10 of U.S. source income for its 1985 taxable year. The $60 NOL is allocated first to X's 1985 general limitation income to the extent thereof ($20) since the general limitation income category of section 904(d) as in effect for pre-effective date taxable years is the income category that is analogous to shipping income for post-effective date taxable years. Therefore, X has no general limitation income for its 1985 taxable year. Next, pursuant to section 904(f) as in effect for pre-effective date taxable years, the remaining $40 of the NOL is allocated first to X's $10 of U.S. source income and then to $30 of X's DISC limitation income for its 1985 taxable year. Accordingly, X has no U.S. source income and $10 of DISC limitation income for its 1985 taxable year after allocation of the NOL. X has a $10 balance in its shipping overall foreign loss account which is subject to recapture pursuant to section 904(f) as in effect for post-effective date taxable years. X will not be required to recharacterize, pursuant to section 904(f)(5), subsequent shipping income as DISC limitation income.

Example 2. Y is a domestic corporation which has a branch operation in Country B. For its taxable year ending December 31, 1987, X has a $200 net operating loss which is carried back pursuant to section 172 to its taxable year ending December 31, 1986. The net operating loss resulted from a ($100) general limitation loss and a ($100) shipping loss. Y had $100 of general limitation income and $200 of U.S. source income for its taxable year ending December 31, 1986. The separate limitation losses for 1987 are allocated pro rata to Y's 1986 general limitation income as follows: $50 of the ($100) general limitation loss ($100 x 100/200) and $50 of the ($100) shipping loss ($100 x 100/200) is allocated to Y's $100 of 1986 general limitation income. The remaining $50 of Y's general limitation loss and the remaining $50 of Y's shipping loss are allocated to Y's 1986 U.S. source income. Accordingly, Y has no foreign source income and $100 of U.S. source income for its 1986 taxable year. Y has a $50 balance in its general limitation overall foreign loss account and a $50 balance in its shipping overall foreign loss account, both of which will be subject to recapture pursuant to section 904(f) as in effect for post-effective date taxable years.

(d) *Recapture of FORI and general limitation overall foreign losses incurred in taxable years beginning before January 1, 1983.* For taxable years beginning after December 31, 1986, and before January 1, 1991, the rules set forth in § 1.904 (f)–6 shall apply for purposes of recapturing general limitation and foreign oil related income (FORI) overall foreign losses incurred in taxable years beginning before January 1, 1983 (pre-1983). For taxable years beginning after December 31, 1990, the rules set forth in this section shall apply for purposes of recapturing pre-1983 general limitation and FORI overall foreign losses.

(e) *Recapture of pre-1983 overall foreign losses determined on a combined basis.* The rules set forth in paragraph (a)(2) of this section shall apply for purposes of recapturing overall foreign losses incurred in taxable years beginning before January 1, 1983, that were computed on a combined basis in accordance with § 1.904 (f)–1(c) (1).

(f) *Transition rules for taxable years beginning before December 31, 1990.* For transition rules for taxable years beginning before January 1, 1990, see 26 CFR 1.904 (f)–13T as it appeared in the Code of Federal Regulations revised as of April 1, 1990.

[T.D. 8306, 55 FR 31381, Aug. 2, 1990]

§ 1.904(i)–1 Limitation on use of deconsolidation to avoid foreign tax credit limitations.

(a) *General rule.* If two or more includible corporations are affiliates, within the meaning of paragraph (b)(1) of this section, at any time during their taxable years, then, solely for purposes of applying the foreign tax credit provisions of section 59(a), sections 901 through 908, and section 960, the rules of this section will apply.

(1) *Determination of taxable income*—(i) Each affiliate must compute its net taxable income or loss in each separate category (as defined in § 1.904–5(a)(1), and treating U.S. source income or loss as a separate category) without regard to sections 904(f) and 907(c)(4). Only affiliates that are members of the same consolidated group use the consolidated return regulations (other than those under sections 904(f) and 907(c)(4)) in computing such net taxable income or loss. To the extent otherwise applicable, other provisions of the Code and regulations must be used in the determination of an affiliate's net taxable income or loss in a separate category.

(ii) The net taxable income amounts in each separate category determined under paragraph (a)(1)(i) of this section are combined for all affiliates to determine one amount for the group of affiliates in each separate category. However, a net loss of an affiliate (first affiliate) in a separate category determined under paragraph (a)(1)(i) of this section will be combined under this paragraph (a) with net income or loss amounts of other affiliates in the same category only if, and to the extent that, the net loss offsets taxable income, whether U.S. or foreign source, of the first affiliate. The consolidated return regulations that apply the principles of sections 904(f) and 907(c)(4) to consolidated groups will then be applied to the combined amounts in each separate category as if all affiliates were members of a single consolidated group.

(2) *Allocation.* Any net taxable income in a separate category calculated under paragraph (a)(1)(ii) of this section for purposes of the foreign tax credit provisions must then be allocated among the affiliates under any consistently applied reasonable method, taking into account all of the facts and circumstances. A method is consistently applied if used by all affiliates from year to year. Once chosen, an allocation method may be changed only with the consent of the Commissioner. This allocation will only affect the source and foreign tax credit separate limitation character of the income for purposes of the foreign tax credit separate limitation of each affiliate, and will not otherwise affect an affiliate's total net income or loss. This section applies whether the federal income tax consequences of its application favor, or are adverse to, the taxpayer.

(b) *Definitions and special rules*— For purposes of this section only, the following terms will have the meanings specified.

(1) *Affiliate*—(i) *Generally.* Affiliates are includible corporations—

(A) That are members of the same affiliated group, as defined in section 1504(a); or

(B) That would be members of the same affiliated group, as defined in section 1504(a) if—

(*1*) Any non-includible corporation meeting the ownership test of section 1504(a)(2) with respect to any such includible corporation was itself an includible corporation; or

(*2*) The constructive ownership rules of section 1563(e) were applied for purposes of section 1504(a).

(ii) *Rules for consolidated groups.* Affiliates that are members of the same consolidated group are treated as a single affiliate for purposes of this section. The provisions of paragraph (a) of this section shall not apply if the only affiliates under this definition are already members of the same consolidated group without operation of this section.

(iii) *Exception for newly acquired affiliates*—(A) With respect to acquisitions after December 7, 1995, an includible corporation acquired from unrelated third parties (First Corporation) will not be considered an affiliate of another includible corporation (Second Corporation) during the taxable year of the First Corporation beginning before the date on which the First Corporation originally becomes an affiliate with respect to the Second Corporation.

(B) With respect to acquisitions on or before December 7, 1995, an includible corporation acquired from unrelated third parties will not be considered an affiliate of another includible corporation during its taxable year beginning before the date on which the first includible corporation first becomes an affiliate with respect to that other includible corporation.

(C) This exception does not apply where the acquisition of an includible corporation is used to avoid the application of this section.

(2) *Includible corporation.* The term *includible corporation* has the same meaning it has in section 1504(b).

(c) *Taxable years.* If all of the affiliates use the same U.S. taxable year, then that taxable year must be used for purposes of applying this section. If, however, the affiliates use more than one U.S. taxable year, then an appropriate taxable year must be used for applying this section. The determination whether a taxable year is appropriate must take into account all of the relevant facts and circumstances, including the U.S. taxable years used by the affiliates for general U.S. income tax purposes. The taxable year chosen by the affiliates for purposes of applying this section must be used consistently from year to year. The taxable year may be changed only with the prior consent of the Commissioner. Those affiliates that do not use the year determined under this paragraph (c) as their U.S. taxable year for general U.S. income tax purposes must, for purposes of this section, use their U.S. taxable year or years ending within the taxable year determined under this paragraph (c). If, however, the stock of an affiliate is disposed of so that it ceases to be an affiliate, then the taxable year of that affiliate will be considered to end on the disposition date for purposes of this section.

(d) *Consistent treatment of foreign taxes paid.* All affiliates must consistently either elect under section 901(a) to claim a credit for foreign income taxes paid or accrued, or deemed paid or accrued, or deduct foreign taxes paid or accrued under section 164. See also §1.1502–4(a); §1.905–1(a).

(e) *Effective date.* Except as provided in paragraph (b)(1)(iii) of this section (relating to newly acquired affiliates), this section is effective for taxable years of affiliates beginning after December 31, 1993.

[T.D. 8627, 60 FR 56119, Nov. 7, 1995]

§1.905–1 When credit for taxes may be taken.

(a) *In general.* The credit for taxes provided in subpart A (section 901 and following), part III, subchapter N, chapter 1 of the Code, may ordinarily be taken either in the return for the year in which the taxes accrued or in which the taxes were paid, dependent upon whether the accounts of the taxpayer are kept and his returns filed using an accrual method or using the cash receipts and disbursements method. Section 905(a) allows the taxpayer, at his option and irrespective of the method of accounting employed in keeping his books, to take such credit for taxes as may be allowable in the return for the year in which the taxes accrued. An election thus made under section 905(a) (or under the corresponding provisions of prior internal revenue laws) must be followed in returns for all subsequent years, and no portion of any such taxes accrued in a year in which a credit is claimed will be allowed as a deduction from gross income in any year. See also § 1.905–4.

(b) *Foreign income subject to exchange controls.* If, however, under the provisions of the regulations under section 461, an amount otherwise constituting gross income for the taxable year from sources without the United States is, owing to monetary, exchange, or other restrictions imposed by a foreign country, not includible in gross income of the taxpayer for such year, the credit for income taxes imposed by such foreign country with respect to such amount shall be taken proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income.

§ 1.905–2 Conditions of allowance of credit.

(a) *Forms and information.* (1) Whenever the taxpayer chooses, in accordance with paragraph (d) of § 1.901–1, to claim the benefits of the foreign tax credit, the claim for credit shall be accompanied by Form 1116 in the case of an individual or by Form 1118 in the case of a corporation.

(2) The form must be carefully filled in with all the information called for and with the calculations of credits indicated. Except where it is established to the satisfaction of the district director that it is impossible for the taxpayer to furnish such evidence, the taxpayer must provide upon request the receipt for each such tax payment if credit is sought for taxes already paid or the return on which each such accrued tax was based if credit is sought for taxes accrued. The receipt or return must be either the original, a duplicate original, or a duly certified or authenticated copy. The preceding two sentences are applicable for returns whose original due date falls on or after January 1, 1988. Any additional information necessary for the determination under part I (section 861 and following), subchapter N, chapter 1 of the Code, of the amount of income derived from sources without the United States and from each foreign country shall, upon the request of the district director, be furnished by the taxpayer. If the taxpayer upon request fails without justification to furnish any such additional information which is significant, including any significant information which he is requested to furnish pursuant to § 1.861–8(f)(5) as proposed in the FEDERAL REGISTER for November 8, 1976, the District Director may disallow the claim of the taxpayer to the benefits of the foreign tax credit.

(b) *Secondary evidence.* Where it has been established to the satisfaction of the District Director that it is impossible to furnish a receipt for such foreign tax payment, the foreign tax return, or direct evidence of the amount of tax withheld at the source, the District Director, may, in his discretion, accept secondary evidence thereof as follows:

(1) *Receipt for payment.* In the absence of a receipt for payment of foreign taxes there shall be submitted a photostatic copy of the check, draft, or other medium of payment showing the amount and date thereof, with certification identifying it with the tax claimed to have been paid, together with evidence establishing that the tax was paid for taxpayer's account as his own tax on his own income. If credit is claimed on an accrual method, it must be shown that the tax accrued in the taxable year.

(2) *Foreign tax return.* If the foreign tax return is not available, the foreign tax has not been paid, and credit is claimed on an accrual method, there shall be submitted—

(i) A certified statement of the amount shall be submitted—

(ii) Excerpts from the taxpayer's accounts showing amounts of foreign income and tax thereon accrued on its books.

(iii) A computation of the foreign tax based on income from the foreign country carried on the books and at current rates of tax to be established by data such as excerpts from the foreign law, assessment notices, or other documentary evidence thereof.

(iv) A bond, if deemed necessary by the District Director, filed in the manner provided in cases where the foreign return is available, and

(v) In case a bond is not required, a specific agreement wherein the taxpayer shall recognize its liability to report the correct amount of tax when ascertained, as required by the provisions of section 905 (c).

If at any time the foreign tax receipts or foreign tax returns become available to the taxpayer, they shall be promptly submitted to the district director.

(3) *Tax withheld at source.* In the case of taxes withheld at the source from dividends, interest, royalties, compensation, or other form of income, where evidence of withholding and of the amount withheld cannot be secured from those who have made the payments, the district director may, in his discretion, accept secondary evidence of such withholding and of the amount of the tax so withheld, having due regard to the taxpayer's books of account and to the rates of taxation prevailing in the particular foreign country during the period involved.

(c) *Credit for taxes accrued but not paid.* In the case of a credit sought for a tax accrued but not paid, the district director may, as a condition precedent to the allowance of a credit, require a bond from the taxpayer, in addition to Form 1116 or 1118. If such a bond is required, Form 1117 shall be used by an individual or by a corporation. It shall be in such sum as the Commissioner may prescribe, and shall be conditioned for the payment by the taxpayer of any amount of tax found due upon any redetermination of the tax made necessary by such credit proving incorrect, with such further conditions as the district director may require. This bond shall be executed by the taxpayer, or the agent or representative of the taxpayer, as principal, and by sureties satisfactory to and approved by the Commissioner. See also 6 U.S.C. 15.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7292, 38 FR 33300, Dec. 3, 1973; 38 FR 34802, Dec. 19, 1973; T.D. 7456, 42 FR 1214, Jan. 6, 1977; T.D. 8210, 53 FR 23613, June 23, 1988; T.D. 8412, 57 FR 20653, May 14, 1992; T.D. 8759, 63 FR 3813, Jan. 27, 1998]

§1.905–3T Adjustments to the pools of foreign taxes and earnings and profits when the allowable foreign tax credit changes (temporary).

(a) *Foreign tax redeterminations subject to sections 985 through 989 of the Internal Revenue Code.* This section applies to a foreign tax redetermination that occurs in a taxpayer's taxable year beginning after December 31, 1986 with respect to—

(1) Tax that is paid or accrued by or on behalf of a taxpayer (including taxes paid or accrued prior to January 1, 1987), or

(2) Tax that is deemed paid or accrued by a taxpayer under section 902 or section 960 with respect to earnings and profits of a foreign corporation accumulated in taxable years of the foreign corporation beginning after December 31, 1986.

(b) *Currency translation rules*—(1) *Accrual of foreign tax.* Accrued and unpaid foreign tax liabilities denominated in foreign currency, as determined under foreign law, shall be translated into dollars at the exchange rate as of the last day of the taxable year of the taxpayer.

(2) *Payments of foreign tax.* Foreign tax liabilities denominated in foreign currency shall be translated into dollars at the rate of exchange for the date of the payment of the foreign tax. Tax withheld in foreign currency shall be translated into dollars at the rate for the date on which the tax is withheld. Estimated tax paid in foreign currency shall be translated into dollars at the rate for the date on which the estimated tax payment is made.

(3) *Refunds of foreign tax.* A refund of foreign tax shall be translated into dollars using the exchange rate for the date of the payment of the foreign taxes. If a refund of foreign tax relates to foreign taxes paid on more than one date, then the refund shall be deemed to be derived from, and shall reduce, the last payment of foreign taxes first, to the extent thereof. See §1.905–3T(d)(3) relating to the method of adjustment of a foreign corporation's pools of earnings and profits and foreign taxes.

(4) *Allocation of refunds of foreign tax.* Refunds of foreign tax shall be allocated to the same separate category as

foreign taxes to which the refunded taxes relate. Refunds are related to foreign taxes of a separate category if the foreign tax that was refunded was imposed with respect to that separate category. See section 904(d) and § 1.904–6 concerning the allocation of taxes to separate categories of income. Earnings and profits of a foreign corporation in the separate category to which the refund relates shall be increased to reflect the foreign tax refund.

(5) *Basis of foreign currency refunded.* A recipient of a refund of foreign tax shall detemine its basis in the currency refunded under the following rules.

(i) If the functional currency of the qualified business unit (as defined in section 989 and the regulations thereunder, hereinafter ''QBU'') that paid the tax and received the refund is the United States dollar or the person receiving the refund is not a QBU, then the recipient's basis in the foreign currency refunded shall be the dollar value of the refund determined, under paragraph (b)(2) of this section, on the date the foreign tax was paid.

(ii) If the functional currency of the QBU receiving the refund is not the United States dollar and is different from the currency in which the foreign tax was paid, then the recipient's basis in the foreign currency refunded shall be equal to the functional currency value of the non-functional refunded translated into functional currency at the exchange rate between the functional currency and the non-functional currency, determined under paragraph (b)(2) of this section, on the date the foreign tax was paid.

(iii) If the functional currency of the QBU receiving the refund is the currency in which the refund was made, then the recipient's basis in the currency received shall be the amount of the functional currency received.

For purposes of determining exchange gain or loss on the initial payment of foreign tax in a non-functional currency, see section 988. For purposes of determining subsequent exchange gain or loss on the disposition of non-functional currency the basis of which is determined under this rule, see section 988.

(c) *Foreign tax redetermination.* For purposes of this section, the term ''foreign tax redetermination'' means a change in the foreign tax liability/ that may affect a United States taxpayer's foreign tax credit. A foreign tax redetermination includes—

(1) A refund of foreign taxes;

(2) A difference between the dollar value of the accrued foreign tax and the dollar value of the foreign tax actually paid attributable to differences in the units of foreign currency paid and the units of foreign currency accrued; or

(3) A difference between the dollar value of the accrued foreign tax and the dollar value of the foreign tax actually paid attributable to fluctuations in the value of the foreign currency relative to the dollar between the date of accrual and the date of payment.

(d) *Redetermination of United States tax liability*—(1) *Foreign taxes paid directly by a United States person.* If a foreign tax redetermination occurs with respect to foreign tax paid or accrued by or on behalf of a United States taxpayer, then a redetermination of the United States tax liability is required for the taxable year for which the foreign tax was claimed as a credit. See § 1.905–4T(b) which requires notification to the Internal Revenue Service of a foreign tax redetermination in situations in which a redetermination of United States liability is required. However, a redetermination of United States tax liability is not required (and a taxpayer need not notify the Service) if the foreign tax redetermination is described in paragraph (c)(3) (that is, it is caused solely by a foreign currency fluctuation), and the amount of the foreign tax redetermination with respect to the foreign country is less than the lesser of ten thousand dollars or two percent of the total dollar amount of the foreign tax initially accrued with respect to that foreign country for the taxable year. In such case, an appropriate adjustment shall be made to the taxpayer's United States tax liability in the taxable year during which the foreign tax redetermination occurs.

(2) *Foreign taxes deemed paid under sections 902 or 960*—(i) *Redetermination of the United States tax liability not required.* Subject to the special rule of paragraph (d)(4), a redetermination of

United States tax liability is not required to account for the effect of a redetermination of foreign tax paid or accrued by a foreign corporation on the foreign taxes deemed paid by a United States corporation under sections 902 or 960. Instead, adjustments shall be made, and notification of such adjustments shall be filed, as required by paragraphs (d) (2) and (3) of this section.

(ii) *Adjustments to pools.* In the case of a foreign tax redetermination that affects the amount of foreign taxes deemed paid by a United States corporation for a taxable year—

(A) If the foreign tax redetermination occurs more than 90 days before the due date (determined with extensions) of the United States taxpayer's United States income tax return for such taxable year and before the taxpayer actually files that return, then that United States taxpayer shall adjust the foreign tax credit to be claimed on that return for such taxable year to account for the effect of the foreign tax redetermination (including the impact of the foreign tax redetermination on the earnings and profits of the foreign corporation);

(B) If a foreign tax redetermination occurs after the filing of the United States tax return for such taxable year, than appropriate upward or downward adjustments shall be made at the time of the foreign tax redetermination to the pool of foreign taxes and the pool of earnings and profits of the foreign corporation as provided in paragraph (d)(3) to reflect the effect of the foreign tax redetermination in calculating foreign taxes deemed paid with respect to distributions and inclusions (and the amount of such distributions and inclusions) that are includible in taxable years subsequent to the taxable year for which such tax return is filed; and

(C) If the foreign tax redetermination occurs within 90 days of the due date (determined with extensions) of the United States tax return and before the taxpayer actually files its tax return, then the taxpayer may elect either to adjust the foreign tax credit to be claimed on that return in the manner described in subparagraph (A) of this paragraph (d)(2)(ii) or adjust the pools of foreign taxes and earnings and profits to reflect the effect of the foreign tax redetermination in the manner described in paragraph (d)(2)(ii)(B), provided that consistent elections are made by the taxpayer and all other members of the affiliated group, as defined in section 1504(a), of which the taxpayer is a member, with respect to all foreign tax redeterminations occurring on or before any date within the 90 day period.

(iii) *Reporting requirements.* If an adjustment to the appropriate pool of foreign taxes and earnings and profits is required under paragraphs (d)(2)(ii) (B) or (C), the United States corporation shall attach a notice of such adjustment to its return for the year with or within which ends the foreign corporation's taxable year during which the foreign tax redetermination occurs. The United States corporation shall provide: its name and identifying number; the foreign corporation's name, address, and identifying number (if any); the amount of any refunds of foreign taxes and the exchange rate as of the time of the original payment of the refunded foreign taxes; the amounts of unrefunded foreign taxes when paid and when accrued in foreign currency, the exchange rates for the accrual and payment dates of unrefunded foreign taxes, and the dollar amounts of unrefunded foreign taxes paid and accrued; the current balances of the pools of earnings and profits and foreign taxes before and after the foreign tax redetermination; and such other information as the Service may require. If a taxpayer may be required to redetermine its United States tax liability under paragraph (d)(4)(ii) of § 1.905–3T (relating to foreign tax adjustments of two percent or more), the notice shall specifically identify foreign tax adjustments described in such paragraph and shall include a complete factual description justifying the overaccrual of foreign tax. If the United States corporation fails to attach the required notice, to provide the necessary information, or to make the required adjustments, then it must provide notification of the foreign tax redetermination under § 1.905–4T. The Service may, in its discretion, make a redetermination of United States tax liability, and subject the taxpayer to the interest provisions of section 6601 and the penalty provisions of section 6689 and the regulations thereunder.

(iv) *Examples.* The following examples illustrate the application of paragraph (d)(2) (ii) and (iii) of this section. In each case, the exceptions of paragraph (d)(4) do not apply.

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. P is a fiscal year taxpayer whose taxable year ends on June 30. P does not request an extension for filing its United States tax return for the taxable year ending June 30, 1988 and files its return on its September 15, 1988 due date. S is a calendar year taxpayer. In 1987, S earned 100u of subpart F income and accrued foreign taxes with respect to that income of 20u. At the time of accrual, the exchange rate was $1:4u. S paid the 20u of accrued tax with respect to its income on June 15, 1988, when the exchange rate was $1:2u. P includes the 100u in gross income under section 951(a) and claims a credit under section 960. P must use the amount of taxes actually paid by S (20u=$10) in determining foreign taxes deemed paid by P. Pursuant to paragraph (d)(2)(ii)(A), P is required to compute foreign taxes deemed paid taking into account the foreign tax redetermination that occurred on June 15, which was more than 90 days before the due date of P's tax return (September 15, 1988) and before P actually filed its return.

Example 2. The facts are the same as in *Example* 1, except that S paid its tax liability on October 16, 1988. P filed its United States income tax return for 1987 on September 15, 1987, before the foreign tax redetermination. P properly computed its section 960 credit on its 1987 return with respect to its 100u subpart F inclusion on the basis of the amount of accrued foreign tax. Subject to the special rule of paragraph (d)(3)(iv), P is required, pursuant to the provisions of paragraph (d)(2)(ii)(B), to make the appropriate adjustments to the relevant pool of foreign taxes and pool of earnings and profits for purposes of calculating foreign taxes deemed paid in subsequent taxable years.

Example 3. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation, P. P is a fiscal year (June 30) taxpayer, and S is a calendar year taxpayer. In 1987, S earned 100u of general limitation manufacturing income that was not subpart F income. S accrued 40u in foreign tax with respect to that income as of the end of its taxable year when the exchange rate was $1:4u. During 1987 and 1988, P received no distributions (and had no section 951(a)(1) inclusions) from S. S paid its taxes on March 15, 1988 when the exchange rate was $1:2u (40u=$20). S received a refund of foreign tax of 20u on July 1, 1988. No section 905 (c) adjustment is required on these facts. As of the end of 1988, S's pool of general limitation accumulated earnings and profits equals 80u (100u − 20u), and its pool of foreign taxes imposed on general limitation income equals $10 (40u − 20u=20u, translated as of the date of payment ($1:2u), equals $10)

(3) *Adjustments to the pools of earnings and profits and foreign taxes*—(i) *In general.* If a foreign corporation is required to adjust its earnings and profits and foreign taxes under § 1.905–3T(d)(2)(ii) (B) or (C), then that adjustment shall be made in accordance with the provisions of this section.

(ii) *Refunds of foreign taxes.* A foreign corporation shall reduce its pool of foreign taxes in the appropriate separate category by the United States dollar amount of a foreign tax refund translated as provided in paragraph (b)(3). A foreign corporation shall increase its pools of earnings and profits in the appropriate separate category by the functional currency amount of the foreign tax refund. The allocation of the refund to the appropriate separate categories shall be made in accordance with §§ 1.905–3T(b)(4) and 1.904–6. If a foreign corporation receives a refund of foreign tax in a currency other than its functional currency, that refund shall be translated into its functional currency, for purposes of computing the increase to its pool of earnings and profits, at the exchange rate as of the date of the payment of the foreign tax.

(iii) *Additional assessments of foreign tax.* A foreign corporation shall increase its pool of foreign taxes in the appropriate separate category by the United States dollar amount of the additional foreign tax paid or accrued translated as provided in paragraphs (b) (1) and (2). A foreign corporation shall decrease its earnings and profits in the appropriate separate category by the functional currency amount of the additional foreign tax paid or accrued. The allocation of the additional amount of foreign tax among separate categories shall be made in accordance with § 1.904–6.

(iv) *Refunds of foreign taxes of lower tier foreign corporations that cause deficits in foreign tax pools.* If a lower tier foreign corporation receives a refund of foreign tax after making a distribution to an upper tier foreign corporation and the refund would have the effect of reducing below zero the lower tier corporation's pool of foreign taxes in any separate category, then both the lower tier and upper tier corporations shall adjust the appropriate pool of foreign taxes to reflect that refund. The upper tier foreign corporation shall adjust its pool of foreign taxes by the difference between the United States dollar amount of foreign tax deemed paid by the upper tier foreign corporation prior to the refund and the United States dollar amount of foreign tax recomputed as if the refund occurred prior to the distribution. The upper tier foreign corporation shall not make any adjustment to its earnings and profits because foreign taxes deemed paid by the upper tier corporation are not included in the upper tier corporation's earnings and profits. The lower tier foreign corporation shall adjust its pool of foreign taxes by the difference between the United States dollar amount of the refund and the United States dollar amount of the adjustment to the upper tier foreign corporation's pool of foreign taxes. The earnings and profits of the lower tier foreign corporation shall be adjusted to reflect the full amount of the refund. The provisions of this paragraph (d)(3)(iv) do not apply to distributions or inclusions to a United States person. See §1.905–3T(d)(4)(iv) for rules relating to actual or deemed distributions made to a United States person.

(v) *Examples.* The following examples illustrate the application of this paragraph (d)(3).

Example 1. Controlled foreign corporation (CFC) is a wholly-owned subsidiary of its domestic parent, P. Both CFC and P are calendar year taxpayers. CFC has a functional currency, the u, other than the dollar and maintains its pool of earnings and profits in that currency. At the end of year 1, CFC paid 100u in taxes with respect to non-subpart F income when the exchange rate was $1:1u. In year 2, on a date that is after P filed its United States tax return, CFC receives a refund of 50u of its year 1 taxes. CFC made no distributions to P in year 1. In accordance with paragraph (d)(3)(ii) and subject to paragraph (d)(4), CFC shall reduce its pool of foreign taxes by $50 and increase its pool of earnings and profits by 50u.

Example 2. Controlled foreign corporation (CFC) is a wholly-owned subsidiary of its domestic parent, P. Both CFC and P are calendar year taxpayers. In year 1 CFC earned 400u of general limitation manufacturing income and 200u of shipping income. On date 1, CFC paid 200u of foreign tax, 100u with respect to general limitation manufacturing income, and 100u with respect to shipping income. On date 1, the exchange rate is $1:1u. On date 2, a date that is after the filing of P's United States tax return, CFC receives a refund of 75u, 25u of which is related to the manufacturing income and 50u of which is related to the shipping income. Subject to paragraph (d)(4), CFC shall reduce its pools of foreign taxes related to general limitation income and shipping income by $25 and $50, respectively (because the refund is translated at the rate of exchange prevailing on the date of payment of the foreign tax), and increase the respective pools of earnings and profits by 25u and 50u (because the earnings and profits are increased by the functional currency amount of the refund received). If the refund to CFC was not specifically related to any separate category of income, CFC, pursuant to §1.904–6, is required to allocate that refund in accordance with the provisions of that section.

Example 3. CFC1 is a foreign corporation that is wholly-owned by P, a domestic corporation. CFC2 is a foreign corporation that is wholly-owned by CFC1. Unless stated otherwise, the exchange rate is always $1.1u. In year 1, CFC2 has earnings and profits of 100u (net of foreign taxes) and paid 100u in foreign taxes with respect to those earnings. CFC2 has no income and pays no foreign taxes in years 2 and 3. CFC1 has no earnings and profits other than those resulting from distributions from CFC2 and pays no foreign taxes.

Situation (i). In year 2, CFC2 receives a refund of foreign taxes of 25u. In year 3, CFC2 makes a distribution of CFC1 of 50u. CFC1 is deemed to have paid $30 of foreign taxes with respect to that distribution (50u/125u×$75). At the end of year 3, the following reflects the pools of earnings and profits and foreign taxes of CFC1 and CFC2.

	Earnings and profits(u)	Foreign taxes
CFC2:		
Y1	100	$100
Y2	100+25=125	$100 – <$25>=$75
Y3	125 – <50>=75	$75 – <$30>=$45
CFC1:		
Y3	50	30

Situation (ii). The facts are the same as situation (i), except that CFC2 makes a distribution of 50u in year 2 and receives a refund of 75u in year 3. In year 2 the amount of foreign taxes deemed paid by CFC1 would be $50 (50u/100u×$100). Both CFC1 and CFC2 must adjust their pools of foreign taxes in year 3 because the year 3 refund would have the effect of reducing below zero CFC2's pool of foreign taxes. CFC1 reduces its pool of foreign taxes by $42.86 determined as follows: $50 (foreign taxes deemed paid on the distribution from CFC2) −$7.14 (the foreign taxes that would have been deemed paid had the refund occurred prior to the distribution (50u/175u×$25)). CFC2 reduces its pool of foreign taxes by $32.14 (the difference between the dollar value of 75u refund determined as of the date of payment of the foreign tax and the $42.86 adjustment to CFC1's pool of foreign taxes). At the end of year 3, the following reflects the pools of foreign taxes and earnings and profits for CFC1 and CFC2.

	Earnings and profits(u)	Foreign taxes
CFC2:		
Y1	100	$100
Y2	100 − <50>=50	$100 − <$50>=$50
Y3	50+75=125	$50 − <$32.14>=$17.86
CFC1:		
Y2	50	$50
Y3	50	$50 − <$42.86>=$7.14

(4) *Exceptions.* The provisions of paragraph (d)(2) of this section shall not apply and a redetermination of United States tax liability is required to account for the effect of a redetermination of foreign tax on foreign taxes deemed paid by a United States corporation under section 902 or section 960 to the extent provided in this paragraph (d)(4).

(i) *Hyperinflationary currencies.* A redetermination of United States tax liability is required if the foreign tax liability is in a hyperinflationary currency. The term ''hyperinflationary currency'' means the currency of a country in which there is cumulative inflation during the base period of at least 100% as determined by reference to the consumer price index of the country listed in the monthly issues of International Financial Statistics, or a successor publication, of the International Monetary Fund. ''Base period'' means, with respect to any taxable year, the thirty-six calendar months immediately preceding the last day of such taxable year (see § 1.985–2T(b)(2)).

(ii) *Foreign tax adjustment of two percent or more.* If the foreign tax liability of a United States taxpayer is in a currency other than a hyperinflationary currency and the amount of foreign tax accrued for the taxable year to a foreign country, as measured in units of foreign currency, exceeds the amount of foreign tax paid to that foreign country for the taxable year (as measured in units of foreign currency) by at least two percent, then the Service, in its discretion, may require a redetermination of United States tax liability.

(iii) *Example.* The provisions of paragraph (d)(4)(ii) are illustrated by the following example.

Example. Controlled foreign corporation is a wholly-owned subsidiary of its domestic parent, P. Both CFC and P are calendar year taxpayers. In year 1, CFC has general limitation income of 200u and, by year-end, had accrued foreign taxes with respect to that income of 100u when the exchange rate is $1:1u. In year 1, CFC makes a distribution to P of 50u, half of its earnings and profits of 100u. P is deemed to have paid $50 of foreign tax with respect to that distribution (50u/100u × $100). In year 2, after P has filed its United States tax return, CFC pays its actual foreign tax liability of 98.50 when the exchange rate is $1:1u. Subject to paragraph (d)(4), CFC must reduce its pool of foreign taxes by $1.50 and increase the corresponding pool of earnings and profits by 1.50u. (The refund is translated into dollars at the rate of exchange prevailing on the date of payment of the foreign tax, and the adjustment to earnings and profits is in ''u''s.) In year 2, CFC earns 200u of general limitation income and accrues 120u of tax when the exchange rate is $1:1u. In year 2, CFC distributes 100u to P. P is deemed to have paid $128 of foreign tax (($48.50 + $120) × 100u/(51.50u + 80u)). In year 3, after P filed its year 2 United States tax return, CFC pays its actual year 2 tax liability of 100u when the exchange rate is $1:1u. The Service may require P to recompute its year 2 United States tax liability to account for the effect of the overaccrual of foreign tax pursuant to § 1.905–3T(d)(4)(ii).

(iv) *Deficit in foreign tax pool.* A redetermination of United States tax liability is required if a foreign tax redetermination occurs with respect to foreign taxes deemed paid with respect to a subpart F inclusion or an actual distribution which has the effect of reducing below zero the distributing foreign corporation's pool of foreign taxes in any separate category. Whether a foreign corporation's pool of foreign taxes is reduced below zero shall be determined at the close of the taxable year of the foreign corporation in which the foreign tax redetermination occurred. In no case shall taxes paid or accrued with respect to one separate category be applied to offset a negative balance in any other separate category.

(v) *Example.* The provisions of paragraph (d)(4)(iv) are illustrated by the following example.

Example. Controlled foreign corporation (CFC) is a wholly-owned subsidiary of P, a domestic corporation. Both P and CFC are calendar year taxpayers. In year 1, CFC has 200u of general limitation income with respect to which 100 of taxes are paid when the exchange rate was $1:1u. In year 1, CFC distributes half (50u) of its earnings and profits (100u). Under section 902, P is deemed to have paid $50 of the foreign taxes paid by CFC with respect to that distribution (50u/100u × $100). In year 2, CFC receives a refund of all of its year 1 taxes (100u). In year 2, CFC earns an additional 290u of income—200u of shipping income with respect to which 100u of taxes are paid, and 90u of general limitation income with respect to which 45u of taxes are paid when the exchange rate was $1:1u. P is required to redetermine its year 1 United States tax liability to account for the foreign tax redetermination occurring in year 2 because, if an adjustment to CFC's pool of general limitation taxes were made, the pool would be <$5≤. CFC is not permitted to carry a deficit in any pool of foreign taxes; therefore, P must redetermine its United States liability for year 1.

(e) *Foreign tax imposed on foreign refund.* If the redetermination of foreign tax for a taxable year or years is occasioned by the refund to the taxpayer of taxes paid to a foreign country or possession of the United States and the foreign country or possession imposed tax on the refund, then the amount of the refund shall be considered to be reduced by the amount of any tax described in section 901 imposed by the foreign country or possession of the United States with respect to such refund. In such case, no other credit under section 901, and no deduction under section 164, shall be allowed for any taxable year with respect to such tax imposed on such refund.

(f) *Reduction of corporate level tax on distribution of earnings and profits.* If a United States shareholder of a controlled foreign corporation receives a distribution out of previously taxed earnings and profits and a foreign country has imposed tax on the income of the controlled foreign corporation, which tax is reduced on distribution of the earnings and profits of the corporation, then the United States shareholder shall redetermine its United States tax liability for the year or years affected.

[T.D. 8210, 53 FR 23613, June 23, 1988]

§ 1.905–4T Notification and redetermination of United States tax liability (temporary).

(a) *Application of this section.* The rules of this section shall apply if, as a result of a foreign tax redetermination as defined in § 1.905–3T(c), a redetermination of United States tax liability is required under § 1.905–3T.

(b) *Notification*—(1) *General rules.* Any United States taxpayer for which a redetermination of United States tax liability is required shall notify the Secretary in the manner described in this paragraph (b), and the Service will redetermine the United States tax liability of the United States taxpayer. Notification shall be made by filing Form 1120X or 1040X, and Form 1118 or 1116, in the manner described in the instructions to Form 1118 with the Service Center where the taxpayer filed the tax return claiming the foreign tax credit to which the notice relates. Notification shall be filed within the time prescribed by and shall contain the information required by this paragraph (b). The amount of tax, if any, due upon a redetermination shall be paid by the taxpayer after notice and demand has been made by the Service. Subchapter B of chapter 63 of the Code (relating to deficiency procedures) shall not apply with respect to the assessment of the amount due upon such redetermination. In accordance with section 905(c) and section 6501(c)(5), the amount of additional tax due shall be assessed and collected without regard to the provisions of section 6401(a) (relating to limitations on assessment and collection). The amount of tax, if any, shown by a redetermination to have been overpaid shall be credited or refunded to the taxpayer in accordance with the provisions of § 301.6511(d)–3.

(2) *Time for filing.* If a redetermination of United States tax liability is necessitated by a foreign tax redetermination that reduced the amount of foreign taxes paid or deemed paid, then the United States taxpayer shall file the notification with respect to such foreign tax redetermination within 180

days after the date the foreign tax redetermination occurs. If a redetermination of United States liability is necessitated by a foreign tax redetermination that increased the amount of foreign taxes paid or deemed paid, then the United States taxpayer claiming foreign tax credits for accrued foreign taxes must notify the Service within the period provided by section 6511(d)(3)(A). Filing of the appropriate notification within the prescribed time shall constitute a claim for the refund of United States tax.

(3) *Notification contents*—(i) *In general.* The taxpayer shall provide the Service with information sufficient to redetermine the tax including, but not limited to the following: the United States taxpayer's name, address, and identifying number; the taxable year or years of the taxpayer that are affected by the redetermination of United States tax liability; information required in paragraph (b) (ii) and (iii) below the respect to foreign tax redeterminations affecting the redetermination of United States tax liability, including information in a form that will enable the Service to verify and compare the original computations with respect to a claimed foreign tax credit, the revised computations resulting from the foreign tax redeterminations, and the net changes resulting therefrom.

(ii) *Direct foreign tax credit.* In the case of foreign taxes paid by or on behalf of the taxpayer, if—

(A) The taxpayer receives a refund of foreign tax, the taxpayer's information shall include: the amount of foreign taxes paid in foreign currency; the date or dates the foreign taxes were paid; the rate of exchange on each date the foreign taxes were paid; the amount of the foreign taxes refunded in foreign currency;

(B) The foreign taxes when paid differ from the accrued amounts claimed as credits by the taxpayer because of fluctuation in the value of the foreign currency in which the foreign taxes were paid, the taxpayer's information shall include the following: the date on which foreign taxes were accrued and the dates on which the foreign taxes were paid; the rates of exchange for each such date; and the amount of foreign taxes accrued or paid in foreign currency on each such date;

(C) The foreign taxes when paid differ from accrued amounts claimed as credits by the taxpayer because the taxpayer is assessed additional or less foreign tax, the taxpayer's information shall include the following: the original amounts and information described in subdivision (B) of this paragraph (b)(3)(ii); the amount of additional or reduced foreign tax in foreign currency; and the revised amounts and information described in subdivision (B) of this paragraph (b)(3)(ii).

(iii) *Foreign taxes deemed paid.* In the case of foreign taxes paid or accrued by a foreign corporation that are deemed paid or accrued under section 902 or section 960 and with respect to which the taxpayer is required to redetermine its United States tax liability, the United States taxpayer's information shall include the following: the foreign corporation's name and identifying number (if any); the dates and amounts of any dividend distributions or other inclusions made out of earnings and profits for the affected year or years; and the amount of earnings and profits from which such dividends were paid for the affected year or years; and information described in paragraph (b)(3)(ii) as applied to the foreign corporation. In the case of a failure to attach the required notification or to make the required adjustments described in §1.905–3T(d)(2)(iii), the taxpayer's information shall also include a complete factual description justifying that failure.

(c) *Interest and penalty*—(1) *General rules.* If a foreign tax redetermination results in a redetermination of United States tax liability, then interest shall be computed on the deficiency or overpayment in accordance with sections 6601 and 6611 and the regulations thereunder. No interest shall be assessed or collected on any deficiency resulting from a refund of foreign tax for any period before the receipt of the refund, except to the extent interest was paid by the foreign country or possession of the United States on the refund for the period. In no case, however, shall interest assessed and collected pursuant to the preceding sentence for any period before receipt of the refund exceed the amount that otherwise would have been assessed and collected under section 6601 and the regulations thereunder for that period. Interest shall be assessed from the time the taxpayer (or the foreign corporation of which the taxpayer is a shareholder) receives a refund until the taxpayer pays the additional tax due the United States.

(2) *No interest on adjustments to pools of foreign taxes.* A deficiency or overpayment of United States tax liability does not result from a redetermination of foreign tax unless a redetermination of United States liability is required. Consequently, no interest will be paid by or to a United States corporation as a result of adjustments by a foreign corporation to its pools of foreign taxes and earnings and profits under paragraph (d)(2) of § 1.905–3T.

(3) *Imposition of penalty.* Failure to comply with the provisions of this section shall subject the taxpayer to the penalty provisions of section 6689 and the regulations thereunder.

(d) *Effective date.* The provisions of this section apply to foreign tax redeterminations described in § 1.905–3T(a). Notwithstanding paragraph (b)(2) of this section (relating to time for filing the required notice), the taxpayer shall have 180 days after the publication of an Announcement in the Internal Revenue Bulletin notifying taxpayers of the availability of the Forms and instructions to comply with the provisions of this section. In no case, however, shall this paragraph (d) operate to extend the statute of limitations provided by section 6511(d)(3)(A).

[T.D. 8210, 53 FR 23617, June 23, 1988]

§ 1.905–5T Foreign tax redeterminations and currency translation rules for foreign tax redeterminations occurring in taxable years beginning prior to January 1, 1987 (temporary).

(a) *In general.* This section sets forth rules governing the application of section 905(c) to foreign tax redeterminations occurring prior to January 1, 1987. However, the rules of this section also apply to foreign tax redeterminations occurring after December 31, 1986 with respect to foreign tax deemed paid under section 902 or section 960 with respect to earnings and profits accumulated in taxable years of a foreign corporation beginning prior to January 1, 1987.

(b) *Currency translation rules*—(1) *Foreign taxes paid by the taxpayer and certain foreign taxes deemed paid.* Foreign taxes paid in foreign currency that are paid by or on behalf of a taxpayer or deemed paid under section 960 (or under section 902 in a deemed distribution under section 1248) shall be translated into dollars at the rate of exchange for the date of the payment of the foreign tax. Refunds of such taxes shall be translated into dollars at the rate of exchange for the date of the refund.

(2) *Foreign taxes deemed paid on an actual distribution.* Foreign taxes deemed paid by a taxpayer under section 902 with respect to an actual distribution and refunds of such taxes shall be translated into dollars at the rate of exchange for the date of the distribution of the earnings to which the taxes relate.

(c) *Foreign tax redetermination.* The term ‘‘foreign tax redetermination’’ means a foreign tax redetermination as defined in § 1.905–3T(c).

(d) *Redetermination of United States tax liability*—(1) *In general.* A redetermination of United States tax liability is required with respect to any foreign tax redetermination subject to this section and shall be subject to the requirements of § 1.905–4T(b). The content of the notification required by this paragraph (d) shall be the same as provided in § 1.905–4(b)(3), except as modified by paragraphs (d) (2), (3), and (4) of this section.

(2) *Refunds.* In the case of any refund of foreign tax, the rate of exchange on the date of the refund shall be included in the information required by § 1.905–4T(b)(3)(ii)(A).

(3) *Foreign taxes deemed paid under section 902.* In the case of foreign taxes paid or accrued by a foreign corporation that are deemed paid or accrued under section 902 with respect to an actual distribution and with respect to which there was a redetermination of foreign tax, the United States taxpayer's information shall include, in lieu of the information required by paragraph (b)(3)(iii), the following: the foreign corporation's name and identifying number (if any); the date on

which the foreign taxes were accrued and the dates on which the foreign taxes were paid; the amounts of the foreign taxes accrued or paid in foreign currency on each such date; the dates on which any foreign taxes were refunded and the amounts thereof; the dates and amounts of any dividend distributions made out of earnings and profits for the affected year or years; the rate of exchange on the date of any such distribution; and the amount of earnings and profits from which such dividends were paid for the affected year or years.

(4) *Foreign taxes deemed paid under section 960.* In the case of foreign taxes paid under section 960 (or under section 902 in the case of an amount treated as a dividend under section 1248), the rate of exchange determined under § 1.964–1 for translating accrued foreign taxes shall be included in the information required by § 1.905–4T(b)(3)(iii) in lieu of the exchange rate for the date of the accrual.

(e) *Exception for de minimis currency fluctuations.* A United States taxpayer need not notify the Service of a foreign tax redetermination that results solely from a currency fluctuation if the amount of such redetermination with respect to the foreign country is less than the lesser of ten thousand dollars or two percent of the total dollar amount of the foreign tax, prior to the adjustment, initially accrued with respect to that foreign country for the taxable year.

(f) *Special effective date.* If a foreign tax redetermination within the meaning of this section occurs after December 31, 1979, and before July 25, 1988, and the taxpayer has not notified the Service before that date of the redetermination as required under § 1.905–3 as it appeared in the CFR dated April 1, 1988, then the taxpayer shall have 180 days after the publication of an Announcement in the Internal Revenue Bulletin notifying taxpayers of the availability of the Forms and instructions to comply with the provisions of this section. Failure to comply with the provisions of this section shall subject the taxpayer to the penalty provisions of section 6689 and the regulations thereunder. In no case, however, shall this paragraph operate to extend the statute of limitations provided by section 6511(d)(3)(A).

[T.D. 8210, 53 FR 23618, June 23, 1988]

§ 1.907–0 Outline of regulation provisions for section 907.

This section lists the paragraphs contained in §§ 1.907(a)–0 through 1.907(f)–1.

§ 1.907(a)–0 Introduction (for taxable years beginning after December 31, 1982).

(a) Effective dates.
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(d) Reduction of creditable FORI taxes.
(e) FOGEI and FORI.
(f) Posted prices.
(g) Transitional rules.
(h) Section 907(f) carrybacks and carryovers.
(i) Statutes covered.

§ 1.907(a)–1 Reduction in taxes paid on FOGEI (for taxable years beginning after December 31, 1982).

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§ 1.907(c)–1 Definitions relating to FOGEI and FORI (for taxable years beginning after December 31, 1982).

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(c) Carryover of foreign oil extraction losses.
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(2) Directly related services.
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(5) Gross income.
(h) Coordination with other provisions.
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§1.907(c)–2 Section 907(c)(3) items (for taxable years beginning after December 31, 1982).

(a) Scope.
(b) Dividend.
(1) Section 1248.
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(c) Taxes deemed paid.
(1) Voting stock test.
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(d) Amount attributable to certain items.
(1) Certain dividends.
(2) Interest received from certain foreign corporations.
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(6) Special rule.
(7) Deficits.
(8) Illustrations.
(e) Dividends, interest, and other amounts from sources within a possession.
(f) Income from partnerships, trusts, etc.

§1.907(c)–3 FOGEI and FORI taxes (for taxable years beginning after December 31, 1982).

(a) Tax characterization, allocation and apportionment.
(1) Scope.
(2) Three classes of income.
(3) More than one class in a foreign tax base.
(4) Allocation of tax within a base.
(5) Modified gross income.
(6) Allocation of tax credits.
(7) Withholding taxes.
(b) Dividends.
(1) In general.
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(c) Includable amounts under section 951(a).
(d) Partnerships.
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§1.907(d)–1 Disregard of posted prices for purposes of chapter 1 of the Code (for taxable years beginning after December 31, 1982).

(a) In general.
(1) Scope.
(2) Initial computation requirement.
(3) Burden of proof.
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(b) Adjustments.
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(1) Foreign government.
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(3) Posted price.
(4) Other pricing arrangement.
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§1.907(f)–1 Carryback and carryover of credits disallowed by section 907(a) (for amounts carried between taxable years that each begin after December 31, 1982).

(a) In general.
(b) Unused FOGEI.
(1) In general.
(2) Year of origin.
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(d) Excess extraction limitation.
(e) Excess general section 904 limitation.
(f) Section 907(f) priority.
(g) Cross-reference.
(h) Example.

[T.D. 8338, 56 FR 11063, Mar. 15, 1991; 56 FR 21926, May 13, 1991; T.D. 8655, 61 FR 516, Jan. 8, 1996]

§1.907(a)–0 Introduction (for taxable years beginning after December 31, 1982).

(a) *Effective dates.* The provisions of §§1.907(a)–0 through 1.907(f)–1 apply to taxable years beginning after December 31, 1982. For provisions that apply to taxable years beginning before January 1, 1983, see §§1.907(a)–0A through 1.907(f)–1A.

(b) *Key terms.* For purposes of the regulations under section 907—

(1) *FOGEI* means foreign oil and gas extraction income.

(2) *FORI* means foreign oil related income.

(3) *FOGEI taxes* mean foreign oil and gas extraction taxes as defined in section 907(c)(5).

(4) *FORI taxes* means foreign taxes on foreign oil related income. See § 1.907(c)–3.

(c) *FOGEI tax limitation.* Section 907(a) limits the foreign tax credit for taxes paid or accrued on FOGEI. See § 1.907(a)–1.

(d) *Reduction of creditable FORI taxes.* Section 907(b) recharacterizes FORI taxes as non-creditable deductible expenses to the extent that the foreign law imposing the FORI taxes is structured, or in fact operates, so that the amount of tax imposed with respect to FORI will be materially greater, over a reasonable period of time, than the amount generally imposed on income that is neither FOGEI nor FORI. See § 1.907(b)–1.

(e) *FOGEI and FORI.* FOGEI includes the taxable income from the extraction of minerals from oil or gas wells by a taxpayer (or another person) and from the sale or exchange of assets used in the extraction business. FORI includes taxable income from the activities of processing oil and gas into their primary products, transporting or distributing oil and gas and their primary products, and from the disposition of assets used in these activities. For this purpose, a disposition includes only a sale or exchange. FOGEI and FORI may also include taxable income from the performance of related services or from the lease of related property and certain dividends, interest, or amounts described in section 951(a). See §§ 1.907(c)–1 through 1.907(c)–3.

(f) *Posted prices.* Certain sales prices are disregarded when computing FOGEI for purposes of chapter 1 of the Code. See § 1.907(d)–1.

(g) *Transitional rules.* Section 907(e) provides rules for the carryover of unused FOGEI taxes from taxable years beginning before January 1, 1983, and carryback of FOGEI taxes arising in taxable years beginning after December 31, 1982. See § 1.907(e)–1.

(h) *Section 907(f) carrybacks and carryovers.* FOGEI taxes disallowed under section 907(a) may be carried back or forward to other taxable years. These FOGEI taxes may be absorbed in another taxable year to the extent of the lesser of the separate excess extraction limitation or the excess limitation in the general limitation category (section 904(d)(1)(I)) for the carryback or carryover year. See § 1.907(f)–1.

(i) *Statutes covered.* The regulations under section 907 are issued as a result of the enactment of section 601 of the Tax Reduction Act of 1975, of section 1035 of the Tax Reform Act of 1976, of section 301(b)(14) of the Revenue Act of 1978, of section 211 of the Tax Equity and Fiscal Responsibility Act of 1982 and of section 1012(g)(6) (A)–(B) of the Technical and Miscellaneous Revenue Act of 1988.

[T.D. 8338, 56 FR 11065, Mar. 15, 1991]

§ 1.907(a)–1 Reduction in taxes paid on FOGEI (for taxable years beginning after December 31, 1982).

(a) *Amount of reduction.* FOGEI taxes are reduced by the amount by which they exceed a limitation level (as defined in paragraph (c) of this section).

(b) *Foreign taxes paid or accrued.* For purposes of the regulations under section 907—

(1) *Foreign taxes.* The term ''foreign taxes'' means income, war profits, or excess profits taxes of foreign countries or possessions of the United States otherwise creditable under section 901 (including those creditable by reason of section 903).

(2) *Foreign taxes paid or accrued.* The terms ''foreign taxes paid or accrued,'' ''FOGEI taxes paid or accrued,'' and ''FORI taxes paid or accrued'' include foreign taxes deemed paid under sections 902 and 960. Unless otherwise expressly provided, these terms do not include foreign taxes deemed paid by reason of sections 904(c) and 907(f).

(c) *Limitation level*—(1) *In general.* The limitation level is FOGEI for the taxable year multiplied by the limitation percentage for that year.

(2) *Limitation percentage for corporations.* A corporation's limitation percentage is the highest rate of tax specified in section 11(b) for the particular year.

(3) *Limitation percentage for individuals.* Section 907(a)(2)(B) provides that the limitation percentage for individual taxpayers is the effective rate of tax for those taxpayers. The effective rate of tax is computed by dividing the entire tax, before the credit under section 901(a) is taken, by the taxpayer's entire taxable income.

(4) *Losses.* (i) For purposes of determining whether income is FOGEI, a taxpayer's FOGEI will be recharacterized as foreign source non-FOGEI to the extent that FOGEI losses for preceding taxable years beginning after December 31, 1982, exceed the amount of FOGEI already recharacterized. See §1.907(c)–1(c). However, taxes that were paid or accrued on the recharacterized FOGEI will remain FOGEI taxes.

(ii) Taxes paid or accrued by a person to a foreign country may be FOGEI taxes even though that person has under U.S. law a net operating loss from sources within that country.

(iii) For purposes of determining whether income is FOGEI, a taxpayer's income will be treated as income from sources outside the United States even though all or a portion of that income may be resourced as income from sources within the United States under section 904(f) (1) and (4).

(5) *Priority.* (i) Section 907(a) applies before section 908, relating to reduction of credit for participation in or cooperation with an international boycott.

(ii) Section 901(f) (relating to certain payments with respect to oil and gas not considered as taxes) applies before section 907.

(d) *Illustrations.* Paragraphs (a) through (c) of this section are illustrated by the following examples.

Example 1. M, a U.S. corporation, uses the accrual method of accounting and the calendar year as its taxable year. For 1984, M has $20,000 of FOGEI, derived from operations in foreign countries X and Y, and has accrued $11,500 of foreign taxes with respect to FOGEI. The highest tax rate specified in section 11(b) for M's 1984 taxable year is 46 percent. Pursuant to section 907(a), M's FOGEI taxes limitation level for 1984 is $9,200 (46%×$20,000). The foreign taxes in excess of this limitation level ($2,300) may be carried back or forward. See section 907(f) and §1.907(f)–1 and section 907(e) and §1.907(e)–1.

Example 2. The facts are the same as in *Example 1* except that M is a partnership owned equally by U.S. citizens A and B who each file as unmarried individuals and do not itemize deductions. Pursuant to section 905(a), A and B have elected to credit foreign taxes in the year accrued. The total amount of foreign taxes accrued by A and B with respect to their distributive shares of M's FOGEI is $11,500 ($5,750 accrued by A and $5,750 accrued by B). A and B have no other FOGEI. A's only taxable income for 1984 is his 50% distributive share ($10,000) of M's FOGEI and A has a preliminary U.S. tax liability of $1,079. B has $112,130 of taxable income for 1984 (including his 50% distributive share ($10,000) of M's FOGEI) and has a preliminary U.S. tax liability of $44,000. Pursuant to section 907(a), A's FOGEI taxes limitation level for 1984 is $1,079 (($1,079/$10,000)×$10,000) and B's FOGEI taxes limitation level for 1984 is $3,924 (($44,000/$112,130)×$10,000).

(e) *Effect on other provisions*—(1) *Deduction denied.* If a credit is claimed under section 901, no deduction under section 164(a)(3) is allowed for the amount of the FOGEI taxes that exceed a taxpayer's limitation level for the taxable year. See section 275(a)(4)(A). Thus, FOGEI taxes disallowed under section 907(a) are not added to the cost or inventory amount of oil or gas.

(2) *Reduction inapplicable.* The reduction under section 907(a) does not apply to a taxpayer that deducts foreign taxes and does not claim the benefits of section 901 for a taxable year.

(3) *Section 78 dividend.* The reduction under section 907(a) has no effect on the amount of foreign taxes that are treated as dividends under section 78.

(f) *Section 904 limitation.* FOGEI taxes as reduced under section 907(a) are creditable only to the extent permitted by the general limitation of section 904(d)(1)(I).

[T.D. 8338, 56 FR 11066, Mar. 15, 1991]

§1.907(b)–1 Reduction of creditable FORI taxes (for taxable years beginning after December 31, 1982).

If the foreign law imposing a FORI tax (as defined in §1.907(c)–3) is either structured in a manner, or operates in a manner, so that the amount of tax imposed on FORI is generally materially greater than the tax imposed by the foreign law on income that is neither FORI nor FOGEI (“described manner”), section 907(b) provides a special rule which limits the amount of FORI taxes paid or accrued by a person to a foreign country which will be considered income, war profits, or excess profits taxes. Section 907(b) will apply to a person regardless of whether that person is a dual capacity taxpayer as defined in §1.901–2(a)(2)(ii)(A). (In general, a dual capacity taxpayer is a person who pays an amount to a foreign country part of which is attributable to an income tax and the remainder of which is a payment for a specific economic benefit derived from that country.) Foreign law imposing a tax on FORI will be considered either to be structured in or to operate in the described manner only if, under the facts and circumstances, there has been a shifting of tax by the foreign country from a tax on FOGEI to a tax on FORI.

[T.D. 8338, 56 FR 11066, Mar. 15, 1991]

§ 1.907(c)–1 Definitions relating to FOGEI and FORI (for taxable years beginning after December 31, 1982).

(a) *Scope.* This section explains the meaning to be given certain terms and items in section 907(c) (1), (2), and (4). See also §§ 1.907(a)–0(b) and 1.907(c)–2 for further definitions.

(b) *FOGEI*—(1) *General rule.* Under section 907(c)(1), FOGEI means taxable income (or loss) derived from sources outside the United States and its possessions from the extraction (by the taxpayer or any other person) of minerals from oil or gas wells located outside the United States and its possessions or from the sale or exchange of assets used by the taxpayer in the trade or business of extracting those minerals. Extraction of minerals from oil or gas wells will result in gross income from extraction in every case in which that person has an economic interest in the minerals in place. For other circumstances in which gross income from extraction may arise, see paragraph (b)(3) of this section. For determination of the amount of gross income from extraction, see paragraph (b)(2) of this section. For definition of the phrase ‘‘assets used by the taxpayer in the trade or business’’ and for rules relating to that type of FOGEI, see paragraph (e)(1) of this section. The term ‘‘minerals’’ is defined in paragraph (f)(1) of this section. For determination of taxable income, see paragraph (f)(2) of this section. FOGEI includes, in addition, items listed in section 907(c)(3) (relating to dividends, interest, partnership distributions, etc.) and explained in § 1.907(c)–2. For the reduction of what would otherwise be FOGEI by losses incurred in a prior year, see section 907(c)(4) and paragraph (c) of this section.

(2) *Amount.* The gross income from extraction is determined by reference to the fair market value of the minerals in the immediate vicinity of the well. Fair market value is determined under paragraph (b)(6) of this section.

(3) *Other circumstances.* Gross income from extraction or the sale or exchange of assets described in section 907(c)(1)(B) includes income from any arrangement, or a combination of arrangements or transactions, to the extent the income is in substance attributable to the extraction of minerals or such a sale or exchange. For instance, a person may have gross income from such a sale or exchange if the person purchased minerals from a foreign government at a discount and the discount reflects an arm’s-length amount in consideration for the government’s nationalization of assets that person owned and used in the extraction of minerals.

(4) *Income directly related to extraction.* Gross income from extraction includes directly related income under paragraph (g) of this section.

(5) *Income not included.* FOGEI as otherwise determined under this paragraph (b), nevertheless, does not include income to the extent attributable to marketing, distributing, processing or transporting minerals or primary products. Income from the purchase and sale of minerals is not ordinarily FOGEI. If the foreign taxes paid or accrued in connection with income from a purchase and sale are not creditable by reason of section 901(f), that income is not FOGEI. A taxpayer to whom section 901(f) applies is not a producer.

(6) *Fair market value.* For purposes of this paragraph (b), the fair market value of oil or gas in the immediate vicinity of the well depends on all of the facts and circumstances as they exist relative to a party in any particular case. The facts and circumstances that may be taken into account include, but are not limited to, the following—

(i) The facts and circumstances pertaining to an independent market value (if any) in the immediate vicinity of the well,

(ii) The facts and circumstances pertaining to the relationships between the taxpayer and the foreign government. If an independent fair market value in the immediate vicinity of the well cannot be determined but fair market value at the port, or a similar point, in the foreign country can be determined (port price), an analysis of the arrangement between the taxpayer and the foreign government that retains a share of production could be evidence of the appropriate, arm's-length difference between the port price and the field price, and

(iii) The other facts and circumstances pertaining to any difference in the producing country between the field and port prices.

(7) *Economic interest.* For purposes of this paragraph (b), the term ''economic interest'' means an economic interest as defined in §1.611–1(b)(1), whether or not a deduction for depletion is allowable under section 611.

(c) *Carryover of foreign oil extraction losses*—(1) *In general.* Pursuant to section 907(c)(4), the determination of FOGEI for a particular taxable year takes into account a foreign oil extraction loss incurred in prior taxable years beginning after December 31, 1982. There is no time limitation on this carryover of foreign oil extraction losses. Section 907(c)(4) does not provide for any carryback of these losses. Section 907(c)(4) operates solely for purposes of determining FOGEI and thus operates independently of section 904(f).

(2) *Reduction.* That portion of the income of the taxpayer for the taxable year which but for this paragraph (c) would be treated as FOGEI is reduced (but not below zero) by the excess of—

(i) The aggregate amount of foreign oil extraction losses for preceding taxable years beginning after December 31, 1982, over

(ii) The aggregate amount of reductions under this paragraph (c) for preceding taxable years beginning after December 31, 1982.

(3) *Foreign oil extraction loss defined*—(i) *In general.* For purposes of this paragraph (c), the term ''foreign oil extraction loss'' means the amount by which the gross income for the taxable year that is taken into account in determining FOGEI for that year is exceeded by the sum of the deductions properly allocated and apportioned to that gross income as determined under paragraph (f)(2) of this section). A person can have a foreign oil extraction loss for a taxable year even if the person has not chosen the benefits of section 901 for that year.

(ii) *Items not taken into account.* For purposes of paragraph (c)(3)(i) of this section, the following items are not taken into account—

(A) The net operating loss deduction allowable for the taxable year under section 172(a),

(B) Any foreign expropriation loss (as defined in section 172(h)) for the taxable year, and

(C) Any loss for the taxable year which arises from fire, storm, shipwreck, or other casualty, or from theft.

A loss mentioned in paragraph (c)(3)(ii) (B) or (C) of this section is taken into account, however, to the extent compensation (for instance by insurance) for the loss is included in gross income.

(4) *Affiliated groups.* The foreign oil extraction loss of an affiliated group of corporations (within the meaning of section 1504(a)) that files a consolidated return is determined on a group basis. If the group does not have a foreign oil extraction loss, the foreign oil extraction loss of a member of that group will not reduce on a separate basis that member's FOGEI for a later taxable year. For special rules affecting the foreign oil extraction loss in the case of certain related domestic corporations that are not members of the same affiliated group, see section 904(i).

(5) *FOGEI taxes.* If FOGEI is reduced pursuant to this paragraph (c) (and thereby recharacterized as non-FOGEI income), any foreign taxes imposed on the FOGEI that is recharacterized as other income retain their character as FOGEI taxes. See section 907(c)(5).

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

Example 1 —(i) *Facts.* X, a U.S. corporation using the accrual method of accounting and the calendar year as its taxable year, is engaged in extraction activities in three foreign countries. X has only the following combined foreign tax items for the three countries (prior to the application of this paragraph (c)) for 1983, 1984, and 1985:

	1983	1984	1985
FOGEI	$(700)	$100	$450
FOGEI taxes	10	60	200
Net operating loss deduction	(200)	0	0
Foreign oil extraction loss allowable after adjustment for paragraph (c)(3)(ii) amounts	(500)	0	0
General limitation taxes other than FOGEI taxes	30	90	230

(ii) *1983.* Because X's FOGEI for 1983 is a loss of $(700), X's section 907(a) limitation for 1983 is $0 (.46×$0). Thus, none of the FOGEI taxes paid or accrued in 1983 ($10) can be credited in 1983. They can, however, be carried back to 1981 or 1982 pursuant to the provisions of section 907(e)(2) and § 1.907(e)–1 and carried forward pursuant to the provisions of section 907(f) and § 1.907(f)–1.

(iii) *1984.* X's FOGEI for 1984, prior to the application of this paragraph (c), is $100. X has a foreign oil extraction loss for 1983 of $(500). This loss must be applied against X's preliminary FOGEI of $100 for 1984. Thus, X's FOGEI for 1984 is $0 and X has $(400) ($500 − $100) of foreign oil extraction loss from 1983 to be carried to 1985. Since X's FOGEI for 1984 is $0, its section 907(a) limitation is $0 (.46×$0). Therefore, none of the FOGEI taxes paid or accrued in 1984 ($60) can be credited in 1984. They can, however, be carried back pursuant to the provisions of section 907(e)(2) and § 1.907(e)–1 and carried forward pursuant to the provisions of section 907(f) and § 1.907(f)–1.

(iv) *1985.* X's FOGEI for 1985, prior to the application of this paragraph (c), is $450. X's remaining foreign oil extraction loss carryover from 1983 is $(400) and this must be applied against X's preliminary FOGEI of $450 for 1985. Thus, X's FOGEI for 1984 is $50 ($450 − $400). X's section 907 (a) limitation is $23 (.46×$50). Therefore, $23 of the FOGEI taxes paid or accrued in 1985, together with the other $230 of general limitation taxes, can be credited in 1985, subject to the general limitation of section 904(d)(1)(E) (as in effect prior to 1987). The excess of FOGEI taxes, $177 ($200 − $23), can be carried back pursuant to the provisions of section 907(e)(2) and § 1.907(e)–1 and carried forward pursuant to the provisions of section 907(f) and § 1.907(f)–1.

Example 2 —(i) *Facts.* The facts are the same as in *Example 1* except that X's paragraph (c)(3)(ii) items for 1983 allocable to FOGEI are $(800) instead of $(200). FOGEI remains a loss of $(700). Thus, X does not have a foreign oil extraction loss for 1983 because it has $100 of FOGEI when its paragraph (c)(3)(ii) items are not taken into account ($(700)+$800).

(ii) *1983.* The results are the same as in Example 1.

(iii) *1984.* Although X had FOGEI loss of $(700) in 1983, there is not a loss that can be carried forward after adjustment for paragraph (c)(3)(ii) items. Thus, X's FOGEI for 1984 is not reduced by the 1983 loss. X's section 907(a) limitation for 1984 is $46 (.46×$100). Therefore, $46 of the FOGEI taxes paid or accrued in 1984, together with the other $90 of general limitation taxes, can be credited in 1984, subject to the general limitation of section 904(d)(1)(E) (as in effect prior to 1987). The excess of $14 ($60 − $46) can be carried back to 1982 pursuant to the provisions of section 907(e)(2) and § 1.907(e)–1 and carried forward pursuant to the provisions of section 907(f) and § 1.907(f)–1.

(iv) *1985.* Since there is no foreign oil extraction loss for either 1983 or 1984 to be applied in 1985, X's FOGEI for 1985 is $450. Thus, its section 907(a) limitation for 1985 is $207 (.46×$450) and all of its FOGEI taxes paid or accrued in 1985 ($200), together with the other $230 of general limitation taxes, can be credited in 1985, subject to the general limitation of section 904(d)(1)(E) (as in effect prior to 1987). FOGEI taxes in the amount of $10 from 1983 and $14 from 1984 may be carried forward to 1985 if they have not been used in carryback years. However, because the excess section 907(a) limitation for 1985 is only $7, that is the maximum potential FOGEI taxes from 1983 or 1984 that may be used in 1985.

Example 3 —(i) *Facts.* Y, a U.S. corporation using the accrual method of accounting and the calendar year as its taxable year, is engaged in extraction activities in three foreign countries. Y's only foreign taxable income is income subject to the general limitation of section 904(d)(1)(E) (as in effect prior to 1987). Y has no paragraph (c)(3)(ii) items. Y has the following foreign tax items for 1983 and 1984:

	1983	1984
FOGEI	$(400)	$300
Other foreign taxable income	250	200
U.S. taxable income	1,000	1,100
Worldwide taxable income	850	1,600
FOGEI taxes	10	180
Other general limitation taxes	50	40
Foreign oil extraction loss	(400)	0

(ii) *1983*—(A) *Section 907(a) limitation.* Because Y's FOGEI for 1983 is a loss of $(400), Y's section 907(a) limitation for 1983 is $0. Thus, none of the FOGEI taxes paid or accrued in 1983 ($10) can be credited in 1983. They can, however, be carried back to 1981 or 1982 pursuant to the provisions of section 907(e)(2) and § 1.907(e)–1 and carried forward pursuant to the provisions of section 907(f) and § 1.907(f)–1.

(B) *Section 904(d) fraction.* Y has a foreign loss of $(150) ($(400 + $250) for 1983. Thus, its fraction for purposes of determining its general limitation of section 904(d)(1)(E) is $0/$850.

(iii) *1984*—(A) *Section 907(a) limitation.* Y's foreign oil extraction loss for 1983 is $(400).

Applying this loss to its preliminary FOGEI for 1984 ($300) eliminates all of Y's FOGEI for 1984. Because Y's FOGEI for 1984 is $0, its section 907(a) limitation is also $0. Thus, none of the FOGEI taxes paid or accrued in 1984 ($180) can be credited in 1984. They can, however, be carried back to 1982 pursuant to the provisions of section 907(e)(2) and §1.907(e)–1 and carried forward pursuant to the provisions of section 907(f) and §1.907(f)–1. Y has a remaining foreign oil extraction loss of $(100) from 1983 to be carried to 1985.

(B) *Section 904(d) fraction.* Y's preliminary foreign taxable income for purposes of determining its general limitation of section 904(d)(1)(E) is $500 ($300 + $200). However, Y has an overall foreign loss from 1983 of $(150) ($(400) + $250) and thus, pursuant to section 904(f), Y must recharacterize $150 (lesser of $150 or 50% of $500) of its 1984 foreign taxable income as U.S. taxable income. Thus, Y's fraction for purposes of determining its general limitation of section 904(d)(1)(E) for 1984 is $350/$1,600.

Example 4 —(i) *Facts.* Assume the same facts as in *Example 3* except that Y has the following foreign tax items:

	1983	1984	1985
FOGEI		$(100)	$225
Other foreign source taxable income subject to the general limitation of section 904(d)(1)(E)	$(50)		
U.S. source taxable income	50		
Worldwide taxable income		(100)	225
FOGEI taxes		10	125
Foreign oil extraction loss		(100)	

(ii) *1983.* For 1983, Y has a section 904(d)(1)(E) overall foreign loss account of $50; see section 904(f) and §1.904(f)–1(b).

(iii) *1984.* Because Y's FOGEI for 1984 is a loss of $(100), Y's section 907(a) limitation for 1984 is $0. Thus, none of the FOGEI taxes paid or accrued in 1984 ($10) can be credited in 1984. They can, however, be carried back under the provisions of section 907(e)(2) and §1.907(e)–1 and carried forward under the provisions of section 907(f) and §1.907(f)–1.

(iv) *1985.* Y's FOGEI loss of $(100) for 1984 is carried forward to 1985 and offsets FOGEI income in that amount in 1985. The entire section 904(d)(1)(E) overall foreign loss account of $50 is recaptured in 1985; therefore, Y has $75 of foreign source income and $50 of U.S. source income. However, Y has $125 of FOGEI since, for purposes of section 907(a), the $50 resourced by section 904(f) will be treated as income from sources outside the United States; see §1.907(a)–1(c)(4)(iii). Accordingly, Y's section 907(a) limitation is $57.50 (.46 x $125). Y's section 904(d)(1)(E) limitation is, however, only $34.50 (.46 x $75). Thus, Y may claim a foreign tax credit of $34.50 in 1985. Y may carry back or carry forward $23 ($57.50–$34.50) and that amount is not subject to the section 907(a) limitation in the carry to year. In addition, $67.50 ($125 − $57.50) may be carried back pursuant to the provisions of section 907(e)(2) and §1.907(e)–1 and carried forward pursuant to the provisions of section 907(f) and §1.907(f)–1. This amount is subject to the section 907(a) limitation in the carry to year.

(d) *FORI*—(1) *In general.* Section 907(c)(2) defines FORI to include taxable income from the processing of oil and gas into their primary products, from the transportation or distribution and sale of oil and gas and their primary products, from the disposition of assets used in these activities and from the performance of any other related service. FORI may also include, under section 907(c)(3), certain dividends, interest, or amounts described in section 951(a). This paragraph (d) defines certain terms and items applicable to FORI.

(2) *Transportation.* Gross income from transportation of minerals or primary products (''gross transportation income'') is gross income arising from carrying minerals or primary products between two places (including time or voyage charter hires) by any means of transportation, such as a vessel, pipeline, truck, railroad, or aircraft. Except for directly related income under paragraphs (d)(7) and (g) of this section, gross transportation income does not include gross income received by a lessor from a bareboat charter hire of a means of transportation, certain other rental income, or income from the performance of certain services.

(3) *Distribution or sale.* The term ''distribution or sale'' means the sale or exchange of minerals or primary products to processors, users who purchase, store, or use in bulk quantities, other persons for further distribution, retailers, or consumers. Gross income from distribution or sale includes interest income attributable to the distribution of minerals or primary products on credit.

(4) *Processing.* The term ''processing'' means the destructive distillation, or a process similar in effect to destructive distillation, of crude oil and the processing of natural gas into their primary products including processes used to remove pollutants from crude oil or natural gas.

(5) *Primary product from oil.* The term ‘‘primary product’’ (in the case of oil) means all products derived from the processing of crude oil, including volatile products, light oils (such as motor fuel and kerosene), distillates (such as naphtha), lubricating oils, greases and waxes, and residues (such as fuel oil).

(6) *Primary product from gas.* The term ‘‘primary product’’ (in the case of gas) means all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including natural gas, condensates, liquefiable petroleum gases (such as ethane, propane, and butane), and liquid products (such as natural gasoline).

(7) *Directly related income.* FORI also includes directly related income under paragraph (g) of this section.

(e) *Assets used in a trade or business*—(1) *In general.* The term ‘‘assets used by the taxpayer in the trade or business’’ in section 907(c) (1)(B) and (2)(D) means property primarily used in one or more of the trades or businesses that are section 907(c) activities. For purposes of this paragraph (e), assets used in a trade or business are assets described in section 1231(b) (applied without regard to any holding period or the character of the asset as being subject to the allowance for depreciation under section 167).

(2) *Section 907(c) activities.* Section 907(c) activities are those described in section 907(c)(1)(A) (for FOGEI) or (c)(2)(A) through (C) (for FORI). If an asset is used primarily in one or more section 907(c) activities, then the entire gain (or loss) will be considered attributable to those activities. For example, if a person uses a service station primarily to distribute primary products from oil, then all of the gain (or loss) on the sale of the station is FORI even though the person uses the station to distribute products that are not primary products (such as tires or batteries). If an asset is not primarily used in one or more section 907(c) activities, then the entire gain or loss will not be FOGEI or FORI.

(3) *Stock.* Stock of any corporation (whether foreign or domestic) will not be treated as an asset used by a person in section 907(c) activities.

(4) *Losses on sale of stock.* If, under § 1.861–8(e)(7), a loss on the sale, exchange, or disposition of stock is considered a deduction which is definitely related and allocable to FOGEI or FORI, then notwithstanding § 1.861–8 (e)(7) and paragraph (f)(2) of this section, this loss shall be allocated and apportioned to the same class of income that would have been produced if there were capital gain from the sale, exchange or disposition.

(5) *Character of gain or loss.* Except in the case of stock, gain or loss from the sale, exchange or disposition of assets used in the trade or business may be FORI or FOGEI to the extent taken into account in computing taxable income for the taxable year, whether or not the gain or loss is ordinary income or ordinary loss.

(6) *Allocation of amount realized.* The amount realized from the sale, exchange or disposition of several assets in one transaction is allocated among them in proportion to their respective fair market values. This allocation is made under the principles set forth in § 1.1245–1(a)(5) (relating to allocation between section 1245 property and non-section 1245 property).

(7) *Interest.* Gross income from the sale, exchange or disposition of an asset used in a section 907(c) activity includes interest income from such a sale, exchange or disposition.

(f) *Terms and items common to FORI and FOGEI*—(1) *Minerals.* The term ‘‘minerals’’ means hydrocarbon minerals extracted from oil and gas wells, including crude oil or natural gas (as defined in section 613A(e)). The term includes incidental impurities from these wells, such as sulphur, nitrogen, or helium. The term does not include hydrocarbon minerals derived from shale oil or tar sands.

(2) *Taxable income.* Deductions to be taken into account in computing taxable income or net operating loss attributable to FOGEI or FORI are determined under the principles of § 1.861–8. For an exception with regard to losses, see paragraph (e)(4) of this section.

(3) *Interest on working capital.* FORI and FOGEI may include interest on bank deposits or on any other temporary investment which is not in excess of funds reasonably necessary to

meet the working capital requirements and the specifically anticipated business needs of the person that is engaged in the conduct of the activities described in section 907(c) (1) or (2).

(4) *Exchange gain or loss.* Exchange gain (and loss) may be FORI and FOGEI. For taxable years beginning after 1986, exchange gain or loss from a section 988 transaction may be FORI or FOGEI only if directly related to the business needs (under the principles of section 954(c)(1)(D)) attributable to the conduct of the section 907(c) activity.

(5) *Allocation.* Interest income and exchange gain (or loss) described, respectively, in paragraph (f) (3) and (4) of this section are allocated among FORI, FOGEI, and any other class of income relevant for purposes of the foreign tax credit limitations under any reasonable method which is consistently applied from year-to-year.

(6) *Facts and circumstances.* Income not described elsewhere in this section may be FOGEI or FORI if, under the facts and circumstances in the particular case, the income is in substance directly attributable to the activities described in section 907(c) (1) or (2). For example, assume that a producer in the North Sea suffers a casualty caused by an explosion, fire, and resulting destruction of a drilling platform. Insurance proceeds received for the platform's destruction in excess of the producer's basis is extraction income if the excess constitutes income from sources outside the United States. In addition, income from an insurance policy for business interruption may be extraction income to the extent the payments under the policy are geared directly to the loss of income from production and are treated as income from sources outside the United States. Also, if an oil company's oil concession or assets used in extraction activities described in section 907(c)(1)(A) and located outside the United States are nationalized or expropriated by a foreign government, or instrumentality thereof, income derived from that nationalization or expropriation (including interest on the income paid pursuant to the nationalization or expropriation) is FOGEI. Likewise, if a company's assets used in the activities described in section 907(c)(2) (A) through (C) and located outside the United States are nationalized or expropriated by a foreign government, or instrumentality thereof, income (including interest on the income paid pursuant to the nationalization or expropriation) derived from the nationalization or expropriation will be FORI. Nationalization or expropriation is deemed to be a sale or exchange for purposes of section 907(c)(1)(B) and a disposition for purposes of section 907(c)(2)(D). In further example, assume that an oil company has an exclusive right to buy all the oil in country X from Y, an instrumentality of the foreign sovereign which owns all of the oil in X. The oil company does not have an economic interest in any oil in country X. Y has a temporary cash-flow problem and demands that the oil company make advance deposits for the purchase of oil not yet delivered. In return, Y grants the oil company a discount on the price of the oil when delivered. Income represented by the discount on the later disposition of the oil is FORI described in section 907(c)(2)(C). The result would be the same if Y credited the oil company with interest on the advance deposits, which had to be used to purchase oil (the interest income would be FORI).

(g) *Directly related income*—(1) *In general.* Section 907(c)(2)(E) and this paragraph (g) include in FORI, and this paragraph (g) includes in FOGEI, income from the performance of directly related services (as defined in paragraph (g)(2) of this section). This paragraph (g) also includes in FORI and FOGEI income from the lease or license of related property (as defined in paragraph (g)(3) of this section). Section 907(c)(2)(E) with regard to FORI and this paragraph (g) with regard to both FORI and FOGEI do not apply to a person if—

(i) Neither that person nor a related person (as defined in paragraph (g)(4) of this section) has FOGEI described in paragraph (b) of this section (other than paragraph (b)(4) of this section relating to directly related income) or FORI described in paragraph (d) of this section (other than paragraph (d)(7) of this section relating to directly related income), or

(ii) Less than 50 percent of that person's gross income from sources outside the United States which is related exclusively to the performance of services and from the lease or license of property described in paragraph (g) (2) and (3) of this section, respectively, is attributable to services performed for (or on behalf of), leases to, or licenses with, related persons, but

(iii) Paragraph (g)(1)(ii) of this section will not apply to a person if 50 percent or more of that person's total gross income from sources outside the United States is FOGEI and FORI (as both are described in paragraph (g)(1)(i) of this section).

A person described in paragraph (g)(1) (i) or (ii) of this section will, however, have directly related services income which is FOGEI if the income is so classified by reason of the income based on output test set forth in paragraph (g)(2)(i)(B) of this section.

(2) *Directly related services*—(i) *FOGEI.* (A) Income from directly related services will be FOGEI, as that term is defined in paragraph (b) (1) and (3) of this section, if those services are directly related to the active conduct of extraction (including exploration) of minerals from oil and gas wells. Paragraph (b)(1) of this section provides that, in order to have extraction income, a person must have an economic interest in the minerals in place. However, paragraph (b)(3) of this section recognizes that income arising from ''other circumstances'' is extraction income if that income is in substance attributable to the extraction of minerals.

(B) An example of ''other circumstances'' under paragraph (b)(3) of this section is the ''income based on output test.'' This income based on output test provides that, if the amount of compensation paid or credited to a person for services is dependent on the amount of minerals discovered or extracted, the income of the person from the performance of the services will be directly related services income which is FOGEI. This test will apply whether or not the person performing the services has, or had, an economic interest in the minerals discovered or extracted.

(ii) *FORI.* With regard to the determination of directly related services income which is FORI, directly related services are those services directly related to the active conduct of the operations described in section 907(c)(2) (A) through (C). Those services include, for example, services performed in relation to the distribution of minerals or primary products or in connection with the operation of a refinery, or the types of services described in § 1.954–6(d) (other than § 1.954–6(d)(4) which relate to foreign base company shipping income.

(iii) *Recipient of the services.* Directly related services described in paragraph (g)(2) (i) and (ii) of this section may be performed for any person without regard to whether that person is a related person.

(iv) *Excluded services*—(A) *FOGEI.* Directly related services which produce FOGEI do not include insurance, accounting or managerial services.

(B) *FORI.* Directly related services which produce FORI do not, generally, include insurance, accounting or managerial services. These services will, however, produce FORI if they are performed by the person performing the operations described in section 907(c)(2) (A) through (C). For these purposes, insurance income which is FORI means taxable income as defined in section 832(a).

(3) *Leases and licenses.* A lease or license of related property is the lease or license of assets used (or held for use) by the lessor, licensor, or another person (including the lessee or a sublessee) in the active conduct of the activities described in section 907 (c)(1)(A) or (c)(2) (A) through (C). The leases or licenses described in this paragraph (g)(3) include, for example, a lease of a means of transportation under a bareboat charter hire, of drilling equipment used in extraction operations, or the license of a patent, know-how, or similar intangible property used in extracting, transporting, distributing or processing minerals or primary products. This paragraph (g)(3) applies without regard to whether the parties are related persons.

(4) *Related person.* A person will be treated as a related person for purposes of this paragraph (g) if that person would be so treated within the meaning

of section 954(d)(3) (as applied by substituting the word ‘‘corporation’’ for the word ‘‘controlled foreign corporation’’) or that person is a partnership or partner described in section 707(b)(1).

(5) *Gross income.* A foreign corporation shall be treated as a domestic corporation for the purpose of applying the gross-income rules in paragraph (g)(1) (ii) and (iii) of this section.

(h) *Coordination with other provisions*—(1) *Certain adjustments.* The character of income as FOGEI or FORI is determined before making any adjustment under section 482 or section 907(d). For example, assume that X and Y are related parties, Y's only income is from the sale of oil that Y purchased from X, and FOGEI from X is diverted to Y through an arrangement described in paragraph (b)(3) of this section. Accordingly, Y has FOGEI. If under section 482 the Commissioner reallocates the FOGEI from Y to X, then Y's remaining income represents only a profit from distributing the oil, and thus is FORI. If the foreign taxes paid by Y on this income are otherwise creditable under section 901, the foreign taxes that are not refunded to Y retain their characterization as FOGEI taxes.

(2) *Section 901(f).* Section 901(f) (relating to certain payments with respect to oil and gas not considered as taxes) applies before section 907. Taxes disallowed by section 901(f) are added to the cost or inventory amount of oil or gas.

[T.D. 8338, 56 FR 11067, Mar. 15, 1991]

§1.907(c)–2 Section 907(c)(3) items (for taxable years beginning after December 31, 1982).

(a) *Scope.* This section provides rules relating to certain items listed in section 907(c)(3). The rules of this section are expressed in terms of FORI but apply for determining FOGEI by substituting ‘‘FOGEI’’ for ‘‘FORI’’ whenever appropriate. FOGEI does not include interest described in section 907(c)(3)(A). Dividends paid prior to January 1, 1987, and described in section 907(c)(3)(B), as in effect prior to amendment by the Technical and Miscellaneous Revenue Act of 1988, are included in FORI and not FOGEI.

(b) *Dividend*—(1) *Section 1248 dividend.* A section 1248 dividend is a dividend described in section 907(c)(3)(A). Except as otherwise provided in this paragraph (b)(1), gain (or loss) from the disposition of stock in any corporation is not FOGEI or FORI. See §1.907(c)–1(e) (3) and (4).

(2) *Section 78 dividend.* A section 78 dividend is FORI to the extent it arises from a dividend described in section 907(c)(3)(A), or an amount described in section 907(c)(3)(C).

(c) *Taxes deemed paid*—(1) *Voting stock test.* Items described in section 907(c)(3)(A) or (C) are FORI only if a deemed-paid-tax test is met under the criteria of section 902 or 960. The purpose of this test is to require minimum direct or indirect ownership by a domestic corporation in the voting stock of a foreign corporation as a prerequisite for the item to qualify as FORI in the hands of the domestic corporation. The test is whether a domestic corporation would be deemed to pay any taxes of a foreign corporation when a dividend or an amount described in section 907(c)(3)(A) or (C), respectively, is included in the domestic corporation's gross income. In the case of interest described in section 907(c)(3)(A), the test is whether any taxes would be deemed paid if there were a hypothetical dividend.

(2) *Dividends and interest.* For purposes of section 907(c)(3)(A), a domestic corporation is deemed under section 902 to pay taxes in respect of dividends and interest received from a foreign corporation whether or not the foreign corporation:

(i) Actually pays or is deemed to pay taxes, or

(ii) In the case of interest, actually pays dividends.

This paragraph (c)(2) also applies to dividends received by a foreign corporation from a second-tier or third-tier foreign corporation (as defined in §1.902–1(a) (3)(i) and (4), respectively). In the case of interest received by a foreign corporation from another foreign corporation, this paragraph (c)(2) applies if the taxes of both foreign corporations would be deemed paid under section 902 (a) or (b) for purposes of applying section 902(a) to the same taxpayer which is a domestic corporation.

In the case of interest received by any corporation (whether foreign or domestic), all members of an affiliated group filing a consolidated return will be treated as the same taxpayer under section 907(c)(3)(A) if the foreign taxes of the payor and (if the recipient is a foreign corporation) the foreign taxes of the recipient would be deemed paid under section 902 by at least one member. The term ''member'' is defined in § 1.1502-1(b). Thus, for example, assume that P owns all of the stock of D1 and D2 and P. D1, and D2 are members of an affiliated group filing a consolidated return. Assume further that D1 owns all of the stock of F1 and D2 owns all of the stock of F2, where F1 and F2 are foreign corporations. Interest paid by F1 to P, D2, or F2 may be FORI.

(3) *Amounts included under section 951(a).* For purposes of section 907(c)(3)(C), a domestic corporation is deemed under section 960 to pay taxes in respect of a foreign corporation, whether or not the foreign corporation actually pays taxes on the amounts included in gross income under section 951(a).

(d) *Amount attributable to certain items*—(1) *Certain dividends*—(i) *General rule.* The portion of a dividend described in section 907(c)(3)(A) that is FORI equals—

Amount of dividend x a/b

a = FORI accumulated profits in excess of FORI taxes paid or accrued, and
b = Total accumulated profits in excess of total foreign taxes paid or accrued.

This paragraph (d)(1)(i) applies even though the FORI accumulated profits arose in a taxable year of a foreign corporation beginning before January 1, 1983. Determination of the FORI amount of dividends under this paragraph (d)(1)(i) must be made separately for FORI accumulated profits and total accumulated profits that arose in taxable years beginning before January 1, 1987, and for FORI accumulated profits and total accumulated profits that arose in taxable years beginning after December 31, 1986. Dividends are deemed to be paid first out of FORI and total accumulated profits that arose in table years beginning after December 31, 1986. With regard to FORI accumulated profits and total accumulated profits that arose in taxable years beginning after December 31, 1986, the portion of a dividend that is FORI equals—

Amount of dividend x a/b

a = Post-1986 undistributed FORI earnings determined under the principles of section 902(c)(1), and
b = Post-1986 undistributed earnings determined under the principles of section 902(c)(1).

(ii) *Cross-references.* See § 1.902–1(g) for the determination of a foreign corporation's earnings and profits and of those out of which a dividend is paid. See § 1.1248–2 or 1.1248–3 for the determination of the earnings and profits attributable to the sale or exchange of stock in certain foreign corporations.

(2) *Interest received from certain foreign corporations.* Interest described in section 907(c)(3)(A) is FORI to the extent the corresponding interest expense of the paying corporation is properly allocable and apportionable to the gross income of the paying corporation that would be FORI were that corporation a domestic corporation. This allocation and apportionment is made in a manner consistent with the rules of section 954(b)(5) and § 1.861–8(e)(2).

(3) *Dividends from domestic corporation.* The amount of a dividend from a corporation described in section 907(c)(3)(B), as in effect prior to amendment by the Technical and Miscellaneous Revenue Act of 1988, paid in a taxable year of that corporation beginning before December 31, 1986, that is FORI is determined under the principles of paragraph (d)(1)(i) of this section with respect to its current earnings and profits under section 316(a)(2) or its accumulated earnings and profits under section 316(a)(1), as the case may be.

(4) *Amounts with respect to which taxes are deemed paid under section 906(a)*—(i) *Portion attributable to FORI.* The portion of an amount described in section 907(c)(3)(C) that is FORI equals:

$$A \times \frac{B}{C}$$

A=Amount described in section 907(c)(3)(C)
B=FORI earnings and profits
C=Total earnings and profits

For taxable years ending after January 23, 1989, the facts and circumstances will be used to determined what part of the amount of the section 907(c)(3)(C) amount is directly attributable to FOGEI, FORI and other income.

(ii) *Earnings and profits.* Total earnings and profits are those of the foreign corporation for a taxable year under section 964 and the regulations under that section.

(5) *Section 78 dividend.* The portion of a section 78 dividend that will be considered FORI will equal the amount of taxes deemed paid under either section 902(a) or section 960(a)(1) with respect to the dividend to the extent the taxes deemed paid are FORI taxes under §1.907(c)–3 (b) or (c). See §1.907(c)–3(a)(1).

(6) *Special rule.* (i) No item in the formula described in paragraph (d)(1)(i) of this section includes amounts excluded from the gross income of a United States shareholder under section 959(a)(1).

(ii) With respect to a foreign corporation, earnings and profits in the formula described in paragraph (d)(4)(i) of this section do not include amounts excluded under section 959(b) from its gross income.

(7) *Deficits*—(i) *Allocation of deficits within a separate category*. In a taxable year in which a foreign corporation described in section 907(c)(3)(A) pays a dividend or has income that is subject to inclusion under section 951, if the foreign corporation has positive post—1986 undistributed earnings in a separate category but within that separate category there is a deficit in post-1986 undistributed earnings attributable to earnings other than FOGEI and FORI, that deficit shall be allocated ratably between the FOGEI and FORI post-1986 undistributed earnings within that separate category. Any deficit in post-1986 undistributed earnings attributable to either FOGEI or FORI shall be allocated first to FOGEI or FORI post-1986 undistributed earnings (as the case may be) to the extent thereof. Post-1986 undistributed FORI earnings are the post-1986 undistributed earnings (as defined in section 902 and the regulations under that section) attributable to FORI as defined in section 907(c) (2) and (3). Post-1986 undistributed FOGEI earnings are the post-1986 undistributed earnings (as defined in section 902 and the regulations under that section) attributable to FOGEI as defined in section 907(c) (1) and (3).

Example. Foreign corporation X for years 1987 and 1988 had the following undistributed earnings (none of which is income that is subject to inclusion under section 951) and foreign taxes:

	Earnings	Taxes
FOGEI	$800	$400
FORI	(750)	....
Other	700	250
Total	$750	$650

On December 31, 1988, X paid a dividend of all of its post-1986 undistributed earnings to its sole shareholder Y. Under paragraph (d)(5) and (7)(i) of this section and §1.907 (c)–2 (d)(5), $450 of Y's dividend is attributable to FOGEI ($50 from undistributed earnings plus a $400 section 78 dividend) and $950 is attributable to other earnings ($700 from undistributed earnings plus a $250 section 78 dividend).

(ii) *Deficits allocated among separate categories.* If a deficit in a separate category (''first separate category'') is allocated to another separate category (''second separate category'') under sections 902 and 960 pursuant to notice 88–71, 1988–2 CB 374 and the regulations under those sections, the following rules shall apply. Any deficit in post-1986 undistributed earnings attributable to either FOGEI (or FORI) from the first separate category shall be allocated to post-1986 undistributed earnings in the second separate category to the extent thereof in the following order:

(A) FOGEI (or FORI),

(B) FORI (or FOGEI), and

(C) Other income.

Any deficit in post-1986 undistributed earnings attributable to other income from the first separate category shall be allocated first to other post-1986 undistributed earnings and then ratably to FOGEI and FORI post—1986 undistributed earnings in the second separate category.

(iii) *Pre-1987 deficits.* The amount of a dividend paid by a foreign corporation described in section 907(c)(3)(A) out of positive pre-1987 earnings that is attributable to FOGEI and FORI shall be determined in a manner similar to that used in paragraph (d)(7) (i) and (ii) of this section except that the determinations shall be made on an annual basis.

(8) *Illustrations.* The application of this paragraph (d) is illustrated by the following examples.

Example 1. X, a domestic corporation, owns all of the stock of Y, a foreign corporation organized in country S. Y owns all of the stock of Z, a foreign corporation also organized in country S. Each corporation uses the calendar year as its taxable year. In 1983, Z has $150 of FOGEI earnings and profits and $250 of earnings and profits other than FOGEI or FORI. Assume that Z paid no taxes to S and X must include $100 in its gross income under section 951(a) with respect to Z. Under paragraph (d)(4)(i) of this section, $37.50 of the amount described in section 951(a) is FOGEI ($100×$150/$400). the remaining $62.50 of the section 951(a) amount represents other income.

Example 2. Assume the same facts as in Example 1 except that the taxable year in question is 1988. In addition, under the facts and circumstances, it is determined that of the $100 section 951(a) amount included in X's gross income, $30 is directly attributable to Z's FOGEI activity, $60 is directly attributable to Z's FORI activity and $10 is directly attributable to Z's other activity. Accordingly, under paragraph (d)(4)(i), $30 will be FOGEI and $60 will be FORI to X.

Example 3. (i) Assume the same facts as in *Example 1.* Assume further that, in 1983, Z distributes its entire earnings and profits ($400) to Y which consists of a dividend of $300 and a section 959(a)(1) distribution of $100. Y has no other earnings and profits during 1983. Assume that the dividend and distribution are not foreign personal holding company income under section 954(c). Y pays no taxes to S. In 1983, Y distributes its entire earnings and profits to X.

(ii) Under paragraphs (c)(2) and (d)(1)(i) of this section, Y has FOGEI of $112.50, *i.e.*, the amount of the dividend received by Y ($300) multiplied by the fraction described in paragraph (d)(1)(i). The numerator of the fraction is Z's FOGEI accumulated profits in excess of the FOGEI taxes paid ($112.50) and the denominator is Z's total accumulated profits in excess of total foreign taxes paid ($400) minus the amount excluded from Y's gross income under section 959(a)(1) ($100). The rule of paragraph (d)(6)(ii) of this section does not apply since X does not include any amount in its gross income under section 951(a) with respect to Y. If Y paid taxes to S, this paragraph (d) would apply to characterize those taxes as FOGEI taxes or other taxes. See § 1.907(c)–3(a)(8) and Example 2 (iii) under § 1.907(c)–3(e).

(iii) The distribution from Y to X is a dividend to the extent of $300, *i.e.*, the amount of the distribution ($400) minus the amount excluded from X's gross income under section 959(a)(1) ($100). Under paragraphs (d) (1)(i) and (6)(i) of this section, $112.50 of the dividend is FOGEI, *i.e.*, the amount of the dividend ($300) multiplied by a fraction. The numerator of the fraction is $112.50, *i.e.*, the FOGEI accumulated profits of Y in excess of FOGEI taxes paid ($150) minus the FOGEI accumulated profits of Y in excess of FOGEI taxes paid excluded from X's gross income under section 959(a)(1) ($37.50). The denominator of the fraction is $300, *i.e.*, the total accumulated profits of Y in excess of taxes paid ($400) minus the amount excluded from X's gross income under section 959(a)(1) ($100).

Example 4. Assume the same facts as in Example 1 with the following modifications: In 1983, Z's only earnings and profits are FORI earnings and profits which are included in X's gross income under section 951(a). Z distributes its entire earnings and profits to Y. In 1983, Y has total earnings and profits of $100 without regard to the dividend from Z, $60 of which are FORI earnings and profits. Y also has $40 which is included in X's gross income under section 951(a). Under paragraph (d)(6)(ii) of this section, the dividend from Z is disregarded for purposes of applying paragraph (d)(4)(i) of this section to the $40 included in X's gross income under section 951(a) with respect to Y. Accordingly, $24 of the amount described in section 951(a) is FORI ($40×$60/$100). Had these circumstances existed in 1988, and if the $40 included in X's gross income under section 951(a) was directly attributable to FORI activity, all of that income would be FORI to X.

(e) *Dividends, interest, and other amounts from sources within a possession.* FORI includes the items listed in (A) and (C) to the extent attributable to FORI of a corporation that is created or organized in or under the laws of a possession of the United States.

(f) *Income from partnerships, trusts, etc.* FORI and FOGEI include a person's distributive share (determined under the principles of section 704) of the income of any partnership and amounts included in income under subchapter J of chapter 1 of the Code (relating to the taxation of trusts, estates, and beneficiaries) to the extent the income and amounts are attributable to FORI and FOGEI. For taxable years beginning after 1986, the principles of § 1.904–5 (h) and (i) shall be applied to determine whether (and to what extent) a person's distributive share is FORI and FOGEI. Thus, for example, a less-than-10 percent corporate partner's share of income of the partnership would generally be treated as passive income to the partner, and not as FORI or FOGEI, unless an exception under §1.904–5 (h) and (i) applies.

[T.D. 8338, 56 FR 11071, Mar. 15, 1991]

§1.907(c)–3 FOGEI and FORI taxes (for taxable years beginning after December 31, 1982).

(a) *Tax characterization, allocation and apportionment*—(1) *Scope.* Paragraphs (a) (2) through (6) of this section provides rules for the characterization, allocation, and apportionment of the income taxes (other than withholding taxes) paid or accrued to a foreign country among FOGEI, FORI, and other income relevant for purposes of sections 907 and 904. Some of the rules in this section are expressed in terms of FOGEI taxes but they apply to FORI taxes by substituting ''FORI taxes'' for ''FOGEI taxes'' whenever appropriate. For the treatment of withholding taxes, see paragraph (a)(8) of this section. FOGEI taxes are determined without any reduction under section 907(a). In addition, determination of FOGEI taxes will not be affected by recharacterization of FOGEI by section 907(c)(4). See §1.907(c)–1(c)(5). Foreign taxes will not be characterized as creditable FORI taxes if section 907(b) and §1.907(b)–1 apply.

(2) *Three classes of income.* There are three classes of income: FOGEI, FORI, and other income.

(3) *More than one class in a foreign tax base.* If more than one class of income is taxed under one tax base under the law of a foreign country, the amount of pre-credit foreign tax for each base must be determined. This amount is the foreign taxes paid or accrued to that country for the base as increased by the tax credits (if any) which reduced those taxes and were allowed in the country for that tax. More than one class of income is taxed under the same base, if, under a foreign country's law, deductions from one class of income may reduce the income of any other class and the classes are subject to foreign tax at the same rates.

(4) *Allocation of tax within a base.* If more than one class of income is taxed under the same base under a foreign country's law, the pre-credit foreign tax for the base is apportioned to each class of income in proportion to the income of each class. Tax credits are than allocated (under paragraph (a)(6) of this section) to the apportioned pre-credit tax. Income of a class over the deductions allowed under foreign law for, and which are attributable to, that class.

(5) *Modified gross income.* Modified gross income is not necessarily the same as gross income as defined for purposes of chapter 1 of the Internal Revenue Code. Modified gross income is determined with reference to the foreign tax base for gross income (or its equivalent). However, the characterization of the base as a particular class of income is governed by general principles of U.S. tax law. Thus, for example—

(i) Gross income from extraction is the fair market value of oil or gas in the immediate vicinity of the well (as determined under §1.907(c)–1(b)(6) (without any deductions)).

(ii) Whether cost of goods sold (or any other deduction) is a deduction from modified gross income and the amount of such a deduction is determined under foreign law.

(iii) Modified gross income includes items that are part of the foreign tax base even though they are not gross income under U.S. law so long as the foreign taxes paid on the base constitute creditable taxes under section 901 (including taxes described in section 903). For example, if a foreign country imposes a tax (creditable under section 901) on a tax base that includes in small part a percentage of the value of a company's oil reserves in place, modified gross income from extraction includes such a percentage of value solely for purposes of making the tax allocation in paragraph (a)(4) of this section.

(iv) Modified gross income from extraction is increased for purposes of this paragraph (a)(5) by the entire excess of the posted price over fair market value if the foreign country uses a posted price system or other pricing arrangement described in section 907(d) in imposing its income tax.

(v) Modified gross income from FORI is that income attributable to the activities in sections 907(c)(2) (A) through (C) and (E).

(vi) Modified gross income for any class may not include gross income that is not subject to taxation by the foreign country.

(6) *Allocation of tax credits.* The foreign taxes paid or accrued on a particular class of income equals the precredit tax on the class reduced (but not below zero) by the credits allowed under foreign law against the foreign tax on the particular class. Any tax credit attributable to a class that is not allocated to that class is allocated to the other class in the base or, if there are three classes in the base, is apportioned ratably among the taxes paid or accrued on the other two classes (as reduced in accordance with the preceding sentence).

(7) *Withholding taxes.* Paragraph (a) (2) through (6) of this section does not apply to withholding taxes imposed by a foreign country. FOGEI taxes may include withholding taxes imposed with respect to a distribution from a corporation. The portion of the total withholding taxes on a distribution that constitutes FOGEI taxes is determined by the portion of the distribution that is FOGEI. In addition, FOGEI taxes may include taxes imposed on a distribution described in section 959(a)(1) or on amounts described in section 959(b). The portion of the total withholding taxes imposed on a distribution described in section 959(a)(1) or on amounts described in section 959(b) is determined by reference to the portion of the amount included in gross income under section 951(a) that was FOGEI.

(b) *Dividenss—In general*—(i) FOGEI taxes deemed paid with respect to a dividend equal the total taxes deemed paid with respect to the dividend multiplied by the fraction:

FOGEI taxes paid or accrued by the payor/Total foreign taxes paid or accrued by the payor.

(ii) With regard to dividends received in taxable years beginning after December 31, 1986, FOGEI taxes deemed paid with respect to a dividend equal the total taxes deemed paid with respect to the portion of the dividend within a separate category multiplied by the fraction:

$$\frac{\text{Post-1986 FOGEI taxes as determined under the principles of section 902(c)(2) that are allocable to that separate category}}{\text{Post-1986 foreign income taxes as determined under the principles of section 902(c)(2) that are allocable to that separate category.}}$$

(iii) This paragraph (b) applies to a dividend described in section 907(c)(3)(A) (including a section 1248 dividend) with reference to the particular taxable year or years of those accumulated profits out of which a dividend is paid. Determination of FOGEI taxes under this paragraph (b) must be made separately.

(A) For FOGEI taxes paid on FOGEI accumulated profits and total taxes paid on accumulated profits that arose in taxable years beginning before January 1, 1987, to which paragraph (b)(1)(i) of this section applies, and

(B) For FOGEI taxes paid on FOGEI accumulated profits and total taxes paid on accumulated profits that arose in taxable years beginning after December 31, 1986, to which paragraph (b)(1)(ii) of this section applies.

For purposes of these determinations, dividends are deemed to be paid first out of FOGEI and total accumulated profits that arose in taxable years beginning after December 31, 1986. See § 1.907(c)–2(d)(1)(i). See section 960(a)(3) and § 1.960–2 relating to distributions that are treated as dividends for purposes of section 902.

(2) *Section 78 dividend.* There are no FOGEI taxes with respect to section 78 dividends.

(c) *Includable amounts under section 951(a)*. (1) FOGEI taxes deemed paid with respect to an amount includable in gross income under section 951(a) equal the total taxes deemed paid with respect to that amount multiplied by the fraction:

$$\frac{\text{FOGEI taxes paid or accrued by the foreign corporation}}{\text{Total foreign taxes paid or accrued by the foreign corporation.}}$$

(2) With regard to an amount includable in gross income under section 951(a) in taxable years beginning after December 31, 1986, FOGEI taxes deemed paid with respect to that amount equal the total taxes deemed paid with respect to that amount within a separate category multiplied by the fraction:

$$\frac{\text{Post-1986 FOGEI taxes as determined under the principles of section 902(c)(2) that are allocable to that separate category}}{\text{Post-1986 foreign income taxes as determined under the principles of section 902(c)(2) that are allocable to that separate category.}}$$

Taxes in the fraction in this paragraph (c)(2) include only those foreign taxes that may be deemed paid under section 960(a) by reason of such inclusion. See §§1.960–1(c)(3) and 1.960–2(c).

(d) *Partnerships.* A partner's distributive share of the partnership's FOGEI taxes is determined under the principles of section 704.

(e) *Illustrations.* The application of this section may be illustrated by the following examples.

Example 1. X, a domestic corporation, owns all of the stock of Y, a foreign corporation organized in country S. Y owns all of the stock of Z, a foreign corporation organized in country T. Each corporation used the calendar year as its taxable year. In 1983, X includes in its gross income an amount described in section 951(a) with respect to Z. Assume that the taxes deemed paid under section 902(a) by X by reason of such an inclusion is $70. Assume further that Z paid total taxes of $120, $80 of which is FOGEI tax. Under paragraph (c) of this section, the FOGEI tax deemed paid is $46.67 (*i.e.*, $70 x $80/$120). This $46.67 is also FOGEI under §1.907(c)–2(d)(5) because it must be included in X's gross income under section 78.

Example 2 —(i) Assume the same facts as in Example 1. Assume further that in 1983, Z distributes its entire earnings and profits to Y. Y has no earnings and profits during 1983 other than this dividend. Y paid a tax of $50 to S. Assume that Y is deemed under section 902(b)(1) to pay $50 of the tax paid by Z which was not deemed paid by X under section 960(a)(1) in 1983. In 1983, Y distributes its entire earnings and profits to X. Assume that X is deemed under section 902(a) to pay $100 of the taxes actually paid, and deemed paid, by Y.

(ii) Paragraph (b)(1) of this section applies to characterize the $50 tax of Z that Y is deemed to pay under section 902(b)(1). Y is deemed to pay $33.33 of FOGEI tax, *i.e.*, the amount of the tax deemed paid by Y ($50) multiplied by a fraction. The numerator of the fraction is the amount of Z's FOGEI tax ($80) and the denominator is the total taxes paid by Z ($120).

(iii) Under paragraph (a)(8) of this section, a portion of the $50 tax actually paid by Y on the earnings and profits received from Z is FOGEI tax. The amount of tax actually paid by Y that is FOGEI tax depends on the amount of the distribution from Z that is FOGEI (see §1.907(c)–2(d)(1) (i) and Example 2 (ii) under §1.907(c)–2(d)(8)). This result does not depend upon whether a portion of the distribution from Z is described in section 959(b) and it follows even though a portion of Y's earnings and profits will be excluded from X's gross income under section 959(a)(1) when distributed by Y. Assume that $12.50 of the $50 tax actually paid by Y is FOGEI tax.

(iv) Under paragraph (b)(1) of this section, X is deemed to pay $45.83 of FOGEI tax by reason of the distribution from Y. This amount is determined by multiplying the total taxes deemed paid by X by reason of such distribution ($100) by a fraction. The numerator of the fraction is the FOGEI tax paid, and deemed paid, by Y ($45.83, *i.e.*, $33.33

under paragraph (ii) of this example plus $12.50 under paragraph (iii) of this example). The denominator of the fraction is the total taxes paid, and deemed paid, by Y ($100). This $45.83 is FOGEI under § 1.907(c)–2(d)(5) because it is included in X's gross income as a section 78 dividend.

Example 3 —(i) X, a domestic corporation, has a concession with foreign country Y that gives it the exclusive right to extract and export the crude oil and natural gas owned by Y. The concession agreement and location of the oil and gas wells mandate that X construct a system of pipelines to transport the minerals that are extracted to a port where they are loaded onto tankers for export. X owns the transportation facilities. Y has an income tax system under which income from mineral operations is subject to a 50 percent tax rate. The taxation by Y of the mineral operations is a separate tax base under paragraph (a)(3) of this section. Under this system, Y imposes the tax at the port prior to export and it establishes a posted price of $12 per barrel. Y also collects royalties of $1.44 per barrel (*i.e.*, 12 percent of this posted price) which is deductible in computing the petroleum tax. Y also allows X deductible lifting costs of $.20 per barrel and deductible transporting costs of $.80 per barrel. Y does not allow any credits against the mineral tax. Assume that X does not have any income in Y other than the mineral income. (In 1983, X extracts, transports, and exports 10,000,000 barrels of crude oil, but for convenience, all computations are in terms of one barrel). X pays foreign taxes of $4.78 per barrel, computed as follows:

Sales		$12.00
Royalties	$1.44	
Lifting	.20	
Transporting	.80	
	2.44	(2.44)
Income base		9.56
Tax rate (percent)		.50
Tax		4.78

Assume that these taxes are creditable taxes under section 901, that the fair market value of the oil at the port is $10 per barrel, and that under § 1.907(c)–1(b)(6) fair market value in the immediate vicinity of the oil wells is $9 per barrel. Thus, at the port, the excess of posted price ($12) over fair market value ($10) is $2.

(ii) The $4.78 foreign tax paid to Y is allocated to FOGEI and FORI in accordance with the rules in paragraph (a) (2) through (5) of this section.

(iii) Under paragraph (a)(3) of this section, FOGEI and FORI are subject to foreign taxation under one tax base. This foreign tax is allocated between FOGEI tax and FORI tax in accordance with paragraph (a) (4) and (5) of this section.

(iv) The modified gross income for FOGEI is $11, *i.e.*, fair market value in the immediate vicinity of the well ($9) plus the excess at the port of posted price over fair market value ($2). The modified gross income for FORI is $1, *i.e.*, value added to the oil beyond the well-head which is part of Y's tax base ($10–$9).

(v) The royalty deductions are all directly attributable to FOGEI.

(vi) Under paragraph (a)(4) of this section, the income of each class is determined as follows:

	FOGEI	FORI
Modified gross income	$11.00	$1.00
Deductions:		
Royalties	1.44	0
Lifting	.20	0
Transporting	0	.80
Total	1.64	.80
Net Income	9.36	.20

(vii) Under paragraph (a)(4) of this section, the total tax paid to Y is allocated to FOGEI and FORI in proportion to the income in each class. The calculation is as follows:

FOGEI tax=$4.78×$9.36/$9.56=$4.68
FORI tax=$4.78×$0.20/$9.56=$0.10

Thus, for the 10,000,000 barrels, the FOGEI tax is $46,800,000 and the FORI tax is $1,000,000.

(viii) The allocation under paragraph (a)(4) of this section, rather than the direct application of stated foreign tax rates to foreign-law taxable income in each class of income (which would produce the same results in the facts of this example), is necessary when a foreign country taxes more than one class of income under a progressive rate structure. See Example 4 in this paragraph (e).

Example 4. Assume the same facts as in Example 3 except that Y's tax is imposed at 40 percent for the first $20,000,000 of income and at 60 percent for all other income. The foreign taxes are allocated under paragraph (a)(4) of this section between FOGEI and FORI in the same manner as in paragraphs (vi) and (vii) of Example 3, as follows:

(1) Taxable income	$95,600,000
(2) Tax:	
(a) 40% of $20,000,000	8,000,000
(b) 60% of $75,600,000	45,360,000
(c) Total tax	53,360,000
(3) FOGEI tax (line 2(c)×$9.36/ $9.56)	52,243,680
(4) FORI tax (line 2(c)×$0.20/$9.56)	1,116,320

Example 5. Assume the same facts as in Example 3. Assume further that X refines the crude oil into primary products prior to export and Y imposes its tax on the basis of crude oil equivalences of $12 per barrel, rather than the value of the primary products, to establish port prices. Assume that this arrangement is a pricing arrangement described in section 907(d). Thus, Y does not

tax the refinery income. The results are the same as in Example 3 even if $12 per barrel is equal to, more than, or less than, the value of the primary products at the port. See paragraph (a)(5)(vi) of this section.

[T.D. 8338, 56 FR 11073, Mar. 15, 1991]

§1.907(d)–1 Disregard of posted prices for purposes of chapter 1 of the Code (for taxable years beginning after December 31, 1982).

(a) *In general*—(1) *Scope.* Section 907(d) applies if a person has FOGEI from the—

(i) Acquisition (other than from a foreign government) or

(ii) Disposition of minerals at a posted price that differs from the fair market value at the time of the transaction. Also, if a seller (other than a foreign government) derives FOGEI upon a disposition described in the preceding sentence, section 907(d) applies to the acquisition by the purchaser whether or not the purchaser has FOGEI. Thus, section 907(d) may apply in determining a person's FORI.

(2) *Initial computation requirement.* If section 907(d) applies to any person, income on the transaction as initially reflected on the person's return shall be computed as if the transaction were effected at fair market value. This requirement applies the first time a person has taxable income derived from either the transaction or an item (such as a dividend described in section 907(c)(3)(A)) determined with reference to that income.

(3) *Burden of proof.* The taxpayer must be able to demonstrate the transaction as it actually occurred and the basis for reporting the transaction under the principles of paragraph (a)(2) of this section.

(4) *Related parties.* Section 907(d) (as a rule of characterization) applies whether or not the parties to the transaction are related. Thus, the excess of the posted price over the fair market value may never be taken into account in determining a person's FOGEI under section 907(a) but may be taken into account in determining a person's FORI.

(b) *Adjustments.* If a taxpayer does not comply with the initial requirement of paragraph (a)(2) of this section, adjustments under section 907(d) may be made only by the Commissioner in the same manner that section 482 is administered. Correlative and similar adjustments consistent with the substantive and procedural principles of section 482 and §1.482–1(d) apply. However, section 907(d) is not a limitation on section 482. If a taxpayer disposing of minerals at a posted price does comply with the initial computation requirement of this section, adjustments and correlative and similar adjustments consistent with the substantive and procedural aspects of section 482 and §1.482–1(d) shall apply, whether made on the return by the taxpayer or on a later audit. This paragraph (b) does not apply to an actual sale or exchange of minerals made between persons with respect to whom adjustments under section 482 would never apply (but see paragraph (a)(4) of this section).

(c) *Definitions.* For purposes of this section—

(1) *Foreign government.* The term *foreign government* means only the integral parts or controlled entities of a foreign sovereign and political subdivisions of a foreign country.

(2) *Minerals.* The term *minerals* has the same meaning as in §1.907(c)–1(f)(1).

(3) *Posted price.* The term *posted price* means the price set by, or at the direction of, a foreign government to calculate income for purposes of its tax or at which minerals must be sold.

(4) *Other pricing arrangement.* The term *other pricing arrangement* in section 907(d) means a pricing arrangement having the effect of a posted price.

(5) *Fair market value.* The term *fair market value,* whether or not at the port prior to export, is determined in the same way that the wellhead price is determined under §1.907(c)–1(b)(6).

[T.D. 8338, 56 FR 11075, Mar. 15, 1991]

§1.907(e)–1 [Reserved]

§1.907(f)–1 Carryback and carryover of credits disallowed by section 907(a) (for amounts carried between taxable years that each begin after December 31, 1982).

(a) *In general.* If a taxpayer chooses the benefits of section 901, any unused FOGEI tax paid or accrued in a taxable year beginning after December 31, 1982, may be carried to the taxable years specified in section 907(f) under the carryback and carryover principles of this section § 1.904–2(b). See section 907(e) and § 1.907(e)–1 for transitional rules that apply to unused FOGEI taxes carried back or forward between a taxable year beginning before January 1, 1983, and a taxable year beginning after December 31, 1982.

(b) *Unused FOGEI tax*—(1) *In general.* The ''unused FOGEI tax'' for purposes of this section is the excess of the FOGEI taxes for a taxable year (year of origin) over that year's limitation level (as defined in § 1.907(a)–1(b)).

(2) *Year of origin.* The term ''year of origin'' in the regulations under section 904 corresponds to the term ''unused credit year'' under section 907(f).

(c) *Tax deemed paid or accrued.* The unused FOGEI tax from a year of origin that may be deemed paid or accrued under section 907(f) in any preceding or succeeding taxable year (''excess limitation year'') may not exceed the lesser of—

(1) The excess extraction limitation for the excess limitation year, or

(2) The excess general section 904 limitation for the excess limitation year.

(d) *Excess extraction limitation.* Under section 907(f)(2)(A), the ''excess extraction limitation'' for an excess limitation year is the amount by which that year's section 907(a) extraction limitation exceeds the sum of—

(1) The FOGEI taxes paid or accrued, and

(2) The FOGEI taxes deemed paid or accrued in that year by reason of a section 907(f) carryback or carryover from preceding years of origin.

(e) *Excess general section 904 limitation.* Under section 907(f)(2)(B), the ''excess general section 904 limitation'' for an excess limitation year is the amount by which that year's section 904 general limitation exceeds the sum of—

(1) The general limitation taxes paid or accrued (or deemed to have been paid under section 902 or 960) to all foreign countries and possessions of the United States during the taxable year,

(2) The general limitation taxes deemed paid or accrued in such taxable year under section 904(c) and which are attributable to taxable years preceding the unused credit year, plus

(3) The FOGEI taxes deemed paid or accrued in that year by reason of a section 907(f) carryover (or carryback) from preceding years of origin.

(f) *Section 907(f) priority.* If a taxable year is a year of origin under both section 907(f) and section 904(c), section 907(f) applies first. See section 907(f)(3)(A).

(g) *Cross-reference.* In computing the carryback and carryover of disallowed credits under section 907(f), the principles of § 1.904–2 (d), (e), and (f) apply.

(h) *Example.* The following example illustrates the application of section 907(f).

Example. X, a U.S. corporation organized on January 1, 1983, uses the accrual method of accounting and the calendar year as its taxable year. X's only income is income which is not subject to a separate tax limitation under section 904(d). X's preliminary U.S. tax liability indicates an effective rate of 46% for taxable years 1983–1985. X has the following foreign tax items for 1983–1985:

	1983	1984	1985
1. FOGEI	$15,000	$20,000	$10,000
2. FOGEI taxes	7,500	9,200	4,200
3. Other foreign taxable income	8,000	5,000	10,000
4. Other foreign taxes	3,200	2,000	3,000
5. (a) Section 907(a) limitation (.46 x Line 1)	6,900	9,200	4,600
(b) General section 904 limitation (.46 x (line 1 plus line 3))	10,580	11,500	9,200
6. (a) Unused FOGEI taxes (excess of line 2 over line 5(a))	600	0	0
(b) Unused general limitation taxes (excess of line 4 plus lesser of line 2 or line 5(a) over line 5(b))	0	0	0
7. (a) FOGEI taxes from years preceding 1983 deemed accrued under section 907(f)	0	0	0
(b) Section 904 general limitation taxes from years preceding 1983 deemed accrued under section 904(c)	0	0	0
8. (a) Excess section 907(a) limitation (excess of line 5(a) over sum of line 2 and line 7(a))	0	0	400
(b) Excess section 904 general limitation (excess of line 5(b) over sum of line 4, lesser of line 2 and line 5(a) and line 7(b))	480	300	2,000
9. Limit on FOGEI taxes that will be deemed accrued under section 907(f) (lesser of line 8(a) and line 8(b)	0	0	400

X has unused 1983 FOGEI taxes of $600. Since the excess section 907(a) limitation for 1984 is zero, the unused FOGEI taxes are carried to 1985. Of the $600 carryover, $400 is deemed accrued in 1985 and the balance of $200 is carried to following years (but not to a year after 1988). After the carryover from 1983 to 1985, the excess section 904 general limitation for 1985 (line 8(b)) is reduced by $400 to $1,600 to reflect the amount of 1983 FOGEI taxes deemed accrued in 1985 under section 907(f).

[T.D. 8338, 56 FR 11079, Mar. 15, 1991]

SUBCHAPTER A—INCOME TAX (Continued)

PART 1—INCOME TAXES (CONTINUED)

Normal Taxes and Surtaxes (Continued)

TAX BASED ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES (CONTINUED)

EARNED INCOME OF CITIZENS OR RESIDENTS OF UNITED STATES

1.911–1 Partial exclusion for earned income from sources within a foreign country and foreign housing costs.
1.911–2 Qualified individuals.
1.911–3 Determination of amount of foreign earned income to be excluded.
1.911–4 Determination of housing cost amount eligible for exclusion or deduction.
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EARNED INCOME OF CITIZENS OF UNITED STATES

1.912–1 Exclusion of certain cost-of-living allowances.
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1.922–1 Requirements that a corporation must satisfy to be a FSC or a small FSC.
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Revenue Service, Treasury

EARNED INCOME OF CITIZENS OR RESIDENTS OF UNITED STATES

§ 1.911–1 Partial exclusion for earned income from sources within a foreign country and foreign housing costs.

(a) *In general.* Section 911 provides that a qualified individual may elect to exclude the individual's foreign earned income and the housing cost amount from the individual's gross income for the taxable year. Foreign earned income is excludable to the extent of the applicable limitation for the taxable year. The housing cost amount for the taxable year is excludable to the extent attributable to employer provided amounts. If a portion of the housing cost amount for the taxable year is attributable to non-employer provided amounts, such amount may be deductible by the qualified individual subject to a limitation. The amounts excluded under section 911(a) and the amount deducted under section 911(c)(3)(A) for the taxable year shall not exceed the individual's foreign earned income for such taxable year. Foreign earned income must be earned during a period for which the individual qualifies to make an election under section 911(d)(1). A housing cost amount that would be deductible except for the application of this limitation may be carried over to the next taxable year and is deductible to the extent of the limitation for that year. Except as otherwise provided, §§ 1.911–1 through 1.911–7 apply to taxable years beginning after December 31, 1981. These sections do not apply to any item of income, expense, deduction, or credit arising before January 1, 1982, even if such item is attributable to services performed after December 31, 1981.

(b) *Scope.* Section 1.911–2 provides rules for determining whether an individual qualifies to make an election under section 911. Section 1.911–3 provides rules for determining the amount of foreign earned income that is excludable under section 911(a)(1). Section 1.911–4 provides rules for determining the housing cost amount and the portions excludable under section 911(a)(2) or deductible under section 911(c)(3). Section 1.911–5 provides special rules applicable to married couples. Section 1.911–6 provides for the disallowance of deductions, exclusions, and credits attributable to amounts excluded under section 911. Section 1.911–7 provides procedural rules for making or revoking an election under section 911. Section 1.911–8 provides a reference to rules applicable to taxable years beginning before January 1, 1982.

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2964, Jan. 23, 1985]

§1.911–2 Qualified individuals.

(a) *In general.* An individual is a qualified individual if:

(1) The individual's tax home is in a foreign country or countries throughout—

(i) The period of bona fide residence described in paragraph (a)(2)(i) of this section, or

(ii) The 330 full days of presence described in paragraph (a)(2)(ii) of this section, and

(2) The individual is either—

(i) A citizen of the United States who establishes to the satisfaction of the Commissioner or his delegate that the individual has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, or

(ii) A citizen or resident of the United States who has been physically present in a foreign country or countries for at least 330 full days during any period of twelve consecutive months.

(b) *Tax home.* For purposes of paragraph (a)(i) of this section, the term "tax home" has the same meaning which it has for purposes of section 162(a)(2) (relating to travel expenses away from home). Thus, under section 911, an individual's tax home is considered to be located at his regular or principal (if more than one regular) place of business or, if the individual has no regular or principal place of business because of the nature of the business, then at his regular place of abode in a real and substantial sense. An individual shall not, however, be considered to have a tax home in a foreign country for any period for which the individual's abode is in the United States. Temporary presence of the individual in the United States does not necessarily mean that the individual's abode is in the United States during that time. Maintenance of a dwelling in the United States by an individual, whether or not that dwelling is used by the individual's spouse and dependents, does not necessarily mean that the individual's abode is in the United States.

(c) *Determination of bona fide residence.* For purposes of paragraph (a)(2)(i) of this section, whether an individual is a bona fide resident of a foreign country shall be determined by applying, to the extent practical, the principles of section 871 and the regulations thereunder, relating to the determination of the residence of aliens. Bona fide residence in a foreign country or countries for an uninterrupted period may be established, even if temporary visits are made during the period to the United States or elsewhere on vacation or business. An individual with earned income from sources within a foreign country is not a bona fide resident of that country if:

(1) The individual claims to be a nonresident of that foreign country in a statement submitted to the authorities of that country, and

(2) The earned income of the individual is not subject, by reason of nonresidency in the foreign country, to the income tax of that country.

If an individual has submitted a statement of nonresidence to the authorities of a foreign country the accuracy of which has not been resolved as of any date when a determination of the individual's bona fide residence is being made, then the individual will not be considered a bona fide resident of the foreign country as of that date.

(d) *Determination of physical presence.* For purposes of paragraph (a)(2)(ii) of this section, the following rules apply.

(1) *Twelve-month test.* A period of twelve consecutive months may begin with any day but must end on the day before the corresponding day in the twelfth succeeding month. The twelve-month period may begin before or after arrival in a foreign country and may end before or after departure.

(2) *330-day test.* The 330 full days need not be consecutive but may be interrupted by periods during which the individual is not present in a foreign country. In computing the minimum 330 full days of presence in a foreign country or countries, all separate periods of such presence during the period of twelve consecutive months are aggregated. A full day is a continuous period of twenty-four hours beginning with midnight and ending with the following midnight. An individual who has been present in a foreign country and then travels over areas not within any foreign country for less than twenty-four hours shall not be deemed outside a foreign country during the period of travel. If an individual who is in transit between two points outside the United States is physically present in the United States for less than twenty-four hours, such individual shall not be treated as present in the United States during such transit but shall be treated as travelling over areas not within any foreign country. For purposes of this paragraph (d)(2), the term ‘‘transit between two points outside the United States’’ has the same meaning that it has when used in section 7701(b)(6)(C).

(3) *Illustrations of the physical presence requirement.* The physical presence requirement of paragraph (a)(2)(ii) of this section is illustrated by the following examples:

Example 1. B, a U.S. citizen, arrives in Venezuela from New York at 12 noon on April 24, 1982. B remains in Venezuela until 2 p.m. on March 21, 1983, at which time B departs for the United States. Among other possible twelve month periods, B is present in a foreign country an aggregate of 330 full days during each of the following twelve month periods: March 21, 1982 through March 20, 1983; and April 25, 1982 through April 24, 1983.

Example 2. C, a U.S. citizen, travels extensively from the time C leaves the United States on March 5, 1982, until the time C departs the United Kingdom on January 1, 1984, to return to the United States permanently. The schedule of C’s travel and the number of full days at each location are listed below:

Country	Time and date of arrival	Time and date of departure	Full days in foreign country
United States		10 p.m. (by air) Mar. 5, 1982	
United Kingdom	9 a.m. Mar. 6, 1982	10 p.m. (by ship) June 25, 1982	110
United States	11 a.m. June 30, 1982	1 p.m. (by ship) July 19, 1982	0
France	3 p.m. July 24, 1982	11 a.m. (by air) Aug. 22, 1983	393
United States	4 p.m. Aug. 22, 1983	9 a.m. (by air) Sept. 4, 1983	0
United Kingdom	9 a.m. Sept. 5, 1983	9 a.m. (by air) Jan. 1, 1984	117
United States	1 p.m. Jan. 1, 1984		

Among other possible twelve–month periods, C is present in a foreign country or countries an aggregate of 330 full days during the following twelve–month periods: March 2, 1982 through March 1, 1983; and January 21, 1983 through January 20, 1984. The computation of days with respect to each twelve month period may be illustrated as follows:

First twelve–month period (March 2, 1982 through March 1, 1983):

	Full days in foreign country
Mar. 2, 1982 through Mar. 6, 1982	0
Mar. 7, 1982 through June 24, 1982	110
June 25, 1982 through July 24, 1982	0
July 25, 1982 through Mar. 1, 1983	220
Total full days	330

Second twelve–month period (January 21, 1983 through January 20, 1984):

	Full days in foreign country
Jan. 21, 1983 through Aug. 21, 1983	213
Aug. 22, 1983 through Sept. 5, 1983	0
Sept. 6, 1983 through Dec. 31, 1983	117

	Full days in foreign country
Jan. 1, 1984 through Jan. 20, 1984	0
Total full days	330

(e) *Special rules.* For purposes only of establishing that an individual is a qualified individual under paragraph (a) of this section, residence or presence in a foreign country while there employed by the U.S. government or any agency or instrumentality of the U.S. government counts towards satisfaction of the requirements of §1.911–2(a). (But see section 911(b)(1)(B)(ii) and §1.911–3(c)(3) for the rule excluding amounts paid by the U.S. government to an employee from the definition of foreign earned income.) Time spent in a foreign country prior to January 1, 1982, counts toward satisfaction of the bona fide residence and physical presence requirements, even though no exclusion or deduction may be allowed under section 911 for income attributable to services performed during that time. For purposes or paragraph (a)(2)(ii) of this section, the term ''resident of the United States'' includes an individual for whom a valid election is in effect under section 6013 (g) or (h) for the taxable year or years during which the physical presence requirement is satisfied.

(f) *Waiver of period of stay in foreign country due to war or civil unrest.* Notwithstanding the requirements of paragraph (a) of this section, an individual whose tax home is in, a foreign country, and who is a bona fide resident of, or present in a foreign country for any period, who leaves the foreign country after August 31, 1978, before meeting the requirements of paragraph (a) of this section, may as provided in this paragraph, qualify to make an election under section 911(a) and §1.911–7(a). If the Secretary determines, after consultation with the Secretary of State or his delegate, that war, civil unrest, or similar adverse conditions existed in a foreign country, then the Secretary shall publish the name of the foreign country and the dates between which such conditions were deemed to exist. In order to qualify to make an election under this paragraph, the individual must establish to the satisfaction of the Secretary that the individual left a foreign country, the name of which has been published by the Secretary, during the period when adverse conditions existed and that the individual could reasonably have expected to meet the requirements of paragraph (a) of this section but for the adverse conditions. The individual shall attach to his return for the taxable year a statement that the individual expected to meet the requirements of paragraph (a) of this section but for the conditions in the foreign country which precluded the normal conduct of business by the individual. Such individual shall be treated as a qualified individual, but only for the actual period of residence or presence. Thus, in determining the number of the individual's qualifying days, only days within the period of actual residence or presence shall be counted.

(g) *United States.* The term ''United States'' when used in a geographical sense includes any territory under the sovereignty of the United States. It includes the states, the District of Columbia, the possessions and territories of the United States, the territorial waters of the United States, the air space over the United States, and the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources.

(h) *Foreign country.* The term ''foreign country'' when used in a geographical sense includes any territory under the sovereignty of a government other than that of the United States. It includes the territorial waters of the foreign country (determined in accordance with the laws of the United States), the air space over the foreign country, and the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the foreign country and over which the foreign country has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources.

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2965, Jan. 23, 1985]

§ 1.911–3 Determination of amount of foreign earned income to be excluded.

(a) *Definition of foreign earned income.* For purposes of section 911 and the regulations thereunder, the term ''foreign earned income'' means earned income (as defined in paragraph (b) of this section) from sources within a foreign country (as defined in § 1.911–2(h)) that is earned during a period for which the individual qualifies under § 1.911–2(a) to make an election. Earned income is from sources within a foreign country if it is attributable to services performed by an individual in a foreign country or countries. The place of receipt of earned income is immaterial in determining whether earned income is attributable to services performed in a foreign country or countries.

(b) *Definition of earned income*—(1) *In general.* The term ''earned income'' means wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered including the fair market value of all remuneration paid in any medium other than cash. Earned income does not include any portion of an amount paid by a corporation which represents a distribution of earnings and profits rather than a reasonable allowance as compensation for personal services actually rendered to the corporation.

(2) *Earned income from business in which capital is material.* In the case of an individual engaged in a trade or business (other than in corporate form) in which both personal services and capital are material income producing factors, a reasonable allowance as compensation for the personal services actually rendered by the individual shall be considered earned income, but the total amount which shall be treated as the earned income of the individual from such trade or business shall in no case exceed thirty percent of the individual's share of the net profits of such trade or business.

(3) *Professional fees.* Earned income includes all fees received by an individual engaged in a professional occupation (such as doctor or lawyer) in the performance of professional activities. Professional fees constitute earned income even though the individual employs assistants to perform part or all of the services, provided the patients or clients are those of the individual and look to the individual as the person responsible for the services rendered.

(c) *Amounts not included in foreign earned income.* Foreign earned income does not include an amount:

(1) Excluded from gross income under section 119;

(2) Received as a pension or annuity (including social security benefits);

(3) Paid to an employee by an employer which is the U.S. government or any U.S. government agency or instrumentality;

(4) Included in the individual's gross income by reason of section 402(b) (relating to the taxability of a beneficiary of a nonexempt trust) or section 403(c) (relating to the taxability of a beneficiary under a nonqualified annuity or under annuities purchased by exempt organizations);

(5) Included in gross income by reason of § 1.911–6(b)(4)(ii); or

(6) Received after the close of the first taxable year following the taxable year in which the services giving rise to the amounts were performed. For treatment of amounts received after December 31, 1962, which are attributable to services performed on or before December 31, 1962, and with respect to which there existed on March 12, 1962, a right (whether forfeitable or nonforfeitable) to receive such amounts, see § 1.72–8.

(d) *Determination of the amount of foreign earned income that may be excluded under section 911(a)(1)*—(1) *In general.* Foreign earned income described in this section may be excluded under section 911(a)(1) and this paragraph only to the extent of the limitation specified in paragraph (d)(2) of this section. Income is considered to be earned in the taxable year in which the services giving rise to the income are performed. The determination of the amount of excluded earned income in this manner does not affect the time for reporting any amounts included in gross income.

(2) *Limitation*—(i) *In general.* The term ‘‘section 911(a)(1) limitation’’ means the amount of foreign earned income for a taxable year which may be excluded under section 911(a)(1). The section 911(a)(1) limitation shall be equal to the lesser of the qualified individual's foreign earned income for the taxable year in excess of amounts that the individual elected to exclude from gross income under section 911(a)(2) or the product of the annual rate for the taxable year (as specified in paragraph (d)(2)(ii) of this section) multiplied by the following fraction:

$$\frac{\text{The number of qualifying days in the taxable year}}{\text{The number of days in the taxable year}}$$

(ii) *Annual rate for the taxable year.* The annual rate for the taxable year is the rate set forth in section 911(b)(2)(A).

(3) *Number of qualifying days.* For purposes of section 911 and the regulations thereunder, the number of qualifying days is the number of days in the taxable year within the period during which the individual met the tax home requirement and either the bona fide residence requirement or the physical presence requirement of §1.911–2(a). Although the period of bona fide residence must include an entire taxable year, the entire uninterrupted period of residence may include fractional parts of a taxable year. For instance, if an individual who was a calendar year taxpayer established a tax home and a residence in a foreign country as of November 1, 1982, and maintained the tax home and the residence through March 31, 1984, then the uninterrupted period of bona fide residence includes fractional parts of the years 1982 and 1984, and all of 1983. The number of qualifying days in 1982 is sixty-one. The number of qualifying days in 1983 is 365. The number of qualifying days in 1984 is ninety-one. The period during which the physical presence requirement of §1.911–2(a)(2)(ii) is met is any twelve consecutive month period during which the individual is physically present in one or more foreign countries for 330 days and the individual's tax home is in a foreign country during each day of such physical presence. Such period may include days when the individual is not physically present in a foreign country, and days when the individual does not maintain a tax home in a foreign country. Such period may include fractional parts of a taxable year. Thus, if an individual's period of physical, presence is the twelve-month period beginning June 1, 1982, and ending May 31, 1983, the number of qualifying days in 1982 is 214 and the number of qualifying days in 1983 is 151.

(e) *Attribution rules*—(1) *In general.* Foreign earned income is considered to be earned in the taxable year in which the individual performed the services giving rise to the income. If income is earned in one taxable year and received in another taxable year, then, for purposes of determining the amount of foreign earned income that the individual may exclude under section 911(a), the individual must attribute the income to the taxable year in which the services giving rise to the income were performed. Thus, any reimbursement would be attributable to the taxable year in which the services giving rise to the obligation to pay the reimbursement were performed, not the taxable year in which the reimbursement was received. For example, tax equalization payments are normally received in the year after the year in which the services giving rise to the obligation to pay the tax equalization payment were performed. Therefore, such payments will almost always have to be attributed to the prior year. Foreign earned income attributable to services performed in a preceding taxable year shall be excludable from gross income in the year of receipt only to the extent such amount could have been excluded under paragraph (d)(1) in the preceding taxable year, had such amount been received in the preceding taxable year. The taxable year to which income is attributable will be determined on the basis of all the facts and circumstances.

(2) *Priority of use of the section 911(a)(1) limitation.* Foreign earned income received in the year in which it is earned shall be applied to the section 911(a)(1) limitation for that year before applying income earned in that year

that is received in any other year. Foreign earned income that is earned in one year and received in another year shall be applied to the section 911(a)(1) limitation for the year in which it was earned, on a year by year basis, in any order that the individual chooses. (But see section 911(b)(1)(B)(iv)). An individual may not amend his return to change the treatment of income with respect to the section 911(a)(1) exclusion after the period provided by section 6511(a). The special period of limitation provided by section 6511(d)(3) does not apply for this purpose. For example, C, a qualified individual, receives an advance bonus of $10,000 in 1982, salary of $70,000 in 1983, and a performance bonus of $10,000 in 1984, all of which are foreign earned income for 1983. C has a section 911(a)(1) limitation for 1983 of $80,000, and has no housing cost amount exclusion. On his income tax return for 1983, C elects to exclude foreign earned income of $70,000 received in 1983. C may also exclude his $10,000 advance bonus received in 1982 (by filing an amended return for 1982), or he may exclude the $10,000 performance bonus received in 1984 on his 1984 income tax return. However, C may not exclude part of the 1982 bonus and part of the 1984 bonus.

(3) *Exception for year-end payroll period.* Notwithstanding paragraph (e)(1) of this section, salary or wage payments of a cash basis taxpayer shall be attributed entirely to the year of receipt under the following circumstances:

(i) The period for which the payment is made is a normal payroll period of the employer which regularly applies to the employee;

(ii) The payroll period includes the last day of the employee's taxable year;

(iii) The payroll period does not exceed 16 days; and

(iv) The payment is part of a normal payroll of the employer that is distributed at the same time, in relation to the payroll period, that such payroll would normally be distributed, and is distributed before the end of the next succeeding payroll period.

(4) *Attribution of bonuses and substantially nonvested property to periods in which services were performed*—(i) *In general.* Bonuses and substantially nonvested property are attributable to all of the services giving rise to the income on the basis of all the facts and circumstances. If an individual receives a bonus or substantially nonvested property (as defined in § 1.83–3(b)) and it is determined to be attributable to services performed in more than one taxable year, then, for purposes of determining the amount eligible for exclusion from gross income in the year the bonus is received or the property vests, a portion of such amount shall be treated as attributable to services performed in each taxable year (or portion thereof) during the period when services giving rise to the bonus or the substantially nonvested property were performed. Such portion shall be determined by dividing the amount of the bonus or the excess of the fair market value of the vested property over the amount paid, if any, for the vested property, by the number of months in the period when services giving rise to such amount were performed, and multiplying the quotient by the number of months in such period in the taxable year. For purposes of this section, the term ''month'' means a calendar month. A fraction of a calendar month shall be deemed a month if it includes fifteen or more days.

(ii) *Examples.* The following examples illustrate the application of this paragraph (e)(4).

Example 1. A, an employee of M Corporation during all of 1983 and 1984, worked in the United States from January 1 through April 30, 1983, and received $12,000 of salary for that period. A worked in country F from May 1, 1983 through the end of 1984, and is a qualified individual under § 1.911–2(a) for that period. For the period from May 1 through December 31, 1983, A received $32,000 of salary. M pays a bonus on December 20, 1983 to each of M's employees in an amount equal to 10 percent of the employee's regular wages or salary for the 1983 calendar year. The amount of A's bonus is $4,400 for 1983. The portion of A's bonus that is attributable to services performed in country F and is foreign earned income for 1983 is $3,200, or $32,000×10 percent. The remaining $1,200 of A's bonus is attributable to services performed in the United States, and is not foreign earned income.

Example 2. The facts are the same as in example 1, except that M determines bonuses separately for each country based on the productivity of the employees in that country. M pays a bonus to employees in country F, in the amount of 15 percent of each employee's wages or salary earned in country F. A's country F bonus is $4,800 for 1983 ($32,000×15 percent), and is foreign earned income for 1983. If A also receives a bonus (or if A's bonus is increased) for working in the United States during 1983, that amount is not foreign earned income.

Example 3. X corporation offers its employees a bonus of $40,000 if the employee accepts employment in a foreign country and remains in a foreign country for a period of at least four years. A, an employee of X, is a calendar year and cash basis taxpayer. A accepts employment with X in foreign country F. A begins work in F on July 1, 1983 and continues to work in F for X until June 30, 1987. In 1987 X pays A a $40,000 bonus. The bonus is attributable to services A performed from July 1, 1983 through June 30, 1987. The amount of the bonus attributable to 1987 is $5,000 (($40,000÷48)×6). The amount of the bonus attributable to 1986 is $10,000 (($40,000÷48)×12). A may exclude the $10,000 attributable to 1986 only to the extent that amount could have been excluded under section 911(a)(1) had A received it in 1986. The remaining $25,000 is attributable to services performed in taxable years before 1986. Such amounts may not be excluded under section 911 because they are received after the close of the taxable year following the taxable year in which the services giving rise to the income were performed.

(iii) *Special rule for elections under section 83(b).* If an individual receives substantially nonvested property and makes an election under section 83(b) and §1.83–2(a) to include in his gross income the amount determined under section 83(b)(1)(A) and (B) and §1.83–2(a) for the taxable year in which the property is transferred (as defined in §1.83–3(a)), then, for the purpose of determining the amount eligible for exclusion in the year of receipt, the individual may elect either of the following options:

(A) Substantially nonvested property may be treated as attributable entirely to services performed in the taxable year in which an election to include it in income is made. If so treated, then the amount otherwise included in gross income as determined under §1.83–2(a) will be excludable under section 911(a) for such year subject to the limitation provided in §1.911–3(d)(2) for such year.

(B) A portion of the substantially nonvested property may be treated as attributable to services performed or to be performed in each taxable year during which the substantial risk of forfeiture (as defined in section 83(c) and §1.83–3(c)) exists. The portion treated as attributable to services performed or to be performed in each taxable year is determined by dividing the amount of the substantially nonvested property included in gross income as determined under §1.83–2(a) by the number of months during the period when a substantial risk of forfeiture exists. The quotient is multiplied by the total number of months in the taxable year during which a substantial risk of forfeiture exists. The amount determined to be attributable to services performed in the year the election is made shall be excluded from gross income for such year as provided in paragraph (d)(2) of this section. Amounts treated as attributable to services performed in subsequent taxable years shall be excludable in the year of receipt only to the extent such amounts could be excluded under paragraph (d)(2) of this section in such subsequent years. An individual may obtain such additional exclusion by filing an amended return for the taxable year in which the property was transferred. The individual may only amend his or her return within the period provided by section 6511(a) and the regulations thereunder.

(5) *Moving expense reimbursements*—(i) *Source of reimbursements.* For the purpose of determining whether a moving expense reimbursement is attributable to services performed within a foreign country or within the United States, in the absence of evidence to the contrary, the reimbursement shall be attributable to future services to be performed at the new principal place of work. Thus, a reimbursement received by an employee from his employer for the expenses of a move to a foreign country will generally be attributable to services performed in the foreign country. A reimbursement received by an employee from his employer for the expenses of a move from a foreign country to the United States will generally be attributable to services performed in the United States. For purposes of this paragraph (e)(5), evidence to the contrary includes, but is not

limited to, an agreement, between the employer and the employee, or a statement of company policy, which is reduced to writing before the move to the foreign country and which is entered into or established to induce the employee or employees to move to a foreign country. The writing must state that the employer will reimburse the employee for moving expenses incurred in returning to the United States regardless of whether the employee continues to work for the employer after the employee returns to the United States. The writing may contain conditions upon which the right to reimbursement is determined as long as the conditions set forth standards that are definitely ascertainable and the conditions can only be fulfilled prior to, or through completion of the employee's return move to the United States that is the subject of the writing. In no case will an oral agreement or statement of company policy concerning moving expenses be considered evidence to the contrary. For the purpose of determining whether a storage expense reimbursement is attributable to services performed within a foreign country, in the case of storage expenses incurred after December 31, 1983, the reimbursement shall be attributable to services performed during the period of time for which the storage expenses are incurred.

(ii) *Attribution of foreign source reimbursements to taxable years in which services are performed*—(A) *In general.* If a reimbursement for moving expenses is determined to be from foreign sources under paragraph (e)(5)(i) of this section, then for the purpose of determining the amount eligible for exclusion in accordance with paragraphs (d)(2) and (e)(2) of this section, the reimbursement shall be considered attributable to services performed in the year of the move as long as the individual is a qualified individual for a period that includes 120 days in the year of the move. The period that is used in determining the number of qualifying days for purposes of the individual's section 911(a)(1) limitation (under paragraph (d)(2) of this section) must also be used in determining whether the individual is a qualified individual for a period that includes 120 days in the year of the move. If the individual is not a qualified individual for such period, then the individual shall treat a portion of the reimbursement as attributable to services performed in the year of the move, and a portion as attributable to services performed in the succeeding taxable year, if the move is from the United States to a foreign country, or to the prior taxable year, if the move is from a foreign country to the United States. The portion of the reimbursement treated as attributable to services performed in the year of the move shall be determined by multiplying the total reimbursement by the following fraction:

$$\frac{\text{The number of qualifying days (as defined in paragraph (d)(3) of this section) in the year of the move}}{\text{The number of days in the taxable year of the move.}}$$

The remaining portion of the reimbursement shall be treated as attributable to services performed in the year succeeding or preceding the year of the move. Amounts treated as attributable to services performed in a year succeeding or preceding the year of the move shall be excludable in the year of receipt only to the extent such amounts could be excluded under paragraph (d)(2) of this section in such succeeding or preceding year.

(B) *Moves beginning before January 1, 1984.* Notwithstanding paragraph (e)(5)(ii)(A) of this section, this paragraph (e)(5)(ii)(B) shall apply for moves begun before January 1, 1984. If a reimbursement for moving expenses is determined to be from foreign sources under paragraph (e)(5)(i) of this section, then for the purpose of determining the amount eligible for exclusion in accordance with paragraphs (d)(2) and (e)(2) of this section, the reimbursement shall be considered attributable to services performed in the year of the move. However, if the individual does not qualify under section 911(d)(1) and §1.911–2(a) for the entire taxable year of the move, then the individual shall treat a portion of the reimbursement as attributable to services performed in the succeeding taxable year, if the move is from the United States to a foreign country, or to the prior taxable year, if the move is from a foreign country to the United States. The portion of the reimbursement treated as attributable to services performed in the year succeeding or preceding the move shall be determined by multiplying the total reimbursement by the following fraction:

$$\frac{\text{The number of qualifying days (as defined in paragraph (d)(3) of this section) in the year of the move}}{\text{The number of days in the taxable year of the move.}}$$

and subtracting the product from the total reimbursement. Amounts treated as attributable to services performed in a year succeeding or preceding the year of the move shall be excludable in the year of receipt only to the extent such amounts could be excluded under paragraph (d)(2) of this section in such succeeding or preceding year.

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

Example 1. A is a U.S. citizen and calendar year taxpayer. A's tax home was in foreign country F and A was physically present in F for 330 days during the period from July 4, 1982 through July 3, 1983. The number of A's qualifying days in 1982 as determined under paragraph (d)(2) of this section is 181. In 1982 A receives $40,000 attributable to services performed in foreign country F in 1982. Under paragraph (d)(2) of this section A's section 911(a)(1) limitation is $37,192, that is the lesser of $40,000 (foreign earned income) or

$$\$75{,}000\,(\text{annual rate}) \times \frac{181\,(\text{qualifying days})}{365\,(\text{days in taxable year}).}$$

Example 2. The facts are the same as in example 1 except that in 1982 A receives $30,000 attributable to services performed in foreign country F. A excludes this amount from gross income under paragraph (d) of this section. In addition, in 1983 A receives $10,000 attributable to services performed in F in 1982 and $35,000 attributable to services performed in F in 1983. On his return for 1983, A must report $45,000 of income. A's section 911(a)(1) limitation for 1983 is the lesser of $35,000 (foreign earned income) or $49,329, the annual rate for the taxable year multiplied by a fraction the numerator of which is A's qualifying days in the taxable year and the denominator of which is the number of days in the taxable year ($80,000×184/365). On his tax return for 1983 A may exclude $35,000 attributable to services performed in 1983. A may only exclude $7,192 of the $10,000 received in 1983 attributable to services performed in 1982 because such amount is only excludable in 1983 to the extent such amount could have been excluded in 1982 subject to the section 911(a)(1) limitation for 1982 which is $37,192 ($75,000×181/365). No portion of amounts attributable to services performed in 1982 may be used in calculating A's section 911(a)(1) limitation for 1983. Thus, even though A could have excluded an additional $5,329 in 1983 if A had had more foreign earned income attributable to 1983, A may not exclude the $2,808 of remaining foreign earned income attributable to 1982.

Example 3. C is a U.S. citizen and calendar year taxpayer. C establishes a bona fide residence and a tax home in foreign country J on March 1, 1982, and maintains a tax home and a residence in J until December 31, 1986. In March of 1982 C's employer, Y corporation, transfers stock in Y to C. The stock is subject to forfeiture if C returns to the U.S. before January 1, 1985. C elects under section 83(b) to include $15,000, the amount determined with respect to such stock under section 83(b)(1), in gross income in 1982. C's other foreign earned income in 1982 is $58,000. C elects under paragraph (e)(4)(iii)(B) of this section to treat the stock as if earned over the period of the substantial risk of forfeiture. The number of months in the period of the substantial risk of forfeiture is thirty-four. The number of months in the taxable year 1982 within the period of foreign employment is ten. For purposes of determining C's section 911(a)(1) limitation, $4,412 (($15,000/34)×10) of the amount included in gross income under section 83(b) is treated as attributable to services performed in 1982, $5,294 is treated as attributable to services to be performed in 1983, and $5,294 is treated as attributable to services to be performed in 1984. In 1982, C excludes $62,412 under section 911(a)(1). That is the lesser of foreign earned income for 1982 ($58,000+$4,412) or the annual rate for the taxable year multiplied by a fraction the numerator of which is C's qualifying days in the taxable year and the denominator of which is the number of days in the taxable year ($75,000×306/365). C continues to perform services in foreign country J throughout 1983 and 1984. C would be able to exclude the remaining $5,294 attributable to services performed in 1983 and $5,294 attributable to services performed in 1984 if those amounts would be excludable if they had been received in 1983 or 1984 respectively. If C is entitled to exclude the additional amounts, C must claim the exclusion by filing an amended return for 1982.

Example 4. D is a U.S. citizen and a calendar year taxpayer. In September, 1984 D moves to a foreign country K. D is physically present in K, and D's tax home is in K, from September 15, 1984 through December 31, 1985. D receives $6,000 in April, 1985 from his employer, as a reimbursement for expenses of moving to K, pursuant to a written agreement that such moving expenses would be reimbursed to D upon successful completion of 6 months employment in K. Under paragraph (e)(15)(i) of this section, the reimbursement is attributable to services performed in K. Under the physical presence test of § 1.911–2(a)(2)(ii), among other periods D is a qualified individual for the period of August 10, 1984 through August 9, 1985, which includes 144 days in 1984. Under paragraph (e)(5)(ii)(A) of this section, for the purpose of determining the amount eligible for exclusion, the reimbursement is considered attributable to services performed in 1984 (the year of the move) because D is a qualified individual under § 1.911–2(a) for a period that includes 120 days in 1984. The reimbursement may be excluded under paragraphs (d)(2) and (e)(2) of this section, to the extent that D's foreign earned income for 1984 that was earned and received in 1984 was less than the annual rate for the taxable year multiplied by the number of D's qualifying days in the taxable year over the number of days in D's taxable year ($80,000×144/366), or $31,475.

Example 5. The facts are the same as in example 4 except that D is not a qualified individual under the physical presence test, but is a qualified individual under the bona fide residence test for the period of September 15, 1984 through December 31, 1985. Under paragraph (e)(5)(ii)(A) of this section, for the purpose of determining the amount eligible for exclusion, the reimbursement is considered attributable to services performed in 1984 and 1985 because D is not a qualified individual for a period that includes 120 days in 1984 (the year of the move). The portion of the reimbursement treated as attributable to services performed in 1984 is $6,000×108/366, or $1,770, and may be excluded, subject to D's 1984 section 911(a)(1) limitation. The balance of the reimbursement, $4,230, is treated as attributable to services performed in 1985, and may be excluded to the extent provided in paragraphs (d)(2) and (e)(2) of this section.

Example 6. The facts are the same as in example 4, with the following additions. Before D moved to K, D and his employer signed a written agreement that D would perform services for the employer for at least one year, primarily in country K, and, if D did not voluntarily cease to work for the employer primarily in country K before one year had elapsed, the employer would reimburse D for one half of D's expenses, up to a maximum of $4,000, of moving back to the United States. The agreement also stated that, if D did not voluntarily leave the employment in K before two years had elapsed, the employer would reimburse D for all of D's reasonable expenses of moving back to the United States. The agreement further stated that D's right to reimbursement would not be conditioned upon the performance of services after D ceased to work in K. D worked in country K for all of 1985. On January 1, 1986, D left K and moved to the United States. In February, 1986 the employer paid D $3,500 as reimbursement for one-half of D's expenses of moving to the United States. Although D did not fulfill the condition in the agreement to receive full reimbursement, all of the conditions in the agreement set forth definitely ascertainable standards and no condition could be fulfilled after D moved back to the United States. The agreement fulfills the requirements of paragraph (e)(5)(i) of this section, and therefore is evidence that the reimbursement should not be attributable to future services to be performed at D's new principal place of work. Under the facts and circumstances, the reimbursement is attributable to services performed in K. Under paragraph (e)(5)(ii)(A) of this section, the entire reimbursement is attributable to services performed in 1985. The amount attributable to

1985 may be excluded to the extent provided in paragraphs (d)(2) and (e)(2) of this section.

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2966, Jan. 23, 1985]

§1.911–4 Determination of housing cost amount eligible for exclusion or deduction.

(a) *Definition of housing cost amount.* The term ‘‘housing cost amount’’ means an amount equal to the reasonable expenses paid or incurred (as defined in section 7701(a)(25)) during the taxable year by or on behalf of the individual attributable to housing in a foreign country for the individual and any spouse or dependents who reside with the individual (or live in a second foreign household described in paragraph (b)(5) of this section) less the base housing amount as defined in paragraph (c) of this section. The housing cost amount must be reduced by the amount of any military or section 912 allowance or similar allowance excludable from gross income that is intended to compensate the individual or the individual’s spouse in whole or in part for the expenses of housing during the same period for which the individual claims a housing cost amount exclusion or deduction.

(b) *Housing expenses*—(1) *Included expenses.* For purposes of paragraph (a) of this section, housing expenses include rent, the fair rental value of housing provided in kind by the employer, utilities (other than telephone charges), real and personal property insurance, occupancy taxes not described in paragraph (b)(2)(v) of this section, nonrefundable fees paid for securing a leasehold, rental of furniture and accessories, household repairs, and residential parking.

(2) *Excluded expenses.* Housing expenses do not include:

(i) The cost of house purchase, improvements, and other costs that are capital expenditures;

(ii) The cost of purchased furniture or accessories or domestic labor (maids, gardeners, etc.);

(iii) Amortized payments of principal with respect to an evidence of indebtedness secured by a mortgage on the taxpayer’s housing;

(iv) Depreciation of housing owned by the taxpayer, or amortization or depreciation of capital improvements made to housing leased by the taxpayer;

(v) Interest and taxes deductible under section 163 or 164 or other amounts deductible under section 216(a) (relating to deduction of interest and taxes by cooperative housing corporation tenant);

(vi) The expenses of more than one foreign household except as provided in paragraph (b)(5) of this section;

(vii) Expenses excluded from gross income under section 119;

(viii) Expenses claimed as deductible moving expenses under section 217; or

(ix) The cost of a pay television subscription.

(3) *Limitation.* Housing expenses are taken into account for purposes of this section only to the extent attributable to housing for portions of the taxable year within the period during which the individual satisfies the requirements of §1.911–2(a). Housing expenses are not taken into account for the period during which the value of the individual’s housing is excluded from gross income under section 119, unless the individual maintains a second foreign household described in paragraph (b)(5) of this section. If an individual maintains two foreign households, only expenses incurred with respect to the abode which bears the closest relationship, not necessarily geographic, with respect to the individual’s tax home shall be taken into account, unless one of the households is a second foreign household.

(4) *Reasonableness.* An amount paid for housing shall not be treated as reasonable, for purposes of paragraph (a) of this section, to the extent that the expense is lavish or extravagant under the circumstances.

(5) *Expenses of a second foreign household*—(i) *In general.* The term ‘‘second foreign household’’ means a separate abode maintained by an individual outside of the U.S. for his or her spouse or dependents (who, if minors, are in the individual’s legal custody or the joint custody of the individual and the individual’s spouse) at a place other than the tax home of the individual because of adverse living conditions at the individual’s tax home. If an individual

maintains a second foreign household the expenses of the second foreign household may be included in the individual's housing expenses under paragraph (b)(1) of this section. Under no circumstances shall an individual be considered to maintain more than one second foreign household at the same time.

(ii) *Adverse living conditions.* Solely for purposes of paragraph (b)(5)(i) of this section, adverse living conditions are living conditions which are dangerous, unhealthful, or otherwise adverse. Adverse living conditions include a state of warfare or civil insurrection in the general area of the individual's tax home. Adverse living conditions exist if the individual resides on the business premises of the employer for the convenience of the employer and, because of the nature of the business (for example, a construction site or drilling rig), it is not feasible for the employer to provide housing for the individual's spouse or dependents. The criteria used by the Department of State in granting a separate maintenance allowance are relevant, but not determinative, for purposes of determining whether a separate household is provided because of adverse living conditions.

(c) *Base housing amount*—(1) *In general.* The base housing amount is equal to the product of 16 percent of the annual salary of an employee of the United States who is compensated at a rate equal to the annual salary rate paid for step 1 of grade GS–14, multiplied by the following fraction:

$$\frac{\text{The number of qualifying days}}{\text{The number of days in the taxable year}}$$

For purposes of the above fraction, the number of qualifying days is determined in accordance with § 1.911–3(d)(3).

(2) *Annual salary of step 1 of grade GS–14.* The annual salary rate for a step 1 of grade GS–14 is determined on January first of the calendar year in which the individual's taxable year begins.

(d) *Housing cost amount exclusion*—(1) *Limitation.* A qualified individual who has elected to exclude his or her housing cost amount may only exclude the lesser of the full amount of either the individual's housing cost amount attributable to employer provided amounts or the individual's foreign earned income for the taxable year. A qualified individual who elects to exclude his or her housing cost amount may not claim less than the full amount of the housing cost exclusion determined under this paragraph.

(2) *Employer provided amounts.* For purposes of this section, the term ''employer provided amounts'' means any amounts paid or incurred on behalf of the individual by the individual's employer which are foreign earned income included in the individual's gross income for the taxable year (without regard to section 911). Employer provided amounts include, but are not limited to, the following amounts: Any salary paid by the employer to the employee; any reimbursement paid by the employer to the employee for housing expenses, educational expenses for the individual's dependents, or as part of a tax equalization plan; the fair market value of compensation provided in kind (including lodging, unless excluded under section 119, relating to meals and lodging furnished for the convenience of the employer); and any amount paid by the employer to any third party on behalf of the employee. An individual will only have earnings that are not employer provided amounts if the individual has earnings from self-employment.

(3) *Housing cost amount attributable to employer provided amounts.* For the purpose of determining what portion of the housing cost amount is excludable and what portion is deductible the following rules apply. If the individual has no income from self-employment, then the entire housing cost amount is attributable to employer provided amounts and is, therefore, excludable to the extent of the limitation provided in paragraph (d)(1) of this section. If the individual only has income from self-employment, then the entire housing cost amount is attributable to non-employer provided amounts and is, therefore, deductible to the extent of the limitation provided in paragraph (e) of this section. In all other instances, the housing cost amount attributable to employer provided amounts shall be determined by multiplying the housing cost amount by the

following fraction: Employer provided amounts over foreign earned income for the taxable year. The housing cost amount attributable to non-employer provided amounts shall be determined by subtracting the portion of the housing cost amount attributable to employer provided amounts from the total housing cost amount.

(e) *Housing cost amount deduction*—(1) *In general.* If a portion of the individual's housing cost amount is determined under paragraph (d)(3) of this section to be attributable to non-employer provided amounts, the individual may deduct that amount from gross income for the taxable year but only to the extent of the individual's foreign earned income (as defined in §1.911–3) for the taxable year in excess of foreign earned income excluded and the housing cost amount excluded from gross income for the taxable year under §1.911–3 and this section.

(2) *Carryover.* If any portion of the individual's housing cost amount deduction is disallowed for the taxable year under paragraph (e)(1) of this section, such portion shall be carried over and treated as a deduction from gross income for the succeeding taxable year (but only for the succeeding taxable year) to the extent of the excess, if any, of:

(i) The amount of foreign earned income for the succeeding taxable year less the foreign earned income and the housing cost amount excluded from gross income under §1.911–3 and this section for the succeeding taxable year over,

(ii) The portion, if any, of the housing cost amount that is deductible under paragraph (e)(1) of this section for the succeeding taxable year.

(f) *Examples.* The following examples illustrate the application of this section. In all examples the annual rate for a step 1 of GS–14 as of January first of the calendar year in which the individual's taxable year begins is $39,689.

Example 1. B, a U.S. citizen is a calendar year taxpayer who was a bona fide resident of and whose tax home was located in foreign country G for the entire taxable year 1982. B receives an $80,000 salary from B's employer for services performed in G. B incurs no business expenses. B receives housing provided by B's employer with a fair rental value of $15,000. The value of the housing furnished by B's employer is not excluded from gross income under section 119. B pays $10,000 for housing expenses. B's gross income and foreign earned income for 1982 is $95,000. B elects the foreign earned income exclusion of section 911(a)(1) and the housing cost amount exclusion of section 911(a)(2). B must first compute his housing cost amount exclusion. B's housing cost amount is $18,650 determined by reducing B's housing expenses, $25,000 ($15,000 fair rental value of housing and $10,000 of other expenses), by the base housing amount of $6,350 (($39,689×.16)×365/365). Because B has no income from self-employment, the entire amount is attributable to employer provided amounts and therefore, is excludable. B's section 911(a)(1) limitation is $75,000. That is the lesser of $75,000×365/365 or $95,000−18,650. B's total exclusion for 1982 under section 911(a)(1) and (2) is $93,650.

Example 2. The facts are the same as in example 1 except that B's salary for 1982 is $70,000. B's foreign earned income for 1982 is $85,000. B's housing cost amount is $18,650, all of which is attributable to employer provided amounts. B's housing cost amount is excludable to the extent of the lesser of B's housing cost amount attributable to employer provided amounts, $18,650, or the foreign earned income for the taxable year, $85,000. Thus, B excludes $18,650 under section 911(a)(2). B's section 911(a)(1) limitation for 1982 is $66,350 (the lesser of $75,000×365/365 or $85,000−18,650). B's total exclusion for 1982 under section 911(a)(1) and (2) is $85,000.

Example 3. The facts are the same as in example 2 except that in 1983, B receives $5,000 attributable to services performed in 1982. B may exclude the entire $5,000 in 1983 because such amount would have been excludable under §1.911–3(d)(1) had it been received in 1982.

Example 4. C is a U.S. citizen self-employed and a calendar year and cash basis taxpayer. C arrived in foreign country H on October 3, 1982, and departed from H on March 8, 1984. C's tax home was located in H throughout that period. C was physically present for 330 full days during the twelve consecutive month period August 30, 1982, through August 29, 1983. The number of C's qualifying days in 1982 is 124. During 1982 C had $35,000 of foreign earned income, none of which was attributable to employer provided amounts and $8,000 of reasonable housing expenses. C's housing cost amount is $5,843 ($8,000−((39,689×.16)×124/365)). C elects to exclude her foreign earned income under §1.911–3(d)(1). C's section 911(a)(1) limitation for 1982 is $25,479 (the lesser of C's foreign earned income for the taxable year ($35,000) or the annual rate for the taxable year multiplied by the number of C's qualifying days over the number of days in the taxable year ($75,000×124/365=$25,479). C may not claim the housing cost amount exclusion under section 911(a)(2) because no portion of the housing cost amount is attributable to employer provided amounts. C may deduct the lesser of her housing cost amount ($5,843) or her foreign earned income in excess of amounts excluded under section 911(a) ($35,000 − 25,479=$9,521). Thus, C's housing cost amount deduction is $5,843.

Example 5. The facts are the same as in example 4 except that C had $30,000 of foreign earned income for 1982, none of which was attributable to employer provided amounts. C elects to exclude $25,479 under § 1.911–3(d)(1). C may only deduct $4,521 of her housing cost amount under paragraph (e)(1) of this section because her foreign earned income in excess of amounts excluded under section 911(a) is $4,521($30,000 − 25,479). The $1,322 of unused housing cost amount deduction may be carried over to the subsequent taxable year.

Example 6. The facts are the same as in example 4 except that C had $15,000 of foreign earned income of 1982, none of which was attributable to employer provided amounts. C elects to exclude the entire $15,000 under § 1.911–3(d)(1). C is not entitled to a housing cost amount deduction for 1982 since she has no foreign earned income in excess of amounts excluded under section 911(a). C may carry over her entire housing cost amount deduction to 1983.

Example 7. The facts are the same as in example 6. In addition, during taxable year 1983 C had $115,000 of foreign earned income, none of which was attributable to employer provided amounts, and $40,000 of reasonable housing expenses C elects to exclude her foreign earned income under § 1.911–3(d)(1). C's section 911(a)(1) limitation is the lesser of $115,000 or $80,000 ($80,000×365/365). C's housing cost amount for 1983 is $33,650 (40,000 − (39,689×.16)×365/365). Since no portion of that amount is attributable to employer provided amounts, C may not claim a housing cost amount exclusion. C may deduct the lesser of her housing cost amount ($33,650) or her foreign earned income in excess of amounts excluded under section 911(a) ($115,000 − 80,000=35,000). Thus, C may deduct her $33,650 housing cost amount in 1983. In addition, C may deduct $1,350 of the housing cost amount deduction carried over from taxable year 1982.

(($115.000 − 80,000) − 33,650=$1,350). The remaining $4,493 ($5,843 − 1,350) of the housing cost amount deduction carried over from taxable year 1982 may not be deducted in 1983 or carried over to 1984.

Example 8. D is a U.S. citizen and a calendar year and cash basis taxpayer. D is a bona fide resident of and maintains his tax home in foreign country J for all of taxable year 1984. In 1984, D earns $80,000 of foreign earned income, $60,000 of which is an employer provided amount and $20,000 of which is a non-employer provided amount. D's total housing cost amount for 1984 is $25,000. D elects to exclude, under section 911(a)(2), the portion of his housing cost amount that is attributable to employer provided amounts. D's excludable housing cost amount is $18,750; that is the total housing cost amount ($25,000) multiplied by employer provided amounts for the taxable year ($60,000) over foreign earned income for the taxable year ($80,000). D also elects to exclude his foreign earned income under § 1.911–3(d)(1). D's section 911(a)(1) limitation for 1984 is $61,250 (the lesser of $80,000 − $18,750 or $80,000×366/366). D's total exclusion for 1984 under section 911(a)(1) and (2) is $80,000. D cannot claim a housing cost amount deduction in 1984 because D has no foreign earned income in excess of his foreign earned income and housing cost amount excluded from gross income for the taxable year under § 1.911–3 and this section. D may carry over his housing cost amount deduction of $6,250, the total housing cost amount less the portion attributable to employer provided amounts ($25,000 − 18,750), to taxable year 1985.

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2970, Jan. 23, 1985]

§ 1.911–5 Special rules for married couples.

(a) *Married couples with two qualified individuals*—(1) *In general.* In the case in which a husband and wife both are qualified individuals under § 1.911–2(a), each individual may make one or more elections under § 1.911–7 and exclude from gross income foreign earned income and exclude or deduct housing cost amounts subject to the rules of paragraphs (a)(2) and (3) of this section.

(2) *Computation of excluded foreign earned income.* The amount of excludable foreign earned income is determined separately for each spouse under the rule of § 1.911–3 on the basis of the income attributable to the services of that spouse. If the spouses file separate returns each may exclude the amount of his or her foreign earned income attributable to his or her services subject to the limitations of § 1.911–3(d)(2). If the spouses file a joint return, the sum of these foreign earned income amounts so determined for each spouse may be excluded. For example, H and W both qualify under § 1.911–2(a)(2)(i) for the entire 1983 taxable year. During 1983 W earns $100,000 of foreign earned income and H earns $45,000 of foreign earned income. H and W file a joint return for 1983. On their joint return H

and W may exclude from gross income a total of $125,000. That amount is determined by adding W's section 911(a)(1) limitation, $80,000 (the lesser of $80,000×365/365 or $100,000), and H's section 911(a)(1) limitation, $45,000 (the lesser of $80,000×365/365 or $45,000).

(3) *Computation of housing cost amount*—(i) *Spouses residing together.* If the spouses reside together, and file a joint return, they may compute their housing cost amount either jointly or separately. If the spouses reside together and file separate returns, they must compute their housing cost amounts separately. If the spouses compute their housing cost amounts separately, they may allocate the housing expenses to either of them or between them for the purpose of calculating separate housing cost amounts, but each spouse claiming a housing cost amount exclusion or deduction must use his or her full base housing amount in such computation. If the spouses compute their housing cost amount jointly, then only one of the spouses may claim the housing cost amount exclusion or deduction.

Either spouse may claim the housing cost amount exclusion or deduction; however, if the spouses have different periods of residence or presence and the spouse with the shorter period of residence or presence claims the exclusion or deduction, then only the expenses incurred in that shorter period may be claimed as housing expenses. The spouse claiming the exclusion or deduction may aggregate the couple's housing expenses, and subtract his or her base housing amount. For example, H and W reside together and file a joint return. H was a bona fide resident of and maintained his tax home in foreign country M from August 17, 1982, through December 31, 1983. W was a bona fide resident of and maintained her tax home in foreign country M from September 15, 1982, through December 31, 1983. During 1982, H and W earn and receive, respectively, $25,000 and $10,000 of foreign earned income. H paid $10,000 for qualified housing expenses in 1982, $7,500 of that was for qualified housing expenses incurred from September 15, 1982, through December 31, 1982. W paid $3,000 for qualified housing expenses in 1982 all of which were incurred during her period of residence. H and W may choose to compute their housing cost amount jointly. If they do so and H claims the housing cost amount exclusion his exclusion would be $10,617. H's housing expenses would be $13,000 ($10,000+$3,000) and his base housing amount would be $2,383 ((39,689×.16)×137/365=$2,383). If instead W claims the housing cost amount exclusion her exclusion would be $8,621. W's housing expenses would be $10,500 ($7,500+3,000) and her base housing amount would be $1,879 (($39,689×.16)×108/365=$1,879). If H and W file jointly and both claim a housing cost amount exclusion, then H's and W's housing cost amounts would be, respectively, $7,617 ($10,000−2,383) and $1,121 ($3,000−1,879).

(ii) *Spouses residing apart.* If the spouses reside apart, both spouses may exclude or deduct their housing cost amount if the spouses have different tax homes that are not within reasonable commuting distance (as defined in §1.119–1(d)(4)) of each other and neither spouse's residence is within a reasonable commuting distance of the other spouse's tax home. If the spouses' tax homes, or one spouse's residence and the other spouse's tax home, are within a reasonable commuting distance of each other, only one spouse may exclude or deduct his or her housing cost amount. Regardless of whether the spouses file joint or separate returns, the amount of the housing cost amount exclusion or deduction must be determined separately for each spouse under the rules of §1.911–4. If both spouses claim a housing cost amount exclusion or deduction directly as qualified individuals, neither may claim any such exclusion or deduction under section 911(c)(2)(B)(ii), relating to a second foreign household maintained for the other spouse. If one spouse fails to claim a housing cost amount exclusion or deduction which that spouse could claim directly, the other spouse may claim such exclusion or deduction under section 911(c)(2)(B)(ii), relating to a second foreign household maintained for the first spouse, provided that all the requirements of that section are met. Spouses may not claim more than one second foreign household and the expenses of such household may only be claimed by one spouse. For example, if both H and W are qualified individuals and H's tax home is in London and W's tax home is in Paris, then both H and W may exclude or deduct their housing cost amounts; however, H and W must compute these amounts separately regardless of whether they file joint or separate returns. If instead of living in Paris, W lives in an area where there are adverse living conditions and W maintains H's home in London, then W may add those housing expenses to her housing expenses and compute one base housing amount. In that case H may not claim a housing cost amount exclusion or deduction.

(iii) *Housing cost amount attributable to employer provided amounts.* Each spouse claiming a housing cost amount exclusion or deduction shall compute the portion of the housing cost amount that is attributable to employer provided amounts separately, based on his or her separate foreign earned income, in accordance with § 1.911–4(d)(3).

(b) *Married couples with community income.* The amount of excludable foreign earned income of a husband and wife with community income is determined separately for each spouse in accordance with paragraph (a) of this section on the basis of income attributable to that spouse's services without regard to community property laws. See sections 879 and 6013 (g) and (h) for special rules regarding treatment of community income of a nonresident alien individual married to a U.S. citizen or resident.

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2972, Jan. 23, 1985]

§ 1.911–6 Disallowance of deductions, exclusions, and credits.

(a) *In general.* No deduction or exclusion from gross income under subtitle A of the Code or credit against the tax imposed by chapter 1 of the Code shall be allowed to the extent the deduction, exclusion, or credit is properly allocable to or chargeable against amounts excluded from gross income under section 911(a). For purposes of the preceding sentence, deductions, exclusions, and credits which are definitely related (as provided in § 1.861–8), in whole or in part, to earned income shall be allocated and apportioned to foreign earned income and U.S. source earned income in accordance with the rules contained in § 1.861–8. Deductions, exclusions, and credits which are definitely related to all gross income under § 1.861–8, including deductions for interest described in § 1.861–8(e)(2)(ii), are definitely related, in whole or in part, to earned income. In the case of interest expense allocable, in whole or in part, to foreign earned income under § 1.861–8(e)(2)(ii), the expense shall normally be apportioned under option one of the optional gross income methods of apportionment (§ 1.861–8(e)(2)(v)i(A)), but without regard to conditions (*1*) and (*2*) of subdivision (vi)(A) (the fifty percent conditions). Such interest expense shall not normally be apportioned under the asset method of § 1.861–8(e)(2)(v). This is because, where section 911 is the operative section, the expense normally relates more closely to gross income generated from activities than to the amount of capital utilized or invested in activities or property. Deductions that are allocated and apportioned to foreign earned income must then be allocated and apportioned to foreign earned income that is excluded under section 911(a). If an individual has foreign earned income from both self-employment and other employment, the amount excluded under section 911(a)(1) shall be deemed to include a pro rata amount of the self-employment income and the income from other employment; thus, a pro rata portion of deductible expenses attributable to self-employment income must be disallowed. For purposes of section 911 (d)(6) and this section only, deductions, exclusions, or credits which are not definitely related to any class of gross income shall not be allocable or chargeable to excluded amounts and are, therefore, deductible to the extent allowed by chapter 1 of the Code. Examples of deductions that are not definitely related to a class of gross income are personal and family medical expenses, qualified retirement contributions (but see section

219(b)(1)), real estate taxes and mortgage interest on a personal residence, charitable contributions, alimony payments, and deductions for personal exemptions. In addition, for purposes of this section, amounts excludable or deductible under section 911 or 119 shall not be allocable or chargeable to other amounts excluded under section 911(a). Thus, an individual's housing cost amount which is excludable or deductible under §1.911–4(d) for a taxable year is not apportioned in part to the individual's foreign earned income which is excluded for such year under §1.911–3(d). Therefore, the entire amount of such exclusion or deduction is allowed to the extent provided in §1.911–4. This section does not affect the time for claiming any deduction, exclusion, or credit that is not allocated or apportioned to excluded amounts.

(b) *Moving expenses*—(1) *In general.* No deduction shall be allowed for moving expenses under section 217 to the extent the deduction is properly allocable to or chargeable against amounts of foreign earned income excluded from gross income under section 911(a). If an individual's new principal place of work is in a foreign country, deductible moving expenses will be allocable to foreign earned income. If an individual treats a reimbursement from his employer for the expenses of a move from a foreign country to the United States as attributable to services performed in a foreign country under §1.911–3(e)(5)(i), then deductible moving expenses attributable to that move will be allocable to foreign earned income. If the individual is a qualified individual who elects to exclude foreign earned income under section 911(a), then some or all of such moving expenses must be disallowed as a deduction.

(2) *Attribution of moving expense deduction to taxable years in which services are performed.* If a moving expense deduction is properly allocable to foreign earned income, the deduction shall be considered attributable to services performed in the year of the move as long as the individual is a qualified individual under §1.911–2(a) for a period that includes 120 days in the year of the move. If the individual is not a qualified individual for such period, then the individual shall treat the deduction as attributable to services performed in both the year of the move and the succeeding taxable year, if the move is from the United States to the foreign country, or the prior taxable year, if the move is from a foreign country to the United States. Notwithstanding the preceding two sentences, storage expenses incurred after December 31, 1983 shall be treated as attributable to services performed in the year in which the expenses are incurred.

(3) *Formula for disallowance of moving expense deduction.* The portion of the moving expense deduction that is disallowed shall be determined by multiplying the moving expense deduction by a fraction the numerator of which is all amounts excluded under section 911(a) for the year or years to which the deduction is attributable (under paragraph (b)(2) of this section) and the denominator of which is foreign earned income (as defined in §1.911–3(a)) for that year or years.

(4) *Effect of disallowance based on attribution of deduction to subsequent year's income.* An individual may claim a moving expense deduction in the taxable year in which the amount of the expense is paid or incurred even if attributable, in part, to the succeeding year. However, at such time as the individual excludes income under section 911(a) for the year or years to which the deduction is attributable, the individual shall either—

(i) File an amended return for the year in which the deduction was claimed that does not claim the portion of the deduction that is disallowed because it is chargeable against excluded income, or

(ii) Include in income for the year following the year in which the deduction was claimed an amount equal to the amount of the deduction that is disallowed.

Any amount included in income under paragraph (b)(4)(ii) of this section is not foreign earned income.

(5) *Moves beginning before January 1, 1984.* Notwithstanding paragraphs (b)(1) through (3) of this section, the rules of this paragraph (b)(5) shall apply for moves beginning before January 1, 1984.

(i) *Individual qualifies for the entire taxable year of the move.* If the individual is a qualified individual for the entire taxable year of the move, then the amount of moving expense disallowed shall be determined by multiplying the moving expense deduction otherwise allowable by a fraction the numerator of which is the foreign earned income excluded under section 911(a) for the taxable year of the move and the denominator of which is the foreign earned income for the same taxable year.

(ii) *Individual qualifies for less than the entire taxable year of the move.* If the individual is a qualified individual for less than the entire taxable year of the move, then, for the purpose of determining the portion of the otherwise allowable moving expense deduction that is disallowed, the individual must attribute a portion of the otherwise allowable moving expense deduction either to the succeeding taxable year, if the move is from the United States to a foreign country, or to the prior taxable year, if the move is from a foreign country to the United States. The portion of the moving expense deduction treated as attributable to services performed in the year of the move shall be determined by multiplying the otherwise allowable moving expense deduction by the following fraction:

$$\frac{\text{The number of qualifying days (as defined in §1.911-3(d)(3) in the year of the move}}{\text{The number of days in the taxable year of the move.}}$$

The portion of the moving expense deduction treated as attributable to the year succeeding or preceding the move shall be determined by subtracting the portion of the moving expense deduction that is attributable to the year of the move from the total moving expense deduction. The allocation of a portion of the moving expense deduction to a succeeding or preceding taxable year does not affect the time for claiming the allowable moving expense deduction. The portion of the moving expense deduction that is disallowed shall be determined by multiplying the moving expense deduction attributable to the year of the move or the succeeding or preceding year, as the case may be, by a fraction the numerator of which is amounts excluded under section 911(a) for that year and the denominator of which is foreign earned income for that year.

(c) *Foreign taxes*—(1) *Amount disallowed.* No deduction or credit is allowed for foreign income, war profits, or excess profits taxes paid or accrued with respect to amounts excluded from gross income under section 911. To determine the amount of disallowed foreign taxes, multiply the foreign tax imposed on foreign earned income (as defined in § 1.911–3(a)) received or accrued during the taxable year by a fraction, the numerator of which is amounts excluded under section 911(a) in such taxable year less deductible expenses properly allocated to such amounts (see paragraphs (a) and (b) of this section), and the denominator of which is foreign earned income (as defined in § 1.911–3(a)) received or accrued during the taxable year less deductible expenses properly allocated or apportioned thereto. For the purpose of determining the extent to which foreign taxes are disallowed, the housing cost amount deduction is treated as definitely related to foreign earned income that is not excluded. If the foreign tax is imposed on foreign earned income and some other income (for example earned income from sources within the United States or an amount not subject to tax in the United States), and the taxes on the other amount cannot be segregated, then the denominator equals the total of the amounts subject to tax less deductible expenses allocable to all such amounts.

(2) *Definitions and special rules*—(i) *Taxable year.* For purposes of paragraph (c)(1) of this section, the term ‘‘taxable year’’ means the individual’s taxable

year for U.S. tax purposes. Such term includes the portion of any foreign taxable year within the individual's U.S. taxable year and excludes the portion of any foreign taxable year not within the individual's U.S. taxable year.

(ii) *Apportionment of foreign taxes.* For purposes of this paragraph (c), foreign taxes imposed on foreign earned income shall be deemed to accrue, on a pro rata basis, to income as the income is received or accrued. The taxes so accrued shall be apportioned to the taxable year during which the income is received or accrued. This rule applies for all individuals, regardless of their method of accounting.

(iii) *Effect of disallowance.* The disallowance of foreign taxes under this paragraph (c) shall not affect the time for claiming any deduction or credit for foreign taxes paid. Rather, the disallowance shall only affect the amount of taxes considered paid or accrued to any foreign country.

(iv) *Interest on foreign taxes.* Any interest expense incurred on a liability for foreign taxes is allocated and apportioned not under this paragraph (c) but under paragraph (a) of this section to foreign earned income and then to excluded foreign earned income and to that extent disallowed as a deduction under paragraph (a). In that regard, see also §1.861–8(e)(2) for the specific rules for allocation and apportionment of interest expense.

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

Example 1. In 1982 A, an architect, operates his business as a sole proprietorship in which capital is not a material income producing factor. A receives $1,000,000 in gross receipts, all of which is foreign source earned income, and incurs $500,000 of otherwise deductible business expenses definitely related to the foreign earned income. A elects to exclude $75,000 under section 911(a)(1). The expenses must be apportioned to excluded earned income as follows: $500,000×$75,000/1,000,000. Thus, $37,500 of the business expenses are not deductible.

Example 2. The facts are the same as in example 1, except that $100,000 of A's gross receipts is U.S. source earned income and $68,000 of A's business expenses are attributable to the U.S. source earned income. Thus, A has $900,000 of foreign earned income and $432,000 of deductions allocated to foreign earned income. The expenses apportioned to excluded earned income are $432,000×$75,000/$900,000, or $36,000, which are not deductible.

Example 3. B is a U.S. citizen, calendar year and cash basis taxpayer. B moves to foreign country N and maintains a tax home and is physically present there from July 1, 1984 through May 26, 1985. Among other possible periods, B is a qualified individual for 219 days in the year of the move. B pays $6,000 of otherwise deductible moving expenses in 1984. For 1984, B's foreign earned income is $60,000 and B excludes $47,869 ($80,000×219/366) under section 911(a). Under paragraph (b)(2) of this section, B's moving expenses are attributable to services performed in 1984. Under paragraph (b)(3) of this section, $6,000×$47,869/$60,000, or $4,789, of B's moving expense deduction is disallowed. B may deduct $1,211 of moving expenses on his 1984 return.

Example 4. The facts are the same as in example 3 except that B maintains a tax home and is physically present in foreign country N from October 9, 1984 through September 3, 1985. Among other possible periods, B is a qualified individual for no more than 119 days in 1984 and 281 days in 1985. B's foreign earned income for 1984 is $60,000. B's foreign earned income for 1985 is $150,000. Because B is a qualified individual for less than 120 days in the year of the move, under paragraph (b)(2) of this section, B's moving expenses are attributable to services performed in 1984 and 1985. At the close of 1984, B may either seek an extension of time to file under §1.911–7(c) or may file an income tax return without claiming the exclusions or deduction under section 911. B does not seek an extension and files without excluding foreign earned income; thus B may deduct his moving expenses in full. B later amends his 1984 return and excludes foreign earned income for that year. B excludes foreign earned income for 1985. B must determine the portion of the moving expense deduction that is disallowed. The portion of the moving expense deduction that is disallowed is determined by multiplying the otherwise allowable moving expense deduction by a fraction. The numerator of the fraction is the sum of amounts excluded under section 911(a) for 1984 and 1985, that is $26,082 or $80,000×119/365, plus $61,589, or $80,000×281/365, which totals $87,671. The denominator of the fraction is the sum of foreign earned income for 1984 and 1985, that is $60,000 plus $150,000, or $210,000. B's allowable moving expense deduction is $3,495, or $6,000−($6,000×$87,671/$210,000). If B does not file an amended 1984 return (and does not exclude foreign earned income for 1984), but excludes foreign earned income under section 911(a) for 1985, a portion of his moving expense deduction is disallowed, based on the same formula. The amount disallowed is $6,000×$61,589/$210,000, or $1,760. This amount may be recaptured either by filing an amended return for 1984 or by including it in income for 1985 (in which case it is not foreign earned income).

Example 5. C is a U.S. citizen, a self-employed individual, and a cash basis and calendar year taxpayer. For the entire 1982 taxable year C maintained his tax home and his bona fide residence in foreign country P. During 1982 C earned and received $120,000 of foreign earned income, none of which was attributable to employer provided amounts. C paid $40,000 of business expenses. C elected to exclude foreign earned income under section 911(a)(1) and claimed a housing cost amount deduction of $15,000. C received $10,000 of foreign source interest income which was included with C's earned income in a single tax base and taxed at graduated rates. For 1982, C paid $30,000 in income tax to foreign country P. The amount of C's business expenses that is properly apportioned to excluded amounts (and therefore, not deductible) equals $25,000, which is determined by multiplying the otherwise allowable deductions by C's excluded amounts over C's foreign earned income ($40,000×75,000/120,000). The amount of country P tax that is properly apportioned to excluded amounts (and therefore, not deductible or creditable) equals $20,000, which is determined by multiplying the tax of $30,000 by the following fraction:

$$\frac{\text{\$50,000 (\$75,000 excluded amounts less \$25,000 of deductible expenses allocable thereto)}}{\text{\$75,000 (((\$120,000 foreign earned income less \$40,000 of deductible expenses allocable thereto) less \$15,000 housing cost amount deduction allocable thereto) plus \$10,000 other taxable income).}}$$

Example 6. D is a U.S. citizen and an accrual basis and calendar year taxpayer for U.S. tax purposes. For the entire period from January 1, 1982 through December 31, 1983, D maintains his tax home and his bona fide residence in foreign country R. For purposes of R's income tax, D is a cash basis taxpayer and uses a fiscal year that begins on April 1 and ends on the following March 31. During his entire period of residence in R, D receives foreign earned income of $10,000 each month, all of which is attributable to employer provided amounts. For his foreign taxable year ending March 31, 1982, D pays $10,000 of income tax to R. For his foreign taxable year ending March 31, 1983, D pays $54,000 of income tax to R. Under paragraph (c)(2)(ii) of this section, all of the $10,000 of tax paid for this foreign taxable year ending March 31, 1982 is imposed on foreign earned income received in 1982, as is $40,500, or 9/12×$54,000, of tax paid for his foreign taxable year ending March 31, 1983. (D received $10,000 per month for the last 3 months of his foreign taxable year ending March 31, 1982, all of which are within his U.S. taxable year ending December 31, 1982 under paragraph (c)(2)(i) of this section, and $10,000 per month for each month of his foreign taxable year ending March 31, 1983, of which the first 9 months are within his U.S. taxable year ending December 31, 1982. Under paragraph (c)(2)(ii) of this section, foreign taxes are deemed to accrue on a pro rata basis to income as it is received or accrued. Thus, all of the $10,000 of foreign taxes imposed on the income received during D's foreign taxable year ending March 31, 1982 accrue to D's 1982 foreign earned income, as do 9/12 (or $90,000/120,000) of foreign taxes imposed on income received during D's foreign taxable year ending March 31, 1983, for purposes of determining the amount of D's foreign taxes that is disallowed.) For 1982, D has no deductible expenses, and elects to exclude his housing cost amount of $21,000 under section 911(a)(2) and foreign earned income of $75,000 under section 911(a)(1). The amount of D's foreign taxes disallowed for deduction or credit purposes for 1982 is $8,000 (that is, $10,000×$96,000/$120,000) of the taxes for his foreign taxable year ending March 31, 1982, plus $32,400 (that is, $40,500×$96,000/$120,000) of the taxes for his foreign taxable year ending March 31, 1983, or $40,400. From 1982, D has $2,000 ($10,000−$8,000) of deductible or creditable taxes accrued on March 31, 1982, and $8,100 ($40,500–$32,400) of deductible or creditable taxes accrued on March 31, 1983, after the disallowance based on his 1982 excluded income.

Example 7. E is a United States citizen, calendar year and cash basis taxpayer. E is physically present in and establishes his tax home in foreign country S on May 1, 1981. For purposes of country S, E's taxable year begins on April 1 and ends the following March 31. E receives foreign earned income of $15,000 each month beginning on May 1, 1981. At the end of his foreign taxable year ending on March 31, 1982, E pays $70,000 of income tax to S on $165,000 of foreign earned income. Under section 911, as in effect for taxable years beginning before January 1, 1982, E may not exclude any income that is earned or received during 1981. None of E's taxes paid in 1982 that are attributable to income earned or received in 1981 are subject to disallowance because, under paragraph (c)(2)(ii) of this section, the only taxes disallowed are those deemed to accrue on income earned and received after December 31, 1981, and excluded from gross income. The amount of E's taxes paid in 1982 that are attributable to 1981 is $50,909, or $70,000×$120,000/$165,000. E elects to exclude foreign earned income for 1982. The amount of E's taxes paid to S in 1982 that accrue to 1982 foreign earned income, and are therefore subject to disallowance based on excluded income, is $19,091, or $70,000×$45,000/$165,000.

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2973, Jan. 23, 1985]

§1.911–7 Procedural rules.

(a) *Elections of a qualified individual* —(1) *In general.* In order to receive either exclusion provided by section 911(a), a qualified individual must elect, separately with respect to each exclusion, to exclude foreign earned income under section 911(a)(1) and the housing cost amount under section 911(a)(2). Any such elections may be made on Form 2555 or on a comparable form. Each election must be filed either with the income tax return, or with an amended return, for the first taxable year of the individual for which the election is to be effective. An election once made remains in effect for that year and all subsequent years unless revoked under paragraph (b) of this section. Each election shall contain information sufficient to determine whether the individual is a qualified individual as provided in §1.911–2. The statement shall include the following information:

(i) The individual's name, address, and social security number;

(ii) The name of the individual's employer;

(iii) Whether the individual claimed exclusions under section 911 for earlier years after 1981 and within the five preceding taxable years;

(iv) Whether the individual has revoked a previously made election and the taxable year for which such revocation was effective;

(v) The exclusion or exclusions the individual is electing;

(vi) The foreign country or countries in which the individual's tax home is located and the date when such tax home was established;

(vii) The status (either bona fide residence or physical presence) under which the individual claims the exclusion;

(viii) The individual's qualifying period of residence or presence;

(ix) The individual's foreign earned income for the taxable year including the fair market value of all noncash remuneration; and,

(x) If the individual elects to exclude the housing cost amount, the individual's housing expenses.

(2) *Requirement of a return*—(i) *In general.* In order to make a valid election under this paragraph (a), the election must be made:

(A) With an income tax return that is timely filed (including any extensions of time to file),

(B) With a later return filed within the period prescribed in section 6511(a) amending the foregoing timely filed income tax return,

(C) With an original income tax return that is filed within one year after the due date of the return (determined without regard to any extension of time to file); this one year period does not constitute an extension of time for any purpose—it is merely a period during which a valid election may be made on a late return, or

(D) With an income tax return filed after the period described in paragraphs (a)(2)(i)(A), (B), or (C) of this section provided—

(*1*) The taxpayer owes no federal income tax after taking into account the exclusion and files Form 1040 with Form 2555 or a comparable form attached either before or after the Internal Revenue Service discovers that the taxpayer failed to elect the exclusion; or

(*2*) The taxpayer owes federal income tax after taking into account the exclusion and files Form 1040 with Form 2555 or a comparable form attached before the Internal Revenue Service discovers that the taxpayer failed to elect the exclusion.

(*3*) A taxpayer filing an income tax return pursuant to paragraph (a)(2)(i)(D)(*1*) or (*2*) of this section must type or legibly print the following statement at the top of the first page of the Form 1040: ‘‘Filed Pursuant to Section 1.911–7(a)(2)(i)(D).’’

(ii) *Election for 1982 and 1983 taxable years.* Solely for purposes of paragraph (a)(2)(i)(A) of this section, an income tax return for any taxable year beginning before January 1, 1984, shall be considered timely filed if it is filed on or before July 23, 1985.

(3) *Housing cost amount deduction.* An individual does not have to make an election in order to claim the housing cost amount deduction. However, such individual must provide the Commissioner with information sufficient to determine the individual's correct amount of tax. Such information shall include the following: The individual's name, address, and social security number; the name of the individual's employer; the foreign country in which the individual's tax home was established; the status under which the individual claims the deduction; the individual's qualifying period of residence or presence; the individual's foreign earned income for the taxable year; and the individual's housing expenses.

(4) *Effect of immaterial error or omission.* An inadvertent error or omission of information required to be provided to make an election under this paragraph (a) shall not render the election invalid if the error or omission is not material in determining whether the individual is a qualified individual or whether the individual intends to make the election.

(b) *Revocation of election*—(1) *In general.* An individual may revoke any election made under paragraph (a) of this section for any taxable year. A revocation must be made separately with respect to each election. The individual may revoke an election for any taxable year, including the first taxable year for which an election was effective, by filing a statement that the individual is revoking one or more of the previously made elections. The statement must be filed with the income tax return, or with an amended return, for the first taxable year of the individual for which the revocation is to be effective. A revocation once made is effective for that year and all subsequent years. If an election is revoked for any taxable year, including the first taxable year for which the election was effective, the individual may not, without the consent of the Commissioner, again make the same election until the sixth taxable year following the taxable year for which the revocation was first effective. For example, a qualified individual makes an election to exclude foreign earned income under section 911(a)(1) and files it with his 1982 income tax return. The individual files 1983 and 1984 income tax returns on which he excludes his foreign earned income. Then, within 3 years after filing his 1982 income tax return, the individual files an amended 1982 income tax return with a statement revoking his election to exclude foreign earned income under section 911(a)(1). The revocation of the election is effective for taxable years 1982, 1983, and 1984. The individual may not elect to exclude income under section 911(a)(1) for any taxable year before 1988, unless he obtains consent to reelect under paragraph (b)(2) of this section.

(2) *Reelection before sixth taxable year after revocation.* If an individual revoked an election under paragraph (b)(1) of this section and within five taxable years the individual wishes to reelect the same exclusion, then the individual may apply for consent to the reelection. The application for consent shall be made by requesting a ruling from the Associate Chief Counsel (Technical), National Office, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224. In determining whether to consent to reelection the Associate Chief Counsel or his delegate shall consider any facts and circumstances that may be relevant to the determination. Relevant facts and circumstances may include the following: a period of United States residence, a move from one foreign country to another foreign country with differing tax rates, a substantial change in the tax laws of the foreign country of residence or physical presence, and a change of employer.

(c) *Returns and extensions*—(1) *In general.* Any return filed before completion of the period necessary to qualify an individual for any exclusion of deduction provided by section 911 shall be filed without regard to any exclusion or deduction provided by that section. A claim for a credit or refund of any overpayment of tax may be filed, however, if the taxpayer subsequently qualifies for any exclusion or deduction under section 911. See section 6012(c) and §1.6012–1(a)(3), relating to returns to be filed and information to be furnished by individuals who qualify for any exclusion or deduction under section 911.

(2) *Extensions.* An individual desiring an extension of time (in addition to the automatic extension of time granted by §1.6081–2) for filing a return until after the completion of the qualifying period described in paragraph (c)(1) of this section for claiming any exclusion or deduction under section 911 may apply for an extension. An individual whose moving expense deduction is attributable to services performed in two years may apply for an extension of time for filing a return until after the end of the second year. The individual may make such application on Form 2350 or a comparable form. The application must be filed with the Director, Internal Revenue Service Center, Philadelphia, Pennsylvania 19255. The application must set forth the facts relied on to justify the extension of time requested and must include a statement as to the earliest date the individual expects to become entitled to any exclusion or deduction by reason of completion of the qualifying period.

(d) *Declaration of estimated tax.* In estimating gross income for the purpose of determining whether a declaration of estimated tax must be made for any taxable year, an individual is not required to take into account income which the individual reasonably believes will be excluded from gross income under the provisions of section 911. In computing estimated tax, however, the individual must take into account, among other things, the denial of the foreign tax credit for foreign taxes allocable to the excluded income (see §1.911–6(c)).

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2976, Jan. 23, 1985, as amended by T.D. 8480, 58 FR 34885, June 30, 1993]

§1.911–8 Former deduction for certain expenses of living abroad.

For rules relating to the deduction for certain expenses of living abroad applicable to taxable years beginning before January 1, 1982, see 26 CFR 1.913–1 through 1.913–13 as they appeared in the Code of Federal Regulations revised as of April 1, 1982.

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2977, Jan. 23, 1985

EARNED INCOME OF CITIZENS OF UNITED STATES

§1.912–1 Exclusion of certain cost-of-living allowances.

(a) Amounts received by Government civilian personnel stationed outside the continental United States as cost-of-living allowances in accordance with regulations approved by the President are, by the provisions of section 912(1), excluded from gross income. Such allowances shall be considered as retaining their characteristics under section 912(1) notwithstanding any combination thereof with any other allowance. For example, the cost-of-living portion of a ‘‘living and quarters allowance’’ would be excluded from gross income whether or not any other portion of such allowance is excluded from gross income.

(b) For purposes of section 912(1), the term ‘‘continental United States’’ includes only the 48 States existing on February 25, 1944 (the date of the enactment of the Revenue Act of 1943 (58 Stat. 21)) and the District of Columbia.

§1.912–2 Exclusion of certain allowances of Foreign Service personnel.

Gross income does not include amounts received by personnel of the Foreign Service of the United States as allowances or otherwise under the provisions of chapter 9 of title I of the Foreign Service Act of 1980 or the provisions of section 28 of the State Department Basic Authorities Act (formerly section 914 of title IX of the Foreign Service Act of 1946).

[T.D. 8256, 54 FR 28620, July 6, 1989]

§ 1.921–1T Temporary regulations providing transition rules for DISCs and FSCs.

(a) *Termination of a DISC*—(1) *At end of 1984.*

Q–1: What is the effect of the termination on December 31, 1984, of a DISC's taxable year?

A–1: Without regard to the annual accounting period of the DISC, the last taxable year of each DISC beginning during 1984 shall be deemed to close on December 31, 1984. The corporation's DISC election also shall be deemed revoked at the close of business on December 31, 1984. (A DISC that does not elect to be an interest charge DISC as of January 1, 1985, in addition to a corporation described in section 992(a)(3), shall be referred to as a ''former DISC''.) A corporation which wishes to be treated as a FSC, a small FSC, or an interest charge DISC must make an election as provided under paragraph (b) (Q & A #1) of this section.

(2) *Deemed distributions for short taxable years.*

Q–2: If the termination of the DISC's taxable year on December 31, 1984, results in a short taxable year, how are the deemed distributions under section 995(b)(1)(E) determined?

A–2: The deemed distributions are determined on the basis of the DISC's taxable income for its short taxable year ending on December 31, 1984. In computing the incremental distribution under section 995(b)(1)(E), the export gross receipts for the short taxable year must be annualized.

(3) *Qualification as a DISC for 1984.*

Q–3: Must the DISC satisfy all the tests set forth in section 992(a)(1) for the DISC's taxable year ending December 31, 1984?

A–3: All of the tests under section 992(a)(1), except the qualified assets test under section 992(a)(1)(B), must be satisfied.

(4) *Commissions for 1984.*

Q–4: Must commissions be paid by a related supplier to a DISC with respect to the DISC's taxable year ending December 31, 1984?

A–4: No.

Q–4A: Must commissions which were earned prior to January 1, 1985, be paid by a related supplier if the last date payment is required (as set forth in § 1.994–1(e)(3)) is after December 31, 1984?

A–4A: No.

(5) *Producer's loans of 1984.*

Q–5: Must the producer's loan rules under section 993(d) be satisfied with respect to the DISC's taxable year ending December 31, 1984?

A–5: Yes.

(6) *Accumulated DISC income.*

Q–6. Under what circumstances is any remaining accumulated DISC income treated as previously taxed income (and not taxed)?

A–6. The accumulated DISC income of a DISC (but not a DISC described in section 992(a)(3)) as of December 31, 1984, is treated as previously taxed income when actually distributed after December 31, 1984. Any amounts distributed by the former DISC (including a DISC which has elected to be an interest charge DISC) after December 31, 1984, shall be treated as made first out of current earnings and profits and then out of previously taxed income to the extent thereof. For purposes of the preceding sentence, amounts distributed before July 1, 1985, shall be treated as made first out of previously taxed income to the extent thereof. If property other than money is distributed and if such property was a qualified export asset within the meaning of section 993(b) on December 31, 1984, then for purposes of section 311, no gain or loss will be recognized on the distribution and the distributee will have the same basis in the property as the distributor.

Q–7: May a DISC that was previously disqualified, but has requalified as of December 31, 1984, treat any accumulated DISC income as previously taxed income?

A–7: If a DISC was previously disqualified, but has requalified as of December 31, 1984, any accumulated DISC income previously required to be taken into income upon prior disqualification shall not be treated as previously taxed income. All accumulated DISC income derived since requalification, however, will be treated as previously taxed income.

(7) *Distribution of previously taxed income.*

Q–8: What effect will the distribution of previously taxed income have on the earnings and profits of corporate shareholders of the former DISC?

A–8: The earnings and profits of the corporate shareholders of the former DISC will be increased by the amount of money and the adjusted basis of any property which is distributed out of previously taxed income.

Q–9: Will the distribution of the former DISC's accumulated DISC income as previously taxed income after December 31, 1984, result in a reduction in the shareholder's basis of the stock of the former DISC and consequent taxation of the excess of the distribution over such basis as capital gain under section 996(d)?

A–9: No. This distribution will be treated both as amounts representing deemed distributions under section 995(b)(1) and as previously taxed income. Thus, no capital gain will arise.

(8) *Qualifying distributions.*

Q–10: How is a qualifying distribution to satisfy the qualified export receipts tests under section 992(c)(1)(A) which is made with respect to the DISC's taxable year ending on December 31, 1984, treated?

A–10: The distribution will not be treated as previously taxed income but will be taxed to the shareholder of the former DISC, as provided under section 992(c) and 996(a)(2) and the regulations thereunder, in the shareholder's taxable year in which the distribution is made.

(9) *Deficiency distributions.*

Q–11: With respect to an audit adjustment made after December 31, 1984, may a deficiency distribution be made, and if so, in what manner may it be made?

A–11: A deficiency distribution may be made notwithstanding the fact that after December 31, 1984, the former DISC is a taxable corporation under subchapter C, has elected to be treated as an interest charge DISC, or has been liquidated, reorganized or is otherwise no longer in existence. However, such deficiency distribution shall be treated as made out of accumulated DISC income which is not previously taxed income because it will be treated as distributed prior to December 31, 1984, to the DISC's shareholders.

Q–11A: Must a former DISC remain in existence in order for a former DISC shareholder to take advantage of the spread provided in section 995(b)(2) with respect to DISC disqualification?

A–11A: No. With respect to distributions deemed to be received by a former DISC shareholder under section 995(b)(2) for taxable years beginning after December 31, 1984, if the former DISC shareholder elects, the rules of section 995(b)(2)(B) shall apply even though the former DISC does not continue in existence. If the former DISC is no longer in existence, the former DISC's shareholders will be deemed to have received the distribution on the last day of their taxable years over the applicable period of time determined under section 995(b)(2) as if the former DISC had remained in existence.

(10) *Deemed distribution for 1984.*

Q–12: How is the deemed distribution to a shareholder for the DISC's taxable year ending December 31, 1984, taken into account?

A–12 (i) If the taxable year of the DISC ending on December 31, 1984, (A) is the first taxable year of the DISC which begins in 1984, (B) begins after the date in 1984 on which the taxable year of the DISC's shareholder begins, and (C) if the DISC's shareholder makes an election under section 805(b)(3) of the Tax Reform Act of 1984, the deemed distribution under section 995(b) with respect to income derived by the DISC for such taxable year of the DISC shall be treated as received by the shareholder in 10 equal installments (unless the shareholder elects to be treated as receiving the deemed distribution in income over a smaller number of equal installments). The first installment shall be treated as received by the shareholder on the last day of the shareholder's second taxable year beginning in 1984 (if any), or if the shareholder had only one taxable year which began in 1984, on the last day of the shareholder's first taxable year beginning in 1985. One installment shall be treated as received by the shareholder on the last day of each succeeding taxable year of the shareholder until the entire amount of the DISC's 1984 deemed distribution has been included in the shareholder's taxable income. To make the election under section 805(b)(3) of the Tax Reform Act of 1984, the DISC shareholder must attach a statement to its timely filed tax return (including extensions) for its taxable year which includes December 31, 1984, indicating the total amount of the shareholder's pro rata share of the DISC's deemed distribution for 1984 (determined under section 995(b) of the Code without regard to the election under section 805(b)(3) of the Tax Reform Act of 1984), and the number of equal installments, if less than 10, over which the shareholder wishes to spread its pro rata share of the deemed distribution for 1984. If the election under section 805(b)(3) of the Tax Reform Act of 1984 is made, it may not be changed or revoked. In determining estimated tax payments, the portion of the deemed distribution includible in the shareholder's taxable income for any taxable year under this subdivision (i) shall be treated as received by the shareholder on the last day of such taxable year.

(ii) Except as provided in subdivision (i), the deemed distribution under section 995(b) with respect to income derived by the DISC for its taxable year ending on December 31, 1984, shall be included in the shareholder's taxable income for its taxable year which includes December 31, 1984. Thus, if the taxable year of the DISC and the DISC's shareholder both begin on January 1, 1984, and end on December 31, 1984 (or, if the taxable year of the DISC beginning in 1984 begins before the taxable year of the DISC's shareholder), the deemed distribution with respect to the DISC's taxable year ending on December 31, 1984, will be included in the DISC shareholder's taxable year ending on (or including) December 31, 1984, and the election described in subdivision (i) may not be made.

(iii) The provisions of this Question and Answer-12 apply without regard to any existence of the DISC after December 31, 1984, as an interest charge DISC.

Q–12A: If under section 805(b)(3) of the Tax Reform Act of 1984 the shareholders of the DISC are permitted to make an election to treat the DISC's 1984 deemed distribution as received over a 10-year period, must the DISC distribute that amount to its shareholders ratably over the 10-year period?

A–12A: No. Under section 805(b)(3) of the Tax Reform Act of 1984, if the DISC's deemed distribution for its taxable year which ended on December 31, 1984, is a qualified distribution, the shareholders of the DISC are permitted to make an election to treat the distribution as received over a 10-year period. The 10-year treatment applies even though the amount of the deemed distribution is distributed to the DISC's shareholders prior to the period in which the distribution is taken into income by the shareholders. In addition, under section 996(e) of the Code, the shareholder's basis in the stock of the DISC will be considered as increased, as of the date of liquidation, by the shareholder's pro rata share of the amount of the undistributed qualified distribution even though that amount is treated as received by the shareholder in later years. Further, the actual distribution in liquidation of the former DISC after 1984 will increase the earnings and profits of a corporate distributee, and the amount actually distributed shall be treated under the rules of section 996.

(11) *Conformity of accounting period.*

Q–13: May a DISC be established or change its annual accounting period for taxable years beginning after March 21, 1984, and before January 1, 1985?

A–13: A DISC that is established or that changes its annual accounting period after March 21, 1984, must conform its annual accounting period to that of its principal shareholder (the shareholder with the highest percentage of voting power as defined in section 441(h)).

(12) *DISC gains and distributions from U.S. sources.*

Q–14: What is the effective date of the amendment to section 996(g), made by section 801(d)(10) of the Tax Reform Act of 1984, which treats certain DISC gains and distributions as derived from sources within the United States?

A–14: Under section 805(a)(3) of the Act, the amendment to section 996(g) shall apply to all gains referred to in section 995(c) and all distributions out of accumulated DISC income including deemed distributions made on or after June 22, 1984.

(b) *Establishing and electing status as a FSC, small FSC or interest charge DISC*—(1) *Ninety-day period.*

Q–1: How does a corporation elect to be treated as a FSC, a small FSC, or an interest charge DISC?

A–1: A corporation electing FSC or small FSC status must file Form 8279. A corporation electing interest charge DISC status must file Form 4876A. A corporation electing to be treated as a FSC, small FSC, or interest charge DISC for its first taxable year shall make its election within 90 days after the beginning of that year. A corporation electing to be treated as a FSC, small FSC, or interest charge DISC for any taxable year other than its first taxable year shall make its election during the 90-day period immediately preceding the first day of that taxable year. The election to be a FSC, small FSC, or interest charge DISC may be made by the corporation, however, during the first 90 days of a taxable year, even if that taxable year is not the corporation's first taxable year, if that taxable year begins before July 1, 1985. Likewise, the election to be a FSC (or a small FSC) may be made during the first 90 days of any taxable year of a corporation if the corporation had in a prior taxable year elected small FSC (or FSC) status and the corporation revokes the small FSC (or FSC) election within the 90 day period. A corporation which was a DISC for its taxable year ending December 31, 1984, which wishes to be treated as an interest charge DISC beginning with its first taxable year beginning after December 31, 1984, may make the election to be treated as an interest charge DISC by filing Form 4876A on or before July 1, 1987. Also, if a corporation which has elected FSC, small FSC or interest charge DISC status, or a shareholder of that corporation, is acquired in a qualified stock purchase under section 338(d)(3), and if an election under section 338(a) is effective with regard to that corporation, the corporation may re-elect FSC, small FSC or interest charge DISC status, (whichever is applicable) not later than the date of the election under section 338(a), see section 338(g)(i) and §1.338–1(d). This re-election is necessary because the original elections are deemed terminated if an election is made under section 338(a). The rules contained in §1.992–2 (a)(1), (b)(1) and (b)(3) shall apply to the manner of making the election and the manner and form of shareholder consent.

(2) *FSC incorporated in a possession.*

Q–2: Where does a FSC which is incorporated in a U.S. possession file its election?

A–2: The election is filed with the Internal Revenue Service Center, Philadelphia, Pennsylvania 19255.

(3) *Information returns.*

Q–3: Must Form 5471 be filed with respect to the organization of a FSC pursuant to section 6046 or to provide information with respect to a FSC pursuant to section 6038?

A–3: A Form 5471 required under section 6046 need not be filed with respect to the organization of a FSC. The requirements of section 6046 shall be satisfied by the filing of a Form 8279 dealing with the election to be treated as a FSC or small FSC. However, a Form 5471 will be required with respect to a reorganization of a FSC (or small FSC) or an acquisition of stock of a FSC (or small FSC), as required under section 6046 and the regulations thereunder. Provided that a Form 1120 FSC is filed, a Form 5471 need not be filed to satisfy the requirements of section 6038.

(4) *Conformity of accounting period.*

Q–4: Since a FSC, small FSC, and interest charge DISC must use the same annual accounting period as the principal shareholder, must such corporation delay the beginning of its first taxable year beyond January 1, 1985 if the principal shareholder (the shareholder with the highest percentage of voting power as defined in section 441(h)) is not a calendar year taxpayer?

A–4: No. Where the principal shareholder is not a calendar year taxpayer, a corporation may elect to be treated as a FFSC, small FSC, or interest charge DISC for a taxable year beginning January 1, 1985. However, such corporation must close its first taxable year and adopt the annual accounting period of its principal shareholder as of the first day of the principal shareholder's first taxable year beginning in 1985. A FSC, small FSC, or interest charge DISC need not obtain the consent of the Commissioner under section 442 to conform its annual accounting period to the annual accounting period of its principal shareholder.

(5) *Dollar limitations for short taxable years.*

Q–5: If a small FSC or an interest charge DISC has a short taxable year, how are the dollar limitations on foreign trading export gross receipts and qualified export gross receipts, respectively, determined for small FSCs and interest charge DISCs?

A–5: The dollar limitations are to be prorated on a daily basis. Thus, for example, if for its 1985 taxable year a small FSC has a short taxable year of 73 days, then in determining exempt foreign trade income, any foreign trading gross receipts that exceed $1 million (73/365 × $5 million) will not be taken into account.

(6) *Change of accounting period.*

Q–6: If the principal shareholder of a FSC, a small FSC, or an interest charge DISC (hereinafter referred to as a ''FSC'') changes its annual accounting period or is replaced by a new principal shareholder during a taxable year, is it necessary for the FSC to change its annual accounting period?

A–6: If the principal shareholder changes its annual accounting period, the FSC must also change its annual accounting period to conform to that of its principal shareholder. If the voting power of the principal shareholder is reduced by an amount equal to at least 10 percent of the total shares entitled to vote and such shareholder is no longer the principal shareholder, the FSC must conform its accounting period to that of its new principal shareholder. However, in determining whether a shareholder is a principal shareholder, the voting power of the shareholders is determined as of the beginning of the FSC's taxable year. Thus, for example, assume that for 1985 a FSC adopts a calendar year period as its annual accounting period to conform to that of its principal shareholder. Assume further than in March 1985 there is a 10 percent change in voting power and a different shareholder whose annual accounting period begins on July 1 becomes the new principal shareholder. The FSC will not be required to adopt the annual accounting period of its new principal shareholder until July 1, 1986. The FSC will have a short taxable year for the period January 1 to June 30, 1986.

(7) *Transition transfers.*

Q–7. Under what circumstances may a DISC or former DISC transfer its assets to a FSC or small FSC without incurring any tax liability on the transfer?

A–7. A DISC or former DISC will recognize no income, gain, or loss on a transfer of its qualified assets (as defined in section 993(b)) to a FSC or small FSC if all of the following conditions are met:

(i) The assets transferred were held by the DISC on August 4, 1983, and were transferred by the DISC or former DISC to the FSC or small FSC in a transfer completed before January 1, 1986; and

(ii) The assets are transferred in a transaction which would qualify for nonrecognition under subchapter C of chapter 1 of the Code, or would so qualify but for section 367 of the Code.

In such case, section 367 shall not apply to the transfer.

In addition, other provisions of subchapter C will apply to the transfer, such as section 358 (basis to shareholders), section 362 (basis to corporations), and section 381 (carryovers in corporate acquisitions). In determining whether a transfer by a DISC to a FSC or small FSC qualifies for nonrecognition under subchapter C, a liquidation of the assets of the DISC into a parent corporation followed by a transfer by the parent of those assets to the FSC or small FSC will be treated as a transaction described in section 368(a)(1)(D).

Notwithstanding the foregoing answer, a taxpayer which transfers a right to use its corporate name to a FSC in a transaction described in sections 332, 351, 354, 356 and 361 shall not be treated as having sold that right under section 367(d) or as having transferred that right to an entity that is not a corporation under section 367(a) provided that the corporate name is used only by the FSC and is not licensed or otherwise made available to others by the FSC.

(8) *Completed contract method.*

Q–8: Under what conditions is a taxpayer using the completed contract method of accounting as defined in § 1.451–3(d) exempted from satisfying the foreign management and foreign economic process requirements of subsections (c) and (d) of section 924?

A–8: If the taxpayer has entered into a binding contract before March 16, 1984, or has on March 15, 1984, and at all times thereafter a firm plan, evidenced in writing, to enter the contract and enters into a binding contract by December 31, 1984, then the taxpayer will be treated as having satisfied the foreign management tests of section 924(c) for periods before December 31, 1984, and the foreign economic process tests of section 924(d) with respect to costs incurred before December 31, 1984, with respect to the transaction. The FSC rules will apply to the income from the long-term contract if an election is made and the general FSC requirements under section 922 are satisfied. However, such taxpayer need not satisfy the activities test under section 925(c) for activities which occur before January 1, 1985 in order to use the transfer pricing rules under section 925.

(9) *Long-term contract—before March 15, 1984.*

Q–9: Under what conditions is a taxpayer who enters into a binding long-term contract (*i.e.*, a contract which is not completed in the taxable year in which it is entered into) before March 15, 1984, but does not use the completed contract method of accounting exempted from satisfying the foreign management and economic process requirements of subsections (c) and (d) of section 924?

A–9: If a taxpayer enters into a binding contract before March 15, 1984, the taxpayer will be treated as having satisfied the foreign management tests of section 924(c) for periods before December 31, 1984, and the foreign economic process tests of section 924(d) with respect to costs incurred before December 31, 1984, but only with respect to income attributable to such contracts that is recognized before December 31, 1986. The FSC rules will apply to the income from the long-term contract if an election is made and the general FSC requirements under section 922 are satisfied. However, such taxpayer need not satisfy the activities test under section 925(c) for activities which occur before January 1, 1985, in order to use the transfer pricing rules under section 925.

(10) *Long-term contract—after March 15, 1984.*

Q–10: Under what conditions is a taxpayer who has a long-term contract (i.e., a contract which is not completed in the taxable year in which it is entered into) but does not use the completed contract method of accounting exempted from satisfying the foreign management and economic process requirements of subsections (c) and (d) of section 924 if such taxpayer enters into a binding contract after March 15, 1984 and before January 1, 1985?

A–10: If a taxpayer enters into a contract after March 15, 1984, and before January 1, 1985, the taxpayer will be treated as having satisfied the foreign management tests of section 924(c) for periods before December 31, 1984, and the foreign economic process tests of section 924(d) with respect to costs incurred before December 31, 1984, but only with respect to income attributable to such contract that is recognized before December 31, 1985.

The FSC rules will apply to the income from the long-term contract if an election is made and the general requirements under section 922 are satisfied. However, such taxpayer need not satisfy the activities test under section 925(c) for activities which occur before January 1, 1985 in order to use the transfer pricing rules under section 925.

(11) *Incomplete transactions.*

Q–11: In computing its foreign trade income, how should a FSC treat transfers of export property from a related supplier to a DISC which is subsequently resold by a FSC after the DISC's termination?

A–11: In applying the gross receipts and combined taxable income methods under section 925 (a)(1) and (a)(2), the transaction is treated as if the transfer of export property were made by the related supplier to the FSC except that the foreign management and economic processes tests under section 924 and the activities test under section 925(c) shall be deemed to be satisfied for purposes of the transaction.

(12) *Pre-effective date costs and activities.*

Q–12: Are costs incurred and activities performed prior to January 1, 1985 taken into account for purposes of satisfying the foreign management and foreign economic processes requirements of subsections (c) and (d) of section 924 and the activities test under section 925(c)?

A–12: For purposes of determining the costs incurred and the activities performed to be taken into account with respect to contracts entered into after December 31, 1984, only those costs incurred and activities performed after December 31, 1984, are taken into consideration. Costs incurred and activities performed by a related supplier prior to January 1, 1985 (or prior to the effective date of a corporation's election to be treated as a FSC if other than January 1, 1985) with respect to transactions occurring after January 1, 1985 (or after the effective date of a corporation's election to be treated as a FSC) need not be taken into account for purposes of computing the FSC's profit under section 925 but are treated for section 925(c) purposes as if they were performed on behalf of the FSC.

(13) *FSC and interest charge DISC.*

Q–13: Can a FSC and an interest charge DISC be members of the same controlled group?

A–13: A FSC and an interest charge DISC cannot be members of the same controlled group. If any controlled group of corporations of which an interest charge DISC is a member establishes a FSC, then any interest charge DISC which is a member of such group shall be treated as having terminated its status as an interest charge DISC.

(c) *Export Trade Corporations*—(1) *Previously taxed income.*

Q–1: Under what circumstances are earnings of an export trade corporation that have not been included in income under section 951 treated as previously taxed income previously included in the income of a U.S. shareholder for purposes of section 959 (and not taxed)?

A–1: A corporation which qualifies as an export trade corporation (ETC) with respect to its last taxable year beginning before January 1, 1985, and elects to discontinue operations as an ETC for all taxable years beginning after December 31, 1984, shall not be required to take into income earnings attributable to previously excluded export trade income, as defined in § 1.970–1(b), derived with respect to taxable years beginning before January 1, 1985. However, any amounts distributed by the former ETC (*i.e.* a corporation which was an ETC for its last taxable year beginning before January 1, 1985) shall be treated as being made out of current earnings and profits and then out of previously taxed income. For purposes of determining the shareholder's basis in the ETC stock, distributions of previously excluded export trade income shall be treated as if made out of previously taxed income which has already been included in gross income under section 951(a)(1)(B). Thus, no basis adjustment under section 961 is necessary. In addition, upon the sale or exchange of the stock of such corporation in a transaction described in section 1248(a), the earnings and profits of the corporation attributable to such previously untaxed income shall not be subject to section 1248(a).

(2) *Qualification as an ETC for last year.*

Q–2: Must an ETC satisfy all of the tests set forth in section 971(a)(1) for the ETC's last taxable year beginning before January 1, 1985?

A–2: All of the tests in section 971(a)(1) must be satisfied, except that for purposes of the working capital requirements set forth in section 971(c)(1), the working capital of the ETC at the close of its last taxable year beginning before January 1, 1985 shall be deemed reasonable.

(3) *Continuation of ETC status.*

Q–3: May a corporation which chooses to remain an ETC after December 31, 1984, continue to do so?

A–3: Yes. However, previously untaxed income of such ETC shall not be treated as previously taxed income in accordance with Q&A #1 of this section.

(4) *Discontinuation of ETC status.*

Q–4: How does an ETC make an election to discontinue its operation as an ETC?

A–4: The United States shareholders (as defined in section 951(b)) must file a statement of election on behalf of the ETC indicating the intent of the ETC to discontinue operations as an ETC for taxable years beginning after December 31, 1984. In addition, the statement of election must include the name, address, taxpayer identification number and stock interest of each

United States shareholder. The statement must also indicate that the corporation on behalf of which the shareholders are making the election qualified as an ETC for its last taxable year beginning before January 1, 1985, and also the amount of earnings attributable to previously excluded export trade income. The statement must be jointly signed by each United States shareholder with each shareholder stating under penalties of perjury that he or she holds the stock interest specified for such shareholder in the statement of election. A copy of the statement of election must be attached to Form 5471 (information return with respect to a foreign corporation) filed with respect to the ETC's last taxable year beginning before January 1, 1985.

(5) *Transition transfers.*

Q–5: Under what circumstances may an electing ETC transfer its assets to a FSC without incurring any tax liability on the transfer?

A–5: An electing ETC will recognize no income, gain, or loss on a transfer of its assets to a FSC but only if all of the following conditions are met:

(i) The assets transferred were held by the ETC on August 4, 1983, and were transferred by the ETC to the FSC in a transfer completed before January 1, 1986; and

(ii) The assets are transferred in a transaction which would qualify for nonrecognition under subchapter C of chapter 1 of the Code, or would so qualify but for section 367 of the Code.

In such case, section 367 shall not apply to the transfer. In addition, other provisions of subchapter C will apply to the transfer such as section 358 (basis to shareholders), section 362 (basis to corporation) and section 381 (carryovers in corporate acquisitions). In determining whether a transfer by an ETC to a FSC qualifies for nonrecognition under subchapter C, a liquidation of the assets of the ETC into a parent corporation followed by a transfer by the parent of those assets to the FSC will be treated as a transaction described in section 368(a)(1)(D).

(Secs. 803 and 805 of the Tax Reform Act of 1984 (98 Stat. 1001) and sec. 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805); sec. 805 (b)(3)(C) and (D) of the Tax Reform Act of 1984 (98 Stat. 1002), and sec. 7805 of the Code (68A Stat. 917; 26 U.S.C. 7805); secs. 367, 927, and 7805 of the Internal Revenue Code of 1954 (98 Stat. 662, 26 U.S.C. 367; 98 Stat. 663, 26 U.S.C. 367; 98 Stat. 993, 26 U.S.C. 927; 98 Stat. 994, 26 U.S.C. 927; and 68A Stat. 917, 26 U.S.C. 7805); sec. 805 of the Tax Reform Act of 1984 (Pub. L. 98–69, 98 Stat. 1000))

[T.D. 7983, 49 FR 40013, Oct. 12, 1984, as amended by T.D. 7992, 49 FR 48283, Dec. 12, 1984; T.D. 7993, 49 FR 48291, Dec. 12, 1984; T.D. 7992, 49 FR 49450, Dec. 20, 1984; T.D. 8126, 52 FR 6434, 6435, Mar. 3, 1987; T.D. 8515, 59 FR 2984, Jan. 20, 1994]

§1.921–2 Foreign Sales Corporation—general rules.

(a) *Definition of a FSC and the Effect of a FSC Election.*

Q–1. What is the definition of a Foreign Sales Corporation (hereinafter referred to as a "FSC" (All references to FSCs include small FSCs unless indicated otherwise))?

A–1. As defined in section 922(a), an FSC must satisfy the following eight requirements.

(i) The FSC must be a corporation organized or created under the laws of a foreign country that meets the requirements of section 927(e)(3) (a "qualifying foreign country") or a U.S. possession other than Puerto Rico (an "eligible possession"). See Q&As 3, 4, and 5 of §1.922–1.

(ii) A FSC may not have more than 25 shareholders at any time during the taxable year. See Q&A 6 of §1.922–1.

(iii) A FSC may not have any preferred stock outstanding during the taxable year. See Q&As 7 and 8 of §1.922–1.

(iv) A FSC must maintain an office outside of the United States in a qualifying foreign country or an eligible possession and maintain a set of permanent books of account (including invoices or summaries of invoices) at such office. See Q&As 9, 10, 11, 12, 13, 14, and 15 of § 1.922–1.

(v) A FSC must maintain within the United States the records required under section 6001. See Q&A 16 of § 1.922–1.

(vi) The FSC must have a board of directors which includes at least one individual who is not a resident of the United States at all times during the taxable year. See Q&As 17, 18, 19, 20, and 21 of § 1.922–1.

(vii) A FSC may not be a member, at any time during the taxable year, of any controlled group of corporations of which an interest charge DISC is a member. See Q&A 2 of this section and Q&A 13, of § 1.921–1T(b)(13).

(viii) A FSC must have made an election under section 927(f)(1) which is in effect for the taxable year. See Q&A 1 of § 1.921–1T(b)(1) and § 1.927(f)–1.

In addition, under section 441(h), the taxable year of a FSC must conform to the taxable year of its principal shareholder. See Q&A 4 of § 1.921–1T(b)(4).

Q–2. Does the reference to a DISC under section 922(a)(1)(F) which provides that a FSC cannot be a member, at any time during the taxable year, of any controlled group of corporations of which a DISC is a member refer solely to an interest charge DISC?

A–2. Yes.

(b) *Small FSC.*

Q–3. What is a small FSC?

A–3. A small FSC is a Foreign Sales Corporation which meets the requirements of section 922(a)(1) enumerated in Q&A 1 of this section as well as the requirements of section 922(b). Section 922(b) requires that a small FSC make a separate election to be treated as a small FSC. See Q&A 1 of § 1.921–1T(b) and § 1.927(f)–1. In addition, section 922(b) requires that the small FSC not be a member, at any time during the taxable year, of a controlled group of corporations which includes a FSC unless such FSC is a small FSC.

Q–4. What is the effect of an election as a small FSC?

A–4. Under section 924(b)(2), a small FSC need not meet the foreign management and economic processes tests of section 924(b)(1) in order to have foreign trading gross receipts. However, in determining the exempt foreign trade income of a small FSC, any foreign trading gross receipts for the taxable year in excess of $5 million are not taken into account. If the foreign trading gross receipts of a small FSC for the taxable year exceed the $5 million limitation, the FSC may select the gross receipts to which the limitation is allocated. In order to use the administrative pricing rules under section 925(a), a small FSC must satisfy the activities test under section 925(c). In addition, under section 441(h), the taxable year of a small FSC must conform to the taxable year of its principal shareholder (defined in Q&A 4 of § 1.921–1T(b)(4) as the shareholder with the highest percentage of its voting power).

Q–5. What is the effect on a small FSC (or FSC) (‘‘target’’) if it is acquired, directly or indirectly, by a corporation if that acquiring corporation (‘‘acquiring’’), or a member of the acquiring corporation's controlled group, is a FSC (or small FSC)?

A–5. Unless the corporations in the controlled group elect to terminate the FSC (or small (FSC) election of the acquiring corporation, the target's small FSC's (or FSC's) taxable year and election will terminate as of the day preceding the date the target small FSC and acquiring FSC became members of the same controlled group. The target small FSC will receive FSC benefits for the period prior to termination, but the $5 million small FSC limitation will be reduced to the amount which bears the same ratio to the $5 million as the number of days in the short year created by the termination bears to 365. The due date of the income tax return for the short taxable year created by this provision will be the date prescribed by section 6072(b), including extensions, starting with the last day of the short taxable year. If the short taxable year created by this provision ends prior to March 3, 1987, the filing date of the tax return for the short taxable year will be automatically extended until the earlier of May 18, 1987 or the date under section 6072 (b) assuming a short taxable year had not been created by these regulations.

(c) *Comparison of FSC to DISC.*

Q–6. How does a FSC differ from a DISC?

A–6. A DISC is a domestic corporation which is not itself taxable while a

FSC must be created or organized under the laws of a jurisdiction which is outside of the United States (including certain U.S. possessions) and may be taxable on its income except for its exempt foreign trade income. The DISC provisions enable a shareholder to obtain a partial deferral of tax on income from export sales and certain services, if 95 percent of its receipts and assets are export related. The FSC provisions contain no assets test, but a portion of income for export sales and certain services is exempt from U.S. taxes if the FSC satisfies certain foreign presence, foreign management, and foreign economic processes tests.

(d) *Organization of a FSC.*

Q–7. Under the laws of what countries may a FSC be organized?

A–7. A FSC may not be created or organized under the laws of the United States, a state, or other political subdivision. However, a FSC may be created or organized under the laws of a possession of the United States, including Guam. American Samoa, the Commonwealth of the Northern Mariana Islands and the Virgin Islands of the United States, but not Puerto Rico. These eligible possessions are located outside the U.S. customs territory. In addition, a FSC may incorporate under the laws of a foreign country that is a party to—

(i) An exchange of information agreement that meets the standards of the Caribbean Basin Economic Recovery Act of 1983 (Code section 274(h)(6)(C)), or

(ii) A bilateral income tax treaty with the United States if the Secretary certifies that the exchange of information program under the treaty carries out the purpose of the exchange of information requirements of the FSC legislation as set forth in section 927(e)(3), if the company is covered under the exchange of information program under subdivision (i) or (ii). The Secretary may terminate the certification. Any termination by the Secretary will be effective six months after the date of the publication of the notice of such termination in the FEDERAL REGISTER.

(e) *Foreign Trade Income.*

Q–8. How is foreign trade income defined?

A–8. Foreign trade income, defined in section 923(b), is gross income of an FSC attributable to foreign trading gross receipts. It includes both the profits earned by the FSC itself from exports and commissions earned by the FSC from products and services exported by others.

(f) *Investment Income and Carrying Charges.*

Q–9. What do the terms ‘‘investment income’’ and ‘‘carrying charges’’ mean?

A–9.

(i) Investment income means:

(A) Dividends,

(B) Interest,

(C) Royalties,

(D) Annuities,

(E) Rents (other than rents from the lease or rental of export property for use by the lessee outside of the United States);

(F) Gains from the sale of stock or securities,

(G) Gains from future transactions in any commodity on, or subject to the rules of, a board of trade or commodity exchange (other than gains which arise out of a bona fide hedging transaction reasonably necessary to conduct the business of the FSC in the manner in which such business is customarily conducted by others),

(H) Amounts includable in computing the taxable income of the corporation under part I of subchapter J, and

(I) Gains from the sale or other disposition of any interest in an estate or trust.

(ii) Carrying charges means:

(A) Charges that are imposed by a FSC or a related supplier and that are identified as carrying charges, (‘‘stated carrying charges’’) and

(B)(*1*) Charges that are considered to be included in the price of the property or services sold by an FSC or a related supplier, as provided under Q&As 1 and 2 of §1.927(d)–1, and

(*2*) Any other unstated interest.

Q–10. How are investment income and carrying charges treated?

A–10. Investment income and carrying charges are not foreign trading gross receipts. Investment income and carrying charges are includable in the taxable income of an FSC, except in the case of a commission FSC where carrying charges are treated as income of the related supplier, and are treated as income effectively connected with a trade or business conducted through a permanent establishment within the United States. The source of investment income and carrying charges is determined under sections 861, 862, and 863 of the Code.

(g) *Small Businesses.*

Q–11. What options are available to small businesses engaged in exporting?

A–11. A small business may elect to be treated as either a small FSC or an interest charge DISC. See Q&As 3 & 4 of § 1.921–2 relating to a small FSC. Rules with respect to interest charge DISCs are the subject of another regulations project.

[T.D. 8127, 52 FR 6469, Mar. 3, 1987]

§ 1.921–3T Temporary regulations; Foreign sales corporation general rules.

(a) *Exclusion*—(1) *Classifications of income.* The extent to which income of a FSC (any further reference to a FSC in this section shall include a small FSC unless indicated otherwise) is subject to the corporate income tax of section 11, or, in the alternative, section 1201(a), is dependent upon the allocation of the FSC's income to the following five categories:

(i) Exempt foreign trade income determined under section 923 and § 1.923–1T;

(ii) Non-exempt foreign trade income determined with regard to the administrative pricing rules of section 925(a)(1) or (2);

(iii) Non-exempt foreign trade income determined without regard to the administrative pricing rules of section 925(a)(1) or (2) (section 923(a)(2) non-exempt income as defined in section 927(d)(6));

(iv) Investment income and carrying charges; and

(v) Other non-foreign trade income.

(2) *Source and characterization of FSC income*—(i) *Exempt foreign trade income.* The exempt foreign trade income of a FSC determined under section 923 and § 1.923–1T is treated as foreign source income which is not effectively connected with a United States trade or business. See § 1.923–1T(a) for the definition of foreign trade income and § 1.923–1T(b) for the definition of exempt foreign trade income.

(ii) *Non-exempt foreign trade income determined with regard to the administrative pricing rules.* The FSC's non-exempt foreign trade income with respect to a transaction or group of transactions will be treated as United States source income which is effectively connected with the FSC's trade or business which is conducted through its permanent establishment within the United States if either of the administrative pricing rules of section 925(a)(1) or (2) is used to determine the FSC's foreign trade income from a transaction or group of transactions. See § 1.923–1T(b) for the definition of non-exempt foreign trade income.

(iii) *Non-exempt foreign trade income determined without regard to the administrative pricing rules.* The source and taxation of the FSC's non-exempt foreign trade income not classified in paragraph (a)(2)(ii) of this section will be determined under the appropriate sections of the Internal Revenue Code and the regulations under those sections. This type of income (section 923(a)(2) non-exempt income) includes both income that is not effectively connected with the conduct of a trade or business in the United States and income that is effectively connected.

(iv) *Investment income and carrying charges.* All of the FSC's investment income and carrying charges will be treated as income which is effectively connected with the FSC's trade or business which is conducted through its permanent establishment within the United States. The source of that income will be determined under the appropriate sections of the Internal Revenue Code and the regulations under those sections. See § 1.921–2(f) (Q & A9) for definition of investment income and carrying charges.

(v) *Non-foreign trade income (other than investment income and carrying charges).* The source and taxation of the FSC's non-foreign trade income (other than investment income and carrying charges) will be determined under the appropriate sections of the Internal Revenue Code and the regulations under those sections.

(b) *Allocation and apportionment of deductions.* Expenses, losses and deductions incurred by the FSC shall be allocated and apportioned under the rules set forth in §1.861–8 to the FSC's foreign trade income and to the FSC's non-foreign trade income. Any deductions incurred by the FSC on a transaction, or group of transactions, which are allocated and apportioned to the FSC's foreign trade income from that transaction, or group of transactions, shall be allocated on a proportionate basis between exempt foreign trade income and non-exempt foreign trade income.

(c) *Net operating losses and capital losses*—(1) *General rule.* (i) If a FSC for any taxable year incurs a deficit in earnings and profits attributable to foreign trade income determined without regard to the administrative pricing rules of section 925(a)(1) or (2), that deficit shall be applied to reduce current earnings and profits, if any, attributable to—

(A) First, exempt foreign trade income determined with regard to the administrative pricing rules,

(B) Second, non-exempt foreign trade income determined with regard to the administrative pricing rules,

(C) Third, investment income and carrying charges, and

(D) Fourth, other non-foreign trade income.

(ii) If a FSC for any taxable year incurs a deficit in earnings and profits attributable to non-foreign trade income (other than investment income, carrying charges and net capital losses), that deficit shall be applied to reduce current earnings and profits, if any, attributable to—

(A) First, investment income and carrying charges,

(B) Second, exempt foreign trade income determined with regard to the administrative pricing rules,

(C) Third, exempt foreign trade income determined without regard to the administrative pricing rules,

(D) Fourth, non-exempt foreign trade income determined with regard to the administrative pricing rules, and

(E) Fifth, section 923(a)(2) non-exempt income.

(iii) If a FSC for any taxable year incurs a deficit in earnings and profits attributable to investment income and carrying charges, that deficit shall be applied to reduce current earnings and profits, if any, attributable to—

(A) First, non-foreign trade income other than capital gains,

(B) Second, exempt foreign trade income determined with regard to the administrative pricing rules,

(C) Third, exempt foreign trade income determined without regard to the administrative pricing rules,

(D) Fourth, non-exempt foreign trade income determined with regard to the administrative pricing rules, and

(E) Fifth, section 923(a)(2) non-exempt income.

(iv) Net capital losses will be available for carryback or carryover pursuant to paragraph (c)(2) of this section.

(v) Because the no-loss rules provide that a related supplier may always compensate the FSC for its expenses either as part of the commission payment or as part of the transfer price if the administrative pricing rules are used (see §1.925(a)–1T(e)(1)(i)), a FSC will not have a deficit in its earnings and profits relating to foreign trade income determined with regard to the administrative pricing rules. To determine the amount of any division of earnings and profits for the purpose of determining under §1.926(a)–1T (a) and (b) the treatment and order of distributions, the portion of a deficit in earnings and profits chargeable under this paragraph to such division prior to such distribution shall be determined in a manner consistent with the rules in §1.316–2(b) for determining the amount of earnings and profits available on the date of any distribution.

(2) *Carryback or carryover of net operating losses and capital losses to other taxable years of a FSC (or former FSC).* (i) The amount of the deduction for the taxable year under section 172 for a net operating loss carryback or carryover, or under section 1212 for a capital loss carryback or carryover, shall be determined in the same manner as if the FSC were a foreign corporation which had not elected to be treated as a FSC. Thus, the amount of the deduction will be the same whether or not the corporation was a FSC in the year of the loss or in the year to which the loss is carried.

(ii) Any carryback or carryover of a FSC's (or former FSC's) net operating loss which is attributable to transactions which give rise to foreign trade income shall be charged—

(A) First, to earnings and profits attributable to exempt foreign trade income which is determined without regard to the administrative pricing rules,

(B) Second, to earnings and profits attributable to section 923(a)(2) non-exempt income,

(C) Third, to earnings and profits attributable to exempt foreign trade income determined with regard to the administrative pricing rules,

(D) Fourth, to earnings and profits attributable to non-exempt foreign trade income determined with regard to the administrative pricing rules,

(E) Fifth, to earnings and profits attributable to investment income and carrying charges (other than capital gain income), and

(F) Sixth, to earnings and profits attributable to non-foreign trade income (other than investment income, carrying charges and capital gain income).

(iii) Any carryback or carryover of a FSC's (or former FSC's) net operating loss which is attributable to non-foreign trade income (other than capital gain income) shall be charged—

(A) First, to earnings and profits attributable to non-foreign trade income (other than investment income, carrying charges and capital gain income),

(B) Second, to earnings and profits attributable to investment income and carrying charges,

(C) Third, to earnings and profits attributable to exempt foreign trade income determined with regard to the administrative pricing rules,

(D) Fourth, to earnings and profits attributable to non-exempt foreign trade income determined with regard to the administrative pricing rules,

(E) Fifth, to earnings and profits attributable to exempt foreign trade income which is determined without regard to the administrative pricing rules, and

(F) Sixth, to earnings and profits attributable to section 923(a)(2) non-exempt income.

(iv) Any carryback or carryover of a net operating loss to a year in which the corporation was (or is) a FSC from a taxable year in which the corporation was not a FSC shall be applied in a manner consistent with subdivision (iii) of this paragraph.

(d) *Credits against tax*—(1) *General rule*. Notwithstanding any other provision of chapter 1, subtitle A, a FSC is allowed under section 921(c) as credits against tax only the following credits:

(i) The foreign tax credit, section 27(a);

(ii) The credit for tax withheld at source on foreign corporations, section 33; and

(iii) The certain uses of gasoline and special fuels credit, section 34.

(2) *Foreign tax credit*. (i) The direct foreign tax credit of section 901(b)(4) as determined under section 906 for income, war profits, and excess profits taxes (or taxes in lieu thereof) paid or accrued to any foreign country or possession of the United States is allowed a FSC only to the extent that those taxes are attributable to the FSC's foreign source non-foreign trade income which is effectively connected with its conduct of a trade or business within the United States. See section 906(b)(5).

(ii) The foreign tax credit for domestic corporate shareholders in foreign corporations (the deemed paid credit) provided under section 901(a) as determined under section 902 is allowed for income, war profits, and excess profits taxes deemed paid or accrued by a FSC (or former FSC) only to the extent those taxes are deemed paid or accrued with respect to the FSC's (or former FSC's) section 923(a)(2) non-exempt income and its non-foreign trade income.

(iii) The foreign tax credit allowed by sections 901 and 903 for tax withheld at source is allowed only to the extent the dividends paid to the FSC's (or former FSC's) shareholder are attributable to the FSC's (or former FSC's) section 923(a)(2) non-exempt income and its non-foreign trade income.

(3) *Foreign tax credit limitation*. (i) For purposes of computation of the direct foreign tax credit of section 901(b)(4) as determined under section 906, the separate limitation of section 904(d)(1)(C) for the FSC's taxable income attributable to its foreign trade income will apply. The direct foreign tax credit is not allowed to a FSC with regard to

taxes it paid which are attributable to its foreign trade income. Since the foreign tax credit is not allowed for that type of income, the effect of the separate limitation is to remove the FSC's foreign trade income from the numerator of the fraction used to compute the FSC's overall foreign tax credit limitation.

(ii) A separate limitation under section 904(d)(1)(D) is provided for distributions from a FSC (or former FSC) that arise through operation of the deemed paid credit of section 902 and are attributable to foreign trade income earned during the period when the distributing corporation was a FSC. This limitation is computed by multiplying the FSC's shareholder's tentative United States tax by a fraction the numerator of which is the foreign source dividend (determined with regard to section 78) attributable to the foreign trade income less dividends received deductions and other expenses allocated and apportioned under §1.861–8 allowed to the shareholder and the denominator of which is the shareholder's worldwide income. The effect of this separate limitation is to remove dividends attributable to the FSC's foreign trade income from the numerator of the fraction used to compute the overall foreign tax credit limitation of the FSC's shareholder.

(iii) The separate limitation under section 904(d)(1)(D) also applies to the foreign tax credit allowed to a FSC shareholder by sections 901 and 903 for tax withheld at source on dividends paid by the FSC. The numerator of this fraction is the part of the dividend attributable to the FSC's foreign trade income and the denominator is the shareholder's worldwide income. The effect of this separate limitation is to remove dividends attributable to foreign trade income of a FSC (or former FSC) from the numerator of the fraction used to compute the overall foreign tax credit limitation of the FSC's shareholder.

(e) *Deduction for foreign income, war profits and excess profits taxes.* Under section 275(a)(4)(B), income, war profits and excess profits taxes imposed by a foreign country or possession of the United States may not be deducted by a FSC to the extent those taxes are paid or accrued with respect to its foreign trade income.

(f) *Payment of estimated tax.* Every FSC which is subject to tax under section 11 or 1201(a) and section 882 must make payment of its estimated tax in accordance with section 6154 and the regulations under that section. In determining the amount of the estimated tax, the FSC must treat the tax imposed by section 881 as though it were a tax imposed by section 11. See section 6154(g).

(g) *Accumulated earnings, personal holding company and foreign personal holding company.* The provisions covering the accumulated earnings tax (sections 531 through 537), personal holding companies (sections 541 through 547) and foreign personal holding companies (sections 551 through 558) apply to FSCs to the extent they would apply to foreign corporations that are not FSCs.

(h) *Subpart F income and increase of earnings invested in U.S. property.* For the mandatory inclusion in the gross income of the U.S. shareholders of the subpart F income and of the increase in earnings invested in U.S. property of a FSC, see sections 951 through 964 and the regulations under those sections. However, the foreign trade income (other than section 923(a)(2) non-exempt income) and, generally, the investment income and carrying charges of a FSC and any deductions which are allocated and apportioned to those classes of income, are not taken into account under sections 951 through 964. See sections 951(e) and 952(b).

(i) *Certain accumulations of earnings and profits.* For the inclusion in the gross income of U.S. persons as a dividend on the gain recognized on certain sales or exchanges of stock in a FSC, to the extent of certain earnings and profits attributable to the stock which were accumulated while the FSC was a controlled foreign corporation, see section 1248 and the regulations under that section. However, section 1248 and the regulations under that section do not apply to a FSC's earnings and profits attributable to foreign trade income, see section 1248(d)(6).

(j) *Limitations on certain multiple tax benefits.* The provisions of section 1561, Limitations on Certain Multiple Tax

Benefits in the Case of Certain Controlled Corporations, and section 1563, Definitions and Special Rules, and the regulations under those sections apply to a FSC and its controlled group.

[T.D. 8126, 52 FR 6435, Mar. 3, 1987]

§ 1.922–1 Requirements that a corporation must satisfy to be a FSC or a small FSC.

(a) *FSC requirements.*

Q–1. What are the requirements that a corporation must satisfy to be an FSC?

A–1. A corporation must satisfy all of the requirements of section 922(a).

(b) *Small FSC requirements.*

Q–2. What are the requirements that a corporation must satisfy to be a small FSC?

A–2. A corporation must satisfy all of the requirements of sections 922(a)(1) and (b).

(c) *Definition of corporation.*

Q–3. What type of entity is considered a corporation for purposes of qualifying as an FSC or a small FSC under section 922?

A–3. A foreign entity that is classified as a corporation under section 7701(a)(3) (other than an insurance company) is considered a corporation for purposes of this requirement.

(d) *Eligible possession.*

Q–4. For purposes of meeting the place of incorporation requirement of section 922(a)(1)(A), what is a possession of the United States?

A–4. For purposes of section 922(a)(1)(A), the possessions of the United States are Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Virgin Islands of the United States (‘‘eligible possessions’’). Puerto Rico, although a possession for certain tax purposes, does not qualify as a jurisdiction in which a FSC or small FSC may be incorporated.

(e) *Qualifying countries.*

Q–5. For purposes of meeting the place of incorporation requirement of section 922(a)(1)(A), what is a foreign country and which foreign countries meet the requirements of section 927(e)(3)?

A–5. (i) A foreign country is a jurisdiction outside the 50 states, the District of Columbia, the Commonwealth of Puerto Rico, and the possessions of the United States. (ii) A list of the foreign countries that meet the requirements of section 927(e)(3) (’’qualifying countries’’) will be published from time to time in the FEDERAL REGISTER and the Internal Revenue Bulletin. A corporation is considered to be created or organized under the laws of a foreign country that meets the requirements of section 927(e)(3) only if the foreign country is a party to (A) an exchange of information agreement under the Caribbean Basin Economic Recovery Act (Code section 274(h)((6)(C)), or (B) a bilateral income tax treaty with the United States if the Secretary certifies that the exchange of information program under the treaty carries out the purposes of the exchange of information requirements of the FSC legislation as set forth in Code section 927(e)(3) and if the corporation is covered under exchange of information program under subdivision (A) or (B).

(f) *Number of shareholders.*

Q–6. Who is counted as a shareholder of a corporation for purposes of determining whether a corporation meets the limitation on the number of shareholders to no more than 25 under section 922(a)(1)(B)?

A–6. Solely for purposes of the limitation on the number of shareholders, the following rules apply:

(i) In general, an individual who owns an interest in stock of the corporation is counted as a shareholder. In the case of joint owners, each joint owner is counted as a shareholder. A member of a corporation’s board of directors who holds qualifying shares that are required to be owned by a resident of the country of incorporation is not counted as a shareholder.

(ii) A corporation that owns an interest in stock of the corporation is counted as a single shareholder.

(iii) An estate that owns an interest in stock of the corporation is counted as a single shareholder. If the limitation on number of shareholders is not satisfied by reason of the closing of an estate, the FSC will continue to qualify for the taxable year of the FSC in which the estate is closed.

(iv) A trust is not counted as a shareholder. In the case of a trust all of which is treated as owned by one or more persons under sections 671 through 679, those persons are counted as shareholders. In the case of all other trusts, a beneficiary is counted as a shareholder.

(v) A partnership is not counted as a shareholder. A general or limited partner is counted as a shareholder if it is a corporation, an individual, or an estate, under the rules contained in subdivisions (i) through (iii). A general or limited partner is not counted as a shareholder if it is a partnership or a trust; the rules contained in subdivision (iv) and this subdivision (v) apply to the determination of who is counted as a shareholder.

(g) *Class of stock.*

Q–7. What is preferred stock for purposes of determining whether a corporation satisfies the requirement under section 922(a)(1)(C) that no preferred stock be outstanding?

A–7. Preferred stock is stock that is limited and preferred as to dividends or distributions in liquidation.

Q–8. Can a corporation have outstanding more than one class of common stock?

A–8. Yes. However, the rights of a class of stock will be disregarded if the right has the effect of avoidance of Federal income tax. For instance, dividend rights may not be used to direct dividends from exempt foreign trade income to shareholders that have taxable income and to direct other dividends to shareholders that have met operating loss carryovers.

(h) *Office.*

Q–9. What is an office for purposes of determining whether a corporation satisfies the requirement of section 922(a)(1)(D)(i)?

A–9. An office is a place for the transaction of the business of the corporation. To be an office a place must meet all of the following requirements;

(i) *It must have a fixed location.* A transient location is not a fixed location.

(ii) *It must be a building or a portion of a building consisting of at least one room.* A room is a partitioned part of the inside of a building. The building or portion thereof used as the corporation's office must be large enough to accommodate the equipment required in subdivison (iii) of this answer 9 and the activity required in subdivision (iv) of this answer 9. However, an office is not limited to a room with communication equipment or an adjacent room. Noncontiguous space within the same building will also constitute an office if it is equipped for the retention of the documentation required to be stored by the FSC and if access to the necessary communication equipment is available for use by the FSC.

(iii) *It must be equipped for the performance of the corporation's business.* An office must be equipped for the communication and retention of information and must be supplied with communication services.

(iv) *It must be regularly used for some business activity of the corporation.* A corporation's business activities must include the maintenance of the documentation described in Q&A 12 of this section. These documents need not be prepared at the office. Any person, whether or not related to the corporation, may perform the business activities of the corporation at the office if the activity is performed pursuant to a contract, oral or written, for the performance of the activity on behalf of the corporation.

(v) *It must be operated, and owned or leased, by the corporation or by a person, whether or not related to the corporation, under contract to the corporation.*

(vi) *It must be maintained by the corporation or by a person, whether or not related, to the corporation, under contract to the corporation at all times during the taxable year.* In the case of a corporation newly organized as a FSC, thirty days may elapse between the time the corporation is organized as a FSC (*i.e.,* the first day for which the FSC election is effective) and the time an office is maintained by the corporation or a person under contract with the corporation. A place that meets the requirements in subdivision (i) through (vi) of this answer 9 can also be used for activities that are unrelated to the business activity of the corporation.

Q–10 Can a corporation locate an office in any foreign country if it has at least one office in a U.S. possession or in a foreign country that meets the requirements of section 927 (e)(3) as provided Q&A 5 of this section?

A–10. Yes.

Q–11. Must a corporation locate the office that is required under section 922(a)(1)(D)(i) in the country or possession of its incorporation?

A–11. No.

(i) *Documentation.*

Q–12. What documentation must be maintained at the corporation's office for purposes of section 922(a)(1)(D)(ii)?

A–12. At least the following documentation must be maintained at the corporation's office under section 922(a)(1)(D)(ii):

(i) The quarterly income statements, a final year-end income statement and a year-end balance sheet of the FSC; and

(ii) All final invoices (or a summary of them) or statements of account with respect to (A) sales by the FSC, and (B) sales by a related person if the FSC realizes income with respect to such sales. A final invoice is an invoice upon which payment is made by the customer. A invoice must contain, at a minimum, the customer's name or idenfitying number and, with respect to the transaction or transactions, the date, product or product code or service of service code, quantity, price, and amount due. In the alternative, a document will be acceptable as a final invoice even though it does not include all of the above listed information if the FSC establishes that the document is considered to be a final invoice under normal commercial practices. An invoice forwarded to the customer after payment has been tendered or received pursuant to a letter of credit, as a receipt for payment, satisfies this definition. A single final invoice may cover more than one transaction with a customer.

(iii) A summary of final invoices may be in any reasonable form provided that the summary contains all substantive information from the invoices. All substantive information includes the customer's name or identifying number, the invoice number, date, product or product code, and amount owed. In the alternative, all substantive information includes a summary of the information that is included on documents considered to be final invoices under normal commercial practice. A statement of account is any summary statement forwarded to a customer to inform of, or confirm, the status of transactions occurring within an accounting period during a taxable year that is not less than one month. A statement of account must contain, at a minimum, the customer's name or identifying number, date of the statement of account and the balance due (even if the balance due is zero) as of the last day of the accounting period covered by the statement of account. In the alternative, a document will be accepted as a statement of account even though it does not include all of the above listed information if the FSC establishes that the document is considered a statement of account under normal commercial practice. For these purposes, a document will be considered to be a statement of account under normal commercial practice if it is sent to domestic as well as to export customers in order to inform the customers of the status of transactions during an accounting period. With regard to quarterly income statements, a reasonable estimate of the FSC's income and expense items will be acceptable. If the FSC is a commission FSC, 1.83% of the related supplier's gross receipts will be considered a reasonable estimate of the FSC's income. The documents required by this Q&A 12 need not be prepared by the FSC. In addition they need not be prepared at the FSC's office.

(iv) The FSC will satisfy the requirement that the documents be maintained at its office even if not all final invoices (or summaries) or statements of account or items to be included on statements of account are maintained at its office as long as it makes a good faith effort to do so and provided that any failure to maintain the required documents is cured within a reasonable time of discovery of the failure.

Q–13. If the required documents are not prepared at the FSC's office, by what date must the documents be maintained at its office?

A–13. With regard to the applicable quarters of years prior to March 3, 1987, the quarterly income statements, final invoices (or summaries), or statements of account and the year-end balance sheet must be maintained at the FSC's office no later than the due date, including extensions, of the FSC tax return for the applicable taxable year in which the period ends. With regard to the applicable quarters or years ending after March 3, 1987, the quarterly income statements for the first three quarters of the FSC year must be maintained at the FSC's office no later than 90 days after the end of the quarter. The quarterly income statement for the fourth quarter of the FSC year, the final year-end income statement, the year-end balance sheet, and the final invoices (or summaries) or statements of account must be maintained at the FSC's office no later than the due date, including extensions, of the FSC tax return for the applicable taxable year.

Q–14. In what form must the documentation required under section 922(a)(1)(D)(ii) be maintained?

A–14. The documentation required to be maintained by the office may be originals or duplicates and may be in any form that qualifies as a record under Rev. Rul. 71–20, 1971–1 C.B. 392. Therefore, documentation may be maintained in the form of punch cards, magnetic tapes, disks, and other machine-sensible media used for recording, consolidating, and summarizing accounting transactions and records within a taxpayer's automatic data processing system. The corporation need not maintain at its office equipment capable of reading the machine-sensible media. That equipment, however, must be situated in a location that is readily accessible to the corporation. The equipment need not be owned by the corporation.

Q–15. How long must the documentation required under section 922(a)(1)(D)(ii) be maintained?

A–15. The documentation required under section 922(a)(1)(D)(ii) for a taxable year must be maintained at the FSC's office described in section 922(a)(1)(D)(i) until the period of limitations for assessment of tax for the taxable year has expired under section 6501.

Q–16. Under what circumstances will a coporation be considered to satisfy the requirement of section 922(a)(1)(D)(iii) that it maintain the records it is required to keep under section 6001 at a location within the United States?

A–16. A corporation will be considered to satisfy this requirement if the records required under section 6001 are kept by any person at any location in the United States provided that the records are retained in accordance with section 6001 and the regulations thereunder.

(j) *Board of directors.*

Q–17. What is a corporation's ''board of directors'' for purposes of the requirement under section 922(a)(1)(E) that, at all times during the taxable year, the corporation must have a board of directors which includes at least one individual who is not a resident of the United States?

A–17. The ''board of directors'' is the body that manages and directs the corporation according to the law of the qualifying country or eligible possession under the laws of which the corporation was created or organized.

Q–18. Can the member of the board of directors who is a nonresident of the United States be a citizen of the United States?

A–18. Yes. For purposes of meeting the requirement under section 922(a)(1)(E), the member of the board who cannot be a United States resident can be a United States citizen. The principles of section 7701(b) shall be used to determine whether a United States citizen is a United States resident.

Q–19. If the only member of the board of directors who is not a resident of the United States dies, or resigns, is removed from the board or becomes a resident of the United States will the corporation be considered to fail the requirement under section 922(a)(1)(E)?

A–19. If the corporation appoints a new member who is a nonresident of the United States to the board within 30 days after the death, resignation or removal of the former nonresident member, the corporation will be considered to satisfy the requirement under section 922(a)(1)(E). Also, the corporation will be considered to satisfy the requirement under section 922(a)(1)(E) if the corporation appoints a new member who is a nonresident of the United States to the board within 30 days after the corporation has knowledge, or reason to know, that the board's former nonresident member was in fact a resident of the United States.

Q–20. Is a nonresident alien individual who elects to be treated as a resident of the United States for a taxable year under section 6013(g) considered a nonresident of the United States for purposes of the requirement under section 922(a)(1)(E)?

A–20. Yes.

Q–21. Will the requirement that a FSC's board of directors have a nonresident member at all times during the taxable year be satisfied if the nonresident member is elected or appointed to the board of directors no later than 30 days after the first day for which the FSC election is effective?

A–21. Yes.

[T.D. 8127, 52 FR 6470, Mar. 3, 1987]

§ 1.923–1T Temporary regulations; exempt foreign trade income.

(a) *Foreign trade income.* Foreign trade income of a FSC is the FSC's gross income attributable to its foreign trading gross receipts. (Any further reference to a FSC in this section shall include a small FSC unless indicated otherwise.) If the FSC is the principal on the sale of export property which it purchased from a related supplier, the FSC's gross income is determined by subtracting from its foreign trading gross receipts the transfer price determined under the transfer pricing methods of section 925(a). If the FSC is the commission agent on the sale of export property by its related supplier, the FSC's gross income is the commission paid or payable by the related supplier to the FSC with respect to the transactions that would have generated foreign trading gross receipts had the FSC been the principal on the transaction. See § 1.925(a)–1T(f) *Examples 1* and *6* for illustrations of the computation of a FSC's foreign trade income, exempt foreign trade income and taxable income.

(b) *Exempt foreign trade income*—(1) *Determination.* (i) If a FSC uses either of the two administrative pricing rules, provided for by sections 925(a)(1) and (2), to determine its income from a transaction, or group of transactions, to which section 925 applies (see § 1.925(a)–1T(b)(2) (ii) and (iii)), 15/23 of the foreign trade income that it earns from the transaction, or group of transactions, will be exempt foreign trade income. If a FSC has a non-corporate shareholder (shareholders), 16/23 of its foreign trade income attributable to the noncorporate shareholder's (shareholders') proportionate interest in the FSC will be exempt foreign trade income. See section 291(a)(4).

(ii) If a FSC does not use the administrative pricing rules to determine its income from a transaction, or group of transactions, which gives rise to foreign trade income, 30 percent of its foreign trade income will be exempt foreign trade income. If a FSC has a noncorporate shareholder (shareholders), 32 percent of its foreign trade income attributable to the non-corporate shareholder's (shareholders') proportionate interest in the FSC will be exempt foreign trade income. See section 291(a)(4).

(iii) Exempt foreign trade income so determined under subdivisions (1)(i) and (ii) of this paragraph is treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States. See section 921(a).

(2) *Special rule for foreign trade income allocable to a qualified cooperative.* (i) Pursuant to section 923(a)(4), if a qualified cooperative is a shareholder of a FSC, the FSC's non-exempt foreign trade income determined by use of either of the administrative pricing methods of section 925(a)(1) or (2) which is allocable to the marketing of agricultural or horticultural products, or the providing of related services, for any taxable year will be treated as exempt foreign trade income to the extent that it is distributed to the qualified cooperative shareholder. A qualified cooperative is defined as any organization to which chapter 1, subchapter T, part 1 of the Code applies. See section 1381(a).

(ii) This special rule of section 923(a)(4) shall apply only if the distribution is made before the due date under section 6072(b), including extensions, for filing the FSC's income tax return for that year. Any distribution which satisfies this requirement will be treated as made on the last day of the

FSC's taxable year. In addition, this special rule shall apply only if the income of the cooperative is based on arm's length transactions between the cooperative and its members or patrons.

(iii) Income attributable to the marketing of agricultural or horticultural products, or the providing of related services, shall be allocated to the FSC shareholders on a per share basis. See §1.926(a)–1T(b) for ordering rules for distributions from a FSC.

(3) *Special rule for military property.* (i) Under section 923(a)(5), the exempt foreign trade income of a FSC relating to the disposition of, or services relating to, military property shall be equal to 50 percent of the amount which, but for section 923(a)(5), would be treated as exempt foreign trade income under section 923(a)(2) or (3). The foreign trade income no longer treated as exempt because of this special rule of section 923(a)(5) will remain income of the FSC and will be treated as non-exempt foreign trade income.

(ii) The term ''military property'' is defined in section 995(b)(3)(B) and includes any property which is an arm, ammunition, or implement of war designated in the munitions list published pursuant to section 38 of the International Security Assistance and Arms Export Control Act of 1976 (22 U.S.C. 2778) (which repealed and replaced the Military Security Act of 1954).

[T.D. 8126, 52 FR 6438, Mar. 3, 1987]

§1.924(a)–1T Temporary regulations; definition of foreign trading gross receipts.

(a) *In general.* The term ''foreign trading gross receipts'' means any of the five amounts described in paragraphs (b) through (f) of this section, except to the extent that any of the five amounts is an excluded receipt within the meaning of paragraph (g) of this section. These amounts will not be foreign trading gross receipts if the FSC is not managed outside the United States, pursuant to section 924(c), or if the economic processes with regard to a transaction, or group of transactions, that are required of a FSC by section 924(d) do not take place outside the United States. The requirement that these activities take place outside the United States does not apply to a small FSC. The activities required by sections 924 (c) and (d) may be performed either by the FSC or by any person (whether or not related to the FSC) acting under contract with the FSC for the performance of the required activities. Sections 1.924(c)–1 and 1.924(d)–1 provide rules to determine whether these requirements have been met. For purposes of this section—

(1) *FSC.* All references to a FSC in this section mean a FSC, except when the context indicates that such term means a corporation in the process of meeting the conditions necessary for that corporation to become a FSC. All references to a FSC in this section shall include a small FSC unless indicated otherwise.

(2) *Sale and lease.* The term ''sale'' includes an exchange or other disposition and the term ''lease'' includes a rental or a sublease. The term ''license'' includes a sublicense. All rules under this section applicable to leases of export property apply in the same manner to licenses of export property. See §1.927(a)–1T(f)(3) for a description of intangible property which cannot be export property.

(3) *Gross receipts.* The term ''gross receipts'' is defined by section 927(b) and §1.927(b)–1T.

(4) *Export property.* The term ''export property'' is defined by section 927(a) and §1.927(a)–1T.

(5) *Controlled group.* The term ''controlled group'' is defined by paragraph (h) of this section.

(6) *Related supplier and related party.* The terms related supplier and related party are defined by §1.927(d)–2T.

(b) *Sales of export property.* Foreign trading gross receipts of a FSC include gross receipts from the sale of export property by the FSC, or by any principal for whom the FSC acts as a commission agent (whether or not the principal is a related supplier), pursuant to the terms of a contract entered into with a purchaser by the FSC or by the principal at any time or by any other person and assigned to the FSC or the principal at any time prior to the shipment of the property to the purchaser. Any agreement, oral or written, which constitutes a contract at law, satisfies the contractual requirements of this paragraph. Gross receipts from the sale of export property, whenever received, do not constitute foreign trading gross receipts unless the seller (or the corporation acting as commission agent for the seller) is a FSC at the time of the shipment of the property to the purchaser. For example, if a corporation which sells export property under the installment method is not a FSC for the taxable year in which the property is shipped to the purchaser, gross receipts from the sale do not constitute foreign trading gross receipts for any taxable year of the corporation.

(c) *Leases of export property*—(1) *In general.* Foreign trading gross receipts of a FSC include gross receipts from the lease of export property provided that—

(i) The property is held by the FSC (or by a principal for whom the FSC acts as commission agent with respect to the lease) either as an owner or lessee at the beginning of the term of the lease, and

(ii) The FSC qualified (or was treated) as a FSC for its taxable year in which the term of the lease began.

(2) *Prepayment of lease receipts.* If the gross receipts from a lease of export property are prepaid, then—

(i) All the prepaid gross receipts are foreign trading gross receipts of a FSC if it is reasonably expected at the time of the prepayment that, throughout the term of the lease, the lease will meet the requirements of this paragraph and the property will be export property; or

(ii) If it is reasonably expected at the time of the prepayment that the prepaid receipts would not be foreign trading gross receipts throughout the term of the lease if those receipts were not received as a prepayment, then only those prepaid receipts, for the taxable years of the FSC for which they would be foreign trading gross receipts, are foreign trading gross receipts. Thus, for example, if a lessee makes a prepayment of the first and last years' rent, and it is reasonably expected that the leased property will be export property for the first half of the lease period but not the second half of such period, the amount of the prepayment which represents the first year's rent will be considered foreign trading gross receipts if it would otherwise qualify, whereas the amount of the prepayment which represents the last year's rent will not be considered foreign trading gross receipts.

(d) *Related and subsidiary services*—(1) *In general.* Foreign trading gross receipts of a FSC include gross receipts from services furnished by the FSC which are related and subsidiary to any sale or lease (as described in paragraph (b) or (c) of this section) of export property by the FSC or with respect to which the FSC acts as a commission agent, provided that the FSC derives foreign trading gross receipts from the sale or lease. The services may be performed within or without the United States.

(2) *Services furnished by the FSC.* Services are considered to be furnished by a FSC for purposes of this paragraph if the services are provided by—

(i) The person who sold or leased the export property to which the services are related and subsidiary, provided that the FSC acts as a commission agent with respect to the sale or lease of the property and with respect to the services,

(ii) The FSC as principal, or any other person pursuant to a contract with the FSC, provided the FSC acted as principal or commission agent with respect to the sale or lease of the property, or

(iii) A member of the same controlled group as the FSC if the sale or lease of the export property is made by another member of the controlled group provided, however, that the FSC acts as principal or commission agent with respect to the sale or lease and as commission agent with respect to the services.

(3) *Related services.* Services which may be related to a sale or lease of export property include but are not limited to warranty service, maintenance service, repair service, and installation service. Transportation (including insurance related to such transportation) will be related to a sale or lease of export property, if the cost of the transportation is included in the sale price or rental of the property or, if the cost is separately stated, is paid by the FSC (or its principal) which sold or leased the property to the person furnishing

the transportation service. Financing or the obtaining of financing for a sale or lease is not a related service for purposes of this paragraph. A service is related to a sale or lease of export property if—

(i) The service is of the type customarily and usually furnished with the type of transaction in the trade or business in which the sale or lease arose, and

(ii) The contract to furnish the service—

(A) Is expressly provided for in or is provided for by implied warranty under the contract of sale or lease,

(B) Is entered into on or before the date which is 2 years after the date on which the contract under which the sale or lease was entered into, provided that the person described in paragraph (d)(2) of this section which is to furnish the service delivers to the purchaser or lessor a written offer or option to furnish the services on or before the date on which the first shipment of goods with respect to which the service is to be performed is delivered, or

(C) Is a renewal of the services contract described in subdivisions (ii)(A) and (B) of this paragraph.

(4) *Subsidiary services*—(i) *In general.* Services related to a sale or lease of export property are subsidiary to the sale or lease only if it is reasonably expected at the time of the sale or lease that the gross receipts from all related services furnished by the FSC (as defined in this paragraph (d)(2)) will not exceed 50 percent of the sum of the gross receipts from the sale or lease and the gross receipts from related services furnished by the FSC (as described in this paragraph (d)(2)). In the case of a sale, reasonable expectations at the time of the sale are based on the gross receipts from all related services which may reasonably be performed at any time before the end of the 10-year period following the date of the sale. In the case of a lease, reasonable expectations at the time of the lease are based on the gross receipts from all related services which may reasonably be performed at any time before the end of the term of the lease (determined without regard to renewal options).

(ii) *Allocation of gross receipts from services.* In determining whether the services related to a sale or lease of export property are subsidiary to the sale or lease, the gross receipts to be treated as derived from the furnishing of services may not be less than the amount of gross receipts reasonably allocated to the services as determined under the facts and circumstances of each case without regard to whether—

(A) The services are furnished under a separate contract or under the same contract pursuant to which the sale or lease occurs, or

(B) The cost of the services is specified in the contract of sale or lease.

(iii) *Transactions involving more than one item of export property.* If more than one item of export property is sold or leased in a single transaction pursuant to one contract, the total gross receipts from the transaction and the total gross receipts from all services related to the transaction are each taken into account in determining whether the services are subsidiary to the transaction. However, the provisions of this subdivision apply only if the items could be included in the same product line, as determined under §1.925(a)–1T(c)(8).

(iv) *Renewed service contracts.* If under the terms of a contract for related services, the contract is renewable within 10 years after a sale of export property, or during the term of a lease of export property, related services to be performed under the renewed contract are subsidiary to the sale or lease if it is reasonably expected at the time of the renewal that the gross receipts from all related services which have been and which are to be furnished by the FSC (as described in paragraph (d)(2) of this section) will not exceed 50 percent of the sum of the gross receipts from the sale or lease and the gross receipts from related services furnished by the FSC (as so described). Reasonable expectations are determined as provided in subdivision (i) of this paragraph.

(v) *Parts used in services.* If a services contract described in paragraph (d)(3) of this section provides for the furnishing of parts in connection with the furnishing of related services, gross receipts from the furnishing of the parts are not taken into account in determining whether under this paragraph (d)(4) the services are subsidiary. See paragraph (b) or (c) of this section to determine whether the gross receipts from the furnishing of parts constitute foreign trading gross receipts. See § 1.927(a)–1T (c)(2) and (e)(3) for rules regarding the treatment of the parts with respect to the manufacture of export property and the foreign content of the property, respectively.

(5) *Relation to leases.* If the gross receipts for services which are related and subsidiary to a lease of property have been prepaid at any time for all the services which are to be performed before the end of the term of the lease, then the rules in paragraph (c)(2) of this section (relating to prepayment of lease receipts) will determine whether prepaid services under this paragraph (d)(5) are foreign trading gross receipts. Thus, for example, if it is reasonably expected that leased property will be export property for the first year of the term of the lease but will not be export property for the second year of the term, prepaid gross receipts for related and subsidiary services to be furnished in the first year may be foreign trading gross receipts. However, any prepaid gross receipts for the services to be furnished in the second year cannot be foreign trading gross receipts.

(6) *Relation with export property determination.* The determination as to whether gross receipts from the sale or lease of export property constitute foreign trading gross receipts does not depend upon whether services connected with the sale or lease are related and subsidiary to the sale or lease. Thus, for example, assume that a FSC receives gross receipts of $1,000 from the sale of export property and gross receipts of $1,100 from installation and maintenance services which are to be furnished by the FSC within 10 years after the sale and which are related to the sale. The $1,100 which the FSC receives for the services would not be foreign trading gross receipts since the gross receipts from the services exceed 50 percent of the sum of the gross receipts from the sale and the gross receipts from the related services furnished by the FSC. The $1,000 which the FSC receives from the sale of export property would, however, be foreign trading gross receipts if the sale met the requirements of paragraph (b) of this section.

(e) *Engineering and architectural services*—(1) *In general.* Foreign trading gross receipts of a FSC include gross receipts from engineering services (as described in paragraph (e)(5) of this section) or architectural services (as described in paragraph (e)(6) of this section) furnished by such FSC (as described in paragraph (e)(7) of this section) for a construction project (as defined in paragraph (e)(8) of this section) located, or proposed for location, outside the United States. Such services may be performed within or without the United States.

(2) *Services included.* Engineering and architectural services include feasibility studies for a proposed construction project whether or not such project is ultimately initiated.

(3) *Excluded services.* Engineering and architectural services do not include—

(i) Services connected with the exploration for oil or gas, or

(ii) Technical assistance or know-how. For purposes of this paragraph, the term ‘‘technical assistance or know-how’’ includes activities or programs designed to enable business, commerce, industrial establishments, and governmental organizations to acquire or use scientific, architectural, or engineering information.

(4) *Other services.* Receipts from the performance of construction activities other than engineering and architectural services constitute foreign trading gross receipts to the extent that the activities are related and subsidiary services (within the meaning of paragraph (d) of this section) with respect to a sale or lease of export property.

(5) *Engineering services.* For purposes of this paragraph, engineering services in connection with any construction project (within the meaning of paragraph (e)(8) of this section) include any professional services requiring engineering education, training, and experience and the application of special knowledge of the mathematical, physical, or engineering sciences to those professional services as consultation, investigation, evaluation, planning, design, or responsible supervision of construction for the purpose of assuring

compliance with plans, specifications, and design.

(6) *Architectural services.* For purposes of this paragraph, architectural services include the offering or furnishing of any professional services such as consultation, planning, aesthetic and structural design, drawings and specifications, or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project (within the meaning of paragraph (e)(8) of this section).

(7) *Definition of ''furnished by the FSC''.* For purposes of this paragraph, the term ''furnished by the FSC'' means architectural and engineering services furnished:

(i) By the FSC,

(ii) By another person (whether or not that person is a United States person) pursuant to a contract entered into with the FSC at any time prior to the furnishing of the services, provided that the FSC acts as principal, or

(iii) By another person (whether or not that person is a United States person) pursuant to a contract for the furnishing of the services entered into by, or assigned to, the person at any time, provided that the FSC acts as a commission agent for the furnishing of the services.

(8) *Definition of ''construction project''.* For purposes of this paragraph, the term ''construction project'' includes the erection, expansion, or repair (but not including minor remodeling or minor repairs) of new or existing buildings or other physical facilities including, for example, roads, dams, canals, bridges, tunnels, railroad tracks, and pipelines. The term also includes site grading and improvement and installation of equipment necessary for the construction. Gross receipts from the sale or lease of construction equipment are not foreign trading gross receipts unless the equipment is export property.

(f) *Managerial services*—(1) *In general.* Foreign trading gross receipts of a first FSC for its taxable year include gross receipts from the furnishing of managerial services provided for an unrelated FSC or unrelated interest charge DISC to aid the unrelated FSC or unrelated interest charge DISC in deriving foreign trading gross receipts or qualified export receipts, as the case may be, provided that at least 50 percent of the first FSC's gross receipts for such year consists of foreign trading gross receipts derived from the sale or lease of export property and the furnishing of related and subsidiary services. For purposes of this paragraph, managerial services are considered furnished by a FSC if the services are provided—

(i) By the first FSC,

(ii) By another person (whether or not a United States person) pursuant to a contract entered into by that person with the first FSC at any time prior to the furnishing of the services, provided that the first FSC acts as principal with respect to the furnishing of the services, or

(iii) By another person (whether or not a United States person) pursuant to a contract for the furnishing of services entered into at any time prior to the furnishing of the services provided that the first FSC acts as commission agent with respect to those services.

(2) *Definition of ''managerial services''.* The term ''managerial services'' as used in this paragraph means activities relating to the operation of an unrelated FSC or an unrelated interest charge DISC which derives foreign trading gross receipts or qualified export receipts as the case may be from the sale or lease of export property and from the furnishing of services related and subsidiary to those sales or leases. The term includes staffing and operational services necessary to operate the unrelated FSC or unrelated interest charge DISC, but does not include legal, accounting, scientific, or technical services. Examples of managerial services are: conducting export market studies, making shipping arrangements, and contacting potential foreign purchasers.

(3) *Status of recipient of managerial services.* Foreign trading gross receipts of a first FSC include receipts from the furnishing of managerial services during any taxable year of a recipient of such services if the recipient qualifies as a FSC or interest charge DISC for the taxable year. For purposes of this paragraph, a recipient is deemed to qualify as a FSC or interest charge

DISC for its taxable year if the first FSC obtains from the recipient a copy of the recipient's election to be treated as a FSC or interest charge DISC together with the recipient's sworn statement that an election has been timely filed with the Internal Revenue Service Center. The recipient may mark out the names of its shareholders on a copy of its election to be treated as a FSC or interest charge DISC before submitting it to the first FSC. The copy of the election and the sworn statement of the recipient must be received by the first FSC within six months after the first FSC furnishes managerial services for the recipient. The copy of the election and the sworn statement of the recipient need not be obtained by the first FSC for subsequent taxable years of the recipient. A recipient of managerial services is not treated as a FSC or interest charge DISC with respect to the services performed during a taxable year for which the recipient does not qualify as a FSC or interest charge DISC if the first FSC performing such services does not believe or if a reasonable person would not believe (taking into account the furnishing FSC's managerial relationship with such recipient FSC or interest charge DISC) at the beginning of such taxable year that the recipient will qualify as a FSC or an interest charge DISC for such taxable year.

(g) *Excluded receipts*—(1) *In general.* Notwithstanding the provisions of paragraphs (b) through (f) of this section, foreign trading gross receipts of a FSC do not include any of the six amounts described in paragraphs (g)(2) through (7) of this section.

(2) *Sales and leases of property for ultimate use in the United States.* Property which is sold or leased for ultimate use in the United States does not constitute export property. See § 1.927(a)–1T(d)(4) relating to determination of where the ultimate use of the property occurs. Thus, foreign trading gross receipts of a FSC described in paragraph (b) or (c) of this section do not include gross receipts of the FSC from the sale or lease of this property.

(3) *Sales or leases of export property and furnishing of services accomplished by subsidy.* Foreign trading gross receipts of a FSC do not include gross receipts described in paragraphs (b) through (f) of this section if the sale or lease of export property or the furnishing of services is accomplished by a subsidy granted by the United States or any instrumentality thereof, see section 924(f)(1)(B). Subsidies covered by section 924(f)(1)(B) are listed in subdivisions (i) through (vi) of this paragraph.

(i) The development loan program, or grants under the technical cooperation and development grants program of the Agency for International Development, or grants under the military assistance program administered by the Department of Defense, pursuant to the Foreign Assistance Act of 1961, as amended (22 U.S.C. 2151) unless the FSC shows to the satisfaction of the Commissioner that, under the conditions existing at the time of the sale (or at the time of lease or at the time the services were rendered), the purchaser (or lessor or recipient of the services) had a reasonable opportunity to purchase (or lease or contract for services) on competitive terms and from a seller (or lessor or performer of services) who was not a U.S. person, goods (or services) which were substantially identical to such property (or services) and which were not manufactured, produced, grown, or extracted in the United States (or performed by a U.S. person);

(ii) The Public Law 480 program authorized under Title I of the Agricultural Trade Development and Assistance Act of 1954, as amended (7 U.S.C. 1691, 1701–1714);

(iii) The Export Payment program of the Commodity Credit Corporation authorized by sections 5 (d) and (f) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714c (d) and (f));

(iv) The section 32 export payment programs authorized by section 32 of the Act of August 24, 1935, as amended (7 U.S.C. 612c);

(v) The Export Sales program of Commodity Credit Corporation authorized by sections 5 (d) and (f) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714c (d) and (f)), other than the GSM–4 program provided under 7 CFR part 1488, and section 407 of the Agricultural Act of 1949, as amended (7 U.S.C. 1427), for the purpose of disposing of surplus agricultural commodities and exporting or causing to be exported agricultural commodities; and

(vi) The Foreign Military Sales direct credit program (22 U.S.C. 2763) or the Foreign Military Sales loan guaranty program (22 U.S.C. 2764) if—

(A) The borrowing country is released from its contractual liability to repay the United States government with respect to those credits or guaranteed loans;

(B) The repayment period exceeds twelve years; or

(C) The interest rate charged is less than the market rate of interest as defined in 22 U.S.C. 2763(c)(2)(B);

unless the FSC shows to the satisfaction of the Commissioner that, under the conditions existing at the time of the sale, the purchaser had a reasonable opportunity to purchase, on competitive terms from a seller who was not a U.S. person, goods which were substantially identical to this property and which were not manufactured, produced, grown, or extracted in the United States. Information regarding whether an export is financed, in whole or in part, with funds derived from the programs identified in this subdivision may be obtained from the Comptroller, Defense Security Assistance Agency, Department of Defense, Washington, DC 20301.

(4) *Sales or leases of export property and furnishing of architectural or engineering services for use by the United States*—(i) *In general.* Foreign trading gross receipts of a FSC do not include gross receipts described in paragraph (b), (c), or (e) of this section if a sale or lease of export property, or the furnishing of architectural or engineering services, is for use by the United States or an instrumentality thereof in any case in which any law or regulation requires in any manner the purchase or lease of property manufactured, produced, grown, or extracted in the United States or requires the use of architectural or engineering services performed by a United States person. See section 924(f)(1)(A)(ii). For example, a sale by a FSC of export property to the Department of Defense for use outside the United States would not produce foreign trading gross receipts for the FSC if the Department of Defense purchased the property from appropriated funds subject to either any provision of the Department of Defense Federal Acquisition Regulations Supplement (48 CFR chapter 2) or any appropriations act for the Department of Defense for the applicable year if the regulations or appropriations act requires that the items purchased must have been grown, reprocessed, reused, or produced in the United States. The Department of Defense's regulations do not require that items purchased by the Department for resale in post or base exchanges and commissary stores located on United States military installations in foreign countries be items grown, reprocessed, reused or produced in the United States. Therefore, receipts arising from the sale by a FSC to those post or base exchanges and commissary stores will not be excluded from the definition of foreign trading gross receipts by this paragraph (g)(4).

(ii) *Direct or indirect sales or leases.* Any sale or lease of export property is for use by the United States or an instrumentality thereof if such property is sold or leased by a FSC (or by a principal for whom the FSC acts as commission agent) to—

(A) A person who is a related person with respect to the FSC or such principal and who sells or leases the property for use by the United States or an instrumentality thereof, or

(B) A person who is not a related person with respect to the FSC or such principal if, at the time of the sale or lease, there is an agreement or understanding that the property will be sold or leased for use by the United States or an instrumentality thereof (or if a reasonable person would have known at the time of the sale or lease that the property would be sold or leased for use by the United States or an instrumentality thereof) within 3 years after the sale or lease.

(iii) *Excluded programs.* The provisions of subdivisions (4)(i) and (ii) of this paragraph do not apply in the case of a purchase by the United States or an instrumentality thereof if the purchase is pursuant to—

(A) The Foreign Military Sales Act, as amended (22 U.S.C. 2751 *et seq.*), or a program under which the United States government purchases property for resale, on commercial terms, to a foreign government or agency or instrumentality thereof, or

(B) A program (whether bilateral or multilateral) under which sales to the United States government are open to international competitive bidding.

(5) *Services.* Foreign trading gross receipts of a FSC do not include gross receipts described in paragraph (d) of this section (concerning related and subsidiary services) if the services from which such gross receipts are derived are related and subsidiary to the sale or lease of property which results in excluded receipts under this paragraph.

(6) *Receipts within controlled group.* (i) For purposes of the transfer pricing methods of section 925(a), gross receipts of a corporation do not constitute foreign trading gross receipts for any taxable year of the corporation if at the time of the sale, lease, or other transaction resulting in the gross receipts, the corporation and the person from whom the gross receipts are directly or indirectly derived (whether or not such corporation and such person are the same person) are members of the same controlled group, and either

(A) The corporation and the person each qualifies as a FSC (or if related FSCs are commission agents of each party to the transaction) for its taxable year in which its receipts arise, or

(B) With regard to sale transactions, a sale of export property to a FSC (or to a related person if the FSC is the commission agent of the related person) by a non-FSC within the same controlled group follows any sale of the export property to a FSC (or to a related person if the FSC is the commission agent of the related person) within the same controlled group if foreign trading gross receipts resulted from the sale. Thus for example, assume that R, S, X, and Y are members of the same controlled group and that X and Y are FSCs. If R sells property to S and pays X a commission relating to that sale and if S sells the same property to an unrelated foreign party and pays Y a commission relating to that sale, the receipts received by X from the sale of such property by R to S will be considered to be derived from Y, a FSC which is a member of the same controlled group as X, and thus will not result in foreign trading gross receipts to X. The receipts received by Y from the sale to an unrelated foreign party may, however, result in foreign trading gross receipts to Y. For another example, if R and S both assign the commissions to X, receipts derived from the sale from R to S will be considered to be derived from X acting as commission agent for S and will not result in foreign trading gross receipts to X. Receipts derived by X from the sale of property by S to an unrelated foreign party may, however, constitute foreign trading gross receipts.

(ii) Section 1.927(a)–1T(f)(2) provides rules regarding property not constituting export property in certain cases where such property is leased to any corporation which is a member of the same controlled group as the lessor.

(7) *Factoring of receivables by a related supplier.* If an account receivable arising with respect to export property is transferred to any person for an amount reflecting a discount from the selling price of the export property, then the gross receipts from the sale which are treated as foreign trading gross receipts for purposes of computing a FSC's profit under the administrative pricing methods of section 925(a)(1) and (2) shall be reduced by the amount of the discount. See § 1.925(a)–1T(f) *Example 11* for illustration of how this special rule affects computation of combined taxable income of a FSC and its related supplier.

(h) *Definition of ''controlled group''.* For purposes of sections 921 through 927 and the regulations under those sections, the term ''controlled group'' has the same meaning as is assigned to the term ''controlled group of corporations'' by section 1563(a), except that (1) the phrase ''more than 50 percent'' is substituted for the phrase ''at least 80 percent'' each place the latter phrase appears in section 1563(a), and (2) section 1563(b) shall not apply. Thus, for example, a foreign corporation subject to tax under section 882 may be a member of a controlled group. Furthermore, two or more corporations (including a foreign corporation) are members of a controlled group at any time such corporations meet the requirements of section 1563(a) (as modified by this paragraph).

(i) *FSC's entitlement to income*—(1) *Application of administrative pricing rules of section 925(a).* A corporation which meets the requirements of section 922(a) (or section 922(b) if the corporation elects small FSC status) and §1.921–2(a) (Q&A1) to be treated as a FSC (or small FSC) for a taxable year is entitled to income, and the administrative pricing rules of section 925(a)(1) or (2) apply, in the case of any transaction described in §1.925(a)–1T(b)(iii) between the FSC and its related supplier (as defined in §1.927(d)–2T(a)) as long as the FSC, or someone under contract to it, satisfies the requirements of section 925(c). The requirements of section 925(c) must be met by a commission FSC as well as by a buy-sell FSC. See §1.925 (a)–1T(a)(3)(i) and (b)(2)(ii).

(2) *Other transactions.* In the case of a transaction to which the provisions of paragraph (i)(1) of this section do not apply but from which a FSC derives gross receipts, the income to which the FSC is entitled as a result of the transaction is determined pursuant to the terms of the contract for the transaction and, if applicable, section 482 and the regulations under that section. For applicability of the section 482 transfer pricing method, see §1.925(a)–1T (a)(3)(ii) and (b)(2)(i).

(j) *Small FSC limitation*—(1) *In general.* Under section 924(b)(2)(B), in determining exempt foreign trade income of a small FSC, the foreign trading gross receipts of the small FSC for the taxable year which exceed $5 million are not taken into account. The foreign trading gross receipts of the small FSC not taken into account for purposes of computing the small FSC's exempt foreign trade income shall be taken into account in computing the small FSC's non-exempt foreign trade income. If the foreign trading gross receipts of the small FSC exceed the $5 million limitation, the small FSC may select the gross receipts to which the limitation is allocated. See section 922(b) and §1.921–2(b) (Q&A3) for a definition of a small FSC.

(2) *Members of a controlled group limited to one $5 million amount*—(i) *General rule.* All small FSCs which are members of a controlled group on a December 31, shall, for their taxable years which include that December 31, be limited to one $5 million amount. The $5 million amount shall be allocated equally among the member small FSCs of the controlled group for their taxable years including that December 31, unless all of the member small FSCs consent to an apportionment plan providing for an unequal allocation of the $5 million amount. The apportionment plan shall provide for the apportionment of a fixed dollar amount to one or more of the corporations, and the sum of the amounts so apportioned shall not exceed the $5 million amount. If the taxable year including the December 31 of any member small FSC is a short period (as defined in section 443), the portion of the $5 million amount allocated to that member small FSC for that short period under the preceding sentence shall be reduced to the amount which bears the same ratio to the amount so allocated as the number of days in such short period bears to 365. The consent of each member small FSC to the apportionment plan for the taxable year shall be signified by a statement which satisfies the requirements of and is filed in the manner specified in §1.1561–3(b). An apportionment plan may be amended in the manner prescribed in §1.1561–3(c), except that an original or an amended plan may not be adopted with respect to a particular December 31 if at the time the original or amended plan is sought to be adopted, less than 12 full months remain in the statutory period (including extensions) for the assessment of a deficiency against any shareholder of a member small FSC the tax liability of which would change by the adoption of the original or amended plan. If less than 12 full months of the period remain with respect to any such shareholder, the director of the service center with which the shareholder files its income tax return will, upon request, enter into an agreement extending the statutory period for the limited purpose of assessing any deficiency against that shareholder attributable to the adoption of the original or amended apportionment plan.

(ii) *Membership determined under section 1563(b).* For purposes of this paragraph (j)(2), the determination of whether a small FSC is a member of a controlled group of corporations with respect to any taxable year shall be made in the manner prescribed in section 1563(b) and the regulations under that section.

(iii) *Certain short taxable years*—(A) *General rule.* If a small FSC has a short period (as defined in section 443) which does not include a December 31, and that small FSC is a member of a controlled group of corporations which includes one or more other small FSC's with respect to the short period, then the amount described in section 924(b)(2)(B) with respect to the short period of that small FSC shall be determined by—

(*1*) Dividing $5 million by the number of small FSCs which are members of that group on the last day of the short period, and

(*2*) Multiplying the result by a fraction, the numerator of which is the number of days in the short period and the denominator of which is 365.

For purposes of the preceding sentence, section 1563(b) shall be applied as if the last day of the short period were substituted for December 31. Except as provided in subdivision (2)(iii)(B) of this paragraph, the small FSC having a short period not including a December 31 may not enter into an apportionment plan with respect to the short period.

(B) *Exception.* If the short period not including a December 31 of two or more small FSCs begins on the same date and ends on the same date and those small FSCs are members of the same controlled group, those small FSCs may enter into an apportionment plan for such short period in the manner provided in subdivision (2)(i) of this paragraph with respect to the combined amount allowed to each of those small FSCs under subdivision (2)(iii)(A) of this paragraph.

[T.D. 8126, 52 FR 6438, Mar. 3, 1987]

§ 1.924(c)–1 Requirement that a FSC be managed outside the United States.

(a) *In general.* Section 924(b)(1)(A) provides that a FSC shall be treated as having foreign trading gross receipts for the taxable year only if the management of the FSC during the year takes place outside the United States, as provided in section 924(c). Section 924(c) and this section set forth the management activities that must take place outside the United States in order to satisfy the requirement of section 924(b)(1)(A). Paragraph (b) of this section provides rules for determining whether the requirements of section 924(c)(1) have been met. Section 924(c)(1) requires that all meetings of the board of directors of the FSC during the taxable year and all meetings of the shareholders of the FSC during the taxable year take place outside the United States. Paragraph (c) of this section provides rules for maintaining the FSC's principal bank account outside the United States as provided in section 924(c)(2). Paragraph (d) of this section provides rules for disbursements required by section 924(c)(3) to be made from bank accounts of the FSC maintained outside the United States.

(b) *Meetings of board of directors and meetings of shareholders must be outside the United States.* All meetings of the board of directors of the FSC and all meetings of the shareholders of the FSC that take place during a taxable year must take place outside the United States to meet the requirements of section 924(c)(1). Only meetings that are formally convened as meetings of the board of directors or as shareholder meetings will be taken into account in determining whether those requirements have been met. In addition, all such meetings must comply with the local laws of the foreign country or possession of the United States in which the FSC was created or organized. The local laws determine whether a meeting must be held, when and where it must be held (if it is held at all), who must be present, quorum requirements, use of proxies, and so on. Where the local law permits action by the board of directors or shareholders to be taken by written consent without a meeting, use of such procedure will not constitute a meeting for purposes of section 924(c)(1). Section 924(c)(1) and this section impose no other requirements except the requirement that meetings that are actually held take place outside the United States. If the participants in a meeting are not all physically present in the same location, the location of the meeting is determined by the location of the persons exercising a majority of the voting power (including proxies) participating in the meeting. For example, a FSC has five directors, and is organized in country A. Country A's law requires that a majority of the directors of a corporation must participate in a meeting to constitute a quorum (and, thus, a meeting), but there is no requirement that the meeting be held in country A or that the directors must be physically present to participate. One director is in country A, another director is in country B, and a third director is in the United States.

These three directors convene a meeting by telephone that constitutes a meeting under the law of country A. The meeting occurs outside the United States because the persons exercising a majority of the voting power participating in the meeting are located outside the United States.

(c) *Maintenance of the principal bank account outside the United States*—(1) *In general.* For purposes of section 924(c), the bank account that shall be regarded as the principal bank account of a FSC is the bank account from which the disbursements described in paragraph (d) of this section are made. A FSC may have more than one principal bank account. The bank account that is regarded as the principal bank account must be maintained in a foreign country which meets the requirements of section 927(e)(3), or in any possession of the United States (as defined in section 927(d)(5)), and it must be so maintained at all times during the taxable year. For taxable years beginning on or after February 19, 1987, a principal bank account or accounts must be designated on the annual return of the FSC by providing the bank name(s) and account number(s).

(2) *Maintenance of the account in a bank.* The bank account that is regarded as the principal bank account must be maintained in an institution that is engaged in the conduct of a banking, financing, or similar business, as defined in §1.954–2(d)(2)(ii) (without regard to whether it is a controlled foreign corporation). The institution may be a U.S. bank, provided that the account is maintained in a branch outside the United States.

(3) *Maintenance of an account outside the United States.* Maintenance of the principal bank account outside the United States means that the account regarded as the principal bank account must be an account maintained on the books of the banking institution at an office outside the United States, but does not require that access to the account may be made only outside the United States. Instructions providing for deposits into or disbursements from the account may originate in the United States without affecting the status of maintenance of the account outside the United States.

(4) *Maintenance of the account at all times during the taxable year.* The term ''at all times during the taxable year'' generally means for each day of the taxable year. In the case of a newly created or organized corporation, thirty days may elapse between the effective date of the corporation's election to be treated as a FSC and the date a bank account is opened without causing the FSC to fail the requirement that it maintain its principal bank account outside the United States at all times during the taxable year. For example, if a corporation is created or organized prior to January 1, 1985, and makes an election to be treated as a FSC within the first 90 days of 1985, the election is effective as of January 1, 1985. Thus, the FSC must open a bank account within 30 days of January 1, or as of January 31, 1985, to satisfy this requirement. Also, a FSC shall be treated as satisfying this requirement if the account that is regarded as its principal bank account is terminated during the taxable year, provided that (i) such termination is the result of circumstances beyond the FSC's control, and (ii) the FSC establishes a new principal bank account within thirty days after such termination. A FSC may close its principal bank account and replace it with another account that qualifies under this paragraph (c) as a principal bank account at any time provided that no lapse of time occurs between the closing of the principal

bank account and the opening of the replacement account.

(5) *Other accounts.* The FSC may maintain other bank accounts in addition to its principal bank account. Such other accounts may be located anywhere, without limitation. The mere existence of such other accounts will not cause the FSC to fail to satisfy the requirements of section 924(c).

(d) *Disbursement of dividends, legal and accounting fees, and salaries of officers and directors out of the principal bank account of the FSC*—(1) *In general.* All dividends, legal fees, accounting fees, salaries of officers of the FSC, and salaries or fees paid to members of the board of directors of the FSC that are disbursed during the taxable year must be disbursed out of bank account(s) of the FSC maintained outside the United States. Such an account is treated as the principal bank account of the FSC for purposes of section 924(c). Dividends, however, may be netted against amounts owed to the FSC (*e.g.*, commissions) by a related supplier through book entries. If the FSC regularly disburses its legal or accounting fees, salaries of officers, and salaries or fees of directors out of its principal bank account, the occasional, inadvertent payment by mistake of fact or law of such amounts out of another bank account will not be considered a disbursement by the FSC if, upon determination that such payment was made from another account, reimbursement to such other account is made from the principal bank account of the FSC within a reasonable period from the date of the determination. Disbursement out of the principal bank account of the FSC may be made by transferring funds from the principal bank account to a U.S. account of the FSC provided that (i) the payment of the dividends, salaries or fees to the recipients is made within 12 months of the transfer, (ii) the purpose of the expenditures is designated and, (iii) the payment of the dividends, salaries or fees is actually made out of the same U.S. account that received the disbursement from the principal bank account.

(2) *Reimbursement.* Legal or accounting fees, salaries of officers, and salaries or fees of directors that are paid by a related person wholly or partially on behalf of a FSC must be reimbursed by the FSC. The amounts paid by the related person are not considered disbursed by the FSC until the related person is reimbursed by the FSC. The related person must be reimbursed no later than the last date prescribed for filing the FSC's tax return (including extensions) for the taxable year to which the reimbursement relates. Any reimbursement for amounts paid on behalf of the FSC must be disbursed out of the FSC's principal bank account (and not netted against any obligation owed by the related person to the FSC), as set forth in paragraph (c) of this section. To determine the amounts paid on behalf of the FSC, the FSC may rely upon a written statement or invoice furnished to it by the related person which shows the following:

(i) The actual fees charged for performing the legal or accounting services for the FSC or, if such fees cannot be ascertained by the related person, a good faith estimate thereof, and the actual salaries or fees paid for services as officers and directors of the FSC, and

(ii) The person who performed or provided the services.

(3) *Good faith exception.* If, after the FSC has filed its tax return, a determination is made by the Commissioner that all or a part of the legal or accounting fees, salaries of officers, and salaries or fees of directors of the FSC were paid by a related person without receiving reimbursement, the FSC may, nonetheless, satisfy the requirements of section 924(c)(3) if the fees and salaries were paid by the related person in good faith, and the FSC reimburses the related person for the fees and salaries paid within 90 days after the determination. The reimbursement shall be treated as made as of the end of the taxable year of the FSC for which the reimbursement is made.

(4) *Dividends*—(i) *Definition.* For purposes of section 924(c) and this section only, the term ‘‘dividends’’ refers solely to cash dividends (including a dividend paid in a foreign functional currency) actually paid pursuant to a declaration or authorization by the FSC. Accordingly, a ‘‘dividend’’ will not include a constructive dividend that is deemed to be paid (regardless of the source of such constructive dividend)

or a distribution of property that is a dividend under section 316 other than a distribution of U.S. dollars or a foreign functional currency.

(ii) *Offset accounting entries.* Payment of dividends by the FSC to its related supplier may be in the form of an accounting entry offsetting an amount payable to the related supplier for the dividend against an existing debt owed to the FSC. The offset accounting entries must be clearly identified in the books of account of both the related supplier and the FSC.

(5) *Legal and accounting fees.* For purposes of this section, legal and accounting fees do not include salaries paid to legal and accounting employees of the FSC (or a related person). Legal and accounting fees are limited to fees paid to independent persons performing legal or accounting services for or with respect to the FSC.

(6) *Salaries of officers and directors.* For purposes of this section, salaries of officers and salaries or fees of directors are only those salaries or fees paid for services as officers or directors of the FSC. Salaries do not include reimbursed travel and entertainment expenses. If an individual officer, director, or employee of a related person is also an officer or director of a FSC and receives additional compensation for services performed for the FSC, the portion of the compensation paid to the individual which is for services performed for the FSC is required to be disbursed out of the FSC's principal bank account. For purposes of this section, the term ''compensation'' is defined as set forth in paragraphs (d)(1) and (2) of §1.415–2.

[T.D. 8125, 52 FR 5089, Feb. 19, 1987]

§1.924(d)–1 Requirement that economic processes take place outside the United States.

(a) *In general.* Section 924(b)(1)(B) provides that a FSC has foreign trading gross receipts from any transaction only if economic processes with respect to such transaction take place outside the United States as provided in section 924(d). Section 924(d) and this section set forth the rules for determining whether a sufficient amount of the economic processes of a transaction take place outside the United States. Generally, a transaction will qualify if the FSC satisfies two different requirements: Participation outside the United States in the sales portion of the transaction, and satisfaction of either the 50-percent or the 85-percent foreign direct cost test. The activities comprising these economic processes may be performed by the FSC or by any other person acting under contract with the FSC. (All references to ''FSC'' in §§1.924(d)–1 and 1.924(e)–1 shall mean the FSC or, if applicable, the person performing the relevant activity under contract on behalf of the FSC.) The FSC may act upon standing instructions from another person in the performance of any activity, whether a sales activity under paragraph (c) of this section or an activity relating to the disposition of export property under paragraph (d) of this section and §1.924(e)–1. The identity of the FSC as a separate entity is not required to be disclosed in the performance of any of the activities comprising the economic processes. Except as otherwise provided, the location of any activity is determined by the place where the activity is initiated by the FSC, and not by the location of any person transmitting instructions to the FSC.

(b) *Activities performed by another person*—(1) *In general.* Any person, whether domestic or foreign, and whether related or unrelated to the FSC, may perform any activity required to satisfy this section, provided that the activity is performed pursuant to a contract for the performance of that activity on behalf of the FSC. Such a contract may be any oral or written agreement which constitutes a contract at law. The person performing the activity is not required to enter into a contract directly with the FSC and, thus, may be a direct or indirect subcontractor of a person under contract with the FSC. For example, assume that a buy-sell FSC enters into an agreement with its related supplier in which the related supplier agrees to perform on behalf of the FSC all sales activities with respect to the FSC's transactions with its foreign customers. Through its existing agreements with a domestic unrelated person, the related supplier subcontracts the performance of these activities to the domestic unrelated person, who, in turn, subcontracts the performance of the sales activities to foreign sales agents. The sales activities performed by the foreign sales agents are considered to be performed on behalf of the FSC for purposes of meeting the requirements of section 924(d)(1)(A).

(2) *Proof of compliance.* If the FSC does not perform the activity itself, it must maintain records adequate to establish, with respect to each transaction or group of transactions, that the activity was performed and that the performance of such activity took place outside the United States. If the person who performed the activity on behalf of the FSC is an independent contractor, the FSC may rely upon a written declaration from that person stating that the activities were performed by that person on behalf of the FSC, and were performed outside the United States. An invoice or a receipt for payment will be considered to be such a written declaration if it specifies that the activities were performed outside the United States or specifies a particular place outside the United States where the activities were performed. If the person performing the activities on behalf of the FSC is a related person, the FSC must maintain records adequate to establish that the activities were actually performed and where the activities were performed. Such records may be stored with the related person provided that the FSC makes such records available to the Commissioner upon request.

(c) *Participation outside the United States in the sales portion of the transaction*—(1) *In general.* The requirement of section 924(d)(1)(A) is met with respect to the gross receipts of a FSC derived from any transaction if the FSC has participated outside the United States in the solicitation, the negotiation, or the making of the contract relating to such transaction (hereinafter described as ‘‘sales activities’’), as provided in this paragraph (c). A sale need not occur in order that the solicitation or negotiation tests be satisfied. Once the FSC has participated outside the United States in an activity that constitutes the solicitation, negotiation, or the making of the contract with respect to a transaction, any prior or subsequent activity by the FSC with respect to such transaction that would otherwise constitute the sales activity will be disregarded for purposes of determining whether the FSC has met the requirements of section 924(d)(1)(A). For example, if a FSC sells a product to a foreign customer by first meeting with the customer in New York to discuss the product and then by mailing to it from outside the United States a brochure describing the product, the prior meeting is disregarded and only the mailing is considered in determining whether there was solicitation outside the United States by the FSC with respect to the transaction which has occurred.

(2) *Solicitation (other than advertising).* For purposes of this paragraph (c), ‘‘solicitation’’ refers to any communication (by any method, including, but not limited to, telephone, telegraph, mail, or in person) by the FSC, at any time during the 12 month period (measured from the date the communication is mailed or transmitted) immediately preceding the execution of a contract relating to the transaction to a specific, targeted customer or potential customer, that specifically addresses the customer’s attention to the product or service which is the subject of the transaction. For purposes of paragraph (c)(2) of this section, communication by mail means depositing the communication in a mailbox. Except as provided in § 1.924(e)–1(a)(1) with respect to second mailings, activities that would otherwise constitute advertising (such as sending sales literature to a customer or potential customer) will be considered solicitation if the activities are directed at a specific, targeted customer or potential customer, and the costs of the activity are not taken into account as advertising under the foreign direct cost tests. Activities that would otherwise constitute sales promotion (such as a promotional meeting in person with a customer) will be considered to be solicitation if the activities are directed at a specific, targeted customer or potential customer, and the costs of the activity are not taken into account as sales promotion under the foreign direct cost tests. Except as provided in § 1.924(e)–1(a)(1) with respect to second

mailings, the same or similar activities cannot be considered both solicitation and advertising, or both solicitation and sales promotion, with respect to the same customer. Solicitation, however, may take place at the same time as, and in conjunction with, another sales activity. Additionally, it may take place with respect to any person, whether domestic or foreign, and whether or not related to the FSC.

(3) *Negotiation.* For purposes of this paragraph (c), ''negotiation'' refers to any communication by the FSC to a customer or potential customer aimed at an agreement on one or more of the terms of a transaction, including, but not limited to, price, credit terms, quantity, or time or manner of delivery. For purposes of this paragraph (c)(3), communication by mail has the same meaning as provided in paragraph (c)(2) of this section. Negotiation does not include the mere receipt of a communication from a customer (such as an order) that includes terms of a sale. Negotiation may take place at the same time as, and in conjunction with, another sales activity. Additionally, it may take place with respect to any person, whether domestic or foreign, and whether or not related to the FSC.

(4) *Making of a contract.* For purposes of this paragraph (c), ''making of a contract'' refers to performance by the FSC of any of the elements necessary to complete a sale, such as making an offer or accepting an offer. A requirements contract is considered an open offer to be accepted from time to time when the customer submits an order for a specified quantity. Thus, the acceptance of such an order will be considered the making of a contract. The written confirmation by the FSC to the customer of the acceptance of the open order will also be considered the making of a contract. Acceptance of an unsolicited bid or order is considered the ''making of a contract'' even if no solicitation or negotiation occurred with respect to the transaction. The written confirmation by the FSC to the customer of an oral or written agreement which confirms variable contract terms, such as price, credit terms, quantity, or time or manner of delivery, or specifies (directly or by cross-reference) additional contract terms will be considered the making of a contract. A written confirmation is any confirmation expressed in writing, including a telegram, telex, or other similar written communication. The making of a contract may take place at the same time as, and in conjunction with, another sales activity. Additionally, it may take place with respect to any person, whether domestic or foreign, and whether or not related to the FSC.

(5) *Grouping transactions.* Generally, the sales activities under this paragraph (c) are to be applied on a transaction-by-transaction basis. By annual election of the FSC, however, any of the sales activities may be applied on the basis of a group as set forth in this paragraph (c)(5). Any groupings used must be supported by adequate documentation of performance of activities relating to the groupings used. An election by the FSC to group transactions must be made on its annual income tax return. The FSC, however, may amend its tax return to group in a manner different from that elected on its original return before the expiration of the statute of limitations.

(i) *Standards of groups.* A determination by a FSC as to a grouping will be accepted by a district director if such determination conforms to any of the following standards:

(A) *Product or product line groupings.* A product or product line grouping may be based upon either a recognized trade or industry usage, or upon a two digit major group (or on any inferior classification or combination of inferior classifications within a major group) of the Standard lndustrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President. For taxable years beginning on or before February 19, 1987, any sales activity that is performed outside the United States with respect to any transaction covered by the product or product line grouping during the FSC's taxable year shall apply to all transactions covered by the product or product line. However, for taxable years beginning after February 19, 1987, the requirement of section 924(d)(1)(A) is met with respect to all transactions covered by the product or product line grouping only if the sales activities are performed outside the United States with respect to customers with sales representing either:

(i) 20 percent or more of the foreign trading gross receipts of the product or product line grouping during the current year or

(ii) 50 percent or more of the foreign trading gross receipts of the product or product line grouping for the prior year irrespective of whether any sales occurred within the current year to the prior year customers.

If during the prior taxable year, the controlled group of which the FSC is a member had a DISC or interest charge DISC, the FSC may use the 50 percent rule with respect to the preceding DISC or interest charge DISC year, substituting qualified export receipts for foreign trading gross receipts. A corporation which has not been treated in the prior year as a FSC, interest charge DISC, or DISC does not have to meet either the 20 percent test or the 50 percent test for the first year in which it is treated as a FSC.

(B) *Customer groupings.* A customer grouping includes all transactions of the FSC with a particular customer during the FSC's taxable year. Thus, any sales activity that is performed outside the United States with respect to any transaction with the customer during the taxable year shall apply to all transactions within the customer grouping.

(C) *Contract groupings.* A contract grouping includes all transactions of the FSC under a particular contract for a taxable year. Thus, any sales activity that is performed outside the United States with respect to any transaction under the contract will apply to all transactions under the contract for such taxable year. For long-term contracts between unrelated parties, the sales activities tests need be satisfied only once for the life of the contract. With respect to requirements contracts and long-term contracts between related parties, the sales activities test must be satisfied annually.

(D) *Product or product line groupings within customer or contract groupings.* Groupings may be based upon product or product line groupings within customer or contract groupings. If, however, the primary grouping is a customer or contract grouping, the 20 percent test set forth in subdivision (A) of this paragraph relating to product or product line grouping will not be applicable.

(ii) *Transactions included in a grouping.* A choice by a FSC to group transactions shall generally apply to all transactions within the scope of that grouping. The choice of a grouping, however, applies only to transactions covered by the grouping and, for transactions not encompassed by the grouping, the determinations may be made on a transaction-by-transaction basis or other grouping basis. For example, a FSC may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year. In addition, if a FSC applies sales activity rules on the basis of other types of groupings, such as all sales to a particular customer, transactions included in those other groupings shall be excluded from product groupings.

(iii) *Different groupings allowed for different purposes.* A choice by the FSC to group transactions may be made separately for each of the sales activities under section 924(d)(1)(A). Groupings used for purposes of section 924(d)(1)(A) will have no relationship to groupings used for other purposes, such as satisfying the foreign direct cost tests. This paragraph (c)(5) does not apply for purposes of section 925.

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

Example 1. In November, a calendar year FSC mailed from its foreign office its catalog to a potential foreign customer. The catalog displayed numerous products along with a brief description and the price of each. In February of the following year, the FSC sold to the customer a product displayed in the catalog. Since the FSC communicated with the customer during the 12-month period prior to the sale, although during the previous taxable year, the FSC participated outside the United States in the solicitation relating to the transaction.

Example 2. A FSC with a taxable year ending April 30, 1986, solicits customer X during that taxable year with respect to Product A. In the previous taxable year, the FSC sold product A to customers V, W, X, Y, Z, none of whom were customers in the taxable year ending April 30, 1986. The sales proceeds from sales to customer X represented 50 percent of the foreign trading gross receipts for the previous FSC year. The FSC meets the 50 percent test for product or product line grouping for the taxable year ending April 30, 1986. If the facts were changed so that there was not a FSC, DISC or interest charge DISC in the same controlled group in the previous taxable year, the single solicitation directed to any customer would qualify all transactions within the product group as meeting the solicitation requirement for that taxable year. For subsequent taxable years, the 50 percent test or the 20 percent test would be applicable.

Example 3. A FSC earns commissions on the sale of export property by its domestic related supplier to United States wholesalers for final sale to foreign customers. The related supplier receives an order from one of its United States wholesalers. The related supplier telephones the United States wholesaler to inform it of the new price and the probability of another price increase soon. The United States wholesaler orally agrees to the new price and the related supplier instructs the FSC to telex the wholesaler from its foreign office a confirmation that the product will be sold at the current new price. The written confirmation by the FSC of an oral agreement on a variable contract term constitutes the making of a contract. Thus, the requirements of section 924(d)(1)(A) are met with respect to the transaction relating to the product.

(d) *Satisfaction of either the 50-percent or the 85-percent foreign direct cost test*—(1) *In general.* Section 924(d)(1)(B) requires, in order for the gross receipts of a transaction to qualify as foreign trading gross receipts, that the foreign direct costs incurred by the FSC attributable to the transaction equal or exceed 50 percent of the total direct costs incurred by the FSC attributable to the transaction. The direct costs are those costs attributable to activities described in the five categories of section 924(e). Section 924(d)(2) provides that, instead of satisfying the 50-percent foreign direct cost test of section 924(d)(1)(B), the FSC may incur foreign direct costs attributable to activities described in each of two of those categories that equal or exceed 85 percent of the total direct costs incurred by the FSC attributable to the activity described in each of the two categories. If no direct costs are incurred by the FSC in a particular category, that category shall not be taken into account for purposes of determining satisfaction of either the 50-percent or the 85-percent foreign direct cost test. If any amount of direct costs is incurred in a particular category, that category shall be taken into account for purposes of the foreign direct costs tests.

(2) *Direct costs*—(i) *Definition of direct costs.* For purposes of section 924 (d), direct costs are those costs which are incident to and necessary for the performance of any activity described in section 924(e). Direct costs include the cost of materials which are consumed in the performance of the activity, and the cost of labor which can be identified or associated directly with the performance of the activity (but only to the extent of wages, salaries, fees for professional services, and other amounts paid for personal services actually rendered, such as bonuses or compensation paid for services on the basis of a percentage of profits). Direct costs also include the allowable depreciation deduction for equipment or facilities (or the rental cost for use thereof) that can be specifically identified or associated with the activity, as well as the contract price of an activity performed on behalf of the FSC by a contractor. If costs of services or the use of facilities are only incidentally related to the performance of an activity described in section 924(e), only the incremental cost is considered to be identified directly with the activity. For example, supervisory, administrative, and general overhead expenses, such as telephone service, normally are not identified directly with particular activities described in section 924(e). The cost of a long distance telephone call made to arrange for delivery of export property, however, is identified directly with the activities described in section 924(e)(2). Direct costs for purposes of section 924(d) do not necessarily include all of the expenses taken into account for purposes of determining the taxable income of the FSC or the combined taxable income of the FSC and its related supplier.

(ii) *Allocation of direct costs.* For purposes of this section only, if costs are identified with more than one activity (whether or not all of the activities are described in section 924(e)), the portion of the costs attributable to each activity shall be determined by allocating the costs among the activities in any manner that is consistently applied and, if applicable, that reasonably reflects relative costs that would be incurred by performing each activity independently. If costs of an activity are attributable to more than one transaction or grouping of transactions, the portion of the costs attributable to each transaction or grouping shall be determined by allocating the costs among the transactions or groupings in any manner that is consistently applied and, if applicable, that reasonably reflects relative costs that would be incurred by performing the activity independently with respect to each transaction or grouping.

(3) *Total direct costs.* The term ‘‘total direct costs’’ means all of the direct costs of any transaction attributable to activities described in any paragraph of section 924(e). For purposes of the 50-percent foreign direct cost test of section 924(d)(1)(B), total direct costs are determined based on the direct costs of all activities described in all of the paragraphs of section 924(e). For purposes of the 85-percent foreign direct cost test of section 924(d)(2), however, the total direct costs are determined separately for each paragraph of section 924(e). If more than one activity is included within a paragraph of section 924(e), direct costs must be incurred with respect to at least one activity listed in the paragraph. If costs are incurred with respect to more than one activity, all direct costs must be considered for purposes of satisfying the direct costs test.

(4) *Foreign direct costs.* The term ‘‘foreign direct costs’’ means the portion of the total direct costs of any transaction which is attributable to activities performed outside the United States. For purposes of the 50-percent foreign direct cost test, foreign direct costs are determined based on the direct costs of all activities described in all of the paragraphs of section 924(e). For purposes of the 85-percent foreign direct cost test, however, foreign direct costs are determined separately for each paragraph of section 924(e).

(5) *Fifty percent foreign direct cost test.* To satisfy the requirement of section 924(d)(1)(B), the foreign direct costs incurred by the FSC attributable to the transaction must equal or exceed 50 percent of the total direct costs attributable to the transaction. This test looks to the cost of the activities described in section 924(e) on an aggregate basis; therefore, it is not necessary that the foreign direct costs of each activity, or of each paragraph of section 924(e), equal or exceed 50 percent of the total direct costs of that activity or paragraph.

(6) *Eighty-five percent foreign direct cost test*—(i) *General rule.* To satisfy the requirement of section 924(d)(2), the foreign direct costs of a transaction incurred by the FSC attributable to activities described in each of at least two paragraphs of section 924(e) must equal or exceed 85 percent of the total direct costs attributable to activities described in that paragraph. This test looks to costs of the activities on a paragraph-by-paragraph basis (but not on an activity-by-activity basis). As an example, the foreign direct costs of advertising and sales promotion are aggregated with each other for this purpose, but they are not aggregated with the foreign direct costs of transportation.

(ii) *Satisfaction of the 85-percent test.* If, after the FSC files its tax return indicating that it has satisfied the 85-percent foreign direct cost test with respect to each of at least two paragraphs of subsection 924(e) and a determination is made by the Commissioner that the foreign direct costs attributable to one or both of the two paragraphs of section 924(e) specified on the return did not equal or exceed 85 percent of the total direct costs attributable to such activities, the FSC may, nonetheless, satisfy the 85-percent foreign direct cost test if the foreign direct costs attributable to any two paragraphs of section 924 (e) equal or exceed 85 percent of the total direct costs attributable to those other paragraphs.

(e) *Grouping transactions.* Generally, the foreign direct cost tests under paragraph (d) of this section are to be applied on a transaction-by-transaction basis. By annual election of the FSC, however, the foreign direct cost tests may be applied on a customer, contract or product or product line grouping basis. Any groupings used must be supported by adequate documentation of performance of activities and costs of activities relating to the groupings used. An election by the FSC to group transactions must be made on its annual income tax return. The FSC may, however, amend its tax return before the expiration of the statute of limitations under section 6501 of the Code to group in a manner different from that elected on its original return.

(1) *Standards for groupings.* A determination by a FSC as to a grouping will be accepted by the district director if such determination conforms to any of the following standards:

(i) *Product or product line groupings.* A product or product line grouping may be based either on a recognized trade or industry usage, or on a two digit major grouping (or on any inferior classification or combination of inferior classifications within a major grouping) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.

(ii) *Customer groupings.* A customer grouping includes all transactions of the FSC with a particular customer during the FSC's taxable year.

(iii) *Contract groupings.* A contract grouping includes all transactions of the FSC under a particular contract, including a requirements contract. The tests will be applied to all transactions within a contract grouping during each taxable year of the FSC; however, by election of the FSC, all transactions under a contract that occur in the first or the last year of the contract may be included with, respectively, the next succeeding or the immediately preceding taxable year in applying these tests. For example, if with respect to transactions during the first calendar year of a 5-year contract, a calendar year FSC incurs direct costs attributable to the transactions of $100X for advertising, all of which are foreign direct costs, and $10X for processing of customers orders and for arranging for delivery, $9X (or 90 percent of the total direct costs) of which are foreign direct costs, the FSC has satisfied the 85-percent foreign direct cost test with respect to those transactions for the taxable year. If with respect to transactions during the second year of the contract, the FSC only incurs $18X of direct costs for processing of customer orders and arranging for delivery, $15X (83.3 percent of the total direct costs) of which are foreign direct costs, the FSC may include the transactions from the first year of the contract to meet the 85-percent foreign direct cost test in the second taxable year. Thus, with respect to the transactions in the second year, the FSC satisfies the foreign direct costs test for advertising (because the entire $100X of direct costs are foreign direct costs) and for processing of customer orders and arranging for delivery (because of the $28X of direct costs, $24X or 85.7 percent of the total direct costs are foreign direct costs). If, however, with respect to transactions in the third year, the FSC satisfies the foreign direct costs test, those transactions cannot be included with the transactions in the fourth year. The FSC may aggregate the direct costs in the fourth and fifth years in the same manner as for the first and second years as described above in order to satisfy the 85 percent foreign direct costs test.

(iv) *Product or product line groupings within customer or contract groupings.* Groupings may be based on product or product line groupings within customer or contract groupings.

(2) *Transactions included in a grouping.* An election by the FSC to group transactions shall generally apply to all transactions within the scope of that grouping. The election of a grouping, however, applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations may be made on a transaction-by-transaction basis or other grouping basis. For example, the FSC may elect a product grouping with respect to one product and elect the transaction-by-transaction method for another product within the same taxable year. In addition, if a FSC is permitted to apply either the 50-percent or the 85-percent foreign direct cost test on the basis of other types of groupings, such as all transactions with respect to a particular customer, transactions included

in those other groupings shall be excluded from product groupings.

(3) *Different groupings allowed for different purposes.* An election by the FSC to group transactions may be made separately for each of the activities relating to disposition of export property under section 924(d)(1)(B) or section 924(d)(2). Groupings used for purposes of section 924 will have no bearing on groupings for other purposes. This paragraph (e) does not apply for purposes of section 925.

(f) *Exception for foreign military property*—(1) *General rule.* The requirements of this section do not apply to any activities performed in connection with foreign military sales except those activities described in section 924(e). The FSC is deemed to have satisfied the requirements of section 924(d)(1)(A).

(2) *Example.* The principles of paragraph (f)(1) of this section may be illustrated by the following example:

Example. A FSC earns commissions on foreign military sales by its related supplier. All solicitation, negotiation, and contract making activities occur in the United States solely between the related supplier and the United States government. The property is delivered, title passes, and payment is made in the United States in accordance with standard United States government practices. The FSC incurs direct costs in the amount of $155X to process the government's orders and arrange for delivery of the goods, all of which are foreign direct costs. In addition, it incurs foreign direct costs in the amount of $250X for assembling and transmitting its final invoice to the government from outside the U.S. and foreign direct costs of $200X associated with receiving payment from the related supplier in accordance with the rules of § 1.924(e)–1(d)(2)(iii). No other activities occur with respect to the foreign military sales. The FSC has satisfied the 85-percent foreign direct cost test and thus has foreign trading gross receipts with respect to the foreign military sales. The fact that the FSC did not participate outside the United States in any of the sales activities has no bearing on the qualification of the receipts since the FSC is deemed to have met the requirements of section 924(d)(1)(A).

[T.D. 8125, 52 FR 5090, Feb. 19, 1987]

§ 1.924(e)–1 Activities relating to the disposition of export property.

(a) *Advertising and sales promotion.* For purposes of section 924(e), advertising and sales promotion are defined as follows.

(1) *Advertising*—(i) *Advertising defined*—(A) *General rule.* Advertising means the announcement or description of property or services described in section 924(a), in some medium of mass communication (such as radio, television, newspaper, trade journals, mass mailings, or billboards), in order to induce multiple customers or potential customers to buy or rent the property or services from the FSC or related supplier. Advertising is not required to be directed to the general public, but may be focused toward any group of export customers or potential export customers. Advertising except for the advertising described in § 1.924(e)–1(a)(1)(B) must describe one or more specific products or product lines (or services) and identify the product as a product offered by the FSC or related supplier. Advertising intended solely to build a favorable image of a company or group of companies is not included in this definition of advertising. Additionally, advertising primarily directed at customers or potential customers in the United States is not included in this definition of advertising, nor is advertising related to property or services not described in section 924(a).

(B) *Special rules for sales to distributors.* If the customer is a distributor (whether domestic or foreign, related or unrelated to the FSC), an expense that is incurred by the distributor and charged to the FSC or related supplier as a reduction in the purchase price or as a separate charge for an announcement or description described in paragraph (a)(1)(A) of this section to induce the distributor's customers, potential customers, or the ultimate users to buy or rent the property or services is advertising for these purposes (i) if the FSC incurs 20 percent or more of the total advertising costs of the distributor or (ii) if the FSC pays the total charge of an advertisement either directly or indirectly. For these purposes, a distributor is anyone other than an end user or a final consumer. A FSC may incur direct advertising costs to a foreign end consumer even though the FSC sells to a U.S. distributor.

(ii) *Direct costs of advertising.* Direct costs of advertising include costs of transmitting, displaying, or distributing the advertising to customers or potential customers and the costs of printing in the case of sales literature, but do not include fees paid to an independent advertising agency to develop the announcement or description, translation costs, or costs of preparing the announcement or description for potential use as advertising. Direct costs of sending sales literature to customers or potential customers may be taken into account as advertising costs as long as the activity is not taken into account for purposes of the sales activity requirements of §1.924(d)–1(c).

(iii) *Location of advertising*—(A) *General rule.* The location of advertising activity is the place to which the advertising is transmitted, displayed, distributed, mailed, or otherwise conveyed to the customers or potential customers (or in the case of advertising described in paragraph (a)(i)(B) of this section, the distributor's customers, or the ultimate users). For example, a television advertisement that is broadcast to a foreign country constitutes advertising activity outside the United States even though the broadcast signal originates in the United States. Therefore, the cost of that advertising activity is a foreign cost. The FSC may rely upon the distribution statistics of the publisher of print media or the broadcaster of broadcast media through which the advertising is distributed. If the distribution statistics show that 85 percent or more of the readership, radio listeners, or viewership are outside the United States, all direct costs of advertising are considered foreign direct costs of advertising.

(B) *Foreign editions of journals, magazines, etc.* Costs related to advertising in foreign English editions of U.S. publications as well as advertising in any publication in a foreign language are foreign direct costs.

(C) *United States editions.* Costs related to advertising in United States publications are not treated as direct costs even if the publication also has a foreign edition in English.

(iv) *Second mailings.* In general, direct costs of sending sales literature to customers may be treated as solicitation or advertising, but not both. A distinction may be made, however, between a first and second mailing so that one may be treated as advertising and the other may be treated as solicitation. To qualify under this second mailing rule, the two mailings must be generically different items such as a price list and a description of the product itself. An amended price list would not be distinguishable from an original price list and would, therefore, not constitute a second mailing.

(v) *Examples.* The principles of paragraph (a)(1) of this section may be illustrated by the following examples:

Example 1. The related supplier, under contract with a buy-sell FSC to advertise export product D on the ‘‘FSC's'' behalf to its foreign unrelated customers, engaged a French advertising agency to develop an advertising campaign to induce French customers to buy the product. As a part of the advertising campaign, the agency places a one-page advertisement in a relevant French trade journal. The advertisement constitutes advertising within the meaning of paragraph (a)(1) of this section.

Example 2. A United States weekly magazine publishes, in addition to its United States edition, a Canadian edition in English and a Mexican edition in Spanish. A FSC incurs costs of $200 X for a one-page display in each of the three editions for a total advertising cost of $600 X. The $200 X cost relating to the advertising in the United States edition is not a direct cost because it relates to United States sales. The total costs of $400 X relating to advertising in the English language Canadian edition and the Spanish language Mexican edition are foreign direct costs.

Example 3. A FSC earns commissions on the sale of export product E by its domestic related supplier to United States distributors for resale to Canadian retail customers. The related supplier, under contract with the FSC to advertise product E, pays an amount equal to 1 percent of its annual gross receipts with respect to product E under a cooperative advertising arrangement with the distributor. The amount, which represents 20 percent of the total advertising costs for product E, is reimbursed by the FSC. The 20-percent amount represents a significant portion of the total advertising costs and thus constitutes advertising within the meaning of paragraph (a)(1)(i) of this section.

Example 4. A FSC mails two items to each customer on its customer list within one taxable year. The first mailing consists of a price list which merely lists the various products by name and provides a price next to each product name. The second mailing consists of a brochure which fully describes and illustrates each product. The two mailings are generically different. Therefore, one mailing may be counted as advertising while the other mailing may be counted as solicitation.

(2) *Sales promotion*—(i) *Sales promotion defined.* Sales promotion means an appeal made in person to an export customer or potential export customer for the sale or rental of property or services described in section 924(a), made in the context of a trade show or customer meeting. A customer meeting means a periodic meeting (*e.g.*, quarterly, semi-annual, or annual) in which 10 or more customers or potential customers are reasonably expected to attend. However, for taxable years beginning before February 19, 1987, a customer meeting may, at the option of the taxpayer, mean any meeting with a customer or potential customer regardless of the frequency of the meetings or the number of customers or potential customers in attendance. A meeting, show or event in the United States that is primarily aimed at the export of goods or services described in section 924(a) constitutes sales promotion. Sales promotion does not include an appeal made in the context of any meeting, show or event primarily aimed at U.S. customers or an appeal for the sale or rental of property or services not described in section 924(a). Whether any meeting, show or event is primarily aimed at U.S. customers or at the export of goods or services described in section 924(a) shall be determined by all of the facts and circumstances including the announced objective of the meeting, show or event; the attendees; the location of the meeting, show or event; and the product or special feature of the product.

(ii) *Direct costs of sales promotion.* Direct costs of sales promotion include costs such as rental of space at trade shows, payments to organizers or other persons hired for the event, rental of display equipment and decorations for the event, and costs of maintaining a showroom. Direct costs of sales promotion also include costs for travel, meals, and lodging for direct sales people attending the event if these costs are paid by the FSC or related supplier. In the case of a customer meeting, direct costs of sales promotion include the costs of materials printed specifically for the meeting and the costs of travel, lodging, and food for both the direct sales people and customers or potential customers attending the meeting. Direct costs of sales promotion do not include the cost of salaries and commissions of direct sales people or the cost of discount coupons, samples of the product, or printed advertising materials that are used for general advertising as well as sales promotion.

(iii) *Location of sales promotion.* The location of sales promotion activity is the place where the trade show or customer meeting is held.

(iv) *Examples.* The principles of paragraph (a)(2)(i) of this section may be illustrated by the following examples:

Example 1. The related supplier sells various export products described in section 924(a) to its foreign customers. As a commission agent for the related supplier with respect to such sales, the FSC performs sales promotion. It contracts with the related supplier to serve as its agent for such purposes. To stimulate the sale of its export products, the related supplier conducts semi-annual meetings with the purchasing agents of its customers at its Kansas City headquarters. Ten or more purchasing agents are reasonably expected to attend each meeting. At such meetings, the purchasing agents see the related supplier's manufacturing facilities, visit with its executives, attend technical updates, and see new export products. These semi-annual customer meetings constitute sales promotion within the meaning of paragraph (a)(2)(i) of this section. Direct costs incurred with respect to the customer meetings are U.S. direct costs because the sales promotion activities occur within the United States.

Example 2. Assume the same facts as in *Example 1,* except that the related supplier exhibits products that only operate on 220 volts at a trade show in the United States. According to the trade show sponsors, the purpose of the show is to increase sales abroad of United States-manufactured products. Since the products exhibited are designed for operation in foreign countries and the purpose of the trade show is to boost sales in those countries, the trade show held in the United States is primarily aimed at the export products described in section 924(a) and not at United States customers. Thus, the trade show constitutes sales promotion within the meaning of paragraph (a)(2)(i) of this section and the direct costs incurred in connection with the trade show are treated as United States direct costs.

(b) *Processing of customer orders and arranging for delivery of the export property*. For purposes of section 924(e), the processing of customer orders and the arranging for delivery of the export property are defined in paragraph (b)(1) and paragraph (b)(2), respectively, of this section. For taxable years beginning after February 19, 1987, if the FSC performs the activities of processing of customer orders and arranging for delivery of the export property and elects to group its transactions, it is considered to have performed the activities with respect to all transactions in the grouping elected by the FSC under §1.924(d)–1(e) during the taxable year if it performs the activities of processing of customer orders and arranging for delivery of the export property with respect to customers generating 20 percent or more of foreign trading gross receipts within the elected grouping.

(1) *Processing of customer orders*—(i) *Processing of customer orders defined*. The processing of customer orders means notification by the FSC to the related supplier of the order and of the requirements for delivery. The related supplier may have independent knowledge of the order and requirements for delivery. If the FSC does not have a related supplier, the processing of customer orders means communication with the customer by any method such as telephone, telegram, or mail to acknowledge receipt of the order and requirements for delivery. Once the related supplier has been notified by the FSC, or the customer has received an acknowledgement from the FSC, of the order and requirements for delivery, subsequent or prior communications with respect to an order (such as changes in quantity or prospective delivery date) are not included in the definition of processing of customer orders.

(ii) *Direct costs of processing customer orders.* Direct costs of processing of customer orders include salaries of clerical personnel and costs of telephone, telegram, mail, or other communication media (including the costs of operating transmission equipment).

(iii) *Location of processing of customer orders.* The location of this activity is the place where the communication is initiated by the FSC.

(iv) *Examples.* The principles of paragraph (b)(1) of this section may be illustrated by the following examples:

Example 1. A domestic related supplier, using a FSC as its commission agent on the sale of export property to foreign customers, receives an order from one of its foreign customers. Information concerning the receipt of such order and its requirements for delivery are transmitted to the FSC. The FSC from its office outside the United States notifies the related supplier of the order and the requirements for delivery by telex. This notification by the FSC to the related supplier constitutes the processing of the customer's order within the meaning of paragraph (b)(1)(i) of this section. In addition, its direct costs of processing the customer's order are foreign direct costs because the communication is initiated by the FSC from outside the United States.

Example 2. A domestic unrelated supplier manufactures a product which it sells to a buy-sell FSC located in Germany for resale to the FSC's German customers. Upon receiving an order from one of its customers, the FSC telephones the customer from its German office to acknowledge receipt of the order and the requirements for delivery. The acknowledgement constitutes the processing of the customer's order within the meaning of paragraph (b)(1)(i) of this section and the direct costs attributable thereto are foreign direct costs.

(2) *Arranging for delivery*—(i) *Arranging for delivery defined.* The arranging for delivery of export property means the taking of necessary steps to have the export property delivered to the customer in accordance with the requirements of the order. Arranging for delivery does not include preparation of shipping documents (*e.g.,* bill of lading) or the property for shipment (*i.e.,* packaging or crating), or shipment of property (*i.e.,* transportation). Arranging for delivery does include communications with a carrier or freight forwarder to provide transportation (as defined in §1.924(e)–1(c)(1), but without regard to when the commission relationship for purposes of transportation begins) for the export property from the FSC or related supplier to the place where the customer takes possession of the property. Arranging for delivery also includes communications with the customer to notify the customer of the time and place of delivery. The carrier or freight forwarder and the customer

may already have knowledge of the information communicated. If the FSC has communicated with the carrier or freight forwarder, where applicable, and the customer to notify it of the time and place of delivery, prior or subsequent communications to either about delivery are not included in the definition of arranging for delivery.

(ii) *Direct costs of arranging for delivery.* The direct costs of arranging for delivery include salaries of clerical personnel and costs of telephone, telegraph, mail, and other communications media, but do not include any actual shipping costs.

(iii) *Location of arranging for delivery.* The location of arranging for delivery activity is the place where the activity is initiated by the FSC.

(iv) *Examples.* The principles of paragraph (b)(2)(i) of this section may be illustrated by the following examples:

Example 1. A FSC earns commissions on the sale of export property by its domestic related supplier to foreign customers. The shipment term of all of the related supplier's sales is F.O.B. (Free on Board) its manufacturing plant in Gary, Indiana. Thus, there is no transportation as defined in § 1.924(e)–1(c)(1) with respect to its sales. From its shipping department at the plant, the related supplier telephones carriers to arrange for delivery. It also notifies the FSC by mail of the time and place of delivery of the customer's orders. The FSC from its office outside the United States transmits the received information to the customers. Because there is no transportation to be arranged, this communication alone by the FSC to the customers to notify them of the time and place of delivery constitutes arranging for delivery within the meaning of paragraph (b)(2)(i) of this section.

Example 2. Assume the same facts as in *Example 1,* except that the shipment term of all of the related supplier's sales is C.I.F. (Cost, Insurance, Freight) and that the commission relationship for transportation begins after the export property leaves the United States customs territory. The related supplier telephones a trucking firm and an overseas carrier from its plant in Gary, Indiana to ascertain information on transporting its property by truck to the docks, and by overseas carrier from the docks to the place where the customer takes possession. Upon receiving the necessary information, the related supplier electronically transmits to the FSC the shipping information and the time and place of delivery to the customer. In addition, it instructs the FSC to communicate the necessary shipping information to the carriers to ensure shipment and to notify the customer of the time and place of delivery. The FSC does both from its office located outside of the United States. The communications by the FSC to the carriers and the customer constitute arranging for delivery within the meaning of paragraph (b)(2)(i) of this section.

(c) *Transportation*—(1) *Transportation defined.* For purposes of section 924(e), transportation means moving or shipping the export property during the period when the FSC owns or is responsible for the property, or, if the FSC is acting as a commission agent, during the period when the related supplier owns or is responsible for the property but after the commission relationship for purposes of transportation begins (even if the relationship begins after the property leaves the U.S. customs territory). The FSC or related supplier is treated as responsible for the property when it either has title, bears the risk of loss, or insures the property during shipment. Since a commission FSC will not generally have title or bear the risk of loss, it will, nevertheless, satisfy the transportation test if the related supplier has either title, bears the risk of loss, or insures the property during shipment. Examples of methods of shipping which would qualify as transportation include F.O.B. (Free on Board) destination, C.I.F. (Cost, Insurance, Freight), Ex Ship, and Ex Quay, but do not include C. & F. (Cost and Freight) or F.O.B. shipping point.

(2) *Direct costs of transportation.* The direct costs of transportation include the expenses of shipping, such as fees paid to carriers and freight forwarders, costs of freight insurance, and documentation fees. With respect to fungible commodities, direct costs include only those costs incurred after the goods have been identified to a contract. Transportation costs do not include any of the costs of arranging for delivery. The FSC is considered to engage in transportation activity whenever it pays the costs of shipping the export property and the property is shipped during the period when the FSC owns or is responsible for the property as provided in paragraph (c)(1) of this section. If the customer pays the shipping costs directly, the FSC is not considered to engage in transportation activity. If, however, the FSC

pays the shipping costs, the ultimate transfer of those costs to the customer will not disqualify the FSC from engaging in transportation for purposes of section 924(e) regardless of whether the costs are included in the sale price of the export property or separately stated.

(3) *Location of transportation.* The location of transportation activity is the area over which the property is transported. Thus, the portion of total direct costs of transportation treated as foreign direct costs is the portion attributable to transportation outside the United States, determined on the basis of the ratio of mileage outside the U.S. customs territory to total mileage. For purposes of determining mileage outside U.S. customs territory, goods are treated as leaving U.S. customs territory when they have been tendered to an international carrier for shipment to a foreign location, as long as they are not removed from the custody of the carrier before they reach a point outside U.S. customs territory. The same rule for determining mileage outside the U.S. customs territory will apply to freight forwarders if (i) the forwarder has the risk of loss or is an insurer of the goods, and (ii) the property is shipped on a single bill of lading issued to the FSC or its agent as the shipper.

(4) *Examples.* The principles of paragraph (c) of this section may be illustrated by the following examples:

Example 1. A buy-sell FSC sells export property to a customer located in Canada. The contract between the FSC and the customer requires that the property be shipped F.O.B. its Canadian destination. Under this shipment term, the FSC holds title and bears the risk of loss until the property is tendered at its Canadian destination. Thus, it is responsible for the property during shipment. The FSC instructs its related supplier to ship the property from its manufacturing facilities in St. Louis. The related supplier negotiates two contracts, one for domestic transportation and the second for foreign transportation. A domestic trucking firm transports the property to the Canadian border where a Canadian trucking company is used to transport the property to its Canadian destination. The documentation fees and the fees for the two trucking firms are paid by the FSC. Because the FSC paid the costs of shipping and the property was shipped during the period when the FSC was responsible for the property, the FSC has engaged in transportation activity, the direct costs of which are the fees paid by the FSC. If 70 percent of the mileage from St. Louis to the Canadian destination is associated with the transportation from the Canadian border to the Canadian destination, 70 percent of the FSC's direct transportation costs are foreign direct costs. If, instead of using two trucking firms, the FSC had tendered the goods to a freight forwarder for shipment to a foreign location and the freight forwarder assumed the risk of loss for the goods and issued a single bill of lading, all of the fees paid by the FSC to the freight forwarder would be foreign direct costs.

Example 2. A related supplier sells export property to its foreign customer in Liverpool, England. The contract between the related supplier and the customer requires that the property be shipped C.I.F. Liverpool. The related supplier engages the FSC as its commission agent with respect to its sales to the customer, requiring the FSC to provide transportation to the customer. The FSC contracts with the related supplier to provide the transportation on behalf of the FSC. The commission agreement between the related supplier and the FSC provides that the FSC's responsibilities with respect to transportation of the export property begins after the property leaves the U.S. customs territory. The related supplier hires a domestic trucking firm to transport the shipment to a New York City port where it is loaded on a cargo ship destined for Liverpool at a total cost of $3,000X, $2,750X of which is allocable to mileage from the U.S. customs territory to Liverpool, England. Because the related supplier insures the property during shipment under C.I.F., the property is shipped during the period when the related supplier is treated as responsible for the property. Thus, the FSC, as the related supplier's commission agent, has satisfied the transportation test. In addition, because the FSC's responsibilities with respect to transportation begins when the property leaves U.S. customs territory, the FSC's payment of $2,750X is a foreign direct cost of transportation. The remaining $250X is not a direct cost of transportation to the FSC because the amount was expended before the commission relationship between the FSC and related supplier began.

Example 3. A FSC earns commissions on sales by the related supplier of export property, all of which falls within a single two-digit SIC group. The related supplier is under contract to the FSC to perform on the FSC's behalf all of the section 924(e) activities attributable to the sales. Of all of the sales made during the year, the FSC has no transportation costs with respect to the sales to customer R because the shipment term is F.O.B. the related supplier's Chicago plant. With respect to the sales to customer S, the

FSC ships the property F.O.B. its destination and pays 100 percent of the transportation costs, all of which are foreign direct costs because the commission relationship for transportation begins outside the U.S. customs territory. For purposes of determining whether the FSC has satisfied the 85-percent foreign direct cost test for transportation, the FSC groups the sales by product. Because the transportation costs for sales to customer S are 100-percent foreign direct costs and because there are no transportation costs on sales to customer R, the FSC is considered to have met the 85-percent foreign direct cost test for transportation for all the sales in the single two-digit SIC group.

(d) *Determination and transmittal of a final invoice or statement of account and receipt of payment.* For purposes of section 924(e), the determination and transmittal of a final invoice or statement of account and the receipt of payment are defined as follows.

(1) *Determination and transmittal of a final invoice or statement of account*—(i) *Definitions*—(A) *In general.* The determination and transmittal of a final invoice or statement of account means the assembly of either a final invoice or statement of account and the forwarding of that document to the customer. A FSC may elect to send either final invoices or statements of account and disregard any costs of the alternative not elected. For taxable years beginning after February 19, 1987, a special grouping rule is provided. If the FSC assembles and forwards either a statement of account or a final invoice from outside the United States to customers with sales representing 50 percent of the current year foreign trading gross receipts within a product or product line grouping or to customers with sales representing 50 percent of the prior year foreign trading gross receipts within a product or product line grouping utilized for the current year, all other U.S. costs will be disregarded and the FSC will be deemed to have no U.S. costs with respect to the determination and transmittal of a final invoice or statement of account. If, during the prior taxable year, the controlled group of which the FSC is a member had a DISC or interest charge DISC, the FSC may apply the 50 percent rule by taking into account the customers and sales of the DISC or interest charge DISC for the preceding taxable year. If no foreign trading gross receipts (or qualified export receipts for DISC purposes) were received in the prior year either by the FSC or by a DISC or interest charge DISC within the controlled group of which the FSC is a member, the FSC must apply the 50 percent rule taking into account customers and foreign trading gross receipts for the current year. In the event that the 50 percent rule is not satisfied, all costs associated with assembly and forwarding of the selected documents (invoices or statements of account) must be included in the costs attributable to activities described in section 924(e)(4).

(B) *Final invoice defined.* A final invoice is an invoice upon which payment is made by the customer. A final invoice must contain the customer's name or identifying number and, with respect to the transaction or transactions, the date, product or service, quantity, price, and amount due. In the alternative, a document will be acceptable as a final invoice even though it does not include all of the above listed information if the FSC establishes that the document is considered to be a final invoice under normal commercial practices. An invoice forwarded to the customer after payment has been tendered or received pursuant to a letter of credit as a receipt for payment satisfies this definition.

(C) *Statement of account defined.* A statement of account is any summary statement forwarded to a customer to inform of, or confirm, the status of transactions occurring within an accounting period during a taxable year that is not less than one month. A statement of account must contain, at a minimum, the customer's name or identifying number, date of the statement of account as of the last day of the accounting period covered by the statement of account and the balance due (even if the balance due is zero). A single final invoice or statement of account can cover more than one transaction with one customer. In the alternative, a document will be accepted as a statement of account even though it does not include all of the above listed information if the FSC establishes that the document is considered a statement of account under normal commercial practice. For these purposes, a document will be considered to be a statement of account under normal commercial practices if it is sent to domestic as well as to export customers in order to inform the customers of the status of transactions during an accounting period. Additional information may be sent separately, such as summary statements forwarded to a related party for purposes of reconciling intercompany accounts for financial reporting requirements. If the information is sent separately, the direct costs associated with the assembly and forwarding of that information are not considered for purposes of section 924(d).

(D) *Assembly and forwarding defined.* Assembly means folding the documents (where applicable), filling envelopes, and addressing envelopes (if window envelopes are not used). Forwarding means mailing or delivery.

(ii) *Direct costs of determination and transmittal of final invoice or statement of account.* Direct costs of this activity include costs of office supplies, office equipment, clerical salaries and costs of mailing or other delivery services, if the costs can be identified or associated directly with the assembly and transmittal of a final invoice or statement of account. Costs of establishing a price, or of communicating prices or other billing information between the FSC and a related supplier are not direct costs of this activity. In addition, the costs of preparing and mailing the final invoices or statements of account to the FSC and the costs of accumulating and formatting data for invoicing or statements of account on computer discs, tapes, or some other storage media along with the costs of transmitting or transporting this data to the FSC are not direct costs of this activity.

(iii) *Location of determination and transmittal of a final invoice or statement of account.* For taxable years beginning before February 19, 1987, the location of this activity is the place where the final invoice or statement of account is assembled for forwarding to the customer or the place from which it is forwarded to the customer. Thus, the forwarding of the final invoice or statement of account from outside the United States is sufficient to source this activity outside the United States. For all other taxable years, the location of this activity is the place where the final invoice or statement of account is both assembled and forwarded to the customer.

(iv) *Examples.* The principles of paragraph (d)(1) of this section may be illustrated by the following examples, all of which apply to taxable years beginning on or after February 19, 1987.

Example 1. A related supplier sells export property to its foreign customers. The related supplier engages the FSC as its commission agent with respect to the sales, requiring the FSC to determine and transmit final invoices or statements of account to the customers with respect to the sales. Annually, the FSC assembles and forwards statements of account to customers representing 40 percent of current year export sales and 35 percent of prior year sales. The statements are sent from its office outside of the United States. The remaining statements of account are sent from the Albany, New York office of the related supplier. The statements are recognized in its industry as a statement of account. Although the statement does not contain all of the information described in §1.924(e)–1(d)(1)(i), it is sent to both domestic and foreign customers of the related supplier to inform the customer of the status of its transactions with the related supplier. The document qualifies as a statement of account under §1.924(e)–1(d)(1)(i); however, the 50 percent test set forth in §1.924(e)–1(d)–1(d)(1)(i)(A) is not satisfied. Therefore, the FSC must take into account all domestic direct costs attributable to assembly and forwarding of statements of account from its domestic office in determining whether the FSC has satisfied the direct costs test with respect to section 924(e)(4) and §924 (e)–1(d).

Example 2. Employees of a FSC, in the FSC's foreign office, fold and place in envelopes the sheet or sheets that constitute the final invoices provided by the related supplier. In addition, the employees address, affix postage to, and mail the envelopes. These activities constitute the determination and transmittal of the final invoices within the meaning of paragraph (d)(1)(i) of this section and, because the final invoices are assembled and forwarded to the customers from outside the United States, all the direct costs of the activities are foreign direct costs.

Example 3. The related supplier sends to the FSC's foreign office a computer tape to be used to prepare a statement of account. A management company, working under contract with the FSC, transcribes the data to a piece of paper which is a statement of account for purposes of §1.924(d)(1)(i), folds the document, and fills, affixes postage to, and mails the envelopes. Only the costs performed by the management company under contract with the FSC that constitute the assembly and forwarding of a statement of account under §1.924(e)–1(d)(1)(i)(D) are direct costs. Therefore, the costs attributable to transcribing the data to a piece of paper are not direct costs for purposes of section 924(e)(4).

(2) *Receipt of payment*—(i) *Receipt of payment defined.* Receipt of payment means the crediting of the FSC's bank account by an amount which is not less than 1.83 percent of the gross receipts (''gross receipts amount'') associated with the transaction. The FSC's bank account is not credited unless the FSC has the authority to withdraw the amount deposited. Where sales proceeds are factored or where payments from related foreign subsidiaries are netted against amounts owed to these foreign subsidiaries in an intercompany account, crediting of the FSC's bank account with no less than the gross receipts amount of the factoring proceeds or the proceeds, net of offsets, respectively, qualifies as receipt of payment. In addition, where a FSC is precluded from receiving a portion of the proceeds of the export transaction, the FSC may satisfy receipt of payment by receiving no less than the gross receipts amount of the remaining portion of the proceeds in its bank account. In the case of advance or progress payments, each payment constitutes a payment for receipt of payment purposes.

(ii) *Direct costs of receipt of payment.* Direct costs of receiving payment include the expenses of maintaining a bank account of the FSC in which payment is deposited, any fees or service charges incurred for converting the payment into U.S. currency, and any transfer fees incurred with respect to the transfer of funds into and out of the FSC's bank account in accordance with the 35 calendar day rule in paragraph (d)(2)(iii) of this section. The transfer fees and the fees or service charges incurred for currency conversion are considered to be foreign direct costs of receiving payment; however, exchange losses are not costs of receiving payment.

(iii) *Location of receipt of payment.* The location of this activity is the office of the banking institution at which the account is maintained. If payment is made by the purchaser directly to the FSC or the related supplier in the United States, and the FSC or related supplier transfers the gross receipts amount associated with the transaction to a bank account of the FSC outside the United States after receipt of payment (i.e., cash, check, wire transfer, etc.), but no later than 35 calendar days after receipt of good funds (i.e., the clearance of the check) the FSC is considered to have received payment outside the United States. Therefore, all transfer fees and the costs of the foreign bank account are treated as foreign direct costs. The United States bank costs are disregarded. If, however, the related supplier does not transfer the gross receipts amount within 35 calendar days, United States bank costs are not disregarded and are domestic direct costs. In either case, the transfer costs, currency conversion charges, and foreign bank costs remain foreign direct costs. The preceding rules apply both to commission FSCs and buy-sell FSCs.

(iv) *Examples.* The principles of paragraph (d)(2) of this section may be illustrated by the following examples:

Example 1. A FSC earns commissions on sales of export property by its related supplier. The related supplier manufactures and sells its export property to its foreign subsidiaries for resale in their respective countries. From time to time, the foreign subsidiaries will return products to the related supplier for credit and, from time to time, the foreign subsidiaries purchase products in their respective countries and sell such products to the related supplier. These transactions result in various amounts being owed to the foreign subsidiaries. Each month the various inter-company obligations are reviewed. The result of such review of intercompany indebtedness is a netting out of the various intercompany liabilities on the books, to the extent possible, and a flow of funds for the net obligation. Due to the nature of these transactions, the amounts owed by the foreign subsidiaries exceed the amounts which the related supplier owes to the foreign subsidiaries. The gross receipts amount (*i.e.*, 1.83 percent of this net amount) is credited to the FSC's bank account. This constitutes receipt of payment for purposes of paragraph (d)(2)(i) of this section.

Example 2. In a leveraged lease transaction, a FSC-lessor obtains purchase financing from a lending institution. The lending institution retains a security interest in the proceeds and requires that a portion of each rental payment be paid by the lessee directly to the lending institution. Since the FSC is precluded from receiving a portion of the proceeds of the export transaction, the FSC may satisfy the receipt of payment requirement by receiving the gross receipts amount with respect to the remaining proceeds.

Example 3. A buy-sell FSC sells its export property to a foreign customer and is paid by means of a ‘‘draw-down’’ letter of credit. Over a substantial period of time prior to delivery of the export property, amounts are advanced to the FSC under the letter of credit. At delivery, the remaining amount available is paid. Each payment made to the FSC constitutes a payment for receipt of payment purposes and thus the gross receipts amount related to each payment must be credited to the FSC's bank account.

Example 4. An FSC earns commissions on sales of export property by its related supplier. The related supplier regularly collects payments from its foreign customers in a San Francisco bank account and, after the San Francisco bank has collected on the checks, transfers, within 35 calendar days, the gross receipts amounts from its New York bank account to the FSC's bank account located outside the United States. The FSC incurred transfer fees of $160X in addition to a fee of $35X for the maintenance of the FSC's bank account outside the United States during the 35 calendar day period. The maintenance fee relating to the United States bank account for the 35 calendar day period is $45X. The receipt of payment test is met because the gross receipts amounts are transferred after payment but within 35 calendar days to the FSC's bank account located outside the United States. The transfer fees of $160X and the maintenance fee of $35X relating to the FSC's foreign bank account are foreign direct costs. The $45X maintenance fee related to the United States bank account is not a direct cost. If the gross receipts amounts had not been transferred to the FSC's foreign bank account within 35 calendar days, the $45X maintenance fee related to the United States bank account would be considered a United States direct cost. The transfer fee of $160X and the maintenance fee of $35X relating to the FSC's foreign bank account, however, would, nonetheless, be considered as foreign direct costs. The same funds received in San Francisco need not be transferred to the FSC's foreign bank account because money is fungible. For the same reason, the gross receipts amounts need not be transferred from the same bank account in which the payments are received.

(e) *Assumption of credit risk*—(1) *Assumption of credit risk defined.* For purposes of section 924(e), the assumption of credit risk means bearing the economic risk of nonpayment with respect to a transaction. If the FSC is acting as a commission agent for the related supplier, this risk is borne by the FSC if the commission contract transfers the costs of the economic risk of nonpayment with respect to the transaction from the related supplier to the FSC. The FSC may elect on its annual return to bear the economic risk of nonpayment with respect to its transactions during a taxable year by either—

(i) Assuming the risk of a bad debt in accordance with the rules of paragraph (e)(4)(i) of this section,

(ii) Obtaining insurance to cover nonpayment,

(iii) Investigating credit of a customer or a potential customer,

(iv) Factoring trade receivables, or

(v) Selling by means of letters of credit or banker's acceptances.

Only the alternative elected to be performed by the FSC during a taxable year is relevant for purposes of section 924(d). For example, if a buy-sell FSC elects to bear the economic risk of nonpayment with respect to its transaction during a taxable year by assuming the risk of a bad debt in accordance with the rules of paragraph (e)(4)(i) of this section, and also factors the transaction's trade receivables, only the direct costs of assuming the risk of a bad debt are relevant for purposes of section 924(d). For purposes of this paragraph, a potential customer is an unrelated person who is engaged in the purchase or sale of export property on whom an investigation is performed, but with whom no export sales contract is executed.

(2) *Direct costs of assumption of credit risk.* (i) With respect to assuming the risk of a bad debt, the direct costs of the assumption of credit risk in the case of a buy-sell FSC include debts that become uncollectible and charges taken into account in determining additions to bad debt reserves of the FSC. In the case of a commission FSC, the direct costs of the assumption of credit risk include the assumption of the

debts and charges of the related supplier attributable to export sales that are allowed as deductions under section 166.

(ii) With respect to insurance, the direct costs of the assumption of credit risk are the costs of obtaining insurance against the risk of nonpayment. Qualifying insurance must be obtained from an unrelated insurer and must cover the risk of nonpayment due to default and bankruptcy by the purchaser. Insurance obtained from a related insurer, or insurance that covers default and bankruptcy due to risks of war or political unrest without covering ordinary default or bankruptcy is not sufficient.

(iii) With respect to investigating credit, the direct costs of assumption of credit risk are the external costs of investigating credit for customers or potential customers, including costs of membership in a credit agency or association for that purpose (but not the costs of approving credit by an internal credit agency).

(iv) With respect to factoring trade receivables, the direct costs of assumption of credit risk are the costs of factoring trade receivables of related and unrelated customers (*e.g.* the amount of the discount and the fees relating to factoring).

(v) With respect to letters of credit or banker's acceptances, the direct costs of assumption of credit risk are the costs of letters of credit or banker's acceptances and the documentary collection costs.

(3) *Location of assumption of credit risk.* The location of the activity of assumption of credit risk is the location of the customer or obligor whose payment is at risk, except that the location of investigating credit is the location of the credit agency or association performing the investigation. A foreign branch of a United States corporation and a foreign office of the United States government are not foreign obligors for purposes of this test. A foreign branch of a United States credit investigation agency or association, however, is treated as located outside the United States.

(4) *Special rules*—(i) *Assuming the risk of a bad debt*—(A) *In general.* If a FSC chooses to bear the economic risk of nonpayment by assuming the risk of a bad debt with respect to a transaction or grouping of transactions and an actual bad debt loss on a foreign trading gross receipt is not incurred in any three consecutive years, the FSC will be deemed to have performed this activity during the first two years of the three year period. For the third year, the FSC will not be deemed to have performed this activity and must satisfy the 85 percent foreign direct costs test by satisfying any two paragraphs included within section 924(e) other than assumption of credit risk activity under section 924(e)(5). An actual bad debt loss will only satisfy the activity test with respect to a single three consecutive year period.

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

Example. In year 1, a related supplier of a commission FSC incurs a bad debt with respect to foreign trading gross receipts owed by a foreign obligor. This expense is the only bad debt incurred with respect to foreign trading gross receipts in year 1. Therefore, the direct costs for the bearing of the economic risk of nonpayment for year 1 are all foreign direct costs and the 85-percent test is satisfied. In year 2, the FSC incurs a bad debt with respect to a U.S. broker/consolidator. The direct costs for year 2 are U.S. direct costs and, therefore, the 85-percent test is not satisfied. No bad debt is incurred in year 3. Because a bad debt with respect to a foreign obligor is incurred in year 1, the FSC is deemed to have satisfied the economic risk of nonpayment for each of years 1, 2 and 3.

(ii) *Grouping with respect to other risk activities.* For taxable years beginning after February 19, 1987, if a FSC elects to bear the economic risk of nonpayment by performing one of the activities described in paragraph (e) of this section and elects to group transactions, it is considered to have performed the elected activity with respect to all transactions within the group during the taxable year if it performs the activity in accordance with the following rules. If a FSC elects to factor trade receivables, at least 20 percent of the face amount of a group's receivables must be factored. If a FSC elects to sell by means of letters of credit or banker's acceptances, a fee must be incurred with respect to 20 percent of the foreign trading gross receipts attributable to sales within the group. If the FSC elects to obtain insurance to cover nonpayment, 20 percent of the face amount of receivables attributable to sales included in the §1.924(d)–1(e) grouping elected by the FSC must be insured. If a FSC elects to investigate credit of customers or potential customers, 20 percent of new or potential customers for which a credit investigation is performed must be investigated.

[T.D. 8125, 52 FR 5094, Feb. 19, 1987]

§1.925(a)–1T Temporary regulations; transfer pricing rules for FSCs.

(a) *Scope*—(1) *Transfer pricing rules.* In the case of a transaction described in paragraph (b) of this section, section 925 permits a related party to a FSC to determine the allowable transfer price charged the FSC (or commission paid to the FSC) by its choice of the three transfer pricing methods described in paragraphs (c)(2), (3), and (4) of this section: The ''1.83 percent'' gross receipts method and the ''23 percent'' combined taxable income method (the administrative pricing rules) of section 925(a)(1) and (2), respectively, and the section 482 method of section 925(a)(3). (Any further reference to a FSC in this section shall include a small FSC unless indicated otherwise.) Subject to the special no-loss rule of §1.925(a)–1T(e)(1)(iii), any, or all, of the transfer pricing methods may be used in the same taxable year of the FSC for separate transactions (or separate groups of transactions). If either of the administrative pricing methods (the gross receipts method or combined taxable income method) is applied to a transaction, the Commissioner may not make distributions, apportionments, or allocations as provided by section 482 and the regulations under that section. The transfer price charged the FSC (or the commission paid to the FSC) on a transaction with a person that is not a related party to the FSC may be determined in any manner agreed to by the FSC and that person. However, the Commissioner will use special scrutiny to determine whether a person selling export property to a FSC (or paying a commission to a FSC) is a related party to the FSC with respect to a transaction if the FSC earns a profit on the transaction in excess of the profit it would have earned had the administrative pricing rules applied to the transaction.

(2) *Special rules.* For rules as to certain ''incomplete transactions'' and for computing full costing combined taxable income, see paragraphs (c)(5) and (6) of this section. For a special rule as to cooperatives and computation of their combined taxable incomes, see paragraph (c)(7) of this section. Grouping of transactions for purposes of applying the administrative pricing method chosen is provided for by paragraph (c)(8) of this section.

The rules in paragraph (c) of this section are directly applicable only in the case of sales or exchanges of export property to a FSC for resale, and are applicable by analogy to leases, commissions, and services as provided in paragraph (d) of this section. For a rule providing for the recovery of the FSC's costs in an overall loss situation, see paragraph (e)(1)(i) of this section. Paragraph (e)(2) of this section provides for the applicability of section 482 to resales by the FSC to related persons or to sales between related persons prior to the sale to the FSC. Paragraph (e)(3) of this section provides for the creation of receivables if the transfer price, rental payment, commission or payment for services rendered is not paid by the due date of the FSC's income tax return for the taxable year under section 6072(b), including extensions provided for by section 6081. Provisions for the subsequent determination and further adjustment to the relevant amounts are set forth in paragraphs (e)(4) and (5) of this section. Paragraph (f) of this section has several examples illustrating the provisions of this section. Section 1.925(b)–1T prescribes the marginal costing rules authorized by section 925(b)(2). Section 1.927(d)–2T provides definitions of related supplier and related party.

(3) *Performance of substantial economic functions*—(i) *Administrative pricing methods.* The application of the administrative pricing methods of section 925 (a)(1) and (2) does not depend on the extent to which the FSC performs substantial economic functions beyond those required by section 925(c). See

paragraph (b)(2)(ii) of this section and § 1.924(a)–1T(i)(1).

(ii) *Section 482 method.* In order to apply the section 482 method of section 925(a)(3), the arm's length standards of section 482 and the regulations under that section must be satisfied. In applying the standards of section 482, all of the rules of section 482 will apply. Thus, if the FSC would not be recognized as a separate entity, it would also not be recognized on application of the section 482 method. Similarly, if a FSC performs no substantial economic function with respect to a transaction, no income will be allocable to the FSC under the section 482 method. See § 1.924(a)–1T(i)(2). If a related supplier performs services under contract with a FSC, the FSC will not be deemed to have performed substantial economic functions for purposes of the section 482 method unless it compensates the related supplier under the provisions of § 1.482–2(b)(1) through (7). See § 1.925(a)–1T(c)(6)(ii) for the applicability of the regulations under section 482 in determination of the FSC's profit under the administrative pricing methods.

(b) *Transactions to which section 925 applies*—(1) *In general.* The transfer pricing methods of section 925 (the administrative pricing methods and the section 482 method) will apply, generally, only if a transaction, or group of transactions, gives rise to foreign trading gross receipts (within the meaning of section 924(a) and § 1.924(a)–1T) to the FSC (or small FSC, as defined in section 922(b) and § 1.921–2(b) (Q&A3)). However, the transfer pricing methods will apply as well if the FSC is acting as commission agent for a related supplier with regard to a transaction, or group of transactions, on which the related supplier is the principal if the transaction, or group of transactions, would have resulted in foreign trading gross receipts had the FSC been the principal.

(2) *Application of the transfer pricing rules*—(i) *Section 482 method.* The section 482 transfer pricing method may be applied to any transaction between a related supplier and a FSC if the requirements of paragraph (a)(3)(ii) of this section have been met.

(ii) *Administrative pricing methods.* The administrative pricing methods may be applied in situations in which the FSC is either the principal or commission agent on the transaction, or group of transactions, only if the requirements of section 925(c) are met. Section 925(c) requires that the FSC performs all the activities described in subsections (d)(1)(A) and (e) of section 924 that are attributable to a particular transaction, or group of transactions. The FSC need not perform any activities with respect to a particular transaction merely to comply with section 925(c) if that activity would not have been performed but for the requirements of that subsection. The FSC need not perform all of the activities outside the United States. None of the activities need be performed outside the United States by a small FSC. Rather than the FSC itself performing the activities required by section 925(c), another person under contract, written or oral, directly or indirectly, with the FSC may perform the activities (see § 1.924(d)–1(b)). If a related supplier is performing the required activities on behalf of the FSC with regard to a transaction, or group of transactions, the requirements of section 925(c) will be met if the FSC pays the related supplier an amount equal to the direct and indirect expenses related to the required activities. See paragraph (c)(6)(ii) of this section for the amount of compensation due the related supplier. The payment made to the related supplier must be reflected on the FSC's books and must be taken into account in computing the FSC's and related supplier's combined taxable income. If it is determined that the related supplier was not compensated for all the expenses related to the required activities or if the entire payment is not reflected on the FSC's books or in computing combined taxable income, the administrative pricing methods may be used but proper adjustments will be made to the FSC's and related supplier's books or income. At the election of the FSC and related supplier, the requirements of section 925(c) will be deemed to have been met if the related supplier is paid by the FSC an amount equal to all of the costs under paragraph (c)(6)(iii)(D) of this section (limited by paragraph (c)(6)(ii) of this section) related to the export sale, other than expenses relating to activities performed directly by the FSC or by a person other than the related supplier, and if that payment is reflected on the FSC's books and in computing the FSC's and related supplier's combined taxable income on the transaction, or group of transactions. If it is determined that the related supplier was not compensated for all its expenses or if the entire payment is not reflected on the FSC's books or in computing combined taxable income, the administrative pricing methods may be used but proper adjustments will be made to the FSC's and related supplier's books or income. All activities that are performed in connection with foreign military sales are considered to be performed by the FSC, or under contract with the FSC, if they are performed by the United States government even though the United States government has not contracted for the performance of those activities. All actual costs incurred by the FSC and related supplier in connection with the performance of those activities must be taken into account, however, in determining the combined taxable income of the FSC and related supplier.

(iii) *Allowable transactions for purposes of the administrative pricing methods.* If the required performance of activities has been met, the administrative pricing methods may be applied to a transaction between a related supplier and a FSC only in the following circumstances.

(A) The related supplier sells export property (as defined in section 927(a) and §1.927(a)–1T) to the FSC for resale or the FSC acts as a commission agent for the related supplier on sales by the related supplier of export property to third parties, whether or not related parties. For purposes of this section, references to sales include references to exchanges or other dispositions.

(B) The related supplier leases export property to the FSC for sublease for a comparable period with comparable terms of payment, or the FSC acts as commission agent for the related supplier on leases of export property by the related supplier, to third parties whether or not related parties.

(C) Services are furnished by a FSC as principal or by a related supplier if a FSC is a commission agent for the related supplier which are related and subsidiary to any sale or lease by the FSC, acting as principal or commission agent, of export property under subdivision (iii)(A) and (B) of this paragraph.

(D) Engineering or architectural services for construction projects located (or proposed for location) outside of the United States are furnished by the FSC if the FSC is acting as principal, or by the related supplier if the FSC is a commission agent for the related supplier, with respect to the furnishing of the services to a third party whether or not a related party.

(E) The FSC acting as principal, or the related supplier where the FSC is a commission agent, furnishes managerial services in furtherance of the production of foreign trading gross receipts of an unrelated FSC or the production of qualified export receipts of an unrelated interest charge DISC.

This subdivision (iii)(E) shall not apply for any taxable year unless at least 50 percent of the gross receipts for such taxable year of the FSC or of the related supplier, whichever party furnishes the managerial services, is derived from activities described in subdivision (iii)(A), (B), or (C) of this paragraph.

(c) *Transfer price for sales of export property*—(1) *In general.* Under this paragraph, rules are prescribed for computing the allowable price for a transfer from a related supplier to a FSC in the case of a sale, described in paragraph (b)(2)(iii)(A) of this section, of export property.

(2) *The "1.83 percent" gross receipts method.* Under the gross receipts method of pricing, described in section 925(a)(1), the transfer price for a sale by the related supplier to the FSC is the price as a result of which the profit derived by the FSC from the sale will not exceed 1.83 percent of the foreign trading gross receipts of the FSC derived from the sale of the export property. Pursuant to section 925(d), the amount of profit derived by the FSC under this method may not exceed twice the amount of profit determined under, at the related supplier's election, either the combined taxable income method of §1.925(a)–1T(c)(3) or the marginal

costing rules of §1.925(b)–1T. For FSC taxable years beginning after December 31, 1986, if the related supplier elects to determine twice the profit determined under the combined taxable income method using the marginal costing rules, because of the no-loss rule of §1.925(a)–1T(e)(1)(i), the profit that may be earned by the FSC is limited to 100% of the full costing combined taxable income as determined under §1.925(a)–1T(c)(3) and (6). Interest or carrying charges with respect to the sale are not foreign trading gross receipts.

(3) *The "23 percent" combined taxable income method.* Under the combined taxable income method of pricing, described in section 925(a)(2), the transfer price for a sale by the related supplier to the FSC is the price as a result of which the profit derived by the FSC from the sale will not exceed 23 percent of the full costing combined taxable income (as defined in paragraph (c)(6) of this section) of the FSC and the related supplier attributable to the foreign trading gross receipts from such sale.

(4) *Section 482 method.* If the methods of paragraph (c)(2) and (3) of this section are inapplicable to a sale or if the related supplier does not choose to use them, the transfer price for a sale by the related supplier to the FSC is to be determined on the basis of the sales price actually charged but subject to the rules provided by section 482 and the regulations for that section and by §1.925(a)–1T(a)(3)(ii).

(5) *Incomplete transactions.* (i) For purposes of the gross receipts and combined taxable income methods, if export property which the FSC purchased from the related supplier is not resold by the FSC before the close of either the FSC's taxable year or the taxable year of the related supplier during which the export property was purchased by the FSC from the related supplier, then—

(A) The transfer price of the export property sold by the FSC during that year shall be computed separately from the transfer price of the export property not sold by the FSC during that year.

(B) With respect to the export property not sold by the FSC during that year, the transfer price paid by the FSC for that year shall be the related supplier's cost of goods sold (see paragraph (c)(6)(iii)(C) of this section) with respect to the property.

(C) For the subsequent taxable year during which the export property is resold by the FSC, an additional amount shall be paid by the FSC (to be treated as income for the later year in which it is received or accrued by the related supplier) equal to the excess of the amount which would have been the transfer price under this section had the transfer to the FSC by the related supplier and the resale by the FSC taken place during the taxable year of the FSC during which it resold the property over the amount already paid under subdivision (B) of this paragraph.

(D) The time and manner of payment of transfer prices required by subdivisions (i)(B) and (C) of this paragraph shall be determined under paragraphs (e)(3), (4) and (5) of this section.

(ii) For purposes of this paragraph, a FSC may determine the year in which it received property from a related supplier and the year in which it resells property in accordance with the method of identifying goods in its inventory properly used under section 471 or section 472 (relating respectively to the general rule for inventories and to the rule for LIFO inventories). Transportation expense of the related supplier in connection with a transaction to which this paragraph applies shall be treated as an item of cost of goods sold with respect to the property if the related supplier includes the cost of intracompany transportation between its branches, divisions, plants, or other units in its cost of goods sold (see paragraph (c)(6)(iii)(C) of this section).

(6) *Full costing combined taxable income*—(i) *In general.* For purposes of section 925 and this section, if a FSC is the principal on the sale of export property, the full costing combined taxable income of the FSC and its related supplier from the sale is the excess of the foreign trading gross receipts of the FSC from the sale over the total costs of the FSC and related supplier including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs (see §1.471–11(c)(2)(ii)) which relate to the foreign trading gross receipts. Interest

or carrying charges with respect to the sale are not foreign trading gross receipts.

(ii) *Section 482 applicability.* Combined taxable income under this paragraph shall be determined after taking into account under paragraph (e)(2) of this section all adjustments required by section 482 with respect to transactions to which the section is applicable. If a related supplier performs services under contract with a FSC, the FSC shall compensate the related supplier an arm's length amount under the provisions of §1.482–2(b) (1) through (6). Section 1.482–2(b)(7), which provides that an arm's length charge shall not be deemed equal to costs or deductions with respect to services which are an integral part of the business activity of either the member rendering the services (*i.e.*, the related supplier) or the member receiving the benefit of the services (*i.e.*, the FSC), shall not apply if the administrative pricing methods of section 925(a)(1) and (2) are used to compute the FSC's profit and if the related supplier is the person rendering the services. Section 1.482–2(b)(7) shall apply, however, if a related person other than the related supplier is the person rendering the services or if the section 482 method of section 925(a)(3) is used to compute the FSC's profit. See §1.925(a)–1T(a)(3)(ii). For a special rule for computation of combined taxable income where the related supplier is a qualified cooperative shareholder of the FSC, see paragraph (c)(7) of this section.

(iii) *Rules for determination of gross receipts and total costs.* In determining the gross receipts of the FSC and the total costs of the FSC and related supplier which relate to such gross receipts, the rules set forth in subdivisions (iii)(A) through (E) of this paragraph shall apply.

(A) Subject to the provisions of subdivisions (iii)(B) through (E) of this paragraph, the methods of accounting used by the FSC and related supplier to compute their taxable incomes will be accepted for purposes of determining the amounts of items of income and expense (including depreciation) and the taxable year for which those items are taken into account.

(B) A FSC may, generally, choose any method of accounting permissible under section 446(c) and the regulations under that section. However, if a FSC is a member of a controlled group (as defined in section 927(d)(4) and §1.924(a)–1T(h)), the FSC may not choose a method of accounting which, when applied to transactions between the FSC and other members of the controlled group, will result in a material distortion of the income of the FSC or of any other member of the controlled group. Changes in the method of accounting of a FSC are subject to the requirements of section 446(e) and the regulations under that section.

(C) Cost of goods sold shall be determined in accordance with the provisions of §1.61–3. See sections 471 and 472 and the regulations thereunder with respect to inventories. With respect to property to which an election under section 631 applies (relating to cutting of timber considered as a sale or exchange), cost of goods sold shall be determined by applying §1.631–1 (d)(3) and (e) (relating to fair market value as of the beginning of the taxable year of the standing timber cut during the year considered as its cost).

(D) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are the expenses, losses, and deductions definitely related, and therefore allocated and apportioned thereto, and a ratable part of any other expenses, losses, or deductions which are not definitely related to any class of gross income, determined in a manner consistent with the rules set forth in §1.861–8. The deduction for depletion allowed by section 611 relates to gross receipts from sales of export property and shall be taken into account in computing the combined taxable income of the FSC and its related supplier.

(7) *Cooperatives and combined taxable income method.* If a qualified cooperative, as defined in section 1381(a), sells export property to a FSC of which it is a shareholder, the combined taxable income of the FSC and the cooperative shall be computed without taking into account deductions allowed under section 1382 (b) and (c) for patronage dividends, per-unit retain allocations and

nonpatronage distributions. The FSC and cooperative must take into account, however, when computing combined taxable income, the cooperative's cost of goods sold, or cost of purchases.

(8) *Grouping transactions.* (i) The determinations under this section are to be made on a transaction-by-transaction basis. However, at the annual choice made by the related supplier if the administrative pricing methods are used, some or all of these determinations may be made on the basis of groups consisting of products or product lines. The election to group transactions shall be evidenced on Schedule P of the FSC's timely filed U.S. income tax return (including extensions thereof) for the taxable year. No untimely or amended returns will be allowed to elect to group, to change a grouping basis, or to change from a grouping basis to a transaction-by-transaction basis. The rules of the previous two sentences of this paragraph (c)(8)(i) are applicable to taxable years beginning after December 31, 1997. For any taxable year beginning before January 1, 1998, for which a redetermination is otherwise permissible under paragraph (e)(4) of this section as in effect for taxable years beginning before January 1, 1998, a redetermination of grouping of transactions cannot be made later than the due date of the FSC's timely filed U.S. income tax return (including extensions thereof) for the FSC's first taxable year beginning after December 31, 1997. The language ''or grouping of transactions'' is removed from the fourth sentence of paragraph (e)(4) of this section, applicable to taxable years beginning after December 31, 1997.

(ii) A determination by the related supplier as to a product or a product line will be accepted by a district director if such determination conforms to either of the following standards: Recognized trade or industry usage, or the two-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President. A product shall be included in only one product line for purposes of this section if a product otherwise falls within more than one product line classification.

(iii) A choice by the related supplier to group transactions for a taxable year on a product or product line basis shall apply to all transactions with respect to that product or product line consummated during the taxable year. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are to be made on a transaction-by-transaction basis. For example, the related supplier may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year. Sale transactions may not be grouped, however, with lease transactions.

(iv) For purposes of this section, transactions involving military property, as defined in section 923(a)(5) and § 1.923–1T(b)(3)(ii), may be grouped only with other military property included within the same product or product line grouping determined under the standards of subdivision (8)(ii) of this paragraph. Non-military property included within a product or product line grouping which includes military property may be grouped, at the election of the related supplier, under the general grouping rules of subdivisions (i) through (iii) of this paragraph.

(v) A special grouping rule applies to agricultural and horticultural products sold to the FSC by a qualified cooperative if the FSC satisfies the requirements of section 923(a)(4). Section 923(a)(4) increases the amount of the FSC's exempt foreign trade income with regard to sales of these products, see § 1.923–1T(b)(2). This special grouping rule provides that if the related supplier elects to group those products that no other export property may be included within that group. Export property which would have been grouped under the general grouping rules of subdivisions (i) through (iii) of this paragraph with the export property covered by this special grouping rule may be grouped, however, at the election of the related supplier, under the general grouping rules.

(vi) For rules as to grouping certain related and subsidiary services, see paragraph (d)(3)(ii) of this section.

(vii) If there is more than one FSC (or more than one small FSC) within a controlled group of corporations, the same grouping of transactions, if any, must be used by all FSCs (or small FSCs) within the controlled group. If the same grouping of transactions is required by this subdivision, and if grouping is elected, the same transfer pricing method must be used to determine each FSC's (or small FSC's) taxable income with respect to that grouping.

(viii) The product or product line groups that are established for purposes of determining combined taxable income may be different from the groups that are established with regard to economic processes (see §1.924(d)–1(e)).

(d) *Rules under section 925(a)(1) and (2) for transactions other than sales by a FSC.* The following rules are prescribed for purposes of applying the gross receipts method or combined taxable income method to transactions other than sales by a FSC.

(1) *Leases.* In the case of a lease of export property by a related supplier to a FSC for sublease by the FSC, the amount of rent the FSC must pay to the related supplier shall be computed in a manner consistent with the rules in paragraph (c) of this section for computing the transfer price in the case of sales and resales of export property under the gross receipts method or combined taxable income method. Transactions may not be so grouped on a product or product line basis under the rules of paragraph (c)(8) of this section as to combine in any one group of transactions both lease transactions and sale transactions.

(2) *Commissions.* If any transaction to which section 925 applies is handled on a commission basis for a related supplier by a FSC and if commissions paid to the FSC give rise to gross receipts to the related supplier which would have been foreign trading gross receipts under section 924(a) had the FSC made the sale directly then—

(i) The administrative pricing methods of section 925(a)(1) and (2) may be used to determine the FSC's commission income only if the requirements of section 925(c) (relating to activities that must be performed in order to use the administrative pricing methods) are met, see §1.925(a)–1T(b)(2)(ii).

(ii) The amount of the income that may be earned by the FSC in any year is the amount, computed in a manner consistent with paragraph (c) of this section, which the FSC would have been permitted to earn under the gross receipts method, the combined taxable income method, or the section 482 method if the related supplier had sold (or leased) the property or service to the FSC and the FSC had in turn sold (or subleased) to a third party, whether or not a related party.

(iii) The combined taxable income of a FSC and the related supplier from the transaction is the excess of the related supplier's gross receipts from the transaction which would have been foreign trading gross receipts had the sale been made by the FSC directly over the related supplier's and the FSC's total costs, excluding the commission paid or payable to the FSC, but including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs (see §1.471–11(c)(2)(ii)) which relate to the gross receipts from the transaction. The related supplier's gross receipts for purposes of the administrative pricing methods shall be reduced by carrying charges, if any, as computed under §1.927(d)–1(a)(Q&A2). These carrying charges shall remain income of the related supplier.

(iv) The maximum commission the FSC may charge the related supplier is the amount of income determined under subdivisions (ii) and (iii) of this paragraph plus the FSC's total costs for the transaction as determined under paragraph (c)(6) of this section.

(3) *Receipts from services*—(i) *Related and subsidiary services attributable to the year of the export transaction.* The gross receipts for related and subsidiary services described in paragraph (b)(2)(iii)(C) of this section shall be treated as part of the receipts from the export transaction to which such services are related and subsidiary, but only if, under the arrangement between the FSC and its related supplier and the accounting method otherwise employed by the FSC, the income from

such services is includible for the same taxable year as income from such export transaction.

(ii) *Other services.* Income from the performance of related and subsidiary services will be treated as a separate type of income if subdivision (i) of this paragraph does not apply. Income from the performance of engineering and architectural services and certain managerial services, as defined in paragraphs (b)(2)(iii)(D) and (E), respectively, of this section, will in all situations be treated as separate types of income. If this subdivision (ii) applies, the amount of taxable income which the FSC may derive for any taxable year shall be determined under the arrangement between the FSC and its related supplier and shall be computed in a manner consistent with the rules in paragraph (c) of this section for computing the transfer price in the case of sales for resale of export property under the transfer pricing rules of section 925. Related and subsidiary services to which the above subdivision (i) of this paragraph does not apply may be grouped, under the rules for grouping of transactions in paragraph (c)(8) of this section, with the products or product lines to which they are related and subsidiary, so long as the grouping of services chosen is consistent with the grouping of products or product lines chosen for the taxable year in which either the products or product lines were sold or in which payment for the services is received or accrued. Grouping of transactions shall not be allowed with respect to the determination of taxable income which the FSC may derive from services described in paragraph (b)(2)(iii)(D) or (E) of this section whether performed by the FSC or by the related supplier. Those determinations shall be made only on a transaction-by-transaction basis.

(e) *Special rules for applying paragraphs (c) and (d) of this section*—(1) *Limitation on FSC income (''no loss'' rules).* (i) If there is a combined loss on a transaction or group of transactions, a FSC may not earn a profit under either the combined taxable income method or the gross receipts method. Also, for FSC taxable years beginning after December 31, 1986, in applying the gross receipts method, the FSC's profit may not exceed 100% of full costing combined taxable income determined under the full costing method of § 1.925(a)–1T(c)(3) and (6). This rule prevents pricing at a loss to the related supplier. The related supplier may in all situations set a transfer price or rental payment or pay a commission in an amount that will allow the FSC to recover an amount not in excess of its costs, if any, even if to do so would create, or increase, a loss in the related supplier.

(ii) For purposes of determining whether a combined loss exists, the basis for grouping transactions chosen by the related supplier under paragraph (c)(8) of this section for the taxable year shall apply.

(iii) If a FSC recognizes income while the related supplier recognizes a loss on a sale transaction under the section 482 method, neither the combined taxable income method nor the gross receipts method may be used by the FSC and related supplier (or by a FSC in the same controlled group and the related supplier) for any other sale transaction, or group of sale transactions, during a year which fall within the same three digit Standard Industrial Classification as the subject sale transaction. The reason for this rule is to prevent the segregation of transactions for the purposes of allowing the related supplier to recognize a loss on the subject transactions, while allowing the FSC to earn a profit under the administrative pricing methods on other transactions within the same three digit Standard Industrial Classification.

(2) *Relationship to section 482.* In applying the administrative pricing methods, it may be necessary to first take into account the price of a transfer (or other transaction) between the related supplier (or FSC) and a related party which is subject to the arm's length standard of section 482. Thus, for example, if a related supplier sells to a FSC export property which the related supplier purchased from related parties, the costs taken into account in computing the combined taxable income of the FSC and the related supplier are determined after any necessary adjustment under section 482 of the price paid by the related supplier

to the related parties. In applying section 482 to a transfer by a FSC to a related party, the parties are treated as if they were a single entity carrying on all the functions performed by the FSC and the related supplier with respect to the transaction. The FSC shall be allowed to receive under the section 482 standard the amount the related supplier would have received had there been no FSC.

(3) *Creation of receivables.* (i) If the amount of the transfer price or rental payment actually charged by a related supplier to a FSC or the sales commission actually charged by a FSC to a related supplier has not been paid, an account receivable and payable will be deemed created as of the due date under section 6072(b), including extensions provided for under section 6081, of the FSC's tax return for the taxable year of the FSC during which a transaction to which section 925 is applicable occurs. The receivable and payable will be in an amount equal to the difference between the amount of the transfer price or rental payment or commission determined under section 925 and this section and the amount (if any) actually paid or received. For example, a calendar year FSC's related supplier paid the FSC on July 1, 1985, a commission of $50 on the sale of export property. On September 15, 1986, the extended due date of the FSC's income tax return for taxable year 1985, the related supplier determined that the commission should have been $60. The additional $10 of commission had not been paid. Accordingly, an interest-bearing payable to the FSC from the related supplier in the amount of $10 was created as of September 15, 1986. A $10 interest bearing receivable was also created on the FSC's books.

(ii) An indebtedness arising under the above subdivision (i) shall bear interest at an arm's length rate, computed in the manner provided by §1.482–2(a)(2), from the due date under section 6072(b), including extensions provided for under section 6081, of the FSC's tax return for the taxable year of the FSC in which the transaction occurred which gave rise to the indebtedness to the date of payment of the indebtedness. The interest so computed shall be accrued and included in the taxable income of the person to whom the indebtedness is owed for each taxable year during which the indebtedness is unpaid if that person is an accrual basis taxpayer or when the interest is paid if a cash basis taxpayer. Because the transactions covered by this subdivision are between the related supplier and FSC, the carrying charges provisions of §1.927(d)–1(a) do not apply.

(iii) Payment of dividends, transfer prices, rents, commissions, service fees, receivables, or payables may be in the form of money, property, sales discount, or an accounting entry offsetting the amount due the related supplier, or FSC, whichever applies, against an existing debt of the other party to the transaction. This provision does not eliminate the requirement that actual cash payments be made by the related supplier to a commission FSC if the receipt of payment test of section 924(e)(4) is used to meet the foreign economic process requirements of section 924(d). The offset accounting entries must be clearly identified in both the related supplier's and FSC's books of account.

(4) *Subsequent determination of transfer price, rental income or commission.* The FSC and its related supplier would ordinarily determine under section 925 and this section the transfer price or rental payment payable by the FSC or the commission payable to the FSC for a transaction before the FSC files its return for the taxable year of the transaction. After the FSC has filed its return, a redetermination of those amounts by the Commissioner may only be made if specifically permitted by a Code provision or regulations under the Code. Such a redetermination would include a redetermination by reason of an adjustment under section 482 and the regulations under that section or section 861 and §1.861–8 which affects the amounts which entered into the determination. In addition, a redetermination may be made by the FSC and related supplier if their taxable years are still open under the statute of limitations for making claims for refund under section 6511 if they determine that a different transfer pricing method may be more beneficial. Also, the FSC and related supplier may redetermine the amount of

foreign trading gross receipts and the amount of the costs and expenses that are used to determine the FSC's and related supplier's profits under the transfer pricing methods. Any redetermination shall affect both the FSC and the related supplier. The FSC and the related suppler may not redetermine that the FSC was operating as a commission FSC rather than a buy-sell FSC, and vice versa. For the election to group transactions for purposes of applying the administrative pricing methods, see paragraph (c)(8)(i) of this section.

(5) *Procedure for adjustments to redeterminations.* (i) If a redetermination under paragraph (e)(4) of this section is made of the transfer price, rental payment or commission for a transaction, or group of transactions, the person who was underpaid under this redetermination shall establish (or be deemed to have established), at the date of the redetermination, an account receivable from the person with whom it engaged in the transaction equal to the difference between the amounts as redetermined and the amounts (if any) previously paid and received, plus the amount (if any) of the account receivable determined under paragraph (e)(3) of this section that remains unpaid. A corresponding account payable will be established by the person who underpaid the amount due.

(ii) An account receivable established in accordance with the above subdivision (5)(i) of this paragraph shall bear interest at an arm's length rate, computed in the manner provided by § 1.482–2(a)(2), from the day after the date the account receivable is deemed established to the date of payment. The interest so computed shall be accrued and included in the taxable income for each taxable year during which the account receivable is outstanding of an accrual basis taxpayer or when paid if a cash basis taxpayer.

(iii) In lieu of establishing an account receivable in accordance with the above subdivision (5)(i) of this paragraph for all or part of an amount due a related supplier, the related supplier and FSC are permitted to treat all or part of any current or prior distribution which was made by the FSC as an additional payment of transfer price or rental payment or repayment of commission (and not as a distribution) made as of the date the distribution was made. Any additional amount arising on the redetermination due the related supplier after this treatment shall be represented by an account receivable established under the above subdivision (5)(i) of this paragraph. To the extent that a distribution is so treated under this subdivision (5)(iii), it shall cease to qualify as a distribution for any Federal income tax purpose. If all or part of any distribution made to a shareholder other than the related supplier is recharacterized under this subdivision (5)(iii), the related supplier shall establish an account receivable from that shareholder for the amount so recharacterized. The Commissioner may prescribe by Revenue Procedure conditions and procedures that must be met in order to obtain the relief provided by this subdivision (5)(iii).

(iv) The procedure for adjustments to transfer price provided by this paragraph does not apply to incomplete transactions described in paragraph (c)(5) of this section. Such procedure will, however, be applied to any such transaction with respect to the taxable year in which the transaction is completed.

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

Example 1. In 1985, F, a FSC, purchases export property from R, a domestic manufacturer of export property A. R is F's related supplier. The sale from R to F is made under a written agreement which provides that the transfer price between R and F shall be that price which allocates to F the maximum amount permitted to be received under the transfer pricing rules of section 925. F resells property A in 1985 to an unrelated purchaser for $1,000. The terms of the sales contract between F and the unrelated purchaser provide that payment of the $1,000 sales price will be made within 90 days after sale. The purchaser pays the entire sales price within 60 days. F incurs indirect and direct expenses in the amount of $260 attributable to the sale which relate to the activities and functions referred to in section 924 (c), (d) and (e). In addition, F incurs additional expenses attributable to the sale in the amount of $35. R's cost of goods sold attributable to the export property is $550. R incurred direct selling expenses in connection with the sale of $50. R's deductible general and administrative expenses allocable to all gross income are $200.

Apportionment of those supportive expenses on the basis of gross income does not result in a material distortion of income and is a reasonable method of apportionment. R's direct selling expenses and its general and administrative expenses were not required to be incurred by F. R's gross income from sources other than the transaction is $17,550 resulting in total gross income of R and F (excluding the transfer price paid by F) of $18,000 ($450 plus $17,550). For purposes of this example, it is assumed that if R sold the export property to F for $690, the price could be justified as satisfying the standards of section 482. Under these facts, F may earn, under the combined taxable income method, the more favorable of the three transfer pricing rules, a profit of $23 on the sale. (Unless otherwise indicated, all examples in this section assume that the marginal costing method of §1.925(b)–1T does not result in a higher profit than the profit under the full costing combined taxable income method of paragraphs (c)(3) and (6) of this section.) F's profit and the transfer price to F from the transaction, using the administrative pricing methods, and F's profit if the transfer price is determined under section 482, would be as follows:

Combined taxable income:	
F's foreign trading gross receipts	$1,000.00
R's cost of goods sold	(550.00)
Combined gross income	450.00
Less:	
R's direct selling expenses	50.00
F's expenses	295.00
Apportionment of R's general and administrative expenses:	
R's total G/A expenses	200.00
Combined gross income	450.00
R's and F's total gross income (foreign and domestic)	18,000.00
Apportionment of G/A expenses:	
$200×$450/$18,000	5.00
Total	(350.00)
Combined taxable income	100.00

The section 482 method—Transfer price to F and F's profit:	
Transfer price to F	$690.00
F's profit:	
F's foreign trading gross receipts	1,000.00
Less:	
F's cost of goods sold	690.00
F's expenses	295.00
Total	(985.00)
F's profit	15.00

The gross receipts method—F's profit and transfer price to F:	
F's profit—lesser of 1.83% of F's foreign trading gross receipts ($18.30) or two times F's profit under the combined taxable income method ($46.00) (See below) (Unless otherwise indicated, all examples in this section assume that the marginal costing method of §1.925(b)–1T does not result in a higher profit than the profit under the full costing combined taxable income method)	18.30
Transfer price to F:	
F's foreign trading gross receipts	1,000.00
Less:	
F's expenses	295.00
F's profit	18.30
Total	(313.30)
Transfer price	686.70

The combined taxable income method— F's profit and transfer price to F:	
F's profit—23% of combined taxable income ($100)	$23.00
Transfer price to F:	
F's foreign trading gross receipts	1,000.00
Less:	
F's expenses	295.00
F's profit	23.00
Total	(318.00)
Transfer price	682.00

With a profit of $23 under the most favorable of the transfer pricing methods, F's exempt foreign trade income under section 923 would be $207.39, computed as follows:

F's foreign trading gross receipts	$1,000.00

F's costs of purchases (transfer price)	(682.00)
F's foreign trade income	318.00
F's exempt foreign trade income $318×15/23	207.39

F's taxable income would be $8.00, computed as follows:

F's foreign trade income	$318.00
F's exempt foreign trade income	(207.39)
F's non-exempt foreign trade income	110.61
Less:	
F's expenses allocable to non-exempt foreign trade income $295×$110.61/$318	(102.61)
F's taxable income	8.00

Of F's total expenses, $192.39 ($295×$207.39/$318) are allocated to F's exempt foreign trade income and are disallowed for purposes of computing F's taxable income.

Example 2. Assume the same facts as in *Example 1* except that the purchaser pays the entire sales price 96 days after delivery, well beyond the 60 day period in which payment must be made to avoid recharacterization of part of the contract price as carrying charges. Therefore, the contract price of $1,000 includes $10 of carrying charges, assuming a discount rate of 10%. See § 1.927(d)–1(a) (Q & A2) for computation method for determining amount of carrying charges. Under these facts, F may earn, under the combined taxable income method, the most favorable of the three transfer pricing rules, a profit of $20.73 on the sale. F's profit and the transfer price to F under the transfer pricing rules, assuming that a carrying charge is incurred, would be as follows:

Combined taxable income:	
F's foreign trading gross receipts	$990.00
R's cost of goods sold	(550.00)
Combined gross income	440.00
Less:	
R's direct selling expenses	50.00
R's apportioned G/A expenses:	
$200×$440/$18,000	4.89
F's expenses	295.00
Total	(349.89)
Combined taxable income	90.11

The combined taxable income method—F's profit and transfer price to F:	
F's profit—23% of combined taxable income ($90.11)	$20.73
Transfer price to F:	
F's foreign trading gross receipts	990.00
Less:	
F's expenses	295.00
F's profit	20.73
Total	(315.73)
Transfer price	674.27

The gross receipts method—F's profit and transfer price to F:	
F's profit—lesser of 1.83% of F's foreign trading gross receipts ($18.12) or two times F's profit under the combined taxable income method ($41.46)	$18.12
Transfer price to F: F's foreign trading gross receipts	990.00
Less:	
F's expenses	295.00
F's profit	18.12
Total	(313.12)
Transfer price	676.88

The section 482 method—Transfer price to F and F's profit:	
Transfer price to F	690.00
F's profit:	
F's foreign trading gross receipts	990.00
Less:	
F's cost of goods sold	690.00
F's expenses	295.00
Total	(985.00)
F's profit	5.00

Example 3. R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During 1985, R produces and sells a product line of export property to F for $157, a price which can be justified as satisfying the arm's length price standard of section 482. The sale from R to F is made under a written agreement which provides that the transfer price between R and F shall be that price which allocates to F the maximum amount permitted to be received under the transfer pricing rules of section

925. F resells the export property for $200. R's cost of goods sold attributable to the export property is $115 so that the combined gross income from the sale of the export property is $85 (*i.e.*, $200 minus $115). R incurs $18 in direct selling expenses in connection with the sale of the property. R's deductible general and administrative expenses allocable to all gross income are $120. R's direct selling and its general and administrative expenses were not required to be incurred by F. R's gross income from sources other than the transaction is $5,015 resulting in total gross income of R and F (excluding the transfer price paid by F) of $5,100 (*i.e.*, $85 plus $5,015). F incurs $50 in direct and indirect expenses attributable to resale of the export property. Of those expenses, $45 relate to activities and functions referred to in section 924 (c), (d) and (e). The maximum profit which F may earn with respect to the product line is $3.66, computed as follows:

Combined taxable income:	
F's foreign trading gross receipts	$200.00
R's cost of goods sold	(115.00)
Combined gross income	85.00
Less:	
R's direct selling expenses	18.00
R's apportioned G/A expenses: $120×$85/$5,100	2.00
F's expenses	50.00
Total	(70.00)
Combined taxable income	15.00
The combined taxable income method—F's profit:	
F's profit—23% of combined taxable income ($15)	$ 3.45
The gross receipts method—F's profit:	
F's profit—lesser of 1.83% of F's foreign trading gross receipts ($3.66) or two times F's profit under the combined taxable income method ($6.90)	$3.66
The section 482 method—F's profit:	
F's foreign trading gross receipts	200.00
Less:	
F's cost of goods sold	157.00
F's expenses	50.00
Total	(207.00)
F's profit (loss)	(7.00)

Since the gross receipts method results in a greater profit to F ($3.66) than does either the combined taxable income method ($3.45) or the section 482 method (a loss of $7), and does not exceed twice the profit under the combined taxable income method, F may earn a maximum profit of $3.66. Accordingly, the transfer price from R to F may be readjusted as long as the transfer price is not readjusted below $146.34, computed as follows:

Transfer price to F:	
F's foreign trading gross receipts	$ 200.00
Less:	
F's expenses	50.00
F's profit	3.66
Total	(53.66)
Transfer price	146.34

Example 4. R and F are fiscal year May 31 year-end taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During August of 1987, R produces and sells 100 units of export property A to F under a written agreement which provides that the transfer price between R and F shall be that price which allocates to F the maximum profit permitted to be received under the transfer pricing rules of section 925. Thereafter, the 100 units are resold for export by F for $950. R's cost of goods sold attributable to the 100 units is $650. R incurs costs, both direct and indirect, in the amount of $270 with regard to activities and functions referred to in section 924 (c), (d) and (e) which it was under contract with F to perform for F. R's direct selling expenses are $40. Those expenses were not required to be incurred by F. For purposes of this example, assume that R has no general and administrative expenses other than those relating to the section 924 (c), (d) and (e) activities and functions. F incurs expenses in the amount of $290 attributable to the resale which relate to the activities and functions referred to in section 924 (c), (d) and (e). Of that amount, $270 was paid to R under contract to perform the activities in section 924. The remaining $20 was paid to independent contractors. R chooses not to apply the section 482 transfer pricing method to determine F's profit on the transaction. F may not earn any income under either the gross receipts (see the special no-loss rule of paragraph (e)(1)(i) of this section) or the combined taxable income administrative pricing methods with respect to resale of the 100 units because there is a combined loss of $(30) on the transaction, computed as follows:

Combined taxable income:	
F's foreign trading gross receipts	$ 950.00
R's cost of goods sold	(650.00)
Combined gross income	300.00
Less:	
R's direct selling expenses	40.00
F's expenses	290.00
Total	(330.00)
Combined taxable income (loss)	(30.00)

Under paragraph (e)(1)(i) of this section, F is permitted to recover its expenses attributable to the sale ($290) even though such recovery results in a loss or increased loss to the related supplier. Accordingly, the transfer price from R to F may be readjusted as long as the transfer price is not readjusted below $660, computed as follows:

Transfer price to F:	
F's foreign trading gross receipts	$950.00
Less:	
F's expenses	(290.00)
Transfer price	660.00

Example 5. Assume the same facts as in *Example 4* except that F performs the section 924 (c), (d) and (e) activities and functions and that R chooses to apply the section 482 transfer pricing method. Under the standards of section 482, a transfer price from R to F of $650 is an arm's length price. Accordingly, the transfer price to F and F's profit on the subsequent resale of product A ($10) are as follows:

The section 482 method—Transfer price to F and F's profit:	
Transfer price to F	$650.00
F's profit:	
F's foreign trading gross receipts	950.00
F's cost of purchases	(650.00)
F's gross income	300.00
Less:	
F's expenses	(290.00)
F's profit	10.00

This sale of product A results in a loss to R of $40 (transfer price of $650 less R's cost of goods sold of $650 and direct selling expenses of $40). Since R chose to use the section 482 transfer pricing method on this loss transaction, under the special no loss rule of paragraph (e)(1)(iii) of this section, the administrative pricing methods of section 925(a)(1) and (2) may not be used for any other sale transactions, or group of sale transactions, during the same year of other products which fall within the same three digit Standard Industrial Classification as product A. F's profit, if any, on these sales must be computed under the section 482 transfer pricing method.

Example 6. R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During 1985, R manufactures 100 units of export property A. R enters into a written agreement with F whereby F is granted a sales franchise with respect to export property A and F will receive commissions with respect to these exports equal to the maximum amount permitted to be received under the administrative pricing rules of section 925 (a)(1) and (2). Thereafter, the 100 units are sold for export by R for $1,000. The total sales price of $1,000 was paid by the purchaser to R within 60 days of the sales transaction. The entire $1,000 would have been foreign trading gross receipts had F been the principal on the sale. R's cost of goods sold attributable to the 100 units is $650. R's direct selling expenses so attributable are $50. R's deductible general and administrative expenses, other than those attributable to the section 924 (c), (d) and (e) activities and functions, allocable to all gross income are $200. Apportionment of those supportive expenses on the basis of gross income does not result in a material distortion of income and is a reasonable method of apportionment. R's direct selling expenses and the portion of the general and administrative expenses not relating to the activities and functions referred to in section 924 (c), (d) and (e) were not required to be incurred by F. R's gross income from sources other than the transaction is $17,650 resulting in total gross income of $18,000 ($350 plus $17,650). R and a related person perform on F's behalf the activities and functions referred to in section 924 (c), (d) and (e). In performing these activities, R and the related person incurred expenses, both direct and indirect, of $200 and $45, respectively. F pays $200 to R under contract and $50 to the related person. The maximum profit which F may earn under the franchise pursuant to the administrative pricing rules is $18.30, computed as follows:

Combined taxable income:	
R's gross receipts from the sale	$1,000.00
R's cost of goods sold	(650.00)
Combined gross income	350.00

Less:	
R's direct selling expenses	50.00
F's expenses	250.00
Apportionment of R's general and administrative expenses:	
R's total G/A expenses	200.00
Combined gross income	350.00
R's and F's total gross income (foreign and domestic)	18,000.00
Apportionment of G/A expenses:	
$200×$350/$18,000	3.89
Total	(303.89)
Combined taxable income	46.11

As reflected in the above computation, F included on its books $200 of expenses related to the section 924 activities and performed by R on behalf of F. R incurred $253.89 of expenses. These expenses were reflected on its books. Under paragraph (b)(2)(ii) of this section, R and F may elect to include all of the expenses related to the export sales on F's books. This will satisfy the requirements of section 925(c) without requiring an allocation of the expenses between R and F. Under this election, as reflected in the following computation, combined taxable income will still be $46.11 but, as reflected in a later part of this example, the commission due F will be increased by $253.89:

Combined taxable income:	
R's gross receipts from the sale	$1,000.00
R's cost of goods sold	(650.00)
Combined gross income	350.00
Less:	
F's expenses	(303.89)
Combined taxable income	46.11
The combined taxable income method—F's profit:	
F's profit—23% of combined taxable income ($46.11)	$10.61
The gross receipts method—F's profit:	
F's profit—lesser of 1.83% of R's gross receipts ($18.30) or two times F's profit under the combined taxable income method ($21.22)	$18.30

If the election provided for in paragraph (b)(2)(ii) of this section is not made, F may receive a commission from R in the amount of $268.30, computed as follows:

F's expenses	$250.00
F's profit	18.30
F's commission	268.30

This $268.30 is F's foreign trade income. F's exempt foreign trade income is $174.98 ($268.30×15/23). F's taxable income is $6.37, computed as follows:

F's foreign trade income	$268.30
F's exempt foreign trade income	(174.98)
F's non-exempt foreign trade income	93.32
Less:	
F's expenses allocable to non-exempt foreign trade income $250×$93.32/$268.30	(86.95)
F's taxable income	6.37

Of F's total expenses, $163.05 ($250×$174.98/$268.30) are allocated to F's exempt foreign trade income and are disallowed for purposes of computing F's taxable income.

If R and F make the election provided for in paragraph (b)(2)(ii) of this section, F may receive a commission from R in the amount of $322.19, computed as follows:

F's expenses	$303.89
F's profit	18.30
F's commission	322.19

With this election, this $322.19 is F's foreign trade income. F's exempt foreign trade income is $210.12 ($322.19×15/23). F's taxable income is still $6.37, computed as follows:

F's foreign trade income	$322.19
F's exempt foreign trade income	(210.12)
F's non-exempt foreign trade income	112.07
Less:	
F's expenses allocable to non-exempt foreign trade income $303.89×$112.07/$322.19	(105.70)
F's taxable income	6.37

Of F's total expenses, $198.19 ($303.89×$210.12/$322.19) are allocated to F's exempt foreign trade income and are disallowed for purposes of computing F's taxable income.

Example 7. Assume the same facts as in *Example 6* except that R's direct selling expenses are $60. The profit which F may earn under the franchise pursuant to the administrative pricing rules is $16.62, computed as follows:

Combined taxable income:	
R's gross receipts from the sale	$1,000.00
R's cost of goods sold	(650.00)
Combined gross income	350.00
Less:	
R's direct selling expenses	60.00
R's apportioned G/A expenses	3.89
F's expenses	250.00
	(313.89)
Combined taxable income	36.11
The combined taxable income method—F's profit:	
F's profit—23% of combined taxable income ($36.11)	8.31
The gross receipts method—F's profit:	
F's profit—lesser of 1.83% of R's gross receipts ($ 18.30) or two times F's profit under the combined taxable income method ($16.62)	16.62

F may receive a commission from R in the amount of $266.62, computed as follows:

F's expenses	$250.00
F's profit	16.62
F's commission	266.62

If the election provided for in paragraph (b)(2)(ii) of this section is made by R and F, the profit which F may earn under the franchise pursuant to the administrative pricing rules will remain at $16.62 but will be computed as follows:

Combined taxable income:	
R's gross receipts from the sale	$1,000.00
R's cost of goods sold	(650.00)
Combined gross income	350.00
Less: F's expenses	(313.89)
Combined taxable income	36.11
The combined taxable income method—F's profit:	
F's profit—23% of combined taxable income ($36.11)	8.31
The gross receipts method—F's profit:	
F's profit—lesser of 1.83% of R's gross receipts ($18.30) or two times F's profit under the combined taxable income method ($16.62)	16.62
F may receive a commission from R in the amount of $330.51, computed as follows:	
F's expenses	313.89
F's profit	16.62
F's commission	330.51

As illustrated by *Example 6,* F's exempt taxable income and taxable income will be the same regardless of which method is used to compute F's commission.

Example 8. Assume the same facts as in *Example 6* except that F's expenses are $300. With this assumption, there is a combined loss of $(3.89) on the transaction under the full costing combined taxable income method, computed as follows:

Combined taxable income:	
R's gross receipts from the sale	$1,000.00
R's cost of goods sold	(650.00)
Combined gross income	350.00
Less:	
R's direct selling expenses	50.00
R's apportioned G/A expenses	3.89
F's expenses	300.00
	(353.89)
Combined taxable income (loss)	(3.89)

Since there is a combined loss, F will not have a profit under the full costing combined taxable income method. However, for purposes of this example, it is assumed that under the marginal costing rules of § 1.925(b)–1T the maximum combined taxable income is $75 and the overall profit percentage limitation is $30. Accordingly, F's profit would be $6.90 (23% of $30) under the marginal costing rules. F's profit under the gross receipts method will be $13.80 (1.83% of $1,000 limited by section 925(d) to two times the profit determined under marginal costing). The commission F may receive from R is $313.80. Had all of the expenses been reflected on F's books pursuant to the election of paragraph (b)(2)(ii) of this section, F's commission would have been $367.69.

Example 9. Assume the same facts as in *Example 6* except that F's expenses are $300 and that the transaction occurred in 1987. F will not earn a profit under the sales franchise pursuant to the administrative pricing rules. This is shown by the following computation:

Combined taxable income:	
R's gross receipts from the sale	$1,000.00
R's cost of goods sold	(650.00)
Combined gross income	350.00
Less:	
R's direct selling expenses	50.00
R's apportioned G/A expenses	3.89
F's expenses	300.00
	(353.89)
Combined taxable income (loss)	(3.89)

F will not have a profit under the full costing combined taxable income method since there is a combined loss of $(3.89). Also, F will not have a profit under the gross receipts method due to section 925(d) and the special no loss rule of paragraph (e)(1)(i) of this section. In addition, F will not have a profit under the marginal costing rules because the profit may not exceed full costing combined taxable income, see § 1.925 (b)–1T(b)(4). Although F may not earn a profit, it is entitled to recoup its expenses. Therefore, the commission F may receive from R is $300.00. R will bear the entire loss. Had all of the expenses been reflected on F's books pursuant to the election of paragraph (b)(2)(ii) of this section, F's commission would have been $353.89.

Example 10. Assume the same facts as in *Example 6* except that R receives total payment of the sale price of $1,000 on the 96th day after delivery, well beyond the 60 day period in which payment must be made to avoid recharacterization of part of the contract price as carrying charges. Therefore, the contract price of $1,000 includes $10 of carrying charges, assuming a discount rate of 10%. See § 1.927(d)–1 (a) (Q & A2) for computation method for determining amount of carrying charges. This $10 of carrying charges is R's income. The profit which F may earn under the franchise pursuant to the administrative pricing rules is $16.66, computed as follows (the election of paragraph (b)(2)(ii) of this section is not made by R and F):

Combined taxable income:	
R's gross receipts from the sale	$990.00
R's cost of goods sold	(650.00)
Combined gross income	340.00
Less:	
R's direct selling expenses	50.00
R's apportioned G/A expenses: $200×$340/$18,000	3.78
F's expenses	250.00
Total	(303.78)
Combined taxable income	36.22
The combined taxable income method—F's profit: F's profit—23% of combined taxable income ($36.22)	$8.33
The gross receipts method—F's profit: F's profit—lesser of 1.83% of R's gross receipts ($18.12) or two times F's profit under the combined taxable income method ($16.66)	$16.66
F may receive a commission from R in the amount of $266.66, computed as follows:	
F's expenses	$250.00
F's profit	16.66
F's commission	266.66

Example 11. Assume the same facts as in *Example 6.* In addition, assume that R also manufactures products K, L, M, N, and P all of which are export property as defined in section 927(a). Product K is military property as defined in section 923(a)(5) and § 1.923–1T(b)(3)(ii). Assume further that products A, L, and P are included within product line X and that products K, L, M, and N are included within product line W. R has entered into a written agreement with F under which F is granted a sales franchise with respect to exporting the products. Under this agreement, F will receive commissions with respect to those exports equal to the maximum amount permitted to be received under the administrative pricing rules. The table set forth below details F's foreign trading gross receipts, R's cost of goods sold and R's and F's expenses allocable and apportioned under § 1.861–8 to the sale of products A, L, M, N, and P. For purposes of this example, it is assumed that R does not incur any general and administrative expenses. Because of the special grouping rule of paragraph (c)(8)(ii) of this section, product L may be included for purposes of the administrative pricing rules in only one product line, at the option of R. Also for these purposes, product K, which is military property, may not be grouped with products L, M, and N. See paragraph (c)(8)(iv) of this section. Under these facts, F will have profits under the franchise agreement from the sale of products A, L, M, N, and P and may receive commissions from R relating to the sale of those products, assuming the election of paragraph (b)(2)(ii) of this section is not made, in the following amounts:

	Profit	F's Expenses	Commissions
Product Line X (products A and P)	$36.34	$490.00	$526.34
Product Line W (products L, M, and N)	$40.48	$421.00	$461.48

On the sale of product K, R received gross receipts of $150. R's cost of goods sold was $130. R's and F's expenses allocable to product K totaled $10 ($7 of R's expenses and $3 of F's). Under the gross receipts method, F earned a profit of $2.75 (1.83% of $150) and $2.30 under the combined taxable income method. F may receive a commission, assuming the election of paragraph (b)(2)(ii) of this section is made by R and F, from R in the amount of $12.75, computed as follows:

F's expenses	$10.00
F's profit	2.75
F's commission	$12.75

	Product A	Product L	Product M	Product N	Product P	Total
Product Line X						
Combined Taxable Income						
R's GR From sale	$1,000	....	....	....	$1,000	$2,000
R's cost of goods sold	(650)	....	....	....	(650)	(1,300)
Combined gross income	350	....	....	....	350	700
Less:						
R's expenses	50	....	....	....	81	131
F's expenses	250	....	....	....	240	490
Total	(300)	....	....	....	(321)	(621)
Combined taxable income (loss)	$50	....	....	....	$29	$79
23% of CTI	$11.50	....	....	....	$6.67	$18.17
1.83% of GR from sale	$18.30	....	....	....	$13.34	$36.34
Product Line W						
Combined Taxable Income						
R's GR from sale	....	$1,000	$625	$1,800	....	$3,425
R's cost of goods sold	....	(650)	(445)	(1,600)	....	(2,695)
Combined gross income	....	350	180	200	....	730
Less:						
R's expenses	....	81	70	70	....	221
F's expenses	....	230	60	131	....	421
Total	....	(311)	(130)	(201)	....	(642)
Combined taxable income (loss)	....	$39	$50	$(1)	....	$88
23% of CTI	....	$8.97	$11.50	$0	....	$20.24
1.83% of GR From sale	....	$17.94	$11.44	$0	....	$40.48

Example 12. R and F are calendar year taxpayers. R owns all the stock of F, an FSC for the taxable year. During 1985, R purchases 100 units of export property A from B, an unrelated domestic manufacturing company for $850. R's direct selling expenses so attributable are $20. R enters into a written agreement with F whereby F is granted a sales franchise with respect to export product A and F will receive commissions with respect to these exports equal to the maximum amount permitted to be received under the administrative pricing rules of section 925. Thereafter, the 100 units are sold for export by R for $1,050. R factors the trade receivable to unrelated person X for $1,000. Under §1.924(a)–1T(g)(7), total gross receipts for purposes of computing R's and F's combined taxable income is $1,000 (total receipts ($1,050) less the discount ($50)). This $1,000 would have been foreign trading gross receipts had F been the principal on the sale. For purposes of this example, it is assumed that R did not incur any general and administrative expenses. F incurs expenses in the amount of $110, all of which were performed by R under contract to F. The profit which F may earn under the franchise pursuant to the administrative pricing rules is $9.20 computed as follows:

Combined taxable income:	
R's gross receipts from the sale	$1,000.00
R's cost of goods sold	(850.00)
	150.00
Less:	
R's direct selling expenses	20.00
F's expenses	110.00
Total	130.00
Combined taxable income	$20.00
The combined taxable income method—F's profit:	
F's profit—23% of combined taxable income ($20)	$4.60

The gross receipts method—F's profit:	
F's profit—lesser of 1.83% of R's gross receipts ($18.30) or two times F's profit under the combined taxable income, method ($9.20)	$9.20

F may receive a commission from R in the amount of $119.20, computed as follows (the election of §1.925(a)–1T(b)(2)(ii) has not been made):

F's expenses	$110.00
F's profit	9.20
F's commission	$119.20

Example 13. R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, an FSC for the taxable year. During March 1985, R manufactures office equipment, export property within the definition of section 927(a)(1), which it leases on April 1, 1985, to F for a term of 1 year at a monthly rental of $1,000, a rent which satisfies the standard of arm's length rental under section 482. F subleases the product on April 1, 1985, for a term of 1 year at a monthly rental of $1,200. R's cost for the product leased is $40,000. R's other deductible expenses attributable to the product are $200, all of which are incurred in 1985. Those expenses were not incurred under contract to F. F's expenses attributable to sublease of the export property are $1,150, all of which are incurred in 1985 directly by F. R depreciates the property on a straight line basis, using a half-year convention, assuming a 10 year recovery period (see section 168(f)(2)(C), §1.48–1(g)). The profit which F may earn with respect to the transaction is $1,483.50 for 1985 and $600 for 1986, computed as follows:

COMPUTATION FOR 1985

Combined taxable income:	
F's sublease rental receipts for year ($1,200 × 9 months)	$10,800.00
Less:	
R's depreciation (($40,000 ×1/10)×9/12)	3,000.00
R's expenses	200.00
F's expense	1,150.00
Total	(4,350.00)
Combined taxable income	6,450.00
The combined taxable income method—F's profit:	
F's profit—23% of combined taxable income ($6,450)	$1,483.50
The gross receipts method—F's profit:	
F's profit—lesser of 1.83% of F's foreign trading gross receipts ($197.64) or two times F's profit under the combined taxable income method ($2,967)	$197.64
The section 482 method—F's profit:	
F's sublease rental receipts for year	$10,800.00
Less:	
F's lease rental payments for year	9,000.00
F's expenses	1,150.00
Total	(10,150.00)
F's profit	650.00

Since the combined taxable income method results in greater profit to F ($1,483.50) than does either the gross receipts method ($197.64) or the section 482 method ($650), F may earn a profit of $1,483.50 for 1985. Accordingly, the monthly rental payable by F to R for 1985 may be readjusted as long as the monthly rental payable is not readjusted below $907.39, computed as follows:

Monthly rental payable by F to R for 1985:	
F's sublease rental receipts for year	$10,800.00
Less:	
F's expenses	1,150.00
F's profit	1,483.50
Total	(2,633.50)
Rental payable for 1985	8,166.50
Rental payable each month ($8,166.50/9 months)	$907.39

COMPUTATION FOR 1986

Combined taxable income:	
F's sublease rental receipts for year ($1,200 x 3 months)	$3,600.00
Less:	
R's depreciation (($40,000 x 1⁄10) x 3⁄12)	(1,000.00)
Combined taxable income	2,600.00

The combined taxable income method—F's profit:	
F's profit—23% of combined taxable income ($2,600)	598.00
The gross receipts method—F's profit:	
F's profit—lesser of 1.83% of F's foreign trading gross receipts ($3,600) or two times F's profit under the combined taxable income method ($1,196)	65.88
The section 482 method—F's profit:	
F's sublease rental receipts for year	$3,600.00
Less:	
F's lease rental payments for year	(3,000.00)
F's profit	600.00

Since the section 482 method results in a greater profit to F ($600) than does either the combined taxable income method ($598) or the gross receipts method ($65.88), F may earn a profit of $600 for 1986. Accordingly, the monthly rental payable by F to R for 1986 may be readjusted as long as the monthly rental payable is not readjusted below $1,000, computed as follows:

Monthly rental payable by F to R for 1986:	
F's sublease rental receipts for year	$3,600.00
Less:	
F's profit	(600.00)
Rental payable for 1986	3,000.00
Rental payable for each month ($3,000/3 months)	1,000.00

(g) *Effective date.* The provisions of this section and § 1.925(b)–1T apply with respect to taxable year ending after December 31, 1984, except that a corporation may not be a FSC for any taxable year beginning before January 1, 1985.

[T.D. 8126, 52 FR 6443, Mar. 3, 1987, as amended by T.D. 8764, 63 FR 10306, Mar. 3, 1998]

§ 1.925(b)–1T Temporary regulations; marginal costing rules.

(a) *In general.* This section prescribes the marginal costing rules authorized by section 925(b)(2). If under paragraph (c)(1) of this section a FSC is treated for its taxable year as seeking to establish or maintain a foreign market for sales of an item, product, or product line of export property (as defined in § 1.927(a)–1T) from which foreign trading gross receipts (as defined in § 1.924(a)–1T) are derived, the marginal costing rules prescribed in paragraph (b) of this section may be applied at the related supplier's election to compute combined taxable income of the FSC and related supplier derived from those sales. (Any further reference to a FSC in this section shall include a small FSC unless indicated otherwise.) The combined taxable income determined under these marginal costing rules may be used to determine whether the ''twice the amount determined under the combined taxable income method'' limitation for the 1.83% of gross receipts test of section 925(d) has been met.

For FSC taxable years beginning after December 31, 1986, if the marginal costing rules are used to determine the section 925(d) limitation, the FSC may not earn more than 100% of full costing combined taxable income determined under the full costing combined taxable income method of § 1.925(a)–1T(c)(3) and (6). The marginal costing rules may be applied even if the related supplier does not manufacture, produce, grow, or extract the export property sold. The marginal costing rules do not apply to sales of export property which in the hands of a purchaser related under section 954(d)(3) to the seller give rise to foreign base company sales income as described in section 954(d) unless, for the purchaser's year in which it resells the export property, section 954(b)(3)(A) is applicable or that income is under the exceptions in section 954(b)(4). In addition, the marginal costing rules do not apply to leases of property or to the performances of any services even if they are related and subsidiary services (as defined in § 1.924(a)–1T(d) and § 1.925(a)–1T(b)(2)(iii)(C)).

(b) *Marginal costing rules*—(1) *In general.* Marginal costing is a method under which only direct production costs of producing a particular item, product, or product line are taken into account for purposes of computing the combined taxable income of the FSC and its related supplier under section

925(a)(2). The costs to be taken into account are the related supplier's direct material and labor costs (as defined in §1.471–11(b)(2)(i)). Costs which are incurred by the FSC and which are not taken into account in computing combined taxable income are deductible by the FSC only to the extent of the FSC's non-foreign trade income. If the related supplier is not the manufacturer or producer of the export property that is sold, the related supplier's purchase price shall be taken into account.

(2) *Overall profit percentage limitation.* Under marginal costing, the combined taxable income of the FSC and its related supplier may not exceed the overall profit percentage (determined under paragraph (c)(2) of this section) multiplied by the FSC's foreign trading gross receipts if the FSC is the principal on the sale (or the related supplier's gross receipts if the FSC is a commission agent) from the sale of export property.

(3) *Grouping of transactions.* (i) In general, for purposes of this section, an item, product, or product line is the item or group consisting of the product or product line pursuant to §1.925(a)–1T(c)(8) used by the taxpayer for purposes of applying the full costing combined taxable income method of §1.925(a)–1T(c)(3) and (6). For the election to group transactions for purposes of applying the administrative pricing methods, see §1.925(a)-1T(c)(8)(i).

(ii) However, for purposes of determining the overall profit percentage under paragraph (c)(2) of this section, any product or product line grouping permissible under §1.925(a)–1T(c)(8) may be used at the annual choice of the FSC even though it may not be the same item or grouping referred to in subdivision (i) of this paragraph as long as the grouping chosen for determining the overall profit percentage is at least as broad as the grouping referred to in the above subdivision (i) of this paragraph. A product may be included for this purpose, however, in only one product group even though under the grouping rules it would otherwise fall in more than one group. Thus, the marginal costing rules will not apply with respect to any regrouping if the regrouping does not include any product (or products) that was included in the group for purposes of the full costing method.

(4) *Application of limitation on FSC income (''no loss'' rules).* The marginal costing rules of this section will not apply if there is a combined loss of the related supplier and the FSC determined in accordance with paragraph (b)(1) of this section. In addition, for FSC taxable years beginning after December 31, 1986, the profit determined under the marginal costing method may be allowed to the FSC only to the extent it does not exceed the FSC's and the related supplier's full costing combined taxable income determined under the full costing combined taxable income method of §1.925(a)–1T(c)(3) and (6). This rule prevents pricing at a loss to the related supplier. If either of these ''no loss'' rules apply, the related supplier may nonetheless charge a transfer price or pay a commission in an amount that will allow the FSC to recover an amount not in excess of its full costs, if any, even if to do so would create or increase a loss in the related supplier. The effect of these no-loss rules and of the overall profit percentage limitation of paragraph (c)(2) of this section is that the FSC's profit under these marginal costing rules is limited to the lesser of the following:

(i) 23% of maximum combined taxable income determined under the marginal costing rules,

(ii) 23% of the overall profit percentage limitation, or

(iii) For FSC taxable years beginning after December 31, 1986, 100% of the full costing combined taxable income determined under the full costing combined taxable income method of §1.925(a)–1T(c)(3) and (6).

(c) *Definitions*—(1) *Establishing or maintaining a foreign market.* A FSC shall be treated for its taxable year as seeking to establish or maintain a foreign market with respect to sales of an item, product, or product line of export property from which foreign trading gross receipts are derived if the combined taxable income computed under paragraph (b) of this section is greater than the full costing combined taxable income computed under the full costing combined taxable income method of §1.925(a)–1T(c)(3) and (6).

(2) *Overall profit percentage.* (i) For purposes of this section, the overall profit percentage for a taxable year of the FSC for a product or product line is the percentage which—

(A) The combined taxable income of the FSC and its related supplier from the sale of export property plus all other taxable income of its related supplier from all sales (domestic and foreign) of such product or product line during the FSC's taxable year, computed under the full costing method, is of

(B) The total gross receipts (determined under § 1.927(b)–1T) of the FSC and related supplier from all sales of the product or product line.

(ii) At the annual option of the related supplier, the overall profit percentage for the FSC's taxable year for all products and product lines may be determined by aggregating the amounts described in subdivisions (i)(A) and (B) of this paragraph of the FSC, and all domestic members of the controlled group (as defined in section 927(d)(4) and § 1.924(a)–1T(h)) of which the FSC is a member, for the FSC's taxable year and for taxable years of the members ending with or within the FSC's taxable year.

(iii) For purposes of determining the amounts in subdivisions (i) and (ii) of this paragraph, a sale of property between a FSC and its related supplier or between domestic members of the controlled group shall be taken into account only during the FSC's taxable year (or taxable year of the member ending within the FSC's taxable year) during which the property is ultimately sold to a person which is not related to the FSC or if related, is a foreign person that is not a FSC.

(3) *Full costing method.* For purposes of section 925 and this section, the term "full costing combined taxable income method" is the method for determining full costing combined taxable income set forth in § 1.925(a)–1T(c)(3) and (6).

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

Example 1. R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During 1985, R produces and sells 100 units of export property A to F under a written agreement which provides that the transfer price between R and F shall be that price which allocates to F the maximum profit permitted to be received under the administrative pricing rules of section 925(a)(1) and (2). Thereafter, the 100 units are resold for export by F for $950. R's cost of goods sold attributable to the 100 units is $650 consisting in part of $400 of direct materials and $200 of direct labor. R incurs selling expenses directly attributable to the sale in the amount of $100. Those expenses were not required to be incurred by F. For purposes of this example, it is assumed that R does not have general and administrative expenses that are not definitely allocable to any item of gross income. F's expenses attributable to the resale of the 100 units are $120. For purposes of this example, R and F have gross receipts of $4,000 from all domestic and foreign sales. R's total cost of goods sold and total expenses relating to its foreign and domestic sales are $2,730 and $450, respectively. Under full costing, the combined taxable income will be $80, computed as follows:

Combined taxable income—full costing:	
F's foreign trading gross receipts	$950.00
R's cost of goods sold	(650.00)
Combined gross income	300.00
Less:	
R's direct selling expenses	100.00
F's expenses	120.00
Total	(220.00)
Combined taxable income (loss)	80.00

F's profit under the full costing combined taxable income method is $18.40, *i.e.*, 23% of full costing combined taxable income ($80). F's profit under the gross receipts method will be $17.39, *i.e.*, 1.83% of F's foreign trading gross receipts ($950). However, under the marginal costing rules, F would have a profit attributable to the export sale in the amount of $38.24, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of $166.25). As shown by the computation below, the combined taxable income under marginal costing is limited to the overall profit percentage limitation ($166.25) since that amount is less than the maximum combined taxable income amount ($350):

Maximum combined taxable income (determined under paragraph (b)(1) of this section):	
F's foreign trading gross receipts	$950.00
Less:	
R's direct materials	400.00
R's direct labor	200.00
Total	(600.00)
Maximum combined total income	350.00
Overall profit percentage limitation calculation (determined under paragraph (c)(2) of this section):	
Gross receipts of R and F from all domestic and foreign sales	$4,000.00
R's cost of goods sold	(2,730.00)
Combined gross income	1,270.00
Less:	
R's expenses	450.00
F's expenses	120.00
Total	(570.00)
Total taxable income from all sales computed on a full costing method	700.00
Overall profit percentage (total taxable income ($700) divided by total gross receipts ($4,000)	17.5%
Overall profit percentage limitation Overall profit percentage times F's foreign trading gross receipts (17.5% times $950.00)	$166.25

The transfer price from R to F may be set at $791.76, computed as follows:

Transfer price to F:	
F's foreign trading gross receipts	$950.00
Less:	
F's expenses	120.00
F's profit	38.24
Total	(158.24)
Transfer price	791.76

Example 2. Assume the same facts as in *Example 1* except that F's expenses are $170. Under full costing, the combined taxable income will be $30, computed as follows:

Combined taxable income—full costing:	
F's foreign trading gross receipts	$950.00
R's cost of goods sold	(650.00)
Combined gross income	300.00
Less:	
R's expenses	100.00
F's expenses	170.00
Total	(270.00)
Combined taxable income (loss)	30.00

F's profit under the full costing combined taxable income method is $6.90, *i.e.*, 23% of combined taxable income, $30. Under the marginal costing rules, F may earn a profit attributable to the export sale in the amount of $35.51, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of $154.38). Had the transaction occurred in 1987, F would have had a profit attributable to the export sale under these marginal costing rules of only $30, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of $154.38) limited, for FSC taxable years beginning after December 31, 1986, to combined taxable income determined under full costing ($30), see paragraph (b)(4) of this section. F's profit under the gross receipts method will be $17.39 *i.e.*, 1.83% of F's foreign trading gross receipts ($950). The computations are as follows:

Maximum combined taxable income (determined under paragraph (b)(1) of this section):	
F's foreign trading gross receipts	$950.00
Less:	
R's direct materials	400.00
R's direct labor	200.00
Total	(600.00)
Maximum combined taxable income	350.00
Overall profit percentage limitation calculation (determined under paragraph (c)(2) of this section):	
Gross receipts of R and F from all domestic and foreign sales	4,000.00
R's cost of goods sold	(2,730.00)
Combined gross income	1,270.00

Less:	
R's expenses	450.00
F's expenses	170.00
Total	(620.00)
Total taxable income from all sales computed on a full costing method	650.00
Overall profit percentage (total taxable income ($650) divided by total gross receipts ($4,000))	16.25%
Overall profit percentage limitation Overall profit percentage times F's foreign trading gross receipts (16.25% times $950.00)	154.38

The transfer price from R to F may be set at $744.49, computed as follows:

Transfer price to F:	
F's foreign trading gross receipts	950.00
Less:	
F's expenses	170.00
F's profit	35.51
Total	(205.51)
Transfer price	744.49

Example 3. Assume the same facts as in *Example 1* except that the transaction occurs in 1987 and that F incurs expenses in the amount of $250. Since a $50 combined loss, as computed below, is incurred, F will not have any profit under either the full costing combined taxable income method, the gross receipts method or the marginal costing rules:

Combined taxable income—full costing:	
F's foreign trading gross receipts	$950.00
R's cost of goods sold	(650.00)
Combined gross income	300.00
Less:	
R's expenses	100.00
F's expenses	250.00
Total	(350.00)
Combined taxable income (loss)	(50.00)

The transfer price to R may be set at $700 so that F may recover its expenses.

Example 4. R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During 1985, R manufactures export property A. R enters into a written agreement with F whereby F will receive a commission with respect to sales of export property A by R which result in gross receipts to R which would have been foreign trading gross receipts had F and not R been the principal on the sale. F will receive commissions with respect to such export sales equal to the maximum amount permitted to be received under the transfer pricing rules of section 925. The maximum commission may be earned by F under these marginal costing rules. In this example, R received $950 from the sale of export property A. R's cost of goods sold for that property was $620. R incurred direct selling expenses of $20. Also, it is assumed that R incurred total general and administrative expenses, in addition to those incurred relating to its contract to perform on behalf of F the functions and activities of section 924 (c), (d) and (e), of $50. R incurred direct and indirect expenses of $130 in performing those functions and activities on behalf of F. During 1985, R had gross receipts from all domestic and foreign sales of $3,500, total cost of goods sold and total expenses relating to the domestic and foreign sales of $1,600 and $259, respectively. The election provided for in § 1.925(a)–1T(b)(2)(ii) was not made by R and F.

Combined taxable income—full costing:		
R's gross receipts from the sale of the export property		$950.00
R's cost of goods sold		(620.00)
Combined gross income		330.00
Less:		
R's direct selling expenses		20.00
F's expenses		130.00
Apportionment of R's general and administrative expenses:		
R's total G/A expenses	$50	
Combined gross income	330	
R's total gross income	1,900	
Apportionment of G/A expenses $50 x $330/$1,900		8.68
Total		(158.68)
Combined taxable income (loss)		171.32

Maximum combined taxable income (determined under paragraph (b)(1) of this section):	
R's gross receipts from the sale of the export property	$950.00
Less:	
R's direct materials	450.00
R's direct labor	100.00
Total	(550.00)
Maximum combined taxable income	400.00
Overall profit percentage limitation calculation (determined under paragraph (c)(2) of this section):	
Gross receipts of R from all domestic and foreign sales	3,500.00
R's cost of goods sold	(1,600.00)
Combined gross income	1,900.00
Less:	
R's total expenses	259.00
F's total expenses	130.00
Total	(450.00)
Total taxable income from all sales computed on a full costing method	1,511.00
Overall profit percentage (total taxable income ($1,511) divided by total gross receipts ($3,500))	43.17%
Overall profit percentage limitation Overall profit percentage times R's gross receipts from the sale of export property (*i.e.,* 43.17% times $950.00)	410.12

Since the overall profit percentage limitation ($410.12) is greater than the maximum combined taxable income ($400), combined taxable income under marginal costing and for purposes of computing F's commission is limited to $400. Under these marginal costing rules, F will have a profit attributable to the sale of $92, *i.e.,* 23% of combined taxable income as determined under the marginal costing rules (23% of $400). Accordingly, the commission F receives from R is $222, *i.e.,* F's expenses ($130) plus F's profit ($92).

Example 5. Assume the same facts as in *Example 4,* except that R's gross receipts from the sale of export property which would have been foreign trading gross receipts had F been the principal on the sale are $1,050 and gross receipts from all sales, domestic and foreign, remain at $3,500. For purposes of applying the combined taxable income method, R and F may compute their combined taxable income attributable to the product line of export property under the marginal costing rules as follows:

Combined taxable income—full costing:	
R's gross receipts from the sale of the export property	$1,050.00
R's cost of goods sold	(620.00)
Combined gross income	430.00
Less:	
R's direct selling expenses	20.00
F's expenses	130.00
Apportionment of R's G/A expenses $50 x $430/$1,900	11.32
Total	(161.32)
Combined taxable income (loss)	268.68

Maximum combined taxable income (determined under paragraph (b)(1) of this section):	
R's gross receipts from the sale of export property	$1,050.00
Less:	
R's direct materials	450.00
R's direct labor	100.00
Total	(550.00)
Maximum combined taxable income	500.00
Overall profit percentage (see example 4)	43.17%
Overall profit percentage limitation (determined under paragraph (c)(2) of this section) (R's gross receipts from sale ($1,050.00) times the overall profit percentage (43.17%))	453.29

Since maximum combined taxable income ($500) is greater than the overall profit percentage limitation ($453.29), combined taxable income under marginal costing and for purposes of computing F's commission is limited to $453.29. Under these marginal costing rules, F will have a profit attributable to the sales of $104.26, *i.e.,* 23% of combined taxable income (23% of $453.29). Accordingly, the commission F receives from R is $234.26, *i.e.,* F's expenses ($130) plus F's profit ($104.26).

Example 6. Assume the same facts as in *Example 5,* except that F has expenses of $140 and R's cost of goods sold for the export sale was $900. R does not incur any direct selling expenses. Since cost of goods sold has increased by $280, R's total gross income has been reduced from $1,900 to $1,620. For purposes of applying the combined taxable income method, R and F may compute their combined taxable income under the marginal costing rules as follows:

Combined taxable income—full costing:	
R's gross receipts from the sale of export property	$1,050.00
R's cost of goods sold	(900.00)
Combined gross income	150.00
Less:	
F's expenses	140.00
Apportionment of R's G/A expenses $50 x $150/$1,620	4.63
Total	(144.63)
Combined taxable income (loss)	5.37
Maximum combined taxable income (determined under paragraph (b)(1) of this section):	
R's gross receipts from the sale of export property	$1,050.00
Less:	
R's direct materials	630.00
R's direct labor	200.00
Total	(830.00)
Maximum combined taxable income	220.00
Overall profit percentage limitation calculation (determined under paragraph (c)(2) of this section):	
Gross receipts of R and F from all domestic and foreign sales	$3,500.00
R's cost of goods sold	(1,880.00)
Combined gross income	1,620.000
Less:	
R's total expenses	259.00
F's total expenses	140.00
Total	(399.00)
Total taxable income from all sales computed on a full costing method	$1,221.00
Overall profit percentage (total taxable income ($1,221) divided by total gross receipts ($3,500))	34.89%
Overall profit percentage limitation—overall profit percentage times R's gross receipts from the sale of export property (i.e., 34.89% times $1,050)	$366.35

Since the overall profit percentage limitation ($366.35) is greater than the maximum combined taxable income ($220), combined taxable income under marginal costing and for purposes of computing F's commission is limited to $220. Under these marginal costing rules, F will have a profit attributable to the sale of $50.60, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of $220). If the transaction occurred in 1987, F's profit would be limited, however, by paragraph (b)(4) of this section to the full costing combined taxable income of $5.37.

[T.D. 8126, 52 FR 6455, Mar. 3, 1987, as amended by T.D.8764, 63 FR 10306, Mar. 3, 1998]

§ 1.926(a)–1 Distributions to shareholders.

(a) *Treatment of distributions.* [Reserved] For guidance, see § 1.926(a)–1T(a).

(b) *Order of distribution*—(1) *In general*—(i) *Distributions by a FSC received by a shareholder in a taxable year of the shareholder beginning before January 1, 1990.* Any actual distribution to a shareholder by a FSC (all references to a FSC in this section shall include a small FSC and a former FSC) that is received by the shareholder in a taxable year of the shareholder beginning before January 1, 1990, and made out of earnings and profits shall be treated as made in the following order, to the extent thereof—

(A) Out of earnings and profits attributable to exempt foreign trade income determined solely because of operation of section 923(a)(4),

(B) Out of earnings and profits attributable to other exempt foreign trade income,

(C) Out of earnings and profits attributable to non-exempt foreign trade income determined under either of the administrative pricing methods of section 925(a)(1) or (2),

(D) Out of earnings and profits attributable to section 923(a)(2) non-exempt income, and

(E) Out of other earnings and profits.

(ii) *Distributions by a FSC received by a shareholder in a taxable year of the shareholder beginning after December 31, 1989.* Any actual distribution to a shareholder by a FSC that is received by the shareholder in a taxable year beginning after December 31, 1989, and that is made out of earnings and profits shall be treated as made in the following order, to the extent thereof—

(A) Out of earnings and profits attributable to exempt foreign trade income determined solely because of the operation of section 923(a)(4),

(B) Out of earnings and profits attributable to foreign trade income (other than exempt foreign trade income determined solely because of the operation of section 923(a)(4)) allocable to the marketing of agricultural or horticultural products (or the providing of related services) by a qualified cooperative which is a shareholder of the FSC,

(C) Out of earnings and profits attributable to non-exempt foreign trade income and other exempt foreign trade income determined under either of the administrative pricing methods of section 925(a)(1) and (2). Distributions out of this classification will be made on a pro rata basis so that 15/23 (16/23 with regard to distribution to a non-corporate shareholder) of each distribution will be out of earnings and profits attributable to exempt foreign trade income and the remainder will be out of earnings and profits attributable to non-exempt foreign trade income. To the extent the distributions are out of earnings and profits attributable to the disposition of, or services related to, military property, 7.5/23 (8/23 with regard to distributions to a non-corporate shareholder) of each distribution will be out of earnings and profits attributable to exempt foreign trade income and the remainder will be out of earnings and profits attributable to non-exempt foreign trade income,

(D) Out of earnings and profits attributable to other exempt foreign trade income determined under the transfer pricing method of section 925(a)(3),

(E) Out of earnings and profits attributable to section 923(a)(2) non-exempt income,

(F) Out of earnings and profits attributable to effectively connected income, as defined in section 245(c)(4)(B), and

(G) Out of other earnings and profits.

(2) *Determination of earnings and profits.* [Reserved] For guidance, see §1.926(a)–1T(b)(1).

(c) *Definition of ''former FSC''.* [Reserved] For guidance, see §1.926(a)–1T(c).

(d) *Personal holding company income.* [Reserved] For guidance, see §1.926(a)–1T(d).

(e) *Sale of stock if section 1248 applies.* [Reserved] For guidance, see §1.926(a)–1T(e).

[T.D. 8340, 56 FR 11093, Mar. 15, 1991]

§1.926(a)–1T Temporary regulations; distributions to shareholders.

(a) *Treatment of distributions.* Any distribution by a FSC (or former FSC) to its shareholder with respect to its stock will be includible in the shareholder's gross income in accordance with the provisions of section 301. (Any further reference to a FSC in this section shall include a small FSC unless indicated otherwise.) See section 245(c) for treatment of distributions to domestic corporate shareholders of the FSC. If earnings and profits of a FSC (or former FSC) attributable to foreign trade income are distributed to a shareholder which is a foreign person (or a nonresident alien individual), that distribution shall be treated as United States source income which is effectively connected with the conduct of a trade or business conducted through a permanent establishment of such shareholder within the United States. For this purpose, distributions to a foreign partnership, foreign trust, foreign estate or other foreign entities that would be treated as pass-through entities under U.S. law shall be treated as made directly to the partners of beneficiaries in proportion to their respective interest in the entity.

(b) *Order of distributions*—(1) *In general.* For guidance, see §1.926(a)–1(b)(1).

(2) *Determination of earnings and profits.* For purposes of this section, the earnings and profits of a FSC (or former FSC) shall be the earnings and

profits computed in accordance with the rules, where applicable, prescribed in § 1.964–1 (relating to determination of the earnings and profits of a foreign corporation) other than subsections (d) and (e) of that section.

(c) *Definition of ''former FSC''.* Under section 926(c), the term ''former FSC'' refers to a corporation which is not a FSC for a taxable year but which was a FSC for a prior taxable year. However, a corporation is not a former FSC for a taxable year unless such corporation has, at the beginning of such taxable year, earnings and profits attributable to foreign trade income. A corporation which is a former FSC for a taxable year is a former FSC for all purposes of the Code.

(d) *Personal holding company income*—(1) *Treatment of dividends.* Any amount includible in a shareholder's gross income as a dividend with respect to the stock of a FSC (or former FSC) under paragraph (a) of this section shall be treated as a dividend for all purposes of the Code, except that that part of the dividend attributable to foreign trade income, other than an amount attributable to section 923(a)(2) non-exempt income, shall not be considered in applying the personal holding company and foreign personal holding company provisions (sections 541 through 547 and 551 through 558, respectively).

(2) *Look through option.* With regard to distributions from a FSC (or former FSC) which are not treated as personal holding company income under paragraph (d)(1) of this section, the shareholder may, however, treat any amount of that distribution as an item of income described under section 543 (or section 553) (for example, rents) if it establishes to the satisfaction of the Commissioner that such amount is attributable to earnings and profits of the FSC derived from such item of income. For example, distributions from a FSC relating to section 923(a)(2) non-exempt income will be treated as dividends for purposes of the personal holding company provisions of sections 541 through 547 unless the look through option is elected. Under this option, if earnings and profits out of which those distributions are made are attributable to the lease of export property, the FSC shareholder may treat the distribution for purposes of the personal holding company provisions as rents rather than as dividends. This may be beneficial to the shareholder because rents are not considered under section 543(a)(2) as personal holding company income, if in general, rents constitute 50% or more of the shareholder's adjusted ordinary gross income.

(e) *Sale of stock if section 1248 applies.* For purposes of section 1248, the earnings and profits of a FSC (or former FSC) shall not include earnings and profits attributable to foreign trade income.

[T.D. 8126, 52 FR 6458, Mar. 3, 1987, as amended by T.D. 8340, 56 FR 11093, Mar. 15, 1991]

§ 1.927(a)–1T Temporary regulations; definition of export property.

(a) *General rule.* Under section 927 (a), except as otherwise provided with respect to excluded property in paragraphs (f), (g) and (h) of this section and with respect to certain short supply property in paragraph (i) of this section, export property is property in the hands of any person (whether or not a FSC) (any further reference to a FSC in this section shall include a small FSC unless indicated otherwise)—

(1) *U.S. manufactured, produced, grown or extracted.* Manufactured, produced, grown, or extracted in the United States by any person or persons other than a FSC (see paragraph (c) of this section),

(2) *Foreign use, consumption or disposition.* Held primarily for sale, lease or rental in the ordinary course of a trade or business by a FSC to a FSC or to any other person for direct use, consumption, or disposition outside the United States (see paragraph (d) of this section),

(3) *Foreign content.* Not more than 50 percent of the fair market value of which is attributable to articles imported into the United States (see paragraph (e) of this section), and

(4) *Non-related FSC purchaser or user.* Which is not sold, leased or rented by a FSC, or with a FSC as commission agent, to another FSC which is a member of the same controlled group (as defined in section 927(d)(4) and § 1.924(a)–1T(h)) as the FSC.

(b) *Services.* For purposes of this section, services (including the written communication of services in any form) are not export property. Whether an item is property or services shall be determined on the basis of the facts and circumstances attending the development and disposition of the item. Thus, for example, the preparation of a map of a particular construction site would constitute services and not export property, but standard maps prepared for sale to customers generally would not constitute services and would be export property if the requirements of this section were otherwise met.

(c) *Manufacture, production, growth, or extraction of property*—(1) *By a person other than a FSC.* Export property may be manufactured, produced, grown, or extracted in the United States by any person, provided that that person does not qualify as a FSC. Property held by a FSC which was manufactured, produced, grown or extracted by it at a time when it did not qualify as a FSC is not export property of the FSC. Property which sustains further manufacture, production or processing outside the United States prior to sale or lease by a person but after manufacture, production, processing or extraction in the United States will be considered as manufactured, produced, grown or extracted in the United States by that person only if the property is reimported into the United States for further manufacturing, production or processing prior to final export sale. In order to be considered export property, the property manufactured, produced, grown or extracted in the United States must satisfy all of the provisions of section 927(a) and this section.

(2) *Manufactured, produced or processed.* For purposes of this section, property which is sold or leased by a person is considered to be manufactured, produced or processed by that person or by another person pursuant to a contract with that person if the property is manufactured or produced, as defined in §1.954–3(a)(4). For purposes of this section, however, in determining if the 20% conversion test of §1.954–3(a)(4)(iii) has been met, conversion costs include assembly and packaging costs but do not include the value of parts provided pursuant to a services contract as described in §1.924(a)–1T(d)(3). In addition, for purposes of this section, the 20% conversion test is extended and applied to the export property's adjusted basis rather than to its cost of goods sold if it is leased or held for lease.

(d) *Foreign use, consumption or disposition*—(1) *In general.* (i) Under paragraph (a)(2) of this section, export property must be held primarily for the purpose of sale, lease or rental in the ordinary course of a trade or business, by a FSC to a FSC or to any other person, and the sale or lease must be for direct use, consumption, or disposition outside the United States. Thus, property cannot qualify as export property unless it is sold or leased for direct use, consumption, or disposition outside the United States. Property is sold or leased for direct use, consumption, or disposition outside the United States if the sale or lease satisfies the destination test described in subdivision (2) of this paragraph, the proof of compliance requirements described in subdivision (3) of this paragraph, and the use outside the United States test described in subdivision (4) of this paragraph.

(ii) *Factors not taken into account.* In determining whether property which is sold or leased to a FSC is sold or leased for direct use, consumption, or disposition outside the United States, the fact that the acquiring FSC holds the property in inventory or for lease prior to the time it sells or leases it for direct use, consumption, or disposition outside the United States will not affect the characterization of the property as export property. Fungible export property must be physically segregated from non-export property at all times after purchase by or rental by a FSC or after the start of the commission relationship between the FSC and related supplier with regard to the export property. Non-fungible export property need not be physically segregated from non-export property.

(2) *Destination test.* (i) For purposes of paragraph (d)(1) of this section, the destination test of this paragraph is satisfied with respect to property sold or leased by a seller or lessor only if it is delivered by the seller or lessor (or

an agent of the seller or lessor) regardless of the F.O.B. point or the place at which title passes or risk of loss shifts from the seller or lessor—

(A) Within the United States to a carrier or freight forwarder for ultimate delivery outside the United States to a purchaser or lessee (or to a subsequent purchaser or sublessee),

(B) Within the United States to a purchaser or lessee, if the property is ultimately delivered outside the United States (including delivery to a carrier or freight forwarder for delivery outside the United States) by the purchaser or lessee (or a subsequent purchaser or sublessee) within 1 year after the sale or lease,

(C) Within or outside the United States to a purchaser or lessee which, at the time of the sale or lease, is a FSC or an interest charge DISC and is not a member of the same controlled group as the seller or lessor,

(D) From the United States to the purchaser or lessee (or a subsequent purchaser or sublessee) at a point outside the United States by means of the seller's or lessor's own ship, aircraft, or other delivery vehicle, owned, leased, or chartered by the seller or lessor,

(E) Outside the United States to a purchaser or lessee from a warehouse, storage facility, or assembly site located outside the United States, if the property was previously shipped by the seller or lessor from the United States, or

(F) Outside the United States to a purchaser or lessee if the property was previously shipped by the seller or lessor from the United States and if the property is located outside the United States pursuant to a prior lease by the seller or lessor, and either (*1*) the prior lease terminated at the expiration of its term (or by the action of the prior lessee acting alone), (*2*) the sale occurred or the term of the subsequent lease began after the time at which the term of the prior lease would have expired, or (*3*) the lessee under the subsequent lease is not a related person with respect to the lessor and the prior lease was terminated by the action of the lessor (acting alone or together with the lessee).

(ii) For purposes of this paragraph (d)(2) (other than paragraphs (d)(2)(i)(C) and (F)(3)), any relationship between the seller or lessor and any purchaser, subsequent purchaser, lessee, or sublessee is immaterial.

(iii) In no event is the destination test of this paragraph (d)(2) satisfied with respect to property which is subject to any use (other than a resale or sublease), manufacture, assembly, or other processing (other than packaging) by any person between the time of the sale or lease by such seller or lessor and the delivery or ultimate delivery outside the United States described in this paragraph (d)(2).

(iv) If property is located outside the United States at the time it is purchased by a person or leased by a person as lessee, such property may be export property in the hands of such purchaser or lessee only if it is imported into the United States prior to its further sale or lease (including a sublease) outside the United States. Paragraphs (a)(3) and (e) of this section (relating to the 50 percent foreign content test) are applicable in determining whether such property is export property. Thus, for example, if such property is not subjected to manufacturing or production (as defined in paragraph (c) of this section) within the United States after such importation, it does not qualify as export property.

(3) *Proof of compliance with destination test*—(i) *Delivery outside the United States.* For purposes of paragraph (d)(2) of this section (other than subdivision (i)(C) thereof), a seller or lessor shall establish ultimate delivery, use, or consumption of property outside the United States by providing—

(A) A facsimile or carbon copy of the export bill of lading issued by the carrier who delivers the property,

(B) A certificate of an agent or representative of the carrier disclosing delivery of the property outside the United States,

(C) A facsimile or carbon copy of the certificate of lading for the property executed by a customs officer of the country to which the property is delivered,

(D) If that country has no customs administration, a written statement by the person to whom delivery outside the United States was made,

(E) A facsimile or carbon copy of the Shipper's Export Declaration, a monthly shipper's summary declaration filed with the Bureau of Customs, or a magnetic tape filed in lieu of the Shipper's Export Declaration, covering the property, or

(F) Any other proof (including evidence as to the nature of the property or the nature of the property or the nature of the transaction) which establishes to the satisfaction of the Commissioner that the property was ultimately delivered, or directly sold, or directly consumed outside the United States within 1 year after the sale or lease.

(ii) The requirements of subdivision (i)(A), (B), (C), or (E) of this paragraph will be considered satisfied even though the name of the ultimate consignee and the price paid for the goods is marked out provided that, in the case of a Shipper's Export Declaration or other document listed in subdivision (i)(E) of this paragraph or a document such as an export bill of lading, such document still indicates the country in which delivery to the ultimate consignee is to be made and, in the case of a certificate of an agent or representative of the carrier, that the document indicates that the property was delivered outside the United States.

(iii) A seller or lessor shall also establish the meeting of the requirement of paragraph (d)(2)(i) of this section (other than subdivision (i)(C) thereof), that the property was delivered outside the United States without further use, manufacture, assembly, or other processing within the United States.

(iv) For purposes of paragraph (d)(2)(i)(C) of this section, a purchaser or lessee of property is deemed to qualify as a FSC or an interest charge DISC for its taxable year if the seller or lessor obtains from the purchaser or lessee a copy of the purchaser's or lessee's election to be treated as a FSC or interest charge DISC together with the purchaser's or lessee's sworn statement that the election has been timely filed with the Internal Revenue Service Center. The copy of the election and the sworn statement of the purchaser or lessee must be received by the seller or lessor within 6 months after the sale or lease. A purchaser or lessee is not treated as a FSC or interest charge DISC with respect to a sale or lease during a taxable year for which the purchaser or lessee does not qualify as a FSC or interest charge DISC if the seller or lessor does not believe or if a reasonable person would not believe at the time the sale or lease is made that the purchaser or lessee will qualify as a FSC or interest charge DISC for the taxable year.

(v) If a seller or lessor fails to provide proof of compliance with the destination test as required by this paragraph (d)(3), the property sold or leased is not export property.

(4) *Sales and leases of property for ultimate use in the United States*—(i) *In general.* For purposes of paragraph (d)(1) of this section, the use test in this paragraph (d)(4) is satisfied with respect to property which—

(A) Under subdivision (4)(ii) through (iv) of this paragraph is not sold for ultimate use in the United States, or

(B) Under subdivision (4)(v) of this paragraph is leased for ultimate use outside the United States.

(ii) *Sales of property for ultimate use in the United States.* For purposes of subdivision (4)(i) of this paragraph, a purchaser of property (including components, as defined in subdivision (4)(vii) of this paragraph) is deemed to use the property ultimately in the United States if any of the following conditions exist:

(A) The purchaser is a related party with respect to the seller and the purchaser ultimately uses the property, or a second product into which the property is incorporated as a component, in the United States.

(B) At the time of the sale, there is an agreement or understanding that the property, or a second product into which the property is incorporated as a component, will be ultimately used by the purchaser in the United States.

(C) At the time of the sale, a reasonable person would have believed that the property or the second product would be ultimately used by the purchaser in the United States unless, in the case of a sale of components, the fair market value of the components at the time of delivery to the purchaser constitutes less than 20 percent of the fair market value of the second product into which the components are incorporated (determined at the time of completion of the production, manufacture, or assembly of the second product).

For purposes of subdivision (4)(ii)(B) of this paragraph, there is an agreement or understanding that property will ultimately be used in the United States if, for example, a component is sold abroad under an express agreement with the foreign purchaser that the component is to be incorporated into a product to be sold back to the United States. As a further example, there would also be such an agreement or understanding if the foreign purchaser indicated at the time of the sale or previously that the component is to be incorporated into a product which is designed principally for the United States market. However, such an agreement or understanding does not result from the mere fact that a second product, into which components exported from the United States have been incorporated and which is sold on the world market, is sold in substantial quantities in the United States.

(iii) *Use in the United States.* For purposes of subdivision (4)(ii) of this paragraph, property (including components incorporated into a second product) is or would be ultimately used in the United States by the purchaser if, at any time within 3 years after the purchase of such property or components, either the property is or the components (or the second product into which the components are incorporated) are resold by the purchaser for use by a subsequent purchaser within the United States or the purchaser or subsequent purchaser fails, for any period of 365 consecutive days, to use the property or second product predominantly outside the United States (as defined in subdivision (4)(vi) of this paragraph).

(iv) *Sales to retailers.* For purposes of subdivision (4)(ii)(C) of this paragraph, property sold to any person whose principal business consists of selling from inventory to retail customers at retail outlets outside the United States will be considered to be used predominantly outside the United States.

(v) *Leases of property for ultimate use outside the United States.* For purposes of subdivision (4)(i) of this paragraph, a lessee of property is deemed to use property ultimately outside the United States during a taxable year of the lessor if the property is used predominantly outside the United States (as defined in subdivision (4)(vi) of this paragraph) by the lessee during the portion of the lessor's taxable year which is included within the term of the lease. A determination as to whether the ultimate use of leased property satisfies the requirements of this subdivision is made for each taxable year of the lessor. Thus, leased property may be used predominantly outside the United States for a taxable year of the lessor (and thus, constitute export property if the remaining requirements of this section are met) even if the property is not used predominantly outside the United States in earlier taxable years or later taxable years of the lessor.

(vi) *Predominant use outside the United States.* For purposes of this paragraph (d)(4), property is used predominantly outside the United States for any period if, during that period, the property is located outside the United States more than 50 percent of the time. An aircraft, railroad rolling stock, vessel, motor vehicle, container, or other property used for transportation purposes is deemed to be used predominantly outside the United States for any period if, during that period, either the property is located outside the United States more than 50 percent of the time or more than 50 percent of the miles traversed in the use of the property are traversed outside the United States. However, property is deemed to be within the United States at all times during which it is engaged in transport between any two points within the United States, except where the transport constitutes uninterrupted international air transportation within the meaning of section 4262(c)(3) and the regulations under that section (relating to tax on air transportation of persons). An orbiting satellite is deemed to be located outside the United States. For purposes of applying section 4262(c)(3) to this subdivision, the term ''United States'' includes the Commonwealth of Puerto Rico.

(vii) *Component.* For purposes of this paragraph (d)(4), a component is property which is (or is reasonably expected to be) incorporated into a second product by the purchaser of such component by means of production, manufacture, or assembly.

(e) *Foreign content of property*—(1) *The 50 percent test.* Under paragraph (a)(3) of this section, no more than 50 percent of the fair market value of export property may be attributable to the fair market value of articles which were imported into the United States. For purposes of this paragraph (e), articles imported into the United States are referred to as ‘‘foreign content.’’ The fair market value of the foreign content of export property is computed in accordance with paragraph (e)(4) of this section. The fair market value of export property which is sold to a person who is not a related person with respect to the seller is the sale price for such property (not including interest, finance or carrying charges, or similar charges.)

(2) *Application of 50 percent test.* The 50 percent test is applied on an item-by-item basis. If, however, a person sells or leases a large volume of substantially identical export property in a taxable year and if all of that property contains substantially identical foreign content in substantially the same proportion, the person may determine the portion of foreign content contained in that property on an aggregate basis.

(3) *Parts and services.* If, at the time property is sold or leased the seller or lessor agrees to furnish parts pursuant to a services contract (as provided in §1.924(a)–1T(d)(3)) and the price for the parts is not separately stated, the 50 percent test is applied on an aggregate basis to the property and parts. If the price for the parts is separately stated, the 50 percent test is applied separately to the property and to the parts.

(4) *Computation of foreign content*—(i) *Valuation.* For purposes of applying the 50 percent test, it is necessary to determine the fair market value of all articles which constitutes foreign content of the property being tested to determine if it is export property. The fair market value of the imported articles is determined as of the time the articles are imported into the United States.

(A) *General rule.* Except as provided in paragraph (e)(4)(i)(B), the fair market value of the imported articles which constitutes foreign content is their appraised value, as determined under section 403 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with their importation. The appraised value of the articles is the full dutiable value of the articles, determined, however, without regard to any special provision in the United States tariff laws which would result in a lower dutiable value.

(B) *Special election.* If all or a portion of the imported article was originally manufactured, produced, grown, or extracted in the United States, the taxpayer may elect to determine the fair market value of the imported articles which constitutes foreign content under the provisions of this paragraph (e)(4)(i)(B) if the property is subjected to manufacturing or production (as defined in paragraph (c) of this section) within the United States after importation. A taxpayer making the election under this paragraph may determine the fair market value of the imported articles which constitutes foreign content to be the fair market value of the imported articles reduced by the fair market value at the time of the initial export of the portion of the property that was manufactured, produced, grown, or extracted in the United States. The taxpayer must establish the fair market value of the imported articles and of the portion of the property manufactured, produced, grown, or extracted in the United States at the time of the initial export in accordance with subdivision (4)(ii)(B) of this paragraph.

(ii) *Evidence of fair market value*— (A) *General rule.* For purposes of subdivision (4)(i)(A) of this paragraph, the fair market value of the imported articles is their appraised value, which may be evidenced by the customs invoice issued on the importation of such articles into the United States. If the holder of the articles is not the importer (or a related person with respect to the importer), the appraised value of the articles may be evidenced by a certificate based upon information contained in the customs invoice and furnished to the holder by the person from whom the articles (or property incorporating the articles) were purchased. If a customs invoice or certificate described in the preceding sentences is not available to a person purchasing property, the person shall establish that no more than 50 percent of the fair market value of such property is attributable to the fair market value of articles which were imported into the United States.

(B) *Special election.* For purposes of the special election set forth in subdivision (4)(i)(B) of this paragraph, if the initial export is made to a controlled person within the meaning of section 482, the fair market value of the imported articles and of the portion of the articles that are manufactured, produced, grown, or extracted within the United States shall be established by the taxpayer in accordance with the rules under section 482 and the regulations under that section. If the initial export is not made to a controlled person, the fair market value must be established by the taxpayer under the facts and circumstances.

(iii) *Interchangeable component articles.* (A) If identical or similar component articles can be incorporated interchangeably into property and a person acquires component articles that are imported into the United States and other component articles that are not imported into the United States, the determination whether imported component articles were incorporated in the property that is exported from the United States shall be made on a substitution basis as in the case of the rules relating to drawback accounts under the customs laws. See section 313(b) of the Tariff Act of 1930, as amended (19 U.S.C. 1313(b)).

(B) The provisions of subdivision (4)(iii)(A) of this paragraph may be illustrated by the following example:

Example. Assume that a manufacturer produces a total of 20,000 electronic devices. The manufacturer exports 5,000 of the devices and subsequently sells 11,000 of the devices to a FSC which exports the 11,000 devices. The major single component article in each device is a tube which represents 60 percent of the fair market value of the device at the time the device is sold by the manufacturer. The manufacturer imports 8,000 of the tubes and produces the remaining 12,000 tubes. For purposes of this subdivision, in accordance with the substitution principle used in the customs drawback laws, the 5,000 devices exported by the manufacturer are each treated as containing an imported tube because the devices were exported prior to the sale to the FSC. The remaining 3,000 imported tubes are treated as being contained in the first 3,000 devices purchased and exported by the FSC. Thus, since the 50 percent test is not met with respect to the first 3,000 devices purchased and exported by the FSC, those devices are not export property. The remaining 8,000 devices purchased and exported by the FSC are treated as containing tubes produced in the United States, and those devices are export property (if they otherwise meet the requirements of this section).

(f) *Excluded property*—(1) *In general.* Notwithstanding any other provision of this section, the following property is not export property—

(i) Property described in subdivision (2) of this paragraph (relating to property leased to a member of controlled group),

(ii) Property described in subdivision (3) of this paragraph (relating to certain types of intangible property),

(iii) Products described in paragraph (g) of this section (relating to oil and gas products), and

(iv) Products described in paragraph (h) of this section (relating to certain export controlled products).

(2) *Property leased to member of controlled group*—(i) *In general.* Property leased to a person (whether or not a FSC) which is a member of the same controlled group as the lessor constitutes export property for any period of time only if during the period—

(A) The property is held for sublease, or is subleased, by the person to a third person for the ultimate use of the third person;

(B) The third person is not a member of the same controlled group; and

(C) The property is used predominantly outside the United States by the third person.

(ii) *Predominant use.* The provisions of paragraph (d)(4)(vi) of this section apply in determining under subdivision (2)(i)(C) of this paragraph whether the property is used predominantly outside the United States by the third person.

(iii) *Leasing rule.* For purposes of this paragraph (f)(2), leased property is deemed to be ultimately used by a member of the same controlled group as the lessor if such property is leased to a person which is not a member of the controlled group but which subleases the property to a person which is a member of the controlled group. Thus, for example, if X, a FSC for the taxable year, leases a movie film to Y, a foreign corporation which is not a member of the same controlled group as X, and Y then subleases the film to persons which are members of the controlled group for showing to the general public, the film is not export property. On the other hand, if X, a FSC for the taxable year, leases a movie film to Z, a foreign corporation which is a member of the same controlled group as X, and Z then subleases the film to Y, another foreign corporation, which is not a member of the same controlled group for showing to the general public, the film is not disqualified from being export property.

(iv) *Certain copyrights.* With respect to a copyright which is not excluded by subdivision (3) of this paragraph from being export property, the ultimate use of the property is the sale or exhibition of the property to the general public. Thus, if A, a FSC for the taxable year, leases recording tapes to B, a foreign corporation which is a member of the same controlled group as A, and if B makes records from the recording tape and sells the records to C, another foreign corporation, which is not a member of the same controlled group, for sale by C to the general public, the recording tape is not disqualified under this paragraph from being export property, notwithstanding the leasing of the recording tape by A to a member of the same controlled group, since the ultimate use of the tape is the sale of the records (*i.e.*, property produced from the recording tape).

(3) *Intangible property.* Export property does not include any patent, invention, model, design, formula, or process, whether or not patented, or any copyright (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademark, tradebrand, franchise, or other like property. Although a copyright such as a copyright on a book or computer software does not constitute export property, a copyrighted article (such as a book or standardized, mass marketed computer software) if not accompanied by a right to reproduce for external use is export property if the requirements of this section are otherwise satisfied. Computer software referred to in the preceding sentence may be on any medium, including, but not limited to, magnetic tape, punched cards, disks, semi-conductor chips and circuit boards. A license of a master recording tape for reproduction outside the United States is not disqualified under this paragraph from being export property.

(g) *Oil and gas*—(1) *In general.* Under section 927(a)(2)(C), export property does not include oil or gas (or any primary product thereof).

(2) *Primary product from oil or gas.* A primary product from oil or gas is not export property. For purposes of this paragraph—

(i) *Primary product from oil.* The term ‘‘primary product from oil’’ means crude oil and all products derived from the destructive distillation of crude oil, including—

(A) Volatile products,

(B) Light oils such as motor fuel and kerosene,

(C) Distillates such as naphtha,

(D) Lubricating oils,

(E) Greases and waxes, and

(F) Residues such as fuel oil.

For purposes of this paragraph, a product or commodity derived from shale oil which would be a primary product from oil if derived from crude oil is considered a primary product from oil.

(ii) *Primary product from gas.* The term ‘‘primary product from gas’’ means all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including—

(A) Natural gas,

(B) Condensates,

(C) Liquefied petroleum gases such as ethane, propane, and butane, and

(D) Liquid products such as natural gasoline.

(iii) *Primary products and changing technology.* The primary products from oil or gas described in subdivisions (2)(i) and (ii) of this paragraph and the processes described in those subdivisions are not intended to represent either the only primary products from oil or gas, or the only processes from which primary products may be derived under existing and future technologies. For example, petroleum coke, although not derived from the destructive distillation of crude oil, is a primary product from oil derived from an existing technology.

(iv) *Non-primary products.* For purposes of this paragraph, petrochemicals, medicinal products, insecticides and alcohols are not considered primary products from oil or gas.

(h) *Export controlled products*—(1) *In general.* Section 927(a)(2)(D) provides that an export controlled product is not export property. A product or commodity may be an export controlled product at one time but not an export controlled product at another time. For purposes of this paragraph, a product or commodity is an ''export controlled product'' at a particular time if at that time the export of such product or commodity is prohibited or curtailed under section 7(a) of the Export Administration Act of 1979, to effectuate the policy relating to the protection of the domestic economy set forth in paragraph (2)(C) of section 3 of the Export Administration Act of 1979. That policy is to use export controls to the extent necessary to protect the domestic economy from the excessive drain of scarce materials and to reduce the serious inflationary impact of foreign demand.

(2) *Products considered export controlled products*—(i) *In general.* For purposes of this paragraph, an export controlled product is a product or commodity, which is subject to short supply export controls under 15 CFR part 377. A product or commodity is considered an export controlled product for the duration of each control period which applies to such product or commodity. A control period of a product or commodity begins on and includes the initial control date (as defined in subdivision (2)(ii) of this paragraph) and ends on and includes the final control date (as defined in subdivision (2)(iii) of this paragraph).

(ii) *Initial control date.* The initial control date of a product or commodity which is subject to short supply export controls is the effective date stated in the regulations to 15 CFR part 377 which subjects the product or commodity to short supply export controls. If there is no effective date stated in these regulations, the initial control date of the product or commodity will be thirty days after the effective date of the regulations which subject the product or commodity to short supply export controls.

(iii) *Final control date.* The final control date of a product or commodity is the effective date stated in the regulations to 15 CFR part 377 which removes the product or commodity from short supply export controls. If there is no effective date stated in those regulations, the final control date of the product or commodity is the date which is thirty days after the effective date of the regulations which remove the product or commodity from short supply export control.

(iv) *Expiration of Export Administration Act.* An initial control date and final control date cannot occur after the expiration date of the Export Administration Act under the authority of which the short supply export controls were issued.

(3) *Effective dates*—(i) *Products controlled on January 1, 1985.* If a product or commodity was subject to short supply export controls on January 1, 1985, this paragraph shall apply to all sales, exchanges, other dispositions, or leases of the product or commodity made after January 1, 1985, by the FSC or by the FSC's related supplier if the FSC is the commission agent on the transaction.

(ii) *Products first controlled after January 1, 1985.* If a product or commodity becomes subject to short supply export controls after January 1, 1985, this paragraph applies to sales, exchanges, other dispositions, or leases of such product or commodity made on or after the initial control date of such product or commodity, and to owning such product or commodity on or after such date.

(iii) *Date of sales, exchange, lease, or other disposition.* For purposes of this paragraph (h)(3), the date of sale, exchange, or other disposition of a product or commodity is the date as of which title to such product or commodity passes. The date of a lease is the date as of which the lessee takes possession of a product or commodity. The accounting method of a person is not determinative of the date of sale, exchange, other disposition, or lease.

(i) *Property in short supply.* If the President determines that the supply of any property which is otherwise export property as defined in this section is insufficient to meet the requirements of the domestic economy, he may by Executive Order designate such property as in short supply. Any property so designated will be treated under section 927(a)(3) as property which is not export property during the period beginning with the date specified in such Executive Order and ending with the date specified in an Executive Order setting forth the President's determination that such property is no longer in short supply.

[T.D. 8126, 52 FR 6459, Mar. 3, 1987]

§1.927(b)–1T Temporary regulations; Definition of gross receipts.

(a) *General rule.* Under section 927(b), for purposes of sections 921 through 927, the gross receipts of a person for a taxable year are—

(1) *Business income.* The total amounts received or accrued by the person from the sale or lease of property held primarily for sale or lease in the ordinary course of a trade or business, and

(2) *Other income.* Gross income recognized from whatever source derived, such as, for example, from—

(i) The furnishing of services (whether or not related to the sale or lease of property described in subdivision (1) of this paragraph),

(ii) Dividends and interest (including tax exempt interest),

(iii) The sale at a gain of any property not described in subdivision (1) of this paragraph, and

(iv) Commission transactions to the extent described in paragraph (e) of this section.

(b) *Non-gross receipts items.* For purposes of paragraph (a) of this section, gross receipts do not include amounts received or accrued by a person from—

(1) *Loan transactions.* The proceeds of a loan or of the repayment of a loan, or

(2) *Non-taxable transactions.* A receipt of property in a transaction to which section 118 (relating to contribution to capital) or section 1032 (relating to exchange of stock for property) applies.

(c) *Non-reduction of total amounts.* For purposes of paragraph (a) of this section, the total amounts received or accrued by a person are not reduced by costs of goods sold, expenses, losses, a deduction for dividends received, or any other deductible amounts. The total amounts received or accrued by a person are reduced by returns and allowances.

(d) *Method of accounting.* For purposes of paragraph (a) of this section, the total amounts received or accrued by a person shall be determined under the method of accounting used in computing its taxable income. If, for example, a FSC receives advance or installment payments for the sale or lease of property described in paragraph (a)(1) of this section, for the furnishing of services, or which represent recognized gain from the sale of property not described in paragraph (a)(1) of this section, any amount of such advance payments is considered to be gross receipts of the FSC for the taxable year for which such amount is included in the gross income of the FSC.

(e) *Commission transactions*—(1) *In general*—(i) *With a related supplier.* In the case of transactions which give rise to a commission from the FSC's related supplier on the sale or lease of property or the furnishing of services by a principal, the FSC's gross income from all such transactions is the commission paid or payable to the FSC by the related supplier. The FSC's gross receipts for purposes of computing its profit under the administrative pricing methods of section 925(a)(1) and (2) shall be the gross receipts (other than gross receipts which would not be foreign trading gross receipts had they been received by the FSC) derived by the related supplier from the sale or lease of the property or from the furnishing of services, with respect to which the commissions are derived. Also, in determining whether the 50% test in section 924(a) has been met, the relevant gross receipts are the gross receipts of the related supplier.

(ii) *With an unrelated principal.* In the case of transactions which give rise to a commission from an unrelated principal to a FSC on the sale or lease of property or the furnishing of services by a principal, the amount recognized by the FSC as gross income from all such transactions shall be the commission received from the principal.

(2) *Selective commission arrangements*—(i) *In general.* A commission arrangement between the FSC and its related supplier may provide that the FSC will not be the related supplier's commission agent with respect to sales or leases of export property, or the furnishing of services, which do not result in foreign trading gross receipts. In addition, the commission agreement may provide that the FSC will not be the related supplier's commission agent on transactions which would result in a loss to the related supplier under the transfer pricing rules of section 925(a). In a buy-sell FSC situation, selective commission arrangements are not applicable. Determination of which transactions fall within the selective commission arrangement may be made up to the due date under section 6072(b), including extensions provided for under section 6081, of the FSC's income tax return for the taxable year of the FSC during which a transaction occurs.

(ii) *Example.* The treatment of a selective commission arrangement may be illustrated by the following example:

Example. A calendar year commission FSC (''F'') entered into a selective commission arrangement with related supplier RS which provided that F will not be RS's commission agent on transactions which would result in a loss to RS under the transfer pricing rules of section 925(a). During 1987, RS sold three different articles of export property A, B and C, all of which fall within the same three digit Standard Industrial Classification. In July of 1988, while preparing the FSC's 1987 income tax return, RS determined that the sale of export property A resulted in a loss to RS under the section 482 method of section 925(a)(3) and that applying that method to the sales of export property B and C resulted in only a small amount of income to both RS and F. In addition, RS determined that grouping export property B and C, while excluding export property A from the grouping, resulted in the highest profit to F under the combined taxable income administrative pricing method of section 925(a)(2). Using the same grouping, the gross receipts method of section 925(a)(1) would result in a lower profit to F. Under the special no-loss rule of § 1.925(a)–1T(e)(1)(iii), RS would be prohibited from using the combined taxable income administrative pricing method to determine F's profit for the grouping of export property B and C if it used the section 482 method on the sale of export property A. This results because there was a loss to RS on the sale of export property A. Under the selective commission arrangement, RS could exercise its option and exclude the sale of export property A. Since F is no longer deemed to have been operating as RS's commission agent on that sale, the combined taxable income method may be used to compute F's profit on the grouping of the sales of export property B and C.

(f) *Example.* The definition of gross receipts under this section may be illustrated by the following example:

Example. During 1985, M, a related supplier of N, is engaged in the manufacture of machines in the United States. N, a calendar year FSC, is engaged in the sale and lease of such machines in foreign countries. N furnishes services which are related and subsidiary to its sale and lease of those machines. N also acts as a commission agent in foreign countries for Z, an unrelated supplier, with respect to Z's sale of products. N receives dividends on stock owned by it, interest on loans, and proceeds from sales of business assets located outside the United States resulting in recognized gains and losses. N's gross receipts for 1985 are $3,550, computed on the basis of the additional facts assumed in the table below:

N's sales receipts for machines manufactured by M (without reduction for cost of goods sold and selling expenses)	$1,500
N's lease receipts for machines manufactured by M (without reduction for depreciation and leasing expenses)	500
N's gross income from related and subsidiary services for machines manufactured by M (without reduction for service expenses)	400
N's sales receipts for products manufactured by Z (without reduction for Z's cost of goods sold, commissions on sales and commission sales expenses)	550
Dividends received by N	150
Interest received by N	200
Proceeds received by N representing recognized gain (but not losses) for sales of business assets located outside the United States	250

N's gross receipts	3,550

[T.D. 8126, 52 FR 6464, Mar. 3, 1987]

§1.927(d)–1 Other definitions.

(a) *Carrying Charges.*

Q–1. Under what circumstances is the sales price of property or services sold by a FSC or a related supplier considered to include carrying charges as defined in subdivision (ii)(B)(*1*) of Q&A–9 of §1.921–2?

A–1. (i) The proceeds received from a sale of export property by a FSC or a related supplier (or the amount paid for services rendered or from rental of export property) may include carrying charges if any part of the sale proceeds (or service or rental payment) is paid after the end of the normal payment period. If the export property is sold or leased by, or if the services are rendered by, the FSC, the entire carrying charges amount as determined in Q&A–2 of this section will be the income of the FSC. If, however, the FSC is the commission agent of a related supplier on these transactions, the carrying charges amount so determined is income of the related supplier. The commission payable to the FSC will be computed by reducing the related supplier's gross receipts from the transaction by the amount of the carrying charges. No carrying charges will be assessed on the commissions paid by the related supplier to the FSC. The carrying charges provisions, likewise, do not apply to any other transaction that does not give rise to foreign trading gross receipts.

(ii) The normal payment period for a sale transaction is 60 days from the earlier of date of sale or date of exchange of property under the contract. For this purpose, the date of sale will be the date the sale is recorded on the seller's books of account under its normal accounting method. The date the transaction was recorded on the seller's books of account shall be disregarded if recording is delayed in order to delay the start of the normal payment period. In these circumstances, the earlier of the date of the contract or date of exchange of property will be deemed the date of sale. For related and subsidiary services that are not separately stated from the sale or lease transaction, the earlier of the date of the sale or date the export property is delivered to the purchaser is the applicable date. For related and subsidiary services which are separately stated from the sale or lease transaction and for other services, such as engineering and architectural services, the normal payment period is 60 days from the earlier of the date payment is due for the services or the date services under the contract are completed. The date of completion of a services contract is the date of final approval of the services by the recipient. With regard to transactions involving the lease or rental of export property, the normal payment period will begin on the date the rental payment is due under the lease. The date the normal payment period begins under this subdivision (ii) will be the same whether or not the transaction is with a related person.

(iii) The carrying charges are computed for the period beginning with the first day after the end of the normal payment period and ending with the date of payment. A FSC may elect at any time prior to the close of the statute of limitations of section 6501(a) for the FSC taxable year to treat the final date of payment stated in the contract as the date of payment if—

(A) The contracts for all transactions completed during the taxable year require that payment be received within the normal payment period,

(B) No more than 20% of transactions for which final payment is received in the taxable year involve payment after the end of the normal payment period. For FSC taxable years beginning after March 3, 1987, the 20% test will apply only to the dollar value of the transactions and not to the number of transactions. For prior taxable years, the 20% test will apply to either the dollar value of the transactions or to the number of transactions. The special grouping rules applicable to determination of the FSC's profit under the administrative pricing rules of section 925 may be applied to this elective provision. Accordingly, transactions may be grouped into product or product-line groupings to determine whether 20% or less of the dollar value (or number of transactions, if applicable) of the grouped transactions involve payment after the end of the normal payment period.

Q–2. How are carrying charges as defined in subdivision (ii)(B)(*1*) of Q&A 9 of § 1.921–9 computed?

A–2. If carrying charges as defined in subdivision (ii)(B)(*1*) of Q&A 9 of § 1.921–9 are considered to be included in the sale price of property income or rental payment services, the amount of the carrying charges is equal to the amount in subdivision (i) of this answer if the contract provides for stated interest or the amount in subdivisions (ii) or (iii) of this answer, whichever is applicable, if the contract does not so provide.

(i) If a contract provides for stated interest beginning on the day after the end of the normal payment period, carrying charges will accrue only if the stated interest rate is less than the short-term, monthly Federal rate as of the day after the end of normal payment period and then only to the extent the stated interest is less than the short-term, monthly Federal rate. The short-term, monthly Federal rate is that rate as determined for purposes of section 1274(d) and which is published in the Internal Revenue Bulletin. Carrying charges will not accrue, however, unless payments are made after the end of the normal payment period.

(ii) If a contract for a transaction does not provide for stated interest, and if the taxpayer does not elect the method described in subdivision (iii) of this answer, the amount of carrying charges is equal to the excess of—

(A) The amount of the sales price of property, services income or rental payment that is unpaid on the day after the end of the normal payment period, over

(B) The present value, as of the day after the end of the normal payment period, of all payments that are required to be made under the contract and that are unpaid on the day after the end of the normal payment period. The amount of the sales price of property, service income or rental payment is the amount under the contract whether it be the sales price, amount paid for services or the rental amount determined as of the actual payment date unless a FSC makes the election provided under subdivision (iii) of Q&A 1. If a FSC makes the election provided under subdivision (III) of Q&A 1, the amount of the sales price is the sales price, services income or rental payment under the contract determined as of the final payment date stated in the contract. All payments that are required to be made under the contract include the stated sales price, services income or rental payment as well as stated amounts of interest and carrying charges. The discount rate for the present value computation is simple interest at the short-term monthly Federal rate published in the Internal Revenue Bulletin, determined as of the day after the end of the normal payment period. The present value of a payment is calculated as follows:

$$P = S\frac{1}{(1+(i\times t))}$$

P=present value of a payment that is required and unpaid after the end of the normal payment period

S=amount of a payment that is required and unpaid after the end of the normal payment period

i=the short-term monthly Federal rate

t=the number of days after the end of the normal payment period and before date of payment divided by 365.

If a sale is made, or if services are completed, or if rent is due under a lease in a taxable year and the required date of payment is in a later taxable year, carrying charges for the first taxable year are computed for the number of days after the end of the normal payment period and before the end of the taxable year. For the following taxable year, carrying charges are computed for the number of days after the beginning of the taxable year and before the date of payment.

(iii) At the election of the taxpayer, the amount of carrying charges may be determined under the method described in this subdivision (iii). If the taxpayer elects this method, it must be used for all applicable transactions within the taxable year of the FSC. If this optional method is used, the computation of carrying charges must be made separately for transactions involving related persons and for those transactions involving unrelated persons. In addition, the computation of carrying charges must be made separately for each of the five types of income of the FSC (or of the related supplier if the related supplier is the principal on the transaction) listed in subparagraph (1) through (5) of section 924(a). These groupings are separate and distinct from the groupings that are established for purposes of determining the FSC's profit on the export transactions. The optional method allowed in this subdivision provides that the amount of carrying charges for a taxable year of a FSC (or related supplier if the related supplier is the principal on the export transaction) is computed using the average of receivables of unrelated persons (or of related persons) and the average time those receivables are outstanding. Receivables are included in this computation only if they are from transactions on which foreign trading gross receipts, as defined in section 924(a), are received by the FSC (or which are received by a related supplier of a FSC and which would have been foreign trading gross receipts had they been received by the FSC). Carrying charges are calculated under this method as follows:

CC=(AR) (I/365) (X) (Y)

CC=Carrying charges

AR=Average monthly receivables balance for the taxable year

I=The average short-term, monthly Federal rate for the year

X=The number of times receivables turn over in the year

Y=The number of days the average receivables are outstanding over 60 days.

This optional method is illustrated in *Example 5* in subdivision (v) of this answer.

(iv) The computation of carrying charges under this answer 2 applies only to the determination of carrying charges under subdivision (ii)(B)(*1*) of Q&A 9 of § 1.921–2 and does not apply to the determination of any other unstated interest or for any other purpose.

(v) The following examples illustrate the computation of carrying charges under this section:

Example 1. On January 1, 1985, a FSC sells export property for $10,000. The export property is delivered to the purchaser on January 10, 1985. The terms of the contract require payment within 90 days after sale. The normal payment period is 60 days. The FSC does not make an election under subdivision (iii) of Q&A. The contract does not require the payment of any interest or carrying charges. The purchaser pays the entire sales price on March 1, 1985. The sales price is not considered to include any carrying charges because the purchase paid the entire sales price within the normal payment period.

Example 2. The facts are the same as in example 1 except that the purchaser pays the entire sales price on April 6, 1985, 96 days after the earlier of the date of sale or date of delivery (*i.e.*, January 1, 1985). Therefore, the sales price is considered to include carrying charges computed as follows:

Step 1: Determines the short-term monthly Federal rate as of the earlier of date of sale or date of delivery. For purposes of this example, the rate is 10%.

Step 2: Determine the fraction of the year represented by the number of days after 60 days and before date of payment. In this example, the number of days beyond 60 is 96–60=36, which is divided by 365

$$\frac{36\text{ days}}{365\text{ days}} = .099\text{ fraction of the year}$$

Step. 3: Using the short-term monthly Federal rate and the fraction of the year, compute the present value of the payment.

$$P = S\frac{1}{\left(1+\left(i\times t\right)\right)}$$

$$P = \$10{,}000\,\frac{1}{\left(1+\left(.10\sqrt{099}\right)\right)}$$

P=$10,000 (.99)

P=$9,900

Step 4: Using the present value of all payments, compute the carrying charges.

Carrying Charges=Sales Price less Present Value.

$10,000	Sales Price
–9,900	Present Value
$100	Carrying charges

Example 3. On October 15, 1985, F, a FSC, leases export property to X for one month with a total rental due of $20,000. Under the terms of the lease, A agreed to pay F $10,000 on October 15, 1985, and the remaining $10,000 on January 15, 1986. The contract does not require the payment of any interest or carrying charges. The second $10,000 payment is made on January 3, 1986. This payment does not include any carrying charges because X paid the $10,000 before the start of the normal payment period.

Example 4. On October 15, 1985, F, a FSC, leases export property to X, for one month with a total amount due under the lease of $10,000, payable on October 15, 1985. X delays payment until January 19, 1986, which was 96 days after the start of the normal payment period. The 60 day normal payment period terminated on December 14, 1985. Therefore, the lease payment is considered to include carrying charges of $100 computed in the same manner as in *Example 2.* Of this $100, 17/36, or $47.22, is carrying charges for 1985 (*i.e.,* 17 days in December), and 19/36, or $52.78, is carrying charges for 1986.

Example 5. During 1986, F, a FSC, sold on account export properties A and B to related and unrelated persons.

(A) *Unrelated persons.* During 1986, the sales on account to unrelated persons totaled $6,000. On the last day of each of the months of 1986, F had total receivables from unrelated persons from sales of export properties A and B, as follows:

January 31	$1,400
February 28	1,400
March 31	1,000
April 30	1,000
May 31	1,200
June 30	1,300
July 31	1,000
August 31	1,300
September 30	1,500
October 31	1,100
November 30	1,200
December 31	1,000
	14,400

Carrying charges for 1986 with unrelated persons under the optional method of subdivision (iii) of this answer will be $19.23, computed as follows:

Step 1: Determine the average short-term, monthly Federal rate for the year. For purposes of this example, the rate is assumed to be 9%.

Step 2: Determine the average receivables for the year. This average is calculated by totaling the end of the month receivables balance of each month of the year and dividing by twelve. In this example, the average monthly receivables balance is $1,200, calculated as follows:

$$\$1{,}200=\$14{,}400/12$$

Step 3: Determine the number of times the receivables turn over during the year. This is calculated by dividing the sales on account for the year by the average monthly receivables balance for the year. For purposes of this example, receivables turned over 5 times for 1986, computed as follows:

$$5=\frac{\$6{,}000}{\$1{,}200}$$

Step 4: Determine the number of days the average receivables are outstanding in excess of 60 days. In this example, there are 13 receivable days in excess of 60 days, computed as follows:

$$13\,\text{days}=\left(\frac{365}{5}\right)-60\,\text{days}$$

Step 5: The amount of carrying charges, $19.23, is calculated by using the following equation:

CC=(AR) (I/365) (X)(Y)

CC=Carrying charges

AR=Average monthly receivables balance for the taxable year (step 2)

I=The average short-term monthly Federal rate for the year (step 1)

X=The number of times receivables turn over in the year (step 3)

Y=The number of days the average receivables are outstanding over 60 days (step 4).

CC=$19.23=($1,200) (.09/365) (5) (13)

(B) *Related persons.* Carrying charges, if any, on the sales on account to related persons must be computed separately using this optional method.

Q–3. Is a discount from the sales price of property or services for prompt payment considered to be stated carrying charges as defined in subdivision (ii)(A) of Q&A 9 of § 1.921–2?

A–3. No.

Q–4. Is the receipt of an arm's length factoring payment from an unrelated person considered a payment of the sales proceeds for purposes of determining whether payment is made within the normal payment period and the possible imposition of carrying charges?

A–4. Yes.

[T.D. 8127, 52 FR 6473, Mar. 3, 1987]

§ 1.927(d)–2T Temporary regulations; definitions and special rules relating to Foreign Sales Corporation.

(a) *Definition of related supplier.* For purposes of sections 921 through 927 and the regulations under those sections, the term ''related supplier'' means a related party which directly supplies to a FSC any property or services which the FSC disposes of in a transaction producing foreign trading gross receipts, or a related party which uses the FSC as a commission agent in the disposition of any property or services producing foreign trading gross receipts. A FSC may have different related suppliers with respect to different transactions. If, for example, X owns all the stock of Y, a corporation, and of F, a FSC, and X sells a product to Y which is resold to F, only Y is the related supplier of F. If, however, X sells directly to F and Y also sells directly to F, then, as to the transactions involving direct sales to F, each of X and Y is a related supplier of F.

(b) *Definition of related party.* The term ''related party'' means a person which is owned or controlled directly or indirectly by the same interests as the FSC within the meaning of section 482 and §1.482–1(a).

[T.D. 8126, 52 FR 6465, Mar. 3, 1987]

§1.927(e)–1 Special sourcing rule.

(a) *Source rules for related persons*—(1) *In general.* The income of a person described in section 482 from a sale of export property giving rise to foreign trading gross receipts of a FSC that is treated as from sources outside the United States shall not exceed the amount that would be treated as foreign source income earned by such person if the pricing rule under section 994 that corresponds to the rule used under section 925 with respect to such transaction applied to such transaction. This special sourcing rule also applies if the FSC is acting as a commission agent for the related supplier with respect to the transaction described in the first sentence of this paragraph (a)(1) that gives rise to foreign trading gross receipts and the transfer pricing rules of section 925 are used to determine the commission payable to the FSC. No limitation results under this section with respect to a transaction to which the section 482 pricing rule under section 925(a)(3) applies.

(2) *Grouping of transactions.* If, for purposes of determining the FSC's profits under the administrative pricing rules of sections 925(a) (1) and (2), grouping of transactions under §1.925(a)–1T(c)(8) was elected, the same grouping shall be used for making the determinations under the special sourcing rule in this section.

(3) *Corresponding DISC pricing rules*—(i) *In general.* For purposes of this section—

(A) The DISC gross receipts pricing rule of section 994(a)(1) corresponds to the gross receipts pricing rule of section 925(a)(1);

(B) The DISC combined taxable income pricing rule of section 994(a)(2) corresponds to the combined taxable income pricing rule of section 925(a)(2); and

(C) The DISC section 482 pricing rule of section 994(a)(3) corresponds to the section 482 pricing rule of section 925(a)(3).

(ii) *Special rules.* For purposes of this section—

(A) The DISC pricing rules of section 994(a)(1) and (2) shall be determined without regard to export promotion expenses;

(B) Qualified export receipts under section 994(a)(1) and

(2) Shall be deemed to be an amount equal to the foreign trading gross receipts arising from the transaction; and

(C) Combined taxable income for purposes of section 994(a)(2) shall be deemed to be an amount equal to the combined taxable income for purposes of section 925(a)(2) arising from the transaction.

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

Example 1. (i) R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, which is a FSC acting as a commission agent for R. For the taxable year, R and F used the combined taxable income pricing rule of section 925(a)(2). For the taxable year, the combined taxable income of R and F is $100 from the sale of export property, as defined in section 927(a), manufactured by R using production assets located in the United States. Title to the export property passed outside of the United States.

(ii) Under section 925(a)(2), 23 percent of the $100 combined taxable income of R and F ($23) is allocated to F and the remaining $77 is allocated to R. Absent the special sourcing rule, under section 863(b) the $77 income allocated to R would be sourced $38.50 U.S. source and $38.50 foreign source. Under the special sourcing rule, the amount of foreign source income earned by a related supplier of a FSC shall not exceed the amount that would result if the corresponding DISC pricing rule applied. The DISC combined taxable income pricing rule of section 994(a)(2) corresponds to the combined taxable income pricing rule of section 925(a)(2). Under section 994(a)(2), $50 of the combined taxable income ($100 x .50) would be allocated to the DISC and the remaining $50 would be allocated to the related supplier. Under section 863(b), the $50 income allocated to the DISC's related supplier would be sourced $25 U.S. source and $25 foreign source. Accordingly, under the special sourcing rule, the foreign source income of R shall not exceed $25.

Example 2. (i) Assume the same facts as in *Example 1* except that R and F used the gross receipts pricing rule of section 925(a)(1). In addition, for the taxable year foreign trading gross receipts derived from the sale of the export property are $2,000.

(ii) Under section 925(a)(1), 1.83 percent of the $2,000 foreign trading gross receipts ($36.60) is allocated to F and the $63.40 remaining combined taxable income ($100−$36.60) is allocated to R. Absent the special sourcing rule, under section 863(b) the $63.40 income allocated to R would be sourced $31.70 U.S. source and $31.70 foreign source. Under the special sourcing rule, the amount of foreign source income earned by a related supplier of a FSC shall not exceed the amount that would result if the corresponding DISC pricing rule applied. The DISC gross receipts pricing rule of section 994(a)(1) corresponds to the gross receipts pricing rule of section 925(a)(1). Under section 994(a)(1), $80 ($2,000 × .04) would be allocated to the DISC and the $20 remaining combined taxable income would be allocated to the related supplier. Under section 863(b), the $20 income allocated to the DISC's related supplier would be sourced $10 U.S. source and $10 foreign source. Accordingly, under the special sourcing rule, the foreign source income of R shall not exceed $10.

(c) *Effective date.* The rules of this section are applicable to taxable years beginning after December 31, 1997.

[T.D. 8782, 63 FR 50144, Sept. 21, 1998]

§ 1.927(e)–2T Temporary regulations; effect of boycott participation on FSC and small FSC benefits.

(a) *International boycott factor.* If the FSC (or small FSC) or any member of the FSC's (or small FSC's) controlled group participates in or cooperates with an international boycott within the meaning of section 999, the FSC's (or small FSC's) exempt foreign trade income as determined under section 923 (a) shall be reduced by an amount equal to the product of the FSC's (or small FSC's) exempt foreign trade income multiplied by the international boycott factor determined under section 999. The amount of the reduction will be considered as non-exempt foreign trade income.

(b) *Specifically attributable taxes and income method.* If the taxpayer clearly demonstrates that the income earned for the taxable year is attributable to specific operations, then in lieu of applying the international boycott factor for such taxable year, the amount of the exempt foreign trade income as determined under section 923(a) that will be reduced by this section shall be the amount specifically attributable to the operations in which there was participation in or cooperation with an international boycott under section 999(b)(1). The amount of the reduction will be considered as non-exempt foreign trade income.

[T.D. 8126, 52 FR 6465, Mar. 3, 1987]

§ 1.927(f)–1 Election and termination of status as a Foreign Sales Corporation.

(a) *Election of status as a FSC or a small FSC.*

Q–1. What is the effect of an election by a corporation to be treated as a FSC or small FSC?

A–1. A valid election to be treated as a FSC or a small FSC applies to the taxable year of the corporation for which made and remains in effect for all succeeding taxable years in which the corporation qualifies to be a FSC unless revoked by the corporation or unless the corporation fails for five consecutive years to qualify as a FSC (in case of a FSC election) or as a small FSC (in case of a small FSC election).

Q–2. Can a corporation established prior to January 1, 1985 be treated as a FSC or a small FSC prior to making a FSC or a small FSC election?

A–2. A corporation cannot be treated as a FSC or a small FSC until it has made a FSC or a small FSC election. An election made within the first 90 days of 1985 relates back to January 1, 1985 unless the taxpayer indicates otherwise.

Q–3. If a shareholder who has not consented to a FSC or small FSC election transfers some or all of its shares before or during the first taxable year for which the election is made, may the holder of the transferred shares consent to the election?

A–3. A holder of the transferred shares may consent to a FSC or small FSC elction under the circumstances described in § 1.922–2(c)(1). The rules contained in § 1.992–(c) shall apply to the consent by a holder of transferred shares.

Q–4. If a shareholder who has consented to a FSC or a small FSC election transfers some or all of its shares before the first taxable year for which the election is made, must the holder of the transferred shares consent to the election?

A–4. Yes. Consent must be made by any recipient of such shares on or before the 90th day after the first day of such first taxable year. If such recipient fails to file his consent on or before such 90th day, and extension of time for filing such consent may be granted in the manner, and subject to the conditions, described in paragraph (b)(3) of § 1.992–2.

Q–5. May an election of a corporation to be a FSC or a small FSC be effective as of a time other than the start of the corporation's taxable year?

A–5. No.

Q–6. If a fiscal year foreign corporation was in existence on December 31, 1984, must it wait until the first day of its taxable year beginning after January 1, 1985, to elect FSC status?

A–6. No. If a fiscal year foreign corporation was in existence on December 31, 1984, its taxable year will be deemed to have terminated on that date if the foreign corporation elects FSC status to be effective January 1, 1985. An income tax return will be required for any short years created by the deemed closing of the taxable year unless the corporation is relieved from the necessity of making a return by section 6012 and the regulations under that section. If the corporation's taxable year is deemed closed by operation of this regulation, the filing date of tax returns for the short taxable year ended on December 31, 1984, will be automatically extended until May 18, 1987.

Q–7. What is the effect of an election to be treated as a FSC or as a small FSC if the corporation or any other member of the controlled group has in effect an election to be treated as an interest charge DISC?

A–7. The interest charge DISC election shall be treated as revoked for all purposes under the Code as of the date the FSC election is effective. An affirmative revocation of the DISC election is unnecessary. The FSC election shall take effect. As long as the FSC election remains in effect, neither the corporation nor any other member of the controlled group is permitted to elect to be treated as an interest charge DISC for any taxable year including any part of a taxable year during which the corporation's FSC election continues to be effective.

Q–8. What is the effect of an election to be treated as a small FSC if the corporation or any other member of the controlled group has in effect an election to be treated as a FSC?

A–8. As long as a FSC election remains in effect, neither the corporation nor any other member of the controlled group is permitted to elect to be treated as a small FSC for any taxable year including any part of a taxable year during which a FSC election continues to be effective. Any FSC within the controlled group must affirmatively revoke its FSC election for a taxable year including any part of a taxable year for which small FSC status is elected.

Q–9. What is the effect of an election to be treated as a FSC if the corporation or any other member of the controlled group has in effect an election to be treated as a small FSC?

A–9. As long as a small FSC election remains in effect, neither the corporation nor any other member of the controlled group is permitted to elect to be treated as a FSC for any taxable year including any part of the taxable year during which a small FSC election continues to be effective. Any small FSC within the controlled group must affirmatively revoke its small FSC election for a taxable year including any part of a taxable year for which FSC status is elected. An election to be treated as a small FSC is permitted if the corporation or any other member of the controlled group has in effect an election to be treated as a small FSC. For a special rule providing for conversion of a small FSC to a FSC within one taxable year, see § 1.921–1T(b)(1) (Q&A–1).

(b) *Termination of election of status as a FSC or a small FSC.*

Q–10. How is the status of a corporation as a FSC or as a small FSC terminated?

A–10. The status of a corporation as a FSC or as a small FSC is terminated through revocation or by its continued failure to be a FSC.

Q–11. For what taxable year may a corporation revoke its election to be treated as a FSC or as a small FSC?

A–11. A corporation may revoke its election to be treated as a FSC or as a small FSC for any taxable year of the corporation after the first taxable year for which the election is effective.

Q–12. When must a corporation revoke a FSC or a small FSC election if revocation is to be effective for the taxable year in which revocation takes place?

A–12. If a corporation files a statement revoking its election to be treated as a FSC or as a small FSC during the first 90 days of a taxable year (other than the first taxable year for which such election is effective), such revocation will be effective for such taxable year and all taxable years thereafter. If the corporation files a statement revoking its election to be treated as a FSC or a small FSC after the firs 90 days of a taxable year, the revocation will be effective for all taxable years following such taxable year.

Q–13. Can a FSC change its status to a small FSC, or can a small FSC change its status to a FSC as of a date other than the first day of a taxable year?

A–13. No. Since a revocation of an election to be a FSC or a small FSC is effective only for entire taxable year, a corporation's change between FSC and small FSC status is effective as of the first day of a taxable year.

Q–14. How may a corporation revoke an election by a corporation to be treated as a FSC or a small FSC?

A–14. A corporation may revoke its election by filing a statement that the corporation revokes its election under section 922(a) to be treated as a FSC or under section 922(b) to be treated as a small FSC. Such statement shall indicate the corporation's name, address, employer identification number, and the first taxable year of the corporation for which the revocation is to be effective. The statement shall be signed by any person authorized to sign a corporate return under section 6062. Such revocation shall be filed with the Service Center with which the corporation filed its return.

Q–15. What if the effect is a corporation that has elected to be treated as a FSC or a small FSC fails to qualify as a FSC because it does not meet the requirements of section 922 for a taxable year?

A–15. If a corporation that has elected to be treated as a FSC or a small FSC does not qualify as a FSC or a small FSC for a taxable year, the corporation will not be treated as a FSC or a small FSC for the taxable year. However, the failure of a corporation to qualify to be treated as a FSC or a small FSC for a taxable year does not terminate the election of the corporation to be treated as FSC or a small FSC unless the corporation does not qualify under section 922 for each of 5 consecutive taxable years, as provided in Q&A 16 of this section.

Q–16. Under what circumstances is the FSC or small FSC election terminated for continued failure to be a FSC?

A–16. If a corporation that has elected to be treated as a FSC or a small FSC does not qualify under section 922 to be treated as a FSC or small FSC for each of 5 consecutive taxable years, such election terminates and will not be effective for any taxable year after such fifth taxable year. Such termination will be effective automatically without notice to such corporation or to the Internal Revenue Service.

[T.D. 8127, 52 FR 6475, Mar. 3, 1987]

POSSESSIONS OF THE UNITED STATES

§ 1.931–1 Citizens of the United States and domestic corporations deriving income from sources within a certain possession of the United States.

(a) *Definitions.* (1) As used in section 931 and this section, the term ''possession of the United States'' includes American Samoa, Guam, Johnston Island, Midway Islands, the Panama Canal Zone, Puerto Rico, and Wake Island. However, the term does not include (i) the Virgin Islands and (ii), when used with respect to citizens of the United States, the term does not include Puerto Rico or, in the case of taxable years beginning after December 31, 1972, Guam.

(2) As used in section 931 and this section, the term ''United States'' includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia.

(b) *General rule*—(1) *Qualifications.* In the case of a citizen of the United States or a domestic corporation satisfying the following conditions, gross income means only gross income from sources within the United States—

(i) If 80 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of section 931) for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States, and

(ii) If 50 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of section 931) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States. In the case of a citizen, the trade or business may be conducted on his own account or as an employee or agent of another. The salary or other compensation paid by the United States to the members of its civil, military, or naval personnel for services rendered within a possession of the United States represents income derived from the active conduct of a trade or business within a possession of the United States. The salary or other compensation paid for services performed by a citizen of the United States as an employee of the United States or any agency thereof shall, for the purposes of section 931 and this section, be deemed to be derived from sources within the United States. Dividends received by a citizen from a corporation whose income was derived from the active conduct of a business within a possession of the United States, does not represent income derived from the active conduct of a trade or business within the possession of the United States even though such citizen was actively engaged in the management of such corporation. For a determination of income from sources within the United States, see part I (section 861 and following), subchapter N, chapter 1 of the Code, and section 931(i), and the regulations thereunder.

(2) *Relationship of sections 931 and 911.* A citizen of the United States who cannot meet the 80-percent and the 50-percent requirements of section 931 but who receives earned income from sources within a possession of the United States, is not deprived of the benefits of the provisions of section 911 (relating to the exemption of earned income from sources outside the United States), provided he meets the requirements thereof. In such a case none of the provisions of section 931 is applicable in determining the citizen's tax liability. For what constitutes earned income, see section 911(b).

(3) *Meaning of ''gross income'' on joint return.* In the case of a husband and wife making a joint return, the term ''gross income,'' as used in this section, means the combined gross income of the spouses.

(4) *Returns.* A citizen entitled to the benefits of section 931 is required to file with his individual return Form 1040 the schedule on Form 1040E. If a citizen entitled to the benefits of section 931 has no income from sources within the United States and does not receive within the United States any income derived from sources without the United States he is not required to file a return or the schedule on Form 1040E.

(5) *Illustration of the operation of section 931.* This section may be illustrated by the following example:

Example. On July 1, 1954, A, who is a citizen of the United States, went to a possession of the United States and established a business there which he actively conducted during the remainder of that year. His gross income from the business during such period was $20,000. In addition, he made a profit of $12,000 from the sale during the latter part of 1954 of some real estate located in such possession and not connected with his trade or business. In the first six months of 1954 he also derived $8,000 gross income from rental property located in the United States. He derived a like amount of gross income from such property during the last six months of 1954. On these facts, A may exclude the

$32,000 derived from sources within the possession of the United States, since he qualified under section 931 with respect to that amount. The period of July 1, 1954, through December 31, 1954, constitutes the applicable part of the 3-year period immediately preceding the close of the taxable year (the calendar year 1954), and for that period, 80 percent of A's gross income was derived from sources within a possession of the United States ($32,000, or 80 percent of $40,000) and 50 percent or more of A's gross income was derived from the active conduct of a trade or business within a possession of the United States ($20,000, or 50 percent of $40,000). A is required to report on his return for 1954 only the gross income derived by him from sources within the United States ($16,000 from the rental property located in the United States).

(c) *Amounts received in the United States.* Notwithstanding the provisions of section 931(a), there shall be included in the gross income of citizens and domestic corporations therein specified all amounts, whether derived from sources within or without the United States, which are received by such citizens or corporations within the United States. From the amounts so included in gross income there shall be deducted only the expenses properly apportioned or allocated thereto. For instance, if in the example set forth in paragraph (b)(5) of this section, the taxpayer during the latter part of 1954 returned to the United States for a few weeks and while there received the proceeds resulting from the sale of the real estate located in the possession, the profits derived from such transaction should be reported in gross income. Such receipt in the United States, however, would not deprive the taxpayer of the benefits of section 931 with respect to other items of gross income excluded by that section.

(d) *Deductions*—(1) *Individuals.* In the case of a citizen entitled to the benefits of section 931, the deductions allowed in computing taxable income, except the standard deduction and a deduction for one personal exemption (see sections 142(b)(2) and 931(e), respectively), are allowed only if and to the extent that they are connected with income from sources within the United States. The provisions of section 873 and the regulations thereunder, relating to the allowance to nonresident alien individuals, who at any time within the taxable year were engaged in trade or business within the United States, of the deductions provided in section 165(c)(2) and (3) for losses not connected with the trade or business, are applicable in the case of citizens entitled to the benefits of section 931. The provisions of section 873 (c) and the regulations thereunder pertaining to the allowance to such nonresident alien individuals of deductions for contributions provided in section 170 are also applied in the case of such citizens.

(2) *Corporations.* Corporations entitled to the benefits of section 931 are allowed the same deductions from their gross income arising from sources within the United States as are allowed to domestic corporations to the extent that such deductions are connected with such gross income, except that the so-called charitable contribution deduction provided by section 170 to corporations is allowed whether or not connected with income from sources within the United States. The proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

(e) *Deduction for personal exemption.* A citizen of the United States entitled to the benefits of section 931 is allowed a deduction for only one exemption under section 151.

(f) *Allowance of deductions and credits.* Unless a citizen of the United States or a domestic corporation entitled to the benefits of section 931 shall file or cause to be filed with the district director a true and accurate return of total income from all sources within the United States, in the manner prescribed in subtitle F of the Code, the tax shall be collected on the basis of the gross income (not the taxable income) from sources within the United States. If such citizen or corporation fails to file a necessary income tax return, the Commissioner will cause a return to be made, including therein all income from sources within the United States and allowing no deductions or credits (except credit for tax withheld at source).

(g) *Foreign tax credit.* Persons entitled to the benefits of section 931 are not allowed the credits provided for in section 901 (relating to credits for taxes of foreign countries and possessions).

(h) *Internees.* If a citizen of the United States—

(1) Was interned by the enemy while serving as an employee within a possession of the United States; and

(2) Was confined in any place not within a possession of the United States, then

(i) Such place of confinement shall be considered as within a possession of the United States for the purposes of section 931; and

(ii) Section 931 (b) shall not apply to any compensation received within the United States by such citizen attributable to the period of time during which such citizen was interned by the enemy.

(i) *Employees of the United States.* For the purposes of section 931, amounts paid for services performed by a citizen of the United States as an employee of the United States or any agency thereof shall be deemed to be derived from sources within the United States.

(j) *Nonapplication to a DISC or shareholder thereof.* Section 931 does not apply to a corporation for a taxable year (1) for which it qualifies (or is treated) as a DISC or (2) during which it owns directly or indirectly at any time stock in a corporation which, at such time, is (or is treated as) a DISC or former DISC. (See section 992(a)(1) and (3), respectively, for the definitions of the terms ''DISC'' and ''former DISC''.) For example, assume X Corporation and Y Corporation have the same taxable years. On the first day of its taxable year, X owns and sells all of the stock in Y, Y on such day owns and sells all of the stock in Z Corporation, and Z qualifies as a DISC as of such day. Section 931 will not apply to X and Y for their taxable years. Section 931 will likewise not apply to Z for the taxable year for which it qualifies as a DISC.

(Secs. 7805 (68A Stat. 917; 26 U.S.C. 7805) and 7654(e) (86 Stat. 1496; 26 U.S.C. 7654 (c)) of the Internal Revenue Code of 1954)

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7283, 38 FR 20825, Aug. 3, 1973; T.D. 7385, 40 FR 50260, Oct. 29, 1975]

§1.932–1 Status of citizens of U.S. possessions.

(a) *General rule*—(1) *Definition and treatment.* A citizen of a possession of the United States (except Puerto Rico and, for taxable years beginning after December 31, 1972, Guam), who is not otherwise a citizen or resident of the United States, including only the States and the District of Columbia, is treated for the purpose of the taxes imposed by subtitle A of the Code (relating to income taxes) as if he were a nonresident alien individual. However, for purposes of the tax imposed on self-employment income by chapter 2 of the Code, the term ''possession of the United States'' as used in section 932 and the preceding sentence does not include American Samoa, Guam, or the Virgin Islands. See section 1402(a)(9). See subpart A (section 871 and following), part II, subchapter N, chapter 1 of the Code, and the regulations thereunder, for rules relating to imposition of tax on nonresident alien individuals. For Federal income tax purposes, a citizen of a possession of the United States who is not otherwise a citizen of the United States is a citizen of a possession of the United States who has not become a citizen of the United States by naturalization in a State, Territory, or the District of Columbia. The fixed or determinable annual or periodical income from sources within the United States of a citizen of a possession of the United States who is treated as if he were a nonresident alien individual is subject to withholding. See section 1441.

(2) *Classification of citizens of United States possessions.* For the purpose of this section citizens of the possessions of the United States who are not otherwise citizens of the United States are divided into two classes:

(i) Citizens of possessions of the United States who at any time within the taxable year are not engaged in trade or business within the United States, and

(ii) Citizens of possessions of the United States who at any time within the taxable year are engaged in trade or business within the United States.

The provisions of subpart A (section 871 and following) and the regulations thereunder, applicable to nonresident alien individuals not engaged in trade or business within the United States are applicable to the citizens of possessions falling within the first class, while the provisions of such sections applicable to nonresident alien individuals who at any time within the taxable year are engaged in trade or business within the United States are applicable to citizens of possessions falling within the second class.

(b) *Nonapplication to citizen of Puerto Rico or Guam.* The provisions of section 932(a) and paragraph (a) of this section do not apply in the case of a citizen of Puerto Rico or, for taxable years beginning after December 31, 1972, a citizen of Guam. Thus, for example, any such citizen who is not a resident of the United States will not be treated by the United States as a nonresident alien individual for purposes of section 2 (b)(3)(A) or (d), relating to definitions and special rules; section 4(d)(1), relating to taxpayers not eligible to use the optional tax tables; section 37(h), relating to denial of retirement income credit; section 116(d), relating to taxpayers ineligible for dividend exclusion; section 142(b)(1), relating to taxpayers ineligible for standard deduction; section 152(b)(3), relating to definition of ''dependent''; section 402(a)(4), relating to distributions by the United States to nonresident aliens; section 545(d), relating to certain foreign corporations; section 565(e), relating to certain consent dividends; section 861(a)(1), relating to interest from sources within the United States; sections 871 to 877, relating to nonresident alien individuals; section 1303(b), relating to individuals not eligible for income averaging; section 1371(a)(3), relating to definition of small business corporation; section 1402(b), relating to definition of ''self-employment income''; section 1441, relating to withholding of tax on nonresident aliens; section 3401(a), relating to definition of wages; section 6013(a)(1), relating to inability to make a joint return; section 6015 (b) and (i), relating to declaration of estimated income tax by nonresident alien individuals; section 6017, relating to self-employment tax returns; section 6042(b)(2), relating to returns regarding payments of dividends; section 6049(b)(2), relating to returns regarding payments of interest; section 6072 (c), relating to time for filing returns of nonresident alien individuals; section 6091(b), relating to place for filing returns of nonresident aliens; and section 6096(a), relating to designation of tax payments to Presidential Election Campaign Fund. For other rules applicable to citizens of Puerto Rico, see §§ 1.1–1(b) and 1.933–1. For other rules applicable to citizens of Guam, see §§ 1.1–1(b) and 1.935–1 of this chapter (Income Tax Regulations) and § 301.7654–1 of this chapter (Regulations on Procedure and Administration).

(Secs. 7805 (68A Stat. 917; 26 U.S.C. 7805) and 7654(e) (86 Stat. 1496; 26 U.S.C. 7654 (e)) of the Internal Revenue Code of 1954)

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7385, 40 FR 50260, Oct. 29, 1975]

§ 1.933–1 Exclusion of certain income from sources within Puerto Rico.

(a) *General rule.* An individual (whether a United States citizen or an alien), who is a bona fide resident of Puerto Rico during the entire taxable year, shall exclude from his gross income the income derived from sources within Puerto Rico, except amounts received for services performed as an employee of the United States or any agency thereof. Whether the individual is a bona fide resident of Puerto Rico shall be determined in general by applying to the facts and circumstances in each case the principles of §§ 1.871–2, 1.871–3, 1.871–4, and 1.871–5, relating to what constitutes residence or nonresidence, as the case may be in the United States in the case of an alien individual. Once bona fide residence in Puerto Rico has been established, temporary absence therefrom in the United States or elsewhere on vacation or business trips will not necessarily deprive an individual of his status as a bona fide resident of Puerto Rico. An individual taking up residence in Puerto Rico during the course of the taxable year is not entitled for such year to the exclusion provided in section 933.

(b) *Taxable year of change of residence from Puerto Rico.* A citizen of the United States who changes his residence from Puerto Rico after having been a bona fide resident thereof for a period of at least two years immediately preceding the date of such change in residence shall exclude from his gross income the income derived from sources within Puerto Rico which is attributable to that part of such period of Puerto Rican residence which preceded the date of such change in residence, except amounts received for services performed as an employee of the United States or any agency thereof.

(c) *Deductions.* In any case in which any amount otherwise constituting gross income is excluded from gross income under the provisions of section 933, there shall not be allowed as a deduction from gross income any items of expenses or losses or other deductions (except the deduction under section 151, relating to personal exemptions) properly allocable to, or chargeable against, the amounts so excluded from gross income.

§1.934–1 Limitation on reduction in income tax liability incurred to the Virgin Islands.

(a) *General rule.* Section 934(a) provides that tax liability incurred to the Virgin Islands shall not be reduced or remitted in any way, directly or indirectly, whether by grant, subsidy, or other similar payment, by any law enacted in the Virgin Islands, except to the extent provided in section 934 (b) or (c). For purposes of the preceding sentence, the term ‘‘tax liability’’ means the liability incurred to the Virgin Islands pursuant to subtitle A of the Code, as made applicable in the Virgin Islands by the Act of July 12, 1921 (48 U.S.C. 1397), or pursuant to section 28(a) of the Revised Organic Act of the Virgin Islands (48 U.S.C. 1642).

(b) *Exception for certain domestic and Virgin Islands corporations*—(1) *General rule.* Section 934(b) provides an exception to the application of section 934(a). Under this exception, section 934(a) does not apply with respect to tax liability incurred to the Virgin Islands by a domestic or Virgin Islands corporation for any taxable year (or for such part of such year as may be applicable) to the extent that such tax liability is attributable to income derived from sources without the United States, if such corporation satisfies the conditions provided in section 934(b)(1) and (2), and if the information required by section 934(d) is supplied. These conditions are enumerated in the remainder of this paragraph, and the information requirement is set forth in paragraph (d) of this section.

(2) *Conditions to be satisfied for exception.* A domestic or Virgin Islands corporation satisfies the conditions of section 934(b)(1) and (2) if—

(i) Eighty percent or more of the gross income of such corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within the Virgin Islands; and

(ii) Fifty percent or more of the gross income of such corporation for such period (or such part thereof) was derived from the active conduct of a trade or business within the Virgin Islands.

(3) *Computation rule.* Except as provided in subparagraph (5) of this paragraph, tax liability incurred to the Virgin Islands by a domestic or Virgin Islands corporation for the taxable year (or such part of such year as may be applicable) attributable to income derived from sources without the United States shall be computed as follows:

(i) Add to the income tax liability incurred to the Virgin Islands any credit against the tax allowed under section 901(a);

(ii) Multiply by taxable income from sources without the United States for the applicable period;

(iii) Divide by total taxable income for the period;

(iv) Subtract any credit against the tax allowed under section 901(a). Tax liability incurred to the Virgin Islands attributable to income derived from sources without the United States, as computed in this subparagraph, however, shall not exceed the total amount of income tax liability actually incurred.

(4) *Examples.* The rule of the preceding subparagraph may be illustrated by the following examples:

Example 1. Corporation X, which satisfies the requirements of section 934(b), incurs an income tax liability to the Virgin Islands for taxable year 1963 of $290, as follows:

Taxable income from sources within the U.S	$200	
Taxable income from sources without the U.S	800	
Total taxable income		$1,000
Credit allowed under section 901(a)		10
Tax liability incurred to the Virgin Islands		290
The income tax liability incurred to the Virgin Islands attributable to income derived from sources without the United States is $230, computed as follows:		
(i) Tax liability incurred to the Virgin Islands	290	
Plus credit allowed under section 901(a)	10	
		300
(ii) Multiply by taxable income from sources without the U.S	800	
		240,000
(iii) Divide by total taxable income	1,000	
		240
(iv) Subtract credit allowed under section 901(a)	10	
		230

Example 2. Corporation Y, which satisfies the requirements of section 934(b), incurs an income tax liability to the Virgin Islands for taxable year 1963 of $140, as follows:

Taxable income from sources within the U.S	($300 net loss)	
Taxable income from sources without the U.S	800	
Total taxable income		$500
Credit allowed under section 901(a)		10
Tax liability incurred to the Virgin Islands		140
The income tax liability incurred to the Virgin Islands attributable to income derived from sources without the United States is 140, computed as follows:		
(i) Tax liability incurred to the Virgin Islands	140	
Plus credit allowed under section 901(a)	10	
		150
(ii) Multiply by taxable income from sources without the U.S.	800	
		120,000
(iii) Divide by total taxable income	500	
		240
(iv) Subtract credit allowed under section 901(a)	10	
		230

Since the $230 derived from the computation is in excess of the actual tax liability incurred, the income tax liability incurred to the Virgin Islands attributable to income derived from sources without the United States is limited to $140, the actual liability incurred.

(5) *Special computation rule for certain domestic corporations.* For purposes of section 934(b) and this paragraph, tax liability incurred to the Virgin Islands by a domestic corporation which is required to file an income tax return with the United States for the taxable year (or such part of such year as may be applicable) attributable to income derived from sources without the United States shall be the actual income tax liability incurred to the Virgin Islands for such year.

(6) *Source of income.* For purposes of section 934(b) and this paragraph, the income of a Virgin Islands corporation, and the sources from which the income of such corporation is derived, shall be determined as if such corporation were a domestic corporation. However, all amounts received by a corporation within the United States, whether derived from sources within or without the United States, shall be considered as being derived from sources within the United States. In determining the sources from which the income of a domestic or Virgin Islands corporation is derived, the principles of part 1 (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder shall apply.

(c) *Exception for certain residents of the Virgin Islands*—(1) *General rule.* Section 934(c) provides another exception to the application of section 934(a). Under this exception, section 934(a) does not apply with respect to the tax liability incurred by an individual citizen of the United States to the Virgin Islands for any taxable year to the extent that such tax liability is attributable to income derived from sources within the Virgin Islands, if such individual is a bona fide resident of the Virgin Islands during the entire taxable year and if he supplies the information required under section 934(d).

(2) *Definition—bona fide resident and United States citizen.* In determining whether a United States citizen is a bona fide resident of the Virgin Islands, the principles of §§ 1.871–2, 1.871–3, 1.871–4, and 1.871–5, relating to the determination of residence and nonresidence in the United States, shall apply. Once

a bona fide residence in the Virgin Islands is established by an individual, temporary absence therefrom will not necessarily deprive such individual of his status as a bona fide resident of the Virgin Islands. For purposes of section 934(c), a citizen of the United States includes any individual who is a citizen of the United States by reason of being a citizen of any possession of the United States.

(3) *Computation rule.* For purposes of section 934(c) and this paragraph, tax liability incurred to the Virgin Islands for the taxable year attributable to income derived from sources within the Virgin Islands shall be computed as follows:

(i) Add to the income tax liability incurred to the Virgin Islands any credit against the tax allowed under section 901(a);

(ii) Multiply by taxable income from sources within the Virgin Islands;

(iii) Divide by total taxable income. Tax liability incurred to the Virgin Islands attributable to income derived from sources within the Virgin Islands, as computed in this subparagraph, however, shall not exceed the total amount of income tax liability actually incurred.

(4) *Examples.* The rule of the preceding subparagraph may be illustrated by the following examples:

Example 1. A, an individual who satisfies the requirements of section 934(c), incurs an income tax liability to the Virgin Islands for taxable year 1963 of $380, as follows:

Taxable income from sources within the Virgin Islands	$1,200	
Taxable income from sources without the Virgin Islands	800	
Total taxable income		$2,000
Credit allowed under section 901(a)		20
Tax liability incurred to the Virgin Islands		380
The income tax liability incurred to the Virgin Islands attributable to income derived from sources within the Virgin Islands is $240, computed as follows:		
(i) Tax liability incurred to the Virgin Islands	380	
Plus credit allowed under section 901(a)	20	
		400
(ii) Multiply by taxable income from sources within the Virgin Islands	1,200	
		480,000
(iii) Divide by total taxable income		$2,000
		240

Example 2. B, an individual who satisfies the requirements of section 934(c), incurs an income tax liability to the Virgin Islands for taxable year 1963 of $100, as follows:

Taxable income from sources within the Virgin Islands	$800	
Taxable income from sources without the Virgin Islands	(200 net loss)	
Total taxable income		$600
Credit allowed under section 901(a)		20
Tax liability incurred to the Virgin Islands		100
The income tax liability incurred to the Virgin Islands attributable to income derived from sources within the Virgin Islands is $100, computed as follows:		
(i) Tax liability incurred to the Virgin Islands	100	
Plus credit allowed under section 901(a)	20	
		120
(ii) Multiply by taxable income from sources within the Virgin Islands	800	
		96,000
(iii) Divide by total taxable income	600	
		160

Since the $160 derived from the computation is in excess of the actual tax liability incurred, the income tax liability incurred to the Virgin Islands attributable to income derived from sources within the Virgin Islands is limited to $100, the actual liability incurred.

(5) *Source of income.* For purposes of section 934(c) and this paragraph, in determining taxable income from sources within and without the Virgin Islands the principles of part 1 (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder shall apply, except that—

(i) Any deductions for personal exemptions allowable under section 151 shall be deducted in computing taxable income from sources within the Virgin Islands but shall not be deducted in computing taxable income from sources without the Virgin Islands;

(ii) Amounts received for services performed as an employee of the United States or any agency thereof shall not be considered as income derived from sources within the Virgin Islands;

(iii) Gain or loss from the sale or exchange of any security (as defined in section 165(g)(2)) shall not be treated as derived from sources within the Virgin Islands.

(6) *Definition—''taxable income'' on a joint return.* In the case of a husband and wife making a joint return, the term ''taxable income'', as used in this paragraph, means the combined taxable income of both spouses.

(d) *Information required.* Section 934(d) provides that the exceptions in section 934 (b) and (c) shall apply only in the case of persons who supply such information as the Secretary or his delegate may by regulations prescribe for purposes of determining the applicability of such exceptions. The following portions of this paragraph, together with paragraphs (e) and (f) of this section, prescribe the information which must be filed. Any person seeking to come within an exception must provide the following information:

(1) The name and address of such person;

(2) If such person is one of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests within the meaning of section 482 and the regulations thereunder—

(i) The name and address of each such organization, trade, or business;

(ii) The relationship which each such organization, trade, or business bears to the other organizations, trades, or businesses in such group;

(iii) The nature of the activity or activities conducted by each such organization, trade, or business.

(3) Any person seeking to come within an exception must make available for inspection by the Director of International Operations such records, and underlying contracts and documents, as are necessary to determine the applicability of section 934(b) or (c).

(e) *Information required—corporations.* Corporations seeking to come within the exception provided in section 934(b) shall, in addition to the information required by paragraph (d) of this section, submit the following information with respect to each taxable year:

(1) The date and place of incorporation;

(2) The name and address of any shareholder of record owning at any time during the taxable year 5 percent or more of the voting stock of any class or 5 percent or more of the value of any class of outstanding stock, and the nature and amount of the stock owned;

(3) For the 3-year period immediately preceding the close of the corporation's taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable)—

(i) The total amount of its gross income;

(ii) The amount of such gross income derived from the active conduct of a trade or business within the Virgin Islands;

(iii) The amount of such gross income from sources within *(a)* the Virgin Islands, *(b)* the United States (including therein and specifically itemizing all amounts received within the United States), and (c) all other countries as a group;

(iv) The ratio which gross income derived from sources within the Virgin Islands bears to total gross income;

(v) The ratio which gross income derived from the active conduct of a trade or business within the Virgin Islands bears to total gross income.

(f) *Information required—individuals.* Individuals seeking to come within the exception provided in section 934(c) shall, in addition to the information required by paragraph (d) of this section, submit the following information with respect to each taxable year:

(1) The date on which such individual became a bona fide resident of the Virgin Islands;

(2) If such individual maintains a place of abode for himself or his family in the United States or elsewhere outside the Virgin Islands, the location of such place of abode and the purpose for which such place is maintained;

(3) The beginning and the ending dates of each period of absence from the Virgin Islands during such taxable year;

(4) The amount of gross income for such taxable year from sources within the Virgin Islands, excluding—

(i) The amount of gain or loss from the sale or exchange of any security, as defined in section 165(g)(2);

(ii) The amount of gross income received for services performed as an employee of the United States or any agency thereof.

(5) Any amounts excluded from gross income from sources within the Virgin Islands under subparagraph (4)(i) and (ii) of this paragraph.

(g) *Time and place for filing statement.* The statement, in duplicate, providing the information required under section 934(d) and paragraphs (d), (e), and (f) of this section shall be attached to the income tax return filed with the Government of the Virgin Islands for the taxable year with respect to which an exception is claimed under section 934 (b) or (c). If an exception is claimed with respect to any taxable year for which the time prescribed by law for filing the return expires prior to 30 days from the publication of these regulations, the required statement must be filed in duplicate on or before 90 days from the publication of these regulations. The return and statement must be available for examination by the Director of International Operations.

(h) *Effective date.* The provisions of this section shall apply to taxable years beginning after December 31, 1959.

[T.D. 6629, 27 FR 12791, Dec. 28, 1962]

§1.935–1 Coordination of U.S. and Guam individual income taxes.

(a) *Application of section*—(1) *Scope.* Section 935 and this section set forth the special rules relating to the filing of income tax returns, income tax liabilities, and estimated income tax of individuals described in subparagraph (2) of this paragraph. For additional rules relating to the collection of income tax at source on the wages of certain individuals, the furnishing of certain information with the returns of certain individuals, and the covering over to the treasury of Guam of net collections of income taxes imposed on certain individuals, see section 7654 and §301.7654–1 of this chapter (Regulations on Procedure and Administration).

(2) *Individuals covered.* This section shall apply for a taxable year to any individual who—

(i) Is a resident of Guam, whether or not he is a citizen of the United States,

(ii) Is a citizen of Guam but not otherwise a citizen of the United States,

(iii) Has income derived from Guam for the taxable year and is a citizen or resident of the United States, or

(iv) Files a joint return for the taxable year with any individual described in subdivision (i), (ii), or (iii) of this subparagraph.

(3) *Determination of residence and citizenship.* For purposes of this section, determinations of residence and citizenship for a taxable year shall be made (except as provided to the contrary in paragraphs (d)(1) and (2) of this section) as of the close of the taxable year. A citizen of the United States is any individual who is a citizen within the meaning of paragraph (c) of §1.1–1, except that the term does not include an individual who is a citizen of Guam but not otherwise a citizen of the United States. An individual who is a citizen of Guam but not otherwise a citizen of the United States is any individual who has become a citizen of the United States by birth or naturalization in Guam. Whether an individual is a resident of Guam or a resident of the United States shall generally be determined by applying to the facts and circumstances in each case the principles of §§1.871–2 through 1.871–5 relating to what constitutes residence or nonresidence, as the case may be, in the United States in the case of an alien individual. However, for special rules for determining the residence for tax purposes of individuals under military or naval orders, see section 514 of the Soldiers' and Sailors' Civil Relief Act of 1940, 50 App. U.S.C. 574. The residence of an individual, and, therefore, the jurisdiction with which he is required to file an income tax return under paragraph (b) of this section, may change from year to year.

(b) *Filing requirement*—(1) *Tax jurisdiction.* An individual described in paragraph (a)(2) of this section shall file his return of income tax for the taxable year—

(i) With the United States if he is a resident of the United States, whether or not he is a citizen of the United States,

(ii) With Guam if he is a resident of Guam, whether or not he is a citizen of Guam, or

(iii) If neither subdivision (i) nor (ii) of this subparagraph applies,

(A) With Guam if he is a citizen of Guam but not otherwise a citizen of the United States, as defined in paragraph (a)(3) of this section, or

(B) With the United States if he is a citizen of the United States, as defined in paragraph (a)(3) of this section. Thus, for example, if a U.S. citizen employed by the United States in Guam becomes a resident of Guam for the taxable year, he must file his return of income tax for such year with Guam. The tax shown on the return shall be paid to the jurisdiction with which such return is required to be filed and shall be determined by taking into account any credit under section 31 for tax withheld by Guam or the United States on wages, any credit under section 6402(b) for an overpayment of income tax to Guam or the United States, and any payments under section 6315 of estimated income tax paid to Guam or the United States. See paragraph (a)(3) of this section for the rule that determinations of residence and citizenship are to be made as of the close of the taxable year.

(2) *Joint returns.* In the case of married persons, if one or both spouses is an individual described in paragraph (a)(2) of this section and they file a joint return of income tax, the spouses shall file their joint return with, and pay the tax due on such return to, the jurisdiction where the spouse who has the greater adjusted gross income for the taxable year would be required under subparagraph (1) of this paragraph to file his return if separate returns were filed. For this purpose, adjusted gross income of each spouse is determined under section 62 and the regulations thereunder but without regard to community property laws; and, if one of the spouses dies, the taxable year of the surviving spouse shall be treated as ending on the date of such death.

(3) *Place for filing returns*—(i) *U.S. returns.* A return required under this paragraph to be filed with the United States shall be filed in accordance with § 1.6091–2, except that such return of a citizen or resident of the United States who is described in § 301.7654–1(a)(2) of this chapter (Regulations on Procedure and Administration) shall be filed with the Internal Revenue Service Center, 11601 Roosevelt Boulevard, Philadelphia, Pennsylvania 19155.

(ii) *Guam returns.* A return required under this paragraph to be filed with Guam shall be filed with the Commissioner of Revenue and Taxation, Agana, Guam 96910.

(4) *Tax accounting standards.* A taxpayer who has filed his return with one of the jurisdictions named in subparagraph (1) of this paragraph for a prior taxable year and is required to file his return for a later taxable year with the other such jurisdiction may not, for such later taxable year, change his accounting period, method of accounting, or any election to which he is bound with respect to his reporting of taxable income to the first jurisdiction unless he obtains the consent of the second jurisdiction to make such change. However, such change will not be effective for returns filed thereafter with the first jurisdiction unless before such later date of filing he also obtains the consent of the first jurisdiction to make such change. Any request for consent to make a change pursuant to this subparagraph must be made to the office where the return is required to be filed under subparagraph (3) of this paragraph and in sufficient time to permit a copy of the consent to be attached to the return for the taxable year.

(c) *Extent of liability for income tax*—(1) *Extension of territory*—(i) *General rule.* With respect to an individual who, for a taxable year, is described in paragraph (a)(2) of this section—

(A) For purposes of so much of the Internal Revenue Code of 1954 as relates to the normal taxes and the surtaxes imposed by chapter 1 thereof, the United States shall be treated, in a geographical and governmental sense, as including Guam, and

(B) For purposes of the Guam Territorial income tax (48 U.S.C. 1421i), Guam shall be treated, in a geographical and governmental sense, as including the United States except that this subdivision shall not apply for purposes of this section, section 7651, and section 7654.

(ii) *Application of general rule.* (A) The significance of the application of the rule of subdivision (i) of this subparagraph will depend upon the facts and circumstances of the particular case. The rule will not be applied where its application would be manifestly inapplicable or incompatible with the intent thereof. Thus, the rule will not be applied for purposes of section 3401, relating to definition of wages. Also, the rule will not be applied in determining the sources of dividends and interest from a domestic corporation. For example, if less than 20 percent of a domestic corporation's gross income is from U.S. sources for the period described in section 861(a)(1)(B) and (2)(A), but more than 20 percent of its gross income is from U.S. and Guam sources taken together for such period, the dividends and interest derived from it will be treated as derived from sources without the United States. In addition, for purposes of section 1372(e)(4), relating to whether an election of a small business corporation has been terminated because it derived more than 80 percent of its gross receipts from sources outside the United States, gross receipts from sources within Guam will be treated as gross receipts from sources outside the United States. On the other hand, some of the conclusions which may be reached as a result of the application of subdivision (i) of this subparagraph to a U.S. taxpayer (that is, an individual described in paragraph (b)(1)(i) or (iii)(B) of this section) are as follows. A U.S. taxpayer may not claim a foreign tax credit based upon his income from sources within Guam. Income tax paid to Guam may be taken into account under sections 31, 6315, and 6402(b) as payments to the United States. For purposes of section 116(a), relating to the partial exclusion of dividends received by individuals, dividends paid to a U.S. taxpayer by a corporation created or organized in Guam or under the law of Guam will be treated as dividends paid by a domestic corporation. Taxes paid to Guam and otherwise satisfying the requirements of section 164(a) will be allowed as a deduction under that section, but income taxes paid to Guam will be disallowed as a deduction under section 275(a).

(B) If a U.S. taxpayer has a net operating loss carryback or carryover under section 172, a foreign tax credit carryback or carryover under section 904, an investment credit carryback or carryover under section 46, a capital loss carryover under section 1212, or a charitable contributions carryover under section 170, the United States will take such carryback or carryover into account for a taxable year for which the taxpayer's return is required to be filed with the United States, and make a refund to the extent required under section 6402, even though the return of the taxpayer for the taxable year (whether beginning on, before, or after December 31, 1972) giving rise to the carryback or carryover was required to be filed with Guam.

(C) For purposes of income averaging of a U.S. taxpayer under sections 1301 through 1305, the taxpayer will not be denied status as an ''eligible individual'' merely because he was during the base period defined in section 1302(c)(2) treated under section 932 as a nonresident alien individual because he was a citizen of Guam but not otherwise a citizen of the United States. See section 1303(b). Furthermore, in determining the base period of such a U.S. taxpayer under section 1302(c)(2), taxable years for which a return was required to be filed with Guam shall be taken into account.

(D) In applying the Guam Territorial income tax the converse of the preceding rules under this subdivision will apply. Thus, for example, income tax paid to the United States may be taken into account under sections 31, 6315, and 6402(b) as payments to Guam. Moreover, a citizen of the United States (as defined in paragraph (a)(3) of this section) not a resident of Guam will not be treated as a nonresident alien individual for purposes of the Guam Territorial income tax. Thus, for example, a citizen of the United States (as so defined), or a resident of the United States, will not be treated as a nonresident alien individual for purposes of section 1371(a)(3) of the Guamanian Territorial income tax.

(2) *Liability to other jurisdiction*—(i) *Filing with Guam.* If for a taxable year

an individual is required under paragraph (b)(1) of this section to file a return with Guam, he is relieved of liability to file an income tax return with, and to pay an income tax to, the United States for the taxable year.

(ii) *Filing with the United States.* If for a taxable year an individual is required under paragraph (b)(1) of this section to file a return with the United States, he is relieved of liability to file an income tax return with, and to pay an income tax to, Guam for the taxable year.

(d) *Special rules for estimated income tax*—(1) *Declaration of estimated income tax.* If, under all the facts and circumstances existing at the date an individual is required to file a declaration of estimated income tax, there is reason to believe that he will, for the taxable year, be an individual described in paragraph (a)(2) of this section, he must file his declaration of estimated income tax (and all amendments thereof) with the jurisdiction with which he would be required to file a return under paragraph (b)(1) of this section if his taxable year had closed on the date he is first required to file a declaration of estimated income tax for the taxable year. Except as provided in paragraph (6) of this section (relating to underpayments of estimated income tax), payments of estimated income tax shall be made to the jurisdiction with which he is required to file the declaration even though for the taxable year he is required under paragraph (b)(1) of this section to file his return with the other jurisdiction. In determining the amount of such estimated income tax, income tax paid to Guam may be taken into account under sections 31 and 6402(b) as payments to the United States, and vice versa. For rules relating to the determination of, and time for filing, declarations of estimated tax, see sections 6015 and 6073; for rules relating to the time for paying installments of the tax, see section 6153.

(2) *Joint declaration of estimated income tax.* In the case of married persons, if, under all the facts and circumstances existing at the date a spouse is required to file a declaration of estimated income tax, there is reason to believe that he will, for the taxable year, be an individual described in paragraph (a)(2) of this section and the spouses file a joint declaration of estimated income tax, the spouses must file their joint declaration of estimated income tax (and all amendments thereof) with the jurisdiction where the spouse who has the greater estimated adjusted gross income for the taxable year would be required under subparagraph (1) of this paragraph to file his declaration of estimated income tax if separate declarations were filed. For this purpose, estimated adjusted gross income of each spouse for the taxable year is determined without regard to community property laws. Except as provided in paragraph (6) of this section, payments of estimated income tax shall be made to the jurisdiction with which the spouses are required to file the joint declaration.

(3) *Early filing of declarations.* If the individual or spouses have in fact filed a declaration or joint declaration of estimated income tax earlier than the time he or they are first required to file the declaration and such declaration was not filed where it is required to be filed under paragraph (d)(1) or (2) of this section, as the case may be, of this paragraph, only subsequent amendments of the declaration are required to be filed pursuant to such paragraph (d)(1) or (2) of this section with the other jurisdiction and only subsequent installments of the estimated income tax are required to be paid to the other jurisdiction.

(4) *Place for filing declarations.* A declaration of estimated income tax required under subparagraph (1) of this paragraph to be filed with Guam, shall be filed as prescribed in paragraph (b)(3)(ii) of this section. A declaration of estimated income tax required under subparagraph (1) of this paragraph to be filed with the United States shall be filed at the place prescribed by § 1.6073–1(c).

(5) *Liability to other jurisdiction*—(i) *Filing with Guam.* If, for a taxable year, an individual is required under this paragraph to file a declaration of estimated income tax with Guam, he is relieved of liability to file a declaration of estimated income tax (and any amendments thereof) with, and to make payments of estimated income

tax to, the United States for the taxable year.

(ii) *Filing with the United States.* If, for a taxable year, an individual is required under this paragraph to file a declaration of estimated income tax with the United States, he is relieved of liability to file a declaration of estimated income tax (and any amendments thereof) with, and to make payments of estimated income tax to, Guam for the taxable year.

(6) *Underpayments.* The liability of an individual described in paragraph (a)(2) of this section for underpayments of estimated income tax for a taxable year, as determined under section 6654 and the regulations thereunder, shall be to the jurisdiction with which he is required under paragraph (b) of this section to file his return for the taxable year.

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

Example 1. B, and individual, files returns on a calendar year basis. B is a resident of the United States at the time he is required to file his declaration of estimated income tax for 1974. If, under the facts and circumstances, B does not reasonably expect at the time he files his declaration of estimated income tax that he will be a resident of Guam at the close of 1974, he will not be subject to this section at the time of such filing. However, B subsequently receives Guam source income which necessitates an amendment of his declaration, and some time later in 1974 he becomes a resident of Guam for the remainder of the year. B is required under paragraph (d)(1) of this section to file his amended declaration with the United States and to make payments of the estimated tax to the United States. However, B is required to file his income tax return for 1974 with Guam and to make any underpayments of estimated tax to Guam, pursuant to paragraphs (b)(1) and (d)(6) of this section.

Example 2. C, an individual, files returns on a calendar year basis. On March 1, 1974, C is a resident of the United States, files his declaration of estimated income tax for 1974 with the United States, and pays his first installment of estimated tax to the United States. Prior to the date C would otherwise be required to file his declaration of estimated income tax for 1974 (April 15, 1974), C becomes a resident of Guam for the remainder of the year. C is required under paragraph (d)(1) of this section to make only his remaining payments of installments of estimated tax to Guam. C is also required to file his income tax return for 1974 with Guam and to make any underpayments of estimated tax to Guam, pursuant to paragraphs (b)(1) and (d)(6) of this section.

Example 3. D, an individual, files returns on a calendar year basis. On August 1, 1974, D ceases to be a resident of the United States for the year and becomes a resident of Guam for the remainder of the year. D is first required to file a declaration of estimated income tax for 1974 on September 15, 1974, because of his receipt of an extraordinary item of income after June 15, 1974. D is required under paragraph (d)(1) of this section to file his declaration with Guam and to make payments of the estimated tax to Guam. D is also required to file his income tax return for 1974 with Guam and to make any underpayments of estimated tax to Guam, pursuant to paragraphs (b)(1) and (d)(6) of this section.

(f) *Effective date.* This section shall apply for taxable years beginning after December 31, 1972.

(Secs. 7805 (68A Stat. 917; 26 U.S.C. 7805) and 7654(e) (86 Stat. 1496; 26 U.S.C. 7654 (e)) of the Internal Revenue Code of 1954)

[T.D. 7385, 40 FR 50261, Oct. 29, 1975]

§1.936–1 Elections.

(a) *Making an election.* A domestic corporation shall make an election under section 936(e), for any taxable year beginning after December 31, 1975, by filing Form 5712 on or before the later of—

(1) The date on which such corporation is required, pursuant to sections 6072(b) and 6081, to file its Federal income tax return for the first taxable year for which the election is made; or

(2) April 8, 1980.

Form 5712 shall be filed with the Internal Revenue Service Center, 11601 Roosevelt Boulevard, Philadelphia, Pennsylvania 19155 (Philadelphia Center).

(b) *Revoking an election.* Any corporation to which an election under section 936 (e) applies on February 8, 1980 is hereby granted the consent of the Secretary to revoke that election for the first taxable year to which the election applied. (The corporation may make a new election under §1.936–1 (a) for any subsequent taxable year.) The corporation shall make this revocation by sending to the Philadelphia Center a written statement of revocation on or before April 8, 1980.

(Secs. 7805 and 936(e) of the Internal Revenue Code of 1954 (68A Stat. 917 and 90 Stat. 1644; 26 U.S.C. 7805 and 936(e)))

[T.D. 7673, 45 FR 8588, Feb. 8, 1980; T.D. 7673, 45 FR 16174, Mar. 13, 1980]

§ 1.936–4 Intangible property income in the absence of an election out.

The rules in this section apply for purposes of section 936(h) and also for purposes of section 934(e), where applicable.

Q. 1: If a possessions corporation and its affiliates do not make an election under either the cost sharing or 50/50 profit split option, what rules will govern the treatment of income attributable to intangible property owned or leased by the possessions corporation?

A. 1: Intangible property income will be allocated to the possessions corporation's U.S. shareholders with the proration of income based on shareholdings. If a shareholder of the possessions corporation is a foreign person or a tax-exempt person, the possessions corporation will be taxable on that shareholder's pro rata amount of the intangible property income. If any class of the stock of a possessions corporation is regularly traded on an established securities market, then the intangible property income will be taxable to the possessions corporation rather than the corporation's U.S. shareholders. For these purposes, a United States shareholder includes any shareholder who is a United States person as described under section 7701(a)(30). The term ''intangible property income'' means the gross income of a possessions corporation attributable to any intangible property other than intangible property which has been licensed to such corporation since prior to 1948 and which was in use by such corporation on September 3, 1982.

Q. 2: What is the source of the intangible property income described in question 1?

A. 2: The intangible property income is U.S. source, whether taxed to U.S. shareholders or taxed to the possessions corporation. Such intangible property income, if treated as income of the possessions corporation, does not enter into the calculation of the 80-percent possessions source test or the 65-percent active trade or business test of section 936(a)(2)(A) and (B).

Q. 3: How will the amount of income attributable to intangible property be measured?

A. 3: Income attributable to intangible property includes the amount received by a possessions corporation from the sale, exchange, or other disposition of any product or from the rendering of a service which is in excess of the reasonable costs it incurs in manufacturing the product or rendering the service (other than costs incurred in connection with intangibles) plus a reasonable profit margin. A reasonable profit margin shall be computed with respect to direct and indirect costs other than (i) costs incurred in connection with intangibles, (ii) interest expense, and (iii) the cost of materials which are subject to processing or which are components in a product manufactured by the possessions corporation. Notwithstanding the above, certain taxpayers who have been permitted by the Internal Revenue Service in taxable years beginning before January 1, 1983, to use the cost-plus method of pricing without reflecting a return from intangibles, but including the cost of materials in the cost base, will not be precluded from doing so. (Sec. 3.02(3), Rev. Proc. 63–10, 1963–1 C.B. 490.) Thus, the Internal Revenue Service may continue in appropriate cases to permit such taxpayers to continue to report their income as they have been under existing procedures described in the previous sentence if it is appropriate under all the facts and circumstances and does not distort the income of the taxpayer.

Q. 4: If there is no intangible property related to a product produced in whole or in part by a possessions corporation, what method may the possessions corporation use to compute its income?

A. 4: The taxpayer may compute its income using the appropriate method as provided under section 482 and the regulations thereunder. The taxpayer may also elect the cost sharing or profit split method.

[T.D. 8090, 51 FR 21524, June 13, 1986]

§1.936–5 Intangible property income when an election out is made: Product, business presence, and contract manufacturing.

The rules in this section apply for purposes of section 936(h) and also for purposes of section 934(e), where applicable.

(a) *Definition of product.*

Q. 1: What does the term ‘‘product’’ mean?

A. 1: The term ‘‘product’’ means an item of property which is the result of a production process. The term ‘‘product’’ includes component products, integrated products, and end-product forms. A component product is a product which is subject to further processing before sale to an unrelated party. A component product may be produced from other items of property, and if it is so produced, may be treated as including or not including (at the choice of the possessions corporation) one or more of such other items of property for all purposes of section 936(h)(5). An integrated product is a product which is not subject to any further processing before sale to an unrelated party and which includes all component products from which it is produced. An end-product form is a product which—

(1) Is not subject to any further processing before sale to an unrelated party;

(2) Is produced from a component product or products; and

(3) Is treated as not including certain component products for all purposes of section 936(h)(5).

A possessions corporation may treat a component product, integrated product, or end-product form as its possession product even though the final stage or stages of production occur outside the possession. Further processing includes transformation, incorporation, assembly, or packaging.

Q. 2: If a possessions corporation produces both a component product and an integrated product (which by definition includes the end-product form), may the possessions corporation use the options under section 936(h)(5) to compute its income with respect to either the component product, the integrated product or the end-product form?

A. 2: Yes. The possessions corporation may choose to treat the component product, the integrated product, or the end-product form as the product for purposes of determining whether the possessions corporation satisfies the significant business presence test. The possessions corporation must treat the same item of property as its product (the possession product) for all purposes of section 936(h)(5) for that taxable year, including the significant business presence test under section 936(h)(5)(B)(ii), the possessions sales calculation under section 936(h)(5)(C)(i)(I), the determination of income under section 936(h)(5)(C)(i)(II), and the combined taxable income computations under section 936(h)(5)(C)(ii). Although the possessions corporation must treat the same item of property as its product for all purposes of section 936(h)(5) in a particular taxable year, its choice of the component product, integrated product or end-product form may be different from year to year. The possessions corporation must specify the possession product on a statement attached to its return (Schedule P of Form 5735). The possessions corporation may specify its choice by either listing the components that are included in the possession product or the components that are excluded from the possession product. The possessions corporation must file a separate Schedule P with respect to each possession product. The possessions corporation must attach to each Schedule P detailed computations indicating how the significant business presence test is satisfied with respect to the possession product identified in that Schedule P.

Q. 3: A possessions corporation produces a product that is sometimes sold to unrelated parties without further processing and is sometimes sold to unrelated parties after further processing. May the possessions corporation choose to treat the same item of property as the possession product even though in some cases it is an integrated product and in some cases it is a component product?

A. 3: Yes. Except as provided in questions and answers 4 and 5, the possessions corporation must designate a single possession product even though it is sometimes a component product and sometimes an integrated product.

Q. 4: A possessions corporation produces a product that is sometimes sold without further processing by any member of the affiliated group to unrelated parties or to related parties for their own consumption and is sometimes sold after further processing by any member of the affiliated group to unrelated parties or to related parties for their own consumption. May the possessions corporation designate two products as possession products?

A. 4: The possessions corporation may designate two or more possession products. The possessions corporation must use a consistent definition of the possession product for all items of property that are sold to unrelated parties or consumed by related parties at the same stage in the production process. The significant business presence test shall apply separately to each product designated by the possessions corporation. The possessions corporation shall compute its income separately with respect to each product.

Q. 5: A possessions corporation produces a product in one taxable year and does not sell all of the units that it produced. In the next taxable year the possessions corporation produces a product which includes the product produced in the prior year. The possessions corporation could not have satisfied the significant business presence test with respect to the units produced the first taxable year if the larger possession product had been designated. May the possessions corporation designate two possession products in the second year?

A. 5: Yes. The possessions corporation may designate two possession products. However, once a product has been designated for a particular year all sales of units produced in that year must be defined in the same manner. In addition, the taxpayer must maintain a significant business presence in a possession with respect to that product. Sales shall be deemed made first out of the current year's production. If all of the current year's production is sold and some inventory is liquidated, then the taxpayer's method of inventory accounting shall be applied to determine what year's layer of inventory is liquidated.

Example 1. A possessions corporation S, manufactures a bulk pharmaceutical in a possession. S transfers the bulk pharmaceutical to its U.S. parent, P, for encapsulation and sale by P to customers. S satisifes the significant business presence test with respect to the bulk pharmaceutical (the component product) and the combination of the bulk pharmaceutical and the capsule (the integrated product). S may use the cost sharing or profit split method to compute its income with respect to either the component product or the integrated product.

Example 2. The facts are the same as in example 1 except that S does not satisfy the significant business presence test with respect to the integrated product. S may use the cost sharing or profit split method to compute its income only with respect to the component product. However, if in a later taxable year S satisfies the significant business presence test with respect to the integrated product, then S may use the cost sharing or profit split method to compute its income with respect to that integrated product for that later taxable year.

Example 3. P, a domestic corporation, produces in bulk form in the United States the active ingredient for a pharmaceutical product, P transfers the bulk form to S, a wholly owned possessions corporation. S uses the bulk form to produce in Puerto Rico the finished dosage form drug. S transfers the drug in finished dosage form to P, which sells the drug to unrelated customers in the U.S. The direct labor costs incurred in Puerto Rico by S during its taxable year in formulating, filling and finishing the dosage form are at least 65 percent of the total direct labor costs incurred by the affiliated group in producing the bulk and finished forms during that period. S manufactures (within the meaning of section 954(d)(1)(A)) the finished dosage form. S has elected out under section 936(h)(5) under the profit split option for the drug product area (SIC 283). P and S may treat the bulk and finished dosage forms as parts of an integrated product. Since S satisfies the significant business presence requirement with respect to the integrated product, it is entitled to 50 percent of the combined taxable income on the integrated product.

Example 4. A possessions corporation, S. produces the keyboard of an electric typewriter and incorporates the keyboard with components acquired from a related corporation into finished typewriters. S does not satisfy the significant business presence test with respect to the typewriters (the integrated product). Therefore, S may use the cost sharing or profit split method to compute its income only with respect to a component product or end-product form. For taxable year 1983, S specifies on a statement attached to its return (Schedule P of Form 5735) that the possession product is the end-product form. The statement indentifies the components—for example, the keyboard structure and frame—which are included in the possession product. S's definition of the possession product will apply to all units of the electric typewriters which S produces in whole or in part in the possession and which are sold in 1983. Thus, all units of a given component incorporated into such typewriters will be treated in the same way. For example, all keyboards and all frames will be included in the possession product, and all electric drive mechanisms and rollers will be excluded from the possession product.

Example 5. Possessions corporation A produces printed circuit boards in a possession. The printed circuit boards are sold to unrelated parties. A also uses the boards to produce personal computers in the possession. A may designate two possession products: printed circuit boards and personal computers. The significant business presence test applies separately with respect to each of these products. Thus, for those printed circuit boards that are sold to unrelated parties, only the costs of the possessions corporation and the other members of the affiliated group that are incurred with respect to units of the printed circuit boards which are produced in whole or in part in the possessions and sold to third parties shall be taken into account. Conversely, with respect to personal computers, only the costs incurred with respect to the personal computers shall be taken into account. This would include the costs with respect to printed circuit boards that are incorporated into personal computers but not the costs incurred with respect to printed circuit boards that are sold without further processing to unrelated parties.

Example 6. Possessions corporation S produces integrated circuits in a possession. P, an affilate of S, produces circuit boards in the United States. P transfers the circuit boards to S. S assembles the integrated circuits and the circuit boards. S sells some of the loaded circuit boards to third parties. S retains some of the loaded circuit boards and incorporates them into central processing units. The central processing units are then sold to third parties. S may designate two possession products. S must use a consistent definition of the possession product for all units that are sold at the same stage in the production process. Thus, with respect to those units sold after assembly of the integrated circuits and the printed circuits boards, if S cannot satisfy the significant business presence test with respect to all the loaded circuit boards (the integrated product), then S must designate a lesser product, either the integrated circuit (the component product) or the loaded circuit board less the printed circuit board (the end-product form) as its possession product. With respect to the central processing units sold the same rule would apply. Thus, if S cannot satisfy the significant business presence test with respect to the entire central processing unit for all of the central processing units sold, S must designate some lesser product as its possession product.

Example 7. S is a possession corporation. In 1985, S produced 100 units of product X. Those units were finished into product Y in 1985 by affiliates of S. Product X is a component of product Y. In 1985, S satisfies the direct labor test with respect to product X but not with respect to product Y. S designates the component product X as its possession product. In 1986 S produces 100 units of product X and finishes those units into product Y. S would have satisfied the significant business presence test with respect to product X if S had designated product X as its possession product in 1986. In addition, in 1986 S satisfies the significant business presence test with respect to the integrated product Y. In 1986, S sells 150 units of Y. One hundred of those units would be deemed to be produced in 1986. With respect to those units S may designate the integrated product Y as its possession product. Under S's method of inventory accounting the remaining 50 units were determined to have been produced in 1985. With respect to those units S must define its possession product as it did for the taxable year in which those units were produced. Thus, S's possession product would be the component product X.

Q. 6: May an affiliated group establish groupings of possession products and treat the groupings as single products?

A. 6: An affiliated group may establish reasonable groupings of possession products based on similarities in the production processes of the possession products. Possession products that are grouped shall be treated as a single product. The determination of whether the production processes involved in producing the products that are to be grouped are similar is based on the production processes of the components that are included in the possession product. The affiliated group may establish new groupings each year. Any grouping which materially distorts a taxpayer's income or the application of the significant business presence test may be disallowed by the Commissioner. The mere fact that a grouping results in an increased allocation of income to the possessions corporation does not, of itself, create a material distortion of income. If the Commissioner determines that the taxpayer's grouping is improper with respect to one or more products in a group, then those products shall be excluded from the group. The effect of excluding a product or products from the group is that the taxpayer must demonstrate that the group without the excluded products (and each excluded product itself) satisfies the significant business presence test. If the group without the excluded products, or any of the excluded products themselves, fails to satisfy the significant business presence test, then the possessions corporation's income from those products shall be determined under section 936(h)(1) through (4) and the regulations thereunder.

Example 1. The following are examples of possession products the processes of production of which are sufficiently similar that they may be grouped and treated as a single product:

(A) Beverage bases or concentrates for different soft drinks or soft drink syrups, regardless of whether some include sweeteners and some do not:

(B) Different styles of clothing;

(C) Different styles of shoes;

(D) Equipment which relies on gravity to deliver solutions to patients intravenously;

(E) Equipment which relies on machines to deliver solutions to patients intravenously;

(F) Video game cartridges, even though the concept and design of each game title is, in part, protected against infringement by separate copyrights;

(G) All integrated circuits;

(H) All printed circuit boards; and

(I) Hardware and software if the software is one of several alternative types of software offered by the manufacturer and sold only with the hardware, and a purchaser of the hardware would ordinarily purchase one or more of the manufacturer-provided alternative types of software. In all other cases, hardware and software may not be grouped and treated as a single product.

Groupings (D) and (E) do not include any solutions which are delivered through the equipment described therein.

Example 2. A possessions corporation produces in Puerto Rico non-programmable, interactive cathode ray tube computer terminals that vary in price. These terminals all interact with a computer or controller to perform their functions of data entry, graphics word processing, and program development. The terminals can be purchased with options that include a built-in printer, different language keyboards, specialized cathode ray tubes, and different power supply features. All terminals are produced in one integrated process requiring the same skills and operations. The differences in the production of the terminals include differences in the number of printed circuit boards incorporated in each terminal, the use of unique keyboards, and the installation and testing of the built-in printer. Some difference in direct labor time to manufacture the terminals occurs, primarily due to the differing number and complexity of printed circuit boards incorporated into each terminal. Different model numbers are assigned to various computer terminals. A grouping by the taxpayer of all of the terminals as one product will be respected by the Service, unless the Service establishes that substantial distortion results. This grouping is proper because the processes of producing each of the terminals are similar.

Example 3. A possessions corporation, S produces several models of serial matrix impact printers and teleprinters. These products have differing performance standards based on such factors as speed (in characters per second), numbers of columns, and cost. The production process for all types of printers involves production of three basic elements: electronic circuitry, the printing head, and the mechanical parts. The process of producing all the printers is similar. Thus, all printers could be grouped and treated as a single product. S purchases electronic circuitry and mechanical parts from a U.S. affiliate. S performs manufacturing functions relative to the printing head and assembles and tests the finished printers. S does not satisfy the significant business presence test with respect to the integrated products. S therefore specifies on a statement attached to its return (Schedule P of Form 5735) that the possession product for both the serial matrix printers and the teleprinters is the end-product form. The statement identifies the components which are included in each possession product. S may group and treat as a single product the serial matrix printers and the teleprinters if both end-product forms include and exclude similar components. Thus, if the end-product form for both the serial matrix printers and the teleprinters includes the mechanical parts and excludes the electronic circuitry, then S may group and treat as a single product the two end-product forms. If, however, the end-product forms for the two items of property contain components that are not similar and as a result of this definition of the end-product forms the production processes involved in producing the two end-product forms are not similar, then S may not group the end-product forms.

Q. 7: Is the affiliated group permitted to include in a group an item of property that is not produced in whole or in part in a possession?

A. 7: No.

Example 1. Possessions corporation S produces 70 units of product A in a possession. P, an affiliate of S, produces 30 units of product A entirely in the United States. All of the units are sold to unrelated parties. The affiliated group is not permitted to group the 30 units of product A produced in the United States with the 70 units produced in the possession because those units are not produced in whole or in part in a possession.

Example 2. The facts are the same as in example 1 except that the 30 units of product A are transferred to possessions corporation S. S incorporates the 100 units of product A into product B. This incorporation takes place in the possession. S may group and treat as a single product all of the units of product B even though some of those units contain units of product A that were produced in the possession and some that were produced in the United States.

Q. 8: What factors should be disregarded in determining whether a particular grouping of similar items of property is reasonable?

A. 8: In general, differences in the following factors will be disregarded in determining whether a particular grouping of items of property is reasonable:

(1) Differences in testing requirements (*e.g.*, some products sold for military use may require more extensive or different testing than products sold for commercial use);

(2) Differences in the product specifications that are designed to accommodate the product to its area of use or for conditions under which used (*e.g.*, electrical products designed for ultimate use in the United States differ from electrical products designed for ultimate use in Europe);

(3) Differences in packaging or labeling (*e.g.*, differences in the number of units of the items shipped in one package); and

(4) Minor differences in the operations of the items of property.

Q. 9: What rules apply for purposes of determining whether pharmaceutical products are properly grouped and treated as a single product?

A. 9: The rules contained in questions and answers 6 through 8 of this section shall apply. Thus, an affiliated group may establish reasonable groupings based on similarities in the production processes of two or more possession products. In establishing a group the affiliated group may only compare the production processes involved in producing the possession products. The fact that two pharmaceutical products contain different active or inert ingredients is not relevant to the determination of whether the pharmaceutical products may be grouped. For example, if the possession products are bulk chemicals and the production processes involved in producing the bulk chemicals are similar, those bulk chemicals may be grouped and treated as a single product even though they contain different active or inert ingredients. The affiliated group may also group and treat as a single product the finished dosage form drug as long as the production processes involved in producing the finished dosage forms are similar. For these purposes, the production processes involved in producing the following classes of items shall be considered to be sufficiently similar that possession products delivered in a form described in one of the categories may be grouped with other possession products delivered in a form described in the same category.

The categories are:

(1) Capsules, tablets, and pills;

(2) Liquids, ointments, and creams; or

(3) Injectable and intravenous preparations.

No distinctions should be based on packaging, list numbers, or size of dosage. The affiliated group may group and treat as a single product the integrated product (combination of the bulk and the delivery form) only if all the production processes involved in producing the integrated products are similar. The rules of this question and answer are illustrated by the following examples.

Example 1. Possessions corporation S produces two chemical active ingredients X and Y. Both chemical ingredients are produced through the process of fermentation. The affiliated group is permitted to group and treat as a single product the two chemical ingredients.

Example 2. The facts are the same as in example 1 and possessions corporation S finishes chemical ingredient X into tablets and chemical ingredient Y into capsules. The affiliated group is permitted to group and treat as a single product the combination of the bulk pharmaceutical and the finishing because the production processes involved in producing the integrated products are similar.

Example 3. Possessions corporation S produces in a possession a bulk chemical X by fermentation. A United States affiliate, P, produces in the United States a bulk chemical, Y, by fermentation. Both bulk chemicals are finished by S in the possession. The finished dosage form of X is in pill form. The finished dosage form of Y is in injectable form. If S's possession product is the integrated product or the end-product form then S may not group X and Y because the production processes involved in producing the finished dosage form of X and Y are not similar. If S's possession product is the component then S may not group X and Y because the bulk chemical Y is not produced in whole or in part in a possession.

Q. 10: Will the fact that a manufacturer of a drug must submit a New Drug Application (''NDA'') or a supplemental NDA to the Food and Drug Administration have any effect on the definition or grouping of a product?

A. 10: No.

Q. 11: A possessions corporation which produced a product or rendered a type of service in a possession on or before September 3, 1982, is not required to meet the significant business presence test in a possession with respect to such product or type of service for its taxable years beginning before January 1, 1986 (the interim period). During such interim period, how will the term ''product'' be defined for purposes of allocating income under the cost sharing or profit split methods?

A. 11: During the interim period the product will be determined based on the activities performed by the possessions corporation within a possession on September 3, 1982. During the interim period the possessions corporation may compute its income under the cost sharing or profit split method only with respect to the product that is produced or manufactured within the meaning of section 954(d)(1)(A) within the possession. If the product is manufactured from a component or components produced by an affiliated corporation or a contract manufacturer, then the product will not be treated as including such component or components for purposes of the computation of income under the cost sharing or profit split methods. Thus, the possessions corporation is not entitled to any return on the intangibles associated with the component or components. Notwithstanding the preceding sentences, for taxable years beginning before January 1, 1986, a possessions corporation may compute its income under the cost sharing or profit split method with respect to a product which includes a component or components produced by an affiliated corporation or contract manufacturer if the possessions corporation satisfies with respect to such product the significant business presence test described in section 936(h)(5)(B)(ii) and the regulations thereunder.

Example 1. A possessions corporation, S, was manufacturing (within the meaning of section 954(d)(1)(A)) integrated circuits in a possession on September 3, 1982. S transferred those integrated circuits to related corporation P. P incorporated the integrated circuits into central processing units (CPUs in the United States) and sold the CPUs to unrelated parties. S continued to manufacture integrated circuits in the possession through Juanuary 1, 1986. For taxable years beginning before January 1, 1986, S may compute its income under the cost sharing or profit split method with respect to the integrated circuits regardless of whether S satisfies the significant business presence test. However, unless S satisfies the significant business presence test with respect to the central processing units, S may not compute its income under the cost sharing or profit split methods with respect to the CPUs, and thus, S is not entitled to any return on manufacturing intangibles associated with CPUs to the extent that they are not related to the integrated circuits produced by S, nor (except as provided in the profit split methods) to any return on marketing intangibles.

Example 2. A possessions corporation, S, was engaged on September 3, 1982, in the manufacture (within the meaning of section 954(d)(1)(A)) of a bulk pharmaceutical in Puerto Rico from raw materials. S sold the bulk pharmaceutical to its U.S. parent, P, for encapsulation and sale by P to customers as the product X. Because S was not engaged in the encapsulation of X, S is not considered to have manufactured the integrated product, X, in Puerto Rico. During the interim period, S may compute its income under the cost sharing or profit split methods with respect to the integrated product, X, only if S satisfies the significant business presence test with respect to X. S may compute its income under the cost sharing or profit split methods with respect to the component product (the bulk pharmaceutical).

Example 3. P is a domestic corporation that is not a possessions corporation. P manufactures a bulk pharmaceutical in the United States. P transfers the bulk pharmaceutical to its wholly owned subsidiary, S, a possessions corporation. On September 3, 1982, S was engaged in the encapsulation of the bulk pharmaceutical in Puerto Rico in a manner which satisfies the test of section 954(d)(1)(A). For taxable years beginning before January 1, 1986, S may compute its income under the cost sharing or profit split methods with respect to the end-product form the (the encapsulated drug) regardless of whether S meets the significant business presence test. However, unless S satisfies the significant business presence test with respect to the integrated product, S may not compute its income under the cost sharing or profit split methods with respect to the integrated product, and thus, S is not entitled to any return on the intangibles associated with the bulk pharmaceutical.

Q. 12: On September 3, 1982, a possessions corporation, S was engaged in the manufacture (within the meaning of section 954(d)(1)(A)) of X in a possession. During the interim period, after September 3, 1982, but before January 1, 1986, S produced Y, which differs from X in terms of minor design features. S did not produce Y in a possession on September 3, 1982. Will S be considered to have commenced production of a new product after September 3, 1982, for purposes of the application of the significant business presence test for the interim period?

A. 12: No. X and Y will be considered to be a single product, and therefore S will not be required to satisfy the business presence test separately with respect to Y during the interim period. In all cases in which the items of property produced on or before September 3, 1982 and the items of property produced after that date could have been grouped together under the guidelines provided in § 1.936–5(a) questions and answers 6 through 10, the possessions corporation will not be considered to manufacture a new product after September 3, 1982.

Q. 13: May the term ''product'' be defined differently for export sales than for domestic sales?

A. 13: Yes. For rules concerning the application of the separate election for export sales see § 1.936–7(b).

(b) *Requirement of significant business presence—(1) General rules.*

Q. 1: In general, a possessions corporation may compute its income under the cost sharing or profit split methods with respect to a product only if the possessions corporation has a significant business presence in a possession with respect to that product. When will a possession corporation be considered to have a significant business presence in a possession?

A. 1: For purposes of the cost sharing method, the significant business presence test is met if the possessions corporation satisfies either a value added test or a direct labor test. For purposes of the profit split method, the significant business presence test is met if the possessions corporation satisfies either a value added test or a direct labor test and also manufactures the product in the possession within the meaning of section 954(d)(1)(A).

Q. 2: How may a possessions corporation satisfy the direct labor test with respect to a product?

A. 2: The possessions corporation will satisfy the direct labor test with respect to a product if the direct labor costs incurred by the possessions corporation as compensation for services performed in a possession are greater than or equal to 65 percent of the direct labor costs of the affiliated group for units of the possession product produced during the taxable year in whole or in part by the possessions corporation.

Q. 3: How may a possessions corporation satisfy the value added test?

A. 3: In order to satisfy the value added test, the production costs of the possessions corporation incurred in the possession with respect to units of the possession product produced in whole or in part by the possessions corporation in the possession and sold or otherwise disposed of during the taxable year by the affiliated group to unrelated parties must be greater than or equal to twenty-five percent of the difference between gross receipts from such sales or other dispositions and the direct material costs of the affilated group for materials purchased for such units from unrelated parties.

Q. 4: Must the significant business presence test be met with respect to all units of the product produced during the taxable year by the affiliated group?

A. 4: No. The significant business presence test must be met with respect to only those units of the product produced during the taxable year in whole or in part by the possessions corporation in a possession.

Q. 5: For purposes of determining whether a possessions corporation satisfies the significant business presence test, how shall the possessions corporation treat the cost of components transferred to the possessions corporation by a member of the affiliated group?

A. 5: The treatment of the cost of components transferred from an affiliate depends on whether the possession product is treated as including the components for purposes of section 936(h). If it is, then for purposes of the value added test, the production costs associated with the component shall be treated as production costs of the affiliated group that are not incurred by the possessions corporation. Those production costs, other than the cost of materials, shall not be treated as a cost of materials. For purposes of the direct labor test and the alternative significant business presence test, the direct labor costs associated with such components shall be treated as direct labor costs of the affiliated group that are not incurred by the possessions corporation. If the possession product is treated as not including such component for purposes of section 936(h), then, solely for purposes of determining whether the possessions corporation satisfies the value added test, the cost of the component shall not be treated as either a cost of materials or as a production cost. For purposes of the direct labor test and the alternative significant business presence test, the direct labor costs associated with such component shall not be treated as direct labor costs of the affiliated group. If the possession product is treated as not including such component, then the possessions corporation shall not be entitled to any return on the intangibles associated with the manufacturing or marketing of the component.

Q. 6: May two or more related possessions corporations aggregate their production or direct labor costs for purposes of determining whether they satisfy the significant business presence test with respect to a single product?

A. 6: No.

Q. 7: A possessions corporation, S, purchases raw materials and components from an unrelated corporation which conducts business outside of a possession. The unrelated corporation is not a contract manufacturer. What is the treatment of such raw materials and components for purposes of the significant business presence test?

A. 7: Where Company S purchases raw materials or components from an unrelated corporation which is not a contract manufacturer, the raw materials and components are treated as materials, and the costs related thereto are treated as a cost of materials.

(2) *Direct labor costs.*

Q. 1: How is the term ''direct labor costs'' to be defined?

A. 1: The term ''direct labor costs'' has the same meaning which it has for purposes of § 1.471–11(b)(2)(i). Thus, direct labor costs include the cost of labor which can be identified or associated with particular units or groups of units of a specific product. The elements of direct labor include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d)), shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor.

Q. 2: May a taxpayer treat a cost as a direct labor cost if it is not included in inventoriable costs under section 471 and the regulations thereunder?

A. 2: No. A cost may be treated as a direct labor cost only if it is included in inventoriable costs. However, a cost may be considered a direct labor cost even though the activity to which it relates would not constitute manufacturing under section 954(d)(1)(A) as long as the cost is included in inventoriable costs.

Q. 3: May the members of the affiliated group include as direct labor costs the labor element in indirect production costs?

A. 3: No. The labor element of indirect production costs may not be considered as part of direct labor costs.

Q. 4: Do direct labor costs include the costs which can be identified or associated with particular units or groups of units of a specific product if those costs could also be described as quality control and inspection?

A. 4: Yes. Direct labor costs include costs which can be identified or associated with particular units or groups of units of a specific product. Thus, if quality control and inspection is an integral part of the production process, then the labor associated with that quality control and inspection shall be considered direct labor. For example, integrated circuits are soldered to printed circuit boards by passing the boards over liquid solder. Employees inspect each of the boards and repair any imperfectly soldered joints discovered on that inspection. The labor associated with this process is direct labor. However, if a person performs random inspections on limited numbers of products, then that labor associated with those inspections shall be considered quality control and therefore indirect labor.

Q. 5: Do direct labor costs of the possessions corporation include only the costs which were actually incurred or do they take into account, in addition, any labor savings which result because the activities were performed in a possession rather than in the United States?

A. 5: Direct labor costs include only the costs which were actually incurred.

Q. 6: For purposes of determining whether a possessions corporation satisfies the significant business presence test for a taxable year with respect to a product, how shall the possessions corporation compute its direct labor costs of units of the product?

A. 6: The direct labor test shall be applied separately to products produced in whole or in part by the possessions corporation in the possession during each taxable year. Sales shall be deemed to be made first out of the current year's production. If sales are made only out of the current year's production, then the direct labor costs of producing those units that are sold shall be the pro rata portion of the total direct labor costs of producing all the units that are produced in whole or in part in the possession by the possessions corporation during the current year. If all of the current year's production is sold and some inventory is liquidated, then the direct labor test shall be applied separately to the current year's production and the liquidated inventory. The direct labor costs of producing the liquidated inventory shall be the pro rata portion of the total direct labor costs that were incurred in producing all the units that were produced in whole or in part by the possessions corporation in the possessions in the layer of liquidated inventory determined under the member's method of inventory accounting.

Example. S is a cash basis calendar year taxpayer that has made an election under section 936(a). In 1985 S produced 100 units of product X. Fifty percent of the direct labor costs of the affiliated group were incurred by S and were compensation for services performed in the possession. Thus, S did not satisfy the significant business presence test with respect to product X in taxable year 1985. During 1986 S produced 100 units of product X. One hundred percent of the direct labor costs of the affiliated group were incurred by S and were compensation for services performed in the possession. In 1986 S sells 150 units of product X. One hundred of those units are deemed to be from the units produced in 1986. With respect to those units S satisfies the significant business presence test. Under S's method of inventory accounting the remaining 50 units were determined to be produced in 1985. With respect to those units S does not satisfy the significant business presence test because only 50% of the direct labor costs incurred in producing those units were incurred by S and were compensation for services performed in the possession.

Q. 7: What is the result if in a particular taxable year the possessions corporation satisfies the significant business presence test with respect to units of the product produced in one year and fails the significant business with respect to units produced in another year?

A. 7: For those units of the product with respect to which the possession corporation satisfies the significant business presence test, the possessions corporation may compute its income under the provisions of section 936(h)(5). For those units of the product with respect to which the possessions corporations fails the significant business presence test, the possessions corporation must compute its income under section 936(h)(1) through (4).

Q. 8: Do direct labor costs include costs incurred in a prior taxable year with respect to units of the possession product that are finished in a later taxable year?

A. 8: Yes.

(3) *Direct material costs.*

Q. 1: How is the term ''direct material costs'' to be defined?

A. 1: Direct material costs include the cost of those materials which become an integral part of the specific product and those materials which are consumed in the ordinary course of manufacturing and can be identified or associated with particular units or groups of units of that product. See § 1.471–3 for the elements of direct material costs.

Q. 2: May a taxpayer treat a cost as a direct material cost if it is not included in inventoriable costs under section 471 and the regulations thereunder?

A. 2: A taxpayer may not treat such costs as direct material costs.

(4) *Production costs.*

Q. 1: How is the term ''production costs'' defined?

A. 1: The term ''production costs'' has the same meaning which it has for purposes of § 1.471–11(b) except that the term does not include direct material costs and interest. Thus, production costs include direct labor costs and fixed and variable indirect production costs (other than interest).

Q. 2: With respect to indirect production costs described in § 1.471–11(c)(2) (ii) and (iii), may a possessions corporation include these costs in production costs for purposes of section 936, if they are not included in inventoriable costs under section 471 and the regulations thereunder?

A. 2: No. A possessions corporation may include these costs only if they are included for purposes of section 471 and the regulations thereunder. If a possessions corporation and the other members of the affiliated group include and exclude different indirect production costs in their inventoriable costs, then, for purposes of the significant business presence test, the possessions corporation shall compute its production costs and the production costs of the other members of the affiliated group by subtracting from the production costs of each member all indirect costs included by that member that are not included in production costs by all other members of the affiliated group.

Q. 3: Does a change in a taxpayer's method of accounting for purposes of section 471 affect the taxpayer's computation of production costs for purposes of section 936?

A. 3: Yes. If a taxpayer changes its method of accounting for purposes of section 471, then the same change shall apply for purposes of section 936.

Q. 4: For purposes of determining whether a possessions corporation satisfies the significant business presence test for a taxable year with respect to a product, how shall the possessions corporation compute its costs of producing units of the product sold or otherwise disposed to unrelated parties during the taxable year?

A. 4: All members of the affiliated group may elect to use their current year production costs regardless of whether the members use the FIFO or LIFO method of inventory accounting. If some or all of the current year's production of a product is sold, then the production costs of producing those units sold shall be the pro rata portion of the total production costs of producing all the units produced in the current year. If all of the current year's production of a product is sold and some inventory is liquidated, then the production costs of producing the liquidated inventory shall be the pro rata portion of the production costs incurred in producing the layer of liquidated inventory as determined under the member's method of inventory accounting.

Q. 5: How should the members of the affiliated group determine the portion of their production costs that is allocable to units of the product sold or otherwise disposed of during the taxable year?

A. 5: The members of the affiliated group may use either standard production costs (so long as variances are not material), average production costs, or FIFO production costs to determine the production costs that will be considered to be attributable to units of the product sold or otherwise disposed of during the taxable year. However, all members of the affiliated group must use the same method.

Q. 6: When is the quality control and inspection of a product considered to be part of the production activity for that product?

A. 6: Quality control and inspection of a manufactured product before its sale or other disposition by the manufacturer, or before its incorporation into other products, is considered to be part of the indirect production activity for that initial product. Subsequent testing of a product to ensure that the product is compatible with other products is not a part of the production activity for the initial product.

When a component is incorporated into an end-product form and the end-product form is then tested, the latter testing will be considered to be a part of the indirect production activity for the end-product form and will not be considered to be a part of the production activity for the component.

Q. 7: For purposes of the significant business presence test and the allocation of income to a possessions corporation, what is the treatment of the cost of installation of a product?

A. 7: For purposes of the significant business presence test and the allocation of income to a possessions corporation, product installation costs need not be taken into account as costs incurred in the manufacture of that product, if the taxpayer keeps such permanent books of account or records as are sufficient to establish the fair market price of the uninstalled product. In such a case, the cost of installation materials, the cost of the labor for installation, and a reasonable profit for installation will not be included in the costs and income associated with the possession product. If the taxpayer does not keep such permanent books of account or records, then the cost of installation materials and the cost of labor for installation shall be treated as costs associated with the possession product and income will be allocated to the possessions corporation and its affiliates under the rules provided in these regulations.

Q. 8: For purposes of the significant business presence test and the allocation of income to a product or service, what is the treatment of the cost of servicing and maintaining a possession product that is sold to an unrelated party?

A. 8: The cost of servicing and maintaining a possession product after it is sold is not associated with the production of that product.

Q. 9: For purposes of the significant business presence test and the allocation of income to a possessions corporation, what is the treatment of the cost of samples?

A. 9: The cost of producing samples will be treated as a marketing expense and not as inventoriable costs for these purposes. However, for taxable years beginning prior to January 1, 1986, the cost of producing samples may be treated as either a marketing expense or as inventoriable costs.

(5) *Gross receipts.*

Q. 1: How shall the affiliated group determine gross receipts from sales or other dispositions by the affiliated group to unrelated parties of the possession product?

A. 1: Gross receipts shall be determined in the same manner as possession sales under the rules contained in §1.936–6(a)(2).

(6) *Manufacturing within the meaning of section 954(d)(1)(A).*

Q. 1: What is the test for determining, within the meaning of section 954(d)(1)(A), whether a product is manufactured or produced by a possessions corporation in a possession?

A. 1: A product is considered to have been manufactured or produced by a possessions corporation in a possession within the meaning of section 954(d)(1)(A) and §1.954–3(a)(4) if—

(i) The property has been substantially transformed by the possessions corporation in the possession;

(ii) The operations conducted by the possessions corporation in the possession in connection with the property are substantial in nature and are generally considered to constitute the manufacture or production of property; or

(iii) The conversion costs sustained by the possessions corporation in the possession, including direct labor, factory burden, testing of components before incorporation into an end product and testing of the manufactured product before sales account for 20 percent or more of the total cost of goods sold of the possessions corporation.

In no event, however, will packaging, repackaging, labeling, or minor assembly operations constitute manufacture or production of property. See particularly examples 2 and 3 of § 1.954–3(a)(4)(iii).

Q. 2: Does the requirement that a possession product be produced or manufactured in a possession within the meaning of section 954(d)(1)(A) apply to taxable years beginning before January 1, 1986?

A. 2: A possessions corporation must satisfy this requirement for taxable years beginning before January 1, 1986, in the following cases:

(i) If the possessions corporation makes a separate election under section 936(h)(5)(F)(iv)(II) with respect to export sales;

(ii) If the possessions corporation is electing as its possession product a product that is subject to the interim period rules of § 1.936–5(a) question and answer (10); or

(iii) If the possessions corporation is electing as its possession product a product that is not subject to the interim period rules of § 1.936–5 (a) question and answer (10) and the possessions corporation computes its income under the profit split method with respect to that product.

For rules concerning products first produced in a possession after September 3, 1982, see § 1.936–5(b)(7) question and answer (2).

(7) *Start-up operations.*

Q. 1: With respect to products not produced (and types of services not rendered) in the possession on or before September 3, 1982, when must a possessions corporation first satisfy the 25 percent value added test or the 65 percent direct labor test?

A. 1: A transitional period is established such that a possessions corporation engaged in start-up operations with respect to a product or service need not satisfy the 25 percent value added test or the 65 percent labor test until the third taxable year following the taxable year in which such product is first sold by the possessions corporation or such service is first rendered by the possessions corporation. During the transitional period, the applicable percentages for these tests will be as follows:

	Any year after 1982		
	1	2	3
Value added test	10	15	20
Labor test	35	45	55

Q. 2: Does the requirement that a possession product be produced or manufactured in a possessions within the meaning of section 954(d)(1)(A) apply to a product if the possessions corporation is engaged in start-up operations with respect to that product?

A. 2: The possessions corporation must produce or manufacture the possessions product within the meaning of section 954(d)(1)(A) if the possessions corporation computes its income with respect to that product under the profit split method.

Q. 3: When will a possessions corporation be considered to be engaged in start-up operations?

A. 3: A possessions corporation is engaged in start-up operations if it begins operations in a possession with respect to a product or type of service after September 3, 1982. Subject to the further provisions of this answer, a possessions corporation will be considered to begin operations with respect to a product if, under the rules of § 1.936–5(a) questions and answers (6) through (10), such product could not be grouped with any other item of property manufactured in whole or in part in the possessions by any member of the affiliated group in any preceding taxable year. Any improvement or other change in a possession product which does not substantially change the production process would not be deemed to create a new product. A change in the division of manufacturing activity between the possessions corporation and its affiliates with respect to an item of property will not give rise to a new product. If a possessions corporation was producing a possession product that was either a component product or an end-product form and the possessions corporation expands its operations in the same possession so that it is now producing a product that includes the earlier possession product, the possessions corporation will not be entitled to use the start-up significant business presence test unless the production costs incurred by the possessions corporation in the possession in producing a unit of its new possession product are at least double the production costs incurred by the possessions corporation in the possession in producing a unit of the earlier possession product. If any member of an affiliated group actually groups two or more items of property then, solely for the purposes of determining whether any item of property in that group is a new product, that grouping shall be respected. However, the fact that an affiliated group does not actually group two or more items of property shall be disregarded in determining whether any item of property is a new product. Notwithstanding the above, if a possessions corporation is producing a possession product in one possession and such corporation or a member of its affiliated group begins operations in a different possession, regardless of whether the items of property could be grouped, the affiliated group may treat the units of the item of property produced at the new site of operations in the different possession as a new product.

(8) *Alternative significant business presence test.*

Q. 1: Will the Secretary adopt a significant business presence test other than those set forth in section 936(h)(5)(B)(ii)?

A. 1: Yes. The following significant business presence test is adopted both for the transitional period and thereafter. A possessions corporation will have a significant business presence in a possession for a taxable year with respect to a product or type of service if—

(i) No less than 50 percent of the direct labor costs of the affiliated group for units of the product produced, in whole or in part, during the taxable year by the possessions corporation or for the type of service rendered by the possessions corporation during the taxable year are incurred by the possessions corporation as compensation for services performed in the possession; and

(ii) The direct labor costs of the possessions corporation for units of the product produced or the type of service rendered plus the base period construction costs are no less than 70 percent of the sum of such base period construction costs and the direct labor costs of the affiliated group for such units of the product produced or the type of service rendered.

Notwithstanding satisfaction of the above test, for purposes of determining whether a possessions corporation may compute its income under the profit split method, a possessions corporation will not be treated as having a significant business presence in a possession with respect to a product unless the possessions corporation manufactures the product in the possession within the meaning of section 954(d)(1)(A).

Q. 2: How is the term ‘‘base period construction costs’’ defined?

A. 2: The term ‘‘base period construction costs’’ means the average construction costs incurred by or on behalf of the possessions corporation for services in the possession during the taxable year and the preceding four taxable years for section 1250 property (as defined in section 1250(c) and the regulations thereunder) that is used for the production of the product or the rendering of the service in the possession, and which represents the original use of the section 1250 property. For purposes of the preceding sentence, if the possessions corporation was not in existence during one or more of the four preceding taxable years, its construction costs for that year or years shall be deemed to be zero. Construction costs include architects’ and engineers’ fees, labor costs, and overhead and profit (if the construction is performed by a person that is not a member of the affiliated group).

(c) *Definition and treatment of contract manufacturing.*

Q. 1: For purposes of determining whether a possessions corporation satisfies the significant business presence test with respect to a product, the costs incurred by the possessions corporation or by any of its affiliates in connection with contract manufacturing which is related to that product and is performed outside the possession shall be treated as direct labor costs of the affiliated group and shall not be treated as production costs of the possessions corporation or as material costs. How is the term ‘‘contract manufacturing’’ to be defined?

A. 1: The term ‘‘contract manufacturing’’ includes any arrangement between a possessions corporation (or another member of the affiliated group) and an unrelated person if the unrelated person:

(1) Performs work on inventory owned by a member of the affiliated group for a fee without the passage of title;

(2) Performs production activities (including manufacturing, assembling, finishing, or packaging) under the direct supervision and control of a member of the affiliated group; or

(3) Does not undertake any significant risk in manufacturing its product (*e.g.*, it is paid by the hour).

Q. 2: Does an arrangement between a member of the affiliated group and an unrelated party constitute contract manufacturing if the unrelated party uses an intangible owned or licensed by a member of the affiliated group?

A. 2: Such an arrangement will be treated as contract manufacturing if the unrelated party makes use of a patent owned or licensed by a member of the affiliated group in producing the product which becomes part of the possession product of the possessions corporation. In addition, such use of manufacturing intangibles other than patents may be treated as contract manufacturing if it is established that the arrangement has the effect of materially distorting the application of the significant business presence test. However, the preceding sentence shall not apply if the possessions corporation establishes that the arrangement was entered into for a substantial business purpose (e.g., to obtain the benefit of special expertise of the manufacturer or economies of scale). These rules shall not apply to such contract manufacturing performed in taxable years beginning before January 1, 1986, nor shall the rules apply to binding contracts for the performance of such contract manufacturing entered into before June 13, 1986.

Q. 3: For purposes of the significant business presence test, how shall a possessions corporation treat the cost of contract manufacturing performed within a possession?

A. 3: If the possessions corporation uses the value added test, it will be permitted to treat the cost of the contract manufacturing performed in a possession, not including material costs, as a production cost of the possessions corporation. If it uses the direct labor test or the alternative significant business presence test set forth in § 1.936–5(b)(8), it is permitted to treat the direct labor costs of the contract manufacturer associated with such contract manufacturing as a cost of direct labor of the possessions corporation. The allowable amount of the direct labor cost shall be determined in accordance with question and answer 4 below.

Q. 4: How are the amounts paid by a possessions corporation to a contract manufacturer for services rendered in a possession to be treated by the possessions corporation in computing the direct labor cost of the product to which such contract manufacturing relates?

A. 4: If the possessions corporation can establish the contract manufacturer’s direct labor cost which was incurred in the possession, such cost will be treated as incurred by the possessions corporation as compensation for services performed in the possession. If the possessions corporation cannot establish such cost, then 50 percent of the amount paid to such contract manufacturer may be treated as incurred by the possessions corporation as compensation for services performed in the possession: provided, that not more than 50 percent of the fair market value of the product manufactured by the contract manufacturer is attributable to articles shipped into the possession, and the possessions corporation receives a statement from the contract manufacturer that this test has been satisfied. If this fair market value test is not satisfied, then the cost of contract manufacturing performed within a possession shall not be treated as a production cost or a direct labor cost of either the possessions corporation or the affiliated group.

Q. 5: For purposes of the significant business presence test, what is the treatment of costs which are incurred by a member of the affiliated group (including the possessions corporation) for contract manufacturing performed outside of the possession with respect to an item of property which is a component of the possession product?

A. 5: If the possession product is treated as including such component, the cost of the contract manufacturing shall be treated as a direct labor cost of members of the affiliated group other than the possessions corporation for purposes of the direct labor test and the alternative significant business presence test, and shall not be treated as a production cost of the possessions corporation or as a cost of materials for purposes of the value added test. If the possession product is treated as not including such component, the cost of the contract manufacturing shall not be treated as a direct labor cost of any member of the affiliated group for purposes of the direct labor test and the alternative significant business presence test, and shall not be treated as a production cost of the possessions corporation or as a cost of materials for purposes of the value added test.

[T.D. 8090, 51 FR 21524, June 13, 1986; 51 FR 27174, July 30, 1986]

§1.936–6 Intangible property income when an election out is made: Cost sharing and profit split options; covered intangibles.

The rules in this section apply for purposes of section 936(h) and also for purposes of section 934(e) where applicable.

(a) *Cost sharing option*—(1) *Product area research.*

Q. 1: Cost sharing payments are based on research undertaken by the affiliated group in the ‘‘product area’’ which includes the possession product. The term ‘‘product area’’ is defined by reference to the three-digit classification under the Standard Industrial Classification (SIC) code. Which governmental agency has jurisdiction to decide the proper SIC category for any specfic product?

A. 1: Solely for the purpose of determining the tax consequences of operating in a possession, the Secretary or his delegate has exclusive jurisdiction to decide the proper SIC category under which a product is classified. For this purpose, the product area under which a product is classified will be determined according to the 1972 edition of the SIC code. From time to time and in appropriate cases, the Secretary may prescribe regulations or issue rulings determining the proper SIC category under which a particular product is to be classified, and may prescribe regulations for aggregating two or more three-digit classifications of the SIC code and for classifying product areas according to a system other than under the SIC code.

Q. 2: How is the term ‘‘affiliated group’’ defined for purposes of the cost sharing option?

A. 2: For purposes of the cost sharing option, the term ‘‘affiliated group’’ means the possessions corporation and all other organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, within the meaning of section 482.

Q. 3: Are research and development expenditures that are included in product area research limited to research and development expenditures that are deductible under section 174 or that are incurred by U.S. affiliates?

A. 3: No, product area research is not limited to product area research expenditures deductible under section 174 or to expenses incurred by U.S. affiliates. Product area research also includes deductions permitted under section 168 with respect to research property which are not deductible under section 174; qualified research expenses within the meaning of section 30(b); payments (such as royalities) for the use of, or right to use, a patent, invention, formula, process, design, pattern or know-how; and a proper allowance for amounts incurred in the acquisition of manufacturing intangible property. In the case of an acquisition of depreciable or amortizable manufacturing intangible property, the annual amount of product area research shall be be equal to the allowable depreciation or amortization on the intangible property for the taxable year. In the case of an acquisition of nondepreciable or nonamortizable manufacturing intangible property, the amount expended for the acquisition shall be deemed to be amortized over a five year period and included in product area research in the year of the deemed amortization. Any contingent payment made with respect to the acquisition of nonamortizable manufacturing intangible property shall be treated as amounts incurred in the acquisition of nonamortizable manufacturing intangible property when paid or accrued.

Q. 4: Does royalty income from a person outside the affiliated group with respect to the manufacturing intangibles within a product area reduce the product area research pool within the same product area?

A. 4: Yes.

Q. 5: Does income received from a person outside the affiliated group from the sale of a manufacturing intangible reduce the product area research pool within the same product area?

A. 5: In determining product area research, the income from the sale attributable to noncontingent payments will reduce product area research ratably over the remaining useful life of the property in the case of an amortizable intangible and ratably over a 5-year period in the case of a nonamortizable intangible. Any income attributable to contingent amounts received with respect to the sale of manufacturing intangible property shall be treated as amounts received from the sale of the manufacturing intangible property in the year in which such contingent amounts are received or accrued.

Q. 6: If a member of an affiliated group incurs research and development expenses pursuant to a contract with an unrelated person who is entitled to exclusive ownership of all the technology resulting from the expenditures, is the amount of product area research reduced by the amount of such expenditures?

A. 6: To the extent that the product area research expenditures can be allocated solely to the technology produced for the unrelated person, such expenditures will not be included in product area research expenditures provided, however, that the unrelated person has exclusive ownership of all the technology resulting from these expenditures, and further that no member of the affiliated group has a right to use any of the technology.

Q. 7: What is the treatment of product area research expenditures attributable to a component where the component and the integrated product fall within different product areas?

A. 7: For purposes of the computation of product area research expenditures in the product area by the affiliated group, the product area in which the component falls is aggregated with the product area in which the integrated product falls. However, if the component product and integrated product are in separate SIC codes and if the component product is not included in the definition of the possession product, then the product area research expenditures are not aggregated. The same rule applies where the taxpayer elects a component product which encompasses another component product and the two component products fall into separate SIC codes. In such case, the product area in which the first component falls is aggregated with the product area in which the second component falls.

(2) *Possession sales and total sales.*

Q. 1: The cost sharing payment is the same proportion of the total cost of product area research which the amount of ‘‘possession sales’’ of the affiliated group bears to the ‘‘total sales’’ of the affiliated group within the product area. How are ‘‘possession sales’’ defined for purposes of the cost sharing fraction?

A. 1: The term ‘‘possession sales’’ means the aggregate sales or other dispositions of the possession product, to persons who are not members of the affiliated group, less returns and allowances and less indirect taxes imposed on the production of the product, for the taxable year. Except as otherwise indicated in § 1.936–6(a)(2), the sales price to be used is the sales price received by the affiliated group from persons who are not members of the affiliated group.

Q. 2: For purposes of the numerator of the cost sharing fraction, how are possession sales computed where the possession product is a component product or an end-product form?

A. 2: (i) The sales price of the component product or end-product form is determined as follows. With respect to a component product, an independent sales price from comparable uncontrolled transactions must be used if such price can be determined in accordance with §1.482–2(e)(2). If an independent sales price of the component product from comparable uncontrolled transactions cannot be determined, then the sales price of the component product shall be deemed to be equal to the transfer price, determined under the appropriate section 482 method, which the possessions corporation uses under the cost sharing method in computing the income it derives from the active conduct of a trade or business in the possession with respect to the component product. The possessions corporation in lieu of using the transfer price determined under the preceding sentence may treat the sales price for the component product as equal to the same proportion of the third party sales price of the integrated product which the production costs attributable to the component product bear to the total production cost for the integrated product. Production cost will be the sum of direct and indirect production costs as defined in §1.936–5(b)(4). If the possessions corporation determines the sales price of the component product using the production cost ratio, the transfer price used by the possessions corporation in computing its income from the component product under the cost sharing method may not be greater than such sales price.

(ii) With respect to an end-product form, the sales price of the end-product form is equal to the difference between the third party sales price of the integrated product and the independent sales price of the excluded component(s) from comparable uncontrolled transactions, if such price can be determined under §1.482–2(e)(2). If an independent sales price of the excluded component(s) from uncontrolled transactions cannot be determined, then the sales price of the end-product form shall be deemed to be equal to the transfer price, determined under the appropriate section 482 method, which the possessions corporation uses under the cost sharing method in computing the income it derives from the active conduct of a trade or business in the possession with respect to such end-product form. The possessions corporation in lieu of using the transfer price determined under the preceding sentence may use the production cost ratio method described above to determine the sales price of the end-product form (*i.e.*, the same proportion of the third party sales price of the integrated product which the production costs attributable to the end-product form bear to the total production costs for the integrated product). If the possessions corporation determines the sales price of the end-product form using the production cost ratio, the transfer price used by the possessions corporation in computing its income from the end-product form under the cost sharing method may not be greater than such sales price. For similar rules applicable to the profit split option see §1.936–6(b)(1), question and answer 12.

Q. 3: For purposes of determining possessions sales in the numerator of the cost sharing fraction, will the replacement part price of the product be treated as a price from comparable uncontrolled transactions?

A. 3: Prices for replacement parts are generally higher than prices for equipment sold as part of an original system. Thus, prices for replacement parts cannot generally be used directly as prices for comparable uncontrolled transactions. However, replacement part prices may be used for estimating comparable uncontrolled prices where the price differential can be reasonably determined and taken into account under §1.482–2(e)(2).

Q. 4: For purposes of determining possession sales in the cost sharing fraction, what is the treatment of components that are purchased by one possessions corporation from an affiliated possessions corporation and which are incorporated into a possession product where the transferor possessions corporation treats the transferred component as a possession product?

A. 4: When one possessions corporation purchases components from a second possessions corporation which is an affiliated corporation, the purchase price of the components paid to the second possessions corporation shall be subtracted from the sales proceeds of the product produced in the possession by the first possessions corporation, and only the remainder is included in the numerator of the cost sharing formula for the first corporation. For example, assume that N corporation manufactures a component for sale to O corporation for $100 (a price which reflects prices in comparable uncontrolled transactions). Both N and O are affiliated possessions corporations. N has designated that component product as its possession product. O then incorporates that product into a second product which is sold to customers for $300 N and O must make separate cost sharing payments. The cost sharing payment of N corporation is determined by including $100 as possession sales, and the payment of O is determined by subtracting that $100 purchase price from the $300 received from customers. Thus, the possessions sales amount of O is $200. This rule is intended to prevent the double counting of the sales of a component produced by one possessions corporation and incorporated into another product by an affiliated possessions corporation.

Q. 5: Are pre-TEFRA sales included in the cost sharing fraction?

A. 5: No. Pre-TEFRA sales are sales of products produced by the possessions corporation and transferred to an affiliate prior to a possessions corporation's first taxable year beginning after December 31, 1982. Pre-TEFRA sales are not included in either the numerator or denominator of the cost sharing fraction. If the U.S. affiliate uses the FIFO method of costing inventory, the pre-TEFRA inventory will be treated as the first inventory sold by the U.S. affiliate during the first year in which section 936(h) applies. If the U.S. affiliate uses the LIFO method of costing inventory (either dollar-value or specific goods LIFO), pre-TEFRA inventor will be treated as inventory sold by the U.S. affiliate in the year in which the U.S. afiliate's LIFO layer containing pre-TEFRA LIFO inventory is liquidated.

Q. 6: How are ''possession sales'' determined under the cost sharing formula if members of the affiliated group (other than the possessions corporation) include purchases of the possession product, X, in a dollar-value LIFO inventory pool (as provided under § 1.472–8)?

A. 6: Possession sales may be determined by applying the revenue identification method provided under paragraph (b)(1) Question and Answer 18 of this section.

Q. 7: Do possession sales include excise taxes paid by the possessions corporation when the product is sold for ultimate use or consumption in the possession?

A. 7: No. The amount of excise taxes is excluded from both the numerator and denominator of the cost sharing fraction.

Q. 8: How are ''total sales'' defined for purposes of the cost sharing fraction?

A. 8: The term ''total sales'' means aggregate sales or other dispositions of products in the same product area as the possession product, less returns and allowances and less indirect taxes imposed on the production of the product, for the taxable year to persons who are not members of the affiliated group. The sales price to be used is the sales price received by the affiliated group from persons who are not members of the affiliated group.

Q. 9: In computing that cost sharing payment, how are ''total sales'' computed if the dollar-value LIFO inventory pool includes some products which are not included in the product area (determined under the 3-digit SIC code) on which the denominator of the cost sharing fraction is based?

A. 9: In such case, the amount of the total sales within the product area to persons who are not members of the affiliated group by persons who are members of the affiliated group is determined by multiplying the total sales of the products within the dollar-value LIFO inventory pool by a fraction. The numerator of the fraction includes the dollar-value of purchases by members of the affiliated group (including the possessions corporation) of products within the product area made during the year, plus any added production costs (as defined in §1.471–11(b), (c), and (d) but not including the costs of materials) incurred by the affiliates during the same period. The denominator of the fraction includes the dollar-value of purchases by members of the affiliated group (including the possessions corporation) of products within the dollar-value LIFO inventory pool made during the same period (including any production costs, as described above, incurred by the affiliate during the same period). For these purposes, purchases of a possession product are determined on the basis of the possessions corporation's cost for its inventory purposes.

Q. 10: May a possessions corporation compute its income under the cost sharing method with respect to a possession product which the possessions corporation sells to a member of its affiliated group and which that member then leases to an unrelated person or uses in its own trade or business?

A. 10: Yes, provided that an independent sales price for the possession product from comparable uncontrolled transactions can be determined in accordance with §1.482–2(e)(2), and, provided further, that such member complies with the requirements of §1.936–6(a)(2), question and answer 14. If, however, there is a comparable uncontrolled price for an integrated product and the possession product is a component product or end-product form thereof, the possessions corporation may, if such member complies with the requirements of §1.936–6(a)(2), question and answer 14, compute its income under the cost sharing method with respect to such possession product. In that case, the cost sharing payment shall be computed under the following question and answer.

Q. 11: How are possession sales and total sales to be determined for purposes of computing the cost sharing payment with respect to a possession product which the possessions corporation sells to a member of its affiliated group where that member then leases the possession product to unrelated persons or uses it in its own trade or business?

A. 11: If the possessions corporation is entitled to compute its income from such sales of the possession product under the cost sharing method, both possession sales and total sales shall be determined as if the possession product had been sold by the affiliate to an unrelated person at the time the possession product was first leased or otherwise placed in service by the affiliate. The sales price on such deemed sale shall be equal to the independent sales price from comparable uncontrolled transactions determined in accordance with §1.482–2(e)(2), if any. If the possession product is a component product or an end-product form for which there is no such independent sales price but there is a comparable uncontrolled price for the integrated product which includes the possession product, the deemed sales price of the possession product shall be computed under the rules of §1.936–6(a)(2) question and answer 2. The full amount of income received under the lease shall be treated as income of (and taxed to) the affiliate and not the possessions corporation.

Q. 12: When may a possessions corporation take into account in computing total sales under the cost sharing method products in the same product area as the possession product (other than the possession product itself) where such products are leased by members of the affiliated group to unrelated persons or used by any such member in its own trade or business?

A. 12: For purposes of computing total sales under the cost sharing method, the possessions corporation may take into account products in the same product area as the possession product itself where such products are leased by members of the affiliated group to unrelated persons or used in the trade or business of any such member, but only if an independent sales price of such products from comparable uncontrolled transactions may be determined under §1.482–2(e)(2). In such cases, the units of such products which are leased or otherwise used internally by members of the affiliated group may be treated as sold to unrelated persons for such independent sales price for purposes of computing total sales.

Q. 13: Assuming that a possessions corporation is entitled to compute its income under the cost sharing method with respect to sales of a possession product to affiliates in cases where those affiliates lease units of the possession product to unrelated persons or use them internally, is the possessions corporation's income from the possession product any different than if the affiliates had sold the product to unrelated parties?

A. 13: No.

Q. 14: If a possessions corporation sells units of a possession product to a member of its affiliated group and that affiliate then leases those units to an unrelated person or uses the units in its own trade or business, what requirements must the affilate meet in order for the possessions corporation to be entitled to the benefits of the cost sharing method with respect to such units?

A. 14: (i) For taxable years of the possessions corporation beginning on or before June 13, 1986, the affiliate need not meet any special requirements in order for the possessions corporation to be entitled to the beneifts of the cost sharing method with respect to such units. Thus, the affiliate's basis in such units shall be equal to the transfer price used for computing the possessions corporation's gross income with respect to such units under section 936(h)(5)(C)(i)(II), and the income derived by the affiliate from such lease or internal use shall be reported by the affiliate when and to the extent actually derived. The affiliate shall not be deemed to have sold such units to an unrelated party at the time they were first leased or otherwise placed in service for any purpose other than the computation of possession sales and total sales. A similar rule applies to other products in the same product area as the possession product which are sold by any member in its own trade or business and which the possessions corporation takes into account in computing total sales under the cost sharing method.

(ii) For taxable years of the possessions corporations beginning after June 13, 1986, a possessions corporations will not be entitled to the benefits of the cost sharing method with respect to units of the possession product which the possessions corporation sells to an affiliate where the affiliate then leases such units to an unrelated person or uses them in its own trade or business, unless the affiliate agrees to be treated for all tax purposes as having sold such units to an unrelated party at the time they were first leased or otherwise placed in service by such affiliate. The affiliate must demonstrate such agreement by reporting its income from such units as if:

(A) It had sold such units to an unrelated person at such time at a price equal to the price used to compute possessions sales under § 1.936–6(a)(2), question and answer 11;

(B) It had immediately repurchased such units for the same price; and

(C) Its basis in such units for all subsequent purposes was equal to its cost basis from such deemed repurchase.

For treatment of other products in the same product area as the possession product see § 1.936–6(a)(2), question and answer 12.

(iii) The principles contained in questions and answers 11, 12, 13, and 14 are illustrated by the following example:

Example. Possessions corporation S and its affiliate A are calendar year taxpayers. In 1985, S manufactures 100 units of possession product X. S sells 50 units of X to unrelated persons in arm's length transactions for $10 per unit. In applying the cost sharing method to determine the portion of its gross income from such sales which qualifies for the possessions tax credit, S determines that $8 of the $10 sales price may be taken into account. S sells the remaining 50 units of X to A, and A then leases such units to unrelated persons. In 1985, A also manufacturers 100 units of product Y, the only other product in the same product area as X manufactured or sold by any member of the affiliated group. A manufactured the 100 units of Y at a cost of $15 per unit, sold 50 units of Y to unrelated persons in arm's length transactions for $20 per unit, and leased the remaining 50 units of Y to unrelated persons.

S may compute its income under the cost sharing method with respect to the 50 units of X it sold to A because S can determine an independent sales price of X from comparable uncontrolled transactions under § 1.482–2(e)(2). For purposes of computing both possessions sales and total sales, the 50 units of X sold to A will be deemed to have been sold by A to an unrelated person for $10 per unit. The income of S qualifying for the possessions tax credit from the sale of those

50 units of X to A, and A's basis in those units, will both be determined using the $8 transfer price determined under section 936 (h)(5)(C)(i)(II). For purposes of computing total sales in the denominator of the cost sharing fraction, S may also take into account the 50 units of Y leased by A to unrelated persons, as if A had sold those units for $20 per unit. A's basis in those units of Y will continue to be its actual cost basis of $15 per unit.

If all of the above transactions had occurred in 1987, S would be entitled to compute its income under the cost sharing method with respect to the 50 units of X it sold to A only if A agreed to be treated for all tax purposes as if it had sold such units for $10 per unit, realized income on such deemed sale of $2 per unit, repurchased such units immediately for $10 per unit, and then leased such units, which would then have a $10 per unit basis in A's hands. For purposes of computing total sales, S would be entitled to take into account the 50 units of X leased by A to unrelated persons as if A had sold such units for $20 per unit.

(3) *Credits against cost sharing payments.*

Q. 1: Is the cost of product area research paid or accrued by the possessions corporation in a taxable year creditable against the cost sharing payment?

A. 1: Yes, if the cost of the product area research is paid or accrued solely by the possessions corporation. Thus, payments by the possessions corporation under cost sharing arrangements with, or royalties paid to, unrelated persons are so creditable. Amounts (such as royalties) paid directly or indirectly to, or on behalf of, related persons and amounts paid under any cost sharing agreements with related persons are not creditable against the cost sharing payment.

Q. 2: Do royalties or other payments made by an affiliate of the possessions corporation to another member of the affiliated group reduce the cost sharing payment if such royalties or other payments are based, in part, on activity of the possessions corporation?

A. 2: No. Payments made between affiliated corporations do not reduce the cost sharing payment. Thus, for example, if a possessions corporation sells a component to a foreign affiliate for incorporation by the foreign affiliate into an integrated product sold to unrelated persons, and the foreign affiliate pays a royalty to the U.S. parent of the possessions corporation based on the total value of the integrated product, the cost sharing payment of the possessions corporation is not reduced.

(4) *Computation of cost sharing payment.*

Q. 1: S is a possessions corporation engaged in the manufacture and sale of four products (A, B, C, and D) all of which are classified under the same three-digit SIC code. S sells its production to a U.S. affiliate, P, which resells it to unrelated parties in the United States. P's third party sales of each of these products produced in whole or in part by S (computed as provided under paragraph (a)(2) of §1.936–6) are $1 million or a total of $4 million for A, B, C, and D. P's other sales of products in the same SIC code are $3,000,000; and the defined worldwide product area research of the affiliated group is $350,000. How should S compute the cost sharing amount for products A, B, C, and D?

A. 1: The cost sharing amount is computed separately for each product on Schedule P of Form 5735. S should use the following formula for each of the products A, B, C, and D:

$$\frac{\text{Sales to unrelated persons of possession product}}{\text{Total sales of products in SIC code}} \times \text{Worldwide product area research}$$

$$\frac{\$1{,}000{,}000}{\$7{,}000{,}000} \times \$350{,}000 = \$50{,}000$$

Q. 2: The facts are the same as in question 1 except that S manufactures product D under a license from an unrelated person. S pays the unrelated party an annual license fee of $20,000.

Thus, the worldwide product area research expense of the affiliated group is $370,000. How should the cost sharing payment be adjusted?

A. 2: The cost sharing fee should be reduced by the $20,000 license fee made as a direct annual payment to a third party on account of product D. The cost sharing payment with respect to product D in this example will be adjusted as follows:

$$\frac{\text{Sales to unrelated persons of possession product}}{\text{Total sales of products in SIC code}} \times \text{Worldwide product area research} - \text{Amount paid by the possessions corporation to an unrelated party}$$

$$\left(\frac{1{,}000{,}000}{\$7{,}000{,}000} \times \$370{,}000\right) - \$20{,}000 = \$32{,}857$$

Q. 3: The facts are the same as in question 1 except that S also manufactures and exports product E to a foreign affiliate, which resells it to unrelated persons for $1 million. S makes a separate election for its export sales. How should S compute the cost sharing amount for product E?

A. 3: The numerator of the cost sharing fraction is the aggregate sales or other dispositions by members of the affiliated group of the units of product E produced in whole or in part in the possession to persons who are not members of the affiliated group. The cost sharing amount for product E would be computed as follows:

$$\frac{\text{Export sales of E}}{\text{Total sales of products in SIC code (In this example, U. S. Sales of A, B, C, and D + export sales of E)}} \times \text{Worldwide product area research}$$

or

$$\frac{\$1{,}000{,}000}{(\$7{,}000{,}000 + \$1{,}000{,}000)} \times \$350{,}000 = \$43{,}750$$

Q. 4: The facts are the same as in question 1, except that S also receives $10,000 in royalty income from unrelated persons for the licensing of certain manufacturing intangible property rights. What is the amount of the product area research that must be allocated in determining the cost sharing amount?

A. 4: If the affiliated group receives royalty income from unrelated persons with respect to manufacturing intangibles in the same product area, then the product area research to be considered shall be first reduced by such royalty income. In this case, the amount of product area research to be used in determining S's cost sharing payment should be reduced by the $10,000 royalty payment received to $340,000.

Q. 5: May a possessions corporation redetermine the amount of its required cost sharing payment after filing its tax return?

A. 5: If after filing its tax return, a possessions corporation files an amended return, or if an adjustment is made on audit, either of which affects the amount of the cost sharing payment required, then a redetermination of the cost sharing payment must be made. See, however, section 936(h)(5)(C)(i)(III)(*a*) with respect to the increase in the cost sharing payment due to interest imposed under section 6601(a).

(5) *Effect of election under the cost sharing method.*

Q. 1: What is the effect of the cost sharing method?

A. 1: The cost sharing payment reduces the amount of deductions (and the amount of reductions in earnings and profits) otherwise allowable to the U.S. affiliates (other than tax-exempt affiliates) within the affiliated group as determined under section 936(h)(5)(C)(i)(I)(*b*) which have incurred research expenditures (as defined in §1.936–6(a)(1), question and answer (3) in the same product area for which the cost sharing option is elected, during the taxable year in which the cost sharing payment accrues. If there are no such U.S. affiliates, the reductions with respect to deductions and earnings and profits, as the case may be, are made with respect to foreign affiliates within the same affiliated group which have incurred product area research expenditures in such product area attributable to a U.S. trade or business. If there are no affiliates which have incurred research expenditures in such product area, the reductions are then made with respect to any other U.S. affiliate and, if there is no such U.S. affiliate, then to any other foreign affiliate. The allocations of these reductions in each case shall be made in proportion to the gross income of the affiliates. In the case of foreign affiliates, the allocation shall be made in proportion to gross income attributable to the U.S. trade or business or worldwide gross income, as the case may be. With respect to each group above, the reduction of deductions shall be applied first to deductions under section 174, then to deductions under section 162, and finally to any other deductions on a pro rata basis.

Q. 2: For purposes of estimated tax payments, when is the cost sharing amount deemed to accrue?

A. 2: The cost sharing amount is deemed to accrue to the appropriate affiliate on the last day of the taxable year of each such affiliate in which or with which the taxable year of the possessions corporation ends.

Q. 3: If the cost sharing method is elected and the year of accrual of the cost sharing payment to the appropriate affiliate (described in question and answer 1 of this paragraph (a)(5)) differs from the year of actual payment by the possessions corporation, in what year are the deductions of the recipients reduced?

A. 3: In the year the cost sharing payment has accrued.

Q. 4: What is the treatment of income from intangibles under the cost sharing method?

A. 4: Under the cost sharing method, a possessions corporation is treated as the owner, for purposes of obtaining a return thereon, of manufacturing intangibles related to a possession product. The term ''manufacturing intangible'' means any patent, invention, formula, process, design, pattern, or know-how. The possessions corporation will not be treated as the owner, for purposes of obtaining a return thereon, of any manufacturing intangibles related to a component product produced by an affiliated corporation and transferred to the possessions corporation for incorporation into the possession product, except in the case that the possession product is treated as including such component product for all purposes of section 936(h)(5). Further, the possessions corporation will not be treated as the owner, for purposes of obtaining a return thereon, of any marketing intangibles except ''covered intangibles.'' (See §1.936–6(c).)

Q. 5: If the cost sharing option is elected, is it necessary for the possessions corporation to be the legal owner of the manufacturing intangibles related to the possession product in order for the possessions corporation to receive a full return with respect to such intangibles?

A. 5: No. There is no requirement that manufacturing intangibles be owned by the possessions corporation.

Q. 6: How is income attributable to marketing intangibles treated under the cost sharing method?

A. 6: Except in the case of ''covered intangibles'' (see § 1.936–6(c)), the possessions corporation is not treated as the owner of any marketing intangibles, and income attributable to marketing intangible of the possessions corporation will be allocated to the possessions corporation's U.S. shareholders with the proration of income based on shareholdings. If a shareholder of the possessions corporation is a foreign, person or is otherwise tax exempt, the possessions corporation is taxable on that shareholder's pro rata amount of the intangible property income. If the possessions corporation is a corporation any class of the stock of which is regularly traded on an established securities market, then the income attributable to marketing intangibles will be taxable to the possessions corporation rather than the corporation's U.S. shareholders.

Q. 7: What is the source of the intangible property income described in question and answer 6?

A. 7: The intangible property income is U.S. source whether taxed to the U.S. shareholder or taxed to the possessions corporation and section 863 (b) does not apply for this purpose. However, such intangible property income, if treated as income of the possessions corporation, does not enter into the calculation of the 80-percent possession source test or the 65-percent active trade or business test.

Q.7a: What is the source of the taxpayer's gross income derived from a sale in the United States of a possession product purchased by the taxpayer (or an affiliate) from a corporation that has an election in effect under section 936, if the income from such sale is taken into account to determine benefits under cost sharing for the section 936 corporation? Is the result different if the taxpayer (or an affiliate) derives gross income from a sale in the United States of an integrated product incorporating a possession product purchased by the taxpayer (or an affiliate) from the section 936 corporation, if the taxpayer (or an affiliate) processes the possession product or an excluded component in the United States?

A.7a: Under either scenario, the income is U.S. source, without regard to whether the possession product is a component, end-product, or integrated product. Section 863 does not apply in determining the source of the taxpayer's income. This Q&A 7a is applicable for taxable years beginning on or after November 13, 1998.

Q. 8: May marketing intangible income, if any, be allocated to the possessions corporation with respect to custom-made products?

A. 8: No. If the cost sharing option is elected, then income attributable to marketing intangibles (other than ''covered intangibles'' described in § 1.936–6(c)) will be taxed as discussed in questions and answers 6 and 7 of paragraph (a)(5) of this section. It is immaterial whether the product is custom-made.

Q. 9: In order to sell a pharmaceutical product in the United States, a New Drug Application (''NDA'') for the product must be approved by the U.S. Food and Drug Administration. Is an NDA considered a manufacturing or marketing intangible for purposes of the allocation of income under the cost sharing method?

A. 9: A manufacturing intangible.

Q. 10: Can a copyright be, in whole or in part, a manufacturing intangible for purposes of the allocation of income under the cost sharing method?

A. 10: In general, a copyright is a marketing intangible. See section 936(h)(3)(B)(ii). However, copyrights may be treated either as manufacturing intangibles or nonmanufacturing intangibles (or as partly each) depending upon the function or the use of the copyright. If the copyright is used in manufacturing, it will be treated as a manufacturing intangible; but if it is used in marketing, even if it is also classified as know-how, it will be treated as a marketing intangible.

Q. 11: If the cost sharing option is elected and a patent is related to the product produced by the possessions corporation, does the return to the possessions corporation with respect to the manufacturing intangible include the make, use, and sell elements of the patent?

A. 11: Yes. A patent confers an exclusive right for 17 years to sell a product covered by the patent. During this period, the return to the possessions corporation includes the make, use and sell elements of the patent.

Q. 12: For purposes of the cost sharing option, may a safe haven rule be applied to determine the amount of marketing intangible income?

A. 12: No. The amount of marketing intangible income is determined on the basis of all relevant facts and circumstances. The section 482 regulations will continue to apply except to the extent modified by the election. Rev. Proc. 63–10 and Rev. Proc. 68–22 do not apply for this purpose.

Q. 13: If a product covered by the cost sharing election is sold by a possessions corporation to an affiliated corporation for resale to an unrelated party, may the resale price method under section 482 be used to determine the intercompany price of the possessions corporation?

A. 13: In general, the resale price method may be used if (a) no comparable uncontrolled price for the product exists, and (b) the affiliated corporation does not add a substantial amount of value to the product by manufacturing or by the provision of services which are reflected in the sales price of the product to the customer. The possessions corporation will not be denied use of the resale price method for purposes of such inter-company pricing merely because the reseller adds more than an insubstantial amount to the value of the product by the use of intangible property.

Q. 14: If a possessions corporation makes the cost sharing election and uses the cost-plus method under section 482 to determine the arm's-length price of a possession product, will the cost base include the cost of materials which are subject to processing or which are components in the possession product?

A. 14: A taxpayer may include the cost of materials in the cost base if it is appropriate under the regulations under §1.482–2(e)(4).

Q. 15: If the possessions corporation computes its income with respect to a product under the cost sharing method, and the price of the product is determined under the cost-plus method under section 482, does the cost base used in computing cost-plus under section 482 include the amount of the cost sharing payment?

A. 15: The amount of the cost sharing payment is included in the cost base. However, no profit with respect to the cost sharing payment will be allowed.

Q. 16: If a member of the affiliated group transfers to a possessions corporation a component which is incorporated into a possession product, how will the transfer price for the component be determined?

A. 16: The transfer price for the component will be determined under section 482, and as follows. If the possession product is treated as not including such component for purposes of section 936(h)(5), the transfer price paid for the component will include a return on all intangibles related to the component product. If the posssession product is treated as including such component for purposes of section 936(h)(5), then the transfer price paid for the component by the possessions corporation will not include a return on any manufacturing intangible related to the component product, and the possessions corporation will obtain the return on the manufacturing intangibles associated with the component.

Q. 17: If the possessions corporation computes its income with respect to a product under the cost sharing method, with respect to which units of the product shall the possessions corporation be treated as owning intangible property as a result of having made the cost sharing election?

A. 17: The possessions corporation shall not be treated as owning intangible property, as a result of having made the cost sharing election, with respect to any units of a possession product which were not taken into account by the possessions corporation in applying the significant business presence test for the current taxable year or for any prior taxable year in which the possessions corporation also had a significant business presence in the possession with respect to such product.

(b) *Profit split option*—(1) *Computation of combined taxable income.*

Q. 1: In determining combined taxable income from sales of a possession product, how are the allocations and apportionments of expenses, losses, and other deductions to be determined?

A. 1: (i) Expenses, losses, and other deductions are to be allocated and apportioned on a ''fully-loaded'' basis under § 1.861–8 to the combined gross income of the possessions corporation and other members of the affiliated group (other than foreign affiliates). For purposes of the profit split option, the term ''affiliated group'' is defined the same as under § 1.936–6 (a)(1) question and answer 2. The amount of research, development, and experimental expenses allocated and apportioned to combined gross income is to be determined under § 1.861–8(e)(3). The amount of research, development and experimental expenses and related deductions (such as royalties paid or accrued with respect to manufacturing intangibles by the possessions corporation or other domestic members of the affiliated group to unrelated persons or to foreign affiliates) allocated and apportioned to combined gross income shall in no event be less than the amount of the cost sharing payment that would have been required under the rules set forth in section 936(h)(5)(C)(i)(II) and paragraph (a) of this section if the cost sharing option had been elected. Other expenses which are subject to § 1.861–8(e) are to be allocated and apportioned in accordance with that section. For example, interest expense (including payments made with respect to bonds issued by the Puerto Rican Industrial, Medical and Environmental Control Facilities Authority (AFICA)) is to be allocated and apportioned under § 1.861–8(e)(2). With the exception of marketing and distribution expenses discussed below, the other remaining expenses which are definitely related to a class of gross income shall be allocated to that class of gross income and shall be apportioned on the basis of any reasonable method, as described in § 1.861–8 (b)(3) and (c)(1). Examples of such methods may include, but are not limited to, those specified in § 1.861–8(c)(1)(i) through (vi).

(ii) The class of gross income to which marketing and distribution expenses relate and shall be allocated is generally to be defined by the same ''product area'' as is determined for the relevant research, development, and experimental expenses (*i.e.*, the appropriate 3-digit SIC code), but shall include only gross income generated or reasonably expected to be generated from the geographic area or areas to which the expenses relate. It shall be presumed that marketing and distribution expenses relate to all product sales within the same product area. If, however, it can be established that any of these expenses are separately identifiable expenses, such as advertising, and relate, directly or indirectly, solely to a specific product or a specific group of products, such expenses shall be allocated to the class of gross income defined by the specific product or group of products. Thus, advertising and other separately identifiable marketing expenses which relate specifically and exclusively to a particular product must be allocated entirely to the gross income from that product, even though the taxpayer or other members of an affiliated group which includes the taxpayer produce and market other products in the same 3-digit SIC code classification. The mere display of a company logo or mention of a company name solely in the context of identifying the manufacturer shall not prevent an advertisement from relating specifically and exclusively to a particular product or group of products.

(iii) If marketing and distribution expenses are allocated to a class of gross income which consists both of income from sales of possession products (the statutory grouping) and other income such as from sale by U.S. affiliates of products not produced in the possession (the residual grouping), then these marketing and distribution expenses shall be apportioned on a ''fully loaded'' basis which reflects, to a reasonably close extent, the factual relationship between these deductions and the statutory and residual groupings of gross income. Apportionment methods based upon comparisons of amounts incurred before ultimate sale of a product (including apportionment on a comparison of costs of goods sold, other expenses incurred, or other comparisons set forth in § 1.861–8 (c)(1)(v), such as time spent) are not on a ''fully-loaded'' basis and do not reflect this required factual relationship. These deductions shall be apportioned on a basis of comparison of the amount of gross sales or receipts or another method if it is established that such method similarly reflects the required factual relationship. Thus, for example, a comparison of units sold may be used only where the units are of the same or similar value and are, thus, in fact comparable.

(iv) The rules for allocation and apportionment of marketing and distribution expenses may be illustrated by the following examples:

Example 1. Assume that possessions corporation A manufacturers prescription pharmaceutical product #1 for resale by P, its U.S. parent corporation, in the United States. Additionally, assume that P manufactures prescription pharmaceutical products #2 and #3 in the United States for sale there. Further, assume that all three products are within the same product area, and that marketing and distribution expenses are internally divided by P among the three products on the basis of time spent by sales persons of P on marketing of the three products, as follows:

Product #1	50X
Product #2	80X
Product #3	110X
Total	240X

These expenses of 240X are allocated to gross income generated by all three products and shall be apportioned on the basis of gross sales or receipts of product #1 as compared to products #2 and #3 or another method which similarly reflects the factual relationship between these expenses and gross income derived from product #1 and products #2 and #3. Thus, if a sales method were used and sales of product #1 accounted for one-third of sales receipts from the three products, 80X (240 ÷ 3) of marketing and distribution expenses would be apportioned to the combined gross income from product #1.

Example 2. Corporation B produces and sells Brand W whiskey, in the United States. B's subsidiary, S, which is a possessions corporation, produces soft drink extract in Puerto Rico which it sells to independent bottlers to produce Brand S soft drinks for sale in the United States. Corporation B's advertisements and other promotional materials for Brand W whiskey make no reference to Brand S soft drinks (or any other Corporation B products), and Brand S soft drink advertisements and other promotional materials make no reference to Brand W whiskey (or any other corporation B products). For purposes of section 936(h), the advertising and other promotional expenses for Brand W whiskey must be allocated entirely to the gross income from sales of Brand W whiskey and the advertising and other promotional expenses for Brand S soft drink must be allocated entirely to the gross income from the sales of soft drink extract, notwithstanding the fact that whiskey and soft drink extract are both included in SIC code 208. A similar result would apply, for example, to separately identifiable advertising and other marketing expenses which relate specifically and exclusively to one or the other of the following pairs of products: chewing gum and granulated sugar (SIC code 206); canned tuna fish and freeze-dried coffee (SIC code 209); children's underwear and ladies' brassieres (SIC code 234); aspirin tablets and prescription antibiotic tablets (SIC code 283); floor wax and perfume (SIC code 284); adhesives and inks (SIC code 289); semi-conductors and cathode-ray tubes (SIC code 367); batteries and extension cords (SIC code 369); bandages and dental supplies (SIC code 384); stainless steel flatware and jewelry parts (SIC code 391); children's toys and sporting goods (SIC code 394); hair curlers and zippers (SIC code 396); and paint brushes and linoleum tiles (SIC code 399).

Example 3. Assume the same facts as in Example 1 and that possessions corporation A also manufactures aspirin, a non-prescription product, for resale by its U.S. parent corporation, P. Further, assume that the advertising and separately identifiable marketing expenses which relate specifically and exclusively to aspirin sales total $100 and that these expenses are allocable solely to gross income derived from aspirin sales. The sales method continues to be used to apportion the marketing and distribution expenses related, directly or indirectly, to products #1, #2, and #3, and the apportionment of such expenses to product #1 for purposes of determining combined taxable income from product #1 will remain as stated in Example 1. None of the advertising and other separately identifiable marketing expenses which relate specifically and exclusively to aspirin will be taken into account in allocating and apportioning the marketing and distribution expenses relating to the gross income attributable to products #1, #2, and #3. Gross income attributable to aspirin will be considered as a separate class of gross income, and all the advertising and separately identifiable marketing expenses which relate specifically and exclusively to aspirin sales of $100 will be allocated to the class of gross income derived from aspirin sales. Similarly, none of the marketing and distribution expenses, directly or indirectly, related solely to the group of products #1, #2, and #3 will be taken into account in determining the combined taxable income from aspirin sales. the remaining marketing and distribution expenses which do not, directly or indirectly, relate solely to any specific product or group of products (*e.g.*, the salaries of a Vice-President of Marketing who has responsibility for marketing all products and his staff) shall be allocated and apportioned on the basis of the gross receipts from the sales of all of the products (or a similar method) in determining combined taxable income of any product.

Q. 2: How may the allocation and apportionment of expenses to combined gross income be verified?

A. 2: Substantiation of the allocation and apportionment of expenses will be required upon audit of the possessions corporation and affiliates. Detailed substantiation may be necessary, particularly where the entities are engaged in multiple lines of business involving distinct product areas. Sources of substantiation may include certified financial reports. Form 10–K's, annual reports, internal production reports, product line assembly work papers, and other relevant materials. In this regard, *see* § 1.861–8(f)(5).

Q. 3: Does section 936(h) override the moratorium provided by section 223 of the Economic Recovery Tax Act of 1981 and any subsequent similar moratorium?

A. 3: Yes. Thus, the allocation and apportionment of product area research described in question and answer 1 must be made without regard to the moratorium.

Q. 4: Is the cost of samples treated as a marketing expense?

A. 4: Yes. The cost of producing samples will be treated as a marketing expense and not as inventoriable costs for purposes of determining combined taxable income (and compliance with the significant business presence test). However, for taxable years beginning prior to January 1, 1986, the cost of producing samples may be treated as either a marketing expense or as inventoriable costs.

Q. 5: If a possessions corporation uses the profit split method to determine its taxable income from sales of a product, how does it determine its gross income for purposes of the 80-percent possession source test and the 65-percent active trade or business test of section 936(a)(2)?

A. 5: One-half of the deductions of the affiliated group (other than foreign affiliates) which are used in determining the combined taxable income from sales of the product are added to the portion of the combined taxable income allocated to the possessions corporation in order to determine the possessions corporation's gross income from sales of such product.

Q. 6: How will income from intangibles related to a possession product be treated under the profit split method?

A. 6: Combined taxable income of the possessions corporation and affiliates from the sale of the possession product will include income attributable to all intangibles, including both manufacturing and marketing intangibles, associated with the product.

Q. 7: Can a possessions corporation apply the profit split option to a possession product if no U.S. affiliates derive income from the sale of the possession product?

A. 7: Yes.

Q. 8: With respect to the factual situation discussed in question and answer 7 how is combined taxable income computed?

A. 8: The profit split option is applied to the taxable income of the possessions corporation from sales of the possession product to foreign affiliates and unrelated persons. Fifty percent of that income is allocated to the possessions corporation, and the remainder is allocated to the appropriate affiliates as described in question and answer 13 of this paragraph (b)(1).

Q. 9: May a possessions corporation compute its income under the profit split method with respect to units of a possession product which it sells to a U.S. affiliate if the U.S. affiliate leases such units to unrelated persons or to foreign affiliates or uses such units in its own trade or business?

A. 9: Yes, provided that an independent sales price for the possession product from comparable uncontrolled transactions can be determined in accordance with § 1.482–2 (e)(2). If, however, there is a comparable uncontrolled price for an integrated product and the possession product is a component product or end-product form thereof, the possessions corporation may compute its income under the profit split method with respect to such units. In either case, the possessions corporation shall compute combined taxable income with respect to such units under the following question and answer.

Q. 10: If the possessions corporation is entitled to use the profit split method in the situation described in *Q. 9* (leasing units of the possession product or use of such units in the taxpayer's own trade or business), how should it compute combined taxable income with respect to such units?

A. 10: (i) Combined taxable income shall be computed as if the U.S. affiliate had sold the units to an unrelated person (or to a foreign affiliate) at the time the units were first leased or otherwise placed in service by the U.S. affiliate. The sales price on such deemed sale shall be equal to the independent sales price from comparable uncontrolled transactions determined in accordance with §1.482–2(e)(2), if any.

(ii) If the possession product is a component product or an end-product form, the combined taxable income with respect to the possession product shall be determined under *Q&A. 12* of this paragraph (b)(1).

(iii) For purposes of determining the basis of a component product or an end-product form, the deemed sales price of such product must be determined. The deemed sales price of the component product shall be determined by multiplying the deemed sales price of the integrated product that includes the component product by a ratio, the numerator of which is the production costs of the component product and the denominator of which is the production costs of the integrated product that includes the component product. The deemed sales price of an end-product form shall be determined by multiplying the deemed sales price of the integrated product that includes the end-product form by a ratio, the numerator of which is the production costs of the end-product form and the denominator of which is the production costs of the integrated product that includes the end-product form. For the definition of production costs, see *Q&A. 12* of this paragraph (b)(1).

(iv)(A) If combined taxable income is determined under paragraph (v) of *A. 12* of this paragraph (b)(1), in the case of a component product, the deemed sales price shall be determined by using the actual sales price of that product when sold as an integrated product (as adjusted under the rules of the fourth sentence of §1.482–3(b)(2)(ii)(A)).

(B) If combined taxable income is determined under paragraph (v) of *A. 12* of this paragraph (b)(1), in the case of an end-product form, the deemed sales price shall be determined by subtracting from the deemed sales price of the integrated product that includes the end-product form (e.g., the leased property) the actual sales price of the excluded component when sold as an integrated product to an unrelated person (as adjusted under the rules of the fourth sentence of §1.482–3(b)(2)(ii)(A)).

(v) The full amount of income received under the lease shall be treated as income of (and be taxed to) the U.S. affiliate and not the possessions corporation.

Q. 11: In the situation described in question 9, how does the U.S. affiliate determine its basis in such units for purposes of computing depreciation and similar items?

A. 11: The U.S. affiliate shall be treated, for purposes of computing its basis in such units, as if it had repurchased such units immediately following the deemed sale and at the deemed sales price as provided in *Q&A. 10* of this paragraph (b)(1).

The principles of questions and answers 10 and 11 are illustrated by the following example:

Example: Possessions corporation S manufactures 100 units of possession product X. S sells 50 units of X to an unrelated person in an arm's length transaction for $10 per unit. S sells the remaining 50 units to its U.S. affiliate, A, which leases such units to unrelated persons. The combined taxable income for the 100 units of X is computed below on the basis of the given production, sales, and cost data:

Sales:	
1. Total sales by S to unrelated persons (50 x $10)	$500
2. Total deemed sales by A to unrelated persons (50 x $10)	500
3. Total gross receipts (line 1 plus line 2)	1,000
Total costs:	
4. Material costs	200
5. Production costs	300

6. Research expenses	0
7. Other expenses	100
8. Total (add lines 4 through 7)	600
Combined taxable income attributable to the 100 units of X:	
9. Combined taxable income (line 3 minus line 8)	400
10. Share of combined taxable income apportioned to S (50% of line 9)	200
11. Share of combined taxable income apportioned to A (line 9 minus line 10)	200
A's basis in 50 units of X leased by it to unrelated persons:	
12. 50 units times $10 deemed repurchase price	500

Subsequent leasing income is entirely taxed to A.

Q. 12: If the possession product is a component product or an end-product form, how is the combined taxable income for such product to be determined?

A. 12: (i) Except as provided in paragraph (v) of this *A. 12,* combined taxable income for a component product or an end-product form is computed under the production cost ratio (PCR) method.

(ii) Under the PCR method, the combined taxable income for a component product will be the same proportion of the combined taxable income for the integrated product that includes the component product that the production costs attributable to the component product bear to the total production costs (including costs incurred by the U.S. affiliates) for the integrated product that includes the component product. Production costs will be the sum of the direct and indirect production costs as defined under § 1.936–5(b)(4) except that the costs will not include any costs of materials. If the possession product is a component product that is transformed into an integrated product in whole or in part by a contract manufacturer outside of the possession, within the meaning of § 1.936–5(c), the denominator of the PCR shall be computed by including the same amount paid to the contract manufacturer, less the costs of materials of the contract manufacturer, as is taken into account for purposes of the significant business presence test under § 1.936–5(c) *Q&A. 5.*

(iii) Under the PCR method the combined taxable income for an end-product form will be the same proportion of the combined taxable income for the integrated product that includes the end-product form that the production costs attributable to the end-product form bear to the total production costs (including costs incurred by the U.S. affiliates) for the integrated product that includes the end-product form. Production costs will be the sum of the direct and indirect production costs as defined under § 1.936–5(b)(4) except that the costs will not include any costs of materials. If the possession product is an end-product form and an excluded component is contract manufactured outside of the possession, within the meaning of § 1.936–5(c), the denominator shall be computed by including the same amount paid to the contract manufacturer, less cost of materials of the contract manufacturer, as is also taken into account for purposes of the significant business presence test under § 1.936–5(c) *Q&A. 5.*

(iv) This paragraph (iv) of *A. 12* illustrates the computation of combined taxable income for a component product or end-product form under the PCR method. S, a possessions corporation, is engaged in the manufacture of microprocessors. S obtains a component from a U.S. affiliate, O. S sells its production to another U.S. affiliate, P, which incorporates the microprocessors into central processing units (CPUs). P transfers the CPUs to a U.S. affiliate, Q, which incorporates the CPUs into computers for sale to unrelated persons. S chooses to define the possession product as the CPUs. The combined taxable income for the sale of the possession product on the basis of the given production, sales, and cost data is computed as follows:

Production costs (excluding costs of materials):	
1. O's costs for the component	100
2. S's costs for the microprocessors	500
3. P's costs for the CPUs (the possession product)	200
4. Q's costs for the computers	400
5. Total production costs for the computer (Add lines 1 through 4)	1,200

6. Combined production costs for the CPU (the possession product) (Add lines 1 through 3)	800
7. Ratio of production costs for the CPUs (the possession product) to the production costs for the computer	0.667
Determination of combined taxable income for computers:	
Sales:	
8. Total possession sales of computers to unrelated customers and foreign affiliates	7,500
Total costs of O, S, P, and Q incurred in production of a computer:	
9. Production costs (enter from line 5)	1,200
10. Material costs	100
11. Total costs (line 9 plus line 10)	1,300
12. Combined gross income from sale of computers (line 8 minus line 11)	6,200
Expenses of the affiliated group (other than foreign affiliates) allocable and apportionable to the computers or any component thereof under the rules of §§1.861–8 through 1.861–14T and 1.936–6 (b)(1), Q&A. 1:	
13. Expenses (other than research expenses)	980
Research expenses of the affiliated group allocable and apportionable to the computers:	
14. Total sales in the 3-digit SIC Code	12,500
15. Possession sales of the computers (enter from line 8)	7,500
16. Cost sharing fraction (divide line 15 by line 14)	0.6
17. Research expenses incurred by the affiliated group in 3-digit SIC Code multiplied by 120 percent	700
18. Cost sharing amount (multiply line 16 by line 17)	420
19. Research of the affiliated group (other than foreign affiliates) allocable and apportionable under §§1.861–17 and 1.861–14T(e)(2) to the computers	300
20. Enter the greater of line 18 or line 19	420
Computation of combined taxable income of the computer and the CPU:	
21. Combined taxable income attributable to the computer (line 12 minus line 13 and line 20)	4,800
22. Combined taxable income attributable to CPUs (multiply line 21 by line 7) (production cost ratio)	3,200
23. Share of combined taxable income apportioned to S (50 percent of line 22) ..	1,600
Share of combined taxable income apportioned to U.S. affiliate(s) of S:	
24. Adjustments for research expenses (line 18 minus line 19 multiplied by line 7)	80
25. Adjusted combined taxable income (line 22 plus line 24)	3,280
26. Share of combined taxable income apportioned to affiliates of S (line 25 minus line 23)	1,680

(v)(A) If a possession product is sold by a taxpayer or its affiliate to unrelated persons in covered sales both as an integrated product and as a component product and the conditions of paragraph (v)(C) of this *A. 12* are satisfied, the taxpayer may elect to determine the combined taxable income derived from covered sales of the component product under this paragraph (v). In that case, the combined taxable income derived from covered sales of the component product shall be determined by using the same per unit combined taxable income as is derived from covered sales of the product as an integrated product, but subject to the limitation of paragraph (v)(D) of this *A. 12*.

(B) In the case of a possession product that is an end-product form, if all of the excluded components are also separately sold by the taxpayer or its affiliate to unrelated persons in uncontrolled transactions and the conditions of paragraph (v)(C) of this *A. 12* are satisfied, the taxpayer may elect to determine the combined taxable income of such end-product form under this paragraph (v). In that case, the combined taxable income derived from covered sales of the end-product form shall be determined by reducing the per unit combined taxable income from the integrated product that includes the end-product form by the per unit combined taxable income for excluded components determined under the rules of this paragraph (v), but subject to the limitation of paragraph (v)(D) of this

A. 12. For this purpose, combined taxable income of the excluded components must be determined under section 936 as if the excluded components were possession products.

(C) In the case of component products, this paragraph (v) applies only if the sales price of the possession product sold in covered sales as an integrated product (i.e., in uncontrolled transactions) would be the most direct and reliable measure of an arm's length price within the meaning of the fourth sentence of § 1.482–3(b)(2)(ii)(A) for the component product. For purposes of applying the fourth sentence of § 1.482–3(b)(2)(ii)(A), the sale of the integrated product that includes the component product is treated as being immediately preceded by a sale of the component (i.e. without further processing) in a controlled transaction. In the case of end-product forms, this paragraph (v) applies only if the sales price of excluded components separately sold in uncontrolled transactions would be the most direct and reliable measure of an arm's length price within the meaning of the fourth sentence of § 1.482–3(b)(2)(ii)(A) for all excluded components of an integrated product that includes an end-product form. For purposes of applying the fourth sentence of § 1.482–3(b)(2)(ii)(A), the sale of the integrated product that includes excluded components is treated as being immediately preceded by a sale of the excluded components (i.e. without further processing) in a controlled transaction. Under the fourth sentence of § 1.482–3(b)(2)(ii)(A), the uncontrolled transactions referred to in this paragraph (v)(C) must have no differences with the controlled transactions that would affect price, or have only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made (resulting in appropriate adjustments to the computation of combined taxable income). If such adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled transactions, the method provided by this paragraph (v)(C) cannot be used. Thus, for example, these uncontrolled transactions must involve substantially identical property in the same or a substantially identical geographic market, and must be substantially identical to the controlled transaction in terms of their volumes, contractual terms, and market level. See § 1.482–3(b)(2)(ii)(B).

(D) In no case can the per unit combined taxable income as determined under paragraph (v)(A) or (B) of this *A. 12* be greater than the per unit combined taxable income of the integrated product that includes the component product or end-product form.

(E) The provisions of this paragraph (v) are illustrated by the following example. Taxpayer manufactures product A in a U.S. possession. Some portion of product A is sold to unrelated persons as an integrated product and the remainder is sold to related persons for transformation into product AB. The combined taxable income of integrated product A is $400 per unit and the combined taxable income of product AB is $300 per unit. The production cost ratio with respect to product A when sold as a component of product AB, is 2/3. Unless the taxpayer elects and satisfies the conditions of this paragraph (v), the combined taxable income with respect to A will be $200 per unit (combined taxable income for AB of $300 × the production cost ratio of 2/3). If, however, the comparability standards of paragraph (v)(C) of this *A. 12* are met, the taxpayer may elect to determine combined taxable income of product A when sold as a component of product AB using the same per unit combined taxable income as product A when sold as an integrated product. However, the per unit combined taxable income from sales of product A as a component product may not exceed the per unit combined taxable income on the sale of product AB. Therefore, the combined taxable income of component product A may not exceed $300 per unit.

(vi) Taxpayers that have not elected the percentage limitation under section 936(a)(1) for the first taxable year beginning after December 31, 1993, may do so if the taxpayer has elected the profit split method and computation of combined taxable income is affected by *Q&A.12* of this paragraph (b)(1).

(vii) The rules of *Q&A. 12* of this paragraph (b)(1) apply for taxable years ending after June 9, 1996. If, however, the election under paragraph (v) of *A. 12* of §1.936–6(b)(1) is made, this election must be made for the taxpayer's first taxable year beginning after December 31, 1993, and if not made effective for that year, the election cannot be made for any later taxable year. A successor corporation that makes the same or substantially similar products as its predecessor corporation cannot make an election under paragraph (v) of A.12 of §1.936–6(b)(1) unless the election was made by its predecessor corporation for its first taxable year beginning after December 31, 1993.

Q. 13: If the profit split option is elected, how is the portion of combined taxable income not allocated to the possessions corporation to be treated?

A. 13: (i) The income shall be allocated to affiliates in the following order, but no allocations will be made to affiliates described in a later category if there are any affiliates in a prior category—

(A) First, to U.S. affiliates (other than tax exempt affiliates) within the group (as determined under section 482) that derive income with respect to the product produced in whole or in part in the possession;

(B) Second, to U.S. affiliates (other than tax exempt affiliates) that derive income from the active conduct of a trade or business in the same product area as the possession product;

(C) Third, to other U.S. affiliates (other than tax-exempt affiliates);

(D) Fourth, to foreign affiliates that derive income from the active conduct of a U.S. trade or business in the same product area as the possession product (or, if the foreign members are resident in a country with which the U.S. has an income tax convention, then to those foreign members that have a permanent establishment in the United States that derives income in the same product area as the possession product); and

(E) Fifth, to all other affiliates.

(ii) The allocations made under paragraph (i)(A) of this *A. 13* shall be made on the basis of the relative gross income derived by each such affiliate with respect to the product produced in whole or in part in the possession. For this purpose, gross income must be determined consistently for each affiliate and consistently from year to year.

(iii) The allocations made under paragraphs (i)(B) and (i)(D) of this *A. 13* shall be made on the basis of the relative gross income derived by each such affiliate from the active conduct of the trade or business in the same product area.

(iv) The allocations made under paragraphs (i)(C) and (i)(E) of this *A. 13* shall be made on the basis of the relative total gross income of each such affiliate before allocating income under this section.

(v) Income allocated to affiliates shall be treated as U.S. source and section 863(b) does not apply for this purpose.

(vi) For purposes of determining an affiliate's estimated tax liability for income thus allocated for taxable years beginning prior to January 1, 1995, the income shall be deemed to be received on the last day of the taxable year of each such affiliate in which or with which the taxable year of the possessions corporation ends. For taxable years beginning after December 31, 1994, quarterly estimated tax payments will be required as provided under section 711 of the Uruguay Round Agreements, Public Law 103–465 (1994), page 230, and any administrative guidance issued by the Internal Revenue Service thereunder.

Q. 14: What is the source of the portion of combined taxable income allocated to the possessions corporation?

A. 14: Income allocated to the possessions corporation shall be treated as possession source income and as derived from the active conduct of a trade or business within the possession.

Q. 15: How is the profit split option to be applied to properly account for costs incurred in a year with respect to products which are sold by the possessions corporation to a U.S. affiliate during such year, but are not resold by the U.S. affiliate to persons who are not members of the affiliated group or to foreign affiliates until a later year?

A. 15: The rules under §1.994–1(c)(5) are to be applied. Incomplete transactions will not be taken into consideration in computing combined taxable income. Thus, for example, if in 1983, A, a possessions corporation, sells units of a product with a cost to A of $5000 to B corporation, its U.S. affiliate, which use the dollar-value LIFO method of costing inventory, and B sells units with a cost of $4000 (representing A's cost) to C corporation, a foreign affiliate, only $4000 of such costs shall be taken into consideration in computing the combined taxable income of the possessions corporation and U.S. affiliates for 1983. If a specific goods LIFO inventory method is used by B, the determination of whether A's goods remain in B's inventory shall be based on whether B's specific goods LIFO grouping has experienced an increment or decrement for the year on the specific LIFO cost of such units, rather than on an average unit cost of such units. If the FIFO method of costing inventory is used by B, transfers may be based on the cost of the specific units transferred or on the average unit production cost of the units transferred, but in each case a FIFO flow assumption shall be used to identify the units transferred. For a determination of which goods are sold by taxpayers using the LIFO method, see question and answer 19.

Q. 16: If a possessions corporation purchases materials from an affiliate and computes combined taxable income for a possession product which includes such materials, how are those materials to be treated in the possessions corporation's inventory?

A. 16: The cost of those materials is considered to be equal to the affiliate's cost using the affiliate's method of costing inventory.

Q. 17: If the possessions corporation uses the FIFO method of costing inventory and the U.S. affiliate uses the LIFO method of costing inventory, or *vice versa*, what method of costing inventory should be used in computing combined taxable income?

A. 17: The transferor corporation's method of costing inventory determines the cost of inventory for purposes of combined taxable income while the transferee corporation's method of costing inventory determines the flow. Assume, for example, that X corporation, a possessions corporation, using the FIFO method of costing inventory purchases materials from Y corporation, U.S. affiliate, also using the FIFO method. X corporation produces a product which it transfers to Z corporation, another U.S. affiliate using the LIFO method. Assume also that the final product satisfies the significant business presence test. Under the facts, the cost of the materials purchased by X from Y is Y's FIFO cost. The costs of the inventory transferred by X to Z are determined under X's FIFO method of accounting as is the flow of the inventory from X to Z. The costs added by Z are determined under Z's LIFO method of inventory, as is the flow of the inventory from Z to unrelated persons or foreign affiliates.

Q. 18: How are the costs of a possession product and the revenues derived from the sale of a possession product determined if the U.S. affiliate includes purchases of the possessions product in a dollar-value LIFO inventory pool (as provided under § 1.472–8)?

A. 18: The following method will be accepted in determining the revenues derived from the sale of a possession product and the costs of a possession product if the U.S. affiliate includes purchases of the possession product in a dollar-value LIFO inventory pool. The rules apply solely for the cost sharing and profit split options under section 936(h).

(i) *Revenue identification.* The identification of revenues derived from sales of a possession product must generally be made on a specific identification basis. The particular method employed by a taxpayer for valuing its inventory will have no impact on the determination of what units are sold or how much revenue is derived from such sales. Thus, if a U.S. affiliate sells both item A (a possession product) and item B (a non-possession product), the actual sales revenues received by the U.S. affiliate from item A sales would constitute possession product revenue for purposes of the profit split option and possession sales for purposes of the cost sharing option regardless of whether the U.S. affiliate values its inventories on the FIFO or the LIFO method. In instances where sales of item A (*i.e.*, the possession product) cannot be determined by use of specific identification (for example, in cases where items A and B are identical except that one is produced in the possession (item A) and the other (item B) is produced outside of the possession and it is not possible to segregate these items in the hands of the U.S. affiliate), it will be necessary to identify the portion of the combined sales of items A and B (which together can be identified on a specific identification basis) which is attributed to item A sales and the portion which is attributed to item B sales. The determination of the portion of aggregated sales attributable to item A and item B is independent of the LIFO method used to determine the cost of such sales and may be made under the following approach. A taxpayer may, for purposes of this section of the regulations, use the relative purchases (in units) of items A and B by the U.S. affiliate during the taxable year (or other appropriate measuring period such as the period during the taxable year used to determine current-year costs, *i.e.*, earliest acquisitions period, latest acquisitions period, etc.) in determining the ratio to apply against the combined items A and B sales revenue. If the sales exceed current purchases, the taxpayer can use a FIFO unit approach which identifies actual unit sales on a first-in, first-out basis. Revenue determination where specific identification is not possible is illustrated by the following example:

Example. At the end of year 1, there are 600 units of combined items A and B which are to be allocated between A and B on the basis of annual purchases of A and B units during year 1. During year 1, 1,000 units of item A, a possession product, and 2,000 units of item B, a non-possession product, were purchased. Thus, the 600 units in year 1 ending inventory are allocated 200 (i.e. ⅓) to item A units and 400 (i.e. ⅔) to item B units based on the relative purchases of A (1,000) and B (2,000) in year 1. These units appear as beginning inventory in year 2.

In year 2, 1,500 units of item A are purchased and 1,500 units of item B are purchased. However, 3,300 units of items A and B in the aggregate are sold for $600,000. The relative proportion of the $600,000 attributable to item A and to item B sales would be determined as follows:

Year 2 sales	Item A	Item B
Unit sales from opening inventory ..	200	400
Unit sale from current-year purchases	1,350	1,350
Total unit sales (3,300)	1,550	1,750
Percentage	47	53

$$\text{Revenues from Item A sales} \ldots\ldots\ldots\ldots\ldots\ldots\ 281{,}818 \left\{ \$600{,}000 \times \frac{1550}{3300} \right\}$$

$$\text{Revenues from Item B sales} \ldots\ldots\ldots\ldots\ldots\ldots\ \$318{,}182 \left\{ \$600{,}000 \times \frac{1750}{3300} \right\}$$

Year 2 Closing Inventory	Units
Item A	150
Item B	150

Thus, revenues from Item A sales for purposes of computing possession sales for the cost sharing option and revenues for the profit split option are $281,818.

(ii) *Cost identification.* The determination of the cost of possession product sales by the U.S. affiliate must be based on the LIFO inventory method of the U.S. affiliate. The LIFO cost of possession product sales will, for purposes of this section of the regulations, be determined by maintaining a separate LIFO cost for possession products in a taxpayer's opening and closing LIFO inventory and using this cost to calculate an independent cost of possession product sales. This separate LIFO cost for possession products in the LIFO pool of a taxpayer is to be determined as follows:

(A) Determine the base-year cost of possession products in ending inventory in a LIFO pool.

(B) Determine the percentage of the base-year cost of possession products in the pool as compared to the total base-year cost of all items in the pool.

(C) Multiply the percentage determined in step (B) of this subdivision (ii) by the ending LIFO inventory value of the pool to determine the deemed LIFO cost attributable to possession products in the pool.

(D) Subtract the LIFO cost of possession products in ending inventory in the pool (as calculated in step (C) of this subdivision (ii)) from the sum of:

(*1*) Possession product purchases for the year, plus

(*2*) The portion of the opening LIFO inventory value of the pool attributed to possession products (*i.e.*, the result obtained in step (C) of this subdivision (ii) for the prior year).

The number determined by this calculation is the LIFO cost of possession product sales from the taxpayer's LIFO pool.

Example: Assume that item A is a possession product and item B is a non-possession product and also assume the inventory and purchases with respect to the LIFO pool as provided below:

YEAR 1—ENDING INVENTORY

	No. of units	Base-year cost/unit	Base-year cost	Percent
Item A	100	$2.00	$200	20
Item B	200	4.00	800	80

YEAR 1—LIFO VALUE

	Base-year cost	Index	LIFO cost
Increment layer 2	$300	3.0	$900
Increment layer 1	400	2.0	800
Base layer	300	1.0	300
Pool total	$1,000		$2,000

YEAR 1—LIFO VALUE PER ITEM

	Base-year cost	LIFO value
Total pool	$1,000	$2,000
Item A	200	400
Item B	800	1,600

YEAR 2—PURCHASES

	Total purchases
Item A	$6,000
Item B	4,000

YEAR 2—ENDING INVENTORY

	No. of units	Base-year cost/unit	Base-year cost	Percent
Item A	200	$2.00	$400	50
Item B	100	4.00	400	50

YEAR 2—LIFO VALUE

	Base-year cost	Index	LIFO cost
Increment layer 2	$100	3.0	$300
Increment layer 1	400	2.0	800
Base layer	$300	1.0	300
Pool total	800		1,400

The year 2 LIFO cost of possession product A sales will be calculated as follows:

(1) Base-year cost of item in year 2 ending inventory=$400

(2) Percentage of item A base-year cost to total base-year cost ($400 ÷ $800) = 50%

(3) LIFO value of item A ($1,400 × 50%) = $700

(4) LIFO cost of item A sales is determined by adding to the beginning inventory in year 2 the purchases of item A in year 2 and subtracting from this amount the ending inventory in year 2 ($400 + $6000 − $700 = $5700). The beginning inventory in year 2 is determined by multiplying the LIFO cost of the year 1 ending inventory by a percentage of item A base year cost to the total base-year cost in year 1. The ending inventory in year 2 is determined under (3) above.

Q. 19: If a possession product is purchased from a possessions corporation by a U.S. affiliate using the dollar-value LIFO method of costing its inventory and is included in a LIFO pool of the U.S. affiliate which includes products purchased from the possessions corporation in pre-TEFRA years, how should the LIFO index computation of the U.S. affiliate be made in the first year in which section 936(h) applies and in subsequent taxable years?

A. 19: The U.S. affiliate should treat the first taxable year for which section 936(h) applies as a new base year in accordance with procedures provided by regulations under section 472. Thus, the opening inventory for the first year for which section 936(h) applies (valuing possession products purchased from the possessions corporation on the basis of the cost of such possession products), would equal the new base year cost of the inventory of such pool of the U.S. affiliate. Increments and decrements at new base year cost would be valued for LIFO purposes pursuant to the procedures provided by regulations under section 472.

Q. 20: If the possessions corporation computes its income with respect to a product under the profit split method, with respect to which units of the product shall the profit split method apply?

A. 20: The profit split method shall apply to units of the possession product produced in whole or in part by the possessions corporation in the possession and sold during the taxable year by members of the affiliated group (other than foreign affiliates) to unrelated parties or to foreign affiliates. In no event shall the profit split method apply to units of the product which were not taken into account by the possessions corporation in applying the significant business presence test for the current taxable year or for any prior taxable year in which the possessions corporation also had a significant business presence in the possession with respect to such product.

(2) *Pre-TEFRA inventory.*

Q. 1: How is pre-TEFRA inventory to be determined if the profit split option is elected and the FIFO method of costing inventory is used by the U.S. affiliate?

A. 1: Pre-TEFRA inventory is inventory which was produced by the possessions corporation and transferred to a U.S. affiliate prior to the possessions corporation's first taxable year beginning after December 31, 1982. Pre-TEFRA inventory will not be included for purposes of the profit split option. If the U.S. affiliate uses the FIFO method of costing inventory, the pre-TEFRA inventory will be treated as the first inventory sold by the U.S. affiliate during the first year in which section 936(h) applies and will not be included in the computation of combined taxable income for purposes of the profit split option. The treatment of pre-TEFRA inventory when FIFO costing is used by both the U.S. affiliate and the possessions corporation is illustrated by the following example in which FIFO unit costing is used:

Example. Assume the following:

	X		Y	
	Possessions corporation		U.S. affiliate	
	Number of units	Cost per unit	Number of units	Cost per unit
Beginning inventory ...	500	$150	200	$225
Units produced during 1983	1,000	200	....	....
Ending inventory	400	200	300	....

In 1983, the beginning inventory of X, a possessions corporation, is 500 units with a unit cost of $150 and the beginning inventory of Y, the U.S. affiliate, is 200 units with a unit cost of $225, which represents the section 482 price paid by Y. Y's beginning inventory in 1983 represents purchases made in 1982 of products produced by X in that year. Y sells all the units it purchases from X to Z, a foreign affiliate. In 1983, X produces 1000 units at a unit cost of $200 and sells 1100 units to Y (the difference between 1500 units, representing X's 1983 beginning inventory (500) and the units produced by X in 1983 (1000), and X's ending inventory of 400 units). Of the 1100 units sold by X to Y in 1983 only 800 units (and not 1000 units) which were sold by Y to Z are taken into consideration in computing combined taxable income for 1983. Since FIFO costing by the possessions corporation is used, the cost is $150 per unit for the first 500 units and $200 per unit for the remaining 300 units. The 200 units sold by X to Y in 1982 are pre-TEFRA inventory and are not included in the computation of combined taxable income for 1983. They are also treated as the first units sold by Y to Z in 1983. This inventory has a unit cost of $225, which reflects the section 482 transfer price from X to Y in 1982. Y's 1983 ending inventory of 300 units will not be taken into consideration in computing the combined taxable income of X and Y for 1983 because the units have not been sold to a foreign affiliate or to persons who are not members of the affiliated group. In a subsequent year when the units are sold to Z, the cost to X and selling price to Z of these units will enter into the computation of combined taxable income for that year.

(c) *Covered Intangibles.*

Q. 1: What are ‘‘covered intangibles’’ under section 936(h)(5)(C)(i)(II)?

A. 1: The term ‘‘covered intangibles’’ means (1) intangible property developed in a possession solely by the possessions corporation and owned by it, (2) manufacturing intangible property (described in section 936(h)(3)(B)(i)) which is acquired by the possessions corporation from unrelated persons, and (3) any other intangible property (described in section 936(h)(3)(B) (ii) through (v), to the extent not described in section 936(h)(3)(B)(i)) which relates to sales of products or services to unrelated persons for ultimate consumption or use in the possession in which the possessions corporation conducts its business. The possessions corporation is treated as the owner of covered intangibles for purposes of obtaining a return thereon.

Q. 2: Do covered intangibles include manufacturing intangible property which is acquired by an affiliate and subsequently transferred to the possessions corporation?

A. 2: No. In order for a manufacturing intangible to be treated as a covered intangible, the intangible property must be acquired directly by the possessions corporation from an unrelated person unless the manufacturing intangible was acquired by an affiliate from an unrelated person and was transferred to the possessions corporation by the affiliate prior to September 3, 1982.

Q. 3: If a possessions corporation licenses a manufacturing intangible from an unrelated party, will the licensed intangible be treated as a covered intangible?

A. 3: No.

Q. 4: How is ultimate consumption or use determined for purposes of the definition of covered intangibles?

A. 4: A product will be treated as having its ultimate use or consumption in a possession if it is sold by the possessions corporation to a related or unrelated person in a possession and is not resold or used or consumed outside of the possession within one year after the date of the sale.

Q. 5: Are sales of products that relate to covered intangibles excluded from the cost sharing fraction?

A. 5: If no manufacturing intangibles other than covered intangibles are associated with the possession product, then sales of such product will be excluded from the cost sharing fraction. If both covered and non-covered manufacturing intangibles are associated with the possession product, then sales of such product will be included in the cost sharing fraction.

Q. 6: If the cost sharing option is elected, is it necessary for the possessions corporation to be the legal owner of covered intangibles described in section 936(h)(5)(C)(i)(II)(*c*) related to the product in order for the possessions corporation to receive a full return with respect to such intangibles?

A. 6: No. For purposes of section 936(h), it is immaterial whether such covered intangibles are owned by the possessions corporation or by another member of the affiliated group. Moreover, if the legal owner of such covered intangibles which are subject to section 936(h)(5) is an affiliate of the possessions corporation, such person will not be required to charge an arm's-length royalty under section 482 to the possessions corporation.

[T.D. 8090, 51 FR 21532, June 13, 1986; 51 FR 27174, July 30, 1986, as amended by T.D. 8669, 61 FR 21367, May 10, 1996; 61 FR 39072, July 26, 1996; T.D. 8786, 63 FR 55025, Oct. 14, 1998]

§ 1.936–7 Manner of making election under section 936 (h)(5); special election for export sales; revocation of election under section 936(a).

The rules in this section apply for purposes of section 936(h) and also for purposes of section 934(e), where applicable.

(a) *Manner of making election.*

Q. 1: How does a possessions corporation make an election to use the cost sharing method or profit split method?

A. 1: A possessions corporation makes an election to use the cost sharing or profit split method by filing Form 5712–A and attaching it to its tax return. Form 5712–A must be filed on or before the due date (including extensions) of the tax return of the possessions corporation for its first taxable year beginning after December 31, 1982. The electing corporation must set forth on the form the name and the taxpayer identification number or address of all members of the affiliated group (including foreign affiliates not required to file a U.S. tax return). All members of the affiliated group must consent to the election. An authorized officer of the electing corporation must sign the statement of election and must declare that he has received a signed statement of consent from an authorized officer, director, or other appropriate official of each member of the affiliated group. The election is not valid unless all affiliates consent. However, a failure to obtain an affiliate's written consent will not invalidate the election out if the possessions corporation made a good faith effort to obtain all the necessary consents or the failure to obtain the missing consent was inadvertent. Subsequently created or acquired affiliates are bound by the election. If an election out is revoked under section 936(h)(5)(F)(iii), a new election out with respect to that product area cannot be made without the consent of the Commissioner. The possessions corporation shall file an amended Form 5712–A with its timely filed income tax return to reflect any changes in the names or number of the members of the affiliated group for any taxable year after the first taxable year to which the election out applies. By consenting to the election out, all affiliates agree to provide information necessary to compute the cost sharing payment under the cost sharing method or combined taxable income under the profit split method, and failure to provide such information shall be treated as a request to revoke the election out under section 936(h)(5)(F)(iii).

Q. 2: May the ‘‘election out’’ under section 936(h)(5) be made on a product-by-product basis, or must it be made on a wide basis?

A. 2: An electing corporation is required to treat products in the same product area in the same manner. Similarly, all possessions corporations in the same affiliated group that produce any products or render any services in the same product area must make the same election for all products that fall within the same product area. However, §1.936–7(b) provides that the electing corporation may make a different election for export sales than for domestic sales. The electing corporation or corporations may also make different elections for products that fall within different product areas.

Q. 3: May the possessions corporation elect to define product area more narrowly than the 3-digit SIC code?

A. 3: No. Certain alternatives, such as the 4-digit SIC code, would not be permitted under the statute. However, other methods for defining product area may be considered by the Commissioner in the future.

Q. 4: May a possessions corporation make an election out under the cost sharing method with respect to a product area if the affiliated group incurs no research, development or experimental costs in the product area?

A. 4: Yes. In that case the cost sharing payment will be zero.

Q. 5: If the significant business presence test is not satisfied for a product or type of service within the product area covered by the election out under section 936(h)(5) what rules will apply with respect to that product?

A. 5: With respect to the product which does not satisfy the significant business presence test, the provisions of section 936 (h)(1) through (h)(4) will apply to the allocation of income. However, if a cost sharing or a profit split election has been made with respect to the product area, the cost sharing payment or the research and development floor under section 936(h)(5)(C)(ii)(II) will not be reduced.

Q. 6: Is a taxpayer permitted to make a change of election with respect to the cost sharing and profit split methods?

A. 6: In general, once the election is properly made, it is binding for the first year in which it applies and all subsequent years (including upon any later created or acquired affiliates), and revocation is only permitted with the consent of the Commissioner of Internal Revenue. However, a taxpayer will be permitted to change its election once from the cost sharing method to the profit split method or *vice versa,* or from the method permitted under section 936 (h)(1) through (h)(4) to cost sharing or profit split or *vice versa,* without the consent of the Commissioner if the change is made on the taxpayer’s return for its first taxable year ending after June 13, 1986. Such change will apply to such taxable year and all subsequent taxable years, and, at the taxpayer’s option, may also apply to all prior taxable years for which section 936(h) was in effect. A change of election will be treated as an election subject to the procedures set forth above and to section 481 of the Internal Revenue Code.

Q. 7: If the Commissioner determines that a possessions corporation does not meet the 80-percent possession source test or the 65-percent active trade or business test (the ‘‘qualification tests’’) for any taxable year beginning after 1982, under what circumstances is the possessions corporation permitted to make a distribution of property after the close of its taxable year to meet the qualification tests?

A. 7: A possessions corporation may make a pro rata distribution of property to its shareholders after the close of the taxable year if the Commissioner determines that the possessions corporation does not satisfy the qualification tests (a) by reason of the exclusion from gross income of intangible income under section 936(h)(1)(B) or section 936(h)(5)(C)(i)(II) or (b) by reason of the allocation to the shareholders of the possessions corporation of income under section 936(h)(5)(C)(ii)(III); provided, however, that the determination of the Commissioner does not contain a finding that the failure of such corporation to satisfy the qualification tests was due, in whole or in part, to fraud with intent to evade tax or willful neglect on the part of the possessions corporation. The possessions corporation must designate the distribution at the time the distribution is made as a distribution to meet qualification requirements, and it will be subject to the provisions of section 936(h)(4). Such distributions will not qualify for the dividends received deduction.

Q. 8: If a possessions corporation owns stock in a subsidiary possessions corporation, any intangible property income allocated to the parent possessions corporation under section 936(h) will be treated as U.S. source income and taxable to the parent possessions corporation. Is the intangible property income taken into consideration in determining whether the parent possessions corporation meets the income tests of section 936(a)(2)?

A. 8: While taxable to the parent possessions corporation, the intangible property income does not enter into the calculation of the 80-percent possession source test or the 65-percent active trade or business test of section 936(a)(2)(A) and (B). This would also be the case if the subsidiary possessions corporation made a qualifying distribution under section 936(h)(4).

(b) *Separate election for export sales.*

Q. 1: What methods of computing income can a possessions corporation use under the separate election for export sales?

A. 1: The only two methods which are available under the separate election for export sales are the cost sharing method and the profit split method.

Q. 2: What is the definition of export sales for purposes of the separate election for export sales?

A. 2: The determination of export sales is based upon the destination of the product, *i.e.*, where it is to be used or consumed. If the product is sold to a U.S. affiliate, it will be treated as an export sale only if resold or otherwise transferred abroad to a foreign person (including a foreign affiliate or foreign branch of a U.S. affiliate) within one year from the date of sale to the U.S. affiliate for ultimate use or consumption outside the United States as provided under § 1.954–3(a)(3)(ii).

Q. 3: Assume that a possessions corporation sells a product to both foreign affiliates and foreign branches of U.S. affiliates. In addition, it sells the product to its U.S. parent for resale in the U.S. The possessions corporation makes a profit split election for domestic sales and a cost sharing election of export sales. Will the sales to foreign branches of U.S. affiliates be treated as exports subject to the cost sharing method or as domestic sales subject to the profit split method?

A. 3: The sales to a foreign branch of a U.S. corporation are exports if for ultimate use or consumption outside of the United States as provided under § 1.954–3(a)(3)(ii).

Q. 4: Under what circumstances may a possessions corporation make the separate election under section 936(h)(5)(F)(iv)(II) for computing its income from products exported to a foreign person when the income derived by such foreign person on the resale of such products is included in foreign base company income under section 954(a)?

A. 4: If the income derived by a foreign person on the resale of products manufactured, in whole or in part, by a possessions corporation is included in foreign base company income under section 954(a), then the possessions corporation may make the separate export election under section

936(h)(5)(F)(iv)(II) for computing its income from such products only if such foreign person has been formed or is availed of for substantial business reasons that are unrelated to an affiliated corporation's U.S. tax liability. For purposes of the proceding sentence, a foreign person will be considered to be formed or availed of for such substantial business reasons if the foreign person in the normal course of business purchases substantial quantities of products from both the possessions corporation and its affiliates for resale, and, in addition provides support services for affiliated companies such as centralized testing, marketing of products, management of local currency exposures, or other similar services. However, a foreign person that purchases and resells products only from a possessions corporation is presumed to be formed or availed of for other than such substantial business reasons, even if the foreign person provides additional services.

Q. 5: When will the ''manufacturing'' test set forth in subsection (d)(1)(A) of section 954 be applicable to the export sales of a product of a possessions corporation which makes a separate election for export sales?

A. 5: An electing corporation will be required to meet the ''manufacturing'' test set forth in subsection (d)(1)(A) of section 954 with respect to export sales of its product in each taxable year in which the separate election for export sales is in effect.

(c) *Revocation of election under section 936(a).*

Q. 1: When may an election under section 936(a) be revoked?

A. 1: An election under section 936(a) may be revoked during the first ten years of section 936 status only with the consent of the Commissioner, and without the Commissioner's consent after that time. The Commissioner hereby consents to all requests for revocation that are made with respect to the taxapayer's first taxable year beginning after December 31, 1982 provided that the section 936(a) election was in effect for the corporation's last taxable year beginning before January 1, 1983, if the taxpayer agrees not to re-elect section 936(a) prior to its first taxable year beginning after December 31, 1988. A taxpayer that wishes to revoke a section 936(a) election under the terms of the blanket revocation must attach a ''Statement of Revocation—Section 936'' to the taxpayer's timely filed return (including extensions) and must state that in revoking the election the taxpayer agrees not to re-elect section 936(a) prior to its first taxable year beginning after December 31, 1988. Other requests to revoke not covered by the Commissioner's blanket consent should be addressed to the District Director having jurisdiction over the taxpayer's tax return.

[T.D. 8090, 51 FR 21545, June 13, 1986]

§1.936–8T Qualified possession source investment income (temporary). [Reserved]

§1.936–9T Source of qualified possession source investment income (temporary). [Reserved]

§1.936–10 Qualified investments.

(a) *In general.* [Reserved]

(b) *Qualified investments in Puerto Rico.* [Reserved]

(c) *Qualified investment in certain Caribbean Basin countries*—(1) *General rule.* An investment of qualified funds described in this section shall be treated as a qualified investment of funds for use in Puerto Rico if the funds are used for a qualified investment in a qualified Caribbean Basin country. A qualified investment in a qualified Caribbean Basin country is a loan of qualified funds by a qualified financial institution (described in paragraph (c)(3) of this section) directly to a qualified recipient (described in paragraph (c)(9) of this section) or indirectly through a single financial intermediary for investment in active busines assets (as defined in paragraph (c)(4) of this section) in a qualified Caribbean Basin country (described in paragraph (c)(10)(ii) of this section) or for investment in development projects (as defined in paragraph (c)(5) of this section) in a qualified Caribbean Basin country, provided—

(i) The investment is authorized, prior to disbursement of the funds, by the Commissioner of Financial Institutions of Puerto Rico (or his delegate) pursuant to regulations issued by such Commissioner; and

(ii) The agreement, certification, and due diligency requirements under paragraphs (c)(11), (12), and (13) of this section are met.

A loan by a qualified financial institution shall not be disqualified merely because the loan transaction is processed by the central bank of issue of the country into which the loan is made pursuant to, and solely for purposes of complying with, the exchange control laws or regulations of such country. Further, a loan by a qualified financial institution shall not be disqualified merely because the loan is acquired by another person, provided such other person is also a qualified financial institution.

(2) *Termination of qualification*—(i) *In general.* An investment that, at any time after having met the requirements for a qualified investment in a qualified Caribbean Basin country under the terms of this paragraph (c), fails to meet any of the conditions enumerated in this paragraph (c) shall no longer be considered a qualified investment in a qualified Caribbean Basin country from the time of such failure, unless the investment satisfies the requirements for a timely cure described in paragraph (c)(2)(ii) of this section. Such a failure includes, but is not limited to, the occurrence of any of the following events:

(A) Active business assets cease to qualify as such;

(B) Proceeds from the investment are diverted for the financing of assets, projects, or operations that are not active business assets or development projects or are not the assests or the project of the qualified recipient;

(C) The holder of the qualified recipient's obligation is not a qualified financial institution;

(D) The qualified recipient's qualified business activity ceases to qualify as such; or

(E) The qualified Caribbean Basin country ceases to be a country described in paragraph (c)(10)(ii) of this section.

(ii) *Timely cure*—(A) *In general.* A timely cure shall be considered to have been made if the event or events that cause disqualification of the investment are corrected within a reasonable period of time. For purposes of this section, a reasonable period of time shall not exceed 60 days after such event or events come to the attention of the qualified recipient or the qualified financial institution or should have some to their attention by the exercise of reasonable diligence.

(B) *Due diligence requirements.* A time cure of a failure to comply with the due diligence requirements of paragraphs (c)(11), (12), and (13) of this section shall be considered to be made if the failure to comply is due to reasonable cause and, upon request of the Commissioner of Financial Institutions of Puerto Rico (or his delegate) or of the Assistant Commissioner (International) (or his authorized representative), the qualified financial institution (and its trustee or agent), if any), the financial intermediary, or the qualified recipient establishes to the satisfaction of the Commissioner of Financial Institutions of Puerto Rico (or his delegate) or of the Assistant Commissioner (International) (or his authorized representative) that it has exercised due diligence in ensuring that the funds were property disbursed to a qualified recipient and applied by or on behalf of such qualified recipient to uses that qualify the investment as an investment in qualified business assets or a development project under the provisions of this paragraph (c).

(iii) *Assumption of qualified recipient's obligation.* An investment shall not cease to qualify merely because the qualified recipient's obligation to the qualified financial institution (or to a financial intermediary, if any) is assumed by another person, provided such other person assumes the qualified recipient's agreement and certification requirements under paragraph (c)(11)(i) of this section and is either—

(A) A qualified recipient on the date of assumption, in which case such person shall be treated for purposes of this section as the original qualified recipient and shall be subject to all the requirements of this section for continued qualification of the loan as a qualified investment in a qualified Caribbean Basin country; or

(B) An international organization, the principal purpose of which is to foster economic development in developing countries and which is described in section 1 of the International Organizations Immunities Act (22 U.S.C. 288), if the assumption of the obligation is pursuant to a bona fide guarantee agreement.

(3) *Qualified financial institution*—(i) *General rule.* For purposes of section 936(d)(4)(A) and this section, a qualified financial institution includes only—

(A) A banking, financing, or similar business defined in § 1.864–4(c)(5)(i) that is an eligible institution described in paragraph (c)(3)(ii) of this section, but not including branches of such institution outside of Puerto Rico;

(B) A single-purpose entity described in paragraph (c)(3)(iii) of this section;

(C) The Government Development Bank for Puerto Rico;

(D) The Puerto Rico Economic Development Bank; and

(E) Such other entity as may be determined by the Commissioner by Revenue Procedure or other guidance published in the Internal Revenue Bulletin.

(ii) *Eligible institution.* An eligible institution means an institution—

(A) That is an entity organized under the laws of the Commonwealth of Puerto Rico or is the Puerto Rican branch of an entity organized under the laws of another jurisdiction, if such entity is engaged in a banking, financing, or similar business defined in § 1.864–4(c)(5)(i), and

(B) That is licensed as an eligible institution under Regulation No. 3582 (or any successor regulation) issued by the Commissioner of Financial Institutions of Puerto Rico (hereinafter ‘‘Puerto Rican Regulation No. 3582’’).

(iii) *Single-purpose entity.* A single-purpose entity is an entity that meets all of the following conditions:

(A) The entity is organized under the laws of the Commonwealth of Puerto Rico and is a corporation, a partnership or a trust, which conducts substantially all of its activities in Puerto Rico.

(B) The sole purpose of the entity is to use qualified funds from possessions corporations to make one or more qualified investments in a qualified Caribbean Basin country and the entity actually uses such funds only for such purpose.

(C) In the case of an entity that is a trust, one of the trustees is a qualified financial institution described in paragraph (c)(3)(i) of this section.

(D) The entity is licensed as an eligible institution under Puerto Rican Regulation No. 3582 (or any successor regulation).

(E) Any temporary investment by the entity for its own account of funds received from a possessions corporation, and the income from the investment thereof, and any temporary investment by the entity for its own account of principal and interest paid by a borrower to the entity, and the income from the investment thereof, are limited to investments in eligible activities, as described in section 6.2.4 of Puerto Rican Regulation No. 3582, as in effect on September 22, 1989.

(4) *Investments in active business assets*—(i) *In general.* For purposes of section 936(d)(4)(A)(i)(I) and this section and subject to the provisions of paragraph (c)(8) of this section, a loan qualifies as an investment in active business assets if—

(A) The amounts disbursed to a qualified recipient under the loan or bond issue are promptly applied (as defined in paragraphs (c)(6) and (7) of this section) by (or on behalf of) the qualified recipient solely for capital expenditures for the construction, rehabilitation (including demolition associated therewith), improvement, or upgrading of qualified assets described in paragraphs (c)(4)(ii)(A), (B), (E), and (F) of this section, for the acquisition of qualified assets described in paragraphs (c)(4)(ii)(B), (C), (E), and (F) of this section, for the expenditures described in paragraphs (c)(4)(ii)(D), (E), and (F) of this section, and, if applicable, for the financing of incidental expenditures described in paragraph (c)(4)(iii) of this section;

(B) The qualified recipient owns the assets for United States income tax purposes and uses them in a qualified business activity (as defined in paragraph (c)(4)(iv)); and

(C) The requirements of paragraph (c)(6) of this section (regarding temporary investments and time periods within which the funds must be invested) and of paragraph (c)(7) of this section (regarding the refinancing of existing funding and the time periods within which funding for investments must be secured) are satisfied.

(ii) *Definition of qualified assets.* For purposes of this paragraph (c), qualified assets mean—

(A) Real property;

(B) Tangible personal property (such as furniture, machinery, or equipment) that is not property described in section 1221(1) and that is either new property or property which at no time during the period specified in paragraph (c)(4)(v) of this section was used in a business activity in the qualified Caribbean Basin country in which the property is to be used;

(C) Rights to intangible property that is a patent, invention, formula, process, design, pattern, know-how, or similar item, or rights under a franchise agreement, provided that such rights—

(*1*) Were not at any time during the period specified in paragraph (c)(4)(v) of this section used in a business activity in the qualified Caribbean Basin country in which the rights are to be used,

(*2*) Are not rights the use of which gives rise, or would give rise if used, to United States source income, and

(*3*) Are not rights acquired by the qualified recipient from a person related (within the meaning of section 267(b), using ''10 percent'' instead of ''50 percent'' in the places where it appears) to the qualified recipient;

(D) Exploration and development expenditures incurred by a qualified recipient for the purpose of ascertaining the existence, location, extent or quality of any deposit of ore, oil, gas, or other mineral in a qualified Caribbean Basin country, as well as for purposes of developing such deposit (within the meaning of section 616 of the Code and the regulations thereunder);

(E) Living plants and animals (other than crops, plants, and animals that are acquired primarily to hold as inventory by the qualified recipient for resale in the ordinary course of trade or business) acquired in connection with a farming business (as defined in § 1.263–1T(c)(4)(i)), expenditures of a preparatory nature to prepare the land or area for farming (such as planting trees, drilling wells, clearing brush, leveling land, laying pipes, building roads, constructing tanks and reservoirs), expenditures for soil and water conservation of a type described in section 175(c)(1), and expenditures of a development nature incurred in connection with, and during, the preproductive period of property produced in a farming business (as defined in § 1.263–1T(c)(4)(ii));

(F) Other assets or expenditures that are not described in paragraphs (c)(4)(ii)(A) through (E) of this section and that the Commissioner may, by Revenue Procedure or other guidance published in the Internal Revenue Bulletin or by ruling issued to a qualified financial institution or qualified recipient upon its request, determine to be qualified assets.

(iii) *Incidental expenditures.* An amount in addition to the loan proceeds borrowed to make an investment in active business assets shall be considered an investment in active business assets if such amount is applied to finance expenditures that are incidental to making the investment in active business assets, provided such amount is disbursed at or about the same time the proceeds for making the investment in active business assets are disbursed. For purposes of this section, expenditures incidental to an investment in active business assets include only the following items:

(A) A reasonable amount of costs (other than the cost of credit enhancement or bond insurance premiums) associated with arranging the financing of an investment in active business assets, not to exceed 3.5 percent of the proceeds of the loan or bond issue.

(B) A reasonable amount of installation costs and other reasonable costs associated with placing an active business asset in service in the qualified business activity.

(C) An amount not in excess of 10 percent of the total amount of investment in qualified assets to finance the acquisition of inventory, and other working capital requirements, but if an investment is in connection with a manufacturing or farming business, the percentage limitation shall be 50 percent rather than 10 percent provided the excess over the 10 percent limitation is used to finance inventory property. For purposes of this paragraph (c), whether a business is a manufacturing business shall be determined under principles similar to those described in section 954(d)(1)(A) and the regulations thereunder; whether a business is a farming business shall be determined under §1.263–1T(c)(4)(i).

(D) An amount not in excess of 5 percent of the sum of the investment in active business assets and the costs described in paragraphs (c)(4)(iii)(A), (B), and (C) of this section for the refinancing of an existing debt of the qualified recipient if such refinancing is incidental to an investment in active business assets. For this purpose, the replacement of an existing loan arrangement shall not be considered the refinancing of an existing indebtedness to the extent that the funds under such loan arrangement have not yet been disbursed to the qualified recipient.

(iv) *Qualified business activity.* A qualified business activity is a lawful industrial or commercial activity that is conducted as an active trade or business (under principles similar to those described in §1.367(a)–2T(b) (2) and (3)) in a qualified Caribbean Basin country. A trade or business for purposes of this paragraph (c)(4)(iv) is any business activity meeting the principles of section 367 of the Code and described in Divisions A through I (excluding group 43 in Division E (relating to the United States Postal Service) and groups 84 (relating to museums, art galleries, and botanical and zoological gardens), 86 (relating to membership organizations), and 88 (relating to private households in Division I) of the 1987 Standard Industrial Classification Manual issued by the Executive Office of the President, Office of Management and Budget, or in the comparable provisions of any successor Standard Industrial Classification Manual that is adopted by the Commissioner of Internal Revenue in a notice, regulation, or other document published in the Internal Revenue Cumulative Bulletin.

(v) *Period of use.* The period referred to in paragraphs (c)(4)(ii)(B) and (C) of this section shall be a five year period preceding the date of acquisition with the loan proceeds, if the date of acquisition is on or before May 13, 1991. If the date of acquisition is after May 13, 1991, then the period specified in this paragraph (c)(4)(v) shall be three years preceding the date of acquisition with the loan proceeds.

(5) *Investments in development projects*—(i) *In general.* Subject to the provisions of paragraph (c)(8) of this section, this paragraph (c)(5)(i) describes the requirements in order for a loan by a qualified financial institution to qualify as an investment in a development project for purposes of section 936(d)(4)(A)(i)(II) and for this section.

(A) The amounts disbursed under the loan or bond issue must be promptly applied (as defined in paragraphs (c)(6) and (7) of this section) by (or on behalf of) the qualified recipient solely for one or more investments described in paragraph (c)(4)(i)(A) of this section and in any land, buildings, or other property functionally related and subordinate to a facility described in paragraph (c)(5)(ii) of this section (determined under principles similar to those described in §1.103–8(a)(3)), for use (under principles similar to those described in §1.367(a)–2T(b)(5)) in connection with one or more activities described in paragraph (c)(5)(i)(B) of this section.

(B) The activities referred to in paragraph (c)(5)(i)(A) of this section are—

(*1*) A development project described in paragraph (c)(5)(ii) of this section in a qualified Caribbean Basin country; or

(*2*) The performance in a qualified Caribbean Basin country of a non-commercial governmental function described in paragraph (c)(5)(iv) of this section;

(C) The qualified recipient must own the assets for United States income tax purposes;

(D) The requirements of paragraph (c)(6) of this section (regarding temporary investments and time periods within which the funds must be invested) and of paragraph (c)(7) of this section (regarding the refinancing of existing funding and time periods within which funding for investments must be secured) must be satisfied.

(ii) *Development project.* For purposes of this paragraph (c), a development project is one or more facilities in a qualified Caribbean Basin country that support economic development in that country and that satisfy the public use requirement of paragraph (c)(5)(iii) of this section. Examples of facilities that may meet the public use requirement include, but are not limited to—

(A) Transportation systems and equipment, including sea, surface, and air, such as roads, railways, air terminals, runways, harbor facilities, and ships and aircraft;

(B) Communications facilities;

(C) Training and education facilities related to qualified business activities;

(D) Industrial parks, including necessary support facilities such as roads; transmission lines for water, gas, electricity, and sewage; docks; plant sites preparations; power generation; sewage disposal; and water treatment;

(E) Sports facilities;

(F) Convention or trade show facilities;

(G) Sewage, solid waste, water, and electric facilities;

(H) Housing projects pursuant to a government program designed to provide affordable housing to low or moderate income families, based upon local standards; and

(I) Hydroelectric generating facilities.

(iii) *Public use requirement.* To satisfy the public use requirement in paragraph (c)(5)(ii) of this section, a facility must serve or be available on a regular basis for general public use, as contrasted with similar types of facilities which are constructed for the exclusive use of a limited number of persons as determined under principles similar to those described in § 1.103–8(a)(2).

(iv) *Non-commercial governmental functions.* For purposes of paragraph (c)(5)(i)(B) of this section, the term ‘‘non-commercial governmental functions’’ refers to activities that, under U.S. standards, are not customarily attributable to or carried on by private enterprises for profit and are performed for the general public with respect to the common welfare or which relate to the administration of some phase of government. For example, the operation of libraries, toll bridges, or local transportation services, and activities substantially equivalent to those carried out by the Federal Aviation Authority, Interstate Commerce Commission, or United States Postal Service, are considered non-commercial governmental functions. For purposes of this section, non-commercial government functions shall not include military activities.

(v) [Reserved]

(6) *Prompt application of borrowed proceeds.* This paragraph (c)(6) provides rules for determining whether amounts disbursed to a qualified recipient by a qualified financial institution (or a financial intermediary) shall be considered to have been promptly applied for the purpose of paragraphs (c)(4)(i)(A) and (c)(5)(i)(A) of this section.

(i) *In general.* Except as otherwise provided in paragraphs (c)(6)(ii) and (c)(7)(iii)(B) of this section, amounts disbursed to a qualified recipient by a qualified financial institution (or a financial intermediary) shall be considered to have been promptly applied for the purpose of paragraphs (c)(4)(i)(A) and (c)(5)(i)(A) of this section if the amounts are fully expended for any of the purposes described in paragraphs (c)(4)(i)(A) or (c)(5)(i)(A) of this section no later than six months from the date of such disbursement and any temporary investment of such funds by the qualified recipient during such period complies with the rules of paragraph (c)(6)(iii)(A) of this section. Where the amounts disbursed are bond proceeds described in paragraph (c)(6)(iv)(A) of this section, the six-month period shall begin on the date of issuance of the bonds. In the event the qualified financial institution (or financial intermediary) invests any part of the bond proceeds before disbursement of those proceeds to the qualified recipient, all earnings from any such investment shall be paid to the qualified recipient or applied for its benefit.

(ii) *Special rules for long term projects financed out of bond proceeds.* In the case of a long term project described in paragraph (c)(6)(iv)(B) of this section that is financed out of bond proceeds, the six-month period described in paragraph (c)(6)(i) of this section shall be extended with respect to the amount of bond proceeds used to fund the project for such reasonable period of time as shall be necessary until completion of the project or until beginning of production (in the case of a farming business), but, in any event, not to exceed three years from the date of issuance of the bonds, and only if—

(A) The project that is financed out of bond proceeds was identified as of the date of issue;

(B) A construction and expenditure plan certified by an independent expert (such as an engineer, an architect, or a farming expert) is filed with, and approved by, the Commissioner of Financial Institutions of Puerto Rico (or his delegate) prior to the date of issue, which makes a reasonable estimate, as of the date of filing of the plan, of the amounts and uses of the bond proceeds and the time of completion or production, and includes a schedule of progress payments until such time;

(C) The terms of the construction and expenditure plan are disclosed in the public offering memorandum, private placement memorandum, or similar document prepared for information or disclosure purposes in relation to the issuance of bonds; and

(D) Any temporary investment of the bond proceeds complies with the rules of paragraph (c)(6)(iii)(A) and (B) of this section.

(iii) *Temporary investments*—(A) *During six-month period.* During the six-month period described in paragraph (c)(6)(i) of this section, during the first six months of the period described in paragraph (c)(6)(ii) of this section, and during the 30-day period described in paragraph (c)(7)(iii)(A) of this section, loan proceeds disbursed to a qualified recipient, bond proceeds, and income from the investment thereof, may be held in unrestricted yield investments, provided such yield reflects normal market yield for such type of investments and provided the income from such investments, if any, is or would be sourced either in Puerto Rico or in a country in which the investment in active business assets or development project is to be made.

(B) *During other periods.* During any other period, any temporary investment of bond proceeds, and of income from such investments, shall be limited to investments in eligible activities. For purposes of this paragraph (c)(6)(iii)(B), the term ‘‘eligible activities’’ shall mean those investments described in section 6.2.4 of Puerto Rican Regulation No. 3582, as in effect on September 22, 1989.

(iv) *Definitions*—(A) *Bond proceeds.* For purposes of this paragraph (c), bond proceeds shall mean the proceeds from the issuance of obligations by way of a public offering or a private placement by a qualified financial institution for investment in active business assets or a development project that has been identified at the time of issue and is described in a public offering memorandum, private placement memorandum, or similar document prepared for information or disclosure purposes in relation to the issuance of the bonds.

(B) *Long term project.* For purposes of this section, the term long term project means—

(*1*) A project, whether or not under a contract, for the construction, rehabilitation, improvement, upgrading, or production of qualified assets, or for expenditures, described in paragraph (c)(4)(ii) of this section (other than paragraph (c)(4)(ii)(C) of this section), which is reasonably expected to require more than 12 months to complete; or

(*2*) The production of property in a farming business referred to in paragraph (c)(4)(ii)(E) of this section, which is reasonably expected to require a preproductive period in excess of 12 months.

(7) *Financing of previously incurred costs.* Loan or bond proceeds which are disbursed after a qualified recipient has paid or incurred part or all of the costs of acquiring active business assets or investing in a development project shall be considered to have been applied for such purposes only as provided in this paragraph (c)(7).

(i) *Replacement of temporary non-section 936 financing of a qualified investment.* This paragraph (c)(7)(i) prescribes the maximum time limits within which temporary non-section 936 financing of qualified investments may be replaced with section 936 funds without being considered a prohibited refinancing transaction. This paragraph (c)(7)(i) applies to the refinancing of costs incurred with respect to investments that, at the time the costs were first incurred, were either qualified investments in a qualified Caribbean Basin country or were investments by a qualified recipient in active business assets or a development project in a qualified Caribbean Basin country. This paragraph (c)(7)(i) applies also to the refinancing of costs incurred with respect to any other investment. However, in the latter case, the amount of costs that may be refinanced with section 936 funds is limited to the amount of costs that are incurred with respect to the investment after the investment becomes a qualified investment in a qualified Caribbean Basin country. For purposes of this paragraph (c)(7)(i), the time when costs are incurred shall be determined under principles similar to those applicable under section 461(h) dealing with the economic performance test for the accrual of deductible liabilities. This paragraph (c)(7)(i) applies only to the situations described in this paragraph (c)(7)(i).

(A) In the case of an investment in active business assets or a development project, a loan shall be a qualified investment for purposes of this paragraph (c) if the loan proceeds are disbursed, or the obligations are issued, no later than six months after the date on which the qualified recipient takes possession of the asset or the facility or, if earlier, places the asset or the facility in service. However, in the case of a small project described in paragraph (c)(8)(v) of this section, the six-month period shall be one year.

(B) In the case of an investment in active business assets or a development project that is part of a long term project described in paragraph (c)(6)(iv)(B) of this section, a loan shall also be a qualified investment for purposes of this paragraph (c) if the loan proceeds are disbursed, or the obligations are issued, no later than six months after completion of the project or, in the case of a farming business, after the beginning of production, and in any event, no later than three years after the date on which the first payment is made toward the eligible costs of the project. The amount of the qualified investment may not exceed the sum of—

(*1*) The eligible costs relating to investments described in paragraph (c)(4)(i)(A) in the case of an investment in active business assets, or the eligible costs relating to investments described in paragraph (c)(5)(i) of this section in the case of a development project, but only to the extent of the costs that are incurred after the date described in paragraph (c)(7)(i)(D) of this section, and

(*2*) The portion of unpaid interest that would be required to be capitalized under U.S. tax rules and that accrued on prior temporary non-section 936 financing from the date described in paragraph (c)(7)(i)(D) of this section through the date the section 936 loan proceeds are disbursed or the section 936 obligations are issued.

(C) In order to qualify for the special rules of this paragraph (c)(7)(i), a plan must be filed with the Commissioner of Financial Institutions of Puerto Rico (or his delegate) stating the qualified recipient's intention to refinance the costs of the long term project with section funds.

(D) The date referred to in paragraph (c)(7)(i)(B) (*1*) and (*2*) of this section is a date that is the later of—

(*1*) The date the plan described in paragraph (c)(7)(i)(C) is filed, or

(*2*) The date the investment becomes a qualified investment by a qualified recipient in active business assets or a development project in a qualified Caribbean Basin country.

(ii) *Refinancing of section 936 financing.* A section 936 loan or bond issue used to finance a qualified investment described in paragraph (c)(1) of this section may be refinanced with section 936 funds through a new loan or bond issue to the extent of the remaining principal balance on such existing qualified financing, increased by the amount of unpaid interest accrued through the date the new loan proceeds are disbursed or the new obligations are issued and that would be required to be capitalized under U.S. tax rules.

(iii) *Prompt application of borrowed proceeds*—(A) *In general.* In the case of a loan or bond issue described in paragraph (c)(7)(i) or (ii) of this section, the rules of paragraph (c)(6) of this section shall apply but the six-month period described in paragraph (c)(6)(i) of this section shall be limited to 30 days from the date of disbursement of loan proceeds to the qualified recipient or from the date of issuance in the case of a bond issue.

(B) *Special rules for long term projects financed out of bond proceeds.* In the case of a long term project described in paragraph (c)(6)(iv)(B) of this section that is financed out of bond proceeds, the 30-day period described in paragraph (c)(7)(iii)(A) of this section shall be extended with respect to the amount of bond proceeds used for the permanent financing of the long term project for such reasonable period of time as shall be necessary until completion of the project or beginning of production (in the case of a farming business), but, in any event, not to exceed three years from the date of issuance of the bonds. For purposes of this paragraph (c)(7)(iii)(B), the period of time shall be considered reasonable only if—

(*1*) A construction and expenditure plan certified by an independent expert (such as an engineer, an architect, or a farming expert) is filed with, and approved by, the Commissioner of Financial Institutions of Puerto Rico (or his delegate) prior to the date of issue, which makes a reasonable estimate, as of the date of issue, of the amounts and uses of the bond proceeds and the time of completion or production, and includes a schedule of progress payments until such time; and

(*2*) The terms of the construction and expenditure plan are disclosed in the public offering memorandum, private placement memorandum, or similar document prepared for information or disclosure purposes in relation to the bond issue.

(8) *Miscellaneous operating rules*—(i) *Sale and leaseback.* An asset that is acquired and leased back to the person from whom acquired does not constitute an investment in an active business asset or an investment in a development project.

(ii) *Use of asset in qualified business activity.* For purposes of paragraph (c)(4)(i)(B), an asset shall be considered used or held for use in a qualified business activity if it is used or held for use in such activity under principles similar to those described in § 1.367(a)-2T(b)(5), or a successor provision.

(iii) *Definition of capital expenditures.* For purposes of this paragraph (c), capital expenditures mean those expenditures described in section 263(a) of the Code (without regard to paragraphs (A) through (G) of section 263(a)(1)), and those costs required to be capitalized under section 263A with respect to property described in section 263A(b)(1), relating to self-constructed assets.

(iv) *Loans through certain financial intermediaries.* A loan by a qualified financial institution shall not be disqualified from being an investment in active business assets or in a development project merely because the proceeds are first lent to a financial intermediary (as defined in paragraph (c)(8)(iv)(H) of this section) which, in turn, on-lends the proceeds directly to a qualified recipient, provided the requirements of this paragraph (c)(8)(iv) are satisfied.

(A) The loan to the qualified recipient must satisfy the requirements of paragraph (c)(4)(i) of this section in the case of an investment in active business assets, or of paragraph (c)(5)(i) of this section in the case of an investment in a development project.

(B) The qualified recipient and the active business assets or development project in which the proceeds are to be invested must be identified prior to disbursement of any part of the proceeds by the qualified financial institution to the financial intermediary.

(C) The effective interest rate charged by the qualified financial institution to the financial intermediary must not exceed the average interest rate paid by the qualified financial institution with respect to its eligible funds, increased by such number of basis points as is required to provide reasonable compensation to the qualified financial institution for services performed and risks assumed with respect to the loan to the financial intermediary that are not ordinarily required to be performed or assumed with respect to a deposit, loan, repurchase agreement or other transfer of eligible funds with another qualified financial institution. The average interest rate shall be the average rate, determined on a daily basis, paid by the qualified financial institution on its eligible funds over the most recent quarter preceding the date on which the rate on the loan to the financial intermediary is committed.

(D) The effective interest rate charged by the financial intermediary to the qualified recipient must not exceed the effective interest rate charged to the financial intermediary by the qualified financial institution, increased by such number of basis points as is required to provide reasonable compensation to the financial intermediary for services performed and risks assumed with respect to the loan to the qualified recipient.

(E) The financial intermediary must borrow from the qualified financial institution under substantially the same terms as it lends to the qualified recipient. In particular, both loans must have disbursement terms, repayment schedules and maturity dates for interest and principal amounts such that the financial intermediary does not retain for more than 48 hours any of the funds disbursed by the qualified financial institution nor any of the funds paid by the qualified recipient in repayment of principal or interest on the loan.

(F) The financial institution and the financial intermediary must agree to comply with the due diligence requirements described in paragraphs (c)(11), (12), and (13) of this section;

(G) The time periods and temporary investments rules in paragraphs (c)(6) and (7) of this section must be complied with; and

(H) For purposes of this paragraph (c), the financial intermediary must be—

(*1*) An active trade or business which a person maintains in a qualified Caribbean Basin country and which consists of a banking, financing or similar business as defined in § 1.864–4(c)(5)(i) (other than a central bank of issue); or

(*2*) A public international organization, the principal purpose of which is to foster economic development in developing countries and which is described in section 1 of the International Organizations Immunities Act (22 U.S.C. 288).

For purposes of paragraphs (c)(8)(iv)(C) and (D) of this section, the determination of whether compensation is reasonable shall be made in relation to normal commercial practices for comparable transactions carrying a similar degree of commercial, currency and political risk. Reasonable credit enhancement fees and other reasonable fees and amounts charged to the financial intermediary or the qualified recipient with respect to the loan transaction in addition to interest shall be added to the interest cost in determining the effective interest rate.

(v) *Small project.* For purposes of this paragraph (c), a small project shall be a project (including the acquisition of an asset) for which the total amount of section 936 funds used for its financing does not exceed $1,000,000 in the aggregate, or such other amount as the Commissioner may publish, from time to time, in the Internal Revenue Bulletin.

(9) *Qualified recipient.* For purposes of this section, a qualified recipient is any person described in paragraph (c)(9)(i) or (ii) of this section. The term ‘‘person’’ means a person described in section 7701(a)(1) or a government (within the meaning of § 1.892–2T(a)(1)) of a qualified Caribbean Basin country.

(i) In the case of an investment described in paragraph (c)(4) of this section (relating to investments in active business assets), a qualified recipient is a person that carries on a qualified business activity in a qualified Caribbean Basin country, and complies with the agreement and certification requirements described in paragraph (c)(11)(i) of this section at all times during the period in which the investment remains outstanding.

(ii) In the case of an investment described in pargraph (c)(5) of this section (relating to investments in development projects), a qualified recipient is the borrower (including a person empowered by the borrower to authorize expenditures for the investment in the development project) that has authority to comply, and complies, with the agreement and certification requirements described in paragraph (c)(11)(i) of this section at all times during the period in which the investment remains outstanding.

(10) *Investments in a qualified Caribbean Basin country*—(i) *Rules for determining the place of an investment.* The rules of this paragraph (c)(10)(i) shall apply to determine the extent to which an investment in an active business asset or a development project will be

considered made in qualified Caribbean Basin Country.

(A) An investment in real property is considered made in the qualified Caribbean Basin country in which the real property is located.

(B) Except as otherwise provided in this paragraph (c)(10)(i)(B), an investment in tangible personal property is considered made in a qualified Caribbean Basin Country so long as the tangible personal property is predominantly used in that country. Whether property is used predominantly in a qualified Caribbean Basin country shall be determined under principles similar to those described in §1.48–1(g)(1), (g)(2)(ii), (g)(2)(iv), (g)(2)(vi), (g)(2)(viii), and (g)(2)(x) (relating to investment tax credits for property used outside the United States) as in effect on December 31, 1985. A vessel, container, or aircraft shall be considered for use predominantly in a qualified Caribbean Basin country in any year if it is used for transport to and from such country with some degree of frequency during that year and at least 30 percent of the income from the use of such vessel, container or aircraft for that year is sourced in such country under principles similar to those described in section 863(c)(1) and (2) (relating to source rules for certain transportation income). Cables and pipelines which are premanently installed as part of a communication or transportation system between a qualified Caribbean Basin country and another country or among several countries which include a qualified Caribbean Basin country shall be considered used in a qualified Caribbean Basin country to the extent of 50 percent of the portion of the facility that directly links the qualified country to another country or to a hub, unless it is established by notice or other guidance published in the Internal Revenue Bulletin or by ruling issued to a qualified institution or qualified recipient upon request that it is appropriate to attribute a greater portion of the cost of the facility to the qualified Caribbean Basin country.

(C) An investment in rights to intangible property is considered made in a qualified Caribbean Basin country to the extent such rights are used in that country. Where rights to intangible property are used shall be determined under principles similar to those described in §1.954–2T(b)(3)(vii) or a successor provision.

(ii) *Qualified Caribbean Basin country.* For purposes of this section, the term ‘‘qualified Caribbean Basin country’’ means any beneficiary country (within the meaning of section 212(a)(1)(A) of the Caribbean Basin Economic Recovery Act, Public Law 98–67 (Aug. 5, 1983), 97 Stat. 384, 19 U.S.C. 2702(a)(1)(A)), which meets the requirements of section 274(h)(6)(A)(i) and (ii) and the U.S. Virgin Islands, and includes the territorial waters and continental shelf thereof.

(11) *Agreements and certifications by qualified recipients and financial intermediaries*—(i) *In general.* In order for an investment to be considered a qualified investment under section 936(d)(4) and paragraph (c)(1) of this section, a qualified recipient must certify to the qualified financial institution (or to the financial intermediary, if the loan is made through a financial intermediary) on the date of closing of the loan agreement and on each anniversary date thereof, that it is a qualified recipient described in paragraph (c)(9) of this section. In addition, the qualified recipient must agree in the loan agreement with the qualified financial institution (or with the financial intermediary, if the loan is made through a financial intermediary)—

(A) To use the funds at all times during the period the loan is outstanding solely for the purposes and in the manner described in paragraph (c)(4) of this section (regarding investment in active business assets) or in paragraph (c)(5) of this section (regarding investment in development projects);

(B) To comply with the requirements of paragraph (c)(6) of this section (regarding temporary investments and time periods within which the funds must be invested) and paragraph (c)(7) of this section (regarding the refinancing of existing funding and the time periods within which funding for investments must be secured);

(C) To notify the Assistant Commissioner (International), the qualified financial institution (or the financial intermediary, if the loan is made through a financial intermediary), and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) pursuant to paragraph (c)(14) of this section if it no longer is a qualified recipient or if, for any other reason, the investment has ceased to qualify as a qualified investment described in paragraph (c)(1) of this section, promptly upon the occurrence of such disqualifying event; and

(D) To permit examination by the office of the Assistant Commissioner (International) (or by the office of any District Director authorized by the Assistant Commissioner (International)) and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) of all necessary books and records that are sufficient to verify that the funds were used for investments in active business assets or development projects in conformity with the terms of the loan agreement.

(ii) *Certification by a financial intermediary.* In the case of a loan by a qualified financial institution to a financial intermediary, the financial intermediary must certify to the qualified financial institution (using the procedures described in paragraph (c)(11)(i) of this section) that it is a financial intermediary described in paragraph (c)(8)(iv)(H) of this section, and must furnish to the qualified financial institution a copy of the qualified recipient's certification described in paragraph (c)(11)(i) of this section and of its loan agreement with the qualified recipient. In addition, the financial intermediary must agree in the loan agreement with the qualified financial institution:

(A) To comply with the requirements of paragraph (c)(8)(iv) of this section; and

(B) To permit examination by the office of the Assistant Commissioner (International) (or by the office of any District Director authorized by the Assistant Commissioner (International)) and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) of all its necessary books and records that are sufficient to verify that the funds were used in conformity with the terms of the loan agreements.

(12) *Certification requirements.* In order for an investment to be considered a qualified investment under section 936(d)(4), section 936(d)(4)(C)(i) requires that both the person in whose trade or business such investment is made and the financial institution certify to the Secretary of the Treasury and the Commissioner of Financial Institutions of Puerto Rico that the proceeds of the loan will be promptly used to acquire active business assets or to make other authorized expenditures. This certification requirement is satisfied as to the qualified financial institution, the financial intermediary (if any), and the qualified recipient if the qualified financial institution submits a certificate to both the Assistant Commissioner (International) and to the Commissioner of Financial Institutions of Puerto Rico (or his delegate) pursuant to paragraph (c)(14) of this section upon authorization of the investment by the Commissioner of Financial Institutions and, in any event, prior to the first disbursement of the loan proceeds to the qualified recipient or to the financial intermediary (if any), in which the qualified financial institution—

(i) Represents that, as of the date of the certification, the qualified recipient and the financial intermediary (if any) have complied with the requirements described in paragraph (c)(11) of this section;

(ii) Describes the important terms of the loan to the financial intermediary (if any) and to the qualified recipient, including the amount of the loan, the nature of the investment, the basis for its qualification as an investment in active business assets or a development project under this section, the identity of the financial intermediary (if any) and of the qualified recipient, the qualified Caribbean Basin country involved, and the nature of the collateral or other security used, including any guarantee;

(iii) Agrees to permit examination by the Assistant Commissioner (International) (or by the office of any District Director authorized by the Assistant Commissioner (International)) and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) of all its necessary books and records that are sufficient to verify that the funds were used for investments in active business assets or development projects in conformity with the terms of the loan agreement or agreements with the financial intermediary (if any) and with the qualified recipient; and

(iv) In the case of a single-purpose entity that is a qualified financial institution, discloses the name and address of the entity's trustee or agent, if any, that assists the qualified financial institution in the performance of its due diligence requirement under paragraph (c) of this section, and represents that the trustee or agent has agreed with the qualified financial institution to permit examination by the Assistant Commissioner (International) (or by the office of any District Director authorized by the Assistant Commissioner (International)) and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) of all necessary books and records of such trustee or agent that are sufficient to verify that the funds were used for investments in active business assets or development projects in conformity with the terms of the loan agreement or agreements with the financial intermediary (if any) and with the qualified recipient.

(13) *Continuing due diligence requirements*. In order to maintain the qualification for an investment under paragraph (c)(1) of this section, the continuing due diligence requirements described in this paragraph (c)(13) must be satisfied.

(i) *Requirements of qualified recipient*. A qualified recipient must—

(A) Submit annually to the qualified financial institution or to the financial intermediary from which its qualified funds were obtained a copy of its most recent annual financial statement accompanied by an opinion of an independent accountant familiar with the financials of the qualified recipient disclosing the amount of the loan, the current outstanding balance of the loan, describing the assets financed with such loan and the qualified business activity in which such assets are used or the development project for which the loan is used, and stating that there are no reasons to doubt that the loan proceeds have been properly used and continue to be properly used, and

(B) Act in a manner consistent with its representations and agreements described in paragraph (c)(11) of this section.

(ii) *Requirements of qualified financial institutions*. Except as otherwise provided in paragraph (c)(13)(iii) of this section, a qualified financial institution described in paragraph (c)(3) of this section must maintain in its records and have available for inspection the documentation described in paragraph (c)(13)(ii)(A) or (B) of this section. In addition, the qualified financial institution is required to notify the Assistant Commissioner (International) and the Commissioner of Financial Institutions of Puerto Rico (or his delegate) pursuant to paragraph (c)(14) of this section upon becoming aware that a loan has ceased to be an investment in active business assets or a development project under this section. For purposes of this paragraph (c)(13)(ii), multiple loans for investment in a single qualified business activity or development project will be aggregated in determining what due diligence requirements apply.

(A) In the case of a small project described in paragraph (c)(8)(v) of this section, the following documents must be maintained and available for inspection:

(*1*) The loan application or other similar document;

(*2*) The financial statements of the qualified recipient filed as part of the loan application;

(*3*) The statement required by section 6.4.3(a)(iii) of Puerto Rican Regulation No. 3582 or any successor thereof, signed by the qualified recipient (or its duly authorized representative), acknowledging the receipt of the loan proceeds, describing the assets financed with such loan and the business activity in which such assets are to be used or the development project for which the funds will be utilized, the collateral to be provided for the transaction including any guarantee, and the basis for its qualification as a qualified recipient;

(*4*) The loan documents; and

(*5*) In the case of a qualified financial institution that is a single-purpose entity, a copy of the agreement with the entity's trustee or agent, if any, described in paragraph (c)(12)(iv) of this section.

(B) In the case of a disbursement concerning a project that is not a small project described in paragraph (c)(8)(v) of this section, the following documents must be maintained and available for inspection, in addition to the documents required by paragraph (c)(13)(ii)(A) of this section:

(*1*) A memorandum of credit prepared by an officer of the qualified financial institution (or, in the case of a single purpose entity, an agent of the entity or a trustee for the entity, if any) and signed by the officer of the qualified financial institution, containing the details of the investigation and review that the qualified financial institution, or its trustee or agent, if any, conducted in order to evaluate whether the investment is qualified under paragraph (c)(1) of this section and the opinion of the officer of the qualified financial institution, or the opinion of an officer of the agent of, or of the trustee for, the qualified financial institution, if any, that there is no reasonable ground for belief that the qualified funds will be diverted to a use that is not permitted under the provisions of this section; in making this investigation and review, factors that must be utilized are ones similar to those listed in Puerto Rico Regulation No. 3582, section 6.4.2;

(*2*) The annual financial statement of the qualified recipient; and

(*3*) The written report of an officer of the qualified financial institution, or of an officer of an agent of, or of the trustee for, the qualified financial institution, if any, documenting discussions, both before and after the disbursement of the loan proceeds, with each recipient's accounting, financial and executive personnel with respect to the proposed and actual use of the loan proceeds and his analysis of the annual financial statements of the qualified recipient including an analysis of the statement of sources and uses of funds. After the loan disbursement, such discussions and review shall occur annually during the term of the loan. Such report shall include the conclusion that in such officer's opinion there is no reasonable ground for belief that the qualified recipient is improperly utilizing the funds.

(iii) *Requirements in the case of a financial intermediary.* Where a qualified financial institution lends funds to a financial intermediary which are on-lent to a qualified recipient—

(A) The obligation to maintain the documentation described in paragraph (c)(13)(ii)(A) or (B) of this section shall apply only to the financial intermediary and not to the qualified financial institution and the provisions of paragraph (c)(13)(ii)(A) or (B) of this section shall be read so as to impose on the financial intermediary any obligation imposed on the qualified financial institution.

(B) The financial intermediary shall forward annually to the qualified financial institution a copy of the documentation it is required to maintain in its records pursuant to the provisions of this paragraph (c)(13)(iii) and shall notify the Assistant Commissioner (International), the Commissioner of Financial Institutions of Puerto Rico (or his delegate) and the qualified financial institution pursuant to paragraph (c)(14) of this section upon becoming aware that a loan has ceased to be an investment in active business assets or a development project under this section. The qualified financial institution must maintain in its records and have available for inspection the documentation furnished by the financial intermediary pursuant to this paragraph (c)(13)(iii)(B).

(C) The qualified financial institution shall cause one of its officers (or one of the officers of its agent or trustee, if any) to prepare a written report documenting his analysis of the documentation furnished by the financial intermediary pursuant to paragraph (c)(13)(iii)(B) of this section, his discussions, both before and after the disbursement of the loan proceeds, with the financial intermediary's accounting, financial and executive personnel with respect to the proposed and actual use of the loan proceeds, and his analysis of the annual financial statements of the qualified recipient including an analysis of the statement of sources and uses of funds. After the loan disbursement, such discussions and review shall occur annually during the term of the loan. Such report shall include the conclusion that in such officer's opinion there is no reasonable ground for belief that the qualified recipient is improperly utilizing the funds.

(14) *Procedures for notices and certifications.* Notices and certifications to the Assistant Commissioner (International) required under paragraphs (c)(11), (12) and (13) of this section shall be addressed to the attention of the Assistant Commissioner (International), Office of Taxpayer Service and Compliance, IN:C, 950 L'Enfant Plaza South, SW., Washington, DC 20024. Notices and certifications to the Commissioner of Financial Institutions of Puerto Rico required under paragraphs (c)(11), (12), and (13) of this section shall be addressed as follows: Commissioner of Financial Institutions, GPO Box 70324, San Juan, Puerto Rico 00936.

(15) *Effective date.* This paragraph (c) is effective May 13, 1991. It is applicable to investments by a possessions corporation in a financial institution that are used by a financial institution for investments in accordance with a specific authorization granted by the Commissioner of Financial Institutions of Puerto Rico (or his delegate) after September 22, 1989. However, the taxpayer may choose to apply §1.936–10T(c) for periods before June 12, 1991.

[T.D. 8350, 56 FR 21927, May 13, 1991]

§1.936–11T New lines of business prohibited (temporary).

(a) *In general.* A possessions corporation that is an existing credit claimant, as defined in section 936(j)(9)(A), and that adds a substantial new line of business during a taxable year, or that has a new line of business that becomes substantial during the taxable year, will cease to be an existing credit claimant as of the close of the taxable year ending before either such taxable year. The term *new line of business* is defined in paragraph (b) of this section. The term *substantial* is defined in paragraph (c) of this section. Paragraph (d) of this section provides examples illustrating the rules of paragraphs (a) through (c) of this section. Paragraph (e) of this section instructs a possessions corporation not to claim the Puerto Rico and possession tax credit on its return if it has added a substantial new line of business during the taxable year. Paragraph (f) of this section is the effective date provision.

(b) *New line of business*—(1) *In general.* A new line of business is any business activity of the possessions corporation that is not closely related to a pre-existing business of the possessions corporation. The term *closely related* is defined in paragraph (b)(2) of this section. The term *pre-existing business* is defined in paragraph (b)(3) of this section.

(2) *Closely related.* All the facts and circumstances must be considered, including paragraphs (b)(2)(i)(A) through (H) of this section, to determine whether a new activity is closely related to a pre-existing business of the possessions corporation, and thus is not a new line of business.

(i) *Factors.* The following factors will help to establish that a new activity is closely related to a pre-existing business activity of the possessions corporation—

(A) The activity provides products or services very similar to the products or services provided by the pre-existing business;

(B) The activity markets products and services to the same class of customers as that of the pre-existing business;

(C) The activity is of a type that is normally conducted in the same business location as the pre-existing business;

(D) The activity requires the use of similar operating assets as those used in the pre-existing business;

(E) The activity's economic success depends on the success of the pre-existing business;

(F) The activity is of a type that would normally be treated as a unit with the pre-existing business in the business' accounting records;

(G) If the activity and the pre-existing business are regulated or licensed, they are regulated or licensed by the same or similar governmental authority; and

(H) The United States Bureau of the Census assigns the activity the same six-digit North American Industry Classification System (NAICS) code or four-digit Industry Number Standard Identification code (SIC code) as the pre-existing business. In the case of a pre-existing business or activity that is listed under a NAICS code of 99999, Unclassified Establishments, or under a miscellaneous category (most NAICS codes that end in a ‘‘9’’ are miscellaneous categories), the similarity in NAICS codes is ignored as a factor in determining whether the activity is closely related to the pre-existing business. The dissimilarity of the NAICS code is considered in determining whether the activity is closely related to the pre-existing business. For purposes of this section, NAICS codes must be set forth in the North American Industry Classification System (United States) Manual that is in effect for the taxable year during which a new line of business is added. The official NAICS-United States Manual is available in both printed and electronic versions from the National Technical Information Service (NTIS) at 1–800–553–6847 or at the NTIS NAICS web site at <http://www.ntis.gov/naics>. In the case of a pre-existing business or activity that is listed under a SIC code of 9999, Nonclassifiable Establishments, or under a miscellaneous category (most SIC codes ending in ‘‘9’’ are miscellaneous categories), the similarity in SIC codes is ignored as a factor in determining whether the activity is closely related to the pre-existing business. The dissimilarity of the SIC codes is considered in determining whether the activity is closely related to the pre-existing business. The SIC codes are set forth in the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual, that is in effect for the taxable year during which a new line of business is added. A printed version of the official SIC Manual is available from the National Technical Information Service (NTIS) at 1–800–553–6847.

(ii) *Safe harbors.* An activity is closely related to a pre-existing business and thus is not a new line of business in the following three cases—

(A) If the activity is within the same six-digit NAICS code (or four-digit SIC code);

(B) If both the pre-existing business activity and the new activity are within the same five-digit NAICS code (or three-digit SIC code) and the facts relating to the new activity satisfy at least three of the factors listed in paragraph (b)(2)(i) (A) through (G) of this section; or

(C) If the pre-existing business is making a component product or end-product form, as defined in § 1.936–5(a)(1), Q & A1, and the new business activity is making an integrated product, or an end-product form with fewer excluded components, that is not within the same six-digit NAICS code (or four-digit SIC code) as the pre-existing business solely because the component product and the integrated product (or two end-product forms) have different end-uses.

(3) *Pre-existing business*—(i) *In general.* Except as provided in paragraph (b)(3) (ii) and (4) of this section, a business activity is a pre-existing business of the existing credit claimant if—

(A) The existing credit claimant was actively engaged in the activity within the possession on or before October 13, 1995; and

(B) The existing credit claimant has elected the benefits of the Puerto Rico and possession tax credit pursuant to an election which is in effect for the taxable year that includes October 13, 1995.

(ii) *Acquisition of all of the assets or stock of an existing credit claimant.* (A) If all the assets of a pre-existing business of an existing credit claimant are acquired by an affiliated or non-affiliated existing credit claimant which carries on the business activity of the predecessor existing credit claimant, the acquired business activity will be treated as a pre-existing business of the acquiring corporation. A non-affiliated acquiring corporation will not be bound by any section 936(h) election made by the predecessor existing credit claimant with respect to that business activity.

(B) Where all of the assets of a pre-existing business of an existing credit claimant are acquired by a corporation that is not an existing credit claimant, if the acquiring corporation makes a section 936(e) election for the taxable year in which the assets are acquired—

(*1*) The acquiring corporation will be treated as an existing credit claimant for the year of acquisition;

(*2*) The activity will be considered a pre-existing business of the acquiring corporation;

(*3*) The acquiring corporation will be deemed to satisfy the rules of section 936(a)(2) for the year of acquisition; and

(*4*) After making an election under section 936(e), a non-affiliated acquiring corporation will not be bound by elections under sections 936(a)(4) and (h) made by the predecessor existing credit claimant.

(C) A mere change in the stock ownership of a possessions corporation will not affect its status as an existing credit claimant for purposes of this section.

(4) *Timing rule.* The tests for a new line of business in this paragraph (whether the new activity is closely related to a pre-existing business) are applied only at the end of the taxable year during which the new activity is added.

(c) *Substantial*—(1) *In general.* For purposes of section 936 and section 30A, a new line of business is considered to be substantial as of the earlier of—

(i) The taxable year in which the possessions corporation derives more that 15 percent of its gross income from that new line of business (gross income test); or

(ii) The taxable year in which the possessions corporation directly uses in that new line of business more that 15 percent of its assets (assets test).

(2) *Gross income test.* The denominator in the gross income test is the amount that is the gross income of the possessions corporation for the current taxable year, while the numerator is the amount that is the gross income of the new line of business for the current taxable year. The gross income test is applied at the end of each taxable year. For purposes of this test, if a new line of business is added late in the taxable year, the income is not to be annualized in that year. In the case of a new line of business acquired through the purchase of assets, the gross income of such new line of business for the taxable year of the acquiring corporation that includes the date of acquisition is determined from the date of acquisition through the end of the taxable year. In the case of a consolidated group election made pursuant to section 936(i)(5), the test applies on a company by company basis and not on a consolidated basis.

(3) *Assets test*—(i) *Computation.* The denominator is the adjusted tax basis of the total assets of the possessions corporation for the current taxable year. The numerator is the adjusted tax basis of the total assets utilized in the new line of business for the current taxable year. The assets test is computed annually using all assets including cash and receivables.

(ii) *Exception.* A new line of business of a possessions corporation will not be treated as substantial as a result of meeting the assets test if an event that is not reasonably anticipated causes assets used in the new line of business of the possessions corporation to exceed 15 percent of the adjusted tax basis of the possession corporation's total assets. For example, an event that is not reasonably anticipated would include the destruction of plant and equipment of the pre-existing business due to a hurricane or other natural disaster, or other similar circumstances beyond the control of the possessions corporation. The expiration of a patent is not such an event and will not trigger this exception.

(d) *Examples.* The following examples illustrate the rules described in paragraphs (a), (b), and (c) of this section. In the following examples, X Corp. is an existing credit claimant unless otherwise indicated:

Example 1. X Corp. is a pharmaceutical corporation which manufactured bulk chemicals (a component product). In March 1997, X Corp. began to also manufacture pills (e.g., finished dosages or an integrated product). The new activity provides products very similar to the products provided by the pre-existing business. The new activity is of a type that is normally conducted in the same business location as the pre-existing business. The activity's economic success depends on the success of the pre-existing business. The manufacture of bulk chemicals is in NAICS code 325411, Medicinal and Botanical Manufacturing, while the manufacture of the pills is in NAICS code 325412, Pharmaceutical Preparation Manufacturing. Although the products have a different end-use, may be marketed to a different class of customers, and may not use similar operating assets, they are within the same five-digit NAICS code and the activity also satisfies paragraphs (b)(2)(i) (A), (C), and (E) of this section. The manufacture of the pills by X

Corp. will be considered closely related to the manufacture of the bulk chemicals. Therefore, X Corp. did not add a new line of business because it falls within the safe harbor rule of paragraph (b)(2)(ii)(B) of this section.

Example 2. X Corp. currently manufactures printed circuit boards in a possession. As a result of a technological breakthrough, X Corp. could produce the printed circuit boards more efficiently if it modified its existing production methods. Because demand was high, X Corp. expanded its facilities to support the production of its current products when it modified its production methods. After these modifications to the facilities and production methods, the products produced through the new technology were in the same six-digit NAICS code as products produced previously by X Corp. See paragraph (b)(2)(ii)(A) of this section. Therefore, X Corp. will not be considered to have added a new line of business for purposes of paragraph (b) of this section.

Example 3. X Corp. has manufactured Device A in Puerto Rico for a number of years and began to manufacture Device B in Puerto Rico in 1997. Device A and Device B are both used to conduct electrical current to the heart and are both sold to cardiologists. There is no significant change in the type of activity conducted in Puerto Rico after the transfer of the manufacturing of Device B to Puerto Rico. Similar manufacturing equipment, manufacturing processes and skills are used in the manufacture of both devices. Both are regulated and licensed by the Food and Drug Administration. The economic success of Device B is dependent upon the success of Device A only to the extent that the liability and manufacturing prowess with respect to one reflects favorably on the other. Depending upon the heart abnormality, the cardiologist may choose to use Device A, Device B or both on a patient. Both devices are within the same business sector of the taxpayer's business. The manufacture of Device A is in the six-digit NAICS code 339112, Surgical and Medical Instrument Manufacturing. The manufacture of Device B is in the six-digit NAICS code 334510, Electromedical and electro-therapeutic Apparatus Manufacturing. (The manufacture of Device A is in the four-digit SIC code 3845, Electromedical and Electrotheraputic Apparatus. The manufacture of Device B is in the four-digit SIC code 3841, Surgical and Medical Instruments and Apparatus.) The safe harbor of paragraph (b)(2)(ii)(B) of this section applies because the two activities are within the same three-digit SIC code and Corp. X satisfies paragraphs (b)(2)(i) (A), (B), (C), (D), (F), and (G) of this section.

Example 4. X Corp. has been manufacturing house slippers in Puerto Rico since 1990. Y Corp. is a U.S. corporation that is not affiliated with X Corp. and is not an existing credit claimant. Y Corp. has been manufacturing snack food in the United States. In 1997, X Corp. purchased the assets of Y Corp. and began to manufacture snack food in Puerto Rico. House slipper manufacturing is in the six-digit NAICS code 316212 (Four-digit SIC code 3142, House Slippers). The manufacture of snack foods falls under the six-digit NAICS code 311919, Other Snack Food Manufacturing (four-digit SIC code 2052, Cookies and Crackers (pretzels)). Because these activities are not within the same five or six digit NAICS code (or the same three or four-digit SIC code), and because snack food is not an integrated product that contains house slippers, the safe harbor of paragraph (b)(2)(ii) of this section cannot apply. Considering all the facts and circumstances, including the eight factors of paragraph (b)(2)(i) of this section, the snack food manufacturing activity is not closely related to the manufacture of house slippers, and is a new line of business, within the meaning of paragraph (b) of this section.

Example 5. X Corp. is an existing credit claimant that has elected the profit-split method for computing taxable income. P Corp. was not an existing credit claimant and manufactured a product in a different five-digit NAICS code than the product manufactured by X Corp. In 1997, X Corp. acquired the stock of P Corp. and liquidated P Corp. in a tax-free liquidation under section 332, but continued the business activity of P Corp. as a new business segment. Assume that this new business segment is a new line of business within the meaning of paragraph (c) of this section. In 1997, X Corp. has gross income from the active conduct of a trade or business in a possession computed under section 936(a)(2) of $500 million and the adjusted tax basis of its assets is $200 million. The new business segment had gross income of $60 million, or 12 percent of the X Corp. gross income, and the adjusted basis of the new segment's assets was $20 million, or 10 percent of the X Corp. total assets. In 1997, X Corp. does not derive more than 15 percent of its gross income, or directly use more that 15 percent of its total assets, from the new business segment. Thus, the new line of business acquired from P Corp. is not a *substantial* new line of business within the meaning of paragraph (c) of this section, and the new activity will not cause X Corp. to lose its status as an existing credit claimant during 1997. In 1998, however, the gross income of X Corp. grew to $750 million while the gross income of the new line of business grew to $150 million, or 20% of the X Corp. 1998 gross income. Thus, in 1998, the new line of business is substantial within the meaning of paragraph (c) of this section, and X Corp. loses its status as an existing credit claimant as of December 31, 1997.

(e) *Loss of status as existing credit claimant.* An existing credit claimant that adds a substantial new line of business in a taxable year, or that has a new line of business that becomes substantial in a taxable year, loses its status as an existing credit claimant as of the close of the taxable year ending before either such taxable year. In such case, the possession corporation must not claim the Puerto Rico and possession tax credit on its return for the taxable year in which the substantial new line of business is added or a new line of business becomes substantial.

(f) *Effective date*—(1) *General rule.* This section applies to taxable years of a possessions corporation beginning after August 19, 1998.

(2) *Election for retroactive application.* Taxpayers may elect to apply retroactively all the provisions of this section for any open taxable year beginning after December 31, 1995. Such election will be effective for the year of the election and all subsequent taxable years. This section will not apply to activities of pre-existing businesses for taxable years beginning before January 1, 1996.

[T.D. 8778, 63 FR 44389, Aug. 19, 1998]

CHINA TRADE ACT CORPORATIONS

§1.941–1 Special deduction for China Trade Act corporations.

In addition to the deductions from taxable income otherwise allowed such a corporation, a China Trade Act corporation is, under certain conditions, allowed an additional deduction in computing taxable income. This special deduction is an amount equal to the proportion of the taxable income derived from sources within Formosa and Hong Kong (determined without regard to this section and determined in a manner similar to that provided in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder) which the par value of the shares of stock of the corporation, owned on the last day of the taxable year by (a) persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and (b) individual citizens of the United States wherever resident, bears to the par value of the whole number of shares of stock of the corporation outstanding on that date. The decrease, by reason of such deduction, in the tax imposed by section 11 must not, however, exceed the amount of the special dividend referred to in section 941 (b), and is not allowable unless the special dividend has been certified to the Commissioner by the Secretary of Commerce.

§1.941–2 Meaning of terms used in connection with China Trade Act corporations.

(a) A China Trade Act corporation is one organized under the provisions of the China Trade Act, 1922 (15 U.S.C. chapter 4).

(b) The term ''special dividend'' means the amount which is distributed as a dividend to or for the benefit of such persons as on the last day of the taxable year were resident in Formosa, Hong Kong, the United States, or possessions of the United States, or were individual citizens of the United States, and owned shares of stock of the corporation. Such dividend must be distributed prior to or at the time fixed by law for filing the return of the corporation, including the period of any extension of time granted under rules and regulations prescribed by the Commissioner with the approval of the Secretary or his delegate. Such special dividend does not include any other amounts payable or to be payable to such persons or for their benefit by reason of their interest in the corporation and must be made in proportion to the par value of the shares of stock of the corporation owned by each.

(c) For the purposes of section 941, the shares of stock of a China Trade Act corporation are considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

(d) ''Taxable income derived from sources within Formosa and Hong Kong'' is the sum of the taxable income from sources wholly within Formosa and Hong Kong and that portion of the taxable income from sources partly within and partly without Formosa and Hong Kong which may be allocated to sources within Formosa and Hong Kong. The method of computing this income is similar to that described in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

§ 1.941–3 Illustration of principles.

The application of section 941 may be illustrated by the following example:

Example. (1) The A Company, a China Trade Act corporation, has taxable income (computed without regard to the deduction under section 941) for the calendar year 1954 of $200,000 and receives no dividends from domestic corporations. All of its stock on December 31, 1954, is owned on that date by persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, or individual citizens of the United States. It distributes a special dividend amounting to $100,000 on February 15, 1955, which is certified by the Secretary of Commerce as provided in section 941(b). For the purpose of the tax imposed by section 11, it is necessary in this example to make two computations, first, without allowing the special deduction from taxable income on account of income derived from sources within Formosa and Hong Kong, and, second, allowing such deduction. The computations are as follows:

(2) First computation; without allowing the special deduction from taxable income.

Taxable income	$200,000
Normal tax (section 11 (b))	60,000
Surtax (section 11 (c))	38,500
Total income tax	98,500

(3) Second computation; allowing the special deduction from taxable income.

Taxable income	$200,000

Since the total taxable income is derived from sources within Formosa and Hong Kong and since the par value of the shares of stock of the corporation owned on the last day of the taxable year by (a) persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and (b) individual citizens of the United States wherever resident, is 100 percent of the par value of the total number of shares of stock of the corporation outstanding on that day, 100 percent of such taxable income is deductible.

Special deduction from taxable income	$200,000
Amount of income subject to tax under section 11	None

(4) Since the special dividend ($100,000) exceeds the diminution of the tax ($98,500) on account of the allowance of the special deduction from taxable income, the entire amount of the special deduction is allowable and the corporation has no income tax liability for 1954.

§ 1.943–1 Withholding by a China Trade Act corporation.

Dividends paid by a China Trade Act corporation to a nonresident alien individual, foreign partnership, or foreign corporation are subject to withholding of tax at source under § 1.1441–1. However, see paragraph (c) of § 1.1441–4 for exemption applicable to dividends paid to residents of Formosa or Hong Kong.

[T.D. 6908, 31 FR 16769, Dec. 31, 1966]

CONTROLLED FOREIGN CORPORATIONS

§ 1.951–1 Amounts included in gross income of United States shareholders.

(a) *In general.* If a foreign corporation is a controlled foreign corporation (within the meaning of section 957) for an uninterrupted period of 30 days or more (determined under paragraph (f) of this section) during any taxable year of such corporation beginning after December 31, 1962, every person—

(1) Who is a United States shareholder (as defined in section 951(b) and paragraph (g) of this section) of such corporation at any time during such taxable year, and

(2) Who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income for his taxable year in which or with which such taxable year of the corporation ends, the sum of—

(i) Except as provided in section 963, such shareholder's pro rata share (determined under paragraph (b) of this section) of the corporation's subpart F income (as defined in section 952) for such taxable year of the corporation,

(ii) Such shareholder's pro rata share (determined under paragraph (c)(1) of this section) of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such taxable year of the corporation,

(iii) Such shareholder's pro rata share (determined under paragraph (c)(2) of this section) of the corporation's previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for such taxable year of the corporation, and

(iv) Such shareholder's pro rata share (determined under paragraph (d) of this section) of the corporation's increase in earnings invested in United States property for such taxable year of the corporation (but only to the extent such pro rata share is not excluded from such shareholder's gross income for his taxable year under section 959(a)(2)).

For purposes of determining whether a United States shareholder which is a domestic corporation is a personal holding company under section 542 and §1.542–1, the character of the amount includible in gross income of such domestic corporation under this paragraph shall be determined as if such amount were realized directly by such corporation from the source from which it is realized by the controlled foreign corporation. See paragraph (a) of §1.957–2 for special limitation on the amount of subpart F income in the case of a controlled foreign corporation described in section 957(b). See section 970(a) and §1.970–1 which provides for the reduction of subpart F income of export trade corporations.

(b) *Limitation on a United States shareholder's pro rata share of subpart F income*—(1) *In general.* For purposes of paragraph (a)(2)(i) of this section, a United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of this section) of the foreign corporation's subpart F income for the taxable year of such corporation is—

(i) The amount which would have been distributed with respect to the stock which such shareholder owns (within the meaning of section 958(a)) in such corporation if on the last day, in such corporation's taxable year, on which such corporation is a controlled foreign corporation it had distributed pro rata to its shareholders an amount which bears the same ratio to its subpart F income for such taxable year as the part of such year during which such corporation is a controlled foreign corporation bears to the entire taxable year, reduced by—

(ii) The amount of distributions received by any other person during such taxable year as a dividend with respect to such stock, but only to the extent that such distributions do not exceed the dividend which would have been received by such other person if the distributions by such corporation to all its shareholders had been the amount which bears the same ratio to the subpart F income of such corporation for the taxable year as the part of such year during which such shareholder did not own (within the meaning of section 958(a)) such stock bears to the entire taxable year.

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

Example 1. A, a United States shareholder, owns 100 percent of the only class of stock of M, a controlled foreign corporation throughout 1963. Both A and M Corporation use the calendar year as a taxable year. For 1963, M Corporation derives $100 of subpart F income, has $100 of earnings and profits, and makes no distributions. A must include $100 in his gross income for 1963 under section 951(a)(1)(A)(i).

Example 2. The facts are the same as in example 1, except that instead of holding 100 percent of the stock of M Corporation for the entire year, A sells 60 percent of such stock to B, a nonresident alien, on May 26, 1963. Thus, M Corporation is a controlled foreign corporation for the period January 1, 1963, through May 26, 1963. A must include $40 ($100×146/365) in his gross income for 1963 under section 951(a)(1)(A)(i).

Example 3. The facts are the same as in example 1, except that instead of holding 100 percent of the stock of M Corporation for the entire year, A holds 60 percent of such stock on December 31, 1963, having acquired such interest on May 26, 1963, from B, a nonresident alien, who owned such interest from January 1, 1963. Before A's acquisition of such stock, M Corporation had distributed a dividend of $15 to B in 1963 with respect to such stock. A must include $21 in his gross income for 1963 under section 951(a)(1)(A)(i), such amount being determined as follows:

Corporation M's Subpart F income for 1963		$100
Less: Reduction under section 951(a)(2)(A) for period (1–1–63 through 5–26–63) during which M Corporation is not a controlled foreign corporation ($100×146/365)		40
Subpart F income for 1963 as limited by section 951(a)(2)(A)		60
A's pro rata share of subpart F income as determined under section 951 (a)(2)(A) (60 percent of $60)		36
Less: Reduction under section 951(a)(2)(B) for dividends received by B during 1963 with respect to the stock acquired by A in M Corporation:		
(i) Dividend received by B	15	

(ii) B's pro rata share of the amount which bears the same ratio to M Corporation's subpart F income for 1963 ($100) as the period during which A did not own (within the meaning of section 958(a)) his stock (146 days) bears to the entire taxable year (365 days) (60 percent of ($100×146/365))	24	
(iii) Amount of reduction (lesser of (i) or (ii))		15
A's pro rata share of Subpart F income as determined under section 951(a)(2)		21

Example 4. A, a United States shareholder, owns 100 percent of the only class of stock of P, a controlled foreign corporation throughout 1963, and P owns 100 percent of the only class of stock of R, a controlled foreign corporation throughout 1963. A and Corporations P and R each use the calendar year as a taxable year. For 1963, R Corporation derives $100 of subpart F income, has $100 of earnings and profits, and distributes a dividend of $20 to P Corporation. Corporation P has no income for 1963 other than the dividend received from R Corporation. A must include $100 in his gross income for 1963 under section 951(a)(1)(A)(i) as subpart F income of R Corporation for such year. Such subpart F income is not reduced under section 951(a)(2)(B) for the dividend of $20 paid to P Corporation because there was no part of the year 1963 during which A did not own (within the meaning of section 958(a)) the stock of R Corporation. By reason of the application of section 959(b), the $20 distribution from R Corporation to P Corporation is not again includible in the gross income of A under section 951(a).

Example 5. The facts are the same as in example 4, except that instead of holding the stock of R Corporation for the entire year, P Corporation acquires 60 percent of the only class of stock of R Corporation on March 14, 1963, from C, a nonresident alien, after R Corporation distributes in 1963 a dividend of $35 to C with respect to the stock so acquired by P Corporation. The stock interest so acquired by P Corporation was owned by C from January 1, 1963, until acquired by P Corporation. A must include $36 in his gross income for 1963 under section 951(a)(1)(A)(i), such amount being determined as follows:

Corporation R's Subpart F income for 1963		$100
Less: Reduction under section 951(a)(2)(A) for period (1–1–63 through 3–14–63) during which R Corporation is not a controlled foreign corporation ($100×73/365)		20
Subpart F income for 1963 as limited by section 951(a)(2)(A)		80
A's pro rata share of subpart F income as determined under section 951 (a)(2)(A) (60 percent of $80)		48
Less: Reduction under section 951(a)(2)(B) for dividends received by C during 1963 with respect to the stock indirectly acquired by A in R Corporation:		
(i) Dividend received by C	35	
(ii) C's pro rata share of the amount which bears the same ratio to R Corporation's Subpart F income for 1963 ($100) as the period during which A did not indirectly own (within the meaning of section 958(a)(2)) his stock (73 days) bears to the entire taxable year (365 days) (60 percent of ($100×73/365))	12	
(iii) Amount of reduction (lesser of (i) or (ii))		12
A's pro rata share of Subpart F income as determined under section 951 (a)(2)		36

(c) *Limitation on a United States shareholder's pro rata share of previously excluded subpart F income withdrawn from investments*—(1) *Investments in less developed countries.* For purposes of paragraph (a)(2)(ii) of this section, a United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of this section) of the foreign corporation's previously excluded subpart F income withdrawn from investment in less developed countries for the taxable year of such corporation shall not exceed an amount which bears the same ratio to such shareholder's pro rata share of such income withdrawn (as determined under section 955(a)(3), as in effect before the enactment of the Tax Reduction Act of 1975, and paragraph (c) of § 1.955–1) for such taxable year as the part of such year during which such corporation is a controlled foreign corporation bears to the entire taxable year. See paragraph (c)(2) of § 1.955–1 for a special rule applicable to exclusions and withdrawals occurring before the date on which the United States shareholder acquires his stock.

(2) *Investments in foreign base company shipping operations.* For purposes of paragraph (a)(2)(iii) of this section, a United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of this section) of the foreign corporation's previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for the taxable year of such corporation shall not exceed an amount which bears the same ratio to such shareholder's pro rata share of such income withdrawn (as determined under section 955(a)(3) and paragraph (c) of § 1.955A–1) for such taxable year as the

part of such year during which such corporation is a controlled foreign corporation bears to the entire taxable year. See paragraph (c)(2) of §1.955A–1 for a special rule applicable to exclusions and withdrawals occurring before the date on which the United States shareholder acquires his stock.

(d) *Limitation on a United States shareholder's pro rata share of increase in investment in United States property.* For purposes of paragraph (a)(2)(iv) of this section, a United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of this section) of the foreign corporation's increase in earnings invested in United States property for the taxable year of such corporation shall not exceed an amount which bears the same ratio to such shareholder's pro rata share of such increase (as determined under section 956(a)(2) and paragraph (c) of §1.956–1) for such taxable year as the part of such year during which such corporation is a controlled foreign corporation bears to the entire taxable year. The amount determined under the preceding sentence, however, shall be taken into account under paragraph (a)(2)(iv) of this section only to the extent such amount is not excluded from such shareholder's gross income for his taxable year under section 959(a)(2) and the regulations thereunder.

(e) *''Pro rata share'' defined*—(1) *In general.* For purposes of paragraphs (b), (c), and (d) of this section, a United States shareholder's pro rata share of a controlled foreign corporation's subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, or increase in earnings invested in United States property, respectively, for any taxable year is his pro rata share determined under paragraph (a) of §1.952–1, paragraph (c) of §1.955–1, paragraph (c) of §1.955A–1, or paragraph (c) of §1.956–1, respectively.

(2) *More than one class of stock.* If a controlled foreign corporation for a taxable year has more than one class of stock outstanding, the amount of such corporation's subpart F income, withdrawal, or increase in investment, for the taxable year which shall be taken into account with respect to any one class of such stock for purposes of subparagraph (1) of this paragraph shall be that amount which bears the same ratio to the total of such subpart F income, withdrawal, or increase in investment for such year as the earnings and profits which would be distributed with respect to such class of stock if all earnings and profits of such corporation for such year were distributed on the last day of such corporation's taxable year on which such corporation is a controlled foreign corporation bear to the total earnings and profits of such corporation for such taxable year. For purposes of the preceding sentence, if an arrearage in dividends for prior taxable years exists with respect to a class of preferred stock of such corporation, the earnings and profits for the taxable year shall be attributed to such arrearage only to the extent such arrearage exceeds the earnings and profits of such corporation remaining from prior taxable years beginning after December 31, 1962.

(3) *Discretionary power to allocate earnings to different classes of stock.* If the allocation of a foreign corporation's earnings and profits for the taxable year between two or more classes of stock depends upon the exercise of discretion by that body of persons which exercises with respect to such corporation the powers ordinarily exercised by the board of directors of a domestic corporation, the allocation of earnings and profits to such classes shall be made for purposes of this paragraph as if such classes constituted one class of stock in which each share has the same rights to dividends as any other share, unless a different method of allocation of earnings and profits is established as proper by the United States shareholder.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. Throughout its taxable year 1964, controlled foreign corporation A has outstanding 40 shares of common stock and 60 shares of 6-percent, nonparticipating, nonvoting, preferred stock with a par value of $100 per share. D, a United States citizen who uses the calendar year as a taxable year, owns 30 shares of the common, and 15 shares of the preferred, stock during 1964: Corporation A for 1964 has earnings and profits of $1,000, and income of $500 with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In such case, if the total $1,000 of earnings and profits were distributed on December 31, 1964, $360 (0.06×$100×60) would be distributed with respect to A Corporation's preferred stock and $640 ($1,000 minus $360) would be distributed with respect to its common stock. Accordingly, of the $500 with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a), $180 ($360/$1,000× $500) is allocated to the outstanding preferred stock and $320 ($640/$1,000×$500) is allocated to the outstanding common stock. D's pro rata share of such amounts for 1964 is $285 [($180×15/60)+($320× 30/40)].

Example 2. The facts are the same as in example 1, except that the preferred stock is cumulative and there is an arrearage in dividends with respect to such stock of $900; on December 31, 1963, Corporation A has accumulated earnings and profits for 1963 of $700; therefore, for purposes of this paragraph, Corporation A's earnings and profits for 1964 attributable to such arrearage may not exceed $200 ($900 minus $700). In such case, for purposes of this paragraph, if the $1,000 earnings and profits for 1964 were distributed on December 31, 1964, $560 [(0.06×$100×60)+$200] would be distributed with respect to A Corporation's preferred stock and $440 ($1,000 minus $560) would be distributed with respect to its common stock. Accordingly, of the $500 with respect to which amounts are required to be included in gross income of United States shareholders under section 951 (a), $280 ($560/$1,000×$500) is allocated to the outstanding preferred stock and $220 ($440/$1,000×$500) is allocated to the outstanding common stock. D's pro rata share of such amounts for 1964 is $235 [($280×15/ 60)+($220×30/40)].

(f) *Determination of holding period.* For purposes of sections 951 through 964, the holding period of an asset (including stock of a controlled foreign corporation) shall be determined by excluding the day on which such asset is acquired and including the day on which such asset is disposed of. The application of this paragraph may be illustrated by the following example:

Example. On June 30, 1963, United States person E acquires 70 of the 100 shares of the only class of stock of foreign corporation A from nonresident alien B, who until such time owns all such 100 shares. E sells 10 shares of stock of such corporation on November 30, 1963, and 60 shares on December 31, 1963, to nonresident alien F. Corporation A is a controlled foreign corporation for the period beginning with July 1, 1963, and extending through December 31, 1963. As to the 10 shares of stock sold on November 30, 1963, E is treated as not owning such shares at any time after November 30, 1963, nor before July 1, 1963. As to the remaining 60 shares of stock, E is treated as not owning them before July 1, 1963, or after December 31, 1963.

(g) *United States shareholder defined*—(1) *In general.* For purposes of sections 951 through 964, the term ''United States shareholder'' means, with respect to a foreign corporation, a United States person (as defined in section 957(d)) who owns within the meaning of section 958(a), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

(2) *Percentage of total combined voting power owned by United States person*—(i) *Meaning of combined voting power.* In determining for purposes of subparagraph (1) of this paragraph whether a United States person owns the requisite percentage of voting power of all classes of stock entitled to vote, consideration will be given to all the facts and circumstances in each case. In any case where—

(a) A foreign corporation has more than one class of stock outstanding, and

(b) One or more United States persons own (within the meaning of section 958) shares of any one class of stock which possesses the power to elect, appoint, or replace a person, or persons, who with respect to such corporation, exercise the powers ordinarily exercised by a member of the board of directors of a domestic corporation,

the percentage of the total combined voting power with respect to such corporation owned by any such United States person shall be his proportionate share of the percentage of the persons exercising the powers ordinarily exercised by members of the board of directors of a domestic corporation (described in *(b)* of this subdivision) which such class of stock (as a class) possesses the power to elect, appoint, or replace. In all cases, however, a United States person will be deemed to own 10 percent or more of the total combined voting power with respect to a foreign corporation if such person owns (within the meaning of section 958) 20 percent or more of the total number of shares of a class of stock of such corporation possessing one or more powers enumerated in paragraph (b)(1) of § 1.957–1. Whether a foreign corporation is a controlled foreign corporation for purposes of sections 951 through 964 shall be determined by applying the rules of section 957 and §§ 1.957–1 through 1.957–4.

(ii) *Illustration.* The application of this paragraph may be illustrated by the following examples:

Example 1. Foreign corporation S has two classes of capital stock outstanding, consisting of 60 shares of class A stock and 40 shares of class B stock. Each class of the outstanding stock is entitled to participate on a share for share basis in any dividend distributions by S Corporation. The owners of a majority of the class A stock are entitled to elect 7 of the 10 corporate directors, and the owners of a majority of the class B stock are entitled to elect the other 3 of the 10 directors. Thus, the class A stock (as a class) possesses 70 percent of the total combined voting power of all classes of stock entitled to vote of S Corporation, and the class B stock (as a class) possesses 30 percent of such voting power. D, a United States person, owns 31 shares of the class A stock and thus owns 36,167 percent (31/60×70 percent) of the total combined voting power of all classes of stock entitled to vote of S Corporation. By reason of the ownership of such voting power, D is a United States shareholder of S Corporation under section 951(b). For purposes of section 957, S Corporation is a controlled foreign corporation by reason of D's ownership of a majority of the class A stock, as illustrated in example 2 of paragraph (c) of § 1.957–1. E, a United States person, owns eight shares of the class A stock and thus owns 9.333 percent (8/60×70 percent) of the total combined voting power of all classes of stock entitled to vote of S Corporation. Since E owns only 9.333 percent of such voting power and less than 20 percent of the number of shares of the class A stock, he is not a United States shareholder of S Corporation under section 951(b). F, a United States person, owns 14 shares of the class B stock and thus owns 10.5 percent (14/40×30 percent) of the total combined voting power of all classes of stock entitled to vote of S Corporation. By reason of the ownership of such voting power, F is a United States shareholder of S Corporation under section 951(b).

Example 2. Foreign corporation R has three classes of stock outstanding, consisting of 10 shares of class A stock, 20 shares of class B stock, and 300 shares of class C stock. Each class of the outstanding stock is entitled to participate on a share for share basis in any distribution by R Corporation. The owners of a majority of the class A stock are entitled to elect 6 of the 10 corporate directors, and the owners of a majority of the class B stock are entitled to elect the other 4 of the 10 directors. The class C stock is not entitled to vote. D, E, and F, United States persons, each own 2 shares of the class A stock and 100 shares of the class C stock. As owners of a majority of the class A stock, D, E, and F elect 6 members of the board of directors. D, E, and F are United States shareholders of R Corporation under section 951(b) since each owns 20 percent of the total number of shares of the class A stock which possesses the power to elect a majority of the board of directors of R Corporation. For purposes of section 957, R Corporation is a controlled foreign corporation by reason of the ownership by D, E, and F of a majority of the class A stock, as illustrated in example 2 of paragraph (c) of § 1.957–1.

[T.D. 6795, 30 FR 935, Jan. 29, 1965, as amended by T.D. 7893, 48 FR 22507, May 19, 1983]

§ 1.951–2 Coordination of subpart F with election of a foreign investment company to distribute income.

A United States shareholder who for his taxable year is a qualified shareholder (within the meaning of section 1247(c)) of a foreign investment company with respect to which an election under section 1247(a) and the regulations thereunder is in effect for the taxable year of such company which ends with or within such taxable year of such shareholder shall not be required to include any amount in his gross income for his taxable year under paragraph (a) of § 1.951–1 with respect to such company for that taxable year of such company.

[T.D. 6795, 30 FR 937, Jan. 29, 1965]

§ 1.951–3 Coordination of subpart F with foreign personal holding company provisions.

A United States shareholder (as defined in section 951(b)) who is required under section 551(b) to include in his gross income for his taxable year his share of the undistributed foreign personal holding company income for the taxable year of a foreign personal holding company (as defined in section 552) which for that taxable year is a controlled foreign corporation (as defined in section 957) shall not be required to include in his gross income for his taxable year under section 951(a) and paragraph (a) of § 1.951–1 any amount attributable to the earnings and profits of such corporation for that taxable year of such corporation. If a foreign corporation is both a foreign personal holding company and a controlled foreign corporation for the same period which is only a part of its taxable year, then, for purposes of applying the immediately preceding sentence, such corporation shall be deemed to be, for such part of such year, a foreign personal holding company and not a controlled foreign corporation and the earnings and profits of such corporation for the taxable year shall be deemed to be that amount which bears the same ratio to its earnings and profits for the taxable year as such part of the taxable year bears to the entire taxable year. The application of this section may be illustrated by the following examples:

Example 1. A, a United States shareholder, owns 100 percent of the only class of stock of controlled foreign corporation M which, in turn, owns 100 percent of the only class of stock of controlled foreign corporation N. A and Corporations M and N use the calendar year as a taxable year. During 1963, N Corporation derives $40,000 of gross income all of which is foreign personal holding company income within the meaning of section 553; thus, N Corporation is a foreign personal holding company for such year within the meaning of section 552(a). For 1963, N Corporation has undistributed foreign personal holding company income (as defined in section 556(a)) of $30,000, derives $25,000 of subpart F income, and has earnings and profits of $32,000. During 1963, M Corporation derives $100,000 of gross income (including as a dividend under section 555(c)(2) the $30,000 of N Corporation's undistributed foreign personal holding company income), 65 percent of which is foreign personal holding company income within the meaning of section 553. Therefore, M Corporation is a foreign personal holding company for such year. For 1963, M Corporation has undistributed foreign personal holding company income (as defined in section 556(a)) of $90,000, determined by taking into account under section 552(c)(1) N Corporation's $30,000 of undistributed foreign personal holding company income for such year; in addition, M Corporation derives $50,000 of subpart F income and has earnings and profits of $92,000. Neither M Corporation nor N Corporation makes any actual distributions during 1963. A is required under section 551(b) to include in his gross income for 1963 as a dividend the $90,000 of M Corporation's undistributed foreign personal holding company income for such year. For 1963, A is not required to include in his gross income under section 951(a) any of the $50,000 subpart F income of M Corporation or of the $25,000 subpart F income of N Corporation.

Example 2. The facts are the same as in example 1, except that only 45 percent of M Corporation's gross income (determined by including under section 555(c)(2) the $30,000 of N Corporation's undistributed foreign personal holding company income) is foreign personal holding company income within the meaning of section 553; accordingly, M Corporation is not a foreign personal holding company for 1963. Since for such year M Corporation is not a foreign personal holding company, the undistributed foreign personal holding company income ($30,000) of N Corporation is not required under section 555(b) to be included in the gross income of M Corporation for 1963; as a result, such income is not required under section 551(b) to be included in the gross income of A for such year even though N Corporation is a foreign personal holding company for that year. For 1963, A is required to include $75,000 in his gross income under section 951(a)(1)(A)(i) and paragraph (a) of § 1.951–1, consisting of the $50,000 subpart F income of M Corporation and the $25,000 subpart F income of N Corporation.

Example 3. The facts are the same as in example 1, except that in 1963 N Corporation actually distributes $30,000 to M Corporation and M Corporation, in turn, actually distributes $90,000 to A. Under section 556 the undistributed foreign personal holding company income of both M corporation and N Corporation is thus reduced to zero; accordingly, no amount is included in the gross income of A under section 551(b) by reason of his interest in corporations M and N. A must include $75,000 in his gross income for 1963 under section 951(a)(1)(A)(i) and paragraph (a) of § 1.951–1, consisting of the $50,000 subpart F income of M Corporation and the $25,000 subpart F income of N Corporation. Of the $90,000 distribution received by A from M Corporation, $75,000 is excludable from his gross income under section 959(a)(1) as previously taxed earnings and profits; the remaining $15,000 is includible in his gross income for 1963 as a dividend.

Example 4. (a) A, a United States shareholder, owns 100 percent of the only class of stock of controlled foreign corporation P, organized on January 1, 1963. Both A and P Corporation use the calendar year as a taxable year. During 1963, 1964, and 1965, P Corporation is not a foreign personal holding company as defined in section 552(a); in each of such years, P Corporation derives dividend income of $10,000 which constitutes foreign personal holding company income (within the meaning of §1.954–2) but under 26 CFR 1.954–1(b)(1) (Revised as of April 1, 1975) excludes such amounts from foreign base company income as dividends received from, and reinvested in, qualified investments in less developed countries. Corporation P's earnings and profits accumulated for 1963, 1964, and 1965 and determined under paragraph (b)(2) of §1.955–1 are $40,000. For 1966, P Corporation is a foreign personal holding company, has predistribution earnings and profits of $10,000, derives $10,000 of income which is both foreign personal holding company income within the meaning of section 553 and subpart F income within the meaning of section 952, distributes $8,000 to A, and has undistributed foreign personal holding company income of $2,000 within the meaning of section 556. In addition, for 1966 P Corporation has a withdrawal (determined under section 955(a) as in effect before the enactment of the Tax Reduction Act of 1975 but without regard to its earnings and profits for such year) of $25,000 of previously excluded subpart F income from investment in less developed countries. A is required under section 551(b) to include in his gross income for 1966 as a dividend the $2,000 undistributed foreign personal holding company income. The $8,000 distribution is includible in A's gross income for 1966 under sections 61(a)(7) and 301 as a distribution to which section 316(a)(2) applies. Corporation P's $25,000 withdrawal of previously excluded subpart F income from investment in less developed countries is includible in A's gross income for 1966 under section 951(a)(1)(A)(ii) and paragraph (a)(2) of §1.951–1.

(b) If P Corporation's earnings and profits accumulated for 1963, 1964, and 1965 were $15,000, instead of $40,000, the result would be the same as in paragraph (a) of this example, except that a withdrawal of only $15,000 of previously excluded subpart F income from investment in less developed countries would be includible in A's gross income for 1966 under section 951(a)(1)(A)(ii) and paragraph (a)(2) of §1.951–1.

(c) The principles of this example also apply to withdrawals (determined under section 955(a), as in effect before the enactment of the Tax Reduction Act of 1975) of previously excluded subpart F income from investment in less developed countries effected after the effective date of such Act, and to withdrawals (determined under section 955(a), as amended by such Act) of previously excluded subpart F income from investment in foreign base company shipping operations.

Example 5. (a) The facts are the same as in paragraph (a) of example 4, except that, instead of having a $25,000 decrease in qualified investments in less developed countries for 1966, P Corporation invests $20,000 in tangible property (not described in section 956(b)(2)) located in the United States and such investment constitutes an increase (determined under section 956(a) but without regard to the earnings and profits of P Corporation for 1966) in earnings invested in United States property. Corporation P's earnings and profits accumulated for 1963, 1964, and 1965 and determined under paragraph (b)(1) of §1.956–1 are $22,000. The result is the same as in paragraph (a) of example 4, except that instead of including the $25,000 withdrawal, A must include $20,000 in his gross income for 1966 under section 951(a)(1)(B) and paragraph (a)(2)(iv) of §1.951–1 as an investment of earnings in United States property.

(b) If P Corporation's earnings and profits accumulated for 1963, 1964, and 1965 were $9,000 instead of $22,000, the result would be the same as in paragraph (a) of this example, except that only $9,000 would be includible in A's gross income for 1966 under section 951(a)(1)(B) and paragraph (a)(2)(iv) of §1.951–1 as an investment of earnings in United States property.

[T.D. 6795, 30 FR 937, Jan. 29, 1965, as amended by T.D. 7893, 48 FR 22508, May 19, 1983]

§1.952–1 Subpart F income defined.

(a) *In general.* For purposes of sections 951 through 964, a controlled foreign corporation's subpart F income for any taxable year shall, except as provided in paragraph (b) of this section and subject to the limitations of paragraphs (c) and (d) of this section, consist of the sum of—

(1) The income derived by such corporation for such year from the insurance of United States risks (determined in accordance with the provisions of section 953 and §§1.953–1 through 1.953–6),

(2) The income derived by such corporation for such year which constitutes foreign base company income (determined in accordance with the provisions of section 954 and §§1.954–1 through 1.954–8),

(3)(i) An amount equal to the product of—

(A) The income of such corporation other than income which—

(*1*) Is attributable to earnings and profits of the foreign corporation included in the gross income of a United States person under section 951 (other than by reason of this paragraph) (determined in accordance with the provisions of section 951 and §1.951–1), or

(*2*) Is described in section 952(b),

multiplied by

(B) The international boycott factor determined in accordance with the provisions of section 999(c)(1), or

(ii) In lieu of the amount determined under paragraph (a)(3)(i) of this section, the amount described under section 999(c)(2) of such international boycott income, and

(4) The sum of the amount of any illegal bribes, kickbacks, or other payments paid after November 3, 1976, by or on behalf of the corporation during the taxable year of the corporation directly or indirectly to an official, employee, or agent in fact of a government. An amount is paid by a controlled foreign corporation where it is paid by an officer, director, employee, shareholder or agent of such corporation for the benefit of such corporation. For purposes of this section, the principles of section 162(c) and the regulations thereunder shall apply. In the case of payments made after September 3, 1982, a payment is illegal if the payment would be unlawful under the Foreign Corrupt Practices Act of 1977 if the payor were a United States person. The fair market value of an illegal payment made in the form of property or services shall be considered the amount of such illegal payment.

Pursuant to section 951(a)(1)(A)(i) and § 1.951–1, a United States shareholder of such controlled foreign corporation must include his pro rata share of such subpart F income in his gross income for his taxable year in which or with which such taxable year of the foreign corporation ends. See section 952(a). However, see paragraph (a) of § 1.957–2 for special rule limiting the subpart F income to the income derived from the insurance of United States risks in the case of certain controlled foreign corporations described in section 957(b).

(b) *Exclusion of U.S. income*—(1) *Taxable years beginning before January 1, 1967.* For rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.952–1(b)(1) (Revisedof April 1, 1975).

(2) *Taxable years beginning after December 31, 1966.* Notwithstanding paragraph (a) of this section, a controlled foreign corporation's subpart F income for any taxable year beginning after December 31, 1966, shall not include any item of income from sources within the United States which is effectively connected for that year with the conduct by such corporation of a trade or business in the United States unless, pursuant to a treaty to which the United States is a party, such item of income either is exempt from the income tax imposed by chapter 1 (relating to normal taxes and surtaxes) of the Code or is subject to such tax at a reduced rate.

Thus, for example, dividends received from sources within the United States by a foreign corporation engaged in business in the United States during the taxable year, which are not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, shall not be excluded from subpart F income under section 952(b) and this subparagraph even though such dividends are subject to the tax of 30 percent imposed by section 881 (a). Also, for example, if, by reason of an income tax convention to which the United States is a party, an amount of interest from sources within the United States which is effectively connected for the taxable year with the conduct of a business in the United States by a foreign corporation is subject to tax under chapter 1 at a flat rate of 15 percent, as provided in § 1.871–12, such interest is not excluded from subpart F income under section 952(b) and this subparagraph. The deductions attributable to items of income which are excluded from subpart F income under this subparagraph shall not be taken into account for purposes of section 952.

(3) *Rule applicable under section 956 (b)(2).* For purposes only of paragraph (b)(1))(viii) of § 1.956–2, an item of income derived by a controlled foreign corporation from sources within the United States with respect to which for the taxable year a tax is imposed in accordance with section 882(a) shall be considered described in section 952(b) whether or not such item of income would have constituted subpart F income for such year.

(c) *Limitation on a controlled foreign corporation's subpart F income*—(1) *In general.* A United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of

§1.951–1) of a controlled foreign corporation's subpart F income for any taxable year shall not exceed his pro rata share of the earnings and profits (as defined in section 964(a) and §1.964–1) of such corporation for such taxable year, computed as of the close of such taxable year without diminution by reason of any distributions made during such taxable year, minus the sum of—

(i) The amount, if any, by which such shareholder's pro rata share of—

(a) The sum of such corporation's deficits in earnings and profits for prior taxable years beginning after December 31, 1962, plus

(b) The sum of such corporation's deficits in earnings and profits for taxable years beginning after December 31, 1959, and before January 1, 1963 (reduced by the sum of the earnings and profits (as so defined) of such corporation for any of such taxable years) exceeds

(c) The sum of such corporation's earnings and profits for prior taxable years beginning after December 31, 1962, which, with respect to such shareholder, are allocated to other earnings and profits under section 959(c)(3) and §1.959–3; and

(ii) Such shareholder's pro rata share of any deficits in earnings and profits of other foreign corporations for a taxable year beginning after December 31, 1962, which are attributable to stock of such other foreign corporations owned by such shareholder within the meaning of section 958(a) and which, in accordance with section 952(d) and paragraph (d) of this section, are taken into account as a reduction in the controlled foreign corporation's earnings and profits for such taxable year.

For purposes of applying this subparagraph, the reduction (if any) provided by subdivision (i) of this subparagraph in a United States shareholder's pro rata share of the earnings and profits of a controlled foreign corporation shall be taken into account before the reduction provided by subdivision (ii) of this subparagraph. See section 952(c).

(2) *Special rules.* For purposes only of determining the limitation under subparagraph (1) of this paragraph on a United States shareholder's pro rata share of a controlled foreign corporation's subpart F income for any taxable year—

(i) *Status of foreign corporation.* The earnings and profits, or deficit in earnings and profits, of a foreign corporation for any taxable year shall be taken into account whether or not such foreign corporation is a controlled foreign corporation at the time such earnings and profits are derived or such deficit in earnings and profits is incurred.

(ii) *Deficits in earnings and profits taken into account only once.* A controlled foreign corporation's deficit in earnings and profits for any taxable year preceding the taxable year shall be taken into account for the taxable year only to the extent such deficit has not been taken into account under this paragraph, paragraph (d) of this section, or paragraph (d)(2)(ii) of §1.963–2 (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975) in computing a minimum distribution, for any taxable year preceding the taxable year, to reduce earnings and profits of such preceding year of such controlled foreign corporation or of any other controlled foreign corporation. To the extent a controlled foreign corporation's (the ''first corporation'') excess foreign base company shipping deductions for any taxable year (determined under §1.955A–3(c)(2)(i)) reduce the foreign base company shipping income of another member of a related group (as defined in §1.955A–2(b)), such deductions shall not be taken into account in determining the earnings and profits or deficits in earnings and profits of such first corporation for such taxable year for purposes of this paragraph (c) and paragraph (d) of this section. The rule of the preceding sentence shall not apply to the extent the excess foreign base company shipping deductions of the first corporation reduce the foreign base company shipping income of another member of a related group below zero.

(iii) *Determination of pro rata share.* A United States shareholder's pro rata share of a controlled foreign corporation's earnings and profits, or deficit in earnings and profits, for any taxable year shall be determined in accordance with the principles of paragraph (e) of § 1.951–1 and paragraph (d)(2)(ii) of § 1.963–2.

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

Example 1. (a) A is a United States shareholder who owns 100 percent of the only class of stock of M Corporation, a controlled foreign corporation organized on January 1, 1963. Both A and M Corporation use the calandar year as a taxable year.

(b) During 1963, M Corporation derives $20,000 of subpart F income and has earnings and profits of $30,000. Corporation M makes no distributions to A during such year. The limitation under section 952(c) on M Corporation's subpart F income for 1963 is $30,000; and $20,000 is includible in A's gross income for such year under section 951(a)(1)(A)(i).

(c) On January 1, 1964, M Corporation acquires 100 percent of the only class of stock of N Corporation, a controlled foreign corporation which uses the calendar year as a taxable year. During 1964, N Corporation derives $6,000 of subpart F income, has $7,000 of earnings and profits, and distributes $5,000 to M Corporation. The limitation under section 952(c) on N Corporation's subpart F income for 1964 is $7,000; and $6,000 of subpart F income is includible in A's gross income for such year under section 951(a)(1)(A)(i).

(d) During 1964, M Corporation derives $8,000 of rents which constitute subpart F income, makes a $10,000 distribution to A, and has earnings and profits of $12,000 (including the $5,000 dividend received from N Corporation). The limitation under section 952(c) on M Corporation's subpart F income for 1964 is $7,000, determined as follows:

Corporation M's earnings and profits for 1964 (determined under section 964(a) and § 1.964–1 as of the close of such year without diminution for any distributions made during such year)	$12,000
Less: Corporation M's earnings and profits for 1964 described in section 959(b)	5,000
Limitation on M Corporation's Subpart F income for 1964	7,000

Thus, for 1964 with respect to A's interest in M Corporation, $7,000 of subpart F income is includible in his gross income under section 951(a)(1)(A)(i). The $10,000 dividend received from M Corporation is excludible from A's gross income for 1964 under section 959(a)(1) and paragraph (b) of § 1.959–1.

Example 2. A is a United States shareholder who owns 100 percent of the only class of stock of R Corporation which was organized on January 1, 1961. R Corporation is a controlled foreign corporation for the entire period after December 31, 1962, here involved. Both A and R Corporation use the calendar year as a taxable year. During 1963, R Corporation derives $25,000 of subpart F income and has $50,000 of earnings and profits. Corporation R has $15,000 of earnings and profits for 1961, and a deficit in earnings and profits of $45,000 for 1962. Thus, R Corporation has as of December 31, 1963, a net deficit in earnings and profits of $30,000 for the years 1961 and 1962. Corporation R makes no distributions to A during 1963. The limitation under section 952(c) on R Corporation's subpart F income for 1963 is $20,000 ($50,000 minus $30,000), and $20,000 of subpart F income is includible in A's gross income for 1963 under section 951(a)(1)(A)(i). During 1964, R Corporation derives $18,000 of subpart F income and has $30,000 of earnings and profits. Corporation R makes no distributions to A during 1964. The entire $18,000 of subpart F income is includible in A's gross income for 1964 under section 951(a)(1)(A)(i).

(d) *Treatment of deficits in earnings and profits attributable to stock of other foreign corporation indirectly owned by a United States shareholder*—(1) *In general.* For purposes of paragraph (c)(1)(ii) of this section, if—

(i) A United States shareholder owns (within the meaning of section 958(a)) stock in two or more foreign corporations in a chain of foreign corporations (as defined in subparagraph (2)(ii) of this paragraph), and

(ii) Any of the corporations in such chain has a deficit in earnings and profits for a taxable year beginning after December 31, 1962,

then, with respect to such shareholder and only for purposes of determining the limitation on subpart F income under paragraph (c) of this section, the earnings and profits for the taxable year of each such foreign corporation which is a controlled foreign corporation shall, in accordance with the rules of subparagraph (2) of this paragraph, be reduced to take into account any deficit in earnings and profits referred to in subdivision (ii) of this subparagraph. See section 952(d).

(2) *Special rules.* For purposes of this paragraph—

(i) *Applicable rules.* The special rules set forth in paragraph (c)(2) of this section shall apply.

(ii) *''Chain'' defined.* A chain of foreign corporations shall, with respect to a United States shareholder, include—

(a) Any foreign corporation in which such shareholder owns (within the meaning of section 958(a)(1)(A)) stock

but, only to the extent of the stock so owned and

(b) All foreign corporations in which such shareholder owns (within the meaning of section 958(a)(2)) stock, but only to the extent of the stock so owned by reason of his ownership of the stock referred to in *(a)* of this subdivision.

(iii) *Allocation of deficit.* If one or more foreign corporations (whether or not a controlled foreign corporation) includible in a chain of foreign corporations has a deficit in earnings and profits (determined under section 964(a) and §1.964–1) for the taxable year, the amount of deficit taken into account under section 952(d) with respect to a United States shareholder in such chain as a reduction in earnings and profits for the taxable year of a controlled foreign corporation includible in such chain shall be an amount which bears the same ratio to such shareholder's pro rata share of the total deficit in earnings and profits for the taxable year of all includible foreign corporations as his pro rata share of the earnings and profits (determined under paragraph (c) of this section but without regard to the provisions of subparagraph (1)(ii) of such paragraph) for the taxable year of such includible controlled foreign corporation bears to his pro rata share of the total earnings and profits (as so determined under paragraph (c) of this section) for the taxable year of all includible controlled foreign corporations. The amount of deficit taken into account under this subdivision with respect to any controlled foreign corporation includible in a chain of foreign corporations shall not exceed the United States shareholder's pro rata share of the controlled foreign corporation's earnings and profits for the taxable year.

(iv) *Taxable year.* The taxable year from which a deficit is allocated under this paragraph, and the taxable year to which such deficit is allocated to reduce earnings and profits, shall be the taxable year of the foreign corporation ending with or within the taxable year of the United States shareholder described in subparagraph (1)(i) of this paragraph.

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

Example 1. (a) Domestic corporation M owns 100 percent, 20 percent, and 100 percent, respectively, of the only class of stock of foreign corporations A, B, and F, respectively. Corporation A owns 80 percent of the only class of stock of each of foreign corporations B and C, respectively. Corporation F owns 20 percent of such stock of C Corporation. Corporation B owns 75 percent of the only class of stock of foreign corporation D, and 50 percent of the only class of stock of each of foreign corporations G and H, respectively. C Corporation owns 75 percent of the only class of stock of foreign corporation E. All the corporations use the calendar year as a taxable year, and all of the foreign corporations, except corporations G and H, are controlled foreign corporations throughout the period here involved.

(b) The subpart F income, and the earnings and profits (determined under paragraph (c) of this section but without regard to subparagraph (1)(ii) of such paragraph) or deficit in earnings and profits (determined under section 964(a) and §1.964–1), of each of the foreign corporations for 1963 are as follows, the deficits being set forth in parentheses:

	Subpart F income	Earnings and profits (deficits)
A Corporation	$6,000	$18,000
B Corporation	....	(7,500)
C Corporation	....	(2,500)
D Corporation	4,000	5,000
E Corporation	12,000	15,000
F Corporation	8,000	20,250
G Corporation	....	(10,000)
H Corporation	....	7,000

(c) The chains of foreign corporations (within the meaning of subparagraph (2)(ii) of this paragraph) for 1963 are the ''A'' chain, consisting of corporations, A, B, C, D, E, G, and H, but only to the extent of M Corporation's stock interest in such corporations under section 958(a) by reason of its ownership of stock in A Corporation; the ''B'' chain, consisting of corporations B, D, G, and H, but only to the extent of M Corporation's stock interest in such corporations under section 958(a) by reason of its ownership of stock in B Corporation; and the ''F'' chain, consisting of corporations F, C, and E, but only to the extent of M Corporation's stock interest in such corporations under section 958(a) by reason of its ownership of stock in F Corporation.

(d) Corporation M's stock interest under section 958(a) in each of the chains of foreign corporations is as follows for 1963:

[In percent]

	A	B	C	D	E	F	G	H
A chain:								
Direct interest	100							
(100%×80%)		80						
(100%×80%)			80					
(80%×75%)				60				
(80%×75%)					60			
(80%×50%)							40	
(80%×50%)								40
B chain:								
Direct interest		20						
(20%×75%)				15				
(20%×50%)							10	
(20%×50%)								10
F chain:								
Direct interest						100		
(100%×20%)			20					
(20%×75%)					15			
Total interests	100	100	100	75	75	100	50	50

(e) Corporation M's pro rata share of the earnings and profits (determined under paragraph (c) of this section but without regard to subparagraph (1)(ii) of such paragraph), or of the deficit, of each controlled foreign corporation of each foreign corporation, respectively, includible in the respective chains for 1963 is as follows:

	Earnings and profits	Deficit
A chain:		
A Corporation (100%)	$18,000	
B Corporation (80%)		($6,000)
C Corporation (80%)		(2,000)
D Corporation (60%)	3,000	
E Corporation (60%)	9,000	
G Corporation (40%)		(4,000)
H Corporation (40%)	[1]	
Total	30,000	(12,000)
B chain:		
B Corporation (20%)		($1,500)
D Corporation (15%)	$750	
G Corporation (10%)		(1,000)
H Corporation (10%)	[1]	
Total	$750	($2,500)
F chain:		
F Corporation (100%)	20,250	
C Corporation (20%)		(500)
E Corporation (15%)	2,250	
Total	$22,500	(500)

[1] The earnings and profits of H Corporation are not included in the total earnings and profits for the chain because H Corporation is not a controlled foreign corporation.

(f) The amount by which M Corporation's pro rata share of the earnings and profits for 1963 of the controlled foreign corporations in each respective chain shall be reduced under section 952(d) by M Corporation's pro rata share of the deficits of corporations B, C, and G for 1963 is determined as follows:

		Amount of reduction
A chain:		
A Corporation ($12,000×$18,000/$30,000)		$7,200
D Corporation ($12,000×$3,000/$30,000)		1,200
E Corporation ($12,000×$9,000/$30,000)		3,600
Total		12,000
B chain:		
D Corporation ($2,500×$750/$750)	$2,500	
Limitation: M Corporation's pro-rata share of D Corporation's earnings and profits	750	
Allocation of used deficit ($750) to M Corporation's pro rata share of the deficits of corporations B and G:		
B Corporation ($750×($1,500/$2,500))	$450	
G Corporation ($750×($1,000/$2,500))	300	
Total	750	$750
F chain:		
F Corporation ($500×$20,250/$22,500)		450
E Corporation ($500×$2,250/$22,500)		50
Total		500

(g) Corporation M's pro rata share of the earnings and profits (determined after reduction for deficits under section 952(d)) for 1963 of each controlled foreign corporation in the respective chains, determined on a chain-by-chain basis, is determined as follows:

	Earnings and profits before reduction	Reduction (sec. 952(d))	Reduced earnings and profits
A chain:			
A Corporation	$18,000	$7,200	$10,800
D Corporation	3,000	1,200	1,800

	Earnings and profits before reduction	Reduction (sec. 952(d))	Reduced earnings and profits
E Corporation	9,000	3,600	5,400
B chain: D Corporation	750	750	
F chain:			
F Corporation	20,250	450	19,800
E Corporation	2,250	50	2,200

(h) Corporation M's pro rata share of each controlled foreign corporation's subpart F income, limited as provided by section 952(c) and paragraph (c) of this section, for 1963 which is includible in its gross income for such year under section 951(a)(1)(A)(i) and §1.951–1 is determined as follows:

	Subpart F income (before limitation)	Earnings and profit (sec. 952 (c))	Amount includible in income
A Corporation (100%)	$6,000	$10,800	$6,000
D Corporation (75%)	3,000	1,800	1,800
E Corporation (75%)	9,000	7,600	7,600
F Corporation (100%)	8,000	19,800	8,000
Total includible under sec. 951(a)(1)(A)(i)			23,400

Example 2. The facts are the same as in example 1 except that, in addition, for 1964, foreign corporations C, D, and E have no subpart F income and no earnings and profits and foreign corporations G and H have no earnings and profits. For 1964, B Corporation has subpart F income of $1,000 and earnings and profits (determined in accordance with section 964(a) and §1.964–1) of $1,500; A Corporation has subpart F income of $800 and earnings and profits of $1,000; and F Corporation has subpart F income of $500 and earnings and profits of $1,000. Such earnings and profits are determined without regard to distributions for 1964. Corporation B has an unused deficit in earnings and profits of $1,050 for 1963 ($1,500 minus $450) applicable to M Corporation's interest in such corporation (paragraph (f) of example 1), and, under paragraph (c)(1)(i)*(a)* of this section, with respect to M Corporation, such deficit reduces B Corporation's earnings and profits for 1964 to $450. Inasmuch as G Corporation is not a controlled foreign corporation for 1964, such corporation's unused deficit in earnings and profits of $700 for 1963 ($1,000 minus $300) applicable to M Corporation's interest in such corporation (paragraph (f) of example 1) may be used under paragraph (c)(1)(i)*(a)* of this section to reduce M Corporation's interest in G Corporation's earnings and profits in a later year or years for which G Corporation is a controlled foreign corporation. Corporation M's pro rata share of each controlled foreign corporation's subpart F income, limited as provided by section 952(c) and paragraph (c) of this section, for 1964 which is includible in its gross income for such year under section 951(a)(1)(A)(i) and §1.951–1 is determined as follows:

	Subpart F income (before limitation)	Earnings and profits (sec. 952(c))	Amount includible in income
A Corporation	$800	$1,000	$800
B Corporation	1,000	450	450
F Corporation	500	1,000	500

Example 3. The facts are the same as in example 2, except that for 1964 B Corporation has subpart F income of $550 and earnings and profits (determined in accordance with section 964(a) and §1.964–1) of $550; such earnings and profits are determined without regard to distributions for 1964. Under paragraph (c)(1)(i)(a) of this section, B Corporation's unused deficit of $1,050 for 1963 reduces its earnings and profits for 1964 with respect to M Corporation to zero. The remaining $500 of the unused deficit for 1963 applicable to M Corporation's interest in B Corporation may be used under paragraph (c)(1)(i)*(a)* of this section in later years to reduce M Corporation's interest in B Corporation's earnings and profits.

(e) *Application of current earnings and profits limitation*—(1) *In general.* If the subpart F income (as defined in section 952(a)) of a controlled foreign corporation exceeds the foreign corporation's earnings and profits for the taxable year, the subpart F income includible in the income of the corporation's United States shareholders is reduced under section 952(c)(1)(A) in accordance with the following rules. The excess of subpart F income over current year earnings and profits shall—

(i) First, proportionately reduce subpart F income in each separate category of the controlled foreign corporation, as defined in §1.904–5(a)(1), in which current earnings and profits are zero or less than zero;

(ii) Second, proportionately reduce subpart F income in each separate category in which subpart F income exceeds current earnings and profits; and

(iii) Third, proportionately reduce subpart F income in other separate categories.

(2) *Allocation to a category of subpart F income.* An excess amount that is allocated under paragraph (e)(1) of this section to a separate category must be further allocated to a category of subpart F income if the separate category contains more than one category of subpart F income described in section

952(a) or, in the case of foreign base company income, described in § 1.954–1(c)(1)(iii)(A) (*1*) or (*2*). In such case, the excess amount that is allocated to the separate category must be allocated to the various categories of subpart F income within that separate category on a proportionate basis.

(3) *Recapture of subpart F income reduced by operation of earnings and profits limitation.* Any amount in a category of subpart F income described in section 952(a) or, in the case of foreign base company income, described in § 1.954–1(c)(1)(iii)(A) (*1*) or (*2*) that is reduced by operation of the current year earnings and profits limitation of section 952(c)(1)(A) and this paragraph (e) shall be subject to recapture in a subsequent year under the rules of section 952(c)(2) and paragraph (f) of this section.

(4) *Coordination with sections 953 and 954.* The rules of this paragraph (e) shall be applied after the application of sections 953 and 954 and the regulations under those sections, except as provided in § 1.954–1(d)(4)(ii).

(5) *Earnings and deficits retain separate limitation character.* The income reduction rules of paragraph (e)(1) of this section shall apply only for purposes of determining the amount of an inclusion under section 951(a)(1)(A) from each separate category as defined in § 1.904–5(a)(1) and the separate categories in which recapture accounts are established under section 952(c)(2) and paragraph (f) of this section. For rules applicable in computing post-1986 undistributed earnings, see generally section 902 and the regulations under that section. For rules relating to the allocation of deficits for purposes of computing foreign taxes deemed paid under section 960 with respect to an inclusion under section 951(a)(1)(A), see § 1.960–1(i).

(f) *Recapture of subpart F income in subsequent taxable year*—(1) *In general.* If a controlled foreign corporation's subpart F income for a taxable year is reduced under the current year earnings and profits limitation of section 952(c)(1)(A) and paragraph (e) of this section, recapture accounts will be established and subject to recharacterization in any subsequent taxable year to the extent the recapture accounts were not previously recharacterized or distributed, as provided in paragraphs (f)(2) and (3) of this section.

(2) *Rules of recapture*—(i) *Recapture account.* If a category of subpart F income described in section 952(a) or, in the case of foreign base company income, described in § 1.954–1(c)(1)(iii)(A) (*1*) or (*2*) is reduced under the current year earnings and profits limitation of section 952(c)(1)(A) and paragraph (e) of this section for a taxable year, the amount of such reduction shall constitute a recapture account.

(ii) *Recapture.* Each recapture account of the controlled foreign corporation will be recharacterized, on a proportionate basis, as subpart F income in the same separate category (as defined in § 1.904–5(a)(1)) as the recapture account to the extent that current year earnings and profits exceed subpart F income in a taxable year. The United States shareholder must include his pro rata share (determined under the rules of § 1.951–1(e)) of each recharacterized amount in income as subpart F income in such separate category for the taxable year.

(iii) *Reduction of recapture account and corresponding earnings.* Each recapture account, and post-1986 undistributed earnings in the separate category containing the recapture account, will be reduced in any taxable year by the amount which is recharacterized under paragraph (f)(2)(ii) of this section. In addition, each recapture account, and post-1986 undistributed earnings in the separate category containing the recapture account, will be reduced in the amount of any distribution out of that account (as determined under the ordering rules of section 959(c) and paragraph (f)(3)(ii) of this section).

(3) *Distribution ordering rules*—(i) *Coordination of recapture and distribution rules.* If a controlled foreign corporation distributes an amount out of earnings and profits described in section 959(c)(3) in a year in which current year earnings and profits exceed subpart F income and there is an amount in a recapture account for such year, the recapture rules will apply first.

(ii) *Distributions reduce recapture accounts first.* Any distribution made by a controlled foreign corporation out of earnings and profits described in section 959(c)(3) shall be treated as made first on a proportionate basis out of the recapture accounts in each separate category to the extent thereof (even if the amount in the recapture account exceeds post-1986 undistributed earnings in the separate category containing the recapture account). Any remaining distribution shall be treated as made on a proportionate basis out of the remaining earnings and profits of the controlled foreign corporation in each separate category. See section 904(d)(3)(D).

(4) *Examples.* The application of paragraphs (e) and (f) of this section may be illustrated by the following examples:

Example 1. (i) A, a U.S. person, is the sole shareholder of CFC, a controlled foreign corporation formed on January 1, 1998, whose functional currency is the u. In 1998, CFC earns 100u of foreign base company sales income that is general limitation income described in section 904(d)(1)(I) and incurs a (200u) loss attributable to activities that would have produced general limitation income that is not subpart F income. In 1998 CFC also earns 100u of foreign personal holding company income that is passive income described in section 904(d)(1)(A), and 100u of foreign personal holding company income that is dividend income subject to a separate limitation described in section 904(d)(1)(E) for dividends from a noncontrolled section 902 corporation. CFC's subpart F income for 1998, 300u, exceeds CFC's current earnings and profits, 100u, by 200u. Under section 952(c)(1)(A) and paragraph (e) of this section, subpart F income is limited to CFC's current earnings and profits of 100u, all of which is included in A's gross income under section 951(a)(1)(A). The 200u of CFC's 1998 subpart F income that is not included in A's income in 1998 by reason of section 952(c)(1)(A) is subject to recapture under section 952(c)(2) and paragraph (f) of this section.

(ii) For purposes of determining the amount and type of income included in A's gross income and the amount and type of income in CFC's recapture account, the rules of paragraphs (e)(1) and (2) of this section apply. Under paragraph (e)(1)(i) of this section, the amount by which CFC's subpart F income exceeds its earnings and profits for 1998, 200u, first reduces from 100u to 0 CFC's subpart F income in the general limitation category, which has a current year deficit of (100u) in earnings and profits. Next, under paragraph (e)(1)(iii) of this section, the remaining 100u by which CFC's 1998 subpart F income exceeds earnings and profits is applied proportionately to reduce CFC's subpart F income in the separate categories for passive income (100u) and dividends from the noncontrolled section 902 corporation (100u). Thus, A includes 50u of passive limitation/foreign personal holding company income and 50u of dividends from the noncontrolled section 902 corporation/foreign personal holding company income in gross income in 1998. CFC has 100u in its general limitation/foreign base company sales income recapture account attributable to the 100u of foreign base company sales income that is not included in A's income by reason of the earnings and profits limitation of section 952(c)(1)(A). CFC also has 50u in its passive limitation recapture account, all of which is attributable to foreign personal holding company income, and 50u in its recapture account for dividends from the noncontrolled section 902 corporation, all of which is attributable to foreign personal holding company income.

(iii) For purposes of computing post-1986 undistributed earnings, the rules of sections 902 and 960, including the rules of §1.960–1(i), apply. Under §1.960–1(i), the general limitation deficit of (100u) is allocated proportionately to reduce passive limitation earnings of 100u and noncontrolled section 902 dividend earnings of 100u. Thus, passive limitation earnings are reduced by 50u to 50u (100u passive limitation earnings/200u total earnings in positive separate categories × (100u) general limitation deficit=50u reduction), and the noncontrolled section 902 corporation earnings are reduced by 50u to 50u (100u noncontrolled section 902 corporation earnings/200u total earnings in positive separate categories × (100u) general limitation deficit=50u reduction). All of CFC's post-1986 foreign income taxes with respect to passive limitation income and dividends from the noncontrolled section 902 corporation are deemed paid by A under section 960 with respect to the subpart F inclusions (50u inclusion/50u earnings in each separate category). After the inclusion and deemed-paid taxes are computed, at the close of 1998 CFC has a (100u) deficit in general limitation earnings (100u subpart F earnings + (200u) nonsubpart F loss), 50u of passive limitation earnings (100u of earnings attributable to foreign personal holding company income −50u inclusion) with a corresponding passive limitation/foreign personal holding company income recapture account of 50u, and 50u of earnings subject to a separate limitation for dividends from the noncontrolled section 902 corporation (100u earnings −50u inclusion) with a corresponding noncontrolled section 902 corporation/foreign personal holding company income recapture account of 50u.

Example 2. (i) The facts are the same as in *Example 1* with the addition of the following facts. In 1999, CFC earns 100u of foreign base company sales income that is general limitation income and 100u of foreign personal holding company income that is passive limitation income. In addition, CFC incurs (10u) of expenses that are allocable to its separate limitation for dividends from the noncontrolled section 902 corporation. Thus, CFC's subpart F income for 1999, 200u, exceeds CFC's current earnings and profits, 190u, by 10u. Under section 952(c)(1)(A) and paragraph (e) of this section, subpart F income is limited to CFC's current earnings and profits of 190u, all of which is included in A's gross income under section 951(a)(1)(A).

(ii) For purposes of determining the amount and type of income included in A's gross income and the amount and type of income in CFC's recapture accounts, the rules of paragraphs (e)(1) and (2) of this section apply. While CFC's general limitation post-1986 undistributed earnings for 1999 are 0 ((100u) opening balance + 100u subpart F income), CFC's general limitation subpart F income (100u) does not exceed its general limitation current earnings and profits (100u) for 1999. Accordingly, under paragraph (e)(1)(iii) of this section, the amount by which CFC's subpart F income exceeds its earnings and profits for 1999, 10u, is applied proportionately to reduce CFC's subpart F income in the separate categories for general limitation income, 100u, and passive income, 100u. Thus, A includes 95u of general limitation foreign base company sales income and 95u of passive limitation foreign personal holding company income in gross income in 1999. At the close of 1999 CFC has 105u in its general limitation/foreign base company sales income recapture account (100u from 1998 + 5u from 1999), 55u in its passive limitation/foreign personal holding company income recapture account (50u from 1998 + 5u from 1999), and 50u in its dividends from the noncontrolled section 902 corporation/foreign personal holding company income recapture account (all from 1998).

(iii) For purposes of computing post-1986 undistributed earnings in each separate category, the rules of sections 902 and 960, including the rules of § 1.960–1(i), apply. Thus, post-1986 undistributed earnings (or an accumulated deficit) in each separate category are increased (or reduced) by current earnings and profits or current deficits in each separate category. The accumulated deficit in CFC's general limitation earnings and profits (100u) is reduced to 0 by the addition of 100u of 1999 earnings and profits. CFC's passive limitation earnings of 50u are increased by 100u to 150u, and CFC's noncontrolled section 902 corporation earnings of 50u are decreased by (10u) to 40u. After the addition of current year earnings and profits and deficits to the separate categories there are no deficits remaining in any separate category. Thus, the allocation rules of § 1.960–1(i)(4) do not apply in 1999. Accordingly, in determining the post-1986 foreign income taxes deemed paid by A, post-1986 undistributed earnings in each separate category are unaffected by earnings in the other categories. Foreign taxes deemed paid under section 960 for 1999 would be determined as follows for each separate category: with respect to the inclusion of 95u of foreign base company sales income out of general limitation earnings, the section 960 fraction is 95u inclusion/0 total earnings; with respect to the inclusion of 95u of passive limitation income the section 960 fraction is 95u inclusion/150u passive earnings. Thus, no general limitation taxes would be associated with the inclusion of the general limitation earnings because there are no accumulated earnings in the general limitation category. After the deemed-paid taxes are computed, at the close of 1999 CFC has a (95u) deficit in general limitation earnings and profits ((100u) opening balance + 100u current earnings −95u inclusion), 55u of passive limitation earnings and profits (50u opening balance + 100u current foreign personal holding company income −95u inclusion), and 40u of earnings and profits subject to the separate limitation for dividends from the noncontrolled section 902 corporation (50u opening balance + (10u) expense).

Example 3. (i) A, a U.S. person, is the sole shareholder of *CFC*, a controlled foreign corporation whose functional currency is the u. At the beginning of 1998, CFC has post-1986 undistributed earnings of 275u, all of which are general limitation earnings described in section 904(d)(1)(I). CFC has no previously-taxed earnings and profits described in section 959(c)(1) or (c)(2). In 1998, CFC has a (200u) loss in the shipping category described in section 904(d)(1)(D), 100u of foreign personal holding company income that is passive income described in section 904(d)(1)(A), and 125u of general limitation manufacturing earnings that are not subpart F income. CFC's subpart F income for 1998, 100u, exceeds CFC's current earnings and profits, 25u, by 75u. Under section 952(c)(1)(A) and paragraph (e) of this section, subpart F income is limited to CFC's current earnings and profits of 25u, all of which is included in A's gross income under section 951(a)(1)(A). The 75u of CFC's 1998 subpart F income that is not included in A's income in 1998 by reason of section 952(c)(1)(A) is subject to recapture under section 952(c)(2) and paragraph (f) of this section.

(ii) For purposes of determining the amount and type of income included in A's gross income and the amount and type of income in CFC's recapture account, the rules of paragraphs (e)(1) and (2) of this section apply. Under paragraph (e)(1) of this section, the amount of CFC's subpart F income in excess of earnings and profits for 1998, 75u, reduces the 100u of passive limitation foreign personal holding company income. Thus, A includes 25u of passive limitation foreign personal holding company income in gross income, and CFC has 75u in its passive limitation/foreign personal holding company income recapture account.

(iii) For purposes of computing post-1986 undistributed earnings in each separate category the rules of sections 902 and 960, including the rules of §1.960–1(i), apply. Under §1.960–1(i), the shipping limitation deficit of (200u) is allocated proportionately to reduce general limitation earnings of 400u and passive limitation earnings of 100u. Thus, general limitation earnings are reduced by 160u to 240u (400u general limitation earnings/500u total earnings in positive separate categories × (200u) shipping deficit=160u reduction), and passive limitation earnings are reduced by 40u to 60u (100u passive earnings/500u total earnings in positive separate categories × (200u) shipping deficit=40u reduction). Five-twelfths of CFC's post-1986 foreign income taxes with respect to passive limitation earnings are deemed paid by A under section 960 with respect to the subpart F inclusion (25u inclusion/60u passive earnings). After the inclusion and deemed-paid taxes are computed, at the close of 1998 CFC has 400u of general limitation earnings (275u opening balance + 125u current earnings), 75u of passive limitation earnings (100u of foreign personal holding company income −25u inclusion), and a (200u) deficit in shipping limitation earnings.

Example 4. (i) The facts are the same as in *Example 3* with the addition of the following facts. In 1999, CFC earns 50u of general limitation earnings that are not subpart F income and 75u of passive limitation income that is foreign personal holding company income. Thus, CFC has 125u of current earnings and profits. CFC distributes 200u to A. Under paragraph (f)(3)(i) of this section, the recapture rules are applied first. Thus, the amount by which 1999 current earnings and profits exceed subpart F income, 50u, is recharacterized as passive limitation foreign personal holding company income. CFC's total subpart F income for 1999 is 125u of passive limitation foreign personal holding company income (75u current earnings plus 50u recapture account), and the passive limitation/foreign personal holding company income recapture account is reduced from 75u to 25u.

(ii) CFC has 150u of previously-taxed earnings and profits described in section 959(c)(2) (25u attributable to 1998 and 125u attributable to 1999), all of which is passive limitation earnings and profits. Under section 959(c), 150u of the 200u distribution is deemed to be made from earnings and profits described in section 959(c)(2). The remaining 50u is deemed to be made from earnings and profits described in section 959(c)(3). Under paragraph (f)(3)(ii) of this section, the dividend distribution is deemed to be made first out of the passive limitation recapture account to the extent thereof (25u). Under paragraph (f)(2)(iii) of this section, the passive limitation recapture account is reduced from 25u to 0. The remaining distribution of 25u is treated as made out of CFC's general limitation earnings and profits.

(iii) For purposes of computing post-1986 undistributed earnings, the rules of section 902 and 960, including the rules of §1.960–1(i), apply. Thus, the shipping limitation accumulated deficit of (200u) reduces general limitation earnings and profits of 450u and passive limitation earnings and profits of 150u on a proportionate basis. Thus, 100% of CFC's post-1986 foreign income taxes with respect to passive limitation earnings are deemed paid by A under section 960 with respect to the 1999 subpart F inclusion of 125u (100u inclusion (numerator limited to denominator)/100u passive earnings). No post-1986 foreign income taxes remain to be deemed paid under section 902 in connection with the 25u distribution from the passive limitation/foreign personal holding company income recapture account. One-twelfth of CFC's post-1986 foreign income taxes with respect to general limitation earnings are deemed paid by A under section 902 with respect to the distribution of 25u general limitation earnings and profits described in section 959(c)(3) (25u inclusion/300u general limitation earnings). After the deemed-paid taxes are computed, at the close of 1999 CFC has 425u of general limitation earnings and profits (400u opening balance + 50u current earnings—25u distribution), 0 of passive limitation earnings (75u recapture account + 75u current foreign personal holding company income—125u inclusion—25u distribution), and a (200u) deficit in shipping limitation earnings.

(5) *Effective date.* Paragraph (e) of this section and this paragraph (f) apply to taxable years of a controlled foreign corporation beginning after March 3, 1997.

[T.D. 6795, 30 FR 938, Jan. 29, 1965, as amended by T.D. 6892, 31 FR 11144, Aug. 23, 1966; T.D. 7293, 38 FR 32802, Nov. 28, 1973; T.D. 7545, 43 FR 19652, May 8, 1978; T.D. 7862, 47 FR 56490, Dec. 17, 1982; T.D. 7893, 48 FR 22508, May 19, 1983; T.D. 7894, 48 FR 22516, May 19, 1983; T.D. 8331, 56 FR 2846, Jan. 25, 1991; T.D. 8704, 62 FR 18, Jan. 2, 1997]

§1.952–2 Determination of gross income and taxable income of a foreign corporation.

(a) *Determination of gross income*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the gross income of a foreign corporation for any taxable year shall, subject to the special rules of paragraph (c) of this section, be determined by treating such foreign corporation as a domestic corporation taxable under section 11 and by applying the principles of section 61 and the regulations thereunder.

(2) *Insurance gross income*—(i) *Life insurance gross income.* The gross income for any taxable year of a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as a life insurance company to which part I (sections 801 through 820) of subchapter L of chapter 1 of the Code applies, shall, subject to the special rules of paragraph (c) of this section, be the sum of—

(a) The gross investment income, as defined under section 804(b), except that interest which is excluded from gross income under section 103 shall not be taken into account;

(b) The sum of the items taken into account under section 809(c), except that advance premiums shall not be taken into account; and

(c) The amount by which the net long-term capital gain exceeds the net short-term capital loss.

(ii) *Mutual and other insurance gross income.* The gross income for any taxable year of a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as a mutual insurance company to which part II (sections 821 through 826) of subchapter L of chapter 1 of the Code applies or as a mutual marine insurance or other insurance company to which part III (sections 831 and 832) of subchapter L of chapter 1 of the Code applies, shall, subject to the special rules of paragraph (c) of this section, be—

(a) The sum of—

(1) The gross income, as defined in section 832(b)(1);

(2) The amount of losses incurred, as defined in section 832(b)(5); and

(3) The amount of expenses incurred, as defined in section 832(b)(6); reduced by

(b) The amount of interest which under section 103 is excluded from gross income.

(b) *Determination of taxable income*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the taxable income of a foreign corporation for any taxable year shall, subject to the special rules of paragraph (c) of this section, be determined by treating such foreign corporation as a domestic corporation taxable under section 11 and by applying the principles of section 63.

(2) *Insurance taxable income.* The taxable income for any taxable year of a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as an insurance company to which subchapter L of chapter 1 of the Code applies shall, subject to the special rules of paragraph (c) of this section, be determined by treating such corporation as a domestic corporation taxable under subchapter L of chapter 1 of the Code and by applying the principles of §§ 1.953–4 and 1.953–5 for determining taxable income.

(c) *Special rules for purposes of this section*—(1) *Nonapplication of certain provisions.* Except where otherwise distinctly expressed, the provisions of subchapters F, G, H, L, M, N, S, and T of chapter 1 of the Internal Revenue Code shall not apply and, for taxable years of a controlled foreign corporation beginning after March 3, 1997, the provisions of section 103 of the Internal Revenue Code shall not apply.

(2) *Application of principles of § 1.964–1.* The determinations with respect to a foreign corporation shall be made as follows:

(i) *Books of account.* The books of account to be used shall be those regularly maintained by the corporation for the purpose of accounting to its shareholders.

(ii) *Accounting principles.* Except as provided in subparagraphs (3) and (4) of this paragraph, the accounting principles to be employed are those described in paragraph (b) of § 1.964–1. Thus, in applying accounting principles generally accepted in the United States for purposes of reflecting in the financial statements of a domestic corporation the operations of foreign affiliates, no adjustment need be made unless such adjustment will have a material effect, within the meaning of paragraph (a) of §1.964–1.

(iii) *Translation into United States dollars—(a) In general.* Except as provided in *(b)* of this subdivision, the amounts determined in accordance with subdivision (ii) of this subparagraph shall be translated into United States dollars in accordance with the principles of paragraph (d) of §1.964–1.

(b) Special rule. In any case in which the value of the foreign currency in relation to the United States dollar fluctuates more than 10 percent during any translation period (within the meaning of paragraph (d)(6) of §1.964–1), the subpart F income and non-subpart F income shall be separately translated as if each constituted all the income of the controlled foreign corporation for the translation period.

(iv) *Tax accounting methods.* The tax accounting methods to be employed are those established or adopted by or on behalf of the foreign corporation under paragraph (c) of §1.964–1. Thus, such accounting methods must be consistent with the manner of treating inventories, depreciation, and elections referred to in subdivisions (ii), (iii), and (iv) of paragraph (c)(1) of §1.964–1 and used for purposes of such paragraph; however, if, in accordance with paragraph (c)(6) of §1.964–1, a foreign corporation receives foreign base company income before any elections are made or before an accounting method is adopted by or on behalf of such corporation under paragraph (c)(3) of §1.964–1, the determinations of whether an exclusion set forth in section 954(b) applies shall be made as if no elections had been made and no accounting method had been adopted.

(v) *Exchange gain or loss*—(*a*) Exchange gain or loss, determined in accordance with the principles of §1.964–1(e), shall be taken into account for purposes of determining gross income and taxable income.

(b) Exchange gain or loss shall be treated as foreign base company shipping income (or as a deduction allocable thereto) to the extent that it is attributable to foreign base company shipping operations. The extent to which exchange gain or loss is attributable to foreign base company shipping operations may be determined under any reasonable method which is consistently applied from year to year. For example, the extent to which the exchange gain or loss is attributable to foreign base company shipping operations may be determined on the basis of the ratio which the foreign based company shipping income of the corporation for the taxable year bears to its total gross income for the taxable year, such ratio to be determined without regard to this subdivision (v).

(c) The remainder of the exchange gain or loss shall be allocated between subpart F income and non-subpart F income under any reasonable method which is consistently applied from year to year. For example, such remainder may be allocated to subpart F income in the same ratio that the gross subpart F income (exclusive of foreign base company shipping income) of the corporation for the taxable year bears to its total gross income (exclusive of foreign base company shipping income) for the taxable year, such ratio to be determined without regard to this subdivision (v).

(3) *Necessity for recognition of gain or loss.* Gross income of a foreign corporation (including an insurance company) includes gain or loss only if such gain or loss would be recognized under the provisions of the Internal Revenue Code if the foreign corporation were a domestic corporation taxable under section 11 (subject to the modifications of subparagraph (1) of this paragraph). See section 1002. However, a foreign corporation shall not be treated as a domestic corporation for purposes of determining whether section 367 applies.

(4) *Gross income and gross receipts.* The term ‘‘gross income’’ may not have the same meaning as the term ‘‘gross receipts’’. For example, in a manufacturing, merchandising, or mining business, gross income means the total sales less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources.

(5) *Treatment of capital loss and net operating loss.* In determining taxable income of a foreign corporation for any taxable year—

(i) *Capital loss carryback and carryover.* The capital loss carryback and carryover provided by section 1212(a) shall not be allowed.

(ii) *Net operating loss deduction.* The net operating loss deduction under section 172(a) or the operations loss deduction under section 812 shall not be allowed.

(6) *Corporations which have insurance income.* For purposes of paragraphs (a)(2) and (b)(2) of this section, in determining whether a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as an insurance company to which subchapter L of chapter 1 of the Code applies, it is immaterial that—

(i) The corporation would be exempt from taxation as an organization described in section 501(a),

(ii) The corporation would not be taxable as an insurance company to which subchapter L of the Code applies, or

(iii) The corporation would be subject to the alternative tax for small mutual insurance companies provided by section 821(c).

[T.D. 6795, 30 FR 941, Jan. 29, 1965, as amended by T.D. 7893, 48 FR 22508, May 19, 1983; T.D. 7894, 48 FR 22516, May 19, 1983; T.D. 8704, 62 FR 20, Jan. 2, 1997]

§ 1.953–1 Income from insurance of United States risks.

(a) *In general.* The subpart F income of a controlled foreign corporation for any taxable year includes its income derived from the insurance of United States risks for such taxable year. See section 952(a)(1). A controlled foreign corporation shall have income derived from the insurance of United States risks for such purpose of it has taxable income, as determined under § 1.953–4 or § 1.953–5, which is attributable to the reinsuring or the issuing of any insurance or annuity contract in connection with United States risks, as defined in § 1.953–2 or § 1.953–3, and if it satisfies the 5-percent minimum premium requirement prescribed in paragraph (b) of this section. It is immaterial for purposes of this section whether the person insured or the beneficiary of any insurance, annuity, or reinsurance contract is, as to such corporation, a related person or a United States shareholder. For definition of the term ‘‘controlled foreign corporation’’ for purposes of taking into account income derived from the insurance of United States risks under section 953, see section 957 (a) and (b) and §§ 1.957–1 and 1.957–2.

(b) *5-percent minimum premium requirement.* A controlled foreign corporation shall not have income derived from the insurance of United States risks for purposes of this section unless the premiums received by such corporation during the taxable year which are attributable to the reinsuring and the issuing of insurance and annuity contracts in connection with the United States risks exceed 5 percent of the total premiums which are received by such corporation during such taxable year and which are attributable to the reinsuring and the issuing of insurance and annuity contracts in connection with all risks.

(c) *General definitions.* For purposes of §§ 1.953–1 to 1.953–6, inclusive—

(1) *Reinsurance, etc.* The terms ‘‘reinsurance’’, ‘‘insurance’’, and ‘‘annuity contract’’ have the same meaning which they have for purposes of applying section 809(c)(1) or section 832(b)(4), as the case may be.

(2) *Premiums.* The term ‘‘premiums’’ means the items taken into account for the taxable year under section 809(c)(1), or the amount computed for the taxable year under section 832(b)(4) without the application of subparagraph (B) thereof, as the case may be; except that, for purposes of determining the amount of premiums received in applying paragraph (b) of this section or paragraph (a) of § 1.953–3, advance premiums and deposits shall not be taken into account.

(3) *Insurance company.* The term ‘‘insurance company’’ has the same meaning which it has for purposes of applying section 801(a), determined by applying the principles of paragraph (a) of § 1.801–3.

(4) *Related person.* The term ‘‘related person’’, when used with respect to a

controlled foreign corporation, shall have the meaning assigned to it by paragraph (e) of §1.954–1.

(5) *Policy period.* With respect to any insurance or annuity contract under which a corporation is potentially liable at any time during its taxable year, the term ''policy period'' means with respect to such year each period of coverage under the contract if such period begins or ends with or within the taxable year, except that, if such period of coverage is more than one year, such term means such of the following periods as are applicable, each one of which is a policy period with respect to the taxable year:

(i) The one-year period which begins with the effective date of the contract and begins or ends with or within the taxable year,

(ii) The one-year period which begins with an anniversary of the contract and begins or ends with or within the taxable year, and

(iii) The period of less than one year if such period begins with an anniversary of the contract, ends with the date on which coverage under the contract terminates, and begins or ends with or within the taxable year.

For such purposes, the effective date of the contract is the date on which coverage under the contract begins, and the anniversary of the contract is the annual return of the effective date. The period of coverage under a contract is the period beginning with the effective date of the contract and ending with the date on which the coverage under the contract expires; except that, if the risk under the contract has been transferred by assumption reinsurance, the period of coverage shall end with the effective date of such transfer or, if the contract is canceled, with the effective date of cancellation. For this purpose, the term ''assumption reinsurance'' shall have the meaning provided by paragraph (a)(7)(ii) of §1.809–5. The application of this subparagraph may be illustrated by the following examples:

Example 1. Controlled foreign corporation A issues to domestic corporation M an insurance contract which provides coverage for the 2½ year period beginning on July 1, 1963. Corporation A uses the calendar year as the taxable year. For 1963, the policy period under such contract as to A Corporation is July 1, 1963, to June 30, 1964. For 1964, the policy periods under such contract as to A Corporation are July 1, 1963, to June 30, 1964, and July 1, 1964, to June 30, 1965. For 1965, the policy periods under such contract as to A Corporation are July 1, 1964, to June 30, 1965, and July 1, 1965, to December 31, 1965.

Example 2. The facts are the same as in example 1 except that M Corporation cancels the contract on August 31, 1963. For 1963, the policy period under such contract as to A Corporation is July 1, 1963, to August 31, 1963.

Example 3. The facts are the same as in example 1 except that on January 15, 1965, A Corporation cedes insurance under the contract to controlled foreign corporation B, which also uses the calendar year as the taxable year. For 1964, the policy periods under such contract as to A Corporation are July 1, 1963, to June 30, 1964, and July 1, 1964, to June 30, 1965. For 1965, the policy periods under such contract as to both A Corporation and B Corporation are July 1, 1964, to June 30, 1965, and July 1, 1965, to December 31, 1965.

Example 4. Controlled foreign corporation C, which uses the calendar year as the taxable year, issues to domestic corporation N an insurance contract which covers the marine risks in connection with shipping a machine to Europe. The contract does not specify the dates during which the machine is covered, but provides coverage from the time the machine is delivered alongside a named vessel in Hoboken, New Jersey, until the machine is delivered alongside such vessel in Liverpool, England. Such deliveries in New Jersey and England take place on February 1, and February 28, 1963, respectively. For 1963, the policy period under such contract as to C Corporation is February 1, to February 28, 1963.

(6) *Foreign country.* The term ''foreign country'' includes, where not otherwise expressly provided, a possession of the United States.

[T.D. 6781, 29 FR 18201, Dec. 23, 1964]

§1.953–2 Actual United States risks.

(a) *In general.* For purposes of paragraph (a) of §1.953–1, the term ''United States risks'' means risks described in section 953(a)(1)(A)—

(1) In connection with property in the United States (as defined in paragraph (b) of this section),

(2) In connection with liability arising out of activity in the United States (as defined in paragraph (c) of this section), or

(3) In connection with the lives or health of residents of the United States

(as defined in paragraph (d) of this section).

For purposes of section 953(a), the term ''United States'' is used in a geographical sense and includes only the States and the District of Columbia. Therefore, the reinsuring or the issuing of insurance or annuity contracts by a controlled foreign corporation in connection with property located in a foreign country or a possession of the United States, in connection with activity in a foreign country or a possession, or in connection with the lives or health of citizens of the United States who are not residents of the United States will not give rise to income to which paragraph (a) of § 1.953–1 applies, unless the income derived by the controlled foreign corporation from such contracts constitutes income derived in connection with risks which are deemed to be United States risks, as defined in § 1.953–3.

(b) *Property in the United States.* The term ''property in the United States'' means property, as defined in subparagraph (1) of this paragraph, which is in the United States, within the meaning of subparagraph (2) of this paragraph.

(1) *Property defined.* The term ''property'' means any interest of an insured in tangible (including real and personal) or intangible property. Such interests include, but are not limited to, those of an owner, landlord, tenant, mortgagor, mortgagee, trustee, beneficiary, or partner. Thus, for example, if insurance is issued against loss from fire and theft with respect to an insured's home and its contents, such risks are risks in connection with property, whether the insured is the owner or lessee and whether the contents include furniture or cash and securities. Furthermore, if insurance is issued against all risks of damage or loss with respect to the automobile of an insured, such risks are risks in connection with property, whether the risks insured against may be caused by the insured, another person, or natural forces.

(2) *United States location*—(i) *In general.* Property will be considered property in the United States when it is exclusively located in the United States. Conversely, property will be considered property not in the United States when it is exclusively located outside the United States. In addition, property which is ordinarily located in, but temporarily located outside, the United States will be considered property in the United States both when it is ordinarily located in, and when it is temporarily located outside, the United States if the premium which is attributable to the reinsuring or issuing of any insurance contract in connection with such property cannot be allocated to, or apportioned between, risks incurred when such property is actually located in the United States and risks incurred when it is actually located outside the United States. If such premium can be so allocated or apportioned on a reasonable basis, however, such property will be considered property not in the United States when it is actually located outside the United States. However, property will not be considered property in the United States if it is neither property which is exclusively located in the United States nor property which is ordinarily located in, but temporarily located outside, the United States. The rules prescribed in subdivision (ii) of this subparagraph shall apply in determining whether a premium can be allocated or apportioned on a reasonable basis to or between risks incurred when property is actually located in the United States and risks incurred when such property is actually located outside the United States. The rules prescribed in subdivisions (iii) through (x) of this subparagraph shall apply in determining whether property is, or will be considered, exclusively located in or outside the United States and whether property is, or will be considered, ordinarily located in the United States; such rules also limit the rule of premium allocation and apportionment prescribed in this subdivision and subdivision (ii) of this subparagraph. The determinations required by this subparagraph shall be made with respect to the location of property during the policy period applicable to the taxable year of the insuring or reinsuring corporation, or, if more than one policy period exists with respect to such taxable year, such determinations shall be

made separately with respect to the location of property during each such policy period.

(ii) *Premium allocation or apportionment.* Whether a premium can be allocated or apportioned on a reasonable basis to or between risks incurred when property is actually located in the United States and risks incurred when such property is actually located outside the United States shall depend on the intention of the parties to the insurance contract, as determined from its provisions and the facts and circumstances preceding its execution. Contract provisions on the basis of which the premium reasonably may be so allocated or apportioned include, but are not limited to, provisions which separately describe each risk covered, the period of coverage of each risk, the special warranties for each risk, the premium for each risk (or the basis for determining such premium), and the conditions of paying the premium for each risk. For purposes of this subdivision, it shall be unnecessary formally to make a separate policy with respect to each risk covered or with respect to each clause attached to the policy, provided that the intention of the parties to the contract is reasonably clear. For example, if in the ordinary course of carrying on an insurance business an insurance policy is issued which covers fire, theft, and water damage risks incurred when property is actually located in the United States and marine risks incurred when such property is actually located outside the United States and which, pursuant to accepted insurance principles, properly describes the premium rates as percentages of the amount of coverage as ''.825% plus .3% fire, etc. risks plus .12% water risks = 1.245%'', a reasonable basis exists to allocate a $124.50 premium paid for $10,000 of such coverage to $82.50 for foreign risks and $42.00 ($30.00+ $12.00) to United States risks.

(iii) *Property in general—(a) Ordinary and temporary location.* Except as otherwise provided in subdivisions (iv) through (x) of this subparagraph, the determination of whether property is ordinarily located in the United States will depend on all the facts and circumstances in each case. Property is ordinarily located in the United States if its location in the United States is regular, usual, or often occurring. However, in all cases property will be considered ordinarily located in the United States if it is actually located in the United States for an aggregate of more than 50 percent of the days in the applicable policy period whereas property will, under no circumstances, be considered ordinarily located in the United States if it is actually located in the United States for an aggregate of not more than 30 percent of the days in the applicable policy period. Property which is ordinarily located in the United States is temporarily located outside the United States when it is actually located outside the United States. For purposes of determining the number and percent of the days in an applicable policy period, the term ''day'' means, not any 24-consecutive-hour period, but a continuous period of twenty-four hours commencing from midnight and ending with the following midnight; in determining the location of property for such purposes, an amount of time which is at least one-half of such a day, but less than the entire day, shall be considered a day, and an amount of time which is less than one-half of such a day shall not be considered a day.

(b) Illustrations. The application of this subdivision may be illustrated by the following examples:

Example 1. Controlled foreign corporation A issues to domestic corporation M a comprehensive blanket or floater insurance policy which, for one year, covers inventory samples which M Corporation regularly ships from the United States in order to encourage sales. Such shipments are made on the condition that they be returned to the United States within 5 days after they are received. During the one-year policy period, such samples are sent from, and returned to, the United States 50 times, and during such one-year period are actually located in the United States for an aggregate of 120 days. Since the location of the samples in the United States during such one-year period is often recurring, they are property ordinarily located in, but temporarily located outside, the United States. Therefore, they will be considered property in the United States even though for such one-year period their location in the United States is not regular or usual and is not for an aggregate of more than 50 percent of the days in the policy period. However, if, by considering such factors as the terms and premium schedule of the insurance contract as well as the number, value, and duration of the location in and outside the United States, of such samples, the premium which is attributable to the issuing of such contract can be allocated to, or apportioned between, risks occurring when such samples are actually located in the United States and risks occurring when they are actually located outside the United States, such samples will be considered property not in the United States when they are actually located outside the United States.

Example 2. A machine, located for several years in a foreign branch of a United States manufacturer, is permanently transferred to the home office of such manufacturer, where it arrives on January 1, 1963, and remains for the remainder of 1963. Under a separate insurance contract issued by a controlled foreign corporation, which uses the calendar year as the taxable year, such machine is insured against damage for the three-year period commencing on May 1, 1962. Because of the change in location of the machine, the premiums are increased as of January 1, 1963. Since the machine is in the United States from January 1, 1963, to April 30, 1963, its location in the United States is regular and usual during the policy period of May 1, 1962, to April 30, 1963. Accordingly, the machine is ordinarily located in the United States for such policy period. However, since the premium which is attributable to the issuing of such contract is allocable to risks occurring when the machine is actually located in, and when it is actually located outside, the United States, such machine will be considered property not in the United States from May 1, 1962, through December 31, 1962.

(iv) *Commercial motor vehicles, ships, aircraft, railroad rolling stock, and containers.* Any motor vehicle, ship, aircraft, railroad rolling stock, or any container transported thereby, which is used exclusively in the commercial transportation of persons or property to or from the United States (including such transportation from one place to another in the United States) and is ordinarily located in the United States will be considered property in the United States both when such property is ordinarily located in, and when such property is temporarily located outside, the United States. Whether such property is used in the transportation of persons or property to or from the United States and is ordinarily located in the United States are issues to be determined from all the facts and circumstances in each case. However, in all cases such transportation property will be considered ordinarily located in the United States if either more than 50 percent of the miles traversed during the applicable policy period in the use of such property are traversed within the United States or such property is located in the United States more than 50 percent of the time during such period. Further, such transportation property will not at any time be considered property in the United States if either not more than 30 percent of the miles traversed during the applicable policy period in the use of such property are traversed within the United States or such property is located in the United States for not more than 30 percent of the time during such period. Nevertheless, if not more than 30 percent of the miles traversed during the applicable policy period in the use of such transportation property are traversed within the United States, such property will be considered ordinarily located in the United States if it is located in the United States more than 50 percent of the time during such period Moreover, if such transportation property is located in the United States for not more than 30 percent of the time during the applicable policy period, such property will be considered ordinarily located in the United States if more than 50 percent of the miles traversed during such period in the use of such property are traversed within the United States. If such transportation property is considered property in the United States because more than 50 percent of the miles traversed during the applicable policy period in the use of such property are traversed within the United States, the apportionment of premium provided in subdivision (i) of this subparagraph shall be made on a mileage basis. If, however, such property is considered property in the United States because such property is located in the United States more than 50 percent of the time during the applicable policy period, the apportionment of premium provided in subdivision (i) of this subparagraph shall be made on a time basis.

(v) *Noncommercial motor vehicles, ships, aircraft, and railroad rolling stock.*

Except as provided in subdivision (iv) of this subparagraph, any motor vehicle, ship or boat, aircraft, or railroad rolling stock which at any time is actually located in the United States and which either *(a)* is registered with the United States, a State (including any political subdivision thereof), or any agency thereof or *(b)*, if not so registered, is owned by a citizen, resident, or corporation of the United States will be considered property which is ordinarily located in the United States. Unless the premium which is attributable to the reinsuring or issuing of any insurance contract in connection with such property considered ordinarily located in the United States is specifically allocated under the contract to risks incurred when such property is actually located in the United States and to risks incurred when it is actually located outside the United States, such property will be considered property in the United States both when it is ordinarily located in, and when it is temporarily located outside, the United States; under no circumstances will such property be considered outside the United States on the basis of any apportionment of such premium.

(vi) *Property exported or imported by railroad or motor vehicle.* Any property which is exported from, or imported to, the United States by railroad or motor vehicle will be considered property ordinarily located in the United States which, when such property is not actually located in the United States, is temporarily located outside the United States. For example, if an insurance contract reinsured or issued in connection with property exported from the United States by motor vehicle covers risks commencing when such property is loaded on the motor vehicle at the United States warehouse and terminating when such property is unloaded at the foreign warehouse, and if the premium payable with respect to risks incurred when the property is in the United States and risks incurred when the property is in the foreign country is not separately stated, such property will be considered property in the United States only until such property is actually located outside the United States, provided that the premium can be properly apportioned (for example) on the basis of time or mileage, between risks incurred when the property is actually located in the United States and risks incurred when it is actually located outside the United States. If in such case the premium is not so apportionable, such property will be considered property in the United States both when such property is ordinarily located in, and when it is temporarily located outside, the United States.

(vii) *Property exported by ship or aircraft.* If an insurance contract which is reinsured or issued in connection with property which is exported from the United States by ship or aircraft covers risks all of which terminate when such property is placed aboard a ship or aircraft at the United States port of exit for shipment from the United States, such property will be considered property in the United States. If such insurance contract covers risks all of which commence when such property is placed aboard a ship or aircraft at the United States port of exit for shipment from the United States, such property will be considered property not in the United States. If such insurance contract covers risks commencing before, and terminating after, such property is placed aboard a ship or aircraft at the United States port of exit for shipment from the United States, such property will be considered property ordinarily located in the United States which, after such property is placed aboard such ship or aircraft at the United States port of exit, is temporarily located outside the United States. The application of this subdivision may be illustrated by the following example:

Example. A controlled foreign corporation issues an insurance contract in connection with property exported from the United States by ship. The contract covers risks commencing after such property is removed from the United States warehouse and terminating when such property is unloaded at the foreign port of entry. Assuming that the premium payable with respect to the risks incurred before and the risks incurred after the property is placed aboard the ship at the United States port of exit for shipment from the United States or with respect to the steps in handling such property during such coverage, such as transporting the property to the United States port of exit, unloading the property there, placing the property aboard the ship, holding the property aboard the ship in port, the actual voyage, and unloading the property at the foreign port of entry, is separately stated in, or is determinable from, such contract, the property will be considered property in the United States only until such property is placed aboard the ship at the United States port of exit for shipment from the United States. Assuming, however, that the premiums payable with respect to such steps, or with respect to the risks incurred before and the risks incurred after the property is placed aboard the ship at the United States port of exit, are not allocable or apportionable under the contract, such property will be considered property in the United States both before and after such property is placed aboard the ship at the United States port of exit.

(viii) *Property imported by ship or aircraft.* If an insurance contract which is reinsured or issued in connection with property which is imported to the United States by ship or aircraft covers risks all of which terminate when such property is unloaded at the United States port of entry, such property will be considered property not in the United States. If such insurance contract covers risks all of which commence after such property is unloaded at the United States port of entry, such property will be considered property in the United States. If such insurance contract covers risks commencing before, and terminating after, such property is unloaded at the United States port of entry, such property will be considered property ordinarily located in the United States which, before such property is unloaded at the United States port of entry, is temporarily located outside the United States. For an illustration pertaining to the allocation or apportionment of the premium, see the example in subdivision (vii) of this subparagraph.

(ix) *Shipments originating and terminating in the United States.* Any property which is shipped from one place in the United States to another place in the United States, on or over a foreign country, the high seas, or the coastal waters of the United States will be considered property actually located at all times in the United States. For example, property which is shipped from New York City to Los Angeles via the Panama Canal or from San Francisco to Hawaii or Alaska will be considered property actually located at all times in the United States.

(x) *Shipments originating and terminating in a foreign country.* Any property which is shipped by any means, or a combination of means, of transportation from one foreign country to another foreign country, or from a contiguous foreign country to the same contiguous foreign country, on or over the United States will be considered property exclusively located outside the United States. Notwithstanding the foregoing, any property which is shipped by any means, or a combination of means, of transportation from one contiguous foreign country to another contiguous foreign country on or over the United States will be considered property ordinarily located in the United States which, when such property is not actually located in the United States, is temporarily located outside the United States.

(c) *Liability from United States activity.* The term ''liability arising out of activity in the United States'' means a loss, as described in subparagraph (1) of this paragraph, or a liability, as described in subparagraph (2) of this paragraph, which could arise from activity performed in the United States, as defined in subparagraph (3) of this paragraph.

(1) *Loss described.* The term ''loss'' includes all loss of an insured which could arise from the occurrence of the event insured against except that such term does not include any loss in connection with property described in paragraph (b) of this section. For example, such term includes, in the case of a promoter of outdoor sporting events, the loss which could arise from the cancellation of such an event because of inclement weather.

(2) *Liability described.* The term ''liability'' includes all liability of an insured in tort, contract, property, or otherwise. It includes, for example, the liability of a principal for the acts of his agent, of a husband for the acts of his spouse, and of a parent for the acts of his child. The term not only includes the direct liability which may be incurred, for example, by a tortfeasor to the person harmed, but also the indirect liability which may be incurred, for example, by a manufacturer to the

purchaser at retail for a breach of warranty.

(3) *Activity in the United States*—(i) *In general.* A loss or liability will be considered a loss or liability which could arise from activity performed in the United States if the loss or liability would result, if at all, from an activity exclusively carried on in the United States. Conversely, a loss or liability will be considered a loss or liability which could not arise from activity performed in the United States if the loss or liability would result, if at all, from an activity exclusively carried on outside the United States. In addition, a loss or liability will be considered a loss or liability which could arise from activity performed in the United States if the loss or liability would result, if at all, from an activity ordinarily carried on in, but partly carried on outside, the United States. If the premium which is attributable to the reinsuring or issuing of any insurance contract in connection with an activity ordinarily carried on in, but partly carried on outside, the United States can, on a reasonable basis, be allocated to, or apportioned between, the risks incurred with respect to the activity carried on in, and the risks incurred with respect to the activity carried on outside, the United States, such loss or liability will be considered a loss or liability which could not arise from activity performed in the United States to the extent the loss or liability would result, if at all, from that activity carried on outside the United States. However, a loss or liability will not be considered a loss or liability which could arise from an activity performed in the United States if such loss or liability would result, if at all, from an activity which is neither exclusively carried on in the United States nor ordinarily carried on in, but partly carried on outside, the United States. The principles of paragraph (b)(2)(ii) of this section for allocating or apportioning a premium on a reasonable basis to or between risks incurred when property is actually located in the United States and risks incurred when such property is actually located outside the United States shall apply for allocating or apportioning a premium on a reasonable basis to or between the risks incurred with respect to the activity carried on in, and the risks incurred with respect to the activity carried on outside, the United States. The rules prescribed in subdivisions (ii) through (vi) of this subparagraph shall apply in determining whether an activity is, or will be considered, exclusively carried on in or outside the United States and whether an activity is, or will be considered, ordinarily carried on in the United States and in determining what is the activity which is performed by the insured from which a loss or liability results or could result; such rules also limit the rule of premium allocation and apportionment prescribed in this subdivision. The determinations required by this subparagraph shall be made with respect to the location of an activity of the insured performed during the policy period applicable to the taxable year of the insuring or reinsuring corporation, or, if more than one policy period exists with respect to such taxable year, such determinations shall be made separately with respect to the location of the activity during each such policy period.

(ii) *Substantial activity carried on in the United States.* The term ‘‘activity’’ is used in its broadest sense and includes the performance of an act unlawfully undertaken, the wrongful performance of an act lawfully undertaken, and the wrongful failure to perform an act lawfully required to be undertaken. With respect to a loss described in subparagraph (1) of this paragraph, the term ‘‘activity’’ includes the occurrence of the event insured against. The determination of whether an activity ordinarily is carried on in, but is partly carried on outside, the United States will depend on all the facts and circumstances in each case. An activity ordinarily is carried on in the United States if a substantial amount of such activity is carried on in the United States. Factors which will be taken into account in determining whether a substantial amount of activity is carried on in the United States are those which are connected with the activity and include, but are not limited to, the location of the insured's assets, the place where personal services are performed, and the place where sales occur, but only if such assets, services, and sales are connected with the activity. In all cases an activity will be considered substantially carried on in the United States if more than 50 percent of the insured's total assets, personal services, and sales, if any, connected with such activity are located, performed, or occur in the United States. On the other hand, an activity will, under no circumstances, be considered substantially carried on in the United States if not more than 30 percent of the insured's total assets, personal services, and sales, if any, connected with such activity are located, performed, or occur in the United States. For this purpose, the mean of the value of the total assets at the beginning and end of the policy period shall be used, determined by taking assets into account at their actual value (not reduced by liabilities), which, in the absence of affirmative evidence to the contrary, shall be deemed to be *(a)* face value in the case of bills receivable, accounts receivable, notes receivable, and open accounts held by an insured using the cash receipts and disbursements method of accounting and *(b)* adjusted basis in the case of all other assets. Personal services shall be measured by the amount of compensation paid or accrued for such services, and sales shall be measured by the volume of gross sales. An activity is carried on partly outside the United States if it is carried on, whether substantially or in substantially, outside the United States.

(iii) *Manufacturing, producing, constructing, or assembling activity.* If a person who manufactures, produces, constructs, or assembles property is liable with regard to the consumption or use of such property, such liability will be considered to result from the activity performed of manufacturing, producing, constructing, or assembling such property. If such person manufactures, produces, constructs, or assembles more than one type of product, the liability with regard to the consumption or use of one of such products will be considered to result from the activity performed of manufacturing, producing, constructing, or assembling that particular product. For example, the liability of a building contractor, which constructs apartment buildings only in the United States, for the improper construction of, or the failure to construct, an apartment building, will be considered to result from an activity exclusively carried on in the United States and will be considered a liability which could arise from activity performed in the United States. In further illustration, the liability (which is covered by a single policy of insurance) of a domestic corporation, which assembles refrigerators exclusively in the United States and manufactures automobiles both in a foreign country and in the United States through substantial activity carried on in each of such countries, for the negligent manufacturing of a part for one of the automobiles by the foreign branch, will be considered to result from an activity ordinarily carried on in, but partly carried on outside, the United States and will be considered a liability which could arise from activity performed in the United States.

(iv) *Selling activity.* If a person is liable with regard to selling activity performed, such liability will be considered, except as provided in subdivisions (iii), (v), and (vi) of this subparagraph, to result from such selling activity. A person will be considered to be engaged in selling activity if such person engages in an activity resulting in the sale of property. Thus, it is immaterial that, under the Code, such activity would not constitute engaging in or carrying on a trade or business in the country in which such activity is carried on, the property in the goods does not pass in such country, or delivery of the property is not made in such country. For example, if a foreign wholesale distributor, which manages its entire business operations in a foreign country and sells its inventory exclusively in the United States—its only contact in the United States being the promotion of such sales to United States retail outlets by advertising in trade publications and distributing sales catalogues—is liable for a breach of warranty with regard to the sale of property to a United States retail outlet, such liability will be considered to result from an activity exclusively carried on in the United States and will be considered a liability which could arise from activity performed in the United States.

(v) *Liability from service or driving activity—(a) In general.* If a person is liable with regard to any service activity performed, or is liable with regard to driving activity performed in connection with a motor vehicle, ship or boat, aircraft, or railroad rolling stock, whether or not exclusively used in the commercial transportation of persons or property, such liability will be considered to result from such service or driving activity. For example, if an oil company which drills for oil exclusively in a foreign country is liable with regard to the negligent handling by its employees of explosives in the course of such drilling there, such liability will be considered to result from an activity exclusively carried on outside the United States and will be considered a liability which could not arise from activity performed in the United States. In further illustration, if a corporation which services machinery exclusively in a foreign country under servicing contracts is liable with regard to the negligent repairing of a machine under such a contract, such liability will be considered to result from an activity exclusively carried on outside the United States and will be considered a liability which could not arise from activity performed in the United States.

(b) Location of activities in connection with transportation property. For purposes of *(a)* of this subdivision, service or driving activity performed in connection with a motor vehicle, ship or boat, aircraft, or railroad rolling stock, whether or not exclusively used in the commercial transportation of persons or property, will be considered activity performed in the United States if the activity is carried on at a time when such property is or will be considered, in accordance with subdivision (iv) or (v) of paragraph (b)(2) of this section, actually in the United States or ordinarily located in the United States. However, if the premium which is attributable to the reinsuring or issuing of any insurance contract in connection with such service or driving activity which is carried on at a time when such property is, or will be considered, ordinarily located in the United States can be allocated to, or apportioned between, the risks incurred when such property is actually located in the United States and risks incurred when it is actually located outside the United States, such liability will be considered a liability which could arise from activity performed in the United States only when such property is actually located in the United States. Any allocation or apportionment of premium under the preceding sentence shall be made in accordance with the rules of allocation and apportionment provided in subdivision (iv) or (v) of paragraph (b)(2) of this section. For example, if a person is liable with regard to the performance of services outside the United States in the operation of a motor vehicle which is used exclusively in the commercial transportation of persons to and from the United States and which, because more than 50 percent of the miles traversed during the applicable policy period in the use of such property are traversed within the United States, is considered ordinarily located in the United States, such liability will be considered to be a liability which could not arise from activity performed in the United States only to the extent that the premium which is attributable to the reinsuring or issuing of any insurance contract in connection with such service activity is apportioned on a mileage basis between the risks incurred when such motor vehicle is actually located in the United States and when such vehicle is actually located outside the United States. See paragraph (b)(2)(iv) of this section. In further illustration, if a person is liable with regard to his negligent driving of a motor vehicle which is not used exclusively in the commercial transportation of persons or property, which is registered with any State, and which is driven both in the United States and a foreign country, such liability will be considered a liability which could arise from activity performed in the United States, unless the premium which is attributable to the reinsuring or issuing of an insurance contract in connection with such driving performed in such motor vehicle ordinarily located in the United States is specifically allocated under

the contract to risks incurred with respect to driving performed in, and to risks incurred with respect to driving performed outside, the United States. See paragraph (b)(2)(v) of this section.

(c) Illustration. The application of this subdivision may be further illustrated by the following example:

Example. Controlled foreign corporation A is a wholly owned subsidiary of domestic corporation M. Both corporations are insurance companies and use the calendar year as the taxable year. Corporation M is exclusively engaged in issuing to owners of commercial rental property which is located in the United States insurance contracts which cover any harm which may be caused in 1963 by the tortious conduct of the owners' employees in managing and maintaining such property. The owners insured under such contracts include both residents and nonresidents of the United States. In 1963, M Corporation cedes to A Corporation one-half of the insurance contracts issued by M Corporation in that year, including the contracts issued to nonresidents. Income of A Corporation derived in 1963 from reinsuring the risks of M Corporation is income from the insurance of United States risks since all the insurance contracts reinsured by it are in connection with a liability which could arise from service activity performed in the United States.

(vi) *Liability from delivery of property.* If the person who is obligated to deliver property is liable with regard to such delivery, such liability will be considered to result from the activity performed of delivering such property. For example, if a corporation which exports all of its inventory from the United States to foreign countries or possessions of the United States is liable with regard to its failure to make delivery outside the United States of inventory it has sold, such liability will be considered to result from an activity exclusively carried on outside the United States and will be considered a liability which could not arise from activity performed in the United States. In further illustration, if a corporation which exports all of its inventory from a foreign country to the United States is liable with regard to its improper delivery in the United States of inventory it has sold, such liability will be considered to result from an activity exclusively carried on in the United States and will be considered a liability which could arise from activity performed in the United States.

(d) *Lives or health of United States residents.* Risks in connection with the lives or health of residents of the United States include those risks which are the subject of insurance contracts referred to in section 801(a), relating to the definition of a life insurance company. If the insured is a resident of the United States at the time the insurance contract is approved, the risk is in connection with the life or health of a resident of the United States for the period of coverage under the contract. However, if during such period of coverage the insured notifies the insurer, or circumstances known to the insurer indicate, that the insured is no longer a resident of the United States, the risk shall cease to be a risk in connection with the life or health of a resident of the United States for the policy period in which the insured gives such notice or such circumstances are known to the insurer, and for each subsequent policy period. Conversely, if the insured is a resident of a particular foreign country at the time the insurance contract is approved, the risk is in connection with the life or health of a resident of such foreign country for the period of coverage under the contract. However, if during such period of coverage the insured notifies the insurer, or circumstances known to the insurer indicate, that the insured is no longer a resident of such foreign country, the risk shall cease to be a risk in connection with the life or health of a resident of such particular foreign country for the policy period in which the insured gives such notice or such circumstances are known to the insurer, and for each subsequent policy period. In determining the country of residence of an insured, the principles of §§ 301.7701(b)–1 through 301.7701(b)–9 of this chapter, relating to the determination of residence and nonresidence in the United States and of foreign residence, shall apply. Citizens of the United States are not residents of the United States merely because of their citizenship. The application of this paragraph may be illustrated by the following example:

Example. Controlled foreign corporation A is a wholly owned subsidiary of domestic corporation M. Corporation A uses the calendar year as the taxable year and is engaged in the life insurance business in foreign country X. In 1963, A Corporation issues ordinary life insurance contracts on the lives of residents of the United States, including one issued on February 1, 1963, to R, a citizen of foreign country Y and a resident of the United States on such date. All activity in connection with the issuing of such contracts is transacted by mail. On May 1, 1963, R abandons his United States residence and establishes residence in foreign country Z. There are no circumstances known to A Corporation that R has changed his residence until R, on March 1, 1964, actually notifies A Corporation of that change. Income of A Corporation for the policy period of February 1, 1963, to January 31, 1964, from issuing such insurance contracts is income derived from the insurance of United States risks. However, income of A Corporation derived for the policy period of February 1, 1964, to January 31, 1965, from R's insurance contract is not income derived from the insurance of United States risks.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 6781, 29 FR 18202, Dec. 23, 1964, as amended by T.D. 7736, 45 FR 76143, Nov. 18, 1980; T.D. 8411, 57 FR 15241, Apr. 27, 1992]

§1.953–3 Risks deemed to be United States risks.

(a) *Artificial arrangements.* For purposes of paragraph (a) of §1.953–1, the term ''United States risks'' also includes under section 953(a)(1)(B) risks which are deemed to be United States risks. They are risks (other than United States risks described in section 953(a)(1)(A) and §1.953–2) which a controlled foreign corporation reinsures under an insurance or annuity contract, or with respect to which a controlled foreign corporation issues any insurance or annuity contract, in accordance with any arrangement whereby another corporation which is not a controlled foreign corporation receives an amount of premiums (for reinsuring or issuing any insurance or annuity contract in connection with the United States risks described in section 953(a)(1)(A) and §1.953–2) which is substantially equal to the amount of premiums which the controlled foreign corporation receives under its contracts. Arrangements to which this rule applies include those entered into by the controlled foreign corporation, by its United States shareholders, or by a related person.

(b) *Evidence of arrangements.* The determination of the existence of an arrangement referred to in paragraph (a) of this section shall depend on all the facts and circumstances in each case. In making this determination, it will be recognized that arrangements of this type generally are orally entered into outside the United States and that direct evidence of such an arrangement is not ordinarily available. Therefore, in determining the existence of such an arrangement, consideration will be given to whether or not there is substantial similarity between the type, location, profit margin expected, and loss experience of the risks which the corporation which is not a controlled foreign corporation insures or reinsures and the risks which the controlled foreign corporation insures or reinsures. Further, consideration will be given to the existence of prior similar arrangements between, and the identity of the directors or shareholders of, the corporation which is not a controlled foreign corporation, its shareholders, or related persons and the controlled foreign corporation, its shareholders, or related persons. However, the absence of such prior arrangements or identity of directors or shareholders will not of itself establish the nonexistence of an arrangement referred to in paragraph (a) of this section. In determining whether the amounts received by the controlled foreign corporation and the corporation which is not a controlled foreign corporation are substantially equal, the period in which the controlled foreign corporation receives premiums need not be the same as, or identical in length with, that of the corporation which is not a controlled foreign corporation nor limited to a taxable year of the controlled foreign corporation.

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

Example 1. Controlled foreign corporation A is a wholly owned subsidiary of domestic corporation M. Foreign corporation B is a wholly owned subsidiary of foreign corporation R. All corporations use the calendar year as the taxable year. Corporations M and R, which are not related persons, agree that from July 1, 1963, through December 31, 1963, B Corporation will reinsure all risks of M Corporation which are United States risks described in section 953(a)(1)(A), and that from January 1, 1964, through June 30, 1964, A Corporation will reinsure all risks of R Corporation which are not United States risks described in section 953(a)(1)(A). The amount of premiums received by A Corporation and B Corporation, respectively, as a result of the agreement are substantially equal. The income of A Corporation derived in 1964 from reinsuring the risks of R Corporation is income derived from the insurance of United States risks described in section 953(a)(1)(B).

Example 2. Assume the same facts as in example 1, except that M and R Corporations also agree, as part of their arrangement, that from July 1, 1964, through December 31, 1964, B Corporation will reinsure all risks of M Corporation which are United States risks described in section 953(a)(1)(A), and that from January 1, 1965, through June 30, 1965, A Corporation will reinsure all risks of R Corporation which are not United States risks described in section 953(a)(1)(A). The amount of premiums derived by B Corporation from July 1, 1963, through December 31, 1963, under the agreement is not substantially equal to the amount of premiums derived by A Corporation from January 1, 1964, through June 30, 1964, and the amount of premiums derived by B Corporation from July 1, 1964, through December 31, 1964, is not substantially equal to the amount of premiums derived by A Corporation from January 1, 1965, through June 30, 1965. However, the aggregate amount of premiums received by B Corporation under the arrangement is substantially equal to the aggregate amount of premiums received by A Corporation. The income of A Corporation derived in 1964 and 1965 from reinsuring the risks of R Corporation is income derived from the insurance of United States risks described in section 953(a)(1)(B).

Example 3. Assume the same facts as in example 1, except that foreign corporation C is also a wholly owned subsidiary of R Corporation. Assume that C Corporation uses the calendar year as its taxable year. Assume further that M Corporation and R Corporation agree that from July 1, 1963, through December 31, 1963, B Corporation and C Corporation together will reinsure the United States risks described in section 953(a)(1)(A) of M Corporation. The amount of premiums received by B Corporation in respect of such United States risks is equal to one-third of the amount received by A Corporation in respect of the risks which are not United States risks described in section 953(a)(1)(A), and the amount of premiums received by C Corporation in respect of such United States risks is equal to two-thirds of the amount so received by A Corporation. The income of A Corporation derived in 1964 from reinsuring the risks of R Corporation is income derived from the insurance of United States risks described in section 953(a)(1)(B).

Example 4. Assume the same facts as in example 3, except that controlled foreign corporation D is also a wholly owned subsidiary of M Corporation and uses the calendar year as its taxable year. Assume further that M Corporation and R Corporation agree that in 1964 R Corporation will pay premiums of $300,000 to A Corporation and $700,000 to D Corporation to reinsure all risks of R Corporation which are not United States risks described in section 953(a)(1)(A), and that in 1963 M Corporation will pay premiums of $400,000 to B Corporation and $600,000 to C Corporation to reinsure all risks of M Corporation which are United States risks described in section 953(a)(1)(A). The income of A Corporation and D Corporation derived in 1964 from reinsuring the risks of R Corporation is income derived from the insurance of United States risks described in section 953(a)(1)(B).

Example 5. Controlled foreign corporation A is a wholly owned subsidiary of domestic insurance corporation M. Controlled foreign corporation B is a wholly owned subsidiary of domestic insurance corporation N. All corporations use the calendar year as the taxable year. As a result of an arrangement between M Corporation and N Corporation, in 1963 A Corporation reinsures all the United States risks described in section 953(a)(1)(A) of N Corporation, and B Corporation reinsures all the United States risks described in section 953(a)(1)(A) of M Corporation. The premiums and other consideration received by A Corporation and B Corporation in respect of such reinsurance are not substantially equal. The income of A Corporation and B Corporation in 1962 from reinsuring the risks of N Corporation and M Corporation, respectively, is income derived from the insurance of United States risks described in section 953(a)(1)(A) and is not income derived from the insurance or United States risks described in section 953(a)(1)(B).

Example 6. Assume the same facts as in example 5, except that B Corporation is not a controlled foreign corporation. The income of A Corporation in 1963 from reinsuring the risks of N Corporation is income derived from the insurance of United States risks described in section 953(a)(1)(A) and is not income derived from the insurance of United States risks described in section 953(a)(1)(B).

[T.D. 6781, 29 FR 18207, Dec. 23, 1964]

§ 1.953–4 Taxable income to which section 953 applies.

(a) *Taxable income defined*—(1) *Life insurance taxable income.* For a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as a life insurance company to which part I (sections 801 through 820) of subchapter L of the Code applies, the term ''taxable income'' means for purposes of paragraph (a) of §1.953–1 the gain from operations, as defined in section 809(b) and as modified by this section, derived from, and attributable to, the insurance of United States risks. For purposes of determining such taxable income, the provisions of section 802(b) (relating to the definition of life insurance company taxable income) shall not apply. Determinations for purposes of this subparagraph shall be made without regard to section 501(a).

(2) *Mutual and other insurance taxable income.* For a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as a mutual insurance company to which part II (sections 821 through 826) of subchapter L of the Code applies or a mutual marine insurance or other insurance company to which part III (sections 831 and 832) of subchapter L of the Code applies, the term ''taxable income'' means for purposes of paragraph (a) of §1.953–1 taxable income, as defined in section 832(a) and as modified by this section, derived from, and attributable to, the insurance of United States risks. Determinations for purposes of this subparagraph shall be made without regard to section 501(a).

(3) *Corporations not qualifying as insurance companies.* For special rules applicable under this section in the case of a controlled foreign corporation which, if it were a domestic corporation, would not qualify as an insurance company, see §1.953–5.

(b) *Certain provisions inapplicable.* In determining taxable income under this section, the following provisions of subchapter L of the Code shall not apply:

(1) Section 809(d)(4), relating to the operations loss deduction;

(2) Section 809(d)(5), relating to certain nonparticipating contracts;

(3) Section 809(d)(6), relating to certain accident and health insurance and group life insurance;

(4) Section 809(d)(10), relating to small business deduction;

(5) Section 817(b), relating to gain on property held on December 31, 1958, and certain substituted property acquired after 1958; and

(6) Section 832(c)(5), relating to capital losses.

(c) *Computation of reserves required by law*—(1) *Law applicable in determining reserves.* The reserves which will be taken into account as reserves required by law under section 801(b)(2), both in determining for any taxable year whether a controlled foreign corporation is a controlled foreign corporation described in paragraph (a)(1) or (2) of this section and in determining taxable income of such corporation for the taxable year under paragraph (a) of this section, shall be the following reserves:

(i) *Reserves required by the law of a State.* The reserves which are required by the law of the State or States to which the insurance business of the controlled foreign corporation is subject, but only with respect to its United States business, if any, which is taxable under section 819(a).

(ii) *Reserves deemed to be required.* To the extent of such controlled foreign corporation's insurance business not taxable under section 819(a)—

(a) Except as provided in *(b)* of this subdivision (ii), the reserves which would result if such reserves were determined by applying the minimum standards of the law of New York as if such controlled foreign corporation were an insurance company transacting all of its insurance business (other than its United States business which is taxable under section 819(a)) for such taxable year in such State, and

(b) With respect to all risks covered by insurance ceded to such controlled foreign corporation by an insurance company to which apply the provisions of subchapter L of the Code (determined without regard to section 501(a)) and in respect of which an election is made by or on behalf of such controlled foreign corporation to determine its reserves in accordance with this subdivision (b), the amount of reserves against

such risks which would result if all of such reserves were determined by applying the law of the State, to which the risks in the hands of such insurance company are subject, as if such controlled foreign corporation were an insurance company engaged in reinsuring such risks in such State.

(2) *Rules of application.* For purposes of subparagraph (1) of this paragraph, the following rules shall apply:

(i) *Life insurance reserves computed on preliminary term basis.* For purposes of determining under paragraph (a) of this section the taxable income of a controlled foreign corporation, an election may be made by or on behalf of such corporation that the amount of reserves which are taken into account as life insurance reserves with respect to contracts for which reserves are computed on a preliminary term basis shall be determined as provided in section 818(c). This election shall apply, subject to section 818(c), to all life insurance reserves of the controlled foreign corporation, whether or not reserves applicable to the United States business taxable under section 819(a). However, reserves determined as provided in section 818(c) shall not be taken into account in determining whether a controlled foreign corporation is a controlled foreign corporation described in paragraph (a)(1) or (2) of this section.

(ii) *Actual reserves required. (a)* A controlled foreign corporation will be considered to have a reserve only to the extent the reserve has been actually held during the taxable year for which such reserve is claimed.

(b) For determining when reserves are required by the law of a State, see paragraph (b) of § 1.801–5 of this chapter.

(iii) *Total reserves to be taken into account.* The total reserves of a controlled foreign corporation shall be taken into account in determining whether such corporation is a controlled foreign corporation described in paragraph (a)(1) or (2) of this section. Therefore, in making such determination, the reserves which, under subparagraph (1)(i) of this paragraph, are required by the law of any State shall be taken into account together with the reserves which, under subparagraph (1)(ii) of this paragraph, are deemed to be required. Moreover, reserves applicable to the reinsuring or the issuing of insurance or annuity contracts of both United States risks and foreign risks shall be taken into account. Finally, except as provided in subdivision (i) of this subparagraph, the reserves which are taken into account in determining whether a controlled foreign corporation is a controlled foreign corporation described in paragraph (a)(1) or (2) of this section shall be the same reserves which are taken into account in determining under paragraph (a) of this section the taxable income of such corporation.

(iv) *Method of comparing reserves when subject to more than one State.* If the insurance business of a controlled foreign corporation is subject to the law of more than one State, the amount of reserves taken into account under subparagraph (1)(i) of this paragraph shall be the amount of the highest aggregate reserve required by any State, determined as provided in paragraph (a) of § 1.801–5 of this chapter.

(d) *Domestic corporation tax attributes.* In determining taxable income of a controlled foreign corporation under this section there shall be allowed, except as provided in section 953(b), this section, and § 1.953–5, the exclusions and deductions from gross income which would be allowed if such corporation were a domestic insurance company engaged in the business of only reinsuring or issuing the insurance or annuity contracts which have been reinsured or issued by such corporation. For this purpose, the provisions of sections 819, 821(e), 822(e), 831(b), and 832(d), relating to foreign insurance companies, shall not apply; however, for the exclusion from the taxable income determined under section 953 of amounts derived from sources within the United States, see section 952(b) and paragraph (b) of § 1.952–1. Furthermore, taxable income shall be determined under this section without regard to section 882 (b) and (c), relating to gross income and deductions of a foreign corporation, and without regard to whether the controlled foreign corporation is carrying on an insurance business in the United States. For other rules relating to the determination of gross income and taxable income of a foreign corporation for purposes of subpart F, see §1.952–2.

(e) *Limitation on certain amounts in respect of United States risks.* In determining taxable income under this section the following amounts shall not, in accordance with section 953(b)(4), be taken into account except to the extent they are attributable to the reinsuring or issuing of any insurance or annuity contract in connection with United States risks described in §1.953–2 or §1.953–3:

(1) The amount of premiums determined under section 809(c)(1);

(2) The net decrease in reserves determined under section 809(c)(2);

(3) The net increase in reserves determined under section 809(d)(2); and

(4) The premiums earned on insurance contracts during the taxable year, as determined under section 832(b)(4). For the allocation and apportionment of such amounts to income from the insurance of United States risks, see paragraphs (f) and (g) of this section.

(f) *Items allocated or apportioned*—(1) *Rules of allocation or apportionment.* In determining taxable income under this section, first determine all items of income, expenses, losses, and other deductions which directly relate to the premiums received for the reinsuring or the issuing of any insurance or annuity contract in connection with United States risks, as defined in §§1.953–2 and 1.953–3, and allocate such items to the insurance of United States risks. For example, the deductions allowed by section 809(d)(1), relating to death benefits, section 809(d)(3), relating to dividends to policyholders, and section 809(d)(7), relating to the assumption by another person of liabilities under insurance contracts, shall be allocated to the insurance of United States risks to the extent they relate directly to the premiums received for reinsuring or issuing insurance or annuity contracts in connection with United States risks. Next, determine all items of income, expenses, losses, and other deductions which directly relate to the premiums received for the reinsuring or the issuing of any insurance or annuity contract in connection with foreign risks and allocate such items to the reinsuring of foreign risks. Finally, determine all items of income, expenses, losses, and other deductions which relate to the premiums received for the reinsuring or the issuing of any insurance or annuity contract in connection with both United States risks and foreign risks, and, except as provided in paragraph (g) of this section, apportion such items between the insurance of United States risks and the insurance of foreign risks in the manner prescribed in subparagraph (2) or (3) of this paragraph, as the case may be. As used in this section, the term ‘‘foreign risks’’ means risks which are not United States risks as defined in §1.953–2 or §1.953–3.

(2) *Method of apportionment in determination of life insurance taxable income*—(i) *Investment yield and net long-term capital gain.* Unless they can be allocated to the insurance of United States risks, as provided in subparagraph (1) of this paragraph, in determining a controlled foreign corporation's taxable income for any taxable year under paragraph (a)(1) of this section—

(a) The investment yield under section 804(c),

(b) The amount (if any) under section 809(b)(1)(B) by which the net long-term capital gain exceeds the net short-term capital loss, and

(c) Those deductions allowed under section 809(d)(8), (9), and (12) which relate to gross investment income shall be apportioned to the reinsuring and issuing of insurance and annuity contracts in connection with United States risks in an amount which bears the same ratio to each of such amounts of investment yield, excess gain, and deductions as the sum of the mean of each of the items described in section 810(c) at the beginning and end of the taxable year attributable to reinsuring and issuing any insurance and annuity contracts in connection with United States risks bears to the sum of the mean of each of the items described in section 810(c) at the beginning and end of the taxable year attributable to reinsuring and issuing all insurance and annuity contracts. Thus, for example, if the ratio which the sum of the mean of each of the items described in section 810(c) at the beginning and end of

the taxable year attributable to reinsuring and issuing insurance and annuity contracts in connection with United States risks bears to the sum of the mean of each of the items described in section 810(c) at the beginning and end of the taxable year attributable to reinsuring and issuing all insurance and annuity contracts in one to three, then, unless an allocation to the insurance of United States risks can be made as provided in subparagraph (1) of this paragraph, one-third of each of such amounts of investment yield, excess gain, and deductions shall be apportioned to the reinsuring and issuing of insurance and annuity contracts in connection with United States risks, and two-thirds of each of such amounts shall be apportioned to the reinsuring and issuing of insurance and annuity contracts in connection with foreign risks.

(ii) *Other income and deductions—(a) Amount taken into account.* In determining a controlled foreign corporation's taxable income for any taxable year under paragraph (a)(1) of this section, all items of income taken into account under section 809(c)(3), relating to other amounts of gross income, and the other deductions allowed under section 809(d)(12) to the extent that such other deductions do not relate to gross investment income shall be apportioned to the reinsuring and issuing of insurance and annuity contracts in connection with United States risks in an amount which bears the same ratio to each of such items of income or of such other deductions as the numerator determined under *(b)* of this subdivision bears to the denominator determined under *(c)* of this subdivision.

(b) Numerator. The numerator used for purposes of the apportionment under *(a)* of this subdivision shall be an amount which equals the amount determined under *(c)* of this subdivision, but only to the extent that the amount so determined is taken into account under paragraph (e) of this section in determining taxable income for the taxable year.

(c) Denominator. The denominator used for purposes of the apportionment under *(a)* of this subdivision shall be an amount which equals—

(1) The amount of premiums determined under section 809(c)(1) for the taxable year, plus

(2) The net decrease in reserves determined under section 809(c)(2) for such year, minus

(3) The net increase in reserves determined under section 809(d)(2) for such year.

(iii) *Reserves used in apportionment formula.* The rules for determining which reserves are taken into account in determining the taxable income of a controlled foreign corporation under paragraph (a) of this section shall also apply under subdivision (ii) *(b)* and *(c)* of this subparagraph in determining the net decrease in reserves under section 809(c)(2) or the net increase in reserves under section 809(d)(2). See paragraph (c) of this section.

(3) *Method of apportionment in determination of mutual and other insurance income*—(i) *In general.* In determining a controlled foreign corporation's taxable income for any taxable year under paragraph (a)(2) of this section, any item which is required to be apportioned under subparagraph (1) of this paragraph shall be apportioned to the reinsuring and issuing of insurance and annuity contracts in connection with United States risks in an amount which bears the same ratio to the total amount of such item as the amount of premiums earned on insurance contracts during the taxable year which is required to be taken into account by such corporation under paragraph (e)(4) of this section in determining such taxable income bears to the total amount of all its premiums earned (as determined under section 832(b)(4)) on insurance contracts during the taxable year.

(ii) *Reserves used in apportionment formula.* The principles of subparagraph (2)(iii) of this paragraph shall apply in determining the reserves included in premiums earned on insurance contracts during the taxable year for purposes of subdivision (i) of this subparagraph.

(g) *Separate accounting.* The methods of apportionment prescribed in subparagraphs (2) and (3) of paragraph (f) of this section for determining taxable income under this section shall not apply if the district director determines that the controlled foreign corporation, in good faith and unaffected by considerations of tax liability, regularly employs in its books of account a detailed segregation of receipts, expenditures, assets, liabilities, and net worth which clearly reflects the income derived from the reinsuring or issuing of insurance or annuity contracts in connection with United States risks. The district director, in making such determination, shall give effect to any foreign law, satisfactory evidence of which is presented by the United States shareholder to the district, director, which requires a reasonable segregation of those items of income, expense, losses, and other deductions which relate to determining such taxable income.

(h) *Illustration.* The application of paragraphs (e) and (f) of this section may be illustrated by the following example:

Example. Controlled foreign corporation A, incorporated under, and engaged in an insurance business subject to, the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Both corporations use the calendar year as the taxable year. Corporation M is a life insurance company as defined in section 801(a); A Corporation would, if it were a domestic corporation, be taxable under part I of subchapter L of the Code. In 1963, A Corporation derives income from the insurance of United States risks as a result of reinsuring the life insurance policies issued by M Corporation on lives of residents of the United States. In 1963, A Corporation also issues policies of life insurance on individuals who are not residents of the United States, but its premiums from the reinsuring of United States risks exceed he 5-percent minimum premium requirement prescribed in paragraph (b) of §1.953–1. Based upon the facts set forth in paragraph (a) of this example, A Corporation for 1963 has taxable income under this section of $40,200, which is attributable to the reinsuring of life insurance contracts in connection with United States risks, determined in the manner provided in paragraphs (b), (c), and (d) of this example.

(a) A summary of the entire operations of A Corporation for 1963, determined under this section as though such corporation were a domestic life insurance company but without applying paragraph (f) of this section, is as follows:

Item	Attributable to all insurance	Attributable to reinsuring U.S. risks	Attributable to insuring foreign risks
Investment Income:			
(1) Investment yield under section 804(c)	$90,000	Unallocable	Unallocable
(2) Sum of the mean of each of the items described in section 810(c) at beginning and end of 1963	2,500,000	$1,000,000	$1,500,000
(3) Required interest under section 809(a)(2)	60,000	25,000	35,000
(4) Deductions allowed under section 809(d)(8), (9), and (12) which relate to gross investment income	10,000	Unallocable	Unallocable
Underwriting Income:			
(5) Premiums under section 809(c)(1)	600,000	200,000	400,000
(6) Net decrease in reserves under section 809(c)(2)	10,000	None	10,000
(7) Net increase in reserves under section 809(d)(2)	40,000	40,000	None
(8) Deductions allowed under section 809(d) (other than deduction allowed under section 809(d)(2) and other than those deductions allowed under section 809(d)(8), (9), and (12) which relate to gross investment income):			
(i) Allocable	330,000	110,000	220,000
(ii) Unallocable	60,000	Unallocable	Unallocable

(b) The unallocable investment yield ($90,000) under paragraph (a)(1) of this example and the unallocable deductions ($10,000) under paragraph (a)(4) relating to gross investment income are apportioned to the reinsuring of United States risks under paragraph (f)(1)(i) of this section in the amounts of $36,000, and $4,000, respectively, determined as follows:

(1) Sum of the mean of each of the items described in section 810(c) at beginning and end of 1963, attributable to reinsuring U.S. risks (paragraph (a)(2))	$1,000,000
(2) Sum of the mean of each of the items described in section 810(c) at beginning and end of 1963, attributable to all insurance (paragraph (a)(2))	$2,500,000
(3) Ratio of amount under subparagraph (1) to amount under subparagraph (2) ($1,000,000/$2,500,000)	40%
(4) Amount of investment yield attributable to reinsuring of U.S. risks (40% of $90,000)	$36,000
(5) Amount of such deductions attributable to reinsuring of U.S. risks (40% of $10,000)	$4,000

(c) The unallocable deductions ($60,000) under paragraph (a)(8)(ii) of this example which do not relate to gross investment income are apportioned to the reinsuring of United States risks under paragraph (f)(2)(ii) of this section in the amount of $16,800, determined as follows:

(1) The numerator determined under paragraph (f)(2)(ii)*(b)* of this section is $160,000, determined as follows:

(i) Premiums under section 809(c)(1) attributable to reinsuring U.S. risks (paragraph (a)(5))	$200,000	
(ii) Plus: Net decrease in reserves under section 809(c)(2) attributable to reinsuring U.S. risks (paragraph (a)(6))		$200,000
(iii) Less: Net increase in reserves under section 809(d)(2) attributable to reinsuring U.S. risks (paragraph (a)(7))		$40,000
		$160,000

(2) The denominator determined under paragraph (f)(2)(ii)(c) of this section is $570,000, determined as follows:

(i) Premiums under section 809(c)(1) attributable to all insurance (paragraph (a)(5))	$600,000	
(ii) Plus: Net decrease in reserves under section 809(c)(2) attributable to all insurance (paragraph (a)(6))	10,000	
		$610,000
(iii) Less: Net increase in reserves under section 809(d)(2) attributable to all insurance (paragraph (a)(7))		40,000
		$570,000

(3) Ratio which the numerator determined under subparagraph (1) bears to the denominator determined under subparagraph (2) ($160,000/$570,000)—28%.

(4) Amount of deductions attributable to reinsuring of U.S. risks (28% of $60,000)—$16,800.

(d) The taxable income of A Corporation for 1963 which constitutes its income derived from the insurance of United States risks for purposes of paragraph (a) of § 1.953–1 is $40,200, determined as follows:

	Attributable to all insurance		Attributable to reinsuring U.S. risks		Attributable to insuring foreign risks	
Item:						
(1) Investment yield under section 804(c) (paragraph (a)(1), unallocable but as apportioned under paragraph (b)(4)	$90,000		$36,000		$54,000	
(2) Less: Required interest under section 809(a)(2) (paragraph (a)(3))	60,000		25,000		35,000	
(3) Life insurance company's share of investment yield under section 809(b)(1)(A)	....	$30,000		$11,000		$19,000
Plus sum of:						
(4) Premiums under section 809(c)(1) (paragraph (a)(5))	600,000		200,000		400,000	
(5) Net decrease in reserves under section 809(c)(2) (paragraph (a)(6))	10,000	610,000	None	200,000	10,000	410,000
Sum determined under section 809(b)(1) ...	....	640,000		211,000		429,000
Less sum of:						
(6) Net increase in reserves under section 809(d)(2) (paragraph (a)(7))	40,000		40,000		None	
(7) Deductions allowed under section 809(d)(8), (9), and (12) which relate to gross investment income (paragraph (a)(4)), unallocable but as apportioned under paragraph (b)(5)	10,000		4,000		6,000	
(8) Deductions allowed under section 809(d) (other than deduction allowed under section 809(d)(2) and other than those deductions allowed under section 809(d)(8), (9), and (12) which relate to gross investment income) (paragraph (a)(8)):.						
(i) Allocable	330,000		110,000		220,000	
(ii) Unallocable, but as apportioned under paragraph (c)(4)	60,000	440,000	16,800	170,800	43,200	269,200
Gain from operations	....	200,000		40,200		159,800

[T.D. 6781, 29 FR 18207, Dec. 23, 1964]

§1.953–5 Corporations not qualifying as insurance companies.

(a) *In general.* A controlled foreign corporation is not excluded from the application of paragraph (a) of §1.953–1 because such corporation, if it were a domestic corporation, would not be taxable as an insurance company to which subchapter L of the Code applies. Thus, if a controlled foreign corporation reinsures or issues insurance or annuity contracts in connection with United States risks, as defined in §1.953–2 or §1.953–3, and satisfies the 5-percent minimum premium requirement prescribed in paragraph (b) of §1.953–1, such corporation may derive income from the insurance of United States risks even though the primary and predominant business activity of such corporation during the taxable year is not the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

(b) *Income from insurance of United States risks by noninsurance company.* For purposes of paragraph (a) of §1.953–1, the taxable income derived from the reinsuring or the issuing of any insurance or annuity contract in connection with United States risks by a controlled foreign corporation which, if it were a domestic corporation, would not be taxable as an insurance company to which subchapter L of the Code applies shall be determined under §1.953–4, subject to, and to the extent not inconsistent with, the special rules prescribed in paragraph (c) or (d) of this section, whichever applies.

(c) *Special rules in determining taxable income*—(1) *In general.* The rules prescribed in this paragraph apply in order to exclude from the determination under §1.953–4 of the taxable income described in paragraph (b) of this section those items of the controlled foreign corporation's gross income and deductions which are not attributable to the reinsuring and issuing of insurance and annuity contracts.

(2) *Life insurance taxable income*—(i) *Amount of investment yield taken into account.* For purposes of determining the taxable income of a controlled foreign corporation which would not be taxable as an insurance company to which subchapter L of the Code applies if it were a domestic corporation but would be taxable as an insurance company to which part I of such subchapter applies if it were a domestic insurance company engaged in the business of only reinsuring or issuing the insurance or annuity contracts which have been reinsured or issued by such corporation, the investment yield under section 804(c), the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss, and all items of income taken into account under section 809(c)(3) shall be taken into account, subject to the provisions of paragraphs (e) and (f) of §1.953–4, in an amount which bears the same ratio to each of such amounts of investment yield, excess gain, and income items, as the case may be, as the numerator determined under subdivision (ii) of this subparagraph bears to the denominator determined under subdivision (iii) of this subparagraph.

(ii) *Numerator.* The numerator used for purposes of the apportionment under subdivision (i) of this subparagraph shall be the sum of—

(a) The mean of each of the items described in section 810(c) at the beginning and end of the taxable year, determined in accordance with the rules prescribed in paragraph (c) of §1.953–4 for purposes of determining taxable income of a controlled foreign corporation under paragraph (a) of §1.953–4,

(b) The mean of other liabilities at the beginning and end of the taxable year which are attributable to the reinsuring and issuing of insurance and annuity contracts, and

(c) The mean of the earnings and profits accumulated by the controlled foreign corporation at the beginning and end of the taxable year (determined without diminution by reason of any distributions made during the taxable year) which are attributable to the reinsuring and issuing of insurance and annuity contracts.

(iii) *Denominator.* The denominator used for purposes of the apportionment under subdivision (i) of this subparagraph shall be the mean of the value of the total assets held by the controlled foreign corporation at the beginning and end of the taxable year, determined by taking assets into account at their actual value (not reduced by liabilities), which, in the absence of affirmative evidence to the contrary, shall be deemed to be (a) face value in the case of bills receivable, accounts receivable, notes receivable, and open accounts held by a controlled foreign corporation using the cash receipts and disbursements method of accounting and (b) adjusted basis in the case of all other assets.

(3) *Mutual and other insurance taxable income*—(i) *Amount of insurance income taken into account.* For purposes of determining the taxable income of a controlled foreign corporation which, if it were a domestic corporation, would not be taxable as an insurance company to which subchapter L of the Code applies but which if it were a domestic insurance company engaged in the business of only reinsuring or issuing the insurance or annuity contracts which have been reinsured or issued by such corporation, would be taxable as a mutual insurance company to which part II of subchapter L of the Code applies, or would be taxable as a mutual marine insurance or other insurance company to which part III of subchapter L of the Code applies, the sum of the items of gross income referred to in section 832(b)(1) (except the gross amount earned during the taxable year from underwriting income described in section 832(b)(1)(A)) reduced by the deductions allowable under section 832(c) which are related to such items of gross income shall be taken into account, subject to the provisions of paragraphs (e) and (f) of § 1.953–4, in an amount which bears the same proportion to the sum of such items of gross income reduced by such deductions as the numerator determined under subdivision (ii) of this subparagraph bears to the denominator determined under subdivision (iii) of this subparagraph.

(ii) *Numerator.* The numerator used for purposes of the apportionment under subdivision (i) of this subparagraph shall be the sum of—

(a) The mean of the controlled foreign corporation's unearned premiums at the beginning and end of the taxable year, determined under section 832(b)(4)(B) and in accordance with the rules prescribed in paragraph (c) of § 1.953–4 for purposes of determining taxable income of a controlled foreign corporation under paragraph (a) of § 1.953–4,

(b) The mean of such corporation's unpaid losses at the beginning and end of the taxable year, determined under section 832(b)(5)(B),

(c) The mean of the items described in section 810(c)(4) at the beginning and end of the taxable year, to the extent allowable to such corporation under section 832(c)(11),

(d) The mean of other liabilities at the beginning and end of the taxable year which are attributable to the reinsuring and issuing of insurance and annuity contracts, and

(e) The mean of the earnings and profits accumulated by such corporation at the beginning and end of the taxable year (determined without diminution by reason of any distributions made during the taxable year) which are attributable to the reinsuring and issuing of insurance and annuity contracts.

(iii) *Denominator.* The denominator used for purposes of the apportionment under subdivision (i) of this subparagraph shall be the mean of the value of the total assets held by the controlled foreign corporation at the beginning and end of the taxable year, determined in the manner prescribed in subparagraph (2)(iii) of this paragraph.

(d) *Separate accounting.* The special rules prescribed in paragraph (c) of this section shall not apply if the district director determines that the controlled foreign corporation, in good faith and unaffected by considerations of tax liability, regularly employs in its books of account a detailed segregation of receipts, expenditures, assets, liabilities, and net worth which clearly reflects the income derived from the reinsuring or issuing of insurance or annuity contracts. The district director, in making such determination, shall give effect to any foreign law, satisfactory evidence of which is presented by the United States shareholder to the district director, which requires a reasonable segregation of the insurance assets of the controlled foreign corporation.

[T.D. 6781, 29 FR 18211, Dec. 23, 1964]

§1.953–6 Relationship of sections 953 and 954.

(a) *Priority of application.* For purposes of determining the subpart F income of a controlled foreign corporation under section 952 for any taxable year, the provisions of section 954, relating to foreign base company income, shall be applied, after first applying section 953, only with respect to income which is not income derived from the insurance of United States risks under section 953. For example, the provisions of section 954 may be applied with respect to the income of a controlled foreign corporation which is not income derived from the insurance of United States risks under section 953 because such corporation does not satisfy the 5-percent minimum premium requirement prescribed in paragraph (b) of §1.953–1, even though such corporation has taxable income, as determined under §1.953–4, which is attributable to the reinsuring or the issuing of any insurance or annuity contracts in connection with United States risks. In addition, the provisions of section 954 may apply with respect to the income of a controlled foreign corporation to the extent such income is not allocated or apportioned under §1.953–4 to the insurance of United States risks.

(b) *Decrease in income not material.* It is not material that the income of a controlled foreign corporation is decreased as a result of the application of paragraph (a) of this section. Thus, in applying §1.953–4 to the income of a controlled foreign corporation described in paragraph (c)(2) of §1.953–5 which would, but for paragraph (a) of this section, be subject to the provisions of section 954, there shall be allowed, in determining the taxable income derived from the insurance of United States risks under §1.953–4, a deduction under section 809(a)(1) for the share of each and every item of investment yield set aside for policyholders; it is not material that in determining foreign base company income such deduction would not be allowed under section 954(b)(5). Further, income of a controlled foreign corporation which is required to be taken into account under section 953 in determining income derived from the insurance of United States risks and would, but for the provisions of paragraph (a) of this section, constitute foreign base company income under section 954 shall not be taken into account under section 954(b)(3)(B) in determining whether foreign base company income exceeds 70 percent of gross income for the taxable year.

(c) *Increase in income not material.* It is not material that the income of a controlled foreign corporation is increased as a result of the application of paragraph (a) of this section. Thus, in applying §1.953–4 to income of a controlled foreign corporation which would, but for paragraph (a) of this section, be subject to the provisions of section 954, it is not material that the dividends, interest, and gains from the sale or exchange of stock or securities derived from certain investments which would not be included in foreign personal holding company income under section 954(c)(3)(B) are included under section 953 in income derived from the insurance of United States risks. Further, income of a controlled foreign corporation which is required to be taken into account under section 953 in determining income derived from the insurance of United States risks and would, but for paragraph (a) of this section, constitute foreign base company income shall not be excluded under section 954(b)(3)(A) for the taxable year.

[T.D. 6781, 29 FR 18212, Dec. 23, 1964]

§1.954–0 Introduction.

(a) *Effective dates*—(1) *Final regulations*—(i) *In general.* Except as otherwise specifically provided, the provisions of §§1.954–1 and 1.954–2 apply to taxable years of a controlled foreign corporation beginning after November 6, 1995. If any of the rules described in §§1.954–1 and 1.954–2 are inconsistent with provisions of other regulations under subpart F, these final regulations are intended to apply instead of such other regulations.

(ii) *Election to apply final regulations retroactively*—(A) *Scope of election.* An election may be made to apply the final regulations retroactively with respect to any taxable year of the controlled foreign corporation beginning on or after January 1, 1987. If such an election is made, these final regulations must be applied in their entirety for such taxable year and all subsequent taxable years. All references to section 11 in the final regulations shall be deemed to include section 15, where applicable.

(B) *Manner of making election.* An election under this paragraph (a)(1)(ii) is binding on all United States shareholders of the controlled foreign corporation and must be made—

(*1*) By the controlling United States shareholders, as defined in § 1.964–1(c)(5), by attaching a statement to such effect with their original or amended income tax returns for the taxable year of such United States shareholders in which or with which the taxable year of the CFC ends, and including any additional information required by applicable administrative pronouncements, or

(*2*) In such other manner as may be prescribed in applicable administrative pronouncements.

(C) *Time for making election.* An election may be made under this paragraph (a)(1)(ii) with respect to a taxable year of the controlled foreign corporation beginning on or after January 1, 1987 only if the time for filing a return or claim for refund has not expired for the taxable year of any United States shareholder of the controlled foreign corporation in which or with which such taxable year of the controlled foreign corporation ends.

(D) *Revocation of election.* An election made under this paragraph (a)(1)(ii) may not be revoked.

(2) *Temporary regulations.* The provisions of §§ 4.954–1 and 4.954–2 of this chapter apply to taxable years of a controlled foreign corporation beginning after December 31, 1986 and on or before November 6, 1995. However, the provisions of § 4.954–2(b)(6) of this chapter continue to apply. For transactions entered into on or before October 10, 1995, taxpayers may rely on Notice 89–90, 1989–2 C.B. 407, in applying the temporary regulations.

(3) *§§ 1.954A–1 and 1.954A–2.* The provisions of §§ 1.954A–1 and 1.954A–2 (as contained in 26 CFR part 1 edition revised April 1, 1995) apply to taxable years of a controlled foreign corporation beginning before January 1, 1987. All references therein to sections of the Code are to the Internal Revenue Code of 1954 prior to the amendments made by the Tax Reform Act of 1986.

(b) *Outline of §§ 1.954–0, 1.954–1 and 1.954–2.*

§ 1.954–0 Introduction.

(a) Effective dates.

(1) Final regulations.

(i) In general.

(ii) Election to apply final regulations retroactively.

(A) Scope of election.

(B) Manner of making election.

(C) Time for making election.

(D) Revocation of election.

(2) Temporary regulations.

(3) §§ 1.954A–1 and 1.954A–2.

(b) Outline of §§ 1.954–0, 1.954–1, and 1.954–2.

§ 1.954–1 Foreign base company income.

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(1) Purpose and scope.

(2) Gross foreign base company income.

(3) Adjusted gross foreign base company income.

(4) Net foreign base company income.

(5) Adjusted net foreign base company income.

(6) Insurance income.

(7) Additional items of adjusted net foreign base company income or adjusted net insurance income by reason of section 952(c).

(b) Computation of adjusted gross foreign base company income and adjusted gross insurance income.

(1) De minimis and full inclusion tests.

(i) De minimis test.

(A) In general.

(B) Currency translation.

(C) Coordination with sections 864(d) and 881(c).

(ii) Seventy percent full inclusion test.

(2) Character of gross income included in adjusted gross foreign base company income.

(3) Coordination with section 952(c).

(4) Anti-abuse rule.

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(ii) Presumption.

(iii) Related persons.

(iv) Example.

(c) Computation of net foreign base company income.

(1) General rule.

(i) Deductions against gross foreign base company income.

(ii) Losses reduce subpart F income by operation of earnings and profits limitation.

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(B) Passive foreign personal holding company income.

(2) Computation of net foreign base company income derived from same country insurance income.
(d) Computation of adjusted net foreign base company income or adjusted net insurance income.
(1) Application of high tax exception.
(2) Effective rate at which taxes are imposed.
(3) Taxes paid or accrued with respect to an item of income.
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(4) Special rules.
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(i) Individuals.
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(2) Control.
(i) Corporations.
(ii) Partnerships.
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§1.954–2 Foreign personal holding company income.

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(2) Coordination of overlapping categories under foreign personal holding company provisions.
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(ii) Priority of categories.
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(B) Hedging transactions.
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(*1*) In general.
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§ 1.954–1 Foreign base company income.

(a) *In general*—(1) *Purpose and scope.* Section 954 and §§ 1.954–1 and 1.954–2 provide rules for computing the foreign base company income of a controlled foreign corporation. Foreign base company income is included in the subpart F income of a controlled foreign corporation under the rules of section 952. Subpart F income is included in the gross income of a United States shareholder of a controlled foreign corporation under the rules of section 951 and thus is subject to current taxation under section 1, 11 or 55 of the Internal Revenue Code. The determination of whether a foreign corporation is a controlled foreign corporation, the subpart F income of which is included currently in the gross income of its United States shareholders, is made under the rules of section 957.

(2) *Gross foreign base company income.* The gross foreign base company income of a controlled foreign corporation consists of the following categories of gross income (determined after the application of section 952(b))—

(i) Foreign personal holding company income, as defined in section 954(c);

(ii) Foreign base company sales income, as defined in section 954(d);

(iii) Foreign base company services income, as defined in section 954(e);

(iv) Foreign base company shipping income, as defined in section 954(f); and

(v) Foreign base company oil related income, as defined in section 954(g).

(3) *Adjusted gross foreign base company income.* The term *adjusted gross foreign base company income* means the gross foreign base company income of a controlled foreign corporation as adjusted by the de minimis and full inclusion rules of paragraph (b) of this section.

(4) *Net foreign base company income.* The term *net foreign base company income* means the adjusted gross foreign base company income of a controlled foreign corporation reduced so as to take account of deductions (including taxes) properly allocable or apportionable to such income under the rules of section 954(b)(5) and paragraph (c) of this section.

(5) *Adjusted net foreign base company income.* The term *adjusted net foreign base company income* means the net foreign base company income of a controlled foreign corporation reduced, first, by any items of net foreign base company income excluded from subpart F income pursuant to section 952(c) and, second, by any items excluded from subpart F income pursuant to the high tax exception of section 954(b). See paragraph (d)(4)(ii) of this section. The term *foreign base company income* as used in the Internal Revenue Code and elsewhere in the Income Tax Regulations means adjusted net foreign base company income, unless otherwise provided.

(6) *Insurance income.* The term *gross insurance income* includes all gross income taken into account in determining insurance income under section 953. The term *adjusted gross insurance income* means gross insurance income as adjusted by the de minimis and full inclusion rules of paragraph (b) of this section. The term *net insurance income* means adjusted gross insurance income reduced under section 953 so as to take into account deductions (including taxes) properly allocable or apportionable to such income. The term *adjusted net insurance income* means net insurance income reduced by any items of net insurance income that are excluded from subpart F income pursuant to section 952(b) or pursuant to the high tax exception of section 954(b). The term *insurance income* as used in subpart F of the Internal Revenue Code and in the regulations under that subpart means adjusted net insurance income, unless otherwise provided.

(7) *Additional items of adjusted net foreign base company income or adjusted net insurance income by reason of section 952(c).* Earnings and profits of the controlled foreign corporation that are recharacterized as foreign base company income or insurance income under section 952(c) are items of adjusted net foreign base company income or adjusted net insurance income, respectively. Amounts subject to recharacterization under section 952(c) are determined after adjusted net foreign base company income and adjusted net insurance income are otherwise determined under subpart F and are not again subject to any exceptions or special rules that would affect the amount of subpart F income. Thus, for example, items of gross foreign base company income or gross insurance income that are excluded from adjusted gross foreign base company income or adjusted gross insurance income because the de minimis test is met are subject to recharacterization under section 952(c). Further, the de minimis and full inclusion tests of paragraph (b)

of this section, and the high tax exception of paragraph (d) of this section, for example, do not apply to such amounts.

(b) *Computation of adjusted gross foreign base company income and adjusted gross insurance income*—(1) *De minimis and full inclusion tests*—(i) *De minimis test*—(A) *In general.* Except as provided in paragraph (b)(1)(i)(C) of this section, adjusted gross foreign base company income and adjusted gross insurance income are equal to zero if the sum of the gross foreign base company income and the gross insurance income of a controlled foreign corporation is less than the lesser of—

(*1*) 5 percent of gross income; or

(*2*) $1,000,000.

(B) *Currency translation.* Controlled foreign corporations having a functional currency other than the United States dollar shall translate the $1,000,000 threshold using the exchange rate provided under section 989(b)(3) for amounts included in income under section 951(a).

(C) *Coordination with sections 864(d) and 881(c).* Adjusted gross foreign base company income or adjusted gross insurance income of a controlled foreign corporation always includes income from trade or service receivables described in section 864(d)(1) or (6), and portfolio interest described in section 881(c), even if the de minimis test of this paragraph (b)(1)(i) is otherwise satisfied.

(ii) *Seventy percent full inclusion test.* Except as provided in section 953, adjusted gross foreign base company income consists of all gross income of the controlled foreign corporation other than gross insurance income and amounts described in section 952(b), and adjusted gross insurance income consists of all gross insurance income other than amounts described in section 952(b), if the sum of the gross foreign base company income and the gross insurance income for the taxable year exceeds 70 percent of gross income. See paragraph (d)(6) of this section, under which certain items of full inclusion foreign base company income may nevertheless be excluded from subpart F income.

(2) *Character of gross income included in adjusted gross foreign base company income.* The gross income included in the adjusted gross foreign base company income of a controlled foreign corporation generally retains its character as foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, or foreign base company oil related income. However, gross income included in adjusted gross foreign base company income because the full inclusion test of paragraph (b)(1)(ii) of this section is met is termed *full inclusion foreign base company income,* and constitutes a separate category of adjusted gross foreign base company income for purposes of allocating and apportioning deductions under paragraph (c) of this section.

(3) *Coordination with section 952(c).* Income that is included in subpart F income because the full inclusion test of paragraph (b)(1)(ii) of this section is met does not reduce amounts that, under section 952(c), are subject to recharacterization.

(4) *Anti-abuse rule*—(i) *In general.* For purposes of applying the de minimis test of paragraph (b)(1)(i) of this section, the income of two or more controlled foreign corporations shall be aggregated and treated as the income of a single corporation if a principal purpose for separately organizing, acquiring, or maintaining such multiple corporations is to prevent income from being treated as foreign base company income or insurance income under the de minimis test. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(ii) *Presumption.* Two or more controlled foreign corporations are presumed to have been organized, acquired or maintained to prevent income from being treated as foreign base company income or insurance income under the de minimis test of paragraph (b)(1)(i) of this section if the corporations are related persons, as defined in paragraph (b)(4)(iii) of this section, and the corporations are described in paragraph (b)(4)(ii)(A), (B), or (C) of this section. This presumption may be rebutted by proof to the contrary.

(A) The activities carried on by the controlled foreign corporations, or the assets used in those activities, are substantially the same activities that were previously carried on, or assets that were previously held, by a single controlled foreign corporation. Further, the United States shareholders of the controlled foreign corporations or related persons (as determined under paragraph (b)(4)(iii) of this section) are substantially the same as the United States shareholders of the one controlled foreign corporation in a prior taxable year. A presumption made in connection with the requirements of this paragraph (b)(4)(ii)(A) may be rebutted by proof that the activities carried on by each controlled foreign corporation would constitute a separate branch under the principles of §1.367(a)–6T(g)(2) if carried on directly by a United States person.

(B) The controlled foreign corporations carry on a business, financial operation, or venture as partners directly or indirectly in a partnership (as defined in section 7701(a)(2) and §301.7701–3 of this chapter) that is a related person (as defined in paragraph (b)(4)(iii) of this section) with respect to each such controlled foreign corporation.

(C) The activities carried on by the controlled foreign corporations would constitute a single branch operation under §1.367(a)–6T(g)(2) if carried on directly by a United States person.

(iii) *Related persons.* For purposes of this paragraph (b), two or more persons are related persons if they are in a relationship described in section 267(b). In determining for purposes of this paragraph (b) whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c). In determining for purposes of this paragraph (b) whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3).

(iv) *Example.* The following example illustrates the application of this paragraph (b)(4).

Example. (i)(1) *USP* is the sole United States shareholder of three controlled foreign corporations: *CFC1, CFC2* and *CFC3.* The three controlled foreign corporations all have the same taxable year. The three controlled foreign corporations are partners in *FP,* a foreign entity classified as a partnership under section 7701(a)(2) and §301.7701–3 of the regulations. For their current taxable years, each of the controlled foreign corporations derives all of its income other than foreign base company income from activities conducted through *FP,* and its foreign base company income from activities conducted both jointly through *FP* and separately without *FP.* Based on the facts in the table below, the foreign base company income derived by each controlled foreign corporation for its current taxable year, including income derived from *FP,* is less than five percent of the gross income of each controlled foreign corporation and is less than $1,000,000:

	CFC1	CFC2	CFC3
Gross income	$4,000,000	$8,000,000	$12,000,000
Five percent of gross income	200,000	400,000	600,000
Foreign base company income	199,000	398,000	597,000

(2) Thus, without the application of the anti-abuse rule of this paragraph (b)(4), each controlled foreign corporation would be treated as having no foreign base company income after the application of the de minimis test of section 954(b)(3)(A) and paragraph (b)(1)(i) of this section.

(ii) However, under these facts, the requirements of paragraph (b)(4)(i) of this section are met unless the presumption of paragraph (b)(4)(ii) of this section is successfully rebutted. The sum of the foreign base company income of the controlled foreign corporations is $1,194,000. Thus, the amount of gross foreign base company income of each controlled foreign corporation will not be reduced by reason of the de minimis rule of section 954(b)(3)(A) and this paragraph (b).

(c) *Computation of net foreign base company income*—(1) *General rule.* The net foreign base company income of a controlled foreign corporation (as defined in paragraph (a)(4) of this section) is computed under the rules of this paragraph (c)(1). The principles of

§ 1.904–5(k) shall apply where payments are made between controlled foreign corporations that are related persons (within the meaning of section 954(d)(3)). Consistent with these principles, only payments described in § 1.954–2(b)(4)(ii)(B)(*2*) may be offset as provided in § 1.904–5(k)(2).

(i) *Deductions against gross foreign base company income.* The net foreign base company income of a controlled foreign corporation is computed first by taking into account deductions in the following manner:

(A) First, the gross amount of each item of income described in paragraph (c)(1)(iii) of this section is determined.

(B) Second, any expenses definitely related to less than all gross income as a class shall be allocated and apportioned under the principles of sections 861, 864 and 904(d) to the gross income described in paragraph (c)(1)(i)(A) of this section.

(C) Third, foreign personal holding company income that is passive within the meaning of section 904 (determined before the application of the high-taxed income rule of § 1.904–4(c)) is reduced by related person interest expense allocable to passive income under § 1.904–5(c)(2); such interest must be further allocated and apportioned to items described in paragraph (c)(1)(iii)(B) of this section.

(D) Fourth, the amount of each item of income described in paragraph (c)(1)(iii) of this section is reduced by other expenses allocable and apportionable to such income under the principles of sections 861, 864 and 904(d).

(ii) *Losses reduce subpart F income by operation of earnings and profits limitation.* Except as otherwise provided in § 1.954–2(g)(4), if after applying the rules of paragraph (c)(1)(i) of this section, the amount remaining in any category of foreign base company income or foreign personal holding company income is less than zero, the loss in that category may not reduce any other category of foreign base company income or foreign personal holding company income except by operation of the earnings and profits limitation of section 952(c)(1).

(iii) *Items of income*—(A) *Income other than passive foreign personal holding company income.* A single item of income (other than foreign personal holding company income that is passive) is the aggregate amount from all transactions that falls within a single separate category (as defined in § 1.904–5(a)(1)), and either—

(*1*) Falls within a single category of foreign personal holding company income as—

(*i*) Dividends, interest, rents, royalties and annuities;

(*ii*) Gain from certain property transactions;

(*iii*) Gain from commodities transactions;

(*iv*) Foreign currency gain; or

(*v*) Income equivalent to interest; or

(*2*) Falls within a single category of foreign base company income, other than foreign personal holding company income, as—

(*i*) Foreign base company sales income;

(*ii*) Foreign base company services income;

(*iii*) Foreign base company shipping income;

(*iv*) Foreign base company oil related income; or

(*v*) Full inclusion foreign base company income.

(B) *Passive foreign personal holding company income.* A single item of foreign personal holding company income that is passive is an amount of income that falls within a single group of passive income under the grouping rules of § 1.904–4(c)(3), (4) and (5) and a single category of foreign personal holding company income described in paragraphs (c)(1)(iii)(A)(*1*) (*i*) through (*v*).

(iv) *Effective date.* Paragraph (c)(1)(i) of this section does not apply to all amounts paid or accrued on or after March 23, 1998 except for amounts paid or accrued pursuant to arrangements entered into before March 23, 1998 and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after March 23, 1998. For rules applicable on or after March 23, 1998, see §1.954–1T(c)(1)(i).

(2) *Computation of net foreign base company income derived from same country insurance income.* Deductions relating to foreign base company income attributable to the issuing (or reinsuring) of any insurance or annuity contract in connection with risks located in the country under the laws of which the controlled foreign corporation is created or organized shall be allocated and apportioned in accordance with the rules set forth in section 953.

(d) *Computation of adjusted net foreign base company income or adjusted net insurance income*—(1) *Application of high tax exception.* Adjusted net foreign base company income (or adjusted net insurance income) equals the net foreign base company income (or net insurance income) of a controlled foreign corporation, reduced by any net item of such income that qualifies for the high tax exception provided by section 954(b)(4) and this paragraph (d). Any item of income that is foreign base company oil related income, as defined in section 954(g), or portfolio interest, as described in section 881(c), does not qualify for the high tax exception. See paragraph (c)(1)(iii) of this section for the definition of the term *item of income.* For rules concerning the treatment for foreign tax credit purposes of amounts excluded from subpart F under section 954(b)(4), see §1.904–4(c). A net item of income qualifies for the high tax exception only if—

(i) An election is made under section 954(b)(4) and paragraph (d)(5) of this section to exclude the income from the computation of subpart F income; and

(ii) It is established that the net item of income was subject to foreign income taxes imposed by a foreign country or countries at an effective rate that is greater than 90 percent of the maximum rate of tax specified in section 11 for the taxable year of the controlled foreign corporation.

(2) *Effective rate at which taxes are imposed.* The effective rate with respect to a net item of income shall be determined separately for each controlled foreign corporation in a chain of corporations through which a distribution is made. The effective rate at which taxes are imposed on a net item of income is—

(i) The United States dollar amount of foreign income taxes paid or accrued (or deemed paid or accrued) with respect to the net item of income, determined under paragraph (d)(3) of this section; divided by

(ii) The United States dollar amount of the net item of foreign base company income or insurance income, described in paragraph (c)(1)(iii) of this section, increased by the amount of foreign income taxes referred to in paragraph (d)(2)(i) of this section.

(3) *Taxes paid or accrued with respect to an item of income*—(i) *Income other than passive foreign personal holding company income.* The amount of foreign income taxes paid or accrued with respect to a net item of income (other than an item of foreign personal holding company income that is passive) for purposes of section 954(b)(4) and this paragraph (d) is the United States dollar amount of foreign income taxes that would be deemed paid under section 960 with respect to that item if that item were included in the gross income of a United States shareholder under section 951(a)(1)(A) (determined, in the case of a United States shareholder that is an individual, as if an election under section 962 has been made, whether or not such election is actually made). For this purpose, in accordance with the regulations under section 960, the amounts that would be deemed paid under section 960 shall be determined separately with respect to each controlled foreign corporation and without regard to the limitation applicable under section 904(a). The amount of foreign income taxes paid or accrued with respect to a net item of income, determined in the manner provided in this paragraph (d), will not be affected by a subsequent reduction in foreign income taxes attributable to a distribution to shareholders of all or part of such income.

(ii) *Passive foreign personal holding company income.* The amount of income taxes paid or accrued with respect to a net item of foreign personal holding company income that is passive for purposes of section 954(b)(4) and this paragraph (d) is the United States dollar amount of foreign income taxes that would be deemed paid under section 960 and that would be taken into account for purposes applying the provisions of § 1.904–4(c) with respect to that net item of income.

(4) *Special rules*—(i) *Consistency rule.* An election to exclude income from the computation of subpart F income for a taxable year must be made consistently with respect to all items of passive foreign personal holding company income eligible to be excluded for the taxable year. Thus, high-taxed passive foreign personal holding company income of a controlled foreign corporation must either be excluded in its entirety, or remain subject to subpart F in its entirety.

(ii) *Coordination with earnings and profits limitation.* If the amount of income included in subpart F income for the taxable year is reduced by the earnings and profits limitation of section 952(c)(1), the amount of income that is a net item of income, within the meaning of paragraph (c)(1)(iii) of this section, is determined after the application of the rules of section 952(c)(1).

(iii) *Example.* The following example illustrates the provisions of paragraph (d)(4)(ii) of this section. All of the taxes referred to in the following example are foreign income taxes. For simplicity, this example assumes that the amount of taxes that are taken into account as a deduction under section 954(b)(5) and the amount of the gross-up required under sections 960 and 78 are equal. Therefore, this example does not separately illustrate the deduction for taxes and gross-up.

Example. During its 1995 taxable year, CFC, a controlled foreign corporation, earns royalty income, net of taxes, of $100 that is foreign personal holding company income. CFC has no expenses associated with this royalty income. CFC pays $50 of foreign income taxes with respect to the royalty income. For 1995, CFC has current earnings and profits of $50. CFC's subpart F income, as determined prior to the application of this paragraph (d), exceeds its current earnings and profits. Thus, under paragraph (d)(4)(ii) of this section, the amount of CFC's only net item of income, the royalty income, will be limited to $50. The remaining $50 will be subject to recharacterization in a subsequent taxable year under section 952(c)(2). Because the amount of foreign income taxes paid with respect to this net item of income is $50, the effective rate of tax on the item, for purposes of this paragraph (d), is 50 percent ($50 of taxes/$50 net item + $50 of taxes). Accordingly, an election under paragraph (d)(5) of this section may be made to exclude the item of income from the computation of subpart F income.

(5) *Procedure.* An election made under the procedure provided by this paragraph (d)(5) is binding on all United States shareholders of the controlled foreign corporation and must be made—

(i) By the controlling United States shareholders, as defined in § 1.964–1(c)(5), by attaching a statement to such effect with their original or amended income tax returns, and including any additional information required by applicable administrative pronouncements; or

(ii) In such other manner as may be prescribed in applicable administrative pronouncements.

(6) *Coordination of full inclusion and high tax exception rules.* Notwithstanding paragraph (b)(1)(ii) of this section, full inclusion foreign base company income will be excluded from subpart F income if more than 90 percent of the adjusted gross foreign base company income and adjusted gross insurance company income of a controlled foreign corporation (determined without regard to the full inclusion test of paragraph (b)(1) of this section) is attributable to net amounts excluded from subpart F income pursuant to an election to have the high tax exception described in section 954(b)(4) and this paragraph (d) apply.

(7) *Examples.* (i) The following examples illustrate the rules of this paragraph (d). All of the taxes referred to in the following examples are foreign income taxes. For simplicity, these examples assume that the amount of taxes that are taken into account as a deduction under section 954(b)(5) and the amount of the gross-up required under sections 960 and 78 are equal. Therefore, these examples do not separately illustrate the deduction for taxes and gross-up. Except as otherwise stated, these examples assume there are no earnings, deficits, or foreign income taxes in the post-1986 pools of earnings and profits or foreign income taxes.

Example 1. (i) *Items of income.* During its 1995 taxable year, controlled foreign corporation *CFC* earns from outside its country of operation portfolio dividend income of $100 and interest income, net of taxes, of $100 (consisting of a gross payment of $150 reduced by a third-country withholding tax of $50). For purposes of illustration, assume that *CFC* incurs no expenses. None of the income is taxed in *CFC*'s country of operation. The dividend income was not subject to third-country withholding taxes. Pursuant to the operation of section 904, the interest income is high withholding tax interest and the dividend income is passive income. Accordingly, pursuant to paragraph (c)(1)(iii) of this section, *CFC* has two net items of income—

(1) $100 of foreign personal holding company (FPHC)/passive income (the dividends); and

(2) $100 of FPHC/high withholding tax income (the interest).

(ii) *Effective rates of tax.* No foreign tax would be deemed paid under section 960 with respect to the net item of income described in paragraph (i)(1) of this *Example 1.* Therefore, the effective rate of foreign tax is 0, and the item may not be excluded from subpart F income under the rules of this paragraph (d). Foreign tax of $50 would be deemed paid under section 960 with respect to the net item of income described in paragraph (i)(2) of this *Example 1.* Therefore, the effective rate of foreign tax is 33 percent ($50 of creditable taxes paid, divided by $150, consisting of the net item of foreign base company income ($100) plus creditable taxes paid thereon ($50)). The highest rate of tax specified in section 11 for the 1995 taxable year is 35 percent. Accordingly, the net item of income described in paragraph (i)(2) of this *Example 1* may be excluded from subpart F income if an election under paragraph (d)(5) of this section is made, since it is subject to foreign tax at an effective rate that is greater than 31.5 percent (90 percent of 35 percent). However, for purposes of section 904(d), it remains high withholding tax interest.

Example 2. (i) The facts are the same as in *Example 1,* except that *CFC*'s country of operation imposes a tax of $50 with respect to *CFC*'s dividend income (and thus *CFC* earns portfolio dividend income, net of taxes, of only $50). The interest income is still high withholding tax interest. The dividend income is still passive income (without regard to the possible applicability of the high tax exception of section 904(d)(2)). Accordingly, *CFC* has two items of income for purposes of this paragraph (d)—

(1) $50 of FPHC/passive income (net of the $50 foreign tax); and

(2) $100 of FPHC/high withholding tax interest income.

(ii) Each item is taxed at an effective rate greater than 31.5 percent. The net item of income described in paragraph (i)(1) of this *Example 2:* foreign tax ($50) divided by sum ($100) of net item of income ($50) plus creditable tax thereon ($50) equals 50 percent. The net item of income described in paragraph (i)(2) of this *Example 2:* foreign tax ($50) divided by sum ($150) of income item ($100) plus creditable tax thereon ($50) equals 33 percent. Accordingly, an election may be made under paragraph (d)(5) of this section to exclude either or both of the net items of income described in paragraphs (i)(1) and (2) of this *Example 2* from subpart F income. If no election is made the items would be included in the subpart F income of *CFC.*

Example 3. (i) The facts are the same as in *Example 1,* except that the $100 of portfolio dividend income is subject to a third-country withholding tax of $50, and the $150 of interest income is from sources within *CFC's* country of operation, is subject to a $10 income tax therein, and is not subject to a withholding tax. Although the interest income and the dividend income are both passive income, under paragraph (c)(1)(iii)(B) of this section they constitute separate items of income pursuant to the application of the grouping rules of § 1.904–4(c). Accordingly, *CFC* has two net items of income for purposes of this paragraph (d)—

(1) $50 (net of $50 tax) of FPHC/non-country of operation/greater than 15 percent withholding tax income; and

(2) $140 (net of $10 tax) of FPHC/country of operation income.

(ii) The item described in paragraph (i)(1) of this *Example 3* is taxed at an effective rate greater than 31.5 percent, but Item 2 is not. The net item of income described in paragraph (i)(1) of this *Example 3:* foreign tax ($50) divided by sum ($100) of net item of income ($50) plus creditable tax thereon ($50) equals 50 percent. The net item of income described in paragraph (i)(2) of this *Example 3:* foreign tax ($10) divided by sum ($150) of net item of income ($140) plus creditable tax thereon ($10) equals 6.67 percent. Therefore, an election may be made under paragraph (d)(5) of this section to exclude the net item of income described in paragraph (i)(1) of this *Example 3* but not the net item of income described in paragraph (i)(2) of this *Example 3* from subpart F income.

Example 4. The facts are the same as in *Example 3,* except that the $150 of interest income is subject to an income tax of $50 in *CFC*'s country of operation. Accordingly, *CFC*'s items of income are the same as in *Example 3,* but both items are taxed at an effective rate greater than 31.5 percent. The net item of income described in paragraph (i)(1) of *Example 3:* foreign tax ($50) divided by sum ($100) of net item of income ($50) plus creditable tax thereon ($50) equals 50 percent. The net item of income described in paragraph (i)(2) of *Example 3:* foreign tax ($50) divided by sum ($150) of net item of income

($100) plus creditable tax thereon ($50) equals 33 percent. Pursuant to the consistency rule of paragraph (d)(4)(i) of this section, an election made by *CFC*'s controlling United States shareholders must exclude from subpart F income both items of FPHC income under the high tax exception of section 954(b)(4) and this paragraph (d). The election may not be made only with respect to one item.

Example 5. The facts are the same as in *Example 1,* except that *CFC* earns $5 of portfolio dividend income and $150 of interest income. In addition, *CFC* earns $45 for performing consulting services within its country of operation for unrelated persons. *CFC*'s gross foreign base company income for 1995 of $155 ($150 of gross interest income and $5 of portfolio dividend income) is greater than 70 percent of its gross income of $200. Therefore, under the full inclusion test of paragraph (b)(1)(ii) of this section, *CFC*'s adjusted gross foreign base company income is $200, and under paragraph (b)(2) of this section, the $45 of consulting income is full inclusion foreign base company income. If *CFC* elects, under paragraph (d)(5) of this section, to exclude the interest income from subpart F income pursuant to the high tax exception, the $45 of full inclusion foreign base company income will be excluded from subpart F income under paragraph (d)(6) of this section because the $150 of gross interest income excluded under the high tax exception is more than 90 percent of *CFC*'s adjusted gross foreign base company income of $155.

(ii) The following examples generally illustrate the application of paragraph (c) of this section and this paragraph (d). *Example 1* illustrates the order of computations. *Example 2* illustrates the computations required by sections 952 and 954 and this § 1.954–1 if the full inclusion test of paragraph (b)(1)(ii) of this section is met and the income is not excluded from subpart F income under section 952(b). Computations in these examples involving the operation of section 952(c) are included for purposes of illustration only and do not provide substantive rules concerning the operation of that section. For simplicity, these examples assume that the amount of taxes that are taken into account as a deduction under section 954(b)(5) and the amount of the gross-up required under sections 960 and 78 are equal. Therefore, these examples do not separately illustrate the deduction for taxes and gross-up.

Example 1. (i) *Gross income. CFC,* a controlled foreign corporation, has gross income of $1000 for the current taxable year. Of that $1000 of income, $100 is interest income that is included in the definition of foreign personal holding company income under section 954(c)(1)(A) and § 1.954–2(b)(1)(ii), is not income from a trade or service receivable described in section 864(d)(1) or (6), or portfolio interest described in section 881(c), and is not excluded from foreign personal holding company income under any provision of section 952(b) or section 954(c). Another $50 is foreign base company sales income under section 954(d). The remaining $850 of gross income is not included in the definition of foreign base company income or insurance income under sections 954 (c), (d), (e), (f) or (g) or 953, and is foreign source general limitation income described in section 904(d)(1)(I).

(ii) *Expenses.* For the current taxable year, *CFC* has expenses of $500. This amount includes $8 of interest paid to a related person that is allocable to foreign personal holding company income under section 904, and $2 of other expense that is directly related to foreign personal holding company income. Another $20 of expense is directly related to foreign base company sales. The remaining $470 of expenses is allocable to general limitation income that is not foreign base company income or insurance income.

(iii) *Earnings and losses. CFC* has earnings and profits for the current taxable year of $500. In the prior taxable year, *CFC* had losses with respect to income other than gross foreign base company income or gross insurance income. By reason of the limitation provided under section 952(c)(1)(A), those losses reduced the subpart F income (consisting entirely of foreign source general limitation income) of *CFC* by $600 for the prior taxable year.

(iv) *Taxes.* Foreign income tax of $30 is considered imposed on the interest income under the rules of section 954(b)(4), this paragraph (d), and § 1.904–6. Foreign income tax of $14 is considered imposed on the foreign base company sales income under the rules of section 954(b)(4), paragraph (d) of this section, and § 1.904–6. Foreign income tax of $177 is considered imposed on the remaining foreign source general limitation income under the rules of section 954(b)(4), this paragraph (d), and § 1.904–6. For the taxable year of *CFC,* the maximum United States rate of taxation under section 11 is 35 percent.

(v) *Conclusion.* Based on these facts, if CFC elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and this paragraph (d), it will have $500 of subpart F income as defined in section 952(a) (consisting entirely of foreign source general limitation income) determined as follows:

Step 1—Determine gross income:

(1) Gross income	$1000

Step 2—Determine gross foreign base company income and gross insurance income:

(2) Interest income included in gross foreign personal holding company income under section 954(c)	100
(3) Gross foreign base company sales income under section 954(d)	50
(4) Total gross foreign base company income and gross insurance income as defined in sections 954 (c), (d), (e), (f) and (g) and 953 (line (2) plus line (3))	150
Step 3—Compute adjusted gross foreign base company income and adjusted gross insurance income:	
(5) Five percent of gross income (.05 × line (1))	50
(6) Seventy percent of gross income (.70 × line (1))	700
(7) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the de minimis test of paragraph (b) (line (4), or zero if line (4) is less than the lesser of line (5) or $1,000,000) (if the amount on this line 7 is zero, proceed to Step 8)	150
(8) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the full inclusion test of paragraph (b) (line (4), or line (1) if line (4) is greater than line (6))	150
Step 4—Compute net foreign base company income:	
(9) Expenses directly related to adjusted gross foreign base company sales income	20
(10) Expenses (other than related person interest expense) directly related to adjusted gross foreign personal holding company income	2
(11) Related person interest expense allocable to adjusted gross foreign personal holding company income under section 904	8
(12) Net foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (2) reduced by lines (10) and (11))	90
(13) Net foreign base company sales income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (3) reduced by line (9))	30
(14) Total net foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (12) plus line (13))	120
Step 5—Compute net insurance income:	
(15) Net insurance income under section 953	0
Step 6—Compute adjusted net foreign base company income:	
(16) Foreign income tax imposed on net foreign personal holding company income (as determined under section 954(b)(4) and this paragraph (d))	30
(17) Foreign income tax imposed on net foreign base company sales income (as determined under section 954(b)(4) and this paragraph (d))	14
(18) Ninety percent of the maximum United States corporate tax rate	31.5%
(19) Effective rate of foreign income tax imposed on net foreign personal holding company income ($90 of interest) under section 954(b)(4) and this paragraph (d) (line (16) divided by line (12))	33%
(20) Effective rate of foreign income tax imposed on $30 of net foreign base company sales income under section 954(b)(4) and this paragraph (d) (line (17) divided by line (13))	47%
(21) Net foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (12) if line (19) is greater than line (18))	90
(22) Net foreign base company sales income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (13) if line (20) is greater than line (18))	30
(23) Adjusted net foreign base company income after applying section 954(b)(4) and this paragraph (d) (line (14), reduced by the sum of line (21) and line (22))	0
Step 7—Compute adjusted net insurance income:	
(24) Adjusted net insurance income	0
Step 8—Additions to or reduction of adjusted net foreign base company income by reason of section 952(c):	
(25) Earnings and profits for the current year	500
(26) Amount subject to being recharacterized as subpart F income under section 952(c)(2) (excess of line (25) over the sum of lines (23) and (24)); if there is a deficit, then the limitation of section 952(c)(1) may apply for the current year	500
(27) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1)	600

(28) Subpart F income as defined in section 952(a), assuming section 952(a)(3), (4), and (5) do not apply (the sum of line (23), line (24), and the lesser of line (26) or line (27))	500
(29) Amount of prior year's deficit to be recharacterized as subpart F income in later years under section 952(c) (excess of line (27) over line (26))	100

Example 2. (i) *Gross income. CFC,* a controlled foreign corporation, has gross income of $1000 for the current taxable year. Of that $1000 of income, $720 is interest income that is included in the definition of foreign personal holding company income under section 954(c)(1)(A) and § 1.954–2(b)(1)(ii), is not income from trade or service receivables described in section 864(d)(1) or (6), or portfolio interest described in section 881(c), and is not excluded from foreign personal holding company income under any provision of section 954(c) and § 1.954–2 or section 952(b). The remaining $280 is services income that is not included in the definition of foreign base company income or insurance income under sections 954 (c), (d), (e), (f), or (g) or 953, and is foreign source general limitation income for purposes of section 904(d)(1)(I).

(ii) *Expenses.* For the current taxable year, *CFC* has expenses of $650. This amount includes $350 of interest paid to related persons that is allocable to foreign personal holding company income under section 904, and $50 of other expense that is directly related to foreign personal holding company income. The remaining $250 of expenses is allocable to services income other than foreign base company income or insurance income.

(iii) *Earnings and losses. CFC* has earnings and profits for the current taxable year of $350. In the prior taxable year, *CFC* had losses with respect to income other than foreign base company income or insurance income. By reason of the limitation provided under section 952(c)(1)(A), those losses reduced the subpart F income of *CFC* (consisting entirely of foreign source general limitation income) by $600 for the prior taxable year.

(iv) *Taxes.* Foreign income tax of $120 is considered imposed on the $720 of interest income under the rules of section 954(b)(4), paragraph (d) of this section, and § 1.904–6. Foreign income tax of $2 is considered imposed on the services income under the rules of section 954(b)(4), paragraph (d) of this section, and § 1.904–6. For the taxable year of *CFC,* the maximum United States rate of taxation under section 11 is 35 percent.

(v) *Conclusion.* Based on these facts, if *CFC* elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and this paragraph (d), it will have $350 of subpart F income as defined in section 952(a), determined as follows.

Step 1—Determine gross income:	
(1) Gross income	$1000
Step 2—Determine gross foreign base company income and gross insurance income:	
(2) Gross foreign base company income and gross insurance income as defined in sections 954 (c), (d), (e), (f) and (g) and 953 (interest income)	720
Step 3—Compute adjusted gross foreign base company income and adjusted gross insurance income:	
(3) Seventy percent of gross income (.70 × line (1))	700
(4) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the full inclusion rule of this paragraph (b)(1) (line (2), or line (1) if line (2) is greater than line (3))	1000
(5) Full inclusion foreign base company income under paragraph (b)(1)(ii) (line (4) minus line (2))	280
Step 4—Compute net foreign base company income:	
(6) Expenses (other than related person interest expense) directly related to adjusted gross foreign personal holding company income	50
(7) Related person interest expense allocable to adjusted gross foreign personal holding company income under section 904	350
(8) Deductions allocable to full inclusion foreign base company income under section 954(b)(5) and paragraph (c) of this section	250
(9) Net foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (2) reduced by line (6) and line (7))	320
(10) Full inclusion foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (5) reduced by line (8))	30
(11) Total net foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (9) plus line (10))	350
Step 5—Compute net insurance income:	
(12) Net insurance income under section 953	0
Step 6—Compute adjusted net foreign base company income:	
(13) Foreign income tax imposed on net foreign personal holding company income (interest)	120

(14) Foreign income tax imposed on net full inclusion foreign base company income	2
(15) Ninety percent of the maximum United States corporate tax rate	31.5%
(16) Effective rate of foreign income tax imposed on $320 of net foreign personal holding company income under section 954(b)(4) and this paragraph (d) (line (13) divided by line (9))	38%
(17) Effective rate of foreign income tax imposed on $30 of net full inclusion foreign base company income under section 954(b)(4) and this paragraph (d) (line (14) divided by line (10))	7%
(18) Net foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (9) if line (16) is greater than line (15))	320
(19) Net full inclusion foreign base company income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (10) if line (17) is greater than line (15))	0
(20) Adjusted net foreign base company income after applying section 954(b)(4) and this paragraph (d) (line (11) reduced by the sum of line (18) and line (19))	30
Step 7—Compute adjusted net insurance income:	
(21) Adjusted net insurance income	0
Step 8—Reduction of adjusted net foreign base company income or adjusted net insurance income by reason of paragraph (d)(6) of this section:	
(22) Adjusted gross foreign base company income and adjusted gross insurance income (determined without regard to the full inclusion test of paragraph (b)(1) of this section) (line (4) reduced by line (5))	720
(23) Ninety percent of adjusted gross foreign base company income and adjusted gross insurance income (determined without regard to the full inclusion test of paragraph (b)(1)(ii) of this section) (90% of the amount on line (22))	648
(24) Net foreign base company income and net insurance income excluded from subpart F income under section 954(b)(4), increased by the amount of expenses that reduced this income under section 954(b)(5) and paragraph (c) of this section (line (18) increased by the sum of line (6) and line (7))	720
(25) Adjusted net full inclusion foreign base company income excluded from subpart F income under paragraph (d)(6) of this section (zero, or line (10) reduced by line (19) if line (24) is greater than line (23))	30
(26) Adjusted net foreign base company income after application of paragraph (d)(6) of this section (line (20) reduced by line (25))	0
Step 9—Additions to or reduction of subpart F income by reason of section 952(c):	
(27) Earnings and profits for the current year	350
(28) Amount subject to being recharacterized as subpart F income under section 952(c)(2) (excess of line (27) over the sum of line (21) and line (26)); if there is a deficit, then the limitation of 952(c)(1) may apply for the current year	350
(29) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1)	600
(30) Subpart F income as defined in section 952(a), assuming section 952(a)(3), (4), and (5) do not apply (the sum of line (21) and line (26) plus the lesser of line (28) or line (29))	350
(31) Amount of prior years' deficit remaining to be recharacterized as subpart F income in later years under section 952(c) (excess of line (29) over line (28))	250

(e) *Character of income*—(1) *Substance of the transaction.* For purposes of section 954, income shall be characterized in accordance with the substance of the transaction, and not in accordance with the designation applied by the parties to the transaction. For example, an amount that is designated as rent by the taxpayer but actually constitutes income from the sale of property, royalties, or income from services shall not be characterized as rent but shall be characterized as income from the sale of property, royalties or income from services, as the case may be. Local law shall not be controlling in characterizing income.

(2) *Separable character.* To the extent the definitional provisions of section 953 or 954 describe the income or gain derived from a transaction, or any portion or portions thereof, that income or gain, or portion or portions thereof,

is so characterized for purposes of subpart F. Thus, a single transaction may give rise to income in more than one category of foreign base company income described in paragraph (a)(2) of this section. For example, if a controlled foreign corporation, in its business of purchasing personal property and selling it to related persons outside its country of incorporation, also performs services outside its country of incorporation with respect to the property it sells, the sales income will be treated as foreign base company sales income and the services income will be treated as foreign base company services income for purposes of these rules.

(3) *Predominant character.* The portion of income or gain derived from a transaction that is included in the computation of foreign personal holding company income is always separately determinable and thus must always be segregated from other income and separately classified under paragraph (e)(2) of this section. However, the portion of income or gain derived from a transaction that would meet a particular definitional provision under section 954 or 953 (other than the definition of foreign personal holding company income) in unusual circumstances may not be separately determinable. If such portion is not separately determinable, it must be classified in accordance with the predominant character of the transaction. For example, if a controlled foreign corporation engineers, fabricates, and installs a fixed offshore drilling platform as part of an integrated transaction, and the portion of income that relates to services is not accounted for separately from the portion that relates to sales, and is otherwise not separately determinable, then the classification of income from the transaction shall be made in accordance with the predominant character of the arrangement.

(4) *Coordination of categories of gross foreign base company income or gross insurance income*—(i) *In general.* The computations of gross foreign base company income and gross insurance income are limited by the following rules:

(A) If income is foreign base company shipping income, pursuant to section 954(f), it shall not be considered insurance income or income in any other category of foreign base company income.

(B) If income is foreign base company oil related income, pursuant to section 954(g), it shall not be considered insurance income or income in any other category of foreign base company income, except as provided in paragraph (e)(4)(i)(A) of this section.

(C) If income is insurance income, pursuant to section 953, it shall not be considered income in any category of foreign base company income except as provided in paragraph (e)(4)(i)(A) or (B) of this section.

(D) If income is foreign personal holding company income, pursuant to section 954(c), it shall not be considered income in any other category of foreign base company income, other than as provided in paragraph (e)(4)(i)(A), (B) or (C) of this section.

(ii) *Income excluded from other categories of gross foreign base company income.* Income shall not be excluded from a category of gross foreign base company income or gross insurance income under this paragraph (e)(4) by reason of being included in another category of gross foreign base company income or gross insurance income, if the income is excluded from that other category by a more specific provision of section 953 or 954. For example, income derived from a commodity transaction that is excluded from foreign personal holding company income under § 1.954–2(f) as income from a qualified active sale may be included in gross foreign base company income if it also meets the definition of foreign base company sales income. See § 1.954–2(a)(2) for the coordination of overlapping categories within the definition of foreign personal holding company income.

(f) *Definition of related person*—(1) *Persons related to controlled foreign corporation.* Unless otherwise provided, for purposes of section 954 and §§ 1.954–1 through 1.954–8 inclusive, the following persons are considered under section 954(d)(3) to be related persons with respect to a controlled foreign corporation:

(i) *Individuals.* An individual, whether or not a citizen or resident of the

United States, who controls the controlled foreign corporation.

(ii) *Other persons.* A foreign or domestic corporation, partnership, trust or estate that controls or is controlled by the controlled foreign corporation, or is controlled by the same person or persons that control the controlled foreign corporation.

(2) *Control*—(i) *Corporations.* With respect to a corporation, control means the ownership, directly or indirectly, of stock possessing more than 50 percent of the total voting power of all classes of stock entitled to vote or of the total value of the stock of the corporation.

(ii) *Partnerships.* With respect to a partnership, control means the ownership, directly or indirectly, of more than 50 percent (by value) of the capital or profits interest in the partnership.

(iii) *Trusts and estates.* With respect to a trust or estate, control means the ownership, directly or indirectly, of more than 50 percent (by value) of the beneficial interest in the trust or estate.

(iv) *Direct or indirect ownership.* For purposes of this paragraph (f), to determine direct or indirect ownership, the principles of section 958 shall be applied without regard to whether a corporation, partnership, trust or estate is foreign or domestic or whether or not an individual is a citizen or resident of the United States.

[T.D. 8618, 60 FR 46509, Sept. 7, 1995; 60 FR 62024, 62025, Dec. 4, 1995, as amended by T.D. 8704, 62 FR 20, Jan. 2, 1997; T.D. 8767, 63 FR 14615, Mar. 26, 1998]

§1.954–1T Foreign base company income (temporary).

(a) through (c)(1)(i) [Reserved]. For further guidance, see §1.954–1(a) through (c)(1).

(c)(1)(i) *Deductions against gross foreign base company income*—(A) *In general.* [Reserved]. For further guidance, see §1.954–1(c)(1)(i).

(B) *Special rule for deductible payments to certain non-fiscally transparent entities.* Notwithstanding any other provision of this section, except as provided in paragraph (c)(1)(i)(C) of this section, an expense (including a distributive share of any expense) that would otherwise be allocable under section 954(b)(5) against the subpart F income of a controlled foreign corporation shall not be allocated against subpart F income of the controlled foreign corporation resulting from the payment giving rise to the expense if—

(*1*) Such expense arises from a payment between the controlled foreign corporation and a partnership in which the controlled foreign corporation is a partner and the partnership is not regarded as fiscally transparent, as defined in §1.954–9T(a)(7), by any country in which the controlled foreign corporation does business or has substantial assets; and

(*2*) The payment from which the expense arises would have met the foreign tax reduction test of §1.954–9T(a)(3) and the tax disparity test of §1.954–9T(a)(5)(iv) if those provisions had been applicable to the payment.

(C) *Limitations.* Paragraph (c)(1)(i)(B) shall not apply to the extent that the controlled foreign corporation partner has no income against which to allocate the expense, other than its distributive share of a payment described in paragraph (c)(1)(i)(B) of this section. Similarly, to the extent an expense described in paragraph (c)(1)(i)(B) of this section exceeds the controlled foreign corporation partner's distributive share of the payment from which the expense arises, such excess amount of the expense may reduce subpart F income (other than such payment) to which it is properly allocable or apportionable under section 954(b)(5).

(D) *Example.* The following example illustrates the application of paragraph (c)(1)(i)(B) and (C) of this section:

Example. CFC, a controlled foreign corporation in Country A, is a 70 percent partner in partnership P, located in Country B. Country A's tax laws do not classify P as a fiscally transparent entity. The rate of tax in country B is 15 percent of the tax rate in country A. P loans $100 to CFC at a market rate of interest. In year 1, CFC pays P $10 of interest on the loan. The interest payment would have caused the recharacterization rules of §1.954–9T to apply if the payment were made between the entities described in §1.954–9T(a)(2). CFC's distributive share of P's interest income is $7, which is foreign personal holding company income to CFC under section 954(c). Under paragraph (c)(1)(i)(B) of this section, $7 of the $10 interest expense may not be allocated against any of CFC's subpart F income. However, to the extent the remaining $3 of interest expense is properly allocable to subpart F income of CFC other than its distributive share of P's interest income, this expense may offset such other subpart F income.

(E) *Effective date.* Paragraph (c)(1)(i)(B), (C) and (D) of this section shall apply to all amounts paid or accrued on or after March 23, 1998, except for amounts paid or accrued pursuant to arrangements entered into before March 23, 1998 and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after March 23, 1998. For rules applicable to amounts paid or accrued pursuant to arrangements entered into before March 23, 1998, see §1.954–1.

(c)(1)(ii) through (f) [Reserved]. For further guidance, see §1.954–1(c)(1)(ii) through (f).

[T.D. 8767, 63 FR 14616, Mar. 26, 1998]

§1.954–2 Foreign personal holding company income.

(a) *Computation of foreign personal holding company income*—(1) *Categories of foreign personal holding company income.* For purposes of subpart F and the regulations under that subpart, foreign personal holding company income consists of the following categories of income—

(i) Dividends, interest, rents, royalties, and annuities as described in paragraph (b) of this section;

(ii) Gain from certain property transactions as described in paragraph (e) of this section;

(iii) Gain from commodities transactions as described in paragraph (f) of this section;

(iv) Foreign currency gain as described in paragraph (g) of this section; and

(v) Income equivalent to interest as described in paragraph (h) of this section.

(2) *Coordination of overlapping categories under foreign personal holding company provisions*—(i) *In general.* If any portion of income, gain or loss from a transaction is described in more than one category of foreign personal holding company income (as described in paragraph (a)(2)(ii) of this section), that portion of income, gain or loss is treated solely as income, gain or loss from the category of foreign personal holding company income with the highest priority.

(ii) *Priority of categories.* The categories of foreign personal holding company income, listed from highest priority (paragraph (a)(2)(ii)(A) of this section) to lowest priority (paragraph (a)(2)(ii)(E) of this section), are—

(A) Dividends, interest, rents, royalties, and annuities, as described in paragraph (b) of this section;

(B) Income equivalent to interest, as described in paragraph (h) of this section without regard to the exceptions in paragraph (h)(1)(ii)(A) of this section;

(C) Foreign currency gain or loss, as described in paragraph (g) of this section without regard to the exclusion in paragraph (g)(2)(ii) of this section;

(D) Gain or loss from commodities transactions, as described in paragraph (f) of this section without regard to the exclusion in paragraph (f)(1)(ii) of this section; and

(E) Gain or loss from certain property transactions, as described in paragraph (e) of this section without regard to the exceptions in paragraph (e)(1)(ii) of this section.

(3) *Changes in the use or purpose for which property is held*—(i) *In general.* Under paragraphs (e), (f), (g) and (h) of this section, transactions in certain property give rise to gain or loss included in the computation of foreign personal holding company income if the controlled foreign corporation holds that property for a particular use or purpose. The use or purpose for which property is held is that use or purpose for which it was held for more than one- half of the period during which the controlled foreign corporation held the property prior to the disposition.

(ii) *Special rules*—(A) *Anti-abuse rule.* If a principal purpose of a change in use or purpose of property was to avoid including gain or loss in the computation of foreign personal holding company income, all the gain or loss from the disposition of the property is treated as foreign personal holding company income. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(B) *Hedging transactions.* The provisions of paragraph (a)(3)(i) of this section shall not apply to bona fide hedging transactions, as defined in paragraph (a)(4)(ii) of this section. A transaction will be treated as a bona fide hedging transaction only so long as it satisfies the requirements of paragraph (a)(4)(ii) of this section.

(iii) *Example.* The following example illustrates the application of this paragraph (a)(3).

Example. At the beginning of taxable year 1, *CFC*, a controlled foreign corporation, purchases a building for investment. During taxable years 1 and 2, *CFC* derives rents from the building that are included in the computation of foreign personal holding company income under paragraph (b)(1)(iii) of this section. At the beginning of taxable year 3, *CFC* changes the use of the building by terminating all leases and using it in an active trade or business. At the beginning of taxable year 4, *CFC* sells the building at a gain. The building was not used in an active trade or business of *CFC* for more than one-half of the period during which it was held by *CFC*. Therefore, the building is considered to be property that gives rise to rents, as described in paragraph (e)(2) of this section, and gain from the sale is included in the computation of *CFC*'s foreign personal holding company income under paragraph (e) of this section.

(4) *Definitions and special rules.* The following definitions and special rules apply for purposes of computing foreign personal holding company income under this section.

(i) *Interest.* The term *interest* includes all amounts that are treated as interest income (including interest on a tax-exempt obligation) by reason of the Internal Revenue Code or Income Tax Regulations or any other provision of law. For example, interest includes stated interest, acquisition discount, original issue discount, de minimis original issue discount, market discount, de minimis market discount, and unstated interest, as adjusted by any amortizable bond premium or acquisition premium.

(ii) *Bona fide hedging transaction*—(A) *Definition.* The term *bona fide hedging transaction* means a transaction that meets the requirements of §1.1221–2 (a) through (c) and that is identified in accordance with the requirements of paragraph (a)(4)(ii)(B) of this section, except that in applying §1.1221–2(b)(1), the risk being hedged may be with respect to ordinary property, section 1231 property, or a section 988 transaction. A transaction that hedges the liabilities, inventory or other assets of a related person (as defined in section 954(d)(3)), that is entered into to assume or reduce risks of a related person, or that is entered into by a person other than a person acting in its capacity as a regular dealer (as defined in paragraph (a)(4)(iv) of this section) to reduce risks assumed from a related person, will not be treated as a bona fide hedging transaction. For an illustration of how this rule applies with respect to foreign currency transactions, see paragraph (g)(2)(ii)(D) of this section.

(B) *Identification.* The identification requirements of this section shall be satisfied if the taxpayer meets the identification and recordkeeping requirements of §1.1221–2(e). However, for bona fide hedging transactions entered into prior to March 7, 1996 the identification and recordkeeping requirements of §1.1221–2 shall not apply. Rather, for bona fide hedging transactions entered into on or after July 22, 1988 and prior to March 7, 1996 the identification and recordkeeping requirements shall be satisfied if such transactions are identified by the close of the fifth day after the day on which they are entered into. For bona fide hedging transactions entered into prior to July 22, 1988, the identification and recordkeeping requirements shall be satisfied if such transactions are identified reasonably contemporaneously with the date they are entered into, but no later than within the normal period prescribed under the method of accounting of the controlled foreign corporation used for financial reporting purposes.

(C) *Effect of identification and non-identification*—(*1*) *Transactions identified.* If a taxpayer identifies a transaction as a bona fide hedging transaction for purposes of this section, the identification is binding with respect to any loss arising from such transaction whether or not all of the requirements of paragraph (a)(4)(ii)(A) of this section are satisfied. Accordingly, such loss will be allocated against income that is not subpart F income (or, in the case of an election under paragraph (g)(3) of this section, against the category of subpart F income to which it relates) and apportioned among the categories of income described in section 904(d)(1). If the transaction is not in fact a bona fide hedging transaction described in paragraph (a)(4)(ii)(A) of this section, however, then any gain realized with respect to such transaction shall not be considered as gain from a bona fide hedging transaction. Accordingly, such gain shall be treated as gain from the appropriate category of foreign personal holding company income. Thus, the taxpayer's identification of the transaction as a hedging transaction does not itself operate to exclude gain from the appropriate category of foreign personal holding company income.

(*2*) *Inadvertent identification.* Notwithstanding paragraph (a)(4)(ii)(C)(*1*) of this section, if the taxpayer identifies a transaction as a bona fide hedging transaction for purposes of this section, the characterization of the loss is determined as if the transaction had not been identified as a bona fide hedging transaction if—

(*i*) The transaction is not a bona fide hedging transaction (as defined in paragraph (a)(4)(ii)(A) of this section);

(*ii*) The identification of the transaction as a bona fide hedging transaction was due to inadvertent error; and

(*iii*) All of the taxpayer's transactions in all open years are being treated on either original or, if necessary, amended returns in a manner consistent with the principles of this section.

(*3*) *Transactions not identified.* Except as provided in paragraphs (a)(4)(ii)(C)(*4*) and (*5*) of this section, the absence of an identification that satisfies the requirements of paragraph (a)(4)(ii)(B) of this section is binding and establishes that a transaction is not a bona fide hedging transaction. Thus, subject to the exceptions, the characterization of gain or loss is determined without reference to whether the transaction is a bona fide hedging transaction.

(*4*) *Inadvertent error.* If a taxpayer does not make an identification that satisfies the requirements of paragraph (a)(4)(ii)(B) of this section, the taxpayer may treat gain or loss from the transaction as gain or loss from a bona fide hedging transaction if—

(*i*) The transaction is a bona fide hedging transaction (as defined in paragraph (a)(4)(ii)(A) of this section);

(*ii*) The failure to identify the transaction was due to inadvertent error; and

(*iii*) All of the taxpayer's bona fide hedging transactions in all open years are being treated on either original or, if necessary, amended returns as bona fide hedging transactions in accordance with the rules of this section.

(*5*) *Anti-abuse rule.* If a taxpayer does not make an identification that satisfies all the requirements of paragraph (a)(4)(ii)(B) of this section but the taxpayer has no reasonable grounds for treating the transaction as other than a bona fide hedging transaction, then loss from the transaction shall be treated as realized with respect to a bona fide hedging transaction. Thus, a taxpayer may not elect to exclude loss from its proper characterization as a bona fide hedging transaction. The reasonableness of the taxpayer's failure to identify a transaction is determined by taking into consideration not only the requirements of paragraph (a)(4)(ii)(A) of this section but also the taxpayer's treatment of the transaction for financial accounting or other purposes and the taxpayer's identification of similar transactions as hedging transactions.

(iii) *Inventory and similar property*—(A) *Definition.* The term *inventory and similar property* (or *inventory or similar property*) means property that is stock in trade of the controlled foreign corporation or other property of a kind that would properly be included in the inventory of the controlled foreign corporation if on hand at the close of the taxable year (if the controlled foreign corporation were a domestic corporation), or property held by the controlled foreign corporation primarily for sale to customers in the ordinary course of its trade or business.

(B) *Hedging transactions.* A bona fide hedging transaction with respect to inventory or similar property (other than a transaction described in section 988(c)(1) without regard to section 988(c)(1)(D)(i)) shall be treated as a transaction in inventory or similar property.

(iv) *Regular dealer.* The term *regular dealer* means a controlled foreign corporation that—

(A) Regularly and actively offers to, and in fact does, purchase property from and sell property to customers who are not related persons (as defined in section 954(d)(3)) with respect to the controlled foreign corporation in the ordinary course of a trade or business; or

(B) Regularly and actively offers to, and in fact does, enter into, assume, offset, assign or otherwise terminate positions in property with customers who are not related persons (as defined in section 954(d)(3)) with respect to the controlled foreign corporation in the ordinary course of a trade or business.

(v) *Dealer property*—(A) *Definition.* Property held by a controlled foreign corporation is *dealer property* if—

(*1*) The controlled foreign corporation is a regular dealer in property of such kind (determined under paragraph (a)(4)(iv) of this section); and

(*2*) The property is held by the controlled foreign corporation in its capacity as a dealer in property of such kind without regard to whether the property arises from a transaction with a related person (as defined in section 954(d)(3)) with respect to the controlled foreign corporation. The property is not held by the controlled foreign corporation in its capacity as a dealer if the property is held for investment or speculation on its own behalf or on behalf of a related person (as defined in section 954(d)(3)).

(B) *Securities dealers.* If a controlled foreign corporation is a licensed securities dealer, only the securities that it has identified as held for investment in accordance with the provisions of section 475(b) or section 1236 will be considered to be property held for investment or speculation under this section. A licensed securities dealer is a controlled foreign corporation that is both a securities dealer, as defined in section 475, and a regular dealer, as defined in paragraph (a)(4)(iv) of this section, and that is either—

(*1*) Registered as a securities dealer under section 15(a) of the Securities Exchange Act of 1934 or as a Government securities dealer under section 15C(a) of such Act; or

(*2*) Licensed or authorized in the country in which it is chartered, incorporated, or organized to purchase and sell securities from or to customers who are residents of that country. The conduct of such securities activities must be subject to bona fide regulation, including appropriate reporting, monitoring, and prudential (including capital adequacy) requirements, by a securities regulatory authority in that country that regularly enforces compliance with such requirements and prudential standards.

(C) *Hedging transactions.* A bona fide hedging transaction with respect to dealer property shall be treated as a transaction in dealer property.

(vi) *Examples.* The following examples illustrate the application of paragraphs (a)(4)(ii), (iv) and (v) of this section.

Example 1. (i) *CFC1* and *CFC2* are related controlled foreign corporations (within the meaning of section 954(d)(3)) located in Countries F and G, respectively. *CFC1* and *CFC2* regularly purchase securities from and sell securities to customers who are not related persons with respect to *CFC1* or *CFC2* (within the meaning of section 954(d)(3)) in the ordinary course of their businesses and regularly and actively hold themselves out as being willing to, and in fact do, enter into either side of options, forward contracts, or other financial instruments. *CFC1* uses securities that are traded in securities markets in Country G to hedge positions that it enters into with customers located in Country F. *CFC1* is not a member of a securities exchange in Country G, so it purchases such securities from *CFC2* and unrelated persons that are registered as securities dealers in Country G and that are members of Country G securities exchanges. Such hedging transactions qualify as bona fide hedging transactions under paragraph (a)(4)(ii) of this section.

(ii) Transactions that *CFC1* and *CFC2* enter into with each other do not affect the determination of whether they are regular dealers. Because *CFC1* and *CFC2* regularly purchase securities from and sell securities to customers who are not related persons within the meaning of section 954(d)(3) in the ordinary course of their businesses and regularly and actively hold themselves out as being willing to, and in fact do, enter into either side of options, forward contracts, or other financial instruments, however, they qualify as regular dealers in such property within the meaning of paragraph (a)(4)(iv) of this section. Moreover, because *CFC1* purchases securities from *CFC2* as bona fide hedging transactions with respect to dealer property, the securities are dealer property under paragraph (a)(4)(v)(C) of this section. Similarly, because *CFC2* sells securities to *CFC1* in the ordinary course of its business as a dealer, the securities are dealer property under paragraph (a)(4)(v)(A) of this section.

Example 2. (i) *CFC* is a controlled foreign corporation located in Country B. *CFC* serves as the currency coordination center for the controlled group, aggregating currency risks incurred by the group and entering into hedging transactions that transfer those risks outside of the group. *CFC* regularly and actively holds itself out as being willing to, and in fact does, enter into either side of options, forward contracts, or other financial instruments with other members of the same controlled group. *CFC* hedges risks arising from such transactions by entering into transactions with persons who are not related persons (within the meaning of section 954(d)(3)) with respect to *CFC*. However, *CFC* does not regularly and actively hold itself out as being willing to, and does not, enter into either side of transactions with unrelated persons.

(ii) *CFC* is not a regular dealer in property under paragraph (a)(4)(iv) of this section and its options, forwards, and other financial instruments are not dealer property within the meaning of paragraph (a)(4)(v) of this section.

(vii) *Debt instrument.* The term *debt instrument* includes bonds, debentures, notes, certificates, accounts receivable, and other evidences of indebtedness.

(b) *Dividends, interest, rents, royalties, and annuities*—(1) *In general.* Foreign personal holding company income includes—

(i) Dividends, except certain dividends from related persons as described in paragraph (b)(4) of this section and distributions of previously taxed income under section 959(b);

(ii) Interest, except export financing interest as defined in paragraph (b)(2) of this section and certain interest received from related persons as described in paragraph (b)(4) of this section;

(iii) Rents and royalties, except certain rents and royalties received from related persons as described in paragraph (b)(5) of this section and rents and royalties derived in the active conduct of a trade or business as defined in paragraph (b)(6) of this section; and

(iv) Annuities.

(2) *Exclusion of certain export financing interest*—(i) *In general.* Foreign personal holding company income does not include interest that is export financing interest. The term *export financing interest* means interest that is derived in the conduct of a banking business and is export financing interest as defined in section 904(d)(2)(G). Solely for purposes of determining whether interest is export financing interest, property is treated as manufactured, produced, grown, or extracted in the United States if it is so treated under § 1.927(a)–1T(c).

(ii) *Exceptions.* Export financing interest does not include income from related party factoring that is treated as interest under section 864(d)(1) or (6) after the application of section 864(d)(7).

(iii) *Conduct of a banking business.* For purposes of this section, export financing interest is considered derived in the conduct of a banking business if, in connection with the financing from which the interest is derived, the corporation, through its own officers or staff of employees, engages in all the activities in which banks customarily engage in issuing and servicing a loan.

(iv) *Examples.* The following examples illustrate the application of this paragraph (b)(2).

Example 1. (i) *DS*, a domestic corporation, manufactures property in the United States. In addition to selling inventory (property described in section 1221(1)), *DS* occasionally sells depreciable equipment it manufactures for use in its trade or business, which is property described in section 1221(2). Less than 50 percent of the fair market value, determined in accordance with section 904(d)(2)(G), of each item of inventory or equipment sold by *DS* is attributable to products imported into the United States. *CFC*, a controlled foreign corporation with respect to which *DS* is a related person (within the meaning of section 954(d)(3)), provides loans described in section 864(d)(6) to unrelated persons for the purchase of property from *DS*. This property is purchased exclusively for use or consumption outside the United States and outside *CFC*'s country of incorporation.

(ii) If, in issuing and servicing loans made with respect to purchases from *DS* of depreciable equipment used in its trade or business, which is property described in section 1221(2) in the hands of *DS, CFC* engages in all the activities in which banks customarily engage in issuing and servicing loans, the interest accrued from these loans would be export financing interest meeting the requirements of this paragraph (b)(2) and, thus, not included in foreign personal holding company income. However, interest from the loans made with respect to purchases from *DS* of property that is inventory in the hands of *DS* cannot be export financing interest because it is treated as income from a trade or service receivable under section 864(d)(6) and the exception under section 864(d)(7) does not apply. Thus the interest from loans made with respect to this inventory is included in foreign personal holding company income under paragraph (b)(1)(ii) of this section.

Example 2. (i) *DS,* a domestic corporation manufactures property in the United States. *DS* wholly owns two controlled foreign corporations organized in Country A, *CFC1* and *CFC2. CFC1* has a substantial part of its assets used in its trade or business in Country A. *CFC1* purchases the property that *DS* manufactures and sells it without further manufacture for use or consumption within Country A. This property is inventory property, as described in section 1221(1), in the hands of *CFC1.* Less than 50 percent of the fair market value, determined in accordance with section 904(d)(2)(G), of each item of inventory sold by *CFC1* is attributable to products imported into the United States. *CFC2* provides loans described in section 864(d)(6) to unrelated persons in Country A for the purchase of the property from *CFC1.*

(ii) If, in issuing and servicing loans made with respect to purchases from *CFC1* of the inventory property, *CFC2* engages in all the activities in which banks customarily engage in issuing and servicing loans, the interest accrued from these loans would be export financing interest meeting the requirements of paragraph (b)(2) of this section. It is not treated as income from a trade or service receivable under section 864(d)(6) because the exception under section 864(d)(7) applies. Thus the interest is excluded from foreign personal holding company income.

Example 3. The facts are the same as in *Example 2* except that the property sold by *CFC1* is manufactured by *CFC1* in Country A from component parts that were manufactured by *DS* in the United States. The interest accrued from the loans by *CFC2* is not export financing interest as defined in section 904(d)(2)(G) because the property is not manufactured in the United States under §1.927(a)–1T(c). No portion of the interest is export financing interest as defined in this paragraph (b)(2). The full amount of the interest is, therefore, included in foreign personal holding company income under paragraph (b)(1)(ii) of this section.

(3) *Treatment of tax exempt interest.* For taxable years of a controlled foreign corporation beginning after March 3, 1997, foreign personal holding company income includes all interest income, including interest that is described in section 103 (see §1.952–2(c)(1)).

(4) *Exclusion of dividends or interest from related persons*—(i) *In general*—(A) *Corporate payor.* Foreign personal holding company income received by a controlled foreign corporation does not include dividends or interest if the payor—

(*1*) Is a corporation that is a related person with respect to the controlled foreign corporation, as defined in section 954(d)(3);

(*2*) Is created or organized under the laws of the same foreign country (the *country of incorporation*) as is the controlled foreign corporation; and

(*3*) Uses a substantial part of its assets in a trade or business in its country of incorporation, as determined under this paragraph (b)(4).

(B) *Payment by a partnership.* For purposes of this paragraph (b)(4), if a partnership with one or more corporate partners makes a payment of interest, a corporate partner will be treated as the payor of the interest—

(*1*) If the interest payment gives rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent that the item of deduction is allocable to the corporate partner under section 704(b); or

(*2*) If the interest payment does not give rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent that a partnership item reasonably related to the payment would be allocated to that partner under an existing allocation under the partnership agreement (made pursuant to section 704(b)).

(ii) *Exceptions*—(A) *Dividends.* Dividends are excluded from foreign personal holding company income under this paragraph (b)(4) only to the extent that they are paid out of earnings and profits that are earned or accumulated during a period in which—

(*1*) The stock on which dividends are paid with respect to which the exclusion is claimed was owned by the recipient controlled foreign corporation directly, or indirectly through a chain of one or more subsidiaries each of which meets the requirements of paragraph (b)(4)(i)(A) of this section; and

(*2*) Each of the requirements of paragraph (b)(4)(i)(A) of this section is satisfied or, to the extent earned or accumulated during a taxable year of the related foreign corporation ending on or before December 31, 1962, during a period in which the payor was a related corporation as to the controlled foreign corporation and the other requirements of paragraph (b)(4)(i)(A) of this section were substantially satisfied.

(*3*) This paragraph (b)(4)(ii)(A) is illustrated by the following example:

Example. A, a domestic corporation, owns all of the stock of *B*, a corporation created and organized under the laws of Country Y, and *C*, a corporation created and organized under the laws of Country X. The taxable year of each of the corporations is the calendar year. In Year 1, *B* earns $100 of income from the sale of products in Country Y that it manufactured in Country Y. *C* had no earnings and profits in Year 1. On January 1 of Year 2, *A* contributes all of the stock of *B* and *C* to Newco, a Country Y corporation, in exchange for all of the stock of Newco. Neither *B* nor *C* earns any income in Year 2, but at the end of Year 2 *B* distributes the $100 accumulated earnings and profits to Newco. Newco's income from the distribution, $100, is foreign personal holding company income because the earnings and profits distributed by *B* were not earned or accumulated during a period in which the stock of *B* was owned by Newco and in which each of the requirements of paragraph (b)(4)(i)(A) of this section was satisfied.

(B) *Interest paid out of adjusted foreign base company income or insurance income*—(*1*) *In general.* Interest may not be excluded from the foreign personal holding company income of the recipient under this paragraph (b)(4) to the extent that the deduction for the interest is allocated under § 1.954–1(a)(4) and (c) to the payor's adjusted gross foreign base company income (as defined in § 1.954–1(a)(3)), adjusted gross insurance income (as defined in § 1.954–1(a)(6)), or any other category of income included in the computation of subpart F income under section 952(a).

(*2*) *Rule for corporations that are both recipients and payors of interest.* If a controlled foreign corporation is both a recipient and payor of interest, the interest that is received will be characterized before the interest that is paid. In addition, the amount of interest paid or accrued, directly or indirectly, by the controlled foreign corporation to a related person (as defined in section 954(d)(3)) shall be offset against and eliminate any interest received or accrued, directly or indirectly, by the controlled foreign corporation from that related person. In a case in which the controlled foreign corporation pays or accrues interest to a related person, as defined in section 954(d)(3), and also receives or accrues interest indirectly from the related person, the smallest interest payment is eliminated and the amounts of all other interest payments are reduced by the amount of the smallest interest payment.

(C) *Coordination with sections 864(d) and 881(c).* Income of a controlled foreign corporation that is treated as interest under section 864(d)(1) or (6), or that is portfolio interest, as defined by section 881(c), is not excluded from foreign personal holding company income under section 954(c)(3)(A)(i) and this paragraph (b)(4).

(iii) *Trade or business requirement.* Except as otherwise provided under this paragraph (b)(4), the principles of section 367(a) apply for purposes of determining whether the payor has a trade or business in its country of incorporation and whether its assets are used in that trade or business. Property purchased or produced for use in a trade or business is not considered used in a trade or business before it is placed in service or after it is retired from service as determined in accordance with the principles of sections 167 and 168.

(iv) *Substantial assets test.* A substantial part of the assets of the payor will be considered to be used in a trade or business located in the payor's country of incorporation for a taxable year only if the average value of the payor's assets for such year that are used in the trade or business and are located in such country equals more than 50 percent of the average value of all the assets of the payor (including assets not used in a trade or business). The average value of assets for the taxable year is determined by averaging the values of assets at the close of each quarter of the taxable year. The value of assets is determined under paragraph (b)(4)(v) of this section, and the location of assets used in a trade or business of the payor is determined under paragraphs (b)(4)(vi) through (xi) of this section.

(v) *Valuation of assets.* For purposes of determining whether a substantial part of the assets of the payor are used in a trade or business in its country of incorporation, the value of assets shall be their fair market value (not reduced by liabilities), which, in the absence of affirmative evidence to the contrary, shall be deemed to be their adjusted basis.

(vi) *Location of tangible property*—(A) *In general.* Tangible property (other than inventory and similar property as defined in paragraph (a)(4)(iii) of this section, and dealer property as defined in paragraph (a)(4)(v) of this section) used in a trade or business is considered located in the country in which it is physically located.

(B) *Exception.* An item of tangible personal property that is used in the trade or business of a payor in the payor's country of incorporation is considered located within the payor's country of incorporation while it is temporarily located elsewhere for inspection or repair if the property is not placed in service in a country other than the payor's country of incorporation and is not to be so placed in service following the inspection or repair.

(vii) *Location of intangible property*—(A) *In general.* Intangible property (other than inventory and similar property as defined in paragraph (a)(4)(iii) of this section, dealer property as defined in paragraph (a)(4)(v) of this section, and debt instruments) is considered located entirely in the payor's country of incorporation for a quarter of the taxable year only if the payor conducts all of its activities in connection with the use or exploitation of the property in that country during that entire quarter. For this purpose, the country in which the activities connected to the use or exploitation of the property are conducted is the country in which the expenses associated with these activities are incurred. Expenses incurred in connection with the use or exploitation of an item of intangible property are included in the computation provided by this paragraph (b)(4) if they would be deductible under section 162 or includible in inventory costs or the cost of goods sold if the payor were a domestic corporation. If the payor conducts such activities through an agent or independent contractor, then the expenses incurred by the payor with respect to the agent or independent contractor shall be deemed to be incurred by the payor in the country in which the expenses of the agent or independent contractor were incurred by the agent or independent contractor.

(B) *Exception for property located in part in the payor's country of incorporation.* If the payor conducts its activities in connection with the use or exploitation of an item of intangible property, including goodwill (other than inventory and similar property, dealer property and debt instruments) during a quarter of the taxable year both in its country of incorporation and elsewhere, then the value of the intangible considered located in the payor's country of incorporation during that quarter is a percentage of the value of the item as of the close of the quarter. That percentage equals the ratio that the expenses incurred by the payor (described in paragraph (b)(4)(vii)(A) of this section) during the entire quarter by reason of activities that are connected with the use or exploitation of the item of intangible property and are conducted in the payor's country of incorporation bear to all expenses incurred by the payor during the entire quarter by reason of all such activities worldwide.

(viii) *Location of inventory and dealer property*—(A) *In general.* Inventory and similar property, as defined in paragraph (a)(4)(iii) of this section, and dealer property, as defined in paragraph (a)(4)(v) of this section, are considered located entirely in the payor's country of incorporation for a quarter of the taxable year only if the payor conducts all of its activities in connection with the production and sale, or purchase and resale, of such property in its country of incorporation during that entire quarter. If the payor conducts such activities through an agent or independent contractor, then the location of such activities is the place in which they are conducted by the agent or independent contractor.

(B) *Inventory and dealer property located in part in the payor's country of incorporation.* If the payor conducts its activities in connection with the production and sale, or purchase and resale, of inventory or similar property or dealer property during a quarter of the taxable year both in its country of incorporation and elsewhere, then the value of the inventory or similar property or dealer property considered located in the payor's country of incorporation during each quarter is a percentage of the value of the inventory or similar property or dealer property as of the close of the quarter. That percentage equals the ratio that the costs and expenses incurred by the payor during the entire quarter by reason of activities connected with the production and sale, or purchase and resale, of inventory or similar property or dealer property that are conducted in the payor's country of incorporation bear to all costs or expenses incurred by the payor during the entire quarter by reason of all such activities worldwide. A cost incurred in connection with the production and sale or purchase and resale of inventory or similar property or dealer property is included in this computation if it—

(*1*) Would be included in inventory costs or otherwise capitalized with respect to inventory or similar property or dealer property under section 61, 263A, 471, or 472 if the payor were a domestic corporation; or

(*2*) Would be deductible under section 162 if the payor were a domestic corporation and is definitely related to gross income derived from such property (but not to all classes of gross income derived by the payor) under the principles of § 1.861–8.

(ix) *Location of debt instruments.* For purposes of this paragraph (b)(4), debt instruments, other than debt instruments that are inventory or similar property (as defined in paragraph (a)(4)(iii) of this section) or dealer property (as defined in paragraph (a)(4)(v) of this section) are considered to be used in a trade or business only if they arise from the sale of inventory or similar property or dealer property by the payor or from the rendition of services by the payor in the ordinary course of a trade or business of the payor, and only until such time as interest is required to be charged under section 482. Debt instruments that arise from the sale of inventory or similar property or dealer property during a quarter are treated as having the same location, proportionately, as the inventory or similar property or dealer property held during that quarter. Debt instruments arising from the rendition of services in the ordinary course of a trade or business are considered located on a proportionate basis in the countries in which the services to which they relate are performed.

(x) *Treatment of certain stock interests.* Stock in a controlled foreign corporation (lower-tier corporation) that is incorporated in the same country as the payor and that is more than 50-percent owned, directly or indirectly, by the payor within the meaning of section 958(a) shall be considered located in the payor's country of incorporation and, solely for purposes of section 954(c)(3), used in a trade or business of the payor in proportion to the value of the assets of the lower-tier corporation that are used in a trade or business in the country of incorporation. The location of assets used in a trade or business of the lower-tier corporation shall be determined under the rules of this paragraph (b)(4).

(xi) *Treatment of banks and insurance companies.* [Reserved]

(5) *Exclusion of rents and royalties derived from related persons*—(i) *In general*—(A) *Corporate payor.* Foreign personal holding company income received by a controlled foreign corporation does not include rents or royalties if—

(*1*) The payor is a corporation that is a related person with respect to the controlled foreign corporation, as defined in section 954(d)(3); and

(*2*) The rents or royalties are for the use of, or the privilege of using, property within the country under the laws of which the controlled foreign corporation receiving the payments is created or organized (the country of incorporation).

(B) *Payment by a partnership.* For purposes of this paragraph (b)(5), if a partnership with one or more corporate partners makes a payment of rents or royalties, a corporate partner will be treated as the payor of the rents or royalties—

(*1*) If the rent or royalty payment gives rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent the item of deduction is allocable to the corporate partner under section 704(b); or

(*2*) If the rent or royalty payment does not give rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent that a partnership item reasonably related to the payment would be allocated to that partner under an existing allocation under the partnership agreement (made pursuant to section 704(b)).

(ii) *Exceptions*—(A) *Rents or royalties paid out of adjusted foreign base company income or insurance income.* Rents or royalties may not be excluded from the foreign personal holding company income of the recipient under this paragraph (b)(5) to the extent that deductions for the payments are allocated under section 954(b)(5) and §1.954–1(a)(4) and (c) to the payor's adjusted gross foreign base company income (as defined in §1.954–1(a)(3)), adjusted gross insurance income (as defined in §1.954–1(a)(6)), or any other category of income included in the computation of subpart F income under section 952(a).

(B) *Property used in part in the controlled foreign corporation's country of incorporation.* If the payor uses the property both in the controlled foreign corporation's country of incorporation and elsewhere, the part of the rent or royalty attributable (determined under the principles of section 482) to the use of, or the privilege of using, the property outside such country of incorporation is included in the computation of foreign personal holding company income under this paragraph (b).

(6) *Exclusion of rents and royalties derived in the active conduct of a trade or business.* Foreign personal holding company income shall not include rents or royalties that are derived in the active conduct of a trade or business and received from a person that is not a related person (as defined in section 954(d)(3)) with respect to the controlled foreign corporation. For purposes of this section, rents or royalties are derived in the active conduct of a trade or business only if the provisions of paragraph (c) or (d) of this section are satisfied.

(c) *Excluded rents*—(1) *Active conduct of a trade or business.* Rents will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such rents are derived by the controlled foreign corporation (the lessor) from leasing any of the following—

(i) Property that the lessor has manufactured or produced, or has acquired and added substantial value to, but only if the lessor is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind;

(ii) Real property with respect to which the lessor, through its own officers or staff of employees, regularly performs active and substantial management and operational functions while the property is leased;

(iii) Personal property ordinarily used by the lessor in the active conduct of a trade or business, leased temporarily during a period when the property would, but for such leasing, be idle; or

(iv) Property that is leased as a result of the performance of marketing functions by such lessor if the lessor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property.

(2) *Special rules*—(i) *Adding substantial value.* For purposes of paragraph (c)(1)(i) of this section, the performance of marketing functions will not be considered to add substantial value to property.

(ii) *Substantiality of foreign organization.* For purposes of paragraph (c)(1)(iv) of this section, whether an organization in a foreign country is substantial in relation to the amount of rents is determined based on all of the facts and circumstances. However, such an organization will be considered substantial in relation to the amount of rents if active leasing expenses, as defined in paragraph (c)(2)(iii) of this section, equal or exceed 25 percent of the adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section.

(iii) *Active leasing expenses.* The term *active leasing expenses* means the deductions incurred by an organization of the lessor in a foreign country that are properly allocable to rental income and that would be allowable under section 162 to the lessor if it were a domestic corporation, other than—

(A) Deductions for compensation for personal services rendered by shareholders of, or related persons (as defined in section 954(d)(3)) with respect to, the lessor;

(B) Deductions for rents paid or accrued;

(C) Deductions that, although generally allowable under section 162, would be specifically allowable to the lessor (if the lessor were a domestic corporation) under any section of the Internal Revenue Code other than section 162; and

(D) Deductions for payments made to agents or independent contractors with respect to the leased property other than payments for insurance, utilities and other expenses for like services, or for capitalized repairs.

(iv) *Adjusted leasing profit.* The term *adjusted leasing profit* means the gross income of the lessor from rents, reduced by the sum of—

(A) The rents paid or incurred by the lessor with respect to such rental income;

(B) The amounts that would be allowable to such lessor (if the lessor were a domestic corporation) as deductions under sections 167 or 168 with respect to such rental income; and

(C) The amounts paid by the lessor to agents or independent contractors with respect to such rental income other than payments for insurance, utilities and other expenses for like services, or for capitalized repairs.

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

Example 1. Controlled foreign corporation *A* is regularly engaged in the production of office machines which it sells or leases to others and services. Under paragraph (c)(1)(i) of this section, the rental income of Corporation *A* from these leases is derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 2. Controlled foreign corporation *D* purchases motor vehicles which it leases to others. In the conduct of its short-term leasing of such vehicles in foreign country X, Corporation *D* owns a large number of motor vehicles in country X which it services and repairs, leases motor vehicles to customers on an hourly, daily, or weekly basis, maintains offices and service facilities in country X from which to lease and service such vehicles, and maintains therein a sizable staff of its own administrative, sales, and service personnel. Corporation *D* also leases in country X on a long-term basis, generally for a term of one year, motor vehicles that it owns. Under the terms of the long-term leases, Corporation *D* is required to repair and service, during the term of the lease, the leased motor vehicles without cost to the lessee. By the maintenance in country X of office, sales, and service facilities and its complete staff of administrative, sales, and service personnel, Corporation *D* maintains and operates an organization therein that is regularly engaged in the business of marketing and servicing the motor vehicles that are leased. The deductions incurred by such organization satisfy the 25-percent test of paragraph (c)(2)(ii) of this section; thus, such organization is substantial in relation to the rents Corporation *D* receives from leasing the motor vehicles. Therefore, under paragraph (c)(1)(iv) of this section, such rents are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 3. Controlled foreign corporation *E* owns a complex of apartment buildings that it has acquired by purchase. Corporation *E* engages a real estate management firm to lease the apartments, manage the buildings and pay over the net rents to Corporation *E*. The rental income of Corporation *E* from such leases is not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 4. Controlled foreign corporation *F* acquired by purchase a twenty-story office building in a foreign country, three floors of which it occupies and the rest of which it leases. Corporation *F* acts as rental agent for the leasing of offices in the building and employs a substantial staff to perform other management and maintenance functions. Under paragraph (c)(1)(ii) of this section, the rents received by Corporation *F* from such leasing operations are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 5. Controlled foreign corporation *G* owns equipment that it ordinarily uses to perform contracts in foreign countries to drill oil wells. For occasional brief and irregular periods it is unable to obtain contracts requiring immediate performance sufficient to employ all such equipment. During such a period it sometimes leases such idle equipment temporarily. After the expiration of such temporary leasing of the property, Corporation *G* continues the use of such equipment in the performance of its own drilling contracts. Under paragraph (c)(1)(iii) of this section, rents Corporation *G* receives from such leasing of idle equipment are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(d) *Excluded royalties*—(1) *Active conduct of a trade or business.* Royalties will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such royalties are derived by the controlled foreign corporation (the licensor) from licensing—

(i) Property that the licensor has developed, created, or produced, or has acquired and added substantial value to, but only so long as the licensor is regularly engaged in the development, creation or production of, or in the acquisition of and addition of substantial value to, property of such kind; or

(ii) Property that is licensed as a result of the performance of marketing functions by such licensor if the licensor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property.

(2) *Special rules*—(i) *Adding substantial value.* For purposes of paragraph (d)(1)(i) of this section, the performance of marketing functions will not be considered to add substantial value to property.

(ii) *Substantiality of foreign organization.* For purposes of paragraph (d)(1)(ii) of this section, whether an organization in a foreign country is substantial in relation to the amount of royalties is determined based on all of the facts and circumstances. However, such an organization will be considered substantial in relation to the amount of royalties if active licensing expenses, as defined in paragraph (d)(2)(iii) of this section, equal or exceed 25 percent of the adjusted licensing profit, as defined in paragraph (d)(2)(iv) of this section.

(iii) *Active licensing expenses.* The term *active licensing expenses* means the deductions incurred by an organization of the licensor in a foreign country that are properly allocable to royalty income and that would be allowable under section 162 to the licensor if it were a domestic corporation, other than—

(A) Deductions for compensation for personal services rendered by shareholders of, or related persons (as defined in section 954(d)(3)) with respect to, the licensor;

(B) Deductions for royalties paid or incurred;

(C) Deductions that, although generally allowable under section 162, would be specifically allowable to the licensor (if the controlled foreign corporation were a domestic corporation) under any section of the Internal Revenue Code other than section 162; and

(D) Deductions for payments made to agents or independent contractors with respect to the licensed property.

(iv) *Adjusted licensing profit.* The term *adjusted licensing profit* means the gross income of the licensor from royalties, reduced by the sum of—

(A) The royalties paid or incurred by the licensor with respect to such royalty income;

(B) The amounts that would be allowable to such licensor as deductions under section 167 or 197 (if the licensor were a domestic corporation) with respect to such royalty income; and

(C) The amounts paid by the licensor to agents or independent contractors with respect to such royalty income.

(3) *Examples.* The application of this paragraph (d) is illustrated by the following examples.

Example 1. Controlled foreign corporation *A*, through its own staff of employees, owns and operates a research facility in foreign country X. At the research facility, employees of Corporation *A* who are scientists, engineers, and technicians regularly perform experiments, tests, and other technical activities, that ultimately result in the issuance of patents that it sells or licenses. Under paragraph (d)(1)(i) of this section, royalties received by Corporation *A* for the privilege of using patented rights that it develops as a result of such research activity are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A), but only so long as the licensor is regularly engaged in the development, creation or production of, or in the acquisition of and addition of substantial value to, property of such kind.

Example 2. Assume that Corporation *A* in *Example 1,* in addition to receiving royalties for the use of patents that it develops, receives royalties for the use of patents that it acquires by purchase and licenses to others without adding any value thereto. Corporation *A* generally consummates royalty agreements on such purchased patents as the result of inquiries received by it from prospective licensees when the fact becomes known in the business community, as a result of the filing of a patent, advertisements in trade journals, announcements, and contacts by employees of Corporation *A*, that Corporation *A* has acquired rights under a patent and is interested in licensing its rights. Corporation *A* does not, however, maintain and operate an organization in a foreign country that is regularly engaged in the business of marketing the purchased patents. The royalties received by Corporation *A* for the use of the purchased patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 3. Controlled foreign corporation *B* receives royalties for the use of patents that it acquires by purchase. The primary business of Corporation *B*, operated on a regular basis, consists of licensing patents that it has purchased raw from inventors and, through the efforts of a substantial staff of employees consisting of scientists, engineers, and technicians, made susceptible to commercial application. For example, Corporation *B*, after purchasing patent rights covering a chemical process, designs specialized production equipment required for the commercial adaptation of the process and, by so doing, substantially increases the value of the patent. Under paragraph (d)(1)(i) of this section, royalties received by Corporation *B* from the use of such patent are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 4. Controlled foreign corporation *C* receives royalties for the use of a patent that it developed through its own staff of employees at its facility in country X. Corporation *C* has developed no other patents. It does not regularly employ a staff of scientists, engineers or technicians to create new products to be patented. Further, it does not purchase and license patents developed by others to which it has added substantial value. The royalties received by Corporation *C* are not derived from the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 5. Controlled foreign corporation *D* finances independent persons in the development of patented items in return for an ownership interest in such items from which it derives a percentage of royalty income, if any, subsequently derived from the use by others of the protected right. Corporation *D* also attempts to increase its royalty income from such patents by contacting prospective licensees and rendering to licensees advice that is intended to promote the use of the patented property. Corporation *D* does not, however, maintain and operate an organization in a foreign country that is regularly engaged in the business of marketing the patents. Royalties received by Corporation *D* for the use of such patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(e) *Certain property transactions*—(1) *In general*—(i) *Inclusions.* Gain from certain property transactions described in section 954(c)(1)(B) includes the excess of gains over losses from the sale or exchange of—

(A) Property that gives rise to dividends, interest, rents, royalties or annuities, as described in paragraph (e)(2) of this section;

(B) Property that is an interest in a partnership, trust or REMIC; and

(C) Property that does not give rise to income, as described in paragraph (e)(3) of this section.

(ii) *Exceptions.* Gain or loss from certain property transactions described in section 954(c)(1)(B) and paragraph (e)(1)(i) of this section does not include gain or loss from the sale or exchange of—

(A) Inventory or similar property, as defined in paragraph (a)(4)(iii) of this section;

(B) Dealer property, as defined in paragraph (a)(4)(v) of this section; or

(C) Property that gives rise to rents or royalties described in paragraph (b)(6) of this section that are derived in the active conduct of a trade or business from persons that are not related persons (as defined in section 954(d)(3)) with respect to the controlled foreign corporation.

(iii) *Treatment of losses.* Section 1.954–1(c)(1)(ii) provides for the treatment of losses in excess of gains from the sale or exchange of property described in paragraph (e)(1)(i) of this section.

(iv) *Dual character property.* Property may, in part, constitute property that gives rise to certain income as described in paragraph (e)(2) of this section or, in part, constitute property that does not give rise to any income as described in paragraph (e)(3) of this section. However, property that is described in paragraph (e)(1)(i)(B) of this section cannot be dual character property. Dual character property must be treated as two separate properties for purposes of paragraph (e)(2) or (3) of this section. Accordingly, the sale or exchange of such dual character property will give rise to gain or loss that in part must be included in the computation of foreign personal holding company income under paragraph (e)(2) or (3) of this section, and in part is excluded from such computation. Gain or loss from the disposition of dual character property must be bifurcated under this paragraph (e)(1)(iv) pursuant to the method that most reasonably reflects the relative uses of the property. Reasonable methods may include comparisons in terms of gross income generated or the physical division of the property. In the case of real property, the physical division of the property will in most cases be the most reasonable method available. For example, if a controlled foreign corporation owns an office building, uses 60 percent of the building in its trade or business, and rents out the other 40 percent, then 40 percent of the gain recognized on the disposition of the property would reasonably be treated as gain that is included in the computation of foreign personal holding company income under this paragraph (e)(1). This paragraph (e)(1)(iv) addresses the contemporaneous use of property for dual purposes. For rules concerning changes in the use of property affecting its classification for purposes of this paragraph (e), see paragraph (a)(3) of this section.

(2) *Property that gives rise to certain income*—(i) *In general.* Property the sale or exchange of which gives rise to foreign personal holding company income under this paragraph (e)(2) includes property that gives rise to dividends, interest, rents, royalties or annuities described in paragraph (b) of this section, including—

(A) Property that gives rise to export financing interest described in paragraph (b)(2) of this section; and

(B) Property that gives rise to income from related persons described in paragraph (b)(4) or (5) of this section.

(ii) *Gain or loss from the disposition of a debt instrument.* Gain or loss from the sale, exchange or retirement of a debt instrument is included in the computation of foreign personal holding company income under this paragraph (e) unless—

(A) In the case of gain—

(*1*) It is interest (as defined in paragraph (a)(4)(i) of this section); or

(*2*) It is income equivalent to interest (as described in paragraph (h) of this section); and

(B) In the case of loss—

(*1*) It is directly allocated to, or treated as an adjustment to, interest income (as described in paragraph (a)(4)(i) of this section) or income equivalent to interest (as defined in paragraph (h) of this section) under any provision of the Internal Revenue Code or Income Tax Regulations; or

(*2*) It is required to be apportioned in the same manner as interest expense under section 864(e) or any other provision of the Internal Revenue Code or Income Tax Regulations.

(3) *Property that does not give rise to income.* Except as otherwise provided in this paragraph (e)(3), for purposes of this section, the term *property that does not give rise to income* includes all rights and interests in property (whether or not a capital asset) including, for example, forwards, futures and options.

Property that does not give rise to income shall not include—

(i) Property that gives rise to dividends, interest, rents, royalties or annuities described in paragraph (e)(2) of this section;

(ii) Tangible property (other than real property) used or held for use in the controlled foreign corporation's trade or business that is of a character that would be subject to the allowance for depreciation under section 167 or 168 and the regulations under those sections (including tangible property described in § 1.167(a)–2);

(iii) Real property that does not give rise to rental or similar income, to the extent used or held for use in the controlled foreign corporation's trade or business;

(iv) Intangible property (as defined in section 936(h)(3)(B)), goodwill or going concern value, to the extent used or held for use in the controlled foreign corporation's trade or business;

(v) Notional principal contracts (but see paragraphs (f)(2), (g)(2) and (h)(3) of this section for rules that include income from certain notional principal contracts in gains from commodities transactions, foreign currency gains and income equivalent to interest, respectively); or

(vi) Other property that is excepted from the general rule of this paragraph (e)(3) by the Commissioner in published guidance. See § 601.601(d)(2) of this chapter.

(f) *Commodities transactions*—(1) *In general*—(i) *Inclusion in foreign personal holding company income.* Foreign personal holding company income includes the excess of gains over losses from commodities transactions.

(ii) *Exception.* Gains and losses from qualified active sales and qualified hedging transactions are excluded from the computation of foreign personal holding company income under this paragraph (f).

(iii) *Treatment of losses.* Section 1.954–1(c)(1)(ii) provides for the treatment of losses in excess of gains from commodities transactions.

(2) *Definitions*—(i) *Commodity.* For purposes of this section, the term *commodity* includes tangible personal property of a kind that is actively traded or with respect to which contractual interests are actively traded.

(ii) *Commodities transaction.* The term *commodities transaction* means the purchase or sale of a commodity for immediate (spot) delivery or deferred (forward) delivery, or the right to purchase, sell, receive, or transfer a commodity, or any other right or obligation with respect to a commodity accomplished through a cash or off-exchange market, an interbank market, an organized exchange or board of trade, or an over-the-counter market, or in a transaction effected between private parties outside of any market. Commodities transactions include, but are not limited to—

(A) A futures or forward contract in a commodity;

(B) A leverage contract in a commodity purchased from a leverage transaction merchant;

(C) An exchange of futures for physical transaction;

(D) A transaction, including a notional principal contract, in which the income or loss to the parties is measured by reference to the price of a commodity, a pool of commodities, or an index of commodities;

(E) The purchase or sale of an option or other right to acquire or transfer a commodity, a futures contract in a commodity, or an index of commodities; and

(F) The delivery of one commodity in exchange for the delivery of another commodity, the same commodity at another time, cash, or nonfunctional currency.

(iii) *Qualified active sale*—(A) *In general.* The term *qualified active sale* means the sale of commodities in the active conduct of a commodities business as a producer, processor, merchant or handler of commodities if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant or handler of commodities. The sale of commodities held by a controlled foreign corporation other than in its capacity as an active producer, processor, merchant or handler of commodities is not a qualified active sale. For example, the sale by a controlled foreign corporation of commodities that were held for investment or speculation would not be a qualified active sale.

(B) *Active conduct of a commodities business.* For purposes of this paragraph, a controlled foreign corporation is engaged in the active conduct of a commodities business as a producer, processor, merchant or handler of commodities only with respect to commodities for which each of the following conditions is satisfied—

(*1*) It holds the commodities directly, and not through an agent or independent contractor, as inventory or similar property (as defined in paragraph (a)(4)(iii) of this section) or as dealer property (as defined in paragraph (a)(4)(v) of this section); and

(*2*) With respect to such commodities, it incurs substantial expenses in the ordinary course of a commodities business from engaging in one or more of the following activities directly, and not through an independent contractor—

(*i*) Substantial activities in the production of the commodities, including planting, tending or harvesting crops, raising or slaughtering livestock, or extracting minerals;

(*ii*) Substantial processing activities prior to the sale of the commodities, including the blending and drying of agricultural commodities, or the concentrating, refining, mixing, crushing, aerating or milling of commodities; or

(*iii*) Significant activities as described in paragraph (f)(2)(iii)(B)(*3*) of this section.

(*3*) For purposes of paragraph (f)(2)(iii)(B)(*2*)(*iii*) of this section, the significant activities must relate to—

(*i*) The physical movement, handling and storage of the commodities, including preparation of contracts and invoices, arranging freight, insurance and credit, arranging for receipt, transfer or negotiation of shipping documents, arranging storage or warehousing, and dealing with quality claims;

(*ii*) Owning and operating facilities for storage or warehousing; or

(*iii*) Owning or chartering vessels or vehicles for the transportation of the commodities.

(C) *Substantially all.* Substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant or handler of commodities if the sum of its gross receipts from all of its qualified active sales (as defined in this paragraph (f)(2)(iii) without regard to the substantially all requirement) of commodities and its gross receipts from all of its qualified hedging transactions (as defined in paragraph (f)(2)(iv) of this section, applied without regard to the substantially all requirement of this paragraph (f)(2)(iii)(C)) equals or exceeds 85 percent of its total gross receipts for the taxable year (computed as though the corporation were a domestic corporation). In computing gross receipts, the District Director may disregard any sale or hedging transaction that has as a principal purpose manipulation of the 85 percent gross receipts test. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(D) *Activities of employees of a related entity.* For purposes of this paragraph (f), activities of employees of an entity related to the controlled foreign corporation, who are made available to and supervised on a day-to-day basis by, and whose salaries are paid by (or reimbursed to the related entity by), the controlled foreign corporation, are treated as activities engaged in directly by the controlled foreign corporation.

(E) *Financial activities.* For purposes of this paragraph (f), a corporation is not engaged in a commodities business as a producer, processor, merchant or handler of commodities if its business is primarily financial. For example, the business of a controlled foreign corporation is primarily financial if its principal business is making a market in notional principal contracts based on a commodities index.

(iv) *Qualified hedging transaction*—(A) *In general.* The term *qualified hedging transaction* means a bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section, with respect to qualified active sales (other than transactions described in section 988(c)(1) without regard to section 988(c)(1)(D)(i)).

(B) *Exception.* The term *qualified hedging transaction* does not include transactions that are not reasonably necessary to the conduct of business of the controlled foreign corporation as a producer, processor, merchant or handler of a commodity in the manner in which such business is customarily and usually conducted by others.

(g) *Foreign currency gain or loss*—(1) *Scope and purpose.* This paragraph (g) provides rules for the treatment of foreign currency gains and losses. Paragraph (g)(2) of this section provides the general rule. Paragraph (g)(3) of this section provides an election to include foreign currency gains or losses that would otherwise be treated as foreign personal holding company income under this paragraph (g) in the computation of another category of subpart F income. Paragraph (g)(4) of this section provides an alternative election to treat any net foreign currency gain or loss as foreign personal holding company income. Paragraph (g)(5) of this section provides rules for certain gains and losses not subject to this paragraph (g).

(2) *In general*—(i) *Inclusion.* Except as otherwise provided in this paragraph (g), foreign personal holding company income includes the excess of foreign currency gains over foreign currency losses attributable to any section 988 transactions (foreign currency gain or loss). Section 1.954–1(c)(1)(ii) provides rules for the treatment of foreign currency losses in excess of foreign currency gains. However, if an election is made under paragraph (g)(4) of this section, the excess of foreign currency losses over foreign currency gains to which the election would apply may be apportioned to, and offset, other categories of foreign personal holding company income.

(ii) *Exclusion for business needs*—(A) *General rule.* Foreign currency gain or loss directly related to the business needs of the controlled foreign corporation is excluded from foreign personal holding company income.

(B) *Business needs.* Foreign currency gain or loss is directly related to the business needs of a controlled foreign corporation if—

(*1*) The foreign currency gain or loss—

(*i*) Arises from a transaction (other than a hedging transaction) entered into, or property used or held for use, in the normal course of the controlled foreign corporation's trade or business, other than the trade or business of trading foreign currency;

(*ii*) Arises from a transaction or property that does not itself (and could not reasonably be expected to) give rise to subpart F income other than foreign currency gain or loss;

(*iii*) Does not arise from a transaction described in section 988(c)(1)(B)(iii); and

(*iv*) Is clearly determinable from the records of the controlled foreign corporation as being derived from such transaction or property; or

(*2*) The foreign currency gain or loss arises from a bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section, with respect to a transaction or property that satisfies the requirements of paragraphs (g)(2)(ii)(B)(*1*)(*i*) through (*iii*) of this section, provided that any gain or loss arising from such transaction or property that is attributable to changes in exchange rates is clearly determinable from the records of the CFC as being derived from such transaction or property. For purposes of this paragraph (g)(2)(ii)(B)(*2*), a hedging transaction will satisfy the aggregate hedging rules of § 1.1221–2(c)(7) only if all (or all but a de minimis amount) of the aggregate risk being hedged arises in connection with transactions or property that satisfy the requirements of paragraphs (g)(2)(ii)(B)(*1*)(*i*) through (*iii*) of this section, provided that any gain or loss arising from such transactions or property that is attributable to changes in exchange rates is clearly determinable from the records of the CFC as being derived from such transactions or property.

(C) *Regular dealers.* Transactions in dealer property (as defined in paragraph (a)(4)(v) of this section) described in section 988(c)(1)(B) or (C) that are entered into by a controlled foreign corporation that is a regular dealer (as defined in paragraph (a)(4)(iv) of this section) in such property in its capacity as a dealer will be treated as directly related to the business needs of the controlled foreign corporation under paragraph (g)(2)(ii)(A) of this section.

(D) *Example.* The following example illustrates the provisions of this paragraph (g)(2).

Example. (i) *CFC1* and *CFC2* are controlled foreign corporations located in Country B, and are members of the same controlled group. *CFC1* is engaged in the active conduct of a trade or business that does not produce any subpart F income. *CFC2* serves as the currency coordination center for the controlled group, aggregating currency risks incurred by the group and entering into hedging transactions that transfer those risks outside of the group. Pursuant to this arrangement, and to hedge the currency risk on a non-interest bearing receivable incurred by *CFC1* in the normal course of its business, on Day 1 *CFC1* enters into a forward contract to sell Japanese Yen to CFC2 in 30 days. Also on Day 1, *CFC2* enters into a forward contract to sell Yen to unrelated Bank X on Day 30. *CFC2* is not a regular dealer in Yen spot and forward contracts, and the Yen is not the functional currency for either *CFC1* or *CFC2*.

(ii) Because the forward contract entered into by *CFC1* to sell Yen hedges a transaction entered into in the normal course of *CFC1*'s business that does not give rise to subpart F income, it qualifies as a bona fide hedging transaction as defined in paragraph (a)(4)(ii) of this section. Therefore, *CFC1*'s foreign exchange gain or loss from that forward contract will not be treated as foreign personal holding company income or loss under this paragraph (g).

(iii) Because the forward contract to purchase Yen was entered into by *CFC2* in order to assume currency risks incurred by *CFC1* it does not qualify as a bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section. Thus, foreign exchange gain or loss recognized by *CFC2* from that forward contract will be foreign personal holding company income. Because *CFC2* entered into the forward contract to sell Yen in order to hedge currency risks of *CFC1,* that forward contract also does not qualify as a bona fide hedging transaction. Thus, *CFC2*'s foreign currency gain or loss arising from that forward contract will be foreign personal holding company income.

(iii) *Special rule for foreign currency gain or loss from an interest-bearing liability.* Except as provided in paragraph (g)(5)(iv) of this section, foreign currency gain or loss arising from an interest-bearing liability is characterized as subpart F income and non-subpart F income in the same manner that interest expense associated with the liability would be allocated and apportioned between subpart F income and non-subpart F income under §§1.861–9T and 1.861–12T.

(3) *Election to characterize foreign currency gain or loss that arises from a specific category of subpart F income as gain or loss in that category*—(i) *In general.* For taxable years of a controlled foreign corporation beginning on or after November 6, 1995, the controlling United States shareholders of the controlled foreign corporation may elect, under this paragraph (g)(3), to exclude foreign currency gain or loss otherwise includible in the computation of foreign personal holding company income under this paragraph (g) from the computation of foreign personal holding company income under this paragraph (g) and include such foreign currency gain or loss in the category (or categories) of subpart F income (described in section 952(a), or, in the case of foreign base company income, described in §1.954–1(c)(1)(iii)(A) (*1*) or (*2*)) to which such gain or loss relates. If an election is made under this paragraph (g)(3) with respect to a category (or categories) of subpart F income described in section 952(a), or, in the case of foreign base company income, described in §1.954–1(c)(1)(iii)(A) (*1*) or (*2*), the election shall apply to all foreign currency gain or loss that arises from—

(A) A transaction (other than a hedging transaction) entered into, or property used or held for use, in the normal course of the controlled foreign corporation's trade or business that gives rise to income in that category (or categories) and that is clearly determinable from the records of the controlled foreign corporation as being derived from such transaction or property; and

(B) A bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section, with respect to a transaction or property described in paragraph (g)(3)(i)(A) of this section. For purposes of this paragraph (g)(3)(i)(B), a hedging transaction will satisfy the aggregate hedging rules of §1.1221–2(c)(7) only if all (or all but a de minimus amount) of the aggregate risk being hedged arises in connection with transactions or property that generate the same category of subpart F income described in section 952(a), or, in the case of foreign base company income, described in §1.954–1(c)(1)(iii)(A) (*1*) or (*2*).

(ii) *Time and manner of election.* The controlling United States shareholders, as defined in §1.964–1(c)(5), make the election on behalf of the controlled foreign corporation by filing a statement with their original income tax returns for the taxable year of such United States shareholders ending with or within the taxable year of the controlled foreign corporation for which the election is made, clearly indicating that such election has been made. If the controlling United States shareholders elect to apply these regulations retroactively, under § 1.954–0(a)(1)(ii), the election under this paragraph (g)(3) may be made by the amended return filed pursuant to the election under § 1.954–0(a)(1)(ii). The controlling United States shareholders filing the election statement described in this paragraph (g)(3)(ii) must provide copies of the election statement to all other United States shareholders of the electing controlled foreign corporation. Failure to provide copies of such statement will not cause an election under this paragraph (g)(3) to be voidable by the controlled foreign corporation or the controlling United States shareholders. However, the District Director has discretion to void the election if it is determined that three was no reasonable cause for the failure to provide copies of such statement. The statement shall include the following information—

(A) The name, address, taxpayer identification number, and taxable year of such United States shareholder;

(B) The name, address, and taxable year of the controlled foreign corporation for which the election is effective; and

(C) Any additional information required by the Commission by administrative pronouncement.

(iii) *Revocation of election.* This election is effective for the taxable year of the controlled foreign corporation for which it is made and all subsequent taxable years of such corporation unless revoked by or with the consent of the Commissioner.

(iv) *Example.* The following example illustrates the provisions of this paragraph (g)(3).

Example. (i) *CFC,* a controlled foreign corporation, is a sales company that earns foreign base company sales income under section 954(d). *CFC* makes an election under this paragraph (g)(3) to treat foreign currency gains or losses that arise from a specific category (or categories) of subpart F income (as described in section 952(a), or, in the case of foreign base company income, as described in § 1.954–1(c)(1)(iii)(A) (*1*) or (*2*)) as that type of income. *CFC* aggregates the currency risk on all of its transactions that generate foreign base company sales income and hedges this net currency exposure.

(ii) Assuming no more than a de minimus amount of risk in the pool of risks being hedged arises from transactions or property that generate income other than foreign base company sales income, pursuant to its election under (g)(3), *CFC*'s net foreign currency gain from the pool and the hedging transactions will be treated as foreign base company sales income under section 954(d), rather than as foreign personal holding company income under section 954(c)(1)(D). If the pool of risks and the hedging transactions generate a net foreign base company sales loss, however, *CFC* must apply the rules of § 1.954–1(c)(1)(ii).

(4) *Election to treat all foreign currency gains or losses as foreign personal holding company income*—(i) *In general.* If the controlling United States shareholders make an election under this paragraph (g)(4), the controlled foreign corporation shall include in its computation of foreign personal holding company income the excess of foreign currency gains over losses or the excess of foreign currency losses over gains attributable to any section 988 transaction (except those described in paragraph (g)(5) of this section) and any section 1256 contract that would be a section 988 transaction but for section 988(c)(1)(D). Separate elections for section 1256 contracts and section 988 transactions are not permitted. An election under this paragraph (g)(4) supersedes an election under paragraph (g)(3) of this section.

(ii) *Time and manner of election.* The controlling United States shareholders, as defined in § 1.964–1(c)(5), make the election on behalf of the controlled foreign corporation in the same time and manner as provided in paragraph (g)(3)(ii) of this section.

(iii) *Revocation of election.* This election is effective for the taxable year of the controlled foreign corporation for which it is made and all subsequent taxable years of such corporation unless revoked by or with the consent of the Commissioner.

(5) *Gains and losses not subject to this paragraph*—(i) *Capital gains and losses.* Gain or loss that is treated as capital gain or loss under section 988(a)(1)(B) is not foreign currency gain or loss for purposes of this paragraph (g). Such gain or loss is treated as gain or loss from the sale or exchange of property that is included in the computation of foreign personal holding company income under paragraph (e)(1) of this section. Paragraph (a)(2) of this section provides other rules concerning income described in more than one category of foreign personal holding company income.

(ii) *Income not subject to section 988.* Gain or loss that is not treated as foreign currency gain or loss by reason of section 988 (a)(2) or (d) is not foreign currency gain or loss for purposes of this paragraph (g). However, such gain or loss may be included in the computation of other categories of foreign personal holding company income in accordance with its characterization under section 988 (a)(2) or (d) (for example, foreign currency gain that is treated as interest income under section 988(a)(2) will be included in the computation of foreign personal holding company income under paragraph (b)(ii) of this section).

(iii) *Qualified business units using the dollar approximate separate transactions method.* This paragraph (g) does not apply to any DASTM gain or loss computed under §1.985–3(d). Such gain or loss is allocated under the rules of §1.985–3 (e)(2)(iv) or (e)(3). However, the provisions of this paragraph (g) do apply to section 988 transactions denominated in a currency other than the United States dollar or the currency that would be the qualified business unit's functional currency were it not hyperinflationary.

(iv) *Gain or loss allocated under §1.861–9.* [Reserved]

(h) *Income equivalent to interest*—(1) *In general*—(i) *Inclusion in foreign personal holding company income.* Except as provided in this paragraph (h), foreign personal holding company income includes income equivalent to interest as defined in paragraph (h)(2) of this section.

(ii) *Exceptions*—(A) *Liability hedging transactions.* Income, gain, deduction or loss that is allocated and apportioned in the same manner as interest expense under the provisions of §1.861–9T is not income equivalent to interest for purposes of this paragraph (h).

(B) *Interest.* Amounts treated as interest under section 954(c)(1)(A) and paragraph (b) of this section are not income equivalent to interest for purposes of this paragraph (h).

(2) *Definition of income equivalent to interest*—(i) *In general.* The term *income equivalent to interest* includes income that is derived from—

(A) A transaction or series of related transactions in which the payments, net payments, cash flows or return predominantly reflect the time value of money;

(B) Transactions in which the payments (or a predominant portion thereof) are, in substance, for the use or forbearance of money;

(C) Notional principal contracts, to the extent provided in paragraph (h)(3) of this section;

(D) Factoring, to the extent provided in paragraph (h)(4) of this section;

(E) Conversion transactions, but only to the extent that gain realized with respect to such a transaction is treated as ordinary income under section 1258;

(F) The performance of services, to the extent provided in paragraph (h)(5) of this section;

(G) The commitment by a lender to provide financing, if any portion of such financing is actually provided;

(H) Transfers of debt securities subject to section 1058; and

(I) Other transactions, as provided by the Commissioner in published guidance. See §601.601(d)(2) of this chapter.

(ii) *Income from the sale of property.* Income from the sale of property will not be treated as income equivalent to interest by reason of paragraph (h)(2)(i)(A) or (B) of this section. Income derived by a controlled foreign corporation will be treated as arising from the sale of property only if the corporation in substance carries out sales activities. Accordingly, an arrangement that is designed to lend the form of a sales transaction to a transaction that in substance constitutes an advance of funds will be disregarded. For example, if a controlled foreign corporation acquires property on 30-

day payment terms from one person and sells that property to another person on 90-day payment terms and at prearranged prices and terms such that the foreign corporation bears no substantial economic risk with respect to the purchase and sale other than the risk of non-payment, the foreign corporation has not in substance derived income from the sale of property.

(3) *Notional principal contracts*—(i) *In general.* Income equivalent to interest includes income from notional principal contracts denominated in the functional currency of the taxpayer (or a qualified business unit of the taxpayer, as defined in section 989(a)), the value of which is determined solely by reference to interest rates or interest rate indices, to the extent that the income from such transactions accrues on or after August 14, 1989.

(ii) *Regular dealers.* Income equivalent to interest does not include income earned by a regular dealer (as defined in paragraph (a)(4)(iv) of this section) from notional principal contracts that are dealer property (as defined in paragraph (a)(4)(v) of this section).

(4) *Income equivalent to interest from factoring*—(i) *General rule.* Income equivalent to interest includes factoring income. Except as provided in paragraph (h)(4)(ii) of this section, the term *factoring income* includes any income (including any discount income or service fee, but excluding any stated interest) derived from the acquisition and collection or disposition of a factored receivable. The amount of income equivalent to interest realized with respect to a factored receivable is the difference (if a positive number) between the amount paid for the receivable by the foreign corporation and the amount that it collects on the receivable (or realizes upon its sale of the receivable). The rules of this paragraph (h)(4) apply only with respect to the tax treatment of factoring income derived from the acquisition and collection or disposition of a factored receivable and shall not affect the characterization of an expense or loss of either the person whose goods or services gave rise to a factored receivable or the obligor under a receivable.

(ii) *Exceptions.* Factoring income shall not include—

(A) Income treated as interest under section 864(d)(1) or (6) (relating to income derived from trade or service receivables of related persons), even if such income is treated as not described in section 864(d)(1) by reason of the same-country exception of section 864(d)(7);

(B) Income derived from a factored receivable if payment for the acquisition of the receivable is made on or after the date on which stated interest begins to accrue, but only if the rate of stated interest equals or exceeds 120 percent of the Federal short-term rate (as defined under section 1274) (or the analogous rate for a currency other than the dollar) as of the date on which the receivable is acquired by the foreign corporation; or

(C) Income derived from a factored receivable if payment for the acquisition of the receivable by the foreign corporation is made only on or after the anticipated date of payment of all principal by the obligor (or the anticipated weighted average date of payment of a pool of purchased receivables).

(iii) *Factored receivable.* For purposes of this paragraph (h)(4), the term *factored receivable* includes any account receivable or other evidence of indebtedness, whether or not issued at a discount and whether or not bearing stated interest, arising out of the disposition of property or the performance of services by any person, if such account receivable or evidence of indebtedness is acquired by a person other than the person who disposed of the property or provided the services that gave rise to the account receivable or evidence of indebtedness. For purposes of this paragraph (h)(4), it is immaterial whether the person providing the property or services agrees to transfer the receivable at the time of sale (as by accepting a third-party charge or credit card) or at a later time.

(iv) *Examples.* The following examples illustrate the application of this paragraph (h)(4).

Example 1. DP, a domestic corporation, owns all of the outstanding stock of *FS,* a controlled foreign corporation. *FS* acquires accounts receivable arising from the sale of property by unrelated corporation *X.* The receivables have a face amount of $100, and after 30 days bear stated interest equal to at least 120 percent of the applicable Federal short-term rate (determined as of the date the receivables are acquired by *FS*). *FS* purchases the receivables from *X* for $95 on Day 1 and collects $100 plus stated interest from the obligor under the receivables on Day 40. Income (other than stated interest) derived by *FS* from the factored receivables is factoring income within the meaning of paragraph (h)(4)(i) of this section and, therefore, is income equivalent to interest.

Example 2. The facts are the same as in *Example 1,* except that, rather than collecting $100 plus stated interest from the obligor under the factored receivables on Day 40, *FS* sells the receivables to controlled foreign corporation *Y* on Day 15 for $97. Both the income derived by *FS* on the factored receivables and the income derived by *Y* (other than stated interest) on the receivables are factoring income within the meaning of paragraph (h)(4)(i) of this section, and therefore, constitute income equivalent to interest.

Example 3. The facts are the same as in *Example 1,* except that *FS* purchases the receivables from *X* for $98 on Day 30. Income derived by *FS* from the factored receivables is excluded from factoring income under paragraph (h)(4)(ii)(B) of this section and, therefore, does not give rise to income equivalent to interest.

Example 4. The facts are the same as in *Example 3,* except that it is anticipated that all principal will be paid by the obligor of the receivables by Day 30. Income derived by *FS* from this maturity factoring of the receivables is excluded from factoring income under paragraph (h)(4)(ii)(C) of this section and, therefore, does not give rise to income equivalent to interest.

Example 5. The facts are the same as in *Example 4,* except that *FS* sells the factored receivables to *Y* for $99 on Day 45, at which time stated interest is accruing on the unpaid balance of $100. Because interest was accruing at the time *Y* acquired the receivables at a rate equal to at least 120 percent of the applicable Federal short-term rate, income derived by *Y* from the factored receivables is excluded from factoring income under paragraph (h)(4)(ii)(B) of this section and, therefore, does not give rise to income equivalent to interest.

Example 6. DP, a domestic corporation engaged in an integrated credit card business, owns all of the outstanding stock of *FS*, a controlled foreign corporation. On Day 1, individual *A* uses a credit card issued by *DP* to purchase shoes priced at $100 from *X*, a foreign corporation unrelated to *DP*, *FS*, or *A*. On Day 7, *X* transfers the receivable (which does not bear stated interest) arising from *A*'s purchase to *FS* in exchange for $95. *FS* collects $100 from *A* on Day 45. Income derived by *FS* on the factored receivable is factoring income within the meaning of paragraph (h)(4)(i) of this section and, therefore, is income equivalent to interest.

(5) *Receivables arising from performance of services.* If payment for services performed by a controlled foreign corporation is not made until more than 120 days after the date on which such services are performed, then the income derived by the controlled foreign corporation constitutes income equivalent to interest to the extent that interest income would be imputed under the principles of section 483 or the original issue discount provisions (sections 1271 through 1275), if—

(i) Such provisions applied to contracts for the performance of services;

(ii) The time period referred to in sections 483(c)(1) and 1274(c)(1)(B) were 120 days rather than six months; and

(iii) The time period referred to in section 483(c)(1)(A) were 120 days rather than one year.

(6) *Examples.* The following examples illustrate the application of this paragraph (h).

Example 1. CFC, a controlled foreign corporation, promises that Corporation *A* may borrow up to $500 in principal for one year beginning at any time during the next three months at an interest rate of 10 percent. In exchange, Corporation *A* pays *CFC* a commitment fee of $2. Pursuant to this agreement, *CFC* lends $80 to Corporation *A*. As a result, the entire $2 fee is included in the computation of *CFC'* s foreign personal holding company income under paragraph (h)(2)(i)(G) of this section.

Example 2. (i) At the beginning of its current taxable year, *CFC,* a controlled foreign corporation, purchases at face value a one-year debt instrument issued by Corporation *A* having a $100 principal amount and bearing a floating rate of interest set at the London Interbank Offered Rate (LIBOR) plus one percentage point. Contemporaneously, *CFC* borrows $100 from Corporation *B* for one year at a fixed interest rate of 10 percent, using the debt instrument as security.

(ii) During its current taxable year, *CFC* accrues $11 of interest from Corporation *A* on the bond. Because interest is excluded from the definition of income equivalent to interest under paragraph (h)(1)(ii)(B) of this section, the $11 is not income equivalent to interest.

(iii) During its current taxable year, *CFC* incurs $10 of interest expense with respect to the borrowing from Corporation *B*. That expense is allocated and apportioned to, and reduces, subpart F income to the extent provided in section 954(b)(5) and §§ 1.861–9T through 1.861–12T and 1.954–1(c).

Example 3. (i) On January 1, 1994, *CFC*, a controlled foreign corporation with the United States dollar as its functional currency, purchases at face value a 10-year debt instrument issued by Corporation *A* having a $100 principal amount and bearing a floating rate of interest set at LIBOR plus one percentage point payable on December 31st of each year. *CFC* subsequently determines that it would prefer receiving a fixed rate of return. Accordingly, on January 1, 1995, *CFC* enters into a 9-year interest rate swap agreement with Corporation *B* whereby Corporation *B* promises to pay *CFC* on December 31st of each year an amount equal to 10 percent on a notional principal amount of $100. In exchange, *CFC* promises to pay Corporation *B* an amount equal to LIBOR plus one percentage point on the notional principal amount.

(ii) On December 31, 1995, *CFC* receives $9 of interest income from Corporation *A* with respect to the debt instrument. On the same day, *CFC* receives a total of $10 from Corporation *B* and pays $9 to Corporation *B* with respect to the interest rate swap.

(iii) The $9 of interest income is foreign personal holding income under section 954(c)(1). Pursuant to § 1.446–3(d), *CFC* recognizes $1 of swap income for its 1995 taxable year that is also foreign personal holding company income because it is income equivalent to interest under paragraph (h)(2)(i)(C) of this section.

Example 4. (i) *CFC*, a controlled foreign corporation, purchases commodity X on the spot market for $100 and, contemporaneously, enter into a 3–month forward contract to sell commodity X for $104, a price set by the forward market.

(ii) Assuming that substantially all of *CFC*'s expected return is attributable to the time value of the net investment, as described in section 1258(c)(1), the transaction is a conversion transaction under section 1258(c). Accordingly, any gain treated as ordinary income under section 1258(a) will be foreign personal holding company income because it is income equivalent to interest under paragraph (h)(2)(i)(E) of this section.

[T.D. 8618, 60 FR 46517, Sept. 7, 1995; 60 FR 58731, Nov. 28, 1995; 60 FR 62025, 62026, Dec. 4, 1995, as amended by T.D. 8704, 62 FR 21, Jan. 2, 1997]

§ 1.954–2T Foreign personal holding company income (temporary).

(a)(1) through (4) [Reserved]. For further guidance, see § 1.954–2(a) through (4).

(5) *Special rules applicable to distributive share of partnership income*—(i) *Application of related person exceptions where payment reduces foreign tax of payor.* If a partnership receives an item of income that reduced the foreign income tax of the payor (determined under the principles of § 1.954–9T(a)(3)), to determine the extent to which a controlled foreign corporation's distributive share of such item of income is foreign personal holding company income, the exceptions contained in section 954(c)(3) shall apply only if—

(A)(*1*) Any such exception would have applied to exclude the income from foreign personal holding company income if the controlled foreign corporation had earned the income directly (determined by testing, with reference to such controlled foreign corporation, whether an entity is a related person, within the meaning of section 954(d)(3), or is organized under the laws of, or uses property in, the foreign country in which the controlled foreign corporation is created or organized); and

(*2*) The distributive share of such income is not in respect of a payment made by the controlled foreign corporation to the partnership; and

(B)(*1*) The partnership is created or organized, and uses a substantial part of its assets in a trade or business in the country under the laws of which the controlled foreign corporation is created or organized (determined under the principles of § 1.954–2(b)(4));

(*2*) The partnership is regarded as fiscally transparent, as defined in § 1.954–9T(a)(7), by all countries under the laws of which the controlled foreign corporation is created or organized or has substantial assets; or

(*3*) The income is taxed in the year when earned at an effective rate of tax (determined under the principles of § 1.954–1(d)(2)) that is not less than 90 percent of, and not more than five percentage points less than, the effective rate of tax that would have applied to such income under the laws of the country in which the controlled foreign corporation is created or organized if such income were earned directly by the controlled foreign corporation partner from local sources.

(ii) *Certain other exceptions applicable to foreign personal holding company income.* [Reserved].

(iii) *Effective date.* Paragraph (a)(5)(i) of this section shall apply to all amounts paid or accrued on or after March 23, 1998, except for amounts paid or accrued pursuant to arrangements entered into before March 23, 1998 and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after March 23, 1998.

(6) *Special rules applicable to exceptions from foreign personal holding company income treatment in circumstances involving hybrid branches*—(i) *In general.* In the case of a payment between a controlled foreign corporation (or its hybrid branch, as defined in §1.954–9T(a)(6)) and the hybrid branch of a related controlled foreign corporation, the exceptions contained in section 954(c)(3) shall apply only if the payment would have qualified for the exception if the payor were a separate controlled foreign corporation created or organized in the jurisdiction where foreign tax is reduced and the payee were a separate controlled foreign corporation created or organized under the laws of the jurisdiction in which the payment is subject to tax (other than a withholding tax).

(ii) *Exception where no tax reduction or tax disparity*. Paragraph (a)(6)(i) of this section shall not apply unless the payment would have met the foreign tax reduction test of §1.954–9T(a)(3) and the tax disparity test of §1.954–9T(a)(5)(iv) if those provisions had been applicable to the payment.

(iii) *Effective date.* The rules of this section shall apply to all amounts paid or accrued on or after January 16, 1998, except for amounts paid or accrued pursuant to arrangements entered into before January 16, 1998, and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after January 16, 1998.

(b) through (h) [Reserved]. For further guidance, see §1.954–2(b) through (h).

[T.D. 8767, 63 FR 14616, Mar. 26, 1998]

§1.954–3 Foreign base company sales income.

(a) *Income included*—(1) *In general*—(i) *General rules.* Foreign base company sales income of a controlled foreign corporation shall, except as provided in subparagraphs (2), (3), and (4) of this paragraph, consist of gross income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with (*a*) the purchase of personal property from a related person and its sale to any person, (*b*) the sale of personal property to any person on behalf of a related person, (*c*) the purchase of personal property from any person and its sale to a related person, or (*d*) the purchase of personal property from any person on behalf of a related person. See section 954(d)(1). This section shall apply to the purchase and/or sale of personal property, whether or not such property was purchased and/or sold in the ordinary course of trade or business, except that income derived in connection with the sale of tangible personal property will not be considered to be foreign base company sales income if such property is sold to an unrelated person, as defined in paragraph (e)(2) of §1.954–1, after substantial use has been made of the property by the controlled foreign corporation in its trade or business. This section shall not apply to the excess of gains over losses from sales or exchanges of securities or from futures transactions, to the extent such excess gains are includible in foreign personal holding company income of the controlled foreign corporation under §1.954–2 or foreign base company shipping income under §1.954–6; nor shall it apply to the sale of the controlled foreign corporation's property (other than its stock in trade or other property of a kind which would properly be included in its inventory if on hand at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of its trade or business) if substantially all the property of such corporation is sold pursuant to the discontinuation of the trade or business previously carried on by such corporation. The term ''any person'' as used in this subparagraph includes a related person, as defined in paragraph (e)(1) of § 1.954–1.

(ii) *Special rule—(a) In general.* The term ''personal property'' as used in section 954(d) and this section shall not include agricultural commodities which are not grown in the United States (within the meaning of section 7701(a)(9)) in commercially marketable quantities. All of the agricultural commodities listed in table I shall be considered grown in the United States in commercially marketable quantities. Bananas, black pepper, cocoa, coconut, coffee, crude rubber, and tea shall not be considered grown in the United States in commercially marketable quantities. All other agricultural commodities shall not be considered grown in the United States in commercially marketable quantities when, in consideration of all of the facts and circumstances of the individual case, such commodities are shown to be produced in the United States in insufficient quantity and quality to be marketed commercially. The term ''agricultural commodities'' includes, but is not limited to, livestock, poultry, fish produced in fish farms, fruit, furbearing animals as well as the products of truck farms, ranches, nurseries, ranges, and orchards. A fish farm is an area where fish are grown or raised (artificially protected and cared for), as opposed to merely caught or harvested. However, the term ''agricultural commodities'' shall not include timber (either standing or felled), or any commodity at least 50 percent of the fair market value of which is attributable to manufacturing or processing, determined in a manner consistent with the regulations under section 993(c) (relating to the definition of export property). For purposes of applying such regulations, the term ''processing'' shall be deemed not to include handling, packing, packaging, grading, storing, transporting, slaughtering, and harvesting. Subdivision (ii) shall apply in the computation of foreign base company sales income for taxable years of controlled foreign corporations beginning after December 31, 1975, and to taxable years of U.S. shareholders (within the meaning of section 951(b)) within which or with which such taxable years of such foreign corporations end.

(b) Table.

TABLE I—AGRICULTURAL COMMODITIES GROWN IN THE UNITED STATES IN COMMERCIALLY MARKETABLE QUANTITIES

Livestock and Products

Beeswax
Cattle and calves
Chickens
Chicken eggs
Ducks
Geese
Goats
Hogs
Honey
Horses
Milk
Mink
Mohair
Rabbits
Sheep and lambs
Turkeys
Wool

Crops

Alfalfa
Almonds
Apples
Apricots
Artichokes
Asparagus
Avocadoes
Barley
Beans
Beets
Blackberries
Blueberries
Brussel sprouts
Broccoli
Bulbs
Cabbage
Cantaloupes
Carrots
Cauliflower
Celery
Cherries
Corn
Cotton
Cranberries
Cucumbers
Cut flowers
Dates
Eggplant
Escarole
Figs
Filberts
Flaxseed
Garlic
Grapes
Grapefruit
Grass seed
Lettuce
Lime
Macadamia nuts
Maple syrup and sugar
Mint
Mushrooms
Nectarines
Oats
Olives
Onions
Oranges
Papayas
Pecans
Peaches
Peanuts
Pears
Peas
Peppers
Plums and prunes
Potatoes
Potted plants
Raspberries
Rice
Rhubarb
Rye
Sorghum grain
Soybeans
Spinach
Strawberries
Sugar beets
Sugarcane
Sweet potatoes
Tangelos
Tangerines
Tobacco

TABLE I—AGRICULTURAL COMMODITIES GROWN IN THE UNITED STATES IN COMMERCIALLY MARKETABLE QUANTITIES—Continued

Hay
Honeydew melons
Hops
Lemons
Tomatoes
Walnuts
Watermelons
Wheat

(iii) The application of this subparagraph may be illustrated by the following examples:

Example 1. Controlled foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A purchases from M Corporation, a related person, articles manufactured in the United States and sells the articles in the form in which purchased to P, not a related person, for delivery and use in foreign country Y. Gross income of A Corporation derived from the purchase and sale of the personal property is foreign base company sales income.

Example 2. Corporation A in example 1 also purchases from P, not a related person, articles manufactured in country Y and sells the articles in the form in which purchased to foreign corporation B, a related person, for use in foreign country Z. Gross income of A Corporation derived from the purchase and sale of the personal property is foreign base company sales income.

Example 3. Controlled foreign corporation C, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation N. By contract, N Corporation agrees to pay C Corporation, a related person, a commission equal to 6 percent of the gross selling price of all personal property shipped by N Corporation as the result of orders solicited by C Corporation in foreign countries Y and Z. In fulfillment of such orders, N Corporation ships products manufactured by it in the United States. Corporation C does not assume title to the property sold. Gross commissions received by C Corporation from N Corporation in connection with the sale of such property for use in countries Y and Z constitute foreign base company sales income.

Example 4. Controlled foreign corporation D, incorporated under the laws of foreign country Y, is a wholly owned subsidiary of domestic corporation R. In 1964, D Corporation acquires a United States manufactured lathe from R Corporation. In 1972, after having made substantial use of the lathe in its manufacturing business, D Corporation sells the lathe to an unrelated person for use in foreign country Z. Gross income from the sale of the lathe is not foreign base company sales income since it is sold to an unrelated person after substantial use has been made of it by D Corporation in its business.

Example 5. Controlled foreign corporation E, incorporated under the laws of foreign country Y, is a wholly owned subsidiary of domestic corporation P. Corporation E purchases from P Corporation articles manufactured by P Corporation outside of country Y and sells the articles to F Corporation, an unrelated person, for use in foreign country Z. Corporation E finances the purchase of the articles by F Corporation by agreeing to accept payment over an extended period of time and receives not only the purchase price but also interest and service fees. All gross income of E Corporation derived in connection with the purchase and sale of the personal property, including interest and service fees derived from financing the sale to F Corporation, constitutes foreign base company sales income.

(2) *Property manufactured, produced, constructed, grown, or extracted within the country in which the controlled foreign corporation is created or organized.* Foreign base company sales income does not include income derived in connection with the purchase and sale of personal property (or purchase or sale of personal property on behalf of a related person) in a transaction described in subparagraph (1) of this paragraph if the property is manufactured, produced, constructed, grown, or extracted in the country under the laws of which the controlled foreign corporation which purchases and sells the property (or acts on behalf of a related person) is created or organized. See section 954(d)(1)(A). The principles set forth in subparagraph (4) of this paragraph with respect to the manufacture, production, or construction of personal property shall apply under this subparagraph in determining what constitutes manufacture, production, or construction of property. The application of this subparagraph may be illustrated by the following examples:

Example 1. Controlled foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A purchases coffee beans grown in country X from foreign corporation P, a related person, and sells the beans to M Corporation, a related person, for use in the United States. Income from the purchase and sale of the coffee beans by A Corporation is not foreign base company sales income since the beans were grown in country X.

Example 2. Controlled foreign corporation B, incorporated under the laws of foreign country X, is a wholly owned subsidiary of controlled foreign corporation C, also incorporated under the laws of country X. Corporation B purchases and imports into country X rough diamonds mined in foreign country Y; in country X it cuts, polishes, and shapes the diamonds in a process which constitutes manufacturing within the meaning of subparagraph (4) of this paragraph. Corporation B sells the finished diamonds to C Corporation, a related person, which in turn sells them for use in foreign country Z. Since for purposes of this subparagraph the finished diamonds are manufactured in country X, gross income derived by C Corporation from their sale is not foreign base company sales income.

(3) *Property sold for use, consumption, or disposition within the country in which the controlled foreign corporation is created or organized*—(i) *In general.* Foreign base company sales income does not include income derived in connection with the purchase and sale of personal property (or purchase or sale of personal property on behalf of a related person) in a transaction described in subparagraph (1) of this paragraph, *(a)* if the property is sold for use, consumption, or disposition in the country under the laws of which the controlled foreign corporation which purchases and sells the property (or sells on behalf of a related person) is created or organized or *(b),* where the property is purchased by the controlled foreign corporation on behalf of a related person, if such property is purchased for use, consumption, or disposition in the country under the laws of which such controlled foreign corporation is created or organized. See section 954(d)(1)(B).

(ii) *Rules for determining country of use, consumption, or disposition.* As a general rule, personal property which is sold to an unrelated person will be presumed for purposes of this subparagraph to have been sold for use, consumption, or disposition in the country of destination of the property sold; for such purpose, the occurrence in a country of a temporary interruption in shipment of goods shall not constitute such country the country of destination. However, if at the time of a sale of personal property to an unrelated person the controlled foreign corporation knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed, or disposed of in the country of destination, the controlled foreign corporation must determine the country of ultimate use, consumption, or disposition of the property or the property will be presumed to have been used, consumed, or disposed of outside the country under the laws of which the controlled foreign corporation is created or organized. A controlled foreign corporation which sells personal property to a related person is presumed to sell such property for use, consumption, or disposition outside the country under the laws of which the controlled foreign corporation is created or organized unless such corporation establishes the use made of the property by the related person; once it has established that the related person has disposed of the property, the rules in the two preceding sentences relating to sales by a controlled foreign corporation to an unrelated person will apply at the first stage in the chain of distribution at which a sale is made by a related person to an unrelated person. Notwithstanding the preceding provisions of this subdivision, a controlled foreign corporation which sells personal property to any person all of whose business except for an insubstantial part consists of selling from inventory to retail customers at retail outlets all within one country may assume at the time of such sale to such person that such property will be used, consumed, or disposed of within such country.

(iii) *Fungible goods.* For purposes of this subparagraph, a controlled foreign corporation which sells to a purchaser personal property which because of its fungible nature cannot reasonable be specifically traced to other purchasers and to the countries of ultimate use, consumption, or disposition shall, unless such corporation establishes a different disposition as being proper, treat such property as being sold, for ultimate use, consumption, or disposition in those countries, and to those other purchasers, in the same proportions in which property from the fungible mass of the first purchaser is sold in the regular course of business by such first purchaser. No apportionment need be made, however, on the basis of sporadic sales by the first purchaser.

This subdivision shall apply only in a case where the controlled foreign corporation knew, or should have known from the facts and circumstances surrounding the transaction, the manner in which the first purchaser disposes of goods from the fungible mass.

(iv) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example 1. Controlled foreign corporation A, incorporated under the laws of foreign country X, and controlled foreign corporation B, incorporated under the laws of foreign country Y, are related persons. Corporation A purchases from B Corporation electric transformers produced by B Corporation in country Y and sells the transformers to D Corporation, an unrelated person, for installation in a factory building being constructed in country X. Since the personal property purchased and sold by A Corporation is to be used within the country in which A Corporation is incorporated, income of A Corporation derived from the purchase and sale of the electric transformers is not foreign base company sales income.

Example 2. Controlled foreign corporation C, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation N. Corporation C purchases from N Corporation sewing machines manufactured in the United States by N Corporation and sells the sewing machines to retail department stores, unrelated persons, located in foreign country X. The entire activities of the department stores to which C Corporation sells the machines consist of selling goods from inventory to retail customers at retail outlets in country X. Under these circumstances, at the time of sale C Corporation may assume the sewing machines will be used, consumed, or disposed of in country X, and no attempt need be made by C Corporation to determine where the sewing machines will ultimately be used by the customers of the retail department stores. Gross income of C Corporation derived from the sales to the department stores located in country X is not foreign base company sales income.

Example 3. Controlled foreign corporation D, incorporated under the laws of foreign country Y, and controlled foreign corporation E, incorporated under the laws of foreign country X, are related persons. Corporation D purchases from E Corporation sulphur extracted by E Corporation from deposits located in country X. Corporation D sells the sulphur to F Corporation, an unrelated person, for delivery to F Corporation’s storage facilities located in country Y. At the time of the sale of the sulphur from D Corporation to F Corporation, D Corporation knows that F Corporation is actively engaged in the business of selling a large amount of sulphur in country Y but also that F Corporation sells, in the normal course of its business, 25 percent of its sulphur for ultimate consumption in foreign country Z. However, D Corporation has no knowledge at the time of sale whether any portion of the particular shipment it sells to F Corporation will be resold by F Corporation for ultimate use, consumption, or disposition outside country Y. Moreover, delivery of the sulphur to F Corporation’s storage facilities constitutes more than a temporary interruption in the shipment of the sulphur. Under such circumstances, D Corporation may, but is not required to, trace the ultimate disposition by F Corporation of the personal property sold to F Corporation; however, if D Corporation does not trace the ultimate disposition and if it does not establish a different disposition as being proper, 25 percent of the sulphur sold by D Corporation to F Corporation will be treated as being sold for consumption in country Z and 25 percent of the gross income from the sale of sulphur by D Corporation to F Corporation will be treated as foreign base company sales income.

Example 4. Controlled foreign corporation G, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation P. Corporation G purchases from P Corporation toys manufactured in the United States by P Corporation and sells the toys to R, an unrelated person, for delivery to a duty-free port in country X. Instructions for the assembly and operation of the toys are printed in a language which is not commonly used in country X. From the facts and circumstances surrounding the sales to R, G Corporation knows, or should know, that the toys will probably not be used, consumed, or disposed of within country X. Therefore, unless G Corporation determines the use to be made of the toys by R, such property will be presumed to have been sold by R for use, consumption, or disposition outside of country X, and the entire gross income of G Corporation derived from the sales will be considered foreign base company sales income.

(4) *Property manufactured or produced by the controlled foreign corporation*—(i) *In general.* Foreign base company sales income does not include income of a controlled foreign corporation derived in connection with the sale of personal property manufactured, produced, or constructed by such corporation in whole or in part from personal property which it has purchased. A foreign corporation will be considered, for purposes of this subparagraph, to have manufactured, produced, or constructed personal property which it

sells if the property sold is in effect not the property which it purchased. In the case of the manufacture, production, or construction of personal property, the property sold will be considered, for purposes of this subparagraph, as not being the property which is purchased if the provisions of subdivision (ii) or (iii) of this subparagraph are satisfied. For rules of apportionment in determining foreign base company sales income derived from the sale of personal property purchased and used as a component part of property which is not manufactured, produced, or constructed, see subparagraph (5) of this paragraph.

(ii) *Substantial transformation of property.* If purchased personal property is substantially transformed prior to sale, the property sold will be treated as having been manufactured, produced, or constructed by the selling corporation. The application of this subdivision may be illustrated by the following examples:

Example 1. Controlled foreign corporation A, incorporated under the laws of foreign country X, operates a paper factory in foreign country Y. Corporation A purchases from a related person wood pulp grown in country Y. Corporation A, by a series of processes, converts the wood pulp to paper which it sells for use in foreign country Z. The transformation of wood pulp to paper constitutes the manufacture or production of property for purposes of this subparagraph.

Example 2. Controlled foreign corporation B, incorporated under the laws of foreign country X, purchases steel rods from a related person which produces the steel in foreign country Y. Corporation B operates a machining plant in country X in which it utilizes the purchased steel rods to make screws and bolts. The transformation of steel rods to screws and bolts constitutes the manufacture or production of property for purposes of this subparagraph.

Example 3. Controlled foreign corporation C, incorporated under the laws of foreign country X, purchases tuna fish from unrelated persons who own fishing boats which catch such fish on the high seas. Corporation C receives such fish in country X in the condition in which taken from the fishing boats and in such country processes, cans, and sells the fish to related person D, incorporated under the laws of foreign country Y, for consumption in foreign country Z. The transformation of such fish into canned fish constitutes the manufacture or production of property for purposes of this subparagraph.

(iii) *Manufacture of a product when purchased components constitute part of the property sold.* If purchased property is used as a component part of personal property which is sold, the sale of the property will be treated as the sale of a manufactured product, rather than the sale of component parts, if the operations conducted by the selling corporation in connection with the property purchased and sold are substantial in nature and are generally considered to constitute the manufacture, production, or construction of property. Without limiting this substantive test, which is dependent on the facts and circumstances of each case, the operations of the selling corporation in connection with the use of the purchased property as a component part of the personal property which is sold will be considered to constitute the manufacture of a product if in connection with such property conversion costs (direct labor and factory burden) of such corporation account for 20 percent or more of the total cost of goods sold. In no event, however, will packaging, repackaging, labeling, or minor assembly operations constitute the manufacture, production, or construction of property for purposes of section 954(d)(1). The application of this subdivision may be illustrated by the following examples:

Example 1. Controlled foreign corporation A, incorporated under the laws of foreign country X, sells industrial engines for use, consumption, and disposition outside country X. Corporation A, in connection with the assembly of such engines, performs machining and assembly operations. In addition, A Corporation purchases, from related and unrelated persons, components manufactured in foreign country Y. On a per unit basis, A Corporation's selling price and costs of such engines are as follows:

Selling price			$400
Cost of goods sold:			
Material—			
Acquired from related persons	$100		
Acquired from others	40		
Total material		$140	
Conversion costs (direct labor and factory burden)		70	
Total cost of goods sold		210	
Gross profit		190	
Administrative and selling expenses		50	

Taxable income		140

The conversion costs incurred by A Corporation are more than 20 percent of total costs of goods sold ($70/$210 or 33 percent). Although the product sold, an engine, is not sufficiently distinguishable from the components to constitute a substantial transformation of the purchased parts within the meaning of subdivision (ii) of this subparagraph, A Corporation will be considered under this subdivision to have manufactured the product it sells.

Example 2. Controlled foreign corporation B, incorporated under the laws of foreign country X, operates an automobile assembly plant. In connection with such activity, B Corporation purchases from related persons assembled engines, transmissions, and certain other components, all of which are manufactured outside of country X; purchases additional components from unrelated persons; conducts stamping, machining, and subassembly operations; and has a substantial investment in tools, jigs, welding equipment, and other machinery and equipment used in the assembly of an automobile. On a per unit basis, B Corporation's selling price and costs of such automobiles are as follows:

Selling price			$2,500
Cost of goods sold:			
Material—			
Acquired from related persons	$1,200		
Acquired from others	275		
Total material		$1,475	
Conversion costs (direct labor and factory burden)		25	
Total cost of goods sold			1,800
Gross profit			700
Administrative and selling expenses			300
Taxable income			400

The product sold, an automobile, is not sufficiently distinguishable from the components purchased (the engine, transmission, etc.) to constitute a substantial transformation of purchased parts within the meaning of subdivision (ii) of this subparagraph. Although conversion costs of B Corporation are less than 20 percent of total cost of goods sold ($325/$1800 or 18 percent), the operations conducted by B Corporation in connection with the property purchased and sold are substantial in nature and are generally considered to constitute the manufacture of a product. Corporation B will be considered under this subdivision to have manufactured the product it sells.

Example 3. Controlled foreign corporation C, incorporated under the laws of foreign country X, purchases from related persons radio parts manufactured in foreign country Y. Corporation C designs radio kits, packages component parts required for assembly of such kits, and sells the parts in a knocked-down condition to unrelated persons for use outside country X. These packaging operations of C Corporation do not constitute the manufacture, production, or construction of personal property for purposes of section 954(d)(1).

(5) *Rules for apportionment of income derived from the sale of purchased components used in property not manufactured, produced, or constructed.* The foreign base company sales income derived by a controlled foreign corporation for the taxable year from sales of personal property purchased and used as a component part of property which is not manufactured, produced, or constructed by such corporation within the meaning of subparagraph (4) of this paragraph shall, unless the records of the controlled foreign corporation show that a different apportionment of income is proper or unless all the income from such sales is treated as foreign base company sales income, be determined by first making for such year the following separate classifications and subclassifications with respect to the property which is sold and then by apportioning the income for such year from such sales in accordance with the rules of this subparagraph:

(i) A classification of the cost of components used in the property which is sold into two classes consisting of the cost of components manufactured, produced, constructed, grown, or extracted—

(a) Within the country under the laws of which the controlled foreign corporation is created or organized, and

(b) Outside such country;

(ii) A subclassification of the class described in subdivision (i) *(b)* of this subparagraph into—

(a) The cost of such components purchased from unrelated persons, and

(b) The cost of such components purchased from related persons;

(iii) A classification of the income derived from such sales into two classes consisting of income derived from sales for use, consumption, or disposition—

(a) Within the country under the laws of which the controlled foreign

corporation is created or organized, and

(b) Outside such country; and

(iv) A subclassification of the class described in subdivision (iii) *(b)* of this subparagraph into income from—

(a) Sales to unrelated persons, and

(b) Sales to related persons.

The foreign base company sales income for the taxable year from purchases of the property from related persons and sales to unrelated persons shall be the amount which bears to the amount described in subdivision (iv) *(a)* of this subparagraph the same ratio that the amount described in subdivision (ii) *(b)* of this subparagraph bears to the total cost of components used in the product which is sold. The foreign base company sales income for the taxable year from purchases of the property from related persons and sales to related persons is the amount which bears to the amount described in subdivision (iv) *(b)* of this subparagraph the same ratio that the amount described in subdivision (ii) *(b)* of this subparagraph bears to the total cost of components used in the product which is sold.

The foreign base company sales income for the taxable year from purchases of the property from unrelated persons and sales to related persons is the amount which bears to the amount described in subdivision (iv) *(b)* of this subparagraph the same ratio that the amount described in subdivision (ii) *(a)* of this subparagraph bears to the total cost of components used in the product which is sold. The application of this subparagraph may be illustrated by the following examples:

Example 1. Controlled foreign corporation C, which is incorporated under the laws of foreign country X, uses the calendar year as the taxable year. For 1964, C Corporation purchases radio parts of which some are manufactured in foreign country Y; and others, in country X. Some of the parts manufactured in country Y are purchased from related persons. Corporation C uses the purchased parts in radio kits which it designs and sells for assembly by its customers, unrelated persons, some of whom use the kits outside country X. Unless the records of C Corporation show that a different apportionment of income is proper, the foreign base company sales income for 1964 is determined in the following manner upon the basis of the following factual classifications for such year:

Cost of components purchased from all persons:		
Manufactured within country X		$20
Manufactured outside country X		40
Total cost		60
Cost of components manufactured outside country X:		
Purchased from unrelated persons		10
Purchased from related persons		30
Total cost		40
Gross income from sales:		
Gross receipts from sales		120
Cost of goods sold:		
Components	$60	
Direct labor and factory burden	10	70
Gross income		50
Gross income from sales:		
For use within country X		26
For use outside country X		24
Gross income		50
Foreign base company sales income from purchases from related persons and sales to unrelated persons ($24×$30/$60)		12

Example 2. The facts are the same as in example 1 except that none of the purchases are from related persons and some of the sales for use outside country X are to related persons. Unless the records of C Corporation show that a different apportionment of income is proper, the foreign base company sales income for 1964 is determined in the following manner upon the basis of the following additional factual classification for such year:

Gross income from sales for use outside country X—	
To unrelated persons	$8
To related persons	16
Total gross income	24
Foreign base company sales income from purchases from unrelated persons and sales to related persons ($16×$40/$60)	10.67

Example 3. The facts are the same as in example 1 except that some of the sales for use outside country X are to related persons as in example 2. Unless the records of C Corporation show that a different apportionment of income is proper, the foreign base company sales income for 1964 is determined in the following manner:

Foreign base company sales income from purchases from related persons and sales to unrelated persons ($8×$30/$60)	$4.00
Foreign base company sales income from purchases from related persons and sales to related persons ($16×$30/$60)	8.00

Foreign base company sales income from purchases from unrelated persons and sales to related persons ($16×$10/$60)	2.67
Total foreign base company sales income	14.67

(b) *Branches of controlled foreign corporation treated as separate corporations*—(1) *General rules for determining when to apply separate treatment*—(i) *Sales or purchase branch—(a) In general.* If a controlled foreign corporation carries on purchasing or selling activities by or through a branch or similar establishment located outside the country under the laws of which such corporation is created or organized and the use of the branch or similar establishment for such activities has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of such controlled foreign corporation, the branch or similar establishment and the remainder of the controlled foreign corporation will be treated as separate corporations for purposes of determining foreign base company sales income of such corporation. See section 954(d)(2).

(b) Allocation of income and comparison of effective rates of tax. The determination as to whether such use of the branch or similar establishment has the same tax effect as if it were a wholly owned subsidiary corporation of the controlled foreign corporation shall be made by allocating to such branch or similar establishment only that income derived by the branch or establishment which, when the special rules of subparagraph (2)(i) of this paragraph are applied, is described in paragraph (a) of this section (but determined without applying subparagraphs (2), (3), and (4) of such paragraph). The use of the branch or similar establishment for such activities will be considered to have substantially the same tax effect as if it were a wholly owned subsidiary corporation of the controlled foreign corporation if the income allocated to the branch or similar establishment under the immediately preceding sentence is, by statute, treaty obligation, or otherwise, taxed in the year when earned at an effective rate of tax that is less than 90 percent of, and at least 5 percentage points less than, the effective rate of tax which would apply to such income under the laws of the country in which the controlled foreign corporation is created or organized, if, under the laws of such country, the entire income of the controlled foreign corporation were considered derived by the corporation from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were managed and controlled in such country.

(c) Use of more than one branch. If a controlled foreign corporation carries on purchasing or selling activities by or through more than one branch or similar establishment located outside the country under the laws of which such corporation is created or organized, or by or through one or more such branches or similar establishments in a case where subdivision (ii) of this subparagraph also applies, then *(b)* of this subdivision shall be applied separately to the income derived by each such branch or similar establishment (by treating such purchasing or selling branch or similar establishment as if it were the only branch or similar establishment of the controlled foreign corporation and as if any such other branches or similar establishments were separate corporations) in determining whether the use of such branch or similar establishment has substantially the same tax effect as if such branch or similar establishment were a wholly owned subsidiary corporation of the controlled foreign corporation.

(ii) *Manufacturing branch—(a) In general.* If a controlled foreign corporation carries on manufacturing, producing, constructing, growing, or extracting activities by or through a branch or similar establishment located outside the country under the laws of which such corporation is created or organized and the use of the branch or similar establishment for such activities with respect to personal property purchased or sold by or through the remainder of the controlled foreign corporation has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of such controlled foreign corporation, the branch or similar establishment and the remainder of the controlled foreign corporation will be treated as separate corporations for purposes of determining foreign base company sales income of such corporation. See section 954(d)(2).

(b) Allocation of income and comparison of effective rates of tax. The determination as to whether such use of the branch or similar establishment has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of the controlled foreign corporation shall be made by allocating to the remainder of such controlled foreign corporation only that income derived by the remainder of such corporation, which, when the special rules of subparagraph (2)(i) of this paragraph are applied, is described in paragraph (a) of this section (but determined without applying subparagraphs (2), (3), and (4) of such paragraph). The use of the branch or similar establishment for such activities will be considered to have substantially the same tax effect as if it were a wholly owned subsidiary corporation of the controlled foreign corporation if income allocated to the remainder of the controlled foreign corporation under the immediately preceding sentence is, by statute, treaty obligation, or otherwise, taxed in the year when earned at an effective rate of tax that is less than 90 percent of, and at least 5 percentage points less than, the effective rate of tax which would apply to such income under the laws of the country in which the branch or similar establishment is located, if, under the laws of such country, the entire income of the controlled foreign corporation were considered derived by such corporation from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were created or organized under the laws of, and managed and controlled in, such country.

(c) Use of one or more sales or purchase branches in addition to a manufacturing branch. If, with respect to personal property manufactured, produced, constructed, grown, or extracted by or through a branch or similar establishment located outside the country under the laws of which the controlled foreign corporation is created or organized, purchasing or selling activities are carried on by or through more than one branch or similar establishment, or by or through one or more branches or similar establishments located outside such country, of such corporation, then *(b)* of this subdivision shall be applied separately to the income derived by each such purchasing or selling branch or similar establishment (by treating such purchasing or selling branch or similar establishment as though it alone were the remainder of the controlled foreign corporation) for purposes of determining whether the use of such manufacturing, producing, constructing, growing, or extracting branch or similar establishment has substantially the same tax effect as if such branch or similar establishment were a wholly owned subsidiary corporation of the controlled foreign corporation.

(2) *Special rules*—(i) *Determination of treatment as a wholly owned subsidiary corporation.* For purposes of determining under this paragraph whether the use of a branch or similar establishment which is treated as a separate corporation has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of a controlled foreign corporation—

(a) Treatment as separate corporations. The branch or similar establishment will be treated as a wholly owned subsidiary corporation of the controlled foreign corporation, and such branch or similar establishment will be deemed to be incorporated in the country in which it is located.

(b) Activities treated as performed on behalf of remainder of corporation. With respect to purchasing or selling activities performed by or through the branch or similar establishment, such purchasing or selling activities shall—

(1) With respect to personal property manufactured, produced, constructed, grown, or extracted by the controlled foreign corporation, or

(2) With respect to personal property (other than property described in *(1)* of this subdivision *(b)*) purchased or sold,

or purchased and sold, by the controlled foreign corporation,

be treated as performed on behalf of the controlled foreign corporation.

(c) Activities treated as performed on behalf of branch. With respect to manufacturing, producing, constructing, growing, or extracting activities performed by or through the branch or similar establishment, purchasing or selling activities performed by or through the remainder of the controlled foreign corporation with respect to the personal property manufactured, produced, constructed, grown, or extracted by or through the branch or similar establishment shall be treated as performed on behalf of the branch or similar establishment.

(d) Determination of hypothetical tax. To the extent applicable, the principles of paragraph (b)(4)(ii) of §1.954–1 shall be used in determining, under subdivision (i) of subparagraph (1) of this paragraph, the effective rate of tax which would apply to the income of the branch or similar establishment under the laws of the country in which the controlled foreign corporation is created or organized, or in determining, under subdivision (ii) of such subparagraph, the effective rate of tax which would apply to the income of the branch or similar establishment under the laws of the country in which the manufacturing, producing, constructing, growing, or extracting branch or similar establishment is located.

(e) Tax laws to be taken into account. Tax determinations shall be made by taking into account only the income, war profits, excess profits, or similar tax laws (or the absence of such laws) of the countries involved.

(ii) *Determination of foreign base company sales income.* Once it has been determined under subparagraph (1) of this paragraph that a branch or similar establishment and the remainder of the controlled foreign corporation are to be treated as separate corporations, the determination of whether such branch or similar establishment, or the remainder of the controlled foreign corporation, as the case may be, has foreign base company sales income shall be made by applying the following rules:

(a) Treatment as separate corporations. The branch or similar establishment will be treated as a wholly owned subsidiary corporation of the controlled foreign corporation, and such branch or similar establishment will be deemed to be incorporated in the country in which it is located.

(b) Activities treated as performed on behalf of remainder of corporation. With respect to purchasing or selling activities performed by or through the branch or similar establishment, such purchasing or selling activities shall—

(1) With respect to personal property manufactured, produced, constructed, grown, or extracted by the controlled foreign corporation, or

(2) With respect to personal property (other than property described in *(1)* of this subdivision *(b)*) purchased or sold, or purchased and sold, by the controlled foreign corporation,

be treated as performed on behalf of the controlled foreign corporation.

(c) Activities treated as performed on behalf of branch. With respect to manufacturing, producing, constructing, growing, or extracting activities performed by or through the branch or similar establishment, purchasing or selling activities performed by or through the remainder of the controlled foreign corporation with respect to the personal property manufactured, produced, constructed, grown, or extracted by or through the branch or similar establishment shall be treated as performed on behalf of the branch or similar establishment.

(d) Items not to be twice included in income. Income which is classified as foreign base company sales income as a result of the application of subdivision (i) of subparagraph (1) of this paragraph shall not be again classified as foreign base company sales income as a result of the application of subdivision (ii) of such subparagraph.

(e) Comparison with ordinary treatment. Income derived by the branch or similar establishment, or by the remainder of the controlled foreign corporation, shall not be considered foreign base company sales income if the income would not be so considered if it were derived by a separate controlled foreign corporation under like circumstances.

(f) Priority of application. If income derived by the branch or similar establishment, or by the remainder of the controlled foreign corporation, from a transaction would be classified as foreign base company sales income of such controlled foreign corporation under section 954(d)(1) and paragraph (a) of this section, the income shall, notwithstanding this paragraph, be treated as foreign base company sales income under paragraph (a) of this section and the branch or similar establishment shall not be treated as a separate corporation with respect to such income.

(3) *Inclusion of amounts in gross income of United States shareholders.* A branch or similar establishment of a controlled foreign corporation and the remainder of such corporation shall be treated as separate corporations under this paragraph solely for purposes of determining the foreign base company sales income of each such corporation and for purposes of including an amount in subpart F income of the controlled foreign corporation under section 953(a). See section 954(b)(3) and paragraph (d)(4) of § 1.954–1 for rules relating to the treatment of a branch or similar establishment of a controlled foreign corporation and the remainder of such corporation as separate corporations for purposes of independently determining if the foreign base company income of each such corporation is less than 10 percent, or more than 70 percent, of its gross income. For all other purposes, however, a branch or similar establishment of a controlled foreign corporation and the remainder of such corporation shall not be treated as separate corporations. For example, if the controlled foreign corporation has a deficit in earnings and profits to which section 952(c) applies, the limitation of such section on the amount includable in the subpart F income of such corporation will apply. Moreover, income, war profits, or excess profits taxes paid by a branch or similar establishment to a foreign country will be treated as having been paid by the controlled foreign corporation for purposes of section 960 (relating to special rules for foreign tax credit) and the regulations thereunder. Also, income of a branch or similar establishment, treated as a separate corporation under this paragraph, will not be treated as dividend income of the controlled foreign corporation of which it is a branch or similar establishment.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. Controlled foreign corporation A, incorporated under the laws of foreign country X, is engaged in the manufacturing business in such country. Corporation A negotiates sales of its products for use outside of country X through a sales office, branch B, maintained in foreign country Y. These activities constitute the only activities of A Corporation. Country X levies an income tax at an effective rate of 50 percent on the income of A Corporation derived by the manufacturing plant in country X but does not tax the sales income of A Corporation derived by branch B in country Y. Country Y levies an income tax at an effective rate of 10 percent on the sales income derived by branch B but does not tax the income of A Corporation derived by the manufacturing plant in country X. If the sales income derived by branch B were, under the laws of country X, derived from sources within country X by A Corporation, such income would be taxed by such country at an effective rate of 50 percent. In determining foreign base company sales income of A Corporation, branch B is treated as a separate wholly owned subsidiary corporation of A Corporation, the 10 percent rate of tax on branch B's income being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate. Income derived by branch B, treated as a separate corporation, from the sale by or through it for use, consumption, or disposition outside country Y of the personal property produced in country X is treated as income from the sale of personal property on behalf of A Corporation, a related person, and constitutes foreign base company sales income. The remainder of A Corporation, treated as a separate corporation, derives no foreign base company sales income since it produces the product which is sold.

Example 2. Controlled foreign corporation C is incorporated under the laws of foreign country X. Corporation C maintains branch B in foreign country Y. Branch B manufactures articles in country Y which are sold through the sales offices of C Corporation located in country X. These activities constitute the only activities of C Corporation. Country Y levies an income tax at an effective rate of 30 percent on the manufacturing profit of C Corporation derived by branch B but does not tax the sales income of C Corporation derived by the sales offices in country X. Country X does not impose an income, war profits, excess profits, or similar tax, and no tax is paid to any foreign country with respect to income of C Corporation which is not derived by branch B. If C Corporation were incorporated under the laws of country Y, the sales income of the sales offices in country X would be taxed by country Y at an effective rate of 30 percent. In determining foreign base company sales income of C Corporation, branch B is treated as a separate wholly owned subsidiary corporation of C Corporation, the zero rate of tax on the income derived by the remainder of C Corporation being less than 90 percent of, and at least 5 percentage points less than, the 30 percent rate. Branch B, treated as a separate corporation, derives no foreign base company sales income since it produces the product which is sold. Income derived by the remainder of C Corporation, treated as a separate corporation, from the sale by or through it for use, consumption, or disposition outside country X of the personal property produced in country Y is treated as income from the sale of personal property on behalf of branch B, a related person, and constitutes foreign base company sales income.

Example 3. Controlled foreign corporation E, incorporated under the laws of foreign country X, is a wholly owned subsidiary of controlled foreign corporation D, also incorporated under the laws of country X. Corporation E maintains branch B in foreign country Y. Both corporations use the calendar year as the taxable year. In 1964, E Corporation's sole activity, carried on through branch B, consists of the purchase of articles manufactured in country X by D Corporation, a related person, and the sale of the articles through branch B for use outside country X. The income of E Corporation derived by branch B from such transactions is taxed to E Corporation by country X only at the time E Corporation distributes such income to D Corporation and is then taxed on the basis of what the tax (a 40 percent effective rate) would have been if the income had been derived in 1964 by E Corporation from sources within country X from doing business through a permanent establishment therein. Country Y levies an income tax at an effective rate of 50 percent on income derived from sources within such country, but the income of branch B for 1964 is effectively taxed by country Y at a 5 percent rate since, under the laws of such country, only 10 percent of branch B's income is derived from sources within such country. Corporation E makes no distributions to D Corporation in 1964. In determining foreign base company sales income of E Corporation for 1964, branch B is treated as a separate wholly owned subsidiary corporation of E Corporation, the 5 percent rate of tax on branch B's income being less than 90 percent of, and at least 5 percentage points less than, the 40 percent rate. Income derived by branch B, treated as a separate corporation, from the sale by or through it for use, consumption, or disposition outside country Y of the personal property produced in country X is treated as income from the sale of personal property on behalf of E Corporation, a related person, and constitutes foreign base company sales income.

Example 4. Controlled foreign corporation F, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation F, through its branch B in foreign country Y, purchases from controlled foreign corporation G, a wholly owned subsidiary of M Corporation incorporated under the laws of foreign country Z, personal property which G Corporation manufactures in country Z. Corporation F sells such property for use in foreign country W. Since the income of F Corporation from such purchases and sales is classified as foreign base company sales income under section 954(d)(1) and paragraph (a) of this section, branch B will not be treated as a separate corporation with respect to such income even if the tax differential between countries X and Y would otherwise justify such treatment.

Example 5. Controlled foreign corporation A, incorporated under the laws of foreign country X, is engaged in manufacturing articles through its home office, located in country X, and selling such articles through branch B, located in foreign country Y, and through branch C, located in foreign country Z, for use outside country X. These activities constitute the only activities of A Corporation for its taxable year 1963. Each such country levies an income tax on only the income derived from sources within such country, and all income derived in 1963 by the home office, branch B, and branch C, respectively, is derived from sources within countries X, Y, and Z, respectively. The income and income taxes of A Corporation for 1963 are as follows:

	X Country	Y Country	Z Country
Income of:			
Home office	$200,000	....	....
Branch B	....	$100,000	....
Branch C	....	....	$100,000
Income tax	$100,000	$20,000	$20,000
Effective rate of tax	50%	20%	20%

By applying subparagraph (1)(i) of this paragraph and by treating branch B as though it were the only branch of A Corporation, branch B is treated as a separate wholly owned subsidiary corporation of A Corporation in determining foreign base company sales income of A Corporation for 1963, the 20 percent rate of tax on the income of such branch being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of branch B under the laws of country X if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch B were derived from sources within country X. Moreover, by applying subparagraph (1)(i) of this paragraph and by treating branch C as though it were the only branch of A Corporation, branch C is treated as a separate wholly owned subsidiary corporation of A Corporation, the 20 percent rate of tax on the income of such branch being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of branch C under the laws of country X if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch C were derived from sources within country X. The income derived by branch B and branch C, respectively, each treated as a separate corporation, from the sale by or through each of them for use, consumption, or disposition outside country Y and country Z, respectively, is treated as income from the sale of personal property on behalf of A Corporation, a related person, and constitutes foreign base company sales income for 1963. The home office of A Corporation, treated as a separate corporation, derives no foreign base company sales income for 1963 since it produces the articles which are sold.

Example 6. Controlled foreign corporation A, incorporated under the laws of foreign country X is engaged in manufacturing articles through branch B, located in foreign country Y, and selling such articles through branch C, located in foreign country Z, and through its home office, located in country X, for use outside country X. These activities constitute the only activities of A Corporation for its taxable year 1963. Each such country levies an income tax on only the income derived from sources within such country, and all income derived in 1963 by the home office, branch B, and branch C, respectively, is derived from sources within countries X, Y, and Z, respectively. The income and income taxes of A Corporation for 1963 are as follows:

	X Country	Y Country	Z Country
Income of:			
Home office	$100,000	....	....
Branch B	....	$200,000	....
Branch C	....	....	$100,000
Income tax	$20,000	$100,000	$20,000
Effective rate of tax	20%	50%	20%

In determining foreign base company sales income of A Corporation for 1963 neither branch B nor branch C is treated, by applying subparagraph (1)(i) of this paragraph, as a separate wholly owned subsidiary corporation of A Corporation since branch B derives no income from the purchase or sale of personal property and since, in the case of branch C treated as though it were the only branch of A Corporation, the 20 percent rate of tax on the income of branch C is not less than 90 percent of, and not as much as 5 percentage points less than, the 20 percent rate of tax which would apply to the income of branch C under the laws of country X if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch C were derived from sources within country X. However, by applying subparagraph (1)(ii) of this paragraph and by treating the home office in country X as though it alone were the remainder of A Corporation, branch B is treated as a separate wholly owned subsidiary corporation of A Corporation, the 20 percent rate of tax on the income of the home office being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of the home office under the laws of country Y if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch B were derived from sources within country Y. Moreover, by applying subparagraph (1)(ii) of this paragraph and by treating branch C as though it alone were the remainder of A Corporation, branch B and branch C are treated as separate wholly owned subsidiary corporations of A Corporation, the 20 percent rate of tax on the income of branch C being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of branch C under the laws of country Y if, under the laws of such country, all the income of A Corporation for 1963 derived through branch B and branch C were derived from sources within country Y. The income derived by the home office and branch C, respectively, each treated as a separate corporation, from the sale by or through each of them for use, consumption, or disposition outside country X and country Z, respectively, is treated as income from the sale of personal property on behalf of branch B, a related person, and constitutes foreign base company sales income for 1963. Branch B, treated as a separate corporation, derives no foreign base company sales income since it produces the articles which are sold.

Example 7. Controlled foreign corporation A, incorporated under the laws of foreign country X, is engaged in manufacturing articles through branch B, located in foreign country Y, and selling such articles through the home office, located in country X, and through branch C, located in foreign country Z, for use outside country X. These activities constitute the only activities of A Corporation for its taxable year 1963. Each such country levies an income tax on only the income derived from sources within such country, and all income derived in 1963 by the home office, branch B, and branch C, respectively, is derived from sources within countries X, Y, and Z, respectively. The income and income taxes of A Corporation for 1963 are as follows:

	X Country	Y Country	Z Country
Income of:			
Home office	$100,000	....	....
Branch B	....	$200,000	....
Branch C	....	....	$100,000
Income tax	$40,000	$100,000	$20,000
Effective rate of tax	40%	50%	20%

By applying subparagraph (1)(i) of this paragraph and by treating branch C as though it were the only branch of A Corporation, branch C is treated as a separate wholly owned subsidiary corporation of A Corporation in determining foreign base company sales income of A Corporation for 1963, the 20 percent rate of tax on the income of branch C being less than 90 percent of, and at least 5 percentage points less than, the 40 percent rate of tax which would apply to the income of branch C under the laws of country X if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch C were derived from sources within country X. In addition, by applying subparagraph (1)(ii) of this paragraph and by treating the home office in country X as though it alone were the remainder of A Corporation, branch B is treated as a separate wholly owned subsidiary corporation of A Corporation, the 40 percent rate of tax on the income of the home office being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of the home office under the laws of country Y if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch B were derived from sources within country Y. Moreover, by applying subparagraph (1)(ii) of this paragraph and by treating branch C as though it alone were the remainder of A Corporation, branch B and branch C would again be treated as separate wholly owned subsidiary corporations of A Corporation, the 20 percent rate of tax on the income of branch C being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of branch C under the laws of country Y if, under the laws of such country, all the income of A Corporation for 1963 derived through branch B and branch C were derived from sources within country Y; however, for purposes of determining foreign base company sales income of A Corporation for 1963, only the classification under subparagraph (1)(i) of this paragraph shall, by reason of the application of subparagraph (2)(ii)*(d)* of this paragraph, be applied with respect to the income derived by branch C. The income derived by the home office and branch C, respectively, each treated as a separate corporation, from the sale by or through each of them for use, consumption, or disposition outside country X and country Z, respectively, is treated as income from the sale of personal property on behalf of branch B, a related person, and constitutes foreign base company sales income for 1963. Branch B, treated as a separate corporation, derives no foreign base company sales income since it produces the articles which are sold.

(c) *Shipping income for taxable years beginning after December 31, 1975.* For taxable years beginning after December 31, 1975, foreign base company shipping income (as determined under §1.954–6) of a controlled foreign corporation shall not also be considered foreign base company sales income of that controlled foreign corporation.

[T.D. 6734, 29 FR 6392, May 15, 1964, as amended by T.D. 7545, 43 FR 32754, May 8, 1978; T.D. 7893, 48 FR 22508, May 19, 1983; T.D. 7894, 48 FR 22523, May 19, 1983]

§1.954–4 Foreign base company services income.

(a) *Items included.* Except as provided in paragraph (d) of this section, foreign base company services income means income of a controlled foreign corporation, whether in the form of compensation, commissions, fees, or otherwise, derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which—

(1) Are performed for, or on behalf of a related person, as defined in paragraph (e)(1) of §1.954–1, and

(2) Are performed outside the country under the laws of which the controlled foreign corporation is created or organized.

(b) *Services performed for, or on behalf of, a related person*—(1) *Specific cases.* For purposes of paragraph (a)(1) of this section, ‘‘services which are performed for, or on behalf of, a related person’’ include (but are not limited to) services performed by a controlled foreign corporation in a case where—

(i) The controlled foreign corporation is paid or reimbursed by, is released from an obligation to, or otherwise receives substantial financial benefit from, a related person for performing such services;

(ii) The controlled foreign corporation performs services (whether or not with respect to property sold by a related person) which a related person is, or has been, obligated to perform;

(iii) The controlled foreign corporation performs services with respect to property sold by a related person and the performance of such services constitutes a condition or a material term of such sale; or

(iv) Substantial assistance contributing to the performance of such services has been furnished by a related person or persons.

(2) *Special rules*—(i) *Guaranty of performance.* Subparagraph (1)(ii) of this paragraph shall not apply with respect to services performed by a controlled foreign corporation pursuant to a contract the performance of which is guaranteed by a related person, if *(a)* the related person's sole obligation with respect to the contract is to guarantee performance of such services, *(b)* the controlled foreign corporation is fully obligated to perform the services under the contract, and *(c)* the related person (or any other person related to the controlled foreign corporation) does not in fact *(1)* pay for performance of, or perform, any of such services the performance of which is so guaranteed or *(2)* pay for performance of, or perform, any significant services related to such services. If the related person (or any other person related to the controlled foreign corporation) does in fact pay for performance of, or perform, any of such services or any significant services related to such services, subparagraph (1)(ii) of this paragraph shall apply with respect to the services performed by the controlled foreign corporation pursuant to the contract the performance of which is guaranteed by the related person, even though such payment or performance is not considered to be substantial assistance for purposes of subparagraph (1)(iv) of this paragraph. For purposes of this subdivision, a related person shall be considered to guarantee performance of the services by the controlled foreign corporation whether it guarantees performance of such services by a separate contract of guaranty or enters into a service contract solely for purposes of guaranteeing performance of such services and immediately thereafter assigns the entire contract to the controlled foreign corporation for execution.

(ii) *Application of substantial assistance test.* For purposes of subparagraph (1)(iv) of this paragraph—

(a) Assistance furnished by a related person or persons to the controlled foreign corporation shall include, but shall not be limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material, or supplies.

(b) Assistance furnished by a related person or persons to a controlled foreign corporation in the form of direction, supervision, services, or know-how shall not be considered substantial unless either *(1)* the assistance so furnished provides the controlled foreign corporation with skills which are a principal element in producing the income from the performance of such services by such corporation or *(2)* the cost to the controlled foreign corporation of the assistance so furnished equals 50 percent or more of the total cost to the controlled foreign corporation of performing the services performed by such corporation. The term ''cost'', as used in this subdivision *(b),* shall be determined after taking into account adjustments, if any, made under section 482.

(c) Financial assistance (other than contributions to capital), equipment, material, or supplies furnished by a related person to a controlled foreign corporation shall be considered assistance only in that amount by which the consideration actually paid by the controlled foreign corporation for the purchase or use of such item is less than the arm's length charge for such purchase or use. The total of such amounts so considered to be assistance in the case of financial assistance, equipment, material, and supplies furnished by all related persons shall be compared with the profits derived by the controlled foreign corporation from

the performance of the services to determine whether the financial assistance, equipment, material, and supplies furnished by a related person or persons are by themselves substantial assistance contributing to the performance of such services. For purposes of this subdivision *(c)*, determinations shall be made after taking into account adjustments, if any, made under section 482 and the term ''consideration actually paid'' shall include any amount which is deemed paid by the controlled foreign corporation pursuant to such an adjustment.

(d) Even though assistance furnished by a related person or persons to a controlled foreign corporation in the form of direction, supervision, services, or know-how is not considered to be substantial under *(b)* of this subdivision and assistance furnished by a related person or persons in the form of financial assistance (other than contributions to capital), equipment, material, or supplies is not considered to be substantial under *(c)* of this subdivision, such assistance may nevertheless constitute substantial assistance when taken together or in combination with other assistance furnished by a related person or persons which in itself is not considered to be substantial.

(e) Assistance furnished by a related person or persons to a controlled foreign corporation in the form of direction, supervision, services, or know-how shall not be taken into account under *(b)* or *(d)* of this subdivision unless the assistance so furnished assists the controlled foreign corporation directly in the performance of the services performed by such corporation.

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

Example 1. Controlled foreign corporation A is paid by related corporation M for the installation and maintenance of industrial machines which M Corporation manufactures and sells to B Corporation. Such installation and maintenance services by A Corporation are performed for, or on behalf of, M Corporation for purposes of section 954(e).

Example 2. Controlled foreign corporation B enters into a contract with an unrelated person to drill an oil well in a foreign country. Domestic corporation M owns all the outstanding stock of B Corporation. Corporation B employs a relatively small clerical and administrative staff and owns the necessary well-drilling equipment. Most of the technical and supervisory personnel who oversee the drilling of the oil well by B Corporation are regular employees of M Corporation who are temporarily employed by B Corporation. In addition, B Corporation hires on the open market unskilled and semiskilled laborers to work on the drilling project. The services performed by B Corporation under the well-drilling contract are performed for, or on behalf of, a related person for purposes of section 954(e) because the services of the technical and supervisory personnel which are provided by M Corporation are of substantial assistance in the performance of such contract in that they assist B Corporation directly in the execution of the contract and provide B Corporation with skills which are a principal element in producing the income from the performance of such contract.

Example 3. Controlled foreign corporation F enters into a contract with an unrelated person to construct a dam in a foreign country. Domestic corporation M owns all the outstanding stock of F Corporation. Corporation F leases or buys from M Corporation, on an arm's length basis, the equipment and material necessary for the construction of the dam. The technical and supervisory personnel who design and oversee the construction of the dam are regular full-time employees of F Corporation who are not on loan from any related person. The principal clerical work, and the financial accounting, required in connection with the construction of the dam by F Corporation are performed, on a remunerated basis, by full-time employees of M Corporation. All other assistance F Corporation requires in completing the construction of the dam is paid for by that corporation and furnished by unrelated persons. The services performed by F Corporation under the contract for the construction of the dam are not performed for, or on behalf of, a related person for purposes of section 954(e) because the clerical and accounting services furnished by M Corporation do not assist F Corporation directly in the performance of the contract.

Example 4. Controlled foreign corporation D, a wholly owned subsidiary of domestic corporation M, procures and enters a contract with an unrelated person to construct a superhighway in a foreign country, but such person enters the contract only on the condition that M Corporation agrees to perform, or to pay for the performance by some person other than D Corporation of, the services called for by the contract if D Corporation should fail to complete their performance. Corporation D is capable of performing such contract. No related person as to D Corporation pays for, or performs, any services called for by the contract, or pays for, or performs, any significant services related to such services. The construction of the superhighway by D Corporation is not considered for purposes of section 954(e) to be the performance of services for, or on behalf of M Corporation.

Example 5. Domestic corporation M is obligated under a contract with an unrelated person to construct a superhighway in a foreign country. At a later date M Corporation assigns the entire contract to its wholly owned subsidiary, controlled foreign corporation C, and the unrelated person releases M Corporation from any obligation under the contract. The construction of such highway by C Corporation is considered for purposes of section 954(e) to be the performance of services for, or on behalf of, M Corporation.

Example 6. Domestic corporation M enters a contract with an unrelated person to construct a superhighway in a foreign country. Corporation M immediately assigns the entire contract to its wholly owned subsidiary, controlled foreign corporation C. The unrelated person does not release M Corporation of its obligation under the contract, the sole purpose of these arrangements being to have M Corporation guarantee performance of the contract by C Corporation. Corporation C is capable of performing the construction contract. Neither M Corporation nor any other person related to C Corporation pays for, or performs, any services called for by the construction contract or at any time pays for, or performs, any significant services related to the services performed under such contract. The construction of the superhighway by C Corporation is not considered for purposes of section 954(e) to be the performance of services for, or on behalf of, M Corporation.

Example 7. The facts are the same as in example 6 except that M Corporation, preparatory to entering the construction contract, prepares plans and specifications which enable the submission of bids for the contract. Since M Corporation has performed significant services related to the services the performance of which it has guaranteed, the construction of such highway by C Corporation is considered for purposes of section 954(e) to be the performance of services for, or on behalf of, M Corporation.

Example 8. Domestic corporation M manufactures an industrial machine which requires specialized installation. Corporation M sells the machines for a basic price if the contract of sale contains no provision for installation. If, however, the customer agrees to employ controlled foreign corporation E, a wholly owned subsidiary of M Corporation, to install the machine and to pay E Corporation a specified installation charge, M Corporation sells the machine at a price which is less than the basic price. The installation services performed by E Corporation for customers of M Corporation purchasing the machine at the reduced price are considered for purposes of section 954(e) to be performed for, or on behalf of, M Corporation.

Example 9. Domestic corporation M manufactures and sells industrial machines with a warranty as to their performance conditional upon their installation and maintenance by a factory-authorized service agency. Controlled foreign corporation F, a wholly owned subsidiary of M Corporation, is the only authorized service agency. Any installation or maintenance services performed by F Corporation on such machines are considered for purposes of section 954(e) to be performed for, or on behalf of, M Corporation.

Example 10. Domestic corporation M manufactures electric office machines which it sells at a basic price without any provision for, or understanding as to, adjustment or maintenance of the machines. The machines require constant adjustment and maintenance services which M Corporation, certain wholly owned subsidiaries of M Corporation, and certain unrelated persons throughout the world are qualified to perform. From among the numerous persons qualified and available to perform adjustment and maintenance services with respect to such office machines, foreign corporation B, a customer of M Corporation, employs controlled foreign corporation G, a wholly owned subsidiary of M Corporation, to adjust and maintain the office machines which B Corporation purchases from M Corporation. The adjustment and maintenance services performed by G Corporation for B Corporation are not considered for purposes of section 954(e) to be performed for, or on behalf of, M Corporation.

(c) *Place where services are performed.* The place where services will be considered to have been performed for purposes of paragraph (a)(2) of this section will depend on the facts and circumstances of each case. As a general rule, services will be considered performed where the persons performing services for the controlled foreign corporation which derives income in connection with the performance of technical, managerial, architectural, engineering, scientific, skilled, industrial, commercial, or like services are physically located when they perform their duties in the execution of the service activity resulting in such income. Therefore, in many cases, total gross income of a controlled foreign corporation derived in connection with each service contract or arrangement performed for or on behalf of a related person must be apportioned, between income which is not foreign base company services income and that which is foreign base company services income, on a basis of employee-time spent within the foreign country under the laws of which the controlled foreign corporation is created or organized and employee-time spent without the foreign country under the laws of which such corporation is created or organized. In allocating time spent within and without the foreign country under the laws of which the controlled foreign corporation is created or organized, relative weight must also be given to the value of the various functions performed by persons in fulfillment of the service contract or arrangement. For example, clerical work will ordinarily be assigned little value, while services performed by technical, highly skilled, and managerial personnel will be assigned greater values in relation to the type of function performed by each individual.

(d) *Items excluded.* Foreign base company services income does not include—

(1) Income derived in connection with the performance of services by a controlled foreign corporation if—

(i) The services directly relate to the sale or exchange of personal property by the controlled foreign corporation,

(ii) The property sold or exchanged was manufactured, produced, grown, or extracted by such controlled foreign corporation, and

(iii) The services were performed before the sale or exchange of such property by the controlled foreign corporation;

(2) Income derived in connection with the performance of services by a controlled foreign corporation if the services directly relate to an offer or effort to sell or exchange personal property which was, or would have been, manufactured, produced, grown, or extracted by such controlled foreign corporation whether or not a sale or exchange of such property was in fact consummated; or

(3) For taxable years beginning after December 31, 1975, foreign base company shipping income (as determined under §1.954–6).

[T.D. 6734, 29 FR 6399, May 15, 1964, as amended by T.D. 6981, 33 FR 16497, Nov. 13, 1968; T.D. 7893, 48 FR 22523, May 19, 1983]

§1.954–5 Increase in qualified investments in less developed countries; taxable years of controlled foreign corporations beginning before January 1, 1976.

For rules applicable to taxable years of controlled foreign corporations beginning before January 1, 1976, see section 954(b)(1) (as in effect before the enactment of the Tax Reduction Act of 1975) and 26 CFR 1.954–5 (Revised as of April 1, 1975).

[T.D. 7893, 48 FR 22508, May 19, 1983]

§1.954–6 Foreign base company shipping income.

(a) *Scope*—(1) *In general.* This section prescribes rules for determining foreign base company shipping income under the provisions of section 954(f), as amended by the Tax Reduction Act of 1975.

(2) *Effective date.* (i) The rules prescribed in this section apply to taxable years of foreign corporations beginning after December 31, 1975, and to taxable years of United States shareholders (as defined in section 951 (b)) within which or with which such taxable years of such foreign corporations end.

(ii) Except as described in paragraph (b)(1)(viii) of this section, foreign base company shipping income does not include amounts earned by a foreign corporation in a taxable year of such corporation beginning before January 1, 1976. See example 1 of paragraph (g)(2) of this section for an illustration of the effect of this subparagraph on partnership income. See example 3 of paragraph (f)(4)(ii) of this section for an illustration of the effect of this subparagraph on certain dividend income. See paragraph (f)(5)(iii) of this section for the effect of this subparagraph on certain interest and gains.

(b) *Definitions*—(1) *Foreign base company shipping income.* The term ‘‘foreign base company shipping income’’ means—

(i) Gross income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce (see paragraph (c) of this section),

(ii) Gross income derived from, or in connection with, the performance of services directly related to the use of any aircraft or vessel in foreign commerce (see paragraph (d) of this section),

(iii) Gross income incidental to income described in subdivisions (i) and (ii) of this subparagraph, as provided in paragraph (e) of this section,

(iv) Gross income derived from the sale, exchange, or other disposition of any aircraft or vessel used or held for use (by the seller or by a person related to the seller) in foreign commerce,

(v) In the case of a controlled foreign corporation, dividends, interest, and gains described in paragraph (f) of this section,

(vi) Income described in paragraph (g) of this section (relating to partnerships, trusts, etc.),

(vii) Exchange gain, to the extent allocable to foreign base company shipping income (see § 1.952–2(c)(2)(v)(*b*), and

(viii) In the case of a controlled foreign corporation and at its option, dividends, interest, and gains attributable to income derived from aircraft and vessels (as defined in 26 CFR 1.954–1(b)(2) (Revised as of April 1, 1975)) by a less developed country shipping company (described in § 1.955–5(b)) in taxable years beginning after December 31, 1962, and before January 1, 1976. The portion of a dividend, interest, or gain attributable to such income shall be determined by the same method as that for determining the portion of a dividend, interest, or gain attributable to foreign base company shipping income under paragraphs (f)(4), (5), and (6) of this section, but without regard to paragraphs (f)(6)(ii) and (iv)(B).

(2) *Foreign base company shipping operations.* For purposes of sections 951 through 964, the term ‘‘foreign base company shipping operations’’ means the trade or business from which gross income described in subparagraph (1)(i) and (ii) of this paragraph is derived.

(3) *Foreign commerce.* For purposes of sections 951 through 964—

(i) An aircraft or vessel is used in foreign commerce to the extent it is used in transportation of property or passengers—

(A) Between a port (or airport) in the United States or possession of the United States and a port (or airport) in a foreign country, or

(B) Between a port (or airport) in a foreign country and another in the same country or between a port (or airport) in a foreign country and one in another foreign country.

Thus, for example, a trawler, a factory ship, and an oil drilling ship are not considered to be used in foreign commerce. On the other hand, a cruise ship which visits one or more foreign ports is considered to be so used. Notwithstanding subdivision (i)(B) of this paragraph (b)(3), foreign base company income does not include income derived from, or in connection with, the use of an aircraft or vessel in transportation of property or passengers between a port (or airport) in a foreign country and another port (or airport) in the same country if both the foreign corporation is created or organized and the aircraft or vessel is registered in that country.

(ii) The term *vessel* includes all water craft and other artificial contrivances of whatever description and at whatever stage of construction, whether on the stocks or launched, which are used or are capable of being used or are intended to be used as a means of transportation on water. This definition does not apply for purposes of section 956(b)(2)(G) and § 1.956–2(b)(1)(ix).

(iii) The term *port* means any place (whether on or off shore) where aircraft or vessels are accustomed to load or unload goods or to take on or let off passengers.

(iv) Any vessel (such as a lighter or beacon lightship) which serves other vessels used in foreign commerce (within the meaning of subdivision (i) of this subparagraph) shall, to the extent so used, also be considered to be used in foreign commerce.

(v) For the meaning of the term ‘‘foreign country’’, see section 638(2).

(4) *Use in foreign commerce.* For purposes of sections 951 through 964, the use of an aircraft or vessel in foreign commerce includes the hiring or leasing (or subleasing) of an aircraft or vessel to another for use in foreign commerce. Thus, for example, an aircraft or vessel is ‘‘used in foreign commerce’’ within the meaning of section 955(b)(1)(A) if such aircraft or vessel is chartered (whether pursuant to a

bareboat charter, time charter, or otherwise) to another for use in foreign commerce.

(5) *Related person.* With respect to a controlled foreign corporation, the term ''related person'' means a related person as defined in §1.954–1(e)(1), and the term ''unrelated person'' means an unrelated person as defined in §1.954–1(e)(2).

(c) *Aircraft or vessel income*—(1) *In general.* The term ''income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce'' as used in paragraph (b)(1)(i) of this section means—

(i) Income derived from transporting passengers or property by aircraft or vessel in foreign commerce and

(ii) Income derived from hiring or leasing an aircraft or vessel to another for use in foreign commerce.

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

Example 1. Foreign corporation C owns a foreign flag vessel which it charters under a long-term charter to foreign corporation D. The vessel is used by D as a tramp which has no fixed or regular schedule. The vessel carries bulk and packaged cargoes, as well as occasional passengers, under charter parties, contracts of affreightment, or other contracts of carriage. The carriage of cargoes and passengers is between a port in the United States and a port in a foreign country or between a port in one foreign country and another port in the same or a different foreign country. The charter hire paid to C by D constitutes income derived from the use of the vessel in foreign commerce, but is not foreign base company income to the extent the charter hire is allocable to income derived from the use of the vessel between ports in the same foreign country in which both C is incorporated and the vessel is registered. The charter hire and freight and passenger revenue (including demurrage and dead freight) derived by D also constitute income derived from the use of the vessel in foreign commerce, but is not foreign base company income to the extent the charter hire and freight and passenger revenue are allocable to the use of the vessel between ports in the same foreign country in which both D is incorporated and the vessel is registered.

Example 2. (a) Foreign corporation E owns a foreign flag tanker which it charters under a long-term bareboat charter to foreign corporation F for use in foreign commerce. F produces oil in a foreign country and ships the oil to other foreign countries and to the United States. The vessel, when not engaged in carrying F's oil, is used to carry bulk cargoes for unrelated persons in foreign commerce as opportunity offers. The charger hire received by E constitutes income derived from the use of the vessel in foreign commerce. The income derived by F from carrying bulk cargoes for unrelated persons also constitutes income derived from the use of the vessel in foreign commerce.

(b) F is forced to lay up the vessel as a result of adverse market developments. Pursuant to the terms of the charter, F continues to pay charter hire to E during the period of lay-up. The charter hire received by E during the period of lay-up constitutes income derived from the use of the vessel in foreign commerce.

Example 3. (a) A shipment of cheese is loaded into a container owned by controlled foreign corporation S at the consignor's place of business in Hamar, Norway. The cheese is transported to Milan, Italy, by the following routings:

(1) Overland by road from Hamar, Norway, to Gothenburg, Sweden, by unrelated motor carriers via Oslo, Norway,

(2) By sea from Gothenburg to Rotterdam, Netherlands, by feeder vessel under foreign flag, time chartered to S by unrelated owner,

(3) By sea from Rotterdam to Algeciras, Spain, by feeder vessel under foreign flag, time chartered to S by unrelated owner.

(4) By sea from Algeciras to Genoa, Italy, by line-haul vessel under U.S. flag, chartered by S from related company, and

(5) Overland from Genoa to Milan, Italy, by unrelated motor carrier.

(b) The consignor pays S total charges of $1,710, and S pays $676 to unrelated third parties, which amounts may be broken down as follows:

Description of charges	Amount billed to customer and collected by S	Revenue collected by S on behalf of an unrelated party	Costs paid to unrelated 3d party and absorbed by S
Ocean freight	$1,420	....	....
Trucking charge of empty equipment to shipper's facility	50	$50	....
Trucking charges Hamar to Oslo	60	60	....
Trucking charges Oslo to Gothenburg	....	....	$315
Trucking charges Genoa to Milan	180	180	....
Brokerage Commission in Europe	....	....	71
Total	1,710	290	386

(c) Of the $1,710 amount billed to the consignor and collected by S, $290 is collected by S on behalf of unrelated third parties. This

$290 amount is not includable in S's gross income, and is therefore not includable in S's foreign base company shipping income. The remaining $1,420 amount (i.e., $1,710 − $290) is includable in S's foreign base company shipping income. The $386 amount paid by S to unrelated third parties and absorbed by S is deductible from foreign base company shipping income under § 1.954–1(c).

(d) *Services directly related*—(1) *In general.* The term ''income derived from, or in connection with, the performance of services directly related to the use of an aircraft or vessel in foreign commerce'', as used in paragraph (b)(1)(ii) of this section, means—

(i) Income derived from, or in connection with, the performance of services described in subparagraph (2) or (3) of this paragraph, and

(ii) Income treated as foreign base company shipping income under subparagraph (4) of this paragraph.

(2) *Intragroup services.* The services described in this subparagraph are services performed for a person who is the owner, lessor, lessee or operator of an aircraft or vessel used in foreign commerce, by such person or by a person related to such person, and which fall into one or more of the following categories:

(i) Terminal services, such as dockage, wharfage, storage, lights, water, refrigeration, and similar services;

(ii) Stevedoring and other cargo handling services;

(iii) Container related services (including the rental of containers and related equipment) performed either in connection with the local drayage or inland haulage of cargo or in the course of transportation in foreign commerce;

(iv) Services performed by tugs, lighters, barges, scows, launches, floating cranes, and other similar equipment;

(v) Maintenance and repairs;

(vi) Training of pilots and crews;

(vii) Licensing of patents, know-how, and similar intangible property developed and used in the course of foreign base company shipping operations;

(viii) Services performed by a booking, operating, or managing agent; and

(ix) Any service performed in the course of the actual transportation of passengers or property.

(3) *Services for passenger, consignor, or consignee.* The services described in this subparagraph are services provided by the operator (or person related to the operator) of an aircraft or vessel in foreign commerce for the passenger, consignor, or consignee, such as—

(i) Services described in one or more of the categories set out in subparagraphs (2)(i) through (iv) and (ix) of this paragraph,

(ii) The rental of staterooms, berths, or living accommodations and the furnishing of meals,

(iii) Barber shop and other services to passengers aboard vessels,

(iv) Excess baggage, and

(v) Demurrage, dispatch, and dead freight.

(4) *The 70-percent test.* At the option of the foreign corporation all the gross income for a taxable year derived by a foreign corporation from any facility used in connection with the performance of services described in one or more of the categories set out in subparagraph (2)(i) through (ix) of this paragraph is foreign base company shipping income if more than 70 percent of such gross income for either—

(i) Such taxable year, or

(ii) Such taxable year and the two preceding taxable years,

is foreign base company shipping income (determined without regard to this subparagraph). Thus, for example, if 80 percent of the gross income derived by a controlled foreign corporation at a stevedoring facility is treated as foreign base company shipping income under subparagraph (2) of this paragraph, then the remaining 20 percent is treated as foreign base company shipping income under this subparagraph.

(5) *Rules for applying subparagraph (4).* (i) Solely for purposes of applying subparagraphs (4) of this paragraph, foreign base company shipping income and gross income shall be deemed to include an arm's length charge (see paragraph (h)(5) of this section) for services performed by the foreign corporation for itself.

(ii) In determining whether services performed by a foreign corporation are performed at a single facility or at two or more different facilities, all of the facts and circumstances involved will be taken into account. Ordinarily, all services performed by a foreign corporation within a single port area will be considered performed at a single facility.

(iii) The application of this subparagraph and subparagraph (4) of this paragraph may be illustrated by the following example in which it is assumed that the foreign corporation has chosen to apply the 70-percent test of subparagraph (4):

Example. (a) Controlled foreign corporation X uses the calendar year as the taxable year. For 1976, X is divided into two operating divisions, A and B. Division A operates a number of vessels in foreign commerce. Division B operates a terminal facility at which it performs services described in subparagraph (2)(i) of this paragraph for vessels some of which are operated by division A, some of which are operated by persons related to X, and some of which are operated by persons unrelated to X. For 1976, X includes under subparagraph (5) as foreign base company shipping income and gross income, for purposes of subparagraph (4), an arm's length charge for services performed for itself. For 1976, the gross income derived by division B is reconstructed for purposes of subparagraph (4) of this paragraph as follows, based on the facts shown in the following table:

(1) Gross income derived from persons unrelated to *X*	$20
(2) Gross income derived from persons related to *X*	10
(3) Actual gross income (line (1) plus line (2))	30
(4) Hypothetical gross income derived from division A (determined by the application of subdivision (i) of this subparagraph)	70
(5) Total reconstructed gross income (line (3) plus line (4))	100

(b) Since 80 percent of the reconstructed gross income derived by division B would be treated as foreign base company shipping income under subparagraph (2) of this paragraph, the entire $30 amount of the gross income actually derived by division B is treated as foreign base company shipping income under subparagraph (4) of this paragraph.

(6) *Arm's length charge.* For purposes of this section, the arm's length charge for services performed by a foreign corporation for itself shall be determined by applying the principles of section 482 and the regulations thereunder as if the party for whom the services are performed and the party by whom the services are performed were not the same person, but were controlled taxpayers within the meaning of §1.482–1(a)(4).

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

Example 1. Controlled foreign corporation A acts as a managing agent for foreign corporation B, a related person which contracts to construct and charter a foreign flag vessel for use in foreign commerce. As managing agent for B, A performs a broad range of services relating to the use of the vessel, including arranging for, and supervising of, construction and chartering of the vessel, and handling of operating services after construction is completed. The income derived by A from its management and operating services constitutes income derived in connection with the performance of services directly related to the use of the vessel in foreign commerce.

Example 2. Controlled foreign corporation C uses the calendar year as the taxable year. During 1976, C is engaged in the trade or business of acting as a steamship agent solely for unrelated persons. C's activities as steamship agent range from ''husbanding'' (i.e., arranging for fuel, supplies and port services, and attending to crew and customs matters) to the solicitation and booking of cargo at a number of foreign ports. None of C's other gross income for 1976 is foreign base company shipping income. Under these circumstances, C's gross income derived from its steamship agency does not constitute foreign base company shipping income.

(e) *Incidental income*—(1) *In general.* Foreign base company shipping income includes all incidental income derived by a foreign corporation in the course of its active conduct of foreign base company shipping operations.

(2) *Examples.* Examples of incidental income derived in the course of the active conduct of foreign base company shipping operations include—

(i) Gain from the sale, exchange or other disposition of assets which are related shipping assets within the meaning of §1.955A–2(b),

(ii) Income derived from temporary investments described in §1.955A–2(b)(2)(i) and (iii),

(iii) Interest on accounts receivable and evidences of indebtedness described in §1.955A–2(b)(2)(ii),

(iv) Income derived from granting concessions to others aboard aircraft or vessels used in foreign commerce,

(v) Income derived from stock and currency futures described in § 1.955A–2(b)(2)(vii) and (viii),

(vi) Income derived by the lessor of an aircraft or vessel used in foreign commerce from additional rentals for the use of related equipment (such as a complement of containers), and

(vii) Interest derived by the seller from a purchase money mortgage loan in respect of the sale of an aircraft or vessel described in § 1.955A–2(a)(1)(i).

(f) *Certain dividends, interest, and gain*—(1) *In general.* (i) The foreign base company shipping income of a controlled foreign corporation (referred to in subdivision (ii)(A) of this paragraph (f)(1) as ''first corporation'') includes—

(A) Dividends and interest received from foreign corporations listed in subdivision (ii) of this paragraph (f)(1), and

(B) Gain recognized from the sale, exchange, or other disposition of stock or obligations of foreign corporations listed in subdivision (ii) of this paragraph (f)(1),

but only to the extent that such dividends, interest, and gains are attributable to foreign base company shipping income of the foreign corporations listed in subdivision (ii) of this paragraph (f)(1).

(ii) The foreign corporations referred to in subdivision (i) of this paragraph (f)(1) are—

(A) Foreign corporations with respect to which the first corporation (see subdivision (i) of this paragraph (f)(1)) would be deemed under section 902(b) to pay taxes,

(B) Controlled foreign corporations which are related persons (within the meaning of section 954(d)(3)), and

(C) Less developed country shipping companies described in § 1.955–5(b).

(2) *Corporation deemed to pay taxes.* (i) For purposes of this paragraph, a controlled foreign corporation would be deemed under section 902(b) to pay taxes in respect of any other foreign corporation if such controlled foreign corporation would be deemed, for purposes of applying section 902(a) to any United States shareholder of such controlled foreign corporation, to pay taxes in respect of dividends which were received from such other foreign corporation (whether or not such other foreign corporation actually pays any taxes or dividends). Solely for purposes of this subdivision, each United States shareholder (within the meaning of section 951(b)) shall be deemed to be a domestic corporation.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. Domestic corporation M owns 100 percent of the one class of stock of controlled foreign corporation X, which in turn owns 40 percent of the one class of stock of foreign corporation Y. Y is not a controlled foreign corporation. For purposes of subdivision (1) of this subparagraph, X is deemed to pay taxes in respect of Y.

Example 2. The facts are the same as in example 1, except that United States shareholder A, an individual, owns 80 percent of the stock of corporation X, and United States shareholders B and C, parent and child, own the other 20 percent in equal shares. For purposes of applying this paragraph to all three United States shareholders (A, B, and C), X is deemed to pay taxes in respect of Y.

(3) *Obligation defined.* For purposes of this section, the term ''obligation'' means any bond, note, debenture, certificate, or other evidence of indebtedness, and a debt recorded in the books of account of both the creditor and the debtor. In the absence of legal, governmental, or business reasons to the contrary, the indebtedness must bear interest or be issued at a discount.

(4) *Dividends.* (i) For purposes of this paragraph and § 1.954–1(b)(2), the portion of a dividend which is attributable to foreign base company shipping income is that amount which bears the same ratio to the total dividend received as the earnings and profits out of which such dividend is paid that are attributable to foreign base company shipping income bears to the total earnings and profits out of which such dividend is paid. For purposes of this subdivision, the source of the earnings and profits out of which a distribution is made shall be determined under section 316(a), except that the source of the earnings and profits out of which a distribution is made by a controlled foreign corporation with respect to stock owned (within the meaning of section 958(a)) by a United States

shareholder of such controlled foreign corporation shall be determined under §1.959–3.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example 1. Domestic corporation M owns 100 percent of the one class of stock of controlled foreign corporation X, which in turn owns 40 percent of the one class of stock of foreign corporation Y. Y, which is not (and has not been) either a controlled foreign corporation or a less developed country shipping company, makes a distribution of $100 to X. Under section 316(a), such distribution is made out of Y's earnings and profits for 1978. Sixty percent of Y's earnings and profits for 1978 are attributable to foreign base company shipping income. As a result, $60 of the $100 distribution constitutes foreign base company shipping income to X under subdivision (i) of this subparagraph.

Example 2. The facts are the same as in example 1, except that under section 316(a) $20 of the $100 dividend is paid out of Y's earnings and profits for 1979, and the other $80 is paid out of Y's earnings and profits for 1978. Thirty percent of Y's earnings and profits for 1979 are attributable to foreign base company shipping income. Since 60 percent of Y's earnings and profits for 1978 are also attributable to foreign base company shipping income, $54, i.e. (.60×$80)+(.30×$20), of the $100 distribution constitutes foreign base company shipping income to X under subdivision (i) of this subparagraph.

Example 3. The facts are the same as in example 1 except that under section 316(a) the $100 dividend is made out of Y's earnings and profits for 1972. Since under paragraph (a)(2)(ii) of this section foreign base company shipping income does not include amounts earned by a foreign corporation (not a less developed country shipping company) in a taxable year beginning before January 1, 1978, no amount of such $100 distribution constitutes foreign base company shipping income to X under subdivision (i) of this subparagraph.

Example 4. Domestic corporation N owns 100 percent of the one class of stock of controlled foreign corporation S, which in turn owns 100 percent of the one class of stock of controlled foreign corporation T. T makes a distribution of $100 to S, of which $80 is allocable under §1.959–3 to earnings and profits for 1977 which are described in §1.959–3(b)(2), and $20 is allocable to earnings and profits for 1978 which are described in §1.959–3(b)(3). The $80 amount is excluded from S's gross income under section 959(b) and therefore is not included in S's foreign base company shipping income. One hundred percent of T's earnings and profits for 1978 described in §1.959–3(b)(3) were attributable to reinvested foreign base company shipping income. As a result, the entire $20 amount is included in S's foreign base company shipping income under this paragraph. See §1.954–1(b)(2) for the rule that such $20 amount may be excluded from the foreign base company income of S.

(5) *Interest and gain.* (i) Except as provided in subdivisions (ii) and (iii) of this subparagraph, the portion of any interest paid by a foreign corporation, or gain recognized from the sale, exchange, or other disposition of stock or obligations of a foreign corporation, which is attributable to the foreign base company shipping income of such foreign corporation is that amount which bears the same ratio to such interest or gain as the foreign base company shipping income of such corporation for the period described in subparagraph (6) of this paragraph bears to its gross income for such period.

(ii) Interest which is paid by a controlled foreign corporation is attributable to such corporation's foreign base company shipping income to the same extent that such interest is allocable (under the principles of §1.954–1(c)) to its foreign base company shipping income.

(iii) If interest is paid by a foreign corporation, or if stock obligations of a foreign corporation are sold, exchanged, or otherwise disposed of, during a taxable year of such foreign corporation beginning before January 1, 1976, then no portion of such interest or gain is attributable to foreign base company shipping income.

(iv) Solely for purposes of subdivision (i) of this subparagraph, if a controlled foreign corporation (the "first corporation") owns more than 10 percent of the stock of another controlled foreign corporation (the "second corporation"), then

(A) The gross income of the first corporation for any taxable year shall be—

(*1*) Increased by its pro rata share of the gross income of the second corporation for the taxable year which ends with or within such taxable year of the first corporation, and

(*2*) Decreased by the amount of any dividends received from the second corporation; and

(B) The foreign base company shipping income of the first corporation for any taxable year shall be—

(*1*) Increased by its pro rata share of the foreign base company shipping income of the second corporation for the taxable year which ends with or within such taxable year of the first corporation, and

(*2*) Decreased by the amount of any dividends received from the second corporation which constitute foreign base company income.

(v) Solely for purposes of applying subdivision (i) of this subparagraph, the district director shall make such other adjustments to the gross income and the foreign base company shipping income of any foreign corporation as are necessary to properly determine the extent to which any interest or gain is attributable to foreign base company shipping income, including proper adjustments to reflect any transaction during the test period described in subparagraph (6) of this paragraph to which section 332, 351, 354, 355, 356, or 361 applies.

(6) *Test period.* (i) Except as provided in subdivisions (ii) and (iii) of this subparagraph the period described in this subparagraph with respect to any foreign corporation is the 3-year period ending with the close of such corporation's taxable year preceding the year during which interest was paid or stock or obligations were sold, exchanged, or otherwise disposed of, or such part of such period as such corporation was in existence.

(ii) The period described in this paragraph shall not include any part of a taxable year beginning before January 1, 1976.

(iii) If interest is paid by a foreign corporation, or if stock or obligations of a foreign corporation are sold, exchanged, or otherwise disposed of during its first taxable year, then the period described in this paragraph shall be such first taxable year.

(iv) For purposes of subdivision (iii) of this subparagraph, the first taxable year of a foreign corporation is the later of—

(A) The first taxable year of its existence, or

(B) Its first taxable year beginning after December 31, 1975.

(g) *Income from partnerships, trusts, etc.*—(1) *In general.* The foreign base company shipping income of any foreign corporation includes—

(i) Its distributive share of the gross income of any partnership, and

(ii) Any amounts includible in its gross income under section 652(a), 662(a), 671, or 691(a),

to the extent that such items would have been includible in its foreign base company shipping income had they been realized by it directly.

(2) *Illustrations.* The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. Controlled foreign corporations X and Y are equal partners in partnership P. The taxable years end on December 31 for X, June 30 for Y, and March 31 for P. In the fiscal year ending March 31, 1976, P's sole business activity is the use of a vessel in foreign commerce. P derives gross income of $200 from the use of the vessel, and incurs expenses, taxes, and other deductions of $160. Assume X's distributive share of such $200 of P's gross income is $100, all of which is includible in X's gross income. If X had realized its distributive share of $100 directly, then the amount which would have been includible in X's foreign base company shipping income under this paragraph is the portion allocable to the months of January, February, and March of 1976. Such amount, $25 (i.e., ½ × $200 × 3 months/12 months), is included in X's foreign base company shipping income for its taxable year ending December 31, 1976. Similarly, X is entitled under this paragraph to a deduction from foreign base company shipping income of $20 (i.e., ½ × $160 × 3 months/12 months). Since foreign base company shipping income does not include amounts earned by a foreign corporation (not a less developed country shipping corporation) in a taxable year beginning before January 1, 1976, Y has no foreign base company shipping income (under this paragraph or otherwise) for its taxable year beginning on July 1, 1975.

Example 2. The facts are the same as in example 1, except that P incurs expenses, taxes, and deductions of $240 in its taxable year ending on March 31, 1976. Accordingly, $25 is includible in X's foreign base company shipping income, and the amount deductible therefrom under this paragraph is $30 (i.e., ½ × $240 × 3 months/12 months).

(3) *Other income.* Except as expressly provided in subparagraph (1) of this paragraph, foreign base company shipping income does not include any amount includible in the gross income of a controlled foreign corporation

under part I of subchapter J (section 641 and following, relating to estates, trusts, and beneficiaries), and gains from the sale or other disposition of any interest in an estate or trust.

(h) *Additional rules*—(1) *Gross income.* For purposes of this section and §1.955A–2, the gross income of a foreign corporation (whether or not a controlled foreign corporation) shall be determined in accordance with the provisions of section 952 and §1.952–2. Thus, for example, section 883 (relating to exclusions from gross income of foreign corporations) is inapplicable under §1.952–2 (a)(1) and (c)(1). In addition, the gross income of a controlled foreign corporation shall be determined, with respect to a United States shareholder of such controlled foreign corporation, by excluding distributions received by such corporation which are excluded from gross income under section 959(b) with respect to such shareholder.

(2) *Earnings and profits.* For purposes of this section, the earnings and profits of a foreign corporation (whether or not a controlled foreign corporation) shall be determined in accordance with the provisions of section 964 and the regulations thereunder.

(3) *No double counting.* No item of gross income shall be counted as foreign base company shipping income under more than one provision of this section. For example, If $200 of gross income derived from the use of a lighter is treated as foreign base company shipping income under both paragraphs (b)(1)(i) and (ii) of this section, then such $200 is counted only once as foreign base company shipping income. A taxpayer may choose under which provision to include an item of income.

(4) *Losses.* (i) Generally, if a controlled foreign corporation has losses which are properly allocable to foreign base company shipping income, the extent to which such losses are deductible from such income shall be determined by treating such foreign corporation as a domestic corporation and applying the principles of section 63. See §§1.954–1(c) and 1.952–2(b). Thus for example, losses from sales or exchanges of capital assets are allowable only to the extent of gains from such sales or exchanges.

(ii) If gain from the sale, exchange, or other disposition of any stock or obligation would be treated (to any extent) as foreign base company shipping income, then loss from such sale, exchange, or other disposition is properly allocable to foreign base company shipping income (to the same extent).

(iii) In determining the extent to which any loss on the disposition of a qualified investment in foreign base company shipping operations is deductible from foreign base company shipping income, it is immaterial that such loss is taken into account under §1.955A–1(b)(1)(ii) as a reduction in the amount of the decrease in (withdrawal from) qualified investments in foreign base company shipping operations.

(5) *Hypothetical charges.* Under paragraph (d)(5)(i) of this section and §1.955A–2(a)(4)(ii)(A), gross income may be deemed to include hypothetical arm's length charges for services performed by a controlled foreign corporation for itself. Under paragraph (d)(2) of this section, certain of these hypothetical charges may be treated as foreign based company shipping income. Such hypothetical charges are deemed to be income solely for purposes of applying the ‘‘extent of use’’ tests prescribed by paragraph (d)(4) of this section and §1.955A–2(a)(4). Charges for services performed by a controlled foreign corporation for itself shall in no event be included in income for any other purposes.

[T.D. 7894, 48 FR 22523, May 19, 1983]

§1.954–7 Increase in qualified investments in foreign base company shipping operations.

(a) *Determination of investments at close of taxable year*—(1) *In general.* Under section 954(g), the increase in qualified investments in foreign base company shipping operations, for purposes of section 954(b)(2) and paragraph (b)(1) of §1.954–1, of any controlled foreign corporation for any taxable year is, except as provided in paragraph (b) of this section, the amount by which—

(i) The controlled foreign corporation's qualified investments in foreign base company shipping operations at the close of the taxable year, exceed

(ii) Its qualified investments in foreign base company shipping operations at the close of the preceding taxable year.

(2) *Preceding taxable year.* For purposes of this section, a taxable year which begins before January 1, 1976, may be a preceding taxable year.

(3) *Cross-reference.* See section 955 (b) and § 1.955A–2 for the definition of the term ''qualified investments in foreign base company shipping operations''.

(b) *Election to determine investments at close of following taxable year*—(1) *General rule.* In lieu of determining an increase in qualified investments in foreign base company shipping operations for a taxable year in the manner provided in paragraph (a) of this section, a United States shareholder of a controlled foreign corporation may make an election under section 955(b)(3) to determine the increase for the corporation's taxable year by ascertaining the amount by which—

(i) Such corporation's qualified investments in foreign base company shipping operations at the close of the taxable year immediately following such taxable year, exceed

(ii) Its qualified investments in foreign base company shipping operations at the close of the taxable year immediately preceding such following taxable year.

(2) *Election with respect to first taxable year.* Notwithstanding subparagraph (1) of this paragraph, if an election is made without consent by a United States shareholder under § 1.955A–4 (b)(1) with respect to a controlled foreign corporation, the increase in such controlled foreign corporation's qualified investments in foreign base company shipping operations for the first taxable year to which such election applies shall be the amount by which—

(i) Such corporation's qualified investments in foreign base company shipping operations at the close of the taxable year immediately following such first taxable year, exceed

(ii) Its qualified investments in foreign base company shipping operations at the close of the taxable year immediately preceding such first taxable year.

(3) *Manner of making election.* For the manner of making an election under section 955(b)(3), and for rules pertaining to the revocation of such an election, see § 1.955A–4.

(4) *Coordination with prior law.* If a United States shareholder makes an election without consent under § 1.955A–4(b)(1) with respect to a controlled foreign corporation, then such corporation's increase in qualified investments in foreign base company shipping operations for the first taxable year to which such election applies shall be determined by disregarding any change which occurs during such taxable year in the amount of such corporation's investments in stock or obligations of a less developed country shipping company described in § 1.955–5 (b) if both of the following conditions exist:

(i) Such taxable year is the first taxable year of such corporation which begins after December 31, 1975, and

(ii) Such United States shareholder has elected to determine the change in such corporation's qualified investments in less developed countries for its last taxable year beginning before January 1, 1976, under § 1.954–5(b) or § 1.955–3.

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

Example 1. (a) Controlled foreign corporation X is a wholly owned subsidiary of domestic corporation M. X uses the calendar year as the taxable year. The amounts of X's qualified investments in foreign base company shipping operations at the close of 1975 through 1979 are as follows:

Qualified investments at December 31, 1975 ...	$16,000
Qualified investments at December 31, 1976 ...	17,000
Qualified investments at December 31, 1977 ...	23,000
Qualified investments at December 31, 1978 ...	28,000
Qualified investments at December 31, 1979 ...	30,000

(b) Assume that M properly files without consent a timely election under § 1.955A–4(b)(1) to determine X's increase for 1976 in qualified investments in foreign base company shipping operations pursuant to this paragraph, and that the election remains in force through 1978. Then X's increases for 1976 through 1978 in qualified investments in foreign base company shipping operations are as follows:

Increase for 1976 ($23,000 minus $16,000)	$7,000
Increase for 1977 ($28,000 minus $23,000)	5,000
Increase for 1978 ($30,000 minus $28,000)	2,000

Example 2. Assume the same facts as in example 1, except that M never files an election under § 1.955A–4(b)(1). X's increases for 1976 through 1978 in qualified investments in

foreign base company shipping operations are as follows:

Increase for 1976 ($17,000 minus $16,000)	$1,000
Increase for 1977 ($23,000 minus $17,000)	6,000
Increase for 1978 ($28,000 minus $23,000)	5,000

Example 3. The facts are the same as in example 1, except that X's qualified investments in foreign base company shipping operations include an investment in less developed country shipping companies described in §1.955–5(b) of $500 on December 31, 1975, and $750 on December 31, 1976. Assume further that M has made an election under section 955(b)(3) (as in effect before the enactment of the Tax Reduction Act of 1975) with respect to X's taxable year 1975. Then X's increase in qualified investments in foreign base company shipping operations for 1976 is $6,750 (i.e., $7,000 − $250).

(c) *Illustration.* The application of this section may be illustrated by the following example:

Example. (a) Controlled foreign corporation X uses the calendar year as the taxable year. On December 31, 1975, X's qualified investments in foreign base company shipping operations (determined as provided in §1.955A–2(g)) consist of the following amounts:

Cash	$6,000
Readily marketable securities	1,000
Stock of related controlled foreign corporations	4,000
Traffic and other receivables	14,000
Marine insurance claims receivables	1,000
Foreign income tax refunds receivable	1,000
Prepaid shipping expenses and shipping inventories ashore	1,000
Vessel construction funds	0
Vessels	123,000
Vessel plans and construction in progress	3,000
Containers and chassis	0
Terminal property and equipment	2,000
Shipping office (land and building)	1,000
Vessel spare parts ashore	1,000
Performance deposits	2,000
Deferred charges	2,000
Stock of less developed country shipping company described in §1–955–5(b)	10,000
	172,000

(b) On December 31, 1976, X's qualified investments in foreign base company shipping operations (determined as provided in §1.955A–2(g)) consists of the following amounts:

Cash	$5,000
Readily marketable securities	2,000
Stock of related controlled foreign corporations	4,000
Traffic and other receivables	16,000
Foreign income tax refunds receivable	3,000
Prepaid shipping expenses and shipping inventories ashore	2,000
Vessel construction funds	1,000
Vessels	117,000
Vessel plans and construction in progress	12,000
Containers and chassis	4,000
Terminal property and equipment	2,000
Shipping office (land and building)	1,000
Vessel spare parts ashore	1,000
Performance deposits	2,000
Deferred charges	2,000
Stock of less developed country shipping company described in §1.955–5(b)	0
	174,000

(c) For 1976, X's increase in qualified investments in foreign base company shipping operations is $2,000, which amount is determined as follows:

Qualified investments at Dec. 31, 1976	$174,000
Qualified investments at Dec. 31, 1975	172,000
Increase for 1976	2,000

[T.D. 7894, 48 FR 22528, May 19, 1983]

§1.954–8 Foreign base company oil related income.

(a) *Foreign base company oil related income*—(1) *In general.* Under section 954(g), the foreign base company oil related income of a controlled foreign corporation (except as provided under paragraph (b) of this section) consists of the items of foreign oil related income ("FORI") described in section 907(c)(2) and (3), other than such income derived from a source within a foreign country in connection with—

(i) Oil or gas which was extracted from an oil or gas well located in that foreign country ("extraction exception"), or

(ii) Oil, gas, or a primary product of oil or gas which is sold by the controlled foreign corporation or a related person for use or consumption within that country or is loaded in that country on a vessel or aircraft as fuel for the vessel or aircraft ("use or consumption exception").

A taxpayer claiming the use or consumption exception must establish its applicability on the basis of facts and circumstances. For special rules for applying the extraction exception, see paragraph (c) of this section.

(2) *Source of income.* The source of foreign base company oil related income is determined generally under the principles of §§1.861–1 to 1.863–5. See §1.863–6. Thus, income from the performance of a service generally is sourced in the country where the service is performed. See §1.861–4. Underwriting income from insuring a foreign oil related activity is sourced at the location of the risk. See section 861(a)(7) and §1.953–2.

(3) *Primary product.* The term "primary product" of oil or gas has the

meaning given this term by § 1.907(c)–1(d)(5) and (6).

(4) *Vessel.* For the definition of the term ''vessel'', see § 1.954–6(b)(3)(ii).

(5) *Foreign country.* For purposes of this section, the term ''foreign country'' has the same meaning as in section 638 (relating to continental shelf areas). Thus, for example, oil or gas extracted from a sea area will be deemed to be extracted in the country which has exclusive rights of exploitation of natural resources with respect to that area if the other conditions of section 638 are met.

(6) *Country of use or consumption.* For rules for determining the country of use or consumption, see § 1.954–3(a)(3)(ii).

(7) *Insurance income.* For purposes of this section, income derived from or attributable to insurance of section 907(c)(2) activities means taxable income as defined in section 832(a) and as modified by the principles of § 1.953–4 (other than as the section is applied to life insurance).

(8) *Fuel product.* For purposes of this section, the term ''fuel product'' means oil, gas or a primary product of oil or gas.

(9) *Effective date.* The provisions of section 954(g) and this section are applicable to taxable years of foreign corporations beginning on or after January 1, 1983, and to taxable years of United States shareholders in which or with which those taxable years of foreign corporations end.

(b) *Exemption for small oil producers*—(1) *In general.* Foreign base company oil related income does not include any income of a foreign corporation which is not a large oil producer.

(2) *Large oil producer.* A corporation is a large oil producer (within the meaning of section 954(g)(2)) if the average daily production (extraction) of foreign crude oil and natural gas by the related group which includes the corporation and related persons (within the meaning of section 954(d)(3)) for the taxable year or immediately preceding taxable year is 1,000 or more barrels. The average daily production of foreign crude oil or natural gas for any taxable year (and the conversion of cubic feet of natural gas into barrels) is determined under rules similar to the rules of section 613A, except that only crude oil or natural gas from a well located outside the United States is taken into account.

(c) *Special rules for applying the extraction exception of paragraph (a)(1)(i) of this section*—(1) *Refining income described in section 907(c)(2)(A).* With regard to a controlled foreign corporation's refining income from the processing of minerals extracted (by the taxpayer or by any other person) from oil or gas wells into their primary products, as described in section 907(c)(2)(A), a pro rata method will be applied for purposes of determining the part of the refining income that qualifies for the extraction exception of paragraph (a)(1)(i) of this section. The pro rata method will be based on the proportion that the barrels of the fuel product extracted in the country of processing bears to the total barrels of the fuel product processed in that country and will apply regardless of the country of sale of the primary product.

(2) *Marketing income described in section 907(c)(2)(C).* With regard to a controlled foreign corporation's marketing income from the distribution or sale of minerals extracted from oil or gas wells or of primary products, as described in section 907(c)(2)(C), a pro rata method will be applied for purposes of determining the part of the marketing income that qualifies for the extraction exception of paragraph (a)(1)(i) of this section. When applying the pro rata method to the sale of a fuel product other than a primary product, the pro rata method will be based on the proportion that the barrels of the fuel product extracted in the country of sale bears to the total barrels of the fuel product sold in that country. When applying the pro rata method to the sale of primary products, the method will be based on the proportion that the barrels of the fuel product extracted in the country of sale bears to the total barrels of the fuel product processed. For purposes of applying the pro rata method, data of the controlled foreign corporation's related group (as defined in section 954(g)(2)(C)) will be taken into account. The pro rata method will not apply, however, if the mineral or primary

product is purchased by the controlled foreign corporation from a person not within the controlled foreign corporation's related group. In that situation, the marketing income will be presumed to qualify for the extraction exception if the country of the source of the marketing income is a net exporter of crude oil or gas, whichever is relevant. If the country of the source of the marketing income is not a net exporter of crude oil or gas, whichever is relevant, the marketing income will be presumed not to qualify for the extraction exception. The controlled foreign corporation may, however, rebut this latter presumption by demonstrating on the basis of all the facts and circumstances that its marketing income does qualify for the extraction exception. If a primary product that is acquired from a person within the controlled foreign corporation's related group is commingled with like products acquired from persons not within that related group, the pro rata method based on the proportion that the barrels of the fuel product extracted in the country of sale bears to the total barrels of the fuel product processed will be applied to that portion of the total products sold that was purchased from persons within the related group, to the extent that that person did not sell product purchased from an unrelated person, and either the presumption or facts and circumstances will determine the characterization of the remainder.

(3) *Transportation income described in section 907(c)(2)(B).* With regard to a controlled foreign corporation's income from the transportation of minerals from oil and gas wells or of primary products, as described in section 907(c)(2)(B), the rules set forth in paragraph (c)(2) of this section will apply for purposes of determining the part of the transportation income that qualifies for the extraction exception of paragraph (a)(1)(i) of this section.

(4) *Illustrations.* The following examples illustrate the application of this paragraph.

Example 1. Controlled foreign corporation M has a refinery in foreign country A that refines 250x barrels of oil during its taxable year beginning in 1984. It is determined that 125x barrels of its 250x barrels were extracted in country A. M sold 150x barrels of its 250x barrels in country A for consumption in country A which resulted in $225x of income from refining and $225x of marketing income, as described in section 907(c)(2)(C). M also sold within foreign country B, for consumption in country B, 100x barrels of its 250x barrels which resulted in an additional $150x of income from refining for M and $170x of marketing income for M. The 100x barrels sold by M within country B, a contiguous country, were transported from M's refinery in country A to country B by a pipeline which is owned by M, and M recognized a total of $10x of income from the transportation of the 100x barrels. Of this $10x, $8x was recognized in country A and $2x was recognized in country B. Under the source of income rules of paragraph (a)(2) of this section, income from refining is considered derived from the country in which the refining occurs and not from the country where the sale of the refined product occurs.

(i) *M's refining income.* M has $75x of foreign base company oil related income with respect to its refining of the 250x barrels, determined as follows:

(A) Total amount of income from refining attributable to oil refined in country A by M	$375x
(B) Amount of income from refining with respect to oil sold for consumption ($225x) in country A (use or consumption exception under paragraph (a)(1)(ii) of this section	(225x)
(C) Pro rate amount of income from refining attributable to sales in country B considered extracted from country A ($150x times 125x barrels/250x barrels) (extraction exception under paragraph (a)(1)(i) of this section	*(75x)*
(D) Foreign base company oil related income	*$75x*

(ii) *M's marketing income.* M does not have foreign base company oil related income with respect to its sale of the 100x barrels in country B and 150x barrels in country A because the $170x and $225x, respectively, of marketing income was derived from the country in which the oil was sold for consumption (an exception under paragraph (a)(1)(ii) of this section).

(iii) *M's transportation income.* M does not have foreign base company oil related income with respect to its $2x of pipeline transportation income recognized in country B because the income was derived from the country in which the 100x barrels were sold for consumption, an exception under paragraph (a)(1)(ii) of this section. With regard to the $8x of pipeline transportation income recognized in country A, however, M has $4x of foreign base company oil related income since of the total barrels refined in country A (250x) only one-half were extracted in that country. Therefore, only one-half of the transportation income qualifies for the extraction exception of paragraph (a)(1)(i) of this section.

(iv) *M's extraction income.* M does not have foreign base company oil related income for its extraction activity because extraction income is excluded in all events. See section 954(g)(1)(A).

Example 2. Assume the same facts as in *Example 1* except that M sold all of the 250x barrels of refined oil in country A. In addition, assume that country A is a net exporter of crude oil. As in *Example 1,* M sold 150x barrels for consumption in country A with the same resulting income. M sold in country A the remaining 100x barrels to unrelated controlled foreign corporation N which resulted in an additional $150x of income from refining for M and $170x of marketing income for M. N immediately resold in country A for export those 100x barrels. N did not commingle the 100x barrels with any other refined oil. N earned $10x of marketing income on that sale.

(i) *M's refining income.* M has $75x foreign base company oil related income with respect to its refining of the 250x barrels determined as follows:

(A) Total amount of income from refining attributable to oil refined in country A by M	$375x
(B) Amount of income from refining with respect to oil sold for consumption ($225x) in country A (use or consumption exception under paragraph (a)(1)(ii) of this section)	(225x)
(C) Pro rata amount of income from refining attributable to sales in country A (for consumption outside of country A) considered extracted from country A ($150x times 125x barrels/250x barrels) (extraction exception under paragraph (a)(1)(i) of this section)	*(75x)*
(D) Foreign base company oil related income	*$75x*

(ii) *M's marketing income.* M does not have foreign base company oil related income with respect to its marketing income from the sale of the 150x barrels in country A because the $225x of marketing income was derived from the country in which the oil was sold for consumption (an exception under paragraph (a)(1)(ii) of this section). M has $85x of foreign base company oil related income with respect to its marketing income from sale to N of the 100x barrels, determined as follows:

(A) Total amount of marketing income from the sale	$170x
(B) Pro rata amount of marketing income attributable to oil product considered extracted in country A ($170x times 125x barrels/250x barrels) (extraction exception under paragraph (a)(1)(i) of this section)	(85x)
(C) Foreign base company oil related income	*$85x*

(iii) *N's marketing income.* N is not related to M. Therefore, since N sold the 100x barrels in country A, a net exporter of crude oil, and since N did not commingle the 100x barrels with other refined products, it is presumed that all of the 100x barrels were extracted in country A. Accordingly, all of N's $10x of marketing income is excepted under paragraph (a)(1)(i) of this section.

Example 3. Assume the same facts as in *Example 2* except that N is related to M. Characterization of M's income remains the same as in *Example 2.* N will have, however, $5x of foreign base company oil related income with regard to its marketing income, determined as follows:

(i) Total amount of marketing income from the sale	$10x
(ii) Pro rata amount of marketing income considered extracted from country A ($10x times 125x barrels/250x barrels) (extraction exception under paragraph (a)(1)(i) of this section)	*5x*
(iii) Foreign base company oil related income	*$5x*

Example 4. Assume that controlled foreign corporation M has a refinery in foreign country A that refines 200x barrels of oil during its taxable year beginning in 1984. It is determined that 100x barrels of that oil were extracted in country A and that the other 100x barrels were extracted in country B. Neither country A nor country B is a net exporter of crude oil. In addition, M purchased from an unrelated country A refiner 100x barrels of already refined oil. M does not know where this oil was extracted. These 100x barrels of purchased refined oil were commingled with the 200x barrels of refined oil from M's refinery. M sold 225x barrels of refined oil in country A for consumption in country A which resulted in $250x of income from refining and $225x of marketing income. M sold within foreign country B for consumption outside of country B 75x barrels of refined oil which resulted in $100x of income from refining and $75x of marketing income. The refined product was transported between country A and country B by an unrelated person.

(i) *M's refining income.* With regard to the sales in country A, M has $50x of foreign base company oil related income with respect to its refining of the 100x barrels, determined as follows:

(A) Total amount of income from refining attributable to oil refined in country A by M	$350x
(B) Amount of income from refining with respect to oil sold for consumption in country A ($250x) (use or consumption exception under paragraph (a)(1)(ii) of this section)	

(250x)

(C) Pro rata amount of income from refining attributable to sales in country B considered extracted from country A ($100x times 100x barrels/200x barrels) (extraction exception under paragraph (a)(1)(i) of this section) *(50x)*

(D) Foreign base company oil related income *$50x*

(ii) *M's marketing income.* Since the barrels from M's refinery and those that M purchased were commingled, a portion, as follows, of the marketing income is deemed to derive from both purchased and refined products. Since M refined 200x barrels and purchased 100x barrels, its marketing income of $225x from the sale of the 225x barrels in country A for consumption in country A will be deemed to consist of $150x (200x/300x × $225x) from the sale of products refined by M and $75x (100x/300x × $225x) from the sale of purchased products. Likewise, its marketing income of $75x from the sale of the 75x barrels in country B for consumption outside of country B will be deemed to consist of $50x (200x/300x × $75x) from the sale of products refined by M and $25x (100x/300x × $75x) from the sale of purchased products.

(A) *Purchased products.* M is considered as having $75x of marketing income from the sale of purchased products in country A for consumption in country A. None of this marketing income is foreign base company oil related income since the marketing income is earned in country A, the country of consumption. See paragraph (a)(1)(ii) of this section. All of the $25x of M's marketing income from the sale of purchased products in country B will be foreign base company oil related income. The exception at paragraph (a)(1)(ii) of this section does not apply since the refined oil is not sold for use or consumption in country B. Likewise, the extraction exception under paragraph (a)(1)(i) of this section does not apply. The purchased product cannot be presumed to be extracted in country B since country B is not a net exporter of crude oil. In addition, M cannot show, on a facts and circumstances basis, that purchased products were refined from crude oil extracted in country B.

(B) *Products refined by M.* With regard to M's marketing income attributable to the sale of products refined by M, M does not have any foreign base company oil related income with regard to its $150x of marketing income in country A since that income was derived from the country in which the oil was sold for consumption (the use or consumption exception under paragraph (a)(1)(ii) of this section). M has $25x of foreign base company oil related income with regard to its $50x of marketing income in country B determined as follows:

(*1*) Total amount of income from marketing attributable to oil refined by M and sold in country B $50x

(*2*) Pro rata amount of income from marketing attributable to sales in country B considered extracted from country B ($50x times 100x barrels/200x barrels) (extraction exception under paragraph (a)(1)(i) of this section) *(25x)*

(*3*) Foreign base company oil related income *$25x*

[T.D. 8331, 56 FR 2847, Jan. 25, 1991; 56 FR 11511, Mar. 19, 1991]

§1.954–9T Hybrid branches (temporary).

(a) *Subpart F income arising from certain payments involving hybrid branches*—(1) *Payment causing foreign tax reduction gives rise to additional subpart F income.* The non-subpart F income of the controlled foreign corporation will be recharacterized as subpart F income, to the extent provided in paragraph (a)(5) of this section, if—

(i) A hybrid branch payment, as defined in paragraph (a)(6) of this section, is made between the entities described in paragraph (a)(2) of this section;

(ii) The hybrid branch payment reduces foreign tax, as determined under paragraph (a)(3) of this section; and

(iii) The hybrid branch payment is treated as falling within a category of foreign personal holding company income under the rules of paragraph (a)(4) of this section.

(2) *Hybrid branch payment between certain entities*—(i) *In general.* Paragraph (a)(1) of this section shall apply to hybrid branch payments between—

(A) A controlled foreign corporation and its hybrid branch;

(B) Hybrid branches of a controlled foreign corporation;

(C) A partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other partnerships) and a hybrid branch of the partnership; or

(D) Hybrid branches of a partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other partnerships).

(ii) *Hybrid branch payment involving partnership*—(A) *Fiscally transparent partnership.* To the extent of the controlled foreign corporation's proportionate share of a hybrid branch payment, the rules of paragraphs (a)(3), (4) and (5) of this section shall be applied by treating the hybrid branch payment between the partnership and the hybrid branch as if it were made directly between the controlled foreign corporation and the hybrid branch, or as if the hybrid branches of the partnership were hybrid branches of the controlled foreign corporation, if the hybrid branch payment is made between—

(*1*) A fiscally transparent partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other fiscally transparent partnerships) and the partnership's hybrid branch; or

(*2*) Hybrid branches of a fiscally transparent partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other fiscally transparent partnerships).

(B) *Non-fiscally transparent partnership.* To the extent of the controlled foreign corporation's proportionate share of a hybrid branch payment, the rules of paragraphs (a)(3) and (4) and (a)(5)(iv) of this section shall be applied to the non-fiscally transparent partnership as if it were the controlled foreign corporation, if the hybrid branch payment is made between—

(*1*) A non-fiscally transparent partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other partnerships) and the partnership's hybrid branch; or

(*2*) Hybrid branches of a non-fiscally transparent partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other partnerships).

(C) *Examples.* The following examples illustrate the application of this paragraph (a)(2)(ii).

Example 1. CFC, a controlled foreign corporation in Country A, is a 90 percent partner in partnership P, which is treated as fiscally transparent under the laws of Country A. P has a hybrid branch, BR, in Country B. P makes an interest payment of $100 to BR. Under Country A law, CFC's 90 percent share of the payment reduces CFC's Country A income tax. Under paragraph (a)(2)(ii)(A) of this section, the recharacterization rules of this section are applied by treating the payment as if made by CFC to BR. Ninety dollars of CFC's non-subpart F income, to the extent available, and subject to the earnings and profits and tax rate limitations of § 1.954–9T(a)(5), is recharacterized as subpart F income.

Example 2. CFC, a controlled foreign corporation in Country A, is a 90 percent partner in partnership P, which is treated as fiscally transparent under the laws of Country A. P has two branches in Country B, BR1 and BR2. BR1 is treated as fiscally transparent under the laws of Country A. BR2 is a hybrid branch. BR1 makes an interest payment of $100 to BR2. Under paragraph (a)(2)(ii)(A) of this section, the payment by BR1, the fiscally transparent branch, is treated as a payment by P, and the deemed payment by P, a fiscally transparent partnership, is treated as made by CFC. Under Country A law, CFC's 90 percent share of BR1's payment reduces CFC's Country A income tax. Ninety dollars of CFC's non-subpart F income, to the extent available, and subject to the earnings and profits and tax rate limitations of § 1.954–9T(a)(5), is recharacterized as subpart F income.

(3) *Application when payment reduces foreign tax.* For purposes of paragraph (a)(1) of this section, a hybrid branch payment reduces foreign tax when the foreign tax imposed on the income of the payor or any owner of the payor is less than the foreign tax that would have been imposed on such income had the hybrid branch payment not been made, or the hybrid branch payment creates or increases a loss or deficit or other tax attribute which may be carried back or forward to reduce the foreign income tax of the payor or any owner in another year (determined by taking into account any refund of such tax made to the payor, payee or any other person).

(4) *Hybrid branch payment that is included within a category of foreign personal holding company income*—(i) *In general.* For purposes of paragraph (a)(1) of this section, whether the hybrid branch payment is treated as income included within a category of foreign personal holding company income is determined by treating a hybrid branch that is either the payor or recipient of the hybrid branch payment as a separate wholly-owned subsidiary corporation of the controlled foreign corporation that is incorporated in the jurisdiction under the laws of which such hybrid branch is created, organized for foreign law purposes, or has substantial assets. Thus, the hybrid

branch payment will be treated as included within a category of foreign personal holding company income if, taking into account any specific exceptions for that category, the payment would be included within a category of foreign personal holding company income if the branch or branches were treated as separately incorporated for U.S. tax purposes.

(ii) *Extent to which controlled foreign corporation and hybrid branches treated as separate entities.* For purposes other than the determination under paragraph (a)(4)(i) of this section, a controlled foreign corporation and its hybrid branch, a partnership and its hybrid branch, or hybrid branches shall not be treated as separate entities. Thus, for example, if a controlled foreign corporation, including all of its hybrid branches, has an overall deficit in earnings and profits to which section 952(c) applies, the limitation of such section on the amount includible in the subpart F income of such corporation will apply. Similarly, for purposes of applying the de minimis and full inclusion rules of section 954(b)(3), a controlled foreign corporation and its hybrid branch, or hybrid branches shall not be treated as separate corporations. Further, a hybrid branch payment that would reduce foreign personal holding company income under section 954(b)(5) if made between two separate entities will not create an expense if made between a controlled foreign corporation and its hybrid branch, a partnership and its hybrid branch, or hybrid branches.

(5) *Recharacterization of income attributable to current earnings and profits as subpart F income*—(i) *General rule.* Non-subpart F income of a controlled foreign corporation in an amount equal to the excess of earnings and profits of the controlled foreign corporation for the taxable year over subpart F income, as defined in section 952(a), will be recharacterized as subpart F income under paragraph (a)(1) of this section only to the extent provided under paragraphs (a)(5)(ii) through (vi) of this section.

(ii) *Subpart F income.* For purposes of determining the excess of current earnings and profits over subpart F income under paragraph (a)(1) of this section, the amount of subpart F income is determined before the application of the rules of this section but after the application of the rules of sections 952(c) and 954(b). Further, such amount is determined by treating the controlled foreign corporation and all of its hybrid branches as a single corporation.

(iii) *Recharacterization limited to gross amount of hybrid branch payment*—(A) *In general.* The amount recharacterized as subpart F income under paragraph (a)(1) of this section is limited to the amount of the hybrid branch payment.

(B) *Exception for duplicative payments.* [Reserved].

(iv) *Tax disparity rule*—(A) *In general.* Paragraph (a)(1) of this section will apply only if the hybrid branch payment falls within the tax disparity rule. The hybrid branch payment falls within the tax disparity rule if it is taxed in the year when earned at an effective rate of tax that is less than 90 percent of, and at least 5 percentage points less than, the hypothetical effective rate of tax imposed on the hybrid branch payment, as determined under paragraph (a)(5)(iv)(B) of this section.

(B) *Hypothetical effective rate of tax*—(*1*) *In general.* The hypothetical effective rate of tax imposed on the hybrid branch payment is—

(*i*) For the taxable year of the payor in which the hybrid branch payment is made, the amount of income taxes that would have been paid or accrued by the payor if the hybrid branch payment had not been made, less the amount of income taxes paid or accrued by the payor; divided by

(*ii*) The amount of the hybrid branch payment.

(*2*) *Hypothetical effective rate of tax when hybrid branch payment causes or increases loss or deficit.* If the hybrid branch payment causes or increases a loss or deficit of the payor for foreign tax purposes, and such loss or deficit can be carried forward or back, the hypothetical effective rate of tax imposed on the hybrid branch payment is the effective rate of tax that would be imposed on the taxable income of the payor for the year in which the foreign law payment is made if the payor's taxable income were equal to the amount of the hybrid branch payment.

(C) *Examples.* The application of this paragraph (a)(5)(iv) is illustrated by the following examples.

Example 1. In 1998, CFC organized in Country A had net income of $60 from manufacturing for Country A tax purposes. It also had a branch (BR) in Country B. BR is a hybrid entity under paragraph (a)(1) of this section. CFC made a payment of $40 to BR, which was a hybrid branch payment under paragraph (a)(6) of this section, and was treated by CFC as a deductible payment for Country A tax purposes. CFC paid $30 of Country A taxes in 1998. It would have paid $50 of Country A taxes without the deductible payment. Country A did not impose any withholding tax on the $40 payment to BR. Country B also did not impose a tax on the $40 received by BR. Therefore, the effective rate of tax on that payment is 0%. Furthermore, the hypothetical effective rate of tax on the $40 hybrid branch payment is 50% ($50 – $30/$40). The effective rate of tax (0%) is less than 90% of, and more than 5 percentage points less than, this hypothetical rate of tax of 50%. As a result, the $40 hybrid branch payment falls within the tax disparity rule of this paragraph (a)(5)(iv).

Example 2. Assume the same facts as in *Example 1,* except that CFC has a loss of $100 for the year for Country A tax purposes. Under Country A law, CFC can carry the loss forward for use in subsequent years. CFC paid no Country A taxes in 1998. The rate of tax in Country A is graduated from 20% to 50%. If the $40 hybrid branch payment were the only item of taxable income of CFC, Country A would have imposed tax at an effective rate of 30%. The effective rate of tax (0%) is less than 90 percent of, and more than 5 percentage points less than, the hypothetical effective rate of tax (30%) imposed on the hybrid branch payment. As a result, the $40 hybrid branch payment falls within the tax disparity rule of this paragraph (a)(5)(iv).

Example 3. Assume the same facts as in *Example 1,* except that Country B imposes tax on the $40 hybrid payment to BR at an effective rate of 50%. The effective rate of 50% is equal to the hypothetical effective rate of tax. As a result, the hybrid branch payment does not fall within the tax disparity rule of this paragraph (a)(5)(iv) and, thus, the recharacterization rules of paragraph (a)(1) of this section do not apply. See also the special high tax exception of paragraph (a)(5)(v) of this section.

(v) *Special high tax exception*—(A) *In general.* Paragraph (a)(1) of this section shall not apply if the non-subpart F income recharacterized as subpart F income under this section was subject to foreign income taxes imposed by a foreign country or countries at an effective rate that is greater than 90 percent of the maximum rate of tax specified in section 11 for the taxable year of the controlled foreign corporation.

(B) *Effective rate of tax.* The effective rate of tax imposed on the net amount of the hybrid branch payment is determined under the principles of § 1.954–1(d)(2) and (3). See paragraph (c) of this section for the application of section 960 to amounts recharacterized as subpart F income under this section.

(vi) *No carryback or carryforward of amounts in excess of current year earnings and profits limitation.* To the extent that some or all of the amount required to be recharacterized under this section is not recharacterized as subpart F income because the hybrid branch payment exceeds the amount that can be recharacterized, as determined under paragraph (a)(5)(i) of this section, this excess shall not be carried back or forward to another year.

(6) *Definitions.* For purposes of this section—

Entity means any person that is treated by the United States or any jurisdiction as other than an individual.

Hybrid branch means an entity that—

(i) Has a single owner (including ownership through branches) that is either a controlled foreign corporation or a partnership in which a controlled foreign corporation is a partner (either directly or indirectly through one or more branches or partnerships);

(ii) Is treated as fiscally transparent by the United States; and

(iii) Is treated as non-fiscally transparent by the country in which the payor entity, any owner of a fiscally-transparent payor entity, the controlled foreign corporation, or any intermediary partnership is created, organized or has substantial assets.

Hybrid branch payment means the gross amount of any payment (including any accrual) which, under the tax laws of any foreign jurisdiction to which the payor is subject, is regarded as a payment between two separate entities but which, under U.S. income tax principles, is not income to the recipient because it is between two parts of a single entity.

(7) *Fiscally transparent and non-fiscally transparent.* For purposes of this section an entity shall be treated as

fiscally transparent with respect to an interest holder of the entity, if such interest holder is required, under the laws of any jurisdiction to which it is subject, to take into account separately, on a current basis, such interest holder's share of all items which, if separately taken into account by such interest holder, would result in an income tax liability for the interest holder in such jurisdiction different from that which would result if the interest holder did not take the share of such items into account separately. A non-fiscally transparent entity is an entity that is not fiscally transparent under this paragraph (a)(7).

(b) *Election to change classification*—(1) *In general.* If a hybrid branch subject to the provisions of paragraph (a) of this section is an entity that has made an election under §301.7701–3(c)(1) of this chapter to be disregarded as an entity separate from its owner, such entity may elect to change its classification to that of an association taxable as a corporation, under the procedures described in §301.7701–3(c) of this chapter, without regard to the limitation of §301.7701–3T(c)(1)(iv) of this chapter, but only if such election is made on or before the last day of the first taxable year beginning on or after January 1, 1998. An election made pursuant to this paragraph (b)(1) is effective as of the first day of such taxable year. The 75 day limitation on retroactivity in §301.7701–3(c)(1)(iii) of this chapter does not apply.

(2) *Limitation.* An entity can elect to change its classification under the provisions of this paragraph only one time.

(c) *Application of section 960*—For purposes of determining the amount of taxes deemed paid under section 960, the amount of non-subpart F income recharacterized as subpart F income under this section shall be treated as attributable to income in separate categories, as defined in §1.904–5(a)(1), in proportion to the ratio of non-subpart F income in each such category to the total amount of non-subpart F income of the controlled foreign corporation for the taxable year.

(d) *Effective dates*—(1) *Hybrid branches of controlled foreign corporations.* With respect to hybrid branch payments described in paragraph (a)(2)(i)(A) and (B) of this section, the rules of this section shall apply to all amounts paid or accrued on or after January 16, 1998, except for amounts paid or accrued pursuant to arrangements entered into before January 16, 1998, and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after January 16, 1998.

(2) *Hybrid branches of partnerships in which controlled foreign corporations are partners.* With respect to hybrid branch payments described in paragraph (a)(2)(i)(C) and (D) of this section, the rules of this section shall apply to all amounts paid or accrued on or after March 23, 1998, except for amounts paid or accrued pursuant to arrangements entered into before March 23, 1998 and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after March 23, 1998.

[T.D. 8767, 63 FR 14617, Mar. 26, 1998]

§1.955–0 Effective dates.

(a) *Section 955 as in effect before the enactment of the Tax Reduction Act of 1975*—(1) *In general.* In general, §§1.955–1 through 1.955–6 are applicable with respect to withdrawals of previously excluded subpart F income from qualified investment in less developed countries for taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States shareholders (as defined in section 951(b)) within which or with which such taxable years of such foreign corporations end. However, such sections are effective with respect to withdrawals of amounts invested in less developed country shipping companies described in section 955(c)(2) (as in effect before the enactment of the Tax Reduction Act of 1975) only for taxable years of foreign corporations beginning before January 1, 1976, and for taxable years of United States shareholders (as defined in section 951(b)) within which or with which such taxable years of such foreign corporations end. For rules applicable to withdrawals of amounts invested in less developed country shipping companies described in section 955(c)(2) (as in effect before such enactment), in taxable years of foreign corporations beginning after December 31, 1975, see section 955(b)(5) (as amended by such Act) and §§1.955A–1 through 1.955A–4.

(2) *References.* Except as otherwise provided therein, all references contained in §§1.955–1 through 1.955–6 to section 954 or 955 or to the regulations under section 954 are to those sections and regulations as in effect before the enactment of the Tax Reduction Act of 1975. For regulations under section 954 (as in effect before such enactment), see 26 CFR §1.954–1 through 1.954–5 (Revised as of April 1, 1975). For taxable years of foreign corporations beginning after December 31, 1975, and for taxable years of United States shareholders (as described in section 951(b)) within which or with which such taxable years of such foreign corporations end, the definitions of less developed countries and less developed country corporations contained in section 902(d) (as amended by such Act) and §1.902–2 apply for purposes of determining the credit for corporate stockholders in foreign corporations under section 902.

(b) *Section 955 as amended by the Tax Reduction Act of 1975.* Except as otherwise provided therein, §§1.955A–1 through 1.955A–4 are applicable to taxable years of foreign corporations beginning after December 31, 1975, and to taxable years of United States shareholders (as defined in section 951(b)) within which or with which such taxable years of such foreign corporations end.

[T.D. 7893, 48 FR 22508, May 19, 1983, as amended by T.D. 7894, 48 FR 22529, May 19, 1983]

§1.955–1 Shareholder's pro rata share of amount of previously excluded subpart F income withdrawn from investment in less developed countries.

(a) *In general.* Pursuant to section 951(a)(1)(A)(ii) and the regulations thereunder, a United States shareholder of a controlled foreign corporation must include in its gross income its pro rata share (as determined in accordance with paragraph (c) of this section) of the amount of such controlled foreign corporation's previously excluded subpart F income which is withdrawn for any taxable year from investment in less developed countries. Section 955 provides rules for determining the amount of a controlled foreign corporation's previously excluded subpart F income for any taxable year of the corporation beginning after December 31, 1962, that is withdrawn from investment in less developed countries for any taxable year of the corporation beginning before January 1, 1976. Except for investment in less developed country shipping companies, section 955 also provides rules for determining the amount of a controlled foreign corporation's previously excluded subpart F income for any taxable year of the corporation beginning after December 31, 1962, which is withdrawn from investment in less developed countries in taxable years of the corporation beginning after December 31, 1975. To determine the amount of a controlled foreign corporation's previously excluded subpart F income withdrawn from investment in less developed country shipping companies described in section 955(c)(2) in taxable years of a controlled foreign corporation beginning after December 31, 1975, see section 955(b)(5) (as in effect after amendment by the Tax Reduction Act of 1975) and §§1.955A–1 through 1.955A–4. For effective dates, see §1.955–0.

(b) *Amount withdrawn by controlled foreign corporation*—(1) *In general.* For purposes of sections 951 through 964, the amount of a controlled foreign corporation's previously excluded subpart F income which is withdrawn for any taxable year from investment in less developed countries is an amount equal to the decrease for such year in such corporation's qualified investments in less developed countries. Such decrease is, except as provided in §1.955–3—

(i) An amount equal to the excess of the amount of its qualified investments in less developed countries at the close of the preceding taxable year over the amount of its qualified investments in less developed countries at the close of the taxable year, minus

(ii) The amount (if any) by which recognized losses on sales or exchanges by such corporation during the taxable year of qualified investments in less developed countries exceed its recognized gains on sales or exchanges during such year of qualified investments in less developed countries,

but only to the extent that the net amount so determined does not exceed the limitation determined under subparagraph (2) of this paragraph. See §1.955–2 for determining the amount of qualified investments in less developed countries.

(2) *Limitations applicable in determining decreases*—(i) *General.* The limitation referred to in subparagraph (1) of this paragraph for any taxable year of a controlled foreign corporation shall be the lesser of the following two limitations:

(a) The sum of the controlled foreign corporation's earnings and profits (or deficit in earnings and profits) for the taxable year, computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year, plus the sum of its earnings and profits (or deficits in earnings and profits) accumulated for prior taxable years beginning after December 31, 1962, (including prior taxable years beginning after December 31, 1975) or,

(b) The sum of the amounts excluded under section 954(b)(1) and paragraph (b)(1) of §1.954–1 from the foreign base company income of such corporation for all prior taxable years, minus the sum of the amounts (determined under this paragraph) of its previously excluded subpart F income withdrawn from investment in less developed countries for all prior taxable years.

(ii) *Treatment of earnings and profits.* For purposes of determining earnings and profits of a controlled foreign corporation under subdivision (i)(*a*) of this subparagraph, such earnings and profits shall be considered not to include any amounts which are attributable to—

(*a*)(*1*) Amounts which, for the current taxable year, are included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a)(1)(A)(i) or (iii), or

(*2*) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a) and have not been distributed; or

(b)(1) Amounts which, for the current taxable year, are included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) or would be so included under such section but for the fact that such amounts were distributed to such shareholder during the taxable year, or

(2) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) and have not been distributed.

The rules of this subdivision apply only in determining the limitation on a controlled foreign corporation's decrease in qualified investments in less developed countries. See section 959 and the regulations thereunder for limitations on the exclusion from gross income of previously taxed earnings and profits.

(3) *Taxable years beginning after December 31, 1975.* (i) In the case of a taxable year of a controlled foreign corporation beginning after December 31, 1975, §1.955–2(b)(5) must be applied in determining the amount of its qualified investments in less developed countries on both of the determination dates applicable to such taxable year.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example 1. (a) Controlled foreign corporation M uses the calendar year as the taxable year. Throughout 1974 through 1976, M owns 100 percent of the only class of stock of foreign corporation N, a less developed country shipping company described in §1.955–5(b), and M owns no other stock or obligations. The amount taken into account under §1.955–2(d) with respect to the stock of N is $10,000 at the close of 1974, 1975, and 1976. The amount of M's previously excluded subpart F income which is withdrawn for 1975 (a year to which § 1.955–2(b)(5) does not apply) from investment in less developed countries is zero, determined as follows:

(1) Qualified investments in less developed countries at the close of 1974	$10,000
(2) Less: qualified investments in less developed countries at the close of 1975	10,000
(3) Balance	0

(Further computations similar to those set out in lines (iv) through (ix) of example 1 of paragraph (d) of this section are unnecessary because the balance in line (3) of this example is zero.)

(b) As a result of § 1.955–2(b)(5)(ii), the amount of M's previously excluded subpart F income which is withdrawn for 1976 from investment in less developed countries is zero, determined as follows:

(1) Qualified investments in less developed countries at the close of 1975	$0
(2) Less: qualified investments in less developed countries at the close of 1976	0
(3) Balance	0

Example 2. The facts are the same as in example 1, except that foreign corporation N is a less developed country corporation described in § 1.955–5(a). The amount of M's previously excluded subpart F income withdrawn for 1976 from investment in less developed countries is zero, determined as follows:

(1) Qualified investments in less developed countries at the close of 1975	$10,000
(2) Less: qualified investments in less developed countries at the close of 1976	10,000
(3) Balance	0

(c) *Shareholder's pro rata share of amount withdrawn by controlled foreign corporation*—(1) *In general.* A United States shareholder's pro rata share of a controlled foreign corporation's previously excluded subpart F income withdrawn for any taxable year from investment in less developed countries is his pro rata share of the amount withdrawn for such year by such corporation, as determined under paragraph (b) of this section. See section 955(a)(3).

(2) *Special rule.* A United States shareholder's pro rata share of the net amount determined under paragraph (b)(2)(i)*(b)* of this section with respect to any stock of the controlled foreign corporation owned by such shareholder shall be determined without taking into account any amount attributable to a period prior to the date on which such shareholder acquired such stock. See section 1248 and the regulations thereunder for rules governing treatment of gain from sales or exchanges of stock in certain foreign corporations.

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

Example 1. A, a United States shareholder, owns 60 percent of the only class of stock of M Corporation, a controlled foreign corporation throughout the entire period here involved. Both A and M Corporation use the calendar year as a taxable year. Corporation M's qualified investments in less developed countries at the close of 1964 amount to $125,000; and, at the close of 1965, to $75,000. During 1965, M Corporation realizes recognized gains of $5,000 and recognized losses of $15,000, on sales of qualified investments in less developed countries. Corporation M's earnings and profits for 1965 and its accumulated earnings and profits for 1963 and 1964 amount to $45,000, as determined under paragraph (b)(2) of this section. The amount excluded under section 954(b)(1) for 1963 from its foreign base company income is $75,000, and the amount of its previously excluded subpart F income withdrawn for 1964 from investment in less developed countries is $25,000. The amount of M Corporation's previously excluded subpart F income withdrawn for 1965 from investment in less developed countries is $40,000, and A's pro rata share of such amount is $24,000, determined as follows:

(i) Qualified investments in less developed countries at the close of 1964	$125,000
(ii) Less: Qualified investments in less developed countries at the close of 1965	75,000
(iii) Balance	50,000
(iv) Less: Excess of recognized losses over recognized gains on sales during 1965 of qualified investments in less developed countries ($15,000 less $5,000)	10,000
(v) Tentative decrease in qualified investments in less developed countries for 1965	40,000
(vi) Earnings and profits for 1963, 1964, and 1965	45,000

(vii) Excess of amount excluded under section 954(b)(1) from foreign base company income for 1963 ($75,000 over amount of previously excluded subpart F income withdrawn for 1964 from investment in less developed countries ($25,000)	50,000
(viii) M Corporation's amount of previously excluded subpart F income withdrawn for 1965 from investment in less developed countries (item (v), but not to exceed the lesser of item (vi) or item (vii))	40,000
(ix) A's pro rata share of M Corporation's amount of previously excluded subpart F income withdrawn for 1965 from investment in less developed countries (60 percent of $40,000)	$24,000

Example 2. The facts are the same as in example 1, except that M Corporation's earnings and profits (determined under paragraph (b)(2) of this section) for 1963, 1964, and 1965 (item (vi)) are $30,000 instead of $45,000. Corporation M's amount of previously excluded subpart F income withdrawn for 1965 from investment in less developed countries is $30,000. A's pro rata share of such amount is $18,000 (60 percent of $30,000).

Example 3. The facts are the same as in example 1, except that the excess of the amount excluded under section 954(b)(1) for 1963 from M Corporation's foreign base company income over the amount of its previously excluded subpart F income withdrawn for 1964 from investment in less developed countries (item (vii)) is $20,000 instead of $50,000. Corporation M's amount of previously excluded subpart F income withdrawn for 1965 from investment in less developed countries is $20,000. A's pro rata share of such amount is $12,000 (60 percent of $20,000).

[T.D. 6683, 28 FR 11178, Oct. 18, 1963, as amended by T.D. 6795, 30 FR 942, Jan. 29, 1965; T.D. 7893, 48 FR 22509, May 19, 1983; T.D. 7894, 48 FR 22529, May 19, 1983]

§1.955–2 Amount of a controlled foreign corporation's qualified investments in less developed countries.

(a) *Included property.* For purposes of sections 951 through 964, a controlled foreign corporation's ‘‘qualified investments in less developed countries'' are items of property (other than property excluded under paragraph (b)(1) of this section) owned directly by such corporation on the applicable determination date for purposes of section 954(f) or section 955(a)(2) and consisting of one or more of the following:

(1) Stock of a less developed country corporation if the controlled foreign corporation owns (within the meaning of paragraph (b)(2) of this section) on the applicable determination date 10 percent or more of the total combined voting power of all classes of stock of such less developed country corporation;

(2) An obligation (as defined in paragraph (b)(3) of this section) of a less developed country corporation which, at the time of acquisition (as defined in paragraph (b)(4) of this section) of such obligation by the controlled foreign corporation, has a maturity of one year or more, but only if the controlled foreign corporation owns (within the meaning of paragraph (b)(2) of this section) on the applicable determination date 10 percent or more of the total combined voting power of all classes of stock of such less developed country corporation; and

(3) An obligation (as defined in paragraph (b)(3) of this section) of a less developed country, including obligations issued or guaranteed by the government of such country or of a political subdivision thereof and obligations of any agency or instrumentality of such country, in which such country is financially committed. The application of this subparagraph may be illustrated by the following example:

Example. A, a political subdivision of foreign country X, constructs and operates a toll bridge. Country X is a less developed country throughout the period here involved. A issues bonds under an indenture which provides for amortization of the principal and interest of such bonds only out of the net revenues derived from operation of the bridge. The bonds of A are obligations in which X country is financially committed and, in the hands of a controlled foreign corporation, are qualified investments in less developed countries.

(b) *Special rules*—(1) *Excluded property.* For purposes of paragraph (a) of this section, property which is disposed of within 6 months after the date of its acquisition shall be excluded from a controlled foreign corporation's qualified investments in less developed countries. However, the fact that property acquired by a controlled foreign corporation has not been held on an applicable determination date for more than 6 months after the date of its acquisition shall not prevent such property from being included in the controlled foreign corporation's qualified investments in less developed countries on such date. Proper adjustments shall be made subsequently, however, to exclude any item of property so included, if the property is in fact disposed of within 6 months after the date of its acquisition. See section 955(b)(4).

(2) *Determination of stock ownership.* In determining for purposes of paragraphs (a)(1) and (2) of this section whether a controlled foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of a less developed country corporation, only stock owned directly by such controlled foreign corporation shall be taken into account and the provisions of section 958 and the regulations thereunder shall not apply. See section 958(a)(1).

(3) *Obligation defined.* For purposes of paragraphs (a)(2) and (3) of this section, the term ''obligation'' means any bond, note, debenture, certificate, or other evidence of indebtedness. In the absence of legal, governmental, or business reasons to the contrary, the indebtedness must bear interest or be issued at a discount.

(4) *Date of acquisition.* For purposes of paragraphs (a)(2) and (b)(5)(i) of this section, stock or an obligation shall be considered acquired by a foreign corporation as of the date such corporation acquires an adjusted basis in the stock or obligation. For this purpose, in a case in which a foreign corporation acquires stock or an obligation in a transaction (other than a reorganization of the type described in section 368(a)(1)(E) or (F)) in which no gain or loss would be recognized had the transaction been between two domestic corporations, such corporation will be considered to have acquired an adjusted basis in such stock or obligation as of the date such transaction occurs.

(5) *Taxable years beginning after December 31, 1975.* For taxable years beginning after December 31, 1975, qualified investments in less developed countries do not include—

(i) Any property acquired after the latest determination date applicable to a taxable year beginning before December 31, 1975,

(ii) Stock or obligations of a less developed country shipping company described in § 1.955–5(b), and

(iii) Stock or obligations which were not treated as qualified investments in less developed countries on the later of the two determination dates applicable to the preceding taxable year.

See § 1.955–1(b)(3) for rules relating to the application of this subparagraph. See § 1.955A–2(h) for rules relating to the treatment of investments in stock or obligations described in subdivision (ii) of this subparagraph as qualified investments in foreign base company shipping operations.

(6) *Determination dates.* For purposes of subparagraph (5) of this paragraph and § 1.955–1(b)(3), the determination dates applicable to a taxable year of a controlled foreign corporation are—

(i) Except as provided in subdivision (ii) of this subparagraph, the close of such taxable year and the close of the preceding taxable year, and

(ii) With respect to a United States shareholder who has made an election under section 955(b)(3) to determine such corporation's increase in qualified investments in less developed countries at the close of the following taxable year, the close of such taxable year and the close of the taxable year immediately following such taxable year.

(c) *Termination of designation as a less developed country.* For purposes of sections 951 through 964, property which would constitute a qualified investment in a less developed country but for the fact that a foreign country or United States possession has, after the acquisition of such property by the controlled foreign corporation, ceased to be a less developed country shall be treated as a qualified investment in a less developed country. The application of this paragraph may be illustrated by the following example:

Example. On December 31, 1969, in accordance with the provisions of § 1.955–4, the designation of the foreign country X as an economically less developed country is terminated. Corporation M, a controlled foreign corporation, has $50,000 of qualified investments in country X acquired before December 31, 1969. After 1969 such investments are treated as qualified investments in a less developed country notwithstanding the termination of the status of X Country as an economically less developed country. However, if such qualified investments of M Corporation are reduced to $40,000, each United States shareholder of M Corporation is required, subject to the provisions of § 1.955–1, to include his pro rata share of the $10,000 decrease in his gross income under section 951(a)(1)(A)(ii) and the regulations thereunder.

(d) *Amount attributable to property*—(1) *General rule.* For purposes of this section, the amount taken into account with respect to any property which constitutes a qualified investment in a less developed country shall be its adjusted basis as of the applicable determination date, reduced by any liability (other than a liability described in subparagraph (2) of this paragraph) to which such property is subject on such date. To be taken into account under this subparagraph, a liability must constitute a specific charge against the property involved. Thus, a liability evidenced by an open account or a liability secured only by the general credit of the controlled foreign corporation will not be taken into account. On the other hand, if a liability constitutes a specific charge against several items of property and cannot definitely be allocated to any single item of property, the liability shall be apportioned against each of such items of property in that ratio which the adjusted basis of such item on the applicable determination date bears to the adjusted basis of all such items at such time. A liability in excess of the adjusted basis of the property which is subject to such liability shall not be taken into account for the purpose of reducing the adjusted basis of other property which is not subject to such liability.

(2) *Excluded charges.* For purposes of subparagraph (1) of this paragraph, a specific charge created with respect to any item of property principally for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's qualified investments in less developed countries will not be recognized; whether a specific charge is created principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to a loan is whether the loan is from a related person, as defined in section 954(d)(3) and paragraph (e) of §1.954–1.

(3) *Statement required.* If for purposes of this section a United States shareholder of a controlled foreign corporation reduces the adjusted basis of property which constitutes a qualified investment in a less developed country on the ground that such property is subject to a liability, he shall attach to his return a statement setting forth the adjusted basis of the property before the reduction and the amount and nature of the reduction.

(4) *Taxable years beginning after December 31, 1975.* For taxable years beginning after December 31, 1975, the amount taken into account under subparagraph (1) of this paragraph with respect to any property which constitutes a qualified investment in less developed countries shall not exceed the amount taken into account with respect to such property at the close of the preceding taxable year.

[T.D. 6683, 28 FR 11179, Oct. 18, 1963, as amended by T.D. 7894, 48 FR 22529, May 19, 1983]

§1.955–3 Election as to date of determining qualified investments in less developed countries.

(a) *Nature of election.* In lieu of determining the increase for a taxable year of a foreign corporation beginning before January 1, 1976, under the provisions of section 954(f) and paragraph (a) of §1.954–5, or the decrease under the provisions of section 955(a)(2) and paragraph (b) of §1.955–1, in a controlled foreign corporation's qualified investments in less developed countries for a taxable year in the manner provided in such provisions, a United States shareholder of such controlled foreign corporation may elect, under the provisions of section 955(b)(3) and this section, to determine such increase in accordance with the provisions of paragraph (b) of §1.954–5 and to determine such decrease by ascertaining the amount by which—

(1) Such controlled foreign corporation's qualified investments in less developed countries at the close of such taxable year exceed its qualified investments in less developed countries at the close of the taxable year immediately following such taxable year, and reducing such excess by

(2) The amount determined under paragraph (b)(1)(ii) of §1.955–1 for such taxable year,

subject to the limitation provided in paragraph (b)(2) of § 1.955–1 for such taxable year. An election under this section may be made with respect to each controlled foreign corporation with respect to which a person is a United States shareholder within the meaning of section 951(b), but the election may not be exercised separately with respect to the increases and the decreases of such controlled foreign corporation. If an election is made under this section to determine the increase of a controlled foreign corporation in accordance with the provisions of paragraph (b) of § 1.954–5, subsequent decreases of such controlled foreign corporation shall be determined in accordance with this paragraph and not in accordance with paragraph (b) of § 1.955–1.

(b) *Time and manner of making election*—(1) *Without consent.* An election under this section with respect to a controlled foreign corporation shall be made without the consent of the Commissioner by a United States shareholder's filing a statement to such effect with his return for his taxable year in which or with which ends the first taxable year of such controlled foreign corporation in which—

(i) Such shareholder owns, within the meaning of section 958(a), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such controlled foreign corporation, and

(ii) Such controlled foreign corporation realizes foreign base company income from which amounts are excluded under section 954(b)(1) and paragraph (b)(1) of § 1.954–1.

The statement shall contain the name and address of the controlled foreign corporation and identification of such first taxable year of such corporation. For taxable years of a foreign corporation beginning after December 31, 1975, no election under this section with respect to a controlled foreign corporation may be made without the consent of the Commissioner.

(2) *With consent.* An election under this section with respect to a controlled foreign corporation may be made by a United States shareholder at any time with the consent of the Commissioner. Consent will not be granted unless the United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the election will be effected. Consent will not be granted if the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to compute an amount described in section 954(b)(1) in accordance with the election provided in this section begins after December 31, 1975. The application for consent to elect shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to compute an amount described in section 954(b)(1) in accordance with the election provided in this section. The application shall include the following information:

(i) The name, address, and taxable year of the United States shareholder;

(ii) The name and address of the controlled foreign corporation;

(iii) The first taxable year of the controlled foreign corporation for which income is to be computed under the election;

(iv) The amount of the controlled foreign corporation's qualified investments in less developed countries at the close of its preceding taxable year; and

(v) The sum of the amounts excluded under section 954(b)(1) and paragraph (b)(1) of § 1.954–1 from the foreign base company income of the controlled foreign corporation for all prior taxable years during which such shareholder was a United States shareholder of such corporation and the sum of the amounts of its previously excluded subpart F income withdrawn from investment in less developed countries for all prior taxable years during which such shareholder was a United States shareholder of such corporation.

(c) *Effect of election*—(1) *General.* Except as provided in subparagraphs (3) and (4) of this paragraph, an election under this section with respect to a controlled foreign corporation shall be binding on the United States shareholder and shall apply to all qualified investments in less developed countries acquired, or disposed of, by such controlled foreign corporation during the taxable year following its taxable year for which income is first computed under the election and during all succeeding taxable years of such corporation.

(2) *Returns.* Any return of a United States shareholder required to be filed before the completion of a period with respect to which determinations are to be made as to a controlled foreign corporation's qualified investments in less developed countries for purposes of computing such shareholder's taxable income shall be filed on the basis of an estimate of the amount of the controlled foreign corporation's qualified investments in less developed countries at the close of the period. If the actual amount of such investments is not the same as the amount of the estimate, the United States shareholder shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of tax of such United States shareholder for the year or years with respect to which the incorrect amount was taken into account. The amount of tax, if any, due upon such redetermination shall be paid by the United States shareholder upon notice and demand by the district director. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the United States shareholder in accordance with the provisions of sections 6402 and 6511 and the regulations thereunder.

(3) *Revocation.* Upon application by the United States shareholder, the election made under this section may, subject to the approval of the Commissioner, be revoked. Approval will not be granted unless the United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the rev- ocation will be effected. Unless such agreement provides otherwise, the change in the controlled foreign corporation's qualified investments in less developed countries for its first taxable year for which income is computed without regard to the election previously made will be considered to be zero for purposes of effectuating the revocation. The application for consent to revocation shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to compute the amounts described in section 954(b)(1) or 955(a) without regard to the election provided in this section. The application may also be filed in a taxable year beginning after December 31, 1975. The application shall include the following information:

(i) The name, address, and taxpayer identification number of the United States shareholder;

(ii) The name and address of the controlled foreign corporation;

(iii) The taxable year of the controlled foreign corporation for which such amounts are to be so computed;

(iv) The amount of the controlled foreign corporation's qualified investments in less developed countries at the close of its preceding taxable year;

(v) The sum of the amounts excluded under section 954(b)(1) and paragraph (b)(1) of §1.954–1 from the foreign base company income of the controlled foreign corporation for all prior taxable years during which such shareholder was a United States shareholder of such corporation and the sum of the amounts of its previously excluded subpart F income withdrawn from investment in less developed countries for all prior taxable years during which such shareholder was a United States shareholder of such corporation; and

(vi) The reasons for the request for consent to revocation.

(4) *Transfer of stock.* If during any taxable year of a controlled foreign corporation—

(i) A United States shareholder who has made an election under this section with respect to such controlled foreign corporation sells, exchanges, or otherwise disposes of all or part of his stock in such controlled foreign corporation, and

(ii) The foreign corporation is a controlled foreign corporation immediately after the sale, exchange, or other disposition,

then, with respect to the stock so sold, exchanged, or disposed of, the controlled foreign corporation's acquisitions and dispositions of qualified investments in less developed countries for such taxable year shall be considered to be zero. If the United States shareholder's successor in interest is entitled to and does make an election under paragraph (b)(1) of this section to determine the controlled foreign corporation's increase in qualified investments in less developed countries for the taxable year in which he acquires such stock, such increase with respect to the stock so acquired shall be determined in accordance with the provisions of paragraph (b)(1) of § 1.954–5. If the controlled foreign corporation realizes no foreign base company income from which amounts are excluded under section 954(b)(1) and paragraph (b)(1) of § 1.954–1 for the taxable year in which the United States shareholder's successor in interest acquires such stock and such successor in interest makes an election under paragraph (b)(1) of this section with respect to a subsequent taxable year of such controlled foreign corporation, the increase in the controlled foreign corporation's qualified investments in less developed countries for such subsequent taxable year shall be determined in accordance with the provisions of paragraph (b)(2) of § 1.954–5.

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

Example 1. Foreign corporation A is a wholly owned subsidiary of domestic corporation M. Both corporations use the calendar year as a taxable year. In a statement filed with its return for 1963, M Corporation makes an election under section 955(b)(3) and the election remains in force for the taxable year 1964. At December 31, 1964, A Corporation's qualified investments in less developed countries amount to $100,000; and, at December 31, 1965, to $80,000. For purposes of paragraph (a)(1) of this section, A Corporation's decrease in qualified investments in less developed countries for the taxable year 1964 is $20,000 and is determined by ascertaining the amount by which A Corporation's qualified investments in less developed countries at December 31, 1964 ($100,000) exceed its qualified investments in less developed countries at December 31, 1965 ($80,000).

Example 2. The facts are the same as in example 1 except that A Corporation experiences no changes in qualified investments in less developed countries during its taxable years 1966 and 1967. If M Corporation's election were to remain in force, A Corporation's acquisitions and dispositions of qualified investments in less developed countries during A Corporation's taxable year 1968 would be taken into account in determining whether A Corporation has experienced an increase or a decrease in qualified investments in less developed countries for its taxable year 1967. However, M Corporation duly files before the close of A Corporation's taxable year 1967 an application for consent to revocation of M Corporation's election under section 955(b)(3), and, pursuant to an agreement between the Commissioner and M Corporation, consent is granted by the Commissioner. Assuming such agreement does not provide otherwise, A Corporation's change in qualified investments in less developed countries for its taxable year 1967 is zero because the effect of the revocation of the election is to treat acquisitions and dispositions of qualified investments in less developed countries actually occurring in 1968 as having occurred in such year rather than in 1967.

Example 3. The facts are the same as in example 2 except that A Corporation's qualified investments in less developed countries at December 31, 1968, amount to $70,000. For purposes of paragraph (b)(1)(i) of § 1.955–1, the decrease in A Corporation's qualified investments in less developed countries for the taxable year 1968 is $10,000 and is determined by ascertaining the amount by which A Corporation's qualified investments in less developed countries at December 31, 1967 ($80,000) exceed its qualified investments in less developed countries at December 31, 1968 ($70,000).

Example 4. The facts are the same as in example 1 except that on September 30, 1965, M Corporation sells 40 percent of the only class of stock of A Corporation to N Corporation, a domestic corporation. Cor- poration N uses the calendar year as a taxable year. Corporation A remains a controlled foreign corporation immediately after such sale of its stock. Corporation A's qualified investments in less developed countries at December 31, 1966, amount to $90,000. The changes in A Corporation's qualified investments in less developed countries occurring in its taxable year 1965 are considered to be zero with respect to the 40-percent stock interest acquired by N Corporation. The entire $20,000 reduction in A Corporation's qualified investments in less developed countries which occurs during the taxable year 1965 is taken into account by M Corporation for purposes of paragraph (a)(1) of this section in determining its tax liability for the taxable year 1964. Corporation A's increase in qualified investments in less developed countries for the taxable year 1965 with respect to the 60-percent stock interest retained by M Corporation is $6,000 and is determined by ascertaining M Corporation's pro rata share (60 percent) of the amount by which A Corporation's qualified investments in less developed countries at December 31, 1968 ($90,000) exceed its qualified investments in less developed countries at December 31, 1965 ($80,000). Corporation N does not make an election under section 955(b)(3) in its return for its taxable year 1966. Corporation A's increase in qualified investments in less developed countries for the taxable year 1966 with respect to the 40-percent stock interest acquired by N Corporation is $4,000.

[T.D. 6683, 28 FR 11180, Oct. 18, 1963, as amended by T.D. 7893, 48 FR 22509, May 19, 1983; T.D. 7894, 48 FR 22530, May 19, 1983]

§1.955–4 Definition of less developed country.

(a) *Designation by Executive order.* For purposes of sections 951 through 964, the term ''less developed country'' means any foreign country (other than an area within the Sino-Soviet bloc) or any possession of the United States with respect to which, on the first day of the foreign corporation's taxable year, there is in effect an Executive order by the President of the United States designating such country or possession as an economically less developed country for purposes of such sections. Each territory, department, province, or possession of any foreign country other than a country within the Sino-Soviet bloc may be treated as a separate foreign country for purposes of such designation if the territory, department, province, or possession is overseas from the country of which it is a territory, department, province, or possession. Thus, for example, an overseas possession of a foreign country may be designated by Executive order as an economically less developed country even though the foreign country itself has not been designated as an economically less developed country; or the foreign country may be so designated even though the overseas possessions of such country have not been designated as economically less developed countries. The term ''possession of the United States'', for purposes of section 955(c)(3) and this section, shall be construed to have the same meaning as that contained in paragraph (b)(2) of §1.957–3.

(b) *Countries not eligible for designation.* Section 955(c)(3) provides that no designation by Executive order may be made under section 955(c)(3) and paragraph (a) of this section with respect to—

Australia, Austria, Belgium, Canada, Denmark, France, Germany (Federal Republic), Hong Kong, Italy, Japan, Liechtenstein, Luxembourg, Monaco, Netherlands, New Zealand, Norway, Union of South Africa, San Marino, Sweden, Switzerland, United Kingdom.

(c) *Termination of designation.* Section 955(c)(3) provides that, after the President has designated any foreign country or possession of the United States as an economically less developed country for purposes of sections 951 through 964, he may not terminate such designation (either by issuing an Executive order for the purpose of terminating such designation or by issuing an Executive order which has the effect of terminating such designation) unless, at least 30 days prior to such termination, he has notified the Senate and the House of Representatives of his intention to terminate such designation. If such 30-day notice is given, no action by the Congress of the United States is necessary to effectuate the termination. The requirement for giving 30-day notice to the Senate and House of Representatives applies also to the termination of a designation with respect to an overseas territory, department, province, or possession of a foreign country. See paragraph (c) of §1.955–2 for the effect of a termination of a Presidential designation upon property which would be a qualified investment in a less developed country but for the fact of such termination.

[T.D. 6683, 28 FR 11182, Oct. 18, 1963]

§1.955–5 Definition of less developed country corporation.

(a) *Less developed country corporation*—(1) *In general.* For purposes of sections 951 through 964, the term ''less developed country corporation'' means a foreign corporation described in paragraph (b) of this section and also any foreign corporation—

(i) Which is engaged in the active conduct of one or more trades or businesses during the entire taxable year;

(ii) Which derives 80 percent or more of its gross income, if any, for such taxable year from sources within less developed countries, as determined under the provisions of § 1.955–6; and

(iii) Which has 80 percent or more in value (within the meaning of paragraph (d) of this section) of its assets on each day of such taxable year consisting of one or more of the following items of property:

(a) Property (other than property described in (*b*) through (*h*) of this subdivision) which is used, or held for use, in such trades or businesses and is located in one or more less developed countries;

(b) Money;

(c) Deposits with persons carrying on the banking business;

(d) Stock of any other less developed country corporation;

(e) Obligations (within the meaning of paragraph (b)(3) of § 1.955–2) of another less developed country corporation which at the time of their acquisition (within the meaning of paragraph (b)(4) of § 1.955–2) by the foreign corporation have a maturity of one year or more;

(f) Obligations (within the meaning of paragraph (b)(3) of § 1.955–2) of any less developed country;

(g) Investments which are required to be made or held because of restrictions imposed by the government of any less developed country; and

(h) Property described in section 956(b)(2).

For purposes of this subparagraph, if a foreign corporation is a partner in a foreign partnership, as defined in section 7701(a)(2) and (5) and the regulations thereunder, such corporation will be considered to be engaged in the active conduct of a trade or business to the extent and in the manner in which the partnership is so engaged and to own directly its proportionate share of each of the assets of the partnership. For purposes of subdivision (i) of this subparagraph, a newly-organized foreign corporation will be considered engaged in the active conduct of a trade or business from the date of its organization if such corporation commences business operations as soon as practicable after such organization. In the absence of affirmative evidence showing that the 80-percent requirement of subdivision (iii) of this subparagraph has not been satisfied on each day of the taxable year, such requirement will be considered satisfied if it is established to the satisfaction of the district director that such requirement has been satisfied on the last day of each quarter of the taxable year of the foreign corporation. For purposes of subdivision (iii) of this subparagraph, property (other than stock in trade or other property of a kind which would properly be included in inventory of the foreign corporation if on hand at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of the trade or business of the foreign corporation) purchased for use in a trade or business and temporarily located outside less developed countries will be considered located in less developed countries if, but only if, such property is shipped to and received in less developed countries promptly after such purchase.

(2) *Special rules.* For purposes of subparagraph (1)(iii)*(a)* of this paragraph—

(i) *Treatment of receivables.* Bills receivable, accounts receivable, notes receivable and open accounts shall be considered to be used in the trade or business and located in less developed countries if, but only if—

(a) Such obligations arise out of the rental of property located in less developed countries, the performance of services within less developed countries, or the sale of property manufactured, produced, grown, or extracted in less developed countries, but only to the extent that the aggregate amount of such obligations at any time during the taxable year does not exceed an amount which is ordinary and necessary to carry on the business of both parties to the transactions if such transactions are between unrelated persons or, if such transactions are between related persons, an amount which would be ordinary and necessary to carry on the business of both parties to the transactions if such transactions were between unrelated persons;

(b) In the case of bills receivable, accounts receivable, notes receivable, and open accounts arising out of transactions other than those referred to in (*a*) of this subdivision—

(1) If the obligor is an individual such individual is a resident of one or more less developed countries and of no other country which is not a less developed country;

(2) If the obligor is a corporation which as to the foreign corporation is a related person as defined in section 954(d)(3) and paragraph (e) of §1.954–1, such obligor meets, with respect to the period ending with the close of its annual accounting period in which occurs the date on which the obligation is incurred, the 80-percent gross income requirement of paragraph (b)(1)(ii) of §1.955–6.

(3) If the obligor is a corporation which as to the foreign corporation is not a related person as defined in section 954(d)(3) and paragraph (e) of §1.954–1, it is reasonable, on the basis of ascertainable facts, for the obligee to believe that the obligor meets, with respect to such period, the 80-percent gross income requirement of paragraph (b)(1)(ii) of §1.955–6.

(ii) *Location of interests in real estate.* Interests in real estate such as leaseholds of land or improvements thereon, mortgages on real property (including interests in mortgages on leaseholds of land or improvements thereon), and mineral, oil, or gas interests shall be considered located in less developed countries if, but only if, the underlying real estate is located in less developed countries.

(iii) *Location of certain other intangibles.* Intangible property (other than any such property described in subdivision (i) or (ii) of this subparagraph) used in the trade or business of the foreign corporation shall be considered to be located in less developed countries in the same ratio that the amount of the foreign corporation's tangible property and property described in subdivision (i) or (ii) of this subparagraph used in its trades or businesses and located or deemed located in less developed countries bears to the total amount of its tangible property and property described in subdivision (i) or (ii) of this subparagraph used in its trades or businesses.

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

Example. Foreign corporation A is formed on November 1, 1963, to engage in the business of manufacturing and selling radios in Brazil, a less developed country as of November 1, 1963. Corporation A uses the calendar year as a taxable year. Shortly after it is formed, A Corporation acquires a plant site and begins construction of a plant which is completed on August 1, 1964. Corporation A commences business operations as soon as practicable and continues such operations through December 31, 1964, and thereafter. Corporation A will be considered for purposes of subparagraph (1)(i) of this paragraph to be engaged in the active conduct of a trade or business for its entire taxable years ending on December 31, 1963, and 1964. The plant site and the plant (while under construction and after completion) will be considered to be property held during such taxable years for use in A Corporation's trade or business.

(b) *Shipping companies.* For purposes of sections 951 through 964, the term ''less developed country corporation'' also means any foreign corporation—

(1) Which has 80 percent or more of its gross income, if any, for the taxable year consisting of one or more of—

(i) Gross income derived—

(a) From, or in connection with, the using (or hiring or leasing for use) in foreign commerce of aircraft or vessels registered under the laws of a less developed country,

(b) From, or in connection with, the performance of services directly related to the use in foreign commerce of aircraft or vessels registered under the laws of a less developed country, or

(c) From the sale or exchange of aircraft or vessels registered under the laws of a less developed country and used in foreign commerce by such foreign corporation;

(ii) Dividends and interest received or accrued from other foreign corporations which are less developed country corporations within the meaning of this paragraph and 10 percent or more of the total combined voting power of all classes of stock of which is owned at the time such dividends and interest are so received or accrued by such foreign corporation; and

(iii) Gain from the sale or exchange of stock or obligations of other foreign corporations which are less developed country corporations within the meaning of this paragraph and 10 percent or more of the total combined voting power of all classes of stock of which is owned by such foreign corporation immediately before such sale or exchange; and

(2) Which has 80 percent or more in value (within the meaning of paragraph (d) of this section) of its assets on each day of the taxable year consisting of—

(i) Assets used, or held for use, for the production of income described in subparagraph (1) of this paragraph, or in connection with the production of such income, whether or not such income is received during the taxable year, and

(ii) Property described in section 956(b)(2).

In the absence of affirmative evidence showing that the 80-percent requirement of this subparagraph has not been satisfied on each day of the taxable year such requirement will be considered satisfied if it is established to the satisfaction of the district director that such requirement has been satisfied on the last day of each quarter of the taxable year of the foreign corporation. The provisions of this subparagraph may be illustrated by the following example:

Example. Foreign corporation A is formed on November 1, 1963, for the purpose of constructing and operating a vessel and, on that date, enters a charter agreement which provides that such vessel will be registered under the laws of Liberia, a less developed country as of November 1, 1963, and operated between South American and European ports. Corporation A uses the calendar year as a taxable year. Construction of the vessel is completed on September 1, 1965, and the vessel is registered under the laws of Liberia and operated between South American and European ports through December 31, 1965, and thereafter. The charter and the vessel (while under construction and after completion), or any interest of A Corporation in such assets, will be considered assets which are held by A Corporation during its taxable years ending on December 31, 1963, 1964, and 1965, for use in the production of income described in subparagraph (1) of this paragraph.

(c) *Determination of stock ownership.* In determining for purposes of paragraph (b)(1)(ii) and (iii) of this section whether a foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of a less developed country corporation, only stock owned directly by such foreign corporation shall be taken into account and the provisions of section 958 and the regulations thereunder shall not apply. See section 958(a)(1).

(d) *Determination of value.* For purposes of paragraphs (a)(1)(iii) and (b)(2) of this section—

(1) *General.* Except as provided in subparagraph (2) of this paragraph, the value at which property shall be taken into account is its actual value (not reduced by liabilities) which, in the absence of affirmative evidence to the contrary, shall be deemed to be its adjusted basis.

(2) *Treatment of certain receivables.* The value at which receivables described in paragraph (a)(2)(i) of this section and held by a foreign corporation using the cash receipts and disbursements method of accounting shall be taken into account is their actual value (not reduced by liabilities) which, in the absence of affirmative evidence to the contrary, shall be deemed to be their face value.

[T.D. 6683, 28 FR 11182, Oct. 18, 1963]

§1.955–6 Gross income from sources within less developed countries.

(a) *General.* For purposes of paragraph (a)(1)(ii) of §1.955.5, the determination whether a foreign corporation has derived 80 percent or more of its gross income from sources within less developed countries for any taxable year shall be made by the application of the provisions of sections 861 through 864, and §§1.861–1 through 1.863–5, in application of which the name of a less developed country shall be substituted for ‘‘the United States’’, except that if income is derived by the foreign corporation from—

(1) Interest (other than interest to which subparagraph (3) of this paragraph applies), the rules set forth in paragraph (b) of this section shall apply;

(2) Dividends, the rules set forth in paragraph (c) of this section shall apply; or

(3) Income (including interest) derived in connection with the sale of

tangible personal property, the rules set forth in paragraph (d) of this section shall apply.

The source of income described in subparagraph (1), (2), or (3) of this paragraph shall be determined solely under the rules of this section and without regard to the rules of sections 861 through 864, and the regulations thereunder.

(b) *Interest*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph and paragraph (d) of this section, gross income derived by the foreign corporation from interest on any indebtedness—

(i) Of an individual shall be treated as income from sources within a less developed country if, but only if, such individual is a resident of one or more less developed countries and of no other country which is not a less developed country.

(ii) Of a corporation shall be treated as income from sources within less developed countries if, but only if, 80 percent or more of the gross income of the payer corporation for the 3-year period ending with the close of its annual accounting period in which such interest is paid, or for such part of such 3-year period as such corporation has been in existence, or for such part of such 3-year period as occurs on and after the beginning of such corporation's first annual accounting period beginning after December 31, 1962, whichever period is shortest, was derived from sources within less developed countries as determined in accordance with the principles of this section; or

(iii) Of a less developed country, including obligations issued or guaranteed by the government of such country or of a political subdivision thereof and obligations of any agency or instrumentality of such country, in which such country is financially committed shall be treated as income from sources within such country.

(2) *Special rule.* Gross income derived by the foreign corporation from interest on obligations of the United States shall be treated as income from sources within less developed countries without regard to the provisions of subparagraph (1) of this paragraph.

(3) *Payers other than related persons.* For purposes of subparagraph (1)(ii) of this paragraph, a payer corporation which as to the recipient corporation is not a related person as defined in section 954(d)(3) and paragraph (e) of §1.954–1 shall be deemed to have satisfied the 80-percent gross income requirement if, on the basis of ascertainable facts, it is reasonable for the recipient corporation to believe that such requirement is satisfied.

(c) *Dividends*—(1) *In general.* Gross income derived by the foreign corporation from dividends, as defined in section 316 and the regulations thereunder, shall be treated as income from sources within less developed countries if, but only if, 80 percent or more of the gross income of the payer corporation for the 3-year period ending with the close of its annual accounting period in which such dividends are distributed, or for such part of such 3-year period as such corporation has been in existence, or for such part of such 3-year period as occurs on and after the beginning of such corporation's first annual accounting period beginning after December 31, 1962, whichever period is shortest, was derived from sources within less developed countries as determined in accordance with the principles of this section.

(2) *Payers other than related persons.* See paragraph (b)(3) of this section for rule governing satisfaction of the 80-percent gross income requirement by payers other than related persons.

(d) *Sale of tangible personal property*—(1) *In general.* Income (whether in the form of profits, commissions, fees, interest, or otherwise) derived by the foreign corporation in connection with the sale of tangible personal property shall be treated as income from sources within less developed countries if, but only if—

(i) Such property is produced (within the meaning of subparagraph (2) of this paragraph) within less developed countries; or

(ii) Such property is sold for use, consumption, or disposition within less developed countries even though produced outside less developed countries and the selling corporation is engaged within less developed countries, in connection with sales of such property, in continuous operational activities which are substantial in relation to such sales, as evidenced, for example, by the maintenance within less developed countries of a substantial sales or service organization or substantial facilities for the storage, handling, transportation, assembly, packaging, or servicing of such property.

(2) *Production defined.* For purposes of this paragraph, the term ''produced'' means manufactured, grown, extracted, or constructed and includes a substantial transformation of property purchased for resale or the manufacture of a product when purchased components constitute part of the property which is sold. See paragraph (a)(4)(ii) and (iii) of § 1.954–3 for a statement and illustration of the principles set forth in the preceding sentence.

[T.D. 6683, 28 FR 11183, Oct. 18, 1963, as amended by T.D. 6688, 28 FR 11632, Oct. 31, 1963]

§ 1.955A–1 Shareholder's pro rata share of amount of previously excluded subpart F income withdrawn from investment in foreign base company shipping operations.

(a) *In general.* Section 955 provides rules for determining the amount of a controlled foreign corporation's previously excluded subpart F income which is withdrawn for any taxable year beginning after December 31, 1975, from investment in foreign base company shipping operations. Pursuant to section 951(a)(1)(A)(iii) and the regulations thereunder, a United States shareholder of such controlled foreign corporation must include in his gross income his pro rata share of such amount as determined in accordance with paragraph (c) of this section.

(b) *Amount withdrawn by controlled foreign corporation*—(1) *In general.* For purposes of sections 951 through 964, the amount of a controlled foreign corporation's previously excluded subpart F income which is withdrawn for any taxable year from investment in foreign base company shipping operations is an amount equal to the decrease for such year in such corporation's qualified investments in foreign base company shipping operations. Such decrease is, except as provided in § 1.955A–4—

(i) An amount equal to the excess of the amount of its qualified investments in foreign base company shipping operations at the close of the preceding taxable year over the amount of its qualified investments in foreign base company shipping operations at the close of the taxable year, minus

(ii) The amount (if any) by which recognized losses on sales or exchanges by such corporation during the taxable year of qualified investments in foreign base company shipping operations exceed its recognized gains on sales or exchanges during such year of qualified investments in foreign base company shipping operations,

but only to the extent that the net amount so determined does not exceed the limitation determined under subparagraph (2) of this paragraph. See § 1.955A–2 for determining the amount of qualified investments in foreign base company shipping operations.

(2) *Limitation applicable in determining decreases*—(i) *In general.* The limitation referred to in subparagraph (i) of this paragraph for any taxable year of a controlled foreign corporation shall be the lesser of the following two limitations:

(A) The sum of (*1*) the controlled foreign corporation's earnings and profits (or deficit in earnings and profits) for the taxable year, computed as of the close of the taxable year without diminution by reason of any distribution made during the taxable year, (*2*) the sum of its earnings and profits (or deficits in earnings and profits) accumulated for prior taxable years beginning after December 31, 1975, and (*3*) the amount described in subparagraph (3) of this paragraph; or

(B) The sum of the amounts excluded under section 954(b)(2) (see subparagraph (4) of this paragraph) from the foreign base company income of such corporation for all prior taxable years beginning after December 31, 1975, minus the sum of the amounts (determined under this paragraph) of its previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for all such prior taxable years.

(C) For purposes of the immediately preceding subparagrah (B), the amount excluded under section 954(b)(2) for a taxable year of a controlled foreign corporation (the ''first corporation'') includes (*1*) an amount excluded under section 954(b)(2) by another corporation which is a member of a related group (as defined in §1.955A–3(b)(1)) attributable to the first corporation's excess investment (see §1.955A–3(c)(4)) for a taxable year beginning after December 31, 1983, (*2*) an amount excluded by a corporation under §1.954–1(b)(4)(ii)(*b*) by reason of the application of the carryover rule there set forth, and (*3*) an amount equal to the first corporation's pro rata share of a group excess deduction (see §1.955A–3(c)(2)) of a related group for a taxable year beginning after December 31, 1983 (but not in excess of that portion of such pro rata share which would reduce the first corporation's foreign base company shipping income to zero). Such amounts will not be treated as excluded under section 954(b)(2) by any other corporation.

(ii) *Certain exclusions from earnings and profits.* For purposes of determining the earnings and profits of a controlled foreign corporation under subdivision (i)(A)(*1*) and (*2*) of this subparagraph, such earnings and profits shall be considered not to include any amounts which are attributable to—

(A)(*1*) Amounts which, for the current taxable year, are included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a)(1)(A)(i), or

(*2*) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a) and have not been distributed; or

(B)(*1*) Amounts which, for the current taxable year, are included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) or would be so included under such section but for the fact that such amounts were distributed to such shareholder during the taxable year, or

(*2*) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) and have not been distributed.

The rules of this subdivision apply only in determining the limitation on a controlled foreign corporation's decrease in qualified investments in foreign base company shipping operations. See section 959 and the regulations thereunder for rules relating to the exclusion from gross income of previously taxed earnings and profits.

(3) *Carryover of amounts relating to investments in less developed country shipping companies*—(i) *In general.* The amount described in this subparagraph for any taxable year of a controlled foreign corporation beginning after December 31, 1975, is the lesser of—

(A) The excess of the amount described in subdivision (ii) of this subparagraph, over the amount described in subdivision (iii) of this subparagraph, or

(B) The limitation determined under subdivision (iv) of this subparagraph.

(ii) *Previously excluded subpart F income invested in less developed country shipping companies.* The amount described in this subdivision for all taxable years of a controlled foreign corporation beginning after December 31, 1975, is the lesser of—

(A) The amount of such corporation's qualified investments (determined under §1.955–2 other than paragraph (b)(5) thereof) in less developed country shipping companies described in §1.955–5(b) at the close of the last taxable year of such corporation beginning before January 1, 1976, or

(B) The limitation determined under §1.955–1(b)(2)(i)(*b*) (relating to previously excluded subpart F income) for the first taxable year of such corporation beginning after January 1, 1976.

(iii) *Amounts previously carried over.* The amount described in this subdivision for any taxable year of a controlled foreign corporation shall be the sum of the excesses determined for each prior taxable year beginning after December 31, 1976, of—

(A) The amount (determined under this paragraph) of such corporation's previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, over

(B) The sum of the earnings and profits determined under subparagraph (2)(i)(A)(*1*) and (*2*) of this paragraph.

(iv) *Extent attributable to accumulated earnings and profits.* The limitation determined under this subdivision for any taxable year of a controlled foreign corporation is the sum of such controlled foreign corporation's earnings and profits (or deficits in earnings and profits) accumulated for taxable years beginning after December 31, 1962, and before January 1, 1976. For purposes of the preceding sentence, earnings and profits shall be determined by excluding the amounts described in subparagraph (2)(ii)(A) and (B) of this paragraph.

(v) *Illustration.* The application of this subparagraph may be illustrated by the following example:

Example. (a) Throughout the period here involved, A is a United States shareholder of controlled foreign corporation M. M is not a foreign personal holding company, and M uses the calendar year as the taxable year.

(b) The amount described in this subparagraph for M's taxable year 1978 with respect to A is determined as follows, based on the facts shown in the following table:

(1) Investment in less developed country shipping companies on December 31, 1975 (subdivision (ii)(A) amount)	$10,000
(2) § 1.955–1(b)(2)(i)(*b*) limitation for 1976 (previously excluded subpart F income not withdrawn from investment in less developed countries) (subdivision (ii)(B) amount)	50,000
(3) Subdivision (ii) amount (lesser of lines (1) and (2))	10,000
(4) Subdivision (iii) amount: Excess for 1977 of M's previously excluded subpart F income withdrawn from investment in foreign base country shipping operations, $3,000, over the sum of the amounts determined under subparagraphs (2)(i)(A)(*1*) and (*2*) of this paragraph, $1,000	2,000
(5) Excess of line (3) over line (4)	8,000
(6) Sum of M's earnings and profits accumulated for 1962 through 1975, determined on December 31, 1978	26,000
(7) Amount described in this subparagraph for 1978 (lesser of line (5) and line (6))	8,000

(c) For 1978, M's earnings and profits (reduced as provided in § 1.955–1(b)(2)(ii)(*a*)(*1*)) are $19,000, and the amount of M's previously excluded subpart F income withdrawn from investment in less developed countries determined under § 1.955–1(b)) is $42,000. Consequently, $23,000 of M's earnings and profits accumulated for 1962 through 1975 are attributable to such $42,000 amount, and will therefore be excluded under subparagraph (2)(ii))(A)(*2*) of this paragraph from M's earnings and profits accumulated for 1962 through 1975, determined as of December 31, 1979. No other portion of M's earnings and profits accumulated for 1962 through 1975 is distributed or included in the gross income of a United States shareholder in 1978.

(d) The amount described in this subparagraph for M's taxable year 1979 with respect to A is determined as follows, based on the additional facts shown in the following table:

(1) Subdivision (ii) amount (line (3) from paragraph (b) of this example)		$10,000
(2) Subdivision (iii) amount: (i) Excess for 1977 from line (4) of paragraph (b) of this example		2,000
(ii) Plus: excess for 1978 of M's previously excluded subpart F income withdrawn from investment in foreign base country shipping operations, $6,000, over the sum of the amounts determined under subparagraphs (2)(i)(A)(*1*) and (*2*) of this paragraph, $25,000	0	
(iii) Subdivision (iii) amount		2,000
(3) Excess of line (1) over line (2)(iii)		8,000
(4) Sum of M's earnings and profits accumulated for 1962 through 1975, determined on December 31, 1979 ($26,000 minus $23,000)		3,000
(5) Amount described in this subparagraph for 1979 (lesser of line (3) and line (4))		3,000

(4) *Amount excluded.* For purposes of subparagraph (2)(i)(B) of this paragraph, the amount excluded under section 954(b)(2) from the foreign base company income of a controlled foreign corporation for any taxable year beginning after December 31, 1975, is the excess of—

(i) The amount which would have been equal to the subpart F income of such corporation for such taxable year if such corporation had had no increase in qualified investments in foreign base company shipping operations for such taxable year, over

(ii) The subpart F income of such corporation for such taxable year.

(c) *Shareholder's pro rata share of amount withdrawn by controlled foreign corporation*—(1) *In general.* A United States shareholder's pro rata share of a controlled foreign corporation's previously excluded subpart F income withdrawn for any taxable year from investment in foreign base company shipping operations is his pro rata share of the amount withdrawn for such year by such corporation, as determined under paragraph (b) of this section. See section 955(a)(3). Such pro rata share shall be determined in accordance with the principles of §1.195–1(e).

(2) *Special rule.* A United States shareholder's pro rata share of the net amount determined under paragraph (b)(2)(i)(B) of this section with respect to any stock of the controlled foreign corporation owned by such shareholder shall be determined without taking into account any amount attributable to a period prior to the date on which such shareholder acquired such stock. See section 1248 and the regulations thereunder for rules governing treatment of gain from sales or exchanges of stock in certain foreign corporations.

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

Example 1. A, a United States shareholder, owns 60 percent of the only class of stock of M Corporation, a controlled foreign coporation throughout the entire period here involved. Both A and M use the calendar year as a taxable year. The amount of M's previously excluded subpart F income withdrawn for 1978 from investment in foreign base company shipping operations is $40,000, and A's pro rata share of such amount is $24,000 determined as follows based on the facts shown in the following table:

(a) Qualified investments in foreign base company shipping operations at the close of 1977	$125,000
(b) Less: qualified investments in foreign base company shipping operations at the close of 1978 ..	75,000
(c) Balance	50,000
(d) Less: excess of recognized losses ($15,000) over recognized gains ($5,000) on sales during 1978 of qualified investments in foreign base company shipping operations	10,000
(e) Tentative decrease in qualified investment in foreign base company shipping operations for 1978	40,000
(f) Earnings and profits for 1976, 1977, and 1978	45,000
(g) Plus: amount determined under paragraph (b)(3) of this section	0
(h) Earnings and profits limitation	45,000
(i) Excess of amount excluded under section 954(b)(2) from foreign base company income for 1976 ($75,000) over amount of previously excluded subpart F income withdrawn for 1977 from investment in foreign base company shipping operations ($25,000)	50,000
(j) M's amount of previously excluded subpart F income withdrawn for 1978 from investment in foreign base company shipping operations (item (e), but not to exceed the lesser of item (h) or item (i)	40,000
(k) A's pro rata share of M Corporation's amount of previously excluded subpart F in come withdrawn for 1978 from investment in foreign base company shipping operations (60 percent of $40,000)	24,000

Example 2. The facts are the same as in example 1, except that M's earnings and profits (determined under paragraph (b)(2) of this section) for 1976, 1977, and 1978 (item (f)) are $30,000 instead of $45,000. M's amount of previously excluded subpart F income withdrawn for 1978 from investment in foreign base company shipping operations is $30,000. A's pro rata share of such amount is $18,000 (60 percent of $30,000).

Example 3. The facts are the same as in example 1, except that the excess of the amount excluded under section 954(b)(2) for 1976 from M Corporation's foreign base company income over the amount of its previously excluded subpart F income withdrawn for 1977 from investment in foreign base company shipping operations (item (i)) is $20,000 instead of $50,000. M's amount of previously excluded subpart F income withdrawn for 1978 from investment in foreign base company shipping operations is $20,000. A's pro rata share of such amount is $12,000 (60 percent of $20,000).

[T.D. 7894, 48 FR 22530, May 19, 1983; 48 FR 40888, Sept. 12, 1983]

§1.955A–2 Amount of a controlled foreign corporation's qualified investments in foreign base company shipping operations.

(a) *Qualified investments*—(1) *In general.* Under section 955(b), for purposes of sections 951 through 964, a controlled foreign corporation's "qualified investments in foreign base company shipping operations" are investments in—

(i) Any aircraft or vessel, to the extent that such aircraft or vessel is used (or hired or leased for use) in foreign commerce,

(ii) Related shipping assets (within the meaning of paragraph (b) of this section),

(iii) Stock or obligations of a related controlled foreign corporation, to the extent provided in paragraph (c) of this section,

(iv) A partnership, to the extent provided in paragraph (d) of this section, and

(v) Stock or obligations of a less developed country shipping company described in § 1.955–5(b), as provided in paragraph (h) of this section.

(2) *Coordination of provisions.* No amount shall be counted as a qualified investment in foreign base company shipping operations under more than one provision of this section. Thus, for example, if a $10,000 investment in stock of a controlled foreign corporation is treated as a qualified investment in foreign base company shipping operations under both subparagraphs (1)(iii) and (v) of this paragraph, then such $10,000 is counted only once as a qualified investment in foreign base company shipping operations.

(3) *Definitions.* If the meaning of any term is defined or explained in § 1.954–6, then such term shall have the same meaning when used in this section.

(4) *Extent of use.* (i) For purposes of subparagraph (1)(i) of this paragraph and paragraph (b)(1) of this section, the extent to which an asset of a controlled foreign corporation is used during a taxable year in foreign base company shipping operations shall be determined on the basis of the proportion for such year which the foreign base company shipping income derived from the use of such asset bears to the total gross income derived from the use of such asset.

(ii) For purposes of determining under subdivision (i) of this subparagraph the amounts of foreign base company shipping income and gross income of a controlled foreign corporation—

(A) Such amounts shall be deemed to include an arm's length charge (see § 1.954–6(h)(5)) for services performed by such corporation for itself,

(B) Such amounts shall be deemed to include an arm's length charge for the use of an asset (such as a vessel under construction or laid up for repairs) which is held for use in foreign base company shipping operations, but is not actually so used,

(C) Foreign base company shipping income shall be deemed to include amounts earned in taxable years beginning before January 1, 1976, and

(D) The district director shall make such other adjustments to such amounts as are necessary to properly determine the extent to which any asset is used in foreign base company shipping operations.

(b) *Related shipping assets*—(1) *In general.* For purposes of this section, the term ''related shipping asset'' means any asset which is used (or held for use) for or in connection with the production of income described in § 1.954–6(b)(1)(i) or (ii), but only to the extent that such asset is so used (or is so held for use).

(2) *Examples.* Examples of assets of a controlled foreign corporation which are used (or held for use) for or in connection with the production of income described in subparagraph (1) of this paragraph include—

(i) Money, bank deposits, and other temporary investments which are reasonably necessary to meet the working capital requirements of such corporation in its conduct of foreign base company shipping operations,

(ii) Accounts receivable and evidences of indebtedness which arise from the conduct of foreign base company shipping operations by such corporation or by a related person,

(iii) Amounts (other than amounts described in subdivision (i) of this subparagraph) deposited in bank accounts or invested in readily marketable securities pursuant to a specific, definite, and feasible plan to purchase any tangible asset for use in foreign base company shipping operations,

(iv) Amounts paid into escrow to secure the payment of (A) charter hire for an aircraft, vessel, or other asset used in foreign base company shipping operations or (B) a debt which constitutes a specific charge against such an asset,

(v) Capitalized expenditures (such as progress payments) made under a contract to purchase any asset for use in foreign base company shipping operations,

(vi) Prepaid expense and deferred charges incurred in the course of foreign base company shipping operations,

(vii) Stock acquired and retained to insure a source of supplies or services used in the conduct of foreign base company shipping operations, and

(viii) Currency futures acquired and retained as a hedge against international currency fluctuations in connection with foreign base company shipping operations.

(3) *Limitations*—(i) *Vessels generally.* Notwithstanding any other provision of this paragraph, the term ''related shipping assets'' does not include any money or other intangible assets of a controlled foreign corporation, to the extent that such assets are permitted to accumulate in excess of the reasonably anticipated needs of the business.

(ii) *Safe harbor.* If a controlled foreign corporation accumulates money or other intangible assets pursuant to a plan to purchase one or more vessels for use in foreign commerce, and if—

(A) The amount so accumulated, plus

(B) The sum of the amounts accumulated by other controlled foreign corporations which are related persons (within the meaning of section 954(d)(3)) pursuant to similar plans, does not exceed 110 percent of a reasonable down payment on each vessel planned to be purchased within a reasonable period, then such plan will be considered to be feasible. For purposes of the preceding sentence, a reasonable down payment shall not exceed 28 percent of the total cost of acquisition. The determination dates applicable to the taxable year of a controlled foreign corporation are those set forth in paragraph (c)(2)(ii) of this section. In the case of accumulation of assets which do not come within the safe harbor limitation of this subdivision (ii), in determining whether such assets have accumulated beyond the reasonably anticipated needs of the business, factors to be taken into account include, but are not limited to, the availability of financing to purchase a vessel and the availability of a vessel suitable for the purposes to which the vessel is to be put.

(iii) *Other assets.* In determining whether a plan to purchase any asset other than a vessel for use in foreign base company shipping operations is feasible, principles similar to those stated in subdivision (ii) of this subparagraph shall be applied.

(4) *Cross-reference.* See §1.954–7(c) for additional illustrations bearing on the application of this paragraph.

(c) *Stock and obligations*—(1) *In general.* Investments by a controlled foreign corporation (the ''first corporation'') in stock or obligations of a second controlled foreign corporation which is a related person (within the meaning of section 954(d)(3) are considered to be qualified investments in foreign base company shipping operations to the extent that the assets of such second corporation are used (or held for use) in foreign base company shipping operations. See subparagraph (2) of this paragraph. However, an investment in an obligation of the second corporation will not be considered a qualified investment in foreign base company shipping operations if the obligation represents a liability which constitutes a specific charge (nonrecourse or otherwise) against an asset of the second corporation which is not either—

(i) An aircraft or vessel used (or held for use) to some extent in foreign commerce, or

(ii) An asset described in paragraphs (a)(1)(ii) through (v) of this section.

(2) *Extent of use.* On any determination date applicable to a taxable year of the first corporation, the extent to which the assets of the second corporation are used in foreign base company shipping operations shall be determined on the basis of the proportion which the amount of such second corporation's qualified investments in foreign base company shipping operations bears to its net worth, such proportion to be determined at the close of the second corporation's last taxable year which ends on or before such determination date. For purposes of the preceding sentence—

(i) A controlled foreign corporation's net worth is the total adjusted basis of the corporate assets reduced by the total outstanding principal amount of the corporate liabilities, and

(ii) The determination dates applicable to a taxable year of a controlled foreign corporation are—

(A) Except as provided in (B) of this subdivision, the close of such taxable year and the close of the preceding taxable year, and

(B) With respect to a United States shareholder who has made an election under section 955(b)(3) to determine such corporation's increase in qualified investments in foreign base company shipping operations at the close of the following taxable year, the close of such taxable year and the close of the taxable year immediately following such taxable year.

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

Example 1. On December 31, 1976, controlled foreign corporation X owns 100 percent of the single class of stock of controlled foreign corporation Y. X and Y both use the calendar year as the taxable year. On December 31, 1976, Y's assets consist of a vessel used in foreign commerce, related shipping assets, and other assets unrelated to its foreign base company shipping operations. On such date Y has qualified investments in foreign base company shipping operations (determined under paragraph (g) of this section) of $60,000, and a net worth of $100,000. If X's investment in the stock of Y is $50,000, then $30,000 of such amount, i.e.,

$$\frac{\$60,000}{\$100,000} \times \$50,000$$

is a qualified investment in foreign base company shipping operations.

Example 2. The facts are the same as in example 1, except that on December 31, 1976, Y's assets consist entirely of a vessel used in foreign commerce and related shipping assets, Y has qualified investments in foreign base company shipping operations (determined under paragraph (g) of this section) of $16,000 and (therefore) a net worth of $16,000. If X's investment in the stock of Y is $50,000, then the entire $50,000, i.e.,

$$\frac{\$16,000}{\$16,000} \times \$50,000$$

is a qualified investment in foreign base company shipping operations.

Example 3. On December 31, 1980, controlled foreign corporation J owns two notes of controlled foreign corporation K, which is a related person (within the meaning of section 954(d)(3)). Both J and K use the calendar year as the taxable year. J's adjusted basis in each of the two notes is $100,000. The first note is secured only by the general credit of K. The second note is secured by (and, therefore, constitutes a specific charge on) a hotel owned by K in a foreign country. On December 31, 1980, K has qualified investments in foreign base company shipping operation with an adjusted basis of $500,000 (before applying the rules of paragraph (g) of this section). The adjusted basis of all of K's corporate assets is $1,100,000. K's only liabilities are the two notes. The amount of K's qualified investments in foreign base company shipping operations (determined under paragraph (g) of this section) is $450,000. K's net worth is $900,000. The amount of J's qualified investment in foreign base company shipping operations in respect of the first note is $50,000, *i.e.*,

$$\frac{\$450,000}{\$900,000} \times \$100,000$$

The amount of J's qualified investment in respect of the second note is zero (see the last sentence of paragraph (c)(1) of this section).

(d) *Partnerships*—(1) *In general.* A controlled foreign corporation's investment in a partnership at the close of any taxable year of such corporation shall be considered a qualified investment in foreign base company shipping operations to the extent of the proportion which such corporation's foreign base company shipping income for such taxable year would bear to its gross income for such taxable year if—

(i) Such corporation had realized no income other than its distributive share of the partnership gross income, and

(ii) Such corporation's income were adjusted in accordance with the rules stated in paragraphs (a)(4)(ii)(B) and (D) of this section.

(2) *Transitional rule.* For purposes of subparagraph (1)(i) of this paragraph, the controlled foreign corporation's distributive share of the partnership gross income shall not include any amount attributable to income earned by the partnership before the first day of such corporation's first taxable year beginning after December 31, 1975.

(3) *Cross-reference.* See paragraph (g)(4) of this section for rules relating to the determination of the amount of a controlled foreign corporation's investment in a partnership.

(e) *Trusts*—(1) *In general.* An investment in a trust is not a qualified investment in a foreign base company shipping operations.

(2) *Grantor trusts.* Notwithstanding subparagraph (1) of this pargraph, if a controlled foreign corporation is treated as the owner of any portion of a trust under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners), then for purposes of this section such controlled foreign corporation is deemed to be the actual owner of such portion of the assets of the trust. Accordingly, its investments in such assets (as determined under paragraph (g)(5) of this section) may be treated as a qualified investment in foreign base company shipping operations.

(3) *Definitions.* For purposes of this section, the term ''trust'' means a trust as defined in §301.7701–4.

(f) *Excluded property.* For purposes of paragraph (a) of this section, property acquired principally for the purpose of artificially increasing the amount of a controlled foreign corporation's qualified investments in foreign base company shipping operations will not be recognized; whether an item of property is acquired principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to an item of property is whether the item is disposed of within 6 months after the date of its acquisition.

(g) *Amount attributable to property*—(1) *General rule.* For purposes of this section, the amount taken into account under section 955(b)(4) with respect to any property which constitutes a qualified investment in foreign base company shipping operations shall be its adjusted basis as of the applicable determination date, reduced by the outstanding principal amount of any liability (other than a liability described in subparagraph (2) of this paragraph) to which such property is subject on such date including a liability secured only by the general credit of the controlled foreign corporation. Liabilities shall be taken into account in the following order:

(i) The adjusted basis of each and every item of corporate property shall be reduced by any specific charge (nonrecourse or otherwise) to which such item is subject. For this purpose, if a liability constitutes a specific charge against several items of property and cannot definitely be allocated to any single item of property, the specific charge shall be apportioned against each of such items of property in that ratio which the adjusted basis of such item on the applicable determination date bears to the adjusted basis of all such items on such date. The excess against property over the adjusted basis of such property shall be taken into account as a liability secured only by the general credit of the corporation.

(ii) A liability which is evidenced by an open account or which is secured only by the general credit of the controlled foreign corporation shall be apportioned against each and every item of corporate property in that ratio which the adjusted basis of such item on the applicable determination date (reduced as provided in subdivision (i) of this subparagraph) bears to the adjusted basis of all the corporate property on such date (reduced as provided in subdivision (i) of this subparagraph); provided that no liability shall be apportioned under this subdivision against any stock or obligations described in paragraph (h)(1) of this section.

(2) *Excluded charges.* For purposes of subparagraph (1) of this paragraph, a liability created principally for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's qualified investments in foreign base company shipping operations will not be recognized. Whether a liability is created principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to a loan is whether the loan was both created after November 20, 1974, and is from a related person, as defined in section 954(d)(3) and paragraph (e) of §1.954–1. Another such factor is whether the liability was created after March 29, 1975, in a taxable year beginning before January 1, 1976. For purposes of this

paragraph (g)(2), payments on liabilities which are represented by an open account are credited against the account transactions arising earliest in time.

(3) *Statement required.* If for purposes of this section the adjusted basis of property which constitutes a qualified investment in foreign base company shipping operations by a controlled foreign corporation is reduced on the ground that such property is subject to a liability, each United States shareholder shall attach to his return a statement setting forth the adjusted basis of the property before the reduction and the amount and nature of the reduction.

(4) *Partnership interest.* If a controlled foreign corporation is a partner in a partnership, its investment in the partnership taken into account under section 955(b)(4) shall be its adjusted basis in the partnership determined under section 722 or 742, adjusted as provided in section 705, and reduced as provided in subparagraph (1) of this paragraph. (However, if the partnership is not engaged solely in the conduct of foreign base company shipping operations, such amount shall be taken into account only to the extent provided in paragraph (d)(1) of this section).

(5) *Grantor trust.* If a controlled foreign corporation is deemed to own a portion of the assets of a trust under paragraph (e)(2) of this section then the amount taken into account under section 955 (b)(4) with respect to such assets shall be determined as provided in subparagraph (1) of this paragraph by the application of the following rules:

(i) Such controlled foreign corporation's adjusted basis in such assets shall be deemed to be a proportionate share of the trust's adjusted basis in such assets, and

(ii) A proportionate share of the liabilities of the trust shall be deemed to be liabilities of such controlled foreign corporation and to constitute specific charges against such assets.

(6) *Translation into United States dollars.* The amounts determined in accordance with this paragraph shall be translated into United States dollars in accordance with the principles of § 1.964–1(e)(4).

(h) *Investments in shipping companies under prior law*—(1) *In general.* If an amount invested in stock or obligations of a less developed country shipping company described in § 1.955–5(b) is treated as a qualified investment in less developed countries under § 1.955–2 (applied without regard to paragraph (b)(5)(ii) thereof) on the applicable determination date for purposes of section 954(g) or section 955(a)(2) with respect to a taxable year beginning after December 31, 1975, then such amount shall be treated as a qualified investment in foreign base company shipping operations on such determination date. See section 955(b)(5).

(2) *Effect on prior law.* See § 1.955–2(b)(5)(ii) for the rule that investments which are treated as qualified investments in foreign base company shipping operations under subparagraph (1) of this paragraph shall not be treated as qualified investments in less developed countries for purposes of section 951(a)(1)(A)(ii).

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

Example. (a) Throughout the period here involved, controlled foreign corporation X owns 100 percent of the single class of stock of controlled foreign corporation Y, X and Y each use the calendar years as the taxable year. At the close of 1975, X's $50,000 investment in the stock of Y is treated as a qualified investment in less developed countries under § 1.955–2 (applied without regard to § 1.955–2(b)(5)(ii), and Y is a less developed country shipping company described in § 1.955–5(b).

(b) On December 31, 1976, Y is still a less developed country shipping company and X's $50,000 investment in the stock of Y is still treated as a qualified investment in less developed countries under § 1.955–2 (applied without regard to § 1.955–2(b)(5)(ii). Under subparagraph (1) of this paragraph X's entire $50,000 investment in the stock of Y is treated as a qualified investment in foreign base company shipping operations.

(c) For 1977, Y's gross income is $10,000 and Y's foreign base company shipping income is $7,500. Since Y fails to meet the 80-percent income test of § 1.955–5(b)(1), Y is no longer a less developed country shipping company described in § 1–955–5(b), and X's investment in the stock of Y is no longer treated as a qualified investment in less developed countries under § 1.955–2 (applied without regard to § 1.955–2(b)(5)(ii). However, assume that on December 31, 1977, Y's net worth (as defined in paragraph (c)(2)(1) of this section) is $100,000, that Y's qualified investments in foreign base company shipping operations (determined under this section) on December 31, 1977, are $75,000, and that X's investment in the stock of Y (as determined under paragraph (g) of this section) continues to be $50,000. Then $67,500, i.e.,

$$\frac{\$75,000}{\$100,000}\times\$50,000$$

of X's $50.000 investment in the stock of Y is treated as a qualified investment in foreign company shipping operations under paragraph (c) of this section.

(d) For 1978, all of Y's gross income is foreign base company shipping income. Although Y is again a less developed country shipping company described in §1.955–5(b), X's investment in the stock of Y is no longer treated as a qualified investment in less developed countries under §1.955–2(b)(5)(iii). Thus, X's investment in the stock of Y is not treated as a qualified investment in foreign base company shipping operations under subparagraph (1) of this paragraph. However, X's investment in the stock of Y may be so treated under another provision of this section, as was the case in item (c) of this example.

(Secs. 955 (b)(2) and 7805 of the Internal Revenue Code of 1954 (89 Stat. 63; 26 U.S.C. 955(b)(2), and 68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7894, 48 FR 22532, May 19, 1983; 48 FR 40888, Sept. 12, 1983, as amended by T.D. 7959, 49 FR 22280, May 29, 1984]

§1.955A–3 Election as to qualified investments by related persons.

(a) *In general.* If a United States shareholder elects the benefits of section 955(b) 2 with respect to a related group (as defined in paragraph (b)(1) of this section) of controlled foreign corporations, then an investment in foreign base company shipping operation made by one member of such group will be treated as having been made by another member to the extent provided in paragraph (c)(4) of this section, and each member will be subject to the other provisions of paragraph (c) of this section. An election once made shall apply for the taxable year for which it is made and for all subsequent years unless the election is revoked or a new election is made to add one or more controlled foreign corporations to election coverage. For the manner of making an election under section 955(b)(2), and for rules relating to the revocation of such an election, see paragraph (d) of this section. For rules relating to the coordination of sections 955(b)(2) and 955(b)(3), see paragraph (e) of this section.

(b) *Related group*—(1) *Related group defined.* The term "related group" means two or more controlled foreign corporations, but only if all of the following requirements are met:

(i) All such corporations use the same taxable year.

(ii) The same United States shareholder controls each such corporation within the meaning of section 954(d)(3) at the end of such taxable year, and

(iii) Such United States shareholder elects to treat such corporations as a related group.

(iv) If any of the corporations is on a 52–53 week taxable year and if all of the taxable years of the corporations end within the same 7-day period, the rule of paragraph (b)(1)(i) of this section shall be deemed satisfied.

(v) An election under paragraph (b)(1)(iii) of this section will not be valid in the case of an election by a U.S. shareholder (the "first U.S. shareholder") if—

(A) The first U.S. shareholder controls a second U.S. shareholder,

(B) The second U.S. shareholder controls one or more controlled foreign corporations, and

(C) Any of the controlled foreign corporations are the subject of the election by the first U.S. shareholder,

unless the second U.S. shareholder consents to the election by the first U.S. shareholder.

(2) *Group taxable years defined.* The "group taxable year" is the common taxable year of a related group.

(3) *Limitation.* If a United States shareholder elects to treat two or more corporations as a related group for a group taxable year (the "first group taxable year"), then such United States shareholder (and any other United States shareholder which is controlled by such shareholder) may not also elect to treat two or more other corporations as a related group for a group taxable year any day of which falls within the first group taxable year.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. Domestic corporation M owns 100 percent of the only class of stock of controlled foreign corporations A, B, C, D, and E. A, B, and C use the calendar year as the taxable year. D and E use the fiscal year ending on June 30 as the taxable year. M may elect to treat A, B and C as a related group. However, M may not elect to treat C, D, and E as a related group.

Example 2. The facts are the same as in example 1. In addition, M elects to treat A, B, and C as a related group for the group taxable year which ends on December 31, 1976. M may not also elect to treat D and E as a related group for the group taxable year ending on June 30, 1977.

Example 3. United States shareholder A owns 60 percent of the only class of stock of controlled foreign corporation X and 40 percent of the only class of stock of controlled foreign corporation Y. United States shareholder B owns the other 40 percent of the stock of X and the other 60 percent of the stock of Y. Neither A nor B (nor both together) may elect to treat X and Y as a related group.

(c) *Effect of election.* If a United States shareholder elects to treat two or more controlled foreign corporations as a related group for any group taxable year then, for purposes of determining the foreign base company income (see § 1.954–1) and the increase or decrease in qualified investments in foreign base company shipping operations (see §§ 1.954–7. 1.955A–1, and 1.955A–4) of each member of such group for such year, the following rules shall apply:

(1) *Intragroup dividends.* The gross income of each member of the related group shall be deemed not to include dividends received from any other member of such group, to the extent that such dividends are attributable (within the meaning of § 1.954–6(f)(4)) to foreign base company shipping income. In determining net foreign base company shipping income, deductions allocable to intragroup dividends attributable to foreign base company shipping income shall not be allowed.

(2) *Group excess deduction.* (i) The deductions allocable under § 1.954–1(c) to the foreign base company shipping income of each member of the related group shall be deemed to include such member's pro rata share of the group excess deduction.

(ii) The group excess deduction for the group taxable year is the sum of the excesses for each member of the related group (having an excess) of—

(A) The member's deductions (determined without regard to this subparagraph) allocable to foreign base company shipping income for such year, over

(B) The member's foreign base company shipping income for such year.

(iii) A member's pro rata share of the group excess deduction is the amount which bears the same ratio to such group excess deduction as—

(A) The excess of such member's foreign base company shipping income over the deductions (so determined) allocable thereto, bears to

(B) The sum of such excesses for each member of the related group having an excess.

(iv) For purposes of this subparagraph, ''foreign base company shipping income'' means foreign base company shipping income (as defined in § 1.954–6), reduced by excluding therefrom all amounts which are—

(A) Excluded from subpart F income under section 952(b) (relating to exclusion of United States income) or

(B) Excluded from foreign base company income under section 954(b)(4) (relating to exception for foreign corporation not availed of to reduce taxes).

(v) The application of this subparagraph may be illustrated by the following example:

Example. Controlled foreign corporations X, Y, and Z are a related group for calendar year 1976. The excess group deduction for 1976 is $9, X's pro rata share of the group excess deduction is $6, and Y's pro rata share is $3, determined as follows on the basis of the facts shown in the following table:

	X	Y	Z	Group
(1) Gross shipping income	$100	$90	$90	....
(2) Shipping deductions	60	70	80	....
(3) Net shipping income	40	20	(9)	....
(4) Group excess deduction	....	....	....	80
(5) X's pro rata share of group excess deduction ($9×$40/$60)	6	....	....	....
(6) Y's pro rata share of group excess deduction ($9×$20/$60)	....	3	....	....

(3) *Intragroup investments.* On both of the determination dates applicable to

the group taxable year for purposes of section 954(g) or section 955(a)(2), the qualified investments in foreign base company shipping operations of each member of the related group shall be deemed not to include stock of any other member of the related group. In addition, neither the gains nor the losses on dispositions of such stock during the group taxable year shall be taken into account under §1.955A–1(b)(1)(ii) in determining the decrease in qualified investments in foreign base company shipping operations of any member of such related group.

(4) *Group excess investment.* (i) On the later (and only the later) of the two determination dates applicable to the group taxable year for purposes of section 954(g) or section 955(a)(2), the qualified investments in foreign base company shipping operations of each member of the related group shall be deemed to include such member's pro rata share of the group excess investment.

(ii) The group excess investment for the group taxable year is the sum of the excess for each member of the related group (having an excess) of—

(A) The member's increase in qualified investments in foreign base company shipping operations (determined under §1.954–7 after the application of subparagraph (3) of this paragraph) for such year, over

(B) The member's foreign base company shipping income for such year.

(iii) A member's pro rata share of the group excess investment is the amount which bears the same ratio to such group excess investment as—

(A) Such member's shortfall, in qualified investments bears to

(B) the sum of the shortfalls in qualified investments of each member of such related group having a shortfall.

(iv) If a member has an increase in qualified investments in foreign base company shipping operations (determined as provided in §1.954–7 after the application of subparagraph (3) of this paragraph) for the group taxable year, then such member's ''shortfall in qualified investments'' is the excess of—

(A) Such member's foreign base company shipping income for such year, over

(B) Such increase.

(v) If a member has a decrease in qualified investments in foreign base company shipping operations (determined under §1.955A–1(b)(1) or §1.955A–4(a), whichever is applicable, after the application of subparagraph (3) of this paragraph) for the group taxable year, then such member's ''shortfall in qualified investments'' is the sum of—

(A) Such member's foreign base company shipping income for such year and

(B) Such decrease.

(vi) For purposes of this subparagraph, ''foreign base company shipping income'' means foreign base company shipping income (as defined in subparagraph (2)(iv) of this paragraph), reduced by the deductions allocable thereto under §1.954–1(c) (including the additional deductions described in subparagraph (2) of this paragraph).

(vii) The application of paragraphs (c)(1), (3), and (4) of this section may be illustrated by the following example:

Example. (a) Controlled foreign corporations R, S, and T are a related group for calendar year 1977. R and S do not own the stock of any member of the related group.

(b) On December 31, 1977, T has qualified investments in foreign base company shipping operations (determined without regard to paragraphs (c)(3) and (4)) of $105, of which $15 consists of stock of S. After application of paragraph (c)(3) (but before application of paragraph (c)(4)), on December 31, 1977, T has qualified investments in foreign base company shipping operations of $90, determined as follows:

(1) Qualified investments (determined without regard to paragraph (c)(3)) on December 31, 1977	$105
(2) Less: Qualified investments in stock of another member of a related group (as required by paragraph (c)(3))	15
(3) Balance	90

(c) During 1977, T's foreign base company shipping income is $180, determined without regard to paragraph (c)(1). Included in the $180 is $5 in dividends in respect of T's stock in S. During 1977, T has shipping deductions of $91. Of T's shipping deductions, $1 is allocable to the dividends from S. After application of paragraph (c)(1), T's net shipping income during 1977 is $85, determined as follows:

(1) Foreign base company shipping income ...	....	$180
(2) Less: intragroup dividends (as required by paragraph (c)(1))	....	5
(3) Balance	....	175
(4) Shipping deductions	$91	....

(5) Less: deductions allocable to intragroup dividends (as required by paragraph (c)(1))	1	....
(6) Balance	90	....
(7) Net shipping income (line (3) minus line (6))	....	85

(d) During 1977 (without regard to paragraph (c)(4)), R's increase in qualified investments in foreign base company shipping operations is $120; S's decrease is $55; and T's increase is $35, determined on the basis of the facts shown in the following table. In all cases, the listed amounts of qualified investments on December 31, 1976, reflect any adjustments required by paragraph (c)(3) for 1976, but not any adjustment required by paragraph (c)(4) for 1976 (see §§ 1.955A–3 (c)(3) and (4)(i)).

	R	S	T
(1) Qualified investments on December 31, 1977 (in the case of T, taken from line (3) of part (b) of this example)	$220	$150	$90
(2) Qualified investments on December 31, 1976	100	205	55
(3) Increase (decrease) (line (1) minus line (2))	120	(55)	35

(e) In 1977, R's net shipping income is $100; S's is $95; and T's is $85, determined as follows:

	R	S	T
(1) Gross foreign base company shipping income (in the case of T, taken from line (3) of part (c) of this example)	$200	$180	$175
(2) Shipping deductions (in the case of T, taken from line (6) of part (c) of this example)	100	85	90
(3) Net shipping income (line (1) minus line (2))	100	95	85

(f) By application of paragraph (c)(4) for 1977, S's pro rata share of the group excess investment is $15, and T's pro rata share is $5, determined as follows:

	R	S	T	Group
(1) Net shipping income (taken from line (3) of part (e) of this example)	$100	$95	$85	....
(2) Increase (decrease) in qualified investments (taken from line (3) of part (d) of this example)	120	(55)	35	....
(3) Excess investment	20	....	....	$20
(4) Shortfall	....	150	50	200
(5) S's pro rata share of group excess investment ($20×$150/$200)	....	15	....	....
(6) T's pro rata share of group excess investment ($20×$50/$200)	....	....	5	....

(g) After application of paragraph (c)(4), for purposes of determining their increase or decrease in qualified investments in foreign base company shipping operations for 1977, on December 31, 1977, the amount of R's qualified investments is $200; the amount of S's is $165; and the amount of T's is $95, determined as follows:

	R	S	T
(1) Qualified investments on December 31, 1977 (taken from line (1) of part (d) of this example)	$220	$150	$90
(2) Plus: pro rata share of group excess investment (as required by paragraph (c)(4)) (taken from lines (5) and (6) of part (f) of this example)	....	15	5
(3) Minus: Excess investment treated as investments of related group members (taken from line (3) of part (f) of this example)	20	....	....
(4) Total qualified investments	200	165	95

(h) After application of paragraph (c)(1), (3), and (4), during 1977, R's increase in qualified investments in foreign base company shipping operations is $100; S's decrease is $40; and T's increase is $40, determined as set forth in the table below. In all cases, the listed amounts of qualified investments on December 31, 1976, reflect any similar adjustments required by paragraph (c)(3) for 1976, but not any adjustment required by paragraph (c)(4) for 1976 (see § 1.955A–3(c)(3) and (4)(i)).

	R	S	T
(1) Qualified investments on December 31, 1977 (taken from line (4) of part (g) of this example)	$200	$165	$95
(2) Qualified investments on December 31, 1976 (see line (2) of part (d) of this example)	100	205	55
(3) Increase (decrease) (line (1) minus line (2))	100	(40)	40

(5) *Collateral effect.* (i) An election under this section by a United States shareholder to treat two or more controlled foreign corporations as a related group for a group taxable year shall have no effect on—

(A) Any other United States shareholder (including a minority shareholder of a member of such related group).

(B) Any other controlled foreign corporation, and

(C) The foreign personal holding company income, foreign base company sales income, and foreign base company services income, and the deductions allocable under §1.954–1(c) thereto, of any member of such related group.

(ii) See §1.952–1(c)(2)(ii) for the effect of an election under this section on the computation of earnings and profits and deficits in earnings and profits under section 952 (c) and (d).

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

Example. United States shareholder A owns 80 percent of the only class of stock of controlled foreign corporations X and Y. United States shareholder B owns the other 20 percent of the stock of X and Y. X and Y both use the calendar year as the taxable year. A elects to treat X and Y as a related group for 1977. For purposes of determining the amounts includible in B's gross income under section 951(a) in respect of X and Y, the election made by A shall be disregarded and all of B's computations shall be made without regard to this section, as illustrated in §1.952–3(d).

(d) *Procedure*—(1) *Time and manner of making election.* A United States shareholder shall make an election under this section to treat two or more controlled foreign corporations as a related group for a group taxable year and subsequent years by filing a statement to such effect with the return for the taxable year within which or with which such group taxable year ends. The statement shall include the following information:

(i) The name, address, taxpayer identification number, and taxable year of the United States shareholder;

(ii) The name, address, and taxable year of each controlled foreign corporation which is a member of the related group and is to be subject to the election; and

(iii) A schedule showing the calculations by which the amounts described in this section have been determined for the taxable year for which the election is first effective. With respect to each subsequent taxable year to which the election applies, a new schedule showing calculations of such amounts for that taxable year must be filed with the return for that taxable year. A consent to an election required by paragraph (b)(1)(v) of this section shall include the same information required for the election statement.

(2) *Revocation.* (i) Except as provided in subdivision (ii) of this subparagraph, an election under this section by a United States shareholder shall be binding for the group taxable year for which it is made and for subsequent years.

(ii) Upon application by the United States shareholder (and any other United States shareholder controlled by such shareholder which consented under paragraph (b)(1)(v) of this section to the election), an election made under this section may, subject to the approval of the Commissioner, be revoked. An application to revoke the election, as of a specified group taxable year, with respect to one or more (but not all) controlled foreign corporations, subject to an election shall be deemed to be an application to revoke the election. Approval will not be granted unless a material and substantial change in circumstances occurs which could not have been anticipated when the election was made. The application for consent to revocation shall be made by mailing a letter for such purpose to Commissioner of Internal Revenue, Attention: T:C:C, Washington, DC 20224, containing a statement of the facts which justify such consent. If a member of a related group subject to an election ceases to meet the requirements of paragraph (b) of this section for membership in the group by reason of any action taken by it or any member of the group or the electing United States shareholder, then the election will be deemed to be revoked as of the beginning of the taxable year in which such action occurred. If such action is taken principally for the purpose of revoking the election without applying for and obtaining the approval of the Commissioner to the revocation, then no further election covering any member of that related group may be made by any United States shareholder for the remainder of the taxable year in which the action occurred and the five succeeding taxable years.

(e) *Coordination with section 955(b)(3).* If a United States shareholder elects under this section to treat two or more controlled foreign corporations as a related group for any taxable year, and if such United States shareholder is required under §1.955A–4(c)(2) for purposes of filing any return to estimate the qualified investments in foreign base company shipping operations of any member of such group, then such United States shareholder shall, for purposes of filing such return, determine the amount includible in his gross income in respect of each member of such related group on the basis of such estimate. If the actual amount of such investments is not the same as the amount of the estimate, the United States shareholder shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of tax of such United States shareholder for the year or years with respect to which the incorrect amount was taken into account. The amount of tax, if any, due upon such redetermination shall be paid by the United States shareholder upon notice and demand by the district director. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the United States shareholder in accordance with the provisions of sections 6402 and 6511 and the regulations thereunder. If a United States shareholder elects under this section and if the United States shareholder has made an election under section 955(b)(3) as to at least one member of the related group, then the qualified investment amounts necessary for the calculations of paragraphs (c)(3) and (4) of this section shall be obtained, for each member of the related group, as of the determination dates applicable to each of the members.

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

Example 1. (a) Controlled foreign corporations X and Y are wholly owned subsidiaries of domestic corporation M, X and Y use the calendar year as the taxable year. For 1977, X and Y are not export trade corporations (as defined in section 971(a)), nor have they any income derived from the insurance of United States risks (within the meaning of section 963(a)). M does not elect to treat X and Y as a related group for 1977.

(b) For 1977, X and Y each have gross income (determined as provided in §1.951–6(h)(1)) of $1,000. X's foreign base company income is $20 and Y's foreign base company imcome is $0, determined as follows, based on the facts shown in the following table:

	X	Y
(1) Foreign lease company shipping income	$1,000	$1,000
(2) Less: amounts excluded from subpart F income under section 952(b) (relating to U.S. income) and amounts excluded from foreign base company income under section 945(b)(4) (relating to corporation not availed of to reduce taxes)	0	0
(3) Balance	1,000	1,000
(4) Less: deductions allocable under §1.954–1(c) to balance	800	1,040
(5) Remaining balance	200	0
(6) Less: Increase in qualified investments in foreign base company shipping operations	180	....
(7) Foreign base company income	20	....

(c) For 1977, Y has a withdrawal of previously excluded Subpart F income from investment in foreign base company shipping operations of $20, determined as follows, on the basis of the facts shown in the following table:

(1) Qualified investments in foreign base company shipping operations at December 31, 1976	$1,210
(2) Less: qualified investments in foreign base company shipping operations at December 31, 1977	1,170
(3) Balance	40
(4) Less: excess of recognized losses over recognized gains on sales during 1977 of qualified investments in foreign base company shipping operations	20
(5) Tentative decrease in qualified investments in foreign base company shipping operations for 1977	20
(6) Limitation described in §1.955A–1(b)(2)	160
(7) Y's amount of previously excluded subpart F income withdrawn from investment in foreign base company shipping operations (lesser of lines (5) and (6))	20

Example 2. (a) The facts are the same as in example 1, except that M does elect to treat X and Y as a related group for 1977.

(b) The group excess deduction, which is solely attributable to Y's net shipping loss, is $40 (i.e., $1,040 − $1,000). Since X is the only member of the related group with net shipping income, X's pro rata share of the group excess deduction is the entire $40 amount.

(c) X's foreign base company income for 1977 is zero, determined as follows:

(1) Preliminary net foreign base company shipping income (line (b)(5) of example 1)	$200
(2) Less: X's pro rata share of group excess deduction	40

(3) Remaining balance	160
(4) Less: increase in qualified investments in foreign base company shipping operations	180
(5) Foreign base company income	0

(d) The group excess investment, which is solely attributable to X's excess investment, is $20 (i.e., $180 minus $160). Since Y is the only member of the related group with a shortfall in qualified investments, Y's share of the group excess investment is the entire $20 amount.

(e) During 1976 and 1977, Y owns no stock of X. Y's withdrawal of previously excluded subpart F income from investment in foreign base company shipping operations for 1977 is zero, determined as follows:

(1) Qualified investments at December 31, 1976	$1,210
(2)(i) Qualified investments at December 31, 1977 (determined without regard to paragraph (c)(4) of this section)	1,170
(ii) Y's pro rata share of group excess investment	20
(iii) Total qualified investments at December 31, 1977 (Line (i) plus line (ii)	1,190
(3) Balance (line (1) minus line (2)(iii)	20
(4) Less: excess of recognized losses over recognized gains on sales during 1977 of qualified investments in foreign base company shipping operations	20
(5) Decrease in qualified investments for 1977	0

(Secs. 955 (b)(2) and 7805 of the Internal Revenue Code of 1954 (89 Stat. 63; 26 U.S.C. 955(b)(2), and 68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7894, 48 FR 22535, May 19, 1983; 48 FR 40888, Sept. 12, 1983, as amended by T.D. 7959, 49 FR 22280, May 29, 1984]

§1.955A–4 Election as to date of determining qualified investment in foreign base company shipping operations.

(a) *Nature of election.* In lieu of determining the increase under the provisions of section 954(g) and §1.954–7(a) or the decrease under the provisions of section 955(a)(2) and §1.955A–1(b) in a controlled foreign corporation's qualified investments in foreign base company shipping operations for a taxable year in the manner provided in such provisions, a United States shareholder of such controlled foreign corporation may elect, under the provisions of section 955(b)(3) and this section, to determine such increase in accordance with the provisions of §1.954–7(b) and to determine such decrease by ascertaining the amount by which—

(1) Such controlled foreign corporation's qualified investments in foreign base company shipping operations at the close of such taxable year exceed its qualified investments in foreign base company shipping operations at the close of the taxable year immediately following such taxable year, and reducing such excess by

(2) The amount determined under §1.955A–1(b)(1)(ii) for such taxable year subject to the limitation provided in §1.995A–1(b)(2) for such taxable year. An election under this section may be made with respect to each controlled foreign corporation with respect to which a person is a United States shareholder within the meaning of section 951(b), but the election may not be exercised separately with respect to the increases and the decreases of such controlled foreign corporation. If an election is made under this section to determine the increase of a controlled foreign corporation in accordance with the provisions of §1.954–7(b), subsequent decreases of such controlled foreign corporation shall be determined in accordance with this paragraph and not in accordance with §1.955A–1(b).

(b) *Time and manner of making election*—(1) *Without consent.* An election under this section with respect to a controlled foreign corporation shall be made without the consent of the Commissioner by a United States shareholder's filing a statement to such effect with his return for his taxable year in which or with which ends the first taxable year of such controlled foreign corporation in which—

(i) Such shareholder is a United States shareholder, and

(ii) Such controlled foreign corporation realizes foreign base company shipping income, as defined in §1.954–6.

The statement shall contain the name and address of the controlled foreign corporation and identification of such first taxable year of such corporation.

(2) *With consent.* An election under this section with respect to a controlled foreign corporation may be made by a United States shareholder at any time with the consent of the Commissioner. Consent will not be granted unless the United States shareholder and the Commissioner agree to the terms, conditions, and adjustments

under which the election will be effected. The application for consent to elect shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to compute an amount described in section 954(b)(2) in accordance with the election provided in this section. The application shall include the following information.

(i) The name, address, and taxpayer identification number, and taxable year of the United States shareholder;

(ii) The name and address of the controlled foreign corporation;

(iii) The first taxable year of the controlled foreign corporation for which income is to be computed under the election;

(iv) The amount of the controlled foreign corporation's qualified investments in foreign base company shipping operations at the close of its preceding taxable year; and

(v) The sum of the amounts excluded under section 954(b)(2) and §1.954–1(b)(1) from the foreign base company income of the controlled foreign corporation for all prior taxable years during which such shareholder was a United States shareholder of such corporation and the sum of the amounts of its previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for all prior taxable years during which such shareholder was a United States shareholder of such corporation.

(c) *Effect of election*—(1) *General.* Except as provided in subparagraphs (3) and (4) of this paragraph, an election under this section with respect to a controlled foreign corporation shall be binding on the United States shareholder and shall apply to all qualified investments in foreign base company shipping operations acquired, or disposed of, by such controlled foreign corporation during the taxable year following its taxable year for which income is first computed under the election and during all succeeding taxable years of such corporation.

(2) *Returns.* Any return of a United States shareholder required to be filed before the completion of a period with respect to which determinations are to be made as to a controlled foreign corporation's qualified investments in foreign base company shipping operations for purposes of computing such shareholder's taxable income shall be filed on the basis of an estimate of the amount of the controlled foreign corporation's qualified investments in foreign base company shipping operations at the close of the period. If the actual amount of such investments is not the same as the amount of the estimate, the United States shareholder shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of tax of such United States shareholder for the year or years with respect to which the incorrect amount was taken into account. The amount of tax, if any, due upon such redetermination shall be paid by the United States shareholder upon notice and demand by the district director. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the United States shareholder in accordance with the provisions of sections 6402 and 6511 and the regulations thereunder.

(3) *Revocation.* Upon application by the United States shareholder, the election made under this section may, subject to the approval of the Commissioner, be revoked. Approval will not be granted unless the United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the revocation will be effected. Unless such agreement provides otherwise, the change in the controlled foreign corporation's qualified investments in foreign base company shipping operations for its first taxable year for which income is computed without regard to the election previously made will be considered to be zero for purposes of effectuating the revocation. The application for consent to revocation shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the first

taxable year of the controlled foreign corporation with respect to which the shareholder desires to compute the amounts described in section 954(b)(2) or 955(a) without regard to the election provided in this section. The application shall include the following information:

(i) The name, address, and taxpayer identification number of the United States shareholder:

(ii) The name and address of the controlled foreign corporation;

(iii) The taxable year of the controlled foreign corporation for which such amounts are to be computed;

(iv) The amount of the controlled foreign corporation's qualified investments in foreign base company shipping operations at the close of its preceding taxable year;

(v) The sum of the amounts excluded under section 954(b)(2) and §1.954–1(b)(1) from the foreign base company income of the controlled foreign corporation for all prior taxable years during which such shareholder was a United States shareholder of such corporation and the sum of the amounts of its previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for all prior taxable years during which such shareholder was a United States shareholder of such corporation; and

(vi) The reasons for the request for consent to revocation.

(4) *Transfer of stock.* If during any taxable year of a controlled foreign corporation—

(i) A United States shareholder who has made an election under this section with respect to such controlled foreign corporation sells, exchanges, or otherwise disposes of all or part of his stock in such controlled foreign corporation, and

(ii) The foreign corporation is a controlled foreign corporation immediately after the sale, exchange, or other disposition,

then, with respect to the stock so sold, exchanged, or disposed of, the change in the controlled foreign corporation's qualified investments in foreign base company shipping operations for such taxable year shall be considered to be zero. If the United States shareholder's successor in interest is entitled to and does make an election under paragraph (b)(1) of this section to determine the controlled foreign corporation's increase in qualified investments in foreign base company shipping operations for the taxable year in which he acquires such stock, such increase with respect to the stock so acquired shall be determined in accordance with the provisions of §1.954–7(b)(1). If the controlled foreign corporation realizes no foreign base company income from which amounts are excluded under section 954(b)(2) and §1.954–1(b)(1) for the taxable year in which the United States shareholder's successor in interest acquires such stock and such successor in interest makes an election under paragraph (b)(1) of this section with respect to a subsequent taxable year of such controlled foreign corporation, the increase in the controlled foreign corporation's qualified investments in foreign base company shipping operations for such subsequent taxable year shall be determined in accordance with the provisions of §1.954–7(b)(2).

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

Example 1. Foreign corporation A is a wholly owned subsidiary of domestic corporation M. Both corporations use the calendar year as a taxable year. In a statement filed with its return for 1977, M makes an election under section 955(b)(3) and the election remains in force for the taxable year 1978. At December 31, 1978, A's qualified investments in foreign base company shipping operations amount to $100,000; and, at December 31, 1979, to $80,000. For purposes of paragraph (a)(1) of this section, A Corporation's decrease in qualified investments in foreign base company shipping operations for the taxable year 1978 is $20,000 and is determined by ascertaining the amount by which A Corporation's qualified investments in foreign base company shipping operations at December 31, 1978 ($100,000) exceed its qualified investments in foreign base company shipping operations at December 31, 1979 ($80,000).

Example 2. The facts are the same as in example 1 except that A experiences no changes in qualified investments in foreign base company shipping operations during its taxable years 1980 and 1981. If M's election were to remain in force, A's acquisitions and dispositions of qualified investments in foreign base company shipping operations during A's taxable year 1982 would be taken into account in determining whether A has experienced an increase or a decrease in qualified investments in foreign base company shipping operations for its taxable year 1981. However, M duly files before the close of A's taxable year 1981 as application for consent to revocation of M Corporation's election under section 955(b)(3), and, pursuant to an agreement between the Commissioner and M, consent is granted by the Commissioner. Assuming such agreement does not provide otherwise, A's change in qualifed investments in foreign base company shipping operations for its taxable year 1981 is zero because the effect of the revocation of the election is to treat acquisitions and dispositions of qualified investments in foreign base company shipping operations actually occurring in 1982 as having occurred in such year rather than in 1981.

Example 3. The facts are the same as in example 2 except that A's qualified investments in foreign base company shipping operations at December 31, 1982, amount to $70,000. For purposes of paragraph (b)(1)(i) of § 1.955A–1, the decrease in A's qualified investments in foreign base company shipping operations for the taxable year 1982 is $10,000 and is determined by ascertaining the amount by which A's qualified investments in foreign base company shipping operations at December 31, 1981 ($80,000) exceed its qualified investments in foreign base company shipping operations at December 31, 1982 ($70,000).

Example 4. The facts are the same as in example 1. Assume further that on September 30, 1979, M sells 40 percent of the only class of stock of A to N Corporation, a domestic corporation. N uses the calendar year as a taxable year. A remains a controlled foreign corporation immediately after such sale of its stock. A's qualified investments in foreign base company shipping operations at December 31, 1980, amount to $90,000. The changes in A Corporation's qualified investments in foreign base company shipping operations occurring in its taxable year 1979 are considered to be zero with respect to the 40-percent stock interest acquired by N Corporation. The entire $20,000 reduction in A Corporation's qualified investments in foreign base company shipping operations which occurs during the taxable year 1979 is taken into account by M for purposes of paragraph (c)(1) of this section in determining its tax liability for the taxable year 1978. A's increase in qualified investments in foreign base company shipping operations for the taxable year 1979 with respect to the 60-percent stock interest retained by M is $6,000 and is determined by ascertaining M's pro rata share (60 percent) of the amount by which A's qualified investments in foreign base company shipping operations at December 31, 1980 ($90,000) exceed its qualified investments in foreign base company shipping operations at December 31, 1979 ($80,000). N does not make an election under section 955(b)(3) in its return for its taxable year 1980. Corporation A's increase in qualified investments in foreign base company shipping operations for the taxable year 1980 with respect to the 40-percent stock interest acquired by N is $4,000.

[T.D. 7894, 48 FR 22539, May 19, 1983]

§ 1.956–1 Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.

(a) *In general.* Section 956(a)(1) and paragraph (b) of this section provide rules for determining the amount of a controlled foreign corporation's earnings invested in United States property at the close of any taxable year. Such amount is the aggregate amount invested in United States property to the extent such amount would have constituted a dividend if it had been distributed on such date. Subject to the provisions of section 951(a)(4) and the regulations thereunder, a United States shareholder of a controlled foreign corporation is required to include in his gross income his pro rata share, as determined in accordance with paragraph (c) of this section, of the controlled foreign corporation's increase for any taxable year in earnings invested in United States property but only to the extent such share is not excludable from his gross income under the provisions of section 959(a)(2) and the regulations thereunder.

(b) *Amount of a controlled foreign corporation's investment of earnings in United States property*—(1) *Dividend limitation.* The amount of a controlled foreign corporation's earnings invested at the close of its taxable year in United States property is the aggregate amount of such property held, directly or indirectly, by such corporation at the close of its taxable year to the extent such amount would have constituted a dividend under section 316 and §§ 1.316–1 and 1.316–2 (determined after the application of section 955(a)) if it had been distributed on such closing day. For purposes of this subparagraph, the determination of whether an amount would have constituted a dividend if distributed shall be made without regard to the provisions of section 959(d) and the regulations thereunder.

(2) *Aggregate amount of United States property.* For purposes of determining an increase in earnings invested in United States property for any taxable year beginning after December 31, 1975, the aggregate amount of United States property held by a controlled foreign corporation at the close of—

(i) Any taxable year beginning after December 31, 1975, and

(ii) The last taxable year beginning before January 1, 1976 does not include stock or obligations of a domestic corporation described in section 956(b)(2)(F) or movable property described in section 956(b)(2)(G).

(3) *Treatment of earnings and profits.* For purposes of making the determination under subparagraph (1) of this paragraph as to whether an amount of investment would have constituted a dividend if distributed at the close of any taxable year of a controlled foreign corporation, earnings and profits of the controlled foreign corporation shall be considered not to include any amounts which are attributable to—

(i) Amounts which have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a)(1)(B) (or which would have been so included but for section 959(a)(2)) and have not been distributed, or

(ii)*(a)* Amounts which are included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) or would be so included under such section but for the fact that such amounts were distributed to such shareholder during the taxable year, or

(b) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) and have not been distributed.

The rules of this subparagraph apply only in determining the limitation on a controlled foreign corporation's increase in earnings invested in United States property. See section 959 and the regulations thereunder for limitations on the exclusion from gross income of previously taxed earnings and profits.

(4) [Reserved]

(c) *Shareholder's pro rata share of increase*—(1) *General rule.* A United States shareholder's pro rata share of a controlled foreign corporation's increase for any taxable year in earnings invested in United States property is the amount determined by subtracting the shareholder's pro rata share of—

(i) The controlled foreign corporation's earnings invested in United States property at the close of its preceding taxable year, as determined under paragraph (b) of this section, reduced by amounts paid by such corporation during such preceding taxable year to which section 959(c)(1) and the regulations thereunder apply, from his pro rata share of

(ii) The controlled foreign corporation's earnings invested in United States property at the close of its current taxable year, as determined under paragraph (b) of this section.

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

Example 1. A is a United States shareholder and direct owner of 60 percent of the only class of stock of R Corporation, a controlled foreign corporation during the entire period here involved. Both A and R Corporation use the calendar year as a taxable year. Corporation R's aggregate investment in United States property on December 31, 1964, which would constitute a dividend (as determined under paragraph (b) of this section) if distributed on such date is $150,000. During the taxable year 1964, R Corporation distributed $50,000 to which section 959(c)(1) applies. Corporation R's aggregate investment in United States property on December 31, 1965, is $250,000; and R Corporation's current and accumulated earnings and profits on such date (determined as provided in paragraph (b) of this section) are $225,000. A's pro rata share of R Corporation's increase for 1965 in earnings invested in United States property is $75,000, determined as follows:

(i) Aggregate investment in United States property on December 31, 1965		$250,000
(ii) Current and accumulated earnings and profits on December 31, 1965		225,000
(iii) Amount of earnings invested in United States property on December 31, 1965, which would constitute a dividend if distributed on such date (lesser of item (i) or item (ii))		225,000
(iv) Aggregate investment in United States property on December 31, 1964, which would constitute a dividend if distributed on such date	$150,000	

Less: Amounts distributed during 1964 to which section 959(c)(1) applies	50,000	100,000
(v) R Corporation's increase for 1965 in earnings invested in United States property (item (iii) minus item (iv))		125,000
(vi) A's pro rata share of R Corporation's increase for 1965 in earnings invested in United States property (item (v) times 60 percent)		75,000

Example 2. The facts are the same as in example 1, except that R Corporation's current and accumulated earnings and profits on December 31, 1965, are $100,000 instead of $225,000. Accordingly, even through R Corporation's aggregate investment in United States property on December 31, 1965, of $250,000 exceeds the net amount ($100,000) taken into account under subparagraph (1)(i) of this paragraph as of December 31, 1964, by $150,000, there is no increase for taxable year 1965 in earnings invested in United States property because of the dividend limitation of paragraph (b)(1) of this section. Corporation R's aggregate investment in United States property on December 31, 1966, is unchanged ($250,000) Corporation R's current and accumulated earnings and profits on December 31, 1966, are $175,000, and, as a consequence, its aggregate investment in United States property which would constitute a dividend if distributed on that date is $175,000. Corporation R pays no amount during 1965 to which section 959(c)(1) applies. Corporation R's increase for the taxable year 1966 in earnings invested in United States property is $75,000, and A's pro rata share of that amount is $45,000 ($75,000 times 60 percent).

(d) *Date and basis of determinations.* The determinations made under paragraph (c)(1)(i) of this section with respect to the close of the preceding taxable year of a controlled foreign corporation and under paragraph (c)(1)(ii) with respect to the close of the current taxable year of such controlled foreign corporation, for purposes of determining the United States shareholder's pro rata share of such corporation's increased investment of earnings in United States property for the current taxable year, shall be made as of the last day of the current taxable year of such corporation but on the basis of stock owned, within the meaning of section 958(a) and the regulations thereunder, by such United States shareholder on the last day of the current taxable year of the foreign corporation on which such corporation is a controlled foreign corporation. See the last sentence of section 956(a)(2). The application of this paragraph may be illustrated from the following example:

Example. Domestic corporation M owns 60 percent of the only class of stock of A Corporation, a controlled foreign corporation during the entire period here involved. Both M Corporation and A Corporation use the calendar year as a taxable year. Corporation A's investment of earnings in United States property at the close of the taxable year 1963 is $100,000, as determined under paragraph (b) of this section, and M Corporation includes its pro rata share of such amount ($60,000) in gross income for its taxable year 1963. On June 1, 1964, M Corporation acquires an additional 25 percent of A Corporation's outstanding stock from a person who is not a United States person as defined in section 957(d). Corporation A's investment of earnings in United States property at the close of the taxable year 1964, as determined under paragraph (b) of this section, is unchanged ($100,000). Corporation A pays no amount during 1963 to which section 959(c)(1) applies. Corporation M is not required, by reason of the acquisition in 1964 of A Corporation's stock, to include an additional amount in its gross income with respect to A Corporation's investment of earnings in United States property even though the earnings invested in United States property by A Corporation attributable to the stock acquired by M Corporation were not previously taxed. The determination made under paragraph (c)(1)(i) of this section as well as the determination made under paragraph (c)(1)(ii) of this section with respect to A Corporation's investment for 1964 of earnings in United States property are made on the basis of stock owned by M Corporation (85 percent) at the close of 1964.

(e) *Amount attributable to property*—(1) *General rule.* Except as provided in subparagraph (2) of this paragraph, for purposes of paragraph (b)(1) of this section the amount taken into account with respect to any United States property shall be its adjusted basis, as of the applicable determination date, reduced by any liability (other than a liability described in subparagraph (3) of this paragraph) to which such property is subject on such date. To be taken into account under this subparagraph, a liability must constitute a specific charge against the property involved. Thus, a liability evidenced by an open account or a liability secured only by the general credit of the controlled foreign corporation will not be taken into account. On the other hand, if a liability constitutes a specific charge against several items of property and cannot definitely be allocated to any single item of property, the liability shall be apportioned against each of such items of property in that ratio which the adjusted basis of such item on the applicable determination date bears to the adjusted basis of all such items at such time. A liability in excess of the adjusted basis of the property which is subject to such liability shall not be taken into account for the purpose of reducing the adjusted basis of other property which is not subject to such liability.

(2) *Rule for pledges and guarantees.* For purposes of this section the amount taken into account with respect to any pledge or guarantee described in paragraph (c)(1) of §1.956–2 shall be the unpaid principal amount on the applicable determination date of the obligation with respect to which the controlled foreign corporation is a pledgor or guarantor.

(3) *Excluded charges.* For purposes of subparagraph (1) of this paragraph, a specific charge created with respect to any item of property principally for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's investment of earnings in United States property will not be recognized; whether a specific charge is created principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to a loan is whether the loan is from a related person, as defined in section 954 (d)(3) and paragraph (e) of §1.954–1.

(4) *Statement required.* If for purposes of this section a United States shareholder of a controlled foreign corporation reduces the adjusted basis of property which constitutes United States property on the ground that such property is subject to a liability, he shall attach to his return a statement setting forth the adjusted basis of the property before the reduction and the amount and nature of the reduction.

(Secs. 956(c), 7805, Internal Revenue Code of 1954 (76 Stat. 1017, 68A Stat. 917; (26 U.S.C. 956(c) and 7805 respectively)))

[T.D. 6704, 29 FR 2600, Feb. 20, 1964, as amended by T.D. 6795, 30 FR 942, Jan. 29, 1965; T.D. 7712, 45 FR 52374, Aug. 7, 1980; T.D. 8209, 53 FR 22171, June 14, 1988]

§1.956–1T Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property (temporary).

(a) [Reserved]

(b)(1)–(3) [Reserved]

(4) *Treatment of certain investments of earnings in United States Property*—(i) *Special rule.* For purposes of §1.956–1(b)(1) of the regulations, a controlled foreign corporation will be considered to hold indirectly (A) the investments in United States property held on its behalf by a trustee or a nominee or (B) at the discretion of the District Director, investments in U.S. property acquired by any other foreign corporation that is controlled by the controlled foreign corporation, if one of the principal purposes for creating, organizing, or funding (through capital contributions or debt) such other foreign corporation is to avoid the application of section 956 with respect to the controlled foreign corporation. For purposes of this paragraph (b), a foreign corporation will be controlled by the controlled foreign corporation if the foreign corporation and the controlled foreign corporation are related parties under section 267(b). In determining for purposes of this paragraph (b) whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c). The following examples illustrate the application of this paragraph.

Example 1. P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation, and all of the outstanding stock of FS2, also a controlled foreign corporation. FS1 sells products to FS2 in exchange for trade receivables due in 60 days. FS2 has no earnings and profits. FS1 has substantial accumulated earnings and profits. FS2 loans to P an amount equal to the debt it owes FS1. FS2 pays the trade receivables according to the terms of the receivables. FS1 will not be considered to hold indirectly the investment in United States property under this paragraph (b)(4), because there was no transfer of funds to FS2.

Example 2. The facts are the same as in Example 1, except that FS2 does not pay the receivables. FS1 is considered to hold indirectly the investment in United States property under this paragraph (b)(4), because there was a transfer of funds to FS2, a principal purpose of which was to avoid the application of section 956 to FS1.

(ii) *Effective date.* This section is effective June 14, 1988, with respect to investments made on or after June 14, 1988.

(c)–(d) [Reserved]

(e)(1)–(4) [Reserved]

(e)(5) *Excluded charges*—(i) *Special rule.* For purposes of § 1.956–1(e)(1) of the regulations, in the case of an investment in United States property consisting of an obligation of a related person, as defined in section 954(d)(3) and paragraph (e) of § 1.954–1, a liability will not be recognized as a specific charge if the liability representing the charge is with recourse with respect to the general credit or other assets of the investing controlled foreign corporation.

(ii) *Effective date.* This section is effective June 14, 1988, with respect to investments made on or after June 14, 1988.

[T.D. 8209, 53 FR 22171, June 14, 1988]

§ 1.956–2 Definition of United States property.

(a) *Included property*—(1) *In general.* For purposes of section 956(a) and § 1.956–1, United States property is (except as provided in paragraph (b) of this section) any property acquired (within the meaning of paragraph (d)(1) of this section) by a foreign corporation (whether or not a controlled foreign corporation at the time) during any taxable year of such foreign corporation beginning after December 31, 1962, which is—

(i) Tangible property (real or personal) located in the United States;

(ii) Stock of a domestic corporation;

(iii) An obligation (as defined in paragraph (d)(2) of this section) of a United States person (as defined in section 957(d)); or

(iv) Any right to the use in the United States of—

(a) A patent or copyright,

(b) An invention, model, or design (whether or not patented),

(c) A secret formula or process, or

(d) Any other similar property right, which is acquired or developed by the foreign corporation for use in the United States by any person. Whether a right described in this subdivision has been acquired or developed for use in the United States by any person is to be determined from all the facts and circumstances of each case. As a general rule, a right actually used principally in the United States will be considered to have been acquired or developed for use in the United States in the absence of affirmative evidence showing that the right was not so acquired or developed for such use.

(2) *Illustrations.* The application of the provisions of this paragraph may be illustrated by the following examples:

Example 1. Foreign corporation R uses as a taxable year a fiscal year ending on June 30. Corporation R acquires on June 1, 1963, and holds on June 30, 1963, $100,000 of tangible property (not described in section 956(b)(2)) located in the United States. Corporation R's aggregate investment in United States property at the close of its taxable year ending June 30, 1963, is zero since the property which is acquired on June 1, 1963, is not acquired during a taxable year of R Corporation beginning after December 31, 1962. Assuming no change in R Corporation's aggregate investment in United States property during its taxable year ending June 30, 1964, R Corporation's increase in earnings invested in United States property for such taxable year is zero.

Example 2. Foreign corporation S uses the calendar year as a taxable year and is a controlled foreign corporation for its entire taxable year 1965. Corporation S is not a controlled foreign corporation at any time during its taxable years 1963 and 1964. Corporation S owns on December 31, 1964, $100,000 of tangible property (not described in section 956(b)(2)) located in the United States which it acquires during taxable years beginning after December 31, 1962. Corporation S's aggregate investment in United States property on December 31, 1964, is $100,000. Corporation S's current and accumulated earnings and profits (determined as provided in paragraph (b) of §1.956–1) as of December 31, 1964, are in excess of $100,000. Assuming no change in S Corporation's aggregate investment in United States property during its taxable year 1965, S Corporation's increase in earnings invested in United States property for such taxable year is zero.

Example 3. Foreign corporation T uses the calendar year as a taxable year and is a controlled foreign corporation for its entire taxable years 1963, 1964, and 1966. At December 31, 1964, T Corporation's investment in United States property is $100,000. Corporation T is not a controlled foreign corporation at any time during its taxable year 1965 in which it acquires $25,000 of tangible property (not described in section 956(b)(2)) located in the United States. On December 31, 1965, T Corporation holds the United States property of $100,000 which it held on December 31, 1964, and, in addition, the United States property acquired in 1965. Corporation T's aggregate investment in United States property at December 31, 1965, is $125,000. Corporation T's current and accumulated earnings and profits (determined as provided in paragraph (b) of §1.956–1) as of December 31, 1965, are in excess of $125,000, and T Corporation pays no amount during 1965 to which section 959 (c)(1) applies. Assuming no change in T Corporation's aggregate investment in United States property during its taxable year 1966, T Corporation's increase in earnings invested in United States property for such taxable year is zero.

(b) *Exceptions*—(1) *Excluded property.* For purposes of section 956(a) and paragraph (a) of this section, United States property does not include the following types of property held by a foreign corporation:

(i) Obligations of the United States.

(ii) Money.

(iii) Deposits with persons carrying on the banking business, unless the deposits serve directly or indirectly as a pledge or guarantee within the meaning of paragraph (c) of this section. See paragraph (e)(2) of §1.956–1.

(iv) Property located in the United States which is purchased in the United States for export to, or use in, foreign countries. For purposes of this subdivision, property to be used outside the United States will be considered property to be used in a foreign country. Whether property is of a type described in this subdivision is to be determined from all the facts and circumstances in each case. Property which constitutes export trade assets within the meaning of section 971(c)(2) and paragraph (c)(3) of §1.971–1 will be considered property of a type described in this subdivision.

(v) Any obligation (as defined in paragraph (d)(2) of this section) of a United States person (as defined in section 957(d)) arising in connection with the sale or processing of property if the amount of such obligation outstanding at any time during the taxable year of the foreign corporation does not exceed an amount which is ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the United States person, or, if the sale or processing transaction occurs between related persons, would be ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the United States person if such persons were unrelated persons. Whether the amount of an obligation described in this subdivision is ordinary and necessary is to be determined from all the facts and circumstances in each case.

(vi) Any aircraft, railroad rolling stock, vessel, motor vehicle, or container used in the transportation of persons or property in foreign commerce and used predominantly outside the United States. Whether transportation property described in this subdivision is used in foreign commerce and predominantly outside the United States is to be determined from all the facts and circumstances in each case. As a general rule, such transportation property will be considered to be used predominantly outside the United States if 70 percent or more of the miles traversed (during the taxable year at the close of which a determination is made under section 956(a)(2)) in the use of such property are traversed outside the United States or if such property is located outside the United States 70 percent of the time during such taxable year.

(vii) An amount of assets described in paragraph (a) of this section of an insurance company equivalent to the unearned premiums or reserves which are ordinary and necessary for the proper conduct of that part of its insurance business which is attributable to contracts other than those described in section 953(a)(1) and the regulations thereunder. For purposes of this subdivision, a reserve will be considered ordinary and necessary for the proper conduct of an insurance business if, under the principles of paragraph (c) of § 1.953–4, such reserve would qualify as a reserve required by law. See paragraph (d)(3) of § 1.954–2 for determining, for purposes of this subdivision, the meaning of insurance company and of unearned premiums.

(viii) For taxable years beginning after December 31, 1975, the voting or nonvoting stock or obligations of an unrelated domestic corporation. For purposes of this subdivision, an unrelated domestic corporation is a domestic corporation which is neither a United States shareholder (as defined in section 951(b)) of the controlled foreign corporation making the investment, nor a corporation 25 percent or more of whose total combined voting power of all classes of stock entitled to vote is owned or considered as owned (within the meaning of section 958 (b)) by United States shareholders of the controlled foreign corporation making the investment. The determination of whether a domestic corporation is an unrelated corporation is made immediately after each acquisition of stock or obligations by the controlled foreign corporations.

(ix) For taxable years beginning after December 31, 1975, movable drilling rigs or barges and other movable exploration and exploitation equipment (other than a vessel or an aircraft) when used on the Continental Shelf (as defined in section 638) of the United States in the exploration for, development, removal, or transportation of natural resources from or under ocean waters. Property used on the Continental Shelf includes property located in the United States which is being constructed or is in storage or in transit within the United States for use on the Continental Shelf. In general, the type of property which qualifies for the exception under this subdivision includes any movable property which would be entitled to the investment credit if used outside the United States in certain geographical areas of the Western Hemisphere pursuant to section 48(a)(2)(B)(x) (without reference to sections 49 and 50).

(x) An amount of—

(a) A controlled foreign corporation's assets described in paragraph (a) of this section equivalent to its earnings and profits which are accumulated after December 31, 1962, and are attributable to items of income described in section 952(b) and the regulations thereunder, reduced by the amount of

(b) The earnings and profits of such corporation which are applied in a taxable year of such corporation beginning after December 31, 1962, to discharge a liability on property, but only if the liability was in existence at the close of such corporation's taxable year immediately preceding its first taxable year beginning after December 31, 1962, and the property would have been United States property if it had been acquired by such corporation immediately before such discharge.

For purposes of this subdivision, distributions made by such corporation for any taxable year shall be considered first made out of earnings and profits for such year other than earnings and profits referred to in (*a*) of this subdivision.

(2) *Statement required.* If a United States shareholder of a controlled foreign corporation excludes any property from the United States property of such controlled foreign corporation on the ground that section 956(b)(2) applies to such excluded property, he shall attach to his return a statement setting forth, by categories described in paragraph (a)(1) of this section, the amount of United States property of the controlled foreign corporation and, by categories described in subparagraph (1) of this paragraph, the amount of such property which is excluded.

(c) *Treatment of pledges and guarantees*—(1) *General rule.* Except as provided in subparagraph (4) of this paragraph, any obligation (as defined in paragraph (d)(2) of this section) of a United States person (as defined in section 957(d)) with respect to which a controlled foreign corporation is a pledgor or guarantor shall be considered for purposes of section 956(a) and paragraph (a) of this section to be United States property held by such controlled foreign corporation.

(2) *Indirect pledge or guarantee.* If the assets of a controlled foreign corporation serve at any time, even though indirectly, as security for the performance of an obligation of a United States person, then, for purposes of paragraph (c)(1) of this section, the controlled foreign corporation will be considered a pledgor or guarantor of that obligation. For this purpose the pledge of stock of a controlled foreign corporation will be considered as the indirect pledge of the assets of the corporation if at least 66 2/3 percent of the total combined voting power of all classes of stock entitled to vote is pledged and if the pledge of stock is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the corporation's discretion with respect to the disposition of assets and the incurrence of liabilities other than in the ordinary course of business. This paragraph (c)(2) applies only to pledges and guarantees which are made after September 8, 1980. For purposes of this paragraph (c)(2) a refinancing shall be considered as a new pledge or guarantee.

(3) *Illustrations.* The following examples illustrate the application of this paragraph (c):

Example 1. A, a United States person, borrows $100,000 from a bank in foreign country X on December 31, 1964. On the same date controlled foreign corporation R pledges its assets as security for A's performance of A's obligation to repay such loan. The place at which or manner in which A uses the money is not material. For purposes of paragraph (b) of §1.956–1, R Corporation will be considered to hold A's obligation to repay the bank $100,000, and, under the provisions of paragraph (e)(2) of §1.956–1, the amount taken into account in computing R Corporation's aggregate investment in United States property on December 31, 1964, is the unpaid principal amount of the obligation on that date ($100,000).

Example 2. The facts are the same as in example 1, except that R Corporation participates in the transaction, not by pledging its assets as security for A's performance of A's obligation to repay the loan, but by agreeing to buy for $1,00,000 at maturity the note representing A's obligation if A does not repay the loan. Separate arrangements are made with respect to the payment of the interest on the loan. The agreement of R Corporation to buy the note constitutes a guarantee of A's obligation. For purposes of paragraph (b) of §1.956–1, R Corporation will be considered to hold A's obligation to repay the bank $100,000, and, under the provisions of paragraph (e)(2) of §1.956–1, the amount taken into account in computing R Corporation's aggregate investment in United States property on December 31, 1964, is the unpaid principal amount of the obligation on that date ($100,000).

Example 3. A, a United States person, borrows $100,000 from a bank on December 10, 1981, pledging 70 percent of the stock of X, a controlled foreign corporation, as collateral for the loan. A and X use the calendar year as their taxable year. in the loan agreement, among other things, A agrees not to cause or permit X Corporation to do any of the following without the consent of the bank:

(a) Borrow money or pledge assets, except as to borrowings in the ordinary course of business of X Corporation;

(b) Guarantee, assume, or become liable on the obligation of another, or invest in or lend funds to another;

(c) Merge or consolidate with any other corporation or transfer shares of any controlled subsidiary;

(d) Sell or lease (other than in the ordinary course of business) or otherwise dispose of any substantial part of its assets;

(e) Pay or secure any debt owing by X Corporation to A; and

(f) Pay any dividends, except in such amounts as may be required to make interest or principal payments on A's loan from the bank.

A retains the right to vote the stock unless a default occurs by A. Under paragraph (c)(2) of this section, the assets of X Corporation serve indirectly as security for A's performance of A's obligation to repay the loan and X Corporation will be considered a pledgor or guarantor with respect to that obligation. For purposes of paragraph (b) of §1.956–1, X Corporation will be considered to hold A's obligation to repay the bank $100,000 and under paragraph (e)(2) of §1.956–1, the amount taken into account in computing X Corporation's aggregate investment in United States property on December 31, 1981, is the unpaid principal amount of the obligation on that date.

(4) *Special rule for certain conduit financing arrangements.* The rule contained in subparagraph (1) of this paragraph shall not apply to a pledge or a guarantee by a controlled foreign corporation to secure the obligation of a United States person if such United States person is a mere conduit in a financing arrangement. Whether the United States person is a mere conduit

in a financing arrangement will depend upon all the facts and circumstances in each case. A United States person will be considered a mere conduit in a financing arrangement in a case in which a controlled foreign corporation pledges stock of its subsidiary corporation, which is also a controlled foreign corporation, to secure the obligation of such United States person, where the following conditions are satisfied:

(i) Such United States person is a domestic corporation which is not engaged in the active conduct of a trade or business and has no substantial assets other than those arising out of its relending of the funds borrowed by it on such obligation to the controlled foreign corporation whose stock is pledged; and

(ii) The assets of such United States person are at all times substantially offset by its obligation to the lender.

(d) *Definitions*—(1) *Meaning of ''acquired''*—(i) *Applicable rules.* For purposes of this section—

(a) Property shall be considered acquired by a foreign corporation when such corporation acquires an adjusted basis in the property;

(*b*) Property which is an obligation of a United States person with respect to which a controlled foreign corporation is a pledgor or guarantor (within the meaning of paragraph (c) of this section) shall be considered acquired when the corporation becomes liable as a pledgor or guarantor or is otherwise considered a pledgor or guarantor (within the meaning of paragraph (c)(2) of this section); and

(c) Property shall not be considered acquired by a foreign corporation if—

(1) Such property is acquired in a transaction in which gain or loss would not be recognized under this chapter to such corporation if such corporation were a domestic corporation;

(2) The basis of the property acquired by the foreign corporation is the same as the basis of the property exchanged by such corporation; and

(3) The property exchanged by the foreign corporation was not United States property (as defined in paragraph (a)(1) of this section) but would have been such property if it had been acquired by such corporation immediately before such exchange.

(ii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example 1. Foreign corporation R uses the calendar year as a taxable year and acquires before January 1, 1963, stock of domestic corporation M having as to R Corporation an adjusted basis of $10,000. The stock of M Corporation is not United States property of R Corporation on December 31, 1962, since it is not acquired in a taxable year of R Corporation beginning on or after Janury 1, 1963. On June 30, 1963, R Corporation sells the M Corporation stock for $15,000 in cash and expends such amount in acquiring stock of domestic corporation N which has as to R Corporation an adjusted basis of $15,000. For purposes of determining R Corporation's aggregate investment in United States property on December 31, 1963, R Corporation has, by virtue of acquiring the stock of N Corporation, acquired $15,000 of United States property.

Example 2. Foreign corporation S, a controlled foreign corporation for the entire period here involved, uses the calendar year as a taxable year and purchases for $100,000 on December 31, 1963, tangible property (not described in section 956(b)(2)) located in the United States and having a remaining estimated useful life of 10 years, subject to a mortgage of $80,000 payable in 5 annual installments. The property constitutes United States property as of December 31, 1963, and the amount taken into account for purposes of determining the aggregate amount of S Corporation's investment in United States property under paragraph (b) of § 1.956–1 is $20,000. No depreciation is sustained with respect to the property during the taxable year 1963. During the taxable year 1964, S Corporation pays $16,000 on the mortgage and sustains $10,000 of depreciation with respect to the property. As of December 31, 1964, the amount taken into account with respect to the property for purposes of determining the aggregate amount of S Corporation's investment in United States property under paragraph (b) of § 1.956–1 is $26,000, computed as follows:

Cost of property		$100,000
Less: Reserve for depreciation		10,000
Adjusted basis of property		90,000
Less: Liability to which property is subject:		
Gross amount of mortgage	$80,000	
Payment during 1964	16,000	
		64,000
Amount taken into account (12–31–64)		26,000

Example 3. Controlled foreign corporation T uses the calendar year as a taxable year and acquires on December 31, 1963, $10,000 of

United States property not described in section 956(b)(2); no depreciation is sustained with respect to the property during 1963. Corporation T's current and accumulated earnings and profits (determined as provided in paragraph (b) of §1.956–1) as of December 31, 1963, are in excess of $10,000, and T Corporation's United States shareholders include in their gross income under section 951(a)(1)(B) their pro rata share of T Corporation's increase ($10,000) for 1963 in earnings invested in United States property. On January 1, 1964, T Corporation acquires an additional $10,000 of United States property not described in section 956(b)(2). Each of the two items of property has an estimated useful life of 5 years, and T Corporation sustains $4,000 of depreciation with respect to such properties during its taxable year 1964. Corporation T's current and accumulated earnings and profits as of December 31, 1964, exceed $16,000, determined as provided in paragraph (b) of §1.956–1. Corporation T pays no amounts during 1963 to which section 959(c)(1) applies. Corporation T's investment of earnings in United States property at December 31, 1964, is $16,000, and its increase for 1964 in earnings invested in United States property is $6,000.

Example 4. Foreign corporation U uses the calendar year as a taxable year and acquires before January 1, 1963, stock in domestic corporation M having as to U Corporation an adjusted basis of $10,000. On December 1, 1964, pursuant to a statutory merger described in section 368(a)(1), M Corporation merges into domestic corporation N, and U Corporation receives on such date one share of stock in N Corporation, the surviving corporation, for each share of stock it held in M Corporation. Pursuant to section 354 no gain or loss is recognized to U Corporation, and pursuant to section 358 the basis of the property received (stock of N Corporation) is the same as that of the property exchanged (stock of M Corporation). Corporation U is not considered for purposes of section 956 to have acquired United States property by reason of its receipt of the stock in N Corporation.

Example 5. The facts are the same as in example 4, except that U Corporation acquires the stock of M Corporation on February 1, 1963, rather than before January 1, 1963. For purposes of determining U Corporation's aggregate investment in United States property on December 31, 1963, U Corporation has, by virtue of acquiring the stock of M Corporation, acquired $10,000 of United States property. Corporation U pays no amount during 1963 to which section 959(c)(1) applies. The reorganization and resulting acquisition on December 1, 1964, by U Corporation of N Corporation's stock also represents an acquisition of United States property; however, assuming no other change in U Corporation's aggregate investment in United States property during 1964, U Corporation's increase for such year in earnings invested in United States property is zero.

(2) [Reserved]

(Secs. 956(c), 7805, Internal Revenue Code of 1954 (76 Stat. 1017, 68A Stat. 917; (26 U.S.C. 956(c) and 7805 respectively)))

[T.D. 6704, 29 FR 2601, Feb. 20, 1964, as amended by T.D. 7712, 45 FR 52374, Aug. 7, 1980; T.D. 7797, 46 FR 57675, Nov. 25, 1981; T.D. 8209, 53 FR 22171, June 14, 1988]

§1.956–2T Definition of United States Property (temporary).

(a)—(c) [Reserved]

(d)(1) [Reserved]

(2) *Obligation defined*—(i) *Rule.* For purposes of §1.956–2 of the regulations, the term ‘‘obligation’’ includes any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not bearing interest, except that such term shall not include:

(A) Any indebtedness arising out of the involuntary conversion of property which is not United States property within the meaning of paragraph (a)(1) of §1.956–2, or

(B) Any obligation of a United States person (as defined in section 957(c)) arising in connection with the provision of services by a controlled foreign corporation to the United States person if the amount of such obligation outstanding at any time during the taxable year of the controlled foreign corporation does not exceed an amount which would be ordinary and necessary to carry on the trade or business of the controlled foreign corporation and the United States person if they were unrelated. The amount of such obligations shall be considered to be ordinary and necessary to the extent of such receivables that are paid within 60 days.

See §1.956–2(b)(1)(v) for the exclusion from United States property of obligations arising in connection with the sale or processing of property where such obligations are ordinary and necessary as to amount.

(ii) *Effective date.* This section is effective June 14, 1988, with respect to investments made on or after June 14, 1988.

[T.D. 8209, 53 FR 22171, June 14, 1988]

§ 1.956–3T Certain trade or service receivables acquired from United States persons (temporary).

(a) *In general.* For purposes of section 956(a) and § 1.956–1, the term ''United States property'' also includes any trade or service receivable if the trade or service receivable is acquired (directly or indirectly) after March 1, 1984, from a related person who is a United States person (as defined in section 7701(a)(30)) (hereinafter referred to as a ''related United States person'') and the obligor under the receivable is a United States person. A trade or service receivable described in this paragraph shall be considered to be United States property notwithstanding the exceptions (other than subparagraph (H)) contained in section 956(b)(2). The terms ''trade or service receivable'' and ''related person'' have the respective meanings given to such terms by section 864(d) and the regulations thereunder. For purposes of this section, the exception contained in § 1.956–2T(d)(2)(i)(B) for short-term obligations shall not apply to service receivables described in this paragraph.

(b) *Acquisition of a trade or service receivable*—(1) *General rule.* The rules of § 1.864–8T(c)(1) shall be applied to determine whether a controlled foreign corporation has acquired a trade or service receivable.

(2) *Indirect acquisitions*—(i) *Acquisition through unrelated person.* A trade or service receivable will be considered to be acquired from a related person if it is acquired from an unrelated person who acquired (directly or indirectly) such receivable from a person who is a related person to the acquiring person.

(ii) *Acquisition by nominee or pass-through entity.* A controlled foreign corporation will be considered to have acquired a trade or service receivable of a related United States person held on its behalf:

(A) By a nominee or by a partnership, simple trust, S corporation or other pass-through entity to the extent the controlled foreign corporation owns (directly or indirectly) a beneficial interest in such partnership or other pass-through entity; or

(B) By another foreign corporation that is controlled by the controlled foreign corporation, if one of the principal purposes for creating, organizing, or funding such other foreign corporation (through capital contributions or debt) is to avoid the application of section 956. *See* § 1.956–1T.

The rule of this paragraph (b)(2)(ii) does not limit the application of paragraph (b)(2)(iii) of this section regarding the characterization of trade or service receivables of unrelated persons acquired pursuant to certain swap or pooling arrangements. The following examples illustrate the application of this paragraph (b)(2)(ii).

Example 1. FS1, a controlled foreign corporation with substantial accumulated earnings and profits, contributes $2,000,000 to PS, a partnership, in exchange for a 20 percent limited partnership interest in PS. PS purchases trade or service receivables of FS1's domestic parent, P. The obligors under the receivables are United States persons. PS does not purchase receivables of any person who is related to any other partner in PS. Under paragraph (b)(2)(ii)(A) of this section, there is an investment of the earnings of FS1 in United States property equal to 20 percent of PS's basis in the receivables of P.

Example 2. FS1, a controlled foreign corporation, has accumulated more than $3,000,000 in earnings and profits. It organizes a wholly-owned foreign corporation, FS2, with a $2,000,000 equity contribution. FS2 has no earnings and profits. FS2 uses the funds to purchase trade or service receivables of FS1's domestic parent, P. The obligors under the receivables are United States persons. Under paragraph (b)(2)(ii)(B) of this section, there is an investment of the earnings of FS1 in United States property equal to $2,000,000.

(iii) *Swap or pooling arrangements.* A trade or service receivable of an unrelated person will be considered to be a trade or service receivable acquired from a related United States person and subject to the rules of this section if it is acquired in accordance with an arrangement that involves two or more groups of related persons that are unrelated to each other and the effect of the arrangement is that one or more related persons in each group acquire (directly or indirectly) trade or service receivables of one or more unrelated United States persons who are also parties to the arrangement, in exchange for reciprocal purchases of receivables of United States persons in the first group. The following example illustrates the application of this paragraph (b)(2)(iii).

Example. Controlled foreign corporations A, B, C, and D are wholly-owned subsidiaries of domestic corporations M, N, O, and P, respectively. M, N, O, and P are not related persons. According to a prearranged plan, A, B, C, and D each acquire trade or service receivables of M, N, O, and/or P. The obligors under some or all of the receivables acquired by each of A, B, C, and D are United States persons. Because the effect of this arrangement is that the unrelated groups acquire each other's trade or service receivables of United States persons pursuant to the arrangement, there is an investment of the earnings of each of A, B, C, and D in United States property to the extent of the purchase price of those receivables under which the obligors are United States persons.

(iv) *Financing arrangements.* If a controlled foreign corporation participates (directly or indirectly) in a lending transaction that results in a loan to a United States person who purchases property described in section 1221(1) (hereinafter referred to as ''inventory property'') or services of a related United States person, or to any person who purchases trade or service receivables of a related United States person under which the obligor is a United States person, or to a person who is related to any such purchaser, and if the loan would not have been made or maintained on the same terms but for the corresponding purchase, then the controlled foreign corporation shall be considered to have indirectly acquired a trade or service receivable described in paragraph (a) of this section. For purposes of this paragraph (b)(2)(iv), it is immaterial that the sums lent are not, in fact, the sums used to finance the purchase of the inventory property or services or trade or service receivables of a related United States person. The amount to be taken into account with respect to the controlled foreign corporation's investment in United States property (resulting from application of this paragraph (b)(2)(iv)) shall be the amount lent pursuant to a lending transaction described in this paragraph (b)(2)(iv), if the amount lent is equal to or less than the purchase price of the inventory property, services, or trade or service receivables. If the amount lent is greater than the purchase price of the inventory property, services or receivables, the amount to be taken into account shall be the purchase price. The following examples illustrate the application of this paragraph (b)(2)(iv).

Example 1. P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation. P sells equipment for $2,000,000 to X, an unrelated United States person. FS1 makes a $1,000,000 short-term loan to X, which loan would not have been made or maintained on the same terms but for X's purchase of P's equipment. Because FS1 directly participates in a lending transaction described in this paragraph (b)(2)(iv), FS1 is considered to have acquired the receivable of a related United States person. Thus, there is an investment of FS1's earnings and profits in United States property in the amount of $1,000,000.

Example 2. The facts are the same as in Example 1, except that instead of loaning money to X directly, FS1 deposits $3,000,000 with an unrelated financial institution that loans $2,000,000 to X in order for X to purchase P's equipment. The loan would not have been made or maintained on the same terms but for the corresponding deposit. Accordingly, the deposit and the loan are treated as a direct loan from FS1 to X. *See* Rev. Rul. 87–89, 1987–37 I.R.B. 16. Because FS1 indirectly participates in a lending transaction described in this paragraph (b)(2)(iv), FS1 is considered to have acquired the receivable of a related United States person. Thus, there is an investment of FS1's earnings and profits in United States property in the amount of $2,000,000.

Example 3. P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation. FS1 makes a $3,000,000 loan to U, an unrelated foreign corporation, in connection with U's purchase for $2,000,000 of receivables from the sale of inventory property by P to United States obligors. Because FS1 directly participates in a lending transaction described in this paragraph (b)(2)(iv), FS1 is considered to have acquired receivables of a related United States person. Thus, there is an investment of FS1's earnings and profits in United States property in the amount of $2,000,000.

(c) *Substitution of obligor.* For purposes of this section, the substitution of another person for a United States obligor may be disregarded. Thus, if a purchaser who is a United States person arranges for a foreign person to pay a United States seller of inventory property or services and the seller transfers by sale or otherwise to its own controlled foreign corporation the foreign person's obligation for payment, then the acquisition of the foreign person's obligation shall constitute an investment in United States property by the seller's controlled foreign corporation, unless it can be demonstrated by the parties to the transaction that the primary purpose for the arrangement was not the avoidance of section 956. The following example illustrates the application of this paragraph.

Example. P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation with substantial accumulated earnings and profits. P sells equipment to X, a domestic corporation unrelated to P. To pay for the equipment, X arranges for a foreign financing entity to issue a note to P. P then sells the note to FS1. FS1 has made an investment in United States property in the amount of the purchase price of the note.

[T.D. 8209, 53 FR 22169, June 14, 1988]

§ 1.957–1 Definition of controlled foreign corporation.

(a) *In general.* The term *controlled foreign corporation* means any foreign corporation of which more than 50 percent (or such lesser amount as is provided in section 957(b) or section 953(c)) of either—

(1) The total combined voting power of all classes of stock of the corporation entitled to vote; or

(2) The total value of the stock of the corporation, is owned within the meaning of section 958(a), or (except for purposes of section 953(c)) is considered as owned by applying the rules of section 958(b) and § 1.958–2, by United States shareholders on any day during the taxable year of such foreign corporation. For the definition of the term *United States shareholder,* see sections 951(b) and 953(c)(1)(A). For the definition of the term *foreign corporation,* see § 301.7701–5 of this chapter (Procedure and Administration Regulations). For the treatment of associations as corporations, see section 7701(a)(3) and §§ 301.7701–1 and 301.7701–2 of this chapter. For the definition of the term *stock,* see sections 958(a)(3) and 7701(a)(7). For the classification of a member in an association, joint stock company or insurance company as a shareholder, see section 7701(a)(8).

(b) *Percentage of total combined voting power owned by United States shareholders*—(1) *Meaning of combined voting power.* In determining for purposes of paragraph (a) of this section whether United States shareholders own the requisite percentage of total combined voting power of all classes of stock entitled to vote, consideration will be given to all the facts and circumstances of each case. In all cases, however, United States shareholders of a foreign corporation will be deemed to own the requisite percentage of total combined voting power with respect to such corporation—

(i) If they have the power to elect, appoint, or replace a majority of that body of persons exercising, with respect to such corporation, the powers ordinarily exercised by the board of directors of a domestic corporation;

(ii) If any person or persons elected or designated by such shareholders have the power, where such shareholders have the power to elect exactly one-half of the members of such governing body of such foreign corporation, either to cast a vote deciding an evenly divided vote of such body or, for the duration of any deadlock which may arise, to exercise the powers ordinarily exercised by such governing body; or

(iii) If the powers which would ordinarily be exercised by the board of directors of a domestic corporation are exercised with respect to such foreign corporation by a person whom such shareholders have the power to elect, appoint, or replace.

(2) *Shifting of formal voting power.* Any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained. The mere ownership of stock entitled to vote does not by itself mean that the shareholder owning such stock has the voting power of such stock for purposes of section 957. For example, if there is any agreement, whether express or implied, that any shareholder will not vote his stock or will vote it only in a specified manner, or that shareholders owning stock having not more than 50 percent of the total combined voting power will exercise voting power normally possessed by a majority of stockholders, then the nominal ownership of the voting power will be disregarded in determining which shareholders actually hold such voting power, and this determination

will be made on the basis of such agreement. Moreover, where United States shareholders own shares of one or more classes of stock of a foreign corporation which has another class of stock outstanding, the voting power ostensibly provided such other class of stock will be deemed owned by any person or persons on whose behalf it is exercised or, if not exercised, will be disregarded if the percentage of voting power of such other class of stock is substantially greater than its proportionate share of the corporate earnings, if the facts indicate that the shareholders of such other class of stock do not exercise their voting rights independently or fail to exercise such voting rights, and if a principal purpose of the arrangement is to avoid the classification of such foreign corporation as a controlled foreign corporation under section 957.

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

Example 1. Foreign corporation R has two classes of capital stock outstanding, 60 shares of class A stock, and 40 shares of class B stock. Each share of each class of stock has one vote for all purposes. E, a United States person, owns 51 shares of class A stock. Corporation R is a controlled foreign corporation.

Example 2. Foreign corporation S has three classes of capital stock outstanding, consisting of 60 shares of class A stock, 40 shares of class B stock, and 200 shares of class C stock. The owners of a majority of class A stock are entitled to elect 6 of the 10 corporate directors, and the owners of a majority of the class B stock are entitled to elect the other 4 of the 10 directors. Class C stock has no voting rights. D, a United States person, owns all of the shares of the class C stock. He also owns 31 shares of class A stock and as such an owner can elect 6 members of the board of directors. None of the remaining shares of class A stock, or the 40 shares of class B stock, is owned, or considered as owned, within the meaning of section 958, by a United States person. Since, as owner of 31 shares of the class A stock, D has sufficient voting power to elect 6 directors, D has more than 50 percent of the total combined voting power of all classes of stock entitled to vote, and S Corporation is a controlled foreign corporation.

Example 3. M, a United States person, owns a 51-percent interest in R Company, a foreign company of which he is a member. The company, if it were domestic, would be taxable as a corporation. The remaining interest of 49 percent in the company is owned by seven other members none of whom is a United States person. The memorandum of association of R Company provides for only one manager, who with respect to the company exercises the powers ordinarily exercised by a board of directors of a domestic corporation. The manager is to be elected by unanimous agreement of all the members. Since M owns 51 percent of the company, he will be deemed to own more than 50 percent of the total combined voting power of all classes of stock of R Company entitled to vote, notwithstanding that he has power to elect a manager only with the agreement of the other members. Company R is a controlled foreign corporation.

Example 4. Domestic corporation M owns a 49-percent interest in S Company, a foreign company of which it is a member. The company, if it were domestic, would be taxable as a corporation. Company S is formed under the laws of foreign country Y. The remaining interest of 51 percent in S Company is owned by persons who are not United States persons. The organization contract of S Company provides for one manager, B, a citizen and resident of country Y who is an officer of M Corporation in charge of its foreign operations in such country, or any person M Corporation may at any time appoint to succeed B in such capacity. The manager has the sole authority with respect to S Company to exercise powers ordinarily exercised by a board of directors of a domestic corporation. Since M Corporation has the discretionary power to replace B and to appoint his successor as manager of S Company, the company is a controlled foreign corporation.

Example 5. N, a United States person, owns 50 percent of the outstanding shares of the only class of capital stock of foreign corporation R. An additional 48 percent of the outstanding shares is owned by foreign corporation S. The remaining 2 percent of shares is owned by P, a citizen and resident of foreign country T, who regularly acts as attorney for N in the conduct of N's business affairs in country T. All of the shares of the outstanding capital stock of R Corporation are bearer shares. At the time of the issuance of the shares to him, P places the certificates for such shares in a depository to which N has access. On several occasions N, with P's acquiescence, has taken such shares from the depository and, on one such occasion, used the shares as collateral in borrowing funds on a loan. Although dividends, when paid, are paid to P on his shares, his charges to N for legal fees are reduced by the amount of the dividends paid on such shares. Although P votes his shares at meetings of shareholders, the facts set forth above indicate an implied agreement between P and N that N is really to retain dominion over the stock. N is deemed to own the voting rights ostensibly attached to the stock owned by P, and R Corporation is a controlled foreign corporation.

Example 6. M, a domestic corporation which manufactures in the United States and distributes all of its production for foreign consumption through N, a person other than a related person or a United States person, forms foreign corporation S to purchase products from M Corporation and sell them to N. Corporations S and M have common directors. The outstanding capital stock of S Corporation consists of 10,000 shares of $100 par value class A stock, which has no voting rights except to vote for dissolution of the corporation on a share-for-share basis, and 500 shares of no par class B stock which has full voting rights. Each class of the outstanding stock is to participate on a share for share basis in any dividend. The class A stock has a preference as to assets on dissolution of the corporation to the extent of its par value as well as the right to participate with the class B stock in all other assets on a share for share basis. All of the shares of class A stock are issued to M Corporation in return for property having a value of $1 million. Of the class B stock, 300 of the shares are issued to N in return for $3,000 in cash and 200 shares are issued to M Corporation for $2,000 in cash. At stockholder meetings N never votes in opposition to M Corporation on important issues. Corporation S has average annual earnings of $200,000, all of which will be subpart F income if S Corporation is held to be a controlled foreign corporation. All such earnings are accumulated. Although N ostensibly has 60 percent of the voting power of S Corporation by virtue of his ownership of 300 shares of class B stock, he has the right to only approximately 3 percent of any dividends which may be paid by S Corporation; in addition, upon liquidation of S Corporation, N is entitled to share in the assets only after M Corporation has received the par value of its 10,000 shares of class A stock, or $1 million. Thus, the voting power owned by N is substantially greater than its proportionate share of the earnings of S Corporation. In addition, the facts set forth above indicate that N is not exercising his voting rights independently and that a principal purpose of the capitalization arrangement is to avoid classification of S Corporation as a controlled foreign corporation. For these reasons, the voting power ostensibly provided the class B stock will be deemed owned by M Corporation, and S Corporation is a controlled foreign corporation.

Example 7. Foreign corporation A, authorized to issue 100 shares of one class of capital stock, issues, for $1,000 per share, 45 shares to domestic corporation M, 45 shares to foreign corporation B, and 10 shares to foreign corporation C. Corporation C, a bank, lends $3 million to finance the operations of A Corporation. In the course of negotiating these financial arrangements, D, an officer of C Corporation, and E, an officer of M Corporation, orally agree that C Corporation will vote its stock as M Corporation directs. By virtue of such oral agreement M Corporation possesses the voting power ostensibly owned by C Corporation, and A Corporation is a controlled foreign corporation.

Example 8. For its prior taxable year, *JV*, a foreign corporation, had outstanding 1000 shares of class A stock, which is voting common, and 1000 shares of class B stock, which is nonvoting preferred. *DP*, a domestic corporation, and *FP*, a foreign corporation, each owned precisely 500 shares of both class A and class B stock, and each elected 5 of the 10 members of *JV*'s board of directors. The other facts and circumstances were such that *JV* was not a controlled foreign corporation on any day of the prior taxable year. On the first day of the current taxable year, *DP* purchased one share of class B stock from *FP*. *JV* was a controlled foreign corporation on the following day because over 50 percent of the total value in the corporation was held by a person that was a United States shareholder under section 951(b). See § 1.951–1(f).

Example 9. The facts are the same as in *Example 8* except that the stock of *FP* was publicly traded, *FP* had one class of stock, and on the first day of the current taxable year *DP* purchased one share of *FP* stock on the foreign stock exchange instead of purchasing one share of *JV* stock from *FP*. *JV* became a controlled foreign corporation on the following day because over 50 percent of the total value in the corporation was held by a person that was a United States shareholder under section 951(b).

Example 10. X, a foreign corporation, is incorporated under the laws of country *Y*. Under the laws of country *Y, X* is considered a mutual insurance company. *X* issues insurance policies that provide the policyholder with the right to vote for directors of the corporation, the right to a share of the assets upon liquidation in proportion to premiums paid, and the right to receive policyholder dividends in proportion to premiums paid. Only policyholders are provided with the right to vote for directors, share in assets upon liquidation, and receive distributions. United States policyholders contribute 25 percent of the premiums and have 25 percent of the outstanding rights to vote for the board of directors. Based on these facts, the United States policyholders are United States shareholders owning the requisite combined voting power and value. Thus, *X* is a controlled foreign corporation for purposes of taking into account related person insurance income under section 953(c).

(d) *Effective date.* Paragraphs (a) and (c) *Examples 8* through *10* of this section are effective for taxable years of a controlled foreign corporation beginning after November 6, 1995.

[T.D. 6688, 28 FR 11631, Oct. 31, 1963, as amended by T.D. 8216, 53 FR 27510, July 21, 1988; T.D. 8618, 60 FR 46529, Sept. 7, 1995; 60 FR 62026, Dec. 4, 1995; T.D. 8704, 62 FR 21, Jan. 2, 1997]

§1.957–2 Controlled foreign corporation deriving income from insurance of United States risks.

(a) *In general.* For purposes of taking into account only the income derived from the insurance of United States risks under §1.953–1, the term ‘‘controlled foreign corporation’’ means any foreign corporation of which more than 25 percent, but not more than 50 percent, of the total combined voting power of all classes of stock entitled to vote is owned within the meaning of section 958(a), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day of the taxable year of such foreign corporation, but only if the gross amount of premiums received by such foreign corporation during such taxable year which are attributable to the reinsuring and the issuing of insurance and annuity contracts in connection with United States risks, as defined in §1.953–2 or 1.953–3, exceeds 75 percent of the gross amount of all premiums received by such foreign corporation during such year which are attributable to the reinsuring and the issuing of insurance and annuity contracts in connection with all risks. The subpart F income for a taxable year of a foreign corporation which is a controlled foreign corporation for such taxable year within the meaning of this paragraph shall, subject to the provisions of section 952(b), (c), and (d), and §1.952–1, include only the income derived from the insurance of United States risks, as determined under §1.953–1.

(b) *Gross amount of premiums defined.* For a foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as—

(1) A life insurance company to which part I (sections 801 through 820) of subchapter L of the Code applies,

(2) A mutual insurance company to which part II (sections 821 through 826) of subchapter L of the Code applies, or

(3) A mutual marine insurance or other insurance company to which part III (sections 831 and 832) of subchapter L of the Code applies,

the term ‘‘gross amount of premiums’’ means, for purposes of paragraph (a) of this section, the gross amount of premiums and other consideration which are taken into account by a life insurance company under section 809(c)(1). Determinations for purposes of this paragraph shall be made without regard to section 501(a).

[T.D. 6795, 30 FR 942, Jan. 29, 1965]

§1.957–3 Corporations organized in United States possessions.

(a) *General rule.* For purposes of sections 951 through 964, a corporation created or organized in a possession of the United States or under the laws of a possession of the United States shall not be treated as a controlled foreign corporation for any taxable year if—

(1) 80 percent or more of the gross income of such corporation for the 3-year period immediately preceding the close of the taxable year or for such part of such 3-year period as such corporation was in existence or for such part of such 3-year period as occurs on and after the beginning of such corporation’s first annual accounting period beginning after December 31, 1962, whichever period is shortest, was derived from sources within a possession of the United States; and

(2) 50 percent or more of the gross income of such corporation for such period, or for such part of such period, was derived from the active conduct within a possession of the United States of one or more trades or businesses constituting—

(i) The manufacture or processing of goods, wares, merchandise, or other tangible personal property;

(ii) The processing of agricultural or horticultural products or commodities (including but not limited to livestock, poultry, or fur-bearing animals);

(iii) The catching or taking of any kind of fish, or any manufacturing or processing of any products or commodities obtained from such activities;

(iv) The mining or extraction of natural resources, or any manufacturing or processing of any products or commodities obtained from such activities; or

(v) The ownership or operation of hotels.

(b) *Special provisions.* For purposes of section 957(c) and this section—

(1) *United States defined.* The term ''United States'' includes only the States and the District of Columbia.

(2) *Possession of the United States defined.* The term ''possession of the United States'' includes Guam, the Midway Islands, the Panama Canal Zone, the Commonwealth of Puerto Rico, American Samoa, the Virgin Islands, and Wake Island.

(3) *Determination of source of gross income.* Whether gross income of a corporation referred to in paragraph (a) of this section is derived from sources within a possession of the United States shall be determined by the application of the provisions of § 1.955–6 except that, for purposes of making such determination, the term ''produced'', as used in paragraph (d)(2) of § 1.955–6, shall also include the activities described in paragraph (a)(2)(i) through (iv) of this section and the activities considered, under subparagraph (4) of this paragraph, to be qualifying trades or businesses.

(4) *Manufacturing or processing.* The trades or businesses which qualify under the provisions of paragraph (a)(2) of this section shall include, but not be limited to, the manufacture of tabulating cards, paper tablets or pads, facial tissues, and paper napkins from rolls of paper; the manufacture of such household products as liquid starch by mixing quantities of the ingredients which are used to produce liquid starch; and the manufacture of juices and drinks from fruit concentrates. In the application of paragraph (a)(2) of this section, proper regard shall be given to the classification of a trade or business as a manufacturing or processing activity under the applicable economic incentive law of the possession involved. The fact that an activity of a corporation qualifies as a trade or business for purposes of paragraph (a) of this section does not necessarily mean that such activity constitutes a substantial transformation of property within the meaning of paragraph (a)(4) of § 1.954–3 for purposes of determining any foreign base company income of such corporation.

[T.D. 6683, 28 FR 11184, Oct. 18, 1963]

§ 1.957–4 United States person defined.

(a) *Basic rule*—(1) *In general.* The term ''United States person'' has the same meaning for purposes of sections 951 through 964 which it has under section 7701(a)(30) and in the regulations thereunder, except as provided in section 957(d) and paragraphs (b), (c), and (d) of this section which provide, with respect to corporations organized in possessions of the United States, that certain residents of such possessions are not United States persons. The effect of determining that an individual is not a United States person for such purposes is to exclude such individual in determining whether a foreign corporation created or organized in, or under the laws of, Puerto Rico, the Virgin Islands, or any possession of the United States (other than Puerto Rico or the Virgin Islands) is a controlled foreign corporation. See § 1.957–1 for definition of the term ''controlled foreign corporation''; § 1.957–2 for a special limitation on the amount of subpart F income of certain controlled foreign corporations deriving income from the insurance of United States risks; and § 1.957–3 for the exclusion of certain corporations organized in United States possessions from the definition of controlled foreign corporation.

(2) *Special provisions applicable to possessions of the United States.* For purposes of section 957(d) and this section—

(i) *Possession of the United States defined.* The term ''possession of the United States'' has the same meaning which it has under paragraph (b)(2) of § 1.957–3.

(ii) *Determination of residence in a possession.* Whether an individual is a bona fide resident of Puerto Rico, the Virgin Islands, or any other possession of the United States, shall be determined in general by applying to the facts and circumstances in each case the principles of §§1.871–2 through 1.871–5, relating to the determination of residence in the United States.

(b) *Puerto Rico corporation and resident.* With respect only to a foreign corporation created or organized in, or under the laws of, Puerto Rico—

(1) If an individual (who, without regard to this paragraph, is a United States person) is a bona fide resident of Puerto Rico during his entire taxable year in which or with which the taxable year of such foreign corporation ends, and

(2) If 50 percent or more of the gross income of such foreign corporation is derived from sources within Puerto Rico, as determined under §1.863–6, for the 3-year period (or for such part of such 3-year period as such foreign corporation has been in existence) ending with the close of the taxable year of such foreign corporation which—

(i) Ends with or within the taxable year next preceding such taxable year of such individual and at any time, during the period beginning with the beginning of such latter taxable year of such individual and ending not later than one year after the close of such taxable year of such foreign corporation, such individual directly owns stock in such foreign corporation, or

(ii) Ends within such taxable year of such individual and at any time, during the period beginning after the close of such taxable year of such foreign corporation and ending with the close of such taxable year of such individual, such individual directly owns stock in such foreign corporation,

then, such individual shall not be considered a United States person with respect to such corporation for the taxable year of such corporation which ends with or within the taxable year of such person. The application of this paragraph may be illustrated by the following examples:

Example 1. Foreign corporation R, incorporated under the laws of Puerto Rico, is wholly owned by D, a United States citizen. D and corporation R use the calendar year as the taxable year. For 1961, 1962, and 1963, 60 percent of the gross income of R Corporation is derived from sources within Puerto Rico and 40 percent of the gross income of R Corporation is derived from sources within Panama, as determined under §1.863–6. During all of 1964, D is a bona fide resident of Puerto Rico. D is not a United States person with respect to R Corporation for 1964. Accordingly, R Corporation is not a controlled foreign corporation at any time in 1964.

Example 2. Foreign corporation R is incorporated on January 1, 1962, under the laws of Puerto Rico. D, a United States citizen, owns all the one class of stock of R Corporation throughout 1962 and 1963. D and corporation R use the calendar year as the taxable year. For 1962, 55 percent of the gross income of R Corporation is derived from sources within Puerto Rico and 45 percent of the gross income of R Corporation is derived from sources within the Netherlands Antilles, as determined under §1.863–6. For 1963, 40 percent of the gross income of R Corporation is derived from sources within Puerto Rico and 60 percent of the gross income of R Corporation is derived from sources within the Netherlands Antilles, as determined under §1.863–6. During all of 1963 D is a bona fide resident of Puerto Rico. With respect to R Corporation, D is not a United States person for 1963 because D is a bona fide resident of Puerto Rico for all of 1963; 55 percent of the gross income of R Corporation for 1962 is derived from sources within Puerto Rico; and D owns stock in R Corporation at some time during 1963. Accordingly, R Corporation is not a controlled foreign corporation at any time in 1963. In making this determination, it is immaterial that R Corporation does not satisfy the 50-percent gross income test for 1963, the taxable year during all of which D is a resident of Puerto Rico.

Example 3. Foreign corporation R is incorporated on January 1, 1962, under the laws of Puerto Rico. D, a United States citizen, owns all the one class of stock of R Corporation throughout 1962 and 1963. D and corporation R use the calendar year as the taxable year. For 1962, 45 percent of the gross income of R Corporation is derived from sources within Puerto Rico and 55 percent of the gross income of R Corporation is derived from sources within the Netherlands Antilles, as determined under §1.863–6. For 1963, 60 percent of the gross income of R Corporation is derived from sources within Puerto Rico and 40 percent of the gross income of R Corporation is derived from sources within the Netherlands Antilles, as determined under §1.863–6. With respect to R Corporation, D is a United States person for 1963, since R Corporation does not satisfy the 50-percent gross income test for 1962. Accordingly, R Corporation is a controlled foreign corporation for all of 1963.

Example 4. Foreign corporation S is incorporated on July 1, 1962, under the laws of Puerto Rico. Corporation S uses the fiscal year ending on June 30 as the taxable year. For its fiscal year ending on June 30, 1963, 55 percent of the gross income of S Corporation is derived from sources within Puerto Rico and 45 percent of the gross income of S Corporation is derived from sources within Switzerland, as determined under § 1.863–6. For its fiscal years ending on June 30, 1964, and June 30, 1965, respectively, 40 percent of the gross income of S Corporation is derived from sources within Puerto Rico and 60 percent of the gross income of S Corporation is derived from sources within Switzerland, as determined under § 1.863–6. B, a United States citizen, who uses the calendar year as the taxable year, is a bona fide resident of Puerto Rico for all of 1964. On July 1, 1964, B acquires, and holds throughout the remainder of 1964, all of the one class of stock of S Corporation. With respect to S Corporation for its taxable year ending June 30, 1964, B is a United States person because—

(a) Although B is a bona fide resident of Puerto Rico for his entire year 1964 in which ends S Corporation's taxable year ending June 30, 1964, and S Corporation meets the 50-percent gross income test for the applicable part of the 3-year period ending June 30, 1963, B does not own stock in S Corporation during the period beginning January 1, 1964, and ending June 30, 1964, and

(b) Although B owns stock in S Corporation during the period beginning July 1, 1964, and ending December 31, 1964, S Corporation does not meet the 50-percent gross income test for the applicable part of the 3-year period ending June 30, 1964.

Accordingly, with respect to B, S Corporation is a controlled foreign corporation for its entire taxable year ending June 30, 1964.

Example 5. The facts are the same as in example 4, except B buys all of the stock of S Corporation on June 1, 1964, rather than on July 1, 1964. With respect to S Corporation for its taxable year ending June 30, 1964, B is not a United States person because B is a bona fide resident of Puerto Rico for his entire taxable year 1964 in which ends S Corporation's taxable year ending June 30, 1964; S Corporation meets the 50-percent gross income test for the applicable part of the 3-year period ending June 30, 1963; and B owns stock in S Corporation during the period beginning January 1, 1964, and ending June 30, 1964. Accordingly, with respect to B, S Corporation is not a controlled foreign corporation at any time during its taxable year ending June 30, 1964.

(c) *Virgin Islands corporation and President.* With respect only to a foreign corporation created or organized in, or under the laws of, the Virgin Islands—

(1) If an individual (who, without regard to this paragraph, is a United States person) is a bona fide resident of the Virgin Islands as of the last day of his taxable year in which or with which the taxable year of such foreign corporation ends, and

(2) Such individual's income tax obligations under subtitle A (relating to income taxes) of the Code for his taxable year are satisfied, in accordance with section 28(a) of the Revised Organic Act of the Virgin Islands (48 U.S.C. 1642), by paying the tax on his income derived from all sources, both within and outside the Virgin Islands, into the treasury of the Virgin Islands, then, such individual shall not be considered a United States person with respect to such corporation for the taxable year of such corporation which ends with or within the taxable year of such person. The application of this paragraph may be illustrated by the following examples:

Example 1. Foreign corporation S, incorporated under the laws of the Virgin Islands, is wholly owned by D, a United States citizen. Corporation S uses the fiscal year ending on June 30 as the taxable year, and D uses the calendar year as the taxable year. From September 1, 1963, to December 31, 1964, inclusive, D is a bona fide resident of the Virgin Islands. For 1963 and 1964, D satisfies his income tax obligations under section 28(a) of the Revised Organic Act of the Virgin Islands by paying the tax on his income derived from all sources, both within and outside the Virgin Islands, into the treasury of the Virgin Islands. With respect to S Corporation for its taxable years ending June 30, 1963, and 1964, D is not a United States person. Accordingly, S Corporation is not a controlled foreign corporation for such taxable years of such corporation.

Example 2. The facts are the same as in example 1, except that from August 15, 1964, to December 31, 1964, inclusive, D is a bona fide resident of the United States. Thus, D does not satisfy his income tax obligations for 1964 under section 28(a) of the Revised Organic Act of the Virgin Islands. The result is the same as in example 1, except that with respect to S Corporation for its taxable year ending June 30, 1964, D is a United States person and, accordingly, S Corporation is a controlled foreign corporation for such taxable year of such corporation.

(d) *Corporation and resident of other United States possessions.* With respect only to a foreign corporation created or organized in, or under the laws of, any possession of the United States (other than Puerto Rico or the Virgin Islands)—

(1) If an individual (who, without regard to this paragraph, is a United

States person) is a bona fide resident of such possession during his entire taxable year in which or with which the taxable year of such foreign corporation ends, and

(2) Any part or all of such individual's income (other than amounts includible in his gross income under section 951(a)) for his taxable year derived, in accordance with §1.863–6, from sources within any possession of the United States (whether or not the possession of which such individual is a resident) is not, as a result of the application of section 931, included in his gross income for his taxable year,

then, such individual shall not be considered a United States person with respect to such corporation for the taxable year of such corporation which ends with or within the taxable year of such person. Subparagraph (2) of this paragraph shall apply only for purposes of determining whether an individual is a United States person; after such determination has been made, section 931 shall be applied to the gross income (including amounts includible in gross income under section 951(a)) of such individual to determine the amount to be excluded from such individual's gross income under section 931. The application of this paragraph may be illustrated by the following examples:

Example 1. Foreign corporation R, incorporated under the laws of Guam, is wholly owned by D, a United States citizen. D and corporation R use the calendar year as the taxable year and the cash receipts and disbursements method of accounting. D is a bona fide resident of Guam for all of 1963 and all of his income of $30,000 (determined without taking into account amounts includible in his gross income under section 951(a)) is derived from sources within Guam. Of such income, $24,000 is received in Guam and $6,000 is erceived in the United States. It meets the 3-year test of section 931(a) and, but for the application of section 931(b), all of his income of $30,000 would be excluded from gross income for 1963 under section 931. However, in accordance with section 931(b) and paragraph (c) of §1.931–1, the $6,000 received in the United States is included in gross income. Nevertheless, since part ($24,000) of his income of $30,000 for 1963 derived, in accordance with §1.863–6, from sources within Guam is not, as a result of the application of section 931, included in his gross income, D is not a United States person with respect to R Corporation for its taxable year 1963. Accordingly, R Corporation is not a controlled foreign corporation for its taxable year 1963.

Example 2. The facts are the same as in example 1, except that, instead of receiving the $6,000 in the United States, D receives $10,000 of the $30,000 in Guam for services performed for an agency of the United States. Under §1.863–6, all of D's income for 1963 is income derived from sources within Guam. However, since D's income of $10,000 from the agency of the United States is deemed under section 931 (i) to be derived from sources within the United States for purposes of section 931, at least 80 percent of his gross income for 1963, determined without the application of section 931, is not derived from sources within Guam. Accordingly, since no part of D's gross income of $30,000 for 1963 derived, in accordance with §1.863–6, from sources within Guam is, as a result of the application of section 931, excluded from gross income for 1963, D is a United States person with respect to R Corporation for R Corporation's taxable year 1963. Accordingly, R Corporation is a controlled foreign corporation for its taxable year 1963.

[T.D. 6775, 29 FR 16082, Dec. 2, 1964]

§1.958–1 Direct and indirect ownership of stock.

(a) *In general.* Section 958(a) provides that, for purposes of sections 951 to 964 (other than sections 955(b)(1)(A) and (B) and 955(c)(2)(A)(ii) (as in effect before the enactment of the Tax Reduction Act of 1975), and 960(a)(1)), stock owned means—

(1) Stock owned directly; and

(2) Stock owned with the application of paragraph (b) of this section.

The rules of section 958(a) and this section provide a limited form of stock attribution primarily for use in determining the amount taxable to a United States shareholder under section 951(a). These rules also apply for purposes of other provisions of the Code and regulations which make express reference to section 958(a).

(b) *Stock ownership through foreign entities.* For purposes of paragraph (a)(2) of this section, stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or foreign estate (within the meaning of section 7701(a)(31)) shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries, respectively. Stock considered to be owned by reason of the application of this paragraph shall, for purposes of reapplying this paragraph, be treated as actually owned by such person. Thus, this rule creates a chain of ownership; however, since the rule applies only to stock owned by a foreign entity, attribution under the rule stops with the first United States person in the chain of ownership running from the foreign entity. The application of this paragraph may be illustrated by the following example:

Example. Domestic corporation M owns 75 percent of the one class of stock in foreign corporation R, which in turn owns 80 percent of the one class of stock in foreign corporation S, which in turn owns 90 percent of the one class of stock in foreign corporation T. Under this paragraph, R Corporation is considered as owning 80 percent of the 90 percent of the stock which S Corporation owns in T Corporation, or 72 percent. Corporation M is considered as owning 75 percent of such 72 percent of the stock in T Corporation, or 54 percent. Since M Corporation is a domestic corporation, the attribution under this paragraph stops with M Corporation, even though, illustratively, such corporation is wholly owned by domestic corporation N.

(c) *Rules of application*—(1) *Special rule for mutual insurance companies.* For purposes of applying paragraph (a) of this section in the case of a foreign mutual insurance company, the term ''stock'' shall include any certificate entitling the holder to voting power in the corporation.

(2) *Amount of interest in foreign corporation, foreign partnership, foreign trust, or foreign estate.* The determination of a person's proportionate interest in a foreign corporation, foreign partnership, foreign trust, or foreign estate will be made on the basis of all the facts and circumstances in each case. Generally, in determining a person's proportionate interest in a foreign corporation, the purpose for which the rules of section 958(a) and this section are being applied will be taken into account. Thus, if the rules of section 958(a) are being applied to determine the amount of stock owned for purposes of section 951(a), a person's proportionate interest in a foreign corporation will generally be determined with reference to such person's interest in the income of such corporation. If the rules of section 958(a) are being applied to determine the amount of voting power owned for purposes of section 951(b) or 957, a person's proportionate interest in a foreign corporation will generally be determined with reference to the amount of voting power in such corporation owned by such person. However, any arrangement which artificially decreases a United States person's proportionate interest will not be recognized. See §§ 1.951–1 and 1.957–1.

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

Example 1. United States persons A and B own 25 percent and 50 percent, respectively, of the one class of stock in foreign corporation M. Corporation M owns 80 percent of the one class of stock in foreign corporation N, and N Corporation owns 60 percent of the one class of stock in foreign corporation P. Under paragraph (b) of this section, M Corporation is considered to own 48 percent (80 percent of 60 percent) of the stock in P Corporation; such 48 percent is treated as actually owned by M Corporation for the purpose of again applying paragraph (b) of this section. Thus, A and B are considered to own 12 percent (25 percent of 48 percent) and 24 percent (50 percent of 48 percent), respectively, of the stock in P Corporation.

Example 2. United States person C is a 60-percent partner in foreign partnership X. Partnership X owns 40 percent of the one class of stock in foreign corporation Q. Corporation Q is a 50-percent partner in foreign partnership Y, and partnership Y owns 100 percent of the one class of stock in foreign corporation R. By the application of paragraph (b) of this section, C is considered to own 12 percent (60 percent of 40 percent of 50 percent of 100 percent) of the stock in R Corporation.

Example 3. Foreign trust Z was created for the benefit of United States persons D, E, and F. Under the terms of the trust instrument, the trust income is required to be divided into three equal shares. Each beneficiary's share of the income may either be accumulated for him or distributed to him in the discretion of the trustee. In 1970, the trust is to terminate and there is to be paid over to each beneficiary the accumulated income applicable to his share and one-third of the corpus. The corpus of trust Z is composed of 90 percent of the one class of stock in foreign corporation S. By the application of this section, each of D, E, and F is considered to own 30 percent (⅓ of 90 percent) of the stock in S Corporation.

Example 4. Among the assets of foreign estate W are Blackacre and a block of stock, consisting of 75 percent of the one class of stock of foreign corporation T. Under the terms of the will governing estate W, Blackacre is left to G, a nonresident alien, for life, remainder to H, a nonresident alien, and the block of stock is left to United States person K. By the application of this section, K is considered to own the 75 percent of the stock of T Corporation, and G and H are not considered to own any of such stock.

[T.D. 6889, 31 FR 9455, July 12, 1966, as amended by T.D. 7893, 48 FR 22509, May 19, 1983]

§1.958–2 Constructive ownership of stock.

(a) *In general.* Section 958(b) provides that, for purposes of sections 951(b), 954(d)(3), 956(b)(2), and 957, the rules of section 318(a) as modified by section 958(b) and this section shall apply to the extent that the effect is to treat a United States person as a United States shareholder within the meaning of section 951(b), to treat a person as a related person within the meaning of section 954(d)(3), to treat the stock of a domestic corporation as owned by a United States shareholder of a controlled foreign corporation under section 956(b)(2), or to treat a foreign corporation as a controlled foreign corporation under section 957. The rules contained in this section also apply for purposes of other provisions of the Code and regulations which make express reference to section 958(b).

(b) *Members of family*—(1) *In general.* Except as provided in subparagraph (3) of this paragraph, an individual shall be considered as owning the stock owned, directly or indirectly, by or for—

(i) His spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance); and

(ii) His children, grandchildren, and parents.

(2) *Effect of adoption.* For purposes of subparagraph (1)(ii) of this paragraph, a legally adopted child of an individual shall be treated as a child of such individual by blood.

(3) *Stock owned by nonresident alien individual.* For purposes of this paragraph, stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered as owned by a United States citizen or a resident alien individual. However, this limitation does not apply for purposes of determining whether the stock of a domestic corporation is owned or considered as owned by a United States shareholder under section 956(b)(2) and §1.956–2(b)(1)(viii). See section 958(b)(1).

(c) *Attribution from partnerships, estates, trusts, and corporations*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph—

(i) *From partnerships and estates.* Stock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries.

(ii) *From trusts—(a) To beneficiaries.* Stock owned, directly or indirectly, by or for a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust.

(b) To owner. Stock owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under sections 671 to 678 (relating to grantors and others treated as substantial owners) shall be considered as owned by such person.

(iii) *From corporations.* If 10 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation. See section 958(b)(3).

(2) *Rules of application.* For purposes of subparagraph (1) of this paragraph, if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote in a corporation, it shall be considered as owning all the stock entitled to vote. See section 958(b)(2).

(d) *Attribution to partnerships, estates, trusts, and corporations*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph—

(i) *To partnerships and estates.* Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as owned by the partnership or estate.

(ii) *To trusts—(a) From beneficiaries.* Stock owned, directly or indirectly, by or for a beneficiary of a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. For purposes of the preceding sentence, a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5 percent or less of the value of the trust property.

(b) From owner. Stock owned, directly or indirectly, by or for a person who is considered the owner of any portion of a trust under sections 671 to 678 (relating to grantors and others treated as substantial owners) shall be considered as owned by the trust.

(iii) *To corporations.* If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person. This subdivision shall not be applied so as to consider a corporation as owning its own stock.

(2) *Limitation.* Subparagraph (1) of this paragraph shall not be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person. This limitation does not apply for purposes of determining whether the stock of a domestic corporation is owned or considered as owned by a United States shareholder under section 956(b)(2) and § 1.956–2(b)(1)(viii). See section 958(b)(4).

(e) *Options.* If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of the preceding sentence, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

(f) *Rules of application.* For purposes of this section—

(1) *Stock treated as actually owned*— (i) *In general.* Except as provided in subdivisions (ii) and (iii) of this subparagraph, stock constructively owned by a person by reason of the application of paragraphs (b), (c), (d), and (e) of this section shall, for purposes of applying such paragraphs, be considered as actually owned by such person.

(ii) *Members of family.* Stock constructively owned by an individual by reason of the application of paragraph (b) of this section shall not be considered as owned by him for purposes of again applying such paragraph in order to make another the constructive owner of such stock.

(iii) *Partnerships, estates, trusts, and corporation.* Stock constructively owned by a partnership, estate, trust, or corporation by reason of the application of paragraph (d) of this section shall not be considered as owned by it for purposes of applying paragraph (c) of this section in order to make another the constructive owner of such stock.

(iv) *Option rule in lieu of family rule.* For purposes of this subparagraph, if stock may be considered as owned by an individual under paragraph (b) or (e) of this section, it shall be considered as owned by him under paragraph (e).

(2) *Coordination of different attribution rules.* For purposes of any one determination, stock which may be owned under more than one of the rules of § 1.958–1 and this section, or by more than one person, shall be owned under that attribution rule which imputes to the person, or persons, concerned the largest total percentage of such stock. The application of this subparagraph may be illustrated by the following examples:

Example 1. (a) United States persons A and B, and domestic corporation M, own 9 percent, 32 percent, and 10 percent, respectively, of the one class of stock in foreign corporation R. A also owns 10 percent of the one class of stock in M Corporation. For purposes of determining whether A is a United States shareholder with respect to R Corporation, 10 percent of the 10-percent interest of M Corporation in R Corporation is considered as owned by A. See paragraph (c)(1)(iii) of this section. Thus, A owns 10 percent (9 percent plus 10 percent of 10 percent) of the stock in R Corporation and is a United States shareholder with respect to such corporation. Corporation M and B, by reason of owning 10 percent and 32 percent, respectively, of the stock in R Corporation are United States shareholders with respect to such corporation.

(b) For purposes of determining whether R Corporation is a controlled foreign corporation, the 1 percent of the stock in R Corporation directly owned by M Corporation and considered as owned by A cannot be counted twice. Therefore, the total amount of stock in R Corporation owned by United States shareholders is 51 percent, determined as follows:

STOCK OWNERSHIP IN R CORPORATION
[percent]

A	9
B	32
M Corporation	10
Total	51

Example 2. United States person C owns 10 percent of the one class of stock in foreign corporation N, which owns 60 percent of the one class of stock in foreign corporation S. Under paragraph (a)(2) of § 1.958–1, C is considered as owning 6 percent (10 percent of 60 percent) of the stock in S Corporation. Under paragraph (c)(1)(iii) and (2) of this section N Corporation is considered as owning 100 percent of the stock in S Corporation and C is considered as owning 10 percent of such 100 percent, or 10 percent of the stock in S Corporation. Thus, for purposes of determining whether C is a United States shareholder with respect to S Corporation, the attribution rules of paragraph (c)(1)(iii) and (2) of this section are used inasmuch as C owns a larger total percentage of the stock of S Corporation under such rules.

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

Example 1. United States persons A and B own 5 percent and 25 percent, respectively, of the one class of stock in foreign corporation M. Corporation M owns 60 percent of the one class of stock in foreign corporation N. Under paragraph (a)(2) of § 1.958–1, A and B are considered as owning 3 percent (5 percent of 60 percent) and 15 percent (25 percent of 60 percent), respectively, of the stock in N Corporation. Under paragraph (c)(2) of this section, M Corporation is treated as owning all the stock in N Corporation, and, under paragraph (c)(1)(iii) of this section, B is considered as owning 25 percent of such 100 percent, or 25 percent of the stock in N Corporation. Inasmuch as A owns less than 10 percent of the stock in M Corporation, he is not considered as owning, under paragraph (c)(1)(iii) of this section, any of the stock in N Corporation owned by M Corporation. Thus, the attribution rules of paragraph (a)(2) of § 1.958–1 are used with respect to A inasmuch as he owns a larger total percentage of the stock of N Corporation under such rules; and the attribution rules of paragraph (c)(1)(iii) and (2) of this section are used with respect to B inasmuch as he owns a larger total percentage of the stock of N Corporation under such rules.

Example 2. United States person C owns 60 percent of the one class of stock in domestic corporation P; corporation P owns 60 percent of the one class of stock in foreign corporation Q; and corporation Q owns 60 percent of the one class of stock in foreign corporation R. Under paragraph (a)(2) of § 1.958–1, P Corporation is considered as owning 36 percent (60 percent of 60 percent) of the stock in R Corporation, and C is considered as owning none of the stock in R Corporation inasmuch as the chain of ownership stops at the first United States person and P Corporation is such a person. Under paragraph (c)(2) of this section, Q Corporation is treated as owning 100 percent of the stock in R Corporation, and under paragraph (c)(1)(iii) of this section, P Corporation is considered as owning 60 percent of such 100 percent, or 60 percent of the stock in R Corporation. For purposes of determining the amount of stock in R Corporation which C is considered as owning, P Corporation is treated under paragraph (c)(2) of this section as owning 100 percent of the stock in R Corporation; therefore, C is considered as owning 60 percent of the stock in R Corporation. Thus, the attribution rules of paragraph (c)(1)(iii) and (2) of this section are used with respect to C and P Corporation inasmuch as they each own a larger total percentage of the stock of R Corporation under such rules.

Example 3. United States person D owns 25 percent of the one class of stock in foreign corporation S. D is also a 40-percent partner in domestic partnership X, which owns 50 percent of the one class of stock in domestic corporation T. Under paragraph (d)(1)(i) of this section, the 25 percent of the stock in S Corporation owned by D is considered as being owned by partnership X; since such stock is treated as actually owned by partnership X under paragraph (f)(1)(i) of this section, such stock is in turn considered as being owned by T Corporation under paragraph (d)(1)(iii) of this section. Thus, under paragraphs (d)(1) and (f)(1)(i) of this section, T Corporation is considered as owning 25 percent of the stock in S Corporation.

Example 4. Foreign corporation U owns 100 percent of the one class of stock in domestic corporation V and also 100 percent of the one class of stock in foreign corporation W. By virtue of paragraph (d)(2) of this section, V Corporation may not be considered under paragraph (d)(1) of this section as owning the stock owned by its sole shareholder, U Corporation, in W Corporation.

Example 5. United States citizen E owns 15 percent of the one class of stock in foreign corporation Y, and United States citizen F, E's spouse, owns 5 percent of such stock. E and F's four nonresident alien grandchildren each own 20 percent of the stock in Y Corporation. Under paragraph (b)(1) of this section, E is considered as owning the stock owned by F in Y Corporation; however, by virtue of paragraph (b)(3) of this section, E may not be considered under paragraph (b)(1) of this section as owning any of the stock in Y Corporation owned by such grandchildren.

Example 6. United States person F owns 10 percent of the one class of stock in foreign corporation Z; corporation Z owns 10 percent of the one class of stock in foreign corporation K; and corporation K owns 100 percent of the one class of stock in foreign corporation L. United States person G, F's spouse, owns 9 percent of the stock in K Corporation. Under paragraph (c)(1)(iii) of this section or paragraph (a)(2) of § 1.958–1, F is considered as owning 1 percent (10 percent of 10 percent of 100 percent) of the stock in L Corporation by reason of his ownership of stock in Z Corporation, and, under paragraph (b)(1) of this section, G is considered as owning such 1 percent of the stock in L Corporation. Under paragraph (a)(2) of § 1.958–1, G is considered as owning 9 percent (9 percent of 100 percent) of the stock in L Corporation by reason of her ownership of stock in K Corporation, and, under paragraph (b)(1) of this section, F is considered as owning such 9 percent of the stock in L Corporation. Thus, for the purpose of determining whether F or G is a United States shareholder with respect to L Corporation, each of F and G is considered as owning a total of 10 percent of the stock in L Corporation by applying the rules of paragraph (a)(2) of § 1.958–1 and paragraphs (b)(1) and (c)(1)(iii) of this section.

(Secs. 956(c), 7805, Internal Revenue Code of 1954 (76 Stat. 1017, 68A Stat. 917; (26 U.S.C. 956(c) and 7805 respectively)))

[T.D. 6889, 31 FR 9455, July 12, 1966, as amended by T.D. 7712, 45 FR 52375, Aug. 7, 1980]

§ 1.959–1 Exclusion from gross income of United States persons of previously taxed earnings and profits.

(a) *In general.* Sections 951 through 964 provide that certain types of income of controlled foreign corporations will be subject to United States income tax even though such amounts are not currently distributed to the United States shareholders of such corporations. The amounts so taxed to certain United States shareholders are described as subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, and increases in earnings invested in United States property. Section 959 provides that amounts taxed as subpart F income, as previously excluded subpart F income withdrawn from investment in less developed countries, or as previously excluded subpart F income withdrawn from investment in foreign base company shipping operations are not taxed again as increases in earnings invested in United States property. Section 959 also provides an exclusion whereby none of the amounts so taxed are taxed again when actually distributed directly, or indirectly through a chain of ownership described in section 958(a), to United States shareholders or to such shareholders' successors in interest. The exclusion also applies to amounts taxed to United States shareholders as income of one controlled foreign corporation and later distributed to another controlled foreign corporation in such a chain of ownership where such amounts would otherwise be again included in the income of such shareholders or their successors in interest as subpart F income of the controlled foreign corporation to which they are distributed. Section 959 also provides rules for the allocation of distributions to earnings and profits and for the nondividend treatment of actual distributions which are excluded from gross income.

(b) *Actual distributions to United States persons.* The earnings and profits for a taxable year of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder of such corporation under section 951(a) shall not, when such amounts are distributed to such shareholder directly, or indirectly through a chain of ownership described in section 958(a), be again included in the gross income of such United States shareholder. See section 959(a)(1). Thus, earnings and profits attributable to amounts which are, or have been, included in the gross income of a United States shareholder of a foreign corporation under section 951 (a)(1)(A)(i) as subpart F income, under section 951(a)(1)(A)(ii) as previously excluded subpart F income withdrawn from investment in less developed countries, under section 951(a)(1)(A)(iii) as previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, or under section 951(a)(1)(B) as earnings invested in United States property, shall not be again included in the gross income of such shareholder when such amounts are actually distributed, directly or indirectly, to such shareholder. See paragraph (d) of this section for exclusion applicable to such shareholder's successor in interest. The application of this paragraph may be illustrated by the following example:

Example. (a) A, a United States shareholder, owns 100 percent of the only class of stock of R Corporation, a corporation organized on January 1, 1963, which is a controlled foreign corporation throughout the period here involved. Both A and R Corporation use the calendar year as a taxable year.

(b) During 1964, R Corporation derives $100 of subpart F income, and A includes such amount in his gross income under section 951(a)(1)(A)(i). Corporation R's current and accumulated earnings and profits (before taking into account distributions made during 1964) are $150. Also, during 1964, R Corporation distributes $50 to A. The $50 distribution is excludable from A's gross income for 1964 under this paragraph and §1.959–3 because such distribution represents earnings and profits attributable to amounts which are included in A's gross income for such year under section 951(a).

(c) If instead of deriving the $100 of subpart F income in 1964, R Corporation derives such amount during 1963 and has earnings and profits for 1963 in excess of $100, A must include $100 in his gross income for 1963 under section 951(a)(1)(A)(i). However, the $50 distribution made by R Corporation to A during 1964 is excludable from A's gross income for such year under this paragraph and §1.959–3 because such distribution represents earnings and profits attributable to amounts which have been included in A's gross income for 1963 under section 951(a).

(d) If, with respect to 1964—

(1) Instead of owning the stock of R Corporation directly, A owns such stock through a chain of ownership described in section 958(a), that is, A owns 100 percent of M Corporation which owns 100 percent of N Corporation which owns 100 percent of R Corporation,

(2) Both M and N Corporations use the calendar year as a taxable year and are controlled foreign corporations throughout the period here involved,

(3) Corporation R derives $100 of subpart F income and has earnings and profits in excess of $100,

(4) Neither M Corporation nor N Corporation has earnings and profits or a deficit in earnings and profits, and

(5) The $50 distribution is from R Corporation to N Corporation to M Corporation to A,

A must include $100 in his gross income for 1964 under section 951(a)(1)(A)(i) by reason of his indirect ownership of R Corporation. However, the $50 distribution is excludable from A's gross income for 1964 under this paragraph and §1.959–3 because such distribution represents earnings and profits attributable to amounts which are included in A's gross income for such year under section 951(a) and are distributed indirectly to A through a chain of ownership described in section 958(a).

(c) *Excludable investment of earnings in United States property.* The earnings and profits for a taxable year of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder of such corporation under section 951(a)(1)(A) shall not, when such amounts would, but for section 959(a)(2) and this paragraph, be included under section 951(a)(1)(B) in the gross income of such shareholder directly, or indirectly through a chain of ownership described in section 958(a), be again included in the gross income of such United States shareholder. Thus, earnings and profits attributable to amounts which are, or have been, included in the gross income of a United States shareholder of a foreign corporation under section 951(a)(1)(A)(i) as subpart F income, under section 951(a)(1)(A)(ii) as previously excluded subpart F income withdrawn from investment in less developed countries, or under section 951(a)(1)(A)(iii) as previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, may be invested in United States property without being again included in such shareholder's income under section 951 (a). Moreover, the first amount deemed invested in United States property are amounts previously included in the gross income of a United States shareholder under section 951(a)(1)(A). See paragraph (d) of this section for exclusion applicable to such shareholder's successor in interest. The application of this paragraph may be illustrated by the following example:

Example. (a) A, a United States shareholder, owns 100 percent of the only class of stock of R Corporation, a corporation organized on January 1, 1963, which is a controlled foreign corporation throughout the period here involved. Both A and R Corporation use the calendar year as a taxable year.

(b) During 1964, R Corporation derives $35 of subpart F income, and A includes such amount in his gross income under section 951(a)(1)(A)(i). During 1964, R Corporation also invests $50 in tangible property (other than property described in section 956(b)(2)) located in the United States. Corporation R makes no distributions during the year, and its current earnings and profits are in excess of $50. Of the $50 investment of earnings in United States property, $35 is excludable from A's gross income for 1964 under section 959(a)(2) because such amount represents earnings and profits which are attributable to amounts which are included in A's gross income for such year under section 951(a)(1)(A)(i) and therefore may be invested in United States property without again being included in A's gross income. The remaining $15 is includible in A's gross income for 1964 under section 951(a)(1)(B).

(c) If, instead of deriving $35 of subpart F income in 1964, R Corporation has no subpart F income for 1964 but derives the $35 of subpart F income during 1963 and has earnings and profits for such year in excess of $35, A must include $35 in his gross income for 1963 under section 951(a)(1)(A)(i). However, of the $50 investment of earnings in United States property made by R Corporation during 1964, $35 is excludable from A's gross income for 1964 under section 959(a)(2) because such amount represents earnings and profits attributable to amounts which have been included in A's gross income for 1963 under section 951(a)(1)(A)(i). The remaining $15 is includible in A's gross income for 1964 under section 951(a)(1)(B).

(d) *Application of exclusions to shareholder's successor in interest.* If a United States person (as defined in § 1.957–4) acquires from any person any portion of the interest in the foreign corporation of a United States shareholder referred to in paragraph (b) or (c) of this section, the rules of such paragraph shall apply to such acquiring person but only to the extent that the acquiring person establishes to the satisfaction of the district director his right to the exclusion provided by such paragraph. The information to be furnished by the acquiring person to the district director with his return for the taxable year to support such exclusion shall include:

(1) The name, address, and taxable year of the foreign corporation from which the distribution is received and of all other corporations, partnerships, trusts, or estates in any applicable chain of ownership described in section 958(a);

(2) The name, address, and (in the case of information required to be furnished after June 20, 1983) taxpayer identification number of the person from whom the stock interest was acquired;

(3) A description of the stock interest acquired and its relation, if any, to a chain of ownership described in section 958(a);

(4) The amount for which an exclusion under section 959(a) is claimed; and

(5) Evidence showing that the earnings and profits for which an exclusion is claimed are attributable to amounts which were included in the gross income of a United States shareholder under section 951(a), that such amounts were not previously excluded from the gross income of a United States person, and the identity of the United States shareholder including such amounts.

The acquiring person shall also furnish to the district director such other information as may be required by the district director in support of the exclusion.

Example. (a) A, a United States shareholder, owns 100 percent of the only class of stock of R Corporation, a corporation organized on January 1, 1964, and a controlled foreign corporation throughout the period here involved. Both A and R Corporation use the calendar year as a taxable year.

(b) During 1964, R Corporation has $100 of subpart F income and earnings and profits in excess of $100. A includes $100 in his gross income for 1964 under section 951(a)(1)(A)(i). During 1965, A sells 40 percent of his stock in R Corporation to B, a United States person who uses the calendar year as a taxable year. In 1965, R Corporation has no earnings and profits and experiences no increase in earnings invested in United States property. Corporation R distributes $40 to B on December 1, 1965. If B establishes his right to the exclusion to the satisfaction of the district director, he may exclude $40 from his gross income for 1965 under section 959(a)(1).

(c) If, instead of selling his 40-percent interest directly to B, A sells on February 1, 1965, 40 percent of his stock in R Corporation to C, a nonresident alien, and on October 1, 1965, B acquires the 40-percent interest in R

Corporation from C, the result is the same as in paragraph (b) of this example, if B establishes his right to the exclusion to the satisfaction of the district director.

(d) If, instead of acquiring 40 percent, B acquires only 5 percent of A's stock in R Corporation and R Corporation distributes $5 to B during 1965, B is not a United States shareholder (within the meaning of section 951(b)) with respect to R Corporation since he owns only 5 percent of the stock of R Corporation. Notwithstanding, B may exclude the $5 distribution from his gross income for 1965 under section 959(a)(1) if he establishes his right to the exclusion to the satisfaction of the district director.

(e) If the facts are assumed to be the same as in paragraphs (a) and (b) of this example except that—

(1) A owns the stock of R Corporation indirectly through a chain of ownership described in section 958(a), that is, A owns 100 percent of M Corporation which owns 100 percent of N Corporation which owns 100 percent of R Corporation,

(2) B acquires from N Corporation 40 percent of the stock in R Corporation,

(3) Both M Corporation and N Corporation are controlled foreign corporations which use the calendar year as a taxable year,

(4) Neither M Corporation nor N Corporation has any amount in 1964 or 1965 which is includible in gross income of United States shareholders under section 951(a), and

(5) Neither M Corporation nor N Corporation has a deficit in earnings and profits for 1964;

the result is the same as in paragraph (b) of this example if B establishes his right to the exclusion to the satisfaction of the district director.

[T.D. 6795, 30 FR 943, Jan. 29, 1965, as amended by T.D. 7893, 48 FR 22509, May 19, 1983]

§1.959–2 Exclusion from gross income of controlled foreign corporations of previously taxed earnings and profits.

(a) *Applicable rule.* The earnings and profits for a taxable year of a controlled foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not, when distributed through a chain of ownership described in section 958(a), be also included in the gross income of another controlled foreign corporation in such chain for purposes of the application of section 951(a) to such other controlled foreign corporation with respect to such United States shareholder. See section 959(b). The exclusion from the income of such other foreign corporation also applies with respect to any other United States shareholder who acquires from such United States shareholder or any other person any portion of the interest of such United States shareholder in the controlled foreign corporation, but only to the extent the acquiring shareholder establishes to the satisfaction of the district director his right to such exclusion. An acquiring shareholder claiming the exclusion under section 959(b) shall furnish to the district director with his return for the taxable year the information required under paragraph (d) of §1.959–1 to support the exclusion under this paragraph.

(b) *Illustration.* The application of this section may be illustrated by the following example:

Example. (a) A, a United States shareholder, owns 100 percent of the only class of stock of M Corporation which in turn owns 100 percent of the only class of stock of N Corporation. A and corporations M and N use the calendar year as a taxable year and corporations M and N are controlled foreign corporations throughout the period here involved.

(b) During 1963, N Corporation invests $100 in tangible property (other than property described in section 956(b)(2)) located in the United States and has earnings and profits in excess of $100. A is required to include $100 in his gross income for 1963 under section 951(a)(1)(B) by reason of his indirect ownership of the stock of N Corporation. During 1963, M Corporation has no income or investments other than the income derived from a distribution of $100 from N Corporation. Corporation M has earnings and profits of $100 for 1963. Under paragraph (a) of §1.954–2, the $100 distribution received by M Corporation from N Corporation would otherwise constitute subpart F income of M Corporation; however, by reason of section 959(b) and this section, this amount does not constitute gross income of M Corporation for purposes of determining amounts includible in A's gross income under section 951(a)(1)(A)(i).

(c) During 1964, N Corporation derives $100 of subpart F income and distributes $100 to M Corporation which has no subpart F income for 1964 but which invests the $100 distribution in tangible property (other than property described in section 956(b)(2)) located in the United States. Corporation N's earnings and profits for 1964 are in excess of $100, and M Corporation's current and accumulated earnings and profits (before taking into account distributions made during 1964) are in excess of $100. A is required with respect to N Corporation to include $100 in his gross income for 1964 under section 951(a)(1)(A)(i) by reason of his indirect ownership of the stock of N Corporation. The investment by M Corporation in United States property would otherwise constitute an investment of earnings in United States property to which section 956 applies; however, by reason of section 959(b) and this section, such amount does not constitute gross income of M Corporation for purposes of determining amounts includible in A's gross income under section 951(a)(1)(B).

(d) If during 1965, N Corporation invests $100 in tangible property (other than property described in section 956(b)(2)) located in the United States and has earnings and profits in excess of $100, A will be required with respect to N Corporation to include $100 in his gross income for 1965 under section 951(a)(1)(B), because the $100 of earnings and profits for 1964 attributable to N Corporation's subpart F income which was taxed to A in 1964 was distributed to M Corporation in such year.

(e) If, with respect to 1966—

(1) Corporation N owns 100 percent of the only class of stock of R Corporation,

(2) Corporation R derives $100 of subpart F income, has earnings and profits in excess of $100, and makes no distributions to N Corporation,

(3) Corporation N invests $25 in tangible property (other than property described in section 956(b)(2)) located in the United States and has current and accumulated earnings and profits in excess of $25, and

(4) Corporation M has no income or investments and does not have a deficit in earnings and profits,

the $100 of subpart F income derived by R Corporation is includible in A's gross income for 1966 under section 951(a)(1)(A)(i) and the $25 investment of earnings in United States property by N Corporation is includible in A's gross income for 1966 under section 951(a)(1)(B).

(f) If, however, the facts are the same as in paragraph (e) of this example except that—

(1) During 1966, R Corporation distributes $20 to N Corporation, and

(2) Corporation N makes no distributions during such year to M Corporation,

of the $25 investment in United States property by N Corporation, $20 is not includible in A's gross income for 1966 because such amount represents earnings and profits which are attributable to amounts included in A's gross income for such year under section 951(a)(1)(A)(i) with respect to R Corporation and which have been distributed to N Corporation by R Corporation. By reason of section 959(B) and this section, such $20 distribution to N Corporation does not constitute gross income of N Corporation for purposes of determining amounts includible in A's gross income under section 951(a)(1)(B); however, the remaining $5 of investment of earnings in United States property by N Corporation in 1966 is includible in A's gross income for such year under section 951(a)(1)(B).

[T.D. 6795, 30 FR 944, Jan. 29, 1965]

§ 1.959–3 Allocation of distributions to earnings and profits of foreign corporations.

(a) *In general.* For purposes of §§ 1.959–1 and 1.959–2, the source of the earnings and profits from which distributions are made by a foreign corporation as between earnings and profits attributable to increases in earnings invested in United States property, previously taxed subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, and other amounts shall be determined in accordance with section 959(c) and paragraphs (b) through (e) of this section.

(b) *Applicability of section 316(a).* For purposes of this section, section 316(a) shall be applied, in determining the source of distributions from the earnings and profits of a foreign corporation, by first applying section 316(a)(2) and then by applying section 316(a)(1)—

(1) First, as provided by section 959 (c)(1), to earnings and profits attributable to amounts included in gross income of a United States shareholder under section 951(a)(1)(B) (or which would have been so included but for section 959(a)(2) and paragraph (c) of § 1.959–1),

(2) Secondly, as provided by section 959(c)(2), to earnings and profits attributable to amounts included in gross income of a United States shareholder under section 951(a)(1)(A) (but reduced by amounts not included in such gross income under section 951(a)(1)(B) because of the exclusion provided by section 959(a)(2) and paragraph (c) of § 1.959–1), and

(3) Finally, as provided by section 959(c)(3), to other earnings and profits. Thus, distributions shall be considered first attributable to amounts, if any, described in subparagraph (1) of this paragraph (first for the current taxable year and then for prior taxable years

beginning with the most recent prior taxable year), secondly to amounts, if any, described in subparagraph (2) of this paragraph (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year), and finally to the amounts, if any, described in subparagraph (3) of this paragraph (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year). See, however, paragraph (e) of §1.963–3 (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975) for a special rule for determination of the source of distributions counting as minimum distributions. Earnings and profits are classified as to year and as to section 959(c) amount in the year in which such amounts are included in gross income of a United States shareholder under section 951(a) and are reclassified as to section 959(c) amount in the year in which such amounts would be so included but for the provisions of section 959(a)(2); any subsequent distribution of such amounts to a higher tier in a chain of ownership described in section 958(a) does not of itself change such classifications. For example, earnings and profits of a foreign corporation attributable to amounts of previously excluded subpart F income withdrawn from investment in less developed countries (or from investments in export trade assets or foreign base company shipping operations) shall be reclassified as amounts to which subparagraph (2), rather than subparagraph (3), of this paragraph applies for purposes of determining priority of distribution, and such earnings and profits shall be considered attributable to the taxable year in which the withdrawal occurs. This paragraph shall apply to distributions by one foreign corporation to another foreign corporation and by a foreign corporation to a United States person. The application of this paragraph may be illustrated by the following example:

Example. (a) M, a controlled foreign corporation, is organized on January 1, 1963, and is 100-percent owned by A, a United States shareholder. Both A and M Corporation use the calendar year as a taxable year, and M Corporation is a controlled foreign corporation throughout the period here involved. As of December 31, 1966, M Corporation's accumulated earnings and profits of $450 (before taking into account distributions made in 1966) applicable to A's interest in such corporation are classified for purposes of section 959(c) as follows:

Year	Classification of earnings and profits for purposes of section 959		
	(c)(1)	(c)(2)	(c)(3)
1963	$100		
1964	100	$75	
1965		75	$50
1966			50

(b) During 1966, M Corporation makes three separate distributions to A of $150 each, and the source of such distributions under section 959(c) is as follows:

	Amount	Year	Allocation of distributions under section 959
Distribution No. 1	$100	1964	(c)(1)
	50	1963	(c)(1)
	150		
Distribution No. 2	50	1963	(c)(1)
	75	1965	(c)(2)
	25	1964	(c)(2)
	150		
Distribution No. 3	50	1964	(c)(2)
	50	1966	(c)(3)
	50	1965	(c)(3)
	150		

(c) If, in addition to the above facts—

(1) M Corporation owns throughout the period here involved 100 percent of the only class of stock of N Corporation, a controlled foreign corporation which uses the calendar year as a taxable year,

(2) Corporation N derives $60 of subpart F income for 1963 which A includes in his gross income for such year under section 951(a)(1)(A)(i),

(3) Corporation N has earnings and profits for 1963 of $60 but has neither earnings or profits nor a deficit in earnings and profits for 1964, 1965, or 1966, and

(4) During 1966, N Corporation invests $20 in tangible property (not described in section 956(b)(2)) located in the United States and distributes $45 to M Corporation,

the $20 investment of earnings in United States property is excludable from A's gross income for 1966, under section 959(a)(2) and paragraph (c) of §1.959–1, with respect to N Corporation and the $45 dividend received by M Corporation does not, under section 959(b) and §1.959–2, constitute gross income of M

Corporation for 1966 for purposes of determining amounts includible in A's gross income under section 951(a)(1)(A)(i) with respect to M Corporation. However, the $45 dividend paid by N Corporation to M Corporation is allocated under section 959(c) and this paragraph to the earnings and profits of N Corporation as follows: $20 to 1963 earnings described in section 959(c)(1) and $25 to 1963 earnings described in section 959(c)(2). In such case, M Corporation's earnings and profits of $495 (before taking into account distributions made in 1966) would be classified as follows for purposes of section 959(c):

Year	Classification of earnings and profits for purposes of section 959		
	(c)(1)	(c)(2)	(c)(3)
1963	$120	$25	....
1964	100	75	....
1965	....	75	$50
1966	....	....	50

(d) The three distributions to A in 1966 of $150 each would then have the following source under section 959(c):

	Amount	Year	Allocation of distributions under section 959
Distribution No. 1	$100	1964	(c)(1)
	50	1963	(c)(1)
	150	....	....
Distribution No. 2	70	1963	(c)(1)
	75	1965	(c)(2)
	5	1964	(c)(2)
	150	....	....
Distribution No. 3	70	1964	(c)(2)
	25	1963	(c)(2)
	50	1966	(c)(3)
	5	1965	(c)(3)
	150	....	....

(c) *Treatment of deficits in earnings and profits.* For purposes of this section, a United States shareholder's pro rata share (determined in accordance with the principles of paragraph (e) of § 1.951–1) of a foreign corporation's deficit in earnings and profits, determined under section 964(a) and § 1.964–1, for any taxable year shall be applied only to earnings and profits described in paragraph (b)(3) of this section.

(d) *Treatment of certain foreign taxes.* For purposes of this section, any amount described in subparagraph (1), (2), or (3) of paragraph (b) of this section which is distributed by a foreign corporation through a chain of ownership described in section 958(a)(2) shall be reduced by any income, war profits, or excess profits taxes imposed on or with respect to such distribution by any foreign country or possession of the United States.

Example. (a) Domestic corporation M owns 100 percent of the only class of stock of foreign corporation A, which is incorporated under the laws of foreign country X and which, in turn, owns 100 percent of the only class of stock of foreign corporation B, which is incorporated under the laws of foreign country Y. All corporations use the calendar year as a taxable year and corporations A and B are controlled foreign corporations throughout the period here involved.

(b) During 1963, B Corporation (a less developed country corporation for 1963 within the meaning of § 1.955–5) derives $90 of subpart F income, after incurring $10 of foreign income tax allocable to such income under paragraph (c) of § 1.954–1, has earnings and profits in excess of $90, and makes no distributions. Corporation M must include $90 in its gross income for 1963 under section 951(a)(1)(A)(i). As of December 31, 1963, with respect to M Corporation, B Corporation has earnings and profits for 1963 described in section 959(c)(2) of $90.

(c) During 1964, B Corporation has neither earnings and profits nor a deficit in earnings and profits but distributes $90 to A Corporation, and, by reason of section 959(b) and § 1.959–2, such amount is not includible in the gross income of M Corporation for 1964 under section 951(a) with respect to A Corporation. Corporation A incurs a withholding tax of $13.50 on the $90 dividend distributed from B Corporation (15 percent of $90) and an additional foreign income tax of 10 percent or $7.65 by reason of the inclusion of the net distribution of $76.50 ($90 minus $13.50) in its taxable income for 1964. As of December 31, 1964, with respect to M Corporation, B Corporation's earnings and profits for 1963 described in section 959(c)(2) amount to zero ($90 minus $90); and A Corporation's earnings and profits for 1963 described in section 959(c)(2) amount to $68.85 ($90 minus $13.50 minus $7.65).

(e) *Determination of foreign tax credit.* For purposes of applying section 902 and section 960 in determining the foreign tax credit allowable under section 901 in a case in which distributions are made by a second-tier corporation or a first-tier corporation, as the case may be, from its earnings and profits for a taxable year which are attributable to an amount included in the gross income of a U.S. shareholder under section 951(a) or which are attributable to amounts excluded from the gross income of such foreign corporation under section 959(b) and §1.959–2 with respect to a U.S. shareholder, the rules of paragraph (b) of this section shall apply except that in applying subparagraph (1) or (2) of such paragraph—

(1) Distributions from the earnings and profits for such taxable year of the second-tier corporation shall be considered first attributable to its earnings and profits attributable to distributions from the earnings and profits of the foreign corporation, if any, next lower in the chain of ownership described in section 958(a), to the extent of such earnings and profits of the second-tier corporation, and then to the other earnings and profits of such second-tier corporation, and

(2) Distributions from the earnings and profits for such taxable year of the first-tier corporation shall be considered first attributable to its earnings and profits attributable to distributions from the earnings and profits of the second-tier corporation, to the extent of such earnings and profits of the first-tier corporation, and then to the other earnings and profits of such first-tier corporation. For purposes of this paragraph, a second-tier corporation is a foreign corporation referred to in section 960(a)(1)(B), and a first-tier corporation is a foreign corporation referred to in section 960 (a)(1)(A). The application of this paragraph may be illustrated by the following examples:

Example 1. (a) Domestic corporation A, a United States shareholder, owns 100 percent of the only class of stock of foreign corporation R which, in turn, owns 100 percent of the only class of stock of foreign corporation S. All corporations use the calendar year as a taxable year, and corporations R and S are controlled foreign corporations throughout the period here involved.

(b) Neither R Corporation nor S Corporation has subpart F income for 1963. During 1963, S Corporation increases by $100 its investment in tangible property (not described in section 956(b)(2)) located in the United States, makes no distributions, and has earnings and profits of $100. Corporation A must include $100 in its gross income for 1963 under section 951(a)(1)(B) with respect to S Corporation. During 1963, R Corporation also increases by $100 its investment in tangible property (not described in section 956(b)(2)) located in the United States, makes no distributions, and has earnings and profits of $100. Corporation A must include $100 in its gross income for 1963 under section 951(a)(1)(B) with respect to R Corporation.

(c) During 1964, S Corporation distributes $100 to R Corporation, and R Corporation distributes $100 to A Corporation. Neither corporation has any earnings or profits or deficit in earnings and profits for such year. On December 31, 1964, R Corporation has earnings and profits (computed before distributions to A Corporation made for the year) of $200, consisting of $100 of section 959(c)(1) amounts of R Corporation for 1963 and of $100 of section 959(c)(1) amounts of S Corporation for 1963. For purposes of determining the foreign tax credit under section 960 and the regulations thereunder, the $100 distribution by R Corporation shall be considered attributable to S Corporation's earnings and profits for 1963 described in section 959(c)(1).

Example 2. (a) Domestic corporation A, a United States shareholder, owns 100 percent of the only class of stock of foreign corporation T which, in turn, owns 100 percent of the only class of stock of foreign corporation U. All corporations use the calendar year as a taxable year, and corporations T and U are controlled foreign corporations throughout the period here involved.

(b) During 1964, T Corporation invests $100 in tangible property (not described in section 956(b)(2)) located in the United States. For 1964, T Corporation has no subpart F income and makes no distributions; A must include $100 in its gross income for 1964 under section 951(a)(1)(B) with respect to T Corporation. For 1964, U Corporation has no subpart F income or investment of earnings in United States property but U Corporation has $100 of earnings and profits which it distributes to T Corporation. At December 31, 1964, T Corporation has earnings and profits of $300, consisting of operating income of $100 for each of the years 1963 and 1964 and $100 in dividends received from the earnings and profits of U Corporation for 1964. These earnings and profits are classified as follows under section 959(c): $100 of section 959(c)(1) amounts of T Corporation for 1964, $100 of section 959(c)(3) amounts of U Corporation for 1964, and $100 of section 959(c)(3) amounts of T Corporation for 1963.

(c) During 1965 neither T Corporation nor U Corporation has any earnings and profits or deficit in earnings and profits or investment of earnings in U.S. property, but T Corporation distributes $100 to A Corporation. For purposes of determining the foreign tax credit under section 960 and the regulations thereunder, the $100 distribution of T Corporation shall be considered attributable to T Corporation's earnings and profits for 1964 described in section 959(c)(1).

(f) *Illustration.* The application of this section may be illustrated by the following example:

Example. (a) M, a controlled foreign corporation is organized on January 1, 1963, and is wholly owned by A, a United States shareholder. Both A and Corporation M use the calendar year as a taxable year.

(b) Corporation M's earnings and profits (before distributions) for 1963 are $200, $100, of which is attributable to subpart F income. Corporation M's earnings and profits for such year also include $25 attributable to subpart F income which is excluded from M Corporation's foreign base company income under section 954(b)(1) as dividends, interest, and gains invested in qualified investments in less developed countries. Corporation M's increase in earnings invested in tangible property (not described in section 956(b)(2)) located in the United States for 1963, is $50, and M Corporation makes a distribution of such property during such year of $20. For purposes of section 959, A's interest in M Corporation's earnings and profits as of December 31, 1963, determined after the distributions of $20, is classified as follows:

Section 959(c)(1) amounts:			
Earnings for 1963 attributable to increased investment in U.S. property which would have been included in A's gross income but for application of section 959(a)(2) and § 1.959–1(c)		$50	
Less: Distribution for 1963 allocated under section 959(c)(1) and paragraph (b)(1) of this section to such amounts		20	$30
Section 959(c)(2) amounts:			
Earnings for 1963 attributable to subpart F income included in A's gross income under section 951(a)(1)(A)(i)		100	
Less: Earnings for 1963 attributable to increased investment in U.S. property which would have been included in A's gross income but for application of section 959(a)(2) and § 1.959–1(c)		50	50
Section 959(c)(3) amounts:			
Predistribution earnings for 1963		200	
Less: Earnings for 1963 classified as:			
Section 959(c)(1) amounts	$50		
Section 959(c)(2) amounts	50	100	100
A's total interest in M Corporation's earnings and profits	....	....	180

For 1963, A is required to include $100 of subpart F income in his gross income under section 951(a)(1)(A)(i). He would have been required to include $50 in his gross income under section 951(a)(1)(B) as M Corporation's increase in earnings invested in United States property, except that section 959(a)(2) and paragraph (c) of § 1.959–1 provide in effect that earnings and profits taxed to A under section 951(a)(1)(A) with respect to M Corporation (whether in the current taxable year or in prior years) may be invested in United States property without again being included in gross income under section 951(a). The $20 dividend from M Corporation is excluded from A's gross income under section 959(a)(1) and paragraph (b) of § 1.959–1, since such distribution is allocated under section 959(c)(1) and paragraph (b)(1) of this section to amounts described in section 959(c)(1).

(c) During 1964, M Corporation's earnings and profits (before distributions) are $300, $75 of which is attributable to subpart F income. Corporation M has no change in investments in United States property during such year and withdraws $15 of previously excluded subpart F income from investment in less developed countries. Corporation M makes a cash distribution of $250 to A during 1964. For purposes of section 959, A's interest in M Corporation's earnings and profits as of December 31, 1964, determined after the distribution of $250, is classified as follows:

Section 959 (c)(1) amounts:	
Section 959(c)(1) net amount for 1963 (as determined under paragraph (b) of this example)	$30
Less: Distribution for 1964 allocated under section 959(c)(1) and paragraph (b)(1) of this section to such amount	30
Section 959(c)(2) amounts:	
Section 959(c)(2) net amount for 1963 (as determined under paragraph (b) of this example)	50
Plus: Earnings for 1964 attributable to:	
Subpart F income for 1964 included in A's gross income under section 951(a)(1)(A)(i)	75
Previously excluded subpart F income withdrawn in 1964 from investment in less developed countries and included in A's gross income under section 951(a)(1)(A)(ii)	15
	140
Less: Distribution for 1964 allocated under section 959(c)(2) and paragraph (b)(2) of this section to such amounts	140

Section 959(c)(3) amounts:				
Section 959(c)(3) net amount for 1963 (as determined under paragraph (b) of this example)			100	
Plus: Section 959(c)(3) net amount for 1964:				
Predistribution earnings for 1964	....	$300		
Less:				
Earnings for 1964 classified as section 959(c)(1) amounts ($0) and as section 959(c)(2) amounts ($75+$15)	$90			
Distributions for 1964 allocated under section 959(c)(3) and paragraph (b)(3) of this section	80	170	130	$230
A's total interest in M Corporation's earnings and profits	....	....	....	230

For 1964, A is required to include in his gross income under section 951(a)(1)(A)(i) $75 of subpart F income, and under section 951 (a)(1)(A)(ii) $15 of previously excluded subpart F income withdrawn from investment in less developed countries. Of the $250 cash distribution, A may exclude $170 from his gross income under section 959(a)(1) and paragraph (b) of §1.959–1 and $80 is includible in his gross income as a dividend.

(d) The source under section 959(c) of the 1964 distribution of $250 to A is as follows:

Year	Amount	Allocation of distribution under section 959
1963	$30	(c)(1).
1964	90	(c)(2).
1963	50	(c)(2).
1964	80	(c)(3).
	250	

[T.D. 6795, 30 FR 945, Jan. 29, 1965, as amended by T.D. 7334, 39 FR 44211, Dec. 23, 1974; T. D. 7545, 43 FR 19652, May 8, 1978; T.D. 7893, 48 FR 22510, May 19, 1983]

§1.959–4 Distributions to United States persons not counting as dividends.

Except as provided in section 960(a)(3) and §1.960–2, any distribution to a United States person which is excluded from the gross income of such person under section 959(a)(1) and §1.959–1 shall be treated for purposes of chapter 1 (relating to normal taxes and surtaxes) of subtitle A (relating to income taxes) of the Code as a distribution which is not a dividend. However, see paragraph (b)(1) of §1.956–1, relating to the dividend limitation on the amount of a controlled foreign corporation's investment of earnings in United States property.

[T.D. 7120, 36 FR 10860, June 4, 1971]

§1.960–1 Foreign tax credit with respect to taxes paid on earnings and profits of controlled foreign corporations.

(a) *Scope of regulations under section 960.* This section prescribes rules for determining the foreign income taxes deemed paid under section 960(a)(1) by a domestic corporation which is required under section 951 to include in gross income an amount attributable to a first-, second-, or third-tier corporation's earnings and profits. Section 1.960–2 prescribes rules for applying section 902 to dividends paid by a third-, second-, or first-tier corporation from earnings and profits attributable to an amount which is, or has been, included in gross income under section 951. Section 1.960–3 provides special rules for the application of the gross-up provisions of section 78 where an amount is included in gross income under section 951. Section 1.960–4 prescribes rules for increasing the applicable foreign tax credit limitation under section 904(a) of the domestic corporation for the taxable year in which it receives a distribution of earnings and profits in respect of which it was required under section 951 to include an amount in its gross income for a prior taxable year. Section 1.960–5 prescribes rules for disallowing a deduction for foreign income taxes for such taxable year of receipt where the domestic corporation received the benefits of the foreign tax credit for such previous taxable year of inclusion. Section 1.960–6 provides that the excess of such an increase in the applicable limitation under section 904(a) over the tax liability of the domestic corporation for such taxable year of receipt results in an overpayment of tax. Section 1.960–7 prescribes the effective dates for application of these rules.

(b) *Definitions.* For purposes of section 960 and §§ 1.960–1 through 1.960–7—

(1) *First-tier corporation.* The term ‘‘first-tier corporation’’ means a foreign corporation at least 10 percent of the voting stock of which is owned by the domestic corporation described in paragraph (a) of this section.

(2) *Second-tier corporation.* In the case of amounts included in the gross income of the taxpayer under section 951—

(i) For taxable years beginning before January 1, 1977, the term ‘‘second-tier corporation’’ means a foreign corporation at least 50 percent of the voting stock of which is owned by such first-tier corporation.

(ii) For taxable years beginning after December 31, 1976, the term ‘‘second-tier corporation’’ means a foreign corporation as least 10 percent of the voting stock of which is owned by such first-tier corporation.

(3) *Third-tier corporation.* In the case of amounts included in the gross income of a domestic shareholder under section 951 for taxable years beginning after December 31, 1976, the term ‘‘third-tier corporation’’ means a foreign corporation at least 10 percent of the voting stock of which is owned by such second-tier corporation.

(4) *Immediately lower-tier corporation.* In the case of a first-tier corporation the term ‘‘immediately lower-tier corporation’’ means a second-tier corporation. In the case of a second-tier corporation, the term ‘‘immediately lower-tier corporation’’ means a third-tier corporation. In the case of a third-tier corporation, the term ‘‘immediately lower-tier corporation’’ means a fourth-tier corporation.

(5) *Foreign income taxes.* The term ‘‘foreign income taxes’’ means income, war profits, and excess profits taxes, and taxes included in the term ‘‘income, war profits, and excess profits taxes’’ by reason of section 903, imposed by a foreign country or a possession of the United States.

(c) *Amount of foreign income taxes deemed paid by domestic corporation in respect of earnings and profits of foreign corporation attributable to amount included in income under section 951*—(1) *In general.* For purposes of section 901—

(i) If for the taxable year there is included in the gross income of a domestic corporation under section 951 an amount attributable to the earnings and profits of a first- or second-tier corporation for any taxable year, the domestic corporation shall be deemed to have paid the same proportion of the total foreign income taxes paid, accrued, or deemed (in accordance with paragraph (b) of § 1.960–2) to be paid by such foreign corporation on or with respect to its earnings and profits for its taxable year as the amount (in the case of a first-tier corporation, determined without regard to section 958(a)(2); in the case of a second-tier corporation, determined without regard to section 958(a)(1)(A) and, to the extent that stock of such second-tier corporation is owned by the domestic corporation through a foreign corporation other than the first-tier corporation, determined without regard to section 958(a)(2)) so included in the gross income of the domestic corporation under section 951 with respect to such foreign corporation bears to the total earnings and profits of such foreign corporation for its taxable year. This paragraph (c)(1)(i) shall not apply to amounts included in the gross income of the domestic corporation under section 951 with respect to the second-tier corporation unless the percentage-of-voting-stock requirement of section 902(b)(3)(A) is satisfied.

(ii) If for the taxable year there is included in the gross income of a domestic corporation under section 951 an amount attributable to the earnings and profits of a third-tier corporation for any taxable year, the domestic corporation shall be deemed to have paid the same proportion of the total foreign income taxes paid or accrued by such foreign corporation on or with respect to its earnings and profits for its taxable year as the amount (determined without regard to section 958(a)(1)(A) and, to the extent that stock of such third-tier corporation is owned by the domestic corporation through a foreign corporation other than the second-tier corporation, determined without regard to section 958(a)(2)) so included in the gross income of the domestic corporation under section 951 with respect to such foreign corporation bears to the total earnings and profits of such foreign corporation. This paragraph (c)(1)(ii) shall not apply unless the percentage-of-voting-stock requirement of section 902(b)(3)(B) is satisfied.

(iii) In applying paragraph (c)(1)(i) or (c)(1)(ii) of this section to a first-, second-, or third-tier corporation which for the taxable year has income excluded under section 959(b), paragraph (c)(3) of this section shall apply for purposes of excluding certain earnings and profits of such foreign corporation and foreign income taxes, if any, attributable to such excluded income.

(iv) This paragraph (c)(1) applies whether or not the first-, second-, or third-tier corporation makes a distribution for the taxable year of its earnings and profits which are attributable to the amount included in the gross income of the domestic corporation under section 951.

(v) This paragraph (c)(1) does not apply to an increase in current earnings invested in United States property which, but for paragraph (e) of §1.963–3 (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975), would be included in the gross income of the domestic corporation under section 951(a)(1)(B) but which, pursuant to such paragraph, counts toward a minimum distribution for the taxable year. This subdivision shall apply in taxable years subsequent to the Tax Reduction Act of 1975 only in those cases where an adjustment is required as a result of an election made under section 963 prior to the Act.

(2) *Taxes paid or accrued on or with respect to earnings and profits of foreign corporation.* For purposes of paragraph (c)(1) of this section, the foreign income taxes paid or accrued by a first-, second- or third-tier corporation on or with respect to its earnings and profits for its taxable years shall be the total amount of the foreign income taxes paid or accrued by such foreign corporation for such taxable year.

(3) *Exclusion of earnings and profits and taxes of a first-, second-, or third-tier corporation having income excluded under section 959(b).* If in the case of a first-, second-, or third-tier corporation to which paragraph (c)(1)(i) or (c)(1)(ii) of this section is applied—

(i) The earnings and profits of such foreign corporation for its taxable year consist of (A) earnings and profits attributable to dividends received from an immediately lower-tier corporation which are attributable to amounts included in the gross income of a domestic corporation under section 951 with respect to the immediately lower- or lower-tier corporations, and (B) other earnings and profits, and

(ii) The effective rate of foreign income taxes paid or accrued by such foreign corporation in respect to the dividends to which its earnings and profits described in paragraph (c)(3)(i)(A) of this section are attributable is higher or lower than the effective rate of foreign income taxes paid or accrued by such foreign corporation in respect to the income to which its earnings and profits described in paragraph (c)(3)(i)(B) of this section are attributable,

then, for the purposes of applying paragraph (c)(1)(i) or (c)(1)(ii) of this section to the foreign income taxes paid, accrued, or deemed to be paid, by such foreign corporation on or with respect to its earnings and profits for such taxable year, the earnings and profits of such foreign corporation for such taxable year shall be considered not to include the earnings and profits described in paragraph (c)(3)(i)(A) of this section and only the foreign income taxes paid, accrued, or deemed to be paid, by such foreign corporation in respect to the income to which its earnings and profits described in paragraph (c)(3)(i)(B) of this section are attributable shall be taken into account. For purposes of applying this paragraph (c)(3), the effective rate of foreign income taxes paid or accrued in respect to income shall be determined consistently with the principles of paragraphs (b)(3)(iv) and (viii) and (c) of §1.954–1. Thus, for example, the effective rate of foreign income taxes paid or accrued in respect to dividends received by such foreign corporation shall be determined by taking into account any intercorporate dividends received deduction allowed to such corporation for such dividends.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. Domestic corporation N owns all the one class of stock of controlled foreign corporation A. Both corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $50 attributable to the earnings and profits of A Corporation for such year, but A Corporation does not distribute any earnings and profits for such year. The foreign income taxes paid by A Corporation for 1978 which are deemed paid by N Corporation for such year under section 960(a)(1) are determined as follows upon the basis of the facts assumed:

Pretax earnings and profits of A Corporation	$100.00
Foreign income taxes (20%)	20.00
Earnings and profits	80.00
Amount required to be included in N Corporation's gross income under section 951	50.00
Dividends paid to N Corporation	0
Foreign income taxes paid on or with respect to earnings and profits of A Corporation	20.00
Foreign income taxes of A Corporation deemed paid by N Corporation under section 960(a)(1) ($50/$80×$20)	12.50

Example 2. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $45 attributable to the earnings and profits of B Corporation for such year, but is not required to include any amount in gross income under section 951 attributable to the earnings and profits of A Corporation for such year. Neither B Corporation nor A Corporation distributes any earnings and profits for 1978. The foreign income taxes paid by B Corporation for 1978 which are deemed paid by N Corporation for such year under section 960(a)(1) are determined as follows upon the basis of the facts assumed:

Pretax earnings and profits of B Corporation	$100.00
Foreign income taxes (40%)	40.00
Earnings and profits	60.00
Amounts required to be included in N Corporation's gross income under section 951 with respect to B Corporation	45.00
Dividends paid	0
Foreign income taxes paid on or with respect to earnings and profits of B Corporation	40.00
Foreign income taxes of B Corporation deemed paid by N Corporation under section 960(a)(1) ($45/$60×$40)	30.00

Example 3. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B, which owns all the one class of stock of foreign corporation C. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $80 attributable to the earnings and profits of C Corporation for such year, $45 attributable to the earnings and profits of B Corporation for such year and $50 attributable to the earnings and profits of A Corporation for such year. Neither C Corporation nor B corporation distributes any earnings and profits for 1978. The foreign income taxes which are deemed paid by N Corporation for such year under section 960(a)(1) are determined as follows upon the basis of the facts assumed:

C Corporation (third-tier corporation):

Pretax earnings of C Corporation	$150.00
Foreign income taxes (40%)	60.00
Earnings and profits	90.00
Amounts required to be included in N Corporation's gross income under section 951	80.00
Dividends paid to B Corporation	0
Foreign income taxes paid on or with respect to earnings and profits of C Corporation	60.00

B Corporation (second-tier corporation):

Pretax earnings of B Corporation	$100.00
Foreign income taxes (40%)	40.00
Earnings and profits	60.00
Amount required to be included in N Corporation's gross income under section 951	45.00
Dividends paid to A Corporation	0
Foreign income taxes paid on or with respect to earnings and profits of B Corporation	40.00

A Corporation (first-tier corporation):

Pretax earnings and profits of A Corporation	$100.00
Foreign income taxes (20%)	20.00
Earnings and profits	80.00
Amount required to be included in N Corporation's gross income under section 951	50.00
Dividends paid to N Corporation	0
Foreign income taxes paid on or with respect to earnings and profits of A Corporation	20.00

N Corporation (domestic corporation):

Foreign income taxes deemed paid by N Corporation under section 960(a)(1):	
Taxes of C Corporation $80/$90×$60	$53.33
Taxes of B Corporation $45/$60×$40	30.00
Taxes of A Corporation $50/$80×$20	12.50
Total taxes deemed paid under section 960(a)(1)	$95.83

Example 4. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns 5 percent of the one class of stock of controlled foreign corporation B. N Corporation also directly owns 95 percent of the one class of stock of B Corporation. (Under these facts, B Corporation is only a first-tier corporation with respect to N Corporation) all such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $60 attributable to the earnings and profits of B Corporation and $79.20 attributable to the earnings and profits of A Corporation. For 1978, B Corporation distributes $19 to N Corporation and $1 to A Corporation, but A

Corporation makes no distribution to N Corporation. The foreign income taxes paid by N Corporation for such year under section 960(a)(1) are determined as follows upon the basis of the facts assumed in accordance with § 1.960–1(c)(1)(i):

B Corporation (first-tier corporation):

Pretax earnings and profits	$100.00
Foreign income taxes (40%)	40.00
Earnings and profits	60.00
Amount required to be included in N Corporation's gross income under section 951 with respect to B Corporation	60.00

A Corporation (first-tier corporation):

Pretax earnings and profits (including $1 dividend from B Corporation)	$100.00
Foreign income taxes (20%)	20.00
Earnings and profits	80.00
Amount required to be included in N Corporation's gross income with respect to A Corporation ($99 − [$99×0.20]	79.20

N Corporation (domestic corporation):

Foreign income taxes deemed paid by N Corporation under section 960(a)(1) with respect to—	
B Corporation ([$60×0.95/$60]×$40)	$38.00
A Corporation ($79.20/$80×$20)	19.80
Total taxes deemed paid under section 960(a)(1)	$57.80

Example 5. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $175 attributable to the earnings and profits of A Corporation for such year. For 1978, B Corporation has earnings and profits of $225, on which it pays foreign income taxes of $75. In 1978, B Corporation distributes $150, which, under paragraph (b) of § 1.960–2, consists of $100 to which section 902(b)(1) does not apply (from B Corporation's earnings and profits attributable to an amount required under section 951 to be included in N Corporation's gross income with respect to B Corporation) and $50 to which section 902(b)(1) applies (from B Corporation's other earnings and profits). The country under the laws of which A Corporation is incorporated imposes an income tax of 40 percent on all income but exempts from tax dividends received from a subsidiary corporation. A Corporation makes no distribution for 1978. Under paragraph (b) of § 1.960–2, A Corporation is deemed to have paid $25 ($50/$150×$75) of the $75 foreign income taxes paid by B Corporation on its pretax earnings and profits of $225. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) with respect to A Corporation are determined as follows upon the basis of the following assumed facts:

Pretax earnings and profits of A Corporation:			
Dividends received from B Corporation			$150.00
Other income			250.00
Total pretax earnings and profits			$400.00
Foreign income taxes:			
On dividends received from B Corporation		0	
On other income ($250×0.40)		100.00	
Total foreign income taxes			100.00
Earnings and profits:			
Attributable to dividends received from B Corporation which are attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation		100.00	
Attributable to other income:			
Attributable to dividends received from B Corporation which are attributable to amounts not included in N Corporation's gross income under 951 with respect to B Corporation	$50.00		
Attributable to other income ($250 − $100 [$250×0.40])	150.00	$200.00	
Total earnings and profits			$300.00
Foreign income taxes deemed paid by N Corporation under section 960(a)(1) with respect to A Corporation:			
Tax paid by A Corporation in respect to its income other than dividends received from B Corporation attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation ($175/$200×$100)			87.50
Tax of B Corporation deemed paid by A Corporation under section 902(b)(1) in respect to such income ($175/$200×$25)			21.88
Total foreign income taxes deemed paid by N Corporation under section 960(a)(1) with respect to A Corporation			$109.38

(d) *Time for meeting stock ownership requirements*—(1) *In general.* For purposes of applying paragraph (c) of this section to amounts included in the gross income of a domestic corporation attributable to the earnings and profits of a first-, second-, or third-tier corporation, the stock ownership requirements of paragraph (b)(1), (2), and (3) of this section and the percentage of voting stock requirements of paragraph (c)(1)(i) and (ii) of this section, if applicable, must be satisfied on the last day in the taxable year of such first-, second-, or third-tier corporation, as the case may be, on which such foreign corporation is a controlled foreign corporation. For paragraph (c) to apply to amounts included in a domestic corporation's gross income attributable to the earnings and profits of a second-tier corporation, the requirements of paragraph (b)(1) and (2) of this section and the percentage of voting stock requirement of paragraph (c)(1)(i) of this section must be met on such date. For paragraph (c) to apply to amounts included in a domestic corporation's gross income attributable to the earnings and profits of a third-tier corporation, the requirements of paragraph (b)(1), (2), and (3) of this section and the percentage of voting stock requirement of paragraph (c)(1)(ii) of this section must be met on such date.

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

Example 1. Domestic corporation N is required for its taxable year ending June 30, 1978, to include in gross income under section 951 an amount attributable to the earnings and profits of controlled foreign corporation A for 1977 and another amount attributable to the earnings and profits of controlled foreign corporation B for such year. Corporations A and B use the calendar year as the taxable year. Such amounts are required to be included in N Corporation's gross income by reason of its ownership of stock in A Corporation and in turn by A Corporation's ownership of stock in B Corporation. Corporation A is a controlled foreign corporation throughout 1977, but B Corporation is a controlled foreign corporation only from January 1, 1977, through September 30, 1977. Corporation N may obtain credit under section 960(a)(1) for the year ending June 30, 1978, for foreign income taxes paid by A Corporation for 1977, only if N Corporation owns at least 10 percent of the voting stock of A Corporation on December 31, 1977. Corporation N may obtain credit under section 960(a)(1) for the year ending June 30, 1978, for foreign income taxes paid by B Corporation for 1977, only if on September 30, 1977, N Corporation owns at least 10 percent of the voting stock of A Corporation, A Corporation owns at least 10 percent of the voting stock of B Corporation, and the percentage of voting stock requirement of paragraph (c)(1)(i) of this section is met.

Example 2. The facts are the same as in example 1, except that A Corporation is a controlled foreign corporation only from January 1, 1977, through March 31, 1977. Corporation N may obtain credit under section 960(a)(1) for the year ending June 30, 1978, for foreign income taxes paid by A Corporation for 1977, only if N Corporation owns at least 10 percent of the voting stock of A Corporation on March 31, 1977. Corporation N may obtain credit under section 960(a)(1) for the year ending June 30, 1978, for foreign income taxes paid by B Corporation for 1977, only if on September 30, 1977, N Corporation owns at least 10 percent of the voting stock of A Corporation, A Corporation owns at least 10 percent of the voting stock of B Corporation, and the percentage of voting stock requirement of paragraph (c)(1)(i) of this section is met.

Example 3. Domestic Corporation N owns 100 percent of the stock of controlled foreign corporation A. A Corporation owns 20 percent of the stock of controlled foreign corporation B. B Corporation owns 10 percent of the voting stock of controlled foreign corporation C. For calendar year 1983, N Corporation is required to include amounts in its gross income attributable to the earnings and profits of A, B, and C Corporations. A, B, and C Corporations were all controlled foreign corporations throughout their respective taxable years ending as follows: A Corporation, December 31, 1983; B Corporation, November 31, 1983; and C Corporation, August 31, 1983. Paragraph (c) of this section applies to amounts included in gross income of N Corporation with respect to the earnings and profits of A Corporation because the 10 percent ownership requirement of paragraph (b)(1) of this section is met on December 31, 1983. Paragraph (c) of this section applies to amounts included in the gross income of N Corporation with respect to the earnings and profits of B Corporation because the 10 percent stock ownership requirements of paragraphs (b)(1) and (2) of this section are met on November 30, 1983, and the percentage of voting stock requirement of paragraph (c)(1)(i) of this section (5 percent) is also met on such date. The percentage of voting stock in A Corporation owned by N Corporation (100 percent) multiplied by the percentage of voting stock in B Corporation owned by A Corporation (20 percent) is 20 percent. Paragraph (c) of this section will not apply to amounts included in N Corporation's gross income attributable to the earnings and profits of C Corporation even though on August 31, 1983, the 10 percent stock ownership requirements of paragraphs (b)(1), (2), and (3) of this section are met, because the percentage of voting stock requirement of paragraph (c)(1)(ii) of this section (5 percent) is not met on such date. The percentage of voting stock of C Corporation owned by B Corporation (10 percent) multiplied by 20 percent (the percentage of voting stock of A Corporation owned by N Corporation multiplied by the percentage of voting stock of B Corporation owned by A Corporation) is 2 percent.

(e) *Information to be furnished.* If the credit for foreign income taxes claimed under section 901 includes taxes deemed paid under section 960(a)(1), the domestic corporation must furnish the same information with respect to the taxes so deemed paid as it is required to furnish with respect to the taxes actually paid or accrued by it and for which credit is claimed. See §1.905–2. For other information required to be furnished by the domestic corporation for the annual accounting period of certain foreign corporations ending with or within such corporation's taxable year, see section 6038(a) and the regulations thereunder.

(f) *Reduction of foreign income taxes paid or deemed paid.* For reduction of the amount of foreign income taxes paid or deemed paid by a foreign corporation for purposes of section 960, see section 6038(c) (as amended by section 338 of the Tax Equity and Fiscal Responsibility Act of 1982) and the regulations thereunder, relating to failure to furnish information with respect to certain foreign corporations. For reduction of the foreign income taxes deemed paid by a domestic corporation under section 960 with respect to foreign oil and gas extraction income, see section 907(a).

(g) *Amounts under section 951 treated as distributions for purposes of applying effective dates.* For purposes of applying section 902 in determining the amount of credit allowed under section 960(a)(1) and paragraph (c) of this section, the effective date provisions of the regulations under section 902 shall apply, and for purposes of so applying the regulations under section 902, any amount attributable to the earnings and profits for the taxable year of a first-, second-, or third-tier corporation which is included in the gross income of a domestic corporation under section 951 shall be treated as a distribution received by such domestic corporation on the last day in such taxable year on which such foreign corporation is a controlled foreign corporation.

(h) *Source of income and country to which tax is deemed paid*—(1) *Source of income.* For purposes of section 904—

(i) The amount included in gross income of a domestic corporation under section 951 for the taxable year with respect to a first-, second-, or third-tier corporation, plus

(ii) Any section 78 dividend to which such section 951 amount gives rise by reason of taxes deemed paid by such domestic corporation under section 960(a)(1),

shall be deemed to be derived from sources within the foreign country or possession of the United States under the laws of which such first-tier corporation, or the first-tier corporation in the same chain of ownership as such second- or third-tier corporation, is created or organized.

(2) *Country to which taxes deemed paid.* For purposes of section 904, the foreign income taxes paid by the first-, second-, or third-tier corporation and deemed to be paid by the domestic corporation under section 960(a)(1) by reason of the inclusion of the amount described in paragraph (h)(1)(i) of this section in the gross income of such domestic corporation shall be deemed to be paid to the foreign country or possession of the United States under the laws of which such first-tier corporation, or the first-tier corporation in the same chain of ownership as such second- or third-tier corporation, is created or organized.

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

Example. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, incorporated under the laws of foreign country X, which owns all the one class of stock of controlled foreign corporation B, incorporated under the laws of foreign country Y. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $45 attributable to the earnings and profits of B Corporation for such year and $50 attributable to the earnings and profits of A Corporation for such year. For 1978, because of the inclusion of such amounts in gross income, N Corporation is deemed under section 960(a)(1) and paragraph (c) of this section to have paid $15 of foreign income taxes paid by B Corporation for such year and $10 of foreign income taxes paid by A Corporation for such year. For purposes of section 904, the amount ($95) included in N Corporation's gross income under section 951 attributable to the earnings and profits of corporations A and B is deemed to be derived from sources within country X, and the section 78 dividend consisting of the foreign income taxes ($25) deemed paid by N Corporation under section

960(a)(1) with respect to such $95 is deemed to be derived from sources within country X. The $25 of foreign income taxes so deemed paid by N Corporation are deemed to be paid to country X for purposes of section 904.

(i) *Computation of deemed-paid taxes in post-1986 taxable years*—(1) *General rule.* If a domestic corporation is eligible to compute deemed-paid taxes under section 960(a)(1) with respect to an amount included in gross income under section 951(a), then, such domestic corporation shall be deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes determined under section 902 and the regulations under that section in the same manner as if the amount so included were a dividend paid by such foreign corporation (determined by applying section 902(c) in accordance with section 904(d)(3)(B)).

(2) *Ordering rule for computing deemed-paid taxes under sections 902 and 960.* If a domestic corporation computes deemed-paid taxes under both sections 902 and 960 in the same taxable year, section 960 shall be applied first. After the deemed-paid taxes are computed under section 960 with respect to a deemed income inclusion, post-1986 undistributed earnings and post-1986 foreign income taxes in each separate category shall be reduced by the appropriate amounts before deemed-paid taxes are computed under section 902 with respect to a dividend distribution.

(3) *Computation of post-1986 undistributed earnings.* Post-1986 undistributed earnings (or an accumulated deficit in post-1986 undistributed earnings) are computed under section 902 and the regulations under that section.

(4) *Allocation of accumulated deficits.* For purposes of computing post-1986 undistributed earnings under sections 902 and 960, a post-1986 accumulated deficit in a separate category shall be allocated proportionately to reduce post-1986 undistributed earnings in the other separate categories. However, a deficit in any separate category shall not permanently reduce earnings in other separate categories, but after the deemed-paid taxes are computed the separate limitation deficit shall be carried forward in the same separate category in which it was incurred. In addition, because deemed-paid taxes may not exceed taxes paid or accrued by the controlled foreign corporation, in computing deemed-paid taxes with respect to an inclusion out of a separate category that exceeds post-1986 undistributed earnings in that separate category, the numerator of the deemed-paid credit fraction (deemed inclusion from the separate category) may not exceed the denominator (post-1986 undistributed earnings in the separate category).

(5) *Examples.* The application of this paragraph (i) may be illustrated by the following examples. See § 1.952–1(f)(4) for additional illustrations of these rules.

Example 1. (i) A, a U.S. person, is the sole shareholder of CFC, a controlled foreign corporation formed on January 1, 1998, whose functional currency is the u. In 1998 CFC earns 100u of general limitation income described in section 904(d)(1)(I) that is not subpart F income and 100u of foreign personal holding company income that is passive income described in section 904(d)(1)(A). In 1998 CFC also incurs a (50u) loss in the shipping category described in section 904(d)(1)(D). CFC's subpart F income for 1998, 100u, does not exceed CFC's current earnings and profits of 150u. Accordingly, all 100u of CFC's subpart F income is included in A's gross income under section 951(a)(1)(A). Under section 904(d)(3)(B) of the Internal Revenue Code and paragraph (i)(1) of this section, A includes 100u of passive limitation income in gross income for 1998.

(ii) For purposes of computing post-1986 undistributed earnings under sections 902, 904(d) and 960 with respect to the subpart F inclusion, the shipping limitation deficit of (50u) is allocated proportionately to reduce general limitation earnings of 100u and passive limitation earnings of 100u. Thus, general limitation earnings are reduced by 25u to 75u (100u general limitation earnings/200u total earnings in positive separate categories × (50u) shipping deficit = 25u reduction), and passive limitation earnings are reduced by 25u to 75u (100u passive earnings/200u total earnings in positive separate categories × (50u) shipping deficit = 25u reduction). All of CFC's post-1986 foreign income taxes with respect to passive limitation earnings are deemed paid by A under section 960 with respect to the 100u subpart F inclusion of passive income (75u inclusion (numerator limited to denominator under paragraph (i)(4) of this section)/75u passive earnings). After the inclusion and deemed-paid taxes are computed, at the close of 1998 CFC has 100u of general limitation earnings, 0 of passive limitation earnings (100u of foreign personal holding company income — 100u inclusion), and a (50u) deficit in shipping limitation earnings.

Example 2. (i) The facts are the same as in *Example 1* with the addition of the following facts. In 1999, CFC distributes 150u to A. CFC has 100u of previously-taxed earnings and profits described in section 959(c)(2) attributable to 1998, all of which is passive limitation earnings and profits. Under section 959(c), 100u of the 150u distribution is deemed to be made from earnings and profits described in section 959(c)(2). The remaining 50u is deemed to be made from earnings and profits described in section 959(c)(3). The entire dividend distribution of 50u is treated as made out of CFC's general limitation earnings and profits. See section 904(d)(3)(D).

(ii) For purposes of computing post-1986 undistributed earnings under section 902 with respect to the 1999 dividend of 50u, the shipping limitation accumulated deficit of (50u) reduces general limitation earnings and profits of 100u to 50u. Thus, 100% of CFC's post-1986 foreign income taxes with respect to general limitation earnings are deemed paid by A under section 902 with respect to the 1999 dividend of 50u (50u dividend/50u general limitation earnings). After the deemed-paid taxes are computed, at the close of 1999 CFC has 50u of general limitation earnings (100u opening balance—50u distribution), 0 of passive limitation earnings, and a (50u) deficit in shipping limitation earnings.

(6) *Effective date.* This paragraph (i) applies to taxable years of a controlled foreign corporation beginning after March 3, 1997.

[T.D. 7120, 36 FR 10852, June 4, 1971; 36 FR 11924, June 23, 1971, as amended by T.D. 7334, 39 FR 44211, Dec. 23, 1974; 40 FR 1014, Jan. 6, 1975; T.D. 7649, 44 FR 60088, 60089, Oct. 18, 1979; T.D. 7843, 47 FR 50472, Nov. 8, 1982; 47 FR 55477, Dec. 10, 1982; T.D. 7961, 49 FR 26225, June 27, 1984; T.D. 8704, 62 FR 21, Jan. 2, 1997]

§1.960–2 Interrelation of section 902 and section 960 when dividends are paid by third-, second-, or first-tier corporation.

(a) *Scope of this section.* This section prescribes rules for the application of section 902 in a case where dividends are paid by a third-, second-, or first-tier corporation, as the case may be, from its earnings and profits for a taxable year when an amount attributable to such earnings and profits is included in the gross income of a domestic corporation under section 951, or when such earnings and profits are attributable to an amount excluded from the gross income of such foreign corporation under section 959(b) and §1.959–2, with respect to the domestic corporation. In making determinations under this section, any portion of a distribution received from a first-tier corporation by the domestic corporation which is excluded from the domestic corporation's gross income under section 959(a) and §1.959–1, or any portion of a distribution received from an immediately lower-tier corporation by the third-, second-, or first-tier corporation which is excluded from such foreign corporation's gross income under section 959(b) and §1.959–2, shall be treated as a dividend for purposes of taking into account under section 902 any foreign income taxes paid by such third-, second-, or first-tier corporation which are not deemed paid by the domestic corporation under section 960(a)(1) and §1.960–1.

(b) *Application of section 902(b) to dividends received from an immediately lower-tier corporation.* For purposes of paragraph (a) of this section and paragraph (c)(1)(i) of §1.960–1, section 902(b) shall apply to all dividends received by the first- or second-tier corporation from the immediately lower-tier corporation other than dividends attributable to earnings and profits of such immediately lower-tier corporation in respect of which an amount is, or has been, included in the gross income of a domestic corporation under section 951 with respect to such immediately lower-tier corporation.

(c) *Application of section 902(a) to dividends received by domestic corporation from first-tier corporation.* For purposes of paragraph (a) of this section, section 902 (a) shall apply to all dividends received by the domestic corporation for its taxable year from the first-tier corporation other than dividends attributable to earnings and profits of such first-tier corporation in respect of which an amount is, or has been, included in the gross income of a domestic corporation under section 951 with respect to such first-tier corporation.

(d) *Allocation of earnings and profits of a first- or second-tier corporation having income excluded under section 959(b)*—(1) *First-tier corporations.* If the first-tier corporation for its taxable year receives dividends from the second-tier corporation to which in accordance with paragraph (b) of this section

902(b)(1) or section 902(b)(2) applies and other dividends from the second-tier corporation to which such sections do not apply, then in applying section 902(a) pursuant to this section and in applying section 960(a)(1) pursuant to § 1.960–1(c)(1)(i), with respect to the foreign income taxes paid and deemed paid by the second-tier corporation which are deemed paid by the first-tier corporation for such taxable year under section 902(b)(1)—

(i) The earnings and profits of the first-tier corporation for such taxable year shall be considered not to include its earnings and profits which are attributable to the dividends to which section 902(b)(1) does not apply (in determining the domestic corporation's credit for the taxes paid by the second-tier corporation) or which are attributable to the dividends to which sections 902(b)(1) and 902(b)(2) do not apply (in determining the domestic corporation's credit for taxes deemed paid by the second-tier corporation) and

(ii) For the purposes of so applying section 902(a), distributions to the domestic corporation from such earnings and profits which are attributable to the dividends to which section 902(b)(1) does not apply (in determining the domestic corporation's credit for taxes paid by the second-tier corporation) or which are attributable to the dividends to which sections 902(b)(1) and 902(b)(2) do not apply (in determining the domestic corporation's credit for taxes deemed paid by the second-tier corporation) shall not be treated as a dividend.

(2) *Second-tier corporations.* If the second-tier corporation for its taxable year receives dividends from the third-tier corporation to which, in accordance with paragraph (b) of this section, section 902(b)(2) applies and other dividends from the third-tier corporation to which such section does not apply, then in applying section 902(b)(1) pursuant to this section, and in applying section 960(a)(1) pursuant to paragraph (c)(1)(i) of § 1.960–1, with respect to the foreign taxes deemed paid by the second-tier corporation for such taxable year under section 902(b)(2)—

(i) The earnings and profits of the second-tier corporation for such taxable year shall be considered not to include its earnings and profits which are attributable to such other dividends from the third-tier corporation, and

(ii) For the purposes of so applying section 902(b)(1), distributions to the first-tier corporation from such earnings and profits which are attributable to such other dividends from the third-tier corporation shall not be treated as a dividend.

(e) *Separate determinations under sections 902(a), 902(b)(1), and 902(b)(2) in the case of a first-, second-, or third-tier corporation having income excluded under section 956(b).* If in the case of a first-, second-, or third-tier corporation to which paragraph (b) or (c) of this section is applied—

(1) The earnings and profits of such foreign corporation for its taxable year consist of—

(i) Dividends received from an immediately lower-tier corporation which are attributable to amounts included in the gross income of a domestic corporation under section 951 with respect to the immediately lower- or lower-tier corporations, and

(ii) Other earnings and profits, and

(2) The effective rate of foreign income taxes paid or accrued by such foreign corporation on the dividends described in paragraph (e)(1)(i) of this section is higher or lower than the effective rate of foreign income taxes attributable to its earnings and profits described in paragraph (e)(1)(ii) of this section,

then, for purposes of applying paragraph (b) or (c) of this section to dividends paid by such foreign corporation to the domestic corporation or the first- or second-tier corporation, sections 902(a), 902(b)(1), and 902(b)(2) shall be applied separately to the portion of the dividend which is attributable to the earnings and profits described in paragraph (e)(1)(i) of this section and separately to the portion of the dividend which is attributable to the earnings and profits described in paragraph (e)(1)(ii) of this section. In making a separate determination with respect to the earnings and profits described in paragraph (e)(1)(i) or (e)(1)(ii) of this section, only the foreign income taxes paid or accrued (or, in the case of earnings and profits of a first- or second-tier corporation described in paragraph (e)(1)(ii) of this section, deemed to be paid) by such foreign corporation on the income attributable to such earnings and profits shall be taken into account. For purposes of applying this paragraph (e), no part of the foreign income taxes paid, accrued, or deemed to be paid which are attributable to the earnings and profits described in paragraph (e)(1)(ii) of this section shall be attributed to the dividend described in paragraph (e)(1)(i) of this section; and no part of the foreign income taxes paid or accrued on the dividend described in paragraph (e)(1)(i) of this section shall be attributed to the earnings and profits described in paragraph (e)(1)(ii) of this section. Furthermore, the effective rate of foreign income taxes paid or accrued shall be determined consistently with the principles of paragraphs (b)(3)(iv) and (viii) and (c) of §1.954–1. Thus, for example, the effective rate of foreign income taxes on dividends received by such foreign corporation shall be determined by taking into account any intercorporate dividends received deduction allowed to such corporation for such dividends.

(f) *Illustrations.* The application of this section may be illustrated by the following examples. In all of the examples other than examples 6, 7, 9 and 10, it is assumed that the effective rate of foreign income taxes paid or accrued by the first- or second-tier corporation, as the case may be, in respect to dividends received from the immediately lower-tier corporation, is the same as the effective rate of foreign income taxes paid or accrued by the first- or second-tier corporation with respect to its other income:

Example 1. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include $50 in gross income attributable to the earnings and profits of A Corporation for such year, but is not required to include any amount in gross income under section 951 attributable to the earnings and profits of B Corporation. For such year, B Corporation distributes a dividend of $45, but A Corporation does not make any distributions. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1), after applying section 902(b)(1) for such year of A Corporation, are determined as follows upon the basis of the facts assumed:

B Corporation (second-tier corporation):		
Pretax earnings and profits		$100.00
Foreign income taxes (40%)		40.00
Earnings and profits		60.00
Dividends paid to A Corporation		$45.00
Foreign income taxes paid by B Corporation on or with respect to its accumulated profits		40.00
Foreign income taxes of B Corporation deemed paid by A Corporation for 1978 under section 902(b)(1) ($45/$60×$40)		30.00
A Corporation (first-tier corporation):		
Pretax earnings and profits:		
Dividends from B Corporation	$45.00	
Other income	100.00	
Total pretax earnings and profits		145.00
Foreign income taxes (20%)		29.00
Earnings and profits		116.00
Foreign income taxes paid, and deemed to be paid, by A Corporation on or with respect to its earnings and profits ($29+$30)		59.00
Amount required to be included in N Corporation's gross income under section 951 with respect to A Corporation		50.00
Dividends paid to N Corporation		0
N Corporation (domestic corporation):		
Foreign income taxes of A Corporation deemed paid by N Corporation for 1978 under section 960(a)(1) ($50/$116×$59)		25.43

Example 2. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $150 attributable to the earnings and profits of B Corporation for such year, which B Corporation distributes during such year. Corporation N is not required for 1978 to include any amount in gross income under section 951 attributable to the earnings and profits of A Corporation, but A Corporation distributes for such year $135 from its earnings and profits attributable to B Corporation's dividend. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1)(C) and section 902(a) are determined as follows upon the basis of the facts assumed:

B Corporation (second-tier corporation):		
Pretax earnings and profits		$250.00
Foreign income taxes (20%)		50.00
Earnings and profits		200.00
Amounts required to be included in N Corporation's gross income under section 951 with respect to B Corporation		150.00
Dividends paid to A Corporation		150.00
Foreign income taxes paid on or with respect to earnings and profits of B Corporation		50.00
A Corporation (first-tier corporation):		
Pretax earnings and profits:		
Dividends from B Corporation	$150.00	
Other income	200.00	
Total pretax earnings and profits		350.00
Foreign income taxes (10%)		35.00

Earnings and profits	315.00
Dividends paid to N Corporation	135.00
Foreign income taxes paid by A Corporation on or with respect to its accumulated profits	35.00
N Corporation (domestic corporation):	
Foreign income taxes of B Corporation deemed paid by N Corporation for 1978 under section 960(a)(1) ($150/$200×$50)	37.50
Foreign income taxes of A Corporation deemed paid by N Corporation for 1978 under section 902(a) ($135/$315×$35)	15.00
Total foreign income taxes deemed paid by N Corporation under section 901	52.50

Example 3. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include $180 in gross income attributable to the earnings and profits of A Corporation for such year, but is not required to include any amount in gross income under section 951 attributable to the earnings and profits of B Corporation. Corporation B distributes from its earnings and profits for 1978 a dividend of $50. For 1978, A Corporation distributes $180 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross income for such year with respect to A Corporation and $20 from its other earnings and profits. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) and section 902(a) are determined as follows upon the basis of the facts assumed:

B Corporation (second-tier corporation):		
Pretax earnings and profits		$100.00
Foreign income taxes (40%)		40.00
Earnings and profits		60.00
Dividends paid to A Corporation		50.00
Foreign income taxes paid by B Corporation on or with respect to its accumulated profits		40.00
Foreign income taxes of B Corporation deemed paid by A Corporation for 1978 under section 902(b)(1) ($50/$60×$40)		33.33
A Corporation (first-tier corporation):		
Pretax earnings and profits:		
Dividends from B Corporation	$50.00	
Other income	200.00	
Total pretax earnings and profits		250.00
Foreign income taxes (10%)		25.00
Earnings and profits		225.00
Foreign income taxes paid, and deemed to be paid, by A Corporation on or with respect to its earnings and profits ($25.00+$33.33)		58.33
Amounts required to be included in N Corporation's gross income for 1978 under section 951 with respect to A Corporation		180.00
Dividends paid to N Corporation:		
Dividends to which section 902(a) does not apply (from A Corporation's earnings and profits in respect of which an amount is required under section 951 to be included in N Corporation's gross income with respect to A Corporation)	180.00	
Dividends to which section 902(a) applies (from A Corporation's other earnings and profits)	20.00	
Total dividends paid to N Corporation		$200.00
N Corporation (domestic corporation):		
Foreign income taxes of corporations A and B deemed paid by N Corporation under section 960(a)(1) ($180/$225×$58.33)		46.66
Foreign income taxes of corporations A and B deemed paid by N Corporation under section 902(a) ($20/$225×$58.33)		5.18
Total foreign income taxes deemed paid by N Corporation under section 901		51.84

Example 4. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $150 attributable to the earnings and profits of B Corporation for such year and $22.50 attributable to the earnings and profits of A Corporation for such year. For 1978, B Corporation distributes $175, consisting of $150 from its earnings and profits attributable to amounts required under section 951 to be included in N Corporation's gross income with respect to B Corporation and $25 from its other earnings and profits. Corporation A does not distribute any dividends for 1978. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) are determined as follows upon the basis of the facts assumed:

B Corporation (second-tier corporation):		
Pretax earnings and profits		$250.00
Foreign income taxes (20%)		50.00
Earnings and profits		200.00
Amounts required to be included in N Corporation's gross income under section 951 for 1978 with respect to B Corporation		150.00
Dividends paid by B Corporation:		
Dividends to which section 902(b) does not apply (from B Corporation's earnings and profits in respect of which an amount is required under section 951 to be included in N Corporation's gross income with respect to B Corporation)	$150.00	

Dividends to which section 902(b)(1) applies (from B Corporation's other earnings and profits)	25.00	
Total dividends paid to A Corporation		175.00
Foreign income taxes paid by B Corporation on or with respect to its accumulated profits		50.50
Foreign income taxes of B Corporation deemed paid by A Corporation for 1978 under section 902(b)(1) ($25/$200×$50)		6.25
A Corporation (first-tier corporation):		
Pretax earnings and profits		175.00
Foreign income tax (10 percent)		17.50
Earnings and profits		157.50
Earnings and profits after exclusion of amounts attributable to dividends to which section 902(b) does not apply ($157.50 less [$150 − ($150×0.10)])		22.50
Amount required to be included in N Corporation's gross income for 1978 under section 951 with respect to A Corporation		22.50
Dividends paid to N Corporation		0
N Corporation (domestic corporation):		
Foreign income taxes deemed paid by N Corporation under section 960(a)(1)(C) with respect to A Corporation:		
Tax actually paid by A Corporation ($22.50/$157.50×$17.50)	2.50	
Tax of B Corporation deemed paid by A Corporation under section 902(b)(1) ($22.50/$22.50×$6.25)	6.25	
		8.75
Foreign income taxes deemed paid by N Corporation under section 960(a)(1)(C) with respect to B Corporation ($150/$200×$50)		37.50
Total taxes deemed paid under section 960(a)(1)(C)		46.20

Example 5. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $150 attributable to the earnings and profits of B Corporation for such year and $22.50 attributable to the earnings and profits of A Corporation for such year. For 1978, B Corporation distributes $175, consisting of $150 from its earnings and profits attributable to amounts required under section 951 to be included in N Corporation's gross income with respect to B Corporation and $25 from its other earnings and profits. For 1978, A Corporation distributes $225, consisting of $135 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross, income with respect to B Corporation, $22.50 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross income with respect to A Corporation, and $67.50 from its other earnings and profits. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) and section 902(a)(1) are determined as follows upon the basis of the facts assumed:

B Corporation (second-tier corporation):		
Pretax earnings and profits		$250.00
Foreign income taxes (20%)		50.00
Earnings and profits		200.00
Amounts required to be included in N Corporation's gross income for 1978 under section 951 with respect to B Corporation		150.00
Dividends paid by B Corporation:		
Dividends to which section 902(b) does not apply (from B Corporation's earnings and profits in respect of which an amount is required under section 951 to be included in N Corporation's gross income with respect to B Corporation)	$150.00	
Dividends to which section 902(b) applies (from B Corporation's other earnings and profits)	$25.00	
Total dividends paid to A Corporation		$175.00
Foreign income taxes paid by B Corporation on or with respect to its accumulated profits		50.00
Foreign income taxes of B Corporation deemed paid by A Corporation for 1978 under section 902(b)(1) ($25/$200×$50)		6.25
A Corporation (first-tier corporation):		
Pretax earnings and profits:		
Dividends received from B Corporation	175.00	
Other income	100.00	
Total pretax earnings and profits		275.00
Foreign income taxes (10 percent)		27.50
Earnings and profits		247.50
Earnings and profits after exclusion of amounts attributable to dividends to which section 902(b) does not apply ($247.50 less [$150 −($150×0.10)])		112.50
Amount required to be included in N Corporation's gross income for 1978 under section 951 with respect to A Corporation		22.50
Distributions paid by A Corporation:		
Dividends to which section 902(a) does not apply (From A Corporation's earnings and profits in respect of which an amount is required under section 951 to be included in N Corporation's gross income with respect to A Corporation)	22.50	
Dividends to which section 902(a) applies (from A Corporation's other earnings and profits)	202.50	
Total dividends paid to N Corporation	225.00	
N Corporation (domestic corporation):		
Foreign income taxes deemed paid by N Corporation under section 960(a)(1) with respect to—		
B Corporation ($150/$200×$50)	....	37.50
A Corporation:		
Tax paid by A Corporation ($22.50/$247.50×$27.50)	2.50	

Tax of B Corporation deemed paid by A Corporation under section 902(b)(1) ($22.50/ $112.50×$6.25)	1.25	3.75
Total taxes deemed paid under section 960(a)(1)		41.25
Foreign income taxes deemed paid by N Corporation under section 902(a)(1) with respect to A Corporation:		
Tax paid by A Corporation ($200.50/$247.50×$27.50)	22.50	
Tax of B Corporation deemed paid by A Corporation ($67.50/ $112.50×$6.25)	3.75	
Total taxes deemed paid under section 902(a)(1)		26.52
Total foreign income taxes deemed paid by N Corporation under section 901		67.05

Example 6. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. A and B corporations are organized under the laws of foreign country X. All of B corporation's assets used in a trade or business are located in country X. Country X imposes an income tax of 20 percent on B corporation's income. For 1978, N Corporation is required under section 951 to include in gross income $100 attributable to the earnings and profits of B Corporation for such year. For 1978, B Corporation distributes $150, consisting of $100 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross income with respect to B Corporation and $50 from its other earnings and profits. Country X imposes an income tax of 10 percent on A Corporation's income but exempts from tax dividends received from B Corporation. N is not required to include any amount in gross income under section 951 for 1978 attributable to the earnings and profits of A Corporation for such year. For 1978, A Corporation distributes $175, consisting of $100 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross income with respect to B Corporation, and $75 from its other earnings and profits. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) and section 902(a) are determined as follows on the basis of the facts assumed:

B Corporation (2d-tier corporation):		
Pretax earnings and profits		$200.00
Foreign income taxes (20%)		40.00
Earnings and profits		160.00
Amount required to be included in N Corporation's gross income for 1978 under section 951 with respect to B Corporation		100.00
Dividends paid by B Corporation:		
Dividends to which section 902(b) does not apply (from B corporation's earnings and profits in respect of which an amount is required under section 951 to be included in N corporation's gross income with respect to B corporation)	$100.00	
Dividends to which section 902(b)(1) applies (from B corporation's other earnings and profits)	50.00	
Total dividends paid to A corporation		150.00
Foreign income taxes of B corporation deemed paid by A corporation for 1978 under section 902(b)(1) ($50/$100× $40)	12.50	
A corporation (1st-tier corporation):		
Pretax earnings and profits:		
Dividends received from B corporation	150.00	
Other income	100.00	
Total pretax earnings and profits		250.00
Foreign income taxes:		
On dividends received from B corporation	None	
On other income ($100×0.10)	10.00	
Total foreign income taxes		10.00
Earnings and profits:		
Attributable to dividends received from B corporation to which section 902(b) does not apply		100.00
Attributable to other income:		
Attributable to dividends received from B Corporation to which section 902(b)(1) applies	50.00	
Attributable to other income ($100 − $10)	90.00	
Subtotal		140.00
Total earnings and profits		240.00
Earnings and profits after exclusion of amounts attributable to dividends to which section 902(b) does not apply ($240 − $100)		140.00
Amount required to be included in N corporation's gross income for 1978 under section 951 with respect to A corporation		None
Dividends paid by A corporation:		
Dividends to which section 902(a) does not apply (from A corporation's earnings and profits in respect of which an amount is required under section 951 to be included in N corporation's gross income with respect to A corporation)	None	
Dividends to which section 902(a) applies (from A corporation's other earnings and profits)	$175.00	
Total dividends paid to N corporation		$175.00
N corporation (domestic corporation):		
Foreign income taxes deemed paid by N corporation under section 960(a)(1) with respect to B corporation ($100/$160×$40)		25.00

Foreign income taxes deemed paid by N corporation under section 902(a) with respect to A corporation (allocation of earnings and profits being made under pars. (c)(2) and (d) of this section):		
Tax paid by A corporation in respect to dividends received from B Corporation to which section 902(b) does not apply ($100/ $100×$0) ..	None	
Tax paid by A corporation in respect to its other income ($75/ $140×$10)	5.36	
Tax paid by B corporation deemed paid by A corporation in respect to such other income ($75/$140×$12.50) ..	6.70	
Total taxes deemed paid under section 902(a)		12.06
Total foreign income taxes deemed paid by N corporation under section 901	37.06	

Example 7. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $150 attributable to the earnings and profits of B Corporation for such year and $47.50 attributable to the earnings and profits of A Corporation for such year. For 1978, B Corporation distributes $200, consisting of $150 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross income with respect to B Corporation and $50 from its other earnings and profits. The country under the laws of which A Corporation is incorporated imposes an income tax of 5 percent on dividends received from a subsidiary corporation and 20 percent on other income. For 1978, A Corporation distributes $100 from its earnings and profits to N Corporation, such amount being attributable under paragraph (e) of §1.959–3 to the amount required under section 951 to be included in N Corporation's gross income with respect to B Corporation. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) and section 902(a) are determined as follows on the basis of the facts assumed:

B Corporation (2d-tier corporation):		
Pretax earnings and profits		$250.00
Foreign income taxes (20 percent)		150.00
Earnings and profits		200.00
Amount required to be included in N Corporation's gross income for 1978 under section 951 with respect to B corporation		150.00
Dividends paid by B corporation:		
Dividends to which section 902(b) does not apply (from B corporation's earnings and profits in respect of which an amount is required under section 951 to be included in N corporation's gross income with respect to B corporation)	$150.00	
Dividends to which section 902(b)(1) applies (from B corporation's other earnings and profits)	50.00	
Total dividends paid to A corporation		200.00
Foreign income taxes of B corporation deemed paid by A corporation for 1978 under section 902(b)(1) ($50/$200×$50)		12.50
A corporation (1st-tier corporation):		
Pretax earnings and profits:		
Dividends received from B corporation	200.00	
Other income	100.00	
Total pretax earnings and profits		300.00
Foreign income taxes:		
On dividends received from B corporation to which section 902(b) does not apply ($150× 0.05)		7.50
On other income:		
Dividends received from B corporation to which section 902(b)(1) applies ($50× 0.05)	2.50	
Other income of A corporation ($100×0.20)	20.00	
Total		22.50
Total foreign income taxes		30.00
Earnings and profits:		
Attributable to dividends received from B corporation to which section 902(b) does not apply ($150 − $7.50)		142.50
Attributable to other income:		
Attributable to dividends received from B corporation to which section 902(b)(1) applies ($50 − $2.50)	47.50	
Attributable to other income ($100 − $20	80.00	
Total		127.50
Total earnings and profits		270.00
Earnings and profits after exclusion of amounts attributable to dividends to which section 902(b) does not apply ($270 less $142.50)		127.50
Amount required to be included in N corporation's gross income for 1978 under section 951 with respect to A corporation		47.50
Dividends paid by A Corporation:		
Dividends to which section 902(a) does not apply (from A corporation's earnings and profits in respect of which an amount is required under section 951 to be included in N corporation's gross income with respect to A corporation)	None	
Dividends to which section 902(a)(1) applies (from A corporation's other earnings and profits)	$100.00	
Total dividends paid to N corporation ...		$100.00

N Corporation (domestic corporation):		
Foreign income taxes deemed paid by N corporation under section 960(a)(1) with respect to—B corporation ($150/$200×$50)		37.50
A corporation (allocation of earnings and profits being made under § 1.960–1(c)(3) and par. (d) of this section):		
Tax paid by A corporation ($47.50/$127.50×$22.50)	8.38	
Tax of B corporation deemed paid by A corporation under section 902(b)(1) ($47.50/$127.50×$12.50)	4.66	
Total		13.04
Total taxes deemed paid under section 960(a)(1)		50.54
Foreign income taxes deemed paid by N corporation under section 902(a) with respect to A corporation (allocations of earnings and profits being made under pars. (c)(2) and (d) of this section) ($100/$142.50×$7.50)	5.26	
Total foreign income taxes deemed paid by N Corporation under section 901		55.80

Example 8. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B, which owns all the one class of stock of controlled foreign corporation C. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include $50 attributable to the earnings and profits of C Corporation and $15 attributable to the earnings and profits of B Corporation in its gross income. N Corporation is not required to include any amount in its gross income with respect to A Corporation under section 951 in 1978. For such year, C Corporation distributes $75 to B Corporation. B Corporation in turn distributes $60 of its earnings and profits to A Corporation. A Corporation has no other earnings and profits for 1978 and distributes $45 of its earnings and profits to N Corporation. The foreign income taxes deemed paid by N Corporation under section 960(a)(1) and section 902(a) are determined as follows on the basis of the facts assumed:

C Corporation (third-tier corporation):

Pretax earnings and profits		$150.00
Foreign taxes paid by C Corporation (30%)		45.00
Earnings and profits		105.00
Amount required to be included in gross income of N Corporation under section 951 with respect to C Corporation		50.00
Dividend to B Corporation		75.00
Dividend from earnings and profits to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation)	50.00	
Dividend from earnings and profits to which section 902(b)(2) applies (attributable to amounts not included in N Corporation's gross income with respect to C Corporation)	$25.00	
Amount of foreign income taxes of C Corporation deemed paid by B Corporation under section 902(b)(2) and § 1.960–2(b):		

$$\frac{\text{Dividend to B Corporation less portion of dividend from earnings included in N Corporation' s gross income under section 951 with respect to C Corporation}}{\text{Earnings and profits of C Corporation}} \times \text{Taxes paid by C Corporation}$$

($25/$105×$45)		$10.71

B Corporation (second-tier corporation):

Pretax earnings and profits:		
Dividend from C Corporation	$75.00	
Other earnings and profits	225.00	
Total pretax earnings and profits		$300.00
Foreign income taxes paid by B Corporation (40%)		120.00
Earnings and profits		180.00
Earnings and profits attributable to amounts to which section 902(b)(2) does not apply (amounts included in N Corporation's gross income under section 951 with respect to C Corporation ($50 − ($50×.40))	30.00	
Other earnings and profits	150.00	
Earnings and profits of B Corporation after exclusion for amounts to which section 902(b)(2) does not apply (amounts attributable to earnings and profits which are included in N Corporation's gross income under section 951 with respect to C Corporation) ($180 − $30)		150.00
Amount to be included in gross income under section 951 of N Corporation with respect to B Corporation		15.00
Amount of dividend to A Corporation		60.00
Dividend from earnings and profits to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation)	30.00	

Dividend from earnings and profits to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation)	15.00	
Dividend from other earnings and profits (attributable to amounts not included in N Corporation's gross income under section 951 with respect to B or C Corporation)	15.00	

Foreign income taxes of B Corporation deemed paid by A Corporation under section 902(b)(1) and § 1.960–2(b):

$$\frac{\begin{array}{c}\text{Dividend to A Corporation less portion of divi}-\\ \text{dend from earnings included in N Corporation' s}\\ \text{gross income under section 951}\\ \text{with respect to B Corporation}\end{array}}{\text{Earnings and profits of B Corporation}}\times\text{Taxes paid by B Corporation}$$

($45/$180×120)		$30.00

Foreign income taxes (of C Corporation) deemed paid by B Corporation deemed paid by A Corporation under section 902(b)(1) in accordance with § 1.960–2(b) and § 1.960–2(d)(2)(i) and (ii):

$$\frac{\begin{array}{c}\text{Dividend to A Corporation less portion}\\ \text{of dividend from earnings included in}\\ \text{N Corporation' s gross income under}\\ \text{section 951 with respect to}\\ \text{B Corporation and C Corporation}\end{array}}{\begin{array}{c}\text{Earnings and profits of B Corporation}\\ \text{less earnings and profits attributable to}\\ \text{amounts included in N Corporation' s gross}\\ \text{income with respect to C Corporation}\end{array}}\times\begin{array}{c}\text{Taxes paid by C Corporation}\\ \text{which are deemed paid by}\\ \text{B Corporation}\end{array}$$

($15/$150×$10.71)		1.07

A Corporation (first-tier corporation):

Pretax earnings and profits:		
Dividend from B Corporation	$60.00	
Other earnings and profits	0	
Total pretax earnings and profits		$60.00
Foreign income taxes paid by A Corporation (10%)		6.00
Earnings and profits		54.00
Earnings and profits attributable to amounts to which section 902(b)(2) does not apply (attributable to amounts previously included in N Corporation's gross income under section 951 with respect to C Corporation) ($30 − ($30X.10))	27.00	
Earnings and profits attributable to amounts to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation) ($15 − ($15X.10))	13.50	
Other earnings and profits ($15— ($15X.10))	13.50	
Earnings and profits of A Corporation after exclusion for amounts to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation) ($54.00 − $13.50)		40.50
Earnings and profits of A Corporation after exclusion for amounts to which sections 902(b)(1) and (2) do not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B or C Corporation) ($40.50 − $27.00)		13.50
Dividend to N Corporation		45.00
Dividend from earnings and profits to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation)	$27.00	
Dividend from earnings and profits to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation)	13.50	

Dividend from earnings and profits to which section 902(a) does not apply (attributable to amounts included in N Corporation’s gross income under section 951 with respect to A Corporation)	0
Dividend from other earnings and profits (attributable to amounts not included in N Corporation’s gross income under section 951 with respect to A, B, or C Corporation)	4.50

N Corporation (domestic corporation):

Foreign income taxes deemed paid by N Corporation under section 960(a)(1) and § 1.960–1(c)(1)(ii) with respect to C Corporation:

$$\frac{\text{Amount included in N Corporation' s gross income under section 951 with respect to C Corporation}}{\text{Earnings and profits of C Corporation}} \times \text{Taxes paid by C Corporation}$$

($50/$105×$45.00)	$21.43
Foreign income taxes deemed paid by N Corporation under section 960(a)(1) and § 1.960–1(c)(1)(i) with respect to B Corporation	11.07

Taxes paid by B Corporation:

$$\frac{\text{Amount included in N Corporation' s gross income under section 951 with respect to B Corporation}}{\text{Earnings and profits of B Corporation}} \times \text{Taxes paid by B Corporation}$$

($15/$180×$120)	$10.00

Taxes deemed paid by B Corporation in accordance with § 1.960–2(d)(2)(i):

$$\frac{\text{Amount included in N Corporation' s gross income under section 951 with respect to B Corporation}}{\text{Earnings and profits of B Corporation less earnings and profits attributable to amounts included in N Corporation' s gross income with respect to C Corporation}} \times \text{Taxes paid by C Corporation which are deemed paid by B Corporation}$$

($15/$150×$10.71)	$1.07
Total taxes deemed paid by N Corporation under section 960(a)(1)	$32.50

Foreign income taxes deemed paid by N Corporation under section 902(a):

Taxes paid by A Corporation in accordance with § 1.960–2(c):

$$\frac{\text{Dividend to N Corporation less portion of dividend from earnings included in N Corporation' s gross income under section 951 with respect to A Corporation}}{\text{Earnings and profits of A Corporation}} \times \text{Taxes paid by A Corporation}$$

($45/$54×$6)	$5.00

Taxes paid by B Corporation deemed paid by A Corporation in accordance with §§1.960–2(c) and 1.960–2(d)(1)(i) and (ii):

$$\frac{\text{Dividend to N Corportion less portionof dividend from earnings included in N Corporation's gross income under section 951 with respect to A and B Corporations}}{\text{Earnings and profits of A Corporation less earnings and profits attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation}} \times \text{Taxes paid by B Corporation which are deemed paid by A Corporation}$$

($31.50/$40.50×$30.00)	23.33

Taxes (of C Corporation) deemed paid by B Corporation deemed paid by A Corporation in accordance with §§1.960–2(c) and 1.960–2(d)(1)(i) and (ii):

$$\frac{\text{Dividend to N Corporation less portion of dividend from earnings included in N Corporation's gross income under section 951 with respect to A, B, and C Corporations}}{\text{Earnings and profits of A Corporation less earnings and profits attributable to amounts included in N Corporation's gross income under section 951 with respect to B and C Corporations}} \times \text{Taxes deemed paid by B Corporation which are deemed paid by A Corporation}$$

($4.50/$13.50×$1.07)	.36	
Total taxes deemed paid by N Corporation under section 902(a)		$28.69
Total foreign income taxes deemed paid by N Corporation under section 901	$61.19	

Example 9. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B, which owns all the one class of stock of controlled foreign corporation C. A and B Corporations are organized under the laws of foreign country X. C Corporation is organized under the laws of foreign country Y. All of B Corporation's assets used in a trade or business are located in country X. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required to include in its gross income under section 951, $50 attributable to the earnings and profits of C Corporation and $100 attributable to the earnings and profits of B Corporation. N Corporation is not required to include any amount in its gross income under section 951 with respect to A Corporation. Country X imposes an income tax of 10 percent on dividends from foreign subsidiaries, 20 percent on dividends from domestic subsidiaries, and 40 percent on other earnings and profits. For 1978, C Corporation distributes $75 to B Corporation. For such year, B Corporation distributes $175 of its earnings

and profits to A Corporation. A Corporation has no other earnings and profits for 1978 and distributes $130 of its earnings and profits to N Corporation. The foreign income taxes deemed paid by N Corporation under sections 960(a)(1) and 902(a) are determined as follows on the basis of the facts assumed:

C Corporation (third-tier corporation):

Pretax earnings and profits		$150.00
Foreign income taxes paid by C Corporation (30%)		45.00
Earnings and profits		105.00
Amount required to be included in gross income of N Corporation under section 951 with respect to C Corporation		50.00
Dividend to B Corporation		75.00
Dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation)	$50.00	
Dividend to which section 902(b)(2) applies (attributable to amounts not included in N Corporation's gross income under section 951 with respect to C Corporation)	25.00	
Amount of foreign income taxes of C Corporation deemed paid by B Corporation under section 902(b)(2) and § 1.960–2(b) ($25/$105×$45)		10.71
(For formula see § 1.960–2(g)(1)(i)(A))		

B Corporation (second-tier corporation):

Pretax earnings and profits:		
Dividend from C Corporation	$75.00	
Other earnings and profits	225.00	
Total pretax earnings and profits		$300.00
Foreign income taxes paid by B Corporation		97.50
On dividends received from C Corporation to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($50×.10)	$5.00	
On dividend from C Corporation to which section 902(b)(2) applies (attributable to amounts not included in N Corporation's gross income under section 951 with respect to C Corporation) ($25×.10)	2.50	
On other income of B Corporation ($225×.40)	90.00	
Earnings and profits		202.50
Attributable to dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($50 − $5)	45.00	
Attributable to dividend from C Corporation to which section 902(b)(2) applies (attributable to amounts not included in N Corporation's gross income under section 951 with respect to C Corporation) ($25 − $2.50)	$22.50	
Attributable to other income of B Corporation ($225 − $90)	135.00	
Earnings and profits after exclusion of amounts attributable to dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($202.50 − $45)		$157.50
Amount required to be included in N Corporation's gross income under section 951 with respect to B Corporation		100.00
Dividend paid by B Corporation		175.00
Dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation)	$45.00	
Dividend to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation)	100.00	
Dividend from other earnings and profits (attributable to amounts not included in N Corporation's gross income with respect to B or C Corporation)	30.00	
Foreign income taxes of B Corporation deemed paid by A Corporation under section 902(b)(1) (separate tax rate applicable to dividend received by B Corporation allocation in accordance with § 1.960–2(e)) (for formula see § 1.960–2(g)(1)(ii)(A)(*2*) (*i*) and (*ii*)):		

Tax paid by B Corporation on earnings previously taxed with respect to C Corporation or lower-tiers which is deemed paid by A Corporation:

$$\frac{\text{Portion of dividend to A Corporation from earnings included in N Corporation's gross income under section 951 with respect to C Corporation or lower-tiers}}{\text{Earnings and profits of B Corporation included in N Corporation's gross income under section 951 with respect to C Corporation or lower-tiers}} \times \text{Tax paid by B Corporation on dividend received by B Corporation from earnings included in N Corporation's gross income with respect to C Corporation or lower-tiers}$$

($45/$45×$5)	$5.00

Tax paid by B Corporation on earnings not previously taxed with respect to C Corporation or lower-tiers which is deemed paid by A Corporation:

$$\frac{\text{Portion of dividend to A Corporation which is from earnings not included in N Corporation's gross income under section 951 with respect to B Corporation or lower-tiers}}{\text{Earnings and profits of B Corporation not included in N Corporation's gross income under section 951 with respect to C Corporation or lower-tiers}} \times \text{Tax paid by B Corporation on earnings not included in N Corporation's gross income with respect to C Corporation or lower-tiers}$$

($30/157.50×$92.50)		$17.62
Foreign income taxes (of C Corporation) deemed paid by B Corporation deemed paid by A Corporation under section 902(b)(1) ($30/$157.50×$10.71)		2.04

(For formula see §1.960–2(g)(1)(ii)(B)(*1*))

A Corporation (first-tier corporation):

Pretax earnings and profits:		
Dividend from B Corporation	$175.00	
Other income	0	
Total pretax earnings and profits		$175.00
Foreign income taxes paid by A Corporation (20%)		35.00
Earnings and profits		140.00
Attributable to dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($45 − ($45×.20))	$36.00	
Attributable to amounts to which section 902(b)(1) does not apply (Attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation) ($100 − ($100×.20))	80.00	
Attributable to other earnings and profits (attributable to amounts not included in N Corporation's gross income with respect to B or C Corporation)	24.00	
Earnings and profits after exclusion for amounts to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation) ($140 − $80)		$60.00
Earnings and profits after exclusion for amounts to which sections 902(b)(1) and 902(b)(2) do not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B or C Corporation) ($60 − $36)		24.00

Amount required to be included in N Corporation's gross income under section 1951 with respect to A Corporation		None
Dividend to N Corporation		$130.00
Dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation)	$36.00	
Dividend to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation)	80.00	
Dividend to which section 902(a) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to A Corporation)	0	
Dividend from other earnings and profits (attributable to amounts not included in N Corporation's gross income with respect to A, B, or C Corporation)	14.00	

N Corporation (domestic corporation):

Foreign income taxes deemed paid by N Corporation under section 960(a)(1) and §1.960–1(c) with respect to C Corporation ($50/$105×$45)	$21.43
(for formula see §1.960–2(g)(2)(i)(A))	
Foreign income taxes deemed paid by N Corporation under section 960(a)(1) with respect to B Corporation (allocation of earnings and profits being made in accordance with §1.960–1(c)(3) and §1.960–2(e)) (Separate tax rate applicable to dividend received by B Corporation)	65.53

Taxes paid by B corporation (for formula see §1.960–2(g)(2)(ii) (A)(*2*)):

$$\frac{\text{Amount included in N Corporation's gross income under section 951 with respect to B Corporation}}{\text{Earnings and profits of B Corporation not included in N Corporation's gross income under section 951 with respect to C Corporation or lower tiers}} \times \text{Tax paid by B Corporation on earnings not included in N Corporation's gross income with respect to C Corporation or lower tiers}$$

($100/$157.50×$92.50)	$58.73	
Taxes (of C Corporation) deemed paid by B Corporation under section 902(b)(2) which are deemed paid by N Corporation under section 960(a)(1) ($100/$157.50×$10.71)	6.80	
(for formula see § 1.960–2(g)(2)(ii)(B)(*1*))		
Total taxes deemed paid by N Corporation under section 960(a)(1)		$86.96

Foreign income taxes deemed paid by N Corporation under section 902(a):

Taxes paid by A Corporation ($130/$140×$35)	$32.50
(for formula see § 1.960–2(g)(1)(iii)(A)(*1*))	

Taxes paid by B Corporation deemed paid by A Corporation (Separate tax rate applicable to dividend received by B Corporation allocation required by § 1.960–2(e)) (for formula see § 1.960–2(g)(1)(iii)(B)(*2*) (*i*) and (*ii*)):

Tax paid by B Corporation on earnings previously taxed with respect to C Corporation or lower tiers which is deemed paid by N Corporation:

$$\frac{\text{Portion of dividend to N Corporation which is from earnings included in N Corporation's gross income under section 951 with respect to C Corporation or lower tiers}}{\text{Earnings and profits of A Corporation included in N Corporation's gross income under section 951 with respect to C Corporation or lower tiers}} \times \text{Tax paid by B Corporation on earnings previously taxed with respect to C Corporation or lower tiers which is deemed paid by A Corporation}$$

($36/$36×$5)	$5.00

Tax paid by B Corporation on earnings not previously taxed with respect to C Corporation or lower tiers which is deemed paid by N Corporation:

$$\frac{\text{Portion of dividend to N Corporation which is from earnings not included in N Corporation's gross income under section 951 with respect to A Corporation or lower tiers}}{\text{Earnings and profits of A Corporation not included in N Corporation's gross income under section 951 with respect to B Corporation or lower tiers}} \times \text{Tax paid by B Corporation on earnings not previously taxed with respect to C Corporation or lower tiers which is deemed paid by A Corporation}$$

($14/$24×$17.62)	$10.28	
Taxes (of C Corporation) deemed paid by B Corporation deemed paid by A Corporation ($14/$24×$2.04)	1.19	
(for formula see § 1.960–2(g)(1)(iii)(C)(*1*))		
Total taxes deemed paid by N Corporation under section 902(a)		$48.97
Total foreign income taxes deemed paid by N Corporation under section 901		135.93

Example 10. The facts are the same as in example 9 except that A Corporation has other earnings and profits of $200 in 1978 and country X imposes a tax of 50 percent on A Corporation's other earnings and profits. A Corporation distributes $200 of its earnings and profits to N Corporation in 1978. The foreign income taxes paid by N Corporation under sections 960 (a)(1) and 902 (a) are determined as follows on the basis of the facts assumed:

C Corporation (third-tier corporation):

Pretax earnings and profits		$150.00
Foreign income taxes paid by C Corporation (30%)		45.00
Earnings and profits		105.00
Amount required to be included in gross income of N Corporation under section 951 with respect to C Corporation		$50.00
Dividend to B Corporation		75.00
Dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation)	50.00	
Dividend to which section 902(b)(2) applies (attributable to amounts not included in N Corporation's gross income under section 951 with respect to C Corporation)	25.00	
Amount of foreign income taxes of C Corporation deemed paid by B Corporation under section 902(b)(2) and §1.960–2(b) ($25/$105×$45)		10.71
(for formula see §1.960–2(g)(1)(i)(A))		

B Corporation (second-tier corporation):

Pretax earnings and profits:		
Dividend from C Corporation	$75.00	
Other earnings and profits	225.00	
Total pretax earnings and profits		$300.00
Foreign income taxes of B Corporation		$97.50
On dividends received from C Corporation to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($50×.10)	$5.00	
On dividend from C Corporation to which section 902(b)(2) applies (attributable to amounts not included in N Corporation's gross income under section 951 with respect to C Corporation) ($25×.10)	2.50	
On other income of B Corporation ($225×.40)	90.00	
Earnings and profits		$202.50
Attributable to dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($50–$5)	$45.00	
Attributable to dividend from C Corporation to which section 902(b)(2) applies (attributable to amounts not included in N Corporation's gross income under section 951 with respect to C Corporation) ($25–$2.50)	22.50	
Attributable to other income of B Corporation ($225–$90)	135.00	
Earnings and profits after exclusion of amounts attributable to dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($202.50–$45)		157.50
Amount required to be included in N Corporation's gross income under section 951 with respect to B Corporation		100.00
Dividend paid by B Corporation		175.00
Dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation)	$45.00	
Dividend to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation)	100.00	
Dividend from other earnings and profits (attributable to amounts not included in N Corporation's gross income with respect to B or C Corporation)	30.00	
Foreign income taxes of B Corporation deemed paid by A Corporation under section 902(b)(1) with allocation required by §1.960–2 (e):		
($45/$45×$5)		5.00
($30/$157.50×$92.50)		17.62
(for formula see §1.960–2(g)(1)(ii)(A)(*2*) (*i*) and (*ii*))		
Foreign income taxes (of C Corporation) deemed paid by B Corporation deemed paid by A Corporation under section 902(b)(1): ($30/$157.50 × $10.71)		2.04
(for formula see §1.960–2(g)(1)(ii)(B)(*1*))		

A Corporation (first-tier corporation):

Pretax earnings and profits:		
Dividend from B Corporation	$175.00	
Other earnings and profits	200.00	
Total pretax earnings and profits		$375.00
Foreign income taxes paid by A Corporation		135.00
On dividend received from B Corporation to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($45×.20)	9.00	
On dividend received from B Corporation to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation) ($100×.20)	20.00	
On dividend from B Corporation attributable to B Corporation's other earnings and profits (attributable to amounts not included in N Corporation's gross income with respect to B or C Corporation) ($30×.20)	6.00	
On other income of A Corporation ($200×.50)	100.00	
Earnings and profits		240.00

Attributable to dividend to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation) ($45 − $9)	36.00	
Attributable to dividend to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income with respect to B Corporation) ($100 − $20)	80.00	
Attributable to other earnings and profits of A Corporation (attributable to amounts not included in N Corporation's gross income with respect to A, B, or C Corporation) [($30 − $6)+($200 − $100)]	124.00	
Amount required to be included in N Corporation's gross income under section 951 with respect to A Corporation		None
Earnings and profits after exclusion of amounts attributable to dividend to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B Corporation)		160.00
Earnings and profits after exclusion of amounts attributable to dividend to which sections 902(b)(1) and 902(b)(2) do not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to B and C Corporation)		124.00
Dividend to N Corporation		200.00
Dividend attributable to amounts to which section 902(b)(2) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to C Corporation)	$36.00	
Dividend attributable to amounts to which section 902(b)(1) does not apply (attributable to amounts included in N Corporation's gross income with respect to B Corporation)	80.00	
Dividend attributable to amounts to which section 902(a) does not apply (attributable to amounts included in N Corporation's gross income under section 951 with respect to A Corporation)	0	
Dividend attributable to A Corporation's other earnings and profits (attributable to amounts not included in N Corporation's gross income under section 951 with respect to A, B, or C Corporation)	$84.00	

N Corporation (domestic corporation).

Foreign income taxes deemed paid by N Corporation under section 960(a)(1) and § 1.960–1(c) with respect to C Corporation ($50/$150×$45) (for formula see § 1.960–2(g)(2)(i)(A))		$21.43
Foreign income taxes deemed paid by N Corporation under section 960(a)(1) with respect to B Corporation (allocation of earning and profits being made in accordance with § 1.960–1(c)(3) and § 1.960–2(e))		65.53
Taxes paid by B Corporation ($100/$157.50×$92.50) (for formula see § 1.960–2(g)(2)(ii)(A)(*2*))	$58.73	
Taxes deemed paid by B Corporation ($100×$157.50×$10.71) (for formula see § 1.960–2(g)(2)(ii)(B)(*1*))	6.80	
Total taxes deemed paid by N Corporation under section 960(a)(1)		86.96
Foreign income taxes deemed paid by N Corporation under section 902(a) (separate tax rate applicable to dividends received by A Corporation allocation required by § 1.960–2(e)) (for formula see § 1.960–2(g)(1)(iii)(A)(*2*) (*i*) and (*ii*)):		

Tax paid by A Corporation on earnings previously taxed with respect to B Corporation or lower tiers which is deemed paid by N Corporation:

$$\frac{\text{Portion of dividend to N Corporation which is from earnings included in N Corporation's gross income under section 951 with respect to B Corporation or lower tiers}}{\text{Earnings and profits of A Corporation included in N Corporation's gross income under section 951 with respect to B Corporation or lower tiers}} \times \text{Tax paid by A Corporation on dividends received by A Corporation from earnings included in N Corporation's gross income with respect to B Corporation or lower tiers}$$

($116/$116×$29)	$29.00

Tax paid by A Corporation on earnings not previously taxed with respect to B Corporation or lower tiers which is deemed paid by N Corporation:

$$\frac{\text{Portion of dividend to N Corporation which is from earnings not included in N Corporation's gross income under section 951 with respect to A Corporation or lower tiers}}{\text{Earnings and profits of A Corporation not included in N Corporation's gross income under section 951 with respect to B Corporation or lower tiers}} \times \text{Tax paid by A Corporation on earnings not included in N Corporation's gross income with respect to B Corporation or lower tiers}$$

($84/$124×$106)	$71.81	
Taxes (paid by B Corporation) deemed paid by A Corporation allocation required by §1.960–2(e):		
($36/$36×$5)	5.00	
($84/$124×$17.62)	11.94	
(for formula see §1.960–2(g)(1)(iii)(B)(*2*) (*i*) and (*ii*))		
Taxes (of C Corporation) deemed paid by B Corporation deemed paid by A Corporation ($84/$124×$2.04)	1.38	
(for formula see §1.960–2(g)(1)(iii)(C)(*1*))		
Total taxes deemed paid by N Corporation under section 902(a) credit		$119.13
Total foreign income taxes deemed paid by N Corporation under section 901		206.09

(g) *Formulas.* This paragraph contains formulas for determining a domestic corporation's section 902 and 960 credits when amounts distributed through a chain of ownership have been included in whole or in part in the gross income of a domestic corporation under section 951 with respect to first-, second-, third-, or lower-tier corporations.

(1) *Determination of the section 902 credit*—(i) *Section 902(b)(2) credit.* If the second-tier corporation receives a dividend from a third-tier corporation attributable in whole or in part to amounts included in a domestic corporation's gross income under section 951 with respect to the third- or lower-tier corporations, the second-tier corporation's credit for taxes paid by the third-tier corporation under section 902(b)(2) is determined as follows:

(A) If the effective rate of tax on dividends received by the third-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Dividend to second-tier corporation less portion of dividend from earnings included in domestic corporation's gross income under section 951 with respect to third-tier corporation}}{\text{Earnings and profits of third-tier corporation}} \times \text{Taxes paid by third-tier corporation}$$

(B) If the effective rate of tax on dividends received by the third-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

(*1*) Credit for tax paid by third-tier corporation on earnings included in domestic corporation's gross income with respect to fourth- or lower-tier corporations—

$$\frac{\text{Portion of dividends to second-tier corporation which is from earnings included in domestic corporation's gross income under section 951 with respect to fourth- or lower-tier corporations}}{\text{Earnings and profits of third-tier corporation included in domestic corporation's gross income under section 951 with respect to fourth- or lower-tier corporations}} \times \text{Tax paid by third-tier corporation on dividend received by third-tier corporation from earnings included in domestic corporation's gross income with respect to fourth- or lower-tier corporations}$$

(*2*) Credit for tax paid by third-tier corporation on earnings not included in domestic corporation's gross income with respect to fourth- or lower-tier corporations—

$$\frac{\text{Portion of dividend to second-tier corporation which is from earnings not included in domestic corporation's gross income under section 951 with respect to third- or lower-tier corporations}}{\text{Earnings and profits of third-tier corporation not included in domestic corporation′s gross income under section 951 with respect to fourth- or lower-tier corporations}} \times \text{Tax paid by third-tier corporation on earnings not included in domestic corporation's gross income with respect to fourth- or lower-tier corporations}$$

(ii) *Section 902(b)(1) credit.* If the first-tier corporation receives a dividend from a second-tier corporation attributable in a whole or in part to amounts included in a domestic corporation's gross income under section 951 with respect to the second- or lower-tier corporations, the first-tier corporation's credit for taxes paid and deemed paid by the second-tier corporation under section 902(b)(1) is determined as follows:

(A) *Taxes paid by the second-tier corporation which are deemed paid by the first-tier corporation*—(*1*) If the effective rate of tax on dividends received by the second-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Dividend to first-tier corporation less portion of dividend from earnings included in domestic corporation's gross income under section 951 with respect to second-tier corporation}}{\text{Earnings and profits of second-tier corporation}} \times \text{Taxes paid by second-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the second-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

(*i*) Credit for tax paid by second-tier corporation on earnings previously taxed with respect to third- or lower-tier corporations—

$$\frac{\text{Portion of dividend to first-tier corporation which is from earnings included in domestic corporation's gross income under section 951 with respect to third- or lower-tier corporations}}{\text{Earnings and profits of second-tier corporation included in domestic corporation's gross income under section 951 with respect to third- or lower-tier corporations}} \times \text{Tax paid by second-tier corporation on dividend received by second-tier corporation from earnings included in domestic corporation's gross income with respect to third- or lower-tier corporations}$$

(*ii*) Credit for tax paid by second-tier corporation on earnings not previously taxed with respect to third- or lower-tier corporations—

$$\frac{\text{Portion of dividend to first-tier corporation which is from earnings not included in domestic corporation' s gross income under section 951 with respect to second- or lower-tier corporations}}{\text{Earnings and profits of second-tier corporation not included in domestic corporation' s gross income under section 951 with respect to third- or lower- tier corporations}} \times \text{Tax paid by second-tier corporation on earnings not included in domestic corporation' s gross income with respect to third- or lower-tier corporations}$$

(B) *Taxes deemed paid by the second-tier corporation which are deemed paid by the first-tier corporation*— (*1*) If the effective rate of tax dividends received by the third-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Dividend to first-tier corporation less portion of dividend from earnings included in domestic corporation' s gross income under section 951 with respect to second- and third-tier corporations}}{\text{Earnings and profits of second-tier corporation less earnings and profits attributable to amounts included in domestic corporation' s gross income under section 951 with respect to third-tier corporation}} \times \text{Taxes paid by third-tier corporation which are deemed paid by second-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the third-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

(*i*) Credit for tax paid by third-tier corporation on earnings previously taxed with respect to fourth- or lower-tier corporations—

$$\frac{\text{Portion of dividend to first-tier corporation which is from earnings included in domestic corporation's gross income under section 951 with respect to fourth- or lower-tier corporations}}{\text{Earnings and profits of second-tier corporations included in domestic corporation's gross income under section 951 with respect to fourth- or lower-tier corporations}} \times \text{Tax paid by third-tier corporation on earnings previously taxed with respect to fourth- or lower-tier corporations which is deemed paid by second-tier corporation}$$

(*ii*) Credit for tax paid by third-tier corporation on earnings not previously taxed with respect to fourth- or lower-tier corporations—

$$\frac{\text{Portion of dividend to first-tier corporation which is from earnings not included in domestic corporation's gross income under section 951 with respect to second- or lower-tier corporations}}{\text{Earnings and profits of second-tier corporation not included in domestic corporation's gross income under section 951 with respect to third- or lower-tier corporations}} \times \text{Tax paid by third-tier corporation on earnings not previously taxed with respect to fourth- or lower-tier corporations which is deemed paid by second-tier corporation}$$

(iii) *Section 902(a) credit.* If the domestic corporation receives a dividend from a first-tier corporation attributable in whole or in part to amounts included in a domestic corporation's gross income under section 951 with respect to the first- or lower-tier corporations, the domestic corporation's credit for taxes paid and deemed paid by the first-tier corporation under section 902(a) is determined as follows:

(A) *Taxes paid by the first-tier corporation which are deemed paid by domestic corporation*—(*1*) If the effective rate of tax on dividends received by the first-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Dividend to domestic corporation less portion of dividend from earnings included in domestic corporation's gross income under section 951 with respect to first-tier corporation}}{\text{Earnings and profits of first-tier corporation}} \times \text{Taxes paid by first-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the first-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

(*i*) Credit for tax paid by first-tier corporation on earnings previously taxed with respect to second- or lower-tier corporations—

$$\frac{\text{Portion of dividend to domestic corporation which is from earnings included in domestic corporation's gross income under section 951 with respect to second- or lower-tier corporations}}{\text{Earnings and profits of first-tier corporation included in domestic corporation's gross income under section 951 with respect to second- or lower-tier corporations}} \times \text{Tax paid by first-tier corporation on dividends received by first-tier corporation from earnings included in domestic corporation's gross income with respect to second- or lower-tier corporations}$$

(*ii*) Credit for tax paid by first-tier corporation on earnings not previously taxed with respect to second- or lower-tier corporations—

$$\frac{\text{Portion of dividend to domestic corporation which is from earnings not included in domestic corporation's gross income under section 951 with respect to first- or lower-tier corporations}}{\text{Earnings and profits of first-tier corporation not included in domestic corporation's gross income under section 951 with respect to second- or lower-tier corporations}} \times \text{Tax paid by first-tier corporation on earnings not included in domestic corporation's gross income with respect to second- or lower-tier corporations}$$

(B) *Taxes (paid by second-tier corporation) deemed paid by first-tier corporation which are deemed paid by domestic corporation*—(*1*) If the effective rate of tax on dividends received by the second-tier corporation is the same as its tax rate on other earnings and profits—

$$\frac{\text{Dividend to domestic corporation less portion of dividend from earnings included in domestic corporation's gross income under section 951 with respect to first- and second-tier corporations}}{\text{Earnings and profits of first-tier corporation less earnings and profits attributable to amounts included in domestic corporation's gross income under section 951 with respect to second-tier corporation}} \times \text{Taxes paid by second-tier corporation which are deemed paid by first-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the second-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

(*i*) Credit for tax paid by second-tier corporation on earnings previously taxed with respect to third-tier or lower-tier corporations—

$$\frac{\text{Portion of dividend to domestic corporation which is from earnings included in domestic corporation's gross income under section 951 with respect to third- or lower-tier corporations}}{\text{Earnings and profits of first-tier corporation included in domestic corporation's gross income under section 951 with respect to third- or lower-tier corporations}} \times \text{Tax paid by second-tier corporation on earnings previously taxed with respect to third- or lower-tier corporations which is deemed paid by first-tier corporation}$$

(*ii*) Credit for tax paid by second-tier corporation on earnings not previously taxed with respect to third- or lower-tier corporations—

$$\frac{\text{Portion of dividend to domestic corporation which is from earnings not included in domestic corporation's gross income under section 951 with respect to first- or lower-tier corporations}}{\text{Earnings and profits of first-tier corporation not included in domestic corporation's gross income under section 951 with respect to second- or lower-tier corporations}} \times \text{Tax paid by second-tier corporation on earnings not previously taxed with respect to third- or lower-tier corporations which is deemed paid by first-tier corporation}$$

(C) *Taxes (of third-tier corporation) deemed paid by first-tier corporation which are deemed paid by domestic corporation*—(*1*) If the effective rate of tax on dividends received by the third-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Dividend to domestic corporation less portion of dividend from earnings included in domestic corporation's gross income under section 951 with respect to first- second- and third-tier corporations}}{\text{Earnings and profits of first-tier corporation less earnings and profits attributable to amounts included in domestic corporation's gross income with respect to second- and third-tier corporations}} \times \text{Taxes deemed paid by second-tier corporation which are deemed paid by first-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the third-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

(*i*) Credit for tax (of third-tier corporation) deemed paid by second-tier corporation on earnings previously taxed with respect to fourth- or lower-tier corporations—

$$\frac{\text{Portion of dividend to domestic corporation which is from earnings included in domestic corporation's gross income under section 951 with respect to fourth- or lower-tier corporations}}{\text{Earnings and profits of first-tier corporation included in domestic corporation's gross income under section 951 with respect to fourth- or lower-tier corporations}} \times \text{Tax deemed paid by second-tier corporation on earnings previously taxed with respect to fourth- or lower-tier corporations which is deemed paid by first-tier corporation}$$

(*ii*) Credit for tax (of third-tier corporation) deemed paid by second-tier on earnings not previously taxed with respect to fourth- or lower-tier corporations—

$$\frac{\text{Portion of dividend to domestic corporation which is from earnings not included in domestic corporation' s gross income under section 951 with respect to first- or lower-tier corporations}}{\text{Earnings and profits of first-tier corporation not included in domestic corpation' s gross income under section 951 with respect to second- or lower-tier corporations}} \times \text{Tax deemed paid by second-tier corporation on earnings not previously taxed with respect to fourth- or lower-tier corpporations which is deemed paid by first-tier corporation}$$

(2) *Determination of domestic corporation's section 960 credit for amounts included in its gross income with respect to a first-, second-, or third-tier corporation which has received a distribution previously included in the gross income of a domestic corporation under section 951*—(i) *Third-tier credit.* If a domestic corporation is required to include an amount in its gross income under section 951 with respect to a third-tier corporation which has received a distribution from a fourth-tier corporation of amounts included in a domestic corporation's gross income under section 951 with respect to the fourth- or lower-tier corporations, the domestic corporation's credit for taxes paid by the third-tier corporation under section 960(a)(1) is determined as follows:

(A) If the effective rate of tax on dividends received by the third-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to third-tier corporation}}{\text{Earnings and profits of third-tier corporation}} \times \text{Taxes paid by third-tier corporation}$$

(B) If the effective rate of tax on dividends received by the third-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to third-tier corporation}}{\text{Earnings and profits of third-tier corporation not included in domestic corporation's gross income under section 951 with respect to fourth- or lower-tier corporations}} \times \text{Tax paid by third-tier corporation on earnings not included in domestic corporation's gross income with respect to fourth- or lower-tier corporations}$$

(ii) *Second-tier credit.* If a domestic corporation is required to include an amount in its gross income under section 951 with respect to a second-tier corporation which has received a distribution from a third-tier corporation of amounts included in a domestic corporation's gross income under section 951 with respect to the third- or lower-tier corporations, the domestic corporation's credit for taxes paid and deemed paid by the second-tier corporation under section 960(a)(1) is determined as follows:

(A) *Credit for taxes paid by the second-tier corporation which are deemed paid by the domestic corporation.*

(*1*) If the effective rate of tax on dividends received by the second-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation' s gross income under section 951 with respect to second-tier corporation}}{\text{Earning and profits of second-tier corporation}} \times \text{Taxes paid by second-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the second-tier is higher or lower than the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to second-tier corporation}}{\text{Earnings and profits of second-tier corporation not included in domestic corporation's gross income under section 951 with respect to third- or lower-tier corporations}} \times \text{Tax paid by second-tier corporation on earnings not included in domestic corporation's gross income with respect to third- or lower-tier corporations}$$

(B) *Credit for taxes (of the third-tier corporation) deemed paid by the second-tier corporation under section 902(b)(2)*—(*1*) If the effective rate of tax on dividends received by the third-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to second-tier corporation}}{\text{Earnings and profits of second-tier corporation less earnings and profits attributable to amounts included in domestic corporation's gross income with respect to third-tier corporation}} \times \text{Taxes paid by third-tier corporation which are deemed paid by second-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the third-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to second-tier corporation}}{\text{Earnings and profits of second-tier corporation not included in domestic corporation's gross income under section 951 with respect to third- or lower-tier corporation}} \times \text{Tax paid by third-tier corporation on earnings not previously taxed with respect to fourth- or lower-tier corproations which is deemed paid by second-tier corporation}$$

(iii) *First-tier credit.* If a domestic corporation is required to include amounts in its gross income under section 951 with respect to a first-tier corporation which has received a distribution from a second-tier corporation of amounts included in a domestic corporation’s gross income under section 951 with respect to the second- or lower-tier corporations, the domestic corporation’s credit for taxes paid and deemed paid by the first-tier corporation under section 960(a)(1) shall be determined as follows:

(A) *Credit for taxes paid by the first-tier corporation.*

(*1*) If the effective rate of tax on dividends received by the first-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to first-tier corporation}}{\text{Earnings and profits of first-tier corporations}} \times \text{Taxes paid by first-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the first-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to first-tier corporation}}{\text{Earnings and profits of first-tier corporation not included in domestic corporation's gross income under section 951 with respect to second- or lower-tier corporations}} \times \text{Tax paid by first-tier corporation on earnings not included in domestic corporation's gross income with respect to second- or lower-tier corporations}$$

(B) *Credit for taxes paid by the second-tier corporation deemed paid by the first-tier corporation under section 902(b)(1).*

(*1*) If the effective rate of tax on dividends received by the second-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to first-tier corporation}}{\text{Earnings and profits of first-tier corporation less earnings and profits attributable to amounts included in domestic corporation's gross income under section 951 with respect to second-tier corporations}} \times \text{Tax paid by second-tier corporation which are deemed paid by first-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the second-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to first-tier corporation}}{\text{Earnings and profits of first-tier corporation not included in domestic corporation's gross income under section 951 with respect to second- or lower-tier corporations}} \times \text{Tax paid by second-tier corporation on earnings not previously taxed with respect to third- or lower-tier corporations which is deemed paid by first-tier corporation}$$

(C) *Credit for taxes (of the third-tier corporation) deemed paid by the second-tier corporation which are deemed paid by first-tier corporation under section 902(b)(1).* (*1*) If the effective rate of tax on dividends received by the third-tier corporation is the same as the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to first-tier corporation}}{\text{Earnings and profits of first-tier corporation less earnings and profits attributable to amounts included in domestic corporation's gross income with respect to second- and third-tier corporation}} \times \text{Taxes deemed paid by second-tier corporation which are deemed paid by first-tier corporation}$$

(*2*) If the effective rate of tax on dividends received by the third-tier corporation is higher or lower than the effective rate of tax on its other earnings and profits—

$$\frac{\text{Amount included in domestic corporation's gross income under section 951 with respect to first-tier corporation}}{\text{Earnings and profits of first-tier corporation not included in domestic corporation's gross income under section 951 with respect to second- or lower-tier corporation}} \times \text{Tax deemed paid by second-tier corporation on earnings not previously taxed with respect to fourth- or lower-tier corporations which is deemed paid by first-tier corporation}$$

[T.D. 7120, 36 FR 10854, June 4, 1971; 36 FR 11924, June 23, 1971, as amended by T.D. 7334, 39 FR 44212, Dec. 23, 1974; 40 FR 1014, Jan. 6, 1975; 40 FR 2802, Jan. 16, 1975; T.D. 7649, 44 FR 60089, Oct. 18, 1979; T.D. 7843, 47 FR 50476, Nov. 8, 1982; 47 FR 55477, Dec. 10, 1982]

§1.960–3 Gross-up of amounts included in income under section 951.

(a) *General rule for including taxes in income.* Any taxes deemed paid by a domestic corporation for the taxable year pursuant to section 960(a)(1) shall, except as provided in paragraph (b) of this section, be included in the gross income of such corporation for such year as a dividend pursuant to section 78 and § 1.78–1.

(b) *Certain taxes not included in income.* Any taxes deemed paid by a domestic corporation for the taxable year pursuant to section 902(a) or section 960(a)(1) shall not be included in the gross income of such corporation for such year as a dividend pursuant to section 78 and § 1.78–1 to the extent that such taxes are paid or accrued by the first-, second-, or third-tier corporation, as the case may be, on or with respect to an amount which is excluded from the gross income of such foreign corporation under section 959(b) and § 1.959–2 as distributions from the earnings and profits of another controlled foreign corporation attributable to an amount which is, or has been, required to be included in the gross income of the domestic corporation under section 951.

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

Example 1. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, B Corporation, after having paid $20 of foreign income taxes, has $80 in earnings and profits, which are attributable to the amount required to be included in N Corporation's gross income for such year under section 951 with respect to B Corporation and all of which are distributed to A Corporation in such year. The dividend so received from B Corporation is excluded from A Corporation's gross income under section 959(b) and § 1.959–2. An income tax of 10 percent is required to be withheld from such dividend by the foreign country under the laws of which B Corporation is created, and the foreign country under the laws of which A Corporation is created imposes an income tax of $22 on the dividend received from B Corporation. For 1978, A Corporation's earnings and profits are $50 ($80 − [0.10×$80] − $22), which it distributes in such year to N Corporation. For 1978, N Corporation is required under section 951 to include $80 in gross income with respect to B Corporation and also is required under the gross-up provisions of section 78 to include in gross income $20 ($80/$80×$20), the amount equal to the foreign income taxes of B Corporation which are deemed paid by N Corporation under section 960(a)(1). Under paragraph (b) of this section N Corporation is not required to include in gross income the $30 ($8+$22) of foreign income taxes which are paid by A Corporation in connection with the dividend received from B Corporation and which are deemed paid by N Corporation under section 902(a) and paragraph (c) of § 1.960–2.

Example 2. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B, which in turn owns all the one class of stock of controlled foreign corporation C. All such corporations use the calendar year as the taxable year. For 1978, C Corporation, after having paid $20 of foreign income taxes, has $80 in earnings and profits, which are attributable to the amount required to be included in N Corporation's gross income for such year under section 951 with respect to C Corporation and all of which are distributed to B Corporation in such year. After having paid foreign income taxes of $10 on the dividend received from C Corporation, B Corporation distributes the balance of $70 to A Corporation. After having paid foreign income taxes of $5 on the dividend received from B Corporation, A Corporation distributes the balance of $65 to N Corporation. The dividend so received by B Corporation, and in turn by A Corporation, is excluded from the gross income of such corporations under section 959(b) and § 1.959–2. Under paragraph (b) of this section N Corporation is not required to include in gross income the $15 ($10+$5) of foreign income taxes which are paid by corporations B and A, respectively, in connection with the dividend so received and which are deemed paid by N Corporation under section 902(a) and paragraphs (b) and (c) of § 1.960–2.

[T.D. 7120, 36 FR 10856, June 4, 1971, as amended by T.D. 7481, 42 FR 20130, Apr. 18, 1977; T.D. 7649, 44 FR 60089, Oct. 18, 1979; T.D. 7843, 47 FR 50484, Nov. 8, 1982]

§ 1.960–4 Additional foreign tax credit in year of receipt of previously taxed earnings and profits.

(a) *Increase in section 904(a) limitation for the taxable year of exclusion*—(1) *In general.* The applicable limitation under section 904(a) for a taxpayer's taxable year (hereinafter in this section referred to as the "taxable year of exclusion") in which he receives an amount which is excluded from gross income under section 959(a)(1) and which is attributable to a controlled foreign corporation's earnings and profits in respect of which an amount was required to be included in the gross income of such taxpayer under section 951(a) for a taxable year (hereinafter in this section referred to as the "taxable year of inclusion'') previous to the taxable year of exclusion shall be increased under section 960(b)(1) by the amount described in paragraph (b) of this section if the conditions described in subparagraph (2) of this paragraph are satisfied.

(2) *Conditions under which increase in limitation is allowed for the taxable year of exclusion.* The increase in limitation described in subparagraph (1) of this paragraph for the taxable year of exclusion shall be made only if the taxpayer—

(i) For the taxable year of inclusion either chose to claim a foreign tax credit as provided in section 901 or did not pay or accrue any foreign income taxes,

(ii) Chooses to claim a foreign tax credit as provided in section 901 for the taxable year of exclusion, and

(iii) For the taxable year of exclusion pays, accrues, or is deemed to have paid foreign income taxes with respect to the amount, described in subparagraph (1) of this paragraph, which is excluded from his gross income for such year under section 959(a)(1).

(b) *Amount of increase in limitation for the taxable year of exclusion.* The amount of increase under section 960 (b)(1) in the applicable limitation under section 904(a) for the taxable year of exclusion shall be—

(1) The amount by which the applicable section 904(a) limitation for the taxable year of inclusion was increased, determined as provided in paragraph (c) of this section, by reason of the inclusion of the amount in the taxpayer's income for such year under section 951(a), reduced by

(2) The amount of foreign income taxes allowed as a credit under section 901 for such taxable year of inclusion and which were allowable to such taxpayer solely by reason of the inclusion of such amount in his gross income under section 951(a), as determined under paragraph (d) of this section, and then by

(3) The additional reduction for such taxable year of inclusion arising by reason of increases in limitation under section 960(b)(1) for taxable years intervening between such taxable year of inclusion and such taxable year of exclusion, as determined under paragraph (e) of this section in respect of such inclusion under section 951(a),

except that the amount of increase determined under this paragraph for the taxable year of exclusion shall in no case exceed the amount of foreign income taxes paid, accrued, or deemed to be paid by such taxpayer for such taxable year of exclusion with respect to the amount, described in paragraph (a)(1) of this section, which is excluded from gross income for such year under section 959(a)(1).

(c) *Determination of increase in limitation for the taxable year of inclusion.* The amount of the increase in the applicable limitation under section 904(a) for the taxable year of inclusion which arises by reason of the inclusion of the amount in gross income under section 951(a) shall be the amount of the applicable limitation under section 904(a) for such year reduced by the amount which would have been the applicable limitation under section 904(a) for such year if the amount had not been included in gross income for such year under section 951(a).

(d) *Determination of foreign income taxes allowed for taxable year of inclusion by reason of section 951(a) amount.* The amount of foreign income taxes allowed as a credit under section 901 for the taxable year of inclusion which were allowable solely by reason of the inclusion of the amount in gross income for such year under section 951(a) shall be the amount of foreign income taxes allowed as a credit under section 901 for such year reduced by the amount of foreign income taxes which would have been allowed as a credit under section 901 for such year if the amount had not been included in gross income for such year under section 951(a). For purposes of this paragraph, the term ''foreign income taxes'' includes foreign income taxes paid or accrued, and foreign income taxes deemed paid under section 902, section 904(d), and section 960(a), for the taxable year of inclusion.

(e) *Additional reduction for the taxable year of inclusion arising by reason of increases in limitation for intervening years.* The amount of increase in the applicable limitation under section 904(a) for the taxable year of inclusion shall also be reduced, after first deducting the foreign income taxes described in paragraph (b)(2) of this section, by any increases in limitation which arise under section 960(b)(1)—by reason of any earlier exclusions under section 959(a)(1) in respect of the same inclusion under section 951(a) for such taxable year of inclusion—for the first, second, third, fourth, etc., succeeding taxable years of exclusion, in that order, which follow such taxable year of inclusion and precede the taxable year of exclusion in respect of which the increase in limitation under section 960(b)(1) and paragraph (b) of this section is being determined. The amount of any increase in limitation which arises under section 960(b)(1) for any such succeeding taxable year of exclusion shall be the amount of foreign income taxes allowed as a credit under section 901 for each such taxable year reduced by the amount of foreign income taxes which would have been allowed as a credit under section 901 for each such year if the limitation for each such year were not increased under section 960(b)(1). For any such succeeding taxable year of exclusion for which the taxpayer does not choose to claim a foreign tax credit as provided in section 901, the same increase in limitation under section 960(b)(1) shall be treated as having been made, for purposes of this paragraph, which would have been made for such taxable year if the taxpayer had chosen to claim the foreign tax credit for such year.

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

Example 1. Domestic corporation N owns all of the one class of stock of controlled foreign corporation A. Corporation A, after paying foreign income taxes of $30, has earnings and profits for 1978 of $70, all of which are attributable to an amount required under section 951(a) to be included in N Corporation's gross income for 1978. Both corporations use the calendar year as the taxable year. For 1979 and 1980, A Corporation has no earnings and profits attributable to an amount required to be included in N Corporation's gross income under section 951(a); for each such year it makes a distribution of $35 (from its earnings and profits for 1978) from which a foreign income tax of $6 is withheld. For each of 1978, 1979, and 1980, N Corporation derives taxable income of $50 from sources within the United States and claims a foreign tax credit under section 901, determined by applying the overall limitation under section 904(a)(2).

The United States tax payable by N Corporation is determined as follows, assuming a corporate tax rate of 48 percent:

1978

Taxable income of N Corporation:		
U.S. sources		$50.00
Sources without the U.S.:		
Amount required to be included in N Corporation's gross income under section 951(a)	$70.00	
Foreign income taxes deemed paid by N Corporation under section 960(a)(1) and included in N Corporation's gross income under section 78 ($30×$70/$70)	30.00	100.00
Total taxable income		150.00
U.S. tax payable for 1978:		
U.S. tax before credit ($150×0.48)		72.00
Credit: Foreign income taxes of $30, but not to exceed overall limitation of $48 for 1978 ($100/$150×$72)		30.00
U.S. tax payable		42.00

1979

Taxable income of N Corporation, consisting of income from U.S. sources		$50.00
U.S. tax before credit ($50×0.48)		24.00
Section 904(a)(2) overall limitation for 1979:		
Limitation for 1979 before increase under section 960(b)(1) ($24×$0/$50)		0
Plus: Increase in overall limitation for 1979 under section 960(b)(1):		
Amount by which 1978 overall limitation was increased by reason of inclusion in N Corporation's gross income under section 951(a) for 1978 ($48 – [($50×0.48)×$0/$50])	$48.00	
Less: Foreign income taxes allowed as a credit for 1978 which were allowable solely by reason of such section 951(a) inclusion ($30 – $0)	30.00	
Balance	18.00	
But: Such balance not to exceed foreign income taxes paid by N Corporation for 1979 with respect to $35 distribution excluded under section 959(a)(1) ($6 tax withheld)	6.00	6.00
Overall limitation for 1979		6.00
U.S. tax payable for 1979:		
U.S. tax before credit ($50×0.48)		24.00
Credit: Foreign income taxes of $6, but not to exceed overall limitation of $6 for 1966		6.00

1979

U.S. tax payable	18.00

1980

Taxable income of N Corporation, consisting of income from U.S. sources		$50.00
U.S. tax before credit ($50×0.48)		24.00
Section 904(a)(2) overall limitation for 1980:		
Limitation for 1980 before increase under section 960(b)(1) ($24×$0/$50)		0
Plus: Increase in overall limitation for 1980 under section 960(b)(1):		
Amount by which 1978 overall limitation was increased by reason of inclusion in N Corporation's gross income under section 951(a) for 1978 ($48−[($50×0.48)×$0/$50])	$48.00	
Less: Foreign income taxes allowed as a credit for 1978 which were allowable solely by reason of such section 951(a) inclusion ($30−$0)	30.00	
Tentative balance	18.00	
Less: Increase in overall limitation under section 960(b)(1) for 1979 by reason of such section 951(a) inclusion	$6.00	
Balance	12.00	
But: Such balance not to exceed foreign income taxes paid by N Corporation for 1980 with respect to $35 distribution excluded under section 959(a)(1) ($6 tax withheld)	6.00	$6.00
Overall limitation for 1980		6.00
U.S. tax payable for 1980:		
U.S. tax before credit ($50×0.48)		24.00
Credit: Foreign income taxes of $6, but not to exceed overall limitation of $6 for 1967		6.00
U.S. tax payable		18.00

Example 2. The facts for 1978, 1979, and 1980, are the same as in example 1, except that in 1977, to which the section 904(a)(2) overall limitation applies, N Corporation pays $18 of foreign income taxes in excess of the overall limitation and that such excess is not absorbed as a carryback to 1975 or 1976 under section 904(c). Therefore, there is no increase under section 960(b)(1) in the overall limitation for 1979 or 1980 since the amount ($48) by which the 1978 overall limitation was increased by reason of the inclusion in N Corporation's gross income for 1978 under section 951(a), less the foreign income taxes ($48) allowed as a credit which were allowable solely by reason of such inclusion, is zero. The foreign income taxes so allowed as a credit for 1978 which were allowable solely by reason of such section 951(a) inclusion consist of the $30 of foreign income taxes deemed paid for 1978 under section 960(a)(1) and the $18 of foreign income taxes for 1977 carried over and deemed paid for 1978 under section 904(c).

Example 3. (a) Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which in turn owns all the one class of stock of controlled foreign corporation B. All corporations use the calendar years as the taxable year. Corporation B, after paying foreign income taxes of $30, has earnings and profits for 1978 of $70, all of which is attributable to an amount required under section 951(a) to be included in N Corporation's gross income for 1978, and $35 of which it distributes in such year to A Corporation. For 1978, A Corporation, after paying foreign income taxes of $5 on such dividend from B Corporation, has total earnings and profits of $30, all of which it distributes in such year to N Corporation, a foreign income tax of $3 being withheld therefrom.

(b) For 1979, B Corporation has no earnings and profits, but distributes in such year to A Corporation the $35 remaining of its earnings and profits for 1965. For 1979, A Corporation, after paying foreign income taxes of $5 on such dividend from B Corporation, has total earnings and profits of $30, all of which it distributes to N Corporation, a foreign income tax of $3 being withheld therefrom.

(c) For each of 1978 and 1979, N Corporation has taxable income of $100 from United States sources and claims a foreign tax credit under section 901, determined by applying the overall limitation under section 904(a)(2). The United States tax payable by N Corporation is determined as follows, assuming a corporate tax rate of 48 percent:

1978

Taxable income of N Corporation:		
U.S. sources		$100
Sources without the U.S.:		
Amount required to be included in N Corporation's gross income under section 951(a) with respect to B Corporation	$70	
Foreign income taxes deemed paid by N Corporation under section 960(a)(1) and included in N Corporation's gross income under section 78 ($30×$70/$70)	30	100
Total taxable income		200
U.S. tax payable for 1978:		
U.S. tax before credit ($200×0.48)		96
Credit: Foreign income taxes of $38 ([$30×$70/$70]+$3), but not to exceed overall limitation of $48 ($96×$100/$200)		38
U.S. tax payable		58

1979

Taxable income of N Corporation, consisting of income from U.S. sources	$100
U.S. tax before credit ($100×0.48)	48
Section 904(a)(2) overall limitation for 1979:	
Limitation for 1979 before increase under section 960(b)(1) ($48×$0/$100)	0

1979		
Plus: Increase in overall limitation for 1979 under section 960(b)(1):		
Amount by which 1978 overall limitation was increased by reason of inclusion in N Corporation's gross income under section 951(a) for 1978 ($48 − [($100×0.48)×$0/$100]) ...	$48	
Less: Foreign income taxes allowed as a credit for 1978 which were allowable solely by reason of such section 951(a) inclusion ($38 − $0)	38	
Balance	10	
But: Such balance not to exceed foreign income taxes paid and deemed paid by N Corporation for 1979 with respect to $30 distribution excluded under section 959(a)(1) ([$5×$30/$30]+$3)	8	8
Overall limitation for 1979		8
U.S. tax payable for 1979:		
U.S. tax before credit ($100×0.48)		48
Credit: Foreign income taxes of $8 ($3+$5), but not to exceed overall limitation of $8 for 1979		8
U.S. tax payable		40

[T.D. 7120, 36 FR 10859, June 4, 1971, as amended by T.D. 7649, 44 FR 60089, Oct. 18, 1979]

§ 1.960–5 Credit for taxable year of inclusion binding for taxable year of exclusion.

(a) *Taxes not allowed as a deduction for taxable year of exclusion.* In the case of any taxpayer who—

(1) Chooses to claim a foreign tax credit as provided in section 901 for the taxable year for which he is required to include in gross income under section 951(a) an amount attributable to the earnings and profits of a controlled foreign corporation, and

(2) Does not choose to claim a foreign tax credit as provided in section 901 for a taxable year in which he receives an amount which is excluded from gross income under section 959(a)(1) and which is attributable to such earnings and profits of such controlled foreign corporation,

No deduction shall be allowed under section 164 for the taxable year of such exclusion for any foreign income taxes paid or accrued on or with respect to such excluded amount.

(b) *Illustration.* The application of this section may be illustrated by the following example:

Example. Domestic Corporation N owns all the one class of stock of controlled foreign corporation A. Both corporations use the calendar year as the taxable year. All of A Corporation's earnings and profits of $80 for 1978 (after payment of foreign income taxes of $20 on its total income of $100 for such year) are attributable to amount required under section 951(a) to be included in N Corporation's gross income for 1978. For 1978, N Corporation chooses to claim a foreign tax credit for the $20 of foreign income taxes which for such year are paid by A Corporation and deemed paid by N Corporation under section 960(a)(1) and paragraph (c)(1) of § 1.960–1. For 1979, A Corporation distributes the entire $80 of 1978 earnings and profits, a foreign income tax of $8 being withheld therefrom. Although N Corporation does not choose to claim a foreign tax credit for 1979, it may not deduct such $8 of foreign income taxes under section 164. Corporation N may, however, deduct under such section a foreign income tax of $4 which is withheld from a distribution of $40 by A Corporation during 1979 from its 1979 earnings and profits.

[T.D. 7120, 36 FR 10859, June 4, 1971, as amended by T.D. 7649, 44 FR 60089, Oct. 18, 1979]

§ 1.960–6 Overpayments resulting from increase in limitation for taxable year of exclusion.

(a) *Amount of overpayment.* If an increase in the limitation under section 960(b)(1) and § 1.960–4 for a taxable year of exclusion exceeds the tax (determined before allowance of any credits against tax) imposed by chapter 1 of the Code for such year, the amount of such excess shall be deemed an overpayment of tax for such year and shall be refunded or credited to the taxpayer in accordance with chapter 65 (section 6401 and following) of the Code.

(b) *Illustration.* The application of this section may be illustrated by the following example:

Example. Domestic corporation N owns all the one class of stock of controlled foreign corporation A. Both corporations use the calendar year as the taxable year. For 1978, A Corporation has total income of $100,000 on which it pays foreign income taxes of $20,000. All of A Corporation's earnings and profits for 1978 of $80,000 are attributable to an amount which is required under section 951(a) to be included in N Corporation's gross income for 1978. By reason of such income inclusion N Corporation is deemed for 1978 to have paid under section 960(a)(1), and is required under section 78 to include in gross income for such year, the $20,000

($20,000×$80,000/$80,000) of foreign income taxes paid by A Corporation for such year. Corporation N also derives $100,000 taxable income from sources within the United States for 1978. For 1979, N Corporation has $25,000 of taxable income, all of which is derived from sources within the United States. No part of A Corporation's earnings and profits for 1979 is attributable to an amount required under section 951(a) to be included in N Corporation's gross income. During 1979, A Corporation makes one distribution consisting of its $80,000 earnings and profits for 1978, all of which is excluded under section 959(a)(1) from N Corporation's gross income for 1979, and from which distribution foreign income taxes of $10,000 are withheld. For 1978 and 1979, N Corporation claims the foreign tax credit under section 901, determined by applying the overall limitation under section 904(a)(2). The United States tax of N Corporation is determined as follows for such years, assuming a corporate tax rate of 22 percent, a surtax of 26 percent and a surtax exemption of $25,000:

1978

Taxable income of N Corporation:		
U.S. sources		$100,000
Sources without the U.S.:		
Amount required to be included in N Corporation's gross income under section 951(a)	$80,000	
Foreign income taxes deemed paid by N Corporation under section 960(a)(1) and included in N Corporation's gross income under section 78 ($20,000×$80,000/$80,000)	20,000	100,000
Total taxable income		200,000
U.S. tax payable for 1978:		
U.S. tax before credit ([$200,000×0.22]+[$175,000×0.26])		89,500
Credit: Foreign income taxes of $20,000, but not to exceed overall limitation of $44,750 ($89,500×$100,000/$200,000)		20,000
U.S. tax payable		69,500

1979

Taxable income of N Corporation, consisting of income from U.S. sources		$25,000
U.S. tax before credit ($25,000×0.22)		5,500
Section 904(a)(2) overall limitation for 1979:		
Limitation for 1979 before increase under section 960(b)(1) ($5,500×$0/$25,000)		0
Plus: Increase in overall limitation for 1979 under section 960(b)(1):		
Amount by which 1978 overall limitation was increased by reason of inclusion in N Corporation's gross income under section 951(a) for 1978 ($44,750 − [$41,500 × $0/$100,000])	$44,750	
Less: Foreign income taxes allowed as a credit for 1978 which were allowable solely by reason of such section 951(a) inclusion ($20,000−$0)	20,000	
Balance	24,750	
But: Such balance not to exceed foreign income taxes paid by N Corporation for 1979 with respect to $80,000 distribution excluded under section 959(a)(1) ($10,000 tax withheld)	10,000	10,000
Overall limitation for 1979		10,000
U.S. tax payable for 1979:		
U.S. tax before credit ($25,000×0.22)		5,500
Credit: Foreign income taxes of $10,000, but not to exceed overall limitation of $10,000 for 1979		10,000
U.S. tax payable		None
Overpayment of tax for 1979:		
Increase in limitation under section 960(b)(1) for 1979		10,000
Less: Tax imposed for 1979 under chapter 1 of the Code		5,500
Excess treated as overpayment		4,500

[T.D. 7120, 36 FR 10859, June 4, 1971, as amended by T.D. 7649, 44 FR 60089, Oct. 18, 1979]

§1.960–7 Effective dates.

(a) *General rule.* Except as provided in paragraph (b), the rules contained in §§1.960–1—1.960–6 shall apply to taxable years of foreign corporations beginning after December 31, 1962, and taxable years of U.S. corporate shareholders within which or with which the taxable year of such foreign corporation ends.

(b) *Exception for less developed country corporations.* If for any taxable year beginning after December 31, 1962, and before January 1, 1976, a first-tier foreign corporation qualified as a less developed country corporation as defined in

26 CFR 1.902–2 revised as of April 1, 1978, the rules pertaining to less developed country corporations contained in 26 CFR 1.960–1—1.960–6 revised as of April 1, 1978, shall apply to any amounts required to be included in gross income under section 951 for such taxable year.

(c) *Third-tier credit.* The rules contained in §§ 1.960–1—1.960–6 shall apply to amounts included in the gross income of a domestic corporation under section 951 with respect to the earnings and profits of third-tier corporations (as defined in § 1.960–1) in taxable years beginning after December 31, 1976.

[T.D. 7649, 44 FR 60089, Oct. 18, 1979, as amended by T.D. 7843, 47 FR 50484, Nov. 8, 1982]

§ 1.961–1 Increase in basis of stock in controlled foreign corporations and of other property.

(a) *Increase in basis*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the basis of a United States shareholder's—

(i) Stock in a controlled foreign corporation; or

(ii) Property (as defined in paragraph (b)(1) of this section) by reason of the ownership of which he is considered under section 958(a)(2) as owning stock in a controlled foreign corporation shall be increased under section 961(a), as of the last day in the taxable year of such corporation on which it is a controlled foreign corporation, by the amount required to be included with respect to such stock or such property in such shareholder's gross income under section 951(a) for his taxable year in which or with which such taxable year of such corporation ends. The increase in basis provided by the preceding sentence shall be made only to the extent to which such amount required to be included in gross income under section 951(a) was so included in gross income.

(2) *Limitation on amount of increase in case of election under section 962.* In the case of a United States shareholder who makes the election under section 962 for the taxable year, the amount of the increase in basis provided by subparagraph (1) of this paragraph shall not exceed the amount of United States tax paid in accordance with such election with respect to the amounts included in such shareholder's gross income under section 951(a) for such year (as determined under § 1.962–1).

(b) *Rules of application*—(1) *Property defined.* The property of a United States shareholder referred to in paragraph (a)(1)(ii) of this section shall consist of—

(i) Stock in a foreign corporation;

(ii) An interest in a foreign partnership; or

(iii) A beneficial interest in a foreign estate or trust (as defined in section 7701(a)(31)).

(2) *Increase with respect to each share of stock.* Any increase under paragraph (a) of this section in the basis of a United States shareholder's stock in a foreign corporation shall be made in the amount included in gross income under section 951(a) or in the amount of United States tax paid in accordance with an election under section 962, as the case may be, with respect to each share of such stock.

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

Example 1. Domestic corporation M owns 800 of the 1,000 shares of the one class of stock in controlled foreign corporation R which owns all of the one class of stock in controlled foreign corporation S. Corporations M, R, and S use the calendar year as a taxable year. In 1964, S Corporation has $100,000 of earnings and profits after the payment of $11,250 of foreign income taxes, and $100,000 of subpart F income. Corporation R has no earnings and profits. With respect to S Corporation, M Corporation is required to include in gross income $80,000 (800/1,000×$100,000) under section 951(a), and $9,000 ($80,000/$100,000×$11,250) under section 78. On December 31, 1964, M Corporation must increase the basis of each share of its stock in R Corporation by $100 ($80,000/800).

Example 2. A, an individual United States shareholder, owns all of the 1,000 shares of the one class of stock in controlled foreign corporation T. Corporation T and A use the calendar year as a taxable year. In 1964, T Corporation has $80,000 of earnings and profits after the payment of $20,000 of foreign income taxes, and $80,000 of subpart F income. A makes the election under section 962 for 1964 and in accordance with such election pays a United States tax of $23,000 with respect to the $80,000 included in his gross income under section 951(a). On December 31, 1964, A must increase the basis of each share of his stock in T Corporation by $23 ($23,000/1,000).

[T.D. 6850, 30 FR 11854, Sept. 16, 1978]

§1.961–2 Reduction in basis of stock in foreign corporations and of other property.

(a) *Reduction in basis*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the adjusted basis of a United States person's—

(i) Stock in a foreign corporation;

(ii) Interest in a foreign partnership; or

(iii) Beneficial interest in a foreign estate or trust (as defined in section 7701(a)(31)),

with respect to which such United States person receives an amount which is excluded from gross income under section 959(a), shall be reduced under section 961(b), as of the time such person receives such excluded amount, by the sum of the amount so excluded and any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States on or with respect to the earnings and profits attributable to such excluded amount when such earnings and profits were actually distributed directly or indirectly through a chain of ownership described in section 958(a)(2).

(2) *Limitation on amount of reduction in case of election under section 962.* In the case of a distribution of earnings and profits attributable to amounts with respect to which an election under section 962 has been made, the amount of the reduction in basis provided by subparagraph (1) of this paragraph shall not exceed the sum of—

(i) The amount of such distribution which is excluded from gross income under section 959(a) after the application of section 962(d) and §1.962–3; and

(ii) Any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States on or with respect to the earnings and profits attributable to such excluded amount when such earnings and profits were actually distributed directly or indirectly through a chain of ownership described in section 958(a)(2).

(b) *Reduction with respect to each share of stock.* Any reduction under paragraph (a) of this section in the adjusted basis of a United States person's stock in a foreign corporation shall be made with respect to each share of such stock in the sum of—

(1)(i) The amount excluded from gross income under section 959(a); or

(ii) The amount excluded from gross income under section 959(a) after the application of section 962(d) and §1.962–3; and

(2) The amount of any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States on or with respect to the earnings and profits attributable to such excluded amount when such earnings and profits were actually distributed directly or indirectly through a chain of ownership described in section 958(a)(2).

(c) *Amount in excess of basis.* To the extent that the amount of the reduction in the adjusted basis of property provided by paragraph (a) of this section exceeds such adjusted basis, the amount shall be treated as gain from the sale or exchange of property.

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

Example 1. (a) Domestic corporation M owns all of the 1,000 shares of the one class of stock in controlled foreign corporation R, which owns all of the 500 shares of the one class of stock in controlled foreign corporation S. Each share of M Corporation's stock in R Corporation has a basis of $200. Corporations M, R, and S use the calendar year as a taxable year. In 1963, S Corporation has $100,000 of earnings and profits after the payment of $50,000 of foreign income taxes and $100,000 of subpart F income. For 1963, M Corporation includes $100,000 in gross income under section 951(a) with respect to S Corporation. In accordance with the provisions of §1.961–1, M Corporation increases the basis of each of its 1,000 shares of stock in R Corporation to $300 ($200+$100,000/1,000) as of December 31, 1963.

(b) On July 31, 1964, M Corporation sells 250 of its shares of stock in R Corporation to domestic corporation N at a price of $350 per share. Corporation N satisfies the requirements of paragraph (d) of §1.959–1 so as to qualify as M Corporation's successor in interest. On September 30, 1964, the earnings and profits attributable to the $100,000 included in M Corporation's gross income under section 951(a) for 1963 are distributed to R Corporation which incurs a withholding tax of $10,000 on such distribution (10 percent of $100,000) and an additional foreign income tax of 33⅓ percent or $30,000 by reason of the inclusion of the net distribution of $90,000 ($100,000 minus $10,000) in its taxable income for 1964. On June 30, 1965, R Corporation distributes the remaining $60,000 of such earnings and profits to corporations M and N: Corporation M receives $45,000 (750/1,000×$60,000) and excludes such amount from gross income under section 959(a); Corporation N receives $15,000 (250/1,000×$60,000) and, as M Corporation's successor in interest, excludes such amount from gross income under section 959(a). As of June 30, 1965, M Corporation must reduce the adjusted basis of each of its 750 shares of stock in R Corporation to $200 ($300 minus ($45,000/750+$10,000/1,000+$30,000/1,000)); and N Corporation must reduce the basis of each of its 250 shares of stock in R Corporation to $250 ($350 minus ($15,000/250+$10,000/1,000+$30,000/1,000)).

Example 2. The facts are the same as in paragraph (a) of example 1, except that in addition, on July 31, 1964, R Corporation sells its 500 shares of stock in S Corporation to domestic corporation P at a price of $600 per share. Corporation P satisfies the requirements of paragraph (d) of § 1.959–1 so as to qualify as M Corporation's successor in interest. On September 30, 1964, S Corporation distributes $100,000 of earnings and profits to P Corporation, which earnings and profits are attributable to the $100,000 included in M Corporation's gross income under section 951(a) for 1963. Corporation P incurs a withholding tax of $10,000 on the distribution from S Corporation (10 percent of $100,000). As M Corporation's successor in interest, P Corporation excludes the $90,000 it receives from gross income under section 959(a). As of September 30, 1964, P Corporation must reduce the basis of each of its 500 shares of stock in S Corporation to $400 ($600 minus ($90,000/500+$10,000/500)).

[T.D. 6850, 30 FR 11854, Sept. 16, 1965]

§ 1.962–1 Limitation of tax for individuals on amounts included in gross income under section 951(a).

(a) *In general.* An individual United States shareholder may, in accordance with § 1.962–2, elect to have the provisions of section 962 apply for his taxable year. In such case—

(1) The tax imposed under chapter 1 of the Internal Revenue Code on all amounts which are included in his gross income for such taxable year under section 951(a) shall (in lieu of the tax determined under section 1) be an amount equal to the tax which would be imposed under section 11 if such amounts were received by a domestic corporation (determined in accordance with paragraph (b)(1) of this section), and

(2) For purposes of applying section 960(a)(1) (relating to foreign tax credit) such amounts shall be treated as if received by a domestic corporation (as provided in paragraph (b)(2) of this section).

Thus, an individual United States shareholder may elect to be subject to tax at corporate rates on amounts included in his gross income under section 951(a) and to have the benefit of a credit for certain foreign taxes paid with respect to the earnings and profits attributable to such amounts. Section 962 also provides rules for the treatment of an actual distribution of earnings and profits previously taxed in accordance with an election of the benefits of this section. See § 1.962–3. For transitional rules for certain taxable years, see § 1.962–4.

(b) *Rules of application.* For purposes of this section—

(1) *Application of section 11.* For purposes of applying section 11 for a taxable year as provided in paragraph (a)(1) of this section in the case of an electing United States shareholder—

(i) *Determination of taxable income.* The term ''taxable income'' as used in section 11 shall mean the sum of—

(a) All amounts required to be included in his gross income under section 951(a) for such taxable year; plus

(b) All amounts which would be required to be included in his gross income under section 78 for such taxable year with respect to the amounts referred to in *(a)* of this subdivision if such shareholder were a domestic corporation.

For purposes of this section, such sum shall not be reduced by any deduction of the United States shareholder even if such shareholder's deductions exceed his gross income.

(ii) *Limitation on surtax exemption.* The surtax exemption provided by section 11(c) shall not exceed an amount which bears the same ratio to $25,000 ($50,000 in the case of a taxable year ending after December 31, 1974, and before January 1, 1976) as the amounts included in his gross income under section 951(a) for the taxable year bear to his pro rata share of the earnings and profits for the taxable year of all controlled foreign corporations with respect to which such United States shareholder includes any amount in his gross income under section 951(a) for the taxable year.

(2) *Allowance of foreign tax credit*—(i) *In general.* Subject to the applicable limitation of section 904 and to the provisions of this subparagraph, there shall be allowed as a credit against the United States tax on the amounts described in subparagraph (1)(i) of this paragraph the foreign income, war profits, and excess profits taxes deemed paid under section 960(a)(1) by the electing United States shareholder with respect to such amounts.

(ii) *Application of section 960(a)(1).* In applying section 960(a)(1) for purposes of this subparagraph in the case of an electing United States shareholder, the term ‘‘domestic corporation’’ as used in sections 960(a)(1) and 78, and the term ‘‘corporation’’ as used in section 901, shall be treated as referring to such shareholder with respect to the amounts described in subparagraph (1)(i) of this paragraph.

(iii) *Carryback and carryover of excess tax deemed paid.* For purposes of this subparagraph, any amount by which the foreign income, war profits, and excess profits taxes deemed paid by the electing United States shareholder for any taxable year under section 960(a)(1) exceed the limitation determined under subdivision (iv)*(a)* of this subparagraph shall be treated as a carryback and carryover of excess tax paid under section 904(d), except that in no case shall excess tax paid be deemed paid in a taxable year if an election under section 962 by such shareholder does not apply for such taxable year. Such carrybacks and carryovers shall be applied only against the United States tax on amounts described in subparagraph (1)(i) of this paragraph.

(iv) *Limitation on credit.* For purposes of determining the limitation under section 904 on the amount of the credit for foreign income, war profits, and excess profits taxes—

(a) Deemed paid with respect to amounts described in subparagraph (1)(i) of this paragraph, the electing United States shareholder's taxable income shall be considered to consist only of the amounts described in such subparagraph (1)(i), and

(b) Paid with respect to amounts other than amounts described in subparagraph (1)(i) of this paragraph, the electing United States shareholder's taxable income shall be considered to consist only of amounts other than the amounts described in such subparagraph (1)(i).

(v) *Effect of choosing benefits of sections 901 to 905.* The provisions of this subparagraph shall apply for a taxable year whether or not the electing United States shareholder chooses the benefits of subpart A of part III of subchapter N of chapter 1 (sections 901 to 905) of the Internal Revenue Code for such year.

(c) *Illustration.* The application of this section may be illustrated by the following example:

Example. Throughout his taxable year ending December 31, 1964, A, an unmarried individual who is not the head of a household, owns 60 of the 100 shares of the one class of stock in foreign corporation M and 80 of the 100 shares of the one class of stock in foreign corporation N. A and corporations M and N use the calendar year as a taxable year, corporations M and N are controlled foreign corporations throughout the period here involved, and neither corporation is a less developed country corporation. The earnings and profits and subpart F income of, and the foreign income taxes paid by, such corporations for 1964 are as follows:

	M	N
Pretax earnings and profits	$500,000	$1,200,000
Foreign income taxes	200,000	400,000
Earnings and profits	300,000	800,000
Subpart F income	150,000	750,000

Apart from his section 951(a) income, A has gross income of $200,600 and $100,000 of deductions attributable to such income. He is required to include $90,000 (0.60×$150,000) in gross income under section 951(a) with respect to M Corporation and $600,000 (0.80×$750,000) with respect to N Corporation. A elects to have the provisions of section 962 apply for 1964 and computes his tax as follows:

Tax on amounts included under section 951(a):	
Income under section 951(a) from M Corporation	$90,000

Gross-up under sections 960(a)(1) and 78 ($90,000/$300,000×$200,000)	60,000		
Income under section 951(a) from N Corporation	600,000		
Gross-up under sections 960(a)(1) and 78 ($600,000/ $800,000×$400,000)	300,000		
Taxable income under section 11	1,050,000		
Normal tax (0.22×$1,050,000)		$231,000	
Surtax exemption ([$90,000+$600,000]/ [0.60×$300,000+(0.80×$800,000)]×$25,000)	21,036		
Subject to surtax under section 11 ($1,050,000−$21,036)	1,028,964		
Surtax (0.28×$1,028,964)		288,110	
Tentative U.S. tax		519,110	
Foreign tax credit ($60,000+$300,000)	360,000		
Total U.S. tax payable on amounts included under section 951(a)			$159,110
Tax with respect to other income:			
Gross income		200,600	
Less:			
Personal exemption	600		
Deductions	100,000		
	100,600		
Taxable income		100,000	
Tax with respect to such other taxable income		59,340	
Total tax ($159,110+$59,340)			218,450

[T.D. 6858, 30 FR 13695, Oct. 28, 1965, as amended by T.D. 7413, 41 FR 12640, Mar. 26, 1976]

§ 1.962–2 Election of limitation of tax for individuals.

(a) *Who may elect.* The election under section 962 may be made only by a United States shareholder who is an individual (including a trust or estate).

(b) *Time and manner of making election.* Except as provided in § 1.962–4, a United States shareholder shall make an election under this section by filing a statement to such effect with his return for the taxable year with respect to which the election is made. The statement shall include the following information:

(1) The name, address, and taxable year of each controlled foreign corporation with respect to which the electing shareholder is a United States shareholder and of all other corporations, partnerships, trusts, or estates in any applicable chain of ownership described in section 958(a);

(2) The amounts, on a corporation-by-corporation basis, which are included in such shareholder's gross income for his taxable year under section 951(a);

(3) Such shareholder's pro rata share of the earnings and profits (determined under § 1.964–1) of each such controlled foreign corporation with respect to which such shareholder includes any amount in gross income for his taxable year under section 951(a) and the foreign income, war profits, excess profits, and similar taxes paid on or with respect to such earnings and profits;

(4) The amount of distributions received by such shareholder during his taxable year from each controlled foreign corporation referred to in subparagraph (1) of this paragraph from excludable section 962 earnings and profits (as defined in paragraph (b)(1)(i) of § 1.962–3), from taxable section 962 earnings and profits (as defined in paragraph (b)(1)(ii) of § 1.962–3), and from earnings and profits other than section 962 earnings and profits, showing the source of such amounts by taxable year; and

(5) Such further information as the Commissioner may prescribe by forms and accompanying instructions relating to such election.

(c) *Effect of election*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph and § 1.962–4, an election under this section by a United States shareholder for a taxable year shall be applicable to all controlled foreign corporations with respect to which such shareholder includes any amount in gross income for his taxable year under section 951(a) and shall be binding for the taxable year for which such election is made.

(2) *Revocation.* Upon application by the United States shareholder, an election made under this section may, subject to the approval of the Commissioner, be revoked. Approval will not be granted unless a material and substantial change in circumstances occurs which could not have been anticipated when the election was made. The application for consent to revocation shall be made by the United States shareholder's mailing a letter for such purpose to Commissioner of Internal Revenue, Attention: T:R, Washington, DC 20224, containing a statement of the facts upon which such shareholder relies in requesting such consent.

[T.D. 6858, 30 FR 13696, Oct. 28, 1965]

§1.962–3 Treatment of actual distributions.

(a) *In general.* Section 962(d) provides that the earnings and profits of a foreign corporation attributable to amounts which are, or have been, included in the gross income of an individual United States shareholder under section 951(a) by reason of such shareholder's ownership (within the meaning of section 958(a)) of stock in such corporation and with respect to which amounts an election under §1.962–2 applies or applied shall, when such earnings and profits are distributed to such shareholder with respect to such stock, notwithstanding the provisions of section 959(a)(1), be included in his gross income to the extent that such earnings and profits exceed the amount of income tax paid by such shareholder under this chapter on the amounts to which such election applies or applied. Thus, when such shareholder receives an actual distribution of section 962 earnings and profits (as defined in paragraph (b)(1) of this section) from a foreign corporation, only the excludable section 962 earnings and profits (as defined in paragraph (b)(1)(i) of this section) may be excluded from his gross income.

(b) *Rules of application.* For purposes of this section—

(1) *Section 962 earnings and profits defined.* With respect to an individual United States shareholder, the term ''section 962 earnings and profits'' means the earnings and profits of a foreign corporation referred to in paragraph (a) of this section. Such earnings and profits include—

(i) *Excludable section 962 earnings and profits.* Excludable section 962 earnings and profits which are the amount of the section 962 earnings and profits equal to the amount of income tax paid under this chapter by such shareholder on the amounts included in his gross income under section 951(a); and

(ii) *Taxable section 962 earnings and profits.* Taxable section 962 earnings and profits which are the excess of section 962 earnings and profits over the amount described in subdivision (i) of this subparagraph.

(2) *Determinations made separately for each taxable year.* If section 962 earnings and profits attributable to more than one taxable year are distributed by a foreign corporation the determinations under this section shall be made separately with respect to each such taxable year.

(3) *Source of distributions*—(i) *In general.* Except as otherwise provided in this subparagraph, the provisions of paragraphs (a) through (d) of §1.959–3 shall apply in determining the source of distributions of earnings and profits by a foreign corporation.

(ii) *Treatment of section 962 earnings and profits under §1.959–3.* For purposes of a section 959(c) amount and year classification under paragraph (b) of §1.959–3, a distribution of earnings and profits by a foreign corporation shall be first allocated to earnings and profits other than section 962 earnings and profits (as defined in subparagraph (1) of this paragraph) and then to section 962 earnings and profits. Thus distributions shall be considered first attributable to amounts described in paragraph (b)(1) of §1.959–3 which are not section 962 earnings and profits and then to amounts described in such paragraph (b)(1) which are section 962 earnings and profits (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year), secondly to amounts described in paragraph (b)(2) of §1.959–3 which are not section 962 earnings and profits and then to amounts described in such paragraph (b)(2) which are section 962 earnings and profits (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year), and finally to the amounts described in paragraph (b)(3) of § 1.959–3 (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year).

(iii) *Allocation to excludable section 962 earnings and profits.* A distribution of section 962 earnings and profits by a foreign corporation for any taxable year shall be considered first attributable to the excludable section 962 earnings and profits (as defined in subparagraph (1)(i) of this paragraph) and then to taxable section 962 earnings and profits.

(iv) *Allocation of deficits in earnings and profits.* A United States shareholder's pro rata share (determined in accordance with the principles of paragraph (e) of § 1.951–1) of a foreign corporation's deficit in earnings and profits (determined under § 1.964–1) for any taxable year shall be applied in accordance with the provisions of paragraph (c) of § 1.959–3 except that such deficit shall also be applied to taxable section 962 earnings and profits (as defined in subparagraph (1)(ii) of this paragraph).

(4) *Distribution in exchange for stock.* The provisions of this section shall not apply to a distribution of section 962 earnings and profits which is treated as in part or full payment in exchange for stock under subchapter C of chapter 1 of the Internal Revenue Code. The application of this subparagraph may be illustrated by the following example:

Example. Individual United States shareholder A owns 60 percent of the only class of stock in foreign corporation M, the basis of which is $10,000. Both A and M Corporation use the calendar year as a taxable year. In each of the taxable years 1964, 1965, and 1966, M Corporation has $1,000 of earnings and profits and $1,000 of subpart F income. With respect to each such amount, A includes $600 in gross income under section 951(a), makes the election under section 962, and pays a United States tax of $132 (22 percent of $600). Accordingly, A increases the basis of his stock in M corporation under section 961(a) by $132 in each of the years 1964, 1965, and 1966, and thus on December 31, 1966, the adjusted basis for A's stock in M Corporation is $10,396. In 1967, M Corporation is completely liquidated (in a transaction described in section 331) and A receives $13,800, consisting of $1,800 of earnings and profits attributable to the amounts which A included in gross income under section 951(a) in 1964, 1965, and 1966, and $12,000 attributable to the other assets of M Corporation. No amount of the $3,404 gain realized by A on such distribution ($13,800 minus $10,396) may be excluded from gross income under section 959(a)(1). However, section 962(d) will not prevent any part of such $3,404 from being treated as a capital gain under section 331.

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

Example. (a) M, a controlled foreign corporation is organized on January 1, 1963; A and B, individual United States shareholders, own 50 percent and 25 percent, respectively, of the only class of stock in M Corporation. Corporation M, A, and B use the calendar year as a taxable year, and M Corporation is a controlled foreign corporation throughout the period here involved. For the taxable years 1963, 1964, 1965, and 1966, A and B must include amounts in gross income under section 951(a) with respect to M Corporation. For the years 1963, 1965, and 1966, A makes the election under section 962. On January 1, 1967, B sells his 25-percent interest in M Corporation to A; A satisfies the requirements of paragraph (d) of § 1.959–1 so as to qualify as B's successor in interest. As of December 31, 1967, M Corporation's accumulated earnings and profits of $675 (before taking into account distributions made in 1967) applicable to A's interest (including his interest as B's successor in interest) in such corporation are classified under § 1.959–3 and this section for purposes of section 962(d) as follows:

CLASSIFICATION OF EARNINGS AND PROFITS FOR PURPOSES OF § 1.962–3

Year	Section 959(c)(1)			Section 959(c)(2)			Section 959 (c)(3)
	Non-section 962 earnings and profits	Excludable section 962 earnings and profits	Taxable section 962, earnings and profits	Non-section 962 earnings and profits	Excludable section 962 earnings and profits	Taxable section 962 earnings and profits	
1963	$25	$11	$39				
1964	75			$60			$15
1965				75	$33	$117	

CLASSIFICATION OF EARNINGS AND PROFITS FOR PURPOSES OF §1.962–3—Continued

Year	Section 959(c)(1)			Section 959(c)(2)			Section 959 (c)(3)
	Non-section 962 earnings and profits	Excludable section 962 earnings and profits	Taxable section 962, earnings and profits	Non-section 962 earnings and profits	Excludable section 962 earnings and profits	Taxable section 962 earnings and profits	
1966				50	22	78	
1967							75

(b) During 1967, M Corporation makes three separate distributions to A of $200, $208, and $267. The source of such distributions under §1.959–3 and this section is as follows:

Distribution	Amount	Year	Classification of distributions under sections 959 and 962(d)
No. 1	$75 25 11 39 50	1964 1963 1963 1963 1966	(c)(1) non-section 962. Do. (c)(1) excludable section 962. (c)(1) taxable section 962. (c)(2) non-section 962.
Total	200		
No. 2	22 78 75 33	1966 1966 1965 1965	(c)(2) excludable section 962 (c)(2) taxable section 962. (c)(2) non-section 962. (c)(2) excludable section 962.
Total	208		
No. 3	117 60 75 15	1965 1964 1967 1964	(c)(2) taxable section 962. (c)(2) non-section 962. (c)(3). Do.
Total	267		

(c) A must include $324 in his gross income for 1967. The source of these amounts is as follows:

Distribution	Amount	Year	Classification
No. 1	$39	1963	(c)(1) taxable section 962.
No. 2	78	1966	(c)(2) taxable section 962.
No. 3	117 75 15	1965 1967 1964	Do. (c)(3). Do.
Total	324		

(c) *Treatment of shareholder's successor in interest*—(1) *In general.* If a United States person (as defined in §1.957–4) acquires from any person any portion of the interest in the foreign corporation of a United States shareholder referred to in this section, the rules of paragraphs (a) and (b) of this section shall apply to such acquiring person. However, no exclusion of section 962 earnings and profits under paragraph (a) of this section shall be allowed unless such acquiring person establishes to the satisfaction of the district director his right to such exclusion. The information to be furnished by the acquiring person to the district director with his return for the taxable year to support such exclusion shall include:

(i) The name, address, and taxable year of the foreign corporation from which a distribution of section 962 earnings and profits is received and of all other corporations, partnerships, trusts, or estates in any applicable chain of ownership described in section 958(a);

(ii) The name and address of the person from whom the stock interest was acquired;

(iii) A description of the stock interest acquired and its relation, if any, to a chain of ownership described in section 958(a);

(iv) The amount for which an exclusion under paragraph (a) of this section is claimed; and

(v) Evidence showing that the section 962 earnings and profits for which an exclusion is claimed are attributable to amounts which were included in the gross income of a United States shareholder under section 951(a) subject to an election under §1.962–2, that such amounts were not previously excluded from the gross income of a United States person, and the identity of the United States shareholder including such amount.

The acquiring person shall also furnish to the district director such other information as may be required by the district director in support of the exclusion.

(2) *Taxes previously deemed paid by an individual United States shareholder.* If a

corporate successor in interest of an individual United States shareholder receives a distribution of section 962 earnings and profits, the income, war profits, and excess profits taxes paid to any foreign country or to any possession of the United States in connection with such earnings and profits shall not be taken into account for purposes of section 902, to the extent such taxes were deemed paid by such individual United States shareholder under paragraph (b)(2) of § 1.962–1 and section 960(a)(1) for any prior taxable year.

[T.D. 6858, 30 FR 13696, Oct. 28, 1965]

§ 1.962–4 Transitional rules for certain taxable years.

(a) *Extension of time for making or revoking election.* Paragraphs (b) and (c) of this section provide additional rules with respect to making or revoking an election under section 962 which apply only to a taxable year of a United States shareholder for which the last day prescribed by law for filing his return (including any extensions of time under section 6081) occurs or occurred on or before January 31, 1966.

(b) *Manner of making election not previously made.* If a United States shareholder who has not previously made an election under section 962 for any taxable year referred to in paragraph (a) of this section desires to make such an election, he may do so by filing his return or an amended return for such taxable year together with a statement setting forth the information required under paragraph (b) of § 1.962–2. Such return or amended return and statement shall be filed on or before January 31, 1966.

(c) *Revocation of election previously made.* If a United States shareholder who has made an election under section 962 on or before November 1, 1965, for any taxable year referred to in paragraph (a) of this section desires to revoke such election, he may do so by filing an amended return to which is attached a statement that the election previously made is revoked. Such amended return and statement shall be filed on or before January 31, 1966.

[T.D. 6858, 30 FR 13698, Oct. 28, 1965]

§ 1.963–0 Repeal of section 963; effective dates.

(a) *Repeal of section 963.* Except as provided in paragraphs (b) and (c) of this section, the provisions of section 963 and §§ 1.963–1 through 1.963–7 are repealed for taxable years of foreign corporations beginning after December 31, 1975, and for taxable years of United States shareholders (within the meaning of section 951(b), within which or with which such taxable years of such foreign corporations end.

(b) *Transitional rules for chain or group election*—(1) *In general.* If a United States shareholder (within the meaning of section 951(b) makes either a chain election pursuant to § 1.963–1(e) or a group election pursuant to § 1.963–1(f) for a taxable year of such shareholder beginning after December 31, 1975, then a foreign corporation shall be includible in such election only if—

(i) It has a taxable year beginning before January 1, 1976, which ends within such taxable year of the United States shareholder, and

(ii) It is either—

(A) A controlled foreign corporation or

(B) A foreign corporation by reason of ownership of stock in which such shareholder indirectly owns (within the meaning of section 958(a)(2)) stock in a controlled foreign corporation to which this subparagraph applies.

(2) *Series rule.* If any foreign corporation in a series of foreign corporations is excluded by subparagraph (i) of this paragraph from a chain or group election of a United States shareholder for its taxable year, then any foreign corporation in which the United States shareholder owns stock indirectly by reason of ownership of stock in such excluded corporation shall also be excluded from such election to the extent of such indirect ownership regardless of when its taxable year begins.

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

Example. (a) M is a domestic corporation, A, B, D, and E are controlled foreign corporations, and C is a foreign corporation other than a controlled foreign corporation. All five foreign corporations, each have only one class of stock outstanding. M owns directly all of the stock of A, which in turn owns directly all of the stock of B, which in turn owns directly 60 percent of the stock of D, which in turn owns directly all of the stock of E. M also owns directly 40 percent of the stock of C, which in turn owns directly the remaining 40 percent of the stock of D. M is a United States shareholder with respect to no other foreign corporation. M and B each use the calendar year as the taxable year. A, C, D, and E each use a fiscal year ending on November 30 as the taxable year. For calendar year 1976, M may make either a first-tier election with respect to A, a chain election with respect to C and D (to the extent of M's indirect 16-percent stock interest in D by reason of its direct ownership of 40 percent of the stock of C) or a group election with respect to A, C, D (to the extent of such 16-percent stock interest) and E (to the extent of M's indirect 16-percent stock interest in E).

(b) M's indirect 100 percent stock interest in B will be excluded from any chain or group election made by M for calendar year 1976 since B is a controlled foreign corporation which does not have a taxable year beginning before January 1, 1976, which ends within the taxable year of M beginning after December 31, 1975, for which M has made either a chain or group election.

(c) M's indirect 60 percent stock interest through A and B in D and E will be excluded from any chain or group election made by M for calendar year 1976 since such 60 percent interests are indirectly owned by M by reason of its indirect ownership of stock in B, which is a foreign corporation which does not have a taxable year beginning before January 1, 1976, which ends within the taxable year of M beginning after December 31, 1975, for which M has made either a chain or group election.

(d) If C used the calendar year as its taxable year and was therefore excluded from a chain election made with respect to it and D, then D would also be excluded from such an election, since D would then be a foreign corporation in which M owns stock indirectly by reason of ownership of stock in C, which is excluded from such election.

(c) *Deficiency distributions.* The rules relating to deficiency distributions under section 963(e)(2) and §1.963–6 shall continue to apply to a taxable year beginning after the effective date of the repeal of section 963 in which it is determined that a deficiency distribution must be made for an earlier taxable year for which a United States shareholder made an election to secure the exclusion under section 963 but failed to receive a minimum distribution.

(d) *Special adjustments pursuant to section 963 to be taken into account for taxable years subsequent to the repeal of section 963.* If a United States shareholder of a controlled foreign corporation elects to receive a minimum distribution under section 963 for a taxable year, section 963 and the regulations thereunder may require certain elections and adjustments to be made in subsequent taxable years. These elections and adjustments shall be taken into account for subsequent taxable years as if section 963 were still in effect and no election to receive a minimum distribution were made after the effective date of the repeal of section 963. Examples of these elections and special adjustments include, but are not limited to, the election which may be made pursuant to §1.963–3(g)(2), relating to the special extended distribution period, and the special adjustments to be made pursuant to §1.963–4, relating to the minimum overall tax burden test.

[T.D. 7545, 43 FR 19652, May 8, 1978]

§1.963–1 Exclusion of subpart F income upon receipt of minimum distribution.

(a) *In general*—(1) *Purpose of section 963.* Section 963 sets forth an exception to section 951(a)(1)(A)(i) by providing that a United States corporate shareholder may exclude from its gross income the subpart F income of a controlled foreign corporation if for the taxable year such shareholder elects such exclusion and, where necessary, receives a distribution of the earnings and profits of such foreign corporation sufficient to bring the aggregate U.S. and foreign income taxes on the pretax earnings and profits of that corporation to a percentage level approaching the U.S. tax rate for such year on the income of a domestic corporation. The election to secure an exclusion under section 963 may be made with respect to a ‘‘single first-tier corporation’’ or a ‘‘chain’’ or ‘‘group’’ of controlled foreign corporations. This section defines the terms ‘‘single first-tier corporations,’’ ‘‘chains,’’ ‘‘group,’’ and certain other terms and prescribes the manner in which such an election is to be made. Section 1.963–2 describes the manner in which the amount of the minimum distribution for any taxable year is to be determined. Section 1.963–3 specifies the distributions counting toward a minimum distribution. Section 1.963–4 sets forth the requirement with respect to a minimum distribution from a chain or group that the overall U.S. and foreign income tax must equal either 90 percent of the U.S. corporate tax rate applied against consolidated pretax and predistribution earnings and profits or, with the application of the special rules set forth in that section, the total U.S. and foreign income taxes which would have been incurred in respect of a pro rata minimum distribution from the chain or group. Section 1.963–5 provides special rules for applying section 963 in certain cases in which the rate of foreign income tax incurred by a foreign corporation varies with the amount of distributions it makes for the taxable year. Section 1.963–6 outlines the deficiency distribution procedure that may be followed if for reasonable cause a U.S. corporate shareholder fails to receive a complete minimum distribution for a taxable year for which it elects the exclusion under section 963. Section 1.963–7 provides transitional rules for the application of section 963 for certain taxable years of U.S. shareholders ending on or before the 90th day after September 30, 1964. Section 1.963–8 provides rules for the determination of the required minimum distribution during the period the §surcharge imposed by section 51 is in effect.

(2) *Conditions for exclusion of subpart F income.* To qualify for an exclusion under section 963 for any taxable year with respect to the subpart F income of a controlled foreign corporation, a corporate United States shareholder must—

(i) Elect such exclusion on or before the last day (including any extensions of time under section 6081) prescribed by law for filing its return of the tax imposed by chapter 1 of the Code for the taxable year;

(ii) Receive, if and to the extent necessary, distributions of the type described in paragraph (a) of § 1.963–3 sufficient in amount to constitute a minimum distribution;

(iii) Incur, in the case of a chain or group election, income tax with respect to such minimum distribution sufficient to satisfy the requirements of paragraph (a) of § 1.963–4, relating to the minimum overall tax burden; and

(iv) Consent, on or before such last day for making the election, to the regulations under section 963 applicable to such taxable year and to any amendments thereof duly prescribed before such last day.

The making of the election under section 963 by filing the return on or before such last day shall constitute the consent to the regulations under such section prescribed before such last day. For an extension of the time for receiving a minimum distribution and making the consent for certain taxable years ending on or before the 90th day after September 30, 1964, see § 1.963–7.

(3) *Subpart F income excluded.* An exclusion under section 963 for a taxable year of a United States shareholder for which the election is made under such section shall apply only to the subpart F income for the taxable year of the single first-tier corporation to which the election applies or of each controlled foreign corporation in the chain or group to which the election applies. Only those amounts attributable to the stock interest to which the election relates may be excluded. Thus, in case of a first-tier election with respect to stock of a controlled foreign corporation owned directly within the meaning of section 958(a)(1)(A), the corporate United States shareholder may not exclude any subpart F income of such foreign corporation which is includible in its gross income under section 951(a)(1)(A)(i) by virtue of its indirect ownership of stock in such foreign corporation through the operation of section 958(a)(2). Subpart F income of a controlled foreign corporation which is excluded from the gross income of a United States shareholder by reason of the receipt of a minimum distribution to which section 963 applies shall not be considered to be excluded under section 954(b)(1) or section 970(a).

(4) *Affiliated group of corporations.* An affiliated group of domestic corporations which makes a consolidated return under section 1501 for the taxable year shall be treated as a single United

States shareholder for purposes of applying section 963 for such year if the common parent corporation in its return for such affiliated group makes any first-tier election, chain election, or group election under section 963 for such affiliated group; in such case, no member of such affiliated group may separately make any first-tier election, chain election, or group election under section 963 for the taxable year. If the common parent of such an affiliated group so making a consolidated return makes no first-tier election, chain election, or group election for such affiliated group, then any member may make a first-tier election, chain election, or group election to the same extent that it could so elect if such affiliated group had not filed a consolidated return; in such case, the affiliated group will not be treated as a single United States shareholder.

(b) *Definitions.* For purposes of section 963 and §§1.963–1 through 1.963–8—

(1) *Controlled foreign corporation.* The term ‘‘Controlled foreign corporation’’ shall have the meaning accorded to it by section 957 and the regulations thereunder but shall not include any foreign corporation for a taxable year beginning before January 1, 1963.

(2) *Single first-tier corporation.* The term ‘‘single first-tier corporation’’ means a controlled foreign corporation described in paragraph (d) of this section with respect to which a first-tier election has been made for the taxable year.

(3) *Chain.* The term ‘‘chain’’ means collectively the foreign corporations described in paragraph (e) of this section with respect to which a chain election has been made for the taxable year.

(4) *Group.* The term ‘‘group’’ means collectively the foreign corporations described in paragraph (f) of this section with respect to which a group election has been made for the taxable year.

(5) *First-tier election, etc.* The term ‘‘first-tier election’’ means an election described in paragraph (c)(1)(i)(a) of this section; the term ‘‘chain election’’ means an election described in paragraph (c)(1)(i)(b) of this section; and the term ‘‘group election’’ means an election described in paragraph (c)(1)(ii) of this section.

(6) *Taxable year.* (i) The term ‘‘taxable year of a single first-tier corporation,’’ ‘‘taxable year of a corporation in a chain,’’ or ‘‘taxable year of a corporation in a group,’’ means, respectively, the taxable year of such corporation ending with or within the taxable year of the electing United States shareholder for which is made under paragraph (c)(1) of this section the election establishing it as a single first-tier corporation, a corporation in a chain, or corporation in a group, as the case may be.

(ii) The term ‘‘taxable year’’ when used in reference to a chain or group refers collectively to the respective taxable years of the foreign corporations in such chain or group to which applies the election establishing such chain or group status, such taxable year being, in the case of each respective corporation in the chain or group, such corporation’s taxable year ending with or within the taxable year of the electing United States shareholder, whether or not such taxable year of the corporation is the same as that of any other foreign corporation in the chain or group.

(7) *Foreign income tax.* The term ‘‘foreign income tax’’ means income, war profits, and excess profits taxes, and taxes included in the term ‘‘income, war profits, and excess profits taxes’’ by reason of section 903, paid or accrued to a foreign country or possession of the United States and taken into account for purposes of sections 901 through 905. Except in determining the foreign tax credit under section 901, the term shall not include any tax which is deemed paid by a foreign corporation under section 902(b).

(c) *Election to exclude subpart F income*—(1) *Foreign corporations included in election.* A corporate United States shareholder may for any taxable year exercise the election to secure an exclusion under section 963 either—

(i)*(a)* Separately with respect to any foreign corporation which as to such shareholder is described in paragraph (d) of this section, and/or

(b) Separately with respect to the foreign corporation or corporations which as to such shareholder are in a

series described in paragraph (e) of this section, except to the extent of any interest (of such shareholder in any such corporation) with respect to which an election has otherwise been made under this subdivision (i); or

(ii) With respect to all foreign corporations which as to such shareholder are described in paragraph (f) of this section.

(2) *Manner of making election.* An election under subparagraph (1) of this paragraph to secure an exclusion under section 963 and the consent to the regulations under such section shall be made for a taxable year by filing with the return for such taxable year—

(i) A written statement stating that such election is made for such taxable year,

(ii) The names of the foreign corporations to which the election applies, the taxable year, country or incorporation, earnings and profits (as determined under paragraph (d) of § 1.963–2), foreign income tax taken into account under paragraph (e) of § 1.963–2, and outstanding capital stock, of each such corporation,

(iii) In case of a group election, the names of all foreign corporations excluded from such group under paragraph (f)(2) and (3) of this section and identifying characterizations for all foreign branches included in, and excluded from, such group under paragraph (f)(4) of this section, together with the authority for such exclusion or inclusion, and

(iv) Such other information relating to the election made as the Commissioner may prescribe by instructions or schedules to support such return.

(3) *Duration of election*—(i) *Year-by-year requirement.* An election under subparagraph (1) of this paragraph to secure an exclusion under section 963 may be made for each taxable year of the United States shareholder but shall be effective only with respect to the taxable year for which made. An election made for any taxable year shall be irrevocable with respect to that taxable year once the period for the making of such election has expired, except to the extent provided by subdivision (ii) of this subparagraph.

(ii) *Revocation or modification of election for reasonable cause—(a) Conditions under which allowed.* If, after the making of an election under subparagraph (1) of this paragraph, the United States shareholder establishes to the satisfaction of the Commissioner that reasonable cause exists for revocation or modification of such election, it may withdraw that election; change from a group election to first-tier elections and/or chain elections or from a chain election to a first-tier election: change from a first-tier election to a chain election or from first-tier elections and/or chain elections to a group election; or, in the case of a chain or group election, alter the composition of the chain or group by adding or eliminating corporations. The United States shareholder shall be allowed to revoke or modify elections pursuant to this subdivision only once for any taxable year of such shareholder and then only at a time prior to the expiration of the period prescribed by law for making an assessment of the tax imposed by chapter 1 of the Code for such taxable year and for any subsequent taxable year for which the tax liability of such shareholder would be affected by such revocation or modification of election. The Commissioner may, as a condition to such revocation or modification of the election, require a consent by the United States shareholder under section 6501 to extend, for the taxable year and such subsequent years affected by the revocation or modification, the period for the making of assessments, and the bringing of distraint or a proceeding in court for collection, in respect of a deficiency and all interest, additional amounts, and assessable penalties.

(b) Nature of reasonable cause. Reasonable cause shall be deemed to exist for the revocation or modification of an election only if, after the making of such election, a material and substantial change in circumstances affecting the election occurs which reasonably could not have been anticipated when the election was made and which, to a significant degree, was beyond the control of the electing United States shareholder. For example, reasonable cause would exist if the minimum distribution were computed on the basis of a contested foreign income tax asserted by a foreign tax authority

which, as a consequence of litigation occurring after the filing of the United States shareholder's return, is refunded, with the result that the United States shareholder is not entitled under the election which was made to an exclusion under section 963.

(c) Request for revocation or modification. A United States shareholder desiring to revoke or modify the election shall mail to the Commissioner of Internal Revenue, Attention: T:R, Washington, DC, 20224, a letter requesting such revocation or modification; such letter shall set forth the information required by subparagraph (2) of this paragraph with respect to any new election and the facts and circumstances which the shareholder considers reasonable cause for such revocation or modification. The shareholder shall also consent, if required, to the extension of assessment period referred to in *(a)* of this subdivision and shall furnish such other information as may be required by the Commissioner in support of such request. If the Commissioner is satisfied that reasonable cause exists for the revocation or modification, the United States shareholder shall file an amended return consistent with any new election which is made.

(d) *Corporations to which a first-tier election may apply*—(1) *Includible interest.* A corporate United States shareholder may make a first-tier election for the taxable year only with respect to a single controlled foreign corporation in which it owns stock directly within the meaning of section 958(a)(1)(A) and only with respect to the stock so owned. The election must apply to all of the stock so owned by such shareholder and shall relate only to the subpart F income of such corporation which would otherwise be required to be included in gross income by reason of owning such stock. The shareholder may for the same taxable year make a first-tier election with respect to one or more controlled foreign corporations in which it directly owns stock and not with respect to other controlled foreign corporations in which it directly owns stock.

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

Example 1. Domestic corporation M directly owns all the one class of stock in each of the controlled foreign corporations A, B, and C. Corporation M may make a first-tier election for a taxable year with respect to any one of corporations A, B, and C; with respect to corporations A and B, respectively; with respect to corporations A and C, respectively; with respect to corporations B and C, respectively; or with respect to corporations A, B, and C, respectively.

Example 2. Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A and 20 percent of the one class of stock of controlled foreign corporation B. Corporation A directly owns 80 percent of the stock of B Corporation. All such corporations use the calendar year as the taxable year. For 1964, M Corporation makes a first-tier election with respect to corporations A and B, respectively, and receives a minimum distribution from each. An exclusion under section 963 for 1964 will be allowed for all of A Corporation's subpart F income for such year but only for the amount of B Corporation's subpart F income which M Corporation would (without regard to section 963) be required to include in gross income for such year under section 951(a)(1)(A)(i) by reason of directly owning 20 percent of the stock of B Corporation. Corporation M may not exclude any amount which it would be required (without regard to section 963) to include in gross income under section 951(a)(1)(A)(i) for such year with respect to the subpart F income of B Corporation by reason of its indirect ownership (through the operation of section 958(a)(2)) of 80 percent of the stock of B Corporation, unless M Corporation separately elects such exclusion and receives a minimum distribution with respect to such interest. See paragraph (e) of this section relating to chain elections.

(e) *Corporations to which a chain election may apply*—(1) *Includible interests.* A Corporate United States shareholder may make a chain election for the taxable year with respect to one or more controlled foreign corporations in any series which includes only one foreign corporation described in subdivision (i), any one or more controlled foreign corporations described in subdivision (ii), and all foreign corporations described in subdivision (iii) of this subparagraph:

(i) A foreign corporation, whether or not a controlled foreign corporation, to the extent of stock owned by such shareholder—

(a) Directly (within the meaning of section 958(a)(1)(A)) in such corporation, or

(b) Indirectly (through the operation of section 958(a)(2)) by virtue of the direct ownership (within the meaning of section 958(a)(1)(A)) of stock in such corporation by a foreign trust, foreign estate, or foreign partnership, in which such shareholder is a beneficiary or partner;

(ii) To the extent that such shareholder so elects, any controlled foreign corporation to the extent that, by reason of its ownership of stock described in subdivision (i) of this subparagraph, such shareholder indirectly owns within the meaning of section 958(a)(2) stock in such controlled foreign corporation; and

(iii) All foreign corporations, whether or not controlled foreign corporations, by reason (and to the extent) of ownership of stock in which such shareholder indirectly owns within the meaning of section 958(a)(2) stock in a controlled foreign corporation included in the series by reason of subdivision (ii) of this subparagraph.

Notwithstanding the preceding sentence, a corporate United States shareholder may make a chain election for the taxable year with respect to a single foreign corporation, but only if such foreign corporation is a controlled foreign corporation described in subdivision (i)*(b)* of this subparagraph. The shareholder may for the same taxable year make a chain election with respect to one or more series, and not with respect to other series, to which this subparagraph applies.

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

Example 1. Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A, which in turn directly owns 80 percent of the one class of stock of controlled foreign corporation B. Corporation M may make a chain election with respect to corporations A and B.

Example 2. Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A, which in turn directly owns 80 percent of the one class of stock of controlled foreign corporation B, which in turn directly owns all the one class of stock of controlled foreign corporation C. Corporation M also directly owns 20 percent of the stock of B Corporation. Corporation M may make a chain election either with respect to corporations A and B or with respect to corporations A, B, and C. In either case corporations B and C can be included in the chain only to the extent of M Corporation's indirect 80-percent stock interest in such corporations by reason of its direct ownership of 100 percent of the stock of A Corporation. Corporation M may also make a chain election with respect to corporations B and C, in which case the chain would include corporations B and C to the extent of the 20-percent stock interest which M Corporation owns directly in B Corporation, and indirectly owns in C Corporation by reason of its direct ownership of such stock interest in B Corporation.

Example 3. Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A, which in turn directly owns all the one class of stock of controlled foreign corporations B and C. Corporation M may make a chain election either with respect to corporations A, B, and C; or with respect to corporations A and B; or with respect to corporations A and C.

Example 4. Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A and 40 percent of the one class of stock of foreign corporation B, not a controlled foreign corporation. Corporation A directly owns 30 percent of the one class of stock of controlled foreign corporation C, and B Corporation directly owns the remaining 70 percent of the stock of C Corporation. Corporation M may make a chain election with respect to corporations A and C, but in such case C Corporation can be included in the chain only to the extent of M Corporation's indirect 30-percent stock interest in such corporation by reason of its direct ownership of 100 percent of the stock of A Corporation. Corporation M may instead make a chain election with respect to corporations B and C, but in such case C Corporation can be included in the chain only to the extent of M Corporation's indirect 28-percent stock interest in such corporation by reason of its direct ownership of 40 percent of the stock of B Corporation. In the latter case, B Corporation must be included in the chain even though it is not a controlled foreign corporation. Corporation M may also make two chain elections, one with respect to corporations A and C, and the other with respect to corporations B and C, as described above.

Example 5. Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A, which in turn directly owns all the one class of stock of controlled foreign corporation B and 40 percent of the one class of stock of foreign corporation C, not a controlled foreign corporation. Corporation M may make a chain election with respect to corporations A and B. Corporation C may not be included in the chain since M Corporation does not, by reason of its indirect ownership of stock in C

Corporation, own stock in any controlled foreign corporation.

Example 6. Domestic corporation M directly owns a 60-percent partnership interest in foreign partnership D and by reason of such interest owns indirectly, within the meaning of section 958(a)(2), 60 percent of the one class of stock of controlled foreign corporation E (all of the stock of which is directly owned by D Partnership) and 60 percent of the one class of stock of controlled foreign corporation F (all the stock of which is also directly owned by D Partnership). By virtue of its direct interest in D Partnership, M Corporation may make a chain election with respect to E Corporation alone or with respect to F Corporation alone. Corporation M may also make two chain elections, one with respect to E Corporation, the other with respect to F Corporation.

(f) *Corporations to which a group election may apply*—(1) *Includible interests.* A corporate United States shareholder may make a group election for the taxable year with respect to a group of foreign corporations which includes, except as provided in subparagraphs (2) and (3) of this paragraph, all of the following corporations:

(i) All controlled foreign corporations in which such shareholder owns stock either directly within the meaning of section 958(a)(1)(A) or indirectly within the meaning of section 958(a)(2), and

(ii) All foreign corporations, whether or not controlled foreign corporations, by reason (and to the extent) of ownership of stock in which such shareholder, indirectly owns within the meaning of section 958(a)(2) stock in a controlled foreign corporation described in subdivision (i) of this subparagraph.

A first-tier election or chain election may not be made for any taxable year with respect to any foreign corporation which for such taxable year has been excluded under subparagraph (2) or (3) of this paragraph from a group with respect to which a group election has been made for such year. The application of this subparagraph may be illustrated by the following examples:

Example 1. Domestic corporation M directly owns all the one class of stock of controlled foreign corporations A and B and is a United States shareholder with respect to no other foreign corporation. M Corporation may make a group election with respect to corporations A and B.

Example 2. Domestic corporation M directly owns all the one class of stock of controlled foreign corporations A and B, and B Corporation directly owns 80 percent of the one class of stock of controlled foreign corporation C. Corporation M is a United States shareholder only with respect to corporations A, B, and C. If M Corporation makes a group election, it must make the election with respect to corporations A, B, and C.

Example 3. Domestic corporation M directly owns all the one class of stock of controlled foreign corporations A and B. Corporation A directly owns 70 percent of the one class of stock of controlled foreign corporation C. Corporation B directly owns 40 percent of the one class of stock of foreign corporation D, not a controlled foreign corporation, and D Corporation directly owns 30 percent of the stock of C Corporation. Corporation M is a United States shareholder with respect to no other foreign corporation. If M Corporation makes a group election, it must make the election with respect to corporations A, B, C, and D. Corporation D must be included in the group even though it is not a controlled foreign corporation.

(2) *Less developed country corporations.* If the United States shareholder so elects, it may for any taxable year exclude from a group for purposes of a group election every controlled foreign corporation which is a less developed country corporation as defined in section 955(c) and §1.955–5 for the taxable year of such foreign corporation ending with or within such taxable year of the shareholder but only if, by reason of ownership of stock in such foreign corporation, the shareholder does not indirectly own within the meaning of section 958(a)(2) stock in any other controlled foreign corporation which is not a less developed country corporation for its taxable year ending with or within such taxable year of the shareholder. The election under this subparagraph to exclude a less developed country corporation is required to be made with respect to all less developed country corporations of which the electing shareholder is a United States shareholder and which, under the preceding sentence, are eligible to be excluded.

Example. Domestic corporation M directly owns all the one class of stock of controlled foreign corporations A and B, not less developed country corporations. Corporation A directly owns all of the one class of stock of controlled foreign corporation C, B Corporation directly owns all the one class of stock of controlled foreign corporation D, and D Corporation directly owns all the one class of stock of controlled foreign corporation E. Corporations C, D, and E are less developed country corporations under section 955(c). Corporation M may make a group election with respect to corporations A, B, C, D, and E; it may also exclude the less developed country corporations and make a group election with respect to corporations A and B only. If E Corporation were not a less developed country corporation, however, neither D Corporation nor E Corporation could be excluded since, by reason of ownership of stock in D Corporation, M Corporation would indirectly own stock in E Corporation, a controlled foreign corporation which is not a less developed country corporation.

(3) *Foreign corporations with blocked foreign income.* If the United States shareholder so elects, it may for any taxable year exclude from a group for purposes of a group election any foreign corporation with respect to which it is established to the satisfaction of the Commissioner that an amount of earnings and profits of such corporation sufficient to constitute its share of a pro rata minimum distribution (as defined in paragraph (a)(2)(i) of § 1.963–4) by the group cannot be distributed to such United States shareholder because of currency or other restrictions or limitations imposed under the laws of any foreign country. If, by reason of ownership of stock in a foreign corporation which is excluded from the group under the preceding sentence, a United States shareholder owns stock in another foreign corporation an amount of whose earnings and profits sufficient to constitute its share of a pro rata minimum distribution by the group cannot be distributed to such United States shareholder through such excluded foreign corporation because of currency or other restrictions or limitations imposed under the laws of any foreign country, such other foreign corporation must also be excluded from the group for purposes of the group election. For purposes of this subparagraph, the determination as to whether earnings and profits cannot be distributed because of currency or other restrictions or limitations imposed under the laws of a foreign country shall be made in accordance with the regulations under section 964(b), except that such restrictions or limitations shall be considered to exist notwithstanding that distributions are made by the foreign corporation in a foreign currency if, assuming the distributee to be the United States shareholder, the distributed amounts would be excludable from the distributee's gross income for the taxable year of receipt under a method of accounting in which the reporting of blocked foreign income is deferred until the income ceases to be blocked.

(4) *Treatment of foreign branches of domestic corporation as foreign subsidiary corporations*—(i) *In general.* If the United States shareholder so elects, all branches (other than a branch excluded under subdivision (iii) of this subparagraph) maintained by such shareholder in foreign countries and possessions of the United States shall be treated, for purposes of applying subparagraph (1) of this paragraph, as wholly owned foreign subsidiary corporations of such shareholder organized under the laws of such respective foreign countries or possessions of the United States. Each branch treated as such a foreign subsidiary corporation shall be included in the group by the United States shareholder making the group election and shall be regarded, for purposes of section 963, as having distributed to such shareholder all of its earnings and profits for the taxable year, irrespective of the statutory percentage applied for the taxable year under paragraph (b) of § 1.963–2. As used in this subparagraph, the term ''branch'' shall mean a permanent organization maintained in a foreign country or a possession of the United States to engage in the active conduct of a trade or business. Whether a permanent organization is maintained in a foreign country or possession of the United States shall depend upon the facts and circumstances of the particular case. As a general rule, a permanent organization shall be considered to be maintained in such country or possession if the United States shareholder maintains therein a significant work force or significant manufacturing, mining, warehousing, sales, office, or similar business facilities of a fixed or permanent nature. If a United States shareholder so operates that it satisfies the branch test with respect to each of several foreign countries or possessions, each such branch shall be

treated as a separate wholly owned foreign subsidiary corporation organized under the laws of such country or possession in respect of which it satisfies such test. In no event shall a branch which is treated as a wholly owned foreign subsidiary corporation under this subparagraph be also treated as a less developed country corporation. The term ‘‘possession of the United States,’’ as used in this subparagraph, shall be construed to have the same meaning as that contained in paragraph (b)(2) of §1.957–3.

(ii) *Earnings and profits and taxes of a foreign branch.* The earnings and profits (or deficit in earnings and profits) for a taxable year of a branch treated as a wholly owned foreign subsidiary corporation under this subparagraph shall be determined by applying against the gross income (as defined in section 61) of the branch its allowable deductions other than any net operating loss deduction. Any excess of gross income over such deductions shall constitute earnings and profits. Any excess of such deductions over gross income shall constitute a deficit in earnings and profits. For purposes of this subparagraph, the gross income of a branch is that which is produced by the trade or business activities separately conducted by it outside the United States and which is derived from sources without the United States under the provisions of sections 861 through 864 and the regulations thereunder; the allowable deductions of a branch are those which are properly allocable to or chargeable against its gross income and which are allowable under chapter 1 of the Code to the corporation of which it is a branch. Only the foreign income tax allocable to the gross income of the branch shall be considered paid or accrued by such branch. Solely for the purpose of determining under paragraph (c)(2) of §1.963–2 the effective foreign tax rate of a group which includes a branch treated as a wholly owned foreign subsidiary corporation, the foreign income tax considered paid or accrued by the branch shall be treated as an allowable deduction of such branch even though the United States shareholder chooses to take the benefits of section 901 for the taxable year.

(iii) *Excluded branches.* For purposes of subdivision (i) of this subparagraph, a branch maintained by the United States shareholder in a possession of the United States shall not be treated as a wholly owned foreign subsidiary corporation of the United States shareholder for the taxable year unless such branch would be a controlled foreign corporation (as defined in section 957 and the regulations thereunder) for such taxable year if it were incorporated under the laws of such possession and unless the gross income of such shareholder for such taxable year includes for purposes of the tax imposed by Chapter 1 of the Code the income, if any, derived by such shareholder from sources within possessions of the United States, as determined under the provisions of sections 861 through 864 and the regulations thereunder.

(iv) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example 1. Throughout 1964, domestic corporation M directly owns all of the one class of stock of controlled foreign corporations A and B. All corporations use the calendar year as the taxable year. During 1964, M Corporation engages in foreign country X in the manufacture and sale of steel tubing and rods, maintaining therein a significant work force and significant manufacturing and sales facilities for such purpose. Corporation M also engages in foreign country Y in the mining and sale of iron ore, maintaining therein a significant work force and substantial mining and sales facilities for such purpose. For 1964, M Corporation may make a group election with respect to corporations A and B and the branches operated in country X and country Y, treating such branches as wholly owned foreign subsidiary corporations. If corporation M elects to include one such branch in the group election, it must include both.

Example 2. Throughout 1964, domestic corporation M directly owns all the one class of stock of controlled foreign corporations A and B. All corporations use the calendar year as the taxable year. During 1964, M Corporation exports tractors to foreign country Z, in which country its sole activities consist of arranging for title to the tractors to pass to the purchasers in that country. Corporation M’s only facility in country Z in 1964 is a small rented office, and its work force therein consists only of a few clerical employees. The activities of M Corporation in country Z do not constitute the maintenance of a branch therein for purposes of this subparagraph. Corporation M may make a group election, only with respect to corporations A and B.

[T.D. 6759, 29 FR 13325, Sept. 25, 1964; 29 FR 13896, Oct. 8, 1964, as amended by T.D. 6767, 29 FR 14877, Nov. 3, 1964; T.D. 7100, 36 FR 5335, Mar. 20, 1971]

§ 1.963–2 Determination of the amount of the minimum distribution.

(a) *Application of statutory percentage to earnings and profits.* The amount of the minimum distribution required to be received by a United States shareholder with respect to stock to which the election under paragraph (c) of § 1.963–1 applies for the taxable year in order to qualify for a section 963 exclusion for such year shall be the amount, if any, determined by the multiplication of the statutory percentage applicable for the taxable year by—

(1) In the case of a first-tier election, such shareholder's proportionate share (as determined under paragraph (d)(2) of this section) of the earnings and profits for the taxable year of the single first-tier corporation to which the election relates,

(2) In the case of a chain election, the consolidated earnings and profits (as determined under paragraph (d)(3) of this section) with respect to such shareholder for the taxable year of the chain to which the election relates, or

(3) In the case of a group election, the consolidated earnings and profits (as determined under paragraph (d)(3) of this section) with respect to such shareholder for the taxable year of the group to which the election relates.

For the requirement that the overall United States and foreign income tax incurred in respect of a minimum distribution from a chain or group must equal or exceed either 90 percent of the United States corporate tax rate applied against pretax and predistribution consolidated earnings and profits or, with the application of the special rules set forth therein, must equal or exceed the overall United States and foreign income tax which would have resulted from a pro rata minimum distribution, see paragraph (a)(1) of § 1.963–4.

(b) *Statutory percentage.* The statutory percentage (referred to in paragraph (a) of this section) for the taxable year shall be determined by applying the effective foreign tax rate (as defined in paragraph (c) of this section) for such year with respect to the single first-tier corporation, chain, or group, as the case may be, against—

(1) The table set forth in section 963(b)(1) in the case of an election to secure an exclusion under section 963 for a taxable year of the United States shareholder beginning in 1963 and a taxable year entirely within the surcharge period ending before January 1, 1970.

(2) The table set forth in section 963(b)(2) in the case of an election to secure an exclusion under section 963 for a taxable year of the U.S. shareholder beginning in 1964 or for a taxable year of such shareholder beginning in 1969 and ending in 1970 to the extent subparagraph (B) of section 963(b)(3) applies,

(3) The table set forth in section 963(b)(3) in the case of an election to secure an exclusion under section 963 for a taxable year of the U.S. shareholder beginning after December 31, 1964 except a taxable year which includes any part of the surcharge period, or

(4) The table set forth in paragraph (b) of § 1.963–8 in the case of an election to secure an exclusion under section 963 for the calendar year 1970.

Example. Domestic corporation M owns all the one class of stock in controlled foreign corporation A. Corporation M uses the calendar year as its taxable year, and A Corporation uses a fiscal year ending August 31. For 1964, M Corporation makes a first-tier election in order to exclude from gross income for such year the subpart F income of A Corporation for its taxable year ending on August 31, 1964. Although, such election applies to the taxable year of A Corporation beginning on September 1, 1963, the applicable table, for purposes of determining the statutory percentages to be used under paragraph (a) of this section for the taxable year, is that set forth in section 963(b)(2), which relates to taxable years of United States shareholders beginning in 1964. Thus, if for the taxable year of A Corporation ending August 31, 1964, the effective foreign tax rate is 30 percent, A Corporation would have to distribute 72 percent of its earnings and profits for such year in order for M Corporation to be entitled to an exclusion under section 963 for 1964.

(c) *Effective foreign tax rate*—(1) *Single first-tier corporation.* For purposes of section 963 the term ‘‘effective foreign tax rate’’ for a taxable year means, with respect to a single first-tier corporation, the percentage which—

(i) The United States shareholder's proportionate share (as determined under paragraph (e)(1) of this section) of the foreign income tax of such corporation for such taxable year is of—

(ii) The sum of—

(a) The United States shareholder's proportionate share (as determined under paragraph (d)(2) of this section) of the earnings and profits of such corporation for such taxable year, and

(b) The amount referred to in subdivision (i) of this subparagraph.

(2) *Chain or group of corporations.* For purposes of section 963, the term ‘‘effective foreign tax rate’’ for a taxable year means, with respect to a chain or group, the percentage which—

(i) The consolidated foreign income taxes (as determined under paragraph (e)(2) of this section) of such chain or group with respect to the United States shareholder for such taxable year is of—

(ii) The sum of—

(a) The consolidated earnings and profits (as determined under paragraph (d)(3) of this section) of such chain or group with respect to such United States shareholder for such taxable year, and

(b) The amount referred to in subdivision (i) of this subparagraph.

(3) *Treatment of United States tax as foreign tax.* For the purpose solely of determining the effective foreign tax rate under this paragraph, if a foreign corporation has pretax earnings and profits attributable to income from sources within the United States for the taxable year upon which it pays United States income tax and if distributions from the earnings and profits of such corporation for such year to the electing United States shareholder with respect to stock to which the election to secure an exclusion under section 963 relates do not entitled such shareholder to the dividends-received deduction under section 245, the amount of the United States income tax shall be taken into account as though such tax were foreign income tax. The amount so treated as foreign income tax shall not exceed 90 percent of an amount determined by multiplying such pretax earnings and profits attributable to income from sources within the United States by a percentage which is the sum of the normal tax rate and the surtax rate (determined without regard to the surtax exemption) prescribed by section 11 for the taxable year of the United States shareholder.

(d) *Determination of proportionate share of earnings and profits and consolidated earnings and profits*—(1) *Earnings and profits of foreign corporations.* For purposes of §§1.963–1 through 1.963–8, the earnings and profits, or deficit in earnings and profits, for the taxable year, of a single first-tier corporation or of a foreign corporation in a chain or group shall be the amount of its earnings and profits for such year, determined under section 964(a) and §1.964–1 but without reduction for foreign income tax or for distributions made by such corporation, less—

(i) In the case of a foreign corporation included in a chain or group, the amount of any distributions received (computed without reduction for any income tax paid or accrued by such corporation with respect to such distributions) by such corporation during its taxable year from the earnings and profits (whether or not from earnings and profits of the taxable year to which the election under section 963 applies) of another foreign corporation in the chain or group.

(ii) In the case of every foreign corporation, the amount of foreign income tax paid or accrued by such corporation during its taxable year other than foreign income tax referred to in subdivision (i) and (iii) of this subparagraph, and

(iii) In the case of a foreign corporation included in a chain or group, the foreign income tax paid or accrued by such corporation with respect to distributions from the earnings and profits of any other foreign corporation in the chain or group for the taxable year of such other corporation to which the election under section 963 applies, but only if the U.S. shareholder chooses under this subdivision to take such tax into account in determining the effective foreign tax rate rather than count it toward the amount of the minimum distribution as provided in paragraph (b)(2) of § 1.963–3.

In the event that the foreign income tax of a corporation included in a chain or group depends upon the extent to which distributions are made by such corporation, the amount of foreign income tax referred to in subdivision (ii) of this subparagraph shall, only for purposes of determining the effective foreign tax rate, be the amount which would have been paid or accrued if no distributions had been made. For the rules in other cases involving corporations whose foreign income tax varies with distributions, see § 1.963–5. For the manner of computing the earnings and profits of a foreign branch treated as a wholly owned foreign subsidiary corporation see paragraph (f)(4)(ii) of § 1.963–1.

(2) *Shareholder's proportionate share of earnings and profits*—(i) *Corporation with earnings and profits—(a) In general.* A United States shareholder's proportionate share, with respect to stock to which the election to secure an exclusion under section 963 relates, of the earnings and profits of a foreign corporation (not including a foreign branch described in *(b)* of this subdivision) for its taxable year shall be the share which such shareholder would receive if the total amount of such corporation's earnings and profits, as determined under subparagraph (1) of this paragraph, for such year were distributed on the last day of such corporation's taxable year on which such corporation is a controlled foreign corporation or is a foreign corporation by reason of the ownership of stock in which the United States shareholder indirectly owns within the meaning of section 958(a)(2) stock in a controlled foreign corporation.

(b) Foreign branch treated as a foreign subsidiary corporation. A United States shareholder's proportionate share of the earnings and profits, for the taxable year, of a branch treated as a wholly owned foreign subsidiary corporation and included in a group under paragraph (f)(4) of § 1.963–1 shall be the total earnings and profits of such branch for the taxable year, as determined under paragraph (f)(4)(ii) of such section.

(c) Indirectly held foreign corporations. If the proportionate share to be determined is of earnings and profits of a foreign corporation the stock of which is owned by the United States shareholder by reason of its ownership of stock (with respect to which the election relates) in another corporation, such shareholder's proportionate share of such earnings and profits for the taxable year shall be determined on the basis of the amount such shareholder would receive from such foreign corporation with respect to stock in such foreign corporation if there were distributed for the taxable year all such earnings and profits, as determined under subparagraph (1) of this paragraph, and of all the earnings and profits of all other corporations through which such earnings and profits must pass in order to be received by such shareholder with respect to the stock to which the election relates. For purposes of the preceding sentence, the amount received by the shareholder from the earnings and profits of a foreign corporation shall be determined without taking into account deductions (whether or not allowable under chapter 1 of the Code) of other foreign corporations through which such earnings and profits are distributed.

(d) More than one class of stock. If a foreign corporation for a taxable year has more than one class of stock outstanding, the earnings and profits of such corporation for such year which shall be taken into account with respect to any one class of such stock shall be the earnings and profits which would be distributed with respect to such class if all earnings and profits of such corporation for such year were distributed on the last day of such corporation's taxable year, on which such corporation is a controlled foreign corporation or is a foreign corporation by reason of the ownership of stock in which the United States shareholder indirectly owns within the meaning of section 958(a)(2) stock in a controlled foreign corporation. If an arrearage in dividends for prior taxable years exists with respect to a class of preferred stock of such corporation, the earnings and profits for the taxable year shall be

attributed to such arrearage only to the extent such arrearage exceeds the earnings and profits of such corporation remaining from prior taxable years beginning after December 31, 1962. For example, if a controlled foreign corporation, using the calendar year as its taxable year, has earnings and profits for 1963 of $100 accumulated at December 31, 1963, and an arrearage of $150 for such year in respect of preferred stock, the earnings and profits for 1964 attributable to such arrearage may not exceed $50 ($150 − $100).

(e) Discretionary power to allocate earnings to different classes of stock. If the allocation of a foreign corporation's earnings and profits for the taxable year between two or more classes of stock depends upon the exercise of discretion by that body of persons which exercises with respect to such corporation the power ordinarily exercised by the board of directors of a domestic corporation, the allocation of such earnings and profits to such classes shall be made for purposes of this subdivision as if such classes constituted one class of stock in which each share has the same rights to dividends as any other share, unless a different method of allocation of such earnings and profits is made by such body not later than 90 days after the close of such taxable year.

(f) Illustrations. The application of this subdivision may be illustrated by the following examples:

Example 1. Domestic corporation M directly owns 80 percent of the one class of stock of controlled foreign corporation A, which directly owns 60 percent of the one class of stock of controlled foreign corporation B. Each such corporation has earnings and profits of $70 for the taxable year, as determined under subparagraph (1) of this paragraph. Corporation M's proportionate share of the earnings and profits is $56 (0.80×$70) as to A Corporation and $33.60 (0.80×0.60×$70) as to B Corporation.

Example 2. Throughout 1964 controlled foreign corporation A, which uses the calendar year as the taxable year, has outstanding 40 shares of common stock and 60 shares of 6-percent, nonparticipating, noncumulative preferred stock with a par value of $100 per share. Corporation A has earnings and profits of $1,000, for 1964, as determined under subparagraph (1) of this paragraph. In such case, $360 (0.06×$100×60) of earnings and profits would be taken into account with respect to the preferred stock and $640 ($1,000 − $360), with respect to the common stock. Thus, if a United States shareholder owns 10 shares of common stock and 30 shares of preferred stock for 1964, its proportionate share of the earnings and profits for such year is $340 ([10/40×$640]+[30/60×$360]).

(ii) *Deficit in earnings and profits of a corporation in a chain or group.* A United States shareholder's proportionate share, with respect to stock to which the election to secure an exclusion under section 963 relates, of a deficit in earnings and profits of a foreign corporation in a chain or group for a taxable year shall be the portion of such deficit which, if such corporation had earnings and profits for such year as determined under subparagraph (1) of this paragraph and all of such earnings and profits were distributed on the date described in subdivision (i)*(a)* of this subparagraph, the share of such earnings and profits such shareholder would receive bears to the total of the earnings and profits which would be so distributed on such date. For the determination of the deficit of a foreign branch treated as a wholly owned foreign subsidiary corporation and included in a group, see paragraph (f)(4)(ii) of § 1.963–1. A United States shareholder's proportionate share of the deficit of such a branch shall be the total deficit of such branch for the taxable year.

(iii) *Controlled foreign corporation for part of year.* If—

(a) Stock in a foreign corporation is owned within the meaning of section 958(a) by a United States shareholder on the last day in the taxable year of such corporation for which such corporation is a controlled foreign corporation to which applies an election by such shareholder to secure an exclusion under section 963 with respect to such stock, or

(b) Stock in a foreign corporation which is not a controlled foreign corporation is owned within the meaning of section 958(a) by a United States shareholder on the last day in the taxable year of such corporation on which another foreign corporation (which, by reason of the stock so owned, is owned by such shareholder within the meaning of section 958(a)) is a controlled foreign corporation to which applies an election by such shareholder to secure

an exclusion under section 963 with respect to such stock,

the earnings and profits of such foreign corporation for the taxable year which are taken into account in determining such shareholder's proportionate share thereof shall be an amount of such earnings and profits, determined as provided in subparagraph (1) of this paragraph, which bears to the total of such earnings and profits the same ratio which the part (computed on a daily basis) of such year during which such corporation is a controlled foreign corporation (or, in case such corporation is not a controlled foreign corporation, during which such other corporation is a controlled foreign corporation) bears to the total taxable year. If the United States shareholder by sufficient records and accounts establishes to the satisfaction of the district director the gross income received or accrued, and the deductions paid or accrued, for the part of such year during which such corporation is a controlled foreign corporation (or, in case such corporation is not a controlled foreign corporation, during which such other corporation is a controlled foreign corporation), the amount of earnings and profits based on such records and accounts may be used in lieu of the amount determined under the preceding sentence. The application of this subdivision may be illustrated by the following examples:

Example 1. Domestic corporation M on June 30, 1963, purchases 60 percent of the one class of stock of A Corporation which on July 1 becomes a controlled foreign corporation and remains such throughout the remainder of 1963. Both corporations use the calendar year as the taxable year. Corporation M makes a first-tier election with respect to A Corporation. For 1963, A Corporation has $100 of earnings and profits, as determined under subparagraph (1) of this paragraph. Corporation M's proportionate share of such earnings and profits for 1963 is $30.25 (0.60×[184/365×$100]).

Example 2. (a) Throughout 1963 domestic corporation M directly owns 20 percent of the one class of stock of foreign corporation A, not a controlled foreign corporation at any time, which directly owns 50 percent of the one class of stock of foreign corporation B, which becomes a controlled foreign corporation on July 1, 1963, and remains such throughout the remainder of 1963. All such corporations use the calendar year as the taxable year. Each of corporations A and B has earnings and profits for 1963 of $100, as determined under subparagraph (1) of this paragraph. Corporation M makes a chain election for 1963 with respect to corporations A and B. Corporation M's proportionate share of the earnings and profits of A Corporation for 1963 is $10.08 (0.20×[184/365×$100]). Corporation M's proportionate share of the earnings and profits of B Corporation for 1963 is $5.04 (0.20×0.50×[184/365×$100]).

(b) If B Corporation had been a controlled foreign corporation throughout 1963, M Corporation's proportionate share of the earnings and profits of corporations A and B for 1963 would have been $20 (0.20×$100) and $10 (0.20×0.50×$100), respectively.

(c) If corporations A and B had each been a controlled foreign corporation only for the period of January 1, 1963, through June 30, 1963, M Corporation's proportionate share of the earnings and profits of such corporations would have been $9.92 (0.20×[181/365×$100]) and $4.98 (0.20×0.50×[181/365× $100]), respectively.

(d) If A Corporation had been a controlled foreign corporation throughout 1963 or during the period of July 1, 1963, through December 31, 1963, but B Corporation had been a controlled foreign corporation only during the period of January 1, 1963, through June 30, 1963, M Corporation's proportionate share of the earnings and profits of such corporations would have been $20 (0.20×$100) and $4.96 (0.20×0.50×[181/365×$100]), respectively.

(3) *Consolidated earnings and profits with respect to United States shareholder.* The consolidated earnings and profits of a chain or group with respect to any United States shareholder for the taxable year shall be the sum of such shareholder's proportionate shares of the earnings and profits, and of the deficit in earnings and profits, determined under subparagraph (2) of this paragraph, for such year of all foreign corporations, whether or not controlled foreign corporations, in such chain or group.

(e) *Foreign income taxes used in determining effective foreign tax rate.* For purposes of determining the effective foreign tax rate under paragraph (c) of this section—

(1) *Shareholder's proportionate share of taxes of a foreign corporation.* The foreign income tax of a foreign corporation for a taxable year shall consist of the foreign income tax referred to in paragraph (d)(1)(ii) of this section with respect to such year and, if the United States shareholder chooses to take the

foreign income tax described in paragraph (d)(1)(iii) of this section into account in determining the effective foreign tax rate of a chain or group which includes such foreign corporation, the foreign income tax referred to in such paragraph with respect to such year. A United States shareholder's proportionate share, with respect to stock to which the election to secure an exclusion under section 963 applies, of the foreign income tax of such foreign corporation for a taxable year shall be the same proportion of such foreign income tax that such shareholder's proportionate share (as determined under paragraph (d)(2)(i) of this section) of the earnings and profits of such corporation for such year bears to the total earnings and profits of such corporation for such year. A United States shareholder's proportionate share of the foreign income tax, for the taxable year, of a branch treated as a wholly owned foreign subsidiary corporation and included in a group under paragraph (f)(4) of §1.963–1 shall be the total foreign income tax of such branch for the taxable year.

(2) *Consolidated foreign income taxes with respect to United States shareholder.* The consolidated foreign income taxes of a chain or group with respect to a United States shareholder for the taxable year of such chain or group shall be the sum of such shareholder's proportionate shares (as determined under subparagraph (1) of this paragraph) of the foreign income tax of all foreign corporations, whether or not controlled foreign corporations, in such chain or group.

(3) *Taxes paid by foreign corporation on distributions received during its distribution period.* If a distribution received by a foreign corporation in a chain or group from another foreign corporation in such chain or group after the close of the recipient's taxable year but during its distribution period for such year is allocated to the earnings and profits of such recipient corporation for such year under paragraph (c)(2) of §1.963–3, then any foreign income tax paid or accrued by such recipient corporation on such distribution shall be treated as paid or accrued for such taxable year.

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

Example 1. For 1966, domestic corporation M makes a first-tier election with respect to controlled foreign corporation A, 80 percent of the one class of stock of which M Corporation owns directly. Both corporations use the calendar year as the taxable year. For 1966, A Corporation has earnings and profits (before reduction for foreign income tax) of $100 with respect to which it pays foreign income tax of $30. Its earnings and profits are $70 ($100 − $30). Corporation M's proportionate share of such earnings and profits is $56 (0.80×$70), and its proportionate share of the foreign income tax is $24 ($56/$70×$30). The effective foreign tax rate is 30 percent ($24/[$56+$24]). Based on such effective foreign tax rate, the statutory percentage under section 963(b)(3) for 1966 is 69 percent. Thus, the amount of the minimum distribution which M Corporation must receive from A Corporation's 1966 earnings and profits is a dividend of $38.64 (0.69×$56).

Example 2. For 1966, domestic corporation M makes a first-tier election with respect to controlled foreign corporation A, all of whose one class of stock M Corporation owns directly. Both corporations use the calendar year as the taxable year. For 1966, A Corporation has earnings and profits (before reduction for income tax) of $100, of which $40 is attributable to income from sources within the United States on which $12 United States income tax is paid. The foreign country in which A Corporation is incorporated imposes an income tax at 30 percent on the $100 but allows a credit against its tax for the $12 of United States income tax, so that it imposes a net foreign income tax of $18 for 1966. In determining the effective foreign tax rate of A Corporation for 1966, such $12 of United States income tax may be treated as foreign income tax to the extent it does not exceed $17.28 ($40×0.90×0.48). Corporation A has earnings and profits of $70 for 1966. Although A Corporation's effective foreign tax rate for 1966 is 30 percent, determined by dividing $30 by the sum of $70 plus $30, none of the United States tax which is taken into account in determining such rate shall be treated as foreign income tax for purposes of determining the foreign tax credit of M Corporation under section 902. Based on such effective foreign tax rate, the statutory percentage under section 963(b)(3) for 1966 is 69 percent. Thus, the amount of the minimum distribution which M Corporation must receive from A Corporation's 1966 earnings and profits is a dividend of $48.30 (0.69×$70).

Example 3. Domestic corporation M directly owns throughout 1966, 60 percent of the one class of stock of controlled foreign corporation A, not a less developed country corporation under section 902(d), which has for 1966 earnings and profits of $70 (all of which is attributable to subpart F income) after having paid foreign income tax of $30. Both corporations use the calendar year as the taxable year. Corporation A is created under the laws of a foreign country which imposes a 6-percent dividend withholding tax. Corporation M would be required, but for section 963, to include $42 (0.60×$70) of A Corporation's subpart F income in gross income under section 951(a)(1)(A)(i). For 1966, however, M Corporation makes a first-tier election with respect to A Corporation. Since the tax withheld on distributions made by A Corporation is considered to have been paid by M Corporation, the effective foreign tax rate applicable to A Corporation for 1966 is only 30 percent, the percentage which such $30 of foreign income tax is of $100 (the sum of $30 plus $70). Thus, the statutory percentage under section 963(b) for 1966 is 69 percent. The amount of the minimum distribution which M Corporation must receive from A Corporation's 1966 earnings and profits is the distribution M Corporation will receive if A Corporation distributes 69 percent of its earnings and profits for 1966. Thus, if M Corporation receives a distribution of 69 percent of its proportionate share of such earnings and profits or $28.98 (0.69×0.60×$70), it may exclude from gross income for 1966 $42 otherwise required to be included in gross income under section 951(a)(1)(A)(i) and will determine its income tax, assuming no other income and no surtax exemption under section 11(c), as follows:

Dividend	$28.98
Gross-up under section 78 ($28.98/ $70×$30)	12.42
Taxable income	41.40
U.S. tax before foreign tax credit ($41.40×0.48)	19.87
Foreign tax credit ($12.42+[0.06 ×$28.98])	14.16
U.S. tax payable	5.71

Example 4. (a) For 1966 domestic corporation M makes a chain election with respect to controlled foreign corporation A, all of whose one class of stock it directly owns, and controlled foreign corporation B, all of whose one class of stock is directly owned by A Corporation. Both foreign corporations are subject to a foreign income tax at a flat rate of 30 percent, and all corporations use the calendar year as a taxable year. For 1966, B Corporation has pretax earnings and profits of $100 and distributes $51.50. For 1966, A Corporation has pretax earnings and profits of $151.50, consisting of $100 from selling activities and $51.50 received as a distribution from B Corporation, upon which it pays a foreign income tax of $45.45 (i.e., 30 percent of $151.50).

(b) Corporation M chooses under paragraph (d)(1)(iii) of this section to take the foreign tax paid by A Corporation on the dividend received from B Corporation into account in determining the effective foreign tax rate of the chain rather than count it toward the amount of the minimum distribution. Thus, to determine consolidated earnings and profits of the chain for 1966, A Corporation's pretax earnings and profits of $151.50 are first reduced by the intercorporate dividend of $51.50 received from B Corporation so that A Corporation has pretax and predistribution earnings and profits of $100 ($151.50 less $51.50). Corporation A's pretax and predistribution earnings and profits of $100 are then reduced by the foreign income tax of $30 (30 percent of $100) paid on such earnings and profits, resulting in predistribution earnings and profits of $70 ($100 less $30). Since M Corporation chooses to count toward the effective foreign tax rate, rather than toward the minimum distribution, A Corporation's foreign income tax of $15.45 (0.30×51.50) imposed on the dividend received from B Corporation, such predistribution earnings and profits of $70 of A Corporation are further reduced by such $15.45 of tax to $54.55 ($70−$15.45). Corporation B, having received no dividends from any other corporation in the chain, has predistribution earnings and profits of $70 ($100 less foreign income tax of $30).

(c) The consolidated earnings and profits of the chain for 1966 are $124.55 ($54.55+$70). The consolidated foreign income taxes for such year are $75.45 ($30+$15.45+$30). The effective foreign tax rate of the chain for 1966 is 37.73 percent ($75.45/[$124.55+$75.45]). The statutory percentage for 1966 under section 963(b)(3) is 51 percent. Thus, the amount of the minimum distribution which M Corporation must receive from the 1966 consolidated earnings and profits of the chain is $63.52 (0.51×$124.55).

Example 5. The facts are the same as in example 4 except that M Corporation does not choose under paragraph (d)(1)(iii) of this section to take into account, in determining the effective foreign tax rate, the foreign income tax of $15.45 paid by A Corporation on the distribution of $51.50 received from B Corporation. In such case, the consolidated earnings and profits of the chain are $140 ($70+$70) and the consolidated foreign income taxes are $60 ($30+$30), the latter amount being determined without taking into account A Corporation's foreign income tax of $15.45 on the distribution of $51.50 received from B Corporation. The effective foreign tax rate for 1966 is 30 percent ($60/[$140+$60]), and the statutory percentage under section 963(b) is 69 percent. Thus, the amount of the minimum distribution which must be made from the 1966 consolidated earnings and profits of the chain is $96.60 (0.69×$140). For the counting of such $15.45 of A Corporation's tax toward the $96.60 amount of the minimum distribution, see paragraph (b)(2) of § 1.963–3.

Example 6. For 1966 domestic corporation M directly owns the following percentages of the one class of stock of the following controlled foreign corporations in respect of which it makes a group election: 80 percent of A Corporation, 60 percent of B Corporation, and 70 percent of C Corporation. All corporations use the calendar year as the taxable year; none of the foreign corporations is a less developed country corporation under section 902(d). Each foreign corporation makes distributions during 1966. The consolidated earnings and profits, and the consolidated foreign income taxes, of the group for 1966 with respect to M Corporation, and the amount of the minimum distribution which M Corporation must receive, are determined as follows, based on the earnings and profits and foreign income tax shown in the following table:

	Controlled foreign corporations		
	A	B	C
Predistribution and pretax earnings and profits	$100	$100	$100.00
Foreign income tax	15	25	35.00
Predistribution earnings and profits	85	75	65.00
M Corporation's proportionate share of earnings and profits:			
(0.80×$85)	68	....	....
(0.60×$75)	....	45	....
(0.70×$65)	....	....	45.50
Consolidated earnings and profits with respect to M Corporation ($68+$45+$45.50)	....	....	158.50
M Corporation's proportionate share of foreign income tax:			
($15×[$68/$85])	12	....	....
($25×[$45/$75])	....	15	....
($35×[$45.50/$65])	....	....	24.50
Consolidated foreign income taxes with respect to M Corporation ($12+$15+$24.50)	....	....	51.50

The effective foreign tax rate for 1966 is 24.5 percent ($51.50/[$158.50+$51.50]) and the statutory percentage under section 963(b)(3) for such year is 76 percent. Thus, the amount of the minimum distribution which M Corporation must receive from the 1966 consolidated earnings and profits of the group is $120.46 (0.76×$158.50).

Example 7. (a) For 1966 domestic corporation M makes a chain election with respect to the following controlled foreign corporations: A Corporation, 80 percent of whose one class of stock M Corporation owns directly; B Corporation, 60 percent of whose one class of stock is directly owned by A Corporation; and C Corporation, 70 percent of whose one class of stock is directly owned by B Corporation. All corporations use the calendar year as the taxable year; none of the foreign corporations is a less developed country corporation under section 902(d). The predistribution and pretax earnings and profits of each foreign corporation are $100. Each foreign corporation pays a flat rate of foreign income tax on all income computed without reduction for dividends paid and determined by including dividends received. Such rate is 15 percent for A Corporation, 25 percent for B Corporation, and 35 percent for C Corporation. Corporation C distributes $65, and B Corporation distributes $100, for 1966. Corporation M chooses under paragraph (d)(1)(iii) of this section to count toward the effective foreign tax rate, rather than toward the amount of the minimum distribution, the foreign income tax paid by corporations A and B, respectively, on distributions received from corporations B and C, respectively.

(b) The consolidated earnings and profits, and the consolidated foreign income taxes, of the chain, and the amount of the minimum distribution for 1966, with respect to M Corporation are determined as follows:

	Controlled foreign corporations			
	A	B	C	Total
Pretax earnings and profits	$160.00	$145.50	$100.00	....
Reduction for intercorporate dividends:				
(0.60×$100)	60.00	....	....	....
(0.70×$65)	....	45.50	....	....
Pretax and predistribution earnings and profits	100.00	100.00	100.00	....
Reduction for foreign income tax on such pretax and predistribution earnings and profits:				
(0.15×$100)	15.00	....	....	....
(0.25×$100)	....	25.00	....	....
(0.35×$100)	....	....	35.00	....
Predistribution earnings and profits	85.00	75.00	65.00	....
Reduction for foreign income tax on intercorporate distributions of 1966 earnings and profits:				
(0.15×$60)	9.00	....	....	....
(0.25×$45.50)	....	11.38	....	....
	76.00	63.62	65.00	
Consolidated earnings and profits with respect to M Corporation:				
(0.80×$76)	60.80	....	....	....
(0.80×0.60×$63.62)	....	30.54	....	....

	Controlled foreign corporations			
	A	B	C	Total
(0.80×0.60×0.70×$65)			21.84	$113.18
Consolidated foreign income taxes with respect to M Corporation:				
($60.80/$76×[$15+$9])	19.20			
($30.54/$63.62×[$25+$11.38])		17.46		
($21.84/$65×$35)			11.76	$48.42
Effective foreign tax rate ($48.42/[$113.18+$48.42])				29.96%
Statutory percentage under section 963(b)				69%
Amount of minimum distribution which M Corporation must receive from 1966 consolidated earnings and profits (0.69×$113.18), no amount of the tax on intercorporate distributions being counted toward the minimum distribution				$78.0

Example 8. The facts are the same as in example 7 except that M Corporation does not choose under paragraph (d)(1)(iii) of this section to take into account, in determining the effective foreign tax rate, the foreign income tax paid by the recipient corporations on the intercorporate distributions. The consolidated earnings and profits, the consolidated foreign income taxes, of the chain, and the amount of the minimum distribution which M Corporation must receive, for 1966 are determined as follows:

	Controlled foreign corporations			
	A	B	C	Total
Pretax earnings and profits	$160.00	$145.50	$100.00	
Reduction for intercorporate dividends:				
(0.60×$100)	60.00			
(0.70×$65)		45.50		
Pretax and predistribution earnings and profits	100.00	100.00	100.00	
Reduction for foreign income tax on such pretax and predistribution earnings and profits:				
(0.15×$100)	15.00			
(0.25×$100)		25.00		
(0.35×$100)			35.00	
Predistribution earnings and profits	85.00	75.00	65.00	
Consolidated earnings and profits with respect to M Corporation:				
(0.80×$85)	68.00			
(0.80×0.60×$75)		36.00		
(0.80×0.60×0.70×$65)			21.84	$125.84
Consolidated foreign income taxes with respect to M Corporation:				
($68/$85×$15)	12.00			
($36/$75×$25)		12.00		
($21.84/$65×$35)			11.76	$35.76
Effective foreign tax rate ($35.76/[$125.84+$35.76])				22.13%
Statutory percentage under section 963(b)				76%
Amount of minimum distribution to be made from 1966 consolidated earnings and profits with respect to M Corporation: (0.76×$125.84)				$95.64
Foreign income tax on intercorporate distributions of 1966 earnings and profits which is counted toward the minimum distribution (see § 1.963–3(b)(2)):				
($68/$85×[0.15×$60])	7.20			
($36/$75×[0.25×$45.50])		5.46		$12.66
Amount of minimum distribution which M Corporation must actually receive from the chain ($95.64 − $12.66)				$82.98

[T.D. 6759, 29 FR 13329, Sept. 25, 1964, as amended by T.D. 6767, 29 FR 14877, Nov. 3, 1964; T.D. 7100, 36 FR 5335, Mar. 20, 1971]

§ 1.963–3 Distributions counting toward a minimum distribution.

(a) *Conditions under which earnings and profits are counted toward a minimum distribution*—(1) *In general.* A distribution to the United States shareholder by a single first-tier corporation or by a foreign corporation included in a chain or group shall count toward a minimum distribution for the taxable year of such shareholder to which the election under section 963 relates only to the extent that—

(i) It is received by such shareholder during such year or within 180 days thereafter,

(ii) It is a distribution of the type described in paragraph (b) of this section,

(iii) Under paragraph (c) of this section, it is deemed to be distributed from the earnings and profits of the foreign corporations for the taxable year of such corporation to which the election relates, and

(iv) Such shareholder chooses to include it in gross income for the taxable year of such shareholder to which the election relates notwithstanding that such distribution, by reason of its receipt after the close of such year, would ordinarily be includible in the gross income of a subsequent year.

Amounts taken into account under this subparagraph as gross income of the United States shareholder for the taxable year to which the election relates shall not be considered to be includible in the gross income of such shareholder for a subsequent taxable year. For purposes of determining the foreign tax credit under sections 901 through 905, foreign income tax paid or accrued by such shareholder on or with respect to such amounts shall be treated as paid or accrued during the taxable year of such election.

(2) *Distributions made prior to acquisition of stock.* A United States shareholder which owns within the meaning of section 958(a) stock in a foreign corporation with respect to which such shareholder elects to secure an exclusion under section 963 for the taxable year may count toward the minimum distribution any distribution made with respect to such stock, and before its acquisition by the United States shareholder, to any other domestic corporation not exempt from income tax under chapter 1 of the Code, to the extent that such distribution is made out of the United States shareholder's proportionate share, as determined under paragraph (d)(2) of §1.963–2, of such corporation's earnings and profits for the taxable year and would have counted toward a minimum distribution if it had been distributed to such United States shareholder. The application of this subparagraph may be illustrated by the following examples:

Example 1. Controlled foreign corporation A, which uses the calendar year as the taxable year, has for 1963 $100 of earnings and profits and 100 shares of only one class of stock outstanding. Domestic corporation M, not exempt from income tax under chapter 1 of the Code, directly owns all of such shares during the period from January 1, 1963, through June 30, 1963. On June 30, 1963, M Corporation transfers all of such shares to domestic corporation N, which owns them throughout the remainder of 1963 and elects to secure an exclusion under section 963 for such year with respect to the subpart F income of A Corporation. During June 1963, M Corporation receives a dividend of $75 from A Corporation, which would count toward a minimum distribution if it had been distributed to N Corporation for such year. Corporation N's proportionate share of the earnings and profits of A Corporation for 1963 is $100; N Corporation may count toward a minimum distribution for 1963 the entire dividend of $75 paid to M Corporation.

Example 2. The facts are the same as in example 1 except that M is a nonresident alien individual. Since A Corporation is not a controlled foreign corporation from January 1, 1963, through June 30, 1963, N Corporation's proportionate share of the earnings and profits of A Corporation for 1963 is $50.41 ($100×184/365), as determined under paragraph (d)(2)(iii) of §1.963–2. Although $25.41 ($75−$49.59) of the $75 distribution to M is paid from N Corporation's proportionate share of A Corporation's 1963 earnings and profits, N Corporation may not count toward a minimum distribution any part of the $75 dividend distributed to M, since M is not a domestic corporation.

(b) *Qualifying distributions*—(1) *Amounts not counted toward a minimum distribution.* No distribution received by a United States shareholder shall count toward a minimum distribution for the taxable year with respect to such shareholder to the extent the distribution is excludable from gross income to the extent gain on the distribution is not recognized, or to the extent the distribution is treated as a distribution in part or full payment in exchange for stock. Undistributed amounts required to be included in gross income under section 551 as undistributed foreign personal holding company income or under section 951 as undistributed amounts of a controlled foreign corporation shall not count toward a minimum distribution under section 963. An amount received by a United States shareholder as a distribution which under section 302 or section 331 is treated as a distribution in part or full payment in exchange for stock shall not count toward a minimum distribution even though such amount is includible in gross income under section 1248 as a dividend. For purposes of this subparagraph, any portion of a distribution of earnings and profits which is attributable to an increase in current earnings, invested in United States property which, but for paragraph (e) of this section, would be included in the gross income of the United States shareholder under section 951(a)(1)(B) shall not be treated as an amount excludable from gross income.

(2) *Inclusion of tax on intercorporate distributions.* In the case of a chain or group election, the United States shareholder's proportionate share of the amount of the foreign income tax paid or accrued for the taxable year by a foreign corporation in the chain or group with respect to distributions received by such corporation from the earnings and profits, of another foreign corporation in such chain or group, for the taxable year of such other corporation to which the election relates shall count toward a minimum distribution from such chain or group for the taxable year, but only if the United States shareholder does not choose under paragraph (d)(1)(iii) of § 1.963–2 to take such tax into account in determining the effective foreign tax rate of such chain or group for the taxable year. To the extent that foreign income tax counts toward a minimum distribution under this subparagraph, it shall be applied against and reduce the amount of the minimum distribution required to be received by the United States shareholder, determined without regard to this paragraph.

(c) *Rules for allocation of distributions to earnings and profits for a taxable year.* To determine whether a distribution to the United States shareholder by a single first-tier corporation or by a foreign corporation in a chain or group is made from the earnings and profits of such corporation for the taxable year to which the election under section 963 relates, the following subparagraphs shall apply:

(1) *Exception to section 316.* Section 316 shall apply except that a distribution of earnings and profits made by a foreign corporation either to another foreign corporation or to the United States shareholder shall be treated as having been paid from the earnings and profits of the distributing corporation for the taxable year of such corporation to which the election relates only if it is made during its distribution period (described in paragraph (g) of this section) for such year.

(2) *Distributions from other corporations.* The earnings and profits of a foreign corporation shall be determined in accordance with paragraph (d)(1) of § 1.963–2 (applied as though the United States shareholder had chosen under subparagraph (1)(iii) of such paragraph to take the tax described therein into account in determining the effective foreign tax rate) except that, in the case of a chain or group election, a distribution received by a foreign corporation in the chain or group from another foreign corporation in such chain or group shall be taken into account as earnings and profits of the recipient corporation for the taxable year of such recipient corporation to which the election relates but only to the extent that—

(i) The distribution is received by the recipient corporation during the distribution period for the taxable year of such recipient corporation to which the election relates,

(ii) If the distribution had been received by the United States shareholder, it would have constituted a distribution of the type described in paragraph (b) of this section, and

(iii) The distribution is made from the earnings and profits of the distributing corporation for the taxable year of such distributing corporation to which the election relates.

(d) *Year of inclusion in income of foreign corporation and effect upon subpart F income.* To the extent that a distribution to the United States shareholder counting toward a minimum distribution from a chain or group consists of earnings and profits distributed to a foreign corporation in the chain or group after the close of the recipient corporation's taxable year but during its distribution period for such year by another foreign corporation in such chain or group, such amount shall be treated as received by the recipient corporation on the last day of such taxable year and shall not be regarded as foreign personal holding company income (within the meaning of section 553(a) or 954(c)) of such corporation for the taxable year in which such amount is actually received. The extent to which a distribution counting toward a minimum distribution consists of earnings and profits distributed to a foreign corporation in a chain or group shall be determined under the ordering rules of paragraph (b)(3) of §1.963–4 (applied in each instance as though the United States shareholder had not chosen under paragraph (d)(1)(iii) of §1.963–2 to take the tax described therein into account in determining the effective foreign tax rate). However, for such purpose, the amount of foreign income tax, if any, which counts toward the minimum distribution shall be determined without regard to paragraph (b)(2) of this section but in accordance with paragraph (b)(3)(iii) of §1.963–4.

(e) *Distribution of current earnings invested in United States property.* A distribution made by a foreign corporation during its distribution period for a taxable year shall, notwithstanding section 959(c), first be attributed to earnings and profits for such year described in section 959(c)(3) and then to other earnings and profits. For such purposes, earnings and profits of such foreign corporation for such year attributable to amounts which would otherwise be included in gross income of the United States shareholder under section 951(a)(1)(B) for such year shall be treated as earnings and profits to which section 959(c)(3) applies, shall not be excluded from gross income under section 959 (a) or (b), and shall count toward a minimum distribution for such year. See paragraph (c)(1)(v) of §1.960–1 and paragraph (a) of §1.960–2.

(f) *Cumulative dividends in arrears.* A distribution in satisfaction of arrearages shall be treated as being made out of earnings and profits of the foreign corporation for the taxable year to which the election under section 963 applies only to the extent the dividend is not attributed, under paragraph (d)(2)(i)*(d)* of §1.963–2, to the earnings and profits of such corporation remaining from prior taxable years beginning after December 31, 1962. The application of this paragraph may be illustrated by the following example:

Example. For 1963, single first-tier corporation A, which uses the calendar year as the taxable year, has earnings and profits of $50; for 1964, a deficit in earnings and profits of $20; for 1965, earnings and profits of $100; and for 1966, earnings and profits of $240. For each of such years preferred dividends accumulate at the rate of $60; but no dividend is paid until 1966 during which year the current dividend is paid and $180 is distributed toward the arrearages. Of this $180, only $50 ($180 – $130) shall be treated as paid from 1966 earnings and profits.

(g) *Distribution period of a foreign corporation*—(1) *General distribution period.* Except as provided by subparagraph (2) of this paragraph, the distribution period with respect to a foreign corporation for its taxable year shall begin immediately after the close of the distribution period for the preceding taxable year and shall end with the close of the 60th day of the next succeeding taxable year. If no election to secure an exclusion under section 963 applied to the preceding taxable year, the distribution period for the taxable year shall begin with the 61st day of the taxable year.

(2) *Special extended distribution period.* If the United States shareholder of the foreign corporation so elects in statement filed with its return for the taxable year for which the election to secure the exclusion under section 963 is made, the distribution period with respect to such foreign corporation for its taxable year to which the election to secure the exclusion applies shall end with any day which occurs no earlier than the last day of such taxable year of such foreign corporation and no later than the 180th day after the close of such taxable year. The statement shall designate the day so elected as the end of the distribution period.

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

Example 1. For 1963 domestic corporation M makes a chain election with respect to controlled foreign corporation A, all of whose one class of stock M Corporation directly owns, and controlled foreign corporation B, all of whose one class of stock is directly owned by A Corporation. All such corporations use the calendar year as the taxable year, and the distribution periods of corporations A and B for 1963 coincide. Corporations A and B each have earnings and profits (before distributions) of $100 for 1963. On June 1, 1963, B Corporation distributes earnings and profits of $120, of which $100 is from its earnings and profits for 1963 and $20 is from prior earnings. For 1963, A Corporation pays no income tax and distributes earnings and profits of $150 to M Corporation. Under paragraph (c) of this section, such $150 is allocated to A Corporation's earnings and profits of $200 for 1963, consisting of its total earnings and profits for that year of $220 less the $20 received as a distribution from B Corporation's prior earnings.

Example 2. Domestic corporation M directly owns all of the one class of stock of controlled foreign corporation A. Both corporations use the calendar year as the taxable year, and A Corporation's taxable year and its distribution period for 1963 coincide. For 1963, $50 is included in the gross income of M Corporation under section 951(a)(1)(B) as A Corporation's increase in earnings invested for such year in United States property. For 1964, M Corporation makes a first-tier election with respect to A Corporation. For 1964, A Corporation has earnings and profits of $100, including $10 attributable to an increase in earnings invested for such year in United States property. During 1964, A Corporation distributes earnings and profits of $80 to M Corporation. Without regard to paragraph (e) of this section, $10 of this distribution is attributable under section 959(c)(1) to A Corporation's 1964 earnings and profits required to be included in M Corporation's gross income under section 951(a)(1)(D). Pursuant to paragraph (e) of this section, however, the entire distribution of $80 counts toward a minimum distribution for 1964 and is considered to be from earnings and profits of A Corporation for 1964 described in section 959(c)(3). Thus the entire distribution of $80 is included in M Corporation's gross income as a dividend and the foreign tax credit in respect of such amount is determined in accordance with section 902 as modified by the regulations under section 963. On the other hand, if A Corporation made no distributions for 1964, no part of the $10 of A Corporation's increase in earnings invested in United States property for such year would count toward a minimum distribution for any other year but would be included in the gross income for M Corporation for 1964 under section 951(a)(1)(B), and the foreign tax credit in respect of such amount would be determined in accordance with § 1.960–1.

Example 3. For 1964 domestic corporation M makes a chain election with respect to controlled foreign corporation A, all the one class of stock of which is owned directly by M Corporation, and controlled foreign corporation B, all the one class of stock of which is owned directly by A Corporation. Corporation M makes no election under section 963 for 1963 or 1965. Corporations M and B use the calendar year as the taxable year, and A Corporation uses for its taxable year a fiscal year ending on September 30. Corporation M elects to have the distribution period for each controlled foreign corporation end on March 29, 1965, such date being the 180th day after the close of A Corporation's taxable year ending on September 30, 1964. Corporation A's distribution period for its taxable year ending on September 30, 1964, begins on November 30, 1963, the 61st day of such taxable year. The distribution period of B Corporation for 1964 begins on March 1, 1964, the 61st day of such taxable year. A distribution counting toward a minimum distribution for 1964 may be made from the earnings and profits of B Corporation only if the amount thereof is distributed by B Corporation to A Corporation, and in turn by A Corporation to M Corporation, during the period of March 1, 1964, through March 29, 1965.

Example 4. The facts are the same as in example 3, except that for their taxable years ending in 1964, corporations A and B each have earnings and profits (before distributions) of $100. On March 10, 1965, B Corporation distributes to A Corporation a dividend of $80 upon which A Corporation incurs foreign income tax at the rate of 10 percent. On March 15, 1965, A Corporation distributes to M Corporation a dividend of $50. Corporation M chooses to take into account as gross income for 1964 from such distribution only $40. For purposes of applying this section, the distribution counting toward a minimum distribution is $44.44, consisting of the $40 of earnings and profits actually received by M Corporation plus the $4.44 ($40/$72×$8) of foreign income tax incurred by A Corporation attributable thereto; A Corporation is deemed to have received $44.44 ($40÷0.90) of the distribution from B Corporation on September 30, 1964, the last day of the taxable year of A Corporation to which the election relates; and the foreign personal holding company income derived by A Corporation for its taxable year ending in 1965 from the distribution from B is only $35.56 ($80 − $44.44). Assuming that no exceptions, exclusions, or exemptions were applicable, subpart F income would be realized by A Corporation for its taxable year ending on September 30, 1965, upon the distribution by B Corporation to A Corporation, but only in the amount of $32 ($35.56 less a deduction under section 954(b)(5) for taxes of $3.56).

[T.D. 7100, 36 FR 10860, June 4, 1971; 36 FR 11924, June 23, 1971, as amended by T.D. 7334, 39 FR 44214, Dec. 23, 1974]

§1.963–4 Limitations on minimum distribution from a chain or group.

(a) *Minimum overall tax burden*—(1) *In general.* Notwithstanding the fact that distributions of the type described in paragraph (a) of §1.963–3 are made by a chain or group to the United States shareholder in an amount sufficient to constitute a minimum distribution for the taxable year of such shareholder to which the chain or group election relates, no exclusion shall be allowable under section 963 to such shareholder with respect to such chain or group for such year unless—

(i) Without applying the special rules set forth in paragraphs (b) and (c) of this section, the overall United States and foreign income tax (as defined in subparagraph (2)(ii) of this paragraph) for the taxable year with respect to the distribution which is made equals or exceeds 90 percent of an amount determined by multiplying the sum of the consolidated earnings and profits (as determined under paragraph (d)(3) of §1.963–2) and the consolidated foreign income taxes (as determined under paragraph (e)(2) of §1.963–2) of such chain or group for the taxable year with respect to such shareholder by a percentage which equals the sum of the normal tax rate and the surtax rate (determined without regard to the surtax exemption) prescribed by section 11 for the taxable year of the shareholder, or

(ii) With the application of the special rules set forth in paragraphs (b) and (c) of this section—

(a) Such shareholder receives a pro rata minimum distribution (as defined in subparagraph (2)(i) of this paragraph) from such chain or group for such taxable year, or

(b) To the extent necessary, the amount of the foreign income tax allowable as a credit for such year under section 901 with respect to the distribution which is made is reduced and credit for the reduction is deferred, as provided in paragraph (c)(3) of this section, so that the overall United States and foreign income tax for the taxable year with respect to such distribution equals or exceeds the lesser of—

(1) The overall United States and foreign income tax which would be paid or accrued for such year with respect to a pro rata minimum distribution received by such shareholder from such chain or group for such year, and

(2) Ninety percent of an amount determined by multiplying the sum of the consolidated earnings and profits (as determined under paragraph (b)(1) of this section) and the consolidated foreign income taxes (as determined under paragraph (b)(1) of this section) of such chain or group for the taxable year with respect to such shareholder by a percentage which equals the sum of the normal tax rate and the surtax rate (determined without regard to the surtax exemption) prescribed by section 11 for the taxable year of the shareholder.

(2) *Definitions.* For purposes of §§1.963–1 through 1.963.8—

(i) *Pro rata minimum distribution.* A pro rata minimum distribution from a chain or group for the taxable year is a distribution of earnings and profits to the United States shareholder, with respect to stock to which the chain or group election relates, which is the statutory percentage (applicable with respect to such chain or group as determined under paragraph (b) of §1.963–2) of the United States shareholder's proportionate share of the taxable year's earnings and profits of each foreign corporation in such chain or group (determined in accordance with paragraph (d)(2) of §1.963–2 but without making any deduction under paragraph (d)(1)(iii) of such section).

(ii) *Overall United States and foreign income tax.* The overall United States and foreign income tax for any taxable year of a chain or group with respect to a minimum distribution is the sum of—

(a) The consolidated foreign income taxes of the chain or group for such year with respect to the United States shareholder making the chain or group election,

(b) Any other foreign income tax paid or accrued by a foreign corporation in the chain or group by reason of the receipt of any distributions counting toward such minimum distribution from such chain or group for that year, and

(c) The foreign income tax, if any, and United States income tax paid or accrued by such shareholder upon

amounts counting toward such minimum distribution from such chain or group for such year.

Such overall United States and foreign income tax shall be determined with respect to such minimum distribution without taking into account any foreign income tax which is deemed paid for such year under section 904(d), relating to carryback and carryover of excess tax paid. For purposes of this subdivision, the consolidated foreign income taxes of the chain or group shall be determined under paragraph (e)(2) of § 1.963–2, applied without regard to the second sentence of paragraph (d)(1) of that section.

(3) *Taxes paid by foreign corporation on distributions received during its distribution period.* For purposes of determining foreign income tax deemed paid by the United States shareholder for the taxable year under section 902, if a distribution received by a foreign corporation in a chain or group from another foreign corporation in such chain or group after the close of the recipient's taxable year but during its distribution period for such year is allocated to the earnings and profits of such recipient corporation for such year under paragraph (c)(2) of § 1.963–3, any foreign income tax paid or accrued by such recipient corporation on such distribution shall be treated as paid or accrued for such taxable year.

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

Example. (a) Domestic corporation M directly owns all of the one class of stock of foreign corporation A, which in turn directly owns all of the one class of stock of foreign corporation B. Corporation M makes a chain election with respect to A Corporation and B Corporation. All such corporations use the calendar year as the taxable year. Assuming that A Corporation does not incur foreign tax on amounts distributed by B Corporation, the foreign income tax and earnings and profits of corporations A and B, the effective foreign tax rate, and the statutory percentage for 1966, are as follows:

	A	B	Consolidated
Pretax and predistribution earnings and profits	$100	$100	$200
Foreign income tax	20	40	60
Earnings and profits	80	60	140
Effective foreign tax rate ($60/[$140+$60])	....	....	30%
Statutory percentage under section 963(b)	....	....	69%

(b) Corporation M is entitled for 1966 to exclude its pro rata share of the subpart F income of corporations A and B for such year if it receives from the 1966 consolidated earnings and profits of the chain distributions totaling at least $96.60 (0.69×$140) and if—

(1) The sum of the consolidated foreign income taxes ($60) of the chain for 1966 and of the United States income tax for 1966 (determined by taking into account the foreign tax credit under section 901 without regard to paragraph (c) of this section) imposed on such distributions equals at least $86.40 (0.90×0.48×$200);

(2) Under the special rules of paragraphs (b) and (c) of this section, the distributions received consist of a distribution from each of corporations A and B which is 69 percent of the earnings and profits for 1966 of such corporation, that is, a distribution of $55.20 (0.69×$80) from A Corporation and of $41.40 (0.69×$60) from B Corporation; or

(3) Under the special rules of paragraphs (b) and (c) of this section, the foreign tax credit is reduced and deferred to such an extent that the sum of the consolidated foreign income taxes ($60) of the chain for 1966 and of the United States income tax for 1966 (determined by taking into account the foreign tax credit under section 901 as modified by paragraph (c) of this section) imposed on such distributions equals the lesser of $86.40 (0.90×0.48×$200) and the amount which the sum of such taxes would be if M Corporation were to receive a distribution of $55.20 (0.69×$80) from the 1966 earnings and profits of A Corporation and $41.40 (0.69×$60) from the 1966 earnings and profits of B Corporation.

(b) *Special rules for determining earnings and profits and foreign income taxes.* For purposes of determining the minimum overall tax burden under paragraph (a)(1)(ii) of this section, §§ 1.963–2 and 1.963–3 shall apply as modified by the following subparagraphs:

(1) *Exclusion of tax on intercorporate distributions.* The consolidated earnings and profits and consolidated foreign income taxes of a chain or group for the taxable year shall be determined in accordance with § 1.963–2, except that foreign income tax referred to in paragraph (d)(1)(iii) of such section may be

taken into account in determining the effective foreign tax rate only—

(i) To the extent that such tax is not deemed paid by the United States shareholder under section 902 (as modified by paragraph (c) of this section) for its taxable year to which the chain or group election relates, or

(ii) If, by taking the tax into account, the effective foreign tax rate with respect to such chain or group, as determined under paragraph (c)(2) of §1.963–2, exceeds the highest effective foreign tax rate requiring a distribution under section 963(b) for such year of the shareholder.

(2) *Allocation of deficits.* For purposes of determining the amount of each foreign corporation's share of a pro rata minimum distribution from a chain or group for the taxable year and for purposes of determining the foreign tax credit under paragraph (c) of this section of the United States shareholder with respect to any minimum distribution from a chain or group for the taxable year—

(i) *Deficits of foreign corporations.* The total of the United States shareholder's proportionate shares, as determined under paragraph (d)(2)(ii) of §1.963–2, of the deficit of every foreign corporation in the chain or group having a deficit for the taxable year shall be allocated against and shall reduce such shareholder's proportionate share, as determined under paragraph (d)(2)(i) of §1.963–2, of the earnings and profits for the taxable year of each other foreign corporation in the chain or group having earnings and profits for such year in an amount which bears to such total of shares of deficit the same ratio which such share of earnings and profits bears to the total of such shareholder's proportionate shares, as so determined, of the earnings and profits of all foreign corporations in the chain or group having earnings and profits for the taxable year.

(ii) *Deficits of foreign branches.* If for the taxable year a group includes under paragraph (f)(4) of §1.963–1 foreign branches the aggregate of whose allowable deductions (other than any net operating loss deduction) exceeds the aggregate of their gross incomes for the taxable year, determined as provided in paragraph (f)(4)(ii) of such section, the amount of such excess shall be allocated as provided by subdivision (i) of this subparagraph.

(3) *Distributions through a chain or group.* In determining whether and to what extent a distribution for any taxable year has been made out of the earnings and profits of a foreign corporation included in a chain of ownership described in section 958(a) consisting of two or more corporations in a chain or group for the taxable year, the following subdivisions shall apply:

(i) *Allocation first to income received as a distribution.* If any foreign corporation included in the chain or group for the taxable year receives a distribution for such year from another foreign corporation in the chain or group and in turn makes a distribution for the taxable year, the distribution so made shall first be allocated to the earnings and profits, to the extent thereof, attributable to the distribution so received; if distributions are received from more than one other corporation in the chain or group, the distribution made by the recipient corporation shall be apportioned among all such amounts. For purposes of determining whether a distribution is made or received for the taxable year, see paragraph (c) of §1.963–3.

(ii) *Successive distributions through a chain or group.* If any foreign corporation included in the chain or group for the taxable year distributes an amount from its earnings and profits of such year, the amount so distributed shall be considered to be received from such earnings and profits by the United States shareholder to the extent the amount is distributed by successive distributions made by each other foreign corporation in the chain or group for the taxable year through the chain of ownership described in section 958(a) into the hands of such shareholder.

(iii) *Distribution determined without reduction by taxes of intervening corporations.* If, for the taxable year to which the election to secure an exclusion under section 963 applies, the United States shareholder receives a distribution to which subdivision (ii) of this subparagraph applies, the entire amount distributed by the foreign corporation from such shareholder's proportionate share of its earnings and profits for the taxable year shall, except where taxes referred to in paragraph (d)(1)(iii) of § 1.963–2 are taken into account as provided by subparagraph (1) of this paragraph, count toward a minimum distribution and shall not be reduced for such purpose by an foreign income tax paid or accrued on such amount by another foreign corporation in the chain or group through which such amount is distributed by successive distributions into the hands of such shareholder. The application of this subdivision may be illustrated by the following examples:

Example 1. For 1966, domestic corporation M makes a chain election with respect to controlled foreign corporation A, all the one class of stock of which is directly owned by M Corporation, and controlled foreign corporation B, all the one class of stock of which is directly owned by A Corporation. All corporations use the calendar year as the taxable year. Corporation M complies with the special rules of this paragraph and paragraph (c) of this section for the taxable year. Corporation A's only income for 1966 is a dividend of $52.50 distributed in such year by B Corporation, on which A Corporation is subject to an income tax of $10.50. The remaining $42 ($52.50 less $10.50) is distributed by A Corporation for 1966 to M Corporation. The full $52.50 distributed by B Corporation counts toward a minimum distribution by the chain for 1966.

Example 2. For 1966, domestic corporation M makes a chain election with respect to controlled foreign corporation A, all the one class of stock of which it owns directly, and controlled foreign corporation B, all the one class of stock of which A Corporation own directly. All corporations use the calendar year as the taxable year. Corporation M complies with the special rules of this paragraph and paragraph (c) of this section for the taxable year. The predistribution and pretax earnings and profits for 1966 of B Corporation are $100, and of A Corporation, $0. Corporation B pays foreign income tax of $30 and during the year distributes $70. On such $70, A Corporation pays foreign income tax of $14. By applying paragraph (d)(1)(iii) of § 1.963–2, the consolidated foreign income taxes of the chain for 1966 are $44 ($30+$14) and the consolidated earnings and profits of the chain are $56 ($70−$14); in such case, the effective foreign tax rate of the chain for 1966 is 44 percent ($44/[$56+$44]) and thus in excess of the highest effective foreign tax rate requiring a distribution for such year under section 963(b). Since M Corporation may thus take A Corporation's tax of $14 into account, the statutory percentage under section 963(b) for 1966 is zero percent and the amount of the minimum distribution required to be made by the chain is $0.

(c) *Special foreign tax credit rules*—(1) *In general.* In determining the minimum overall tax burden under paragraph (a)(1)(ii) of this section, the foreign tax credit of the United States shareholder with respect to a minimum distribution received for the taxable year from the chain or group shall be determined under the provisions of sections 901 through 905 as modified by § 1.963–3 except that—

(i) Under subparagraph (2) of this paragraph—

(a) Taxes of a second-tier corporation making a distribution through a first-tier corporation shall not be averaged with taxes of such first-tier corporation,

(b) Taxes of a first-tier corporation or a second-tier corporation on a distribution made through such corporation shall not be averaged with such corporation's taxes on its other income; and

(c) Taxes of a first-tier corporation or a second-tier corporation shall not be deemed paid with respect to distributions from the earnings and profits of such corporation which are offset by a deficit allocated under paragraph (b)(2) of this section to the United States shareholder's proportionate share of the earnings and profits of such corporation; and

(ii) The foreign tax credit may be reduced and the reduction deferred under subparagraph (3) of this paragraph to another taxable year of the United States shareholder.

(2) *Nonaveraging of tax*—(i) *Year of minimum distribution—(a) Taxes deemed paid by a first-tier corporation and taxes actually paid by such corporation.* If, by successive distributions through a chain or group, a United States shareholder receives for a taxable year a distribution of the earnings and profits for such year of any corporation in such chain or group, and if both section 902(a) and section 902(b) apply with respect to such distribution, all the taxes deemed paid under section 902(b) by the first-tier corporation described in section 902(a) with respect to such distribution of such earnings and profits shall be deemed paid by the United States shareholder for such taxable

year under section 902(a) with respect to the earnings and profits so distributed and, notwithstanding the rules otherwise applicable under section 902, no part of the taxes so deemed paid by such first-tier corporation shall be attributed to other earnings and profits of such first-tier corporation for such year and no part of the taxes paid or accrued with respect to such other earnings and profits shall be attributed to the earnings and profits so received as a distribution.

(b) Taxes of a foreign corporation paid on intercorporate distributions and on other income. If, by successive distributions through a chain or group, a United States shareholder receives for a taxable year a distribution of the earnings and profits for such year of any corporation in such chain or group, then in applying section 902(a) with respect to such distribution through a first-tier corporation described in section 902(a), or in applying section 902(b) with respect to such distribution through a second-tier corporation described in section 902(b), as the case may be, the taxes of such corporation which shall be taken into account in determining taxes deemed paid under such section shall be the foreign income tax actually paid or accrued for the taxable year by such first-tier or second-tier corporation, as the case may be, with respect to such distribution; and, notwithstanding the rules otherwise applicable under section 902, no part of the taxes so paid by such first-tier or second-tier corporation shall be attributed to other earnings and profits of such corporation for such year and no part of the taxes paid or accrued with respect to such other earnings and profits shall be attributed to the earnings and profits so received as a distribution.

(c) Corporation with earnings and profits reduced by allocated deficits. In the application of section 902, a United States shareholder's proportionate share of the earnings and profits for the taxable year of a foreign corporation to which the chain or group election applies shall reflect the reduction of such earnings and profits by deficits allocated thereto under paragraph (b)(2) of this section. No taxes paid or accrued by such corporation shall be deemed paid under section 902 with respect to a distribution to such shareholder from the earnings and profits of such corporation for such year to the extent that such distribution exceeds the shareholder's proportionate share as so reduced.

(ii) *Year of distribution of remaining earnings and profits.* If for a taxable year in respect of which a United States shareholder receives a minimum distribution pursuant to an election under section 963 and in respect of which the provisions of this subparagraph are applied—

(a) The foreign income tax which is paid or accrued by a foreign corporation for such year, by reason of the receipt and payment of earnings and profits counting toward such minimum distribution, is deemed paid under subdivision (i) *(a)* or *(b)* of this subparagraph,

(b) The pretax and predistribution earnings and profits for such year of a foreign corporation in a chain or group with respect to stock on which such minimum distribution is received are reduced by reason of the deduction under paragraph (d)(1)(i) of §1.963–2 of distributions received from other corporations in such chain or group, or

(c) Such shareholder's proportionate share of the earnings and profits for such year of a foreign corporation in a chain or group making a distribution counting toward such minimum distribution is reduced by the allocation thereto under paragraph (b)(2) of this section of a portion of the deficits of foreign branches or other foreign corporations in such chain or group,

the pretax and predistribution earnings and profits of such foreign corporation for such year to which such minimum distribution is attributable and the foreign income tax which is taken into account in determining tax deemed paid under section 902 on such pretax and predistribution earnings and profits shall not be taken into account in the application of section 902 when other earnings and profits of such foreign corporation for such year are distributed in a subsequent taxable year of such foreign corporation to such shareholder. For the purpose of applying the preceding sentence to a case in which *(c)* of this subdivision applies, the pretax and predistribution earnings and profits of the foreign corporation for such year to which the minimum distributed is attributable shall be the amount of such corporation's earnings and profits which are distributed and count toward the minimum distribution plus the foreign income tax of such foreign corporation allocated thereto in determining the taxes deemed paid under section 902 for the taxable year of the minimum distribution.

(iii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example 1. Domestic corporation M makes a chain election for 1966 with respect to controlled foreign corporation A, which is wholly owned directly by M Corporation, and controlled foreign corporation B, which is wholly owned directly by A Corporation. Each corporation uses the calendar year as the taxable year. In 1966, corporations A and B are subject to foreign income tax at the rates of 20 percent and 30 percent, respectively, with no deduction being allowed for dividends received or paid; each such corporation has pretax and predistribution earnings and profits of $100. Corporation M receives from the chain a pro rata minimum distribution for such year and applies thereto the special rules of this paragraph and paragraph (b) of this section. Corporation A is not a less developed country corporation under section 902(d). The 1966 foreign income tax of corporations A and B which is deemed paid by M Corporation under section 902(a) for 1966, and the remaining tax which is allocated to earnings and profits to be distributed to M Corporation in future years, are determined as follows:

	A	B	Total
Pretax and predistribution earnings and profits	$100.00	$100.00	$200.00
Foreign income tax	20.00	30.00	50.00
Consolidated earnings and profits	80.00	70.00	150.00
Effective foreign tax rate ($50/[$150+$50])			25%
Statutory percentage under section 963(b)			76%
Amount distributed as pro rata minimum distribution for 1966:			
(0.76×$80)	60.80		
(0.76×$70)		53.20	114.00
Amount received by M Corporation as pro rata minimum distribution:			
A Corporation's distribution	$60.80		
B Corporation's distribution ($53.20 − [0.20 × $53.20]), or ($53.20 − $10.64)		$42.56	$103.36
Amount of tax counted toward minimum distribution			10.64
Tax deemed paid by M Corporation for 1966 for purposes of gross-up under section 78 and foreign tax credit:			
($60.80/$80×$20)	15.20		
([$42.56/$42.56×$10.64] +[$53.20/$70×$30]) or ($10.64+$22.80)		33.44	48.64
Remaining 1966 earnings and profits for future distribution to M Corporation:			
($80 − $60.80)	19.20		
($70 − $53.20)		16.80	36.00
Foreign income tax attributable to 1966 earnings and profits remaining for future distribution to M Corporation:			
($19.20/$80×$20)	4.80		
($16.80/$70×$30)		7.20	12.00

Example 2. The facts are the same as in example 1 except that A Corporation pays foreign income tax at the rate of 30 percent and B Corporation, at the rate of 20 percent; and A Corporation is allowed a deduction, in computing its income subject to tax, for the full amount of dividends received. The determination of tax deemed paid for 1966 is as follows:

	A	B	Total
Pretax and predistribution earnings and profits	$100.00	$100.00	$200.00
Foreign income tax	30.00	20.00	50.00
Consolidated earnings and profits	70.00	80.00	50.00
Effective foreign tax rate ($50/[$150+$50])			25%
Statutory percentage under section 963(b)			76%
Amount distributed by foreign corporations as a pro rata minimum distribution for 1966 and amount received by M Corporation:			
(0.76×$70)	$53.20		
(0.76×$80)		$60.80	$114.00
Tax deemed paid by M Corporation for 1966 for purposes of gross-up under section 78 and foreign tax credit:			
($53.20/$70×$30)	22.80		
($60.80/$80×$20)		15.20	38.00

	A	B	Total
Remaining 1966 earnings and profits for future distribution to M Corporation:			
($70 − $53.20)	16.80	....	....
($80 − $60.80)	....	19.20	36.00
Foreign income tax attributable to 1966 earnings and profits remaining for future distribution to M Corporation:			
($16.80/$70×$30)	7.20	....	....
($19.20/$80×$20)	....	4.80	12.00

Example 3. For 1966, domestic corporation M makes a group election with respect to controlled foreign corporations A and B, both of which are wholly owned directly by M Corporation, and foreign branch C of M Corporation. All such corporations use the calendar year as the taxable year. Corporation M receives a pro rata minimum distribution from the group for 1966 and applies thereto the special rules of this paragraph and paragraph (b) of this section. Neither foreign corporation is a less developed country corporation under section 902(d). Corporations A and B pay foreign income tax at a flat rate of 20 percent and 30 percent, respectively. The 1966 foreign income tax of corporations A and B which is deemed paid by M Corporation under section 902(a) for 1966, and the remaining tax which is allocated to earnings and profits to be distributed to M Corporation in future years, are determined as follows:

	A	B	Branch C	Total
Pretax and predistribution earnings and profits (and deficit) of the group	$60.00	$60.00	($20)	$100.00
Foreign income tax	12.00	18.00	....	30.00
Earnings and profits (and deficit)	48.00	42.00	(20)	70.00
Allocation of deficit of Branch C:				
($48/[$48+$42]×$20)	(10.67)	....	....	....
($42/[$48+$42]×$20)	....	(9.33)	....	....
Consolidated earnings and profits of the group	37.33	32.67	....	70.00
Effective foreign tax rate ($30/$100)	....	....	....	30%
Statutory percentage under section 963(b)	....	....	....	69%
Amount received by M Corporation as pro rata minimum distribution for 1966:				
(0.69×$37.33)	25.76	....	....	....
(0.69×$32.67)	....	22.54	....	$48.30
Tax deemed paid by M Corporation for 1966 for purposes of gross-up under section 78 and foreign tax credit:				
($25.76/$37.33×$12)	8.28	....	....	....
($22.54/$32.67×$18)	....	12.42	....	20.70
Remaining 1966 earnings and profits for future distribution to M Corporation:				
($48 − $25.76)	22.24	....	....	....
($42 − $22.54)	....	19.46	....	41.70
Foreign income tax attributable to 1966 earnings and profits remaining for future distribution to M Corporation:				
($12 − $8.28)	3.72	....	....	....
($18 − $12.42)	....	5.58	....	9.30

Example 4. The facts are the same as in example 3 except that the group does not make a pro rata minimum distribution but distributes $48.30, consisting of $40 distributed by A Corporation and $8.30 distributed by B Corporation. Corporation M complies with the special rules of this paragraph and paragraph (b) of this section. The 1966 foreign income tax of corporations A and B which is deemed paid by M Corporation under section 902(a) for 1966, and the remaining tax which is allocated to earnings and profits to be distributed to M Corporation in future years, are determined as follows, the minimum overall tax burden for 1966 being such as to satisfy the requirement of paragraph (a)(1)(ii)*(b)* of this section:

	A	B	Branch C	Total
Amount received by M Corporation	$40.00	$8.30	....	$48.30
Tax deemed paid by M Corporation for 1966 for purposes of gross-up under section 78 and foreign tax credit:				
($37.33/$37.33×$12)	12.00	....	....	....
($8.30/$32.67×$18)	....	4.57	....	16.57
Remaining 1966 earnings and profits for future distribution to M Corporation:				
($48 − $40)	8.00	....	....	....
($42 − $8.30)	....	33.70	....	41.70

	A	B	Branch C	Total
Foreign income tax attributable to 1966 earnings and profits remaining for future distribution to M Corporation:				
($12 – $12)	0			
($18 – $4.57)		13.43		13.43

(3) *Reduction and deferral of the foreign tax credit*—(i) *In general.* To the extent specified in paragraph (a)(1)(ii)*(b)* of this section a reduction shall be made in the foreign tax credit allowable under section 901 for the taxable year with respect to distributions counting toward a minimum distribution for such year from the chain or group; and such reduction in credit shall be allocated, as provided in subdivision (ii) of this subparagraph, to foreign corporations in such chain or group and deferred, as provided in subdivision (iii) of this subparagraph, to subsequent taxable years of the United States shareholder.

(ii) *Allocation of reduction in foreign tax credit.* The amount of any reduction in foreign tax credit for the taxable year which is made under subdivision (i) of this subparagraph with respect to a minimum distribution for any taxable year from the chain or group shall be allocated among any first-tier and second-tier corporations described in section 902 (a) and (b), respectively, which are in such chain or group. The amount of any such reduction in foreign tax credit shall be allocated among such first-tier and second-tier corporations in the ratio which the United States shareholder's proportionate share of undistributed earnings and profits of each such corporation for the taxable year bears to the total of such shareholder's proportionate shares of the undistributed earnings and profits of all such corporations for such year. None of such reduction shall be allocated to any other corporations in the chain or group or to any foreign branches included under paragraph (f)(4) of § 1.963–1 in the group as wholly owned foreign subsidiary corporations.

(iii) *Deferral of allocated credit—(a) Allowance of credit in subsequent years.* The reduction in foreign tax credit allocated to a first-tier or second-tier corporation in the chain or group for a taxable year under subdivision (ii) of this subparagraph shall be deemed paid under the principles of section 902 (applicable to foreign corporations which are not less developed country corporations) with respect to distributions, to the extent made by such corporation to the United States shareholder referred to in subdivision (ii) of this subparagraph, in a subsequent taxable year from the undistributed earnings and profits of such corporation for such year of allocation. Thus, for example, in the case of a distribution in the subsequent year from such earnings and profits by a first-tier corporation, the tax deemed paid shall be an amount which bears to the total of such reduction in foreign tax credit the same ratio that the distribution to the shareholder in the subsequent year bears to such shareholder's proportionate share of such undistributed earnings and profits for the year of allocation.

(b) Limitations on use of deferred credit. The deferred tax so deemed paid shall be deemed paid for such subsequent taxable year and shall be allowed under section 901 (without regard to the limitations under section 904) as a credit against the income tax imposed for such year by chapter 1 of the Code, but the amount of such credit shall not exceed the excess of the tax so imposed for such year over the credit (determined without regard to this subdivision (iii) allowed under sections 901 through 905 for such year. Any amount by which the deferred tax so deemed paid in such subsequent taxable year exceeds the limitation under the preceding sentence shall not be carried back or carried over under section 904(d) to another taxable year of the United States shareholder. No credit shall be allowed under this subdivision for the subsequent taxable year to the extent that the credit would reduce the tax of the United States shareholder under chapter 1 of the Code on any minimum distribution for such year to which section 963 applies.

(c) Gross-up not applicable. Any amount allowed as a credit for a subsequent taxable year under this subdivision shall not be included in the gross income of the United States shareholder for such year under section 78.

(d) Illustrations. The application of this section may be illustrated by the following examples, in which the surtax exemption provided by section 11(c) is disregarded:

Example 1. (a) For 1966, domestic corporation M makes a chain election with respect to controlled foreign corporation A, which it wholly owns directly, and controlled foreign corporation B, which A Corporation wholly owns directly. Corporation A is not a less developed country corporation under section 902(d). All corporations use the calendar year as the taxable year. For 1966, M Corporation complies with the special rules of paragraphs (b) and (c) of this section. Corporation A has pretax and predistribution earnings and profits for 1966 of $40 and is subject to foreign income tax at a flat rate of 36 percent, with no deduction being allowed for dividends received or paid. B Corporation has pretax and predistribution earnings and profits of $60 for 1966 and is subject to a foreign income tax at a flat rate of 20 percent, with no deduction being allowed for dividends received or paid. For 1967, B Corporation has no earnings and profits, A Corporation has no earnings and profits other than a dividend of $21.22 from B Corporation, and M Corporation has taxable income of $20.98 from United States sources. Corporation M uses the overall limitation under section 904(a)(2) on the foreign tax credit.

(b) If a pro rata minimum distribution were made for 1966, the overall United States and foreign income tax for such year with respect to such distribution would be $41.30, determined as follows:

	A	B	Total
Pretax and predistribution earnings and profits	$40.00	$60.00	$100.00
Foreign income tax:			
(0.36×$40)	14.40	....	....
(0.20×$60)	....	12.00	$26.40
Consolidated earnings and profits	25.60	48.00	73.60
Effective foreign tax rate ($26.40/[$73.60+$26.40])	....	....	26.4%
Statutory percentage under section 963(b)	....	....	69%
Amount distributed as pro rata minimum distribution:			
(0.69×$25.60)	17.66	....	....
(0.69×$48)	....	33.12	$50.78
Amount received by M Corporation as pro rata minimum distribution:			
Corporation's distribution	17.66	....	....
B Corporation's distribution ($33.12 – [0.36× $33.12]), or ($33.12 – $11.92)	....	21.20	38.86
Gross-up under section 78:			
($17.66/$25.60×$14.40)	9.94	....	....
($21.20/$21.20× [$11.92+($33.12/ $48×$12)]), or ($11.92+$8.28)	....	20.20	30.14
Taxable income of M Corporation	....	....	69.00
U.S. tax before foreign tax credit ($69×0.48)	....	....	33.12
Foreign tax credit (as determined under gross-up above)	....	....	30.14
U.S. tax payable	....	....	2.98
Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($26.40+$11.92+$2.98)	....	....	41.30

(c) The chain, however, does not make a pro rata distribution for 1966, but distributes $24 from A Corporation's earnings and profits and $26.78 from B Corporation's earnings and profits, the total distribution of $50.78 being equal to the statutory percentage of the consolidated earnings and profits (0.69×$73.60) of the chain with respect to M Corporation. Thus, M Corporation must make such a reduction in its foreign tax credit that the overall United States and foreign income tax for 1966 with respect to the distribution equals the lesser of $41.30 (the overall United States and foreign income tax which would be paid with respect to a pro rata minimum distribution) and $43.20 (90 percent of 48 percent of pretax and predistribution consolidated earnings and profits of $100). The remaining 1956 earnings and profits of the chain are distributed late in 1967. Corporation M determines its tax as follows for such years:

1966

	A	B	Total
Distributions made	$24.00	$26.78	$50.78
Amount received by M Corporation:			
A Corporation's distribution	24.00	....	....
B Corporation's distribution ($26.78 – [0.36× 26.78]), or ($26.78 – $9.64)	....	17.14	41.14

1966

	A	B	Total
Gross-up under section 78:			
($24/$25.60×$14.40)	13.50		
($17.14/$17.14×[$9.64+ ($26.78/$48×$12)]), or ($9.64+$6.70)		16.34	29.84
Taxable income of M Corporation			$70.98
Tentative U.S. tax before foreign tax credit ($70.98×.48)			34.07
Less: Tentative foreign tax credit (as computed under gross-up above)			29.84
Tentative U.S. tax payable			4.23
Tentative overall U.S. and foreign income tax ($26.40+$9.64+$4.23)			40.27
Overall U.S. and foreign tax which would be paid with respect to a pro rata minimum distribution (part (b) of this example)			41.30
Insufficient overall U.S. and foreign income tax ($41.30 – $40.27)			1.03
Reduced foreign tax credit ($29.84 – $1.03)			28.81
U.S. tax payable ($34.07 – $28.81)			5.26
Overall U.S. and foreign income tax ($26.40+$9.64+$5.26)			41.30
Reduction in foreign tax credit to be deferred ($29.84 – $28.81)			1.03
Remaining 1966 earnings and profits of:			
A Corporation ($25.60 – $24)	$1.60		
B Corporation ($48 – $26.78)		$21.22	22.82
Allocation of reduction in foreign tax credit to remaining 1966 earnings and profits of:			
A Corporation ($1.60/22.82×$1.03)	.07		
B Corporation ($21.22/$22.82×$1.03)		.96	1.03
Foreign income tax attributable to remaining 1966 earnings and profits of:			
A Corporation ($1.60/$25.60×$14.40)	.90		
B Corporation ($21.22/$48×$12)		5.30	6.20

1967

Taxable income of M Corporation consisting of distributions from:			
A Corporation's remaining 1966 earnings and profits	1.60		
B Corporation's remaining 1966 earnings and profits ($21.22 – [.36×21.22]), or ($21.22 – $7.64)		13.58	15.18
Gross-up under section 78:			
($1.60/$1.60×$0.90)	.90		
($13.58/$13.58× [$7.64+($21.22/ 21.22×$5.30)])		12.94	13.84
Taxable income from sources without the U.S.			29.02
Taxable income from sources within the U.S.			20.98
Total taxable income of M Corporation			50.00
U.S. tax before foreign tax credit (0.48×$50)			24.00
Foreign tax credit:			
Tax deemed paid under section 902:			
$13.84, but not to exceed section 904 limitation of $13.93 ($29.02/$50×$24) (see gross-up above)			13.84
Tax deemed paid under the principles of section 902:			
($1.60/$1.60×$0.07)	.07		
($21.22/$21.22× 0.96)		.96	1.03
U.S. tax payable ($24 – [$13.84+$1.03])			9.13

Example 2. (a) For 1963, domestic corporation M makes a group election with respect to controlled foreign corporations A and B, both of which M Corporation wholly owns directly. All such corporations use the calendar year as the taxable year. Corporation A is created under the laws of foreign country X, and B Corporation is created under the laws of foreign country Y; neither of such corporations is a less developed country corporation under section 902(d). Corporation M complies with the special rules of paragraphs (b) and (c) of this section. Each foreign corporation has pretax earnings and profits of $100 for 1963. The income of A Corporation is subject to a foreign income tax rate of 20 percent, and the income of B Corporation is subject to a foreign income tax rate of 30 percent. Corporation M uses the per-country limitation under section 904(a)(1) on the foreign tax credit.

(b) If a pro rata minimum distribution were made for 1963, the group would distribute $123 based upon an effective foreign tax rate of 25 percent ($50/[$50+$150]) and a statutory percentage of 82 percent under section 963(b); of this amount $57.40 (0.82×$70) would be distributed from B Corporation's earnings and profits and $65.60 (0.82×$80) would be distributed from A Corporation's earnings and profits. In such case, the overall United States and foreign income tax for 1963 with respect to the pro rata minimum distribution would be determined as follows, using the 52 percent United States corporate income tax rate applicable for such year:

Taxable income of M Corporation from sources in—		
Y Country:		
B Corporation dividend	$57.40	
Gross-up under section 78 ($57.40/$70×$30)	24.60	$82.00
X Country:		
A Corporation dividend	65.60	
Gross-up under section 78 ($65.60/$80×$20)	16.40	82.00
Taxable income		164.00
U.S. tax before tax credit (0.52×$164)		85.28
Foreign tax credit:		
Y Country tax	24.60	
X Country tax	16.40	41.00
U.S. tax payable		44.28
Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($44.28+ $50)		94.28

(c) The group, however, does not make a pro rata minimum distribution for 1963 but distributes $123, consisting of $70 from B Corporation's earnings and profits and $53 from A Corporation's earnings and profits. Thus, M Corporation must make such a reduction in its foreign tax credit that the overall United States and foreign income tax for 1963 with respect to the distribution equals the lesser of $94.28 (the overall United States and foreign income tax which would be paid with respect to a pro rata minimum distribution) and $93.60 (90 percent of 52 percent of pretax and predistribution consolidated earnings and profits of $200). The remaining 1963 earnings and profits of the group are distributed late in 1964. Neither A Corporation nor B Corporation has earnings and profits for 1964. Corporation M determines its tax as follows for such years, assuming a 52 percent (instead of 50 percent) United States corporate income tax rate for 1964:

1963

Taxable income of M Corporation from sources in—		
Y Country:		
B Corporation dividend	$70.00	
Gross-up under section 78 ($70/$70×$30)	30.00	$100.00
X Country:		
A Corporation dividend	53.00	
Gross-up under section 78 ($53/$80×$20)	13.25	66.25
Taxable income for 1963		166.25
U.S. tax before foreign tax credit (0.52×$166.25)		86.45
Less: Tentative foreign tax credit:		
Y Country tax ($30.00 but not to exceed ($100.00/$166.25×$86.45))	30.00	
X Country tax ($13.25 but not to exceed ($66.25/$166.25×$86.45))	13.24	43.25
Tentative U.S. tax payable		43.20
Tentative overall U.S. and foreign income tax ($50+$43.20)		93.60
Insufficient overall U.S. and foreign income tax ($93.60−$93.20)		.40
Reduced foreign tax credit ($43.25−$0.40)		42.85
U.S. tax payable for 1963 ($86.45−$42.85)		43.00
Overall U.S. and foreign income tax ($50+$43.60)		93.60
Reduction in foreign tax credit to be deferred ($43.25−$42.85)		.40
Remaining 1963 earnings and profits of:		
A Corporation ($80−$53)	27.00	
B Corporation ($70−$70)	0	27.00
Allocation of reduction in foreign tax credit to remaining 1963 earnings and profits of A Corporation ($27/$27× $0.40)		.40
Foreign income tax attributable to remaining 1963 earnings and profits of:		
A Corporation ($20−$13.25)	6.75	
B Corporation ($30−$30)	0	6.75

1964

Taxable income of M Corporation from sources in X Country:		
A Corporation dividend		27.00
Gross-up under section 78 ($27/$27× $6.75)		6.75
Taxable income for 1964		33.75
U.S. tax before foreign tax credit ($33.75×0.52)		17.55
Less: Foreign tax credit:		
Tax deemed paid under section 902 (as computed under gross-up, but not to exceed $33.75/$33.75 × $17.55)	6.75	
Tax deemed paid under the principles of section 902 ($27/$27×$0.40)	.40	7.15
U.S. tax payable for 1964		10.40

Example 3. (a) For 1966, domestic corporation M makes a chain election with respect to controlled foreign corporation A, which it wholly owns directly, and controlled foreign corporation B, which A Corporation wholly owns directly. Corporation A is a less developed country corporation under section 902(d). All corporations use the calendar year as the taxable year. For 1966, each of the foreign corporations has pretax and predistribution earnings and profits of $100. The income of A Corporation is subject to a

foreign income tax rate of 20 percent, with no deduction being allowed for dividends received or paid; and the income of B Corporation is subject to a foreign income tax rate of 30 percent on such basis. During 1966, B Corporation distributes $50 to A Corporation, and A Corporation distributes $104 to M Corporation. During 1967 the remaining 1966 earnings and profits of such corporations are distributed to M Corporation.

(b) If M Corporation were not to comply with the special rules of paragraphs (b) and (c) of this section and were to deduct foreign income tax on intercorporate distributions under paragraph (d)(1)(iii) of § 1.963–2, the chain would not be considered to make a minimum distribution for 1966 because, although it makes a distribution which is sufficient in amount to constitute a minimum distribution, the overall United States and foreign income tax for such year with respect to such distribution would be insufficient under paragraph (a)(1)(i) of this section. The determination that M Corporation would not be entitled to the section 963 exclusion for 1966 by reason of such distribution in such circumstances is made as follows:

	A	B	Total
Pretax earnings and profits	$150	$100	....
Reduction for intercorporate dividends	50	....	....
Pretax and predistribution earnings and profits	100	100	$200.00
Reduction for foreign income tax on such pretax and predistribution earnings and profits	20	30	50.00
Predistribution earnings and profits	80	70	150.00
Reduction for foreign income tax on intercorporate distributions of 1966 earnings and profits ($50×0.20)	10	....	10.00
Consolidated earnings and profits of the chain	70	70	140.00
Consolidated foreign income taxes ($30+$20+$10)	....	....	60.00
Effective foreign tax rate ($60/[$140+$60])	....	....	30%
Statutory percentage under section 963(b)	....	....	69%
Amount of a minimum distribution ($140×0.69)	....	....	96.60
Overall United States and foreign income tax required to be paid (part (a)(1)(i) of this section) (0.90× [0.22+0.26]×$200)	....	....	86.40
Tentative taxable income of M Corporation	....	....	$104.00
Tentative U.S. tax before foreign tax credit (0.48×$104)	....	....	49.92
Tentative foreign tax credit ($104/ $120×[($120/ $150×$30)+($50/ $100×$30)] or ($104/$120×$39)	....	....	33.80
Tentative U.S. tax payable ($49.92 − $33.80)	....	....	16.12
Overall U.S. and foreign income tax ($60+$16.12)	....	....	76.12
Insufficient overall U.S. and foreign income tax ($86.40 − $76.12)	....	....	10.28

(c) By complying with the special rules of paragraphs (b) and (c) of this section, however, M Corporation will receive a minimum distribution for 1966 if it receives the statutory percentage of consolidated earnings and profits and if the overall United States and foreign income tax with respect to the distribution which is made is at least the lesser of $86.40 (0.90×0.48×$200) and of the overall United States and foreign income tax which would be paid with respect to a pro rata minimum distribution from the chain. If a pro rata minimum distribution were made for 1966, the chain would be required to distribute earnings and profits of $114, based upon an effective foreign tax rate of 25 percent ($50/[$50+$150]) and a statutory percentage of 76 percent under section 963(b); of this amount $53.20 (0.76×$70) would be distributed from B Corporation's earnings and profits and $60.80 (0.76×$80) would be distributed from A Corporation's earnings and profits. The overall United States and foreign income tax with respect to such a pro rata minimum distribution would be $73.62, determined as follows:

Taxable income of M Corporation ($60.80+[$53.20 − ($53.20×0.20)])	....	$103.36
U.S. tax before foreign tax credit (0.48 ×$103.36)	....	49.61
Foreign tax credit:		
B Corporation's distribution ($53.20/[$70+$30]×$30)+ ($42.56+ $10.64]×$10.64)	$24.47	....
A Corporation's distribution ($60.80/[$80+20]×$20)	12.16	36.63
U.S. tax payable	....	12.98
Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($50+ $10.64+$12.98)	....	73.62

(d) The United States income tax of M Corporation for 1966 and 1967 is determined as follows, assuming that the minimum overall tax burden is determined under paragraph (a)(1)(ii)(b) of this section:

1966

Dividend from earnings and profits of—		
B Corporation ($50 minus tax of $10 on A Corporation at the rate of 20 percent)	....	$40.00
A Corporation	....	64.00
Taxable income of M Corporation	....	104.00
U.S. tax before foreign tax credit (0.48×$104)	....	$49.92

1966

Less: Foreign tax credit:		
B Corporation's distribution ($50/[$70+$30]×$30+($40/[$40+$10]×$10), or ($15+$8)	$23.00	
A Corporation's distribution ($64/$80+$20]×$20)	12.80	35.80
U.S. tax payable		$14.12
Overall U.S. and foreign income tax with respect to actual distribution ($50+$10+$14.12)		74.12
Overall U.S. and foreign income tax that would be paid with respect to a pro rata minimum distribution (part (c) of this example)		73.62
Remaining 1966 earnings and profits for future distribution by:		
B Corporation ($70 − $50)		20.00
A Corporation ($80 − $64)		16.00
Total		36.00
Foreign income tax attributable to remaining 1966 earnings and profits of:		
B Corporation ($20/$70×$30)		8.57
A Corporation ($16/$80×$20)		4.00

1967

Dividend from remaining 1966 earnings and profits of—		
B Corporation ($20 minus tax of $4 on A Corporation at the rate of 20 percent)		16.00
A Corporation		16.00
Taxable income of M Corporation		32.00
U.S. tax before foreign tax credit (0.48×$32)		15.36
Less: Foreign tax credit:		
B Corporation's distribution ($20/[$20+$8.57]×$8.57)+($16/[$16+$4] ×$4), or ($6+$3.20)	$9.20	
A Corporation's distribution ($16/[$16+$4]×$4)	3.20	12.40
U.S. tax payable		2.96

Example 4. (a) Domestic corporation M directly owns 90 percent of the one class of stock of controlled foreign corporation A, which directly owns 80 percent of the one class of stock of controlled foreign corporation B, which in turn directly owns 60 percent of the one class of stock of controlled foreign corporation C. None of the foreign corporations are less developed country corporations under section 902(d); all corporations use the calendar year as the taxable year. For 1963, M Corporation makes a chain election with respect to corporations A, B, and C and receives a distribution from the consolidated earnings and profits of the chain which does not constitute a pro rata minimum distribution. The remaining 1963 consolidated earnings and profits of the chain are distributed late in 1964, for which year it is assumed that the United States corporate income tax rate is the same (52 percent) as for 1963. No corporation in the chain has earnings and profits for 1964 other than from distributions received from remaining 1963 earnings and profits of another corporation in the chain. The foreign country under the laws of which A Corporation is created does not tax dividends which are received by such corporation from B Corporation, but B Corporation is taxed on dividends received from C Corporation. Corporation M complies with the special rules of paragraphs (b) and (c) of this section and determines the minimum overall tax burden under paragraph (a)(1)(ii)(b) of this section with respect to the distribution which is made. Corporation M uses the overall limitation under section 904(a)(2) on the foreign tax credit. The distribution received by M Corporation for 1963 from the consolidated earnings and profits of the chain is sufficient in amount to constitute a minimum distribution. The overall United States and foreign income tax for 1963 with respect to the distribution which is made must be at least equal to the lesser of $32.21 (the amount payable, as determined under paragraph (b) of this example, with respect to a pro rata minimum distribution) and $31.34 (90 percent of 52 percent of pretax and predistribution consolidated earnings and profits of $66.96).

(b) If the chain were to make a pro rata minimum distribution, the distributions and the overall United States and foreign income tax for 1963 with respect to the minimum distribution would be determined as follows, based upon the facts assumed:

	A	B	C	Total
Pretax and predistribution earnings and profits	$20.00	$50.00	$30.00	
Reduction for foreign income tax on such earnings and profits (10%, 40%, and 10%, respectively)	2.00	20.00	3.00	
Predistribution earnings and profits	18.00	30.00	27.00	
Consolidated earnings and profits with respect to M Corporation:				
(0.90×$18)	16.20			
(0.90×0.80×$30) or (0.72×$30)		21.60		
(0.90×0.80×0.60×$27) or (0.432×$27)			11.66	$49.46
Consolidated foreign income taxes with respect to M Corporation:				
($16.20/$18×$2)	1.80			
($21.60/$30×$20)		14.40		
($11.66/$27×$3)			1.30	17.50

	A	B	C	Total
Effective foreign tax rate of the chain for 1963 ($17.50/[$49.46+$17.50]), or ($17.50/ $66.96)				26.14%
Statutory percentage under section 963(b)				82%
Pro rata minimum distribution (before reduction of dividend from C Corporation's share by B Corporation tax paid on such amount):				
(0.82×$16.20)	13.28			
(0.82×$21.60)		17.71		
(0.82×$11.66)			9.56	
(0.82×$49.46)				40.56
Such amounts as reduced by further foreign income tax imposed on distributions through the chain:				
No further foreign tax	13.28			
No further foreign tax		17.71		
B Corporation tax ($9.56 − [0.40×$9.56]), or ($9.56 − $3.82)			5.74	36.73
Gross-up under section 78:				
($13.28/$16.20×$1.80)	1.48			
($17.71/$21.60×$14.40)		11.81		
($5.74/$5.74×$3.82)		3.82		17.11
M Corporation's taxable income for 1963 attributable to minimum distribution ($36.73+$17.11)				53.84
U.S. tax before foreign tax credit ($53.84×0.52)				28.00
Foreign tax credit (as determined under gross-up above)				17.11
U.S. tax payable for 1963 ($28 − $17.11)				10.89
Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($17.50+$3.82+$10.89)				32.21

(c) Based upon the distributions which are made by corporations A, B, and C, M. Corporation pays United States tax as follows for 1963 and 1964:

1963

	A	B	C	Total
Distribution made from consolidated earnings and profits of the chain	$9.36	$21.60	$9.60	$40.56
Excess of distribution over statutory percentage of consolidated earnings and profits for 1963 ($40.56 − [0.82×$49.46])				None
Determination of whether the overall U.S. and foreign income tax with respect to the actual distribution is equal to, or exceeds, the lesser of $32.21 (paragraph (b) of example) and $31.34 (paragraph (a) of example):				
Amount received by M Corporation after reduction by further foreign income tax imposed on distributions through the chain:				
No further foreign tax	9.36			
No further foreign tax		21.60		
B Corporation tax ($9.60 − [0.40×$9.60]), or ($9.60 − $3.84)			5.76	36.72
Gross-up under section 78:				
($9.36/$16.20×$1.80)	1.04			
($21.60/$21.60×$14.40)		14.40		
($5.76/$5.76×$3.84)		3.84		19.28
Taxable income of M Corporation for 1963 attributable to actual distribution ($36.72+$19.28)				56.00
U.S. tax before foreign tax credit ($56×0.52)				29.12
Tentative foreign tax credit (as determined under gross-up above)				19.28
Tentative U.S. tax payable ($29.12 − $19.28)				9.84
Overall U.S. and foreign income tax with respect to actual distribution ($17.50+ $3.84+$9.84)				31.18
Insufficient overall U.S. and foreign income tax ($31.34 [i.e., 0.90×0.52×$66.96] − 31,18)				.16
Reduced foreign tax credit ($19.28 − $0.16)				19.12
U.S. tax payable for 1963 ($29.12 − $19.12)				10.00
Overall U.S. and foreign income tax with respect to actual distribution ($17.50+$3.84+$10)				31.34
Allocation of reduction in foreign tax credit to undistributed consolidated 1963 earnings and profits of A and B Corporations to be deemed paid by M Corporation in future years:				
Reduction in foreign tax credit ($19.28 − $19.12)				.16
Undistributed 1963 consolidated earnings and profits of the chain:				
($16.20 − $9.36)	6.84			
($21.60 − $21.00)		0		
($11.66 − $9.60)			$2.06	8.90
Allocation of reduction in credit:				
($6.84/$6.84×$0.16)	.16			.16

1963

	A	B	C	Total
Foreign income tax attributable to undistributed 1963 earnings and profits of the chain to be taken into account in determining tax deemed paid under section 902:				
($1.80 – $1.04)	.76			
($14.40 – $14.40)				.7
1964				
Distribution from remaining 1963 consolidated earnings and profits of the chain:				
($16.20 – $9.36)	6.84			
($21.60 – $21.60)		0		
($11.66 – $9.60)			2.06	8.90
Such amounts as reduced by further foreign income tax imposed on distributions through the chain:				
No further foreign tax	6.84			
B Corporation tax ($2.06 – [0.40×$2.06]), or ($2.06 – $0.82)		1.24		8.08
Gross-up under section 78:				
($6.84/$6.84×$0.76)	0.76			
($1.24/$1.24×$0.82)		0.82		1.58
Taxable income of M Corporation for 1964 attributable to 1964 distribution ($8.08+$1.58)				9.66
U.S. tax before foreign tax credit ($9.66×0.52)				5.02
Foreign tax credit:				
Deferred credit in accordance with principles of section 902 ($6.84/$6.84×$0.16)	0.16			0.16
Tax deemed paid under section 902 (computed under gross-up above)				1.58
U.S. tax payable for 1964 ($5.02 – [$0.16+$1.58])				3.28

Example 5. (a) Domestic corporation M directly owns all the one class of stock of each of controlled foreign corporations A, B, C, and D. All such corporations use the calendar year as the taxable year. None of the foreign corporations is a less developed country corporation under section 902(d). For 1963, M Corporation makes a group election with respect to corporations A, B, C, and D and receives from the 1963 consolidated earnings and profits of the group a distribution which is not a pro rata minimum distribution. None of the foreign corporations has earnings and profits for 1964, but the remaining 1963 earnings and profits of the group are distributed late in 1964, for which year it is assumed that the United States corporate income tax rate is the same (52 percent) as for 1963. The overall limitation under section 904(a)(2) on the foreign tax credit applies for both years.

(b) Assume that M Corporation does not comply with the special rules of paragraphs (b) and (c) of this section and that for 1963 it draws a distribution of all of B Corporation's earnings and profits and enough of C Corporation's earnings and profits to receive the amount of a minimum distribution and to assure that the overall United States and foreign income tax for such year with respect to the distribution from the group satisfies the overall minimum tax requirement of paragraph (a)(1)(i) of this section. In such case, the overall United States and foreign income tax for 1963 with respect to the distribution which is made, determined by using the foreign tax credit under section 901 without applying the special credit rules of paragraph (c) of this section, must at least equal $37.44 (90 percent of 52 percent of pretax and predistribution consolidated earnings and profits of $80). Corporation M's United States income tax for 1963 and 1964 with respect to the distribution of the 1963 earnings and profits of the group is determined as follows, based upon the facts assumed:

1963

	A	B	C	D	Total
Pretax and predistribution earnings and profits (and deficits) of the group	$25.00	$25.00	$50.00	($20.00)	$80.00
Consolidated foreign income taxes	2.50	12.50	15.00		30.00
Consolidated earnings and profits	22.50	12.50	35.00	(20.00)	50.00
Effective foreign tax rate ($30/[$50+$30])					37.5%
Statutory percentage under section 963(b)					68%
Amount of a minimum distribution (0.68×$50)					34.00
Tentative distribution		12.50	21.50		34.00

1963

	A	B	C	D	Total
Tentative gross-up under section 78:					
($12.50/$12.50×$12.50)		12.50			
($21.50/$35×$15)			9.21		21.71
Tentative taxable income of M Corporation ($34+$21.71)					55.71
Tentative U.S. tax before foreign tax credit (0.52×$55.71)					28.97
Tentative foreign tax credit (as computed under gross-up above)					21.71
Tentative U.S. tax payable ($28.97 – $21.71)					7.26
Tentative overall U.S. and foreign income tax ($30+$7.26)					37.26
Minimum overall U.S. and foreign income tax required to be paid (0.90× .52×$80)					37.44
Insufficient overall U.S. and foreign income tax ($37.44 – $37.26)					.18
Revised distribution		12.50	22.07		34.57
Gross-up under section 78:					
($12.50/$12.50×$12.50)		12.50			
($22.07/$35×$15)			9.46		21.96
Taxable income of M Corporation ($34.57+$21.96)					56.53
U.S. tax before foreign tax credit (.52×$56.53)					29.40
Foreign tax credit (as computed under gross-up above)					21.96
U.S. tax payable ($29.40 – $21.96)					7.44
Overall U.S. and foreign income tax on actual distribution ($30+$7.44)					37.44

1964

Distribution of remaining 1963 consolidated earnings and profits:					
($22.50 – $0)	22.50				
($12.50 – $12.50)					
($35 – $22.07)			12.93		35.43
Gross-up under section 78:					
($22.50/$22.50×$2.50)	2.50				
($12.93/$35×$15)			5.54		8.04
Taxable income of M Corporation ($35.43+$8.04)					43.47
U.S. tax before foreign tax credit ($43.47×0.52)					22.60
Foreign tax credit (as computed under gross-up above)					8.04
U.S. tax payable ($22.60 – $8.04)					14.56

(c) Assume that M Corporation does comply with the special rules of paragraphs (b) and (c) of this section and for 1963 receives a minimum distribution consisting of $20 from A Corporation and $14 from C Corporation. In such case, the overall United States and foreign income tax for 1963 with respect to the minimum distribution must at least equal the lesser of $37.44 (0.90 × 0.52 × $80) and the overall United States and foreign income tax of $37.89 that would be paid with respect to a pro rata minimum distribution from the group for such year. In such case, the determinations would be made pursuant to subparagraphs (1) and (2) of this paragraph.

(1) If a pro rata minimum distribution were made for 1963 by the group, the overall United States and foreign income tax for such year with respect to such distribution would be $37.89, determined as follows:

	A	B	C	D	Total
Pretax and predistribution earnings and profits (and deficits) of the group	$25.00	$25.00	$50.00	($20)	$80.00
Consolidated foreign income taxes	2.50	12.50	15.00		30.00
Consolidated earnings and profits before allocation of deficits	22.50	12.50	35.00		70.00
Allocation of deficit of D Corporation:					
($22.50/$70×$20)	(6.43)				
($12.50/$70×$20)		(3.57)			
($35/$70×$20)			(10.00)		(20.00)
Consolidated earnings and profits	16.07	8.93	25.00		50.00
Effective foreign tax rate ($30/$80)					37.50%
Statutory percentage under section 963(b)					68%
Pro rata minimum distribution:					
(0.68×$16.07)	10.93				
(0.68×$8.93)		6.07			
(0.68×$25)			17.00		34.00
Gross-up under section 78:					
($10.93/$16.07×$2.50)	1.70				
($6.07/$8.93×$12.50)		8.50			

	A	B	C	D	Total
($17/$25×$15)			10.20		20.40
Taxable income of M Corporation ($34+$20.40)					54.40
U.S. tax before foreign tax credit (0.52×$54.40)					28.29
Foreign tax credit (as computed under the gross-up above)					20.40
U.S. tax payable ($28.29 − $20.40)					7.89
Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($30+$7.89)					37.89

(2) Corporation M's United States income tax for 1963 and 1964 with respect to the distribution of the 1963 earnings and profits of the group is determined as follows:

1963

	A	B	C	D	Total
Distributions actually made	$20.00		$14.00		$34.00
Gross-up under section 78:					
($16.07/$16.07×$2.50)	2.50				
($14/$25×$15)			8.40		10.90
Taxable income of M Corporation ($34+$10.90)					44.90
U.S. tax before foreign tax credit (0.52×$44.90)					23.35
Foreign tax credit (as computed under gross-up above)					10.90
U.S. tax payable ($23.35 − $10.90)					12.45
Overall U.S. and foreign income tax with respect to the distribution actually made ($30+$12.45), such amount being in excess of the minimum overall tax burden of $37.44					42.45

1964

Earnings and profits for 1963 to which minimum distribution for such year was not attributable:					
($22.50 − $20)	$2.50				
($12.50 − $0)		$12.50			
($35.00 − $14)			$21.00		$36.00
Foreign income tax for 1963 not taken into account in determining tax deemed paid for such year on pretax earnings and profits to which the minimum distribution for such year was attributable:					
([$16.07 − $16.07]/$16.07×$2.50)	0				
([$8.93 − $0]/$8.93×$12.50)		12.50			
([$25 − $14]/$25×$15)			6.60		19.10
Distributions to M Corporation in 1964	2.50	12.50	21.00		36.00
Gross-up under section 78:					
($2.50/$2.50×$0)	0				
($12.50/$12.50×$12.50)		12.50			
($21/$21×$6.60)			6.60		19.10
Taxable income of M Corporation ($36+$19.10)					55.10
U.S. tax before foreign tax credit (0.52×$55.10)					28.65
Foreign tax credit (as computed under gross-up above)					19.10
U.S. tax payable ($28.65 − $19.10)					9.55

Example 6. Throughout 1963, domestic corporation M directly owns all the one class of stock of controlled foreign corporations A, B, and C, and maintains in a foreign country a branch which qualifies under paragraph (f)(4) of §1.963–1 for inclusion in a group as a wholly owned foreign subsidiary corporation. For 1963, a year for which the overall limitation under section 904(a)(2) on the foreign tax credit applies, M Corporation makes a group election with respect to A, B, and C Corporations and the foreign branch. All such corporations use the calendar year as the taxable year. The foreign branch has pretax and predistribution earnings and profits of $40 for 1963, as determined under paragraph (f)(4)(ii) of §1.963–1. None of the foreign corporations is a less developed country corporation under section 902(d). Corporation M complies with the special rules of paragraphs (b) and (c) of this section. The United States income tax of M Corporation for 1963 is as follows, based upon the facts assumed:

	A	B	C	Branch	Total
Pretax and predistribution consolidated earnings and profits of the group	$20.00	$30.00	$10	$40	$100.00
Consolidated income taxes	2.00	15.00	5	20	42.00
Effective foreign tax rate ($42/$100)					42%
Statutory percentage under section 963(b)					40%
Posttax and predistribution consolidated earnings and profits of the group	18.00	15.00	5	20	58.00
U.S. tax which would be paid on a pro rata minimum distribution from consolidated earnings and profits of the group:					
Pro rata minimum distribution (and amount which would be received by M Corporation):					
(0.40×$18)	7.20				
(0.40×$15)		6.00			
(0.40×$5)			2		
(0.40×$40)				16	31.20
Gross-up under section 78:					
($7.20/$18×$2)	.80				
($6/$15×$15)		6.00			
($2/$5×$5)			2		8.80
Taxable income of M Corporation ($31.20+$8.80)					40.00
U.S. tax before foreign tax credit (0.52×$40)					20.80
Foreign tax credit ($8.80, as computed under the gross-up, plus 40 percent of $20)					16.80
U.S. tax payable ($20.80 − $16.80)					4.00
Overall U.S. and foreign income tax with respect to a pro rata minimum distribution for 1963 ($4+$42)					46.00
Tentative tax on distribution actually received by M Corporation:					
Actual distribution received			$5	$40	$45.00
Gross-up under section 78 ($5/$5×$5)			5		5.00
Taxable income of M Corporation ($45+$5)					50.00
U.S. tax before foreign tax credit (0.52×$50)					26.00
Tentative foreign tax credit ($5, as computed under the gross-up above, plus 100 percent of $20)					25.00
Tentative U.S. tax payable ($26 − $25)					1.00
Insufficient overall U.S. and foreign income tax (the lesser of $46 or $46.80 [0.90×0.52×$100] minus $43 [$1+$42])					3.00
Reduced foreign tax credit ($25 − $3)					22.00
U.S. tax payable ($26 − $22)					4.00
Overall U.S. and foreign income tax with respect to actual distribution for 1963 ($4+$42)					46.00
Reduction in foreign tax credit for 1963 ($25 − $22)					3.00
Allocation of reduction in foreign tax credit to undistributed 1963 consolidated earnings and profits of the group:					
($18/[$18+$15]×$3.00)	1.64				
($15/[$18+$15]×$3.00)		1.36			3.00

Example 7. Domestic group M, an affiliated group of domestic corporations filing a consolidated return under section 1501, makes a group election for 1963 with respect to a group consisting of two controlled foreign corporations C and D, all of whose one class of stock is directly owned by group M, and foreign branch B, a foreign branch of a Western Hemisphere trade corporation (as defined in section 921) included in group M. No distributions are received for the taxable year from corporations C and D, but the foreign group makes a minimum distribution by reason of the deemed distribution of all of branch B's earnings and profits. Group M complies with the special rules of paragraphs (b) and (c) of this section. For 1963, a year for which the United States corporate income tax rate is 52 percent, the overall limitation under section 904(a)(2) on the foreign tax credit applies. All corporations use the calendar year as the taxable year. None of the foreign corporations is a less developed country corporation under section 902(d) for 1963. The income, and the United States and foreign income tax for 1963, are determined as follows, based upon the facts assumed:

	Branch	C	D	Total
Pretax and predistribution consolidated earnings and profits of the foreign group (before Western Hemisphere trade corporation deduction)	$100.00	$10.00	$10.00	$120.00
Western Hemisphere trade corporation deduction ($100×0.14/0.52)	26.92			26.92
Pretax and predistribution consolidated earnings and profits of the foreign group (after Western Hemisphere trade corporation deduction)	73.08	10.00	10.00	93.08

	Branch	C	D	Total
Consolidated foreign income taxes (38%, 20%, and zero rate, respectively):				
(0.38×$100)	38.00			
(0.20×$10)		2.00		40.00
Consolidated earnings and profits of the foreign group	35.08	8.00	10.00	53.08
Effective foreign tax rate ($40/$93.08)				43%
Statutory percentage under section 963(b)				40%
Tax which would be paid with respect to a pro rata minimum distribution from consolidated earnings and profits of the foreign group:				
Pro rata minimum distribution:				
(0.40×$73.08)	29.23			
(0.40×$8.00)		3.20		
(0.40×$10.00)			4.00	36.43
Gross-up under section 78: ($3.20/$8.00×$2)		.80		.80
Taxable income of group M	29.23	4.00	4.00	37.23
U.S. tax before foreign tax credit:				
(0.52×$29.23)	15.20			
(0.54×$4.00)		2.16		
(0.54×$4.00)			2.16	19.52
Foreign tax credit ($0.80, as computed under the gross-up above, plus 40 percent of $38)	15.20	.80		16.00
U.S. tax payable		1.36	2.16	3.52
Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($3.52+$40)				43.52
Tentative tax on distribution actually received by group M:				
Taxable income of branch	73.08			73.08
U.S. tax before foreign tax credit (0.52×$73.08)	38.00			38.00
Tentative foreign tax credit	38.00			38.00
Tentative U.S. tax payable				0
Insufficient overall U.S. and foreign income tax (the lesser of $43.52 or $43.56 [0.90×0.52×$93.08] minus $40)				3.52
Reduced foreign tax credit ($38 − $3.52)				34.48
U.S. tax payable ($38 − $34.48)				3.52
Overall U.S. and foreign income tax ($3.52+$40.00)				43.52
Reduction in foreign tax credit for 1963 ($38 − $34.48)				3.52
Allocation of reduction in foreign tax credit to 1963 undistributed consolidated earnings and profits of the foreign group:				
($8/[$8+$10]×$3.52)		1.56		
($10/[$8+$10]×$3.52)			1.96	3.52

[T.D. 6759, 29 FR 13335, Sept. 25, 1964; 29 FR 13896, Oct. 8, 1964, as amended by T.D. 6767, 29 FR 14878, Nov. 3, 1964; T.D. 7100, 36 FR 5336, Mar. 20, 1971]

§1.963–5 Foreign corporations with variation in foreign tax rate because of distributions.

(a) *Limited application of section.* The rules of this section shall apply to a foreign corporation only if—

(1) Under the laws of a foreign country or possession of the United States the foreign income tax of the corporation for the taxable year depends upon the extent to which distributions are made by such corporation from its earnings and profits for the taxable year, so that the rate of such tax for the taxable year on income which is distributed differs from the rate of such tax for such year on the income which is not distributed, and

(2) The corporation—

(i) Is a single first-tier corporation, or

(ii) Is for the taxable year in a chain or group from which the United States shareholder receives a minimum distribution in respect of which the minimum overall tax burden is determined in accordance with paragraph (a)(1)(ii) of §1.963–4.

(b) *Foreign income tax determined as though no distributions were made.* The foreign income tax on the pretax and predistribution earnings and profits of the foreign corporation for the taxable year shall (solely for the purpose of determining the effective foreign tax rate under paragraph (c) of §1.963–2) be determined as if the foreign corporation made no distributions for the taxable year. However, notwithstanding the second sentence of paragraph (d)(1) of §1.963–2, where the United States shareholder owns the stock (with respect to which the election under section 963 is made) in such corporation by reason of stock owned through a chain of ownership described in section 958(a) and the foreign income tax of such corporation for the taxable year decreases as distributions are made from its earnings and profits, the rule in the preceding sentence shall not apply if the electing United States shareholder does not actually receive for the taxable year its proportionate share of the earnings and profits which are actually distributed. In such case, the foreign income tax on pretax and predistribution earnings and profits shall be the actual foreign income tax of such corporation, computed on the basis of the distributions which are made. For example, assume that a second-tier foreign corporation in a chain has pretax and predistribution earnings of $100 for the taxable year and that foreign law imposes on such corporation a foreign income tax of 50 percent of the pretax earnings and profits minus dividends for such year and of 20 percent of such dividends. If the second-tier foreign corporation distributes $20 of earnings and profits to a first-tier foreign corporation which is part of the same chain, and if the first-tier corporation retains the dividend so received, the foreign income tax of the second-tier foreign corporation shall be considered to be the tax actually paid for the taxable year, that is, $44 (50 percent of $80 plus 20 percent of $20). If the first-tier foreign corporation distributes the dividend so received, the foreign income tax of the second-tier foreign corporation shall be considered to be $50 (50 percent of $100). For purposes of this paragraph, the principles of paragraph (b)(3) of §1.963–4 shall apply.

(c) *Minimum distribution*—(1) *Single first-tier corporation.* A minimum distribution for a taxable year by a single first-tier corporation described in paragraph (a)(1) of this section shall be a distribution which is equal to—

(i) The amount resulting from the multiplication of the statutory percentage specified in paragraph (b) of §1.963–2 for such year by the United States shareholder's proportionate share of the earnings and profits of such corporation, as determined under paragraph (d)(2)(i) of §1.963–2 but without the deduction for foreign income tax provided by paragraph (d)(1)(ii) and (iii) of such section, reduced by

(ii) The foreign income tax on the pretax amount determined under subdivision (i) of this subparagraph which would be paid or accrued by such corporation by reason of distributing such amount, less such tax, for such taxable year.

(2) *Corporation in a chain or group making a pro rata minimum distribution.* In case of a corporation described in paragraph (a)(2)(ii) of this section in a chain or group, such corporation's share of a pro rata minimum distribution by the chain or group for the taxable year shall be—

(i) The amount resulting from the multiplication of the statutory percentage specified in paragraph (b) of §1.963–2 for the taxable year by the United States shareholder's proportionate share of the earnings and profits of such corporation, as determined under paragraph (d)(3) of §1.963–2 but without the deduction for foreign income tax provided by paragraph (d)(1)(ii) and (iii) of such section, reduced by

(ii) The foreign income tax on the pretax amount determined under subdivision (i) of this subparagraph which would be paid or accrued by such corporation by reason of distributing such amount, less such tax, for such taxable year.

(3) *A chain or group making a distribution other than a pro rata minimum distribution.* If a chain or group contains one or more foreign corporations described in paragraph (a)(2)(ii) of this section and such chain or group makes a minimum distribution other than a pro rata minimum distribution for the taxable year, the amount of such minimum distribution to the electing United States shareholder shall be at least—

(i) The amount resulting from the multiplication of the statutory percentage specified in paragraph (b) of §1.963–2 for the taxable year by the consolidated earnings and profits of such chain or group with respect to such shareholder, as determined under paragraph (d)(3) of such section but without any deduction for foreign income tax provided by paragraph (d)(1)(ii) and (iii) of such section, reduced by

(ii) The foreign income tax on the pretax amount determined under subdivision (i) of this subparagraph which would be paid or accrued by the foreign corporations in the chain or group by reason of distributing such amount, less such tax, for such taxable year.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. Domestic corporation M directly owns 80 percent of the one class of stock of single first-tier corporation B, which for 1964 has $100 of pretax earnings and profits on which is imposed a foreign income tax of 40 percent of pretax earnings and profits minus dividends for the taxable year and of 20 percent of the amount of such dividends. Both corporations use the calendar year as the taxable year. The effective foreign tax rate applicable to B Corporation, as determined under paragraph (c) of §1.963–2, is 40 percent, and the statutory percentage under paragraph (b) of §1.963–2 for 1964 is 38 percent. Corporation M receives a minimum distribution for 1964 if it receives from B Corporation's earnings and profits for such year $22.80, that is, 80 percent of $28.50, the distribution which would be made if there were distributed that amount of earnings and profits which, together with the foreign income tax at the rate effectively applicable to pretax earnings and profits to which such distribution is attributable, equals 38 percent of $100. Such distribution may be determined by solving for ‘‘d’’ in the following formula:

$$\begin{array}{rl} & d=\$38-0.20d-0.40(\$38-d) \\ & d=\$38-0.20d-\$15.20+0.40d \\ & d=\$22.80+0.20d \\ 0.80 & d=\$22.80 \\ & d=\$22.80/0.80 \\ & d=\$28.50 \end{array}$$

Example 2. Domestic corporation M directly owns 80 percent of the one class of stock of each of controlled foreign corporations A and B, which constitute a group and each of which for 1964 has pretax earnings and profits of $100. All corporations use the calendar year as the taxable year. Corporation A is subject to foreign income tax at a flat rate of 40 percent; and B Corporation is subject to a foreign income tax of 40 percent of $100 minus dividends for the taxable year and of 20 percent of the amount of such dividends. The effective foreign tax rate with respect to the group, as determined under paragraph (c) of §1.963–2, is 40 percent, and the statutory percentage under paragraph (b) of §1.963–2 for 1964 is 38 percent. Corporation B distributes $25 for 1964 toward a minimum distribution from the group which is not a pro rata minimum distribution. The minimum distribution by the group for 1964 with respect to M Corporation is determined as follows:

M Corporation's proportionate share of B Corporation's distribution (0.80×$25)	$20.00
Pretax and predistribution consolidated earnings and profits of the group (0.80×$200)	160.00
Statutory percentage of pretax and predistribution consolidated earnings and profits (0.33×$160)	60.80
Less: portion of such statutory percentage to which the $20 dividend received from B Corporation is attributable: Total dividend paid by B Corporation	25.00
Plus: Foreign income tax on B Corporation's pretax and predistribution earnings and profits to which such dividend is attributable, letting ‘‘t’’ represent such tax:	
$t=0.20\ (\$25)+0.40t$	
$t=\$5+0.40t$	
$0.60t=\$5$	
$t=\$5/0.60$	8.33
B Corporation's pretax and predistribution earnings and profits to which such dividend is attributable	33.33
M Corporation's proportionate share of B Corporation's pretax and predistribution earnings and profits to which the dividend is attributable (0.80×$33.33)	26.67
The statutory percentage of the pretax and predistribution consolidated earnings and profits of the group to which A Corporation's distribution must be attributable	34.13
Dividend required to be received from A Corporation ($34.13 – [0.40×$34.13])	20.48
Minimum distribution to M Corporation of the taxable year's consolidated earnings and profits of the group ($20+$20.48)	40.48

Example 3. The facts are the same as in example 2 except that the $25 distribution of earnings and profits is made by A Corporation. The amount of the minimum distribution for 1964 is determined as follows:

M Corporation's proportionate share of A Corporation's distribution (0.80×$25)	$20.00
Pretax and predistribution consolidated earnings and profits of the group (0.80×$200)	160.00
Statutory percentage of pretax and predistribution consolidated earnings and profits (0.38×$160)	60.80
Less: Portion of such statutory percentage to which the $20 dividend received from A Corporation is attributable: Total dividend paid by A Corporation	25.00
Plus: Foreign income tax on A Corporation's pretax and predistribution earnings and profits to which such dividend is attributable (0.40×[$25/0.60])	16.67
A Corporation's pretax and predistribution earnings and profits to which such dividend is attributable	41.67
M Corporation's proportionate share of A Corporation's pretax and predistribution earnings and profits to which dividend is attributable ($41.67×0.80)	33.34

Portion of the statutory percentage of the pretax and predistribution consolidated earnings and profits of the group to which B Corporation's distribution must be attributable	27.46
Dividend received from B Corporation, letting "d" represent the dividend:	
d=$27.46 − 0.20d − 0.40 ($27.46 − d)	
d=$27.46 − 0.20d − $10.98+0.40d	
d=$16.48+0.20d	
0.80d=$16.48	
d=$16.48/0.80	20.60
Minimum distribution to M Corporation of the taxable year's consolidated earnings and profits of the group ($20+$20.60)	40.60

(d) *Distributions through a chain or group.* In the application of paragraph (b)(3)(i) of § 1.963–4, relating to the allocation of dividend payments first to income received as a distribution from other foreign corporations in the chain or group, if one or more of such other foreign corporations is a corporation whose foreign income tax rate decreases as the distributions are made, the allocation under such paragraph shall be made first to such corporations' distributions.

(e) *Foreign tax credit*—(1) *Year of minimum distribution.* If a United States shareholder receives for a taxable year a distribution of the earnings and profits for the taxable year of a foreign corporation described in paragraph (a) of this section and if for such year such corporation is a first-tier corporation, or a second-tier corporation described in section 902 (a) or (b), as the case may be, then, in applying paragraph (c)(2)(i) of § 1.963–4, only the foreign income tax which is effectively applicable to pretax earnings and profits to which are attributable the earnings and profits which are distributed shall be deemed paid for such year under section 902 (a) or (b), as the case may be, and the foreign income tax so paid or accrued by such corporation shall not be averaged, for purposes of such section, with its foreign income tax paid or accrued for such year on its pretax earnings and profits to which are attributable the earnings and profits which are not distributed.

(2) *Year of distribution of remaining earnings and profits.* If for a taxable year a United States shareholder receives a minimum distribution from a corporation described in paragraph (a) of this section, the pretax and predistribution earnings and profits of such corporation for the taxable year to which such minimum distribution is attributable and the foreign income tax which is taken into account, in accordance with paragraph (c)(2)(i) of § 1.963–4, in determining tax deemed paid under section 902 on such pretax and predistribution earnings and profits shall not be taken into account in the application of section 902 when other earnings and profits of such foreign corporation for such year are distributed in a subsequent taxable year of such foreign corporation to such shareholder.

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

Example 1. (a) All the income of controlled foreign corporation B, wholly owned directly by domestic corporation M, is taxed by foreign country Y, the tax laws of which impose at the local level a corporate income tax of 10 percent of earnings and profits (before reduction for income taxes) and, at the national level, an income tax of 30 percent of such earnings and profits reduced by the local tax and by any profits which are distributed. Also, at the national level, a tax of 20 percent is imposed on B Corporation on the dividends which are paid for the taxable year. Both corporations use the calendar year as the taxable year. For 1963, B Corporation has earnings and profits (before reduction by income taxes) of $100. B Corporation is not a less developed country corporation under section 902(d). For 1963, M Corporation makes a first-tier election with respect to B Corporation and receives a minimum distribution. Corporation B has no 1964 earnings and profits, and its remaining 1963 earnings and profits are distributed late in 1964. The amount of the minimum distribution required to be received by M Corporation for 1963 and the United States tax with respect to the 1963 earnings and profits of B Corporation are determined as follows, assuming a United States corporate income tax rate of 52 percent (instead of 50 percent) for 1964 and no surtax exemption under section 11(c) for either year:

	1963
Effective foreign tax rate which obtains if no earnings and profits of B Corporation are distributed [($100×0.10)+([$100 − ($100×0.10)]×0.30)]/$100	37%
Minimum percentage of earnings and profits required under section 963(b) to be distributed, given a 37 percent effective foreign tax rate	68%

1963	
Amount of earnings and profits (before reduction by foreign income tax) to which minimum distribution would be attributable if the effective foreign tax rate of 37 percent obtained (0.68×$100)	$68.00
Minimum distribution required to be received by M Corporation, i.e., such an amount that is $68 less the foreign income tax on such $68, determined by letting "d" equal the dividend in the algebraic equation:	
d=$68 − (0.10 × $68) − 0.30 ($68 − [0.10 × $68] − d) − 0.20d	
d=$68 − $6.80 − ($20.40 − $2.04 − 0.30d) − 0.20d	
d=$61.20 − $20.40 + $2.04 + 0.30d − 0.20d	
d=$42.84 + 0.10d	
0.90d=$42.84	
d=$42.84/0.90, or	$47.60
Gross-up under section 78, using the actual foreign income tax imposed on pretax profits to which are attributable the earnings and profits distributed ($6.80+0.30 [$61.20−$47.60]+0.20 [$47.60])	$20.40
Taxable income of M Corporation for 1963 ($47.60+$20.40)	$68.00
U.S. tax before foreign tax credit ($68×0.52)	$35.36
Foreign tax credit ($47.60/$47.60× $20.40)	$20.40
U.S. tax payable for 1963 ($35.36−$20.40)	$14.96
Overall U.S. and foreign income tax rate [$14.96+$20.40+($32×0.37)]/ $100	47.20%

1964	
Dividend received by M Corporation ($32−[0.37×$32])	$20.16
Gross-up under section 78, using the foreign income tax paid or accrued on pretax earnings and profits to which are attributable 1963 earnings and profits distributed during 1964 ($20.16/$20.16×[$32× 0.37])	$11.84
Taxable income of M Corporation for 1964 ($20.16+$11.84)	$32.00
U.S. tax before foreign tax credit ($32×0.52)	$16.64
Foreign tax credit ($20.16/$20.16× $11.84)	$11.84
U.S. tax payable ($16.64−$11.84)	$4.80

(b) If B Corporation were a less developed country corporation under section 902(d), there would be no gross-up under section 78 and the foreign tax credit of M Corporation would be $14.28 for 1963 ($47.60/[47.60+ $20.40]×$20.40), and $7.46 for 1964 ($20.16/ [$20.16+$11.84]×$11.84).

Example 2. For 1963, domestic corporation M receives a dividend of $21 from B Corporation which counts toward a minimum distribution from a group, determined by applying the special rules of paragraphs (b) and (c) of § 1.963–4. Both corporations use the calendar year as the taxable year. Foreign law imposes on B Corporation an income tax of 40 percent of the year's pretax earnings and profits, less dividends paid for such year, and of 20 percent of such dividends. Corporation M directly owns 70 percent of the one class of stock of B Corporation, which for 1963 has pretax and predistribution earnings and profits of $100. Corporation B is not a less developed country corporation under section 902(d). In late 1964, M Corporation receives a distribution of all of B Corporation's 1964 earnings and profits and of $25.20 from its 1963 earnings and profits. The foreign income tax of B Corporation deemed paid for 1963 by M Corporation under section 902(a) is based on the foreign income tax actually paid by B Corporation on an amount of pretax earnings and profits which, when reduced by the tax so paid, equals the total dividend which is paid. The determination of tax deemed paid by M Corporation with respect to distributions from 1963 earnings and profits of B Corporation is as follows:

1963	
Pretax and predistribution earnings and profits of B Corporation for 1963	$100
Total dividend paid by B Corporation in 1963 ($21/ 0.70)	30
Total foreign income tax paid by B Corporation for 1963 (0.40[$100− $30]+[0.20×$30]) or ($28+$6)	34
Foreign income tax, represented by "t" in the following equation, to be taken into account with respect to total dividend in determining tax deemed paid under section 902(a) by M Corporation:	
t=(0.20×$30)+0.40t	
t=$6+0.40t	
0.60t=$6	
t=$6/0.60, or	$10
Foreign income tax deemed paid by M Corporation for 1963 ($21/$30×$10)	7

1964	
Remaining 1963 earnings and profits of B Corporation ([$100−$34]−$30) or ($66−$30)	36
Dividend received by M Corporation for 1964 (0.70×$36)	25.20
Foreign income tax deemed paid by M Corporation for 1964 ($25.20/$36× [$34−$10]) or ($25.20/ $36×$24)	16.80

[T.D. 6759, 29 Sept. 25, 1964; 29 FR 13896, Oct. 8, 1964, as amended by T.D. 6767, 29 FR 14879, Nov. 3, 1964]

§ 1.963–6 Deficiency distribution.

(a) *In general.* Section 963(e)(2) and this section provide a method under which, by virtue of a deficiency distribution, a United States shareholder may be relieved from the payment of a deficiency in tax for any taxable year arising by reason of failure to include subpart F income in gross income under section 951(a)(1)(A)(i), when it has been determined that such shareholder has failed to receive a minimum distribution for such year in respect of which it elected to secure the exclusion under section 963. In addition, this section provides rules with respect to a credit or refund of part or all of any such deficiency which has been paid. Under the method provided, the benefit of the exclusion of subpart F income from gross income of the United States shareholder is allowed retroactively for the taxable year in respect of which the election under section 963 applied, but only if the subsequent deficiency distribution meets the requirements of this section. The benefits of the retroactive exclusion will not, however, prevent the assessment of interest, additional amounts, and assessable penalties.

(b) *Requirements for deficiency distribution*—(1) *Distribution made on or after date of determination.* If—

(i) A United States shareholder, in making its return of the tax imposed by chapter 1 of the Code for any taxable year, elects to secure an exclusion under section 963 for such year,

(ii) It is subsequently determined (within the meaning of paragraph (c) of this section) that an exclusion under section 963 of subpart F income with respect to stock to which such election relates does not apply for such taxable year because of the failure of such shareholder to receive a minimum distribution for such year with respect to such stock, and

(iii) Such failure is due to reasonable cause, a deficiency distribution which is received by such shareholder with respect to such stock from a foreign corporation which was the single first-tier corporation, or a corporation in the chain or group, as the case may be, with respect to which the election was made, shall count toward a minimum distribution under section 963 for such year of election if such deficiency distribution is received (except as provided by subparagraph (2) of this paragraph) on, or within 90 days after, the date of such determination and prior to the filing of a claim under paragraph (d)(1) of this section. Such claim must be filed within 120 days after the date of such determination, and the deficiency distribution must be a dividend of such a nature (except as otherwise provided in this section) as would have permitted it to count toward a minimum distribution for the taxable year of the election if it had been received by the United States shareholder during such year. No distribution shall count as a deficiency distribution under this subparagraph unless a claim therefor is filed under paragraph (d)(1) of this section.

(2) *Distribution made before date of determination.* A deficiency distribution may also be received by a United States shareholder at any time prior to the date on which the determination required by subparagraph (1) of this paragraph is made. A distribution will count as a deficiency distribution under this subparagraph—

(i) To the extent that such distribution otherwise satisfies the requirements of this section;

(ii) If the United States shareholder files within 90 days after such distribution but before the determination date an advance claim described in paragraph (d)(2) of this section for treatment of such distribution as a deficiency distribution;

(iii) If such shareholder consents in such claim to include such deficiency distribution in gross income for the taxable year of the election to the extent necessary to complete a minimum distribution for such year and under section 6501 to extend the period for the making of assessments, and the bringing of distraint or a proceeding in court for collection, in respect of a deficiency and all interest, additional amounts, and assessable penalties for such taxable year;

(iv) If, when requested by the district director, such shareholder consents under section 6501 in such claim to extend the period for the making of assessments, and the bringing of distraint or a proceeding in court for collection, in respect of a deficiency and all interest, additional amounts and assessable penalties for the year of receipt of such distribution; and

(v) To the extent that such shareholder makes advance payment of tax which would result from the inclusion of such distribution in gross income as a minimum distribution for the year of such deficiency.

To the extent that such distribution is not necesasry under the determination (when made under paragraph (c) of this section) for a deficiency distribution, it shall be included in the United States shareholder's gross income for the taxable year of receipt of such distribution and paragraph (g) of this section shall not apply.

(3) *Earnings and profits of year of election to be first distributed.* If—

(i) In the case of a first-tier election, the United States shareholder's proportionate share of the earnings and profits of the foreign corporation which was the single first-tier corporation, or

(ii) In the case of a chain or group election, any portion of the share of any corporation or corporations (which were in the chain or group) of the consolidated earnings and profits with respect to the United States shareholder, for the taxable year of the election has not been distributed on the stock with respect to which the election was made, then a distribution, in order to be counted toward a deficiency distribution, must be made by such corporation or corporations and from such earnings and profits to the extent thereof. Once all such earnings and profits of such corporation or corporations have been completely distributed, a deficiency distribution may be made from other earnings and profits of such foreign corporation which was a single first-tier corporation, or of such corporation or corporations which were in such chain or group, as the case may be.

(4) *Proof of reasonable cause.* Reasonable cause for failure to receive a minimum distribution shall be deemed to exist, in the absence of circumstances demonstrating bad faith, if the electing United States shareholder receives, within the period prescribed by paragraph (a)(1)(i) of §1.963–3 with respect to the year of election, at least 80 percent of the amount of a minimum distribution (from the earnings and profits to which the election for such year relates) which if received during such period would have satisfied the conditions for the section 963 exclusion to apply to such year. If less than 80 percent of the amount of a minimum distribution is received during such period, the existence of a reasonable cause for failure to receive a minimum distribution must be established by clear and convincing evidence; however, the preceding sentence shall not be taken as a limitation on the establishment of reasonable cause by any other proof of reasonable cause. For example, reasonable cause will exist if a single first-tier corporation for its taxable year makes a distribution which would be a minimum distribution but for a refund of foreign income tax which it has paid in good faith under foreign law but which is found not to be due after the United States income tax return of the United States shareholder has been filed.

(c) *Nature and details of determination.* (1) A determination that the section 963 exclusion does not apply to a United States shareholder for a taxable year due to its failure to receive a minimum distribution for such year shall, for the purposes of this section, be established by—

(i) A decision by the Tax Court or a judgment, decree, or other order by any court of competent jurisdiction, which has become final;

(ii) A closing agreement made under section 7121; or,

(iii) An agreement which is signed by the district director, or such other official to whom authority to sign the agreement is delegated, and by, or on behalf of, such shareholder and which relates to the liability of such shareholder for the tax under chapter 1 of the Code for such year.

(2) The date of determination by a decision of the Tax Court shall be the date upon which such decision becomes final, as prescribed in section 7481.

(3) The date upon which a judgment of a court becomes final shall be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States district court shall become final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims shall become final upon the expiration of the time allowed for filing a petition for certiorari, if no such petition is duly filed within such time.

(4) The date of determination by a closing agreement made under section 7121 shall be the date such agreement is approved by the Commissioner.

(5) The date of a determination made by an agreement which is signed by the district director, or such other official to whom authority to sign the agreement is delegated, shall be the date prescribed by this subparagraph. The agreement shall be sent to the United States shareholder at his last known address by either registered or certified mail. If registered mail is used for such purpose, the date of registration shall be treated as the date of determination; if certified mail is used for such purpose, the date of the postmark on the sender's receipt for such mail shall be treated as the date of determination. However, if the deficiency distribution is received by such shareholder before such registration or postmark date but on or after the date the agreement is signed by the district director or such other official to whom authority to sign the agreement is delegated, the date of determination shall be the date on which the agreement is so signed.

(6) The determination under this paragraph shall find that, due to the United States shareholder's failure to receive a minimum distribution, the section 963 exclusion does not apply for the taxable year with respect to stock to which the election under such section relates. A determination described in subdivision (ii) or (iii) of subparagraph (1) of this paragraph shall set forth the amount of the deficiency distribution and the amount of additional income tax for which the United States shareholder is liable under Chapter 1 of the Code by reason of not including in gross income for such year the amount of the deficiency distribution. If a determination described in subdivision (i) of subparagraph (1) of this paragraph does not establish the amount of the deficiency distribution and such amount of additional tax, such amounts may be established by an agreement which is signed by the district director, or such other official to whom authority to sign the agreement is delegated.

(d) *Claim for treatment of distribution as a deficiency distribution*—(1) *Claim filed after date of determination*. A claim (including any amendments thereof) for treatment of a deficiency distribution as counting toward a minimum distribution for the taxable year of election shall be filed in duplicate, within 120 days after the date of the determination described in paragraph (c) of this section, with the requisite declaration prescribed by the Commissioner on the appropriate claim form and shall be accompanied by—

(i) A copy of such determination and a description of how it became final;

(ii) If requested by the district director, or by such other official to whom authority to sign the agreement referred to in paragraph (c)(1) or (6) of this section is delegated, a consent by the United States shareholder under section 6501 to extend the period for the making of assessments, and the bringing of distraint or a proceeding in court for collection, in respect of a deficiency and all interest, additional amounts, and assessable penalties for the taxable year of election; and

(iii) Such other information as may be required by the claim form or the district director, or other official, in support of the claim.

(2) *Advance claim*. An advance claim for treatment of a deficiency distribution as counting toward a minimum distribution for the taxable year of election shall be filed in duplicate, within 90 days after such distribution but before the date of determination described in paragraph (c) of this section, and shall satisfy all requirements of subparagraph (1) of this paragraph other than subdivision (i) of such subparagraph. However, within 120 days after the date of the determination described in paragraph (c) of this section, the advance claim shall be completed so that it satisfies all requirements of subparagraph (1) of this paragraph.

(e) *Computation of interest on deficiencies in tax*. If a United States shareholder, for the taxable year of the election under section 963, completes a minimum distribution for such year by receiving a deficiency distribution to which this section applies, the interest on the deficiency in tax due by reason of the failure to include the amount of such deficiency distribution in such shareholder's gross income for such year shall be computed for the period from the last date prescribed for payment of the tax for such year to the date such deficiency in tax is paid. No interest shall be due by reason of the failure to include Subpart F income in gross income for a taxable year in respect of which a minimum distribution under section 963 is completed by a deficiency distribution to which this section applies.

(f) *Claim for credit or refund.* If a deficiency in tax is asserted for any taxable year by reason of failure to include Subpart F income in gross income under section 951(a)(1)(A)(i) and the United States shareholder has paid any portion of such asserted deficiency, such shareholder is entitled to a credit or refund of such payment to the extent that such payment constitutes an overpayment of tax as the result of the receipt of a deficiency distribution to which this section applies. To secure credit or refund of such overpayment of tax, the United States shareholder must file a claim for refund in accordance with §301.6402–3, in addition to the claim form required under paragraph (d) of this section. No interest shall be allowed on such credit or refund. For other rules applicable to the filing of claims for credit or refund of an overpayment of tax, see section 6402 and the regulations thereunder. For the limitations applicable to the credit or refund for an overpayment of tax, see section 6511 and the regulations thereunder.

(g) *Effect of deficiency distribution*—(1) *Allocation of distributions.* The deficiency distribution shall be allocated, by applying the rules of §1.963–3 (and paragraph (b) of §1.963–4, if applicable for the year of election), as a distribution first from the earnings and profits (to the extent thereof) of the foreign corporation which was the single first-tier corporation, or of the distributing corporation or corporations which were in the chain or group, as the case may be, for the taxable year in respect of which the election was made, and then from earnings and profits (to the extent thereof) described in section 959(c)(3) and determined as provided in section 959 for the most recent taxable year and the first, second, etc., taxable years preceding such recent taxable years, in that order, of the distributing corporation or corporations. In applying the preceding sentence to taxable years other than the taxable year in respect of which the election was made, the deficiency distribution shall first be allocated, in the order of allocation prescribed by such sentence, first to taxable years in respect of which no election under section 963 was made with respect to the stock on which such distribution is received and then to taxable years in respect of which an election under such section was made.

(2) *Year of receipt.* Any deficiency distribution made with respect to a taxable year of the United States shareholder shall be treated, except as provided in paragraph (b)(2) of this section, as having been received by the shareholder in that year for which such shareholder elected to secure an exclusion under section 963; and, for purposes of the foreign tax credit under section 901, the foreign income taxes paid or accrued, or deemed paid, by the United States shareholder by reason of a distribution of any amount treated as a deficiency distribution for such year shall be treated as paid or accrued, or deemed paid, for such year.

(3) *Year of payment.* A distribution counting toward a deficiency distribution for a taxable year of election shall, except as provided in paragraph (b)(2) of this section, be treated for purposes of applying paragraph (a) of §1.963–3, relating to conditions under which earnings and profits are counted toward a minimum distribution, and paragraph (b)(3) of §1.963–4, relating to rules for distributing through a chain or group, as if it were distributed during the distribution period (as defined in paragraph (g) of §1.963–3) with respect to the distributing corporation and each foreign corporation through which such distribution is made to the United States shareholder, for the taxable year to which the election under section 963 applies; and the foreign income taxes paid by any foreign corporation by reason of such distribution shall, in the application of section 902 and of the special rules of paragraph (c) of §1.963–4, be treated as paid or accrued by such foreign corporation for its taxable year to which such election applies. The distribution shall not count toward a minimum distribution for any other taxable year.

(4) *Allocation of reduction in tax credit.* If any portion of a deficiency distribution from a corporation which was in a chain or group is paid from earnings and profits of a taxable year other than that in respect of which the election was made, then the minimum distribution toward which such deficiency distribution counts may not be treated as a pro rata minimum distribution for purposes of § 1.963–4. Moreover, the amount of the overall United States and foreign income tax with respect to such minimum distribution must satisfy the minimum tax requirements of paragraph (a)(1)(i), or paragraph (ii), of § 1.963–4, but, if the latter applies, without any reduction and deferral under paragraph (c)(3) of such section of the foreign tax credit allowable under section 901 with respect to the deficiency distribution.

[T.D. 6759, 29 FR 13346, Sept. 25, 1964, as amended by T.D. 6767, 29 FR 14879, Nov. 3, 1964; T.D. 7410, 41 FR 11020, Mar. 16, 1976]

§ 1.963–7 Transitional rules for certain taxable years.

(a) *Extension of time for making, revoking, or changing election*—(1) *In general.* Subparagraphs (2) and (3) of this paragraph provide additional rules which apply only to a taxable year of a United States shareholder for which the last day prescribed by law for filing its return (including any extensions of time under section 6081) occurs on or before the 90th day after September 30, 1964.

(2) *Manner of making the election.* The election of the United States shareholder to secure the exclusion under section 963 and the consent to the regulations under such section may be made for the taxable year—

(i) By filing with the return (or with an amended return filed on or before such 90th day) for such taxable year—

(a) A written statement stating that such election is made for such taxable year, and

(b) The names of the foreign corporations to which such election applies, the taxable year, country of incorporation, pretax earnings and profits, foreign income taxes, earnings and profits, and outstanding capital stock, of each such corporation, and such other information relating to the election made as the Commissioner may prescribe, on or before the date of filing, by instructions or schedules to support such return; or

(ii) In case of any extension of time under section 6081 with respect to such taxable year where the last day prescribed by law for filing the return by the electing United States shareholder (not including any extensions thereof) occurs on or before September 30, 1964, by filing with the request for the first such extension of time a written statement stating that such election is made for such taxable year and setting forth the names of the foreign corporations to which each election applies.

(3) *Revocation or change of election.* An election made in the manner provided by subparagraph (2) of this paragraph may be revoked or changed—

(i) By filing with the return on or before the 90th day after September 30, 1964, a written statement that such election is revoked or changed, as the case may be, and by setting forth with respect to any such modified election the information prescribed by subparagraph (2)(i)*(b)* of this paragraph, or

(ii) Where the return has been filed on or before such 90th day, by filing on or before such 90th day an amended return and an accompanying statement that such election is revoked or changed, as the case may be, and by setting forth with respect to any such modified election the information prescribed by subparagraph (2)(i)*(b)* of this paragraph.

(b) *Extension of time for making a minimum distribution*—(1) *In general.* This paragraph applies only with respect to a taxable year of a United States shareholder ending on or before September 30, 1964, for which an election to secure an exclusion under section 963 is made where, in case of a first-tier election, the distribution period of such first-tier corporation with respect to its taxable year to which such election applies ends on or before the 90th day after such date, and where, in the case of a chain or group election, the distribution period ends on or before such 90th day with respect to the taxable year to which the election applies of any of the foreign corporations in such chain or group.

(2) *Conditions for obtaining extension of time.* A distribution on stock with respect to which the election under section 963 was made which is received by the United States shareholder from a foreign corporation which was the single first-tier corporation, or a corporation in the chain or group, as the case may be, with respect to which the election was made, shall count toward a minimum distribution under section 963 for such year of election if—

(i) The distribution is made on or before such 90th day,

(ii) The shareholder, in a statement attached to its return or amended return for such year (which is filed on or before such 90th day) indicates the foreign corporation or corporations from which the distribution is made and states that, and the extent to which, the distribution is to count toward such minimum distribution,

(iii) The distribution is of such a nature as would have permitted it to count toward a minimum distribution for such taxable year of the United States shareholder if it had been made on the last day of such year, and

(iv) The United States shareholder includes the distribution in gross income as if it were received on the last day of such taxable year of election.

The distribution shall be applied against the earnings and profits of the single first-tier corporation or the foreign corporations in the chain or group for the taxable year of such corporation or corporations to which the election applies.

(3) *Year of receipt.* To the extent that a distribution counts toward a minimum distribution under this paragraph with respect to a taxable year of the United States shareholder, it shall be treated as having been received by the shareholder in that year for the purpose of determining gross income and the assessment of interest, additional amounts, and assessable penalties; and, for purposes of the foreign tax credit under section 901, the foreign income taxes paid or accrued, or deemed paid, by the United States shareholder by reason of a distribution of any amount treated as a distribution for such year under this paragraph shall be treated as paid or accrued, or deemed paid, for such year.

(4) *Year of payment.* The distribution shall be treated for purposes of applying paragraph (a) of §1.963–3, relating to conditions under which earnings and profits are counted toward a minimum distribution, and paragraph (b)(3) of §1.963–4, relating to rules for distributing through a chain or group, as if it were distributed during the distribution period (as defined in paragraph (g) of §1.963–3) with respect to the distributing corporation and each foreign corporation through which such distribution is made to the United States shareholder, for the taxable year to which the election under section 963 applies; and the foreign income taxes paid by any foreign corporation by reason of such distribution shall, in the application of section 902 and of the special rules of paragraph (c) of §1.963–4, be treated as paid or accrued by such foreign corporation for its taxable year to which such election applies. The distribution shall not count toward a minimum distribution for any other taxable year.

[T.D. 6759, 29 FR 13348, Sept. 25, 1964, as amended by T.D. 6767, 29 FR 14879, Nov. 3, 1964]

§1.963–8 Determination of minimum distribution during the surcharge period.

(a) *Taxable years not wholly within the surcharge period.* In the case of a taxable year beginning before the surcharge period and ending within the surcharge period, or beginning within the surcharge period and ending after the surcharge period, or beginning before January 1, 1970, and ending after December 31, 1969, section 963(b) provides the method for determining the required minimum distribution. Under the method prescribed in section 963(b) for such years, the required minimum distribution is an amount equal to the sums of:

(1) That portion of the minimum distribution which would be required if the provisions of section 963(b)(1) were applicable to the taxable year, which the number of days in such taxable year which are within the surcharge period and before January 1, 1970, bears to the total number of days in such taxable year.

(2) That portion of the minimum distribution which would be required if the provisions of section 963(b)(2) were applicable to such taxable year, which the number of days in such taxable year which are within the surcharge period and after December 31, 1969, bears to the total number of days in such taxable year, and

(3) That portion of the minimum distribution which would be required if the provisions of section 963(b)(3) were applicable to such taxable year, which the number of days in such taxable year which are not within the surcharge period bears to the total number of days in such taxable year.

(b) *Calendar year 1970.* For calendar year 1970, the required minimum distribution shall be an amount determined in accordance with the following table:

If the effective foreign tax rate is (percentage)—	The required minimum distribution of earnings and profits is (percentage)—
Under 9	84.983562
9 or over but less than 10	82.967123
10 or over but less than 18	80.983562
18 or over but less than 19	79.471233
19 or over but less than 26	77.487671
26 or over but less than 27	73.958904
27 or over but less than 32	70.487671
32 or over but less than 33	67.463014
33 or over but less than 36	63.991781
36 or over but less than 37	57.942466
37 or over but less than 39	51.991781
39 or over but less than 40	44.934247
40 or over but less than 41	37.495890
41 or over but less than 42	31.446575
42 or over but less than 43	19.446575
43 or over but less than 44	12.893151
44 or over but less than 45	6.446575
45 or over	0

(c) *Surcharge period.* For purposes of this section the term ‘‘surcharge period’’ means the period beginning January 1, 1968, and ending June 30, 1970.

(d) *Illustration of principles.* The application of the rules set forth in paragraphs (a), (b), and (c) of this section may be illustrated by the following example. It is assumed that all computations are carried to sufficient accuracy:

Example. (a) M, a domestic corporation, and A, its controlled corporation (the one class of stock of which is wholly owned by M), both have a taxable year beginning December 1, 1969, and ending November 30, 1970. For such taxable year M makes a first-tier election with respect to A corporation. The effective foreign tax rate for such year is 30 percent.

(b) Under section 963(b) and paragraph (b) of this section the surcharge period ends June 30, 1970. Therefore, of the 365 days in the taxable year, 153 days are not within the surcharge period. Of the remaining 212 days, 31 are within the surcharge period and before January 1, 1970 and 181 days are within the surcharge period and after December 31, 1969. If section 963(b)(1) were applicable to the entire taxable year, the required minimum distribution of earnings and profits would be 75 percent. If section 963(b)(2) were applicable to the entire taxable year, the required minimum distribution would be 72 percent. If section 963(b)(3) were applicable to the entire taxable year, the required minimum distribution would be 69 percent.

(c) Under section 963(b) and this section the required minimum distribution of earnings and profits is 71 percent, computed as follows:

$$(75\% \times 31 \div 365) + (72\% \times 181 \div 365) + (69\% \times 153 \div 365) = 71\%.$$

[T.D. 7100, 36 FR 5336, Mar. 20, 1971]

§ 1.964–1 Determination of the earnings and profits of a foreign corporation.

(a) *In general.* For purposes of sections 951 through 964, the earnings and profits (or deficit in earnings and profits) of a foreign corporation for its taxable year shall, except as provided in paragraph (f) of this section, be computed substantially as if such corporation were a domestic corporation by—

(1) Preparing a profit and loss statement with respect to such year from the books of account regularly maintained by the corporation for the purpose of accounting to its shareholders;

(2) Making the adjustments necessary to conform such statement to the accounting principles described in paragraph (b) of this section;

(3) Making the further adjustments necessary to conform such statement to the tax accounting standards described in paragraph (c) of this section;

(4) Translating the amounts shown on such adjusted statement into United States dollars in accordance with paragraph (d) of this section, and

(5) Adjusting the amount of profit or loss shown on such translated and adjusted statement in accordance with paragraph (e) of this section to reflect any exchange gain or loss determined thereunder.

The computation described in the preceding sentence may be made by following the procedures described in paragraphs (a)(1) through (5) of this section in an order other than the one listed, as long as the result so obtained would be the same. In determining earnings and profits, or the deficit in earnings and profits, of a foreign corporation under section 964, the amount of any illegal bribe, kickback, or other payment (within the meaning of section 162(c), as amended by section 288 of the Tax Equity and Fiscal Responsibility Act of 1982 in the case of payments made after September 3, 1982, and the regulations thereunder) paid after November 3, 1976, by or on behalf of the corporation during the taxable year of the corporation directly or indirectly to an official, employee, or agent in fact of a government shall not be taken into account to decrease such earnings and profits or to increase such deficit. No adjustment shall be required under subparagraph (2) or (3) of this paragraph unless it is material. Whether an adjustment is material depends on the facts and circumstances of the particular case, including the amount of the adjustment, its size relative to the general level of the corporation's total assets and annual profit or loss, the consistency with which the practice has been applied, and whether the item to which the adjustment relates is of a recurring or merely a nonrecurring nature. For the treatment of earnings and profits whose distribution is prevented by restrictions and limitations imposed by a foreign government, see section 964(b) and the regulations thereunder.

(b) *Accounting adjustments*—(1) *In general.* The accounting principles to be applied in making the adjustments required by paragraph (a)(2) of this section shall be those accounting principles generally accepted in the United States for purposes of reflecting in the financial statements of a domestic corporation the operations of its foreign affiliates, including the following:

(i) *Clear reflection of income.* Any accounting practice designed for purposes other than the clear reflection on a current basis of income and expense for the taxable year shall not be given effect. For example, an adjustment will be required where an allocation is made to an arbitrary reserve out of current income.

(ii) *Physical assets, depreciation, etc.* All physical assets (as defined in paragraph (e)(5)(ii) of this section), including inventory when reflected at cost, shall be taken into account at historical cost computed either for individual assets or groups of similar assets. The historical cost of such an asset shall not reflect any appreciation or depreciation in its value or in the relative value of the currency in which its cost was incurred. Depreciation, depletion, and amortization allowances shall be based on the historical cost of the underlying asset and no effect shall be given to any such allowance determined on the basis of a factor other than historical cost. For special rules for determining historical cost where assets are acquired during a taxable year beginning before January 1, 1950, or a majority interest in the foreign corporation is acquired after December 31, 1949, but before October 27, 1964, see subparagraph (2) of this paragraph.

(iii) *Valuation of assets and liabilities.* Any accounting practice which results in the systematic undervaluation of assets or overvaluation of liabilities shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under paragraph (c) of this section. For example, an adjustment will be required where inventory is written down below market value. For the definition of market value, see paragraph (a) of §1.471–4.

(iv) *Income equalization.* Income and expense shall be taken into account without regard to equalization over more than one accounting period; and any equalization reserve or similar provision affecting income or expense shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under paragraph (c) of this section.

(v) *Foreign currency.* If transactions effected in a foreign currency other than that in which the books of the corporation are kept are translated into the foreign currency reflected in the books, such translation shall be made in a manner substantially similar to that prescribed by paragraph (d) of this section for the translation of foreign currency amounts into United States dollars.

(2) *Historical cost.* For purposes of this section, the historical cost of an asset acquired by the foreign corporation during a taxable year beginning before January 1, 1963, shall be determined, if it is so elected by or on behalf of such corporation—

(i) In the event that the foreign corporation became a majority owned subsidiary of a United States person (within the meaning of section 7701(a)(30)) after December 31, 1949, but before October 27, 1964, and the asset was held by such foreign corporation at that time, as though the asset was purchased on the date during such period the foreign corporation first became a majority owned subsidiary at a price equal to its then fair market value, or

(ii) In the event that subdivision (i) of this subparagraph is inapplicable but the asset was acquired by the foreign corporation during a taxable year beginning before January 1, 1950, as though the asset were purchased on the first day of the first taxable year of the foreign corporation beginning after December 31, 1949, at a price equal to the undepreciated cost (cost or other basis minus book depreciation) of that asset as of that date as shown on the books of account of such corporation regularly maintained for the purpose of accounting to its shareholders.

For purposes of this subparagraph, a foreign corporation shall be considered a majority owned subsidiary of a United States person if, taking into account only stock acquired by purchase (as defined in section 334(b)(3)), the United States person owns (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote. The election under this subparagraph shall be made for the first taxable year beginning after December 31, 1962, in which the foreign corporation is a controlled foreign corporation (within the meaning of section 957), or for which it is included in a chain or group under section 963(c)(2)(B) or (3)(B) (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975), or has a deficit in earnings and profits sought to be taken into account under section 952(d) or pays a dividend that is included in the foreign base company shipping income of a controlled foreign corporation under § 1.954–6(f). Once made, such an election shall be irrevocable. For the time and manner in which an election may be made on behalf of a foreign corporation, see paragraph (c)(3) of this section.

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

Example 1. Corporation M is a controlled foreign corporation which regularly maintains books of account for the purpose of accounting to its shareholders in accordance with the accounting practices prevalent in country X, the country in which it operates. As a consequence of those practices, the profit and loss statement prepared from these books of account reflects an allocation to an arbitrary reserve out of current income and depreciation allowances based on replacement values which are greater than historical cost. Adjustments are necessary to conform such statement to accounting principles generally accepted in the United States. Assuming these adjustments to be material, the unacceptable practices, will have to be eliminated from the statement, an increase in the amount of profit (or a decrease in the amount of loss) thereby resulting.

Example 2. In 1973, Corporation N is a foreign corporation which is not a controlled foreign corporation but which is included in a chain, for minimum distribution purposes, under section 963(c)(2)(B). Corporation N regularly maintains books of account for the purpose of accounting to its shareholders in accordance with the accounting practices of country Y, the country in which it operates. As a consequence of those practices, the profit and loss statement prepared from these books of account reflects the inclusion in income of stock dividends and of corporate distributions representing a return of capital. Adjustments are necessary to conform such statement to accounting principles generally accepted in the United States. Assuming these adjustments to be material, the unacceptable practices will have to be eliminated from the statement, a decrease in the amount of profit (or increase in the amount of loss) thereby resulting.

(c) *Tax adjustments*—(1) *In general.* The tax accounting standards to be applied in making the adjustments required by paragraph (a)(3) of this section shall be the following:

(i) *Accounting methods.* The method of accounting shall reflect the provisions of section 446 and the regulations thereunder.

(ii) *Inventories.* Inventories shall be taken into account in accordance with the provisions of sections 471 and 472 and the regulations thereunder.

(iii) *Depreciation.* Depreciation shall be computed as follows:

(a) For any taxable year beginning before July 1, 1972; depreciation shall be computed in accordance with section 167 and the regulations thereunder.

(b) If, for any taxable year beginning after June 30, 1972, 20 percent or more of the gross income from all sources of the corporation is derived from sources within the United States, then depreciation shall be computed in accordance with the provisions of §1.312–15.

(c) If, for any taxable year beginning after June 30, 1972, less than 20 percent of the gross income from all sources of the corporation is derived from sources within the United States, then depreciation shall be computed in accordance with section 167 and the regulations thereunder.

(iv) *Elections.* Effect shall be given to any election made in accordance with an applicable provision of the Code and the regulations thereunder and these regulations.

Except as provided in subparagraphs (2) and (3) of this paragraph, any requirements imposed by the Code or applicable regulations with respect to making an election or adopting or changing a method of accounting must be satisfied by or on behalf of the foreign corporation just as though it were a domestic corporation if such election or such adoption or change of method is to be taken into account in the computation of its earnings and profits.

(2) *Adoption of method.* For the first taxable year beginning after December 31, 1962, in which the foreign corporation is a controlled foreign corporation (within the meaning of section 957), or for which it is included in a chain or group under section 963(c)(2)(B) or (3)(B) (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975), or has a deficit in earnings and profits sought to be taken into account under section 952(d), or pays a dividend that is included in the foreign base company shipping income of a controlled foreign corporation under §1.954–6(f), there may be adopted or made by such corporation or on its behalf any method of accounting or election allowable under this section notwithstanding that, in previous years, its earnings and profits were computed, or its books or financial statements prepared, on a different basis and notwithstanding that such election is required by the Code or regulations to be made in a prior taxable year. For purposes of determining the amount of a deficit in earnings and profits taken into account pursuant to section 952(c)(1)(B), if a different basis is used in previous years, ratable adjustments shall be made in the earnings and profits attributable to such previous years to prevent any duplication or omission of amounts that would otherwise result from the adoption of such method or the making of such election. See subparagraph (3) of this paragraph for the manner in which a method of accounting or an election may be adopted or made on behalf of the foreign corporation.

(3) *Action on behalf of corporation*—(i) *In general.* An election shall be deemed made, or an adoption or change in method of accounting deemed effectuated, on behalf of the foreign corporation only if its controlling United States shareholders (as defined in subparagraph (5) of this paragraph)—

(a) Satisfy for such corporation any requirements imposed by the Code or applicable regulations with respect to such election or such adoption or change in method, such as the filing of forms, the execution of consents, securing the permission of the Commissioner, or maintaining books and records in a particular manner,

(b) File the written statement described in subdivision (ii) of this subparagraph at the time and in the manner prescribed therein, and

(c) Provide the written notice required by subdivision (iii) of this subparagraph at the time and in the manner prescribed therein.

For purposes of the preceding sentence, the books of the foreign corporation shall be considered to be maintained in a particular manner if the controlling

United States shareholders or the foreign corporation regularly keep the records and accounts required by section 964(c) and the regulations thereunder in that manner. Any election required to be made or information required to be filed with a tax return shall be deemed made or furnished on behalf of the foreign corporation if its controlling United States shareholders file the written statement described in subdivision (ii) of this subparagraph with respect to such election within the period specified therein. For a special rule postponing the time for taking action by or on behalf of a foreign corporation until the amount of its earnings and profits becomes significant, see subparagraph (6) of this paragraph.

(ii) *Written statement.* The written statement required by subdivision (i) of this subparagraph shall be jointly executed by the controlling United States shareholders, shall be filed with the Director of the Internal Revenue Service Center, 11601 Roosevelt Blvd., Philadelphia, Pennsylvania 19155, within 180 days after the close of the taxable year of the foreign corporation with respect to which the election is made or the adoption or change of method effected, or before May 1, 1965, whichever is later, and shall set forth the name and country or organization of the foreign corporation, the names, addresses, taxpayer identification numbers (in the case of statements required to be filed after June 20, 1983), and stock interests of the controlling United States shareholders, the nature of the action taken, the names, addresses, and (in the case of statements required to be filed after June 20, 1983) taxpayer identification numbers of all other United States shareholders notified of the election or adoption or change of method, and such other information as the Commissioner may by forms require.

(iii) *Notice.* Prior to the filing of the written statement described in subdivision (ii) of this subparagraph, the controlling United States shareholders shall provide written notice of the election made or the adoption or change of method effected to all other persons known by them to be United States shareholders who own (within the meaning of section 958(a)) stock of the foreign corporation. Such notice shall set forth the name and country of organization of the foreign corporation, the names, addresses, and stock interests of the controlling United States shareholders, the nature of the action taken, and such other information as the Commissioner may by forms require. However, the failure of the controlling United States shareholders to provide such notice to a person required to be notified thereunder shall not invalidate the election made or the adoption or change of method effected, if it is established to the satisfaction of the Commissioner that reasonable cause existed for such failure.

(4) *Effect of action by controlling United States shareholders.* Any action taken by the controlling United States shareholders on behalf of the foreign corporation pursuant to subparagraph (3) of this paragraph shall be reflected in the computation of the earnings and profits of such corporation under this section to the extent that it bears upon the tax liability of a United States shareholder who either—

(i) Was a controlling United States shareholder with respect to the action taken;

(ii) Received the written notice provided by subparagraph (3)(iii) of this paragraph;

(iii) Failed to file any of the returns required by section 6046 and the regulations thereunder within the period prescribed by section 6046(d); or

(iv) Was notified by the Director of the Philadelphia Service Center of the action taken—

(a) Within 61 days after the last day (including extensions of time) prescribed with respect to the taxable year of the foreign corporation by subparagraph (3)(ii) of this paragraph for filing the written statement described in such subparagraph, or

(b) Within 180 days after the close of the first taxable year in which such shareholder becomes a United States shareholder, whichever is later.

To the extent that the computation of the earnings and profits of the foreign corporation bears upon the tax liability of any United States shareholder other than those enumerated in the preceding sentence, the computation shall reflect the action taken only if such shareholder assents to such treatment. Such assent may be given at any time, but not later than 90 days after the shareholder is first apprised of such action by the Director of the Philadelphia Service Center. The shareholder shall signify his assent by filing a written statement with the Director of the Internal Revenue Service Center, 11601 Roosevelt Blvd., Philadelphia, Pennsylvania, 19155, setting forth the name and country of organization of the foreign corporation, his own name, address, and stock interest in the corporation, the nature of the action being assented to, and such other information as the Commissioner may by forms require.

(5) *Controlling United States shareholders.* For purposes of this paragraph the controlling United States shareholders of a foreign corporation shall be those United States shareholders (as defined in section 951(b)), who, in the aggregate, own (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of the stock of such corporation entitled to vote and who undertake to act on its behalf. In the event that the foreign corporation is not a controlled foreign corporation but is included in a chain or group under section 963(c)(2)(B) or (3)(B), the controlling United States shareholder with respect to such foreign corporation shall be deemed to be the domestic corporation which elects to receive the minimum distribution from such chain or group. In the event that the foreign corporation is neither a controlled foreign corporation nor included in a chain or group under section 963(c)(2)(B) or (3)(B) but has a deficit in earnings and profits sought to be taken into account under section 952(d), the controlling United States shareholder with respect to such foreign corporation shall be the shareholder seeking to take such deficit into account. In the event that the foreign corporation is a controlled foreign corporation but the United States shareholders (as defined in section 951(b)) do not, in the aggregate, own (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of the stock of such corporation entitled to vote, the controlling United States shareholders of the foreign corporation shall be all those United States shareholders who own (within the meaning of section 958(a)) stock of such corporation. In the event that a foreign corporation is not a controlled foreign corporation but pays a dividend to a controlled foreign corporation that is attributable to foreign base company shipping income under §1.954–6(f), the controlling United States shareholders (as defined in this subparagraph) of the controlled foreign corporation shall be considered the controlling United States shareholders of the foreign corporation.

(6) *Action not required until significant.* Notwithstanding any other provision of this paragraph, action by or on behalf of a foreign corporation (other than a foreign corporation subject to tax under section 882) to make an election or to adopt a method of accounting shall not be required until 180 days after the close of the first taxable year for which—

(i) An amount is includible in gross income with respect to such corporation under section 951(a);

(ii) It is sought to be established that such corporation is a less developed country corporation (within the meaning of section 955(c), as in effect before the enactment of the Tax Reduction Act of 1975);

(iii) An amount is excluded from Subpart F income (within the meaning of section 952) by section 952(c), section 952(d), or section 970(a);

(iv) Such corporation is the subject of an election to secure an exclusion under section 963 (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975); or

(v) It is sought to be established that the corporation has foreign base company shipping income (within the meaning of section 954(f)).

In the event that action by or on behalf of the foreign corporation is not undertaken by the time specified in the preceding sentence and such failure is shown to the satisfaction of the Commissioner to be due to inadvertence or a reasonable cause, such action may be undertaken during any period of at least 30 days occurring after such showing is made which the Commissioner may specify as appropriate for this purpose. Where the action necessary to make an election or to adopt a method of accounting is undertaken by or on behalf of the foreign corporation in accordance with this subparagraph, such election shall be deemed to have been made, or such adoption of accounting method effected, for the first taxable year of the foreign corporation beginning after December 31, 1962, in which such corporation is a controlled foreign corporation (within the meaning of section 957) or for which it is included in a chain or group under section 963(c)(2)(B) or (3)(B) (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975) or has a deficit in earnings and profits sought to be taken into account under section 952(d) or pays a dividend that is included in the foreign base company shipping income of a controlled foreign corporation under § 1.954–6(f). For special rules for computing earnings and profits for purposes of section 1248 or income for purposes of applying an exclusion set forth in section 954(b) where the taxable year of the foreign corporation occurs prior to the making of elections or the adoption of methods of accounting under this subparagraph, see the regulations under section 952 and section 1248.

(7) *Revocation of election.* Notwithstanding any other provision of this section, any election made by or on behalf of a foreign corporation (other than a foreign corporation subject to tax under section 882) may be modified or revoked by or on behalf of such corporation for the taxable year for which made whenever the consent of the Commissioner is secured for such modification or revocation, even though such election would be irrevocable but for this subparagraph.

(8) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. X Corporation is a controlled foreign corporation which maintains its books, in accordance with the laws of the country in which it operates, by taking inventoriable items into account under the ‘‘first-in, first-out’’ method. A, B, and C, the United States shareholders of X Corporation, own 45 percent, 30 percent, and 25 percent of its voting stock, respectively. For the first taxable year of X Corporation beginning after December 31, 1962, B and C adopt on its behalf the ‘‘last-in, first-out’’ inventory method, notifying A of the action taken. Even though A may object to such action, adjustments must be made to reflect the use of the LIFO method of inventorying in the computation of the earnings and profits of X Corporation with respect to him as well as with respect to B and C.

Example 2. Y Corporation is a controlled foreign corporation which maintains its books, in accordance with the laws of the country in which it operates, by employing the straight-line method of depreciation. D and E, the United States shareholders of Y Corporation, own 51 percent and 10 percent of its voting stock, respectively. For the first taxable year of Y Corporation beginning after December 31, 1962, D adopts on its behalf the declining balance method of depreciation. However, not knowing that E is a United States shareholder of the company, D fails to provide him with notice of the action taken. Assuming that E has filed the return required by section 6046 and the regulations thereunder within the period prescribed by section 6046(d), adjustments in the computation of earnings and profits will not be required with respect to him unless the Director of International Operations notifies him of the action taken within 240 days after the close of Y’s taxable year. If notice is not provided to E within this period, he will not be compelled to make the adjustments. At his option, however, he may accept the action taken by assenting thereto not later than 90 days after he is first apprised of such action by the Director of International Operations.

(d) *Translation into United States dollars*—(1) *In general*—(i) *General rule.* Except as provided in subdivisions (ii), (iii), and (iv) of this subparagraph, the amounts to be shown on the profit and loss statement, adjusted pursuant to paragraphs (b) and (c) of this section, shall be translated into United States dollars (as required by paragraph (a)(4) of this section) at the appropriate exchange rate for the translation period (as defined in subparagraph (6) of this paragraph) to which they relate.

(ii) *Cost of goods sold.* Amounts representing items of inventory reflected in the cost of goods sold shall be translated—

(a) To the extent that such amounts represent items included in the opening inventory balance, so as to obtain the same amount of United States dollars which represented (after translation and adjustment) such items in the closing inventory balance for the preceding taxable year,

(b) To the extent that such amounts represent items purchased or otherwise first included in inventory during the taxable year, at the appropriate exchange rate for the translation period in which the historical cost of such items was incurred, and

(c) To the extent that such amounts represent items included in the closing inventory balance, at the appropriate exchange rate for the translation period in which the historical cost of such items was incurred, except that, if such amounts are written down to market value, such market value shall be determined at the year-end rate. Notwithstanding the preceding sentence, amounts representing items of inventory included in the closing inventory balance may be translated at the year-end rate even though not written down to market value; however, once such a rate is employed under those circumstances, translation may not be made for subsequent taxable years at the appropriate exchange rate for the translation period in which the historical cost of the items of inventory was incurred unless the permission of the Commissioner is secured.

(iii) *Depreciation, depletion, and amortization.* Amounts representing allowances for depreciation, depletion, or amortization shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the underlying asset was incurred or is deemed to have been incurred. For purposes of this subdivision, if the historical cost of an asset is determined under paragraph (b)(2) of this section, such cost shall be deemed to have been incurred on the date the asset is considered to have been purchased under that paragraph.

(iv) *Prepaid expenses or income.* Amounts representing expenses or income paid or received in a prior taxable year shall be translated at the appropriate exchange rate for the translation period during which they were paid or received. Notwithstanding the preceding sentence, amounts representing such prepaid income or expenses may be translated at the year-end rate; however, once such a rate is employed, translation may not be made for subsequent taxable years at the appropriate exchange rate for the translation period during which such income or expenses were paid or received unless the permission of the Commissioner is secured.

(2) *Appropriate exchange rate*—(i) *In general.* Where the value of the foreign currency relative to the United States dollar does not fluctuate substantially during a translation period, a single exchange rate shall be appropriate for all amounts representing classes of items which relate to such period, such rate to be a simple average determined by dividing the sum of the closing rates for each of the calendar months ending with or within such period by the number of such months. On the other hand, where the value of the foreign currency relative to the United States dollar does fluctuate substantially during a translation period, the exchange rate appropriate to an amount representing a class of items which relates to such period shall be either *(a)* a simple average determined in accordance with the preceding sentence, or *(b)* a weighted average taking into account the volume of transactions (reflected by the amount being translated) for the calendar months ending with or within such period, depending upon which average would produce a result more representative of that which would have been obtained by translating the individual transactions reflected by that amount at the closing rate for the month to which each such transaction relates. Whether the value of the foreign currency relative to the United States dollar fluctuates substantially during the translation period is a question of fact, depending upon, among other things, the extent to which the volume of transactions varies from month to month. In general, however, the degree of fluctuation will be considered substantial if the closing rate for any calendar month ending with or within the translation period varies by more than 10 percent from the closing rate for any preceding calendar month ending within that period.

(ii) *Monthly rate.* Notwithstanding subdivision (i) of this subparagraph, if it is so elected by or on behalf of the foreign corporation, and if the closing rate for any calendar month ending with or within a translation period does not vary by more than 3 percent from the closing rate for any preceding calendar month ending within that period, the appropriate exchange rate for amounts representing all classes of items relating to such period shall be any exchange rate which is designated in the election and which does not vary by more than 3 percent from the closing rate for any calendar month ending with or within such period. An election under this subdivision may be made with respect to any translation period of any taxable year of the foreign corporation beginning after December 31, 1962. Such election shall be effective only with respect to the translation period for which it is made, and once made shall be irrevocable with respect to that period. See paragraph (c)(3) of this section for the time and manner in which an election may be made on behalf of the foreign corporation.

(iii) *Class of items.* For purposes of this subparagraph, the term ''class of items'' means any category which is reflected separately on books of account or financial statements. For example, sales is a class of items which is reflected separately on the profit and loss statement, and accounts receivable is a class of items which is reflected separately on the balance sheet.

(3) *Closing rate.* The closing rate for any calendar month shall be the exchange rate on the last day of that month determined by reference to a qualified source of exchange rates within the meaning of subparagraph (5) of this paragraph.

(4) *Year-end rate.* The year-end rate shall be the closing rate for the last calendar month of the taxable year.

(5) *Qualified source of exchange rates.* A qualified source of exchange rates shall be any source which is demonstrated to the satisfaction of the district director to reflect actual transactions conducted in a free market and involving representative amounts. In the absence of such a demonstration, the exchange rates taken into account in the computation of the earnings and profits of the foreign corporation shall be determined by reference to the free market rate set forth in the pertinent monthly issue of ''International Financial Statistics'' or a successor publication of the International Monetary Fund, or such other source of exchange rates reflecting actual transactions conducted in a free market and involving representative amounts as the Commissioner may designate as appropriate for this purpose.

(6) *Translation period*—(i) *In general.* Except as provided in subdivision (ii) of this subparagraph, the translation period shall be a taxable year.

(ii) *Currency fluctuations.* If it is so elected by or on behalf of the foreign corporation, the taxable year shall be divided into groups consisting of a calendar month or consecutive calendar months as specified in the election, each such group constituting a separate translation period. Where the value of the foreign currency relative to the United States dollar fluctuates substantially during the taxable year, the use of the weighted average referred to in subparagraph (2)(i) of this paragraph ordinarily may be avoided by dividing the taxable year into translation periods so that the first translation period begins with the first day of such year and each subsequent translation period begins with the first day of the first calendar month thereafter ending with or within such year for which the closing rate varies by more than 10 percent from the closing rate for any month in the preceding translation period. An election under this subdivision may be made with respect to any taxable year of the foreign corporation beginning after December 31, 1962. Such election shall be effective only with respect to the taxable year for which it is made, and once made shall be irrevocable with respect to such year. For the time and manner in which an election may be made on behalf of the foreign corporation, see paragraph (c)(3) of this section.

(7) *Actual transactions.* Notwithstanding any other provisions of this paragraph—

(i) *Dollar transactions.* Any transaction involving the payment or receipt of United States dollars shall be reflected in the profit and loss statement by the amount of United States dollars involved in such transaction.

(ii) *Conversion transactions.* Any transaction involving the conversion of a foreign currency into United States dollars, or the conversion of United States dollars into a foreign currency, shall be reflected in the profit and loss statement by an amount expressed in United States dollars and determined by translation at the exchange rate at which conversion was effected if the foreign corporation knows, or reasonably should know, that exchange rate.

(iii) *Daily rate.* Any transaction other than one described in subdivision (i) or (ii) may be translated into United States dollars at the exchange rate for the day on which that transaction occurred, such rate to be determined by reference to a qualified source of exchange rates within the meaning of subparagraph (5) of this paragraph.

No transaction shall be required to be taken into account under subdivision (i) or (ii) unless the United States dollars involved are material in amount.

(8) *Other methods.* Notwithstanding the other provisions of this paragraph, translation into United States dollars may be made in accordance with a system or method not otherwise described in this paragraph, provided that such system or method (i) was employed by the corporation for purposes of accounting to its shareholders prior to January 1, 1963, and (ii) is shown to the satisfaction of the Commissioner to clearly reflect the earnings and profits of the corporation.

(9) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. M Corporation, a controlled foreign corporation organized on January 1, 1963, employs the calendar year as its taxable year and maintains its books of account in abbas, the currency of the country in which it operates. During 1963 M Corporation's monthly sales amounted to 100,000 abbas per month, its total payroll and other expenses for the year amounted to 180,000 abbas, and its total inventory purchases amounted to 1,050,000 abbas. Also during 1963, M Corporation purchased depreciable assets for 1,000,000 abbas. The value of the abba relative to the United States dollar fluctuated only slightly in 1963; the monthly closing rate moved between 19.8 abbas and 20.2 abbas per United States dollar and stood at 19.9 abbas per United States dollar for most of the year and at yearend. An election under subparagraph (2)(ii) of this paragraph is made on behalf of M Corporation to use the par rate of 20 abbas per United States dollar as the exchange rate appropriate for 1963. Assuming that none of the amounts shown therein reflects a transaction described in subparagraph (7) of this paragraph, M Corporation's adjusted profit and loss statement for 1963 would be translated into United States dollars as follows:

	Local currency	Exchange rate	U.S. dollars
Sales	1,200,000	20:1	60,000
Cost of goods sold:			
Purchases	1,050,000	20:1	52,500
Less: Closing inventory	(350,000)	20:1	(17,500)
	700,000	....	35,000
Wages and other expenses	180,000	20:1	9,000
Depreciation	200,000	20:1	10,000
Total costs and expenses	1,080,000	....	54,000
Operating profit	120,000	....	6,000

Example 2. The facts are the same as in example 1 and in addition during 1964 M Corporation had annual sales of 1,470,000 abbas, annual wages and other expenses of 252,000 abbas, and inventory purchases of 910,000 abbas. Also during 1964, M Corporation purchased additional depreciable assets for 430,000 abbas, the bulk of such purchases being made in the last half of the year. The value of the abba relative to the United States dollar gradually declined in 1964, the monthly closing rate moving from 19.9 abbas per United States dollar down to 22 abbas per United States dollar. For most classes of items, the appropriate exchange rate is a simple average of monthly closing rates or 21 abbas per United States dollar. However, since the bulk of the depreciable asset purchases were made in the last half of the year, the rate representative of those transactions is a weighted average of 21.5 abbas per United States dollar. Assuming that none of the amounts shown therein reflects a transaction described in subparagraph (7) of this paragraph and that closing inventory is translated at historical rates, M Corporation's adjusted profit and loss statement for 1964 would be translated into United States dollars as follows:

	Local currency	Exchange rate	U.S. dollars
Sales	1,470,000	21:1	70,000
Cost of goods sold:			
Opening inventory	350,000	20:1	17,500
Purchases	910,000	21:1	43,333
Less: Closing inventory	(418,000)	21:1	(19,905)
	842,000	....	40,928
Wages and other expenses	252,000	21:1	12,000
Depreciation:			
1963 assets	150,000	20:1	7,500
1964 assets	86,000	21.5:1	4,000

	Local currency	Exchange rate	U.S. dollars
Total costs and expenses	1,330,000	....	64,428
Operating profit	140,000	....	5,572

Example 3. The facts are the same as in examples 1 and 2 except that the 1964 sales of M Corporation amounted to 1,260,000 abbas plus $10,500 in United States dollars. Assuming that closing inventory is translated at historical rates, M Corporation's adjusted profit and loss statement for 1964 would be translated as follows:

	Local currency	Exchange rate	U.S. dollars
Sales—Abbas	1,260,000	21:1	60,000
Sales—U.S. dollars	215,250	[1]	10,500
Total sales	1,475,250	....	70,500
Cost of goods sold:			
Opening inventory	350,000	20:1	17,500
Purchases	910,000	21:1	43,333
Less: Closing inventory	(418,000)	21:1	19,905
	842,000	....	40,928
Wages and other expenses	252,000	21:1	12,000
Depreciation:			
1963 assets	150,000	20:1	7,500
1964 assets	86,000	21.5:1	4,000
Total costs and expenses	1,330,000	....	64,428
Operating profit	145,250	....	6,072

[1] Transaction.

Example 4. The facts are the same as in examples 1 and 2. M Corporation continues to operate during 1965 and the value of the abba relative to the United States dollar declines materially during that year; the monthly closing rate drops from 22 abbas per United States dollar to 26 abbas per United States dollar, a decrease of more than 10 percent. An election under subparagraph (6)(ii) of this paragraph is made on behalf of M Corporation to divide the year into translation periods, the applicable periods being January 1 through July 31 and August 1 through December 31. For most classes of items, the appropriate exchange rate for each of these translation periods is a simple average of monthly closing rates, or 23 abbas and 25 abbas per United States dollar, respectively. However, all of the depreciable asset purchases were made at the end of the first translation period—January 1 through July 31—and, therefore, the rate representative of those transactions is a weighted average of 24 abbas per United States dollar. The classes of items reflecting M Corporation's 1965 financial transactions and the representative rates of exchange for such classes of items are as follows:

	Local currency	Exchange rate
Sales:		
Jan. 1–July 31	1,000,000	23:1
Aug. 1–Dec. 31	500,000	25:1
Inventory purchases:		
Jan. 1–July 31	559,000	23:1
Aug. 1–Dec. 31	361,000	25:1
Expenses:		
Jan. 1–July 31	115,000	23:1
Aug. 1–Dec. 31	145,000	25:1
Fixed asset purchases	216,000	24:1
Closing inventory	430,000	[1]

[1] Historical.

Assuming that M Corporation uses the first-in, first-out method of inventory valuation, the closing inventory is assumed in normal circumstances to consist of purchases made during the most recent translation period as follows:

	Local currency	Exchange rate	U.S. dollars
All of the August-December purchases	361,000	25:1	14,440
Balance from January- July purchases	69,000	23:1	3,000
Total closing inventory	430,000	....	17,440

Assuming that none of the amounts shown therein reflects a transaction described in subparagraph (7) of this paragraph, and that closing inventory is translated at historical rates, M Corporation's adjusted profit and loss statement for 1965 would be translated into United States dollars as follows:

	Local currency	Exchange rate	U.S. dollars
Sales:			
Jan. 1–July 31	1,000,000	23:1	43,478
Aug. 1–Dec. 31	500,000	25:1	20,000
	1,500,000	....	63,478
Cost of goods sold:			
Opening inventory purchases	418,000	21:1	19,905
Jan. 1–July 31	559,000	23:1	24,304
Aug. 1–Dec. 31	361,000	25:1	14,440
Less: Closing inventory	(430,000)	[1]	(17,440)
	908,000	....	41,209
Wages and other expenses:			
Jan. 1–July 31	115,000	23:1	5,000
Aug. 1–Dec. 31	145,000	25:1	5,800
Depreciation:			
1963 assets	120,000	20:1	6,000
1964 assets	64,500	21.5:1	3,000
1965 assets	43,200	24:1	1,800
Total costs and expenses	1,395,700	....	62,809
Operating profit	104,300	....	669

[1] Historical.

(e) *Exchange gain or loss*—(1) *In general.* The exchange gain or loss determined in accordance with subparagraph (2) of this paragraph shall be applied against and reduce, or applied to and increase, as the case may be, the amount of profit or loss shown on the profit and loss statement prepared pursuant to paragraph (a)(1) of this section, as adjusted and translated pursuant to paragraph (a)(2), (3), and (4) of this section. For the manner in which the exchange gain or loss is to be allocated to or applied against Subpart F income, see section 952 and the regulations thereunder.

(2) *Determination of exchange gain or loss.* The exchange gain (or loss) for the taxable year shall be the amount which equals—

(i) The retained earnings for the taxable year as determined under subparagraph (3) of this paragraph, plus

(ii) The amount of any distributions made during the taxable year translated at the exchange rate appropriate to the translation period during which such distributions were made (or taken into account) in accordance with paragraph (d)(7) of this section, if applicable, minus

(iii) The amount representing retained earnings for the preceding taxable year as determined under subparagraph (3) of this paragraph, minus

(iv) The amount of profit (or plus the amount of any loss) shown on the profit and loss statement for the taxable year prepared pursuant to paragraph (a)(1) of this section and adjusted and translated pursuant to paragraph (a)(2), (3), and (4) of this section.

(3) *Retained earnings.* The retained earnings for any taxable year shall be determined by first—

(i) Preparing a balance sheet as of the end of such year from the books of account regularly maintained by the foreign corporation for the purpose of accounting to its shareholders;

(ii) Making the adjustments necessary to conform such balance sheet to the accounting principles described in paragraph (b) of this section;

(iii) Making the further adjustments necessary to conform such balance sheet to the tax accounting standards described in paragraph (c) of this section; and

(iv) Translating the amounts shown on the balance sheet (other than amounts representing retained earnings) into United States dollars in accordance with subparagraph (4) of this paragraph.

The retained earnings shall be an amount equal to the excess of the aggregate amount representing assets on the balance sheet (as adjusted and translated under this subparagraph) over the aggregate amount representing liabilities, reserves (other than reserves out of current or accumulated earnings), and paid- in capital on the balance sheet (as adjusted and translated under this subparagraph).

(4) *Translation of balance sheet.* Amounts shown on the balance sheet as adjusted pursuant to subparagraphs (3)(ii) and (iii) of this paragraph (other than amounts representing retained earnings) shall be translated into United States dollars as follows:

(i) *Financial assets.* Amounts representing financial assets shall be translated at the year-end rate.

(ii) *Physical assets.* Amounts representing physical assets (other than inventory) shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the asset was incurred or is deemed to have been incurred. For special rules for determining date on which the historical cost of certain assets acquired during taxable years beginning before January 1, 1950, or owned at the time a majority interest in the corporation was acquired after December 31, 1949, but before October 27, 1964, is deemed to have been incurred, see paragraph (b)(2) of this section.

(iii) *Depreciation and similar reserves.* Amounts representing depreciation, depletion, and amortization reserves shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the underlying asset was incurred or is deemed to have been incurred.

(iv) *Inventory.* Amounts representing items of inventory included in the closing inventory balance shall be translated in accordance with paragraph (d)(1)(ii) of this section.

(v) *Bad debt reserves.* Amounts representing bad debts reserves shall be translated at the year-end rate.

(vi) *Prepaid income or expense.* Amounts representing expenses or income paid or received in a prior taxable year shall be translated in accordance with paragraph (d)(1)(iv) of this section.

(vii) *Short-term liabilities.* Amounts representing short-term liabilities shall be translated at the year-end rate.

(viii) *Long-term liabilities.* Amounts representing long-term liabilities shall be translated at the appropriate exchange rate for the translation period in which such liabilities were incurred.

(ix) *Paid-in capital.* Amounts representing paid-in capital shall be translated at the appropriate exchange rate for the translation period in which such capital was paid in.

Notwithstanding any other provisions of this subparagraph, where the amount representing an item shown on the balance sheet reflects a transaction described in paragraph (d)(7) of this section, such transaction shall be taken into account in accordance with that paragraph.

(5) *Definitions.* For purposes of this paragraph—

(i) *Financial assets.* A financial asset shall be any asset reflecting a fixed amount of foreign currency, such as cash on hand, bank deposits, and loans and accounts receivable. Securities (within the meaning of section 1236(c)) shall be considered physical assets if they have been or are reasonably expected to be held for at least six months; if not they shall be considered financial assets whether or not they reflect a fixed amount of foreign currency. Moreover, advances on open account to any corporation in which the foreign corporation and any related persons (within the meaning of section 954(d)(3) and the regulations thereunder) with respect thereto own at least 10 percent of the combined voting power of all classes of stock entitled to vote shall not be considered financial assets if such advances have remained open for more than one year.

(ii) *Physical assets.* A physical asset shall be any asset other than a financial asset and shall include goodwill, patents, and other intangibles.

(iii) *Short-term liabilities.* A short-term liability shall be any indebtedness of the foreign corporation which is due or overdue as of the date of the balance sheet or which will become due within 1 year thereafter.

(iv) *Long-term liabilities.* A long- term liability is any indebtedness of the foreign corporation other than a short-term liability.

For the definition of ‘‘appropriate exchange rate’’, ‘‘year-end rate’’, and ‘‘translation period’’, see paragraphs (d)(2), (4), and (6), respectively, of this section.

(6) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. N Corporation is a controlled foreign corporation which uses the calendar year as its taxable year and which maintains its books in yuccas, the currency of the country in which it operates. For 1963, its operating profit is 140,000 yuccas or $55,720. At the end of the year, its balance sheet, as translated and adjusted pursuant to subparagraph (3) of this paragraph, is as follows:

	Local currency	Exchange rate	U.S. dollars
Cash	77,000	2.20:1	35,000
Accounts receivable	209,000	2.20:1	95,000
Inventory	418,000	[1]	199,050
Fixed assets	1,430,000	[1]	700,000
Less: Accumulated depreciation	(436,000)	[1]	(215,000)
Total assets	1,698,000		814,050
Current liabilities	338,000	2.20:1	153,640
Long-term liabilities	300,000	[1]	150,000
Paid-in capital	800,000	[1]	400,000
Retained earnings	260,000		110,410
Total liabilities and net worth	1,698,000		814,050

[1] Historical.

N Corporation’s retained earnings for 1962 are determined on the basis of its balance sheet as of the end of that year, translated as follows:

	Local currency	Exchange rate	U.S. dollars
Cash	70,000	2.00:1	35,000
Accounts receivable	180,000	2.00:1	90,000
Inventory	350,000	[1]	175,000
Fixed assets	1,000,000	[1]	500,000
Less: Accumulated depreciation	(200,000)	[1]	(100,000)
Total assets	1,400,000		700,000

	Local currency	Exchange rate	U.S. dollars
Current liabilities	180,000	2.00:1	90,000
Long-term liabilities	300,000	[1]	150,000
Paid-in capital	800,000	[1]	400,000
Retained earnings	120,000		60,000
Total liabilities and net worth	1,400,000		700,000

[1] Historical.

The exchange gain or loss of N Corporation for 1963 may be computed as follows:

Retained earnings—1963		$110,410
Less:		
Retained earnings—1962	$60,000	
Operating profit—1963	55,720	115,720
Exchange loss		(5,310)

Example 2. Assume the same facts as in example 1. For 1964, N Corporation's operating profit is 104,300 yuccas or $15,740. It pays a dividend of 26,000 yuccas during a translation period when the appropriate exchange rate is 2.60 yuccas per United States dollar. At year-end, its balance sheet, as translated and adjusted pursuant to subparagraph (3) of this paragraph, is as follows:

	Local currency	Exchange rate	U.S. dollars
Cash	91,000	2.60:1	35,000
Accounts receivable	260,000	2.60:1	100,000
Inventory	430,000	[1]	174,400
Fixed assets	1,646,000	[1]	790,000
Less: Accumulated depreciation	(663,700)	[1]	(323,000)
Total assets	1,763,300		776,400
Current liabilities	325,000	2.60:1	125,000
Long-term liabilities	300,000	[1]	150,000
Paid-in capital	800,000	[1]	400,000
Retained earnings	338,300		101,400
Total liabilities and net worth	1,763,300		776,400

[1] Historical.

The exchange gain or loss of N Corporation for 1964 would be computed as follows:

Retained earnings—1964		$101,400
Add:		
Dividends—1964		10,000
Predistribution earnings		111,400
Less:		
Retained earnings—1963	$110,410	
Operating profit—1964	15,740	126,150
Exchange loss		(14,750)

(f) *Determination of earnings and profits as if a domestic corporation*—(1) *In general.* If the books of account regularly maintained by a foreign corporation for the purpose of accounting to its shareholders are kept in U.S. dollars and in accordance with accounting principles generally accepted in the United States, and if it is so elected by or on behalf of such corporation, the earnings and profits of the foreign corporation for a taxable year shall, except as otherwise provided in paragraph (f)(2) of this section, be determined in every respect as if it were a domestic corporation. Such election shall be effective only for the taxable year with respect to which the election is made. Once made, such election shall be irrevocable. See paragraph (c)(3) of this section for the time and manner in which an election may be made on behalf of a foreign corporation.

(2) *Illegal payments.* The amount of any illegal bribe, kickback, or other payment (within the meaning of section 162(c), as amended by section 288 of the Tax Equity and Fiscal Responsibility Act of 1982 in the case of payments made after September 3, 1982, and the regulations thereunder) paid after November 3, 1976, by or on behalf of the corporation during the taxable year of the corporation directly or indirectly to an official, employee, or agent in fact of a government shall not be taken into account to decrease earnings and profits or increase the deficit in earnings and profits otherwise determined under paragraph (f)(1) of this section.

[T.D. 6764, 29 FR 14628, Oct. 27, 1964; 29 FR 15204, Nov. 11, 1964, as amended by T.D. 6787, 29 FR 18502, Dec. 29, 1964; T.D. 6995, 34 FR 832, Jan. 18, 1969; T.D. 7221, 37 FR 24747, Nov. 21, 1972; T.D. 7322, 39 FR 30931, Aug. 27, 1974; T.D. 7545, 43 FR 19652, May 8, 1978; T.D. 7862, 47 FR 56491, Dec. 17, 1982; T.D. 7893, 48 FR 22510, May 19, 1983]

§ 1.964–1T Special rules for computing earnings and profits of controlled foreign corporations in taxable years beginning after December 31, 1986 (temporary).

(a)–(f) [Reserved]

(g)(1) *Earnings and profits computed in functional currency*—(i) *Rule.* For taxable years of a controlled foreign corporation (within the meaning of section 957) beginning after December 31, 1986, earnings and profits shall be computed in the controlled foreign corporation's functional currency (determined under section 985 and the regulations thereunder) in accordance with § 1.964–1 as modified by this paragraph (g). Accordingly, § 1.964–1 (d), (e), and (f) and (to the extent inconsistent with this paragraph (g)) § 1.964–1(c) do not apply for taxable years of a controlled foreign corporation beginning after December 31, 1986. For purposes of this section, the term ''earnings and profits'' includes a deficit in earnings and profits.

(ii) *Cross reference.* In the case of a controlled foreign corporation with a functional currency other than the United States dollar (dollar), see sections 986(b) and 989(b) for rules regarding the time and manner of translating distributions or inclusions of the controlled foreign corporation's earnings and profits into dollars.

(2) *Election required when first significant.* Tax accounting methods or elections may be adopted or made by, or on behalf of, a controlled foreign corporation in the manner prescribed by the Code and regulations no later than 180 days after the close of the first taxable year of the controlled foreign corporation in which the computation of its earnings and profits is significant for United States income tax purposes with respect to its controlling United States shareholders (as defined in § 1.964–1(c)(5)). For taxable years of a controlled foreign corporation beginning before January 1, 1989, only the events listed in § 1.964–1(c)(6) are considered to cause a controlled foreign corporation's earnings and profits to have United States tax significance. For taxable years of a controlled foreign corporation beginning after December 31, 1988, events that cause a controlled foreign corporation's earnings and profits to have United States tax significance include, without limitation—

(i) The events listed in § 1.964–1(c)(6),

(ii) A distribution from the controlled foreign corporation to its shareholders with respect to their stock,

(iii) Any event making the controlled foreign corporation subject to tax under section 882,

(iv) An election by the controlled foreign corporation's controlling United States shareholders to use the tax book value method of allocating interest expense under section 864(e)(4), and

(v) A sale or exchange of the controlled foreign corporation's stock by the controlling United States shareholders.

The filing of the information return required by section 6038 shall not itself constitute a significant event.

(3) *Effect of failure to make required election.* If an accounting method or election is not timely adopted or made by, or on behalf of, a controlled foreign corporation, and such failure is not shown to the satisfaction of the Commissioner to be due to reasonable cause under § 1.964–1(c)(6), earnings and profits shall be computed in accordance with this section. Such computation shall be made as if no elections had been made and any permissible accounting methods not requiring an election and reflected in the books of account regularly maintained by the controlled foreign corporation for the purpose of accounting to its shareholders had been adopted. Thereafter, any change in a particular accounting method or methods may be made by, or on behalf of, the controlled foreign corporation only with the Commission's consent.

(4) *Computation of earnings and profits by a minority shareholder prior to majority election or significant event.* A minority United States shareholder (as defined in section 951(b)) of a controlled foreign corporation may be required to compute a controlled foreign corporation's earnings and profits before the controlled foreign corporation or its controlling United States shareholders make, or are required under this section to make, an election or adopt a method of accounting for United States tax purposes. In such a case, the minority United States shareholder must compute earnings and profits in accordance with this section. Such computation shall be made as if no elections had been made and any permissible accounting methods not requiring an election and reflected in the books of account regularly maintained by the controlled foreign corporation for the purpose of accounting to its shareholders had been adopted. However, a later, properly filed, and timely election or adoption of method by, or on

behalf of, the controlled foreign corporation shall not be treated as a change in accounting method.

(5) *Binding effect.* For taxable years beginning after December 31, 1986, except as otherwise provided in the Code or regulations, earnings and profits of a controlled foreign corporation shall be computed consistently under the rules of sections 964(a) and 986(b) for all federal income tax purposes. An election or adoption of a method of accounting for United States tax purposes by a controlled foreign corporation, or on its behalf pursuant to § 1.964–1(c) or any other provision of the regulations (*e.g.*, § 1.985–2(c)(3)), shall bind both the controlled foreign corporation and its United States shareholders as to the computation of the controlled foreign corporation's earnings and profits under section 964(a) for the year of the election or adoption and in subsequent taxable years unless the Commissioner consents to a change. The preceding sentence shall apply regardless of—

(i) Whether the election or adoption of a method of accounting was made in a pre-1987 or a post-1986 taxable year;

(ii) Whether the controlled foreign corporation was a controlled foreign corporation at the time of the election or adoption of method;

(iii) When ownership was acquired; or

(iv) Whether the United States shareholder received the written notice required by § 1.964–1(c)(3).

Adjustments to the appropriate separate category (as defined in § 1.904–5(a)(1)) of earnings and profits and income of the controlled foreign corporation shall be required using the principles of section 481 to prevent any duplication or omission of amounts attributable to previous years that would otherwise result from any such election or adoption.

(6) *Examples.* The following examples illustrate the rules of this section.

Example 1—(i) *P,* a calendar year domestic corporation, owns all of the outstanding stock of *FX,* a calendar year controlled foreign corporation. None of the significant events specified in § 1.964–1(c)(6) or this section has occurred. In addition, neither *P* nor *FX* has ever made or adopted, or been required to make or adopt, an election or method of accounting for United States tax purposes with respect to *FX*. On June 1, 1990, *FX* makes a distribution to *P*. *FX* does not act to make any election or adopt a method of accounting for United States tax purposes.

(ii) *P* must compute *FX*'s earnings and profits in order to determine if any portion of the distribution is taxable as a dividend and to determine *P*'s foreign tax credit on such portion under section 902. *P* must satisfy the requirements of § 1.964–1(c)(3) and file the written statement and notice described therein within 180 days after the close of *FX*'s 1990 taxable year in order to make an election or to adopt a method of accounting on behalf of *FX*. Any such election or adoption will govern the computation of earnings and profits of *FX* for all federal income tax purposes (including, *e.g.*, the determination of foreign tax credits on subpart F inclusions) in 1990 and subsequent taxable years unless the Commissioner consents to a change.

(iii) If *P* fails to satisfy the regulatory requirements in a timely manner and such failure is not shown to the satisfaction of the Commissioner to be due to reasonable cause, the earnings and profits of *FX* shall be computed as if no elections were made and any permissible methods of accounting not requiring an election and reflected in its books were adopted. Any subsequent attempt by *FX* or *P* to change an accounting method shall be effective only if the Commissioner consents to the change.

Example 2—(i) The facts are the same as in *Example 1,* except that *P* elects to allocate its interest expense under section 864(e)(4) for its 1989 taxable year under the tax book value method of § 1.861–12T(c) of the Temporary Income Tax Regulations.

(ii) *P* must compute the earnings and profits of *FX* in order to determine the adjustment to *P*'s basis in the stock of *FX* for *P*'s 1989 taxable year. *P* must satisfy the requirements of § 1.964–1(c)(3) and file the written statement and notice described therein within 180 days after the close of *FX*'s 1989 taxable year in order to make an election or to adopt a method of accounting on behalf of *FX*. Any such election or adoption will govern the computation of *FX*'s earnings and profits in 1989 and subsequent taxable years for all federal income tax purposes (including, *e.g.*, the characterization of the June 1, 1990 distribution and the determination of *P*'s foreign tax credit, if any, with respect thereto) unless the Commissioner consents to a change.

(iii) If *P* fails to satisfy the regulatory requirements in a timely manner and such failure is not shown to the satisfaction of the Commissioner to be due to reasonable cause, the earnings and profits of *FX* shall be computed as if no elections were made and any permissible methods of accounting not requiring an election and reflected in its books were adopted. Any subsequent attempt by *FX* or *P* to change an accounting method shall be effective only if the Commissioner consents to the change.

Example 3—(i) The facts are the same as in *Example 2,* except that *P* elects to allocate its interest expense under section 864(e)(4) for its 1988 taxable year under the tax book value method of §1.861–12T (c) of the Temporary Income Tax Regulations.

(ii) *P* must compute the earnings and profits of *FX* in order to determine the adjustment to *P*'s basis in the stock of *FX* for *P*'s 1988 taxable year. *P* must satisfy the requirements of §1.964–1(c)(3) and file the written statement and notice described therein within 180 days after the close of *FX*'s 1988 taxable year in order to make an election or to adopt a method of accounting on behalf of *FX*. Any such election or adoption will govern the computation of *FX*'s earnings and profits in 1988 and subsequent taxable years for all federal income tax purposes (including, *e.g.*, *P*'s basis adjustment for purposes of section 864(e)(4) in 1989 and the characterization of the June 1, 1990 distribution and the determination of *P*'s foreign tax credit, if any, with respect thereto) unless the Commissioner consents to a change.

(iii) If *P* fails to satisfy the regulatory requirements in a timely manner and such failure is not shown to the satisfaction of the Commissioner to be due to reasonable cause, the earnings and profits of *FX* for 1988 shall be computed as if no elections were made and any permissible methods of accounting not requiring an election and reflected in its books were adopted. However, a properly filed, timely election or adoption of method by, or on behalf of, *FX* with respect to its 1989 taxable year, when *P*'s basis adjustment for purposes of section 864(e)(4) first constitutes a significant event, shall not be treated as a change in accounting method. No recomputation of *P*'s basis adjustment for 1988 shall be required by reason of any such election or adoption of method with respect to *FX*'s 1989 taxable year, but prospective adjustments to *FX*'s earnings and profits and income shall be made to the extent required by §1.964–1T(g)(5).

Example 4—(i) The facts are the same as in *Example 3,* except that *FX* had subpart F income taxable to *P* in 1986, and *P* computed *FX*'s earnings and profits for purposes of determining the amount of the inclusion and the foreign taxes deemed paid by *P* in 1986 under section 960 pursuant to §1.964–1 (a) through (e).

(ii) Any election made or method of accounting adopted on behalf of *FX* by *P* pursuant to §1.964–1(c) in 1986 is binding on *P* and *FX* for purposes of computing *FX*'s earnings and profits in 1986 and subsequent taxable years. Thus, in determining *P*'s basis adjustment for purposes of section 864(e)(4) in 1988 and 1989 and its deemed-paid credit with respect to the 1990 dividend, *FX*'s earnings and profits must be computed consistently with the method used by *P* with regard to the 1986 subpart F inclusion. (However, §1.964–1 (d), (e), and (f) do not apply in computing *FX*'s earnings and profits in post-1986 taxable years.)

Example 5—(i) The facts are the same as in *Example 4,* except that *FX* made a dividend distribution to *P* on June 1, 1985, and *P* computed *FX*'s earnings and profits for purposes of computing the foreign taxes deemed paid by *P* in 1985 under section 902 with respect to the distribution under §1.964–1 exclusive of paragraphs (d), (e), and (f) pursuant to a timely election under §1.902–1(g)(1).

(ii) Any election made or method of accounting adopted on behalf of *FX* by *P* pursuant to §1.964–1(c) in 1985 is binding on *P* and *FX* for purposes of computing *FX*'s earnings and profits in 1985 and subsequent taxable years. Thus, in determining *P*'s basis adjustment for purposes of section 864(e)(4) in 1988 and 1989 and its deemed-paid credit with respect to the 1986 subpart F inclusion and the 1990 dividend, *FX*'s earnings and profits must be computed consistently with the method used by *P* with regard to the 1985 dividend. If, rather than choosing under §1.902–1(g)(1) to use the section 964 rules, *P* computed *FX*'s earnings and profits for purposes of section 902 in 1985 in all respects as if *FX* were a domestic corporation, then *P* would have been free to make elections or adopt a method of accounting on behalf of *FX* under §1.964–1(c) with respect to the subpart F inclusion in 1986. Any such election or adoption would be binding on *P* and *FX* as to the computation of *FX*'s earnings and profits in 1986 and subsequent taxable years.

[T.D. 8283, 55 FR 2516, Jan. 25, 1990; 55 FR 7711, Mar. 5, 1990]

§1.964–2 Treatment of blocked earnings and profits.

(a) *General rule.* If, in accordance with paragraph (d) of this section, it is established to the satisfaction of the district director that any amount of the earnings and profits of a controlled foreign corporation for the taxable year (determined under §1.964–1) was subject to a currency or other restriction or limitation imposed under the laws of any foreign country (within the meaning of paragraph (b) of this section) on its distribution to United States shareholders who own (within the meaning of section 958(a)) stock of such corporation, such amount shall not be included in earnings and profits for purposes of sections 952, 955 (as in effect both before and after the enactment of the Tax Reduction Act of 1975), and 956 for such taxable year. For rules governing the treatment of amounts with respect to which such restriction or limitation is removed, see paragraph (c) of this section.

(b) *Rules of application.* For purposes of paragraph (a) of this section—

(1) *Period of restriction or limitation.* An amount of earnings and profits of a controlled foreign corporation for any taxable year shall not be included in earnings and profits for purposes of sections 952, 955 (as in effect both before and after the enactment of the Tax Reduction Act of 1975), and 956 only if such amount of earnings and profits is subject to a currency or other restriction or limitation (within the meaning of subparagraph (2) of this paragraph) throughout the 150-day period beginning 90 days before the close of the taxable year and ending 60 days after the close of such taxable year.

(2) *Restriction or limitation defined.* Whether earnings and profits of a controlled foreign corporation are subject to a currency or other restriction or limitation imposed under the laws of a foreign country must be determined on the basis of all the facts and circumstances in each case. Generally, such a restriction or limitation must prevent—

(i) The ready conversion (directly or indirectly) of such currency into United States dollars, or into property of a type normally owned by such corporation in the operation of its business or other money which is readily convertible into United States dollars; or

(ii) The distribution of dividends by such corporation to its United States shareholders.

For purposes of this subparagraph, if a United States shareholder owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 80 percent or more of the total combined voting power of all classes of stock of a foreign corporation in a chain of ownership described in section 958(a), the distribution of dividends by such corporation to such shareholder will not be considered prevented solely by reason of the existence of a currency or other restriction or limitation at an intermediate tier in such chain if dividends may be distributed directly to such shareholders.

(3) *Foreign laws.* A currency or other restriction or limitation on the distribution of earnings and profits may be imposed in a foreign country by express statutory provisions, executive orders or decrees, rules or regulations of a governmental agency, court decisions, the actions of appropriate officials who are acting within the scope of their authority, or by any similar official action. A currency restriction will not be considered to exist unless export restrictions are also imposed which prevent the exportation of property of a type normally owned by the controlled foreign corporation in the operation of its business which could be readily converted into United States dollars.

(4) *Voluntary restriction or limitation.* A currency or other restriction or limitation arising from the voluntary act of the controlled foreign corporation or its United States shareholders during a taxable year beginning after December 31, 1962, will not be taken into account. For example, if a controlled foreign corporation—

(i) Issues a stock dividend which has the effect of capitalizing earnings and profits;

(ii) Elects to restrict its earnings and profits or to make certain investments as a means of avoiding current tax or securing a reduced rate of tax; or

(iii) Allocates earnings and profits to an optional or arbitrary reserve; such restriction is voluntary and will not be taken into account.

(5) *Treatment of earnings and profits in cases of certain mandatory reserves*—(i) *In general.* If a controlled foreign corporation is required under the laws of a foreign country to establish a reserve out of earnings and profits for the taxable year, such earnings and profits shall be considered subject to a restriction or limitation by reason of such requirement only to the extent that the amount required to be included in such reserve at the close of the taxable year exceeds the accumulated earnings and profits (determined in accordance with subdivision (ii) of this subparagraph) of such corporation at the close of the preceding taxable year.

(ii) *Determination of earnings and profits.* For purposes of determining the accumulated earnings and profits of a controlled foreign corporation under subdivision (i) of this subparagraph, such earnings and profits shall not include any amounts which are attributable to—

(a) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder under section 951(a) and have not been distributed;

(b) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such foreign corporation under section 551(b) and have not been distributed; or

(c) Amounts which become subject to a voluntary restriction or limitation (within the meaning of subparagraph (4) of this paragraph) during a taxable year beginning before January 1, 1963.

The rules of this subdivision apply only in determining the accumulated earnings and profits of a controlled foreign corporation for purposes of this subparagraph. See section 959 and the regulations thereunder for limitations on the exclusion from gross income of previously taxed earnings and profits.

(6) *Exhaustion of procedures for distributing earnings and profits.* Earnings and profits of a controlled foreign corporation for a taxable year will not be considered subject to a currency or other restriction or limitation on their distribution unless the United States shareholders of such corporation demonstrate either that the available procedures for distributing such earnings and profits have been exhausted or that the use of such procedures will be futile. As a general rule, such procedures will be considered to have been exhausted if the foreign corporation applies for dollars (or foreign currency readily convertible into dollars) at the appropriate rate of exchange and complies with the applicable laws and regulations governing the acquisition and transfer of such currency including submission of the necessary documentation to the exchange authority. The fact that available procedures for distributing earnings and profits were exhausted without success with respect to a prior year is not, of itself, sufficient evidence that such procedures would not be successful with respect to the current taxable year.

(c) *Removal of restriction or limitation*—(1) *In general.* If, during any taxable year, a currency or other restriction or limitation (within the meaning of paragraph (b) of this section) imposed under the laws of a foreign country on the distribution of earnings and profits of a controlled foreign corporation to its United States shareholders is removed—

(i) *Treatment of deferred income.* Each United States shareholder of such corporation on the last day in such year that such corporation is a controlled foreign corporation shall include in his gross income for such taxable year the amounts attributable to such earnings and profits which would have been includible in his gross income under section 951(a) for prior taxable years but for the existence of the currency or other restriction or limitation except that the amounts included under this subdivision (i) shall not exceed his pro rata share of—

(a) The earnings and profits upon which the restriction was removed determined on the basis of his stock ownership on the last day of the immediately preceding taxable year, and

(*b*) The applicable limitations under paragraph (c) of §1.952–1, paragraph (b)(2) of §1.955–1, paragraph (b)(2) of §1.955A–1, or paragraph (b) of §1.956–1, determined as of the last day of the immediately preceding taxable year, taking into account the provisions of subdivision (ii) of this subparagraph.

(ii) *Treatment of earnings and profits.* For purposes of sections 952, 955 (as in effect both before and after the enactment of the Tax Reduction Act of 1975), and 956, the earnings and profits which are no longer subject to a currency or other restriction or limitation shall be treated as included in the corporation’s earnings and profits for the year in which such earnings and profits were derived.

Amounts with respect to which a currency or other restriction or limitation is removed shall be translated into United States dollars at the appropriate exchange rate for the translation period during which such currency or other restriction or limitation is removed. See paragraph (d) of § 1.964–1. Amounts with respect to which a currency or other restriction or limitation is removed shall not be taken into account in determining whether a deficiency distribution (within the meaning of § 1.963–6 (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975)) is required to be made for the year in which such earnings and profits were derived.

(2) *Removal of restriction or limitation defined.* An amount of earnings and profits shall be considered no longer subject to a limitation or restriction if and to the extent that—

(i) Money or property in such foreign country is readily convertible into United States dollars, or into other money or property of a type normally owned by such corporation in the operation of its business which is readily convertible into United States dollars;

(ii) Notwithstanding the existence of any laws or regulations forbidding the exchange of money or property into United States dollars, conversion is actually made into United States dollars, or other money or property of a type normally owned by such corporation in the operation of its business which is readily convertible into United States dollars; or

(iii) A mandatory reserve requirement (described in paragraph (b)(5) of this section) is removed either by a change in law of the foreign country imposing such requirement or by an accumulation of earnings and profits not subject to such requirement.

(3) *Distribution in foreign country.* If, during any taxable year, earnings and profits previously subject to a currency or other restriction or limitation are distributed in a foreign country to one or more United States shareholders of a controlled foreign corporation directly, or indirectly through a chain of ownership described in section 958(a), such earnings and profits shall be considered no longer subject to a restriction or limitation. However, distributed amounts may be excluded from such shareholder's gross income for the taxable year of receipt if such shareholder elects a method of accounting under which the reporting of blocked foreign income is deferred until the income ceases to be blocked.

(4) *Source of distribution.* If, during any taxable year, earnings and profits previously subject to a currency or other restriction or limitation is distributed to one or more United States shareholders of a controlled foreign corporation directly, or indirectly through a chain of ownership described in section 958(a), the source of such distribution shall be determined in accordance with the rules of § 1.959–3.

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

Example. (a) M, a United States person, owns all of the only class of stock of A Corporation, a foreign corporation incorporated under the laws of foreign country X on January 1, 1963. Both M and A Corporations use the calendar year as a taxable year and A Corporation is a controlled foreign corporation throughout the period here involved.

(b) During 1963, A Corporation derives income of $100,000 all of which is subpart F income and has earnings and profits of $100,000. Under the laws of X Country, currency cannot be exported without a license. During the last 90 days of 1963 and the first 60 days of 1964, A Corporation can obtain a license to distribute only an amount equivalent to $10,000. M must include $10,000 in his gross income for 1963 under section 951(a)(1)(A)(i) and $90,000 of A Corporation's earnings and profits for 1963 are not taken into account for purposes of sections 952, 955, and 956.

(c) During 1964, A Corporation has no income and no earnings and profits. On June 1, 1964, A Corporation converts an amount equivalent to $20,000 into property of a type normally owned by such corporation in the operation of its business which is readily convertible into United States dollars but does not distribute such amount. Corporation A must include $20,000 in its earnings and profits for 1963 for purposes of sections 952, 955, and 956. M must include $20,000 in his gross income for 1964.

(d) During 1965, A Corporation has no income and no earnings and profits. On December 15, 1965, A Corporation distributes an amount equivalent to $15,000 to M in X Country. Neither M nor A Corporation can obtain a license to export currency from X Country. In his return for the taxable year 1965, M elects a method of accounting under which the reporting of blocked foreign income is deferred until the income ceases to be blocked. Accordingly, M does not include the $15,000 in his gross income for 1965.

(e) During 1966, A Corporation has no income and no earnings and profits. On February 1, 1966, notwithstanding the laws and regulations of X Country which forbid the exchange of X Country's currency into

United States dollars, M converts an amount equivalent to $15,000 into a currency which is readily convertible into United States dollars. Since the income has ceased to be blocked, M must include $15,000 in his gross income for 1966.

(d) *Manner of claiming existence of restriction or limitation on distribution of earnings and profits.* A United States shareholder claiming that an amount of the earnings and profits of a controlled foreign corporation for the taxable year was subject to a currency or other restriction or limitation imposed under the laws of a foreign country on its distribution shall file a statement with his return for the taxable year with or within which the taxable year of the foreign corporation ends which shall include—

(1) The name and address of the foreign corporation,

(2) A description of the classes of stock of the foreign corporation and a statement of the number of shares of each class owned (within the meaning of section 958(a)) or considered as owned (by applying the rules of ownership of section 958(b)) by the United States shareholder,

(3) A description of the currency or other restriction or limitation on the distribution of earnings and profits,

(4) The total earnings and profits of the foreign corporation for the taxable year (before any amount is excluded from earnings and profits under this section) and the United States shareholder's pro rata share of such total earnings and profits,

(5) The United States shareholder's pro rata share of the amount of earnings and profits subject to a restriction or limitation on distribution,

(6) The amounts which would be includible in the United States shareholder's gross income under section 951(a) but for the existence of the currency or other restriction or limitation,

(7) A description of the available procedures for distributing earnings and profits and a statement setting forth the steps taken to exhaust such procedures or a statement setting forth the reasons that the use of such procedures would be futile, and

(8) The amount of distributions made in a foreign country and a statement as to whether a method of accounting has been elected under which the reporting of blocked income is deferred until such income ceases to be blocked, including an identification of the taxable year and place of filing of such election.

In addition, such United States shareholder shall furnish to the district director such other information as he may require to verify the status of a currency or other restriction or limitation.

[T.D. 6892, 31 FR 11142, Aug. 23, 1966, as amended by T.D. 7545, 43 FR 19652, May 8, 1978; T.D. 7893, 48 FR 22510, May 19, 1983]

§ 1.964–3 Records to be provided by United States shareholders.

(a) *Shareholder's responsibility for providing records.* For purposes of verifying his income tax liability in respect of amounts includible in income under section 951 for the taxable year of a controlled foreign corporation each United State shareholder (as defined in section 951(b)) who owns (within the meaning of section 958(a)) stock of such corporation shall, within a reasonable time after demand by the district director, provide the district director—

(1) Such permanent books of account or records as are sufficient to satisfy the requirements of section 6001 and section 964(c), or true copies thereof, as are reasonably demanded, and

(2) If such books or records are not maintained in the English language, either (i) an accurate English translation of such books or records or (ii) the services of a qualified interpreter satisfactory to the district director.

If such books or records are being used by another district director, the United States shareholder upon whom the district director has made a demand to provide such books or records shall file a statement of such fact with his district director, indicating the location of such books or records. For the length of time the United States shareholder of a controlled foreign corporation must cause such books or records as are under his control to be retained, see paragraph (e) of § 1.6001–1.

(b) *Records to be provided.* Except as otherwise provided in paragraph (c) of this section, the requirements of section 6001 and section 964(c) for record keeping shall be considered satisfied if the books or records produced are sufficient to verify for the taxable year—

(1) The subpart F income of the controlled foreign corporation and, if any part of such income is excluded from the income of the United States shareholder under section 963 or section 970(a), the application of such exclusion,

(2) The previously excluded subpart F income of such corporation withdrawn from investment in less developed countries,

(3) The previously excluded subpart F income of such corporation withdrawn from investment in foreign base company shipping operations,

(4) The previously excluded export trade income of such corporation withdrawn from investment, and

(5) The increase in earnings invested by such corporation in United States property.

(c) *Special rules.* Verification of the subpart F income of the controlled foreign corporation for the taxable year shall not be required if—

(1) It can be demonstrated to the satisfaction of the district director that—

(i) The locus and nature of such corporation's activities were such as to make it unlikely that the foreign base company income of such corporation (determined in accordance with paragraph (c)(3) of §1.952–3) exceeded 5 percent of its gross income (determined in accordance with paragraph (b)(1) of §1.952–3) for the taxable year. (For taxable years to which §1.952–3 does not apply, such amounts shall be determined under 26 CFR §1.954–1(d)(3)(i) and (ii) (Revised as of April 1, 1975))), and

(ii) If such corporation reinsures or issues insurance or annuity contracts in connection with United States risks, the 5-percent minimum premium requirement prescribed in paragraph (b) of §1.953–1 has not been exceeded for the taxable year, or

(2) The United States shareholder's pro rata share of such subpart F income is excluded in full from his income under section 963 and the books or records verify the application of such exclusion.

[T.D. 6824, 30 FR 6480, May 11, 1965, as amended by T.D. 7893, 48 FR 22510, May 19, 1983]

§1.964–4 Verification of certain classes of income.

(a) *In general.* The provisions of this section shall apply for purposes of determining when books or records are sufficient for purposes of §1.964–3 to verify the classes of income described in such section.

(b) *Subpart F income.* Books or records sufficient to verify the subpart F income of a controlled foreign corporation must establish for the taxable year—

(1) Its gross income and deductions,

(2) The income derived from the insurance of United States risks (as provided in paragraph (c) of this section),

(3) The foreign base company income (as provided in paragraph (d) of this section), and

(4) In the case of a United States shareholder claiming the benefit of the exclusion provided in section 952(b) or the limitation provided in section 952(c)—

(i) The items of income excluded from subpart F income by paragraph (b) of §1.952–1 as income derived from sources within the United States, the United States income tax incurred with respect thereto, and the deductions properly allocable thereto and connected therewith, and

(ii) The earnings and profits, or deficit in earnings and profits, of any foreign corporation necessary for the determinations provided in paragraphs (c) and (d) of §1.952–1.

(c) *Income from insurance of United States risks.* Books or records sufficient to verify the income of a controlled foreign corporation from the insurance of United States risks must establish for the taxable year—

(1) That the 5-percent minimum premium requirement prescribed in paragraph (b) of §1.953–1 has not been exceeded, or

(2) The taxable income, as determined under §1.953–4 or §1.953–5, which is attributable to the reinsuring or the issuing of any insurance or annuity contracts in connection with United States risks, as defined in §1.953–2 or §1.953–3.

(d) *Foreign base company income and exclusions therefrom.* Books or records sufficient to verify the income of a controlled foreign corporation which is foreign base company income must establish for the taxable year the following items:

(1) *Foreign personal holding company income.* The foreign personal holding company income to which section 954(c) and § 1.954–2 apply, for which purpose there must be established the gross income from—

(i) All rents and royalties,

(ii) Rents and royalties received in the active conduct of a trade or business from an unrelated person, as determined under section 954(c)(3)(A) and paragraph (d)(1) of § 1.954–2,

(iii) Rents and royalties received from a related person for the use of property in the country of incorporation of the controlled foreign corporation, as determined under section 954(c)(4)(C) and paragraph (e)(3) of § 1.954–2,

(iv) All dividends, interest, and except where the controlled foreign corporation is a regular dealer in stock or securities, all gains and losses from the sale or exchange of stock or securities,

(v) Dividends, interest, and gains from the sale or exchange of stock or securities, received in the conduct of a banking, financing, or insurance business from an unrelated person, as determined under section 954(c)(3)(B) and paragraph (d)(2) and (3) of § 1.954–2,

(vi) Dividends and interest received from a related corporation organized in the country of incorporation of the controlled foreign corporation, as determined under section 954(c)(4)(A) and paragraph (e)(1) of § 1.954–2,

(vii) Interest received in the conduct of a banking or other financing business from a related person, as determined under section 954(c)(4)(B) and paragraph (e)(2) of § 1.954–2,

(viii) All annuities,

(ix) All gains from commodities transactions described in section 553(a)(3),

(x) All income from estates and trusts described in section 553(a)(4),

(xi) All income from personal service contracts described in section 553(a)(5), and

(xii) All compensation for the use of corporate property by shareholders described in section 553(a)(6).

(2) *Foreign base company sales income.* The foreign base company sales income to which section 954(d) and § 1.954–3 apply, for which purpose there must be established the gross income from—

(i) All sales by the controlled foreign corporation of its personal property and all purchases or sales of personal property by such corporation on behalf of another person,

(ii) Purchases and/or sales of personal property in connection with transactions not involving related persons (as defined in paragraph (e)(2) of § 1.954–1),

(iii) Purchases and/or sales of personal property manufactured, produced, etc., in the country of incorporation of the controlled foreign corporation, as determined under paragraph (a)(2) of § 1.954–3,

(iv) Purchases and/or sales of personal property for use, etc., in the country of incorporation of the controlled foreign corporation, as determined under paragraph (a)(3) of § 1.954–3, and

(v) Sales of personal property manufactured or produced by the controlled foreign corporation, as determined under paragraph (a)(4) of § 1.954–3.

Where an item of income falls within more than one of subdivisions (ii) through (v) of this subparagraph, it shall be sufficient to establish that it falls within any one of them. If a branch or similar establishment is treated as a wholly owned subsidiary corporation through the application of section 954(d)(2) and paragraph (b) of § 1.954–3, the requirements of this subparagraph shall be satisfied separately for each branch or similar establishment so treated and for the remainder of the controlled foreign corporation.

(3) *Foreign base company services income.* The foreign base company services income to which section 954(e) and § 1.954–4 apply, for which purpose there must be established the gross income from—

(i) All services performed by the controlled foreign corporation,

(ii) Services other than those (as determined under paragraph (b) of § 1.954–4) performed for, or on behalf of, a related person,

(iii) Services performed in the country of incorporation of the controlled foreign corporation, as determined under paragraph (c) of § 1.954–4, and

(iv) Services performed in connection with the sale or exchange of, or with an offer or effort to sell or exchange, personal property manufactured, produced, etc., by the controlled foreign corporation, as determined under paragraph (d) of §1.954–4.

Where an item of income falls within more than one of subdivisions (ii) through (iv) of this subparagraph, it shall be sufficient to establish that it falls within any one of them.

(4) *Foreign base company oil related income.* (i) The foreign base company oil related income described in section 954(g) and §1.954–8, for which purpose there must be established, with respect to each foreign country, the gross income derived from—

(A) The processing of minerals extracted (by the taxpayer or by any other person) from oil or gas wells into their primary products, as determined under section 907(c)(2)(A),

(B) The transportation of such minerals or primary products, as determined under section 907(c)(2)(B),

(C) The distribution or sale of such minerals or primary products, as determined under section 907(c)(2)(C),

(D) The disposition of assets used by the taxpayer in a trade or business described in subdivision (A), (B) or (C), as determined under section 907(c)(2)(D),

(E) Dividends, interests, partnership distributions, and other amounts, as determined under section 907(c)(3).

Where an item of income falls within more than one of the listings in paragraphs (d)(4)(i)(A) through (E) of this section, it shall be sufficient to establish that it falls within any one of them.

(ii) If any of the items of income listed in paragraph (d)(4)(i) of this section arising from sources within a foreign country relates to oil, gas, or a primary product thereof and is described in section 954(g)(1)(A) or (B) and §1.954–8(a)(1)(i) or (ii) (and, hence, is not foreign base company oil related income), then there must be established facts sufficient to verify the amount of such item of income which is not foreign base company oil related income. In this regard, the total quantities of oil, gas and primary products thereof which gave rise to such item of income and the portions of such quantities which were extracted or sold within the foreign country must be established.

(5) *Qualified investments in less developed countries.* For rules in effect for taxable years of foreign corporations beginning before January 1, 1976, see 26 CFR 1.964–4(d)(4) (Revised as of April 1, 1975).

(6) *Income derived from aircraft or ships.* For rules in effect for taxable years of foreign corporations beginning before January 1, 1976, see CFR §1.964–4(d)(5) (Revised as of April 1, 1975).

(7) *Foreign base company shipping income.* The foreign base company shipping income to which section 954(f) and §1.954–6 apply, for which purpose there must be established—

(i) Gross income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, as determined under §1.954–6(c),

(ii) Gross income derived from, or in connection with, the performance of services directly related to the use of any aircraft or vessel in foreign commerce, as determined under §1.954–6(d),

(iii) Gross income incidental to income described in subdivisions (i) and (ii) of this subparagraph, as determined under §1.954–6(e),

(iv) Gross income derived from the sale, exchange, or other disposition of any aircraft or vessel used (by the seller or by a person related to the seller) in foreign commerce,

(v) Dividends, interest, and gains described in §§1.954–6(f) and 1.954(b)(1)(viii),

(vi) Income described in §1.954–6(g) (relating to partnerships, trusts, etc.), and

(vii) Exchange gain, to the extent allocable to foreign base company shipping income, as determined under §1.952–2(c)(2)(v)(*b*).

If the controlled foreign corporation has income derived from or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, or derived from, or in connection with, the performance of services directly related to the use of any aircraft or vessel in foreign commerce, it shall be necessary to establish, from the books and records of the controlled foreign corporation, that such aircraft or vessel was used in foreign commerce within the meaning of subparagraphs (3) and (4) of § 1.954–6(b).

(8) *Income on which taxes are not substantially reduced.* The gross income excluded from foreign base company income under section 954(b)(4) and paragraph (b)(3) or (4) of § 1.954–1 in the case of a controlled foreign corporation not availed of to substantially reduce income taxes, the income or similar taxes incurred with respect thereto, and all other factors necessary to verify the application of such exclusion.

(9) *Qualified investments in foreign base company shipping operations.* The foreign base company shipping income that is excluded from foreign base company income under section 954(b)(2) and § 1.954–1(b)(1).

(10) *Special rule for shipping income.* The distributions received through a chain of ownership described in section 958(a) which are excluded from foreign base company income under section 954(b)(6)(B) and § 1.954–1(b)(2).

(11) *Deductions.* The deductions allocable, under paragraph (c) of § 1.954–1, to each of the classes and subclasses of gross income described in subparagraphs (1) through (9) of this paragraph.

(e) *Exclusion under section 963.* Books or records sufficient to verify the application of the exclusion provided by section 963 with respect to the subpart F income for the taxable year of a controlled foreign corporation must establish that the conditions set forth in paragraph (a)(2) of § 1.963–1 have been met.

(f) *Exclusion under section 970(a).* Books or records sufficient to verify the application for the taxable year of the exclusion provided by section 970(a) in respect of export trade income which is foreign base company income must establish for such year—

(1) That the controlled foreign corporation is an export trade corporation, as defined in section 971(a) and paragraph (a) of § 1.971–1,

(2) The export trade income, as determined under section 971(b) and paragraph (b) of § 1.971–1, which constitutes foreign base company income,

(3) The export promotion expenses, as determined under section 971(d) and paragraph (d) of § 1.971–1, which are allocable to the excludable export trade income,

(4) The gross receipts, and the gross amount on which is computed compensation included in gross receipts, from property in respect of which the excludable export trade income is derived, as described in section 970(a)(1)(B) and paragraph (b)(2)(ii) of § 1.970–1, and

(5) The increase in investments in export trade assets, as determined under section 970(c)(2) and paragraph (d)(2) of § 1.970–1.

(g–1) *Withdrawal of previously excluded subpart F income from qualified investment in less developed countries.* Books or records sufficient to verify the previously excluded subpart F income of the controlled foreign corporation withdrawn from investment in less developed countries for the taxable year must establish—

(1) The sum of the amounts of income excluded from foreign base company income under section 954(b)(1) and paragraph (b)(1) of § 1.954–1 (as in effect for taxable years beginning before January 1, 1976; see 26 CFR 1.954–1(b)(1) (Revised as of April 1, 1975)) for all prior taxable years,

(2) The sum of the amounts of previously excluded subpart F income withdrawn from investment in less developed countries for all prior taxable years, as determined under section 955(a) (as in effect before the enactment of the Tax Reduction Act of 1975) and paragraph (b) of § 1.955–1, and

(3) The amount withdrawn from investment in less developed countries for the taxable year as determined under section 955(a) (as in effect before the enactment of the Tax Reduction Act of 1975) and paragraph (b) of § 1.955–1.

(g–2) *Withdrawal of previously excluded subpart F income from investment in foreign base company shipping operations.* Books or records sufficient to verify the previously excluded subpart F income of the controlled foreign corporation withdrawn from investment in foreign base company shipping operations for the taxable year must establish—

(1) The sum of the amounts of income excluded from foreign base company income under section 954(b)(2) and

paragraph (b)(1) of §1.954–1 for all prior taxable years,

(2) The sum of the amounts of previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for all prior taxable years, as determined under section 955(a) and paragraph (b) of §1.955A–1,

(3) The amount withdrawn from investment in foreign base company shipping operations for the taxable year as determined under section 955(a) and paragraph (b) of §1.955A–1, and

(4) If the carryover (as described in §1.955A–1(b)(3)) of amounts relating to investments in less developed country shipping companies (as described in §1.995–5(b)) is applicable, (i) the amount of the corporation's qualified investments (determined under §1.955–2 other than paragraph (b)(5) thereof) in less developed country shipping companies at the close of the last taxable year of the corporation beginning before January 1, 1976, and (ii) the amount of the limitation with respect to previously excluded subpart F income (determined under §1.955–1(b)(1)(i)(*b*)) for the first taxable year of the corporation beginning after December 31, 1975.

(h) *Withdrawal of previously excluded export trade income from investment.* Books or records sufficient to verify the previously excluded export trade income of the controlled foreign corporation withdrawn from investment for the taxable year must establish the United States shareholder's proportionate share of—

(1) The sum of the amounts by which the subpart F income of such corporation was reduced for all prior taxable years under section 970(a) and paragraph (b) of §1.970–1,

(2) The sum of the amounts described in section 970(b)(1)(B),

(3) The sum of the amounts of previously excluded export trade income of such corporation withdrawn from investment under section 970(b) and paragraph (c) of §1.970–1 for all prior taxable years, and

(4) The amount withdrawn from investment under section 970(b) and paragraph (c) of §1.970–1 for the taxable year.

(i) *Increase in earnings invested in United States property.* Books or records sufficient to verify the increase for the taxable year in earnings invested by the controlled foreign corporations in United States property must establish—

(1) The amount of such corporation's earnings invested in United States property (as defined in section 956(b)(1) and paragraph (a) of §1.956–2) at the close of the current and preceding taxable years, as determined under paragraph (b) of §1.956–1,

(2) The amount of excluded property described in section 956(b)(2) and paragraph (b) of §1.956–2 held by such corporation at the close of such years,

(3) The earnings and profits, to which section 959(c)(1) and paragraph (b)(1) of §1.959–3 apply, distributed by such corporation during the preceding taxable year, and

(4) The amount of increase in earnings invested by such corporation in United States property which is excluded from the United States shareholder's gross income for the taxable year under section 959(a)(2) and paragraph (c) of §1.959–1.

[T.D. 6824, 30 FR 6481, May 11, 1965, as amended by T.D. 7211, 37 FR 21436, Oct. 11, 1972; T.D. 7893, 48 FR 22511, May 19, 1983; T.D. 8331, 56 FR 2849, Jan. 25, 1991]

§1.964–5 Effective date of subpart F.

Sections 951 through 964 and §§1.951 through 1.964–4 shall apply with respect to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States shareholders within which or with which such taxable years of such corporations end.

[T.D. 7120, 36 FR 10862, June 4, 1971

EXPORT TRADE CORPORATIONS

§1.970–1 Export trade corporations.

(a) *In general.* Sections 970 through 972 provide in general that if a controlled foreign corporation is an export trade corporation for any taxable year, the subpart F income of such corporation shall, subject to limitations provided by section 970(a) and paragraph (b) of this section, be reduced by so much of such corporation's export trade income as constitutes foreign base company income. To the extent subpart F income of an export trade corporation is reduced under section 970 and this section, an amount is required by section 970(b) and paragraph (c) of this section to be included in gross income of United States shareholders of the corporation if there is a subsequent decrease in such corporation's investments in export trade assets. See section 971(a) and paragraph (a) of § 1.971–1 for definition of the term ''export trade corporation'', section 971(b) and paragraph (b) of § 1.971–1 for definition of the term ''export trade income'', and section 971(c) and paragraph (c) of § 1.971–1 for definition of the term ''export trade assets''.

(b) *Amount by which export trade income shall reduce subpart F income*—(1) *Deductible amount.* The subpart F income, determined as provided in section 952 and the regulations thereunder but without regard to section 970 and this paragraph, of a controlled foreign corporation which is an export trade corporation for its taxable year shall be reduced by an amount equal to so much of its export trade income as constitutes foreign base company income for such taxable year, but only to the extent that such amount of export trade income does not exceed the limitation determined under subparagraph (2) of this paragraph for such taxable year. See section 972 and § 1.972–1 for rules relating to the consolidation of export trade corporations for purposes of determining the limitations described in subparagraph (2) of this paragraph.

(2) *Limitation on the amount of export trade income deductible from subpart F income.* The amount by which subpart F income of an export trade corporation may be reduced for any taxable year under subparagraph (1) of this paragraph may not exceed whichever of the following limitations is the smallest:

(i) The amount which is equal to 150 percent of the export promotion expenses, as defined in section 971(d) and paragraph (d) of § 1.971–1, of the export trade corporation paid or incurred during the taxable year which are properly allocable to the receipt or the production of so much of its export trade income as constitutes foreign base company income for such taxable year;

(ii) The amount which is equal to 10 percent of the gross receipts (other than from commissions, fees, or other compensation for services), plus 10 percent of the gross amount upon the basis of which are computed commissions, fees, or other compensation for services included in gross receipts, of the export trade corporation received or accrued during the taxable year from, or in connection with, the sale, installation, operation, maintenance, or use of property in respect of which such corporation derives export trade income which constitutes foreign base company income for such taxable year; or

(iii) The amount which bears the same ratio to the increase in investments in export trade assets, as defined in section 970(c)(2) and paragraph (d)(2) of this section, of the export trade corporation for its taxable year as the export trade income which constitutes foreign base company income of such corporation for such taxable year bears to the entire export trade income of the corporation for such year.

Under subdivision (ii) of this subparagraph, in the case of minimum or maximum fee arrangements, the determination shall be made on the basis of the actual gross amounts with respect to which such fees are paid, rather than on the basis of the amounts upon which such minimum or maximum fees are computed. All determinations of limitations under this subparagraph shall be made on an aggregate basis and not with respect to separate items or categories of income described in paragraph (b)(1) of § 1.971–1.

(3) *Determination of export promotion expense limitation.* For purposes of determining the limitation contained in subparagraph (2)(i) of this paragraph for any taxable year of the export trade corporation, there shall be taken into account with respect to those items or categories of export trade income which constitute foreign base company income the entire amount of those export promotion expenses which are directly related to such items or categories of income and a ratable part of any other export promotion expenses which are indirectly related to such items or categories of income, except that no export promotion expense shall

be allocated to an item or category of income to which it clearly does not apply and no deduction allowable to such corporation under section 882(c) and the regulations thereunder shall be taken into account.

(4) *Application of section 482.* The limitations provided in section 970(a) and subparagraph (2) of this paragraph shall not affect the authority of the district director to apply the provisions of section 482 and the regulations thereunder, relating to allocation of income and deductions among taxpayers.

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

Example 1. Foreign corporation A is a wholly owned subsidiary of domestic corporation M. Both corporations use the calendar year as the taxable year. For 1963, A Corporation's subpart F income determined under section 952 and the regulations thereunder is $35, the total of its gross receipts and gross amounts referred to in subparagraph (2)(ii) of this paragraph is $310, its export promotion expenses properly allocable to its export trade income which constitutes foreign base company income are $18, its increase in investments in export trade assets is $32, and its export trade income is $40, of which $30 constitutes foreign base company income and $10 does not constitute foreign base company income. The subpart F income of A Corporation for 1963 as reduced under section 970(a) is $11, determined as follows:

(i) Subpart F income		$35
(ii) Less: $30 export trade income which constitutes foreign base company income, but deduction not to exceed the smallest of the following limitations (smallest of *(a), (b),* or *(c)):*		
(a) 150 percent of allocable export promotion expenses referred to in subparagraph (2)(i) of this paragraph (150% of $18)	$27	
(b) 10 percent of gross receipts and gross amounts referred to in subparagraph (2)(ii) of this paragraph (10% of $310)	$31	
(c) Amount which bears to the increase in investments in export trade assets ($32) the same ratio as the export trade income which constitutes foreign base company income ($30) bears to total export trade income ($40) (75% [$30/$40] of $32)	$24	$24
(iii) Subpart F income as reduced under section 970(a)		11

Example 2. The facts are the same as in example 1, except that A Corporation's export promotion expenses properly allocable to export trade income which constitutes foreign base company income are $14 instead of $18. The applicable limitation on the amount deductible from A Corporation's subpart F income for 1963 is $21 (150% of $14) instead of $24. The subpart F income as reduced under section 970(a) is $14 ($35 less $21).

Example 3. The facts are the same as in example 1, except that the total amount of A Corporation's gross receipts and gross amounts referred to in subparagraph (2)(ii) of this paragraph is $200 instead of $310. The applicable limitation on the amount deductible from A Corporation's subpart F income for 1963 is $20 (10 percent of $200) instead of $24. The subpart F income as reduced under section 970(a) is $15 ($35 less $20).

Example 4. The facts are the same as in example 1, except that A Corporation derives its export trade income which constitutes foreign base company income of $30 in a service arrangement with M Corporation under which it receives as a fee 5 percent of the gross receipts from M Corporation's sales or a minimum fee of $30. Such gross receipts are $220. The gross amounts taken into account in determining the limitation under subparagraph (2)(ii) of this paragraph are $220. The applicable limitation on the amount deductible from A Corporation's subpart F income for 1963 is $22 (10 percent of $220) instead of $24. The subpart F income as reduced under section 970(a) is $13 ($35 minus $22).

Example 5. The facts are the same as in example 1, except that A Corporation derives its export trade income which constitutes foreign base company income of $30 in a service arrangement with M Corporation under which it receives as a fee 9 percent of the gross receipts from M Corporation's sales or a maximum fee of $30. Such gross receipts are $400. In such instance, the limitation under (ii)*(b)* of example 1 is $40 (10 percent of $400) instead of $31. The applicable limitation on the amount deductible from A Corporation's subpart F income for 1963 is $24, the smallest of the three limitations. The subpart F income as reduced under section 970(a) is $11 ($35 less $24).

(c) *Withdrawal of previously excluded export trade income*—(1) *Inclusion of withdrawal in income of United States shareholders.* If—

(i) A controlled foreign corporation was an export trade corporation for any taxable year,

(ii) Such corporation in any such taxable year derived subpart F income which, under the provisions of section 970(a) and paragraph (b) of this section, was reduced, and

(iii) Such corporation has in a subsequent taxable year a decrease in investments in export trade assets, every person who is a United States shareholder, as defined in section 951(b), of such corporation on the last day of such subsequent taxable year on which such corporation is a controlled foreign corporation shall include in his gross income, under section 951(a)(1)(A)(ii) and the regulations thereunder as an amount to which section 955 (as in effect before the enactment of the Tax Reduction Act of 1975) applies, his pro rata share of the amount of such decrease in investments but only to the extent that such pro rata share does not exceed the limitations determined under subparagraph (2) of this paragraph. A United States shareholder's pro rata share of a controlled foreign corporation's decrease for any taxable year in investments in export trade assets shall be his pro rata share of such corporation's decrease for such year determined under section 970(c)(3) and paragraph (d)(3) of this section.

(2) *Limitations applicable in determining amount includible in income*—(i) *General.* A United States shareholder's pro rata share of a controlled foreign corporation's decrease in investments in export trade assets for any taxable year of such corporation shall, for purposes of determining an amount to be included in the gross income for any taxable year of such shareholder, not exceed the lesser of the limitations determined under *(a)* and *(b)* of this subdivision:

(a) Such shareholder's pro rata share of the sum of the controlled foreign corporation's earnings and profits (or deficit in earnings and profits) for the taxable year, computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year, plus his pro rata share of the sum of its earnings and profits (or deficits in earnings and profits) accumulated for prior taxable years beginning after December 31, 1962, or

(b)(1) Such shareholder's pro rata share of the sum of the amounts by which the subpart F income of such controlled foreign corporation for prior taxable years was reduced under section 970(a) and paragraph (b) of this section, plus

(2) Such shareholder's pro rata share of the sum of the amounts which were not included in the subpart F income of such controlled foreign corporation for such prior taxable years by reason of the application of section 972 and § 1.972–1, minus

(3) Such shareholder's pro rata share of the sum of the amounts which were previously included in his gross income for prior taxable years under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) and this paragraph with respect to such controlled foreign corporation.

The net amount determined under *(b)* of this subdivision with respect to any stock owned by the United States shareholder shall be determined without taking into account any amount attributable to a period prior to the date on which such shareholder acquired such stock. See section 1248 and the regulations thereunder for rules governing the treatment of gain from sales or exchanges of stock in certain foreign corporations.

(ii) *Treatment of earnings and profits.* For purposes of determining earnings and profits of a controlled foreign corporation under subdivision (i) *(a)* of this subparagraph, such earnings and profits shall be considered not to include any amounts which are attributable to—

(a) Amounts which are, or have been, included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a) (other than an amount included in the gross income of a United States shareholder under section 951(a)(1)(A)(ii) or section 951(a)(1)(B) for the taxable year) and have not been distributed, or

(b)(1) Amounts which for the current taxable year, are included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) or would be so included under such section but for the fact that such amounts were distributed to such shareholder during the taxable year, or

(2) Amounts which, for any prior taxable year, have been included in the

gross income of a United States shareholder of such controlled foreign corporation under section 551(b) and have not been distributed.

The rules of this subdivision apply only in determining the limitation on a United States shareholder's pro rata share of a controlled foreign corporation's decrease in investments in export trade assets. See section 959 and the regulations thereunder for limitations on the exclusion of previously taxed earnings and profits.

(iii) *Rules of application.* The determinations made under subdivision (i) of this subparagraph for purposes of determining the United States shareholder's pro rata share of a controlled foreign corporation's decrease in investments in export trade assets for any taxable year shall be made on the basis of the stock such shareholder owns, within the meaning of section 958(a) and the regulations thereunder, in the controlled foreign corporation on the last day in the taxable year on which such corporation is a controlled foreign corporation even though such shareholder owned more or less stock in such corporation prior to that date. See section 972 and paragraph (b)(3) of §1.972–1 for rules relating to the allocation of a decrease in investments in export trade assets of export trade corporations in a consolidated chain of such corporations. See section 951(a)(3) and the regulations thereunder for an additional limitation upon the amount of a United States shareholder's pro rata share determined under this paragraph.

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

Example 1. Foreign corporation A, which has one class of stock outstanding, is a wholly owned subsidiary of domestic corporation M throughout 1963 and 1964. Both corporations use the calendar year as the taxable year. For 1963, A Corporation qualifies as an export trade corporation and its subpart F income, determined in accordance with the provisions of section 952 and the regulations thereunder, is reduced by $20 under the provisions of section 970(a) and paragraph (b) of this section. Section 972 is assumed not to apply to A Corporation. For 1964, A Corporation has a decrease of $8 in investments in export trade assets. For 1963 and 1964, A Corporation has earnings and profits of $30 (determined under the provisions of subparagraph (2) of this paragraph). Corporation M's pro rata share of A Corporation's decrease in investments in export trade assets for 1964 which is includible in M Corporation's gross income for 1964 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) is $8, determined as follows:

(i) Corporation M's pro rata share of A Corporation's decrease in investments in export trade assets for 1964 (100% of $8)	....	....	$8
(ii) Limitation on amount includible in gross income of M Corporation for 1964 (smaller of *(a)* or *(b)*):			
(a) Corporation M's pro rata share of A Corporation's earnings and profits for 1963 and 1964 determined under subparagraph (2) of this paragraph (100% of $30)	....	$30	
(b) Corporation M's pro rata share of amounts by which the subpart F income of A Corporation for 1963 was reduced under section 970(a) (100% of $20)	$20		
Plus: Corporation M's pro rata share of amounts which were not included in subpart F income of A Corporation for 1963 by reason of the application of section 972	0		
Total	20		
Less: Corporation M's pro rata share of the sum of amounts which were previously included in gross income of M Corporation under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) with respect to A Corporation	0	20	
(iii) Corporation M's pro rata share includible in gross income for 1964 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) (smaller of (i) or (ii))	....	....	8

Example 2. Assume the same facts as in example 1, except that on February 14, 1965, M Corporation sells 25 percent of its stock in A Corporation to N Corporation. Corporation N is a domestic corporation which also uses the calendar year as a taxable year. For 1965, A Corporation has a decrease of $16 in investments in export trade assets. Corporation A's earnings and profits for 1963 and 1964 (determined under the provisions of subparagraph (2) of this paragraph) are $22 ($30 minus $8). Corporation A's earnings and profits for 1965 are $6 (determined under the provisions of subparagraph (2) of this paragraph). For 1965, M Corporation's pro rata share of A Corporation's decrease in investments in export trade assets which is includible in M Corporation's gross income under section 951(a)(1)(A)(ii) is $9, and N Corporation's pro rata share includible in gross income under such section is $0, determined as follows:

M CORPORATION

(i) Corporation M's pro rata share of A Corporation's decrease in investments in export trade assets for 1965 (75% of $16)			$12
(ii) Limitation on amount includible in gross income of M Corporation for 1965 (smaller of *(a)* or *(b)):*			
(a) Corporation M's pro rata share of A Corporation's earnings and profits for 1963, 1964, and 1965 determined under subparagraph (2) of this paragraph (75% of $28)		$21	
(b) Corporation M's pro rata share of amounts by which the subpart F income of A Corporation for 1963 was reduced under section 970(a) (75% of $20)	$15		
Plus: Corporation M's pro rata share of amounts which were not included in subpart F income of A Corporation for 1963 and 1964 by reason of the application of section 972	0		
Total	$15		
Less: Corporation M's pro rata share of the sum of amounts which were previously included in gross income of M Corporation under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) with respect to A Corporation (75% of $8)	6	9	
(iii) Corporation M's pro rata share includible in gross income for 1965 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) (smaller of (i) or (ii))			9

N CORPORATION

(i) Corporation N's pro rata share of A Corporation's decrease in investments in export trade assets for 1965 (25% of $16)			0
(ii) Limitation on amount includible in gross income of N Corporation for 1965 (smaller of *(a)* or *(b)):*			
(a) Corporation N's pro rata share of A Corporation's earnings and profits for 1963, 1964, and 1965 determined under subparagraph (2) of this paragraph (25% of $28)		07	
(b) Corporation N's pro rata share of amounts by which the subpart F income of A Corporation for 1963 was reduced under section 970(a) (amounts prior to 2/14/65 not being taken into account)	0		
Plus: Corporation N's pro rata share of amounts which were not included in subpart F income of A Corporation for 1963 and 1964 by reason of the application of section 972 (amounts prior to 2/14/65 not being taken into account)	0		
Total	0		
Less: Corporation N's pro rata share of the sum of amounts which were previously included in gross income of N Corporation under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) with respect to A Corporation (amounts prior to 2/14/65 not being taken into account)	0	0	
(iii) Corporation N's pro rata share includible in gross income for 1965 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) (smaller of (i) or (ii))			0

(d) *Investments in export trade assets*—(1) *Amount of investments.* For purposes of sections 970 through 972 and §§ 1.970–1 to 1.972–1, inclusive, export trade assets shall be taken into account on the following bases:

(i) *Working capital.* Working capital to which section 971(c)(1) applies shall be taken into account at the adjusted basis of current assets, determined as of the applicable determination date, less any current liabilities (except as provided in subdivision (iii) of this subparagraph).

(ii) *Other export trade assets.* Inventory to which section 971(c)(2) applies, facilities to which section 971(c)(3) applies, and evidences of indebtedness to which section 971(c)(4) applies, shall be taken into account at their adjusted bases as of the applicable determination date, reduced by any liabilities (except as provided in subdivision (iii) of this subparagraph) to which such property is subject on such date. To be taken into account under this subparagraph, a liability must constitute a specific charge against the property involved. Thus, a liability evidenced by an open account or a liability secured only by the general credit of the controlled foreign corporation will not be taken into account. On the other hand, if a liability constitutes a specific charge against several items of property and cannot definitely be allocated to any single item of property, the liability shall be apportioned against each of such items of property in that ratio which the adjusted basis of such item on the applicable determination date bears to the adjusted basis of all such items on such date. A liability in excess of the adjusted basis of the property which is subject to such liability will not be taken into account for the purpose of reducing the adjusted basis of other property which is not subject to such liability. See paragraph (c)(6) of §1.971–1 for treatment of export trade assets which constitute working capital to which section 971(c)(1) applies and which also constitute inventory to which section 971(c)(2) applies or evidences of indebtedness to which section 971(c)(4) applies.

(iii) *Treatment of certain liabilities.* For purposes of subdivisions (i) and (ii) of this subparagraph, a current liability, or a specific charge created with respect to any item of property, principally for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's investments in export trade assets shall be taken into account in such a manner as to properly reflect the controlled foreign corporation's investments in export trade assets; whether a specific charge or current liability is created principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to a loan is whether the loan is from a related person, as defined in section 954(d)(3) and paragraph (e) of §1.954–1.

(iv) *Statement required.* If for purposes of this section a United States shareholder of a controlled foreign corporation reduces the adjusted basis of property which constitutes an export trade asset on the ground that such property is subject to a liability, he shall attach to his return a statement setting forth the adjusted basis of the property before the reduction and the amount and nature of the reduction.

(2) *Increase in investments in export trade assets.* For purposes of section 970(a) and paragraph (b) of this section, the amount of increase in investments in export trade assets of a controlled foreign corporation for a taxable year shall be, except as provided in §1.970–2, the amount by which—

(i) The amount of its investments in export trade assets at the close of such taxable year, exceeds

(ii) The amount of its investments in export trade assets at the close of the preceding taxable year.

(3) *Decrease in investments in export trade assets.* For purposes of section 970(b) and paragraph (c) of this section, the amount of the decrease in investments in export trade assets of a controlled foreign corporation for a taxable year shall be, except as provided in §1.970–2, the amount by which—

(i) The amount of its investments in export trade assets at the close of the preceding taxable year, minus

(ii) An amount equal to the excess of recognized losses over recognized gains on sales, exchanges, involuntary conversions, assets or other dispositions, of export trade during the taxable year, exceeds

(iii) The amount of its investments in export trade assets at the close of the taxable year.

For purposes of subdivision (ii) of this subparagraph, recognized losses include a write-down of inventory to lower of cost or market in accordance with a method of inventory valuation established or adopted by or on behalf of such foreign corporation under paragraph (c) of §1.964–1.

[T.D. 6755, 29 FR 12704, Sept. 9, 1964, as amended by T.D. 6795, 30 FR 947, Jan. 29, 1965; T.D. 6892, 31 FR 11144, Aug. 23, 1966; T.D. 7293, 38 FR 32802, Nov. 28, 1973; T.D. 7893, 48 FR 22511, May 19, 1983]

§1.970–2 Elections as to date of determining investments in export trade assets.

(a) *Nature of elections*—(1) *In general.* In lieu of determining the increase under the provisions of paragraph (d)(2) of §1.970–1, or the decrease under the provisions of paragraph (d)(3) of §1.970–1, in a controlled foreign corporation's investments in export trade assets for a taxable year in the manner provided in such provisions, a United States shareholder of such corporation may elect, under the provisions of section 970(c)(4) and this section, to determine such increase or decrease in accordance with the provisions of subparagraph (2) of this paragraph or, in the case of export trade assets which are facilities described in section 971(c)(3), in accordance with the provisions of subparagraph (3) of this paragraph. Separate elections may be made under subparagraph (2) and/or (3) of this paragraph with respect to each controlled foreign corporation with respect to which a person is a United States shareholder, within the meaning of section 951(b).

(2) *Election of 75-day rule.* A United States shareholder of a controlled foreign corporation may elect with respect to a taxable year of such corporation to make the determinations under subparagraphs (2)(i) and (3)(iii) of paragraph (d) of § 1.970–1 of the amount of such corporation's investments in export trade assets as of the 75th day after the close of the taxable year referred to in such subparagraphs of paragraph (d) of § 1.970–1. The election provided by this subparagraph may be made with respect to export trade assets other than facilities described in section 971(c)(3) or with respect to export trade assets which are facilities or with respect to both types of export trade assets (but the election under this paragraph with respect to export trade assets which are facilities or with respect to both types of export trade assets may be made only if the election provided by subparagraph (3) of this paragraph is not made). If the election provided by this subparagraph is made, the amount of export trade assets with respect to which such election is made at the close of the preceding taxable year which is described in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of § 1.970–1 shall be the amount of export trade assets which was considered by application of the 75-day rule to be the amount of export trade assets at the close of such preceding taxable year; except that for the first taxable year of the controlled foreign corporation for which the 75-day rule is elected the amount of investments in export trade assets with respect to which such election is made at the close of such preceding year described in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of § 1.970–1 shall be the amount of investments in export trade assets at the actual close of such preceding year. In the case of a taxable year of such corporation beginning after December 31, 1962, and before December 31, 1963, the amount of investments in export trade assets with respect to which such election is made alternatively may be determined by the United States shareholder as of the 75th day after the close of the preceding taxable year referred to in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of § 1.970–1 rather than as of the close of such preceding taxable year.

(3) *Election for export trade assets which are facilities.* A United States shareholder of a controlled foreign corporation may elect with respect to a taxable year of such corporation to make the determinations under subparagraphs (2)(i) and (3)(iii) of paragraph (d) of § 1.970–1 of the amount of such corporation's investments in export trade assets which are facilities described in section 971(c)(3) as of the close of such corporation's taxable year following the taxable year referred to in such subparagraphs of paragraph (d) of § 1.970–1. The election provided by this subparagraph may be made only if the United States shareholder does not elect the 75-day rule of subparagraph (2) of this paragraph with respect to export trade assets which are facilities. If the election provided by this subparagraph is made, the amount of investments in export trade assets which are facilities at the close of the preceding taxable year which is described in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of § 1.970–1 shall be the amount of export trade assets which are facilities which was considered, by reason of the application of the following-year rule provided in this subparagraph with respect to such preceding taxable year, to be the amount of export trade assets which are facilities at the close of such preceding taxable year; except that for the first taxable year of the controlled foreign corporation for which such following-year rule is elected the amount of investments in export trade assets which are facilities at the close of the preceding taxable year described in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of § 1.970–1 shall be the amount of investments in export trade assets which are facilities at the actual close of such preceding taxable year.

(b) *Time and manner of making elections*—(1) *Without consent.* A United States shareholder may, with respect to any controlled foreign corporation, make one or both of the elections described in paragraph (a)(2) or (3) of this section without the consent of the Commissioner by filing a statement to such effect with his return for his taxable year in which or with which ends the first taxable year of such corporation in which—

(i) Such shareholder owns, within the meaning of section 958(a), or is considered as owning, by applying the rules of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such corporation, and

(ii) Such corporation realizes subpart F income which is reduced under section 970(a) and paragraph (b) of §1.970–1.

The statement shall contain the name and address of the controlled foreign corporation, identification of such first taxable year of such corporation, and an indication as to which election or elections described in paragraph (a) of this section the United States shareholder is making. If such return has been filed on or before the 90th day after the date these regulations are published in the FEDERAL REGISTER, such United States shareholder shall file such statement with the district director with which the return was filed on or before such 90th day.

(2) *With consent.* A United States shareholder may make one or both of the elections described in paragraph (a)(2) or (3) of this section with respect to any controlled foreign corporation at any time with the consent of the Commissioner. Consent will not be granted unless the shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the election will be effected. The application for consent to elect shall be made by the shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to determine an exclusion under section 970(a) in accordance with one or both of the elections provided in paragraph (a) of this section. The application shall include the following information:

(i) The name, address, and taxable year of the United States shareholder;

(ii) The name, address, and taxable year of the controlled foreign corporation;

(iii) A statement indicating which of the elections the shareholder desires to make;

(iv) The amount of the foreign corporation's investments in export trade assets (by a category which includes export trade assets other than facilities and a category which includes only export trade assets which are facilities) at the close of its preceding taxable year;

(v) The shareholder's pro rata share of the sum of the amounts by which the subpart F income of the foreign corporation, for all prior taxable years during which such shareholder was a United States shareholder of such corporation, was reduced under section 970(a) and paragraph (b) of §1.970–1;

(vi) The shareholder's pro rata share of the sum of the amounts which were not included in the subpart F income of the foreign corporation, for all prior taxable years during which such shareholder was a United States shareholder of such corporation, by reason of the application of section 972 and §1.972–1; and

(vii) The shareholder's pro rata share of the sum of the amounts which were previously included in his gross income, for all prior taxable years during which such shareholder was a United States shareholder of such corporation, under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) and paragraph (b) of §1.970–1 to the foreign corporation.

(c) *Effect of elections*—(1) *In general.* Except as provided in subparagraphs (3) and (4) of this paragraph, an election made under paragraph (a) of this section with respect to a controlled foreign corporation shall be binding on the United States shareholder and—

(i) In the case of the election described in paragraph (a)(2) of this section, shall apply to all investments in export trade assets with respect to which such election is made acquired, or disposed of, by such corporation during the 75-day period following its taxable year for which subpart F income is first computed under the election and during all succeeding corresponding 75-day periods of such corporation, or

(ii) In the case of the election described in paragraph (a)(3) of this section, shall apply to all investments in export trade assets which are facilities acquired, or disposed of, by such corporation during the taxable year following its taxable year for which subpart F income is first computed under the election and during all succeeding corresponding taxable years of such corporation.

(2) *Returns.* Any return of a United States shareholder required to be filed before the completion of a period with respect to which determinations are to be made as to a controlled foreign corporation's investments in export trade assets for purposes of computing such shareholder's taxable income shall be filed on the basis of an estimate of the amount of such corporation's investments in export trade assets at the close of the period. If the actual amount of such investments is not the same as the amount of the estimate, the shareholder shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of such shareholder's tax for the year or years with respect to which the incorrect amount was taken into account. The amount of tax, if any, due upon such redetermination shall be paid by the shareholder upon notice and demand by the district director. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the shareholder in accordance with the provisions of sections 6402 and 6511 and the regulations thereunder.

(3) *Revocation*—(i) *In general—(a) Consent required.* Upon application by the United States shareholder, an election made under paragraph (a) of this section may, subject to the approval of the Commissioner, be revoked. Approval will not be granted unless the shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the revocation will be effected.

(b) Revocation of 75-day rule. In the case of the revocation of an election described in paragraph (a)(2) of this section, the change in the controlled foreign corporation's investments in export trade assets with respect to which such election was made for its first taxable year for which subpart F income or a decrease in investments in export trade assets is computed without regard to the election previously made shall, unless the agreement with the Commissioner provides otherwise, be considered to be the amount by which—

(1) Such corporation's investments in export trade assets with respect to which such election was made at the close of such taxable year exceeds or, if applicable, is exceeded by

(2) Such corporation's investments in export trade assets with respect to which such election was made at the close of the 75th day after the close of the preceding taxable year of such corporation.

(c) Revocation of following-year rule. In the case of the revocation of an election described in paragraph (a)(3) of this section, the change in the controlled foreign corporation's investments in export trade assets which are facilities for its first taxable year for which subpart F income or a decrease in investments in export trade assets is computed without regard to the election previously made shall, unless the agreement with the Commissioner provides otherwise, be considered to be zero.

(ii) *Time and manner of applying for consent to revocation—(a) Application to Commissioner.* The application for consent to revocation of an election shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC, 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to determine an exclusion under section 970(a) or an inclusion under section 970(b) without regard to such election.

(b) Information required. The application shall include the following information:

(1) The name, address, and taxable year of the United States shareholder;

(2) The name, address, and taxable year of the controlled foreign corporation;

(3) A statement indicating the election the shareholder desires to revoke under this subparagraph;

(4) The information required under subdivisions (iv) through (vii) of paragraph (b)(2) of this section;

(5) In the case of an application for consent to revocation of an election made under paragraph (a)(2) of this section, the amount of the foreign corporation's investments in export trade assets with respect to which such election was made at the close of the 75th day after the close of such corporation's taxable year immediately preceding the taxable year of such corporation; and

(6) The reasons for the request for consent to revocation.

(4) *Transfer of stock*—(i) *Election of 75-day rule in force. (a)* If during any taxable year of a controlled foreign corporation—

(1) A United States shareholder who has made the election described in paragraph (a)(2) of this section with respect to such corporation sells, exchanges, or otherwise disposes of all or part of his stock in such corporation, and

(2) The foreign corporation is a controlled foreign corporation immediately after the sale, exchange, or other disposition,

then, with respect to the stock so sold, exchanged, or disposed of, the successor in interest shall consider the controlled foreign corporation's change during the first 75 days of such taxable year in investments in export trade assets with respect to which such election is made to be zero.

(b) If the United States shareholder's successor in interest makes an election under paragraph (a)(2) of this section in order to determine an exclusion under section 970(a) for the taxable year of such corporation in which the acquires such stock, the amount of the controlled foreign corporation's investments in export trade assets with respect to which such election is made at the close of its preceding taxable year shall be considered, with respect to the stock so acquired, to be the amount of such corporation's investments in export trade assets with respect to which such election is made at the close of the 75th day after the close of such preceding taxable year.

(c) If the United States shareholder's successor in interest makes an election under paragraph (a)(2) of this section in order to determine an exclusion under section 970(a) for a taxable year of such corporation subsequent to the taxable year in which he acquired the stock, the amount of the controlled foreign corporation's investments in export trade assets with respect to which such election is made at the close of its taxable year immediately preceding such subsequent taxable year shall, with respect to the stock so acquired, be the amount of such corporation's investments in such assets at the actual close of such preceding taxable year.

(ii) *Election in force with respect to export trade assets which are facilities—(a)* If during any taxable year of a controlled foreign corporation—

(1) A United States shareholder who has made the election described in paragraph (a)(3) of this section with respect to such corporation sells, exchanges, or otherwise disposes of all or part of his stock in such corporation, and

(2) The foreign corporation is a controlled foreign corporation immediately after the sale, exchange or other disposition,

then, with respect to the stock so sold, exchanged, or disposed of, the successor in interest shall consider the controlled foreign corporation's change for such taxable year in investments in export trade assets which are facilities to be zero.

(b) If the United States shareholder's successor in interest makes an election under paragraph (a)(3) of this section in order to determine an exclusion under section 970(a) for the taxable year of such corporation in which he acquires such stock, the amount of the controlled foreign corporation's investments in export trade assets which are facilities at the close of its preceding taxable year shall be considered, with respect to the stock so acquired, to be the amount of such corporation's investments in export trade assets which are facilities at the close of the taxable year in which such stock is acquired.

(c) If the United States shareholder's successor in interest makes an election under paragraph (a)(3) of this section in order to determine an exclusion under section 970(a) for a taxable year of such corporation subsequent to the taxable

year in which he acquired the stock, the amount of the controlled foreign corporation's investments in export trade assets which are facilities at the close of its taxable year immediately preceding such subsequent taxable year shall, with respect to the stock so acquired, be the amount of such corporation's investments in such assets at the actual close of such preceding taxable year.

(d) *Illustrations.* The principles contained in this section are illustrated by the examples set forth in paragraph (d) of § 1.955.3.

[T.D. 6755, 29 FR 12707, Sept. 9, 1964]

§ 1.970–3 Effective date of subpart G.

Sections 970 through 972 and §§ 1.970–1 through 1.972–1 shall apply with respect to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States shareholders within which or with which such taxable years of such corporations end.

[T.D. 6755, 29 FR 12709, Sept. 9, 1964]

§ 1.971–1 Definitions with respect to export trade corporations.

(a) *Export trade corporations*—(1) *In general.* For purposes of sections 970 through 972 and §§ 1.970–1 to 1.972–1, inclusive, the term ''export trade corporation'' means a controlled foreign corporation which for the period specified in subparagraph (2) of this paragraph satisfies the conditions specified in subparagraph (3) of this paragraph. However, no controlled foreign corporation may qualify as an export trade corporation for any taxable year beginning after October 31, 1971, unless it qualified as an export trade corporation for any taxable year beginning before such date. In addition, if a corporation fails to qualify as an export trade corporation for a period of any 3 consecutive taxable years beginning after October 31, 1971, then for any taxable year beginning after such 3-year period, such corporation shall not be included within the term ''export trade corporation''.

(2) *Three-year period.* The period referred to in subparagraph (1) of this paragraph is the 3-year period ending with the close of the controlled foreign corporation's current taxable year, or such part of such 3-year period as occurs on and after the beginning of the corporation's first taxable year beginning after December 31, 1962, whichever period is shorter.

(3) *Gross income requirements.* The conditions referred to in subparagraph (1) of this paragraph are that the controlled foreign corporation derives—

(i) 90 percent or more of its gross income from sources without the United States, and

(ii)*(a)* 75 percent of more of its gross income from transactions, activities, or interest described in section 971(b) and paragraph (b) of this section, or

(b) 50 percent or more of its gross income from transactions, activities, or interest described in section 971(b) and paragraph (b) of this section in respect of agricultural products grown in the United States.

(4) *Determination of sources of gross income.* The sources of gross income of a controlled foreign corporation shall be determined for purposes of subparagraph (3)(i) of this paragraph in accordance with the rules for determining sources of gross income set forth in sections 861 through 864 and the regulations thereunder.

(b) *Export trade income*—(1) *General rule.* For purposes of sections 970 through 972 and §§ 1.970–1 to 1.972–1, inclusive, the term ''export trade income'' means the gross export trade income of a controlled foreign corporation derived from transactions, activities, or interest described in subdivisions (i) through (vii) of this subparagraph, less deductions allowed under subdivision (viii) of this subparagraph.

(i) *Sale of export property.* Gross export trade income of a controlled foreign corporation includes gross income it derives from the sale of export property (as defined in paragraph (e) of this section) which it purchases, if the sale is made to an unrelated person for use, consumption, or disposition outside the United States. See section 971(b)(1). As a general rule, property will be presumed to have been sold for use, consumption, or disposition in the country of destination of the sale. However, if at the time of the sale the controlled foreign corporation knows, or should have known from the facts and circumstances surrounding the sales transaction, that the property will probably be used, consumed, or disposed of in the United States, such property will be presumed to have been sold for use, consumption, or disposition in the United States unless the controlled foreign corporation establishes that such property was used, consumed, or disposed of outside the United States. For purposes of this subdivision, export property must be sold by a controlled foreign corporation in essentially the same form in which such property is purchased. Whether export property sold is in essentially the same form in which such property is purchased shall be determined on the basis of all the facts and circumstances in each case. Storage, handling, transportation, packaging, or servicing of property will be considered not to alter the form in which property is purchased. However, manufacture or production, within the meaning of paragraph (a)(4) of §1.954–3, will be considered to alter the form in which property is purchased and no part of the gross income from the sale of such property will be treated as export trade income. The application of this subdivision may be illustrated by the following example:

Example. Controlled foreign corporation A, incorporated under the laws of foreign country Y, purchases articles manufactured in the United States from domestic corporation M and sells them in the form in which purchased to foreign corporation B, unrelated to A Corporation, for use in foreign countries, X, Y, and Z. The gross income of A Corporation from the purchase and sale of the articles constitutes gross export trade income.

(ii) *Commissions and other income derived in connection with the sale of export property.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, compensation, or other income derived by such corporation from the performance for any person of commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services in respect of a sale by such corporation in a transaction described in subdivision (i) of this subparagraph or in respect of the sale by any other person of export property to a person unrelated to the controlled foreign corporation for use, consumption, or disposition outside the United States. Such gross export trade income includes payments received for surveys made prior to, and in connection with, the sale of such export property (whether or not such sales are ultimately consummated). See section 971(b)(1). The term ‘‘any person’’ or ‘‘any other person’’ as used in this subdivision includes a related person as defined in section 954(d)(3) and paragraph (e) of §1.954–1. The application of this subdivision may be illustrated by the following examples:

Example 1. Controlled foreign corporation A, incorporated under the laws of foreign country X, receives from M Corporation a commission equal to 6 percent of the gross selling price of all personal property shipped by M Corporation as a result of services performed by A Corporation in soliciting orders in foreign countries X, Y, and Z. In fulfillment of such orders, M Corporation ships products manufactured by it in the United States. Corporation A does not assume title to the property sold. Gross commissions received by A Corporation from M Corporation in connection with the sale of such property to persons unrelated to A Corporation for use, consumption, or disposition outside the United States constitute gross export trade income.

Example 2. Foreign corporation B, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation N. Corporation N, is engaged in the business of manufacturing heavy duty electrical equipment in the United States. By contract, N Corporation engages B Corporation for the purpose of conducting engineering, technical, and financial studies required by N Corporation in the preparation of bids to supply foreign country Y with electrical equipment for a construction project to be undertaken by such country. Corporation N pays B Corporation a fee for the services, all of which are performed in country Y, which is based upon the number of hours of work performed without regard to whether a sale is ultimately consummated. Corporation N does not receive a contract from country Y on its bid to supply equipment. Income derived by B Corporation from performance of the service contract constitutes gross export trade income.

(iii) *Commissions and other income derived in connection with the installation or maintenance of export property.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, compensation, or other income derived by such corporation from the performance for any person of commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services in respect of the installation or maintenance of export property which has been sold by such corporation in a transaction described in subdivision (i) of this subparagraph or by any other person to a person unrelated to the controlled foreign corporation for use, consumption, or disposition outside the United States. See section 971(b)(1). The term ''any person'' or ''any other person'' as used in this subdivision includes a related person as defined in section 954(d)(3) and paragraph (e) of § 1.954–1.

(iv) *Commissions and other income derived in connection with the use of patents, copyrights, and other like property.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, compensation, or other income derived by such corporation from the performance for any person of commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services in connection with the use outside of the United States by an unrelated person of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property, including gross income derived from obtaining licensees for patents, but only if the patent, copyright, or other like property is acquired, or developed, and owned by the manufacturer, producer, grower, or extractor of any export property, in respect of which the controlled foreign corporation also derives gross export trade income within the meaning of subdivision (i), (ii), or (iii) of this subparagraph. See section 971(b)(2). The application of this subdivision may be illustrated by the following example:

Example. Foreign corporation A incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation M, the owner of a patent registered in foreign country X, grants B Corporation, a corporation unrelated to A Corporation, the right to use such patent in foreign country Y in exchange for payment of a royalty. By a separate contract with B Corporation, A Corporation agrees for a gross fee of $100,000 to furnish, by maintaining a staff of technical representatives at the offices of B Corporation, technical services to B Corporation in connection with B Corporation's use of the patent. Corporation A also derives export trade income from the sale of export property which it purchases from M Corporation, the manufacturer of such property, and sells to C Corporation, an unrelated person, for use in country Y by C Corporation. The gross fee of $100,000 received by A Corporation for the furnishing of technical services in connection with B Corporation's use of M Corporation's patent constitutes gross export trade income since the service for which the fee is paid is performed in connection with the use outside the United States by an unrelated person (B Corporation) of a patent owned by a manufacturer (M Corporation) of export property in respect of which the controlled foreign corporation (A Corporation) derives gross export trade income from the sale to an unrelated person (C Corporation) for use outside the United States of export property purchased by it from the manufacturer (M Corporation).

(v) *Income attributable to use of export property by an unrelated person.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, rents, compensation, or other income which is received by such corporation from an unrelated person and is attributable to the use of export property by such unrelated person. See section 971(b)(3). The application of this subdivision may be illustrated by the following example:

Example. Foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A acquires by purchase bottling machines manufactured in the United States and leases the machines to B Corporation, a corporation unrelated to A Corporation, for use by B Corporation in foreign country Y. Gross rental income of A Corporation from the lease of the machines to B Corporation constitutes gross export trade income.

(vi) *Income attributable to the use of export property in the rendition of technical, scientific, or engineering services—(a) General.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, compensation, or other income which is received by such corporation from an unrelated person and is attributable to the use of export property in the performance of technical, scientific, or engineering services to such unrelated person. See section 971(b)(3).

(b) Rule of apportionment. If a commission, fee, or other income received by a controlled foreign corporation from an unrelated person under a contract or arrangement for the performance of technical, scientific, or engineering services is not solely attributable to the use of export property in the performance of such services and the amount of the gross income attributable to such use of export property cannot be established by reference to transactions between other unrelated persons, such gross income shall be an amount which bears the same ratio to total gross income from the contract or arrangement as the cost of the export property consumed in the performance of such services, including a reasonable allowance for depreciation with respect to the export property so used, bears to the total costs and expenses attributable to the production of income under the contract or arrangement.

(c) Illustration. The application of this subdivision may be illustrated by the following example:

Example. Foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A is engaged in the seismograph service business in foreign country X. In an effort to establish the probable existence of oil in a concession area it owns in foreign country Y, B Corporation which is unrelated to A Corporation enters into a contract with A Corporation whereby A Corporation is required to make seismographic tests of the area in country Y for a fixed fee of $100,000. In performance of the contract, A Corporation hires a skilled crew to carry out the contract and utilizes equipment and supplies (for example, trucks, seismographic equipment, etc.) which constitute export property. Corporation A cannot establish by reference to transactions between other unrelated persons, the income attributable to the use of the export property in the performance of the contract. Corporation A's total costs and expenses (for example, salaries of the crew, administrative expenses, all supplies, total depreciation on property used in performance of the contract, etc.) incurred in performance of the contract are $80,000. The cost of export property consumed in performance of the contract (for example, dynamite, motor oil, and other supplies which were produced in the United States, reasonable depreciation on trucks and seismographic equipment manufactured in the United States and used in performance of the contract, etc.) is $30,000. Corporation A's gross export trade income from the contract is $37,500, that is, the amount which bears the same ratio to total gross income from the contract ($100,000) as the cost of the export property consumed in the rendition of the services ($30,000) bears to total costs and expenses attributable to the contract ($80,000).

(vii) *Interest from export trade assets.* Gross export trade income of a controlled foreign corporation includes interest derived by it from export trade assets described in section 971(c)(4) and paragraph (c)(5) of this section. See section 971(b)(4).

(viii) *Deductions to be taken into account.* Export trade income of a controlled foreign corporation for any taxable year shall be the amount determined by deducting from the items or categories of gross income described in subdivisions (i) through (vii) of this subparagraph the entire amount of those expenses, taxes, and other deductions properly allocable to such items or categories of income. For purposes of this section, expenses, taxes, and other deductions shall first be allocated to items or categories of gross income to which they directly relate; then, expenses, taxes, and other deductions which cannot definitely be allocated to some item or category of gross income shall be ratably apportioned among all items or categories of gross income, except that no expense, tax, or other deduction shall be allocated to an item or category of income to which it clearly does not apply and no deduction allowable to such controlled foreign corporation under section 882(c) and the regulations thereunder shall be taken into account.

(2) *Cross reference.* For rules governing the determination of gross income and taxable income of a foreign corporation, see §1.952–2.

(c) *Export trade assets*—(1) *In general.* For purposes of sections 970 through 972 and §§1.970–1 to 1.972–1, inclusive, the term ‘‘export trade assets’’ means—

(i) Working capital reasonably necessary for the production of export trade income,

(ii) Inventory of export property held for use, consumption, or disposition outside the United States,

(iii) Facilities located outside the United States for the storage, handling, transportation, packaging, servicing, sale, or distribution of export property, and

(iv) Evidences of indebtedness executed by unrelated persons in connection with payment for purchases of export property for use, consumption, or disposition outside the United States, or in connection with the payment for services described in section 971(b)(2) or (3) and paragraph (b)(1)(iv), (v), or (vi) of this section.

(2) *Working capital.* For purposes of subparagraph (1)(i) of this paragraph, working capital of a controlled foreign corporation is the excess of its current assets over its current liabilities. Liabilities maturing in one year or less shall be considered current liabilities. A determination of the amount of working capital of a controlled foreign corporation which is reasonably necessary for the production of export trade income will depend upon the nature and volume of the activities of the controlled foreign corporation which produce export trade income as they exist on the applicable determination date. In determining working capital which is reasonably necessary for the production of export trade income, the anticipated future needs of the business will be taken into account to the extent that such needs relate to the year of the controlled foreign corporation following the applicable determination date; anticipated future needs relating to a later period will not be taken into account unless it is clearly established that such needs are reasonably related to the production of export trade income as of the applicable determination date.

(3) *Inventory of export property.* For purposes of subparagraph (1)(ii) of this paragraph, the inclusion of items in inventory shall be determined in accordance with rules applicable to domestic corporations. See §§ 1.471–1 through 1.471–9. Inventory of export property of a controlled foreign corporation includes export property held for use, consumption, or disposition outside the United States regardless of where it is located on the applicable determination date. Thus, such property may be physically located in the United States on such date. However, for property physically located in the United States to constitute export property, it must have been acquired by the controlled foreign corporation with a clear intent that it would dispose of the property for use, consumption, or disposition outside the United States. As a general rule, if during the year following the applicable determination date export property which was physically located in the United States on such date is actually exported for use, consumption, or disposition outside the United States, such property will be deemed held for such purpose on the applicable determination date. On the other hand, the indefinite warehousing of export property in the United States by the controlled foreign corporation, or the subsequent sale of export property by such corporation for use, consumption, or disposition in the United States, will evidence a lack of intent by such corporation on the applicable determination date to hold such property for use, consumption, or disposition outside the United States.

(4) *Facilities located outside the United States*—(i) *In general.* For purposes of subparagraph (1)(iii) of this paragraph, a facility, as defined in subdivision (ii)*(a)* of this subparagraph, will be considered an export trade asset only—

(a) If such facility is located outside the United States, and

(b) To the extent that such facility is used, within the meaning of subdivision (ii)*(c)* of this subparagraph, by the controlled foreign corporation for the storage, handling, transportation, packaging, servicing, sale, or distribution of export property in essentially the same form in which such property is acquired by such corporation.

Thus, a facility in which property is manufactured or produced, even though export property is used or consumed in the production or becomes a component part of the manufactured article, will not qualify as an export trade asset.

(ii) *Special rules—(a) Facility defined.* For purposes of subdivision (i) of this subparagraph, the term ‘‘facility’’ includes any asset or group of assets used for the storage, handling, transportation, packaging, servicing, sale, or distribution of export property. Thus, such term includes warehouse, storage, or sales facilities (for example, sales office equipment), transportation equipment (for example, motor trucks, vessels, etc.), and machinery and equipment (for example, packaging equipment, servicing equipment, cranes, forklift trucks used in warehouses, etc.).

(b) Determination of location of transportation facilities. A transportation facility shall be considered to be located outside the United States for purposes of subdivision (i)*(a)* of this subparagraph if such property is predominantly located outside the United States. As a general rule, on an applicable determination date a transportation facility will be considered to be predominantly located outside the United States if 70 percent or more of the miles traversed (during the 12-month period immediately preceding such determination date or for such part of such period as such facility is owned by the controlled foreign corporation) in the use of such facility are traversed outside the United States or if such facility is located outside the United States at least 70 percent of the time during such period or such part thereof.

(c) Determination of use. For purposes of subdivision (i)*(b)* of this subparagraph, the extent to which a facility is used in carrying on the activities described in such subdivision depends on the use made of the facility for the 12-month period immediately preceding the applicable determination date or for such part of such period as such facility is owned by the controlled foreign corporation. The method of measuring such use will depend upon the facts and circumstances in each case. However, such determinations of use will generally be made for a facility as a whole and not on the basis of individual items used in the operation of a facility. Thus, a determination as to the use of a warehouse facility will generally be made with respect to the entire facility and not separately for the items used in such warehouse, such as forklift trucks, storage bins, etc.

(5) *Evidences of indebtedness.* For purposes of subparagraph (1)(iv) of this paragraph, the term ‘‘evidence of indebtedness’’ shall mean a note, installment sales contract, a time bill of exchange evidencing a sale on credit, or similar written instrument executed by an unrelated person which evidences the obligation of an unrelated person to pay for export property which an unrelated person purchases for use, consumption, or disposition outside the United States or to pay for services described in section 971(b)(2) or (3) and paragraph (b)(1)(iv), (v), or (vi) of this section which are performed for an unrelated person. Receivables which arise out of the delivery of export property, or the performance of services, which are evidenced by invoices, bills of lading, bills of exchange which do not evidence a sale on credit, sales slips, and similar documents created by the unilateral act of a creditor shall not be considered evidences of indebtedness for purposes of section 971(c)(4).

(6) *Duplication of treatment and priority of application.* No asset which constitutes an export trade asset shall be taken into account more than once in determining the investments in export trade assets of a controlled foreign corporation. Assets which constitute working capital and also constitute inventory to which section 971(c)(2) applies or evidences of indebtedness to which section 971(c)(4) applies shall be taken into account in determining whether the amount of working capital of the controlled foreign corporation is reasonably necessary for the production of export trade income. However, to the extent that the amount of inventory to which section 971(c)(2) applies or evidences of indebtedness to which section 971(c)(4) applies is not included in working capital to which section 971(c)(1) applies on the ground that such amount is not reasonably necessary for the production of export trade income, the amount shall be included under section 971(c)(2) or 971(c)(4), as the case may be, in a controlled foreign corporation’s investments in export trade assets.

(d) *Export promotion expenses*—(1) *In general.* For purposes of sections 970 through 972 and §§1.970–1 to 1.972–1, inclusive, the term ‘‘export promotion expenses'' means, subject to the provisions of subparagraph (2) of this paragraph, all the ordinary and necessary expenses paid or incurred during the taxable year by the controlled foreign corporation which are reasonably allocable to the receipt or production of export trade income including—

(i) A reasonable allowance for salaries or other compensation for personal services actually rendered for such purpose,

(ii) Rentals or other payments for the use of property actually used for such purpose, and

(iii) A reasonable allowance for the exhaustion, wear and tear, or obsolescence of property actually used for such purpose.

In determining for purposes of this subparagraph whether expenses are reasonably allocable to the receipt or production of export trade income, consideration shall be given to the facts and circumstances of each case. As a general rule, if export trade income results from the sale of export property, export promotion expenses allocable to such income shall include warehousing, advertising, selling, billing, collection, other administrative, and similar costs properly allocable to the marketing activity, but shall not include cost of goods sold, income or similar tax, any expense which does not advance the distribution or sale of export property for use, consumption, or disposition outside the United States, or any expense for which the controlled foreign corporation is reimbursed. If export trade income results from the rental of export property, export promotion expenses allocable to such income shall include a reasonable allowance for depreciation and servicing of such property, and the administrative and similar costs properly allocable to the rental activity. If export trade income results from the performance of services, export promotion expenses shall include a reasonable allowance for compensation of the persons performing services for the controlled foreign corporation in the execution of the service contract or arrangement and administrative expenses reasonably allocable to the service activity. In no case shall income taxes be included in export promotion expenses.

(2) *Expenses incurred within the United States.* No expense incurred within the United States shall be treated as an export promotion expense for purposes of section 971(d) and subparagraph (1) of this paragraph unless at least—

(i) 90 percent of all salaries and other personal service compensation incurred in the receipt or the production of export trade income,

(ii) 90 percent of rents and other payments for the use of property used in the receipt or the production of export trade income,

(iii) 90 percent of the allowances for the exhaustion, wear and tear, or obsolescence of property used in the receipt or the production of export trade income, and

(iv) 90 percent of all other ordinary and necessary expenses reasonably allocable to the receipt or the production of export trade income,

is incurred outside the United States. For this purpose, personal service compensation will be considered incurred at the place where the service is performed (for example, salaries will be considered incurred at the place where the employee works; payments for art work will be considered incurred at the place where the art work is prepared, etc.); rent, depreciation, and other expenses related to real or personal property will be considered incurred at the place where the property is located; and expenses for media advertising will be considered incurred at the place where the advertising is consumed. For such purpose, newspaper or periodical advertising will be considered consumed where the newspaper or periodical is principally distributed, and television and radio advertising will be considered consumed at the place where the audience is primarily located. Technicalities of contract or payment, for example, the place where a contract is executed or the location of a bank account from which payment is made, shall not be determinative of the place where an expense is incurred.

(e) *Export property.* For purposes of sections 970 through 972 and §§ 1.970–1 to 1.972–1, inclusive, the term ''export property'' means property, or any interest in property, which is manufactured, produced, grown, or extracted in the United States. Whether property will be considered manufactured or produced in the United States will depend on the facts and circumstances of each case. As a general rule, if—

(1) The property sold, serviced, used, or rented by the controlled foreign corporation is substantially transformed in the United States prior to its export from the United States, or

(2) The operations conducted in the United States with respect to the property sold, serviced, used, or rented by the controlled foreign corporation, whether performed in the United States by one person or a series of persons in a chain of distribution, are substantial in nature and are generally considered to constitute the manufacture or production of property,

then the property sold, serviced, used, or rented will be considered to have been manufactured or produced in the United States. The rules under paragraph (a)(4)(ii) of §1.954–3, relating to the substantial transformation of property, and paragraph (a)(4)(iii) of such section, dealing with a substantive test for determining whether property will be treated as having been manufactured or produced, shall apply for purposes of making determinations under this paragraph.

(f) *Unrelated person.* For purposes of sections 970 through 972 and §§1.970–1 to 1.972–1, inclusive, the term ''unrelated person'' means a person other than a related person as defined in section 954(d)(3) and paragraph (e) of §1.954–1.

[T.D. 6755, 29 FR 12710, Sept. 9, 1964, as amended by T.D. 7293, 38 FR 32802, Nov. 28, 1973; T.D. 7533, 43 FR 6603, Feb. 15, 1978]

§1.972–1 Consolidation of group of export trade corporations.

(a) *Election to consolidate*—(1) *In general.* One or more United States shareholders (as defined in section 951(b)) owning (within the meaning of section 958(a)) or who are considered as owning by applying the rules of ownership of section 958(b) more than 50 percent of the total combined voting power of all classes of stock entitled to vote of an export trade corporation, which is the top-tier corporation in a chain (within the meaning of subparagraph (2) of this paragraph) of export trade corporations, may, subject to the provisions of this section, elect to consolidate such chain for purposes of determining—

(i) The limitations, described in section 970(a) and paragraph (b)(2) of §1.970–1, on the amount by which subpart F income of an export trade corporation in such chain shall be reduced as provided in section 970(a) and paragraph (b)(1) of §1.970–1, and

(ii) The amount includible in gross income of such shareholders under section 951(a)(1)(A)(ii) with respect to such a corporation's decrease in investments in export trade assets to which section 970(b) applies as described in paragraph (c) of §1.970–1.

(2) *''Chain'' defined.* A chain of export trade corporations shall include—

(i) The top-tier export trade corporation referred to in subparagraph (1) of this paragraph which is the first export trade corporation in a chain of ownership described in section 958(a);

(ii) All export trade corporations 80 percent or more of the total combined voting power of all classes of stock entitled to vote of which is owned directly by such top-tier export trade corporation on the last day of its taxable year; and

(iii) All export trade corporations 80 percent or more of the total combined voting power of all classes of stock entitled to vote of which is owned directly by the export trade corporations described in subdivision (ii) of this subparagraph on the last day of the taxable year of the export trade corporation described in subdivision (i) of this subparagraph.

For purposes of this section, a reference to a top-tier corporation shall mean an export trade corporation described in subdivision (i) of this subparagraph, a reference to a second-tier corporation shall mean an export trade corporation described in subdivision (ii) of this subparagraph, and a reference to a third-tier corporation shall mean an export trade corporation described in subdivision (iii) of this subparagraph.

(3) *Inclusion requirement.* If an election is made by a United States shareholder under this paragraph with respect to a chain of export trade corporations (as defined in subparagraph (2) of this paragraph), all export trade corporations which are included in the

chain must be included in the consolidation. If such an election is made, the determinations under section 970 shall be made on a consolidated basis with respect to the entire interest which the electing United States shareholder owns in each of the export trade corporations in the chain, including any minority interests owned directly or indirectly by such shareholder in second-tier and third-tier corporations in the chain. A United States shareholder may elect to consolidate his interest in export trade corporations in one chain of such corporations without electing to consolidate his interest in export trade corporations in other chains.

(4) *Conditions for making initial election*—(i) *Without consent.* The initial election to consolidate a chain of export trade corporations may be made without the consent of the Commissioner only if, immediately before the election to consolidate, each of the export trade corporations to be included in the consolidation is using the same taxable year and has the same elections under section 970(c)(4) and § 1.970–2 in force, or not in force, as the case may be. The election shall be made by the electing shareholder or shareholders with respect to the taxable year in which or with which ends the first taxable year of the top-tier corporation to which the election to consolidate applies and at the time of filing such shareholders' returns for such taxable year or within 90 days after final regulations under this section are published in the FEDERAL REGISTER, whichever date occurs later. Each United States shareholder making such an election shall attach to his return a statement showing:

(a) The name, address, and taxable year of each export trade corporation in the chain of such corporations for which an election is made,

(b) The amount and percentage of each class of stock owned by such shareholder (within the meaning of section 958), corporation by corporation, in each of such export trade corporations, and

(c) A list of the names and addresses, and a description of the ownership interests, of all other United States shareholders, if any, who are making the same election to consolidate and a statement that such shareholders are also making the election.

(ii) *With consent.* If, immediately before the election to consolidate, each of the export trade corporations in a chain of such corporations does not use the same taxable year or does not have the same elections under section 970(c)(4) and § 1.970–2 in force, or not in force, as the case may be, the initial election to consolidate such chain may be exercised by the electing shareholder or shareholders only with the consent of the Commissioner. Consent will not be granted unless each electing United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which such consolidation is to be effected and unless, subject to such terms, conditions, and adjustments as the Commissioner may prescribe, each of the export trade corporations in the chain adopts a common taxable year and has the same elections under section 970(c)(4) and § 1.970–2 in force, or not in force, as the case may be. The application for consent to consolidate shall be made by mailing a letter, signed by each of the electing United States shareholders, to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the first taxable year of the top-tier corporation with respect to which the electing shareholder or shareholders desire to make a consolidation or before the close of the 90th day after final regulations under this section are published in the FEDERAL REGISTER, whichever date occurs later, and shall include the statement described in subdivision (i) of this subparagraph.

(5) *Effect of election.* If an election to consolidate a chain of export trade corporations is made for a taxable year of a United States shareholder, such election shall, except as provided in subparagraph (6) of this paragraph, be binding on such shareholder for such taxable year and for all succeeding taxable years. If, in a subsequent taxable year of the United States shareholder, an export trade corporation for the first time qualifies as a second-tier or third-tier corporation in such chain on the last day of the taxable year of the top-tier corporation which ends in or

with the subsequent taxable year of such shareholder, the shareholder's interest in such export trade corporation shall be included in the consolidation to which the election applies, but only if such export trade corporation as of such last day uses the same taxable year and has the same elections under section 970(c)(4) and §1.970–2 in force, or not in force, as the case may be, as such top-tier corporation. The United States shareholder shall, with respect to such additional export trade corporation, submit with his return for such subsequent taxable year the statement described in subparagraph (4)(i) of this paragraph.

(6) *Termination of election.* An election under this paragraph to consolidate a chain of export trade corporations shall terminate for the first taxable year of the foreign corporation which during the period of consolidation is a top-tier corporation—

(i) At the close of which any foreign corporation which was included in such consolidation for the preceding taxable year ceases to qualify as an export trade corporation or to be eligible under this paragraph for inclusion in such chain,

(ii) At the close of which an export trade corporation for the first time qualifies as a second-tier or third-tier corporation in such chain but does not as of such close of the year use the same taxable year or have the same elections under section 970(c)(4) and §1.970–2 in force, or not in force, as the case may be, as such top-tier corporation, or

(iii)*(a)* In respect of which the Commissioner, upon application made by a United States shareholder who made the election to consolidate, or his successor in interest, consents to a termination of the election. Approval will not be granted unless the United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the termination will be effected.

(b) The application for consent to termination shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall be mailed before the close of the taxable year of the foreign corporations with respect to which the shareholder desires to terminate the consolidation and shall include the following information:

(1) The name, address, and taxable year of each export trade corporation in the chain of such corporations for which the election was made,

(2) The amount and percentage of each class of stock owned by such shareholder (within the meaning of section 958), corporation by corporation, in each of such export trade corporations, and

(3) A list of the names and addresses, and a description of the ownership interests, of all other United States shareholders, if any, who participated in making the election with such United States shareholder, or their successors in interest, and a statement whether such other persons are or are not terminating the election.

(7) *Election subsequent to initial election.* If a United States shareholder elects under subparagraph (4) of this paragraph to consolidate his interest in a chain of export trade corporations and the election to consolidate such corporations terminates under the provisions of subparagraph (6) of this paragraph, such shareholder may not thereafter elect under this section to consolidate his interest in any corporation which was in that chain of export trade corporations unless he receives the consent of the Commissioner to do so. Application to obtain such consent of the Commissioner shall be made by a letter mailed to the Commissioner of Internal Revenue, Washington, DC, 20224, before the close of the first taxable year of the top-tier corporation of the chain of export trade corporations in which the election to include such interest is to apply. Such application for consent shall include a statement showing:

(i) With respect to such chain, the information required to be shown in the statement described in subparagraph (4)(i) of this paragraph, and

(ii) The United States shareholder's interest in such chain which was previously included in a consolidation, the taxable years of such previous consolidation, and the manner in which such previous consolidation was terminated.

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

Example. Domestic corporation M owns 60 percent of the only class of stock of foreign corporation A, and 100 percent of the only class of stock of foreign corporation F, respectively. Corporation A owns 80 percent of the only class of stock of foreign corporations B and C, respectively. Corporation M also owns 20 percent of the stock of B Corporation. Corporation B owns 80 percent of the only class of stock of foreign corporation D. Corporations B and C each own 50 percent of the only class of stock of foreign corporation E. Corporation F owns 100 percent of the only class of stock of foreign corporation G, which owns 100 percent of the only class of stock of foreign corporation H. Corporation F also owns 20 percent of the stock of C Corporation. Domestic corporations N and R own 30 percent and 10 percent, respectively, of the stock of A Corporation. All corporations use the calendar year as a taxable year, and all foreign corporations qualify as export trade corporations for 1963. Corporation M may elect for 1963 to consolidate its interest in the chain (the ''A'' chain) of export trade corporations which includes corporations A, B, C, D, and E; and Corporation M need not, but may, elect to consolidate its interest in the chain (the ''F'' chain) of export trade corporations which includes corporations F, G, and H. Consolidation of M Corporation's interest in the ''A'' chain with its interest in the ''F'' chain is not permitted. If M Corporation elects to consolidate the ''A'' chain, M Corporation must include in the consolidation its 20 percent directly owned interest in B Corporation and its 20 percent indirectly owned (through F Corporation) interest in C Corporation. Either N Corporation or R Corporation, or both, may join M Corporation in electing to consolidate their interests in the ''A'' chain. However, neither N Corporation nor R Corporation may elect to consolidate the ''A'' chain unless M Corporation also agrees to so elect, because corporations N and R, neither jointly nor separately, own more than 50 percent of the total combined voting power of all classes of stock entitled to vote of A Corporation. If corporations M, N, and R elect to consolidate the ''A'' chain, the determinations specified in subparagraph (1) of this paragraph will be made on a consolidated basis with respect to such corporations' respective interest in the chain as shown in the following tabulation:

	A	B	C	D	E
	%	%	%	%	%
M Corporation's interest:					
Direct interest	60				
(60%×80%)+20% direct interest		68			
(60%×80%)+20% indirect interest			68		
(68%×80%)				54.4	
(68%×50%)+(68%×50%)					68
N Corporation's interest:					
Direct interest	30				
(30%×80%)		24			
(30%×80%)			24		
(24%×80%)				19.2	
(24%×50%)+(24%×50%)					24
R Corporation's interest:					
Direct interest	10				
(10%×80%)		8			
(10%×80%)			8		
(8%×80%)				6.4	
(8%×50%)+(8%×50%)					8
Total interests to which consolidation applies	100	100	100	80	100

(b) *Effect of consolidation*—(1) *Determination of subpart F income, export trade income, etc.* An election under paragraph (a) of this section to consolidate export trade corporations in a chain of such corporations shall have no effect on the determination of the character of income as subpart F income or on the determination of export trade income, export trade income which constitutes foreign base company income, or earnings and profits of the individual export trade corporations in the chain. Thus, the consolidation of export trade corporations under this section shall not have the effect of reducing earnings and profits of such corporations or of changing the characterization of income from that which is, for example, foreign base company income to that which is not. The application of this paragraph may be illustrated by the following example:

Example. Corporation A, incorporated under the laws of foreign country X, and corporation B, incorporated under the laws of foreign country Y, are both wholly owned subsidiaries of domestic corporation M. Corporations A and B both qualify under section 971(a) as export trade corporations. Corporation A purchases personal property produced in the United States from an unrelated person and sells the property to B Corporation for use outside of country X. Corporation B resells the property to an unrelated person for use in foreign country Z. Corporations A and B each derive foreign base company sales income described in §1.954–3 from the purchase and sale transactions. Consolidation of Corporations A and B under this section does not result in the two transactions being treated as one transaction which is a purchase of property from an unrelated person and a sale of property to an unrelated person or the nonrecognition of gain on the sale of export property by A Corporation to B Corporation.

(2) *Determination of amount by which consolidated subpart F income is reduced*—(i) *In general.* In determining the amount by which the subpart F income of each export trade corporation includible in a consolidation of export trade corporations shall be reduced as provided in section 970(a) and paragraph (b)(1) of §1.970–1 for any taxable year of consolidation, the limitations provided by section 970(a) and paragraph (b)(2) of §1.970–1 on such amount for each such export trade corporation shall be determined on the basis of such corporation's separate share of—

(a) Amounts included in the total export promotion expense,

(b) The total gross receipts from the sale, installation, operation, maintenance, or use of property in respect of which each such corporation derives such export trade income as is properly allocable to the export trade income which constitutes foreign base company income, and

(c) The total increase in investments in export trade assets,

of all export trade corporations to which the consolidation applies for the taxable year.

(ii) *Limitations not effective.* If for any taxable year each of the limitations under paragraph (b)(2) of §1.970–1, determined on a consolidated basis, equals or exceeds the total export trade income which constitutes foreign base company income of all corporations includible in the consolidation of export trade corporations, the subpart F income of each includible corporation shall be reduced under section 970(a) for such year by its separate export trade income which constitutes foreign base company income.

(iii) *Limitation effective.* If for any taxable year one of the limitations under paragraph (b)(2) of §1.970–1, determined on a consolidated basis, is less than the total export trade income which constitutes foreign base company income of all corporations includible in the consolidation of export trade corporations, the amount by which the subpart F income of each includible corporation shall be reduced under section 970(a) for such year shall be an amount which bears the same ratio to the amount by which the subpart F income may be reduced on a consolidated basis as the export trade income which constitutes foreign base company income of each includible corporation bears to the total export trade income which constitutes foreign base company income of all export trade corporations includible in the consolidation of export trade corporations.

(iv) *Illustration.* The application of this subparagraph may be illustrated by the following example:

Example. (a) Domestic corporation M owns 100 percent of the only class of stock of controlled foreign corporation A, which, in turn, owns 100 percent of the only class of stock of controlled foreign corporation B. All corporations use the calendar year as the taxable year, and corporations A and B are export trade corporations throughout the period here involved. Corporation M elects under this section to consolidate corporations A and B for the entire period here involved. Corporation M elects under paragraph (a)(2) of §1.970–2 for 1963 to determine both A Corporation's and B Corporation's investments in export trade assets as of the close of the 75th day after the close of such corporations' taxable year.

(b) The following amounts are applicable to corporations A and B for 1964:

	Corporation A	Corporation B
Subpart F income	$100	$200

	Corporation A	Corporation B
Export trade income which constitutes foreign base company income	25	75
Other export trade income	10	15
Export promotion expenses allocable to export trade income which constitutes foreign base company income	10	80
Gross receipts from the sale of property in respect of which export trade income which constitutes foreign base company income is derived	400	600
Increase in investments in export trade assets for period beginning with March 16, 1964, and ending with March 16, 1965	35	120

(c) The amount by which subpart F income of corporations A and B is reduced for 1964 on a separate-company basis without regard to section 972 may be determined as set forth in items (i) through (vii) below, and the results of the consolidation of corporations A and B for 1964 are set forth in items (viii) through (x). Assuming an alternative case in which for 1964 the facts are the same as set forth in paragraphs (a) and (b) of this example except that B Corporation incurs export promotion expenses of $50 (rather than $80) which are allocable to the export trade income which constitutes foreign base company income, the results of the consolidation of corporations A and B for such year (a case where one of the limitations under paragraph (b)(2) of § 1.970–1 is effective) are set forth in items (xi) through (xiii):

	A Corporation (1)	B Corporation (2)	Total (3)
(i) Subpart F income	$100	$200	$300
(ii) Export trade income which constitutes foreign base company income	25	75	100
(iii) Other export trade income	10	15	25
(iv) Total export trade income	35	90	125
(v) Limitations under § 1.970–1(b)(2):			
(a) Increase in export trade assets limitation:			
($35×$25/$35)	25	....	....
($120×$75/$90)	....	100	....
([$35+$120]×$100/$125)	....	....	124
(b) Gross receipts limitation:			
(10% of $400)	40	....	....
(10% of $600)	....	60	....
(10% of $1,000)	....	....	100
(c) Export promotion expenses limitation:			
(150% of $10)	15	....	....
(150% of $80)	....	120	....
(150% of $90)	....	....	135
(d) Export promotion expenses limitation (alternative case):			
(150% of $10)	15	....	....
(150% of $50)	....	75	....
(150% of $60)	....	....	90
(vi) Reduction in subpart F income on a separate company basis determined without regard to section 972 (item (ii), but not to exceed smallest of items (v) *(a), (b),* and *(c),* in columns (1) and (2))	15	60	75
(vii) Subpart F income as reduced on a separate company basis (item (i) minus item (vi))	85	140	225
(viii) Reduction in subpart F income on a consolidated basis determined under section 972 (item (ii), but not to exceed smallest of items (v) *(a), (b),* and *(c),* in column (3))	....	....	100
(ix) Apportionment of reduction in subpart F income (item (ii))	25	75	100
(x) Subpart F income as reduced on a consolidated basis (item (i) minus item (ix))	75	125	200
ALTERNATIVE CASE			
(xi) Reduction in subpart F income on a consolidated basis determined under section 972 (item (ii) but not to exceed smallest of items (v) *(a), (b),* and *(d),* in column (3))	....	....	9
(xii) Apportionment of reduction in subpart F income (item (xi) times [item (ii) of column (1) over item (ii) of column (3)] and item (xi) times [item (ii) of column (2) over item (ii) of column (3)]); ($90 × $25/$100)	$22.50		
($90 × $75/$100)		$67.50	90
(xiii) Subpart F income as reduced on a consolidated basis (item (i) minus item (xii))	77.50	132.50	210

(3) *Determination of pro rata share of consolidated withdrawal of previously excluded export trade income*—(i) *In general.* If, for any taxable year, there is a decrease in investments in export trade assets under section 970(b) and paragraph (c)(1) of § 1.970–1, determined on a consolidated basis, of export trade corporations includible in a consolidated chain of such corporations, each United States shareholder who has elected under paragraph (a) of this section to

consolidate his interest in such chain of corporations shall include in his gross income, under section 951(a)(1)(A)(ii) and the regulations thereunder as an amount to which section 955 (as in effect before the enactment of the Tax Reduction Act of 1975) applies, his pro rata share of the amount of such consolidated decrease in investments but only to the extent such pro rata share does not exceed the lesser of the limitations provided by section 970(b) and paragraph (c)(2) of §1.970–1 with respect to such shareholder determined on a consolidated basis. The consolidated decrease in investments and the consolidated limitations shall be determined by aggregating the applicable amounts determined under paragraph (c) of §1.970–1 with respect to such shareholder's interest in each corporation includible in the consolidation.

(ii) *Allocation of pro rata share of consolidated decrease in investments in export trade assets.* For purposes of determining the amount referred to in paragraph (c)(2)(i)*(b)(3)* of §1.970–1 for a subsequent taxable year, a United States shareholder's pro rata share of a consolidated decrease in investments determined under subdivision (i) of this subparagraph for the current taxable year shall be allocated to such shareholder's interest in each of the export trade corporations includible in the consolidation in that ratio which—

(a) The net amount determined under paragraph (c)(2)(i)*(b)* of §1.970–1 with respect to such shareholder's interest in such corporation for all prior taxable years (whether or not a taxable year occurring during the period of consolidation) bears to

(b) The total of the net amounts determined under paragraph (c)(2)(i) *(b)* of §1.970–1 with respect to such shareholder's interests in all export trade corporations includible in such consolidation for all prior taxable years (whether or not a taxable year occurring during the period of consolidation).

(iii) *Illustration.* The application of this subparagraph may be illustrated by the following example:

Example. (a) Domestic corporation M owns 60 percent of the only class of stock of controlled foreign corporation A, which, in turn, owns 100 percent of the only class of stock of controlled foreign corporation B. All corporations use the calendar year as a taxable year, and corporations A and B are export trade corporations throughout the period here involved. Corporation M elects to consolidate corporations A and B for the entire period here involved.

(b) The following amounts are applicable to corporations A and B for 1964:

	A (1)	B (2)	Consolidated (3)
(i) Consolidated decrease in investments in export trade assets (determined before application of §1.970–1(c)(2))	....	....	$100
(ii) M Corporation's pro rata share of consolidated decrease (60%)	....	....	60
(iii) M Corporation's pro rata share of earnings and profits for 1963 and 1964 (§1.970–1(c) (2)(i)*(a)*)	$120	$90	210
(iv) M Corporation's pro rata share of net amount determined under §1.970–1(c)(2)(i)*(b)* for 1963	180	60	240
(v) Amount includible in M Corporation's gross income for 1964 (smallest of items (ii), (iii), and (iv) in column (3))	....	....	60

Corporation M must include $60 in its gross income for 1964 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) as its pro rata share of the consolidated decrease in investments in export trade assets; and, for purposes of determining the amount under paragraph (c)(2)(i)*(b)*(3) of §1.970–1 with respect to M Corporation's interest in each of corporations A and B for a subsequent taxable year, such consolidated decrease for 1964 is allocated as follows: to M Corporation's interest in A Corporation, $45 ($60 times $180/$240); and to its interest in B Corporation, $15 ($60 times $60/$240).

(c) The following amounts are applicable to corporations A and B for 1965:

	A(1)	B(2)	Consolidated (3)
(i) Consolidated decrease in investments in export trade assets (determined before application of §1.970–1(c)(2))	....	....	$150
(ii) M Corporation's pro rata share of consolidated decrease (60%)	....	....	90
(iii) M Corporation's pro rata share of earnings and profits (and deficits in earnings and profits) for 1963, 1964, and 1965 (§1.970–1(c)(2)(i)*(a)*)	$100	($20)	80

	A(1)	B(2)	Consolidated (3)
(iv) M Corporation's pro rata share of the net amount determined under § 1.970–1(c)(2)(i)*(b)* for 1963 and 1964			
($180 − $45)	135	....	....
($60 − $15)		45	....
Total			180
(v) Amount includible in M Corporation's gross income for 1965 (smallest of items (ii), (iii), and (iv) in column (3)).			80

Corporation M must include $80 in its gross income for 1965 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) as its pro rata share of the consolidated decrease in investments in export trade assets; and, for purposes of determining the amount under paragraph (c)(2)(i)*(b)*(3) of § 1.970–1 with respect to M Corporation's interest in each of corporations A and B for a subsequent taxable year, such consolidated decrease for 1965 is allocated as follows: to M Corporation's interest in A Corporation, $60 ($80 times $135/$180); and to its interest in B Corporation, $20 ($80 times $45/$180).

(d) The following amounts are applicable to corporations A and B for 1966:

	A(1)	B(2)	Consolidated (3)
(i) Consolidated decrease in investments in export trade assets (determined before application of § 1.970–1(c)(2))	....	....	$200
(ii) M Corporation's pro rata share of consolidated decrease (60%)	....	....	120
(iii) M Corporation's pro rata share of earnings and profits (and deficits in earnings and profits) for 1963, 1964, 1965, and 1966 (§ 1.970–1(c)(2)(i)*(a)*)	$120	$50	170
(iv) M Corporation's pro rata share of the net amount determined under § 1.970–1(c)(2)(i)(b) for 1963, 1964, and 1965			
($180 minus [$45+$60])	75	....	....
($60 − [$15+$20])		25	....
Total			100
(v) Amount includible in M Corporation's gross income for 1966 (smallest of items (ii), (iii), and (iv) in column (3))	....	....	100

Corporation M must include $100 in its gross income for 1966 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) as its pro rata share of the consolidated decrease in investments in export trade assets; and, for purposes of determining the amount under paragraph (c)(2)(i)(b)(3) of § 1.970–1 with respect to M Corporation's interest in each of corporations A and B for a subsequent taxable year, such consolidated decrease for 1966 is allocated as follows: to M Corporation's interest in A Corporation, $75 ($100 times $75/$100); and to its interest in B Corporation, $25 ($100 times $25/$100).

[T.D. 6754, 29 FR 12714, Sept. 9, 1964, as amended by T.D. 7893, 48 FR 22512, May 19, 1983]

§ 1.981–0 Repeal of section 981; effective dates.

The provisions of section 981 are not effective for taxable years beginning after December 31, 1976. For the treatment of the community income of aliens and their spouses for taxable years beginning after December 31, 1976, see section 879 and the regulations thereunder.

[T.D. 7670, 45 FR 6929, Jan. 31, 1980]

§ 1.981–1 Foreign law community income for taxable years beginning after December 31, 1966, and before January 1, 1977.

(a) *Election for special treatment*—(1) *In general.* An individual citizen of the United States who meets the requirements of section 981(a)(1) and subparagraph (2) of this paragraph for any open taxable year beginning after December 31, 1966, and before January 1, 1977, may make a binding election with his nonresident alien spouse to have section 981(b) and paragraph (b) of this section apply to their income for such year which is treated as community income under the applicable community property laws of a foreign country or countries. Generally, the community property laws of a foreign country operate upon land situated within its jurisdiction and upon personal property owned by spouses domiciled therein. If the election is made for any taxable year, it shall also apply for all subsequent open taxable years of such citizen and his nonresident alien spouse for which all the requirements of section 981(a)(1) and subparagraph (2) of this paragraph are met, unless the Director of International Operations consents, in accordance with paragraph (c)(2) of this section, to a termination of the election. An election under section 981(a) and this section has no effect for any taxable year beginning before January 1, 1967, for which a separate election, if made, must be made under section

981(c)(1) and §1.981–2. For the definition of ‘‘open taxable year’’ see section 981(e)(2) and paragraph (a) of §1.981–3. If the citizen and his nonresident alien spouse have different taxable years, see paragraph (c) of §1.981–3. If one of the spouses is deceased, see paragraph (d) of §1.981–3.

(2) *Requirements to be met.* In order for a U.S. citizen and his nonresident alien spouse to make an election under section 981(a) and this section for any taxable year and in order for the election to apply for any subsequent taxable year it is required under section 981(a)(1) that, for each such taxable year, such citizen be (i) a citizen of the United States, (ii) a bona fide resident of a foreign country or countries during the entire taxable year, and (iii) married at the close of the taxable year to an individual who is *(a)* a nonresident alien during the entire taxable year and *(b)*, in the case of any such subsequent taxable year, the same nonresident alien individual to whom the citizen was married at the close of the earliest of such taxable years. If either spouse dies during a taxable year, the taxable year of the surviving spouse shall be treated, solely for purposes of making the determination under subdivision (iii) of this subparagraph, as ending on the date of such death. A citizen of the United States shall be considered as not married at the close of his taxable year if he is legally separated from his spouse under a decree of divorce or of separate maintenance. However, the mere fact that spouses have not lived together during the course of the taxable year shall not cause them to be considered as not married at the close of the taxable year. A husband and wife who are separated under an interlocutory decree of divorce retain the relationship of husband and wife until the decree becomes final.

(3) *Determination of residence.* The principles of paragraphs (a)(2) and (b)(7) of §1.911–1 (26 CFR 1.911–1 (1978)) shall apply in order to determine for purposes of this paragraph whether a U.S. citizen is a *bona fide* resident of a foreign country or countries during the entire taxable year. The principles of §§1.871.2 through 1.871–5 shall apply in order to determine whether the alien spouse of a U.S. citizen is a nonresident during the entire taxable year.

(4) *Manner of electing.* The election under section 981(a) and this section shall be made in accordance with the applicable rules set forth in paragraph (c) of this section.

(b) *Treatment of community income*—(1) *In general.* Community income for any taxable year to which an election under section 981(a) and this section applies, and the deductions properly allocable to such income, shall be divided between the electing U.S. citizen and nonresident alien spouses in accordance with the rules set forth in section 981(b) and subparagraphs (2) through (6) of this paragraph. Community income for this purpose means all gross income, whether derived from sources within or without the United States, which is treated as community income of the spouses under the community property laws of the foreign country having jurisdiction to determine the legal ownership of the income. A spouse has ownership of the income for this purpose if under the applicable foreign law he has a proprietary vested interest in the income.

(2) *Earned income.* Wages, salaries, or professional fees, and other amounts received as compensation for personal services actually performed, which are community income for the taxable year, shall be treated as the income of the spouse who actually performed the personal services. This subparagraph does not apply, however, to community income (i) derived from any trade or business carried on by the husband or the wife, (ii) attributable to a spouse’s distributive share of the income of a partnership to which subparagraph (4) of this paragraph applies, (iii) consisting of compensation for personal services rendered to a corporation which represents a distribution of the earnings and profits of the corporation rather than a reasonable allowance as compensation for the personal services actually performed, or (iv) derived from property which is acquired as consideration for personal services performed.

(3) *Trade or business income.* If any income derived from a trade or business carried on by the husband or wife is community income for the taxable

year, all of the gross income, and the deductions attributable to such income, shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of the trade or business, in which case all of the gross income and deductions shall be treated as the gross income and deductions of the wife. This subparagraph does not apply to any income derived from a trade or business carried on by a partnership of which both or one of the spouses is a member. For purposes of this subparagraph, income derived from a trade or business includes any income derived from a trade or business in which both personal services and capital are material income producing factors. The term ''management and control'' means management and control in fact, not the management and control imputed to the husband under the community property laws of a foreign country. For example, a wife who operates a beauty parlor without any appreciable collaboration on the part of a husband is considered as having substantially all of the management and control of the business despite the provisions of any community property laws of a foreign country vesting in the husband the right of management and control of community property; and the income and deductions attributable to the operation of the beauty parlor are considered the income and deductions of the wife.

(4) *Partnership income.* If any portion of a spouse's distributive share of the income of a partnership of which such spouse is a member is community income for the taxable year, all of that distributive share shall be treated as the income of that spouse and shall not be taken into account in determining the income of the other spouse. If both spouses are members of the same partnership, the distributive share of the income of each spouse which is community income shall be treated as the income of that spouse. A spouse's distributive share of such income of a partnership shall be determined as provided in section 704, and the regulations thereunder.

(5) *Income from separate property.* Any community income for the taxable year, other than income described in section 981(b)(1) or (2) and subparagraph (2), (3), or (4) of this paragraph, which is derived from the separate property of one of the spouses shall be treated as the income of that spouse. The determination of what property is separate property for this purpose shall be made in accordance with the laws of the foreign country which, in accordance with subparagraph (1) of this paragraph, has jurisdiction to determine that the income from such property is community income.

(6) *Other community income.* Any community income for the taxable year, other than income described in section 981(b)(1), (2), or (3), and subparagraph (2), (3), (4), or (5) of this paragraph, shall be treated as the income of that spouse who has a proprietary vested interest in that income under the laws of the foreign country which, in accordance with subparagraph (1) of this paragraph, has jurisdiction to determine that such income is community income. Thus, for example, this subparagraph applies to community income not described in subparagraph (2), (3), (4), or (5) of this paragraph which consists of dividends, interest, rents, royalties, or gains, from community property or of the earnings of unemancipated minor children.

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

Example 1. H, a nonresident alien individual and W, a U.S. citizen, each of whose taxable years is the calendar year, were married throughout 1967. H and W were residents of, and domiciled in, foreign country Z during the entire taxable year. During 1967, H earned $10,000 from the performance of personal services as an employee. H also received $500 in dividend income from stock which under the community property laws of country Z is considered to be the separate property of H. W had no separate income for 1967. Under the community property laws of country Z all income earned by either spouse is considered to be community income, and one-half of such income is considered to belong to the other spouse. In addition, such laws of country Z provide that all income derived from property held separately by either spouse is to be treated as community income and treated as belonging one-half to each spouse. Thus, under the community property laws of country Z, H and W are both considered to have realized income of $5,250 during

1967, even though such laws recognize the stock as the separate property of H. If the election under this section is in effect for 1967, under the rules of subparagraphs (2) and (5) of this paragraph all of the income of $10,500 derived during 1967 shall be treated, for U.S. income tax purposes, as the income of H.

Example 2. The facts are the same as in example 1 except that H is the sole proprietor of a retail merchandising company and such company has a $10,000 profit during 1967. W exercises no management and control over the business. In addition, H is a partner in a wholesale distributing company, and his distributive share of the partnership profit is $5,000. Both of these amounts of income are treated as community income under the community property laws of country Z, and under such laws both H and W are treated as realizing $7,500 of such income. If the election under this section is in effect for 1967, under the rule of subparagraphs (3) and (4) of this paragraph all $15,000 of such income shall be treated as the income of H for U.S. income tax purposes.

Example 3. The facts are the same as in example 1 except that H also received $1,000 in dividends on stock held separately in his name. Under the community property laws of country Z the stock is considered to be community property; and the dividends, to be community income, one-half of such income being treated as the income of each spouse. If the election under this section is in effect for 1967, under the rule of subparagraph (6) of this paragraph, $500 of the dividend income shall be treated, for U.S. income tax purposes, as the income of each spouse.

(c) *Time and manner of making or terminating an election*—(1) *In general.* A citizen of the United States and his nonresident alien spouse shall, for the first taxable year beginning after December 31, 1966, for which an election under section 981(a) and this section is to apply, make the election by filing a return, an amended return, or a claim for refund, whichever is proper, for such taxable year and attaching thereto a statement that the election is being made and that the requirements of paragraph (a)(2) of this section are met for such taxable year. The statement must show the name, address, and account number, if any, of each spouse, the name and address of the executor, administrator, or other person making the election for a deceased spouse, the taxable year to which the election applies, and the name of the foreign country or countries having jurisdiction to determine the ownership of any income being treated in accordance with section 981(b) and paragraph (b) of this section. The statement must be signed by both persons making the election. An election under this section may be made only for a taxable year which, on the date of the election, as defined in paragraph (b) of §1.981–3, is open within the meaning of section 981(e)(2) and paragraph (a) of §1.981–3.

(2) *Termination only with consent of Director of International Operations*—(i) *In general.* An election under this section for any taxable year is binding and may not be revoked. The election shall also remain in effect for all subsequent taxable years of the spouses for which the requirements of paragraph (a)(2) of this section are met and which on the date of the election are open, within the meaning of paragraph (a) of §1.981–3, unless the election is terminated for any such subsequent taxable year or years in accordance with subdivision (ii) of this subparagraph. Any return, amended return, or claim for refund in respect of any such subsequent taxable year for which the election is in effect shall have attached thereto a copy of the statement filed in accordance with subparagraph (1) of this paragraph and an additional signed statement that for such subsequent taxable year the requirements of paragraph (a)(2) of this section are met.

(ii) *Written request to terminate required.* A request to terminate an election under this section for a subsequent taxable year or years shall be made in writing by the persons who made the election and shall be addressed to the Director of International Operations, Internal Revenue Service, Washington, DC 20225. The request must include the name, address, and account number, if any, of each spouse and must be signed by the persons making the request. It must specify the taxable year or years for which the termination is to be effective and the grounds which justify the termination. The request shall be filed not later than 90 days before the close of the period for assessing a deficiency against the U.S. citizen for the earliest taxable year of such citizen for which the termination is to be effective. The Director of International Operations may require such other information as may be necessary in order to determine whether the termination will be permitted. A copy of the consent by the Director of International Operations to terminate must be attached to an amended income tax return for each taxable year for which the termination is effective and for which a return has previously been filed.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7330, 39 FR 38372, Oct. 31, 1974, as amended by T.D. 7670, 45 FR 6929, Jan. 31, 1980; T.D. 7736, 45 FR 76143, Nov. 18, 1980]

§ 1.981–2 Foreign law community income for taxable years beginning before January 1, 1967.

(a) *Election for special treatment*—(1) *In general.* For all open taxable years beginning before January 1, 1967, for which an individual citizen of the United States meets the requirements of subparagraphs (A) and (C) of section 981(a)(1) and subparagraph (2) of this paragraph, such citizen and his nonresident alien spouse may make a joint election to have section 981(c)(2) and paragraph (b) of this section apply to their income which is treated as community income under the applicable community property laws of a foreign country or countries. However, if the conditions prescribed by section 981(d)(3) and subparagraph (3) of this paragraph are met, the nonresident alien spouse is not required to join in the election and such citizen may make a separate election to have section 981(c)(2) and paragraph (b) of this section apply to such income for such taxable years. An election under section 981(c)(1) and this section shall apply to every open taxable year of such citizen and his nonresident alien spouse beginning before January 1, 1967, for which all the requirements of subparagraphs (A) and (C) of section 981(a)(1) and subparagraph (2) of this paragraph are met. It is immaterial whether such open taxable year is a taxable year subject to the provisions of the 1954 Code, the 1939 Code, or any other internal revenue law in effect before the 1939 Code. An election under section 981(c)(1) and this section has no effect for any taxable year beginning after December 31, 1966. For the definition of ‘‘open taxable year’’ see section 981(e)(2) and paragraph (a) of § 1.981–3. If the citizen and his nonresident alien spouse have different taxable years, see paragraph (c) of § 1.981–3. If one of the spouses is deceased, see paragraph (d) of § 1.981–3. An election under section 981(c)(1) and this section is binding and may not be revoked.

(2) *Requirements to be met.* In order for the citizen of the United States to make an election under this section, whether required to be made jointly with his nonresident alien spouse or permitted to be made separately, it is required under section 981(c)(1) that, for each taxable year to which the election applies, the citizen making the election be (i) a citizen of the United States and (ii) married at the close of the taxable year to an individual who is *(a)* a nonresident alien during the entire taxable year and *(b),* in the case of any such taxable years subsequent to the first, the same nonresident alien individual to whom the citizen was married at the close of such first taxable year. The provisions of paragraph (a)(2) of § 1.981–1 apply to determine whether a U.S. citizen making an election under section 981(c)(1) and this section is married at the close of a taxable year to an individual who is a nonresident alien during the entire taxable year.

(3) *Cases where joint election is not required.* A nonresident alien spouse is not required to join in an election under section 981(c)(1) and this section if the Director of International Operations determines in accordance with paragraph (c)(4) of this section—

(i) That an election under section 981(c)(1) and this section would not affect the liability for Federal income tax of the nonresident alien spouse for any taxable year, whether beginning on, before, or after January 1, 1967, or

(ii) That the effect of the election on the liability of the nonresident alien spouse for Federal income tax for any such taxable year cannot be ascertained and that to deny the election to the U.S. citizen spouse would be inequitable and cause undue hardship to the U.S. citizen.

If in accordance with this subparagraph the nonresident alien spouse is not required to join in the election by the U.S. citizen, the provisions of section 981(d)(2) and paragraph (e) of §1.981–3 shall not apply so as to extend the period for assessing deficiencies or filing a claim for credit or refund for any taxable year of the nonresident alien spouse.

(4) *Manner of electing.* The election under section 981(c)(1) and this section shall be made in accordance with the applicable rules set forth in paragraph (c) of this section.

(b) *Treatment of community income*—(1) *In general.* Community income, as defined in paragraph (b)(1) of §1.981–1, for any taxable year beginning before January 1, 1967, to which an election under section 981(c)(1) and this section applies, and the deductions properly allocable to such income, shall be divided between the U.S. citizen and his nonresident alien spouse in accordance with the rules set forth in section 981(c)(2) and subparagraphs (2) and (3) of this paragraph. The income shall be divided in such manner even though the nonresident alien spouse is not required, in accordance with paragraph (a)(3) of this section, to join in the election by the U.S. citizen.

(2) *Earned income, business income, partnership income, and income from separate property.* All community income for any taxable year to which this paragraph applies which is treated as the income of one of the spouses in accordance with section 981(b)(1), (2), or (3) and paragraph (b)(2), (3), (4), or (5) of §1.981–1 shall be treated as the income of that spouse for purposes of this paragraph.

(3) *Other community income.* All community income for any taxable year to which this paragraph applies, other than income described in subparagraph (2) of this paragraph, shall be treated as the income of the spouse who, for such taxable year, has a greater amount of gross income than the other spouse, determined by adding to the amount of gross income which is treated as the gross income of that spouse in accordance with subparagraph (2) of this paragraph the amount of the gross income for the taxable year which is treated as the separate income of that spouse under the community property laws of the foreign country having jurisdiction to determine the legal ownership of the income. If either spouse dies during a taxable year, the taxable year of the surviving spouse shall be treated as ending on the date of such death for the purpose of determining which spouse has the greater amount of gross income for such taxable year. Moreover, if the U.S. citizen and his nonresident alien spouse do not have the same taxable year, as defined in section 441(b) and the regulations thereunder, the periods for which the amounts of gross income are to be compared under this subparagraph are (i) the taxable year of the citizen and (ii) that period falling within the consecutive taxable years of the nonresident alien spouse which coincides with the period covered by such taxable year of the citizen. See paragraph (c) of §1.981–3.

(c) *Time and manner of making election*—(1) *In general.* A citizen of the United States and his nonresident alien spouse or, if subparagraph (4) of this paragraph applies, such citizen alone may make an election under section 981(c)(1) and this section at any time on or after November 13, 1966, for each and every taxable year beginning before January 1, 1967, which on the date of the election, as defined in paragraph (b) of §1.981–3, is open within the meaning of section 981(e)(2) and paragraph (a) of §1.981–3. The election shall be made by filing a return, an amended return, or a claim for refund, whichever is proper, for each taxable year to which the election applies and attaching thereto a statement that the election is being made and that the requirements of paragraph (a)(2) of this section are met for each such taxable year. The statement must also show the information required by subparagraph (2) of this paragraph and must, where applicable, be signed by both persons making the election.

(2) *Information required.* The statement described in subparagraph (1) of this paragraph must show—

(i) The name, address, and account number, if any, of each spouse,

(ii) The name and address of the executor, administrator, or other person making the election for a deceased spouse,

(iii) The taxable years to which the election applies,

(iv) The office of the district director, or the service center, where the return or returns, if any, for such taxable year or years were filed,

(v) The dates on which such return or returns, if any, were filed and on which the tax for such taxable year or years was paid, if the tax has been paid, and

(vi) The name of the foreign country or countries having jurisdiction to determine the ownership of any income being treated in accordance with section 981(c)(2) and paragraph (b) of this section.

(3) *Place for filing.* Any return, amended return, or claim for refund filed under subparagraph (1) of this paragraph in respect of any taxable year shall be filed with the Director of International Operations, Internal Revenue Service, Washington, DC 20225. (See § 1.6091–3.)

(4) *Determination that joint election is not required.* A U.S. citizen spouse entitled to make an election under section 981(c)(1) and this section for open taxable years beginning before January 1, 1967, may apply to the Director of International Operations for a determination under section 981(d)(3) that the nonresident alien spouse is not required to join in the election by such citizen. This application shall be made by filing with the Director of International Operations, Internal Revenue Service, Washington, DC 20225, a statement setting forth the same information required by subparagraph (2) of this paragraph and such other information as is required by the Director of International Operations to justify a claim that the requirements of section 981(d)(3) and paragraph (a)(3) of this section are met. The Director of International Operations shall notify the U.S. citizen by letter of his determination with respect to the application. If the determination is that the nonresident alien spouse is not required to join in the election, a copy of the letter of determination shall be attached to each return, amended return, or claim for refund, to be filed pursuant to subparagraph (1) of this paragraph.

[T.D. 7330, 39 FR 38373, Oct. 31, 1974]

§ 1.981–3 Definitions and other special rules.

(a) *Open taxable years.* (1) For purposes of paragraph (a) of § 1.981–1, and paragraph (a) of § 1.981–2, a taxable year of the U.S. citizen, and the taxable year or years of his nonresident alien spouse ending or beginning within such taxable year of such citizen, shall be treated as open if the period prescribed by section 6501(a) (or section 6501(c)(4) if the period is extended by agreement) for assessing a deficiency against the citizen for his taxable year has not expired before the date of the election, determined under paragraph (b) of this section. Thus, for example, a taxable year of a U.S. citizen beginning before January 1, 1967, is open for purposes of this subparagraph if, before the election under section 981(c)(1) and § 1.981–2, such citizen has never filed a return for such year and a return was required under section 6012 without reference to section 981. For example, if a U.S. citizen spouse on a calendar year basis who has never filed a return for 1960 decides in 1975 that he wishes to make the election under section 981(c)(1) and § 1.981–2 in order to avoid being subject to tax for 1960 on his share of the community income for that year, he may in 1975 elect the benefits of section 981(c)(2) by filing an election in accordance with paragraph (c) of § 1.981–2. In such case, a taxable year or years of the nonresident alien spouse of such citizen ending or beginning within 1960 shall be treated in 1975 as an open taxable year.

(2) Subparagraph (1) of this paragraph shall apply even though the period prescribed by section 6501 for assessing a deficiency against the nonresident alien spouse for his taxable year or years ending or beginning within the taxable year of the U.S. citizen has expired before the election is made.

(3) If either spouse dies during a taxable year to which an election under § 1.981–1 or § 1.981–2 applies, the taxable year of the decedent and the surviving spouse shall be determined under this paragraph without regard to section 981(e)(4), relating to death of spouse

during the taxable year. See paragraph (a)(2) of §1.443–1.

(4) For definition of the term ''taxable year'', see section 441(b) and the regulations thereunder.

(b) *Date of election.* (1) For purposes of §1.981–1 and this section the date of an election made under section 981(a) and §1.981–1 is the date on which the return, amended return, or claim for refund required by paragraph (c)(1) of §1.981–1 is filed.

(2) For purposes of §1.981–2 and this section the date of an election made under section 981(c)(1) and §1.981–2 is the date on which the returns, amended returns, or claims for refund, required by paragraph (c)(1) of §1.981–2 are filed.

(3) For provisions treating timely mailing as timely filing, see section 7502 and the regulations thereunder.

(c) *Spouses with different taxable years.* If the U.S. citizen and his nonresident alien spouse do not have the same taxable year, as defined in section 441(b) and the regulations thereunder, the election under §1.981–1 or §1.981–2 shall apply to each taxable year of such citizen in respect of which the election is made and to that period falling within the consecutive taxable years of the nonresident alien spouse which coincides with the period covered by such taxable year of the citizen.

(d) *Election on behalf of deceased spouse.* Any election, statement, or request, required to be made under paragraph (c) of §1.981–1, or paragraph (c) of §1.981–2, by one of the spouses may, if such spouse is deceased, be made by the executor, administrator, or other person charged with the property of such deceased spouse.

(e) *Extension of period of limitations on assessment or refund*—(1) *Assessment of deficiency.* Except as provided in subparagraph (3) of this paragraph, if an election under section 981(a) and §1.981–1, or under section 981(c)(1) and §1.981–2, is properly made, the period within which a deficiency may be assessed for any taxable year to which the election applies shall, to the extent the deficiency is attributable to the application of such election, not expire before one year after the date of the election, determined under paragraph (b) of this section.

(2) *Refund of tax.* Except as provided in subparagraph (3) of this paragraph, if an election under section 981(a) and §1.981–1, or under section 981(c)(1) and §1.981–2, is properly made, the period within which a claim for credit or refund of an overpayment for any taxable year to which the election applies may be filed shall, to the extent the overpayment is attributable to the application of the election, not expire before one year after the date of the election, determined under paragraph (b) of this section.

(3) *Exception in case of nonelecting alien.* Subparagraphs (1) and (2) of this paragraph shall not apply to any taxable year of a nonresident alien spouse who, in accordance with paragraph (a)(3) of §1.981–2, is not required to join in the election by the U.S. citizen spouse under section 981(c)(1) and §1.981–2.

(f) *Payment of interest for extension period.* To the extent that an overpayment or deficiency for any taxable year is attributable to an election made under §1.981–1 or §1.981–2, no interest shall be allowed or paid for any period ending with the day before the date which is one year after the date of the election, determined under paragraph (b) of this section.

[T.D. 7330, 39 FR 38374, Oct. 31, 1974]

§1.985–0 Outline of regulation.

This section lists the paragraphs contained in §§1.985–1 through 1.985–6.

§1.985–1 Functional currency.

(a) Applicability and effective date.
(b) Dollar functional currency.
(c) Functional currency of a QBU that is not required to use the dollar.
(d) Single functional currency for a foreign corporation.
(e) Translation of nonfunctional currency transactions.
(f) Examples.

§1.985–2 Election to use the United States dollar as the functional currency of a QBU.

(a) Background and scope.
(b) Eligible QBU.
(c) Time and manner for dollar election.
(d) Effect of dollar election.

§1.985–3 United States dollar approximate separate transactions method.

(a) Scope and effective date.
(b) Statement of method.

(c) Translation into United States dollars.
(d) Computation of DASTM gain or loss.
(e) Effect of DASTM gain or loss on gross income, taxable income, or earnings and profits.

§ 1.985–4 Method of accounting.

(a) Adoption or election.
(b) Condition for changing functional currencies.
(c) Relationship to certain other sections of the Code.

§ 1.985–5 Adjustments required upon change in functional currency.

(a) In general.
(b) Step 1—Taking into account exchange gain or loss on certain section 988 transactions.
(c) Step 2—Determining the new functional currency basis of property and the new functional currency amount of liabilities and any other relevant items.
(d) Step 3A—Additional adjustments that are necessary when a branch changes functional currency.
(e) Step 3B—Additional adjustments that are necessary when a taxpayer changes functional currency.
(f) Examples.

Section 1.985–6 Transition rules for a QBU that uses the dollar approximate separate transactions method for its first taxable year beginning in 1987.

(a) In general.
(b) Certain controlled foreign corporations.
(c) All other foreign corporations.
(d) Pre-1987 section 902 amounts.
(e) Net worth branch.
(f) Profit and loss branch.

[T.D. 8263, 54 FR 38653, Sept. 20, 1989, as amended by T.D. 8464, 58 FR 232, Jan. 5, 1993; T.D. 8556, 59 FR 37672, July 25, 1994]

§ 1.985–1 Functional currency.

(a) *Applicability and effective date*—(1) *Purpose and scope.* These regulations provide guidance with respect to defining the functional currency of a taxpayer and each qualified business unit (QBU), as defined in section 989(a). Generally, a taxpayer and each QBU must make all determinations under subtitle A of the Code (relating to income taxes) in its respective functional currency. This section sets forth rules for determining when the functional currency is the United States dollar (dollar) or a currency other than the dollar. Section 1.985–2 provides an election to use the dollar as the functional currency for certain QBUs that absent the election would have a functional currency that is a hyperinflationary currency, and explains the effect of making the election. Section 1.985–3 sets forth the dollar approximate separate transactions method that certain QBUs must use to compute their income or loss or earnings and profits. Section 1.985–4 provides that the adoption of a functional currency is a method of accounting and sets forth conditions for a change in functional currency. Section 1.985–5 provides adjustments that are required to be made upon a change in functional currency. Finally, § 1.985–6 provides transition rules for a QBU that uses the dollar approximate separate transactions method for its first taxable year beginning after December 31, 1986.

(2) *Effective date.* These regulations apply to taxable years beginning after December 31, 1986. However, any taxpayer desiring to apply temporary Income Tax Regulations § 1.985–0T through § 1.985–4T in lieu of these regulations to all taxable years beginning after December 31, 1986, and on or before October 20, 1989 may (on a consistent basis) so choose. For the text of the temporary regulations, see 53 FR 20308 (1988).

(b) *Dollar functional currency*—(1) *In general.* The dollar shall be the functional currency of a taxpayer or QBU described in paragraph (b)(1)(i) through (v) of this section regardless of the currency used in keeping its books and records (as defined in § 1.989(a)–1(d)). The dollar shall be the functional currency of—

(i) A taxpayer that is not a QBU (e.g., an individual);

(ii) A QBU that conducts its activities primarily in dollars. A QBU conducts its activities primarily in dollars if the currency of the economic environment in which the QBU conducts its activities is primarily the dollar. The facts and circumstances test set forth in paragraph (c)(2) of this section shall apply in making this determination;

(iii) Except as otherwise provided by ruling or administrative pronouncement, a QBU that has the United States, or any possession or territory of the United States where the dollar is the standard currency, as its residence (as defined in section 988(a)(3)(B));

(iv) A QBU that does not keep books and records in the currency of any economic environment in which a significant part of its activities is conducted. Whether a QBU keeps such books and records is determined in accordance with paragraph (c)(3) of this section; or

(v) A QBU that produces income or loss that is, or is treated as, effectively connected with the conduct of a trade or business within the United States.

(2) *QBUs operating in a hyperinflationary environment*—(i) *Taxable years beginning on or before August 24, 1994.* For taxable years beginning on or before August 24, 1994, see §1.985–2 with respect to a QBU that elects to use, or is otherwise required to use, the dollar as its functional currency.

(ii) *Taxable years beginning after August 24, 1994*—(A) *In general.* For taxable years beginning after August 24, 1994, except as otherwise provided in paragraph (b)(2)(ii)(B) of this section, any QBU that otherwise would be required to use a hyperinflationary currency as its functional currency must use the dollar as its functional currency and compute income or loss or earnings and profits under the rules of §1.985–3.

(B) *Exceptions*—(*1*)—*Certain QBU branches.* The functional currency of a QBU that otherwise would be required to use a hyperinflationary currency as its functional currency and that is a branch of a foreign corporation having a non-dollar functional currency that is not hyperinflationary shall be the functional currency of the foreign corporation. Such QBU's income or loss or earnings and profits shall be determined under §1.985–3 by substituting the functional currency of the foreign corporation for the dollar.

(*2*) *Corporation that is not a controlled foreign corporation.* A foreign corporation (or its QBU branch) operating in a hyperinflationary environment is not required to use the dollar as its functional currency pursuant to paragraph (b)(2)(ii)(A) of this section if that foreign corporation is not a controlled foreign corporation as defined in section 957 or 953(c)(1)(B). However, a noncontrolled section 902 corporation, as defined in section 904(d)(2)(E), may elect to use the dollar (or, if appropriate, the currency specified in paragraph (b)(2)(ii)(B)(*1*) of this section) as its (or its QBU branch's) functional currency under the procedures set forth in §1.985–2(c)(3).

(C) *Change in functional currency. (1) In general.* If a QBU is required to change its functional currency to the dollar under paragraph (b)(2)(ii)(A) of this section, or chooses or is required to change its functional currency to the dollar for any open taxable year (and all subsequent taxable years) under §1.985–3(a)(2)(ii), the change is considered to be made with the consent of the Commissioner for purposes of §1.985–4. A QBU changing functional currency must make adjustments described in §1.985–7 if the year of change (as defined in §1.481–1(a)(1)) begins after 1987, or the adjustments described in §1.985–6 if the year of change begins in 1987. No adjustments under section 481 are required solely because of a change in functional currency described in this paragraph (b)(2)(ii)(C).

(*2*) *Effective date.* This paragraph (b)(2)(ii)(C) applies to taxable years beginning after April 6, 1998. However, a taxpayer may choose to apply this paragraph (b)(2)(ii)(C) to all open years after December 31, 1986, provided each person, and each QBU branch of a person, that is related (within the meaning of §1.985–2(d)(3)) also applies to this paragraph (b)(2)(ii)(C).

(D) *Hyperinflationary currency.* For purposes of sections 985 through 989, the term hyperinflationary currency means the currency of a country in which there is cumulative inflation during the base period of at least 100 percent as determined by reference to the consumer price index of the country listed in the monthly issues of the ‘‘International Financial Statistics’’ or a successor publication of the International Monetary Fund. If a country's currency is not listed in the monthly issues of ‘‘International Financial Statistics,’’ a QBU may use any other reasonable method consistently applied for determining the country's consumer price index. Base period means, with respect to any taxable year, the thirty-six calendar months immediately preceding the first day of the current calendar year. For this purpose, the cumulative inflation rate for the base period is based on compounded inflation rates. Thus, if for 1991, 1992, and 1993, a country’s annual inflation rates are 29 percent, 25 percent, and 30 percent, respectively, the cumulative inflation rate for the three-year base period is 110 percent [((1.29 × 1.25 × 1.3) − 1.0 × 1.10)x100=110%] and the currency of the country for the QBU’s 1994 year is considered hyperinflationary. In making the determination whether a currency is hyperinflationary, the determination for purposes of United States generally accepted accounting principles may be used for income tax purposes provided the determination is based on criteria that is substantially similar to the rules previously set forth in this paragraph (b)(2)(ii)(D), the method of determination is applied consistently from year to year, and the same method is applied to all related persons as defined in § 1.985–3(e)(2)(vi).

(E) *Change in functional currency when currency ceases to be hyperinflationary*—(*1*) *In general.* A QBU that has been required to use the dollar as its functional currency under paragraph (b)(2) of this section, or has elected to use the dollar as its functional currency under paragraph (b)(2)(ii)(B)(*2*) of this section or § 1.985–2, must change its functional currency as of the first day of the first taxable year that follows three consecutive taxable years in which the currency of its economic environment, determined under paragraph (c)(2) of this section, is not a hyperinflationary currency. The functional currency of the QBU for such year shall be determined in accordance with paragraph (c) of this section. For purposes of § 1.985–4, the change is considered to be made with the consent of the Commissioner. See § 1.985–5 for adjustments that are required upon a change in functional currency.

(*2*) *Effective Date.* This paragraph (b)(2)(ii)(E) of this section applies to taxable years beginning after April 6, 1998.

(c) *Functional currency of a QBU that is not required to use the dollar*—(1) *General rule.* The functional currency of a QBU that is not required to use the dollar under paragraph (b) of this section shall be the currency of the economic environment in which a significant part of the QBU’s activities is conducted, if the QBU keeps, or is presumed under paragraph (c)(3) of this section to keep, its books and records in such currency.

(2) *Economic environment.* For purposes of section 985 and the regulations thereunder, the economic environment in which a significant part of a QBU’s activities is conducted shall be determined by taking into account all the facts and circumstances.

(i) *Facts and circumstances.* The facts and circumstances that are considered in determining the economic environment in which a significant part of a QBU’s activities is conducted include, but are not limited to, the following:

(A) The currency of the country in which the QBU is a resident as determined under section 988(a)(3)(B);

(B) The currencies of the QBU’s cash flows;

(C) The currencies in which the QBU generates revenues and incurs expenses;

(D) The currencies in which the QBU borrows and lends;

(E) The currencies of the QBU’s sales markets;

(F) The currencies in which pricing and other financial decisions are made;

(G) The duration of the QBU’s business operations; and

(H) The significance and/or volume of the QBU’s independent activities.

(ii) *Rate of inflation.* The rate of inflation (regardless of how it is determined) shall not be a factor used to determine a QBU’s economic environment.

(iii) *Consistency.* A taxpayer must consistently apply the facts and circumstances test set forth in this paragraph (c)(2) in evaluating the economic environment of its QBUs, *e.g.*, its branches, that engage in the same or similar trades or businesses.

(3) *Books and records presumption.* A QBU shall be presumed to keep books and records in the currency of the economic environment in which a significant part of its activities are conducted. The presumption may be overcome only if the QBU can demonstrate to the satisfaction of the district director that a substantial nontax purpose exists for not keeping any books and records in such currency. A taxpayer

may not use this presumption affirmatively in determining a QBU's functional currency.

(4) *Multiple currencies.* If a QBU has more than one currency that satisfies the requirements of paragraph (c)(1) of this section, the QBU may choose any such currency as its functional currency.

(5) *Relationship of United States accounting principles.* In making the functional currency determination under this paragraph (c), the currency of the QBU for purposes of United States generally accepted accounting principles (GAAP) will ordinarily be accepted as the functional currency of the QBU for income tax purposes, provided that the GAAP determination is based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section.

(6) *Effect of changed circumstances.* Regardless of any change in circumstances, a QBU may change its functional currency determined under this paragraph (c) only if the QBU complies with §1.985–4 or the Commissioner's consent is considered to have been granted under §1.985–2(d)(4) or §1.985–3(a)(2)(ii). For special rules relating to the conversion to the euro, see §1.985–8T.

(d) *Single functional currency for a foreign corporation*—(1) *General rule.* This paragraph (d) applies to a foreign corporation that has two or more QBUs that do not have the same functional currency. The foreign corporation shall be treated as having a single functional currency for the corporation as a whole that is different from the functional currency of one or more of its QBUs. The determination of a foreign corporation's functional currency shall be made by first applying paragraph (d)(1)(i) and then paragraph (d)(l)(ii) of this section.

(i) *Step 1.* Each QBU of the foreign corporation determines its functional currency in accordance with the rules set forth in paragraphs (b) and (c) of this section and §1.985–2.

(ii) *Step 2.* The foreign corporation determines its functional currency applying the principles of paragraphs (b) and (c) of this section to the corporation's activities as a whole. Thus, if a foreign corporation has two branches, the corporation shall determine its functional currency by applying the principles of paragraphs (b) and (c) of this section to the combined activities of the corporation and the branches. For purposes of this paragraph (d)(1), if a QBU of a foreign corporation has the dollar as its functional currency under paragraph (b)(2) of this section, the QBU's activities shall be considered dollar activities of the corporation.

(2) *Translation of income or loss of QBUs having different functional currencies than the foreign corporation as a whole.* Where the functional currency of a foreign corporation as a whole differs from the functional currency of one or more of its QBUs, each such QBU shall determine the amount of its income or loss or earnings and profits (or deficit in earnings and profits) in its functional currency under the principles of section 987 (relating to branch transactions). The amount of income or loss or earnings and profits (or deficit in earnings and profits) of each QBU in its functional currency shall then be translated into the foreign corporation's functional currency using the appropriate exchange rate as defined in section 989(b)(4) for purposes of determining the corporation's income or loss or earnings and profits (or deficit in earnings and profits).

(e) *Translation of nonfunctional currency transactions.* Except for a QBU using the dollar approximate separate transactions method described in §1.985–3, *see* section 988 and the regulations thereunder for the treatment of nonfunctional currency transactions.

(f) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. P, a domestic corporation, operates exclusively through foreign branch X in Country A. X is a QBU within the meaning of section 989(a) and its residence is Country A as determined under section 988 (a)(3)(B). The currency of Country A is the LC. All of X's purchases, sales, and expenses are in the LC. The laws of A require X to keep books and records in the LC. It is determined that the LC is the currency of X under United States generally accepted accounting principles. This determination is based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section. Under these facts, while the functional currency of P is the dollar since its residence is the United States, the functional currency of X is the LC.

Example 2. P, a publicly-held domestic regulated investment company (as defined under section 851), operates exclusively through foreign branch B in Country R. B is a QBU within the meaning of section 989(a) and its residence is Country R as determined under section 988(a)(3)(B). The currency of Country R is the LC. B's principal activities consist of purchasing and selling stock and securities of Country R companies and securities issued by Country R. It is determined that the dollar is the currency of B under United States generally accepted accounting principles. This determination is not based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section. Under these facts, while the functional currency of P is the dollar since its residence is the United States, B may choose the LC as its functional currency because it has significant activities in the LC provided it keeps books and records in the LC. The fact that the dollar is the currency of B under generally accepted accounting principles is irrelevant for purposes of determining B's functional currency because the GAAP determination was not based on factors similar to those set forth in paragraph (c)(2) of this section.

Example 3. P, a domestic bank, operates through foreign branch X in Country R. X is a QBU within the meaning of section 989(a) and its residence is Country R as determined under section 988(a)(3)(B). The currency of Country R is the LC. The laws of R require X to keep books and records in the LC. The branch customarily loans dollars and LCs. In the case of its LC loans, X ordinarily fixes the terms of the loans by reference to a contemporary London Inter-Bank Offered Rate (LIBOR) on dollar deposits. For instance, the interest on the amount of the outstanding LC loan principal might equal LIBOR plus 2 percent and the amount of the outstanding LC loan principal would be adjusted to reflect changes in the dollar value of the LC. X is primarily funded with dollar-denominated funds borrowed from related and unrelated parties. X's only LC activities are paying local taxes, employee wages, and local expenses such as rent and electricity. Under these facts, X's activities are primarily conducted in dollars. Thus, although X keeps its books and records in LCs, X's functional currency is the dollar.

Example 4. S, a foreign corporation organized in Country U, is wholly-owned by P, a domestic corporation. The currency of Country U is the LC. S's sole function is acting as a financing vehicle for P and domestic corporations that are affiliated with P. All borrowing and lending transactions between S and P and its domestic affiliates are in dollars. Furthermore, primarily all of S's other borrowings are dollar-denominated or based on a dollar index. S's only LC activities are paying local taxes, employee wages, and local expenses such as rent and electricity. S keeps its books and records in the LC. Under these facts, S's activities are primarily conducted in dollars. Thus, although S keeps its books and records in LCs, S's functional currency is the dollar.

Example 5. D is a domestic corporation whose primary activity is the extraction of natural gas and oil through foreign branch X in Country Y. X is a QBU within the meaning of section 989(a) and its residence is Country Y as determined under section 988(a)(3)(B). The currency of Country Y is the LC. X bills a significant amount of its natural gas and oil sales in dollars and a significant amount in LCs. X also incurs significant LC and dollar expenses and liabilities. The laws of Country Y require X to keep its books and records in the LC. It is determined that the LC is the currency of X under United States generally accepted accounting principles. This determination is based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section. Absent other factors indicating that X primarily conducts its activities in the dollar, D could choose either the dollar or the LC as X's functional currency because X has significant activities in both the dollar and the LC, provided the books and records requirement is satisfied. If, instead, X's activities were determined to be primarily in the dollar, then X would have to use the dollar as its functional currency.

Example 6. S, a foreign corporation organized in Country U, is wholly-owned by P, a domestic corporation. The currency of U is the LC. S purchases the products it sells from related and unrelated parties, including P. These purchases are made in the LC. In addition, most of S's gross receipts are generated by transactions denominated in the LC. S attempts to determine its LC price for goods sold in such a manner as to obtain an LC equivalent of a certain dollar amount after reduction for all LC costs. However, local market conditions sometimes result in pricing adjustments. Thus, changes in the LC-dollar exchange rate from period to period generally result in corresponding changes in the LC price of S's products. S pays local taxes, employee wages, and other local expenses in the LC. It is determined that the dollar is the currency of S under United States generally accepted accounting principles. This determination is not based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section. Under these facts, S could choose either the dollar or the LC as its functional currency because S has significant activities in both the dollar and the LC, provided that the books and records requirement is satisfied.

Example 7. S, a foreign corporation organized in Country X, is wholly-owned by P, a domestic corporation. S conducts all of its operations through two branches. Branch A is located in Country F and branch B is located in Country G. S, A, and B are QBUs within the meaning of section 989(a). Branch A's and branch B's residences are Country F and Country G respectively as determined under section 988(a)(3)(B). The currency of Country F is the FC and the currency of Country G is the LC. The functional currencies of S, A, and B are determined in a two step procedure.

Step 1: The functional currency of branches A and B. Branch A and branch B both conduct all activities in their respective local currencies. The FC is the currency of branch A and the LC is the currency of branch B under United States generally accepted accounting principles. This determination is based on facts and circumstances substantially similar to those set forth in paragraph (c)(2) of this section. Under these facts, the functional currency of branch A is the FC and the functional currency of branch B is the LC.

Step 2: The functional currency of S. S's functional currency is determined by disregarding the fact that A and B are branches. When A's activities and B's activities are viewed as a whole, S determines that it only conducts significant activities in the LC. Therefore, S's functional currency is the LC. See Examples 9, 10, and 11 for how the earnings and profits of a foreign corporation, which has branches with different functional currencies, are determined.

Example 8. Assume the same facts as in Example 7, except that S does not exist and P conducts all of its operations through branch A and branch B. In this instance P's functional currency in Step 2 is the dollar, regardless of the fact that its branches' activities viewed as a whole are in the LC, because P is a taxpayer whose residence is the United States under section 988(a)(3)(B)(i). Therefore, while the functional currency of branch A is the FC and the functional currency of branch B is the LC, the functional currency of P is the dollar because its residence is the United States.

Example 9. The facts are the same as in Example 7. ln addition, assume that in 1987 branch A has earnings of 100 FC and branch B has earnings of 100 LC as determined under section 987. The weighted average exchange rate for the year is 1 FC/2 LC. Branch A's earnings are translated into 200 LC for purposes of computing S's earnings and profits in 1987. Thus, the total earnings and profits of S from branch A and branch B for 1987 is 300 LC.

Example 10. (i) X, a foreign corporation organized in Country W, is wholly-owned by P, a domestic corporation. Both X and P are calendar year taxpayers that began business during 1987. X operates exclusively through two branches, A and B both of which are located outside of Country W. The functional currency of X and A is the LC, while the functional currency of B is the DC as determined under section 985 and §1.985–1. The earnings of B must be computed under section 987, relating to branch transactions. In 1987, A earns 900 LCs of nonsubpart F income and B earns 200 DCs of nonsubpart F income. Under section 904(d)(2), A's income is financial service income and B's income is general limitation income. In order to determine X's earnings and profits, B's income must be translated into LCs (the functional currency of X). The weighted average exchange rate for 1987 is 1 LC/2 DC. Thus, in 1987 X's current earnings and profits (and its post-1986 undistributed earnings) are 1000 LCs consisting of 900 LCs of financial services income earned by A and 100 LCs (200 DC/2) of general limitation income earned by B. Neither A nor B makes any remittances during 1987.

(ii) In 1988, neither A nor B earns any income or generates any loss. On December 31, 1988, A remits 50 LCs directly to P. The remittance to P is considered to be remitted by A to X and then immediately distributed by X as a dividend. The 50 LC remittance does not result in an exchange gain or loss under section 987 to X because the functional currency of X and A is the LC. See section 987(3). Under section 904(d)(3)(D), the 50 LC dividend is treated as income in a separate category to the extent of the dividend's pro rata share of X's earnings and profits in each separate limitation category. Thus, 90 percent, or 45 LCs, is treated as financial services income, and 10 percent, or 5 LCs, is treated as general limitation income. After the dividend distribution, X has 950 LCs of accumulated earnings and profits (and post-1986 undistributed earnings) consisting of 855 LCs of financial service limitation income and 95 LCs of general limitation income.

Example 11. The facts are the same as in Example 10, except that A makes no remittance during 1988 but B remits 120 DCs to X on December 31, 1988, which X immediately converts into LCs, and X makes no dividend distribution during 1988. Assume that the appropriate exchange rate for the remittance is 1 LC/3 DCs. B's remittance triggers exchange loss to X. See section 987(3). Under section 987, the exchange loss on the remittance is 20 LCs calculated as follows: 40 LCs, which is the LC value of the 120 DC remittance (120 DCs/3), less 60 LCs, their LC basis (120 DCs/2). This loss is sourced and characterized under section 987 and regulations thereunder.

Example 12. F, a foreign corporation, has gain from the disposition of a United States real property interest (as defined in section 897(c)). The gain is taken into account as if F were engaged in a trade or business within the United States during the taxable year and as if such gain were effectively connected with such trade or business. F's disposition activity shall be treated as a separate QBU with a dollar functional currency because such activity produced income that is treated as effectively connected with a trade or business within the United States. Therefore, F must compute its gain from the disposition by giving the United States real property interest an historic dollar basis.

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§ 1.985–2 Election to use the United States dollar as the functional currency of a QBU.

(a) *Background and scope*—(1) *In general.* This section permits an eligible QBU to elect to use the dollar as its functional currency for taxable years beginning on or before August 24, 1994. An election to use a dollar functional currency is not permitted for a QBU other than an eligible QBU. Paragraph (b) of this section defines an eligible QBU. Paragraph (c) of this section describes the time and manner for making the dollar election and paragraph (d) of this section describes the effect of making the election. For the definition of a QBU, see section 989(a). See § 1.985–1(b)(2)(ii) for rules requiring a QBU to use the dollar as its functional currency in taxable years beginning after August 24, 1994.

(2) *Exception.* Pursuant to § 1.985–1(b)(2)(ii)(B)(*2*), the rules of paragraph (c)(3) of this section shall apply with respect to the procedure required to be followed by a noncontrolled section 902 corporation as defined in section 904(d)(2)(E) to elect the dollar as its (or its QBU branch's) functional currency and the application of § 1.985–3.

(b) *Eligible QBU*—(1) *In general.* The term "eligible QBU" means a QBU that could have used a hyperinflationary currency as its functional currency absent the dollar election. *See* § 1.985–1 for how a QBU determines its functional currency absent the dollar election.

(2) *Hyperinflationary currency.* See § 1.985–1(b)(2)(ii)(D) for the definition of hyperinflationary currency.

(c) *Time and manner for dollar election*—(1) *QBUs that are branches of United States persons*—(i) *Rule.* If an eligible QBU is a branch of a United States person, the dollar election shall be made by attaching a completed Form 8819 to the United States person's timely filed (taking extensions into account) tax return for the first taxable year for which the election is to be effective.

(ii) *Procedure prior to the issuance of Form 8819.* In the absence of Form 8819, the election shall be made in accordance with § 1.985–2T(c)(1). Failure to file an amended return within the time period prescribed in § 1.985–2T(c)(1) shall not invalidate the dollar election if it is established to the satisfaction of the district director that reasonable cause existed for such failure. A subsequent election for 1988 will not prejudice the taxpayer with respect to such reasonable cause determination. Nevertheless, each United States person making an election under the § 1.985–2T(c)(1) must file a Form 8819 in the time and manner provided in the Form's instructions.

(2) *Eligible QBUs that are controlled foreign corporations or branches of controlled foreign corporations*—(i) *Rule.* If an eligible QBU is a controlled foreign corporation (as described in section 957), or a branch of a controlled foreign corporation, the election may be made either by the foreign corporation or by the controlling United States shareholders on behalf of the foreign corporation by—

(A) Filing a completed Form 8819 in the time and manner provided in the Form's instructions, and

(B) Providing the written notice required by paragraph (c)(2)(ii) of this section at the time and in the manner prescribed therein.

The term *controlling United States shareholders* means those United States shareholders (as defined in section 951(b)) who, in the aggregate, own (within the meaning of section 958(a)) greater than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote. If the foreign corporation is a controlled foreign corporation (as described in section 957) but the United States shareholders do not, in the aggregate, own the requisite voting power, the term "controlling United States shareholders" means all the United States shareholders (as defined in section 951(b)) who own (within the meaning of section 958(a)) stock of the controlled foreign corporation.

(ii) *Notice.* Prior to filing Form 8819, the controlling United States shareholders (or the foreign corporation, if the dollar election is made by the corporation) shall provide written notice that the dollar election will be made to all United States persons known to be shareholders who own (within the meaning of section 958(a)) stock of the foreign corporation. Such notice shall also include all information required in Form 8819.

(iii) *Reasonable cause exception.* Failure of the controlling United States shareholders (or the foreign corporation, if the dollar election is made by the corporation) to timely file Form 8819 or provide written notice to a United States person required to be notified by paragraph (c)(2)(ii) of this section shall not invalidate the dollar election, if it is established to the satisfaction of the district director that reasonable cause existed for such failure.

(iv) *Procedure prior to the issuance of Form 8819.* In the absence of Form 8819, an eligible QBU described in paragraph (c)(2)(i) of this section shall make the dollar election in accordance with §1.985–2T(c)(2). Nevertheless, the person or persons that made such election must file a Form 8819 in the time and manner provided in the Form's instructions.

(3) *Eligible QBUs that are noncontrolled foreign corporations or branches of noncontrolled foreign corporations*—(i) *Rule.* If an eligible QBU is a noncontrolled foreign corporation (a foreign corporation not described in section 957), or a branch of a noncontrolled foreign corporation, the dollar election must be made by the corporation or the majority domestic corporate shareholders on behalf of the corporation by applying the rules provided in paragraph (c)(2)(i)(A) and (B), (ii), (iii), and (iv) of this section substituting ''majority domestic corporate shareholders'' for ''controlling United States shareholders'' wherever it appears therein. The term ''majority domestic corporate shareholders'' means those domestic corporate shareholders (as described in section 902(a)) who, in the aggregate, own (within the meaning of section 958(a)) greater than 50 percent of the total combined voting stock of all classes of stock of the noncontrolled foreign corporation entitled to vote that is owned (within the meaning of section 958(a)) by all the domestic corporate shareholders.

(ii) *Procedure prior to the issuance of Form 8819.* In the absence of Form 8819, an eligible QBU described in paragraph (c)(3)(i) of this section shall make the dollar election in accordance with §1.985–2T(c)(3). Nevertheless, the person or persons that made such election must file a Form 8819 in the time and manner provided in the Form's instructions.

(4) *Others.* Any other person making a dollar election under this section shall elect by filing Form 8819 and fulfilling any other notice requirements that may be required by the Commissioner.

(d) *Effect of dollar election*—(1) *General rule.* If a dollar election is made (or considered made under paragraph (d)(3) of this section) by or on behalf of an eligible QBU, the QBU shall be deemed to have the dollar as its functional currency. Each United States person that owns (within the meaning of section 958(a)) stock of a foreign corporation which has the dollar as its functional currency under §1.985–2 must make all of its federal income tax calculations with respect to the foreign corporation using the dollar as the corporation's functional currency (regardless of when ownership was acquired or whether the United States person received the written notice required by paragraph (c)(2)(i)(B) of this section).

(2) *Computation*—(i) *In general.* Except as provided in paragraph (d)(2)(ii) of this section, any eligible QBU that pursuant to this §1.985–2 has a dollar functional currency must compute income or loss or earnings and profits (or deficit in earnings and profits) in dollars using the dollar approximate separate transactions method described in §1.985–3.

(ii) *Alternative method.* An eligible QBU that has a dollar functional currency pursuant to this §1.985–2 may use a method other than the dollar approximate separate transactions method described in §1.985–3 only if the QBU demonstrates to the satisfaction of the Commissioner that it can properly employ such method. Generally, the QBU must show that it could compute foreign currency gain or loss under the principles of section 988 with respect to each of its section 988 transactions. If subsequently the QBU can no longer demonstrate to the satisfaction of the district director that it can properly employ such an alternative method, then the QBU will be deemed to have changed its method of accounting to the dollar approximate separate transactions method described in §1.985–3. This change in accounting will be treated as having been made with the consent of the Commissioner. No adjustments under either §1.985–5T (or any succeeding final regulation) or section 481(a) shall be required solely because of the change. Rather the QBU shall begin accounting for its operations under §1.985–3 based on its dollar books and records as of the time of the change.

(3) *Conformity*—(i) *General rule.* If a dollar election is made under this §1.985–2 for an eligible QBU (''electing QBU''), then the dollar shall be the functional currency of any related person (regardless of when such person became related to the electing QBU) that is an eligible QBU, or any branch of any such related person that is an eligible QBU. For purposes of the preceding sentence, the term ''related person'' means any person with a relationship defined in section 267 (b) to the electing QBU (or to the United States or foreign person of which the electing QBU is a part). In determining whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c).

(ii) *Branches of United States and foreign persons.* If a dollar election is made for a QBU branch of any person, each eligible QBU branch of such person shall have the dollar as its functional currency.

(4) *Required adjustments.* If an eligible QBU's functional currency changes due to a dollar election, or due to the conformity requirements of paragraph (d)(3) of this section, such change shall be deemed for purposes of §1.9B5–4 to be consented to by the Commissioner. No adjustments under section 481(a) shall be required solely because of the change. However, the QBU must make those adjustments required by §1.985–5T (or any succeeding final regulation).

(5) *Taxable year conformity required.* Generally, the adjustments required by paragraph (d)(4) of this section shall be made for a related person's taxable year—

(i) That includes the date in which the electing QBU made the dollar election if the person was related to such electing QBU at any time during the QBU's taxable year that includes such date, or

(ii) During which the person first becomes related to any electing QBU, in all other cases.

For purposes of this paragraph (d)(5), the date in which the electing QBU makes the dollar election shall be the last day of the electing QBU's taxable year. The district director may permit the related party to make such adjustments beginning one taxable year later if, in the district director's sole judgment, reasonable cause exists for the related party not being able to make the required adjustments for the earlier year.

(6) *Availability of election.* A dollar election may be made by or on behalf of a QBU, or considered made under the conformity rule of paragraph (d)(3), in any year in which the QBU is an eligible QBU. If a dollar election is not made by or on behalf of a QBU for its first taxable year beginning after December 31, 1986 in which it is an eligible QBU, then any dollar election made by or on behalf of the QBU, or considered made under the conformity rules of paragraph (d)(3) of this section, that results in a change in the QBU's functional currency shall be treated as having been made with the consent of the Commissioner. In such a case, however, the taxpayer must make those adjustments required by §1.985–5T (or any succeeding final regulation).

(7) *Effect of changed circumstances.* Regardless of any change in circumstances (*e.g.*, a currency ceases to qualify as hyperinflationary), a QBU whose functional currency is the dollar

under this section may change its functional currency only if the QBU complies with §1.985–4.

(8) *Examples.* The provisions of this section are illustrated by the following examples.

Example 1. X is a calendar year domestic corporation that in 1987 establishes a branch, A, in Country Z. A's functional currency under sections 985(b)(1) and (2) and §1.985–1 is the ''h'', the currency of Country Z. The cumulative inflation in Country Z exceeds 100 percent for the thirty-six months prior to January 1987, as measured by the consumer price index of Country Z listed in the monthly issues of the ''International Financial Statistics''. Accordingly, A is an eligible QBU in 1987 because the h is a hyperinflationary currency. Thus, X may elect the dollar as the functional currency of A for 1987.

Example 2. The facts are the same as in Example (1). X does not elect the dollar as the functional currency of A for 1987. Rather, X elects the dollar as the functional currency of A for l991, a year A is an eligible QBU. The election constitutes a change in A's functional currency that is made with the consent of the Commissioner. However, A must make the adjustments required under §1.985–5T (or any succeeding final regulation).

Example 3. X is a domestic corporation that establishes A, an eligible QBU branch. X is wholly owned by domestic corporation Y. Y has an eligible QBU branch, B. Both X and Y are calendar year taxpayers. X makes a dollar election for A in 1987. Thus, A is an electing QBU. X and Y are related persons as defined in section 267(b) (*i.e.*, Y has a relationship under section 267(b)(3) to X, the corporation of which A is a part). Therefore, the dollar election by X for A in 1987 results in B, the eligible QBU branch of Y, also having the dollar as its functional currency for 1987.

Example 4. The facts are the same as in Example 3, except that Y does not have an eligible QBU branch but owns all the stock of C, a calendar year controlled foreign corporation, which is not itself an eligible QBU but which has an eligible QBU branch, D. X and C are related persons as defined in section 267(b) (*i.e.*, C has a relationship under section 267(b)(3) to X, the corporation of which A is a part). Therefore, the dollar election by X for A in 1987 results in D, the eligible QBU branch of C, also having the dollar as its functional currency for 1987.

Example 5. X, whose taxable year ends September 30, is an eligible QBU that does not use the dollar as its functional currency. X is wholly-owned by domestic corporation W. On January 1, 1989, X acquires all the stock of Y, an unrelated eligible QBU that made the dollar election under §1.985–2. Y is a calendar year taxpayer. After the stock purchase, X and Y are related persons as defined in section 267(b). Under §§1.985–2(d)(3) and (5), the dollar shall be the functional currency of X, any person related to X, and any branch of such related person that is an eligible QBU beginning with the taxable year that includes December 31, 1989. Thus, X must change to the dollar for its taxable year beginning October 1, 1988. However, the district director may allow X to change to the dollar for its taxable year beginning October 1, 1989, provided reasonable cause exists. Those QBUs changing to the dollar as their functional currency as the result of the conformity requirements must make the adjustments required under §1.985–5T (or any succeeding final regulation).

Example 6. The facts are the same as in Example 5, except that before X purchased the Y stock, X made the dollar election under §1.985–2 but Y did not use the dollar as its functional currency. Under §§1.985–2(d)(3) and (5) the dollar shall be the functional currency of Y, any person related to Y, and any branch of such related person that is an eligible QBU beginning with the taxable year that includes September 30, 1989. Thus, Y must change to the dollar for its taxable year beginning January 1, 1989. However the district director may allow Y to change to the dollar for its taxable year beginning January 1, 1990, provided reasonable cause exists. Those QBUs changing to the dollar as their functional currency as the result of the conformity requirements must make the adjustments required under §1.985–5T (or any succeeding final regulation).

[T.D. 8263, 54 FR 38656, Sept. 20, 1989, as amended by T.D. 8556, 59 FR 37673, July 25, 1994]

§1.985–3 United States dollar approximate separate transactions method.

(a) *Scope and effective date*—(1) *Scope.* This section describes the United States dollar (dollar) approximate separate transactions method of accounting (DASTM). For all purposes of subtitle A, this method of accounting must be used to compute the gross income, taxable income or loss, or earnings and profits (or deficit in earnings and profits) of a QBU (as defined in section 989(a)) that has the dollar as its functional currency pursuant to §1.985–1(b)(2).

(2) *Effective date*—(i) *In general.* This section is effective for taxable years beginning after August 24, 1994.

(ii) *DASTM prior-year election.* A taxpayer may elect to apply this section to any open taxable year beginning after December 31, 1986 (whether or not

DASTM has been previously elected for some or all of those years). In order to make this election, the taxpayer must apply § 1.985–3 to that year and all subsequent years. In addition, each person that is related (within the meaning of § 1.985–3(e)(2)(vi)) to the taxpayer on the last day of any taxable year for which the election is effective and that would have been eligible to elect DASTM must also apply these rules to that year and all subsequent years. A taxpayer that has not previously elected to apply DASTM to its prior taxable years may make the DASTM election for the pertinent years by filing amended returns and complying with the applicable election procedures of § 1.985–2. Form 8819 shall be attached to the return for the first year for which the election is to be effective. A taxpayer that has elected DASTM for prior taxable years and applied the rules under § 1.985–3 (as contained in the April 1, 1994 edition of 26 CFR part 1 (1.908 to 1.1000)) may amend its returns to apply the rules of this § 1.985–3. In either case, the DASTM election for prior taxable years shall be deemed to be made with the consent of the Commissioner.

(b) *Statement of method.* Under DASTM, income or loss or earnings and profits (or a deficit in earnings and profits) of a QBU for its taxable year shall be determined in dollars by—

(1) Preparing an income or loss statement from the QBU's books and records (within the meaning of § 1.989(a)–1(d)) as recorded in the QBU's hyperinflationary currency (as defined in § 1.985–1(b)(2)(ii)(D));

(2) Making the adjustments necessary to conform such statement to United States generally accepted accounting principles and tax accounting principles (including reversing monetary correction adjustments required by local accounting principles);

(3) Translating the amounts of hyperinflationary currency as shown on such adjusted statement into dollars in accordance with paragraph (c) of this section; and

(4) Adjusting the resulting dollar income or loss or earnings and profits (or deficit in earnings and profits) and, where necessary, particular items of gross income, deductible expense or other amounts, in accordance with paragraph (e) of this section to reflect the amount of DASTM gain or loss as determined under paragraph (d) of this section.

(c) *Translation into United States dollars*—(1) *In general.* Except as otherwise provided in this paragraph (c), the amounts shown on the income or loss statement, as adjusted under paragraph (b)(2) of this section, shall be translated into dollars at the exchange rate (as defined in paragraph (c)(6) of this section) for the translation period (as defined in paragraph (c)(7) of this section) to which they relate. However, if the QBU previously changed its functional currency to the dollar, and the rules of § 1.985–5 (or, if applicable, § 1.985–5T, as contained in the April 1, 1993 edition of 26 CFR part 1 (1.908 to 1.1000)) applied in translating its balance sheet amounts into dollars, then the spot exchange rate applied under those rules shall be used to translate any amount that would otherwise be translated at a rate determined by reference to a translation period prior to the change in functional currency. For example, depreciation with respect to an asset acquired while the QBU had a nondollar functional currency shall be translated into dollars at the spot rate on the last day of the taxable year before the year of change to a dollar functional currency, rather than at the rate for the period in which the asset was acquired.

(2) *Cost of goods sold.* The dollar value of cost of goods sold shall equal the sum of the dollar values of beginning inventory and purchases less the dollar value of closing inventory as these amounts are determined under paragraph (c)(3) of this section.

(3) *Beginning inventory, purchases, and closing inventory*—(i) *Beginning inventory.* Amounts representing beginning inventory shall be translated so as to obtain the same amount of dollars which represented such items in the closing inventory balance for the preceding taxable year.

(ii) *Purchases.* Amounts representing items purchased or otherwise first included in inventory during the taxable year shall be translated at the exchange rate for the translation period in which the cost of such items was incurred.

(iii) *Closing inventory*—(A) *In general.* Amounts representing items included in the closing inventory balance shall be translated at the exchange rate for the translation period in which the cost of such items was incurred. However, if amounts representing items included in the closing inventory balance are either valued at market or written down to market value, they shall be translated at the exchange rate existing on the last day of the taxable year. For purposes of determining lower of cost or market, items of inventory included in the closing inventory balance shall be translated into dollars at the exchange rate for the translation period in which the cost of such items was incurred and compared with market as determined in the QBU's hyperinflationary currency translated into dollars at the exchange rate existing on the last day of the taxable year.

(B) *Determination of translation period.* The method used to determine the translation period of amounts representing items of closing inventory for purposes of paragraph (c)(3)(iii)(A) of this section may be based upon reasonable approximations and averages, including rates of turnover, provided that the method is used consistently from year to year.

(4) *Depreciation, depletion, and amortization.* Amounts representing allowances for depreciation, depletion, or amortization shall be translated at the exchange rate for the translation period in which the cost of the underlying asset was incurred, except as provided in paragraph (c)(1) of this section.

(5) *Prepaid expenses or income.* Amounts representing expense or income paid or received in a prior taxable year shall be translated at the exchange rate for the translation period during which they were paid or received.

(6) *Exchange rate.* The exchange rate for a translation period may be determined under any reasonable method, provided that the method is consistently applied to all translation periods and conforms to the taxpayer's method of financial accounting. Reasonable methods include the average of beginning and ending exchange rates for the translation period and the spot rate on the last day of the translation period. Once chosen, a method for determining an exchange rate can be changed only with the consent of the district director.

(7) *Translation period*—(i) *In general.* Except as provided in paragraphs (c)(3)(iii)(B) and (c)(7)(ii) of this section, a translation period shall be each month within a QBU's taxable year.

(ii) *Exception.* A taxpayer may divide its taxable year into translation periods of equal length (with not more than one short period annually) that are less than one month. Once such a translation period is established, it may not be changed without the consent of the district director.

(8) *Dollar transactions*—(i) *In general.* Except as provided in paragraph (c)(8)(ii) of this section, no DASTM gain or loss is realized with respect to dollar transactions since the dollar is the functional currency of the QBU. Thus, the amount of any payment or receipt of dollars shall be reflected in the income or loss statement by the amount of such dollars. Also, the income or loss attributable to any transaction in which the amount that a QBU is entitled to receive (or is required to pay) by reason of such transaction is denominated in terms of the dollar, or is determined by reference to the value of the dollar, must be computed transaction by transaction. For example, if a foreign corporation lends 20 LC when 20 LC=$20 and is entitled to receive the LC equivalent of $20 at maturity plus a market rate of interest in dollars (or its LC equivalent), the loan is a dollar transaction. Similarly, this paragraph applies to any transaction that is determined to be a dollar transaction under section 988.

(ii) *Non-dollar functional currency.* If pursuant to §1.985–1(b)(2)(ii)(B)(*1*), a QBU is required to use a functional currency other than the dollar, then that currency shall be substituted for the dollar in applying paragraph (c)(8)(i) of this section.

(9) *Third currency transactions.*—A taxpayer may use any reasonable method of accounting for transactions described in sections 988(c)(1)(B) and

(C) that are denominated in, or determined by reference to, a currency other than the QBU's hyperinflationary currency or the dollar (third currency transactions) so long as such method is consistent with its method of financial accounting.

(10) *Examples.* The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. S is an accrual basis QBU that is required to use the dollar as its functional currency for its first taxable year beginning in 1994. S's hyperinflationary currency is the ''h.'' During 1994, S accrues 100 dollars attributable to dollar-denominated sales. Because this is a dollar transaction under paragraph (c)(8) of this section, S's income or loss for 1994 shall reflect the 100 dollars (not the hyperinflationary value of such dollars when accrued).

Example 2. (i) S is an accrual basis QBU that is required to use the dollar as its functional currency for its first taxable year beginning in 1994. S's hyperinflationary currency is the ''h.'' During 1994, S's sales amounted to 240,000,000h, its currently deductible expenses were 26,000,000h, and its total inventory purchases amounted to 100,000,000h. During January and February of 1994, S purchased depreciable assets for 80,000,000h and was allowed depreciation of 4,000,000h. At the end of 1994, S's closing inventory was 23,000,000h. No election to use a translation period other than the month is made, S had no transactions described in paragraph (c)(8) or (c)(9) of this section, and S's closing inventory was computed on the first-in, first-out inventory method. S's adjusted income or loss statement for 1994 is translated into dollars as follows:

	Hyperinflationary currency	Exchange rate	United States dollars
Sales			
(Jan.–Feb.)	10,000,000h	[1] 20:1	$500,000
(Mar.–Apr.)	20,000,000	21:1	952,381
(May.–June.)	50,000,000	22:1	2,272,727
(July)	50,000,000	23:1	2,173,913
(August)	20,000,000	26:1	769,231
(Sept.)	20,000,000	28:1	714,286
(Oct.)	20,000,000	29:1	689,655
(Nov.)	20,000,000	30:1	666,667
(Dec.)	30,000,000	31:1	967,742
Total	240,000,000h	....	9,706,602
Cost of Goods Sold			
Opening Inventory Purchases:	0	....	0
(Jan.–Feb.)	15,000,000h	20:1	750,000
(Mar.–Apr.)	10,000,000	21:1	476,190
(May–June)	30,000,000	22:1	1,363,636
(July)	20,000,000	23:1	869,565
(August)	10,000,000	26:1	384,615
(Sept.)	5,000,000	28:1	178,571
(Oct.)	5,000,000	29:1	172,414
(Nov.)	2,500,000	30:1	83,333
(Dec.)	2,500,000	31:1	80,645
Less Closing Inventory	(23,000,000)	([2])	(822,655)
	77,000,000h	....	3,536,314

[1] Where multiple months are indicated, the exchange rate applies for all months.
[2] See paragraph (ii) of this *Example.*

(ii) Since S uses the first-in, first-out inventory method, the closing inventory is assumed to consist of purchases made during the most recent translation period as follows:

	Hyperinflationary currency	Exchange rate	United States dollars
December	2,500,000h	31:1	$ 80,645
November	2,500,000	30:1	83,333
October	5,000,000	29:1	172,414
September	5,000,000	28:1	178,571
August	8,000,000	26:1	307,692
Total	23,000,000h	....	822,655

	Hyperinflationary currency	Exchange rate	United States dollars
Non-Capitalized Expenses			
(Jan.–Feb.)	4,000,000h	20:1	200,000
(Mar.–Apr.)	2,500,000	21:1	119,048
(May–June)	2,500,000	22:1	113,636
(July)	2,000,000	23:1	86,957
(August)	3,000,000	26:1	115,385
(Sept.)	3,000,000	28:1	107,143
(Oct.)	2,000,000	29:1	68,966
(Nov.)	3,000,000	30:1	100,000
(Dec.)	4,000,000	31:1	129,032
Total	26,000,000h		1,040,167
Depreciation	4,000,000h	20:1	200,000
Total Cost & Expenses	107,000,000h		4,776,481
Operating Profit	133,000,000h		4,930,121

(d) *Computation of DASTM gain or loss*—(1) *Rule.* DASTM gain or loss of a QBU equals—

(i) The net worth of the QBU (as determined under paragraph (d)(2) of this section) at the end of the taxable year minus the net worth of the QBU at the end of the preceding taxable year; plus

(ii) The dollar amount of the items described in paragraph (d)(3) of this section and minus the dollar amount of the items described in paragraph (d)(4) of this section; minus

(iii) The amount of dollar income or earnings and profits (or plus the amount of any dollar loss or deficit in earnings and profits) as determined for the taxable year pursuant to paragraphs (b)(1) through (b)(3) of this section.

(2) *Net worth.* Net worth of a QBU at the end of any taxable year equals the aggregate dollar amount representing assets on the QBU's balance sheet at the end of the taxable year less the aggregate dollar amount representing liabilities on the balance sheet. Notwithstanding any other provision in this paragraph (d)(2), the district director may adjust the amount of any asset or liability if a purpose for acquiring (or disposing of) the asset or incurring (or discharging) the liability is to manipulate the composition of the balance sheet for any period during the taxable year in order to avoid tax. The taxpayer shall determine net worth by—

(i) Preparing a balance sheet as of the end of the taxable year from the QBU's books and records (within the meaning of §1.989(a)–1(d)) as recorded in the QBU's hyperinflationary currency;

(ii) Making adjustments necessary to conform such balance sheet to United States generally accepted accounting principles and tax accounting principles (including reversing monetary correction adjustments required by local accounting principles); and

(iii) Translating the asset and liability amounts shown on the balance sheet into United States dollars in accordance with paragraph (d)(5) of this section.

(3) *Positive adjustments.* The items described in this paragraph (d)(3) are dividend distributions for the taxable year and any items that decrease net worth for the taxable year but that generally do not affect income or loss or earnings and profits (or a deficit in earnings and profits). Such items include a transfer to the home office of a QBU branch and a return of capital. Except as otherwise provided by ruling or administrative pronouncement, the amount of a transfer to the home office of a QBU branch, a dividend, or a distribution that is a return of capital shall be translated into dollars at the exchange rate on the date the amount is paid.

(4) *Negative adjustments.* The items described in this paragraph (d)(4) are items that increase net worth for the taxable year but that generally do not affect income or loss or earnings and profits (or a deficit in earnings and profits). Such items include a capital contribution or a transfer from a home

office to a QBU branch. Except as otherwise provided by ruling or administrative pronouncement, if the contribution or transfer is not in dollars, the amount of a capital contribution or transfer shall be translated into dollars at the exchange rate on the date made.

(5) *Translation of balance sheet.* Asset and liability amounts shown on the balance sheet in hyperinflationary currency (adjusted pursuant to paragraph (d)(2)(ii) of this section) shall be translated into dollars as provided in this paragraph (d)(5). However, if the QBU previously changed its functional currency to the dollar and the rules of § 1.985–5 (or, if applicable, § 1.985–5T, as contained in the April 1, 1993 edition of 26 CFR part 1 (1.908 to 1.1000)) applied in translating its balance sheet amounts into dollars, then the spot exchange rate applied under those rules shall be used to translate any amount that would otherwise be translated at a rate determined by reference to a translation period prior to the change in functional currency. For example, the basis of real property acquired while the QBU had a nondollar functional currency shall be translated into dollars at the spot rate on the last day of the taxable year before the year of change to a dollar functional currency, rather than at the rate for the period in which the cost was incurred.

(i) *Closing inventory.* Amounts representing items of inventory included in the closing inventory balance shall be translated in accordance with paragraph (c)(3)(iii) of this section.

(ii) *Bad debt reserves.* Amounts representing bad debt reserves shall be translated at the exchange rate for the last translation period for the taxable year.

(iii) *Prepaid income or expense.* Amounts representing expenses or income paid or received in a prior taxable year shall be translated in accordance with paragraph (c)(5) of this section.

(iv) *Hyperinflationary currency.* Amounts of the hyperinflationary currency and hyperinflationary demand deposit balances shall be translated at the exchange rate for the last translation period of the taxable year.

(v) *Certain assets*—(A) *In general.* Amounts representing plant, real property, equipment, goodwill, and patents and other intangibles shall be translated at the exchange rate for the translation period in which the cost of the asset was incurred.

(B) *Adjustment to certain assets.* Amounts representing depreciation, depletion, and amortization reserves shall be translated in accordance with paragraph (c)(4) of this section.

(vi) *Hyperinflationary debt obligations.* Except as provided in paragraph (d)(5)(vii) of this section, amounts representing a hyperinflationary debt obligation (including accounts receivable and payable) shall be translated at the exchange rate for the last translation period for the taxable year.

(vii) *Accrued foreign income taxes.* Amounts representing an accrued but unpaid foreign income tax shall be translated at the exchange rate on the last day of the last translation period of the taxable year of accrual.

(viii) *Certain hyperinflationary financial instruments.* Amounts representing any item described in section 988(c)(1)(B)(iii) (relating to forward contracts, futures contracts, options, or similar financial instruments) denominated in or determined by reference to the hyperinflationary currency shall be translated at the exchange rate for the last translation period for the taxable year.

(ix) *Other assets and liabilities.* Amounts representing assets and liabilities, other than those described in paragraphs (d)(5)(i) through (viii) of this section, shall be translated at the exchange rate for the translation period in which the cost of the asset or the amount of the liability was incurred.

(6) *Dollar transactions.* Notwithstanding any other provisions of this paragraph (d), where the amount representing an item shown on the balance sheet reflects a dollar transaction (described in paragraph (c)(8) of this section), the transaction shall be taken into account in accordance with that paragraph.

(7) *Third currency transactions.* A taxpayer may use any reasonable method of accounting for transactions described in section 988(c)(1)(B) and (C) that are denominated in, or determined by reference to, a currency other than

the QBU's hyperinflationary currency or the dollar (third currency transactions), so long as such method is consistent with its method of financial accounting.

(8) *Character.* The amount of DASTM gain or loss determined under paragraph (d)(1) of this section shall be ordinary income or loss.

(9) *Example.* The provisions of this paragraph (d) are illustrated by the following example:

Example. (i) S, an accrual method calendar year foreign corporation, uses DASTM. S's hyperinflationary currency is the "h." S's net worth at December 31, 1993 was $3,246,495. For 1994, S's operating profit is 81,340,000h, or $2,038,200. S made a 5,000,000h distribution in April and again in December of 1994. S's translation period is the month. None of S's assets or liabilities reflect a dollar or third currency transaction described in paragraph (c)(8) or (c)(9) of this section, respectively. The exchange rate for each month in 1994 is as follows:

January	32h:$1
Feb.–Mar.	33:1
April–May	34:1
June	35:1
July	36:1
Aug.–Sept.	37:1
Oct.	38:1
Nov.	39:1
Dec.	40:1

(ii) At the end of 1994, S's assets and liabilities, as adjusted and translated pursuant to paragraphs (d)(2) and (d)(5) of this section, are as follows:

	Hyperinflationary	Exchange rate	U.S. dollar
Hyperinflationary cash on hand	40,000h	40:1	$1,000
Checking account	400,000	40:1	10,000
Accounts Receivable- 30 Day Accounts	20,000,000	[1] 40:1	500,000
60 Day Accounts	25,000,000	40:1	625,000
Inventory	65,000,000	([2])	2,500,000
Fixed assets—Property	90,000,000	27:1	3,333,333
Plant	190,000,000	([3])	6,785,714
Accumulated Depreciation	(600,000)	([3])	(21,428)
Equipment	10,000,000	([4])	340,000
Accumulated Depreciation	(400,000)	([4])	(13,333)
Common Stock—Stock A	500,000	34:1	14,706
Stock B	400,000	26:1	15,385
Preferred Stock	1,000,000	32:1	31,250
C.D.s	5,000,000	40:1	125,000
Total Assets	406,340,000		14,246,627
Accounts Payable Long-term liabilities:	35,000,000	40:1	875,000
Liability A	150,000,000	40:1	3,750,000
Liability B	80,000,000	40:1	2,000,000
Liability C	30,000,000	40:1	750,000
Total Liabilities	295,000,000h		$7,375,000

[1] S ages its accounts receivable and groups them into two categories—those outstanding for 30 days and those outstanding for 60 days.

[2] Translated the same as closing inventory under paragraph (c)(3)(iii).

[3] The cost of S's plant was incurred in several translation periods. Therefore, the dollar cost and dollar depreciation reflect several translation rates.

[4] S has a variety of equipment. Therefore, S's dollar basis represents the sum of the hyperinflationary cost of each, translated according to the exchange rate for the translation period incurred.

(iii) The DASTM gain of S for 1994 is computed as follows:

Net worth—1994		$6,871,627
Less—Net worth—1993		$3,246,495
Plus—1994 Dividends:		
April	$149,254	
December	[1] 126,582	275,836
Less Operating Profit—1994		2,038,200
DASTM Gain		$1,862,768

[1] The exchange rates on the date of the April and December dividends were 33.5h:$1 and 39.5h:$1, respectively.

(iv) Thus, total profit = $2,038,200 + $1,862,768 = $3,900,968

(e) *Effect of DASTM gain or loss on gross income, taxable income, or earnings and profits*—(1) *In general.* For all purposes of subtitle A, the amount of DASTM gain or loss of a QBU determined under paragraph (d) of this section is taken into account by the QBU for purposes of determining the amount of its gross income, taxable income or loss, earnings and profits (or deficit in earnings and profits), and, where necessary, particular items of income, expense or other amounts. DASTM gain or loss is allocated under one of two methods. Certain small QBUs may elect the small QBU DASTM allocation described in paragraph (e)(2) of this section. All other QBUs must use the 9-step procedure described in paragraph (e)(3) of this section.

(2) *Small QBU DASTM allocation*—(i) *Election threshold.* A taxpayer may elect to use the small QBU DASTM allocation described in paragraph (e)(2)(iv) of this section with respect to a QBU that has an adjusted basis in assets (translated as provided in paragraph (d)(5) of this section) of $10 million or less at the end of any taxable year. In calculating the $10 million threshold, a QBU shall be treated as owning all of the assets of each related QBU (as defined in paragraph (e)(2)(vi) of this section) having its residence (as defined in section 988(a)(3)(B)) in the QBU's country of residence (related same- country QBU). For this purpose, appropriate adjustment shall be made to eliminate the double counting of assets created in transactions between related QBUs resident in the same country. For example, assume QBU–1, resident in country X, sells inventory to related QBU–2, also resident in country X, in exchange for an account receivable. For purposes of determining the assets of QBU–1 under this paragraph (e)(2)(i), the taxpayer shall take into account either the inventory shown on the books of QBU–2 or QBU–1's receivable from QBU–2 (but not both).

(ii) *Consent to election.* The election of the small QBU DASTM allocation or subsequent application of the rules of paragraph (e)(3) of this section due to an increase in the adjusted basis of the QBU's assets shall be deemed to have been made with the consent of the Commissioner. Once the election under paragraph (e)(2)(iii) of this section is made, it shall apply for all years in which the adjusted basis of the assets of the QBU (and any related same-country QBU) is $10 million or less, unless revoked with the Commissioner's consent. If the adjusted basis of the assets of the QBU (and any related same-country QBU) exceeds $10 million at the end of any taxable year, the rules of paragraph (e)(3) of this section shall apply to that QBU (and any related same-country QBU) for such year and each subsequent year unless such QBU again qualifies, and applies for and obtains the Commissioner's consent, to use the small QBU DASTM allocation. However, if a QBU acquires assets with a principal purpose of avoiding the application of paragraph (e)(2)(iv) of this section, the Commissioner may disregard the acquisition of such assets.

(iii) *Manner of making election*—(A) *QBUs that are branches of United States persons.* For the first year in which this election is effective, in the case of a QBU branch of a United States person, a statement shall be attached to the United States person's timely filed Federal income tax return (taking extensions into account). The statement shall identify the QBU (or QBUs) for which the election is being made by describing its business and its country of residence, state the adjusted basis of the assets of the QBU (and any related same-country QBUs) to which the election applies, and include a statement that the election is being made pursuant to § 1.985–3(e)(2).

(B) *Other QBUs.* In the case of a QBU other than one described in paragraph (e)(2)(iii)(A) of this section, an election must be made in the manner prescribed in § 1.964–1. The statement filed with the Internal Revenue Service as required under § 1.964–1 must include the information required under paragraph (e)(2)(iii)(A) of this section.

(iv) *Effect of election.* If a taxpayer elects under this paragraph (e)(2) to use the small QBU DASTM allocation, DASTM gain or loss, as determined under paragraph (d) of this section, of a small QBU shall be allocated ratably to all items of the QBU's gross income (determined prior to adjustment for DASTM gain or loss). Therefore, for purposes of the foreign tax credit, DASTM gain or loss shall be allocated on the basis of the relative amounts of gross income in each separate category as defined in §1.904–5(a)(1). In the case of a controlled foreign corporation (within the meaning of section 957 or 953(c)(1)(B)), for purposes of section 952, DASTM gain or loss shall be allocated to subpart F income in a separate category in the same ratio that the gross subpart F income in that category for the taxable year bears to its total gross income in that category for the taxable year.

(v) *Conformity.* If a person (or a QBU of such person) makes an election under this paragraph (e)(2) to use the small QBU DASTM allocation, then each QBU of any related person (as defined in paragraph (e)(2)(vi) of this section) that satisfies the threshold requirement of paragraph (e)(2)(i) of this section (after application of the aggregation rule of paragraph (e)(2)(i) of this section) shall be deemed to have made the election.

(vi) *Related person.* The term related person means any person with a relationship to the QBU (or to the United States or foreign person of which the electing QBU is a part) that is defined in section 267(b) or section 707(b).

(3) *DASTM 9-step procedure*—(i) *Step 1—prepare balance sheets.* The taxpayer shall prepare an opening and a closing balance sheet for the QBU for each balance sheet period during the taxable year. The balance sheet period is the most frequent period for which balance sheet data are reasonably available (but in no event less frequently than quarterly). The balance sheet period may not be changed without the consent of the district director. The balance sheets must be prepared under the principles of paragraph (d)(2) of this section.

(ii) *Step 2—identify certain assets and liabilities.* The taxpayer shall identify each item on the balance sheet that is described in section 988(c)(1)(B) or (C) and that would have been translated under paragraph (d)(5) of this section into dollars at the exchange rate for the last translation period for the taxable year (or the exchange rate on the last day of the last translation period of the taxable year in the case of an accrued foreign income tax liability).

(iii) *Step 3—characterize the assets.* The taxpayer shall characterize and group the assets identified in paragraph (e)(3)(ii) of this section (Step 2) according to the source and the type of income that they generate, have generated, or may reasonably be expected to generate by applying the principles of §1.861–9T(g)(3) or its successor regulation (relating to characterization of assets for purposes of interest expense allocation). If a purpose for a taxpayer's business practices is to manipulate asset characterization or groupings, the district director may allocate or apportion DASTM gain or loss attributable to the assets. Thus, if a taxpayer that previously did not separately state interest on accounts receivable begins to impose an interest charge and a purpose for the change was to manipulate tax characterizations or groupings, then the district director may require that none of the DASTM gain or loss attributable to those receivables be allocated or apportioned to interest income.

(iv) *Step 4—determine DASTM gain or loss attributable to certain assets*—(A) *General rule.* The taxpayer shall determine the dollar amount of DASTM gain or loss attributable to assets in each group identified in paragraph (e)(3)(iii) of this section (Step 3) as follows:

$$\left[(\mathrm{bb}+\mathrm{eb})\div 2\right]\times\left[\mathrm{er}-\mathrm{br}\right]$$

where

bb = the hyperinflationary currency adjusted basis of the assets in the group at the beginning of the balance sheet period.

eb = the hyperinflationary currency adjusted basis of the assets in the group at the end of the balance sheet period.

er = one dollar divided by the number of hyperinflationary currency units that equal one dollar at the end of the balance sheet period.

br = one dollar divided by the number of hyperinflationary currency units that equal one dollar at the beginning of the balance sheet period.

(B) *Weighting to prevent distortion.* If averaging the adjusted basis of assets in a group at the beginning and end of a balance sheet period results in an allocation of DASTM gain or loss that does not clearly reflect income, as might be the case in the event of a purchase or disposition of an asset that is not in the normal course of business, the taxpayer must use a weighting method that reflects the time the assets are held by the QBU during the translation period.

(C) *Example.* The provisions of this paragraph (e)(3)(iv) are illustrated by the following example:

Example. S is a foreign corporation that operates in the hyperinflationary currency ''h'' and computes its income or loss or earnings and profits under DASTM. S's adjusted basis in a group of assets described in section 988(c)(1)(B) or (C) that generate general limitation foreign source income (as characterized under paragraph (e)(3)(iii) of this section) at the beginning of the balance sheet period is 750,000h. S's basis in such assets at the end of the balance sheet period is 1,250,000h. The exchange rate at the beginning of the balance sheet period is $1 = 200h. The exchange rate at the end of the balance sheet period is $1 = 500h. The DASTM loss attributable to the assets described above is $3,000, determined as follows:

$$[(750{,}000h+1{,}250{,}000h)\div 2]\times [(\$1\div 500h)-(\$1\div 200h)]=(\$3000)$$

(v) *Step 5—adjust dollar gross income by DASTM gain or loss from assets.* The taxpayer shall adjust the dollar amount of the QBU's gross income (computed under paragraphs (b)(1) through (b)(3) of this section) generated by each group of assets characterized in paragraph (e)(3)(iii) of this section (Step 3) by the amount of DASTM gain or loss attributable to those assets computed under paragraph (e)(3)(iv) of this section (Step 4). Thus, if a group of assets, such as accounts receivable, generates both a category of income described in section 904(d)(1)(I) (relating to general limitation income) that is not foreign base company income as defined in section 954 and a DASTM loss under paragraph (e)(3)(iv) of this section (Step 4), the amount of the DASTM loss would reduce the amount of the QBU's gross income in that category. Similarly, if a group of assets, such as short-term bank deposits, generates both foreign personal holding company income that is passive income (described in sections 954(c)(1)(A) and 904(d)(1)(A)) and a DASTM loss under paragraph (e)(3)(iv) of this section (Step 4), the amount of the DASTM loss would reduce the amount of the QBU's foreign personal holding company income and passive income. See section 904(f) and the regulations thereunder in the case where that section would apply and DASTM loss attributable to a group of assets exceeds the income generated by such assets.

(vi) *Step 6—determine DASTM gain or loss attributable to liabilities*—(A) *General rule.* The taxpayer shall determine the dollar amount of DASTM gain or loss attributable to liabilities identified in paragraph (e)(3)(ii) of this section (Step 2), and described in paragraph (e)(3)(vi)(B) of this section as follows:

$$\left[(bl+el)\div 2\right]\times\left[br-er\right]$$

where

bl = the hyperinflationary currency amount of liabilities at the beginning of the balance sheet period.

el = the hyperinflationary currency amount of liabilities at the end of the balance sheet translation period.

br = one dollar divided by the number of hyperinflationary currency units that equal one dollar at the beginning of the balance sheet period.

er = one dollar divided by the number of hyperinflationary currency units that equal one dollar at the end of the balance sheet period.

(B) *Separate calculation.* The calculation shall be made separately for interest-bearing liabilities described in paragraph (e)(3)(vii) of this section (Step 7) and for each of the classes of non-interest-bearing liabilities described in paragraph (e)(3)(viii) of this section (Step 8).

(C) *Weighting to prevent distortion.* Where a distortion would result from averaging the amount of liabilities at the beginning and end of a balance sheet period, as might be the case where a taxpayer incurs or retires a substantial liability, the taxpayer must use a different method that more clearly reflects the average amount of liabilities weighted to reflect the time the liability was outstanding during the balance sheet period.

(vii) *Step 7—adjust dollar income and expense by DASTM gain or loss from interest-bearing liabilities*—(A) *In general.* The taxpayer shall apply the amount of DASTM gain on interest-bearing liabilities computed under paragraph (e)(3)(vi) of this section (Step 6) to reduce interest expense generated by such liabilities (*e.g.*, prior to the application of §1.861–9T or its successor regulation). To the extent DASTM gain on such liabilities exceeds interest expense, it shall be sourced or otherwise classified in the same manner that interest expense is allocated and apportioned under §1.861–9T or its successor regulation. The amount of DASTM loss on interest-bearing liabilities computed under paragraph (e)(3)(vi) of this section (Step 6) shall be allocated and apportioned in the same manner that interest expense is allocated and apportioned under §1.861–9T or its successor regulation (without regard to the exceptions to fungibility in §1.861–10T or its successor regulation). For purposes of this section, an interest-bearing liability is a liability that requires payment of periodic interest (whether fixed or variable), has original issue discount, or would have interest imputed under subtitle A.

(B) *Allocation of DASTM gain or loss from interest-bearing liabilities that generate related person interest expense.* DASTM gain or loss from interest-bearing liabilities that generate related person interest expense (as provided in section 954(b)(5)) shall be allocated for purposes of subtitle A (including sections 904 and 952) in the same manner that the related person interest expense of that debt is required to be allocated under the rules of section 954(b)(5) and §1.904–5(c)(2).

(C) *Modified gross income method.* In applying the modified gross income method described in §1.861–9T(j) or its successor regulation, gross income shall be adjusted for any DASTM gain or loss from assets as provided in paragraph (e)(3)(v) of this section (Step 5) and any DASTM gain or loss with respect to short-term, non-interest-bearing trade payables as provided in paragraph (e)(3)(viii)(A) of this section.

(viii) *Step 8—adjust dollar income and expense by DASTM gain or loss from non-interest bearing liabilities*—(A) *Short-term, non-interest-bearing trade payables.* The taxpayer shall allocate DASTM gain or loss on short-term non-interest-bearing trade payables for purposes of subtitle A (including sections 904 and 952) to the same category or type of gross income as the cost or expense to which the trade payable relates. For this purpose, a short-term, non-interest-bearing trade payable is a non-interest-bearing liability with a term of 183 days or less that is incurred to purchase property or services to be used by the obligor in an active trade or business.

(B) *Excise tax payables.* The taxpayer shall allocate DASTM gain or loss on excise tax payables for purposes of subtitle A (including sections 904 and 952) to the same category or type of gross income as would be derived from the activity to which the excise tax relates.

(C) *Other non-interest-bearing liabilities*—(*1*) *In general.* Except as provided in paragraphs (e)(3)(viii)(A), (e)(3)(viii)(B), and (e)(3)(viii)(C)(*2*) of this section, DASTM gain or loss on non-interest-bearing liabilities shall be allocated under paragraph (e)(3)(ix) of this section (Step 9).

(*2*) *Tracing if substantial distortion of income.* DASTM gains and losses on liabilities described in paragraph (e)(3)(viii)(C)(*1*) of this section may be attributed to the same section 904(d) separate category or subpart F category as the transaction to which the liability relates if the taxpayer demonstrates to the satisfaction of the district director, or it is determined by the district director, that application of paragraph (e)(3)(viii)(C)(*1*) of this section results in a substantial distortion of income.

(ix) *Step 9—allocate residual DASTM gain or loss.* If there is a difference between the net DASTM gain or loss determined under paragraphs (e)(3)(i) through (viii) of this section (Steps 1 through 8) and the DASTM gain or loss determined under paragraph (d) of this section, the amount of the difference must be allocated for purposes of subtitle A (including sections 904 and 952) to the QBU’s gross income (computed under paragraphs (b)(1) through (3) of this section, as adjusted under paragraphs (e)(3)(i) through (viii) of this section (Steps 1 through 8)) on the basis of the relative amounts of each category or type of gross income.

[T.D. 8556, 59 FR 37673, July 25, 1994]

§ 1.985–4 Method of accounting.

(a) *Adoption of election.* The adoption of, or the election to use, a functional currency shall be treated as a method of accounting. The functional currency shall be used for the year of adoption (or election) and for all subsequent taxable years unless permission to change is granted, or considered to be granted under § 1.985–2 or 1.985–8T, by the Commissioner.

(b) *Condition for changing functional currencies.* Generally, permission to change functional currencies shall not be granted unless significant changes in the facts and circumstances of the QBU's economic environment occur. If the determination of the functional currency of the QBU for purposes of United States generally accepted accounting principles (GAAP) is based on facts and circumstances substantially similar to those set forth in § 1.985–1(c)(2), then ordinarily the Commissioner will grant a taxpayer's request to change its functional currency (or the functional currency of its branch that is a QBU) to a new functional currency only if the taxpayer (or its QBU) also changes to the new functional currency for purposes of GAAP. However, permission to change will not necessarily be granted merely because the new functional currency will conform to the taxpayer's GAAP functional currency.

(c) *Relationship to certain other sections of the Code.* Nothing in this section shall be construed to override the provisions of any other sections of the Code of regulations that require the use of consistent accounting methods. Such provisions must be independently satisfied separate and apart from the identification of a functional currency. For instance, while separate geographical divisions of a taxpayer's trade or business may have different functional currencies, such geographical divisions may nevertheless be required to consistently use other methods of accounting.

[T.D. 8263, 54 FR 38661, Sept. 20, 1989, as amended by T.D. 8776, 63 FR 40368, July 29, 1998]

§ 1.985–5 Adjustments required upon change in functional currency.

(a) *In general.* This section applies in the case of a QBU that changes from one functional currency (old functional currency) to another functional currency (new functional currency). A taxpayer or QBU subject to the rules of this section shall make the adjustments set forth in the 3-step procedure described in paragraphs (b) through (e) of this section. The adjustments shall be made on the last day of the taxable year ending before the year of change as defined in § 1.481–1(a)(1). Gain or loss required to be recognized under paragraphs (b), (d)(2), and (e)(2) of this section is not subject to section 481 and, therefore, the full amount of the gain or loss must be included in income or earnings and profits on the last day of the taxable year ending before the year of change. Except as provided in § 1.985–6, a QBU with a functional currency for its first taxable year beginning in 1987 that is different from the currency in which it had kept its books and records for United States accounting and tax accounting purposes for its prior taxable year shall apply the principles of this § 1.985–5 for purposes of computing the relevant functional currency items, such as earnings and profits, basis of an asset, and amount of a liability, as of the first day of a taxpayer's first taxable year beginning in 1987. However, a QBU that changes to the dollar pursuant to § 1.985–1(b)(2) after 1987 shall apply § 1.985–7.

(b) *Step 1—Taking into account exchange gain or loss on certain section 988 transactions.* The QBU shall recognize or otherwise take into account for all purposes of the Code the amount of any unrealized exchange gain or loss attributable to a section 988 transaction (as defined in section 988(c)(1)(A), (B), and (C)) that, after applying section 988(d), is denominated in terms of or determined by reference to the new functional currency. The amount of such gain or loss shall be determined without regard to the limitations of section

988(b) (*i.e.*, whether any gain or loss would be realized on the transaction as a whole). The character and source of such gain or loss shall be determined under section 988.

(c) *Step 2—Determining the new functional currency basis of property and the new functional currency amount of liabilities and any other relevant items.* The new functional currency adjusted basis of property and the new functional currency amount of liabilities and any other relevant items (*e.g.*, items described in section 988(c)(1)(B)(iii)) shall equal the product of the amount of the old functional currency adjusted basis or amount multiplied by the new functional currency/old functional currency spot exchange rate on the last day of the taxable year ending before the year of change (spot rate).

(d) *Step 3A—Additional adjustments that are necessary when a branch changes functional currency*—(1) *Branch changing to a functional currency other than the taxpayer's functional currency*—(i) *Rule.* If a QBU that is a branch of a taxpayer changes to a functional currency other than the taxpayer's functional currency, the branch shall make the adjustments set forth in either paragraph (d)(1)(ii) or (d)(1)(iii) of this section for purposes of section 987. See §1.987–5(d) for rules for computing the branch's equity pool and basis pool.

(ii) *Where prior to the change the branch and taxpayer had different functional currencies.* If the branch and the taxpayer had different functional currencies prior to the change, the branch's new functional currency equity pool shall equal the product of the old functional currency amount of the equity pool multiplied by the spot rate. No adjustment to the basis pool is necessary.

(iii) *Where prior to the change the branch and taxpayer had the same functional currency.* If the branch and the taxpayer had the same functional currency prior to the change, the branch's basis pool shall equal the difference between the branch's total old functional currency basis of its assets and its total old functional currency amount of its liabilities. The branch's equity pool shall equal the product of the basis pool multiplied by the spot rate.

(2) *Branch changing to the taxpayer's functional currency.* If a branch changes its functional currency to the taxpayer's functional currency, the branch shall be treated as if it terminated on the last day of the taxable year ending before the year of change. In such a case, the taxpayer shall realize gain or loss attributable to the branch's equity pool under the principles of section 987.

(e) *Step 3B—Additional adjustments that are necessary when a taxpayer changes functional currency*—(1) *Corporations.* The amount of a corporation's new functional currency earnings and profits and the amount of its new functional currency paid-in capital shall equal the product of the old functional currency amounts of such items multiplied by the spot rate. The foreign income taxes and accumulated profits or deficits in accumulated profits of a foreign corporation that were maintained in foreign currency for purposes of section 902 and that are attributable to taxable years of the foreign corporation beginning before January 1, 1987, also shall be translated into the new functional currency at the spot rate.

(2) *Collateral consequences to a United States shareholder of a corporation changing to the United States dollar as its functional currency.* A United States shareholder (within the meaning of section 951(b) or section 953(c)(1)(A)) of a controlled foreign corporation (within the meaning of section 957 or section 953(c)(1)(B)) changing its functional currency to the dollar shall recognize foreign currency gain or loss computed under section 986(c) as if all previously taxed earnings and profits, if any, (including amounts attributable to pre-1987 taxable years that were translated from dollars into functional currency in the foreign corporation's first post-1986 taxable year) were distributed immediately prior to the change. Such a shareholder shall also recognize gain or loss attributable to the corporation's paid-in capital to the same extent, if any, that such gain or loss would be recognized under the regulations under section 367(b) if the corporation was liquidated completely.

(3) *Taxpayers that are not corporations.* [Reserved]

(4) *Adjustments to a branch's accounts when a taxpayer changes functional currency*—(i) *Taxpayer changing to a functional currency other than the branch's functional currency.* If a taxpayer changes to a functional currency that differs from the functional currency of a branch of the taxpayer, the branch shall adjust its basis pool in the manner prescribed in paragraph (d)(1)(ii) of this section for adjusting the equity pool, if the taxpayer's old functional currency was different from the branch's functional currency. If the taxpayer's old functional currency was the same as the branch's functional currency, the branch shall determine its equity pool and basis pool in the manner set forth in paragraph (d)(1)(iii) of this section for determining the basis pool and equity pool, respectively.

(ii) *Taxpayer changing to the same functional currency as the branch.* If a taxpayer changes to the same functional currency as a branch of the taxpayer, the taxpayer shall realize gain or loss as set forth in paragraph (d)(2) of this section.

(f) *Examples.* The provisions of this section are illustrated by the following examples.

Example 1. S, a calendar year foreign corporation, is wholly owned by domestic corporation P. The Commissioner granted permission to change S's functional currency from the LC to the FC beginning January 1, 1993. The LC/FC exchange rate on December 31, 1992 is 1 LC/2 FC. The following shows how S must convert the items on its balance sheet from the LC to the FC.

	1:2	
	LC	FC
Assets:		
Cash on hand	40,000	80,000
Accounts Receivable	10,000	20,000
Inventory	100,000	200,000
100,000 FC Bond (100,000 LC historical basis)	[1]50,000	100,000
Fixed assets:		
Property	200,000	400,000
Plant	500,000	1,000,000
Accumulated Depreciation	(200,000)	(400,000)
Equipment	1,000,000	2,000,000
Accumulated Depreciation	(400,000)	(800,000)
Total Assets	1,300,000	2,600,000
Liabilities:		
Accounts Payable	50,000	100,000
Long-term Liabilities	400,000	800,000
Paid-in-Capital	800,000	1,600,000
Retained Earnings	[2]50,000	100,000
Total Liabilities and Equity	1,300,000	2,600,000

[1] Under § 1.985–5(b), S will recognize a 50,000 LC loss (100,000 LC basis − 50,000 LC value) on the bond resulting from the change in functional currency. Thus, immediately before the change, S's basis in the FC bond (taking into account the loss) is 50,000 LC.

[2] The amount of S's LC retained earnings reflects the 50,000 LC loss on the bond.

Example 2. P, a domestic corporation, operates a foreign branch, S. The Commissioner granted permission to change S's functional currency from the LC to the FC beginning January 1, 1993. As of December 31, 1992, S's equity pool was 2,000 LC and its basis pool was $4,000. The LC/FC exchange rate on December 31, 1992 is 1 LC/2 FC. On January 1, 1993, the new functional currency amount of S's equity pool is 4,000 FC. The basis pool is not affected.

[T.D. 8464, 58 FR 233, Jan. 5, 1993; 58 FR 11099, Feb. 23, 1993, as amended by T.D. 8765, 63 FR 10774, Mar. 5, 1998]

§ 1.985–6 Transition rules for a QBU that uses the dollar approximate separate transactions method for its first taxable year beginning in 1987.

(a) *In general.* This section sets forth transition rules for a QBU that used the dollar approximate separate transactions method of accounting set forth in § 1.985–3 or § 1.985–3T (as contained in the April 1, 1989 edition of 26 CFR part 1 (1.908 to 1.1000)) for its first taxable year beginning in 1987 (DASTM QBU). A DASTM QBU must determine the dollar and hyperinflationary currency basis of its assets and the dollar and hyperinflationary currency amount of its liabilities that were acquired or incurred in taxable years beginning before January 1, 1987. In addition, a DASTM QBU must determine its net worth, including its retained earnings, at the end of the QBU's last taxable year beginning before January 1, 1987. This section provides rules for controlled foreign corporations (as defined in section 957 or section 953(c)(1)(B)), other foreign corporations, and branches of United States persons that must make these determinations.

(b) *Certain controlled foreign corporations.* If a DASTM QBU was a controlled foreign corporation for its last taxable year beginning before January

1, 1987, and it had a significant event as described in §1.964–1(c)(6) in a taxable year beginning before January 1, 1987, then the rules of this paragraph (b) shall apply.

(1) *Basis in assets and amount of liabilities.* The hyperinflationary currency adjusted basis of the QBU's assets and the hyperinflationary currency amount of the QBU's liabilities acquired or incurred by the QBU in a taxable year beginning before January 1, 1987, shall be the basis or the amount as determined under §1.964–1(e) prior to translation under §1.964–1(e)(4). The dollar adjusted basis of such assets and the dollar amount of such liabilities shall be the adjusted basis or the amount as determined under the rules of §1.964–1(e) after translation under §1.964–1(e)(4).

(2) *Retained earnings.* The dollar amount of the QBU's retained earnings at the end of its last taxable year beginning before January 1, 1987, shall be the dollar amount determined under §1.964–1(e)(3).

(c) *All other foreign corporations.* If a foreign corporation is a DASTM QBU that is not described in paragraph (b) of this section, then the hyperinflationary currency and dollar adjusted basis in the QBU's assets acquired in taxable years beginning before January 1, 1987, the hyperinflationary currency and dollar amount of the QBU's liabilities acquired or incurred in taxable years beginning before January 1, 1987, and the dollar amount of the QBU's net worth, including its retained earnings, at the end of its last taxable year beginning before January 1, 1987, shall be determined by applying the principles of §1.985–3T or §1.985–3. Thus, for example, the dollar basis of plant and equipment shall be determined using the appropriate historical exchange rate.

(d) *Pre-1987 section 902 amounts*—(1) *Translation of pre-1987 section 902 accumulated profits and taxes into United States dollars.* The foreign income taxes and accumulated profits or deficits in accumulated profits of a foreign corporation that were maintained in foreign currency for purposes of section 902 and that are attributable to taxable years of the foreign corporation beginning before January 1, 1987, shall be translated into dollars at the spot exchange rate on the first day of its first taxable year beginning after December 31, 1986. Once translated into dollars, these accumulated profits and taxes shall (absent a change in functional currency) remain in dollars for all federal income tax purposes.

(2) *Carryforward of accumulated deficits in accumulated profits from pre-1987 taxable years to post-1986 taxable years.* For purposes of sections 902 and 960, the post-1986 undistributed earnings of a foreign corporation that is subject to the rules of this section shall be reduced by the dollar amount of the corporation's deficit in accumulated profits, if any, determined under section 902 and the regulations thereunder, that was accumulated at the end of the corporation's last taxable year beginning before January 1, 1987. The dollar amount of the accumulated deficit shall be determined by multiplying the foreign currency amount of such deficit by the spot exchange rate on the last day of the corporation's last taxable year beginning before January 1, 1987, and shall be taken into account on the first day of the corporation's first taxable year beginning after December 31, 1986. Post-1986 undistributed earnings may not be reduced by the dollar amount of a pre-1987 deficit in retained earnings determined under §1.964–1(e).

(e) *Net worth branch.* If a DASTM QBU is a branch of a United States person and the QBU used a net worth method of accounting for its last taxable year beginning before January 1, 1987, then the rules of this paragraph (e) shall apply. A net worth method of accounting is any method of accounting under which the taxpayer calculates the taxable income of a QBU based on the net change in the dollar value of the QBU's equity (assets minus liabilities) during the course of a taxable year, taking into account any contributions or remittances made during the year. See, *e.g.*, Rev. Rul. 75–106, 1975–1 C.B. 31. (See §601.601(d)(2)(ii)(*b*) of this chapter).

(1) *Basis in assets and amount of liabilities*—(i) *Hyperinflationary amounts.* For the first taxable year beginning in 1987, the hyperinflationary currency adjusted basis of a QBU's assets or the hyperinflationary currency amounts of its liabilities acquired or incurred in a

taxable year beginning before January 1, 1987 is the hyperinflationary currency basis or amount at the date when acquired or incurred, as adjusted according to United States generally accepted accounting and tax accounting principles. If a hyperinflationary currency basis or amount was not determined at such date, the dollar basis or amount, as adjusted according to United States generally accepted accounting and tax accounting principles, shall be translated into hyperinflationary currency at the spot exchange rate on the date when the asset or liability was acquired or incurred.

(ii) *Dollar amounts.* For the first taxable year beginning in 1987, the dollar adjusted basis of the QBU's assets and the amounts of its liabilities shall be those amounts reflected on the QBU's dollar books and records at the end of the taxpayer's last taxable year beginning before January 1, 1987, after adjusting the books and records according to United States generally accepted accounting and tax accounting principles.

(2) *Ending net worth.* The dollar amount of the QBU's net worth at the end of its last taxable year beginning before January 1, 1987 shall equal the QBU's net worth at that date as determined under paragraph (e)(1)(ii) of this section.

(f) *Profit and loss branch.* If a DASTM QBU is a branch of a United States person and the QBU used a profit and loss method of accounting for its last taxable year beginning before January 1, 1987, then the United States person shall first apply the transition rules of §1.987–5 in order to determine the beginning amount and dollar basis of the branch's EQ pool, the hyperinflationary currency basis of the branch's assets, and the hyperinflationary currency amounts of its liabilities. A profit and loss method of accounting is any method of accounting under which the taxpayer calculates the profits of a QBU by computing the QBU's profits in its functional currency and translating the net result into dollars. See *e.g.*, Rev. Rul. 75–107, 1975–1 C.B. 32. (See §601.601(d)(2)(ii)(*b*) of this chapter). The QBU and the taxpayer must then make the adjustments required by §1.985–5, *e.g.*, the QBU must take into account unrealized exchange gain or loss on dollar-denominated section 988 transactions, the taxpayer must account for the deemed termination of the branch, and the taxpayer must translate the QBU's balance sheet items from hyperinflationary currency into dollars at the spot rate.

[T.D. 8464, 58 FR 234, Jan. 5, 1993]

§1.985–7 Adjustments required in connection with a change to DASTM.

(a) *In general.* If a QBU begins to use the dollar approximate separate transactions method of accounting set forth in §1.985–3 (DASTM) in a taxable year beginning after April 6, 1998, adjustments shall be made as provided by this section. For the rules with respect to foreign corporations, see paragraph (b) of this section. For the rules with respect to adjustments to the income of United States shareholders of controlled foreign corporations, see paragraph (c) of this section. For the rules with respect to adjustments relating to QBU branches, see paragraph (d) of this section. For the effective date of this section, see paragraph (e). For purposes of applying this section, the look-back period shall be the period beginning with the first taxable year after the transition date and ending on the last day prior to the taxable year of change. The term transition date means the later of the last day of the last taxable year ending before the base period as defined in §1.985–1(b)(2)(ii)(D) or the last day of the taxable year in which the QBU last applied DASTM. The taxable year of change shall mean the taxable year of change as defined in §1.481–1(a)(1). The application of this paragraph may be illustrated by the following examples:

Example 1. A calendar year QBU that has not previously used DASTM operates in a country in which the functional currency of the country is hyperinflationary as defined under §1.985–1(b)(2)(ii)(D) for the QBU's 1999 tax year. The look-back period is the period from January 1, 1996 through December 31, 1998, the transition date is December 31, 1995, and the taxable year of change is the taxable year beginning January 1, 1999.

Example 2. A QBU that has not previously used DASTM with a taxable year ending June 30, operates in a country in which the functional currency of the country is hyperinflationary for the QBU's tax year beginning July 1, 1999 as defined under §1.985–1(b)(2)(ii)(D) (where the base period is the thirty-six calendar months immediately preceding the first day of the current calendar year 1999). The look-back period is the period from July 1, 1995 through June 30, 1999, the transition date is June 30, 1995, and the taxable year of change is the taxable year beginning July 1, 1999.

(b) *Adjustments to foreign corporations*—(1) *In general.* In the case of a foreign corporation, the corporation shall make the adjustments set forth in paragraphs (b)(2) through (4) of this section. The adjustments shall be made on the first day of the taxable year of change.

(2) *Treatment of certain section 988 transactions*—(i) *Exchange gain or loss from section 988 transactions unrealized as of the transition date.* A foreign corporation shall adjust earnings and profits by the amount of any unrealized exchange gain or loss that was attributable to a section 988 transaction (as defined in sections 988(c)(1)(A), (B), and (C)) that was denominated in terms of (or determined by reference to) the dollar and was held by the corporation on the transition date. Such gain or loss shall be computed as if recognized on the transition date and shall be reduced by any gain and increased by any loss recognized by the corporation with respect to such transaction during the look-back period. The amount of such gain or loss shall be determined without regard to the limitations of section 988(b) (i.e., whether any gain or loss would be realized on the transaction as a whole). The character and source of such gain or loss shall be determined under section 988. Proper adjustments shall be made to account for gain or loss taken into account by reason of this paragraph (b)(2). See §1.985–5(f) *Example 1, footnote 1.*

(ii) *Treatment of a section 988 transaction entered into and terminated during the look-back period.* A foreign corporation shall reduce earnings and profits by the amount of any gain, and increase earnings and profits by the amount of any loss, that was recognized with respect to any dollar denominated section 988 transactions entered into and terminated during the look-back period.

(3) *Opening balance sheet.* The opening balance sheet of a foreign corporation for the taxable year of change shall be determined as if the corporation had changed its functional currency to the dollar by applying §1.985–5(c) on the transition date and had translated its assets and liabilities acquired and incurred during the look-back period under §1.985–3.

(4) *Earnings and profits adjustments*—(i) *Pre-1987 accumulated profits.* The foreign income taxes and accumulated profits or deficits in accumulated profits of a foreign corporation that are attributable to taxable years beginning before January 1, 1987, as stated on the transition date, and that were maintained for purposes of section 902 in the old functional currency, shall be translated into dollars at the spot rate in effect on the transition date. The applicable accumulated profits shall be reduced on a last-in, first-out basis by the aggregate dollar amount (translated from functional currency in accordance with the rules of section 989(b)) attributable to earnings and profits that were distributed (or treated as distributed) during the look-back period to the extent such amounts distributed exceed the earnings and profits calculated under (b)(4)(ii) or (b)(4)(iii), as applicable. See §1.902–1(b)(2)(ii). Once translated into dollars, these pre-1987 taxes and accumulated profits or deficits in accumulated profits shall (absent a change in functional currency) remain in dollars for all federal income tax purposes.

(ii) *Post-1986 undistributed earnings of a CFC.* In the case of a controlled foreign corporation (within the meaning of section 957 or section 953(c)(1)(B))(CFC) or a foreign corporation subject to the rules of §1.904–6(a)(2), the corporation's post-1986 undistributed earnings in each separate category as defined in §1.904–5(a)(1) as of the first day of the taxable year of change (and prior to adjustment under paragraph (c)(1) of this section) shall equal the sum of—

(A) The corporation's post-1986 undistributed earnings and profits (or deficit in earnings and profits) in each separate category as defined in §1.904–5(a)(1) as stated on the transition date translated into dollars at the spot rate in effect on the transition date; and

(B) The sum of the earnings and profits (or deficit in earnings and profits) in each separate category determined under § 1.985–3 for each post-transition date taxable year prior to the taxable year of change.

Such amount shall be reduced by the aggregate dollar amount (translated from functional currency in accordance with the rules of section 989(b)) attributable to earnings and profits that were distributed (or treated as distributed) during the look-back period out of post-1986 earnings and profits in such separate category. For purposes of applying this paragraph (b)(4)(ii)(B), the opening balance sheet for calculating earnings and profits under § 1.985–3 for the first post-transition year shall be translated into dollars pursuant to § 1.985–5(c).

(iii) *Post-1986 undistributed earnings of other foreign corporations.* In the case of a foreign corporation that is not a CFC or subject to the rules of § 1.904–6(a)(2), the corporation's post-1986 undistributed earnings shall equal the sum of—

(A) The corporation's post-1986 undistributed earnings (or deficit) on the transition date translated into dollars at the spot rate in effect on the transition date; and

(B) The sum of the earnings and profits (or deficit in earnings and profits) determined under § 1.985–3 for each post-transition date taxable year (or such later year determined under section 902(c)(3)(A)) prior to the taxable year of change.

Such amount shall be reduced by the aggregate dollar amount (translated from functional currency in accordance with the rules of section 989(b)) that was distributed (or treated as distributed) during the look-back period out of post-1986 earnings and profits. For purposes of applying this paragraph (b)(4)(iii)(B), the opening balance sheet for calculating earnings and profits under § 1.985–3 for the first post-transition year shall be translated into dollars pursuant to § 1.985–5(c).

(c) *United States shareholders of controlled foreign corporations*—(1) *In general.* A United States shareholder (within the meaning of section 951(b) or section 953(c)(1)(B)) of a CFC that changes to DASTM shall make the adjustments set forth in paragraphs (c)(2) through (5) of this section on the first day of the taxable year of change. Adjustments under this section shall be taken into account by the shareholder (or such shareholder s successor in interest) ratably over four taxable years beginning with the taxable year of change. Similar rules shall apply in determining adjustments to income of United States persons who have made an election under section 1295 to treat a passive foreign investment company as a qualified electing fund.

(2) *Treatment under subpart F of income recognized on section 988 transactions.* The character of amounts taken into account under paragraph (b)(2) of this section for purposes of sections 951 through 964, shall be determined on the transition date and to the extent characterized as subpart F income shall be taken into account in accordance with the rules of paragraph (c)(1) of this section. Such amounts shall retain their character for all federal income tax purposes (including sections 902, 959, 960, 961, 1248, and 6038).

(3) *Recognition of foreign currency gain or loss on previously taxed earnings and profits on the transition date.* Gain or loss is recognized under section 986(c) as if all previously taxed earnings and profits as determined on the transition date, if any, were distributed on such date. Such gain or loss shall be reduced by any foreign currency gain and increased by any foreign currency loss that was recognized under section 986(c) with respect to distributions of previously taxed earnings and profits during the look-back period. Such amount shall be characterized in accordance with section 986(c) and taken into account in accordance with the rules of paragraph (c)(1) of this section.

(4) *Subpart F income adjustment.* Subpart F income in a separate category shall be determined under § 1.985–3 for each look-back year. For this purpose, the opening DASTM balance sheet shall be determined under § 1.985–5. The sum of the difference (positive or negative) between the amount computed pursuant to § 1.985–3 and amount that was included in income for each year

shall be taken into account in the taxable year of change pursuant to paragraph (c)(1) of this section. Such amounts shall retain their character for all federal income tax purposes (including sections 902, 959, 960, 961, 1248, and 6038). For rules applicable if an adjustment under this section results in a loss for the taxable year in a separate category, see section 904(f) and the regulations thereunder. The amount of previously taxed earnings and profits as determined under section 959(c)(2) shall be adjusted (positively or negatively) by the amount taken into account under this paragraph (c)(4) as of the first day of the taxable year of change.

(5) *Foreign tax credit.* A United States shareholder of a CFC shall compute an amount of foreign taxes deemed paid under section 960 with respect to any positive adjustments determined under paragraph (c) of this section. The amount of foreign tax deemed paid shall be computed with reference to the full amount of the adjustment and to the post-1986 undistributed earnings determined under paragraph (b)(4) (i) and (ii) of this section and the post-1986 foreign income taxes of the CFC on the first day of the taxable year of change (i.e., without taking into account earnings and taxes for the taxable year of change). For purposes of section 960, the associated taxes in each separate category shall be allocated pro rata among, and deemed paid in, the shareholder's taxable years in which the income is taken into account. (No adjustment to foreign taxes deemed paid in prior years is required solely by reason of a negative adjustment to income under paragraph (c)(1) of this section).

(d) *QBU branches*—(1) *In general.* In the case of a QBU branch, the taxpayer shall make the adjustments set forth in paragraphs (d)(2) through (d)(4) of this section. Adjustments under this section shall be taken into account by the taxpayer ratably over four taxable years beginning with the taxable year of change.

(2) *Treatment of certain section 988 transactions*—(i) *Exchange gain or loss from section 988 transactions unrealized as of the transition date.* A QBU branch shall adjust income by the amount of any unrealized exchange gain or loss that was attributable to a section 988 transaction (as defined in sections 988(c)(1) (A), (B), and (C)) that was denominated in terms of (or determined by reference to) the dollar and was held by the QBU branch on the transition date. Such gain or loss shall be computed as if recognized on the transition date and shall be reduced by any gain and increased by any loss recognized by the QBU branch with respect to such transaction during the look-back period. The amount of such gain or loss shall be determined without regard to the limitations of section 988(b) (i.e., whether any gain or loss would be realized on the transaction as a whole). The character and source of such gain or loss shall be determined under section 988. Proper adjustments shall be made to account for gain or loss taken into account by reason of this paragraph (d)(2). See §1.985–5(f) *Example 1, footnote 1.*

(ii) *Treatment of a section 988 transaction entered into and terminated during the look-back period.* A QBU branch shall reduce income by the amount of any gain, and increase income by the amount of any loss, that was recognized with respect to any dollar denominated section 988 transactions entered into and terminated during the look-back period.

(3) *Deemed termination income adjustment.* The taxpayer shall realize gain or loss attributable to the QBU branch's equity pool (as stated on the transition date) under the principles of section 987, computed as if the branch terminated on the transition date. Such amount shall be reduced by section 987 gain and increased by section 987 loss that was recognized by such taxpayer with respect to remittances during the look-back period.

(4) *Branch income adjustment.* Branch income in a separate category shall be determined under §1.985–3 for each look-back year. For this purpose, the opening DASTM balance sheet shall be determined under §1.985–5. The sum of the difference (positive or negative) between the amount computed pursuant to §1.985–3 and amount taken into account for each year shall be taken into account in the taxable year of change pursuant to paragraph (d)(1) of this section. Such amounts shall retain their

character for all federal income tax purposes.

(5) *Opening balance sheet.* The opening balance sheet of a QBU branch for the taxable year of change shall be determined as if the branch had changed its functional currency to the dollar by applying § 1.985–5(c) on the transition date and had translated its assets and liabilities acquired and incurred during the look-back period under § 1.985–3.

(e) *Effective date.* This section is effective for taxable years beginning after April 6, 1998. However, a taxpayer may choose to apply this section to all open taxable years beginning after December 31, 1986, provided each person, and each QBU branch of a person, that is related (within the meaning of § 1.985–2(d)(3)) to the taxpayer also applies this section.

[T.D. 8765, 63 FR 10774, Mar. 5, 1998]

§ 1.985–8T Special rules applicable to the European Monetary Union (conversion to the euro) (temporary).

(a) *Definitions*—(1) *Legacy currency.* A legacy currency is the national currency of a participating member state of the European Union used prior to the substitution of the euro for the national currency of that state in accordance with the Treaty on European Union signed February 7, 1992. The term legacy currency shall also include the European Currency Unit.

(2) *Conversion rate.* The conversion rate is the rate at which the euro is substituted for a legacy currency.

(b) *Operative rules*—(1) *Initial adoption.* A QBU (as defined in § 1.989(a)–1(b)) whose first taxable year begins after the euro has been substituted for a legacy currency may not adopt that legacy currency as its functional currency.

(2) *QBU with a legacy functional currency*—(i) *Required change.* A QBU with a legacy currency as its functional currency is required to change its functional currency to the euro beginning the first day of the first taxable year:

(A) That begins on or after the day that the euro is substituted for that legacy currency (in accordance with the Treaty on European Union); and

(B) In which the QBU begins to maintain its books and records (as described in § 1.989(a)–1(d)) in the euro.

(ii) Notwithstanding paragraph (b)(2)(i) of this section, a QBU with a legacy currency as its functional currency is required to change its functional currency to the euro no later than the last taxable year beginning on or before the first day such legacy currency is no longer valid legal tender.

(iii) *Consent of Commissioner.* A change made pursuant to paragraph (b)(2)(i) of this section shall be deemed to be made with the consent of the Commissioner for purposes of § 1.985–4. A QBU changing its functional currency to the euro pursuant to this paragraph (b)(2) must make adjustments as provided in paragraph (c) of this section.

(3) *Statement to file upon change.* With respect to a QBU that changes its functional currency to the euro under paragraph (b)(2) of this section, an affected taxpayer shall attach to its return for the taxable year of change a statement that includes the following: ‘‘TAXPAYER CERTIFIES THAT A QBU OF THE TAXPAYER HAS CHANGED ITS FUNCTIONAL CURRENCY TO THE EURO PURSUANT TO TREAS. REG. § 1.985–8T.’’ For purposes of this paragraph (b)(3), an affected taxpayer shall be in the case where the QBU is: a QBU of an individual U.S. resident (as a result of the activities of such individual), the individual; a QBU branch of a U.S. corporation, the corporation; a controlled foreign corporation (as described in section 957)(or QBU branch thereof), each United States shareholder (as described in section 951(b)); a partnership, each partner separately; a noncontrolled section 902 corporation (as described in section 904(d)(2)(E)) (or branch thereof), each domestic shareholder as described in § 1.902–1(a)(1); or a trust or estate, the fiduciary of such trust or estate.

(c) *Adjustments required*—(1) *In general.* A QBU that changes its functional currency to the euro pursuant to paragraph (b) of this section must make the adjustments described in paragraphs (c)(2) through (5) of this section. Section 1.985–5 shall not apply.

(2) *Determining the euro basis of property and the euro amount of liabilities and other relevant items.* The euro basis in property and the euro amount of liabilities and other relevant items shall

equal the product of the legacy functional currency adjusted basis or amount of liabilities multiplied by the applicable conversion rate.

(3) *Taking into account exchange gain or loss on legacy currency section 988 transactions*—(i) *In general.* Except as provided in paragraphs (c)(3) (iii) and (iv) of this section, a legacy currency denominated section 988 transaction (determined after applying section 988(d)) outstanding on the last day of the taxable year immediately prior to the year of change shall continue to be treated as a section 988 transaction after the change and the principles of section 988 shall apply.

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

Example 1. X, a calendar year QBU on the cash method of accounting, uses the deutschmark as its functional currency. X is not described in section 1281(b). On July 1, 1998, X converts 10,000 deutschmarks(DM) into Dutch guilders(fl) at the spot rate of fl 1 = DM1 and loans the 10,000 guilders to Y (an unrelated party) for one year at a rate of 10% with principal and interest to be paid on June 30, 1999. On January 1, 1999, X changes its functional currency to the euro pursuant to this section. The euro/deutschmark conversion rate is set by the European Council at 1= DM2. The euro/guilder conversion rate is set at 1 = fl 2.25. Accordingly, under the terms of the note, on June 30, 1999, X will receive 4444.44 (fl10,000/2.25) of principal and 444.44 (fl 1,000/2.25) of interest. Pursuant to this paragraph (c)(3), X will realize an exchange loss on the principal computed under the principles of § 1.988–2(b)(5). For this purpose, the exchange rate used under § 1.988–2(b)(5)(i) shall be the guilder/euro conversion rate. The amount under § 1.988–2(b)(5)(ii) is determined by translating the fl 10,000 at the guilder/deutschmark spot rate on July 1, 1998, and translating that deutschmark amount into euros at the deutschmark/euro conversion rate. Thus, X will compute an exchange loss for 1999 of 555.56 determined as follows: [4444.44 (fl 10,000/2.25)– 5000 ((fl 10,000/1)/2) =– 555.56]. Pursuant to this paragraph (c)(3), the character and source of the loss are determined pursuant to section 988 and regulations thereunder. Because X uses the cash method of accounting for the interest on this debt instrument, X does not realize exchange gain or loss on the receipt of that interest.

Example 2. (i) X, a calendar year QBU on the accrual method of accounting, uses the deutschmark as its functional currency.

On February 1, 1998, X converts 12,000 deutschmarks into Dutch guilders at the spot rate of fl 1 = DM1 and loans the 12,000 guilders to Y (an unrelated party) for one year at a rate of 10% with principal and interest to be paid on January 31, 1999. In addition, assume the average rate (deutschmark/guilder) for the period from February 1, 1998, through December 31, 1998 is fl 1.07 = DM1. Pursuant to § 1.988–2(b)(2)(ii)(C), X will accrue eleven months of interest on the note and recognize interest income of DM1028.04 (fl 1100/1.07) in the 1998 taxable year.

(ii) On January 1, 1999, the euro will replace the deutschmark as the national currency of Germany pursuant to the Treaty on European Union signed February 7, 1992. Assume that on January 1, 1999, X changes its functional currency to the euro pursuant to this section. The euro/deutschmark conversion rate is set by the European Council at 1 = DM2. The euro/guilder conversion rate is set at 1 = fl 2.25. In 1999, X will accrue one month of interest equal to 44.44 (fl 100/2.25). On January 31, 1999, pursuant to the note, X will receive interest denominated in euros of 533.33 (fl 1200/2.25). Pursuant to this paragraph (c)(3), X will realize an exchange loss in the 1999 taxable year with respect to accrued interest computed under the principles of § 1.988–2(b)(3). For this purpose, the exchange rate used under § 1.988–2(b)(3)(i) is the guilder/euro conversion rate and the exchange rate used under § 1.988–2(b)(3)(ii) is the deutschmark/euro conversion rate. Thus, with respect to the interest accrued in 1998, X will realize exchange loss of 25.13 under § 1.988–2(b)(3) as follows: [488.89 (fl 1100/2.25)– 514.02 (DM1028.04/2) = – 25.13]. With respect to the one month of interest accrued in 1999, X will realize no exchange gain or loss since the exchange rate when the interest accrued and the spot rate on the payment date are the same.

(iii) X will realize exchange loss of 666.67 on repayment of the loan principal computed in the same manner as in *Example 1* [5333.33 (fl 12,000/2.25)– 6000 fl 12,000/1)/2)]. The losses with respect to accrued interest and principal are characterized and sourced under the rules of section 988.

(iii) *Special rule for legacy nonfunctional currency.* The QBU shall realize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to nonfunctional currency (as described in section 988(c)(1)(C)(ii)) that is denominated in a legacy currency as if the currency were disposed of on the last day of the taxable year immediately prior to the year of change. The character and source of the gain or loss are determined under section 988.

(iv) *Legacy currency denominated accounts receivable and payable*—(A) *In general.* A QBU may elect to realize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to a legacy currency denominated item described in section 988(c)(1)(B)(ii) as if the item were terminated on the last day of the taxable year ending prior to the year of change.

(B) *Time and manner of election.* With respect to a QBU that makes an election described in paragraph (c)(3)(iv)(A) of this section, an affected taxpayer (as described in paragraph (b)(3) of this section) shall attach a statement to its tax return for the taxable year ending immediately prior to the year of change which includes the following: ‘‘TAXPAYER CERTIFIES THAT A QBU OF THE TAXPAYER HAS ELECTED TO REALIZE CURRENCY GAIN OR LOSS ON LEGACY CURRENCY DENOMINATED ACCOUNTS RECEIVABLE AND PAYABLE UPON CHANGE OF FUNCTIONAL CURRENCY TO THE EURO.’’ A QBU making the election must do so for all legacy currency denominated items described in section 988(c)(1)(B)(ii).

(4) *Adjustments when a branch changes its functional currency to the euro*—(i) *Branch changing from a legacy currency to the euro in a taxable year during which taxpayer's functional currency is other than the euro.* If a branch changes its functional currency from a legacy currency to the euro for a taxable year during which the taxpayer's functional currency is other than the euro, the branch's euro equity pool shall equal the product of the legacy currency amount of the equity pool multiplied by the applicable conversion rate. No adjustment to the basis pool is required.

(ii) *Branch changing from a legacy currency to the euro in a taxable year during which taxpayer's functional currency is the euro.* If a branch changes its functional currency from a legacy currency to the euro for a taxable year during which the taxpayer's functional currency is the euro, the taxpayer shall realize gain or loss attributable to the branch's equity pool under the principles of section 987, computed as if the branch terminated on the last day prior to the year of change. Adjustments under this paragraph (c)(4)(ii) shall be taken into account by the taxpayer ratably over four taxable years beginning with the taxable year of change.

(5) *Adjustments to a branch's accounts when a taxpayer changes to the euro*—(i) *Taxpayer changing from a legacy currency to the euro in a taxable year during which a branch's functional currency is other than the euro.* If a taxpayer changes its functional currency to the euro for a taxable year during which the functional currency of a branch of the taxpayer is other than the euro, the basis pool shall equal the product of the legacy currency amount of the basis pool multiplied by the applicable conversion rate. No adjustment to the equity pool is required.

(ii) *Taxpayer changing from a legacy currency to the euro in a taxable year during which a branch's functional currency is the euro.* If a taxpayer changes its functional currency from a legacy currency to the euro for a taxable year during which the functional currency of a branch of the taxpayer is the euro, the taxpayer shall take into account gain or loss as determined under paragraph (c)(4)(ii) of this section.

(6) *Additional adjustments that are necessary when a corporation changes its*

functional currency to the euro. The amount of a corporation's euro currency earnings and profits and the amount of its euro paid-in capital shall equal the product of the legacy currency amounts of these items multiplied by the applicable conversion rate. The foreign income taxes and accumulated profits or deficits in accumulated profits of a foreign corporation that were maintained in foreign currency for purposes of section 902 and that are attributable to taxable years of the foreign corporation beginning before January 1, 1987, also shall be translated into the euro at the conversion rate.

(d) *Effective date.* This section applies to tax years ending after July 29, 1998.

[T.D. 8776, 63 FR 40368, July 29, 1998; 63 FR 55333, Oct. 15, 1998]

§1.987–1 Profit and loss method of accounting for a qualified business unit of a taxpayer having a different functional currency from the taxpayer. [Reserved]

§1.987–2 Accounting for gain or loss on certain transfers of property. [Reserved]

§1.987–3 Termination. [Reserved]

§1.987–4 Special rules relating to QBU branches of foreign taxpayers. [Reserved]

§1.987–5 Transition rules for certain qualified business units using a profit and loss method of accounting for taxable years beginning before January 1, 1987.

(a) *Applicability*—(1) *In general.* This section applies to qualified business unit (QBU) branches of United States persons, whose functional currency (as defined in section 985 of the Code and the regulations thereunder) is other than the United States dollar (dollar) and that used a profit and loss method of accounting for their last taxable year beginning before January 1, 1987. Generally, a profit and loss method of accounting is any method of accounting under which the taxpayer calculates the profits of a QBU branch in its functional currency and translates the net result into dollars. For all taxable years beginning after December 31, 1986, such QBU branches must use the profit and loss method of accounting as described in section 987, except to the extent otherwise provided in regulations under section 985 or any other provision of the Code. See §1.989(c)–1 regarding transition rules for QBU branches of United States persons that have a nondollar functional currency and that used a net worth method of accounting for their last taxable year beginning before January 1, 1987.

(2) *Insolvent QBU branches.* A taxpayer may apply the principles of this section to a QBU branch that used a profit and loss method of accounting for its last taxable year beginning before January 1, 1987, whose $E pool (as defined in paragraph (d)(3)(i) of this section) is negative. For taxable years beginning on or after October 25, 1991, the principles of this section shall apply to insolvent QBU branches.

(b) *General rules.* Generally, section 987 gain or loss occurs when a QBU branch makes a remittance. A remittance is considered to be made from one or more functional currency pools under rules provided in paragraph (c) of this section. In general, the amount of section 987 gain or loss from a remittance equals the difference between the dollar value of the functional currency adjusted basis of the property remitted and the portion of the dollar basis in the applicable pool. Section 987 gain or loss is calculated under a 4-step procedure described in paragraph (d) of this section. Section 987 gain or loss attributable to a remittance is realized and must be recognized in the taxable year of the remittance except to the extent otherwise provided in regulations.

(c) *Determining the pool(s) from which a remittance is made*—(1) *Remittances made during taxable years beginning after December 31, 1986, and before October 25, 1991.* A remittance made during taxable years beginning after December 31, 1986 and before October 25, 1991, first represents an amount of the QBU branch's post-86 profits pool (including functional currency profits for the current taxable year determined without regard to remittances made during the current year). To the extent the functional currency amount of the remittance exceeds the post-86 profits pool, it is considered to come out of the EQ pool. Paragraph (d)(2) of this section describes the EQ pool and the post-86 profits pool.

(2) *Remittances made in taxable years beginning on or after October 25, 1991.* For remittances made in taxable years beginning on or after October 25, 1991, the post-86 profits and EQ pools are combined into one pool called the equity pool. Therefore, remittances made during those taxable years will only come from the equity pool. The dollar basis of, and section 987 gain or loss on, such remittances shall be calculated utilizing the principles set forth in paragraphs (d)(4) and (5) of this section.

(d) *Calculation of section 987 gain or loss*—(1) *In general.* This paragraph (d) describes the 4-step procedure for calculating section 987 gain or loss.

(2) *Step 1—Calculate the amount of the functional currency pools*—(i) *EQ pool*—(A) *Beginning pool.* The beginning amount of the EQ pool is equal to the functional currency adjusted bases of a QBU branch's assets less the functional currency amount of the QBU branch's liabilities at the end of the taxpayer's last taxable year beginning before January 1, 1987, as these amounts are determined under the rules of paragraphs (e) and (f) of the section. The district director may allow for additional adjustments to the beginning amount of the EQ pool to prevent the recognition of section 987 gain or loss due to factors unrelated to the movement of exchange rates.

(B) *Adjusting the EQ pool.* The EQ pool is increased by the functional currency amount of any transfer (as determined under section 987) to the QBU branch made during the current taxable year or any prior taxable year beginning after December 31, 1986. If the transfer is made in a nonfunctional currency, this amount is translated into the QBU branch's functional currency at the spot rate (determined under the principles of section 988 and the regulations thereunder) on the date of the transfer. The method for determining the rate must be applied consistently each quarter. The EQ pool is decreased by the functional currency amount of any remittance (as determined under section 987) made during a prior taxable year beginning after December 31, 1986, that is considered remitted from the EQ pool under paragraph (c) of this section. The EQ pool must also be decreased by any transfer from the QBU branch that is not a remittance.

(ii) *Post-86 profits pool.* The amount of a QBU branch's post-86 profits pool is calculated at the end of each taxable year beginning after December 31, 1986. The opening balance of the post-86 profits pool at the beginning of the first taxable year beginning after December 31, 1986, is zero. The post-86 profits pool is increased by the functional currency amount of the QBU branch's profits (determined under section 987) for the taxable year. The post-86 profits pool is decreased by the functional currency amount of the QBU branch's losses (determined under section 987) for the taxable year and the amount of any remittances by the QBU branch during the taxable year from the post-86 profits pool as provided under paragraph (c) of this section.

(iii) *Adjustments to the equity pool.* For remittances made in taxable years beginning on or after October 25, 1991 under paragraph (c)(2) of this section, the post-86 profits and EQ pools are combined into one pool called the equity pool. Additions to and subtractions from the equity pool shall be made utilizing the principles of paragraphs (d)(2)(i)(B) and (ii) of this section. For example, remittances shall reduce the equity pool.

(3) *Step 2—Calculate the dollar basis of the pools*—(i) *Dollar basis of the EQ pool*—(A) *Beginning dollar basis.* The beginning dollar basis of the EQ pool (hereinafter referred to as the $E pool) equals:

(*1*) The dollar amount of all the QBU branch's profits reported on the taxpayer's income tax returns for taxable years beginning before January 1, 1987, plus the total dollar amount of all transfers to the QBU branch during that period (properly reflected on the taxpayer's books), less

(*2*) The dollar amount of all the QBU branch's losses reported on the taxpayer's income tax returns for such years, and the total dollar basis of all remittances and all transfers made by the QBU branch during that period (properly reflected on the taxpayer's books).

A QBU branch’s profits and losses shall be properly adjusted for foreign taxes of the QBU branch.

(B) *Adjusting the $E pool.* The $E pool is increased by the dollar amount of any transfers to the QBU branch made during the current taxable year or any prior taxable year beginning after December 31, 1986. If a transfer is made in a currency other than the dollar, the amount of the currency is translated into dollars at the spot rate (determined under the principles of section 988 and the regulations thereunder) on the date of the transfer. The $E pool is decreased by the dollar basis of any remittance made during a prior taxable year beginning after December 31, 1986, that is considered remitted from the $E pool under paragraphs (c) and (d)(4) of these section. The $E pool is also reduced by the amount of a transfer (other than a remittance) from the QBU branch translated into dollars at the spot rate (determined under the principles of section 988 and the regulations thereunder) on the date of the transfer. The method for determining the spot rate must be applied consistently to all transfers to and from a QBU branch.

(ii) *Dollar basis of the post-86 profits pool.* The amount of a QBU branch’s dollar basis in the post-86 profits pool (the $P pool) is calculated at the end of each taxable year beginning after December 31, 1986. The opening balance of the $P pool at the beginning of the first taxable year beginning after December 31, 1986, is zero. The $P pool is increased by the functional currency amount of the QBU branch’s profits (determined under section 987) for the taxable year translated into dollars at the weighted average exchange rate (as defined in §1.989 (b)–1) for the year. The $P pool is decreased by the functional currency amount of the QBU branch’s losses (determined under section 987) for the taxable year translated into dollars at the weighted average exchange rate for the year and by the dollar basis of any remittances made by the QBU branch during the taxable year from the post-86 profits pool under paragraph (c)(1) of this section.

(iii) *Combination of the $E and the $P pools.* For taxable years beginning on or after October 25, 1991 the $P and the $E pools are combined into one pool called the basis pool. Additions to and subtractions from the basis pool shall be made utilizing the principles set forth in paragraphs (d)(3)(i) and (ii) of this section.

(4) *Step 3—Calculation of the dollar basis of a remittance.* For all taxable years beginning after December 31, 1986, the dollar basis of a remittance is calculated using the following formula:

$$\frac{\text{Amount of remittance (in QBC branch' s functional currency) from the applicable pool (EQ, post-86 profits, or equity pool)}}{\text{Balance of the applicable pool (EQ, post-86 profits or equity pool) reduced by prior remittances}} \times \text{The dollar basis of the applicable pool (\$E, \$P, or basis pool) reduced by prior remittances}$$

(5) *Step 4—Calculation of the section 987 gain or loss on a remittance.* Section 987 gains or loss equals the difference between—

(i) The dollar amount of the remittance, and

(ii) The dollar basis of the remittance as calculated under paragraph (d)(4) of this section.

(e) *Functional currency adjusted basis of QBU branch assets acquired in taxable years beginning before January 1, 1987*—(1) *Basis of asset.* For taxable years beginning after December 31, 1986, the functional currency adjusted basis of a QBU branch asset acquired in a taxable year beginning before January 1, 1987, is the functional currency basis of the asset at the date of acquisition, as adjusted according to United States tax principles. The functional currency adjusted basis of an asset for which a functional currency basis was not determined at the date of acquisition is the nonfunctional currency basis of the asset at the date of acquisition multiplied by the spot exchange rate on the date of acquisition, as adjusted according to United States tax principles.

(2) *Adjustment to basis of asset.* Any future adjustments to the functional currency adjusted basis of such an asset are determined with respect to the appropriate functional currency adjusted basis of the asset as determined under this paragraph (e).

(f) *Functional currency amount of QBU branch liabilities acquired in taxable years beginning before January 1, 1987.* For the first taxable year beginning after December 31, 1986, the amount of a QBU branch liability incurred in a taxable year beginning before January 1, 1987, is the functional currency amount of the liability at the date incurred, as adjusted according to United States tax principles. The functional currency amount of a liability for which a functional currency amount was not determined at the date incurred is the nonfunctional currency amount of the liability at the date incurred multiplied by the spot exchange rate on the date incurred, as adjusted according to the United States tax principles.

(g) *Examples.* The provisions of this section are illustrated by the following examples.

Example 1—(i) *Facts.* U.S. is a domestic corporation. B, a QBU branch of U.S., operates in country X and was established in 1985. B's functional currency is the FC. U.S. is on a calendar taxable year and, prior to January 1, 1987, accounted for the operations of B by the profit and loss method of accounting as set forth in Rev. Rul. 75–107, 1975–1 C.B. 32. B's books and records were kept according to United States tax principles. B received a transfer of $2,000 in 1985, and had profits of $3,000 in 1985 and $5,000 in 1986. B made a remittance in 1986, the dollar basis of which was $1,000. As of December 31, 1986, the adjusted basis of B's functional currency assets exceeded the functional currency amount of its liabilities by 15,000 FC (the beginning pool of EQ). Under section 987, B has profits of 8,000 FC in 1987, which are worth $1,000 when translated at the weighted average exchange rate for 1987 as required by sections 987(2) and 989(b)(4). B has no profits or loss in 1988. There are no transfers to B in 1987 and 1988. B remits 18,000 FC in 1988. Under section 987, the appropriate exchange rate for the 1988 remittance is 10 FC/$1.

(ii) *Calculation of section 987 loss on remittance*—(A) *Post-86 profits.* Under paragraph (c)(i) of this section, the 18,000 FC remittance comes first out of the post-86 profits pool (8,000 FC) and second out of EQ (10,000 FC). The loss on the 1988 remittance out of the post-86 profits pool equals:

Dollar value of post-86 profits remitted − Dollar basis of post-86 profits remitted= (8,000 FC × 10 FC/$1) − $1,000 = $800 − $1,000 = ≤$200> loss.

(B) *EQ.* Under paragraph (d) of this section, U.S. calculates 987 gain or loss on the 10,000 FC remittance of EQ from B as follows:

Step 1. The total EQ pool equals 15,000 FC (the functional currency adjusted bases of its assets less the functional currency amount of its liabilities as of December 31, 1986). There are no adjustments necessary under paragraph (d)(2)(i)(B) of this section.

Step 2. The $E pool is $9,000 (the $2,000 transfer in 1985 plus profits of $3,000 in 1985 and $5,000 in 1986 and less than $1,000 basis of the 1986 remittance). There are no adjustments necessary under paragraph (d)(3)(i)(B) of this section.

Step 3. The entire 10,000 FC remittance is deemed to come out of EQ.

Step 4. The dollar basis of the EQ remitted equals: N x $E determined under paragraph (d)(3)(i)=

$$\frac{10{,}000\ \text{FC}}{15{,}000\ \text{FC}} \times \$9{,}000 = \$6{,}000$$

Where:

$$\text{N} = \frac{\text{Portion of remittance out of EQ}}{\begin{array}{c}\text{EQ balance determined under paragraph}\\ \text{(d)(2)(i) of this section}\end{array}}$$

Step 5. Section 987 loss of U.S. on remittance equals:

Dollar value of the EQ remitted − Dollar basis of the EQ remitted = (10,000 FC × 10 FC/$1) − $6,000 = $1,000 − $6,000 = ≤$5,000> loss.

(C) *Total loss on remittance.* The total combined loss on the remittance is ′$5,200>. The total of amounts determined in paragraphs (ii)(A) and (B) of this Example 1.

Example 2—(i) *Facts.* D is a domestic corporation. B, a QBU branch of D, operates in country X. B's functional currency is the FC. At the end of B's last taxable year beginning before October 25, 1991, B's EQ pool equals 15,000 FC and B's post-86 profits pool equals 8,000 FC. B's $E amount equals $9,000, and the $P pool equals $1,000. In B's first taxable year beginning on or after October 25, 1991, B remits 18,000 FC. Under section 987, the appropriate exchange rate for this remittance is 10FC:$1.

(ii) *Computation of the equity pool.*

15,000 FC (EQ pool) + 8,000 FC (post-86 profits pool) = 23,000 FC (equity pool)

(iii) *Computation of the basis pool.*

$$\$9{,}000\text{ (\$E amount)} + \$1{,}000\text{ (\$P amount)} = \$10{,}000$$

(iv) *Dollar basis in remittance.*

$$\frac{18{,}000\text{ FC (amount of remittance)}}{23{,}000\text{ FC (equity pool)}} \times \$10{,}000 = \$7{,}826$$

(v) *Computation of section 987 loss by U.S. on remittance.*

$$\$1{,}800\text{ (dollar value of remittance)} - \$7{,}826\text{ (dollar basis in remittance)} =<\$6{,}026> \\ \text{(loss on remittance)}$$

(h) *Character and source of section 987 gain or loss.* Section 987 gain or loss is sourced and characterized as provided by section 987 and regulations issued under that section.

[T.D. 8367, 56 FR 48434, Sept. 25, 1991; 56 FR 65684, Dec. 18, 1991]

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[T.D. 8400, 57 FR 9177, Mar. 17, 1992]

§ 1.988–1 Certain definitions and special rules.

(a) *Section 988 transaction*—(1) *In general.* The term ‘‘section 988 transaction’’ means any of the following transactions—

(i) A disposition of nonfunctional currency as defined in paragraph (c) of this section;

(ii) Any transaction described in paragraph (a)(2) of this section if any amount which the taxpayer is entitled to receive or is required to pay by reason of such transaction is denominated in terms of a nonfunctional currency or is determined by reference to the value of one or more nonfunctional currencies.

A transaction described in this paragraph (a) need not require or permit payment with a nonfunctional currency as long as any amount paid or received is determined by reference to the value of one or more nonfunctional currencies. The acquisition of nonfunctional currency is treated as a section 988 transaction for purposes of establishing the taxpayer's basis in such currency and determining exchange gain or loss thereon.

(2) *Description of transactions.* The following transactions are described in this paragraph (a)(2).

(i) *Debt instruments.* Acquiring a debt instrument or becoming an obligor under a debt instrument. The term ''debt instrument'' means a bond, debenture, note, certificate or other evidence of indebtedness.

(ii) *Payables, receivables, etc.* Accruing, or otherwise taking into account, for purposes of subtitle A of the Internal Revenue Code, any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued or taken into account. A payable relating to cost of goods sold, or a payable or receivable relating to a capital expenditure or receipt, is within the meaning of this paragraph (a)(2)(ii). Generally, a payable relating to foreign taxes (whether or not claimed as a credit under section 901) is within the meaning of this paragraph (a)(2)(ii). However, a payable of a domestic person relating to accrued foreign taxes of its qualified business unit (QBU branch) is not within the meaning of this paragraph (a)(2)(ii) if the QBU branch's functional currency is the U.S. dollar and the foreign taxes are claimed as a credit under section 901.

(iii) *Forward contract, futures contract, option contract, or similar financial instrument.* Except as otherwise provided in this paragraph (a)(2)(iii) and paragraph (a)(4)(i) of this section, entering into or acquiring any forward contract, futures contract, option, warrant, or similar financial instrument.

(A) *Limitation for certain derivative instruments.* A forward contract, futures contract, option, warrant, or similar financial instrument is within this paragraph (a)(2)(iii) only if the underlying property to which the instrument ultimately relates is a nonfunctional currency or is otherwise described in paragraph (a)(1)(ii) of this section. Thus, if the underlying property of an instrument is another financial instrument (*e.g.*, an option on a futures contract), then the underlying property to which such other instrument (*e.g.*, the futures contract) ultimately relates must be a nonfunctional currency. For example, a forward contract to purchase wheat denominated in a nonfunctional currency, an option to enter into a forward contract to purchase wheat denominated in a nonfunctional currency, or a warrant to purchase stock denominated in a nonfunctional currency is not described in this paragraph (a)(2)(iii). On the other hand, a forward contract to purchase a nonfunctional currency, an option to enter into a forward contract to purchase a nonfunctional currency, an option to purchase a bond denominated in or the payments of which are determined by reference to the value of a nonfunctional currency, or a warrant to purchase nonfunctional currency is described in this paragraph (a)(2)(iii).

(B) *Nonfunctional currency notional principal contracts*—(*1*) *In general.* The term ''similar financial instrument'' includes a notional principal contract only if the payments required to be made or received under the contract are determined with reference to a nonfunctional currency.

(*2*) *Definition of notional principal contract.* The term ''notional principal contract'' means a contract (*e.g.*, a swap, cap, floor or collar) that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. For this purpose, a ''notional principal contract'' shall only include an instrument where the underlying property to which the instrument ultimately relates is money (*e.g.*, functional currency), nonfunctional currency, or property the value of which is determined by reference to an interest rate. Thus, the term ''notional principal contract'' includes a currency swap as defined in §1.988–2(e)(2)(ii), but does not include a swap referenced to a commodity or equity index.

(C) *Effective date with respect to certain contracts.* This paragraph (a)(2)(iii) does not apply to any forward contract, futures contract, option, warrant, or similar financial instrument entered into or acquired on or before October 21, 1988, if such instrument would have been marked to market under section 1256 if held on the last day of the taxable year.

(3)–(5) [Reserved]

(6) *Examples.* The following examples illustrate the application of paragraph (a) of this section. The examples assume that X is a U.S. corporation on an accrual method with the calendar year as its taxable year. Because X is a U.S. corporation the U.S. dollar is its functional currency under section 985. The examples also assume that section 988(d) does not apply.

Example 1. On January 1, 1989, X acquires 10,000 Canadian dollars. On January 15, 1989, X uses the 10,000 Canadian dollars to purchase inventory. The acquisition of the 10,000 Canadian dollars is a section 988 transaction for purposes of establishing X's basis in such Canadian dollars. The disposition of the 10,000 Canadian dollars is a section 988 transaction pursuant to paragraph (a)(1) of this section.

Example 2. On January 1, 1989, X acquires 10,000 Canadian dollars. On January 15, 1989, X converts the 10,000 Canadian dollars to U.S. dollars. The acquisition of the 10,000 Canadian dollars is a section 988 transaction for purposes of establishing X's basis in such Canadian dollars. The conversion of the 10,000 Canadian dollars to U.S. dollars is a section 988 transaction pursuant to paragraph (a)(1) of this section.

Example 3. On January 1, 1989, X borrows 100,000 British pounds (£) for a period of 10 years and issues a note to the lender with a face amount of £100,000. The note provides for payments of interest at an annual rate of 10% paid quarterly in pounds and has a stated redemption price at maturity of £100,000. X's becoming the obligor under the note is a section 988 transaction pursuant to paragraphs (a)(1)(ii) and (2)(i) of this section. Because X is an accrual basis taxpayer, the accrual of interest expense under X's note is a section 988 transaction pursuant to paragraphs (a)(1)(ii) and (2)(ii) of this section. In addition, the acquisition of the British pounds to make payments under the note is a section 988 transaction for purposes of establishing X's basis in such pounds, and the disposition of such pounds is a section 988 transaction under paragraph (a)(1)(i) of this section. See §1.988–2(b) with respect to the translation of accrued interest expense and the determination of exchange gain or loss upon payment of accrued interest expense.

Example 4. On January 1, 1989, X purchases an original issue for 74,621.54 British pounds (£) a 3-year bond maturing on December 31, 1991, at a stated redemption price of £100,000. The bond provides for no stated interest. The bond has a yield to maturity of 10% compounded semiannually and has £25,378.46 of original issue discount. The acquisition of the bond is a section 988 transaction as provided in paragraphs (a)(1)(ii) and (2)(i) of this section. The accrual of original issue discount with respect to the bond is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section. See §1.988–2(b) with respect to the translation of original issue discount and the determination of exchange gain or loss upon receipt of such amounts.

Example 5. On January 1, 1989, X sells and delivers inventory to Y for 10,000,000 Italian lira for payment on April 1, 1989. Under X's method of accounting, January 1, 1989 is the accrual date. Because X is an accrual basis taxpayer, the accrual of a nonfunctional currency denominated item of gross receipts on January 1, 1989, for payment after the date of accrual is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section.

Example 6. On January 1, 1989, X agrees to purchase a machine from Y for delivery on March 1, 1990 for 1,000,000 yen. The agreement calls for X to pay Y for the machine on June 1, 1990. Under X's method of accounting, the expenditure for the machine does not accrue until delivery on March 1, 1990. The agreement to purchase the machine is not a section 988 transaction. In particular, the agreement to purchase the machine is not described in paragraph (a)(2)(ii) of this section because the agreement is not an item of expense taken into account under subtitle A (but rather is an agreement to purchase a capital asset in the future). However, the payable that will arise on the delivery date is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section even though the payable relates to a capital expenditure. In addition, the disposition of yen to satisfy the payable on June 1, 1990, is a section 988 transaction under paragraph (a)(1)(i) of this section.

Example 7. On January 1, 1989, X purchases and takes delivery of inventory for 10,000 French francs with payment to be made on

April 1, 1989. Under X's method of accounting, the expense accrues on January 1, 1989. On January 1, 1989, X also enters into a forward contract with a bank to purchase 10,000 French francs for $2,000 on April 1, 1989. Because X is an accrual basis taxpayer, the accrual of a nonfunctional currency denominated item of expense on January 1, 1989, for payment after the date of accrual is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section. Entering into the forward contract to purchase the 10,000 French francs is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(iii) of this section.

Example 8. On January 1, 1989, X acquires 100,000 Norwegian krone. On January 15, 1989, X purchases and takes delivery of 1,000 shares of common stock with the 100,000 krone acquired on January 1, 1989. On August 1, 1989, X sells the 1,000 shares of common stock and receives 120,000 krone in payment. On August 30, 1989, X converts the 120,000 krone to U.S. dollars. The acquisition of the 100,000 krone on January 1, 1989, and the acquisition of the 120,000 krone on August 1, 1989, are section 988 transactions for purposes of establishing the basis of such krone. The disposition of the 100,000 krone on January 15, 1989, and the 120,000 krone on August 30, 1989, are section 988 transactions as provided in paragraph (a)(1)(i) of this section. Neither the acquisition on January 15, 1989, nor the disposition on August 1, 1989, of the stock is a section 988 transaction.

Example 9. On May 11, 1989, X purchases a one year note at original issue for its issue price of $1,000. The note pays interest in dollars at the rate of 4 percent compounded semiannually. The amount of principal received by X upon maturity is equal to $1,000 plus the equivalent of the excess, if any, of (a) the Financial Times One Hundred Stock Index (an index of stocks traded on the London Stock Exchange hereafter referred to as the FT100) determined and translated into dollars on the last business day prior to the maturity date, over (b) £2,150, the ''stated value'' of the FT100, which is equal to 110% of the average value of the index for the six months prior to the issue date, translated at the exchange rate of £1=$1.50. The purchase by X of the instrument described above is not a section 988 transaction because the index used to compute the principal amount received upon maturity is determined with reference to the value of stock and not nonfunctional currency.

Example 10. On April 9, 1989, X enters into an interest rate swap that provides for the payment of amounts by X to its counterparty based on 4% of a 10,000 yen principal amount in exchange for amounts based on yen LIBOR rates. Pursuant to paragraphs (a)(1)(ii) and (2)(iii) of this section, this yen for yen interest rate swap is a section 988 transaction.

Example 11. On August 11, 1989, X enters into an option contract for sale of a group of stocks traded on the Japanese Nikkei exchange. The contract is not a section 988 transaction within the meaning of §1.988–1(a)(2)(iii) because the underlying property to which the option relates is a group of stocks and not nonfunctional currency.

(7) *Special rules for regulated futures contracts and non-equity options*—(i) *In general.* Except as provided in paragraph (a)(7)(ii) of this section, paragraph (a)(2)(iii) of this section shall not apply to any regulated futures contract or non-equity option which would be marked to market under section 1256 if held on the last day of the taxable year.

(ii) *Election to have paragraph (a)(2)(iii) of this section apply.* Notwithstanding paragraph (a)(7)(i) of this section, a taxpayer may elect to have paragraph (a)(2)(iii) of this section apply to regulated futures contracts and non-equity options as provided in paragraphs (a)(7)(iii) and (iv) of this section.

(iii) *Procedure for making the election.* A taxpayer shall make the election provided in paragraph (a)(7)(ii) of this section by sending to the Internal Revenue Service Center, Examination Branch, Stop Number 92, Kansas City, MO 64999 a statement titled ''Election to Treat Regulated Futures Contracts and Non-Equity Options as Section 988 Transactions Under Section 988 (c)(1)(D)(ii)'' that contains the following:

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

(B) The date the notice is mailed or otherwise delivered to the Internal Revenue Service Center;

(C) A statement that the taxpayer (including all members of such person's affiliated group as defined in section 1504 or in the case of an individual all persons filing a joint return with such individual) elects to have section 988(c)(1)(D)(i) and §1.988–1(a)(7)(i) not apply;

(D) The date of the beginning of the taxable year for which the election is being made;

(E) If the election is filed after the first day of the taxable year, a statement regarding whether the taxpayer has previously held a contract described in section 988(c)(1)(D)(i) or

§ 1.988–1(a)(7)(i) during such taxable year, and if so, the first date during the taxable year on which such contract was held; and

(F) The signature of the person making the election (in the case of individuals filing a joint return, the signature of all persons filing such return).

The election shall be made by the following persons: in the case of an individual, by such individual; in the case of a partnership, by each partner separately; effective for taxable years beginning after March 17, 1992, in the case of tiered partnerships, each ultimate partner; in the case of an S corporation, by each shareholder separately; in the case of a trust (other than a grantor trust) or estate, by the fiduciary of such trust or estate; in the case of any corporation other than an S corporation, by such corporation (in the case of a corporation that is a member of an affiliated group that files a consolidated return, such election shall be valid and binding only if made by the common parent, as that term is used in § 1.1502–77(a)); in the case of a controlled foreign corporation, by its controlling United States shareholders under § 1.964–1(c)(3). With respect to a corporation (other than an S corporation), the election, when made by the common parent, shall be binding on all members of such corporation's affiliated group as defined in section 1504 that file a consolidated return. The election shall be binding on any income or loss derived from the partner's share (determined under the principles of section 702(a)) of all contracts described in section 988(c)(1)(D)(i) or paragraph (a)(7)(i) of this section in which the taxpayer holds a direct interest or indirect interest through a partnership or S corporation; however, the election shall not apply to any income or loss of a partnership for any taxable year if such partnership made an election under section 988(c)(1)(E)(iii)(V) for such year or any preceding year. Generally, a copy of the election must be attached to the taxpayer's income tax return for the first year it is effective. It is not required to be attached to subsequent returns. However, in the case of a partner, a copy of the election must be attached to the taxpayer's income tax return for every year during which the taxpayer is a partner in a partnership that engages in a transaction that is subject to the election.

(iv) *Time for making the election*—(A) *In general.* Unless the requirements for making a late election described in paragraph (a)(7)(iv)(B) of this section are satisfied, an election under section 988 (c)(1)(D)(ii) and paragraph (a)(7)(ii) of this section for any taxable year shall be made on or before the first day of the taxable year or, if later, on or before the first day during such taxable year on which the taxpayer holds a contract described in section 988(c)(1)(D)(ii) and paragraph (a)(7)(ii) of this section. The election under section 988(c)(1)(D)(ii) and paragraph (a)(7)(ii) of this section shall apply to contracts entered into or acquired after October 21, 1988, and held on or after the effective date of the election. The election shall be effective as of the beginning of the taxable year and shall be binding with respect to all succeeding taxable years unless revoked with the prior consent of the Commissioner. In determining whether to grant revocation of the election, recapture of the tax benefit derived from the election in previous taxable years will be considered.

(B) *Late elections.* A taxpayer may make an election under section 988(c)(1)(D)(ii) and paragraph (a)(7)(ii) of this section within 30 days after the time prescribed in the first sentence of paragraph (a)(7)(iv)(A) of this section. Such a late election shall be effective as of the beginning of the taxable year; however, any losses recognized during the taxable year with respect to contracts described in section 988(c)(1)(D)(ii) or paragraph (a)(7)(ii) of this section which were entered into or acquired after October 21, 1988, and held on or before the date on which the late election is mailed or otherwise delivered to the Internal Revenue Service Center shall not be treated as derived from a section 988 transaction. A late election must comply with the procedures set forth in paragraph (a)(7)(iii) of this section.

(v) *Transition rule.* An election made prior to September 21, 1989 which satisfied the requirements of Notice 88–124, 1988–51 I.R.B. 6, shall be deemed to satisfy the requirements of paragraphs (a)(7)(iii) and (iv) of this section.

(vi) *General effective date provision*. This paragraph (a)(7) shall apply with respect to futures contracts and options entered into or acquired after October 21, 1988.

(8) *Special rules for qualified funds*—(i) *Definition of qualified fund.* The term ‘‘qualified fund’’ means any partnership if—

(A) At all times during the taxable year (and during each preceding taxable year to which an election under section 988(c)(1)(E)(iii)(V) applied) such partnership has at least 20 partners and no single partner owns more than 20 percent of the interests in the capital or profits of the partnership;

(B) The principa1 activity of such partnership for such taxable year (and each such preceding taxable year) consists of buying and selling options, futures, or forwards with respect to commodities;

(C) At least 90 percent of the gross income of the partnership for the taxable year (and each such preceding year) consists of income or gains described in subparagraph (A), (B), or (G) of section 7704(d)(1) or gain from the sale or disposition of capital assets held for the production of interest or dividends;

(D) No more than a de minimis amount of the gross income of the partnership for the taxable year (and each such preceding taxable year) was derived from buying and selling commodities; and

(E) An election under section 988 (c)(1)(E)(iii)(V) as provided in paragraph (a)(8)(iv) of this section applies to the taxable year.

(ii) *Special rules relating to paragraph (a)(8)(i)(A) of this section*—(A) *Certain general partners.* The interest of a general partner in the partnership shall not be treated as failing to meet the 20 percent ownership requirement of paragraph (a)(8)(i)(A) of this section for any taxable year of the partnership if, for the taxable year of the partner in which such partnership's taxable year ends, such partner (and each corporation filing a consolidated return with such partner) had no ordinary income or loss from a section 988 transaction (other than income from the partnership) which is exchange gain or loss (as the case may be).

(B) *Treatment of incentive compensation.* For purposes of paragraph (a)(8)(i)(A) of this section, any income allocable to a general partner as incentive compensation based on profits rather than capital shall not be taken into account in determining such partner's interest in the profits of the partnership.

(C) *Treatment of tax exempt partners.* The interest of a partner in the partnership shall not be treated as failing to meet the 20 percent ownership requirements of paragraph (a)(5)(8)(A) of this section if none of the income of such partner from such partnership is subject to tax under chapter 1 of subtitle A of the Internal Revenue Code (whether directly or through one or more pass-through entities).

(D) *Look-through rule.* In determining whether the 20 percent ownership requirement of paragraph (a)(8)(i)(A) of this section is met with respect to any partnership, any interest in such partnership held by another partnership shall be treated as held proportionately by the partners in such other partnership.

(iii) *Other special rules*—(A) *Related persons.* Interests in the partnership held by persons related to each other (within the meaning of section 267(b) or 707(b)) shall be treated as held by one person.

(B) *Predecessors.* Reference to any partnership shall include a reference to any predecessor thereof.

(C) *Treatment of certain debt instruments.* Solely for purposes of paragraph (a)(8)(i)(D) of this section, any debt instrument which is described in both paragraphs (a)(1)(ii) and (2)(i) of this section shall be treated as a commodity.

(iv) *Procedure for making the election provided in section 988(c)(1)(E)(iii)(V).* A partnership shall make the election provided in section 988(c)(1)(E)(iii)(V) by sending to the Internal Revenue Service Center, Examination Branch, Stop Number 92, Kansas City, MO 64999 a statement titled ‘‘QUALIFIED FUND ELECTION UNDER SECTION 988(c)(1)(E)(iii)(V)’’ that contains the following:

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

(B) The name, address and taxpayer identification number of the general partner making the election on behalf of the partnership;

(C) The date the notice is mailed or otherwise delivered to the Internal Revenue Service Center;

(D) A brief description of the activity of the partnership;

(E) A statement that the partnership is making the election provided in section 988(c)(1)(E)(iii)(V);

(F) The date of the beginning of the taxable year for which the election is being made;

(G) If the election is filed after the first day of the taxable year, then a statement regarding whether the partnership previously held an instrument referred to in section 988(c)(1)(E)(i) during such taxable year and, if so, the first date during the taxable year on which such contract was held; and

(H) The signature of the general partner making the election.

The election shall be made by a general partner with management responsibility of the partnership's activities and a copy of such election shall be attached to the partnership's income tax return (Form 1065) for the first taxable year it is effective. It is not required to be attached to subsequent returns.

(v) *Time for making the election.* The election under section 988(c)(1)(E)(iii)(V) for any taxable year shall be made on or before the first day of the taxable year or, if later, on or before the first day during such year on which the partnership holds an instrument described in section 988(c)(1)(E)(i). The election under section 988(c)(1)(E)(iii)(V) shall apply to the taxable year for which made and all succeeding taxable years. Such election may only be revoked with the consent of the Commissioner. In determining whether to grant revocation of the election, recapture by the partners of the tax benefit derived from the election in previous taxable years will be considered.

(vi) *Operative rules applicable to qualified funds*—(A) *In general.* In the case of a qualified fund, any bank forward contract or any foreign currency futures contract traded on a foreign exchange which is not otherwise a section 1256 contract shall be treated as a section 1256 contract for purposes of section 1256.

(B) *Gains and losses treated as short-term.* In the case of any instrument treated as a section 1256 contract under paragraph (a)(8)(vi)(A) of this section, subparagraph (A) of section 1256(a)(3) shall be applied by substituting ''100 percent'' for ''40 percent'' (and subparagraph (B) of such section shall not apply).

(vii) *Transition rule.* An election made prior to September 21, 1989, which satisfied the requirements of Notice 88–124, 1988–51 I.R.B. 6, shall be deemed to satisfy the requirements of § 1.988–1(a)(8)(iv) and (v).

(viii) *General effective date rules*—(A) The requirements of subclause (IV) of section 988(c)(1)(E)(iii) shall not apply to contracts entered into or acquired on or before October 21, 1988.

(B) In the case of any partner in an existing partnership, the 20 percent ownership requirements of subclause (I) of section 988(c)(1)(E)(iii) shall be treated as met during any period during which such partner does not own a percentage interest in the capital or profits of such partnership greater than 33⅓ percent (or, if lower, the lowest such percentage interest of such partner during any period after October 21, 1988, during which such partnership is in existence). For purposes of the preceding sentence, the term ''existing partnership'' means any partnership if—

(*1*) Such partnership was in existence on October 21, 1988, and principally engaged on such date in buying and selling options, futures, or forwards with respect to commodities; or

(*2*) A registration statement was filed with respect to such partnership with the Securities and Exchange Commission on or before such date and such registration statement indicated that the principal activity of such partnership will consist of buying and selling instruments referred to in paragraph (a)(8)(viii)(B)(*1*) of this section.

(9) *Exception for certain transactions entered into by an individual*—(i) *In general.* A transaction entered into by an individual which otherwise qualifies as

a section 988 transaction shall be considered a section 988 transaction only to the extent expenses properly allocable to such transaction meet the requirements of section 162 or 212 (other than the part of section 212 dealing with expenses incurred in connection with taxes).

(ii) *Examples.* The following examples illustrate the application of paragraph (a)(9) of this section.

Example 1. X is a U.S. citizen who therefore has the U.S. dollar as his functional currency. On January 1, 1990, X enters into a spot contract to purchase 10,000 British pounds (£) for $15,000 for delivery on January 3, 1990. Immediately upon delivery, X acquires at original issue a pound denominated bond with an issue price of £10,000. The bond matures on January 3, 1993, pays interest in pounds at a rate of 10% compounded semi-annually, and has no original issue discount. Assume that all expenses properly allocable to these transactions would meet the requirements of section 212. Under §1.988–2(d)(1)(ii), entering into the spot contract on January 1, 1990, is not a section 988 transaction. The acquisition of the pounds on January 3, 1990, under the spot contract is a section 988 transaction for purposes of establishing X's basis in the pounds. The disposition of the pounds and the acquisition of the bond by X are section 988 transactions. These transactions are not excluded from the definition of a section 988 transaction under paragraph (a)(9) of this section because expenses properly allocable to such transactions meet the requirements of section 212.

Example 2. X is a U.S. citizen who therefore has the dollar as his functional currency. In preparation for X's vacation, X purchases 1,000 British pounds (£) from a bank on June 1, 1989. During the period of X's vacation in the United Kingdom beginning June 10, 1989, and ending June 20, 1989, X spends £500 for hotel rooms, £300 for food and £200 for miscellaneous vacation expenses. The expenses properly allocable to such dispositions do not meet the requirements of section 162 or 212. Thus, the disposition of the pounds by X on his vacation are not section 988 transactions.

(10) *Intra-taxpayer transactions*—(i) *In general.* Except as provided in paragraph (a)(10)(ii) of this section, transactions between or among the taxpayer and/or qualified business units of that taxpayer (‘‘intra-taxpayer transactions'') are not section 988 transactions. See section 987 and the regulations thereunder.

(ii) *Certain transfers.* Exchange gain or loss with respect to nonfunctional currency or any item described in paragraph (a)(2) of this section entered into with another taxpayer shall be realized upon an intra-taxpayer transfer of such currency or item where as the result of the transfer the currency or other such item—

(A) Loses its character as nonfunctional currency or an item described in paragraph (a)(2) of this section; or

(B) Where the source of the exchange gain or loss could be altered absent the application of this paragraph (a)(10)(ii).

Such exchange gain or loss shall be computed in accordance with §1.988–2 (without regard to §1.988–2(b)(8)) as if the nonfunctional currency or item described in paragraph (a)(2) of this section had been sold or otherwise transferred at fair market value between unrelated taxpayers. For purposes of the preceding sentence, a taxpayer must use the translation rate that it uses for purposes of computing section 987 gain or loss with respect to the QBU branch that makes the transfer. In the case of a gain or loss incurred in a transaction described in this paragraph (a)(10)(ii) that does not have a significant business purpose, the Commissioner, may defer such gain or loss.

(iii) *Example.* The following example illustrates the provisions of this paragraph (a)(10).

Example. (A) X, a corporation with the U.S. dollar as its functional currency, operates through foreign branches Y and Z. Y and Z are qualified business units as defined in section 989(a) with the LC as their functional currency. X computes Y's and Z's income under section 987 (relating to branch transactions). On November 12, 1988, Y transfers $25 to the home office of X when the fair market value of such amount equals LC120. Y has a basis of LC100 in the $25. Under paragraph (a)(10)(ii) of this section, Y realizes foreign source exchange gain of LC20 (LC120—LC100) as the result of the $25 transfer. For purposes of determining whether the transfer is a remittance resulting in additional gain or loss, see section 987 and the regulations thereunder.

(B) If instead Y transfers the $25 to Z, exchange gain is not realized because the $25 is nonfunctional currency with respect to Z and if Z were to immediately convert the $25 into LCs, the gain would be foreign source. For purposes of determining whether the transfer is a remittance resulting in additional gain or loss, see section 987 and the regulations thereunder.

(11) *Authority to include or exclude transactions from section 988*—(i) *In general.* The Commissioner may recharacterize a transaction (or series of transactions) in whole or in part as a section 988 transaction if the effect of such transaction (or series of transactions) is to avoid section 988. In addition, the Commissioner may exclude a transaction (or series of transactions) which in form is a section 988 transaction from the provisions of section 988 if the substance of the transaction (or series of transactions) indicates that it is not properly considered a section 988 transaction.

(ii) *Example.* The following example illustrates the provisions of this paragraph (a)(11).

Example. B is an individual with the U.S. dollar as its functional currency. B holds 500,000 Swiss francs which have a basis of $100,000 and a fair market value of $400,000 as of October 15, 1989. On October 16, 1989, B transfers the 500,000 Swiss francs to a newly formed U.S. corporation, X, with the dollar as its functional currency. On October 16, 1989, B sells the stock of X for $400,000. Assume the transfer to X qualified for nonrecognition under section 351. Because the sale of the stock of X is a substitute for the disposition of an asset subject to section 988, the Commissioner may recharacterize the sale of the stock as a section 988 transaction. The same result would obtain if B transferred the Swiss francs to a partnership and then sold the partnership interest.

(b) *Spot contract.* A spot contract is a contract to buy or sell nonfunctional currency on or before two business days following the date of the execution of the contract. See §1.988–2 (d)(1)(ii) for operative rules regarding spot contracts.

(c) *Nonfunctional currency.* The term ‘‘nonfunctional currency’’ means with respect to a taxpayer or a qualified business unit (as defined in section 989 (a)) a currency (including the European Currency Unit) other than the taxpayer's or the qualified business unit's functional currency as defined in section 985 and the regulations thereunder. For rules relating to nonrecognition of exchange gain or loss with respect to certain dispositions of nonfunctional currency, see §1.988–2 (a)(1)(iii).

(d) *Spot rate*—(1) *In general.* Except as otherwise provided in this paragraph, the term ‘‘spot rate’’ means a rate demonstrated to the satisfaction of the District Director or the Assistant Commissioner (International) to reflect a fair market rate of exchange available to the public for currency under a spot contract in a free market and involving representative amounts. In the absence of such a demonstration, the District Director or the Assistant Commissioner (International), in his or her sole discretion, shall determine the spot rate from a source of exchange rate information reflecting actual transactions conducted in a free market. For example, the taxpayer or the District Director or the Assistant Commissioner (International) may determine the spot rate by reference to exchange rates published in the pertinent monthly issue of ‘‘International Financial Statistics’’ or a successor publication of the International Monetary Fund; exchange rates published by the Board of Governors of the Federal Reserve System pursuant to 31 U.S.C. section 5151; exchange rates published in newspapers, financial journals or other daily financial news sources; or exchange rates quoted by electronic financial news services.

(2) *Consistency required in valuing transactions subject to section 988.* If the use of inconsistent sources of spot rate quotations results in the distortion of income, the District Director or the Assistant Commissioner (International) may determine the appropriate spot rate.

(3) *Use of certain spot rate conventions for payables and receivables denominated in nonfunctional currency.* If consistent with the taxpayer's financial accounting, a taxpayer may utilize a spot rate convention determined at intervals of one quarter year or less for purposes of computing exchange gain or loss with respect to payables and receivables denominated in a nonfunctional currency that are incurred in the ordinary course of business with respect to the acquisition or sale of goods or the obtaining or performance of services. For example, if consistent with the taxpayer's financial accounting, a taxpayer may accrue all payables and receivables incurred during the month of January at the spot rate on December 31 or January 31 (or at an average of

any spot rates occurring between these two dates) and record the payment or receipt of amounts in satisfaction of such payables and receivables consistent with such convention. The use of a spot rate convention cannot be changed without the consent of the Commissioner.

(4) *Currency where an official government established rate differs from a free market rate*—(i) *In general.* If a currency has an official government established rate that differs from a free market rate, the spot rate shall be the rate which most clearly reflects the taxpayer's income. Generally, this shall be the free market rate.

(ii) *Examples.* The following examples illustrate the application of this paragraph (d)(4).

Example 1. X is an accrual method U.S. corporation with the dollar as its functional currency. X owns all the stock of a Country L subsidiary, CFC. CFC has the currency of Country L, the LC, as its functional currency. Country L imposes restrictions on the remittance of dividends. On April 1, 1990, CFC pays a dividend to X in the amount of LC100. Assume that the official governnent established rate is $1=LC1 and the free market rate, which takes into account the remittance restrictions and which is the rate that most clearly reflects income, is $1=LC4. On April 1, 1990, X donates the LC100 in a transaction that otherwise qualifies as a charitable contribution under section 170 (c). Both the amount of the dividend income and the deduction under section 170 is $25 (LC100 x the free market rate, $.25).

Example 2. X, a corporation with the U.S. dollar as its functional currency, operates in foreign country L through branch Y. Y is a qualified business unit as defined in section 989 (a). X computes Y's income under the dollar approximate separate transactions method as described in §1.985–3. The currency of L is the LC. X can purchase legally United States dollars ($) in L only from the L government. In order to take advantage of an arbitrage between the official and secondary dollar to LC exchange rates in L:

(i) X purchases LC100 for $60 in L on the secondary market when the official exchange rate is S1=LC1;

(ii) X transfers the LC100 to Y;

(iii) Y purchases $100 for LC100; and

(iv) Y transfers $65 ($100 less an L tax withheld of $35 on the transfer) to the home office of X.

Under paragraph (a)(7) of this section, the transfer of the LC100 by X to Y is a realization event. X has a basis of $60 in the LC100. Under these facts, the appropriate dollar to LC exchange rate for computing the amount realized by X is the official exchange rate. Therefore, X realizes $40 ($100–$60) of U.S. source gain from the transfer to Y. The same result would obtain if Y rather than X purchased the LC100 on the secondary market in L with $60 supplied by X, because the substance of this transaction is that X is performing the arbitrage.

(e) *Exchange gain or loss.* The term ''exchange gain or loss'' means the amount of gain or loss realized as determined in §1.988–2 with respect to a section 988 transaction. Except as otherwise provided in these regulations (*e.g.*, §1.98B–5), the amount of exchange gain or loss from a section 988 transaction shall be separately computed for each section 988 transaction, and such amount shall not be integrated with gain or loss recognized on another transaction (whether or not such transaction is economically related to the section 988 transaction). See §1.988–2 (b)(8) for a special rule with respect to debt instruments.

(f) *Hyperinflationary currency.* For the definition of hyperinflationary currency see §1.985–2 (b)(2). Unless otherwise provided, the currency in any example used in §§1.988–1 through 1.988–5 is not a hyperinflationary currency.

(g) *Fair market value.* The fair market value of an item shall, where relevant, reflect an appropriate premium or discount for the time value of money (*e.g.*, the fair market value of a forward contract to buy or sell nonfunctional currency shall reflect the present value of the difference between the units of nonfunctional currency times the market forward rate at the time of valuation and the units of nonfunctional currency times the forward rate set forth in the contract). However, if consistent with the taxpayer's method of financial accounting (and consistently applied from year to year), the preceding sentence shall not apply to a financial instrument that matures within one year from the date of issuance or acquisition. Unless otherwise provided, the fair market value given in any example used in §§1.988–1 through 1.988–5 is deemed to reflect appropriately the time value of money. If the use of inconsistent sources of forward or other market rate quotations results in the distortion of income, the

District Director or the Assistant Commissioner (International) may determine the appropriate rate.

(h) *Interaction with sections 1092 and 1256.* Unless otherwise provided, it is assumed for purposes of §§ 1.988–1 through 1.988–5 that any contract used in any example is not a section 1256 contract and is not part of a straddle as defined in section 1092. No inference is intended regarding the application of section 1092 or 1256 unless expressly stated.

(i) *Effective date.* Except as otherwise provided in this section, this section shall be effective for taxable years beginning after December 31, 1986. Thus, except as otherwise provided in this section, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section.

[T.D. 8400, 57 FR 9178, Mar. 17, 1992]

§ 1.988–2 Recognition and computation of exchange gain or loss.

(a) *Disposition of nonfunctional currency*—(1) *Recognition of exchange gain or loss*—(i) *In general.* Except as otherwise provided in this section, § 1.988–1(a)(7)(ii), and § 1.988–5, the recognition of exchange gain or loss upon the sale or other disposition of nonfunctional currency shall be governed by the recognition provisions of the Internal Revenue Code which apply to the sale or disposition of property (*e.g.*, section 1001 or, to the extent provided in regulations, section 1092). The disposition of nonfunctional currency in settlement of a forward contract, futures contract, option contract, or similar financial instrument is considered to be a sale or disposition of the nonfunctional currency for purposes of the preceding sentence.

(ii) *Clarification of section 1031.* An amount of one nonfunctional currency is not ‘‘property of like kind’’ with respect to an amount of a different nonfunctional currency.

(iii) *Coordination with section 988(c)(1)(C)(ii).* No exchange gain or loss is recognized with respect to the following transactions—

(A) An exchange of units of nonfunctional currency for different units of the same nonfunctional currency;

(B) The deposit of nonfunctional currency in a demand or time deposit or similar instrument (including a certificate of deposit) issued by a bank or other financial institution if such instrument is denominated in such currency;

(C) The withdrawal of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution if such instrument is denominated in such currency;

(D) The receipt of nonfunctional currency from a bank or other financial institution from which the taxpayer purchased a certificate of deposit or similar instrument denominated in such currency by reason of the maturing or other termination of such instrument; and

(E) The transfer of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution to another demand or time deposit or similar instrument denominated in the same nonfunctional currency issued by a bank or other financial institution.

The taxpayer's basis in the units of nonfunctional currency or other property received in the transaction shall be the adjusted basis of the units of nonfunctional currency or other property transferred. See paragraph (b) of this section with respect to the timing of interest income or expense and the determination of exchange gain or loss thereon.

(iv) *Example.* The following example illustrates the provisions of paragraph (a)(1)(iii) of this section.

Example. X is a corporation on the accrual method of accounting with the U.S. dollar as its functional currency. On January 1, 1989, X acquires 1,500 British pounds (£) for $2,250 (£1 = $1.50). On January 3, 1989, when the spot rate is £1 = $1.49, X deposits the £1,500 with a British financial institution in a non-interest bearing demand account. On February 1, 1989, when the spot rate is £1 = $1.45, X withdraws the £1,500. On February 5, 1989, when the spot rate is £1 = $1.42, X purchases inventory in the amount of £1,500. Pursuant to paragraph (a)(1)(iii) of this section, no exchange loss is realized until February 5, 1989, when X disposes of the £1,500 for inventory. At that time, X realizes exchange loss in the amount of $120 computed under paragraph (a)(2) of this section. The loss is not an adjustment to the cost of the inventory.

(2) *Computation of gain or loss*—(i) *In general.* Exchange gain realized from the sale or other disposition of nonfunctional currency shall be the excess of the amount realized over the adjusted basis of such currency, and exchange loss realized shall be the excess of the adjusted basis of such currency over the amount realized.

(ii) *Amount realized*—(A) *In general.* The amount realized from the disposition of nonfunctional currency shall be determined under section 1001(b). A taxpayer that uses a spot rate convention under §1.988–1(d)(3) to determine exchange gain or loss with respect to a payable shall determine the amount realized upon the disposition of nonfunctional currency paid in satisfaction of the payable in a manner consistent with such convention.

(B) *Exchange of nonfunctional currency for property.* For purpose of paragraph (a)(2) of this section, the exchange of nonfunctional currency for property (other than nonfunctional currency) shall be treated as—

(*1*) An exchange of the units of nonfunctional currency for units of functional currency at the spot rate on the date of the exchange, and

(*2*) The purchase or sale of the property for such units of functional currency.

(C) *Example.* The following example illustrates the provisions of paragraph (a)(2)(ii)(B) of this section.

Example. G is a U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1989, G enters into a contract to purchase a paper manufacturing machine for 10,000,000 British pounds (£) for delivery on January 1, 1991. On January 1, 1991, when G exchanges £10,000,000 (which G purchased for $12,000,000) for the machine, the fair market value of the machine is £17,000,000. On January 1, 1991, the spot exchange rate is £1 = $1.50. Under paragraph (a)(2)(ii)(B) of this section, the transaction is treated as an exchange of £10,000,000 for $15,000,000 and the purchase of the machine for $15,000,000. Accordingly, in computing G's exchange gain of $3,000,000 on the disposition of the £10,000,000, the amount realized is $15,000,000. G's basis in the machine is $15,000,000. No gain is recognized on the bargain purchase of the machine.

(iii) *Adjusted basis*—(A) *In general.* Except as provided in paragraph (a)(2)(iii)(B) of this section, the adjusted basis of nonfunctional currency is determined under the applicable provisions of the Internal Revenue Code (*e.g.*, sections 1011 through 1023). A taxpayer that uses a spot rate convention under §1.988–1 (d)(3) to determine exchange gain or loss with respect to a receivable shall determine the basis of nonfunctional currency received in satisfaction of such receivable in a manner consistent with such convention.

(B) *Determination of the basis of nonfunctional currency withdrawn from an account with a bank or other financial institution*—(*1*) *In general.* The basis of nonfunctional currency withdrawn from an account with a bank or other financial institution shall be determined under any reasonable method that is consistently applied from year to year by the taxpayer to all accounts denominated in a nonfunctional currency. For example, a taxpayer may use a first in first out method, a last in first out method, a pro rata method (as illustrated in the example below), or any other reasonable method that is consistently applied. However, a method that consistently results in units of nonfunctional currency with the highest basis being withdrawn first shall not be considered reasonable.

(*2*) *Example.* The following example illustrates the provisions of this paragraph (a)(2)(iii)(B).

Example. (i) X, a cash basis individual with the dollar as his functional currency, opens a demand account with a Swiss bank. Assume expenses associated with the demand account are deductible under section 212. The following chart indicates Swiss franc deposits to the account, Swiss franc interest credited to the account, the dollar basis of each deposit, and the determination of the aggregate dollar basis of all Swiss francs in the account. Assume that the taxpayer has properly translated all the amounts specified in the chart and that all transactions are subject to section 988.

Date	Swiss francs deposited	Interest received	U.S. dollar basis	Aggregate U.S. dollar basis
1/01/89	1000 Sf		$500	$500
3/31/89		50 Sf	25	525

Date	Swiss francs deposited	Interest received	U.S. dollar basis	Aggregate U.S. dollar basis
6/30/89		50 Sf	24	549
9/30/89		50 Sf	25	574
12/31/89		50 Sf	26	600

(ii) On January 1, 1990, X withdraws 500 Swiss francs from the account. X may determine his basis in the Swiss francs by multiplying the aggregate U.S. dollar basis of Swiss francs in the account by a fraction the numerator of which is the number of Swiss francs withdrawn from the account and the denominator is the total number of Swiss francs in the account. Under this method, X's basis in the 500 Swiss francs is $250 computed as follows:

$$\frac{500\ \mathrm{Sf}}{1200\ \mathrm{Sf}} \times \$600 = \$250$$

(iii) X's basis in the Swiss francs remaining in the account is $350 ($600−$250). X must use this method consistently from year to year with respect to withdrawals of nonfunctional currency from all of X's accounts.

(iv) Purchase and sale of stock or securities traded on an established securities market by cash basis taxpayer—

(A) *Amount realized.* If stock or securities traded on an established securities market are sold by a cash basis taxpayer for nonfunctional currency, the amount realized with respect to the stock or securities (as determined on the trade date) shall be computed by translating the units of nonfunctional currency received into functional currency at the spot rate on the settlement date of the sale. This rule applies notwithstanding that the stock or securities are treated as disposed of on a date other than the settlement date under another section of the Code. See section 453(k).

(B) *Basis.* If stock or securities traded on an established securities market are purchased by a cash basis taxpayer for nonfunctional currency, the basis of the stock or securities shall be determined by translating the units of nonfunctional currency paid into functional currency at the spot rate on the settlement date of the purchase.

(C) *Example.* The following example illustrates the provisions of this paragraph (a)(2)(iv).

Example. On November 1, 1989 (the trade date), X, a calendar year cash basis U.S. individual, purchases stock for £100 for settlement on November 5, 1989. On November 1, 1989, the spot value of the £100 is $140. On November 5, 1989, X purchases £100 for $141 which X uses to pay for the stock. X's basis in the stock is $141. On December 30, 1990 (the trade date), X sells the stock for £110 for settlement on January 5, 1991. On December 30, 1990, the spot value of £110 is $165. On January 5, 1991, X transfers the stock and receives £110 which, translated at the spot rate, equal $166. Under section 453(k), the stock is considered disposed of on December 30, 1990. The amount realized with respect to such disposition is the value of the £110 on January 5, 1991 ($166). Accordingly, X's gain realized on December 30, 1990, from the disposition of the stock is $25 ($166 amount realized less $141 basis). X's basis in the £110 received from the sale of the stock is $166.

(v) *Purchase and sale of stock or securities traded on an established securities market by accrual basis taxpayer.* For taxable years beginning after March 17, 1992, an accrual basis taxpayer may elect to apply the rules of paragraph (a)(2)(iv) of this section. The election shall be made by filing a statement with the taxpayer's first return in which the election is effective clearly indicating that the election has been made. A method so elected must be applied consistently from year to year and cannot be changed without the consent of the Commissioner.

(b) *Translation of interest income or expense and determination of exchange gain or loss with respect to debt instruments*—(1) *Translation of interest income received with respect to a nonfunctional currency demand account.* Interest income received with respect to a demand account with a bank or other financial institution which is denominated in (or the payments of which are determined by reference to) a nonfunctional currency shall be translated into functional currency at the spot rate on the date received or accrued or pursuant to any reasonable spot rate convention consistently applied by the taxpayer to all taxable years and to all accounts denominated in nonfunctional currency in the same financial institution. For example, a taxpayer may translate interest income received with respect to a demand account on the last day of each month of the taxable year, on the last day of each quarter of the taxable year, on the last day of each half of the taxable year, or on the last day of the taxable year. No exchange gain or loss is realized upon the receipt or accrual of interest income with respect to a demand account subject to this paragraph (b)(1).

(2) *Translation of nonfunctional currency interest income or expense received or paid with respect to a debt instrument described in §1.988–1(a)(1)(ii) and (2)(i)*—(i) *Scope*—(A) *In general.* Paragraph (b) of this section only applies to debt instruments described in §1.988–1(a)(1)(ii) and (2)(i) where all payments are denominated in, or determined with reference to, a single nonfunctional currency. Except as provided in paragraph (b)(2)(i)(B) of this section, this paragraph (b) shall not apply to contingent payment debt instruments.

(B) *Nonfunctional currency contingent payment debt instruments*—(*1*) *Operative rules.* [Reserved]

(*2*) *Certain instruments are not contingent payment debt instruments.* For purposes of section 1275(d), a debt instrument denominated in, or all payments of which are determined with reference to, a single nonfunctional currency (with no contingencies) is not a contingent payment debt instrument. See §1.988–1(a)(4) and (5) for the treatment of dual currency and multi-currency debt instruments.

(ii) *Determination and translation of interest income or expense*—(A) *In general.* Interest income or expense on a debt instrument described in paragraph (b)(2)(i) of this section (including original issue discount determined in accordance with sections 1271 through 1275 and 163(e) as adjusted for acquisition premium under section 1272(a)(7), and acquisition discount determined in accordance with sections 1281 through 1283) shall be determined in units of nonfunctional currency and translated into functional currency as provided in paragraphs (b)(2)(ii)(B) and (C) of this section. For purposes of sections 483, 1273(b)(5) and 1274, the nonfunctional currency in which an instrument is denominated (or by reference to which payments are determined) shall be considered money.

(B) *Translation of interest income or expense that is not required to be accrued prior to receipt or payment.* With respect to an instrument described in paragraph (b)(2)(i) of this section, interest income or expense received or paid that is not required to be accrued by the taxpayer prior to receipt or payment shall be translated at the spot rate on the date of receipt or payment. No exchange gain or loss is realized with respect to the receipt or payment of such interest income or expense (other than the exchange gain or loss that might be realized under paragraph (a) of this section upon the disposition of the nonfunctional currency so received or paid).

(C) *Translation of interest income or expense that is required to be accrued prior to receipt or payment.* With respect to an instrument described in paragraph (b)(2)(i) of this section, interest income or expense that is required to be accrued prior to receipt or payment (*e.g.*, under section 1272, 1281 or 163(e) or because the taxpayer uses an accrual method of accounting) shall be translated at the average rate (or other rate specified in paragraph (b)(2)(iii)(B) of this section) for the interest accrual period or, with respect to an interest accrual period that spans two taxable years, at the average rate (or other rate specified in paragraph (b)(2)(iii)(B) of this section) for the partial period within the taxable year. See paragraphs (b)(3) and (4) of this section for the determination of exchange gain or loss on the receipt or payment of accrued interest income or expense.

(iii) *Determination of average rate or other accrual convention*—(A) *In general.* For purposes of this paragraph (b), the average rate for an accrual period (or partial period) shall be a simple average of the spot exchange rates for each business day of such period or other average exchange rate for the period reasonably derived and consistently applied by the taxpayer.

(B) *Election to use spot accrual convention.* For taxable years beginning after March 17, 1992, a taxpayer may elect to translate interest income and expense at the spot rate on the last day of the interest accrual period (and in the case of a partial accrual period, the spot rate on the last day of the taxable year). If the last day of the interest accrual period is within five business days of the date of receipt or payment, the taxpayer may translate interest income or expense at the spot rate on the date of receipt or payment. The election shall be made by filing a statement with the taxpayer's first return in which the election is effective clearly indicating that the election has been made. A method so elected must be applied consistently to all debt instruments from year to year and cannot be changed without the consent of the Commissioner.

(3) *Exchange gain or loss recognized by the holder with respect to accrued interest income.* The holder of a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to accrued interest income on the date such accrued interest income is received or the instrument is disposed of (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). Except as otherwise provided in this paragraph (b) (*e.g.*, paragraph (b)(8) of this section), exchange gain or loss realized with respect to accrued interest income shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. The amount of exchange gain or loss so realized with respect to accrued interest income is determined for each accrual period by—

(i) Translating the units of nonfunctional currency interest income received with respect to such accrual period (as determined under the ordering rules of paragraph (b)(7) of this section) into functional currency at the spot rate on the date the interest income is received or the instrument is disposed of (or deemed disposed of), and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency interest income accrued with respect to such income received at the average rate (or other rate specified in paragraph (b)(2)(iii)(B) of this section) for the accrual period.

(4) *Exchange gain or loss recognized by the obligor with respect to accrued interest expense.* The obligor under a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to accrued interest expense on the date such accrued interest expense is paid or the obligation to make payments is transferred or extinguished (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). Except as otherwise provided in this paragraph (b) (*e.g.*, paragraph (b)(8) of this section), exchange gain or loss realized with respect to accrued interest expense shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. The amount of exchange gain or loss so realized with respect to accrued interest expense is determined for each accrual period by—

(i) Translating the units of nonfunctional currency interest expense accrued with respect to the amount of interest paid into functional currency at the average rate (or other rate specified in paragraph (b)(2)(iii)(B) of this section) for such accrual period; and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency interest paid (or, if the obligation to make payments is extinguished or transferred, the units accrued) with respect to such accrual period (as determined under the ordering rules in paragraph (b)(7) of this section) into functional currency at the spot rate on the date payment is made or the obligation is transferred or extinguished (or deemed extinguished).

(5) *Exchange gain or loss recognized by the holder of a debt instrument with respect to principal.* The holder of a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to the principal amount of such instrument on the date principal (determined under the ordering rules of paragraph (b)(7) of this section) is received from the obligor or the instrument is disposed of (including a deemed disposition under section 1001 that results from a material change in terms of the

instrument). For purposes of computing exchange gain or loss, the principal amount of a debt instrument is the holder's purchase price in units of nonfunctional currency. See paragraph (b)(10) of this section for rules regarding the amortization of that part of the principal amount that represents bond premium and the computation of exchange gain or loss thereon. If, however, the holder acquired the instrument in a transaction in which exchange gain or loss was realized but not recognized by the transferor, the nonfunctional currency principal amount of the instrument with respect to the holder shall be the same as that of the transferor. Except as otherwise provided in this paragraph (b) (*e.g.*, paragraph (b)(8) of this section), exchange gain or loss realized with respect to such principal amount shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. The amount of exchange gain or loss so realized by the holder with respect to principal is determined by—

(i) Translating the units of nonfunctional currency principal at the spot rate on the date payment is received or the instrument is disposed of (or deemed disposed of); and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency principal at the spot rate on the date the holder (or a transferor from whom the nonfunctional principal amount is carried over) acquired the instrument (is deemed to acquire the instrument).

(6) *Exchange gain or loss recognized by the obligor of a debt instrument with respect to principal.* The obligor under a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to the principal amount of such instrument on the date principal (determined under the ordering rules of paragraph (b)(7) of this section) is paid or the obligation to make payments is transferred or extinguished (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). For purposes of computing exchange gain or loss, the principal amount of a debt instrument is the amount received by the obligor for the debt instrument in units of nonfunctional currency. See paragraph (b)(10) of this section for rules regarding the amortization of that part of the principal amount that represents bond premium and the computation of exchange gain or loss thereon. If, however, the obligor became the obligor in a transaction in which exchange gain or loss was realized but not recognized by the transferor, the nonfunctional currency principal amount of the instrument with respect to such obligor shall be the same as that of the transferor. Except as otherwise provided in this paragraph (b) (*e.g.*, paragraph (b)(8) of this section), exchange gain or loss realized with respect to such principal shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. The amount of exchange gain or loss so realized by the obligor is determined by—

(i) Translating the units of nonfunctional currency principal at the spot rate on the date the obligor (or a transferor from whom the principal amount is carried over) became the obligor (or is deemed to have become the obligor); and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency principal at the spot rate on the date payment is made or the obligation is transferred or extinguished (or deemed extinguished).

(7) *Payment ordering rules*—(i) *Debt instruments subject to the rules of sections 163(e), or 1271 through 1288.* In the case of a debt instrument described in paragraph (b)(2)(i) of this section that is subject to the rules of sections 163(e), or 1272 through 1288, units of nonfunctional currency (or an amount determined with reference to nonfunctional currency) received or paid with respect to such debt instrument shall be treated first as a receipt or payment of periodic interest under the principles of section 1273 and the regulations thereunder, second as a receipt or payment of original issue discount to the extent accrued as of the date of the receipt or payment, and finally as a receipt or payment of principal. Units of nonfunctional currency (or an amount determined with reference to nonfunctional

currency) treated as a receipt or payment of original issue discount under the preceding sentence are attributed to the earliest accrual period in which original issue discount has accrued and to which prior receipts or payments have not been attributed. No portion thereof shall be treated as prepaid interest. These rules are illustrated by *Example 10* of paragraph (b)(9) of this section.

(ii) *Other debt instruments.* In the case of a debt instrument described in paragraph (b)(2)(i) of this section that is not subject to the rules of section 163(e) or 1272 through 1288, whether units of nonfunctional currency (or an amount determined with reference to nonfunctional currency) received or paid with respect to such debt instrument are treated as interest or principal shall be determined under section 163 or other applicable section of the Code.

(8) *Limitation of exchange gain or loss on payment or disposition of a debt instrument.* When a debt instrument described in paragraph (b)(2)(i) of this section is paid or disposed of, or when the obligation to make payments thereunder is satisfied by another person, or extinguished or assumed by another person, exchange gain or loss is computed with respect to both principal and any accrued interest (including original issue discount), as provided in paragraph (b)(3) through (7) of this section. However, pursuant to section 988(b)(1) and (2), the sum of any exchange gain or loss with respect to the principal and interest of any such debt instrument shall be realized only to the extent of the total gain or loss realized on the transaction. The gain or loss realized shall be recognized in accordance with the general principles of the Code. See *Examples 3, 4* and *6* of paragraph (b)(9) of this section.

(9) *Examples.* The preceding provisions are illustrated in the following examples. The examples assume that any transaction involving an individual is a section 988 transaction.

Example 1. (i) X is an individual on the cash method of accounting with the dollar as his functional currency. On January 1, 1992, X converts $13,000 to 10,000 British pounds (£) at the spot rate of £1 = $1.30 and loans the £10,000 to Y for 3 years. The terms of the loan provide that Y will make interest payments of £1,000 on December 31 of 1992, 1993, and 1994, and will repay X's £10,000 principal on December 31, 1994. Assume the spot rates for the pertinent dates are as follows:

Date	Spot rate (pounds to dollars)
Jan. 1, 1992	£1=$1.30
Dec. 31, 1992	£1=$1.35
Dec. 31, 1993	£1=$1.40
Dec. 31, 1994	£1=$1.45

(ii) Under paragraph (b)(2)(ii)(B) of this section, X will trans1ate the £1,000 interest payments at the spot rate on the date received. Accordingly, X will have interest income of $1,350 in 1992, $1,400 in 1993, and $1,450 in 1994. Because X is a cash basis taxpayer, X does not realize exchange gain or loss on the receipt of interest income.

(iii) Under paragraph (b)(5) of this section, X will realize exchange gain upon repayment of the £10,000 principal amount determined by translating the £10,000 at the spot rate on the date it is received (£10,000×$1.45 = $14,500) and subtracting from such amount, the amount determined by translating the £10,000 at the spot rate on the date the loan was made (£10,000×$1.30 = $13,000). Accordingly, X will realize an exchange gain of $1,500 on the repayment of the loan on December 31, 1994.

Example 2. (i) Assume the same facts as in *Example 1* except that X is an accrual method taxpayer and that average rates are as follows:

Accrual period	Average rate (pounds to dollars)
1992	£1=$1.32
1993	£1=$1.37
1994	£1=$1.42

(ii) Under paragraph (b)(2)(ii)(C) of this section, X will accrue the £1,000 interest payments at the average rate for the accrual period. Accordingly, X will have interest income of $1,320 in 1992, $1,370 in 1993, and $1,420 in 1994. Because X is an accrual basis taxpayer, X determines exchange gain or loss for each interest accrual period by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the date received and subtracting the amounts of interest income accrued for such period. Thus, X will realize $90 of exchange gain with respect to interest received under the loan, computed as follows:

Year	Spot value interest received	Accrued interest @ average rate	Exch. gain
1992	$1,350	$1,320	$30
1993	1,400	1,370	30

Year	Spot value interest received	Accrued interest @ average rate	Exch. gain
1994	1,450	1,420	30
Total			$90

(iii) Under paragraph (b)(5) of this section, X will realize exchange gain upon repayment of the £10,000 loan principal determined in the same manner as in *Example 1.* Accordingly, X will realize an exchange gain of $1,500 on the repayment of the loan principal on December 31, 1994.

Example 3. Assume the same facts as in *Example 1* except that X is a calendar year taxpayer on the accrual method of accounting that elects to use a spot rate convention to translate interest income as provided in § 1.988–2(b)(2)(iii)(B). Interest income is received by X on the last day of each accrual period. Under paragraph (b)(2)(ii)(C), X will translate the interest income at the spot rate on the last day of each interest accrual period. Accordingly, X will have interest income of $1,350 in 1992, and $1,400 in 1993, $1,450 in 1994. Because the rate at which the interest income is translated is the same as the rate on the day of receipt, X will not realize any exchange gain or loss with respect to the interest income. Under paragraph (b)(5) of this section, X will realize exchange gain upon repayment of the £10,000 loan principal determined in the same manner as in *Example 1.* Accordingly, X will realize an exchange gain of $1,500 on the repayment of the loan principal on December 31, 1994.

Example 4. Assume the same facts as in *Example 1* except that on December 31, 1993, X sells Y's note for 9,821.13 British pounds (£) after the interest payment. Under paragraph (b)(8) of this section, X will compute exchange gain on the £10,000 principal. The exchange gain is $1,000 [(£10,000×$1.40) − (£10,000×$1.30)]. This exchange gain, however, is only realized to the extent of the total gain on the disposition. X's total gain is $749.58 [(£9,821.13×$1.40) − (£10,000×$1.30)]. Thus, X will realize $749.58 of exchange gain (and will realize no market loss).

Example 5. (i) The facts are the same as in *Example 1* except that Y becomes insolvent and fails to repay the full £10,000 principal when due. Instead, X and Y agree to compromise the debt for a payment of £8,000 on December 31, 1994. Under paragraph (b)(8) of this section, X will compute exchange gain on the £10,000 originally booked. The exchange gain is $1,500 [(£10,000×$1.45) − (£10,000×$1.30) = $1,500]. This exchange gain, however, is only realized to the extent of the total gain on the disposition. X realizes an overall loss on the disposition of $1,400 [(£8,000×$1.45) − (£10,000×$1.30) = ($1,400)]. Thus, X will realize no exchange gain (and a $1400 market loss).

(ii) If the exchange rate on December 31, 1994, were £1 = $1.25, rather than £1 = $1.45, X would compute exchange loss under paragraph (b)(8) of this section, on the £10,000 originally booked. The exchange loss would be $500 [(£10,000×$1.25) − (£10,000×$1.30) = ($500)]. X's total loss on the disposition would be $3,000 [(£8,000×$1.25)–(£10,000×$1.30) = ($3,000)]. Thus, X would realize $500 of exchange loss and a $2,500 market loss on the disposition.

Example 6. (i) X is an individual with the dollar as his functional currency. X is on the cash method of accounting. On January 1, 1989, X borrows 10,000 British pounds (£) from Y, an unrelated person. The terms of the loan provide that X will make interest payments of £1,200 on December 31 of 1989 and 1990 and will repay Y's £10,000 principal on December 31, 1990. The spot rates for the pertinent dates are as follows:

Date	Spot rate[1]
Jan. 1, 1989	1=$1.50
Dec. 31, 1989	1=1.60
Dec. 31, 1990	1=1.70

[1] Pounds to dollars.

Assume that the basis of the £1,200 paid as interest by X on December 31, 1989, is $2,000, the basis of the £1,200 paid as interest by X on December 31, 1990, is $2,020 and the basis of the £10,000 principal paid by X on December 31, 1990, is $16,000.

(ii) Under paragraph (b)(2)(ii)(B) of this section, X translates the £1,200 interest payments at the spot rate on the day paid. Thus, X paid $1,920 (£1,200×$1.60) of interest on December 31, 1989, and $2,040 (£1,200×$1.70) of interest on December 31, 1990. In addition, X will realize exchange gain or loss on the disposition of the £1,200 on December 31, 1989 and 1990, under paragraph (a) of this section. Pursuant to paragraph (a)(2) of this section, X will realize an exchange loss of $80 [(£1,200×$1.60) − $2,000] on December 31, 1989, and exchange gain of $20 [(£1,200×$1.70) − $2,020] on December 31, 1990.

(iii) Under paragraph (b)(6) of this section, X will realize exchange loss on December 31, 1990, upon repayment of the £10,000 principal amount determined by translating the £10,000 received at the spot rate on January 1, 1989 (£10,000×$1.50 = $15,000) and subtracting from such amount, the amount determined by translating the £10,000 paid at the spot rate on December 31, 1990 (£10,000×$1.70 = $17,000). Thus, under paragraph (b)(6) of this section, X has an exchange loss with respect to the £10,000 principal of $2,000. Further, under paragraph (a)(2) of this section, X will realize an exchange gain upon disposition of the £10,000 on December 31, 1990. Under paragraph (a)(2) of this section, X will subtract his adjusted basis in the £10,000 ($16,000) from the amount realized upon the disposition of the £10,000 (£10,000×$1.70 = $17,000) resulting in a gain of $1,000. Accordingly, X's combined exchange gain and loss realized on December 31, 1990, with respect to the repayment of the £10,000 is a $1,000 exchange loss.

Example 7. (i) X is a calendar year corporation on the accrual method of accounting and with the dollar as its functional currency. On January 1, 1989, X purchases at original issue for 82.64 Canadian dollars (C$) M corporation's 2 year note maturing on December 31, 1990, at a stated redemption price of C$100. The yield to maturity in Canadian dollars is 10 percent and the accrual period is the one year period beginning January 1 and ending December 31. The note has C$17.36 of original issue discount. Assume that the spot rates are as follows: C$1 = U.S.$.72 on January 1, 1989; C$1 = U.S.$.80 on January 1, 1990; C$1 = U.S.$ .82 on December 31, 1990. Assume further that the average rate for 1989 is C$1 = U.S.$ .76 and for 1990 is C$1 = U.S. $.81.

(ii) Under paragraph (b)(2)(ii)(A) of this section, X will determine its interest income in Canadian dollars. Accordingly, under section 1272, X must take into account original issue discount in the amount of C$8.26 on December 31, 1989, and C$9.10 on December 31, 1990. Pursuant to paragraph (b)(2)(ii)(C) of this section, X will translate these amounts into U.S. dollars at the average exchange rate for the relevant accrual period. Thus, the amount of interest income taken into account in 1989 is U.S.$6.28 (C$8.26×U.S.$.76) and in 1990 is U.S.$7.37 (C$9.10×U.S.$.81). Pursuant to paragraph (b)(3)(ii) of this section, X will realize exchange gain or loss with respect to the accrued interest determined for each accrual period by translating the Canadian dollars received with respect to such accrual period into U.S. dollars at the spot rate on the date the interest is received and subtracting from that amount the amount accrued in U.S. dollars. Thus, the amount of exchange gain realized on December 31, 1990, is U.S.$.58 (U.S.$.49 from 1989+U.S.$.09 from 1990). Pursuant to paragraph (b)(5) of this section, X shall realize exchange gain or loss with respect to the principal (C$82.64) on December 31, 1990, computed by translating the C$82.64 at the spot rate on December 31, 1990 (U.S.$67.76) and subtracting the C$82.64 translated at the spot rate on January 1, 1989 (U.S.$59.50) for an exchange gain of U.S.$8.26. Thus, X's combined exchange gain is U.S.$8.84 (U.S.$.49+U.S.$.09+U.S.$8.26).

(iii) Assume instead that on January 1, 1990, X sells the note for C$86.95, which it immediately converts to U.S. dollars. X's exchange gain is computed under paragraph (b)(8) of this section with reference to the nonfunctional currency denominated principal amount (C$82.64) and the nonfunctional currency denominated accrued original issue discount (C$8.26). X will compute an exchange gain of U.S.$6.61 with respect to the issue price [(C$82.64×U.S.$ .80)−(C$82.64×U.S.$.72)] and an exchange gain of U.S.$.33 with respect to the accrued original issue discount [(C$8.26×U.S.$.80)−(C$8.26×U.S.$ .76)]. Accordingly, prior to the application of paragraph (b)(8) of this section, X's total exchange gain is U.S.$6.94 (U.S.$6.61+U.S.$.33), and X's market loss is U.S.$3.16 [(C$90.90−C$86.95)×U.S.$.80]. Pursuant to paragraph (b)(8) of this section, however, X's market loss on the note of U.S.$3.16 is netted against X's exchange gain of U.S.$6.94, resulting in a realized exchange gain of U.S.$3.78 and no market loss.

Example 8. (i) The facts are the same as in *Example 7* (i) except that on January 1, 1990, X contributes the M corporation note to Y, a wholly-owned U.S. subsidiary of X with the dollar as its functional currency, and Y collects C$100 from M corporation at maturity on December 31, 1990, when the spot rate is C$1 = U.S.$.82. The transfer of the note from X to Y qualifies for nonrecognition of gain under section 351(a). On December 31, 1990, Y includes C$9.10 of accrued interest in income which translated at the average exchange rate of C$1 = U.S.$.81 for the year results in U.S.$7.37 of interest income.

(ii) Y's exchange gain is computed under paragraph (b)(3) of this section with respect to accrued interest income and paragraph (b)(5) of this section with respect to the nonfunctional currency principal amount. Under paragraph (b)(3) of this section, Y will realize exchange gain or loss for each accrual period computed by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the day received and subtracting the amounts of interest income accrued for such period. Thus, Y will realize $.49 of exchange gain with respect to original issue discount accrued in 1989 [(C$8.26×U.S.$.82)−(C$8.26×U.S.$.76) = U.S. $.49] and $.09 of exchange gain with respect to original issue discount accrued in 1990 [(C$9.10×U.S.$.82)−(C$9.10×U.S.$.81) = $.09].

(iii) Pursuant to paragraph (b)(5) of this section, the nonfunctional currency principal amount of the M bond in the hands of Y is C$82.64, the amount carried over from X, the transferor. Y's exchange gain with respect to the nonfunctional currency principal amount is $8.26 [(C$82.64×U.S.$.82)−(C$82.64×U.S.$.72) = U.S. $8.26]. Accordingly, Y's combined exchange gain is U.S. $8.84 ($.49+$.09+$8.26). Because the amount realized in Canadian dollars equals the adjusted issue price (C$100) on retirement of the M note, there is no market loss, and the netting rule of paragraph (b)(8) of this section does not limit realization of the exchange gain.

Example 9. (i) X is a calendar year corporation on the accrual method of accounting and with the dollar as its functional currency. X elects to use the spot rate convention to translate interest income as provided in paragraph (b)(2)(iii)(B) of this section. On January 31, 1992, X loans £1000 to Y, an unrelated person. Under the terms of the loan, Y will pay X interest of £50 on July 31, 1992, and January 31, 1993, and will repay the £1000 principal on January 31, 1993. Assume the following spot exchange rates:

Date	Spot rate [1]
Jan. 31, 1992	£1=$1.50
July 31, 1992	£1=1.55
Dec. 31, 1992	£1=1.60
Jan. 31, 1993	£1=1.61

[1] Pounds to dollars.

(ii) Under paragraph (b)(2)(ii)(C) of this section, X will translate the interest income at the spot rate on the last day of each interest accrual period (and in the case of a partial accrual period, at the spot rate on the last day of the taxable year). Accordingly, X will have interest income of $77.50 (£50×$1.55) on July 31, 1992. Assuming under X's method of accounting that interest is accrued daily, X will accrue $66.50 (153/184×£50)×$1.60) of interest income on December 31, 1992. On January 31, 1993, X will have interest income of $13.60 ((31/184×£50)×$1.61). Because the rate at which the interest income is translated is the same as the rate on the day of receipt, X will not realize any exchange gain or loss with respect to the interest income received on July 31, 1992. However, X will realize exchange gain on the £41.50 (153/184×£50) of accrued interest income of $.41 [(£41.50×$1.61)−(£41.50×$1.60) = $.41].

(iii) Under paragraph (b)(5) of this section, X will realize exchange gain upon repayment of the £100 principal amount determined by translating the £100 at the spot rate on the date it is received (£100×$1.61 = $161.00) and subtracting from such amount, the amount determined by translating the £100 at the spot rate on the date the loan was made (£100×$1.50 = $150.00). Accordingly, X will realize an exchange gain of $11 on the repayment of the loan on January 31, 1993.

Example 10. (i) X, a cash basis taxpayer with the dollar as its functional currency, has the calendar year as its taxable year. On January 1, 1992, X purchases at original issue for 65.88 British pounds (£) M corporation's 5-year bond maturing on December 31, 1996, having a stated redemption price at maturity of £100. The bond provides for annual payments of interest in pounds of 1 pound per year on December 31 of each year. The bond has 34.12 British pounds of original issue discount. The yield to maturity is 10 percent in British pounds and the accrual period is the one year period beginning January 1 and ending December 31 of each calendar year. The amount of original issue discount is determined in pounds for each accrual period by multiplying the adjusted issue price expressed in pounds by the yield and subtracting from such amount the periodic interest payments expressed in pounds for such period. The periodic interest payments are translated at the spot rate on the payment date (December 31 of each year). The original issue discount is translated at the average rate for the accrual period (January 1 through December 31). The following chart describes the determination of interest income with respect to the facts presented and provides other pertinent information.

TABLE 1

Year (Dec. 31)	Periodic interest payments in pounds for the accrual period	Original issue discount in pounds for the accrual period	Issue price or adjusted issue price in pounds	Assumed spot rate on Dec. 31 (pounds to dollars)	Assumed average rate for accrual period (pounds to dollars)	Periodic interest payments in pounds multiplied by spot rate on the date of payment (column 2 times column 5)	Original issue discount in pounds multiplied by the average rate for the accrual period (column 3 times column 6)	Total interest income in dollars (column 7 plus column 8)	Adjusted issue price in dollars
1	2	3	4	5	6	7	8	9	10
Issue Date:			65.88	1=$1.20	....	....	....	....	$79.06
1992	1	5.59	71.47	1=1.30	1=$1.25	$1.30	$6.99	$8.29	86.05
1993	1	6.15	77.62	1=1.40	1=1.35	1.40	8.30	9.70	94.35
1994	1	6.76	84.38	1=1.50	1=1.45	1.50	9.80	11.30	104.15
1995	1	7.44	91.82	1=1.60	1=1.55	1.60	11.53	13.13	115.68
1996	1	8.18	100.00	1=1.70	1=1.65	1.70	13.50	15.20	129.18

(ii) Because X is a cash basis taxpayer, X does not realize exchange gain or loss on the receipt of the £1 periodic interest payments. However, X will realize exchange gain on December 31, 1996 totaling $7.88 with respect to the original issue discount. Exchange gain is determined for each interest accrual period by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the date received and subtracting from such amount, the amount computed by translating the units of nonfunctional currency interest income accrued for such period at the average rate for the period. The following chart illustrates this computation:

TABLE 2

Year	OID accrued in pounds for each accrual period	Assumed spot rate on date payment received (pounds to dollars)	Interest received times spot rate on the date received (col. 2 times col. 3)	Assumed average rate for accrual period (pounds to dollars)	IOD in pounds times the average rate for the accrual period (col. 2 times col. 5)	Exchange gain or loss (col. 4 less col. 6)
1	2	3	4	5	6	7
1992	5.59	1=$1.70	$9.50	1=$1.25	$6.99	$2.51
1993	6.15	1=1.70	10.46	1=1.35	8.30	2.16
1994	6.76	1=1.70	11.49	1=1.45	9.80	1.69
1995	7.44	1=1.70	12.65	1=1.55	11.53	1.12
1996	8.18	1=1.70	13.90	1=1.65	13.50	.40
Total						$7.88

(iii) X will also realize exchange gain with respect to the principal of the loan (*i.e.*, the issue price of 65.88 British pounds) on December 31, 1996 computed by translating the units of nonfunctional currency principal received at the spot rate on the date principal is received (65.88 British pounds × $1.70 = $112.00) and subtracting from such amount, the units of nonfunctional currency principal received translated at the spot rate on the date the instrument was acquired (65.88 British pounds × $1.20 = $79.06). Accordingly, X's exchange gain on the principal is $32.94 and X's total exchange gain with respect to the accrued interest and principal is $40.82. It should be noted that, under this fact pattern, the total exchange gain may be determined in an alternative fashion. Exchange gain may be computed by subtracting the adjusted issue price in dollars at maturity ($129.18—see column 10 of Table 1) from the amount computed by multiplying the stated redemption price at maturity in pounds times the spot rate on the maturity date (£100×$1.70 = $170), which equals $40.82.

Example 11. (i) The facts are the same as in *Example 10* except that X makes an election under paragraph (b)(2)(iii) of this section to translate accrued interest on the last day of the accrual period. Accordingly, columns 8, 9 and 10 in Table 1 would change as follows:

Year (Dec. 31)	Original issue discount in pounds multiplied by the spot rate on last day of accrual period (Dec. 31)	Total interest income in dollars (column 7 plus column 8)	Adjusted issue price in dollars
1	8	9	10
			$79.06
1992	$7.27	$8.57	87.63
1993	8.61	10.01	97.64
1994	10.14	11.64	109.28
1995	11.90	13.50	122.78
1996	13.91	15.61	138.39

(ii) Because X is a cash basis taxpayer, X does not realize exchange gain or loss on the receipt of the £1 periodic interest payments. However, X will realize exchange gain on December 31, 1993 totaling $6.18 with respect to the original issue discount. Exchange gain is determined for each interest accrual period by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the date received and subtracting from such amount, the amount computed by translating the units of nonfunctional currency interest income accrued for such period at the spot rate on the last day of the accrual period. Accordingly, columns 5, 6 and 7 of Table 2 would change as follows:

Year	Spot rate on last day of accrual period	OID in pounds times the spot rate on the last day of the accrual period (col 2 times col. 3)	Exchange gain or loss (col. 4 less col. 6)
1	5	6	7
1992	$1.30	$7.27	$2.23
1993	1.40	8.61	1.85
1994	1.50	10.14	1.35
1995	1.60	11.90	0.75
1996	1.70	13.90	0.00
			6.18

(iii) X will realize exchange gain with respect to the principal amount of the loan as provided in the preceding example.

Example 12. (i) C is a corporation that is a calendar year accrual method taxpayer with the dollar as its functional currency. On January 1, 1989, C lends 100 British pounds (£) in exchange for a note under the terms of which C will receive two equal payments of £57.62 on December 31, 1989, and December 31, 1990. Each payment of £57.62 represents the annual payment necessary to amortize the £100 principal amount at a rate of 10% compounded annually over a two year period. The following tables reflect the amounts of principal and interest that compose each payment and assumptions as to the relevant exchange rates:

Date	Principal	Interest
Dec. 31, 1989	£47.62	£10.00
Dec. 12, 1990	£52.38	£5.24

Date	Spot rate £1=	Average rate for year ending
Jan. 1, 1989	$1.30	
Dec. 31, 1989	1.40	1.35
Dec. 31, 1990	1.50	1.45

(ii) Because each interest payment is equal to the product of the outstanding principal balance of the obligation and a single fixed rate of interest, each stated interest payment constitutes periodic interest under the principles of section 1273. Accordingly, there is no original issue discount.

(iii) Because C is an accrual basis taxpayer, C will translate the interest income at the average rate for the annual accrual period pursuant to paragraph (b)(2)(ii)(C) of this section. Thus, C's interest income is $13.50 (£10.00×$1.35) in 1989, and $7.60 (£5.24×$1.45) in 1990. C will realize exchange gain or loss upon receipt of accrued interest computed in accordance with paragraph (b)(3) of this section. Thus, C will realize exchange gain in the amount of $.50 [(£10.00×$1.40) − $13.50] in 1989, and $.26 [(£5.24×$1.50) − $7.60] in 1990.

(iv) In addition, C will realize exchange gain or loss upon the receipt of principal each year computed under paragraph (b)(5) of this section. Thus, C will realize exchange gain in the amount of $4.76 [(£47.62×$1.40) − (£47.62×$1.30)] in 1989, and $10.48 [(£52.38×$1.50) − (£52.38×$1.30)] in 1990.

(10) *Treatment of bond premium*—(i) *In general.* Amortizable bond premium on a bond described in paragraph (b)(2)(i) of this section shall be computed in the units of nonfunctional currency in which the bond is denominated (or in which the payments are determined). Amortizable bond premium properly taken into account under section 171 or § 1.61–12 (or the successor provision thereof) shall reduce interest income or expense in units of nonfunctional currency. Exchange gain or loss is realized with respect to bond premium described in the preceding sentence by treating the portion of premium amortized with respect to any period as a return of principal. With respect to a holder that does not elect to amortize bond premium under section 171, the amount of bond premium will constitute a market loss when the bond matures. See paragraph (b)(8) of this section. The principles set forth in this paragraph (b)(10) shall apply to determine the treatment of acquisition premium described in section 1272(a)(7).

(ii) *Example.* The following example illustrates the provisions of this paragraph (b)(10).

Example. (A) X is an individual on the cash method of accounting with the dollar as his functional currency. On January 1, 1989, X purchases Y corporation's note for 107.99 British pounds (£) from Z, an unrelated party. The note has an issue price of £100, a stated redemption price at maturity of £100, pays interest in pounds at the rate of 10% compounded annually, and matures on December 31, 1993. X elects to amortize the bond premium of £7.99 under the rules of section 171. Pursuant to paragraph (b)(10)(i) of this section, bond premium is determined and amortized in British pounds. Assume the amortization schedule is as follows:

Year ending 12/31	Bond premium amortized	Unamortized premium plus principal	Interest
		£107.99	
1989	£1.36	£106.63	£8.64
1990	£1.47	£105.16	£8.53
1991	£1.59	£103.57	£8.41

Year ending 12/31	Bond premium amortized	Unamortized premium plus principal	Interest
1992	£1.71	£101.86	£8.29
1993	£1.85	£100.00	£8.15

(B) The bond premium reduces X's pound interest income under the note. For example, the £10 stated interest payment made in 1989 is reduced by £1.36 of bond premium, and the resulting £8.64 interest income is translated into dollars at the spot rate on December 31, 1989. Exchange gain or loss is realized on the £1.36 bond premium based on the difference between the spot rates on January 1, 1989, the date the premium is paid to acquire the bond, and December 31, 1989, the date the bond premium is returned as part of the stated interest. The £1.36 bond premium reduces the unamortized premium plus principal to £106.63 (£107.99 − £1.36). On December 31, 1993, when the bond matures and the £7.99 of bond premium has been fully amortized, X will realize exchange gain or loss with respect to the remaining purchase price of £100.

(11) *Market discount*—(i) *In general.* Market discount as defined in section 1278(a)(2) shall be determined in units of nonfunctional currency in which the market discount bond is denominated (or in which the payments are determined). Accrued market discount (other than market discount currently included in income pursuant to section 1278(b)) shall be translated into functional currency at the spot rate on the date the market discount bond is disposed of. No part of such accrued market discount is treated as exchange gain or loss. Accrued market discount currently includible in income pursuant to section 1278(b) shall be translated into functional currency at the average exchange rate for the accrual period. Exchange gain or loss with respect to accrued market discount currently includible in income under section 1278(b) shall be determined in accordance with paragraph (b)(3) of this section relating to accrued interest income.

(ii) *Example.* The following example illustrates the provisions of this paragraph (b)(11).

Example. (A) X is a calendar year corporation with the U.S. dollar as its functional currency. On January 1, 1990, X purchases a bond of M corporation for 96,530 British pounds (£). The bond, which was issued on January 1, 1989, has an issue price of £100,000, a stated redemption price at maturity of £100,000, and provides for annual pound payments of interest at 8 percent. The bond matures on December 31, 1991. X purchased the bond at a market discount of 3,470 pounds and did not elect to include the market discount currently in income under section 1278(b). X holds the bond to maturity and on December 31, 1991, receives payment of £100,000 (plus £8,000 interest) when the exchange rate is £1 = $1.50.

(B) Pursuant to paragraph (b)(11) of this section, X computes market discount in units of nonfunctional currency. Thus, the market discount as defined under section 1278(a)(2) is £3,470. Accrued market discount (other than market discount currently included in income pursuant to section 1278(b)) is translated at the spot rate on the date the market discount bond is disposed of. Accordingly, X will translate the accrued market discount of £3,470 at the spot rate on December 31, 1991 (£3,470×$1.50 = $5,205). No exchange gain or loss is realized with respect to the £3,470 of accrued market discount. See paragraphs (b)(3) and (5) of this section for the realization and recognition of exchange gain or loss with respect to accrued interest and principal.

(12) *Tax exempt bonds.* See §1.988–3(c)(2), which characterizes exchange loss realized with respect to a nonfunctional currency tax exempt bond as a reduction of interest income.

(13) *Nonfunctional currency debt exchanged for stock of obligor*—(i) *In general.* Notwithstanding any other section of the Code other than section 267, 1091 or 1092, exchange gain or loss shall be realized and recognized by the holder and the obligor in accordance with the rules of paragraphs (b)(3) through (7) of this section with respect to the principal and accrued interest of a debt instrument described in paragraph (b)(2)(i) of this section that is acquired by the obligor in exchange for its stock, provided however, that such gain or loss shall be recognized only to the extent of the total gain or loss on the exchange (regardless of whether such gain or loss would otherwise be recognized). This rule shall apply whether the debt instrument is converted into stock according to its terms or exchanged pursuant to a separate agreement between the obligor and the holder. A debt instrument that is acquired by the obligor from a shareholder as a contribution to capital shall be treated for purposes of this section as exchanged for stock, whether or not additional stock is issued.

(ii) *Coordination with section 108.* Section 988 and this section shall apply before section 108. Exchange gain realized by the obligor on an exchange described in paragraph (b)(13)(i) of this section shall not be treated as discharge of indebtedness income, but shall be considered to reduce the amount of the liability for purposes of computing the obligor's income on the exchange under section 108(e)(4), section 108(e)(6) or section 108(e)(10).

(iii) *Effective date.* This paragraph (b)(13) shall be effective for exchanges of debt for stock effected after September 21, 1989.

(iv) *Examples.* The following examples illustrate the operation of this paragraph (b)(13). In each such example, assume that sections 267, 1091 and 1092 do not apply.

Example 1. (i) X is a calendar year U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1990 (the issue date), X acquired a convertible bond maturing on December 31, 1998, issued by Y corporation, a U.K. corporation with the British pound (£) as its functional currency. The issue price of the bond is £100,000, the stated redemption price at maturity is £100,000, and the bond provides for annual pound interest payments at the rate of 10%. The terms of the bond also provide that at any time prior to December 31, 1998, the holder may surrender all of his interest in the bond in exchange for 20 shares of Y common stock. On January 1, 1994, X surrenders his interest in the bond for 20 shares of Y common stock. Assume the following: (a) The spot rate on January 1, 1990, is £1 = $1.30, (b) The spot rate on January 1, 1994, is £1 = $1.50, and (c) The 20 shares of Y common stock have a market value of £200,000 on January 1, 1994.

(ii) Pursuant to paragraph (b)(13) of this section, X will realize and recognize exchange gain with respect to the issue price (£100,000) of the bond on January 1, 1994, when the bond is converted to stock. X will compute exchange gain pursuant to paragraph (b)(5) of this section by translating the issue price at the spot rate on the conversion date (£100.000×$1.50 = $150,000) and subtracting from such amount the issue price translated at the spot rate on the date X acquired the bond (£100,000×$1.30 = $130,000). Thus, X will realize and recognize $20,000 of exchange gain. X's basis in the 20 shares of Y common stock is $150,000 ($130,000 substituted basis + $20,000 recognized gain).

Example 2. (i) X, a foreign corporation with the British pound (£) as its functional currency, lends £100 at a market rate of interest to Y, its wholly-owned U.S. subsidiary, on January 1, 1990, on which date the spot exchange rate is £1 = $1. Y's functional currency is the U.S. dollar. On January 1, 1992, when the spot exchange rate is £1 = $.50, X cancels the debt as a contribution to capital. Pursuant to paragraph (b)(13) of this section, Y will realize and recognize exchange gain with respect to the £100 issue price of the debt instrument on January 1, 1992. Y will compute exchange gain pursuant to paragraph (b)(6) of this section by translating the issue price at the spot rate on the date Y became the obligor (£100×$1 = $100) and subtracting from such amount the issue price translated at the spot rate on the date of extinguishment (£100×$.50 = $50). Thus, Y will realize and recognize $50 of exchange gain.

(ii) Under section 108(e)(6), on the acquisition of its indebtedness from X as a contribution to capital Y is treated as having satisfied the debt with an amount of money equal to X's adjusted basis in the debt (£100). For purposes of section 108(e)(6), X's adjusted basis is translated into United States dollars at the spot rate on the date Y acquires the debt (£1 = $.50). Therefore, Y is treated as having satisfied the debt for $50. Pursuant to paragraph (b)(13) of this section, for purposes of section 108 the amount of the indebtedness is considered to be reduced by the exchange gain from $100 to $50. Accordingly, Y recognizes $50 of exchange gain and no discharge of indebtedness income on the extinguishment of its debt to X.

(iii) If X were a United States taxpayer with a dollar functional currency and a $100 basis in Y's obligation. X would realize and recognize an exchange loss of $50 under paragraph (b)(5) of this section on the contribution of the debt to Y. The recognized loss would reduce X's adjusted basis in the debt from $100 to $50, so that for purposes of applying section 108(e)(6) Y is treated as having satisfied the debt for $50. Accordingly, under these facts as well Y would recognize $50 of exchange gain and no discharge of indebtedness income.

Example 3. (i) X and Y are unrelated calendar year U.S. corporations with the U.S. dollar as their functional currency. On January 1, 1990 (the issue date), X acquires Y's bond maturing on December 31, 1999. The issue price of the bond is £100,000, the stated redemption price at maturity is £100,000, and the bond provides for annual pound interest payments at the rate of 10%. On January 1, 1994, X and Y agree that Y will redeem its bond from X in exchange for 20 shares of Y common stock. Assume the following:

(a) The spot rate on January 1, 1990, is £1 = $1.00,

(b) The spot rate on January 1, 1994, is £1 = $.50,

(c) Interest rates on equivalent bonds have increased so that as of January 1, 1994, the value of Y's bond has declined to £90,000, and

(d) The 20 shares of Y common stock have a market value of £90,000 as of January 1, 1994.

(ii) Pursuant to paragraph (b)(13) of this section, X will realize and recognize exchange loss with respect to the issue price (£100,000) of the bond on January 1, 1994, when the bond is exchanged for stock. X will compute exchange loss pursuant to paragraph (b)(5) of this section by translating the issue price at the spot rate on the exchange date (£100,000×$.50 = $50,000) and subtracting from such amount the issue price translated at the spot rate on the date X acquired the bond (£100,000×$1.00 = $100,000). Thus, X will compute $50,000 of exchange loss, all of which will be realized and recognized because it does not exceed the total $55,000 realized loss on the exchange ($45,000 worth of stock received less $100,000 basis in the exchanged bond).

(iii) Pursuant to paragraph (b)(13) of this section, Y will realize and recognize exchange gain with respect to the issue price, computed under paragraph (b)(6) of this section by translating the issue price at the spot rate on the date Y became the obligor (£100,000×$1.00 = $100,000) and subtracting from such amount the issue price translated at the spot rate on the exchange date (£100,000×$.50 = $50,000). Thus, Y will realize and recognize $50,000 of exchange gain. Under section 108(e)(10), on the transfer of stock to X in satisfaction of its indebtedness Y is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock (£90,000×$.50 = $45,000). Pursuant to paragraph (b)(13) of this section, for purposes of section 108 the amount of the indebtedness is considered to be reduced by the recognized exchange gain from $100,000 to $50,000. Accordingly, Y recognizes an additional $5,000 of discharge of indebtedness income on the exchange.

Example 4. (i) The facts are the same as in *Example 3* except that interest rates on equivalent bonds have declined, rather than increased, so that the value of Y's bond on January 1, 1994, has risen to £112,500; and X and Y agree that Y will redeem its bond from X on that date in exchange for 25 shares of Y common stock worth £112,500. Pursuant to paragraphs (b)(13) and (b)(5) of this section, X will compute $50,000 of exchange loss on the exchange with respect to the £100,000 issue price of the bond. See Example 3. However, because X's total loss on the exchange is only $43,750 ($56,250 worth of stock received less $100,000 basis in the exchanged bond), under the netting rule of paragraph (b)(13) of this section the realized exchange loss is limited to $43,750.

(ii) Pursuant to paragraphs (b)(13) and (b)(6) of this section, Y will compute $50,000 of exchange gain with respect to the issue price. See *Example 3.* Under section 108(e)(10), Y is treated as having satisfied the $100,000 indebtedness with an amount of money equal to the fair market value of the stock (£112,500×$.50 = $56,250), resulting in a total gain on the exchange of $43,750. Accordingly, under paragraph (b)(13) of this section Y's realized (and recognized) exchange gain on the exchange is limited to $43,750. Also pursuant to paragraph (b)(13) of this section, for purposes of section 108 the amount of the indebtedness is considered to be reduced by the recognized exchange gain from $100,000 to $56,250. Accordingly, Y recognizes no discharge of indebtedness income on the exchange.

(14)–(15) [Reserved]

(16) *Coordination with section 267 regarding debt instruments*—(i) *Treatment of a creditor.* For rules applicable to a corporation included in a controlled group that is a creditor under a debt instrument see §1.267(f)–-1(h).

(ii) *Treatment of a debtor.* [Reserved]

(17) *Coordination with installment method under section 453.* [Reserved]

(c) *Item of expense or gross income or receipts which is to be paid or received after the date accrued*—(1) *In general.* Except as provided in §1.988–5, exchange gain or loss with respect to an item described in §1.988–1(a)(1)(ii) and (2)(ii) (other than accrued interest income or expense subject to paragraph (b) of this section) shall be realized on the date payment is made or received. Except as provided in the succeeding sentence, such exchange gain or loss shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. If the taxpayer's right to receive income, or obligation to pay an expense, is transferred or modified in a transaction in which gain or loss would otherwise be recognized, exchange gain or loss shall be realized and recognized only to the extent of the total gain or loss on the transaction.

(2) *Determination of exchange gain or loss with respect to an item of gross income or receipts.* Exchange gain or loss realized on an item of gross income or receipts described in paragraph (c)(1) of this section shall be determined by multiplying the units of nonfunctional currency received by the spot rate on the payment date, and subtracting from such amount the amount determined by multiplying the units of nonfunctional currency received by the spot rate on the booking date. The

term ''spot rate on the payment date'' means the spot rate determined under §1.988–1(d) on the date payment is received or otherwise taken into account. Pursuant to §1.988–1(d)(3), a taxpayer may use a spot rate convention for purposes of determining the spot rate on the payment date. The term ''spot rate on the booking date'' means the spot rate determined under §1.988–1(d) on the date the item of gross income or receipts is accrued or otherwise taken into account. Pursuant to §1.988–1(d)(3), a taxpayer may use a spot rate convention for purposes of determining the spot rate on the booking date.

(3) *Determination of exchange gain or loss with respect to an item of expense.* Exchange gain or loss realized on an item of expense described in paragraph (c)(1) of this section shall be determined by multiplying the units of nonfunctional currency paid by the spot rate on the booking date and subtracting from such amount the amount determined by multiplying the units of nonfunctional currency paid by the spot rate on the payment date. The term ''spot rate on the booking date'' means the spot rate determined under §1.988–1(d) on the date the item of expense is accrued or otherwise taken into account. Pursuant to §1.988–1(d)(3), a taxpayer may use a spot rate convention for purposes of determining the spot rate on the booking date. The term ''spot rate on the payment date'' means the spot rate determined under §1.988–1(d) on the date payment is made or otherwise taken into account. Pursuant to §1.988–1(d)(3), a taxpayer may use a spot rate convention for purposes of determining the spot rate on the date.

(4) *Examples.* The following examples illustrate the application of paragraph (c) of this section.

Example 1. X is a calendar year corporation with the dollar as its functional currency. X is on the accrual method of accounting. On January 15, 1989, X sells inventory for 10,000 Canadian dollars (C$). The spot rate on January 15, 1989, is C$1 = U.S. $.55. On February 23, 1989, when X receives payment of the C$10,000, the spot rate is C$1 = U.S. $.50. On February 23, 1989, X will realize exchange loss. X's loss is computed by multiplying the C$10,000 by the spot rate on the date the C$10,000 are received (C$10,000×.50 = U.S. $5,000) and subtracting from such amount, the amount computed by multiplying the C$10,000 by the spot rate on the booking date (C$10,000×.55 = U.S. $5,500). Thus, X's exchange loss on the transaction is U.S. $500 (U.S. $5,000 − U.S. $5,500).

Example 2. The facts are the same as in *Example 1* except that X uses a spot rate convention to determine the spot rate as provided in §1.988–1(d)(3). Pursuant to X's spot rate convention, the spot rate at which a payable or receivable is booked is determined monthly for each nonfunctional currency payable or receivable by adding the spot rate at the beginning of the month and the spot rate at the end of the month and dividing by two. All payables and receivables in a nonfunctional currency booked during the month are translated into functional currency at the rate described in the preceding sentence. Further, the translation of nonfunctional currency paid with respect to a payable, and nonfunctional currency received with respect to a receivable, is also performed pursuant to the spot rate convention. Assume the spot rate determined under the spot rate convention for the month of January is C$1 = U.S. $.54 and for the month of February is C$1 = U.S. $.51. On the last date in February, X will realize exchange loss. X's loss is computed by multiplying the C$10,000 by the spot rate convention for the month of February (C$10,000×U.S. $.51 = U.S. $5,100) and subtracting from such amount, the amount computed by multiplying the C$10,000 by the spot rate convention for the month of January (C$10,000×U.S. $.54 = $5,400). Thus, X's exchange loss on the transaction is U.S. $300 (U.S. $5,100–U.S. $5,400). X's basis in the C$10,000 is U.S. $5,400.

Example 3. The facts are the same as in *Example 2* except that X has a standing order with X's bank for the bank to convert any nonfunctional currency received in satisfaction of a receivable into U.S. dollars on the day received and to deposit those U.S. dollars in X's U.S. dollar bank account. X may use its convention to translate the amount booked into U.S. dollars, but must use the U.S. dollar amounts received from the bank with respect to such receivables to determine X's exchange gain or loss. Thus, if X receives payment of the C$10,000 on February 23, 1989, when the spot rate is C$1 = U.S.$ .50, X determines exchange gain or loss by subtracting the amount booked under X's convention (U.S.$5,400) from the amount of U.S. dollars received from the bank under the standing conversion order (assume $5,000). X's exchange loss is U.S.$400.

(d) *Exchange gain or loss with respect to forward contracts, futures contracts and option contracts*—(1) *Scope*—(i) *In general.* This paragraph (d) applies to forward contracts, futures contracts and option contracts described in

§1.988–1(a)(1)(ii) and (2)(iii). For rules applicable to currency swaps and notional principal contracts described in §1.988–1(a) (1)(ii) and (2)(iii), see paragraph (e) of this section.

(ii) *Treatment of spot contracts.* Solely for purposes of this paragraph (d), a spot contract as defined in §1.988–1(b) to buy or sell nonfunctional currency is not considered a forward contract or similar transaction described in §1.988–1(a)(2)(iii) unless such spot contract is disposed of (or otherwise terminated) prior to making or taking delivery of the currency. For example, if a taxpayer with the dollar as its functional currency enters into a spot contract to purchase British pounds, and takes delivery of such pounds under the contract, the delivery of the pounds is not a realization event under section 988(c)(5) and paragraph (e)(4)(ii) of this section because the contract is not considered a forward contract or similar transaction described in §1.988–1(a)(2)(iii). However, if the taxpayer sells or otherwise terminates the contract before taking delivery of the pounds, exchange gain or loss shall be realized and recognized in accordance with paragraphs (d)(2) and (3) of this section.

(2) *Realization of exchange gain or loss*—(i) *In general.* Except as provided in §1.988–5, exchange gain or loss on a contract described in §1.988–2(d)(1) shall be realized in accordance with the applicable realization section of the Internal Revenue Code (*e.g.*, sections 1001, 1092, and 1256). See also section 988(c)(5). For purposes of determining the timing of the realization of exchange gain or loss, sections 1092 and 1256 shall take precedence over section 988(c)(5).

(ii) *Realization by offset*—(A) *In general.* Except as provided in paragraphs (d)(2)(ii)(B) and (C) of this section, exchange gain or loss with respect to a transaction described in §1.988–1(a)(1)(ii) and (2)(iii) shall not be realized solely because such transaction is offset by another transaction (or transactions).

(B) *Exception where economic benefit is derived.* If a transaction described in §1.988–1(a)(1)(ii) and (2)(iii) is offset by another transaction or transactions, exchange gain shall be realized to the extent the taxpayer derives, by pledge or otherwise, an economic benefit (*e.g.*, cash, property or the proceeds from a borrowing) from any gain inherent in such offsetting positions. Proper adjustment shall be made in the amount of any gain or loss subsequently realized for gain taken into account by reason of the preceding sentence. This paragraph (d)(2)(ii)(B) shall apply to transactions creating an offset after September 21, 1989.

(C) *Certain contracts traded on an exchange.* If a transaction described in §1.988–1(a)(1)(ii) and (2)(iii) is traded on an exchange and it is the general practice of the exchange to terminate offsetting contracts, entering into an offsetting contract shall be considered a termination of the contract being offset.

(iii) *Clarification of section 988(c)(5).* If the delivery date of a contract subject to section 988(c)(5) and paragraph (d)(4)(ii) of this section is different than the date the contract expires, then for purposes of determining the date exchange gain or loss is realized, the term delivery date shall mean expiration date.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (d)(1) and (2).

Example 1. On August 1, 1989, X, a calendar year corporation with the dollar as its functional currency, enters into a forward contract with Bank A to buy 100 New Zealand dollars for $80 for delivery on January 31, 1990. (The forward purchase contract is not a section 1256 contract.) On November 1, 1989, the market price for the purchase of 100 New Zealand dollars for delivery on January 31, 1990, is $76. On November 1, 1989, X cancels its obligation under the forward purchase contract and pays Bank A $3.95 (the present value of $4 discounted at 12% for the period) in cancellation of such contract. Under section 1001 (a), X realizes an exchange loss of $3.95 on November 1, 1989, because cancellation of the forward purchase contract for cash results in the termination of X's contract.

Example 2. X is a corporation with the dollar as its functional currency. On January 1, 1989, X enters into a currency swap contract with Bank A under which X is obligated to make a series of Japanese yen payments in exchange for a series of dollar payments. On February 21, 1992, X has a gain of $100,000 inherent in such contract as a result of interest rate and exchange rate movements. Also on February 21, 1992, X enters into an offsetting swap with Bank A to lock in such gain. If on February 21, 1992, X pledges the gain inherent in such offsetting positions as collateral for a loan, X's initial swap contract is treated as being terminated on February 21, 1992, under paragraph (d)(2)(ii)(B) of this section. Proper adjustment is made in the amount of any gain or loss subsequently realized for the gain taken into account by reason of paragraph (d)(2)(ii)(B) of this section.

Example 3. X is a calendar year corporation with the dollar as its functional currency. On October 1, 1989, X enters into a forward contract to buy 100,000 Swiss francs (Sf) for delivery on March l, 1990, for $51,220. Assume that the contract is a section 1256 contract under section 1256(g)(2) and that section 1256(e) does not apply. Pursuant to section 1256(a)(1), the forward contract is treated as sold for its fair market value on December 31, 1989. Assume that the fair market value of the contract is $1,000 determined under § 1.988–1(g). Thus X will realize an exchange gain of $1,000 on December 31, 1989. Such gain is subject to the character rules of § 1.988–3 and the source rules of § 1.988–4.

(v) *Extension of the maturity date of certain contracts.* An extension of time for making or taking delivery under a contract described in paragraph (d)(1) of this section (*e.g.,* a historical rate rollover as defined in § 1.988–5(b)(2)(iii)(C)) shall be considered a sale or exchange of the contract for its fair market value on the date of the extension and the establishment of a new contract on such date. If, under the terms of the extension, the time value of any gain or loss recognized pursuant to the preceding sentence adjusts the price of the currency to be bought or sold under the new contract, the amount attributable to such time value shall be treated as interest income or expense for all purposes of the Code. However, the preceding sentence shall not apply and the amount attributable to the time value of any gain or loss recognized shall be treated as exchange gain or loss if the period beginning on the first date the contract is rolled over and ending on the date payment is ultimately made or received with respect to such contract does not exceed 183 days.

(3) *Recognition of exchange gain or loss.* Except as provided in § 1.988–5 (relating to section 988 hedging transactions), exchange gain or loss realized with respect to a contract described in paragraph (d)(1) of this section shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. For example, a loss realized with respect to a contract described in paragraph (d)(1) of this section which is part of a straddle shall be recognized in accordance with the provisions of section 1092 to the extent such section is applicable.

(4) *Determination of exchange gain or loss*—(i) *In general.* Exchange gain or loss with respect to a contract described in § 1.988–2(d)(1) shall be determined by subtracting the amount paid (or deemed paid), if any, for or with respect to the contract (including any amount paid upon termination of the contract) from the amount received (or deemed received), if any, for or with respect to the contract (including any amount received upon termination of the contract). Any gain or loss determined according to the preceding sentence shall be treated as exchange gain or loss.

(ii) *Special rules where taxpayer makes or takes delivery.* If the taxpayer makes or takes delivery in connection with a contract described in paragraph (d)(1) of this section, any gain or loss shall be realized and recognized in the same manner as if the taxpayer sold the contract (or paid another person to assume the contract) on the date on which he took or made delivery for its fair market value on such date. See paragraph (d)(2)(iii) of this section regarding the definition of the term ''delivery date.'' This paragraph (d)(4)(ii) shall not apply in any case in which the taxpayer makes or takes delivery before June 11, 1987.

(iii) *Examples.* The following examples illustrate the application of paragraph (d)(4) of this section.

Example 1. X is a calendar year corporation with the dollar as its functional currency. On October 1, 1989, when the six month forward rate is $.4907, X enters into a forward contract to buy 100,000 New Zealand dollars (NZD) for delivery on March 1, 1990. On March 1, 1990, when X takes delivery of the 100,000 NZD, the spot rate is 1NZD equals $.48. Pursuant to section 988(c)(5) and paragraph (d)(4)(ii) of this section, a taxpayer that takes delivery of nonfunctional currency under a forward contract that is subject to section 988 is treated as if the taxpayer sold the contract for its fair market value on the date delivery is taken. If X sold the contract on March 1, 1990, the transferee would require a payment of $1,070 [($.48×100,000NZD)−($.4907×100,000NZD)] to compensate him for the loss in value of the 100,000NZD. Therefore, X realizes an exchange loss of $1,070. X has a basis in the 100,000NZD of $48,000.

Example 2. Assume the same facts as in *Example 1* except that the contract is for Swiss francs and is a section 1256 contract. Assume further that on December 31, 1989, the value to X of the contract as marked to market is $1,000. Pursuant to section 1256(a), X realizes an exchange gain of $1,000. Such gain, however, is characterized as ordinary income under §1.988–3 and will be sourced under §1.988–4.

Example 3. X is a calendar year corporation with the dollar as its functional currency. On May 2, 1989, X enters into an option contract with Bank A to purchase 50,000 Canadian dollars (C$) for U.S. $42,500 (C$1 = U.S. $.85) for delivery on or before September 18, 1989. X pays a $285 premium to Bank A to obtain the option contract. On September 18, 1989, when X exercises the option and takes delivery of the C$50,000, the spot rate is C$1 equals U.S. $.90. Pursuant to section 988(c)(5) and paragraph (d)(4)(ii) of this section, a taxpayer that takes delivery under an option contract that is subject to section 988 is treated as if the taxpayer sold the contract for its fair market value on the date delivery is taken. If X sold the contract for its fair market value on September 18, 1989, X would receive U.S. $2,500 [(C$50,000×U.S. $.90)−(C$50,000×U.S. $.85)]. Accordingly, X is deemed to have received U.S. $2,500 on the sale of the contract at its fair market value. X will realize U.S. $2,215 ($2,500 deemed received less $285 paid) of exchange gain with respect to the delivery of Canadian dollars under the option contract. X's basis in the 50,000 Canadian dollars is U.S. $45,000.

(5) [Reserved]

(e) *Currency swaps and other notional principal contracts*—(1) *In general.* Except as provided in paragraph (e)(2) of this section or in §1.988–5, the timing of income, deduction and loss with respect to a notional principal contract that is a section 988 transaction shall be governed by section 446 and the regulations thereunder. Such income, deduction and loss is characterized as exchange gain or loss (except as provided in another section of the Internal Revenue Code (or regulations thereunder), §1.988–5, or in paragraph (f) of this section).

(2) *Special rules for currency swaps*—(i) *In general.* Except as provided in paragraph (e)(2)(iii)(B) of this section, the provisions of this paragraph (e)(2) shall apply solely for purposes of determining the realization, recognition and amount of exchange gain or loss with respect to a currency swap contract, and not for purposes of determining the source of such gain or loss, or characterizing such gain or loss as interest. Except as provided in §1.988–3(c), any income or loss realized with respect to a currency swap contract shall be characterized as exchange gain or loss (and not as interest income or expense). Any exchange gain or loss realized in accordance with this paragraph (e)(2) shall be recognized unless otherwise provided in an applicable section of the Code. For purposes of this paragraph (e)(2), a currency swap contract is a contract defined in paragraph (e)(2)(ii) of this section. With respect to a contract which requires the payment of swap principal prior to maturity of such contract, see paragraph (f) of this section. For purposes of this paragraph (e), the rules of paragraph (d)(2)(ii) of this section (regarding realization by offset) apply. See Example 2 of paragraph (d)(2)(iv) of this section.

(ii) *Definition of currency swap contract*—(A) *In general.* A currency swap contract is a contract involving different currencies between two or more parties to—

(*1*) Exchange periodic interim payments, as defined in paragraph (e)(2)(ii)(C) of this section, on or prior to maturity of the contract; and

(*2*) Exchange the swap principal amount upon maturity of the contract.

A currency swap contract may also require an exchange of the swap principal amount upon commencement of the agreement.

(B) *Swap principal amount.* The swap principal amount is an amount of two different currencies which, under the terms of the currency swap contract, is used to determine the periodic interim payments in each currency and which is exchanged upon maturity of the contract. If such amount is not clearly set forth in the contract, the Commissioner may determine the swap principal amount.

(C) *Exchange of periodic interim payments.* An exchange of periodic interim payments is an exchange of one or more payments in one currency specified by the contract for one or more payments in a different currency specified by the contract where the payments in each currency are computed by reference to an interest index applied to the swap principal amount. A currency swap contract must clearly indicate the periodic interim payments, or the interest index used to compute the periodic interim payments, in each currency.

(iii) *Timing and computation of periodic interim payments*—(A) *In general.* Except as provided in paragraph (e)(2)(iii)(B) of this section and §1.988–5, the timing and computation of the periodic interim payments provided in a currency swap agreement shall be determined by treating—

(*1*) Payments made under the swap as payments made pursuant to a hypothetical borrowing that is denominated in the currency in which payments are required to be made (or are determined with reference to) under the swap, and

(*2*) Payments received under the swap as payments received pursuant to a hypothetical loan that is denominated in the currency in which payments are received (or are determined with reference to) under the swap.

Except as provided in paragraph (e)(2)(v) of this section, the hypothetical issue price of such hypothetical borrowing and loan shall be the swap principal amount. The hypothetical stated redemption price at maturity is the total of all payments (excluding any exchange of the swap principal amount at the inception of the contract) provided under the hypothetical borrowing or loan other than periodic interest payments under the principles of section 1273. For purposes of determining economic accrual under the currency swap, the number of hypothetical interest compounding periods of such hypothetical borrowing and loan shall be determined pursuant to a semiannual compounding convention unless the currency swap contract indicates otherwise. For purposes of determining the timing and amount of the periodic interim payments, the principles regarding the amortization of interest (see generally, sections 1272 through 1275 and 163(e)) shall apply to the hypothetical interest expense and income of such hypothetical borrowing and loan. However, such principles shall not apply to determine the time when principal is deemed to be paid on the hypothetical borrowing and loan. See paragraph (d)(2)(iii) of this section and *Example 2* of paragraph (d)(5) of this section with respect to the time when principal is deemed to be paid. With respect to the translation and computation of exchange gain or loss on any hypothetical interest income or expense, see §1.988–2(b). The amount treated as exchange gain or loss by the taxpayer with respect to the periodic interim payments for the taxable year shall be the amount of hypothetical interest income and exchange gain or loss attributable to such interest income from the hypothetical borrowing and loan for such year less the amount of hypothetical interest expense and exchange gain or loss attributable to the interest expense from such hypothetical borrowing and loan for such year.

(B) *Effect of prepayment for purposes of section 956.* For purposes of section 956, the Commissioner may treat any prepayment of a currency swap as a loan.

(iv) *Timing and determination of exchange gain or loss with respect to the swap principal amount.* Exchange gain or loss with respect to the swap principal amount shall be realized on the day the units of swap principal in each currency are exchanged. (See paragraph (e)(2)(ii)(A)(*2*) of this section which requires that the entire swap principal amount be exchanged upon maturity of the contract.) Such gain or loss shall be determined on the date of the exchange by subtracting the value (on such date) of the units of swap principal paid from the value of the units of swap principal received. This paragraph (e)(2)(iv) does not apply to an equal exchange of the swap principal amount at the commencement of the agreement at a market exchange rate.

(v) *Anti-abuse rules*—(A) *Method of accounting does not clearly reflect income.* If the taxpayer's method of accounting for income, expense, gain or loss attributable to a currency swap does not clearly reflect income, or if the present value of the payments to be made is not equivalent to that of the payments to be received (including the swap premium or discount, as defined in paragraph (e)(3)(ii) of this section) on the day the taxpayer enters into or acquires the contract, the Commissioner may apply principles analogous to those of section 1274 or such other rules as the Commissioner deems appropriate to clearly reflect income. For example, in order to clearly reflect income the Commissioner may determine the hypothetical issue price, the hypothetical stated redemption price at maturity, and the amounts required to be taken into account within a taxable year. Further, if the present value of the payments to be made is not equivalent to that of the payments to be received (including the swap premium or discount, as defined in paragraph (e)(3)(ii) of this section) on the day the taxpayer enters into or acquires the contract, the Commissioner may integrate the swap with another transaction (or transactions) in order to clearly reflect income.

(B) *Terms must be clearly stated.* If the currency swap contract does not clearly set forth the swap principal amount in each currency, and the periodic interim payments in each currency (or the interest index used to compute the periodic interim payments in each currency), the Commissioner may defer any income, deduction, gain or loss with respect to such contract until termination of the contract.

(3) *Amortization of swap premium or discount in the case of off-market currency swaps*—(i) *In general.* An ‘‘off-market currency swap’’ is a currency swap contract under which the present value of the payments to be made is not equal to that of the payments to be received on the day the taxpayer enters into or acquires the contract (absent the swap premium or discount, as defined in paragraph (e)(3)(ii) of this section). Generally, such present values may not be equal if the swap exchange rate (as defined in paragraph (e)(3)(iii) of this section) is not the spot rate, or the interest indices used to compute the periodic interim payments do not reflect current values, on the day the taxpayer enters into or acquires the currency swap.

(ii) *Treatment of taxpayer entering into or acquiring an off-market currency swap.* If a taxpayer that enters into or acquires a currency swap makes a payment (that is, the taxpayer pays a premium, ‘‘swap premium,’’ to enter into or acquire the currency swap) or receives a payment (that is, the taxpayer enters into or acquires the currency swap at a discount, ‘‘swap discount’’) in order to make the present value of the amounts to be paid equal the amounts to be received, such payment shall be amortized in a manner which places the taxpayer in the same position it would have been in had the taxpayer entered into a currency swap contract under which the present value of the amounts to be paid equal the amounts to be received (absent any swap premium or discount). Thus, swap premium or discount shall be amortized as follows—

(A) The amount of swap premium or discount that is attributable to the difference between the swap exchange rate (as defined in paragraph (e)(3)(iii) of this section) and the spot rate on the date the contract is entered into or acquired shall be taken into account as income or expense on the date the swap principal amounts are taken into account; and

(B) The amount of swap premium or discount attributable to the difference in values of the periodic interim payments shall be amortized in a manner consistent with the principles of economic accrual. *Cf.,* section 171.

Any amount taken into account pursuant to this paragraph (e)(3)(ii) shall be treated as exchange gain or loss.

(iii) *Definition of swap exchange rate.* The swap exchange rate is the single exchange rate set forth in the contract at which the swap principal amounts are determined. If the swap exchange rate is not clearly set forth in the contract, the Commissioner may determine such rate.

(iv) [Reserved]

(4) *Treatment of taxpayer disposing of a currency swap.* Any gain or loss realized on the disposition or the termination of a currency swap is exchange gain or loss.

(5) *Examples.* The following examples illustrate the application of this paragraph (e).

Example 1. (i) C is an accrual method calendar year corporation with the dollar as its functional currency. On January 1, 1989, C enters into a currency swap with J with the following terms:

(1) the principal amount is $150 and 100 British pounds (£) (the equivalent of $150 on the effective date of the contract assuming a spot rate of £1 = $1.50 on January 1, 1989);

(2) C will make payments equal to 10% of the dollar principal amount on December 31, 1989, and December 31, 1990;

(3) J will make payments equal to 12% of the pound principal amount on December 31, 1989, and December 31, 1990; and

(4) on December 31, 1990, C will pay to J the $150 principal amount and J will pay to C the £100 principal amount.

Assume that the spot rate is £1 = $1.50 on January 1, 1989, £1 = $1.40 on December 31, 1989, and £1 = $1.30 on December 31, 1990. Assume further that the average rate for 1989 is £1 = $1.45 and for 1990 is £1 = $1.35.

(ii) Solely for determining the realization of gain or loss in accordance with paragraph (e)(2) of this section (and not for purposes of determining whether any payments are treated as interest), C will treat the dollar payments made by C as payments made pursuant to a dollar borrowing with an issue price of $150, a stated redemption price at maturity of $150, and yield to maturity of 10%. C will treat the pound payments received as payments received pursuant to a pound loan with an issue price of £100, a stated redemption price at maturity of £100, and a yield of 12% to maturity. Pursuant to § 1.988–2(b), C is required to compute hypothetical accrued pound interest income at the average rate for the accrual period and then determine exchange gain or loss on the day payment is received with respect to such accrued amount. Accordingly, C will accrue $17.40 (£12×$1.45) in 1989 and $16.20 (£12×$1.35) in 1990. C also will compute hypothetical exchange loss of $.60 on December 31, 1989 [(£12×$1.40)−(£12×$1.45)] and hypothetical exchange loss of $.60 on December 31, 1990 [(£12×$1.30)−(£12×$1.35)]. All such hypothetical interest income and exchange loss are characterized and sourced as exchange gain and loss. Further, C is treated as having paid $15 ($150×10%) of hypothetical interest on December 31, 1989, and again on December 31, 1990. Such hypothetical interest expense is characterized and sourced as exchange loss. Thus, C will have a net exchange gain of $1.80 ($17.40−$.60−$15.00) with respect to the periodic interim payments in 1989 and a net exchange gain of $.60 ($16.20−$.60−$15.00) with respect to the periodic interim payments in 1990. Finally, C will realize an exchange loss on December 31, 1990, with respect to the exchange of the swap principal amount. This loss is determined by subtracting the value of the units of swap principal paid ($150) from the value of the units of swap principal received (£100×$1.30 = $130) resulting in a $20 exchange loss.

Example 2. (i) C is an accrual method calendar year corporation with the dollar as its functional currency. On January 1, 1989, when the spot rate is £1 = $1.50, C enters into a currency swap contract with J under which C agrees to make and receive the following payments:

Date	C pays	J pays
December 31, 1989	$15.00	£12.00
December 31, 1990	41.04	12.00
December 31, 1991	0.00	12.00
December 31, 1992	150.00	112.00

(ii) Under paragraph (e)(2)(iii) of this section, C must treat the dollar periodic interim payments under the swap as made pursuant to a hypothetical dollar borrowing. The hypothetical issue price is $150 and the stated redemption price at maturity is $206.04. The amount of hypothetical interest expense must be amortized in accordance with economic accrual. Thus J must include and C must deduct periodic interim payment amounts as follows:

	Amount taken into account	Adjusted issue price
December 31, 1989	$15.00	150.00
December 31, 1990	$15.00	123.96
December 31, 1991	$12.40	136.36
December 31, 1992	$13.64	

(iii) Gain or loss with respect to the periodic interim payments of the currency swap is determined under paragraph (e)(2)(iii)(A) of this section with respect to the dollar cash flow amortized as set forth above and the corresponding pound cash flow as stated in the currency swap contract. Gain or loss with respect to the principal payments (*i.e.*, $150 and £100) exchanged on December 31, 1992, is determined under paragraph (e)(2)(iv) of this section on December 31, 1992, notwithstanding that under the principles regarding amortization of interest $26.04 would have been regarded as a payment of principal on December 31, 1990.

Example 3. (i) X is a corporation on the accrual method of accounting with the dollar as its functional currency and the calendar year as its taxable year. On January 1, 1989, X enters into a three year currency swap contract with Y with the following terms. The swap principal amount is $100 and the Swiss franc (Sf) equivalent of such amount which equals Sf200 translated at the swap exchange rate of $1 = Sf2. There is no initial exchange of the swap principal amount. The interest rates used to compute the periodic interim payments are 10% compounded annually for U.S. dollar payments and 5% compounded annually for Swiss franc payments. Thus, under the currency swap, X agrees to pay Y $10 (10%×$100) on December 31st of 1989, 1990 and 1991 and to pay Y the swap principal amount of $100 on December 31, 1991. Y agrees to pay X Sf10 (5%×Sf200) on December 31st of 1989, 1990 and 1991 and to pay X the swap principal amount of Sf200 on December 31, 1991. Assume that the average rate for 1989 and the spot rate on December 31, 1989, is $1 = Sf2.5.

(ii) Under paragraph (e)(2)(iii) of this section, on December 31, 1989, X will realize an exchange loss of $6 (the sum of $10 of loss by reason of the $10 periodic interim payment paid to Y and $4.00 of gain, the value of Sf10 on December 31, 1989, from the receipt of Sf10 on such date).

(iii) On January 1, 1990, X transfers its rights and obligations under the swap contract to Z, an unrelated corporation. Z has the dollar as its functional currency, is on the accrual method of accounting, and has the calendar year as its taxable year. On January 1, 1990, the exchange rate is $1 = Sf2.50. The relevant dollar interest rate is 8% compounded annually and the relevant Swiss franc interest rate is 5% compounded annually. Because of the movement in exchange and interest rates, the agreement between X and Z to transfer the currency swap requires X to pay Z $23.56 (the swap discount as determined under paragraph (e)(3) of this section).

(iv) Pursuant to paragraph (e)(4) of this section, X may deduct the loss of $23.56 in 1990. The loss is characterized under § 1.988–3 and sourced under § 1.988–4.

(v) Pursuant to paragraph (e)(3)(ii) of this section, Z is required to amortize the $23.56 received as follows. The amount of the $23.56 payment that is attributable to movements in exchange rates ($20) is taken into account on December 31, 1991, the date the swap principal amounts are exchanged, under paragraph (e)(3)(ii)(A) of this section. This amount is the present value (discounted at 10%, the rate under the currency swap contract used to compute the dollar periodic interim payments) of the financial asset required to compensate Z for the loss in value of the hypothetical Swiss franc loan resulting from movements in exchange rates between January 1, 1989, and January 1, 1990. This amount is determined by assuming that interest rates did not change from the date the swap originally was entered into (January 1, 1989), but that the exchange rate is $1 = Sf2.50. Under this assumption, a taxpayer undertaking the obligation to pay dollars under the currency swap on January 1, 1990, would only agree to pay $8 for Sf10 on December 31, 1990, and $88 for Sf210 on December 31, 1991, because the exchange rates have moved from $1 = Sf2 to $1 = Sf2.50. Thus, Z requires $2 on December 31, 1990, and $22 on December 31, 1991, to compensate for the amount of dollar payments Z is required to make in exchange for the Swiss francs received on December 31, 1990 and 1991. The present value of $2 on December 31, 1990, and $22 on December 31, 1991, discounted at the rate for U.S. dollar payments of 10% is $20 ($1.82+$18.18). This amount is discounted at the rate for U.S. dollar payments (i.e., at the historic rate) because the amount of the $23.56 payment received by Z that is attributable to movements in interest rates is computed and amortized separately as provided in the following paragraph.

(vi) Pursuant to paragraph (e)(3)(ii)(B) of this section, Z is required to amortize the portion of the $23.56 payment attributable to movements in interest rates under principles of economic accrual over the term of the currency swap agreement. The amount of the $23.56 payment that is attributable to movements in interest rates (assuming that exchange rates have not changed) is the present value ($3.56) of the excess ($2.00 in 1990 and $2.00 in 1991) of the periodic interim payments Z is required to pay under the currency swap agreement ($10 in 1990 and $10 in 1991) over the amount Z would be required to pay if the currency swap agreement reflected current interest rates on the day Z acquired the swap contract ($8 in 1990 and $8 in 1991) discounted at the appropriate dollar interest rate on January 1, 1990. Thus, under principles of economic accrual (e.g., see section 171 of the Code), Z will include in income $1.72 on December 31, 1990, the amount that, when added to the interest ($.28) on the $3.56 computed at the 8% rate on the date Z acquired the currency swap contract, will equal the $2.00 needed to compensate Z for the movement in interest rates between January 1, 1989, and January 1, 1990. Z also will include in income $1.85 on December 31, 1991, the amount that, when added to the interest ($.15) on the $1.85 (the remaining balance of the $3.56 payment) computed at the 8% rate on the date Z acquired the currency swap contract, will equal the $2.00 needed to compensate Z for the movement in interest rates between January 1, 1990, and January 1, 1991. This amount is computed assuming exchange rates have not changed because the amount attributable to movements in exchange rates is computed and amortized separately under the preceding paragraph.

(6) *Special effective date for rules regarding currency swaps.* Paragraph (e)(3) of this section regarding amortization of swap premium or discount in the case of off-market currency swaps shall be effective for transactions entered into after September 21, 1989, unless such swap premium or discount was paid or received pursuant to a binding contract with an unrelated party that was entered into prior to such date. For transactions entered into prior to this date, see Notice 89–21, 1989–8 I.R.B. 23.

(7) [Reserved]

(f) *Substance over form*—(1) *In general.* If the substance of a transaction described in § 1.988–1(a)(1) differs from its form, the timing, source, and character of gains or losses with respect to such transaction may be recharacterized by the Commissioner in accordance with its substance. For example, if a taxpayer enters into a transaction that it designates a ''currency swap contract'' that requires the prepayment of all payments to be made or to be received (but not both), the Commissioner may recharacterize the contract as a loan. In applying the substance over form principle, separate transactions may be integrated where appropriate. See also § 1.861–9T(b)(1).

(2) *Example.* The following example illustrates the provisions of this paragraph (f).

Example. (i) On January 1, 1990, X, a U.S. corporation with the dollar as its functional currency, enters into a contract with Y under which X will pay Y $100 and Y will pay X LC100 on January 1, 1990, and X will pay Y LC109.3 and Y will pay X $133 on December 31, 1992. On January 1, 1990, the spot exchange rate is LC1 = $1 and the 3 year forward rate is LC1 = $.8218. X's cash flows are summarized below:

Date	Dollar	LC
1/1/90	(100)	100
12/31/90	0	0
12/31/91	0	0
12/31/92	133	(109.3)

(ii) X and Y designate this contract as a ''currency swap.'' Notwithstanding this designation, for purposes of determining the timing, source, and character with respect to the transaction, the transaction is characterized by the Commissioner in accordance with its substance. Thus, the January 1, 1990, exchange by X of $100 for LC 100 is treated as a spot purchase of LCs by X and the December 31, 1992, exchange by X at 109.3LC for $133 is treated as a forward sale of LCs by X. Under such treatment there would be no tax consequences to X under paragraph (e)(2) of this section in 1990, 1991, and 1992 with respect to this transaction other than the realization of exchange gain or loss on the sale of the LC109.3 on December 31, 1992. Calculation of such gain or loss would be governed by the rules of paragraph (d) of this section.

(g) *Effective date.* Except as otherwise provided in this section, this section shall be effective for taxable years beginning after December 31, 1986. Thus, except as otherwise provided in this section, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section.

(h) *Timing of income and deductions from notional principal contracts.* Except as otherwise provided (e.g., in § 1.988–5 or 1.446–3(g)), income or loss from a notional principal contract described in § 1.988–1(a)(2)(iii)(B) (other than a currency swap) is exchange gain or loss. For the rules governing the timing of income and deductions with respect to notional principal contracts, see § 1.446–3. See paragraph (e)(2) of this section with respect to currency swaps.

[T.D. 8400, 57 FR 9183, Mar. 17, 1992, as amended by T.D. 8491, 58 FR 53135, Oct. 14, 1993]

§ 1.988–3 Character of exchange gain or loss.

(a) *In general.* The character of exchange gain or loss recognized on a section 988 transaction is governed by section 988 and this section. Except as otherwise provided in section 988(c)(1)(E), section 1092, § 1.988–5 and this section, exchange gain or loss realized with respect to a section 988 transaction (including a section 1256 contract that is also a section 988 transaction) shall be characterized as ordinary gain or loss. Accordingly, unless a valid election is made under paragraph (b) of this section, any section providing special rules for capital gain or loss treatment, such as sections 1233, 1234, 1234A, 1236 and 1256(f)(3), shall not apply.

(b) *Election to characterize exchange gain or loss on certain identified forward contracts, futures contracts and option contracts as capital gain or loss*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, a taxpayer may elect, subject to the requirements of paragraph (b)(3) of this section, to treat any gain or loss recognized on a contract described in § 1.988–2(d)(1) as capital gain or loss, but only if the contract—

(i) Is a capital asset in the hands of the taxpayer;

(ii) Is not part of a straddle within the meaning of section 1092(c) (without regard to subsections (c)(4) or (e)); and

(iii) Is not a regulated futures contract or nonequity option with respect to which an election under section 988(c)(1)(D)(ii) is in effect.

If a valid election under this paragraph (b) is made with respect to a section 1256 contract, section 1256 shall govern the character of any gain or loss recognized on such contract.

(2) *Special rule for contracts that become part of a straddle after an election is made.* If a contract which is the subject of an election under paragraph (b)(1) of this section becomes part of a straddle within the meaning of section 1092(c) (without regard to subsections (c)(4) or (e)) after the date of the election, the election shall be invalid with respect to gains from such contract and the Commissioner, in his sole discretion, may invalidate the election with respect to losses.

(3) *Requirements for making the election.* A taxpayer elects to treat gain or loss on a transaction described in paragraph (b)(1) of this section as capital gain or loss by clearly identifying such transaction on its books and records on the date the transaction is entered into. No specific language or account is necessary for identifying a transaction referred to in the preceding sentence. However, the method of identification must be consistently applied and must clearly identify the pertinent transaction as subject to the section 988(a)(1)(B) election. The Commissioner, in his sole discretion, may invalidate any purported election that does not comply with the preceding sentence.

(4) *Verification.* A taxpayer that has made an election under §1.988–3(b)(3) must attach to his income tax return a statement which sets forth the following:

(i) A description and the date of each election made by the taxpayer during the taxpayer's taxable year;

(ii) A statement that each election made during the taxable year was made before the close of the date the transaction was entered into;

(iii) A description of any contract for which an election was in effect and the date such contract expired or was otherwise sold or exchanged during the taxable year;

(iv) A statement that the contract was never part of a straddle as defined in section 1092; and

(v) A statement that all transactions subject to the election are included on the statement attached to the taxpayer's income tax return.

In addition to any penalty that may otherwise apply, the Commissioner, in his sole discretion, may invalidate any or all elections made during the taxable year under §1.988–3(b)(1) if the taxpayer fails to verify each election as provided in this §1.988–3(b)(4). The preceding sentence shall not apply if the taxpayer's failure to verify each election was due to reasonable cause or bona fide mistake. The burden of proof to show reasonable cause or bona fide mistake made in good faith is on the taxpayer.

(5) *Independent verification*—(i) *Effect of independent verification.* If the taxpayer receives independent verification of the election in paragraph (b)(3) of this section, the taxpayer shall be presumed to have satisfied the requirements of paragraphs (b)(3) and (4) of this section. A contract that is a part of a straddle as defined in section 1092 may not be independently verified and shall be subject to the rules of paragraph (b)(2) of this section.

(ii) *Requirements for independent verification.* A taxpayer receives independent verification of the election in paragraph (b)(3) of this section if—

(A) The taxpayer establishes a separate account(s) with an unrelated broker(s) or dealer(s) through which all transactions to be independently verified pursuant to this paragraph (b)(5) are conducted and reported.

(B) Only transactions entered into on or after the date the taxpayer establishes such account may be recorded in the account.

(C) Transactions subject to the election of paragraph (b)(3) of this section are entered into such account on the date such transactions are entered into.

(D) The broker or dealer provides the taxpayer a statement detailing the transactions conducted through such account and includes on such statement the following: ‘‘Each transaction identified in this account is subject to the election set forth in section 988(a)(1)(B).''

(iii) *Special effective date for independent verification.* The rules of this paragraph (b)(5) shall be effective for transactions entered into after March 17, 1992.

(6) *Effective date.* Except as otherwise provided, this paragraph (b) is effective for taxable years beginning on or after September 21, 1989. For prior taxable years, any reasonable contemporaneous election meeting the requirements of section 988(a)(1)(B) shall satisfy this paragraph (b).

(c) *Exchange gain or loss treated as interest*—(1) *In general.* Except as provided in this paragraph (c)(1), exchange gain or loss realized on a section 988 transaction shall not be treated as interest income or expense. Exchange gain or loss realized on a section 988 transaction shall be treated as interest income or expense as provided in paragraph (c)(2) of this section with regard to tax exempt bonds, § 1.988–2(e)(2)(ii)(B), § 1.988–5, and in administrative pronouncements. See § 1.861–9T(b), providing rules for the allocation of certain items of exchange gain or loss in the same manner as interest expense.

(2) *Exchange loss realized by the holder on nonfunctional currency tax exempt bonds.* Exchange loss realized by the holder of a debt instrument the interest on which is excluded from gross income under section 103(a) or any similar provision of law shall be treated as an offset to and reduce total interest income received or accrued with respect to such instrument. Therefore, to the extent of total interest income, no exchange loss shall be recognized. This paragraph (c)(2) shall be effective with respect to debt instruments acquired on or after June 24, 1987.

(d) *Effective date.* Except as otherwise provided in this section, this section shall be effective for taxable years beginning after December 31, 1986. Thus, except as otherwise provided in this section, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section. Thus, for example, a payment made prior to January 1, 1987, under a forward contract that results in the deferral of a loss under section 1092 to a taxable year beginning after December 31, 1986, is not characterized as an ordinary loss by virtue of paragraph (a) of this section because payment was made prior to January 1, 1987.

[T.D. 8400, 57 FR 9197, Mar. 17, 1992]

§ 1.988–4 Source of gain or loss realized on a section 988 transaction.

(a) *In general.* Except as otherwise provided in § 1.988–5 and this section, the source of exchange gain or loss shall be determined by reference to the residence of the taxpayer. This rule applies even if the taxpayer has made an election under § 1.988–3(b) to characterize exchange gain or loss as capital gain or loss. This section takes precedence over section 865.

(b) *Qualified business unit*—(1) *In general.* The source of exchange gain or loss shall be determined by reference to the residence of the qualified business unit of the taxpayer on whose books the asset, liability, or item of income or expense giving rise to such gain or loss is properly reflected.

(2) *Proper reflection on the books of the taxpayer or qualified business unit*—(i) *In general.* Whether an asset, liability, or item of income or expense is properly reflected on the books of a qualified business unit is a question of fact.

(ii) *Presumption if booking practices are inconsistent.* It shall be presumed that an asset, liability, or item of income or expense is not properly reflected on the books of the qualified business unit if the taxpayer and its qualified business units employ inconsistent booking practices with respect to the same or similar assets, liabilities, or items of income or expense. If not properly reflected on the books, the Commissioner may allocate any asset, liability, or item of income or expense between or among the taxpayer and its qualified business units to properly reflect the source (or realization) of exchange gain or loss.

(c) *Effectively connected exchange gain or loss.* Notwithstanding paragraphs (a) and (b) of this section, exchange gain or loss that under principles similar to those set forth in § 1.864–4(c) arises from the conduct of a United States trade or business shall be sourced in the United States and such gain or loss shall be treated as effectively connected to the conduct of a United States trade or business for purposes of sections 871(b) and 882 (a)(1).

(d) *Residence*—(1) *In general.* Except as otherwise provided in this paragraph (d), for purposes of sections 985 through 989, the residence of any person shall be—

(i) In the case of an individual, the country in which such individual's tax home (as defined in section 911(d)(3)) is located;

(ii) In the case of a corporation, partnership, trust or estate which is a United States person (as defined in section 7701(a)(30)), the United States; and

(iii) In the case of a corporation, partnership, trust or estate which is not a United States person, a country other than the United States.

If an individual does not have a tax home (as defined in section 911(d)(3)), the residence of such individual shall be the United States if such individual is a United States citizen or a resident alien and shall be a country other than the United States if such individual is not a United States citizen or resident alien. If the taxpayer is a U.S. person and has no principal place of business outside the United States, the residence of the taxpayer is the United States. Notwithstanding paragraph (d)(1)(ii) of this section, if a partnership is formed or availed of to avoid tax by altering the source of exchange gain or loss, the source of such gain or loss shall be determined by reference to the residence of the partners rather than the partnership.

(2) *Exception.* In the case of a qualified business unit of any taxpayer (including an individual), the residence of such unit shall be the country in which the principal place of business of such qualified business unit is located.

(3) *Partner in a partnership not engaged in a U.S. trade or business under section 864(b)(2).* The determination of residence shall be made at the partner level (without regard to whether the partnership is a qualified business unit of the partners) in the case of partners in a partnership that are not engaged in a U.S. trade or business by reason of section 864(b)(2).

(e) *Special rule for certain related party loans*—(1) *In general.* In the case of a loan by a United States person or a related person to a 10 percent owned foreign corporation, or a corporation that meets the 80 percent foreign business requirements test of section 861(c)(1), other than a corporation subject to §1.861–11T(e)(2)(i), which is denominated in, or determined by reference to, a currency other than the U.S. dollar and bears interest at a rate at least 10 percentage points higher than the Federal mid-term rate (as determined under section 1274(d)) at the time such loan is entered into, the following rules shall apply—

(i) For purposes of section 904 only, such loan shall be marked to market annually on the earlier of the last business day of the United States person's (or related person's) taxable year or the date the loan matures; and

(ii) Any interest income earned with respect to such loan for the taxable year shall be treated as income from sources within the United States to the extent of any notional loss attributable to such loan under paragraph (d)(1)(i) of this section.

(2) *United States person.* For purposes of this paragraph (e), the term ''United States person'' means a person described in section 7701(a)(30).

(3) *Loans by related foreign persons*—(i) *In general.* [Reserved]

(ii) *Definition of related person.* For purposes of this paragraph (e), the term ''related person'' has the meaning given such term by section 954(d)(3) except that such section shall be applied by substituting ''United States person'' for ''controlled foreign corporation'' each place such term appears.

(4) *10 percent owned foreign corporation.* For purposes of this paragraph (e), the term ''10 percent owned foreign corporation'' means any foreign corporation in which the United States person owns directly or indirectly (within the meaning of section 318(a)) at least 10 percent of the voting stock.

(f) *Exchange gain or loss treated as interest under §1.988–3.* Notwithstanding the provisions of this section, any gain or loss realized on a section 988 transaction that is treated as interest income or expense under §1.988–3(c)(1) shall be sourced or allocated and apportioned pursuant to section 861(a)(1), 862(a)(1), or 864(e) as the case may be.

(g) *Exchange gain or loss allocated in the same manner as interest under § 1.861–9T.* The allocation and apportionment of exchange gain or loss under § 1.861–9T shall not affect the source of exchange gain or loss for purposes of sections 871(a), 881, 1441, 1442 and 6049.

(h) *Effective date.* This section shall be effective for taxable years beginning after December 31, 1986. Thus, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section.

[T.D. 8400, 57 FR 9199, Mar. 17, 1992]

§ 1.988–5 Section 988(d) hedging transactions.

(a) *Integration of a nonfunctional currency debt instrument and a § 1.988–5(a) hedge*—(1) *In general.* This paragraph (a) applies to a qualified hedging transaction as defined in this paragraph (a)(1). A qualified hedging transaction is an integrated economic transaction, as provided in paragraph (a)(5) of this section, consisting of a qualifying debt instrument as defined in paragraph (a)(3) of this section and a § 1.988–5(a) hedge as defined in paragraph (a)(4) of this section. If a taxpayer enters into a transaction that is a qualified hedging transaction, no exchange gain or loss is recognized by the taxpayer on the qualifying debt instrument or on the § 1.988–5(a) hedge for the period that either is part of a qualified hedging transaction, and the transactions shall be integrated as provided in paragraph (a)(9) of this section. However, if the qualified hedging transaction results in a synthetic nonfunctional currency denominated debt instrument, such instrument shall be subject to the rules of § 1.988–2(b).

(2) *Exception.* This paragraph (a) does not apply with respect to a qualified hedging transaction that creates a synthetic asset or liability denominated in, or determined by reference to, a currency other than the U.S. dollar if the rate that approximates the Federal short-term rate in such currency is at least 20 percentage points higher than the Federal short term rate (determined under section 1274(d)) on the date the taxpayer identifies the transaction as a qualified hedging transaction.

(3) *Qualifying debt instrument*—(i) *In general.* A qualifying debt instrument is a debt instrument described in § 1.988–1(a)(2)(i), regardless of whether denominated in, or determined by reference to, nonfunctional currency (including dual currency debt instruments, multi-currency debt instruments and contingent payment debt instruments). A qualifying debt instrument does not include accounts payable, accounts receivable or similar items of expense or income.

(ii) *Special rule for debt instrument of which all payments are proportionately hedged.* If a debt instrument satisfies the requirements of paragraph (a)(3)(i) of this section, and all principal and interest payments under the instrument are hedged in the same proportion, then for purposes of this paragraph (a), that portion of the instrument that is hedged is eligible to be treated as a qualifying debt instrument, and the rules of this paragraph (a) shall apply separately to such qualifying debt instrument. See Example 8 in paragraph (a)(9)(iv) of this section.

(4) *Section 1.988–5(a) hedge*—(i) *In general.* A § 1.988–5(a) hedge (hereinafter referred to in this paragraph (a) as a ‘‘hedge’’) is a spot contract, futures contract, forward contract, option contract, notional principal contract, currency swap contract, similar financial instrument, or series or combination thereof, that when integrated with a qualifying debt instrument permits the calculation of a yield to maturity (under principles of section 1272) in the currency in which the synthetic debt instrument is denominated (as determined under paragraph (a)(9)(ii)(A) of this section).

(ii) *Retroactive application of definition of currency swap contract.* A taxpayer may apply the definition of currency swap contract set forth in § 1.988–2(e)(2)(ii) in lieu of the definition of swap agreement in section 2(e)(5) of Notice 87–11, 1987–1 C.B. 423 to transactions entered into after December 31, 1986 and before September 21, 1989.

(5) *Definition of integrated economic transaction.* A qualifying debt instrument and a hedge are an integrated

economic transaction if all of the following requirements are satisfied—

(i) All payments to be made or received under the qualifying debt instrument (or amounts determined by reference to a nonfunctional currency) are fully hedged on the date the taxpayer identifies the transaction under paragraph (a) of this section as a qualified hedging transaction such that a yield to maturity (under principles of section 1272) in the currency in which the synthetic debt instrument is denominated (as determined under paragraph (a)(9)(ii)(A) of this section) can be calculated. Any contingent payment features of the qualifying debt instrument must be fully offset by the hedge such that the synthetic debt instrument is not classified as a contingent payment debt instrument. See Examples 6 and 7 of paragraph (a)(9)(iv) of this section.

(ii) The hedge is identified in accordance with paragraph (a)(8) of this section on or before the date the acquisition of the financial instrument (or instruments) constituting the hedge is settled or closed.

(iii) None of the parties to the hedge are related. The term ‘‘related’’ means the relationships defined in section 267(b) or section 707(b).

(iv) In the case of a qualified business unit with a residence, as defined in section 988(a)(3)(B), outside of the United States, both the qualifying debt instrument and the hedge are properly reflected on the books of such qualified business unit throughout the term of the qualified hedging transaction.

(v) Subject to the limitations of paragraph (a)(5) of this section, both the qualifying debt instrument and the hedge are entered into by the same individual, partnership, trust, estate, or corporation. With respect to a corporation, the same corporation must enter into both the qualifying debt instrument and the hedge whether or not such corporation is a member of an affiliated group of corporations that files a consolidated return.

(vi) With respect to a foreign person engaged in a U.S. trade or business that enters into a qualifying debt instrument or hedge through such trade or business, all items of income and expense associated with the qualifying debt instrument and the hedge (other than interest expense that is subject to §1.882–5), would have been effectively connected with such U.S. trade or business throughout the term of the qualified hedging transaction had this paragraph (a) not applied.

(6) *Special rules for legging in and legging out of integrated treatment*—(i) *Legging in.* ‘‘Legging in’’ to integrated treatment under this paragraph (a) means that a hedge is entered into after the date the qualifying debt instrument is entered into or acquired, and the requirements of this paragraph (a) are satisfied on the date the hedge is entered into (‘‘leg in date’’). If a taxpayer legs into integrated treatment, the following rules shall apply—

(A) Exchange gain or loss shall be realized with respect to the qualifying debt instrument determined solely by reference to changes in exchange rates between—

(*1*) The date the instrument was acquired by the holder, or the date the obligor assumed the obligation to make payments under the instrument; and

(*2*) The leg in date.

(B) The recognition of such gain or loss will be deferred until the date the qualifying debt instrument matures or is otherwise disposed of.

(C) The source and character of such gain or loss shall be determined on the leg in date as if the qualifying debt instrument was actually sold or otherwise terminated by the taxpayer.

(ii) *Legging out.* With respect to a qualifying debt instrument and hedge that are properly identified as a qualified hedging transaction, ‘‘legging out’’ of integrated treatment under this paragraph (a) means that the taxpayer disposes of or otherwise terminates all or a part of the qualifying debt instrument or hedge prior to maturity of the qualified hedging transaction, or the taxpayer changes a material term of the qualifying debt instrument (*e.g.*, exercises an option to change the interest rate or index, or the maturity date) or hedge (*e.g.*, changes the interest or exchange rates underlying the hedge, or the expiration date) prior to maturity of the qualified hedging transaction. A taxpayer that disposes of or terminates a qualified hedging transaction (*i.e.,* disposes of or terminates both the qualifying transaction and the hedge on the same day) shall be considered to have disposed of or otherwise terminated the synthetic debt instrument rather than as legging out. If a taxpayer legs out of integrated treatment, the following rules shall apply—

(A) The transaction will be treated as a qualified hedging transaction during the time the requirements of this paragraph (a) were satisfied.

(B) If the hedge is disposed of or otherwise terminated, the qualifying debt instrument shall be treated as sold for its fair market value on the date the hedge is disposed of or otherwise terminated (the ''leg-out date''), and any gain or loss (including gain or loss resulting from factors other than movements in exchange rates) from the identification date to the leg-out date is realized and recognized on the leg-out date. The spot rate on the leg-out date shall be used to determine exchange gain or loss on the debt instrument for the period beginning on the leg-out date and ending on the date such instrument matures or is disposed of or otherwise terminated. Proper adjustment to the principal amount of the debt instrument must be made to reflect any gain or loss taken into account. The netting rule of § 1.988–2(b)(8) shall apply.

(C) If the qualifying debt instrument is disposed of or otherwise terminated, the hedge shall be treated as sold for its fair market value on the date the qualifying debt instrument is disposed of or otherwise terminated (the ''leg-out date''), and any gain or loss from the identification date to the leg-out date is realized and recognized on the leg-out date. The spot rate on the leg-out date shall be used to determine exchange gain or loss on the hedge for the period beginning on the leg-out date and ending on the date such hedge is disposed of or otherwise terminated.

(D) Except as provided in paragraph (a)(8)(iii) of this section (regarding identification by the Commissioner), that part of the qualified hedging transaction that has not been terminated (*i.e.,* the remaining debt instrument in its entirety even if partially hedged, or hedge) cannot be part of a qualified hedging transaction for any period subsequent to the leg out date.

(E) If a taxpayer legs out of a qualified hedging transaction and realizes a gain with respect to the terminated instrument, then paragraph (a)(6)(ii)(B) or (C) of this section, as appropriate, shall not apply if during the period beginning 30 days before the leg-out date and ending 30 days after that date the taxpayer enters into another transaction that hedges at least 50% of the remaining currency flow with respect to the qualifying debt instrument which was part of the qualified hedging transaction (or, if appropriate, an equivalent amount under the § 1.988–5 hedge which was part of the qualified hedging transaction).

(7) *Transactions part of a straddle.* At the discretion of the Commissioner, a transaction shall not satisfy the requirements of paragraph (a)(5) of this section if the debt instrument making up the qualified hedging transaction is part of a straddle as defined in section 1092(c) prior to the time the qualified hedging transaction is identified.

(8) *Identification requirements*—(i) *Identification by the taxpayer.* A taxpayer must establish a record and before the close of the date the hedge is entered into, the taxpayer must enter into the record for each qualified hedging transaction the following information—

(A) The date the qualifying debt instrument and hedge were entered into;

(B) The date the qualifying debt instrument and the hedge are identified as constituting a qualified hedging transaction;

(C) The amount that must be deferred, if any, under paragraph (a)(6) of this section and the source and character of such deferred amount;

(D) A description of the qualifying debt instrument and the hedge; and

(E) A summary of the cash flow resulting from treating the qualifying debt instrument and the hedge as a qualified hedging transaction.

(ii) *Identification by trustee on behalf of beneficiary.* A trustee of a trust that enters into a qualified hedging transaction may satisfy the identification requirements described in paragraph (a)(8)(i) of this section on behalf of a beneficiary of such trust.

(iii) *Identification by the Commissioner.* If—

(A) A taxpayer enters into a qualifying debt instrument and a hedge but fails to comply with one or more of the requirements of this paragraph (a), and

(B) On the basis of all the facts and circumstances, the Commissioner concludes that the qualifying debt instrument and the hedge are, in substance, a qualified hedging transaction,

then the Commissioner may treat the qualifying debt instrument and the hedge as a qualified hedging transaction. The Commissioner may identify a qualifying debt instrument and a hedge as a qualified hedging transaction regardless of whether the qualifying debt instrument and the hedge are held by the same taxpayer.

(9) *Taxation of qualified hedging transactions*—(i) *In general*—(A) *General rule.* If a transaction constitutes a qualified hedging transaction, the qualifying debt instrument and the hedge are integrated and treated as a single transaction with respect to the taxpayer that has entered into the qualified hedging transaction during the period that the transaction qualifies as a qualified hedging transaction. Neither the qualifying debt instrument nor the hedge that makes up the qualified hedging transaction shall be subject to section 263(g), 1092 or 1256 for the period such transactions are integrated. However, the qualified hedging transaction may be subject to section 263(g) or 1092 if such transaction is part of a straddle.

(B) *Special rule for income or expense of foreign persons effectively connected with a U.S. trade or business.* Interest income of a foreign person resulting from a qualified hedging transaction entered into by such foreign person that satisfies the requirements of paragraph (a)(5)(vii) of this section shall be treated as effectively connected with a U.S. trade or business. Interest expense of a foreign person resulting from a qualified hedging transaction entered into by such foreign person that satisfies the requirements of paragraph (a)(5)(vii) of this section shall be allocated and apportioned under §1.882–5 of the regulations.

(C) *Special rule for foreign persons that enter into qualified hedging transactions giving rise to U.S. source income not effectively connected with a U.S. trade or business.* If a foreign person enters into a qualified hedging transaction that gives rise to U.S. source interest income (determined under the source rules for synthetic asset transactions as provided in this section) not effectively connected with a U.S. trade or business of such foreign person, for purposes of sections 871(a), 881, 1441, 1442 and 6049, the provisions of this paragraph (a) shall not apply and such sections of the Internal Revenue Code shall be applied separately to the qualifying debt instrument and the hedge. To the extent relevant to any foreign person, if the requirements of this paragraph (a) are otherwise met, the provisions of this paragraph (a) shall apply for all other purposes of the Internal Revenue Code (*e.g.*, for purposes of calculating the earnings and profits of a controlled foreign corporation that enters into a qualified hedging transaction through a qualified business unit resident outside the United States, income or expense with respect to such qualified hedging transaction shall be calculated under the provisions of this paragraph (a)).

(ii) *Income tax effects of integration.* The effect of integrating and treating a transaction as a single transaction is to create a synthetic debt instrument for income tax purposes, which is subject to the original issue discount provisions of sections 1272 through 1288 and 163(e), the terms of which are determined as follows:

(A) *Denomination of synthetic debt instrument.* In the case where the qualifying debt instrument is a borrowing, the denomination of the synthetic debt instrument is the same as the currency paid under the terms of the hedge to acquire the currency used to make payments under the qualifying debt instrument. In the case where the qualifying debt instrument is a lending, the denomination of the synthetic debt instrument is the same as the currency received under the terms of the hedge in exchange for amounts received under the qualifying debt instrument. For example, if the hedge is a forward contract to acquire British pounds for dollars, and the qualifying debt instrument is a borrowing denominated in

British pounds, the synthetic debt instrument is considered a borrowing in dollars.

(B) *Term and accrual periods.* The term of the synthetic debt instrument shall be the period beginning on the identification date and ending on the date the qualifying debt instrument matures or such earlier date that the qualifying debt instrument or hedge is disposed of or otherwise terminated. Unless otherwise clearly indicated by the payment interval under the hedge, the accrual period shall be a six month period which ends on the dates determined under section 1272(a)(5).

(C) *Issue price.* The issue price of the synthetic debt instrument is the adjusted issue price of the qualifying debt instrument translated into the currency in which the synthetic debt instrument is denominated at the spot rate on the identification date.

(D) *Stated redemption price at maturity.* In the case where the qualifying debt instrument is a borrowing, the stated redemption price at maturity shall be determined under section 1273(a)(2) on the identification date by reference to the amounts to be paid under the hedge to acquire the currency necessary to make interest and principal payments on the qualifying debt instrument. In the case where the qualifying debt instrument is a lending, the stated redemption price at maturity shall be determined under section 1273(a)(2) on the identification date by reference to the amounts to be received under the hedge in exchange for the interest and principal payments received pursuant to the terms of the qualifying debt instrument.

(iii) *Source of interest income and allocation of expense.* Interest income from a synthetic debt instrument described in paragraph (a)(9)(ii) of this section shall be sourced by reference to the source of income under sections 861 (a)(1) and 862(a)(1) of the qualifying debt instrument. The character for purposes of section 904 of interest income from a synthetic debt instrument shall be determined by reference to the character of the interest income from qualifying debt instrument. Interest expense from a synthetic debt instrument described in paragraph (a)(9)(ii) of this section shall be allocated and apportioned under §§ 1.861–8T through 1.861–12T or the successor sections thereof or under § 1.882–5.

(iv) *Examples.* The following examples illustrate the application of this paragraph (a)(9).

Example 1. (i) K is a U.S. corporation with the U.S. dollar as its functional currency. On December 24, 1989, K agrees to close the following transaction on December 31, 1989. K will borrow from an unrelated party on December 31, 1989, 100 British pounds (£) for 3 years at a 10 percent rate of interest, payable annually, with no principal payment due until the final installment. K will also enter into a currency swap contract with an unrelated counterparty under the terms of which—

(a) K will swap, on December 31, 1989, the £100 obtained from the borrowing for $100; and

(b) K will exchange dollars for pounds pursuant to the following table in order to obtain the pounds necessary to make payments on the pound borrowing:

Date	U.S. dollars	Pounds
December 31, 1990	8	10
December 31, 1991	8	10
December 31, 1992	108	110

(ii) The interest rate on the borrowing is set and the exchange rates on the swap are fixed on December 24, 1989. On December 31, 1989, K borrows the £100 and swaps such pounds for $100. Assume x has satisfied the identification requirements of paragraph (a)(8) of this section.

(iii) The pound borrowing (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, the pound borrowing and the swap are integrated and treated as one transaction with the following consequences:

(A) The integration of the pound borrowing and the swap results in a synthetic dollar borrowing with an issue price of $100 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar borrowing is equal to the dollar payments made by K under the currency swap contract (i.e., $8 in 1990, $8 in 1991, and $108 in 1992).

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is $100. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar borrowing.

(D) K may deduct the annual interest payments of $8 under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. K has also paid $100 as a return of principal in 1992.

(E) K must allocate and apportion its interest expense with respect to the synthetic dollar borrowing under the rules of §§ 1.861–8T through 1.861–12T.

Example 2. (i) K, a U.S. corporation, has the U.S. dollar as its functional currency. On December 24, 1989, when the spot rate for Swiss francs (Sf) is Sf1 = $1, K enters into a forward contract to purchase Sf100 in exchange for $100.04 for delivery on December 31, 1989. The Sf100 are to be used for the purchase of a franc denominated debt instrument on December 31, 1989. The instrument will have a term of 3 years, an issue price of Sf100, and will bear interest at 6 percent, payable annually, with no repayment of principal until the final installment. On December 24, 1989, K also enters into a series of forward contracts to sell the franc interest and principal payments that will be received under the terms of the franc denominated debt instrument for dollars according to the following schedule:

Date	U.S. dollars	Francs
December 31, 1990	6.12	6
December 31, 1991	6.23	6
December 31, 1992	112.16	106

(ii) On December 31, 1989, K takes delivery of the Sf100 and purchases the franc denominated debt instrument. Assume K satisfies the identification requirements of paragraph (a)(8) of this section. The purchase of the franc debt instrument (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the series of forward contracts (which constitute a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction under paragraph (a)(1) of this section. Accordingly, the franc debt instrument and all the forward contracts are integrated and treated as one transaction with the following consequences:

(A) The integration of the franc debt instrument and the forward contracts results in a synthetic dollar debt instrument in an amount equal to the dollars exchanged under the forward contract to purchase the francs necessary to acquire the franc debt instrument. Accordingly, the issue price is $100.04 (section 1273(b)(2) of the Code).

(B) The total amount of interest and principal received by K with respect to the synthetic dollar debt instrument is equal to the dollars received under the forward sales contracts (i.e., $6.12 in 1990, $6.23 in 1991, and $112.16 in 1992).

(C) The synthetic dollar debt instrument is an installment obligation and its stated redemption price at maturity is $106.15 (i.e., $6.12 of the payments in 1990, 1991, and 1992 are treated as periodic interest payments under the principles of section 1273). Because the stated redemption price at maturity exceeds the issue price, under section 1273(a)(1) the synthetic dollar debt instrument has OID of $6.11.

(D) The yield to maturity of the synthetic dollar debt instrument is 8.00 percent, compounded annually. Assuming K is a calendar year taxpayer, it must include interest income of $8.00 in 1990 (of which $1.88 constitutes OID), $8.15 in 1991 (of which $2.03 constitutes OID), and $8.32 in 1992 (of which $2.20 constitutes OID). The amount of the final payment received by K in excess of the interest income includible is a return of principal and a payment of previously accrued OID.

(E) The source of the interest income shall be determined by applying sections 861(a)(1) and 862(a)(1) with reference to the franc interest income that would have been received had the transaction not been integrated.

Example 3. (i) K is an accrual method U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1992, K borrows 100 British pounds (£) for 3 years at a 10% rate of interest payable on December 31 of each year with no principal payment due until the final installment. The spot rate on January 1, 1992, is £1 = $1.50. On January 1, 1993, when the spot rate is £1 = $1.60, K enters into a currency swap contract with an unrelated counterparty under the terms of which K will exchange dollars for pounds pursuant to the following table in order to obtain the pounds necessary to make the remaining payments on the pound borrowing:

Date	U.S. dollars	Pounds
December 31, 1993	12.80	10
December 31, 1994	12.80	10
December 31, 1994	160.00	100

(ii) Assume that British pound interest rates are still 10% and that K properly identifies the pound borrowing and the currency swap contract as a qualified hedging transaction as provided in paragraph (a)(8) of this section. Under paragraph (a)(6)(i) of this section, K must realize exchange gain or loss with respect to the pound borrowing determined solely by reference to changes in exchange rates between January 1, 1992 and January 1, 1993. (Thus, gain or loss from other factors such as movements in interest rates or changes in credit quality of K are not taken into account). Recognition of such gain or loss is deferred until K terminates its pound borrowing. Accordingly, K must defer exchange loss in the amount of $10 [(£100×1.50) − (£100×1.60)].

(iii) Additionally, the qualified hedging transaction is treated as a synthetic U.S. dollar debt instrument with an issue date of January 1, 1993, and a maturity date of December 31, 1994. The issue price of the synthetic debt instrument is $160 (£100×1.60, the spot rate on January 1, 1993) and the total amount of interest and principal is $185.60. The accrual period is the one year period beginning on January 1 and ending December 31 of each year. The stated redemption price at maturity is $160. Thus, K is treated as paying $12.80 of interest in 1993, $12.80 of interest in 1994, and $160 of principal in 1994. The interest expense from the synthetic instrument is allocated and apportioned in accordance with the rules of §§ 1.861–8T through 1.861–12T. Sections 263(g), 1092, and 1256 do not apply to the positions comprising the synthetic dollar borrowing.

Example 4. (i) K is an accrual method U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1990, K borrows 100 British pounds (£) for 3 years at a 10% rate of interest payable on December 31 of each year with no principal payment due until the final installment. The spot rate on January 1, 1990, is £1 = $1.50. Also on January 1, 1990, K enters into a currency swap contract with an unrelated counterparty under the terms of which K will exchange dollars for pounds pursuant to the following table in order to obtain the pounds necessary to make the remaining payments on the pound borrowing:

Date	U.S. dollars	Pounds
December 31, 1990	12.00	10
December 31, 1991	12.00	10
December 31, 1992	162.00	110

(ii) Assume that K properly identifies the pound borrowing and the currency swap contract as a qualified hedging transaction as provided in paragraph (a)(1) of this section.

(iii) The pound borrowing (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, the pound borrowing and the swap are integrated and treated as one transaction with the following consequences:

(A) The integration of the pound borrowing and the swap results in a synthetic dollar borrowing with an issue price of $150 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar borrowing is equal to the dollar payments made by K under the currency swap contract (i.e., $12 in 1990, $12 in 1991, and $162 in 1992).

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is $150. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar borrowing.

(D) K may deduct the annual interest payments of $12 under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. K has also paid $150 as a return of principal in 1992.

(E) K must allocate and apportion its interest expense from the synthetic instrument under the rules of §§ 1.861–8T through 1.861–12T.

(iv) Assume that on January 1, 1991, the spot exchange rate is £1 = $1.60, interest rates have not changed since January 1, 1990, (accordingly, assume that the market value of K's bond in pounds has not changed) and that K transfers its rights and obligations under the currency swap contract in exchange for $10. Under § 1.988–2(e)(3)(iii), K will include in income as exchange gain $10 on January 1, 1991. Pursuant to paragraph (a)(6)(ii) of this section, the pound borrowing and the currency swap contract are treated as a qualified hedging transaction for 1990. The loss inherent in the pound borrowing from January 1, 1990, to January 1, 1991, is realized and recognized on January 1, 1991. Such loss is exchange loss in the amount of $10.00 [(£100×$1.50, the spot rate on January 1, 1990)—(£100×$1.60, the spot rate on January 1, 1991)]. For purposes of determining exchange gain or loss on the £100 principal amount of the debt instrument for the period January 1, 1991, to December 31, 1992, the spot rate on January 1, 1991 is used rather than the spot rate on the issue date. Thus, assuming that the spot rate on December 31, 1992, the maturity date, is £1 = $1.80, K realizes exchange loss in the amount of $20 [(£100×$1.60) − (£100×$1.80)]. Except as provided in paragraph (a)(8)(iii) (regarding identification by the Commissioner), the pound borrowing cannot be part of a qualified hedging transaction for any period subsequent to the leg out date.

Example 5. (i) K, a U.S. corporation, has the U.S. dollar as its functional currency. On January 1, 1990, when the spot rate for Swiss francs (Sf) is Sf1 = $.50, K converts $100 to Sf200 and purchases a franc denominated debt instrument. The instrument has a term of 3 years, an adjusted issue price of Sf200, and will bear interest at 5 percent, payable annually, with no repayment of principal until the final installment. The U.S. dollar interest rate on an equivalent instrument is 8% on January 1, 1990, compounded annually. On January 1, 1990, K also enters into a series of forward contracts to sell the franc interest and principal payments that will be received under the terms of the franc denominated debt instrument for dollars according to the following schedule:

Date	U.S. dollars	Francs
December 31, 1990	5.14	10
December 31, 1991	5.29	10
December 31, 1992	114.26	210

(ii) Assume K satisfies the identification requirements of paragraph (a)(8) of this section. Assume further that on January 1, 1991, the spot exchange rate is Sf1 = U.S.$.5143, the U.S. dollar interest rate is 10%, compounded annually, and the Swiss franc interest rate is the same as on January 1, 1990 (5%, compounded annually). On January 1, 1991, K disposes of the forward contracts that were to mature on December 31, 1991, and December 31, 1992 and incurs a loss of $3.62 (the present value of $.10 with respect to the 1991 contract and $4.27 with respect to the 1992 contract).

(iii) The purchase of the franc debt instrument (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the series of forward contracts (which constitute a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction under paragraph (a)(1) of this section. Accordingly, the franc debt instrument and all the forward contracts are integrated for the period beginning January 1, 1990, and ending January 1, 1991.

(A) The integration of the franc debt instrument and the forward contracts results in a synthetic dollar debt instrument with an issue price of $100.

(B) The total amount of interest and principal to be received by K with respect to the synthetic dollar debt instrument is equal to the dollars to be received under the forward sales contracts (i.e., $5.14 in 1990, $5.29 in 1991, and $114.26 in 1992).

(C) The synthetic dollar debt instrument is an installment obligation and its stated redemption price at maturity is $109.27 (i.e., $5.14 of the payments in 1990, 1991, and 1992 is treated as periodic interest payments under the principles of section 1273). Because the stated redemption price at maturity exceeds the issue price, under section 1273(a)(1) the synthetic dollar debt instrument has OID of $9.27.

(D) The yield to maturity of the synthetic dollar debt instrument is 8.00 percent, compounded annually. Assuming K is a calendar year taxpayer, it must include interest income of $8.00 in 1990 (of which $2.86 constitutes OID).

(E) The source of the interest income is determined by applying sections 861(a)(1) and 862(a)(1) with reference to the franc interest income that would have been received had the transaction not been integrated.

(iv) Because K disposed of the forward contracts on January 1, 1991, the rules of paragraph (a)(6)(ii) of this section shall apply. Accordingly, the $3.62 loss from the disposition of the forward contracts is realized and recognized on January 1, 1991. Additionally, K is deemed to have sold the franc debt instrument for $102.86, its fair market value in dollars on January 1, 1991. K will compute gain or loss with respect to the deemed sale of the franc debt instrument by subtracting its adjusted basis in the instrument ($102.86—the value of the Sf200 issue price at the spot rate on the identification date plus $2.86 of original issue discount accrued on the synthetic dollar debt instrument for 1990) from the amount realized on the deemed sale of $102.86. Thus K realizes and recognizes no gain or loss from the deemed sale of the debt instrument. The dollar amount used to determine exchange gain or loss with respect to the franc debt instrument is the Sf200 issue price on January 1, 1991, translated into dollars at the spot rate on January 1, 1991, of Sf1 = U.S.$.5143. Except as provided in paragraph (a)(8)(iii) of this section (regarding identification by the Commissioner), the franc borrowing cannot be part of a qualified hedging transaction for any period subsequent to the leg out date.

Example 6. (i) K is a U.S. corporation with the dollar as its functional currency. On January 1, 1992, K issues a debt instrument with the following terms: the issue price is $1,000, the instrument pays interest annually at a rate of 8% on the $1,000 principal amount, the instrument matures on December 31, 1996, and the amount paid at maturity is the greater of zero or $2,000 less the U.S. dollar value (determined on December 31, 1996) of 150,000 Japanese yen.

(ii) Also on January 1, 1992, K enters into the following hedges with respect to the instrument described in the preceding paragraph: a forward contract under which K will sell 150,000 yen for $1,000 on December 31, 1996 (note that this forward rate assumes that interest rates in yen and dollars are equal); and an option contract that expires on December 31, 1996, under which K has the right (but not the obligation) to acquire 150,000 yen for $2,000. K will pay for the option by making payments to the writer of the option equal to $5 each December 31 from 1992 through 1996.

(iii) The net economic effect of these transactions is that K has created a liability with a principal amount and amount paid at maturity of $1,000, with an interest cost of 8.5% (8% on debt instrument, 0.5% option price) compounded annually. For example, if on December 31, 1996, the spot exchange rate is $1 = 100 yen, K pays $500 on the bond [$2,000 − (150,000 yen/$100)], and $500 in satisfaction of the forward contract [$1,000 − (150,000 yen/$100)]. If instead the spot exchange rate on December 31, 1996 is $1 = 200 yen, K pays $1,250 on the bond [$2,000 − (150,000 yen/$200)] and K receives $250 in satisfaction of the forward contract [$1,000 − (150,000 yen/$200)]. Finally, if the spot exchange rate on December 31, 1996 is $1 = 50 yen, K pays $0 on the bond [$2,000 − (150,000 yen/$50), but the bond holder is not required under the terms of the instrument to pay additional principal]; K exercises the option to buy 150,000 yen for $2,000; and K then delivers the 150,000 yen as required by the forward contract in exchange for $1,000.

(iv) Assume K satisfies the identification requirements of paragraph (a)(8) of this section. The debt instrument described in paragraph (i) of this *Example 6* (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the forward contract and option contract described in paragraph (ii) of this example (which constitute a hedge under paragraph (a)(4) of this section and are collectively referred to hereafter as ''the contracts'') together are a qualified hedging transaction under paragraph (a)(1) of this section. Accordingly, with respect to K, the debt instrument and the contracts are integrated, resulting in a synthetic dollar debt instrument with an issue price of $1000, a stated redemption price at maturity of $1000 and a yield to maturity of 8.5% compounded annually (with no original issue discount). K must allocate and apportion its annual interest expense of $85 under the rules of §§ 1.861–8T through 1.861–12T.

Example 7. (i) R is a U.S. corporation with the dollar as its functional currency. On January 1, 1995, R issues a debt instrument with the following terms: the issue price is 504 British pounds (£), the instrument pays interest at a rate of 3.7% (compounded semi-annually) on the £504 principal amount, the instrument matures on December 31, 1999, with a repayment at maturity of the £504 principal plus the proportional gain, if any, in the ''Financial Times'' 100 Stock Exchange (FTSE) index (determined by the excess of the value of the FTSE index on the maturity date over the value of the FTSE on the issue date, divided by the value of the FTSE index on the issue date, multiplied by the number of FTSE index contracts that could be purchased on the issue date for £504).

(ii) Also on January 1, 1995, R enters into a contract with a bank under which on January 1, 1995, R will swap the £504 for $1,000 (at the current spot rate). R will make U.S. dollar payments to the bank equal to 8.15% on the notional principal amount of $1,000 (compounded semi-annually) for the period beginning January 1, 1995 and ending December 31, 1999. R will receive pound payments from the bank equal to 3.7% on the notional principal amount of £504 (compounded semi-annually) for the period beginning January 1, 1995 and ending December 31, 1999. On December 31, 1999, R will swap with the bank $1,000 for £504 plus the proportional gain, if any, in the FTSE index (computed as provided above).

(iii) Economically, both the indexed debt instrument and the hedging contract are hybrid instruments with the following components. The indexed debt instrument is composed of a par pound debt instrument that is assumed to have a 10.85% coupon (compounded semi-annually) plus an embedded FTSE equity index option for which the investor pays a premium of 7.15% (amortized semi-annually) on the pound principal amount. The combined effect is that the premium paid by the investor partially offsets the coupon payments resulting in a return of 3.7% (10.85% − 7.15%). Similarly, the dollar payments under the hedging contract to be made by R are computed by multiplying the dollar notional principal amount by an 8.00% rate (compounded semi-annually) which the facts assume would be the rate paid on a conventional currency swap plus a premium of 0.15% (amortized semi-annually) on the dollar notional principal amount for an embedded FTSE equity index option.

(iv) Assume R satisfies the identification requirements of paragraph (a)(8) of this section. The indexed debt instrument described in paragraph (i) of this *Example 7* constitutes a qualifying debt instrument under paragraph (a)(3) of this section. The hedging contract described in paragraph (ii) of this *Example 7* constitutes a hedge under paragraph (a)(4) of this section. Since both the pound exposure of the indexed debt instrument and the exposure to movements of the FTSE embedded in the indexed debt instrument are hedged such that a yield to maturity can be determined in dollars, the transaction satisfies the requirement of paragraph (a)(5)(i) of this section. Assuming the transactions satisfy the other requirements of paragraph (a)(5) of this section, the indexed debt instrument and hedge are a qualified hedging transaction under paragraph (a)(1) of this section. Accordingly, with respect to R, the debt instrument and the contracts are integrated, resulting in a synthetic dollar debt instrument with an issue price of $1000, a stated redemption price at maturity of $1000 and a yield to maturity of 8.15% compounded semi-annually (with no original issue discount). K must allocate and apportion its interest expense from the synthetic instrument under the rules §§ 1.861–8T through 1.861–12T.

Example 8. (i) K is a U.S. corporation with the U.S. dollar as its functional currency. On December 24, 1992, K agrees to close the following transaction on December 31, 1992. K will borrow from an unrelated party on December 31, 1992, 200 British pounds (£) for 3 years at a 10 percent rate of interest, payable annually, with no principal payment due until the final installment. K will also enter into a currency swap contract with an unrelated counterparty under the terms of which—

(A) K will swap, on December 31, 1992, £100 obtained from the borrowing for $100; and

(B) K will exchange dollars for pounds pursuant to the following table:

Date	U.S. dollars	Pounds
December 31, 1993	8	10
December 31, 1994	8	10
December 31, 1995	108	110

(ii) The interest rate on the borrowing is set and the exchange rates on the swap are fixed on December 24, 1992. On December 31, 1992, K borrows the £200 and swaps £100 for $100. Assume K has satisfied the identification requirements of paragraph (a)(8) of this section.

(iii) The £200 debt instrument satisfies the requirements of paragraph (a)(3)(i) of this section. Because all principal and interest payments under the instrument are hedged in the same proportion (50% of all interest and principal payments are hedged), 50% of the payments under the £200 instrument (principal amount of £100 and annual interest of £10) are treated as a qualifying debt instrument for purposes of paragraph (a) of this section. Thus, the distinct £100 borrowing and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, £100 of the pound borrowing and the swap are integrated and treated as one synthetic dollar transaction with the following consequences:

(A) The integration of £100 of the pound borrowing and the swap results in a synthetic dollar borrowing with an issue price of $100 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar borrowing is equal to the dollar payments made by K under the currency swap contract (i.e., $8 in 1993, $8 in 1994, and $108 in 1995).

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is $100. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar borrowing.

(D) K may deduct the annual interest payments of $8 under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. K has also paid $100 as a return of principal in 1995.

(E) K must allocate and apportion its interest expense from the synthetic instrument under the rules of §§1.861–8T through 1.861–12T.

That portion of the £200 pound debt instrument that is not hedged (*i.e.*, £100) is treated as a separate debt instrument subject to the rules of §1.988–2 (b) and §§1.861–8T through 1.861–12T.

Example 9. (i) K is an accrual method U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1992, K borrows 100 British pounds (£) for 3 years at a 10% rate of interest payable on December 31 of each year with no principal payment due until the final installment. On the same day, K enters into a currency swap agreement with an unrelated bank under which K agrees to the following:

(A) On January 1, 1992, K will exchange the £100 borrowed for $150.

(B) For the period beginning January 1, 1992 and ending December 31, 1994, K will pay at the end of each month an amount determined by multiplying $150 by one month LIBOR less 65 basis points and receive from the bank on December 31st of 1992, 1993, and 1994, £10.

(C) On December 31, 1994, K will exchange $150 for £100.

Assume K satisfies the identification requirements of paragraph (a)(8) of this section.

(ii) The pound borrowing (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, the pound borrowing and the swap are integrated and treated as one transaction with the following consequences:

(A) The integration of the pound borrowing and the swap results in a synthetic dollar borrowing with an issue price of $150 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar borrowing is equal to the dollar payments made by K under the currency swap contract.

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is $150. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar borrowing.

(D) K may deduct the monthly variable interest payments under section 163(a) (subject to any limitations on deductibility imposed by other provisions of the Code) according to its regular method of accounting. K has also paid $150 as a return of principal in 1994.

(E) K must allocate and apportion its interest expense from the synthetic instrument under the rules of §§1.861–8T through 1.861–12T.

Example 10. (i) K is an accrual method U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1992, K loans 100 British pounds (£) for 3 years at a 10% rate of interest payable on December 31 of each year with no principal payment due until the final installment. The spot rate on January 1, 1992, is £1 = $1.50. Also on January 1, 1992, K enters into a currency swap contract with an unrelated counterparty under the terms of which K will exchange pounds for dollars pursuant to the following table:

Date	Pounds	Dollars
December 31, 1992	10	12
December 31, 1993	10	12
December 31, 1994	110	162

(ii) Assume that K properly identifies the pound borrowing and the currency swap contract as a qualified hedging transaction as provided in paragraph (a)(1) of this section.

(iii) The pound loan (which constitutes a qualifying debt instrument under paragraph (a)(3) of this section) and the currency swap contract (which constitutes a hedge under paragraph (a)(4) of this section) are a qualified hedging transaction as defined in paragraph (a)(1) of this section. Accordingly, the pound loan and the swap are integrated and treated as one transaction with the following consequences:

(A) The integration of the pound loan and the swap results in a synthetic dollar loan with an issue price of $150 under section 1273(b)(2).

(B) The total amount of interest and principal of the synthetic dollar loan is equal to the dollar payments received by K under the currency swap contract (i.e., $12 in 1992, $12 in 1993, and $162 in 1994).

(C) The stated redemption price at maturity (defined in section 1273(a)(2)) is $150. Because the stated redemption price equals the issue price, there is no OID on the synthetic dollar loan.

(D) K must include in income as interest $12 in 1992, 1993, and 1994.

(E) The source of the interest income shall be determined by applying sections 861(a)(1) and 862(a)(1) with reference to the pound interest income that would have been received had the transaction not been integrated.

(iv) On January 1, 1993, K transfers both the pound loan and the currency swap to B, its wholly owned U.S. subsidiary, in exchange for B stock in a transfer that satisfies the requirements of section 351. Under paragraph (a)(6) of this section, the transfer of both instruments is not ‘‘legging out.’’ Rather, K is considered to have transferred the synthetic dollar loan to B in a transaction in which gain or loss is not recognized. B’s basis in the loan under section 362 is $100.

(10) *Transition rules and effective dates for certain provisions*—(i) *Coordination with Notice 87–11.* Any transaction entered into prior to September 21, 1989, which satisfied the requirements of Notice 87–11, 1987–1 C.B. 423, shall be deemed to satisfy the requirements of paragraph (a) of this section.

(ii) *Prospective application to contingent payment debt instruments.* In the case of a contingent payment debt instrument, the definition of qualifying debt instrument set forth in paragraph (a)(3)(i) of this section applies to transactions entered into after March 17, 1992.

(iii) *Prospective application of partial hedging rule.* Paragraph (a)(3)(ii) of this section is effective for transactions entered into after March 17, 1992.

(iv) *Effective date for paragraph (a)(6)(i) of this section.* The rules of paragraph (a)(6)(i) of this section are effective for qualified hedging transactions that are legged into after March 17, 1992.

(b) *Hedged executory contracts*—(1) *In general.* If the taxpayer enters into a hedged executory contract as defined in paragraph (b)(2) of this section, the executory contract and the hedge shall be integrated as provided in paragraph (b)(4) of this section.

(2) *Definitions*—(i) *Hedged executory contract.* A hedged executory contract is an executory contract as defined in paragraph (b)(2)(ii) of this section that is the subject of a hedge as defined in paragraph (b)(2)(iii) of this section, provided that the following requirements are satisfied—

(A) The executory contract and the hedge are identified as a hedged executory contract as provided in paragraph (b)(3) of this section.

(B) The hedge is entered into (*i.e.*, settled or closed, or in the case of nonfunctional currency deposited in an account with a bank or other financial institution, such currency is acquired and deposited) on or after the date the executory contract is entered into and before the accrual date as defined in paragraph (b)(2)(iv) of this section.

(C) The executory contract is hedged in whole or in part throughout the period beginning with the date the hedge is identified in accordance with paragraph (b)(3) of this section and ending on or after the accrual date.

(D) None of the parties to the hedge are related. The term related means the relationships defined in section 267(b) and section 707(c)(1).

(E) In the case of a qualified business unit with a residence, as defined in section 988(a)(3)(B), outside of the United States, both the executory contract and the hedge are properly reflected on the books of the same qualified business unit.

(F) Subject to the limitations of paragraph (b)(2)(i)(E) of this section, both the executory contract and the hedge are entered into by the same individual, partnership, trust, estate, or corporation. With respect to a corporation, the same corporation must enter into both the executory contract and the hedge whether or not such corporation is a member of an affiliated group of corporations that files a consolidated return.

(G) With respect to a foreign person engaged in a U.S. trade or business that enters into an executory contract or hedge through such trade or business, all items of income and expense associated with the executory contract and the hedge would have been effectively connected with such U.S. trade or business throughout the term of the hedged executory contract had this paragraph (b) not applied.

(ii) *Executory contract*—(A) *In general.* Except as provided in paragraph (b)(2)(ii)(B) of this section, an executory contract is an agreement entered into before the accrual date to pay nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the purchase of property used in the ordinary course of the taxpayer's business, or the acquisition of a service (or services), in the future, or to receive nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the sale of property used or held for sale in the ordinary course of the taxpayer's business, or the performance of a service (or services), in the future. Notwithstanding the preceding sentence, a contract to buy or sell stock shall be considered an executory contract. (Thus, for example, a contract to sell stock of an affiliate is an executory contract for this purpose.) On the accrual date, such agreement ceases to be considered an executory contract and is treated as an account payable or receivable.

(B) *Exceptions.* An executory contract does not include a section 988 transaction. For example, a forward contract to purchase nonfunctional currency is not an executory contract. An executory contract also does not include a transaction described in paragraph (c) of this section.

(C) *Effective date for contracts to buy or sell stock.* That part of paragraph (b)(2)(ii)(A) of this section which provides that a contract to buy or sell stock shall be considered an executory contract applies to contracts to buy or sell stock entered into on or after March 17, 1992.

(iii) *Hedge*—(A) *In general.* For purposes of this paragraph (b), the term hedge means a deposit of nonfunctional currency in a hedging account (as defined paragraph (b)(3)(iii)(D) of this section), a forward or futures contract described in §1.988–1(a)(1)(ii) and (2)(iii), or combination thereof, which reduces the risk of exchange rate fluctuations by reference to the taxpayer's functional currency with respect to nonfunctional currency payments made or received under an executory contract. The term hedge also includes an option contract described in §1.988–1(a)(1)(ii) and (2)(iii), but only if the option's expiration date is on or before the accrual date. The premium paid for an option that lapses shall be integrated with the executory contract.

(B) *Special rule for series of hedges.* A series of hedges as defined in paragraph (b)(3)(iii)(A) of this section shall be considered a hedge if the executory contract is hedged in whole or in part throughout the period beginning with the date the hedge is identified in accordance with paragraph (b)(3)(i) of this section and ending on or after the accrual date. A taxpayer that enters into a series of hedges will be deemed to have satisfied the preceding sentence if the hedge that succeeds a hedge that has been terminated is entered into no later than the business day following such termination.

(C) *Special rules for historical rate rollovers*—(*1*) *Definition.* A historical rate rollover is an extension of the maturity date of a forward contract where the new forward rate is adjusted on the rollover date to reflect the taxpayer's gain or loss on the contract as of the rollover date plus the time value of such gain or loss through the new maturity date.

(*2*) *Certain historical rate rollovers considered a hedge.* A historical rate rollover is considered a hedge if the rollover date is before the accrual date.

(*3*) *Treatment of time value component of certain historical rate rollovers that are hedges.* Interest income or expense determined under §1.988–2(d)(2)(v) with respect to a historical rate rollover shall be considered part of a hedge if the period beginning on the first date a hedging contract is rolled over and ending on the date payment is made or received under the executory contract does not exceed 183 days. Such interest income or expense shall not be recognized and shall be an adjustment to the income from, or expense of, the services performed or received under the executory contract, or to the amount realized or basis of the property sold or purchased under the executory contract. For the treatment of such interest income or expense that is not considered part of a hedge, see § 1.988–2(d)(2)(v).

(D) *Special rules regarding deposits of nonfunctional currency in a hedging account.* A hedging account is an account with a bank or other financial institution used exclusively for deposits of nonfunctional currency used to hedge executory contracts. For purposes of determining the basis of units in such account that comprise the hedge, only those units in the account as of the accrual date shall be taken into consideration. A taxpayer may adopt any reasonable convention (consistently applied to all hedging accounts) to determine which units comprise the hedge as of the accrual date and the basis of the units as of such date.

(E) *Interest income on deposit of nonfunctional currency in a hedging account.* Interest income on a deposit of nonfunctional currency in a hedging account may be taken into account for purposes of determining the amount of a hedge if such interest is accrued on or before the accrual date. However, such interest income shall be included in income as provided in section 61. For example, if a taxpayer with the dollar as its functional currency enters into an executory contract for the purchase and delivery of a machine in one year for 100 British pounds (£), and on such date deposits £90.91 in a properly identified bank account that bears interest at the rate of 10%, the interest that accrues prior to the accrual date shall be included in income and may be considered a hedge.

(iv) *Accrual date.* The accrual date is the date when the item of income or expense (including a capital expenditure) that relates to an executory contract is required to be accrued under the taxpayer's method of accounting.

(v) *Payment date.* The payment date is the date when payment is made or received with respect to an executory contract or the subsequent corresponding account payable or receivable.

(3) *Identification rules*—(i) *Identification by the taxpayer.* A taxpayer must establish a record and before the close of the date the hedge is entered into, the taxpayer must enter into the record a clear description of the executory contract and the hedge and indicate that the transaction is being identified in accordance with paragraph (b)(3) of this section.

(ii) *Identification by the Commissioner.* If a taxpayer enters into an executory contract and a hedge but fails to satisfy one or more of the requirements of paragraph (b) of this section and, based on the facts and circumstances, the Commissioner concludes that the executory contract in substance is hedged, then the Commissioner may apply the provisions of paragraph (b) of this section as if the taxpayer had satisfied all of the requirements therein, and may make appropriate adjustments. The Commissioner may apply the provisions of paragraph (b) of this section regardless of whether the executory contract and the hedge are held by the same taxpayer.

(4) *Effect of hedged executory contract*—(i) *In general.* If a taxpayer enters into a hedged executory contract, amounts paid or received under the hedge by the taxpayer are treated as paid or received by the taxpayer under the executory contract, or any subsequent account payable or receivable, or that portion to which the hedge relates. Also, the taxpayer recognizes no exchange gain or loss on the hedge. If an executory contract, on the accrual date, becomes an account payable or receivable, the taxpayer recognizes no exchange gain or loss on such payable or receivable for the period covered by the hedge.

(ii) *Partially hedged executory contracts.* The effect of integrating an executory contract and a hedge that partially hedges such contract is to treat the amounts paid or received under the hedge as paid or received under the portion of the executory contract being hedged, or any subsequent account payable or receivable. The income or expense of services performed or received under the executory contract, or the amount realized or basis of property sold or purchased under the executory contract, that is attributable to that portion of the executory contract that is not hedged shall be translated into functional currency on the accrual date. Exchange gain or loss shall be realized when payment is made or received with respect to any payable or receivable arising on the accrual date with respect to such unhedged amount.

(iii) *Disposition of a hedge or executory contract prior to the accrual date*—(A) *In general.* If a taxpayer identifies an executory contract as part of a hedged executory contract as defined in paragraph (b)(2) of this section, and disposes of (or otherwise terminates) the executory contract prior to the accrual date, the hedge shall be treated as sold for its fair market value on the date the executory contract is disposed of and any gain or loss shall be realized and recognized on such date. Such gain or loss shall be an adjustment to the amount received or expended with respect to the disposition or termination, if any. The spot rate on the date the hedge is treated as sold shall be used to determine subsequent exchange gain or loss on the hedge. If a taxpayer identifies a hedge as part of a hedged executory contract as defined in paragraph (b)(2) of this section, and disposes of the hedge prior to the accrual date, any gain or loss realized on such disposition shall not be recognized and shall be an adjustment to the income from, or expense of, the services performed or received under the executory contract, or to the amount realized or basis of the property sold or purchased under the executory contract.

(B) *Certain events in a series of hedges treated as a termination of the hedged executory contract.* If the rules of paragraph (b)(2)(iii)(B) of this section are not satisfied, the hedged executory contract shall be terminated and the provisions of paragraph (b)(4)(iii)(A) of this section shall apply to any gain or loss previously realized with respect to such hedge. Any subsequent hedging contracts entered into to reduce the risk of exchange rate movements with respect to such executory contract shall not be considered a hedge as defined in paragraph (b)(2)(iii) of this section.

(C) *Executory contracts between related persons.* If an executory contract is between related persons as defined in sections 267(b) and 707(b), and the taxpayer disposes of the hedge or terminates the executory contract prior to the accrual date, the Commissioner may redetermine the timing, source, and character of gain or loss from the hedge or the executory contract if he determines that a significant purpose for disposing of the hedge or terminating the executory contract prior to the accrual date was to affect the timing, source, or character of income, gain, expense, or loss for Federal income tax purposes.

(iv) *Disposition of a hedge on or after the accrual date.* If a taxpayer identifies a hedge as part of a hedged executory contract as defined in paragraph (b)(2) of this section, and disposes of the hedge on or after the accrual date, no gain or loss is recognized on the hedge and the booking date as defined in §1.988–2(c)(2) of the payable or receivable for purposes of computing exchange gain or loss shall be the date such hedge is disposed of. See *Example 3* of paragraph (b)(4)(iv) of this section.

(v) *Sections 263(g), 1092, and 1256 do not apply.* Sections 263(g), 1092, and 1256 do not apply with respect to an executory contract or hedge which comprise a hedged executory contract as defined in paragraph (b)(2) of this section. However, sections 263(g), 1092 and 1256 may apply to the hedged executory contract if such transaction is part of a straddle.

(vi) *Examples.* The principles set forth in paragraph (b) of this section are illustrated in the following examples. The examples assume that K is an accrual method, calendar year U.S. corporation with the dollar as its functional currency.

Example 1. (i) On January 1, 1992, K enters into a contract with JPF, a Swiss machine manufacturer, to pay 500,000 Swiss francs for delivery of a machine on June 1, 1993. Also on January 1, 1992, K enters into a foreign currency forward agreement to purchase

500,000 Swiss francs for $250,000 for delivery on June 1, 1993. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3)(i) of this section. On June 1, 1993, K takes delivery of the 500,000 Swiss francs (in exchange for $250,000) under the forward contract and makes payment of 500,000 Swiss francs to JPF in exchange for the machine. Assume that the accrual date is June 1, 1993.

(ii) Under paragraph (b)(1) of this section, the hedge is integrated with the executory contract. Therefore, K is deemed to have paid $250,000 for the machine and there is no exchange gain or loss on the foreign currency forward contract. K's basis in the machine is $250,000. Section 1256 does not apply to the forward contract.

Example 2. (i) On January 1, 1992, K enters into a contract with S, a Swiss machine manufacturer, to pay 500,000 Swiss francs for delivery of a machine on June 1, 1993. Under the contract, K is not obligated to pay for the machine until September 1, 1993. On February 1, 1992, K enters into a foreign currency forward agreement to purchase 500,000 Swiss francs for $250,000 for delivery on September 1, 1993. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On June 1, 1993, K takes delivery of machine. Assume that under K's method of accounting the delivery date is the accrual date. On September 1, 1993, K takes delivery of the 500,000 Swiss francs (in exchange for $250,000) under the forward contract and makes payment of 500,000 Swiss francs to S.

(ii) Under paragraph (b)(1) of this section, the hedge is integrated with the executory contract. Therefore K is deemed to have paid $250,000 for the machine and there is no exchange gain or loss on the foreign currency forward contract. Thus K's basis in the machine is $250,000. In addition, no exchange gain or loss is recognized on the payable in existence from June 1, 1993, to September 1, 1993. Section 1256 does not apply to the forward contract.

Example 3. The facts are the same as in *Example 2* except that K disposed of the forward contract on August 1, 1993 for $10,000. Pursuant to paragraph (b)(4)(iv) of this section, K does not recognize the $10,000 gain. K's basis in the machine is $250,000 (the amount fixed by the forward contract), regardless of the amount in dollars that K actually pays to acquire the Sf500,000 when K pays for the machine. K has a payable with a booking date of August 1, 1993, payable on September 1, 1993 for 500,000 Swiss francs. Thus, K will realize exchange gain or loss on the difference between the amount booked on August 1, 1993 and the amount paid on September 1, 1993 under § 1.988–2(c).

Example 4. (i) On January 1, 1992, K enters into a contract with S, a Swiss machine repair firm, to pay 500,000 Swiss francs for repairs to be performed on June 1, 1992. Under the contract, K is not obligated to pay for the repairs until September 1, 1992. On February 1, 1992, K enters into a foreign currency forward agreement to purchase 500,000 Swiss francs for $250,000 for delivery on August 1, 1992. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On June 1, 1992, S performs the repair services. Assume that under K's method of accounting this date is the accrual date. On August 1, 1992, K takes delivery of the 500,000 Swiss francs (in exchange for $250,000) under the forward contract. On the same day, K deposits the Sf500,000 in a separate account with a bank and properly identifies the transaction as a continuation of the hedged executory contract. On September 1, 1992, K makes payment of the Sf500,000 in the account to S.

(ii) Under paragraph (b)(1) of this section, the hedge is integrated with the executory contract. Therefore K is deemed to have paid $250,000 for the services and there is no exchange gain or loss on the foreign currency forward contract or on the disposition of Sf500,000 in the account. Any interest on the Swiss francs in the account is included in income but is not considered part of the hedge (because the amount paid for the services must be set on or before the accrual date). In addition, no exchange gain or loss is recognized on the payable in existence from June 1, 1992, to September 1, 1992. Section 1256 does not apply to the forward contract.

Example 5. (i) On January 1, 1992, K enters into a contract with S, a Swiss machine manufacturer, to pay 500,000 Swiss francs for delivery of a machine on June 1, 1993. Under the contract, K is not obligated to pay for the machine until September 1, 1993. On February 1, 1992, K enters into a foreign currency forward agreement to purchase 250,000 Swiss francs for $125,000 for delivery on September 1, 1993. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On June 1, 1993, K takes delivery of the machine. Assume that under K's method of accounting the delivery date is the accrual date. Assume further that the exchange rate is Sf1 = $.50 on June 1, 1993. On August 30, 1993, K purchases Sf250,000 for $135,000. On September 1, 1993, K takes delivery of the 250,000 Swiss francs (in exchange for $125,000) under the forward contract and makes payment of 500,000 Swiss francs (the Sf250,000 received under the contract plus the Sf250,000 purchased on August 30, 1993) to S. Assume the spot rate on September 1, 1993, is 1 Sf = $.5420 (Sf250,000 equal $135,500).

(ii) Under paragraph (b)(1) of this section, the partial hedge is integrated with the executory contract. K is deemed to have paid $250,000 for the machine [$125,000 on the hedged portion of the Sf500,000 and $125,000 ($.50, the spot rate on June 1, 1993, times

Sf250,000) on the unhedged portion of the Sf500,000]. K's basis in the machine therefore is $250,000. K recognizes no exchange gain or loss on the foreign currency forward contract but K will realize exchange gain of $500 on the disposition of the Sf250,000 purchased on August 30, 1993 under §1.988–2(a). In addition, exchange loss is realized on the unhedged portion of the payable in existence from June 1, 1993, to September 1, 1993. Thus, K will realize exchange loss of $10,500 ($125,000 booked less $135,500 paid) under §1.988–2(c) on the payable. Section 1256 does not apply to the forward contract.

Example 6. (i) On January 1, 1990, K enters into a contract with S, a Swiss steel manufacturer, to buy steel for 1,000,000 Swiss francs (Sf) for delivery and payment on December 31, 1990. On January 1, 1990, the spot rate is Sf1 = $.50, the U.S. dollar interest rate is 10% compounded annually, and the Swiss franc rate is 5% compounded annually. Under K's method of accounting, the delivery date is the accrual date.

(ii) Assume that on January 1, 1990, K enters into a foreign currency forward contract to buy Sf1,000,000 for $523,800 for delivery on December 31, 1990. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. Pursuant to paragraph (b)(2)(iii) of this section, the forward contract constitutes a hedge. Assuming that the requirements of paragraph (b)(2)(i) of this section are satisfied, the executory contract to buy steel and the forward contract are integrated under paragraph (b)(1) of this section. Thus, K is deemed to have paid $523,800 for the steel and will have a basis in the steel of $523,800. No gain or loss is realized with respect to the forward contract and section 1256 does not apply to such contract.

(iii) Assume instead that on January 1, 1990, K enters into a foreign currency forward contract to buy Sf1,000,000 for $512,200 for delivery on July 1, 1990. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On July 1, 1990, when the spot rate is Sf1 = $.53, K cancels the forward contract in exchange for $17,800 ($530,000 − $512,200). On July 1, 1990, K enters into a second forward agreement to buy Sf1,000,000 for $542,900 for delivery on December 31, 1990. K properly identifies the second forward agreement as a hedge in accordance with paragraph (b)(3) of this section. Pursuant to paragraph (b)(2)(iii) of this section, the forward contract entered into on January 1, 1990, and the forward contract entered into on July 1, 1990, constitute a hedge. Assuming that the requirements of paragraph (b)(2)(i) of this section are satisfied, the executory contract to buy steel and the forward agreements are integrated under paragraph (b)(1) of this section. Thus, K is deemed to have paid $525,100 for the steel (the forward price in the second forward agreement of $542,900 less the gain on the first forward agreement of $17,800) and will have a basis in the steel of $525,100. No gain is realized with respect to the forward contracts and section 1256 does not apply to such contracts.

(iv) Assume instead that on January 1, 1990, K enters into a foreign currency forward contract to buy Sf1,000,000 for $512,200 for delivery on July 1, 1990. K properly identifies the executory contract and the hedge in accordance with paragraph (b)(3) of this section. On July 1, 1990, when the spot rate is Sf1 = $.53, K enters into a historical rate rollover of its $17,800 gain ($530,000 − $512,200) on the forward agreement. Thus, K enters into a second foreign currency forward agreement to buy Sf1,000,000 for $524,210 for delivery on December 31, 1990. (The forward price of $524,210 is the market forward price on July 1, 1990, for the purchase of Sf1,000,000 for delivery on December 31, 1990, of $542,900 less the $17,800 gain on January 1, 1990, contract and less the time value of such gain of $890.) K properly identifies the second forward agreement as a hedge in accordance with paragraph (b)(3) of this section. On December 31, 1990, when the spot rate is Sf1 = $.54, K takes delivery of the Sf1,000,000 (in exchange for $524,210) and purchases the steel for Sf1,000,000. Pursuant to paragraph (b)(2)(iii) of this section, the forward contract entered into on January 1, 1990, and the forward contract entered into on July 1, 1990, which incorporates the rollover of K's gain on the January 1, 1990, contract, constitute a hedge. Assuming that the requirements of paragraph (b)(2)(i) of this section are satisfied, the executory contract to buy steel and the forward agreements are integrated under paragraph (b)(1) of this section. Because the period from the rollover date to the date payment is made under the executory contract does not exceed 183 days, the $890 of interest income is considered part of the hedge and is not recognized. Thus, K is deemed to have paid $524,210 for the steel and will have a basis in the steel of $524,210. No gain is realized with respect to the forward contracts and section 1256 does not apply to such contracts.

(v) Assume instead that on January 1, 1990, K purchases Sf952,380.95 (the present value of Sf1,000,000 to be paid on December 31, 1990) for $476,190.48 and on the same day deposits the Swiss francs in a separate bank account that bears interest at a rate of 5%, compounded annually. K properly identifies the transaction as a hedged executory contract. Over the period beginning January 1, 1990, and ending December 31, 1990, K receives Sf47,619.05 in interest on the account that is included in income and that has a basis of $25,714.29. (Assume that under §1.988–2(b)(1), K uses the spot rate of Sf1 = $.54 to translate the interest income). On December 31, 1990, K makes payment of the Sf1,000,000 principal and accrued interest in the account to S. Pursuant to paragraph (b)(2)(iii) of this section, the principal in the bank account and the interest constitute a hedge. Under paragraph (b)(1) of this section, the hedge is integrated with the executory contract. Therefore K is deemed to have paid $501,904.77 (the basis of the principal deposited plus the basis of the interest) for the steel and there is no exchange gain or loss on the disposition of the Sf1,000,000. K's basis in the steel therefore is $501,904.77.

(5) *References to this paragraph (b).* If the rules of this paragraph (b) are referred to in another paragraph of this section (*e.g.*, paragraph (c) of this section), then the rules of this paragraph (b) shall be applied for purposes of such other paragraph by substituting terms appropriate for such other paragraph. For example, paragraph (c)(2) of this section refers to the identification rules of paragraph (b)(3) of this section. Accordingly, for purposes of paragraph (c)(2), the rules of paragraph (b)(3) will be applied by substituting the term ''stock or security'' for ''executory contract''.

(c) *Hedges of period between trade date and settlement date on purchase or sale of publicly traded stock or security.* If a taxpayer purchases or sells stocks or securities which are traded on an established securities market and—

(1) Hedges all or part of such purchase or sale for any part of the period beginning on the trade date and ending on the settlement date; and

(2) Identifies the hedge and the underlying stock or securities as an integrated transaction under the rules of paragraph (b)(3) of this section;

then any gain or loss on the hedge shall be an adjustment to the amount realized or the adjusted basis of the stock or securities sold or purchased (and shall not be taken into account as exchange gain or loss). The term hedge means a deposit of nonfunctional currency in a hedging account (within the meaning of paragraph (b)(2)(iii)(D) of this section), or a forward or futures contract described in §1.988–1(a)(1)(ii) and (2)(iii), or combination thereof, which reduces the risk of exchange rate fluctuations for any portion of the period beginning on the trade date and ending on the settlement date. The provisions of paragraphs (b)(2)(i)(D) through (G), and (b)(2)(iii)(D) and (E) of this section shall apply. Sections 263(g), 1092, and 1256 do not apply with respect to stock or securities and a hedge which are subject to this paragraph (c).

(d) [Reserved]

(e) *Advance rulings regarding net hedging and anticipatory hedging systems.* In his sole discretion, the Commissioner may issue an advance ruling addressing the income tax consequences of a taxpayer's system of hedging either its net nonfunctional currency exposure or anticipated nonfunctional currency exposure. The ruling may address the character, source, and timing of both the section 988 transaction(s) making up the hedge and the underlying transactions being hedged. The procedures for obtaining a ruling shall be governed by such pertinent revenue procedures and revenue rulings as the Commissioner may provide. The Commissioner will not issue a ruling regarding hedges of a taxpayer's investment in a foreign subsidiary.

(f) [Reserved]

(g) *General effective date.* Except as otherwise provided in this section, the rules of this section shall apply to qualified hedging transactions, hedged executory contracts and transactions described in paragraph (c) of this section entered into on or after September 21, 1989. This section shall apply even if the transaction being hedged (*e.g.*, the debt instrument) was entered into or acquired prior to such date. The effective date regarding advance rulings for net and anticipatory hedging shall be governed by such revenue procedures that the Commissioner may publish.

[T.D. 8400, 57 FR 9199, Mar. 17, 1992]

§1.989(a)–1 Definition of a qualified business unit.

(a) *Applicability*—(1) *In general.* This section provides rules relating to the definition of the term ''qualified business unit'' (QBU) within the meaning of section 989.

(2) *Effective date.* These rules shall apply to taxable years beginning after December 31, 1986. However, any person may apply on a consistent basis §1.989(a)–1T (c) of the Temporary Income Tax Regulations in lieu of §1.989(a)–1 (c) to all taxable years beginning after December 31, 1986, and on

or before February 5, 1990. For the text of the temporary regulation, see 53 FR 20612 (June 8, 1988).

(b) *Definition of a qualified business unit*—(1) *In general.* A QBU is any separate and clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained.

(2) *Application of the QBU definition*—(i) *Persons.* A corporation is QBU. An individual is not a QBU. A partnership, trust, or estate is a QBU of a partner or beneficiary.

(ii) *Activities.* Activities of a corporation, partnership, trust, estate, or individual qualify as a QBU if—

(A) The activities constitute a trade or business; and

(B) A separate set of books and records is maintained with respect to the activities.

(3) *Special rule.* Any activity (wherever conducted and regardless of its frequency) that produces income or loss that is, or is treated as, effectively connected with the conduct of a trade or business within the United States shall be treated as a separate QBU, provided the books and records requirement of paragraph (d)(2) of this section is satisfied.

(c) *Trade or business.* The determination as to whether activities constitute a trade or business is ultimately dependent upon an examination of all the facts and circumstances. Generally, a trade or business for purposes of section 989(a) is a specific unified group of activities that constitutes (or could constitute) an independent economic enterprise carried on for profit, the expenses related to which are deductible under section 162 or 212 (other than that part of section 212 dealing with expenses incurred in connection with taxes). To constitute a trade or business, a group of activities must ordinarily include every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit. Such group of activities must ordinarily include the collection of income and the payment of expenses. It is not necessary that the activities carried out by a QBU constitute a different trade or business from those carried out by other QBUs of the taxpayer. A vertical, functional, or geographic division of the same trade or business may be a trade or business for this purpose provided that the activities otherwise qualify as trade or business under this paragraph (c). However, activities that are merely ancillary to a trade or business will not constitute a trade or business under this paragraph (c). Activities of an individual as an employee are not considered by themselves to constitute a trade or business under this paragraph (c).

(d) *Separate books and records*—(1) *General rule.* Except as provided in paragraph (d)(2) of this section, a separate set of books and records shall include books of original entry and ledger accounts, both general and subsidiary, or similar records. For example, in the case of a taxpayer using the cash receipts and disbursements method of accounting, the books of original entry include a cash receipts and disbursements journal where each receipt and each disbursement is recorded. Similarly, in the case of a taxpayer using an accrual method of accounting, the books of original entry include a journal to record sales (accounts receivable) and a journal to record expenses incurred (accounts payable). In general, a journal represents a chronological account of all transactions entered into by an entity for an accounting period. A ledger account, on the other hand, chronicles the impact during an accounting period of the specific transactions recorded in the journal for that period upon the various items shown on the entity's balance sheet (*i.e.*, assets, liabilities, and capital accounts) and income statement (*i.e.*, revenues and expenses).

(2) *Special rule.* For purposes of paragraph (b)(3) of this section, books and records include books and records used to determine income or loss that is, or is treated as, effectively connected with the conduct of a trade or business within the United States.

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

Example 1. Corporation X is a domestic corporation. Corporation X manufactures widgets in the U.S. for export. Corporation X sells widgets in the United Kingdom through a branch office in London. The London office has its own employees and solicits and processes orders. Corporation X maintains in the U.S. a separate set of books and records for all transactions conducted by the London office. Corporation X is a QBU under paragraph (b)(2)(i) of this section because of its corporate status. The London branch office is a QBU under paragraph (b)(2)(ii) of this section because (1) the sale of widgets is a trade or business as defined in paragraph (c) of this section; and (2) a complete and separate set of books and records (as described in paragraph (d) of this section) is maintained with respect to its sales operations.

Example 2. A domestic corporation incorporates a wholly-owned subsidiary in Switzerland. The domestic corporation is a manufacturer that markets its product abroad primarily through the Swiss subsidiary. To facilitate sales of the parent's product in Europe, the Swiss subsidiary has branch offices in France and West Germany that are responsible for all marketing operations in those countries. Each branch has its own employees, solicits and processes orders, and maintains a separate set of books and records. The domestic corporation and the Swiss subsidiary are both QBUs under paragraph (b)(2)(i) of this section because of their corporate status. The French and West German branches are QBUs of the Swiss subsidiary. They satisfy paragraph (b)(2)(ii) because each constitutes a trade or business (as defined in paragraph (c) of this section) and because separate sets of books and records (as described in paragraph (d) of this section) of their respective operations is maintained. Each branch is considered to have a trade or business although each is a geographical division of the same trade or business.

Example 3. W is a domestic corporation that manufactures product X in the United States for sale worldwide. All of W's sales functions are conducted exclusively in the United States. W employs individual Q to work in France. Q's sole function is to act as a courier to deliver sales documents to customers in France. With respect to Q's activities in France, a separate set of books and records as described in paragraph (d) is maintained. Under paragraph (c) of this section, Q's activities in France do not constitute a QBU since they are merely ancillary to W's manufacturing and selling business. Q is not considered to have a QBU because an individual's activities as an employee are not considered to constitute a trade or business of the individual under paragraph (c).

Example 4. The facts are the same as in example (3) except that the courier function is the sole activity of a wholly-owned French subsidiary of W. Under paragraph (b)(2)(i) of this section, the French subsidiary is considered to be a QBU.

Example 5. A corporation incorporated in the Netherlands is a subsidiary of a domestic corporation and a holding company for the stock of one or more subsidiaries incorporated in other countries. The Dutch corporation's activities are limited to paying its directors and its administrative expenses, receiving capital contributions from its United States parent corporation, contributing capital to its subsidiaries, receiving dividend distributions from its subsidiaries, and distributing dividends to its domestic parent corporation. Under paragraph (b)(2)(i) of this section, the Netherlands corporation is considered to be a QBU.

Example 6. Taxpayer A, an individual resident of the United States, is engaged in a trade or business wholly unrelated to any type of investment activity. A also maintains a portfolio of foreign currency-denominated investments through a foreign broker. The broker is responsible for all activities necessary to the management of A's investments and maintains books and records as described in paragraph (d) of this section, with respect to all investment activities of A. A's investment activities qualify as a QBU under paragraph (b)(2)(ii) of this section to the extent the activities engaged in by A generate expenses that are deductible under section 212 (other than that part of section 212 dealing with expenses incurred in connection with taxes).

Example 7. Taxpayer A, an individual resident of the United States, is the sole shareholder of foreign corporation (FC) whose activities are limited to trading in stocks and securities. FC is a QBU under paragraph (b)(2)(i) of this section.

Example 8. Taxpayer A, an individual resident of the United States, markets and sells in Spain and in the United States various products produced by other United States manufacturers. A has an office and employs a salesman to manage A's activities in Spain, maintains a separate set of books and records with respect to his activities in Spain, and is engaged in a trade or business as defined in paragraph (c) of this section. Therefore, under paragraph (b)(2)(ii) of this section, the activities of A in Spain are considered to be a QBU.

Example 9. Foreign corporation FX is incorporated in Mexico and is wholly owned by a domestic corporation. The domestic corporation elects to treat FX as a domestic corporation under section 1504(d). FX operates entirely in Mexico and maintains a separate set of books and records with respect to its activities in Mexico. FX is a QBU under paragraph (b)(2)(i) of this section. The activities of FX in Mexico also constitute a QBU under paragraph (b)(2)(ii) of this section.

Example 10. F, a foreign corporation, computes a gain of $100 from the disposition of a United States real property interest (as defined in section 897(c)). The gain is taken into account as if F were engaged in a trade or business in the United States and as if such gain were effectively connected with such trade or business. F is a QBU under paragraph (b)(2)(i) of this section because of its corporate status. F's disposition activity constitutes a separate QBU under paragraph (b)(3) of this section.

[T.D. 8279, 55 FR 284, Jan. 4, 1990]

§1.989(b)–1 Definition of weighted average exchange rate.

For purposes of section 989(b)(3) and (4), the term ''weighted average exchange rate'' means the simple average of the daily exchange rates (determined by reference to a qualified source of exchange rates within the meaning of §1.964–1(d)(5)), excluding weekends, holidays and any other nonbusiness days for the taxable year.

[T.D. 8263, 54 FR 38664, Sept. 20, 1989. Redesignated by T.D. 8367, 56 FR 48437, Sept. 25, 1991; 57 FR 6060, Feb. 18, 1992]

§1.989(c)–1 Transition rules for certain branches of United States persons using a net worth method of accounting for taxable years beginning before January 1, 1987.

(a) *Applicability*—(1) *In general.* This section applies to qualified business units (QBU) branches of United States persons, whose functional currency (as defined in section 985 of the Code and regulations issued thereunder) is other than the United States dollar (dollar) and that used a net worth method of accounting for their last taxable year beginning before January 1, 1987. Generally, a net worth method of accounting is any method of accounting under which the taxpayer calculates the taxable income of a QBU branch based on the net change in the dollar value of the QBU branch's equity over the course of a taxable year, taking into account any remittance made during the year. QBU branch equity is the excess of QBU branch assets over QBU branch liabilities. For all taxable years beginning after December 31, 1986, such QBU branches must use the profit and loss method of accounting as described in section 987, except to the extent otherwise provided in regulations under section 985 or any other provision of the Code.

(2) *Insolvent QBU branches.* A taxpayer may apply the principles of this section to a QBU branch that used a net worth method of accounting for its last taxable year beginning before January 1, 1987, whose $E pool (as defined in paragraph (d)(3)(i) of this section) is negative. For taxable years beginning on or after October 25, 1991, the principles of this section shall apply to insolvent QBU branches.

(b) *General rules.* For the general rules, see §1.987–5(b).

(c) *Determining the pool(s) from which a remittance is made.* To determine from which pool(s) a remittance is made, see §1.987–5(c).

(d) *Calculation of section 987 gain or loss*—(1) *In general.* See §1.987–5(d)(1) for rules to make this calculation.

(2) *Step 1—Calculate the amount of the functional currency pools.* For calculation of the amount of the functional currency pools, see §1.987–5(d)(2).

(3) *Step 2—Calculate the dollar basis pools*—(i) *Dollar basis of the EQ pool*—(A) *Beginning dollar basis.* The beginning dollar basis of the EQ pool (hereinafter referred to as the $E pool) equals the final net worth of the QBU branch. Final net worth of the QBU branch equals the QBU branch's equity value (assets less liabilities) measured in dollars at the end of the taxpayer's last taxable year beginning before January 1, 1987, determined on the basis of the QBU branch's books and records as adjusted according to United States tax principles.

(B) *Adjusting the $E pool.* For adjustments to be made to the $E pool, see §1.987–5(d)(3)(i)(B).

(ii) *Dollar basis of the post-86 profits pool.* To calculate the dollar basis of the post-86 profits pool, see §1.987–5(d)(3)(ii).

(iii) *Dollar basis of the equity pool.* To calculate the dollar basis of the equity pool, see §1.987–5(d)(3)(iii).

(4) *Step 3—Calculation of the dollar basis of a remittance.* To calculate the dollar basis of the EQ remitted, see §1.987–5(d)(4).

(5) *Step 4—Calculation of the section 987 gain or loss on a remittance.* To calculate 987 gain or loss determined on a remittance, see §1.987–5(d)(5).

(e) *Functional currency adjusted basis of QBU branch assets acquired in taxable years beginning before January 1, 1987.* To determine the functional currency adjusted basis of QBU branch assets acquired in taxable years beginning before January 1, 1987, see § 1.987–5(e).

(f) *Functional currency amount of QBU branch liabilities acquired in taxable years beginning before January 1, 1987.* To determine the functional currency amount of QBU branch liabilities acquired in taxable years beginning before January 1, 1987, see § 1.987–5(f).

[T.D. 8367, 56 FR 48437, Sept. 25, 1991]

DOMESTIC INTERNATIONAL SALES CORPORATIONS

§ 1.991–1 Taxation of a domestic international sales corporation.

(a) *In general.* A corporation which is a DISC for a taxable year is not subject to any tax imposed by subtitle A of the Code (sections 1 through 1564) for such taxable year, except for the tax imposed by chapter 5 thereof (sections 1491 through 1494) on certain transfers to avoid tax. Thus, for example, a corporation which is a DISC for a taxable year is not subject for such year to the corporate income tax (section 11), the minimum tax on tax preferences (sections 56 through 58), or the accumulated earnings tax (sections 531 through 537). A DISC is liable for the payment of all taxes payable by corporations under other subtitles of the Code, such as, for example, income taxes withheld at the source and other employment taxes under subtitle C and the interest equalization tax and other miscellaneous excise taxes imposed by subtitle D. In addition, a DISC is subject to the provisions of chapter 3 of subtitle A (including section 1461), relating to withholding of tax on nonresident aliens and foreign corporations and tax-free covenant bonds. See § 1.992–1 for the definition of the term ''DISC.''

(b) *Determination of taxable income*—(1) *In general.* Although a DISC is not subject to tax under subtitle A of the Code (other than chapter 5 thereof), a DISC's taxable income shall be determined for each taxable year in order to determine, for example, the amount deemed distributed for that taxable year to its shareholders pursuant to § 1.995–2. Except as otherwise provided in the Code and the regulations thereunder, the taxable income of a DISC shall be determined in the same manner as if the DISC were a domestic corporation which had not elected to be treated as a DISC. Thus, for example, a DISC chooses its method of depreciation, inventory method, and annual accounting period in the same manner as if it were a corporation which had not elected to be treated as a DISC. Any elections affecting the determination of taxable income shall be made by the DISC. Thus, as a further example, a DISC which makes an installment sale described in section 453 is able to avail itself of the benefits of section 453: *Provided,* The DISC complies with the election requirements of such section. See § 1.995–2(e) and § 1.996–8 and the regulations thereunder for rules relating to the application for a taxable year of a DISC of a deduction under section 172 for a net operating loss carryback or carryover or of a capital loss carryback or carryover under section 1212.

(2) *Choice of method of accounting.* A DISC may, generally, choose any method of accounting permissible under section 446(c) and the regulations thereunder. However, if a DISC is a member of a controlled group (as defined in § 1.993–1(k)), the DISC may not choose a method of accounting which, when applied to transactions between the DISC and other members of the controlled group, will result in a material distortion of the income of the DISC or any other member of the controlled group. Such a material distortion of income would occur, for example, if a DISC chooses to use the cash method of accounting where the DISC acts as commission agent in a substantial volume of sales of property by a related corporation which uses the accrual method of accounting and which customarily pays commissions to the DISC more than 2 months after such sales. As a further example, a material distortion of income would occur if a DISC chooses to use the accrual method of accounting where the DISC leases a substantial amount of property from a related corporation which uses the cash method of accounting, if the DISC customarily accrues any portion of the rent on such property more than 2 months before the rent is paid. Changes in the method of accounting of a DISC

are subject to the requirements of section 446(e) and the regulations thereunder.

(3) *Choice of annual accounting period*—(i) *In general.* A DISC may choose its annual accounting period without regard to the annual accounting period of any of its stockholders. In general, changes in the annual accounting period of a DISC are subject to the requirements of section 442 and the regulations thereunder.

(ii) *Transition rule for change in taxable year in order to become a DISC.* A corporation may, without the consent of the Commissioner, change its annual accounting period and adopt a new taxable year beginning on the first day of any month in 1972: *Provided,* That—

(a) Such change has the effect of accelerating the time as of which such corporation can become a DISC,

(b) The Commissioner is notified of such change by means of a statement filed (with the regional service center with which such corporation files its election to be treated as a DISC) not later than the end of the period during which such corporation may file an election to be treated as a DISC for such new taxable year, and

(c) The short period required to effect such change is not a taxable year in which such corporation has a net operating loss as defined in section 172.

Thus, for example, if a corporation which uses the calendar year for its taxable year does not complete arrangements to become a DISC until May 15, 1972, such corporation can, pursuant to this subdivision, change its annual accounting period and adopt a taxable year beginning on the first day of any month in 1972 after May. A change to a new annual accounting period made pursuant to this subdivision is effective only if the corporation which makes such change qualifies as a DISC for such new period. A corporation may change its annual accounting period and adopt a new taxable year pursuant to this subdivision without regard to the provisions of §1.1502–76 (relating to the taxable year of members of a group). A copy of the statement described in *(b)* of this subdivision shall be attached to the return of a corporation for the new taxable year to which such corporation changes pursuant to this subdivision. A corporation which changes its annual accounting period pursuant to this subparagraph will not be permitted under section 442 to change its annual accounting period at any time before 1982, except with the consent of the Commissioner as provided in §1.442–1(b)(1) or pursuant to subparagraph (4) of this paragraph.

(4) *Transition rule for change of taxable year of certain DISC's.* In the case of a DISC all of the shares of which are held by a single shareholder or by members of a group who file a consolidated return, such DISC may (without the consent of the Commissioner) change its annual accounting period and adopt a taxable year beginning in 1972 which is the same as the taxable year of such shareholder or the members of such group. A change to a new annual accounting period may be made by a DISC pursuant to this subparagraph even if such DISC has changed its annual accounting period pursuant to subparagraph (3)(ii) of this paragraph.

(5) *Transition rule for beginning of first taxable year of certain corporations.* If a corporation organized before January 1, 1972, neither acquires assets (other than cash or other property acquired as consideration for the issuance of stock) nor begins doing business prior to January 1, 1972, the first taxable year of such corporation is deemed to begin at the time such corporation acquires any asset (other than cash or other property acquired as consideration for the issuance of stock) or begins doing business, whichever is earlier: *Provided,* That such corporation is a DISC for such first taxable year. For purposes of §1.6012–2(a), such corporation is treated as not coming into existence until the beginning of such first taxable year.

(c) *Effective date.* The provisions of this section and the regulations under sections 992 through 997 apply with respect to taxable years ending after December 31, 1971, except that a corporation may not be a DISC for any taxable year beginning before January 1, 1972.

(d) *Related statutes.* For rules relating to the transfer, during a taxable year beginning before January 1, 1976, to a DISC of assets of an export trade corporation (as defined in section 971), where a parent owns all the outstanding stock of both such DISC and such export trade corporation, see section 505(b) of the Revenue Act of 1971 (85 Stat. 551). For rules regarding limitations on the qualification of a corporation as an export trade corporation for any taxable year beginning after October 31, 1971, see section 971(a)(3).

[T.D. 7323, 39 FR 34402, Sept. 25, 1974, as amended by T.D. 7854, 47 FR 51738, Nov. 17, 1982]

§ 1.992–1 Requirements of a DISC.

(a) *''DISC'' defined.* The term ''DISC'' refers to a domestic international sales corporation. The term ''DISC'' means a corporation which, for a taxable year—

(1) Is duly incorporated and existing under the laws of any State or the District of Columbia,

(2) Satisfies the gross receipts test described in paragraph (b) of this section,

(3) Satisfies the assets test described in paragraph (c) of this section,

(4) Satisfies the capitalization requirement described in paragraph (d) of this section,

(5) Satisfies the requirement that an election to be treated as a DISC be in effect for such year, as described in paragraph (e) of this section,

(6) [Reserved]

(7) Maintains separate books and records, and

(8) Is not an ineligible corporation described in paragraph (f) of this section.

A corporation which satisfies the requirements described in subparagraphs (1) through (8) of this paragraph for a taxable year is treated as a separate corporation for Federal tax purposes and qualifies as a DISC, even though such corporation would not be treated (if it were not a DISC) as a corporate entity for Federal income tax purposes. An association cannot qualify as a DISC even if such association is taxable as a corporation pursuant to section 7701(a)(3). In addition, a corporation created or organized in, or under the law of, a possession of the United States cannot qualify as a DISC. The rules contained in this paragraph constitute a relaxation of the general rules of corporate substance otherwise applicable under the Code. The separate incorporation of a DISC is required under section 992(a)(1) to make it possible to keep a better record of the income which is subject to the special treatment provided by sections 991 through 996, but this does not necessitate in all other respects the separate relationships which otherwise would be required between a parent corporation and its subsidiary. However, this relaxation of the general rules of corporate substance does not apply with respect to other corporations in other contexts. In the case of a transaction between a DISC and a person related to such DISC for purposes of section 482, see § 1.993–1(l) for rules for determining whether income is income of a DISC to which the intercompany pricing rules authorized by section 994 apply.

(b) *Gross receipts test.* In order for a corporation described in paragraph (a)(1) of this section to be a DISC for a taxable year, 95 percent or more of its gross receipts (as defined in § 1.993–6) for such year must consist of qualified export receipts (as defined in § 1.993–1). Gross receipts for a taxable year are determined in accordance with the method of accounting adopted by the corporation pursuant to § 1.991–1(b)(2). However, for rules regarding gross receipts in the case of a commission sale by such corporation, see § 1.993–6.

(c) *Assets test*—(1) *In general.* In order for a corporation described in paragraph (a)(1) of this section to be a DISC for a taxable year, the adjusted basis (determined under section 1011) of its qualified export assets at the close of such year must equal or exceed 95 percent of the sum of the adjusted bases (determined under section 1011) of all assets of such corporation at the close of such year.

(2) *Assets acquired to meet assets test.* For purposes of determining whether the requirements of subparagraph (1) of this paragraph are satisfied by a corporation at the end of a taxable year, an asset which is a qualified export asset is treated as not being an asset of such corporation at such time if such asset is held for a total of 60 days or less and is acquired directly or indirectly through borrowing, unless the acquisition of such asset is established to the satisfaction of the Commissioner or his delegate to have been for bona

fide purposes. Such acquisition is deemed to have been for bona fide purposes if, for example, it is made in the usual course of the corporation's trade or business.

(d) *Capitalization requirement*—(1) *In general.* To qualify as a DISC for a taxable year, a corporation must have, on each day of that taxable year, only one class of stock. The par value (or, in the case of stock without par value, the stated value) of the corporation's outstanding stock must be on each day of the taxable year at least $2,500. In the case of a corporation which elects to be treated as a DISC for its first taxable year, the requirements of this paragraph (d)(1) are satisfied if the corporation has no more than one class of stock at any time during the year and if the par value (or, in the case of stock without par value, the stated value) of the corporation's outstanding stock is at least $2,500 on the last day of the period within which the election must be made and on each succeeding day of the year. For purposes of this paragraph (d)(1), the stated value of shares is the aggregate amount of the consideration paid for such shares which is not allotted to paid in surplus, or other surplus. The law of the State of incorporation of the DISC determines what consideration may be used to capitalize the DISC. A corporation will not be a qualified DISC unless at least $2,500 of valid consideration was used for this purpose. If a corporation has a realized or unrealized loss during a taxable year which results in the impairment of all or part of the capital required under this paragraph (d)(1), that impairment does not result in disqualification under this paragraph (d)(1), provided that the corporation does not take any legal or formal action under State law to reduce capital for that year below the amount required under this paragraph (d)(1).

(2) *Treatment of debt payable to shareholders*—(i) *In general.* Purported debt of a DISC payable to any person, whether or not such person is a shareholder or a member of a controlled group (as defined in §1.993–1(k)) of which such DISC is a member, is treated as debt for all purposes of the Code, provided that such purported debt—

(a) Would qualify as debt for purposes of the Code if the DISC were a corporation which did not qualify as a DISC,

(b) Qualifies under subdivision (ii) of this subparagraph, or

(c) Are trade accounts payable described in subdivision (iii) of this subparagraph.

Such debt is not treated as stock, and interest payable by the DISC on such debt is treated as interest by both the DISC and the holder of such debt. Payment of the principal of such debt by a DISC does not constitute the payment of a dividend by such DISC. The provisions of this subparagraph apply for a taxable year of a DISC, even though debt described in this subparagraph would be treated as stock of the corporation if such corporation did not qualify as a DISC for such year.

(ii) *Safe harbor rule.* Purported debt of a DISC will in no event be treated as other than debt for purposes of subdivision (i) of this subparagraph if—

(a) It is a written obligation to pay a sum certain on or before a fixed maturity date,

(b) Interest is payable on such purported debt at an arm's length interest rate (as determined under §1.482–2(a)(2)), expressed as a fixed dollar amount or a fixed percentage of principal,

(c) Such purported debt is not convertible into stock or into other purported debt unless such other purported debt qualifies under this subparagraph as debt of the DISC,

(d) Such purported debt does not confer voting rights upon its holder, except in the event of default thereon, and

(e) Interest and principal are paid in accordance with the terms of such purported debt or with any modification of such terms consistent with *(a)* through *(d)* of this subdivision.

The determination of whether purported debt of a DISC constitutes debt described in this subdivision is made without regard to the proportion of debt of the DISC held by any of its shareholders, to the ratio of the outstanding debt of the DISC to its equity, or to the amount of outstanding debt of such DISC. The provisions of *(e)* of this subdivision do not prevent the modification of the terms of debt of a

DISC where, for example, a DISC becomes unable to make timely payments of principal required under such terms, provided that such modification is consistent with *(a)* through *(d)* of this subdivision.

(iii) *Trade accounts payable.* Trade accounts payable of a DISC which arise in the normal course of its trade or business (such as in consideration for inventory or supplies) constitute debt of the DISC (whether or not such accounts payable are debt described in subdivision (i) *(a)* or *(b)* of this subparagraph), provided that such accounts are payable within 15 months after they arise. If such accounts are payable more than 15 months after they arise, they are debt of such DISC only if they are debt described in subdivision (i) *(a)* or *(b)* of this subparagraph.

(iv) *Relation of subparagraph to other corporations.* The provisions of this subparagraph generally constitute a relaxation of the ordinary rules used in determining whether purported debt of a corporation is debt or equity. This relaxation is in recognition of the principle that a corporation may qualify as a DISC even though it has relatively little capital. This relaxation does not apply with respect to purported debt of other corporations in other contexts. The provisions of subdivisions (i), (ii), and (iii) of this subparagraph apply only for taxable years for which a corporation qualifies (or is treated) as a DISC.

(3) *Classes of stock.* [Reserved]

(e) *Election in effect.* In order for a corporation to be a DISC for a taxable year, an election to be treated as a DISC must be made by such corporation pursuant to § 1.992–2 and must be in effect for such taxable year. A corporation does not become or remain a DISC solely by making such an election. A corporation is a DISC for a taxable year only if such an election is in effect for that year and the corporation also satisfies the requirements of paragraphs (a) through (d) of this section. See § 1.992–2 for rules regarding the time and manner of making such an election.

(f) *Ineligible corporations.* The following corporations shall not be eligible to be treated as a DISC—

(1) A corporation exempt from tax by reason of section 501,

(2) A personal holding company (as defined in section 542),

(3) A financial institution to which section 581 or 593 applies,

(4) An insurance company subject to the tax imposed by subchapter L,

(5) A regulated investment company (as defined in section 851(a)),

(6) A China Trade Act corporation receiving the special deduction provided in section 941(a), or

(7) An electing small business corporation (as defined in section 1371(b)).

(g) *Status as DISC after having filed return as a DISC.* Under section 992(a)(2), notwithstanding the failure of a corporation to meet the requirements of paragraph (a) of this section for a taxable year, such corporation will be treated as a DISC for purposes of the Code for such taxable year (and, thus, will not be able to claim that it is not eligible to be a DISC) if—

(1) Such corporation files a return as a DISC for such taxable year,

(2) Such corporation does not notify the district director, more than 30 days before the expiration of the period of limitation (including extensions thereof) on assessment for underpayment of tax for such taxable year (as determined under section 6501 and the regulations thereunder), that it is not a DISC for such taxable year, and

(3) The Internal Revenue Service has not issued, within such period of limitation (including extensions thereof) on assessment for underpayment of tax for such taxable year, a notice of deficiency based on a determination that such corporation is not a DISC for such taxable year.

A corporation is treated as a DISC, for all purposes, pursuant to the provisions of this paragraph for any taxable year for which it meets the requirements of this paragraph, even if such corporation is an ineligible corporation described in paragraph (f) of this section for such taxable year. Thus, for example, a corporation which is treated as a DISC for a taxable year pursuant to this paragraph is treated as a DISC for that taxable year for purposes of § 1.992–2(e)(3) (relating to the termination of a DISC election if a corporation is not a DISC for each of any 5 consecutive taxable years). If a corporation is treated as a DISC for a taxable year pursuant to this paragraph, persons who held stock of such corporation at any time during such taxable year are treated, with respect to such stock, as holders of stock in a DISC for the period or periods during which they held such stock within such taxable year.

(h) *Definition of ''former DISC''.* Under section 992(a)(3), the term ''former DISC'' refers to a corporation which is not a DISC for a taxable year but which was (or was treated as) a DISC for a prior taxable year. However, a corporation is not a former DISC for a taxable year unless such corporation has, at the beginning of such taxable year, undistributed previously taxed income (as defined in §1.996–3(c) or accumulated DISC income (as defined in §1.996–3(b)). A corporation which is a former DISC for a taxable year is a former DISC for all purposes of the Code.

(Secs. 385 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 613 and 68A Stat. 917; 26 U.S.C. 385 and 7805))

[T.D. 7323, 39 FR 34403, Sept. 25, 1974, as amended by T.D. 7420, 41 FR 20654, May 20, 1976; 41 FR 22267, June 2, 1976; T.D. 7747, 45 FR 86459, Dec. 31, 1980; T.D. 7920, 48 FR 50712, Nov. 3, 1983; T.D. 8371, 56 FR 55234, Oct. 25, 1991]

§1.992–2 Election to be treated as a DISC.

(a) *Manner and time of election*—(1) *Manner*—(i) *In general.* A corporation can elect to be treated as a DISC for a taxable year beginning after December 31, 1971. Except as provided in paragraph (a)(1)(ii) of this section, the election is made by the corporation filing Form 4876 with the service center with which it would file its income tax return if it were subject for such taxable year to all the taxes imposed by subtitle A of the Internal Revenue Code of 1954. The form shall be signed by any person authorized to sign a corporation return under section 6062, and shall contain the information required by such form. Except as provided in paragraphs (b)(3) and (c) of this section, such election to be treated as a DISC shall be valid only if the consent of every person who is a shareholder of the corporation as of the beginning of the first taxable year for which such election is effective is on or attached to such Form 4876 when filed with the service center.

(ii) *Transitional rule for corporations electing during 1972.* If the first taxable year for which an election by a corporation to be treated as a DISC is a taxable year beginning after December 31, 1971, and on or before December 31, 1972, such election may be made either in the manner prescribed in subdivision (i) of this subparagraph or by filing, at the place prescribed in subdivision (i) of this subparagraph, a statement captioned ''Election to be Treated as a DISC.'' Such statement of election shall be valid only if the consent of each shareholder is filed with the service center in the form, and at the time, prescribed in paragraph (b) of this section. Such statement shall be signed by any person authorized to sign a corporation return under section 6062 and shall include the name, address, and employer identification number (if known) of the corporation, the beginning date of the first taxable year for which the election is effective, the number of shares of stock of the corporation issued and outstanding as of the earlier of the beginning of the first taxable year for which the election is effective or the time the statement is filed, the number of shares held by each shareholder as of the earlier of such dates, and the date and place of incorporation. As a condition of the election being effective, a corporation which elects to become a DISC by filing a statement in accordance with this subdivision must furnish (to the service center with which the statement was filed) such additional information as is required by Form 4876 by March 31, 1973.

(2) *Time of making election*—(i) *In general.* In the case of a corporation making an election to be treated as a DISC for its first taxable year, such election shall be made within 90 days after the beginning of such taxable year. In the case of a corporation which makes an election to be treated as a DISC for any taxable year beginning after March 31, 1972 (other than the first taxable year of such corporation), the election shall

be made during the 90-day period immediately preceding the first day of such taxable year.

(ii) *Transitional rules for certain corporations electing during 1972.* In the case of a corporation which makes an election to be treated as a DISC for a taxable year beginning after December 31, 1971, and on or before March 31, 1972 (other than its first taxable year), the election shall be made within 90 days after the beginning of such taxable year.

(b) *Consent by shareholders*—(1) *In general*—(i) *Time and manner of consent.* Under paragraph (a)(1)(i) of this section, subject to certain exceptions, the election to be treated as a DISC is not valid unless each person who is a shareholder as of the beginning of the first taxable year for which the election is effective signs either the statement of consent on Form 4876 or a separate statement of consent attached to such form. A shareholder's consent is binding on such shareholder and all transferees of his shares and may not be withdrawn after a valid election is made by the corporation. In the case of a corporation which files an election to become a DISC for a taxable year beginning after December 31, 1972, if a person who is a shareholder as of the beginning of the first taxable year for which the election is effective does not consent by signing the statement of consent set forth on Form 4876, such election shall be valid (except in the case of an extension of the time for filing granted under the provisions of subparagraph (3) of this paragraph or paragraph (c) of this section) only if the consent of such shareholder is attached to the Form 4876 upon which such election is made.

(ii) *Form of consent.* A consent other than the statement of consent set forth on Form 4876 shall be in the form of a statement which is signed by the shareholder and which sets forth *(a)* the name and address of the corporation and of the shareholder and *(b)* the number of shares held by each such shareholder as of the time the consent is made and (if the consent is made after the beginning of the corporation's taxable year for which the election is effective) as of the beginning of such year. If the consent is made by a recipient of transferred shares pursuant to paragraph (c) of this section, the statement of consent shall also set forth the name and address of the person who held such shares as of the beginning of such taxable year and the number of such shares. Consent shall be made in the following form: ''I (insert name of shareholder), a shareholder of (insert name of corporation seeking to make the election) consent to the election of (insert name of corporation seeking to make the election) to be treated as a DISC under section 992(b) of the Internal Revenue Code. The consent so made by me is irrevocable and is binding upon all transferees of my shares in (insert name of corporation seeking to make the election).'' The consents of all shareholders may be incorporated in one statement.

(iii) *Who may consent.* Where stock of the corporation is owned by a husband and wife as community property (or the income from such stock is community property), or is owned by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest in such stock or the income therefrom and each tenant in common, joint tenant, and tenant by the entirety must consent to the election. The consent of a minor shall be made by his legal guardian or by his natural guardian if no legal guardian has been appointed. The consent of an estate shall be made by the executor or administrator thereof. The consent of a trust shall be made by the trustee thereof. The consent of an estate or trust having more than one executor, administrator, or trustee, may be made by any executor, administrator, or trustee, authorized to make a return of such estate or trust pursuant to section 6012(b)(5). The consent of a corporation or partnership shall be made by an officer or partner authorized pursuant to section 6062 or 6063, as the case may be, to sign the return of such corporation or partnership. In the case of a foreign person, the consent may be signed by any individual (whether or not a U.S. person) who would be authorized under sections 6061 through 6063 to sign the return of such foreign person if he were a U.S. person.

(2) *Transitional rule for corporations electing during 1972.* In the case of a corporation which files an election to be treated as a DISC for a taxable year beginning after December 31, 1971, and on or before December 31, 1972, such election shall be valid only if the consent of each person who is a shareholder as of the beginning of the first taxable year for which such election is effective is filed with the service center with which the election was filed within 90 days after the first day of such taxable year or within the time granted for an extension of time for filing such consent. The form of such consent shall be the same as that prescribed in subparagraph (1) of this paragraph. Such consent shall be attached to the statement of election or shall be filed separately (with such service center) with a copy of the statement of election. An extension of time for filing a consent may be granted in the manner, and subject to the conditions, described in subparagraph (3) of this paragraph.

(3) *Extension of time to consent.* An election which is timely filed and would be valid except for the failure to attach the consent of any shareholder to the Form 4876 upon which the election was made or to comply with the 90-day requirement in subparagraph (2) of this paragraph or paragraph (c)(1) of this section, as the case may be, will not be invalid for such reason if it is shown to the satisfaction of the service center that there was reasonable cause for the failure to file such consent, and if such shareholder files a proper consent to the election within such extended period of time as may be granted by the Internal Revenue Service. In the case of a late filing of a consent, a copy of the Form 4876 or statement of election shall be attached to such consent and shall be filed with the same service center as the election. The form of such consent shall be the same as that set forth in paragraph (b)(1)(ii) of this section. In no event can any consent be made pursuant to this paragraph on or after the last day of the first taxable year for which a corporation elects to be treated as a DISC.

(c) *Consent by holder of transferred shares*—(1) *In general.* If a shareholder of a corporation transfers—

(i) Prior to the first day of the first taxable year for which such corporation elects to be treated as a DISC, some or all of the shares held by him without having consented to such election, or

(ii) On or before the 90th day after the first day of the first taxable year for which such corporation elects to be treated as a DISC, some or all of the shares held by him as of the first day of such year (or if later, held by him as of the time such shares are issued) without having consented to such election, then consent may be made by any recipient of such shares on or before the 90th day after the first day of such first taxable year. If such recipient fails to file his consent on or before such 90th day, an extension of time for filing such consent may be granted in the manner, and subject to the conditions, described in paragraph (b)(3) of this section. In addition, if the transfer occurs more than 90 days after the first day of such taxable year, an extension of time for filing such consent may be granted to such recipient only if it is determined under paragraph (b)(3) of this section that an extension of time would have been granted the transferor for the filing of such consent if the transfer had not occurred. A consent which is not attached to the original Form 4876 or statement of election (as the case may be) shall be filed with the same service center as the original Form 4876 or statement of election and shall have attached a copy of such original form or statement of election. The form of such consent shall be the same as that set forth in paragraph (b)(1)(ii) of this section. For the purposes of this paragraph, a transfer of shares includes any sale, exchange, or other disposition, including a transfer by gift or at death.

(2) *Requirement for the filing of an amended Form 4876 or statement of election.* In any case in which a consent to a corporation's election to be treated as a DISC is made pursuant to subparagraph (1) of this paragraph, such corporation must file an amended Form 4876 or statement of election (as the case may be) reflecting all changes in ownership of shares. Such form must be filed with the same service center with which the original Form 4876 or

statement of election was filed by such corporation.

(d) *Effect of election*—(1) *Effect on corporation.* A valid election to be treated as a DISC remains in effect (without regard to whether the electing corporation qualifies as a DISC for a particular year) until terminated by any of the methods provided in paragraph (e) of this section. While such election is in effect, the electing corporation is subject to sections 991 through 997 and other provisions of the Code applicable to DISC's for any taxable year for which it qualifies as a DISC (or is treated as qualifying as a DISC pursuant to § 1.992–1(g)). Such corporation is also subject to such provisions for any taxable year for which it is treated as a former DISC as a result of qualifying or being treated as a DISC for any taxable year for which such election was in effect.

(2) *Effect on shareholders.* A valid election by a corporation to be treated as a DISC subjects the shareholders of such corporation to the provisions of section 995 (relating to the taxation of the shareholders of a DISC or former DISC) and to all other provisions of the Code relating to the shareholders of a DISC or former DISC. Such provisions of the Code apply to any person who is a shareholder of a DISC or former DISC whether or not such person was a shareholder at the time the corporation elected to become a DISC.

(e) *Termination of election*—(1) *In general.* An election to be treated as a DISC is terminated only as provided in subparagraph (2) or (3) of this paragraph.

(2) *Revocation of election*—(i) *Manner of revocation.* An election by a corporation to be treated as a DISC may be revoked by the corporation for any taxable year of the corporation after the first taxable year for which the election is effective. Such revocation shall be made by the corporation filing a statement that the corporation revokes its election under section 992(b) to be treated as a DISC. Such statement shall indicate the corporation's name, address, employer identification number, and the first taxable year of the corporation for which the revocation is to be effective. The statement shall be signed by any person authorized to sign a corporation return under section 6062. Such revocation shall be filed with the service center with which the corporation filed its election, except that, if it filed an annual information return under section 6011(e)(2), the revocation shall be filed with the service center with which it filed its last such return.

(ii) *Years for which revocation is effective.* If a corporation files a statement revoking its election to be treated as a DISC during the first 90 days of a taxable year (other than the first taxable year for which such election is effective), such revocation will be effective for such taxable year and all taxable years thereafter. If the corporation files a statement revoking its election to be treated as a DISC after the first 90 days of a taxable year, the revocation will be effective for all taxable years following such taxable year.

(3) *Continued failure to be a DISC.* If a corporation which has elected to be treated as a DISC does not qualify as a DISC (and is not treated as a DISC pursuant to § 1.992–1(g)) for each of any 5 consecutive taxable years, such election terminates and will not be effective for any taxable year after such fifth taxable year. Such termination will be effective automatically, without notice to such corporation or to the Internal Revenue Service. If, during any 5-year period for which an election is effective, the corporation should qualify as a DISC (or be treated as a DISC pursuant to § 1.992–1(g)) for a taxable year, a new 5-year period shall automatically start at the beginning of the following taxable year.

(4) *Election after termination.* If a corporation has made a valid election to be treated as a DISC and such election terminates in either manner described in subparagraph (2) or (3) of this paragraph, such corporation is eligible to reelect to be treated as a DISC at any time by following the procedures described in paragraphs (a) through (c) of this section. If a corporation terminates its election and subsequently reelects to be treated as a DISC, the corporation and its shareholders continue to be subject to sections 995 and 996 with respect to the period during which its first election was in effect. Thus,

for example, distributions upon disqualification includible in the gross incomes of shareholders of a corporation pursuant to section 995(b)(2) continue to be so includible for taxable years for which a second election of such corporation is in effect without regard to the second election.

[T.D. 7323, 39 FR 34405, Sept. 25, 1974, as amended by T.D. 7420, 41 FR 20655, May 20, 1976]

§1.992–3 Deficiency distributions to meet qualification requirements.

(a) *In general.* A corporation which meets the requirements described in §1.992–1 for treatment as a DISC for a taxable year, other than the 95 percent of gross receipts test described in §1.992–1(b) or the 95-percent assets test described in §1.992–1(c), or both tests, may nevertheless qualify as a DISC for such year by making deficiency distributions (attributable to its gross receipts other than qualified export receipts and its assets other than qualified export assets) if all of the following requirements are satisfied:

(1) The corporation distributes the amount determined under paragraph (b) of this section as a deficiency distribution. The amount of a deficiency distribution is determined without regard to the amount by which the corporation fails to meet either test.

(2) The reasonable cause requirements prescribed in paragraph (c)(1) of this section are satisfied with respect to both the corporation's failure to meet either test and its failure to make a deficiency distribution prior to the time the distribution is made.

(3) The corporation makes such deficiency distribution pro rata to all its shareholders.

(4) The corporation designates the distribution, at the time of the distribution, as a deficiency distribution, pursuant to section 992(c), to meet the qualification requirements to be a DISC. Such designation shall be in the form of a communication sent at the time of such distribution to each shareholder and to the service center with which the corporation has filed or will file its return for the taxable year to which the distribution relates. A corporation may not retroactively designate a prior distribution as a deficiency distribution to meet qualification requirements. Subject to the limitation described in paragraph (c)(3) of this section, a corporation may make a deficiency distribution with respect to a taxable year at any time after the close of such taxable year or, in the case of a deficiency distribution made on or before September 29, 1975, at any time during or after such taxable year. See sections 246(d), 904(f), 995, and 996 for rules regarding the treatment of a deficiency distribution to meet qualification requirements by the shareholders and the corporation.

(b) *Amount of deficiency distribution*—(1) *In general.* In order to meet the requirements of paragraph (a) of this section, the amount of a deficiency distribution must be, if the corporation fails to meet—

(i) The 95 percent of gross receipts test, the amount determined in subparagraph (2) of this paragraph,

(ii) The 95-percent assets test, the amount determined in subparagraph (3) of this paragraph, and

(iii) Both such tests, except as provided in subparagraph (4) of this paragraph, the sum of the amounts determined in subparagraphs (2) and (3) of this paragraph.

(2) *Computation of deficiency distribution to meet 95 percent of gross receipts test*—(i) *In general.* If a corporation fails to meet the 95 percent of gross receipts test described in §1.992–1(b) for its taxable year, the amount of the deficiency distribution required by this subparagraph is an amount equal to the sum of its taxable income (if any) from each transaction giving rise to gross receipts (as defined in §1.993–6) which are not qualified export receipts (as defined in §1.993–1). A corporation's taxable income from a transaction shall be the amount of such gross receipts from such transaction reduced only by *(a)* its cost of goods sold attributable to such gross receipts, and by *(b)* its expenses, losses, and other deductions properly apportioned or allocated thereto in a manner consistent with the rules set forth in §1.861–8. For purposes of this subdivision, however, any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income in such manner shall not reduce such

gross receipts. If the corporation is a commission agent for a principal in a transaction, the corporation's taxable income is the amount of the commission from such transaction reduced only by the amounts described in *(b)* of this subdivision.

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

Example. (*a*) X and Y are calendar year taxpayers. X, a domestic manufacturing company, owns all the stock of Y, which seeks to qualify as a DISC for 1973. During 1973, X manufactures a machine which is eligible to be export property as defined in § 1.993–3. Y is made a commission agent with respect to exporting such machine. Thereafter, during 1973 Y is considered to receive gross receipts of $100,000, as determined under section 993(f), attributable to X's sale of the machine in a manner which causes the gross receipts to be excluded receipts pursuant to section 993(a)(2) and, therefore, not qualified export receipts. Y's total gross receipts for 1973 are $1 million of which $900,000 (*i.e.*, 90 percent) are qualified export receipts. Therefore, Y does not satisfy the 95 percent of gross receipts test for 1973 because less than 95 percent of its gross receipts are qualified export receipts. Y has $9,000 of expenses properly apportioned or allocated to its gross income from such sale and $1,000 of other expenses which cannot definitely be allocated to some item or class of gross income, determined in a manner consistent with the rules set forth in § 1.861–8. In order to satisfy the 95 percent of gross receipts test for 1973, if the commission due from X to Y were $15,000, Y must make a deficiency distribution of $6,000 computed as follows:

Y's commission (gross income) from the transaction	$15,000
Less: Y's expenses apportioned or allocated to its gross income from the transaction	9,000
Required deficiency distribution by reason of $100,000 of gross receipts which are not qualified export receipts	6,000

(*b*) If the commission due from X to Y were $9,400, resulting in a net loss of $600 to Y ($9,400 to $10,000), Y must make a deficiency distribution of $400 computed as follows:

Y's commissions (gross income) from the transaction	$9,400
Less: Y's expenses apportioned or allocated to its gross income from the transaction	9,000
Required deficiency distribution by reason of $100,000 of gross receipts which are not qualified export receipts	400

(*c*) If the commission due from X to Y were $8,500, Y would not be required to make a deficiency distribution since, under this subparagraph, there would be no taxable income attributable to gross receipts from the sale.

(3) *Computation of deficiency distribution to meet 95 percent assets test*—(i) *In general.* If a corporation fails to meet the 95 percent assets test described in § 1.992–1(c) for its taxable year, the amount of the deficiency distribution required by this subparagraph is an amount equal to the fair market value as of the last day of such taxable year of the assets which are not qualified export assets held by such corporation on such last day.

(ii) *Asset held for more than 1 year.* In the case of a corporation which holds continuously an asset which is not a qualified export asset at the close of more than 1 taxable year, it must distribute an amount equal to its fair market value (or, if greater, the amount determined under subparagraph (4) of this paragraph) only once if, at the close of the first such taxable year, such corporation reasonably believed that such asset was a qualified export asset. This subdivision shall not apply for any taxable year beginning after the date the corporation knows (or a reasonable man would have known) that an asset is not a qualified export asset and in order to qualify for each such year, the corporation must distribute the fair market value of such asset for each such year.

(4) *Computation in the case of a failure to meet both tests as a result of a single transaction.* If a corporation fails to meet both the 95 percent of gross receipts test and the 95 percent assets test for a taxable year, and if the corporation holds at the end of such year assets (other than cash or qualified export assets) which were received as proceeds of a sale or exchange during such year which resulted in gross receipts other than qualified export receipts, then the amount of the deficiency distribution required by this paragraph with respect to such sale or exchange and assets held is the larger of the amount required by subparagraph (2) of this paragraph with respect to the sale or exchange or the amount required by subparagraph (3) of this paragraph with respect to such assets held. Thus, for example, if a corporation sells property which is not a qualified export asset for $100, receives $85 in cash and a note for

$15, and derives $25 of taxable income from the sale as determined under subparagraph (2) of this paragraph, it must distribute $25. If the provisions of this subparagraph are applied with respect to assets of a DISC (other than qualified export assets), such provisions do not apply to any property received as proceeds from a sale or exchange of such assets.

(c) *Reasonable cause for failure*—(1) *In general.* If for a taxable year, a corporation has failed to meet the 95 percent of gross receipts test, the 95 percent assets test, or both tests, such corporation may satisfy any such test for such year by means of a deficiency distribution in the amount determined under paragraph (b) of this section only if the reasonable cause requirements of this subparagraph are satisfied. Such reasonable cause requirements are satisfied if—

(i) There is reasonable cause (as determined in accordance with subparagraph (2) of this paragraph) for such corporation's failure to satisfy such test and to make such distribution prior to the date on which it was made, the time limit in subparagraph (3) of this paragraph for making the distribution is satisfied, and interest (if required) is paid in the amount and in the manner prescribed by subparagraph (4) of this paragraph, or

(ii) The time and ''70-percent'' requirements of the reasonable cause test of paragraph (d) of this section are satisfied.

(2) *Determination of reasonable cause.* In general, whether a corporation's failure to meet the 95 percent of gross receipts test, the 95 percent assets test, or both tests for a taxable year and its failure to make a pro rata distribution prior to the date on which it was made will be considered for reasonable cause where the action or inaction which resulted in such failure occurred in good faith, such as failure to meet the 95 percent assets test resulting from blocked currency or expropriation, or failure to meet either test because of reasonable uncertainty as to what constitutes a qualified export receipt or a qualified export asset. For further examples, if a corporation's reasonable determination of the percentage of its total gross receipts that are qualified export receipts is subsequently redetermined to be less than 95 percent as a result of a price adjustment by the Internal Revenue Service under section 482, or if the corporation has a casualty loss for which it receives an unanticipated insurance recovery which causes its qualified export receipts to be less than 95 percent of its total gross receipts, then the failure to satisfy the 95 percent of gross receipts test is considered to be due to reasonable cause.

(3) *Time limit for deficiency distribution.* Except as otherwise provided in this subparagraph, the time limit prescribed by this subparagraph for making a deficiency distribution is satisfied if the amount of the distribution required by paragraph (b) of this section is made within 90 days from the date of the first written notification to the corporation by the Internal Revenue Service that it had not satisfied the 95 percent of gross receipts test or the 95 percent assets test or both tests, for a taxable year. Upon a showing by the corporation that an extension of the 90-day time limit is reasonable and necessary, the Commissioner may grant such extension of such time limit. In any case in which a corporation contests the decision of the Internal Revenue Service that such corporation has not met the 95 percent of gross receipts test, the 95 percent assets test, or both tests, an extension of the 90-day time limit will be allowed until 30 days after the final determination of such contest. The date of the final determination of such contest shall, for purposes of section 992(c), be established in the manner specified in subdivisions (i) through (iv) of this subparagraph:

(i) The date of final determination by a decision of the United States Tax Court is the date upon which such decision becomes final, as prescribed in section 7481.

(ii) The date of final determination in a case which is contested in a court (and upon which there is a judgment) other than the Tax Court is the date upon which the judgment becomes final and will be determined on the basis of the facts and circumstances of each particular case. For example, ordinarily a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari if no such petition is duly filed within such time.

(iii) The date of a final determination by a closing agreement, made under section 7121, is the date such agreement is approved by the Commissioner.

(iv) A final determination under section 992(c) may be made by an agreement signed by the district director or director of the service center with which the corporation files its annual return or by such other official to which authority to sign has been delegated, and by or on behalf of the taxpayer. The agreement shall set forth the total amount of the deficiency distribution to be paid to the shareholders of the DISC for the taxable year or years. An agreement under this subdivision shall be sent to the taxpayer at his last known address by either registered or certified mail. If registered mail is used for such purpose, the date of registration is considered the date of final determination; if certified mail is used for such purpose, the date of postmark on the sender's receipt for such mail is considered the date of final determination. If the corporation makes a deficiency distribution before such registration or postmark date but on or after the date the district director or director of the service center or other official has signed the agreement, the date of signature by the district director or director of the service center or other official is considered the date of final determination. If the corporation makes a deficiency distribution before the district director or director of the service center or other official signs the agreement, the date of final determination is considered to be the date of the making of the deficiency distribution. During any extension of time the interest charge provided in subparagraph (4) of this paragraph will continue to accrue at the rate provided for in such subparagraph.

(4) *Payment of interest for delayed distribution*—(i) *In general.* If a corporation makes a deficiency distribution after the 15th day of the ninth month after the close of the taxable year with respect to which such distribution is made, such distribution will not be deemed to satisfy the 95 percent of gross receipts test or the 95 percent assets test for such year unless such corporation pays to the Internal Revenue Service a charge determined by multiplying (a) an amount equal to 4½ percent of such distribution by *(b)* the number of its taxable years which begin *(1)* after the taxable year with respect to which the distribution is made and *(2)* before such distribution is made. Such charge must be paid, within the 30-day period beginning with the day on which such distribution is made, to the service center with which the corporation files its annual information return for its taxable year in which the distribution is made. For purposes of the Internal Revenue Code, such charge is considered interest.

(ii) *Example.* The provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. X corporation, which uses the calendar year as its taxable year, meets the 95 percent assets test but fails to meet the 95 percent of gross receipts test for 1972 and does not by September 15, 1973, make the deficiency distribution required by reason of its failure to meet such test. Assume that reasonable cause exists for the corporation's failure to meet the 95 percent of gross receipts test and failure to make the required deficiency distribution. If X makes the required deficiency distribution, in the amount of $10,000, on April 1, 1976, X must pay on or before April 30, 1976, to the service center with which it files its annual information return a charge of $1,800, computed as follows:

Deficiency distribution made by X	$10,000
Multiplied by 4½ percent	.045
Intermediate product	450
Multiplied by: Number of X's taxable years beginning after 1972 and before April 1, 1976	4
Charge to be paid service center because of late deficiency distribution (which is considered interest)	1,800

(d) *Certain distributions deemed for reasonable cause.* If a corporation makes a distribution in the amount required by paragraph (b) of this section with respect to a taxable year on or before the 15th day of the ninth month after the close of such year, it will be deemed to have acted with reasonable cause with respect to its failure to satisfy the 95 percent of gross receipts test, the 95 percent assets test, or both tests, for such year and its failure to make such distribution prior to the date on which the distribution was made if—

(1) At least 70 percent of the gross receipts of such corporation for such taxable year consist of qualified export receipts, and

(2) The sum of the adjusted bases of the qualified export assets held by such corporation on the last day of each month of the taxable year equals or exceeds 70 percent of the sum of the adjusted bases of all assets held by the corporation on each such day.

[T.D. 7323, 39 FR 34407, Sept. 25, 1974; 39 FR 36009, Oct. 7, 1974, as amended by T.D. 7420, 41 FR 20655, May 20, 1976; T.D. 7854, 47 FR 51739, Nov. 17, 1982]

§1.992–4 Coordination with personal holding company provisions in case of certain produced film rents.

(a) *In general.* Section 992(d)(2) provides that a personal holding company is not eligible to be treated as a DISC. Section 543(a)(5)(B) provides that, for purposes of section 543, the term ‘‘produced film rents’’ means payments received with respect to an interest in a film for the use of, or the right to use, such film, but only to the extent that such interest was acquired before substantial completion of production of such film. Under section 992(e), if such produced film rents are included in the ordinary gross income (as defined in section 543(b)(1)) of a qualified subsidiary for a taxable year of such subsidiary, and such interest was acquired by such subsidiary from its parent, such interest is deemed (for purposes of the application of sections 541, 543(b)(1), and 992(d)(2), and §1.992–1(f) for such taxable year) to have been acquired by such subsidiary at the time such interest was acquired by such parent. Thus, for example, if a parent acquires an interest in a film before it is substantially completed, then substantially completes such film prior to transferring an interest in such motion picture to a qualified subsidiary, the qualified subsidiary is considered as having acquired such interest prior to substantial completion of such motion picture for purposes of determining whether payments from the rental of such motion picture will be classified as produced film rents of such subsidiary. The provisions of section 992(e) and this section are not applicable in determining whether payments received with respect to an interest in a film are included in the ordinary gross income of a parent or a qualified subsidiary. Thus, even though a qualified subsidiary is treated pursuant to this section as having acquired an interest in a film at the time such interest was acquired by such subsidiary’s parent, payments received by such parent with respect to such interest prior to the transfer of such interest to such subsidiary are includible in the ordinary gross income of such parent and not includible in the ordinary gross income of such subsidiary.

(b) *Definitions*—(1) *Qualified subsidiary.* For purposes of this section, a corporation is a qualified subsidiary for a taxable year if—

(i) Such corporation was established for the purpose of becoming a DISC,

(ii) Such corporation would qualify (or be treated) as a DISC for such taxable year if it is not a personal holding company, and

(iii) On every day of such taxable year on which shares of such corporation are outstanding, at least 80 percent of such shares are held directly by a second corporation.

(2) *Parent.* For purposes of this section, the term ‘‘parent’’ means a second corporation referred to in subparagraph (1)(iii) of this paragraph.

[T.D. 7323, 39 FR 34409, Sept. 25, 1974]

§1.993–1 Definition of qualified export receipts.

(a) *In general.* For a corporation to qualify as a DISC, at least 95 percent of its gross receipts for a taxable year must consist of qualified export receipts. Under section 993(a), the term ‘‘qualified export receipts’’ means any of the eight amounts described in paragraphs (b) through (i) of this section, except to the extent that any of the eight amounts is an excluded receipt within the meaning of paragraph (j) of this section. For purposes of this section and §§1.993–2 through 1.993–6—

(1) *DISC.* All references to a DISC mean a DISC, except when the context

indicates that such term means a corporation in the process of meeting the conditions necessary for that corporation to become a DISC, or a corporation being tested as to whether it qualifies as a DISC.

(2) *Sale, lease, and license.* The term ''sale'' includes an exchange or other disposition and the term ''lease'' includes a rental or a sublease. The term ''license'' includes a sublicense. All rules under this section and §§ 1.993–2 through 1.993–6 applicable to leases of export property apply in the same manner to licenses of export property. See § 1.993–3(f)(3) for a description of intangible property which cannot be export property.

(3) *Gross receipts.* The term ''gross receipts'' is defined by section 993(f) and § 1.993–6.

(4) *Qualified export assets.* The term ''qualified export assests'' is defined by section 993(b) and § 1.993–2.

(5) *Export property.* The term ''export property'' is defined by section 993(c) and § 1.993–3.

(6) *Related person.* The term ''related person'' means a person who is related to another person if either immediately before or after a transaction—

(i) The relationship between such persons would result in a disallowance of losses under section 267 (relating to disallowance of losses, etc., between related taxpayers), or section 707(b) (relating to losses disallowed, etc., between partners and controlled partnerships), and the regulations thereunder, or

(ii) Such persons are members of the same controlled group of corporations, as defined in section 1563(a) (relating to definition of controlled group of corporations), except that (*a*) ''more than 50 percent'' shall be substituted for ''at least 80 percent'' each place it appears in section 1563(a) and the regulations thereunder, and (*b*) the provisions of section 1563(b) shall not apply in determining whether such persons are members of the same controlled group.

(7) *Related supplier.* The term ''related supplier'' is defined by § 1.994–1(a)(3)(ii).

(8) *Controlled group.* The term ''controlled group'' is defined by paragraph (k) of this section.

(b) *Sales of export property.* Qualified export receipts of a DISC include gross receipts from the sale of export property by such DISC, or by any principal for whom such DISC acts as a commission agent (whether or not such principal is a related supplier), pursuant to the terms of a contract entered into with a purchaser by such DISC or by such principal at any time or by any other person and assigned to such DISC or such principal at any time prior to the shipment of such property to the purchaser. Any agreement, oral or written, which constitutes a contract at law, satisfies the contractual requirement of this paragraph. Gross receipts from the sale of export property, whenever received, do not constitute qualified export receipts unless the seller (or the corporation acting as commission agent for the seller) is a DISC at the time of the shipment of such property to the purchaser. For example, if a corporation which sells export property under the installment method is not a DISC for the taxable year in which the property is shipped to the purchaser, gross receipts from such sale do not constitute qualified export receipts for any taxable year of the corporation.

(c) *Leases of export property*—(1) *In general.* Qualified export receipts of a DISC include gross receipts from the lease of export property provided that—

(i) Such property is held by such DISC (or by a principal for whom such DISC acts as commission agent with respect to the lease) either as an owner or lessee at the beginning of the term of such lease, and

(ii) Such DISC qualified (or was treated) as a DISC for its taxable year in which the term of such lease began.

(2) *Prepayment of lease receipts.* If part or all of the gross receipts from a lease of property are prepaid, then—

(i) All such prepaid gross receipts are qualified export receipts of a DISC if it is reasonably expected at the time of such prepayment that throughout the term of such lease they would be qualified export receipts if received not as a prepayment; or

(ii) If it is reasonably expected at the time of such prepayment that throughout the term of such lease they would not be qualified export receipts if received not as a prepayment, then only those prepaid receipts, for the taxable years of the DISC for which they would be qualified export receipts, are qualified export receipts.

Thus, for example, if a lessee makes a prepayment of the first and last years' rent, and it is reasonably expected that the leased property will be export property for the first half of the lease period but not the second half of such period, the amount of the prepayment which represents the first year's rent will be considered qualified export receipts if it would otherwise qualify, whereas the amount of the prepayment which represents the last year's rent will not be considered qualified export receipts.

(d) *Related and subsidiary services*—(1) *In general.* Qualified export receipts of a DISC include gross receipts from services furnished by such DISC which are related and subsidiary to any sale or lease (as described in paragraph (b) or (c) of this section) of export property by such DISC or with respect to which such DISC acts as a commission agent, provided that such DISC derives qualified export receipts from such sale or lease. Such services may be performed within or without the United States.

(2) *Services furnished by DISC.* Services are considered to be furnished by a DISC for purposes of this paragraph if such services are provided by—

(i) The person who sold or lease the export property to which such services are related and subsidiary, provided that the DISC acts as a commission agent with respect to the sale or lease of such property and with respect to such services,

(ii) The DISC as principal, or any other person pursuant to a contract between such person and such DISC, provided the DISC acted as principal or commission agent with respect to the sale or lease of such property, or

(iii) A member of the same controlled group as the DISC where the sale or lease of the export property is made by another member of such controlled group provided, however, that the DISC act as principal or commission agent with respect to such sale or lease and as commission agent with respect to such services.

(3) *Related services.* A service is related to a sale or lease of export property if—

(i) Such service is of the type customarily and usually furnished with the type of transaction in the trade or business in which such sale or lease arose and

(ii) The contract to furnish such service—

(*a*) Is expressly provided for in or is provided for by implied warranty under the contract of sale or lease,

(*b*) Is entered into on or before the date which is 2 years after the date on which the contract under which such sale or lease was entered into, provided that the person described in subparagraph (2) of this paragraph which is to furnish such service delivers to the purchaser or lessor a written offer or option to furnish such services on or before the date on which the first shipment of goods with respect to which the service is to be performed is delivered, or

(*c*) Is a renewal of the services contract described in (*a*) or (*b*) of this subdivision. Services which may be related to a sale or lease of export property include but are not limited to warranty service, maintenance service, repair service, and installation service. Transportation (including insurance related to such transportation) may be related to a sale or lease of export property, provided that the cost of such transportation is included in the sale price or rental of the property or, if such cost is separately stated, is paid by the DISC (or its principal) which sold or leased the property to the person furnishing the transportation service. Financing or the obtaining of financing for a sale or lease is not a related service for purposes of this paragraph.

(4) *Subsidiary services*—(i) *In general.* Services related to a sale or lease of export property are subsidiary to such sale or lease only if it is reasonably expected at the time of such sale or lease that the gross receipts from all related services furnished by the DISC (as defined in subparagraphs (2) and (3) of this paragraph) will not exceed 50 percent of the sum of (a) the gross receipts from such sale or lease and (b) the gross receipts from related services furnished by the DISC (as described in

subparagraph (2) of this paragraph). In the case of a sale, reasonable expectations at the time of the sale are based on the gross receipts from all related services which may reasonably be expected to be performed at any time before the end of the 10-year period following the date of such-sale. In the case of a lease, reasonable expectations at the time of the lease are based on the gross receipts from all related services which may reasonably be expected to be performed at any time before the end of the term of such lease (determined without regard to renewal options).

(ii) *Allocation of gross receipts from services.* In determining whether the services related to a sale or lease of export property are subsidiary to such sale or lease, the gross receipts to be treated as derived from the furnishing of services may not be less than the amount of gross receipts reasonably allocated to such services as determined under the facts and circumstances of each case without regard to whether—

(*a*) Such services are furnished under a separate contract or under the same contract pursuant to which such sale or lease occurs or

(*b*) The cost of such services is specified in the contract of sale or lease.

(iii) *Transactions involving more than one item of export property.* If more than one item of export property is sold or leased in a single transaction pursuant to one contract, the total gross receipts from such transaction and the total gross receipts from all services related to such transaction are each taken into account in determining whether such services are subsidiary to such transaction. However, the provisions of this subdivision apply only if such items could be included in the same product line, as determined under § 1.994–1(c)(7).

(iv) *Renewed service contracts.* If under the terms of a contract for related services, such contract is renewable within 10 years after a sale of export property, or during the term of a lease of export property, related services to be performed under the renewed contract are subsidiary to such sale or lease if it is reasonably expected at the time of such renewal that the gross receipts from all related services which have been and which are to be furnished by the DISC (as described in subparagraph (2) of this paragraph) will not exceed 50 percent of the sum of (*a*) the gross receipts from such sale or lease and (*b*) the gross receipts from related services furnished by the DISC (as so described). Reasonable expectations are determined as provided in subdivision (i) of this subparagraph.

(v) *Parts used in services.* In a services contract described in subparagraph (3) of this paragraph provides for the furnishing of parts in connection with the furnishing of related services, gross receipts from the furnishing of such parts are not taken into account in determining whether under this subparagraph the services are subsidiary. See paragraph (b) or (c) of this section to determine whether the gross receipts from the furnishing of parts consitute qualified export receipts. See § 1.993–3(c)(2)(iv) and (e)(3) for rules regarding the treatment of such parts with respect to the manufacture of export property and the foreign content of such property, respectively.

(5) *Relation to leases.* If the gross receipts for services which are related and subsidiary to a lease of property have been prepaid at any time for all such services which are to be performed before the end of the term of such lease, then as of the time of the prepayment the rules in paragraph (c)(2) of this section (relating to prepayment of lease receipts) will determine whether prepaid services under this subdivision are qualified export receipts. Thus, for example if it is reasonably expected that leased property will be export property for the first year of the term of the lease but will not be export property for the second year of the term, prepaid gross receipts for related and subsidiary services to be furnished in the first year may be qualified export receipts. However, any prepaid gross receipts for such services to be furnished in the second year cannot be qualified export receipts.

(6) *Relation with export property determination.* The determination as to whether gross receipts from the sale or lease of export property constitute qualified export receipts does not depend upon whether services connected with such sale or lease are related and

subsidiary to such sale or lease. Thus, for example, assume that a DISC receives gross receipts of $1,000 from the sale of export property and gross, receipts of $1,100 from installation and maintenance services which are to be furnished by such DISC within 10 years after the sale and which are related to such sale. The $1,100 which the DISC receives for such services would not be qualified export receipts since the gross receipts from the services exceed 50 percent of the sum of the gross receipts from the sale and the gross receipts from the related services furnished by such DISC. The $1,000 which the DISC receives from the sale of export property would, however, be a qualified export receipt if the sale met the requirements of paragraph (b) of this section.

(e) *Gains from sales of certain qualified export assets.* Qualified export receipts of a DISC include gross receipts from the sale by such DISC of any assets (wherever located) which, as of the date of such sale, are qualified export assets as defined in §1.993–2 even though such assets are not export property (as defined in §1.993–3). Gross receipts are derived from the sale of such assets only where such sale results in recognized gain (see §1.993–6(a)). For purposes of this paragraph, losses from the sale of such qualified export assets shall not be taken into account for purposes of determining the DISC's qualified export receipts.

(f) *Dividends.* Qualified export receipts of a DISC for a taxable year include all dividends includible in the gross income of such DISC for such taxable year with respect to the stock of related foreign export corporations (as defined in §1.993–5) and all amounts includible in the gross income of such DISC with respect to such corporations pursuant to section 951 (relating to amounts included in the gross income of U.S. shareholders of controlled foreign corporations).

(g) *Interest on obligations which are qualified export assets.* Qualified export receipts of a DISC include interest on any obligation which is a qualified export asset of such DISC, including any amount includible in gross income as interest (such as, for example, an amount treated as original issue discount pursuant to section 1232) or as imputed interest under section 483. Gain from the sale of obligations described in this paragraph is treated (to the extent such gain is not treated as interest on such obligations) as qualified export receipts pursuant to paragraph (e) of this section.

(h) *Engineering and architectural services*—(1) *In general.* Qualified export receipts of a DISC include gross receipts from engineering services (as described in subparagraph (5) of this paragraph) or architectural services (as described in subparagraph (5) of this paragraph) or architectural services (as described in subparagraph (6) of this paragraph) furnished by such DISC (as described in subparagraph (7) of this paragraph) for a construction project (as defined in subparagraph (8) of this paragraph) located, or proposed for location, outside the United States. Such services may be performed within or without the United States.

(2) *Services included.* Engineering and architectural services include feasibility studies for a proposed construction project whether or not such project is ultimately initiated.

(3) *Excluded services.* Engineering and architectural services do not include—

(i) Services connected with the exploration for minerals or

(ii) Technical assistance or knowhow.

For purposes of this paragraph, the term ‘‘technical assistance or knowhow’’ includes activities or programs designed to enable business, commerce, industrial establishments, and governmental organizations to acquire or use scientific, architectural, or engineering information.

(4) *Other services.* Receipts from the performance of construction activities other than engineering and architectural services constitute qualified export receipts to the extent that such activities are related and subsidiary services (within the meaning of paragraph (d) of this section) with respect to a sale or lease of export property.

(5) *Engineering services.* For purposes of this paragraph, engineering services in connection with any construction project (within the meaning of subparagraph (8) of this paragraph) include

any professional services requiring engineering education, training, and experience and the application of special knowledge of the mathematical, physical, or engineering sciences to such professional services as consultation, investigation, evaluation, planning, design, or responsible supervision of construction for the purpose of assuring compliance with plans, specifications, and design.

(6) *Architectural services.* For purposes of this paragraph, architectural services include the offering or furnishing of any professional services such as consultation, planning, aesthetic, and structural design, drawings and specifications, or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project (within the meaning of subparagraph (8) of this paragraph).

(7) *Definition of ''furnished by such DISC''.* For purposes of this paragraph, architectural and engineering services are considered furnished by a DISC if such services are provided—

(i) By the DISC,

(ii) By another person (whether or not a United States person) pursuant to a contract entered into by such person with the DISC at any time prior to the furnishing of such services, provided that the DISC acts as principal with respect to the furnishing of such services, or

(iii) By another person (whether or not a United States person) pursuant to a contract for the furnishing of such services entered into at any time prior to the furnishing of such services provided that the DISC acts as commission agent with respect to such services.

(8) *Definition of ''construction project''.* For purposes of this paragraph, the term ''construction project'' includes the erection, expansion, or repair (but not including minor remodeling or minor repairs) of new or existing buildings or other physical facilities including, for example, roads, dams, canals, bridges, tunnels, railroad, tracks, and pipelines. The term also includes site grading and improvement and installation of equipment necessary for the construction. Gross receipts from the sale or lease of construction equipment are not qualified export receipts unless such equipment is export property (as defined in § 1.993–3).

(i) *Managerial services*—(1) *In general.* Qualified export receipts of a first DISC for its taxable year include gross receipts from the furnishing of managerial services provided for another DISC, which is not a related person, to aid such unrelated DISC in deriving qualified export receipts, provided that at least 50 percent of the gross receipts of the first DISC for such year consists of qualified export receipts derived from the sale or lease of export property and the furnishing of related and subsidiary services, as described in paragraph (b), (c), and (d) of this section, respectively.

For purposes of this paragraph, managerial services are considered furnished by a DISC if such services are provided—

(i) By the first DISC,

(ii) By another person (whether or not a United States person) pursuant to a contract entered into by such person with the first DISC at any time prior to the furnishing of such services, provided that the first DISC acts as principal with respect to the furnishing of such services, or

(iii) By another person (whether or not a United States person) pursuant to a contract for the furnishing of such services entered into at any time prior to the furnishing of such services provided that the DISC acts as commission agent with respect to such services.

(2) *Definition of ''managerial services.''* The term ''managerial services'' as used in this paragraph means activities relating to the operation of another unrelated DISC which derives qualified export receipts from the sale or lease of export property and from the furnishing of services related and subsidiary to such sales or leases. Such term includes staffing and operational services necessary to operate such other DISC, but does not include legal, accounting, scientific, or technical services. Examples of managerial services are: (i) Export market studies, (ii) making shipping arrangements, and (iii) contracting potential foreign purchasers.

(3) *Status of recipient of managerial services*—(i) *In general.* Qualified export receipts of a first DISC include receipts from the furnishing of managerial services during any taxable year of a recipient if such recipient qualifies as a DISC (within the meaning of §1.992–1(a) for such taxable year.

(ii) *Recipient deemed to qualify as a DISC.* For purposes of subdivision (i) of this subparagraph, a recipient is deemed to qualify as a DISC for its taxable year if the first DISC obtains from such recipient a copy of such recipient's election to be treated as a DISC as described in §1.992–2(a) together with such recipient's sworn statement that such election has been filed with the Internal Revenue Service Center. The recipient may mark out the names of its shareholders on a copy of its election to be treated as a DISC before submitting it to the first DISC. The copy of the election and the sworn statement of such recipient must be received by the first DISC within 6 months after the beginning of the first taxable year of the recipient during which such first DISC furnishes managerial services for such recipient. The copy of the election and the sworn statement of the recipient need not be obtained by the first DISC for subsequent taxable years of the recipient.

(iii) *Recipient not treated as a DISC.* For purposes of subdivision (i) of this subparagraph, a recipient of managerial services is not treated as a DISC with respect to such services performed during a taxable year for which such recipient does not qualify as a DISC if the DISC performing such services does not believe or if a reasonable person would not believe (taking into account the furnishing DISC's managerial relationship with such recipient DISC) at the beginning of such taxable year that the recipient will qualify as a DISC for such taxable year.

(j) *Excluded receipts*—(1) *In general.* Notwithstanding the provisions of paragraphs (b) through (i) of this section, qualified export receipts of a DISC do not include any of the five amounts described in subparagraphs (2) through (6) of this paragraph.

(2) *Sales and leases of property for ultimate use in the United States.* Property which is sold or leased for ultimate use in the United States does not constitute export property. See §1.993–3(d)(4) (relating to determination of where the ultimate use of the property occurs). Thus, qualified export receipts of a DISC described in paragraph (b) or (c) of this section do not include gross receipts of the DISC from the sale or lease of such property.

(3) *Sales of export property accomplished by subsidy.* Qualified export receipts of a DISC do not include gross receipts described in paragraph (b) of this section if the sale of export property (whether or not such property consists of agricultural products) is pursuant to any of the following:

(i) The development loan program, or grants under the technical cooperation and development grants program of the Agency for International Development, or grants under the military assistance program administered by the Department of Defense, pursuant to the Foreign Assistance Act of 1961, as amended (22 U.S.C. 2151), unless the DISC shows to the satisfaction of the district director that, under the conditions existing at the time of the sale, the purchaser had a reasonable opportunity to purchase, on competitive terms and from a seller who was not a U.S. person, goods which were substantially identical to such property and which were not manufactured, produced, grown, or extracted (as described in §1.993–3(c)) in the United States,

(ii) The Pub. L. 480 program authorized under title I of the Agricultural Trade Development and Assistance Act of 1954, as amended (7 U.S.C. 1691, 1701–1710),

(iii) For taxable years ending before January 1, 1974, the Barter program of the Commodity Credit Corporation authorized by section 4(h) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714b(h)), and section 303 of the Agricultural Trade Development and Assistance Act of 1954, as amended (7 U.S.C. 1692) but only if the taxpayer treats such sales as sales giving rise to excluded receipts,

(iv) The Export Payment program of the Commodity Credit Corporation authorized by sections 5(d) and (f) of the Commodity Credit Corporation Charter

Act, as amended (15 U.S.C. 714c (d) and (f)),

(v) The section 32 export payment programs authorized by section 32 of the Act of August 24, 1935, as amended (7 U.S.C. 612c), and

(vi) For taxable years beginning after November 3, 1972, the Export Sales program of the Commodity Credit Corporation authorized by sections 5 (d) and (f) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714c (d) and (f)), other than the GSM–4 program provided under 7 CFR part 1488, and section 407 of the Agricultural Act of 1949, as amended (7 U.S.C. 1427), for the purpose of disposing of surplus agricultural commodities and exporting or causing to be exported agricultural commodities, except that for taxable years beginning on or before November 3, 1972, the taxpayer may treat such sales as sales giving rise to excluded receipts.

(4) *Sales or lease of export property and furnishing of engineering or architectural services for use by the United States*—(i) *In general.* Qualified export receipts of a DISC do not include gross receipts described in paragraph (b), (c), or (h) of this section if a sale or lease of export property, or the furnishing of engineering or architectural services, is for use by the United States or an instrumentality thereof in any case in which any law or regulation requires in any manner the purchase or lease of property manufactured, produced, grown, or extracted in the United States or requires the use of engineering or architectural services performed by a U.S. person. For example, a sale by a DISC of export property to the Department of Defense for use outside the United States would not produce qualified export receipts for such DISC if the Department of Defense purchased such property from appropriated funds subject to any provisions of the Armed Services Procurement Regulations (32 CFR subchapter A, part 6, subpart A) or any appropriations act for the Department of Defense for the applicable year which restricts the availability of such appropriated funds to the procurement of items which are grown, reprocessed, reused, or produced in the United States.

(ii) *Direct or indirect sales or leases.* Any sale or lease of export property is for use by the United States or an instrumentality thereof is such property is sold or leased by a DISC (or by a principal for whom such DISC acts as commission agent) to—

(*a*) A person who is a related person with respect to such DISC or such principal and who sells or leases such property for use by the United States or an instrumentality thereof or

(*b*) A person who is not a related person with respect to such DISC or such principal if, at the time of such sale or lease, there is an agreement or understanding that such property will be sold or leased for use by the United States or an instrumentality thereof (or if a reasonable person would have known at the time of such sale or lease that such property would be sold or leased for use by the United States or an instrumentality thereof) within 3 years after such sale or lease.

(iii) *Excluded programs.* The provisions of subdivisions (i) and (ii) of this subparagraph do not apply in the case of a purchase by the United States or an instrumentality thereof if such purchase is pursuant to—

(*a*) The Foreign Military Sales Act, as amended (22 U.S.C. 2751 *et seq.*), or a program under which the U.S. Government purchases property for resale, on commercial terms, to a foreign government or agency or instrumentality thereof, or

(*b*) A program (whether bilateral or multilateral) under which sales to the U.S. Government are open to international competitive bidding.

(5) *Services.* Qualified export receipts of a DISC do not include gross receipts described in paragraph (d) of this section (concerning related and subsidiary services) if the services from which such gross receipts are derived are related and subsidiary to the sale or lease of property which results in excluded receipts pursuant to this paragraph.

(6) *Receipts within controlled group*—(i) *In general.* Gross receipts of a corporation do not constitute qualified export receipts for any taxable year of such corporation if—

(*a*) At the time of the sale, lease, or other transaction resulting in such gross receipts, such corporation and the person from whom such receipts are directly or indirectly derived (whether or not such corporation and such person are the same person) are members of the same controlled group (as defined in paragraph (k) of this section) and

(*b*) Such corporation and such person each qualifies (or is treated under section 992(a)(2)) as a DISC for its taxable year in which its receipts arise.

Thus, for example, assume that R, S, X, and Y are members of the same controlled group and that X and Y are DISC's. If R sells property to S and pays X a commission relating to that sale and if S sells the same property to an unrelated foreign party and pays Y a commission relating to that sale, the receipts received by X from the sale of such property by R to S will be considered to be derived from Y, a DISC which is a member of the same controlled group as X, and thus will not result in qualified export receipts to X. The receipts received by Y from the sale to an unrelated foreign party may, however, result in qualified export receipts to Y. For another example, if R and S both assign the commissions to X, receipts derived from the sale from R to S will be considered to be derived from X acting as commission agent for S and will not result in qualified export receipts to X. Receipts derived by X from the sale of property by S to an unrelated foreign party, may, however, constitute qualified export receipts.

(ii) *Leased property*. See §1.993–3(f)(2) regarding property not constituting export property in certain cases where such property is leased to any corporation which is a member of the same controlled group as the lessor.

(k) *Definition of ''controlled group''*. For purposes of sections 991 through 996 and the regulations thereunder, the term ''controlled group'' has the same meaning as is assigned to the term ''controlled group of corporations'' by section 1563(a), except that (1) the phrase ''more than 50 percent'' is substituted for the phrase ''at least 80 percent'' each place the latter phrase appears in section 1563(a), and (2) section 1563(b) shall not apply. Thus, for example, a foreign corporation subject to tax under section 881 may be a member of a controlled group. Furthermore, two or more corporations (including a foreign corporation) are members of a controlled group at any time such corporations meet the requirements of section 1563(a) (as modified by this paragraph).

(l) *DISC's entitlement to income*—(1) *Application of section 994.* A corporation which meets the requirements of §1.992–1(a) to be treated as a DISC for a taxable year is entitled to income, and the intercompany pricing rules of section 994(a)(1) or (2) apply, in the case of any transactions described in §1.994–1(b) between such DISC and its related supplier (as defined in §1.994–1(a)(3)). For purposes of this subparagraph, such DISC need not have employees or perform any specific function.

(2) *Other transactions.* In the case of a transaction to which the provisions of subparagraph (1) of this paragraph do not apply but from which a DISC derives gross receipts, the income to which the DISC is entitled as a result of the transaction is determined pursuant to the terms of the contract for such transaction and, if applicable, section 482 and the regulations thereunder.

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

Example 1. P Corporation forms S Corporation as a wholly-owned subsidiary. S qualifies as a DISC for its taxable year. S has no employees on its payroll. S is granted a franchise with respect to specified exports of P. P will sell such exports to S for resale by S. Such exports are of a type which produce qualified export receipts as defined in paragraph (b) of this section. P's sales force will solicit orders in the name of S using S's order forms. S places orders with P only when S itself has received orders. No inventory is maintained by S. P makes shipments directly to customers of S. Employees of P will act for S and billings and collections will be handled by P in the name of S. Under these facts, the income derived by S for such taxable year from the purchase and resale of the specified export is treated for Federal income tax purposes as the income of S, and the amount of income allocable to S will be determined under section 994 of the Code.

Example 2. P Corporation forms S Corporation as a wholly-owned subsidiary. S qualifies as a DISC for its taxable year. S has no employees on its payroll. S is granted a sales franchise with respect to specified exports of P and will receive commissions with respect to such exports. Such exports are of a type which will produce gross receipts for S which are qualified export receipts as defined in paragraph (b) of this section. P's sales force will solicit orders in the name of P. Billings and collections are handled directly by P. Under these facts, the commissions paid to S for such taxable year with respect to the specified exports shall be treated for Federal income tax purposes as the income of S, and the amount of income allocable to S is determined under section 994 of the Code.

[T.D. 7514, 42 FR 55454, Oct. 17, 1977; 42 FR 60910, Nov. 30, 1977, as amended by T.D. 7854, 47 FR 51739, Nov. 17, 1982]

§ 1.993–2 Definition of qualified export assets.

(a) *In general.* For a corporation to qualify as a DISC, at the close of its taxable year it must have qualified export assets with adjusted bases equal to at least 95 percent of the sum of the adjusted bases of all its assets. An asset which is a qualified export asset under more than one paragraph of this section shall be taken into account only once in determining the sum of the adjusted bases of all qualified export assets. Under section 993(b), the qualified export assets held by a corporation are—

(1) Export property as defined in § 1.993–3 (see paragraph (b) of this section),

(2) Business assets described in paragraph (c) of this section,

(3) Trade receivables described in paragraph (d) of this section,

(4) Temporary investments to the extent described in paragraph (e) of this section,

(5) Producer's loans as defined in § 1.993–4 (see paragraph (f) of this section),

(6) Stock or securities (described in paragraph (g) of this section) of related foreign export corporations as defined in § 1.993–5,

(7) Export-Import Bank and other obligations described in paragraph (h) of this section,

(8) Financing obligations described in paragraph (i) of this section, and

(9) Funds awaiting investment described in paragraph (j) of this section.

(b) *Export property.* In general, export property is certain property held for sale or lease which meets the requirements of § 1.993–3.

(c) *Business assets.* For purposes of this section, business assets are assets used by a DISC (other than as a lessor) primarily in connection with—

(1) The sale, lease, storage, handling, transportation, packaging, assembly, or servicing of export property, or

(2) The performance of engineering or architectural services (described in § 1.993–1(h)) or managerial services (described in § 1.993–1(i)) in furtherance of the production of qualified export receipts.

Assets used primarily in the manufacture, production, growth, or extraction (within the meaning of § 1.993–3(c)) of property are not business assets.

(d) *Trade receivables*—(1) *In general.* For purposes of this section, trade receivables are accounts receivable and evidences of indebtedness which arise by reason of transactions of such corporation or of another corporation which is a DISC and which is a member of a controlled group which includes such corporation described in subparagraph (A), (B), (C), (D), (G), or (H), of section 993(a)(1) and which are due the DISC (or, if it acts as an agent, due its principal) and held by the DISC.

(2) *Trade receivables representing commissions.* If a DISC acts as commission agent for a principal in a transaction described in § 1.993–1 (b), (c), (d), (e), (h), or (i) which results in qualified export receipts for the DISC, and if an account receivable or evidence of indebtedness held by the DISC and representing the commission payable to the DISC as a result of the transaction arises (and, in the case of an evidence of indebtedness, designated on its face as representing such commission), such account receivable or evidence of indebtedness shall be treated as a trade receiveable. If, however, the principal is a related supplier (as defined in § 1.994–1(a)(3)) with respect to the DISC, such account receivable or evidence of indebtedness will not be treated as a trade receivable unless it is payable and paid in a time and manner which satisfy the requirements of § 1.994–1(e)(3) or (5) (relating to initial payment of transfer price or commission and procedure for adjustments to transfer price or commission, respectively), as the case may be. However, see subparagraph (3) of

this paragraph for rules regarding certain accounts receivable representing commissions payable to a DISC by its related supplier.

(3) *Indebtedness arising under §1.994–1(e).* An indebtedness arising under §1.994–1(e)(3)(iii) (relating to initial payment of transfer price or commission) in favor of a DISC is not a qualified export asset. An indebtedness arising under §1.994–1(e)(5)(i) (relating to procedure for adjustments to transfer price or commission) in favor of a DISC is a trade receivable if it is paid in the time and manner described in §1.994–1(e)(5)(i) and (ii) and if it otherwise satisfies the requirements of subparagraph (2) of this paragraph. If such an indebtedness is not paid in the time and manner described in §1.994–1(e)(5)(i) and (ii), it is not a qualified export asset.

(e) *Temporary investments*—(1) *In general.* For purposes of this section, temporary investments are money, bank deposits (not including time deposits of more than 1 year), and other similar temporary investments to the extent maintained by a DISC as reasonably necessary to meet its requirements for working capital. For purposes of this paragraph, a temporary investment is an obligation, including an evidence of indebtedness as defined in paragraph (d)(1) of this section, which is a demand obligation or has a period remaining to maturity of not more than 1 year at the date it is acquired by the DISC. A temporary investment does not include trade receivables.

(2) *Determination of amount of working capital maintained.* For purposes of this paragraph—

(i) The working capital of a DISC is the excess of its current assets over current liabilities.

(ii) Current assets are cash and other assets (other than trade receivables) which may reasonably be expected to be converted into cash or sold or consumed during the current normal operating cycle of the DISC's trade or business.

(iii) Current liabilities are obligations (or portions of obligations) due within the current normal operating cycle of the trade or business of the DISC whose satisfaction when due is reasonably expected to require the use of current assets.

(iv) Generally accepted financial accounting treatments will be accepted, and

(v) Current assets (other than temporary investments) are taken into account before temporary investments, and trade receivables are never taken into account, in determining whether such temporary investments are maintained by the DISC as reasonably necessary to meet his current liabilities and its requirements for working capital.

(3) *Determination of amount of working capital reasonably required.* For purposes of this paragraph, a determination of the amount of money, bank deposits, and other similar temporary investments reasonably necessary to meet the requirements of the DISC for working capital will depend upon the nature and volume of the activities of the DISC existing at the end of the DISC's taxable year for which such determination is made, such as, for example—

(i) In the case of a DISC which purchases and sells inventory, the amount of working capital reasonably required is limited to an amount reasonably necessary to meet the ordinary operating expenses during the current normal operating cycle of the trade or business of the DISC, an amount reasonably needed to meet specific and definite plans for expansion and any amounts necessary for reasonably anticipated extraordinary business expenses.

(ii) In the case of a DISC which actively conducts a trade or business (including the employment of a sales force) and receives commissions in respect of goods to which such DISC does not have title, the amount of working capital required will depend upon the nature and volume of the activities of the DISC which produce such income as they exist on the applicable determination date. In determining the amount of working capital which is reasonably required for the production of such income, the anticipated future needs of the business will be taken into account to the extent that such needs relate to the year of the DISC following the applicable determination date. Anticipated future needs relating to a later period will not be taken into account unless it is clearly established that such needs are reasonably related to the production of such income as of the applicable determination date.

(iii) In the case of a DISC which does not actively conduct a trade or business, and which receives commissions solely by reason of section 994(a)(1), (a)(2), or (b) with respect to goods to which such DISC does not have title, no working capital would be required beyond a de minimis amount unless it appears from the facts and circumstances that additional working capital will be required.

(iv) In the case of a DISC deriving income from the leasing of property, the amount of working capital required will be determined on the basis of the facts and circumstances in such case.

(4) *Relationship of working capital to other qualified export assets.* If a temporary investment is a qualified export asset under any provision of this section (other than this paragraph), this paragraph shall not affect its status as a qualified export asset. However, any such temporary investment is taken into account before other temporary investments in determining whether such other temporary investments are maintained by a DISC as reasonably necessary to meet its requirements for working capital. Current assets (other than temporary investments) are taken into account before temporary investments, and trade receivables are never taken into account, in determining whether such temporary investments are maintained by the DISC as reasonably necessary requirements for working capital. An obligation issued or incurred by a member of a controlled group (as defined in § 1.993–1(k)) of which the DISC is a member is not a qualified export asset under this paragraph. For rules regarding working capital as of the end of each month of a taxable year for purposes of the 70-percent reasonableness standard with respect to certain deficiency distributions, see paragraph (j)(3) of this section.

(f) *Producer's loans.* For purposes of this section, a producer's loan is an evidence of indebtedness arising in connection with producer's loans which are made by a DISC and which meet the requirements of § 1.993–4. If a producer's loan is a qualified export asset, interest accrued with respect to the producer's loan will also be treated as a qualified export asset provided that payment is made in the form of money, property (valued at its fair market value on its date of transfer and including accounts receivable for sales by or through a DISC), a written obligation which qualifies as a debt under the safe harbor rule of § 1.992–1(d)(2)(ii), or an accounting entry offsetting the account receivable against an existing debt owed by the person in whose favor the account receivable was established to the person with whom it engaged in the transaction and that payment is made no later than 60 days following the close of the taxable year of accrual of the interest. This paragraph (f) is effective for taxable years beginning after January 10, 1985 except that the taxpayer may at its option apply the provisions of this paragraph to taxable years ending after December 31, 1971.

(g) *Stock or securities of related foreign corporations.* For purposes of this section, the term ''stock or securities'', with respect to a related foreign export corporation (as defined in § 1.993–5), has the same meaning as such term has as used in section 351 (relating to transfers to controlled corporations), except that the term ''securities'' does not include obligations which are repaid, in whole or in part, at any time during the taxable year of the DISC following the taxable year of the DISC during which such obligations were acquired by the DISC or were issued, unless the DISC demonstrates to the satisfaction of the district director that the repayment was for bona fide business purposes and not for the purpose of avoidance of Federal income taxes.

(h) *Export-Import Bank obligations.* For purposes of this section, the term ''Export-Import Bank obligations'' means obligations issued, guaranteed, insured, or reinsured (in whole or in part) by the Export-Import Bank of the United States or by the Foreign Credit Insurance Association, but only if such obligations are acquired by the DISC—

(1) From the Export-Import Bank of the United States,

(2) From the Foreign Credit Insurance Association, or

(3) From the person selling or purchasing the goods or services by reason

of which such obligations arose, or from any corporation which is a member of the same controlled group (as defined in §1.993–1(k)) as such person.

For purposes of this paragraph, obligations issued by a person described in subparagraphs (1), (2), and (3) of this paragraph are treated as acquired from such person by the DISC if acquired from any person not more than 90 days after the date of original issue (as defined in §1.1232–3(b)(3)). Examples of specific types of Export-Import Bank obligations include debentures issued by such bank and certificates of loan participation.

(i) *Financing obligations.* For purposes of this section, financing obligations are obligations (held by a DISC) of a domestic corporation organized solely for the purpose of financing sales of export property pursuant to an agreement with the Export-Import Bank of the United States under which such corporation makes export loans guaranteed by such Bank.

(j) *Funds awaiting investment*—(1) *In general.* For purposes of this section, subject to the limitation descibed in subparagraph (2) of this paragraph, if, at the close of a DISC's taxable year, the sum of the DISC's money, bank deposits, and other similar temporary investments is determined under paragraph (e) of this section to exceed an amount reasonably necessary to meet the DISC's requirements for working capital, the amount of the DISC's bank deposits in the United States to the extent of the amount of this excess are funds awaiting investment at the close of such taxable year.

(2) *Limitation.* Bank deposits described in subparagraph (1) of this paragraph are funds awaiting investment only if, by the last day of each of the sixth, seventh, and eighth months after the close of such taxable year, the sum of the adjusted bases of the qualified export assets of the DISC (other than such bank deposits) equals or exceeds 95 percent of the sum of the adjusted bases of all assets of the DISC (including such bank deposits) it held on the last day of such taxable year. For purposes of this subparagraph, the adjusted bases of assets of a DISC are determined as of the end of each of the months referred to in this subparagraph. Funds awaiting investment as described in this paragraph need not be traceable to any of the qualified export assets held by the DISC at the end of any of the months referred to in this subparagraph.

(3) *Coordination with certain deficiency distribution provisions.* Under section 992(c)(3) and §1.992–3(d) a deficiency distribution made on or before the 15th day of the ninth month after the end of a corporation's taxable year is deemed to be for reasonable cause if certain requirements are met, including the requirement (described in section 992(c)(3)(B) and §1.992–3(d)(2)) that the sum of the adjusted bases of the qualified export assets held by the corporation on the last day of each month of such year equals or exceeds 70 percent of the sum of the adjusted bases of all assets held by the corporation on each such last day. If, on any such last day, the sum or a DISC's money, bank deposits, and other similar temporary investments is determined under paragraph (e) of this section to exceed an amount reasonably necessary to meet the DISC's requirements for working capital, the amount of the DISC's bank deposits to the extent of the amount of this excess are funds awaiting investment on such last day, if either—

(i) The requirements of subparagraph (2) of this paragraph are satisfied with respect to the taxable year of the DISC which includes such month or

(ii) At the close of such taxable year the sum of the DISC's money, bank deposits, and other similar temporary investments is determined under paragraph (e) of this section not to exceed an amount reasonably necessary to meet the DISC's requirements for working capital.

(Secs. 995(e)(7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995 (e)(7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat 917, 26 U.S.C. 7805))

[T.D. 7514, 42 FR 55459, Oct. 17, 1977; 42 FR 60910, Nov. 30, 1977, as amended by T.D. 7854, 47 FR 51740, Nov. 17, 1982; T.D. 7984, 49 FR 40018, Oct. 12, 1984]

§ 1.993–3 Definition of export property.

(a) *General rule.* Under section 993(c), except as otherwise provided with respect to excluded property in paragraph (f) of this section and with respect to certain short supply property in paragraph (i) of this section, export property is property in the hands of any person (whether or not a DISC)—

(1) Manufactured, produced, grown, or extracted in the United States by any person or persons other than a DISC (see paragraph (c) of this section),

(2) Held primarily for sale or lease in the ordinary course of a trade or business to any person for direct use, consumption, or disposition outside the United States (see paragraph (d) of this section),

(3) Not more than 50 percent of the fair market value of which is attributable to articles imported into the United States (see paragraph (e) of this section), and

(4) Which is not sold or leased by a DISC, or with a DISC as commission agent, to another DISC which is a member of the same controlled group (as defined in § 1.993–1(k)) as the DISC.

(b) *Services.* For purposes of this section, services (including the written communication of services in any form) are not export property. Whether an item is property or services shall be determined on the basis of the facts and circumstances attending the development and disposition of the item. Thus, for example, the preparation of a map of a particular construction site would constitute services and not export property, but standard maps prepared for sale to customers generally would not constitute services and would be export property if the requirements of this section were otherwise met.

(c) *Manufacture, production, growth, or extraction of property*—(1) *By a person other than a DISC.* Export property may be manufactured, produced, grown, or extracted in the United States by any person, provided that such person does not qualify (and is not treated) as a DISC. Property held by a DISC which was manufactured, produced, grown, or extracted by it at a time when it did not qualify (and was not treated) as a DISC is not export property of the DISC. Property which sustains further manufacture or production outside the United States prior to sale or lease by a person but after manufacture or production in the United States will not be considered as manufactured, produced, grown, or extracted in the United States by such person.

(2) *Manufactured or produced*—(i) *In general.* For purposes of this section, property which is sold or leased by a person is considered to be manufactured or produced by such person if such property is manufactured or produced (within the meaning of either subdivision (ii), (iii), or (iv) of this subparagraph) by such person or by another person pursuant to a contract with such person. Except as provided in subdivision (iv) of this subparagraph, manufacture or production of property does not include assembly or packaging operations with respect to property.

(ii) *Substantial transformation.* Property is manufactured or produced by a person if such property is substantially transformed by such person. Examples of substantial transformation of property would include the conversion of woodpulp to paper, steel rods to screws and bolts, and the canning of fish.

(iii) *Operations generally considered to constitute manufacturing.* Property is manufactured or produced by a person if the operations performed by such person in connection with such property are substantial in nature and are generally considered to constitute the manufacture or production of property.

(iv) *Value added to property.* Property is manufactured or produced by a person if with respect to such property conversion costs (direct labor and factory burden including packaging or assembly) of such person account for 20 percent of more of—

(*a*) The cost of goods sold or inventory amount of such person for such property is such property is sold or held for sale, or

(*b*) The adjusted basis of such person for such property, as determined in accordance with the provisions of section 1011, if such property is held for lease or leased.

The value of parts provided pursuant to a services contract, as described in § 1.993–1 (d)(4)(v), is not taken into account in applying this subdivision.

(d) *Primary purpose of which property is held*—(1) *In general*—(i) *General rule.* Under paragraph (a)(2) of this section, export property (*a*) must be held primarily for the purpose of sale or lease in the ordinary course of trade or business to a DISC, or to any other person, and (*b*) such sale or lease must be for direct use, consumption, or disposition outside the United States. Thus, property cannot qualify as export property unless it is sold or leased for direct use, consumption or disposition outside the United States. Property is sold or leased for direct use, consumption, or disposition outside the United States if such sale or lease satisfies the destination test described in subparagraph (2) of this paragraph, the proof of compliance requirements described in subparagraph (3) of this paragraph, and the use outside the United States test described in subparagraph (4) of this paragraph.

(ii) *Factors not taken into account.* In determining whether property which is sold or leased to a DISC is sold or leased for direct use consumption, or disposition outside the United States, the fact that the acquiring DISC holds the property in inventory or for lease prior to the time it sells or leases it for direct use, consumption, or disposition outside the United States will not affect the characterization of the property as export property. Export property need not be physically segregated from other property.

(2) *Destination test.* (i) For purposes of subparagraph (1) of this paragraph the destination test in this subparagraph is satisfied with respect to property sold or leased by a seller or lessor only if it is delivered by such seller or lessor (or an agent of such seller or lessor) regardless of the F.O.B. point or the place at which title passes or risk of loss shifts from the seller or lessor—

(*a*) Within the United States to a carrier or freight forwarder for ultimate delivery outside the United States to a purchaser or lessee (or to a subsequent purchaser or sublessee),

(*b*) Within the United States to a purchaser or lessee, if such property is ultimately delivered, directly used, or directly consumed outside the United States (including delivery to a carrier or freight forwarder for delivery outside the United States) by the purchaser or lessee (or a subsequent purchaser or sublessee) within 1 year after such sale or lease,

(*c*) Within or outside the United States to a purchaser or lessee which, at the time of the sale or lease, is a DISC and is not a member of the same controlled group (as defined in § 1.993–1(k)) as the seller or lessor,

(*d*) From the United States to the purchaser or lessee (or a subsequent purchaser or sublessee) at a point outside the United States by means of a ship, aircraft, or other delivery vehicle, owned, leased, or chartered by the seller or lessor,

(*e*) Outside the United States to a purchaser or lessee from a warehouse, a storage facility, or assembly site located outside the United States, if such property was previously shipped by such seller or lessor from the United States, or

(*f*) Outside the United States to a purchaser or lessee if such property was previously shipped by such seller or lessor from the United States and if such property is located outside the United States pursuant to a prior lease by the seller or lessor, and either (*1*) such prior lease terminated at the expiration of its term (or by the action of the prior lessee acting alone), (*2*) the sale occurred or the term of the subsequent lease began after the time at which the term of the prior lease would have expired, or (*3*) the lessee under the subsequent lease is not a related person (as defined in § 1.993–1(a)(6)) with respect to the lessor and the prior lease was terminated by the action of the lessor (acting alone or together with the lessee).

(ii) For purposes of this subparagraph (other than (*c*) and (*f*)(*3*) of subdivision (i) thereof), any relationship between the seller or lessor and any purchaser, subsequent purchaser, lessee, or sublessee is immaterial.

(iii) In no event is the destination test of this subparagraph satisfied with respect to property which is subject to any use (other than a resale or sublease), manufacture, assembly, or other processing (other than packaging) by any person between the time of the sale or lease by such seller or lessor and the delivery or ultimate delivery outside the United States described in this subparagraph.

(iv) If property is located outside the United States at the time it is purchased by a person or leased by a person as lessee, such property may be export property in the hands of such purchaser or lessee only if it is imported into the United States prior to its further sale or lease (including a sublease) outside the United States. Paragraphs (a)(3) and (e) of this section (relating to 50 percent foreign content test) are applicable in determining whether such property is export property. Thus, for example, if such property is not subjected to manufacturing or production (as defined in paragraph (c) of this section) within the United States after such importation, it does not qualify as export property.

(3) *Proof of compliance with destination test*—(i) *Delivery outside the United States.* For purposes of subparagraph (2) of this paragraph (other than subdivision (i)(*c*) thereof), a seller or lessor shall establish ultimate delivery, use, or consumption of property outside the United States by providing—

(a) A facsimile or carbon copy of the export bill of lading issued by the carrier who delivers the property,

(b) A certificate of an agent or representative of the carrier disclosing delivery of the property outside the United States,

(c) A facsimile or carbon copy of the certificate of lading for the property executed by a customs officer of the country to which the property is delivered,

(d) If such country has no customs administration, a written statement by the person to whom delivery outside the United States was made,

(e) A facsimile or carbon copy of the shipper's export declaration, a monthly shipper's summary declaration filed with the Bureau of Customs, or a magnetic tape filed in lieu of the Shipper's Export Declaration, covering the property,

(*f*) Any other proof (including evidence as to the nature of the property or the nature of the transaction) which establishes to the satisfaction of the Commissioner that the property was ultimately delivered, or directly sold, or directly consumed outside the United States within 1 year after the sale or lease.

(ii) The requirements of subdivision (i) *(a), (b), (c),* or *(e)* of this subparagraph will be considered satisfied even though the name of the ultimate consignee and the price paid for the goods is marked out provided that, in the case of a Shipper's Export Declaration or other document listed in such subdivision *(e)* or a document such as an export bill of lading such document still indicates the country in which delivery to the ultimate consignee is to be made and, in the case of a certificate of an agent or representative of the carrier, that such document indicates that the property was delivered outside the United States.

(iii) A seller or lessor shall also establish the meeting of the requirement of subparagraph (2)(i) of this paragraph (other than subdivision *(c)* thereof), that the property was delivered outside the United States without further use, manufacture, assembly, or other processing within the United States.

(iv) *Sale or lease to an unrelated DISC.* For purposes of subparagraph (2)(i)(*c*) of this paragraph, a purchaser or lessee of property is deemed to qualify as a DISC for its taxable year if the seller or lessor obtains from such purchaser or lessee a copy of such purchaser's or lessee's election to be treated as a DISC as described in § 1.992–2(a) together with such purchaser's or lessee's sworn statement that such election has been filed with the Internal Revenue Service Center. The copy of the election and the sworn statement of such purchaser or lessee must be received by the seller or lessor within 6 months after the sale or lease. A purchaser or lessee is not treated as a DISC with respect to a sale or lease during a taxable year for which such purchaser or lessee does not qualify as a DISC if the seller or lessor does not believe or if a reasonable person would not believe at the time such sale or lease is made that the purchaser or lessee will qualify as a DISC for such taxable year.

(v) *Failure of proof.* If a seller or lessor fails to provide proof of compliance with the destination test as required by this subparagraph, the property sold or leased is not export property.

(4) *Sales and leases of property for ultimate use in the United States*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, the use test in this subparagraph is satisfied with respect to property which—

(a) Under subdivisions (ii) through (iv) of this subparagraph is not sold for ultimate use in the United States or

(b) Under subdivision (v) of this subparagraph is leased for ultimate use outside the United States.

(ii) *Sales of property for ultimate use in the United States.* For purposes of subdivision (i) of this subparagraph, a purchaser of property (including components, as defined in subdivision (vii) of this subparagraph) is deemed to use such property ultimately in the United States if any of the following conditions exists:

(a) Such purchaser is a related person (as defined in §1.993–1(a)(6)) with respect to the seller and such purchaser ultimately uses such property, or a second product into which such property is incorporated as a component, in the United States.

(b) At the time of the sale, there is an agreement or understanding that such property, or a second product into which such property is incorporated as a component, will be ultimately used by the purchaser in the United States.

(c) At the time of the sale, a reasonable person would have believed that such property or such second product would be ultimately used by such purchaser in the United States unless, in the case of a sale of components, the fair market value of such components at the time of delivery to the purchaser constitutes less than 20 percent of the fair market value of the second product into which such components are incorporated (determined at the time of completion of the production, manufacture or assembly of such second product).

For purposes of (b) of this subdivision, there is an agreement or understanding that property will ultimately be used in the United States if, for example, a component is sold abroad under an express agreement with the foreign purchaser that the component is to be incorporated into a product to be sold back to the United States. As a further example there would also be such an agreement or understanding if the foreign purchaser indicated at the time of the sale or previously that the component is to be incorporated into a product which is designed principally for the United States market. However, such an agreement or understanding does not result from the mere fact that a second product, into which components exported from the United States have been incorporated and which is sold on the world market, is sold in substantial quantities in the United States.

(iii) *Use in the United States.* For purposes of subdivision (ii) of this subparagraph, property (including components incorporated into a second product) is or would be ultimately used in the United States by such purchaser if, at any time within 3 years after the purchase of such property or components, either such property or components (or the second product into which such components are incorporated) is resold by such purchaser for use by a subsequent purchaser within the United States or such purchaser or subsequent purchaser fails, for any period of 365 consecutive days, to use such property or second product predominantly outside the United States as defined in subdivision (vi) of this subparagraph).

(iv) *Sales to retailers.* For purposes of subdivision (ii)(*c*) of this subparagraph, property sold to any person whose principal business consists of selling from inventory to retail customers at retail outlets ouside the United States will be considered as property for ultimate use outside the United States.

(v) *Leases of property for ultimate use outside the United States.* For purposes of subdivision (i) of this subparagraph a lessee of property is deemed to use such property ultimately outside the United States during a taxable year of the lessor if such property is used predominantly outside the United States (as defined in subdivision (vi) of this subparagraph) by the lessee during the portion of the lessor's taxable year which is included within the term of the lease. A determination as to whether the ultimate use of leased property satisfies the requirements of this subdivision is made for each taxable year of the lessor. Thus, leased property may be used predominantly outside the

United States for a taxable year of the lessor (and thus, constitute export property if the remaining requirements of this section are met) even if the property is not used predominantly outside the United States in earlier taxable years or later taxable years of the lessor.

(vi) *Predominant use outside the United States.* For purposes of this subparagraph, property is used predominantly outside the United States for any period if, during such period, such property is located outside the United States more than 50 percent of the time. An aircraft, railroad rolling stock, vessel, motor vehicle, container, or other property used for transportation purposes in deemed to be used predominantly outside the United States for any period if, during such period, either such property is located outside the United States more than 50 percent of the time or more than 50 percent of the miles traversed in the use of such property are traversed in outside the United States. However, any such property is deemed to be within the United States at all times during which it is engaged in transport between any two points within the United States, except where such transport constitutes uninterrupted international air transportation within the meaning of section 4262(c)(3) and the regulations thereunder (relating to tax on air transportation of persons). For purposes of applying section 4262(c)(3) to this subdivision, the term ''United States'' has the same meaning as in § 1.993–7.

(vii) *Component.* For purposes of this subparagraph, a component is property which is (or is reasonably expected to be) incorporated into a second product by the purchaser of such component by means of production, manufacture, or assembly.

(e) *Foreign content of property*—(1) *The 50 percent test.* Under paragraph (a)(3) of this section, no more than 50 percent of the fair market value of export property may be attributable to the fair market value of articles which were imported into the United States. For purposes of this paragraph, articles imported into the United States are referred to as ''foreign content''. The fair market value of the foreign content of export property is computed in accordance with subparagraph (4) of this paragraph. The fair market value of export property which is sold to a person who is not a related person with respect to the seller is the sale price for such property (not including interest finance or carrying charges, or similar charges)

(2) *Application of 50 percent test.* The 50 percent test described in subparagraph (1) of this paragraph is applied on an item-by-item basis If, however, a person sells or leases a substantial volume of substantially identical export property in a taxable year and if all of such property contains substantially identical foreign content is substantially the same proportion, such person may determine the portion of foreign content contained in such property on an aggregate basis.

(3) *Parts and services.* If, at the time property is sold or leased the seller or lessor agrees to furnish parts pursuant to a services contract (as provided in § 1.993–1(d)(4)(v)) and the price for the parts is not separately stated, the 50 percent test described in subparagraph (1) of this paragraph is applied on an aggregate basis to the property and parts. If the price for the parts is described in subparagraph (1) of this paragraph is applied separately to the property and to the parts.

(4) *Computation of foreign content*— (i) *Valuation.* For purposes of applying the 50 percent test described in subparagraph (1) of this paragraph, it is necessary to determine the fair market value of all articles which constitute foreign content of the property being tested to determine if it is export property. The fair market value of such imported articles is determined as of the time such articles are imported into the United States. With respect to articles imported into the United States before July 1, 1980, the fair market value of such articles is their appraised value as determined under section 402 or 402a of the Tariff Act of 1930 (19 U.S.C. 1401a or 1402) in connection with their importation. With respect to articles imported into the United States on or after July 1, 1980, the fair market value of such articles is their appraised value as determined under section 402 of the Tariff Act of 1930 (19 U.S.C.

1401a) in connection with their importation. The appraised value of such articles is the full dutiable value of such articles, determined, however, without regard to any special provision in the United States tariff laws which would result in a lower dutiable value. Thus, an article which is imported into the United States is treated as entirely imported even if all or a portion of such article was originally manufactured, produced, grown, or extracted in the United States.

(ii) *Evidence of fair market value.* For purposes of subdivision (i) of this subparagraph, the fair market value of imported articles constituting foreign content may be evidenced by the customs invoice issued on the importation of such articles into the United States. If the holder of such articles is not the importer (or a related person with respect to the importer), the fair market value of such articles may be evidenced by a certificate based upon information contained in the customs invoice and furnished to the holder by the person from whom such articles (or property incorporating such articles) were purchased. If a customs invoice or certificate described in the preceding sentence is not available to a person purchasing property, such person shall establish that no more than 50 percent of the fair market value of such property is attributable to the fair market value of articles which were imported into the United States.

(iii) *Interchangeable component articles—(a)* Where identical or similar component articles can be incorporated interchangeably into property and a person acquires some such component articles that are imported into the United States and other such component articles that are not imported into the United States, the determination whether imported component articles were incorporated in such property as is exported from the United States shall be made on a substitution basis as in the case of the rules relating to drawback accounts under the customs laws. See section 313(b) of the Tariff Act of 1930, as amended (19 U.S.C. 1313(b)).

(*b*) The provisions of (*a*) of this subdivision may be illustrated by the following example:

Example. Assume that a manufacturer produces a total of 20,000 electronic devices. The manufacturer exports 5,000 of the devices and subsequently sells 11,000 of the devices to a DISC which exports the 11,000 devices. The major single component article in each device is a tube which represents 60 percent of the fair market value of the device at the time the device is sold by the manufacturer. The manufacturer imports 8,000 of the tubes and produces the remaining 12,000 tubes. For purposes of this subdivision, in accordance with the substitution principle used in the customs drawback laws, the 5,000 devices exported by the manufacturer are each treated as containing an imported tube because the devices were exported prior to the sale to the DISC. The remaining 3,000 imported tubes are treated as being contained in the first 3,000 devices purchased and exported by the DISC. Thus, since the 50 percent test is not met with respect to the first 3,000 devices purchased and exported by the DISC, those devices are not export property. The remaining 8,000 devices purchased and exported by the DISC are treated as containing tubes produced in United States, and those devices are export property (if they otherwise meet the requirements of this section).

(f) *Excluded property*—(1) *In general.* Notwithstanding any other provision of this section, the following property is not export property—

(i) Property described in subparagraph (2) of this paragraph (relating to property leased to a member of a controlled group),

(ii) Property described in subparagraph (3) of this paragraph (relating to certain types of intangible property),

(iii) Products described in paragraph (g) of this section (relating to depletable products), and

(iv) Products described in paragraph (h) of this section (relating to certain export controlled products).

(2) *Property leased to member of controlled group*—(i) *In general.* Property leased to a person (whether or not a DISC) which is a member of the same controlled group (as defined in §1.993–1(k)) as the lessor constitutes export property for any period of time only if during the period—

(*a*) Such property is held for sublease, or is subleased, by such person to a third person for the ultimate use of such third person;

(*b*) Such third person is not a member of the same controlled group; and (*c*) Such property is used predominantly outside the United States by such third person.

(ii) *Predominant use.* The provisions of paragraph (d)(4)(vi) of this section apply in determining under subdivision (i)(*c*) of this subparagraph whether such property is used predominently outside the United States by such third person.

(iii) *Leasing rule.* For purposes of this subparagraph, leased property is deemed to be ultimately used by a member of the same controlled group as the lessor if such property is leased to a person which is not a member of such controlled group but which subleases such property to a person which is a member of such controlled group. Thus, for example, if X, a DISC for the taxable year, leases a movie film to Y, a foreign corporation which is not a member of the same controlled group as X, and Y then subleases the film to persons which are members of such group for showing to the general public, the film is not export property. On the other hand, if X, a DISC for the taxable year, leases a movie film to Z, a foreign corporation which is a member of the same controlled group as X, and Z then subleases the film to Y, another foreign corporation, which is not a member of the same controlled group for showing to the general public, the film is not disqualified under this subparagraph from being export property.

(iv) *Certain copyrights.* With respect to a copyright which is not excluded by subparagraph (3) of this paragraph from being export property, the ultimate use of such property is the sale or exhibition of such property to the general public. Thus, if A, a DISC for the taxable year, leases recording tapes to B, a foreign corporation which is a member of the same controlled group as A, and if B makes records from the recording tape and sells the records to C, another foreign corporation, which is not a member of the same controlled group, for sale by C to the general public, the recording tape is not disqualified under this subparagraph from being export property, notwithstanding the leasing of the recording tape by A to a member of the same controlled group, since the ultimate use of the tape is the sale of the records (*i.e.*, property produced from the recording tape).

(3) *Intangible property.* Export property does not include any patent, invention, model, design, formula, or process, whether or not patented, or any copyright (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademark, tradebrand, franchise, or other like property. Although a copyright such as a copyright on a book does not constitute export property, a copyrighted article (such as a book) if not accompanied by a right to reproduce it is export property if the requirements of this section are otherwise satisfied. However, a license of a master recording tape for reproduction outside the United States is not disqualified under this subparagraph from being export property.

(g) *Depletable products*—(1) *In general.* Under section 993(c)(2)(C), a product or commodity which is a depletable product (as defined in subparagraph (2) of this paragraph) or contains a depletable product is not export property if—

(i) It is a primary product from oil, gas, coal, or uranium (as described in subparagraph (3) of this paragraph), or

(ii) It does not qualify as a 50-percent manufactured or processed product (as described in subparagraph (4) of this paragraph).

(2) *Definition of ''depletable product''.* For purposes of this paragraph, the term ''depletable product'' means any product or commodity of a character with respect to which a deduction for depletion is allowable under section 613 or 613A. Thus, the term depletable product includes any mineral extracted from a mine, an oil or gas well, or any other natural deposit, whether or not the DISC or related supplier is allowed a deduction, or is eligible to take a deduction, for depletion with respect to the mineral in computing its taxable income. Thus, for example, iron ore purchased by a DISC from a broker is a depletable product in the hands of the DISC for purposes of this paragraph even though the DISC is not eligible to take a deduction for depletion under section 613 or 613A.

(3) *Primary product from oil, gas, coal, or uranium.* A primary product from oil, gas, coal, or uranium is not export

property. For purposes of this paragraph—

(i) *Primary product from oil.* The term ''primary product from oil'' means crude oil and all products derived from the destructive distillation of crude oil, including—

(a) Volatile products,

(b) Light oils such as motor fuel and kerosene,

(c) Distillates such as naphtha,

(d) Lubricating oils,

(e) Greases and waxes, and

(f) Residues such as fuel oil.

For purposes of this paragraph, a product or commodity derived from shale oil which would be a primary product from oil if derived from crude oil is considered a primary product from oil.

(ii) *Primary product from gas.* The term ''primary product from gas'' means all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including—

(a) Natural gas,

(b) Condensates,

(c) Liquefied petroleum gases such as ethane, propane, and butane, and

(d) Liquid products such as natural gasoline.

(iii) *Primary product from coal.* The term ''primary product from coal'' means coal and all products recovered from the carbonization of coal including—

(a) Coke,

(b) Coke-oven gas,

(c) Gas liquor,

(d) Crude light oil, and

(e) Coal tar.

(iv) *Primary product from uranium.* The term ''primary product from uranium'' means uranium ore and uranium concentrates (known in the industry as ''yellow cake''), and nuclear fuel materials derived from the refining of uranium ore and uranium concentrates, or produced in a nuclear reaction, including—

(a) Uranium hexafluoride,

(b) Enriched uranium hexafluoride,

(c) Uranium metal,

(d) Uranium compounds, such as uranium carbide,

(e) Uranium dioxide, and

(f) Plutonium fuels.

(v) *Primary products and changing technology.* The primary products from oil, gas, coal, or uranium described in subdivisions (i) through (iv) of this subparagraph and the processes described in those subdivisions are not intended to represent either the only primary products from oil, gas, coal, or uranium, or the only processes from which primary products may be derived under existing and future technologies, such as the gasification and liquefaction of coal.

(vi) *Petrochemicals.* For purposes of this paragraph, petrochemicals are not considered primary products from oil, gas, or coal.

(4) *50-percent manufactured or processed product*—(i) *In general.* A product or commodity (other than a primary product from oil, gas, coal, or uranium) which is or contains a depletable product is not excluded from the term ''export property'' by reason of section 993(c)(2)(C) if it is a 50-percent manufactured or processed product. Such a product or commodity is a ''50-percent manufactured or processed product'' if, after the cutoff point of the depletable product, it is manufactured or processed (as defined in subdivision (ii) of this subparagraph) and either the cost test described in subdivision (iv) of this subparagraph or the fair market value test described in subdivision (v) of this subparagraph is satisfied. To determine cutoff point, see subdivisions (vi) and (vii) of this subparagraph.

(ii) *Manufactured or processed.* A product is manufactured or processed if it is manufactured or produced within the meaning of paragraph (c)(2) of this section, except that for purposes of this subdivision the term manufacturing or processing does not include any excluded process (as defined in subdivision (iii) of this subparagraph) and the term conversion costs (as used in subdivision (iv) of such paragraph (c)(2)) does not include any costs attributable to any excluded process.

(iii) *Excluded processes.* For purposes of this paragraph, excluded processes are extracting *(i.e.,* all processes which are applied before the cutoff point of the mineral to which such processes are applied), and handling, packing, packaging, grading, storing, and transporting.

(iv) *Cost test.* A product or commodity will qualify as a 50-percent manufactured or processed product if—

(a) Its manufacturing and processing costs (that is, the portion of the cost of goods sold or inventory amount of the product or commodity attributable to the aggregate cost of manufacturing or processing each mineral contained therein) equal or exceed—

(b) An amount equal to either of the following:

(1) 50 percent of its cost of goods sold or inventory amount (decreased, at the DISC's option, by the portion of such cost or amount the DISC establishes is allocable to the difference between each prior owner's selling price for each depletable product contained in such product or commodity and such prior owner's cost of goods sold with respect thereto).

(2) The aggregate of the cost at the cutoff point (see subdivisions (vi) and (vii) of this subparagraph) properly attributable to each mineral contained in such product or commodity. However, if this subdivision *(2)* is applied, then the amount in *(a)* of this subparagraph (iv) shall be decreased and the amount in this subdivision *(2)* shall be increased, by so much of the cost of goods sold or inventory amount of the product or commodity as is properly allocable to any process other than transportation applied after the cutoff point of such mineral which would be a mining process (within the meaning of § 1.613–4) were it applied before such point.

(v) *Fair market value test.* A product or commodity will qualify as a 50-percent manufactured or processed product if—

(a) The excess of its fair market value on the date it is sold, exchanged, or otherwise disposed of (or, if not sold, exchanged, or otherwise disposed of, the last day of the DISC's taxable year) over the portion thereof properly allocable to excluded processes other than extracting is equal to or greater than

(*b*) Twice the aggregate of the fair market value at the cutoff point for each mineral contained in such product or commodity.

For purposes of this subdivision (v), the fair market value of a product or commodity on the date it is sold, exchanged, or otherwise disposed of is the price at which it is disposed of, subject to any adjustment that may be required under the arm's length standard of section 482 and the regulations thereunder. If such product or commodity is not sold, exchanged, or otherwise disposed of, then, for purposes of section 992(a)(1)(B) (relating to the 95-percent test with respect to qualified export assets), the fair market value of a product or commodity on the last day of the DISC's taxable year is the arm's length price at which such product or commodity would have been sold on such date, determined by applying the principles of section 482 and the regulations thereunder.

(vi) *Cutoff point of a mineral.* For purposes of this subparagraph:

(*a*) The cutoff point is the point at which gross income from the property (within the meaning of section 613(a)) was in fact determined.

(*b*) The cost at the cutoff point is deemed to be the amount of the gross income from the property of the taxpayer eligible for a depletion deduction with respect to the mineral.

(*c*) The fair market value at the cutoff point is deemed to be the amount of the gross income from the property of the taxpayer eligible for a depletion deduction with respect to the mineral, except that, if (*1*) the fair market value of a product or commodity on the date specified in subdivision (v)(*a*) of this subparagraph exceeds the aggregate of the fair market value at the cutoff point for each mineral contained therein and (*2*) 10 percent or more of such excess is attributable to a net increase in the fair market values of such minerals by reason of factors other than manufacturing or processing or the application of excluded processes (such as, for example, increases in the fair market values of some minerals by reason of inflation or speculation exceed decreases in such values of other minerals by reason of deflation or speculation), then the aggregate of the fair market value at the cutoff point for each such mineral shall be increased to reflect the net excess so attributable.

(*d*) The provisions of this subdivision (vi) are illustrated by the following example.

Example. An integrated manufacturer, X, on February 1, 1976, had gross income from the property (within the meaning of section 613(a)) of $50 with respect to a specified volume of a mineral. Thus, the cost at the cutoff point of the mineral was $50. X converted the mineral into a product which it sold on July 15, 1976, for $75. Of the $25 excess of the selling price over the gross income from the property, $23 was attributable to manufacturing, processing, and the application or excluded processes, and $2 was attributable to an increase in the fair market value of the mineral due to inflation between February 1 and July 15, 1976. Since only 8 percent of such excess ($2/$25) was attributable to factors other than manufacturing, processing, and the application of excluded processes, the fair market value at the cutoff point of the mineral is $50. However, had $3 of the $25 excess, or 12 percent, been attributable to an increase in the fair market value of the mineral due to inflation, then the fair market value at the cutoff point of the mineral would be $53.

(vii) [Reserved]

(viii) *Special rule for certain used products and scrap products.* If a product or commodity is a used 50-percent manufactured or processed product, or is recovered as scrap from a 50-percent manufactured or processed product, such product or commodity will be treated as a 50-percent manufactured or processed product.

(ix) *Special rule for byproducts and waste products.* For purposes of applying the cost test or fair market value test of subdivision (iv) or (v) of this subparagraph if a depletable product is recovered from a manufacturing process as a byproduct or waste product, then the cost and fair market value at the cutoff point are each deemed to be the lesser of—

(*a*) The fair market value of the waste product or byproduct containing the depletable product, determined as of the date the byproduct or waste product is recovered, or

(*b*) The amount the cost at the cutoff point would be for a depletable product of like kind and grade which is extracted, determined as of the date the byproduct or waste product is recovered.

For purposes of (*b*) of this subdivision the cutoff point for the depletable product of like kind and grade is deemed to be the point at which gross income from the property would be determined if such depletable product were sold by the taxpayer eligible to take a deduction for depletion after the completion of all mining processes applied to the depletable product and before the application of any nonmining process.

(x) *Proof of satisfaction of 50-percent manufactured or processed test.* (*a*) No substantiation is required to establish that either the cost test or the fair market value test of subdivisions (iv) or (v) of this subparagraph is satisfied or that a product or commodity qualifies under (viii) of this subdivision as either a used 50-percent manufactured or processed product or as scrap from a 50-percent manufactured or processed product as long as it is reasonably obvious, on the basis of all relevant facts and circumstances, that either the cost test or fair market value test is satisfied, or that the product or commodity qualifies as either as used 50-percent manufactured or processed product or as scrap from a 50-percent manufactured or processed product. Thus, for example, in the case of a DISC exporting a high precision lens at least 50 percent of the fair market value of which is obviously attributable to grinding, no substantiation of gross income from the property properly allocable to the depletable products contained in the lens, cost, or fair market values will be required.

(*b*) In cases in which satisfaction of either the cost test or the fair market value test is not reasonably obvious, a DISC will be required to substantiate the gross income from the property properly allocable to each depletable product in a product or commodity and either all costs or fair market values relied upon the DISC.

(*c*) For purposes of substantiating (*1*) gross income from the property properly allocable to a depletable product, (*2*) costs, and (*3*) fair market values, the DISC and related supplier shall each identify items in (or that were in) inventory in the same manner each used to identify items in inventory for purposes of computing Federal income tax.

(xi) *Application of 50-percent test.* The 50-percent test described in this subparagraph is applied on an item-by-item basis. If, however, a DISC sells a substantial volume of substantially identical products or commodities and if all or a group of such products or commodities contain substantially identical depletable products in substantially the same proportions and have cost or fair market value relationships (as the case may be) that are in substantially the same proportions, such DISC may apply the 50-percent test on an aggregate basis with respect to all such products or commodities, or group, as the case may be.

(5) *Effective dates.* Except as provided in subparagraph (6) of this paragraph, section 993(c)(2)(C) applies—

(i) With respect to any product or commodity not owned by a DISC, to sales, exchanges, or other dispositions made after March 18, 1975, with respect to which the DISC derives gross receipts.

(ii) With respect to any product or commodity acquired by a DISC after March 18, 1975.

(iii) With respect to any product or commodity owned by a DISC on March 18, 1975, to sales, exchanges, or other dispositions made after March 18, 1976, and to owning such product or commodity after such date.

For purposes of this paragraph and subparagraph (6) of this paragraph, the date of a sale, exchange, or other disposition of a product or commodity is the date as of which title to such product or commodity passes. The accounting method of a person is not determinative of the date of a sale, exchange, or other disposition.

(6) *Fixed contracts.* Section 1101(f) of the Tax Reform Act of 1976 provides an exception to the effective date rules in this paragraph and in paragraph (h) of this section. Section 1101(f)(2) of the Act provides that section 993(c)(2)(C) and (D) shall not apply to sales, exchanges, and other dispositions made after March 18, 1975, but before March 19, 1980, if they are made pursuant to a fixed contract. Section 1101(f)(2) also defines fixed contract. Under that definition, if the seller can vary the price of the product for unspecified cost increases (which could include tax cost increases), or if the quantity of products or commodities to be sold can be increased or decreased under the contract by the seller without penalty, the contract is not to be considered a fixed contract with respect to the amount over which the seller has discretion. For example, if a contract calls for a minimum delivery of *x* amount of a product but allows the seller to refuse to deliver goods beyond that minimum amount (or allows a renegotiation of the sales price of goods beyond that amount), then with respect to the amount above the minimum the contract is not a fixed quantity contract.

(h) *Export controlled products*—(1) *In general.* An export controlled product is not export property. A product or commodity may be an export controlled product at one time but not an export controlled product at another time. For purposes of this paragraph, a product or commodity is an ‘‘export controlled product’’ at a particular time if at that time the export of such product or commodity is prohibited or curtailed under section 4(b) of the Export Administration Act of 1969 or section 7(a) of the Export Administration Act of 1979, to effectuate the policy relating to the protection of the domestic economy set forth in such Acts (paragraph (2)(A) of section 3 of the Export Administration Act of 1969 and paragraph (2)(C) of section 3 of the Export Administration Act of 1979). Such policy is to use export controls to the extent necessary ‘‘to protect the domestic economy from the excessive drain of scarce materials and to reduce the serious inflationary impact of foreign demand.’’

(2) *Products considered export controlled products*—(i) *In general.* For purposes of this paragraph, an export controlled product is a product or commodity which is subject to short supply export controls under 15 CFR part 377. A product or commodity is considered an export controlled product for the duration of each control period which applies to such product or commodity. A control period of a product or commodity begins on and includes the initial control date (as defined in subdivision (ii) of this subparagraph) and ends on and includes the final control date (as defined in subdivision (iii) of this subparagraph).

(ii) *Initial control date.* The initial control date of a product or commodity which was subject to short supply export controls on March 19, 1975, is

March 19, 1975. The initial control date of a product or commodity which is subject to short supply export controls after March 19, 1975, is the effective date stated in the regulations to 15 CFR part 377 which subjects such product or commodity to short supply export controls. If there is no effective date stated in such regulations, the initial control date of such product or commodity is the date on which such regulations are filed for publications in the FEDERAL REGISTER.

(iii) *Final control date.* The final control date of a product or commodity is the effective date stated in the regulations to 15 CFR part 377 which removes such product or commodity from short supply export controls. If there is no effective date stated in such regulations, the final control date of such product or commodity is the date on which such regulations are filed for publication in the FEDERAL REGISTER.

(iv) *Expiration of Export Administration Act.* An initial control date and a final control date cannot occur after the expiration date of the Export Administration Act under the authority of which the short supply export controls were issued.

(3) *Effective dates*—(i) *Products controlled on March 19, 1975.* Except as provided in paragraph (g)(6) of this section, if a product or commodity was subject to short supply export controls on March 19, 1975, this paragraph applies—

(*a*) With respect to any such product or commodity not owned by a DISC, to sales, exchanges, other dispositions, or leases made after March 18, 1975, with respect to which the DISC derives gross receipts.

(*b*) With respect to any such product or commodity acquired by a DISC after March 18, 1975, and

(*c*) With respect to any such product or commodity owned by a DISC on March 18, 1975, to sales, exchanges, other dispositions, and leases made after March 18, 1976, and to owning such product or commodity after such date.

(ii) *Products first controlled after March 19, 1975.* If a product or commodity becomes subject to short supply export controls after March 19, 1975, this paragraph applies to sales, exchanges, other dispositions, or leases of such product or commodity made on or after the initial control date of such product or commodity, and to owning such product or commodity on or after such date.

(iii) *Date of sale, exchange, lease, or other disposition.* For purposes of this subparagraph, the date of sale, exchange, or other disposition of a product or commodity is the date as of which title to such product or commodity passes. The date of a lease is the date as of which the lessee takes possession of a product or commodity. The accounting method of a person is not determinative of the date of sale, exchange, other disposition, or lease.

(iv) *Property in short supply.* If the President determines that the supply of any property which is otherwise export property as defined in this section is insufficient to meet the requirements of the domestic economy, he may by Executive order designate such property as in short supply. Any property so designated will be treated as property which is not export property during the period beginning with the date specified in such Executive order and ending with the date specified in an Executive order setting forth the President's determination that such property is no longer in short supply.

[T.D. 7514, 42 FR 55461, Oct. 17, 1977, as amended by T.D. 7513, 42 FR 57309, Nov. 2, 1977; T.D. 7854, 47 FR 51740, Nov. 17, 1982]

§1.993–4 Definition of producer's loans.

(a) *General rule*—(1) *Definition.* Under section 993(d), a loan made by a DISC to a person, referred to in this section as the ''borrower,'' is a producer's loan if—

(i) The loan is made out of accumulated DISC income within the meaning of subparagraph (3) of this paragraph.

(ii) The loan is evidenced by an obligation described in subparagraph (4) of this paragraph.

(iii) The requirement as to the trade or business of the borrower described in subparagraph (5) of this paragraph is satisfied.

(iv) At the time the loan is made, the obligation referred to in subdivision (ii) of this subparagraph bears a legend stating ''This Obligation Is Designated

A Producer's Loan Within The Meaning of section 993(d) of the Internal Revenue Code'' or words of substantially the same meaning.

(v) The limitation as to the export-related assets of the borrower described in paragraph (b) of this section is satisfied.

(vi) The requirement as to the increased investment of the borrower in export-related assets described in paragraph (c) of this section is satisfied, and

(vii) The requirement of paragraph (d) of this section as to proof of compliance with paragraphs (b) and (c) of this section is satisfied.

(2) *Application of this section*—(i) *In general.* A loan which is a producer's loan is a qualified export asset of the DISC (see § 1.993–2(a)(5) and (F)). The interest on a producer's loan is a qualified export receipt of the DISC (see § 1.993–1(g)). A producer's loan is not a dividend to a borrower which is also a shareholder of the DISC making the loan. For rules with respect to deemed distributions by reason of the amount of foreign investment attributable to producer's loans, see section 995(b)(1)(G) and (d) and the regulations thereunder.

(ii) *No tracing of loan proceeds.* For purposes of applying this section, in order to qualify as a producer's loan, the proceeds of the loan need not be traced to an investment in any specific asset.

(iii) *Unrelated borrower.* For purposes of applying this section, it is not necessary for a borrower to be a related person with respect to the DISC from which it receives a producer's loan, or a member of the same controlled group as the DISC.

(iv) *Unpaid balance of producer's loans.* For purposes of applying this section, the unpaid balance of producer's loans does not include the unpaid balance of any producer's loan to the extent the loan has been deducted or charged off by the DISC as totally or partially worthless under section 165 or 166.

(v) *Refinancing, renewal, and extension.* For purposes of applying this section, the refinancing, renewal, or extension of a producer's loan shall be treated as the making of a new loan which may qualify as a producer's loan only if the requirements of subparagraph (1) of this paragraph are met.

(vi) *Events subsequent to time loan is made.* The determination as to whether a loan qualifies as a producer's loan is made on the basis of the relevant facts taken into account for purposes of determining whether the loan was a producer's loan when made. Thus, for example, if the accumulated DISC income of the lender is later reduced below the unpaid balance of all producer's loans previously made by the DISC, such subsequent decrease in the amount of accumulated DISC income will not result in later disqualification of such loan (or part thereof) as a producer's loan. Similarly, if a loan (or part of a loan) does not qualify as a producer's loan because of an insufficient amount of accumulated DISC income at the time the loan is made, a subsequent increase in the amount of accumulated DISC income will not result in later qualification of such loan (or part thereof) as a producer's loan. As a further example, for purposes of applying the borrower's export related assets limitation described in paragraph (b) of this section, a loan which qualifies as a producer's loan when made will not later be disqualified if property, the gross receipts from the sale or lease of which were includible in the numerator of the fraction described in paragraph (b)(3)(i) of this section at the time of sale or lease by the borrower, is later characterized as excluded property (as defined in § 1.993–3(f)).

(vii) *Application of tests under paragraphs (b) and (c) on controlled group bases.* If the borrower is a member of a controlled group (as defined in § 1.993–1(k)) at the time a loan is made, all amounts that must be determined for purposes of applying the limitation and increased investment requirement with respect to the export-related assets of the borrower (described in paragraphs (b) and (c), respectively, of this section) may be determined at the election of the borrower by aggregating such amounts for all members of the controlled group, determined for the taxable year of each member of the controlled group during which the loan is made, excluding only such members of the group as are DISC's or foreign corporations for such year. However, such amounts may be included only to the extent that such amounts have not already been taken into account in applying the limitation and increased investment requirement with respect to any other borrower. Amounts to be aggregated for all such members if such election is made include, for example, gross receipts (described in paragraphs (b)(3)(i) and (ii) of this section) and export-related assets (described in paragraph (b)(2) of this section). The borrower may make such election by causing its written statement of election to be attached to the lending DISC's return under section 6011(e)(2) for the first taxable year of the lending DISC within which or with which the borrower's taxable year for which the election is to apply ends. An election once made is binding on all members of the controlled group which includes the borrower with respect to all taxable years of the borrower beginning with its first taxable year for which the election is made. A borrower who makes such election may revoke it only if it secures the consent of the Commissioner to such revocation upon application made through the lending DISC.

(3) *Loan out of accumulated DISC income*—(i) *In general.* A loan is a producer's loan only to the extent that it is made out of accumulated DISC income. A loan is made out of accumulated DISC income only if the amount of the loan, when added to the unpaid balance at the time such loan is made of all other producer's loans made by a DISC, does not exceed the amount of accumulated DISC income of the DISC at the beginning of the month in which the loan is made. The amount of accumulated DISC income at the beginning of any month is determined as if the DISC's taxable year closed at the end of the immediately preceding month.

(ii) *Presumption.* A loan made during a taxable year shall be deemed under subdivision (i) of this subparagraph to have been made out of accumulated DISC income if the balance of producer's loans at the beginning of the year and those made during the year do not exceed accumulated DISC income at the end of the year.

(iii) *Deemed distributions.* For purposes of this subparagraph, accumulated DISC income as of the end of any taxable year (or month) shall be determined without regard to deemed distributions under section 995(b)(1)(G) for the amount of foreign investment attributable to producer's loans for such year (or for the taxable year for which such month is a part) but actual distributions shall be taken into account.

(4) *Evidence and terms of obligation.* A loan is a producer's loan only if the loan is evidenced by a note or other evidence of indebtedness which is made by the borrower and which has a stated maturity date not more than 5 years from the date the loan is made. Accordingly, a loan which does not have a stated maturity date or which has a stated maturity date more than 5 years from the date such loan is made can never meet the 5-year requirement of this subparagraph. Thus, for example, even if there is a period of less than 5 years remaining to the stated maturity date of a loan, the loan can never be a producer's loan if it had a stated maturity date more than 5 years from the date it was made. For a further example, if a loan having a period remaining to maturity of 2 years is extended for a further period of 3 years (making a total of 5 years to maturity from the date of the extension), the extension of the loan would under subparagraph (2)(v) of this paragraph constitute the making of a new producer's loan and the original producer's loan would terminate. If, however, a loan having a period remaining to maturity of 2 years is extended for a further period of 4 years (making a total of 6 years to maturity from the date of the extension), the original producer's loan will terminate and the new loan will not be a producer's loan. If a producer's loan is not paid in full at its maturity date and is not formally refinanced, renewed, or extended, such loan shall be deemed to be a new loan which does not have a stated maturity date and, thus, will not be a producer's loan. For purposes of this subparagraph, an evidence of indebtedness is a written instrument of indebtedness. Section 482 and the regulations thereunder are applicable to determine, in the case of a loan by the DISC to a borrower which

is owned or controlled directly or indirectly by the same interests as the DISC within the meaning of section 482, whether the interest charged on such loan is at an arm's length rate.

(5) *Borrower's trade or business.* A loan is a producer's loan only if the loan is made to a person engaged in the United States in the manufacture, production, growth, or extraction (within the meaning of §1.993–3(c)) of export property determined without regard to §1.993–3(f)(1)(iii) and (iv). The borrower may also be engaged in other trades or businesses and the loan need not be traceable to specific investments in export property.

(b) *Borrower's export related assets limitation*—(1) *General rule.* A loan to a borrower is a producer's loan only to the extent that the amount of the loan, when added to the unpaid balance of all other producer's loans made by all DISC's to the borrower which are outstanding at the time the loan is made, does not exceed an amount equal to the amount of the borrower's export-related assets (determined under subparagraph (2) of this paragraph) multiplied by the fraction set forth in subparagraph (3) of this paragraph.

(2) *Amount of export-related assets*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, the amount of the borrower's export-related assets is the sum of the amounts described in subdivisions (ii), (iii), and (iv) of this subparagraph.

(ii) *Borrower's plant and equipment.* The amount described in this subdivision is the sum of the borrower's adjusted bases (determined as of the beginning of the borrower's taxable year in which a loan is made to it) for plant, machinery, equipment, and supporting production facilities, which are located in the United States. Supporting production facilities are all property used primarily in connection with the manufacture, production, growth, or extraction (within the meaning of §1.993–3(c)) or storage, handling, transportation, or assembly of property by the borrower.

(iii) *Borrower's property held primarily for sale or lease.* The amount described in this subdivision is the amount of the borrower's property (at the beginning of the taxable year of the borrower in which a loan is made to it) held primarily for sale or lease to customers in the ordinary course of its trade or business. The amount of such property held for sale is determined under the methods of identifying and valuing inventory normally used by the borrower. The amount of such property held for lease or leased is the borrower's adjusted bases, determined under section 1011, for such property.

(iv) *Borrower's research and experimental expenditures.* The amount described in this subdivision is the aggregate amount, whether or not charged to capital account, of research and experimental expenditures (within the meaning of section 174) incurred in the United States by the borrower during each of its taxable years which begin after December 31, 1971, and precede the taxable year in which the loan is made to the borrower. Such research and experimental expenditures need bear no relationship to export property (as defined in §1.993–3) of the borrower. The aggregate amount of all such expenditures for each of such preceding taxable years is taken into account for purposes of this subparagraph, regardless of whether all or any portion of the aggregate amount has been taken into account with respect to producer's loans made to the borrower by any DISC in preceding taxable years. The aggregate amount of all such expenditures shall include such expenditures of a corporation, the assets of which were acquired by the borrower in a distribution or a transfer described in section 381(a)(1) or (2) (relating to carryovers in certain corporate acquisitions).

(3) *Fraction referred to in subparagraph (1) of this paragraph*—(i) *Numerator of fraction.* The numerator of the fraction set forth in this subparagraph is the sum of the borrower's gross receipts for each of its 3 taxable years immediately preceding the taxable year in which the loan is made (but not including any taxable year beginning before January 1, 1972) from the sale or lease of export property (determined without regard to §1.993–3(f)(1)(iii) and (iv)) which is manufactured, produced, grown, or extracted (within the meaning of §1.993–3(c)) by the borrower whether or not

sold or leased directly or through a related domestic person (notwithstanding §1.993–3(a)(4) and (f)(2)). For purposes of the preceding sentence, with respect to a sale or lease to a related DISC in which the transfer price is determined under section 994(a)(1) or (2), the rules under §1.994–1(c)(5) (relating to incomplete transactions) shall be applied, and with respect to all other sales and leases the rules under §1.994–1(c)(5) other than subdivision (i)(*d*) thereof shall be applied.

(ii) *Denominator of fraction.* The denominator of the fraction set forth in this subparagraph is the sum of the amount included in the numerator and all other gross receipts of the borrower, for each of its taxable years for which gross receipts are included in the numerator of the fraction, from all sales or leases of all property held by the borrower primarily for sale or lease to customers in the ordinary course of its trade or business. For purposes of subdivision (i) of this subparagraph and this subdivision, if such property is sold or leased to a domestic related person which resells or subleases such property, the borrower's gross receipts shall be the gross receipts derived by the domestic related person from the resale or sublease of the export property.

(iii) *Taxable years.* If the borrower has not engaged in the sale or lease of property (as described in this subparagraph) for the 3 immediately preceding taxable years, or if 3 taxable years beginning after December 31, 1971, have not elapsed, the fraction will be computed on the basis of such gross receipts for its taxable years immediately preceding the loan and beginning after December 31, 1971, during which the borrower has so engaged. No producer's loans can be made to a borrower until after the end of the first taxable year of the borrower beginning after December 31, 1971.

(c) *Requirement for increased investment in export-related assets*—(1) *In general.* A loan to a borrower is a producer's loan only to the extent that the amount of the loan, when added to the unpaid balance of all other producer's loans made by all DISC's to the borrower during the borrower's taxable year during which such loan is made, does not exceed the amount of the borrower's increase for the year in investment in export-related assets. Such increase for any taxable year is the sum of—

(i) The increase (if any) in the borrowers adjusted basis of certain types of assets as determined under subparagraph (2) of this paragraph and

(ii) The amount (if any) during the year of its research and experimental expenditures as determined under paragraph (b)(2)(iv) of this section.

(2) *Increase in adjusted basis.* The amount under this subparagraph is the amount (not less than zero) by which—

(i) The borrower's adjusted basis (determined as of the end of its taxable year in which the producer's loan is made) in all of its property which is described in paragraph (b)(2)(ii) (plant and equipment), and (iii) (property held primarily for sale or lease) of this section, including any such property acquired by it during such taxable year, exceeds

(ii) Its adjusted bases in all such property (determined as of the beginning of such year).

(3) *Ordering rule.* If during the borrower's taxable year the amount of increase in investment in export-related assets determined under this subparagraph is exceeded by amounts loaned to the borrower during such year that would otherwise qualify as producer's loans, such loans shall be applied in the order made against the amount of such increase in order to determine which loans qualify as producer's loans.

(d) *Proof of borrower's compliance with paragraphs (b) and (c) of this section.* For purposes of paragraphs (b) and (c) of this section, a DISC shall be prepared to establish initially the compliance of the borrower with the requirements of such paragraphs by providing the written statement of the borrower, certified by a certified public accountant, stating that the borrower has complied with the limitation and increased investment requirement in section 993(d)(2) and (3) of the Internal Revenue Code of 1954. In lieu of certification by a certified public accountant, the DISC may attach to its return a statement signed by the borrower under penalties of perjury on a form provided by the Internal Revenue Service certifying that the borrower has complied with the limitation and increased investment requirement in section 993(d)(2) and (3) of the Internal Revenue Code of 1954. For taxable years ending after October 17, 1977, the DISC must attach either the certification by the certified public accountant or the certification by the borrower to its return. Additional full substantiation of the borrower's compliance with the requirements of such paragraphs may be required by the district director. If full substantiation of such compliance is not provided by the DISC (or the borrower) when required, the loan shall be deemed not to be a producer's loan.

(e) *Special limitation in the case of domestic film maker*—(1) *General rule.* The limitation of paragraph (b) of this section as to the export-related assets of the borrower will be considered satisfied if the DISC—

(i) Is engaged in the trade or business of selling or leasing films which are export property, or is acting as a commission agent for a person who is so engaged,

(ii) Makes a loan to a borrower which is a domestic film maker (as defined in subparagraph (5) of this paragraph) for the purpose of making a film, and

(iii) The amount of such loan, when added to the unpaid balance of all other producer's loans made by all DISC's to the borrower which are outstanding at the time the loan is made, does not exceed an amount determined by multiplying—

(a) The sum of *(1)* the amount of the export-related assets of the borrower (determined under paragraph (b)(2)(i) of this section as of the beginning of the borrower's taxable year in which the loan is made), plus *(2)* the amount of a reasonable estimate of the amount of such export related assets obtained or to be obtained by the borrower during such year and subsequent years with respect to films as to which filming begins within such year by

(b) The percentage which, based on the experience of other film makers of similar films for the 5 calendar years preceding the calendar year in which the loan is made, the annual gross receipts (as described in § 1.993–6(a)(1), whether or not such films constitute property described therein) of such other film makers from the sale or lease of such films outside the United States is of the annual gross receipts of such other film makers from all sales or leases of such films.

(2) *Purpose of loan.* A loan by a DISC will be deemed to be for the making of a film if there exists a written agreement between the DISC and the borrower, executed at or before the time the loan is made, stating that the loan is made or to be made to enable the borrower to make such film.

(3) *Reasonable estimate of amounts.* For purposes of subparagraph (1)(iii)*(a)(2)* of this paragraph, a reasonable estimate shall be based on the conditions known by the DISC and borrower to exist at the time a loan is made (or which the DISC and borrower have reason to know to exist at such time).

(4) *Experience of film makers.* For purposes of subparagraph (1)(iii)(*b*) of this paragraph, the experience of other film makers of similar films for the 5 calendar years preceding the calendar year in which the loan is made shall be derived from such records and statistics as are acknowledged in the trade as reasonably reliable.

(5) *Domestic film maker.* For purposes of this section, a borrower is a domestic film maker with respect to a film if—

(i) The borrower is a U.S. person within the meaning of section 7701(a)(30), except that *(a)* with respect to a partnership all of the partners must be U.S. persons and *(b)* with respect to a corporation all of its officers and at least a majority of its directors must be U.S. persons,

(ii) The borrower is engaged in the trade or business of making the film with respect to which the loan is made,

(iii) Each studio, if any, used or to be used for filming or for recording sound incorporated into such film is located in the United States (as defined in section 7701(a)(9)),

(iv) At least 80 percent of the aggregate playing time of the film is or will be photographed within the United States (as defined in section 7701(a)(9)), and

(v) At least 80 percent of the total amount (not including any amount which is contingent upon receipts or profits of such film and which is fully taxable by the United States) paid or to be paid for services performed in the making of the film is either paid or to be paid to persons who are U.S. persons at the time such services are performed or consists of amounts which are fully taxable by the United States.

(6) *Amounts as fully taxable.* For purposes of subparagraph (5)(v) of this paragraph, an amount is considered fully taxable by the United States if the entire amount is included in gross income under section 61 or is subject to withholding under any provision of U.S. law or treaty to which the U.S. is a party and is not exempt from taxation under any provision of such law or treaty. Where a nonresident alien individual is engaged for the making of a film or where a foreign corporation is engaged to furnish the services of one of its officers or employees for the making of a film, the amount paid such individual or corporation will be considered as fully taxable by the United States only if it meets the test of this subparagraph.

[T.D. 7514, 42 FR 55464, Oct. 17, 1977, as amended by T.D. 7513, 42 FR 57311, Nov. 2, 1977; T.D. 7514, 42 FR 60910, Nov. 30, 1977; T.D. 7854, 47 FR 51741, Nov. 17, 1982]

§1.993–5 Definition of related foreign export corporation.

(a) *General rule*—(1) *Definition.* Under section 993(e), a foreign corporation is a related foreign export corporation with respect to a DISC if—

(i) It is a foreign international sales corporation described in paragraph (b) of this section,

(ii) It is a real property holding company described in paragraph (c) of this section, or

(iii) It is an associated foreign corporation described in paragraph (d) of this section.

(2) *Application of this section.* It is necessary to determine whether a foreign corporation is a related foreign export corporation with respect to a DISC for the following two purposes:

(i) *Qualified export assets.* Under §1.993–2(g), the stock or securities of a related foreign export corporation held by the DISC are qualified export assets.

(ii) *Qualified export receipts.* Under §1.993–1 (e), (f), and (g), certain receipts of the DISC with respect to stock or securities of a related foreign export corporation held by the DISC are qualified export receipts.

(b) *Foreign international sales corporation*—(1) *In general.* A foreign corporation is a foreign international sales corporation with respect to a taxable year of a DISC if—

(i) On each day during such taxable year of the DISC on which the foreign corporation has stock issued and outstanding, the DISC owns directly stock of the foreign corporation possessing more than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote as determined under the principles of §1.957–1(b) (relating to definition of controlled foreign corporation),

(ii) 95 percent or more of such foreign corporation's gross receipts (as defined in §1.993–6) for its taxable year ending with or within such taxable year of the DISC consists of qualified export receipts described in §1.993–1 (b) through (e) or interest described in §1.993–1(g) derived from any obligations described in §1.993–2 (d) or (e), and

(iii) The sum of the adjusted bases of the assets of the foreign corporation which are qualified export assets described in §1.993–2 (b) through (e) and which are held by the foreign corporation at the close of its taxable year which ends with or within such taxable year of the DISC equals or exceeds 95 percent of the sum of the adjusted bases of all assets held by the foreign corporation at the close of such taxable year.

(2) *Certain determinations.* The determinations as to whether gross receipts are qualified export receipts described in subparagraph (1)(ii) of this paragraph and as to whether assets are qualified export assets described in subparagraph (1)(iii) of this paragraph are made by applying the requirements of §§1.993–1 and 1.993–2 to the foreign corporation as if it were a domestic corporation being tested to determine whether it is a DISC. For purposes of making either of such determinations, the principles of accounting applicable for purposes of computing earnings and profits under §1.964–1 (relating to a controlled foreign corporation's earnings and profits) shall apply.

(c) *Real property holding company*—(1) *In general.* A foreign corporation is a real property holding company with respect to a taxable year of a DISC if—

(i) On each day during such taxable year of the DISC on which the foreign corporation has stock issued and outstanding, the DISC owns directly stock of the foreign corporation possessing more than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote as determined under the principles of § 1.957–1(b) and

(ii) The sole function of the foreign corporation is to hold title to real property situated outside the United States for the exclusive use of the DISC, title to which may not be held by the DISC (and, if the DISC subleases such property to a related supplier, as described in subparagraph (3) of this paragraph, by such related supplier) under the law of the country in which such property is situated.

(2) *Activities of the foreign corporation.* For purposes of subparagraph (1)(ii) of this paragraph, a foreign corporation which holds title to real property situated outside the United States may also perform activities with respect to such property (such as management, maintenance, and payment of taxes) which are ancillary to its function of holding title to such property.

(3) *Exclusive use by the DISC.* Real property held by the foreign corporation must be used exclusively by the DISC whether under a lease or any other arrangement. Real property is not so used by the DISC if the DISC subleases such property to any other person. If, however, during a taxable year of the DISC—

(i) 90 percent or more of the qualified export receipts of the DISC for such year are derived from transactions with respect to which it is a commission agent for a related supplier (as defined in § 1.994–1(a)(3)(ii)), and

(ii) The DISC subleases such property to such related supplier

then such property will be considered as used exclusively by the DISC during such year if such related supplier does not sublease such property.

(d) *Associated foreign corporation*—(1) *In general.* A foreign corporation is an associated foreign corporation with respect to a taxable year of the DISC if—

(i) On each day during such taxable year of the DISC on which the foreign corporation has stock issued and outstanding, the DISC, or one or more members of the same controlled group of corporations (as defined in subparagraph (2) of this paragraph) as the DISC, owns (within the meaning of section 1563 (d) and (e)) stock of the foreign corporation possessing less than 10 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote, as determined under the principles of § 1.957–1(b), or owns no stock of such corporation, and

(ii) The ownership of stock, or of securities (as defined in § 1.993–2(g)), of the foreign corporation by the DISC or by one or more members of such controlled group of corporations reasonably furthers a transaction or transactions giving rise to qualified export receipts for the DISC.

(2) *Controlled group of corporations.* For purposes of this paragraph, the term ‘‘controlled group of corporations’’ has the same meaning assigned to the term in section 1563(a) and not section 993(a)(3) and § 1.993–1(k). Thus, for purposes of this paragraph, the test of control is 80 percent control and, since the rules of section 1563(b) apply, only domestic members are considered to be members of the controlled group.

(3) *Furtherance of qualified export receipts.* Ownership of stock or securities of a foreign corporation will be considered as reasonably furthering a transaction or transactions giving rise to qualified export receipts for a DISC if—

(i) The ownership is necessary to obtain or maintain the foreign corporation as a customer of the DISC or of a related supplier, as defined in § 1.994–1(a)(3)(ii) of the DISC or to aid the sales distribution system of the DISC or of such related supplier, and

(ii) The amount of the investment in the foreign corporation bears a reasonable relationship to the amount of the DISC's annual net profit from transactions in its trade or business which it may reasonably expect to derive on account of such ownership.

In determining whether the amount of the investment is reasonable, there shall be taken into account any stock or securities of the foreign corporation owned by any other foreign corporation which, if it were a domestic corporation, would be a member of the same controlled group of corporations as the DISC.

[T.D. 7514, 42 FR 55467, Oct. 17, 1977; 42 FR 60910, Nov. 30, 1977]

§1.993–6 Definition of gross receipts.

(a) *General rule.* Under section 993(f), for purposes of sections 991 through 996, the gross receipts of a person for a taxable year are—

(1) The total amounts received or accrued by the person from the sale or lease of property held primarily for sale or lease in the ordinary course of a trade or business, and

(2) Gross income recognized from all other sources, such as, for example, from—

(i) The furnishing of services (whether or not related to the sale or lease of property described in subparagraph (1) of this paragraph),

(ii) Dividends and interest,

(iii) The sale at a gain of any property not described in subparagraph (1) of this paragraph, and

(iv) Commission transactions as and to the extent described in paragraph (e) of this section.

(b) *Nongross receipts items.* For purposes of paragraph (a) of this section, gross receipts do not include amounts received or accrued by a person from—

(1) The proceeds of a loan or of the repayment of a loan, or

(2) A receipt of property in a transaction to which section 118 (relating to contribution to capital) or 1032 (relating to exchange of stock for property) applies.

(c) *Nonreduction of total amounts.* For purposes of paragraph (a) of this section, the total amounts received or accrued by a person are not reduced by returns and allowances, costs of goods sold, expenses, losses, a deduction for dividends received under section 243, or any other deductible amounts.

(d) *Method of accounting.* For purposes of paragraph (a) of this section, the total amounts received or accrued by a person shall be determined under the method of accounting used in computing its taxable income. If, for example, a DISC receives advance or installment payments for the sale or lease of property described in paragraph (a)(1) of this section, for the furnishing of services, or which represent recognized gain from the sale of property not described in paragraph (a)(1) of this section, any amount of such advance payments is considered to be gross receipts of the DISC for the taxable year for which such amount is included in the gross income of the DISC.

(e) *Commission transactions.* (1) In the case of transactions which give rise to a commission on the sale or lease of property or the furnishing of services by a principal, the amount recognized by the commission agent as gross income from all such transactions shall be the gross receipts derived by the principal from the sale or lease of the property, or the gross income derived by the principal from the furnishing of services, with respect to which the commissions are derived. In the case of a commission agent for a related supplier (as defined in §1.994–1(a)(3)(ii)), the gross receipts or gross income of such agent shall be determined as if it used the same method of accounting as its related supplier. In the case of a commission agent for a principal other than a related supplier, the gross receipts or gross income of such principal shall be determined as if such principal used the same method of accounting as its agent.

(2) If the commission arrangement provides that the commission agent will receive a commission only with respect to sales or leases of export property, or the furnishing of services, which result in qualified export receipts, the commission agent will not take into account the gross receipts or gross income, as the case may be, derived by the principal from any transaction for which the commission agent would not be entitled to a commission under the commission arrangement.

(f) *Example.* The provisions of this section may be illustrated by the following example:

Example. During 1973, M, a related supplier (as defined in §1.994–1(a)(3)(ii)) of N, is engaged in the manufacture of machines in the United States. N, a calendar year taxpayer, is engaged in the sale and lease of such machines in foreign countries. N furnishes services which are related and subsidiary to its sale and lease of such machines. N also acts as a commission agent in foreign countries for Z, an unrelated supplier, with respect to Z's sale of products. N receives dividends on stock owned by it in a related foreign export corporation (as defined in § 1.993–5), interest on producer's loans made to M, and proceeds from sales of business assets located outside the United States resulting in a recognized gains and losses. N's gross receipts for 1973 are $3,550, computed on the basis of the additional facts assumed in the table below:

(1) N's sales receipts for machines manufactured by M (without reduction for cost of goods sold and selling expenses)	$1,500
(2) N's lease receipts for machines manufactured by M (without reduction for depreciation and leasing expenses)	500
(3) N's gross income from services for machines manufactured by M (without reduction for service expenses)	400
(4) Z's sale receipts for products manufactured by Z (without reduction for Z's cost of goods sold, commissions on sales, and commission sales expenses)	550
(5) Dividends received by N	150
(6) Interest received by N on producer's loans	200
(7) Proceeds received by N representing recognized gain (but not losses) from sales of business assets located outside the United States	250
(8) N's gross receipts	3,550

[T.D. 7514, 42 FR 55468, Oct. 17, 1977]

§ 1.993–7 Definition of United States.

Under section 993(g), the term ''United States'' includes the States, the District of Columbia, the Commonwealth of Puerto Rico, and possessions of the United States. For the requirement that a DISC must be incorporated and existing under the laws of a State or the District of Columbia, see § 1.992–1(a)(1).

[T.D. 7514, 42 FR 55468, Oct. 17, 1977]

§ 1.994–1 Inter-company pricing rules for DISC's.

(a) *In general*—(1) *Scope.* In the case of a transaction described in paragraph (b) of this section, section 994 permits a person related to a DISC to determine the allowable transfer price charged the DISC (or commission paid the DISC) by its choice of three methods described in paragraph (c)(2), (3), and (4) of this section: The ''4 percent'' gross receipts method, the ''50–50'' combined taxable income method, and the section 482 method. Under the first two methods, the DISC is entitled to 10 percent of its export promotion expenses as additional taxable income. When the gross receipts method or combined taxable income method is applied to a transaction, the Commissioner may not make distributions, apportionments, or allocations as provided by section 482 and the regulations thereunder. For rules as to certain ''incomplete transactions'' and for computing combined taxable income, see paragraph (c)(5) and (6) of this section. Grouping of transactions for purposes of applying the method chosen is provided by paragraph (c)(7) of this section. The rules in paragraph (c) of this section are directly applicable only in the case of sales or exchanges of export property to a DISC for resale, and are applicable by analogy to leases, commissions, and services as provided in paragraph (d) of this section. For rules limiting the application of the gross receipts method and combined taxable income method so that the supplier related to the DISC will not incur a loss on transactions, see paragraph (e)(1) of this section. Paragraph (e)(2) of this section provides for the applicability of section 482 to resales by the DISC to related persons. Paragraph (e)(3) of this section provides for the time by which a reasonable estimate of the transfer price (including commissions and other payments) should be paid. The subsequent determination and further adjustments to transfer prices are set forth in paragraph (e)(4) of this section. Export promotion expenses are defined in paragraph (f) of this section. Paragraph (g) of this section has several examples illustrating the provisions of this section. Section 1.994–2 prescribes the marginal costing rules authorized by section 994(b)(2).

(2) *Performance of substantial economic functions.* The application of section 994(a)(1) or (2) does not depend on the extent to which the DISC performs substantial economic functions (except with respect to export promotion expenses). See paragraph (l) of § 1.993–1.

(3) *Related party and related supplier.* For the purposes of this section—

(i) The term ''related party'' means a person which is owned or controlled directly or indirectly by the same interests as the DISC within the meaning of section 482 and §1.482–1(a).

(ii) The term ''related supplier'' means a related party which singly engages in a transaction directly with the DISC which is subject to the rules of section 994 and this section. However, a DISC may have different related suppliers with respect to different transactions. If, for example, X owns all the stock of Y, a corporation, and of Z, a DISC, and sells a product to Y which is resold to Z, only Y is the related supplier of Z, and, thus, only the resale from Y to Z is subject to section 994 and this section. If, however, X sells directly to Z and Y also sells directly to Z, then, as to the transactions involving direct sales to Z, each of X and Y is a related supplier of Z.

(b) *Transactions to which section 994 applies.* Section 994(a)(3) may be applied, as described in paragraph (a) of this section, to any transaction between a related supplier and a DISC. Section 994(a)(1) or (2) may be applied, as described in paragraph (a) of this section, to a transaction between a related supplier and a DISC only in the following cases:

(1) Where the related supplier sells export property to the DISC for resale or where the DISC is commission agent for the related supplier on sales by the related supplier of export property to third parties whether or not related parties. For purposes of this section, references to sales include exchanges.

(2) Where the related supplier leases export property to the DISC for sublease for a comparable period with comparable terms of payment or where the DISC is commission agent for the related supplier on leases by the related supplier of export property to third parties whether or not related parties.

(3) Where services are furnished by a related supplier which are related and subsidiary to any sale or lease by the DISC, acting as principal or commission agent, of export property under subparagraph (1) or (2) of this paragraph.

(4) Where engineering or architectural services for construction projects located (or proposed for location) outside of the United States are furnished by a related supplier where the DISC is acting as principal or commission agent with respect to the furnishing of such services to a third party whether or not a related party.

(5) Where the related supplier furnishes managerial services in furtherance of the production of qualified export receipts of an unrelated DISC where the related DISC is acting as principal or commission agent with respect to the furnishing of such services to an unrelated DISC.

Transactions are included, for purposes of this paragraph, only if they give rise to qualified export receipts (within the meaning of section 993(a)) in the hands of the related DISC. If a transaction is not included in subparagraph (1), (2), (3), (4), or (5) of this paragraph, the rules of section 994(a)(1) or (2) do not apply. Thus, for example, the rules of sectoin 994(a)(1) or (2) would not apply if a DISC purchased export property from its related supplier and leased such property to a third party.

(c) *Transfer price for sales of export property*—(1) *In general.* Under this paragraph, rules are prescribed for computing the allowable price for a transfer from a related supplier to a DISC in the case of a sale of export property described in paragraph (b)(1) of this section.

(2) *The ''4-percent'' gross receipts method.* Under the gross receipts method of pricing, the transfer price for a sale by the related supplier to the DISC is the price as a result of which the taxable income derived by the DISC from the sale will not exceed the sum of (i) 4 percent of the qualified export receipts of the DISC derived from the sale of the export property (as defined in section 993 (c)) and (ii) 10 percent of the export promotion expenses (as defined in paragraph (f) of this section) of the DISC attributable to such qualified export receipts.

(3) *The ''50–50'' combined taxable income method.* Under the combined taxable income method of pricing, the transfer price for a sale by the related supplier to the DISC is the price as a result of which the taxable income derived by the DISC from the sale will not exceed the sum of (i) 50 percent of

the combined taxable income (as defined in subparagraph (6) of this paragraph) of the DISC and its related supplier attributable to the qualified export receipts from such sale and (ii) 10 percent of the export promotion expenses (as defined in paragraph (f) of this section) of the DISC attributable to such qualified export receipts.

(4) *Section 482 method.* If the rules of subparagraphs (2) and (3) of this paragraph are inapplicable to a sale or a taxpayer does not choose to use them, the transfer price for a sale by the related supplier to the DISC is to be determined on the basis of the sale price actually charged but subject to the rules provided by section 482 and the regulations thereunder.

(5) *Incomplete transactions.* (i) For purposes of the gross receipts and combined taxable income methods, where property (encompassed within a transaction or group chosen under subparagraph (7) of this paragraph) is transferred by a related supplier to a DISC during a taxable year of either the DISC or related supplier, but some or all of such property is not sold by the DISC during such year—

(a) The transfer price of such property sold by the DISC during such year shall be computed separately from the transfer price of the property not sold by the DISC during such year,

(b) With respect to such property not sold by the DISC during such year, the transfer price paid by the DISC for such year shall be the related supplier's cost of goods sold (see subparagraph (6)(ii) of this paragraph) with respect to the property, except that, with respect to such taxable years ending on or before August 15, 1975, the transfer price paid by the DISC shall be at least (but need not exceed) the related supplier's cost of goods sold with respect to the property.

(c) For the subsequent taxable year during which such property is resold by the DISC, an additional amount shall be paid by the DISC (to be treated as income for such year by the related supplier) equal to the excess of the amount which would have been the transfer price under this section had the transfer to the DISC by the related supplier and the resale by the DISC taken place during the taxable year of the DISC during which it resold the property over the amount already paid under *(b)* of this subdivision.

(d) The time and manner of payment of transfer prices required by *(b)* and *(c)* of this subdivision shall be determined under paragraphs (e)(3), (4), and (5) of this section.

(ii) For purposes of this paragraph, a DISC may determine the year in which it receives property from a related supplier and the year in which it sells property in accordance with the method of identifying goods in its inventory properly used under section 471 or 472 (relating respectively to general rule for inventories and to LIFO inventories). Transportation expense of the related supplier in connection with a transaction to which this subparagraph applies shall be treated as an item of cost of goods sold with respect to the property if the related supplier includes the cost of intracompany transportation between its branches, divisions, plants, or other units in its cost of goods sold (see subparagraph (6)(ii) of this paragraph).

(6) *Combined taxable income.* For purposes of this section, the combined taxable income of a DISC and its related supplier from a sale of export property is the excess of the gross receipts (as defined in section 993(f)) of the DISC from such sale over the total costs of the DISC and related supplier which relate to such gross receipts. Gross receipts from a sale do not include interest with respect to the sale. Combined taxable income under this paragraph shall be determined after taking into account under paragraph (e)(2) of this section all adjustments required by section 482 with respect to transactions to which such section is applicable. In determining the gross receipts of the DISC and the total costs of the DISC and related supplier which relate to such gross receipts, the following rules shall be applied:

(i) Subject to subdivisions (ii) through (v) of this subparagraph, the taxpayer's method of accounting used in computing taxable income will be accepted for purposes of determining amounts and the taxable year for which items of income and expense (including depreciation) are taken into account. See § 1.991–1(b)(2) with respect to the method of accounting which may be used by a DISC.

(ii) Cost of goods sold shall be determined in accordance with the provisions of §1.61–3. See sections 471 and 472 and the regulations thereunder with respect to inventories. With respect to property to which an election under section 631 applies (relating to cutting of timber considered as a sale or exchange), cost of goods sold shall be determined by applying §1.631–1(d)(3) and (e) (relating to fair market value as of the beginning of the taxable year of the standing timber cut during the year considered as its cost).

(iii) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are *(a)* the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto, and *(b)* a ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in §1.861–8.

(iv) The taxpayer's choice in accordance with subparagraph (7) of this paragraph as to the grouping of transactions shall be controlling, and costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping.

(v) If an account receivable arising with respect to a sale of export property is transferred by the related supplier to a DISC which is a member of the same controlled group within the meaning of §1.993–1(k) for an amount reflecting a discount from the selling price taken into account in computing (without regard to this subdivision) combined taxable income of the DISC and its related supplier, then the combined taxable income from such sale shall be reduced by the amount of the discount.

(7) *Grouping transactions.* (i) Generally, the determinations under this section are to be made on a transaction-by-transaction basis. However, at the annual choice of the taxpayer some or all of these determinations may be made on the basis of groups consisting of products or product lines.

(ii) A determination by a taxpayer as to a product or a product line will be accepted by a district director if such determination conforms to any one of the following standards: *(a)* A recognized industry or trade usage, or *(b)* the 2-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.

(iii) A choice by the taxpayer to group transactions for a taxable year on a product or product line basis shall apply to all transactions with respect to that product or product line consummated during the taxable year. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are made on a transaction-by-transaction basis. For example, the taxpayer may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year.

(iv) For rules as to grouping certain related and subsidiary services, see paragraph (d)(3)(ii) of this section.

(d) *Rules under section 994(a)(1) and (2) for transactions other than sales.* The following rules are prescribed for purposes of applying the gross receipts method or combined taxable income method to transactions other than sales:

(1) *Leases.* In the case of a lease of export property by a related supplier to a DISC for sublease by the DISC to produce gross receipts, for any taxable year the amount of rent the DISC must pay to the related supplier shall be determined under the DISC's lease with its related supplier but must be computed in a manner consistent with the rules in paragraph (c) of this section for computing the transfer price in the case of sales and resales of export property under the gross receipts method or combined taxable income method. For purposes of applying this subparagraph, transactions may not be so grouped on a product or product line basis under the rules of paragraph (c)(7)

of this section as to combine in any one group of transactions both lease transactions and sale transactions involving the same product or product line.

(2) *Commissions.* If any transaction to which section 994 applies is handled on a commission basis for a related supplier by a DISC and such commissions give rise to qualified export receipts under section 993(a)—

(i) The amount of the income that may be earned by the DISC in any year is the amount, computed in a manner consistent with paragraph (c) of this section, which the DISC would have been permitted to earn under the gross receipts method, the combined taxable income method, or section 482 method if the related supplier had sold (or leased) the property or service to the DISC and the DISC in turn sold (or subleased) to a third party, whether or not a related party, and

(ii) The maximum commission the DISC may charge the related supplier is the sum of the amount of income determined under subdivision (i) of this subparagraph plus the DISC's total costs for the transaction as determined under paragraph (c)(6) of this section.

(3) *Receipts from services*—(i) *Related and subsidiary services attributable to the year of the export transaction.* The gross receipts for related and subsidiary services described in paragraph (b)(3) of this section shall be treated as part of the receipts from the export transaction to which such services are related and subsidiary, but only if, under the arrangement between the DISC and its related supplier and the accounting method otherwise employed by the DISC, the income from such services is includible for the same taxable year as income from such export transaction.

(ii) *Other services.* In the case of related and subsidiary services to which subdivision (i) of this subparagraph does not apply and other services described in paragraph (b)(4) or (5) of this section performed by a related supplier (relating respectively to engineering and architectural services and certain managerial services), the amount of taxable income which the DISC may derive for any taxable year shall be determined under the arrangement between the DISC and its related supplier and shall be computed in a manner consistent with the rules in paragraph (c) of this section for computing the transfer price in the case of sales for resale of export property under the gross receipts method or combined taxable income method. Related and subsidiary services to which subdivision (i) of this subparagraph does not apply may be grouped, under the rules for grouping of transactions in paragraph (c)(7) of this section, with the products or product lines to which they are related and subsidiary, so long as the grouping of services chosen is consistent with the grouping of products or product lines chosen for the taxable year in which either the product or product lines were sold or in which payment for such services is received or accrued. The rules for grouping of transactions in paragraph (c)(7) of this section shall not apply with respect to the determination of taxable income which the DISC may derive from other services described in paragraph (b)(4) or (5) of this section performed by a related supplier or commissions on such services, and such determination shall be made only on a transaction-by-transaction basis.

(e) *Methods of applying paragraphs (c) and (d) of this section*—(1) *Limitation on DISC income (''no loss'' rule)*—(i) *In general.* Except as otherwise provided in this subparagraph, neither the gross receipts method nor the combined taxable income method may be applied to cause in any taxable year a loss to the related supplier, but either method may be applied to the extent it does not cause a loss. A loss to a related supplier would result if the taxable income of the DISC would exceed the combined taxable income of the related supplier and the DISC. If, however, there is no combined taxable income of the DISC and the related supplier (because, for example, a combined loss is incurred), a transfer price (or commission) will not be deemed to cause a loss to the related supplier if it allows the DISC to recover an amount not in excess of its costs (if any).

(ii) *Special rule for applying ''4 percent'' gross receipts method to sales.* A transfer price or commission, determined under the ‘‘4 percent’’ gross receipts method (determined without regard to subdivision (i) of this subparagraph), for a sale of export property referred to in paragraph (b)(1) of this section, will not be considered to cause a loss for the related supplier if for the DISC's taxable year, the ratio that (a) the taxable income of the DISC derived from such sale by using such price or commission bears to *(b)* the DISC's gross receipts from such sale is not greater than the ratio that *(c)* all of the taxable income of the related supplier and the DISC from all sales of the same product or product line (domestic and foreign) to third parties whether or not related parties bears to *(d)* the total gross receipts of the related supplier and the DISC from such sales. For purposes of the preceding sentence, sales between the DISC and its related suppliers shall not be taken into account under *(c)* or *(d)* of this subdivision. For example, assume that for a taxable year of a DISC the total costs of the related supplier and the DISC with respect to all sales ($150 for domestic and $44 for foreign) of a product line are $194 and the total gross receipts of the related supplier and the DISC with respect to such sales are $200 so that the total taxable income of the related supplier and the DISC with respect to such sales is $6. The parties would thus be entitled to compute a transfer price determined under the gross receipts method on any given sale of product A of such product line by the related supplier to the DISC which would allocate to the DISC taxable income equal to not more than 3 percent (*i.e.*, $6/$200) of its gross receipts derived from its resale of such product. If the DISC were to resell an item of product A for $10, the transfer price paid by the DISC to the related supplier determined under the gross receipts method could be as low as $9.70.

(iii) *Grouping transactions.* For purposes of subdivision (i) of this subparagraph, the basis for grouping transactions chosen by the taxpayer under paragraph (c)(7) of this section for the taxable year shall be applied. For purposes of making the computations of subdivision (ii) *(c)* and *(d)* of this subparagraph, however, the taxpayer may choose any basis for grouping transactions permissible under paragraph (c)(7) of this section, even though it may not be the same basis as that already chosen under paragraph (c)(7) of this section for computing transfer prices or commissions to a DISC. If, for example, the taxpayer has chosen to group transactions on a product basis for computing transfer prices or commissions to a DISC for a taxable year, the taxpayer may still group transactions on a product line basis for purposes of computing taxable income and total gross receipts under subdivision (ii) *(c)* and *(d)* of this subparagraph. For a further example, if the taxpayer computes taxable income for one group of transactions under the gross receipts method and computes taxable income for a second group of transactions under the combined taxable income method, the taxpayer may aggregate these transactions for purposes of computing taxable income and total gross receipts under subdivision (ii) *(c)* and *(d)* of this subparagraph.

(2) *Relationship to section 482.* In applying the rules under section 994, it may be necessary to first take into account the price of a transfer (or other transaction) between the DISC (or related supplier) and a related party which is subject to the arm's length standard of section 482. Thus, for example, where a related supplier sells export property to a DISC which the related supplier purchased from related parties, the costs taken into account in computing the combined taxable income of the DISC and the related supplier are determined after any necessary adjustment under section 482 of the price paid by the related supplier to the related parties. In applying section 482 to a transfer by a DISC, however, the DISC and its related supplier are treated as if they were a single entity carrying on all the functions performed by the DISC and the related supplier with respect to the transaction and the DISC shall be allowed to receive under the section 482 standard the amount the related supplier would have received had there been no DISC.

(3) *Initial payment of transfer price or commission.* (i) The amount of a transfer price (or reasonable estimate thereof) actually charged by a related supplier

to a DISC, or a sales commission (or reasonable estimate thereof) actually charged by a DISC to a related supplier, in a transaction to which section 994 applies must be paid no later than 60 days following the close of the taxable year of the DISC during which the transaction occurred.

(ii) Payment must be in the form of money, property (including accounts receivable from sales by or through the DISC), a written obligation which qualifies as debt under the safe harbor rule of § 1.992–1(d)(2)(ii), or an accounting entry offsetting the account receivable against an existing debt owed by the person in whose favor the account receivable was established to the person with whom it engaged in the transaction. The form of the payment to a DISC need not be a qualified export asset under § 1.993–2. However, for the requirement that the adjusted basis of the qualified export assets of the DISC at the close of its taxable year must equal or exceed 95 percent of the sum of the adjusted bases of all assets of the DISC at the close of its taxable year, see section 992(a)(1)(B).

(iii) If the district director can demonstrate, based upon the data available as of the 60th day after the close of such taxable year, that the amount actually paid did not represent a reasonable estimate of the transfer price or commission (as the case may be) to be determined under section 994 and this section, an indebtedness will be deemed to arise, from the person required to make the payment in favor of the person to whom the payment is required to be made, in an amount equal to the difference between the amount of the transfer price or commission determined under section 994 and this section and the amount (if any) actually paid and received. Such indebtedness will be deemed to arise as of the date the transaction occurred which gave rise to the indebtedness, except that, if such transaction occurred in a taxable year of the DISC ending on or before August 15, 1975, at the taxpayer's option, the indebtedness will be deemed to arise as of the date by which payment was required under subdivision (i) of this paragraph (e)(3). Such indebtedness owed to a DISC shall be treated as an asset but shall not be treated as a trade receivable or other qualified export asset (see § 1.993–2(d)(3)) as of the end of the taxable year of the DISC in which the indebtedness is deemed to arise.

(iv)*(a)* Except with respect to incomplete transactions to which paragraph (c)(5)(i)*(b)* of this section applies, if the amount actually paid results in the DISC realizing at least 50 percent of the DISC's taxable income from the transaction as reported in its tax return for the taxable year the transaction is completed, then the amount actually paid shall be deemed to be a reasonable estimate of such transfer price or commission.

(b) With respect to incomplete transactions to which paragraph (c)(5)(i)*(b)* of this section applies and which were initiated during a taxable year ending after August 15, 1975, the amount actually paid shall be deemed to be a reasonable estimate of such transfer price if any one of the following three tests is met:

(1) The amount actually paid by the DISC to the related supplier in respect of the property does not exceed the related supplier's cost of goods sold (see paragraph (c)(6)(ii) of this section) with respect to the property.

(2) If the transaction is completed by the date on which the DISC's return is required to be filed for the year in which the transaction was initiated, the amount actually paid by the DISC to the related supplier in respect of the property results in the DISC realizing at least 50 percent of the DISC's taxable income from the transaction when completed.

(3) The percentage that *(i)* an amount equal to *(a)* the amount actually paid by the DISC to the related supplier in respect of the property minus *(b)* the related supplier's cost of goods sold with respect to the property, bears to *(ii)* the related supplier's cost of goods sold in respect of the property, is not greater than 50 percent of the percentage that *(iii)* the combined taxable income for completed transactions of the same group as the property during the DISC's taxable year in which the incomplete transaction was initiated, bears to *(iv)* the cost of goods sold of the related supplier and DISC with respect to such transactions.

(c) For purposes of this subdivision (iv), whether the transfer price or commission actually paid is deemed a reasonable estimate may be determined on the basis for grouping transactions chosen by the taxpayer under paragraph (c)(5) and (7) of this section.

(v) An indebtedness arising under subdivision (iii) of this subparagraph shall bear interest at an arm's length rate, computed in the manner provided by §1.482–2(a)(2) from the 61st day after the close of the DISC's taxable year in which the transaction occurred which gave rise to the indebtedness to the date of payment. The interest so computed shall be accrued and included in the taxable income of the person to whom the indebtedness is owed for each taxable year during which the indebtedness is unpaid.

(4) *Subsequent determination of transfer price or commission.* The DISC and its related supplier would ordinarily determine under section 994 and this section the transfer price payable by the DISC (or the commission payable to the DISC) for a transaction before the DISC files its return for the taxable year of the transaction. After the DISC has filed its return, a redetermination of the transfer price (or commission) may only be made if permitted by the Code and the regulations thereunder. Such a redetermination would include a redetermination by reason of an adjustment under section 482 and the regulations thereunder or section 861 and §1.861–8 which affects the amounts which entered into the determination of the transfer price or commission.

(5) *Procedure for adjustments to transfer price or commission*—(i)*(a)* If the transfer price (or commission) for a transaction determined under section 994 is different from the price (or commission) actually charged, the person who received too small a transfer price (or commission) or paid too large a transfer price (or commission) shall establish (or be deemed to have established), at the date of the determination or redetermination under subparagraph (4) of this paragraph of the transfer price (or commission) under section 994, an account receivable due the DISC from the person with whom it engaged in the transaction equal to the difference in amount between the transfer price (or commission) so determined and the transfer price (or commission) previously paid and received. If the account receivable is paid within 90 days after the date it is established (or deemed established), then as of the end of the taxable year of the DISC in which the transaction occurred which gave rise to the indebtedness, the account receivable shall be treated as an asset and, under §1.993–2(d)(3) as a trade receivable, and thus as a qualified export asset.

(b) If, for example, during 1972, a DISC which uses the calendar year as its taxable year sold a product which it purchased that year from its related supplier and paid a price of $10,000 which price is a reasonable estimate under subparagraph (3)(iii) of this paragraph but is later determined under section 994 to be $8,000 immediately before the DISC filed its return for 1972, the DISC must be paid $2,000 (i.e., $10,000 − $8,000) by its related supplier or establish an account receivable from its related supplier of $2,000. The account receivable may be paid without tax consequences, provided that such account receivable is paid within 90 days after the date it is established (or deemed established). Such account receivable paid within such 90 days will be considered to relate to the taxable year in which the transaction occurred which gave rise thereto rather than the taxable year during which it is established or paid.

(ii) Payment must be in a form specified in subparagraph (3) of this paragraph.

(iii) If an account receivable of a DISC described in subdivision (i) of this paragraph (e)(5) is not paid within 90 days of the date it is established (or deemed established), then, as of the end of the taxable year of the DISC in which the transaction occurred which gives rise to the indebtedness, the account receivable shall be treated as an asset except that, if the account receivable is established (or deemed established) in a taxable year of the DISC ending on or before August 15, 1975, at the taxpayer's option, the account receivable shall be treated as an asset as of the end of such taxable year. However, under §1.993–2(d)(3), an account receivable referred to in the preceding sentence shall not be treated as a trade receivable or other qualified export asset.

(iv) An account receivable established in accordance with subdivision (i) of this subparagraph shall bear interest at an arm's length rate, computed in the manner provided by § 1.482–2(a)(2) from the day after the date the account receivable is deemed established to the date of payment. The interest so computed shall be accrued and included in the taxpayer's taxable income for each taxable year during which the account receivable is outstanding.

(v)(*a*) In lieu of establishing an account receivable in accordance with subdivision (i) of this subparagraph for all or part of an amount due a related supplier, the related supplier and DISC are permitted to treat all or part of any distribution which was made by the DISC out of its previously taxed income with respect to the year to which the determination or redetermination relates as an additional payment of transfer price or repayment of commission (and not as a distribution) made as of the date the distribution was made. Any additional amount arising on the determination or redetermination due the related supplier after this treatment shall be represented by an account receivable established under subdivision (i) of this subparagraph. To the extent that a distribution is so treated under this subdivision (v), it shall cease to qualify as distribution for any Federal income tax purpose, and the DISC's account for previously taxed income shall be adjusted accordingly. If all or part of any distribution made to a shareholder other than the related supplier is recharacterized under this subdivision (v), the related supplier shall establish an account receivable from that shareholder for the amount so recharacterized. Such account receivable shall be paid in the time and manner set forth in this paragraph (e)(5). In order to obtain the relief provided by this subdivision (v), the conditions and procedures prescribed by Revenue Procedure 84–3 must be met. The provisions of this paragraph (e)(5)(v) shall apply to all open taxable years ending after December 31, 1971.

(*b*) If, for example, during 1982, a DISC commission from a related supplier with respect to a transaction completed in 1980 was redetermined to be $1,000 less than the commission actually charged by, and paid to, the DISC, the amount of any distribution previously made by the DISC from its 1980 previously taxed income to the related supplies as a shareholder may, to the extent of $1,000, be treated not as a distribution but as a repayment of the commission.

(vi) The procedure for adjustments to transfer price provided by this subparagraph does not apply to incomplete transactions described in paragraph (c)(5)(i)*(b)* of this section. Such procedure will, however, be applied to any such transaction with respect to the taxable year in which the transaction is completed.

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

Example 1. (i) During 1975, a DISC which uses the calendar year as its taxable year purchased a product from its related supplier and made an initial payment of $8,500. If $8,500 were determined to be the transfer price under section 994, the DISC's taxable income from the transaction would be $1,000. Immediately before the DISC filed its return for 1975, under section 994 it is determined that the transfer price is $8,000 and the DISC's taxable income is $1,500. Thus, the requirement of a reasonable estimate under subparagraph (3) of this paragraph was met because the amount ($8,500) actually paid resulted in the DISC realizing taxable income of $1,000 which is not less than 50 percent of the DISC's taxable income ($1,500) from the transaction as determined under section 994.

(ii) Pursuant to subparagraph (5) of this paragraph, an account receivable due the DISC for $500, i.e., $8,500 − $8,000, is established on September 15, 1976, the date the DISC files its return for 1975, and is paid on December 1, 1976. The account receivable for $500 will be considered to relate to the taxable year (1975) in which the transaction occurred which gave rise thereto and will be a qualified export asset under § 1.993–2(d)(3) for the last day of such year.

Example 2. Assume the same facts as in example 1 except that the account receivable for $500 is paid on January 1, 1977. The account receivable for $500 will still be considered to relate to the taxable year (1975) in which the transaction occurred which gave rise thereto. However, such account receivable will be treated as an asset which is not a qualified export asset under §1.993–2(d)(3) for the last day of such year.

(f) *Export promotion expenses*—(1) *Purpose of expense*. (i) In order for an expense or cost of a type described in subparagraph (2) of this paragraph to be an export promotion expense, the expense or cost must be incurred or treated as incurred by the DISC (under subparagraph (7) of this paragraph) to advance the sale, lease, or other distribution of export property for use, consumption, or distribution outside the United States. Costs of services in performing installation (but not assembly) on the site and for meeting warranty commitments if such services are related and subsidiary (within the meaning of §1.993–1(d)) to any qualified sale, lease, or other distribution of export property by the DISC (or with respect to which the DISC received a commission) will be considered to advance the sale, lease, or other distribution of export property. General and administrative expenses attributable to billing customers, other clerical functions of the DISC, or generally operating the DISC, will also be considered to advance the sale, lease, or other distribution of export property.

(ii) Where an expense or cost incurred or treated as incurred by the DISC qualifies only in part as an export promotion expense, such expense or cost must be allocated between the qualified portion and such other portion on a reasonable basis. See §1.994–2(b)(2) for the option of the related supplier not to claim expenses as export promotion expenses.

(2) *Types of expenses*. The only expenses or costs which may be export promotion expenses are those expenses or costs meeting the test of subparagraph (1) of this paragraph which constitute—

(i) Ordinary and necessary expenses of the DISC paid or incurred during the DISC's taxable year in carrying on any trade or business, allowable as deductions under section 162, such as expenses for market studies, advertising, salaries and wages (including contributions or compensations deductible under section 404) of sales, clerical, and other personnel, rentals on property, sales commissions, warehousing, and other selling expenses,

(ii) A reasonable allowance under section 167 for exhaustion, wear and tear, or obsolescence of the property of the DISC,

(iii) Costs of freight (subject to the limitations of subparagraph (4) of this paragraph),

(iv) Costs of packaging for export (as defined in subparagraph (5) of this paragraph), or

(v) Costs of designing and labeling packages exclusively for export markets (under subparagraph (6) of this paragraph).

(3) *Ineligible expenses*. Items ineligible to be export promotion expenses include, for example, interest expenses, bad debt expenses, freight insurance, State and local income and franchise taxes, the cost of manufacture or assembly operations, and items of cost of goods sold (except as otherwise provided in this paragraph in the case of certain freight, packaging, and designing and labeling expenses). Income or similar taxes eligible for a foreign tax credit under sections 901 and 903 are also not eligible to be export promotion expenses.

(4) *Freight expenses*—(i) *In general*. Export promotion expenses include one-half of the freight expense (not including insurance) for shipping export property aboard a U.S.-flag carrier in those cases where law or regulation of the United States or of any State or political subdivision thereof or of any agency or instrumentality of any of these does not require that the export property be shipped aboard a U.S.-flag carrier. For purposes of this paragraph, the term ''freight expense'' includes charges paid for c.o.d. service, miscellaneous ground charges, such as charges incurred for services normally performed by U.S.-flag carriers, charges for services of loading aboard U.S.-flag carriers normally performed by such carriers, freight forwarders, or independent contractors engaged in loading property, and charges attributable to a freight consolidation function normally performed by freight forwarders. In order for one-half of freight expenses paid to the owner (or the agent of the owner) of a U.S.-flag carrier to be claimed as an export promotion expense, the DISC must obtain

a written statement (such as, for example, a bill of lading) from the owner (or the agent) disclosing that the export property was shipped aboard the owner's U.S.-flag carrier or another U.S.-flag carrier, and the DISC must have no reasonable basis for disbelieving such statement of the owner (or the agent). For the requirement of a written statement from a freight forwarder, see subdivision (iv) of this subparagraph.

(ii) *U.S.-flag carrier defined.* For purposes of this paragraph, the term ''U.S.-flag carrier'' is an airplane owned and operated by a U.S. person or persons (as defined in section 7701(a)(30)) or a ship documented under the laws of the United States. Shipment initiated by delivery to the U.S. Postal Service shall be considered shipment aboard a U.S.-flag carrier, but not if shipped to a place to which mail shipments from the United States are ordinarily accomplished by land transportation, such as to Canada or Mexico, unless airmail is specified.

(iii) *Shipment pursuant to law or regulation.* Shipment pursuant to law or regulation includes instances where a U.S.-flag carrier must be used in order to obtain permission from the Government to make the export. If the law or regulation requires a fixed portion of the export property to be shipped aboard a U.S.-flag carrier, the freight expense on that portion of such export property that was so shipped in order to satisfy such requirement cannot qualify as an export promotion expense.

(iv) *Freight forwarders.* A payment to a freight forwarder shall be considered freight expense within the meaning of this paragraph to the extent the forwarder utilizes a U.S.-flag carrier. For purposes of this paragraph, the term ''freight forwarder'' includes air freight consolidators and carriers owned and operated by U.S. persons utilizing U.S.-flag carriers such as non-vessel-owning common carriers. In order for one-half of freight expenses paid to a freight forwarder to be claimed as export promotion expenses, the DISC must obtain a written statement (such as, for example, a bill of lading) from the freight forwarder disclosing that the export property was shipped aboard a U.S.-flag carrier, and the DISC must have no reasonable basis for disbelieving such statement of the freight forwarder.

(v) *Freight within the United States.* A DISC may not claim as export promotion expense any amount that is attributable to carriage of export property between points within the United States. If, however, export property is carried from the United States to a foreign country on a through shipment pursuant to a single bill of lading or similar document aboard one or more U.S.-flag carriers, the freight expense of such carriage shall not be apportioned between the domestic and foreign portions of such carriage, even though a carrier may stop en route within the United States or the export property may be shifted from one carrier to another, and one-half of such freight expense may be claimed as an export promotion expense. Freight expense does not include the cost of transporting the export property to the depot of the U.S.-flag carrier or freight forwarder for shipment abroad. The expense of shipment of export property initiated by delivery to the U.S. Postal Service for ultimate delivery outside the United States shall be considered as attributable entirely to carriage of such property outside the United States.

(5) *Packaging for export.* (i) Export promotion expenses include the direct and indirect cost of packaging export property (including the cost of the package) for export whether or not the packaging is the same as domestic packaging. Such packaging costs do not include costs of manufacturing (as defined in the regulations under section 993) and assembly. Thus, if a DISC buys and packages export property for resale, its costs of packaging the export property are export promotion expenses. If, however, the process of such packaging by the DISC is physically integrated with the process of manufacturing the export property by the related supplier, the costs of such packaging are not export promotion expenses.

(ii) The cost of containers leased from a shipping company to which the DISC also pays freight for the property packaged is not a cost of packaging. However, in such circumstances, one-half of the rental charge may be allowable as a freight expense if permitted under subparagraph (4) of this paragraph.

(6) *Designing and labeling packages.* Export promotion expenses include the direct and indirect costs of designing and labeling packages, including bottles, cans, jars, boxes, cartons, or containers, to the extent incurred for export markets. Thus, for example, to the extent incurred for supplying export markets, the cost of designing labels in a foreign language and the cost of printing such labels are export promotion expenses.

(7) *DISC must incur export promotion expenses*—(i) *In general.* In order for an expense to be an export promotion expense it must be incurred or treated as incurred under this subparagraph by the DISC. For example, an expense is incurred by a DISC if the expense results from *(a)* the DISC incurring an obligation to pay compensation to its employees, *(b)* depreciation of property owned by the DISC and used by its employees, *(c)* the DISC incurring an obligation to pay for office supplies used by its employees, *(d)* the DISC incurring an obligation to pay space costs for use by its employees, or *(e)* the DISC incurring an obligation to pay other costs supporting efforts by its employees.

(ii) *Payments to independent contractors.* A payment to an independent contractor, directly or indirectly, is treated as incurred by the DISC if the cost of performing the function performed by the independent contractor would be considered an export promotion expense described in subparagraphs (1) and (2) of this paragraph if performed by the DISC, and if, in a case where the services of the independent contractor were engaged by a party related to the DISC, such related party and such DISC agreed in writing before the contract was entered into that a specified portion or all of the contract was for the benefit of the DISC and that all of the expenses of the contract (eligible to be considered as export promotion expenses) with respect to such portion would be borne by the DISC.

(iii) *Expenses incurred by related parties.* Reimbursements or other payments by a DISC to a related party are export promotion expenses only if the expenses of the related party for which reimbursement is made are for space in a building actually used by employees of the DISC or for export property owned by the DISC. Except as otherwise provided in the preceding sentence, expenses incurred by a foreign international sales corporation (FISC) or a real property holding company (as defined in section 993(e)(1) and (2), respectively) shall not be treated as export promotion expenses of its DISC.

(iv) *Selling commissions paid by a DISC.* A commission paid by a DISC to a person other than a related person, with respect to a transaction which gives rise to qualified export receipts of the DISC, is an export promotion expense of the DISC. A commission paid by a DISC to a related person is not an export promotion expense.

(v) *Sales of promotional material.* If a DISC sells promotional material to a buyer of export property from the DISC at a price which is greater than the costs of the DISC for such material, such costs are not export promotion expenses. If, however, the DISC sells promotional material at a price which is less than its costs for such material, the excess of such costs over such price is an export promotion expense. For rules relating to the status of promotional material as qualified export assets and export property, see §§1.993–2 and 1.993–3, respectively.

(vi) An expense may be incurred by the DISC under subdivisions (i) through (v) of this subparagraph even if the accounting for and payment of such expense is handled by a related party and the DISC reimburses the related party for such expenses.

(8) *Incomplete transactions.* Expenses eligible to be treated as export promotion expenses which are attributable to the sale, lease, or other distribution of export property and which are incurred prior to the taxable year of sale, lease, or other distribution by the DISC are not treated as export promotion expenses until the taxable year of sale, lease, or other distribution or until the taxable year in which it is first determined that no transaction is reasonably expected to result from the expense incurred (whether or not a transaction subsequently results).

Thus, for example, if a DISC incurs a packaging cost which is otherwise eligible to be treated as an export promotion expense, the DISC may not include such charge as an export promotion expense until the year in which the export property with respect to which the packaging cost was incurred is actually sold by the DISC. If no transaction is reasonably expected to result from the packaging cost, such cost should be allocated as an export promotion expense to the group of transactions to which such cost is most closely related.

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

Example 1. J and K are calendar year taxpayers. J, a domestic manufacturing company, owns all the stock of K, a DISC for the taxable year. During 1972, J manufactures only 100 units of a product (which is eligible to be export property as defined in section 993(c)). J enters into a written agreement with K whereby K is granted a sales franchise with respect to exporting such property and K will receive commissions with respect to such exports equal to the maximum amount permitted to be received under the intercompany pricing rules of section 994. Thereafter, the 100 units are sold for $1,000. J's cost of goods sold attributable to the 100 units is $650. J's direct selling expenses so attributable are $100. Although J has other deductible expenses, for purposes of this example assume that J has no other deductible expenses. K pays $230 to independent contractors which qualify as export promotion expenses under paragraph (f)(7)(ii) of this section. K does not perform functions substantial enough to entitle it to an allocation of income which meets the arm's length standard of section 482. The income which K may earn under section 994 under the franchise is $20, computed as follows:

(1) Combined taxable income:		
(a) K's sales price		$1,000
(b) Less deductions:		
J's cost of goods sold	$650	
J's direct selling expenses	100	
K's export promotion expenses	230	
Total deductions		980
(c) Combined taxable income		20
(2) K's profit under combined taxable income method (before application of loss limitation):		
(a) 50 percent of combined taxable income		10
(b) Plus: 10 percent of K's export promotion expenses (10% of $230)		23
(c) K's profit		33
(3) K's profit under gross receipts method (before application of loss limitation):		
(a) 4 percent of K's sales price (4% of $1,000)		40
(b) Plus: 10 percent of K's export promotion expenses (10% of $230)		23
(c) K's profit		63

Since combined taxable income ($20) is lower than both K's profit under the combined taxable income method ($33) and under the gross receipts method ($63), the maximum income K may earn is $20. Accordingly, the commissions K may receive from J are $250, *i.e.*, K's expenses ($230) plus K's profit ($20).

Example 2. M and N are calendar year taxpayers. M, a domestic manufacturing company, owns all the stock of N, a DISC for the taxable year. During 1972, M produces and sells a particular product line of export property to N for $75, a price which can be justified as satisfying the standard of arm's length price of section 482. N performs substantial functions with respect to the transaction and resells the export property for $100. M's cost of goods sold attributable to the export property is $60. M's direct selling expenses so attributable (relating to advertising of the product line in foreign markets) are $12. Although M has other deductible expenses, for purposes of this example, assume that M has no other deductible expenses. N's expenses attributable to resale of the export property are $22 of which $20 are export promotion expenses. The maximum profit which N may earn with respect to the product line is $6, computed as follows:

(1) Combined taxable income:		
(a) N's sales price		$100
(b) Less deductions:		
M's cost of goods sold	$60	
M's direct selling expenses	12	
N's expenses	22	
Total deductions		94
(c) Combined taxable income		6
(2) N's profit under combined taxable income method (before application of loss limitation):		
(a) 50 percent of combined taxable income		3
(b) Plus: 10 percent of N's export promotion expenses (10% of $20)		2
(c) N's profit		5
(3) N's profit under gross receipts method (before application of loss limitation):		
(a) 4 percent of N's sales price (4% of $100)		4
(b) Plus: 10 percent of N's export promotion expenses (10% of $20)		2
(c) N's profit		6
(4) N's profit under section 482 method:		
(a) N's sales price		100
(b) Less deductions:		
N's cost of goods sold (price paid by N to M)	75	

N's expenses	22	
Total deductions		97
(c) N's profit		3

Since the gross receipts method results in greater profit to N ($6) than does the combined taxable income method ($5) or section 482 method ($3), and does not exceed combined taxable income ($6), N may earn a maximum profit of $6. Accordingly, the transfer price from M to N may be readjusted as long as the transfer price is not readjusted below $72, computed as follows:

(5) Transfer price from M to N:		
(a) N's sales price		$100
(b) Less:		
N's expenses	$22	
N's profit	6	
Total subtractions		28
(c) Transfer price		72

Example 3. Q and R are calendar year taxpayers. Q, a domestic manufacturing company, owns all the stock of R, a DISC for the taxable year. During 1972, Q produces and sells a product line of export property to R for $170, a price which can be justified as satisfying the standards of arm's length price of section 482, and R resells the export property for $200. Q's cost of goods sold attributable to the export property is $115 so that the combined gross income from the sale of the export property is $85 (*i.e.,* $200 minus $115). Q's expenses incurred in connection with the property sold are $35. Q's deductible overhead and other supportive expenses allocable to all gross income are $6. Apportionment of these supportive expenses on the basis of gross income does not result in a material distortion of income and is a reasonable method of apportionment. Q's gross income from sources other than the transaction is $170 making total gross income of Q and R (excluding the transfer price paid by R) $255 (i.e., $85 plus $170). R's expenses attributable to resale of the export property are $20, all of which are export promotion expenses. The maximum profit which R may earn with respect to the product line is $16, computed as follows:

(1) Combined taxable income:			
(a) R's sales price			$200
(b) Less deductions:			
(i) Q's cost of goods sold		115	
(ii) Q's expenses incurred in connection with the property sold		35	
(iii) Apportionment of Q's supportive expenses:			
Q's supportive expenses	$6		
Combined gross income from sale of export property	85		
Total gross income of Q and R	255		
Apportionment	(6×85)/255	2	
(iv) R's expenses		20	
Total deductions			172
(c) Combined taxable income			28
(2) R's profit under combined taxable income method (before application of loss limitation):			
(a) 50 percent of combined taxable income			14
(b) Plus: 10 percent of R's export promotion expenses (10% of $20)			2
(c) R's profit			16
(3) R's profit under gross receipts method (before application of loss limitation):			
(a) 4 percent of R's sales price (4% of $200)			8
(b) Plus: 10 percent of R's export promotion expenses (10% of $20)			2
(c) R's profit			10
(4) R's profit under section 482 method:			
(a) R's sales price			200
(b) Less deductions:			
R's cost of goods sold (price paid by R to Q)		170	
R's expenses		20	
Total deductions			190
(c) R's profit			10

Since the combined taxable income method results in greater profit to R ($16) than does the gross receipts method ($10) or section 482 method ($10), and does not exceed combined taxable income ($28), R may earn a maximum profit of $16. Accordingly, the transfer price from Q to R may be readjusted as long as the transfer price is not readjusted below $164 computed as follows:

(5) Transfer price from Q to R:		
(a) R's sales price		$200
(b) Less:		
R's expenses	$20	
R's profit	16	
Total		36
(c) Transfer price		164

Example 4. S and T are calendar year taxpayers. S, a domestic manufacturing company, owns all the stock of T, a DISC for the taxable year. During 1972, S produces and sells 100 units of a particular product to T under a written agreement which provides that the transfer price between S and T shall be that price which allocates to T the maximum permitted to be received under the intercompany pricing rules of section 994. Thereafter, the 100 units are sold by T for $950. S's cost of goods sold attributable to the 100 units is $650. S's other deductible expenses so attributable are $300. Although S has other deductible expenses, for purposes of this example, assume that S has no deductible expenses not definitely allocable to

any item of gross income. T's expenses attributable to the resale of the 100 units are $50. S chooses not to apply the section 482 method. T may not earn any income under the gross receipts or combined taxable income method with respect to resale of the 100 units because combined taxable income is a negative figure, computed as follows:

(1) Combined taxable income:		
(a) T's sales price		$950
(b) Less deductions:		
S's cost of goods sold	$650	
S's expenses	300	
T's expenses	50	
Total deductions		1,000
(c) Combined taxable income (loss)		($50)

Under paragraph (e)(1)(i) of this section, T is permitted to recover its expenses attributable to the 100 units ($50) even though such recovery results in a loss or increased loss to the related supplier. Accordingly, the transfer price from S to T may be readjusted as long as the transfer price is not readjusted below $900, computed as follows:

(2) Transfer price from S to T:	
(a) T's sales price	$950
(b) Less: T's expenses	50
(c) Transfer price	900

Example 5. Assume the same facts as in example 4 except that S chooses to apply the section 482 method and that under arm's length dealings T would have derived $10 of income. Accordingly, the transfer price from S to T may be set at an amount not less than $890, computed as follows:

(1) Transfer price from S to T:		
(a) T's sales price		$950
(b) Less:		
T's expenses	$50	
T's profit	10	
Total deductions		60
(c) Transfer price		890

Example 6. X and Y are calendar year taxpayers. X, a domestic manufacturing company, owns all the stock of Y, a DISC for the taxable year. During March 1972, X manufactures a particular product of export property which it leases on April 1, 1972, to Y for a term of 1 year at a monthly rental of $1,000, a rent which satisfies the standard of arm's length rental under section 482. Y subleases the product on April 1, 1972, for a term of 1 year at a monthly rental of $1,200. X's cost for the product leased is $40,000. X's other deductible expenses attributable to the product are $900, all of which are incurred in 1972. Although X has other deductible expenses, for purposes of this example, assume that X has no other deductible expenses. Y's expenses attributable to sublease of the export property are $450, all of which are incurred in 1972 and are export promotion expenses. X depreciates the property on a straight line basis without the use of an averaging convention, assuming a useful life of 8 years and no salvage value. The profit which Y may earn with respect to the transaction is $2,895 for 1972 and $1,175 for 1973, computed as follows:

COMPUTATION FOR 1972

(1) Combined taxable income:		
(a) Y's sublease rental receipts for year ($1,200×9 months)		$10,800
(b) Less deductions:		
X's depreciation ($40,000×1/8×9/12)	$3,750	
X's other expenses	900	
Y's expenses	450	
Total deductions		5,100
(c) Combined taxable income		5,700
(2) Y's profit under combined taxable income method (before application of loss limitation):		
(a) 50 percent of combined taxable income		2,850
(b) Plus: 10 percent of Y's export promotion expenses (10% of $450)		45
(c) Y's profit		2,895
(3) Y's profit under gross receipts method (before application of loss limitation):		
(a) 4 percent of Y's sublease rental receipts for year (4% of $10,800)		432
(b) Plus: 10 percent of Y's export promotion expenses (10% of $450)		45
(c) Y's profit		477
(4) Y's profit under section 482 method:		
(a) Y's sublease rental receipts for year		$10,800
(b) Less deductions:		
Y's lease rental payments for year	$9,000	
Y's expenses	450	
Total deductions		9,450
(c) Y's profit		1,350

Since the combined taxable income method results in greater profit to Y ($2,895) than does the gross receipts method ($477) or section 482 method ($1,350), Y may earn a profit of $2,895 for 1972. Accordingly, the monthly rental payable by Y to X for 1972 may be readjusted as long as the monthly rental payable is not readjusted below $828.33, computed as follows:

(5) Monthly rental payable by Y to X for 1972:		
(a) Y's sublease rental receipts for year		$10,800.00
(b) Less:		
Y's expenses	450.00	
Y's profit	2,895.00	
Total		3,345.00
(c) Rental payable for 1972		7,455.00

(d) Rental payable each month ($7,455÷9 months)	828.33

COMPUTATION FOR 1973

(1) Combined taxable income:	
(a) Y's sublease rental receipts for year ($1,200×3 months)	$3,600
(b) Less: X's depreciation ($40,000×1/8×3/12)	1,250
(c) Combined taxable income	2,350
(2) Y's profit under combined taxable income method (before application of loss limitation):	
(a) 50 percent of combined taxable income	$1,175
(b) Y's profit	1,175
(3) Y's profit under gross receipts method (before application of loss limitation):	
(a) 4 percent of Y's sublease rental receipts for year (4% of $3,600)	144
(b) Y's profit	144
(4) Y's profit under section 482 method:	
(a) Y's sublease rental receipts for year	3,600
(b) Less: Y's lease rental payments for year	3,000
(c) Y's profit	600

Since the combined taxable income method results in greater profit to Y ($1,175) than does the gross receipts method ($144) or section 482 method ($600), Y may earn a profit of $1,175 for 1973. Accordingly, the monthly rental payable by Y to X for 1973 may be readjusted as long as the monthly rental payable is not readjusted below $808.33, computed as follows:

(5) Monthly rental payable by Y to X for 1973:	
(a) Y's sublease rental receipts for year	$3,600.00
(b) Less: Y's profit	1,175.00
(c) Rental payable for 1973	2,425.00
(d) Rental payable for each month ($2,425÷3 months)	808.33

(Secs. 995(e)(7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995 (e)(7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat 917, 26 U.S.C. 7805))

[T.D. 7364, 40 FR 29827, July 16, 1975, as amended by T.D. 7435, 41 FR 43142, Sept. 30, 1976; T.D. 7854, 47 FR 51741, Nov. 17, 1982; T.D. 7984, 49 FR 40018, Oct. 12, 1984]

§1.994–2 Marginal costing rules.

(a) *In general.* This section prescribes the marginal costing rules authorized by section 994(b)(2). If under paragraph (c)(1) of this section a DISC is treated for its taxable year as seeking to establish or maintain a foreign market for sales of an item, product, or product line of export property (as defined in §1.993–3) from which qualified export receipts are derived, the marginal costing rules prescribed in paragraph (b) of this section may be applied to allocate costs between gross receipts derived from such sales and other gross receipts for purposes of computing, under the ‘‘50–50’’ combined taxable income method of §1.994–1(c)(3), the combined taxable income of the DISC and related supplier derived from such sales. Such marginal costing rules may be applied whether or not the related supplier manufactures, produces, grows, or extracts (within the meaning of §1.993–3(c)) the export property sold. Such marginal costing rules do not apply to sales of export property which in the hands of a purchaser related under section 954(d)(3) to the seller give rise to foreign base company sales income as described in section 954(d) unless, for the purchaser's year in which it resells the export property, section 954(b)(3)(A) is applicable or such income is under the exceptions in section 954(b)(4). Such marginal costing rules do not apply to leases of property or the performance of any services whether or not related and subsidiary services (as defined in §1.994–1(b)(3).

(b) *Marginal costing rules for allocations of costs*—(1) *In general.* Marginal costing is a method under which only marginal or variable costs of producing and selling a particular item, product, or product line are taken into account for purposes of section 994. Where this section is applicable, costs attributable to deriving qualified export receipts for the DISC's taxable year from sales of an item, product, or product line may be determined in any manner the related supplier (as defined in §1.994–1(a)(3)(ii)) chooses, provided that the requirements of both subparagraphs (2) and (3) of this paragraph are met.

(2) *Variable costs taken into account.* There are taken into account in computing the combined taxable income of the DISC and its related supplier from sales of an item, product, or product line the following costs:

(i) Direct production costs (as defined in §1.471–11(b)(2)(i)) and

(ii) Costs which are export promotion expenses, but only if they are claimed as export promotion expenses in determining taxable income derived by the

DISC under the combined taxable income method of § 1.994–1(c)(3).

At the taxpayer's option, all, a part, or none of the costs which qualify as export promotion expenses may be so claimed as export promotion expenses.

(3) *Overall profit percentage limitation.* As a result of such determination of costs attributable to such qualified export receipts for the DISC's taxable year, the combined taxable income of the DISC and its related supplier from sales of such item, product, or product line for the DISC's taxable year does not exceed gross receipts (determined under § 1.993–6) of the DISC derived from such sales, multiplied by the overall profit percentage (determined under paragraph (c)(2) of this section).

(c) *Definitions*—(1) *Establishing or maintaining a foreign market.* A DISC shall be treated for its taxable year as seeking to establish or maintain a foreign market with respect to sales of an item, product, or product line of export property from which qualified export receipts are derived if the combined taxable income computed under paragraph (b) of this section is greater than the combined taxable income computed under § 1.994–1(c)(6).

(2) *Overall profit percentage.* (i) For purposes of this section, the overall profit percentage for a taxable year of the DISC for a product or product line is the percentage which—

(a) The combined taxable income of the DISC and its related supplier plus all other taxable income of its related supplier from all sales (domestic and foreign) of such product or product line during the DISC's taxable year, computed under the full costing method, is of

(b) The total gross receipts (determined under § 1.993–6) from all such sales.

(ii) At the annual option of the related supplier, the overall profit percentage for the DISC's taxable year for all products and product lines may be determined by aggregating the amounts described in subdivision (i) *(a)* and *(b)* of this subparagraph of the DISC, and all domestic members of the controlled group (as defined in § 1.993–1(k)) of which the DISC is a member, for the DISC's taxable year and for taxable years of such members ending with or within the DISC's taxable year.

(iii) For purposes of determining the amounts in subdivisions (i) *(b)* and (ii) of this subparagraph, a sale of property between a DISC and its related supplier or between domestic members of the controlled group shall be taken into account only during the DISC's taxable year (or taxable year of the member ending within the DISC's taxable year) during which the property is ultimately sold to a person which is neither the DISC nor such a domestic member.

(3) *Grouping of transactions.* (i) In general, for purposes of this section, an item, product, or product line is the item or group consisting of the product or product line pursuant to § 1.994–1(c)(7) used by the taxpayer for purposes of applying the intercompany pricing rules of § 1.994–1.

(ii) However, for purposes of determining the overall profit percentage under subparagraph (2) of this paragraph, any product or product line grouping permissible under § 1.994–1(c)(7) may be used at the annual choice of the taxpayer, even though it may not be the same item or grouping referred to in subdivision (i) of this subparagraph, as long as the grouping chosen for determining the overall profit percentage is at least as broad as the grouping referred to in such subdivision (i).

(4) *Full costing method.* For purposes of this section, the term ''full costing method'' is the method for determining combined taxable income set forth in § 1.994–1(c)(6).

(d) *Application of limitation on DISC income (''no loss'' rule).* If the marginal costing rules of this section are applied, the combined taxable income method of § 1.994–1(c)(3) may not be applied to cause in any taxable year a loss to the related supplier, but such method may be applied to the extent it does not cause a loss. For purposes of the preceding sentence, a loss to a related supplier would result if the taxable income of the DISC would exceed the combined taxable income of the related supplier and the DISC determined in accordance with paragraph (b) of this section. If, however, there is no combined taxable income (so determined), see the last sentence of § 1.994–1(e)(1)(i).

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

Example 1. X and Y are calendar year taxpayers. X, a domestic manufacturing company, owns all the stock of Y, a DISC for the taxable year. During 1973, X manufactures a product line which is eligible to be export property (as defined in § 1.993–3). X enters into a written agreement with Y whereby Y is granted a sales franchise with respect to exporting such product line from which qualified export receipts will be derived and Y will receive commissions with respect to such exports equal to the maximum amount permitted to be received under the intercompany pricing rules of section 994. Commissions are computed using the combined taxable income method under § 1.994–1(c)(3). For purposes of applying the combined taxable income method, X and Y compute their combined taxable income attributable to the product line of export property under the marginal costing rules in accordance with the additional facts assumed in the table below:

(1) Maximum combined taxable income (determined under paragraph (b)(2) of this section):		
(a) Y's gross receipts from export sales		$95.00
(b) Less:		
(i) Direct materials	40.00	
(ii) Direct labor	20.00	
(iii) Y's export promotion expenses claimed in determining Y's DISC taxable income	5.00	
(iv) Total deductions	65.00	
(c) Maximum combined taxable income		30.00
(2) Overall profit percentage limitation (determined under paragraph (b)(3) of this section):		
(a) Gross receipts of X and Y from all domestic and foreign sales		400.00
(b) Less deductions:		
(i) Direct materials	160.00	
(ii) Direct labor	80.00	
(iii) Other costs (of which $8 are costs of the DISC including $5 of export promotion expenses claimed in determining Y's taxable income)	40.00	
(c) Total deductions		280.00
(d) Total taxable income from all sales computed on a full costing method		120.00
(e) Overall profit percentage (line (d) ($120) divided by line (a) ($400)) (percent)		30%
(f) Multiply by gross receipts from Y's export sales (line (1)(a))		$95.00
(g) Overall profit percentage limitations		28.50

Since the overall profit percentage limitation under line (2)(g) ($28.50) is less than maximum combined taxable income under line (1)(c) ($30), combined taxable income under marginal costing is limited to $28.50. Since under the franchise agreement Y is to earn the maximum commission permitted under the intercompany pricing rules of section 994, combined taxable income on the transactions is $28.50. Accordingly, the costs attributable to export sales (other than for direct material, direct labor, and export promotion expenses) are $1.50, *i.e.*, line (1)(c) ($30) minus line (2)(g) ($28.50). Under the combined taxable income method of § 1.994–1(c)(3), Y will have taxable income attributable to the sales of $14.75, i.e., the sum of 1/2 of combined taxable income (1/2 of $28.50) and 10 percent of Y's export promotion expenses claimed in determining Y's taxable income (10 percent of $5). Accordingly, the commissions Y receives from X are $22.75, i.e., Y's costs ($8, see line (2)(b)(iii)) plus Y's profit ($14.75).

Example 2. (1) Assume the same facts as in example 1, except that gross receipts from export sales are only $85 and gross receipts from all sales remain at $400. For purposes of applying the combined taxable income method, X and Y may compute their combined taxable income attributable to the product line of export property under the marginal costing rules as follows:

(1) Maximum combined taxable income (determined under paragraph (b)(2) of this section):		
(a) Y's gross receipts from export sales		$85.00
(b) Less:		
(i) Direct materials	40.00	
(ii) Direct labor	20.00	
(iii) Y's export promotion expenses claimed in determining Y's taxable income	5.00	
(iv) Total deductions		65.00
(c) Maximum combined taxable income		20.00
(2) Overall profit percentage limitation (determined under paragraph (b)(3) of this section):		
(a) Gross receipts from Y's export sales (line (1)(a))		85.00
(b) Multiply by overall profit percentage (as determined in example 1) (percent)		30%
(c) Overall profit percentage limitation		25.50

Since maximum combined taxable income under line (1)(c) ($20) is less than the overall profit percentage limitation under line (2)(c) ($25.50), combined taxable income under marginal costing is limited to $20. Since under the franchise agreement Y is to earn the maximum commission permitted under the intercompany pricing rules of section 994, combined taxable income on the transactions is $20. Accordingly, no costs (other than for direct material, direct labor, and export promotion expenses) will be attributed to export sales. Under the combined taxable income method of § 1.994–1(c)(3), Y will have taxable income attributable to the sales of $10.50, i.e., the sum of 1/2 of combined taxable income (1/2 of $20) and 10 percent of Y's export promotion expenses claimed in determining Y's taxable income (10 percent of $5). Accordingly, the Commissions Y receives from X are $18.50, *i.e.*, Y's costs ($8, see line (2)(b)(iii) of example 1) plus Y's profit ($10.50).

(2) If export promotion expenses are not claimed in determining taxable income of Y under the combined taxable income method, the taxable income of Y would be increased to $12.50 and commissions payable to Y would be increased to $20.50, computed as follows:

(3) Maximum combined taxable income (determined under paragraph (b)(2) of this section):		
(a) Y's gross receipts from export sales	$85.00	
(b) Less:		
(i) Direct materials	40.00	
(ii) Direct labor	20.00	
(iii) Total deductions		60.00
(c) Maximum combined taxable income		25.00
(4) Overall profit percentage limitation (line (2)(c))		25.50

Since maximum combined taxable income under line (3)(c) ($25) is less than the overall profit percentage under line (4) ($25.50), combined taxable income under marginal costing is limited to $25. Since under the franchise agreement Y is to earn the maximum commission permitted under the intercompany pricing rules of section 994, combined taxable income on the transactions is $25. Accordingly, no costs (other than for direct material and direct labor) will be attributed to export sales. Under the combined taxable income method of §1.994–1(c)(3), Y will have taxable income attributable to the sales of $12.50, i.e., 1/2 of combined taxable income (1/2 of $25). Accordingly, the commissions Y receives from X are $20.50, *i.e.*, Y's costs ($8, see line (2)(b)(iii) of example 1) plus Y's profit ($12.50).

Example 3. (1) Assume the same facts as in example 1, except that gross receipts from export sales are only $85, gross receipts from all sales remain at $400, and Y has costs of $40 consisting of Y's export promotion expenses of $35 and costs of $5 other than for direct material, direct labor, or export promotion expenses. For purposes of applying the combined taxable income method, X and Y may compute their combined taxable income attributable to the product line of export property under the marginal costing rules as follows:

(1) Maximum combined taxable income (determined under paragraph (b)(2) of this section):		
(a) Y's gross receipts from export sales	$85.00	
(b) Less:		
(i) Direct materials	40.00	
(ii) Direct labor	20.00	
(iii) Y's export promotion expenses claimed in determining Y's taxable income	35.00	
(iv) Total deductions		95.00
(c) Maximum combined taxable income (loss)		(10.00)
(2) Overall profit percentage limitation (as determined in example 2)		25.50

Since maximum combined taxable income under line (1)(c) (which is a loss of $10) is less than the overall profit percentage limitation under line (2)(c) ($25.50), combined taxable income under marginal costing is a loss of $10 and, under the combined taxable income method of §1.994–1(c)(3), Y will have no taxable income or loss attributable to the sales. Accordingly, the commissions Y receives from X are $40, *i.e.*, Y's costs ($40).

(2) If export promotion expenses are not claimed in determining Y's taxable income under the combined taxable income method, the taxable income of Y would be increased to $12.50 and commissions payable to Y would be increased to $52.50 computed as follows:

(3) Maximum combined taxable income (determined under paragraph (b)(2) of this section) (line (3)(c) of example 2)	$25.00
(4) Overall profit percentage limitation (as determined in example 2)	25.50

The results would be the same as in part (2) of example 2, except that the commissions Y receives from X are $52.50, *i.e.*, Y's costs ($40) plus Y's profit ($12.50).

[T.D. 7364, 40 FR 29836, July 16, 1975; 40 FR 33972, Aug. 13, 1975]

§1.995–1 Taxation of DISC income to shareholders.

(a) *In general.* (1) Under §1.991–1(a), a corporation which is a DISC for a taxable year is not subject to any tax imposed by subtitle A of the Code (sections 1 through 1564) for the taxable year, except for the tax imposed by chapter 5 thereof (sections 1491 through 1494) on certain transfers to avoid tax.

(2) Under section 995(a), the shareholders of a DISC, or a former DISC, are subject to taxation on the earnings and profits of the DISC in accordance with the provisions of chapter 1 of the

Code generally applicable to shareholders, but subject to the modifications provided in sections 995, 996, and 997.

(3) Under §1.996–3, three divisions of earnings and profits of a DISC, or former DISC, are defined: ‘‘accumulated DISC income’’, ‘‘previously taxed income’’, and ‘‘other earnings and profits’’. Under §1.995–2, certain amounts of the DISC’s earnings and profits are deemed to be distributed as dividends to shareholders of the DISC at the close of the DISC’s taxable year in which such earnings were derived. Such deemed distributions do not cause a reduction in the DISC’s earnings and profits, but are taken into account in §1.996–3(c) as an increase in previously taxed income. To the extent the DISC’s earnings and profits are paid out in a subsequent distribution which is, under §1.996–1, treated as made out of such ‘‘previously taxed income,’’ they will not be taxable to the shareholders a second time.

(4) In general, ‘‘accumulated DISC income’’ is the earnings and profits of the DISC which have not been deemed distributed and which may be deferred from taxation so long as they are not actually distributed with respect to its stock. However, deferral of taxation on ‘‘accumulated DISC income’’ may be terminated, in whole or in part, in the event of: (i) Certain foreign investment attributable to producer’s loans (see §1.995–2(a)(5) and §1.995–5); (ii) revocation of the election to be treated as a DISC or other disqualification (see §1.995–3); and (iii) certain dispositions of DISC stock in which gain is realized (see §1.995–4).

(5) Since a DISC is not taxed on its taxable income, section 246(d) and §1.246–4 provide that the deduction otherwise allowed under section 243 shall not be allowed with respect to a dividend from a DISC, or former DISC, paid or treated as paid out of accumulated DISC income or previously taxed income or with respect to a deemed distribution in a qualified year under §1.995–2(a).

(b) *Amounts and character of amounts includible in shareholder’s gross income.* Each shareholder of a corporation which is a DISC, or former DISC, shall include in his gross income—

(1) Amounts actually distributed to him that are includible in his gross income in accordance with paragraph (c) of this section.

(2) Amounts which, pursuant to §1.995–2, he is deemed to receive as a distribution taxable as a dividend on the last day of each of the corporation’s taxable years for which it qualifies as a DISC,

(3) Amounts which, pursuant to §1.995–3, he is deemed to receive as a distribution taxable as a dividend in the event the corporation revokes its election to be treated as a DISC or otherwise is disqualified as a DISC, and

(4) Gain realized on certain dispositions of stock in the corporation which, under §1.995–4, is includible in his gross income as a dividend.

(c) *Treatment of actual distributions.* (1) Except as provided in subparagraph (3) of this paragraph, amounts actually distributed to a shareholder of a DISC, or former DISC, with respect to his stock are includible in his gross income in accordance with section 301.

(2) Since a deemed distribution does not reduce the earnings and profits of a DISC, it does not affect the determination as to whether a subsequent actual distribution is a ‘‘dividend’’ under section 316(a). Since, however, the amount of a deemed distribution increases ‘‘previously taxed income’’, it does affect the determination as to whether a subsequent actual distribution is excluded (as described in subparagraph (3) of this paragraph) from gross income.

(3) Under §1.996–1(c), the amount of any actual distribution (including a deficiency distribution made pursuant to §1.992–3), with respect to stock in a DISC, or former DISC, which is treated under §1.996–1 as made out of previously taxed income, is excluded by the distributee from gross income, but only to the extent that such amount does not exceed the adjusted basis of the distributee’s stock. Under §1.996–5(b), that portion of any actual distribution which is treated as made out of previously taxed income shall be applied against and reduce the adjusted basis of the stock and, to the extent that it exceeds the adjusted basis of the stock, it shall be treated as gain from the sale or exchange of property.

(4) A deficiency distribution pursuant to § 1.992–3 may be made after the close of the DISC's taxable year with respect to which it is made. The determinations as to whether such deficiency distribution is a dividend under section 301 and as to which division of earnings and profits is the source thereof depend upon the status of the DISC's earnings and profits account and divisions thereof at the time the distribution is actually made. See § 1.996–1(d) for the priority of such deficiency distribution over other actual distributions made during the same taxable year.

(d) *Personal holding company income.* (1) Any amount includible in a shareholder's gross income as a dividend with respect to the stock of a DISC, or former DISC, pursuant to paragraph (b) of this section shall be treated as a dividend for all purposes of the Code, except that for purposes of determining whether such shareholder is a personal holding company within the meaning of section 542 any amount deemed distributed for qualified years under § 1.995–2 or upon disqualification under § 1.995–3, any amount of gain on certain dispositions of DISC stock to which § 1.995–4 applies, and any amount treated under § 1.996–1 as distributed out of accumulated DISC income or previously taxed income shall not be treated as a dividend or any other kind of income described in section 543(a).

(2) Notwithstanding subparagraph (1) of this paragraph, the shareholder may treat as an item of income described under section 543 (for example, rents) any amount to which the exception in such subparagraph (1) applies, if it establishes to the satisfaction of the district director that such amount is attributable to earnings and profits derived from such item of income.

[T.D. 7324, 39 FR 35109, Sept. 30, 1974]

§ 1.995–2 Deemed distributions in qualified years.

(a) *General rule.* Under section 995 (b)(1), each shareholder of a DISC shall be treated as having received a distribution taxable as a dividend with respect to his stock on the last day of each taxable year of the DISC, in an amount which is equal to his pro rata share of the sum (as limited by paragraph (b) of this section), of the following seven items:

(1) An amount equal to the gross interest derived by the DISC during such year from producer's loans (as defined in § 1.993–4).

(2) An amount equal to the lower of—

(i) Any gain recognized by the DISC during such year on the sale or exchange of property (other than property which in the hands of the DISC is a qualified export asset) which was previously transferred to it in a transaction in which the transferor realized gain which was not recognized in whole or in part, or

(ii) The amount of the transferor's gain which was not recognized on the previous transfer of the property to the DISC.

For purposes of this subparagraph, each item of property shall be considered separately. See paragraph (d) of this section for special rules with respect to certain tax-free acquisitions of property by the DISC.

(3) An amount equal to the lower of—

(i) Any gain recognized by the DISC during such year on the sale or exchange of property which in the hands of the DISC is a qualified export asset (other than stock in trade or property described in section 1221(1)) and which was previously transferred to the DISC in a transaction in which the transferor realized gain which was not recognized in whole or in part, or

(ii) The amount of the transferor's gain which was not recognized on the previous transfer of the property to the DISC and which would have been includible in the transferor's gross income as ordinary income if its entire realized gain had been recognized upon the transfer.

For purposes of this subparagraph, each item of property shall be considered separately. See paragraph (d) of this section for special rules with respect to certain tax-free acquisitions of property by the DISC.

(4) For taxable years beginning after December 31, 1975, an amount equal to 50 percent of the taxable income of the DISC for the taxable years attributable to military property (as defined in § 1.995–6).

(5) For taxable years beginning after December 31, 1975, the taxable income

for the taxable year attributable to base period export gross receipts (as defined in §1.995–7).

(6) The sum of—

(i)(A) In the case of a corporate share holder, an amount equal to 57.5 percent of the excess (if any) (one-half for DISCs' taxable years beginning before January 1, 1983) of the taxable income of the DISC for such year (computed as provided in §1.991–1(b)(1)) over the sum of the amounts deemed distributed for the taxable year in accordance with subparagraphs (1), (2), (3), (4) and (5) of this paragraph, or

(B) In the case of a non-corporate share holder, an amount equal to one-half of the excess (if any) of the taxable income of the DISC for such year (computed as provided in §1.991–1(b)(1)) over the sum of the amounts deemed distributed for the taxable year in accordance with subparagraphs (1), (2), (3), (4), and (5) of this paragraph.

(ii)(A) An amount equal to the amount under subdivision (i) of paragraph (a)(6) of this section multiplied by the international boycott factor as determined under section 999 (c)(1) , or

(B) In lieu of the amount determined under subdivision (ii)(A) of paragraph (a)(6) of this section, the amount described under section 999 (c)(2) of such international boycott income, and

(iii) An amount equal to the sum of any illegal bribes, kickbacks, or other payments paid by or on behalf of the DISC directly or indirectly to an official, employee, or agent in fact of a government. An amount is paid by a DISC where it is paid by any officer, director, employee, shareholder, or agent of the DISC for the benefit of such DISC. For purposes of this section, the principles of section 162 (c) and the regulations thereunder shall apply. The fair market value of an illegal payment made in the form of property or services shall be considered the amount of such illegal payment.

(7) The amount of foreign investment attributable to producer's loans of the DISC, as of the close of the ''group taxable year'' ending with such taxable year of the DISC, determined in accordance with §1.995–5. The amount of such foreign investment attributable to producer's loans so determined for any taxable year of a former DISC shall be deemed distributed as a dividend to the shareholders of such former DISC on the last day of such taxable year. See §1.995–3(e) for the effect that such deemed distribution has on scheduled installments of deemed distributions of accumulated DISC income under §1.995–3(a) upon disqualification.

(b) *Limitation on amount of deemed distributions under section 995(b)(1).* (1) The sum of the amounts described in paragraph (a)(1) through (a)(6) of this section which is deemed distributed pro rata to the DISC's shareholders a dividend for any taxable year of the corporation shall not exceed the DISC's earnings and profits for such year.

(2) The amount of foreign investment attributable to producer's loans of the DISC (as described in paragraph (a)(7) of this section) which is deemed to be distributed pro rata to the DISC's shareholders as dividends for any taxable year of the corporation shall not exceed the lower of the corporation's accumulated DISC income at the beginning of such year or the corporation's accumulated earnings and profits at the beginning of such year (but not less than zero)—

(i) Increased by any DISC income of the corporation for such year as defined in §1.996–3(b)(2) (*i.e.*, any excess of the DISC's earnings and profits for such year over the sum of the amounts described in paragraph (a)(1) through (a)(6) of this section), or

(ii) Decreased by any deficit in the corporation's earnings and profits for such year.

Thus, for example, if a DISC has a deficit in accumulated earnings and profits at the beginning of a taxable year of $10,000, current earnings and profits of $12,000, no amounts described in paragraphs (a)(1) through (a)(6) of this section for the year, and foreign investment attributable to producer's loans for the taxable year of $5,000, the DISC would have a deemed distribution described in paragraph (a)(7) of this section of $5,000 for the taxable year. On the other hand, suppose the DISC had accumulated earnings and profits of $13,000 at the beginning of the taxable year, accumulated DISC income of $10,000 at the beginning of the taxable year, a deficit in earnings and profits for the taxable year of $12,000, no amounts described in paragraphs (a)(1) through (a)(6) of this section for the taxable year, and foreign investment attributable to producer's loans for the taxable year of $5,000. Under these facts the DISC would have no deemed distribution described in paragraph (a)(7) of this section because the corporation had no DISC income for the taxable year and the current year's deficit in earnings and profits subtracted from the DISC's accumulated DISC income at the beginning of the year produces a negative amount. For rules relating to the carryover to a subsequent year of the $5,000 of foreign investment attributable to producer's loans, see § 1.995–5(a)(6).

(3) If, by reason of the limitation in subparagraph (1) of this paragraph, less than the sum of the amounts described in paragraphs (a)(1) through (a)(6) of this section is deemed distributed, then the portion of such sum which is deemed distributed shall be attributed first to the amount described in subparagraph (1) of such paragraph, to the extent thereof; second to the amount described in subparagraph (2) of such paragraph, to the extent thereof; third to the amount described in subparagraph (3) of such paragraph, to the extent thereof; and so forth, and finally to the amount described in paragraph (b)(6) of this paragraph.

(c) *Examples.* Paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. Y is a corporation which uses the calendar year as its taxable year and which elects to be treated as a DISC beginning with 1972. X is its sole shareholder. In 1972, X transfers certain property to Y in exchange for Y's stock in a transaction in which X does not recognize gain or loss by reason of the application of section 351(a). Included in the property transferred to Y is depreciable property described in paragraph (a)(3) of this section on which X realizes, but does not recognize by reason of the application of section 1245(b)(3), a gain of $20,000. If X had sold such property for cash, the $20,000 gain would have been recognized as ordinary income under section 1245. Also included in the transfer to Y is 100 shares of stock in a third corporation (which is not a related foreign export corporation) on which X realizes, but does not recognize, a gain of $5,000. In 1973, Y sells such property and recognizes a gain of $25,000 on the depreciable property and $8,000 on the 100 shares of stock. Y has accumulated earnings and profits at the beginning of 1973 of $5,000, earnings and profits for 1973 of $72,000, and taxable income for 1973 of $100,000. At the beginning of 1973, Y has $6,000 of accumulated DISC income, no previously taxed income, and a deficit of $1,000 of other earnings and profits. Under these facts and the additional facts assumed in the table below, X is treated as having received a deemed distribution taxable as a dividend of $76,000 on December 31, 1973, determined as follows:

(1) Gross interest derived by Y in 1973 from producer's loans	$7,000
(2) Amount of gain on depreciable property (lower of Y's recognized gain ($25,000) or X's gain not recognized on section 1245 property ($20,000))	20,000
(3) Amount of gain on stock (lower of X's gain not recognized or Y's recognized gain ($8,000) ($5,000))	5,000
(4) One-half excess of taxable income for 1973 over the sum of lines (1), (2), and (3) (1/2 of ($100,000 minus $32,000))	34,000
(5) Limitation on lines (1) through (4):	
(a) Sum of lines (1) through (4)	66,000
(b) Earnings and profits for 1973	72,000
(c) Lower of lines (a) and (b)	66,000
(6) Amount under paragraph (a)(5) of this section:	
(a) Foreign investment attributable to producer's loans under § 1.995–5	10,000
(b) Sum of the lower of accumulated earnings and profits at beginning of 1973 ($5,000) or accumulated DISC income at beginning of 1973 ($6,000) and excess of earnings and profits for 1973 over line (5)(c) ($72,000 minus $66,000)	11,000
(c) Lower of lines (a) and (b)	10,000
(7) Total deemed distribution (sum of lines (5)(c) and (6)(c))	76,000

Example 2. Assume the facts are the same as in example 1, except that earnings and profits for 1973 amount to only $60,000. Under these facts, X is treated as receiving a deemed distribution taxable as a dividend of $65,000 on December 31, 1973, determined as follows:

(5) Limitation on lines (1) through (4):	
(a) Line (5)(a) of example 1	$66,000
(b) Earnings and profits for 1973	60,000
(c) Lower of lines (a) and (b)	60,000
(6) Amount under paragraph (a)(5) of this section:	
(a) Line (6)(a) of example 1	10,000
(b) Sum of the lower of accumulated earnings and profits at beginning of 1973 ($5,000) or accumulated DISC income at beginning of 1973 ($6,000) plus excess of earnings and profits for 1973 over line (5)(c) ($60,000 minus $60,000)	5,000
(c) Lower of lines (a) and (b)	5,000

(7) Total deemed distribution (sum of lines (5)(c) and (6)(c))	65,000

Example 3. Assume the facts are the same as in example 1, except that Y has a deficit in accumulated earnings and profits at the beginning of 1973 of $4,000. Such deficit is comprised of accumulated DISC income of $1,000, no previously taxed income, and a deficit in other earnings and profits of $5,000. Under these facts, X is treated as receiving a deemed distribution taxable as a dividend in the amount of $72,000 on December 31, 1973, determined as follows:

(5) Limitation on lines (1) through (4):	
(a) Line (5)(a) of example 1	$66,000
(b) Earnings and profits for 1973	72,000
(c) Lower of lines (a) and (b)	66,000
(6) Amount under paragraph (a)(5) of this section:	
(a) Line (6)(a) of example 1	10,000
(b) Sum of accumulated earnings and profits at beginning of 1973 (not less than $0), and excess of earnings and profits for 1973 over amount in line (5)(c) ($72,000 minus $66,000)	6,000
(c) Lower of lines (a) and (b)	6,000
(7) Total deemed distribution sum of lines (5)(c) and (6)(c)	72,000

(d) *Special rules for certain tax-free acquisitions of property by the DISC.* (1) For purposes of paragraph (a)(2)(i) and (3)(i) of this section, if—

(i) A DISC acquires property in a first transaction and in a second transaction it disposes of such property in exchange for other property, and

(ii) By reason of the application of section 1031 (relating to like-kind exchanges) or section 1033 (relating to involuntary conversions), the basis in the DISC's hands of the other property acquired in such second transaction is determined in whole or in part with reference to the basis of the property acquired in the first transaction,

then upon a disposition of such other property in a third transaction by the DISC such other property shall be treated as though it had been transferred to the DISC in the first transaction. Thus, if the first transaction is a purchase of the property for cash, then paragraphs (a)(2) and (3) of this section will not apply to a sale by the DISC of the other property acquired in the second transaction.

(2) For purposes of paragraphs (a)(2)(i) and (3)(i) of this section, if a DISC acquires property in a first transaction and it transfers such property to a transferee DISC in a second transaction in which the transferor DISC's gain is not recognized in whole or in part, then such property shall be treated as though it had been transferred to the transferee DISC in the same manner in which it was acquired in the first transaction by the transferor DISC. For example, if X and Y both qualify as DISC's and X transfers property to Y in a second transaction in which gain or loss is not recognized, paragraph (a)(2) or (3) of this section does not apply to a sale of such property by Y in a third transaction if X had acquired the property in a first transaction by a purchase for cash. If, however, X acquired the property from a transferor other than a DISC in the first transaction in which the transferor's realized gain was not recognized, then paragraph (a)(2) or (3) of this section may apply to the sale by Y if the other conditions of such paragraph (a)(2) or (3) are met.

(3) If a DISC acquires property in a second transaction described in subparagraph (1) or (2) of this paragraph in which it (or, in the case of a second transaction described in subparagraph (2) of this paragraph, the transferor DISC) recognizes a portion (but not all) of the realized gain, then the amount described in paragraph (a)(2)(ii) or (a)(3)(ii) of this section with respect to a disposition by the DISC of such acquired property in a third transaction shall not exceed the transferor's gain which was not recognized on the first transaction minus the amount of gain recognized by the DISC (or transferor DISC) on the second transaction.

(4) The provisions of this paragraph may be illustrated by the following examples:

Example 1. X and Y are corporations each of which qualifies as a DISC and uses the calendar year as its taxable year. In 1972, X acquires section 1245 property in a first transaction in which the transferor's entire realized gain of $17 is not recognized. In 1973, X transfers such property to Y in a second transaction in which X realizes a gain of $20 of which only $4 is recognized. (On December 31, 1973, X's shareholders are treated as having received a deemed distribution of a dividend which includes such $4 under paragraph (a)(3) of this section, provided the limitation in paragraph (b) of this section is met.) In a third transaction in 1974, Y sells such property and recognizes a gain of $25. With respect to Y's shareholders on December 31, 1974, the amount described in paragraph (a)(3)(ii) of this section would be limited to $13, which is the amount of the transferor's gain which was not recognized on the first transaction ($17) minus the amount of gain recognized by X on the second transaction ($4).

Example 2. Z is a DISC using the calendar year as its taxable year. In a first transaction in 1972, in exchange for its stock, Z acquires section 1245 property from A, an individual who is its sole shareholder, in a transaction in which A's realized gain of $30 is not recognized by reason of the application of section 351(a). In a second transaction in 1973, Z exchanges such property for other property in a like-kind exchange to which section 1031(b) applies and recognizes $10 of a realized gain of $35. (On December 31, 1973, A is treated as having received a deemed distribution of a dividend which includes such $10 under paragraph (a)(3) of this section, provided the limitation in paragraph (b) of this section is met.) In a third transaction in 1974, Z sells the property acquired in the like-kind exchange and recognizes a gain of $25. With respect to A on December 31, 1974, the amount described in paragraph (a)(3)(ii) of this section is limited to $20, which is the amount of A's gain which was not recognized on the first transaction ($30) minus the amount of gain recognized by Z on the second transaction ($10).

(e) *Carry back of net operating loss and capital loss to prior DISC taxable year.* For purposes of sections 991, 995, and 996, the amount of the deduction for the taxable year under section 172 for a net operating loss carryback or carryover or under section 1212 for a capital loss carryback or carryover shall be determined in the same manner as if the DISC were a domestic corporation which had not elected to be treated as a DISC. Thus, the amount of the deduction will be the same whether or not the corporation was a DISC in the year of the loss or in the year to which the loss is carried. For provisions setting forth adjustments to the DISC's, or former DISC's, deemed distributions, adjustments to its divisions of earnings and profits, and other tax consequences arising from such carrybacks, see § 1.996–8.

(Secs. 995(e)(7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995 (e)(7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat 917, 26 U.S.C. 7805))

[T.D. 7324, 39 FR 35110, Sept. 30, 1974, as amended by T.D. 7862, 47 FR 56492, Dec. 17, 1982; T.D. 7984, 49 FR 40018, Oct. 12, 1984]

§ 1.995–3 Distributions upon disqualification.

(a) *General rule.* Under section 995 (b)(2), a shareholder of a corporation which is disqualified from being a DISC, either because pursuant to § 1.992–2(e)(2) it revoked its election to be treated as a DISC or because it has failed to satisfy the requirements as set forth in § 1.992–1 to be a DISC for a taxable year, shall be deemed to have received (at the times specified in paragraph (b) of this section) distributions taxable as dividends aggregating an amount equal to his pro rata share of the accumulated DISC income (as defined in § 1.996–3(b)) of such corporation which was accumulated during the immediately preceding consecutive taxable years for which the corporation was a DISC. The pro rata share referred to in the preceding sentence shall be determined as of the close of the last of such consecutive taxable years for which the corporation was a DISC. See § 1.996–7(c) for rules relating to the carryover of, and maintaining a separate account for, such accumulated DISC income in certain reorganizations.

(b) *Time of receipt of deemed distributions.* Distributions described in paragraph (a) of this section shall be deemed to be received in equal installments on the last day of each of the 10 taxable years of the corporation following the year of the disqualification described in paragraph (a) of this section, except that in no case may the number of equal installments exceed the number of the immediately preceding consecutive taxable years for which the corporation was a DISC.

(c) *Transfer of shares.* Deemed distributions are includible under paragraphs (a) and (b) of this section in a shareholder's gross income as a dividend only so long as he continues to hold the shares with respect to which the distribution is deemed made. Thus, the transferee of such shareholder will include in his gross income under paragraphs (a) and (b) of this section the remaining installments of the deemed distribution which the transferor would have included in his gross income as a dividend had he not transferred the shares. However, if the transferee acquires the shares in a transaction in which the transferor's gain is treated under §1.995–4 in whole or in part as a dividend, then under §1.996–4(a) such transferee does not include subsequent installments in his gross income to the extent that the transferee treats such subsequent installments as made out of previously taxed income.

(d) *Effect of requalification.* Deemed distributions under paragraphs (a) and (b) of this section continue and are includible in gross income as dividends by the shareholders whether or not the corporation subsequently requalifies and is treated as a DISC.

(e) *Effect of actual distributions and deemed distributions under section 995(b)(1)(G).* If, during the period a shareholder of a DISC, or former DISC, is taking into account deemed distributions under paragraphs (a) and (b) of this section, an actual distribution is made to him out of accumulated DISC income or a deemed distribution because of foreign investment attributable to producer's loans is made under §1.995–2(a)(5) out of accumulated DISC income, such actual or deemed distribution shall first reduce the last installment of the deemed distributions scheduled to be included in the shareholder's gross income as a dividend, and then the preceding scheduled installments in reverse order. If deemed distributions are scheduled to be included in gross income for two or more disqualifications, an actual distribution or a deemed distribution under §1.995–2 (a)(5) which is treated as made out of accumulated DISC income reduces the deemed distributions resulting from the earlier disqualification first.

(f) *Examples.* This section may be illustrated by the following examples:

Example 1. X Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1972. X qualifies as a DISC for taxable years 1972 through 1975, but, pursuant to §1.992–2(e)(2), revokes its election as of January 1, 1976, and is disqualified as a DISC. On that date, X has $24,000 of accumulated DISC income. X's shareholders will be deemed to receive $6,000 in distributions taxable as a dividend on the last day of each of X's four succeeding taxable years (1977, 1978, 1979, and 1980).

Example 2. Assume the same facts as in example 1, except that in 1978 X makes an actual distribution of $22,000 to its shareholders of which $10,000 is treated under §1.996–1 as made out of accumulated DISC income. (The remaining $12,000 of such distribution is treated as made out of previously taxed income.) The actual distribution would first reduce the $6,000 deemed distribution scheduled for 1980 to zero and then reduce the $6,000 deemed distribution scheduled for 1979 to $2,000. Thus, X's shareholders include in 1978 $16,000 is gross income as dividends ($10,000 of actual distributions and the $6,000 deemed distribution scheduled for that year) and $2,000 as a dividend in 1979.

Example 3. Assume the same facts as in example 2, except that X requalifies as a DISC for taxable year 1977 during which it derives $7,000 of DISC income (computed after taking into account a deemed distribution under §1.995–2(a)(4) of $7,000), but is again disqualified in 1978. In addition X makes an actual distribution in 1977 equal to the deemed distribution of $7,000. Such actual distribution is excluded from gross income under §1.996–1(c). In 1977. X's shareholders include in gross income as dividends the $6,000 deemed distribution upon disqualification (in addition to the deemed distributions of $7,000 under §1.995–2 for 1977 when it was treated as a DISC). The actual distribution in 1978 still reduces the installments resulting from the earlier disqualification. Thus, in 1978, X's shareholders include $16,000 in gross income as dividends. In 1979, X's shareholders include $9,000 in gross income as dividends (the final installment of $2,000 from the earlier disqualification plus the single deemed distribution of $7,000 resulting from the later disqualification).

[T.D. 7324, 39 FR 35112, Sept. 30, 1974, as amended by T.D. 7854, 47 FR 51741, Nov. 17, 1982]

§1.995–4 Gain on disposition of stock in a DISC.

(a) *Disposition in which gain is recognized*—(1) *In general.* If a shareholder disposes, or is treated as disposing, of stock in a DISC, or former DISC, then any gain recognized on such disposition shall be included in the shareholder's gross income as a dividend, notwithstanding any other provision of the Code, to the extent of the accumulated DISC income amount (described in paragraph (d) of this section). To the extent the recognized gain exceeds the accumulated DISC income amount, it is taxable as gain from the sale or exchange of the stock.

(2) *Nonapplication of subparagraph (1).* The provisions of subparagraph (1) of this paragraph do not apply (i) to the extent gain is not recognized (such as, for example, in the case of a gift or an exchange of stock to which section 354 applies) and (ii) to the amount of any recognized gain which is taxable as a dividend (such as, for example, under section 301 or 356(a)(2)) or as gain from the sale or exchange of property which is not a capital asset. The amount taxable as a dividend under section 301 or 356(a)(2) is subject to the rules provided in § 1.995–1(c) for the treatment of actual distributions by a DISC.

(b) *Disposition in which separate corporate existence of DISC is terminated*—(1) *General.* If stock in a corporation that is a DISC, or former DISC, is disposed of in a transaction in which its separate corporate existence as a DISC, or former DISC, is terminated, then, notwithstanding any other provision of the Code, an amount of realized gain shall be recognized and included in the transferor's gross income as a dividend. The realized gain shall be recognized to the extent that such gain—

(i) Would not have been recognized but for the provisions of this paragraph, and

(ii) Does not exceed the accumulated DISC income amount (described in paragraph (d) of this section).

(2) *Cessation of separate corporate existence as a DISC, or former DISC.* For purposes of subparagraph (1) of this paragraph, separate corporate existence as a DISC, or former DISC, will be treated as having ceased if, as a result of the transaction, there is no separate entity which is a DISC and to which is carried over the accumulated DISC income and other tax attributes of the DISC, or former DISC, the stock of which is disposed of. Thus, for example, if stock in a DISC, or former DISC, is exchanged in a transaction described in section 381(a) (relating to carryovers in certain corporate acquisitions), the gain realized on the transfer of such stock will not be recognized under subparagraph (1) of this paragraph if the assets of such DISC, or former DISC, are acquired by a corporation which immediately after the acquisition qualifies as a DISC. For a further example, if a DISC, or former DISC, is liquidated in a transaction to which section 332 (relating to complete liquidations of subsidiaries) applies, the transaction will be subject to subparagraph (1) of this paragraph if the basis to the transferee corporation of the assets acquired on the liquidation is determined under section 334(b)(2) (as in effect prior to amendment by the Tax Equity and Fiscal Responsibility Act of 1982) or if immediately after such liquidation the transferee of such assets does not qualify as a DISC. However, separate corporate existence as a DISC, or former DISC, will not be treated as having ceased in the case of a mere change in place of organization, however effected. See § 1.996–7 for rules for the carryover of the divisions of a DISC's earnings and profits to one or more DISC's.

(c) *Disposition to which section 311, 336, or 337 applies*—(1) *In general.* If, after December 31, 1976, a shareholder distributes, sells, or exchanges stock in a DISC, or former DISC, in a transaction to which section 311, 336, or 337 applies, then an amount equal to the excess of the fair market value of such stock over its adjusted basis in the hands of the shareholder shall, notwithstanding any other provision of the Code, be included in gross income of the shareholder as a dividend to the extent of the accumulated DISC income amount (described in paragraph (d) of this section).

(2) *Nonapplication of subparagraph (1).* Subparagraph (1) shall not apply if the person receiving the stock in the disposition has a holding period for the stock which includes the period for which the stock was held by the shareholder disposing of such stock.

(d) *Accumulated DISC income amount*—(1) *General.* For purposes of this section, the accumulated DISC income amount is the accumulated DISC income of the DISC or former DISC which is attributable to the stock disposed of and which was accumulated in taxable years of such DISC or former DISC during the period or periods such stock was held by the shareholder who disposed of such stock.

(2) *Period during which a shareholder has held stock.* For purposes of this section, the period during which a shareholder has held stock includes the period he is considered to have held it by reason of the application of section 1223 and, if his basis is determined in whole or in part under the provisions of section 1014(d) (relating to special rule for DISC stock acquired from decedent), the holding period of the decedent. Such holding period is to exclude the day of acquisition but include the day of disposition. Thus, for example, if A purchases stock in a DISC on December 31, 1972, and makes a gift of such stock to B on June 30, 1973, then on December 31, 1974, B will be treated as having held the stock for 2 full years. If the basis of the stock in C's hands is determined under section 1014(d) upon a transfer from B's estate on December 31, 1976, by reason of B's death on June 30, 1974, then on December 31, 1976, C will be treated as having held the stock for 4 full years.

(e) *Accumulated DISC income allocable to shareholder under section 995(c)(2)*—(1) *In general.* Under this paragraph, rules are prescribed for purposes of paragraph (d) of this section as to the manner of determining, with respect to the stock of a DISC, or former DISC, disposed of, the amount of accumulated DISC income which is attributable to such stock and which was accumulated in taxable years of the corporation during the period or periods the stock disposed of was held or treated under paragraph (d)(2) of this section as held by the transferor. Subparagraphs (2), (3), and (4) of this paragraph set forth a method of computation which may be employed to determine such amount. Any other method may be employed so long as the result obtained would be the same as the result obtained under such method.

(2) *Step 1.* Determine the increase (or decrease) in accumulated DISC income for each taxable year of the DISC, or former DISC, by subtracting from the amount of accumulated DISC income (as defined in §1.996–3(b)) at the close of each taxable year the amount thereof as of the close of the immediately preceding taxable year.

(3) *Step 2.* (i) Determine for each taxable year of the DISC, or former DISC, the increase (or decrease) in accumulated DISC income per share by dividing such increase (or decrease) for the year by the number of shares outstanding or deemed outstanding on each day of such year.

(ii) If the number of shares of stock in the corporation outstanding on each day of a taxable year of the DISC, or former DISC, is not constant, then the number of such shares deemed outstanding on each day of such year shall be the sum of the fractional amounts in respect of each share which was outstanding on any day of the taxable year. The fractional amount in respect of a share shall be determined by dividing the number of days in the taxable year on which such share was outstanding (excluding the day the share became outstanding, but including the day the share ceased to be outstanding), by the total number of days in such taxable year.

(iii) If for any taxable year of a DISC, or former DISC, the share disposed of was not held (or treated under paragraph (d)(2) of this section as held) by the disposing shareholder for the entire year, then the amount of increase (or decrease) in accumulated DISC income attributable to such share for such year is the amount determined as if he held the share until the end of such year multiplied by a fraction the numerator of which is the number of days in the taxable year on which the shareholder held (or under paragraph (d)(2) of this section is treated as having held) such share and the denominator of which is the total number of days in the taxable year.

(4) *Step 3.* Add the amounts computed in step 2 for each taxable year of the DISC, or former DISC, in which the shareholder held such share of stock.

(5) *Examples.* This paragraph may be illustrated by the following examples:

Example 1. X Corporation uses the calendar year as its taxable year and elects to be a DISC for the first time for 1973. On January 1, 1973, X has 20 shares issued and outstanding. A and B each own 10 shares. On July 1, 1976, X issues 10 shares to C. On December 31, 1977, A sells his 10 shares to D and recognizes a gain of $120. Under these facts and other facts assumed in the table below, A includes in his gross income for 1977 a dividend under paragraph (b) of this section of $61.30 and long-term capital gain of $58.70.

Year	(a)—Year end accumulated DISC income	(b)—Increase (decrease) in accumulated DISC income	(c)—Shares outstanding	(d)—Increase (decrease) per share (column (b) divided by column (c))
1973	$80	$80	20	$4.00
1974	50	(30)	20	(1.50)
1975	80	30	20	1.50
1976	100	20	[1]25	.80
1977	140	40	30	1.33
(1) Total increase in accumulated DISC income for each share disposed of (sum of amounts in column (d))				6.13
Multiply by number of shares disposed of				10
(2) Total amount of accumulated DISC income attributable to A's shares disposed of				61.30
(3) A's gain				120.00
(4) Portion of A's gain taxable as a dividend (lower of lines (2) and (3))				61.30
(5) Portion of A's gain taxable as long-term capital gain (line (3) minus line (4))				58.70

[1] Under subparagraph (3)(ii) of this paragraph, the aggregate fractional amounts of the 10 shares issued on July 1, 1976, is 5 shares, i.e., 10 shares, multiplied by (183 days/366 days). Thus, the number of shares deemed outstanding for 1976 is 25 shares, i.e., 20 shares plus 5 shares.

Example 2. Assume the same facts as in example 1, except that A sells his 10 shares to D on July 1, 1977. Under subparagraph (3)(iii) of this paragraph, the amount of increase in accumulated DISC income for 1977 which is attributable to each share disposed of is limited to $.67, *i.e.*, $1.33 multiplied by 182 days/365 days. Therefore, the sum of the yearly increases (and decreases) in accumulated DISC income for each share is reduced by $.66 (*i.e.*, $1.33 minus $.67). The total increase in accumulated DISC income for each share disposed of is $5.47 (i.e., $6.13 minus $.66). Under these facts, A would include in his gross income for 1977 a dividend of $54.70 and long-term capital gain of $65.30 determined as follows:

(1) Total increase in accumulated DISC income for each share disposed of	$5.47
Multiplied by number of shares disposed of	10
(2) Total amount of accumulated DISC income attributable of to all shares disposed of	54.70
(3) A's gain	120.00
(4) Portion of A's gain taxable as a dividend (lower of lines (2) and (3))	54.70
(5) Portion of A's gain taxable as long-term capital gain (line (3) minus line (4))	65.30

[T.D. 7324, 39 FR 35112, Sept. 30, 1974, as amended by T.D. 7854, 47 FR 51741, Nov. 17, 1982]

§ 1.995–5 Foreign investment attributable to producer's loans.

(a) *In general*—(1) *Limitation.* Under section 995(d), the amount as of the close of a ‘‘group taxable year’’ (as defined in subparagraph (3) of this paragraph) of foreign investment attributable to producer's loans of a DISC for purposes of section 995(b)(1)(G) shall be the excess (as of the close of such year) of—

(i) The smallest of—

(a) The amount of the net increase in foreign assets (as defined in paragraph (b) of this section) by domestic and foreign members of the controlled group which includes the DISC,

(b) The amount of the actual foreign investment by the domestic members of such group (as determined under paragraph (c) of this section), or

(c) The amount of outstanding producer's loans (as determined under § 1.993–4) by such DISC to members of such controlled group, over

(ii) The amount (determined under § 1.995–2 (a)(5) and (b)(2)) of foreign investment attributable to producer's loans treated under section 995(b)(1)(G) as deemed distributions by the particular DISC taxable as dividends for prior taxable years of that particular DISC.

Thus, for example, if the shareholders of a DISC which uses the calendar year as its taxable year (and which is a member of a controlled group in which all of the members use the calendar year as their taxable year) are treated under section 995(b)(1)(G) as receiving foreign investment attributable to producer's loans of a DISC of $0 in 1972, $10 in 1973, and $30 in 1974, or a total of $40, and if the smallest of the amounts described in subdivision (i) of this subparagraph at the end of 1975 is $90, then the amount of the foreign investment attributable to producer's loans of a DISC at the end of 1975 is $50, *i.e.*, the excess (as of the close of 1975) of the smallest of the amounts described in subdivision (i) of this subparagraph ($90) over the sum of the amounts of foreign investment attributable to producer's loans treated under section 995(b)(1)(G) as deemed distributions by the DISC taxable as dividends for prior taxable years of the DISC ($40). If the separate corporate existence of the DISC as to which the amount described in subdivision (ii) of this subparagraph relates ceases to exist within the meaning of § 1.995–4(c)(2), then such amount shall no longer be taken into account by the group for any purpose. For inclusion of amounts because of certain corporate acquisitions, see paragraph (d) of this section.

(2) *Controlled group; domestic and foreign member.* For purposes of this section—

(i) The term ''controlled group'' has the meaning assigned to such term by § 1.993–1(k).

(ii) The term *domestic member* means a domestic corporation which is a member of a controlled group, and the term *foreign member* means a foreign corporation which is a member of a controlled group.

(3) *Group taxable year.* (i) The term *group taxable year* refers collectively to the taxable year of the DISC and to the taxable year of each corporation in the controlled group which includes the DISC ending with or within the taxable year of the DISC. Thus, for example, if a corporation has a subsidiary which uses the calendar year as its taxable year and which elects to be treated as a DISC, and if the parent has a taxable year ending on October 31, the ''group taxable year'' for 1973 would refer to calendar year 1973 for the DISC and to the parent's taxable year ending October 31, 1973.

(ii) In cases in which the DISC makes a return for a short taxable year, that is, for a taxable year consisting of a period of less than 12 months, pursuant to section 443 and the regulations thereunder, or § 1.991–1(b)(3), the following rules shall apply—

(a) In the case of a change in the annual accounting period of the DISC resulting in a short taxable year, the *group taxable year* refers collectively to the short taxable year and to the taxable year of each corporation in the controlled group which includes the DISC ending with or within the short taxable year.

(b) In the case of a DISC which is in existence during only part of what would otherwise be its taxable year, the *group taxable year* refers collectively to the short period during which the DISC was in existence and to the taxable year of each corporation in the controlled group which includes the DISC ending with or within the 12-month period ending on the last day of the short period.

(iii) With respect to periods prior to the first taxable year for which a member of the group qualified (or is treated) as a DISC, each group taxable year shall be determined under subdivision (i) of this subparagraph as if such member was in existence, it qualified as a DISC, and its taxable year ended on that date corresponding to the date such member's first taxable year ended after it qualified (or is treated) as a DISC whether or not the corporation which qualifies (or is treated) as a DISC used the same taxable year before it so qualified (or is so treated). Thus, for example, if a corporation which is organized on March 3, 1975, uses the calendar year as its taxable year, and is a member of a controlled group which does not include a DISC, first qualifies (or is treated) as a DISC for calendar year 1975, then the term ''group taxable year'' with respect to years prior to 1975 refers collectively to such prior calendar years and to the taxable year of each corporation in the group ending with or within such prior calendar years.

(iv) For special rules in the case of a group which includes more than one DISC, see paragraph (g) of this section.

(4) *Amounts determined for prior years.* Unless the 3-year limitation is properly elected under subparagraph (5) of this paragraph, the amounts described in paragraphs (b) (relating to net increase in foreign assets) and (c) (relating to actual foreign investments by domestic members) of this section reflect, as of the close of a group taxable year, amounts for all taxable years of members of the group beginning after December 31, 1971 (and amounts arising after December 31, 1971, or such other date prescribed in paragraph (b)(7) of this section), provided that such amounts relate to such group taxable year and preceding group taxable years. Thus, for example, if all members of a controlled group use the calendar year as the taxable year, and 1980 is the first taxable year for which any member of the group qualifies (or is treated) as a DISC, then, unless the 3-year limitation is elected under subparagraph (5) of this paragraph, the amounts described in paragraphs (b) and (c) of this section will be taken into account beginning with the dates specified in the preceding sentence. For rules as to carryovers on certain corporate acquisitions and reorganizations, see paragraph (d) of this section.

(5) *Three-year elective limitation.* (i) A DISC may elect to take into account only amounts described in paragraphs (b) (relating to net increase in foreign assets) and (c) (relating to actual foreign investment by domestic members) of this section for the 3 taxable years of each member immediately preceding its taxable year included in that first group taxable year which includes a member's first taxable year during which it qualifies (or is treated) as a DISC. For purposes of the preceding sentence, determinations shall be made by reference to the taxable year of the issuer or transferor (as the case may be). If an election is made under this subdivision, the offset for uncommitted transitional funds under paragraph (b)(7) of this section is not allowed. If an election is made under this subdivision, the 3-year limitation applies to amounts described in paragraphs (b)(4) and (c)(1) and (2) of this section.

(ii) An election under subdivision (i) of this subparagraph shall not apply with respect to amounts which must be carried over under paragraph (d) of this section in the case of certain corporate acquisitions and reorganizations.

(iii) An election under subdivision (i) of this subparagraph shall be made by the DISC attaching to its first return, filed under section 6011(e)(2), a statement to the effect that the 3-year limitation is being elected under §1.995–5(a)(5)(i).

(6) *Cumulative basis.* Pursuant to section 995(d)(5), all determinations of amounts specified in this section are to be made on a cumulative basis from the 1st year (or date) provided for in this section. Thus, each such determination shall take into account a net increase or a net decrease during the year, as the case may be. However, if the 3-year limitation is elected under subparagraph (5) of this paragraph, then only amounts with respect to periods specified in such subparagraph (5) are amounts taken into account for years before a member of the group qualifies (or is treated) as a DISC. The computations described in this section may be made in any way chosen by the DISC (including a corporation being tested as to whether it qualifies as a DISC), provided such method results in the amount prescribed by this section.

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

Example. X Corporation, which uses the calendar year as its taxable year, is a member of a controlled group (within the meaning of subparagraph (2) of this paragraph). X elects to be treated as a DISC beginning with 1972. The amount of foreign investment attributable to X's producer's loans treated under section 995(b)(1)(G) as a distribution taxable as a dividend as of the close of each group taxable year with respect to each taxable year of X from 1972 through 1975 are set forth in the table below, computed on the basis of the facts assumed (the amounts on lines (1), (2), (3), and (5) being running balances):

Taxable year of X	1972	1973	1974	1975
(1) Net increase (or decrease) in foreign assets since January 1, 1972, at close of group taxable year	($30)	$10	$100	$150
(2) Actual foreign investment at close of group taxable year	20	60	80	140
(3) Outstanding producer's loans of X (the DISC) as of the close of group taxable year	0	40	90	120
(4) Smallest of lines (1), (2), or (3) (not less than zero)	0	10	80	120
(5) Less section 995(b)(1)(G) deemed distributions for prior taxable years (sum of lines (5) and (6) from prior year)	0	0	10	80
(6) Section 995(b)(1)(G) deemed distribution as of close of taxable year	0	10	70	40

(b) *Net increase in foreign assets*—(1) *In general.* (i) The term *net increase in foreign assets* when used in this section means the excess for the controlled group (as of the close of the group taxable year) of *(a)* the investment in foreign assets to be taken into account under subparagraph (2) of this paragraph over *(b)* the aggregate of the five offsets allowed by subparagraphs (3) through (7) of this paragraph.

(ii) No amount described in this paragraph (other than amounts described in subparagraphs (4) and (7) of this paragraph) with respect to a member of the group (or foreign branch of a member) shall be taken into account unless it is attributable to a taxable year of such member beginning after December 31, 1971. For a 3-year elective limitation with respect to the first taxable year for which a member qualifies (or is treated) as a DISC, see paragraph (a)(5) of this section. For manner of determining amounts on a cumulative basis, see paragraph (a)(6) of this section.

(2) *Investments made in foreign assets.* (i) For purposes of subparagraph (1) of this paragraph, there shall be taken into account as investment in foreign assets the aggregate of the amounts expended (within the meaning of subdivision (ii) of this subparagraph) during the period described in subparagraph (1)(ii) of this paragraph by all members of the controlled group which includes the DISC to acquire assets described in section 1231(b) (determined without regard to any holding period therein provided) which are located outside the United States (as defined in §1.993–7) reduced by the aggregate of the amounts received by all such members of the controlled group from the sale, exchange, or involuntary conversion of such assets described in section 1231(b) which are located outside the United States. For purposes of this section, amounts expended for assets which are qualified export assets (as defined in §1.993–2) of a DISC (or which would be qualified export assets if owned by a DISC) shall not be taken into account. Thus, for example, if a DISC acquires a qualified export asset located outside the United States, the asset is not to be taken into account for purposes of determining the net increase in foreign assets.

(ii) As used in subdivision (i) of this subparagraph, the term *amounts expended* (or amounts received) means the amount of any money or the fair market value (on the date of acquisition, sale, exchange, or involuntary conversion) of any property (other than money) used to acquire (or received for) the assets described in such subdivision (i).

(iii) For purposes of this subparagraph, an asset (other than an aircraft or vessel) is considered as located outside the United States if it was used predominantly outside the United States during the group taxable year. The determination as to whether such an asset is used predominantly outside the United States during the group taxable year in which it was acquired or sold, exchanged, or involuntarily converted shall be made by applying the rules of §1.993–3(d) except that an aircraft described in section 48(a)(2)(B)(i) or a vessel described in section 48(a)(2)(B)(iii) shall be considered located in the United States and all other aircraft or vessels shall be considered located outside the United States. Thus, for example, if a member of a controlled group which includes a

DISC acquires a vessel which is documented under the laws of a foreign country, the amount expended to acquire that vessel is an amount described in subdivision (i) of this subparagraph.

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

Example 1. X Corporation, which uses the calendar year as its taxable year, is a domestic member of a controlled group (within the meaning of paragraph (a)(2) of this section). During 1972, in a transaction to which section 1031 applies, X acquires a warehouse located outside the United States and having a fair market value of $100. As consideration, X transfers $20 in cash and a warehouse located within the United States and having a fair market value of $80. Under these facts, $100 will be taken into account as investment in foreign assets.

Example 2. The facts are the same as in example 1, except that the warehouse transferred by X as consideration is located outside the United States. Under these facts, only $20 will be taken into account as investment in foreign assets because the amount expended for such assets (*i.e.,* $100) is reduced by the fair market value of any property located outside the United States received in exchange for such assets (*i.e.,* $80).

(3) *Depreciation with respect to all foreign assets of a controlled group.* (i) An offset allowed by this subparagraph is the depreciation (determined under subdivision (ii) of this subparagraph) or depletion (determined under subdivision (iii) of this subparagraph) attributable to taxable years of the member beginning after December 31, 1971, with respect to all of the group's foreign assets described in subparagraph (2) of this paragraph including such assets acquired prior to the date provided in such subparagraph (2), and without regard to whether the 3-year election in paragraph (a)(5) of this section is made. Thus, for example, depreciation for a taxable year of a member beginning after December 31, 1971, with respect to an asset described in section 1231(b) which is located outside of the United States and which was acquired during a taxable year of the member beginning before January 1, 1972, is an offset allowed by this subparagraph. For a further example, depreciation with respect to a qualified export asset is not such an offset.

(ii) The depreciation taken into account under subdivision (i) of this subparagraph shall be—

(a) In the case of an asset owned by a domestic member, only the amount allowed under section 167(b)(1) (relating to the allowance of the straight-line method of depreciation) and § 1.162–11 (b) (relating to amortization in lieu of depreciation), but not the amount allowed under section 179 (relating to the additional first-year depreciation allowance).

(b) In the case of an asset owned by a foreign member, the depreciation and amortization (referred to in *(a)* of this subdivision) allowable for purposes of computing earnings and profits under subparagraph (5)(i) of this paragraph.

(iii) The depletion taken into account under subdivision (i) of this subparagraph shall be limited to cost depletion computed under sections 611 and 612 and the regulations thereunder. Thus, percentage depletion is not to be taken into account in computing the offset under this subparagraph.

(4) *Amount of outstanding stock or debt.* (i) An offset allowed by this subparagraph is the outstanding amount of stock (including treasury stock) or debt obligations of any member of the group issued, sold, or exchanged after December 31, 1971, by any member (whether or not the same member) to persons who (on the date of such issuance, sale, or exchange) were neither United States persons (within the meaning of section 7701(a)(30)) nor members of the group: *Provided,* That, in the case of a debt obligation, such obligation is not repaid within 12 months after such issuance, sale, or exchange. Thus, for example, if stock is issued to a member of the group before January 1, 1972, and after December 31, 1971, it is sold to a person who is neither a United States person nor a member of the group, an offset allowed by this subparagraph includes the outstanding amount of such stock. For purposes of this subparagraph, foreign branches of United States banks are not considered to be United States persons.

(ii) The outstanding amount of stock or debt obligations shall be determined in accordance with the following provisions:

(a) The outstanding amount of stock or debt obligations described in subdivision (i) of this subparagraph is equal to the net amount described in *(b)* of this subdivision reduced (but not below zero) by the amount described in *(c)* of this subdivision.

(b) The net amount described in this subdivision *(b)* is the excess of *(1)* the aggregate of the amount of money and the fair market value of property (other than money) transferred by persons who are not members of the group and who are not U.S. persons as consideration for such stock and debt obligations over *(2)* fees and commission expenses borne by the issuer or transferror with respect to their issuance, sale, or exchange.

(c) The amount described in this subdivision *(c)* is the aggregate amount of money and fair market value of property (other than money) distributed to such persons on distributions in respect of such stock from other than earnings and profits or on distributions in redemption of such stock and the amount of principal paid pursuant to such debt obligations.

(d) For purposes of this subdivision (ii), in the case of a redemption, the stock or debt redeemed shall be charged against the earliest of such stock or debt issued, sold, or exchanged in order to determine the amount by which the balance of outstanding stock or debt is to be reduced. For purposes of this subparagraph, the fair market value of property received as consideration shall be determined as of the date the transaction occurs, and a contribution to capital within the meaning of section 118 shall be treated as the issuance of stock.

(iii) The provisions of subdivision (i) of this subparagraph apply regardless of the treatment under the Code of the transaction in which the stock or debt was issued, sold, or exchanged. Thus, for example, if X Corporation, a member of a controlled group which includes a DISC, acquires from a nonresident alien individual in exchange solely for X's voting stock all of the stock of Y Corporation pursuant to a reorganization as defined in section 368(a)(1)(B), the fair market value of the Y stock on the date of the exchange would be an offset allowed by this subparagraph.

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

Example. X Corporation is a member of a controlled group (within a meaning of paragraph (a)(2) of this section) every member of which uses the calendar year as its taxable year. On January 1, 1972, X issues in a public offering its stock to persons described in subdivision (i) of this subparagraph who, in the aggregate, pay $1,000 as consideration. X pays $100 in underwriting fees. On the same date, X receives $425 upon issuing a $500 debt obligation to such persons at a discount of $75 and pays $25 in underwriting fees. On December 31, 1972, the offset allowed under this subparagraph is $1,300, i.e., ($1,000 minus $100) plus ($425 minus $25). If, during 1973, X makes a distribution of $150 (not in redemption) from other than earnings and profits with respect to such stock, then the offset is reduced to $1,150.

(5) *Earnings and profits.* (i) An offset allowed by this subparagraph is one-half the aggregate of the earnings and profits accumulated for all taxable years beginning after December 31, 1971, computed (without regard to any distributions from earnings and profits by a foreign corporation to a domestic corporation in accordance with §1.964–1 (relating to a controlled foreign corporation's earnings and profits), of each foreign member of the group which is controlled directly or indirectly (as determined under the principles of section 958 and the regulations thereunder) by a domestic member of the group and each foreign branch of a domestic member of the group (computed as if the branch were a foreign corporation). The DISC is bound by any action on behalf of a foreign member that was taken pursuant to §1.964–1(c)(3) or by any failure to take action by or on behalf of a foreign member within the time specified in §1.964–1(c)(6). With respect to a foreign member for which action was not previously required under §1.964–1(c)(6) to be taken, the DISC may take action on behalf of such member by attaching a statement to that effect to the return of the DISC under section 6011(e)(2) for the first taxable year during which it qualifies (or is treated) as a DISC and there is outstanding a producer's loan made by such DISC to a member of the

controlled group which includes the DISC.

(ii) If the aggregate of the accumulated earnings and profits described in subdivision (i) of this subparagraph is a deficit, the amount allowable as an offset under this subparagraph is zero.

(6) *Royalties and fees.* An offset allowed by this subparagraph is one-half the royalties and fees paid by foreign members of the group to domestic members of the group and by foreign branches of domestic members of the group to domestic members of the group during the taxable years of such members beginning after December 31, 1971.

(7) *Uncommitted transitional funds.* (i) An offset allowed by this subparagraph for the uncommitted transitional funds of the group is the sum described in subdivision (ii) of this subparagraph of the amount of certain capital raised under the foreign direct investment program and the amounts described in subdivision (iv) of this subparagraph of certain foreign excess working capital held on October 31, 1971.

(ii) The amount described in this subdivision of certain capital raised under the foreign direct investment program is the excess (if any) of—

(a) The amount of the offset allowed by subparagraph (4) of this paragraph, determined, however, with respect to the stock and debt obligations of domestic members of the group outstanding on December 31, 1971 (including amounts treated as stock outstanding by reason of a contribution to capital), whether or not outstanding after such date, which were issued, sold, or exchanged on or after January 1, 1968, by any member (whether or not the same member) to persons who (on the date of such issuance, sale, or exchange) were neither United States persons (within the meaning of section 7701(a)(30)) nor members of the group, but only to the extent the taxpayer establishes that such amount constitutes a long-term borrowing (see 15 CFR 1000.324[1]) for purposes of the foreign direct investment program (see 15 CFR part 1000[1]), over

(b) The amount (determined under paragraph (c) of this section) of actual foreign investment by the domestic members of the group during the portion of the period such stock or debt obligations have been outstanding prior to January 1, 1972, such determination to be made by substituting January 1, 1968, for the December 31, 1971, date specified in such paragraph (c) and by not taking into account the earnings and profits described in paragraph (c)(3) of this section.

For purposes of this subparagraph, foreign branches of United States banks are not considered to be United States persons.

(iii)*(a)* A taxpayer may establish that an amount under subdivision (ii) *(a)* of this subparagraph constitutes a long-term borrowing for purposes of the foreign direct investment program by keeping records sufficient to demonstrate that appropriate reports were filed with the Office of Foreign Direct Investment of the Department of Commerce with respect to the foreign borrowing or by any other method satisfactory to the district director.

(b) The amounts described in subdivision (ii) *(a)* of this subparagraph include amounts with respect to which an election under section 4912(c), to subject certain obligations of a United States person to the interest equalization tax, has been made: *Provided,* That the obligations to which such amounts relate were issued by an ‘‘overseas financing subsidiary’’ described in 15 CFR part 1000[1] and were assumed by a United States person from such overseas financing subsidiary. Thus, for example, if an overseas financing subsidiary issues its notes to a foreign person in 1968, and such notes are assumed by its United States parent in 1973, which parent elects under section 4912(c) to have the notes subject to the interest equalization tax, then the amount of money received by the subsidiary is an amount described in subdivision (ii)*(a)* of this subparagraph.

(iv) The amount described in this subdivision of foreign excess working capital is the amount of liquid assets held by the foreign members of such group and foreign branches of domestic members of such group on October 31,

[1] EDITORIAL NOTE: 15 CFR part 1000 was removed at 39 FR 30481, Aug. 23, 1974.

1971 (whether or not so held after such date) in excess of their reasonable working capital needs (as defined in §1.993–2 (e)) on that date, but only to the extent not included in subdivision (ii) of this subparagraph. For purposes of this subdivision, the term *liquid assets* means money, bank deposits (not including time deposits), and indebtedness of any kind (including time deposits) which on the day acquired had a maturity of 2 years or less.

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

Example. X Corporation, which uses the calendar year as its taxable year is a member of a controlled group (within the meaning of paragraph (a)(2) of this section). X elects to be treated as a DISC beginning with 1972. The amount of net increase in foreign assets of the group at the close of each group taxable year with respect to each taxable year of X from 1972 through 1975 are set forth in the table below, computed on the basis of the facts assumed (the amounts on each line being running balances):

Taxable year of X	1972	1973	1974	1975
(1) Investment in foreign assets	$150	$165	$260	$300
(2) Depreciation with respect to foreign assets of group	20	40	60	80
(3) Amount of stock or debt outstanding issued after December 31, 1971	30	30	30	30
(4) One-half earnings and profits of foreign members	40	70	100	130
(5) Royalties and fees paid by foreign members to domestic members	10	15	20	20
(6) Uncommitted transitional funds	10	10	10	10
(7) Sum of lines (2) through (6)	110	165	220	270
(8) Net increase in foreign assets (line (1) minus line (6))	40	0	40	30

(c) *Actual foreign investment by domestic members.* For purposes of determining the limitation in paragraph (a) of this section, the amount of the actual foreign investment by domestic members of a controlled group is the sum (as of the close of the group taxable year) determined on a cumulative basis (see paragraph (a)(6) of this section) of—

(1) *Outstanding stock or debt (including contributions to capital).* The outstanding amount (determined in accordance with the principles of paragraph (b)(4)(ii) of this section, applied with respect to stock or debt obligations described in this subparagraph) of stock (including treasury stock) or debt obligations (other than normal trade indebtedness) of foreign members of the group issued, sold, or exchanged after December 31, 1971, by any person (whether or not a member) which is not a domestic member to domestic members of the group: *Provided,* That the outstanding amount of debt obligations of any foreign member shall be the greater of such amount outstanding at the close of the taxable year of such member or the highest such amount outstanding at any time during the immediately preceding 90 days,

(2) *Transfers to foreign branches.* The amount of money or the fair market value of property (other than money) transferred by domestic members of the group after December 31, 1971, to foreign branches of such members in transactions which would, if the branch were a corporation, be in consideration for the sale of stock or debt obligations of (or a contribution of capital to) such foreign branches (as determined under subparagraph (1) of this paragraph), and

(3) *Earnings and profits of foreign members.* One-half of the earnings and profits (computed in accordance with paragraph (b)(5) of this section for purposes of computing net increase in foreign assets) of foreign members of the group which are controlled directly or indirectly (as determined under the principles of section 958 and the regulations thereunder) by a domestic member of the group and foreign branches (treated for this purpose as a corporation) of domestic members of the group accumulated during the taxable years of such foreign members (or branches) beginning after December 31, 1971, or, if later, the taxable year referred to in paragraph (a)(5)(i) of this section if the 3-year election provided for in such paragraph (a)(5)(i) is made.

(d) *Carryovers on certain corporate acquisitions and reorganizations*—(1) *Certain corporate acquisitions.* (i) If—

(a) A member of a controlled group (''first controlled group'') acquires in a transaction to which section 381 applies the assets of a corporation which is a member of a second controlled group or acquires stock in such a corporation pursuant to a reorganization as defined in section 368(a)(1)(B) to which section 361 applies, or

(b) A member or combination of members of the first controlled group acquire in a transaction not described in *(a)* of this subdivision a majority interest (as defined in paragraph (e)(2) of this section) in the stock of a corporation which is a member of a second controlled group which includes a DISC so that such DISC after the acquisition is a member of the new controlled group,

then, for purposes of computing foreign investment attributable to producer's loans with respect to the new controlled group as constituted after such acquisition, all amounts described in paragraphs (a) through (c) of this section, including the amount specified in paragraph (a)(1)(ii) of this section (relating to amounts treated under section 995(b)(1)(G) as deemed distributions by the DISC taxable as dividends for prior taxable years of the DISC), with respect to members of the second controlled group which become members of the new controlled group shall carry over to such new controlled group. For purposes of this subdivision (i), a controlled group may consist of only one member. With respect to certain transactions involving foreign corporations, see section 367.

(ii) If a member or combination of members of a controlled group, immediately after an acquisition of stock to which subdivision (i) of this subparagraph applies, do not control the total combined voting power (determined under § 1.957–1(b)) of the corporation whose stock was acquired, proper apportionment consistent with the principles of paragraph (e)(5) of this section shall be made with respect to amounts to which paragraphs (a) through (c) of this section apply.

(iii)*(a)* If subdivision (i) of this subparagraph applies, then for purposes of determining the application of the 3-year elective limitation provided for in paragraph (a)(5) of this section, the rules in *(b), (c),* and *(d)* of this subdivision (iii) apply.

(b) If both the ''first controlled group'' and the ''second controlled group'' (as those terms are defined in subdivision (i) of this subparagraph) include a DISC, and a DISC in either group has elected the 3-year limitation provided in paragraph (a)(5) of this section, then only those amounts taken into account under such paragraph (a)(5) by the electing DISC or DISC's shall be taken into account.

(c) If one of the groups includes a DISC and the other does not, and if the DISC has elected the 3-year limitation provided in paragraph (a)(5) of this section, then, for purposes of computing foreign investment attributable to producer's loans with respect to the new controlled group as constituted after the acquisition, all amounts described in paragraphs (a) through (c) of this section with respect to members of the controlled group which did not include the DISC shall carry over to such new controlled group, but only to the extent provided in such paragraph (a)(5), computed as if the group taxable year in which the acquisition occurred was the first group taxable year which includes a member's first taxable year during which it qualifies (or is treated) as a DISC.

(d) If *(c)* of this subdivision (iii) applies, except that the DISC has not elected the 3-year limitation provided in paragraph (a)(5) of this section, then the DISC in the new controlled group as constituted after the acquisition may, with respect to members of the controlled group which did not include the DISC, make the election provided in such paragraph (a)(5), and treat the year in which the acquisition occurred as if it were the first group taxable year which includes a member's first taxable year during which it qualifies (or is treated) as a DISC.

(iv) If a majority interest, or an interest in addition to a majority interest, is acquired in a transaction other than a transaction described in subdivision (i) of this subparagraph, then the rules in paragraph (e) of this section (relating to the acquisition of the foreign assets of a corporation) apply.

(2) *Corporation ceasing to be a member.* As of the date a corporation which is a

member of a controlled group ceases to be a member of such group, the amounts of such group described in paragraphs (a) through (c) of this section will be reduced by such amounts which are attributable to the corporation which is no longer a member of the group.

(e) *Acquisition of a majority interest in a corporation*—(1) *In general.* If paragraph (d)(1)(i) of this section (relating to certain corporate acquisitions in which all amounts described in paragraphs (a) through (c) of this section carry over) does not apply, then, for purposes of determining under paragraph (b)(2) of this section the investments made in foreign assets by a controlled group, the acquisition of a majority interest (as defined in subparagraph (2) of this paragraph) or an interest in addition to a majority interest in a corporation by any member or combination of members of the controlled group is considered an acquisition of the assets (to the extent provided in subparagraph (5) of this paragraph) of the acquired corporation by the group, including the assets of any foreign corporation in which the acquired corporation owns a majority interest (to the extent provided in subparagraph (5) of this paragraph). For the rules concerning the date upon which an acquisition of a majority interest is considered to have occurred, see subparagraph (3) of this paragraph.

(2) *Majority interest.* For purposes of this section, a majority interest is more than 50 percent of the total combined voting power of all classes of a corporation's stock entitled to vote, as determined under §1.957–1(b).

(3) *Acquisition date.* For purposes of this paragraph, an acquisition of a majority interest shall be considered to have occurred on the day on which the combined voting power of the group first reached the percentage required in subparagraph (2) of this paragraph.

(4) *Valuation of assets.* For purposes of this section, the amount of a corporation's assets deemed acquired is the fair market value of the assets on the date a majority interest, or an interest in addition to a previously held majority interest, is acquired.

(5) *Apportionment in the case of the acquisition of less than all of the voting stock.* (i) If the acquisition described in subparagraph (1) of this paragraph of a majority interest is of less than 100 percent of the total combined voting power of all classes of stock of the acquired corporation entitled to vote, then for purposes of subparagraph (1) of this paragraph the amount of the foreign assets of the corporation deemed acquired as of the day the majority interest is considered acquired shall be an amount equal to the fair market value of all of the corporation's foreign assets described in paragraph (b)(2) of this section as of such day multiplied by the percentage of the total combined voting power (determined under §1.957–1(b)) held by members of the group on the day the majority interest is considered acquired.

(ii) If any member or combination of members of the controlled group hold a majority interest in a corporation, then for purposes of subparagraph (1) of this paragraph the acquisition of additional combined voting power by members of the controlled group shall be considered an acquisition of its foreign assets described in paragraph (b)(2) of this section in an amount equal to the fair market value of all such assets held by the foreign corporation on the date of the acquisition, multiplied by the increase (expressed in percentage points) in total combined voting power (as determined under §1.957–1(b)) which occurred.

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

Example 1. M Corporation uses the calendar year as its taxable year. On November 18, 1973, M acquires from A, an individual United States person, for $1 million cash all 10,000 shares of the voting stock of N, a foreign corporation. N's only asset is a warehouse located in France with a fair market value on the date of acquisition of $1 million. Under subparagraph (1) of this paragraph, the controlled group of which M is a member is considered to have expended $1 million for the acquisition of foreign assets described in paragraph (b)(2) of this section.

Example 2. The facts are the same as in example 1, except that on November 18, 1973, M acquires only 80 percent of N's voting stock. M is considered to have expended $800,000 for the acquisition of assets described in paragraph (b)(2) of this section, computed as follows:

(1) Fair market value of N's foreign assets described in paragraph (b)(2) of this section	$1,000,000
(2) Multiply by percentage of total combined voting power of all classes of N stock entitled to vote acquired by M	.8
(3) Amount considered expended	$800,000

Example 3. The facts are the same as in example 2, except that individual A is not a United States person, and M acquires the 80 percent of N voting stock in exchange for cash of $100,000 and M stock having a fair market value on the date of the acquisition of $700,000. M is considered to have acquired assets described in paragraph (b)(2) of this section in the amount of $800,000 (see computations in example 2) and to have an offset under paragraph (b)(4) of this section (relating to outstanding stock or debt) of $700,000 (the fair market value of the M stock transferred to A who is not a United States person). However, the controlled group of which M is a member is not considered to have acquired any other amounts described in paragraphs (a) through (c) of this section with respect to N for taxable years prior to the taxable year of N during which the acquisition occurred.

Example 4. P Corporation, which uses the calendar year as its taxable year, is a member of a controlled group which includes a DISC. During 1973, P acquires from B, an individual United States person, for cash, 30 percent of the total combined voting power of all classes of stock entitled to vote of Q, a foreign corporation. All of Q's assets are assets described in paragraph (b)(2) of this section. No additional interest in Q is acquired by members of the group during 1973. The controlled group of which Q is a member is not considered to have made any investments in foreign assets described in such paragraph (b)(2) as of the close of 1973.

Example 5. Assume the same facts as in example 4. Assume further that during 1974, R Corporation, a member of the controlled group which includes P, acquires for cash 40 percent of the total combined voting power of all classes of stock of Q entitled to vote as follows: 20 percent on July 31, and 20 percent on December 31. Thus, on December 31, 1974, members of the controlled group own 70 percent of Q's voting power (30+20+20) and on that date are considered to have acquired a majority interest in Q. The fair market value of Q's assets on December 31, 1974, is $5 million. The group is considered to have expended $3,500,000 for the acquisition of assets described in paragraph (b)(2) of this section computed as follows:

(1) Fair market value of Q's foreign assets described in paragraph (b)(2) of this section as of the date the acquisition is deemed to have occurred under subparagraph (3) of this paragraph (December 31, 1974)	$5,000,000
(2) Multiply by percentage of total combined voting power of all classes of Q stock entitled to vote held by members of the group on such date	.7
	$3,500,000

Example 6. The facts are the same as in example 5. Assume further that on July 15, 1975, P acquires the remaining 30 percent of the total combined voting power of all classes of Q stock entitled to vote, and on such date the fair market value of Q's assets is $5,500,000. The group is considered to have expended $5,150,000 for the acquisition of assets described in paragraph (b)(2) of this section as of the close of 1975, computed as follows:

(1) Amount of prior years' investment	$3,500,000
(2) Investment during 1975:	
(a) Fair market value of Q's foreign assets described in paragraph (b)(2) of this section on July 15, 1975	$5,500,000
(b) Multiply by additional percentage acquired of total combined voting power of all classes of Q stock entitled to vote	.3
(c) Investment during 1975	$1,650,000
(3) Amount considered expended for foreign assets described in paragraph (b)(2) of this section by reason of the acquisition of Q stock	$5,150,000

(f) *Records.* A DISC shall keep or be readily able to produce such permanent books of account or records as are sufficient to establish the transactions and amounts described in this section. Where applicable, such books of account or records shall be cumulative and shall show transactions and amounts of the members of the controlled group which includes the DISC which occurred prior to the date the DISC qualified (or is treated) as a DISC.

(g) *Multiple DISC's*—(1) *Allocation among DISC's.* In the case of a controlled group which includes more than one DISC, the amounts described in paragraphs (b) and (c) of this section shall be allocated among the DISC's in order to determine the limitation in paragraph (a) of this section. Each DISC's allocable portion of these amounts shall be equal to the total of such amounts multiplied by a fraction the numerator of which is the individual DISC's outstanding producer's loans to members of the group, and the denominator of which is the aggregate amounts of outstanding producer's loans to members of the group by all

DISC's which are members of the group.

(2) *Different taxable years.* If all of the DISC's which are members of the controlled group do not have the same taxable year, then one such DISC shall on behalf of all such DISC's elect to make all computations under section 995(d) as if all DISC's that are members of the group use the same taxable year as the actual taxable year of any one of the DISC's. The election as to which DISC's taxable year is to be used shall be made by the electing DISC attaching to its first return, filed under section 6011(e)(2), a statement indicating which such taxable year will be used. Once such an election is made it may not be revoked until such time as all of the DISC's which are members of the group use the same taxable year. If this subparagraph applies, books and records must be kept by the group which are adequate to show the necessary computations under section 995(d).

(3) This paragraph may be illustrated by the following example:

Example. Corporation X and corporation Y are members of the same controlled group and each has elected to be treated as a DISC. X uses a taxable year ending March 31, and Y uses a taxable year ending November 30. Notwithstanding the fact that all other members of the group use the calendar year as their taxable year, all computations for purposes of determining the amount of foreign investment attributable to producer's loans under section 995(d) must be made as if both DISC's use a taxable year ending either March 31 (X's taxable year) or November 30 (Y's taxable year).

[T.D. 7324, 39 FR 35114, Sept. 30, 1974, as amended by T.D. 7420, 41 FR 20655, May 20, 1976; T.D. 7854, 47 FR 51742, Nov. 17, 1982]

§1.995–6 Taxable income attributable to military property.

(a) *Gross income attributable to military property.* For purposes of section 995(b)(3)(A)(i), the term ''gross income which is attributable to military property'' includes income from the sale, exchange, lease, or rental of military property (as described in paragraph (c) of this section). The term also includes gross income from the performance of services which are related and subsidiary (as defined in §1.993–1(d)) to any qualified sale, exchange, lease, or rental of military property. Where gross income cannot be determined on an item by item basis, the gross income with respect to those items not so determinable shall be apportioned. Such apportionment shall be accomplished using appropriate facts and circumstances, so that the gross income apportioned to sale of military property bears a reasonably close factual relationship to the actual gross income earned on such sales. The apportionment shall be based on methods which include the fair market value of property sold or exchanged, the fair rental value of any leaseholds granted, the fair market value of any related or subsidiary services performed in connection with such sale or leases or methods based on gross receipts or costs of goods sold, where appropriate.

(b) *Deductions.* For purposes of section 995(b)(3)(A)(ii), deductions shall be properly allocated and apportioned to gross income, described in paragraph (a) of this section, in accordance with the rules of §1.861–8. These deductions include all applicable deductions from gross income provided under part VI of subchapter B of chapter 1 of the Code.

(c) *Military property.* For purposes of this section, the term *military property* means any property which is an arm, ammunition, or implement of war designated in the munitions list published pursuant to section 38 of the International Security Assistance and Arms Export Control Act of 1976 (22 U.S.C. 2778 which superseded 22 U.S.C. 1934) and the regulations thereunder (22 CFR 121.01).

(d) *Illustration.* The principles of this section may be illustrated by the following example:

Example. X Corporation elects to be a DISC for the first time in 1976. X has taxable income of $50,000, of which $30,000 is attributable to military property and $10,000 to interest on producer's loans. The total deemed distributions with respect to X are as follows:

(1) Gross interest from Producer's loans in 1976	$10,000
(2) 50 percent of the taxable income of the DISC attributable to military property in 1976	15,000
(3) One-half of the excess of taxable income for 1976 over the sum of lines (1) and (2) (½ of ($50,000 minus $25,000))	12,500

(4) Total deemed distributions (sum of total lines (1), (2), and (3))	37,500

(Secs. 995(e)(7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995 (e)(7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat 917, 26 U.S.C. 7805))

[T.D. 7984, 49 FR 40019, Oct. 12, 1984]

§ 1.996–1 Rules for actual distributions and certain deemed distributions.

(a) *General rule.* Under section 996(a)(1), any actual distribution (other than a distribution described in paragraph (b) of this section or to which § 1.995–4 applies) to a shareholder by a DISC, or former DISC, which is made out of earnings and profits shall be treated as made—

(1) First, out of ''previously taxed income'' (as defined in § 1.996–3(c)) to the extent thereof,

(2) Second, out of ''accumulated DISC income'' (as defined in § 1.996–3(b)) to the extent thereof, and

(3) Third, out of ''other earnings and profits'' (as defined in § 1.996–3(d)) to the extent thereof.

(b) *Rules for qualifying distributions and deemed distributions under section 995(b)(1)(G)*—(1) *In general.* Except as provided in subparagraph (2), any actual distribution to meet qualification requirements made pursuant to § 1.992–3 and any deemed distribution pursuant to § 1.995–2(a)(5) (relating to foreign investment attributable to producer's loans) which is made out of earnings and profits shall be treated as made—

(i) First, out of ''accumulated DISC income'' (as defined in § 1.996–3(b)) to the extent thereof.

(ii) Second, out of ''other earnings and profits'' (as defined in § 1.996–3(d)) to the extent thereof, and

(iii) Third, out of ''previously taxed income'' (as defined in § 1.996–3(c)) to the extent thereof.

(2) *Special rule.* For taxable years beginning after December 31, 1975, paragraph (b)(1) of this section shall apply to one-half of the amount of an actual distribution made pursuant to § 1.992–3 to satisfy the condition of § 1.992–1(b) (the gross receipts test) and paragraph (a) of this section shall apply to the remaining one-half of such amount.

(c) *Exclusion from gross income.* Under section 996(a)(3), amounts distributed out of previously taxed income shall be excluded by the distributee from gross income. However, see § 1.996–5(b) for treatment as gain from the sale or exchange of property of the portion of an actual distribution out of previously taxed income to the extent it exceeds the adjusted basis of the stock with respect to which the distribution is made.

(d) *Priority of distributions.* Under section 996(c), for purposes of determining their treatment under paragraphs (a), (b), and (c) of this section, distributions made during a taxable year shall be treated as being made in the following order—

(1) Deemed distributions under §§ 1.995–2 and 1.995–3.

(2) Actual distributions to meet qualification requirements made pursuant to § 1.992–3 in the order in which they are made, and

(3) Other actual distributions in the order in which they are made.

Thus, the treatment of any distribution shall be determined after the divisions of earnings and profits have been properly adjusted by taking into account distributions of higher priority which are made or deemed made during the same taxable year.

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

Example 1. Y Corporation, which uses the calendar year as its taxable year elects to be treated as a DISC beginning with 1972. During 1973, Y makes a cash distribution of $100 to X Corporation, Y's sole shareholder. For 1973, Y has no earnings and profits. As of the beginning of 1973, Y has $300 of accumulated earnings and profits, which consist of $70 of accumulated DISC income, $40 of previously taxed income, and $190 of other earnings and profits. The entire $100 distribution is a dividend under section 316. However, $40 thereof is treated as made out of previously taxed income and is thus excluded from gross income. Accordingly, only $60 is treated as distributed out of accumulated DISC income and includible in gross income. See § 1.246–4 for the inapplicability of the dividend received deduction with respect to the entire distribution of $100.

Example 2. Assume the same facts as in example 1, except that the cash distribution is designated as a distribution to meet qualification requirements made pursuant to § 1.992–3. Under these facts, X includes the entire distribution in its gross income as a dividend. Of the $100 distributed, $70 is treated as made out of accumulated DISC income and the remaining $30 is treated as made out of other earnings and profits. The dividend received deduction under section 243 is available only with respect to such $30.

Example 3. Y Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1972. As of the end of 1975, Y had failed to meet the gross receipts test for that year. In 1975 Y had $100 of taxable income, $80 of which was attributable to qualified export receipts and $20 of which was attributable to receipts that did not qualify as qualified export receipts. As of the beginning of 1976, Y had $300 of accumulated earnings and profits, which consisted of $70 of accumulated DISC income, $40 of previously taxed income, and $190 of other earnings and profits. In 1976 Y makes a cash distribution of $20 pursuant to §1.992–3 in order to satisfy the gross receipts test for 1975. For 1976 Y has no earnings and profits and no deemed distributions. The entire $20 distribution is a dividend under section 316. Under §1.996–1(b)(2), half of the $20 cash distribution is treated pursuant to §1.996–1(b)(1) and half is treated pursuant to §1.996–1(a). Thus, $10 is treated as distributed out of accumulated DISC income and is includible in gross income. The other $10 is treated as made out of previously taxed income and is thus excluded from gross income. As of the beginning of 1977, Y has $280 of accumulated earnings and profits, which consists of $60 of accumulated DISC income, $30 of previously taxed income, and $190 of other earnings and profits.

[T.D. 7324, 39 FR 35120, Sept. 30, 1974, as amended by T.D. 7854, 47 FR 51742, Nov. 17, 1982]

§1.996–2 Ordering rules for losses.

(a) *In general.* Under section 996(b), if for any taxable year a DISC, or a former DISC, incurs a deficit in earnings and profits, such deficit shall be charged—

(1) First, to other earnings and profits (as defined in §1.996–3(d)) to the extent thereof,

(2) Second, to accumulated DISC income (as defined in §1.996–3(b)) to the extent thereof, subject to the special rule in paragraph (b) of this section,

(3) Third, to previously taxed income (as defined in §1.996–3(c)) to the extent thereof, and

(4) To the extent that the amount of such deficit exceeds the sum of the amounts charged in accordance with subparagraphs (1), (2), and (3) of this paragraph, to other earnings and profits (as defined in §1.996–3(d)).

Thus, the excess deficit charged to other earnings and profits under subparagraph (4) of this paragraph will create a deficit therein in the amount of such excess. To determine the amount of any division of earnings and profits for the purpose of determining under §1.996–1 the treatment of any actual and certain deemed distributions, the portion of a deficit in earnings and profits chargeable under this paragraph to such division prior to such distribution shall be determined in a manner consistent with the rules in §1.316–2(b) for determining the amount of earnings and profits available on the date of any distribution.

(b) *Deficits subsequent to a disqualification.* A deficit in earnings and profits of a DISC, or former DISC, shall not be charged to accumulated DISC income which has been determined is to be deemed distributed to the shareholders pursuant to §1.995–3 as a result of a revocation of election or other disqualification. Thus, in accordance with paragraph (a) of this section as modified by this paragraph, a deficit incurred by a former DISC following such a revocation or disqualification shall be charged first to other earnings and profits and then to previously taxed income with any balance being charged to other earnings and profits and creating a deficit therein. The preceding sentence shall also apply in the case of a deficit incurred by a DISC which has no accumulated DISC income accumulated during its current taxable year and all immediately preceding consecutive taxable years for which it was a DISC. If as a result of the application of this paragraph the amount of a deficit in other earnings and profits exceeds the amount of a deficit in accumulated earnings and profits, then upon any subsequent actual distribution the deficit in other earnings and profits shall be reduced by the lower of (1) the amount of such actual distribution chargeable to accumulated DISC income or previously taxed income or (2) the amount of such excess.

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

Example 1. X Corporation, which uses the calendar year as its taxable year, becomes a DISC beginning with 1976. In addition to other facts assumed in the table below, X incurs a deficit in earnings and profits for 1979 of $70. Such deficit is charged to the divisions of X's earnings and profits pursuant to paragraph (a) of this section in the manner set forth in such table.

	Accumulated DISC income	Previously taxed income	Other earnings and profits
Balance January 1, 1976	....	....	$50
Increase for 1976	$10	$8	
Increase for 1977	10	8	
Increase for 1978	10	8	
Balance January 1, 1979	30	24	50
Deficit for 1979 of $70:			
Charge No. 1	....	....	(50)
Charge No. 2	(20)	....	....
Balance January 1, 1980	10	....	0

Example 2. Assume the same facts as in example 1, except that effective for taxable years beginning with 1979, X revokes its election to be treated as a DISC. Under § 1.995–3, X has $30 of accumulated DISC income which is to be deemed distributed $10 per year in 1980, 1981, and 1982. The deficit in earnings and profits for 1979 is charged to the divisions of X's earnings and profits pursuant to paragraph (b) of this section in the manner set forth in the table below:

	Accumulated DISC income	Previously taxed income	Other earnings and profits
Balance January 1, 1979	$30	$24	$50
Deficit for 1979 of $70:.			
Charge No. 1	....	....	(50)
Charge No. 2	....	(20)	....
Balance January 1, 1980	30	4	0

Example 3. Assume the same facts as in example 2, except that the deficit in earnings and profits for 1979 is $120. Assume further that for 1980, 1981, and 1982, during which years X's shareholders are receiving scheduled installments of the deemed distributions of accumulated DISC income under § 1.995–3, X, a former DISC, has neither earnings and profits nor a deficit in earnings and profits. The $120 deficit for 1979 is charged to the divisions of X's earnings and profits pursuant to paragraph (b) of this section in the manner set forth in the table below:

	Accumulated DISC income	Previously taxed income	Other earnings and profits	Accumulated earnings and profits
Balance January 1, 1979	$30	$24	$50	$104
Deficit for 1979 of $120	....	....	....	(120)
Charge No. 1	....	....	(50)	....
Charge No. 2	....	(24)	....	....
Charge No. 3	....	....	(46)	....
Balance January 1, 1980	30	0	(46)	(16)
Deemed distributions in 1980 under § 1.995–3	(10)	10	....	....
Balance January 1, 1981	20	10	(46)	(16)

Example 4. Assume the same facts as in example 3, except that on December 31, 1980, X makes an actual distribution of $10 out of previously taxed income. On January 1, 1981, X has $20 of accumulated DISC income, no previously taxed income, and a deficit of $36 in other earnings and profits. The deficit of $16 in accumulated earnings and profits remains the same.

[T.D. 7324, 39 FR 35120, Sept. 30, 1974]

§ 1.996–3 Divisions of earnings and profits.

(a) *In general.* For purposes of sections 991 through 997, the earnings and profits of a DISC, or former DISC, shall be treated as composed of the following three divisions:

(1) Accumulated DISC income (as defined in paragraph (b) of this section),

(2) Previously taxed income (as defined in paragraph (c) of this section), and

(3) Other earnings and profits (as defined in paragraph (d) of this section),

(b) *Accumulated DISC income defined.* (1) Accumulated DISC income is that portion of a corporation's earnings and profits which were derived during taxable years for which it qualified as a DISC and which were deferred from taxation. Accumulated DISC income as of the close of each taxable year of the corporation is—

(i) The amount of accumulated DISC income as of the close of the immediately preceding taxable year increased by,

(ii) The amount of DISC income for the year (as determined in subparagraph (2) of this paragraph) and reduced (but not below zero) by,

(iii) The items enumerated in subparagraph (3) of this paragraph.

(2) Under section 996(f)(1), DISC income is (i) the earnings and profits derived by the corporation during a taxable year for which such corporation is a DISC minus (ii) amounts deemed distributed under §1.995–2 other than the amount of foreign investment attributable to producer's loans described in §1.995–2(a)(5). For example, the earnings and profits of a DISC for a taxable year include any amounts includible in such DISC's gross income pursuant to section 951(a) (relating to controlled foreign corporations). Deemed distributions under §1.995–2(a)(5) are taken into account under subparagraph (3) of this paragraph as a reduction in computing accumulated DISC income.

(3) The accumulated DISC income (as increased by DISC income for the year determined under subparagraph (2) of this paragraph) is reduced by each of the following items in the following order:

(i) Any amount deemed distributed for such year under §1.995–3 (relating to deemed distributions upon disqualification),

(ii) Any amount of foreign investment attributable to producer's loans deemed distributed for such year under §1.995–2(a)(5) to the extent it is charged to accumulated DISC income under §1.996–1(b)(1)(i),

(iii) The amount of any adjustment to accumulated DISC income for such year under §1.966–4(b)(1), and

(iv) To the extent they are treated, under §1.996–1 (a) or (b) (relating to ordering rules for distributions), as made out of accumulated DISC income, the amounts of any actual qualifying distributions pursuant to §1.992–3 in the order in which they are made, and thereafter by the amounts of any other actual distributions in the order in which they are made, except that, prior to each actual distribution, accumulated DISC income shall be reduced by the portion of any deficit in earnings and profits for the taxable year chargeable at that time under §1.996–2(a)(2) to accumulated DISC income.

(4) Every distribution or other reduction in accumulated DISC income pursuant to subparagraph (3) of this paragraph shall be charged to the most recently accumulated DISC income.

(c) *Previously taxed income.* Under section 996(f)(2), previously taxed income as of the close of each taxable year of the corporation is an amount equal to—

(1) The sum of—

(i) The amount of previously taxed income as of the close of the immediately preceding taxable year,

(ii) Amounts deemed distributed for the current year under §1.995–2 (relating to deemed distributions in qualified years),

(iii) Amounts deemed distributed for the current year under §1.995–3 (relating to deemed distributions upon disqualification),

(iv) With respect to a distribution in redemption to which §1.996–4(b)(1) applies, an amount equal to the excess (if any) of *(a)* the amount of the reduction under §1.996–4(b)(1) in accumulated DISC income over *(b)* the reduction in the corporation's earnings and profits (see section 312(e)), and

(v) Any amount by which accumulated DISC income is reduced under paragraph (b)(3)(ii) of this section by reason of a deemed distribution as a dividend, under §1.995–2(a)(5), of an amount of foreign investment attributable to producer's loans,

(2) Decreased (but not below zero), to the extent they are treated, under §1.996–1 (a) or (b) (relating to ordering rules for distributions), as made out of previously taxed income, by the amounts of any actual qualifying distributions pursuant to §1.992–3 in the order in which they are made, and thereafter by the amounts of any other actual distributions in the order in which they are made, except that, prior to any actual distribution, previously taxed income shall be reduced by the portion of any deficit in earnings and profits for the taxable year chargeable at that time under §1.996–2(a)(3) to previously taxed income.

(d) *Other earnings and profits.* Under section 996(f)(3), other earnings and profits consist of earnings and profits other than accumulated DISC income and previously taxed income described respectively in paragraphs (b) and (c) of this section. Other earnings and profits as of the close of each taxable year of the corporation is (subject to paragraph (e) of this section) an amount equal to the amount of other earnings and profits as of the close of the immediately preceding taxable year decreased (if necessary, below zero) in the following order by—

(1) To the extent they are treated, under § 1.996–1 (a) or (b) (relating to ordering rules for distributions), as made out of other earnings and profits, the amounts of any actual qualifying distributions pursuant to § 1.992–3 in the order in which they are made, and thereafter the amounts of any other actual distributions in the order in which they are made, except that, prior to any actual distribution, other earnings and profits shall be reduced by the portion of any deficit in earnings and profits for the taxable year chargeable at that time under § 1.996–2(a)(1) to other earnings and profits, and

(2) With respect to a distribution in redemption to which § 1.996–4(b)(1) applies, an amount equal to the excess (if any) of *(a)* the reduction in the corporation's earnings and profits (see section 312(e)) over *(b)* the amount of the reduction under § 1.996–4(b)(1) in accumulated DISC income.

(e) *Distributions in kind.* (1) For purposes of determining, under paragraphs (b), (c), and (d) of this section, the amount by which any division of earnings and profits is reduced by reason of a distribution of property (other than money or the DISC's, or former DISC's, own obligations), the amount of such distribution is the fair market value of such property at the time of the distribution.

(2) For any taxable year in which the DISC makes a distribution of such property, the amount of other earnings and profits determined under paragraph (d) of this section (without regard to this subparagraph) shall be—

(i) Increased by the excess (if any) of the amount of such distribution treated as a dividend under section 316(a) over the adjusted basis of such property, and

(ii) Decreased by the excess (if any) of the adjusted basis of such property over the amount of such distribution treated as a dividend under section 316 (a).

Each item of property shall be considered separately for purposes of making the adjustment under this subparagraph.

(f) *Examples.* The provisions of §§ 1.996–1, 1.996–2, and this section may be illustrated by the following examples:

Example 1. M Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1974. During 1975, M derives no earnings and profits and makes no deemed or actual distributions, except that on December 31, 1975, M's shareholders are treated as having received a dividend distribution of $100 under § 1.995–2 (a)(5) (relating to foreign investment attributable to producer's loans). M's earnings and profits are adjusted as shown on line (2) of the table below on the basis of facts assumed therein.

	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance January 1, 1975	$450	$100	$250	$100
(2) Adjustments (see paragraphs (b)(3)(ii) and (c)(1)(v) of this section)	0	(100)	100	0
(3) Balance January 1, 1976	450	0	350	100

Example 2. N Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1972. During 1973, N derives no earnings and profits for the year and makes no deemed or actual distributions, except that A, a shareholder, realized $200 of gain upon receiving an actual cash distribution of $300 in redemption of N stock having an adjusted basis of $100 in his hands. The redemption is treated as an exchange under section 302(a) but, under section 995(c), A includes the $200 of gain in his gross income as a dividend. Assuming that, under section 312(e), $240 is properly chargeable to capital account of N and that, under § 1.996–4(b), accumulated DISC income is reduced by $200, N's accounts are adjusted on line (2) of the table below on the basis of facts assumed therein.

	Capital	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance January 1, 1973	$2,000	$400	$300	$100	0
(2) Adjustments (see §1.996–4(b) and paragraph (c)(1)(iv) of this section)	(240)	(60)	(200)	140	0
(3) Balance January 1, 1974	1,760	340	100	240	0

Example 3. P Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1973. During 1974, P derives no earnings and profits for the year and makes no deemed or actual distributions, except for a distribution to B, its sole shareholder, of property with a fair market value of $100 and an adjusted basis in P's hands of $40. Under §1.996–1(a)(1), B treats the entire amount of the distribution as being made out of previously taxed income and, under §1.996–1(c), excludes it from his gross income. P's earnings and profits, divisions are adjusted on lines (2) and (3) of the table below on the basis of facts assumed therein.

	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance January 1, 1974	$200	$80	$120	0
(2) Adjustment under paragraphs (c)(2) and (e)(1) this section	(40)	0	(100)	0
(3) Adjustment under paragraph (e)(2)(i) of this section	0	0	0	$60
(4) Balance January 1, 1975	160	80	20	60

Example 4. Q Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1974. On January 1, 1975, Q has accumulated earnings and profits of $1,200 and, during 1975, Q incurs a deficit in earnings and profits of $365. The amount of such deficit incurred as of any date before the close of 1975 cannot be shown. On July 1, 1975, Q makes a cash distribution of $650, with respect to its stock to C, Q's sole shareholder. C subsequently transfers by gift all of his Q stock to D. On December 31, 1975, Q makes a cash distribution of $650, with respect to its stock, to D. Under these facts and additional facts assumed in the table below, C is treated as having received a dividend of $650 of which $320 is treated as distributed out of previously taxed income and excluded from gross income. D is treated as receiving a dividend of $186. Adjustments to Q's earnings and profits accounts are illustrated in the table below:

	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance January 1, 1975	$1,200	$800	$320	$80
(2) Portion of 1975 deficit of $365 chargeable as of June 30, 1975, pursuant to §1.996–2(a)	(181)	(101)	0	(80)
(3) Balance July 1, 1975	1,019	699	320	0
(4) $650 distributed to C on July 1, 1975	(650)	(330)	(320)	0
(5) Portion of 1975 deficit of $365 chargeable as of December 30, 1975, pursuant to §1.996–2(a)	(183)	(183)	0	0
(6) Balance December 31, 1975	$186	$186	0	0
(7) $650 distributed to D on December 31, 1975[1]	(186)	(186)	0	0
(8) Balance January 1, 1976	0	0	0	0

[1] $60 treated as return of capital pursuant to section 301(c)(2).

Examples 5—(1) *Facts.* R Corporation, which uses the calendar year as its taxable year elects to be treated as a DISC beginning with 1972. X Corporation is its sole shareholder. At the beginning of 1974, R has a deficit in earnings and profits of $60 all of which is composed of "other earnings and profits".

For 1974, R has earnings and profits of $80 before reduction for any distributions and taxable income of $70. On June 15, 1974, R makes a cash distribution to X of $60, with respect to its stock, to which section 301 applies. On August 15, 1974, R makes a cash distribution to X of $30 designated as a distribution to meet qualification requirements pursuant to § 1.992–3. Under § 1.995–2(a), X is deemed to receive, on December 31, 1974, a distribution of a dividend of $35, i.e., one-half of R's taxable income of $70. The tax consequences of these facts to X and their effect on R's earnings and profits are set forth in the subsequent subparagraphs of this example.

(2) *Dividend treatment of actual distributions.* Since R had $80 of earnings and profits for 1974 and a deficit in accumulated earnings and profits at the beginning of 1974, only $80 of the actual distributions ($90) are treated as dividends under sections 301(c)(1) and 316(a)(2). ($10 of the actual distribution, which is not treated as a dividend is treated in the manner specified in section 301(c) (2) and (3).) Thus, under § 1.316–2(b), $26.67 of the actual qualifying distribution made on August 15, 1974 ($30× $80/$90), and $53.33 of the actual distribution made on June 15, 1974 ($60×$80/$90), are considered made out of earnings and profits.

(3) *Priority of distributions.* Under § 1.996–1(d), for purposes of adjusting the divisions of R's earnings and profits and determining the treatment of subsequent distributions, the sequence in which each distribution is treated as having been made is—

(i) First, the deemed distribution of $35,

(ii) Second, the actual qualifying distribution of $30 made on August 15, 1974, pursuant to § 1.992–3, and

(iii) Finally, the actual distribution of $60 made on June 15, 1974.

(4) *Treatment and effect of deemed distribution.* Under § 1.995–2(a), on December 31, 1974, X includes the deemed distribution of $35 in its gross income as a dividend. Under paragraph (c)(1)(ii) of this section, R's previously taxed income is increased by $35 as shown on line (3) of the table in subparagraph (7) of this example. Under paragraph (b)(1)(ii) and (2) of this section, accumulated DISC income is increased by $45 of DISC income, i.e., R's earnings and profits for 1974, $80, minus the deemed distribution of $35, as shown on line (4) of the table.

(5) *Treatment and effect of actual qualifying distribution of $30.* As indicated in subparagraph (2) of this example, $26.67 of the $30 qualifying distribution on August 15, 1974, is treated as made out of earnings and profits for 1974. Under § 1.996–1(b)(1)(i), the entire $26.67 is treated as distributed out of accumulated DISC income. Thus, on August 15, 1974, X includes $26.67 in its gross income as a dividend. No deduction is allowable under section 243. Under paragraph (b)(3)(iv) of this section, R's accumulated DISC income is reduced by $26.67 as shown on line (6) of the table in subparagraph (7) of this example.

(6) *Treatment and effect of actual distribution of $60.* As indicated in subparagraph (2) of this example, $53.33 of the $60 distribution on June 15, 1974, is treated as made out of earnings and profits for 1974. Under § 1.996–1(a), the $53.33 is treated as distributed out of previously taxed income to the extent thereof, $35, and then out of accumulated DISC income, $18.33. Thus, on June 15, 1974, X includes $18.33 in its gross income as a dividend. Under § 1.996–1(c), the distribution of $35 out of previously taxed income is excluded from gross income. No deduction is allowable under section 243 with respect to the actual distribution of $53.33. Under paragraph (b)(3)(iv) of this section, accumulated DISC income is reduced by $18.33 and, under paragraph (c)(2) of this section, previously taxed income is reduced by $35, as shown on line (7) of the table in subparagraph (7) of this example.

(7) *Summary.* The effects on earnings and profits and the divisions of earnings and profits are summarized in the following table:

	Earnings and profits for year	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance January 1, 1974		($60.00)			($60.00)
(2) Earnings and profits for year before reduction for distributions	$80.00				
(3) Deemed distribution of $35 to X on December 31, 1974, under § 1.995–2(a)				$35.00	
(4) DISC income for 1974 of $45 as defined in paragraph (b)(2) of this section (line 2 ($80) minus line 3 ($35))			$45.00		
(5) Balance before actual distributions	80.00	(60.00)	45.00	35.00	(60.00)
(6) Qualifying distribution of $30 to X on August 15, 1974, pursuant to § 1.992–3	(26.67)		(26.67)		
(7) Actual distribution to P of $60 on June 15, 1974	(53.33)		(18.33)	(35.00)	
(8) Balance January 1, 1975	0	(60.00)	0		(60.00)

Example 6. Assume the facts are the same as in example 5, except that at the beginning of 1974 R's accumulated earnings and profits amount to $60 consisting of accumulated DISC income of $20, previously taxed income of $10, and other earnings and profits of $30. In addition, on August 1, 1974, X transfers all R's stock to Y Corporation in a reorganization described in section 368(a)(1)(B) in which under section 354 X recognizes no gain or loss. Under these facts, X includes in its gross income for 1974 a dividend of $15 which is attributable to the actual distribution of $60 paid out of earnings and profits on June 15, 1974. X excludes from gross income the balance of the $60 distribution ($45) paid out of earnings and profits because, under §1.996–1(a), it is treated as paid out of previously taxed income. Y includes in its gross income for 1974 a dividend of $65 of which $35 is attributable to the deemed distribution of a dividend to Y on December 31, 1974, under §1.995–2(a) and $30 is attributable to the qualifying distribution paid out of earnings and profits to Y on August 15, 1974. The adjustments to R's earnings and profits are summarized in the following table:

	Earnings and profits for year	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance January 1, 1974		$60	$20	$10	$30
(2) Earnings and profits for year before reduction for distributions	$80				
(3) Deemed distribution of $35 to Y on December 31, 1974, under §1.995–2(a)				35	
(4) DISC income for 1974 of $45 as defined in paragraph (b)(2) of this section (line 2 ($80) minus line 3 ($35))			45		
(5) Balance before actual distributions	80	60	65	45	30
(6) Qualifying distribution of $30 to Y on August 15, 1974, pursuant to §1.992–3	(26.67)	(3.33)	(30)		
(7) Actual distribution to X of $60 on June 15, 1974	(53.33)	(6.67)	(15)	(45)	
(8) Balance January 1, 1975		50	20	0	30

(g) *DISCs having corporate and noncorporate shareholders.* In the case of a DISC having one or more corporate shareholders but less than all of its shareholders subject to the special rules of section 291(a)(4), relating to certain deferred DISC income as a corporate preference item, accumulated DISC income and previously taxed income of the DISC are divided between the corporate shareholders, as a class, and the other shareholders, as a class, in proportion to amounts of DISC income not deemed distributed and amounts deemed distributed to each class. Subsequent taxation of actual and qualifying distributions shall be based upon this division. Thus, if a DISC is owned 50 percent by corporate shareholders and 50 percent by individual shareholders and has undistributed taxable income of $2,000 for its year, the division is made as follows:

Corporate shareholders:	
Previously taxed income (57.5% of $2,000÷2)	$575
Accumulated DISC income (42.5% of $2,000÷2)	425
Individual shareholders:	
Previously taxed income (50% of $2,000÷2)	500
Accumulated DISC income (50% of $2,000÷2)	500

(Secs. 995(e)(7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995 (e)(7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7324, 39 FR 35121, Sept. 30, 1974, as amended by T.D. 7854, 47 FR 51742, Nov. 17, 1982; T.D. 7984, 49 FR 40024, Oct. 12, 1984]

§1.996–4 Subsequent effect of previous disposition of DISC stock.

(a) *Shareholder adjustment for previously taxed income.* (1) Under section 996(d)(1), except as provided in subparagraph (2) of this paragraph, if—

(i) Gain with respect to a share of stock of a DISC, or former DISC, is treated under §1.995–4 as a dividend, and

(ii) With respect to such share, any person subsequently receives an actual distribution made out of accumulated DISC income, or a deemed distribution made, pursuant to § 1.995–3, by reason of disqualification, out of accumulated DISC income,

then such person shall treat such distribution in the same manner as a distribution from previously taxed income (and thus excludable from gross income under § 1.996–1(c)) to the extent that the gain referred to in subdivision (i) of this subparagraph exceeds the aggregate amount of any other distributions with respect to such share which were treated under this subparagraph as made from previously taxed income.

(2) In applying subparagraph (1) of this paragraph with respect to a share of stock in a DISC, or former DISC, the gain referred to in subparagraph (1)(i) of this paragraph does not include any gain to a shareholder on a redemption of such share which qualifies as an exchange under section 302(a) or any gain on a disposition of such share prior to such redemption. Distributions described in subparagraph (1)(ii) of this paragraph do not include a distribution in a redemption which qualifies as an exchange under section 302(a). For adjustments to accumulated DISC income by reason of dividend treatment under § 1.995–4 with respect to gain upon a redemption of DISC stock to which section 302(a) applies and upon a prior disposition of such stock, see paragraph (b) of this section.

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

Example. In 1974, under § 1.995–4, A, a shareholder of a DISC, on the sale of his DISC stock to B, is required to treat $20 of his gain as a dividend. The DISC has no previously taxed income and $40 of accumulated DISC income. Subsequently in the same year, B, the purchaser of the stock, receives an actual dividend distribution of $15 with respect to such stock which, under § 1.996–1(a), is treated as made out of accumulated DISC income. The amounts of the DISC's previously taxed income and accumulated DISC income were not adjusted by reason of the $20 treated as a dividend on the prior sale. However, even though the DISC had no previously taxed income, the purchaser would treat the $15 as though it had been paid out of previously taxed income and, therefore would not include the $15 in gross income. If in 1975, B receives another actual distribution of $9 with respect to such stock, $5 (*i.e.*, $20 dividend on A's sale less the $15 distribution to B in 1974 which was treated under subparagraph (1) of this paragraph as made from previously taxed income) is treated as made from previously taxed income and excluded from gross income. The result would be the same if, on January 1, 1975, B had transferred such stock to C by gift and the $9 distribution had been made to C.

(b) *Corporate adjustment upon redemption.* (1) Under section 996(d)(2), if by reason of § 1.995–4 gain on a redemption of stock in a DISC, or former DISC, is included in the shareholder's gross income as a dividend, then the accumulated DISC income shall be reduced by an amount equal to the sum of—

(i) The amount of gain on such redemption which, under § 1.995–4, is treated as a dividend, and

(ii) The amount of any gain with respect to such redeemed stock which, under § 1.995–4, was treated as a dividend on a disposition prior to such redemption minus the amount of distributions with respect to such stock which have been treated as made out of previously taxed income by reason of the application of paragraph (a)(1) of this section.

(2) The provisions of this paragraph may be illustrated by the following examples:

Example 1. The entire stock of a DISC, which uses the calendar year as its taxable year, has been owned equally by A, B, C, and D since it was organized. At the close of 1976, when the DISC has $100 of accumulated DISC income, it redeems all of A's shares in a transaction qualifying as an exchange under section 302(a) and A, under § 1.995–4, includes $25 in his gross income as a dividend. The redemption has the effect of reducing accumulated DISC income by $25 to $75.

Example 2. Assume the same facts as in example 1 except that the stock of the DISC has not been held equally by A, B, C, and D since its organization. A purchased his shares from X in 1974 in a transaction in which X, under § 1.995–4, included in his gross income $30 as a dividend. In 1975, A receives a distribution of $10 out of accumulated DISC income which, under paragraph (a)(1) of this section, is treated as made out of previously taxed income. Under these facts, the redemption of A's stock in 1976 has the effect of reducing accumulated DISC income by $45 to $55 determined as follows:

(a) Accumulated DISC income		$100
(b) Minus sum of:		
(1) Dividend on redemption of A's stock	$25	

(2) Excess of dividend on X's sale ($30) over distribution to A treated as made out of previously taxed income ($10)	$20	
Total		45
(c) Accumulated DISC income on 12/31/76		55

[T.D. 7324, 39 FR 35121, Sept. 30, 1974]

§1.996–5 Adjustment to basis.

(a) *Addition to basis.* Under section 996(e)(1) amounts representing deemed distributions as provided in section 995(b) shall increase the basis of the stock with respect to which the distribution is made.

(b) *Reductions of basis.* Under section 996(e)(2), the portion of an actual distribution treated as made out of previously taxed income shall reduce the basis of the stock with respect to which it is made and, to the extent that it exceeds the adjusted basis of such stock, shall be treated as gain from the sale or exchange of property. In the case of stock includible in the gross estate of a decedent for which an election is made under section 2032 (relating to alternate valuation), this paragraph shall not apply to any distribution made after the date of the decendent's death and before the alternate valuation date provided by section 2032. See section 1014(d) for a special rule for determining the basis of stock in a DISC, or former DISC, acquired from a decedent.

[T.D. 7324, 39 FR 35124, Sept. 30, 1974]

§1.996–6 Effectively connected income.

In the case of a shareholder who is a nonresident alien individual or a foreign corporation, trust, or estate, amounts taxable as dividends by reason of the application of §1.995–4 (relating to gain on disposition of stock in a DISC), amounts treated under §1.996–1 as distributed out of accumulated DISC income, and amounts deemed distributed under §1.995–2(a) (1) through (4) shall be treated as gains and distributions which are effectively connected with the conduct of a trade or business conducted through a permanent establishment of such shareholder within the United States, and shall be subject to tax in accordance with the provisions of section 871(b) and the regulations thereunder in the case of nonresident alien individuals, trusts, or estates, or section 882 and the regulations thereunder in the case of foreign corporations. In no case, however shall other income of such shareholder be taxable as effectively connected with the conduct of a trade or business through a permanent establishment in the United States solely because of the application of this section.

[T.D. 7324, 39 FR 35124, Sept. 30, 1974]

§1.996–7 Carryover of DISC tax attributes.

(a) *In general.* Carryover of a DISC's divisions of earnings and profits to acquiring corporations in nontaxable transactions shall be subject to rules generally applicable to other corporate tax attributes. For example, a DISC which acquires the assets of another DISC in a transaction to which section 381(a) applies shall succeed to, and take into account, the divisions of the earnings and profits of the transferor DISC in accordance with section 381(c)(2).

(b) *Allocation of divisions of earnings and profits in corporate separations.* (1) If one DISC transfers part of its assets to a controlled DISC in a transaction to which section 368(a)(1)(D) applies and immediately thereafter the stock of the controlled DISC is distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, then—

(i) The earnings and profits of the distributing DISC immediately before the transaction shall be allocated between the distributing DISC and the controlled DISC in accordance with the provisions of §1.312–10.

(ii) Each of the divisions of such earnings and profits, namely previously taxed income, accumulated DISC income, and other earnings and profits, shall be allocated between the distributing DISC and the controlled DISC on the same basis as the earnings and profits are allocated.

(iii) Any assets of the distributing DISC whose status as qualified export assets is limited by its accumulated DISC income (e.g., producer's loans described in §1.993–4, Export-Import Bank and other obligations described in §1.993–2(h), and financing obligations described in §1.993–2(i)) shall be treated as having been allocated, for the purpose of determining the classification of such assets in the hands of the distributing DISC or the controlled DISC, on the same basis as the earnings and profits are allocated regardless of how such assets are actually allocated.

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

Example. On January 1, 1974, P Corporation transfers part of its assets to S Corporation, a newly organized subsidiary of P, in a transaction described in section 368(a)(1)(D) and distributes all the S stock in a transaction which qualifies under section 355. Immediately before such transfer, P had earnings and profits of $120,000 of which $100,000 constitutes accumulated DISC income. The unpaid balance of P's producer's loans is $80,000 all of which is retained by P. Pursuant to § 1.312–10, 25 percent of P's accumulated DISC income is allocated to S (*i.e.*, $25,000). P's producer's loans will be treated as allocated to S in the same proportion. Accordingly, for purposes of determining, under § 1.993–4(a)(3), the amount of producer's loans which S is entitled to make, S is treated as having an unpaid balance of producer's loans of $20,000 (*i.e.*, 25% × $80,000) and P is treated as having an unpaid balance of $60,000 (*i.e.*, 75% × $80,000).

(c) *Accumulated DISC income accounts of separate DISC's maintained after corporate combination.* If two or more DISC's combine to form a new DISC, or if the assets of one DISC are acquired by another DISC, in a transaction described in section 381(a), accumulated DISC income of the acquired DISC or DISC's shall carry over and be taken into account by the acquiring or new DISC, except that a separate account shall be maintained for the accumulated DISC income of any DISC scheduled to be received as a deemed distribution by its shareholders under § 1.995–3 (relating to deemed distributions upon disqualification). If, as a part of such transaction, the stock of the DISC which has accumulated DISC income scheduled to be deemed distributed is exchanged for stock of the acquiring or new DISC to which such accumulated DISC income is carried over and which maintains a separate account, then such accumulated DISC income shall be deemed distributed pro rata to shareholders of the acquiring or new DISC on the basis of stock ownership immediately after the exchange.

[T.D. 7324, 39 FR 35125, Sept. 30, 1974]

§ 1.996–8 Effect of carryback of capital loss or net operating loss to prior DISC taxable year.

(a) Under § 1.995–2(e), the deduction under section 172 for a net operating loss carryback or under section 1212 for a capital loss carryback is determined as if the DISC were a domestic corporation which had not elected to be treated as a DISC. A carryback of a net operating loss or of a capital loss of any corporation which reduces its taxable income for a preceding taxable year for which it qualified as a DISC will have the consequences enumerated in paragraphs (b) through (e) of this section.

(b) For such preceding taxable year, the amount of a deemed distribution of one-half of certain taxable income described in § 1.995–2(a)(4) will ordinarily be reduced in effect (but not below zero) by one-half of the sum of the amount of the deduction under section 172 for such year for net operating loss carrybacks and the amount of the deduction under section 1212 for such year for capital loss carrybacks.

(c) The amount of reduction in the deemed distribution under paragraph (b) of this section will have the effect of increasing the limitation, provided in § 1.995–2(b)(2), on the amount of foreign investment attributable to producer's loans which is deemed distributed under § 1.995–2(a)(5).

(d) If the amount of a deemed distribution for a preceding taxable year is reduced as described in paragraph (b) of this section, then for such preceding taxable year the previously taxed income (as defined in § 1.996–3(c)) shall be decreased by the amount of such reduction and the accumulated DISC income (as defined in § 1.996–3(b)) shall be increased by the amount of such reduction. Such adjustments shall be made as of the time the deemed distribution for such preceding taxable year is treated as having occurred. See § 1.996–1(d) for the priority of such deemed distribution in relation to other distributions made in that preceding taxable year.

(e) The amount and treatment of any actual distribution made in such preceding taxable year or a year subsequent to such preceding year, and the treatment of gain on a disposition (in any such year) of the DISC's stock to which §1.995–4 applies, shall be properly adjusted to reflect the adjustments to previously taxed income and accumulated DISC income described in paragraph (d) of this section.

[T.D. 7324, 39 FR 35125, Sept. 30, 1974]

§1.997–1 Special rules for subchapter C of the Code.

(a) For purposes of applying the provisions of sections 301 through 395 of the Code, any distribution in property to a corporation by a DISC, or former DISC, which is made out of previously taxed income or accumulated DISC income shall be treated as a distribution in the same amount as if such distribution of property were made to an individual, and have a basis, in the hands of the recipient corporation, equal to such amount treated as having been distributed.

(b) This section may be illustrated by the following example:

Example. X Corporation is the sole shareholder of Y Corporation which is a DISC. Y makes an actual distribution of property to X with respect to X's stock in Y. The property has a basis of $50 and a fair market value of $100. The distribution is treated as made out of accumulated DISC income under section 996(a) and is taxable as a dividend under section 301(c)(1). Even though X is a corporation, the amount of the distribution is $100 notwithstanding the provisions of section 301(b)(1)(B) and the basis the property in X's hands is $100 notwithstanding the provisions of section 301(d)(2).

[T.D. 7324, 39 FR 35125, Sept. 30 1974]

SUBCHAPTER A—INCOME TAX (Continued)

PART 1—INCOME TAXES (Continued)

NORMAL TAXES AND SURTAXES (CONTINUED)

GAIN OR LOSS ON DISPOSITION OF PROPERTY

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Section 1.1059(e)–1 also issued under 26 U.S.C. 1059 (e)(1) and (e)(2).
Section 1.1060–1T also issued under 26 U.S.C. 1060.
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Section 1.1092(d)–2 also issued under 26 U.S.C. 1092(d)(3)(B).
Section 1.1202–2 is also issued under 26 U.S.C. 1202(k).
Section 1.1221–2 also issued under 26 U.S.C. 1502 and 6001.
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Section 1.1254–6 also issued under 26 U.S.C. 1254(b).
Section 1.1271–1 also issued under 26 U.S.C. 1275(d).
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Section 1.1272–3 also issued under 26 U.S.C. 1275(d).
Section 1.1273–1 also issued under 26 U.S.C. 1275(d).
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Section 1.1274–3 also issued under 26 U.S.C. 1275(d).
Section 1.1274–4 also issued under 26 U.S.C. 1275(d).
Section 1.1274–5 also issued under 26 U.S.C. 1275(d).
Section 1.1274A–1 also issued under 26 U.S.C. 1274A(e) and 26 U.S.C. 1275(d).
Section 1.1275–1 also issued under 26 U.S.C. 1275(d).
Section 1.1275–2 also issued under 26 U.S.C. 1275(d).
Section 1.1275–3 also issued under 26 U.S.C. 1275(d).
Section 1.1275–4 also issued under 26 U.S.C. 1275(d).
Section 1.1275–5 also issued under 26 U.S.C. 1275(d).
Section 1.1275–6 also issued under 26 U.S.C. 1275(d).
Section 1.1275–7T also issued under 26 U.S.C. 1275(d).
Section 1.1286–1 also issued under 26 U.S.C. 1275(D) and 1286(f).
Section 1.1286–2T also issued under 26 U.S.C. 1286(f).
Section 1.1287–1 also issued under 26 U.S.C. 165 (j)(3).
Section 1.1291–1T also issued under 26 U.S.C. 1291.
Section 1.1291–9 also issued under 26 U.S.C. 1291(d)(2).
Section 1.1291–10 also issued under 26 U.S.C. 1291(d)(2).
Section 1.1293–1T also issued under 26 U.S.C. 1293.
Section 1.1294–1T also issued under 26 U.S.C. 1294.
Section 1.1295–1T also issued under 26 U.S.C. 1295(b).
Section 1.1295–3T also issued under 26 U.S.C. 1295(b).
Section 1.1297–3T also issued under 26 U.S.C. 1297(b)(1).
Section 1.1361–1(j) (6), (10) and (11) also issued under 26 U.S.C. 1361(d)(2)(B)(iii).
Section 1.1361–1(l) also issued under 26 U.S.C. 1361(c)(5)(C).
Sections 1.1362–1, 1.1362–2, 1.1362–3, 1.1362–4, 1.1362–5, 1.1362–6, 1.1362–7, and 1.1363–1 also issued under 26 U.S.C. 1377.
Section 1.1368–1(f) and (g) also issued under 26 U.S.C. 1377(c).
Section 1.1368–2(b) also issued under 26 U.S.C. 1368(c).
Section 1.1374–1 also issued under 26 U.S.C. 1374(e) and 337(d).
Section 1.1374–2 also issued under 26 U.S.C. 1374(e) and 337(d).
Section 1.1374–3 also issued under 26 U.S.C. 1374(e) and 337(d).
Section 1.1374–4 also issued under 26 U.S.C. 1374(e) and 337(d).
Section 1.1374–5 also issued under 26 U.S.C. 1374(e) and 337(d).
Section 1.1374–6 also issued under 26 U.S.C. 1374(e) and 337(d).
Section 1.1374–7 also issued under 26 U.S.C. 1374(e) and 337(d).

Section 1.1374–8 also issued under 26 U.S.C. 1374(e) and 337(d).

Section 1.1374–9 also issued under 26 U.S.C. 1374(e) and 337(d).

Section 1.1374–10 also issued under 26 U.S.C. 1374(e) and 337(d).

Section 1.1377–1 also issued under 26 U.S.C. 1377(a)(2) and (c).

Section 1.1394–1 also issued under 26 U.S.C. 1397D.

Section 1.1396–1 also issued under 26 U.S.C. 1397D.

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GAIN OR LOSS ON DISPOSITION OF PROPERTY

DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS

§1.1001–1 Computation of gain or loss.

(a) *General rule.* Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001 (a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and the regulations thereunder (i.e., the cost or other basis adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations thereunder. Section 1001(e) and paragraph (f) of this section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property the adjusted basis (or a portion) of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gift or by a transfer in trust).

(b) *Real estate taxes as amounts received.* (1) Section 1001(b) and section 1012 state rules applicable in making an adjustment upon a sale of real property with respect to the real property taxes apportioned between seller and purchaser under section 164(d). Thus, if the seller pays (or agrees to pay) real property taxes attributable to the real property tax year in which the sale occurs, he shall not take into account, in determining the amount realized from the sale under section 1001(b), any amount received as reimbursement for taxes which are treated under section 164(d) as imposed upon the purchaser. Similarly, in computing the cost of the property under section 1012, the purchaser shall not take into account any amount paid to the seller as reimbursement for real property taxes which are treated under section 164(d) as imposed upon the purchaser. These rules apply whether or not the contract of sale calls for the purchaser to reimburse the seller for such real property taxes paid or to be paid by the seller.

(2) On the other hand, if the purchaser pays (or is to pay) an amount representing real property taxes which are treated under section 164(d) as imposed upon the seller, that amount shall be taken into account both in determining the amount realized from the sale under section 1001(b) and in computing the cost of the property under section 1012. It is immaterial whether or not the contract of sale specifies that the sale price has been reduced by, or is in any way intended to reflect, the taxes allocable to the

seller. See also paragraph (b) of § 1.1012–1.

(3) Subparagraph (1) of this paragraph shall not apply to a seller who, in a taxable year prior to the taxable year of sale, pays an amount representing real property taxes which are treated under section 164(d) as imposed on the purchaser, if such seller has elected to capitalize such amount in accordance with section 266 and the regulations thereunder (relating to election to capitalize certain carrying charges and taxes).

(4) The application of this paragraph may be illustrated by the following examples:

Example 1. Assume that the contract price on the sale of a parcel of real estate is $50,000 and that real property taxes thereon in the amount of $1,000 for the real property tax year in which occurred the date of sale were previously paid by the seller. Assume further that $750 of the taxes are treated under section 164(d) as imposed upon the purchaser and that he reimburses the seller in that amount in addition to the contract price. The amount realized by the seller is $50,000. Similarly, $50,000 is the purchaser's cost. If, in this example, the purchaser made no payment other than the contract price of $50,000, the amount realized by the seller would be $49,250, since the sales price would be deemed to include $750 paid to the seller in reimbursement for real property taxes imposed upon the purchaser. Similarly, $49,250 would be the purchaser's cost.

Example 2. Assume that the purchaser in example (1), above, paid all of the real property taxes. Assume further that $250 of the taxes are treated under section 164(d) as imposed upon the seller. The amount realized by the seller is $50,250. Similarly, $50,250 is the purchaser's cost, regardless of the taxable year in which the purchaser makes actual payment of the taxes.

Example 3. Assume that the seller described in the first part of example (1), above, paid the real property taxes of $1,000 in the taxable year prior to the taxable year of sale and elected under section 266 to capitalize the $1,000 of taxes. In such a case, the amount realized is $50,750. Moreover, regardless of whether the seller elected to capitalize the real property taxes, the purchaser in that case could elect under section 266 to capitalize the $750 of taxes treated under section 164(d) as imposed upon him, in which case his adjusted basis would be $50,750 (cost of $50,000 plus capitalized taxes of $570).

(c) *Other rules.* (1) Even though property is not sold or otherwise disposed of, gain is realized if the sum of all the amounts received which are required by section 1016 and other applicable provisions of subtitle A of the Code to be applied against the basis of the property exceeds such basis. Except as otherwise provided in section 301(c)(3)(B) with respect to distributions out of increase in value of property accrued prior to March 1, 1913, such gain is includible in gross income under section 61 as ''income from whatever source derived''. On the other hand, a loss is not ordinarily sustained prior to the sale or other disposition of the property, for the reason that until such sale or other disposition occurs there remains the possibility that the taxpayer may recover or recoup the adjusted basis of the property. Until some identifiable event fixes the actual sustaining of a loss and the amount thereof, it is not taken into account.

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

Example: A, an individual on a calendar year basis, purchased certain shares of stock subsequent to February 28, 1913, for $10,000. On January 1, 1954, A's adjusted basis for the stock had been reduced to $1,000 by reason of receipts and distributions described in sections 1016(a)(1) and 1016(a)(4). He received in 1954 a further distribution of $5,000, being a distribution covered by section 1016(a)(4), other than a distribution out of increase of value of property accrued prior to March 1, 1913. This distribution applied against the adjusted basis as required by section 1016(a)(4) exceeds that basis by $4,000. The $4,000 excess is a gain realized by A in 1954 and is includible in gross income in his return for that calendar year. In computing gain from the stock, as in adjusting basis, no distinction is made between items of receipts or distributions described in section 1016. If A sells the stock in 1955 for $5,000, he realizes in 1955 a gain of $5,000, since the adjusted basis of the stock for the purpose of computing gain or loss from the sale is zero.

(d) *Installment sales.* In the case of property sold on the installment plan, special rules for the taxation of the gain are prescribed in section 453.

(e) *Transfers in part a sale and in part a gift.* (1) Where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property. However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis. For the determination of basis of property in the hands of the transferee, see §1.1015–4. For the allocation of the adjusted basis of property in the case of a bargain sale to a charitable organization, see §1.1011–2.

(2) *Examples.* The provisions of subparagraph (1) may be illustrated by the following examples:

Example 1. A transfers property to his son for $60,000. Such property in the hands of A has an adjusted basis of $30,000 (and a fair market value of $90,000). A's gain is $30,000, the excess of $60,000, the amount realized, over the adjusted basis, $30,000. He has made a gift of $30,000, the excess of $90,000, the fair market value, over the amount realized, $60,000.

Example 2. A transfers property to his son for $30,000. Such property in the hands of A has an adjusted basis of $60,000 (and a fair market value of $90,000). A has no gain or loss, and has made a gift of $60,000, the excess of $90,000, the fair market value, over the amount realized, $30,000.

Example 3. A transfers property to his son for $30,000. Such property in A's hands has an adjusted basis of $30,000 (and a fair market value of $60,000). A has no gain and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

Example 4. A transfers property to his son for $30,000. Such property in A's hands has an adjusted basis of $90,000 (and a fair market value of $60,000). A has sustained no loss, and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

(f) *Sale or other disposition of a term interest in property*—(1) *General rule.* Except as otherwise provided in subparagraph (3) of this paragraph, for purposes of determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in subparagraph (2) of this paragraph) a taxpayer shall not take into account that portion of the adjusted basis of such interest which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gift or by a transfer in trust) to the extent that such adjusted basis is a portion of the adjusted uniform basis of the entire property (as defined in §1.1014–5). Where a term interest in property is transferred to a corporation in connection with a transaction to which section 351 applies and the adjusted basis of the term interest (i) is determined pursuant to section 1014 or 1015 and (ii) is also a portion of the adjusted uniform basis of the entire property, a subsequent sale or other disposition of such term interest by the corporation will be subject to the provisions of section 1001(e) and this paragraph to the extent that the basis of the term interest so sold or otherwise disposed of is determined by reference to its basis in the hands of the transferor as provided by section 362(a). See subparagraph (2) of this paragraph for rules relating to the characterization of stock received by the transferor of a term interest in property in connection with a transaction to which section 351 applies. That portion of the adjusted uniform basis of the entire property which is assignable to such interest at the time of its sale or other disposition shall be determined under the rules provided in §1.1014–5. Thus, gain or loss realized from a sale or other disposition of a term interest in property shall be determined by comparing the amount of the proceeds of such sale with that part of the adjusted basis of such interest which is not a portion of the adjusted uniform basis of the entire property.

(2) *Term interest defined.* For purposes of section 1001(e) and this paragraph, a *term interest in property* means—

(i) A life interest in property,

(ii) An interest in property for a term of years, or

(iii) An income interest in a trust.

Generally, subdivisions (i), (ii), and (iii) refer to an interest, present or future, in the income from property or the right to use property which will terminate or fail on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur. Such divisions do not refer to remainder or reversionary interests in the property itself or other interests in the property which will ripen into ownership of the entire property upon termination or failure of a preceding term interest. A *term interest in property* also includes any property received upon a sale or other disposition of a life interest in property, an interest in property for a term of years, or an income interest in a trust by the original holder of such interest, but only to the extent that the adjusted basis of the property received is determined by reference to the adjusted basis of the term interest so transferred.

(3) *Exception.* Paragraph (1) of section 1001(e) and subparagraph (1) of this paragraph shall not apply to a sale or other disposition of a term interest in property as a part of a single transaction in which the entire interest in the property is transferred to a third person or to two or more other persons, including persons who acquire such entire interest as joint tenants, tenants by the entirety, or tenants in common. See § 1.1014–5 for computation of gain or loss upon such a sale or other disposition where the property has been acquired from a decedent or by gift or transfer in trust.

(4) *Illustrations.* For examples illustrating the application of this paragraph, see paragraph (c) of § 1.1014–5.

(g) *Debt instruments issued in exchange for property*—(1) *In general.* If a debt instrument is issued in exchange for property, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under § 1.1273–2 or § 1.1274–2, whichever is applicable. If, however, the issue price of the debt instrument is determined under section 1273(b)(4), the amount realized attributable to the debt instrument is its stated principal amount reduced by any unstated interest (as determined under section 483).

(2) *Certain debt instruments that provide for contingent payments*—(i) *In general.* Paragraph (g)(1) of this section does not apply to a debt instrument subject to either § 1.483–4 or § 1.1275–4(c) (certain contingent payment debt instruments issued for nonpublicly traded property).

(ii) *Special rule to determine amount realized.* If a debt instrument subject to § 1.1275–4(c) is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under § 1.1274–2(g), increased by the fair market value of the contingent payments payable on the debt instrument. If a debt instrument subject to § 1.483–4 is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, the amount realized attributable to the debt instrument is its stated principal amount, reduced by any unstated interest (as determined under section 483), and increased by the fair market value of the contingent payments payable on the debt instrument. This paragraph (g)(2)(ii), however, does not apply to a debt instrument if the fair market value of the contingent payments is not reasonably ascertainable. Only in rare and extraordinary cases will the fair market value of the contingent payments be treated as not reasonably ascertainable.

(3) *Coordination with section 453.* If a debt instrument is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, this paragraph (g) applies rather than § 15a.453–1(d)(2) to determine the taxpayer's amount realized attributable to the debt instrument.

(4) *Effective date.* This paragraph (g) applies to sales or exchanges that occur on or after August 13, 1996.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7142, 36 FR 18950, Sept. 24, 1971; T.D. 7207, 37 FR 20797, Oct. 5, 1972; T.D. 7213, 37 FR 21992, Oct. 18, 1972; T.D. 8517, 59 FR 4807, Feb. 2, 1994; T.D. 8674, 61 FR 30139, June 14, 1996]

§ 1.1001–2 Discharge of liabilities.

(a) *Inclusion in amount realized*—(1) *In general.* Except as provided in paragraph (a) (2) and (3) of this section, the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.

(2) *Discharge of indebtedness.* The amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). For situations where amounts arising from the discharge of indebtedness are not realized and recognized, see section 108 and § 1.61–12(b)(1).

(3) *Liability incurred on acquisition.* In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property.

(4) *Special rules.* For purposes of this section—

(i) The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability;

(ii) The sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability);

(iii) A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject;

(iv) Contributions and distributions of property between a partner and a partnership are not sales or other dispositions of property; and

(v) The liabilities from which a transferor is discharged as a result of the sale or disposition of a partnership interest include the transferor's share of the liabilities of the partnership.

(b) *Effect of fair market value of security.* The fair market value of the security at the time of sale or disposition is not relevant for purposes of determining under paragraph (a) of this section the amount of liabilities from which the taxpayer is discharged or treated as discharged. Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property. However, see paragraph (a)(2) of this section for a rule relating to certain income from discharge of indebtedness.

(c) *Examples.* The provisions of this section may be illustrated by the following examples. In each example assume the taxpayer uses the cash receipts and disbursements method of accounting, makes a return on the basis of the calendar year, and sells or disposes of all property which is security for a given liability.

Example 1. In 1976 A purchases an asset for $10,000. A pays the seller $1,000 in cash and signs a note payable to the seller for $9,000. A is personally liable for repayment with the seller having full recourse in the event of default. In addition, the asset which was purchased is pledged as security. During the years 1976 and 1977, A takes depreciation deductions on the asset in the amount of $3,100. During this same time period A reduces the outstanding principal on the note to $7,600. At the beginning of 1978 A sells the asset. The buyer pays A $1,600 in cash and assumes personal liability for the $7,600 outstanding liability. A becomes secondarily liable for repayment of the liability. A's amount realized is $9,200 ($1,600 + $7,600). Since A's adjusted basis in the asset is $6,900 ($10,000 − $3,100) A realizes a gain of $2,300 ($9,200 − $6,900).

Example 2. Assume the same facts as in example (1) except that A is not personally liable on the $9,000 note given to the seller and in the event of default the seller's only recourse is to the asset. In addition, on the sale of the asset by A, the purchaser takes the asset subject to the liability. Nevertheless, A's amount realized is $9,200 and A's gain realized is $2,300 on the sale.

Example 3. In 1975 L becomes a limited partner in partnership GL. L contributes $10,000 in cash to GL and L's distributive share of partnership income and loss is 10 percent. L is not entitled to receive any guaranteed payments. In 1978 M purchases L's entire interest in partnership GL. At the time of the sale L's adjusted basis in the partnership interest is $20,000. At that time L's proportionate share of liabilities, of which no partner has assumed personal liability, is $15,000. M pays $10,000 in cash for L's interest in the partnership. Under section 752(d) and this section, L's share of partnership liabilities, $15,000, is treated as money received. Accordingly, L's amount realized on the sale of the partnership interest is $25,000 ($10,000 + $15,000). L's gain realized on the sale is $5,000 ($25,000 − $20,000).

Example 4. In 1976 B becomes a limited partner in partnership BG. In 1978 B contributes B's entire interest in BG to a charitable organization described in section 170(c). At the time of the contribution all of the partnership liabilities are liabilities for which neither B nor G has assumed any personal liability and B's proportionate share of which is $9,000. The charitable organization does not pay any cash or other property to B, but takes the partnership interest subject to the $9,000 of liabilities. Assume that the contribution is treated as a bargain sale to a charitable organization and that under section 1011(b) $3,000 is determined to be the portion of B's basis in the partnership interest allocable to the sale. Under section 752(d) and this section, the $9,000 of liabilities is treated by B as money received, thereby making B's amount realized $9,000. B's gain realized is $6,000 ($9,000 − $3,000).

Example 5. In 1975 C, an individual, creates T, an irrevocable trust. Due to certain powers expressly retained by C, T is a ''grantor trust'' for purposes of subpart E of part 1 of subchapter J of the code and therefore C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. In 1978, when the adjusted basis of the partnership interest held by T is $1,200, C renounces the powers previously and expressly retained that initially resulted in T being classified as a grantor trust. Consequently, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. At the time of the renunciation all of P's liabilities are liabilities on which none of the partners have assumed any personal liability and the proportionate share of which of the interest held by T is $11,000. Since prior to the renunciation C was the owner of the entire trust, C was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. Since C was considered to be the owner of the partnership interest, C not T, was considered to be the partner in P during the time T was a ''grantor trust''. However, at the time C renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor C. On the transfer, C's share of partnership liabilities ($11,000) is treated as money received. Accordingly, C's amount realized is $11,000 and C's gain realized is $9,800 ($11,000 − $1,200).

Example 6. In 1977 D purchases an asset for $7,500. D pays the seller $1,500 in cash and signs a note payable to the seller for $6,000. D is not personally liable for repayment but pledges as security the newly purchased asset. In the event of default, the seller's only recourse is to the asset. During the years 1977 and 1978 D takes depreciation deductions on the asset totaling $4,200 thereby reducing D's basis in the asset to $3,300 ($7,500 − $4,200). In 1979 D transfers the asset to a trust which is not a ''grantor trust'' for purposes of subpart E of part 1 of subchapter J of the Code. Therefore D is not treated as the owner of the trust. The trust takes the asset subject to the liability and in addition pays D $750 in cash. Prior to the transfer D had reduced the amount outstanding on the liability to $4,700. D's amount realized on the transfer is $5,450 ($4,700 + $750). Since D's adjusted basis is $3,300, D's gain realized is $2,150 ($5,450 − $3,300).

Example 7. In 1974 E purchases a herd of cattle for breeding purposes. The purchase price is $20,000 consisting of $1,000 cash and a $19,000 note. E is not personally liable for repayment of the liability and the seller's only recourse in the event of default is to the herd of cattle. In 1977 E transfers the herd back to the original seller thereby satisfying the indebtedness pursuant to a provision in the original sales agreement. At the time of the transfer the fair market value of the herd is $15,000 and the remaining principal balance on the note is $19,000. At that time E's adjusted basis in the herd is $16,500 due to a deductible loss incurred when a portion of the herd died as a result of disease. As a result of the indebtedness being satisfied, E's amount realized is $19,000 notwithstanding the fact that the fair market value of the herd was less than $19,000. E's realized gain is $2,500 ($19,000 − $16,500).

Example 8. In 1980, F transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value ($6,000). In addition, F has income from the discharge of indebtedness of $1,500 ($7,500 − $6,000).

[T.D. 7741, 45 FR 81744, Dec. 12, 1980]

§ 1.1001–3 Modifications of debt instruments.

(a) *Scope*—(1) *In general.* This section provides rules for determining whether a modification of the terms of a debt instrument results in an exchange for purposes of § 1.1001–1(a). This section applies to any modification of a debt instrument, regardless of the form of the modification. For example, this section applies to an exchange of a new instrument for an existing debt instrument, or to an amendment of an existing debt instrument. This section also applies to a modification of a debt instrument that the issuer and holder accomplish indirectly through one or more transactions with third parties. This section, however, does not apply to exchanges of debt instruments between holders.

(2) *Qualified tender bonds.* This section does not apply for purposes of determining whether tax-exempt bonds that are qualified tender bonds are reissued for purposes of sections 103 and 141 through 150.

(b) *General rule.* For purposes of §1.1001–1(a), a significant modification of a debt instrument, within the meaning of this section, results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent. A modification that is not a significant modification is not an exchange for purposes of §1.1001–1(a). Paragraphs (c) and (d) of this section define the term *modification* and contain examples illustrating the application of the rule. Paragraphs (e) and (f) of this section provide rules for determining when a modification is a significant modification. Paragraph (g) of this section contains examples illustrating the application of the rules in paragraphs (e) and (f) of this section.

(c) *Modification defined*—(1) *In general*—(i) *Alteration of terms.* A *modification* means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.

(ii) *Alterations occurring by operation of the terms of a debt instrument.* Except as provided in paragraph (c)(2) of this section, an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification. An alteration that occurs by operation of the terms may occur automatically (for example, an annual resetting of the interest rate based on the value of an index or a specified increase in the interest rate if the value of the collateral declines from a specified level) or may occur as a result of the exercise of an option provided to an issuer or a holder to change a term of a debt instrument.

(2) *Exceptions.* The alterations described in this paragraph (c)(2) are modifications, even if the alterations occur by operation of the terms of a debt instrument.

(i) *Change in obligor or nature of instrument.* An alteration that results in the substitution of a new obligor, the addition or deletion of a co-obligor, or a change (in whole or in part) in the recourse nature of the instrument (from recourse to nonrecourse or from nonrecourse to recourse) is a modification.

(ii) *Property that is not debt.* An alteration that results in an instrument or property right that is not debt for Federal income tax purposes is a modification unless the alteration occurs pursuant to a holder's option under the terms of the instrument to convert the instrument into equity of the issuer (notwithstanding paragraph (c)(2)(iii) of this section).

(iii) *Certain alterations resulting from the exercise of an option.* An alteration that results from the exercise of an option provided to an issuer or a holder to change a term of a debt instrument is a modification unless—

(A) The option is unilateral (as defined in paragraph (c)(3) of this section); and

(B) In the case of an option exercisable by a holder, the exercise of the option does not result in (or, in the case of a variable or contingent payment, is not reasonably expected to result in) a deferral of, or a reduction in, any scheduled payment of interest or principal.

(3) *Unilateral option.* For purposes of this section, an option is unilateral only if, under the terms of an instrument or under applicable law—

(i) There does not exist at the time the option is exercised, or as a result of the exercise, a right of the other party to alter or terminate the instrument or put the instrument to a person who is related (within the meaning of section 267(b) or section 707(b)(1)) to the issuer;

(ii) The exercise of the option does not require the consent or approval of—

(A) The other party;

(B) A person who is related to that party (within the meaning of section 267(b) or section 707(b)(1)), whether or not that person is a party to the instrument; or

(C) A court or arbitrator; and

(iii) The exercise of the option does not require consideration (other than incidental costs and expenses relating to the exercise of the option), unless, on the issue date of the instrument, the consideration is a de minimis amount, a specified amount, or an amount that is based on a formula that uses objective financial information (as defined in § 1.446–3(c)(4)(ii)).

(4) *Failure to perform*—(i) *In general.* The failure of an issuer to perform its obligations under a debt instrument is not itself an alteration of a legal right or obligation and is not a modification.

(ii) *Holder's temporary forbearance.* Notwithstanding paragraph (c)(1) of this section, absent a written or oral agreement to alter other terms of the debt instrument, an agreement by the holder to stay collection or temporarily waive an acceleration clause or similar default right (including such a waiver following the exercise of a right to demand payment in full) is not a modification unless and until the forbearance remains in effect for a period that exceeds—

(A) Two years following the issuer's initial failure to perform; and

(B) Any additional period during which the parties conduct good faith negotiations or during which the issuer is in a title 11 or similar case (as defined in section 368(a)(3)(A)).

(5) *Failure to exercise an option.* If a party to a debt instrument has an option to change a term of an instrument, the failure of the party to exercise that option is not a modification.

(6) *Time of modification*—(i) *In general.* Except as provided in this paragraph (c)(6), an agreement to change a term of a debt instrument is a modification at the time the issuer and holder enter into the agreement, even if the change in the term is not immediately effective.

(ii) *Closing conditions.* If the parties condition a change in a term of a debt instrument on reasonable closing conditions (for example, shareholder, regulatory, or senior creditor approval, or additional financing), a modification occurs on the closing date of the agreement. Thus, if the reasonable closing conditions do not occur so that the change in the term does not become effective, a modification does not occur.

(iii) *Bankruptcy proceedings.* If a change in a term of a debt instrument occurs pursuant to a plan of reorganization in a title 11 or similar case (within the meaning of section 368(a)(3)(A)), a modification occurs upon the effective date of the plan. Thus, unless the plan becomes effective, a modification does not occur.

(d) *Examples.* The following examples illustrate the provisions of paragraph (c) of this section:

Example 1. Reset bond. A bond provides for the interest rate to be reset every 49 days through an auction by a remarketing agent. The reset of the interest rate occurs by operation of the terms of the bond and is not an alteration described in paragraph (c)(2) of this section. Thus, the reset of the interest rate is not a modification.

Example 2. Obligation to maintain collateral. The original terms of a bond provide that the bond must be secured by a certain type of collateral having a specified value. The terms also require the issuer to substitute collateral if the value of the original collateral decreases. Any substitution of collateral that is required to maintain the value of the collateral occurs by operation of the terms of the bond and is not an alteration described in paragraph (c)(2) of this section. Thus, such a substitution of collateral is not a modification.

Example 3. Alteration contingent on an act of a party. The original terms of a bond provide that the interest rate is 9 percent. The terms also provide that, if the issuer files an effective registration statement covering the bonds with the Securities and Exchange Commission, the interest rate will decrease to 8 percent. If the issuer registers the bond, the resulting decrease in the interest rate occurs by operation of the terms of the bond and is not an alteration described in paragraph (c)(2) of this section. Thus, such a decrease in the interest rate is not a modification.

Example 4. Substitution of a new obligor occurring by operation of the terms of the debt instrument. Under the original terms of a bond issued by a corporation, an acquirer of substantially all of the corporation's assets may assume the corporation's obligations under the bond. Substantially all of the corporation's assets are acquired by another corporation and the acquiring corporation becomes the new obligor on the bond. Under paragraph (c)(2)(i) of this section, the substitution of a new obligor, even though it occurs by operation of the terms of the bond, is a modification.

Example 5. Defeasance with release of covenants. (i) A corporation issues a 30-year, recourse bond. Under the terms of the bond, the corporation may secure a release of the financial and restrictive covenants by placing in trust government securities as collateral that will provide interest and principal payments sufficient to satisfy all scheduled payments on the bond. The corporation remains obligated for all payments, including the contribution of additional securities to the trust if necessary to provide sufficient amounts to satisfy the payment obligations. Under paragraph (c)(3) of this section, the option to defease the bond is a unilateral option.

(ii) The alterations occur by operation of the terms of the debt instrument and are not described in paragraph (c)(2) of this section. Thus, such a release of the covenants is not a modification.

Example 6. Legal defeasance. Under the terms of a recourse bond, the issuer may secure a release of the financial and restrictive covenants by placing in trust government securities that will provide interest and principal payments sufficient to satisfy all scheduled payments on the bond. Upon the creation of the trust, the issuer is released from any recourse liability on the bond and has no obligation to contribute additional securities to the trust if the trust funds are not sufficient to satisfy the scheduled payments on the bond. The release of the issuer is an alteration described in paragraph (c)(2)(i) of this section, and thus is a modification.

Example 7. Exercise of an option by a holder that reduces amounts payable. (i) A financial institution holds a residential mortgage. Under the original terms of the mortgage, the financial institution has an option to decrease the interest rate. The financial institution anticipates that, if market interest rates decline, it may exercise this option in lieu of the mortgagor refinancing with another lender.

(ii) The financial institution exercises the option to reduce the interest rate. The exercise of the option results in a reduction in scheduled payments and is an alteration described in paragraph (c)(2)(iii) of this section. Thus, the change in interest rate is a modification.

Example 8. Conversion of adjustable rate to fixed rate mortgage. (i) The original terms of a mortgage provide for a variable interest rate, reset annually based on the value of an objective index. Under the terms of the mortgage, the mortgagor may, upon the payment of a fee equal to a specified percentage of the outstanding principal amount of the mortgage, convert to a fixed rate of interest as determined based on the value of a second objective index. The exercise of the option does not require the consent or approval of any person or create a right of the holder to alter the terms of, or to put, the instrument.

(ii) Because the required consideration to exercise the option is a specified amount fixed on the issue date, the exercise of the option is unilateral as defined in paragraph (c)(3) of this section. The conversion to a fixed rate of interest is not an alteration described in paragraph (c)(2) of this section. Thus, the change in the type of interest rate occurs by operation of the terms of the instrument and is not a modification.

Example 9. Holder's option to increase interest rate. (i) A corporation issues an 8-year note to a bank in exchange for cash. Under the terms of the note, the bank has the option to increase the rate of interest by a specified amount upon a certain decline in the corporation's credit rating. The bank's right to increase the interest rate is a unilateral option as described in paragraph (c)(3) of this section.

(ii) The credit rating of the corporation declines below the specified level. The bank exercises its option to increase the rate of interest. The increase in the rate of interest occurs by operation of the terms of the note and does not result in a deferral or a reduction in the scheduled payments or any other alteration described in paragraph (c)(2) of this section. Thus, the change in interest rate is not a modification.

Example 10. Issuer's right to defer payment of interest. A corporation issues a 5-year note. Under the terms of the note, interest is payable annually at the rate of 10 percent. The corporation, however, has an option to defer any payment of interest until maturity. For any payments that are deferred, interest will compound at a rate of 12 percent. The exercise of the option, which results in the deferral of payments, does not result from the exercise of an option by the holder. The exercise of the option occurs by operation of the terms of the debt instrument and is not a modification.

Example 11. Holder's option to grant deferral of payment. (i) A corporation issues a 10-year note to a bank in exchange for cash. Interest on the note is payable semi-annually. Under the terms of the note, the bank may grant the corporation the right to defer all or part of the interest payments. For any payments that are deferred, interest will compound at a rate 150 basis points greater than the stated rate of interest.

(ii) The corporation encounters financial difficulty and is unable to satisfy its obligations under the note. The bank exercises its option under the note and grants the corporation the right to defer payments. The exercise of the option results in a right of the corporation to defer scheduled payments and, under paragraph (c)(3)(i) of this section, is not a unilateral option. Thus, the alteration is described in paragraph (c)(2)(iii) of this section and is a modification.

Example 12. Alteration requiring consent. The original terms of a bond include a provision that the issuer may extend the maturity of the bond with the consent of the holder. Because any extension pursuant to this term requires the consent of both parties, such an extension does not occur by the exercise of a unilateral option (as defined in paragraph (c)(3) of this section) and is a modification.

Example 13. Waiver of an acceleration clause. Under the terms of a bond, if the issuer fails to make a scheduled payment, the full principal amount of the bond is due and payable immediately. Following the issuer's failure to make a scheduled payment, the holder temporarily waives its right to receive the full principal for a period ending one year from the date of the issuer's default to allow the issuer to obtain additional financial resources. Under paragraph (c)(4)(ii) of this section, the temporary waiver in this situation is not a modification. The result would be the same if the terms provided the holder with the right to demand the full principal amount upon the failure of the issuer to make a scheduled payment and, upon such a failure, the holder exercised that right and then waived the right to receive the payment for one year.

(e) *Significant modifications.* Whether the modification of a debt instrument is a significant modification is determined under the rules of this paragraph (e). Paragraph (e)(1) of this section provides a general rule for determining the significance of modifications not otherwise addressed in this paragraph (e). Paragraphs (e) (2) through (6) of this section provide specific rules for determining the significance of certain types of modifications. Paragraph (f) of this section provides rules of application, including rules for modifications that are effective on a deferred basis or upon the occurrence of a contingency.

(1) *General rule.* Except as otherwise provided in paragraphs (e)(2) through (e)(6) of this section, a modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant. In making a determination under this paragraph (e)(1), all modifications to the debt instrument (other than modifications subject to paragraphs (e) (2) through (6) of this section) are considered collectively, so that a series of such modifications may be significant when considered together although each modification, if considered alone, would not be significant.

(2) *Change in yield*—(i) *Scope of rule.* This paragraph (e)(2) applies to debt instruments that provide for only fixed payments, debt instruments with alternative payment schedules subject to § 1.1272–1(c), debt instruments that provide for a fixed yield subject to § 1.1272–1(d) (such as certain demand loans), and variable rate debt instruments. Whether a change in the yield of other debt instruments (for example, a contingent payment debt instrument) is a significant modification is determined under paragraph (e)(1) of this section.

(ii) *In general.* A change in the yield of a debt instrument is a significant modification if the yield computed under paragraph (e)(2)(iii) of this section varies from the annual yield on the unmodified instrument (determined as of the date of the modification) by more than the greater of—

(A) ¼ of one percent (25 basis points); or

(B) 5 percent of the annual yield of the unmodified instrument (.05 × annual yield).

(iii) *Yield of the modified instrument*—(A) *In general.* The yield computed under this paragraph (e)(2)(iii) is the annual yield of a debt instrument with—

(*1*) An issue price equal to the adjusted issue price of the unmodified instrument on the date of the modification (increased by any accrued but unpaid interest and decreased by any accrued bond issuance premium not yet taken into account, and increased or decreased, respectively, to reflect payments made to the issuer or to the holder as consideration for the modification); and

(*2*) Payments equal to the payments on the modified debt instrument from the date of the modification.

(B) *Prepayment penalty.* For purposes of this paragraph (e)(2)(iii), a commercially reasonable prepayment penalty for a pro rata prepayment (as defined in § 1.1275–2(f)) is not consideration for a modification of a debt instrument and is not taken into account in determining the yield of the modified instrument.

(iv) *Variable rate debt instruments.* For purposes of this paragraph (e)(2), the annual yield of a variable rate debt instrument is the annual yield of the equivalent fixed rate debt instrument (as defined in § 1.1275–5(e)) which is constructed based on the terms of the instrument (either modified or unmodified, whichever is applicable) as of the date of the modification.

(3) *Changes in timing of payments*—(i) *In general.* A modification that changes

the timing of payments (including any resulting change in the amount of payments) due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments. The deferral may occur either through an extension of the final maturity date of an instrument or through a deferral of payments due prior to maturity. The materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the instrument, the amounts of the payments that are deferred, and the time period between the modification and the actual deferral of payments.

(ii) *Safe-harbor period.* The deferral of one or more scheduled payments within the safe-harbor period is not a material deferral if the deferred payments are unconditionally payable no later than at the end of the safe-harbor period. The safe-harbor period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50 percent of the original term of the instrument. For purposes of this paragraph (e)(3)(ii), the term of an instrument is determined without regard to any option to extend the original maturity and deferrals of de minimis payments are ignored. If the period during which payments are deferred is less than the full safe-harbor period, the unused portion of the period remains a safe-harbor period for any subsequent deferral of payments on the instrument.

(4) *Change in obligor or security*—(i) *Substitution of a new obligor on recourse debt instruments*—(A) *In general.* Except as provided in paragraph (e)(4)(i) (B), (C), or (D) of this section, the substitution of a new obligor on a recourse debt instrument is a significant modification.

(B) *Section 381(a) transaction.* The substitution of a new obligor is not a significant modification if the acquiring corporation (within the meaning of section 381) becomes the new obligor pursuant to a transaction to which section 381(a) applies, the transaction does not result in a change in payment expectations, and the transaction (other than a reorganization within the meaning of section 368(a)(1)(F)) does not result in a significant alteration.

(C) *Certain asset acquisitions.* The substitution of a new obligor is not a significant modification if the new obligor acquires substantially all of the assets of the original obligor, the transaction does not result in a change in payment expectations, and the transaction does not result in a significant alteration.

(D) *Tax-exempt bonds.* The substitution of a new obligor on a tax-exempt bond is not a significant modification if the new obligor is a related entity to the original obligor as defined in section 168(h)(4)(A) and the collateral securing the instrument continues to include the original collateral.

(E) *Significant alteration.* For purposes of this paragraph (e)(4), a significant alteration is an alteration that would be a significant modification but for the fact that the alteration occurs by operation of the terms of the instrument.

(F) *Section 338 election.* For purposes of this section, an election under section 338 following a qualified stock purchase of an issuer's stock does not result in the substitution of a new obligor.

(G) *Bankruptcy proceedings.* For purposes of this section, the filing of a petition in a title 11 or similar case (as defined in section 368(a)(3)(A)) by itself does not result in the substitution of a new obligor.

(ii) *Substitution of a new obligor on nonrecourse debt instruments.* The substitution of a new obligor on a nonrecourse debt instrument is not a significant modification.

(iii) *Addition or deletion of co-obligor.* The addition or deletion of a co-obligor on a debt instrument is a significant modification if the addition or deletion of the co-obligor results in a change in payment expectations. If the addition or deletion of a co-obligor is part of a transaction or series of related transactions that results in the substitution of a new obligor, however, the transaction is treated as a substitution of a new obligor (and is tested under paragraph (e)(4)(i)) of this section rather than as an addition or deletion of a co-obligor.

(iv) *Change in security or credit enhancement*—(A) *Recourse debt instruments.* A modification that releases, substitutes, adds or otherwise alters the collateral for, a guarantee on, or other form of credit enhancement for a recourse debt instrument is a significant modification if the modification results in a change in payment expectations.

(B) *Nonrecourse debt instruments.* A modification that releases, substitutes, adds or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for a nonrecourse debt instrument is a significant modification. A substitution of collateral is not a significant modification, however, if the collateral is fungible or otherwise of a type where the particular units pledged are unimportant (for example, government securities or financial instruments of a particular type and rating). In addition, the substitution of a similar commercially available credit enhancement contract is not a significant modification, and an improvement to the property securing a nonrecourse debt instrument does not result in a significant modification.

(v) *Change in priority of debt.* A change in the priority of a debt instrument relative to other debt of the issuer is a significant modification if it results in a change in payment expectations.

(vi) *Change in payment expectations*—(A) *In general.* For purposes of this section, a change in payment expectations occurs if, as a result of a transaction—

(*1*) There is a substantial enhancement of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was primarily speculative prior to the modification and is adequate after the modification; or

(*2*) There is a substantial impairment of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was adequate prior to the modification and is primarily speculative after the modification.

(B) *Obligor's capacity.* The obligor's capacity includes any source for payment, including collateral, guarantees, or other credit enhancement.

(5) *Changes in the nature of a debt instrument*—(i) *Property that is not debt.* A modification of a debt instrument that results in an instrument or property right that is not debt for Federal income tax purposes is a significant modification. For purposes of this paragraph (e)(5)(i), any deterioration in the financial condition of the obligor between the issue date of the unmodified instrument and the date of modification (as it relates to the obligor's ability to repay the debt) is not taken into account unless, in connection with the modification, there is a substitution of a new obligor or the addition or deletion of a co-obligor.

(ii) *Change in recourse nature*—(A) *In general.* Except as provided in paragraph (e)(5)(ii)(B) of this section, a change in the nature of a debt instrument from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse) is a significant modification. Thus, for example, a legal defeasance of a debt instrument in which the issuer is released from all liability to make payments on the debt instrument (including an obligation to contribute additional securities to a trust if necessary to provide sufficient funds to meet all scheduled payments on the instrument) is a significant modification. Similarly, a change in the nature of the debt instrument from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse) is a significant modification. If an instrument is not substantially all recourse or not substantially all nonrecourse either before or after a modification, the significance of the modification is determined under paragraph (e)(1) of this section.

(B) *Exceptions*—(*1*) *Defeasance of tax-exempt bonds.* A defeasance of a tax-exempt bond is not a significant modification even if the issuer is released from any liability to make payments under the instrument if the defeasance occurs by operation of the terms of the original bond and the issuer places in trust government securities or tax-exempt government bonds that are reasonably expected to provide interest and principal payments sufficient to satisfy the payment obligations under the bond.

(*2*) *Original collateral.* A modification that changes a recourse debt instrument to a nonrecourse debt instrument is not a significant modification if the instrument continues to be secured only by the original collateral and the modification does not result in a change in payment expectations. For this purpose, if the original collateral is fungible or otherwise of a type where the particular units pledged are unimportant (for example, government securities or financial instruments of a particular type and rating), replacement of some or all units of the original collateral with other units of the same or similar type and aggregate value is not considered a change in the original collateral.

(6) *Accounting or financial covenants.* A modification that adds, deletes, or alters customary accounting or financial covenants is not a significant modification.

(f) *Rules of application*—(1) *Testing for significance*—(i) *In general.* Whether a modification of any term is a significant modification is determined under each applicable rule in paragraphs (e) (2) through (6) of this section and, if not specifically addressed in those rules, under the general rule in paragraph (e)(1) of this section. For example, a deferral of payments that changes the yield of a fixed rate debt instrument must be tested under both paragraphs (e) (2) and (3) of this section.

(ii) *Contingent modifications.* If a modification described in paragraphs (e) (2) through (5) of this section is effective only upon the occurrence of a substantial contingency, whether or not the change is a significant modification is determined under paragraph (e)(1) of this section rather than under paragraphs (e) (2) through (5) of this section.

(iii) *Deferred modifications.* If a modification described in paragraphs (e) (4) and (5) of this section is effective on a substantially deferred basis, whether or not the change is a significant modification is determined under paragraph (e)(1) of this section rather than under paragraphs (e) (4) and (5) of this section.

(2) *Modifications that are not significant.* If a rule in paragraphs (e) (2) through (4) of this section prescribes a degree of change in a term of a debt instrument that is a significant modification, a change of the same type but of a lesser degree is not a significant modification under that rule. For example, a 20 basis point change in the yield of a fixed rate debt instrument is not a significant modification under paragraph (e)(2) of this section. Likewise, if a rule in paragraph (e)(4) of this section requires a change in payment expectations for a modification to be significant, a modification of the same type that does not result in a change in payment expectations is not a significant modification under that rule.

(3) *Cumulative effect of modifications.* Two or more modifications of a debt instrument over any period of time constitute a significant modification if, had they been done as a single change, the change would have resulted in a significant modification under paragraph (e) of this section. Thus, for example, a series of changes in the maturity of a debt instrument constitutes a significant modification if, combined as a single change, the change would have resulted in a significant modification. The significant modification occurs at the time that the cumulative modification would be significant under paragraph (e) of this section. In testing for a change of yield under paragraph (e)(2) of this section, however, any prior modification occurring more than 5 years before the date of the modification being tested is disregarded.

(4) *Modifications of different terms.* Modifications of different terms of a debt instrument, none of which separately would be a significant modification under paragraphs (e) (2) through (6) of this section, do not collectively constitute a significant modification. For example, a change in yield that is not a significant modification under paragraph (e)(2) of this section and a substitution of collateral that is not a significant modification under paragraph (e)(4)(iv) of this section do not together result in a significant modification. Although the significance of each modification is determined independently, in testing a particular modification it is assumed that all

other simultaneous modifications have already occurred.

(5) *Definitions.* For purposes of this section:

(i) *Issuer* and *obligor* are used interchangeably and mean the issuer of a debt instrument or a successor obligor.

(ii) *Variable rate debt instrument* and *contingent payment debt instrument* have the meanings given those terms in section 1275 and the regulations thereunder.

(iii) *Tax-exempt bond* means a state or local bond that satisfies the requirements of section 103(a).

(iv) *Conduit loan* and *conduit borrower* have the same meanings as in § 1.150–1(b).

(6) *Certain rules for tax-exempt bonds*—(i) *Conduit loans.* For purposes of this section, the obligor of a tax-exempt bond is the entity that actually issues the bond and not a conduit borrower of bond proceeds. In determining whether there is a significant modification of a tax-exempt bond, however, transactions between holders of the tax-exempt bond and a borrower of a conduit loan may be an indirect modification under paragraph (a)(1) of this section. For example, a payment by the holder of a tax-exempt bond to a conduit borrower to waive a call right may result in an indirect modification of the tax-exempt bond by changing the yield on that bond.

(ii) *Recourse nature*—(A) *In general.* For purposes of this section, a tax-exempt bond that does not finance a conduit loan is a recourse debt instrument.

(B) *Proceeds used for conduit loans.* For purposes of this section, a tax-exempt bond that finances a conduit loan is a recourse debt instrument unless both the bond and the conduit loan are nonrecourse instruments.

(C) *Government securities as collateral.* Notwithstanding paragraphs (f)(6)(ii) (A) and (B) of this section, for purposes of this section a tax-exempt bond that is secured only by a trust holding government securities or tax-exempt government bonds that are reasonably expected to provide interest and principal payments sufficient to satisfy the payment obligations under the bond is a nonrecourse instrument.

(g) *Examples.* The following examples illustrate the provisions of paragraphs (e) and (f) of this section:

Example 1. Modification of call right. (i) Under the terms of a 30-year, fixed-rate bond, the issuer can call the bond for 102 percent of par at the end of ten years or for 101 percent of par at the end of 20 years. At the end of the eighth year, the holder of the bond pays the issuer to waive the issuer's right to call the bond at the end of the tenth year. On the date of the modification, the issuer's credit rating is approximately the same as when the bond was issued, but market rates of interest have declined from that date.

(ii) The holder's payment to the issuer changes the yield on the bond. Whether the change in yield is a significant modification depends on whether the yield on the modified bond varies from the yield on the original bond by more than the change in yield as described in paragraph (e)(2)(ii) of this section.

(iii) If the change in yield is not a significant modification, the elimination of the issuer's call right must also be tested for significance. Because the specific rules of paragraphs (e)(2) through (e)(6) of this section do not address this modification, the significance of the modification must be determined under the general rule of paragraph (e)(1) of this section.

Example 2. Extension of maturity and change in yield. (i) A zero-coupon bond has an original maturity of ten years. At the end of the fifth year, the parties agree to extend the maturity for a period of two years without increasing the stated redemption price at maturity (i.e., there are no additional payments due between the original and extended maturity dates, and the amount due at the extended maturity date is equal to the amount due at the original maturity date).

(ii) The deferral of the scheduled payment at maturity is tested under paragraph (e)(3) of this section. The safe-harbor period under paragraph (e)(3)(ii) of this section starts with the date the payment that is being deferred is due. For this modification, the safe-harbor period starts on the original maturity date, and ends five years from this date. All payments deferred within this period are unconditionally payable before the end of the safe-harbor period. Thus, the deferral of the payment at maturity for a period of two years is not a material deferral under the safe-harbor rule of paragraph (e)(3)(ii) of this section and thus is not a significant modification.

(iii) Even though the extension of maturity is not a significant modification under paragraph (e)(3)(ii) of this section, the modification also decreases the yield of the bond. The change in yield must be tested under paragraph (e)(2) of this section.

Example 3. Change in yield resulting from reduction of principal. (i) A debt instrument issued at par has an original maturity of ten years and provides for the payment of $100,000 at maturity with interest payments at the rate of 10 percent payable at the end of each year. At the end of the fifth year, and after the annual payment of interest, the issuer and holder agree to reduce the amount payable at maturity to $80,000. The annual interest rate remains at 10 percent but is payable on the reduced principal.

(ii) In applying the change in yield rule of paragraph (e)(2) of this section, the yield of the instrument after the modification (measured from the date that the parties agree to the modification to its final maturity date) is computed using the adjusted issue price of $100,000. With four annual payments of $8,000, and a payment of $88,000 at maturity, the yield on the instrument after the modification for purposes of determining if there has been a significant modification under paragraph (e)(2)(i) of this section is 4.332 percent. Thus, the reduction in principal is a significant modification.

Example 4. Deferral of scheduled interest payments. (i) A 20-year debt instrument issued at par provides for the payment of $100,000 at maturity with annual interest payments at the rate of 10 percent. At the beginning of the eleventh year, the issuer and holder agree to defer all remaining interest payments until maturity with compounding. The yield of the modified instrument remains at 10 percent.

(ii) The safe-harbor period of paragraph (e)(3)(ii) of this section begins at the end of the eleventh year, when the interest payment for that year is deferred, and ends at the end of the sixteenth year. However, the payments deferred during this period are not unconditionally payable by the end of that 5-year period. Thus, the deferral of the interest payments is not within the safe-harbor period.

(iii) This modification materially defers the payments due under the instrument and is a significant modification under paragraph (e)(3)(i) of this section.

Example 5. Assumption of mortgage with increase in interest rate. (i) A recourse debt instrument with a 9 percent annual yield is secured by an office building. Under the terms of the instrument, a purchaser of the building may assume the debt and be substituted for the original obligor if the purchaser has a specified credit rating and if the interest rate on the instrument is increased by one-half percent (50 basis points). The building is sold, the purchaser assumes the debt, and the interest rate increases by 50 basis points.

(ii) If the purchaser's acquisition of the building does not satisfy the requirements of paragraphs (e)(4)(i) (B) or (C) of this section, the substitution of the purchaser as the obligor is a significant modification under paragraph (e)(4)(i)(A) of this section.

(iii) If the purchaser acquires substantially all of the assets of the original obligor, the assumption of the debt instrument will not result in a significant modification if there is not a change in payment expectations and the assumption does not result in a significant alteration.

(iv) The change in the interest rate, if tested under the rules of paragraph (e)(2) of this section, would result in a significant modification. The change in interest rate that results from the transaction is a significant alteration. Thus, the transaction does not meet the requirements of paragraph (e)(4)(i)(C) of this section and is a significant modification under paragraph (e)(4)(i)(A) of this section.

Example 6. Assumption of mortgage. (i) A recourse debt instrument is secured by a building. In connection with the sale of the building, the purchaser of the building assumes the debt and is substituted as the new obligor on the debt instrument. The purchaser does not acquire substantially all of the assets of the original obligor.

(ii) The transaction does not satisfy any of the exceptions set forth in paragraph (e)(4)(i) (B) or (C) of this section. Thus, the substitution of the purchaser as the obligor is a significant modification under paragraph (e)(4)(i)(A) of this section.

(iii) Section 1274(c)(4), however, provides that if a debt instrument is assumed in connection with the sale or exchange of property, the assumption is not taken into account in determining if section 1274 applies to the debt instrument unless the terms and conditions of the debt instrument are modified in connection with the sale or exchange. Because the purchaser assumed the debt instrument in connection with the sale of property and the debt instrument was not otherwise modified, the debt instrument is not retested to determine whether it provides for adequate stated interest.

Example 7. Substitution of a new obligor in section 381(a) transaction. (i) The interest rate on a 30-year debt instrument issued by a corporation provides for a variable rate of interest that is reset annually on June 1st based on an objective index.

(ii) In the tenth year, the issuer merges (in a transaction to which section 381(a) applies) into another corporation that becomes the new obligor on the debt instrument. The merger occurs on June 1st, at which time the interest rate is also reset by operation of the terms of the instrument. The new interest rate varies from the previous interest rate by more than the greater of 25 basis points and 5 percent of the annual yield of the unmodified instrument. The substitution of a new obligor does not result in a change in payment expectations.

(iii) The substitution of the new obligor occurs in a section 381(a) transaction and does not result in a change in payment expectations. Although the interest rate changed by more than the greater of 25 basis points and

5 percent of the annual yield of the unmodified instrument, this alteration did not occur as a result of the transaction and is not a significant alteration under paragraph (e)(4)(i)(E) of this section. Thus, the substitution meets the requirements of paragraph (e)(4)(i)(B) of this section and is not a significant modification.

Example 8. Substitution of credit enhancement contract. (i) Under the terms of a recourse debt instrument, the issuer's obligations are secured by a letter of credit from a specified bank. The debt instrument does not contain any provision allowing a substitution of a letter of credit from a different bank. The specified bank, however, encounters financial difficulty and rating agencies lower its credit rating. The issuer and holder agree that the issuer will substitute a letter of credit from another bank with a higher credit rating.

(ii) Under paragraph (e)(4)(iv)(A) of this section, the substitution of a different credit enhancement contract is not a significant modification of a recourse debt instrument unless the substitution results in a change in payment expectations. While the substitution of a new letter of credit by a bank with a higher credit rating does not itself result in a change in payment expectations, such a substitution may result in a change in payment expectations under certain circumstances (for example, if the obligor's capacity to meet payment obligations is dependent on the letter of credit and the substitution substantially enhances that capacity from primarily speculative to adequate).

Example 9. Improvement to collateral securing nonrecourse debt. A parcel of land and its improvements, a shopping center, secure a nonrecourse debt instrument. The obligor expands the shopping center with the construction of an additional building on the same parcel of land. After the construction, the improvements that secure the nonrecourse debt include the new building. The building is an improvement to the property securing the nonrecourse debt instrument and its inclusion in the collateral securing the debt is not a significant modification under paragraph (e)(4)(iv)(B) of this section.

(h) *Effective date.* This section applies to alterations of the terms of a debt instrument on or after September 24, 1996. Taxpayers, however, may rely on this section for alterations of the terms of a debt instrument after December 2, 1992, and before September 24, 1996.

[T.D. 8675, 61 FR 32930, June 26, 1996; 61 FR 47822, Sept. 11, 1996]

§ 1.1001–4 Modifications of certain notional principal contracts.

(a) *Dealer assignments.* For purposes of § 1.1001–1(a), the substitution of a new party on an interest rate or commodity swap, or other notional principal contract (as defined in § 1.446–3(c)(1)), is not treated as a deemed exchange by the nonassigning party of the original contract for a modified contract that differs materially either in kind or in extent if—

(1) The party assigning its rights and obligations under the contract and the party to which the rights and obligations are assigned are both dealers in notional principal contracts, as defined in § 1.446–3(c)(4)(iii); and

(2) The terms of the contract permit the substitution.

(b) *Effective date.* This section applies to assignments of interest rate swaps, commodity swaps, and other notional principal contracts occurring on or after September 23, 1996.

[T.D. 8763, 63 FR 4396, Jan. 29, 1998]

§ 1.1001–5T European Monetary Union (conversion to the euro)(temporary).

(a) *Conversion of currencies.* For purposes of § 1.1001–1(a), the conversion to the euro of legacy currencies (as defined in § 1.985–8T(a)(1)) is not the exchange of property for other property differing materially in kind or extent.

(b) *Effect of currency conversion on other rights and obligations.* For purposes of § 1.1001–1(a), if, solely as the result of the conversion of legacy currencies to the euro, rights or obligations denominated in a legacy currency become rights or obligations denominated in the euro, that event is not the exchange of property for other property differing materially in kind or extent. Thus, for example, when a debt instrument that requires payments of amounts denominated in a legacy currency becomes a debt instrument requiring payments of euros, that alteration is not a modification within the meaning of § 1.1001–3(c).

(c) *Effective date.* This section applies to tax years ending after July 29, 1998.

[T.D. 8776, 63 FR 40369, July 29, 1998]

§1.1002–1 Sales or exchanges.

(a) *General rule.* The general rule with respect to gain or loss realized upon the sale or exchange of property as determined under section 1001 is that the entire amount of such gain or loss is recognized except in cases where specific provisions of subtitle A of the code provide otherwise.

(b) *Strict construction of exceptions from general rule.* The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

(c) *Certain exceptions to general rule.* Exceptions to the general rule are made, for example, by sections 351(a), 354, 361(a), 371(a)(1), 371(b)(1), 721, 1031, 1035 and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

(d) *Exchange.* Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

BASIS RULES OF GENERAL APPLICATION

§1.1011–1 Adjusted basis.

The adjusted basis for determining the gain or loss from the sale or other disposition of property is the cost or other basis prescribed in section 1012 or other applicable provisions of subtitle A of the code, adjusted to the extent provided in sections 1016, 1017, and 1018 or as otherwise specifically provided for under applicable provisions of internal revenue laws.

§1.1011–2 Bargain sale to a charitable organization.

(a) *In general.* (1) If for the taxable year a charitable contributions deduction is allowable under section 170 by reason of a sale or exchange of property, the taxpayer's adjusted basis of such property for purposes of determining gain from such sale or exchange must be computed as provided in section 1011(b) and paragraph (b) of this section. If after applying the provisions of section 170 for the taxable year, including the percentage limitations of section 170(b), no deduction is allowable under that section by reason of the sale or exchange of the property, section 1011(b) does not apply and the adjusted basis of the property is not required to be apportioned pursuant to paragraph (b) of this section. In such case the entire adjusted basis of the property is to be taken into account in determining gain from the sale or exchange, as provided in §1.1011–1(e). In ascertaining whether or not a charitable contributions deduction is allowable under section 170 for the taxable year for such purposes, that section is to be applied without regard to this section and the amount by which the contributed portion of the property must be reduced under section 170(e)(1) is the amount determined by taking into account the amount of gain which would have been ordinary income or long-term capital gain if the contributed portion of the property had been sold by the donor at its fair market value at the time of the sale or exchange.

(2) If in the taxable year there is a sale or exchange of property which gives rise to a charitable contribution which is carried over under section 170(b)(1)(D)(ii) or section 170(d) to a subsequent taxable year or is postponed under section 170(a)(3) to a subsequent taxable year, section 1011(b) and paragraph (b) of this section must be applied for purposes of apportioning the adjusted basis of the property for the year of the sale or exchange, whether or not such contribution is allowable as a deduction under section 170 in such subsequent year.

(3) If property is transferred subject to an indebtedness, the amount of the indebtedness must be treated as an amount realized for purposes of determining whether there is a sale or exchange to which section 1011(b) and this section apply, even though the transferee does not agree to assume or pay the indebtedness.

(4)(i) Section 1011(b) and this section apply where property is sold or exchanged in return for an obligation to pay an annuity and a charitable contributions deduction is allowable under section 170 by reason of such sale or exchange.

(ii) If in such case the annuity received in exchange for the property is nonassignable, or is assignable but only to the charitable organization to which the property is sold or exchanged, and if the transferor is the only annuitant or the transferor and a designated survivor annuitant or annuitants are the only annuitants, any gain on such exchange is to be reported as provided in example (8) in paragraph (c) of this section. In determining the period over which gain may be reported as provided in such example, the life expectancy of the survivor annuitant may not be taken into account. The fact that the transferor may retain the right to revoke the survivor's annuity or relinquish his own right to the annuity will not be considered, for purposes of this subdivision, to make the annuity assignable to someone other than the charitable organization. Gain on an exchange of the type described in this subdivision pursuant to an agreement which is entered into after December 19, 1969, and before May 3, 1971, may be reported as provided in example (8) in paragraph (c) of this section, even though the annuity is assignable.

(iii) In the case of an annuity to which subdivision (ii) of this subparagraph applies, the gain unreported by the transferor with respect to annuity payments not yet due when the following events occur is not required to be included in gross income of any person where—

(*a*) The transferor dies before the entire amount of gain has been reported and there is no surviving annuitant, or

(*b*) The transferor relinquishes the annuity to the charitable organization.

If the transferor dies before the entire amount of gain on a two-life annuity has been reported, the unreported gain is required to be reported by the surviving annuitant or annuitants with respect to the annuity payments received by them.

(b) *Apportionment of adjusted basis.* For purposes of determining gain on a sale or exchange to which this paragraph applies, the adjusted basis of the property which is sold or exchanged shall be that portion of the adjusted basis of the entire property which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the entire property. The amount of such gain which shall be treated as ordinary income (or long-term capital gain) shall be that amount which bears the same ratio to the ordinary income (or long-term capital gain) which would have been recognized if the entire property had been sold by the donor at its fair market value at the time of the sale or exchange as the amount realized on the sale or exchange bears to the fair market value of the entire property at such time. The terms *ordinary income* and *long-term capital gain,* as used in this section, have the same meaning as they have in paragraph (a) of § 1.170A–4. For determining the portion of the adjusted basis, ordinary income, and long- term capital gain allocated to the contributed portion of the property for purposes of applying section 170(e)(1) and paragraph (a) of § 1.170A–4 to the contributed portion of the property, and for determining the donee's basis in such contributed portion, see paragraph (c) (2) and (4) of §1.170A–4. For determining the holding period of such contributed portion, see section 1223(2) and the regulations thereunder.

(c) *Illustrations.* The application of this section may be illustrated by the following examples, which are supplemented by other examples in paragraph (d) of §1.170A–4:

Example 1. In 1970, A, a calendar-year individual taxpayer, sells to a church for $4,000 stock held for more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. A's contribution base for 1970, as defined in section 170(b)(1)(F), is $100,000, and during that year he makes no other charitable contributions. Thus, A makes a charitable contribution to the church of $6,000 ($10,000 value −$4,000 amount realized). Without regard to this section, A is allowed a deduction under section 170 of $6,000 for his charitable contribution to the church, since there is no reduction under section 170(e)(1) with respect to the long-term capital gain. Accordingly, under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $1,600 ($4,000 adjusted basis × $4,000 amount realized / $10,000 value of property). A has recognized long-term capital gain of $2,400 ($4,000 amount realized − $1,600 adjusted basis) on the bargain sale.

Example 2. The facts are the same as in example (1) except that A also makes a charitable contribution in 1970 of $50,000 cash to the church. By reason of section 170(b)(1)(A), the deduction allowed under section 170 for 1970 is $50,000 for the amount of cash contributed to the church; however, the $6,000 contribution of property is carried over to 1971 under section 170(d). Under paragraphs (a)(2) and (b) of this section the adjusted basis for determining gain for 1970 on the bargain sale in that year is $1,600 ($4,000 × $4,000 / $10,000). A has a recognized long-term capital gain for 1970 of $2,400 ($4,000 − $1,600) on the sale.

Example 3. In 1970, C, a calendar-year individual taxpayer, makes a charitable contribution of $50,000 cash to a church. In addition, he sells for $4,000 to a private foundation not described in section 170(b)(1)(E) stock held for more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. Thus, C makes a charitable contribution of $6,000 of such property to the private foundation ($10,000 value − $4,000 amount realized). C's contribution base for 1970, as defined in section 170(b)(1)(F), is $100,000, and during that year he makes no other charitable contributions. By reason of section 170(b)(1)(A), the deduction allowed under section 170 for 1970 is $50,000 for the amount of cash contributed to the church. Under section 170(e)(1)(B)(ii) and paragraphs (a)(1) and (c)(2)(i) of §1.170A–4, the $6,000 contribution of stock is reduced to $4,800 ($6,000 − [50% × ($6,000 value of contributed portion of stock − $3,600 adjusted basis)]). However, by reason of section 170(b)(1)(B)(ii), applied without regard to section 1011(b), no deduction is allowed under section 170 for 1970 or any other year for the reduced contribution of $4,800 to the private foundation. Accordingly, paragraph (b) of this section does not apply for purposes of apportioning the adjusted basis of the stock sold to the private foundation, and under section 1.1011–1(e) the recognized gain on the bargain sale is $0 ($4,000 amount realized − $4,000 adjusted basis).

Example 4. In 1970, B, a calendar-year individual taxpayer, sells to a church for $2,000 stock held for not more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. B's contribution base for 1970, as defined in section 170(b)(1)(F), is $20,000 and during such year B makes no other charitable contributions. Thus, he makes a charitable contribution to the church of $8,000 ($10,000 value − $2,000 amount realized). Under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $800 ($4,000 adjusted basis × $2,000 amount realized / $10,000 value of stock). Accordingly, B, has a recognized short-term capital gain of $1,200 ($2,000 amount realized − $800 adjusted basis) on the bargain sale. After applying section 1011(b) and paragraphs (a)(1) and (c)(2)(i) of §1.170A–4, B is allowed a charitable contributions deduction for 1970 of $3,200 ($8,000 value of gift − [$8,000 − ($4,000 adjusted basis of property × $8,000 value of gift / $10,000 value of property)]).

Example 5. The facts are the same as in Example 4 except that B sells the property to the church for $4,000. Thus, B makes a charitable contribution to the church of $6,000 ($10,000 value −$4,000 amount realized). Under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $1,600 ($4,000 adjusted basis × $4,000 amount realized / $10,000 value of stock). Accordingly, B has a recognized short-term capital gain of $2,400 ($4,000 amount realized − $1,600 adjusted basis) on the bargain sale. After applying section 1011(b) and paragraphs (a)(1) and (c)(2)(i) of §1.170A–4, B is allowed a charitable contributions deduction for 1970 of $2,400 ($6,000 value of gift − [$6,000 − ($4,000 adjusted basis of property × $6,000 value of gifts / $10,000 value of property)]).

Example 6. The facts are the same as in Example 4 except that B sells the property to the church for $6,000. Thus, B makes a charitable contribution to the church of $4,000 ($10,000 value −$6,000 amount realized). Under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $2,400 ($4,000 adjusted basis

×$6,000 amount realized/$10,000 value of stock). Accordingly, B has a recognized short-term capital gain of $3,600 ($6,000 amount realized −$2,400 adjusted basis) on the bargain sale. After applying section 1011(b) and paragraphs (a)(1) and (c)(2)(i) of § 1.170A–4, B is allowed a charitable contributions deduction for 1970 of $1,600 ($4,000 value of gift −[$4,000 −($4,000 adjusted basis of property ×$4,000 value of gift/$10,000 value of property]).

Example 7. In 1970, C, a calendar-year individual taxpayer, sells to a church for $4,000 tangible personal property used in his business for more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. Thus, C makes a charitable contribution to the church of $6,000 ($10,000 value −$4,000 adjusted basis). C's contribution base for 1970, as defined in section 170(b)(1)(F) is $100,000 and during such year he makes no other charitable contributions. If C had sold the property at its fair market value at the time of its contribution, it is assumed that under section 1245 $4,000 of the gain of $6,000 ($10,000 value −$4,000 adjusted basis) would have been treated as ordinary icome. Thus, there would have been long-term capital gain of $2,000. It is also assumed that the church does not put the property to an unrelated use, as defined in paragraph (b)(3) of § 1.170A–4. Under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $1,600 ($4,000 adjusted basis ×$4,000 amount realized/ $10,000 value of property). Accordingly, C has a recognized gain of $2,400 ($4,000 amount realized −$1,600 adjusted basis) on the bargain sale, consisting of ordinary income of $1,600 ($4,000 ordinary income ×$4,000 amount realized/$10,000 value of property) and of long-term capital gain of $800 ($2,000 long-term gain ×$4,000 amount realized/$10,000 value of property). After applying section 1011(b) and paragraphs (a) and (c)(2)(i) of § 1.170A–4, C is allowed a charitable contributions deduction for 1970 of $3,600 ($6,000 gift −[$4,000 ordinary income ×$6,000 value of gift/$10,000 value of property]).

Example 8. (a) On January 1, 1970, A, a male of age 65, transfers capital assets consisting of securities held for more than 6 months to a church in exchange for a promise by the church to pay A a nonassignable annuity of $5,000 per year for life. The annuity is payable monthly with the first payment to be made on February 1, 1970. A's contribution base for 1970, as defined in section 170(b)(1)(F), is $200,000, and during that year he makes no other charitable contributions. On the date of transfer the securities have a fair market value of $100,000 and an adjusted basis to A of $20,000.

(b) The present value of the right of a male age 65 to receive a life annuity of $5,000 per annum, payable in equal installments at the end of each monthly period, is $59,755 ($5,000 × [11.469 + 0.482]), determined in accordance with section 101(b) of the Code, paragraph (e)(1)(iii)(b)(2) of § 1.101–2, and section 3 of Rev. Rul. 62–216, C.B. 1962–2, 30. Thus, A makes a charitable contribution to the church of $40,245 ($100,000 −$59,755). See Rev. Rul. 84–162, 1984–2 C.B. 200, for transfers for which the valuation date falls after November 23, 1984. (See § 601.601(d)(2)(ii)(*b*) of this chapter). For the applicable valuation tables in connection therewith, see § 20.2031–7(d)(6) of this chapter. See, however, § 1.7520–3(b) (relating to exceptions to the use of standard actuarial factors in certain circumstances).

(c) Under paragraph (b) of this section, the adjusted basis for determining gain on the bargain sale is $11,951 ($20,000 × $59,755 / $100,000). Accordingly, A has a recognized long-term capital gain of $47,804 ($59,755 − $11,951) on the bargain sale. Such gain is to be reported by A ratably over the period of years measured by the expected return multiple under the contract, but only from that portion of the annual payments which is a return of his investment in the contract under section 72 of the Code. For such purposes, the investment in the contract is $59,755, that is, the present value of the annuity.

(d) The computation and application of the exclusion ratio, the gain, and the ordinary annuity income are as follows, determined by using the expected return multiple of 15.0 applicable under table I of § 1.72–9:

A's expected return (annual payments of $5,000 × 15)	$75,000.00
Exclusion ratio ($59,755 investment in contract divided by expected return of $75,000)	79.7%
Annual exclusion (annual payments of $5,000 × 79.7%)	$3,985.00
Ordinary annuity income ($5,000−$3,985)	$1,015.00
Long-term capital gain per year ($47,804/15) with respect to the annual exclusion	$3,186.93

(e) The exclusion ratio of 79.7 percent applies throughout the life of the contract. During the first 15 years of the annuity, A is required to report ordinary income of $1,015 and long-term capital gain of $3,186.93 with respect to the annuity payments he receives. After the total long-term capital gain of $47,804 has been reported by A, he is required to report only ordinary income of $1,015.00 per annum with respect to the annuity payments he receives.

(d) *Effective date.* This section applies only to sales and exchanges made after December 19, 1969.

(e) *Cross reference.* For rules relating to the treatment of liabilities on the sale or other disposition or encumbered property, see §1.1001–2.

[T.D. 7207, 37 FR 20798, Oct. 5, 1972, as amended by T.D. 7741, 45 FR 81745, Dec. 12, 1980; T.D. 8176, 53 FR 5570, Feb. 25, 1988; 53 FR 11002, Apr. 4, 1988; T.D. 8540, 59 FR 30148, June 10, 1994]

§1.1012–1 Basis of property.

(a) *General rule.* In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property. This general rule is subject to exceptions stated in subchapter O (relating to gain or loss on the disposition of property), subchapter C (relating to corporate distributions and adjustments), subchapter K (relating to partners and partnerships), and subchapter P (relating to capital gains and losses), chapter 1 of the code.

(b) *Real estate taxes as part of cost.* In computing the cost of real property, the purchaser shall not take into account any amount paid to the seller as reimbursement for real property taxes which are treated under section 164(d) as imposed upon the purchaser. This rule applies whether or not the contract of sale calls for the purchaser to reimburse the seller for such real estate taxes paid or to be paid by the seller. On the other hand, where the purchaser pays (or assumes liability for) real estate taxes which are treated under section 164(d) as imposed upon the seller, such taxes shall be considered part of the cost of the property. It is immaterial whether or not the contract of sale specifies that the sale price has been reduced by, or is in any way intended to reflect, real estate taxes allocable to the seller under section 164(d). For illustrations of the application of this paragraph, see paragraph (b) of §1.1001–1.

(c) *Sale of stock*—(1) *In general.* If shares of stock in a corporation are sold or transferred by a taxpayer who purchased or acquired lots of stock on different dates or at different prices, and the lot from which the stock was sold or transferred cannot be adequately identified, the stock sold or transferred shall be charged against the earliest of such lots purchased or acquired in order to determine the cost or other basis of such stock and in order to determine the holding period of such stock for purposes of subchapter P, chapter 1 of the code. If, on the other hand, the lot from which the stock is sold or transferred can be adequately identified, the rule stated in the preceding sentence is not applicable. As to what constitutes ‘‘adequate identification’’, see subparagraphs (2), (3), and (4) of this paragraph.

(2) *Identification of stock.* An adequate identification is made if it is shown that certificates representing shares of stock from a lot which was purchased or acquired on a certain date or for a certain price were delivered to the taxpayer's transferee. Except as otherwise provided in subparagraph (3) or (4) of this paragraph, such stock certificates delivered to the transferee constitute the stock sold or transferred by the taxpayer. Thus, unless the requirements of subparagraph (3) or (4) of this paragraph are met, the stock sold or transferred is charged to the lot to which the certificates delivered to the transferee belong, whether or not the taxpayer intends, or instructs his broker or other agent, to sell or transfer stock from a lot purchased or acquired on a different date or for a different price.

(3) *Identification on confirmation document.* (i) Where the stock is left in the custody of a broker or other agent, an adequate identification is made if—

(*a*) At the time of the sale or transfer, the taxpayer specifies to such broker or other agent having custody of the stock the particular stock to be sold or transferred, and

(*b*) Within a reasonable time thereafter, confirmation of such specification is set forth in a written document from such broker or other agent.

Stock identified pursuant to this subdivision is the stock sold or transferred by the taxpayer, even though stock certificates from a different lot are delivered to the taxpayer's transferee.

(ii) Where a single stock certificate represents stock from different lots, where such certificate is held by the taxpayer rather than his broker or other agent, and where the taxpayer sells a part of the stock represented by such certificate through a broker or other agent, an adequate identification is made if—

(*a*) At the time of the delivery of the certificate to the broker or other agent, the taxpayer specifies to such broker or other agent the particular stock to be sold or transferred, and

(*b*) Within a reasonable time thereafter, confirmation of such specification is set forth in a written document from such broker or agent.

Where part of the stock represented by a single certificate is sold or transferred directly by the taxpayer to the purchaser or transferee instead of through a broker or other agent, an adequate identification is made if the taxpayer maintains a written record of the particular stock which he intended to sell or transfer.

(4) *Stock held by a trustee, executor, or administrator.* Where stock is held by a trustee or by an executor or administrator of an estate (and not left in the custody of a broker or other agent), an adequate identification is made if at the time of a sale, transfer, or distribution, the trustee, executor, or administrator—

(i) Specifies in writing in the books and records of the trust or estate the particular stock to be sold, transferred, or distributed, and

(ii) In the case of a distribution, also furnishes the distributee with a written document setting forth the particular stock distributed to him.

Stock identified pursuant to this subparagraph is the stock sold, transferred, or distributed by the trust or estate, even though stock certificates from a different lot are delivered to the purchaser, transferee, or distributee.

(5) *Subsequent sales.* If stock identified under subparagraph (3) or (4) of this paragraph as belonging to a particular lot is sold, transferred, or distributed, the stock so identified shall be deemed to have been sold, transferred, or distributed, and such sale, transfer, or distribution will be taken into consideration in identifying the taxpayer's remaining stock for purposes of subsequent sales, transfers, or distributions.

(6) *Bonds.* The provisions of subparagraphs (1) through (5) of this paragraph shall apply to the sale or transfer of bonds after July 13, 1965.

(7) *Book-entry securities.* (i) In applying the provisions of subparagraph (3)(i)(*a*) of this paragraph in the case of a sale or transfer of a book-entry security (as defined in subdivision (iii) (*a*) of this subparagraph) which is made after December 31, 1970, pursuant to a written instruction by the taxpayer, a specification by the taxpayer of the unique lot number which he has assigned to the lot which contains the securities being sold or transferred shall constitute specification as required by such subparagraph. The specification of the lot number shall be made either—

(*a*) In such written instruction, or

(*b*) In the case of a taxpayer in whose name the book entry by the Reserve Bank is made, in a list of lot numbers with respect to all book-entry securities on the books of the Reserve Bank sold or transferred on that date by the taxpayer, provided such list is mailed to or received by the Reserve Bank on or before the Reserve Bank's next business day.

This subdivision shall apply only if the taxpayer assigns lot numbers in numerical sequence to successive purchases of securities of the same loan title (series) and maturity date, except that securities of the same loan title (series) and maturity date which are purchased at the same price on the same date may be included within the same lot.

(ii) In applying the provisions of subparagraph (3)(i)(*b*) of this paragraph in the case of a sale or transfer of a book-entry security which is made pursuant to a written instruction by the taxpayer, a confirmation as required by such subparagraph shall be deemed made by—

(*a*) In the case of a sale or transfer made after December 31, 1970, the furnishing to the taxpayer of a written advice of transaction, by the Reserve Bank or the person through whom the taxpayer sells or transfers the securities, which specifies the amount and description of the securities sold or transferred and the date of the transaction, or

(*b*) In the case of a sale or transfer made before January 1, 1971, the furnishing of a serially-numbered advice of transaction by a Reserve Bank.

(iii) For purposes of this subparagraph:

(*a*) The term *book-entry security* means—

(*1*) In the case of a sale or transfer made after December 31, 1970, a transferable Treasury bond, note, certificate of indebtedness, or bill issued under the Second Liberty Bond Act (31 U.S.C. 774 (2)), as amended, or other security of the United States (as defined in (*b*) of this subdivision (iii)) in the form of an entry made as prescribed in 31 CFR part 306, or other comparable Federal regulations, on the records of a Reserve Bank, or

(*2*) In the case of a sale or transfer made before January 1, 1971, a transferable Treasury bond, note, certificate of indebtedness, or bill issued under the Second Liberty Bond Act, as amended, in the form of an entry made as prescribed in 31 CFR part 306, subpart O, on the records of a Reserve Bank which is deposited in an account with a Reserve Bank (*i*) as collateral pledged to a Reserve Bank (in its individual capacity) for advances by it, (*ii*) as collateral pledged to the United States under Treasury Department Circular No. 92 or 176, both as revised and amended, (*iii*) by a member bank of the Federal Reserve System for its sole account for safekeeping by a Reserve Bank in its individual capacity, (*iv*) in lieu of a surety or sureties upon the bond required by section 61 of the Bankruptcy Act, as amended (11 U.S.C. 101), of a banking institution designated by a judge of one of the several courts of bankruptcy under such section as a depository for the moneys of a bankrupt's estate, (*v*) pursuant to 6 U.S.C. 15, in lieu of a surety or sureties required in connection with any recognizance, stipulation, bond, guaranty, or undertaking which must be furnished under any law of the United States or regulations made pursuant thereto, (*vi*) by a banking institution, pursuant to a State or local law, to secure the deposit in such banking institution of public funds by a State, municipality, or other political subdivision, (*vii*) by a State bank or trust company or a national bank, pursuant to a State or local law, to secure the faithful performance of trust or other fiduciary obligations by such State bank or trust company or national bank, or (*viii*) to secure funds which are deposited or held in trust by a State bank or trust company or a national bank and are awaiting investment, but which are used by such State bank or trust company or national bank in the conduct of its business;

(*b*) The term *other security of the United States* means a bond, note, certificate of indebtedness, bill, debenture, or similar obligation which is subject to the provisions of 31 CFR part 306 or other comparable Federal regulations and which is issued by (*1*) any department or agency of the Government of the United States, or (*2*) the Federal National Mortgage Association, the Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation, the Federal Land Banks, the Federal Intermediate Credit Banks, the Banks for Cooperatives, or the Tennessee Valley Authority;

(*c*) The term *serially-numbered advice of transaction* means the confirmation (prescribed in 31 CFR 306.116) issued by the Reserve Bank which is identifiable by a unique number and indicates that a particular written instruction to the Reserve Bank with respect to the deposit or withdrawal of a specified book-entry security (or securities) has been executed; and

(*d*) The term *Reserve Bank* means a Federal Reserve Bank and its branches acting as Fiscal Agent of the United States.

(d) *Obligations issued as part of an investment unit.* For purposes of determining the basis of the individual elements of an investment unit (as defined in paragraph (b)(2)(ii)(*a*) of §1.1232–3) consisting of an obligation and an option (which is not an excluded option under paragraph (b)(1)(iii)(*c*) of §1.1232–3), security, or other property, the cost of such investment unit shall be allocated to such individual elements on the basis of their respective fair market values. In the case of the initial issuance of an investment unit consisting of an obligation and an option, security, or other property, where neither the obligation nor the option, security, or other property has a readily ascertainable fair market value, the portion of the cost of the unit which is allocable to the obligation shall be an amount equal to the issue price of the obligation as determined under paragraph (b)(2)(ii)(*a*) of § 1.1232–3.

(e) *Election as to certain regulated investment company stock*—(1) *General rule*—(i) *In general.* Notwithstanding paragraph (c) of this section, and except as provided in subdivision (ii) of this subparagraph, if—

(*a*) Shares of stock of a regulated investment company (as defined in subparagraph (5) of this paragraph) are left by a taxpayer in the custody of a custodian or agent in an account maintained for the acquisition or redemption of shares of such company, and

(*b*) The taxpayer purchased or acquired shares of stock held in the account at different prices or bases, the taxpayer may elect to determine the cost or other basis of shares of stock he sells or transfers from such account by using one of the methods described in subparagraphs (3) and (4) of this paragraph. The cost or other basis determined in accordance with either of such methods shall be known as the *average basis.* For purposes of this paragraph, securities issued by unit investment trusts shall be treated as shares of stock and the term *share* or *shares* shall include fractions of a share.

(ii) *Certain gift shares.* (*a*) Except as provided in subdivision (*b*) of this subdivision (ii), this paragraph shall not apply to any account which contains shares which were acquired by the taxpayer by gift after December 31, 1920, if the basis of such shares (adjusted for the period before the date of the gift as provided in section 1016) in the hands of the donor or the last preceding owner by whom it was not acquired by gift was greater than the fair market value of such shares at the time of the gift. However, shares acquired by a taxpayer as a result of a taxable dividend or a capital gain distribution from such an account may be included in an account to which this paragraph applies.

(*b*) Notwithstanding the provisions of subdivision (*a*) of this subdivision (ii), this paragraph shall apply with respect to accounts containing gift shares described in such subdivision (*a*) if, at the time the election described in this paragraph is made in the manner prescribed in subparagraph (6) of this paragraph, the taxpayer includes a statement, in writing, indicating that the basis of such gift shares shall be the fair market value of such gift shares at the time they were acquired by the taxpayer by gift and that such basis shall be used in computing average basis in the manner described in subparagraph (3) or (4) of this paragraph. Such statement shall be effective with respect to gift shares acquired prior to making such election and with respect to gift shares acquired after such time and shall remain in effect so long as such election remains in effect.

(2) *Determination of average basis.* Average basis shall be determined using either the method described in subparagraph (3) of this paragraph (the double-category method) or the method described in subparagraph (4) of this paragraph (the single-category method). The taxpayer shall specify, in the manner described in subparagraph (6) of this paragraph, the method used. Such method shall be used with respect to an account until such time as the election is revoked with the consent of the Commissioner. Although a taxpayer may specify different methods with respect to accounts in different regulated investment companies, the same method shall be used with respect to all of the taxpayer's accounts in the same regulated investment company.

(3) *Double-category method*—(i) *In general.* In determining average basis using the double category method, all shares in an account at the time of each sale or transfer shall be divided into two categories. The first category shall include all shares in such account having, at the time of the sale or transfer, a holding period of more than 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977) (the ''more-than 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)'' category), and the second category shall include all shares in such account having, at such time, a holding period of 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977) or less (the ''1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less'' category). The cost or other basis of each

share in a category shall be an amount equal to the remaining aggregate cost or other basis of all shares in that category at the time of the sale or transfer divided by the aggregate number of shares in that category at such time.

(ii) *Order of disposition of shares old or transferred.* Prior to a sale or transfer of shares from such an account, the taxpayer may specify, to the custodian or agent having custody of the account, from which category (described in subdivision (i) of this subparagraph) the shares are to be sold or transferred. Shares shall be deemed sold or transferred from the category specified without regard to the stock certificates, if any, actually delivered if, within a reasonable time thereafter, confirmation of such specification is set forth in a written document from the custodian or agent having custody of the account. In the absence of such specification or confirmation, shares sold or transferred shall be charged against the more-than-1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977) category. However, if the number of shares sold or transferred exceeds the number in such category, the additional shares sold or transferred shall be charged against the shares in the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category. Any gain or loss attributable to a sale or transfer which is charged against shares in the more-than-1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977) category shall constitute long-term gain or loss, and any gain or loss attributable to a sale or transfer which is charged against shares in the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category shall constitute short-term gain or loss. As to adjustments from wash sales, see section 1091(d) and subdivisions (iii) (*c*) and (*d*) of this subparagraph.

(iii) *Special rules with respect to shares from the 1 year-or-less category. (a)* After the taxpayer's holding period with respect to a share is more than 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977), such share shall be changed from the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category to the more-than 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977) category. For purposes of such change, the basis of a changed share shall be its actual cost or other basis to the taxpayer or its basis determined in accordance with the rules contained in subdivision (*b*)(*2*) of this subdivision (iii) if the rules of such subdivision (*b*)(*2*) are applicable.

(*b*) If, during the period that shares are in the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category some but not all of the shares in such category are sold or transferred, then—

(*1*) The shares sold or transferred (the basis of which was determined in the manner prescribed by subdivision (i) of this subparagraph) shall be assumed to be those shares in such category which were earliest purchased or acquired, and

(*2*) The basis of those shares which are not sold or transferred and which are changed from the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category to the more-than-1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977) category shall be the average basis of the shares in the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category at the time of the most recent sale or transfer of shares from such category. For such purposes, the average basis shall be determined in the manner prescribed in subdivision (i) of this subparagraph.

(*c*) Paragraph (a) of §1.1091–2 contains examples which illustrate the general application of section 1091(d), relating to unadjusted basis in the case of a wash sale of stock. However, in the case of certain wash sales of stock from the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category, the provisions of section 1091(d) shall be applied in the manner described in subdivision (*d*) of this subdivision (iii).

(*d*) In the case of a wash sale of stock (determined in accordance with the provisions of section 1091) from the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category which occurs after the acquisition of shares of stock into such category, the aggregate cost or other basis of all shares remaining in the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category after such sale shall be increased by the amount of the loss which is not deductible because of the provisions of section 1091 and the regulations thereunder. The provisions of this subdivision may be illustrated by the following example:

Example: Assume the following acquisitions to, and sale from, the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category:

1-YEAR (6-MONTHS FOR TAXABLE YEARS BEGINNING BEFORE 1977; 9-MONTHS FOR TAXABLE YEARS BEGINNING IN 1977)-OR-LESS CATEGORY

Date	Action	Number shares	Price/ share	Aggregate
1–5–71	Purchase	10	$110	$1,100
2–5–71	do	10	100	1,000
3–5–71	do	10	90	900
Average		30	100	3,000
3–15–71	Sale	10	90	900
	Loss	10	10	100

In this example, the unadjusted basis of the shares remaining in the account after the sale is $2,000 (aggregate basis of $3,000 before the sale, less $1,000, the aggregate basis of the shares sold after the averaging of costs). The adjusted basis of the shares remaining in the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category after the sale and after adjustment is $2,100 (the unadjusted basis of $2,000, plus the $100 loss resulting from the sale).

(4) *Single-category method*—(i) *In general.* In determining average basis using the single-category method, the cost or other basis of all shares in an account at the time of each sale or transfer (whether such shares have a holding period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977)-or-less) shall be used in making the computation. The cost or other basis of each share in such account shall be an amount equal to the remaining aggregate cost or other basis of all shares in such account at the time of the sale or transfer divided by the aggregate number of shares in such account at such time.

(ii) *Order of disposition of shares sold or transferred.* In the case of the sale or transfer of shares from an account to which the election provided by this paragraph applies, and with respect to which the taxpayer has specified that he uses the single-category method of determining average basis, shares sold or transferred shall be deemed to be those shares first acquired. Thus, when shares are sold or transferred from an account such shares will be those with a holding period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) to the extent that such account contains shares with a holding period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). If the number of shares sold or transferred exceeds the number of shares in the account with a holding period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), any such excess shares sold or transferred will be deemed to be shares with a holding period of 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less. Any gain or loss attributable to shares held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) shall constitute long-term gain or loss, and any gain or loss attributable to shares held for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less shall constitute short-term gain or loss. For example, if a taxpayer sells or transfers

50 shares from an account containing 100 shares with a holding period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and 100 shares with a holding period of 6 months or less, all of the shares sold or transferred will be deemed to be shares with a holding period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). If, however, the account contains 40 shares with a holding period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and 100 shares with a holding period of 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less, the taxpayer will be deemed to have sold or transferred 40 shares with a holding period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and 10 shares with a holding period of 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less.

(iii) *Restriction on use of single-category method.* The single-category method of determining average basis shall not be used where it appears from the facts and circumstances that a purpose of using such single-category method is to convert long-term capital gains or losses to short-term capital gains or losses or to convert short-term capital gains or losses to long-term capital gains or losses.

(iv) *Wash sales.* The provisions of section 1091(d) (relating to unadjusted basis in the case of a wash sale of stock) and the regulations thereunder shall apply in the case of wash sales of stock from an account with respect to which the single-category method of determining average basis is being used.

(5) *Definition.* (i) For purposes of this paragraph, a *regulated investment company* means any domestic corporation (other than a personal holding company as defined in section 542) which meets the limitations of section 851(b) and § 1.851–2, and which is registered at all times during the taxable year under the Investment Company Act of 1940, as amended (15 U.S.C. 80a–1 to 80b–2), either as a management company, or as a unit investment trust.

(ii) Notwithstanding subdivision (i), this paragraph shall not apply in the case of a unit investment trust unless it is one—

(*a*) Substantially all of the assets of which consist (*1*) of securities issued by a single management company (as defined in such Act) and securities acquired pursuant to subdivision (*b*) of this subdivision (ii), or (*2*) securities issued by a single other corporation, and

(*b*) Which has no power to invest in any other securities except securities issued by a single other management company, when permitted by such Act or the rules and regulations of the Securities and Exchange Commission.

(6) *Election.* (i) An election to adopt one of the methods described in this paragraph shall be made in an income tax return for the first taxable year ending on or after December 31, 1970, for which the taxpayer desires the election to apply. If the taxpayer does not file a timely return (taking into account extensions of the time for filing) for such taxable year, the election shall be filed at the time the taxpayer files his first return for such year. The election may be made with an amended return only if such amended return is filed no later than the time prescribed by law (including extensions thereof) for filing the return for such taxable year. If the election is made, the taxpayer shall clearly indicate on his income tax return for each year to which the election is applicable that an average basis has been used in reporting gain or loss from the sale or transfer of shares sold or transferred. In addition, the taxpayer shall specify on such return the method (either the single-category method or the double-category method) used in determining average basis. The taxpayer shall also indicate in a statement described in subparagraph (1)(ii)(*b*) of this paragraph if the election is to apply to accounts described in subparagraph (1)(ii) of this paragraph. Such statement shall be attached to, or incorporated in, such return. A taxpayer making the election shall maintain such records as are necessary to substantiate the average

basis (or bases) used on his income tax return.

(ii) An election made with respect to some of the shares of a regulated investment company sold or transferred from an account described in subparagraph (1)(i) of this paragraph applies to all such shares in the account. Such election also applies to all shares of that regulated investment company held in other such accounts (i.e., those described in subparagraph (1)(i) of this paragraph) by the electing taxpayer for his own benefit. Thus, the election shall apply to all shares of the regulated investment company held by the electing taxpayer (for his own benefit) in such accounts on or after the first day of the first taxable year for which the election is made. Such election does not apply to shares held in accounts described in subparagraph (1)(ii) of this paragraph unless the taxpayer indicates, in the manner described in subdivision (i) of this subparagraph, that the election is to apply to shares held in such accounts. An election made pursuant to the provisions of this paragraph may not be revoked without the prior written permission of the Commissioner.

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

Example 1. (i) On January 11, 1971, taxpayer A, who files his income tax return on a calendar year basis, enters into an agreement with the W Bank establishing an account for the periodic acquisition of shares of the Y Company, an open-end mutual fund. The agreement provides (1) that the bank is to purchase, for A, shares of Y stock as A may from time to time direct, (2) that all shares in the account are to be left in the custody of the bank, and (3) that the bank is to reinvest any dividends paid by Y (including capital gain dividends) in additional shares of Y stock. Pursuant to the agreement, on January 11, 1971, February 1, 1971, and March 1, 1971, respectively, the bank purchases, at A's direction, 100 shares of Y stock for a total of $1,880, 20 shares of Y stock for a total of $400, and 20 shares of Y stock for a total of $410. On March 15, 1971, the bank reinvests a $1-per-share capital gain dividend (that is, a total of $140) in seven additional shares of Y stock. The acquisitions to A's account, are, therefore, as follows:

Date	Number of shares	Basis
January 11, 1971	100	$1,880
February 1, 1971	20	400
March 1, 1971	20	410
March 15, 1971	7	140

On August 20, 1971, at A's direction, the bank redeems (i.e., sells) 40 shares of Y stock, and on September 20, 1971, 30 shares. A elects to determine the gain or loss from the sales of the stock by reference to its average basis using the double-category method of determining average basis. A did not specify from which category the sales were to take place, and therefore, each sale is deemed to have been made from the more-than-6-months category.

(ii) The average basis for the shares sold on August 20, 1971, is $19, and the total average basis for the 40 shares which are sold is $760, computed as follows:

Number of shares in the more-than-6-months category at the time of sale	Basis
100	$1,880
20	400
Total 120	2,280

Average cost or other basis: $2,280 ÷ 120 = $19.40 shares × $19 each = $760, total average basis. Therefore, after the sale on August 20, 1971, 80 shares remain in the more-than-6-months category, and their remaining aggregate cost is $1,520.

(iii) The average basis for the shares sold on September 20, 1971, must reflect the sale which was made on August 20, 1971. Accordingly, such average basis would be $19.35 and may be computed as follows:

Number of shares in the more-than-6-months category at the time of sale	Basis
80	$1,520
20	410
7	140
Total 107	2,070

Average cost or other basis: $2,070 ÷ 107 shares = $19.35 (to the nearest cent).

Example 2. Taxpayer B, who files his income tax returns on a calendar year basis, enters into an agreement with the X Bank establishing an account for the periodic acquisition of shares of the Z Company, an open-end mutual fund. X acquired for B's account shares of Z on the following dates in the designated amounts:

January 15, 1971	50 shares.
February 16, 1971	30 shares.
March 15, 1971	25 shares.

Pursuant to B's direction, the Bank redeemed (i.e., sold) 25 shares from the account on February 1, 1971, and 20 shares on April 1, 1971, for a total of 45 shares. All of such shares had been held for less than 6 months. B elects to determine the gain or loss from the sales of the stock by reference to its average basis using the double-category method of determining average basis. Thus, the 45 shares which were sold are assumed to be from the 50 shares which were purchased on January 15, 1971. Accordingly, on July 16, 1971, only five shares from those shares which had been purchased on January 15, 1971, remain to be transferred from the 6-months-or-less category to the more- than-6-months category. The basis of such five shares for purposes of the change to the more-than-6-months category would be the average basis of the shares in the 6-months-or-less category at the time of the sale on April 1, 1971.

Example 3. Assume the same facts as in example (2), except that an additional sale of 18 shares was made on May 3, 1971. There were, therefore, a total of 63 shares sold during the 6-month period beginning on January 15, 1971, the date of the earliest purchase. Fifty of the shares which were sold during such period shall be assumed to be the shares purchased on January 15, 1971, and the remaining 13 shares shall be assumed to be from the shares which were purchased on February 16, 1971. Thus, none of the shares which were purchased on January 15, 1971, remain to be changed from the 6-months-or-less category to the more-than-6-months category. In the absence of further dispositions of shares during the 6-month holding period for the shares purchased on February 16, 1971, there would be 17 of such shares to be changed over after the expiration of that period since 13 of the shares sold on May 3, 1971, were assumed to be from the shares purchased on February 16, 1971. The basis of the 17 shares for purposes of the change to the more-than-6-months category would be the average basis of the shares in the 6-months-or-less category at the time of the sale on May 3, 1971.

Example 4. Taxpayer C, who files his income tax returns on a calendar year basis, enters into an agreement with Y Bank establishing an account for the periodic acquisition of XYZ Company, a closed-end mutual fund. Y acquired for B's account shares of XYZ on the following dates in the designated amounts:

Date	Number of shares	Cost
January 8, 1971	25	$200
February 8, 1971	24	200
March 8, 1971	23	200
April 8, 1971	23	200

Pursuant to C's direction, the bank redeemed (i.e., sold) 40 shares from the account on July 15, 1971, for $10 per share or a total of $400. C elects to determine the gain or loss from the sale of the stock by reference to its average basis using the single-category method of determining average basis. The average basis for the shares sold on July 15, 1971 (determined by dividing the total number of shares in the account at such time (95) into the aggregate cost of such shares ($800)) is $8.42 (to the nearest cent). Under the rules of subparagraph (4) of this paragraph the shares sold would be deemed to be those first acquired. Thus, C would realize a $39.50 ($1.58 × 25) long-term capital gain with respect to the 25 shares acquired on January 8, 1971, and he would realize a $23.70 ($1.58 × 15 short-term capital gain with respect to 15 of the shares acquired on February 8, 1971. The next sale occurred on August 16, 1971. At that time, absent further intervening acquisitions or dispositions, the account contained nine shares (the 24 shares acquired on February 8, 1971, less 15 of such shares which were sold on July 15, 1971) with a holding period of more than 6 months, and 46 shares with a holding period of 6 months or less.

Example 5. Taxpayer D owns four separate accounts (D–1, D–2, D–3, and D–4) for the periodic acquisition of shares of the Y Company, an open-end mutual fund. Account D–4 contains shares which D acquired by gift on April 15, 1970. These shares had an adjusted basis in the hands of the donor which was greater than the fair market value of the donated shares on such date. For his taxable year ending on December 31, 1971, D elects to use an average basis for shares sold from account D–1 during such year using the single-category method of determining average basis. Under the provisions of subparagraph (1)(ii) of this paragraph, D may use an average basis for shares sold or transferred from account D–4 if he includes with his statement of election a statement, in writing, indicating that the basis of such gift shares in account D–4 shall be the fair market value of such shares at the time he acquired such shares and that such basis shall be used in computing the average basis of shares in account D–4. In addition, since D elected to use an average basis for shares sold from account D–1, he must also use an average basis for all shares sold or transferred from accounts D–2 and D–3 (as well as account D–1) for his taxable year ending on December 31, 1971, and for all subsequent years until he revokes (with the consent of the Commissioner) his election to use an average basis for such accounts. Further, D must use the single-category method of determining average basis with respect to accounts D–2, D–3 (and D–4 if the above-mentioned statement is filed).

(f) *Special rules.* For special rules for determining the basis for gain or loss in the case of certain vessels acquired through the Maritime Commission (or its successors) or pursuant to an agreement with the Secretary of Commerce, see sections 510, 511, and 607 of the Merchant Marine Act, 1936, as amended (46 U.S.C. 1160, 1161) and parts 2 and 3 of this chapter. For special rules for determining the unadjusted basis of property recovered in respect of war losses, see section 1336. For special rules with respect to taxable years beginning before January 1, 1964, for determining the basis for gain or loss in the case of a disposition of a share of stock acquired pursuant to the timely exercise of a restricted stock option where the option price was between 85 percent and 95 percent of the fair market value of the stock at the time the option was granted, see paragraph (b) of § 1.421–5. See section 423(c)(1) or 424(c)(1), whichever is applicable, for special rules with respect to taxable years ending after December 31, 1963, for determining the basis for gain or loss in the case of the disposition of a share of stock acquired pursuant to the timely exercise of a stock option described in such sections. See section 422(c)(1) for special rules with respect to taxable years ending after December 31, 1963, for determining the basis for gain or loss in the case of an exercise of a qualified stock option.

(g) *Debt instruments issued in exchange for property*—(1) *In general.* For purposes of paragraph (a) of this section, if a debt instrument is issued in exchange for property, the cost of the property that is attributable to the debt instrument is the issue price of the debt instrument as determined under § 1.1273–2 or § 1.1274–2, whichever is applicable. If, however, the issue price of the debt instrument is determined under section 1273(b)(4), the cost of the property attributable to the debt instrument is its stated principal amount reduced by any unstated interest (as determined under section 483).

(2) *Certain tax-exempt obligations.* This paragraph (g)(2) applies to a tax-exempt obligation (as defined in section 1275(a)(3)) that is issued in exchange for property and that has an issue price determined under § 1.1274–2(j) (concerning tax-exempt contingent payment obligations and certain tax-exempt variable rate debt instruments subject to section 1274). Notwithstanding paragraph (g)(1) of this section, if this paragraph (g)(2) applies to a tax-exempt obligation, for purposes of paragraph (a) of this section, the cost of the property that is attributable to the obligation is the sum of the present values of the noncontingent payments (as determined under § 1.1274–2(c)).

(3) *Effective date.* This paragraph (g) applies to sales or exchanges that occur on or after August 13, 1996.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.1012–1, see the List of CFR Sections Affected in the Finding Aids section of this volume.

§ 1.1012–2 Transfers in part a sale and in part a gift.

For rules relating to basis of property acquired in a transfer which is in part a gift and in part a sale, see §§ 1.170A–4(c), 1.1011–2(b), and § 1.105–4.

[T.D. 7207, 37 FR 20799, Oct. 5, 1972]

§ 1.1013–1 Property included in inventory.

The basis of property required to be included in inventory is the last inventory value of such property in the hands of the taxpayer. The requirements with respect to the valuation of an inventory are stated in subpart D (section 471 and following), part II, subchapter E, chapter 1 of the Code, and the regulations thereunder.

§ 1.1014–1 Basis of property acquired from a decedent.

(a) *General rule.* The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death, or, if the decedent's executor so elects, at the alternate valuation date prescribed in section 2032, or in section 811(j) of the Internal Revenue Code of 1939. Property acquired from a decedent includes, principally, property acquired by bequest, devise, or inheritance, and, in the case of decedents dying after December 31, 1953, property required to be included in determining the value of the decedent's gross estate under any provision of the Internal Revenue Code of 1954 or the Internal Revenue Code of 1939. The general rule governing basis of property acquired from a decedent, as well as other rules prescribed elsewhere in this section, shall have no application if the property is sold, exchanged, or otherwise disposed of before the decedent's death by the person who acquired the property from the decedent. For general rules on the applicable valuation date where the executor of a decedent's estate elects under section 2032, or under section 811(j) of the Internal Revenue Code of 1939, to value the decedent's gross estate at the alternate valuation date prescribed in such sections, see paragraph (e) of §1.1014–3.

(b) *Scope and application.* With certain limitations, the general rule described in paragraph (a) of this section is applicable to the classes of property described in paragraphs (a) and (b) of §1.1014–2, including stock in a DISC or former DISC. In the case of stock in a DISC or former DISC, the provisions of this section and §§1.1014–2 through 1.1014–8 are applicable, except as provided in §1.1014–9. Special basis rules with respect to the basis of certain other property acquired from a decedent are set forth in paragraph (c) of §1.1014–2. These special rules concern certain stock or securities of a foreign personal holding company and the surviving spouse's one-half share of community property held with a decedent dying after October 21, 1942, and on or before December 31, 1947. In this section and §§1.1014–2 to 1.1014–6, inclusive, whenever the words *property acquired from a decedent* are used, they shall also mean *property passed from a decedent,* and the phrase *person who acquired it from the decedent* shall include the *person to whom it passed from the decedent.*

(c) *Property to which section 1014 does not apply.* Section 1014 shall have no application to the following classes of property:

(1) Property which constitutes a right to receive an item of income in respect of a decedent under section 691; and

(2) Restricted stock options described in section 421 which the employee has not exercised at death if the employee died before January 1, 1957. In the case of employees dying after December 31, 1956, see paragraph (d)(4) of §1.421–5. In the case of employees dying in a taxable year ending after December 31, 1963, see paragraph (c)(4) of §1.421–8 with respect to an option described in part II of subchapter D.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 413, Jan. 19, 1961; T.D. 6887, 31 FR 8812, June 24, 1966; T.D. 7283, 38 FR 20825, Aug. 3, 1973]

§1.1014–2 Property acquired from a decedent.

(a) *In general.* The following property, except where otherwise indicated, is considered to have been acquired from a decedent and the basis thereof is determined in accordance with the general rule in §1.1014–1:

(1) Without regard to the date of the decedent's death, property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, whether the property was acquired under the decedent's will or under the law governing the descent and distribution of the property of decedents. However, see paragraph (c)(1) of this section if the property was acquired by bequest or inheritance from a decedent dying after August 26, 1937, and if such property consists of stock or securities of a foreign personal holding company.

(2) Without regard to the date of the decedent's death, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust.

(3) In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust.

(4) Without regard to the date of the decedent's death, property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will.

(See section 2041(b) for definition of general power of appointment.)

(5) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in that property was includible in determining the value of the decedent's gross estate under part III, chapter 11 of the Internal Revenue Code of 1954 (relating to the estate tax) or section 811 of the Internal Revenue Code of 1939. It is not necessary for the application of this subparagraph that an estate tax return be required to be filed for the estate of the decedent or that an estate tax be payable.

(6) In the case of decedents dying after December 31, 1950, and before January 1, 1954, property which represents the survivor's interest in a joint and survivor's annuity if the value of any part of that interest was required to be included in determining the value of the decedent's gross estate under section 811 of the Internal Revenue Code of 1939. It is necessary only that the value of a part of the survivor's interest in the annuity be includible in the gross estate under section 811. It is not necessary for the application of this subparagraph that an estate tax return be required to be filed for the estate of the decedent or that an estate tax be payable.

(b) *Property acquired from a decedent dying after December 31, 1953*—(1) *In general.* In addition to the property described in paragraph (a) of this section, and except as otherwise provided in subparagraph (3) of this paragraph, in the case of a decedent dying after December 31, 1953, property shall also be considered to have been acquired from the decedent to the extent that both of the following conditions are met: (i) The property was acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), and (ii) the property is includible in the decedent's gross estate under the provisions of the Internal Revenue Code of 1954, or the Internal Revenue Code of 1939, because of such acquisition. The basis of such property in the hands of the person who acquired it from the decedent shall be determined in accordance with the general rule in § 1.1014–1. See, however, § 1.1014–6 for special adjustments if such property is acquired before the death of the decedent. See also subparagraph (3) of this paragraph for a description of property not within the scope of this paragraph.

(2) *Rules for the application of subparagraph (1) of this paragraph.* Except as provided in subparagraph (3) of this paragraph, this paragraph generally includes all property acquired from a decedent, which is includible in the gross estate of the decedent if the decedent died after December 31, 1953. It is not necessary for the application of this paragraph that an estate tax return be required to be filed for the estate of the decedent or that an estate tax be payable. Property acquired prior to the death of a decedent which is includible in the decedent's gross estate, such as property transferred by a decedent in contemplation of death, and property held by a taxpayer and the decedent as joint tenants or as tenants by the entireties is within the scope of this paragraph. Also, this paragraph includes property acquired through the exercise or nonexercise of a power of appointment where such property is includible in the decedent's gross estate. It does not include property not includible in the decedent's gross estate such as property not situated in the United States acquired from a nonresident who is not a citizen of the United States.

(3) *Exceptions to application of this paragraph.* The rules in this paragraph are not applicable to the following property:

(i) Annuities described in section 72;

(ii) Stock or securities of a foreign personal holding company as described in section 1014(b)(5) (see paragraph (c)(1) of this section);

(iii) Property described in any paragraph other than paragraph (9) of section 1014(b). See paragraphs (a) and (c) of this section.

In illustration of subdivision (ii), assume that A acquired by gift stock of a character described in paragraph (c)(1) of this section from a donor and upon the death of the donor the stock was includible in the donor's estate as being a gift in contemplation of death. A's basis in the stock would not be determined by reference to its fair market value at the donor's death under the general rule in section 1014(a). Furthermore, the special basis rules prescribed in paragraph (c)(1) of this section are not applicable to such property acquired by gift in contemplation of death. It will be necessary to refer to the rules in section 1015(a) to determine the basis.

(c) *Special basis rules with respect to certain property acquired from a decedent*—(1) *Stock or securities of a foreign personal holding company.* The basis of certain stock or securities of a foreign corporation which was a foreign personal holding company with respect to its taxable year next preceding the date of the decedent's death is governed by a special rule. If such stock was acquired from a decedent dying after August 26, 1937, by bequest or inheritance, or by the decedent's estate from the decedent, the basis of the property in the hands of the person who so acquired it (notwithstanding any other provision of section 1014) shall be the fair market value of such property at the date of the decedent's death or the adjusted basis of the stock in the hands of the decedent, whichever is lower.

(2) *Spouse's interest in community property of decedent dying after October 21, 1942, and on or before December 31, 1947.* In the case of a decedent dying after October 21, 1942, and on or before December 31, 1947, a special rule is provided for determining the basis of such part of any property, representing the surviving spouse's one-half share of property held by the decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, as was included in determining the value of the decedent's gross estate, if a tax under chapter 3 of the Internal Revenue Code of 1939 was payable upon the decedent's net estate. In such case the basis shall be the fair market value of such part of the property at the date of death (or the optional valuation elected under section 811(j) of the Internal Revenue Code of 1939) or the adjusted basis of the property determined without regard to this subparagraph, whichever is the higher.

§1.1014–3 Other basis rules.

(a) *Fair market value.* For purposes of this section and §1.1014–1, the value of property as of the date of the decedent's death as appraised for the purpose of the Federal estate tax or the alternate value as appraised for such purpose, whichever is applicable, shall be deemed to be its fair market value. If no estate tax return is required to be filed under section 6018 (or under section 821 or 864 of the Internal Revenue Code of 1939), the value of the property appraised as of the date of the decedent's death for the purpose of State inheritance or transmission taxes shall be deemed to be its fair market value and no alternate valuation date shall be applicable.

(b) *Property acquired from a decedent dying before March 1, 1913.* If the decedent died before March 1, 1913, the fair market value on that date is taken in lieu of the fair market value on the date of death, but only to the same extent and for the same purposes as the fair market value on March 1, 1913, is taken under section 1053.

(c) *Reinvestments by a fiduciary.* The basis of property acquired after the death of the decedent by a fiduciary as an investment is the cost or other basis of such property to the fiduciary, and not the fair market value of such property at the death of the decedent. For example, the executor of an estate purchases stock of X company at a price of $100 per share with the proceeds of the sale of property acquired from a decedent. At the date of the decedent's death the fair market value of such stock was $98 per share. The basis of such stock to the executor or to a legatee, assuming the stock is distributed, is $100 per share.

(d) *Reinvestments of property transferred during life.* Where property is transferred by a decedent during life and the property is sold, exchanged, or otherwise disposed of before the decedent's death by the person who acquired the property from the decedent, the general rule stated in paragraph (a) of § 1.1014–1 shall not apply to such property. However, in such a case, the basis of any property acquired by such donee in exchange for the original property, or of any property acquired by the donee through reinvesting the proceeds of the sale of the original property, shall be the fair market value of the property thus acquired at the date of the decedent's death (or applicable alternate valuation date) if the property thus acquired is properly included in the decedent's gross estate for Federal estate tax purposes. These rules also apply to property acquired by the donee in any further exchanges or in further reinvestments. For example, on January 1, 1956, the decedent made a gift of real property to a trust for the benefit of his children, reserving to himself the power to revoke the trust at will. Prior to the decedent's death, the trustee sold the real property and invested the proceeds in stock of the Y company at $50 per share. At the time of the decedent's death, the value of such stock was $75 per share. The corpus of the trust was required to be included in the decedent's gross estate owing to his reservation of the power of revocation. The basis of the Y company stock following the decedent's death is $75 per share. Moreover, if the trustee sold the Y Company stock before the decedent's death for $65 a share and reinvested the proceeds in Z company stock which increased in value to $85 per share at the time of the decedent's death, the basis of the Z company stock following the decedent's death would be $85 per share.

(e) *Alternate valuation dates.* Section 1014(a) provides a special rule applicable in determining the basis of property described in § 1.1014–2 where—

(1) The property is includible in the gross estate of a decedent who died after October 21, 1942, and

(2) The executor elects for estate tax purposes under section 2032, or section 811(j) of the Internal Revenue Code of 1939, to value the decedent's gross estate at the alternate valuation date prescribed in such sections.

In those cases, the value applicable in determining the basis of the property is not the value at the date of the decedent's death but (with certain limitations) the value at the date one year after his death if not distributed, sold, exchanged, or otherwise disposed of in the meantime. If such property was distributed, sold, exchanged, or otherwise disposed of within one year after the date of the decedent's death by the person who acquired it from the decedent, the value applicable in determining the basis is its value as of the date of such distribution, sale, exchange, or other disposition. For illustrations of the operation of this paragraph, see the estate tax regulations under section 2032.

§ 1.1014–4 Uniformity of basis; adjustment to basis.

(a) *In general.* (1) The basis of property acquired from a decedent, as determined under section 1014(a), is uniform in the hands of every person having possession or enjoyment of the property at any time under the will or other instrument or under the laws of descent and distribution. The principle of uniform basis means that the basis of the property (to which proper adjustments must, of course, be made) will be the same, or uniform, whether the property is possessed or enjoyed by the executor or administrator, the heir, the legatee or devisee, or the trustee or beneficiary of a trust created by a will or an inter vivos trust. In determining the amount allowed or allowable to a taxpayer in computing taxable income as deductions for depreciation or depletion under section 1016(a)(2), the uniform basis of the property shall at all times be used and adjusted. The sale, exchange, or other disposition by a life tenant or remainderman of his interest in property will, for purposes of this section, have no effect upon the uniform basis of the property in the hands of those who acquired it from the decedent. Thus, gain or loss on sale of trust assets by the trustee will be determined without regard to the prior sale of any interest in the property. Moreover, any adjustment for depreciation shall be made to the uniform basis of the property without regard to such prior sale, exchange, or other disposition.

(2) Under the law governing wills and the distribution of the property of decedents, all titles to property acquired by bequest, devise, or inheritance relate back to the death of the decedent, even though the interest of the person taking the title was, at the date of death of the decedent, legal, equitable, vested, contingent, general, specific, residual, conditional, executory, or otherwise. Accordingly, there is a common acquisition date for all titles to property acquired from a decedent within the meaning of section 1014, and, for this reason, a common or uniform basis for all such interests. For example, if distribution of personal property left by a decedent is not made until one year after his death, the basis of such property in the hands of the legatee is its fair market value at the time when the decedent died, and not when the legatee actually received the property. If the bequest is of the residue to trustees in trust, and the executors do not distribute the residue to such trustees until five years after the death of the decedent, the basis of each piece of property left by the decedent and thus received, in the hands of the trustees, is its fair market value at the time when the decedent dies. If the bequest is to trustees in trust to pay to A during his lifetime the income of the property bequeathed, and after his death to distribute such property to the survivors of a class, and upon A's death the property is distributed to the taxpayer as the sole survivor, the basis of such property, in the hands of the taxpayer, is its fair market value at the time when the decedent died. The purpose of the Code in prescribing a general uniform basis rule for property acquired from a decedent is, on the one hand, to tax the gain, in respect of such property, to him who realizes it (without regard to the circumstances that at the death of the decedent it may have been quite uncertain whether the taxpayer would take or gain anything); and, on the other hand, not to recognize as gain any element of value resulting solely from the circumstance that the possession or enjoyment of the taxpayer was postponed. Such postponement may be, for example, until the administration of the decedent's estate is completed, until the period of the possession or enjoyment of another has terminated, or until an uncertain event has happened. It is the increase or decrease in the value of property reflected in a sale or other disposition which is recognized as the measure of gain or loss.

(3) The principles stated in subparagraphs (1) and (2) of this paragraph do not apply to property transferred by an executor, administrator or trustee, to an heir, legatee, devisee or beneficiary under circumstances such that the transfer constitutes a sale or exchange. In such a case, gain or loss must be recognized by the transferor to the extent required by the revenue laws, and the transferee acquires a basis equal to the fair market value of the property on the date of the transfer. Thus, for example, if the trustee of a trust created by will transfers to a beneficiary, in satisfaction of a specific bequest of $10,000, securities which had a fair market value of $9,000 on the date of the decedent's death (the applicable valuation date) and $10,000 on the date of the transfer, the trust realizes a taxable gain of $1,000 and the basis of the securities in the hands of the beneficiary would be $10,000. As a further example, if the executor of an estate transfers to a trust property worth $200,000, which had a fair market value of $175,000 on the date of the decedent's death (the applicable valuation date), in satisfaction of the decedent's bequest in trust for the benefit of his wife of cash or securities to be selected by the executor in an amount sufficient to utilize the marital deduction to the maximum extent authorized by law (after taking into consideration any other property qualifying for the marital deduction), capital gain in the amount of $25,000 would be realized by the estate and the basis of the property in the hands of the trustees would be $200,000. If, on the other hand, the decedent bequeathed a fraction of his residuary estate to a trust for the benefit of his wife, which fraction will not change regardless of any fluctuations in value of property in the decedent's estate after his death, no gain or loss would be realized by the estate upon transfer of property to the trust, and the basis

of the property in the hands of the trustee would be its fair market value on the date of the decedent's death or on the alternate valuation date.

(b) *Multiple interests.* Where more than one person has an interest in property acquired from a decedent, the basis of such property shall be determined and adjusted without regard to the multiple interests. The basis of computing gain or loss on the sale of any one of such multiple interests shall be determined under §1.1014–5. Thus, the deductions for depreciation and for depletion allowed or allowable, under sections 167 and 611, to a legal life tenant as if the life tenant were the absolute owner of the property, constitute an adjustment to the basis of the property not only in the hands of the life tenant, but also in the hands of the remainderman and every other person to whom the same uniform basis is applicable. Similarly, the deductions allowed or allowable under sections 167 and 611, both to the trustee and to the trust beneficiaries, constitute an adjustment to the basis of the property not only in the hands of the trustee, but also in the hands of the trust beneficiaries and every other person to whom the uniform basis is applicable. See, however, section 262. Similarly, adjustments in respect of capital expenditures or losses, tax-free distributions, or other distributions applicable in reduction of basis, or other items for which the basis is adjustable are made without regard to which one of the persons to whom the same uniform basis is applicable makes the capital expenditures or sustains the capital losses, or to whom the tax-free or other distributions are made, or to whom the deductions are allowed or allowable. See §1.1014–6 for adjustments in respect of property acquired from a decedent prior to his death.

(c) *Records.* The executor or other legal representative of the decedent, the fiduciary of a trust under a will, the life tenant and every other person to whom a uniform basis under this section is applicable, shall maintain records showing in detail all deductions, distributions, or other items for which adjustment to basis is required to be made by sections 1016 and 1017, and shall furnish to the district director such information with respect to those adjustments as he may require.

§1.1014–5 Gain or loss.

(a) *Sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent.* (1) Except as provided in paragraph (b) of this section with respect to the sale or other disposition after October 9, 1969, of a term interest in property, gain or loss from a sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent is determined by comparing the amount of the proceeds with the amount of that part of the adjusted uniform basis which is assignable to the interest so transferred. The adjusted uniform basis is the uniform basis of the entire property adjusted to the date of sale or other disposition of any such interest as required by sections 1016 and 1017. The uniform basis is the unadjusted basis of the entire property determined immediately after the decedent's death under the applicable sections of part II of subchapter O of chapter 1 of the Code.

(2) Except as provided in paragraph (b) of this section, the proper measure of gain or loss resulting from a sale or other disposition of an interest in property acquired from a decedent is so much of the increase or decrease in the value of the entire property as is reflected in such sale or other disposition. Hence, in ascertaining the basis of a life interest, remainder interest, or other interest which has been so transferred, the uniform basis rule contemplates that proper adjustments will be made to reflect the change in relative value of the interests on account of the passage of time.

(3) The factors set forth in the tables contained in §20.2031–7 or, for certain prior periods, §20.2031–7A, of part 20 of this chapter (Estate Tax Regulations) shall be used in the manner provided therein in determining the basis of the life interest, the remainder interest, or the term certain interest in the property on the date such interest is sold. The basis of the life interest, the remainder interest, or the term certain interest is computed by multiplying the uniform basis (adjusted to the time of the sale) by the appropriate factor.

In the case of the sale of a life interest or a remainder interest, the factor used is the factor (adjusted where appropriate) which appears in the life interest or the remainder interest column of the table opposite the age (on the date of the sale) of the person at whose death the life interest will terminate. In the case of the sale of a term certain interest, the factor used is the factor (adjusted where appropriate) which appears in the term certain column of the table opposite the number of years remaining (on the date of sale) before the term certain interest will terminate.

(b) *Sale or other disposition of certain term interests.* In determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in paragraph (f)(2) of §1.1001–1) the adjusted basis of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), that part of the adjusted uniform basis assignable under the rules of paragraph (a) of this section to the interest sold or otherwise disposed of shall be disregarded to the extent and in the manner provided by section 1001(e) and paragraph (f) of §1.1001–1.

(c) *Illustrations.* The application of this section may be illustrated by the following examples, in which references are made to the actuarial tables contained in part 20 of this chapter (Estate Tax Regulations):

Example 1. Securities worth $500,000 at the date of decedent's death on January 1, 1971, are bequeathed to his wife, W, for life, with remainder over to his son, S. W is 48 years of age when the life interest is acquired. The estate does not elect the alternate valuation allowed by section 2032. By reference to §20.2031–7A(c), the life estate factor for age 48, female, is found to be 0.77488 and the remainder factor for such age is found to be 0.22512. Therefore, the present value of the portion of the uniform basis assigned to W's life interest is $387,440 ($500,000 × 0.77488), and the present value of the portion of the uniform basis assigned to S's remainder interest is $112,560 ($500,000 × 0.22512). W sells her life interest to her nephew, A, on February 1, 1971, for $370,000, at which time W is still 48 years of age. Pursuant to section 1001(e), W realizes no loss; her gain is $370,000, the amount realized from the sale. A has a basis of $370,000 which he can recover by amortization deductions over W's life expectancy.

Example 2. The facts are the same as in example (1) except that W retains the life interest for 12 years, until she is 60 years of age, and then sells it to A on February 1, 1983, when the fair market value of the securities has increased to $650,000. By reference to §20.2031–7A(c), the life estate factor for age 60, female, is found to be 0.63226 and the remainder factor for such age is found to be 0.36774. Therefore, the present value on February 1, 1983, of the portion of the uniform basis assigned to W's life interest is $316,130 ($500,000 × 0.63226) and the present value on that date of the portion of the uniform basis assigned to S's remainder interest is $183,870 ($500,000 × 0.36774). W sells her life interest for $410,969, that being the commuted value of her remaining life interest in the securities as appreciated ($650,000 × 0.63226). Pursuant to section 1001(e), W's gain is $410,969, the amount realized. A has a basis of $410,969 which he can recover by amortization deductions over W's life expectancy.

Example 3. Unimproved land having a fair market value of $18,800 at the date of the decedent's death on January 1, 1970, is devised to A, a male, for life, with remainder over to B, a female. The estate does not elect the alternate valuation allowed by section 2032. On January 1, 1971, A sells his life interest to S for $12,500. S is not related to A or B. At the time of the sale, A is 39 years of age. By reference to §20.2031–7A(c), the life estate factor for age 39, male, is found to be 0.79854. Therefore, the present value of the portion of the uniform basis assigned to A's life interest is $15,012.55 ($18,800 × 0.79854). This portion is disregarded under section 1001(e). A realizes no loss; his gain is $12,500, the amount realized. S has a basis of $12,500 which he can recover by amortization deductions over A's life expectancy.

Example 4. The facts are the same as in example (3) except that on January 1, 1971, A and B jointly sell the entire property to S for $25,000 and divide the proceeds equally between them. A and B are not related, and there is no element of gift or compensation in the transaction. By reference to §20.2031–7A(c), the remainder factor for age 39, male, is found to be 0.20146. Therefore, the present value of the uniform basis assigned to B's remainder interest is $3,787.45 ($18,800 × 0.20146). On the sale A realizes a loss of $2,512.55 ($15,012.55 less $12,500), the portion of the uniform basis assigned to his life interest not being disregarded by reason of section 1001(e)(3). B's gain on the sale is $8,712.55 ($12,500 less $3,787.45). S has a basis in the entire property of $25,000, no part of which, however, can be recovered by amortization deductions over A's life expectancy.

Example 5. (a) Nondepreciable property having a fair market value of $54,000 at the date of decedent's death on January 1, 1971, is devised to her husband, H, for life and, after his death, to her daughter, D, for life, with remainder over to her grandson, G. The estate does not elect the alternate valuation allowed by section 2032. On January 1, 1973, H sells his life interest to D for $32,000. At the date of the sale, H is 62 years of age, and D is 45 years of age. By reference to § 20.2031–7A(c), the life estate factor for age 62, male, is found to be 0.52321. Therefore, the present value on January 1, 1973, of the portion of the adjusted uniform basis assigned to H's life interest is $28,253 ($54,000 × 0.52321). Pursuant to section 1001(e), H realizes no loss; his gain is $32,000, the amount realized from the sale. D has a basis of $32,000 which she can recover by amortization deductions over H's life expectancy.

(b) On January 1, 1976, D sells both life estates to G for $40,000. During each of the years 1973 through 1975, D is allowed a deduction for the amortization of H's life interest. At the date of the sale H is 65 years of age, and D is 48 years of age. For purposes of determining gain or loss on the sale by D, the portion of the adjusted uniform basis assigned to H's life interest and the portion assigned to D's life interest are not taken into account under section 1001(e). However, pursuant to § 1.1001–1(f)(1), D's cost basis in H's life interest, minus deductions for the amortization of such interest, is taken into account. On the sale, D realizes gain of $40,000 minus an amount which is equal to the $32,000 cost basis (for H's life estate) reduced by amortization deductions. G is entitled to amortize over H's life expectancy that part of the $40,000 cost which is attributable to H's life interest. That part of the $40,000 cost which is attributable to D's life interest is not amortizable by G until H dies.

Example 6. Securities worth $1,000,000 at the date of decedent's death on January 1, 1971, are bequeathed to his wife, W, for life, with remainder over to his son, S. W is 48 years of age when the life interest is acquired. The estate does not elect the alternate valuation allowed by section 2032. By reference to § 20.2031–7A(c), the life estate factor for age 48, female, is found to be 0.77488, and the remainder factor for such age is found to be 0.22512. Therefore, the present value of the portion of the uniform basis assigned to W's life interest is $774,880 ($1,000,000 × 0.77488), and the present value of the portion of the uniform basis assigned to S's remainder interest is $225,120 ($1,000,000 × 0.22512). On February 1, 1971, W transfers her life interest to corporation X in exchange for all of the stock of X pursuant to a transaction in which no gain or loss is recognized by reason of section 351. On February 1, 1972, W sells all of her stock in X to S for $800,000. Pursuant to section 1001(e) and § 1.1001–1(f)(2), W realizes no loss; her gain is $800,000, the amount realized from the sale. On February 1, 1972, X sells to N for $900,000 the life interest transferred to it by W. Pursuant to section 1001(e) and § 1.1001–1(f)(1), X realizes no loss; its gain is $900,000, the amount realized from the sale. N has a basis of $900,000 which he can recover by amortization deductions over W's life expectancy.

[T.D. 7142, 36 FR 18951, Sept. 24, 1971, as amended by T.D. 8540, 59 FR 30102, June 10, 1994]

§ 1.1014–6 Special rule for adjustments to basis where property is acquired from a decedent prior to his death.

(a) *In general.* (1) The basis of property described in section 1014(b)(9) which is acquired from a decedent prior to his death shall be adjusted for depreciation, obsolescence, amortization, and depletion allowed the taxpayer on such property for the period prior to the decedent's death. Thus, in general, the adjusted basis of such property will be its fair market value at the decedent's death, or the applicable alternate valuation date, less the amount allowed (determined with regard to section 1016(a)(2)(B)) to the taxpayer as deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion for the period held by the taxpayer prior to the decedent's death. The deduction allowed for a taxable year in which the decedent dies shall be an amount properly allocable to that part of the year prior to his death. For a discussion of the basis adjustment required by section 1014(b)(9) where property is held in trust, see paragraph (c) of this section.

(2) Where property coming within the purview of subparagraph (1) of this paragraph was held by the decedent and his surviving spouse as tenants by the entirety or as joint tenants with right of survivorship, and joint income tax returns were filed by the decedent and the surviving spouse in which the deductions referred to in subparagraph (1) were taken, there shall be allocated to the surviving spouse's interest in the property that proportion of the deductions allowed for each period for which the joint returns were filed which her income from the property bears to the total income from the property. Each spouse's income from the property shall be determined in accordance with local law.

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

Example 1. The taxpayer acquired income-producing property by gift on January 1, 1954. The property had a fair market value of $50,000 on the date of the donor's death, January 1, 1956, and was included in his gross estate at that amount for estate tax purposes as a transfer in contemplation of death. Depreciation in the amount of $750 per year was allowable for each of the taxable years 1954 and 1955. However, the taxpayer claimed depreciation in the amount of $500 for each of these years (resulting in a reduction in his taxes) and his income tax returns were accepted as filed. The adjusted basis of the property as of the date of the decedent's death is $49,000 ($50,000, the fair market value at the decedent's death, less $1,000, the total of the amounts actually allowed as deductions).

Example 2. On July 1, 1952, H purchased for $30,000 income-producing property which he conveyed to himself and W, his wife, as tenants by the entirety. Under local law each spouse was entitled to one-half of the income therefrom. H died on January 1, 1955, at which time the fair market value of the property was $40,000. The entire value of the property was included in H's gross estate. H and W filed joint income tax returns for the years 1952, 1953, and 1954. The total depreciation allowance for the year 1952 was $500 and for each of the other years 1953 and 1954 was $1,000. One-half of the $2,500 depreciation will be allocated to W. The adjusted basis of the property in W's hands of January 1, 1955, was $38,750 ($40,000, value on the date of H's death, less $1,250, depreciation allocated to W for periods before H's death). However, if, under local law, all of the income from the property was allocable to H, no adjustment under this paragraph would be required and W's basis for the property as of the date of H's death would be $40,000.

(b) *Multiple interests in property described in section 1014(b)(9) and acquired from a decedent prior to his death.* (1) Where more than one person has an interest in property described in section 1014(b)(9) which was acquired from a decedent before his death, the basis of such property and of each of the several interests therein shall, in general, be determined and adjusted in accordance with the principles contained in §§1.1014–4 and 1.1014–5, relating to the uniformity of basis rule. Application of these principles to the determination of basis under section 1014(b)(9) is shown in the remaining subparagraphs of this paragraph in connection with certain commonly encountered situations involving multiple interests in property acquired from a decedent before his death.

(2) Where property is acquired from a decedent before his death, and the entire property is subsequently included in the decedent's gross estate for estate tax purposes, the uniform basis of the property, as well as the basis of each of the several interests in the property, shall be determined by taking into account the basis adjustments required by section 1014(a) owing to such inclusion of the entire property in the decedent's gross estate. For example, suppose that the decedent transfers property in trust, with a life estate to A, and the remainder to B or his estate. The transferred property consists of 100 shares of the common stock of X Corporation, with a basis of $10,000 at the time of the transfer. At the time of the decedent's death the value of the stock is $20,000. The transfer is held to have been made in contemplation of death and the entire value of the trust is included in the decedent's gross estate. Under section 1014(a), the uniform basis of the property in the hands of the trustee, the life tenant, and the remainderman, is $20,000. If immediately prior to the decedent's death, A's share of the uniform basis of $10,000 was $6,000, and B's share was $4,000, then, immediately after the decedent's death, A's share of the uniform basis of $20,000 is $12,000, and B's share is $8,000.

(3)(i) In cases where, due to the operation of the estate tax, only a portion of property acquired from a decedent before his death is included in the decedent's gross estate, as in cases where the decedent retained a reversion to take effect upon the expiration of a life estate in another, the uniform basis of the entire property shall be determined by taking into account any basis adjustments required by section 1014(a) owing to such inclusion of a portion of the property in the decedent's gross estate. In such cases the uniform basis is the adjusted basis of the entire property immediately prior to the decedent's death increased (or decreased) by an amount which bears the same relation to the total appreciation (or diminution) in value of the entire property (over the adjusted basis of the entire property immediately prior to the decedent's death) as the value of the property included in the decedent's gross estate bears to the value of the entire property. For example, assume that the decedent creates a trust to pay the income to A for life, remainder to B or his estate. The trust instrument further provides that if the decedent should survive A, the income shall be paid to the decedent for life. Assume that the decedent predeceases A, so that, due to the operation of the estate tax, only the present value of the remainder interest is included in the decedent's gross estate. The trust consists of 100 shares of the common stock of X Corporation with an adjusted basis immediately prior to the decedent's death of $10,000 (as determined under section 1015). At the time of the decedent's death, the value of the stock is $20,000, and the value of the remainder interest in the hands of B is $8,000. The uniform basis of the entire property following the decedent's death is $14,000, computed as follows:

Uniform basis prior to decedent's death	$10,000
plus	
Increase in uniform basis (determined by the following formula)	4,000
[Increase in uniform basis (to be determined)/ $10,000 (total appreciation)]=	
[$8,000 (value of property included in gross estate)/$20,000 (value of entire property)]	
Uniform basis under section 1014(a)	14,000

(ii) In cases of the type described in subdivision (i) of this subparagraph, the basis of any interest which is included in the decedent's gross estate may be ascertained by adding to (or subtracting from) the basis of such interest determined immediately prior to the decedent's death the increase (or decrease) in the uniform basis of the property attributable to the inclusion of the interest in the decedent's gross estate. Where the interest is sold or otherwise disposed of at any time after the decedent's death, proper adjustment must be made in order to reflect the change in value of the interest on account of the passage of time, as provided in § 1.1014–5. For an illustration of the operation of this subdivision, see step 6 of the example in § 1.1014–7.

(iii) In cases of the type described in subdivision (i) of this subparagraph (cases where, due to the operation of the estate tax, only a portion of the property is included in the decedent's gross estate), the basis for computing the depreciation, amortization, or depletion allowance shall be the uniform basis of the property determined under section 1014(a). However, the manner of taking into account such allowance computed with respect to such uniform basis is subject to the following limitations:

(*a*) In cases where the value of the life interest is not included in the decedent's gross estate, the amount of such allowance to the life tenant under section 167(h) (or section 611(b)) shall not exceed (or be less than) the amount which would have been allowable to the life tenant if no portion of the basis of the property was determined under section 1014(a). Proper adjustment shall be made for the amount allowable to the life tenant, as required by section 1016. Thus, an appropriate adjustment shall be made to the uniform basis of the property in the hands of the trustee, to the basis of the life interest in the hands of the life tenant, and to the basis of the remainder in the hands of the remainderman.

(*b*) Any remaining allowance (that is, the increase in the amount of depreciation, amortization, or depletion allowable resulting from any increase in the uniform basis of the property under section 1014(a)) shall not be allowed to the life tenant. The remaining allowance shall, instead, be allowed to the trustee to the extent that the trustee both (*1*) is required or permitted, by the governing trust instrument (or under local law), to maintain a reserve for depreciation, amortization, or depletion, and (*2*) actually maintains such a reserve. If, in accordance with the preceding sentence, the trustee does maintain such a reserve, the remaining allowance shall be taken into account, under section 1016, in adjusting the uniform basis of the property in the hands of the trustee and in adjusting the basis of the remainder interest in the hands of the remainderman, but shall not be taken into account, under section 1016, in determining the basis of the life interest in the hands of the life tenant. For an example of the operation of this subdivision, see paragraph (b) of §1.1014–7.

(4) In cases where the basis of any interest in property is not determined under section 1014(a), as where such interest (i) is not included in the decedent's gross estate, or (ii) is sold, exchanged or otherwise disposed of before the decedent's death, the basis of such interest shall be determined under other applicable provisions of the Code. To illustrate, in the example shown in subparagraph (3)(i) of this paragraph the basis of the life estate in the hands of A shall be determined under section 1015, relating to the basis of property acquired by gift. If, on the other hand, A had sold his life interest prior to the decedent's death, the basis of the life estate in the hands of A's transferee would be determined under section 1012.

(c) *Adjustments for deductions allowed prior to the decedent's death.* (1) As stated in paragraph (a) of this section, section 1014(b)(9) requires a reduction in the uniform basis of property acquired from a decedent before his death for certain deductions allowed in respect of such property during the decedent's lifetime. In general, the amount of the reduction in basis required by section 1014(b)(9) shall be the aggregate of the deductions allowed in respect of the property, but shall not include deductions allowed in respect of the property to the decedent himself. In cases where, owing to the operation of the estate tax, only a part of the value of the entire property is included in the decedent's gross estate, the amount of the reduction required by section 1014(b)(9) shall be an amount which bears the same relation to the total of all deductions (described in paragraph (a) of this section) allowed in respect of the property as the value of the property included in the decedent's gross estate bears to the value of the entire property.

(2) The application of this paragraph may be illustrated by the following examples:

Example 1. The decedent creates a trust to pay the income to A for life, remainder to B or his estate. The property transferred in trust consists of an apartment building with a basis of $50,000 at the time of the transfer. The decedent dies 2 years after the transfer is made and the gift is held to have been made in contemplation of death. Depreciation on the property was allowed in the amount of $1,000 annually. At the time of the decedent's death the value of the property is $58,000. The uniform basis of the property in the hands of the trustee, the life tenant, and the remainderman, immediately after the decedent's death is $56,000 ($58,000, fair market value of the property immediately after the decedent's death, reduced by $2,000, deductions for depreciation allowed prior to the decedent's death).

Example 2. The decedent creates a trust to pay the income to A for life, remainder to B or his estate. The trust instrument provides that if the decedent should survive A, the income shall be paid to the decedent for life. The decedent predeceases A and the present value of the remainder interest is included in the decedent's gross estate for estate tax purposes. The property transferred consists of an apartment building with a basis of $110,000 at the time of the transfer. Following the creation of the trust and during the balance of the decedent's life, deductions for depreciation were allowed on the property in the amount of $10,000. At the time of decedent's death the value of the entire property is $150,000, and the value of the remainder interest is $100,000. Accordingly, the uniform basis of the property in the hands of the trustee, the life tenant, and the remainderman, as adjusted under section 1014(b)(9), is $126,666, computed as follows:

Uniform basis prior to decedent's death	$100,000
plus	
Increase in uniform basis—before reduction (determined by the following formula)	33,333
[Increase in uniform basis (to be determined)/ $50,000 (total appreciation of property since time of transfer)]=	
[$100,000 (value of property included in gross estate)/$150,000 (value of entire property)]	
less	133,333
Deductions allowed prior to decedent's death—taken into account under section 1014(b)(9) (determined by the following formula)	6,667
[Prior deductions taken into account (to be determined) $10,000 (total deductions allowed prior to decedent's death)]=	
[$100,000 (value of property included in gross estate) $150,000 (value of entire property)]	
Uniform basis under section 1014	126,666

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3656, Mar. 24, 1964; T.D. 7142, 36 FR 18952, Sept. 24, 1971]

§1.1014–7 Example applying rules of §§1.1014–4 through 1.1014–6 to case involving multiple interests.

(a) On January 1, 1950, the decedent creates a trust to pay the income to A for life, remainder to B or his estate.

The trust instrument provides that if the decedent should survive A, the income shall be paid to the decedent for life. The decedent, who died on January 1, 1955, predeceases A, so that, due to the operation of the estate tax, only the present value of the remainder interest is included in the decedent's gross estate. The trust consists of an apartment building with a basis of $30,000 at the time of transfer. Under the trust instrument the trustee is required to maintain a reserve for depreciation. During the decedent's lifetime depreciation is allowed in the amount of $800 annually. At the time of the decedent's death the value of the apartment building is $45,000. A, the life tenant, is 43 years of age at the time of the decedent's death. Immediately after the decedent's death, the uniform basis of the entire property under section 1014(a) is $32,027; A's basis for the life interest is $15,553; and B's basis for the remainder interest is $16,474, computed as follows:

Step 1. Uniform basis (adjusted) immediately prior to decedent's death:	
Basis at time of transfer	$30,000
less	
Depreciation allowed under section 1016 before decedent's death ($800 × 5)	4,000
	26,000
Step 2. Value of property included in decedent's gross estate:	
0.40180 (remainder factor, age 43) ×$45,000 (value of entire property)	$18,081
Step 3. Uniform basis of property under section 1014(a), before reduction required by section 1014(b)(9):	
Uniform basis (adjusted) prior to decedent's death	26,000
Increase in uniform basis (determined by the following formula)	7,634
Increase in uniform basis (to be determined) $19,000 (total appreciation, $45,000 − $26,000)]=	
$18,081 (value of property included in gross estate) $45,000 (value of entire property)]	
	33,634
Step 4. Uniform basis reduced as required by section 1014(b)(9) for deductions allowed prior to death:	
Uniform basis before reduction	$33,634
less	
Deductions allowed prior to decedent's death—taken into account under section 1014(b)(9) (determined by the following formula)	1,607
Prior deductions taken into account (to be determined) $4,000 (total deductions allowed prior to decedent's death)]=	
$18,081 (value of property included in gross estate) $45,000 (value of entire property)	
	32,027

Step 5. A's basis for the life interest at the time of the decedent's death, determined under section 1015: 0.59820 (life factor, age 43) × $26,000		15,553
Step 6. B's basis for the remainder interest, determined under section 1014(a): Basis prior to the decedent's death:		
0.40180 (remainder factor, age 43) × $26,000		10,447
plus		
Increase in uniform basis owing to decedent's death:		
Increase in uniform basis	$7,634	
plus		
Reduction required by section 1014(b)(9)	1,607	
		6,027
		16,474

(b) Assume the same facts as in paragraph (a) of this section. Assume further, that following the decedent's death depreciation is allowed in the amount of $1,000 annually. As of January 1, 1964, when A's age is 52, the adjusted uniform basis of the entire property is $23,027; A's basis for the life interest is $9,323; and B's basis for the remainder interest is $13,704, computed as follows:

Step 7. Uniform basis (adjusted) as of January 1, 1964:	
Uniform basis determined under section 1014(a), reduced as required by section 1014(b)(9)	$32,027
less	
Depreciation allowed since decedent's death ($1,000 × 9)	9,000
	23,027
Step 8. Allocable share of adjustment for depreciation allowable in the nine years since the decedent's death:	
A's interest	
0.49587 (life factor, age 52) ×$7,200 ($800, depreciation attributable to uniform basis before increase under section 1014(a), ×9)	3,570
B's interest	
0.50413 (remainder factor, age 52) ×$7,200 ($800, depreciation attributable to uniform basis before increase under section 1014(a), ×9)	3,630
plus	
$200 (annual depreciation attributable to increase in uniform basis under section 1014(a)) ×9	1,800
	5,430
Step 9. Tentative bases of A's and B's interests as of January 1, 1964 (before adjustment for depreciation).	
A's interest	
0.49587 (life factor, age 52) ×$26,000 (adjusted uniform basis immediately before decedent's death)	12,893
B's interest	
0.50413 (remainder factor, age 52) ×$26,000 (adjusted uniform basis immediately before decedent's death)	13,107
plus	
Increase in uniform basis owing to inclusion of remainder in decedent's gross estate	6,027
	19,134

Step 10. Bases of A's and B's interests as of January 1, 1964.

A	
Tentative basis (Step 9)	12,893
less	
Allocable depreciation (Step 8)	3,570
	9,323
B	
Tentative basis (Step 9)	19,134
less	
Allocable depreciation (Step 8)	5,430
	13,704

§1.1014–8 Bequest, devise, or inheritance of a remainder interest.

(a)(1) Where property is transferred for life, with remainder in fee, and the remainderman dies before the life tenant, no adjustment is made to the uniform basis of the property on the death of the remainderman (see paragraph (a) of §1.1014–4). However, the basis of the remainderman's heir, legatee, or devisee for the remainder interest is determined by adding to (or subtracting from) the part of the adjusted uniform basis assigned to the remainder interest (determined in accordance with the principles set forth in §§1.1014–4 through 1.1014–6) the difference between—

(i) The value of the remainder interest included in the remainderman's estate, and

(ii) The basis of the remainder interest immediately prior to the remainderman's death.

(2) The basis of any property distributed to the heir, legatee, or devisee upon termination of a trust (or legal life estate) or at any other time (unless included in the gross income of the legatee or devisee) shall be determined by adding to (or subtracting from) the adjusted uniform basis of the property thus distributed the difference between—

(i) The value of the remainder interest in the property included in the remainderman's estate, and

(ii) The basis of the remainder interest in the property immediately prior to the remainderman's death.

(b) The provisions of paragraph (a) of this section are illustrated by the following examples:

Example 1. Assume that, under the will of a decedent, property consisting of common stock with a value of $1,000 at the time of the decedent's death is transferred in trust, to pay the income to A for life, remainder to B or to B's estate. B predeceases A and bequeaths the remainder interest to C. Assume that B dies on January 1, 1956, and that the value of the stock originally transferred is $1,600 at B's death. A's age at that time is 37. The value of the remainder interest included in B's estate is $547 (0.34185, remainder factor age 37, ×$1,600), and hence $547 is C's basis for the remainder interest immediately after B's death. Assume that C sells the remainder interest on January 1, 1961, when A's age is 42. C's basis for the remainder interest at the time of such sale is $596, computed as follows:

Basis of remainder interest computed with respect to uniform basis of entire property (0.39131, remainder factor age 42, ×$1,000, uniform basis of entire property)		$391
plus		
Value of remainder interest included in B's estate	$547	
less		
Basis of remainder interest immediately prior to B's death (0.34185, remainder factor age 37, ×$1,000)	342	
		205
Basis of C's remainder interest at the time of sale		596

Example 2. Assume the same facts as in example (1), except that C does not sell the remainder interest. Upon A's death terminating the trust, C's basis for the stock distributed to him is computed as follows:

Uniform basis of the property, adjusted to date of termination of the trust		$1,000
plus		
Value of remainder interests in the property at the time of B's death	$547	
less		
B's share of uniform basis of the property at the time of his death	342	
		205
C's basis for the stock distributed to him upon the termination of the trust		1,205

Example 3. Assume the same facts as in example (2), except that the property transferred is depreciable. Assume further that $100 of depreciation was allowed prior to B's death and that $50 of depreciation is allowed between the time of B's death and the termination of the trust. Upon A's death terminating the trust, C's basis for the property distributed to him is computed as follows:

Uniform basis of the property, adjusted to date of termination of the trust:		
Uniform basis immediately after decedent's death	$1,000	
Depreciation allowed following decedent's death	150	
		$350
plus		
Value of remainder interest in the property at the time of B's death	547	
less		
B's share of uniform basis of the property at the time of his death (0.34185×$900, uniform basis at B's death)	308	

C's basis for the property distributed to him upon the termination of the trust	1,089

(c) The rules stated in paragraph (a) of this section do not apply where the basis of the remainder interest in the hands of the remainderman's transferee is determined by reference to its cost to such transferee. See also paragraph (a) of § 1.1014–4. Thus, if, in example (*1*) of paragraph (b) of this section B sold his remainder interest to C for $547 in cash, C's basis for the stock distributed to him upon the death of A terminating the trust is $547.

§ 1.1014–9 Special rule with respect to DISC stock.

(a) *In general.* If property consisting of stock of a DISC or former DISC (as defined in section 992(a) (1) or (3) as the case may be) is considered to have been acquired from a decedent (within the meaning of paragraph (a) or (b) of § 1.1014–2), the uniform basis of such stock under section 1014, as determined pursuant to §§ 1.1014–1 through 1.1014–8 shall be reduced as provided in this section. Such uniform basis shall be reduced by the amount (hereinafter referred to in this section as the amount of reduction), if any, which the decedent would have included in his gross income under section 995(c) as a dividend if the decedent had lived and sold such stock at its fair market value on the estate tax valuation date. If the alternate valuation date for Federal estate tax purposes is elected under section 2032, in computing the gain which the decedent would have had if he had lived and sold the stock on the alternate valuation date, the decedent's basis shall be determined with reduction for any distributions with respect to the stock which may have been made, after the date of the decedent's death and on or before the alternate valuation date, from the DISC's previously taxed income (as defined in section 996(f)(2)). For this purpose, the last sentence of section 996(e)(2) (relating to reductions of basis of DISC stock) shall not apply. For purposes of this section, if the corporation is not a DISC or former DISC at the date of the decedent's death but is a DISC for a taxable year which begins after such date and on or before the alternate valuation date, the corporation will be considered to be a DISC or former DISC only if the alternate valuation date is elected. The provisions of this paragraph apply with respect to stock of a DISC or former DISC which is included in the gross estate of the decedent, including but not limited to property which—

(1) Is acquired from the decedent before his death, and the entire property is subsequently included in the decedent's gross estate for estate tax purposes, or

(2) Is acquired property described in paragraph (d) of § 1.1014–3.

(b) *Portion of property acquired from decedent before his death included in decedent's gross estate*—(1) *In general.* In cases where, due to the operation of the estate tax, only a portion of property which consists of stock of a DISC or former DISC and which is acquired from a decedent before his death is included in the decedent's gross estate, the uniform basis of such stock under section 1014, as determined pursuant to §§ 1.1014–1 through 1.1014–8, shall be reduced by an amount which bears the same ratio to the amount of reduction which would have been determined under paragraph (a) of this section if the entire property consisting of such stock were included in the decedent's gross estate as the value of such property included in the decedent's gross estate bears to the value of the entire property.

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

Example: The decedent creates a trust during his lifetime to pay the income to A for life, remainder to B or his estate. The trust instrument further provides that if the decedent shall survive A, the income shall be paid to the decedent for life. The decedent predeceases A, so that, due to the operation of the estate tax, only the present value of the remainder interest is included in the decedent's gross estate. The trust consists of 100 shares of the stock of X corporation (which is a DISC at the time the shares are transferred to the trust and at the time of the decedent's death) with an adjusted basis immediately prior to the decedent's death of $10,000 (as determined under section 1015). At the time of the decedent's death the value of the stock is $20,000, and the value of the remainder interest in the hands of B is $8,000. Applying the principles of paragraph (b)(3)(i) of § 1.1014–6, the uniform basis of the entire property following the decedent's death, prior to reduction pursuant to this paragraph, is $14,000. The amount of reduction which would have been determined under paragraph (a) of this section if the entire property consisting of such stock of X corporation were included in the decedent's gross estate is $5,000. The uniform basis of the entire property following the decedent's death, as reduced pursuant to this paragraph, is $12,000, computed as follows:

Uniform basis under section 1014(a), prior to reduction pursuant to this paragraph	$14,000
Less decrease in uniform basis (determined by the following formula)	2,000
[Reduction in uniform basis (to be determined)/ $5,000 (amount of reduction if paragraph (a) applied)] =	
[$8,000 (value of property included in gross estate/$20,000 (value of entire property)]	
Uniform basis under section 1014(a) reduced pursuant to this paragraph	12,000

(c) *Estate tax valuation date.* For purposes of section 1014(d) and this section, the estate tax valuation date is the date of the decedent's death or, in the case of an election under section 2032, the applicable valuation date prescribed by that section.

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

Example 1. At the date of A's death, his DISC stock has a fair market value of $100. The estate does not elect the alternate valuation allowed by section 2032, and A's basis in such stock is $60 at the date of his death. The person who acquires such stock from the decedent will take as a basis for such stock its fair market value at A's death ($100), reduced by the amount which would have been included in A's gross income under section 995(c) as a dividend if A had sold stock on the date he died. Thus, if the amount that would have been treated as a dividend under section 995(c) were $30, such person will take a basis of $70 for such stock ($100, reduced by $30). If such person were immediately to sell the DISC stock so received for $100, $30 of the proceeds from the sale would be treated as a dividend by such person under section 995(c).

Example 2. Assume the same facts as in example (1) except that the estate elects the alternate valuation allowed by section 2032, the DISC stock has a fair market value of $140 on the alternate valuation date, the amount that would have been treated as a dividend under section 995(c) in the event of a sale on such date is $50 and the DISC has $20 of previously taxed income which accrued after the date of the decedent's death and before the alternate valuation date. The basis of the person who acquires such stock will be $90 determined as follows:

(1) Fair market value of DISC stock at alternate valuation date	$140
(2) Less: Amount which would have been treated as a dividend under section 995(c)	50
(3) Basis of person who acquires DISC stock	90

If a distribution of $20 attributable to such previously taxed income had been made by the DISC on or before the alternate valuation date (with the DISC stock having a fair market value of $120 after such distribution), the basis of the person who acquires such stock will be $70 determined as follows:

(1) Fair market value of DISC stock at alternate valuation date	$120
(2) Less: Amount which would have been treated as a dividend under section 995(c)	50
(3) Basis of person who acquires DISC stock	70

[T.D. 7283, 38 FR 20825, Aug. 3, 1973]

§1.1015–1 Basis of property acquired by gift after December 31, 1920.

(a) *General rule.* (1) In the case of property acquired by gift after December 31, 1920 (whether by a transfer in trust or otherwise), the basis of the property for the purpose of determining gain is the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift. The same rule applies in determining loss unless the basis (adjusted for the period prior to the date of gift in accordance with sections 1016 and 1017) is greater than the fair market value of the property at the time of the gift. In such case, the basis for determining loss is the fair market value at the time of the gift.

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

Example: A acquires by gift income-producing property which has an adjusted basis of $100,000 at the date of gift. The fair market value of the property at the date of gift is $90,000. A later sells the property for $95,000. In such case there is neither gain nor loss. The basis for determining loss is $90,000; therefore, there is no loss. Furthermore, there is no gain, since the basis for determining gain is $100,000.

(3) If the facts necessary to determine the basis of property in the hands of the donor or the last preceding

owner by whom it was not acquired by gift are unknown to the donee, the district director shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the district director finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the district director as of the date or approximate date at which, according to the best information the district director is able to obtain, such property was acquired by such donor or last preceding owner. See paragraph (e) of this section for rules relating to fair market value.

(b) *Uniform basis; proportionate parts of.* Property acquired by gift has a single or uniform basis although more than one person may acquire an interest in such property. The uniform basis of the property remains fixed subject to proper adjustment for items under sections 1016 and 1017. However, the value of the proportionate parts of the uniform basis represented, for instance, by the respective interests of the life tenant and remainderman are adjustable to reflect the change in the relative values of such interest on account of the lapse of time. The portion of the basis attributable to an interest at the time of its sale or other disposition shall be determined under the rules provided in § 1.1014–5. In determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in § 1.1001–1(f)(2)) the adjusted basis of which is determined pursuant, or by reference, to section 1015, that part of the adjusted uniform basis assignable under the rules of § 1.1014– 5(a) to the interest sold or otherwise disposed of shall be disregarded to the extent and in the manner provided by section 1001(e) and § 1.1001–1(f).

(c) *Time of acquisition.* The date that the donee acquires an interest in property by gift is when the donor relinquishes dominion over the property and not necessarily when title to the property is acquired by the donee. Thus, the date that the donee acquires an interest in property by gift where he is a successor in interest, such as in the case of a remainderman of a life estate or a beneficiary of the distribution of the corpus of a trust, is the date such interests are created by the donor and not the date the property is actually acquired.

(d) *Property acquired by gift from a decedent dying after December 31, 1953.* If an interest in property was acquired by the taxpayer by gift from a donor dying after December 31, 1953, under conditions which required the inclusion of the property in the donor's gross estate for estate tax purposes, and the property had not been sold, exchanged, or otherwise disposed of by the taxpayer before the donor's death, see the rules prescribed in section 1014 and the regulations thereunder.

(e) *Fair market value.* For the purposes of this section, the value of property as appraised for the purpose of the Federal gift tax, or, if the gift is not subject to such tax, its value as appraised for the purpose of a State gift tax, shall be deemed to be the fair market value of the property at the time of the gift.

(f) *Reinvestments by fiduciary.* If the property is an investment by the fiduciary under the terms of the gift (as, for example, in the case of a sale by the fiduciary of property transferred under the terms of the gift, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the basis specified in paragraph (a) of this section.

(g) *Records.* To insure a fair and adequate determination of the proper basis under section 1015, persons making or receiving gifts of property should preserve and keep accessible a record of the facts necessary to determine the cost of the property and, if pertinent, its fair market value as of March 1, 1913, or its fair market value as of the date of the gift.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6693, 28 FR 12818, Dec. 3, 1963; T.D. 7142, 36 FR 18952, Sept. 24, 1971]

§ 1.1015–2 Transfer of property in trust after December 31, 1920.

(a) *General rule.* (1) In the case of property acquired after December 31, 1920, by transfer in trust (other than by a transfer in trust by a gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by a transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to the termination of the trust and distribution of the property, or thereafter.

(2) The principles stated in paragraph (b) of §1.1015–1 concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by transfer in trust after December 31, 1920.

(b) *Reinvestment by fiduciary.* If the property is an investment made by the fiduciary (as, for example, in the case of a sale by the fiduciary of property transferred by the grantor, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the basis specified in paragraph (a) of this section.

§1.1015–3 Gift or transfer in trust before January 1, 1921.

(a) In the case of property acquired by gift or transfer in trust before January 1, 1921, the basis of such property is the fair market value thereof at the time of the gift or at the time of the transfer in trust.

(b) The principles stated in paragraph (b) of §1.1015–1 concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by gift or transfer in trust before January 1, 1921. In addition, if an interest in such property was acquired from a decedent and the property had not been sold, exchanged, or otherwise disposed of before the death of the donor, the rules prescribed in section 1014 and the regulations thereunder are applicable in determining the basis of such property in the hands of the taxpayer.

§1.1015–4 Transfers in part a gift and in part a sale.

(a) *General rule.* Where a transfer of property is in part a sale and in part a gift, the unadjusted basis of the property in the hands of the transferee is the sum of—

(1) Whichever of the following is the greater:

(i) The amount paid by the transferee for the property, or

(ii) The transferor's adjusted basis for the property at the time of the transfer, and

(2) The amount of increase, if any, in basis authorized by section 1015(d) for gift tax paid (see §1.1015–5).

For determining loss, the unadjusted basis of the property in the hands of the transferee shall not be greater than the fair market value of the property at the time of such transfer. For determination of gain or loss of the transferor, see §1.1001–1(e) and §1.1011–2. For special rule where there has been a charitable contribution of less than a taxpayer's entire interest in property, see section 170(e)(2) and §1.170A–4(c).

(b) *Examples.* The rule of paragraph (a) of this section is illustrated by the following examples:

Example 1. If A transfers property to his son for $30,000, and such property at the time of the transfer has an adjusted basis of $30,000 in A's hands (and a fair market value of $60,000), the unadjusted basis of the property in the hands of the son is $30,000.

Example 2. If A transfers property to his son for $60,000, and such property at the time of transfer has an adjusted basis of $30,000 in A's hands (and a fair market value of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

Example 3. If A transfers property to his son for $30,000, and such property at the time of transfer has an adjusted basis in A's hands of $60,000 (and a fair market value of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

Example 4. If A transfers property to his son for $30,000 and such property at the time of transfer has an adjusted basis of $90,000 in A's hands (and a fair market value of $60,000), the unadjusted basis of the property in the hands of the son ins $90,000. However, since the adjusted basis of the property in A's hands at the time of the transfer was greater than the fair market value at that time, for the purpose of determining any loss on a later sale or other disposition of the property by the son its unadjusted basis in his hands is $60,000.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6693, 28 FR 12818, Dec. 3, 1963; T.D. 7207, 37 FR 20799, Oct. 5, 1972]

§ 1.1015–5 Increased basis for gift tax paid.

(a) *General rule in the case of gifts made on or before December 31, 1976.* (1)(i) Subject to the conditions and limitations provided in section 1015(d), as added by the Technical Amendments Act of 1958, the basis (as determined under section 1015(a) and paragraph (a) of § 1.1015–1) of property acquired by gift is increased by the amount of gift tax paid with respect to the gift of such property. Under section 1015(d)(1)(A), such increase in basis applies to property acquired by gift on or after September 2, 1958 (the date of enactment of the Technical Amendments Act of 1958). Under section 1015(d)(1)(B), such increase in basis applies to property acquired by gift before September 2, 1958, and not sold, exchanged, or otherwise disposed of before such date. If section 1015(d)(1)(A) applies, the basis of the property is increased as of the date of the gift regardless of the date of payment of the gift tax. For example, if the property was acquired by gift on September 8, 1958, and sold by the donee on October 15, 1958, the basis of the property would be increased (subject to the limitation of section 1015(d)) as of September 8, 1958 (the date of the gift), by the amount of gift tax applicable to such gift even though such tax was not paid until March 1, 1959. If section 1015(d)(1)(B) applies, any increase in the basis of the property due to gift tax paid (regardless of date of payment) with respect to the gift is made as of September 2, 1958. Any increase in basis under section 1015(d) can be no greater than the amount by which the fair market value of the property at the time of the gift exceeds the basis of such property in the hands of the donor at the time of the gift. See paragraph (b) of this section for rules for determining the amount of gift tax paid in respect of property transferred by gift.

(ii) With respect to property acquired by gift before September 2, 1958, the provisions of section 1015(d) and this section do not apply if, before such date, the donee has sold, exchanged, or otherwise disposed of such property. The phrase *sold, exchanged, or otherwise disposed of* includes the surrender of a stock certificate for corporate assets in complete or partial liquidation of a corporation pursuant to section 331. It also includes the exchange of property for property of a like kind such as the exchange of one apartment house for another. The phrase does not, however, extend to transactions which are mere changes in form. Thus, it does not include a transfer of assets to a corporation in exchange for its stock in a transaction with respect to which no gain or loss would be recognizable for income tax purposes under section 351. Nor does it include an exchange of stock or securities in a corporation for stock or securities in the same corporation or another corporation in a transaction such as a merger, recapitalization, reorganization, or other transaction described in section 368(a) or 355, with respect to which no gain or loss is recognizable for income tax purposes under section 354 or 355. If a binding contract for the sale, exchange, or other disposition of property is entered into, the property is considered as sold, exchanged, or otherwise disposed of on the effective date of the contract, unless the contract is not subsequently carried out substantially in accordance with its terms. The effective date of a contract is normally the date it is entered into (and not the date it is consummated, or the date legal title to the property passes) unless the contract specifies a different effective date. For purposes of this subdivision, in determining whether a transaction comes within the phrase *sold, exchanged, or otherwise disposed of,* if a transaction would be treated as a mere change in the form of the property if it occurred in a taxable year subject to the Internal Revenue Code of 1954, it will be so treated if the transaction occurred in a taxable year subject to the Internal Revenue Code of 1939 or prior revenue law.

(2) Application of the provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. In 1938, A purchased a business building at a cost of $120,000. On September 2, 1958, at which time the property had an adjusted basis in A's hands of $60,000, he gave the property to his nephew, B. At the time of the gift to B, the property had a fair market value of $65,000 with respect to which A paid a gift tax in the amount of $7,545. The basis of the property in B's hands at the time of the gift, as determined under section 1015(a) and §1.1015–1, would be the same as the adjusted basis in A's hands at the time of the gift, or $60,000. Under section 1015(d) and this section, the basis of the building in B's hands as of the date of the gift would be increased by the amount of the gift tax paid with respect to such gift, limited to an amount by which the fair market value of the property at the time of the gift exceeded the basis of the property in the hands of A at the time of gift, or $5,000. Therefore, the basis of the property in B's hands immediately after the gift, both for determining gain or loss on the sale of the property, would be $65,000.

Example 2. C purchased property in 1938 at a cost of $100,000. On October 1, 1952, at which time the property had an adjusted basis of $72,000 in C's hands, he gave the property to his daughter, D. At the date of the gift to D, the property had a fair market value of $85,000 with respect to which C paid a gift tax in the amount of $11,745. On September 2, 1958, D still held the property which then had an adjusted basis in her hands of $65,000. Since the excess of the fair market value of the property at the time of the gift to D over the adjusted basis of the property in C's hands at such time is greater than the amount of gift tax paid, the basis of the property in D's hands would be increased as of September 2, 1958, by the amount of the gift tax paid, or $11,745. The adjusted basis of the property in D's hands, both for determining gain or loss on the sale of the property, would then be $76,745 ($65,000 plus $11,745).

Example 3. On December 31, 1951, E gave to his son, F, 500 shares of common stock of the X Corporation which shares had been purchased earlier by E at a cost of $100 per share, or a total cost of $50,000. The basis in E's hands was still $50,000 on the date of the gift to F. On the date of the gift, the fair market value of the 500 shares was $80,000 with respect to which E paid a gift tax in the amount of $10,695. In 1956, the 500 shares of X Corporation stock were exchanged for 500 shares of common stock of the Y Corporation in a reorganization with respect to which no gain or loss was recognized for income tax purposes under section 354. F still held the 500 shares of Y Corporation stock on September 2, 1958. Under such circumstances, the 500 shares of X Corporation stock would not, for purposes of section 1015(d) and this section, be considered as having been *sold, exchanged, or otherwise disposed of* by F before September 2, 1958. Therefore, the basis of the 500 shares of Y Corporation stock held by F as of such date would, by reason of section 1015(d) and this section, be increased by $10,695, the amount of gift tax paid with respect to the gift to F of the X Corporation stock.

Example 4. On November 15, 1953, G gave H property which had a fair market value of $53,000 and a basis in the hands of G of $20,000. G paid gift tax of $5,250 on the transfer. On November 16, 1956, H gave the property to J who still held it on September 2, 1958. The value of the property on the date of the gift to J was $63,000 and H paid gift tax of $7,125 on the transfer. Since the property was not sold, exchanged, or otherwise disposed of by J before September 2, 1958, and the gift tax paid on the transfer to J did not exceed $43,000 ($63,000, fair market value of property at time of gift to J, less $20,000, basis of property in H's hands at that time), the basis of property in his hands is increased on September 2, 1958, by $7,125, the amount of gift tax paid by H on the transfer. No increase in basis is allowed for the $5,250 gift tax paid by G on the transfer to H, since H had sold, exchanged, or otherwise disposed of the property before September 2, 1958.

(b) *Amount of gift tax paid with respect to gifts made on or before December 31, 1976.* (1)(i) If only one gift was made during a certain *calendar period* (as defined in §25.2502–1(c)(1)), the entire amount of the gift tax paid under chapter 12 or the corresponding provisions of prior revenue laws for that calendar period is the amount of the gift tax paid with respect to the gift.

(ii) If more than one gift was made during a certain calendar period, the amount of the gift tax paid under chapter 12 or the corresponding provisions of prior revenue laws with respect to any specified gift made during that calendar period is an amount, A, which bears the same ratio to B (the total gift tax paid for that calendar period) as C (the *amount of the gift,* computed as described in this paragraph (b)(1)(ii)) bears to D (the total taxable gifts for the calendar period computed without deduction for the gift tax specific exemption under section 2521 (as in effect prior to its repeal by the Tax Reform Act of 1976) or the corresponding provisions of prior revenue laws). Stated algebraically, the amount of the gift tax paid with respect to a gift equals:

[*Amount of the gift* (C) / TOTAL TAXABLE GIFTS, PLUS SPECIFIC EXEMPTION ALLOWED (D)] × TOTAL GIFT TAX PAID (B)

For purposes of the ratio stated in the preceding sentence, the *amount of the gift* referred to as factor ''C'' is the value of the gift reduced by any portion excluded or deducted under section 2503(b) (annual exclusion), 2522 (charitable deduction), or 2523 (marital deduction) of the Code or the corresponding provisions of prior revenue laws. In making the computations described in this paragraph, the values to be used are those finally determined for purposes of the gift tax.

(iii) If a gift consists of more than one item of property, the gift tax paid with respect to each item shall be computed by allocating to each item a proportionate part of the gift tax paid with respect to the gift, computed in accordance with the provisions of this paragraph.

(2) For purposes of this paragraph, it is immaterial whether the gift tax is paid by the donor or the donee. Where more than one gift of a present interest in property is made to the same donee during a *calendar period* (as defined in § 25.2502–1(c)(1)), the annual exclusion shall apply to the earliest of such gifts in point of time.

(3) Where the donor and his spouse elect under section 2513 or the corresponding provisions of prior law to have any gifts made by either of them considered as made one-half by each, the amount of gift tax paid with respect to such a gift is the sum of the amounts of tax (computed separately) paid with respect to each half of the gift by the donor and his spouse.

(4) The method described in section 1015(d)(2) and this paragraph for computing the amount of gift tax paid in respect of a gift may be illustrated by the following examples:

Example 1. Prior to 1959 H made no taxable gifts. On July 1, 1959, he made a gift to his wife, W, of land having a value for gift purposes of $60,000 and gave to his son, S, certain securities valued at $60,000. During the year 1959, H also contributed $5,000 in cash to a charitable organization described in section 2522. H filed a timely gift tax return for 1959 with respect to which he paid gift tax in the amount of $6,000, computed as follows:

Value of land given to W		$60,000	
Less: Annual exclusion	$3,000		
Marital deduction	30,000	33,000	
Included amount of gift			$27,000
Value of securities given to S		60,000	
Less: Annual exclusion		3,000	
Included amount of gift			57,000
Gift to charitable organization		5,000	
Less: Annual exclusion	3,000		
Charitable deduction	2,000	5,000	
Included amount of gift			0
Total included gifts			84,000
Less: Specific exemption allowed			30,000
Taxable gifts for 1959			54,000
Gift tax on $54,000			6,000

In determining the gift tax paid with respect to the land given to W, amount C of the ratio set forth in subparagraph (1)(ii) of this paragraph is $60,000, value of property given to W, less $33,000 (the sum of $3,000, the amount excluded under section 2503(b), and $30,000, the amount deducted under section 2523), or $27,000. Amount D of the ratio is $84,000 (the amount of taxable gifts, $54,000, plus the gift tax specific exemption, $30,000). The gift tax paid with respect to the land given to W is $1,928.57, computed as follows:

$$\$27{,}000(C) \div \$84{,}000(D) \times \$6{,}000(B)$$

Example 2. The facts are the same as in example (1) except that H made his gifts to W and S on July 1, 1971, and that prior to 1971, H made no taxable gifts. Furthermore, H made his charitable contribution on August 12, 1971. These were the only gifts made by H during 1971. H filed his gift tax return for the third quarter of 1971 on November 15, 1971, as required by section 6075(b). With respect to the above gifts H paid a gift tax in the amount of $6,000 on total taxable gifts of $54,000 for the third quarter of 1971. The gift tax paid with respect to the land given to W is $1,928.57. The computations for these figures are identical to those used in example (1).

Example 3. On January 15, 1956, A made a gift to his nephew, N, of land valued at $86,000, and on June 30, 1956, gave N securities valued at $40,000. On July 1, 1956, A gave to his sister, S, $46,000 in cash. A and his wife, B, were married during the entire calendar year 1956. The amount of A's taxable gifts for prior years was zero although in arriving at that amount A had used in full the specific exemption authorized by section 2521. B did not make any gifts before 1956. A and B elected under section 2513 to have all gifts made by either during 1956 treated as made one-half by A and one-half by B. Pursuant to that election, A and B each filed a gift tax return for 1956. A paid gift tax of $11,325 and B paid gift tax of $5,250, computed as follows:

	A	B
Value of land given to N	$43,000	$43,000
Less: exclusion	3,000	3,000
Included amount of gift	40,000	40,000
Value of securities given to N	20,000	20,000
Less: exclusion	None	None

	A	B
Included amount of gift	20,000	20,000
Cash gift to S	23,000	23,000
Less: exclusion	3,000	3,000
Included amount of gift	20,000	20,000
Total included gifts	80,000	80,000
Less: specific exemption	None	30,000
Taxable gifts for 1956	80,000	50,000
Gift tax for 1956	11,325	5,250

The amount of the gift tax paid by A with respect to the land given to N is computed as follows:

$40,000(C) / $80,000(D) × $11,325(B) = $5,662.50

The amount of the gift tax paid by B with respect to the land given to N is computed as follows:

$40,000(C) / $80,000(D) × $5,250(B) = $2,625

The amount of the gift tax paid with respect to the land is $5,662.50 plus $2,625, or $8,287.50. Computed in a similar manner, the amount of gift tax paid by A with respect to the securities given to N is $2,831.25, and the amount of gift tax paid by B with respect thereto is $1,312.50, or a total of $4,143.75.

Example 4. The facts are the same as in example (3) except that A gave the land to N on January 15, 1972, the securities to N on February 3, 1972, and the cash to S on March 7, 1972. As in example (3), the amount of A's taxable gifts for taxable years prior to 1972 was zero, although in arriving at that amount A had used in full the specific exemption authorized by section 2521. B did not make any gifts before 1972. Pursuant to the election under section 2513, A and B treated all gifts made by either during 1972 as made one-half by A and one-half by B. A and B each filed a gift tax return for the first quarter of 1972 on May 15, 1972, as required by section 6075(b). A paid gift tax of $11,325 on taxable gifts of $80,000 and B paid gift tax of $5,250 on taxable gifts of $50,000. The amount of the gift tax paid by A and B with respect to the land given to N is $5,662.50 and $2,625, respectively. The computations for these figures are identical to those used in example (3).

(c) *Special rule for increased basis for gift tax paid in the case of gifts made after December 31, 1976*—(1) *In general.* With respect to gifts made after December 31, 1976 (other than gifts between spouses described in section 1015(e)), the increase in basis for gift tax paid is determined under section 1015(d)(6). Under section 1015(d)(6)(A), the increase in basis with respect to gift tax paid is limited to the amount (not in excess of the amount of gift tax paid) that bears the same ratio to the amount of gift tax paid as the net appreciation in value of the gift bears to the amount of the gift.

(2) *Amount of gift.* In general, for purposes of section 1015(d)(6)(A)(ii), the amount of the gift is determined in conformance with the provisions of paragraph (b) of this section. Thus, the amount of the gift is the amount included with respect to the gift in determining (for purposes of section 2503(a)) the total amount of gifts made during the calendar year (or calendar quarter in the case of a gift made on or before December 31, 1981), reduced by the amount of any annual exclusion allowable with respect to the gift under section 2503(b), and any deductions allowed with respect to the gift under section 2522 (relating to the charitable deduction) and section 2523 (relating to the marital deduction). Where more than one gift of a present interest in property is made to the same donee during a calendar year, the annual exclusion shall apply to the earliest of such gifts in point of time.

(3) *Amount of gift tax paid with respect to the gift.* In general, for purposes of section 1015(d)(6), the amount of gift tax paid with respect to the gift is determined in conformance with the provisions of paragraph (b) of this section. Where more than one gift is made by the donor in a calendar year (or quarter in the case of gifts made on or before December 31, 1981), the amount of gift tax paid with respect to any specific gift made during that period is the amount which bears the same ratio to the total gift tax paid for that period (determined after reduction for any gift tax unified credit available under section 2505) as the amount of the gift (computed as described in paragraph (c)(2) of this section) bears to the total taxable gifts for the period.

(4) *Qualified domestic trusts.* For purposes of section 1015(d)(6), in the case of a qualified domestic trust (QDOT) described in section 2056A(a), any distribution during the noncitizen surviving spouse's lifetime with respect to which a tax is imposed under section 2056A(b)(1)(A) is treated as a transfer by gift, and any estate tax paid on the distribution under section

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

§1.1016–2 Items properly chargeable to capital account.

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

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

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

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

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

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

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

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

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

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

(ii) The determination of the amount properly allowable for exhaustion, wear and tear, obsolescence, amortization, and depletion shall be made on the basis of facts reasonably known to exist at the end of the taxable year. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any such allowance or his taking an allowance plainly inadequate under the known facts in prior years. In the case of depreciation, if in prior years the taxpayer has consistently taken proper deductions under one method, the amount allowable for such prior years shall not be increased even though a greater amount would have been allowable under another proper method. For rules governing losses on retirement of depreciable property, including rules for determining basis, see § 1.167(a)–8. This subdivision may be illustrated by the following example:

Example: An asset was purchased January 1, 1950, at a cost of $10,000. The useful life of the asset is 10 years. It has no salvage value. Depreciation was deducted and allowed for 1950 to 1954 as follows:

1950	$500
1951	....
1952	1,000
1953	1,000
1954	1,000
Total amount allowed	3,500

The correct reserve as of December 31, 1954, is computed as follows:

December 31:	
1950 ($10,000÷10)	$1,000
1951 ($9,000÷9)	1,000
1952 ($8,000÷8)	1,000
1953 ($7,000÷7)	1,000
1954 ($6,000÷6)	1,000
Reserve December 31, 1954	5,000
Depreciation for 1955 is computed as follows:	
Cost	10,000
Reserve as of December 31, 1954	5,000
Unrecovered cost	5,000
Depreciation allowable for 1955 ($5,000÷5)	1,000

(2) *Adjustment for amount allowable where no depreciation deduction claimed.* (i) If the taxpayer has not taken a depreciation deduction either in the taxable year or for any prior taxable year, adjustments to basis of the property for depreciation allowable shall be determined by using the straight-line method of depreciation. (See § 1.1016–4 for adjustments in the case of persons exempt from income taxation.)

(ii) For taxable years beginning after December 31, 1953, and ending after August 16, 1954, if the taxpayer with respect to any property has taken a deduction for depreciation properly under one of the methods provided in section 167(b) for one or more years but has omitted the deduction in other years, the adjustment to basis for the depreciation allowable in such a case will be the deduction under the method which was used by the taxpayer with respect to that property. Thus, if A acquired property in 1954 on which he properly computed his depreciation deduction under the method described in section 167(b)(2) (the declining-balance method) for the first year of its useful life but did not take a deduction in the second and third year of the asset's life, the adjustment to basis for depreciation allowable for the second and third year will be likewise computed under the declining-balance method.

(3) *Adjustment for depletion deductions with respect to taxable years before 1932.* Where for any taxable year before the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall not exceed a depletion deduction which would have been allowable for such year if computed without reference to discovery value or a percentage of income.

(b) *Adjustment for periods beginning on or after January 1, 1952.* The decrease required by paragraph (a) of this section for deductions in respect of any period beginning on or after January 1, 1952, shall be whichever is the greater of the following amounts:

(1) The amount allowed as deductions in computing taxable income under subtitle A of the Code or prior income tax laws and resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under subtitle A of the Code (other than chapter 2, relating to tax on self-employment income) or prior income, war-profits, or excess-profits tax laws; or

(2) The amount properly allowable as deductions in computing taxable income under subtitle A of the Code or prior income tax laws (whether or not the amount properly allowable would have caused a reduction for any taxable year of the taxpayer's taxes).

(c) *Adjustment for periods since February 28, 1913, and before January 1, 1952, where no election made.* If no election has been properly made under section 1020, or under section 113(d) of the Internal Revenue Code of 1939 (see paragraph (d) of this section), the decrease required by paragraph (a) of this section for deductions in respect of any period since February 28, 1913, and before January 1, 1952, shall be whichever of the following amounts is the greater:

(1) The amount allowed as deductions in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws;

(2) The amount properly allowable in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws.

For the purpose of determining the decrease required by this paragraph, it is immaterial whether or not the amount under subparagraph (1) of this paragraph or the amount under subparagraph (2) of this paragraph would have resulted in a reduction for any taxable year of the taxpayer's taxes.

(d) *Adjustment for periods since February 28, 1913, and before January 1, 1952, where election made.* If an election has been properly made under section 1020, or under section 113(d) of the Internal Revenue Code of 1939, the decrease required by paragraph (a) of this section for deductions in respect of any period since February 28, 1913, and before January 1, 1952, shall be whichever is the greater of the following amounts:

(1) The amount allowed as deductions in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws and resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under such chapter 1 (other than subchapter E, relating to tax on self-employment income), subchapter E, chapter 2, of the Internal Revenue Code of 1939, or prior income, war-profits, or excess-profits tax laws;

(2) The amount properly allowable as deductions in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws (whether or not the amount properly allowable would have caused a reduction for any taxable year of the taxpayer's taxes).

(e) *Determination of amount allowed which reduced taxpayer's taxes.* (1) As indicated in paragraphs (b) and (d) of this section, there are situations in which it is necessary to determine (for the purpose of ascertaining the basis adjustment required by paragraph (a) of this section) the extent to which the amount allowed as deductions resulted in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2 relating to tax on self-employment income) of the Code, or prior income, war-profits, or excess-profits tax laws. This amount (amount allowed which resulted in a reduction of the taxpayer's taxes) is hereinafter referred to as the *tax-benefit amount allowed.* For the purpose of determining whether the tax-benefit amount allowed exceeded the amount allowable, a determination must be made of that portion of the excess of the amount allowed over the amount allowable which, if disallowed, would not have resulted in an increase in any such tax previously determined. If the entire excess of the amount allowed over the amount allowable could be disallowed without any such increase in tax, the tax-benefit amount allowed shall not be considered to have exceeded the amount allowable. In such a case (if paragraph (b) or (d) of this section is applicable) the reduction in basis required by paragraph (a) of this section would be the amount properly allowable as a deduction. If only part of such excess could be disallowed without any such increase in tax, the tax-benefit amount allowed shall be considered to exceed the amount allowable to the extent of the remainder of such excess. In such a case (if paragraph (b) or (d) of this section is applicable), the reduction in basis required by paragraph (a) of this section would be the amount of the tax-benefit amount allowed.

(2) For the purpose of determining the tax-benefit amount allowed the tax previously determined shall be determined under the principles of section 1314. The only adjustments made in determining whether there would be an increase in tax shall be those resulting from the disallowance of the amount allowed. The taxable years for which the determination is made shall be the taxable year for which the deduction was allowed and any other taxable year which would be affected by the disallowance of such deduction. Examples of such other taxable years are taxable years to which there was a carryover or carryback of a net operating loss from the taxable year for which the deduction was allowed, and taxable years for which a computation under section

111 or section 1333 was made by reference to the taxable year for which the deduction was allowed. In determining whether the disallowance of any part of the deduction would not have resulted in an increase in any tax previously determined, proper adjustment must be made for previous determinations under section 1311, or section 3801 of the Internal Revenue Code of 1939, and for any previous application of section 1016(a)(2)(B), or section 113(b) (1)(B)(ii) of the Internal Revenue Code of 1939.

(3) If a determination under section 1016(a)(2)(B) must be made with respect to several properties for each of which the amount allowed for the taxable year exceeded the amount allowable, the tax-benefit amount allowed with respect to each of such properties shall be an allocated portion of the tax-benefit amount allowed determined by reference to the sum of the amounts allowed and the sum of the amounts allowable with respect to such several properties.

(4) In the case of property held by a partnership or trust, the computation of the tax-benefit amount allowed shall take into account the tax benefit of the partners or beneficiaries, as the case may be, from the deduction by the partnership or trust of the amount allowed to the partnership or the trust. For this purpose, the determination of the amount allowed which resulted in a tax benefit to the partners or beneficiaries shall be made in the same manner as that provided above with respect to the taxes of the person holding the property.

(5) A taxpayer seeking to limit the adjustment to basis to the tax-benefit amount allowed for any period, in lieu of the amount allowed, must establish the tax-benefit amount allowed. A failure of adequate proof as to the tax-benefit amount allowed with respect to one period does not preclude the taxpayer from limiting the adjustment to basis to the tax-benefit amount allowed with respect to another period for which adequate proof is available. For example, a corporate transferee may have available adequate records with respect to the tax effect of the deduction of erroneous depreciation for certain taxable years, but may not have available adequate records with respect to the deduction of excessive depreciation for other taxable years during which the property was held by its transferor. In such case the corporate transferee shall not be denied the right to apply this section with respect to the erroneous depreciation for the period for which adequate proof is available.

(f) *Determination of amount allowable in prior taxable years.* (1) One of the factors in determining the adjustment to basis as of any date is the amount of depreciation, depletion, etc., allowable for periods prior to such date. The amount allowable for such prior periods is determined under the law applicable to such prior periods; all adjustments required by the law applicable to such periods are made in determining the adjusted basis of the property for the purpose of determining the amount allowable. Provisions corresponding to the rules in section 1016(a)(2)(B) described in paragraphs (d) and (e) of this section, which limit adjustments to the *tax-benefit amount allowed* where an election is properly exercised, were first enacted by the Act of July 14, 1952 (66 Stat. 629). That law provided that corresponding rules are deemed to be includible in all revenue laws applicable to taxable years ending after December 31, 1931. Accordingly, those rules shall be taken into account in determining the amount of depreciation, etc., allowable for any taxable year ending after December 31, 1931. For example, if the adjusted basis of property held by the taxpayer since January 1, 1930, is determined as of January 1, 1955, and if an election was properly made under section 1020, or section 113(d) of the Internal Revenue Code of 1939, then the amount allowable which is taken into account in computing the adjusted basis as of January 1, 1955, shall be determined by taking those rules into account for all taxable years ending after December 31, 1931. The Act of July 14, 1952, made no change in the law applicable in determining the amount allowable for taxable years ending before January 1, 1932. If there was a final decision of a court prior to the enactment of the Act of July 14, 1952, determining the amount allowable for a particular taxable year, such determination shall be adjusted. In such case the adjustment shall be made only for the purpose of taking the provision of that law into account and only to the extent made necessary by such provisions.

(2) Although the Act of July 14, 1952, amended the law applicable to all taxable years ending after December 31, 1931, the amendment does not permit refund, credit, or assessment of a deficiency for any taxable year for which such refund, credit, or assessment was barred by any law or rule of law.

(g) *Property with transferred basis.* The following rules apply in the determination of the adjustments to basis of property in the hands of a transferee, donee, or grantee which are required by section 1016(b), or section 113(b)(2) of the Internal Revenue Code of 1939, with respect to the period the property was held by the transferor, donor, or grantor:

(1) An election or a revocation of an election under section 1020, or section 113(d) of the Internal Revenue Code of 1939, by a transferor, donor, or grantor, which is made after the date of the transfer, gift, or grant of the property shall not affect the basis of such property in the hands of the transferee, donee, or grantee. An election or a revocation of an election made before the date of the transfer, gift, or grant of the property shall be taken into account in determining under section 1016(b) the adjustments to basis of such property as of the date of the transfer, gift, or grant, whether or not an election or a revocation of an election under section 1020, or section 113(d) of the Internal Revenue Code of 1939, was made by the transferee, donee, or grantee.

(2) An election by the transferee, donee, or grantee or a revocation of such an election shall be applicable in determining the adjustments to basis for the period during which the property was held by the transferor, donor, or grantor, whether or not the transferor, donor, or grantor had made an election or a revocation of an election, provided that the property was held by the transferee, donee, or grantee at any time on or before the date on which the election or revocation was made.

(h) *Examples.* The application of section 1016(a) (1) and (2) may be illustrated by the following examples:

Example 1. The case of Corporation A discloses the following facts:

The cost or other basis is to be adjusted by $16,500 with respect to the years 1952–54, that is, by the amount allowable but not less than the amount allowed which reduced the taxpayer's taxes. An adjustment must also be made with respect to the years 1949–1951, the amount of such adjustment depending upon whether an election was properly made under section 1020, or section 113(d) of the Internal Revenue Code of 1939. If no such election was made, the amount of the adjustment with respect to the years 1949–1951 is $19,500, that is, the amount allowed but not less than the amount allowable. If an election was properly made, the amount of the adjustment with respect to the years 1949–1951 is $19,000, that is, the amount allowable but not less than the amount allowed which reduced the taxpayer's taxes.

(1)—Year	(2)—Amount allowed	(3)—Amount allowed which reduced taxpayer's taxes	(4)—Amount allowable	(5)—Amount allowable but not less than amount allowed	(6)—Amount allowable but not less than amount allowed which reduced taxpayer's taxes
1949	$6,000	$5,500	$5,000	$6,000	$5,500
1950	7,000	7,000	6,500	7,000	7,000
1951	5,000	4,000	6,500	6,500	6,500
Total, 1949–1951	....	....	....	19,500	19,000
1952	6,500	6,500	6,000	....	6,500
1953	5,000	4,000	4,000	....	4,000

(1)—Year	(2)—Amount allowed	(3)—Amount allowed which reduced taxpayer's taxes	(4)—Amount allowable	(5)—Amount allowable but not less than amount allowed	(6)—Amount allowable but not less than amount allowed which reduced taxpayer's taxes
1954	4,500	4,500	6,000	....	6,000
Total, 1952–1954	....	....	....	....	16,500

Example 2. Corporation A, which files its returns on the basis of a calendar year, purchased a building on January 1, 1950, at a cost of $100,000. On the basis of the facts reasonably known to exist at the end of 1950, a period of 50 years should have been used as the correct useful life of the building; nevertheless, depreciation was computed by Corporation A on the basis of a useful life of 25 years, and was allowed for 1950 through 1953 as a deduction in an annual amount of $4,000. The building was sold on January 1, 1954. Corporation A did not make an election under section 1020, or section 113(d) of the Internal Revenue Code of 1939. No part of the amount allowed Corporation A for any of the years 1950 through 1953 resulted in a reduction of Corporation A's taxes. The adjusted basis of the building as of January 1, 1954, is $88,166, computed as follows:

Taxable year	Adjustments to basis as of beginning of taxable year	Adjusted basis on January 1	Remaining life on January 1	Depreciation allowable	Depreciation allowed
1950	....	$100,000	50	$2,000	$4,000
1951	$4,000	96,000	49	1,959	4,000
1952	8,000	92,000	48	1,917	4,000
1953	9,917	90,083	47	1,917	4,000
1954	11,834	88,166	....	....	....

Example 3. The facts are the same as in example (2), except that Corporation A made a proper election under section 1020. In such case, the adjusted basis of the building as of January 1, 1954, is $92,000 computed as follows:

Taxable year	Adjustments to basis as of beginning of taxable year	Adjusted basis on January 1	Remaining life on January 1	Depreciation allowable	Depreciation allowed
1950	....	$100,000	50	$2,000	$4,000
1951	$2,000	98,000	49	2,000	4,000
1952	4,000	96,000	48	2,000	4,000
1953	6,000	94,000	47	2,000	4,000
1954	8,000	92,000			

Example 4. If it is assumed that in example (2), or in example (3), all of the deduction allowed Corporation A for 1953 had resulted in a reduction of A's taxes, the adjustment to the basis of the building for depreciation for 1953 would reflect the entire $4,000 deduction. In such case, the adjusted basis of the building as of January 1, 1954, would be $86,083 in example (2), and $90,000 in example (3).

Example 5. The facts are the same as in example (2), except that for the year 1950 all of the $4,000 amount allowed Corporation A as a deduction for depreciation for that year resulted in a reduction of A's taxes. In such case, the adjustments to the basis of the building remain the same as those set forth in example (2).

Example 6. The facts are the same as in example (3), except that for the year 1950 all of the $4,000 amount allowed Corporation A as a deduction for depreciation resulted in a reduction of A's taxes. In such case, the adjusted basis of the building as of January 1, 1954, is $90,123, computed as follows:

Taxable year	Adjustments to basis as of beginning of taxable year	Adjusted basis on January 1	Remaining life on January 1	Depreciation allowable	Depreciation allowed
1950	....	$100,000	50	$2,000	$4,000
1951	$4,000	96,000	49	1,959	4,000
1952	5,959	94,041	48	1,959	4,000
1953	7,918	92,082	47	1,959	4,000
1954	9,877	90,123			

§1.1016–4 Exhaustion, wear and tear, obsolescence, amortization, and depletion; periods during which income was not subject to tax.

(a) Adjustments to basis must be made for exhaustion, wear and tear, obsolescence, amortization, and depletion to the extent actually sustained in respect of:

(1) Any period before March 1, 1913,

(2) Any period since February 28, 1913, during which the property was held by a person or organization not subject to income taxation under chapter 1 of the Code or prior income tax laws,

(3) Any period since February 28, 1913, and before January 1, 1958, during which the property was held by a person subject to tax under part I, subchapter L, chapter 1 of the Code, or prior income tax law, to the extent that section 1016(a)(2) does not apply, and

(4) Any period since February 28, 1913, during which such property was held by a person subject to tax under part II of subchapter L, chapter 1 of the Code, or prior income tax law, to the extent that section 1016(a)(2) does not apply.

(b) The amount of the adjustments described in paragraph (a) of this section actually sustained is that amount charged off on the books of the taxpayer where such amount is considered by the Commissioner to be reasonable. Otherwise, the amount actually sustained will be the amount that would have been allowable as a deduction:

(1) During the period described in paragraph (a) (1) or (2) of this section, had the taxpayer been subject to income tax during those periods, or

(2) During the period described in paragraph (a) (3) or (4) of this section, with respect to property held by a taxpayer described in that paragraph, to the extent that section 1016(a)(2) was inapplicable to such property during that period.

In the case of a taxpayer subject to the adjustment required by subparagraph (1) or (2) of this paragraph, depreciation shall be determined by using the straight line method.

[T.D. 6681, 28 FR 11131, Oct. 17, 1963]

§1.1016–5 Miscellaneous adjustments to basis.

(a) *Certain stock distributions.* (1) In the case of stock, the cost or other basis must be diminished by the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax free or were applicable in reduction of basis (not including distributions made by a corporation which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 (40 Stat. 1057) or the Revenue Act of 1921 (42 Stat. 227), out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or the Revenue Act of 1921). For adjustments to basis in the case of certain corporate distributions, see section 301 and the regulations thereunder.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example: A, who makes his returns upon the calendar year basis, purchased stock in 1923 for $5,000. He received in 1924 a distribution of $2,000 paid out of earnings and profits of the corporation accumulated before March 1, 1913. The adjusted basis for determining the gain or loss from the sale or other disposition of the stock in 1954 is $5,000 less $2,000, or $3,000, and the amount of the gain or loss from the sale or other disposition of the stock is the difference between $3,000 and the amount realized from the sale or other disposition.

(b) *Amortizable bond premium*—(1) *In general.* A holder's basis in a bond is reduced by the amount of bond premium used to offset qualified stated interest income under §1.171–2. This reduction occurs when the holder takes the qualified stated interest into account under the holder's regular method of accounting.

(2) *Special rules for taxable bonds.* A holder's basis in a taxable bond is reduced by the amount of bond premium allowed as a deduction under § 1.171–3(c)(5)(ii) (relating to the issuer's call of a taxable bond) or under § 1.171–2(a)(4)(i)(A) (relating to excess bond premium).

(3) *Special rule for tax-exempt obligations.* A holder's basis in a tax-exempt obligation is reduced by the amount of excess bond premium that is treated as a nondeductible loss under § 1.171–2(a)(4)(ii).

(c) *Municipal bonds.* In the case of a municipal bond (as defined in section 75(b)), basis shall be adjusted to the extent provided in section 75 or as provided in section 22(o) of the Internal Revenue Code of 1939, and the regulations thereunder.

(d) *Sale or exchange of residence.* Where the acquisition of a new residence results in the nonrecognition of any part of the gain on the sale, or exchange, or involuntary conversion of the old residence, the basis of the new residence shall be reduced by the amount of the gain not so recognized pursuant to section 1034(a), or section 112(n) of the Internal Revenue Code of 1939, and the regulations thereunder. See section 1034(e) and the regulations thereunder.

(e) *Loans from Commodity Credit Corporation.* In the case of property pledged to the Commodity Credit Corporation, the basis of such property shall be increased by the amount received as a loan from such corporation and treated by the taxpayer as income for the year in which received under section 77, or under section 123 of the Internal Revenue Code of 1939. The basis of such property shall be reduced to the extent of any deficiency on such loan with respect to which the taxpayer has been relieved from liability.

(f) *Deferred development and exploration expenses.* Expenditures for development and exploration of mines or mineral deposits treated as deferred expenses under sections 615 and 616, or under the corresponding provisions of prior income tax laws, are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions which results in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2 relating to tax on self-employment income) of the Code, or prior income, war-profits, or excess-profits tax laws, but not less than the amounts allowable under such provisions for the taxable year and prior years. This amount is considered as the *tax-benefit amount allowed* and shall be determined in accordance with paragraph (e) of § 1.1016–3. For example, if a taxpayer purchases unexplored and undeveloped mining property for $1,000,000 and at the close of the development stage has incurred exploration and development costs of $9,000,000 treated as deferred expenses, the basis of such property at such time for computing gain or loss will be $10,000,000. Assuming that the taxpayer in this example has operated the mine for several years and has deducted allowable percentage depletion in the amount of $2,000,000 and has deducted allowable deferred exploration and development expenditures of $2,000,000, the basis of the property in the taxpayer's hands for purposes of determining gain or loss from a sale will be $6,000,000.

(g) *Sale of land with unharvested crop.* In the case of an unharvested crop which is sold, exchanged, or involuntarily converted with the land and which is considered as property used in the trade or business under section 1231, the basis of such crop shall be increased by the amount of the items which are attributable to the production of such crop and which are disallowed, under section 268, as deductions in computing taxable income. The basis of any other property shall be decreased by the amount of any such items which are attributable to such other property, notwithstanding any provisions of section 1016 or of this section to the contrary. For example, if the items attributable to the production of an unharvested crop consist only of fertilizer costing $100 and $50 depreciation on a tractor used only to cultivate such crop, and such items are disallowed under section 268, the adjustments to the basis of such crop shall include an increase of $150 for such items and the adjustments to the basis of the tractor shall incude a reduction of $50 for depreciation.

(h) *Consent dividends.* (1) In the case of amounts specified in a shareholder's consent to which section 28 of the Internal Revenue Code of 1939 applies, the basis of the consent stock shall be increased to the extent provided in subsection (h) of such section.

(2) In the case of amounts specified in a shareholder's consent to be treated as a consent dividend to which section 565 applies, the basis of the consent stock shall be increased by the amount which, under section 565(c)(2), is treated as contributed to the capital of the corporation.

(i) *Stock in foreign personal holding company.* In the case of the stock of a United States shareholder in a foreign personal holding company, basis shall be adjusted to the extent provided in section 551(f) or corresponding provisions of prior income tax laws.

(j) *Research and experimental expenditures.* Research and experimental expenditures treated as deferred expenses under section 174(b) are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions which results in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2 relating to tax on self-employment income) of the Code, or prior income, war-profits, or excess-profits tax laws, but not less than the amounts allowable under such provisions for the taxable year and prior years. This amount is considered as the *tax-benefit amount allowed* and shall be determined in accordance with paragraph (e) of § 1.1016–3.

(k) *Deductions disallowed in connection with disposal of coal or domestic iron ore.* Basis shall be adjusted by the amount of the deductions disallowed under section 272 with respect to the disposal of coal or domestic iron ore covered by section 631.

(l) *Expenditures attributable to grants or loans covered by section 621.* In the case of expenditures attributable to a grant or loan made to a taxpayer by the United States for the encouragement of exploration for, or development or mining of, critical and strategic minerals or metals, basis shall be adjusted to the extent provided in section 621, or in section 22(b)(15) of the Internal Revenue Code of 1939.

(m) *Trademark and trade name expenditures.* Trademark and trade name expenditures treated as deferred expenses under section 177 are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions which results in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2, relating to tax on self-employment income) of the Code, but not less than the amounts allowable under such section for the taxable year and prior years. This amount is considered as the *tax-benefit amount allowed* and shall be determined in accordance with paragraph (e) of § 1.1016–3.

(n) *Life insurance companies.* In the case of any evidence of indebtedness referred to in section 818(b), the basis shall be adjusted to the extent of the adjustments required under section 818(b) (or the corresponding provisions of prior income tax laws) for the taxable year and all prior taxable years. The basis of any such evidence of indebtedness shall be reduced by the amount of the adjustment required under section 818(b) (or the corresponding provision of prior income tax laws) on account of amortizable premium and shall be increased by the amount of the adjustment required under section 818(b) on account of accruable discounts.

(o) *Stock and indebtedness of electing small business corporation.* In the case of a shareholder of an electing small business corporation, as defined in section 1371(b), the basis of the shareholder's stock in such corporation, and the basis of any indebtedness of such corporation owing to the shareholder, shall be adjusted to the extent provided in §§ 1.1375–4, 1.1376–1, and 1.1376–2.

(p) *Gift tax paid on certain property acquired by gift.* Basis shall be adjusted by that amount of the gift tax paid in respect of property acquired by gift which, under section 1015(d), is an increase in the basis of such property.

(q) *Section 38 property.* In the case of property which is or has been section 38 property (as defined in section 48(a)), the basis shall be adjusted to the extent provided in section 48(g) and in section 203(a)(2) of the Revenue Act of 1964.

(r) *Stock in controlled foreign corporations and other property.* In the case of stock in controlled foreign corporations (or foreign corporations which were controlled foreign corporations) and of property by reason of which a person is considered as owning such stock, the basis shall be adjusted to the extent provided in section 961.

(s) *Original issue discount.* In the case of certain corporate obligations issued at a discount after May 27, 1969, the basis shall be increased under section 1232(a)(3)(E) by the amount of original issue discount included in the holder's gross income pursuant to section 1232(a)(3).

(t) *Section 23 credit.* In the case of property with respect to which a credit has been allowed under section 23 or former section 44C (relating to residential energy credit), basis shall be adjusted as provided in paragraph (k) of § 1.23–3.

(u) *Gas guzzler tax.* In the case of an automobile upon which the gas guzzler tax was imposed, the basis shall be reduced as provided in section 1016 (d).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.1016–5, see the List of CFR Sections Affected in the Finding Aids section of this volume.

§ 1.1016–6 Other applicable rules.

(a) Adjustments must always be made to eliminate double deductions or their equivalent. Thus, in the case of the stock of a subsidiary company, the basis thereof must be properly adjusted for the amount of the subsidiary company's losses for the years in which consolidated returns were made.

(b) In determining basis, and adjustments to basis, the principles of estoppel apply, as elsewhere under the Code, and prior internal revenue laws.

§ 1.1016–10 Substituted basis.

(a) Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, as defined in section 1016(b), the adjustments indicated in §§ 1.1016–1 to 1.1016–6, inclusive, shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor, or during which the other property was held by the person for whom the basis is to be determined. In addition, whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, as defined in section 1016(b)(1), the adjustments indicated in §§ 1.1016–7 to 1.1016–9, inclusive, and in section 1017 shall also be made, whenever necessary, after first making in respect of such substituted basis a proper adjustment of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor. Similar rules shall also be applied in the case of a series of substituted bases.

(b)cation of this section may be illustrated by the following example:

Example: A, who makes his returns upon the calendar year basis, in 1935 purchased the X Building and subsequently gave it to his son B. B exchanged the X Building for the Y Building in a tax-free exchange, and then gave the Y Building to his wife C. C, in determining the gain from the sale or disposition of the Y Building in 1954, is required to reduce the basis of the building by deductions for depreciation which were successively allowed (but not less than the amount allowable) to A and B upon the X Building and to B upon the Y Building, in addition to the deductions for depreciation allowed (but not less than the amount allowable) to herself during her ownership of the Y Building.

§ 1.1017–1 Basis reductions following a discharge of indebtedness.

(a) *General rule for section 108(b)(2)(E).* This paragraph (a) applies to basis reductions under section 108(b)(2)(E) that are required by section 108(a)(1) (A) or (B) because the taxpayer excluded discharge of indebtedness (COD income) from gross income. A taxpayer must reduce in the following order, to the extent of the excluded COD income (but not below zero), the adjusted bases of property held on the first day of the taxable year following the taxable year that the taxpayer excluded COD income from gross income (in proportion to adjusted basis):—

(1) Real property used in a trade or business or held for investment, other than real property described in section 1221(1), that secured the discharged indebtedness immediately before the discharge;

(2) Personal property used in a trade or business or held for investment, other than inventory, accounts receivable, and notes receivable, that secured the discharged indebtedness immediately before the discharge;

(3) Remaining property used in a trade or business or held for investment, other than inventory, accounts receivable, notes receivable, and real property described in section 1221(1);

(4) Inventory, accounts receivable, notes receivable, and real property described in section 1221(1); and

(5) Property not used in a trade or business nor held for investment.

(b) *Operating rules*—(1) *Prior tax-attribute reduction.* The amount of excluded COD income applied to reduce basis does not include any COD income applied to reduce tax attributes under sections 108(b)(2) (A) through (D) and, if applicable, section 108(b)(5). For example, if a taxpayer excludes $100 of COD income from gross income under section 108(a) and reduces tax attributes by $40 under sections 108(b)(2) (A) through (D), the taxpayer is required to reduce the adjusted bases of property by $60 ($100−$40) under section 108(b)(2)(E).

(2) *Multiple discharged indebtednesses.* If a taxpayer has COD income attributable to more than one discharged indebtedness resulting in the reduction of tax attributes under sections 108(b)(2) (A) through (D) and, if applicable, section 108(b)(5), paragraph (b)(1) of this section must be applied by allocating the tax-attribute reductions among the indebtednesses in proportion to the amount of COD income attributable to each discharged indebtedness. For example, if a taxpayer excludes $20 of COD income attributable to secured indebtedness A and excludes $80 of COD income attributable to unsecured indebtedness B (a total exclusion of $100), and if the taxpayer reduces tax attributes by $40 under sections 108(b)(2) (A) through (D), the taxpayer must reduce the amount of COD income attributable to secured indebtedness A to $12 ($20 − ($20 / $100 × $40)) and must reduce the amount of COD income attributable to unsecured indebtedness B to $48 ($80 − ($80 / $100 × $40)).

(3) *Limitation on basis reductions under section 108(b)(2)(E) in bankruptcy or insolvency.* If COD income arises from a discharge of indebtedness in a title 11 case or while the taxpayer is insolvent, the amount of any basis reduction under section 108(b)(2)(E) shall not exceed the excess of—

(i) The aggregate of the adjusted bases of property and the amount of money held by the taxpayer immediately after the discharge; over

(ii) The aggregate of the liabilities of the taxpayer immediately after the discharge.

(c) *Modification of ordering rules for basis reductions under sections 108(b)(5) and 108(c)*—(1) *In general.* The ordering rules prescribed in paragraph (a) of this section apply, with appropriate modifications, to basis reductions under sections 108(b)(5) and (c). Thus, a taxpayer that elects to reduce basis under section 108(b)(5) may, to the extent that the election applies, reduce only the adjusted basis of property described in paragraphs (a) (1), (2), and (3) of this section and, if an election is made under paragraph (f) of this section, paragraph (a) (4) of this section. Within paragraphs (a) (1), (2), (3) and (4) of this section, such a taxpayer may reduce only the adjusted bases of depreciable property. A taxpayer that elects to apply section 108(c) may reduce only the adjusted basis of property described in paragraphs (a) (1) and (3) of this section and, within paragraphs (a)(1) and (3) of this section, may reduce only the adjusted bases of depreciable real property. Furthermore, for basis reductions under section 108(c), a taxpayer must reduce the adjusted basis of the qualifying real property to the extent of the discharged qualified real property business indebtedness before reducing the adjusted bases of other depreciable real property. The term *qualifying real property* means real property with respect to which the indebtedness is qualified real property business indebtedness within the meaning of section 108(c)(3).

See paragraphs (f) and (g) of this section for elections relating to section 1221(1) property and partnership interests.

(2) *Partial basis reductions under section 108(b)(5).* If the amount of basis reductions under section 108(b)(5) is less than the amount of the COD income excluded from gross income under section 108(a), the taxpayer must reduce the balance of its tax attributes, including any remaining adjusted bases of depreciable and other property, by following the ordering rules under section 108(b)(2). For example, if a taxpayer excludes $100 of COD income from gross income under section 108(a) and elects to reduce the adjusted bases of depreciable property by $10 under section 108(b)(5), the taxpayer must reduce its remaining tax attributes by $90, starting with net operating losses under section 108(b)(2).

(3) *Modification of fresh start rule for prior basis reductions under section 108(b)(5).* After reducing the adjusted bases of depreciable property under section 108(b)(5), a taxpayer must compute the limitation on basis reductions under section 1017(b)(2) using the aggregate of the remaining adjusted bases of property. For example, if, immediately after the discharge of indebtedness in a title 11 case, a taxpayer's adjusted bases of property is $100 and its undischarged indebtedness is $70, and if the taxpayer elects to reduce the adjusted bases of depreciable property by $10 under section 108(b)(5), section 1017(b)(2) limits any further basis reductions under section 108(b)(2)(E) to $20 (($100 − $10) − $70).

(d) *Changes in security.* If any property is added or eliminated as security for an indebtedness during the one-year period preceding the discharge of that indebtedness, such addition or elimination shall be disregarded where a principal purpose of the change is to affect the taxpayer's basis reductions under section 1017.

(e) *Depreciable property.* For purposes of this section, the term *depreciable property* means any property of a character subject to the allowance for depreciation or amortization, but only if the basis reduction would reduce the amount of depreciation or amortization which otherwise would be allowable for the period immediately following such reduction. Thus, for example, a lessor cannot reduce the basis of leased property where the lessee's obligation in respect of the property will restore to the lessor the loss due to depreciation during the term of the lease, since the lessor cannot take depreciation in respect of such property.

(f) *Election to treat section 1221(1) real property as depreciable*—(1) *In general.* For basis reductions under section 108(b)(5) and basis reductions relating to qualified farm indebtedness, a taxpayer may elect under sections 1017(b)(3)(E) and (4)(C), respectively, to treat real property described in section 1221(1) as depreciable property. This election is not available, however, for basis reductions under section 108(c).

(2) *Time and manner.* To make an election under section 1017(b) (3)(E) or (4)(C), a taxpayer must enter the appropriate information on Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment),* and attach the form to a timely filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a). An election under this paragraph (f) may be revoked only with the consent of the Commissioner.

(g) *Partnerships*—(1) *Partnership COD income.* For purposes of paragraph (a) of this section, a taxpayer must treat a distributive share of a partnership's COD income as attributable to a discharged indebtedness secured by the taxpayer's interest in that partnership.

(2) *Partnership interest treated as depreciable property*—(i) *In general.* For purposes of making basis reductions, if a taxpayer makes an election under section 108(b)(5) (or 108(c)), the taxpayer must treat a partnership interest as depreciable property (or depreciable real property) to the extent of the partner's proportionate share of the partnership's basis in depreciable property (or depreciable real property), provided that the partnership consents to a corresponding reduction in the partnership's basis (inside basis) in depreciable property (or depreciable real property) with respect to such partner.

(ii) *Request by partner and consent of partnership*—(A) *In general.* Except as otherwise provided in this paragraph (g)(2)(ii), a taxpayer may choose whether or not to request that a partnership reduce the inside basis of its depreciable property (or depreciable real property) with respect to the taxpayer, and the partnership may grant or withhold such consent, in its sole discretion. A request by the taxpayer must be made before the due date (including extensions) for filing the taxpayer's Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a).

(B) *Request for consent required.* A taxpayer must request a partnership's consent to reduce inside basis if, at the time of the discharge, the taxpayer owns (directly or indirectly) a greater than 50 percent interest in the capital and profits of the partnership, or if reductions to the basis of the taxpayer's depreciable property (or depreciable real property) are being made with respect to the taxpayer's distributive share of COD income of the partnership.

(C) *Granting of request required.* A partnership must consent to reduce its partners' shares of inside basis with respect to a discharged indebtedness if consent is requested with respect to that indebtedness by partners owning (directly or indirectly) an aggregate of more than 80 percent of the capital and profits interests of the partnership or five or fewer partners owning (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership. For example, if there is a cancellation of partnership indebtedness that is secured by real property used in a partnership's trade or business, and if partners owning (in the aggregate) 90 percent of the capital and profits interests of the partnership elect to exclude the COD income under section 108(c), the partnership must make the appropriate reductions in those partners' shares of inside basis.

(iii) *Partnership consent statement*—(A) *Partnership requirement.* A consenting partnership must include with the Form 1065, U.S. Partnership Return of Income, for the taxable year following the year that ends with or within the taxable year the taxpayer excludes COD income from gross income under section 108(a), and must provide to the taxpayer on or before the due date of the taxpayer's return (including extensions) for the taxable year in which the taxpayer excludes COD income from gross income, a statement that—

(*1*) Contains the name, address, and taxpayer identification number of the partnership; and

(*2*) States the amount of the reduction of the partner's proportionate interest in the adjusted bases of the partnership's depreciable property or depreciable real property, whichever is applicable.

(B) *Taxpayer's requirement.* Statements described in paragraph (g)(2)(iii)(A) of this section must be attached to a taxpayer's timely filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a).

(iv) *Partner's share of partnership's adjusted basis.* [Reserved]

(3) *Partnership basis reduction.* The rules of this section (including this paragraph (g)) apply in determining the properties to which the partnership's basis reductions must be made.

(h) *Special allocation rule for cases to which section 1398 applies.* If a bankruptcy estate and a taxpayer to whom section 1398 applies (concerning only individuals under Chapter 7 or 11 of title 11 of the United States Code) hold property subject to basis reduction under section 108(b) (2)(E) or (5) on the first day of the taxable year following the taxable year of discharge, the bankruptcy estate must reduce all of the adjusted bases of its property before the taxpayer is required to reduce any adjusted bases of property.

(i) *Effective date.* This section applies to discharges of indebtedness occurring on or after October 22, 1998.

[T.D. 8787, 63 FR 56563, Oct. 22, 1998]

§1.1018–1 Adjusted basis; exception to section 270 of the Bankruptcy Act, as amended.

The adjustment to basis provided by section 270 of the Bankruptcy Act, as amended (11 U.S.C. 670), and by

§§ 1.1016–7 and 1.1016–8 shall not be made if, in a proceeding under section 77B of such Act, as amended (11 U.S.C. 207; 48 Stat. 912), indebtedness was canceled in pursuance of a plan of reorganization which was consummated by adjustment of the capital or debt structure of the insolvent corporation, and the final judgment or decree in such proceeding was entered before September 22, 1938. Section 1018 and this section do not apply if the plan of reorganization under such section 77B was consummated by the transfer of assets of the insolvent corporation to another corporation.

§ 1.1019–1 Property on which lessee has made improvements.

In any case in which a lessee of real property has erected buildings or made other improvements upon the leased property and the lease is terminated by forfeiture or otherwise resulting in the realization by such lessor of income which, were it not for the provisions of section 109, would be includible in gross income of the lessor, the amount so excluded from gross income shall not be taken into account in determining the basis or the adjusted basis of such property or any portion thereof in the hands of the lessor. If, however, in any taxable year beginning before January 1, 1942, there has been included in the gross income of the lessor an amount representing any part of the value of such property attributable to such buildings or improvements, the basis of each portion of such property shall be properly adjusted for the amount so included in gross income. For example, A leased in 1930 to B for a period of 25 years unimproved real property and in accordance with the terms of the lease B erected a building on the property. It was estimated that upon expiration of the lease the building would have a depreciated value of $50,000, which value the lessor elected to report (beginning in 1931) as income over the term of the lease. This method of reporting was used until 1942. In 1952 B forfeits the lease. The amount of $22,000 reported as income by A during the years 1931 to 1941, inclusive, shall be added to the basis of the property represented by the improvements in the hands of A. If in such case A did not report during the period of the lease any income attributable to the value of the building erected by the lessee and the lease was forfeited in 1940 when the building was worth $75,000, such amount, having been included in gross income under the law applicable to that year, is added to the basis of the property represented by the improvements in the hands of A. As to treatment of such property for the purposes of capital gains and losses, see subchapter P (section 1201 and following), chapter 1 of the Code.

§ 1.1020–1 Election as to amounts allowed in respect of depreciation, etc., before 1952.

(a) *In general.* (1) Any person may elect to have the adjustments to the cost or other basis of property under section 1016(a)(2) determined in accordance with subparagraph (B) of such section by filing a statement of election in accordance with the requirements set forth in paragraph (b) of this section. Any election made after 1952 shall be irrevocable when made. Any election made after 1952 shall apply with respect to all property held by the person making the election at any time on or before December 31, 1952, and shall apply to all periods since February 28, 1913, and before January 1, 1952, during which such person held such property or for which adjustments must be made under section 1016(b). For rules with respect to an election made on or before December 31, 1952, see paragraph (c) of this section.

(2) An election by a partner on his own behalf is not an election for the partnership of which he is a member. A separate election must be made on behalf of the partnership. (See section 703(b) (relating to elections of the partnership).) An election on behalf of the partnership applies only with respect to the partnership, and does not apply to the separate property of the partners. A similar rule applies with respect to elections by trusts and beneficiaries of trusts. These rules also apply with respect to a revocation of an election where such election was made on or before December 31, 1952.

(b) *Rules applicable to making of election.* The following rules are applicable to the making of an election under section 1020:

(1) *Form of election.* The election shall be in the form of a statement in writing, shall state the name and address of the taxpayer making the election, and shall contain a statement that such taxpayer elects to have the provisions of section 1016(a)(2)(B) apply in respect of all periods since February 28, 1913, and before January 1, 1952.

(2) *Signature.* The statement shall be signed by the taxpayer making the election, if an individual, or, if the taxpayer making the election is not an individual, the statement shall be signed by the person or persons required to sign the income return of such taxpayer.

(3) *Filing.* The statement must be filed on or before December 31, 1954, in the office of the district director for the internal revenue district in which the income tax return for the year of the election is required to be filed. For rules as to when timely mailing will be treated as timely filing of the statement see section 7502.

(4) *Filing of duplicate.* A copy of the statement of election must be filed with the first return, amended return, or claim for refund filed on or after the date on which the election is made.

(c) *Election made on or before December 31, 1952.* An election made on or before December 31, 1952, in accordance with the provisions of section 113(d) of the Internal Revenue Code of 1939, may be revoked by filing on or before December 31, 1954, in the same office in which the election was filed, a statement of revocation signed in the same manner as the election. Such statement made by any person is irrevocable when made with respect to such person, and no new election may thereafter be made by such person. A copy of the revocation must be filed with the first return, amended return, or claim for refund, filed after the date of the revocation. For additional rules with respect to election made on or before December 31, 1952, see 26 CFR (1939) 39.113(b)(1)–1 (Regulations 118).

(d) *Validity of elections or revocation of elections.* An election or revocation of an election which conforms in substance to the provisions of this section will not be deemed invalid solely because it was filed before the date on which the regulations in this section were promulgated.

(e) *Effect of election.* For rules relating to the effect of an election under this section, see section 1016(a)(2) and the regulations thereunder.

§1.1021–1 Sale of annuities.

In the case of a transfer for value of an annuity contract to which section 72(g) and paragraph (a) of §1.72–10 apply, the transferor shall adjust his basis in such contract as of the time immediately prior to such transfer by subtracting from the premiums or other consideration he has paid or is deemed to have paid for such contract all amounts he has received or is deemed to have received under such annuity contract to the extent that such amounts were not includible in the gross income of the transferor or other recipient under the applicable income tax law. In any case where the amounts which were not includible in the gross income of the recipient were received or deemed to have been received by such transferor exceed the amounts paid or deemed paid by him, the adjusted basis of the contract shall be zero. The income realized by the transferor on such a transfer shall not exceed the total of the amounts received as consideration for the transfer.

COMMON NONTAXABLE EXCHANGES

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

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

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

(i) Stock in trade or other property held primarily for sale;

(ii) Stocks, bonds, or notes;

(iii) Other securities or evidences of indebtedness or interest;

(iv) Interests in a partnership;

(v) Certificates of trust or beneficial interests; or

(vi) Choses in action.

Section 1031(a)(1) does not apply to any exchange of interests in a partnership regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or in different partnerships. An interest in a partnership that has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K is treated as an interest in each of the assets of the partnership and not as an interest in a partnership for purposes of section 1031(a)(2)(D) and paragraph (a)(1)(iv) of this section. An exchange of an interest in such a partnership does not qualify for nonrecognition of gain or loss under section 1031 with respect to any asset of the partnership that is described in section 1031(a)(2) or to the extent the exchange of assets of the partnership does not otherwise satisfy the requirements of section 1031(a).

(2) *Exchanges of property not solely for property of a like kind.* A transfer is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or property which does not meet the requirements of section 1031(a), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). Similarly, a transfer is not within the provisions of section 1031(a) if, as part of the consideration, the other party to the exchange assumes a liability of the taxpayer (or acquires property from the taxpayer that is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c).

A transfer of property meeting the requirements of section 1031(a) may be within the provisions of section 1031(a) even though the taxpayer transfers in addition property not meeting the requirements of section 1031(a) or money. However, the nonrecognition treatment provided by section 1031(a) does not apply to the property transferred which does not meet the requirements of section 1031(a).

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

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

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

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

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

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

(a) *Introduction.* Section 1.1031(a)–1(b) provides that the nonrecognition rules of section 1031 do not apply to an exchange of one kind or class of property for property of a different kind or class. This section contains additional rules for determining whether personal property has been exchanged for property of a like kind or like class. Personal properties of a like class are considered to be of a ''like kind'' for purposes of section 1031. In addition, an exchange of properties of a like kind may qualify under section 1031 regardless of whether the properties are also of a like class. In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class. Under paragraph (b) of this section, depreciable tangible personal properties are of a like class if they are either within the same General Asset Class (as defined in paragraph (b)(2) of this section) or within the same Product Class (as defined in paragraph (b)(3) of this section). Paragraph (c) of this section provides rules for exchanges of intangible personal property and nondepreciable personal property.

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

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

(i) Office furniture, fixtures, and equipment (asset class 00.11),

(ii) Information systems (computers and peripheral equipment) (asset class 00.12),

(iii) Data handling equipment, except computers (asset class 00.13),

(iv) Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21),

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

(vi) Buses (asset class 00.23),

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

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

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

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

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

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

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

(3) *Product Classes.* Except as provided in paragraphs (b)(4) and (b)(5) of this section, property within a Product Class consists of depreciable tangible personal property that is listed in a 4-digit product class within Division D of the Standard Industrial Classification codes, set forth in Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (1987) (SIC Manual). Copies of the SIC Manual may be obtained from the National Technical Information Service, an agency of the U.S. Department of Commerce. Division D of the SIC Manual contains a listing of manufactured products and equipment. For this purpose, any 4-digit product class ending in a ''9'' (i.e., a miscellaneous category) will not be considered a Product Class. If a property is listed in more than one product class, the property is treated as listed in any one of those product classes. A property's 4-digit product classification is referred to as the property's ''SIC Code.''

(4) *Modifications of Rev. Proc. 87–56 and SIC Manual.* The asset classes of Rev. Proc. 87–56 and the product classes of the SIC Manual may be updated or otherwise modified from time to time. In the event Rev. Proc. 87–56 is modified, the General Asset Classes will follow the modification, and the modification will be effective for exchanges occurring on or after the date the modification is published in the Internal Revenue Bulletin, unless otherwise provided. Similarly, in the event the SIC Manual is modified, the Product Classes will follow the modification, and the modification will be effective for exchanges occurring on or after the effective date of the modification. However, taxpayers may rely on the unmodified SIC Manual for exchanges occurring during the one-year period following the effective date of the modification. The SIC Manual generally is modified every five years, in years ending in a 2 or 7 (e.g., 1987 and 1992). The effective date of the modified SIC Manual is announced in the FEDERAL REGISTER and generally is January 1 of the year the SIC Manual is modified.

(5) *Modified classification through published guidance.* The Commissioner may, by guidance published in the Internal Revenue Bulletin, supplement the guidance provided in this section relating to classification of properties. For example, the Commissioner may determine not to follow, in whole or in part, any modification of Rev. Proc. 87–

56 or the SIC Manual. The Commissioner may also determine that two types of property that are listed in separate product classes each ending in a ''9'' are of a like class, or that a type of property that has a SIC Code is of a like class to a type of property that does not have a SIC Code.

(6) *No inference outside of section 1031.* The rules provided in this section concerning the use of Rev. Proc. 87–56 and the SIC Manual are limited to exchanges under section 1031. No inference is intended with respect to the classification of property for other purposes, such as depreciation.

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

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

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

Example 3. Taxpayer E transfers a grader to F in exchange for a scraper. Neither property is within any of the General Asset Classes, and both properties are within the same Product Class (SIC Code 3533). With respect to E, therefore, the properties exchanged are of a like class.

Example 4. Taxpayer G transfers a personal computer (asset class 00.12), an airplane (asset class 00.21) and a sanding machine (SIC Code 3553), to H in exchange for a printer (asset class 00.12), a heavy general purpose truck (asset class 00.242) and a lathe (SIC Code 3553). The personal computer and the printer are of a like class because they are within the same General Asset Class; the sanding machine and the lathe are of a like class because neither property is within any of the General Asset Classes and they are within the same Product Class. The airplane and the heavy general purpose truck are neither within the same General Asset Class nor within the same Product Class, and are not of a like kind.

(c) *Intangible personal property and nondepreciable personal property*—(1) *General rule.* An exchange of intangible personal property of nondepreciable personal property qualifies for nonrecognition of gain or loss under section 1031 only if the exchanged properties are of a like kind. No like classes are provided for these properties. Whether intangible personal property is of a like kind to other intangible personal property generally depends on the nature or character of the rights involved (e.g., a patent or a copyright) and also on the nature or character of the underlying property to which the intangible personal property relates.

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

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

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

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

(d) *Effective date.* Section 1.1031(a)–2 is effective for exchanges occurring on or after April 11, 1991.

[T.D. 8343, 56 FR 14854, Apr. 12, 1991]

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

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

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

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

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

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

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

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

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

(b) On October 1, 1963, the redemption value of each such bond was $1,396, and the total redemption value of the four bonds was $5,584. On that date B submitted the four $1,000 series E bonds to the United States in a transaction in which one of such $1,000 bonds was reissued by issuing four $100 series E U.S. savings bonds bearing an issue date of March 1, 1943, and by considering six $100 series E bonds bearing an issue date of March 1, 1943, to have been issued. The redemption value of each such $100 series E bond was $139.60 on October 1, 1963. Then, as part of the transaction, the six $100 series E bonds so considered to have been issued and the three $1,000 series E bonds were exchanged, in an exchange qualifying under section 1037(a), for five $1,000 series H U.S. savings bonds plus $25.60 in cash.

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

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

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

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

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

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

(c) The redemption on October 1, 1963, of the four $100 series E bonds considered to have been issued at such time results in gain of $258.40, which is then recognized and must be included in B's gross income for 1963. This gain of $258.40 is the difference between the $558.40 redemption value of such bonds on the date of the exchange and the $300 (4×$75) paid for such series E bonds in 1943.

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

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

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

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

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

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

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

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

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

§1.1031(c)–1 Nonrecognition of loss.

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

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

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

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

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

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

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

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

Example: A, who is not a dealer in real estate, in 1954 transfers real estate held for investment which he purchased in 1940 for $10,000 in exchange for other real estate (to be held for investment) which has a fair market value of $9,000, an automobile which has a fair market value of $2,000, and $1,500 in cash. A realizes a gain of $2,500, all of which is recognized under section 1031(b). The basis of the property received in exchange is the basis of the real estate A transfers ($10,000) decreased by the amount of money received ($1,500) and increased in the amount of gain that was recognized ($2,500), which results in a basis for the property received of $11,000. This basis of $11,000 is allocated between the automobile and the real estate received by A, the basis of the automobile being its fair market value at the date of the exchange, $2,000, and the basis of the real estate received being the remainder, $9,000.

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

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

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

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

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

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

If the properties exchanged under section 1031 are part of a group of assets which constitute a trade or business under section 1060, the like-kind property and other property or money which are treated as transferred in exchange for the like-kind property shall be excluded from the allocation rules of section 1060. However, section 1060 shall apply to property which is not like-kind property or other property or money which is treated as transferred in exchange for the like-kind property. For application of the section 1060 allocation rules to property which is not part of the like-kind exchange, see §1.1060–1T (b), (d), and (g) *Example 3.*

[T.D. 8215, 53 FR 27044, July 18, 1988]

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

For the purposes of section 1031(d), the amount of any liabilities of the taxpayer assumed by the other party to the exchange (or of any liabilities to which the property exchanged by the taxpayer is subject) is to be treated as money received by the taxpayer upon the exchange, whether or not the assumption resulted in a recognition of gain or loss to the taxpayer under the law applicable to the year in which the exchange was made. The application of this section may be illustrated by the following examples:

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

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

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

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

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

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

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

For purposes of section 1031(b), the amount of *other property or money* received by D is $40,000. (Consideration received by D in the form of a transfer subject to a liability of $80,000 is offset by consideration given in the form of a receipt of property subject to a

$150,000 liability. Thus, only the consideration received in the form of cash, $40,000, is treated as *other property or money* for purposes of section 1031(b).) Accordingly, under section 1031(b), $40,000 of the $120,000 gain is recognized. The basis of the apartment house acquired by D is $170,000, computed as follows:

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

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

Value of property received		$220,000
Liabilities subject to which old property was transferred		150,000
Total consideration received		370,000
Less:		
Adjusted basis of property transferred	$175,000	
Cash	40,000	
Liabilities to which new property is subject	80,000	
		295,000
Gain realized		75,000

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(3) *Amount of gain recognized.* (i) For purposes of this section, the amount of gain or loss realized with respect to each exchange group and the residual group is the difference between the aggregate fair market value of the properties transferred in that exchange group or residual group and the properties' aggregate adjusted basis. The

gain realized with respect to each exchange group is recognized to the extent of the lesser of the gain realized and the amount of the exchange group deficiency, if any. Losses realized with respect to an exchange group are not recognized. See section 1031 (a) and (c). The total amount of gain recognized under section 1031 in the exchange is the sum of the amount of gain recognized with respect to each exchange group. With respect to the residual group, the gain or loss realized (as determined under this section) is recognized as provided in section 1001 or other applicable provision of the Code.

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

(c) *Computation of basis of properties received.* In an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031 and this section, the aggregate basis of properties received in each of the exchange groups is the aggregate adjusted basis of the properties transferred by the taxpayer within that exchange group, increased by the amount of gain recognized by the taxpayer with respect to that exchange group, increased by the amount of the exchange group surplus or decreased by the amount of the exchange group deficiency, and increased by the amount, if any, of excess liabilities assumed by the taxpayer that are allocated to that exchange group. The resulting aggregate basis of each exchange group is allocated proportionately to each property received in the exchange group in accordance with its fair market value. The basis of each property received within the residual group (other than money) is equal to its fair market value.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(A) The first exchange group consists of computer A and printer B (both are within the same General Asset Class) and, as to F, has an exchange group deficiency of $200 because the fair market value of computer A ($1000) exceeds the fair market value of printer B ($800) by that amount.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(A) The first exchange group consists of computer A, computer B, printer C, computer Z, and printer Y (all are within the same General Asset Class) and, as to J, has an exchange group deficiency of $2500 (($5000 + $3000 + $1500) − ($4500 + $2500)).

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

(C) The third exchange group consists of scraper F and grader V (both are within the same Product Class (SIC Code 3531)) and, as to J, has an exchange group deficiency of $500 ($2500 − $2000).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(*3*) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group ($700), increased by the amount of gain recognized with respect to that exchange group ($715), decreased by the amount of the exchange group deficiency ($715), and increased by the amount of excess liabilities assumed allocated to that exchange group ($115), or $815. Because truck R was the only property received within the third exchange group, the entire basis of $815 is allocated to truck R.

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

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

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

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

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

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

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

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

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

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

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

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

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

(*2*) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile R ($3100) over its adjusted basis ($2100), or $1000. The amount of gain recognized is the lesser of the gain realized ($1000) and the exchange group deficiency ($600), or $600.

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

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

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

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

(*1*) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($1100), increased by the amount of gain recognized with respect to that exchange group ($100), decreased by the amount of the exchange group deficiency

($100), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $1100. Because computer A was the only property received within the first exchange group, the entire basis of $1100 is allocated to computer A.

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

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

Example 5. (i) U exchanges real estate A, real estate B, and grader A (SIC Code 3531) with V for real estate R and railroad car R (General Asset Class 00.25). All properties transferred by either U or V were held for productive use in the respective transferor's business. Similarly, all properties to be received by either U or V will be held for productive use in the respective recipient's business. Real estate R is secured by a recourse liability and is transferred subject to that liability. The adjusted basis, fair market value, and liability secured by each property, if any, are as follows:

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

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

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

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

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

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

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

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

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

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

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

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

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

(*1*) The basis of the property received in the exchange group is the aggregate adjusted basis of the property transferred within that exchange group ($10,000), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus

($1000), and increased by the amount of excess liabilities assumed allocated to that exchange group ($7000), or $18,000. Because real estate R is the only property received within the exchange group, the entire basis of $18,000 is allocated to real estate R.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[T.D. 8343, 56 FR 14855, Apr. 12, 1991]

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

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

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

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

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

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

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

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

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

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

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

(ii) The identification period ends at midnight on December 31, 1992, the day which is 45 days after the date of transfer of property X. The exchange period ends at midnight on March 15, 1993, the due date for M's Federal income tax return for the taxable year in which M transferred property X. However, if M is allowed the automatic six-month extension for filing its tax return, the exchange period ends at midnight on May 15, 1993, the day which is 180 days after the date of transfer of property X.

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

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

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

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

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

(3) *Description of replacement property.* Replacement property is identified only if it is unambiguously described in the written document or agreement. Real property generally is unambiguously described if it is described by a legal description, street address, or distinguishable name (e.g., the Mayfair Apartment Building). Personal property generally is unambiguously described if it is described by a specific description of the particular type of property. For example, a truck generally is unambigously described if it is described by a specific make, model, and year.

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

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

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

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

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

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

For this purpose, the fair market value of each identified replacement property is determined as of the earlier of the date the property is received by the taxpayer or the last day of the exchange period.

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

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

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

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

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

Example 1. For purposes of paragraph (c) of this section, a spare tire and tool kit will not be treated as separate property from a truck with a fair market value of $10,000, if the aggregate fair market value of the spare tire and tool kit does not exceed $1,500. For purposes of the 3-property rule, the truck, spare tire, and tool kit are treated as 1 property. Moreover, for purposes of paragraph (c)(3) of this section (relating to the description of replacement property), the truck, spare tire, and tool kit are all considered to be unambiguously described if the make, model, and year of the truck are specified, even if no reference is made to the spare tire and tool kit.

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

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

(7) *Examples.* This paragraph (c) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. No replacement property is identified in the agreement. When subsequently identified, the replacement property is described by legal description and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to

hold the replacement property received for investment.

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

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

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

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

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

Example 3. (i) On June 3, 1991, B identifies the replacement property as ''unimproved land located in Hood County with a fair market value not to exceed $100,000.'' The designation is made in a written document signed by B and personally delivered to C. On July 8, 1991, B and C agree that real property G is the property described in the June 3, 1991 document.

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

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

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

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

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

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

(ii) B has revoked the identification of real properties Q and R in the manner provided by paragraph (c)(6) of this section. Identifications of replacement property that have been revoked in the manner provided by paragraph (c)(6) of this section are not taken into account for purposes of applying the 3-property rule. Thus, as of June 28, 1991, B has identified only replacement properties S, T, and U for purposes of the 3-property rule. Because B did not identify more than three properties as replacement properties for purposes of the 3-property rule, the requirements of that rule are satisfied, and real properties S, T, and U are all identified before the end of the identification period.

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

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

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

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

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

If the taxpayer has identified more than one replacement property, section 1031(a)(3)(B) and this paragraph (d) are applied separately to each replacement property.

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

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

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

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

Example 2. (i) In the agreement, B identifies real property P as replacement property. Real property P consists of two acres of unimproved land. On October 15, 1991, the owner of real property P erects a fence on the property. On November 1, 1991, C purchases real property P and transfers it to B.

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

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

(ii) The barn and underlying land differ in basic nature or character from real property

Q as a whole, B is not considered to have received substantially the same property as identified.

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

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

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

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

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

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

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

(iii) If the identified replacement property is real property to be produced and the production of the property is not completed on or before the date the taxpayer receives the property, the property received will be considered to be substantially the same property as identified only if, had production been completed on or before the date the taxpayer receives the replacement property, the property received would have been considered to be substantially the same property as identified. Even so, the property received is considered to be substantially the same property as identified only to the extent the property received constitutes real property under local law.

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

will not be treated as the receipt of property of a like kind.

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

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

(ii) Because property N is personal property to be produced and production of property N is not completed before the date the property is received by B, property N is not considered to be substantially the same property as identified and is treated as property which is not of a like kind to property Y.

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

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

(2) *Actual and constructive receipt.* Except as provided in paragraph (g) of this section (relating to safe harbors), for purposes of section 1031 and this section, the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. The taxpayer is in actual receipt of money or property at the time the taxpayer actually receives the money or property or receives the economic benefit of the money or property. The taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given. Although the taxpayer is not in constructive receipt of money or property if the taxpayer's control of its receipt is subject to substantial limitations or restrictions, the taxpayer is in constructive receipt of the money or property at the time the limitations or restrictions lapse, expire, or are waived. In addition, actual or constructive receipt of money or property by an agent of the taxpayer (determined without regard to paragraph (k) of this section) is actual or constructive receipt by the taxpayer.

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

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

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

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

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

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

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

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

(C) A guarantee of a third party.

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

(3) *Qualified escrow accounts and qualified trusts.* (i) In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured by cash or a cash equivalent if the cash or cash equivalent is held in a qualified escrow account or in a qualified trust.

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

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

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

(iii) A qualified trust is a trust wherein—

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

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

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

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

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

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

(iii) A qualified intermediary is a person who—

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(*1*) Relates to the deferred exchange,

(*2*) Is provided for in writing, and

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

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

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

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

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

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

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

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

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

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

Example 2. (i) On May 17, 1991, B transfers real property X to C, and C deposits $100,000 in escrow as security for C's obligation to perform under the agreement. Also on May 17, B identifies real property J as replacement property. The escrow agreement provides that no funds may be paid out without prior written approval of both B and C. The escrow agreement also provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow before November 14, 1991, except that:

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

(*1*) real property J is destroyed, seized, requisitioned, or condemned, or

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

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

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

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

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

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

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

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

(iii) Because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section, the escrow account was a qualified escrow account. For purposes of section 1031 and this section, therefore, B is determined not to be in actual or constructive receipt of the funds in escrow before B received real property K.

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

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

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

(ii) The exchange agreement entered into by B and C satisfied the requirements of paragraph (g)(4)(iii)(B) of this section. Because B's rights in its agreements with D and E were assigned to C, and D and E were notified in writing of the assignment on or before the transfer of real properties X and L, respectively, C is treated as entering into those agreements. Because C is treated as entering into an agreement with D for the transfer of real property X and, pursuant to that agreement, real property X was transferred to D, C is treated as acquiring and transferring real property X. Similarly, because C is treated as entering into an agreement with E for the transfer of real property K and, pursuant to that agreement, real property K was transferred to B, C is treated as acquiring and transferring real property K. This result is reached for purposes of this section regardless of whether C was B's agent under state law and regardless of whether C is considered, under general tax principles, to have acquired title or beneficial ownership of the properties. Thus, C was a qualified intermediary.

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

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

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

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

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

(2) *Treatment as interest.* If, as part of a deferred exchange, the taxpayer receives interest or a growth factor, the interest or growth factor will be treated as interest, regardless of whether it is paid to the taxpayer in cash or in property (including property of a like kind). The taxpayer must include the interest or growth factor in income according to the taxpayer's method of accounting.

(i) [Reserved]

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

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

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

(B) The end of the exchange period.

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

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

(B) The end of the exchange period.

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

(iv) *Bona fide intent requirement.* The provisions of paragraphs (j)(2) (i) and (ii) of this section do not apply unless the taxpayer has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period. A taxpayer will be treated as having a bona fide intent only if it is reasonable to believe, based on all the facts and circumstances as of the beginning of the exchange period, that like-kind replacement property will be acquired before the end of the exchange period.

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

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

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

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

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

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

Example 3. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B enters into an exchange agreement with C whereby B retains C as a qualified intermediary to facilitate an exchange with respect to real property X. On December 1, 1994, pursuant to the agreement, B transfers real property X to C who transfers it to D for $100,000 in cash. On that date B has a bona fide intent to enter into a deferred exchange. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash held by C until the earliest of the end of the identification period if B has not identified replacement property, the date the replacement property is delivered to B, or the end of the exchange period. Although B has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period, B does not identify or acquire any replacement property. In 1995, at the end of the identification period, C delivers the entire $100,000 from the sale of real property X to B.

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

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

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

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

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis of real property X ($60,000), or $40,000. The directors' authorization of a like-kind exchange, the terms of the exchange agreement with C, and the absence of other relevant facts, indicate that B had a bona fide intent at the beginning of the exchange period to enter into a deferred like-kind exchange. Thus, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(ii) of this section inapplicable, even though B fails to acquire replacement property. Further, under paragraph (j)(2)(ii) of this section, C is a qualified intermediary, even though C does not transfer replacement property to B. Thus, any agency relationship between B and C is disregarded for purposes of section 453 and § 15a.453–1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment until January 12, 1995, on receipt of the $100,000 cash from C. Subject to the other requirements of sections 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

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

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis of real property X ($60,000), or $40,000. The terms of the exchange agreement with D, the identification of properties J, K, and L, the efforts to have those properties rezoned for commercial purposes, and the absence of other relevant facts, indicate that B had a bona fide intent at the beginning of the exchange period to enter into a deferred exchange. Moreover, the limitations imposed in the exchange agreement on acceptable replacement property do not make it unreasonable to believe that like-kind replacement property would be acquired before the end of the exchange period. Therefore, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(i) of this section inapplicable even though B fails to acquire replacement property. Thus, for purposes of section 453 and § 15a.453–1(b)(3)(i) of this chapter, the qualified escrow account is disregarded in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on September 22, 1994, on D's deposit of the $100,000 cash into the qualified escrow account. Instead, B is treated as receiving payment on January 5, 1995. Subject to the other requirements of sections 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

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

(3) *Examples.* This paragraph (j) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B is to transfer real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. B's adjusted basis in real property X is $40,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received. The replacement property is identified as provided in paragraph (c) of this section and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

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

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

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

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

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

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

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

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

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

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

(k) *Definition of disqualified person.* (1) For purposes of this section, a disqualified person is a person described in paragraph (k)(2), (k)(3), or (k)(4) of this section.

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

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

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

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

(4) The person and a person described in paragraph (k)(2) of this section bear a relationship described in either section 267(b) or section 707(b) (determined by substituting in each section ''10 percent'' for ''50 percent'' each place it appears).

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

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

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

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

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

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

Example 3. (i) C is a corporation that is only engaged in the trade or business of acting as an intermediary to facilitate deferred exchanges. Each of 10 law firms owns 10 percent of the outstanding stock of C. One of the 10 law firms that owns 10 percent of C is M. J is the managing partner of M and is the president of C. J, in his capacity as a partner in M, has also rendered legal advice to B within the 2-year period ending on May 17, 1991, on matters other than exchanges intended to qualify for nonrecognition of gain or loss under section 1031.

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

(l) [Reserved]

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

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

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

[T.D. 8346, 56 FR 19938, May 1, 1991, as amended by T.D. 8535, 59 FR 18749, Apr. 20, 1994]

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

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

(b) Section 1032(a) does not apply to the acquisition by a corporation of shares of its own stock except where the corporation acquires such shares in exchange for shares of its own stock (including treasury stock). See paragraph (e) of §1.311–1, relating to treatment of acquisitions of a corporation's own stock. Section 1032(a) also does not relate to the tax treatment of the recipient of a corporation's stock.

(c) Where a corporation acquires shares of its own stock in exchange for shares of its own stock (including treasury stock) the transaction may qualify not only under section 1032(a), but also under section 368(a)(1)(E) (recapitalization) or section 305(a) (distribution of stock and stock rights).

(d) For basis of property acquired by a corporation in connection with a transaction to which section 351 applies or in connection with a reorganization, see section 362. For basis of property acquired by a corporation in a transaction to which section 1032 applies but which does not qualify under any other nonrecognition provision, see section 1012.

§1.1032–2 Disposition by a corporation of stock of a controlling corporation in certain triangular reorganizations.

(a) *Scope.* This section provides rules for certain triangular reorganizations described in §1.358–6(b) when the acquiring corporation (*S*) acquires property or stock of another corporation (*T*) in exchange for stock of the corporation (*P*) in control of *S*.

(b) *General nonrecognition of gain or loss.* For purposes of §1.1032–1(a), in the case of a forward triangular merger, a triangular C reorganization, or a triangular B reorganization (as described in §1.358–6(b)), *P* stock provided by *P* to *S*, or directly to *T* or *T*'s shareholders on behalf of *S*, pursuant to the plan of reorganization is treated as a disposition by *P* of shares of its own stock for *T*'s assets or stock, as applicable. For rules governing the use of *P* stock in a reverse triangular merger, see section 361.

(c) *Treatment of S. S* must recognize gain or loss on its exchange of *P* stock as consideration in a forward triangular merger, a triangular C reorganization, or a triangular B reorganization (as described in §1.358–6(b)), if *S* did not receive the *P* stock from *P* pursuant to the plan of reorganization. See §1.358–6(d) for the effect on *P*'s basis in its *S* or *T* stock, as applicable. For rules governing *S*'s use of *P* stock in a reverse triangular merger, see section 361.

(d) *Examples.* The rules of this section are illustrated by the following examples. For purposes of these examples, *P*, *S*, and *T* are domestic corporations, *P* and *S* do not file consolidated returns, *P* owns all of the only class of *S* stock, the *P* stock exchanged in the transaction satisfies the requirements of the applicable reorganization provisions, and the facts set forth the only corporate activity.

Example 1. Forward triangular merger solely for P stock. (a) *Facts. T* has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. Pursuant to a plan, *P* forms *S* by transferring $100 of *P* stock to *S* and *T* merges into *S*. In the merger, the *T* shareholders receive, in exchange for their *T* stock, the *P* stock that *P* transferred to *S*. The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(D) apply.

(b) *No gain or loss recognized on the use of P stock.* Under paragraph (b) of this section, the *P* stock provided by *P* pursuant to the plan of reorganization is treated for purposes of §1.1032–1(a) as disposed of by *P* for the *T* assets acquired by *S* in the merger. Consequently, neither *P* nor *S* has taxable gain or deductible loss on the exchange.

Example 2. Forward triangular merger solely for P stock provided in part by S. (a) *Facts. T* has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. *S* is an operating company with substantial assets that has been in existence for several years. *S* also owns *P* stock with a $20 adjusted basis and $30 fair market value. *S* acquired the *P* stock in an unrelated transaction several years before the reorganization. Pursuant to a plan, *P* transfers additional *P* stock worth $70 to *S* and *T* merges into *S*. In the merger, the *T* shareholders receive $100 of *P* stock ($70 of *P* stock provided by *P* to *S* as part of the plan and $30 of *P* stock held by *S* previously). The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(D) apply.

(b) *Gain or loss recognized by S on the use of its P* stock. Under paragraph (b) of this section, the $70 of *P* stock provided by *P* pursuant to the plan of reorganization is treated as disposed of by *P* for the *T* assets acquired by *S* in the merger. Consequently, neither *P* nor *S* has taxable gain or deductible loss on the exchange of those shares. Under paragraph (c) of this section, however, *S* recognizes $10 of gain on the exchange of its *P* stock in the reorganization because *S* did not receive the *P* stock from *P* pursuant to the plan of reorganization. See §1.358–6(d) for the effect on *P*'s basis in its *S* stock.

(e) *Effective date.* This section applies to triangular reorganizations occurring on or after December 23, 1994.

[T.D. 8648, 60 FR 66081, Dec. 21, 1995]

§1.1033(a)–1 Involuntary conversions; nonrecognition of gain.

(a) *In general.* Section 1033 applies to cases where property is compulsorily or involuntarily converted. An *involuntary conversion* may be the result of the destruction of property in whole or in part, the theft of property, the seizure of property, the requisition or condemnation of property, or the threat or imminence of requisition or condemnation of property. An *involuntary conversion* may be a conversion into similar property or into money or into dissimilar property. Section 1033 provides that, under certain specified circumstances, any gain which is realized from an involuntary conversion shall not be recognized. In cases where property is converted into other property similar or related in service or use to the converted property, no gain shall be recognized regardless of when the disposition of the converted property occurred and regardless of whether or not the taxpayer elects to have the gain not recognized. In other types of involuntary conversion cases, however, the proceeds arising from the disposition of the converted property must (within the time limits specified) be reinvested in similar property in order to avoid recognition of any gain realized. Section 1033 applies only with respect to gains; losses from involuntary conversions are recognized or not recognized without regard to this section.

(b) *Special rules.* For rules relating to the application of section 1033 to involuntary conversions of a principal residence with respect to which an election has been made under section 121 (relating to gain from sale or exchange of residence of individual who has attained age 65), see paragraph (g) of §1.121–5. For rules applicable to involuntary conversions of a principal residence occurring before January 1, 1951, see §1.1033(a)–3. For rules applicable to involuntary conversions of a principal residence occurring after December 31, 1950, and before January 1, 1954, see paragraph (h)(1) of §1.1034–1. For rules applicable to involuntary conversions of a personal residence occurring after December 31, 1953, see §1.1033(a)–3. For special rules relating to the election to have section 1034 apply to certain involuntary conversions of a principal reisdence occurring after December 31, 1957, see paragraph (h)(2) of §1.1034–1. For special rules relating to certain involuntary conversions of real property held either for productive use in trade or business or for investment and occurring after December 31, 1957, see §1.1033(g)–1. See also special rules applicable to involuntary conversions of property sold pursuant to reclamation laws, livestock destroyed by disease, and livestock sold on account of drought provided in §§1.1033(c)–1, 1.1033(d)–1, and 1.1033(e)–1, respectively. For rules relating to basis of property acquired through involuntary conversions, see §1.1033(b)–1. For determination of the period for which the taxpayer has held property acquired as a result of certain involuntary conversions, see section 1223 and regulations issued thereunder. For treatment of gains from involuntary conversions as capital gains in certain cases, see section 1231(a) and regulations issued thereunder. For portion of war loss recoveries treated as gain on involuntary conversion, see section 1332(b)(3) and regulations issued thereunder.

(Secs. 1033 (90 Stat. 1920, 26 U.S.C. 1033), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6856, 30 FR 13318, Oct. 20, 1965; T.D. 7625, 44 FR 31013, May 30, 1979; T.D. 7758, 46 FR 6925, Jan. 22, 1981]

§1.1033(a)–2 Involuntary conversion into similiar property, into money or into dissimilar property.

(a) *In general.* The term *disposition of the converted property* means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(b) *Conversion into similar property.* If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted only into property similar or related in service or use to the property so converted, no gain shall be recognized. Such nonrecognition of gain is mandatory.

(c) *Conversion into money or into dissimilar property.* (1) If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, the gain, if any, shall be recognized, at the election of the taxpayer, only to the extent that the amount realized upon such conversion exceeds the cost of other property purchased by the taxpayer which is similar or related in service or use to the property so converted, or the cost of stock of a corporation owning such other property which is purchased by the taxpayer in the acquisition of control of such corporation, if the taxpayer purchased such other property, or such stock, for the purpose of replacing the property so converted and during the period specified in subparagraph (3) of this paragraph. For the purposes of section 1033, the term *control* means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

(2) All of the details in connection with an involuntary conversion of property at a gain (including those relating to the replacement of the converted property, or a decision not to replace, or the expiration of the period for replacement) shall be reported in the return for the taxable year or years in which any of such gain is realized. An election to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph shall be made by including such gain in gross income for such year or years only to such extent. If, at the time of filing such a return, the period within which the converted property must be replaced has expired, or if such an election is not desired, the gain should be included in gross income for such year or years in the regular manner. A failure to so include such gain in gross income in the regular manner shall be deemed to be an election by the taxpayer to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph even though the details in connection with the conversion are not reported in such return. If, after having made an election under section 1033(a)(2), the converted property is not replaced within the required period of time, or replacement is made at a cost lower than was anticipated at the time of the election, or a decision is made not to replace, the tax liability for the year or years for which the election was made shall be recomputed. Such recomputation should be in the form of an *amended return*. If a decision is made to make an election under section 1033(a)(2) after the filing of the return and the payment of the tax for the year or years in which any of the gain on an involuntary conversion is realized and before the expiration of the period within which the converted property must be replaced, a claim for credit or refund for such year or years should be filed. If the replacement of the converted property occurs in a year or years in which none of the gain on the conversion is realized, all of the details in connection with such replacement shall be reported in the return for such year or years.

(3) The period referred to in subparagraphs (1) and (2) of this paragraph is the period of time commencing with the date of the disposition of the converted property, or the date of the beginning of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and ending 2 years (or, in the case of a disposition occurring before December 31, 1969, 1 year) after the close of the first taxable year in which any part of the gain upon the conversion is realized, or at the close of such later date as may be designated pursuant to an application of the taxpayer. Such application shall be made prior to the expiration of 2 years (or, in the case of a disposition occurring before December 31, 1969, 1 year) after the close of the first taxable year in which any part of the gain from the conversion is realized, unless the taxpayer can show to the satisfaction of the district director—

(i) Reasonable cause for not having filed the application within the required period of time, and

(ii) The filing of such application was made within a reasonable time after the expiration of the required period of time. The application shall contain all of the details in connection with the involuntary conversion. Such application shall be made to the district director for the internal revenue district in which the return is filed for the first taxable year in which any of the gain from the involuntary conversion is realized. No extension of time shall be granted pursuant to such application unless the taxpayer can show reasonable cause for not being able to replace the converted property within the required period of time.

See section 1033(g)(4) and § 1.1033(g)–1 for the circumstances under which, in the case of the conversion of real property held either for productive use in trade or business or for investment, the 2-year period referred to in this paragraph (c)(3) shall be extended to 3 years.

(4) Property or stock purchased before the disposition of the converted property shall be considered to have been purchased for the purpose of replacing the converted property only if such property or stock is held by the taxpayer on the date of the disposition of the converted property. Property or stock shall be considered to have been purchased only if, but for the provisions of section 1033(b), the unadjusted basis of such property or stock would be its cost to the taxpayer within the meaning of section 1012. If the taxpayers unadjusted basis of the replacement property would be determined, in the absence of section 1033(b), under any of the exceptions referred to in section 1012, the unadjusted basis of the property would not be its cost within the meaning of section 1012. For example, if property similar or related in service or use to the converted property is acquired by gift and its basis is determined under section 1015, such property will not qualify as a replacement for the converted property.

(5) If a taxpayer makes an election under section 1033(a)(2), any deficiency, for any taxable year in which any part of the gain upon the conversion is realized, which is attributable to such gain may be assessed at any time before the expiration of three years from the date the district director with whom the return for such year has been filed is notified by the taxpayer of the replacement of the converted property or of an intention not to replace, or of a failure to replace, within the required period, notwithstanding the provisions of section 6212(c) or the provisions of any other law or rule of law which would otherwise prevent such assessment. If replacement has been made, such notification shall contain all of the details in connection with such replacement. Such notification should be made in the return for the taxable year or years in which the replacement occurs, or the intention not to replace is formed, or the period for replacement expires, if this return is filed with such district director. If this return is not filed with such district director, then such notification shall be made to such district director at the time of filing this return. If the taxpayer so desires, he may, in either event, also notify such district director before the filing of such return.

(6) If a taxpayer makes an election under section 1033(a)(2) and the replacement property or stock was purchased before the beginning of the last taxable

year in which any part of the gain upon the conversion is realized, any deficiency, for any taxable year ending before such last taxable year, which is attributable to such election may be assessed at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed, notwithstanding the provisions of section 6212(c) or 6501 or the provisions of any law or rule of law which would otherwise prevent such assessment.

(7) If the taxpayer makes an election under section 1033(a)(2), the gain upon the conversion shall be recognized to the extent that the amount realized upon such conversion exceeds the cost of the replacement property or stock, regardless of whether such amount is realized in one or more taxable years.

(8) The proceeds of a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been.

(9) There is no investment in property similar in character and devoted to a similar use if—

(i) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.

(ii) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase or a leasehold.

(iii) The owner of a requisitioned tug uses the proceeds to buy barges.

(10) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation, the amount so retained shall be deducted from the gross award in determining the amount of the net award.

(11) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation) and mortgages against the property, and itself pays the same, the amount so retained shall not be deducted from the gross award in determining the amount of the net award. If, in a condemnation proceeding, the Government makes an award to a mortgagee to satisfy a mortgage on the condemned property, the amount of such award shall be considered as a part of the *amount realized* upon the conversion regardless of whether or not the taxpayer was personally liable for the mortgage debt. Thus, if a taxpayer has acquired property worth $100,000 subject to a $50,000 mortgage (regardless of whether or not he was personally liable for the mortgage debt) and, in a condemnation proceeding, the Government awards the taxpayer $60,000 and awards the mortgagee $50,000 in satisfaction of the mortgage, the entire $110,000 is considered to be the *amount realized* by the taxpayer.

(12) An amount expended for replacement of an asset, in excess of the recovery for loss, represents a capital expenditure and is not a deductible loss for income tax purposes.

(Secs. 1033 (90 Stat. 1920, 26 U.S.C. 1033), and 7805 (68A Stat. 917, 26 U.S.C. 7805)

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6679, 28 FR 10515, Oct. 1, 1963; T.D. 7075, 35 FR 17996, Nov. 24, 1970; T.D. 7625, 44 FR 31013, May 30, 1979; T.D. 7758, 46 FR 6925, Jan. 22, 1981]

§1.1033(a)–3 Involuntary conversion of principal residence.

Section 1033 shall apply in the case of property used by the taxpayer as his principal residence if the destruction, theft, seizure, requisition, or condemnation of such residence, or the sale or exchange of such residence under threat or imminence thereof, occurs before January 1, 1951, or after December 31, 1953. However, section 1033 shall not apply to the seizure, requisition, or condemnation (but not destruction), or the sale or exchange under threat or imminence thereof, of such residence property if the seizure, requisition, condemnation, sale, or exchange occurs after December 31, 1957, and if the taxpayer properly elects under section 1034(i) to treat the transaction as a sale (see paragraph (h)(2)(ii) of §1.1034–1). See section 121 and paragraphs (d) and (g) of §1.121–5 for special rules relating to the involuntary conversion of a principal residence of individuals who have attained age 65.

[T.D. 6856, 30 FR 13319, Oct. 20, 1965. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979]

§1.1033(b)–1 Basis of property acquired as a result of an involuntary conversion.

(a) The provisions of the first sentence of section 1033(b) may be illustrated by the following example:

Example: A's vessel which has an adjusted basis of $100,000 is destroyed in 1950 and A receives in 1951 insurance in the amount of $200,000. If A invests $150,000 in a new vessel, taxable gain to the extent of $50,000 would be recognized. The basis of the new vessel is $100,000; that is, the adjusted basis of the old vessel ($100,000) minus the money received by the taxpayer which was not expended in the acquisition of the new vessel ($50,000) plus the amount of gain recognized upon the conversion ($50,000). If any amount in excess of the proceeds of the conversion is expended in the acquisition of the new property, such amount may be added to the basis otherwise determined.

(b) The provisions of the last sentence of section 1033(b) may be illustrated by the following example:

Example: A taxpayer realizes $22,000 from the involuntary conversion of his barn in 1955; the adjusted basis of the barn to him was $10,000, and he spent in the same year $20,000 for a new barn which resulted in the nonrecognition of $10,000 of the $12,000 gain on the conversion. The basis of the new barn to the taxpayer would be $10,000—the cost of the new barn ($20,000) less the amount of the gain not recognized on the conversion ($10,000). The basis of the new barn would not be a substituted basis in the hands of the taxpayer within the meaning of section 1016(b)(2). If the replacement of the converted barn had been made by the purchase of two smaller barns which, together, were similar or related in service or use to the converted barn and which cost $8,000 and $12,000, respectively, then the basis of the two barns would be $4,000 and $6,000, respectively, the total basis of the purchased property ($10,000) allocated in proportion to their respective costs (8,000/ 20,000 of $10,000 or $4,000; and 12,000/20,000 of $10,000, or $6,000).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979]

§1.1033(c)–1 Disposition of excess property within irrigation project deemed to be involuntary conversion.

(a) The sale, exchange, or other disposition occurring in a taxable year to which the Internal Revenue Code of 1954 applies, of excess lands lying within an irrigation project or division in order to conform to acreage limitations of the Federal reclamation laws effective with respect to such project or division shall be treated as an involuntary conversion to which the provisions of section 1033 and the regulations thereunder shall be applicable. The term *excess lands* means irrigable lands within an irrigation project or division held by one owner in excess of the amount of irrigable land held by such owner entitled to receive water under the Federal reclamation laws applicable to such owner in such project or division. Such excess lands may be either (1) lands receiving no water from the project or division, or (2) lands receiving water only because the owner thereof has executed a valid recordable contract agreeing to sell such lands under terms and conditions satisfactory to the Secretary of the Interior.

(b) If a disposition in order to conform to the acreage limitation provisions of Federal reclamation laws includes property other than excess lands (as, for example, where the excess lands alone do not constitute a marketable parcel) the provisions of section 1033(d) shall apply only to the part of the disposition that relates to excess lands.

(c) The provisions of §1.1033(a)–2 shall be applicable in the case of dispositions treated as involuntary conversions under this section. The details in connection with such a disposition required to be reported under paragraph (c)(2) of §1.1033(a)–2 shall include the authority whereby the lands disposed of are considered *excess lands*, as defined in this section, and a statement that such disposition is not part of a plan contemplating the disposition of all or any nonexcess land within the irrigation project or division.

(d) The term *involuntary conversion,* where it appears in subtitle A of the Code or the regulations thereunder, includes dispositions of excess property within irrigation projects described in this section. (See, e.g., section 1231 and the regulations thereunder.)

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979]

§1.1033(d)–1 Destruction or disposition of livestock because of disease.

(a) The destruction occurring in a taxable year to which the Internal Revenue Code of 1954 applies, of livestock by, or on account of, disease, or the sale or exchange, in such a year, of livestock because of disease, shall be treated as an involuntary conversion to which the provisions of section 1033 and the regulations thereunder shall be applicable. Livestock which are killed either because they are diseased or because of exposure to disease shall be considered destroyed on account of disease. Livestock which are sold or exchanged because they are diseased or have been exposed to disease, and would not otherwise have been sold or exchanged at that particular time shall be considered sold or exchanged because of disease.

(b) The provisions of §1.1033(a)–2 shall be applicable in the case of a disposition treated as an involuntary conversion under this section. The details in connection with such a disposition required to be reported under paragraph (c)(2) of §1.1033(a)–2 shall include a recital of the evidence that the livestock were destroyed by or on account of disease, or sold or exchanged because of disease.

(c) The term *involuntary conversion,* where it appears in subtitle A of the Code or the regulations thereunder, includes disposition of livestock described in this section. (See, e.g., section 1231 and the regulations thereunder.)

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated by T.D. 7625, 44 FR 31013, May 30, 1979]

§1.1033(e)–1 Sale or exchange of livestock solely on account of drought.

(a) The sale or exchange of livestock (other than poultry) held for draft, breeding, or dairy purposes in excess of the number the taxpayer would sell or exchange during the taxable year if he followed his usual business practices shall be treated as an involuntary conversion to which section 1033 and the regulations thereunder are applicable if the sale or exchange of such livestock by the taxpayer is solely on account of drought. Section 1033(e) and this section shall apply only to sales and exchanges occurring after December 31, 1955.

(b) To qualify under section 1033(e) and this section, the sale or exchange of the livestock need not take place in a drought area. While it is not necessary that the livestock be held in a drought area, the sale or exchange of the livestock must be solely on account of drought conditions the existence of which affected the water, grazing, or other requirements of the livestock so as to necessitate their sale or exchange.

(c) The total sales or exchanges of livestock held for draft, breeding, or dairy purposes occurring in any taxable year which may qualify as an involuntary conversion under section 1033(e) and this section is limited to the excess of the total number of such livestock sold or exchanged during the taxable year over the number that the taxpayer would have sold or exchanged if he had followed his usual business practices, that is, the number he would have been expected to sell or exchange under ordinary circumstances if there had been no drought. For example, if in the past it has been a taxpayer's practice to sell or exchange annually one-half of his herd of dairy cows, only the number sold or exchanged solely on account of drought conditions which is in excess of one-half of his herd, may qualify as an involuntary conversion under section 1033(e) and this section.

(d) The replacement requirements of section 1033 will be satisfied only if the livestock sold or exchanged is replaced within the prescribed period with livestock which is similar or related in service or use to the livestock sold or exchanged because of drought, that is, the new livestock must be functionally the same as the livestock involuntarily converted. This means that the new livestock must be held for the same useful purpose as the old was held. Thus, although dairy cows could be replaced by dairy cows, a taxpayer could not replace draft animals with breeding or dairy animals.

(e) The provisions of § 1.1033(a)–2 shall be applicable in the case of a sale or exchange treated as an involuntary conversion under this section. The details in connection with such a disposition required to be reported under paragraph (c)(2) of § 1.1033(a)–2 shall include:

(1) Evidence of the existence of the drought conditions which forced the sale or exchange of the livestock;

(2) A computation of the amount of gain realized on the sale or exchange;

(3) The number and kind of livestock sold or exchanged; and

(4) The number of livestocks of each kind that would have been sold or exchanged under the usual business practice in the absence of the drought.

(f) The term *involuntary conversion,* where it appears in subtitle A of the Code or the regulations thereunder, includes the sale or exchange of livestock described in this section.

(g) The provisions of section 1033(e) and this section apply to taxable years ending after December 31, 1955, but only in the case of sales or exchange of livestock after December 31, 1955.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated by T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1033(g)–1 Condemnation of real property held for productive use in trade or business or for investment.

(a) *Special rule in general.* This section provides special rules for applying section 1033 with respect to certain dispositions, occurring after December 31, 1957, of real property held either for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale). For this purpose, disposition means the seizure, requisition, or condemnation (but not destruction) of the converted property, or the sale or exchange of such property under threat or imminence of seizure, requisition, or condemnation. In such cases, for purposes of applying section 1033, the replacement of such property with property of like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted. For principles in determining whether the replacement property is property of like kind, see paragraph (b) of § 1.1031(a)–1.

(b) *Election to treat outdoor advertising displays as real property*—(1) *In general.* Under section 1033(g)(3) of the Code, a taxpayer may elect to treat property which constitutes an outdoor advertising display as real property for purposes of chapter 1 of the Code. The election is available for taxable years beginning after December 31, 1970. In the case of an election made on or before July 21, 1981, the election is available whether or not the period for filing a claim for credit or refund under section 6511 has expired. No election may be made with respect to any property for which (i) the investment credit under section 38 has been claimed, or (ii) an election to expense certain depreciable business assets under section 179(a) is in effect. The election once made applies to all outdoor advertising displays of the taxpayer which may be made the subject of an election under this paragraph, including all outdoor advertising displays acquired or constructed by the taxpayer in a taxable year after the taxable year for which the election is made. The election applies with respect to dispositions during the taxable year for which made and all subsequent taxable years (unless an effective revocation is made pursuant to paragraph (b)(2) (ii) or (iii)).

(2) *Election*—(i) *Time and manner of making election*—(A) *In general.* Unless otherwise provided in the return or in the instructions for a return for a taxable year, any election made under section 1033(g)(3) shall be made by attaching a statement to the return (or amended return if filed on or before July 21, 1981) for the first taxable year to which the election is to apply. Any election made under this paragraph must be made not later than the time, including extensions thereof, prescribed by law for filing the income tax return for such taxable year or July 21, 1981, whichever occurs last. If a taxpayer makes an election (or revokes an election under subdivision (ii) or (iii) of this subparagraph (b) (2)) for a taxable

year for which he or she has previously filed a return, the return for that taxable year and all other taxable years affected by the election (or revocation) must be amended to reflect any tax consequences of the election (or revocation). However, no return for a taxable year for which the period for filing a claim for credit or refund under section 6511 has expired may be amended to make any changes other than those resulting from the election (or revocation). In order for the election (or revocation) to be effective, the taxpayer must remit with the amended return any additional tax due resulting from the election (or revocation), notwithstanding the provisions of section 6212(c) or 6501 or the provisions of any other law which would prevent assessment or collection of such tax.

(B) *Statement required when making election.* The statement required when making the election must clearly indicate that the election to treat outdoor advertising displays as real property is being made.

(ii) *Revocation of election by Commissioner's consent.* Except as otherwise provided in paragraph (b)(2)(iii) of this section, an election under section 1033(g)(3) shall be irrevocable unless consent to revoke is obtained from the Commissioner. In order to secure the Commissioner's consent to revoke an election, the taxpayer must file a request for revocation of election with the Commissioner of Internal Revenue, Washington, DC 20224. The request for revocation shall include—

(A) The taxpayer's name, address, and taxpayer identification number,

(B) The date on which and taxable year for which the election was made and the Internal Revenue Service office with which it was filed,

(C) Identification of all outdoor advertising displays of the taxpayer to which the revocation would apply (including the location, date of purchase, and adjusted basis in such property),

(D) The effective date desired for the revocation, and

(E) The reasons for requesting the revocation.

The Commissioner may require such other information as may be necessary in order to determine whether the requested revocation will be permitted. The Commissioner may prescribe administrative procedures (subject to such limitations, terms and conditions as he deems necessary) to obtain his consent to permit the taxpayer to revoke the election. The taxpayer may submit a request for revocation for any taxable year for which the period of limitations for filing a claim for credit or refund or overpayment of tax has not expired.

(iii) *Revocation where election was made on or before December 11, 1979.* In the case of an election made on or before December 11, 1979, the taxpayer may revoke such election provided such revocation is made not later than March 23, 1981. The request for revocation shall be made in conformity with the requirements of paragraph (b)(2)(ii), except that, in lieu of the information required by paragraph (b)(2)(ii)(E), the taxpayer shall state that the revocation is being made pursuant to this paragraph. In addition, the taxpayer must forward, with the statement of revocation, copies of his or her tax returns, including both the original return and any amended returns, for the taxable year in which the original election was made and for all subsequent years and must remit any additional tax due as a result of the revocation.

(3) *Definition of outdoor advertising display.* The term *outdoor advertising display* means a rigidly assembled sign, display, or device that constitutes, or is used to display, a commercial or other advertisement to the public and is permanently affixed to the ground or permanently atttached to a building or other inherently permanent structure. The term includes highway billboards affixed to the ground with wood or metal poles, pipes, or beams, with or without concrete footings.

(4) *Character of replacement property.* For purposes of section 1033(g), an interest in real property purchased as replacement property for a compulsorily or involuntarily converted outdoor advertising display (with respect to which an election under this section is in effect) shall be considered property of a like kind as the property converted even though a taxpayer's interest in the replacement property is different from the interest held in the

property converted. Thus, for example, a fee simple interest in real estate acquired to replace a converted billboard and a 5-year leasehold interest in the real property on which the billboard was located qualifies as property of a like kind under this section.

(c) *Special rule for period within which property must be replaced.* In the case of a disposition described in paragraph (a) of this section, section 1033(a)(2)(B) and § 1.1033(a)–2(c)(3) (relating to the period within which the property must be replaced) shall be applied by substituting 3 years for 2 years. This paragraph shall apply to any disposition described in section 1033(f)(1) and paragraph (a) of this section occurring after December 31, 1974, unless a condemnation proceeding with respect to the property was begun before October 4, 1976. Thus, regardless of when the property is disposed of, the taxpayer will not be eligible for the 3-year replacement period if a condemnation proceeding was begun before October 4, 1976. However, if the property is disposed of after December 31, 1974, and the condemnation proceeding was begun (if at all) after October 4, 1976, then the taxpayer is eligible for the 3-year replacement period. For the purposes of this paragraph, whether a condemnation proceeding is considered as having begun is determined under the applicable State or Federal procedural law.

(d) *Limitation on application of special rule.* This section shall not apply to the purchase of stock in the acquisition of control of a corporation described in section 1033(a)(2)(A).

(Secs. 1033 (90 Stat. 1920, 26 U.S.C. 1033), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979; 44 FR 38458, July 2, 1979. Further redesignated and amended by T.D. 7758, 46 FR 6925, Jan. 22, 1981; T.D. 7758, 46 FR 23235, Apr. 24, 1981; T.D. 8121, 52 FR 414, Jan. 6, 1987]

§ 1.1033(h)–1 Effective date.

Except as provided otherwise in § 1.1033(e)–1 and § 1.1033(g)–1, the provisions of section 1033 and the regulations thereunder are effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954.

(Secs. 1033 (90 Stat. 1920, 26 U.S.C. 1033), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979. Further redesignated and amended by T.D. 7758, 46 FR 6925, Jan. 22, 1981]

§ 1.1034–1 Sale or exchange of residence.

(a) *Nonrecognition of gain; general statement.* Section 1034 provides rules for the nonrecognition of gain in certain cases where a taxpayer sells one residence after December 31, 1953, and buys or builds, and uses as his principal residence, another residence within specified time limits before or after such sale. In general, if the taxpayer invests in a new residence an amount at least as large as the adjusted sales price of his old residence, no gain is recognized on the sale of the old residence (see paragraph (b) of this section for definitions of *adjusted sales price, new residence,* and *old residence*). On the other hand, if the new residence costs the taxpayer less than the adjusted sales price of the old residence, gain is recognized to the extent of the difference. Thus, if an amount equal to or greater than the adjusted sales price of an old residence is invested in a new residence, according to the rules stated in section 1034, none of the gain (if any) realized from the sale shall be recognized. If an amount less than such adjusted sales price is so invested, gain shall be recognized, but only to the extent provided in section 1034. If there is no investment in a new residence, section 1034 is inapplicable and all of the gain shall be recognized. Whenever, as a result of the application of section 1034, any or all of the gain realized on the sale of an old residence is not recognized, a corresponding reduction must be made in the basis of the new residence. The provisions of section 1034 are mandatory, so that the taxpayer cannot elect to have gain recognized under circumstances where this section is applicable. Section 1034 applies only to gains; losses are recognized or not recognized without regard to the provisions of this section. Section 1034 affects only the amount of gain recognized, and not the amount of gain realized (see also section 1001 and the regulations issued thereunder). Any gain realized upon disposition of other property in exchange for the new residence is not affected by section 1034. For special rules relating to the sale or exchange of a principal residence by a taxpayer who has attained age 65, see section 121 and paragraph (g) of §1.121–5. For special rules relating to a case where real property with respect to the sale of which gain is not recognized under this section is reacquired by the seller in partial or full satisfaction of the indebtedness arising from such sale and resold by him within 1 year after the date of such reacquisition, see §1.1038–2.

(b) *Definitions.* The following definitions of frequently used terms are applicable for purposes of section 1034 (other definitions and detailed explanations appear in subsequent paragraphs of this regulation):

(1) *Old residence* means property used by the taxpayer as his principal residence which is the subject of a sale by him after December 31, 1953 (section 1034(a); for detailed explanation see paragraph (c)(3) of this section).

(2) *New residence* means property used by the taxpayer as his principal residence which is the subject of a purchase by him (section 1034(a); for detailed explanation and limitations see paragraphs (c)(3) and (d)(1) of this section).

(3) *Adjusted sales price* means the amount realized reduced by the fixing-up expenses (section 1034(b)(1); for special rule applicable in some cases to husband and wife, see paragraph (f) of this section).

(4) *Amount realized* is to be computed by subtracting,

(i) The amount of the items which, in determining the gain from the sale of the old residence, are properly an offset against the consideration received upon the sale (such as commissions and expenses of advertising the property for sale, of preparing the deed, and of other legal services in connection with the sale); from

(ii) The amount of the consideration so received, determined (in accordance with section 1001(b) and regulations issued thereunder) by adding to the sum of any money so received, the fair market value of the property (other than money) so received. If, as part of the consideration for the sale, the purchaser either assumes a liability of the taxpayer or acquires the old residence subject to a liability (whether or not the taxpayer is personally liable on the debt), such assumption or acquisition, in the amount of the liability, shall be treated as money received by the taxpayer in computing the *amount realized.*

(5) *Gain realized* is the excess (if any) of the amount realized over the adjusted basis of the old residence (see also section 1001(a) and regulations issued thereunder).

(6) *Fixing-up expenses* means the aggregate of the expenses for work performed (in any taxable year, whether beginning before, on, or after January 1, 1954) on the old residence in order to assist in its sale, provided that such expenses (i) are incurred for work performed during the 90-day period ending on the day on which the contract to sell the old residence is entered into; and (ii) are paid on or before the 30th day after the date of the sale of the old residence; and (iii) are neither (a) allowable as deductions in computing taxable income under section 63(a), nor (b) taken into account in computing the amount realized from the sale of the old residence (section 1034(b) (2) and (3)). *Fixing-up expenses* does not include expenditures which are properly chargeable to capital account and which would, therefore, constitute adjustments to the basis of the old residence (see section 1016 and regulations issued thereunder).

(7) *Cost of purchasing the new residence* means the total of all amounts which are attributable to the acquisition, construction, reconstruction, and improvements constituting capital expenditures, made during the period beginning 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) before the date of sale of the old residence and ending either (i) 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after such date in the case of a new residence purchased but not constructed by the taxpayer, or (ii) two years (18 months in the case of a sale of an old residence prior to January 1,

1975) after such date in the case of a new residence the construction of which was commenced by the taxpayer before the expiration of 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after such date (section 1034(a), (c)(2) and (c)(5); for detailed explanation, see paragraph (c)(4) of this section; for special rule applicable in some cases to husband and wife, see paragraph (f) of this section; see also paragraph (b)(9) of this section for definition of *purchase*).

(8) *Sale* (of a residence) means a sale or an exchange (of a residence) for other property which occurs after December 31, 1953, an involuntary conversion (of a residence) which occurs after December 31, 1950, and before January 1, 1954, or certain involuntary conversions where the disposition of the property occurs after December 31, 1957, in respect of which a proper election is made under section 1034(i)(2) (see sections 1034(c)(1), 1034(i)(1)(A), and 1034(i)(2); for detailed explanation concerning involuntary conversions, see paragraph (h) of this section).

(9) *Purchase* (of a residence) means a purchase or an acquisition (of a residence) on the exchange of property or the partial or total construction or reconstruction (of a residence) by the taxpayer (section 1034(c) (1) and (2)). However, the mere improvement of a residence, not amounting to reconstruction, does not constitute *purchase* of a residence.

(c) *Rules for application of section 1034*—(1) *General rule; limitations on applicability.* Gain realized from the sale (after December 31, 1953) of an old residence will be recognized only to the extent that the taxpayer's adjusted sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence, provided that the taxpayer either (i) within a period beginning 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) before the date of such sale and ending 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after such date purchases property and uses it as his principal residence, or (ii) within a period beginning 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) before the date of such sale and ending two years (18 months in the case of a sale of an old residence prior to January 1, 1975) after such date uses as his principal residence a new residence the construction of which was commenced by him at any time before the expiration of 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after the date of the sale of the old residence (section 1034 (a) and (c)(5); for detailed explanation of use as *principal residence* see subparagraph (3) of this paragraph). The rule stated in the preceding sentence applies to a new residence purchased by the taxpayer before the date of sale of the old residence provided the new residence is still owned by him on such date (section 1034(c)(3)). Whether the construction of a new residence was commenced by the taxpayer before the expiration of 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after the date of the sale of the old residence will depend upon the facts and circumstances of each case. Section 1034 is not applicable to the sale of a residence if within the previous 18 months (previous year in the case of a sale of an old residence prior to January 1, 1975) the taxpayer made another sale of residential property on which gain was realized but not recognized (section 1034(d)). For further details concerning limitations on the application of section 1034, see paragraph (d) of this section.

(2) *Computation and examples.* In applying the general rule stated in subparagraph (1) of this paragraph, the taxpayer should first subtract the commissions and other selling expenses from the selling price of his old residence, to determine the amount realized. A comparison of the amount realized with the cost or other basis of the old residence will then indicate whether there is any gain realized on the sale. Unless the amount realized is greater than the cost or other basis, no gain is realized and section 1034 does not apply. If the amount realized exceeds the cost or other basis, the amount of such excess constitutes the gain realized. The amount realized should then be reduced by the fixing-up expenses (if any), to determined the adjusted sales price. A comparison of the adjusted sales price of the old residence

with the cost of purchasing the new residence will indicate how much (if any) of the realized gain is to be recognized. If the cost of purchasing the new residence is the same as, or greater than, the adjusted sales price of the old residence, then none of the realized gain is to be recognized. On the other hand, if the cost of purchasing the new residence is smaller than the adjusted sales price of the old residence, the gain realized, all of the gain realized is to be recognized to the extent of the difference. It should be noted that any amount of gain realized but not recognized is to be applied as a downward adjustment to the basis of the new residence (for details see paragraph (e) of this section).) The application of the general rule stated above may be illustrated by the following examples:

Example 1. A taxpayer decides to sell his residence, which has a basis of $17,500. To make it more attractive to buyers, he paints the outside at a cost of $300 in April, 1954. He pays for the painting when the work is finished. In May, 1954, he sells the house for $20,000. Brokers' commissions and other selling expenses are $1,000. In October, 1954, the taxpayer buys a new residence for $18,000. The amount realized, the gain realized, the adjusted sales price, and the gain to be recognized are computed as follows:

Selling price	$20,000
Less: Commissions and other selling expenses	1,000
Amount realized	19,000
Less: Basis	17,500
Gain realized	1,500
Amount realized	19,000
Less: Fixing-up expenses	300
Adjusted sales price	18,700
Cost of purchasing new residence	18,000
Gain recognized	700
Gain realized but not recognized	800
Adjusted basis of new residence (see paragraph (e) of this section)	17,200

Example 2. The facts are the same as in example (1), except that the selling price of the old residence is $18,500. The computations are as follows:

Selling price	$18,500
Less: Commissions and other selling expenses	1,000
Amount realized	17,500
Less: Basis	17,500
Gain realized	0

NOTE: Since no gain is realized, section 1034 is inapplicable; it is, therefore, unnecessary to compute the adjusted sales price of the old residence and compare it with the cost of purchasing the new residence. No adjustment to the basis of the new residence is to be made.

Example 3. The facts are the same as in example (1), except that the cost of purchasing the new residence is $17,000. The computations are as follows:

Selling price	$20,000
Less: Commissions and other selling expenses	1,000
Amount realized	19,000
Less: Basis	17,500
Gain realized	1,500
Amount realized	19,000
Less: Fixing-up expenses	300
Adjusted sales price	18,700
Cost of purchasing the new residence	17,000
Gain recognized	1,500

NOTE: Since the adjusted sales price of the old residence exceeds the cost of purchasing the new residence by $1,700, which is more than the gain realized, all of the gain realized is recognized. No adjustment to the basis of the new residence is to be made.

Gain realized but not recognized	$0

Example 4. The facts are the same as in example (1), except that the fixing-up expenses are $1,100. The computations are as follows:

Selling price	$20,000
Less: Commissions and other selling expenses	1,000
Amount realized	19,000
Less: Basis	17,500
Gain realized	1,500
Amount realized	19,000
Less: Fixing-up expenses	1,100
Adjusted sales price	17,900
Cost of purchasing the new residence	18,000
Gain recognized	0

NOTE: Since the cost of purchasing the new residence exceeds the adjusted sales price, none of the gain realized is recognized.

Gain realized but not recognized	$1,500
Adjusted basis of new residence (see paragraph (e) of this section)	16,500

(3) *Property used by the taxpayer as his principal residence.* (i) Whether or not property is used by the taxpayer as his residence, and whether or not property is used by the taxpayer as his principal residence (in the case of a taxpayer using more than one property as a residence), depends upon all the facts and circumstances in each case, including the good faith of the taxpayer. The mere fact that property is, or has been, rented is not determinative that such property is not used by the taxpayer as

his principal residence. For example, if the taxpayer purchases his new residence before he sells his old residence, the fact that he temporarily rents out the new residence during the period before he vacates the old residence may not, in the light of all the facts and circumstances in the case, prevent the new residence from being considered as property used by the taxpayer as his principal residence. Property used by the taxpayer as his principal residence may include a houseboat, a house trailer, or stock held by a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b) (1) and (2)), if the dwelling which the taxpayer is entitled to occupy as such stockholder is used by him as his principal residence (section 1034(f)). Property used by the taxpayer as his principal residence does not include personal property such as a piece of furniture, a radio, etc., which, in accordance with the applicable local law, is not a fixture.

(ii) Where part of a property is used by the taxpayer as his principal residence and part is used for other purposes, an allocation must be made to determine the application of this section. If the old residence is used only partially for residential purposes, only that part of the gain allocable to the residential portion is not to be recognized under this section and only an amount allocable to the selling price of such portion need be invested in the new residence in order to have the gain allocable to such portion not recognized under this section. If the new residence is used only partially for residential purposes only so much of its cost as is allocable to the residential portion may be counted as the cost of purchasing the new residence.

(4) *Cost of purchasing new residence.* (i) The taxpayer's cost of purchasing the new residence includes not only cash but also any indebtedness to which the property purchased is subject at the time of purchase whether or not assumed by the taxpayer (including purchase-money mortgages, etc.) and the face amount of any liabilities of the taxpayer which are part of the consideration for the purchase. Commissions and other purchasing expenses paid or incurred by the taxpayer on the purchase of the new residence are to be included in determining such cost. In the case of an acquisition of a residence upon an exchange which is considered as a *purchase* under this section, the fair market value of the new residence on the date of the exchange shall be considered as the taxpayer's cost of purchasing the new residence. Where any part of the new residence is acquired by the taxpayer other than by *purchase,* the value of such part is not to be included in determining the taxpayer's cost of the new residence (see paragraph (b)(9) of this section for definition of *purchase*). For example, if the taxpayer acquires a residence by gift or inheritance, and spends $20,000 in reconstructing such residence, only such $20,000 may be treated as his cost of purchasing the new residence.

(ii) The taxpayer's cost of purchasing the new residence includes only so much of such cost as is attributable to acquisition, construction, reconstruction, or improvements made within the period of three years or 42 months (two years or 30 months in the case of a sale of an old residence prior to January 1, 1975), as the case may be, in which the purchase and use of the new residence must be made in order to have gain on the sale of the old residence not recognized under this section. Thus, if the construction of the new residence is begun three years before the date of sale of the old residence and completed on the date of sale of the old residence, only that portion of the cost which is attributable to the last 18 months (last year in the case of a sale of an old residence prior to January 1, 1975) of such construction constitutes the taxpayer's cost of purchasing the new residence, for purposes of section 1034. Furthermore, the taxpayer's cost of purchasing the new residence includes only such amounts as are properly chargeable to capital account rather than to current expense. As to what constitutes capital expenditures, see section 263.

(iii) The provisions of this subparagraph may be illustrated by the following example:

Example: M began the construction of a new residence on January 15, 1974, and completed it on October 14, 1974. The cost of $45,000 was incurred ratably over the 9-month period of construction. On December 14, 1975, M sold his old residence and realized a gain. In determining the extent to which the realized gain is not to be recognized under section 1034, M's cost of constructing the new residence shall include only the $20,000 which was attributable to the June 15—October 14, 1974, period (4 months at $5,000). The $25,000 balance of the cost of constructing the new residence was not attributable to the period beginning 18 months before the date of the sale of the old residence and ending two years after such date and, under section 1034, is not properly a part of M's cost of constructing the new residence.

(d) *Limitations on application of section 1034.* (1) If a residence is purchased by the taxpayer prior to the date of the sale of the old residence, the purchased residence shall, in no event, be treated as a new residence if such purchased residence is sold or otherwise disposed of by him prior to the date of the sale of the old residence (section 1034(c)(3)). And, if the taxpayer, during the period within which the purchase and use of the new residence must be made in order to have any gain on the sale of the old residence not recognized under this section, purchases more than one property which is used by him as his principal residence during the 18 months (or two years in the case of the construction of the new residence) succeeding the date of the sale of the old residence, only the last of such properties shall be considered a new residence (section 1034(c)(4)). In the case of a sale of an old residence prior to January 1, 1975, the period of 18 months (or two years) referred to in the preceding sentence shall be one year (or 18 months). If within 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) before the date of the sale of the old residence, the taxpayer sold other property used by him as his principal residence at a gain, and any part of such gain was not recognized under this section or section 112(n) of the Internal Revenue Code of 1939, this section shall not apply with respect to the sale of the old residence (section 1034(d)).

(2) The following example will illustrate the rules of subparagraph (1) of this paragraph:

Example: A taxpayer sells his old residence on January 15, 1954, and purchases another residence on February 15, 1954. On March 15, 1954, he sells the residence which he bought on February 15, 1954, and purchases another residence on April 15, 1954. The gain on the sale of the old residence on January 15, 1954, will not be recognized except to the extent to which the taxpayer's adjusted sales price of the old residence exceeds the cost of purchasing the residence which he purchased on April 15, 1954. Gain on the sale of the residence which was bought on February 15, 1954, and sold on March 15, 1954, will be recognized.

(e) *Basis of new residence.* (1) Where the purchase of a new residence results, under this section, in the nonrecognition of any part of the gain realized upon the sale of an old residence, then, in determining the adjusted basis of the new residence as of any time following the sale of the old residence, the adjustments to basis shall include a reduction by an amount equal to the amount of the gain which was not recognized upon the sale of the old residence (section 1034(e); for special rule applicable in some cases to husband and wife, see paragraph (f) of this section). Such a reduction is not to be made for the purpose of determining the adjusted basis of the new residence as of any time preceding the sale of the old residence. For the purpose of this determination, the amount of the gain not recognized under this section upon the sale of the old residence includes only so much of the gain as is not recognized because of the taxpayer's cost, up to the date of the determination of the adjusted basis, of purchasing the new residence.

(2) The following example will illustrate the rule of subparagraph (1) of this paragraph:

Example: On January 1, 1954, the taxpayer buys a new residence for $10,000. On March 1, 1954, he sells for an adjusted sales price of $15,000 his old residence, which has an adjusted basis to him of $5,000 (no fixing-up expenses are involved, so that $15,000 is the *amount realized* as well as the *adjusted sales price*). Between April 1 and April 15 a wing is constructed on the new house at a cost of $5,000. Between May 1 and May 15 a garage is constructed at a cost of $2,000. The adjusted basis of the new residence is $10,000 during January and February, $5,000 during March, $5,000 following the completion of the construction in April, and $7,000 following the completion of the construction in May. Since the old residence was not sold until March 1, no adjustment to the basis of the new residence is made during January and

February. Computations for March, April, and May are as follows:

Amount realized on sale of old residence	$15,000
Less: Adjusted basis of old residence	5,000
Gain realized on sale of old residence	10,000
March 1, 1954	
Adjusted sales price of old residence	15,000
Less: Cost of purchasing new residence	10,000
Gain recognized	5,000
Gain realized but not recognized	5,000
Cost of purchasing new residence	10,000
Less: Gain realized but not recognized	5,000
Adjusted basis of new residence	5,000
April 15, 1954	
Gain realized on sale of old residence	10,000
Adjusted sales price of old residence	15,000
Less: Cost of purchasing new residence	15,000
Gain recognized	0
Gain realized but not recognized	10,000
Cost of purchasing new residence	15,000
Less: Gain realized but not recognized	10,000
Adjusted basis of new residence	5,000
May 15, 1954	
Gain realized on sale of old residence	10,000
Adjusted sales price of old residence	15,000
Less: Cost of purchasing new residence	17,000
Gain recognized	0
Gain realized but not recognized	10,000
Cost of purchasing new residence	17,000
Less: Gain realized but not recognized	10,000
Adjusted basis of new residence	7,000

(f) *Husband and wife.* (1) If the taxpayer and his spouse file the consent referred to in this paragraph, then the *taxpayer's adjusted sales price of the old residence* shall mean the taxpayer's, or the taxpayer's and his spouse's, adjusted sales price of the old residence, and the *taxpayer's cost of purchasing the new residence* shall mean the cost to the taxpayer, or to his spouse, or to both of them, of purchasing the new residence, whether such new residence is held by the taxpayer, or his spouse, or both (section 1034(g)). Such consent may be filed only if the old residence and the new residence are each used by the taxpayer and his same spouse as their principal residence. If the taxpayer and his spouse do not file such a consent, the recognition of gain upon sale of the old residence shall be determined under this section without regard to the foregoing.

(2) The consent referred to in subparagraph (1) of this paragraph is a consent by the taxpayer and his spouse to have the basis of the interest of either of them in the new residence reduced from what it would have been but for the filing of such consent by an amount by which the gain of either of them on the sale of his interest in the old residence is not recognized solely by reason of the filing of such consent. Such reduction in basis is applicable to the basis of the new residence, whether such basis is that of the husband, of the wife, or divided between them. If the basis is divided between the husband and wife, the reduction in basis shall be divided between them in the same proportion as the basis (determined without regard to such reduction) is divided. Such consent shall be filed with the district director with whom the taxpayer filed the return for the taxable year or years in which the gain from the sale of the old residence was realized.

(3) The following examples will illustrate the application of this rule:

Example 1. A taxpayer, in 1954, sells for an adjusted sales price of $10,000 the principal residence of himself and his wife, which he owns individually and which has an adjusted basis to him of $5,000 (no fixing-up expenses are involved, so that $10,000 is the *amount realized* as well as the *adjusted sales price*). Within a year after such sale he and his wife contribute $5,000 each from their separate funds for the purchase of their new principal residence which they hold as tenants in common, each owning an undivided one-half interest therein. If the taxpayer and his wife file the required consent, the gain of $5,000 upon the sale of the old residence will not be recognized to the taxpayer, and the adjusted basis of the taxpayer's interest in the new residence will be $2,500 and the adjusted basis of his wife's interest in such property will be $2,500.

Example 2. A taxpayer and his wife, in 1954, sell for an adjusted sales price of $10,000 their principal residence, which they own as joint tenants and which has an adjusted basis of $2,500 to each of them ($5,000 together) (no fixing-up expenses are involved, so that $10,000 is the *amount realized* as well as the *adjusted sales price*). Within a year after such sale, the wife spends $10,000 of her own funds in the purchase of a principal residence for herself and the taxpayer and takes title in her name only. If the taxpayer and his wife file the required consent, the adjusted basis to the wife of the new residence will be $5,000, and the gain of the taxpayer will be $2,500 upon the sale of the old residence will not be recognized. The wife, as a taxpayer herself, will have her gain of $2,500 on the sale of the old residence not recognized under the general rule.

(g) *Members of Armed Forces.* (1) Section 1034(h) provides a special rule for members of the Armed Forces with respect to the period after the sale of the old residence within which the acquisition of a new residence may result in a non-recognition of gain on such sale. The running of the period of 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after the sale of the old residence in the case of the purchase of a new residence, or the period of two years (18 months in the case of a sale of an old residence prior to January 12, 1975) after such sale in the case of the construction of a new residence, is suspended during any time that the taxpayer serves on extended active duty with the Armed Forces of the United States. (This paragraph applies to time served on extended active duty prior to July 1, 1973, only if such extended active duty occurred during an induction period as defined in section 112(c)(5) as in effect prior to July 1, 1973.) However, in no event may such suspension extend for more than four years after the date of the sale of the old residence the period within which the purchase or construction of a new residence may result in a nonrecognition of gain. For example, if the taxpayer is on extended active duty with the Army from January 1, 1975, to June 30, 1976, and if he sold his old residence on January 10, 1975, the latest date on which the taxpayer may use a new residence constructed by him and have any part of the gain on the sale of his old residence not recognized under this section is June 30, 1978 (the date two years following the taxpayer's termination of active duty). However, if this taxpayer were on extended active duty with the Army from January 1, 1975, to December 31, 1978, the latest date on which he might use a new residence constructed by him and have any part of the gain on the sale of his old residence not recognized under this section would be January 10, 1979 (the date four years following the date of the sale of the old residence).

(2) This suspension covers not only the Armed Forces service of the taxpayer but if the taxpayer and his same spouse used both the old and the new residences as their principal residence, then the extension applies in like manner to the time the taxpayer's spouse is on extended active duty with the Armed Forces of the United States.

(3) The time during which the running of the period is suspended is part of such period. Thus, construction costs during such time are includible in the cost of purchasing the new residence under paragraph (c)(4) of this section.

(4) The running of the period of 18 months (or two years) after the date of sale of the old residence referred to in section 1034(c)(4) and in paragraph (d) of this section is not suspended. The running of the 18-month period prior to the date of the sale of the old residence within which the new residence may be purchased in order to have gain on the sale of the old residence not recognized under this section is also not suspended. In the case of a sale of an old residence prior to January 1, 1975, the periods of 18 months (or two years) referred to in each of the two preceding sentences shall be one year (or 18 months).

(5) The term *extended active duty* means any period of active duty which is served pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. If the call or order is for a period of more than 90 days, it is immaterial that the time served pursuant to such call or order is less than 90 days, if the reason for such shorter period of service occurs after the beginning of such duty. As to what constitutes active service as a member of the Armed Forces of the United States, see paragraph (i) of §1.112–1. As to who are members of the Armed Forces of the United States, see section 7701(a)(15), and the regulations in part 301 of this chapter (Regulations on Procedure and Administration).

(h) *Special rules for involuntary conversions*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, section 1034 is inapplicable to involuntary conversions of personal residences occurring after December 31, 1953 (section 1034(i)(1)(B)). For purposes of section 1034, an involuntary conversion of a personal residence occurring after December 31, 1950, and before January 1, 1954, is treated as a sale of such residence (section 1034(i)(1)(A); see paragraph (b)(8) of this section). For purposes of this paragraph, an involuntary conversion is defined, as the destruction in whole or in part, theft, seizure, requisition, or condemnation of property, or the sale or exchange of property under threat or imminence thereof. See section 1033 and § 1.1033(a)–3 for treatment of residences involuntarily converted after December 31, 1953.

(2) *Election to treat condemnation of personal residence as sale.* (i) Section 1034(i)(2) provides a special rule which permits a taxpayer to elect to treat the seizure, requisition, or condemnation of his principal residence, or the sale or exchange of such residence under threat or imminence thereof, if occurring after December 31, 1957, as the sale of such residence for purposes of section 1034 (relating to sale or exchange of residence). A taxpayer may thus elect to have section 1034 apply, rather than section 1033 (relating to involuntary conversions), in determining the amount of gain realized on the disposition of his old residence that will not be recognized and the extent to which the basis of his new residence acquired in lieu thereof shall be reduced. Once made, the election shall be irrevocable.

(ii) If the taxpayer elects to be governed by the provisions of section 1034, section 1033 will have no application. Thus, a taxpayer who elects under section 1034(i)(2) to treat the seizure, requisition, or condemnation of his principal residence (but not the destruction), or the sale or exchange of such residence under threat or imminence thereof, as a sale for the purpose of section 1034 must satisfy the requirements of section 1034 and this section. For example, under section 1034 a taxpayer generally must replace his old residence with a new residence which he uses as his principal residence, within a period beginning 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) before the date of disposition of his old residence, and ending 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after such date. However, in the case of a new residence the construction of which was commenced by the taxpayer within such period, the replacement period shall not expire until 2 years (18 months in the case of a sale of an old residence prior to January 1, 1975) after the date of disposition of the old residence.

(iii) *Time and manner of making election.* The election under section 1034(i)(2) shall be made in a statement attached to the taxpayer's income tax return, when filed, for the taxable year during which the disposition of his old residence occurs. The statement shall indicate that the taxpayer elects under section 1034(i)(2) to treat the disposition of his old residence as a sale for purposes of section 1034, and shall also show—

(*a*) The basis of the old residence;

(*b*) The date of its disposition;

(*c*) The adjusted sales price of the old residence, if known; and

(*d*) The purchase price, date of purchase, and date of occupancy of the new residence if it has been acquired prior to the time of making the election.

(i) *Statute of limitations.* (1) Whenever a taxpayer sells property used as his principal residence at a gain, the statutory period prescribed in section 6501(a) for the assessment of a deficiency attributable to any part of such gain shall not expire prior to the expiration of three years from the date of receipt, by the district director with whom the return was filed for the taxable year or years in which the gain from the sale of the old residence was realized (section 1034(j)), of a written notice from the taxpayer of—

(i) The taxpayer's cost of purchasing the new residence which the taxpayer claims result in nonrecognition of any part of such gain.

(ii) The taxpayer's intention not to purchase a new residence within the period when such a purchase will result in nonrecognition of any part of such gain, or

(iii) The taxpayer's failure to make such a purchase within such period.

Any gain from the sale of the old residence which is required to be recognized shall be included in gross income for the taxable year or years in which such gain was realized. Any deficiency attributable to any portion of such gain may be assessed before the expiration of the 3-year period described in this paragraph, notwithstanding the provisions of any law or rule of law which might otherwise bar such assessment.

(2) The notification required by the preceding subparagraph shall contain all pertinent details in connection with the sale of the old residence and, where applicable, the purchase price of the new residence. The notification shall be in the form of a written statement and shall be accompanied, where appropriate, by an amended return for the year in which the gain from the sale of the old residence was realized, in order to reflect the inclusion in gross income for that year of gain required to be recognized in connection with such sale.

(j) *Effective date.* Pursuant to section 7851(a)(1)(C), paragraphs (a), (b), (c), (d), (f), (g), and (i) of this section apply in the case of any *sale* (as defined in paragraph (b)(8) of this section) made after December 31, 1953, although such sale may occur in a taxable year subject to the Internal Revenue Code of 1939. Similarly, the rule in paragraph (h) of this section that involuntary conversions of personal residences are not to be treated as sales for purposes of section 1034 but are governed by section 1033 applies to any such involuntary conversion made after December 31, 1953, although such involuntary conversion may occur in a taxable year subject to the Internal Revenue Code of 1939. The rule in paragraph (e) of this section requiring an adjustment to the basis of a new residence, the purchase of which results (under section 1034, or section 112(n) of the Internal Revenue Code of 1939) in the nonrecognition of gain on the sale of an old residence, applies in determining the adjusted basis of the new residence at any time following such sale, although such sale may occur in a taxable year subject to the Internal Revenue Code of 1939.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6916, 32 FR 5924, Apr. 13, 1967; 32 FR 6971, May 6, 1967; T.D. 7404, 41 FR 6758, Feb. 13, 1976; T.D. 7625, 44 FR 31013, May 30, 1979]

§1.1035–1 Certain exchanges of insurance policies.

Under the provisions of section 1035 no gain or loss is recognized on the exchange of:

(a) A contract of life insurance for another contract of life insurance or for an endowment or annuity contract (section 1035(a)(1));

(b) A contract of endowment insurance for another contract of endowment insurance providing for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or an annuity contract (section 1035(a)(2)); or

(c) An annuity contract for another annuity contract (section 1035(a)(3)), but section 1035 does not apply to such exchanges if the policies exchanged to not relate to the same insured. The exchange, without recognition of gain or loss, of an annuity contract for another annuity contract under section 1035(a)(3) is limited to cases where the same person or persons are the obligee or obligees under the contract received in exchange as under the original contract. This section and section 1035 do not apply to transactions involving the exchange of an endowment contract or annuity contract for a life insurance contract, nor an annuity contract for an endowment contract. In the case of such exchanges, any gain or loss shall be recognized. In the case of exchanges which would be governed by section 1035 except for the fact that the property received in exchange consists not only of property which could otherwise be received without the recognition of gain or loss, but also of other property or money, see section 1031 (b) and (c) and the regulations thereunder. Such an exchange does not come within the provisions of section 1035. Determination of the basis of property acquired in an exchange under section 1035(a) shall be governed by section 1031(d) and the regulations thereunder.

§1.1036–1 Stock for stock of the same corporation.

(a) Section 1036 permits the exchange, without the recognition of gain or loss, of common stock for common stock, or of preferred stock for preferred stock, in the same corporation.

Section 1036 applies even though voting stock is exchanged for nonvoting stock or nonvoting stock is exchanged for voting stock. It is not limited to an exchange between two individual stockholders; it includes a transaction between a stockholder and the corporation. However, a transaction between a stockholder and the corporation may qualify not only under section 1036(a), but also under section 368(a)(1)(E) (recapitalization) or section 305(a) (distribution of stock and stock rights). The provisions of section 1036(a) do not apply if stock is exchanged for bonds, or preferred stock is exchanged for common stock, or common stock is exchanged for preferred stock, or common stock in one corporation is exchanged for common stock in another corporation. See paragraph (l) of section 1301–1 for certain transactions treated as distributions under section 301. See paragraph (e)(5) of § 1.368–2 for certain transactions which result in deemed distributions under section 305(c) to which sections 305(b)(4) and 301 apply.

(b) For rules relating to recognition of gain or loss where an exchange is not wholly in kind, see subsections (b) and (c) of section 1031. For rules relating to the basis of property acquired in an exchange described in paragraph (a) of this section, see subsection (d) of section 1031.

(c) A transfer is not within the provisions of section 1036(a) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer (or if the property transferred is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of section 1031(b).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7281, 38 FR 18540, July 12, 1973]

§ 1.1037–1 Certain exchanges of United States obligations.

(a) *Nonrecognition of gain or loss*—(1) *In general.* Section 1037(a) provides for the nonrecognition of gain or loss on the surrender to the United States of obligations of the United States issued under the Second Liberty Bond Act (31 U.S.C. 774(2)) when such obligations are exchanged solely for other obligations issued under that Act and the Secretary provides by regulations promulgated in connection with the issue of such other obligations that gain or loss is not to be recognized on such exchange. It is not necessary that at the time of the exchange the obligation which is surrendered to the United States be a capital asset in the hands of the taxpayer. For purposes of section 1037(a) and this subparagraph, a circular of the Treasury Department which offers to exchange obligations of the United States issued under the Second Liberty Bond Act for other obligations issued under that Act shall constitute regulations promulgated by the Secretary in connection with the issue of the obligations offered to be exchanged if such circular contains a declaration by the Secretary that no gain or loss shall be recognized for Federal income tax purposes on the exchange or grants the privilege of continuing to defer the reporting of the income of the bonds exchanged until such time as the bonds received in the exchange are redeemed or disposed of, or have reached final maturity, whichever is earlier. See, for example, regulations of the Bureau of the Public Debt, 31 CFR part 339, or Treasury Department Circular 1066, 26 FR 8647. The application of section 1037(a) and this subparagraph will not be precluded merely because the taxpayer is required to pay money on the exchange. See section 1031 and the regulations thereunder if the taxpayer receives money on the exchange.

(2) *Recognition of gain or loss postponed.* Gain or loss which has been realized but not recognized on the exchange of a U.S. obligation for another such obligation because of the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as related to section 1037(a)) shall be recognized at such time as the obligation received in the exchange is disposed of, or redeemed, in a transaction other than an exchange described in section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) or reaches final maturity, whichever is earlier, to the extent gain or loss is realized on such later transaction.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the

cash receipts and disbursements method of accounting and has never elected under section 454(a) to include in gross income currently the annual increase in the redemption price of non-interest-bearing obligations issued at a discount. In addition, it is assumed that the old obligations exchanged are capital assets transferred in an exchange in respect of which regulations are promulgated pursuant to section 1037(a):

Example 1. A, the owner of a $1,000 series E U.S. savings bond purchased for $750 and bearing an issue date of May 1, 1945, surrenders the bond to the United States in exchange solely for series H U.S. savings bonds on February 1, 1964, when the series E bond has a redemption value of $1,304.80. In the exchange A pays an additional $195.20 and obtains three $500 series H bonds. None of the $554.80 gain ($1,304.80 less $750) realized by A on the series E bond is recognized at the time of the exchange.

Example 2. In 1963, B purchased for $97 a marketable U.S. bond which was originally issued at its par value of $100. In 1964 he surrenders the bond to the United States in exchange solely for another marketable U.S. bond which then has a fair market value of $95. B's loss of $2 on the old bond is not recognized at the time of the exchange, and his basis for the new bond is $97 under section 1031(d). If it has been necessary for B to pay $1 additional consideration in the exchange, his basis in the new bond would be $98.

Example 3. The facts are the same as in example (2) except that B also receives $1 interest on the old bond for the period which has elapsed since the last interest payment date and that B does not pay any additional consideration on the exchange. As in example (2), B has a loss of $2 which is not recognized at the time of the exchange and his basis in the new bond is $97. In addition, the $1 of interest received on the old bond is includible in gross income. B holds the new bond 1 year and sells it in the market for $99 plus interest. At this time he has a gain of $2, the difference between his basis of $97 in the new bond and the sales price of such bond. In addition, the interest received on the new bond is includible in gross income.

Example 4. The facts are the same as in example (2), except that in addition to the new bond B also receives $1.85 in cash, $0.85 of which is interest. The $0.85 interest received is includible in gross income. B's loss of $1 ($97 less $96) on the old bond is not recognized at the time of the exchange by reason of section 1031(c). Under section 1031(d) B's basis in the new bond is $96 (his basis of $97 in the old bond, reduced by the $1 cash received in the exchange).

Example 5. (a) For $975 D subscribes to a marketable U.S. obligation which has a face value of $1,000. Thereafter, he surrenders this obligation to the United States in exchange solely for a 10-year marketable $1,000 obligation which at the time of exchange has a fair market value of $930, at which price such obligation is initially offered to the public. At the time of issue of the new obligation there was no intention to call it before maturity. Five years after the exchange D sells the new obligation for $960.

(b) On the exchange of the old obligation for the new obligation D sustains a loss of $45 ($975 less $930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new obligation in D's hands, determined under section 1031(d), is $975 (the same basis as that of the old obligation).

(d) On the sale of the new obligation D sustains a loss of $15 ($975 less $960), all of which is recognized by reason of section 1002.

Example 6. (a) The facts are the same as in example (5), except that five years after the exchange D sells the new obligation for $1,020.

(b) On the exchange of the old obligation for the new obligation D sustains a loss of $45 ($975 less $930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new obligation in D's hands, determined under section 1031(d), is $975 (the same basis as that of the old obligation). The issue price of the new obligation under section 1232(b)(2) is $930.

(d) On the sale of the new obligation D realizes a gain of $45 ($1,020 less $975), all of which is recognized by reason of section 1002. Of this gain of $45, the amount of $35 is treated as ordinary income and $10 is treated as long-term capital gain, determined as follows:

(1) Ordinary income under first sentence of section 1232(a)(2)(B) on sale of new obligation:	
Stated redemption price of new obligation at maturity	$1,000
Less: Issue price of new obligation under section 1232(b)(2)	930
Original issue discount on new obligation	70
Proration under section 1232(a)(2)(B)(ii): ($70×60 months/120 months)	35
(2) Long-term capital gain ($45 less $35)	10

Example 7. (a) The facts are the same as in example (5), except that D retains the new obligation and redeems it at maturity for $1,000.

(b) On the exchange of the old obligation for the new obligation D sustains a loss of $45 ($975 less $930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new obligation in D's hands, determined under section 1031(d), is $975 (the same basis as that of the old obligation). The issue price of the new obligation is $930 under section 1232(b)(2).

(d) On the redemption of the new obligation D realizes a gain of $25 ($1,000 less $975), all of which is recognized by reason of section 1002. Of this gain of $25, the entire amount is treated as ordinary income, determined as follows:

Ordinary income under first sentence of section 1232(a)(2)(B) on redemption of new obligation:	
Stated redemption price of new obligation at maturity	$1,000
Less: Issue price of new obligation under section 1232(b)(2)	930
Original issue discount on new obligation	70
Proration under section 1232(a)(2)(B)(ii): ($70×120 months/120 months), but such amount not to exceed the $25 gain recognized on redemption	25

(b) *Application of section 1232 upon disposition or redemption of new obligation*—(1) *Exchanges involving nonrecognition of gain on obligations issued at a discount.* If an obligation, the gain on which is subject to the first sentence of section 1232(a)(2)(B), because the obligation was originally issued at a discount, is surrendered to the United States in exchange for another obligation and any part of the gain realized on the exchange is not then recognized because of the provisions of section 1037(a) (or because of so much of section 1031(b) as relates to section 1037(a)), the first sentence of section 1232(a)(2)(B) shall apply to so much of such unrecognized gain as is later recognized upon the disposition or redemption of the obligation which is received in the exchange as though the obligation so disposed of or redeemed were the obligation surrendered, rather than the obligation received, in such exchange. See the first sentence of section 1037(b)(1). Thus, in effect that portion of the gain which is unrecognized on the exchange but is recognized upon the later disposition or redemption of the obligation received from the United States in the exchange shall be considered as ordinary income in an amount which is equal to the gain which, by applying the first sentence of section 1232(a)(2)(B) upon the earlier surrender of the old obligation to the United States, would have been considered as ordinary income if the gain had been recognized upon such earlier exchange. Any portion of the gain which is recognized under section 1031(b) upon the earlier exchange and is treated at such time as ordinary income shall be deducted from the gain which is treated as ordinary income by applying the first sentence of section 1232(a)(2)(B) pursuant to this subparagraph upon the disposition or redemption of the obligation which is received in the earlier exchange. This subparagraph shall apply only in a case where on the exchange of United States obligations there was some gain not recognized by reason of section 1037(a) (or so much of section 1031(b) as relates to section 1037(a)); it shall not apply where, only loss was unrecognized by reason of section 1037(a).

(2) *Rules to apply when a nontransferable obligation is surrendered in the exchange.* For purposes of applying both section 1232(a)(2)(B) and subparagraph (1) of this paragraph to the total gain realized on the obligation which is later disposed of or redeemed, if the obligation surrendered to the United States in the earlier exchange is a nontransferable obligation described in section 454 (a) or (c)—

(i) The aggregate amount considered, with respect to the obligation so surrendered in the earlier exchange, as ordinary income shall not exceed the difference between the issue price of the surrendered obligation and the stated redemption price of the surrendered obligation which applied at the time of the earlier exchange, and

(ii) The issue price of the obligation which is received from the United States in the earlier exchange shall be considered to be the stated redemption price of the surrendered obligation which applied at the time of the earlier exchange, increased by the amount of other consideration (if any) paid to the United States as part of the earlier exchange.

If the obligation received in the earlier exchange is a nontransferable obligation described in section 454(c) and such obligation is partially redeemed before final maturity or partially disposed of by being partially reissued to another owner, the amount determined by applying subdivision (i) of this subparagraph shall be determined on a basis proportional to the total denomination of obligations redeemed or disposed of. See paragraph (c) of § 1.454–1.

(3) *Long-term capital gain.* If, in a case where both subparagraphs (1) and (2) of this paragraph are applied, the total

gain realized on the redemption or disposition of the obligation which is received from the United States in the exchange to which section 1037(a) (or so much of section 1031(b) as related to section 1037(a)) applies exceeds the amount of gain which, by applying such subparagraphs, is treated as ordinary income, the gain in excess of such amount shall be treated as long-term capital gain.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and has never elected under section 454(a) to include in gross income currently the annual increase in the redemption price of non-interest-bearing obligations issued at a discount. In addition, it is assumed that the old obligations exchanged are capital assets transferred in an exchange in respect of which regulations are promulgated pursuant to section 1037(a):

Example 1. (a) A purchased a noninterest-bearing nontransferable U.S. bond for $74 which was issued after December 31, 1954, and redeemable in 10 years for $100. Several years later, when the stated redemption value of such bond is $94.50, A surrenders it to the United States in exchange for $1 in cash and a 10-year marketable bond having a face value of $100. On the date of exchange the bond received in the exchange has a fair market value of $96. Less than one month after the exchange, A sells the new bond for $96.

(b) On the exchange of the old bond for the new bond A realizes a gain of $23, determined as follows:

Amount realized (a new bond worth $96 plus $1 cash)	$97
Less: Adjusted basis of old bond	74
Gain realized	23

Pursuant to so much of section 1031(b) as applies to section 1037(a), the amount of such gain which is recognized is $1 (the money received). Such recognized gain of $1 is treated as ordinary income. On the exchange of the old bond a gain of $22 ($23 less $1) is not recognized.

(c) The basis of the new bond in A's hands, determined under section 1031(d) is $74 (the basis of the old bond, decreased by the $1 received in cash and increased by the $1 gain recognized on the exchange).

(d) On the sale of the new bond A realizes a gain of $22 ($96 less $74), all of which is recognized by reason of section 1002. Of this gain of $22, the amount of $19.50 is treated as ordinary income and $2.50 is treated as long-term capital gain, determined as follows:

(1) Ordinary income, treating sale of new bond as though a sale of old bond and applying section 1037(b)(1)(A):		
Stated redemption price of old bond		$94.50
Less: Issue price of old bond		74.00
Aggregate gain under section 1037(b)(1)(A) (not to exceed $22 not recognized at time of exchange)		20.50
Less: Amount of such gain recognized at time of exchange		1.00
Ordinary income		19.50
(2) Ordinary income under first sentence of section 1232(a)(2)(B), applying section 1037(b)(1)(B) to sale of new bond:		
Stated redemption price of new bond at maturity	$100.00	
Less: Issue price of new bond under section 1037(b)(1)(B) ($94.50 plus $0 additional consideration paid on exchange)	94.50	
Original issue discount on new bond	5.50	
Proration under section 1232(a)(2)(B)(ii): ($5.50×0 months/120 months)		0
(3) Total ordinary income (sum of subparagraphs (1) and (2))		19.50
(4) Long-term capital gain ($22 less $19.50)		2.50

Example 2. (a) The facts are the same as in example (1), except that, less than one month after the exchange of the old bond, the new bond is sold for $92.

(b) On the sale of the new bond A realizes a gain of $18 ($92 less $74), all of which is recognized by reason of section 1002. Of this gain, the entire amount of $18 is treated as ordinary income. This amount is determined as provided in paragraph (d)(1) of example (1) except that the ordinary income of $19.50 is limited to the $18 recognized on the sale of the new bond.

Example 3. (a) The facts are the same as in example (1), except that 2 years after the exchange of the old bond A sells the new bond for $98.

(b) On the sale of the new bond A realizes a gain of $24 ($98 less $74), all of which is recognized by reason of section 1002. Of this gain of $24, the amount of $20.60 is treated as ordinary income and $3.40 is treated as long-term capital gain, determined as follows:

(1) Ordinary income applicable to old bond (determined as provided in paragraph (d)(1) of example (1))	$19.50
(2) Ordinary income applicable to new bond (determined as provided in paragraph (d)(2) of example (1), except that the proration of the original issue discount under section 1232(a)(2)(B)(ii) amounts to $1.10 ($5.50×24 months/120 months)	1.10

(3) Total ordinary income (sum of subparagraphs (1) and (2))	20.60
(4) Long-term capital gain ($24 less $20.60)	3.40

Example 4. (a) The facts are the same as in example (1), except that A retains the new bond and redeems it at maturity for $100.

(b) On the redemption of the new bond A realizes a gain of $26 ($100 less $74), all of which is recognized by reason of section 1002. Of this gain of $26, the amount of $25 is treated as ordinary income and $1 is treated as long-term capital gain, determined as follows:

(1) Ordinary income applicable to old bond (determined as provided in paragraph (d)(1) of example (1))	$19.50
(2) Ordinary income applicable to new bond (determined as provided in paragraph (d)(2) of example (1), except that the proration of the original issue discount under section 1232(a)(2)(B)(ii) amounts to $5.50 ($5.50×120 months/120 months))	5.50
(3) Total ordinary income (sum of subparagraphs (1) and (2))	25.00
(4) Long-term capital gain ($26 less $25)	1.00

Example 5. (a) In 1958 B purchased for $7,500 a series E United States savings bond having a face value of $10,000. In 1965 when the stated redemption value of the series E bond is $9,760, B surrenders it to the United States in exchange solely for a $10,000 series H U.S. savings bond, after paying $240 additional consideration. B retains the series H bond and redeems it at maturity in 1975 for $10,000, after receiving all the semiannual interest payments thereon.

(b) On the exchange of the series E bond for the series H bond, B realizes a gain of $2,260 ($9,760 less $7,500), none of which is recognized at such time by reason of section 1037(a).

(c) The basis of the series H bond in B's hands, determined under section 1031(d), is $7,740 (the $7,500 basis of the series E bond, plus $240 additional consideration paid for the series H bond).

(d) On the redemption of the series H bond, B realizes a gain of $2,260 ($10,000 less $7,740), all of which is recognized by reason of section 1002. This entire gain is treated as ordinary income by treating the redemption of the series H bond as though it were a redemption of the series E bond and by applying section 1037(b)(1)(A).

(e) Under section 1037(b)(1)(B) the issue price of the series H bonds is $10,000 ($9,760 stated redemption price of the series E bond at time of exchange, plus $240 additional consideration paid). Thus, with respect to the series H bond, there is no original issue discount to which section 1232(a)(2)(B) might apply.

Example 6. (a) The facts are the same as in example (5), except that in 1970 B submits the $10,000 series H bond to the United States for partial redemption in the amount of $3,000 and for reissuance of the remainder in $1,000 series H savings bonds registered in his name. On this transaction B receives $3,000 cash and seven $1,000 series H bonds, bearing the original issue date of the $10,000 bond which is partially redeemed. The $1,000, series H bonds are redeemed at maturity in 1975 for $7,000.

(b) On the partial redemption of the $10,000 series H bond in 1970 B realizes a gain of $678 ($3,000 less $2,322 [$7,740×$3,000/$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of § 1.454–1. This entire gain is treated as ordinary income, by treating the partial redemption of the series H bond as though it were a redemption of the relevant denominational portion of the series E bond and by applying section 1037(b)(1)(A).

(c) On the redemption at maturity in 1975 of the seven $1,000 series H bonds B realizes a gain of $1,582 ($7,000 less $5,418 [$7,740×$7,000/$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of § 1.454–1. This entire gain is treated as ordinary income, determined in the manner described in paragraph (b) of this example.

Example 7. (a) The facts are the same as in example (5), except that in 1970 B requests the United States to reissue the $10,000 series H bond by issuing two $5,000 series H bonds bearing the original issue date of such $10,000 bond. One of such $5,000 bonds is registered in B's name, and the other is registered in the name of C, who is B's son. Each $5,000 series H bond is redeemed at maturity in 1975 for $5,000.

(b) On the issuing in 1970 of the $5,000 series H bond to C, B realizes a gain of $1,130 ($5,000 less $3,870 [$7,740×$5,000/$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of § 1.454–1. This entire gain is treated as ordinary income by treating the transaction as though it were a redemption of the relevant denominational portion of the series E bond and by applying section 1037(b)(1)(A).

(c) On the redemption at maturity in 1975 of the $5,000 series H bond registered in his name B realizes a gain of $1,130 ($5,000 less $3,870 [$7,740×$5,000/$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of § 1.454–1. This entire gain is treated as ordinary income, determined in the manner described in paragraph (b) of this example.

(d) On the redemption at maturity in 1975 of the $5,000 series H bond registered in his name C does not realize any gain, since the amount realized on redemption does not exceed his basis in the property, determined as provided in section 1015.

(5) *Exchanges involving nonrecognition of gain or loss on transferable obligations issued at not less than par*—(i) *In general.* If a transferable obligation of the United States which was originally

issued at not less than par is surrendered to the United States for another transferable obligation in an exchange to which the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) apply, the issue price of the obligation received from the United States in the exchange shall be considered for purposes of applying section 1232 to gain realized on the disposition or redemption of the obligation so received, to be the same as the issue price of the obligation which is surrendered to the United States in the exchange, increased by the amount of other consideration, if any, paid to the United States as part of the exchange. This subparagraph shall apply irrespective of whether there is gain or loss unrecognized on the exchange and irrespective of the fair market value, at the time of the exchange, of either the obligation surrendered to, or the obligation received from, the United States in the exchange.

(ii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and that the old obligations exchanged are capital assets transferred in an exchange in respect of which regulations are promulgated pursuant to section 1037(a):

Example 1. (a) A purchases in the market for $85 a marketable U.S. bond which was originally issued at its par value of $100. Three months later, A surrenders this bond to the United States in exchange solely for another $100 marketable U.S. bond which then has a fair market value of $88. He holds the new bond for 5 months and then sells it on the market for $92.

(b) On the exchange of the old bond for the new bond A realizes a gain of $3 ($88 less $85), none of which is recognized by reason of section 1037(a).

(c) The basis of the new bond in A's hands, determined under section 1031(d), is $85 (the same as that of the old bond). The issue price of the new bond for purposes of section 1232(a)(2)(B) is considered under section 1037(b)(2) to be $100 (the same issue price as that of the old bond).

(d) On the sale of the new bond A realizes a gain of $7 ($92 less $85), all of which is recognized by reason of section 1002. Of this gain of $7, the entire amount is treated as long-term capital gain, determined as follows:

(1) Ordinary income under first sentence of section 1232(a)(2)(B), applicable to old bond:		
Stated redemption price of old bond at maturity	$100	
Less: Issue price of old bond	100	
Original issue discount on old bond		0
(2) Ordinary income under first sentence of section 1232(a)(2)(B), applying section 1037(b)(2) to sale of new bond:		
Stated redemption price of new bond at maturity	100	
Less: Issue price of new bond under section 1037(b)(2)	100	
Original issue discount on new bond		0
(3) Long-term capital gain ($7 less sum of subparagraphs (1) and (2))		$7

Example 2. The facts are the same as in example (1), except that A retains the new bond and redeems it at maturity for $100. On the redemption of the new bond, A realizes a gain of $15 ($100 less $85), all of which is recognized under section 1002. This entire gain is treated as long-term capital gain, determined in the same manner as provided in paragraph (d) of example (1).

Example 3. (a) For $1,000 B subscribes to a marketable U.S. bond which has a face value of $1,000. Thereafter, he surrenders this bond to the United States in exchange solely for a 10-year marketable $1,000 bond which at the time of exchange has a fair market value of $930, at which price such bond is initially offered to the public. Five years after the exchange, B sells the new bond for $950.

(b) On the exchange of the old bond for the new bond, B sustains a loss of $70 ($1,000 less $930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new bond in A's hands, determined under section 1031(d), is $1,000 (the same basis as that of the old bond).

(d) On the sale of the new bond B sustains a loss of $50 ($1,000 less $950), all of which is recognized by reason of section 1002.

Example 4. (a) The facts are the same as in example (3), except that 5 years after the exchange B sells the new bond for $1,020.

(b) On the exchange of the old bond for the new bond B sustains a loss of $70 ($1,000 less $930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new bond in B's hands, determined under section 1031(d), is $1,000 (the same basis as that of the old bond). The issue price of the new bond for purposes of section 1232(a)(2)(B) is considered under section 1037(b)(2) to be $1,000 (the same issue price as that of the old bond).

(d) On the sale of the new bond B realizes a gain of $20 ($1,020 less $1,000), all of which is recognized by reason of section 1002. This entire gain is treated as long-term capital gain, determined in the same manner as provided in paragraph (d) of example (1).

(6) *Other rules for applying section 1232.* To the extent not specifically affected by the provisions of section 1037(b) and subparagraphs (1) through (5) of this paragraph, any gain realized on the disposition or redemption of any obligation received from the United States in an exchange to which section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) applies shall be treated in the manner provided by section 1232 if the facts and circumstances relating to the acquisition and disposition or redemption of such obligation require the application of section 1232.

(c) *Holding period of obligation received in the exchange.* The holding period of an obligation received from the United States in an exchange to which the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) apply shall include the period for which the obligation which was surrendered to the United States in the exchange was held by the taxpayer, but only if the obligation so surrendered was at the time of the exchange a capital asset in the hands of the taxpayer. See section 1223 and the regulations thereunder.

(d) *Basis.* The basis of an obligation received from the United States in an exchange to which the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) apply shall be determined as provided in section 1031(d) and the regulations thereunder.

(e) *Effective date.* Section 1.1037 and this section shall apply only for taxable years ending after September 22, 1959.

[T.D. 6935, 32 FR 15824, Nov. 17, 1967, as amended by T.D. 7154, 36 FR 24998, Dec. 28, 1971]

§ 1.1038–1 Reacquisitions of real property in satisfaction of indebtedness.

(a) *Scope of section 1038*—(1) *General rule on gain or loss.* If a sale of real property gives rise to indebtedness to the seller which is secured by the real property which is sold, and the seller of such property reacquires such property in a taxable year beginning after September 2, 1964, in partial or full satisfaction of such indebtedness, then, except as provided in paragraphs (b) and (f) of this section, no gain or loss shall result to the seller from such reacquisition. The treatment so provided is mandatory; however, see § 1.1038–3 for an election to apply the provisions of this section to certain taxable years beginning after December 31, 1957. It is immaterial, for purposes of applying this subparagraph, whether the seller realized a gain or sustained a loss on the sale of the real property, or whether it can be ascertained at the time of the sale whether gain or loss occurs as a result of the sale. It is also immaterial what method of accounting the seller used in reporting gain or loss from the sale of the real property or whether at the time of reacquisition such property has depreciated or appreciated in value since the time of the original sale. Moreover, the character of the gain realized on the original sale of the property is immaterial for purposes of applying this subparagraph. The provisions of this section shall apply, except as provided in § 1.1038–2, to the reacquisition of real property which was used by the seller as his principal residence and with respect to the sale of which an election under section 121 is in effect or with respect to the sale of which gain was not recognized under section 1034.

(2) *Sales giving rise to indebtedness*—(i) *Sale defined.* For purposes of this section, it is not necessary for title to the property to have passed to the purchaser in order to have a sale. Ordinarily, a sale of property has occurred in a transaction in which title to the property has not passed to the purchaser, if the purchaser has a contractual right to retain possession of the property so long as he performs his obligations under the contract and to obtain title to the property upon the completion of the contract. However, a sale may have occurred even if the purchaser does not have the right to possession until he partially or fully satisfies the terms of the contract. For example, if S contracts to sell real property to P, and if S promises to convey title to P upon the completion of all of the payments due under the contract and to allow P to obtain possession of the property after 10 percent of the purchase price has been paid, there has been a sale on the date of the contract

for purposes of this section. This section shall not apply to a disposition of real property which constituted an exchange of property or was treated as a sale under section 121(d)(4) or section 1034(i); nor shall it apply to a sale of stock in a cooperative housing corporation described in section 121(d)(3) or section 1034(f).

(ii) *Secured indebtedness defined.* An indebtedness to the seller is secured by the real property for purposes of this section whenever the seller has the right to take title or possession of the property or both if there is a default with respect to such indebtedness. A sale of real property may give rise to an indebtedness to the seller although the seller is limited in his recourse to the property for payment of the indebtedness in the case of a default.

(3) *Reacquisitions in partial or full satisfaction of indebtedness*—(i) *Purpose of reacquisition.* This section applies only where the seller reacquires the real property in partial or full satisfaction of the indebtedness to him that arose from the sale of the real property and was secured by the property. That is, the reacquisition must be in furtherance of the seller's security rights in the property with respect to indebtedness to him that arose at the time of the sale. Accordingly, if the seller in reacquiring the real property does not pay consideration in addition to discharging the purchaser's indebtedness to him that arose from the sale and was secured by such property, this section shall apply to the reacquisition even though the purchaser has not defaulted in his obligations under the contract or such a default is not imminent. If in addition to discharging the purchaser's indebtedness to him that arose from the sale the seller pays consideration in reacquiring the real property, this section shall generally apply to the reacquisition if the reacquisition and the payment of additional consideration is provided for in the original contract for the sale of the property. This section generally shall apply to a reacquisition of real property if the seller reacquires the property either when the purchaser has defaulted in his obligations under the contract or when such a default is imminent. This section generally shall not apply to a reacquisition of real property where the seller pays consideration in addition to discharging the purchaser's indebtedness to him that arose from the sale if the reacquisition and payment of additional consideration was not provided for in the original contract for the sale of the property and if the purchaser has not defaulted in his obligations under the contract or such a default is not imminent. Thus, for example, if the purchaser is in arrears on the payment of interest or principal or has in any other way defaulted on his contract for the purchase of the property, or if the facts of the case indicate that the purchaser is unable satisfactorily to perform his obligations under the contract, and the seller reacquires the property from the purchaser in a transaction in which the seller pays consideration in addition to discharging the purchaser's indebtedness to him that arose from the sale and was secured by the property, this section shall apply to the reacquisition. Additional consideration paid by the seller includes money and other property paid or transferred by the seller. Also, the reacquisition by the seller of real property subject to an indebtedness (or the assumption, upon the reacquisition, of indebtedness) which arose subsequent to the original sale shall be considered as a payment by the seller of additional consideration. However, the reacquisition by the seller of real property subject to an indebtedness (or the assumption, upon the reacquisition, of an indebtedness) which arose prior to or arose out of the original sale shall not be considered as a payment by the seller of additional consideration.

(ii) *Manner of reacquisition.* For purposes of applying section 1038 and this section there must be a reacquisition by the seller of the real property itself, but the manner in which the seller so reduces the property to ownership or possession, as the case may be, shall generally be immaterial. Thus, the seller may reduce the real property to ownership or possession or both, as the case may require, by agreement or by process of law. The reduction of the real property to ownership or possession by agreement includes, where valid under local law, such methods as voluntary conveyance from the purchaser and abandonment to the seller. The reduction of the real property to ownership or possession by process of law includes foreclosure proceedings in which a competitive bid is entered, such as foreclosure by judicial sale or by power of sale contained in the loan agreement without recourse to the courts, as well as those types of foreclosure proceedings in which a competitive bid is not entered, such as strict foreclosure and foreclosure by entry and possession, by writ of entry, or by publication or notice.

(4) *Persons from whom real property may be reacquired.* The real property reacquired in satisfaction of the indebtedness need not be reacquired from the purchaser but may be reacquired from the purchaser's transferee or assignee, or from a trustee holding title to such property pending the purchaser's satisfaction of the terms of the contract, so long as the indebtedness that is partially or completely satisfied in the reacquisition of such property arose in the original sale of the property and was secured by the property so reacquired. In such a case, a reference in this section to the purchaser shall, where appropriate, include the purchaser's transferee or assignee. Thus, for example, this section will apply if the seller reacquires the property from a purchaser from the original purchaser and either the property is subject to, or the subsequent purchaser assumes, the liability to the seller on the indebtedness.

(5) *Reacquisitions not included.* This section shall not apply to reacquisitions of real property by mutual savings banks, domestic building and loan associations, and cooperative banks, described in section 593(a). However, for rules respecting the reacquisition of real property by such organizations, see § 1.595–1.

(b) *Amount of gain resulting from a reacquisition*—(1) *Determination of amount*—(i) *In general.* As a result of a reacquisition to which paragraph (a) of this section applies gain shall be derived by the seller to the extent that the amount of money and the fair market value of other property (other than obligations of the purchaser arising with respect to the sale) which are received by the seller, prior to such reacquisition, with respect to the sale of the property exceed the amount of the gain derived by the seller on the sale of such property which is returned as income for periods prior to the reacquisition. However, the amount of gain so determined shall in no case exceed the amount determined under paragraph (c) of this section with respect to such reacquisition.

(ii) *Amount of gain returned as income for prior periods.* For purposes of this subparagraph and paragraph (c)(1) of this section, the amount of gain on the sale of the property which is returned as income for periods prior to the reacquisition of the real property does not include any amount of income determined under paragraph (f)(2) of this section which is considered to be received at the time of the reacquisition of the property. However, the amount of gain on the sale of the property which is returned as income for such periods does include gain on the sale resulting from payments received in the taxable year in which the date of reacquisition occurs if such payments are received prior to such reacquisition. The application of this subdivision may be illustrated by the following example:

Example: In 1965 S, who uses the calendar year as the taxable year, sells to P for $10,000 real property which has an adjusted basis of $3,000. S properly elects under section 453 to report the income from the sale on the installment method. In 1965 and 1966, S receives a total of $4,000 on the contract. On May 15, 1967, S receives $1,000 on the contract. Because of P's default, S reacquires the property on August 31, 1967. The gain on the sale which is returned as income for periods prior to the reacquisition is $3,500 ($5,000×$7,000/$10,000).

(2) *Amount of money and other property received with respect to the sale*—(i) *In general.* Amounts of money and other property received by the seller with respect to the sale of the property include payments made by the purchaser for the seller's benefit, as well as payments made and other property transferred directly to the seller. If the purchaser of the real property makes payments on a mortgage or other indebtedness to which the property is subject at the time of the sale of such property

to him, or on which the seller was personally liable at the time of such sale, such payments are considered amounts received by the seller with respect to the sale. However, if after the sale the purchaser borrows money and uses the property as security for the loan, payments by the purchaser in satisfaction of the indebtedness are not considered as amounts received by the seller with respect to the sale, although the seller does in fact receive some indirect benefit when the purchaser makes such payments.

(ii) *Payments by purchaser at time of reacquisition.* All payments made by the purchaser at the time of the reacquisition of the real property that are with respect to the original sale of the property shall be treated, for purposes of subparagraph (1) of this paragraph, by the seller as having been received prior to the reacquisition with respect to such sale. For example, if the purchaser, at the time of the reacquisition by the seller, pays money or other property to the seller in partial or complete satisfaction of the purchaser's indebtedness on the original sale, the seller shall treat such amounts as having been received prior to the reacquisition with respect to the sale.

(iii) *Interest received.* For purposes of this subparagraph and paragraph (c)(1) of this section any amounts received by the seller as interest, stated or unstated, are excluded from the computation of gain on the sale of the property and are not considered amounts of money or other property received with respect to the sale.

(iv) *Amounts received on sale of purchaser's indebtedness.* Money or other property received by the seller on the sale of the purchaser's indebtedness that arose at the time of the sale of the real property are amounts received by the seller with respect to the sale of such real property, except that the amounts so received from the sale of such indebtedness shall be reduced by the amount of money and the fair market value of other property paid or transferred by the seller, before the reacquisition of the real property, to reacquire such indebtedness. For example, if S sells real property to P for $25,000, and under the contract receives $10,000 down and a note from P for $15,000, S would receive $22,000 with respect to the sale if he were to discount the note for $12,000. If before the reacquisition of the real property S were to reacquire the discounted note for $8,000, he would receive $14,000 with respect to the sale.

(3) *Obligations of the purchaser arising with respect to the sale.* The term *obligations of the purchaser arising with respect to the sale* of the real property includes, for purposes of subparagraph (1) of this paragraph, only that indebtedness on which the purchaser is liable to the seller and which arises out of the sale of such property. Thus, the term does not include any indebtedness in respect of the property that the seller owes to a third person which the purchaser assumes, or to which the property is subject, at the time of the sale of the property to the purchaser. Nor does the term include any indebtedness on which the purchaser is liable to the seller if such indebtedness arises subsequent to the sale of such property.

(c) *Limitation upon amount of gain*—(1) *In general.* Except as provided by subparagraph (2) of this paragraph, the amount of gain on a reacquisition of real property, as determined under paragraph (b) of this section, shall in no case exceed—

(i) The amount by which the price at which the real property was sold exceeded its adjusted basis at the time of the sale, as determined under § 1.1011–1, reduced by

(ii) The amount of gain on the sale of such real property which is returned as income for periods prior to the reacquisition, and by

(iii) The amount of money and the fair market value of other property (other than obligations of the purchaser to the seller which are secured by the real property) paid or transferred by the seller in connection with the reacquisition of such real property.

(2) *Cases where limitation does not apply.* The limitation provided by subparagraph (1) of this paragraph shall not apply in a case where the selling price of property is indefinite in amount and cannot be ascertained at the time of the reacquisition of such property, as, for example, where the selling price is stated as a percentage

of the profits to be realized from the development of the property which is sold. Moreover, the limitation so provided shall not apply to a reacquisition of real property occurring in a taxable year beginning before September 3, 1964, to which the provisions of this section are applied pursuant to an election under § 1.1038–3.

(3) *Determination of sales price.* The price at which the real property was sold shall be, for purposes of subparagraph (1) of this paragraph, the gross sales price reduced by the selling commissions, legal fees, and other expenses incident to the sale of such property which are properly taken into account in determining gain or loss on the sale. For example, the amount of selling commissions paid by a nondealer will be deducted from the gross sales price in determining the price at which the real property was sold; on the other hand, selling commissions paid by a real estate dealer will be deducted as a business expense. Examples of other expenses incident to the sale of the property are expenses for appraisal fees, advertising expense, cost of preparing maps, recording fees, and documentary stamp taxes. Payments on indebtedness to the seller which are for interest, stated or unstated, are not included in determining the price at which the property was sold. See paragraph (b)(2)(iii) of this section.

(4) *Determination of amounts paid or transferred in connection with a reacquisition*—(i) *In general.* Amounts of money or property paid or transferred by the seller of the real property in connection with the reacquisition of such property include payments of money, or transfers of property, to persons from whom the real property is reacquired as well as to other persons. Payments or transfers in connection with the reacquisition of the property do not include money or property paid or transferred by the seller to reacquire obligations of the purchaser to the seller which were received by the seller with respect to the sale of the property or which arose subsequent to the sale. Amounts of money or property paid or transferred by the seller in connection with the reacquisition of the property include payments or transfers for such items as court costs and fees for services of an attorney, master, trustee, or auctioneer, or for publication, acquiring title, clearing liens, or filing and recording.

(ii) *Assumption of indebtedness.* The assumption by the seller, upon reacquisition of the real property, of any indebtedness to another person which at such time is secured by such property will be considered a payment of money by the seller in connection with the reacquisition. Also, if at the time of reacquisition such property is subject to an indebtedness which is not an indebtedness of the purchaser to the seller, the seller shall be considered to have paid money, in an amount equal to such indebtedness, in connection with the reacquisition of the property. Thus, for example, if at the time of the sale the purchaser executes in connection with the sale a first mortgage to a bank and a second mortgage to the seller and at the time of reacquisition the seller reacquires the property subject to the first mortgage which he does not assume, the seller will be considered to have paid money, in an amount equal to the unpaid amount of the first mortgage, in connection with the reacquisition.

(d) *Character of gain resulting from a reacquisition.* Paragraphs (b) and (c) of this section set forth the extent to which gain shall be derived from a reacquisition to which paragraph (a) of this section applies, but the rule provided by section 1038 and this section do not affect the character of the gain so derived. The character of the gain resulting from such a reacquisition is determined on the basis of whether the gain on the original sale was returned on the installment method or, if not, on the basis of whether title to the real property was transferred to the purchaser; and, if title was transferred to the purchaser in a deferred-payment sale, whether the reconveyance of the property to the seller was voluntary. For example, if the gain on the original sale of the reacquired property was returned on the installment method, the character of the gain on reacquisition by the seller shall be determined in accordance with the rules provided in paragraph (a) of § 1.453–9. If the original sale was not on the installment method but was a deferred-payment sale, as described in §1.453–6(a), where title to the real property was transferred to the purchaser and the seller accepts a voluntary reconveyance of the property, the gain on the reacquisition shall be ordinary income; however, if the obligations satisfied are securities (as defined in section 165(g)(2)(C)), any gain resulting from the reacquisition is capital gain subject to the provisions of subchapter P of chapter 1 of the Code.

(e) *Recognition of gain.* The entire amount of the gain determined under paragraphs (b) and (c) of this section with respect to a reacquisition to which paragraph (a) of this section applies shall be recognized notwithstanding any other provisions of subtitle A (relating to income taxes) of the Code.

(f) *Special rules applicable to worthless indebtedness*—(1) *Worthlessness resulting from reacquisition.* No debt of the purchaser to the seller which was secured by the reacquired real property shall be considered as becoming worthless or partially worthless as a result of a reacquisition of such real property to which paragraph (a) of this section applies. Accordingly, no deduction for a bad debt and no charge against a reserve for bad debts shall be allowed, as a result of the reacquisition, in order to reflect the noncollectibility of any indebtedness of the purchaser to the seller which at the time of reacquisition was secured by such real property.

(2) *Indebtedness treated as worthless prior to reacquisition*—(i) *Prior taxable years.* If for any taxable year ending before the taxable year in which occurs a reacquisition of real property to which paragraph (a) of this section applies the seller of such property has treated any indebtedness of the purchaser which is secured by such property as having become worthless or partially worthless by taking a bad debt deduction under section 166(a), he shall be considered as receiving, at the time of such reacquisition, income in an amount equal to the amount of such indebtedness previously treated by him as having become worthless. The amount so treated as income received shall be treated as a recovery of a bad debt previously deducted as worthless or partially worthless. Accordingly, the amount of such income shall be excluded from gross income, as provided in §1.111–1, to the extent of the *recovery exclusion* with respect to such item. For purposes of §1.111–1, if the indebtedness was treated as partially worthless in a prior taxable year, the amount treated under this subparagraph as a recovery shall be considered to be with respect to the part of the indebtedness that was previously deducted as worthless. The seller shall not be considered to have treated an indebtedness as worthless in any taxable year for which he took the standard deduction under section 141 or paid the tax imposed by section 3 if a deduction in respect of such indebtedness was not allowed in determining adjusted gross income for such year under section 62.

(ii) *Current taxable year.* No deduction shall be allowed under section 166 (a), for the taxable year in which occurs a reacquisition of real property to which paragraph (a) of this section applies, in respect of any indebtedness of the purchaser secured by such property which has been treated by the seller as having become worthless or partially worthless in such taxable year but prior to the date of such reacquisition.

(3) *Basis adjustment.* The basis of any indebtedness described in subparagraph (2)(i) of this paragraph shall be increased (as of the date of the reacquisition) by an amount equal to the amount which, under such subparagraph of this paragraph, is treated as income received by the seller with respect to such indebtedness, but only to the extent the amount so treated as received is not excluded from gross income by reason of the application of §1.111–1.

(g) *Rules for determining gain or loss on disposition of reacquired property*—(1) *Basis of reacquired real property.* The basis of any real property acquired in a reacquisition to which paragraph (a) of this section applies shall be the sum of the following amounts, determined as of the date of such reacquisition:

(i) The amount of the adjusted basis, determined under sections 453 and 1011, and the regulations thereunder, of all indebtedness of the purchaser to the seller which at the time of reacquisition was secured by such property, including any increase by reason of paragraph (f)(3) of this section,

(ii) The amount of gain determined under paragraphs (b) and (c) of this section with respect to such reacquisition, and

(iii) The amount of money and the fair market value of other property (other than obligations of the purchaser to the seller which are secured by the real property) paid or transferred by the seller in connection with the reacquisition of such real property, determined as provided in paragraph (c) of this section even though such paragraph does not apply to the reacquisition.

(2) *Basis of undischarged indebtedness.* The basis of any indebtedness of the purchaser to the seller which was secured by the reacquired real property described in subparagraph (1) of this paragraph, to the extent that such indebtedness is not discharged upon the reacquisition of such property, shall be zero. Therefore, to the extent not discharged upon the reacquisition of the real property, indebtedness on the original obligation of the purchaser, a substituted obligation of the purchaser, a deficiency judgment entered in a court of law into which the purchaser's obligation has merged, or any other obligation of the purchaser to the seller, shall be zero if such indebtedness constitutes an indebtedness to the seller which was secured by such property.

(3) *Holding period of reacquired property.* Since the reacquisition described in subparagraph (1) of this paragraph is in a sense considered a nullification of the original sale of the real property, for purposes of determining gain or loss on a disposition of such property after its reacquisition the period for which the seller has held the real property at the time of such disposition shall include the period for which such property is held by him prior to the original sale. However, the holding period shall not include the period of time commencing with the date following the date on which the property is originally sold to the purchaser and ending with the date on which the property is reacquired by the seller. The period for which the property was held by the seller prior to the original sale shall be determined as provided in § 1.1223–1. For example, if under paragraph (a) of § 1.1223–1 real property, which was acquired as the result of an involuntary conversion, has been held for five months on January 1, 1965, the date of its sale, and such property is reacquired on July 2, 1965, and resold on July 3, 1965, the seller will be considered to have held such property for five months and one day for purposes of this subparagraph.

(h) *Illustrations.* The application of this section may be illustrated by the following examples in which it is assumed that the reacquisition is in satisfaction of secured indebtedness arising out of the sale of the real property:

Example 1. (a) S purchases real property for $20 and sells it to P for $100, the property not being mortgaged at the time of sale. Under the contract P pays $10 down and executes a note for $90, with stated interest at 6 percent, to be paid in nine annual installments. S properly elects to report the gain on the installment method. After the second $10 annual payment P defaults and S accepts a voluntary reconveyance of the property in complete satisfaction of the indebtedness. S pays $5 in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is $110.

(b) The gain derived by S on the reacquisition of the property is $6, determined as follows:

Gain before application of limitation:		
Money with respect to the sale received by S prior to the reacquisition		$30
Less: Gain returned by S as income for periods prior to the reacquisition ($30×[($100 – $20)/$100])		24
Gain before application of limitation		6
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at the time of sale	$20	
Gain returned by S as income for periods prior to the reacquisition	24	
Amount of money paid by S in connection with the reacquisition	5	49
Limitation on amount of gain		51
Gain resulting from the reacquisition of the property		6

(c) The basis of the reacquired real property at the date of the reacquisition is $25, determined as follows:

Adjusted basis of P's indebtedness to S ($70 − [$70×$80/$100])	$14
Gain resulting from the reacquisition of the property	6
Amount of money paid by S in connection with the reacquisition	5
Basis of reacquired property	25

Example 2. (a) The facts are the same as in example (1) except that S purchased the property for $80.

(b) The gain derived by S on the reacquisition of the property is $9, determined as follows:

Gain before application of limitation:		
Money with respect to the sale received by S prior to the reacquisition		$30
Less: Gain returned by S as income for periods prior to the reacquisition ($30×[($100 − $80)/$100])		$6
Gain before application of limitation		24
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at the time of sale	$80	
Gain returned by S as income for periods prior to the reacquisition	6	
Amount of money paid by S in connection with the reacquisition	5	91
Limitation on amount of gain		9
Gain resulting from the reacquisition of the property		9

(c) The basis of the reacquired real property at the date of the reacquisition is $70, determined as follows:

Adjusted basis of P's indebtedness to S ($70 − [$70×$20/$100])	$56
Gain resulting from the reacquisition of the property	9
Amount of money paid by S in connection with the reacquisition	5
Basis of reacquired property	70

Example 3. (a) S purchases real property for $70 and sells it to P for $100, the property not being mortgaged at the time of sale. Under the contract P pays $10 down and executes a note for $90, with stated interest at 6 percent, to be paid in nine annual installments. S properly elects to report the gain on the installment method. After the first $10 annual payment P defaults and S accepts a voluntary reconveyance of the property in complete satisfaction of the indebtedness. S pays $5 in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is $50.

(b) The gain derived by S on the reacquisition of the property is $14, determined as follows:

Gain before application of limitation:		
Money with respect to the sale received by S prior to the reacquisition		$20
Less: Gain returned by S as income for periods prior to the reacquisition ($20×[($100 − $70)/$100])		6
Gain before application of limitation		14
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at time of sale	$70	
Gain returned by S as income for periods prior to the reacquisition	6	
Amount paid by S in connection with the reacquisition	5	81
Limitation on amount of gain		19
Gain resulting from the reacquisition of the property		14

(c) The basis of the reacquired real property at the date of the reacquisition is $75, determined as follows:

Adjusted basis of P's indebtedness to S ($80 − [$80×$30/$100])	$56
Gain resulting from the reacquisition of the property	14
Amount of money paid by S in connection with the reacquisition	5
Basis of reacquired property	75

Example 4. (a) S purchases real property for $20 and sells it to P for $100, the property not being mortgaged at the time of sale. Under the contract P pays $10 down and executes a note for $90, with stated interest at 6 percent, to be paid in nine annual installments. S properly elects to report gain on the installment method. After the second $10 annual payment P defaults and S accepts from P in complete satisfaction of the indebtedness a voluntary reconveyance of the property plus cash in the amount of $20. S does not pay any amount in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is $30.

(b) The gain derived by S on the reacquisition of the property is $10, determined as follows:

Gain before application of the limitation:		
Money with respect to the sale received by S prior to the reacquisition ($30+$20)		$50
Less: Gain returned by S as income for periods prior to the reacquisition ($50×[($100 − $20)/$100])		40
Gain before application of limitation		10
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at time of sale	$20	

Gain returned by S as income for periods prior to the reacquisition	40	60
Limitation on amount of gain		40
Gain resulting from the reacquisition of the property		10

(c) The basis of the reacquired real property at the date of the reacquisition is $20, determined as follows:

Adjusted basis of P's indebtedness to S ($50 – [$50×$80/$100])	$10
Gain resulting from the reacquisition of the property	10
Basis of reacquired property	20

Example 5. (a) S purchases real property for $80 and sells it to P for $100, the property not being mortgaged at the time of sale. Under the contract P pays $10 down and executes a note for $90, with stated interest at 6 percent, to be paid in nine annual installments. At the time of sale P's note has a fair market value of $90. S does not elect to report the gain on the installment method but treats the transaction as a deferred-payment sale. After the third $10 annual payment P defaults and S forecloses. Under the foreclosure sale S bids in the property at $70, cancels P's obligation of $60, and pays $10 to P. There are no other amounts paid by S in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is $70.

(b) The gain derived by S on the reacquisition of the property is $0, determined as follows:

Gain before application of the limitation:		
Money with respect to the sale received by S prior to the reacquisition		$40
Less: Gain returned by S as income for periods prior to the reacquisition ([$10+$90] – $80)		20
Gain before application of limitation		20
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at the time of sale	$80	
Gain returned by S as income for periods prior to the reacquisition	20	
Amount of money paid by S in connection with the reacquisition	10	110
Limitation on amount of gain (not to be less than zero)		0
Gain resulting from the reacquisition of the property		0

(c) The basis of the reacquired real property at the date of the reacquisition is $70, determined as follows:

Adjusted basis of P's indebtedness to S (face value at time of reacquisition)	$60
Gain resulting from the reacquisition of the property	0
Amount of money paid by S in connection with the reacquisition	10
Basis of reacquired property	70

[T.D. 6916, 32 FR 5925, Apr. 13, 1967; 32 FR 6971, May 6, 1967]

§ 1.1038–2 Reacquisition and resale of property used as a principal residence.

(a) *Application of special rules*—(1) *In general.* If paragraph (a) of § 1.1038–1 applies to the reacquisition of real property which was used by the seller as his principal residence and with respect to the sale of which an election under section 121 is in effect or with respect to the sale of which gain was not recognized under section 1034, the provisions of § 1.1038–1 (other than paragraph (a) thereof) shall not, and this section shall, apply to the reacquisition of such property if the property is resold by the seller within one year after the date of the reacquisition. For purposes of this section an election under section 121 shall be considered to be in effect with respect to the sale of the property if, at the close of the last day for making such an election under section 121(c) with respect to such sale, an election under section 121 has been made and not revoked. Thus, a taxpayer who properly elects, subsequent to the reacquisition, to have section 121 apply to a sale of his residence may be eligible for the treatment provided in this section. The treatment provided by this section is mandatory; however, see § 1.1038–3 for an election to apply the provisions of this section to certain taxable years beginning after December 31, 1957.

(2) *Sale and resale treated as one transaction.* In the case of a reacquisition to which this section applies, the resale of the reacquired property shall be treated, for purposes of applying sections 121 and 1034, as part of the transaction constituting the original sale of such property. In effect, the reacquisition is generally disregarded pursuant to this section and, for purposes of applying sections 121 and 1034, the resale of the property is considered to constitute a sale of such property occurring on the date of the original sale of such property.

(b) *Transactions not included.* (1) If with respect to the original sale of the property there was no nonrecognition of gain under section 1034 and an election under section 121 is not in effect, the provisions of § 1.1038–1, and not this section, shall apply to the reacquisition. Thus, for example, if in the case of a taxpayer not entitled to the benefit of section 121 there is no gain on the original sale of the property, the provisions of § 1.1038–1, and not this section, shall apply even though a redetermination of gain under this section would result in the nonrecognition of gain on the sale under section 1034. Also, if in the case of such a taxpayer there was gain on the original sale of the property but after the application of section 1034 all of such gain was recognized, the provisions of § 1.1038–1, and not this section, shall apply to the reacquisition.

(2) If the original sale of the property was not eligible for the treatment provided by section 121 and section 1034, the provisions of § 1.1038–1, and not this section, shall apply to the reacquisition of the property even though the resale of such property is eligible for the treatment provided by either or both of sections 121 and 1034.

(c) *Redetermination of gain required*—(1) *Sale of old residence.* The amount of gain excluded under section 121 on the sale of the property and the amount of gain recognized under section 1034 on the sale of the property shall be redetermined under this section by recomputing the adjusted sales price and the adjusted basis of the property, and any adjustments resulting from the redetermination of the gain on the sale of such property shall be reflected in the income of the seller for his taxable year in which the resale of the property occurs.

(2) *Sale of new residence.* If gain was not recognized under section 1034 on the original sale of the property, the adjusted basis of the new residence shall be redetermined under this section. If the new residence has been sold, the amount of gain returned on such sale of the new residence which is affected by the redetermination of the recognized gain on the sale of the old residence shall be redetermined under this section, and any adjustments resulting from the redetermination of the gain on the sale of the new residence shall be reflected in income of the seller for his taxable year in which the resale of the old residence occurs.

(d) *Redetermination of adjusted sales price.* For purposes of applying sections 121 and 1034 pursuant to this section, the adjusted sales price of the reacquired real property shall be redetermined by taking into account both the sale and the resale of the property and shall be—

(1) The amount realized, which for purposes of section 1001 shall be—

(i) The amount realized on the resale of the property, as determined under paragraph (b)(4) of § 1.1034–1, plus

(ii) The amount realized on the original sale of the property, determined as provided in paragraph (b)(4) of § 1.1034–1, less that portion of any obligations of the purchaser arising with respect to such sale which at the time of reacquisition is secured by such property and is unpaid, less

(iii) The amount of money and the fair market value of other property (other than obligations of the purchaser to the seller secured by the real property) paid or transferred by the seller in connection with the reacquisition of such real property,

reduced by

(2) The total of the fixing-up expenses (as defined in par. (b)(6) of § 1.1034–1) incurred for work performed on such real property to assist in both its original sale and its resale.

For purposes of applying paragraph (b)(6) of § 1.1034–1, there shall be two 90-day periods, the first ending on the day on which the contract to sell is entered into in connection with the original sale of the property, and the second ending on the day on which the contract to sell is entered into in connection with the resale of the property. There shall also be two 30-day periods for such purposes, the first ending on the 30th day after the date of the original sale, and the second ending on the 30th day after the date of the resale. For determination of the obligations of the purchaser arising with respect to the original sale of the property, see paragraph (b)(3) of § 1.1038–1. For determination of amounts paid or transferred by the seller in connection with the reacquisition of the property, see paragraph (c)(4) of § 1.1038–1.

(e) *Determination of adjusted basis at time of resale.* For purposes of applying sections 121 and 1034 pursuant to this section, the adjusted basis of the reacquired real property at the time of its resale shall be—

(1) The sum of—

(i) The adjusted basis of such property at the time of the original sale, with proper adjustment under section 1016(a) in respect of such property for the period occurring after the reacquisition of such property, and

(ii) Any indebtedness of the purchaser to the seller which arose subsequent to the original sale of such property and which at the time of reacquisition was secured by such property,

reduced by

(2) Any indebtedness of the purchaser to the seller which at the time of reacquisition was secured by the reacquired real property and which, for any taxable year ending before the taxable year in which occurs the reacquisition to the seller which was secured by the seller as having become worthless or partially worthless by taking a bad debt deduction under section 166(a).

The reduction under the preceding sentence by reason of having treated indebtedness as worthless or partially worthless shall not exceed the amount by which there would be an increase in the basis of such indebtedness under paragraph (f)(3) of § 1.1038–1 if section 1038(d) had been applicable to the reacquisition of such property.

(f) *Treatment of indebtedness secured by the property*—(1) *Year of reacquisition.* No debt of the purchaser to the seller which was secured by the reacquired real property shall be considered as becoming worthless or partially worthless as a result of a reacquisition of such real property to which this section applies. Accordingly, no deduction for a bad debt shall be allowed, as a result of the reacquisition, in order to reflect the noncollectibility of any indebtedness of the purchaser to the seller which at the time of reacquisition was secured by such real property. In addition, no deduction shall be allowed, for the taxable year in which occurs a reacquisition of real property to which this section applies, in respect of any indebtedness of the purchaser secured by such property which has been treated by the seller as having become worthless or partially worthless in such taxable year but prior to the date of such reacquisition.

(2) *Prior taxable years.* For reduction of the basis of the real property for indebtedness treated as worthless or partially worthless for taxable years ending before the taxable year in which occurs the reacquisition, see paragraph (e) of this section.

(3) *Basis of indebtedness.* The basis of any indebtedness of the purchaser to the seller which was secured by the reacquired real property, to the extent that such indebtedness is not discharged upon the reacquisition of such property, shall be zero.

(g) *Date of sale.* Since the resale of the property, by being treated as part of the transaction constituting the original sale of the property, is treated as having occurred on the date of the original sale, in determining whether any of the time requirements of section 121 or section 1034 are satisfied for purposes of this section the date of the original sale is used, except to the extent provided in paragraph (d)(2) of this section.

(h) *Illustrations.* The application of this section may be illustrated by the following examples:

Example 1. (a) On June 30, 1964, S, a single individual over 65 years of age, sells his principal residence to P for $25,000, the property not being mortgaged at the time of sale. S properly elects to apply the provisions of section 121 to the sale. Under the contract, P pays $5,000 down and executes a note for $20,000 with stated interest at 6 percent, the principal being payable in installments of $5,000 each on January 1 of each year and the note being secured by the real property which is sold. At the time of sale P's note has a fair market value of $20,000. S does not elect to report the gain on the installment method but treats the transaction as a deferred-payment sale, title to the property being transferred to P at the time of sale. S uses the calendar year as the taxable year and the cash receipts and disbursements method of accounting. After making two annual payments of $5,000 each on the note, P defaults on the contract, and on March 1, 1967, S reacquires the real property in full satisfaction of P's indebtedness, title to the property being voluntarily reconveyed to S. On November 1, 1967, S sells the property to T for $35,000. The assumption is made that no fixing-up expenses are incurred for work performed on the principal residence in order to assist in the sale of the property in 1964 or in the resale of the property in 1967. At the time of sale in 1964 the property has an adjusted basis of $15,000. S does not treat any indebtedness with respect to the sale in 1964 as being worthless or partially worthless or make any capital expenditures with respect to the property after such sale. In his return for 1964, S includes in income $2,000 capital gain from the sale of his residence.

(b) The results obtained before and after the reacquisition of the property are as follows:

	Before reacquisition	After reacquisition
Adjusted sales price:		
$5,000+$20,000	$25,000	....
$15,000+$35,000	....	$50,000
Less: Adjusted basis of property at time of sale	15,000	15,000
Gain on sale	10,000	35,000
Gain excluded from income under section 121:.		
$10,000×$20,000/$25,000	8,000	....
$35,000×$20,000/$50,000	....	14,000
Gain included in income after applying section 121:		
$10,000 − $8,000	2,000	....
$35,000 − $14,000	....	21,000

(c) S is required to show the additional inclusion of $19,000 capital gain ($21,000 − $2,000) in income on his return for 1967.

Example 2. (a) The facts are the same as in example (1) except that on April 1, 1965, S purchases a new residence at a cost of $30,000 and qualifies for the nonrecognition of gain under section 1034 in respect of the sale of his principal residence on June 30, 1964. In his return for 1964, S does not include any capital gain in income as a result of the sale of the old residence.

(b) The results obtained before and after the reacquisition of the property are as follows:

	Before reacquisition	After reacquisition
Application of section 121 (see example (1)):		
Adjusted sales price	$25,000	$50,000
Less: Adjusted basis of property at time of sale	15,000	15,000
Gain on sale	10,000	35,000
Gain excluded from income under section 121	8,000	14,000
Gain not excluded from income under section 121	2,000	21,000
Application of section 1034: Adjusted sales price:		
$25,000 − $8,000	17,000	....
$50,000 − $14,000	....	36,000
Less: Cost of new residence	30,000	30,000
Gain recognized under section 1034 on sale of old residence	0	6,000
Gain not recognized under section 1034 on sale of old residence:		
($10,000 − [$8,000+$0])	2,000	....
($35,000 − [$14,000+$6,000])	....	15,000
Adjusted basis of new residence on April 1, 1965:		
$30,000 − $2,000	28,000	....
$30,000 − $15,000	....	15,000

(c) The $6,000 of capital gain on the sale of the old residence is required to be included in income on the return for 1967. The adjusted basis on April 1, 1965, for determining gain on a sale or exchange of the new residence at any time on or after that date is $15,000, after taking into account the reacquisition and resale of the old residence.

Example 3. The facts are the same as in example (2) except that S sells the new residence on June 20, 1965, for $40,000 and includes $12,000 of capital gain ($40,000 − $28,000) on its sale in his income on the return for 1965. S is required to include the additional capital gain of $13,000 ([$40,000 − $15,000] − $12,000) on the sale of the new residence in his income on the return for 1967. For this purpose, the assumption is also made that there are no additional adjustments to the basis of the new residence after April 1, 1965.

[T.D. 6916, 32 FR 5929, Apr. 13, 1967; 32 FR 6971, May 6, 1967]

§1.1038–3 Election to have section 1038 apply for taxable years beginning after December 31, 1957.

(a) *In general.* If an election is made in the manner provided by paragraph (b) of this section, the applicable provisions of §§1.1038–1 and 1.1038–2 shall apply to all reacquisitions of real property occurring in each and every taxable year beginning after December 31, 1957, and before September 3, 1964, for which the assessment of a deficiency, or the credit or refund of an overpayment, is not prevented on September 2, 1964, by the operation of any law or rule of law. The election so made shall apply to all taxable years beginning after December 31, 1957, and before September 3, 1964, for which the assessment of a deficiency, or the credit or refund of an overpayment, is not prevented on September 2, 1964, by the operation of any law or rule of law and shall apply to every reacquisition occurring in such taxable years. The fact that the assessment of a deficiency, or the credit or refund of an overpayment, is prevented for any other taxable year or years affected by the election will not prohibit the making of an election under this section. For example, if an individual who uses the calendar year as the taxable year were to sell in 1960 real property used as his principal residence in respect of the sale of which gain is not recognized under section 1034, and if such property were reacquired by the seller in 1962 and resold within 1 year, he would be permitted to make an election under this section with respect to such reacquisition even though on September 2, 1964, the period of limitations on assessment or refund has run for 1960. An election under this section shall be deemed a consent to the application of the provisions of this section.

(b) *Time and manner of making election*—(1) *In general.* (i) An election to have the provisions of § 1.1038–2 apply to reacquisitions of real property occurring in taxable years beginning after December 31, 1957, and before September 3, 1964, shall be made by filing on or before September 3, 1965, a return, an amended return, or a claim for refund, whichever is proper, for each taxable year in which the resale of such real property occurs. If the return for any such year is not due on or before such date and has not been filed, the election with respect to such taxable year shall be made by filing on or before such date the statement described in subparagraph (2) of this paragraph.

(ii) An election to have the provisions of § 1.1038–1 apply to reacquisitions of real property occurring in taxable years beginning after December 31, 1957, and before September 3, 1964, shall be made by filing on or before September 3, 1965, a return, an amended return, or a claim for refund, whichever is proper, for each taxable year in which such reacquisitions occur. If the return for any such year is not due on or before such date and has not been filed, the election with respect to such taxable year shall be made by filing on or before such date the statement described in subparagraph (2) of this paragraph.

(iii) If the facts are such that § 1.1038–2 applies to a reacquisition of property except that the reacquisition occurs in a taxable year beginning after December 31, 1957, and before September 3, 1964, an election may not be made under this paragraph to have the provisions of § 1.1038–1 apply to such reacquisition.

(iv) Once made, an election under this paragraph may not be revoked after September 3, 1965. To any return, amended return, or claim for refund filed under this subparagraph there shall be attached the statement described in subparagraph (2) of this paragraph.

(2) *Statement to be attached.* The statement described in subparagraph (1) of this paragraph shall indicate—

(i) The name, address and account number of the taxpayer, and the fact that the taxpayer is electing to have the provisions of section 1038 apply to the reacquisitions of real property,

(ii) The taxable years in which the reacquisitions of property occur and any other taxable year or years the tax for which is affected by the application of section 1038 to such reacquisitions,

(iii) The office of the district director where the return or returns for such taxable year or years were or will be filed,

(iv) The dates on which such return or returns were filed and on which the tax for such taxable year or years was paid,

(v) The type of real property reacquired, the terms under which such property was sold and reacquired, and an indication of whether the taxpayer is applying the provisions of § 1.1038–2 to the reacquisition of such property,

(vi) If § 1.1038–2 is being applied to the reacquisition, the terms under which the old residence was resold and, if applicable, the terms under which the new residence was sold, and

(vii) The office where, and the date when, the election to apply section 121 in respect to any sale of such property was or will be made.

(3) *Place for filing.* Any claim for refund, amended return, or statement, filed under this paragraph in respect of any taxable year, whether the taxable year in which occurs the reacquisition of property or the taxable year in which occurs the resale of the old residence, shall be filed in the office of the district director in which the return for such taxable year was or will be filed.

(c) *Extension of period of limitations on assessment or refund*—(1) *Assessment of tax.* If an election is properly made under paragraph (b) of this section and the assessment of a deficiency for the taxable years to which such election applies is not prevented on September 2, 1964, by the operation of any law or rule of law, the period within which a deficiency for such taxable years may be assessed shall, to the extent such deficiency is attributable to the application of section 1038, not expire prior to one year after the date on which such election is made.

(2) *Refund of tax.* If an election is properly made under paragraph (b) of this section and the credit or refund of any overpayment for the taxable years to which such election applies is not prevented on September 2, 1964, by the operation of any law or rule of law, the period within which a claim for credit or refund of an overpayment for such taxable years may be filed shall, to the extent such overpayment is attributable to the application of section 1038, not expire prior to one year after the date on which such election is made.

(d) *Payment of interest for period prior to September 2, 1964.* No interest shall be payable with respect to any deficiency attributable to the application of the provisions of section 1038, and no interest shall be allowed with respect to any credit or refund of any overpayment attributable to the application of such section, for any period prior to September 2, 1964. See section 2(c)(3) of the Act of September 2, 1964 (Pub. L. 88–750, 78 Stat. 856).

[T.D. 6916, 32 FR 5930, Apr. 13, 1967]

§1.1039–1 Certain sales of low-income housing projects.

(a) *Nonrecognition of gain.* Section 1039 provides rules under which the taxpayer may elect not to recognize gain in certain cases where a qualified housing project is sold or disposed of after October 9, 1969, in an approved disposition and another such qualified housing project or projects (referred to as the *replacement project*) is acquired, constructed, or reconstructed within a specified reinvestment period. If the requirements of section 1039 are met, and if the taxpayer makes an election in accordance with the provisions of paragraph (b)(4) of this section, then the gain realized upon the sale or disposition is recognized only to the extent that the net amount realized on such sale or disposition exceeds the cost of the replacement project. However, notwithstanding section 1039, gain may be recognized by reason of the application of section 1245 or 1250 to the sale or disposition. (See §1.1245–6(b) and §1.1250–3(h). The terms *qualified housing project, approved disposition, reinvestment period,* and *net amount realized* are defined in paragraph (c) of this section.

(b) *Rules of application*—(1) *In general.* The election under section 1039(a) may be made only by the taxpayer owning the qualified housing project disposed of. Thus, if the qualified housing project disposed of is owned by a partnership, the partnership must make the election. (See section 703(b).) Similarly, if the qualified housing project disposed of is owned by a corporation or trust, the corporation or trust must make the election. In addition, the reinvestment of the taxpayer must be in such a manner that the taxpayer would be entitled to a deduction for depreciation on the replacement project. Thus, if the qualified housing project disposed of is owned by individual A, the purchase by A of stock in a corporation owning or constructing such a project or of an interest in a partnership owning or constructing such a project will not be considered as the purchase or construction by A of such a project.

(2) *Special rules.* (i) The cost of a replacement project acquired before the approved disposition of a qualified housing project shall be taken into account under section 1039 only if such

property is held by the taxpayer on the date of the approved disposition.

(ii) Except as provided in section 1039 (d), no property acquired by the taxpayer shall be taken into account for purposes of section 1039(a)(2) unless the unadjusted basis of such property is its cost within the meaning of section 1012. For example, if a qualified housing project is acquired in an exchange under section 1031, relating to exchange of property held for productive use or investment, such property will not be taken into account under section 1039(a)(2) because its basis is determined by reference to the basis of the property exchanged. (See section 1031(d).)

(3) *Cost of replacement project.* The taxpayer's cost for the replacement project includes only amounts properly treated as capital expenditures by the taxpayer that are attributable to acquisition, construction, or reconstruction made within the reinvestment period (as defined in paragraph (c)(4) of this section). See section 263 for rules as to what constitutes capital expenditures. Thus, assume that a calendar year taxpayer realizes gain in 1970 upon the approved disposition of a qualified housing project occurring on January 1, 1970. If the taxpayer had begun construction of another qualified housing project on January 1, 1969, and completes such construction on June 1, 1972, only that portion of the cost attributable to the period before January 1, 1972, constitutes the cost of the replacement project for purposes of section 1039. For purposes of determining the cost of a replacement project attributable to a particular period, the total cost of the project may be allocated to such period on the basis of the portion of the total project actually constructed during such period.

(4) *Election.* (i) An election not to recognize the gain realized upon an approved disposition of a qualified housing project to the extent provided in section 1039(a) may be made by attaching a statement to the income tax return filed for the first taxable year in which any portion of the gain on such disposition is realized. Such a statement shall contain the information required by subdivision (iii) of this subparagraph. If the taxpayer does not file such a statement for the first taxable year in which any portion of the gain is realized, but fails to report a portion of the gain realized upon the approved disposition as income for such year or for any subsequent taxable year, then an election shall be deemed to be made under section 1039 (a) with respect to that portion of the gain not reported as income.

(ii) An election may be made under section 1039(a) even though the replacement project has not been acquired or constructed at the time of election. However, if an election has been made and (*a*) a replacement project is not constructed, reconstructed, or acquired, (*b*) the cost of the replacement project is lower than the net amount realized from the approved disposition, or (*c*) a decision is made not to construct, reconstruct, or acquire a replacement project, then the tax liability for the year or years for which the election was made shall be recomputed and an amended return filed. An election may be made even though the taxpayer has filed his return and recognized gain upon the disposition provided that the period of limitation on filing claims for credit or refund prescribed by section 6511 has not expired. In such case, a statement containing the information required by subdivision (iii) of this subparagraph should be filed together with a claim for credit or refund for the taxable year or years in which gain was recognized.

(iii) The statement referred to in subdivisions (i) and (ii) of this subparagraph shall contain the following information:

(*a*) The date of the approved disposition;

(*b*) If a replacement project has been acquired, the date of acquisition and cost of the project;

(*c*) If a replacement project has been constructed or reconstructed by or for the taxpayer, the date construction was begun, the date construction was completed, and the percentage of construction completed within the reinvestment period;

(*d*) If no replacement project has been constructed, reconstructed, or acquired prior to the time of filing of the statement, the estimated cost of such construction, reconstruction, or acquisition;

(*e*) The adjusted basis of the project disposed of; and

(*f*) The amount realized upon the approved disposition and a description of the expenses directly connected with the disposition and the taxes (other than income taxes) attributable to the disposition.

(c) *Definitions*—(1) *General.* The definitions contained in subparagraphs (2) through (5) of this paragraph shall apply for purposes of this section.

(2) *Qualified housing project.* The term *qualified housing project* means a rental or cooperative housing project for lower income families that has been constructed, reconstructed, or rehabilitated pursuant to a mortgage which is insured under section 221(d)(3) or 236 of the National Housing Act, provided that with respect to the housing project disposed of and the replacement project constructed, reconstructed, or acquired, the owner of the project at the time of the approved disposition and prior to the close of the reinvestment period is, under such sections or regulations issued thereunder,

(i) Limited as to rate of return on his investment in the project, and

(ii) Limited as to rentals or occupancy charges for units in the project.

If the owner of the project is organized and operated as a nonprofit cooperative or other nonprofit organization, then such owner shall be considered to meet the requirement of subdivision (i) of this subparagraph.

(3) *Approved disposition.* The term *approved disposition* means a sale or other disposition of a qualified housing project to the tenants or occupants of units in such project, or to a nonprofit cooperative or other nonprofit organization formed and operated solely for the benefit of such tenants or occupants, provided that it is approved by the Secretary of Housing and Urban Development or his delegate under section 221 (d)(3) or 236 of the National Housing Act or regulations issued under such sections. Evidence of such approval should be attached to the tax return or statement in which the election under section 1039 is made.

(4) *Reinvestment period.* (i) The term *reinvestment period* means the period beginning 1 year before the date of the disposition and ending 1 year after the close of the first taxable year in which any part of the gain from such disposition is realized, or at such later date as may be designated pursuant to an application made by the taxpayer. Such application shall be made before the expiration of one year after the close of the first taxable year in which any part of the gain from such disposition is realized, unless the taxpayer can show to the satisfaction of the district director that—

(*a*) Reasonable cause exists for not having filed the application within the required period, and

(*b*) The filing of such application was made within a reasonable time after the expiration of the required period.

The application shall contain all the information required by paragraph (b)(4) of this section and shall be made to the district director for the internal revenue district in which the return is filed for the first taxable year in which any of the gain from the approved disposition is realized.

(ii) Ordinarily, requests for extension of the reinvestment period will not be granted until near the end of such period and any extension will usually be limited to a period not exceeding one year. Although granting of an extension depends upon the facts and circumstances of a particular case, if a predominant portion of the construction of the replacement project has been completed or is reasonably expected to be completed within the reinvestment period (determined without regard to any extension thereof), an extension of the reinvestment period will ordinarily be granted. The fact that there is a scarcity of replacement property for acquisition will not be considered sufficient grounds for granting an extension.

(5) *Net amount realized.* (i) The *net amount realized* from the approved disposition of a qualified housing project is the amount realized from such disposition, reduced by—

(*a*) The expenses paid or incurred by the taxpayer which are directly connected with the approved disposition, and (*b*) The amount of taxes (other than income taxes) paid or incurred by the taxpayer which are attributable to the approved disposition.

(ii) Examples of expenses directly connected with an approved disposition of a qualified housing project include amounts paid for sales or other commissions, advertising, and for the preparation of a deed or other legal services in connection with the disposition. An amount paid for a repair to the building will be considered as an expense directly connected with the approved disposition under subdivision (i)(*a*) of this subparagraph only if such repair is required as a condition of sale, or is required by the Secretary of Housing and Urban Development or his delegate as a condition of approval of the disposition.

(iii) Examples of taxes that are attributable to the approved disposition include local property transfer taxes and stamp taxes. A local real property tax is not so attributable.

(d) *Basis and holding period of replacement project*—(1) *Basis.* If the taxpayer makes an election under section 1039, the basis of the replacement housing project shall be its cost (including costs incurred subsequent to the reinvestment period) reduced by the amount of gain not recognized under section 1039 (a). If the replacement consists of more than one housing project, the basis determined under this subparagraph shall be allocated to the properties in proportion to their respective costs.

(2) *Holding period.* The holding period of the replacement housing project shall begin on the date the taxpayer acquires such project, that is, on the date the taxpayer first acquires possession or control of such project and bears the burdens and enjoys the benefits of ownership of the replacement project. (For special rule regarding the holding period of property for purposes of section 1250, see section 1250(e)(4).)

(e) *Assessment of deficiencies*—(1) *Deficiency attributable to gain.* If a taxpayer makes an election under section 1039(a) with respect to an approved disposition, any deficiency attributable to the gain on such disposition, for any taxable year in which any part of such gain is realized, may be assessed at any time before the expiration of 3 years after the date the district director or director of the regional service center with whom the return for such year has been filed is notified by the taxpayer of the acquisition or the completion of construction or reconstruction of the replacement qualified housing project or of the failure to acquire, construct, or reconstruct a replacement qualified housing project, as the case may be. Such a deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of section 6212(c) or the provisions of any other law or rule of law which would otherwise prevent such assessment. If replacement has been made, such notification shall contain the information required by paragraph (b)(4)(iii) of this section. Such notification shall be attached to the return filed for the taxable year or years in which the replacement occurs, or in which the period for the replacement expires, and a copy of such notification shall be filed with the district director or director of regional service center with whom the election under section 1039(a) was required to be filed, if the return is not filed with such director.

(2) *Deficiency attributable to election.* If gain upon an approved disposition is realized in two (or more) taxable years, and the replacement qualified housing project was acquired, constructed, or reconstructed before the beginning of the last such year, any deficiency, for any taxable year before such last year, which is attributable to an election by the taxpayer under section 1039(a) may be assessed at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed, notwithstanding the provisions of section 6212(c) or 6501 or the provisions of any law or rule of law which would otherwise prevent such assessment. Thus, if gain upon an approved disposition is realized in 1971 and 1975, and if a replacement project is purchased in 1971, any deficiency for 1971 may be assessed within the period for assessing a deficiency for 1975.

[T.D. 7191, 37 FR 12951, June 30, 1972; 37 FR 14385, July 20, 1972, as amended by T.D. 7400, 41 FR 5101, Feb. 4, 1976]

§1.1041–1T Treatment of transfer of property between spouses or incident to divorce (temporary).

Q–1: How is the transfer of property between spouses treated under section 1041?

A–1: Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse or, if the transfer is incident to a divorce, a former spouse. The following questions and answers describe more fully the scope, tax consequences and other rules which apply to transfers of property under section 1041.

(a) *Scope of section 1041 in general.*

Q–2: Does section 1041 apply only to transfers of property incident to divorce?

A–2: No. Section 1041 is not limited to transfers of property incident to divorce. Section 1041 applies to any transfer of property between spouses regardless of whether the transfer is a gift or is a sale or exchange between spouses acting at arm's length (including a transfer in exchange for the relinquishment of property or marital rights or an exchange otherwise governed by another nonrecognition provision of the Code). A divorce or legal separation need not be contemplated between the spouses at the time of the transfer nor must a divorce or legal separation ever occur.

Example 1. A and B are married and file a joint return. A is the sole owner of a condominium unit. A sale or gift of the condominium from A to B is a transfer which is subject to the rules of section 1041.

Example 2. A and B are married and file separate returns. A is the owner of an independent sole proprietorship, X Company. In the ordinary course of business, X Company makes a sale of property to B. This sale is a transfer of property between spouses and is subject to the rules of section 1041.

Example 3. Assume the same facts as in example (2), except that X Company is a corporation wholly owned by A. This sale is not a sale between spouses subject to the rules of section 1041. However, in appropriate circumstances, general tax principles, including the step-transaction doctrine, may be applicable in recharacterizing the transaction.

Q–3: Do the rules of section 1041 apply to a transfer between spouses if the transferee spouse is a nonresident alien?

A–3: No. Gain or loss (if any) is recognized (assuming no other nonrecognition provision applies) at the time of a transfer of property if the property is transferred to a spouse who is a nonresident alien.

Q–4: What kinds of transfers are governed by section 1041?

A–4: Only transfers of property (whether real or personal, tangible or intangible) are governed by section 1041. Transfers of services are not subject to the rules of section 1041.

Q–5: Must the property transferred to a former spouse have been owned by the transferor spouse during the marriage?

A–5: No. A transfer of property acquired after the marriage ceases may be governed by section 1041.

(b) *Transfer incident to the divorce.*

Q–6: When is a transfer of property *incident to the divorce*?

A–6: A transfer of property is *incident to the divorce* in either of the following 2 circumstances—

(1) The transfer occurs not more than one year after the date on which the marriage ceases, or

(2) The transfer is related to the cessation of the marriage.

Thus, a transfer of property occurring not more than one year after the date on which the marriage ceases need not be related to the cessation of the marriage to qualify for section 1041 treatment. (See A–7 for transfers occurring more than one year after the cessation of the marriage.)

Q–7: When is a transfer of property *related to the cessation of the marriage*?

A–7: A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument, as defined in section 71(b)(2), and the transfer occurs not more than 6 years after the date on which the marriage ceases. A divorce or separation instrument includes a modification or amendment to such decree or instrument. Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage. This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. For example, the presumption may be rebutted by showing that (a) the transfer was not made within the one- and six-year periods described above because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (b) the transfer is effected promptly after the impediment to transfer is removed.

Q–8: Do annulments and the cessations of marriages that are void *ab initio* due to violations of state law constitute divorces for purposes of section 1041?

A–8: Yes.

(c) *Transfers on behalf of a spouse.*

Q–9: May transfers of property to third parties on behalf of a spouse (or former spouse) qualify under section 1041?

A–9: Yes. There are three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) will qualify under section 1041, provided all other requirements of the section are satisfied. The first situation is where the transfer to the third party is required by a divorce or separation instrument. The second situation is where the transfer to the third party is pursuant to the written request of the other spouse (or former spouse). The third situation is where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party. Such consent or ratification must state that the parties intend the transfer to be treated as a transfer to the nontransferring spouse (or former spouse) subject to the rules of section 1041 and must be received by the transferor prior to the date of filing of the transferor's first return of tax for the taxable year in which the transfer was made. In the three situations described above, the transfer of property will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition of gain under section 1041.

(d) *Tax consequences of transfers subject to section 1041.*

Q–10: How is the transferor of property under section 1041 treated for income tax purposes?

A–10: The transferor of property under section 1041 recognizes no gain or loss on the transfer even if the transfer was in exchange for the release of marital rights or other consideration. This rule applies regardless of whether the transfer is of property separately owned by the transferor or is a division (equal or unequal) of community property. Thus, the result under section 1041 differs from the result in *United States* v. *Davis,* 370 U.S. 65 (1962).

Q–11: How is the transferee of property under section 1041 treated for income tax purposes?

A–11: The transferee of property under section 1041 recognizes no gain or loss upon receipt of the transferred property. In all cases, the basis of the transferred property in the hands of the transferee is the adjusted basis of such property in the hands of the transferor immediately before the transfer. Even if the transfer is a bona fide sale, the transferee does not acquire a basis in the transferred property equal to the transferee's cost (the fair market value). This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of transfer (or the value of any consideration provided by the transferee) and applies for purposes of determining loss as well as gain upon the subsequent disposition of the property by the transferee. Thus, this rule is different from the rule applied in section 1015(a) for determining the basis of property acquired by gift.

Q–12: Do the rules described in A–10 and A–11 apply even if the transferred property is subject to liabilities which exceed the adjusted basis of the property?

A–12: Yes. For example, assume A owns property having a fair market value of $10,000 and an adjusted basis of $1,000. In contemplation of making a transfer of this property incident to a divorce from B, A borrows $5,000 from a bank, using the property as security for the borrowing. A then transfers the property to B and B assumes, or takes the property subject to, the liability to pay the $5,000 debt. Under section 1041, A recognizes no gain or loss upon the transfer of the property, and the adjusted basis of the property in the hands of B is $1,000.

Q–13: Will a transfer under section 1041 result in a recapture of investment tax credits with respect to the property transferred?

A–13: In general, no. Property transferred under section 1041 will not be treated as being disposed of by, or ceasing to be section 38 property with respect to, the transferor. However, the transferee will be subject to investment tax credit recapture if, upon or after the transfer, the property is disposed of by, or ceases to be section 38 property with respect to, the transferee. For example, as part of a divorce property settlement, B receives a car from A that has been used in A's business for two years and for which an investment tax credit was taken by A. No part of A's business is transferred to B and B's use of the car is solely personal. B is subject to recapture of the investment tax credit previously taken by A.

(e) *Notice and recordkeeping requirement with respect to transactions under section 1041.*

Q–14: Does the trasnsferor of property in a transaction described in section 1041 have to supply, at the time of the transfer, the transferee with records sufficient to determine the adjusted basis and holding period of the property at the time of the transfer and (if applicable) with notice that the property transferred under section 1041 is potentially subject to recapture of the investment tax credit?

A–14: Yes. A transferor of property under section 1041 must, at the time of the transfer, supply the transferee with records sufficient to determine the adjusted basis and holding period of the property as of the date of the transfer. In addition, in the case of a transfer of property which carries with it a potential liability for investment tax credit recapture, the transferor must, at the time of the transfer, supply the transferee with records sufficient to determine the amount and period of such potential liability. Such records must be preserved and kept accessible by the transferee.

(f) *Property settlements—effective dates, transitional periods and elections.*

Q–15: When does section 1041 become effective?

A–15: Generally, section 1041 applies to all transfers after July 18, 1984. However, it does not apply to transfers after July 18, 1984 pursuant to instruments in effect on or before July 18, 1984. (See A–16 with respect to exceptions to the general rule.)

Q–16: Are there any exceptions to the general rule stated in A–15 above?

A–16: Yes. Two transitional rules provide exceptions to the general rule stated in A–15. First, section 1041 will apply to transfers after July 18, 1984 under instruments that were in effect on or before July 18, 1984 if both spouses (or former spouses) elect to have section 1041 apply to such transfers. Second, section 1041 will apply to all transfers after December 31, 1983 (including transfers under instruments in effect on or before July 18, 1984) if both spouses (or former spouses) elect to have section 1041 apply. (See A–18 relating to the time and manner of making the elections under the first or second transitional rule.)

Q–17: Can an election be made to have section 1041 apply to some, but not all, transfers made after December 31, 1983, or some but not all, transfers made after July 18, 1984 under instruments in effect on or before July 18, 1984?

A–17: No. Partial elections are not allowed. An election under either of the two elective transitional rules applies to all transfers governed by that election whether before or after the election is made, and is irrevocable.

(g) *Property settlements—time and manner of making the elections under section 1041.*

Q–18: How do spouses (or former spouses) elect to have section 1041 apply to transfers after December 31, 1983, or to transfers after July 18, 1984 under instruments in effect on or before July 18, 1984?

A–18: In order to make an election under section 1041 for property transfers after December 31, 1983, or property transfers under instruments that were in effect on or before July 18, 1984, both spouses (or former spouses) must elect the application of the rules of section 1041 by attaching to the transferor's first filed income tax return for the taxable year in which the first transfer occurs, a statement signed by both spouses (or former spouses) which includes each spouse's social security number and is in substantially the form set forth at the end of this answer.

In addition, the transferor must attach a copy of such statement to his or her return for each subsequent taxable year in which a transfer is made that is governed by the transitional election. A copy of the signed statment must be kept by both parties.

The election statements shall be in substantially the following form:

In the case of an election regarding transfers after 1983:

SECTION 1041 ELECTION

The undersigned hereby elect to have the provisions of section 1041 of the Internal Revenue Code apply to all qualifying transfers of property after December 31, 1983. The undersigned understand that section 1041 applies to all property transferred between spouses, or former spouses incident to divorce. The parties further understand that the effects for Federal income tax purposes of having section 1041 apply are that (1) no gain or loss is recognized by the transferor spouse or former spouse as a result of this transfer; and (2) the basis of the transferred property in the hands of the transferee is the adjusted basis of the property in the hands of the transferor immediately before the transfer, whether or not the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of the transfer. The undersigned understand that if the transferee spouse or former spouse disposes of the property in a transaction in which gain is recognized, the amount of gain which is taxable may be larger than it would have been if this election had not been made.

In the case of an election regarding preexisting decrees:

SECTION 1041 ELECTION

The undersigned hereby elect to have the provisions of section 1041 of the Internal Revenue Code apply to all qualifying transfers of property after July 18, 1984 under any instrument in effect on or before July 18, 1984. The undersigned understand that section 1041 applies to all property transferred between spouses, or former spouses incident to the divorce. The parties further understand that the effects for Federal income tax purposes of having section 1041 apply are that (1) no gain or loss is recognized by the transferor spouse or former spouse as a result of this transfer; and (2) the basis of the transferred property in the hands of the transferee is the adjusted basis of the property in the hands of the transferor immediately before the transfer, whether or not the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of the transfer. The undersigned understand that if the transferee spouse or former spouse disposes of the property in a transaction in which gain is recognized, the amount of gain which is taxable may be larger than it would have been if this election had not been made.

(Secs. 1041(d)(4), (98 Stat. 798, 26 U.S.C. 1041(d)(4)), 152(e)(2)(A) (98 Stat. 802, 26 U.S.C. 152(e)(2)(A)), 215(c) (98 Stat. 800, 26 U.S.C. 215(c)) and 7805 (68A Stat. 917, 26 U.S.C. 7805) of the Internal Revenue Code of 1954))

[T.D. 7973, 49 FR 34452, Aug. 31, 1984]

§ 1.1042–1T Questions and answers relating to the sales of stock to employee stock ownership plans or certain cooperatives (temporary).

Q–1: What does section 1042 provide?

A–1: (a) Section 1042 provides rules under which a taxpayer may elect not to recognize gain in certain cases where *qualified securities* are sold to a qualifying employee stock ownership plan or worker-owned cooperative in taxable years of the seller beginning after July 18, 1984, and *qualified replacement property* is purchased by the taxpayer within the *replacement period.* If the requirements of Q&A–2 of this section are met, and if the taxpayer makes an election under section 1042(a) in accordance with Q&A–3 of this section, the gain realized by the taxpayer on the sale of the qualified securities is recognized only to the extent that the amount realized on such sale exceeds the cost to the taxpayer of the qualified replacement property.

(b) Under section 1042, the term *qualified securities* means employer securities (as defined in section 409(l)) with respect to which each of the following requirements is satisfied: (1) The employer securities were issued by a domestic corporation; (2) for at least one year before and immediately after the sale, the domestic corporation that issued the employer securities (and each corporation that is a member of a *controlled group of corporations* with such corporation for purposes of section 409(l)) has no stock outstanding that is readily tradeable on an established market; (3) as of the time of the sale, the employer securities have been held by the taxpayer for more than 1 year; and (4) the employer securities were not received by the taxpayer in a distribution from a plan described in section 401(a) or in a transfer pursuant to an option or other right to acquire stock to which section 83, 422, 422A, 423, or 424 applies.

(c) The term *replacement period* means the period which begins 3 months before the date on which the sale of qualified securities occurs and which ends 12 months after the date of such sale. A replacement period may include any period which occurs prior to July 19, 1984.

(d) The term *qualified replacement property* means any securities (as defined in section 165(g)(2)) issued by a domestic corporation which does not, for the taxable year of such corporation in which the securities are purchased by the taxpayer, have passive investment income (as defined in section 1362(d)(3)(D)) that exceeds 25 percent of the gross receipts of such corporation for the taxable year preceding the taxable year of purchase. In addition, securities of the domestic corporation that issued the employer securities qualifying under section 1042 (and of any corporation that is a member of a *controlled group of corporations* with such corporation for purposes of section 409(l)) will not qualify as *qualified replacement property*.

(e) For purposes of section 1042(a), there is a *purchase* of qualified replacement property only if the basis of such property is determined by reference to its cost to the taxpayer. If the basis of the qualified replacement property is determined by reference to its basis in the hands of the transferor thereof or another person, or by reference to the basis of property (other than cash or its equivalent) exchanged for such property, then the basis of such property is not determined solely by reference to its cost to the taxpayer.

Q–2: What is a sale of qualified securities for purposes of section 1042(b)?

A–2: (a) Under section 1042(b), a sale of qualified securities is one under which all of the following requirements are met:

(1) The qualified securities are sold to an employee stock ownership plan (as defined in section 4975(e)(7)) maintained by the corporation that issued the qualified securities (or by a member of the *controlled group of corporations* with such corporation for purposes of section 409(l)) or to an eligible worker-owned cooperative (as defined in section 1042(c)(2));

(2) The employee stock ownership plan or eligible worker-owned cooperative owns, immediately after the sale, 30 percent or more of the total value of the employer securities (within the meaning of section 409(l) outstanding as of such time;

(3) No portion of the assets of the employee stock ownership plan or eligible worker-owned cooperative attributable to qualified securities that are sold to the plan or cooperative by the taxpayer or by any other person in a sale with respect to which an election under section 1042(a) is made accrue under the plan or are allocated by the cooperative, either directly or indirectly and either concurrently with or at any time thereafter, for the benefit of (i) the taxpayer; (ii) any person who is a member of the family of the taxpayer (within the meaning of section 267(c)(4)); or (iii) any person who owns (after the application of section 318(a)), at any time after July 18, 1984, and until immediately after the sale, more than 25 percent of in value of the outstanding portion of any class of stock of the corporation that issued the qualified securities (or of any member of the *controlled group of corporations* with such corporation for purposes of section 409(l)). For purposes of this calculation, stock that is owned, directly or indirectly, by or for a qualified plan shall not be treated as outstanding.

(4) The taxpayer files with the Secretary (as part of the required election described in Q&A–3 of this section) a

verified written statement of the domestic corporation (or corporations) whose employees are covered by the plan acquiring the qualified securities or of any authorized officer of the eligible workerowned cooperative, consenting to the application of section 4978(a) with respect to such corporation or cooperative.

(b) For purposes of determining whether paragraph (a)(2) of this section is satisfied, sales of qualified securities by two or more taxpayers may be treated as a single sale if such sales are made as part of a single, integrated transaction under a prearranged agreement between the taxpayers.

(c) For purposes of determining whether paragraph (a)(3) of this section is satisfied with respect to the prohibition against an accrual or allocation of qualified securities, the accrual or allocation of any benefits or contributions or other assets that are not attributable to qualified securities sold to the employee stock ownership plan or eligible worker-owned cooperative in a sale with respect to which an election under section 1042(a) is made (including any accrual or allocation under any other plan or arrangement maintained by the corporation or any member of *the controlled group of corporations* with such corporation for purposes of section 409(l)) must be made without regard to the allocation of such qualified securities. Paragraph (a)(3) of this section above may be illustrated in part by the following example: Individuals A, B, and C own 50, 25, and 25, respectively, of the 100 outstanding shares of common stock of Corporation X. Such shares constitute qualified securities as defined in Q&A–1 of this section. A and B, but not C, are employees of Corporation X. For the benefit of all its employees, Corporation X establishes an employee stock ownership plan that obtains a loan meeting the exemption requirements of section 4975(d)(3). The loan proceeds are used by the plan to purchase the 100 shares of qualified securities from A, B, and C, all of whom elect nonrecognition treatment under section 1042(a) with respect to the gain realized on their sale of such securities. Under the requirements of paragraph (a)(3) of this section, no part of the assets of the plan attributable to the 100 shares of qualified securities may accrue under the plan (or under any other plan or arrangement maintained by Corporation X) for the benefit of A or B or any person who is a member of the family of A or B (as determined under section 267(c)(4)). Furthermore, no other assets of the plan or assets of the employer may accrue for the benefit of such individuals in lieu of the receipt of assets attributable to such qualified securities.

(d) A sale under section 1042(a) shall not include any sale of securities by a dealer or underwriter in the ordinary course of its trade or business as a dealer or underwriter, whether or not guaranteed.

Q–3: What is the time and manner for making the election under section 1042(a)?

A–3: (a) The election not to recognize the gain realized upon the sale of qualified securities to the extent provided under section 1042(a) shall be made in a *statement of election* attached to the taxpayer's income tax return filed on or before the due date (including extensions of time) for the taxable year in which the sale occurs. If a taxpayer does not make a timely election under this section to obtain section 1042(a) nonrecognition treatment with respect to the sale of qualified securities, it may not subsequently make an election on an amended return or otherwise. Also, an election once made is irrevocable.

(b) The statement of election shall provide that the taxpayer elects to treat the sale of securities as a sale of qualified securities under section 1042(a), and shall contain the following information:

(1) A description of the qualified securities sold, including the type and number of shares;

(2) The date of the sale of the qualified securities;

(3) The adjusted basis of the qualified securities;

(4) The amount realized upon the sale of the qualified securities;

(5) The identity of the employee stock ownership plan or eligible worker-owned cooperative to which the qualified securities were sold; and

(6) If the sale was part of a single, interrelated transaction under a prearranged agreement between taxpayers involving other sales of qualified securities, the names and taxpayer identification numbers of the other taxpayers under the agreement and the number of shares sold by the other taxpayers. See Q&A–2 of this section.

If the taxpayer has purchased qualified replacement property at the time of the election, the taxpayer must attach as part of the statement of election a *statement of purchase* describing the qualified replacement property, the date of the purchase, and the cost of the property, and declaring such property to be the qualified replacement property with respect to the sale of qualified securities. Such statement of purchase must be notarized by the later of thirty days after the purchase or March 6, 1986. In addition, the statement of election must be accompanied by the verified written statement of consent required under Q&A–2 of this section with respect to the qualified securities sold.

(c) If the taxpayer has not purchased qualified replacement property at the time of the filing of the statement of election, a timely election under this Q&A shall not be considered to have been made unless the taxpayer attaches the notarized statement of purchase described above to the taxpayer's income tax return filed for the taxable year following the year for which the election under section 1042(a) was made. Such notarized statement of purchase shall be filed with the district director or the director of the regional service center with whom such election was originally filed, if the return is not filed with such director.

Q–4: What is the basis of qualified replacement property?

A–4: If a taxpayer makes an election under section 1042(a), the basis of the qualified replacement property purchased by the taxpayer during the replacement period shall be reduced by an amount equal to the amount of gain which was not recognized. If more than one item of qualified replacement property is purchased, the basis of each of such items shall be reduced by an amount determined by multiplying the total gain not recognized by reason of the application of section 1042(a) by a fraction, the numerator of which is the cost of such item of property and the denominator of which is the total cost of all such items of property. For the rule regarding the holding period of qualified replacement property, see section 1223(13).

Q–5: What is the statute of limitations for the assessment of a deficiency relating to the gain on the sale of qualified securities?

A–5: (a) If any gain is realized by the taxpayer on the sale of any qualified securities and such gain has not been recognized under section 1042(a) in accordance with the requirements of this section, the statutory period provided in section 6501(a) for the assessment of any deficiency with respect to such gain shall not expire prior to the expiration of 3 years from the date of receipt, by the district director or director of regional service center with whom the statement of election under 1042(a) was originally filed, of:

(1) A notarized statement of purchase as described in Q&A–3;

(2) A written statement of the taxpayer's intention not to purchase qualified replacement property within the replacement period; or

(3) A written statement of the taxpayer's failure to purchase qualified replacement property within the replacement period.

In those situations when a taxpayer is providing a written statement of an intention not to purchase or of a failure to purchase qualified replacement property, the statement shall be accompanied, where appropriate, by an amended return for the taxable year in which the gain from the sale of the qualified securities was realized, in order to reflect the inclusion in gross income for that year of gain required to be recognized in connection with such sale.

(b) Any gain from the sale of qualified securities which is required to be recognized due to a failure to meet the requirements under section 1042 shall be included in the gross income for the taxable year in which the gain was realized. If any gain from the sale of qualified securities is not recognized under section 1042(a) in accordance with the requirements of this section, any deficiency attributable to any portion of such gain may be assessed at any time before the expiration of the 3-year period described in this Q&A, notwithstanding the provision of any law or rule of law which would otherwise prevent such assessment.

Q–6: When does section 1042 become effective?

A–6: Section 1042 applies to sales of qualified securities in taxable years of sellers beginning after July 18, 1984.

[T.D. 8073, 51 FR 4333, Feb. 4, 1986]

§ 1.1044(a)–1 Time and manner for making election under the Omnibus Budget Reconciliation Act of 1993.

(a) *Description*. Section 1044(a), as added by section 13114 of the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103–66, 107 Stat. 430), generally allows individuals and C corporations that sell publicly traded securities after August 9, 1993, to elect not to recognize certain gain from the sale if the taxpayer purchases common stock or a partnership interest in a specialized small business investment company (SSBIC) within the 60-day period beginning on the date the publicly traded securities are sold.

(b) *Time and manner for making the election*. The election under section 1044(a) must be made on or before the due date (including extensions) for the income tax return for the year in which the publicly traded securities are sold. The election is to be made by reporting the entire gain from the sale of publicly traded securities on Schedule D of the income tax return in accordance with instructions for Schedule D, and by attaching a statement to Schedule D showing—

(1) How the nonrecognized gain was calculated;

(2) The SSBIC in which common stock or a partnership interest was purchased;

(3) The date the SSBIC stock or partnership interest was purchased; and

(4) The basis of the SSBIC stock or partnership interest.

(c) *Revocability of election*. The election described in this section is revocable with the consent of the Commissioner.

(d) *Effective date*. The rules set forth in this section are effective December 12, 1996.

[T.D. 8688, 61 FR 65322, Dec. 12, 1996]

SPECIAL RULES

§ 1.1051–1 Basis of property acquired during affiliation.

(a)(1) The basis of property acquired by a corporation during a period of affiliation from a corporation with which it was affiliated shall be the same as it would be in the hands of the corporation from which acquired. This rule is applicable if the basis of the property is material in determining tax liability for any year, whether a separate return or a consolidated return is made in respect of such year. For the purpose of this section, the term *period of affiliation* means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto), but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example: The X Corporation, the Y Corporation, and the Z Corporation were affiliated for the taxable year 1920. During that year the X Corporation transferred assets to the Y Corporation for $120,000 cash, and the Y Corporation in turn transferred the assets during the same year to the Z Corporation for $130,000 cash. The assets were acquired by the X Corporation in 1916 at a cost of $100,000. The basis of the assets in the hands of the Z Corporation is $100,000.

(b) The basis of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return was made or was required under the regulations governing the making of consolidated returns, shall be determined in accordance with such regulations. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made or is required under the regulations governing the making of consolidated returns, shall be adjusted in respect of any items relating to such period in accordance with such regulations.

(c) Except as otherwise provided in the regulations promulgated under section 1502 of the Internal Revenue Code of 1954 or the regulations under section 141 of the Internal Revenue Code of 1939 or the Revenue Act of 1938 (52 Stat. 447), 1936 (49 Stat. 1652), 1934 (48 Stat. 683), 1932 (47 Stat. 169), or 1928 (45 Stat. 791), the basis of property after a consolidated return period shall be the same as the basis immediately prior to the close of such period.

§1.1052–1 Basis of property established by Revenue Act of 1932.

Section 1052(a) provides that if property was acquired after February 28, 1913, in any taxable year beginning before January 1, 1934, and the basis of the property, for the purposes of the Revenue Act of 1932 (47 Stat. 169), was prescribed by section 113(a) (6), (7), or (9) of that act, then for purposes of subtitle A of the Code, the basis shall be the same as the basis prescribed in the Revenue Act of 1932. For the rules applicable in determining the basis of stocks or securities under section 113(a)(9) of the Revenue Act of 1932 in case of certain distributions after December 31, 1923, and in any taxable year beginning before January 1, 1934, see 26 CFR (1939) 39.113 (a)(12)–1 (Regulations 118).

§1.1052–2 Basis of property established by Revenue Act of 1934.

Section 1052(b) provides that if property was acquired after February 28, 1913, in any taxable year beginning before January 1, 1936, and the basis of the property for the purposes of the Revenue Act of 1934 (48 Stat. 683) was prescribed by section 113(a) (6), (7), or (8) of that act, then for purposes of subtitle A of the Code, the basis shall be the same as the basis prescribed in the Revenue Act of 1934. For example, if after December 31, 1920, and in any taxable year beginning before January 1, 1936, property was acquired by a corporation by the issuance of its stock or securities in connection with a transaction which is not described in section 112(b)(5) of the Internal Revenue Code of 1939 but which is described in section 112(b)(5) of the Revenue Act of 1934, the basis of the property so acquired shall be the same as it would be in the hands of the transferor, with proper adjustments to the date of the exchange.

§1.1052–3 Basis of property established by the Internal Revenue Code of 1939.

Section 1052(c) provides that if property was acquired after February 28, 1913, in a transaction to which the Internal Revenue Code of 1939 applied and the basis thereof was prescribed by section 113(a) (6), (7), (8), (13), (15), (18), (19) or (23) of such Code, then for purposes of subtitle A of the Internal Revenue Code of 1954, the basis shall be the same as the basis prescribed in the Internal Revenue Code of 1939. In such cases, see section 113(a) of the Internal Revenue Code of 1939 and the regulations thereunder.

§1.1053–1 Property acquired before March 1, 1913.

(a) *Basis for determining gain.* In the case of property acquired before March 1, 1913, the basis as of March 1, 1913, for determining gain is the cost or other basis, adjusted as provided in section 1016 and other applicable provisions of chapter 1 of the Code, or its fair market value as of March 1, 1913, whichever is greater.

(b) *Basis for determining loss.* In the case of property acquired before March 1, 1913, the basis as of March 1, 1913, for determining loss is the basis determined in accordance with part II (section 1011 and following), subchapter O, chapter 1 of the Code, or other applicable provisions of chapter 1 of the Code, without reference to the fair market value as of March 1, 1913.

(c) *Example.* The application of paragraphs (a) and (b) of this section may be illustrated by the following example:

Example: (i) On March 1, 1908, a taxpayer purchased for $100,000, property having a useful life of 50 years. Assuming that there were no capital improvements to the property, the depreciation sustained on the property before March 1, 1913, was $10,000 (5 years @ $2,000), so that the original cost adjusted, as of March 1, 1913, for depreciation sustained prior to that date is $90,000. On that date the property had a fair market value of $94,500 with a remaining life of 45 years.

(ii) For the purpose of determining gain from the sale or other disposition of the property on March 1, 1954, the basis of the property is the fair market value of $94,500 as of March 1, 1913, adjusted for depreciation allowed or allowable after February 28, 1913, computed on $94,500. Thus, the substituted basis, $94,500, is reduced by the depreciation adjustment from March 1, 1913, to February 28, 1954, in the aggregate of $86,100 (41 years @ $2,100), leaving an adjusted basis for determining gain of $8,400 ($94,500 less $86,100).

(iii) For the purpose of determining loss from the sale or other disposition of such property on March 1, 1954, the basis of the property is its cost, adjusted for depreciation sustained before March 1, 1913, computed on cost, and the amount of depreciation allowed or allowable after February 28, 1913, computed on the fair market value of $94,500 as of March 1, 1913. In this example, the amount of depreciation sustained before March 1, 1913, is $10,000 and the amount of depreciation determined for the period after February 28, 1913, is $86,100. Therefore, the aggregate amount of depreciation for which the cost ($100,000) should be adjusted is $96,100 ($10,000 plus $86,100), and the adjusted basis for determining loss on March 1, 1954, is $3,900 ($100,000 less $96,100).

(d) *Fair market value.* The determination of the fair market value of property on March 1, 1913, is generally a question of fact and shall be established by competent evidence. In determining the fair market value of stock or other securities, due regard shall be given to the fair market value of the corporate assets as of such date, and other pertinent factors. In the case of property traded in on public exchanges, actual sales on or near the basic date afford evidence of value. In general, the fair market value of a block or aggregate of a particular kind of property is not to be determined by a forced-sale price, or by an estimate of what a whole block or aggregate would bring if placed upon the market at one and the same time. In such a case the value should be determined by ascertaining as the basis the fair market value of each unit of the property. All relevant facts and elements of value as of the basic date should be considered in each case.

§ 1.1054–1 Certain stock of Federal National Mortgage Association.

(a) *In general.* The basis in the hands of the initial holder of a share of stock which is issued pursuant to section 303(c) of the Federal National Mortgage Association Charter Act (12 U.S.C., section 1718) in a taxable year beginning after December 31, 1959, shall be an amount equal to the issuance price of the stock reduced by the amount, if any, required by section 162(d) to be treated (with respect to such share) as an ordinary and necessary business expense. See section 162(d) and § 1.162–19. For purposes of this section the initial holder is the original purchaser who is issued stock of the Federal National Mortgage Association (FNMA) pursuant to section 303(c) of the Act and who appears on the books of FNMA as the initial holder. See § 1.162–19.

(b) *Example.* The provisions of this section may be illustrated by the following example:

Example: Pursuant to section 303(c) of the Federal National Mortgage Association Charter Act a certificate of FNMA stock is issued to A as of January 1, 1961. The issuance price of the stock was $100 and the fair market value of the stock on the date of issue was $69. A was required by section 162(d) to treat $31 as a business expense for the year 1961. The basis of the share of stock in the hands of A, the initial holder, shall be $69, the amount paid for the stock ($100) reduced by $31.

[T.D. 6690, 28 FR 12254, Nov. 19, 1963]

§ 1.1055–1 General rule with respect to redeemable ground rents.

(a) *Character of a redeemable ground rent.* For purposes of subtitle A of the Code (1) a redeemable ground rent (as defined in section 1055(c) and paragraph (b) of this section) shall be treated as being in the nature of a mortgage, and (2) real property held subject to liabilities under such a redeemable ground rent shall be treated as held subject to liabilities under a mortgage. Thus, under section 1055(a) and this paragraph, the transfer of property subject to a redeemable ground rent has the same effect as the transfer of property subject to a mortgage, the acquisition of property subject to a redeemable ground rent is to be treated the same as the acquisition of property subject to a mortgage, and the holding of property subject to a redeemable ground rent is to be treated in the same manner as the holding of property subject to a mortgage. See section 163(c) for the treatment of any annual or periodic rental payment under a redeemable ground rent as interest.

(b) *Definition of redeemable ground rent.* For purposes of subtitle A of the Code, the term *redeemable ground rent* means only a ground rent with respect to which all the following conditions are met:

(1) There is a lease of land which is assignable by the lessee without the consent of the lessor.

(2) The term of the lease is for a period in excess of 15 years, taking into account all periods for which the lease may be renewed at the option of the lessee.

(3) The lessee has a present or future right to terminate the lease and to acquire the lessor's interest in the land (i.e., to redeem the ground rent) by the payment of a determined or determinable amount, which amount is referred to in §§1.1055–2, 1.1055–3, and 1.1055–4 as a *redemption price.* Such right must exist by virtue of State or local law. If the lessee's right to terminate the lease and to acquire the lessor's interest is not granted by State or local law but exists solely by virtue of a private agreement or privately created condition, the ground rent is not a *redeemable ground rent.*

(4) The lessor's interest in the land subject to the lease is primarily a security interest to protect the payment to him of the annual or periodic rental payments due under the lease.

(c) *Effective date.* In general, the provisions of section 1055 and paragraph (a) of this section take effect on April 11, 1963, and apply with respect to taxable years ending on or after such date. See §1.1055–3 for rules for determining the basis of real property acquired subject to liabilities under a redeemable ground rent regardless of when such property was acquired. See also §1.1055–4 for rules for determining the basis of a redeemable ground rent in the hands of a holder who reserved or created such ground rent in connection with a transfer, occurring before April 11, 1963, of the right to hold real property subject to liabilities under such ground rent.

[T.D. 6821, 30 FR 6216, May 4, 1965]

§1.1055–2 Determination of amount realized on the transfer of the right to hold real property subject to liabilities under a redeemable ground rent.

In determining the amount realized from a transfer, occurring on or after April 11, 1963, of the right to hold real property subject to liabilities under a redeemable ground rent, such ground rent shall be accounted for in the same manner as a mortgage for an amount of money equal to the redemption price of the ground rent. The provisions of this section apply in respect of any such transfer even though such ground rent was created prior to April 11, 1963. For provisions relating to the determination of the amount of and recognition of gain or loss from the sale or other disposition of property, see section 1001 and the regulations thereunder.

[T.D. 6821, 30 FR 6217, May 4, 1965]

§1.1055–3 Basis of real property held subject to liabilities under a redeemable ground rent.

(a) *In general.* The provisions of section 1055(a) and paragraph (a) of §1.1055–1 are applicable in determining the basis of real property held on or after April 11, 1963, in any case where the property at the time of acquisition was subject to liabilities under a redeemable ground rent. (See section 1055(b)(2).) Thus, if on or after April 11, 1963, a taxpayer holds real property which was subject to liabilities under a redeemable ground rent at the time he acquired it, the basis of such property in the hands of such taxpayer, regardless of when the property was acquired, will include the redeemable ground rent in the same manner as if it were a mortgage in an amount equal to the redemption price of such ground rent. Likewise, if on or after April 11, 1963, a taxpayer holds real property which was subject to liabilities under a redeemable ground rent at the time he acquired it and which has a substituted basis in his hands, the basis of the property in the hands of the taxpayer's predecessor in interest is to be determined by treating the redeemable ground rent in the same manner as a mortgage in an amount equal to the redemption price of such ground rent.

(b) *Illustrations.* The provisions of this section may be illustrated by the following examples:

Example 1. On April 11, 1963, taxpayer A held residential property which he acquired on January 15, 1963, for a purchase price of $10,000 and which, at the time he acquired it, was subject to a ground rent redeemable for a redemption price of $1,600. A's basis for the property includes the purchase price ($10,000) plus the redeemable ground rent in the same manner as if it were a mortgage for $1,600.

Example 2. In 1962, taxpayer X, a corporation, acquired real property subject to a redeemable ground rent in a transfer to which section 351 (relating to transfer of property to corporation controlled by transferor) applied and in which the basis of the property to X was the transferor's basis. X still held the property on April 11, 1963. The transferor's basis in the property is to be determined by treating the redeemable ground rent to which it was subject in the transferor's hands as if it were a mortgage.

[T.D. 6821, 30 FR 6217, May 4, 1965]

§ 1.1055–4 Basis of redeemable ground rent reserved or created in connection with transfers of real property before April 11, 1963.

(a) *In general.* In the case of a redeemable ground rent created or reserved in connection with a transfer, occurring before April 11, 1963, of the right to hold real property subject to liabilities under such ground rent, the basis of such ground rent on or after April 11, 1963, in the hands of the person who reserved or created the ground rent is the amount which was taken into account in respect of such ground rent in computing the amount realized from the transfer of such real property. Thus, if no such amount was taken into account, such basis shall be determined without regard to section 1055. (See section 1055(b)(3).)

(b) The provisions of this section may be illustrated by the following examples:

Example 1. The taxpayer, who was in the business of building houses, purchased an undeveloped lot of land for $500 and built a house thereon at a cost of $10,000. Subsequently, he transferred the right to hold the lot improved by the house for a consideration of $12,000, and an annual ground rent for such property of $120 which was redeemable for a redemption price of $2,000. The taxpayer reported a $2,000 gain on the transfer, treating the amount realized as $12,000 and his cost allocable to the interest transferred as $10,000. Since the builder did not take the redeemable ground rent into account in computing gain on the transfer, his basis for such ground rent is $500 (the cost of the land not offset against the consideration received for the transfer). Thus, if he subsequently sells the redeemable ground rent (or if it is redeemed from him) for $2,000, he has no gain of $1,500 in the year of sale (or redemption).

Example 2. Assume the same facts as in Example 1 except that the builder reported a gain of $3,500 on the transfer, treating the amount realized as $14,000 ($12,000 cash plus $2,000 for the redeemable ground rent) and his costs as $10,500 ($10,000 for the house and $500 for the lot). Since the taxpayer took the entire amount of the redeemable ground rent into account in computing his gain, his basis for such ground rent is $2,000. Thus, if he subsequently sells the redeemable ground rent (or if it is redeemed from him) for $2,000, he has no gain or loss on the transaction.

Example 3. Assume the same facts as in Example 1 except that the builder reported a gain of $3,000 on the transfer. He computed this gain by treating the amount realized as $12,000 but treating his cost allocable to the interest transferred as $12,000/$14,000ths of his total $10,500 cost, or $9,000. Since the builder still has remaining $1,500 of unallocated cost, his basis for the redeemable ground rent is $1,500. Thus, if he subsequently sells the redeemable ground rent (or if it is redeemed from him) for $2,000, he has a gain of $500 in the year of sale (or redemption).

[T.D. 6821, 30 FR 6217, May 4, 1965]

§ 1.1059(e)–1 Non-pro rata redemptions.

(a) *In general.* Section 1059(d)(6) (exception where stock held during entire existence of corporation) and section 1059(e)(2) (qualifying dividends) do not apply to any distribution treated as an extraordinary dividend under section 1059(e)(1). For example, if a redemption of stock is not pro rata as to all shareholders, any amount treated as a dividend under section 301 is treated as an extraordinary dividend regardless of whether the dividend is a qualifying dividend.

(b) *Reorganizations.* For purposes of section 1059(e)(1), any exchange under section 356 is treated as a redemption and, to the extent any amount is treated as a dividend under section 356(a)(2), it is treated as a dividend under section 301.

(c) *Effective date.* This section applies to distributions announced (within the meaning of section 1059(d)(5)) on or after June 17, 1996.

[T.D. 8724, 62 FR 38028, July 16, 1997]

§1.1059A–1 Limitation on taxpayer's basis or inventory cost in property imported from related persons.

(a) *General rule.* In the case of property imported into the United States in a transaction (directly or indirectly) by a controlled taxpayer from another member of a controlled group of taxpayers, except for the adjustments permitted by paragraph (c) (2) of this section, the amount of any costs taken into account in computing the basis or inventory cost of the property by the purchasing U.S. taxpayer and which costs are also taken into account in computing the valuation of the property for customs purposes may not, for purposes of the basis or inventory cost, be greater than the amount of the costs used in computing the customs value. For purposes of this section, the terms *controlled taxpayer* and *group of controlled taxpayers* shall have the meaning set forth in §1.482–1(a).

(b) *Definitions*—(1) *Import.* For purposes of section 1059A and this section only, the term *import* means the filing of the entry documentation required by the U.S. Customs Service to secure the release of imported merchandise from custody of the U.S. Customs Service.

(2) *Indirectly.* For purposes of this section, *indirectly* refers to a transaction between a controlled taxpayer and another member of the controlled group whereby property is imported through a person acting as an agent of, or otherwise on behalf of, either or both related persons, or as a middleman or conduit for transfer of the property between a controlled taxpayer and another member of the controlled group. In the case of the importation of property indirectly, an adjustment shall be permitted under paragraph (c)(2) of this section for a commission or markup paid to the person acting as agent, middleman, or conduit, only to the extent that the commission or markup: is otherwise properly included in cost basis or inventory cost; was actually incurred by the taxpayer and not remitted, directly or indirectly, to the taxpayer or related party; and there is a substantial business reason for the use of a middleman, agent, or conduit.

(c) *Customs value*—(1) *Definition.* For purposes of this section only, the term *customs value* means the value required to be taken into account for purposes of determining the amount of any customs duties or any other duties which may be imposed on the importation of any property. Where an item or a portion of an item is not subject to any customs duty or is subject to a free rate of duty, such item or portion of such item shall not be subject to the provisions of section 1059A or this section. Thus, for example, the portion of an item that is an American good returned and not subject to duty (items 806.20 and 806.30, Tariff Schedules of the United States, 19 U.S.C. 1202); imports on which no duty is imposed that are valued by customs for statistical purposes only; and items subject to a zero rate of duty (19 U.S.C. 1202, General Headnote 3) are not subject to section 1059A or this section. Also, items subject only to the user fee under 19 U.S.C. 58(c), or the harbor maintenance tax imposed by 26 U.S.C. 4461, or only to both, are not subject to section 1059A or this section. This section imposes no limitation on a claimed basis or inventory cost in property which is less than the value used to compute the customs duty with respect to the same property. Section 1059A and this section have no application to imported property not subject to any customs duty based on value, including property subject only to a per item duty or a duty based on volume, because there is no customs value, within the meaning of this paragraph, with respect to such property.

(2) *Adjustments to customs value.* To the extent not otherwise included in customs value, a taxpayer, for purposes of determining the limitation on claimed basis or inventory cost of property under this section, may increase the customs value of imported property by the amounts incurred by it and properly included in inventory cost for—

(i) Freight charges,

(ii) Insurance charges,

(iii) The construction, erection, assembly, or technical assistance provided with respect to, the property after its importation into the United States, and

(iv) Any other amounts which are not taken into account in determining the customs value, which are not properly includible in customs value, and which are appropriately included in the cost basis or inventory cost for income tax purposes. See § 1.471–11 and section 263A.

Appropriate adjustments may also be made to customs values when the taxpayer has not allocated the value of assists to individual articles but rather has reported the value of assists on a periodic basis in accordance with 19 CFR 152.103(e). When 19 CFR 152.103(e) has been utilized for customs purposes, the taxpayer may adjust his customs values by allocating the value of the assists to all imported articles to which the assists relate. To the extent that an amount attributable to an adjustment permitted by this section is paid by a controlled taxpayer to another member of the group of controlled taxpayers, an adjustment is permitted under this section only to the extent that the amount incurred represents an arm's length charge within the meaning of § 1.482–1(d)(3).

(3) *Offsets to adjustments.* To the extent that a customs value is adjusted under paragraph (c)(2) of this section for purposes of calculating the limitation on claimed cost basis or inventory cost under this section, the amount of the adjustments must be offset (reduced) by amounts that properly reduce the cost basis of inventory and that are not taken into account in determining customs value, such as rebates and other reductions in the price actually incurred, effected between the purchaser and related seller after the date of importation of the property.

(4) *Application of section 1059A to property having dutiable and nondutiable portions.* When an item of imported property is subiect to a duty upon the full value of the imported article, less the cost or value of American goods returned, and the taxpayer claims a basis or inventory cost greater than the customs value reported for the item, the claimed tax basis or inventory cost in the dutiable portion of the item is limited under section 1059A and this section to the customs value of the dutiable portion under paragraph (c)(1). The claimed tax basis or inventory cost in the nondutiable portion of the item is determined by multiplying the customs value of the nondutiable portion by a fraction the numerator of which is the amount by which the claimed basis or inventory cost of the item exceeds the customs value of the item and the denominator of which is the customs value of the item and adding this amount to the customs value of the nondutiable portion of the item. The claimed tax basis or inventory cost in the dutiable portion is determined by multiplying the customs value of the dutiable portion by a fraction the numerator of which is the amount by which the claimed basis or inventory cost of the item exceeds the customs value of the item and the denominator of which is the customs value of the item and adding this amount to the customs value of the dutiable portion of the item. However, the taxpayer may not claim a tax basis or inventory cost in the dutiable portion greater than the customs value of this portion of the item.

(5) *Allocation of adjustments to property having dutiable and nondutiable portions.* When an item of imported property is subject to a duty upon the full value of the imported article, less the cost or value of American goods returned, and the taxpayer establishes that the customs value may be increased by adjustments permitted under paragraph (c)(2) of this section for purposes of the section 1059A limitation, the taxpayer's basis or inventory cost of the dutiable portion of the item is determined by multiplying the customs value of the dutiable portion times the percentage that the adjustments represent of the total customs value of the item and adding this amount to the customs value of the dutiable portion of the item. The taxpayer's basis or inventory cost of the nondutiable portion of the item is determined in the same manner. The amount so determined for the dutiable portion of the item is the section 1059A limitation for this portion of the item.

(6) *Alternative method of demonstrating compliance.* In lieu of calculating all adjustments and offsets to adjustments to customs value for an item of property pursuant to paragraph (c) (2) and (3) of this section, a taxpayer may demonstrate compliance with this section and section 1059A by comparing costs taken into account in computing basis or inventory costs of the property and the costs taken into account in computing customs value at any time after importation, provided that in any such comparison the same costs are included both in basis or inventory costs and in customs value. If, on the basis of such comparison, the basis or inventory cost is equal to or less than the customs value, the taxpayer shall be deemed to have met the requirements of this section and section 1059A.

(7) *Relationship of section 1059A to section 482.* Neither this section nor section 1059A limits in any way the authority of the Commissioner to increase or decrease the claimed basis or inventory cost under section 482 or any other appropriate provision of law. Neither does this section or section 1059A permit a taxpayer to adjust upward its cost basis or inventory cost for property appropriately determined under section 482 because such basis or inventory cost is less than the customs value with respect to such property.

(8) *Illustrations.* The application of this section may be illustrated by the following examples:

Example 1. Corporation X, a United States taxpayer, and Y Corporation are members of a group of controlled corporations. X pays $2,000 to Y for merchandise imported into the United States and an additional $150 for ocean freight and insurance. The customs value of the shipment is determined to be the amount actually paid by X ($2,000) and does not include the charges for ocean freight and insurance. For purposes of computing the limitation on its inventory cost for the merchandise under section 1059A and this section, X is permitted, under paragraph (c)(2) of this section, to increase the customs value ($2,000) by amounts it paid for ocean freight and insurance charges ($150). Thus, the inventory cost claimed by X in the merchandise may not exceed $2,150.

Example 2. Assume the same facts as in Example 1 except that, subsequent to the date of importation of the merchandise, Y grants to X a rebate of $200 of the purchase price. At the time of sale, the rebate was contingent upon the volume of merchandise ultimately bought by X from Y. The value of the merchandise, for customs purposes, is not decreased by the rebate paid to X by Y. Therefore, the customs value, for customs purposes, of the merchandise remains the same ($2,000). For purposes of computing its inventory cost, X was permitted, under paragraph (c)(2) of this section, to increase the customs value for purposes of section 1059A of $2,000 by the amounts it paid for ocean freight and insurance charges ($150). However, under paragraph (c)(3) of this section, X is required to reduce the amount of the customs value by the lesser of the amount of the rebate or the amount of any positive adjustments to the original customs value. The inventory price claimed by X may not exceed $2,000 ($2,000 customs value, plus $150 transportation adjustment, less $150 offsetting rebate adjustment). While X's limitation under section 1059A is $2,000, X may not claim a basis or inventory cost in the merchandise in excess of $1,950. *See* I.R.C. section 1012; and section 1.471–2.

Example 3. Corporation X, a United States taxpayer, and Y Corporation are members of a group of controlled corporations. X pays $10,000 to Y for merchandise imported into the United States. The merchandise is composed, in part, of American goods returned. The customs value of the merchandise, on which a customs duty is imposed, is determined to be $8,000 ($10,000, the amount declared by X, less $2,000, the value of the American goods returned). For income tax purposes, X claims a cost basis in the merchandise of $11,000. None of the adjustments permitted by paragraph (c)(2) of this section is applicable. The portion of the merchandise constituting American goods returned represented 20 percent of the total customs value of the merchandise. Since the cost basis claimed by X for income tax purposes represents a 10 percent increase over the customs valuation (before reduction for American goods returned), the claimed tax basis in the dutiable content is considered to be $8,800 and in the portion constituting American goods returned is $2,200. Since a customs duty was imposed only on the dutiable content of the merchandise, the limitation in section 1059A and this section is applicable only to the claimed tax basis in this portion of the merchandise. Accordingly, under paragraph (a) of this section, X is limited to a cost basis of $10,200 in the merchandise. This amount represents a cost basis of $8,000 in the dutiable content and of $2,200 in the portion of the merchandise constituting American goods returned.

Example 4. Assume the same facts as in Example 3 except that X establishes that it is entitled to increase its customs value by $1,000 in adjustments permitted by paragraph (c)(2) of this section. Since the adjustments to customs value that X is entitled to under paragraph (c)(2) of this section are 10 percent of the customs value, for purposes of determining the limitation under section 1059A and this section, both the dutiable content and the portion of the merchandise constituting American goods returned shall be increased to an amount 10 percent greater than the respective values determined for customs purposes, or $8,800 for the dutiable content and $2,200 for the portion of the merchandise constituting American goods returned. Accordingly, under paragraph (a) of this section, X is limited to a cost basis of $11,000 in the merchandise.

Example 5. Corporation X, a United States taxpayer, and Y Corporation are members of a group of controlled corporations. X pays $10,000 to Y for merchandise imported into the United States. The customs value of the merchandise, on which a customs duty is imposed, is determined to be $10,000. Subsequent to the date of importation of the merchandise, Y grants to X a rebate of $1,000 of the purchase price. The value of the merchandise, for customs purposes, is not decreased by the rebate paid to X by Y. Notwithstanding the fact that X correctly reported and paid customs duty on a value of $10,000 and that its limitation on basis or inventory cost under this section is $10,000, X may not claim a basis or inventory cost in the merchandise in excess of $9,000. *See* I.R.C. section 1012; and section 1.471–2.

Example 6. Corporation X, a United States taxpayer, and Y Corporation are members of a group of controlled corporations. X pays $5,000 to Y for merchandise imported into the United States. The merchandise is not subject to a customs duty or is subject to a free rate of duty and is valued by customs solely for statistical purposes. Accordingly, pursuant to paragraph (c)(1) of this section, the merchandise is not subject to the provisions of section 1059A or this section.

Example 7. Assume the same facts as in Example 6, except that the merchandise is subject to a customs duty based on value and that the customs value (taking into account no costs other than the value of the goods) is determined to be $5,000. Assume further that the $5,000 payment is only for the value of the goods, no other cost is reflected in that payment, and only the $5,000 payment to Y is reflected in X's inventory cost or basis prior to inclusion of any other amounts properly included in inventory or cost basis. Pursuant to paragraph (c)(6) of this section, X, by demonstrating these facts is deemed to meet the requirements of this section and section 1059A.

Example 8. Corporation X, a United States taxpayer, and Y Corporation are members of a group of controlled corporations. X pays $9 to Y for merchandise imported into the United States and an additional $1 for ocean freight. The customs value of the article does not include the $l paid for ocean freight. Furthermore, for customs purposes the value is calculated pursuant to computed value and is determined to be $8. For purposes of computing the limitation on its inventory cost for the article under section 1059A and this section, X is permitted, under paragraph (c)(2) of this section, to increase the customs value ($8) by the amount it paid for ocean freight ($1). Thus, the inventory cost claimed by X in the article may not exceed $9.

(9) *Averaged customs values.* In cases of transactions in which (i) an appropriate transfer price is properly determined for tax purposes by reference to events occurring after importation, (ii) the value for customs purposes of one article is higher and of a second article is lower than the actual transaction values, (iii) the relevant articles have been appraised on the basis of a value estimated at the time of importation in accordance with customs regulations, and (iv) the entries have been liquidated upon importation, the section 1059A limitation on the undervalued article may be increased up to the amount of actual transaction value by the amount of the duty overpaid on the overvalued article times a fraction the numerator of which is "1" and the denominator of which is the rate of duty on the undervalued article. This paragraph (c)(9) applies exclusively to cases of property imported in transactions that are open for tax purposes in which the actual transaction value cannot be determined and the entry has been liquidated for customs purposes on the basis of a value estimated at the time of importation in accordance with customs regulations; in these cases, the property is appropriately valued for tax purposes by reference to a formula, in existence at the time of importation, based on subsequent events and valued for customs purposes by a different formula. This paragraph (c)(9) does not apply where customs value is correctly determined for purposes of liquidating the entry and where the customs value is subsequently adjusted for tax purposes, for example by a rebate, under paragraph (c)(2) of this section. The application of paragraph (c)(9) may be illustrated by the following example:

Example: Corporation X, a United States taxpayer, and Y Corporation are members of a group of controlled corporations. X purchases Articles A and B from Y on consignment and imports the Articles into the United States. The purchase price paid by X will be determined as a percentage of the sale prices that X realizes. Rather than deferring liquidation, customs liquidates the entry on the basis of estimated values and the customs duties are paid by X. Ultimately, it is determined that Article A was undervalued and Article B was overvalued by X for customs purposes. The section 1059A limitation for Article A is computed as follows:

	Article A	Article B
Finally-determined customs value	$9	$9
Transaction value	$10	$5
Duty rate	10%	5%
Customs duty paid	$.90	$.45
Duty overpaid or (underpaid)	($.10)	$.20

The section 1059A limitation on Article A may be increased by the amount of the duty over-paid on Article B, $.20, times 1/.10, up to the amount of the transaction value. Therefore, the section 1059A limitation on Article A is $9.00 plus $1.00, or a total of $10.00. The section 1059A limitation on Article B is reduced (but never below transaction value) by $2.00 to $7.00.

(d) *Finality of customs value and of other determinations of the U.S. Customs Service.* For purposes of section 1059A and this section, a taxpayer is bound by the finally-determined customs value and by every final determination made by the U.S. Customs Service, including, but not limited to, dutiable value, the value attributable to the cost or value of products of the United States, and classification of the product for purposes of imposing any duty. The customs value is considered to be finally determined, and all U.S. Customs Service determinations are considered final, when liquidation of the entry becomes final. For this purpose, the term *liquidation* means the ascertainment of the customs duties occurring on the entry of the property, and liquidation of the entry is considered to become final after 90 days following notice of liquidation to the importer, unless a protest is filed. If the importer files a protest, the customs value will be considered finally determined and all other U.S. Customs Service determinations will be considered final either when a decision by the Customs Service on the protest is not contested after expiration of the period allowed to contest the decision or when a judgment of the Court of International Trade becomes final. For purposes of this section, any adjustments to the customs value resulting from a petition under 19 U.S.C. section 1516 (requests by interested parties unrelated to the importer for redetermination of the appraised value, classification, or the rate of duty imposed on imported merchandise) or reliquidation under 19 U.S.C. section 1521 (reliquidation by the Customs Service upon a finding that fraud was involved in the original liquidation) will not be taken into account. However, reliquidation under 19 U.S.C. section 1501 (voluntary reliquidation by the Customs Service within 90 days of the original liquidation to correct errors in appraisement, classification, or any element entering into a liquidation or reliquidation) or reliquidation under 19 U.S.C. section 1520(c)(1) (to correct a clerical error, mistake of fact, or other inadvertance within one year of a liquidation or reliquidation) will be taken into account in the same manner as, and take the place of, the original liquidation in determining customs value.

(e) *Drawbacks.* For purposes of this section, a drawback, that is, a refund or remission (in whole or in part) of a customs duty because of a particular use made (or to be made) of the property on which the duty was assessed or collected, shall not affect the determination of the customs value of the property.

(f) *Effective date.* Property imported by a taxpayer is subject to section 1059A and this section if the entry documentation required to be filed to obtain the release of the property from the custody of the United States Customs Service was filed after March 18, 1986. Section 1059A and this section will not apply to imported property where (1) the entry documentation is filed prior to September 3, 1987; and (2) the importation was liquidated under the circumstances described in paragraph (c)(9) of this section.

[T.D. 8260, 54 FR 37311, Sept. 8, 1989]

§ 1.1060–1T Special allocation rules for certain asset acquisitions (temporary).

(a) *Scope*—(1) *In general.* This section prescribes rules relating to the requirements of section 1060, which, in the case of an applicable asset acquisition, requires the transferor (the *seller*) and the transferee (the *purchaser*) each to allocate the consideration paid or received in the transaction among the assets transferred in the same manner as amounts are allocated under section 338(b)(5) (relating to the allocation of adjusted grossed-up basis among the assets of the target corporation when a section 338 election is made). In the case of an applicable asset acquisition described in paragraph (b)(1) of this section, sellers and purchasers must allocate the consideration under the residual method, as described in paragraph (d) of this section, in order to determine, respectively, the amount realized from, and the basis in, each of the transferred assets. Subsequent adjustments to the consideration for the transferred assets must be allocated under the residual method in the manner described in paragraph (f) of this section. For rules relating to an applicable asset acquisition that is the transfer of a partnership interest, see § 1.755–2T.

(2) *Effective date*—(i) *In general.* This section applies with respect to any acquisition of assets that occurs after May 6, 1986, unless it occurs pursuant to a binding contract in effect on May 6, 1986, and at all times thereafter. The reporting requirements of this section apply to asset acquisitions occurring in a taxable year for which the due date (including extensions of time) of the income tax return or return of income is on or after September 13, 1988. See paragraph (h) of this section for special effective dates for certain reporting requirements.

(ii) *Allocation of consideration.* Paragraphs (d) and (h)(3) of this section and conforming amendments to other provisions of this section apply to applicable asset acquisitions completed on or after February 14, 1997. For applicable asset acquisitions completed before February 14, 1997, if section 197 does not apply to any of the acquired assets, the provisions of the regulations in effect before February 14, 1997 apply (see § 1.1060–1T as contained in 26 CFR part 1 revised April 1, 1996). For applicable asset acquisitions completed before February 14, 1997, if section 197 applies to any of the acquired assets, the taxpayer (and related parties) may consistently (in all transactions in which AGUB (as defined in § 1.338(b)–1), ADSP (as defined in § 1.338–3), MADSP (as defined in § 1.338(h)(10)–1), or consideration must be allocated under section 338 or 1060)—

(A) Apply the provisions of this section;

(B) Apply the provisions of this section as in effect before February 14, 1997 (see § 1.1060–1T as contained in 26 CFR part 1 revised April 1, 1996); or

(C) Apply the provisions of this section as in effect before February 14, 1997 (see § 1.1060–1T as contained in 26 CFR part 1 revised April 1, 1996), but treat all amortizable section 197 intangibles as Class IV assets.

(3) *Outline of topics.* In order to facilitate the use of this section, this paragraph (a)(3) lists the paragraphs, subparagraphs, and subdivisions contained in this section.

(a) Scope.
(1) In general.
(2) Effective date.
(i) In general.
(ii) Allocation of consideration.
(3) Outline of topics.
(b) Applicable asset acquisition.
(1) In general.
(2) Assets constituting a trade or business.
(3) Examples.
(4) Like-kind exchange.
(c) Definitions.
(1) Consideration.
(2) Fair market value.
(3) Purchase date.
(d) Allocation of consideration among assets under the residual method.
(1) Reduction in the amount of consideration for cash and other items designated by the Internal Revenue Service.
(2) Assets other than Class I assets.
(i) In general.
(ii) Class II assets.
(iii) Class III assets.
(iv) Class IV assets.
(v) Class V assets.
(e) Certain limitations and special rules for consideration allocable to an asset.
(1) Allocation not to exceed fair market value.
(2) Other limitations.

(3) Liabilities taken into account in determining amount realized on subsequent disposition.

(4) Internal Revenue Service authority.

(f) Subsequent adjustments to consideration.

(1) In general.

(2) Allocation of increases in consideration.

(i) In general.

(ii) Effect of disposition or depreciation of assets by purchaser.

(3) Allocation of decreases in consideration.

(i) In general.

(ii) Effect of disposition of assets or reduction of basis below zero.

(4) Specific allocation of increases (or decreases) in consideration to certain contingent income assets.

(i) Patents and similar property.

(ii) Specific allocation.

(5) Internal Revenue Service authority.

(g) Examples.

(h) Applicable asset acquisition reporting requirements.

(1) In general.

(2) Time and manner of reporting.

(i) In general.

(ii) Additional reporting requirement.

(3) Interim procedures for Form 8594.

(b) *Applicable asset acquisition*—(1) *In general.* An *applicable asset acquisition* is any transfer, whether direct or indirect, of a group of assets if (i) the assets transferred constitute a trade or business in the hands of either the seller or the purchaser and (ii) except as provided in paragraph (b)(4) of this section, the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration.

(2) *Assets constituting a trade or business.* For purposes of this section, a group of assets constitutes a trade or business if the use of such assets would constitute an active trade or business for purposes of section 355. Even though a group of assets may not qualify as an active trade or business for purposes of section 355, it will constitute a trade or business for purposes of this section if its character is such that goodwill or going concern value could under any circumstances attach to such group. In making this determination, all the facts and circumstances surrounding the transaction shall be taken into account. Factors to be considered include:

(i) The existence of an excess of the total consideration over the aggregate book value of the tangible and intangible assets purchased (other than goodwill and going concern value) as shown in the financial accounting books and records of the purchaser; and

(ii) Related transactions, including lease agreements, licenses, convenants not to compete, employment contracts, management contracts, or other similar agreements between the purchaser and seller (or managers, directors, owners, or employees of the seller) in connection with the transfer.

(3) *Examples.* Paragraphs (b) (1) and (2) of this section may be illustrated by the following examples:

Example 1. S is a high grade machine shop that manufactures microwave connectors in limited quantities. It is a successful company with a reputation within the industry and among its customers for manufacturing unique, high quality products. Its tangible assets consist primarily of ordinary machinery for working metal and plating. It has no secret formulas or patented drawings of value. P is a company that designs, manufactures, and markets electronic components. It wants to establish an immediate presence in the microwave industry, an area in which it previously has not been engaged. P is acquiring assets of a number of smaller companies and hopes that these assets will collectively allow it to offer a broad product mix. P acquires the assets of S in order to augment its product mix and to promote its presence in the microwave industry. P will not use the assets acquired from S to manufacture microwave connectors. The assets transferred are assets which constitute a trade or business in the hands of the seller. Thus, P's purchase of S's assets is an applicable asset acquisition. The fact that P will not use the assets acquired from S to continue the business of S does not affect this conclusion.

Example 2. S, a sole proprietor who operates a restaurant, leases the building housing the restaurant and sells all its restaurant equipment to P. S's use of the building and the restaurant equipment constitute a trade or business. P begins operating a restaurant in the building it leases from S. Because the assets transferred together with the asset leased are assets which constitute a trade or business, P's purchase of S's assets is an applicable asset acquisition.

Example 3. The S corporation conducts various business enterprises including a retail store in State X that conducts activities that meet the active trade or business requirements for purposes of section 355. P is a minority shareholder of S. In complete redemption of P's stock in S held by P within the meaning of section 302(b)(3), S distributes to P all the assets of S used in S's retail business in State X. The distribution of S's assets in redemption of P's stock is treated as a sale or exchange, and P's basis in the assets transferred is determined wholly by reference to the consideration paid, the S stock. Thus, S's distribution of assets constituting a trade or business to P is an applicable asset acquisition.

(4) *Like-kind exchange.* Notwithstanding the fact that a portion of a group of assets which constitute a trade or business is exchanged for like-kind property, the transaction nevertheless may constitute an applicable asset acquisition. For purposes of this subparagraph (4), like-kind property means any property permitted by section 1031, 1035, or 1036 to be received without the recognition of gain or loss. For purposes of determining whether the transaction constitutes an applicable asset acquisition, (i) the fact that, by reason of section 1031(d), the purchaser's basis in the group of assets is not determined wholly by reference to the consideration paid is disregarded, and (ii) whether the assets transferred constitute a trade or business is determined by taking into account all the assets transferred (including the like-kind property). If an applicable asset acquisition includes like-kind property, then for purposes of allocating consideration among the assets under paragraph (d) of this section, the like-kind property exchanged and any other property or money which is treated as transferred in exchange for the like-kind property are excluded. The basis in and the gain or loss recognized from the like-kind property exchanged and the other property (if any) which is treated as transferred in exchange for the like-kind property is determined under section 1031. For purposes of this section, the amount of money and other property that is treated as transferred in exchange for the like-kind property is equal to so much of the amount of money and the fair market value of other property as does not exceed the difference between the fair market values of the like-kind properties exchanged. The money and other property that are treated as transferred in exchange for the like-kind property (and which are excluded from the assets to which section 1060 applies) are considered to come from the following assets in the following order: first from Class I assets, then from Class II assets, then from Class III assets, then from Class IV assets, and then from Class V assets. For this purpose, liabilities assumed (or to which the like-kind property or other property that is part of the like-kind exchange is subject) are treated as Class I assets. See *Example 3* in paragraph (g) of this section for an example of the application of section 1060 to a single transaction which is, in part, a like-kind exchange.

(c) *Definitions*—(1) *Consideration.* The purchaser's consideration is the cost of the assets acquired in the applicable asset acquisition. The seller's consideration is the amount realized from the applicable asset acquisition under section 1001(b).

(2) *Fair market value.* Generally, the fair market value of an asset is its gross fair market value (i.e., fair market value determined without regard to mortgages, liens, pledges, or other liabilities). However, for purposes of determining the amount of the seller's gain or loss, the fair market value of any property subject to a nonrecourse indebtedness shall be treated as being not less than the amount of such indebtedness. (For purposes of the preceding sentence, a liability that was incurred by reason of the acquisition of the property is disregarded to the extent that such liability was not taken into account in determining the seller's basis in such property.)

(3) *Purchase date.* The purchase date is the date on which the applicable asset acquisition occurs.

(d) *Allocation of consideration among assets under the residual method*—(1) *Reduction in the amount of consideration for cash and other items designated by the Internal Revenue Service.* Consideration is first reduced by the amount of Class I assets (if any) transferred by the seller. Class I assets are cash, demand deposits and like accounts in banks, savings and loan associations (and other depository institutions), and other similar items designated in the Internal Revenue Bulletin by the Internal Revenue Service. The amount of the consideration remaining after the reduction is to be allocated to the other assets transferred.

(2) *Assets other than Class I assets*—(i) *In general.* Subject to the limitations and other special rules of paragraph (e) of this section, consideration (as reduced by the amount of Class I assets) is allocated among Class II assets transferred by the seller in proportion to the fair market values of such Class II assets on the purchase date, then among Class III assets transferred by the seller in proportion to the fair market values of such Class III assets on that date, then among Class IV assets transferred by the seller in proportion to the fair market values of such Class IV assets on that date, and finally to Class V assets.

(ii) *Class II assets.* Class II assets are certificates of deposit, U.S. government securities, readily marketable stock or securities (within the meaning of §1.351–1(c)(3)), foreign currency, and other items designated in the Internal Revenue Bulletin by the Internal Revenue Service.

(iii) *Class III assets.* Class III assets are all assets other than Class I, II, IV, and V assets.

(iv) *Class IV assets.* Class IV assets are all section 197 intangibles, as defined in section 197, except those in the nature of goodwill and going concern value.

(v) *Class V assets.* Class V assets are section 197 intangibles in the nature of goodwill and going concern value.

(e) *Certain limitations and special rules for consideration allocable to an asset*—(1) *Allocation not to exceed fair market value.* The amount of consideration allocated to an asset (other than Class V assets) shall not exceed the fair market value of that asset on the purchase date.

(2) *Other limitations.* The amount of consideration allocated to an asset is subject to any applicable limitations under the Code or general principles of tax law. For example, if the applicable asset acquisition is a transaction described in section 1056(a) (relating to basis limitation for player contracts transferred in connection with the sale of a franchise), the amount of consideration the purchaser may allocate to a contract for the services of an athlete shall not exceed the limitation imposed by that section.

(3) *Liabilities taken into account in determining amount realized on subsequent disposition.* In determining the amount realized on a subsequent sale or other disposition of property acquired by the purchaser, the entire amount of any liability included in determining the purchaser's consideration is considered to be an amount taken into account in determining the purchaser's basis in property which secures such liability for purposes of applying §1.1001–2(a). Thus, if a liability is included in the purchaser's consideration, §1.1001–2(a)(3) shall not prevent the amount of such liability from being treated as discharged within the meaning of §1.1001–2(a)(4) as a result of the purchaser's sale or disposition of the property which secures such liability.

(4) *Internal Revenue Service authority.* In connection with the examination of a return, the Internal Revenue Service may challenge the taxpayer's determination of the fair market value of any asset by any appropriate method and take into account all factors, including any lack of adverse tax interests between the parties. For example, in certain cases the Internal Revenue Service may make an independent showing of the value of goodwill and going concern value as a means of calling into question the validity of the taxpayer's valuation of other assets.

(f) *Subsequent adjustments to consideration*—(1) *In general.* If there is an increase or a decrease in consideration of either the seller or the purchaser after the purchase date that must be taken into account in order to adjust or redetermine, under applicable principles of tax law, the seller's amount realized with respect to, or the purchaser's cost of, the assets transferred, then such increase or decrease is allocated by the seller or the purchaser among the assets pursuant to this paragraph (f).

(2) *Allocation of increases in consideration*—(i) *In general.* An increase in consideration is allocated under paragraph (d) of this section among the assets transferred. Amounts allocable to an asset (or with respect to an asset disposed of by the purchaser) are subject to the fair market value limitation and other limitations in paragraph

(e) of this section. Except as provided in paragraph (f)(4)(ii) of this section, for the purpose of applying paragraph (e) of this section, the fair market value is the fair market value on the purchase date.

(ii) *Effect of disposition or depreciation of assets by purchaser.* If an asset has been disposed of, depreciated, amortized, or depleted by the purchaser before an increase in consideration is taken into account, the increase in consideration otherwise allocable to such asset by the purchaser shall be taken into account under principles of tax law applicable when part of the cost of an asset (not previously reflected in its basis) is paid after the asset has been disposed of, depreciated, amortized, or depleted.

(3) *Allocation of decreases in consideration*—(i) *In general.* A decrease in consideration is allocated in the following order: first, as a reduction in the amount previously allocated to Class V assets, second, as a reduction in the amount previously allocated to Class IV assets in proportion to their fair market values, third, as a reduction in the amount previously allocated to Class III assets in proportion to their fair market values, and finally, as a reduction in the amount previously allocated to Class II assets in proportion to their fair market values. Decreases in consideration allocated to an asset shall not exceed the amount of consideration previously allocated to that asset. Except as provided in paragraph (f)(4)(ii) of this section (relating to patents and similar property), the fair market value is the fair market value on the purchase date.

(ii) *Effect of disposition of assets or reduction of basis below zero.* If an asset has been disposed of, depreciated, amortized, or depleted by the purchaser before a decrease in consideration is taken into account, the decrease in the purchaser's consideration otherwise allocable to such asset shall be taken into account under principles of tax law applicable when the cost of an asset (previously reflected in basis) is reduced after the asset has been disposed of or depreciated, amortized, or depleted. For purposes of this subdivision (ii), an asset is considered to have been disposed of to the extent that its allocable portion of the decrease in consideration would reduce its basis below zero.

(4) *Specific allocation of increases (or decreases) in consideration to certain contingent income assets*—(i) *Patents and similar property.* The specific allocation under paragraph (f)(4)(ii) of this section of an increase (or decrease) in consideration applies if (A) the increase (or decrease) is the result of a contingency that directly relates to income produced by a particular intangible asset (*contingent income asset*), such as a patent, a secret process, or a copyright, and (B) the increase (or decrease) is related to such contingent income asset and not to other assets. Consideration as initially determined, and any increase (or decrease) in consideration to which this specific allocation rule does not apply, are allocated among the assets (including contingent income assets) in accordance with the provisions of paragraphs (f) (2) and (3) of this section.

(ii) *Specific allocation.* Subject to the fair market value and other limitations in paragraph (e) of this section, any increase (or decrease) in consideration to which this subdivision (ii) applies is allocated first, specifically to the contingent income asset to which the increase (or decrease) relates and, then, under paragraph (f) (2) (or 3)) of this section. Solely for purposes of applying the fair market value and other limitations to a contingent income asset, the fair market value of such asset on the purchase date shall be redetermined when the increase (or decrease) is taken into account. (For purposes of this redetermination, only those circumstances that resulted in the increase (or decrease) in consideration are taken into account.) This redetermination does not affect the fair market value limitations or other limitations as they apply to other transferred assets.

(5) *Internal Revenue Service authority.* In connection with the examination of a return, the Internal Revenue Service, in appropriate cases, may apply the principles of paragraph (f)(4) of this section to allocate an increase (or decrease) in consideration among particular assets to the extent such allocation is necessary to reflect properly

the consideration that relates to each of those assets.

(g) *Examples.* The provisions of paragraphs (b), (d), (e), and (f) of this section may be illustrated by the following examples:

Example 1. (i) On January 1, 1998, S, a sole proprietor, sells to P, a corporation, a group of assets which constitute a trade or business under paragraph (b)(2) of this section. P pays S $2,000 in cash and assumes $1,000 in liabilities. Thus, the total consideration is $3,000.

(ii) Assume that P acquires no Class I assets and that on the purchase date, the fair market values of the Class II, Class III, and Class IV assets S sold to P are as follows:

Asset class	Asset	Fair market value
II	Portfolio of marketable securities	$ 400
	Total Class II	$ 400
III	Furniture and fixtures	$ 800
	Building	800
	Land	200
	Equipment	400
	Accounts receivable	100
	Total Class III	$2,300
IV	Covenant not to compete	$100
	Total Class IV	$100

(iii) Under paragraphs (d) (1) and (2) of this section, the amount of consideration allocable to the Class II, III, IV, and V assets is the total consideration reduced by the amount of any Class I assets. Since P acquired no Class I assets, the total consideration of $3,000 is next allocated first to Class II, then to Class III, and then to Class IV assets. Since the fair market value of the Class II assets is $400, $400 of consideration is allocated to the Class II assets. Since the remaining amount of consideration is $2,600 ($3,000 − $400), an amount which exceeds the sum of the fair market values of the Class III assets ($2,300), the amount allocated to each Class III asset is its fair market value. Since, after the allocation to Class III assets, the remaining amount of consideration is $300 ($3,000 − ($400 + $2,300)), an amount which exceeds the fair market value of the Class IV asset ($100), the amount allocated to the Class IV asset is its fair market value. Thus, the total amount allocated to the Class II assets is $400, the total amount allocated to the Class III assets is $2,300, and the total amount allocated to the Class IV asset is $100.

(iv) The amount allocated to the Class V assets (assets in the nature of goodwill and going concern value) is $200 (i.e., $3,000 − ($400 + $2,300 + $100)).

Example 2. (i) Assume the same facts as in *Example 1.* Assume further that P and S each use the calendar year as the taxable year and that, on September 30, 1998, P files a claim against S alleging fraud in the sale of all of the assets.

(ii) On January 1, 2007, S refunds $400 of the purchase price to P in a settlement of the lawsuit.

(iii) Under paragraph (f)(3)(i) of this section, both S and P take into account the $400 decrease in consideration and allocate it among the assets. First, since $200 of consideration previously was allocated to the assets in the nature of goodwill and going concern value (Class V assets), $200 of the decrease in consideration is allocated to those assets. Then, since $100 of consideration previously was allocated to the only Class IV asset, the covenant not to compete, the next $100 of the remaining decrease in consideration ($200) is allocated to that asset. The remaining decrease in consideration ($100) is then allocated to the Class III assets in proportion to their fair market values on the purchase date as follows:

Asset	Fair market value	Allocation fraction	Decrease in consideration ($100 × Col. (2))
Furniture and fixtures	$800	800/2,300	$34.78
Building	800	800/2,300	34.78
Land	200	200/2,300	8.70
Equipment	400	400/2,300	17.39
Accounts receivable	100	100/2,300	4.35
Total	$2,300		$100.00

(iv) In summary, the redetermined consideration that S received for the group of assets is $2,600 after taking into account the decrease in consideration. After allocating the decrease, P's and S's redetermined consideration is as follows:

Asset	Original consideration	Decrease in consideration	Redetermined consideration
Portfolio of marketable securities	$400.00	$0.00	$400.00

Asset	Original consideration	Decrease in consideration	Redetermined consideration
Furniture and fixtures	800.00	34.78	765.22
Building	800.00	34.78	765.22
Land	200.00	8.70	191.30
Equipment	400.00	17.39	382.61
Accounts receivable	100.00	4.35	95.65
Covenant not to compete	100.00	100.00	0.00
Goodwill and going concern value	200.00	200.00	0.00
Total	$3,000.00	$400.00	$2,600.00

(v) Assume that, as a result of deductions under section 168, P's adjusted basis in the equipment immediately before the decrease in consideration is zero. P, therefore, treats the equipment as if it were disposed of before the decrease is taken into account. In 2007, P recognizes income of $17.39, the character of which is determined under the principles of *Arrowsmith* v. *Commissioner*, 344 U.S. 6 (1952), and the tax benefit rule. No adjustment to the basis of P's assets is made for any tax paid on this amount. Assume also that, as a result of amortization deductions, the adjusted basis of the covenant not to compete and the goodwill and going concern value immediately before the decrease in consideration is $120. A similar adjustment to income is made in 2007 with respect to the $180 of previously amortized covenant not to compete and goodwill and going concern value.

Example 3. (i) On January 1, 1998, A transfers assets X, Y, and Z worth $1,000 to B in exchange for assets D, E, and F, worth $100, plus $1,000 cash.

(ii) Assume the exchange of assets constitutes an exchange of like-kind property to which section 1031 applies. Assume also that goodwill or going concern value could under any circumstances attach to each group of assets and, therefore, each group constitutes a trade or business under section 1060.

(iii) Assume the fair market values of the assets and the amount of money transferred are as follows:

Asset	Fair market value
By A	
X	$400
Y	400
Z	200
Total	1,000
By B	
D	40
E	30
F	30
Cash (amount)	1,000
	1,100

(iv) Under paragraph (b)(4) of this section, for purposes of allocating consideration under paragraph (d) of this section, the like-kind assets exchanged and any money or other property which are treated as transferred in exchange for the like-kind property are excluded from the application of section 1060.

(v) Since assets X, Y, and Z are like-kind property, they are excluded from the application of the section 1060 allocation rules.

(vi) Since assets D, E, and F are like-kind property, they are excluded from the application of the section 1060 allocation rules. In addition, $900 of the $1,000 cash B gave to A for A's like-kind assets is treated as transferred in exchange for the like-kind property in order to equalize the fair market values of the like-kind assets. Therefore, $900 of the cash is excluded from the application of the section 1060 allocation rules.

(vii) $100 of the cash is allocated under section 1060 and paragraph (d) of this section.

(viii) A, as transferor of assets X, Y, and Z, received $100 that must be allocated under section 1060 and paragraph (d) of this section. Since A transferred no Class I, II, III, or IV assets to which section 1060 applies, the $100 is allocated to Class V assets (assets in the nature of goodwill and going concern value).

(ix) A, as transferee of assets D, E, and F, gave consideration only for assets to which section 1031 applies. Therefore, the allocation rules of section 1060 and paragraph (d) of this section are not applied to determine the bases of the assets A received.

(x) B, as transferor of assets D, E, and F, received consideration only for assets to which section 1031 applies. Therefore, the allocation rules of section 1060 do not apply in determining B's gain or loss.

(xi) B, as transferee of assets X, Y, and Z, gave A $100 that must be allocated under section 1060 and paragraph (d) of this section. Since B received from A no Class I, II, III, or IV assets to which section 1060 applies, the $100 consideration is allocated by B to Class V assets (assets in the nature of goodwill and going concern value).

Example 4. (i) On January 1, 1998, S, a sole proprietor, sells to P, a corporation, a group of assets which constitutes a trade or business under paragraph (b)(2) of this section. S, who plans to retire immediately, also executes a covenant not to compete in P's favor.

P pays S $3,000 in cash and assumes $1,000 in liabilities. Thus, the total consideration is $4,000.

(ii) On the purchase date, P and S also execute a separate agreement that states that the fair market values of the Class II, Class III, and Class IV assets S sold to P are as follows:

Asset class	Asset	Fair market value
II	Portfolio of marketable securities	$500
	Total Class II	$500
III	Furniture and fixtures	$800
	Building	800
	Land	200
	Equipment	400
	Accounts receivable	200
	Total Class III	$2,400
IV	Covenant not to compete	$900
	Total Class IV	$900

(iii) P and S each allocate the consideration in the transaction among the assets transferred under paragraph (d) of this section in accordance with the agreed upon fair market values of the assets, so that $500 is allocated to Class II assets, $2,400 is allocated to Class III assets, $900 is allocated to Class IV assets, and $200 ($4,000 total consideration less $3,800 allocated to asset classes II, III, and IV is allocated to the Class V assets (assets in the nature of goodwill and going concern value).

(iv) In connection with the examination of P's return, the District Director, in determining the fair market values of the assets transferred, may disregard the parties' agreement. Assume that the District Director correctly determines that the fair market value of the covenant not to compete was $100. Since the allocation of consideration among Class II, III, and IV assets results in allocation up to the fair market value limitation, the $800 of unallocated consideration resulting from the District Director's redetermination of the value of the covenant not to compete is allocated to Class V assets (assets in the nature of goodwill and going concern value).

(h) *Applicable asset acquisition reporting requirements*—(1) *In general.* The seller and the purchaser in an applicable asset acquisition each shall report information concerning the amount of consideration in the transaction and its allocation among the assets transferred. They also must report information concerning subsequent adjustments to consideration. For reporting requirements relating to the transfer of the partnership interest, see §1.755–2T(c).

(2) *Time and manner of reporting*—(i) *In general.* The seller and the purchaser each must file asset acquisition statements on Form 8594 with their income tax returns or returns of income for the taxable year that includes the purchase date. This reporting requirement applies to asset acquisitions that occur in a taxable year for which the due date (including extensions of time) of the income tax return or return of income is on or after September 13, 1988.

(ii) *Additional reporting requirement.* If the amount of consideration allocated to any asset by the seller or the purchaser is increased (or decreased) after the taxable year that includes the purchase date, the seller or purchaser making the increase (or decrease) shall file a supplemental asset acquisition statement on Form 8594 with the income tax return or return of income for the taxable year in which the increase (or decrease) is properly taken into account. This reporting requirement applies to an increase (or decrease) in the amount of consideration allocated to any asset that is properly taken into account in a taxable year for which the due date (including extensions of time) of the income tax return or return of income is on or after September 13, 1988, even if the seller or purchaser may not have been required to file an asset acquisition statement for the taxable year that included the purchase date because of the effective date rule in paragraph (h)(2)(i) of this section.

(3) *Interim procedures for Form 8594.* Until such time, if any, as Form 8594 is revised to require otherwise, the sum of the amounts allocated to Classes IV and V should be reported on Form 8594 as Class IV assets.

[T.D. 8215, 53 FR 27039, July 18, 1988; 53 FR 29801, Aug. 8, 1988, as amended by T.D. 8711, 62 FR 2272, Jan. 16, 1997; 62 FR 14821, Mar. 28, 1997]

CHANGES TO EFFECTUATE F.C.C. POLICY

§1.1071–1 Gain from sale or exchange to effectuate policies of Federal Communications Commission.

(a)(1) At the election of the taxpayer, section 1071 postpones the recognition of the gain upon the sale or exchange of property if the Federal Communications Commission grants the taxpayer a certificate with respect to the ownership and control of radio broadcasting stations which is in accordance with subparagraph (2) of this paragraph. Any taxpayer desiring to obtain the benefits of section 1071 shall file such certificate with the Commissioner of Internal Revenue, or the district director for the internal revenue district in which the income tax return of the taxpayer is required to be filed.

(2)(i) In the case of a sale or exchange before January 1, 1958, the certificate from the Federal Communications Commission must clearly identify the property and show that the sale or exchange is necessary or appropriate to effectuate the policies of such Commission with respect to the ownership and control of radio broadcasting stations.

(ii) In the case of a sale or exchange after December 31, 1957, the certificate from the Federal Communications Commission must clearly identify the property and show that the sale or exchange is necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, such Commission with respect to the ownership and control of radio broadcasting stations.

(3) The certificate shall be accompanied by a detailed statement showing the kind of property, the date of acquisition, the cost or other basis of the property, the date of sale or exchange, the name and address of the transferee, and the amount of money and the fair market value of the property other than money received upon such sale or exchange.

(b) Section 1071 applies only in the case of a sale or exchange made necessary by reason of the Federal Communications Commission's policies as to ownership or control of radio facilities. Section 1071 does not apply in the case of a sale or exchange made necessary as a result of other matters, such as the operation of a broadcasting station in a manner determined by the Commission to be not in the public interest or in violation of Federal or State law.

(c) An election to have the benefits of section 1071 shall be made in the manner prescribed in §1.1071–4.

(d) For purposes of section 1071, the term *radio broadcasting* includes telecasting.

§1.1071–2 Nature and effect of election.

(a) *Alternative elections.* (1) A taxpayer entitled to the benefits of section 1071 in respect of a sale or exchange of property may elect—

(i) To treat such sale or exchange as an involuntary conversion under the provisions of section 1033; or

(ii) To treat such sale or exchange as an involuntary conversion under the provisions of section 1033, and in addition elect to reduce the basis of property, in accordance with the regulations prescribed in §1.1071–3, by all or part of the gain that would otherwise be recognized under section 1033; or

(iii) To reduce the basis of property, in accordance with the regulations prescribed in §1.1071–3, by all or part of the gain realized upon the sale or exchange.

(2) The effect of the provisions of subparagraph (1) of this paragraph is, in general, to grant the taxpayer an election to treat the proceeds of the sale or exchange as the proceeds of an involuntary conversion subject to the provisions of section 1033, and a further election to reduce the basis of certain property owned by the taxpayer by the amount of the gain realized upon the sale or exchange to the extent of that portion of the proceeds which is not treated as the proceeds of an involuntary conversion.

(3) An election in respect to a sale or exchange under section 1071 shall be irrevocable and binding for the taxable year in which the sale or exchange takes place and for all subsequent taxable years.

(b) *Application of section 1033.* (1) If the taxpayer elects, under either paragraph (a)(1) (i) or (ii) of this section, to treat the sale or exchange as an involuntary conversion, the provisions of section 1033, as modified by section 1071, together with the regulations prescribed under such sections, shall be applicable in determining the amount of recognized gain and the basis of property required as a result of such sale or exchange. For the purposes of section 1071 and the regulations thereunder, stock of a corporation operating a radio broadcasting station shall be treated as property similar or related in service or use to the property sold or exchanged. Securities of such a corporation other than stock, or securities of a corporation not operating a radio broadcasting station, do not constitute property similar or related in service or use to the property sold or exchanged. If the taxpayer exercises the election referred to in paragraph (a)(1)(i) of this section, the gain realized upon such sale or exchange shall be recognized to the extent of that part of the money received upon the sale or exchange which is not expended in the manner prescribed in section 1033 and the regulations thereunder. If, however, the taxpayer exercises the elections referred to in paragraph (a)(1)(ii) of this section, the amount of the gain which would be recognized, determined in the same manner as in the case of an election under paragraph (a)(1)(i) of this section, shall not be recognized but shall be applied to reduce the basis of property, remaining in the hands of the taxpayer after such sale or exchange or acquired by him during the same taxable year, which is of a character subject to the allowance for depreciation under section 167. Such reduction of basis shall be made in accordance with and under the conditions prescribed by §1.1071–3.

(2) In the application of section 1033 to determine the recognized gain and the basis of property acquired as a result of a sale or exchange pursuant to an election under paragraph (a)(1) (i) or (ii) of this section, the entire amount of the proceeds of such sale or exchange shall be taken into account.

(c) *Example.* The application of the provisions of section 1071 may be illustrated by the following example:

Example: A, who makes his return on a calendar year basis, sold in 1954, for $100,000 cash, stock of X Corporation, which operates a radio broadcasting station. A's basis of this stock was $75,000. The sale was certified by the Federal Communications Commission as provided in section 1071. Soon after, in the same taxable year, A used $50,000 of the proceeds of the sale to purchase stock in Y Corporation, which operates a radio broadcasting station. A elected in his 1954 return to treat such sale and purchase as an involuntary conversion subject to the provisions of section 1033. He also elected at the same time to reduce the basis of depreciable property by the amount of the gain that otherwise would be recognized under the provisions of section 1033, as made applicable by section 1071. The sale results in a recognized gain of $25,000 under section 1033. However, this gain is not recognized in this case because the taxpayer elected to reduce the basis of other property by the amount of the gain. This may be shown as follows:

(1) Sale price of X Corporation stock ..	$100,000
Basis for gain or loss	75,000
Gain realized	25,000
Proceeds of sale	100,000
Amount expended to replace property sold	50,000
Amount not expended in manner prescribed in section 1033	50,000
Realized gain, recognized under section 1033 (not to exceed the unexpended portion of proceeds of sale)	25,000
Less: Amount applied as a reduction of basis of depreciable property	25,000
Recognized gain for tax purposes	None

(2) The basis of Y Corporation stock in the hands of A is $50,000, computed in accordance with section 1033 and the regulations prescribed under that section. The $50,000 basis is computed as follows:

Basis of property sold (converted)	$75,000
Less: Amount of proceeds not expended	50,000
Balance	25,000
Plus amount of gain recognized under section 1033	25,000
Basis of Y Corporation stock in A's hands	50,000

§1.1071–3 Reduction of basis of property pursuant to election under section 1071.

(a) *General rule.* (1) In addition to the adjustments provided in section 1016 and other applicable provisions of chapter 1 of the Code which adjustments are required to be made with respect to the cost or other basis of property, a further adjustment shall be made in the amount of the unrecognized gain under section 1071, if the taxpayer so elects. Such further adjustment shall be made only with respect to the cost or other basis of property which is of a character subject to the allowance for depreciation under section 167 (whether or not used in connection with a broadcasting business), and which remains in the hands of the taxpayer immediately after the sale or exchange in respect of which the election is made, or which is acquired by the taxpayer in the same taxable year in which such sale or exchange occurs. If the property is in the hands of the taxpayer immediately after the sale or exchange, the time of reduction of the basis is the date of the sale or exchange; in all other cases the time of reduction of the basis is the date of acquisition.

(2) The reduction of basis under section 1071 in the amount of the unrecognized gain shall be made in respect of the cost or other basis, as of the time prescribed, of all units of property of the specified character. The cost or other basis of each unit shall be decreased in an amount equal to such proportion of the unrecognized gain as the adjusted basis (for determining gain, determined without regard to this section) of such unit bears to the aggregate of such adjusted bases of all units of such property, but the amount of the decrease shall not be more than the amount of such adjusted basis. If in the application of such rule the adjusted basis of any unit is reduced to zero, the process shall be repeated to reduce the adjusted basis of the remaining units of property by the portion of the unrecognized gain which is not absorbed in the first application of the rule. For such purpose the *adjusted basis* of the remaining units shall be the adjusted basis for determining gain reduced by the amount of the adjustment previously made under this section. The process shall be repeated until the entire amount of the unrecognized gain has been absorbed.

(3) The application of the provisions of this section may be illustrated by the following example:

Example: Using the facts given in the example set forth in § 1.1071–2(c), except that the taxpayer elects to reduce the basis of depreciable property in accordance with paragraph (a)(1)(iii) of § 1.1071–2, the computation may be illustrated as follows:

Sale price of X Corporation stock	$100,000
Basis for gain or loss	75,000
Realized gain (recognized except for the election under § 1.1071–1)	$25,000
Adjusted basis of other depreciable property in hands of A immediately after sale:	
Building	80,000
Transmitter	16,000
Fixtures	4,000
Total	100,000
Computation of reduction:	
Building (80,000/100,000)×$25,000 (gain)	20,000
Transmitter (16,000/100,000)×$25,000	4,000
Fixtures (4,000/100,000)×$25,000	1,000
Total reduction	25,000
New basis of assets:	
Building ($80,000 minus $20,000)	60,000
Transmitter ($16,000 minus $4,000)	12,000
Fixtures ($4,000 minus $1,000)	3,000
Total adjusted basis after reduction under section 1071	75,000
Realized gain upon sale of X Corporation stock	25,000
Less: Amount applied as a reduction to basis of depreciable property	25,000
Recognized gain for tax purposes	None

(b) *Special cases.* With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property of the class specified in section 1071 and this section adjusted in a manner different from the general rule set forth in paragraph (a) of this section. Variations from such general rule may, for example, involve adjusting the basis of only certain units of such property. The request for variations from such general rule should be filed by the taxpayer with his return for the taxable year in which he elects to have the basis of property reduced under section 1071. Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effective only if incorporated in a closing agreement entered into under the provisions of section 7121.

§ 1.1071–4 Manner of election.

(a) An election under the provisions of section 1071 shall be in the form of a written statement and shall be executed and filed in duplicate. Such statement shall be signed by the taxpayer or his authorized representative.

In the case of a corporation, the statement shall be signed with the corporate name, followed by the signature and title of an officer of the corporation empowered to sign for the corporation, and the corporate seal must be affixed. An election under section 1071 to reduce the basis of property and an election under such section to treat the sale or exchange as an involuntary conversion under section 1033 may be exercised independently of each other. An election under section 1071 must be filed with the return for the taxable year in which the sale or exchange occurs. Where practicable, the certificate of the Federal Communications Commission required by §1.1071–1 should be filed with the election.

(b) If, in pursuance of an election to have the basis of its property adjusted under section 1071, the taxpayer desires to have such basis adjusted in any manner different from the general rule set forth in paragraph (a) of §1.1071–3, the precise method (including allocation of amounts) should be set forth in detail on separate sheets accompanying the election. Consent by the Commissioner to any departure from such general rule shall be effected only by a closing agreement entered into under the provisions of section 7121.

EXCHANGES IN OBEDIENCE TO S.E.C. ORDERS

§1.1081–1 Terms used.

The following terms, when used in this section and §§1.1081–2 to 1.1083–1, inclusive, shall have the meanings assigned to them in section 1083: *Order of the Securities and Exchange Commission*; *registered holding company*; *holding company system*; *associate company*; *majority-owned subsidiary company*; *system group*; *nonexempt property*; and *stock or securities*. Any other term used in this section and §§1.1081–2 to 1.1083–1, inclusive, which is defined in the Internal Revenue Code of 1954, shall be given the respective definition contained in such Code.

§1.1081–2 Purpose and scope of exception.

(a) The general rule is that the entire amount of gain or loss from the sale or exchange of property is to be recognized (see section 1002) and that the entire amount received as a dividend is to be included in gross income. (See sections 61 and 301.) Exceptions to the general rule are provided elsewhere in subchapters C and O, chapter 1 of the Code, one of which is that made by section 1081 with respect to exchanges, sales, and distributions specifically described in section 1081. Section 1081 provides the extent to which gain or loss is not to be recognized on (1) the receipt of a distribution described in section 1081(c)(2), or (2) an exchange or sale, or the receipt of a distribution, made in obedience to an order of the Securities and Exchange Commission, which is issued to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79k (b)). Section 331 provides that a distribution in liquidation of a corporation shall be treated as an exchange. Such distribution is to be treated as an exchange under the provisions of sections 1081 to 1083, inclusive. The order of the Securities and Exchange Commission must be one requiring or approving action which the Commission finds to be necessary or appropriate to effect a simplification or geographical integration of a particular public utility holding company system. For specific requirements with respect to an order of the Securities and Exchange Commission, see section 1081 (f).

(b) The requirements for nonrecognition of gain or loss as provided in section 1081 are precisely stated with respect to the following general types of transactions:

(1) The exchange that is provided for in section 1081 (a), in which stock or securities in a registered holding company or a majority-owned subsidiary company are exchanged for stock or securities.

(2) The exchange that is provided for in section 1081 (b), in which a registered holding company or an associate company of a registered holding company exchanges property for property.

(3) The distribution that is provided for in section 1081 (c)(1), in which stock or securities are distributed to a shareholder in a corporation which is a registered holding company or a majority-

owned subsidiary company, or the distribution that is provided for in section 1081 (c)(2), in which a corporation distributes to a shareholder, rights to acquire common stock in a second corporation.

(4) The transfer that is provided for in section 1081 (d), in which a corporation which is a member of a system group transfers property to another member of the same system group.

Certain rules with respect to the receipt of nonexempt property on an exchange described in section 1081 (a) are prescribed in section 1081 (e).

(c) These exceptions to the general rule are to be strictly construed. Unless both the purpose and the specific requirements of sections 1081 to 1083, inclusive, are clearly met, the recognition of gain or loss upon the exchange, sale, or distribution will not be postponed under those sections. Moreover, even though a taxable transaction occurs in connection or simultaneously with a realization of gain or loss to which nonrecognition is accorded, nevertheless, nonrecognition will not be accorded to such taxable transaction. In other words, the provisions of section 1081 do not extend in any case to gain or loss other than that realized from and directly attributable to a disposition of property as such, or the receipt of a corporate distribution as such, in an exchange, sale, or distribution specifically described in section 1081.

(d) The application of the provisions of part VI (section 1081 and following), subchapter O, chapter 1 of the Code, is intended to result only in postponing the recognition of gain or loss until a disposition of property is made which is not covered by such provisions, and, in the case of an exchange or sale subject to the provisions of section 1081 (b), in the reduction of basis of certain property. The provisions of section 1082 with respect to the continuation of basis and the reduction in basis are designed to effect these results. Although the time of recognition may be shifted, there must be a true reflection of income in all cases, and it is intended that the provisions of such part VI, shall not be construed or applied in such a way as to defeat this purpose.

§ 1.1081–3 Exchanges of stock or securities solely for stock or securities.

The exchange, without the recognition of gain or loss, that is provided for in section 1081 (a) must be one in which stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary company are exchanged solely for stock or securities other than stock or securities which constitute nonexempt property. An exchange is not within the provisions of section 1081 (a) unless the stock or securities transferred and those received are stock or securities as defined by section 1083 (f). The stock or securities which may be received without the recognition of gain or loss are not limited to stock or securities in the corporation from which they are received. An exchange within the provisions of section 1081 (a) may be a transaction between the holder of stock or securities and the corporation which issued the stock or securities. Also the exchange may be made by a holder of stock or securities with an associate company (i.e., a corporation in the same holding company system with the issuing corporation) which is a registered holding company or a majority-owned subsidiary company. In either case, the nonrecognition provisions of section 1081 (a) apply only to the holder of the stock or securities. However, the transferee corporation must be acting in obedience to an order of the Securities and Exchange Commission directed to such corporation, if no gain or loss is to be recognized to the holder of the stock or securities who makes the exchange with such corporation. See also section 1081(b), in case the holder of the stock or securities is a registered holding company or an associate company of a registered holding company. An exchange is not within the provisions of section 1081(a) if it is within the provisions of section 1081(d), relating to transfers within a system group. For treatment when nonexempt property is received, see section 1081(e); for further limitations, see section 1081(f).

§1.1081–4 Exchanges of property for property by corporations.

(a) *Application of section 1081(b).* Section 1081(b) applies only to the transfers specified therein with respect to which section 1081(d) is inapplicable, and deals only with such transfers if gain is realized upon the sale or other disposition effected by such transfers. If loss is realized section 1081(b) is inapplicable and the application of other provisions of subtitle A of the Code must be determined. See section 1081(g). If section 1081(b) is applicable, the other provisions of subchapters C and O, chapter 1 of the Code, relating to the nonrecognition of gain are inapplicable, and the conditions under which, and the extent to which, the realized gain is not recognized are set forth in paragraphs (b), (c), (d), (e), and (f) of this section.

(b) *Nonrecognition of gain; no nonexempt proceeds.* No gain is recognized to a transferor corporation upon the sale or other disposition of property transferred by such transferor corporation in exchange solely for property other than nonexempt property, as defined in section 1083(e), but only if all of the following requirements are satisfied:

(1) The transferor corporation is, under the definition in section 1083 (b), a registered holding company or an associate company of a registered holding company;

(2) Such transfer is in obedience to an order of the Securities and Exchange Commission (as defined in section 1083 (a)) and such order satisfies the requirements of section 1081 (f);

(3) The transferor corporation has filed the required consent to the regulations under section 1082(a)(2) (see paragraph (g) of this section); and

(4) The entire amount of the gain, as determined under section 1001, can be applied in reduction of basis under section 1082(a)(2).

(c) *Nonrecognition of gain; nonexempt proceeds.* If the transaction would be within the provisions of paragraph (b) of this section if it were not for the fact that the property received in exchange consists in whole or in part of nonexempt property (as defined in section 1083 (e)), then no gain is recognized if such nonexempt property, or an amount equal to the fair market value of such nonexempt property at the time of the transfer.

(1) Is expended within the required 24-month period for property other than nonexempt property; or

(2) Is invested within the required 24-month period as a contribution to the capital, or as paid-in surplus, of another corporation;

but only if the expenditure or investment is made

(3) In accordance with an order of the Securities and Exchange Commission (as defined in section 1083 (a)) which satisfies the requirements of section 1081 (f) and which recites that such expenditure or investment by the transferor corporation is necessary or appropriate to the integration or simplification of the holding company system of which the transferor corporation is a member; and

(4) The required consent, waiver, and bond have been executed and filed. See paragraphs (g) and (h) of this section.

(d) *Recognition of gain in part; insufficient expenditure or investment in case of nonexempt proceeds.* If the transaction would be within the provisions of paragraph (c) of this section if it were not for the fact that the amount expended or invested is less than the fair market value of the nonexempt property received in exchange, then the gain, if any, is recognized, but in an amount not in excess of the amount by which the fair market value of such nonexempt property at the time of the transfer exceeds the amount so expended and invested.

(e) *Items treated as expenditures for the purpose of paragraphs (c) and (d) of this section.* For the purposes of paragraphs (c) and (d) of this section, the following are treated as expenditures for property other than nonexempt property:

(1) A distribution in cancellation or redemption (except a distribution having the effect of a dividend) of the whole or a part of the transferor's own stock (not acquired on the transfer);

(2) A payment in complete or partial retirement or cancellation of securities representing indebtedness of the transferor or a complete or partial retirement or cancellation of such securities which is a part of the consideration for the transfer; and

(3) If, on the transfer, a liability of the transferor is assumed, or property of the transferor is transferred subject to a liability, the amount of such liability.

(f) *Recognition of gain in part; inability to reduce basis.* If the transaction would be within the provisions of paragraph (b) or (c) of this section, if it were not for the fact that an amount of gain cannot be applied in reduction of basis under section 1082(a)(2), then the gain, if any, is recognized, but in an amount not in excess of the amount which cannot be so applied in reduction of basis. If the transaction would be within the provisions of paragraph (d) of this section, if it were not for the fact that an amount of gain cannot be applied in reduction of basis under section 1082(a)(2), then the gain, if any, is recognized, but in an amount not in excess of the aggregate of—

(1) The amount of gain which would be recognized under paragraph (d) of this section if there were no inability to reduce basis under section 1082(a)(2); and

(2) The amount of gain which cannot be applied in reduction of basis under section 1082(a)(2).

(g) *Consent to regulations under section 1082(a)(2).* To be entitled to the benefits of the provisions of section 1081(b), a corporation must file with its return for the taxable year in which the transfer occurs a consent to have the basis of its property adjusted under section 1082(a)(2) (see § 1.1082–3), in accordance with the provisions of the regulations in effect at the time of filing of the return for the taxable year in which the transfer occurs. Such consent shall be made on Form 982 in accordance with these regulations and instructions on the form or issued therewith.

(h) *Requirements with respect to expenditure or investment.* If the full amount of the expenditure or investment required for the application of paragraph (c) of this section has not been made by the close of the taxable year in which such transfer occurred, the taxpayer shall file with the return for such year an application for the benefit of the 24-month period for expenditure and investment, reciting the nature and time of the proposed expenditure or investment. When requested by the district director, the taxpayer shall execute and file (at such time and in such form) such waiver of the statute of limitations with respect to the assessment of deficiencies (for the taxable year of the transfer and for all succeeding taxable years in any of which falls any part of the period beginning with the date of the transfer and ending 24 months thereafter) as the district director may specify, and such bond with such surety as the district director may require, in an amount not in excess of double the estimated maximum income tax which would be payable if the corporation does not make the required expenditure or investment within the required 24-month period.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6751, 29 FR 11356, Aug. 6, 1964; T.D. 7517, 42 FR 58935, Nov. 14, 1977]

§ 1.1081–5 Distribution solely of stock or securities.

(a) *In general.* If, without any surrender of his stock or securities as defined in section 1083(f), a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company receives stock or securities in such corporation or owned by such corporation, no gain to the shareholder will be recognized with respect to the stock or securities received by such shareholder which do not constitute nonexempt property, if the distribution to such shareholder is made by the distributing corporation in obedience to an order of the Securities and Exchange Commission directed to such corporation. A distribution is not within the provisions of section 1081(c)(1) if it is within the provisions of section 1081(d), relating to transfers within a system group. A distribution is also not within the provisions of section 1081(c)(1) if it involves a surrender by the shareholder of stock or securities or a transfer by the shareholder of property in exchange for the stock or securities received by the shareholder. For further limitations, see section 1081(f).

(b) *Special rule.* (1) If there is distributed to a shareholder in a corporation rights to acquire common stock in a second corporation, no gain to the shareholder from the receipt of the rights shall be recognized, but only if all the following requirements are met:

(i) The rights are received by the shareholder without the surrender by the shareholder of any stock in the distributing corporation,

(ii) Such distribution is in accordance with an arrangement forming a ground for an order of the Securities and Exchange Commission issued pursuant to section 3 of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79c) that the distributing corporation is exempt from any provision or provisions of such act, and

(iii) Before January 1, 1958, the distributing corporation disposes of all the common stock in the second corporation which it owns.

(2) The distributing corporation shall, as soon as practicable, notify the district director in whose district the corporation's income tax return and supporting data was filed (see paragraph (g) of §1.1081–11), as to whether or not the requirement of subparagraph (1)(iii) of this paragraph has been met. If such requirement has not been met, the periods of limitation (sections 6501 and 6502) with respect to any deficiency, including interest and additions to the tax, resulting solely from the receipt of such rights to acquire stock, shall include one year immediately following the date of such notification; and assessment and collection shall be made notwithstanding any provisions of law or rule of law which would otherwise prevent such assessment and collection.

§1.1081–6 Transfers within system group.

(a) The nonrecognition of gain or loss provided for in section 1081(d)(1) is applicable to an exchange of property for other property (including money and other nonexempt property) between corporations which are all members of the same system group. The term *system group* is defined in section 1083 (d).

(b) Section 1081 (d)(1) also provides for nonrecognition of gain to a corporation which is a member of a system group if property (including money or other nonexempt property) is distributed to such corporation as a shareholder in a corporation which is a member of the same system group, without the surrender by such shareholder of stock or securities in the distributing corporation.

(c) As stated in §1.1081–2, nonrecognition of gain or loss will not be accorded to a transaction not clearly provided for in part VI (section 1081 and following), subchapter O, chapter 1 of the Code, even though such transaction occurs simultaneously or in connection with an exchange, sale, or distribution to which nonrecognition is specifically accorded. Therefore, nonrecognition will not be accorded to any gain or loss realized from the discharge, or the removal of the burden, of the pecuniary obligations of a member of a system group, even though such obligations are acquired upon a transfer or distribution specifically described in section 1081 (d)(1); but the fact that the acquisition of such obligations was upon a transfer or distribution specifically described in section 1081 (d)(1) will, because of the basis provisions of section 1082 (d), affect the cost to the member of such discharge or its equivalent. Thus, section 1081 (d)(1) does not provide for the nonrecognition of any gain or loss realized from the discharge of the indebtedness of a member of a system group as the result of the acquisition in exchange, sale, or distribution of its own bonds, notes, or other evidences of indebtedness which were acquired by another member of the same system group for a consideration less or more than the issuing price thereof (with proper adjustments for amortization of premiums or discounts).

(d) The provisions of paragraph (c) of this section may be illustrated by the following example:

Example: Suppose that the A Corporation and the B Corporation are both members of the same system group; that the A Corporation holds at a cost of $900 a bond issued by the B Corporation at par, $1,000; and that the A Corporation and the B Corporation enter into an exchange subject to the provisions of section 1081 (d)(1) in which the $1,000 bond of the B Corporation is transferred from the A Corporation to the B Corporation. The $900 basis reflecting the cost to the A Corporation which would have been the basis available to the B Corporation if the property transferred to it had been something other than its own securities (see §1.1082–6) will, in this type of transaction, reflect the cost to the B Corporation of effecting a retirement of its own $1,000 bond. The $100 gain of the B Corporation reflected in the retirement will therefore be recognized.

(e) No exchange or distribution may be made without the recognition of gain or loss as provided for in section 1081 (d)(1), unless all the corporations which are parties to such exchange or distribution are acting in obedience to an order of the Securities and Exchange Commission. If an exchange or distribution is within the provisions of section 1081 (d)(1) and also may be considered to be within some other provisions of section 1081, it shall be considered that only the provisions of section 1081 (d)(1) apply and that the nonrecognition of gain or loss upon such exchange or distribution is by virtue of that section.

§ 1.1081–7 Sale of stock or securities received upon exchange by members of system group.

(a) Section 1081(d)(2) provides that to the extent that property received upon an exchange by corporations which are members of the same system group consists of stock or securities issued by the corporation from which such property was received, such stock or securities may, under certain specifically described circumstances, be sold to a party not a member of the system group, without the recognition of gain or loss to the selling corporation. The nonrecognition of gain or loss is limited, in the case of stock, to a sale of stock which is preferred as to both dividends and assets. The stock or securities must have been received upon an exchange with respect to which section 1081(d)(1) operated to prevent recognition of gain or loss to any party to the exchange. Nonrecognition of gain or loss upon the sale of such stock or securities is permitted only if the proceeds derived from the sale are applied in retirement or cancellation of stock or securities of the selling corporation which were outstanding at the time the exchange was made. It is also essential to nonrecognition of gain or loss upon the sale that both the sale of the stock or securities and the application of the proceeds derived therefrom be made in obedience to an order of the Securities and Exchange Commission. If any part of the proceeds derived from the sale is not applied in making the required retirement or cancellation of stock or securities and if the sale is otherwise within the provisions of section 1081 (d)(2), the gain resulting from the sale shall be recognized, but in an amount not in excess of the proceeds which are not so applied. In any event, if the proceeds derived from the sale of the stock or securities exceed the fair market value of such stock or securities at the time of the exchange through which they were acquired by the selling corporation, the gain resulting from the sale is to be recognized to the extent of such excess. Section 1081 (d)(2) does not provide for the nonrecognition of any gain resulting from the retirement of bonds, notes, or other evidences of indebtedness for a consideration less than the issuing price thereof. Also, that section does not provide for the nonrecognition of gain or loss upon the sale of any stock or securities received upon a distribution or otherwise than upon an exchange.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example: The X Corporation and the Y Corporation, both of which make their income tax returns on a calendar year basis, are members of the same system group. As part of an exchange to which section 1081 (d)(1) is applicable the Y Corporation on June 1, 1954, issued to the X Corporation 1,000 shares of class A stock, preferred as to both dividends and assets. The fair market value of such stock at the time of issuance was $90,000 and its basis to the X Corporation was $75,000. On December 1, 1954, in obedience to an appropriate order of the Securities and Exchange Commission, the X Corporation sells all of such stock to the public for $100,000 and applies $95,000 of this amount to the retirement of its own bonds, which were outstanding on June 1, 1954. The remaining $5,000 is not used to retire any of the X Corporation’s stock or securities. Of the total gain of $25,000 realized on the disposition of the Y Corporation stock, only $10,000 is recognized (the difference between the fair market value of the stock when acquired and the amount for which it was sold), since such amount is greater than the portion ($5,000) of the proceeds not applied to the retirement of the X Corporation’s stock or securities. If in this example the stock acquired by the X Corporation had not been stock of the Y Corporation issued to the X Corporation or if it had been stock not preferred as to both dividends and assets, the full amount of the gain

($25,000) realized upon its disposition would have been recognized, regardless of what was done with the proceeds.

§1.1081–8 Exchanges in which money or other nonexempt property is received.

(a) Under section 1081(e)(1), if in any exchange (not within any of the provisions of section 1081(d)) in which stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary are exchanged for stock or securities as provided for in section 1081 (a), there is received by the taxpayer money or other nonexempt property (in addition to property permitted to be received without recognition of gain), then—

(1) The gain, if any, to the taxpayer is to be recognized in an amount not in excess of the sum of the money and the fair market value of the other nonexempt property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent.

(b) If money or other nonexempt property is received from a corporation in an exchange described in paragraph (a) of this section and if the distribution of such money or other nonexempt property by or on behalf of such corporation has the effect of the distribution of a taxable dividend, then, as provided in section 1081 (e)(2), there shall be taxed to each distributee (1) as a dividend, such an amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) the remainder of the gain so recognized shall be taxed as a gain from the exchange of property.

§1.1081–9 Requirements with respect to order of Securities and Exchange Commission.

The term *order of the Securities and Exchange Commission* is defined in section 1083(a). In addition to the requirements specified in that definition, section 1081(f) provides that, except in the case of a distribution described in section 1081(c)(2), the provisions of section 1081 shall not apply to an exchange, expenditure, investment, distribution, or sale unless each of the following requirements is met:

(a) The order of the Securities and Exchange Commission must recite that the exchange, expenditure, investment, distribution, or sale is necessary or appropriate to effectuate the provisions of section 11(b) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79k (b)).

(b) The order shall specify and itemize the stocks and securities and other property (including money) which are ordered to be acquired, transferred, received, or sold upon such exchange, acquisition, expenditure, distribution, or sale and, in the case of an investment, the investment to be made, so as clearly to identify such property.

(c) The exchange, acquisition, expenditure, investment, distribution, or sale shall be made in obedience to such order and shall be completed within the time prescribed in such order.

These requirements were not designed merely to simplify the administration of the provisions of section 1081, and they are not to be considered as pertaining only to administrative matters. Each one of the three requirements is essential and must be met if gain or loss is not to be recognized upon the transaction.

§1.1081–10 Nonapplication of other provisions of the Internal Revenue Code of 1954.

The effect of section 1081(g) is that an exchange, sale, or distribution which is within section 1081 shall, with respect to the nonrecognition of gain or loss and the determination of basis, be governed only by the provisions of part VI (section 1081 and following), subchapter O, chapter 1 of the Code, the purpose being to prevent overlapping of those provisions and other provisions of subtitle A of the Code. In other words, if by virtue of section 1081 any portion of a person's gain or loss on any particular exchange, sale, or distribution is not to be recognized, then the gain or loss of such person shall be nonrecognized only to the extent provided in section 1081, regardless of what the result might have been if part VI (section 1081 and following), subchapter O, chapter 1 of the Code, had not been enacted;

and similarly, the basis in the hands of such person of the property received by him in such transaction shall be the basis provided by section 1082, regardless of what the basis of such property might have been under section 1011 if such part VI had not been enacted. On the other hand, if section 1081 does not provide for the nonrecognition of any portion of a person's gain or loss (whether or not such person is another party to the same transaction referred to above), then the gain or loss of such person shall be recognized or nonrecognized to the extent provided for by other provisions of subtitle A of the Code as if such part VI had not been enacted; and similarly, the basis in his hands of the property received by him in such transaction shall be the basis provided by other provisions of subtitle A of the Code as if such part VI had not been enacted.

§ 1.1081–11 Records to be kept and information to be filed with returns.

(a) *Exchanges; holders of stock or securities.* Every holder of stock or securities who receives stock or securities and other property (including money) upon an exchange shall, if the exchange is made with a corporation acting in obedience to an order of the Securities and Exchange Commission, file as a part of his income tax return for the taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including—

(1) A clear description of the stock or securities transferred in the exchange, together with a statement of the cost or other basis of such stock or securities.

(2) The name and address of the corporation from which the stock or securities were received in the exchange.

(3) A statement of the amount of stock or securities and other property (including money) received from the exchange. The amount of each kind of stock or securities and other property received shall be set forth upon the basis of the fair market value thereof at the date of the exchange.

(b) *Exchanges; corporations subject to S.E.C. orders.* Each corporation which is a party to an exchange made in obedience to an order of the Securities and Exchange Commission directed to such corporation shall file as a part of its income tax return for its taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including—

(1) A copy of the order of the Securities and Exchange Commission directed to such corporation, in obedience to which the exchange was made.

(2) A certified copy of the corporate resolution authorizing the exchange.

(3) A clear description of all property, including all stock or securities, transferred in the exchange, together with a complete statement of the cost or other basis of each class of property.

(4) The date of acquisition of any stock or securities transferred in the exchange, and, if any of such stock or securities were acquired by the corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(5) The name and address of all persons to whom any property was transferred in the exchange.

(6) If any property transferred in the exchange was transferred to another corporation, a copy of any order of the Securities and Exchange Commission directed to the other corporation, in obedience to which the exchange was made by such other corporation.

(7) If the corporation transfers any nonexempt property, the amount of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, to the time of the exchange, computed in accordance with the last sentence in paragraph (b) of § 1.316–2.

(8) A statement of the amount of stock or securities and other property (including money) received upon the exchange, including a statement of all distributions or other dispositions made thereof. The amount of each kind of stock or securities and other property received shall be stated on the basis of the fair market value thereof at the date of the exchange.

(9) A statement showing as to each class of its stock the number of shares and percentage owned by any other

corporation, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(10) The term *exchange* shall, whenever occurring in this paragraph, be read as *exchange, expenditure, or investment.*

(c) *Distributions; shareholders.* Each shareholder who receives stock or securities or other property (including money) upon a distribution made by a corporation in obedience to an order of the Securities and Exchange Commission shall file as a part of his income tax return for the taxable year in which such distribution is received a complete statement of all facts pertinent to the nonrecognition of gain upon such distribution, including—

(1) The name and address of the corporation from which the distribution is received.

(2) A statement of the amount of stock or securities or other property received upon the distribution, including (in case the shareholder is a corporation) a statement of all distributions or other disposition made of such stock or securities or other property by the shareholder. The amount of each class of stock or securities and each kind of property shall be stated on the basis of the fair market value thereof at the date of the distribution.

(3) If the shareholder is a corporation, a statement showing as to each class of its stock the number of shares and percentage owned by a registered holding company or a majority-owned subsidiary company of a registered holding company, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(d) *Distributions; distributing corporations subject to S.E.C. orders.* Every corporation making a distribution in obedience to an order of the Securities and Exchange Commission shall file as a part of its income tax return for its taxable year in which the distribution is made a complete statement of all facts pertinent to the nonrecognition of gain to the distributee upon such distribution including—

(1) A copy of the order of the Securities and Exchange Commission, in obedience to which the distribution was made.

(2) A certified copy of the corporate resolution authorizing the distribution.

(3) A statement of the amount of stock or securities or other property (including money) distributed to each shareholder. The amount of each kind of stock or securities or other property shall be stated on the basis of the fair market value thereof at the date of the distribution.

(4) The date of acquisition of the stock or securities distributed, and, if any of such stock or securities were acquired by the distributing corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(5) The amount of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, to the time of the distribution, computed in accordance with the last sentence in paragraph (b) of §1.316–2.

(6) A statement showing as to each class of its stock the number of shares and percentage owned by any other corporation, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(e) *Sales by members of system groups.* Each corporation which is a member of a system group and which in obedience to an order of the Securities and Exchange Commission sells stock or securities received upon an exchange (made in obedience to an order of the Securities and Exchange Commission) and applies the proceeds derived therefrom in retirement or cancellation of its own stock or securities shall file as a part of its income tax return for the taxable year in which the sale is made a complete statement of all facts pertaining to the nonrecognition of gain or loss upon such sale, including—

(1) A copy of the order of the Securities and Exchange Commission in obedience to which the sale was made.

(2) A copy of the order of the Securities and Exchange Commission in obedience to which the proceeds derived from the sale were applied in whole or in part in the retirement or cancellation of its stock or securities.

(3) A certified copy of the corporate resolutions authorizing the sale of the stock or securities and the application of the proceeds derived therefrom.

(4) A clear description of the stock or securities sold, including the name and address of the corporation by which they were issued.

(5) The date of acquisition of the stock or securities sold, together with a statement of the fair market value of such stock or securities at the date of acquisition, and a copy of all orders of the Securities and Exchange Commission in obedience to which such stock or securities were acquired.

(6) The amount of the proceeds derived from such sale.

(7) The portion of the proceeds of such sale which was applied in retirement or cancellation of its stock or securities, together with a statement showing how long such stock or securities were outstanding prior to retirement or cancellation.

(8) The issuing price of its stock or securities which were retired or canceled.

(f) *Section 1081 (c)(2) distributions; shareholders.* Each shareholder who receives a distribution described in section 1081 (c)(2) (concerning rights to acquire common stock) shall file as a part of his income tax return for the taxable year in which such distribution is received a complete statement of all the facts pertinent to the nonrecognition of gain upon such distribution, including—

(1) The name and address of the corporation from which the distribution is received.

(2) A statement of the amount of the rights received upon the distribution, stated on the basis of their fair market value at the date of the distribution.

(g) *Section 1081 (c)(2) distributions; distributing corporations.* Every corporation making a distribution described in section 1081(c)(2) (concerning rights to acquire common stock) shall file as a part of its income tax return for its taxable year in which the distribution is made a complete statement of all facts pertinent to the nonrecognition of gain to the distributees upon such distribution including—

(1) A copy of the arrangement forming the basis for the issuance of the order by the Securities and Exchange Commission.

(2) A copy of the order issued by the Securities and Exchange Commission pursuant to section 3 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79c).

(3) A certified copy of the corporate resolution authorizing the arrangement and the distribution.

(4) A statement of the amount of the rights distributed to each shareholder, stated on the basis of their fair market value at the date of the distribution.

(5) The date of acquisition of the stock with respect to which such rights are distributed, and if any were acquired by the distributing corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(6) The amount of the undistributed earnings and profits of the distributing corporation accumulated after February 28, 1913, to the time of the distribution computed in accordance with the last sentence in paragraph (b) of §1.316–2.

(h) *General requirements.* Permanent records in substantial form shall be kept by every taxpayer who participates in an exchange or distribution to which sections 1081 to 1083, inclusive, are applicable, showing the cost or other basis of the property transferred and the amount of stock or securities and other property (including money) received, in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received on the exchange or distribution.

§1.1082–1 Basis for determining gain or loss.

(a) For determining the basis of property acquired in a taxable year beginning before January 1, 1942, in any manner described in section 372 of the Internal Revenue Code of 1939 prior to its amendment by the Revenue Act of 1942 (56 Stat. 798), see such section (before its amendment by such Act).

(b) If the property was acquired in a taxable year beginning after December 31, 1941, in any manner described in section 1082 (other than subsection (a)(2)), or section 372 (other than subsection (a)(2)) of the Internal Revenue Code of 1939 after its amendments, the basis shall be that prescribed in section 1082 with respect to such property.

However, in the case of property acquired in a transaction described in section 1081(c)(2), this paragraph is applicable only if the property was acquired in a distribution made in a taxable year subject to the Internal Revenue Code of 1954.

(c) Section 1082 makes provisions with respect to the basis of property acquired in a transfer in connection with which the recognition of gain or loss is prohibited by the provisions of section 1081 with respect to the whole or any part of the property received. In general, and except as provided in §1.1082–3, it is intended that the basis for determining gain or loss pertaining to the property prior to its transfer, as well as the basis for determining the amount of depreciation or depletion deductible and the amount of earnings or profits available for distribution, shall continue notwithstanding the non-taxable conversion of the asset in form or its change in ownership. The continuance of the basis may be reflected in a shift thereof from one asset to another in the hands of the same owner, or in its transfer with the property from one owner into the hands of another. See also §1.1081–2.

§1.1082–2 Basis of property acquired upon exchanges under section 1081 (a) or (e).

(a) In the case of an exchange of stock or securities for stock or securities as described in section 1081 (a), if no part of the gain or loss upon such exchange was recognized under section 1081, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange.

(b) If, in an exchange of stock or securities as described in section 1081 (a), gain to the taxpayer was recognized under section 1081 (e) on account of the receipt of money, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized upon the exchange. If, upon such exchange, there were received by the taxpayer money and other nonexempt property (not permitted to be received without the recognition of gain), and gain from the transaction was recognized under section 1081 (e), the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of money received and increased by the amount of gain recognized, must be apportioned to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of such basis to the properties received, there must be assigned to the nonexempt property (other than money) an amount equivalent to its fair market value at the date of the exchange.

(c) Section 1081(e) provides that no loss may be recognized on an exchange of stock or securities for stock or securities as described in section 1081(a), although the taxpayer receives money or other nonexempt property from the transaction. However, the basis of the property (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be apportioned to the properties received, and for this purpose there must be allocated to the nonexempt property (other than money) an amount of such basis equivalent to the fair market value of such nonexempt property at the date of the exchange.

(d) Section 1082 (a) does not apply in ascertaining the basis of property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it. For the rule in such cases, see section 1082 (b).

(e) For purposes of this section, any reference to section 1081 shall be deemed to include a reference to corresponding provisions of prior internal revenue laws.

§1.1082–3 Reduction of basis of property by reason of gain not recognized under section 1081(b).

(a) *Introductory.* In addition to the adjustments provided in section 1016 and other applicable provisions of chapter 1 of the Code, and the regulations relating thereto, which are required to be made with respect to the cost or other basis of property, section

1082(a)(2) provides that a further adjustment shall be made in any case in which there shall have been a nonrecognition of gain under section 1081(b). Such further adjustment shall be made with respect to the basis of the property in the hands of the transferor immediately after the transfer and of the property acquired within 24 months after such transfer by an expenditure or investment to which section 1081(b) relates, and on account of which expenditure or investment gain is not recognized. If the property is in the hands of the transferor immediately after the transfer, the time of reduction is the day of the transfer; in all other cases the time of reduction is the date of acquisition. The effect of applying an amount in reduction of basis of property under section 1081 (b) is to reduce by such amount the basis for determining gain upon sale or other disposition, the basis for determining loss upon sale or other disposition, the basis for depreciation and for depletion, and any other amount which the Code prescribes shall be the same as any of such bases. For the purposes of the application of an amount in reduction of basis under section 1081(b), property is not considered as having a basis capable of reduction if—

(1) It is money, or

(2) If its adjusted basis for determining gain at the time the reduction is to be made is zero, or becomes zero at any time in the application of section 1081 (b).

(b) *General rule.* (1) Section 1082 (a)(2) sets forth seven categories of property, the basis of which for determining gain or loss shall be reduced in the order stated.

(2) If any of the property in the first category has a basis capable of reduction, the reduction must first be made before applying an amount in reduction of the basis of any property in the second or in a succeeding category, to each of which in turn a similar rule is applied.

(3) In the application of the rule to each category, the amount of the gain not recognized shall be applied to reduce the cost or other basis of all the property in the category as follows: The cost or other basis (at the time immediately after the transfer or, if the property is not then held but is thereafter acquired, at the time of such acquisition) of each unit of property in the first category shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis at such time for determining gain, determined without regard to this section) in an amount equal to such proportion of the unrecognized gain as the adjusted basis (for determining gain, determined without regard to this section) at such time of each unit of property of the taxpayer in that category bears to the aggregate of the adjusted basis (for determining gain, computed without regard to this section) at such time of all the property of the taxpayer in that category. When such adjusted basis of the property in the first category has been thus reduced to zero, a similar rule shall be applied, with respect to the portion of such gain which is unabsorbed in such reduction of the basis of the property in such category, in reducing the basis of the property in the second category. A similar rule with respect to the remaining unabsorbed gain shall be applied in reducing the basis of the property in the next succeeding category.

(c) *Special cases.* (1) With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property within a particular category specified in section 1082(a)(2) adjusted in a manner different from the general rule set forth in paragraph (b) of this section. Variations from such general rule may, for example, involve adjusting the basis of only certain units of the taxpayer's property within a given category. A request for variations from the general rule should be filed by the taxpayer with its income tax return for the taxable year in which the transfer of property has occurred.

(2) Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effective only if incorporated in a closing agreement entered into under the provisions of section 7121. If no such agreement is entered into by the taxpayer and the Commissioner, then the consent filed on Form 982 shall (except as otherwise provided in this subparagraph) be deemed to be a consent to the

application of such general rule, and such general rule shall apply in the determination of the basis of the taxpayer's property. If, however, the taxpayer specifically states on such form that it does not consent to the application of the general rule, then, in the absence of a closing agreement, the document filed shall not be deemed a consent within the meaning of section 1081(b)(4).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7517, 42 FR 58935, Nov. 14, 1977]

§1.1082–4 Basis of property acquired by corporation under section 1081(a), 1081(b), or 1081(e) as contribution of capital or surplus, or in consideration for its own stock or securities.

If, in connection with an exchange of stock or securities for stock or securities as described in section 1081(a), or an exchange of property for property as described in section 1081(b), or an exchange as described in section 1081(e), property is acquired by a corporation by the issuance of its stock or securities, the basis of such property shall be determined under section 1082(b). If the corporation issued its stock or securities as part or sole consideration for the property acquired, the basis of the property in the hands of the acquiring corporation is the basis (adjusted to the date of the exchange) which the property would have had in the hands of the transferor if the transfer had not been made, increased in the amount of gain or decreased in the amount of loss recognized under section 1081 to the transferor upon the transfer. If any property is acquired by a corporation from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property to the corporation is the basis (adjusted to the date of acquisition) of the property in the hands of the transferor.

§1.1082–5 Basis of property acquired by shareholder upon tax-free distribution under section 1081(c) (1) or (2).

(a) *Stock or securities.* If there was distributed to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company, stock or securities (other than stock or securities which are nonexempt property), and if by virtue of section 1081 (c)(1) no gain was recognized to the shareholder upon such distribution, then the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock or securities so distributed to the shareholder. The basis of the old shares and the stock or securities received upon the distribution shall be determined in accordance with the following rules:

(1) If the stock or securities received upon the distribution consist solely of stock in the distributing corporation and the stock received is all of substantially the same character and preference as the stock in respect of which the distribution is made, the basis of each share will be the quotient of the cost or other basis of the old shares of stock divided by the total number of the old and the new shares.

(2) If the stock or securities received upon the distribution are in whole or in part stock in a corporation other than the distributing corporation, or are in whole or in part stock of a character or preference materially different from the stock in respect of which the distribution is made, or if the distribution consists in whole or in part of securities other than stock, the cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock or securities distributed in proportion, as nearly as may be, to the respective values of each class of stock or security, old and new, at the time of such distribution, and the basis of each share of stock or unit of security will be the quotient of the cost or other basis of the class of stock or security to which such share or unit belongs, divided by the number of shares or units in the class. Within the meaning of this subparagraph, stocks or securities in one corporation are different in class from stocks or securities in another corporation, and, in general, any material difference in character or preference or terms sufficient to distinguish one stock or security from another stock or security, so that different values may properly be assigned thereto, will constitute a difference in class.

(b) *Stock rights.* If there was distributed to a shareholder in a corporation rights to acquire common stock in a second corporation, and if by virtue of section 1081 (c)(2) no gain was recognized to the shareholder upon such distribution, then the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock rights so distributed to the shareholder. The basis of such stock and the stock rights received upon the distribution shall be determined in accordance with the following:

(1) The cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock rights distributed, in proportion to the respective values thereof at the time the rights are issued.

(2) The basis for determining gain or loss from the sale of a right, or from the sale of a share of stock in respect of which the distribution is made, will be the quotient of the cost or other basis, properly adjusted, assigned to the rights or the stock, divided, as the case may be, by the number of rights acquired or by the number of shares of such stock held.

(c) *Cross reference.* As to the basis of stock or securities distributed by one member of a system group to another member of the same system group, see § 1.1082–6.

§ 1.1082–6 Basis of property acquired under section 1081(d) in transactions between corporations of the same system group.

(a) If property was acquired by a corporation which is a member of a system group, from a corporation which is a member of the same system group, upon a transfer or distribution described in section 1081 (d)(1), then as a general rule the basis of such property in the hands of the acquiring corporation is the basis which such property would have had in the hands of the transferor if the transfer or distribution had not been made. Except as otherwise indicated in this section, this rule will apply equally to cases in which the consideration for the property acquired consists of stock or securities, money, and other property, or any of them, but it is contemplated that an ultimate true reflection of income will be obtained in all cases, notwithstanding any peculiarities in form which the various transactions may assume. See the example in § 1.1081–6.

(b) An exception to the general rule is provided for in case the property acquired consists of stock or securities issued by the corporation from which such stock or securities were received. If such stock or securities were the sole consideration for the property transferred to the corporation issuing such stock or securities, then the basis of the stock or securities shall be (1) the same as the basis (adjusted to the time of the transfer) of the property transferred for such stock or securities, or (2) the fair market value of such stock or securities at the time of their receipt, whichever is the lower. If such stock or securities constituted only part consideration for the property transferred to the corporation issuing such stock or securities, then the basis shall be an amount which bears the same ratio to the basis of the property transferred as the fair market value of such stock or securities on their receipt bears to the total fair market value of the entire consideration received, except that the fair market value of such stock or securities at the time of their receipt shall be the basis therefor, if such value is lower than such amount.

(c) The application of paragraph (b) of this section may be illustrated by the following examples:

Example 1. Suppose the A Corporation has property with an adjusted basis of $600,000 and, in an exchange in which section 1081 (d)(1) is applicable, transfers such property to the B Corporation in exchange for a total consideration of $1,000,000, consisting of (1) cash in the amount of $100,000, (2) tangible property having a fair market value of $400,000 and an adjusted basis in the hands of the B Corporation of $300,000, and (3) stock or securities issued by the B Corporation with a par value and a fair market value as of the date of their receipt in the amount of $500,000. The basis to the B Corporation of the property received by it is $600,000, which is the adjusted basis of such property in the hands of the A Corporation. The basis to the A Corporation of the assets (other than cash) received by it is as follows: Tangible property, $300,000, the adjusted basis of such property to the B Corporation, the former owner;

stock or securities issued by the B Corporation, $300,000, an amount equal to 550,000/1,000,000ths of $600,000.

Example 2. Suppose that in example (1) the property of the A Corporation transferred to the B Corporation had an adjusted basis of $1,100,000 instead of $600,000, and that all other factors in the example remain the same. In such case, the basis to the A Corporation of the stock or securities in the B Corporation is $500,000, which was the fair market value of such stock or securities at the time of their receipt by the A Corporation, because this amount is less than the amount established as 500,000/1,000,000ths of $1,100,000 or $550,000.

§ 1.1083–1 Definitions.

(a) *Order of the Securities and Exchange Commission.* (1) An order of the Securities and Exchange Commission as defined in section 1083(a) must be issued after May 28, 1938 (the date of the enactment of the Revenue Act of 1938 (52 Stat. 447)), and must be issued under the authority of section 11(b) or 11(e) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79k (b), (e)), to effectuate the provisions of section 11(b) of such Act. In all cases the order must become or have become final in accordance with law; i.e., it must be valid, outstanding, and not subject to further appeal. See further sections 1083(a) and 1081(f).

(2) Section 11 (b) of the Public Utility Holding Company Act of 1935 provides:

> Sec. 11. *Simplification of holding company systems.** * *
>
> (b) It shall be the duty of the Commission, as soon as practicable after January 1, 1938:
>
> (1) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such action as the Commission shall find necessary to limit the operations of the holding-company system of which such company is a part to a single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system: *Provided, however,* That the Commission shall permit a registered holding company to continue to control one or more additional integrated public-utility systems, if, after notice and opportunity for hearing, it finds that—
>
> (A) Each of such additional systems cannot be operated as an independent system without the loss of substantial economies which can be secured by the retention of control by such holding company of such system;
>
> (B) All of such additional systems are located in one State, or in adjoining States, or in a contiguous foreign country; and
>
> (C) The continued combination of such systems under the control of such holding company is not so large (considering the state of the art and the area or region affected) as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation.
>
> The Commission may permit as reasonably incidental, or economically necessary or appropriate to the operations of one or more integrated public-utility systems the retention of an interest in any business (other than the business of a public-utility company as such) which the Commission shall find necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system or systems.
>
> (2) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such steps as the Commission shall find necessary to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system. In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company. Except for the purpose of fairly and equitably distributing voting power among the security holders of such company, nothing in this paragraph shall authorize the Commission to require any change in the corporate structure or existence of any company which is not a holding company, or of any company whose principal business is that of a public-utility company. The Commission may by order revoke or modify any order previously made under this subsection, if, after notice and opportunity for hearing, it finds that the conditions upon which the order was predicated do not exist. Any order made under this subsection shall be subject to judicial review as provided in section 24.

(3) Section 11(e) of the Public Utility Holding Company Act of 1935 provides:

> Sec. 11. *Simplification of holding company systems.* * * *
>
> (e) In accordance with such rules and regulations or order as the Commission may

deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control, securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted or as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan; and the Commission, at the request of the company, may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. If, upon any such application, the court, after notice and opportunity for hearing, shall approve such plan as fair and equitable and as appropriate to effectuate the provisions of section 11, the court as a court of equity may, to such extent as it deems necessary for the purpose of carrying out the terms and provisions of such plan, take exclusive jurisdiction and possession of the company or companies and the assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer, under the direction of the court and in accordance with the plan theretofore approved by the court and the Commission, the assets so possessed.

(b) *Registered holding company, holding-company system, and associate company*. (1) Under section 5 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79e), any holding company may register by filing with the Securities and Exchange Commission a notification of registration, in such form as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers. A holding company shall be deemed to be registered upon receipt by the Securities and Exchange Commission of such notification of registration. As used in this part, the term *registered holding company* means a holding company whose notification of registration has been so received and whose registration is still in effect under section 5 of the Public Utility Holding Company Act of 1935. Under section 2 (a)(7) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79b (a)(7)), a corporation is a holding company (unless it is declared not to be such by the Securities and Exchange Commission), if such corporation directly or indirectly owns, controls, or holds with power to vote 10 percent or more of the outstanding voting securities of a public-utility company (i.e., an electric utility company or a gas utility company as defined by such act) or of any other holding company. A corporation is also a holding company if the Securities and Exchange Commission determines, after notice and opportunity for hearing, that such corporation directly or indirectly exercises (either alone or pursuant to an arrangement or understanding with one or more other persons) such a controlling influence over the management or policies of any public-utility company (i.e., an electric utility company or a gas utility company as defined by such act) or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such corporation be subject to the obligations, duties, and liabilities imposed upon holding companies by the Public Utility Holding Company Act of 1935 (15 U.S.C. ch. 2C). An electric utility company is defined by section 2 (a)(3) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79b (a)(3)) to mean a company which owns or operates facilities used for the generation, transmission, or distribution of electrical energy for sale, other than sale to tenants or employees of the company operating such facilities for their own use and not for resale; and a gas utility company is defined by section 2 (a)(4) of such act (15 U.S.C. 79b (a)(4)), to mean a company which owns or operates facilities used for the distribution at retail (other than distribution only in enclosed portable containers, or distribution to tenants or employees of the company operating such facilities for their own use and not for resale) of natural or manufactured gas for heat, light, or power. However, under certain conditions the Securities and Exchange Commission may declare a company not to be an electric utility company or a gas utility company, as the case may be, in which event the company shall not be considered an electric utility company or a gas utility company.

(2) The term *holding company system* has the meaning assigned to it by section 2 (a)(9) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79b (a)(9)), and hence means any holding company, together with all its subsidiary companies (i.e., subsidiary companies within the meaning of section 2(a)(8) of such act (15 U.S.C. 79b (a)(8)), which in general include all companies 10 percent of whose outstanding voting securities is owned directly or indirectly by such holding company) and all mutual service companies of which such holding company or any subsidiary company thereof is a member company. The term *mutual service company* means a company approved as a mutual service company under section 13 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79m). The term *member company* is defined by action 2 (a)(14) of such act (15 U.S.C. 79b (a)(14)), to mean a company which is a member of an association or group of companies mutually served by a mutual service company.

(3) The term *associate company* has the meaning assigned to it by section 2 (a)(10) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79b (a)(10)), and hence an associate company of a company is any company in the same holding-company system with such company.

(c) *Majority-owned subsidiary company.* The term *majority-owned subsidiary company* is defined in section 1083 (c). Direct ownership by a registered holding company of more than 50 percent of the specified stock of another corporation is not necessary to constitute such corporation a majority-owned subsidiary company. To illustrate, if the H Corporation, a registered holding company, owns 51 percent of the common stock of the A Corporation and 31 percent of the common stock of the B Corporation, and the A Corporation owns 20 percent of the common stock of the B Corporation (the common stock in each case being the only stock entitled to vote), both the A Corporation and the B Corporation are majority-owned subsidiary companies.

(d) *System group.* The term *system group* is defined in section 1083 (d) to mean one or more chains of corporations connected through stock ownership with a common parent corporation, if at least 90 percent of each class of stock (other than (1) stock which is preferred as to both dividends and assets, and (2) stock which is limited and preferred as to dividends but which is not preferred as to assets but only if the total value of such stock is less than 1 percent of the aggregate value of all classes of stock which are not preferred as to both dividends and assets) of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations, and if the common parent corporation owns directly at least 90 percent of each class of stock (other than stock preferred as to both dividends and assets) of at least one of the other corporations; but no corporation is a member of a system group unless it is either a registered holding company or a majority-owned subsidiary company. While the type of stock which must, for the purpose of this definition, be at least 90 percent owned may be different from the voting stock which must be more than 50 percent owned for the purpose of the definition of a majority-owned subsidiary company under section 1083(c), as a general rule both types of ownership tests must be met under section 1083(d), since a corporation, in order to be a member of a system group, must also be a registered holding company or a majority-owned subsidiary company.

(e) *Nonexempt property.* The term *nonexempt property* is defined by section 1083(e) to include—

(1) The amount of any consideration in the form of a cancellation or assumption of debts or other liabilities of the transferor (including a continuance of encumbrances subject to which the property was transferred). To illustrate, if in obedience to an order of the Securities and Exchange Commission the X Corporation, a registered holding company, transfers property to the Y Corporation in exchange for property (not nonexempt property) with a fair

market value of $500,000, the X Corporation receives $100,000 of nonexempt property, if for example—

(i) The Y Corporation cancels $100,000 of indebtedness owed to it by the X Corporation;

(ii) The Y Corporation assumes an indebtedness of $100,000 owed by the X Corporation to another company, the A Corporation; or

(iii) The Y Corporation takes over the property conveyed to it by the X Corporation subject to a mortgage of $100,000.

(2) Short-term obligations (including notes, drafts, bills of exchange, and bankers' acceptances) having a maturity at the time of issuance of not exceeding 24 months, exclusive of days of grace.

(3) Securities issued or guaranteed as to principal or interest by a government or subdivision thereof (including those issued by a corporation which is an instrumentality of a government or subdivision thereof).

(4) Stock or securities which were acquired from a registered holding company which acquired such stock or securities after February 28, 1938, or an associate company of a registered holding company which acquired such stock or securities after February 28, 1938, unless such stock or securities were acquired in obedience to an order of the Securities and Exchange Commission (as defined in section 1083 (a)) or were acquired with the authorization or approval of the Securities and Exchange Commission under any section of the Public Utility Holding Company Act of 1935, and are not nonexempt property within the meaning of section 1083(e) (1), (2), or (3).

(5) Money, and the right to receive money not evidenced by a security other than an obligation described as nonexempt property in section 1083 (e) (2) or (3). The term *the right to receive money* includes, among other items, accounts receivable, claims for damages, and rights to refunds of taxes.

(f) *Stock or securities.* The term *stock or securities* is defined in section 1083(f) for the purposes of part VI (section 1081 and following), subchapter O, chapter 1 of the Code. As therein defined, the term includes voting trust certificates and stock rights or warrants.

WASH SALES OF STOCK OR SECURITIES

§ 1.1091–1 Losses from wash sales of stock or securities.

(a) A taxpayer cannot deduct any loss claimed to have been sustained from the sale or other disposition of stock or securities if, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date (referred to in this section as the 61-day period), he has acquired (by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities. However, this prohibition does not apply (1) in the case of a taxpayer, not a corporation, if the sale or other disposition of stock or securities is made in connection with the taxpayer's trade or business, or (2) in the case of a corporation, a dealer in stock or securities, if the sale or other disposition of stock or securities is made in the ordinary course of its business as such dealer.

(b) Where more than one loss is claimed to have been sustained within the taxable year from the sale or other disposition of stock or securities, the provisions of this section shall be applied to the losses in the order in which the stock or securities the disposition of which resulted in the respective losses were disposed of (beginning with the earliest disposition). If the order of disposition of stock or securities disposed of at a loss on the same day cannot be determined, the stock or securities will be considered to have been disposed of in the order in which they were originally acquired (beginning with the earliest acquisition).

(c) Where the amount of stock or securities acquired within the 61-day period is less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the loss from the sale or other disposition of which is not deductible shall be those with which the stock or securities acquired are matched in accordance with the following rule: The stock or securities acquired will be matched in accordance with the order of their acquisition (beginning with the earliest acquisition) with an equal number of the shares of stock or securities sold or otherwise disposed of.

(d) Where the amount of stock or securities acquired within the 61-day period is not less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the acquisition of which resulted in the nondeductibility of the loss shall be those with which the stock or securities disposed of are matched in accordance with the following rule: The stock or securities sold or otherwise disposed of will be matched with an equal number of the shares of stock or securities acquired in accordance with the order of acquisition (beginning with the earliest acquisition) of the stock or securities acquired.

(e) The acquisition of any share of stock or any security which results in the nondeductibility of a loss under the provisions of this section shall be disregarded in determining the deductibility of any other loss.

(f) The word *acquired* as used in this section means acquired by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law, and comprehends cases where the taxpayer has entered into a contract or option within the 61-day period to acquire by purchase or by such an exchange.

(g) For purposes of determining under this section the 61-day period applicable to a short sale of stock or securities, the principles of paragraph (a) of §1.1233–1 for determining the consummation of a short sale shall generally apply except that the date of entering into the short sale shall be deemed to be the date of sale if, on the date of entering into the short sale, the taxpayer owns (or on or before such date has entered into a contract or option to acquire) stock or securities identical to those sold short and subsequently delivers such stock or securities to close the short sale.

(h) The following examples illustrate the application of this section:

Example 1. A, whose taxable year is the calendar year, on December 1, 1954, purchased 100 shares of common stock in the M Company for $10,000 and on December 15, 1954, purchased 100 additional shares for $9,000. On January 3, 1955, he sold the 100 shares purchased on December 1, 1954, for $9,000. Because of the provisions of section 1091, no loss from the sale is allowable as a deduction.

Example 2. A, whose taxable year is the calendar year, on September 21, 1954, purchased 100 shares of the common stock of the M Company for $5,000. On December 21, 1954, he purchased 50 shares of substantially identical stock for $2,750, and on December 27, 1954, he purchased 25 additional shares of such stock for $1,125. On January 3, 1955, he sold for $4,000 the 100 shares purchased on September 21, 1954. There is an indicated loss of $1,000 on the sale of the 100 shares. Since, within the 61-day period, A purchased 75 shares of substantially identical stock, the loss on the sale of 75 of the shares ($3,750−$3,000, or $750) is not allowable as a deduction because of the provisions of section 1091. The loss on the sale of the remaining 25 shares ($1,250−$1,000, or $250) is deductible subject to the limitations provided in sections 267 and 1211. The basis of the 50 shares purchased December 21, 1954, the acquisition of which resulted in the nondeductibility of the loss ($500) sustained on 50 of the 100 shares sold on January 3, 1955, is $2,500 (the cost of 50 of the shares sold on January 3, 1955) + $750 (the difference between the purchase price ($2,750) of the 50 shares acquired on December 21, 1954, and the selling price ($2,000) of 50 of the shares sold on January 3, 1955), or $3,250. Similarly, the basis of the 25 shares purchased on December 27, 1954, the acquisition of which resulted in the nondeductibility of the loss ($250) sustained on 25 of the shares sold on January 3, 1955, is $1,250+$125, or $1,375. See §1.1091–2.

Example 3. A, whose taxable year is the calendar year, on September 15, 1954, purchased 100 shares of the stock of the M Company for $5,000. He sold these shares on February 1, 1956, for $4,000. On each of the four days from February 15, 1956, to February 18, 1956, inclusive, he purchased 50 shares of substantially identical stock for $2,000. There is an indicated loss of $1,000 from the sale of the 100 shares on February 1, 1956, but, since within the 61-day period A purchased not less than 100 shares of substantially identical stock, the loss is not deductible. The particular shares of stock the purchase of which resulted in the nondeductibility of the loss are the first 100 shares purchased within such period, that is, the 50 shares purchased on February 15, 1956, and the 50 shares purchased on February 16, 1956. In determining the period for which the 50 shares purchased on February 15, 1956, and the 50 shares purchased on February 16, 1956, were held, there is to be included the period for which the 100 shares purchased on September 15, 1954, and sold on February 1, 1956, were held.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6926, 32 FR 11468, Aug. 9, 1967]

§ 1.1091–2 Basis of stock or securities acquired in "wash sales".

(a) *In general.* The application of section 1091(d) may be illustrated by the following examples:

Example 1. A purchased a share of common stock of the X Corporation for $100 in 1935, which he sold January 15, 1955, for $80. On February 1, 1955, he purchased a share of common stock of the same corporation for $90. No loss from the sale is recognized under section 1091. The basis of the new share is $110; that is, the basis of the old share ($100) increased by $10, the excess of the price at which the new share was acquired ($90) over the price at which the old share was sold ($80).

Example 2. A purchased a share of common stock of the Y Corporation for $100 in 1935, which he sold January 15, 1955, for $80. On February 1, 1955, he purchased a share of common stock of the same corporation for $70. No loss from the sale is recognized under section 1091. The basis of the new share is $90; that is, the basis of the old share ($100) decreased by $10, the excess of the price at which the old share was sold ($80) over the price at which the new share was acquired ($70).

(b) *Special rule.* For a special rule as to the adjustment to basis required under section 1091(d) in the case of wash sales involving certain regulated investment company stock for which there is an average basis, see paragraph (e)(3)(iii) (*c*) and (*d*) of § 1.1012–1.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7129, 36 FR 12738, July 7, 1971]

§ 1.1092(b)–1T Coordination of loss deferral rules and wash sale rules (temporary).

(a) *In general.* Except as otherwise provided, in the case of the disposition of a position or positions of a straddle, the rules of paragraph (a)(1) of this section apply before the application of the rules of paragraph (a)(2) of this section.

(1) Any loss sustained from the disposition of shares of stock or securities that constitute positions of a straddle shall not be taken into account for purposes of this subtitle if, within a period beginning 30 days before the date of such disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange on which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities.

(2) Except as otherwise provided, if a taxpayer disposes of less than all of the positions of a straddle, any loss sustained with respect to the disposition of that position or positions (hereinafter referred to as *loss position*) shall not be taken into account for purposes of this subtitle to the extent that the amount of unrecognized gain as of the close of the taxable year in one or more of the following positions—

(i) Successor positions,

(ii) Offsetting positions to the loss position, or

(iii) Offsetting positions to any successor position,

exceeds the amount of loss disallowed under paragraph (a)(1) of this section. See § 1.1092(b)–5T relating to definitions.

(b) *Carryover of disallowed loss.* Any loss that is disallowed under paragraph (a) of this section shall, subject to any further application of paragraph (a)(1) of this section and the limitations under paragraph (a)(2) of this section, be treated as sustained in the succeeding taxable year. However, a loss disallowed in Year 1, for example, under paragraph (a)(1) of this section will not be allowed in Year 2 unless the substantially identical stock or securities, the acquisition of which caused the loss to be disallowed in Year 1, are disposed of during Year 2 and paragraphs (a)(1) and (a)(2) of this section do not apply in Year 2 to disallow the loss.

(c) *Treatment of disallowed loss*—(1) *Character.* If the disposition of a loss position would (but for the application of this section) result in a capital loss, the loss allowed under paragraph (b) of this section with respect to the disposition of the loss position shall be treated as a capital loss. In any other case, a loss allowed under paragraph (b) of this section shall be treated as an ordinary loss. For example, if the disposition of a loss position would, but for the application of paragraph (a) of this section, give rise to a capital loss, that loss when allowed pursuant to paragraph (b) of this section will be treated as a capital loss on the date the loss is allowed regardless of whether any gain or loss with respect to one or more successor positions would be treated as ordinary income or loss.

(2) *Section 1256 contracts.* If the disposition of a loss position would (but for the application of this section) result in 60 percent long-term capital loss and 40 percent short-term capital loss, the loss allowed under paragraph (b) of this section with respect to the disposition of the loss position shall be treated as 60 percent long-term capital loss and 40 percent short-term capital loss regardless of whether any gain or loss with respect to one or more successor positions would be treated as 100 percent long-term or short-term capital gain or loss.

(d) *Exceptions.* (1) This section shall not apply to losses sustained—

(i) With respect to the disposition of one or more positions that constitute part of a hedging transaction;

(ii) With respect to the disposition of a loss position included in a mixed straddle account (as defined in paragraph (b) of § 1.1092(b)–4T); and

(iii) With respect to the disposition of a position that is part of a straddle consisting only of section 1256 contracts.

(2) Paragraph (a)(1) of this section shall not apply to losses sustained by a dealer in stock or securities if such losses are sustained in a transaction made in the ordinary course of such business.

(e) *Coordination with section 1091.* Section 1092(b) applies in lieu of section 1091 to losses sustained from the disposition of positions in a straddle. See example (18) of paragraph (g) of this section.

(f) *Effective date.* The provisions of this section apply to dispositions of loss positions on or after January 24, 1985.

(g) *Examples.* This section may be illustrated by the following examples. It is assumed in each example that the following positions are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year and none of the exceptions contained in paragraph (d) of this section apply.

Example 1. On December 1, 1985, A enters into offsetting long and short positions. On December 10, 1985, A disposes of the short position at an $11 loss, at which time there is $5 of unrealized gain in the offsetting long position. At year-end there is still $5 of unrecognized gain in the offsetting long position. Under these circumstances, $5 of the $11 loss will be disallowed for 1985 because there is $5 of unrecognized gain in the offsetting long position; the remaining $6 of loss, however, will be taken into account in 1985.

Example 2. Assume the facts are the same as in example (1), except that at year-end there is $11 of unrecognized gain in the offsetting long position. Under these circumstances, the entire $11 loss will be disallowed for 1985 because there is $11 of unrecognized gain at year-end in the offsetting long position.

Example 3. Assume the facts are the same as in example (1), except that at year-end there is no unrecognized gain in the offsetting long position. Under these circumstances, the entire $11 loss will be allowed for 1985.

Example 4. On November 1, 1985, A enters into offsetting long and short positions. On November 10, 1985, A disposes of the long position at a $10 loss, at which time there is $10 of unrealized gain in the short position. On November 11, 1985, A enters into a new long position (successor position) that is offsetting with respect to the retained short position but is not substantially identical to the long position disposed of on November 10, 1985. A holds both positions through year-end, at which time there is $10 of unrecognized gain in the successor long position and no unrecognized gain in the offsetting short position. Under these circumstances, the entire $10 loss will be disallowed for 1985 because there is $10 of unrecognized gain in the successor long position.

Example 5. Assume the facts are the same as in example (4), except that at year-end there is $4 of unrecognized gain in the successor long position and $6 of unrecognized gain in the offsetting short position. Under these circumstances, the entire $10 loss will be disallowed for 1985 because there is a total of $10 of unrecognized gain in both the successor long position and offsetting short position.

Example 6. Assume the facts are the same as in example (4), except that at year-end A disposes of the offsetting short position at a $2 loss. Under these circumstances, $10 of the total $12 loss will be disallowed because there is $10 of unrecognized gain in the successor long position.

Example 7. Assume the facts are the same as in example (4), and on January 10, 1986, A disposes of the successor long position at no gain or loss. A holds the offsetting short position until year-end, at which time there is $10 of unrecognized gain. Under these circumstances, the $10 loss will be disallowed for 1986 because there is $10 of unrecognized gain in an offsetting position at year-end.

Example 8. Assume the facts are the same as in example (4), except at year-end there is $8 of unrecognized gain in the successor long position and $8 of unrecognized loss in the offsetting short position. Under these circumstances, $8 of the total $10 realized loss will be disallowed because there is $8 of unrecognized gain in the successor long position.

Example 9. On October 1, 1985, A enters into offsetting long and short positions. Neither the long nor the short position is stock or securities. On October 2, 1985, A disposes of the short position at a $10 loss and the long position at a $10 gain. On October 3, 1985, A enters into a long position identical to the original long position. At year-end there is $10 of unrecognized gain in the second long position. Under these circumstances, the $10 loss is allowed because the second long position is not a successor position or offsetting position to the short loss position.

Example 10. On November 1, 1985, A enters into offsetting long and short positions. On November 10, 1985, there is $20 of unrealized gain in the long position and A disposes of the short position at a $20 loss. By November 15, 1985, the value of the long position has declined eliminating all unrealized gain in the position. On November 15, 1985, A establishes a second short position (successor position) that is offsetting with respect to the long position but is not substantially identical to the short position disposed of on November 10, 1985. At year-end there is no unrecognized gain in the offsetting long position or in the successor short position. Under these circumstances, the $20 loss sustained with respect to the short loss position will be allowed for 1985 because at year-end there is no unrecognized gain in the successor short position or the offsetting long position.

Example 11. Assume the facts are the same as in example (10), except that the second short position was established on November 8, 1985, and there is $20 of unrecognized gain in the second short position at year-end. Since the second short position was entered into within 30 days before the disposition of the loss position, the second short position is considered a successor position to the loss position. Under these circumstances, the $20 loss will be disallowed because there is $20 of unrecognized gain in a successor position.

Example 12. Assume the facts are the same as in example (10), except that at year-end there is $18 of unrecognized gain in the offsetting long position and $18 of unrecognized gain in the successor short position. Under these circumstances, the entire loss will be disallowed because there is more than $20 of unrecognized gain in both the successor short position and offsetting long position.

Example 13. Assume the facts are the same as in example (10), except that there is $20 of unrecognized gain in the successor short position and no unrecognized gain in the offsetting long position at year-end. Under these circumstances, the entire $20 loss will be disallowed because there is $20 of unrecognized gain in the successor short position.

Example 14. On January 2, 1986, A enters into offsetting long and short positions. Neither the long nor the short position is stock or securities. On March 3, 1986, A disposes of the long position at a $10 gain. On March 10, 1986, A disposes of the short position at a $10 loss. On March 14, 1986, A enters into a new short position. On April 10, 1986, A enters into an offsetting long position. A holds both positions to year-end, at which time there is $10 of unrecognized gain in the offsetting long position and no unrecognized gain or loss in the short position. Under these circumstances, the $10 loss will be allowed because (1) the rules of paragraph (a)(1) of this section are not applicable; and (2) the rules of paragraph (a)(2) of this section do not apply, since all positions of the straddle that contained the loss position were disposed of.

Example 15. On December 1, 1985, A enters into offsetting long and short positions. On December 4, 1985, A disposes of the short position at a $10 loss. On December 5, 1985, A establishes a new short position that is offsetting to the long position, but is not substantially identical to the short position disposed of on December 4, 1985. On December 6, 1985, A disposes of the long position at a $10 gain. On December 7, 1985, A enters into a second long position that is offsetting to the new short position, but is not substantially identical to the long position disposed of on December 6, 1985. A holds both positions to year-end at which time there is no unrecognized gain in the second short position and $10 of unrecognized gain in the offsetting long position. Under these circumstances, the entire $10 loss will be disallowed for the 1985 taxable year because the second long position is an offsetting position with respect to the second short position which is a successor position.

Example 16. On September 1, 1985, A enters into offsetting positions consisting of a long section 1256 contract and short non-section 1256 position. No elections under sections 1256(d)(1) or 1092(b)(2)(A), relating to mixed straddles, are made. On November 1, 1985, at which time there is $20 of unrecognized gain in the short non-section 1256 position, A disposes of the long section 1256 contract at a $20 loss and on the same day acquires a long non-section 1256 position (successor position) that is offsetting with respect to the short non-section 1256 position. But for the application of this section, A's disposition of the section 1256 contract would give rise to a capital loss. At year-end there is a $20 of unrecognized gain in the offsetting short non-section 1256 position and no unrecognized gain in the successor long position. Under these circumstances, the entire $20 loss will be disallowed for 1985 because there is $20 unrecognized gain in the offsetting short position. In 1986, A disposes of the successor long non-section 1256 position and there is no unrecognized gain at year-end in the offsetting short position. Under these circumstances, the $20 loss disallowed in 1985 with respect to the section 1256 contract will be treated in 1986 as 60 percent long-term capital loss and 40 percent short-term capital loss.

Example 17. On January 2, 1986, A, not a dealer in stock or securities, acquires stock in X Corporation (X stock) and an offsetting put option. On March 3, 1986, A disposes of the X stock at a $10 loss. On March 10, 1986, A disposes of the put option at a $10 gain. On March 14, 1986, A acquires new X stock that is substantially identical to the X stock disposed of on March 3, 1986. A holds the X stock to year-end. Under these circumstances, the $10 loss will be disallowed for 1986 under paragraph (a)(1) of this section because A, within a period beginning 30 days before March 3, 1986 and ending 30 days after such date, acquired stock substantially identical to the X stock disposed of.

Example 18. On June 2, 1986, A, not a dealer in stock or securities, acquires stock in X Corporation (X stock). On September 2, 1986, A disposes of the X stock at a $100 loss. On September 15, 1986, A acquires new X stock that is substantially identical to the X stock disposed of on September 2, 1986, and an offsetting put option. A holds these straddle positions to year-end. Under these circumstances, section 1091, rather than section 1092(b), will apply to disallow the $100 loss for 1986 because the loss was not sustained from the disposition of a position that was part of a straddle. See paragraph (e) of this section.

Example 19. On November 1, 1985, A, not a dealer in stock or securities, acquires stock in Y Corporation (Y stock) and an offsetting put option. On November 12, 1985, there is $20 of unrealized gain in the put option and A disposes of the Y stock at a $20 loss. By November 15, 1985, the value of the put option has declined eliminating all unrealized gain in the position. On November 15, 1985, A acquires a second Y stock position that is substantially identical to the Y stock disposed of on November 12, 1985. At year-end there is no unrecognized gain in the put option or the Y stock. Under these circumstances, the $20 loss will be disallowed for 1985 under paragraph (a)(1) of this section because A, within a period beginning 30 days before November 12, 1985 and ending 30 days after such date, acquired stock substantially identical to the Y stock disposed of.

Example 20. Assume the facts are the same as in Example 19 and that on December 31, 1986, A disposes of the put option at a $40 gain and there is $20 of unrecognized loss in the Y stock. Under these circumstances, the $20 loss which was disallowed in 1985 also will be disallowed for 1986 under the rules of paragraph (a)(1) of this section because A has not disposed of the stock substantially identical to the Y stock disposed of on November 12, 1985.

Example 21. Assume the facts are the same as in example (19), except that on December 31, 1986, A disposes of the Y stock at a $20 loss and there is $40 of unrecognized gain in the put option. Under these circumstances, A will not recognize in 1986 either the $20 loss disallowed in 1985 or the $20 loss sustained with respect to the December 31, 1986 disposition of Y stock. Paragraph (a)(1) of this section does not apply to disallow the losses in 1986 since the substantially identical Y stock was disposed of during the year (and no substantially identical stock or securities was acquired by A within the 61 day period). However, paragraph (a)(2) of this section applies to disallow for 1986 the $40 of losses sustained with respect to the dispositions of positions in the straddle because there is $40 of unrecognized gain in the put option, an offsetting position to the loss positions.

Example 22. On January 2, 1986, A, not a dealer in stock or securities, acquires stock in X Corporation (X stock) and an offsetting put option. On March 3, 1986, A disposes of the X stock at a $10 loss. On March 17, 1986, A acquires new X stock that is substantially identical to the X stock disposed of on March 3, 1986. On December 31, 1986, A disposes of the X stock at a $5 gain, at which time there is $5 of unrecognized gain in the put option. Under these circumstances, the $10 loss sustained with respect to the March 3, 1986, disposition of X stock will be allowed under paragraph (a) (1) of this section since the substantially identical X stock acquired on March 17, 1986, was disposed of by year-end (and no substantially identical stock or securities were acquired by A within the 61 day period). However, $5 of the $10 loss will be disallowed under paragraph (a)(2) of this section because there is $5 of unrecognized gain in the put option, an offsetting position to the loss position.

Example 23. Assume the facts are the same as in example (22), except that on December 31, 1986, A disposes of the offsetting put option at a $5 loss and there is $5 of unrecognized gain in the X stock acquired on March 17, 1986. Under these circumstances, the $10 loss sustained with respect to the X stock disposed of on March 3, 1986, will be disallowed for 1986 under paragraph (a)(1) of this section. The $5 loss sustained upon the disposition of the put option will be allowed because (1) the rules of paragraph (a)(1) of this section are not applicable; and (2) the rules of paragraph (a)(2) of this section allow the loss, since the unrecognized gain in the X stock ($5) is not in excess of the loss ($10) disallowed under paragraph (a)(1) of this section.

Example 24. On January 2, 1986, A, not a dealer in stock or securities, acquires 200 shares of Z Corporation stock (Z stock) and 2 put options on Z stock (giving A the right to sell 200 shares of Z stock). On September 2, 1986, there is $200 of unrealized gain in the put option positions and A disposes of the 200 shares of Z stock at a $200 loss. On September 10, 1986, A acquires 100 shares of Z stock (substantially identical to the Z stock disposed of on September 2, 1986), and a call option that is offsetting to the put options on Z stock and that is not an option to acquire property substantially identical to the Z stock disposed of on September 2, 1986. At year-end, there is $80 of unrecognized gain in the Z stock position, $80 of unrecognized gain in the call option position, and no unrecognized gain or loss in the offsetting put option positions. Under these circumstances, $40 of the $200 loss sustained with respect to the September 2, 1986 disposition of Z stock will be recognized by A in 1986 under paragraph (a) of this section, as set forth below. Paragraph (a)(1) of this section applies first to disallow $100 of the loss (½ of the loss), since 100 shares of substantially identical Z stock (½ of the stock) were acquired within the 61 day period. Paragraph (a)(2) of this section then applies to disallow that portion of the loss allowed under paragraph (a)(1) of this section ($200 − $100=$100) equal to the excess of the total unrecognized gain in the Z stock and call option positions (successor positions to the loss position) ($80+$80=$160) over the $100 loss disallowed under paragraph (a)(1) of this section ($160 − $100=$60; $100 − $60=$40).

Example 25. Assume the facts are the same as in example (24), except that at year-end there is $110 of unrecognized gain in the Z stock position, $78 of unrecognized gain in the call option position, and $10 of unrecognized gain in the offsetting put option positions. Under these circumstances, $2 of the $200 loss sustained with respect to the September 2, 1986 disposition of Z stock will be allowed in 1986 under paragraph (a) of this section, as set forth below. Paragraph (a)(1) of this section applies first to disallow $100 of the loss (½ of the loss) since 100 shares of substantially identical Z stock (½ of the stock) were acquired within the 61 day period. Paragraph (a)(2) of this section then applies to disallow that portion of the loss allowed under paragraph (a)(1) of this section ($200 − $100=$100) equal to the excess of the total unrecognized gain in the Z stock and call option positions (successor positions to the loss position) and the put option positions (offsetting positions to the loss position) ($110+$78+$10=$198) over the $100 loss disallowed under paragraph (a)(1) of this section ($198 − $100=$98; $100 − $98=$2).

Example 26. Assume the facts are the same as in example (24), except that at year-end there is $120 of unrecognized gain in the Z stock position, $88 of unrecognized gain in the call option position, and $10 of unrecognized loss in one of the offsetting put option positions. At year-end A disposes of the other put option position at a $10 loss. Under these circumstances, $2 of the $210 loss sustained with respect to the September 2, 1986 disposition of Z stock ($200) and the year-end disposition of a put option ($10) will be allowed in 1986 under paragraph (a) of this section, as set forth below. Paragraph (a)(1) of this section applies first to disallow $100 of the loss from the disposition of Z stock (½ of the loss), since 100 shares of substantially identical Z stock (½ of the stock) were acquired within the 61 day period. Paragraph (a)(2) of this section then applies to disallow that portion of the loss allowed under paragraph (a)(1) of this section ($210 − $100=$110) equal to the excess of the total unrecognized gain in the Z stock and call option positions (successor positions to the Z stock loss position, and offsetting positions to the put option loss position) ($120+$88=$208) over the $100 loss disallowed under paragraph (a)(1) of this section ($208 − $100=$108; $110 − $108=$2).

Example 27. On January 27, 1986, A enters into offsetting long (L1) and short (S1) positions. Neither L1 nor S1 nor any other positions entered into by A in 1986 are stock or securities. On February 3, 1986, A disposes of L1 at a $10 loss. On February 5, 1986, A enters into a new long position (L2) that is offsetting to S1. On October 15, 1986, A disposes of S1 at an $11 loss. On October 17, 1986, A enters into a new short position (S2) that is offsetting to L2. On December 30, 1986, A disposes of L2 at a $12 loss. On December 31, 1986, A enters into a new long position (L3) that is offsetting to S2. At year-end, S2 has an unrecognized gain of $33. Paragraph (a)(1) of this section does not apply since none of the positions were shares of stock or securities. However, all $33 ($10+$11+$12) of the losses sustained with respect to L1, S1 and L2 will be disallowed under paragraph (a)(2) because there is $33 of unrecognized gain in S2 at year-end. The $10 loss from the disposition of L1 is disallowed because S2 is or was an offsetting position to a successor long position (L2 or L3). The $11 loss from the disposition of S1 is disallowed because S2 is a successor position to S1. The $12 loss from the disposition of L2 is disallowed because S2 was an offsetting position to L2.

(Secs. 1092(b) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 95 Stat. 324, 26 U.S.C. 1092(b), 7805) and sec. 102(h) of the Tax Reform Act of 1984 (98 Stat. 625))

[T.D. 8007, 50 FR 3319, Jan. 24, 1985, as amended by T.D. 8070, 51 FR 1786, Jan. 15, 1986; 51 FR 3773, Jan. 30, 1986; 51 FR 5516, Feb. 14, 1986]

§1.1092(b)–2T Treatment of holding periods and losses with respect to straddle positions (temporary).

(a) *Holding period*—(1) *In general.* Except as otherwise provided in this section, the holding period of any position that is part of a straddle shall not begin earlier than the date the taxpayer no longer holds directly or indirectly (through a related person or flowthrough entity) an offsetting position with respect to that position. See §1.1092(b)–5T relating to definitions.

(2) *Positions held for the long-term capital gain holding period (or longer) prior to establishment of the straddle.* Paragraph (a)(1) of this section shall not apply to a position held by a taxpayer for the long-term capital gain holding period (or longer) before a straddle that includes such position is established. The determination of whether a position has been held by a taxpayer for the long-term capital gain holding period (or longer) shall be made by taking into account the application of paragraph (a)(1) of this section. See section 1222(3) relating to the holding period for long-term capital gains.

(b) *Treatment of loss*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, loss on the disposition of one or more positions (*loss position*) of a straddle shall be treated as a long-term capital loss if—

(i) On the date the taxpayer entered into the loss position the taxpayer held directly or indirectly (through a related person or flowthrough entity) one or more offsetting positions with respect to the loss position; and

(ii) All gain or loss with respect to one or more positions in the straddle would be treated as long-term capital gain or loss if such positions were disposed of on the day the loss position was entered into.

(2) *Special rules for non-section 1256 positions in a mixed straddle.* Loss on the disposition of one or more positions (*loss position*) that are part of a mixed straddle and that are non-section 1256 positions shall be treated as 60 percent long-term capital loss and 40 percent short-term capital loss if—

(i) Gain or loss from the disposition of one or more of the positions of the straddle that are section 1256 contracts would be considered gain or loss from the sale or exchange of a capital asset;

(ii) The disposition of no position in the straddle (other than a section 1256 contract) would result in a long-term capital gain or loss; and

(iii) An election under section 1092(b)(2)(A)(i)(I) (relating to straddle-by-straddle identification) or 1092(b)(2)(A)(i)(II) (relating to mixed straddle accounts) has not been made.

(c) *Exceptions*—(1) *In general.* This section shall not apply to positions that—

(i) Constitute part of a hedging transaction;

(ii) Are included in a straddle consisting only of section 1256 contracts; or

(iii) Are included in a mixed straddle account (as defined in paragraph (b) of §1.1092(b)–4T).

(2) *Straddle-by-straddle identification.* Paragraphs (a)(2) and (b) of this section shall not apply to positions in a section 1092(b)(2) identified mixed straddle. See §1.1092(b)–3T.

(d) *Special rule for positions held by regulated investment companies.* For purposes of section 851(b)(3) (relating to the definition of a regulated investment company), the holding period rule of paragraph (a) of this section shall not apply to positions of a straddle. However, if section 1233(b) (without regard to sections 1233(e)(2)(A) and 1092(b)) would have applied to such positions, then for purposes of section 851(b)(3) the rules of section 1233(b) shall apply. Similarly, the effect of daily marking-to-market provided under §1.1092(b)–4T(c) will be disregarded for purposes of section 851(b)(3).

(e) *Effective date*—(1) *In general.* Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to positions in a straddle established after June 23, 1981, in taxable years ending after such date.

(2) *Special effective date for mixed straddle positions.* The provisions of paragraph (b)(2) of this section shall apply to positions in a mixed straddle established on or after January 1, 1984.

(f) *Examples.* Paragraphs (a) through (e) may be illustrated by the following examples. It is assumed in each example that the following positions are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year and none of the exceptions in paragraph (c) of this section apply.

Example 1. On October 1, 1984, A acquires gold. On January 1, 1985, A enters into an offsetting short gold forward contract. On April 1, 1985, A disposes of the short gold forward contract at no gain or loss. On April 10, 1985, A sells the gold at a gain. Since the gold had not been held for more than 6 months before the offsetting short position was entered into, the holding period for the gold begins no earlier than the time the straddle is terminated. Thus, the holding period of the original gold purchased on October 1, 1984, and sold on April 10, 1985, begins on April 1, 1985, the date the straddle was terminated. Consequently, gain recognized with respect to the gold will be treated as short-term capital gain.

Example 2. On January 1, 1985, A enters into a long gold forward contract. On May 1, 1985, A enters into an offsetting short gold regulated futures contract. A does not make an election under section 1256(d) or 1092(b)(2)(A). On August 1, 1985, A disposes of the gold forward contract at a gain. Since the forward contract had not been held by A for more than 6 months prior to the establishment of the straddle, the holding period for the forward contract begins no earlier than the time the straddle is terminated. Thus, the gain recognized on the closing of the gold forward contract will be treated as short-term capital gain.

Example 3. Assume the facts are the same as in example (2), except that A disposes of the short gold regulated futures contract on July 1, 1985, at no gain or loss and the forward contract on November 1, 1985. Since the forward contract had not been held for more than 6 months before the mixed straddle was established, the holding period for the forward contract begins July 1, 1985, the date the straddle terminated. Thus, the gain recognized on the closing of the forward contract will be treated as short-term capital gain.

Example 4. On January 1, 1985, A enters into a long gold forward contract and on August 4, 1985, A enters into an offsetting short gold forward contract. On September 1, 1985, A disposes of the short position at a loss. Since an offsetting long position had been held by A for more than 6 months prior to the acquisition of the offsetting short position, the loss with respect to the closing of the short position will be treated as long-term capital loss.

Example 5. On March 1, 1985, A enters into a long gold forward contract and on July 17, 1985, A enters into an offsetting short gold regulated futures contract. A does not make an election under section 1256(d) or 1092(b)(2)(A). On August 10, 1985, A disposes of the long gold forward contract at a loss. Since the gold forward contract was part of a mixed straddle, and the disposition of no position in the straddle (other than the regulated futures contract) would give rise to a long-term capital loss, the loss recognized on the termination of the gold forward contract will be treated as 40 percent short-term capital loss and 60 percent long-term capital loss.

Example 6. Assume the facts are the same as in example (5), except that on August 11, 1985, A disposes of the short gold regulated futures contract at a gain. Under these circumstances, the gain will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain since the holding period rules of paragraph (a) of this section are not applicable to section 1256 contracts.

Example 7. Assume the facts are the same as in example (5), except that A enters into the long gold forward contract on January 1, 1985, and does not dispose of the long gold forward contract but instead on August 10, 1985, disposes of the short gold regulated futures contract at a loss. Under these circumstances, the loss will be treated as a long-term capital loss since A held an offsetting non-section 1256 position for more than 6 months prior to the establishment of the straddle. However, such loss may be subject to the rules of § 1.1092(b)–1T.

(Secs. 1092(b) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 95 Stat. 324, 26 U.S.C. 1092(b), 7805) and sec. 102(h) of the Tax Reform Act of 1984 (98 Stat. 625))

[T.D. 8007, 50 FR 3320, Jan. 24, 1985, as amended by T.D. 8070, 51 FR 1788, Jan. 15, 1986]

§ 1.1092(b)–3T Mixed straddles; straddle-by-straddle identification under section 1092(b)(2)(A)(i)(I) (temporary).

(a) *In general.* Except as otherwise provided, a taxpayer shall treat in accordance with paragraph (b) of this section gains and losses on positions that are part of a mixed straddle for which the taxpayer has made an election under paragraph (d) of this section (hereinafter referred to as a *section 1092(b)(2) identified mixed straddle*). No election may be made under this section for any straddle composed of one or more positions that are includible in a mixed straddle account (as defined in paragraph (b) of §1.1092(b)–4T) or for any straddle for which an election under section 1256(d) has been made. See §1.1092(b)–5T relating to definitions.

(b) *Treatment of gains and losses from positions included in a section 1092(b)(2) identified mixed straddle*—(1) *In general.* Gains and losses from positions that are part of a section 1092(b)(2) identified mixed straddle shall be determined and treated in accordance with the rules of paragraph (b) (2) through (7) of this section.

(2) *All positions of a section 1092(b)(2) identified mixed straddle are disposed of on the same day.* If all positions of a section 1092(b)(2) identified mixed straddle are disposed of (or deemed disposed of) on the same say, gains and losses from section 1256 contracts in the straddle shall be netted, and gains and losses from non-section 1256 positions in the straddle shall be netted. Net gain or loss from the section 1256 contracts shall then be offset against net gain or loss from the non-section 1256 positions to determine the net gain or loss from the straddle. If net gain or loss from the straddle is attributable to the positions of the straddle that are section 1256 contracts, such gain or loss shall be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. If net gain or loss from the straddle is attributable to the positions of the straddle that are non-section 1256 positions, such gain or loss shall be treated as short-term capital gain or loss. This paragraph (b)(2) may be illustrated by the following examples. It is assumed in each example that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year.

Example 1. On April 1, 1985, A enters into a non-section 1256 position and an offsetting section 1256 contract and makes a valid election to treat such straddle as a section 1092(b)(2) identified mixed straddle. On April 10, 1985, A disposes of the non-section 1256 position at a $600 loss and the section 1256 contract at a $600 gain. Under these circumstances, the $600 loss on the non-section 1256 position will be offset against the $600 gain on the section 1256 contract and the net gain or loss from the straddle will be zero.

Example 2. Assume the facts are the same as in example (1), except that the gain on the section 1256 contract is $800. Under these circumstances, the $600 loss on the non-section 1256 position will be offset against the $800 gain on the section 1256 contract. The net gain of $200 from the straddle will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain because it is attributable to the section 1256 contract.

Example 3. Assume the facts are the same as in example (1), except that the loss on the non-section 1256 position is $800. Under these circumstances, the $600 gain on the section 1256 contract will be offset against the $800 loss on the non-section 1256 position. The net loss of $200 from the straddle will be treated as short-term capital loss because it is attributable to the non-section 1256 position.

Example 4. On May 1, 1985, A enters into a straddle consisting of two non-section 1256 positions and two section 1256 contracts and makes a valid election to treat the straddle as a section 1092(b)(2) identified mixed straddle. On May 10, 1985, A disposes of the non-section 1256 positions, one at a $700 loss and the other at a $500 gain, and disposes of the section 1256 contracts, one at a $400 gain and the other at a $300 loss. Under these circumstances, the gain and losses from the section 1256 contracts and non-section 1256 positions will first be netted, resulting in a net gain of $100 ($400–$300) on the section 1256 contracts and a net loss of $200 ($700–$500) on the non-section 1256 positions. The net gain of $100 from the section 1256 contracts will then be offset against the $200 net loss on the non-section 1256 positions. The net loss of $100 from the straddle will be treated as short-term capital loss because it is attributable to the non-section 1256 positions.

Example 5. On December 30, 1985, A enters into a section 1256 contract and an offsetting non-section 1256 position and makes a valid election to treat such straddle as a section 1092(b)(2) identified mixed straddle. On December 31, 1985, A disposes of the non-section 1256 position at a $2,000 gain. A also realizes a $2,000 loss on the section 1256 contract because it is deemed disposed of under section 1256(a)(1). Under these circumstances, the $2,000 gain on the non-section 1256 position will be offset against the $2,000 loss on the section 1256 contract, and the net gain or loss from the straddle will be zero.

Example 6. Assume the facts are the same as in example (5), except that the section 1092(b)(2) identified mixed straddle was entered into on November 12, 1985, A realizes a $2,200 loss on the section 1256 contract, and on December 15, 1985, A enters into a non-section 1256 position that is offsetting to the non-section 1256 gain position of the section 1092(b)(2) identified mixed straddle. At year-end there is $200 of unrecognized gain in the non-section 1256 position that was entered into on December 15. Under these circumstances, the $2,200 loss on the section 1256 contract will be offset against the $2,000 gain on the non-section 1256 position. The net $200 loss from the straddle will be treated as 60 percent long-term capital loss and 40 percent short-term capital loss because it is attributable to the section 1256 contract. The net loss of $200 from the straddle will be disallowed in 1985 under the loss deferral rules of section 1092(a) because there is $200 of unrecognized gain in a successor position (as defined in paragraph (n) of § 1.1092(b)–5T) at year-end. See paragraph (c) of this section.

(3) *All of the non-section 1256 positions of a section 1092(b)(2) identified mixed straddle disposed of on the same day*. This paragraph (b)(3) applies if all of the non-section 1256 positions of a section 1092(b)(2) identified mixed straddle are disposed of on the same day or if this paragraph (b)(3) is made applicable by paragraph (b)(5) of this section. In the case to which this paragraph (b)(3) applies, gain and loss realized from non-section 1256 positions shall be netted. Realized and unrealized gain and loss with respect to the section 1256 contracts of the straddle also shall be netted on that day. Realized net gain or loss from the non-section 1256 positions shall then be offset against net gain or loss from the section 1256 contracts to determine the net gain or loss from the straddle on that day. Net gain or loss from the straddle that is attributable to the non-section 1256 positions shall be realized and treated as short-term capital gain or loss on that day. Net gain or loss from the straddle that is attributable to realized gain or loss with respect to section 1256 contracts shall be realized and treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. Any gain or loss subsequently realized on the section 1256 contracts shall be adjusted (through an adjustment to basis or otherwise) to take into account the extent to which gain or loss was offset by unrealized gain or loss on the section 1256 contracts on that day. This paragraph (b)(3) may be illustrated by the following examples. It is assumed in each example that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year.

Example 1. On July 20, 1985, A enters into a section 1256 contract and an offsetting non-section 1256 position and makes a valid election to treat such straddle as a section 1092(b)(2) identified mixed straddle. On July 27, 1985, A disposes of the non-section 1256 position at a $1,500 loss, at which time there is $1,500 of unrealized gain in the section 1256 contract. A holds the section 1256 contract at year-end at which time there is $1,800 of gain. Under these circumstances, on July 27, 1985, A offsets the $1,500 loss on the non-section 1256 position against the $1,500 gain on the section 1256 contract and realizes no gain or loss. On December 31, 1985, A realizes a $300 gain on the section 1256 contract because the position is deemed disposed of under section 1256(a)(1). The $300 gain is equal to $1,800 of gain less a $1,500 adjustment for unrealized gain offset against the loss realized on the non-section 1256 position on July 27, 1985, and the gain will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain.

Example 2. Assume the facts are the same as in example (1), except that on July 27, 1985, A realized a $1,700 loss on the non-section 1256 position. Under these circumstances, on July 27, 1985, A offsets the $1,700 loss on the non-section 1256 position against the $1,500 gain on the section 1256 contract. A realizes a $200 loss from the straddle on July 27, 1985, which will be treated as short-term capital loss because it is attributable to the non-section 1256 position. On December 31, 1985, A realizes a $300 gain on the section 1256 contract, computed as in example (1), which will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain.

Example 3. On March 1, 1985, A enters into a straddle consisting of two non-section 1256 positions and two section 1256 contracts and makes a valid election to treat such straddle as a section 1092(b)(2) identified mixed straddle. On March 11, 1985, A disposes of the non-section 1256 positions, one at a $100 loss and the other at a $150 loss, and disposes of one section 1256 contract at a $100 loss. On that day there is $100 of unrealized gain on the section 1256 contract retained by A. A holds the remaining section 1256 contract at year-end, at which time there is $150 of gain. Under these circumstances, on March 11, 1985, A will first net the gains and losses from the section 1256 contracts and net the gains and losses from the non-section 1256 positions resulting in no gain or loss on the section 1256 contracts and a net loss of $250 on the non-section 1256 positions. Since there is no gain or loss to offset against the non-section 1256 positions, the net loss of $250 will be treated as short-term capital loss because it is attributable to the non-section 1256 positions. On December 31, 1985, A realizes a $50 gain on the remaining section 1256 contract because the position is deemed disposed of under section 1256(a)(1). The $50 gain is equal to $150 gain less a $100 adjustment to take into account the $100 unrealized gain that was offset against the $100 loss realized on the section 1256 contract on March 11, 1985.

Example 4. Assume the facts are the same as in example (3), except that A disposes of the section 1256 contract at a $500 gain. As in example (3), A has a net loss of $250 on the non-section 1256 positions disposed of. In this example, however, A has net gain of $600 ($500+$100) on the section 1256 contracts on March 11, 1985. Therefore, of the net gain from the straddle of $350 ($600–$250), $250 ($500–$250) is treated as 60 percent long-term capital gain and 40 percent short-term capital gain because only $250 is attributable to the realized gain from the section 1256 contract. In addition, because none of the $100 unrealized gain from the remaining section 1256 contract was offset against gain or loss on the non-section 1256 positions, no adjustment is made under paragraph (b)(3) of this section and the entire $150 gain on December 31 with respect to that contract is realized on that date.

(4) *All of the section 1256 contracts of a section 1092(b)(2) identified mixed straddle disposed of on the same day.* This paragraph (b)(4) applies if all of the section 1256 contracts of a section 1092(b)(2) identified mixed straddle are disposed of (or deemed disposed of) on the same day or if this paragraph (b)(4) is made applicable by paragraph (b)(5) of this section. In the case to which this paragraph (b)(4) applies, gain and loss realized from section 1256 contracts shall be netted. Realized and unrealized gain and loss with respect to the non-section 1256 positions of the straddle also shall be netted on that day. Realized net gain or loss from the section 1256 contracts shall be treated as short-term capital gain or loss to the extent of net gain or loss on the non-section 1256 positions on that day. Net gain or loss with respect to the section 1256 contracts that exceeds the net gain or loss with respect to the non-section 1256 positions of the straddle shall be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. See paragraph (b)(7) of this section relating to the gain or loss on such non-section 1256 positions. This paragraph (b)(4) may be illustrated by the following examples. It is assumed in each example that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year.

Example 1. On December 30, 1985, A enters into a section 1256 contract and an offsetting non-section 1256 position and makes a valid election to treat such straddle as a section 1092(b)(2) identified mixed straddle. On December 31, 1985, A disposes of the section 1256 contract at a $1,000 gain, at which time there is $1,000 of unrealized loss in the non-section 1256 position. Under these circumstances, the $1,000 gain realized on the section 1256 contract will be treated as short-term capital gain because there is a $1,000 loss on the non-section 1256 position.

Example 2. Assume the facts are the same as in example (1), except that A realized a $1,500 gain on the disposition of the section 1256 contract. Under these circumstances, $1,000 of the gain realized on the section 1256 contract will be treated as short-term capital gain because there is a $1,000 loss on the non-section 1256 position. The net gain of $500 from the straddle will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain because it is attributable to the section 1256 contract.

Example 3. Assume the facts are the same as in example (1), except that A realized a $1,000 loss on the section 1256 contract and there is $1,000 of unrecognized gain on the non-section 1256 position. Under these circumstances, the $1,000 loss on the section 1256 contract will be treated as short-term capital loss because there is a $1,000 gain on the non-section 1256 position. Such loss, however, will be disallowed in 1985 under the loss deferral rules of section 1092(a) because there is $1,000 of unrecognized gain in an offsetting position at year-end. See paragraph (c) of this section.

Example 4. Assume the facts are the same as in example (1), except that the section 1256 contract and non-section 1256 position were entered into on December 1, 1985, and the section 1256 contract is disposed of on December 19, 1985, for a $1,000 gain, at which time there is $1,000 of unrealized loss on the non-section 1256 position. At year-end there is only $800 of unrealized loss in the non-section 1256 position. Under these circumstances, the result is the same as in example (1) because there was $1,000 of unrealized loss on the non-section 1256 position at the time of the disposition of the section 1256 contract.

Example 5. On July 15, 1985, A enters into a straddle consisting of two non-section 1256 positions and two section 1256 contracts and makes a valid election to treat such straddle as a section 1092(b)(2) identified mixed straddle. On July 20, 1985, A disposes of one non-section 1256 position at a gain of $1,000 and both section 1256 contracts at a net loss of $1,000. On the same day there is $200 of unrealized loss on the non-section 1256 position retained by A. Under these circumstances, realized and unrealized gain and loss with respect to the non-section 1256 positions is netted, resulting in a net gain of $800. Thus, $800 of the net loss on the section 1256 contracts disposed of will be treated as short-term capital loss because there is $800 of net gain on the non-section 1256 positions. In addition, the net loss of $200 from the straddle will be treated as 60 percent long-term capital loss and 40 percent short-term capital loss because it is attributable to the section 1256 contract.

(5) *Disposition of one or more, but not all, positions of a section 1092(b)(2) identified mixed straddle on the same day.* If one or more, but not all, of the positions of a section 1092(b)(2) identified mixed straddle are disposed of on the same day, and paragraphs (b) (3) and (4) of this section are not applicable (without regard to this paragraph (b)(5)), the gain and loss from the non-section 1256 positions that are disposed of on that day shall be netted, and the gain and loss from the section 1256 contracts that are disposed of on that day shall be netted. In order to determine whether the rules of paragraph (b)(3) or (b)(4) of this section apply, net gain or loss from the section 1256 contracts disposed of shall then be offset against net gain or loss from the non-section 1256 positions disposed of to determine net gain or loss from such positions of the straddle. If net gain or loss from the disposition of such positions of the straddle is attributable to the non-section 1256 positions disposed of, the rules prescribed in paragraph (b)(3) of this section apply. If net gain or loss from the disposition of such positions is attributable to the section 1256 contracts disposed of, the rules prescribed in paragraph (b)(4) of this section apply. If the net gain or loss from the netting of non-section 1256 positions disposed of and the netting of section 1256 contracts disposed of are either both gains or losses, the rules prescribed in paragraph (b)(3) of this section shall apply to net gain or loss from such non-section 1256 positions, and the rules prescribed in paragraph (b)(4) of this section shall apply to net gain or loss from such section 1256 contracts. However, for purposes of determining the treatment of gain or loss subsequently realized on a position of such straddle, to the extent that unrealized gain or loss on other positions was used to offset realized gain or loss on a non-section 1256 position under paragraph (b)(3) of this section, or was used to treat realized gain or loss on a section 1256 contract as short-term capital gain or loss under paragraph (b)(4) of this section, such amount shall not be used for such purposes again. This paragraph (b)(5) may be illustrated by the following examples. It is assumed that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year.

Example 1. On July 15, 1985, A enters into a straddle consisting of four non-section 1256 positions and four section 1256 contracts and makes a valid election to treat such straddle as a section 1092(b)(2) identified mixed straddle. On July 20, 1985, A disposes of one non-section 1256 position at a gain of $800 and one section 1256 contract at a loss of $300. On the same day there is $400 of unrealized net loss on the section 1256 contracts retained by A and $100 of unrealized net loss on the non-section 1256 positions retained by A. Under these circumstances, the loss of $300 on the section 1256 contract disposed of will be offset against the gain of $800 on the non-section 1256 position disposed of. The net gain of $500 is attributable to the non-section 1256 position. Therefore, the rules of paragraph (b)(3) of this section apply. Under the rules of paragraph (b)(3) of this section, the net loss of $700 on the section 1256 contracts is offset against the net gain of $800 attributable to the non-section 1256 position disposed of. The net gain of $100 will be treated as short-term capital gain because it is attributable to the non-section 1256 position disposed of. Gain or loss subsequently realized on the section 1256 contracts will be adjusted to take into account the unrealized loss of $400 that was offset against the $800 gain attributable to the non-section 1256 position disposed of.

Example 2. Assume the facts are the same as in Example 1, except that A disposes of the non-section 1256 position at a gain of $300 and the section 1256 contract at a loss of $800, and there is $200 of unrealized net gain in the non-section 1256 positions retained by A. Under these circumstances, the gain of $300 on the non-section 1256 position disposed of will be offset against the loss of $800 on the section 1256 contract disposed of. The net loss of $500 is attributable to the section 1256 contract. Therefore, the rules of paragraph (b)(4) of this section apply. Under the rules of paragraph (b)(4) of this section, $500 of the net loss realized on the section 1256 contract will be treated as short-term capital loss because there is $500 of realized and unrealized gain in the non-section 1256 positions. The remaining net loss of $300 will be treated as 60 percent long-term capital loss and 40 percent short-term capital loss because it is attributable to a section 1256 contract disposed of. In addition, A realizes a $300 short-term capital gain attributable to the disposition of the non-section 1256 position.

Example 3. (i) Assume the facts are the same as in example (1), except that the section 1256 contract was disposed of at a $500 gain. Under these circumstances, there is gain of $500 attributable to the section 1256 contact disposed of and a gain of $800 attributable to the non-section 1256 position. Therefore, the rules of both paragraphs (b)(3) and (4) of this § 1.1092(b)–3T apply.

(ii) Under paragraph (b)(3) of this section, the realized and unrealized gains and losses on the section 1256 contracts are netted, resulting in a net gain of $100 ($500–$400). The section 1256 contract net gain does not offset the gain on the non-section 1256 position disposed of. Therefore, the gain of $800 on the non-section 1256 position disposed of will be treated as a short-term capital gain because there is no net loss on the section 1256 contracts.

(iii) Under paragraph (b)(4) of this section, the realized and unrealized gains and losses on the non-section 1256 positions are netted, resulting in a non-section 1256 position net gain of $700 ($800–$100). Because there is no net loss on the non-section 1256 positions, the $500 gain realized on the section 1256 contract will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain.

(6) *Accrued gain and loss with respect to positions of a section 1092(b)(2) identified mixed straddle.* If one or more positions of a section 1092(b)(2) identified mixed straddle were held by the taxpayer on the day prior to the day the section 1092(b)(2) identified mixed straddle is established, such position or positions shall be deemed sold for their fair market value as of the close of the last business day preceding the day such straddle is established. See §§ 1.1092(b)–1T and 1.1092(b)–2T for application of the loss deferral and wash sale rules and for treatment of holding periods and losses with respect to such positions. An adjustment (through an adjustment to basis or otherwise) shall be made to any subsequent gain or loss realized with respect to such to such position or positions for any gain or loss recognized under this paragraph (b)(6). This paragraph (b)(6) may be illustrated by the following examples. It is assumed in each example that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year.

Example 1. On January 1, 1985, A enters into a non-section 1256 position. As of the close of the day on July 9, 1985, there is $500 of unrealized long-term capital gain in the non-section 1256 position. On July 10, 1985, A enters into an offsetting section 1256 contract and makes a valid election to treat the straddle as a section 1092(b)(2) identified mixed straddle. Under these circumstances, on July 9, 1985, A will recognize $500 of long-term capital gain on the non-section 1256 position.

Example 2. On February 1, 1985, A enters into a section 1256 contract. As of the close of the day on February 4, 1985, there is $500 of unrealized gain on the section 1256 contract. On February 5, 1985, A enters into an offsetting non-section 1256 position and makes a valid election to treat the straddle as a section 1092(b)(2) identified mixed straddle. Under these circumstances, on February 4, 1985, A will recognize a $500 gain on the section 1256 contract, which will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain.

Example 3. Assume the facts are the same as in example (2) and that on February 10, 1985, there is $2,000 of unrealized gain in the section 1256 contract. A disposes of the section 1256 contract at a $2,000 gain and disposes of the offsetting non-section 1256 position at a $1,000 loss. Under these circumstances, the $2,000 gain on the section 1256 contract will be reduced to $1,500 to take into account the $500 gain recognized when the section 1092(b)(2) identified mixed straddle was established. The $1,500 gain on the section 1256 contract will be offset against the $1,000 loss on the non-section 1256 position. The net $500 gain from the straddle will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain because it is attributable to the section 1256 contract.

Example 4. On March 1, 1985, A enters into a non-section 1256 position. As of the close of the day on March 2, 1985, there is $400 of unrealized short-term capital gain in the non-section 1256 position. On March 3, 1985, A enters into an offsetting section 1256 contract and makes a valid election to treat the straddle as a section 1092(b)(2) identified mixed straddle. On March 10, 1985, A disposes of the section 1256 contract at a $500 loss and the non-section 1256 position at a $500 gain. Under these circumstances, on March 2, 1985, A will recognize $400 of short-term capital gain attributable to the gain accrued on the non-section 1256 position prior to the day the section 1092(b)(2) identified mixed straddle was established. On March 10, 1985, the gain of $500 on the non-section 1256 position will be reduced to $100 to take into account the $400 of gain recognized when the section 1092(b)(2) identified mixed straddle was established. The $100 gain on the non-section 1256 position will be offset against the $500 loss on the section 1256 contract. The net loss of $400 from the straddle will be treated as 60 percent long-term capital loss and 40 percent short-term capital loss because it is attributable to the section 1256 contract.

(7) *Treatment of gain and loss from non-section 1256 positions after disposition of all section 1256 contracts.* Gain or loss on a non-section 1256 position that is part of a section 1092(b)(2) identified mixed straddle and that is held after all section 1256 contracts in the straddle are disposed of shall be treated as short-term capital gain or loss to the extent attributable to the period when the positions were part of such straddle. See § 1.1092(b)–2T for rules concerning the holding period of such positions. This paragraph (b)(7) may be illustrated by the following example. It is assumed that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) during the taxable years.

Example: On December 1, 1985, A, an individual calendar year taxpayer, enters into a section 1256 contract and an offsetting non-section 1256 position and makes a valid election to treat such straddle as a section 1092(b)(2) identified mixed straddle. On December 31, 1985, A disposes of the section 1256 contract at a $1,000 loss. On the same day, there is $1,000 of unrecognized gain in the non-section 1256 position. The $1,000 loss on the section 1256 contract is treated as short-term capital loss because there is a $1,000 gain on the non-section 1256 position, but the $1,000 loss is disallowed in 1985 because there is $1,000 of unrecognized gain in the offsetting nonsection 1256 position. See section 1092(a) and § 1.1092(b)–1T. On July 10, 1986, A disposes of the non-section 1256 position at a $1,500 gain, $500 of which is attributable to the post-straddle period. Under these circumstances, $1,000 of the gain on the non-section 1256 position will be treated as short-term capital gain because that amount of the gain is attributable to the period when the position was part of a section 1092(b)(2) identified mixed straddle. The remaining $500 of the gain will be treated as long-term capital gain because the position was held for more than six months after the straddle was terminated. In addition, the $1,000 short-term capital loss disallowed in 1985 will be taken into account at this time.

(c) *Coordination with loss deferral and wash sale rules of § 1.1092(b)–1T.* This section shall apply prior to the application of the loss deferral and wash sale rules of § 1.1092(b)–1T.

(d) *Identification required*—(1) *In general.* To elect the provisions of this section, a taxpayer must clearly identify on a reasonable and consistently applied economic basis each position that is part of the section 1092(b)(2) identified mixed straddle before the close of the day on which the section 1092(b)(2) identified mixed straddle is established. If the taxpayer disposes of a position that is part of a section 1092(b)(2) identified mixed straddle before the close of the day on which the straddle is established, such identification must be made at or before the time that the taxpayer disposes of the position. In the case of a taxpayer who is an individual, the close of the day is midnight (local time) in the location of the taxpayer's principal residence. In the case of all other taxpayers, the close of the day is midnight (local time) in the location of the taxpayer's principal place of business. Only the person or entity that directly holds all positions of a straddle may make the election under this section.

(2) *Presumptions.* A taxpayer is presumed to have identified a section 1092(b)(2) identified mixed straddle by the time prescribed in paragraph (d)(1) of this section if the taxpayer receives independent verification of the identification (within the meaning of paragraph (d)(4) of this section). The presumption referred to in this paragraph (d)(2) may be rebutted by clear and convincing evidence to the contrary.

(3) *Corroborating evidence.* If the presumption of paragraph (d)(2) of this section does not apply, the burden shall be on the taxpayer to establish that an election under paragraph (d)(1) of this section was made by the time specified in paragraph (d)(1) of this section. If the taxpayer has no evidence of

the time when the identification required by paragraph (d)(1) of this section is made, other than the taxpayer's own testimony, the election is invalid unless the taxpayer shows good cause for failure to have evidence other than the taxpayer's own testimony.

(4) *Independent verification.* For purposes of this section, the following constitute independent verification:

(i) *Separate account.* Placement of one or more positions of a section 1092(b)(2) identified mixed straddle in a separate account designated as a *section 1092(b)(2) identified mixed straddle account* that is maintained by a broker (as defined in §1.6045–1(a)(1)), futures commission merchant (as defined in 7 U.S.C. 2 and 17 CFR 1.3(p)), or similar person and in which notations are made by such person identifying all positions of the section 1092(b)(2) identified mixed straddle and stating the date the straddle is established.

(ii) *Confirmation.* A written confirmation from a person referred to in paragraph (d)(4)(i) of this section, or from the party from which one or more positions of the section 1092(b)(2) identified mixed straddle are acquired, stating the date the straddle is established and identifying the other positions of the straddle.

(iii) *Other methods.* Such other methods of independent verification as the Commissioner may approve at the Commissioner's discretion.

(5) *Section 1092 (b)(2) identified mixed straddles established before February 25, 1985.* Notwithstanding the provisions of paragraph (d)(1) of this section, relating to the time of identification of a section 1092(b)(2) identified mixed straddle, a taxpayer may identify straddles that were established before February 25, 1985 as section 1092(b)(2) identified mixed straddles after the time specified in paragraph (d)(1) of this section if the taxpayer adopts a reasonable and consistent economic basis for identifying the positions of such straddles.

(e) *Effective date*—(1) *In general.* The provisions of this section shall apply to straddles established on or after January 1, 1984.

(2) *Pre-1984 accrued gain.* If the last business day referred to in paragraph (b)(6) of this section is contained in a period to which paragraph (b)(6) does not apply, the gains and losses from the deemed sale shall be included in the first period to which paragraph (b)(6) applies.

(Secs. 1092(b)(1), 1092(b)(2) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 98 Stat. 627; 26 U.S.C. 1092(b)(1), 1092(b)(2), 7805))

[T.D. 8008, 50 FR 3325, Jan. 24, 1985; 50 FR 12243, Mar. 28, 1985; 50 FR 19344, May 8, 1985]

§1.1092(b)–4T Mixed straddles; mixed straddle account (temporary).

(a) *In general.* A taxpayer may elect (in accordance with paragraph (f) of this section) to establish one or more mixed straddle accounts (as defined in paragraph (b) of this section). Gains and losses from positions includible in a mixed straddle account shall be determined and treated in accordance with the rules set forth in paragraph (c) of this section. A mixed straddle account is treated as established as of the first day of the taxable year for which the taxpayer makes the election or January 1, 1984, whichever is later. See §1.1092(b)–5T relating to definitions.

(b) *Mixed straddle account defined*—(1) *In general.* The term *mixed straddle account* means an account for determining gains and losses from all positions held as capital assets in a designated class of activities by the taxpayer at the time the taxpayer elects to establish a mixed straddle account. A separate mixed straddle account must be established for each separate designated class of activities.

(2) *Permissible designations.* Except as otherwise provided in this section, a taxpayer may designate as a class of activities the types of positions that a reasonable person, on the basis of all the facts and circumstances, would ordinarily expect to be offsetting positions. This paragraph (b)(2) may be illustrated by the following example. It is assumed in the example that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) during the taxable year, and that gain or loss from the positions is treated as gain or loss from a capital asset.

Example: B engages in transactions in dealer equity options on XYZ Corporation stock, stock in XYZ Corporation, dealer equity options on UVW Corporation stock, and stock in UVW Corporation. A reasonable person, on the basis of all the facts and circumstances, would not expect dealer equity options on XYZ Corporation stock and stock in XYZ Corporation to offset any dealer equity options on UVW Corporation stock or any stock in UVW Corporation. If B makes the mixed straddle account election under this section for all such positions, B must designate two separate classes of activities, one consisting of transactions in dealer equity options on XYZ Corporation stock and stock in XYZ Corporation, and the other consisting of transactions in dealer equity options on UVW Corporation stock and stock in UVW Corporation, and maintain two separate mixed straddle accounts.

(3) *Positions that offset positions in more than one mixed straddle account.* Gains and losses from positions that a reasonable person, on the basis of all the facts and circumstances, ordinarily would expect to be offsetting with respect to positions in more than one mixed straddle account shall be allocated among such accounts under a reasonable and consistent method that clearly reflects income. This paragraph (b)(2) may be illustrated by the following example. It is assumed that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) during the taxable year, and that gain or loss from the positions is treated as gain or loss from a capital asset.

Example: B holds stock in XYZ Corporation, UVW Corporation, and RST Corporation, and options on a broad based stock index future. A reasonable person, on the basis of all the facts and circumstances, would expect the stock in XYZ Corporation, UVW Corporation, and RST Corporation to be offsetting positions with respect to the options on the broad based stock index future. A reasonable person, on the basis of all the facts and circumstances, would not expect that stock in XYZ Corporation, UVW Corporation, or RST Corporation would be offsetting positions with respect to each other. If B makes the mixed straddle account election under this section for all such positions, B must designate three separate classes of activities: one consisting of stock in XYZ Corporation; one consisting of stock in UVW Corporation; and one consisting of stock in RST Corporation, and maintain three separate mixed straddle accounts. Options on the broad based stock index future must be designated as part of all three classes of activities and gains and losses from such options must be allocated among such accounts under a reasonable and consistent method that clearly reflects income, because such options are a type of position expected to be offsetting with respect to the positions in all three mixed straddle accounts.

(4) *Impermissible designations*—(i) *Types of positions that are not offsetting included in designated class of activities.* If the Commissioner determines, on the basis of all the facts and circumstances, that a class of activities designated by a taxpayer includes types of positions that a reasonable person, on the basis of all the facts and circumstances, ordinarily would not expect to be offsetting positions with respect to other types of positions in the account, the Commissioner may—

(A) Amend the class of activities designated by the taxpayer and remove positions from the account that are not within the amended designated class of activities; or

(B) Amend the class of activities designated by the taxpayer to establish two or more mixed straddle accounts.

(ii) *Types of positions that are offsetting not included in designated class of activities.* If the Commissioner determines, on the basis of all the facts and circumstances, that a designated class of activities does not include types of positions that are offsetting with respect to types of positions within the designated class, the Commissioner may—

(A) Amend the class of activities designated by the taxpayer to include types of positions that are offsetting with respect to the types of positions within the designated class and place such positions in the account; or

(B) Amend the class of activities designated by the taxpayer to exclude types of positions that are offsetting with respect to the types of positions that are not in the account.

(iii) *Treatment of positions removed from or included in the account.* (A) Positions removed from a mixed straddle account will be subject to the rules of taxation generally applicable to such positions. Thus, for example, if the positions removed from the account are offsetting positions with respect to other positions outside the account, the rules of §§ 1.1092(b)–1T and 1.1092(b)–2T apply.

(B) If the taxpayer acted consistently and in good faith in designating the class of activities of the account and in placing positions in the account, the rules of §1.1092(b)–2T(b)(2) shall not apply to any mixed straddles resulting from the removal of such positions from the account and the Commissioner, at the Commissioner's discretion, may identify such mixed straddles as section 1092(b)(2) identified mixed straddles and apply the rules of §1.1092(b)–3T(b) to such straddles.

(C) If positions are placed in a mixed straddle account, such positions shall be treated as if they were originally included in the mixed straddle account in which they are placed.

(5) *Positions included in a mixed straddle account that are not within the designated class of activities.* The Commissioner may remove one or more positions from a mixed straddle account if, on the basis of all the facts and circumstances, the Commissioner determines that such positions are not within the designated class of activities of the account. See paragraph (b)(4)(iii) of this section for rules concerning the treatment of such positions.

(6) *Positions outside a mixed straddle account that are within the designated class of activities.* If a taxpayer holds types of positions outside of a mixed straddle account (including positions in another mixed straddle account) that are within the designated class of activities of a mixed straddle account, the Commissioner may require the taxpayer to include such types of positions in the mixed straddle account, move positions from one account to another, or remove from the mixed straddle account types of positions that are offsetting with respect to the types of positions held outside the account. See paragraph (b)(4)(iii) of this section for the treatment of such positions.

(c) *Treatment of gains and losses from positions in a mixed straddle account*—(1) *Daily account net gain or loss.* Except as provided in paragraphs (d) and (e) of this section (relating to positions in a mixed straddle account before January 1, 1985) as of the close of each business day of the taxable year, gain or loss shall be determined for each position in a mixed straddle account that is disposed of during the day. Positions in a mixed straddle account that have not been disposed of as of the close of the day shall be treated as if sold for their fair market value at the close of each business day. Gains and losses for each business day from non-section 1256 positions in each mixed straddle account shall be netted to determine *net non-section 1256 position gain or loss* for the account, and gains and losses for each business day from section 1256 contracts in each mixed straddle account shall be netted to determine *net section 1256 contract gain or loss* for the account. Net non-section 1256 position gain or loss from the account is then offset against net section 1256 contract gain or loss from the same mixed straddle account to determine the *daily account net gain or loss* for the account. If daily account net gain or loss is attributable to the net non-section 1256 position gain or loss, daily account net gain or loss for such account shall be treated as short-term capital gain or loss. If daily account net gain or loss is attributable to the net section 1256 contract gain or loss, daily account net gain or loss for such account shall be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. If net non-section 1256 position gain or loss and net section 1256 contract gain or loss are either both gains or both losses, that portion of the daily account net gain or loss attributable to net non-section 1256 position gain or loss shall be treated as short-term capital gain or loss and that portion of the daily account net gain or loss attributable to net section 1256 contract gain or loss shall be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. An adjustment (through an adjustment to basis or otherwise) shall be made to any subsequent gain or loss determined under this paragraph (c)(1) to take into account any gain or loss determined for prior business days under this paragraph (c)(1).

(2) *Annual account net gain or loss; total annual account net gain or loss.* On the last business day of the taxable year, the *annual account net gain or loss* for each mixed straddle account established by the taxpayer shall be determined by netting the daily account net gain or loss for each business day in

the taxable year for each account. Annual account net gain or loss for each mixed straddle account shall be adjusted pursuant to paragraph (c)(3) of this section. The *total annual account net gain or loss* shall be determined by netting the annual account net gain or loss for all mixed straddle accounts established by the taxpayer, as adjusted pursuant to paragraph (c)(3) of this section. Total annual account net gain or loss is subject to the limitations of paragraph (c)(4) of this section. See paragraphs (d) and (e) of this section for determining the annual account net gain or loss for mixed straddle accounts established for taxable years beginning before January 1, 1985.

(3) *Application of section 263(g) to mixed straddle accounts.* No deduction shall be allowed for interest and carrying charges (as defined in section 263(g)(2)) properly allocable to a mixed straddle account. Interest and carrying charges properly allocable to a mixed straddle account means the excess of—

(i) The sum of—

(A) Interest on indebtedness incurred or continued during the taxable year to purchase or carry any position in the account; and

(B) All other amounts (including charges to insure, store or transport the personal property) paid or incurred to carry any position in the account; over

(ii) The sum of—

(A) The amount of interest (including original issue discount) includible in gross income for the taxable year with respect to all positions in the account;

(B) Any amount treated as ordinary income under section 1271(a)(3)(A), 1278, or 1281(a) with respect to any position in the account for the taxable year; and

(C) The excess of any dividends includible in gross income with respect to positions in the account for the taxable year over the amount of any deduction allowable with respect to such dividends under section 243, 244, or 245.

For purposes of paragraph (c)(3)(i) of this section, the term *interest* includes any amount paid or incurred in connection with positions in the account used in a short sale. Any interest and carrying charges disallowed under this paragraph (c)(3) shall be capitalized by treating such charges as an adjustment to the annual account net gain or loss and shall be allocated pro rata between net short-term capital gain or loss and net long–term capital gain or loss.

(4) *Limitation on total annual account net gain or loss.* No more than 50 percent of total annual account net gain for the taxable year shall be treated as long-term capital gain. Any long-term capital gain in excess of the 50 percent limit shall be treated as short-term capital gain. No more than 40 percent of total annual account net loss for the taxable year shall be treated as short-term capital loss. Any short-term capital loss in excess of the 40 percent limit shall be treated as long-term capital loss.

(5) *Accrued gain and loss with respect to positions includible in a mixed straddle account.* Positions includable in a mixed straddle account that are held by a taxpayer on the day prior to the day the mixed straddle account is established shall be deemed sold for their fair market value as of the close of the last business day preceding the day such mixed straddle account is established. See §§ 1.1092(b)–1T and 1.1092(b)–2T for application of the loss deferral and wash sale rules and for treatment of holding periods and losses with respect to such positions. An adjustment (through an adjustment to basis or otherwise) shall be made to any subsequent gain or loss realized with respect to such positions for any gain or loss recognized under this paragraph (c)(5).

(6) *Examples.* This paragraph (c) may be illustrated by the following examples. It is assumed in each example that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year, and that gain or loss from the positions is treated as gain or loss from a capital asset.

Example 1. A establishes a mixed straddle account for a class of activities consisting of transactions in stock of XYZ Corporation and dealer equity options on XYZ Corporation stock. Assume that A enters into no transactions in XYZ Corporation stock or dealer equity options on XYZ Corporation stock prior to December 26, 1985. Thus, the net non-section 1256 position gain or loss and the net section 1256 contract gain or loss for the account are zero for each business day except the following days:

	Net non-section 1256 position gain or loss (XYZ corporation stock)	Net section 1256 contract gain or loss (XYZ corporation dealer equity options)
December 26, 1985	$1,000	$20,000
December 27, 1985	(9,000)	3,000
December 30, 1985	(5,000)	15,000
December 31, 1985	7,000	(2,000)

The daily account net gain or loss is as follows:

	Daily account net gain or loss	Treatment of daily account net gain or loss	Long-term	Short-term
December 26, 1985	$21,000	$1,000 short-term capital gain, $20,000 60 percent long-term capital gain and 40 percent short-term capital gain.	$12,000	$9,000
December 27, 1985	(6,000)	Short-term capital loss	....	(6,000)
December 30, 1985	10,000	60 percent long-term capital gain and 40 percent short-term capital gain.	6,000	4,000
December 31, 1985	5,000	Short-term capital gain	....	5,000

The annual account net gain or loss is $18,000 of long-term capital gain and $12,000 of short-term capital gain. Because A has no other mixed straddle accounts, total annual account net gain or loss is also $18,000 long-term capital gain and $12,000 short-term capital gain. Because more than 50 percent of the total annual account net gain is long-term capital gain, $3,000 of the $18,000 long-term capital gain will be treated as short-term capital gain.

Example 2. Assume the facts are the same as in example (1), except that interest and carrying charges in the amount of $6,000 are allocable to the mixed straddle account and are capitalized under paragraph (c)(3) of this section. Under these circumstances, $3,600 (($18,000/$30,000)×$6,000) of the interest and carrying charges will reduce the $18,000 long-term capital gain to $14,400 long-term capital gain and $2,400 (($12,000/$30,000)×$6,000) of the interest and carrying charges will reduce the $12,000 short-term capital gain to $9,600 short-term capital gain. Because more than 50 percent of the total annual account net gain is long-term capital gain, $2,400 of the $14,400 long-term capital gain will be treated as short-term capital gain.

Example 3. Assume the facts are the same as in example (1), except that A has a second mixed straddle account, which has an annual account net loss of $14,000 of long-term capital loss and $6,000 of short-term capital loss. Under these circumstances, the total annual account net gain is $4,000 ($18,000−$14,000) of long-term capital gain and $6,000 ($12,000−$6,000) of short-term capital gain. Because not more than 50 percent of the total annual account net gain is long-term capital gain, none of the long-term capital gain will be treated as short-term capital gain.

Example 4. Assume the facts are the same as in example (3), except that interest and carrying charges in the amount of $4,000 are allocable to the second mixed straddle account and are capitalized under paragraph (c)(3) of this section. Under these circumstances, $2,800 (($14,000/$20,000)×$4,000)) of the interest and carrying charges will increase the $14,000 long-term capital loss to $16,800 of long-term capital loss and $1,200 (($6,000/$20,000)×$4,000)) of the interest and carrying charges will increase the $6,000 short-term capital loss to $7,200 short-term capital loss. The total annual account net gain is $1,200 of long-term capital gain ($18,000 $16,800) and $4,800 ($12,000−$7,200) of short-term capital gain. Because not more than 50 percent of the total annual account net gain is long-term capital gain, none of the $1,200 long-term capital gain will be treated as short-term capital gain.

Example 5. Assume the facts are the same as in example (1), except that A has a second mixed straddle account, which has an annual account net loss of $20,000 of long-term capital loss and $15,000 of short-term capital loss. Under these circumstances, the total annual account net loss is $2,000 ($20,000−$18,000) of long-term capital loss and $3,000 ($15,000−$12,000) of short-term capital loss. Because more than 40 percent of the total annual account net loss is short-term capital loss, $1,000 of the short-term capital loss will be treated as long-term capital loss.

Example 6. A establishes two mixed straddle accounts. Account 1 has an annual account net gain of $5,000 short-term capital gain, which results from netting $5,000 of long-term capital loss and $10,000 of short-term capital gain. Account 2 has an annual account net loss of $2,000 long-term capital loss, which results from netting $3,000 of long-term capital loss against $1,000 of short-term capital gain. The total annual account net gain is $3,000 short-term capital gain, which results from netting the annual account net gain of $5,000 short-term capital gain from Account 1 against the annual account net loss of $2,000 long-term capital loss from Account 2.

(d) *Treatment of gains and losses from positions in a mixed straddle account established on or before December 31, 1984, in taxable years ending after December 31, 1984; pre-1985 account net gain or loss.* For mixed straddle accounts established on or before December 31, 1984, in taxable years ending after December 31, 1984, the taxpayer on December 31, 1984, shall determine gain or loss for each position in the mixed straddle account that has been disposed of on any day during the period beginning on the first day of the taxpayer's taxable year that includes December 31, 1984, and ending on December 31, 1984. Positions in the mixed straddle account that have not been disposed of as of the close of December 31, 1984, shall be treated as if sold for their fair market value as of the close of December 31, 1984. Gains and losses for such period from non-section 1256 positions in each mixed straddle account shall be netted to determine *pre-1985 net non-section 1256 position gain or loss* and gains and losses for such period from section 1256 contracts in each mixed straddle account shall be netted to determine *pre-1985 net section 1256 contract gain or loss.* Pre-1985 net non-section 1256 position gain or loss is then offset against pre-1985 net section 1256 contract gain or loss from the same mixed straddle account to determine the *pre-1985 account net gain or loss* for the period. If the pre-1985 account net gain or loss is attributable to pre-1985 net non-section 1256 position gain or loss, the pre-1985 account net gain or loss from such account shall be treated as short-term capital gain or loss. If the pre-1985 account net gain or loss is attributable to pre-1985 net section 1256 contract gain or loss, the pre-1985 account net gain or loss from such account shall be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. If pre-1985 net non-section 1256 position gain or loss and pre-1985 net section 1256 contract gain or loss are either both gains or losses, that portion of the pre-1985 account net gain or loss attributable to pre-1985 net non-section 1256 position gain or loss shall be treated as short-term capital gain or loss and that portion of the pre-1985 account net gain or loss attributable to pre-1985 net section 1256 contract gain or loss shall be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. An adjustment (through an adjustment to basis or otherwise) shall be made to any subsequent gain or loss realized with respect to such positions for any gain or loss recognized under this paragraph (d). To determine the annual account net gain or loss for such account, the pre-1985 account net gain or loss shall be treated as daily account net gain or loss for purposes of paragraph (c)(2) of this section. See paragraph (c)(5) of this section for treatment of accrued gain or loss with respect to positions includible in a mixed straddle account.

(e) *Treatment of gains and losses from positions in a mixed straddle account for taxable years ending on or before December 31, 1984*—(1) *In general.* For mixed straddle accounts established on or before December 31, 1984, in taxable years ending on or before December 31, 1984, the taxpayer at the close of the taxable year shall determine gain or loss for each position in the mixed straddle account that has been disposed of on any day during the period beginning on the later of the first day of the taxable year or January 1, 1984, and ending on the last day of the taxable year. Positions in the mixed straddle account that have not been disposed of as of the close of the last business day of the taxable year shall be treated as if sold for their fair market value at the close of such day. Gains and losses from non-section 1256 positions in each mixed straddle account shall be netted to determine *1984 net non-section 1256 position gain or loss* for the account and gains and losses from section 1256 contracts shall be netted to determine *1984 net section 1256 contract gain or loss* for the account. The 1984 net non-section 1256 position gain or loss is then offset against 1984 net section 1256 contract gain or loss from the same mixed straddle account to determine *annual account net gain or loss* for the account. If annual account net gain or loss is attributable to 1984 net non-section 1256 position gain or loss, annual account net gain or loss shall be treated as short-term capital gain or loss. If annual account net gain or loss is attributable to 1984 net section 1256 contract gain or loss, annual account net gain or loss shall be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. If 1984 net non-section 1256 position gain or loss and 1984 net section 1256 contract gain or loss are either both gains or both losses, that portion of annual account net gain or loss attributable to 1984 net non-section 1256 position gain or loss shall be treated as short-term capital gain or loss and that portion of annual account net gain or loss attributable to 1984 net section 1256 contract gain or loss shall be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. An adjustment (through an adjustment to basis or otherwise) shall be made to any subsequent gain or loss realized with respect to such positions for any gain or loss recognized under this paragraph (e). See paragraph (c) (2) through (5) of this section relating to determining the total annual account net gain or loss, application of section 263(g) to mixed straddle accounts, the limitation on the total annual account net gain or loss, and treatment of accrued gain or loss with respect to positions includible in a mixed straddle account.

(2) *Pre-1984 accrued gain.* If the last business day referred to in paragraph (c)(5) of this section is contained in a period to which such paragraph (c)(5) does not apply, the gains and losses from the deemed sale shall be included in the first period to which paragraph (c)(5) applies.

(f) *Election*—(1) *Time for making the election.* Except as otherwise provided, the election under this section to establish one or more mixed straddle accounts for a taxable year must be made by the due date (without regard to automatic and discretionary extensions) of the taxpayer's income tax return for the immediately preceding taxable year (or part thereof). For example, an individual taxpayer on a calendar year basis must make the election by April 15, 1986, to establish one or more mixed straddle accounts for taxable year 1986. Similarly, a calendar year corporate taxpayer must make its election by March 15, 1986, to establish one or more mixed straddle accounts for 1986. If a taxpayer begins trading or investing in positions in a new class of activities during a taxable year, the election under this section with respect to the new class of activities must be made by the taxpayer by the later of the due date of the taxpayer's income tax return for the immediately preceding taxable year (without regard to automatic and discretionary extensions), or 60 days after the first mixed straddle in the new class of activities is entered into. Similarly, if on or after the date the election is made with respect to an account, the taxpayer begins trading or investing in positions that are includible in such account but were not specified in the original election, the taxpayer must make an amended election as prescribed in paragraph (f)(2)(ii) of this section by the later of the due date of the taxpayer's income tax return for the immediately preceding taxable year (without regard to automatic and discretionary extensions), or 60 days after the acquisition of the first of the positions. If an election is made after the times specified in this paragraph (f)(1), the election will be permitted only if the Commissioner concludes that the taxpayer had reasonable cause for failing to make a timely election. For example, if a calendar year taxpayer holds few positions in one class of activities prior to April 15 of a taxable year, and the taxpayer greatly increases trading activity with respect to positions in the class of activities after April 15, then the Commissioner may conclude that the taxpayer had reasonable cause for failing to make a timely election and allow the taxpayer to make a mixed straddle account election for the taxable year. See paragraph (f)(2) of this section for rules relating to the manner for making these elections.

(2) *Manner for making the election*—(i) *In general.* A taxpayer must make the election on Form 6781 in the manner prescribed by such Form, and by attaching the Form to the taxpayer's income tax return for the immediately

preceding taxable year (or request for an automatic extension). In addition, the taxpayer must attach a statement to Form 6781 designating with specificity the class of activities for which a mixed straddle account is established. The designation must describe the class of activities in sufficient detail so that the Commissioner may determine, on the basis of the designation, whether specific positions are includible in the mixed straddle account. In the case of a taxpayer who elects to establish more than one mixed straddle account, the Commissioner must be able to determine, on the basis of the designations, that specific positions are placed in the appropriate account. The election applies to all positions in the designated class of activities held by the taxpayer during the taxable year.

(ii) *Elections for new classes of activities and expanded elections.* Amended elections and elections made with respect to a new class of activities that the taxpayer has begun trading or investing in during a taxable year, shall be made on Form 6781 within the times prescribed in paragraph (f)(1) of this section. A statement must be attached to the Form containing the information required in paragraph (f)(2)(i) of this section, with respect to the new or expanded designated class of activities.

(iii) *Special rule.* The Commissioner may disregard a mixed straddle account election if the Commissioner determines, on the basis of all the facts and circumstances, that the principal purpose for making the mixed straddle account election with respect to a class of activities was to avoid the rules of § 1.1092(b)–1T (a). For example, if a taxpayer holds stock that is not part of a straddle and that would generate a loss if sold or otherwise disposed of, and the taxpayer both acquires offsetting option positions with respect to the stock and makes a mixed straddle account election with respect to the stock and stock options near the end of a taxable year, the Commissioner may disregard the mixed straddle account election.

(3) *Special rule for taxable years ending after 1983 and before September 1, 1986.* An election under this section to establish one or more mixed straddle accounts for any taxable year that includes July 17, 1984, and any taxable year that ends before September 1, 1986 (or, in the case of a corporation, October 1, 1986), must be made by the later of—

(i) December 31, 1985, or

(ii) The due date (without regard to automatic and discretionary extensions) of the return for the taxpayer's taxable year that begins in 1984 if the due date of the taxpayer's return for such year (without regard to automatic and discretionary extensions) is after December 31, 1985.

The election shall be made by attaching Form 6781 together with a statement to the taxpayer's income tax return, amended return, or other appropriate form that is filed on or before the deadline determined in the preceding sentence. The attached statement must designate with specificity, in accordance with paragraph (f)(2)(i) of this section, the class of activities for which a mixed straddle account is established. For example, if a fiscal year taxpayer's return (for its taxable year ending September 30, 1985) is due (without regard to extensions) on January 15, 1986, and the taxpayer intends to obtain an automatic extension to file the return, the election under this section for any or all of the fiscal years ending in 1984, 1985 or 1986 must be made on or before January 15, 1986, with the request for an automatic extension. Similarly, a calendar year taxpayer (whether or not such taxpayer has obtained an automatic extension of time to file) who has filed its 1984 income tax return before October 15, 1985, without making a mixed straddle account election for either 1984 or 1985, or both, may make the mixed straddle account election under this section for either or for both of such years with an amended return filed on or before December 31, 1985. The mixed straddle account elected on this amended return will be effective for all positions in the designated class of activities even if the taxpayer had elected straddle-by-straddle identification as provided under § 1.1092(b)–3T for purposes of the previously filed 1984 income tax return. For taxable years beginning in 1984 and 1985, the election under this paragraph (f)(3) is effective for the entire taxable year. For taxable years beginning in 1983, an election shall be effective for that part of the year beginning after December 31, 1983, for which the election under § 1.1256(h)–1T or 1.1256(h)–2T is made. See § 1.6081–1T regarding an extension of time to file certain individual income tax returns.

(4) *Period for which election is effective.* For taxable years beginning on or after January 1, 1984, an election under this section, including an amendment to the election pursuant to paragraph (f)(1) of this section, shall be effective only for the taxable year for which the election is made. This election may be revoked during the taxable year for the remainder of the taxable year only with the consent of the Commissioner. An application for consent to revoke the election shall be filed with the service center with which the election was filed and shall—

(i) Contain the name, address, and taxpayer identification number of the taxpayer;

(ii) Show that the volume or nature of the taxpayer's activities has changed substantially since the election was made, and that the taxpayer's activities no longer warrant the use of such mixed straddle account; and

(iii) Any other relevant information.

If a taxpayer's election for a taxable year is revoked, the taxpayer may not make a new election for the same class of activities under paragraph (f)(1) of this section during the same taxable year.

(g) *Effective date.* The provisions of this section apply to positions held on or after January 1, 1984.

(Secs. 1092(b)(1), 1092(b)(2) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 98 Stat. 627; 26 U.S.C. 1092(b)(1), 1092(b)(2), 7805))

[T.D. 8008, 50 FR 3329, Jan. 24, 1985; 50 FR 12243, Mar. 28, 1985, as amended by T.D. 8058, 50 FR 42013, Oct. 17, 1985]

§ 1.1092(b)–5T Definitions (temporary).

The following definitions apply for purposes of §§ 1.1092(b)–1T through 1.1092(b)–4T.

(a) *Disposing, disposes, or disposed.* The term *disposing, disposes,* or *disposed* includes the sale, exchange, cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property (as defined in section 1092(d)(1)).

(b) *Hedging transaction.* The term *hedging transaction* means a hedging transaction as defined in section 1256(e).

(c) *Identified straddle.* The term *identified straddle* means an identified straddle as defined in section 1092(a)(2)(B).

(d) *Loss.* The term *loss* means a loss otherwise allowable under section 165(a) (without regard to the limitation contained in section 165(f)) and includes a write-down in inventory.

(e) *Mixed straddle.* The term *mixed straddle* means a straddle—

(1) All of the positions of which are held as capital assets;

(2) At least one (but not all) of the positions of which is a section 1256 contract;

(3) For which an election under section 1256(d) has not been made; and

(4) Which is not part of a larger straddle.

(f) *Non-section 1256 position.* The term *non-section 1256 position* means a position that is not a section 1256 contract.

(g) *Offsetting position.* The term *offsetting position* means an offsetting position as defined in section 1092(c)(2).

(h) *Position.* The term *position* means a position as defined in section 1092(d)(2).

(i) [Reserved]

(j) *Related person or flowthrough entity.* The term *related person or flowthrough entity* means a related person or flowthrough entity as defined in sections 1092(d)(4) (B) and (C) respectively.

(k) *Section 1256 contract.* The term *section 1256 contract* means a section 1256 contract as defined in section 1256(b).

(l) [Reserved]

(m) *Straddle.* The term *straddle* means a straddle as defined in section 1092(c)(1).

(n) *Successor position.* The term *successor position* means a position (''P'') that is or was at any time offsetting to a second position if—

(1) The second position was offsetting to any loss position disposed of; and

(2) P is entered into during a period commencing 30 days prior to, and ending 30 days after, the disposition of the loss position referred to in paragraph (n)(1) of this section.

(o) *Unrecognized gain.* The term *unrecognized gain* means unrecognized gain as defined in section 1092(a)(3)(A).

(p) *Substantially identical.* The term *substantially identical* has the same meaning as substantially identical in section 1091(a).

(q) *Securities.* The term *security* means a security as defined in section 1236(c).

(Secs. 1092(b) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 95 Stat. 324, 26 U.S.C. 1092(b), 7805) and sec. 102(h) of the Tax Reform Act of 1984 (98 Stat. 625))

[T.D. 8007, 50 FR 3321, Jan. 24, 1985, as amended by T.D. 8070, 51 FR 1788, Jan. 15, 1986]

§1.1092(d)–1 Definitions and special rules.

(a) *Actively traded.* Actively traded personal property includes any personal property for which there is an established financial market.

(b) *Established financial market*—(1) *In general.* For purposes of this section, an established financial market includes—

(i) A national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);

(ii) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934;

(iii) A domestic board of trade designated as a contract market by the Commodities Futures Trading Commission;

(iv) A foreign securities exchange or board of trade that satisfies analogous regulatory requirements under the law of the jurisdiction in which it is organized (such as the London International Financial Futures Exchange, the Marche a Terme International de France, the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited, the Frankfurt Stock Exchange, and the Tokyo Stock Exchange);

(v) An interbank market;

(vi) An interdealer market (as defined in paragraph (b)(2)(i) of this section); and

(vii) Solely with respect to a debt instrument, a debt market (as defined in paragraph (b)(2)(ii) of this section).

(2) *Definitions*—(i) *Interdealer market.* An interdealer market is characterized by a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations (including rates, yields, or other pricing information) of one or more identified brokers, dealers, or traders or actual prices (including rates, yields, or other pricing information) of recent transactions. An interdealer market does not include a directory or listing of brokers, dealers, or traders for specific contracts (such as yellow sheets) that provides neither price quotations nor actual prices of recent transactions.

(ii) *Debt market.* A debt market exists with respect to a debt instrument if price quotations for the instrument are readily available from brokers, dealers, or traders. A debt market does not exist with respect to a debt instrument if—

(A) No other outstanding debt instrument of the issuer (or of any person who guarantees the debt instrument) is traded on an established financial market described in paragraph (b)(1)(i), (ii), (iii), (iv), (v), or (vi) of this section (other traded debt);

(B) The original stated principal amount of the issue that includes the debt instrument does not exceed $25 million;

(C) The conditions and covenants relating to the issuer's performance with respect to the debt instrument are materially less restrictive than the conditions and covenants included in all of the issuer's other traded debt (e.g., the debt instrument is subject to an economically significant subordination provision whereas the issuer's other traded debt is senior); or

(D) The maturity date of the debt instrument is more than 3 years after the latest maturity date of the issuer's other traded debt.

(c) *Notional principal contracts.* For purposes of section 1092(d)—

(1) A notional principal contract (as defined in §1.446–3(c)(1)) constitutes personal property of a type that is actively traded if contracts based on the same or substantially similar specified indices are purchased, sold, or entered into on an established financial market

within the meaning of paragraph (b) of this section; and

(2) The rights and obligations of a party to a notional principal contract are rights and obligations with respect to personal property and constitute an interest in personal property.

(d) *Effective dates.* Paragraph (b)(1)(vii) of this section applies to positions entered into on or after October 14, 1993. Paragraph (c) of this section applies to positions entered into on or after July 8, 1991.

[T.D. 8491, 58 FR 53135, Oct. 14, 1993]

§1.1092(d)–2 Personal property.

(a) *Special rules for stock.* Under section 1092(d)(3)(B), personal property includes any stock that is part of a straddle, at least one of the offsetting positions of which is a position with respect to substantially similar or related property (other than stock). For purposes of this rule, the term *substantially similar or related property* is defined in §1.246–5 (other than §1.246–5(b)(3)). The rule in §1.246–5(c)(6) does not narrow the related party rule in section 1092(d)(4).

(b) *Effective date*—(1) *In general.* This section applies to positions established on or after March 17, 1995.

(2) *Special rule for certain straddles.* This section applies to positions established after March 1, 1984, if the taxpayer substantially diminished its risk of loss by holding substantially similar or related property involving the following types of transactions—

(i) Holding offsetting positions consisting of stock and a convertible debenture of the same corporation where the price movements of the two positions are related; or

(ii) Holding a short position in a stock index regulated futures contract (or alternatively an option on such a regulated futures contract or an option on the stock index) and stock in an investment company whose principal holdings mimic the performance of the stocks included in the stock index (or alternatively a portfolio of stocks whose performance mimics the performance of the stocks included in the stock index).

[T.D. 8590, 60 FR 14641, Mar. 20, 1995]

CAPITAL GAINS AND LOSSES

Treatment of Capital Gains

§1.1201–1 Alternative tax.

(a) *Corporations*—(1) *In general.* (i) If for any taxable year a corporation has net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977) (as defined in section 1222(11)) section 1201(a) imposes an alternative tax in lieu of the tax imposed by sections 11 and 511, but only if such alternative tax is less than the tax imposed by sections 11 and 511. The alternative tax is not in lieu of the personal holding company tax imposed by section 541 or of any other tax not specifically set forth in section 1201(a).

(ii) In the case of an insurance company, the alternative tax imposed by section 1201(a) is also in lieu of the tax imposed by sections 821 (a) or (c) and 831 (a), except that for taxable years beginning before January 1, 1963, the reference to section 821 (a) or (c) is to be read as reference to section 821 (a)(1) or (b). For taxable years beginning after December 31, 1954, and before January 1, 1958, the alternative tax imposed by section 1201(a) shall also be in lieu of the tax imposed by section 802(a), as amended by the Life Insurance Company Tax Act for 1955 (70 Stat. 38), if such alternative tax is less than the tax imposed by such section. See section 802(e), as added by the Life Insurance Company Tax Act for 1955 (70 Stat. 39). However, for taxable years beginning after December 31, 1958, and before January 1, 1962, section 802(a)(2), as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 115), imposes a separate tax equal to 25 percent of the amount by which the net long-term capital gain of any life insurance company (as defined in section 801(a) and paragraph (b) of §1.801–3) exceeds its net short-term capital loss. See paragraph (f) of §1.802–3. For alternative tax for life insurance companies in the case of taxable years beginning after December 31, 1961, see section 802(a)(2) and the regulations thereunder.

(iii) See section 56 and the regulations thereunder for provisions relating to the minimum tax for tax preferences.

(2) *Alternative tax.* The alternative tax is the sum of:

(i) A partial tax computed at the rates provided in sections 11, 511, 821 (a) or (c), and 831(a), on the taxable income of the taxpayer reduced by the amount of the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977), and

(ii) An amount equal to the tax determined under subparagraph (3) of this paragraph.

For taxable years beginning after December 31, 1954, and before January 1, 1958, the partial tax under subdivision (i) of this subparagraph shall also be computed at the rates provided in section 802(a). For taxable years beginning before January 1, 1963, the reference in such subdivision to section 821 (a) or (c) is to be read as a reference to section 821 (a) or (b).

(3) *Tax on capital gains.* For purposes of subparagraph (2)(ii) of this paragraph, the tax shall be:

(i) In the case of a taxable year beginning after December 31, 1974, a tax of 30 percent of the net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976),

(ii) In the case of a taxable year beginning after December 31, 1969, and before January 1, 1975:

(*a*) A tax of 25 percent of the lesser of the amount of the subsection (d) gain (as defined in section 1201(d) and paragraph (f) of this section) or the amount of the net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976), plus

(*b*) A tax of 30 percent (28 percent in the case of a taxable year beginning after December 31, 1969, and before January 1, 1971) of the excess, if any, of the net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976) over the subsection (d) gain,

(iii) In the case of a taxable year beginning before January 1, 1970, and after March 31, 1954, a tax of 25 percent of the net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976), or

(iv) In the case of a taxable year beginning before April 1, 1954, a tax of 26 percent of the net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976).

(4) *Determination of special deductions.* In the computation of the partial tax described in subparagraph (2)(i) of this paragraph the special deductions provided for in sections 243, 244, 245, 247, 922, and 941 shall not be recomputed as the result of the reduction of taxable income by the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977).

(b) *Other taxpayers*—(1) *In general.* If for any taxable year a taxpayer (other than a corporation) has net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977) (as defined in section 1222(11)) section 1201(b) imposes an alternative tax in lieu of the tax imposed by sections 1 and 511, but only if such alternative tax is less than the tax imposed by sections 1 and 511. The alternative tax is not in lieu of any other tax not specifically set forth in section 1201(b). See section 56 and the regulations thereunder for provisions relating to the minimum tax for tax preferences.

(2) *Alternative tax.* The alternative tax is the sum of:

(i) A partial tax computed at the rates provided by sections 1 and 511 on the taxable income reduced by an amount equal to 50 percent of the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977), and

(ii) In the case of a taxable year beginning after December 31, 1969:

(*a*) A tax of 25 percent of the lesser of the amount of the subsection (d) gain (as defined in section 1201(d) and paragraph (f) of this section) or the amount of the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977), plus

(*b*) A tax computed as provided in section 1201(c) and paragraph (e) of this section on the excess, if any, of the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977) over the subsection (d) gain, or

(iii) In the case of a taxable year beginning before January 1, 1970, a tax of 25 percent of the net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976).

(3) *Cross references.* See § 1.1–2(a) for rule relating to the computation of the limitation on tax in cases where the alternative tax is imposed. See § 1.34–2 (a)

for rule relating to the computation of the dividend received credit under section 34 (for dividends received on or before December 31, 1964), and §1.35–1 (a) for rule relating to the computation of credit for partially tax-exempt interest under section 35 in cases where the alternative tax is imposed.

(c) *Tax-exempt trusts and organizations.* In applying section 1201 in the case of tax-exempt trusts or organizations subject to the tax imposed by section 511, the only amount which is taken into account as capital gain or loss is that which is taken into account in computing unrelated business taxable income under section 512. Under section 512, the only amount taken into account as capital gain or loss is that resulting from the application of section 631(a), relating to the election to treat the cutting of timber as a sale or exchange.

(d) *Joint returns.* In the case of a joint return, the excess of any net long-term capital gain over any net short-term capital loss is to be determined by combining the long-term capital gains and losses and the short-term capital gains and losses of the spouses.

(e) *Computation of tax on capital gain in excess of subsection (d) gain*—(1) *In general.* The tax computed for purposes of section 1201(b)(3) and paragraph (b)(2)(ii)(*b*) of this section shall be the amount by which a tax determined under section 1 or 511 on an amount equal to the taxable income (but not less than 50 percent of the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977)) for the taxable year exceeds a tax determined under section 1 or 511 on an amount equal to the sum of (i) the amount subject to tax under section 1201 (b)(1) and paragraph (b)(2)(i) of this section for such year plus (ii) an amount equal to 50 percent of the subsection (d) gain for such year.

(2) *Limitation.* Notwithstanding subparagraph (1) of this paragraph, the tax computed for purposes of section 1201(b) (3) and paragraph (b)(2)(ii)(*b*) of this section shall not exceed an amount equal to the following percentage of the excess of the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977) over the subsection (d) gain for the taxable year:

(i) 29½ percent, in the case of a taxable year beginning after December 31, 1969, and before January 1, 1971, or

(ii) 32½ percent, in the case of a taxable year beginning after December 31, 1970, and before January 1, 1972.

(f) *Definition of subsection (d) gain*—(1) *In general.* For purposes of section 1201 and this section, the term *subsection (d) gain* means the sum of the long-term capital gains for the taxable year arising:

(i) In the case of amounts received or accrued, as the case may be, before January 1, 1975 (other than any gain from a transaction described in section 631 or 1235), from:

(*a*) Sales or other dispositions on or before October 9, 1969, including sales or other dispositions the income from which is returned as provided in section 453 (a)(1) or (b)(1), or

(*b*) Sales or other dispostions after October 9, 1969, pursuant to binding contracts entered into on or before that date, including sales or other dispositions the income from which is returned as provided in section 453 (a)(1) or (b)(1),

(ii) From liquidating distributions made by a corporation which are made (a) before October 10, 1970, and (b) pursuant to a plan of complete liquidation adopted on or before October 9, 1969, or

(iii) In the case of a taxpayer (other than a corporation), from any other source not described in subdivision (i) or (ii) of this subparagraph, but the amount taken into account from such other sources shall be limited to the amount, if any, by which $50,000 ($25,000 in the case of a married individual filing a separate return) exceeds the sum of the gains to which subdivisions (i) and (ii) of this subparagraph apply.

(2) *Special rules.* For purposes of subparagraph (1) of this paragraph:

(i) A binding contract entered into on or before October 9, 1969, means a contract, whether written or unwritten, which on or before that date was legally enforceable against the taxpayer under applicable law. If on or before October 9, 1969, a taxpayer grants an irrevocable option or irrevocable contractual right to another party to buy certain property and such other party exercises that option or right after October 9, 1969, the sale of such property is a sale pursuant to a binding contract entered into on or before October 9, 1969. The application of this subdivision may be illustrated by the following example:

Example: During 1964, A, B, and C formed a closely held corporation, and A was appointed as president of the organization. On July 1, 1964, A received for consideration 100 shares of common stock in the corporation subject to the agreement that, if A should retire from the management of the corporation or die, A or his estate would first offer his shares of stock to the corporation for purchase and that, if the corporation did not buy the stock within 60 days, the stock could be sold to any party other than the corporation. On September 1, 1970, A retired from the management of the corporation and offered his shares to the corporation for purchase. Pursuant to the agreement, the corporation purchased A's stock on September 30, 1970. A's sale of such stock was pursuant to a binding contract entered into on or before October 9, 1969.

(ii) A contract which pursuant to subdivision (i) of this subparagraph constitutes a binding contract entered into on or before October 9, 1969, does not cease to qualify as such a contract by reason of the fact that after October 9, 1969, there is a modification of the terms of the contract such as a change in the time of performance, or in the amount of the debt or in the terms and mode of payment, or in the rate of interest, or there is a change in the form or nature of the obligation or the character of the security, so long as the taxpayer is at all times on and after October 9, 1969, legally bound by such contract. The application of this subdivision may be illustrated by the following examples:

Example 1. On August 1, 1969, A sold certain capital assets to B on the installment plan and elected to return the gain therefrom under section 453, the agreement providing for payments over a period of 2 years. At the time of the sale these assets had been held by A for more than 6 months. On July 31, 1970, A and B agreed to a modification of the terms of payment under the sales agreement, the only change in the contract being that the installment payments due after July 31, 1970, would be paid over a 3-year period. For purposes of this paragraph the payments received by A after July 31, 1970, are considered amounts received from the sale on August 1, 1969. (See section 483 for rules with respect to interest on deferred payments.)

Example 2. On April 1, 1969, A sold certain capital assets to B on the installment plan and elected to return the gain therefrom under section 453, the agreement providing for payments over a period of 3 years. At the time of the sale these assets had been held by A for more than 6 months. On March 31, 1970, C assumed B's obligation to pay the balance of the installments which were due after that date. For purposes of this paragraph any installment payments received by A after March 31, 1970, from C are considered amounts received from a sale made on or before October 9, 1969.

Example 3. On May 1, 1969, A offers to sell certain capital assets to B if B accepts the offer within 1 year, unless it is previously withdrawn by A. B accepts the offer on November 1, 1969, and the transaction is consummated shortly thereafter. For purposes of this paragraph, any payment received by A pursuant to the sale is not considered an amount received from a sale made on or before October 9, 1969, or from a sale pursuant to a binding contract entered into on or before that date.

(iii) An amount which is considered under section 402(a)(2) or 403(a)(2) as gain of the taxpayer from the sale or exchange of a capital asset held for more than 6 months shall be treated as gain subject to the provisions of section 1201 (d)(1) and subdivision (i) of such subparagraph, but only if on or before October 9, 1969, (*a*) the employee with respect to whom such amount is distributed or paid, died or was otherwise separated from the service, and (*b*) the terms of the plan required, or the employee elected, that total distributions or amounts payable be paid to the taxpayer within 1 taxable year.

(iv) Gain described in section 1201(d) (1) or (2) with respect to a partnership, estate, or trust, which is required to be included in the gross income of a partner in such partnership, or of a beneficiary of such estate or trust, shall be treated as such gain with respect to such partner or beneficiary. Thus, for example, if during 1974 a partnership which uses the calendar year as its taxable year receives amounts which give rise to section 1201(d)(1) gain, a partner who uses the fiscal year ending June 30 as his taxable year shall treat his distributive share of such gain as subsection (d) gain for his taxable year ending June 30, 1975, even though such share is distributed to him after December 31, 1974. See §1.706–1.

(v) An individual shall be considered married for purposes of subdivision (iii) of such subparagraph if for the taxable year he may elect with his spouse to make a joint return under section 6013(a).

(vi) In applying such subparagraph for purposes of section 21(a) (1) long-term capital gains arising from amounts received before January 1, 1970, shall be taken into account if such amounts are received during the taxable year.

(g) *Illustrations.* The application of this section may be illustrated by the following examples in which the assumption is made that section 56 (relating to minimum tax for tax preferences) does not apply:

Example 1. A, a single individual, has for the calendar year 1954 taxable income (exclusive of capital gains and losses) of $99,400. He realizes in 1954 a gain of $50,000 on the sale of a capital asset held for 19 months and sustains a loss of $20,000 on the sale of a capital asset held for 5 months. He had no other capital gains or losses. Since the alternative tax is less than the tax otherwise computed under section 1, the tax payable is the alternative tax, that is $74,298. The tax is computed as follows:

Tax Under Section 1

Taxable income exclusive of capital gains and losses		$99,400
Net long-term capital gain (100 percent of $50,000)	$50,000	
Net short-term capital loss (100 percent of $20,000)	20,000	
Excess of net long-term capital gain over the net short-term capital loss		30,000
		129,400
Deduction of 50 percent of excess of net long-term capital gain over the net short-term capital loss (section 1202)		15,000
Taxable income		114,400
Tax under section 1		80,136
Alternative Tax Under Section 1201(b)		
Taxable income		$114,400
Less 50 percent of excess of net long-term capital gain over net short-term capital loss (section 1201(b)(1))		15,000
Taxable income exclusive of capital gains and losses		99,400
Partial tax (tax on $99,400)		66,798
Plus 25 percent of $30,000		7,500
Alternative tax under section 1201(b)		74,298

Example 2. A husband and wife, who file a joint return for the calendar year 1970, have taxable income (exclusive of capital gains and losses) of $100,000. In 1970 they realize $200,000 of net long-term capital gain in excess of net short-term capital loss, including long-term capital gains of $100,000 arising from sales consummated in 1968 the income from which is returned on the installment method under section 453, and long-term capital gains of $50,000, arising in respect of distributions from X corporation made before October 10, 1970, which were pursuant to a plan of complete liquidation adopted on October 9, 1969. Since the alternative tax under section 1201(b) is less than the tax otherwise computed under section 1, the tax payable for 1970 is the alternative tax, that is, $97,430 plus the tax surcharge under section 51. The tax (without regard to the tax surcharge) is computed as follows:

Tax Under Section 1

Taxable income exclusive of capital gains and losses		$100,000
Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976) (excess of net long-term capital gain over the net short-term capital loss)		200,000
Total		300,000
Deduction of 50 percent of net section 1201 (net capital gain for taxable years beginning after December 31, 1976) gain (section 1202)		100,000
Taxable income		200,000
Tax under section 1		110,980
Alternative Tax Under Section 1201(b)		
(1) Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)		$200,000
(2) Subsection (d) gain:		
Section 1201(d)(1)		100,000
Section 1201(d)(2)		50,000
Total subsection (d) gain		150,000
(3) Net section 1201 (net capital gain for taxable years beginning after December 31, 1976) gain in excess of subsection (d) gain ($200,000 less $150,000)		50,000
(4) Tax under section 1201(b)(1):		
(i) Taxable income	$200,000	
(ii) Less: 50% of item (1)	100,000	
(iii) Amount subject to tax under section 1201(b)(1)	100,000	
Partial tax (computed under section 1) ...		45,180
(5) Tax under section 1201(b)(2): (25% of item (1) or of item (2), whichever is lesser [25% of $150,000])		37,500
(6) Tax under section 1201(b)(3) on item (3):		
Tax under section 1 on taxable income ($200,000)	$110,980	
Less: Tax under section 1 on sum of item (4)(iii)(c) ($100,000) plus 50% of item (2) ($75,000) (Total $175,000)	93,780	
Tax under section 1201(c)(1)	17,200	

Limitation under section.

1201(c)(2)(A) (29½% of item (3))	14,750	14,750
(7) Alternative tax under section 1201(b)		97,430

Example 3. A husband and wife, who file a joint return for the calender year 1971, have taxable income (exclusive of capital gains and losses) of $80,000. In 1971 they realize long-term capital gain of $30,000 arising from a sale consummated on July 1, 1969, the income from which is returned on the installment method under section 453. From securities transactions in 1971 they have long-term capital gains of 60,000 and a short-term capital loss of $10,000. Since the alternative tax under section 1201(b) is less than the tax otherwise computed under section 1, the tax payable is the alternative tax, that is, $55,140. The tax is computed as follows:

Tax Under Section 1		
Taxable income exclusive of capital gains and losses		$80,000
Net long-term capital gains (100% of $90,000)	$90,000	
Net short-term capital loss (100% of $10,000)	10,000	
Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)		80,000
Total		160,000
Deduction of 50% of net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976) (section 1202)		40,000
Taxable income		120,000
Tax under section 1		57,580
Alternative Tax Under Section 1201(b)		
(1) Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)		$80,000
(2) Subsection (d) gain:		
Section 1201(d)(1)		30,000
Section 1201(d)(2)		
Section 1201(d)(3) ($50,000 less $30,000)		20,000
Total subsection (d) gain		50,000
(3) Net section 1201 (net capital gain for taxable years beginning after December 31, 1976) gain in excess of subsection (d) gain ($80,000 less $50,000)		30,000
(4) Tax under section 1201(b)(1):		
(i) Taxable income	$120,000	
(ii) Less: 50% of item (1)	40,000	
(iii) Amount subject to tax under section 1201(b)(1)	80,000	
Partial tax (computed under section 1)		33,340
(5) Tax under section 1201(b)(2): (25% of item (1) or of item (2), whichever is lesser [25% of $50,000])		12,500
(6) Tax under section 1201 (b)(3) on item (3):		
Tax under section 1 on taxable income ($120,000)	$57,580	
Less: Tax under sec. 1 on sum of item (4) (iii) ($80,000) plus 50% of item (2) ($25,000) (Total $105,000)	$48,280	
Tax under section 1201(c)(1)	9,300	
Limitation under section 1201(c) (2)(B) (32½% of item (3))	9,750	$9,300
(7) Alternative tax under section 1201(b)		55,140

Example 4. A husband and wife, who file a joint return for the calendar year 1973, have taxable income (exclusive of capital gains and losses) of $250,000. In 1973 they realize long-term capital gains (not described in section 1201(d) (1) or (2)) of $140,000 and a short-term capital loss of $50,000. Since the alternative tax under section 1201(b) is less than the tax otherwise computed under section 1, the tax payable is the alternative tax, that is, $172,480. The tax is computed as follows:

Tax Under Section 1		
Taxable income exclusive of capital gains and losses		$250,000
Net long-term capital gains (100% of $140,000)	$140,000	
Net short-term capital loss (100% of $50,000)	50,000	
Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)		90,000
Total		340,000
Deduction of 50% of net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976) (section 1202)		45,000
Taxable income		295,000
Tax under section 1		177,480
Alternative Tax Under Section 1201(b)		
(1) Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)		$90,000
(2) Subsection (d) gain:		
Section 1201(d)(1)		....
Section 1201(d)(2)		....
Section 1201(d)(3)		50,000
Total subsection (d) gain		50,000
(3) Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976) in excess of subsection (d) gain ($90,000 less $50,000)		40,000
(4) Tax under section 1201(b)(1):		
(i) Taxable income	$295,000	
(ii) Less: 50% of item (1)	45,000	
(iii) Amount subject to tax under section 1201(b)(1)	250,000	
Partial tax (computed under section 1)		145,980
(5) Tax under section 1201(b)(2): (25% of item (1) or of item (2), whichever is lesser [25% of $50,000])		$12,500
(6) Tax under section 1201(b)(3) on item (3):		
Tax under section 1 on taxable income ($295,000)	$177,480	
Less: Tax under section 1 on sum of item (4) (iii) ($250,000) plus 50% of item (2) ($25,000) (Total $275,000)	163,480	14,000
(7) Alternative tax under section 1201(b)		172,480

[T.D. 7337, 39 FR 44975, Dec. 30, 1974, as amended by T.D. 7728, 45 FR 72651, Nov. 3, 1980]

§ 1.1202–0 Table of contents.

This section lists the major captions that appear in the regulations under § 1.1202–2.

§ 1.1202–2 Qualified small business stock; effect of redemptions.
(a) Redemptions from taxpayer or related person.
(1) In general.
(2) De minimis amount.
(b) Significant redemptions.
(1) In general.
(2) De minimis amount.
(c) Transfers by shareholders in connection with the performance of services not treated as purchases.
(d) Exceptions for termination of services, death, disability or mental incompetency, or divorce.
(1) Termination of services.
(2) Death.
(3) Disability or mental incompetency.
(4) Divorce.
(e) Effective date.

[T.D. 8749, 62 FR 68166, Dec. 31, 1997]

§ 1.1202–1 Deduction for capital gains.

(a) In computing gross income, adjusted gross income, taxable income, capital gain net income (net capital gain for taxable years beginning before January 1, 1977) and net capital loss, 100 percent of any gain or loss (computed under section 1001, recognized under section 1002, and taken into account without regard to subchapter P (section 1201 and following), chapter 1 of the Code) upon the sale or exchange of a capital asset shall be taken into account regardless of the period for which the capital asset has been held. Nevertheless, the net short-term capital gain or loss and the net long-term capital gain or loss must be separately computed. In computing the adjusted gross income or the taxable income of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of the excess is allowable as a deduction from gross income under section 1202.

(b) For the purpose of computing the deduction allowable under section 1202 in the case of an estate or trust, any long-term or short-term capital gains which, under sections 652 and 662, are includible in the gross income of its income beneficiaries as gains derived from the sale or exchange of capital assets must be excluded in determining whether, for the taxable year of the estate or trust, its net long-term capital gain exceeds its net short-term capital loss. To determine the extent to which such gains are includible in the gross income of a beneficiary, see the regulations under sections 652 and 662. For example, during 1954 a trust realized a gain of $1,000 upon the sale of stock held for 10 months. Under the terms of the trust instrument all of such gain must be distributed during the taxable year to A, the sole income beneficiary. Assuming that under section 652 or 662 A must include all of such gain in his gross income, the trust is not entitled to any deduction with respect to such gain under section 1202. Assuming A had no other capital gains or losses for 1954, he would be entitled to a deduction of $500 under section 1202. For purposes of this section, an income beneficiary shall be any beneficiary to whom an amount is required to be distributed, or is paid or credited, which is includible in his gross income.

(c) The provisions of this section may be illustrated by the following example:

Example: A, an individual, had the following transactions in 1954:

Long-term capital gain	$6,000	
Long-term capital loss	4,000	
Net long-term capital gain		$2,000
Short-term capital loss	1,800	
Short-term capital gain	300	
Net short-term capital loss		1,500
Excess of net long-term capital gain over net short-term capital loss		500

Since the net long-term capital gain exceeds the net short-term capital loss by $500, 50 percent of the excess, or $250, is allowable as a deduction under section 1202.

[T.D. 6500, 25 FR 12001, Nov. 26, 1960, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1202–2 Qualified small business stock; effect of redemptions.

(a) *Redemptions from taxpayer or related person*—(1) *In general.* Stock acquired by a taxpayer is not qualified small business stock if, in one or more purchases during the 4-year period beginning on the date 2 years before the issuance of the stock, the issuing corporation purchases (directly or indirectly) more than a de minimis amount of its stock from the taxpayer or from a person related (within the meaning of section 267(b) or 707(b)) to the taxpayer.

(2) *De minimis amount.* For purposes of this paragraph (a), stock acquired from the taxpayer or a related person exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of the stock held by the taxpayer and related persons is acquired. The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

(b) *Significant redemptions*—(1) *In general.* Stock is not qualified small business stock if, in one or more purchases during the 2-year period beginning on the date 1 year before the issuance of the stock, the issuing corporation purchases more than a de minimis amount of its stock and the purchased stock has an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of the issuing corporation's stock as of the beginning of such 2-year period.

(2) *De minimis amount.* For purposes of this paragraph (b), stock exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of all outstanding stock is purchased. The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of the stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

(c) *Transfers by shareholders in connection with the performance of services not treated as purchases.* A transfer of stock by a shareholder to an employee or independent contractor (or to a beneficiary of an employee or independent contractor) is not treated as a purchase of the stock by the issuing corporation for purposes of this section even if the stock is treated as having first been transferred to the corporation under § 1.83–6(d)(1) (relating to transfers by shareholders to employees or independent contractors).

(d) *Exceptions for termination of services, death, disability or mental incompetency, or divorce.* A stock purchase is disregarded if the stock is acquired in the following circumstances:

(1) *Termination of services*—(i) *Employees and directors.* The stock was acquired by the seller in connection with the performance of services as an employee or director and the stock is purchased from the seller incident to the seller's retirement or other bona fide termination of such services;

(ii) *Independent contractors.* [Reserved]

(2) *Death.* Prior to a decedent's death, the stock (or an option to acquire the stock) was held by the decedent or the decedent's spouse (or by both), by the decedent and joint tenant, or by a trust revocable by the decedent or the decedent's spouse (or by both), and—

(i) The stock is purchased from the decedent's estate, beneficiary (whether by bequest or lifetime gift), heir, surviving joint tenant, or surviving spouse, or from a trust established by the decedent or decedent's spouse; and

(ii) The stock is purchased within 3 years and 9 months from the date of the decedent's death;

(3) *Disability or mental incompetency.* The stock is purchased incident to the disability or mental incompetency of the selling shareholder; or

(4) *Divorce.* The stock is purchased incident to the divorce (within the meaning of section 1041(c)) of the selling shareholder.

(e) *Effective date.* This section applies to stock issued after August 10, 1993.

[T.D. 8749, 62 FR 68166, Dec. 31, 1997]

TREATMENT OF CAPITAL LOSSES

§1.1211–1 Limitation on capital losses.

(a) *Corporations*—(1) *General rule.* In the case of a corporation, there shall be allowed as a deduction an amount equal to the sum of:

(i) Losses sustained during the taxable year from sales or exchanges of capital assets, plus

(ii) The aggregate of all losses sustained in other taxable years which are treated as a short-term capital loss in such taxable year pursuant to section 1212(a)(1),

but only to the extent of gains from such sales or exchanges of capital assets in such taxable year.

(2) *Banks.* See section 582(c) for modification of the limitation under section 1211(a) in the case of a bank, as defined in section 581.

(b) *Taxpayers other than corporations*—(1) *General rule.* In the case of a taxpayer other than a corporation, there shall be allowed as a deduction an amount equal to the sum of:

(i) Losses sustained during the taxable year from sales or exchanges of capital assets, plus

(ii) The aggregate of all losses sustained in other taxable years which are treated either as a short-term capital loss or as a long-term capital loss in such taxable year pursuant to section 1212(b), but only to the extent of gains from sales or exchanges of capital assets in such taxable year, plus (if such losses exceed such gains) the additional allowance or transitional additional allowance deductible under section 1211(b) from ordinary income for such taxable year. The additional allowance deductible under section 1211(b) shall be determined by application of subparagraph (2) of this paragraph, and the transitional additional allowance by application of subparagraph (3) of this paragraph.

(2) *Additional allowance.* Except as otherwise provided by subparagraph (3) of this paragraph, the additional allowance deductible under section 1211(b) for taxable years beginning after December 31, 1969, shall be the least of:

(i) The taxable income for the taxable year reduced, but not below zero, by the zero bracket amount (in the case of taxable years beginning before January 1, 1977, the taxable income for the taxable year);

(ii) $3,000 ($2,000 for taxable years beginning in 1977; $1,000 for taxable years beginning before January 1, 1977); or

(iii) The sum of the excess of the net short-term capital loss over the net long-term capital gain, plus one-half of the excess of the net long-term capital loss over the net short-term capital gain.

(3) *Transitional additional allowance*—(i) *In general.* If, pursuant to the provisions of §1.1212–1(b) and subdivision (iii) of this subparagraph, there is carried to the taxable year from a taxable year beginning before January 1, 1970, a long-term capital loss, and if for the taxable year there is an excess of net long-term capital loss over net short-term capital gain, then, in lieu of the additional allowance provided by subparagraph (2) of this paragraph, the transitional additional allowance deductible under section 1211(b) shall be the least of:

(*a*) The taxable income for the taxable year reduced, but not below zero, by the zero bracket amount (in the case of taxable years beginning before January 1, 1977, the taxable income for the taxable year);

(*b*) $3,000 ($2,000 for taxable years beginning in 1977; $1,000 for taxable years beginning before January 1, 1977); or

(*c*) The sum of the excess of the net short-term capital loss over the net long-term capital gain; that portion of the excess of the net long-term capital loss over the net short-term capital gain computed as provided in subdivision (ii) of this subparagraph; plus one-half of the remaining portion of the excess of the net long-term capital loss over the net short-term capital gain.

(ii) *Computation of specially treated portion of excess long-term capital loss over net short-term capital gain.* In determining the transitional additional allowance deductible as provided by this subparagraph, there shall be applied thereto in full on a dollar-for-dollar basis the excess of net long-term capital loss over net short-term capital gain (computed with regard to capital losses carried to the taxable year) to the extent that the long-term capital losses carried to the taxable year from taxable years beginning before January

1, 1970, as provided by § 1.1212–1(b) and subdivision (iii) of this subparagraph, exceed the sum of (*a*) the portion of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) actually realized in the taxable year (i.e., computed without regard to capital losses carried to the taxable year) which consists of net long-term capital gain actually realized in the taxable year, plus (*b*) the amount by which the portion of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) actually realized in the taxable year (i.e., computed without regard to capital losses carried to the taxable year) which consists of net short-term capital gain actually realized in the taxable year exceeds the total of short-term capital losses carried to the taxable year from taxable years beginning before January 1, 1970, as provided by § 1.1212–1(b) and subdivision (iv) of this subparagraph.

The amount by which the net long-term capital losses carried to the taxable year from taxable years beginning before January 1, 1970, exceeds the sum of (*a*) plus (*b*) shall constitute the *transitional net long-term capital loss component* for the taxable year for the purpose of this subparagraph.

(iii) *Carryover of certain long-term capital losses not utilized in computation of transitional additional allowance.* If for a taxable year beginning after December 31, 1969, the transitional net long-term capital loss component determined as provided in subdivision (ii) of this subparagraph exceeds the amount of such component applied to the transitional additional allowance for the taxable year as provided by subdivision (i) of this subparagraph and subparagraph (4)(ii) of this paragraph, then such excess shall for the purposes of this subparagraph be carried to the succeeding taxable year as long-term capital losses from taxable years beginning before January 1, 1970, for utilization in the computation of the transitional additional allowance in the succeeding taxable year as provided in subdivisions (i) and (ii) of this subparagraph. In no event, however, shall the amount of such component carried to the following taxable year as otherwise provided by this subdivision exceed the total of net long-term capital losses actually carried to such succeeding taxable year pursuant to section 1212(b) and § 1.1212–1(b).

(iv) *Carryover of certain short-term capital losses not utilized in computation of additional allowance or transitional additional allowance.* If for a taxable year beginning after December 31, 1969, the total short-term capital losses carried to such year from taxable years beginning before January 1, 1970, as provided by § 1.1212–1(b) and this subdivision exceed the sum of:

(*a*) The portion of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) actually realized in the taxable year (i.e., computed without regard to capital losses carried to the taxable year) which consists of net short-term capital gain actually realized in the taxable year, plus

(*b*) The amount by which the portion of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) actually realized in the taxable year (i.e., computed without regard to capital losses carried to the taxable year) which consists of net long-term capital gain actually realized in the taxable year exceeds the total long-term capital losses carried to the taxable year from taxable years beginning before January 1, 1970, as provided in § 1.1212–1(b) and subdivision (iii) of this subparagraph,

then such excess shall constitute the *transitional net short-term capital loss component* for the taxable year, and to the extent such component also exceeds the net short-term capital loss applied to the additional allowance (as provided in subparagraphs (2) and (4)(i) of this paragraph) or the transitional additional allowance (as provided by subdivision (i) of this subparagraph and subparagraph (4)(i) of this paragraph) for the taxable year shall be carried to the succeeding taxable year as short-term capital losses from taxable years beginning before January 1, 1970, for utilization in such succeeding taxable year in the computation of the additional allowance (as provided by subparagraph (2) of this paragraph) or the transitional additional allowance (as provided by subdivision (i) and (ii) of this subparagraph). In no event, however, shall the amount of such component so carried to the following taxable year as otherwise provided by this subdivision exceed the total of net short-term capital losses actually carried to such succeeding taxable year pursuant to section 1212(b) and §1.1212–1(b).

(v) *Scope of rules.* The rules provided by this subparagraph are for the purpose of computing the amount of the transitional additional allowance deductible for the taxable year pursuant to the provisions of section 1212(b)(3) and this subparagraph. More specifically, their operation permits the limited use of a long-term capital loss carried to the taxable year from a taxable year beginning before December 31, 1969, in full on a dollar-for-dollar basis in computing the transitional additional allowance deductible for the taxable year. These rules have no application to, or effect upon, a determination of the character or amount of capital gain net income (net capital gain for taxable years beginning before January 1, 1977) reportable in the taxable year. See paragraph (b)(1) of this section and §1.1212–1 for the determination of the amount and character of capital gains and losses reportable in the taxable year. Further, except to the extent that their application may affect the amount of the transitional additional allowance deductible for the taxable year and thus the amount to be treated as short-term capital loss for carryover purposes under section 1212(b) and §1.1212–1(b)(2), these rules have no effect upon a determination of the character or amount of capital losses carried to or from the taxable year pursuant to section 1212(b) and §1.1212–1(b).

(4) *Order of application of capital losses to additional allowance or transitional additional allowance.* In applying the excess of the net short-term capital loss over the net long-term capital gain and the excess of the net long-term capital loss over the net short-term capital gain to the additional allowance or transitional additional allowance deductible under section 1211(b) and this paragraph, such excesses shall, subject to the limitations of subparagraph (2) or (3) of this paragraph, be used in the following order:

(i) First, there shall be applied to the additional allowance or transitional additional allowance the excess, if any, of the net short-term capital loss over the net long-term capital gain.

(ii) Second, if such transitional additional allowance exceeds the amount so applied thereto as provided in subdivision (i) of this subparagraph, there shall next be applied thereto as provided in subparagraph (3) of this paragraph the excess, if any, of the net long-term capital loss over the net short-term capital gain to the extent of the transitional net long-term capital loss component for the taxable year computed as provided by subdivision (ii) of subparagraph (3) of this paragraph.

(iii) Third, if such additional allowance or transitional additional allowance exceeds the sum of the amounts so applied thereto as provided in subdivisions (i) and (ii) of this subparagraph, there shall be applied thereto one-half of the balance, if any, of the excess net long-term capital loss not applied pursuant to the provisions of subdivision (ii) of this subparagraph.

(5) *Taxable years beginning prior to January 1, 1970.* For any taxable year beginning prior to January 1, 1970, subparagraphs (2) and (3) of this paragraph shall not apply and losses from sales or exchanges of capital assets shall be allowed as a deduction only to the extent of gains from such sales or exchanges, plus (if such losses exceed such gains) the taxable income of the taxpayer or $1,000, whichever is smaller.

(6) *Special rules.* (i) For purposes of section 1211(b) and this paragraph, taxable income is to be computed without regard to gains or losses from sales or exchanges of capital assets and without regard to the deductions provided in section 151 (relating to personal exemptions) or any deduction in lieu thereof. For example, the deductions available to estates and trusts under section 642(b) are in lieu of the deductions allowed under section 151, and, in the case of estates and trusts, are to be added back to taxable income for the purposes of section 1211(b) and this paragraph.

(ii) For taxable years beginning before January 1, 1976, in case the tax is computed under section 3 and the regulations thereunder (relating to optional tax tables for individuals), the term *taxable income* as used in section 1211(b) and this paragraph shall be read as *adjusted gross income.*

(iii) In the case of a joint return, the limitation under section 1211(b) and this paragraph, relating to the allowance of losses from sales or exchanges of capital assets, is to be computed and the net capital loss determined with respect to the combined taxable income and the combined capital gains and losses of the spouses.

(7) *Married taxpayers filing separate returns*—(i) *In general.* In the case of a husband or a wife who files a separate return for a taxable year beginning after December 31, 1969, the $3,000, $2,000, and $1,000 amounts specified in subparagraphs (2)(ii) and (3)(i)(*b*) of this paragraph shall instead be $1,500, $1,000, and $500, respectively.

(ii) *Special rule.* If, pursuant to the provisions of § 1.1212–1(b) and subparagraph (3) (iii) or (iv) of this paragraph, there is carried to the taxable year from a taxable year beginning before January 1, 1970, a short-term capital loss or a long-term capital loss, the $1,500, $1,000 and $500 amounts specified in subdivision (i) of this subparagraph shall instead be maximum amounts of $3,000, $2,000, and $1,000 respectively, equal to $1,500, $1,000, and $500, respectively, plus the total of the transitional net long-term capital loss component for the taxable year computed as provided by subparagraph (3)(ii) of this paragraph and the transitional net short-term capital loss component for the taxable year computed as provided by subparagraph (3)(iv) of this paragraph.

(8) *Examples.* The provisions of section 1211(b) may be illustrated by the following examples:

Example 1. A, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1970:

Taxable income exclusive of capital gains and losses		$4,400
Deduction provided by section 151		625
Taxable income for purposes of section 1211(b)		5,025
Long-term capital gain	$1,200	
Long-term capital loss	(5,300)	
Net long-term capital loss	(4,100)	
Losses to the extent of gains	(1,200)	
Additional allowance deductible under section 1211(b)		1,000

The net long-term capital loss of $4,100 is deductible in 1970 only to the extent of an additional allowance of $1,000 which is smaller than the taxable income of $5,025. Under section 1211(b) and subparagraph (2) of this paragraph, $2,000 of excess net long-term capital loss was required to produce the $1,000 additional allowance. Therefore, a net long-term capital loss of $2,100 ($4,100 minus $2,000) is carried over under section 1212(b) to the succeeding taxable year. If A had the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions in 1977, the additional allowance would be $2,000, and a net long-term capital loss of $100 would be carried over. For a taxable year beginning in 1978 or thereafter, these facts would give rise to a $2,050 additional allowance and no carryover.

Example 2. B, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1970:

Taxable income exclusive of capital gains and losses	$90	
Deduction provided by section 151	625	
Taxable income for purposes of section 1211(b)	715	
Long-term capital gain	$1,200	
Long-term capital loss	(5,200)	
Net long-term capital loss	(4,000)	
Losses to the extent of gains	(1,200)	
Additional allowance deductible under section 1211(b)		715

The net long-term capital loss of $4,000 is deductible in 1970 only to the extent of an additional allowance of $715, since the $715 of taxable income for purposes of section 1211(b) is smaller than $1,000. Under section 1211(b) and subparagraph (2) of this paragraph, $1,430 of net long-term capital loss was required to produce the $715 additional allowance. Therefore, a net long-term capital loss of $2,570 ($4,000 minus $1,430) is carried over under section 1212(b) to the succeeding taxable year. For illustration of the result if the net capital loss for the taxable year is smaller than both $1,000 and taxable income for the purposes of section 1211(b), see examples (3) and (4) of this subparagraph. For carryover of a net capital loss, see § 1.1212–1. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transations for taxable years beginning in 1977 or thereafter, the same result would be reached.

Example 3. A, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1971:

Taxable income exclusive of capital gains and losses	$13,300	
Deduction provided by section 151	675	
Taxable income for purposes of section 1211(b)	13,975	
Long-term capital gain	$400	
Long-term capital loss	($600)	
Net long-term capital loss	(200)	
Short-term capital gain	900	
Short-term capital loss	(1,400)	
Net short-term capital loss	(500)	
Losses to extent of gains	(1,300)	
Additional allowance deductible under section 1211(b)		$600

The $600 additional allowance deductible under section 1211(b) is the least of: (i) Taxable income of $13,975, (ii) $1,000, or (iii) the sum of the excess of the net short-term capital loss of $500 over the net long-term capital gain, plus one-half of the excess of the net long-term capital loss of $200 over the net short-term capital gain. The $600 additional allowance, therefore, consists of the net short-term capital loss of $500, plus $100 (one-half of the net long-term capital loss of $200), the total of which is smaller than both $1,000 and taxable income for purposes of section 1211(b). No amount of net capital loss remains to be carried over under section 1212(b) to the succeeding taxable year since the entire amount of the net short-term capital loss of $500 plus the entire amount of the net long-term capital loss of $200 required to produce $100 of the deduction was absorbed by the additional allowance deductible under section 1211(b) for 1971. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for taxable years beginning in 1977 or thereafter, the result would remain unchanged.

Example 4. A, a married individual filing a separate return with one exemption allowable as a deduction under section 151, has the following transactions in 1971:

Taxable income exclusive of capital gains and losses	$12,000	
Deduction provided by section 151	675	
Taxable income for purposes of section 1211(b)	12,675	
Long-term capital loss	($800)	
Long-term capital gain	300	
Net long-term capital loss	(500)	
Short-term capital loss	(500)	
Short-term capital gain	600	
Net short-term capital gain	100	
Losses to the extent of gains		(900)
Additional allowance deductible under section 1211(b)		200

The excess net long-term capital loss of $400 (net long-term capital loss of $500 minus net short-term capital gain of $100) is deductible in 1971 only to the extent of an additional allowance of $200 (one-half of $400) which is smaller than both $500 (married taxpayer filing a separate return for a taxable year beginning after December 31, 1969) and taxable income for purposes of section 1211(b). Since there is no net short-term capital loss in excess of net long-term capital gains for the taxable year, the $200 additional allowance deductible under section 1211(b) consists entirely of excess net long-term capital loss. No amount of net capital loss remains to be carried over under section 1212(b) to the succeeding taxable year. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for taxable years beginning in 1977 or thereafter, the result would remain unchanged.

Example 5. A, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1970:

Taxable income exclusive of capital gains and losses	$13,300
Deduction provided by section 151	625
Taxable income for purposes of section 1211(b)	13,925
Long-term capital loss	($6,000)
Long-term capital gain	2,000
Net long-term capital loss	(4,000)
Short-term capital gain	3,000
Short-term capital loss carried to 1970 from 1969 under section 1212(b)(1)	(3,000)
Net short-term capital loss	0
Losses to the extent of gains	(5,000)
Additional allowance deductible under section 1211(b)	1,000

The $1,000 additional allowance deductible under section 1211(b) is the least of (i) taxable income of $13,925, (ii) $1,000, or (iii) the sum of the net short-term capital loss ($0) plus one-half of the net long-term capital loss of $4,000. The $1,000 additional allowance, therefore, consists of net long-term capital loss. Since $2,000 of the net long-term capital loss of $4,000 was required to produce the $1,000 additional allowance, the $2,000 balance of the net long-term capital loss is carried over under section 1212(b) to 1971. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for taxable years beginning in 1977 or thereafter, the additional allowance would be $2,000, and there would be no carryover.

Example 6. A, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1970:

Taxable income exclusive of capital gains and losses		$13,300
Deduction provided by section 151		625
Taxable income for purposes of section 1211(b)		13,925
Long-term capital gain	$5,000	
Long-term capital loss	(7,000)	
Long-term capital loss carried to 1970 from 1969 under section 1212 (b)(1)	(500)	
Net long-term capital Loss	(2,500)	
Short-term capital gain	1,100	
Short-term capital loss	(1,400)	
Net short-term capital loss	(300)	
Losses to extent of gains	(6,100)	
Transitional additional allowance deductible under section 1211(b)	1,000	

Because a component of the net long-term capital loss for 1970 is a $500 long-term capital loss carried to 1970 from 1969, the transitional additional allowance deductible under section 1211(b) and subparagraph (3) of this paragraph is the least of (i) taxable income of $13,925, (ii) $1,000 or (iii) the sum of the net short-term capital loss of $300, plus the net long-term capital loss for 1970, to the extent of the $500 long-term capital loss carried to 1970 from 1969 and one-half of the $2,000 balance of the net long-term capital loss. The entire $500 long-term capital loss carried to 1970 from 1969 is applicable in full to the transitional additional allowance because there was no net capital gain (capital gain net income for taxable years beginning after December 31, 1976) actually realized in 1970. The $1,000 transitional additional allowance, therefore, consists of the net short-term capital loss of $300, the $500 long-term capital loss carried to 1970 from 1969, plus one-half of enough of the balance of the 1970 net long-term capital loss ($400) to make up the $200 balance of the $1,000 transitional additional allowance. A long-term capital loss of $1,600 ($2,500 minus $900), all of which is attributable to 1970, is carried over under section 1212(b) to 1971. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for taxable years beginning in 1977 or thereafter, the transitional additional allowance would be $1,800. No amount would remain to be carried over to the succeeding taxable year.

Example 7. A, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1970:

Taxable income exclusive of capital gains and losses		$13,300
Deduction provided by section 151		625
Taxable income for purposes of section 1211(b)		13,925
Long-term capital loss	($2,000)	
Long-term capital loss carried to 1970 from 1969 under section 1212 (b)(1)	(500)	
Net long-term capital loss	(2,500)	
Short-term capital gain	2,600	
Short-term capital loss carried to 1970 from 1969 under section 1212 (b)(1)	(3,000)	
Net short-term capital loss	(400)	
Losses to the extent of gains	(2,600)	
Transitional additional allowance deductible under section 1211(b)	1,000	

Because a component of the net long-term capital loss for 1970 is a $500 long-term capital loss carried to 1970 from 1969, the transitional additional allowance deductible under section 1211(b) and subparagraph (3) of this paragraph is the least of (i) taxable income of $13,925, (ii) $1,000, or (iii) the sum of the net short-term capital loss of $400, plus the net long-term capital loss for 1970 to the extent of the $500 long-term capital loss carried to 1970 from 1969, and one-half of the $2,000 balance of the net long-term capital loss. The entire $500 long-term capital loss carried to 1970 from 1969 is applicable in full to the transitional additional allowance because the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for the taxable year (computed without regard to capital losses carried to the taxable year) consisted entirely of net short-term capital gain not in excess of the short-term capital loss carried to 1970 from 1969. The $1,000 transitional additional allowance, therefore, consists of the net short-term capital loss of $400, the $500 long-term capital loss carried to 1970 from 1969, plus one-half of enough of the balance of the 1970 net long-term capital loss ($200) to make up the $100 balance of the $1,000 transitional additional allowance. A long-term capital loss of $1,800 ($2,500 minus $700), all of which is attributable to 1970, is carried over under section 1212(b) to 1971. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for taxable years beginning in 1977 or thereafter, the transitional additional allowance would be $1,900. No amount would remain to be carried over to the succeeding taxable year.

Example 8. Assume the facts in Example (7) but assume that the individual with one exemption allowable as a deduction under section 151 is married and files a separate return for 1970. The maximum transitional additional allowance to which the individual would be entitled for 1970 pursuant to subparagraph (7)(ii) of this paragraph would be the sum of $500 plus (i) $2,400 of the short-term capital loss of $3,000 carried to 1970 from 1969 (the amount by which such carryover exceeds the $600 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) actually realized in 1970, all of which is net short-term capital gain) and (ii) the $500 long-term capital loss carried to 1970 from 1969. However, since this sum ($3,400) exceeds $1,000, the maximum transitional additional allowance to which the individual is entitled for 1970 is limited to $1,000. If for 1971, the same married individual had taxable income of $13,925 for purposes of section 1211(b) and no capital transactions, and filed a separate return, the additional allowance deductible under section 1211(b) for 1971 would be limited to $500 by reason of subdivision (i) of subparagraph (7) of this paragraph, since, as illustrated in Example 7, no part of the capital loss carried over to 1971 under section 1212 (b) is attributable to 1969. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions as in example (7) for a married individual filing a separate return for a taxable year beginning in 1977 or thereafter, the transitional additional allowance would be $1,900. No amount would remain to be carried over to the succeeding taxable year.

Example 9. B, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1971:

Taxable income exclusive of capital gains and losses		$10,000
Deductions provided by section 151		675
Taxable income for purposes of section 1211(b)		10,675
Long-term capital gain	$2,500	
Long-term capital loss treated under §1.1211–1 (b)(3)(iii) as carried over from 1969	(5,000)	
Net long-term capital loss	(2,500)	
Short-term capital gain	2,700	
Short-term capital loss carried to 1971 from 1970 under section 1212 (b)(1)	(1,000)	
Short-term capital loss treated under §1.1211–1 (b)(3)(iv) as carried over from 1969	($2,000)	
Net short-term capital loss	(300)	
Losses to extent of gain	(5,200)	
Transitional additional allowance deductible under section 1211(b)	1,000	

Because a component of the net long-term capital loss for 1971 is a long-term capital loss treated under subparagraph (3)(iii) of this paragraph as carried over from 1969, the rules for computation of the transitional additional allowance under subparagraph (3) (i) and (ii) of this paragraph apply. The *transitional net long-term capital loss component* for 1971 under subparagraph (3)(ii) of this paragraph is $1,800, that is, the amount by which the $5,000 long-term loss treated as carried over from 1969 to 1971 exceeds (a) the net long-term capital gain of $2,500 actually realized in 1971 plus (b) the $700 excess of the $2,700 net short-term capital gain actually realized in 1971 over the $2,000 short-term capital loss treated as carried over to 1971 from 1969. The transitional additional allowance for 1971 consists of the $300 net short-term capital loss plus $700 of the net long-term capital loss attributable to 1969. A net long-term capital loss of $1,800 ($2,500 minus $700) is carried over to 1972 under section 1212(b). Only $1,100 of the $1,800 will be treated in 1972 as carried over from 1969 since under subparagraph (3)(iii) of this paragraph the *transitional net long-term capital loss component* of $1,800 is reduced by the amount ($700) applied to the transitional additional allowance for 1971. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for a taxable year beginning in 1977, the transitional additional allowance would be $2,000. A net long-term capital loss of $800 would remain to be carried over. Of this amount $100 would be treated as carried over from 1969. Assuming the original facts for a taxable year beginning in 1978, the transitional additional allowance would be $2,450. No amount would remain to be carried over to the succeeding taxable year.

[T.D. 7301, 39 FR 964, Jan. 4, 1974; 39 FR 2758, Jan. 24, 1974, as amended by T.D. 7597, 44 FR 12419, Mar. 7, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§1.1212–1 Capital loss carryovers and carrybacks.

(a) *Corporations; other taxpayers for taxable years beginning before January 1, 1964*—(1) *Regular net capital loss sustained for taxable years beginning before January 1, 1970.* (i) A corporation sustaining a net capital loss for any taxable year beginning before January 1, 1970, and a taxpayer other than a corporation sustaining a net capital loss for any taxable year beginning before January 1, 1964, shall carry over such net loss to each of the 5 succeeding taxable years and treat it in each of such 5 succeeding taxable years as a short-term capital loss to the extent not allowed as a deduction against any net capital gains (capital gain net income for taxable years beginning after December 31, 1976) of any taxable years intervening between the taxable year in which the net capital loss was sustained and the taxable year to which carried. The carryover is thus applied in each succeeding taxable year to offset any net capital gain in such succeeding taxable year. The amount of the capital loss carryover may not be included in computing a new net capital loss of a taxable year which can be carried over to the next 5 succeeding taxable years. For purposes of this subparagraph, a net capital gain (capital gain net income for taxable years beginning after December 31, 1976) shall be computed without regard to capital loss carryovers or carrybacks. In the case of nonresident alien individuals, see section 871 for special rules on capital loss carryovers. For the rules applicable to the portion of a net capital loss of a corporation which is attributable to a foreign expropriation capital loss sustained in taxable years beginning after December 31, 1958, see subparagraph (2) of this paragraph. For the rules applicable to a taxpayer other than a corporation in the treatment of that amount of a net capital loss which may be carried over under section 1212 and this subparagraph as a short-term capital loss to the first taxable year beginning after December 31, 1963, see paragraph (b) of this section.

(ii) The practical operation of the provisions of this subparagraph may be illustrated by the following example:

Example: (a) For the taxable years 1952 to 1956, inclusive, an individual with one exemption allowable under section 151 (or corresponding provision of prior law) is assumed to have a net short-term capital loss, net short-term capital gain, net long-term capital loss, net long-term capital gain, and taxable income (net income for 1952 and 1953) as follows:

	1952	1953	1954	1955	1956
Carryover from prior years:					
From 1952		($50,000)	($29,500)	($29,500)	
From 1954				(19,500)	($13,000)
Net short-term loss (computed without regard to the carryovers)	($30,000)	(5,000)	(10,000)		
Net short-term gain (computed without regard to the carryovers)				40,000	
Net long-term loss	(20,500)		(10,000)	(5,000)	
Net long-term gain		25,000			15,000
Net income or taxable income, computed without regard to capital gains and losses, and, after 1953, without regard to the deduction provided by section 151	500	500	500	1,000	500
Net capital gain (capital gain net income for taxable years beginning after December 31, 1976) (computed without regard to the carryovers)		20,500		36,000	
Net capital loss	(50,000)		(19,500)		
Deduction allowable under section 1202					1,000
Taxable income (after deductions allowable under sections 151 and 1202)					900

(b) *Net capital loss of 1952.* The net capital loss is $50,000. This figure is the excess of the losses from sales or exchanges of capital assets over the sum of (1) gains (in this case, none) from sales or exchanges of capital assets, and (2) net income (computed without regard to capital gains and losses) of $500. This amount may be carried forward in full as a short-term loss to 1953. However, in 1953 there was a net capital gain (capital gain net income for taxable years beginning after December 31, 1976) of $20,500, as defined by section 117(a)(10)(B) of the Internal Revenue Code of 1939, and limited by section 117(e)(1) of the 1939 Code, against which this net capital loss of $50,000 is allowed in part. The remaining portion—$29,500—may be carried forward to 1954 and 1955 since there was no net capital gain (capital gain net income for taxable years beginning after December 31, 1976) in 1954. In 1955 this $29,500 is allowed in full against net capital gain of $36,000, as defined by paragraph (d) of § 1.1222–1 and limited by subdivision (i) of this subparagraph.

(c) *Net capital loss of 1954.* The net capital loss is $19,500. This figure is the excess of the losses from sales or exchanges of capital assets over the sum of (1) gains (in this case, none) from sales or exchanges of capital assets and (2) taxable income (computed without regard to capital gains and losses and the deductions provided in section 151) of

$500. This amount may be carried forward in full as a short-term loss to 1955. The net capital gain (capital gain net income for taxable years beginning after December 31, 1976) in 1955, before deduction of any carryovers, is $36,000. (See sections 1222(9)(B) and 1212 of the Internal Revenue Code of 1954, as it existed prior to the enactment of the Revenue Act of 1964.) The $29,500 balance of the 1952 loss is first applied against the $36,000, leaving a balance of $6,500. Against this amount the $19,500 loss arising in 1954 is applied, leaving a loss of $13,000, which may be carried forward to 1956. Since this amount is treated as a short-term capital loss in 1956 under subdivision (i) of this subparagraph, the excess of the net long-term capital gain over the net short-term capital loss is $2,000 ($15,000 minus $13,000). Half of this excess is allowable as a deduction under section 1202. Thus, after also deducting the exemption allowed as a deduction under section 151 ($600), the taxpayer has a taxable income of $900 ($2,500 minus $1,600) for 1956.

(2) *Corporations sustaining foreign expropriation capital losses for taxable years ending after December 31, 1958*—(i) *In general.* A corporation sustaining a net capital loss for any taxable year ending after December 31, 1958, any portion of which is attributable to a foreign expropriation capital loss, shall carry over such portion of the loss to each of the ten succeeding taxable years and treat it in each of such succeeding taxable years as a short-term capital loss to the extent and consistent with the manner provided in subparagraph (1) of this paragraph. For such purposes, the portion of any net capital loss for any taxable year which is attributable to a foreign expropriation capital loss is the amount, not in excess of the net capital loss for such year, of the foreign expropriation capital loss for such year. The portion of a net capital loss for any taxable year which is attributable to a foreign expropriation capital loss shall be treated as a separate net capital loss for that year and shall be applied, after first applying the remaining portion of such net capital loss, to offset any capital gain net income (net capital gain for taxable years beginning before January 1, 1977) in a succeeding taxable year. In applying net capital losses of two or more taxable years to offset the capital gain net income (net capital gain(s) for taxable years beginning before January 1, 1977) of a subsequent taxable year, such net capital losses shall be offset against such capital gain net income (net capital gain(s) for taxable years beginning before January 1, 1977) in the order of the taxable years in which the losses were sustained, beginning with the loss for the earliest preceding taxable year, even though one or more of such net capital losses are attributable in whole or in part to a foreign expropriation capital loss.

(ii) *Foreign expropriation capital loss defined.* For purposes of this subaparagraph the term *foreign expropriation capital loss* means, for any taxable year, the sum of the losses taken into account in computing the net capital loss for such year which are:

(*a*) Losses sustained directly by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing, or

(*b*) Losses (treated under section 165 (g)(1) as losses from the sale or exchange of capital assets) from securities which become worthless by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing.

(iii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example 1. X, a domestic corporation which uses the calendar year as the taxable year, owns as a capital asset 75 percent of the outstanding stock of Y, a foreign corporation operating in a foreign country. In 1961, the foreign country seizes all of the assets of Y, rendering X's stock in Y worthless and thus causing X to sustain a $40,000 foreign expropriation capital loss for such year. In 1961, X has $30,000 of other losses from the sale or exchange of capital assets and $50,000 of gains from the sale or exchange of capital assets. X's net capital loss for 1961 is $20,000 ($70,000 − $50,000). Since the foreign expropriation capital loss exceeds this amount, the entire $20,000 is a foreign expropriation capital loss for 1961.

Example 2. Z, a domestic corporation which uses the calendar year as the taxable year, has a net capital loss of $50,000 for 1961, $30,000 of which is attributable to a foreign expropriation capital loss. Pursuant to the provisions of this paragraph, $30,000 of such net capital loss shall be carried over as a short-term capital loss to each of the 10 taxable years succeeding 1961, and the remaining $20,000 of the net capital loss shall be carried over as a short-term capital loss to each of the 5 taxable years succeeding 1961. Z has a $35,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) (determined without regard to any capital loss carryover) for 1962. In offsetting the $50,000 capital loss carryover from 1961 against the $35,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for 1962, the $30,000 portion of such carryover which is attributable to the foreign expropriation capital loss for 1961 is applied against the 1962 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) after applying the $20,000 remaining portion of the carryover. Thus, there is a capital loss carryover of $15,000 to 1963, all of which is attributable to the foreign expropriation capital loss for 1961. Z has a net capital loss for 1963 of $10,000, no portion of which is attributable to a foreign expropriation capital loss. For 1964, Z has a net capital gain (capital gain net income for taxable years beginning after December 31, 1976) of $22,000 (determined without regard to the capital loss carryovers from 1961 and 1963). In offsetting the capital loss carryovers from 1961 and 1963 against Z's $22,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for 1964, the $15,000 carryover from 1961 is applied against the 1964 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) before the $10,000 capital loss carryover from 1963 is applied against such gain. Thus, $3,000 of the 1963 net capital loss remains to be carried over to 1965.

(3) *Regular net capital loss sustained by a corporation for taxable years beginning after December 31, 1969*—(i) *General rule.* A corporation sustaining a net capital loss for any taxable year beginning after December 31, 1969 (hereinafter in this paragraph referred to as the *loss year*), shall:

(*a*) Carry back such net capital loss to each of the 3 taxable years preceding the loss year, but only to the extent that such net capital loss is not attributable to a foreign expropriation capital loss and the carryback of such net capital loss does not increase or produce a net operating loss (as defined in section 172(c)) for the taxable year to which it is carried back; and

(*b*) Carry over such net capital loss to each of the 5 taxable years succeeding the loss year,

and, subject to subdivision (ii) of this subparagraph, treat such net capital loss in each of such 3 preceding and 5 succeeding taxable years as a short-term capital loss.

(ii) *Amount treated as a short-term capital loss in each year.* The entire amount of the net capital loss for any loss year shall be carried to the earliest of the taxable years to which such net capital loss may be carried, and the portion of such net capital loss which shall be carried to each of the other taxable years to which such net capital loss may be carried shall be the excess, if any, of such net capital loss over the total of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (computed without regard to the capital loss carryback from the loss year or any taxable year thereafter) for each of the prior taxable years to which such net capital loss may be carried.

(iii) *Special rules. (a)* In the case of a net capital loss which is not a foreign expropriation capital loss and which cannot be carried back in full to a preceding taxable year by reason of section 1212(a)(1)(A)(ii) and subdivision (i)(*a*) of this subparagraph because such loss would produce or increase a net operating loss in such preceding taxable year, the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such preceding taxable year shall in no case be treated as greater than the amount of such net capital loss which can be carried back to such preceding taxable year upon the application of section 1212(a)(1)(A)(ii) and subdivision (i)(*a*) of this subparagraph.

(*b*) For the rules applicable to the portion of a net capital loss of a corporation which is attributable to a foreign expropriation capital loss sustained in a taxable year beginning after December 31, 1958, see section 1212(a)(2) and subparagraph (2) of this paragraph.

(*c*) Section 1212(a)(1)(A) and subdivision (*i*)(*a*) of this subparagraph shall not apply to (and no carryback shall be allowed with respect to) the net capital loss of a corporation for any taxable year for which such corporation is an electing small business corporation under subchapter S. See § 1.1372–1.

(*d*) A net capital loss of a corporation for a year for which it is not an electing small business corporation under subchapter S shall not be carried back under section 1212(a)(1)(A) and subdivision (i)(*a*) of this subparagraph to a taxable year for which such corporation is an electing small business corporation. See section 1212(a)(3).

(*e*) A net capital loss of a corporation shall not be carried back under section 1212(a)(1)(A) and subdivision (i)(*a*) of this subparagraph to a taxable year for which the corporation was a foreign personal holding company, a regulated investment company, or a real estate investment trust, or for which an election made by the corporation under section 1247 is applicable. See section 1212(a)(4).

(*f*) A taxable year to which a net capital loss of a corporation cannot, by reason of (*d*) or (*e*) of this subdivision, be carried back under section 1212(a)(1)(A) and subdivision (i)(*a*) of this subparagraph shall nevertheless be treated as 1 of the 3 taxable years preceding the loss year for purposes of section 1212(a)(1)(A) and such subdivision (i)(*a*); but any capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such taxable year to which such net capital loss cannot be carried back shall be disregarded for purposes of subdivision (ii) of this subparagraph.

(*g*) A regulated investment company (as defined in section 851) sustaining a net capital loss shall carry over that loss to each of the 8 taxable years succeeding the loss year. However, the 8-year period prescribed in the preceding sentence shall be reduced (but not to less than 5 years) by the sum of (*1*) the number of taxable years to which the net capital loss must be carried back pursuant to subdivision (i)(*a*) of this subparagraph (as limited by subdivision (iii)(*e*) of this subparagraph) and (*2*) the number of taxable years, of the 8 taxable year succeeding the loss year, that the corporation failed to qualify as a regulated investment company as defined in section 851. This subdivision shall not extend the carryover period prescribed in subdivision (i)(*b*) of this subparagraph to a year in which a corporation is not a regulated investment company as defined in section 851.

(iv) The application of this subparagraph may be illustrated by the following examples, in each of which it is assumed that the corporation is not, and never has been, a corporation described in subdivision (iii) (*c*) or (*d*) of this subparagraph, that the corporation files its tax returns on a calendar year basis, and that no capital loss sustained is a foreign expropriation capital loss:

Example 1. A corporation has a net capital loss for 1970 which section 1212(a)(1)(A) permits to be carried back. The entire net capital loss for 1970 may be carried back to 1967, but only to the extent that a net operating loss for 1967 would not be produced or increased. The amount of the carryback to 1968 is the excess of the net capital loss for 1970 over the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for 1967, computed without regard to a capital loss carryback from 1970 or any taxable year thereafter. The amount of the carryback to 1969 is the excess of the net capital loss for 1970 over the sum of the net capital gains (capital gain net income for taxable years beginning after December 31, 1976) for 1967 and 1968, computed without regard to a capital loss carryback from 1970 or any taxable year thereafter. The amount of the carryover to 1971 is the excess of the net capital loss for 1970 over the sum of the net capital gains (capital gain net income for taxable years beginning after December 31, 1976) for 1967, 1968, and 1969, computed without regard to a capital loss carryback from 1970 or any taxable year thereafter. Similarly, the amount of the carryover to 1972, 1973, 1974, and 1975, respectively, is the excess of the net capital loss for 1970 over the sum of the net capital gains (capital gain net income for taxable years beginning after December 31, 1976) for taxable years prior to 1972, 1973, 1974, or 1975, as the case may be, to which the net capital loss for 1970 may be carried, computed without regard to a capital loss carryback from 1970 or any year thereafter.

Example 2. For the taxable years 1967 to 1975, inclusive, a corporation is assumed to have net capital loss, net capital gain (capital gain net income for taxable years beginning after December 31, 1976), and taxable income (computed without regard to capital gains and losses) as follows:

	1967	1968	1969	1970	1971	1972	1973	1974	1975
Taxable income (computed without regard to capital gains or losses)	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000
Net capital loss			(1,000)	(29,500)	(16,000)	(500)			
Net capital gain (capital gain net income for taxable years beginning after December 31, 1976) (computed without regard to carrybacks or carryovers)	14,000	16,000					8,000	7,500	6,500
Carryback or carryover:									
From 1969							(1,000)		
From 1970	(14,000)	(15,500)							
From 1971		(500)					(7,000)	(7,500)	(1,000)
From 1972									(500)

The net capital loss of 1969, under the rules of subparagraph (1) of this paragraph, may not be carried back. Thus, the net capital loss for 1970 is carried back and partially absorbed by the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for 1967, and a portion of the net capital losses of both 1970 and 1971 are carried back to 1968. The net capital loss for 1969 is the oldest that may be carried to 1973, and thus, it is the first carried over and absorbed by the net capital gain for 1973. The net capital loss for 1972 (which is not carried back because of the net capital losses in the 3 years preceding 1972) may be carried over to 1973.

Example 3. For the taxable years 1967 to 1970, inclusive, a corporation which was organized on January 1, 1967, realized operating income and net capital gains (capital gain net income for taxable years beginning after December 31, 1976) and sustained operating losses and net capital losses as follows:

	Operating income or loss (exclusive of capital gain or loss)	Capital gain or loss
1967	$20,000	$24,000
1968	20,000	0
1969	20,000	0
1970	(25,000)	(20,000)

The net capital loss of $20,000 for 1970 is carried back to 1967 and applied against the $24,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) realized in that year, reducing such net capital gain (capital gain net income for taxable years beginning after December 31, 1976) to $4,000. The net operating loss of $25,000 for 1970 is then carried back to 1967 and applied first to eliminate the $20,000 of operating income for that year and then to eliminate the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for that year of $4,000 (as reduced by the 1970 capital loss carryback).

Example 4. Assume the same facts as in Example 3 but substitute the following figures:

	Operating income or loss (exclusive of capital gain or loss)	Capital gain or loss
1967	($20,000)	$24,000
1968	20,000	0
1969	20,000	0
1970	(25,000)	(20,000)

The net capital loss of $20,000 for 1970 is carried back to 1967 and applied against the $24,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) realized in that year only to the extent of $4,000, the maximum amount to which the 1970 capital loss carryback can be applied without producing a net operating loss for 1967. The unused $16,000 balance of the 1970 net long-term capital loss can be carried forward to 1971 and subsequent taxable years to the extent provided in subdivision (i)(*b*) of this subparagraph.

Example 5. Assume the same facts as in Example 3 but substitute the following figures:

	Operating income or loss (exclusive of capital gain or loss)	Capital gain or loss
1967	0	0
1968	($20,000)	0
1969	0	$24,000
1970	20,000	(24,000)

The net capital loss of $24,000 for 1970 is carried back to 1969 and applied against the $24,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) realized in that year to the extent of $24,000. The application of the capital loss carryback is not limited as it was in Example 4 because such carryback neither increases nor produces a net operating loss, as such, for 1969. The $20,000 net operating loss for 1968 is then carried forward to 1970 to eliminate the $20,000 of operating income for that year.

Example 6. Assume the same facts as in Example 3 but substitute the following figures:

	Operating income or loss (exclusive of capital gain or loss)	Capital gain or loss
1967	0	0
1968	0	0
1969	($20,000)	($24,000)
1970	20,000	20,000

The net capital loss of $24,000 for 1969 is carried forward to 1970 and applied against the $20,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) realized in that year. The unused $4,000 balance of the 1969 net capital loss can be carried forward to 1971 and subsequent taxable years to the extent provided in subdivision (i)(*b*) of this subparagraph.

(b) *Taxpayers other than corporations for taxable years beginning after December 31, 1963*—(1) *In general.* If a taxpayer other than a corporation sustains a net capital loss for any taxable year beginning after December 31, 1963, the portion thereof which is a short-term capital loss carryover shall be carried over to the succeeding taxable year and treated as a short-term capital loss sustained in such succeeding taxable year, and the portion thereof which constitutes a long-term capital loss carryover shall be carried over to the succeeding taxable year and treated as a long-term capital loss sustained in such succeeding taxable year. The carryovers are included in the succeeding taxable year in the determination of the amount of the short-term capital loss, the net short-term capital gain or loss, the long-term capital loss, and the net long-term capital gain or loss in such year, the net capital loss in such year, and the capital loss carryovers from such year. For purposes of this subparagraph:

(i) A short-term capital loss carryover is the excess of the net short-term capital loss for the taxable year over the net long-term capital gain for such year, and

(ii) A long-term capital loss carryover is the excess of the net long-term capital loss for the taxable year over the net short-term capital gain for such year.

(2) *Special rules for determining a net short-term capital gain or loss for purposes of carryover*—(i) *Taxable years beginning after December 31, 1963, and before January 1, 1970.* In determining a net short-term capital gain or loss of a taxable year beginning after December 31, 1963, and before January 1, 1970, for purposes of computing a short-term or long-term capital loss carryover to the succeeding taxable year, an amount equal to the additional allowance deductible under section 1211(b) for the taxable year (determined as provided in section 1211(b), as in effect for taxable years beginning before January 1, 1970, and §1.1211–1(b)(5)) is treated as a short-term capital gain occurring in such year.

(ii) *Taxable years beginning after December 31, 1969.* In determining a net short-term capital gain or loss of a taxable year beginning after December 31, 1969:

(*a*) For purposes of computing a short-term capital loss carryover to the succeeding taxable year, an amount equal to the additional allowance for the taxable year (determined as provided in section 1211(b) and §1.1211–1(b)(2)) is treated as a short-term capital gain occurring in such year, and

(*b*) For purposes of computing a long-term capital loss carryover to the succeeding taxable year, an amount equal to the sum of the additional allowance for the taxable year (determined as provided in section 1211(b) and §1.1211–1(b)(2)), plus the excess of such additional allowance over the net short-term capital loss (determined without regard to section 1212(b)(2) for such year) is treated as a short-term capital gain in such year.

The rules provided in this subdivision are for the purpose of taking into account the additional allowance deductible for the current taxable year under section 1211(b) and §1.1211–1(b)(2) in determining the amount and character of capital loss carryovers from the current taxable year to the succeeding taxable year. Their practical application to a determination of the amount and character of capital loss carryovers from the current taxable year to the succeeding taxable year involves identification of the net long-term and net short-term capital loss components of the additional allowance deductible in the current taxable year as provided by § 1.1211–1(b)(2)(iii). To the extent that the additional allowance is composed of net short-term capital losses, such losses are treated as a short-term capital gain in the current taxable year in determining the capital loss carryovers to the succeeding year. To the extent that the additional allowance is composed of net long-term capital losses applied pursuant to the provisions of § 1.1211–1(b)(2)(iii), an amount equal to twice the amount of such component of the additional allowance is treated as a short-term capital gain in the current taxable year. See paragraph (4) of this section for transitional rules if any part of the additional allowance is composed of net long-term capital losses carried to the current taxable year from a taxable year beginning before January 1, 1970.

(3) *Transitional rule for net capital losses sustained in a taxable year beginning before January 1, 1964.* A taxpayer other than a corporation sustaining a net capital loss for any taxable year beginning before January 1, 1964, shall treat as a short-term capital loss in the first taxable year beginning after December 31, 1963, any amount which would be treated as a short-term capital loss in such year under subchapter P of chapter 1 of the Code as in effect immediately before the enactment of the Revenue Act of 1964.

(4) *Transitional rule for net long-term capital losses sustained in a taxable year beginning before January 1, 1970.* In the case of a net long-term capital loss sustained by a taxpayer other than a corporation in a taxable year beginning prior to January 1, 1970 (referred to in this section as a *pre-1970 taxable year*) which is carried over and treated as a long-term capital loss in the first taxable year beginning after December 31, 1969 (referred to in this section as a *post-1969 taxable year*), the transitional additional allowance deductible under section 1211(b) for the taxable year shall be determined by application of section 1211(b) as in effect for pre-1970 taxable years and § 1.1211–1(b)(3), and the amount of such long-term capital loss carried over and treated as a long-term capital loss in the succeeding taxable year shall be determined by application of section 1212(b)(1) as in effect for pre-1970 taxable years and subparagraph (2)(i) of this paragraph (instead of under sections 1211(b) and 1212(b)(1) as in effect for post-1969 taxable years and § 1.1211–1(b)(2) and subparagraph (2)(ii) of this paragraph, respectively) but only to the extent that such pre-1970 long-term capital loss constitutes a *transitional net long-term capital loss component* (determined as provided in § 1.1211–1(b)(3)(ii)) in the taxable year to which such pre-1970 long-term capital loss is carried. Thus, for purposes of paragraph (2) of this section, to the extent that a component of the transitional additional allowance deductible for a post-1969 taxable year under section 1211(b) and § 1.1211–1(b)(3)(i) is a transitional net long-term capital loss component carried over to such post-1969 taxable year, such component shall be treated as a short-term capital gain in determining the amount and character of capital loss carryovers from such post-1969 taxable year to the succeeding taxable year. Such component shall be so treated as a short-term capital gain in full on a dollar-for-dollar basis and shall not be doubled for this purpose as is provided by subdivision (ii) of paragraph (2) of this section in the case of a component of the additional allowance made up of net long-term capital losses applied pursuant to the provisions of § 1.1211–1(b)(2)(iii). The transitional rule provided in this paragraph does not apply to a determination of the character of capital losses (as long-term or short-term) actually deductible for the current taxable year under section 1211(b) and § 1.1211–1(b).

(5) *Examples.* The application of this paragraph can be illustrated by the following examples:

Example 1. For the taxable year 1971, an unmarried individual has taxable income for purposes of section 1211(b) of $8,000, a long-term capital loss of $2,000, and no other capital gains or losses. $1,000 (one-half) of the net long-term capital loss is deductible in 1971 as the additional allowance deductible under section 1211(b). No amount of capital loss remains to be carried over to the succeeding taxable year.

Example 2. For the taxable year 1972, the same unmarried individual has taxable income for purposes of section 1211(b) of $8,000, a long-term capital loss of $3,000 and no other capital gains or losses. $1,500 (one-half of the excess net capital loss) is deductible in

1972, but limited to the $1,000 maximum additional allowance deductible under section 1211(b). By application of section 1212(b)(1), he will carry over to 1973 a long-term capital loss of $1,000 determined as follows:

Net long-term capital loss		($3,000)
Additional allowance deductible under section 1211(b)	$1,000	
Excess of additional allowance over net short-term capital loss (determined without regard to section 1212(b)(2)(B)(i))	1,000	
Total amount treated as short-term capital gain under 1212(b)(2)(B) for purposes of determining carryover		2,000
Long-term capital loss carryover to 1973		(1,000)

If, in 1973, he had taxable income for purposes of section 1211(b) of $8,000, but no capital gains or losses, $500 (one-half) of the net long-term capital loss carryover from 1972 would be deductible in 1973 as the additional allowance deductible under section 1211(b). No amount of capital loss would be carried over to 1974.

Example 3. For the taxable year 1971, an unmarried individual has taxable income for purposes of section 1211(b) of $9,000, a $500 short-term capital gain, a $700 short-term capital loss, a $1,000 long-term capital gain and a $1,700 long-term capital loss. He will offset $1,500 of capital losses against capital gains. The excess net capital loss of $900 is deductible in 1971 to the extent of a $550 additional allowance deductible under 1211(b) which is smaller than both $1,000 and taxable income for purposes of section 1211(b), determined as follows:

Losses allowed to the extent of gains	($1,500)
Amount allowed under section 1211(b)(1)(C):	
(i) Excess of net short-term capital loss over net long-term capital gain	(200)
(ii) One-half of the excess of net long-term capital loss over net short-term capital gain	(350)
Additional allowance deductible under section 1211(b)	550

The total amount treated as short-term capital gain under section 1212(b)(2)(B) for purposes of determining any carryover to the succeeding taxable year exceeds $900. No amount of net capital loss remains to be carried over to the succeeding taxable year.

Example 4. If in example (3) above, the long-term capital loss had been $2,800, the taxpayer would carry over $200 of long-term capital loss to 1972, determined as follows:

Losses allowed to extent of gains	($1,500)
Amount allowed under section 1211(b)(1) (B) and (C):	
(i) Excess of net short-term capital loss over net long-term capital gain	(200)
(ii) One-half the excess of net long-term capital loss over net short-term capital gain	(900)

as limited by 1211(b)(1)(B) to an additional allowance of $1,000.

Carryover under section 1212(b)(1):

Net long-term capital loss for 1971	($1,800)
Additional allowance under section 1211(b)(1)(B)	1,000
Excess of additional allowance deductible under section 1211(b) over net short-term capital loss determined without regard to section 1212(b)(2)(B)(i) ($1,000 less $200)	800
Total amount treated as short-term capital gain under section 1212(b)(2)(B) for purposes of determining carryover	1,800
Short-term capital gain for 1971	500
Total short-term capital gain	2,300
Short-term capital loss for 1971	(700)
Net short-term capital gain	1,600
Long-term capital loss carryover ($1,800 less $1,600)	200

Example 5. For 1969, an unmarried individual has taxable income for purposes of section 1211(b) of $8,000, a long-term capital loss of $3,000, and no other capital gains or losses. He is allowed to deduct in 1969 $1,000 as the additional allowance deductible under section 1211(b) (as in effect for pre-1970 taxable years) and to carry over to 1970, a long-term capital loss of $2,000 under section 1212(b) (as in effect for pre-1970 taxable years).

If, in 1970, the same unmarried individual with taxable income for purposes of section 1211(b) of $8,000, has no capital gains or losses, he would deduct $1,000 of his pre- 1970 capital loss carryover as the transitional additional allowance deductible under section 1211(b) (as in effect for pre-1970 years) and carry over under section 1212(b)(1) (as in effect for pre-1970 taxable years) to 1971 the remaining $1,000 as a pre-1970 long-term capital loss.

If, in 1970, the same individual instead has a long-term capital gain of $2,500, and a long-term capital loss of $1,500, he would net these two items with the $2,000 carried to 1970 as a long-term capital loss. Thus, he would have a net long-term capital loss for 1970 of $1,000 which is deductible in 1970 as the transitional additional allowance deductible under section 1211(b). He would have no amount to carry over under section 1212(b)(1) to 1971.

If, in 1970, the same individual instead has a long-term capital loss of $1,200, and a long-term capital gain of $200, resulting in a net long-term capital loss of $3,000 when netted with the $2,000 carried to 1970 as a long-term capital loss, he would deduct $1,000 in respect of his pre-1970 long-term capital loss carryover as the transitional additional allowance deductible under section 1211(b) (as in effect for pre-1970 taxable years) and carry over under section 1212(b)(1) (as in effect for pre-1970 taxable years) to 1971 the remaining $1,000 of the pre-1970 component of his long-term capital loss carryover, and the $1,000 net long-term capital loss actually sustained in 1970 as the second component of his long-term capital loss carryover.

Example 6. For 1970 a married individual filing a separate return has taxable income of $8,000, a long-term capital loss of $3,500 and a short-term capital gain of $3,000. He also has a pre-1970 short-term capital loss of $2,000 which is carried to 1970. The $3,000 short-term capital gain realized in 1970 would first be reduced by the $2,000 short-term capital loss carryover, and then the remaining $1,000 balance of the short-term capital gain would be offset against the $3,500 long-term capital loss, producing a net long-term capital loss of $2,500, no part of which is a net long-term capital loss carried over from 1969. However, under the special rule of § 1.1211–1(b)(7)(ii) in 1970, the taxpayer would deduct as the additional allowance deductible under section 1211(b), the $500 limitation in § 1.1211–1(b)(2)(ii) in the case of a married taxpayer filing a separate return in a taxable year ending after December 31, 1969, plus the *transitional net short-term capital loss component* of $2,000 computed under § 1.1211–1(b)(3)(iv), but limited to a total deduction of $1,000. The $1,000 additional allowance deductible under section 1211(b) would absorb $2,000 of the $2,500 net long-term capital loss, and he would carry the unused $500 balance of such loss to 1971 for use in that year.

Example 7. For 1970, an unmarried individual filing a separate return has taxable income for purposes of section 1211(b) of $8,000, and a long-term capital loss of $2,000. He also has a pre-1970 long-term capital loss of $2,500 which is carried to 1970. In 1970, the taxpayer would deduct as the transitional additional allowance deductible under section 1211(b) $1,000, absorbing $1,000 of the pre-1970 long-term capital loss of $2,500. He would carry to 1971 the unused $1,500 balance of his pre-1970 long-term capital loss plus the 1970 long-term capital loss of $2,000, or a total of $3,500, for use in 1971.

For 1971, the same taxpayer filing a separate return with taxable income for purposes of section 1211(b) of $8,000, has a $3,600 long-term capital gain and a $2,200 long-term capital loss. When these gains and losses are combined with the long-term capital loss carryover from 1970 of $3,500, a net long-term capital loss of $2,100 results. He would deduct $1,000 as the transitional additional allowance deductible under section 1211(b). The $1,000 additional allowance would absorb $100 of the unused pre-1970 long-term capital loss carryover of $1,500 plus $1,800 of the unused post-1969 long-term capital loss carryover of $2,100 (the amount of the 1971 net long-term capital loss necessary to make up the remaining $900 balance of the additional allowance). Although a component of the 1971 net long-term capital loss is the unused pre-1970 long-term capital loss carryover of $1,500, only $100 of this carryover is available for use in full on a dollar-for-dollar basis in computing the transitional additional allowance for 1971 since it only exceeds by that amount the $1,400 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) actually realized in 1971 all of which is net long-term capital gain (long-term capital gain of $3,600 reduced by long-term capital loss of $2,200). See § 1.1221–1(b)(3)(ii). The taxpayer would carry over to 1972 as a long-term capital loss the remaining $200 of the 1971 long-term capital loss.

Example 8. For 1970, an unmarried individual has taxable income for purposes of section 1211(b) of $8,000 and a short-term capital loss of $700. He also has a pre-1970 long-term capital loss carryover of $1,200. He would deduct $1,000 as the transitional additional allowance deductible under section 1211(b). The $1,000 transitional additional allowance would be composed of the 1970 short-term capital loss of $700 and $300 of the pre-1970 long-term capital loss carryover. He would carry over to 1971 the unused $900 balance of his $1,200 pre-1970 long-term capital loss carryover for use in 1971.

(c) *Husband and wife.* (1) The following rules shall be applied in computing capital loss carryovers by husband and wife:

(i) If a husband and wife making a joint return for any taxable year made separate returns for the preceding year, any capital loss carryovers of each spouse from such preceding taxable year may be carried forward to the taxable year in accordance with paragraph (a) or (b) of this section.

(ii) If a joint return was made for the preceding taxable year, any capital loss carryover from such preceding taxable year may be carried forward to the taxable year in accordance with paragraph (a) or (b) of this section.

(iii) If a husband and wife make separate returns for the first taxable year beginning after December 31, 1963, or any prior taxable year, and they made a joint return for the preceding taxable year, any capital loss carryover from such preceding taxable year shall be allocated to the spouses on the basis of their individual net capital loss which gave rise to such capital loss carryover. The capital loss carryover so allocated to each spouse may be carried forward by such spouse to the taxable year in accordance with paragraph (a) or (b) of this section.

(iv) If a husband and wife making separate returns for any taxable year following the first taxable year beginning after December 31, 1963, made a joint return for the preceding taxable year, any long-term or short-term capital loss carryovers shall be allocated to the spouses on the basis of their individual net long-term and net short-term capital losses for the preceding taxable year which gave rise to such capital loss carryovers, and the portions of the long-term or short-term capital loss carryovers so allocated to each spouse may be carried forward by such spouse to the taxable year in accordance with paragraph (b) of this section.

(v) If separate returns are made both for the taxable year and the preceding taxable year, any capital loss carryover of each spouse may be carried forward by such spouse in accordance with paragraph (a) or (b) of this section.

(2) The provisions of subparagraph (1) (i), (iii), and (iv) of this paragraph may be illustrated by the following examples:

Example 1. If H and W, husband and wife, make a joint return for 1955, having made separate returns for 1954 in which H had a net capital loss of $3,000 and W had a net capital loss of $2,000, in their joint return for 1955 they would have a short-term capital loss of $5,000 (the sum of their separate capital loss carryovers from 1954), allowable in accordance with paragraph (a) of this section. If, on the other hand, they make separate returns in 1955 following a joint return in 1954 in which their net capital loss was $5,000 allocable $3,000 to H and $2,000 to W, the carryover of H as a short-term capital loss for the purpose of his 1955 separate return would be $3,000 and that of W for her separate return would be $2,000, each allowable in accordance with paragraph (a) of this section.

Example 2. H and W, husband and wife, make separate returns for 1966 following a joint return for 1965. The capital gains and losses incurred by H and W in 1965, including those carried over by them to 1965, were as follows:

	H	W
Long-term capital gains	$8,000	$9,000
Long-term capital losses	(15,000)	(6,000)
Short-term capital gains	10,000	4,000
Short-term capital losses	(19,000)	(5,000)

Thus, in 1965 H and W had a net capital loss of $14,000 on their joint return. Of this amount, $4,000 was a long-term capital loss carryover, and $10,000 was a short-term capital loss carryover, determined in accordance paragraph (b) of this section. H's net long-term capital loss was $7,000 for 1965. This amount was offset on the joint return by W's net long-term capital gain of $3,000. Thus, H may carry over to his separate return for 1966, a long-term capital loss carryover of $4,000. H and W may carry over to their separate returns for 1966, as short-term capital loss carryovers, the amounts of their respective net short-term losses from 1965, $9,000 and $1,000.

[T.D. 6828, 30 FR 7806, June 17, 1965, as amended by T.D. 6867, 30 FR 15095, Dec. 7, 1965; T.D. 7301, 39 FR 968, Jan. 4, 1974; 39 FR 2758, Jan. 24, 1974; T.D. 7659, 44 FR 73019, Dec. 17, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

General Rules for Determining Capital Gains and Losses

§ 1.1221–1 Meaning of terms.

(a) The term *capital assets* includes all classes of property not specifically excluded by section 1221. In determining whether property is a *capital asset,* the period for which held is immaterial.

(b) Property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 167 and real property used in the trade or business of a taxpayer is excluded from the term *capital assets.* Gains and losses from the sale or exchange of such property are not treated as gains and losses from the sale or exchange of capital assets, except to the extent provided in section 1231. See § 1.1231–1. Property held for the production of income, but not used in a trade or business of the taxpayer, is not excluded from the term *capital assets* even though depreciation may have been allowed with respect to such property under section 23(l) of the Internal Revenue Code of 1939 before its amendment by section 121(c) of the Revenue Act of 1942 (56 Stat. 819). However, gain or loss upon the sale or exchange of land held by a taxpayer primarily for sale to customers in the ordinary course of his business, as in the case of a dealer in real estate, is not subject to the provisions of subchapter P (section 1201 and following), chapter 1 of the Code.

(c)(1) A copyright, a literary, musical, or artistic composition, and similar property are excluded from the term *capital assets* if held by a taxpayer whose personal efforts created such property, or if held by a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of a taxpayer whose personal efforts created such property. For purposes of this subparagraph, the phrase *similar property* includes for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law.

(2) In the case of sales and other dispositions occurring after July 25, 1969, a letter, a memorandum, or similar property is excluded from the term *capital asset* if held by (i) a taxpayer whose personal efforts created such property, (ii) a taxpayer for whom such property was prepared or produced, or (iii) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of a taxpayer described in subdivision (i) or (ii) of this subparagraph. In the case of a collection of letters, memorandums, or similar property held by a person who is a taxpayer described in subdivision (i), (ii), or (iii) of this subparagraph as to some of such letters, memorandums, or similar property but not as to others, this subparagraph shall apply only to those letters, memorandums, or similar property as to which such person is a taxpayer described in such subdivision. For purposes of this subparagraph, the phrase *similar property* includes, for example, such property as a draft of a speech, a manuscript, a research paper, an oral recording of any type, a transcript of an oral recording, a transcript of an oral interview or of dictation, a personal or business diary, a log or journal, a corporate archive, including a corporate charter, office correspondence, a financial record, a drawing, a photograph, or a dispatch. A letter, memorandum, or property similar to a letter or memorandum, addressed to a taxpayer shall be considered as prepared or produced for him. This subparagraph does not apply to property, such as a corporate archive, office correspondence, or a financial record, sold or disposed of as part of a going business if such property has no significant value separate and apart from its relation to and use in such business; it also does not apply to any property to which subparagraph (1) of this paragraph applies (i.e., property to which section 1221(3) applied before its amendment by section 514(a) of the Tax Reform Act of 1969 (83 Stat. 643)).

(3) For purposes of this paragraph, in general, property is created in whole or in part by the personal efforts of a taxpayer if such taxpayer performs literary, theatrical, musical, artistic, or other creative or productive work which affirmatively contributes to the creation of the property, or if such taxpayer directs and guides others in the performance of such work. A taxpayer, such as corporate executive, who merely has administrative control of writers, actors, artists, or personnel and who does not substantially engage in the direction and guidance of such persons in the performance of their work, does not create property by his personal efforts. However, for purposes of subparagraph (2) of this paragraph, a letter or memorandum, or property similar to a letter or memorandum, which is prepared by personnel who are under the administrative control of a taxpayer, such as a corporate executive, shall be deemed to have been prepared or produced for him whether or not such letter, memorandum, or similar property is reviewed by him.

(4) For the application of section 1231 to the sale or exchange of property to which this paragraph applies, see § 1.1231–1. For the application of section 170 to the charitable contribution of property to which this paragraph applies, see section 170(e) and the regulations thereunder.

(d) Section 1221(4) excludes from the definition of *capital asset* accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of stock in trade or inventory or property held for sale to customers in the ordinary course of trade or business. Thus, if a taxpayer acquires a note receivable for services rendered, reports the fair market value of the note as income, and later sells the note for less than the amount previously reported, the loss is an ordinary loss. On the other hand, if the taxpayer later sells the note for more than the amount originally reported, the excess is treated as ordinary income.

(e) Obligations of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, are excluded from the term *capital assets.* An obligation may be issued on a discount basis even though the price paid exceeds the face amount. Thus, although the Second Liberty Bond Act (31 U.S.C. 754) provides that United States Treasury bills shall be issued on a discount basis, the issuing price paid for a particular bill may, by reason of competitive bidding, actually exceed the face amount of the bill. Since the obligations of the type described in this paragraph are excluded from the term *capital assets,* gains or losses from the sale or exchange of such obligations are not subject to the limitations provided in such subchapter P. It is, therefore, not necessary for a taxpayer (other than a life insurance company taxable under part I (section 801 and following), subchapter L, chapter 1 of the Code, as amended by the Life Insurance Company Tax Act of 1955 (70 Stat. 36), and, in the case of taxable years beginning before January 1, 1955, subject to taxation only on interest, dividends, and rents) to segregate the original discount accrued and the gain or loss realized upon the sale or other disposition of any such obligation. See section 454(b) with respect to the original discount accrued. The provisions of this paragraph may be illustrated by the following examples:

Example 1. A (not a life insurance company) buys a $100,000, 90-day Treasury bill upon issuance for $99,998. As of the close of the forty-fifth day of the life of such bill, he sells it to B (not a life insurance company) for $99,999.50. The entire net gain to A of $1.50 may be taken into account as a single item of income, without allocating $1 to interest and $0.50 to gain. If B holds the bill until maturity his net gain of $0.50 may similarly be taken into account as a single item of income, without allocating $1 to interest and $0.50 to loss.

Example 2. The facts in this example are the same as in example (1) except that the selling price to B is $99,998.50. The net gain to A of $0.50 may be taken into account without allocating $1 to interest and $0.50 to loss, and, similarly, if B holds the bill until maturity his entire net gain of $1.50 may be taken into account as a single item of income without allocating $1 to interest and $0.50 to gain.

[T.D. 6500, 25 FR 12003, Nov. 26, 1960, as amended by T.D. 7369, 40 FR 29840, July 16, 1975]

§1.1221–2 Hedging transactions.

(a) *Treatment of hedging transactions*—(1) *In general.* This section governs the treatment of hedging transactions under section 1221. Except as provided in paragraph (f)(2) of this section (and notwithstanding the provisions of §1.1221–1(a)), the term capital asset does not include property that is part of a hedging transaction (as defined in paragraph (b) of this section).

(2) *Short sales and options.* This section also governs the character of gain or loss from a short sale or option that is part of a hedging transaction. See §§1.1233–2 and 1.1234–4. Except as provided in paragraph (f)(2) of this section, gain or loss on a short sale or option that is part of a hedging transaction (as defined in paragraph (b) of this section) is ordinary income or loss.

(3) *Exclusivity.* If a transaction is not a hedging transaction as defined in paragraph (b) of this section, gain or loss from the transaction is not made ordinary on the grounds that property involved in the transaction is a surrogate for a noncapital asset, that the transaction serves as insurance against a business risk, that the transaction serves a hedging function, or that the transaction serves a similar function or purpose.

(4) *Coordination with other sections*—(i) *Section 988.* This section does not apply

to determine the character of gain or loss realized on a section 988 transaction as defined in section 988(c)(1) or realized with respect to a qualified fund as defined in section 988(c)(1)(E)(iii). This section does apply, however, to transactions or payments that would be subject to section 988 but for the date that the transactions were entered into or the date that the payments were made.

(ii) *Sections 864(e) and 954(c).* Except as otherwise provided in regulations issued pursuant to sections 864(e) and 954(c), the definition of hedging transaction in paragraph (b) of this section does not apply for purposes of section 864(e) and 954(c).

(b) *Hedging transaction defined.* A hedging transaction is a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily—

(1) To reduce risk of price changes or currency fluctuations with respect to ordinary property (as defined in paragraph (c)(5) of this section) that is held or to be held by the taxpayer; or

(2) To reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer.

(c) *Rules of application.* The rules of this paragraph (c) apply for purposes of the definition of the term hedging transaction in paragraph (b) of this section. These rules must be interpreted reasonably and consistently with the purposes of this section. Where no specific rules of application control, the definition of hedging transaction must be interpreted reasonably and consistently with the purposes of this section.

(1) *Reducing risk*—(i) *Transactions that reduce risk.* Whether a transaction reduces a taxpayer's risk is determined based on all of the facts and circumstances surrounding the taxpayer's business and the transaction. In general, a taxpayer's hedging strategies and policies as reflected in the taxpayer's minutes or other records are evidence of whether particular transactions reduce the taxpayer's risk.

(ii) *Micro and macro hedges*—(A) *In general.* A taxpayer has risk of a particular type only if it is at risk when all of its operations are considered. Nonetheless, a hedge of a particular asset or liability generally will be respected as reducing risk if it reduces the risk attributable to the asset or liability and if it is reasonably expected to reduce the overall risk of the taxpayer's operations. If a taxpayer hedges particular assets or liabilities, or groups of assets or liabilities, and the hedges are undertaken as part of a program that, as a whole, is reasonably expected to reduce the overall risk of the taxpayer's operations, the taxpayer generally does not have to demonstrate that each hedge that was entered into pursuant to the program reduces its overall risk.

(B) *Fixed-to-floating hedges.* Under the principles of paragraph (c)(1)(ii)(A) of this section, a transaction that economically converts an interest rate or price from a fixed price or rate to a floating price or rate may reduce risk. For example, if a taxpayer's income varies with interest rates, the taxpayer may be at risk if it has a fixed rate liability. Similarly, a taxpayer with a fixed cost for its inventory may be at risk if the price at which the inventory can be sold varies with a particular factor. Thus, a transaction that converts an interest rate or price from fixed to floating may be a hedging transaction.

(iii) *Written options.* A written option may reduce risk. For example, in appropriate circumstances, a written call option with respect to assets held by a taxpayer or a written put option with respect to assets to be acquired by a taxpayer may be a hedging transaction. See also paragraph (c)(1)(v) of this section.

(iv) *Extent of risk reduction.* A taxpayer may hedge all or any portion of its risk for all or any part of the period during which it is exposed to the risk.

(v) *Transactions that counteract hedging transactions.* If a transaction is entered into primarily to counteract all or any part of the risk reduction effected by one or more hedging transactions, the transaction is a hedging transaction. For example, if a written option is used to reduce or eliminate the risk reduction obtained from another position such as a purchased option, then it may be part of a hedging transaction.

(vi) *Number of transactions.* The fact that a taxpayer frequently enters into and terminates positions (even if done on a daily or more frequent basis) is not relevant to whether these transactions are hedging transactions. Thus, for example, a taxpayer hedging the risk associated with an asset or liability may frequently establish and terminate positions that hedge that risk, depending on the extent the taxpayer wishes to be hedged. Similarly, if a taxpayer maintains its level of risk exposure by entering into and terminating a large number of transactions in a single day, its transactions may nonetheless qualify as hedging transactions.

(vii) *Transactions that do not reduce risk.* A transaction that is not entered into to reduce a taxpayer's risk is not a hedging transaction. For example, assume that a taxpayer produces a commodity for sale, sells the commodity, and enters into a long futures or forward contract in that commodity in the hope that the price will increase. Because the long position does not reduce risk, the transaction is not a hedging transaction. Moreover, gain or loss on the contract is not made ordinary on the grounds that it is a surrogate for inventory. See paragraph (a)(3) of this section.

(2) *Entering into a hedging transaction.* A taxpayer may enter into a hedging transaction by using a position that was a hedge of one asset or liability to hedge another asset or liability (recycling).

(3) *No investments as hedging transactions.* If an asset (such as an investment) is not acquired primarily to reduce risk, the purchase or sale of that asset is not a hedging transaction even if the terms of the asset limit or reduce the taxpayer's risk with respect to other assets or liabilities. For example, a taxpayer's interest rate risk from a floating rate borrowing may be reduced by the purchase of debt instruments that bear a comparable floating rate. The acquisition of the debt instruments, however, is not a hedging transaction because the transaction is not entered into primarily to reduce the taxpayer's risk. Similarly, borrowings generally are not made primarily to reduce risk.

(4) *Normal course.* Solely for purposes of paragraph (b) of this section, if a transaction is entered into in furtherance of a taxpayer's trade or business, the transaction is entered into in the normal course of the taxpayer's trade or business. This rule applies even if the risk to be reduced relates to the expansion of an existing business or the acquisition of a new trade or business.

(5) *Ordinary property and obligations*—(i) *In general.* Except as provided in paragraph (g)(3) of this section (which contains transition rules), property is ordinary property to a taxpayer only if a sale or exchange of the property by the taxpayer could not produce capital gain or loss regardless of the taxpayer's holding period when the sale or exchange occurs. Thus, for example, property used in a trade or business within the meaning of section 1231(b) (determined without regard to the holding period specified in that section) is not ordinary property. An obligation is an ordinary obligation if performance or termination of the obligation by the taxpayer could not produce capital gain or loss. For purposes of the preceding sentence, termination has the same meaning as in section 1234A.

(ii) *Hedges of noninventory supplies.* Notwithstanding paragraph (c)(5)(i) of this section, if a taxpayer sells only a negligible amount of a noninventory supply, then, only for purposes of determining whether a transaction to hedge the purchase of that noninventory supply is a hedging transaction, the supply is treated as ordinary property. A noninventory supply is a supply that a taxpayer purchases for consumption in its trade or business and that is not an asset described in sections 1221 (1) through (5).

(6) *Borrowings.* Whether hedges of a taxpayer's debt issuances (borrowings) are hedging transactions is determined without regard to the use of the proceeds of the borrowing.

(7) *Hedging an aggregate risk.* The term hedging transaction includes a transaction that reduces an aggregate risk of interest rate changes, price changes, and/or currency fluctuations only if all of the risk, or all but a de

minimis amount of the risk, is with respect to ordinary property, ordinary obligations, and borrowings.

(d) *Hedging by members of a consolidated group*—(1) *General rule: single-entity approach.* For purposes of this section, the risk of one member of a consolidated group is treated as the risk of the other members as if all of the members of the group were divisions of a single corporation. For example, if any member of a consolidated group hedges the risk of another member of the group by entering into a transaction with a third party, that transaction may potentially qualify as a hedging transaction. Conversely, intercompany transactions are not hedging transactions because, when considered as transactions between divisions of a single corporation, they do not reduce the risk of that single corporation.

(2) *Separate-entity election.* In lieu of the single-entity approach specified in paragraph (d)(1) of this section, a consolidated group may elect separate-entity treatment of its hedging transactions. If a group makes this separate-entity election, the following rules apply.

(i) *Risk of one member not risk of other members.* Notwithstanding paragraph (d)(1) of this section, the risk of one member is not treated as the risk of other members.

(ii) *Intercompany transactions.* An intercompany transaction is a hedging transaction (an intercompany hedging transaction) with respect to a member of a consolidated group if and only if it meets the following requirements—

(A) The position of the member in the intercompany transaction would qualify as a hedging transaction with respect to the member (taking into account paragraph (d)(2)(i) of this section) if the member had entered into the transaction with an unrelated party; and

(B) The position of the other member (the marking member) in the transaction is marked to market under the marking member's method of accounting.

(iii) *Treatment of intercompany hedging transactions.* An intercompany hedging transaction (that is, a transaction that meets the requirements of paragraphs (d)(2)(ii) (A) and (B) of this section) is subject to the following rules—

(A) The character and timing rules of §1.1502–13 do not apply to the income, deduction, gain, or loss from the intercompany hedging transaction; and

(B) Except as provided in paragraph (f)(3) of this section, the character of the marking member's gain or loss from the transaction is ordinary.

(iv) *Making and revoking the election.* Unless the Commissioner otherwise prescribes, the election described in this paragraph (d)(2) must be made in a separate statement saying ''[Insert Name and Employer Identification Number of Common Parent] HEREBY ELECTS THE APPLICATION OF SECTION 1.1221–2(d)(2) (THE SEPARATE-ENTITY APPROACH).'' The statement must also indicate the date as of which the election is to be effective. The election must be signed by the common parent and filed with the group's Federal income tax return for the taxable year that includes the first date for which the election is to apply. The election applies to all transactions entered into on or after the date so indicated. The election may be revoked only with the consent of the Commissioner.

(3) *Definitions.* For definitions of consolidated group, divisions of a single corporation, group, intercompany transactions, and member, see section 1502 and the regulations thereunder.

(4) *Examples.* The following examples illustrate this paragraph (d):

General Facts. In these examples, O and H are members of the same consolidated group. O's business operations give rise to interest rate risk ''A,'' which O wishes to hedge. O enters into an intercompany transaction with H that transfers the risk to H. O's position in the intercompany transaction is ''B,'' and H's position in the transaction is ''C.'' H enters into position ''D'' with a third party to reduce the interest rate risk it has with respect to its position C. D would be a hedging transaction with respect to risk A if O's risk A were H's risk.

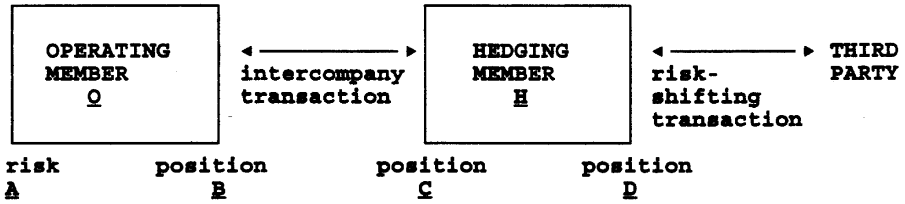

Example 1. Single-entity treatment—(i) *General rule.* Under paragraph (d)(1) of this section, O's risk A is treated as H's risk, and therefore D is a hedging transaction with respect to risk A. Thus, the character of D is determined under the rules of this section, and the income, deduction, gain, or loss from D must be accounted for under a method of accounting that satisfies §1.446–4. The intercompany transaction B–C is not a hedging transaction and is taken into account under §1.1502–13.

(ii) *Identification.* D must be identified as a hedging transaction under paragraph (e)(1) of this section, and A must be identified as the hedged item under paragraph (e)(2) of this section. Under paragraph (e)(5) of this section, the identification of A as the hedged item can be accomplished by identifying the positions in the intercompany transaction as hedges or hedged items, as appropriate. Thus, substantially contemporaneous with entering into D, H may identify C as the hedged item and O may identify B as a hedge and A as the hedged item.

Example 2. Separate-entity election; counterparty that does not mark to market. In addition to the *General Facts* stated above, assume that the group makes a separate-entity election under paragraph (d)(2) of this section. If H does not mark C to market under its method of accounting, then B is not a hedging transaction, and the B–C intercompany transaction is taken into account under the rules of section 1502. D is not a hedging transaction with respect to A, but D may be a hedging transaction with respect to C if C is ordinary property or an ordinary obligation and if the other requirements of paragraph (b) of this section are met. If D is not part of a hedging transaction, then D may be part of a straddle for purposes of section 1092.

Example 3. Separate-entity election; counterparty that marks to market. The facts are the same as in *Example 2* above, except that H marks C to market under its method of accounting. Also assume that B would be a hedging transaction with respect to risk A if O had entered into that transaction with an unrelated party. Thus, for O, the B–C transaction is an intercompany hedging transaction with respect to O's risk A, the character and timing rules of §1.1502–13 do not apply to the B–C transaction, and H's income, deduction, gain, or loss from C is ordinary. However, other attributes of the items from the B–C transaction are determined under §1.1502–13. D is a hedging transaction with respect to C if it meets the requirements of paragraph (b) of this section.

(e) *Identification and recordkeeping*—(1) *Same-day identification of hedging transactions.* A taxpayer that enters into a hedging transaction (including recycling an existing hedge) must identify it as a hedging transaction. This identification must be made before the close of the day on which the taxpayer enters into the transaction.

(2) *Substantially contemporaneous identification of hedged item*—(i) *Content of the identification.* A taxpayer that enters into a hedging transaction must identify the item, items, or aggregate risk being hedged. Identification of an item being hedged generally involves identifying a transaction that creates risk, and the type of risk that the transaction creates. For example, if a taxpayer is hedging the price risk with respect to its June purchases of corn inventory, the transaction being hedged is the June purchase of corn and the risk is price movements in the market where the taxpayer buys its corn. For additional rules concerning the content of this identification, see paragraph (e)(3) of this section.

(ii) *Timing of the identification.* The identification required by this paragraph (e)(2) must be made substantially contemporaneously with entering into the hedging transaction. An identification is not substantially contemporaneous if it is made more than 35 days after entering into the hedging transaction.

(3) *Identification requirements for certain hedging transactions.* In the case of the hedging transactions described in this paragraph (e)(3), the identification

under paragraph (e)(2) of this section must include the information specified.

(i) *Anticipatory asset hedges.* If the hedging transaction relates to the anticipated acquisition of assets by the taxpayer, the identification must include the expected date or dates of acquisition and the amounts expected to be acquired.

(ii) *Inventory hedges.* If the hedging transaction relates to the purchase or sale of inventory by the taxpayer, the identification is made by specifying the type or class of inventory to which the transaction relates. If the hedging transaction relates to specific purchases or sales, the identification must also include the expected dates of the purchases or sales and the amounts to be purchased or sold.

(iii) *Hedges of debt of the taxpayer*—(A) *Existing debt.* If the hedging transaction relates to accruals or payments under an issue of existing debt of the taxpayer, the identification must specify the issue and, if the hedge is for less than the full adjusted issue price or the full term of the debt, the amount and the term covered by the hedge.

(B) *Debt to be issued.* If the hedging transaction relates to the expected issuance of debt by the taxpayer or to accruals or payments under debt that is expected to be issued by the taxpayer, the identification must specify the following information: the expected date of issuance of the debt; the expected maturity or maturities; the total expected issue price of the issue; and the expected interest provisions. If the hedge is for less than the entire expected issue price of the debt or the full expected term of the debt, the identification must also include the amount or the term being hedged. The identification may indicate a range of dates, terms, and amounts, rather than specific dates, terms, or amounts. For example, a taxpayer might identify a transaction as hedging the yield on an anticipated issuance of fixed rate debt during the second half of its fiscal year, with the anticipated amount of the debt between $75 million and $125 million, and an anticipated term of approximately 20 to 30 years.

(iv) *Hedges of aggregate risk*—(A) *Required identification.* If a transaction hedges aggregate risk as described in paragraph (c)(7) of this section, the identification under paragraph (e)(2) of this section must include a description of the risk being hedged and of the hedging program under which the hedging transaction was entered. This requirement may be met by placing in the taxpayer's records a description of the hedging program and by establishing a system under which individual transactions are identified as being entered into pursuant to the program.

(B) *Description of hedging program.* A description of a hedging program must include an identification of the type of risk being hedged, a description of the type of items giving rise to the risk being aggregated, and sufficient additional information to demonstrate that the program is designed to reduce aggregate risk of the type identified. If the program contains controls on speculation (for example, position limits), the description of the hedging program must also explain how the controls are established, communicated, and implemented.

(4) *Manner of identification and records to be retained*—(i) *Inclusion of identification in tax records.* The identification required by this paragraph (e) must be made on, and retained as part of, the taxpayer's books and records.

(ii) *Presence or absence of identification must be unambiguous.* The presence or absence of an identification for purposes of this paragraph (e) must be unambiguous. The identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement unless the taxpayer's books and records indicate that the identification is also being made for tax purposes. The taxpayer may indicate that individual hedging transactions, or a class or classes of hedging transactions, that are identified for financial accounting or regulatory purposes are also being identified as hedging transactions for purposes of this section.

(iii) *Manner of identification.* The taxpayer may separately and explicitly make each identification, or, so long as paragraph (e)(4)(ii) of this section is satisfied, the taxpayer may establish a system pursuant to which the identification is indicated by the type of transaction or by the manner in which the transaction is consummated or recorded. An identification under this system is made at the later of the time that the system is established or the time that the transaction satisfies the terms of the system by being entered, or by being consummated or recorded, in the designated fashion.

(iv) *Examples.* The following examples illustrate the principles of paragraph (e)(4)(iii) of this section and assume that the other requirements of paragraph (e) of this section are satisfied.

(A) A taxpayer can make an identification by designating a hedging transaction for (or placing it in) an account that has been identified as containing only hedges of a specified item (or of specified items or specified aggregate risk).

(B) A taxpayer can make an identification by including and retaining in its books and records a statement that designates all future transactions in a specified derivative product as hedges of a specified item, items, or aggregate risk.

(C) A taxpayer can make an identification by placing a designated mark on a record of the transaction (for example, trading ticket, purchase order, or trade confirmation) or by using a designated form or a record that contains a designated legend.

(5) *Identification of hedges involving members of a consolidated group*—(i) *General rule: single-entity approach.* A member of a consolidated group must satisfy the requirements of this paragraph (e) as if all of the members of the group were divisions of a single corporation. Thus, the member entering into the hedging transaction with a third party must identify the hedging transaction under paragraph (e)(1) of this section. Under paragraph (e)(2) of this section, that member must also identify the item, items, or aggregate risk that is being hedged, even if the item, items, or aggregate risk relates primarily or entirely to other members of the group. If the members of a group use intercompany transactions to transfer risk within the group, the requirements of paragraph (e)(2) of this section may be met by identifying the intercompany transactions, and the risks hedged by the intercompany transactions, as hedges or hedged items, as appropriate. Because identification of the intercompany transaction as a hedge serves solely to identify the hedged item, the identification is timely if made within the period required by paragraph (e)(2) of this section. For example, if a member transfers risk in an intercompany transaction, it may identify under the rules of this paragraph (e) both its position in that transaction and the item, items, or aggregate risk being hedged. The member that hedges the risk outside the group may identify under the rules of this paragraph (e) both its position with the third party and its position in the intercompany transaction. Paragraph (d)(4) *Example 1* of this section illustrates this identification.

(ii) *Rule for consolidated groups making the separate-entity election.* If a consolidated group makes the separate-entity election under paragraph (d)(2) of this section, each member of the group must satisfy the requirements of this paragraph (e) as though it were not a member of a consolidated group.

(6) *Consistency with section 1256(e)(2)(C).* Any identification for purposes of section 1256(e)(2)(C) is also an identification for purposes of paragraph (e)(1) of this section.

(f) *Effect of identification and non-identification*—(1) *Transactions identified*—(i) *In general.* If a taxpayer identifies a transaction as a hedging transaction for purposes of paragraph (e)(1) of this section, the identification is binding with respect to gain, whether or not all of the requirements of paragraph (e) of this section are satisfied. Thus, gain from that transaction is ordinary income. If the transaction is not in fact a hedging transaction described in paragraph (b) of this section, however, paragraphs (a)(1) and (a)(2) of this section do not apply and the character of loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function, or serves a similar function or purpose. Thus, the taxpayer's identification of the transaction as a hedging transaction does not itself make loss from the transaction ordinary.

(ii) *Inadvertent identification.* Notwithstanding paragraph (f)(1)(i) of this section, if the taxpayer identifies a transaction as a hedging transaction for purposes of paragraph (e) of this section, the character of the gain is determined as if the transaction had not been identified as a hedging transaction if—

(A) The transaction is not a hedging transaction (as defined in paragraph (b) of this section);

(B) The identification of the transaction as a hedging transaction was due to inadvertent error; and

(C) All of the taxpayer's transactions in all open years are being treated on either original or, if necessary, amended returns in a manner consistent with the principles of this section.

(2) *Transactions not identified*—(i) *In general.* Except as provided in paragraphs (f)(2) (ii) and (iii) of this section, the absence of an identification that satisfies the requirements of paragraph (e)(1) of this section is binding and establishes that a transaction is not a hedging transaction. Thus, subject to the exceptions, the rules of paragraphs (a) (1) and (2) of this section do not apply, and the character of gain or loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function, or serves a similar function or purpose.

(ii) *Inadvertent error.* If a taxpayer does not make an identification that satisfies the requirements of paragraph (e) of this section, the taxpayer may treat gain or loss from the transaction as ordinary income or loss under paragraph (a)(1) or (a)(2) of this section if—

(A) The transaction is a hedging transaction (as defined in paragraph (b) of this section);

(B) The failure to identify the transaction was due to inadvertent error; and

(C) All of the taxpayer's hedging transactions in all open years are being treated on either original or, if necessary, amended returns as provided in paragraphs (a)(1) and (a)(2) of this section.

(iii) *Anti-abuse rule.* If a taxpayer does not make an identification that satisfies all the requirements of paragraph (e) of this section but the taxpayer has no reasonable grounds for treating the transaction as other than a hedging transaction, then gain from the transaction is ordinary. Thus, a taxpayer may not elect to treat gain or loss from a hedging transaction as capital gain or loss. The reasonableness of the taxpayer's failure to identify a transaction is determined by taking into consideration not only the requirements of paragraph (b) of this section but also the taxpayer's treatment of the transaction for financial accounting or other purposes and the taxpayer's identification of similar transactions as hedging transactions.

(3) *Transactions by members of a consolidated group*—(i) *Single-entity approach.* If a consolidated group is under the general rule of paragraph (d)(1) of this section (the single-entity approach), the rules of this paragraph (f) apply only to transactions that are not intercompany transactions.

(ii) *Separate-entity election.* If a consolidated group has made the election under paragraph (d)(2) of this section, then, in addition to the rules of paragraphs (f) (1) and (2) of this section, the following rules apply.

(A) If an intercompany transaction is identified as a hedging transaction but does not meet the requirements of paragraphs (d)(2)(ii) (A) and (B) of this section, then, notwithstanding any contrary provision in § 1.1502–13, each party to the transaction is subject to the rules of paragraph (f)(1) of this section with respect to the transaction as though it had incorrectly identified its position in the transaction as a hedging transaction.

(B) If a transaction meets the requirements of paragraphs (d)(2)(ii) (A) and (B) of this section but the transaction is not identified as a hedging transaction, each party to the transaction is subject to the rules of paragraph (f)(2) of this section. (Because the transaction is an intercompany hedging transaction, the character and timing rules of § 1.1502–13 do not apply. See paragraph (d)(2)(iii)(A) of this section.)

(g) *Effective dates and transition rules*—(1) *Effective date for identification requirements*—(i) *In general.* Paragraph

(e) of this section applies to transactions that—

(A) Are entered into on or after January 1, 1994; or

(B) Are entered into before that date and remain in existence on March 31, 1994.

(ii) *Transition rule.* In the case of a hedging transaction that is entered into before January 1, 1994, and remains in existence on March 31, 1994, an identification is timely if it is made before the close of business on March 31, 1994.

(iii) *Special rules for hedging transactions not described in §1.1221–2T(b).* In the case of a transaction that is entered into before October 1, 1994, that is a hedging transaction within the meaning of paragraph (b) of this section (or is treated as a hedging transaction under paragraph (g)(3) of this section), and that the taxpayer reasonably treated as not being a hedging transaction within the meaning of paragraph (b) of §1.1221–2T (26 CFR part 1 revised as of April 1, 1994)—

(A) If the transaction does not remain in existence on October 1, 1994, paragraph (e) of this section does not apply; and

(B) If the transaction remains in existence on October 1, 1994, paragraph (e) of this section applies, and an identification is timely if it is made before the close of business on October 1, 1994.

(2) *Reliance on §1.1221–2T*—(i) *General rule.* A taxpayer may rely on any paragraph in §1.1221–2T (26 CFR part 1 revised as of April 1, 1994), for transactions entered into prior to October 1, 1994, provided that the taxpayer applies the paragraph reasonably and consistently.

(ii) *Identification.* In the case of a transaction entered into before October 1, 1994, an identification is deemed to satisfy paragraph (e) of this section if it satisfies §1.1221–2T(c) (26 CFR part 1 revised as of April 1, 1994). For this purpose, identification of the hedged item is timely if it is made within the period specified in paragraph (e)(2)(ii) of this section.

(3) *Transition rules for hedges of certain property*—(i) *Transition rule for section 1231 assets.* For all taxable years that ended prior to July 18, 1994 and that, as of September 1, 1994, were still open for assessment under section 6501, a taxpayer may treat as hedging transactions all transactions that were entered into during those years and that hedge property used in the trade or business within the meaning of section 1231(b) (a section 1231 asset) if the taxpayer can establish that, during those years—

(A) Sales of section 1231 assets did not give rise to net gain treated as capital gain (after application of section 1231(c));

(B) All of the hedges of section 1231 assets would be hedging transactions under paragraph (b) of this section if section 1231 assets were ordinary property; and

(C) On original or amended returns, the taxpayer consistently treats all of the hedges of section 1231 assets as hedging transactions.

(ii) *Transition rule for noninventory supplies.* For all taxable years that ended prior to July 18, 1994 and that, as of September 1, 1994, were still open for assessment under section 6501, a taxpayer may treat as hedging transactions all hedges of purchases of noninventory supplies (as defined in paragraph (c)(5)(ii) of this section) that would not otherwise qualify as hedging transactions and that were entered into during those years if the taxpayer can establish that, during those years—

(A) The taxpayer did not sell in any of those years more than 15 percent of the greater of the total amount of the supply held at the beginning of the year or the total amount of the supply acquired during that year;

(B) All of the hedges would be hedging transactions under paragraph (b) of this section if noninventory supplies were ordinary property; and

(C) On original or amended returns, the taxpayer consistently treats all of the hedges of noninventory supplies as hedging transactions.

(4) *Effective date and transition rules for hedges by members of a consolidated group.* Paragraphs (d), (e)(5), and (f)(3) of this section apply to transactions entered into on or after March 8, 1996.

(5) *Elections to accelerate the effective date of the regulations*—(i) *Election to apply the single-entity approach retroactively.* A consolidated group may

elect to begin to apply paragraphs (d) (1) and (3), (e)(5)(i), and (f)(3)(i) of this section to all transactions entered into in any taxable year (the election year) beginning prior to March 8, 1996. This election must be made in the manner, and at the time, prescribed by the Commissioner. A group may make the election only if the election year, and each subsequent taxable year, are still open for assessment under section 6501 on July 1, 1996 (or such earlier date as the Commissioner may allow). The election applies to all transactions entered into in the election year and in all subsequent consolidated return years until the date, if any, as of which the group makes a separate-entity election under paragraph (d)(2) of this section. The rules of paragraph (g)(6) of this section apply to all transactions that were entered into before March 8, 1996 in taxable years subject to an election under this paragraph (g)(5)(i). The election may be revoked only with the consent of the Commissioner.

(ii) *Ability to apply the separate-entity approach retroactively*. Notwithstanding paragraph (g)(4) of this section, the separate-entity election described in paragraph (d)(2) of this section may be made for any taxable year beginning on or after July 12, 1995. If that election is made for a taxable year beginning before March 8, 1996, then paragraphs (d) (2) and (3), (e)(5)(ii), and (f)(3)(ii) of this section apply to all transactions entered into on or after the beginning of that taxable year and while the election is in effect, and the rules of paragraph (g)(6) of this section (other than paragraph (g)(6)(i)) apply to all transactions that were entered into on or after the first day of the first year for which the election is made and before March 8, 1996.

(6) *Transitional identification rules*. To allow a consolidated group to conform to paragraphs (g)(5) (i) and (ii) of this section, this paragraph (g)(6) nullifies certain hedge identifications and permits a member of a consolidated group to add certain hedge identifications. This paragraph (g)(6) applies only to the extent provided in paragraph (g)(5) of this section.

(i) *Intercompany transactions previously identified*. Notwithstanding paragraph (f)(1)(i) of this section, if, for purposes of paragraph (e)(1) of this section, a member identified as a hedging transaction an intercompany transaction (or a transaction that would qualify as an intercompany transaction under § 1.1502–13(b)(1) if the taxable year in which the transaction was entered into were described in § 1.1502–13(*l*)), the character of the gain on the intercompany transaction is determined as if it had not been identified as a hedging transaction. The identification may, however, serve to identify the hedged item under paragraph (e)(5)(i) of this section.

(ii) *Additional identifications of hedging transactions*. A member of a consolidated group must identify under paragraph (e)(5) of this section a transaction that—

(A) Was entered into before March 8, 1996,

(B) When entered into was not a hedging transaction (as defined in paragraph (b) of this section),

(C) Solely as a result of the group's election under paragraph (g)(5) (i) or (ii) of this section, is a hedging transaction (as defined in paragraph (b) of this section), and

(D) Remains in existence on March 8, 1996.

(iii) *Additional identification of hedged items*. In the case of transactions described in paragraph (g)(6)(ii) of this section, the hedging member must identify under paragraph (e)(5) of this section the item, items, or aggregate risk being hedged.

(iv) *Consistency requirement for hedge identifications*. In identifying transactions as hedging transactions under paragraph (g)(6)(ii) of this section, all of the members of the group must treat similar or identical transactions consistently within the same year and from year to year. If paragraph (g)(6)(ii) of this section requires a member to identify a transaction, and the member fails to identify a transaction as a hedging transaction, but it or another member of the group identifies similar or identical hedging transactions in the same or a subsequent year, then for purposes of paragraphs (f)(2)(iii) and (3) of this section, the member entering into the transaction is treated as having no reasonable grounds for treating the transaction as other than a hedging transaction.

(v) *Extension of time for making additional identifications.* If an identification of a hedging transaction would not be required but for the rules of paragraph (g)(6)(ii) of this section, the identification is timely for purposes of paragraph (e)(1) of this section if made before the close of business on May 7, 1996. If an identification of a hedged item would not be required but for the rules of paragraph (g)(6)(iii) of this section, it is timely for purposes of paragraph (e)(2) of this section if made before the close of business on the later of May 7, 1996 or the last day of the period specified in paragraph (e)(2)(ii) of this section.

[T.D. 8555, 59 FR 36363, July 18, 1994, as amended by T.D. 8653, 61 FR 519, Jan. 8, 1996; 61 FR 11547, Mar. 21, 1996]

§1.1222–1 Other terms relating to capital gains and losses.

(a) The phrase *short-term* applies to the category of gains and losses arising from the sale or exchange of capital assets held for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less; the phrase *long-term* to the category of gains and losses arising from the sale or exchange of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). The fact that some part of a loss from the sale or exchange of a capital asset may be finally disallowed because of the operation of section 1211 does not mean that such loss is not *taken into account in computing taxable income* within the meaning of that phrase as used in sections 1222(2) and 1222(4).

(b)(1) In the definition of *net short-term capital gain,* as provided in section 1222(5), the amounts brought forward to the taxable year under section 1212 (other than section 1212(b)(1)(B)) are short-term capital losses for such taxable year.

(2) In the definition of *net long-term capital gain,* as provided in section 1222(7), the amounts brought forward to the taxable year under section 1212(b)(1)(B) are long-term capital losses for such taxable year.

(c) Gains and losses from the sale or exchange of capital assets held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) (described as short-term capital gains and short-term capital losses) shall be segregated from gains and losses arising from the sale or exchange of such assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) (described as long-term capital gains and long-term capital losses).

(d)(1) The term capital gain net income (net capital gain for taxable years beginning before January 1, 1977) means the excess of the gains from sales or exchanges of capital assets over the losses from sales or exchanges of capital assets, which losses include any amounts carried to the taxable year pursuant to section 1212(a) or section 1212(b).

(2) Notwithstanding subparagraph (1) of this paragraph, in the case of a taxpayer other than a corporation for taxable years beginning before January 1, 1964, the term *net capital gain* means the excess of (i) the sum of the gains from sales or exchanges of capital assets, plus the taxable income (computed without regard to gains and losses from sales or exchanges of capital assets and without regard to the deductions provided by section 151, relating to personal exemptions, or any deductions in lieu thereof) of the taxpayer or $1,000, whichever is smaller, over (ii) the losses from sales or exchanges of capital assets, which losses include amounts carried to the taxable year by such taxpayer under paragraph (a)(1) of §1.1212–1. Thus, in the case of estates and trusts for taxable years beginning before January 1, 1964, taxable income for the purposes of this paragraph shall be computed without regard to gains and losses from sales or exchanges of capital assets and without regard to the deductions allowed by section 642(b) to estates and trusts in lieu of personal exemptions. The term *net capital gain* is not applicable in the case of a taxpayer other than a corporation for taxable years beginning after December 31, 1963, and before January 1, 1970. In the case of a taxpayer

whose tax liability is computed under section 3 for taxable years beginning before January 1, 1964, the term *taxable income,* for purposes of this paragraph, shall be read as *adjusted gross income.*

(e) The term *net capital loss* means the excess of the losses from sales or exchanges of capital assets over the sum allowed under section 1211. However, in the case of a corporation, amounts which are short-term capital losses under § 1.1212–1(a) are excluded in determining such *net capital loss.*

(f) See section 165(g) and section 166(e), under which losses from worthless stocks, bonds, and other securities (if they constitute capital assets) are required to be treated as losses under subchapter P (section 1201 and following), chapter 1 of the Code, from the sale or exchange of capital assets, even though such securities are not actually sold or exchanged. See also section 1231 and § 1.1231–1 for the determination of whether or not gains and losses from the involuntary conversion of capital assets and from the sale, exchange, or involuntary conversion of certain property used in the trade or business shall be treated as gains and losses from the sale or exchange of capital assets. See also section 1236 and § 1.1236–1 for the determination of whether or not gains from the sale or exchange of securities by a dealer in securities shall be treated as capital gains, or whether losses from such sales or exchanges shall be treated as ordinary losses.

(g) In the case of nonresident alien individuals not engaged in trade or business within the United States, see section 871 and the regulations thereunder for the determination of the net amount of capital gains subject to tax.

(h) The term net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977) means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year.

[T.D. 6500, 25 FR 12004, Nov. 26, 1960, as amended by T.D. 6828, 30 FR 7808, June 17, 1965; T.D. 6867, 30 FR 15096, Dec. 7, 1965; T.D. 7301, 39 FR 971, Jan. 4, 1974; T.D. 7337, 39 FR 44978, Dec. 30, 1974; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1223–1 Determination of period for which capital assets are held.

(a) The holding period of property received in an exchange by a taxpayer includes the period for which the property which he exchanged was held by him, if the property received has the same basis in whole or in part for determining gain or loss in the hands of the taxpayer as the property exchanged. However, this rule shall apply, in the case of exchanges after March 1, 1954, only if the property exchanged was at the time of the exchange a capital asset in the hands of the taxpayer or property used in his trade or business as defined in section 1231(b). For the purposes of this paragraph, the term *exchange* includes the following transactions:

(1) An involuntary conversion described in section 1033, and

(2) A distribution to which section 355 (or so much of section 356 as relates to section 355) applies.

Thus, if property acquired as the result of a compulsory or involuntary conversion of other property of the taxpayer has under section 1033(c) the same basis in whole or in part in the hands of the taxpayer as the property so converted, its acquisition is treated as an exchange and the holding period of the newly acquired property shall include the period during which the converted property was held by the taxpayer. Thus, also, where stock of a controlled corporation is received by a taxpayer pursuant to a distribution to which section 355 (or so much of section 356 as relates to section 355) applies, the distribution is treated as an exchange and the period for which the taxpayer has held the stock of the controlled corporation shall include the period for which he held the stock of the distributing corporation with respect to which such distribution was made.

(b) The holding period of property in the hands of a taxpayer shall include the period during which the property was held by any other person, if such property has the same basis in whole or in part in the hands of the taxpayer for determining gain or loss from a sale or exchange as it would have in the hands of such other person. For example, the period for which property acquired by gift after December 31, 1920, was held by the donor must be included in determining the period for which the property was held by the taxpayer if, under the provisions of section 1015, such property has, for the purpose of determining gain or loss from the sale or exchange, the same basis in the hands of the taxpayer as it would have in the hands of the donor.

(c) In determining the period for which the taxpayer has held stock or securities received upon a distribution where no gain was recognized to the distributee under section 1081(c) (or under section 112(g) of the Revenue Act of 1928 (45 Stat. 818) or the Revenue Act of 1932 (47 Stat. 197)), there shall be included the period for which he held the stock or securities in the distributing corporation before the receipt of the stock or securities on such distribution.

(d) If the acquisition of stock or securities resulted in the nondeductibility (under section 1091, relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, the holding period of the newly acquired securities shall include the period for which the taxpayer held the securities with respect to which the loss was not allowable.

(e) The period for which the taxpayer has held stock, or stock subscription rights, received on a distribution shall be determined as though the stock dividend, or stock right, as the case may be, were the stock in respect of which the dividend was issued if the basis for determining gain or loss upon the sale or other disposition of such stock dividend or stock right is determined under section 307. If the basis of stock received by a taxpayer pursuant to a spin-off is determined under so much of section 1052(c) as refers to section 113(a)(23) of the Internal Revenue Code of 1939, and such stock is sold or otherwise disposed of in a taxable year which is subject to the Internal Revenue Code of 1954, the period for which the taxpayer has held the stock received in such spin-off shall include the period for which he held the stock of the distributing corporation with respect to which such distribution was made.

(f) The period for which the taxpayer has held stock or securities issued to him by a corporation pursuant to the exercise by him of rights to acquire such stock or securities from the corporation will, in every case and whether or not the receipt of taxable gain was recognized in connection with the distribution of the rights, begin with and include the day upon which the rights to acquire such stock or securities were exercised. A taxpayer will be deemed to have exercised rights received from a corporation to acquire stock or securities therein where there is an expression of assent to the terms of such rights made by the taxpayer in the manner requested or authorized by the corporation.

(g) The period for which the taxpayer has held a residence, the acquisition of which resulted under the provisions of section 1034 in the nonrecognition of any part of the gain realized on the sale or exchange of another residence, shall include the period for which such other residence had been held as of the date of such sale or exchange. See § 1.1034–1. For purposes of this paragraph, the term *sale or exchange* includes an involuntary conversion occurring after December 31, 1950, and before January 1, 1954.

(h) If a taxpayer accepts delivery of a commodity in satisfaction of a commodity futures contract, the holding period of the commodity shall include the period for which the taxpayer held the commodity futures contract, if such futures contract was a capital asset in his hands.

(i) If shares of stock in a corporation are sold from lots purchased at different dates or at different prices and the identity of the lots cannot be determined, the rules prescribed by the regulations under section 1012 for determining the cost or other basis of such stocks so sold or transferred shall also apply for the purpose of determining the holding period of such stock.

(j) In the case of a person acquiring property, or to whom property passed, from a decedent (within the meaning of section 1014(b)) dying after December 31, 1970, such person shall be considered to have held the property for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) if the property:

(1) Has a basis in the hands of such person which is determined in whole or in part under section 1014, and

(2) Is sold or otherwise disposed of by such person within 6 months after the decedent's death.

The provisions of this paragraph apply to sales of such property included in the decedent's gross estate for the purposes of the estate tax by the executor or administrator of the estate and to sales of such property by other persons who have acquired property from the decedent. The provisions of this paragraph may also be applicable to cases involving joint tenancies, community property, and properties transferred in contemplation of death. Thus, if a surviving joint tenant, who acquired property by right of survivorship, sells or otherwise disposes of such property within 6 months after the date of the decedent's death, and the basis of the property in his hands is determined in whole or in part under section 1014, the property shall be considered to have been held by the surviving joint tenant for more than 6 months. Similarly, a surviving spouse's share of community property shall be considered to have been held by her for more than 6 months if it is sold or otherwise disposed of within 6 months after the date of the decedent's death, regardless of when the property was actually acquired by the marital community. For the purposes of this paragraph, it is immaterial that the sale or other disposition produces gain or loss. If property is considered to have been held for more than 6 months by reason of this paragraph, it also is considered to have been held for that period for purposes of section 1231 (if that section is otherwise applicable).

(k) Any reference in section 1223 or this section to another provision of the Internal Revenue Code of 1954 is, where applicable, to be deemed a reference to the corresponding provision of the Internal Revenue Code of 1939, or prior internal revenue laws. The provisions of prior internal revenue laws here intended are the sections referred to in the sections of the Internal Revenue Code of 1939 which correspond to the sections of the Internal Revenue Code of 1954 referred to in section 1223. Thus, the sections corresponding to section 1081(c) are section 371(c) of the Revenue Act of 1938 (52 Stat. 553) and section 371(c) of the Internal Revenue Code of 1939. The sections corresponding to section 1091 are section 118 of each of the following: The Revenue Acts of 1928 (45 Stat. 826), 1932 (47 Stat. 208), 1934 (48 Stat. 715), 1936 (49 Stat. 1692), 1938 (52 Stat. 503), and the Internal Revenue Code of 1939.

[T.D. 6500, 25 FR 12005, Nov. 26, 1960, as amended by T.D. 7238, 37 FR 28717, Dec. 29, 1972; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

Special Rules for Determining Capital Gains and Losses

§ 1.1231–1 Gains and losses from the sale or exchange of certain property used in the trade or business.

(a) *In general.* Section 1231 provides that, subject to the provisions of paragraph (e) of this section, a taxpayer's gains and losses from the disposition (including involuntary conversion) of assets described in that section as *property used in the trade or business* and from the involuntary conversion of capital assets held for more than 6 months shall be treated as long-term capital gains and losses if the total gains exceed the total losses. If the total gains do not exceed the total losses, all such gains and losses are treated as ordinary gains and losses. Therefore, if the taxpayer has no gains subject to section 1231, a recognized loss from the condemnation (or from a sale or exchange under threat of condemnation) of even a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) is an ordinary loss. Capital assets subject to section 1231 treatment include only capital assets involuntarily converted. The noncapital assets subject to section 1231 treatment are (1) depreciable business property and business real property held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) other than stock in trade and certain copyrights and artistic property and, in the case of sales and other dispositions occurring after July 25, 1969, other than a letter, memorandum, or property similar to a letter or memorandum; (2) timber, coal, and iron ore which do not otherwise meet the requirements of section 1231 but with respect to which section 631 applies; and (3) certain livestock and unharvested crops. See paragraph (c) of this section.

(b) *Treatment of gains and losses.* For the purpose of applying section 1231, a taxpayer must aggregate his recognized gains and losses from:

(1) The sale, exchange, or involuntary conversion of property used in the trade or business (as defined in section 1231(b)), and

(2) The involuntary conversion (but not sale or exchange) of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

If the gains to which section 1231 applies exceed the losses to which the section applies, the gains and losses are treated as long-term capital gains and losses and are subject to the provisions of parts I and II (section 1201 and following), subchapter P, chapter 1 of the Code, relating to capital gains and losses. If the gains to which section 1231 applies do not exceed the losses to which the section applies, the gains and losses are treated as ordinary gains and losses. Therefore, in the latter case, a loss from the involuntary conversion of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) is treated as an ordinary loss and is not subject to the limitation on capital losses in section 1211. The phrase *involuntary conversion* is defined in paragraph (e) of this section.

(c) *Transactions to which section applies.* Section 1231 applies to recognized gains and losses from the following:

(1) The sale, exchange, or involuntary conversion of property held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and used in the taxpayer's trade or business, which is either real property or is of a character subject to the allowance for depreciation under section 167 (even though fully depreciated), and which is not:

(i) Property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of business;

(ii) A copyright, a literary, musical, or artistic composition, or similar property, or (in the case of sales and other dispositions occurring after July 25, 1969) a letter, memorandum, or property similar to a letter or memorandum, held by a taxpayer described in section 1221(3); or

(iii) Livestock held for draft, breeding, dairy, or sporting purposes, except to the extent included under paragraph (4) of this paragraph, or poultry.

(2) The involuntary conversion of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(3) The cutting or disposal of timber, or the disposal of coal or iron ore, to the extent considered arising from a sale or exchange by reason of the provisions of section 631 and the regulations thereunder.

(4) The sale, exchange, or involuntary conversion of livestock if the requirements of §1.1231–2 are met.

(5) The sale, exchange, or involuntary conversion of unharvested crops on land which is (i) used in the taxpayer's trade or business and held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), and (ii) sold or exchanged at the same time and to the same person. See paragraph (f) of this section.

For purposes of section 1231, the phrase *property used in the trade or business* means property described in this paragraph (other than property described in subparagraph (2) of this paragraph). Notwithstanding any of the provisions of this paragraph, section 1231(a) does not apply to gains and losses under the circumstances described in paragraph (e) (2) or (3) of this section.

(d) *Extent to which gains and losses are taken into account.* All gains and losses to which section 1231 applies must be taken into account in determining whether and to what extent the gains exceed the losses. For the purpose of this computation, the provisions of section 1211 limiting the deduction of capital losses do not apply, and no losses are excluded by that section. With that exception, gains are included in the computations under section 1231 only to the extent that they are taken into account in computing gross income, and losses are included only to the extent that they are taken into account in computing taxable income. The following are examples of gains and losses not included in the computations under section 1231:

(1) Losses of a personal nature which are not deductible by reason of section 165 (c) or (d), such as losses from the sale of property held for personal use;

(2) Losses which are not deductible under section 267 (relating to losses with respect to transactions between related taxpayers) or section 1091 (relating to losses from wash sales);

(3) Gain on the sale of property (to which section 1231 applies) reported for any taxable year on the installment method under section 453, except to the extent the gain is to be reported under section 453 for the taxable year; and

(4) Gains and losses which are not recognized under section 1002, such as those to which sections 1031 through 1036, relating to common nontaxable exchanges, apply.

(e) *Involuntary conversion*—(1) *General rule.* For purposes of section 1231, the terms *compulsory or involuntary conversion* and *involuntary conversion* of property mean the conversion of proeprty into money or other property as a result of complete or partial destruction, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof. Losses upon the complete or partial destruction, theft, seizure, requisition, or condemnation of property are treated as losses upon an involuntary conversion whether or not there is a conversion of the property into other property or money and whether or not the property is uninsured, partially insured, or totally insured. For example, if a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), with an adjusted basis of $400, but not held for the production of income, is stolen, and the loss which is sustained in the taxable year 1956 is not compensated for by insurance or otherwise, section 1231 applies to the $400 loss. For certain exceptions to this subparagraph, see subparagraphs (2) and (3) of this paragraph.

(2) *Certain uninsured losses.* Notwithstanding the provisions of subparagraph (1) of this paragraph, losses sustained during a taxable year beginning after December 31, 1957, and before January 1, 1970, with respect to both property used in the trade or business and any capital asset held for more than 6 months and held for the production of income, which losses arise from fire, storm, shipwreck, or other casualty, or from theft, and which are not compensated for by insurance in any amount, are not losses to which section 1231(a) applies. Such losses shall not be taken into account in applying the provisions of this section.

(3) *Exclusion of gains and losses from certain involuntary conversions.* Notwithstanding the provisions of subparagraph (1) of this paragraph, if for any taxable year beginning after December 31, 1969, the recognized losses from the involuntary conversion as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) exceed the recognized gains from the involuntary conversion of any such property as a result of fire, storm, shipwreck, or other casualty, or from theft, such gains and losses are not gains and losses to which section 1231 applies and shall not be taken into account in applying the provisions of this section. The net loss, in effect, will be treated as an ordinary loss. This subparagraph shall apply whether such property is uninsured, partially insured, or totally insured and, in the case of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), whether the property is property used in the trade or business, property

held for the production of income, or a personal asset.

(f) *Unharvested crops.* Section 1231 does not apply to a sale, exchange, or involuntary conversion of an unharvested crop if the taxpayer retains any right or option to reacquire the land the crop is on, directly or indirectly (other than a right customarily incident to a mortgage or other security transaction). The length of time for which the crop, as distinguished from the land, is held is immaterial. A leasehold or estate for years is not *land* for the purpose of section 1231.

(g) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. A, an individual, makes his income tax return on the calendar year basis. A's recognized gains and losses for 1957 of the kind described in section 1231 are as follows:

	Gains	*Losses*
1. Gain on sale of machinery, used in the business and subject to an allowance for depreciation, held for more than 6 months	$4,000	
2. Gain reported in 1957 (under section 453) on installment sale in 1956 of factory premises used in the business (including building and land, each held for more than 6 months)	6,000	
3. Gain reported in 1957 (under section 453) on installment sale in 1957 of land held for more than 6 months, used in the business as a storage lot for trucks	2,000	
4. Gain on proceeds from requisition by Government of boat, held for more than 6 months, used in the business and subject to an allowance for depreciation	500	
5. Loss upon the destruction by fire of warehouse, held for more than 6 months and used in the business (excess of adjusted basis of warehouse over compensation by insurance, etc.)		$3,000
6. Loss upon theft of unregistered bearer bonds, held for more than 6 months	....	5,000
7. Loss in storm of pleasure yacht, purchased in 1950 for $1,800 and having a fair market value of $1,000 at the time of the storm		1,000
8. Total gains	12,500	
9. Total losses		9,000
10. Excess of gains over losses	3,500	

Since the aggregate of the recognized gains ($12,500) exceeds the aggregate of the recognized losses ($9,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months. For any taxable year beginning after December 31, 1957, and before January 1, 1970, the $5,000 loss upon theft of bonds (item 6) would not be taken into account under section 1231. See paragraph (e)(2) of this section.

Example 2. If in example (1), A also had a loss of $4,000 from the sale under threat of condemnation of a capital asset acquired for profit and held for more than six months, then the gains ($12,500) would not exceed the losses ($9,000 plus $4,000, or $13,000). Neither the loss on that sale nor any of the other items set forth in example (1) would then be treated as gains and losses from the sale or exchanges of capital assets, but all of such items would be treated as ordinary gains and losses. Likewise, if A had no other gain or loss, the $4,000 loss would be treated as an ordinary loss.

Example 3. A's yacht, used for pleasure and acquired for that use in 1945 at a cost of $25,000, was requisitioned by the Government in 1957 for $15,000. A sustained no loss deductible under section 165(c) and since no loss with respect to the requisition is recognizable, the loss will not be included in the computations under section 1231.

Example 4. A, an individual, makes his income tax return on a calendar year basis. During 1970 trees on A's residential property which were planted in 1950 after the purchase of such property were destroyed by fire. The loss, which was in the amount of $2,000 after applying section 165(c)(3), was not compensated for by insurance or otherwise. During the same year A also recognized a $1,500 gain from insurance proceeds compensating him for the theft sustained in 1970 of a diamond brooch purchased in 1960 for personal use. A has no other gains or losses for 1970 from the involuntary conversion of property. Since the recognized losses exceed the recognized gains from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months, neither the gain nor the loss is included in making the computations under section 1231.

Example 5. The facts are the same as in example (4), except that A also recognized a gain of $1,000 from insurance proceeds compensating him for the total destruction by fire of a truck, held for more than 6 months, used in A's business and subject to an allowance for depreciation. A has no other gains or losses for 1970 from the involuntary conversion of property. Since the recognized losses ($2,000) do not exceed the recognized gains ($2,500) from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months, such gains and losses are included in making the computations under section 1231. Thus, if A has no other gains or losses for 1970 to which section 1231 applies, the gains and losses from these involuntary conversions are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months.

Example 6. The facts are the same as in example (5) except that A also has the following recognized gains and losses for 1970 to which section 1231 applies:

	Gains	*Losses*
Gain on sale of machinery, used in the business and subject to an allowance for depreciation, held for more than 6 months	$4,000	
Gain reported in 1970 (under section 453) on installment sale in 1969 of factory premises used in the business (including building and land, each held for more than 6 months)	6,000	
Gain reported in 1970 (under section 453) on installment sale in 1970 of land held for more than 6 months, used in the business as a storage lot for trucks	$2,000	
Loss upon the sale in 1970 of warehouse, used in the business and subject to an allowance for depreciation, held for more than 6 months		$5,000
Total gains	12,000	
Total losses		5,000

Since the aggregate of the recognized gains ($14,500) exceeds the aggregate of the recognized losses ($7,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months.

Example 7. B, an individual, makes his income tax return on the calendar year basis. During 1970 furniture used in his business and held for more than 6 months was destroyed by fire. The recognized loss, after compensation by insurance, was $2,000. During the same year B recognized a $1,000 gain upon the sale of a parcel of real estate used in his business and held for more than 6 months, and a $6,000 loss upon the sale of stock held for more than 6 months. B has no other gains or losses for 1970 from the involuntary conversion, or the sale or exchange of, property. The $6,000 loss upon the sale of stock is not a loss to which section 1231 applies since the stock is not property used in the trade or business, as defined in section 1231(b). The $2,000 loss upon the destruction of the furniture is not a loss to which section 1231 applies since the recognized losses ($2,000) exceed the recognized gains ($0) from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months. Accordingly, the $1,000 gain upon the sale of real estate is considered to be gain from the sale or exchange of a capital asset held for more than 6 months since the gains ($1,000) to which section 1231 applies exceed the losses ($0) to which such section applies.

Example 8. The facts are the same as in example (7) except that B also recognized a gain of $4,000 from insurance proceeds compensating him for the total destruction by fire of a freighter, held for more than 6 months, used in B's business and subject to an allowance for depreciation. Since the recognized losses ($2,000) do not exceed the recognized gains ($4,000) from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months, such gains and losses are included in making the computations under section 1231. Since the aggregate of the recognized gains to which section 1231 applies ($5,000) exceeds the aggregate of the recognized losses to which such section applies ($2,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months. The $6,000 loss upon the sale of stock is not taken into account in making such computation since it is not a loss to which section 1231 applies.

[T.D. 6500, 25 FR 12006, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9309, July 27, 1965; T.D. 7369, 40 FR 29841, July 16, 1975; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 7829, 47 FR 38515, Sept. 1, 1982]

§ 1.1231–2 Livestock held for draft, breeding, dairy, or sporting purposes.

(a)(1) In the case of cattle, horses, or other livestock acquired by the taxpayer after December 31, 1969, section 1231 applies to the sale, exchange, or involuntary conversion of such cattle, horses, or other livestock, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him:

(i) For 24 months or more from the date of acquisition in the case of cattle or horses, or

(ii) For 12 months or more from the date of acquisition in the case of such other livestock.

(2) In the case of livestock (including cattle or horses) acquired by the taxpayer on or before December 31, 1969,

section 1231 applies to the sale, exchange, or involuntary conversion of such livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition.

(3) For the purposes of section 1231, the term *livestock* is given a broad, rather than a narrow, interpretation and includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals. However, it does not include poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc.

(b)(1) Whether or not livestock is held by the taxpayer for draft, breeding, dairy, or sporting purposes depends upon all of the facts and circumstances in each case. The purpose for which the animal is held is ordinarily shown by the taxpayer's actual use of the animal. However, a draft, breeding, dairy, or sporting purpose may be present if an animal is disposed of within a reasonable time after its intended use for such purpose is prevented or made undesirable by reason of accident, disease, drought, unfitness of the animal for such purpose, or a similar factual circumstance. Under certain circumstances, an animal held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business may be considered as held for draft, breeding, dairy, or sporting purposes. However, an animal is not held by the taxpayer for draft, breeding, dairy, or sporting purposes merely because it is suitable for such purposes or merely because it is held by the taxpayer for sale to other persons for use by them for such purposes. Furthermore, an animal held by the taxpayer for other purposes is not considered as held for draft, breeding, dairy, or sporting purposes merely because of a negligible use of the animal for such purposes or merely because of the use of the animal for such purposes as an ordinary or necessary incident to the other purposes for which the animal is held. See paragraph (c) of this section for the rules to be used in determining when horses are held for racing purposes and, therefore, are considered as held for sporting purposes.

(2) The application of this paragraph is illustrated by the following examples:

Example 1. An animal intended by the taxpayer for use by him for breeding purposes is discovered to be sterile or unfit for the breeding purposes for which it was held, and is disposed of within a reasonable time thereafter. This animal is considered as held for breeding purposes.

Example 2. The taxpayer retires from the breeding or dairy business and sells his entire herd, including young animals which would have been used by him for breeding or dairy purposes if he had remained in business. These young animals are considered as held for breeding or dairy purposes. The same would be true with respect to young animals which would have been used by the taxpayer for breeding or dairy purposes but which are sold by him in reduction of his breeding or dairy herd, because of, for example, drought.

Example 3. A taxpayer in the business of raising hogs for slaughter customarily breeds sows to obtain a single litter to be raised by him for sale, and sells these brood sows after obtaining the litter. Even though these brood sows are held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business, they are considered as held for breeding purposes.

Example 4. A taxpayer in the business of raising horses for sale to others for use by them as draft horses uses them for draft purposes on his own farm in order to train them. This use is an ordinary or necessary incident to the purpose of selling the animals, and, accordingly, these horses are not considered as held for draft purposes.

Example 5. The taxpayer is in the business of raising registered cattle for sale to others for use by them as breeding cattle. It is the business practice of this particular taxpayer to breed the offspring of his herd which he is holding for sale to others prior to sale in order to establish their fitness for sale as registered breeding cattle. In such case, the taxpayer's breeding of such offspring is an ordinary and necessary incident to his holding them for the purpose of selling them as bred heifers or proven bulls and does not demonstrate that the taxpayer is holding them for breeding purposes. However, those cattle held by the taxpayer as additions or replacements to his own breeding herd to produce calves are considered to be held for breeding purposes, even though they may not actually have produced calves.

Example 6. A taxpayer, engaged in the business of buying cattle and fattening them for slaughter, purchased cows with calf. The calves were born while the cows were held by the taxpayer. These cows are not considered as held for breeding purposes.

(c)(1) For purposes of paragraph (b) of this section, a horse held for racing purposes shall be considered as held for sporting purposes. Whether a horse is held for racing purposes shall be determined in accordance with the following rules:

(i) A horse which has actually been raced at a public race track shall, except in rare and unusual circumstances, be considered as held for racing purposes.

(ii) A horse which has not been raced at a public track shall be considered as held for racing purposes if it has been trained to race and other facts and circumstances in the particular case also indicate that the horse was held for this purpose. For example, assume that the taxpayer maintains a written training record on all horses he keeps in training status, which shows that a particular horse does not meet objective standards (including, but not limited to, such considerations as failure to achieve predetermined standards of performance during training, or the existence of a physical or other defect) established by the taxpayer for determining the fitness and quality of horses to be retained in his racing stable. Under such circumstances, if the taxpayer disposes of the horse within a reasonable time after he determined that it did not meet his objective standards for retention, the horse shall be considered as held for racing purposes.

(iii) A horse which has neither been raced at a public track nor trained for racing shall not, except in rare and unusual circumstances, be considered as held for racing purposes.

(2) This paragraph may be illustrated by the following examples:

Example 1. The taxpayer breeds, raises, and trains horses for the purpose of racing. Every year he culls some horses from his racing stable. In 1971, the taxpayer decided that in order to prevent his racing stable from getting too large to be effectively operated he must cull six horses from it. All six of the horses culled by the taxpayer had been raced at public tracks in 1970. Under subparagraph (1)(i) of this paragraph, all these horses are considered as held for racing purposes.

Example 2. Assume the same facts as in example (1). Assume further that the taxpayer decided to cull four more horses from his racing stable in 1971. All these horses had been trained to race but had not been raced at public tracks. The taxpayer culled these four horses because the training log which the taxpayer maintains on all the horses he trains showed these horses to be unfit to remain in his racing stable. Horse A was culled because it developed shin splints during training. Horses B and C were culled because of poor temperament. B bolted every time a rider tried to mount it, and C became extremely nervous when it was placed in the starting gate. Horse D was culled because it did not qualify for retention under one of the objective standards the taxpayer had established for determining which horses to retain since it was unable to run a specified distance in a minimum time. These four horses were disposed of within a reasonable time after the taxpayer determined that they were unfit to remain in his stable. Under subparagraph (1)(ii) of this paragraph, all these horses are considered as held for racing purposes.

[T.D. 7141, 36 FR 18792, Sept. 22, 1971]

§ 1.1232–1 Bonds and other evidences of indebtedness; scope of section.

(a) *In general.* Section 1232 applies to any bond, debenture, note, or certificate or other evidence of indebtedness (referred to in this section and §§ 1.1232–2 through 1.1232–4 as an obligation) (1) which is a capital asset in the hands of the taxpayer, and (2) which is issued by any corporation, or by any government or political subdivision thereof. In general, section 1232(a)(1) provides that the retirement of an obligation, other than certain obligations issued before January 1, 1955, is considered to be an exchange and, therefore, is usually subject to capital gain or loss treatment. In general, section 1232(a)(2)(B) provides that in the case of a gain realized on the sale or exchange of certain obligations issued at a discount after December 31, 1954, which are either corporate bonds issued on or before May 27, 1969, or government bonds, the amount of gain equal to such discount or, under certain circumstances, the amount of gain equal to a specified portion of such discount, constitutes ordinary income. In the case of certain corporate obligations issued after May 27, 1969, in general, section 1232(a)(3) provides for the inclusion as interest in gross income of a ratable portion of original issue discount for each taxable year over the life of the obligation, section 1232(a)(3)(E) provides for an increase in basis equal to the original issue discount included in gross income, and section 1232(a)(2)(A) provides that any gain realized on such an obligation held more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) shall be considered gain from the sale or exchange of a capital asset held more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). For the requirements for reporting original issue discount on certain obligations issued after May 27, 1969, see section 6049(a) and the regulations thereunder. Section 1232(c) treats as ordinary income a portion of any gain realized upon the disposition of (i) coupon obligations which were acquired after August 16, 1954, and before January 1, 1958, without all coupons maturing more than 12 months after purchase attached, and (ii) coupon obligations which were acquired after December 31, 1957, without all coupons maturing after the date of purchase attached.

(b) *Requirement that obligations be capital assets.* In order for section 1232 to be applicable, an obligation must be a capital asset in the hands of the taxpayer. See section 1221 and the regulations thereunder. Obligations held by a dealer in securities (except as provided in section 1236) or obligations arising from the sale of inventory or personal services by the holder are not capital assets. However, obligations held by a financial institution, as defined in section 582(c) (relating to treatment of losses and gains on bonds of certain financial institutions) for investment and not primarily for sale to customers in the ordinary course of the financial institution's trade or business, are capital assets. Thus, with respect ot obligations held as capital assets by such a financial institution which are corporate obligations to which section 1232(a)(3) applies, there is ratable inclusion of original issue discount as interest in gross income under paragraph (a) of §1.1232–3A, and gain on a sale or exchange (including retirement) may be subject to ordinary income treatment under section 582(c) and paragraph (a)(1) of §1.1232–3.

(c) *Face-amount certificates*—(1) *In general.* For purposes of section 1232, this section and §§1.1232–2 through 1.1232–4, the term *other evidence of indebtedness* includes *face amount certificates* as defined in section 2(a)(15) and 4 of the Investment Company Act of 1940 (15 U.S.C. 80a–2 and 80a–4).

(2) *Amounts received in taxable years beginning prior to January 1, 1964.* Amounts received in taxable years beginning prior to January 1, 1964 under face amount certificates which were issued after December 31, 1954, are subject to the limitation on tax under section 72(e)(3). See paragraph (g) of §1.72–11 (relating to limit on tax attributable to receipt of a lump sum received as an annuity payment). However, section 72(e)(3) does not apply to any such amounts received in taxable years beginning after December 31, 1963.

(3) *Certificates issued after December 31, 1975.* In the case of a face-amount certificate issued after December 31, 1975 (other than such a certificate issued pursuant to a written commitment which was binding on such date and at all times thereafter), the provisions of section 1232(a)(3) (relating to the ratable inclusion of original issue discount in gross income) shall apply. See section 1232–3A(f). For treatment of any increase in basis under section 1232(a)(3)(A) as consideration paid for purposes of computing the investment in the contract under section 72, see §1.72–6(c)(4).

(d) *Certain deposits in financial institutions.* For purposes of section 1232, this section and §§1.1232–2 through 1.1232–4, the term *other evidence of indebtedness* includes certificates of deposit, time deposits, bonus plans, and other deposit arrangements with banks, domestic building and loan associations, and similar financial institutions. For application of section 1232 to such deposits, see paragraph (e) of §1.1232–3A. However, section 1232, this section, and §§1.1232–2 through 1.1232–4 shall not apply to such deposits made prior to January 1, 1971. For treatment of renewable certificates of deposit, see paragraph (e)(4) of §1.1232–3A.

[T.D. 7154, 36 FR 25000, Dec. 28, 1971, as amended by T.D. 7311, 39 FR 11880, Apr. 1, 1974; T.D. 7365, 40 FR 27936, July 2, 1975; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1232–2 Retirement.

Section 1232(a)(1) provides that any amount received by the holder upon the retirement of an obligation shall be considered as an amount received in exchange therefor. However, section 1232(a)(1) does not apply in the case of an obligation issued before January 1, 1955, which was not issued with interest coupons or in registered form on March 1, 1954. For treatment of gain on an obligation held by certain financial institutions, see section 582(c) and paragraph (a)(1)(iii) of § 1.1232–3.

[T.D. 7154, 36 FR 25000, Dec. 28, 1971]

§ 1.1232–3 Gain upon sale or exchange of obligations issued at a discount after December 31, 1954.

(a) *General rule; sale or exchange*—(1) *Obligations issued by a corporation after May 27, 1969*—(i) *General rule.* Under section 1232(a)(2)(A), in the case of gain realized upon the sale or exchange of an obligation issued at a discount by a corporation after May 27, 1969 (other than an obligation subject to the transitional rule of subparagraph (4) of this paragraph), and held by the taxpayer for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977):

(*a*) If at the time of original issue there was no intention to call the obligation before maturity, such gain shall be considered as long-term capital gain, or

(*b*) If at the time of original issue there was an intention to call the obligation before maturity, such gain shall be considered ordinary income to the extent it does not exceed the excess of:

(*1*) An amount equal to the entire *original issue discount,* over

(*2*) An amount equal to the entire *original issue discount* multiplied by a fraction the numerator of which is the sum of the number of complete months and any fractional part of a month elapsed since the date of original issue and the denominator of which is the number of complete months and any fractional part of a month from the date of original issue to the stated maturity date.

The balance, if any, of the gain shall be considered as long-term capital gain. The amount described in (*2*) of this subdivision (*b*) in effect reduces the amount of original issue discount to be treated as ordinary income under this subdivision (*b*) by the amounts previously includible (regardless of whether included) by all holders (computed, however, as to any holder without regard to any purchase allowance under paragraph (a)(2)(ii) of § 1.1232–3A and without regard to whether any holder purchased at a premium as defined in paragraph (d)(2) of § 1.1232–3).

(ii) *Cross references.* For definition of the terms *original issue discount* and *intention to call before maturity,* see paragraphs (b) (1) and (4) respectively of this section. For definition of the term *date of original issue,* see paragraph (b)(3) of this section. For computation of the number of complete months and any fractional portion of a month, see paragraph (a)(3) of § 1.1232–3A.

(iii) *Effect of section 582(c).* Gain shall not be considered to be long-term capital gain under subdivision (i) of this subparagraph if section 582(c) (relating to treatment of losses and gains on bonds of certain financial institutions) applies.

(2) *Examples.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. On January 1, 1970, A, a calendar-year taxpayer, purchases at original issue for cash of $7,600, M Corporation's 10-year, 5 percent bond which has a stated redemption price at maturity of $10,000. On January 1, 1972, A sells the bond to B, for $9,040. A has previously included $480 of the original issue discount in his gross income (see example (1) of paragraph (d) of § 1.1232–3A) and increased his basis in the bond by that amount to $8,080 (see paragraph (c) of § 1.1232–3A). Thus, if at the time of original issue there was no intention to call the bond before maturity, A's gain of $960 (amount realized, $9,040, less adjusted basis, $8,080) is considered long-term capital gain.

Example 2. (i) Assume the same facts as in example (1), except that at the time of original issue there was an intention to call the bond before maturity. The amount of the entire gain includible by A as ordinary income under subparagraph (1)(i) of this paragraph is determined as follows:

(1) Entire original issue discount (stated redemption price at maturity, $10,000, minus issue price, $7,600)	$2,400

(2) Less: Line (1), $2,400, multiplied by months elapsed since date of original issue, 24, divided by months from such date to stated maturity date, 120	$480
(3) Maximum amount includible by A as ordinary income	$1,920

Since the amount in line (3) is greater than A's gain, $960, A's entire gain is includible as ordinary income.

(ii) On January 1, 1979, B, a calendar-year taxpayer, sells the bond to C for $10,150. Assume that B has included $120 of original issue discount in his gross income for each taxable year he held the bond (see example (2) of paragraph (d) of §1.1232–3A) and therefore increased his basis by $840 (i.e., $120 each year×7 years) to $9,880. B's gain is therefore $270 (amount realized, $10,150, less basis, $9,880). The amount of such gain includible by B as ordinary income under subparagraph (1)(i) of this paragraph is determined as follows:

(1) Entire original issue discount (as determined in part (i) of this example)	$2,400
(2) Less: Line (1), $2,400, multiplied by months elapsed since date of original issue, 108, divided by months from such date to stated maturity date, 120	$2,160
(3) Maximum amount includible by B as ordinary income	$240

Since the amount in line (3) is less than B's gain, $270, only $240 of B's gain is includible as ordinary income. The remaining portion of B's gain, $30, is considered long-term capital gain.

(3) *Obligations issued by a corporation on or before May 27, 1969, and government obligations.* Under section 1232(a)(2)(B), if gain is realized on the sale or exchange after December 31, 1957, of an obligation held by the taxpayer more than 6 months, and if the obligation either was issued at a discount after December 31, 1954, and on or before May 27, 1969, by a corporation or was issued at a discount after December 31, 1954, by or on behalf of the United States or a foreign country, or a political subdivision of either, then such gain shall be considered ordinary income to the extent it does not exceed:

(i) An amount equal to the entire *original issue discount,* or

(ii) If at the time of original issue there was no intention to call the obligation before maturity, a portion of the *original issue discount* determined in accordance with paragraph (c) of this section,

And the balance, if any, of the gain shall be considered as long-term capital gain. For the definition of the terms *original issue discount* and *intention to call before maturity,* see paragraphs (b) (1) and (4) respectively of this section. See section 1037(b) and paragraph (b) of §1.1037–1 for special rules which are applicable in applying section 1232(a)(2)(B) and this subparagraph to gain realized on the disposition or redemption of obligations of the United States which were received from the United States in an exchange upon which gain or loss is not recognized because of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)).

(4) *Transitional rule.* Subparagraph (3) of this paragraph (in lieu of subparagraph (1) of this paragraph) shall apply to an obligation issued by a corporation pursuant to a written commitment which was binding on May 27, 1969, and at all times thereafter.

(5) *Obligations issued after December 31, 1954, and sold or exchanged before January 1, 1958.* Gain realized upon the sale or exchange before January 1, 1958, of an obligation issued at a discount after December 31, 1954, and held by the taxpayer for more than 6 months, shall be considered ordinary income to the extent it equals a specified portion of the *original issue discount,* and the balance, if any, of the gain shall be considered as long-term capital gain. The term *original issue discount* is defined in paragraph (b)(1) of this section. The computation of the amount of gain which constitutes ordinary income is illustrated in paragraph (c) of this section.

(6) *Obligations issued before January 1, 1955.* Whether gain representing original issue discount realized upon the sale or exchange of obligations issued at a discount before January 1, 1955, is capital gain or ordinary income shall be determined without reference to section 1232.

(b) *Definitions*—(1) *Original issue discount*—(i) *In general.* For purposes of section 1232, the term *original issue discount* means the difference between the issue price and the stated redemption price at maturity. The stated redemption price is determined without regard to optional call dates.

(ii) *De minimis rule.* If the original issue discount is less than one-fourth of 1 percent of the stated redemption price at maturity multiplied by the number of full years from the date of original issue to maturity, then the discount shall be considered to be zero. For example, a 10-year bond with a stated redemption price at maturity of $100 issued at $98 would be regarded as having an original issue discount of zero. Thus, any gain realized by the holder would be a long-term capital gain if the bond was a capital asset in the hands of the holder and held by him for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). However, if the bond were issued at $97.50 or less, the original issue discount would not be considered zero.

(iii) *Stated redemption price at maturity*—(*a*) Definition. Except as otherwise provided in this subdivision (iii), the term *stated redemption price at maturity* means the amount fixed by the last modification of the purchase agreement, including dividends, interest, and any other amounts, however designated, payable at that time. If any amount based on a fixed rate of simple or compound interest is actually payable or will be treated as constructively received under section 451 and the regulations thereunder either: (*1*) At fixed periodic intervals of one year or less during the entire term of an obligation, or (*2*) except as provided in subdivision (*e*) of this paragraph (b)(1)(iii), at maturity in the case of an obligation with a term of one year or less, any such amount payable at maturity shall not be included in determining the stated redemption price at maturity. For purposes of subdivision (*a*)(*2*) of this paragraph (b)(1)(iii), the term of an obligation shall include any renewal period with respect to which, under the terms of the obligation, the holder may either take action or refrain from taking action which would prevent the actual or constructive receipt of any interest on such obligation until the expiration of any such renewal period. To illustrate this paragraph (b)(1)(iii), assume that a note which promises to pay $1,000 at the end of three years provides for additional amounts labeled as interest to be paid at the rate of $50 at the end of the first year, $50 at the end of the second year, and $120 at the end of the third year. The stated redemption price at maturity will be $1,070 since only $50 of the $120 payable at the end of the third year is based on a fixed rate of simple or compound interest. If, however, the $120 were payable at the end of the second year, so that only $50 in addition to principal would be payable at the end of the third year, then under the rule for serial obligations contained in subparagraph (2)(iv)(*c*) of this paragraph, the $1,000 note is treated as consisting of two series. The first series is treated as maturing at the end of the second year at a stated redemption price of $70. The second series is treated as maturing at the end of the third year at a stated redemption price of $1,000. For the calculation of issue price and the allocation of original issue discount with respect to each such series, see example (3) of subparagraph (2)(iv)(*f*) of this paragraph.

(*b*) *Special rules.* In the case of face -amount certificates, the redemption price at maturity is the price as modified through changes such as extensions of the purchase agreement and includes any dividends which are payable at maturity. In the case of an obligation issued as part of an investment unit consisting of such obligation and an option (which is not excluded by (*c*) of this subdivision (iii)), security, or other property, the term *stated redemption price at maturity* means the amount payable on maturity in respect of the obligation, and does not include any amount payable in respect of the option, security, or other property under a repurchase agreement or option to buy or sell the option, security, or other property. For application of this subdivision to certain deposits in financial institutions, see paragraph (e) of § 1.1232–3A.

(*c*) *Excluded option*. An option is excluded by this subdivision (c) if it is an option to which paragraph (a) of § 1.61–15 applies or if it is an option, referred to in paragraph (a) of § 1.83–7, granted in connection with performance of services to which section 421 does not apply.

(*d*) *Obligation issued in installments.* If an obligation is issued by a corporation under terms whereby the holder makes installment payments, then the stated redemption price for each installment payment shall be computed in a manner consistent with the rules contained in subparagraph (2)(iv) of this paragraph for computing the issue price for each series of a serial obligation. For application of this subdivision (*d*) to certain open account deposit arrangements, see examples (1) and (2) of paragraph (e)(5)(ii) of §1.1232–3A.

(*e*) *Application of definition.* Subdivision (*a*)(*2*) of this paragraph (b)(1)(iii) shall not apply:

(*1*) For taxable years beginning before September 19, 1979, if for the issuer's last taxable year beginning before September 19, 1978, the rules of §1.163–4 were properly applied by the issuer, or

(*2*) In the case of an obligation with a term of six months or less held by a nonresident alien individual or foreign corporation, but only for purposes of the appliction of sections 871 and 881.

(iv) *Carryover of original issue discount.* If in pursuance of a plan of reorganization an obligation is received in an exchange for another obligation, and if gain or loss is not recognized in whole or in part on such exchange of obligations by reason, for example, of section 354 or 356, then the obligation received shall be considered to have the same original issue discount as the obligation surrendered reduced by the amount of gain (if any) recognized as ordinary income upon such exchange of obligations, and by the amount of original issue discount with respect to the obligation surrendered which was included as interest income under the ratable inclusion rules of sections 1232(a)(3) and 1.1232–3A. If inclusion as interest of the ratable monthly portion of original issue discount is required under section 1232(a)(3) with respect to the obligation received, see paragraph (a)(2)(iii) of §1.1232–3A for computation of the ratable monthly portion of original issue discount. For special rules in connection with certain exchanges of U.S. obligations, see section 1037.

(2) *Issue price defined*—(i) *In general.* The term *issue price* in the case of obligations registered with the Securities and Exchange Commission means the initial offering price to the public at which price a substantial amount of such obligations were sold. For this purpose, the term *the public* does not include bond houses and brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers. Ordinarily, the issue price will be the first price at which the obligations were sold to the public, and the issue price will not change if, due to market developments, part of the issue must be sold at a different price. When obligations are privately placed, the issue price of each obligation is the price paid by the first buyer of the particular obligation, irrespective of the issue price of the remainder of the issue. In the case of an obligation issued by a foreign obligor, the issue price shall be increased by the amount, if any, of interest equalization tax paid under section 4911 (and not credited, refunded, or reimbursed) on the acquisition of the obligation by the first buyer. In the case of an obligation which is convertible into stock or another obligation, the issue price includes any amount paid in respect of the conversion privilege. However, in the case of an obligation issued as part of an investment unit (as defined in subdivision (ii)(*a*) of this subparagraph), the issue price of the obligation includes only that portion of the initial offering price or price paid by the first buyer properly allocable to the obligation under the rules prescribed in subdivision (ii) of this subparagraph. The terms *initial offering price* and *price paid by the first buyer* include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof. Thus, all amounts paid by the purchaser under the purchase agreement or a modification of it are included in the issue price (but in the case of an obligation issued as part of an investment unit, only to the extent allocable to such obligation under subdivision (ii) of this subparagraph), such as amounts paid upon face-amount certificates or installment trust certificates in which the purchaser contracts to make a series of payments which will be returnable to the holder with an increment at a later date.

(ii) *Investment units consisting of obligations and property—(a) In general.* An investment unit, within the meaning of this subdivision (ii) and for purposes of section 1232, consists of an obligation and an option, security, or other property. For purposes of this subparagraph, the initial offering price of an investment unit shall be allocated to the individual elements of the unit on the basis of their respective fair market values. However, if the fair market value of the option, security, or other property is not readily ascertainable (within the meaning of paragraph (c) of § 1.421–6), then the portion of the initial offering price or price paid by the first buyer of the unit which is allocable to the obligation issued as part of such unit shall be ascertained as of the time of acquisition of such unit by reference to the assumed price at which such obligation would have been issued had it been issued apart from such unit. The assumed price of the obligation shall be ascertained by comparison to the yields at which obligations of a similar character which are not issued as part of an investment unit are sold in arm's length transactions, and by adjusting the price of the obligation in question to this yield. The adjustment may be made by subtracting from the face amount of the obligation the total present value of the interest foregone by the purchaser as a result of purchasing the obligation at a lower yield as part of an investment unit. In most cases, assumed price may also be determined in a similar manner through the use of standard bond tables. Any reasonable method may be used in selecting an obligation for comparative purposes. Obligations of the same grade and classification shall be used to the extent possible, and proper regard shall be given, with respect to both the obligation in question and the comparative obligation, to the solvency of the issuer, the nature of the issuer's trade or business, the presence and nature of security for the obligation, the geographic area in which the loan is made, and all other factors relevant to the circumstances. An obligation which is convertible into stock or another obligation must not be used as a comparative obligation (except where the investment unit contains an obligation convertible into stock or another obligation), since such an obligation would not reflect the yield attributable solely to the obligation element of the investment unit.

(*b*) *Agreement as to assumed price.* In the case of an investment unit which is privately placed, the assumed price at which the obligation would have been issued had it been issued apart from such unit may be agreed to by the issuer and the original purchaser of the investment unit in writing on or before the date of purchase. Alternatively, an agreement between the issuer and original purchaser may specify the rate of interest which would have been paid on the obligation if the transaction were one not involving the issuance of options, and an assumed issue price may be determined (in the manner described in (*a*) of this subdivision) from such agreed assumed rate of interest. An assumed price based upon such an agreement between the parties will generally be presumed to be the issue price of the obligation with respect to the issuer, original purchaser, and all subsequent holders: *Provided,* That the agreement was made in arm's length negotiations between parties having adverse interests: *And, provided further,* That such price does not, under the rules stated in (*a*) of this subdivision, appear to be clearly erroneous. An assumed issue price agreed to by the parties as provided herein will not be considered clearly erroneous if it is not less than the face value adjusted (in the manner described in (*a*) of this subdivision) to a yield which is one percentage point greater than the actual rate of interest payable on the obligation. Similarly, if the agreement between the parties specifies an agreed assumed rate of interest (in lieu of an agreed assumed issue price) and such agreed rate is not more than 1 percentage point greater than the actual rate payable on the obligation, an adjusted issue price based upon such agreed assumed rate of interest will not be considered clearly erroneous.

(*c*) *Cross references.* For rules relating to the deductibility by the issuing corporation of bond discount resulting from an allocation under the rule stated in (*a*) of this subdivision, see §§ 1.163–3 and 1.163–4. For rules relating to the basis of obligations and options, securities, or other property acquired in investment units, see § 1.1012–1(d). For rules relating to certain reporting requirements with respect to options acquired in connection with evidences of indebtedness and for the tax treatment of such options, see § 1.61–15, and section 1234 and the regulations thereunder. With respect to the tax consequences to the issuing corporation upon the exercise of options issued in connection with evidences of indebtedness to which this section applies, see section 1032 and the regulations thereunder.

(*d*) *Examples.* The application of the principles set forth in this subdivision (ii) may be illustrated by the following examples in each of which it is assumed that there was no intention to call the note before maturity:

Example 1. M Corporation is a small manufacturer of electronic components located in the southwestern United States. On January 1, 1969, in consideration for the payment of $41,500, M issues to X its unsecured note for $40,000 together with warrants to purchase 3,000 shares of M stock at $10 per share at any time during the term of the note. The note is payable in 4 years and provides for interest at the rate of 5 percent per year, payable semiannually. The fair market values of the note and the warrants are not readily ascertainable. Assume that companies in the same industry as M Corporation, and similarly situated both financially and geographically, are generally able to borrow money on their unsecured notes at an annual interest rate of 6 percent. Using a present value table, the calculation of the issue price of a 5 percent, 4 year, $40,000 note, discounted to yield 6 percent compounded semiannually is made as follows:

(1)	(2)	(3)	(2)×(3)
Semiannual interest period	Amount payable at 5 percent	Factor for present value discounted at 3 percent per period	Present value of payment
1	$1,000	0.9709	$970.90
2	1,000	.9426	942.60
3	1,000	.9151	915.10
4	1,000	.8885	888.50
5	1,000	.8626	862.60
6	1,000	.8375	837.50
7	1,000	.8131	813.10
8	1,000	.7894	789.40
8	40,000	.7804	31,576.00
Total present value of note discounted at 6 percent, compounded semiannually			38,595.70

The same result may be reached through the use of a standard bond table or by the following present value calculation:

Present value of annuity of $1,000 payable over 8 periods at 3 percent per period=1000×7.0197=	$7,019.70
Add: Present value of principal (as calculated above)	31,576.00
Total	$38,595.70

Accordingly, the assumed price at which M's note would have been issued had it been issued without stock purchase warrants, i.e., that portion of the $41,500 price paid by X which is allocable to M's note, is $38,596 (rounded). Since the price payable on redemption of M's note at maturity is $40,000, the original issue discount on M's note is $1,404 ($40,000 minus $38,596). Under the rules stated in § 1.163–3, M is entitled to a deduction, to be prorated or amortized over the life of the note, equal to this original issue discount on the note. The excess of the price for the unit over the portion of such price allocable to the note, $2,904 ($41,500 minus $38,596), is allocable to and is the basis of the stock purchase warrants acquired by X in connection with M's note. Upon the exercise of X's warrants, M will be allowed no deduction and will have no income. Upon maturity of the note X will receive $40,000 from M, of which $1,404, the amount of the original issue discount, will be taxable as ordinary income. If X were to transfer the note at its face amount to A 2 years after the issue date, X would realize, under section 1232(a)(2)(B), ordinary income of $702 (one-half of $1,404).

Example 2. (1) On January 1, 1969, N Corporation negotiates with Y, a small business investment company, for a loan in the amount of $51,500 in consideration of which N Corporation issues to Y its unsecured 5-year note for $50,000, together with warrants to purchase 2,000 shares of N stock at $5 per share at any time during the term of the note. The note provides for interest of 6 percent, payable semiannually. The fair market values of the note and warrants are not readily ascertainable. The loan agreement between Y and N contains a provision, agreed to in arms-length bargaining between the parties, that a rate of 7 percent payable semiannually would have been applied to the loan if warrants were not issued as part of the consideration for the loan. The issue price of the note is $47,921 (rounded), determined with the use of a standard bond table, or computed in the manner illustrated in Example 1 or in the following alternative manner:

(1)	(2)	(3)	(4)	(5)	(4)×(5)
Interest period	Interest rate differential	Principal	Interest foregone for period (½%)	Factor for present value discounted at 3½ percent per period	Present value of interest foregone
1	1%(7%-6%)	$50,000	250	0.9662	$241.53
2	1%	50,000	250	.9335	233.38
3	1%	50,000	250	.9019	225.48
4	1%	50,000	250	.8714	217.85
5	1%	50,000	250	.8420	210.50
6	1%	50,000	250	.8135	203.38
7	1%	50,000	250	.7860	196.50
8	1%	50,000	250	.7594	189.85
9	1%	50,000	250	.7337	183.43
10	1%	50,000	250	.7089	177.25
Total present value of interest foregone					$2,079.15
Principal					50,000.00
Less: Total present value of interest foregone					2,079.15
Issue price					47,920.85

The calculation of present value of interest foregone may also be made as follows:

Present value of annuity of $250 discounted for 10 periods at 3½ percent per period=$250×8.3166=$2,079.15.

The total present value of interest foregone, $2,079, is also the original issue discount attributable to the note ($50,000 − $47,921). Under (*b*) of this subdivision, since the agreed assumed rate of interest of 7 percent is not more than 1 percentage point greater than the actual rate payable on the note, determination of the issue price of the note (and original issue discount) based upon such assumed rate will be presumed to be correct and will not be considered clearly erroneous, provided that both N and Y adhere to such determination. Under the rules in § 1.163–3, N is entitled to a deduction, to be prorated or amortized over the life of the note, equal to the original issue discount on the note. The excess of the price paid for the unit over the portion of such price allocable to the note, $3,579 ($51,500 − $47,921) is allocable to and is the basis of the stock purchase warrants acquired by Y in connection with N's note. Upon the exercise or sale of the warrants by Y, N will be allowed no deduction and will have no income. Upon maturity of the note Y will receive $50,000 from N, of which $2,079, the amount of the original issue discount, will be taxable as ordinary income. If Y were to transfer the note at its face value to B 2½ years after the issue date, Y would realize, under section 1232(a)(2)(B), ordinary income of $1,039.50 (one-half of $2,079).

(2) Assume that instead of the parties agreeing on an assumed interest rate at which the obligation would have been issued without the warrants, the parties agreed that the obligation at the actual 6 percent rate would have been issued without the warrants at a discounted price of $48,000. In this situation the agreed assumed issue price is presumed to be correct since it is not less than the face value adjusted (in the manner illustrated in part (*1*) of this example) to a yield which is one percentage point greater than the actual rate of interest payable on the obligation ($47,921).

Example 3. O Corporation is a small advertising company located in the northeastern United States. Z is a tax-exempt organization. In consideration for the payment of $60,000, O issues to Z, in a transaction not within the scope of section 503(b), its unsecured 5-year note for $60,000, together with warrants to purchase 6,000 shares of O stock at $10 per share at any time during the term of the note. The note is subject to quarterly amortization at the rate of $3,000 per quarter, and provides for interest on the outstanding unpaid balance at an annual rate of 6 percent payable quarterly (1½ percent per quarter). The fair market values of the notes and warrants are not readily ascertainable. The loan agreement between O and Z contains a recital that if the $60,000 note had been issued without the warrants only $45,000 would have been paid for it. An examination of relevant facts indicates that companies in the same industry as O Corporation, and similarly situated both financially and geographically, are able to borrow money on their unsecured notes at an annual interest cost of 8½ percent payable quarterly (2⅛ percent per quarter). By reference to a present value table, it is found that the present value of O's note discounted to yield 8½ percent compounded quarterly is $56,608 (rounded). The computation is as follows:

(1)	(2)	(3)	(4)	(5)	(6)
Quarterly interest period	Principal payable	Interest payable (1½ percent)	Total amount payable (2)+(3)	Factor for present value discounted at 2⅛ percent per quarter	Present value of total payment (4)×(5)
1	$3,000	$900	$3,900	0.9792	$3,818.88
2	3,000	855	3,855	.9588	3,696.17
3	3,000	810	3,810	.9389	3,577.21
4	3,000	765	3,765	.9193	3,461.16
5	3,000	720	3,720	.9002	3,348.74
6	3,000	675	3,675	.8815	3,239.51
7	3,000	630	3,630	.8631	3,133.05
8	3,000	585	3,585	.8452	3,030.04
9	3,000	540	3,540	.8276	2,929.70
10	3,000	495	3,495	.8104	2,832.35
11	3,000	450	3,450	.7935	2,737.58
12	3,000	405	3,405	.7770	2,645.69
13	3,000	360	3,360	.7608	2,556.29
14	3,000	315	3,315	.7450	2,469.68
15	3,000	270	3,270	.7295	2,385.47
16	3,000	225	3,225	.7143	2,303.62
17	3,000	180	3,180	.6994	2,224.09
18	3,000	135	3,135	.6849	2,147.16
19	3,000	90	3,090	.6706	2,072.15
20	3,000	45	3,045	.6567	1,999.65
Total					56,608.19

This amount ($56,608) is the assumed price at which the note would have been issued had it been issued without stock purchase warrants. The assumed price of $45,000 agreed to by the parties is not presumed to be correct since it is less than the face value adjusted to a yield which is one percentage point greater than the actual rate of interest payable on the obligation. The parties did not have adverse interests in agreeing upon an assumed price (since an excessively large amount of original issue discount would benefit O, the borrower, without adversely affecting Z, an exempt organization which would pay no tax on original issue discount income), and the price agreed to appears to be clearly erroneous when compared to the $56,608 assumed issue price determined under the principles of (*a*) of this subdivision. Since the maturity value of O's note is $60,000, the original issue discount on O's note is $3,392 ($60,000 minus $56,608). Under the rules in §1.163–3, O is entitled to a deduction, to be prorated or amortized over the life of the note, equal to this original issue discount on the note. The excess of the price paid for the unit over the portion of such price allocable to the note, $3,392 ($60,000 minus $56,608), is allocable to and is the basis of the stock purchase warrants acquired by Z in connection with O's note. Upon the exercise or sale of the warrants by Z, O will be allowed no deduction and will have no income.

(iii) *Issuance for property after May 27, 1969*—(*a*) *In general.* Except as provided in (*b*) of this subdivision, if an obligation or an investment unit is issued for property other than money, the issue price of such obligation shall be the stated redemption price at maturity and, therefore, no original issue discount is created as a result of the exchange. However, in such case, there may be an amount treated as interest under section 483. In the case of certain exchanges of obligations of the United States for other such obligations, see section 1037 for the determination of the amount of original issue discount on the obligation acquired in the exchange. For carryover of original issue discount in the case of certain exchanges of obligations, see subparagraph (1)(iv) of this paragraph.

(*b*) *Exceptions for original issue discount.* If an obligation or investment unit is issued for property in an exchange which is not pursuant to a plan of reorganization referred to in (*d*) of this subdivision, and if:

(*1*) The obligation, investment unit, or an element of the investment unit is part of an issue a portion of which is traded on an established securities market, or

(*2*) The property for which such obligation or investment unit is issued is stock or securities which are traded on an established securities market, then the issue price of the obligation or investment unit shall be the fair market value of the property for which such obligation or investment unit is issued, as determined under (*c*) of this subdivision. Such issue price shall control for purposes of determining the amount realized by the person exchanging the property for the obligation or unit issued and the bases of the property acquired by the holder and issuer.

An obligation which is not traded on an established securities market and which is not part of an issue or investment unit a portion of which is so traded shall not be treated as property described in (*1*) of this (*b*) even though the obligation is convertible into property so traded. For purposes of this (*b*), an obligation, investment unit, or element of an investment unit shall be treated as traded on an established securities market if it is so traded on or within 10 *trading* days after the date it is issued. *Trading* days shall mean those days on which an established securities market is open. For purposes of this subdivision (iii), the term *established securities market* shall have the same meaning as in paragraph (d)(4) of § 1.453–3 (relating to limitations on installment method for purchaser evidences of indebtedness payable on demand or readily tradable).

(*c*) *Determination of fair market value in cases to which (b) of this subdivision applies.* In general, for purposes of (*b*) of this subdivision, the fair market value of property for which an obligation or investment unit is issued shall be deemed to be the same as the fair market value of such obligation or investment unit, determined by reference to the fair market value of that portion of the issue, of which such obligation or unit is a part, which is traded on an established securities market. The fair market value of such obligation or unit shall be determined as of the first date after the date of issue (within the meaning of section 1232(b)(3)) that such obligation or unit is traded on an established securities market. If, however, the obligation or investment unit is not part of an issue a portion of which is traded on an established securities market, but the property for which the obligation or investment unit is issued is stock or securities which are traded on an established securities market, the fair market value of such property shall be the fair market value of such stock or securities on the date such obligation or unit is issued for such property. The fair market value of property for purposes of this (*c*) shall be determined as provided in § 20.2031–2 of this chapter (Estate Tax Regulations) but without applying the blockage and other special rules contained in paragraph (e) thereof.

(*d*) *Not in reorganization.* An exchange which is not pursuant to a reorganization referred to in this subdivision (*d*) is an exchange in which the obligation or investment unit is not issued pursuant to a plan of reorganization within the meaning of section 368(a)(1) or pursuant to an insolvency reorganization within the meaning of section 371, 373, or 374. Thus, for example, no original issue discount is created on an obligation issued in a recapitalization within the meaning of section 368(a)(1)(E). Similarly, no original issue discount is created on an obligation issued in an exchange, pursuant to a plan of reorganization, to which section 361 applies regardless of the income tax consequences to any person who pursuant to such plan is the ultimate recipient of the obligation. The application of section 351 shall not preclude the creation of original issue discount. For carryover of original issue discount in the case of an exchange of obligations pursuant to a plan of reorganization, see subparagraph (1)(iv) of this paragraph.

(*e*) *Effective date.* Determinations with respect to obligations issued on or before May 27, 1969, or pursuant to a written commitment which was binding on that date and at all times thereafter, shall be made without regard to this subdivision (iii).

(iv) *Serial obligations—(a) In general.* If an issue of obligations which matures serially is issued by a corporation, and if on the basis of the facts and circumstances in such case an independent issue price for each particular maturity can be established, then the obligations with each particular maturity shall be considered a separate series, and the obligations of each such series shall be treated as a separate issue with a separate issue price, maturity date, and stated redemption price at maturity. The ratable monthly portion of original issue discount attributable to each obligation within a particular series shall be determined and ratably included as interest in gross income under the rules of §1.1232–3A.

(*b*) *Issue price not independently established.* If a separate issue price cannot be established with respect to each series of an issue of obligations which matures serially, the issue price for each obligation of each series shall be its stated redemption price at maturity minus the amount of original issue discount allocated thereto in accordance with (*d*) of this subdivision. The amount of original issue discount so allocated shall be ratably included as interest in gross income under rules of §1.1232–3A.

(*c*) *Single obligation rule.* If a single corporate obligation provides for payments (other than payments which would not be included in the stated redemption price at maturity under subparagraph (1)(iii) of this paragraph) in two or more installments, the provisions of (*b*) of this subdivision shall be applied by treating such obligation as an issue of obligations consisting of more than one series each of which matures on the due date of each such installment payment.

(*d*) *Allocation of discount.* For purposes of (*b*) and (*c*) of this subdivision, the original issue discount with respect to each series of an issue shall be the total original issue discount for the issue multiplied by a fraction:

(*1*) The numerator of which is the product of (*i*) the stated redemption price of such series and (*ii*) the number of complete years (and any fraction thereof) constituting the period for such series from the date of original issue (as defined in paragraph (b)(3) of this section) to its stated maturity date, and

(*2*) The denominator of which is the sum of the products determined in (*1*) of this subdivision (*d*) with respect to each such series.

If a series consists of more than one obligation, the original issue discount allocated to such series shall be apportioned to such obligations in proportion to the stated redemption price of each. Computations under this subdivision (*d*) may be made using periods other than years, such as, for example, months or periods of 3 months.

(*e*) *Effective date.* The provisions of this subdivision (iv) shall apply with respect to corporate obligations issued after July 22, 1971. However, no inference shall be drawn from the preceding sentence with respect to serial obligations issued prior to such date.

(*f*) *Examples.* The provisions of this subdivision (iv) may be illustrated by the following examples:

Example 1. On January 1, 1972, P Corporation issued a note with a total face value of $100,000 to B for cash of $94,000. The terms of the note provide that $50,000 is payable on December 31, 1973, and the other $50,000 on December 31, 1975. Each payment is treated as the stated redemption price of a series, and the total original issue discount with respect to the note, $6,000, is allocated to each such series as follows:

Year of maturity	1973	1975	Total
(1) Stated redemption price	$50,000	$50,000	
(2) Multiply by years outstanding	2	4	
(3) Product of bond years	$100,000	$200,000	
(4) Sum of products	....	....	$300,000
(5) Fractional portion of discount	$100,000	$200,000	
	$300,000	$300,000	
(6) Multiply line (5) by discount for entire issue	$6,000	$6,000	
(7) Discount for each series	$2,000	$4,000	
(8) Issue price (line (1), minus line (7))	$48,000	$46,000	

Example 2. Assume the same facts as in example (1) except that a separate note is issued for each payment. The result is the same as in example (1).

Example 3. On January 1, 1971, Y Bank, a corporation, issues a note to C for $1,000 cash. The terms of the note provide that $50 will be paid at the end of the first year, $120 at the end of the second year, and $1,050 at the end of the third year. Under (*c*) of this subdivision (iv), the $1,000 note is treated as consisting of two series, the first of which matures at the end of the second year, and the second of which matures at the end of the third year. The issue price and the allocation of original issue discount with respect to each series is computed as follows:

Year of maturity	1972	1973	Total
(1) Stated redemption price	$70	$1,000	
(2) Multiply by years outstanding	2	3	
(3) Product of bond years	$140	$3,000	
(4) Sum of products	....	....	$3,140
(5) Fractional portion of discount	$140 $3,140	$3,000 $3,140	
(6) Multiply line (5) by discount for entire issue	$70	$70	
(7) Discount for each series	$3.12	$66.88	
(8) Issue price (line 1 minus line (7))	$66.88	$933.12	

(3) *Date of original issue.* In the case of issues of obligations which are registered with the Securities and Exchange Commission, the term *date of original issue* means the date on which the issue was first sold to the public at the issue price. In the case of issues which are privately placed, the term *date of original issue* means the date on which each obligation was sold to the original purchaser.

(4) *Intention to call before maturity*—(i) *Meaning of term.* For purposes of section 1232, the term *intention to call the bond or other evidence of indebtedness before maturity* means an understanding between (*a*) the issuing corporation (such corporation is hereinafter referred to as the *issuer*), and (*b*) the original purchaser of such obligation (or, in the case of obligations constituting part of an issue, any of the original purchasers of such obligations) that the issuer will redeem the obligation before maturity. For purposes of this subparagraph, the term *original purchaser* does not include persons or organizations acting in the capacity of underwriters or dealers, who purchased the obligation for resale in the ordinary course of their trade or business. It is not necessary that the issuer's intention to call the obligation before maturity be communicated directly to the original purchaser by the issuer. The understanding to call before maturity need not be unconditional; it may, for example, be dependent upon the financial condition of the issuer on the proposed early call date.

(ii) *Proof of intent—(a) In general.* Ordinarily, the existence or nonexistance of an understanding at the time of original issue that the obligation will be redeemed before maturity shall be determined by an examination of all of the circumstances under which the obligation was issued and held. The fact that the obligation is issued with provisions on its face giving the issuer the privilege of redeeming the obligation before maturity is not determinative of an intention to call before maturity; likewise, the absence of such provision is not determinative of the absence of an intention to call before maturity. However, such provision, or the absence of such provision, is one of the circumstances to be given consideration along with other factors in determining whether an understanding existed. If the obligation was part of an issue registered with the Securities and Exchange Commission and was sold to the public (whether or not sold directly to the public by the obligor) without representation to the public that the obligor intends to call the obligation before maturity, there shall be a presumption that no intention to call the obligation before maturity was in existence at the time of original issue. The existence of a provision on the face of an obligation giving the issuer the privilege of redeeming the obligation before maturity shall not in and of itself overcome the presumption set forth in the preceding sentence.

(*b*) *Circumstances indicating absence of understanding.* Examples of circumstances which would be evidence that there was no understanding at the time of original issue to redeem the obligation before maturity are:

(*1*) The issue price and term of the obligation appear to be reasonable, taking into account the interest rate, if any, on the obligation, for a corporation in the financial condition of the issuer at the time of issue.

(*2*) The original purchaser and the issuer are not related within the meaning of section 267(b) and have not engaged in transactions with each other (other than concerning the obligation).

(*3*) The original purchaser is not related within the meaning of section 267(b) to any of the officers or directors of the issuer, and he has not engaged in transactions with such officers or directors (other than concerning the obligation).

(*4*) The officers and directors of the issuer at the time of issue of the obligation are different from those in control at the time the obligation is called or the taxpayer disposes of it.

(c) *Gain treated as ordinary income in certain cases; computation.* The amount of gain treated as ordinary income under paragraph (a) (3)(ii) or (5) of this section is computed by multiplying the original issue discount by a fraction, the numerator of which is the number of full months the obligation was held by the holder and the denominator of which is the number of full months from the date of original issue to the date specified as the redemption date at maturity. (See paragraph (b)(3) of this section for definition of *date of original issue.*) The period that the obligation was held by the taxpayer shall include any period that it was held by another person if, under chapter 1 of the Code, for the purpose of determining gain or loss from a sale or exchange, the obligation has the same basis, in whole or in part, in the hands of the taxpayer as it would have in the hands of such other person. This computation is illustrated by the following examples:

Example 1. An individual purchases a 10-year, 3-percent coupon bond for $900 on original issue on February 1, 1955, and sells it on February 20, 1960, for $940. The redemption price is $1,000. At the time of original issue, there was no intention to call the bond before maturity. The bond has been held by the taxpayer for 60 full months. (The additional days amounting to less than a full month are not taken into account.) The number of complete months from date of issue to date of maturity is 120 (10 years). The fraction $^{60}/_{120}$ multiplied by the discount of $100 is equal to $50, which represents the proportionate part of the original issue discount attributable to the period of ownership by the taxpayer. Accordingly, any part of the gain up to $50 will be treated as ordinary income. Therefore, in this case the entire gain of $40 is treated as ordinary income.

Example 2. Assume the same facts in the preceding example, except that the selling price of the bond is $970. In this case $50 of the gain of $70 is treated as ordinary income and the balance of $20 is treated as long-term capital gain.

Example 3. Assume the same facts as in example (1), except that the selling price of the bond is $800. In this case, the individual has a long-term capital loss of $100.

Example 4. Assume the same facts as in example (1), except that the bond is purchased by the second holder February 1, 1960, for $800. The second holder keeps it to the maturity date (February 1, 1965) when it is redeemed for $1,000. Since that holder has held the bond for 60 full months, he will, upon redemption, have $50 in ordinary income and $150 in long-term capital gain.

(d) *Exceptions to the general rule*—(1) *In general.* Section 1232(a)(2)(C) provides that section 1232(a)(2) does not apply (i) to obligations the interest on which is excluded from gross income under section 103 (relating to certain government obligations), or (ii) to any holder who purchases an obligation at a premium.

(2) *Premium.* For purposes of section 1232, this section, and §1.1232–3A, *premium* means a purchase price which exceeds the stated redemption price of an obligation at its maturity. For purposes of the preceding sentence, if an obligation is acquired as part of an investment unit consisting of an option, security, or other property and an obligation, the purchase price of the obligation is that portion of the price paid or payable for the unit which is allocable to the obligation. The price paid for the unit shall be allocated to the individual elements of the unit on the basis of their respective fair market values. However, if the fair market value of the option, security, or other property is not readily ascertainable (within the meaning of paragraph (c) of §1.421–6), then the price paid for the unit shall be allocated in accordance with the rules under paragraph (b)(2)(ii) of this section for allocating the initial offering price of an investment unit to its elements. If, under chapter 1 of the Code, the basis of an obligation in the hands of the holder is the same, in whole or in part, for the purposes of determining gain or loss from a sale or exchange, as the basis of the obligation in the hands of another person who purchased the obligation at a premium, then the holder shall be considered to have purchased the obligation at a premium. Thus, the donee of an obligation purchased at a premium by the doner will be considered a holder who purchased the obligation at a premium.

(e) *Amounts previously includible in income.* Nothing in section 1232(a)(2) shall require the inclusion of any amount previously includible in gross income. Thus, if an amount was previously includible in a taxpayer's income on account of obligations issued at a discount and redeemable for fixed amounts increasing at stated intervals, or, under section 818(b) (relating to accrual of discount on bonds and other evidences of indebtedness held by life insurance companies), such amount is not again includible in the taxpayer's gross income under section 1232(a)(2). For example, amounts includible in gross income by a cash receipts and disbursements method taxpayer who has made an election under section 454 (a) or (c) (relating to accounting rules for certain obligations issued at a discount to which section 1232(a)(3) does not apply) are not includible in gross income under section 1232(a)(2). In the case of a gain which would include, under section 1232(a)(2), an amount considered to be ordinary income and a further amount considered long-term capital gain, any amount to which this paragraph applies is first used to offset the amount considered ordinary income. For example, on January 1, 1955, A purchases a 10-year bond which is redeemable for fixed amounts increasing at stated intervals. At the time of original issue, there was no intention to call the bond before maturity. The purchase price of the bond is $75, which is also the issue price. The stated redemption price at maturity of the bond is $100. A elects to treat the annual increase in the redemption price of the bond as income pursuant to section 454(a). On January 1, 1960, A sells the bond for $90. The total stated increase in the redemption price of the bond which A has reported annually as income for the taxable years 1955 through 1959 is $7. The portion of the original issue discount of $25 attributable to this period is $12.50, computed as follows:

60 (months bond is held by A)/120 (months from date of original issue to redemption date)×$25 (original issue discount)

However, $7, which represents the annual stated increase taken into income, is offset against the amount of $12.50, leaving $5.50 of the gain from the sale to be treated as ordinary income.

(f) *Recordkeeping requirements.* In the case of any obligation held by a taxpayer which was issued at an original issue discount after December 31, 1954, the taxpayer shall keep a record of the issue price and issue date upon or with each obligation (if known to or reasonably ascertainable by him). If the obligation held by the taxpayer is an obligation of the United States received from the United States in an exchange upon which gain or loss is not recognized because of section 1037 (a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)), the taxpayer shall keep sufficient records to determine the issue price of such obligation for purposes of applying section 1037(b) and paragraphs (a) and (b) of § 1.1037–1 upon the disposition or redemption of such obligation. The issuer (or in the case of obligations first sold to the public through an underwriter or wholesaler, the underwriter or wholesaler) shall mark the issue price and issue date upon every obligation which is issued at an original issue discount after September 26, 1957, but only if the period between the date of original issue (as defined in paragraph (b)(3) of this section) and the stated maturity date is more than 6 months.

[T.D. 6500, 25 FR 12008, Nov. 26, 1960, as amended by T.D. 6984, 33 FR 19176, Dec. 21, 1968; T.D. 7154, 36 FR 25000, Dec. 28, 1971; 37 FR 527, Jan. 13, 1972; T.D. 7213, 37 FR 21992, Oct. 18, 1972; 37 FR 22863, Oct. 26, 1972; T.D. 7663, 44 FR 76782, Dec. 28, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1232–3A Inclusion as interest of original issue discount on certain obligations issued after May 27, 1969.

(a) *Ratable inclusion as interest*—(1) *General rule.* Under section 1232(a)(3), the holder of any obligation issued by a corporation after May 27, 1969 (other than an obligation issued by or on behalf of the United States or a foreign country, or a political subdivision of either) shall include as interest in his gross income an amount equal to the ratable monthly portion of original issue discount multiplied by the sum of the number of complete months and any fractional part of a month such holder held the obligation during the taxable year. For increase in basis for amounts included as interest in gross income pursuant to this paragraph, see paragraph (c) of this section. For requirements for reporting original issue discount, see section 6049(a) and the regulations thereunder.

(2) *Ratable monthly portion of original issue discount*—(i) *General rule.* Except when subdivision (ii) of this subparagraph applies, the term *ratable monthly portion of original issue discount* means an amount equal to the original issue discount divided by the sum of the number of complete months (plus any fractional part of a month) beginning on the date of original issue and ending the day before the stated maturity date of such obligation.

(ii) *Reduction for purchase allowance.* With respect to an obligation which has been acquired by purchase (within the meaning of subparagraph (4) of this paragraph), the term *ratable monthly portion of original issue discount* means the lesser of the amount determined under subdivision (i) of this subparagraph or an amount equal to:

(*a*) The excess (if any) of the stated redemption price of the obligation at maturity over its cost to the purchaser divided by

(*b*) The sum of the number of complete months (plus any fractional part of a month) beginning on the date of such purchase and ending the day before the stated maturity date of such obligation.

The amount of the ratable monthly portion within the meaning of this subdivision reflects a purchase allowance provided under section 1232(a)(3)(B) where a purchase is made at a price in excess of the sum of the issue price plus the portion of original issue discount previously includible (regardless of whether included) in the gross income of all previous holders (computed, however, as to such previous holders without regard to any purchase allowance under this subdivision and without regard to whether any previous holder purchased at a premium).

(iii) *Ratable monthly portion upon carryover to new obligation.* In any case in which there is a carryover of original issue discount under paragraph (b)(1)(iv) of §1.1232–3 from an obligation exchanged to an obligation received in such exchange, the ratable monthly portion of original issue discount in respect of the obligation received shall be computed by dividing the amount of original issue discount carried over by the sum of the number of complete months (plus any fractional part of a month) beginning on the date of the exchange and ending the day before the stated maturity date of the obligation received.

(iv) *Cross references.* For definitions of the terms *original issue discount* and *date of original issue,* see subparagraphs (1) and (3) respectively, of §1.1232–3(b). For definition of the term *premium,* see paragraph (d)(2) of §1.1232–3.

(3) *Determination of number of complete months*—(i) *In general.* For purposes of this section:

(*a*) A complete month and a fractional part of a month commence with the date of original issue and the corresponding day of each succeeding calendar month (or the last day of a calendar month in which there is no corresponding day),

(*b*) If an obligation is acquired on any day other than the date a complete month commences, the ratable monthly portion of original issue discount for the complete month in which the acquisition occurs shall be allocated between the transferor and the transferee in accordance with the number of days in such complete month each held the obligation,

(*c*) In determining the allocation under (*b*) of this subdivision, any holder may treat each month as having 30 days,

(*d*) The transferee, and not the transferor, shall be deemed to hold the obligation during the entire day on the date of acquisition, and

(*e*) The obligor will be treated as the transferee on the date of redemption.

(ii) *Example.* The provisions of this subparagraph may be illustrated by the following example:

Example: On February 22, 1970, A acquires an obligation of X Corporation for which February 1, 1970, is the date of original issue. B acquires the obligation on June 16, 1970. A does not choose to treat each month as having 30 days. Thus, A held the obligation for 3¾ months during 1970, i.e., one-fourth of February (7⁄28 days), March, April, May, one-half of June (15⁄30 days). The ratable monthly portion of original issue discount for the obligation is multiplied by 3¾ months to determine the amount included in A's gross income for 1970 pursuant to this paragraph.

(4) *Purchase.* For purposes of this section, the term *purchase* means any acquisition (including an acquisition upon original issue) of an obligation to which this section applies, but only if the basis of such obligation is not determined in whole or in part by reference to the adjusted basis of such obligation in the hands of the person from whom it was acquired or under section 1014(a) (relating to property acquired from a decedent).

(b) *Exceptions*—(1) *Binding commitment.* Section 1232(a)(3) shall not apply to any obligation issued pursuant to a written commitment which was binding on May 27, 1969, and at all times thereafter.

(2) *Exception for 1-year obligations.* Section 1232(a)(3) shall not apply to any obligation in respect of which the period between the date of original issue (as defined in paragraph (b)(3) of § 1.1232–3) and the stated maturity date is 1 year or less. In such case, gain on the sale or exchange of such obligation shall be included in gross income as interest to the extent the gain does not exceed an amount equal to the ratable monthly portion of original issue discount multiplied by the sum of the number of complete months and any fractional part of a month such taxpayer held such obligation.

(3) *Purchase at a premium.* Section 1232(a)(3) shall not apply to any holder who purchased the obligation at a premium (within the meaning of paragraph (d)(2) of § 1.1232–3).

(4) *Life insurance companies.* Section 1232(a)(3) shall not apply to any holder which is a life insurance company to which section 818(b) applies. However, ratable inclusion of original issue discount as interest under section 1232(a)(3) is required by an insurance company which is subject to the tax imposed by section 821 or 831.

(c) *Basis adjustment.* The basis of an obligation in the hands of the holder thereof shall be increased by any amount of original issue discount with respect thereto included as interest in his gross income pursuant to paragraph (a) of this section. See section 1232(a)(3)(E). However, the basis of an obligation shall not be increased by any amount that was includible as interest in gross income under paragraph (a) of this section, but was not actually included by the holder in his gross income.

(d) *Examples.* The provisions of paragraphs (a) through (c) of this section may be illustrated by the following examples:

Example 1. On January 1, 1970, A, a calendar-year taxpayer, purchases at original issue, for cash of $7,600, M Corporation's 10-year, 5-percent bond which has a stated redemption price of $10,000. The ratable monthly portion of original issue discount, as determined under section 1232(a)(3) and this section, to be included as interest in A's gross income for each month he holds such bond is $20, computed as follows:

Original issue discount (stated redemption price, $10,000, minus issue price, $7,600)	$2,400	
Divide by: Number of months from date of original issue to stated maturity date	120	months
Ratable monthly portion	$20	

Assume that A holds the bond for all of 1970 and 1971 and includes as interest in his gross income for each such year an amount equal to the ratable monthly portion, $20, multiplied by the number of months he held the bond each such year, 12 months, or $240. Accordingly, on January 1, 1972, A's basis in the bond will have increased under paragraph (c) of this section by the amount so included, $480 (i.e., $240×2), from his cost, $7,600, to $8,080. For results if A sells the bond on that date, see examples (1) and (2) of paragraph (a)(2) of § 1.1282–3.

Example 2. Assume the same facts as in example (1). Assume further that on January 1, 1972, A sells the bond to B, a calendar-year taxpayer for $9,040.

Since B purchased the bond, he determines under paragraph (a)(2)(ii) of this section the amount of the ratable monthly portion he must include as interest in his gross income in order to reflect the amount of his purchase allowance (if any). B determines that his ratable monthly portion is $10, computed as follows:

(1) Stated redemption price at maturity	$10,000	
(2) Minus: B's cost	$9,040	
(3) Excess	$960	
(4) Divide by: Number of months from date of purchase to stated maturity date	96	months
(5) Tentative ratable monthly portion	$10	
(6) Ratable monthly portion as computed in example (1)	$20	

Since line (5) is lower than line (6), B's ratable monthly portion is $10. Accordingly, if B holds the bond for all of 1972, he must include $120 (i.e., ratable monthly portion, $10×12 months) as interest in his gross income.

Example 3. (1) Assume the same facts as in example (1). Assume further that on January 1, 1975, A sells the bond to B for $10,150. Under the exception of paragraph (b)(3) of this section, B is not required to include any amount in respect of original issue discount as interest in his gross income since he has purchased the bond at a premium.

(2) On January 1, 1979, B sells the bond to C, a calendar-year taxpayer, for $9,940. Since C is now the holder of the bond (and no exception applies to him), he must include as interest in his gross income the ratable monthly portion of original issue determined under section 1232(a)(3) and this section. Since C purchased the bond he determines under paragraph (a)(2)(ii) of this section the amount of the ratable monthly portion he must include as interest in his gross income in order to reflect the amount of his purchase allowance (if any). C determines that his ratable monthly portion is $5, computed as follows:

(1) Stated redemption price at maturity	$10,000	
(2) Minus: C's cost	$9,940	
(3) Excess	$60	
(4) Divide by: Number of months from date of purchase to stated maturity date	12	months
(5) Tentative ratable monthly portion	$5	
(6) Ratable monthly portion as computed in example (1)	$20	

Since line (5) is lower than line (6), C's ratable monthly portion is $5. Accordingly, if C holds the bond for all of 1979, he must include $60 (i.e., ratable monthly portion, $5, ×12 months) as interest in his gross income. Upon maturity of the bond on January 1, 1980, C will receive $10,000 from M, which under paragraph (c) of this section will equal his adjusted basis (the sum of his cost, $9,940, plus original issue discount included as interest in his gross income, $60).

Example 4. On January 1, 1968, D, a calendar-year taxpayer, purchases at original issue, for cash of $8,000, P Corporation's 20-year, 6 percent bond which has a stated redemption price of $10,000 and which will mature on January 1, 1988. The original issue discount with respect to such bond is $2,000. However, the ratable inclusion rules of section 1232(a)(3) do not apply to D, since the bond was issued by P before May 28, 1969. On January 1, 1973, pursuant to a plan of reorganization as defined in section 368(a)(1)(E), and in which no gain or loss is recognized by D under section 354, D's 20-year bond is exchanged for a 10-year, 6 percent bond which also has a stated redemption price of $10,000 but will mature on January 1, 1983. Under paragraph (b)(1)(iv) of §1.1232–3, the $2,000 of original issue discount is carried over to the new 10-year bond received in such exchange. Since the new bond is an obligation issued after May 27, 1969, D is required to begin ratable inclusion of the $2,000 of discount as interest in his gross income for 1973. The ratable monthly portion of original issue discount, as determined under section 1232(a)(3) to be included as interest in gross income is computed as follows:

Amount of original issue discount carried over	$2,000	
Divide by: Number of complete months beginning on January 1, 1973, and ending on December 31, 1982	120	months
Ratable monthly portion	$16.67	

(e) *Application of section 1232 to certain deposits in financial institutions and similar arrangements*—(1) *In general.* Under paragraph (d) of §1.1232–1, the term *other evidence of indebtedness* includes certificates of deposit, time deposits, bonus plans, and other deposit arrangements with banks, domestic building and loan associations, and similar financial institutions.

(2) *Adjustments where obligation redeemed before maturity*—(i) *In general.* If an obligation described in subparagraph (1) of this paragraph is redeemed for a price less than the stated redemption price at maturity from a taxpayer who acquired the obligation upon original issue, such taxpayer shall be allowed as a deduction, in computing adjusted gross income, the amount of the original issue discount he included in gross income but did not receive (as determined under subdivision (ii) of this subparagraph). The taxpayer's basis of such obligation (determined after any increase in basis for the taxable year under section 1232(a)(3)(E) by the amount of original issue discount included in the holder's gross income under section 1232(a)(3)) shall be decreased by the amount of such adjustment.

(ii) *Computation.* The amount of the adjustment under subdivision (i) of this subparagraph shall be an amount equal to the excess (if any) of (*a*) the ratable monthly portion of the original issue discount included in the holder's gross income under section 1232(a)(3) for the period he held the obligation, over (*b*) the excess (if any) of the amount received upon the redemption over the issue price. Under paragraph (b)(1)(iii)(*a*) of § 1.1232–3, if any amount based on a fixed rate of simple or compound interest is actually payable or will be treated as constructively received under section 451 and the regulations thereunder at fixed periodic intervals of 1 year or less during the term of the obligation, any such amount payable upon redemption shall not be included in determining the amount received upon such redemption.

(iii) *Partial redemption. (a)* In the case of an obligation (other than a single obligation having serial maturity dates), if a portion of the obligation is redeemed prior to the stated maturity date of the entire obligation, the provisions of this subdivision shall be applied and not the provisions of subdivision (ii) of this subparagraph. In such case, the adjusted basis of the unredeemed portion of the obligation on the date of the partial redemption shall be an amount equal to the adjusted basis of the entire obligation on that date minus the amount paid upon the redemption.

(*b*) If the adjusted basis of the unredeemed portion (as computed under (*a*) of this subdivision) is equal to or in excess of the amount to be received for the unredeemed portion at maturity, no gain or loss shall be recognized at the time of the partial redemption but the holder shall be allowed a deduction, in computing adjusted gross income for the taxable year during which such partial redemption occurs, equal to the amount of such excess (if any), and no further original issue discount will be includible in the holder's gross income under section 1232(a)(3) over the remaining term of the unredeemed portion. In such case, the holder shall decrease his basis in the unredeemed portion (as computed under (a) of this subdivision) by the amount of such adjustment.

(*c*) If the adjusted basis of the unredeemed portion (as computed under (*a*) of this subdivision) is less than the redemption price of the unredeemed portion at maturity, a new computation shall be made under paragraph (a) of this section (without regard to the exception for one-year obligations in paragraph (b)(2) of this section) of the ratable monthly portion of original issue discount to be included as interest in the gross income of the holder over the remaining term of the unredeemed portion. For purposes of such computation, the adjusted basis of the unredeemed portion shall be treated as the issue price, the date of the partial redemption shall be treated as the issue date, and the amount to be paid for the unredeemed portion at maturity shall be treated as the stated redemption price.

(3) *Examples.* The application of section 1232 to obligations to which this paragraph applies may be illustrated by the following examples:

Example 1. A is a cash method taxpayer who uses the calendar year as his taxable year. On January 1, 1971, he purchases a certificate of deposit from X Bank, a corporation, for $10,000. The certificate of deposit is not redeemable until December 31, 1975, except in an emergency as defined in, and subject to the qualifications provided by, Regulation Q of the Board of Governors of the Federal Reserve. See 12 CFR 217.4(d). The stated redemption price at maturity is $13,382.26. The terms of the certificate do not expressly refer to any amount as interest. A's certificate of deposit is an obligation to which section 1232 and this paragraph apply. A shall include the ratable portion of original issue discount in gross income for 1971 as determined under section 1232(a)(3). Thus, if A holds the certificate of deposit for the full calendar year 1971, the amount to be included in A's gross income for 1971 is $676.45, that is, 12/60 months, multiplied by the excess of the stated redemption price ($13,382.26) over the issue price ($10,000).

Example 2. Assume the same facts as in example (1), except that the certificate of deposit provides for payment upon redemption at December 31, 1975, of an amount equal to ''$10,000, plus 6 percent compound interest from January 1, 1971, to December 31, 1975.'' Thus, the total amount payable upon redemption in both example (1) and this example is $13,382.26. The certificate of deposit is an obligation to which section 1232 and this paragraph apply and, since the substance of the deposit arrangement is identical to that contained in example (1), A must include the same amount in gross income.

Example 3. Assume the same facts as in example (1), except that the certificate provides for the payment of interest in the amount of $200 on December 31, of each year and $2,000 plus $10,000 (the original amount) payable upon redemption at December 31,

1975. Thus, if A holds the certificate of deposit for the full calendar year 1971, A must include in his gross income for 1971 the $200 interest payable on December 31, 1971, and $400 of original issue discount, that is, 12⁄60 months multiplied by the excess of the stated redemption price ($12,000) over the issue price ($10,000).

Example 4. B is a cash method taxpayer who uses the calendar year as his taxable year. On January 1, 1971, B purchases a 4-year savings certificate from the Y Building and Loan Corporation for $4,000, redeemable on December 31, 1974, for $5,000. On December 31, 1973, Y redeems the certificate for $4,660. Under section 1232(a)(3), B included $250 of original issue discount in his gross income for 1971, $250 for 1972, and includes $250 in his gross income for 1973 for a total of $750. Since the excess of (i) the amount received upon the redemption, $4,660, over (ii) the issue price, $4,000, or $660, is lower than the total amount of original issue discount ($750) included in B's gross income for the period he held the certificate by $90, the $90 will be treated under subparagraph (2) of this paragraph as a deduction in computing adjusted gross income, and accordingly, will decrease the basis of his certificate by such amount. B has no gain or loss upon the redemption, as determined in accordance with the following computation:

Adjusted basis January 1, 1973	$4,500
Increase under section 1232(a)(3)(E)	250
Subtotal	4,750
Decrease under subparagraph (b)(2) of this paragraph	90
Basis upon redemption	4,660
Amount realized upon redemption	4,660
Gain or loss	0

Example 5. On January 1, 1971, C, a cash method taxpayer who uses the calendar year as his taxable year, opens a savings account in Z bank with a $10,000 deposit. Under the terms of the account, interest is made available semiannually at 6 percent annual interest, compounded semiannually. Since all of the interest on C's account in Z Bank is made available semiannually, the stated redemption price at maturity under paragraph (b)(1)(iii)(*a*) of § 1.1232–3 equals the issue price, and, therefore, no original issue discount is reportable by C under section 1232(a)(3). However, C must include the sum of $300 (i.e., ½ × 6% × $10,000) plus $309 (i.e., ½ × 6% × $10,300) or $609, of interest made available during 1971 in his gross income for 1971.

Example 6. (i) D is a cash method taxpayer who uses the calendar year as his taxable year. On January 1, 1971, D purchases a $10,000 deferred income certificate from M Bank. Under the terms of the certificate, interest accrues at 6 percent per annum, compounded quarterly. The period of the account is 10 years. In addition, the holder is permitted to withdraw the entire amount of the purchase price at any time (but not interest prior to the expiration of the 10 year term), and upon such a withdrawal of the purchase price, no further interest accrues. If the certificate is held to maturity, the issue price plus accrued interest will aggregate $18,140.18.

(ii) In respect of the certificate, the original issue discount is $8,140.18, determined by subtracting the issue price of the certificate ($10,000) from the stated redemption price at maturity ($18,140.18). Thus, under section 1232(a)(3) the ratable monthly portion of original issue discount is $67.835 (i.e., 1⁄20 months, multiplied by $8,140.18). Under section 1232(a)(3), D includes $814.02 (i.e., 12 months, multiplied by $67.835) in his gross income for each calendar year the certificate remains outstanding and under section 1232(a)(3)(E) increases his basis by that amount. Thus, on December 31, 1975, D's basis for the certificate is $14,070.10 (i.e., issue price, $10,000, increased by product of $814.02×5 years).

(iii) On December 31, 1975, D withdraws the $10,000. Under the terms of the certificate $3,468.55 cannot be withdrawn until December 31, 1980. Under the provisions of subparagraph (2)(iii) of this paragraph, the $10,000 partial redemption shall be treated as follows:

(1) Adjusted basis of obligation at time of partial redemption	$14,070.10
(2) Amount paid upon redemption	10,000.00
(3) Adjusted basis of unredeemed portion (line (1) less line (2))	4,070.10
(4) Amount to be paid for unredeemed portion at maturity (December 31, 1980)	3,468.55
(5) Adjustment in computing adjusted gross income (excess of line (3) over line (4))	601.55

Since the adjusted basis of the unredeemed portion exceeds the amount to be received for the unredeemed portion at maturity, D is allowed a deduction, in computing adjusted gross income, of $601.25 in 1975 and no further original issue discount is includible as interest in his gross income. In addition, D will decrease his basis in the unredeemed portion by $601.55, the amount of such adjustment, from $4,070.10 to $3,468.55.

Example 7. E is a cash method taxpayer who uses the calendar year as his taxable year. On January 1, 1971, E purchases a $10,000 ''Bonus Savings Certificate'' from N Building and Loan Corporation. Under the terms of the certificate, interest is payable at 5 percent per annum, compounded quarterly, and the period of the account is 3 years. In addition, the certificate provides that if the holder makes no withdrawals of principal or interest during the term of the certificate, a bonus payment equal to 5 percent of the purchase price of the certificate will be paid to the holder of the certificate at maturity. Thus, the amount of the bonus payment is $500 (i.e., 5 percent multiplied by $10,000). Since the 5 percent annual interest is payable quarterly, the amount of such interest is not included in determining the stated redemption price at maturity under paragraph (b)(1)(iii) of § 1.1232–3. However, since the bonus payment is only payable at maturity, the amount of such bonus is included as part of the stated redemption price at maturity. Thus, the stated redemption price at maturity equals $10,500 (purchase price, $10,000, plus bonus payment $500). Accordingly, the original issue discount attributable to such certificate equals $500 (stated redemption price at maturity. $10,500, minus issue price, $10,000). Therefore, E must include as interest $166.67 (i.e., 12⁄36 months, multiplied by the original issue discount, $500) in his gross income for each taxable year he holds the certificate.

(4) *Renewable certificates of deposit*—(i) *In general.* The renewal of a certificate of deposit shall be treated as a purchase of the certificate on the date the renewal period begins regardless of any requirement pursuant to the terms of the certificate that the holder give notice of an intention to renew or not to renew. Thus, for example, in the case of a certificate of deposit for which a renewal period begins after December 31, 1970, such renewal shall be treated as a purchase after such date whether or not the initial period began before such date.

(ii) *Computation.* For purposes of computing the amount of original issue discount to be ratably included as interest in gross income under section 1232(a)(3) in respect of a renewable certificate of deposit for the initial period or any renewal period, the following rules apply:

(*a*) The issue price on the date any renewal period begins is considered to be in the case of a certificate of deposit initially purchased:

(*1*) After December 31, 1970, the adjusted basis of the certificate on the date such period begins,

(*2*) Before January 1, 1971, the amount the adjusted basis would have been on the date such period begins had the holder included all amounts of original issue discount as interest in gross income that would have been includible if section 1232(a)(3) had applied to the certificate from the date of original purchase.

Thus, if under the terms of the certificate, no amount is forfeited upon a failure to renew, then the issue price on the date any renewal period begins is considered to be the amount which would have been received by the holder on such date had it not been renewed.

(*b*) The date of original issue for any renewal period shall be considered to be the date it begins.

(*c*) The date of maturity for the initial period or any renewal period shall be considered to be the date it ends.

(*d*) The stated redemption price at maturity for the initial period or any renewal period shall be considered to be the maximum amount which would be received at the end of any such period, without regard to any reduction resulting from withdrawal prior to maturity or failure to renew at any renewal date.

(iii) *Application of 1-year rule.* For purposes of paragraph (b)(2) of this section (relating to nonapplication of section 1232(a)(3) to any obligation having a term of 1 year or less), the period between the date of original issue (as defined in paragraph (b)(3) of § 1.1232–3) of a renewable certificate of deposit and its stated maturity date shall include all renewal periods with respect to which, under the terms of the certificate, the holder may either take action or refrain from taking action which would prevent the actual or constructive receipt of any interest on such certificate until the expiration of any such renewal period whether or not the original date of issue is prior to January 1, 1971.

(iv) *Example.* The provisions of this subparagraph may be illustrated by the following example:

Example: (a) On May 1, 1969, A purchases a 2-year renewable certificate of deposit from M bank, a corporation, for $10,000. Interest will be compounded semiannually at 6 percent on May 1 and November 1. The terms of the certificate provide that such certificate will be automatically renewed on the anniversary date every 2 years if the holder does not notify M of an intention not to renew prior to 60 days before the particular anniversary date. Thus, on May 1, 1971, and May 1, 1973, the certificate may be redeemed for

$11,255.09 and $12,667.60, respectively. However, in no event shall the initial period and the renewal periods exceed 10 years. A does not notify M of an intention not to renew by March 1, 1971, and the certificate is automatically renewed for an additional 2-year period on May 1, 1971.

(*b*) Under subdivision (i) of this subparagraph, the May 1, 1971, renewal shall be treated as the purchase of a certificate of deposit on that date, i.e., after December 31, 1970. Under subdivision (ii) of this subparagraph, the issue price is considered to be $11,255.09 and the date of maturity is considered to be May 1, 1973. Since the stated redemption price at maturity is $12,667.60. A must include $58.85 as interest in gross income for each month he holds the certificate during the renewal period beginning May 1, 1971, computed as follows:

Original issue discount (stated redemption price, $12,667.60, minus issue price, $11,255.09)	$1,412.51
Divided by: Number of months from renewal to maturity date	24 months
Ratable monthly portion	$58.85

(5) *Time deposit open account arrangements*—(i) *In general.* The term *time deposit open account arrangement* means an arrangement with a fixed maturity date where deposits may be made from time to time and ordinarily no interest will be paid or constructively received until such fixed maturity date. All deposits pursuant to such an arrangement constitute parts of a single obligation. The amount of original issue discount to be ratably included as interest in the gross income of the depositor for any taxable year shall be the sum of the amounts separately computed for each deposit. For this purpose, the issue price for a deposit is the amount thereof and the stated redemption price at maturity is computed under paragraph (b)(1)(iii)(*d*) of § 1.1232–3.

(ii) *Obligations redeemed before maturity.* In the event of a partial redemption of a time deposit open account before maturity, the following rules, in addition to subparagraph (2) of this paragraph, shall apply:

(*a*) If, pursuant to the terms of the withdrawal, the amount received by the depositor is determined with reference to the principal amount of a specific deposit and interest earned from the date of such deposit, then such terms shall control for the purpose of determining which deposit was withdrawn.

(*b*) If (*a*) of this subdivision (ii) does not apply, then the withdrawal shall be deemed to be of specific deposits together with interest earned from the date of such deposits, on a first-in, first-out basis.

(iii) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1. (i) F is a cash method taxpayer who uses the calendar year as his taxable year. On December 1, 1970, F enters into a 5-year deposit open account arrangement with M Savings and Loan Corp. The terms of the arrangement provide that F will deposit $100 each month for a period of 5 years, and that interest will be compounded semiannually (on June 1 and December 1) at 6 percent, but will be paid only at maturity. Thus, assuming F makes deposits of $100 on the first of each month beginning with December 1, 1970, the account will have a stated redemption price of $6,998.20 at maturity on December 1, 1975. Since, however, section 1232 applies only to deposits made after December 31, 1970 (see paragraph (d) of § 1.1232–1), the $34.39 of compound interest to be earned on the first deposit of $100 over the term of the arrangement will not be subject to the ratable inclusion rules of section 1232(a)(3). F must include such $34.39 of interest in his gross income on December 1, 1975, the date it is paid.

(ii) For 1971, F must include $44.19 of original issue discount as interest in gross income, to be computed as follows:

(1)	(2)	(3)	(4)	(5)	(6)	(7)
Date of $100 deposit	Months to maturity	Redemption price at maturity	Original issue discount (Col.3 – $100)	Ratable monthly portion (Col.4÷Col.2)	Months on deposit in 1971	1971 original issue discount (Col.5×Col.6)
1–1–71	59	$133.73	$33.73	$0.5717	12	$6.86
2–1–71	58	133.07	33.07	.5702	11	6.27
3–1–71	57	132.42	32.42	.5688	10	5.69
4–1–71	56	131.77	31.77	.5673	9	5.11
5–1–71	55	131.12	31.12	.5658	8	4.53
6–1–71	54	130.48	30.48	.5644	7	3.95
7–1–71	53	129.84	29.84	.5630	6	3.38

(1)	(2)	(3)	(4)	(5)	(6)	(7)
Date of $100 deposit	Months to maturity	Redemption price at maturity	Original issue discount (Col.3 − $100)	Ratable monthly portion (Col.4÷Col.2)	Months on deposit in 1971	1971 original issue discount (Col.5×Col.6)
8–1–71	52	129.20	29.20	.5615	5	2.81
9–1–71	51	128.56	28.56	.5600	4	2.24
10–1–71	50	127.93	27.93	.5586	3	1.68
11–1–71	49	127.30	27.30	.5571	2	1.11
12–1–71	48	126.68	26.68	.5558	1	0.56
Total original issue discount to be included as interest in F's gross income for 1971						44.19

Example 2. (i) G is a cash method taxpayer who uses the calendar year as his taxable year. On February 1, 1971, G enters into a 4-year deposit open account arrangement with T Bank, a corporation. The terms of the deposit arrangement provide that G may deposit any amount from time to time in multiples of $50 for a period of 4 years. The terms also provide that G may not redeem any amount until February 1, 1975, except in an emergency as defined in, and subject to the qualifications provided by, Regulation Q of the Board of Governors of the Federal Reserve System. See 12 CFR 217.4(d). Interest will be compounded semiannually (on February 1 and August 1) at 6 percent, providing there is no redemption prior to February 1, 1975. However, if there is a redemption prior to such date, interest will be compounded semiannually at 5½ percent.

(ii) The schedule of deposits made by G pursuant to the arrangement, and computation of ratable monthly portion for each deposit, is set forth in the table below:

(1)	(2)	(3)	(4)	(5)	(6)
Date of deposit	Months to maturity	Amount of deposit	Redemption price at maturity	Original issue discount (Col.4 − Col.3)	Ratable monthly portion (Col.5÷Col.2)
2–1–71	48	100	$126.68	$26.68	0.5558
6–1–71	44	200	248.42	48.42	1.1005
12–1–71	38	500	602.95	102.95	2.7092
2–1–72	36	800	955.24	155.24	4.3122
3–1–72	35	800	950.56	150.56	4.3017
7–1–72	31	600	699.00	99.00	3.1935
8–1–72	30	250	289.82	39.82	1.3273

(iii) With respect to amounts on deposit pursuant to the arrangement, the amounts of original issue discount G must include as interest in his gross income for 1971 and 1972 are computed in the table below:

(1)	(2)	(3)	(4)	(5)	(6)
Date of deposit	Ratable monthly portion	Months on deposit in 1971	1971 original issue discount (Col.2× Col.3)	Months on deposit in 1972	1972 original issue discount (Col.2× Col.5)
2–1–71	$0.5558	11	$6.11	12	$6.67
6–1–71	1.1005	7	7.70	12	13.21
12–1–71	2.7092	1	2.71	12	32.51
2–1–72	4.3122			11	47.43
3–1–72	4.3017			10	43.02
7–1–72	3.1935			6	19.16
8–1–72	1.3273			5	6.64
Total original issue discount includible as interest in gross income for taxable year			16.52		168.64

(6) *Certain contingent interest arrangement*—(i) *In general.* If under the terms of a deposit arrangement:

(*a*) The holder cannot receive payment of any interest or constructively receive any interest prior to a fixed maturity date, (*b*) Interest is earned at a guaranteed minimum rate of compound interest,

(*c*) Additional contingent interest may be earned for any year at a rate not to exceed one percentage point above such guaranteed minimum rate, and

(*d*) Any additional contingent interest is credited at least annually to the depositor's account,

Then any contingent interest credited to the depositor shall be treated as creating a separate obligation subject to the rules of subdivision (ii) of this subparagraph.

(ii) *Computation.* For purposes of computing the original issue discount to be included as interest in the depositor's gross income under section 1232(a)(3) with respect to such separate obligation:

(*a*) The issue price shall be zero,

(*b*) The date of original issue shall be the date on which the contingent interest is credited to the depositor's account and begins to earn interest,

(*c*) The date of maturity shall be the fixed maturity date of the deposit, and

(*d*) The stated redemption price at maturity is the sum of the amount of such contingent interest plus any interest to be earned thereon at the guaranteed minimum rate of compound interest between such dates of original issue and maturity.

(7) *Contingent interest arrangements other than those described in subparagraph (6)*—(i) *In general.* If under the terms of a deposit arrangement, contingent interest may be earned and credited to a depositor's account, but is neither actually or constructively received before a fixed maturity date nor treated under subparagraph (6)(i) of this paragraph as creating a separate obligation, then the redemption price shall include the amount which would be credited to such account assuming the issuer, during the term of such account, credits contingent interest at the greater of the rate:

(*a*) Last credited on a similar account, or

(*b*) Equal to the average rate credited for the preceding 5 calendar years on a similar account.

(ii) *Adjustments for additional interest.* The rate taken into account under this subparagraph in computing the redemption price shall be treated as the guaranteed minimum rate for purposes of applying subparagraph (6) of this paragraph in the event the rate at which contingent interest is actually credited to the depositor's account exceeds such rate previously taken into account. If for any period the actual rate at which contingent interest is credited to the account exceeds by more than 1 percentage point the rate for the previous period taken into account under this subparagraph in computing the redemption price, a new computation shall be made to determine the ratable monthly portion of original issue discount to be included as interest in the gross income of the depositor over the remaining term of the account. For purposes of such computation, the date that interest is first so credited to the account shall be treated as the issue date, the adjusted basis of the account on such date shall be the issue price, and the redemption price shall equal the amount actually on deposit in the account on such date plus the amount which would be credited to such account assuming the issuer, during the remaining term of such account, continues to credit contingent interest at the new rate.

(iii) *Adjustment for reduced interest.* If for any period the actual rate of interest at which contingent interest is credited to the depositor's account is less than the rate for the previous period taken into account under this subparagraph in computing the redemption price, the difference between the amount of interest which would have been credited to the account at the rate for such previous period and the amount actually credited shall be allowed as a deduction against the amount of original issue discount with respect to such account required to be included in the gross income of the depositor. If an account is redeemed for a price less than the adjusted basis of the account, the depositor shall be allowed as a deduction, in computing adjusted gross income, the amount of the original issue discount he included in gross income but did not receive.

(f) *Application of section 1232(a)(3) to face-amount certificates*—(1) *In general.* Under paragraph (c)(3) of §1.1232–1, the provisions of section 1232(a)(3) and this section apply in the case of a face-amount certificate issued after December 31, 1975 (other than such a certificate issued pursuant to a written commitment which was binding on such date and at all times thereafter).

(2) *Relationship with paragraph (e) of this section.* Determinations with regard to the inclusion as interest of original issue discount on, and certain adjustments with respect to, face-amount certificates to which this section applies shall be made in a manner consistent with the rules of paragraph (e) of this section (relating to the application of section 1232 to certain deposits in financial institutions and similar arrangements). Thus, for example, if a face-amount certificate is redeemed before maturity, the holder shall be allowed a deduction in computing adjusted gross income computed in a manner consistent with the rules of paragraph (e)(2) of this section. For a further example, if under the terms of a face-amount certificate, the issuer may grant additional credits to be paid at a fixed maturity date, computations with respect to such additional credits shall be made in a manner consistent with the rules of paragraphs (e) (6) and (7) of this section (as applicable) relating to contingent interest arrangements.

[T.D. 7154, 36 FR 25005, Dec. 28, 1971; 37 FR 527, Jan. 13, 1972, as amended by T.D. 7213, 37 FR 21993, Oct. 18, 1972; 37 FR 22863, Oct. 26, 1972; T.D. 7311, 39 FR 11880, Apr. 1, 1974; T.D. 7365, 40 FR 27936, July 2, 1975]

§ 1.1232–4 Obligations with excess coupons detached.

Section 1232(c) provides that if an obligation which is issued at any time with interest coupons:

(a) Is purchased after August 16, 1954, and before January 1, 1958, and the purchaser does not receive all the coupons which first become payable more than 12 months after the date of the purchase, or

(b) Is purchased after December 31, 1957, and the purchaser does not receive all the coupons which first become payable after the date of purchase,

Any gain on the later sale or other disposition of the obligation by the purchaser (or by a transferee of the purchaser whose basis is determined by reference to the basis of the obligation in the hands of the purchaser) shall be treated as ordinary income to the extent that the fair market value of the obligation (determined as of the time of the purchase) with coupons attached exceeds the purchase price. If both the preceding sentence and section 1232(a)(2) apply with respect to the gain realized on the retirement or other disposition of an obligation, then section 1232(a)(2) shall apply only with respect to that part of the gain to which the preceding sentence does not apply. For example, a $100 bond which sells at $90 with all its coupons attached is purchased by A for $80 with 3 years' coupons detached. Three years later, A sells the bond for $92. The first $10 of the $12 profit is taxable as ordinary income. The remaining $2 gain is taxable either as ordinary income or as long-term capital gain, depending upon the application of section 1232(a)(2). Pursuant to section 7851(a)(1)(C), the regulations prescribed in this section shall also apply to taxable years beginning before January 1, 1954, and ending after December 31, 1953, although such years are subject to the Internal Revenue Code of 1939.

[T.D. 7154, 36 FR 25009, Dec. 28, 1971]

§ 1.1233–1 Gains and losses from short sales.

(a) *General.* (1) For income tax purposes, a short sale is not deemed to be consummated until delivery of property to close the short sale. Whether the recognized gain or loss from a short sale is capital gain or loss or ordinary gain or loss depends upon whether the property so delivered constitutes a capital asset in the hands of the taxpayer.

(2) Thus, if a dealer in securities makes a short sale of X Corporation stock, ordinary gain or loss results on closing of the short sale if the stock used to close the short sale was stock which he held primarily for sale to customers in the ordinary course of his trade or business. If the stock used to close the short sale was a capital asset in his hands, or if the taxpayer in this example was not a dealer, a capital gain or loss would result.

(3) Generally, the period for which a taxpayer holds property delivered to close a short sale determines whether

long-term or short-term capital gain or loss results.

(4) Thus, if a taxpayer makes a short sale of shares of stock and covers the short sale by purchasing and delivering shares which he held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), the recognized gain or loss would be considered short-term capital gain or loss. If the short sale is made through a broker and the broker borrows property to make a delivery, the short sale is not deemed to be consummated until the obligation of the seller created by the short sale is finally discharged by delivery of property to the broker to replace the property borrowed by the broker.

(5) For rules for determining the date of sale for purposes of applying under section 1091 the 61-day period applicable to a short sale of stock or securities at a loss, see paragraph (g) of §1.1091–1.

(b) *Hedging transactions.* Under section 1233(g), the provisions of section 1233 and this section shall not apply to any bona fide hedging transaction in commodity futures entered into by flour millers, producers of cloth, operators of grain elevators, etc., for the purpose of their business. Gain or loss from a short sale of commodity futures which does not qualify as a hedging transaction shall be considered gain or loss from the sale or exchange of a capital asset if the commodity future used to close the short sale constitutes a capital asset in the hands of the taxpayer as explained in paragraph (a) of this section.

(c) *Special short sales*—(1) *General.* Section 1233 provides rules as to the tax consequences of a short sale of property if gain or loss from the short sale is considered as gain or loss from the sale or exchange of a capital asset under section 1233(a) and paragraph (a) of this section and if, at the time of the short sale or on or before the date of the closing of the short sale, the taxpayer holds property substantially identical to that sold short. The term *property* is defined for purposes of such rules to include only stocks and securities (including stocks and securities dealt with on a *when issued* basis) and commodity futures, which are capital assets in the hands of the taxpayer. Certain restrictions on the application of the section to commodity futures are provided in section 1233(e) and paragraph (d)(2) of this section. Section 1233(f) contains special provisions governing the operation of rule (2) in subparagraph (2) of this paragraph in the case of a purchase and short sale of stock (as defined in subparagraph (3) qualifying as an arbitrage operation. See paragraph (f) of this section for detailed rules relating to arbitrage operations in stocks and securities.

(2) *Treatment of special short sales.* The first two rules, which are set forth in section 1233(b), are applicable whenever property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) (determined without regard to rule (2), contained in this subparagraph, relating to the holding period) or is acquired by him after the short sale and on or before the date of the closing thereof. These rules are:

Rule (1). Any gain upon the closing of such short sale shall be considered as a gain upon the sale or exchange of a capital asset held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) (notwithstanding the period of time any property used to close such short sale has been held); and

Rule (2). The holding period of such substantially identical property shall be considered to begin (notwithstanding the provisions of section 1223) on the date of the closing of such short sale or on the date of a sale, gift, or other disposition of such property, whichever date occurs first.

(3) *Options to sell.* For the purpose of rule (1) and rule (2) in subparagraph (2) of this paragraph, the acquisition of an option to sell property at a fixed price shall be considered a short sale, and the exercise or failure to exercise such option shall be considered as a closing of such short sale, except that any option to sell property at a fixed price acquired on or after August 17, 1954 (the day after enactment of the Internal Revenue Code of 1954), shall not be considered a short sale and the exercise or failure to exercise such option shall not be considered as the closing of a

short sale provided that the option and property identified as intended to be used in its exercise are acquired on the same date. This exception shall not apply, if the option is exercised, unless it is exercised by the sale of the property so identified. In the case of any option not exercised which falls within this exception, the cost of such option shall be added to the basis of the property with which such option is identified. If the option itself does not specifically identify the property intended to be used in exercising the option, then the identification of such property shall be made by appropriate entries in the taxpayer's records within 15 days after the date such property is acquired or before November 17, 1956, whichever expiration date later occurs.

(4) *Treatment of losses.* The third rule, which is set forth in section 1233(d), is applicable whenever property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). This rule is:

Rule (3). Any loss upon the closing of such short sale shall be considered as a loss upon the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), notwithstanding the period of time any property used to close such short sale has been held. For the purpose of this rule, the acquisition of an option to sell property at a fixed price is not considered a short sale, and the exercise or failure to exercise such option is not considered as a closing of a short sale.

(5) *Application of rules.* Rules (1) and (3) contained in subparagraphs (2) and (4) of this paragraph do not apply to the gain or loss attributable to so much of the property sold short as exceeds in quantity the substantially identical property referred to in section 1233 (b) and (d), respectively. Except as otherwise provided in section 1233(f), rule (2) in subparagraph (2) of this paragraph applies to the substantially identical property referred to in section 1233(b) in the order of the dates of the acquisition of such property, but only to so much of such property as does not exceed the quantity sold short. If property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), or is acquired by him after the short sale and on or before the date of the closing thereof, and if property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), all three rules are applicable.

(6) *Examples.* The following examples illustrate the application of these rules to short sales of stock in the case of a taxpayer who makes his return on the basis of the calendar year:

Example 1. A buys 100 shares of X stock at $10 per share on February 1, 1955, sells short 100 shares of X stock at $16 per share on July 1, 1955, and closes the short sale on August 2, 1955, by delivering the 100 shares of X stock purchased on February 1, 1955, to the lender of the stock used to effect the short sale. Since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the gain of $600 realized upon the closing of the short sale is, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain.

Example 2. A buys 100 shares of X stock at $10 per share on February 1, 1955, sells short 100 shares of X stock at $16 per share on July 1, 1955, closes the short sale on August 1, 1955, with 100 shares of X stock purchased on that date at $18 per share, and on August 2, 1955, sells at $18 per share the 100 shares of X stock purchased on February 1, 1955. The $200 loss sustained upon the closing of the short sale is a short-term capital loss to which section 1233(d) has no application. By application of rule (2) in subparagraph (2) of this paragraph, however, the holding period of the 100 shares of X stock purchased on February 1, 1955, and sold on August 2, 1955 is considered to begin on August 1, 1955, the date of the closing of the short sale. The $800 gain realized upon the sale of such stock is, therefore, a short-term capital gain.

Example 3. A buys 100 shares of X stock at $10 per share on February 1, 1955, sells short 100 shares of X stock at $16 per share on September 1, 1955, sells on October 1, 1955, at $18 per share the 100 shares of X stock purchased on February 1, 1955, and closes the short sale on October 1, 1955, with 100 shares of X stock purchased on that date at $18 per share. The $800 gain realized upon the sale of the 100 shares of X stock purchased on February 1, 1955, is a long-term capital gain to which section 1233(b) has no application. Since A had held 100 shares of X stock on the date of the short sale for more than 6 months, the $200 loss sustained upon the closing of the short sale is, by application of rule (3) in subparagraph (4) of this paragraph, a long-term capital loss. If, instead of purchasing 100 shares of X stock on October 1, 1955, A closed the short sale with the 100 shares of stock purchased on February 1, 1955, the $600 gain realized on the closing of the short sale would be a long-term capital gain to which section 1233(b) has no application.

Example 4. A sells short 100 shares of X stock at $16 per share on February 1, 1955. He buys 250 shares of X stock on March 1, 1955, at $10 per share and holds the latter stock until September 2, 1955 (more than 6 months), at which time, 100 shares of the 250 shares of X stock are delivered to close the short sale made on February 1, 1955. Since substantially identical property was acquired by A after the short sale and before it was closed, the $600 gain realized on the closing of the short sale is, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain. The holding period of the remaining 150 shares of X stock is not affected by section 1233 since this amount of the substantially identical property exceeds the quantity of the property sold short.

Example 5. A buys 100 shares of X stock at $10 per share on February 1, 1955, buys an additional 100 shares of X stock at $20 per share on July 1, 1955, sells short 100 shares of X stock at $30 per share on September 1, 1955, and closes the short sale on February 1, 1956, by delivering the 100 shares of X stock purchased on February 1, 1955, to the lender of the stock used to effect the short sale. Since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the gain of $2,000 realized upon the closing of the short sale is, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain and the holding period of the 100 shares of X stock purchased on July 1, 1955, is considered, by application of rule (2) in subparagraph (2) of this paragraph to begin on February 1, 1956, the date of the closing of the short sale. If, however, the 100 shares of X stock purchased on July 1, 1955, had been used by A to close the short sale, then, since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the gain of $1,000 realized upon the closing of the short sale would be, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain, but the holding period of the 100 shares of X stock purchased on February 1, 1955, would not be affected by section 1233. If, on the other hand, A purchased an additional 100 shares of X stock at $40 per share on February 1, 1956, and used such shares to close the short sale at that time, then, since 100 shares of X stock had been held by A on the date of the short sale for more than 6 months, the loss of $1,000 sustained upon the closing of the short sale would be, by application of rule (3) in subparagraph (4) of this paragraph, a long-term capital loss, and since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the holding period of the 100 shares of X stock purchased on July 1, 1955, would be considered, by application of rule (2) in subparagraph (2) of this paragraph, to begin on February 1, 1956, but the holding period of the 100 shares of X stock purchased on February 1, 1955, would not be affected by section 1233.

Example 6. A buys 100 shares of X preferred stock at $10 per share on February 1, 1955. On July 1, 1955, he enters into a contract to sell 100 shares of XY common stock at $16 per share when, as, and if issued pursuant to a particular plan of reorganization. On August 2, 1955, he receives 100 shares of XY common stock in exchange for the 100 shares of X preferred stock purchased on February 1, 1955, and delivers such common shares in performance of his July 1, 1955, contract. Assume that the exchange of the X preferred stock for the XY common stock is a tax-free exchange pursuant to section 354(a)(1), and that on the basis of all of the facts and circumstances existing on July 1, 1955, the *when issued* XY common stock is substantially identical to the X preferred stock. Since 100 shares of substantially identical property had been held by A for not more than 6 months on the date of entering into the July 1, 1955, contract of sale, the gain of $600 realized upon the closing of the contract of sale is, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain.

(d) *Other rules for the application of section 1233*—(1) *Substantially identical property.* The term *substantially identical property* is to be applied according to the facts and circumstances in each case. In general, as applied to stocks or securities, the term has the same meaning as the term *substantially identical stock or securities* used in section 1091, relating to wash sales of stocks or securities. For certain restrictions on the term as applied to commodity futures see subparagraph (2) of this paragraph. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. In certain situations they may be substantially identical; for example, in the case of a reorganization the facts and circumstances may be such that the stocks and securities of predecessor and successor corporations are substantially identical property. Similarly, bonds or preferred stock of a corporation are not ordinarily considered substantially identical to the common stock of the same corporation. However, in certain situations, as, for example, where the preferred stock or bonds are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may be such as to make such bonds or preferred stock and the common stock substantially identical property. Similarly, depending on the facts and circumstances, the term may apply to the stocks and securities to be received in a corporate reorganization or recapitalization, traded in on a when issued basis, as compared with the stocks or securities to be exchanged in such reorganization or recapitalization.

(2) *Commodity futures.* (i) As provided in section 1233(e)(2)(B), in the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, a commodity future requiring delivery in one calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month. For example, commodity futures in May wheat and July wheat are not considered, for the purpose of section 1233, substantially identical property. Similarly, futures in different commodities which are not generally through custom of the trade used as hedges for each other (such as corn and wheat, for example) are not considered substantially identical property. If commodity futures are otherwise substantially identical property, the mere fact that they were procured through different brokers will not remove them from the scope of the term *substantially identical property.* Commodity futures procured on different markets may come within the term *substantially identical property* depending upon the facts and circumstances in the case, with the historical similarity in the price movements in the two markets as the primary factor to be considered.

(ii) Section 1233(e)(3), relating to so-called *arbitrage* transactions in commodity futures, provides that where a taxpayer enters into two commodity futures transactions on the same day, one requiring delivery by him in one market and the other requiring delivery to him of the same (or substantially identical) commodity in the same calendar month in a different market, and the taxpayer subsequently closes both such transactions on the same day, section 1233 shall have no application to so much of the commodity involved in either such transaction as does not exceed in quantity the commodity involved in the other. Section 1233(f), relating to arbitrage operations in stocks or securities, has no application to arbitrage transactions in commodity futures.

(iii) The following example indicates the application of section 1233 to a commodity futures transaction:

Example: A, who makes his return on the basis of the calendar year, on February 1, 1955, enters into a contract through broker X to purchase 10,000 bushels of December wheat on the Chicago market at $2 per bushel. On July 1, 1955, he enters into a contract through broker Y to sell 10,000 bushels of December wheat on the Chicago market at $2.25 per bushel. On August 2, 1955, he closes both transactions at $2.50 per bushel. The $2,500 loss sustained on the closing of the short sale is a short-term capital loss to which section 1233(d) has no application. By application of rule (2) in paragraph (c)(2) of this section, however, the holding period of the futures contract entered into on February 1, 1955, is considered to begin on August 2, 1955, the date of the closing of the short sale. The $5,000 gain realized upon the closing of such contract is, therefore, a short-term capital gain.

(3) *Husband and wife.* Section 1233(e)(2)(C) provides that, in the case of a short sale of property by an individual, the term *taxpayer* in the application of subsections (b), (d), and (e) shall be read as *taxpayer or his spouse.* Thus, if the spouse of a taxpayer holds or acquires property substantially identical to that sold short by the taxpayer, and other conditions of subsections (b), (d), and (e) are met, then the rules set forth therein are applicable to the same extent as if the taxpayer held or acquired the substantially identical property. For this purpose, an individual who is legally separated from the taxpayer under a decree of divorce or of separate maintenance

shall not be considered as the spouse of the taxpayer.

(e) *Special rule for short sales by dealers in securities under certain circumstances.* In the case of a short sale of stock (as defined in subparagraph (3) of this paragraph) after December 31, 1957, by a dealer in securities, section 1233(e)(4)(A) provides that the holding period of substantially identical stock which he has held as an investment for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) shall be determined in accordance with section 1233(b)(2) unless such short sale is closed within 20 days of the date on which it was made. See rule (2) in paragraph (c)(2) of this section for the purpose of determining the holding period of such substantially identical stock. In addition, section 1233(e)(4)(B) provides that for the purpose of the special rule of section 1233(e)(4)(A), the acquisition of an option to sell property at a fixed price shall be considered a short sale, and the exercise or failure to exercise such option shall be considered a closing of such short sale. For purposes of this paragraph:

(1) Whether or not a taxpayer is a *dealer in securities* shall be determined in accordance with the meaning of the term for purposes of section 1236;

(2) Whether or not stock is *substantially identical* with other property shall be determined in accordance with the provisions of paragraph (d)(1) of this section; and

(3) The term *stock* means:

(i) Any share or certificate of stock,

(ii) Any bond or other evidence of indebtedness which is convertible into a share or certificate of stock, and

(iii) Any evidence of an interest in, or right to subscribe to or purchase, any of the items described in subdivision (i) or (ii) of this subparagraph.

(f) *Arbitrage operations in stocks and securities and holding periods*—(1) *General rule.* (i) In the case of a short sale entered into as part of an arbitrage operation, rule (2) of paragraph (c)(2) of this section shall apply first to substantially identical property acquired for arbitrage operations and held by the taxpayer at the close of business on the day of the short sale. The holding period of substantially identical property not acquired for arbitrage operations shall be affected only to the extent that the amount of property sold short exceeds the amount of substantially identical property acquired for arbitrage operations and held by the tapayer at the close of business on the day of the short sale.

(ii) If the substantially identical property acquired for arbitrage operations is disposed of without closing the short sale so that a net short position in assets acquired for arbitrage operations is created, a short sale in the amount of such net short position will be deemed to have been made on the day such net short position is created. Rule (2) of paragraph (c)(2) of this section will then apply to substantially identical property not acquired for arbitrage operations to the same extent as if the taxpayer, on the day such net short position is created, sold short an amount equal to the amount of the net short position in a transaction not entered into as part of an arbitrage operation.

(iii) The following examples illustrate the application of rule (2) of paragraph (c)(2) of this section to arbitrage operations:

Example 1. On August 13, 1957, A buys 100 bonds of X Corporation for purposes other than arbitrage operations. The bonds are convertible at the option of the bondholders into common stock of X Corporation on the basis of one bond for one share of stock. On November 1, 1957, A sells short 100 shares of common stock of X Corporation in a transaction identified and intended to be part of an arbitrage operation and on the same day buys another 100 bonds of X Corporation in a transaction identified and intended to be part of the same arbitrage operation. The bonds acquired on both August 13, 1957, and November 1, 1957, are, on the basis of all the facts and circumstances, substantially identical to the common stock of X Corporation. On December 1, 1957, A closes the short sale with 100 shares of common stock of X Corporation acquired on that day. The holding period of the bonds acquired on November 1, by application of rule (2) of paragraph (c)(2) of this section, will be deemed to begin on December 1 and the holding period of the bonds acquired on August 13 will be unaffected. If, instead of purchasing the 100 shares of common stock of X Corporation on December 1, 1957, A had converted the bonds acquired on November 1 into common stock and, on December 1, 1957, used the stock so acquired to close the short sale, rule (2) of paragraph (c)(2) of this section would similarly have no effect on the holding period of the bonds acquired on August 13.

Example 2. Assume the same facts as in example (1), except that A, on December 1, sells the bonds acquired on November 1 (or converts such bonds into common stock and sells the stock), but does not close the short sale. The sale of the bonds (or stock) creates a net short position in assets acquired for arbitrage operations which is deemed to be a short sale made on December 1. Accordingly, the holding period of the bonds acquired on August 13 will, by application of rule (2) of paragraph (c)(2) of this section, begin on the date such short sale is closed or on the date of sale, gift, or other disposition of such bonds, whichever date occurs first.

(2) *Right to receive or acquire property.* (i) For purposes of section 1233(f) (1) and (2) and subparagraph (1) of this paragraph, a taxpayer will be deemed to hold substantially identical property acquired for arbitrage operations at the close of any business day if, by virtue of the ownership of other property acquired for arbitrage operations (whether or not substantially identical) or because of any contract entered into by the taxpayer in an arbitrage operation, he then has the right to receive or acquire such substantially identical property.

(ii) The application of section 1233(f)(3) and subdivision (i) of this subparagraph may be illustrated by the following example:

Example: A acquires on August 13, 1957, 100 shares of common stock of X Corporation for purposes other than arbitrage operations. On November 1, A sells short, in a transaction identified and intended to be part of an arbitrage operation, 100 shares of X common stock. On the same day, in a transaction also identified and intended to be part of the same arbitrage operation, A contracts to purchase 100 shares of preferred stock of X. The preferred stock of X may be converted into common stock of X on the basis of one share of preferred stock for one share of common stock. The preferred stock is not actually delivered to A until November 3. Since A has contracted before the close of business on the date of the short sale, as part of an arbitrage operation, to purchase property by virtue of which he has the right to receive or acquire substantially identical property to that sold short, he will be deemed, for purposes of section 1233(f) (1) and (2), to hold such substantially identical property at the close of business on the date of the short sale. For purposes of this subparagraph, it is immaterial whether, on the basis of all the facts and circumstances, the preferred stock of X is substantially identical to the common stock of X. The short sale on November 1 does not affect the holding period of the 100 shares of X Corporation common stock purchased on August 13, 1957. Because of the operation of rule (2) of paragraph (c)(2) of this section, the holding period of the preferred stock acquired as the result of A's contract to purchase it as part of an arbitrage operation (or the common stock which A acquires by conversion of such preferred stock into common stock) will not begin until the short sale entered into in the arbitrage operation is closed.

(3) *Definition of arbitrage operations.* For the purpose of section 1233(f), arbitrage operations are transactions involving the purchase and sale of property entered into for the purpose of profiting from a current difference between the price of the property purchased and the price of the property sold. Assets acquired for arbitrage operations include only stocks and securities and rights to acquire stocks and securities. The property purchased may be either identical to the property sold or, if not so identical, such that its acquisition will entitle the taxpayer to acquire property which is so identical. Thus, the purchase of bonds or preferred stock convertible, at the holder's option, into common stock and the short sale of the common stock which may be acquired therefor, or the purchase of stock rights and the short sale of the stock to be acquired on the exercise of such rights, may qualify as arbitrage operations. A transaction will qualify as an arbitrage operation under section 1233(f) only if the taxpayer properly identifies the transaction as an arbitrage operation on his records as soon as he is able to do so. Such identification must ordinarily be entered in the taxpayer's records on the day of the transaction. Property acquired in a transaction properly identified as part of an arbitrage operation is the only property which will be deemed acquired for an arbitrage operation. The provisions of section 1233(f) and this paragraph shall continue to apply to property acquired in a transaction properly identified as an arbitrage operation although, because of subsequent events, e.g., a change in the value of bonds so acquired or of stock

into which such bonds may be converted, the taxpayer sells such property outright rather than using it to complete the arbitrage operation.

(4) *Effective date of section 1233(f).* Section 1233(f), relating to arbitrage operations involving short sales of property, is effective only with respect to taxable years ending after August 12, 1955, and only with respect to short sales made after such date.

[T.D. 6500, 25 FR 12011, Nov. 26, 1960, as amended by T.D. 6494, 25 FR 9372, Sept. 30, 1960; T.D. 6926, 32 FR 11468, Aug. 9, 1967; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1233–2 Hedging transactions.

The character of gain or loss on a short sale that is (or is identified as being) part of a hedging transaction is determined under the rules of § 1.1221–2.

[T.D. 8555, 59 FR 36367, July 18, 1994]

§ 1.1234–1 Options to buy or sell.

(a) *Sale or exchange*—(1) *Capital assets.* Gain or loss from the sale or exchange of an option (or privilege) to buy or sell property which is (or if acquired would be) a capital asset in the hands of the taxpayer holding the option is considered as gain or loss from the sale or exchange of a capital asset (unless, under the provisions of subparagraph (2) of this paragraph, the gain or loss is subject to the provisions of section 1231). The period for which the taxpayer has held the option determines whether the capital gain or loss is short-term or long-term.

(2) *Section 1231 transactions.* Gain or loss from the sale or exchange of an option to buy or sell property is considered a gain or loss subject to the provisions of section 1231 if, had the sale or exchange been of the property subject to the option, held by the taxpayer for the length of time he held the option, the sale or exchange would have been subject to the provisions of section 1231.

(3) *Other property.* Gain or loss from the sale or exchange of an option to buy or sell property which is not (or if acquired would not be) a capital asset in the hands of the taxpayer holding the option is considered ordinary income or loss (unless under the provisions of subparagraph (2) of this paragraph, the gain or loss is subject to the provisions of section 1231).

(b) *Failure to exercise option.* If the holder of an option to buy or sell property incurs a loss on failure to exercise the option, the option is deemed to have been sold or exchanged on the date that it expired. Any such loss to the holder of an option is treated under the general rule provided in paragraph (a) of this section. In general, any gain to the grantor of an option arising from the failure of the holder to exercise it, and any gain or loss realized by the grantor of an option as a result of a closing transaction, such as repurchasing the option from the holder, is considered ordinary income or loss. However, for the treatment of gain or loss from a closing transaction with respect to or gain on the lapse of an option granted in stock, securities, commodities or commodity futures, see section 1234(b) and § 1.1234–3. For special rules for grantors of straddles applicable to certain options granted on or before September 1, 1976, see § 1.1234–2.

(c) *Certain options to sell property at a fixed price.* Section 1234 does not apply to a loss on the failure to exercise an option to sell property at a fixed price which is acquired on the same day on which the property identified as intended to be used in exercising the option is acquired. Such a loss is not recognized, but the cost of the option is added to the basis of the property with which it is identified. See section 1233(c) and the regulations thereunder.

(d) *Dealers in options to buy or sell.* Any gain or loss realized by a dealer in options from the sale or exchange or an option to buy or sell property is considered ordinary income or loss under paragraph (a)(3) of this section. A dealer in options to buy or sell property is considered a dealer in the property subject to the option.

(e) *Other exceptions.* Section 1234 does not apply to gain resulting from the sale or exchange of an option:

(1) To the extent that the gain is in the nature of compensation (see sections 61 and 421, and the regulations thereunder, relating to employee stock options);

(2) If the option is treated as section 306 stock (see section 306 and the regulations thereunder, relating to dispositions of certain stock); or

(3) To the extent that the gain is a distribution of earnings or profits taxable as a dividend (see section 301 and the regulations thereunder, relating to distributions of property).

(4) Acquired by the taxpayer before March 1, 1954, if in the hands of the taxpayer such option is a capital asset (whether or not the property to which the option relates is, or would be if acquired by the taxpayer, a capital asset in the hands of the taxpayer).

(f) *Limitations on effect of section.* Losses to which section 1234 applies are subject to the limitations on losses under sections 165(c) and 1211 when applicable. Section 1234 does not permit the deduction of any loss which is disallowed under any other provision of law. In addition, section 1234 does not apply to an option to lease property, but does apply to an option to buy or sell a lease. Thus, an option to obtain all the right, title, and interest of a lessee in leased property is subject to the provisions of section 1234, but an option to obtain a sublease from the lessee is not. Furthermore, if section 1234 applies to an option to buy or sell a lease, it is the character the lease itself, if acquired, would have in the hands of the taxpayer, and not the character of the property leased, which determines the treatment of gain or loss experienced by the taxpayer with respect to such an option.

(g) *Examples.* The rules set forth in this section may be illustrated by the following examples:

Example 1. A taxpayer is considering buying a new house for his residence and acquires an option to buy a certain house at a fixed price. Although the property goes up in value, the taxpayer decides he does not want the house for his residence and sells the option for more than he paid for it. The gain which taxpayer realized is a capital gain since the property, if acquired, would have been a capital asset in his hands.

Example 2. Assume the same facts as in example (1), except that the property goes down in value, and the taxpayer decides not to purchase the house. He sells the option at a loss. While this is a capital loss under section 1234, it is not a deductible loss because of the provisions of section 165(c).

Example 3. A dealer in industrial property acquires an option to buy an industrial site and fails to exercise the option. The loss is an ordinary loss since he would have held the property for sale to customers in the ordinary course of his trade or business if he had acquired it.

[T.D. 6500, 25 FR 12013, Nov. 26, 1960, as amended by T.D. 7652, 44 FR 62282, Oct. 30, 1979]

§ 1.1234–2 Special rule for grantors of straddles applicable to certain options granted on or before September 1, 1976.

(a) *In general.* Section 1234(c)(1) provides a special rule applicable in the case of gain on the lapse of an option granted by the taxpayer as part of a straddle. In such a case, the gain shall be deemed to be gain from the sale or exchange of a capital asset held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) on the day that the option expired. Thus, such gain shall be treated as a short-term capital gain, as defined in section 1222(1). Section 1234(c)(1) does not apply to any person who holds securities (including options to acquire or sell securities) for sale to customers in the ordinary course of his trade or business.

(b) *Definitions.* The following definitions apply for purposes of section 1234(c) and this section.

(1) *Straddle.* The term *straddle* means a simultaneously granted combination of an option to buy (i.e., a *call*) and an option to sell (i.e., a *put*) the same quantity of a security at the same price during the same period of time.

(2) *Security.* The term *security* has the meaning assigned to such term by section 1236(c) and the regulations thereunder. Thus, for example, the term *security* does not include commodity futures.

(3) *Grantor.* The term *grantor* means the writer or issuer of the option contracts making up the straddle.

(4) *Multiple option.* The term *multiple option* means a simultaneously granted combination of an option to buy plus an option to sell plus one or more additional options to buy or sell a security.

(c) *Special rules in the case of a multiple option.* (1) If, in the case of a multiple option, the number of the options to sell and the number of the options to buy are the same and if the terms of all of the options are identical (as to the quantity of the security, price, and period of time), then each of the options contained in the multiple option shall be deemed to be a component of a straddle for purposes of section 1234(c)(1) and paragraph (a) of this section.

(2) If, in the case of a multiple option, the number of the options to sell and the number of the options to buy are not the same or if the terms of all of the options are not identical (as to the quantity of the security, price, and period of time), then section 1234(c)(1) applies to gain on the lapse of an option granted as part of the multiple option only if:

(i) The grantor of the multiple option identifies the two options which comprise each straddle contained in the multiple option in the manner prescribed in subparagraph (3) of this paragraph; or

(ii) It is clear from the facts and circumstances that the lapsed option was part of a straddle. See example (6) of paragraph (f) of this section. A multiple option to which this subdivision applies may not be regarded as consisting of a number of straddles which exceeds the lesser of the options to sell or the options to buy as the case may be. For example, if a multiple option of five puts and four calls is granted it may not be regarded as consisting of more than four straddles, although the particular facts and circumstances could dictate that the option consists of less than four straddles.

(3) The identification required under subparagraph (2)(i) of this paragraph shall be made by the grantor indicating in his records, to the extent feasible, the individual serial number of, or other characteristic symbol imprinted upon, each of the two individual options which comprise the straddle, or by adopting any other method of identification satisfactory to the Commissioner. Such identification must be made before the expiration of the 15th day after the day on which the multiple option is granted. The preceding sentence shall apply only with respect to multiple options granted after January 24, 1972. In computing the 15-day period prescribed by this paragraph, the first day of such period is the day following the day on which the multiple option is granted.

(d) *Allocation of premium.* The allocation of a premium received for a straddle or a multiple option between or among the component options thereof shall be made on the basis of the relative market value of such component options at the time of their issuance or on any other reasonable and consistently applied basis which is acceptable to the Commissioner.

(e) *Effective date*—(1) *In general.* This section, relating to special rules for grantors of straddles, shall apply only with respect to straddle transactions entered into after January 25, 1965, and before September 2, 1976.

(2) *Special rule.* For a special rule with respect to the identification of a straddle granted as part of a multiple option, see paragraph (c).

(f) *Illustrations.* The application of section 1234(c) and this section may be illustrated by the following examples:

Example 1. On February 1, 1971, taxpayer A, who files his income tax returns on a calendar year basis, issues a straddle for 100 shares of X Corporation stock and receives a premium of $1,000. The options comprising the straddle were to expire on August 10, 1971. A has allocated $450 (45 percent of $1,000) of the premium to the put and $550 (55 percent of $1,000) to the call. On March 1, 1971, B, the holder of the put, exercises his option. C, the holder of the call, fails to exercise his option prior to its expiration. As a result of C's failure to exercise his option, A realizes a short-term capital gain of $550 (that part of the premium allocated to the call) on August 10, 1971.

Example 2. Assume the same facts as in example (1), except that C exercises his call on March 1, 1971, and B fails to exercise his put prior to its expiration. As a result of B's failure to exercise his option, A realizes a short-term capital gain of $450 (that part of the premium allocated to the put) on August 10, 1971.

Example 3. Assume the same facts as in example (1), except that both B and C fail to exercise their respective options. As a result of the failure of B and C to exercise their options, A realizes short-term capital gains of $1,000 (the premium for granting the straddle) on August 10, 1971.

Example 4. On March 1, 1971, taxpayer D issues a multiple option containing five puts and five calls. Each put and each call is for the same number of shares of Y Corporation stock, at the same price, and for the same period of time. Thus, each of the puts and calls is deemed to be a component part of a straddle. The puts and calls comprising the multiple option were to expire on September 10, 1971. All of the puts are exercised, and all of the calls lapse. As a result of the lapse of the calls, D realizes a short-term capital gain on September 10, 1971, in the amount of that part of the premium for the multiple option which is allocable to all of the calls.

Example 5. Assume the same facts as in example (4) except that one of the puts and two of the calls lapse and the remaining puts and calls are exercised. As a result, on September 10, 1971, D realizes a short-term capital gain in the amount of that part of the premium for the multiple option which is allocable to both of the lapsed calls and the lapsed put.

Example 6. On March 1, 1971, taxpayer E issues a multiple option containing five puts and four calls. Each put and call is for the same number of shares of Y Corporation stock at the same price and for the same period of time, E does not identify the puts and calls as parts of straddles in the manner prescribed in paragraph (c)(3) of this section. However, because the terms of all of the puts and all of the calls are identical four of the puts and four of the calls are deemed to be a component part of a straddle. The puts and calls comprising the multiple option were to expire on September 10, 1971. Four of the puts are exercised and the four calls and one of the puts lapse. As a result, on September 10, 1971, E realizes short-term capital gain in the amount of that part of the premium for the multiple option which is allocable to the four lapsed calls and realizes ordinary income in the amount of that part of such premium which is allocable to the lapsed put. If E had identified four of the puts and four of the calls as constituting parts of straddles in the manner prescribed in paragraph (c)(3) of this section and the put that lapsed constituted part of a straddle, then the gain on the lapse of the put would also be short-term capital gain.

Example 7. Assume the same facts as in example (6) except that two of the puts are for Y Corporation stock at a price which is greater than that of the other puts and the other calls and that two of the calls expire on October 10, 1971. Additionally, assume that the put which lapses is at the lower price. The two puts offering the Y Corporation stock at the greater price and the two calls with the later expiration date cannot be deemed to be component parts of a straddle. Thus, only two of the puts and two of the calls are deemed to be a component part of a straddle. As a result, E realizes income as follows:

(i) On September 10, 1971, short-term capital gain in the amount of that part of the premium for the multiple option which is allocable to the two lapsed calls with the expiration date of September 10, 1971, and ordinary income in the amount of that part of such premium which is allocable to the lapsed put. If E had identified two of the puts at the lower price and the two calls with the expiration date of September 10, 1971, as constituting parts of straddles in the manner prescribed in paragraph (c)(3) of this section and if the put that lapsed was one of those identified as constituting a part of a straddle, then the gain on the lapse of that put would also be short-term capital gain.

(ii) On October 10, 1971, ordinary income in the amount of that part of the premium for the multiple option which is allocable to the lapsed calls with an expiration date of October 10, 1971.

[T.D. 7152, 36 FR 24801, Dec. 23, 1971, as amended by T.D. 7210, 37 FR 20688, Oct. 3, 1972; T.D. 7652; 44 FR 62282, Oct. 30, 1979; 44 FR 67657, Nov. 27, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1234–3 Special rules for the treatment of grantors of certain options granted after September 1, 1976.

(a) *In general.* In the case of the grantor of an option (including an option granted as part of a straddle or multiple option), gain of loss from any closing transaction with respect to, and gain on the lapse of, an option in property shall be treated as a gain or loss from the sale or exchange of a capital asset held not more than 1 year. (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(b) *Definitions.* The following definitions apply for purposes of this section.

(1) The term *closing transaction* means any termination of a grantor's obligation under an option to buy property (a *call*) or an option to sell property (a *put*) other than through the exercise or lapse of the option. For example, the grantor of a call may effectively terminate his obligation under the option by either:

(i) Repurchasing the option from the holder or

(ii) Purchasing from an options exchange a call with terms identical to the original option granted and designating the purchase as a closing transaction.

A put or call purchased to make a closing transaction is identical as to striking price and expiration date. Such put or call need not match the granted option in time of creation, date of acquisition, cost of the entire option or units therein, or number of units subject to the option. If such put or call terminates only part of a grantor's obligation under the granted option, a closing transaction is made as to that part.

(2) The term *property* means stocks and securities (including stocks and securities dealt with on a *when issued* basis), commodities, and commodity futures.

(3) The term *grantor* means the writer or issuer of an option.

(4) The term *straddle* means a simultaneously granted combination of an option to buy and an option to sell the same quantity of property at the same price during the same period of time.

(5) The term *multiple option* means a simultaneously granted combination of an option to buy plus an option to sell plus one or more additional options to buy or sell property.

(c) *Nonapplicability to broker-dealers.* The provisions of this section do not apply to any option granted in the ordinary course of the taxpayer's trade or business of granting options. However, the provisions of this section do apply to:

(1) Gain from any closing transaction with respect to an option and gain on lapse of an option if gain on the sale or exchange of the option would be considered capital gain by a dealer in securities under section 1236(a) and the regulations thereunder, and

(2) Loss from any closing transaction with respect to an option if loss on the sale or exchange of the option would not be considered ordinary loss by a dealer in securities under section 1236(b) and the regulations thereunder.

The preceding sentence shall be applied with respect to dealers in *property* (as defined in paragraph (b)(2) of this section) and without regard to the limitation of the applicability of section 1236 to dealers in securities.

(d) *Nonapplicability to compensatory options.* Section 1234 does not apply to options to purchase stock or other property which are issued as compensation for services, as described in sections 61, 83, and 421 and the regulations thereunder.

(e) *Premium allocation for simultaneously granted options.* The allocation of a premium received for a straddle or multiple option between or among the component options thereof shall be made on the basis of the relative market value of the component options at the time of their issuance or on any other reasonable and consistently applied basis which is acceptable to the Commissioner.

(f) *Effective date.* This section, relating to special rules for the treatment of grantors of certain options, shall apply to options granted after September 1, 1976.

[T.D. 7652, 44 FR 62282, Oct. 30, 1979; 44 FR 67657, Nov. 27, 1979]

§1.1234–4 Hedging transactions.

The character of gain or loss on an acquired or a written option that is (or is identified as being) part of a hedging transaction is determined under the rules of §1.1221–2.

[T.D. 8555, 59 FR 36367, July 18, 1994]

§1.1235–1 Sale or exchange of patents.

(a) *General rule.* Section 1235 provides that a transfer (other than by gift, inheritance, or devise) of all substantial rights to a patent, or of an undivided interest in all such rights to a patent, by a holder to a person other than a related person constitutes the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), whether or not payments therefor are:

(1) Payable periodically over a period generally coterminous with the transferee's use of the patent, or

(2) Contingent on the productivity, use, or disposition of the property transferred.

(b) *Scope of section 1235.* If a transfer is not one described in paragraph (a) of this section, section 1235 shall be disregarded in determining whether or not such transfer is the sale or exchange of a capital asset. For example, a transfer by a person other than a holder or a transfer by a holder to a related person is not governed by section 1235. The tax consequences of such transfers shall be determined under other provisions of the internal revenue laws.

(c) *Special rules*—(1) *Payments for infringement.* If section 1235 applies to the transfer of all substantial rights to a patent (or an undivided interest therein), amounts received in settlement of, or as the award of damages in, a suit for compensatory damages for infringement of the patent shall be considered payments attributable to a transfer to which section 1235 applies to the extent that such amounts relate to the interest transferred. For taxable years beginning before January 1, 1964, see section 1304, as in effect before such date, and § 1.1304A–1 for treatment of compensatory damages for patent infringement.

(2) *Payments to an employee.* Payments received by an employee as compensation for services rendered as an employee under an employment contract requiring the employee to transfer to the employer the rights to any invention by such employee are not attributable to a transfer to which section 1235 applies. However, whether payments received by an employee from his employer (under an employment contract or otherwise) are attributable to the transfer by the employee of all substantial rights to a patent (or an undivided interest therein) or are compensation for services rendered the employer by the employee is a question of fact. In determining which is the case, consideration shall be given not only to all the facts and circumstances of the employment relationship but also to whether the amount of such payments depends upon the production, sale, or use by, or the value to, the employer of the patent rights transferred by the employee. If it is determined that payments are attributable to the transfer of patent rights, and all other requirements under section 1235 are met, such payments shall be treated as proceeds derived from the sale of a patent.

(3) *Successive transfers.* The applicability of section 1235 to transfers of undivided interest in patents, or to successive transfers of such rights, shall be determined separately with respect to each transfer. For example, X, who is a holder, and Y, who is not a holder, transfer their respective two-thirds and one-third undivided interests in a patent to Z. Assume the transfer by X qualifies under section 1235 and that X in a later transfer acquires all the rights with respect to Y's interest, including the rights to payments from Z. One-third of all the payments thereafter received by X from Z are not attributable to a transfer to which section 1235 applies.

(d) *Payor's treatment of payments in a transfer under section 1235.* Payments made by the transferee of patent rights pursuant to a transfer satisfying the requirements of section 1235 are payments of the purchase price for the patent rights and are not the payment of royalties.

(e) *Effective date.* Amounts received or accrued, and payments made or accrued, during any taxable year beginning after December 31, 1953 and ending after August 16, 1954, pursuant to a transfer satisfying the requirements of section 1235, whether such transfer occurred in a taxable year to which the Internal Revenue Code of 1954 applies, or in a year prior thereto, are subject to the provisions of section 1235.

(f) *Nonresident aliens.* For the special rule relating to nonresident aliens who have gains arising from a transfer to which section 1235 applies, see section 871 and the regulations thereunder. For withholding of tax from income of nonresident aliens, see section 1441 and the regulations thereunder.

[T.D. 6500, 25 FR 12014, Nov. 26, 1960, as amended by T.D. 6885, 31 FR 7803, June 2, 1966; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1235–2 Definition of terms.

For the purposes of section 1235 and § 1.1235–1:

(a) *Patent.* The term *patent* means a patent granted under the provisions of title 35 of the United States Code, or any foreign patent granting rights generally similar to those under a United States patent. It is not necessary that the patent or patent application for the invention be in existence if the requirements of section 1235 are otherwise met.

(b) *All substantial rights to a patent.* (1) The term *all substantial rights to a patent* means all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent (or an undivided interest therein) are transferred. The term *all substantial rights to a patent* does not include a grant of rights to a patent:

(i) Which is limited geographically within the country of issuance;

(ii) Which is limited in duration by the terms of the agreement to a period less than the remaining life of the patent;

(iii) Which grants rights to the grantee, in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant; or

(iv) Which grants to the grantee less than all the claims or inventions covered by the patent which exist and have value at the time of the grant.

The circumstances of the whole transaction, rather than the particular terminology used in the instrument of transfer, shall be considered in determining whether or not all substantial rights to a patent are transferred in a transaction.

(2) Rights which are not considered substantial for purposes of section 1235 may be retained by the holder. Examples of such rights are:

(i) The retention by the transferor of legal title for the purpose of securing performance or payment by the transferee in a transaction involving transfer of an exclusive license to manufacture, use, and sell for the life of the patent;

(ii) The retention by the transferor of rights in the property which are not inconsistent with the passage of ownership, such as the retention of a security interest (such as a vendor's lien), or a reservation in the nature of a condition subsequent (such as a provision for forfeiture on account of nonperformance).

(3) Examples of rights which may or may not be substantial, depending upon the circumstances of the whole transaction in which rights to a patent are transferred, are:

(i) The retention by the transferor of an absolute right to prohibit sublicensing or subassignment by the transferee;

(ii) The failure to convey to the transferee the right to use or to sell the patent property.

(4) The retention of a right to terminate the transfer at will is the retention of a substantial right for the purposes of section 1235.

(c) *Undivided interest.* A person owns an *undivided interest* in all substantial rights to a patent when he owns the same fractional share of each and every substantial right to the patent. It does not include, for example, a right to the income from a patent, or a license limited geographically, or a license which covers some, but not all, of the valuable claims or uses covered by the patent. A transfer limited in duration by the terms of the instrument to a period less than the remaining life of the patent is not a transfer of an undivided interest in all substantial rights to a patent.

(d) *Holder.* (1) The term *holder* means any individual:

(i) Whose efforts created the patent property and who would qualify as the *original and first* inventor, or joint inventor, within the meaning of title 35 U.S.C., or

(ii) Who has acquired his interest in the patent property in exchange for a consideration paid to the inventor in money or money's worth prior to the actual reduction of the invention to practice (see paragraph (e) of this section), provided that such individual was neither the employer of the inventor nor related to him (see paragraph (f) of this section). The requirement that such individual is neither the employer of the inventor nor related to him must be satisfied at the time when the substantive rights as to the interest to be acquired are determined, and at the time when the consideration in money or money's worth to be paid is definitely fixed. For example, if prior to the actual reduction to practice of an invention an individual who is neither the employer of the inventor nor related to him agrees to pay the inventor a sum of money definitely fixed as to amount in return for an undivided one-half interest in rights to a patent and at a later date, when such individual has become the employer of the inventor, he pays the definitely fixed sum of money pursuant to the earlier agreement, such individual will not be denied the status of a holder because of such employment relationship.

(2) Although a partnership cannot be a holder, each member of a partnership who is an individual may qualify as a holder as to his share of a patent

owned by the partnership. For example, if an inventor who is a member of a partnership composed solely of individuals uses partnership property in the development of his invention with the understanding that the patent when issued will become partnership property, each of the inventor's partners during this period would qualify as a holder. If, in this example, the partnership were not composed solely of individuals, nevertheless, each of the individual partners' distributive shares of income attributable to the transfer of all substantial rights to the patent or an undivided interest therein, would be considered proceeds from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(3) An individual may qualify as a holder whether or not he is in the business of making inventions or in the business of buying and selling patents.

(e) *Actual reduction to practice.* For the purposes of determining whether an individual is a holder under paragraph (d) of this section, the term *actual reduction to practice* has the same meaning as it does under section 102(g) of title 35 of the United States Code. Generally, an invention is reduced to actual practice when it has been tested and operated successfully under operating conditions. This may occur either before or after application for a patent but cannot occur later than the earliest time that commercial exploitation of the invention occurs.

(f) *Related person.* (1) The term *related person* means one whose relationship to another person at the time of the transfer is described in section 267(b), except that the term does not include a brother or sister, whether of the whole or the half blood. Thus, if a holder transfers all his substantial rights to a patent to his brother or sister, or both, such transfer is not to a related person.

(2) If, prior to September 3, 1958, a holder transferred all his substantial rights to a patent to a corporation in which he owned more than 50 percent in value of the outstanding stock, he is considered as having transferred such rights to a related person for the purpose of section 1235. On the other hand, if a holder, prior to September 3, 1958, transferred all his substantial rights to a patent to a corporation in which he owned 50 percent or less in value of the outstanding stock and his brother owned the remaining stock, he is not considered as having transferred such rights to a related person since the brother relationship is to be disregarded for purposes of section 1235.

(3) If, subsequent to September 2, 1958, a holder transfers all his substantial rights to a patent to a corporation in which he owns 25 percent or more in value of the outstanding stock, he is considered as transferring such rights to a related person for the purpose of section 1235. On the other hand if a holder, subsequent to September 2, 1958, transfers all his substantial rights to a patent to a corporation in which he owns less than 25 percent in value of the outstanding stock and his brother owns the remaining stock, he is not considered as transferring such rights to a related person since the brother relationship is to be disregarded for purposes of section 1235.

(4) If a relationship described in section 267(b) exists independently of family status, the brother-sister exception, described in subparagraphs (1), (2), and (3) of this paragraph, does not apply. Thus, if a holder transfers all his substantial rights to a patent to the fiduciary of a trust of which the holder is the grantor, the holder and the fiduciary are related persons for purposes of section 1235(d). (See section 267(b)(4).) The transfer, therefore, would not qualify under section 1235(a). This result obtains whether or not the fiduciary is the brother or sister of the holder since the disqualifying relationship exists because of the grantor-fiduciary status and not because of family status.

[T.D. 6500, 25 FR 12014, Nov. 26, 1960, as amended by T.D. 6852, 30 FR 12730, Oct. 6, 1965; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1236–1 Dealers in securities.

(a) *Capital gains.* Section 1236(a) provides that gain realized by a dealer in securities from the sale or exchange of a security (as defined in paragraph (c) of this section) shall not be considered as gain from the sale or exchange of a capital asset unless:

(1) The security is, before the expiration of the thirtieth day after the date of its acquisition, clearly identified in the dealer's records as a security held for investment or, if acquired before October 20, 1951, was so identified before November 20, 1951; and

(2) The security is not held by the dealer primarily for sale to customers in the ordinary course of his trade or business at any time after the identification referred to in subparagraph (1) of this paragraph has been made.

Unless both of these requirements are met, the gain is considered as gain from the sale of assets held by the dealer primarily for sale to customers in the course of his business.

(b) *Ordinary losses.* Section 1236(b) provides that a loss sustained by a dealer in securities from the sale or exchange of a security shall not be considered a loss from the sale or exchange of property which is not a capital asset if at any time after November 19, 1951, the security has been clearly identified in the dealer's records as a security held for investment. Once a security has been identified after November 19, 1951, as being held by the dealer for investment, it shall retain that character for purposes of determining loss on its ultimate disposition, even though at the time of its disposition the dealer holds it primarily for sale to his customers in the ordinary course of his business. However, section 1236 has no application to the extent that section 582(c) applies to losses of banks.

(c) *Definitions*—(1) *Security.* For the purposes of this section, the term *security* means any share of stock in any corporation, any certificate of stock or interest in any corporation, any note, bond, debenture, or other evidence of indebtedness, or any evidence of any interest in, or right to subscribe to or purchase, any of the foregoing.

(2) *Dealer in securities.* For definition of a *dealer in securities,* see the regulations under section 471.

(d) *Identification of security in dealer's records.* (1) A security is clearly identified in the dealer's records as a security held for investment when there is an accounting separation of the security from other securities, as by making appropriate entries in the dealer's books of account to distinguish the security from inventories and to designate it as an investment and by (i) indicating with such entries, to the extent feasible, the individual serial number of, or other characteristic symbol imprinted upon, the individual security, or (ii) adopting any other method of identification satisfactory to the Commissioner.

(2) In computing the 30-day period prescribed by section 1236(a), the first day of the period is the day following the date of acquisition. Thus, in the case of a security acquired on March 18, 1957, the 30-day period expires at midnight on April 17, 1957.

[T.D. 6500, 25 FR 12015, Nov. 26, 1960, as amended by T.D. 6726, 29 FR 5667, Apr. 29, 1964]

§1.1237–1 Real property subdivided for sale.

(a) *General rule*—(1) *Introductory.* This section provides a special rule for determining whether the taxpayer holds real property primarily for sale to customers in the ordinary course of his business under section 1221(1). This rule is to permit taxpayers qualifying under it to sell real estate from a single tract held for investment without the income being treated as ordinary income merely because of subdividing the tract or of active efforts to sell it. The rule is not applicable to dealers in real estate or to corporations, except a corporation making such sales in a taxable year beginning after December 3l, 1954, if such corporation qualifies under the provisions of paragraph (c)(5)(iv) of this section.

(2) *When subdividing and selling activities are to be disregarded.* When its conditions are met, section 1237 provides that if there is no other substantial evidence that a taxpayer holds real estate primarily for sale to customers in the ordinary course of his business, he shall not be considered a real estate dealer holding it primarily for sale merely because he has (i) subdivided the tract into lots (or parcels) and (ii) engaged in advertising, promotion, selling activities or the use of sales agents in connection with the sale of lots in such subdivision. Such subdividing and selling activities shall be disregarded in determining the purpose

for which the taxpayer held real property sold from a subdivision whenever it is the only substantial evidence indicating that the taxpayer has ever held the real property sold primarily for sale to customers in the ordinary course of his business.

(3) *When subdividing and selling activities are to be taken into account.* When other substantial evidence tends to show that the taxpayer held real property for sale to customers in the ordinary course of his business, his activities in connection with the subdivision and sale of the property sold shall be taken into account in determining the purpose for which the taxpayer held both the subdivided property and any other real property. For example, such other evidence may consist of the taxpayer's selling activities in connection with other property in prior years during which he was engaged in subdividing or selling activities with respect to the subdivided tract, his intention in prior years (or at the time of acquiring the property subdivided) to hold the tract primarily for sale in his business, his subdivision of other tracts in the same year, his holding other real property for sale to customers in the same year, or his construction of a permanent real estate office which he could use in selling other real property. On the other hand, if the only evidence of the taxpayer's purpose in holding real property consisted of not more than one of the following, in the year in question, such fact would not be considered substantial other evidence:

(i) Holding a real estate dealer's license;

(ii) Selling other real property which was clearly investment property;

(iii) Acting as a salesman for a real estate dealer, but without any financial interest in the business; or

(iv) Mere ownership of other vacant real property without engaging in any selling activity whatsoever with respect to it.

If more than one of the above exists, the circumstances may or may not constitute substantial evidence that the taxpayer held real property for sale in his business, depending upon the particular facts in each case.

(4) *Section 1237 not exclusive.* (i) The rule in section 1237 is not exclusive in its application. Section 1237 has no application in determining whether or not real property is held by a taxpayer primarily for sale in his business if any requirement under the section is not met. Also, even though the conditions of section 1237 are met, the rules of section 1237 are not applicable if without regard to section 1237 the real property sold would not have been considered real property held primarily for sale to customers in the ordinary course of his business. Thus, the district director may at all times conclude from convincing evidence that the taxpayer held the real property solely as an investment. Furthermore, whether or not the conditions of section 1237 are met, the section has no application to losses realized upon the sale of realty from subdivided property.

(ii) If, owing solely to the application of section 1237, the real property sold is deemed not to have been held primarily for sale in the ordinary course of business, any gain realized upon such sale shall be treated as ordinary income to the extent provided in section 1237(b) (1) and (2) and paragraph (e) of this section. Any additional gain realized upon the sale shall be treated as gain arising from the sale of a capital asset or, if the circumstances so indicate, as gain arising from the sale of real property used in the trade or business as defined in section 1231 (b)(1). For the relationship between sections 1237 and 1231, see paragraph (f) of this section.

(5) *Principal conditions of qualification.* Before section 1237 applies, the taxpayer must meet three basic conditions, more fully explained later: He cannot have held any part of the tract at any time previously for sale in the ordinary course of his business, nor in the year of sale held any other real estate for sale to customers; he cannot make substantial improvements on the tract which increase the value of the lot sold substantially; and he must have owned the property 5 years, unless he inherited it. However, the taxpayer may make certain improvements if they are necessary to make the property marketable if he elects neither to add their cost to the basis of the property, or of any other property, nor to deduct the cost as an expense, and he

has held the property at least 10 years. If the requirements of section 1237 are met, gain (but not more than 5 percent of the selling price of each lot) shall be treated as ordinary income in and after the year in which the sixth lot or parcel is sold.

(b) *Disqualification arising from holding real property primarily for sale*—(1) *General rule.* Section 1237 does not apply to any transaction if the taxpayer either:

(i) Held the lot sold (or the tract of which it was a part) primarily for sale in the ordinary course of his business in a prior year, or

(ii) Holds other real property primarily for sale in the ordinary course of his business in the same year in which such lot is sold.

Where either of these elements is present, section 1237 shall be disregarded in determining the proper treatment of any gain arising from such sale.

(2) *Method of applying general rule.* For purposes of this paragraph, in determining whether the lot sold was held primarily for sale in the ordinary course of business in a prior year, the principles of section 1237 shall be applied, whether or not section 1237 was effective for such prior year, if the sale of the lot occurs after December 31, 1953, or, in the case of a corporation meeting the requirements of paragraph (c)(5)(iv) of this section, if the sale of the lot occurs in a taxable year beginning after December 31, 1954. Whether, on the other hand, the taxpayer holds other real property for sale in the ordinary course of his business in the same year such lot was sold shall be determined without regard to the application of section 1237 to such other real property.

(3) *Attribution rules with respect to the holding of property.* The taxpayer is considered as holding property which he owns individually, jointly, or as a member of a partnership. He is not generally considered as holding property owned by members of his family, an estate or trust, or a corporation. See, however, paragraph (c)(5) (iv)(c) of this section for an exception to this rule. The purpose for which a prior owner held the lot or tract, or his activities, are immaterial except to the extent they indicate the purpose for which the taxpayer has held the lot or tract. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held. The principles of this subparagraph may be illustrated by the following example:

Example: A dealer in real property held a tract of land for sale to customers in the ordinary course of his business for 5 years. He then made a gift of it to his son. As a result of the operation of section 1223(2) the son will have held the property for the period of time required by section 1237. However, he will not qualify for the benefits of section 1237 because, there being no evidence to the contrary, the circumstances involved establish that the son holds the property for sale to customers, as did his father.

(c) *Disqualification arising from substantial improvements*—(1) *General rule.* Section 1237 will not apply if the taxpayer or certain others make improvements on the tract which are substantial and which substantially increase the value of the lot sold. Certain improvements are not substantial within the meaning of section 1237(a)(2) if they are necessary to make the lot marketable at the prevailing local price and meet the other conditions of section 1237(b)(3). See subparagraph (5) of this paragraph.

(2) *Improvements made or deemed to be made by the taxpayer.* Certain improvements made by the taxpayer or made under a contract of sale between the taxpayer and the buyer make section 1237 inapplicable.

(i) For the purposes of section 1237 (a)(2) the taxpayer is deemed to have made any improvements on the tract while he held it which are made by:

(*a*) The taxpayer’s whole or half brothers and sisters, spouse, ancestors and lineal descendants.

(*b*) A corporation controlled by the taxpayer. A corporation is controlled by the taxpayer if he controls, as the result of direct ownership, constructive ownership, or otherwise, more than 50 percent of the corporation’s voting stock.

(*c*) A partnership of which the taxpayer was a member at the time the improvements were made.

(*d*) A lessee if the improvement takes the place of a payment of rental income. See section 109 and the regulations thereunder.

(*e*) A Federal, State, or local government, or political subdivision thereof, if the improvement results in an increase in the taxpayer's basis for the property, as it would, for example, from a special tax assessment for paving streets.

(ii) The principles of subdivision (i) of this subparagraph may be illustrated by the following example:

Example: A held a tract of land for 3 years during which he made substantial improvements thereon which substantially enhanced the value of every lot on the tract. A then made a gift of the tract to his son. The son made no further improvements on the tract but held it for 3 years and then sold several lots therefrom. The son is not entitled to the benefits of section 1237 since under section 1237(a)(2) he is deemed to have made the substantial improvements made by his father, and under section 1223(2) he is treated as having held the property for the period during which his father held it. Thus, the disqualifying improvements are deemed to have been made by the son while the tract was held by him. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held.

(iii) The taxpayer is also charged with making any improvements made pursuant to a contract of sale entered into between the taxpayer and the buyer. Therefore, the buyer, as well as the taxpayer, may make improvements which prevent the application of section 1237.

(*a*) If a contract of sale obligates either the taxpayer or the buyer to make a substantial improvement which would substantially increase the value of the lot, the taxpayer may not claim the application of section 1237 unless the obligation to improve the lot ceases (for any reason other than that the improvement has been made) before or within the period, prescribed by section 6511, within which the taxpayer may file a claim for credit or refund of an overpayment of his tax on the gain from the sale of the lot. The following example illustrates this rule:

Example: In 1956, A sells several lots from a tract he has subdivided for sale. Section 1237 would apply to the sales of these lots except that in the contract of sale, A agreed to install sewers, hard surface roads, and other utilities which would increase the value of the lots substantially. If in 1957, instead of requiring the improvements, the buyer releases A from this obligation, A may then claim the application of section 1237 to the sale of lots in 1956 in computing his income tax for 1956, since the period of limitations in which A may file a claim for credit or refund of an overpayment of his 1956 income tax has not expired.

(*b*) An improvement is made pursuant to a contract if the contract imposes an obligation on either party to make the improvement, but not if the contract merely places restrictions on the improvements, if any, either party may make. The following example illustrates this rule:

Example: B sells several lots from a tract which he has subdivided. Each contract of sale prohibits the purchaser from building any structure on his lot except a personal residence costing $15,000 or more. Even if the purchasers build such residences, that does not preclude B from applying section 1237 to the sales of such lots, since the contracts did not obligate the purchasers to make any improvements.

(iv) Improvements made by a bona fide lessee (other than as rent) or by others not described in section 1237(a)(2) do not preclude the use of section 1237.

(3) *When improvements substantially enhance the value of the lot sold.* Before a substantial improvement will preclude the use of section 1237, it must substantially enhance the value of the lot sold.

(i) The increase in value to be considered is only the increase attributable to the improvement or improvements. Other changes in the market price of the lot, not arising from improvements made by the taxpayer, shall be disregarded. The difference between the value of the lot, including improvements, when the improvement has been completed and an appraisal of its value if unimproved at that time, will disclose the value added by the improvements.

(ii) Whether improvements have substantially increased the value of a lot depends upon the circumstances in each case. If improvements increase the value of a lot by 10 percent or less, such increase will not be considered as substantial, but if the value of the lot is increased by more than 10 percent, then all relevant factors must be considered to determine whether, under such circumstances, the increase is substantial.

(iii) Improvement may increase the value of some lots in a tract without equally affecting other lots in the same tract. Only the lots whose value was substantially increased are ineligible for application of the rule established by section 1237.

(4) *When an improvement is substantial.* To prevent the application of section 1237, the improvement itself must be substantial in character. Among the improvements considered substantial are shopping centers, other commercial or residential buildings, and the installation of hard surface roads or utilities such as sewers, water, gas, or electric lines. On the other hand a temporary structure used as a field office, surveying, filling, draining, leveling and clearing operations, and the construction of minimum all-weather access roads, including gravel roads where required by the climate, are not substantial improvements.

(5) *Special rules relating to substantial improvements.* Under certain conditions a taxpayer, including a corporation to which subdivision (iv) of this subparagraph applies, may obtain the benefits of section 1237 whether or not substantial improvements have been made. In addition, an individual taxpayer may, under certain circumstances elect to have substantial improvements treated as necessary and not substantial.

(i) *When an improvement is not considered substantial.* An improvement will not be considered substantial if all of the following conditions are met:

(*a*) The taxpayer has held the property for 10 years. The full 10-year period must elapse, whether or not the taxpayer inherited the property. Although the taxpayer must hold the property 10 years, he need not hold it for 10 years after subdividing it. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held.

(*b*) The improvement consists of the building or installation of water, sewer, or drainage facilities (either surface, sub-surface, or both) or roads, including hard surface roads, curbs, and gutters.

(*c*) The district director with whom the taxpayer must file his return is satisfied that, without such improvement, the lot sold would not have brought the prevailing local price for similar building sites.

(*d*) The taxpayer elects, as provided in subdivision (iii) of this subparagraph, not to adjust the basis of the lot sold or any other property held by him for any part of the cost of such improvement attributable to such lot and not to deduct any part of such cost as an expense.

(ii) *Meaning of similar building site.* A *similar building site* is any real property in the immediate vicinity whose size, terrain, and other characteristics are comparable to the taxpayer's property. For the purpose of determining whether a tract is marketable at the prevailing local price for similar building sites, the taxpayer shall furnish the district director with sufficient evidence to enable him to compare (*a*) the value of the taxpayer's property in an unimproved state with (*b*) the amount for which similar building sites, improved by the installation of water, sewer, or drainage facilities or roads, have recently been sold, reduced by the present cost of such improvements. Such comparison may be made and expressed in terms of dollars per square foot, dollars per acre, or dollars per front foot, or in any other suitable terms depending upon the practice generally followed by real estate dealers in the taxpayer's locality. The taxpayer shall also furnish evidence, where possible, of the best bona fide offer received for the tract or a lot thereof just before making the improvement, to assist the district director in determining the value of the tract or lot if it had been sold in its unimproved state. The operation of this subdivision and subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. A has been offered $500 per acre for a tract without roads, water, or sewer facilities which he has owned for 15 years. The adjacent tract has been subdivided and improved with water facilities and hard surface roads, and has sold for $4,000 per acre. The estimated cost of roads and water facilities on the adjacent tract is $2,500 per acre. The prevailing local price for similar building sites in the vicinity would be $1,500 per acre (i.e., $4,000 less $2,500). If A installed roads and water facilities at a cost of $2,500 per acre, his tract would sell for approximately $4,000 per acre. Under section 1237(b)(3) the installation of roads and water facilities does not constitute a substantial improvement if A elects to disregard the cost of such improvements ($2,500 per acre) in computing his cost or other basis for the lots sold from the tract, and in computing his basis for any other property owned by him.

Example 2. Assume the same facts as in example (1) of this subdivision, except that A can obtain $1,600 per acre for his property without improvements. The installation of any substantial improvements would not constitute a necessary improvement under section 1237(b)(3), since the prevailing local price could have been obtained without any improvement.

Example 3. Assume the same facts as in example (1) of this subdivision, except that the adjacent tract has also been improved with sewer facilities, the present cost of which is $1,200 per acre. The installation of the substantial improvements would not constitute a necessary improvement under section 1237(b)(3) on A's part, since the prevailing local price ($4,000 less the sum of $1,200 plus $2,500, or $300) could have been obtained by A without any improvement.

(iii) *Manner of making election.* The election required by section 1237(b)(3)(C) shall be made as follows:

(*a*) The taxpayer shall submit:

(*1*) A plat showing the subdivision and all improvements attributable to him.

(*2*) A list of all improvements to the tract, showing:

(*i*) The cost of such improvements.

(*ii*) Which of the improvements, without regard to the election, he considers *substantial* and which he considers not *substantial.*

(*iii*) Those improvements which are substantial to which the election is to apply, with a fair allocation of their cost to each lot they affect, and the amount by which they have increased the values of such lots.

(*iv*) The date on which each lot was acquired and its basis for determining gain or loss, exclusive of the cost of any improvements listed in subdivision (iii) of this subdivision.

(*3*) A statement that he will neither deduct as an expense nor add to the basis of any lot sold, or of any other property, any portion of the cost of any substantial improvement which substantially increased the value of any lot in the tract and which either he listed pursuant to (*a*)(*2*)(iii) of this subdivision or which the district director deems substantial.

(*b*) The election and the information required under (*a*) of this subdivision shall be submitted to the district director:

(*1*) With the taxpayer's income tax return for the taxable year in which the lots subject to the election were sold, or

(*2*) In the case of a return filed prior to August 14, 1957, either with a timely claim for refund, where the benefits of section 1237 have not been claimed on such return, or, independently, before November 13, 1957, where such benefits have been claimed, or

(*3*) If there is an obligation to make disqualifying improvements outstanding when the taxpayer files his return, with a formal claim for refund at the time of the release of the obligation, if it is then still possible to file a timely claim.

(*c*) Once made, the election as to the necessary improvement costs attributable to any lot sold shall be irrevocable and binding on the taxpayer unless the district director assesses an income tax as to such lot as if it were held for sale in the ordinary course of taxpayer's business. Under such circumstances, in computing gain, the cost or other basis shall be computed without regard to section 1237.

(iv) *Exceptions with respect to necessary* improvements and certain corporations. For taxable years beginning after December 31, 1954, individual taxpayers and certain corporations may obtain the benefits of section 1237 without complying with the provisions of subdivisions (i) (*c*) and (*d*), (ii), and (iii) of this subparagraph if the requirements of section 1237 are otherwise met and if:

(*a*) The property in question was acquired by the taxpayer through the foreclosure of a lien thereon,

(*b*) The lien foreclosed secured the payment of an indebtedness to the taxpayer or (in the case of a corporation) secured the payment of an indebtedness to a creditor who has transferred the foreclosure bid to the taxpayer in exchange for all of the stock of the corporation and other consideration, and (*c*) In the case of a corporate taxpayer, no shareholder of the corporation holds real property for sale to customers in the ordinary course of his trade or business or holds a controlling interest in another corporation which actually so holds real property, or which, but for the application of this subdivision, would be considered to so hold real property.

Thus, in the case of such property, it is not necessary for the taxpayer to satisfy the district director that the property would not have brought the prevailing local price without improvements or to elect not to add the cost of the improvements to his basis. In addition, if 80 percent or more of the real property owned by a taxpayer is property to which this subdivision applies, the requirements of (*a*) and (*b*) of this subdivision need not be met with respect to property adjacent to such property which is also owned by the taxpayer.

(d) *Holding period required*—(1) *General rules.* To apply section 1237, the taxpayer must either have inherited the lot sold or have held it for 5 years. Generally, the provisions of section 1223 are applicable in determining the period for which the taxpayer has held the property. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. A held a tract of land for 3 years under circumstances otherwise qualifying for section 1237 treatment. He made a gift of the tract to B at a time when the fair market value of the tract exceeded A's basis for the tract. B held the tract for 2 more years under similar circumstances. B then sold 4 lots from the tract. B is entitled to the benefits of section 1237 since under section 1223(2) he held the lots for 5 years and all the other requirements of section 1237 are met.

Example 2. C purchased all the stock in a corporation in 1955. The corporation purchased an unimproved tract of land in 1957. In 1961 the corporation was liquidated under section 333 and C acquired the tract of land. For purposes of section 1237, C's holding period commenced on the date the corporation actually acquired the land in 1957 and not on the date C purchased the stock.

(2) *Rules relating to property acquired upon death.* If the taxpayer inherited the property there is no 5-year holding period required under section 1237. However, any holding period required by any other provision of the Code, such as section 1222, is nevertheless applicable. For purposes of section 1237, neither the survivor's one-half of community property, nor property acquired by survivorship in a joint tenancy, is property acquired by devise or inheritance. The holding period for the surviving joint tenant begins on the date the property was originally acquired.

(e) *Tax consequences if section 1237 applies*—(1) *Introductory.* Where there is no substantial evidence other than subdivision and related selling activities that real property is held for sale in the ordinary course of taxpayer's business and section 1237 applies, section 1237(b)(1) provides a special rule for computing taxable gain. For the relationship between sections 1237 and 1231, see paragraph (f) of this section.

(2) *Characterization of gain and its relation to selling expenses.* (i) When the taxpayer has sold less than 6 lots or parcels from the same tract up to the end of his taxable year, the entire gain will be capital gain. (Where the land is used in a trade or business, see paragraph (f) of this section.) In computing the number of lots or parcels sold, two or more contiguous lots sold to a single buyer in a single sale will be counted as only one parcel. The following example illustrates this rule:

Example: A meets all the conditions of section 1237 in subdividing and selling a single tract. In 1956 he sells 4 lots to B, C, D, and E. In the same year F buys 3 adjacent lots. Since A has sold only 5 lots or parcels from the tract, any gain A realizes on the sales will be capital gain.

(ii) If the taxpayer has sold the sixth lot or parcel from the same tract within the taxable year, then the amount, if any, by which 5 percent of the selling price of each lot exceeds the expenses incurred in connection with its sale or exchange, shall, to the extent it represents gain, be ordinary income. Any part of the gain not treated as ordinary income will be treated as capital gain. (Where the land is used in a trade or business, see paragraph (f) of this section.) Five percent of the selling price of each lot sold from the tract in the taxable year the sixth lot is sold and thereafter is, to the extent it represents gain, considered ordinary income. However, all expenses of sale of the lot are to be deducted first from the 5 percent of the gain which would otherwise be considered ordinary income, and any remainder of such expenses shall reduce the gain upon the sale or exchange which would otherwise be considered capital gain. Such expenses cannot be deducted as ordinary business expenses from other income. The 5-percent rule applies to all lots sold from the tract in the year the sixth lot or parcel is sold. Thus, if the taxpayer sells the first 6 lots of a single tract in one year, 5 percent of the selling price of each lot sold shall be treated as ordinary income and reduced by the selling expenses. On the other hand, if the taxpayer sells the first 3 lots of a single tract in 1955, and the next 3 lots in 1956, only the gain realized from the sales made in 1956 shall be so treated. For the effect of a 5-year interval between sales, see paragraph (g)(2) of this section. The operation of this subdivision may be illustrated by the following examples:

Example 1. Assume the selling price of the sixth lot of a tract is $10,000, the basis of the lot in the hands of the taxpayer is $5,000, and the expenses of sale are $750. The amount of gain realized by the taxpayer is $4,250, of which the amount of ordinary income attributable to the sale is zero, computed as follows:

Selling price		$10,000
Basis		5,000
Excess over basis		5,000
5 percent of selling price	500	
Expenses of sale	750	
Amount of gain realized treated as ordinary income		0
Excess over basis		5,000
5 percent of selling price	500	
Excess of expenses over 5 percent of selling price	250	
		750
Amount of gain realized from sale of property not held for sale in ordinary course of business		4,250

Example 2. Assume the same facts as in Example 1, except that the expenses of sale of such sixth lot are $300. The amount of gain realized by the taxpayer is $4,700, of which the amount of ordinary income attributable to the sale is $200, computed as follows:

Selling price		$10,000
Basis		5,000
Excess over basis		5,000
5 percent of selling price	$500	
Expenses of sale	300	
Amount of gain realized treated as ordinary income		200
Excess over basis		5,000
5 percent of selling price	500	
Excess of expenses over 5 percent of selling price	0	
		500
Amount of gain realized from sale of property not held for sale in ordinary course of business		4,500

(iii) In the case of an exchange, the term *selling price* shall mean the fair market value of property received plus any sum of money received in exchange for the lot. See section 1031 for those exchanges in which no gain is recognized. For the purpose of subsections (b) and (c) of section 1237 and paragraphs (e) and (g) of this section, an exchange shall be treated as a sale or exchange whether or not gain or loss is recognized with respect to such exchange.

(f) *Relationship of section 1237 and section 1231.* Application of section 1237 to a sale of real property may, in some cases, result in the property being treated as real property used in the trade or business, as described in section 1231(b)(1). Thus, assuming section 1237 is otherwise applicable, if the lot sold would be considered property described in section 1231(b)(1) except for the fact that the taxpayer subdivided the tract of which it was a part, then evidence of such subdivision and connected sales activities shall be disregarded and the lot sold shall be considered real property used in the trade or business. Under such circumstances, any gain or loss realized from the sale shall be treated as gain or loss arising from the sale of real property used in the trade or business.

(g) *Definition of tract*—(1) *Aggregation of properties.* For the purposes of section 1237, the term *tract* means either (i) a single piece of real property or (ii) two or more pieces of real property if they were contiguous at any time while held by the taxpayer, or would have been contiguous but for the interposition of a road, street, railroad, stream, or similar property. Properties are contiguous if their boundaries meet at one or more points. The single piece of contiguous properties need not have been conveyed by a single deed. The taxpayer may have assembled them over a period of time and may hold them separately, jointly, or as a partner, or in any combination of such forms of ownership.

(2) *When a subdivision will be considered a new tract.* If the taxpayer sells or exchanges no lots from the tract for a period of 5 years after the sale or exchange of at least 1 lot in the tract, then the remainder of the tract shall be deemed a new tract for the purpose of counting the number of lots sold from the same tract under section 1237(b)(1). The pieces in the new tract need not be contiguous. The 5-year period is measured between the dates of the sales or exchanges.

(h) *Effective date.* This section shall apply only to gain realized on sales made after December 31, 1953, or, in the case of a person meeting the requirements of paragraph (c)(5)(iv) of this section, if the sale of the lot occurs in a taxable year beginning after December 31, 1954. Pursuant to section 7851(a)(1)(C), the regulations prescribed in this section (other than subdivision (iv) of paragraph (c)(5)) shall also apply to taxable years beginning before January 1, 1954, and ending after December 31, 1953, and to taxable years beginning after December 31, 1953, and ending before August 17, 1954, although such years are subject to the Internal Revenue Code of 1939. Irrespective of whether the taxable year involved is subject to the Internal Revenue Code of 1939 or the Internal Revenue Code of 1954, sales or exchanges made before January 1, 1954, shall be taken into account to determine whether: (1) No sales or exchanges have been made for 5 years, under section 1237(c), and (2) more than 5 lots or parcels have been sold or exchanged from the same tract, under section 1237(b)(1). Thus, if the taxpayer sold 5 lots from a single tract in 1950, and another lot is sold in 1954, the lot sold in 1954 constitutes the *sixth lot* sold from the original tract. On the other hand, if the first 5 lots were sold in 1948, the sale made in 1954 shall be deemed to have been made from a new tract.

[T.D. 6500, 25 FR 12016, Nov. 26, 1960]

§1.1238–1 Amortization in excess of depreciation.

(a) *In general.* Section 1238 provides that if a taxpayer is entitled to a deduction for amortization of an emergency facility under section 168, and if the facility is later sold or exchanged, any gain realized shall be considered as ordinary income to the extent that the amortization deduction exceeds normal depreciation. Thus, under section 1238 gain from a sale or exchange of property shall be considered as ordinary income to the extent that its adjusted basis is less than its adjusted basis would be if it were determined without regard to section 168. If an entire facility is certified under section 168(e), the taxpayer may use allowances for depreciation based on any rate and method which would have been proper if the basis of the facility were not subject to amortization under section 168, in determining what the adjusted basis of the facility would be if it were determined without regard to section 168. If only a portion of a facility is certified under section 168(e), allowances for depreciation based on the rate and method properly used with respect to the uncertified part of the facility are used in determining what the adjusted basis of the facility would be if it were determined without regard to section 168. The principles of this paragraph may be illustrated by the following examples:

Example 1. On December 31, 1954, a taxpayer making his income tax returns on a calendar year basis acquires at a cost of $20,000 an emergency facility (used in his business) 50 percent of the adjusted basis of which has been certified under section 168(e). The facility would normally have a useful life of 20 years and a salvage value of $2,000 allocable equally between the certified and uncertified portions. Under section 168 the taxpayer elects to begin the 60-month amortization period on January 1, 1955. He takes amortization deductions with respect to the certified portion in the amount of $4,000 for the years 1955 and 1956 (24 months). On December 31, 1956, he sells the facility for a price of $19,000 which is allocable equally between the certified and uncertified portions. The adjusted basis of the certified portion on that date is

$6,000 ($10,000 cost, less $4,000 amortization). With respect to the uncertified portion, the straight line method of depreciation is used and a deduction for depreciation in the amount of $450 is claimed and allowed for the year 1955. The adjusted basis of the uncertified portion on January 1, 1956, is $9,550 ($10,000 cost, less $450 depreciation). The depreciation allowance for the uncertified portion for the year 1956 would be limited to $50, the amount by which the adjusted basis of such portion at the beginning of the year exceeded its aliquot portion of the sales price. Thus, on December 31, 1956, the adjusted basis of the uncertified portion would be $9,500. Without regard to section 168, and using the rate and method the taxpayer properly applied to the uncertified portion of the facility, the adjusted basis of the certified portion on December 31, 1956, would be $9,500, computed in the same manner as the adjusted basis of the uncertified portion. The difference between the facility's actual adjusted basis ($15,500) and its adjusted basis determined without regard to section 168 ($19,000), is $3,500. Accordingly, the entire $3,500 gain on the sale of the facility ($19,000 sale price, less $15,500 adjusted basis) is treated as ordinary income.

Example 2. Assume that the entire facility in example (1) had been certified under section 168(e) and that, therefore, the adjusted basis of the facility on December 31, 1956, is $12,000. Assume further that the taxpayer adopts straight line depreciation as a proper method of depreciation for determining the adjusted basis of the facility without regard to section 168. Thus, the adjusted basis, without regard to section 168, would be $19,000. This amount is $7,000 more than the $12,000 adjusted basis under section 168. Hence, the entire $7,000 gain on the sale of the facility ($19,000 sale price less $12,000 adjusted basis) is treated as ordinary income.

(b) *Substituted basis.* If a taxpayer acquires other property in an exchange for an emergency facility with respect to which amortization deductions have been allowed or allowable, and if the basis in his hands of the other property is determined by reference to the basis of the emergency facility, then the basis of the other property is determined with regard to section 168, and therefore the provisions of section 1238 apply with respect to gain realized on a subsequent sale or exchange of the other property. The provisions of section 1238 also apply to gain realized on the sale or exchange of an emergency facility (or other property acquired, as described in the preceding sentence, in exchange for an emergency facility) by a taxpayer in whose hands the basis of the facility (or other property) is determined by reference to its basis in the hands of another person to whom deductions were allowable or allowed with respect to the facility under section 168.

[T.D. 6500, 25 FR 12020, Nov. 26, 1960, as amended by T.D. 6825, 30 FR 7281, June 2, 1965]

§1.1239–1 Gain from sale or exchange of depreciable property between certain related taxpayers after October 4, 1976.

(a) *In general.* In the case of a sale or exchange of property, directly or indirectly, between related persons after October 4, 1976 (other than a sale or exchange made under a binding contract entered into on or before that date), any gain recognized by the transferor shall be treated as ordinary income if such property is, in the hands of the transferee, subject to the allowance for depreciation provided in section 167. This rule also applies to property which would be subject to the allowance for depreciation provided in section 167 except that the purchaser has elected a different form of deduction, such as those allowed under sections 169, 188, and 191.

(b) *Related persons.* For purposes of paragraph (a) of this section, the term *related persons* means:

(1) A husband and wife,

(2) An individual and a corporation 80 percent or more in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual, or

(3) Two or more corporations 80 percent or more in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual.

(c) *Rules of construction*—(1) *Husband and wife.* For purposes of paragraph (b)(1) of this section, if on the date of the sale or exchange a taxpayer is legally separated from his spouse under an interlocutory decree of divorce, the taxpayer and his spouse shall not be treated as husband and wife, provided the sale or exchange is made pursuant to the decree and the decree subsequently becomes final. Thus, if pursuant to an interlocutory decree of divorce, an individual transfers depreciable property to his spouse and, because of this section, the gain recognized on the transfer of the property is treated as ordinary income, the individual may, if the interlocutory decree becomes final after his tax return has been filed, file a claim for a refund.

(2) *Sales between commonly controlled corporations.* In general, in the case of a sale or exchange of depreciable property between related corporations (within the meaning of paragraph (b)(3) of this section), gain which is treated as ordinary income by reason of this section shall be taxable to the transferor corporation rather than to a controlling shareholder. However, such gain shall be treated as ordinary income taxable to a controlling shareholder rather than the transferor corporation if the transferor corporation is used by a controlling shareholder as a mere conduit to make a sale to another controlled corporation, or the entity of the corporate transferor is otherwise properly disregarded for tax purposes. Sales between two or more corporations that are related within the meaning of paragraph (b)(3) of this section may also be subject to the rules of section 482 (relating to allocation of income between or among organizations, trades, or businesses which are commonly owned or controlled), and to rules requiring constructive dividend treatment to the controlling shareholder in appropriate circumstances.

(3) *Relationship determination for transfers made after January 6, 1983—taxpayer and an 80-percent owned entity.* For purposes of paragraph (b)(2) of this section with respect to transfers made after January 6, 1983—

(i) If the transferor is an entity, the transferee and such entity are related if the entity is an 80-percent owned entity with respect to such transferee either immediately before or immediately after the sale or exchange of depreciable property, and

(ii) If the transferor is not an entity, the transferee and such transferor are related if the transferee is an 80-percent owned entity with respect to such transferor immediately after the sale or exchange of depreciable property.

(4) *Relationship determination for transfers made after January 6, 1983—two 80-percent owned entities.* For purposes of paragraph (b)(3) of this section, with respect to transfers made after January 6, 1983, two entities are related if the same shareholder both owns 80 percent or more in value of the stock of the transferor before the sale or exchange of depreciable property and owns 80 percent or more in value of the stock of the transferee immediately after the sale or exchange of depreciable property.

(5) *Ownership of stock.* For purposes of determining the ownership of stock under this section, the constructive ownership rules of section 318 shall be applied, except that section 318(a)(2)(C) (relating to attribution of stock ownership from a corporation) and section 318(a)(3)(C) (relating to attribution of stock ownership to a corporation) shall be applied without regard to the 50-percent limitation contained therein. The application of the constructive ownership rules of section 318 to section 1239 is illustrated by the following examples:

Example 1. A, an individual, owns 79 percent of the stock (by value) of Corporation X, and a trust for A's children owns the remaining 21 percent of the stock. A's children are deemed to own the stock owned for their benefit by the trust in proportion to their actuarial interests in the trust (section 318(a)(2)(B)). A, in turn, constructively owns the stock so deemed to be owned by his children (section 318(a)(1)(A)(ii)). Thus, A is treated as owning all the stock of Corporation X, and any gain A recognizes from the sale of depreciable property to Corporation X is treated under section 1239 as ordinary income.

Example 2. Y Corporation owns 100 percent in value of the stock of Z Corporation. Y Corporation sells depreciable property at a gain to Z Corporation. P and his daughter, D, own 80 percent in value of the Y Corporation stock. Under the constructive ownership rules of section 318, as applied to section 1239, P and D are each considered to own the stock in Z Corporation owned by Y Corporation. Also, P and D are each considered to own the stock in Y Corporation owned by the other. As a result, both P and D constructively own 80 percent or more in value of the stock of both Y and Z Corporations. Thus, the sale between Y and Z is governed by section 1239 and produces ordinary income to Y.

[T.D. 7569, 43 FR 51388, Nov. 3, 1978, as amended by T.D. 8106, 51 FR 42835, Nov. 26, 1986]

§ 1.1239–2 Gain from sale or exchange of depreciable property between certain related taxpayers on or before October 4, 1976.

Section 1239 provides in general that any gain from the sale or exchange of depreciable property between a husband and wife or between an individual and a controlled corporation on or before October 4, 1976 (and in the case of a sale or exchange occurring after that date if made under a binding contract entered into on or before that date), shall be treated as ordinary income. Thus, any gain recognized to the transferor from a sale or exchange after May 3, 1951, and on or before October 4, 1976 (or thereafter if pursuant to a binding contract entered into on or before that date), directly or indirectly, between a husband and wife or between an individual and a controlled corporation, of property which, in the hands of the transferee, is property of a character subject to an allowance for depreciation provided in section 167 (including such property on which a deduction for amortization is allowable under sections 168 and 169) shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. For the purpose of section 1239, a corporation is controlled when more than 80 percent in value of all outstanding stock of the corporation is beneficially owned by the taxpayer, his spouse, and his minor children and minor grandchildren. For the purpose of this section, the terms *children* and *grandchildren* include legally adopted children and their children. The provisions of section 1239(a)(2) are applicable whether property is transferred from a corporation to a shareholder or from a shareholder to a corporation.

[T.D. 6500, 25 FR 12021, Nov. 26, 1960, as amended by T.D. 7569, 43 FR 51388, Nov. 3, 1978]

§ 1.1240–1 Capital gains treatment of certain termination payments.

Any amounts received by an employee for the assignment or release of all his rights to receive, after termination of his employment and for a period of not less than five years or for a period ending with his death, a percentage of the profits or receipts of his employer attributable to a time subsequent to such termination, are considered received from the sale or exchange of a capital asset held for more than six months if the following requirements are met:

(a) The employee was employed by the employer, in whose future profits or receipts the employee had an interest, for a period of more than 20 years before the assignment or release by the employee of his rights in such future profits or receipts,

(b) The full rights of the employee to the percentage of the future profits or receipts on such employer, which rights are the subject of the assignment or release, were incorporated in the terms of the contract of employment between the employee and the employer for a period of at least 12 years, and were so incorporated before August 16, 1954,

(c) The assignment or release was made after the termination of the employee's employment with such employer,

(d) The assignment or release conveyed all the rights of the employee in the future profits or receipts of such employer and conveyed no other rights of the employee, and

(e) The total amount to which the employee became entitled pursuant to the assignment or release was received by the employee after the termination of his employment with such employer and in one taxable year of the employee.

The requirement that the assignment or release be made after the termination of the employee's employment contemplates a complete and bona fide termination of the relationship of employer and employee. This requires more than a mere termination of such relationship under the particular contract or contracts of employment pursuant to which the employee acquired his rights in the future profits or receipts of the employer. The contract need not expressly provide that the employee shall share in the future profits or receipts of the employer for a minimum period of five years. However, if the contract does not expressly so provide and the assignment or release is made before the expiration of five years following the termination of employment, the terms of the contract considered in conjunction with the facts in the particular situation must establish that the rights of the employee to a percentage of future profits or receipts, in all probability, will extend to a period of not less than five years from the date of termination of employment or for a period ending with his death. Section 1240 has application only to an assignment or release made by the employee who acquired the right to a percentage of future profits or receipts of the employer, and has no application to amounts received other than as payment for assignment or release of such right. Section 1240 has no effect upon the determination of the income tax of the employer making the payment to the employee.

[T.D. 6500, 25 FR 12021, Nov. 26, 1960]

§1.1241–1 Cancellation of lease or distributor's agreement.

(a) *In general.* Section 1241 provides that proceeds received by lessees or distributors from the cancellation of leases or of certain distributorship agreements are considered as amounts received in exchange therefor. Section 1241 applies to leases of both real and personal property. Distributorship agreements to which section 1241 applies are described in paragraph (c) of this section. Section 1241 has no application in determining whether or not a cancellation not qualifying under that section is a sale or exchange. Further, section 1241 has no application in determining whether or not a lease or a distributorship agreement is a capital asset, even though its cancellation qualifies as an exchange under section 1241.

(b) *Definition of cancellation.* The term *cancellation* of a lease or a distributor's agreement, as used in section 1241, means a termination of all the contractual rights of a lessee or distributor with respect to particular premises or a particular distributorship, other than by the expiration of the lease or agreement in accordance with its terms. A payment made in good faith for a partial cancellation of a lease or a distributorship agreement is recognized as an amount received for cancellation under section 1241 if the cancellation relates to a severable economic unit, such as a portion of the premises covered by a lease, a reduction in the unexpired term of a lease or distributorship agreement, or a distributorship in one of several areas or of one of several products. Payments made for other modifications of leases or distributorship agreements, however, are not recognized as amounts received for cancellation under section 1241.

(c) *Amounts received upon cancellation of a distributorship agreement.* Section 1241 applies to distributorship agreements only if they are for marketing or marketing and servicing of goods. It does not apply to agreements for selling intangible property or for rendering personal services as, for example, agreements establishing insurance agencies or agencies for the brokerage of securities. Further, it applies to a distributorship agreement only if the distributor has made a substantial investment of capital in the distributorship. The substantial capital investment must be reflected in physical assets such as inventories of tangible goods, equipment, machinery, storage facilities, or similar property. An investment is not considered substantial for purposes of section 1241 unless it consists of a significant fraction or more of the facilities for storing, transporting, processing, or otherwise dealing with the goods distributed, or consists of a substantial inventory of such goods. The investment required in the maintenance of an office merely for clerical operations is not considered substantial for purposes of this section. Furthermore, section 1241 shall not apply unless a substantial amount of the capital or assets needed for carrying on the operations of a distributorship are acquired by the distributor and actually used in carrying on the distributorship at some time before the cancellation of the distributorship agreement. It is immaterial for the purposes of section 1241 whether the distributor acquired the assets used in performing the functions of the distributorship before or after beginning his operations under the distributorship agreement. It is also immaterial whether the distributor is a retailer, wholesaler, jobber, or other type of distributor. The application of this paragraph may be illustrated by the following examples:

Example 1. Taxpayer is a distributor of various food products. He leases a warehouse including cold storage facilities and owns a number of motor trucks. In 1955 he obtains the exclusive rights to market certain frozen food products in his State. The marketing is accomplished by using the warehouse and trucks acquired before he entered into the agreement and entails no additional capital. Payments received upon the cancellation of the agreement are treated under section 1241 as though received upon the sale or exchange of the agreement.

Example 2. Assume that the taxpayer in example (1) entered into an exclusive distributorship agreement with the producer under which the taxpayer merely solicits orders through his staff of salesmen, the goods being shipped direct to the purchasers. Payments received upon the cancellation of the agreement would not be treated under section 1241 as though received upon the sale or exchange of the agreement.

Example 3. Taxpayer is an exclusive distributor for M city of certain frozen food products which he distributes to frozen-food freezer and locker customers. The terms of his distributorship do not make it necessary for him to have any substantial investment in inventory. Taxpayer rents a loading platform for a nominal amount, but has no warehouse space. Orders for goods from customers are consolidated by the taxpayer and forwarded to the producer from time to time. Upon receipt of these goods, taxpayer allocates them to the individual orders of customers and delivers them immediately by truck. Although it would require a fleet of fifteen or twenty trucks to carry out this operation, the distributor uses only one truck of his own and hires cartage companies to deliver the bulk of the merchandise to the customers. Payments received upon the cancellation of the distributorship agreement in such a case would not be considered received upon the sale or exchange of the agreement under section 1241 since the taxpayer does not have facilities for the physical handling of more than a small fraction of the goods involved in carrying on the distributorship and, therefore, does not have a substantial capital investment in the distributorship. On the other hand, if the taxpayer had acquired and used a substantial number of the trucks necessary for the deliveries to his customers, payments received upon the cancellation of the agreement would be considered received in exchange therefor under section 1241.

[T.D. 6500, 25 FR 12021, Nov. 26, 1960]

§ 1.1242–1 Losses on small business investment company stock.

(a) *In general.* Any taxpayer who sustains a loss for a taxable year beginning after September 2, 1958, as a result of the worthlessness, or from the sale or exchange, of the stock of a small business investment company (whether or not such stock was originally issued to such taxpayer) shall treat such loss as a loss from the sale or exchange of property which is not a capital asset, if at the time of such loss:

(1) The company which issued the stock is licensed to operate as a small business investment company pursuant to regulations promulgated by the Small Business Administration (13 CFR part 107), and

(2) Such loss would, but for the provisions of section 1242, be a loss from the sale or exchange of a capital asset.

(b) *Treatment of losses for purposes of section 172.* For the purposes of section 172 (relating to the net operating loss deduction), any amount of loss treated by reason of section 1242 as a loss from the sale or exchange of property which is not a capital asset shall be treated as attributable to the trade or business of the taxpayer. Accordingly, the limitation of section 172(d)(4) on the allowance of nonbusiness deductions in computing a net operating loss shall not apply to any loss with respect to the stock of a small business investment company as described in paragraph (a) of this section. See section 172(d) and § 1.172–3.

(c) *Statement to be filed with return.* A taxpayer claiming a deduction for a loss on the stock of a small business investment company shall file with his income tax return a statement containing: The name and address of the small business investment company which issued the stock, the number of shares, basis, and selling price of the stock with respect to which the loss is claimed, the respective dates of purchase and sale of such stock, or the reason for its worthlessness and approximate date thereof. For the rules applicable in determining the worthlessness of securities, see section 165 and the regulations thereunder.

[T.D. 6500, 25 FR 12022, Nov. 26, 1960]

§1.1243–1 Loss of small business investment company.

(a) *In general*—(1) *Taxable years beginning after July 11, 1969.* For taxable years beginning after July 11, 1969, a small business investment company to which section 582(c) applies, and which sustains a loss as a result of the worthlessness, or on the sale or exchange, of the stock of a small business concern (as defined in section 103(5) of the Small Business Investment Act of 1958, as amended (15 U.S.C. 662(5)) and in 13 CFR 107.3), shall treat such loss as a loss from the sale or exchange of property which is not a capital asset if:

(i) The stock was issued pursuant to the conversion privilege of the convertible debentures acquired in accordance with the provisions of section 304 of the Small Business Investment Act of 1958 (15 U.S.C. 684) and the regulations thereunder.

(ii) Such loss would, but for the provisions of section 1243, be a loss from the sale or exchange of a capital asset, and

(iii) At the time of the loss, the company is licensed to operate as a small business investment company pursuant to regulations promulgated by the Small Business Administration (13 CFR part 107).

If section 582(c) does not apply for the taxable year, see subparagraph (2) of this paragraph.

(2) *Taxable years beginning before July 11, 1974.* For taxable years beginning after September 2, 1958, but before July 11, 1974, a small business investment company to which section 582(c) does not apply, and which sustains a loss as a result of the worthlessness, or on the sale or exchange, of the securities of a small business concern (as defined in section 103(5) of the Small Business Investment Act of 1958, as amended (15 U.S.C. 662(5)) and in 13 CFR 107.3), shall treat such loss as a loss from the sale or exchange of property which is not a capital asset if:

(i) The securities are either the convertible debentures, or the stock issued pursuant to the conversion privilege thereof, acquired in accordance with the provisions of section 304 of the Small Business Investment Act of 1958 (15 U.S.C. 684) and the regulations thereunder.

(ii) Such loss would, but for the provisions of this subparagraph, be a loss from the sale or exchange of a capital asset, and

(iii) At the time of the loss, the company is licensed to operate as a small business investment company pursuant to regulations promulgated by the Small Business Administration (13 CFR part 107).

If section 582(c) applies for the taxable year, see subparagraph (1) of this paragraph.

(b) *Material to be filed with return.* A small business investment company which claims a deduction for a loss on the convertible debentures (pursuant to paragraph (a)(2) of this section) or stock (pursuant to paragraph (a) (1) or (2) of this section) of a small business concern shall submit with its income tax return a statement that it is a Federal licensee under the Small Business Investment Act of 1958 (15 U.S.C. chapter 14B). The statement shall also set forth: the name and address of the small business concern with respect to whose securities the loss was sustained, the number of shares of stock or the number and denomination of debentures with respect to which the loss is claimed, the basis and selling price thereof, and the respective dates of purchase and sale of the securities, or the reason for their worthlessness and the approximate date thereof. For the rules applicable in determining the worthlessness of securities, see section 165 and the regulations thereunder.

[T.D. 7171, 37 FR 5621, Mar. 17, 1972]

§1.1244(a)–1 Loss on small business stock treated as ordinary loss.

(a) *In general.* Subject to certain conditions and limitations, section 1244 provides that a loss on the sale or exchange (including a transaction treated as a sale or exchange, such as worthlessness) of *section 1244 stock* which would otherwise be treated as a loss from the sale or exchange of a capital asset shall be treated as a loss from the sale or exchange of an asset which is not a capital asset (referred to in this section and §§ 1.1244(b)–1 to 1.1244(e)–1, inclusive, as an *ordinary loss*). Such a loss shall be allowed as a deduction from gross income in arriving at adjusted gross income. The requirements that must be satisfied in order that stock may be considered section 1244 stock are described in §§ 1.1244(c)–1 and 1.1244(c)–2. These requirements relate to the stock itself and the corporation issuing such stock. In addition, the taxpayer who claims an ordinary loss deduction pursuant to section 1244 must satisfy the requirements of paragraph (b) of this section.

(b) *Taxpayers entitled to ordinary loss.* The allowance of an ordinary loss deduction for a loss of section 1244 stock is permitted only to the following two classes of taxpayers:

(1) An individual sustaining the loss to whom the stock was issued by a small business corporation, or

(2) An individual who is a partner in a partnership at the time the partnership acquired the stock in an issuance from a small business corporation and whose distributive share of partnership items reflects the loss sustained by the partnership. The ordinary loss deduction is limited to the lesser of the partner's distributive share at the time of the issuance of the stock or the partner's distributive share at the time the loss is sustained. In order to claim a deduction under section 1244 the individual, or the partnership, sustaining the loss must have continuously held the stock from the date of issuance. A corporation, trust, or estate is not entitled to ordinary loss treatment under section 1244 regardless of how the stock was acquired. An individual who acquires stock from a shareholder by purchase, gift, devise, or in any other manner is not entitled to an ordinary loss under section 1244 with respect to this stock.

Thus, ordinary loss treatment is not available to a partner to whom the stock is distributed by the partnership. Stock acquired through an investment banking firm, or other person, participating in the sale of an issue may qualify for ordinary loss treatment only if the stock is not first issued to the firm or person. Thus, for example, if the firm acts as a selling agent for the issuing corporation the stock may qualify. On the other hand, stock purchased by an investment firm and subsequently resold does not qualify as section 1244 stock in the hands of the person acquiring the stock from the firm.

(c) *Examples.* The provisions of paragraph (b) of this section may be illustrated by the following examples:

Example 1. A and B, both individuals, and C, a trust, are equal partners in a partnership to which a small business corporation issues section 1244 stock. The partnership sells the stock at a loss. A's and B's distributive share of the loss may be treated as an ordinary loss pursuant to section 1244, but C's distributive share of the loss may not be so treated.

Example 2. The facts are the same as in example (1) except that the section 1244 stock is distributed by the partnership to partner A and he subsequently sells the stock at a loss. Section 1244 is not applicable to the loss since A did not acquire the stock by issuance from the small business corporation.

[T.D. 6495, 25 FR 9675, Oct. 8, 1960, as amended by T.D. 7779, 46 FR 29467, June 2, 1981]

§ 1.1244(b)–1 Annual limitation.

(a) *In general.* Subsection (b) of section 1244 imposes a limitation on the aggregate amount of loss that for any taxable year may be treated as an ordinary loss by a taxpayer by reason of that section. In the case of a partnership, the limitation is determined separately as to each partner. Any amount of loss in excess of the applicable limitation is treated as loss from the sale or exchange of a capital asset.

(b) *Amount of loss*—(1) *Taxable years beginning after December 31, 1978.* For any taxable year beginning after December 31, 1978, the maximum amount that may be treated as an ordinary loss under section 1244 is:

(i) $50,000, or

(ii) $100,000, if a husband and wife file a joint return under section 6013.

These limitations on the maximum amount of ordinary loss apply whether the loss or losses are sustained on pre-November 1978 stock (as defined in § 1.1244 (c)–1 (a)(1)), post-November 1978 stock (as defined in § 1.1244 (c)–1 (a)(2)), or on any combination of pre-November 1978 stock and post-November 1978 stock. The limitation referred to in (ii) applies to a joint return whether the loss or losses are sustained by one or both spouses.

(2) *Taxable years ending before November 6, 1978.* For any taxable year ending before November 6, 1978, the maximum amount that may be treated as an ordinary loss under section 1244 is:

(i) $25,000 or

(ii) $50,000, if a husband and wife file a joint return under section 6013.

The limitation referred to in (ii) applies to a joint return whether the loss or losses are sustained by one or both spouses.

(3) *Taxable years including November 6, 1978.* For a taxable year including November 6, 1978, the maximum amount that may be treated as ordinary loss under section 1244 is the sum of:

(i) The amount calculated by applying the limitations described in subparagraph (1) of this paragraph (b) to the amount of loss, if any, sustained during the taxable year on post-November 1978 stock, plus

(ii) The amount calculated by applying the limitations described in subparagraph (2) of this paragraph (b) to the amount of loss, if any, sustained during the taxable year on pre-November 1978 stock,

To the extent this sum does not exceed $50,000, or, if a husband and wife file a joint return under section 6013 for the taxable year, $100,000.

(4) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. A, a married taxpayer who files a joint return for the taxable year ending December 31, 1977, sustains a $50,000 loss qualifying under section 1244 on pre-November 1978 stock in Corporation X and an equal amount of loss qualifying under section 1244 on pre-November 1978 stock in Corporation Y. A is limited to $50,000 of ordinary loss under paragraph (b)(2)(ii). The remaining $50,000 of loss is treated as loss from the sale or exchange of a capital asset.

Example 2. For the taxable year ending December 31, 1979, B, a married taxpayer who files a joint return, sustains a $90,000 loss on post-November 1978 stock in Corporation X. In the same taxable year, C, B's spouse, sustains a $25,000 loss on post-November 1978 stock in Corporation Y. Both losses qualify under section 1244. B and C's ordinary loss is limited to $100,000 under paragraph (b)(1)(ii). The remaining $15,000 of loss is treated as loss from the sale or exchange of a capital asset.

Example 3. D, a married taxpayer who files a joint return and reports income on a fiscal year basis for the taxable year ending November 30, 1978, sustains a $60,000 loss qualifying under section 1244 on pre-November 1978 stock and a $40,000 loss qualifying under section 1244 on post-November 1978 stock. D's ordinary loss on pre-November 1978 stock is limited to $50,000 under subparagraph (3)(ii) of this paragraph (b). D's $40,000 loss on post-November 1978 stock is within the limit of subparagraph (3)(i) of this paragraph (b). The total of these losses, $90,000, is the aggregate amount deductible by D as ordinary loss under section 1244. The remaining $10,000 of loss is treated as loss from the sale or exchange of a capital asset.

Example 4. E, a married taxpayer who files a joint return for the taxable year ending December 31, 1980, sustains a $75,000 loss qualifying under section 1244 on pre-November 1978 stock and a $10,000 loss qualifying under section 1244 on post-November 1978 stock. E may deduct the total of these losses, $85,000, as ordinary loss under paragraph (b)(1)(ii).

Example 5. Assume the same facts as in the preceding example, except that the losses are sustained in the taxable year beginning January 1, 1978, and ending December 31, 1978. E is limited to $60,000 of ordinary loss ($50,000 on pre-November 1978 stock plus $10,000 on post-November 1978 stock) under paragraph (b)(3). The remaining $25,000 of loss is treated as loss from the sale or exchange of a capital asset.

Example 6. F, a married taxpayer who files a joint return for the taxable year beginning January 1, 1978, and ending December 31, 1978, sustains a $75,000 loss qualifying under section 1244 on pre-November 1978 stock and a $125,000 loss qualifying under section 1244 on post-November 1978 stock. F's loss on pre-November 1978 stock is limited to $50,000 of ordinary loss under subparagraph (3)(ii) of this paragraph (b). F's loss on post-November 1978 stock is limited to $100,000 of ordinary loss under subparagraph (3)(i) of this paragraph (b). The total of these losses, $150,000, is limited to $100,000 of ordinary loss under paragraph (b)(3). F's aggregate amount of ordinary loss under section 1244 is $100,000. The remaining $100,000 of loss is treated as loss from the sale or exchange of a capital asset.

[T.D. 7779, 46 FR 29467, June 2, 1981]

§1.1244(c)–1 Section 1244 stock defined.

(a) *In general.* For purposes of §§1.1244(a)–1 to 1.1244(e)–1, inclusive:

(1) The term *pre-November 1978 stock* means stock issued after June 30, 1958, and on or before November 6, 1978.

(2) The term *post-November 1978 stock* means stock issued after November 6, 1978.

In order that stock may qualify as section 1244 stock, the requirements described in paragraphs (b) through (e) of this section must be satisfied. In addition, the requirements of paragraph (f) of this section must be satisfied in the case of pre-November 1978 stock. Whether these requirements have been met is determined at the time the stock is issued, except for the requirement in paragraph (e) of this section. Whether the requirement in paragraph (e) of this section, relating to gross receipts of the corporation, has been satisfied is determined at the time a loss is sustained. Therefore, at the time of issuance it cannot be said with certainty that stock will qualify for the benefits of section 1244.

(b) *Common stock.* Only common stock, either voting or nonvoting, in a domestic corporation may qualify as section 1244 stock. For purposes of section 1244, neither securities of the corporation convertible into common stock nor common stock convertible into other securities of the corporation are treated as common stock. An increase in the basis of outstanding stock as a result of a contribution to capital is not treated as an issuance of stock under section 1244. For definition of domestic corporation, see section 7701(a)(4) and the regulations under that section.

(c) *Small business corporation.* At the time the stock is issued (or, in the case of pre-November 1978 stock, at the time of adoption of the plan described in paragraph (f)(1) of this section) the corporation must be a *small business corporation.* See § 1.1244(c)–2 for the definition of a small business corporation.

(d) *Issued for money or other property.* (1) The stock must be issued to the taxpayer for money or other property transferred by the taxpayer to the corporation. However, stock issued in exchange for stock or securities, including stock or securities of the issuing corporation, cannot qualify as section 1244 stock, except as provided in § 1.1244(d)–3, relating to certain cases where stock is issued in exchange for section 1244 stock. Stock issued for services rendered or to be rendered to, or for the benefit of, the issuing corporation does not qualify as section 1244 stock. Stock issued in consideration for cancellation of indebtedness of the corporation shall be considered issued in exchange for money or other property unless such indebtedness is evidenced by a security, or arises out of the performance of personal services.

(2) The following examples illustrate situations where stock fails to qualify as section 1244 stock as a result of the rules in subparagraph (1) of this paragraph:

Example 1. A taxpayer owns stock of Corporation X issued to him prior to July 1, 1958. Under a plan adopted in 1977, he exchanges his stock for a new issuance of stock of Corporation X. The stock received by the taxpayer in the exchange may not qualify as section 1244 stock even if the corporation has adopted a valid plan and is a small business corporation.

Example 2. A taxpayer owns stock in Corporation X. Corporation X merges into Corporation Y. In exchange for his stock, Corporation Y issues shares of its stock to the taxpayer. The stock in Corporation Y does not qualify as section 1244 stock even if the stock exchanged by the taxpayer did qualify.

Example 3. Corporation X transfers part of its business assets to Corporation Y, a new corporation, and all of the stock of Corporation Y is issued directly to the shareholders of Corporation X. Since the Corporation Y stock was not issued to the shareholders for a transfer by them of money or other property, none of the Corporation Y stock in the hands of the shareholders can qualify.

(e) *Gross receipts.* (1)(i)(*a*) Except as provided in subparagraph (2) of this paragraph, stock will not qualify under section 1244, if 50 percent or more of the gross receipts of the corporation, for the period consisting of the five most recent taxable years of the corporation ending before the date the loss on such stock is sustained by the shareholders, is derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. If the corporation has not been in existence for five taxable years ending before such date, the percentage test referred to in the preceding sentence applies to the period of the taxable years ending before such date during which the corporation has been in existence; and if the loss is sustained during the first taxable year of the corporation such test applies to the period beginning with the first day of such taxable year and ending on the day before the loss is sustained. The test under this paragraph shall be made on the basis of total gross receipts, except that gross receipts from the sales or exchanges of stock or securities shall be taken into account only to the extent of gains therefrom. The term *gross receipts* as used in section 1244(c)(1)(C) is not synonymous with *gross income.* Gross receipts means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income. Thus, the total amount of receipts is not reduced by returns and allowances, cost, or deductions. For example, gross receipts will include the total amount received or accrued during the corporation's taxable year from the sale or exchange (including a sale or exchange to which section 337 applies) of any kind of property, from investments, and for services rendered by the corporation. However, gross receipts does not include amounts received in nontaxable sales or exchanges (other than those to which section 337 applies), except to the extent that gain is recognized by the corporation, nor does that term include amounts received as a loan, as a repayment of a loan, as a contribution to capital, or on the issuance by the corporation of its own stock.

(*b*) The meaning of the term *gross receipts* as used in section 1244(c)(1)(C) may be further illustrated by the following examples:

Example 1. A corporation on the accrual method sells property (other than stock or securities) and receives payment partly in money and partly in the form of a note payable at a future time. The amount of the money and the face amount of the note would be considered gross receipts in the taxable year of the sale and would not be reduced by the adjusted basis of the property, the costs of sale, or any other amount.

Example 2. A corporation has a long-term contract as defined in paragraph (a) of §1.451–3 with respect to which it reports income according to the percentage-of-completion method as described in paragraph (b)(1) of §1.451–3. The portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year shall be included in gross receipts for such year.

Example 3. A corporation which regularly sells personal property on the installment plan elects to report its taxable income from the sale of property (other than stock or securities) on the installment method in accordance with section 453. The installment payments actually received in a given taxable year of the corporation shall be included in gross receipts for such year.

(ii) The term *royalties* as used in subdivision (i) of this subparagraph means all royalties, including mineral, oil, and gas royalties (whether or not the aggregate amount of such royalties constitutes 50 percent or more of the gross income of the corporation for the taxable year), and amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property. The term *royalties* does not include amounts received upon the disposal of timber, coal, or domestic iron ore with a retained economic interest to which the special rules of section 631 (b) and (c) apply or amounts received from the transfer of patent rights to which section 1235 applies. For the definition of *mineral, oil, or gas royalties,* see paragraph (b)(11) (ii) and (iii) of §1.543–1. For purposes of this subdivision, the gross amount of royalties shall not be reduced by any part of the cost of the rights under which they are received or by any amount allowable as a deduction in computing taxable income.

(iii) The term *rents* as used in subdivision (i) of this subparagraph means amounts received for the use of, or right to use, property (whether real or personal) of the corporation, whether or not such amounts constitute 50 percent or more of the gross income of the corporation for the taxable year. The term *rents* does not include payments for the use or occupancy of rooms or other space where significant services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist homes, motor courts, or motels. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such services; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in an office building, etc., are generally *rents* under section 1244(c)(1)(C). Payments for the parking of automobiles ordinarily do not constitute rents. Payments for the warehousing of goods or for the use of personal property do not constitute rents if significant services are rendered in connection with such payments.

(iv) The term *dividends* as used in subdivision (i) of this subparagraph includes dividends as defined in section 316, amounts required to be included in gross income under section 551 (relating to foreign personal holding company income taxed to United States shareholders), and consent dividends determined as provided in section 565.

(v) The term *interest* as used in subdivision (i) of this subparagraph means any amounts received for the use of money (including tax-exempt interest).

(vi) The term *annuities* as used in subdivision (i) of this subparagraph means the entire amount received as an annuity under an annuity, endowment, or life insurance contract, regardless of whether only part of such amount would be includible in gross income under section 72.

(vii) For purposes of subdivision (i) of this subparagraph, gross receipts from the sales or exchanges of stock or securities are taken into account only to the extent of gains therefrom. Thus, the gross receipts from the sale of a particular share of stock will be the excess of the amount realized over the adjusted basis of such share. If the adjusted basis should equal or exceed the amount realized on the sale or exchange of a certain share of stock, bond, etc., there would be no gross receipts resulting from the sale of such security. Losses on sales or exchanges of stock or securities do not offset gains on the sales or exchanges of other stock or securities for purposes of computing gross receipts from such sales or exchanges. Gross receipts from the sale or exchange of stocks and securities include gains received from such sales or exchanges by a corporation even though such corporation is a regular dealer in stocks and securities. For the meaning of the term *stocks or securities,* see paragraph (b)(5)(i) of § 1.543–1.

(2) The requirement of subparagraph (1) of this paragraph need not be satisfied if for the applicable period the aggregate amount of deductions allowed to the corporation exceeds the aggregate amount of its gross income. But for this purpose the deductions allowed by section 172, relating to the net operating loss deduction, and by sections 242, 243, 244, and 245, relating to certain special deductions for corporations, shall not be taken into account. Notwithstanding the provisions of this subparagraph and of subparagraph (1) of this paragraph, pursuant to the specific delegation of authority granted in section 1244(e) to prescribe such regulations as may be necessary to carry out the purposes of section 1244, ordinary loss treatment will not be available with respect to stock of a corporation which is not largely an operating company within the five most recent taxable years (or such lesser period as the corporation is in existence) ending before the date of the loss. Thus, for example, assume that a person who is not a dealer in real estate forms a corporation which issues stock to him which meets all the formal requirements of section 1244 stock. The corporation then acquires a piece of unimproved real estate which it holds as an investment. The property declines in value and the stockholder sells his stock at a loss. The loss does not qualify for ordinary loss treatment under section 1244 but must be treated as a capital loss.

(3) In applying subparagraphs (1) and (2) of this paragraph to a successor corporation in a reorganization described in section 368(a)(1)(F), such corporation shall be treated as the same corporation as its predecessor. See paragraph (d)(2) of § 1.1244(d)–3.

(f) *Special rules applicable to pre-November 1978 stock.* (1)(i) Pre-November 1978 common stock must have been issued under a written plan adopted by the corporation after June 30, 1958, and on or before November 6, 1978, to offer only this stock during a period specified in the plan ending not later than 2 years after the date the plan is adopted. The 2-year requirement referred to in the preceding sentence is met if the period specified in the plan is based upon the date when, under the rules or regulations of a Government agency relating to the issuance of the stock, the stock may lawfully be sold, and it is clear that this period will end, and in fact does end, within 2 years after the plan is adopted. The plan must specifically state, in terms of dollars, the maximum amount to be received by the corporation in consideration for the stock to be issued under the plan. See §1.1244(c)–2 for the limitation on the amount that may be received by the corporation under the plan.

(ii) To qualify, the pre-November 1978 stock must be issued during the period of the offer, which period must end not later than two years after the date the plan is adopted. Pre-November 1978 stock which is subscribed for during the period of the plan but not issued during this period cannot qualify as section 1244 stock. Pre-November 1978 stock issued on the exercise of a stock right, stock warrant, or stock option (which right, warrant, or option was not outstanding at the time the plan was adopted) will be treated as issued under a plan only if the right, warrant, or option is applicable solely to unissued stock offered under the plan and is exercised during the period of the plan.

(iii) Pre-November 1978 stock subscribed for prior to the adoption of the plan, including stock subscribed for prior to the date the corporation comes into existence, may be considered issued under a plan adopted by the corporation if the stock is not in fact issued prior to the adoption of the plan.

(iv) Pre-November 1978 stock issued for a payment which, alone or together with prior payments, exceeds the maximum amount that may be received under the plan, is not considered issued under the plan, and none of the stock can qualify as section 1244 stock. See §1.1244(c)–2(b) for a different rule with respect to post-November 1978 stock.

(2) Pre-November 1978 stock does not qualify as section 1244 stock if at the time of the adoption of the plan under which it is issued there remains unissued any portion of a prior offering of stock. Thus, if any portion of an outstanding offering of common or preferred stock is unissued at the time of the adoption of the plan, stock issued under the plan will not qualify as section 1244 stock. An offer is outstanding unless and until it is withdrawn by affirmative action before the plan is adopted. Stock rights, stock warrants, stock options, or securities convertible into stock, that are outstanding at the time the plan is adopted, are considered prior offerings. The authorization in the corporate charter to issue stock different from stock offered under the plan or in excess of stock offered under the plan is not of itself a prior offering.

(3)(i) Even though the plan satisfies the requirements of subparagraph (1) of this paragraph (f), if another offering of pre-November 1978 stock is made by the corporation subsequent to, or simultaneous with, the adoption of the plan, pre-November 1978 stock issued under the plan after the other offering does not qualify as section 1244 stock. The issuance of stock options, stock rights, or stock warrants at any time during the period of the plan, that are exercisable on stock other than stock offered under the plan, is considered a subsequent offering. Similarly, the issuance of pre-November 1978 stock other than that offered under the plan is considered a subsequent offering. Because stock issued upon exercise of a converson privilege is stock issued for a security, and stock issued under a stock option granted in whole or in part for services is not issued for money or other property, the issuance of securities with a conversion privilege and the issuance of such a stock option are subsequent offerings, because the conversion privilege and the stock option are exercisable with respect to stock other than that which may properly be offered under the plan. Pre-November 1978 stock issued under the plan before a subsequent offering is not disqualified because of the subsequent offering. The rule of the subparagraph, together with the rule of subparagraph (2) of this paragraph (f), relating to offers prior to the adoption of the plan, limits pre-November 1978 section 1244 stock to stock issued by the corporation during a period when any stock issued by it must have been issued under the plan.

(ii) Any modification of a plan that changes the offering to include preferred stock, or that increases the amount of pre-November 1978 stock that may be issued under the plan to such an extent that the requirements of paragraph (c) of this section would not have been satisfied if determined with reference to this amount as of the date the plan was initially adopted, or that extends the period of time during which stock may be issued under the plan to more than 2 years from the date the plan was initially adopted, is considered a subsequent offering, and no stock issued after this offering may qualify. However, a corporation may withdraw a plan and adopt a new plan to issue stock. To determine whether stock issued under this new plan may qualify, this paragraph (f) must be applied with respect to the new plan as of the date of its adoption. For example, amounts received for stock under the prior plan must be taken into account in determining whether the statutory requirements relating to definition of small business corporation are satisfied. In applying the requirements of paragraph (c) of this section, reference should be made to equity capital as of the date the new plan is adopted. The same principles apply if the period of the initial plan expires and the corporation adopts a new plan.

[T.D. 7779, 46 FR 29468, June 2, 1981]

§ 1.1244(c)–2 Small business corporation defined.

(a) *In general.* A corporation is treated as a small business corporation if it is a domestic corporation that satisfies the requirements described in paragraph (b) or (c) of this section. The requirements of paragraph (b) of this section apply if a loss is sustained on post-November 1978 stock. The requirements of paragraph (c) of this section apply if a loss is sustained on pre-November 1978 stock. If losses are sustained on both pre-November 1978 stock and post-November 1978 stock in the same taxable year, the requirements of paragraph (b) of this section are applied to the corporation at the time of the issuance of the stock (as required by paragraph (b) in the case of a loss on post-November 1978 stock) in order to determine whether the loss on post-November 1978 stock qualifies as a section 1244 loss, and the requirements of paragraph (c) of this section are applied to the corporation at the time of the adoption of the plan (as required by paragraph (c) in the case of a loss on pre-November 1978 stock) in order to determine whether the loss on pre-November 1978 stock qualifies as a section 1244 loss. For definition of domestic corporation, see section 7701 (a)(4) and the regulations under that section.

(b) *Post-November 1978 stock*—(1) *Amount received by corporation for stock.* Capital receipts of a small business corporation may not exceed $1,000,000. For purposes of this paragraph the term *capital receipts* means the aggregate dollar amount received by the corporation for its stock, as a contribution to capital, and as paid-in surplus. If the $1,000,000 limitation is exceeded, the rules of subparagraph (2) of this paragraph (b) apply. In making these determinations, (i) property is taken into account at its adjusted basis to the corporation (for determining gain) as of the date received by the corporation, and (ii) this aggregate amount is reduced by the amount of any liability to which the property was subject and by the amount of any liability assumed by the corporation at the time the property was received. Capital receipts are not reduced by distributions to shareholders, even though the distributions may be capital distributions.

(2) *Requirement of designation in event $1,000,000 limitation exceeded.* (i) If capital receipts exceed $1,000,000, the corporation shall designate as section 1244 stock certain shares of post-November 1978 common stock issued for money or other property in the transitional year. For purposes of this paragraph, the term *transitional year* means the first taxable year in which capital receipts exceed $1,000,000 and in which the corporation issues stock. This designation shall be made in accordance with the rules of subdivision (iii) of this paragraph (b)(2). The amount received for designated stock shall not exceed $1,000,000 less amounts received—

(A) In exchange for stock in years prior to the transitional year;

(B) As contributions to capital in years prior to the transitional year; and

(C) As paid-in surplus in years prior to the transitional year.

(ii) Post-November 1978 common stock issued for money or other property before the transitional year qualifies as section 1244 stock without affirmative designation by the corporation. Post-November 1978 common stock issued after the transitional year does not qualify as section 1244 stock.

(iii) The corporation shall make the designation required by subdivision (i) of this paragraph (b)(2) not later than the 15th day of the third month following the close of the transitional year. However, in the case of post-November 1978 common stock issued on or before June 2, 1981 the corporation shall make the required designation by August 3, 1981 or by the 15th day of the 3rd month following the close of the transitional year, whichever is later. The designation shall be made by entering the numbers of the qualifying share certificates on the corporation's records. If the shares do not bear serial numbers or other identifying numbers or letters, or are not represented by share certificates, the corporation shall make an alternative designation in writing at the time of issuance, or, in the case of post-November 1978 common stock issued on or before June 2, 1981 by August 3, 1981. This alternative designation may be made in any manner sufficient to identify the shares qualifying for section 1244 treatment. If the corporation fails to make a designation by share certificate number or an alternative written designation as described, the rules of subparagraph (3) of this paragraph (b) apply.

(3) *Allocation of section 1244 benefit in event corporation fails to designate qualifying shares.* If a corporation issues post-November 1978 stock in the transitional year and fails to designate certain shares of post-November 1978 common stock as section 1244 stock in accordance with the rules of subparagraph (2) of this paragraph (b), the following rules apply:

(i) Section 1244 treatment is extended to losses sustained on post-November 1978 common stock issued for money or other property in taxable years before the transitional year and is withheld from losses sustained on post-November 1978 stock issued in taxable years after the transitional year.

(ii) Post-1958 capital received before the transitional year is subtracted from $1,000,000.

iii) Subject to the annual limitation described in §1.1244(b)–1, an ordinary loss on post-November 1978 common stock issued for money or other property in the transitional year is allowed in an amount which bears the same ratio to the total loss sustained by the individual as:

(A) The amount described in §1.1244(c)–2(b) (3) (ii) bears to

(B) The total amount of money and other property received by the corporation in exchange for stock, as a contribution to capital, and as paid-in surplus in the transitional year.

(4) *Examples.* The provisions of this paragraph (b) may be illustrated by the following examples:

Example 1. On December 1, 1978, Corporation W, a newly-formed corporation, issues 10,000 shares of common stock at $125 a share for an amount (determined under subparagraph (1) of this paragraph (b)) of money and other property totaling $1,250,000. The board of directors specifies that 8,000 shares are section 1244 stock and records the certificate numbers of the qualifying shares in its minutes. Because Corporation W issued post-November 1978 common stock in exchange for money and other property exceeding $1,000,000, but has designated shares of stock as section 1244 stock and the designated shares were issued in exchange for money and other property not exceeding $1,000,000 (8,000 shares × $125 price per share = $1,000,000), the 8,000 designated shares qualify as section 1244 stock.

Example 2. Corporation X comes into existence on June 1, 1979. On June 10, 1979, Corporation X issues 2,500 shares of common stock at $250 per share to shareholder A and 2,500 shares of common stock at $250 per share to shareholder B. By written agreement dated September 1, 1981, shareholder A and shareholder B determine that 1,500 of shareholder A's shares and all of shareholder B's shares will be treated as section 1244 stock. Although shareholder A's 1,500 shares and shareholder B's 2,500 shares were issued for money and other property not exceeding $1,000,000 (4,000 shares × $250 price per share = $1,000,000, these 4,000 shares do not qualify as section 1244 stock under the rules of subparagraph (2) of this paragraph (b) for three reasons: The agreement of September 1, 1979, (i) did not identify which 1,500 of shareholder A's 2,500 shares were intended to qualify for section 1244 treatment, (ii) was made by the shareholders and not by Corporation X, and (iii) was made later than the 15th day of the third month following the close of the transitional year. However, certain of the shares issued by Corporation X may qualify as section 1244 stock under the rules of subparagraph (3) of this paragraph (b). See example (4).

Example 3. On December 1, 1980, Corporation Y issues common stock to shareholder A in exchange for $500,000 in cash. On August 1, 1981, Corporation Y issues common stock to shareholder B in exchange for property having an adjusted basis to Corporation Y of $500,000. On December 1, 1981, B transfers a tract of land having a basis in B's hands of $250,000 to Corporation Y as a contribution to capital. Under section 362(a)(2) of the Code, Corporation Y takes a basis of $250,000 in the tract of land. Corporation Y is a calendar year corporation. On February 15, 1982, it designates all of shareholder B's stock as section 1244 stock by entering the numbers of the qualifying certificates on the corporation's records. The designation made by Corporation Y is effective because it identifies which shares of its stock qualify for section 1244 treatment, was made in writing before the 15th day of the 3rd month following the close of the transitional year (1981), and because the amount received for designated stock does not exceed $1,000,000, less amounts received (i) in exchange for stock in years prior to the transitional year; (ii) as contributions to capital in years prior to the transitional year; and (iii) as paid-in surplus in years prior to the transitional year. Nevertheless, in the event of B's sale of his stock at a loss, the increase in basis attributable to his December, 1981, contribution to capital will be treated as allocable to stock that is not section 1244 stock under § 1.1244(d)–2.

Example 4. Corporation Z, a newly-formed corporation, issues 10,000 shares of common stock at $200 per share on July 1, 1979. In exchange for its stock Corporation Z receives property (other than stock or securities) having a basis to the corporation of $400,000, and $1,600,000 in cash, for a total of $2,000,000. Corporation Z fails to designate any of the issued shares as section 1244 stock. Shareholder C purchases 2,500 shares of the 10,000 shares of Corporation Z stock for $500,000 on July 1, 1979. Subsequently, shareholder C sells the 2,500 shares for $400,000. Shareholder C may treat $50,000 of the $100,000 loss as an ordinary loss under section 1244. The amount of that loss is computed under the rule of subparagraph (3) of this paragraph (b) as follows:

$$\frac{X \text{ [C's section 1244 loss]}}{\$100{,}000 \text{ [C's total loss]}} = \frac{\$1{,}000{,}000 \text{ [\$1,000,000} - 0 = \$1{,}000{,}000\text{]}}{\$2{,}000{,}000 \text{ [total amount received by Corporation Z]}}$$

$$X = \$50{,}000$$

The remaining $50,000 is not treated as an ordinary loss under section 1244.

Example 5. (i) Corporation V, a newly-formed corporation, issues common stock to shareholder A and shareholder B on June 15, 1980, in exchange for $800,000 in cash ($400,000 from A and $400,000 from B). On September 15, 1981, the corporation issues common stock to shareholder C in exchange for $600,000 in cash. On January 1, 1982, common stock is issued to shareholder D in exchange for $100,000 in cash. Corporation V fails to designate any of the issued shares as section 1244 stock. A, B, C, and D subsequently sell their Corporation Y stock at a loss.

(ii) Subject to the annual limitation discussed in § 1.1244(b)–1, A and B may treat their entire loss as an ordinary loss under section 1244. D may not treat any part of his loss as an ordinary loss under section 1244. Subject to the annual limitation, one-third of the loss sustained by shareholder C is treated as an ordinary loss under section 1244. These results are calculated under the rules of subparagraph (3) of this paragraph (b) as follows: First, section 1244 treatment is extended to post-November 1978 stock issued to A and B in 1980, a taxable year before the transitional year (1981); section 1244 treatment is withheld from the stock issued to D in 1982, a taxable year after the transitional year. Second $800,000 the amount of post-1958 capital received in taxable years before the transitional year, is subtracted from $1,000,000 to leave $200,000. Third, subject to the annual limitation, an ordinary loss is allowed to C in an amount which bears the same ratio to his total loss as the amount calculated in the preceding sentence ($200,000) bears to the total amount received by the corporation in the transitional year in exchange for stock, as a contribution to capital, or as paid-in surplus ($600,000).

Example 6. Corporation V comes into existence on July 1, 1982. On that date it issues 10 shares of voting common stock to shareholder A in exchange for $500,000 and 5 shares of voting common stock to shareholder B in exchange for $250,000, designating the shares issued to both A and B as section 1244 stock. On September 15, 1982, Corporation V receives a contribution to capital from shareholders A and B having a basis in their hands of $225,000. On February 1, 1983, Corporation V issues one share of stock to shareholder C in exchange for $50,000. Corporation V may designate one-half of the share issued to shareholder C as section 1244 stock under

§1.1244(c)–2 (b)(2). In 1982 the corporation received $750,000 for stock ($500,000 from A and $250,000 from B) and $225,000 as a capital contribution, totaling $975,000 in capital receipts. The receipt of $50,000 from shareholder C in exchange for stock in 1983 causes capital receipts to exceed $1,000,000 and 1983 thus becomes Corporation V's transitional year. Corporation V may receive only $25,000 for designated stock in 1983 under the rule set forth in §1.1244 (c)–2 (b)(2)(i), which states that the amount received for designated stock shall not exceed $1,000,000, less amounts received (i) in exchange for stock in years prior to the transitional year ($750,000 from A and B), (ii) as contributions to capital in years prior to the transitional year ($225,000), and (iii) as paid-in surplus in years prior to the transitional year ($0). Thus, one-half of C's share (representing the receipt of $25,000) may be designated as section 1244 stock by Corporation V. In the event of the sale of A's stock or B's stock at a loss, the increase in basis attributable to their contribution to capital will be treated as allocable to stock that is not section 1244 stock under §1.1244(d)–2.

(c) *Pre-November 1978 stock*—(1) *Amount received by corporation for stock.* At the time of the adoption of the plan, the sum of the aggregate dollar amount to be paid for pre-November 1978 stock that may be offered under the plan plus the aggregate amount of money and other property that has been received by the corporation after June 30, 1958, and on or before November 6, 1978, for its stock, as a contribution to capital by its shareholders, and as paid-in surplus must not exceed $500,000. In making these determinations (i) property is taken into account at its adjusted basis to the corporation (for determining gain) as of the date received by the corporation, and (ii) this aggregate amount is reduced by the amount of any liability to which the property was subject and by the amount of any liability assumed by the corporation at the time the property was received. For purposes of the $500,000 test, the total amount of money and other property received for stock, as a contribution to capital, and as paid-in surplus is not reduced by distributions to shareholders, even though the distributions may be capital distributions. Thus, once the total amount of money and other property received after June 30, 1958, reaches $500,000, the corporation is precluded from subsequently issuing pre-November 1978 stock. For a different rule that applies to post-November 1978 stock see §1.1244(c)–2(b).

(2) *Equity capital.* The sum of the aggregate dollar amount to be paid for pre-November 1978 stock that may be offered under the plan plus the equity capital of the corporation (determined on the date of the adoption of the plan) may not exceed $1,000,000. For this purpose, equity capital is the sum of the corporation's money and other property (in an amount equal to its adjusted basis for determining gain) less the amount of the corporation's indebtedness to persons other than its shareholders.

(3) *Examples.* The provisions of this paragraph (c) may be illustrated by the following examples:

Example 1. Corporation W comes into existence on December 1, 1958. On that date the corporation may adopt a plan to issue common stock for an amount (determined under subparagraph (1) of this paragraph (c)) not in excess of $500,000 during a period ending not later than November 30, 1960. Such corporation will qualify as a small business corporation as of the date that the plan is adopted. However, if the corporation adopts a plan to issue stock for an amount in excess of $500,000 it is not a small business corporation at the time the plan is adopted and no stock issued under the plan may qualify as section 1244 stock. If the cost of organizing corporation W amounted to $1,000 and constituted paid-in surplus or a contribution to capital, such amount must be taken into account in determining the amount that may be received under the plan, with the result that only $499,000 may be so received.

Example 2. On December 1, 1958, Corporation X, a newly formed corporation, adopts a plan to issue common stock for an amount (determined under subparagraph (1) of this paragraph (c)) not in excess of $500,000 during a period ending not later than November 30, 1960. By January 1, 1960, the corporation has, pursuant to the plan, issued at par, stock having an aggregate par value of $400,000, $200,000 of which was issued for $200,000 cash, and $200,000 of which was issued for property (other than stock or securities) having a basis to the corporation of $100,000 and a fair market value of $200,000. The corporation may, prior to November 30, 1960, issue stock for an amount not in excess of $200,000 cash or property having a basis to it not in excess of $200,000. Stock issued for any payment which, alone or together with any payments received after January 1, 1960, exceeds such $200,000 amount would not qualify as section 1244 stock because it would not be issued pursuant to the plan.

Example 3. Assume that on December 1, 1958, Corporation Y, a newly formed corporation, adopts a plan to issue common stock for an amount (determined under subparagraph (1) of this paragraph (c)) not in excess of $500,000 during a period ending not later than November 30, 1960. By January 1960 the corporation has received $400,000 cash for stock issued pursuant to the plan, but due to business successes the equity capital of the corporation exceeds $1,000,000. Since the equity capital test is made as of the date that the plan is adopted, the corporation may still, prior to November 30, 1960, issue section 1244 stock pursuant to the plan until the full amount specified in the plan has been received.

Example 4. Subsequent to June 30, 1958, Corporation Z receives a total of $600,000 cash on the issuance of its stock. In 1960 Corporation Z redeems shares of its stock for the total amount of $300,000 and the redemptions reduce Corporation Z's capital to substantially less than $500,000. Notwithstanding the redemptions, pre-November 1978 stock subsequently issued by Corporation Z will not qualify as section 1244 stock because the $500,000 limitation has been previously exceeded.

[T.D. 7779, 46 FR 29470, June 2, 1981, as amended by T.D. 7837, 47 FR 42729, Sept. 29, 1982; 60 FR 16575, Mar. 31, 1995]

§ 1.1244(d)–1 Contributions of property having basis in excess of value.

(a) *In general.* (1) Section 1244(d)(1)(A) provides a special rule which limits the amount of loss on section 1244 stock that may be treated as an ordinary loss. This rule applies only when section 1244 stock is issued by a corporation in exchange for property that, immediately before the exchange, has an adjusted basis (for determining loss) in excess of its fair market value. If section 1244 stock is issued in exchange for such property and the basis of such stock in the hands of the taxpayer is determined by reference to the basis of such property, then for purposes of section 1244, the basis of such stock shall be reduced by an amount equal to the excess, at the time of the exchange, of the adjusted basis of the property over its fair market value.

(2) The provisions of section 1244(d)(1)(A) do not affect the basis of stock for purposes other than section 1244. Such provisions are to be used only in determining the portion of the total loss sustained that may be treated as an ordinary loss pursuant to section 1244.

(b) *Transfer of more than one item.* If a taxpayer exchanges several items of property for stock in a single transaction so that the basis of the property transferred is allocated evenly among the shares of stock received, the computation under this section should be made by reference to the aggregate fair market value and the aggregate basis of the property transferred.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. B transfers property with an adjusted basis of $1,000 and a fair market value of $250 to a corporation for 10 shares of section 1244 stock in an exchange that qualifies under section 351. The basis of B's stock is $1,000 ($100 per share), but, solely for purposes of section 1244, the total basis of the stock must be reduced by $750, the excess of the adjusted basis of the property exchanged over its fair market value. Thus, the basis of such stock for purposes of section 1244 is $250 and the basis of each share for such purposes is $25. If B sells his 10 shares for $250, he will recognize a loss of $750, all of which must be treated as a capital loss. If he sells the 10 shares for $200, then $50 of his total loss of $800 will be treated as an ordinary loss under section 1244, assuming the various requirements of such section are satisfied, and the remaining $750 will be a capital loss.

Example 2. B owns property with a basis of $20,000. The fair market value of the property unencumbered is $15,000 but the property is subject to a $2,000 mortgage. B transfers the encumbered property to a corporation for 100 shares of section 1244 stock in an exchange that qualifies under section 351. The basis of the shares, determined in accordance with section 358, is $18,000 or $180 per share, but solely for purposes of section 1244 the basis is $13,000 ($130 per share), which is its basis for purposes other than section 1244, reduced by $5,000, the excess of the adjusted basis, immediately before the exchange, of the property transferred over its fair market value.

Example 3. C transfers business assets to a corporation for 100 shares of section 1244 stock in an exchange that qualifies under section 351. The assets transferred are as follows:

	Basis	Fair market value
Cash	$10,000	$10,000
Inventory	15,000	30,000
Depreciable property	50,000	20,000
Land	25,000	10,000
	100,000	70,000

The basis for the shares received by C is $100,000, which is applied $1,000 to each share. However, the basis of the shares for purposes of section 1244 is $70,000 ($700 per share), the basis for general purposes reduced by $30,000, the excess of the aggregate adjusted basis of the property transferred over the aggregate fair market value of such property.

[T.D. 6495, 25 FR 9679, Oct. 8, 1960]

§1.1244(d)–2 Increases in basis of section 1244 stock.

(a) *In general.* If subsequent to the time of its issuance there is for any reason, including the operation of section 1376(a), an increase in the basis of section 1244 stock, such increase shall be treated as allocable to stock which is not section 1244 stock. Therefore, a loss on stock, the basis of which has been increased subsequent to its issuance, must be apportioned between the part that qualifies as section 1244 stock and the part that does not so qualify. Only the loss apportioned to the part that so qualifies may be treated as an ordinary loss pursuant to section 1244. The amount of loss apportioned to the part that qualifies is the amount which bears the same ratio to the total loss as the basis of the stock which is treated as allocated to section 1244 stock bears to the total basis of the stock.

(b) *Example.* The provisions of paragraph (a) of this section may be illustrated by the following example:

Example: For $10,000 a corporation issues 100 shares of section 1244 stock to X. X later contributes $2,000 to the capital of the corporation and this increases the total basis of his 100 shares to $12,000. Subsequently, he sells the 100 shares for $9,000. Of the $3,000 loss, $2,500 is allocated to the portion of the stock that qualifies as section 1244 stock ($10,000/$12,000 of $3,000), and the remaining $500 is allocated to the portion of the stock that does not so qualify. Therefore, to the extent of $2,500, the loss may be treated as an ordinary loss assuming the various requirements of section 1244 stock are satisfied. However, the remaining $500 loss must be treated as a capital loss.

[T.D. 6495, 25 FR 9680, Oct. 8, 1960]

§1.1244(d)–3 Stock dividend, recapitalizations, changes in name, etc.

(a) *In general.* Section 1244(c)(1) provides that stock may not qualify for the benefits of section 1244 unless it is issued to the taxpayer for money or other property not including stock or securities. However, section 1244(d)(2) authorizes exceptions to this rule. The exceptions may apply in three situations: (1) The receipt of a stock dividend; (2) the exchange of stock for stock pursuant to a reorganization described in section 368(a)(1)(E); and (3) the exchange of stock for stock pursuant to a reorganization described in section 368(a)(1)(F).

(b) *Stock dividends.* (1) If common stock is received by an individual or partnership in a nontaxable distribution under section 305(a) made solely with respect to stock owned by such individual or partnership which meets the requirements of section 1244 stock determinable at the time of the distribution, then the common stock so received will also be treated as meeting such requirements. For purposes of this paragraph and paragraphs (c) and (d) of this section, the requirements of section 1244 stock determinable at the time of the distribution or exchange are all of the requirements of section 1244(c)(1) other than the one described in subparagraph (C) thereof, relating to the gross receipts test.

(2) If, however, such stock dividend is received by such individual or partnership partly with respect to stock meeting the requirements of section 1244 stock determinable at the time of the distribution, and partly with respect to stock not meeting such requirements, then only part of the stock received as a stock dividend will be treated as meeting such requirements. Assuming all the shares with respect to which the dividend is received have equal rights to dividends, such part is the number of shares which bears the same ratio to the total number of shares received as the number of shares owned immediately before the stock dividend which meets such qualifications bears to the total number of shares with respect to which the stock dividend is received. In determining the basis of shares received in the stock dividend and of the shares held before the stock dividend, section 307 shall apply as if two separate nontaxable stock dividends were made, one with respect to the shares that meet the requirements and the other with respect to shares that do not meet the requirements.

(3) The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. Corporation X issues 100 shares of its common stock to B for $1,000. Subsequently, in a nontaxable stock dividend B receives 5 more shares of common stock of Corporation X. If the 100 shares meet all the requirements of section 1244 stock determinable at the time of the distribution of the stock dividend, the 5 additional shares shall also be treated as meeting such requirements.

Example 2. In 1959, Corporation Y issues 100 shares of its common stock to C for $1,000 and these shares meet the requirements of section 1244 stock determinable at the time of the issuance. In 1960, C purchases an additional 200 shares of such stock from another shareholder for $3,000; however, these shares do not meet the requirements of section 1244 stock because they were not originally issued to C by the corporation. In 1961, C receives 15 shares of Corporation Y common stock as a stock dividend. Of the shares received, 5 shares, the number received with respect to the 100 shares of stock which met the requirements of section 1244 at the time of the distribution, i.e., 100/300 × 15, shall also be treated as meeting such requirements. The remaining 10 shares do not meet such requirements as they are not received with respect to section 1244 stock. The basis of such 5 shares is determined by applying section 307 as if the 5 shares were received as a separate stock dividend made solely with respect to shares that meet the requirements of section 1244 stock at the time of the distribution. Thus, the basis of the 5 shares is $47.61 (5⁄105 of $1,000).

(c) *Recapitalizations.* (1) If, pursuant to a recapitalization described in section 368(a)(1)(E), common stock of a corporation is received by an individual or partnership in exchange for stock of such corporation meeting the requirements of section 1244 stock determinable at the time of the exchange, such common stock shall be treated as meeting such requirements.

(2) If common stock is received pursuant to such a recapitalization partly in exchange for stock meeting the requirements of section 1244 stock determinable at the time of the exchange and partly in exchange for stock not meeting such requirements, then only part of such common stock will be treated as meeting such requirements. Such part is the number of shares which bears the same ratio to the total number of shares of common stock so received as the basis of the shares transferred which meet such requirements bears to the basis of all the shares transferred for such common stock. The basis allocable, pursuant to section 358, to the common stock which is treated as meeting such requirements is limited to the basis of stock that meets such requirements transferred in the exchange.

(3) The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 3. A owns 500 shares of voting common stock of Corporation X. Corporation X revises its capital structure to provide for two classes of common stock: Class A voting and Class B nonvoting. In a recapitalization described in subparagraph (E) of section 368(a)(1). A exchanges his 500 shares for 750 shares of Class B nonvoting stock. If the 500 shares meet all the requirements of section 1244 stock determinable at the time of the exchange, the 750 shares received in the exchange are treated as meeting such requirements.

Example 4. B owns 500 shares of common stock of Corporation X with a basis of $5,000, and 100 shares of preferred stock of that corporation with a basis of $2,500. Pursuant to a recapitalization described in section 368(a)(1)(E), B exchanges all of his shares for 900 shares of common stock of Corporation X. The 500 common shares meet the requirements of section 1244 stock determinable at the time of the exchange, but the 100 preferred shares do not meet such requirements since only common stock may qualify. Of the 900 common shares received, 600 shares ($5,000/$7,500×900 shares) are treated as meeting the requirements of section 1244 stock at the time of the exchange, because they are deemed to be received in exchange for the 500 common shares which met such requirements. The remaining 300 shares do not meet such requirements as they are not deemed to be received in exchange for section 1244 stock. The basis of the 600 shares is $5,000, the basis of the relinquished shares meeting the requirements of section 1244.

(d) *Change of name, etc.* (1) If, pursuant to a reorganization described in section 368(a)(1)(F), common stock of a successor corporation is received by an individual or partnership in exchange for stock of the predecessor corporation meeting the requirements of section 1244 stock determinable at the time of the exchange, such common stock shall be treated as meeting such requirements. If common stock is received pursuant to such a reorganization partly in exchange for stock meeting the requirements of section 1244 stock determinable at the time of the exchange and partly in exchange for stock not meeting such requirements, the principles of paragraph (c)(2) of this section apply in determinating the number of shares received which are treated as meeting the requirements of section 1244 stock and the basis of those shares.

(2) For purposes of paragraphs (1)(C) and (3)(A) of section 1244(c), a successor corporation in a reorganization described in section 368(a)(1)(F) shall be treated as the same corporation as its predecessor.

[T.D. 7779, 46 FR 29472, June 2, 1981]

§1.1244(d)–4 Net operating loss deduction.

(a) *General rule.* For purpose of section 172, relating to the net operating loss deduction, any amount of loss that is treated as an ordinary loss under section 1244 (taking into account the annual dollar limitation of that section) shall be treated as attributable to the trade or business of the taxpayer. Therefore, this loss is allowable in determining the taxpayer's net operating loss for a taxable year and is not subject to the application of section 172(d)(4), relating to nonbusiness deductions. A taxpayer may deduct the maximum of ordinary loss permitted under section 1244(b) even though all or a portion of the taxpayer's net operating loss carryback or carryover for the taxable year was, when incurred, a loss on section 1244 stock.

(b) *Example.* The provisions of this section may be illustrated by the following example:

Example: A, a single individual, computes a net operating loss of $15,000 for 1980 in accordance with the rules of §1.172–3, relating to net operating loss in case of a taxpayer other than a corporation. Included within A's computation of this net operating loss is a deduction arising under section 1244 for a loss on small business stock. A had no taxable income in 1977, 1978, or 1979. Assume that A can carry over the entire $15,000 loss under the rules of section 172. In 1981 A has gross income of $75,000 and again sustains a loss on section 1244 stock. The amount of A's 1981 loss on section 1244 stock is $50,000. A may deduct the full $50,000 as an ordinary loss under section 1244 and the full $15,000 as a net operating loss carryover in 1981.

[T.D. 7779, 46 FR 29473, June 2, 1981]

§1.1244(e)–1 Records to be kept.

(a) *By the corporation*—(1) *Mandatory records.* A plan to issue pre-November 1978 stock must appear upon the records of the corporation. Any designation of post-November 1978 stock under §1.1244(c)–2(b)(2) also must appear upon the records of the corporation.

(2) *Discretionary records.* In order to substantiate an ordinary loss deduction claimed by its shareholders, the corporation should maintain records showing the following:

(i) The persons to whom stock was issued, the date of issuance to these persons, and a description of the amount and type of consideration received from each;

(ii) If the consideration received is property, the basis in the hands of the shareholder and the fair market value of the property when received by the corporation;

(iii) The amount of money and the basis in the hands of the corporation of other property received for its stock, as a contribution to capital, and as paid-in surplus;

(iv) Financial statements of the corporation, such as its income tax returns, that identify the source of the gross receipt of the corporation for the period consisting of the five most recent taxable years of the corporation, or, if the corporation has not been in existence for 5 taxable years, for the period of the corporation's existence;

(v) Information relating to any tax-free stock dividend made with respect to section 1244 stock and any reorganization in which stock is transferred by the corporation in exchange for section 1244 stock; and

(vi) With respect to pre-November 1978 stock;

(A) Which certificates represent stock issued under the plan;

(B) The amount of money and the basis in the hands of the corporation of other property received after June 30, 1958, and before the adoption of the plan, for its stock, as a contribution to capital, and as paid-in surplus; and

(C) The equity capital of the corporation on the date of adoption of the plan.

(b) *By the taxpayer.* A person who claims an ordinary loss with respect to stock under section 1244 must have records sufficient to establish that the taxpayer is entitled to the loss and satisfies the requirements of section 1244. See also section 6001, requiring records to be maintained.

In addition, a person who owns section 1244 stock in a corporation shall maintain records sufficient to distinguish such stock from any other stock he may own in the corporation.

[T.D. 6495, 25 FR 9681, Oct. 8, 1960, as amended by T.D. 7779, 46 FR 29473, June 2, 1981; 46 FR 31881, June 18, 1981; T.D. 8594, 60 FR 20898, Apr. 28, 1995]

§ 1.1245–1 General rule for treatment of gain from dispositions of certain depreciable property.

(a) *General.* (1) In general, section 1245(a)(1) provides that, upon a disposition of an item of section 1245 property, the amount by which the lower of (i) the *recomputed basis* of the property, or (ii) the amount realized on a sale, exchange, or involuntary conversion (or the fair market value of the property on any other disposition), exceeds the adjusted basis of the property shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (that is, shall be recognized as ordinary income). The amount of such gain shall be determined separately for each item of section 1245 property. In general, the term *recomputed basis* means the adjusted basis of property plus all adjustments reflected in such adjusted basis on account of depreciation allowed or allowable for all periods after December 31, 1961. See section 1245(a)(2) and § 1.1245–2. Generally, the ordinary income treatment applies even though in the absence of section 1245 no gain would be recognized under the Code. For example, if a corporation distributes section 1245 property as a dividend, gain may be recognized as ordinary income to the corporation even though, in the absence of section 1245, section 311(a) would preclude any recognition of gain to the corporation. For the definition of *section 1245 property,* see section 1245(a)(3) and § 1.1245–3. For exceptions and limitations to the application of section 1245(a)(1), see section 1245(b) and § 1.1245–4.

(2) Section 1245(a)(1) applies to dispositions of section 1245 property in taxable years beginning after December 31, 1962, except that:

(i) In respect of section 1245 property which is an elevator or escalator, section 1245(a)(1) applies to dispositions after December 31, 1963, and

(ii) In respect of section 1245 property which is livestock (described in subparagraph (4) of § 1.1245–3(a)), section 1245(a)(1) applies to dispositions made in taxable years beginning after December 31, 1969, and

(iii) [Reserved].

(3) For purposes of this section and §§ 1.1245–2 through 1.1245–6, the term *disposition* includes a sale in a sale-and-leaseback transaction and a transfer upon the foreclosure of a security interest, but such term does not include a mere transfer of title to a creditor upon creation of a security interest or to a debtor upon termination of a security interest. Thus, for example, a disposition occurs upon a sale of property pursuant to a conditional sales contract even though the seller retains legal title to the property for purposes of security but a disposition does not occur when the seller ultimately gives up his security interest following payment by the purchaser.

(4) For purposes of applying section 1245, the facts and circumstances of each disposition shall be considered in determining what is the appropriate item of section 1245 property. A taxpayer may treat any number of units of section 1245 property in any particular depreciation account (as defined in § 1.167(a)–7) as one item of section 1245 property as long as it is reasonably clear, from the best estimates obtainable on the basis of all the facts and circumstances, that the amount of gain to which section 1245(a)(1) applies is not less than the total of the gain under section 1245(a)(1) which would be computed separately for each unit. Thus, for example, if 50 units of section 1245 property X, 25 units of section 1245

property Y, and other property are accounted for in one depreciation account, and if each such unit is sold at a gain in one transaction in which the total gain realized on the sale exceeds the sum of the adjustments reflected in the adjusted basis (as defined in paragraph (a)(2) of §1.1245–2) of each such unit on account of depreciation allowed or allowable for periods after December 31, 1961, all 75 units may be treated as one item of section 1245 property. If, however, 5 such units of section 1245 property Y were sold at a loss, then only 70 of such units (50 of X plus the 20 of Y sold at a gain) may be treated as one item of section 1245 property.

(5) In case of a sale, exchange, or involuntary conversion of section 1245 and non-section 1245 property in one transaction, the total amount realized upon the disposition shall be allocated between the section 1245 property and the non-section 1245 property in proportion to their respective fair market values. In general, if a buyer and seller have adverse interests as to the allocation of the amount realized between the section 1245 property and the non-section 1245 property, any arm's length agreement between the buyer and the seller will establish the allocation. In the absence of such an agreement, the allocation shall be made by taking into account the appropriate facts and circumstances. Some of the facts and circumstances which shall be taken into account to the extent appropriate include, but are not limited to, a comparison between the section 1245 property and all the property disposed of in such transaction of (i) the original cost and reproduction cost of construction, erection, or production, (ii) the remaining economic useful life, (iii) state of obsolescence, and (iv) anticipated expenditures to maintain, renovate, or to modernize.

(b) *Sale, exchange, or involuntary conversion.* (1) In the case of a sale, exchange, or involuntary conversion of section 1245 property, the gain to which section 1245(a)(1) applies is the amount by which (i) the lower of the amount realized upon the disposition of the property or the recomputed basis of the property, exceeds (ii) the adjusted basis of the property.

(2) The provisions of this paragraph may be illustrated by the following examples:

Example 1. On January 1, 1964, Brown purchases section 1245 property for use in his manufacturing business. The property has a basis for depreciation of $3,300. After taking depreciation deductions of $1,300 (the amount allowable), Brown realizes after selling expenses the amount of $2,900 upon sale of the property on January 1, 1969. Brown's gain is $900 ($2,900 amount realized minus $2,000 adjusted basis). Since the amount realized upon disposition of the property ($2,900) is lower than its recomputed basis ($3,300, i.e., $2,000 adjusted basis plus $1,300 in depreciation deductions), the entire gain is treated as ordinary income under section 1245(a)(1) and not as gain from the sale or exchange of property described in section 1231.

Example 2. Assume the same facts as in example (1) except that Brown exchanges the section 1245 property for land which has a fair market value of $3,700, thereby realizing a gain of $1,700 ($3,700 amount realized minus $2,000 adjusted basis). Since the recomputed basis of the property ($3,300) is lower than the amount realized upon its disposition ($3,700), the excess of recomputed basis over adjusted basis, or $1,300, is treated as ordinary income under section 1245(a)(1). The remaining $400 of the gain may be treated as gain from the sale or exchange of property described in section 1231.

(c) *Other dispositions.* (1) In the case of a disposition of section 1245 property other than by way of a sale, exchange, or involuntary conversion, the gain to which section 1245(a)(1) applies is the amount by which (i) the lower of the fair market value of the property on the date of disposition or the recomputed basis of the property, exceeds (ii) the adjusted basis of the property. If property is transferred by a corporation to a shareholder for an amount less than its fair market value in a sale or exchange, for purposes of applying section 1245 such transfer shall be treated as a disposition other than by way of a sale, exchange, or involuntary conversion.

(2) The provisions of this paragraph may be illustrated by the following examples:

Example 1. X Corporation distributes section 1245 property to its shareholders as a dividend. The property has an adjusted basis of $2,000 to the corporation, a recomputed basis of $3,300, and a fair market value of $3,100. Since the fair market value of the property ($3,100) is lower than its recomputed basis ($3,300), the excess of fair market value over adjusted basis, or $1,100, is treated under section 1245(a)(1) as ordinary income to the corporation even though, in the absence of section 1245, section 311(a) would preclude recognition of gain to the corporation.

Example 2. Assume the same facts as in example (1) except that X Corporation distributes the section 1245 property to its shareholders in complete liquidation of the corporation. Assume further that section 1245(b)(3) does not apply and that the fair market value of the property is $3,800 at the time of the distribution. Since the recomputed basis of the property ($3,300) is lower than its fair market value ($3,800), the excess of recomputed basis over adjusted basis, or $1,300, is treated under section 1245(a)(1) as ordinary income to the corporation even though, in the absence of section 1245, section 336 would preclude recognition of gain to the corporation.

(d) *Losses.* Section 1245(a)(1) does not apply to losses. Thus, section 1245(a)(1) does not apply if a loss is realized upon a sale, exchange, or involuntary conversion of property, all of which is considered section 1245 property, nor does the section apply to a disposition of such property other than by way of sale, exchange, or involuntary conversion if at the time of the disposition the fair market value of such property is not greater than its adjusted basis.

(e) *Treatment of partnership and partners.* (1) The manner of determining the amount of gain recognized under section 1245(a)(1) to a partnership may be illustrated by the following example:

Example: A partnership sells for $63 section 1245 property which has an adjusted basis to the partnership of $30 and a recomputed basis to the partnership of $60. The partnership recognizes under section 1245(a)(1) gain of $30, i.e., the lower of the amount realized ($63) or recomputed basis ($60), minus adjusted basis ($30). This result would not be changed if one or more partners had, in respect of the property, a special basis adjustment described in section 743(b) or had taken depreciation deductions in respect of such special basis adjustment.

(2)(i) Unless paragraph (e)(3) of this section applies, a partner's distributive share of gain recognized under section 1245(a)(1) by the partnership is equal to the lesser of the partner's share of total gain from the disposition of the property (gain limitation) or the partner's share of depreciation or amortization with respect to the property (as determined under paragraph (e)(2)(ii) of this section). Any gain recognized under section 1245(a)(1) by the partnership that is not allocated under the first sentence of this paragraph (e)(2)(i) (excess depreciation recapture) is allocated among the partners whose shares of total gain from the disposition of the property exceed their shares of depreciation or amortization with respect to the property. Excess depreciation recapture is allocated among those partners in proportion to their relative shares of the total gain (including gain recognized under section 1245(a)(1)) from the disposition of the property that is allocated to the partners who are not subject to the gain limitation. See *Example 2* of paragraph (e)(2)(iii) of this section.

(ii)(A) Subject to the adjustments described in paragraphs (e)(2)(ii)(B) and (e)(2)(ii)(C) of this section, a partner's share of depreciation or amortization with respect to property equals the total amount of allowed or allowable depreciation or amortization previously allocated to that partner with respect to the property.

(B) If a partner transfers a partnership interest, a share of depreciation or amortization must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the partner transfers a portion of the partnership interest, a share of depreciation or amortization proportionate to the interest transferred must be allocated to the transferee partner.

(C)(*1*) A partner's share of depreciation or amortization with respect to property contributed by the partner includes the amount of depreciation or amortization allowed or allowable to the partner for the period before the property is contributed.

(*2*) A partner's share of depreciation or amortization with respect to property contributed by a partner is adjusted to account for any curative allocations. (See § 1.704–3(c) for a description of the traditional method with curative allocations.) The contributing partner's share of depreciation or amortization with respect to the contributed property is decreased (but not below zero) by the amount of any curative allocation of ordinary income to the contributing partner with respect to that property and by the amount of any curative allocation of deduction or loss (other than capital loss) to the noncontributing partners with respect to that property. A noncontributing partner's share of depreciation or amortization with respect to the contributed property is increased by the noncontributing partner's share of any curative allocation of ordinary income to the contributing partner with respect to that property and by the amount of any curative allocation of deduction or loss (other than capital loss) to the noncontributing partner with respect to that property. The partners' shares of depreciation or amortization with respect to property from which curative allocations of depreciation or amortization are taken is determined without regard to those curative allocations. See *Example 3(iii)* of paragraph (e)(2)(iii) of this section.

(*3*) A partner's share of depreciation or amortization with respect to property contributed by a partner is adjusted to account for any remedial allocations. (See §1.704–3(d) for a description of the remedial allocation method.) The contributing partner's share of depreciation or amortization with respect to the contributed property is decreased (but not below zero) by the amount of any remedial allocation of income to the contributing partner with respect to that property. A noncontributing partner's share of depreciation or amortization with respect to the contributed property is increased by the amount of any remedial allocation of depreciation or amortization to the noncontributing partner with respect to that property. See *Example 3(iv)* of paragraph (e)(2)(iii) of this section.

(*4*) If, under paragraphs (e)(2)(ii)(C)(*2*) and (e)(2)(ii)(C)(*3*) of this section, the partners' shares of depreciation or amortization with respect to a contributed property exceed the adjustments reflected in the adjusted basis of the property under §1.1245–2(a) at the partnership level, then the partnership's gain recognized under section 1245(a)(1) with respect to that property is allocated among the partners in proportion to their relative shares of depreciation or amortization (subject to any gain limitation that might apply).

(*5*) This paragraph (e)(2)(ii)(C) also applies in determining a partner's share of depreciation or amortization with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to §1.704–1(b)(2)(iv)(*f*).

(iii) *Examples.* The application of this paragraph (e)(2) may be illustrated by the following examples:

Example 1. Recapture allocations. (i) *Facts.* A and B each contribute $5,000 cash to form AB, a general partnership. The partnership agreement provides that depreciation deductions will be allocated 90 percent to A and 10 percent to B, and, on the sale of depreciable property, A will first be allocated gain to the extent necessary to equalize A's and B's capital accounts. Any remaining gain will be allocated 50 percent to A and 50 percent to B. In its first year of operations, AB purchases depreciable equipment for $5,000. AB depreciates the equipment over its 5-year recovery period and elects to use the straight-line method. In its first year of operations, AB's operating income equals its expenses (other than depreciation). (To simplify this example, AB's depreciation deductions are determined without regard to any first-year depreciation conventions.)

(ii) *Year 1.* In its first year of operations, AB has $1,000 of depreciation from the partnership equipment. In accordance with the partnership agreement, AB allocates 90 percent ($900) of the depreciation to A and 10 percent ($100) of the depreciation to B. At the end of the year, AB sells the equipment for $5,200, recognizing $1,200 of gain ($5,200 amount realized less $4,000 adjusted tax basis). In accordance with the partnership agreement, the first $800 of gain is allocated to A to equalize the partners' capital accounts, and the remaining $400 of gain is allocated $200 to A and $200 to B.

(iii) *Recapture allocations.* $1,000 of the gain from the sale of the equipment is treated as section 1245(a)(1) gain. Under paragraph (e)(2)(i) of this section, each partner's share of the section 1245(a)(1) gain is equal to the lesser of the partner's share of total gain recognized on the sale of the equipment or the partner's share of total depreciation with respect to the equipment. Thus, A's share of the section 1245(a)(1) gain is $900 (the lesser of A's share of the total gain ($1,000) and A's share of depreciation ($900)). B's share of the section 1245(a)(1) gain is $100 (the lesser of B's share of the total gain ($200) and B's share of depreciation ($100)). Accordingly, $900 of the $1,000 of total gain allocated to A is treated as ordinary income and $100 of the $200 of total gain allocated to B is treated as ordinary income.

Example 2. Recapture allocation subject to gain limitation. (i) *Facts.* A, B, and C form general partnership ABC. The partnership agreement provides that depreciation deductions will be allocated equally among the partners, but that gain from the sale of depreciable property will be allocated 75 percent to A and 25 percent to B. ABC purchases depreciable personal property for $300 and subsequently allocates $100 of depreciation deductions each to A, B, and C, reducing the adjusted tax basis of the property to $0. ABC then sells the property for $440. ABC allocates $330 of the gain to A (75 percent of $440) and allocates $110 of the gain to B (25 percent of $440). No gain is allocated to C.

(ii) *Application of gain limitation.* Each partner's share of depreciation with respect to the property is $100. C's share of the total gain from the disposition of the property, however, is $0. As a result, under the gain limitation provision in paragraph (e)(2)(i) of this section, C's share of section 1245(a)(1) gain is limited to $0.

(iii) *Excess depreciation recapture.* Under paragraph (e)(2)(i) of this section, the $100 of section 1245(a)(1) gain that cannot be allocated to C under the gain limitation provision (excess depreciation recapture) is allocated to A and B (the partners not subject to the gain limitation at the time of the allocation) in proportion to their relative shares of total gain from the disposition of the property. A's relative share of the total gain allocated to A and B is 75 percent ($330 of $440 total gain). B's relative share of the total gain allocated to A and B is 25 percent ($110 of $440 total gain). However, under the gain limitation provision of paragraph (e)(2)(i) of this section, B cannot be allocated 25 percent of the excess depreciation recapture ($25) because that would result in a total allocation of $125 of depreciation recapture to B (a $100 allocation equal to B's share of depreciation plus a $25 allocation of excess depreciation recapture), which is in excess of B's share of the total gain from the disposition of the property ($110). Therefore, only $10 of excess depreciation recapture is allocated to B and the remaining $90 of excess depreciation recapture is allocated to A. A is not subject to the gain limitation because A's share of the total gain ($330) still exceeds A's share of section 1245(a)(1) gain ($190). Accordingly, all $110 of the total gain allocated to B is treated as ordinary income ($100 share of depreciation allocated to B plus $10 of excess depreciation recapture) and $190 of the total gain allocated to A is treated as ordinary income ($100 share of depreciation allocated to A plus $90 of excess depreciation recapture).

Example 3. Determination of partners' shares of depreciation with respect to contributed property. (i) *Facts.*C and D form partnership CD as equal partners. C contributes depreciable personal property C1 with an adjusted tax basis of $800 and a fair market value of $2,800. Prior to the contribution, C claimed $200 of depreciation from C1. At the time of the contribution, C1 is depreciable under the straight-line method and has four years remaining on its 5-year recovery period. D contributes $2,800 cash, which CD uses to purchase depreciable personal property D1, which is depreciable over seven years under the straight-line method. (To simplify the example, all depreciation is determined without regard to any first-year depreciation conventions.)

(ii) *Traditional method.* C1 generates $700 of book depreciation (¼ of $2,800 book value) and $200 of tax depreciation (¼ of $800 adjusted tax basis) each year. C and D will each be allocated $350 of book depreciation from C1 in year 1. Under the traditional method of making section 704(c) allocations, D will be allocated the entire $200 of tax depreciation from C1 in year 1. D1 generates $400 of book and tax depreciation each year (1/7 of $2,800 book value and adjusted tax basis). C and D will each be allocated $200 of book and tax depreciation from D1 in year 1. As a result, after the first year of partnership operations, C's share of depreciation with respect to C1 is $200 (the depreciation taken by C prior to contribution) and D's share of depreciation with respect to C1 is $200 (the amount of tax depreciation allocated to D). C and D each have a $200 share of depreciation with respect to D1. At the end of four years, C's share of depreciation with respect to C1 will be $200 (the depreciation taken by C prior to contribution) and D's share of depreciation with respect to C1 will be $800 (four years of $200 depreciation per year). At the end of four years, C and D will each have an $800 share of depreciation with respect to D1 (four years of $200 depreciation per year).

(iii) *Effect of curative allocations.* (A) *Year 1.* If the partnership elects to make curative allocations under § 1.704–3(c) using depreciation from D1, the results will be the same as under the traditional method, except that $150 of the $200 of tax depreciation from D1 that would be allocated to C under the traditional method will be allocated to D as additional depreciation with respect to C1. As a result, after the first year of partnership operations, C's share of depreciation with respect to C1 will be reduced to $50 (the total depreciation taken by C prior to contribution ($200) decreased by the amount of the curative allocation to D ($150)). D's share of depreciation with respect to C1 will be $350 (the depreciation allocated to D under the traditional method ($200) increased by the amount of the curative allocation to D ($150)). C and D will each have a $200 share of depreciation with respect to D1.

(B) *Year 4.* At the end of four years, C's share of depreciation with respect to C1 will be reduced to $0 (the total depreciation taken by C prior to contribution ($200) decreased, but not below zero, by the amount of the curative allocations to D ($600)), and D's share of depreciation with respect to C1 will be $1,400 (the total depreciation allocated to D under the traditional method ($800) increased by the amount of the curative allocations to D ($600)). However, CD's section 1245(a)(1) gain with respect to C1 will not be more than $1,000 (CD's tax depreciation ($800) plus C's tax depreciation prior to contribution ($200)). Under paragraph (e)(2)(ii)(C)(*4*) of this section, because the partners' shares of depreciation with respect to C1 exceed the adjustments reflected in the property's adjusted basis, CD's section 1245(a)(1) gain will be allocated in proportion to the partners' relative shares of depreciation with respect to C1. Because C's share of depreciation with respect to C1 is $0, and D's share of depreciation with respect to C1 is $1,400, all of CD's $1,000 of section 1245(a)(1) gain will be allocated to D. At the end of four years, C and D will each have an $800 share of depreciation with respect to D1 (four years of $200 depreciation per year).

(iv) *Effect of remedial allocations.* (A) *Year 1.* If the partnership elects to make remedial allocations under §1.704–3(d), there will be $600 of book depreciation from C1 in year 1. (Under the remedial allocation method, the amount by which C1's book basis ($2,800) exceeds its tax basis ($800) is depreciated over a 5-year life, rather than a 4-year life.) C and D will each be allocated one-half ($300) of the total book depreciation. As under the traditional method, D will be allocated all $200 of tax depreciation from C1. Because the ceiling rule would cause a disparity of $100 between D's book and tax allocations of depreciation, D will also receive a $100 remedial allocation of depreciation with respect to C1, and C will receive a $100 remedial allocation of income with respect to C1. As a result, after the first year of partnership operations, D's share of depreciation with respect to C1 is $300 (the depreciation allocated to D under the traditional method ($200) increased by the amount of the remedial allocation ($100)). C's share of depreciation with respect to C1 is $100 (the total depreciation taken by C prior to contribution ($200) decreased by the amount of the remedial allocation of income ($100)). C and D will each have a $200 share of depreciation with respect to D1.

(B) *Year 5.* At the end of five years, C's share of depreciation with respect to C1 will be $0 (the total depreciation taken by C prior to contribution ($200) decreased, but not below zero, by the total amount of the remedial allocations of income to C ($600)). D's share of depreciation with respect to C1 will be $1,400 (the total depreciation allocated to D under the traditional method ($800) increased by the total amount of the remedial allocations of depreciation to D ($600)). However, CD's section 1245(a)(1) gain with respect to C1 will not be more than $1,000 (CD's tax depreciation ($800) plus C's tax depreciation prior to contribution ($200)). Under paragraph (e)(2)(ii)(C)(*4*) of this section, because the partners' shares of depreciation with respect to C1 exceed the adjustments reflected in the property's adjusted basis, CD's section 1245(a)(1) gain will be allocated in proportion to the partners' relative shares of depreciation with respect to C1. Because C's share of depreciation with respect to C1 is $0, and D's share of depreciation with respect to C1 is $1,400, all of CD's $1,000 of section 1245(a)(1) gain will be allocated to D. At the end of five years, C and D will each have a $1,000 share of depreciation with respect to D1 (five years of $200 depreciation per year).

(iv) *Effective date.* This paragraph (e)(2) is effective for properties acquired by a partnership on or after August 20, 1997. However, partnerships may rely on this paragraph (e)(2) for properties acquired before August 20, 1997 and disposed of on or after August 20, 1997.

(3)(i) If (*a*) a partner had a special basis adjustment under section 743(b) in respect of section 1245 property, or (*b*) on the date he acquired his partnership interest by way of a sale or exchange (or upon death of another partner) the partnership owned section 1245 property and an election under section 754 (relating to optional adjustment to basis of partnership property) was in effect with respect to the partnership, then the amount of gain recognized under section 1245(a)(1) by him upon a disposition by the partnership of such property shall be determined under this subparagraph.

(ii) There shall be allocated to such partner, in the same proportion as the partnership's total gain is allocated to him as his distributive share under section 704, a portion of (*a*) the common partnership adjusted basis for the property, and (*b*) the amount realized by the partnership upon the disposition, or, if nothing is realized, the fair market value of the property. There shall also be allocated to him, in the same proportion as the partnership's gain recognized under section 1245(a)(1) is allocated under subparagraph (2) of this paragraph as his distributive share of such gain, a portion of *the adjustments reflected in the adjusted basis* (as defined in paragraph (a)(2) of §1.1245–2) of such property. If on the date he acquired his partnership interest by way of a sale or exchange the partnership owned such property and an election under section 754 was in effect, then for purposes of the preceding sentence the amount of the adjustments reflected in the adjusted basis of such property on such date shall be deemed to be zero. For special rules relating to the amount of adjustments reflected in the adjusted basis of property after partnership transactions, see paragraph (c)(6) of § 1.1245–2.

(iii) The partner's adjusted basis in respect of the property shall be deemed to be (*a*) the portion of the partnership's adjusted basis for the property allocated to the partner under subdivision (ii) of this subparagraph, (*b*) increased by the amount of any special basis adjustment described in section 743(b)(1) (or decreased by the amount of any special basis adjustment described in section 743(b)(2) which the partner may have in respect of the property on the date the partnership disposed of the property.

(iv) The partner's recomputed basis in respect of the property shall be deemed to be (*a*) the sum of the partner's adjusted basis for the property, as determined in subdivision (iii) of this subparagraph, plus the amount of *the adjustments reflected in the adjusted basis* (as defined in paragraph (a)(2) of § 1.1245–2) for the property allocated to the partner under subdivision (ii) of this subparagraph, (*b*) increased by the amount by which any special basis adjustment described in section 743(b)(1) (or decreased by the amount by which any special basis adjustment described in section 743(b)(2)) in respect of the property was reduced, but only to the extent such amount was applied to adjust the amount of the deductions allowed or allowable to the partner for depreciation or amortization of section 1245 property attributable to periods referred to in paragraph (a)(2) of § 1.1245–2. The terms *allowed or allowable, depreciation or amortization,* and *attributable to periods* shall have the meanings assigned to these terms in paragraph (a) of § 1.1245–2.

(4) The application of subparagraph (3) of this paragraph may be illustrated by the following example:

Example: A, B, and C each hold a one-third interest in calendar year partnership ABC. On December 31, 1962, the firm holds section 1245 property which has an adjusted basis of $30,000 and a recomputed basis of $33,000. Depreciation deductions in respect of the property for 1962 were $3,000. On January 1, 1963, when D purchases C's partnership interest, the election under section 754 is in effect and a $5,000 special basis adjustment is made in respect of D to his one-third share of the common partnership adjusted basis for the property. For 1963 and 1964 the partnership deducts $6,000 as depreciation in respect of the property, thereby reducing its adjusted basis to $24,000, and D deducts $2,800, i.e., his distributive share of partnership depreciation ($2,000) plus depreciation in respect of his special basis adjustment ($800). On March 15, 1965, the partnership sells the property for $48,000. Since the partnership's recomputed basis for the property ($33,000, i.e., 24,000 adjusted basis plus $9,000 in depreciation deductions) is lower than the amount realized upon the sale ($48,000), the excess of recomputed basis over adjusted basis, or $9,000, is treated as partnership gain under section 1245(a)(1). D's distributive share of such gain is $3,000 (⅓ of $9,000). However, the amount of gain recognized by D under section 1245 (a)(1) is only $2,800, determined as follows:

(1) Adjusted basis:		
D's portion of partnership adjusted basis (⅓ of $24,000)	$8,000	
D's special basis adjustment as of December 31, 1964 ($5,000 minus $800)	4,200	
D's adjusted basis		$12,200
(2) Recomputed basis:		
D's adjusted basis	12,200	
D's portion of partnership depreciation for 1963 and 1964, i.e., for periods after he acquired his partnership interest (⅓ of $6,000)	2,000	
Depreciation for 1963 and 1964 in respect of D's special basis adjustment	800	
D's recomputed basis.		15,000
(3) D's portion of amount realized by partnership (⅓ of $48,000)		16,000
(4) Gain recognized to D under section 1245(a)(1), i.e., the lower of (2) or (3), minus (1)		2,800

[T.D. 6832, 30 FR 8576, July 7, 1965, as amended by T.D. 7084, 36 FR 268, Jan. 8, 1971; T.D. 7141, 36 FR 18793, Sept. 22, 1971; T.D. 8730, 62 FR 44216, Aug. 20, 1997]

§ 1.1245–2 Definition of recomputed basis.

(a) *General rule*—(1) *Recomputed basis defined.* The term *recomputed basis* means, with respect to any property, an amount equal to the sum of:

(i) The adjusted basis of the property, as defined in section 1011, plus

(ii) The amount of the adjustments reflected in the adjusted basis.

(2) *Definition of adjustments reflected in adjusted basis.* The term *adjustments reflected in the adjusted basis* means:

(i) With respect to any property other than property described in subdivision (ii), (iii), or (iv) of this subparagraph, the amount of the adjustments attributable to periods after December 31, 1961,

(ii) With respect to an elevator or escalator, the amount of the adjustments attributable to periods after June 30, 1963,

(iii) With respect to livestock (described in subparagraph (4) of §1.1245–3(a)), the amount of the adjustments attributable to periods after December 31, 1969, or

(iv) [Reserved]

which are reflected in the adjusted basis of such property on account of deductions allowed or allowable for depreciation or amortization (within the meaning of subparagraph (3) of this paragraph). For cases where the taxpayer can establish that the amount allowed for any period was less than the amount allowable, see subparagraph (7) of this paragraph. For determination of adjusted basis of property in a multiple asset account, see paragraph (c)(3) of §1.167(a)–8.

(3) *Meaning of depreciation or amortization.* (i) For purposes of subparagraph (2) of this paragraph, the term *depreciation or amortization* includes allowances (and amounts treated as allowances) for depreciation (or amortization in lieu thereof), and deductions for amortization of emergency facilities under section 168. Thus, for example, such term includes a reasonable allowance for exhaustion, wear and tear (including a reasonable allowance for obsolescence) under section 167, an expense allowance (additional first-year depreciation allowance for property placed in service before January 1, 1981), under section 179, an expenditure treated as an amount allowed under section 167 by reason of the application of section 182(d)(2)(B) (relating to expenditures by farmers for clearing land), and a deduction for depreciation of improvements under section 611 (relating to depletion). For further examples, the term *depreciation or amortization* includes periodic deductions referred to in §1.162–11 in respect of a specified sum paid for the acquisition of a leasehold and in respect of the cost to a lessee of improvements on property of which he is the lessee. However, such term does not include deductions for the periodic payment of rent.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example: On January 1, 1966, Smith purchases for $1,000, and places in service, an item of property described in section 1245(a)(3)(A). Smith deducts an additional first-year allowance for depreciation under section 179 of $200. Accordingly, the basis of the property for purposes of depreciation is $800 on January 1, 1966. Between that date and January 1, 1974, Smith deducts $640 in depreciation (the amount allowable) with respect to the property, thereby reducing its adjusted basis to $160. Since this adjusted basis reflects deductions for depreciation and amortization (within the meaning of this subparagraph) amounting to $840 ($200 plus $640), the recomputed basis of the property is $1,000 ($160 plus $840).

(4) *Adjustments of other taxpayers or in respect of other property.* (i) For purposes of subparagraph (2) of this paragraph, the adjustments reflected in adjusted basis on account of depreciation or amortization which must be taken into account in determining recomputed basis are not limited to those adjustments on account of depreciation or amortization with respect to the property disposed of, nor are such adjustments limited to those on account of depreciation or amortization allowed or allowable to the taxpayer disposing of such property. Except as provided in subparagraph (7) of this paragraph, all such adjustments are taken into account, whether the deductions were allowed or allowable in respect of the same or other property and whether to the taxpayer or to any other person. For manner of determining the amount of adjustments reflected in the adjusted basis of property immediately after certain dispositions, see paragraph (c) of this section.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example: On January 1, 1966, Jones purchases machine X for use in his trade or business. The machine, which is section 1245 property, has a basis for depreciation of $10,000. After taking depreciation deductions of $2,000 (the amount allowable), Jones transfers the machine to his son as a gift on January 1, 1968. Since the exception for gifts in section 1245(b)(1) applies, Jones does not recognize gain under section 1245(a)(1). The son's adjusted basis for the machine is $8,000. On January 1, 1969, after taking a depreciation deduction of $1,000 (the amount allowable), the son exchanges machine X for machine Y in a like kind exchange described in section 1031. Since the exception for like kind exchanges in section 1245(b)(4) applies, the son does not recognize gain under section 1245(a)(1). The son's adjusted basis for machine Y is $7,000. In 1969, the son takes a depreciation deduction of $1,000 (the amount allowable) in respect of machine Y. The son sells machine Y on June 30, 1970. No depreciation was allowed or allowable for 1970, the year of the sale. The recomputed basis of machine Y on June 30, 1970, is determined in the following manner:

Adjusted basis	$6,000	
Adjustments reflected in the adjusted basis:		
Depreciation deducted by Jones for 1966 and 1967 on machine X	2,000	
Depreciation deducted by son for 1968 on machine X	1,000	
Depreciation deducted by son for 1969 on machine Y	1,000	
Total adjustments reflected in the adjusted basis		$4,000
Recomputed basis		10,000

(5) *Adjustments reflected in adjusted basis of property described in section 1245(a)(3)(B).* For purposes of subparagraph (2) of this paragraph, the adjustments reflected in the adjusted basis of property described in section 1245(a)(3)(B), on account of depreciation or amortization which must be taken into account in determining recomputed basis, may include deductions attributable to periods during which the property is not used as an integral part of an activity, or does not constitute a facility, specified in section 1245(a)(3)(B) (i) or (ii). Thus, for example, if depreciation deductions taken with respect to such property after December 31, 1961, amount to $10,000 (the amount allowable), of which $6,000 is attributable to periods during which the property is used as an integral part of a specified activity or constitutes a specified facility, then the entire $10,000 of depreciation deductions are adjustments reflected in the adjusted basis for purposes of determining recomputed basis. Moreover, if the property was never so used but was acquired in a transaction to which section 1245(b)(4) (relating to like kind exchanges and involuntary conversions) applies, and if by reason of the application of paragraph (d)(3) of § 1.1245–4 the property is considered as section 1245 property described in section 1245(a)(3)(B), then the entire $10,000 of depreciation deductions would also be adjustments reflected in the adjusted basis for purposes of determining recomputed basis.

(6) *Allocation of adjustments attributable to periods after certain dates.* (i) For purposes of determining recomputed basis, the amount of adjustments reflected in the adjusted basis of property other than property described in subparagraph (2) (ii), (iii), or (iv) of this paragraph are limited to adjustments attributable to periods after December 31, 1961. Accordingly, if depreciation deducted with respect to such property of a calendar year taxpayer is $1,000 a year (the amount allowable) for each of 10 years beginning with 1956, only the depreciation deducted in 1962 and succeeding years shall be treated as reflected in the adjusted basis for purposes of determining recomputed basis. With respect to a taxable year beginning in 1961 and ending in 1962, the deduction for depreciation or amortization shall be ascertained by applying the principles stated in paragraph (c)(3) of § 1.167(a)–8 (relating to determination of adjusted basis of retired asset). The amount of the deduction, determined in such manner, shall be allocated on a daily basis in order to determine the portion thereof which is attributable to a period after December 31, 1961. Thus, for example, if a taxpayer, whose fiscal year ends on May 31, 1962, acquires section 1245 property on November 12, 1961, and the deduction for depreciation attributable to the property for such fiscal year is ascertained (under the principles of paragraph (c)(3) of § 1.167(a)–8) to be $400, then the portion thereof attributable to a period after December 31, 1961, is $302 ($^{151}/_{200}$ of $400). If, however, the property were acquired by such taxpayer after December 31, 1961, the

entire deduction for depreciation attributable to the property for such fiscal year would be allocable to a period after December 31, 1961. For treatment of certain normal retirements described in paragraph (e)(2) of §1.167(a)–8, see paragraph (c) of §1.1245–6. For principles of determining the amount of adjustments for depreciation or amortization reflected in the adjusted basis of property upon an abnormal retirement of property in a multiple asset account, see paragraph (c)(3) of §1.167(a)–8.

(ii) For purposes of determining recomputed basis, the amount of adjustments reflected in the adjusted basis of an elevator or escalator are limited to adjustments attributable to periods after June 30, 1963.

(iii) For purposes of determining recomputed basis, the amount of adjustments reflected in the adjusted basis of livestock (described in subparagraph (2)(iii) of this paragraph) are limited to adjustments attributable to periods after December 31, 1969.

(7) *Depreciation or amortization allowed or allowable.* For purposes of determin ing recomputed basis, generally all adjustments (for periods after Dec. 31, 1961, or, in the case of property described in subparagraph (2) (ii), (iii), or (iv) of this paragraph, for periods after the applicable date) attributable to allowed or allowable depreciation or amortization must be taken into account. See section 1016(a)(2) and the regulations thereunder for the meaning of *allowed* and *allowable.* However, if a taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for depreciation or amortization for any period was less than the amount allowable for such period, the amount to be taken into account for such period shall be the amount allowed. No adjustment is to be made on account of the tax imposed by section 56 (relating to the minimum tax for tax preferences). See paragraph (b) of this section (relating to records to be kept and information to be filed). For example, assume that in the year 1967 it becomes necessary to determine the recomputed basis of property, the $500 adjusted basis of which reflects adjustments of $1,000 with respect to depreciation deductions allowable for periods after December 31, 1961. If the taxpayer can establish by adequate records or other sufficient evidence that he had been allowed deductions amounting to only $800 for the period, then in determining recomputed basis the amount added to adjusted basis with respect to the $1,000 adjustments to basis for the period will be only $800.

(8) *Exempt organizations.* In respect of property disposed of by an organization which is or was exempt from income taxes (within the meaning of section 501(a)), adjustments reflected in the adjusted basis (within the meaning of subparagraph (2) of this paragraph) shall include only depreciation or amortization allowed or allowable (i) in computing unrelated business taxable income (as defined in section 512(a), or (ii) in computing taxable income of the organization (or a predecessor organization) for a period during which it was not exempt or, by reason of the application of section 502, 503, or 504, was denied its exemption.

(b) *Records to be kept.* In any case in which it is necessary to determine recomputed basis of an item of section 1245 property, the taxpayer shall have available permanent records of all the facts necessary to determine with reasonable accuracy the amount of such recomputed basis, including the following:

(1) The date, and the manner in which, the property was acquired,

(2) The taxpayer's basis on the date the property was acquired and the manner in which the basis was determined,

(3) The amount and date of all adjustments to the basis of the property allowed or allowable to the taxpayer for depreciation or amortization and the amount and date of any other adjustments by the taxpayer to the basis of the property,

(4) In the case of section 1245 property which has an adjusted basis reflecting adjustments for depreciation or amortization taken by the taxpayer with respect to other property, or by another taxpayer with respect to the same or other property, the information described in subparagraphs (1), (2), and (3) of this paragraph with respect

to such other property or such other taxpayer.

(c) *Adjustments reflected in adjusted basis immediately after certain acquisitions*—(1) *Zero.* (i) If on the date a person acquires property his basis for the property is determined solely by reference to its cost (within the meaning of section 1012), then on such date the amount of the adjustments reflected in his adjusted basis for the property is zero.

(ii) If on the date a person acquires property his basis for the property is determined solely by reason of the application of section 301(d) (relating to basis of property received in corporate distribution) or section 334(a) (relating to basis of property received in a liquidation in which gain or loss is recognized), then on such date the amount of the adjustments reflected in his adjusted basis for the property is zero.

(iii) If on the date a person acquires property his basis for the property is determined solely under the rules of section 334 (b)(2) or (c) relating to basis of property received in certain corporate liquidations), then on such date the amount of the adjustments reflected in his adjusted basis for the property is zero.

(iv) If as of the date a person acquires property from a decedent such person's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the property on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), then on such date the amount of the adjustments reflected in his adjusted basis for the property is zero.

(2) *Gifts and certain tax-free transactions.* (i) If property is disposed of in a transaction described in subdivision (ii) of this subparagraph, then the amount of the adjustments reflected in the adjusted basis of the property in the hands of a transferee immediately after the disposition shall be an amount equal to:

(*a*) The amount of the adjustments reflected in the adjusted basis of the property in the hands of the transferor immediately before the disposition, minus

(*b*) The amount of any gain taken into account under section 1245(a)(1) by the transferor upon the disposition.

(ii) The transactions referred to in subdivision (i) of this subparagraph are:

(*a*) A disposition which is in part a sale or exchange and in part a gift (see paragraph (a)(3) of § 1.1245–4).

(*b*) A disposition (other than a disposition to which section 1245(b)(6)(A) applies) which is described in section 1245(b)(3) (relating to certain tax-free transactions), or

(*c*) An exchange described in paragraph (e)(2) of § 1.1245–4 (relating to transfers described in section 1081(d)(1)(A)).

(iii) The provisions of this subparagraph may be illustrated by the following example:

Example: Jones transfers section 1245 property to a corporation in exchange for stock of the corporation and $1,000 cash in a transaction which qualifies under section 351 (relating to transfer to a corporation controlled by transferor). Before the exchange the amount of the adjustments reflected in the adjusted basis of the property is $3,000. Upon the exchange $1,000 gain is recognized under section 1245(a)(1). Immediately after the exchange, the amount of the adjustments reflected in the adjusted basis of the property in the hands of the corporation is $2,000 (that is, $3,000 minus $1,000).

(3) *Certain transfers at death.* (i) If property is acquired in a transfer at death to which section 1245(b)(2) applies, the amount of the adjustments reflected in the adjusted basis of property in the hands of the transferee immediately after the transfer shall be the amount (if any) of depreciation or amortization deductions allowed the transferee before the decedent's death, to the extent that the basis of the property (determined under section 1014(a)) is required to be reduced under the second sentence of section 1014(b)(9) (relating to adjustments to basis where property is acquired from a decedent prior to his death).

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example: H purchases section 1245 property in 1965 which he immediately conveys to himself and W, his wife, as tenants by the entirety. Under local law each spouse is entitled to one-half the income from the property. H and W file joint income tax returns for calendar years 1965, 1966, and 1967. Over the 3 years, depreciation deductions amounting to $4,000 (the amount allowable) are allowed in respect of the property of which one-half thereof, or $2,000, is allocable to W. On January 1, 1968, H dies and the entire value of the property at the date of death is included in H's gross estate. Since W's basis for the property (determined under section 1014(a)) is reduced (under the second sentence of section 1014(b)(9)) by the $2,000 depreciation deductions allowed W before H's death, the adjustments reflected in the adjusted basis of the property in the hands of W immediately after H's death amount to $2,000.

(4) *Property received in a like kind exchange, involuntary conversion, or F.C.C. transaction.* (i) If property is acquired in a transaction described in subdivision (ii) of this subparagraph then immediately after the acquisition (and before applying subparagraph (5) of this paragraph, if applicable) the amount of the adjustments reflected in the adjusted basis of the property acquired shall be an amount equal to:

(*a*) The amount of the adjustments reflected in the adjusted basis of the property disposed of immediately before the disposition, minus

(*b*) The sum of (*1*) the amount of any gain recognized under section 1245(a)(1) upon the disposition, plus (*2*) the amount of gain (if any) referred to in subparagraph (5)(ii) of this paragraph.

(ii) The transactions referred to in subdivision (i) of this subparagraph are:

(*a*) A disposition which is a like kind exchange or an involuntary conversion to which section 1245(b)(4) applies, or

(*b*) A disposition to which the provisions of section 1071 and paragraph (e)(1) of §1.1245–4 apply.

(iii) The provisions of subdivisions (i) and (ii) of this subparagraph may be illustrated by the following examples:

Example 1. Smith exchanges machine A for machine B and $1,000 cash in a like kind exchange. Gain of $1,000 is recognized under section 1245(a)(1). If before the exchange the amount of the adjustments reflected in the adjusted basis of machine A was $5,000, the amount of adjustments reflected in the adjusted basis of machine B after the exchange is $4,000 (that is, $5,000 minus $1,000).

Example 2. Assume the same facts as in example (1) except that machine A is destroyed by fire, that $5,000 in insurance proceeds are received of which $4,000 is used to purchase machine B, and that Smith properly elects under section 1033(a)(3)(A) to limit recognition of gain. The result is the same as in example (1), that is, the amount of adjustments reflected in the adjusted basis of machine B is $4,000 ($5,000 minus $1,000).

(iv) If more than one item of section 1245 property is acquired in a transaction referred to in subdivision (i) of this subparagraph, the total amount of the adjustments reflected in the adjusted bases of the items acquired shall be allocated to such items in proportion to their respective adjusted bases.

(5) *Property after a reduction in basis pursuant to election under section 1071 or application of section 1082(a)(2).* If the basis of section 1245 property is reduced pursuant to an election under section 1071 (relating to gain from sale or exchange to effectuate policies of F.C.C.), or the application of section 1082(a)(2) (relating to sale or exchange in obedience to order of S.E.C.), then immediately after the basis reduction the amount of the adjustments reflected in the adjusted basis of the property shall be the sum of:

(i) The amount of the adjustments reflected in the adjusted basis of the property immediately before the basis reduction (but after applying subparagraph (4) of this paragraph, if applicable), plus

(ii) The amount of gain which was not recognized under section 1245(a)(1) by reason of the reduction in the basis of the property. See paragraph (e)(1) of §1.1245–4.

(6) *Partnership property after certain transactions.* (i) For the amount of adjustments reflected in the adjusted basis of property immediately after certain distributions of the property by a partnership to a partner, see section 1245(b)(6)(B).

(ii) If under paragraph (b)(3) of §1.751–1 (relating to certain distributions of partnership property other than section 751 property treated as sales or exchanges) a partnership is treated as purchasing section 1245 property (or a portion thereof) from a distributee who relinquishes his interest in such property (or portion), then on the date of such purchase the amount of adjustments reflected in the adjusted basis of such purchased property (or portion) shall be zero.

(iii) See paragraph (e)(3)(ii) of § 1.1245–1 for the amount of adjustments reflected in the adjusted basis of partnership property in respect of a partner who acquired his partnership interest in certain transactions when an election under section 754 (relating to optional adjustments to basis of partnership property) was in effect.

[T.D. 6832, 30 FR 8578, July 7, 1965, as amended by T.D. 7084, 36 FR 268, Jan. 8, 1971; T.D. 7141, 36 FR 18793, Sept. 22, 1971; 36 FR 19160, Sept. 30, 1971; T.D. 7564, 43 FR 40496, Sept. 12, 1978; T.D. 8121, 52 FR 414, Jan. 6, 1987]

§ 1.1245–3 Definition of section 1245 property.

(a) *In general.* (1) The term *section 1245 property* means any property (other than livestock excluded by the effective date limitation in subparagraph (4) of this paragraph) which is or has been property of a character subject to the allowance for depreciation provided in section 167 and which is either:

(i) Personal property (within the meaning of paragraph (b) of this section),

(ii) Property described in section 1245(a)(3)(B) (see paragraph (c) of this section), or

(iii) An elevator or an escalator within the meaning of subparagraph (C) of section 48(a)(1) (relating to the definition of *section 38 property* for purposes of the investment credit), but without regard to the limitations in such subparagraph (C).

(2) If property is section 1245 property under a subdivision of subparagraph (1) of this paragraph, a leasehold of such property is also section 1245 property under such subdivision. Thus, for example, if A owns personal property which is section 1245 property under subparagraph (1)(i) of this paragraph, and if A leases the personal property to B, B's leasehold is also section 1245 property under such provision. For a further example, if C owns and leases to D for a single lump-sum payment of $100,000 property consisting of land and a fully equipped factory building thereon, and if 40 percent of the fair market value of such property is properly allocable to section 1245 property, then 40 percent of D's leasehold is also section 1245 property. A leasehold of land is not section 1245 property.

(3) Even though property may not be of a character subject to the allowance for depreciation in the hands of the taxpayer, such property may nevertheless be section 1245 property if the taxpayer's basis for the property is determined by reference to its basis in the hands of a prior owner of the property and such property was of a character subject to the allowance for depreciation in the hands of such prior owner, or if the taxpayer's basis for the property is determined by reference to the basis of other property which in the hands of the taxpayer was property of a character subject to the allowance for depreciation. Thus, for example, if a father uses an automobile in his trade or business during a period after December 31, 1961, and then gives the automobile to his son as a gift for the son's personal use, the automobile is section 1245 property in the hands of the son.

(4) Section 1245 property includes livestock, but only with respect to taxable years beginning after December 31, 1969. For purposes of section 1245, the term *livestock* includes horses, cattle, hogs, sheep, goats, and mink and other furbearing animals, irrespective of the use to which they are put or the purpose for which they are held.

(b) *Personal property defined.* The term *personal property* means:

(1) Tangible personal property (as defined in paragraph (c) of § 1.48–1, relating to the definition of *section 38 property* for purposes of the investment credit), and

(2) Intangible personal property.

(c) *Property described in section 1245(a)(3)(B).* (1) The term *property described in section 1245(a)(3)(B)* means tangible property of the requisite depreciable character other than personal property (and other than a building and its structural components), but only if there are adjustments reflected in the adjusted basis of the property (within the meaning of paragraph (a)(2) of § 1.1245–2) for a period during which such property (or other property):

(i) Was used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or

(ii) Constituted a research or storage facility used in connection with any of the foregoing activities.

Thus, even though during the period immediately preceding its disposition the property is not used as an integral part of an activity specified in subdivision (i) of this subparagraph and does not constitute a facility specified in subdivision (ii) of this subparagraph, such property is nevertheless property described in section 1245(a)(3)(B) if, for example, there are adjustments reflected in the adjusted basis of the property for a period during which the property was used as an integral part of manufacturing by the taxpayer or another taxpayer, or for a period during which other property (which was involuntarily converted into, or exchanged in a like kind exchange for, the property) was so used by the taxpayer or another taxpayer. For rules applicable to involuntary conversions and like kind exchanges, see paragraph (d)(3) of §1.1245–4.

(2) The language used in subparagraph (1) (i) and (ii) of this paragraph shall have the same meaning as when used in paragraph (a) of §1.48–1, and the terms *building* and *structural components* shall have the meanings assigned to those terms in paragraph (e) of §1.48–1.

[T.D. 6832, 30 FR 8580, July 7, 1965, as amended by T.D. 7141, 36 FR 18794, Sept. 22, 1971]

§1.1245–4 Exceptions and limitations.

(a) *Exception for gifts*—(1) *General rule.* Section 1245(b)(1) provides that no gain shall be recognized under section 1245(a)(1) upon a disposition by gift. For purposes of this paragraph, the term *gift* means, except to the extent that subparagraph (3) of this paragraph applies, a transfer of property which, in the hands of the transferee, has a basis determined under the provisions of section 1015 (a) or (d) (relating to basis of property acquired by gifts). For reduction in amount of charitable contribution in case of a gift of section 1245 property, see section 170(e) and the regulations thereunder.

(2) *Examples.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. A places section 1245 property in trust to pay the income from the property to B for his life, and after B's death to distribute the property to C. If the basis of the property to the fiduciary and to C is determined under the uniform basis rules prescribed in paragraph (b) of §1.1015–1, and under paragraph (c) of §1.1015–1 the time the fiduciary and C acquire their interests in the property is the time the donor relinquished dominion over the property, then section 1245(a)(1) does not apply to the transfer by A to the trust or to the distribution to C.

Example 2. Assume the same facts as in example (1), except that the fiduciary sells the section 1245 property and reinvests the proceeds in other section 1245 property which is distributed to C upon B's death. Assume further that under paragraph (f) of §1.1015–1 C's basis for the distributed property is the cost or other basis to the fiduciary. Section 1245(a)(1) applies to the sale but not to the distribution.

(3) *Disposition in part a sale or exchange and in part a gift.* Where a disposition of property is in part a sale or exchange and in part a gift, the gain to which section 1245(a)(1) applies is the amount by which (i) the lower of the amount realized upon the disposition of the property or the recomputed basis of the property, exceeds (ii) the adjusted basis of the property. For determination of the recomputed basis of the property in the hands of the transferee, see paragraph (c)(2) of §1.1245–2.

(4) *Example.* The provisions of subparagraph (3) of this paragraph may be illustrated by the following example:

Example: (i) Smith transfers section 1245 property, which he has held in excess of 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), to his son for $60,000. Immediately before the transfer the property in the hands of Smith has an adjusted basis of $30,000, a fair market value of $90,000, and a recomputed basis of $110,000. Since the amount realized upon disposition of the property ($60,000) is lower than its recomputed basis ($110,000), the excess of the amount realized over adjusted basis, or $30,000, is treated as ordinary income under section 1245(a)(1) and not as gain from the sale or exchange of property described in section 1231. Smith has made a gift of $30,000 ($90,000 fair market value minus $60,000 amount realized) to which section 1245(a)(1) does not apply.

(ii) Immediately before the transfer, the amount of adjustments reflected in the adjusted basis of the property was $80,000. Under paragraph (c)(2) of § 1.1245–2, $50,000 of adjustments are reflected in the adjusted basis of the property immediately after the transfer, that is, $80,000 of such adjustments immediately before the transfer, minus $30,000 gain taken into account under section 1245(a)(1) upon the transfer. Thus, the recomputed basis of the property in the hands of the son is $110,000.

(b) *Exception for transfers at death*—(1) *General rule.* Section 1245(b)(2) provides that, except as provided in section 691 (relating to income in respect of a decedent), no gain shall be recognized under section 1245(a)(1) upon a transfer at death. For purposes of this paragraph, the term *transfer at death* means a transfer of property which, in the hands of the transferee, has a basis determined under the provisions of section 1014(a) (relating to basis of property acquired from a decedent) because of the death of the transferor. For recomputed basis of property acquired in a transfer at death, see paragraph (c)(1)(iv) of § 1.1245–2.

(2) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. Smith owns section 1245 property which, upon Smith's death, is inherited by his son. Since the property is described in section 1014(b)(1), its basis in the hands of the son is determined under the provisions of section 1014(a). Therefore, section 1245(a)(1) does not apply to the transfer at Smith's death.

Example 2. H purchases section 1245 property which he conveys to himself and W, his wife, as tenants by the entirety. Upon H's death in 1970 the property (including W's share) is included in his gross estate. Since the entire property is described in section 1014(b) (1) and (9), its basis in the hands of W is determined under the provisions of section 1014(a). Therefore, section 1245(a)(1) does not apply to the transfer at H's death. For determination of the recomputed basis of the property in the hands of W, see paragraph (c)(3) of § 1.1245–2.

Example 3. Green's will provides for the bequest of section 1245 property to trustees to pay the income from the property to his wife for her lifetime, and upon her death to distribute the property to his son. If under paragraph (a)(2) of § 1.1014–4 the son's unadjusted basis for the property is its fair market value at the time the decedent died, section 1245(a)(1) does not apply to the distribution of the property to the son.

Example 4. The trustee of a trust created by will transfers section 1245 property to a beneficiary in satisfaction of a specific bequest of $10,000. If under the principles of paragraph (a)(3) of § 1.1014–4 the trust realizes a taxable gain upon the transfer, section 1245(a)(1) applies to the transfer.

(c) *Limitation for certain tax-free transactions*—(1) *Limitation on amount of gain.* Section 1245(b)(3) provides that upon a transfer of property described in subparagraph (2) of this paragraph, the amount of gain taken into account by the transferor under section 1245(a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer (determined without regard to section 1245). For purposes of this subparagraph, in case of a transfer of both section 1245 property and non-section 1245 property in one transaction, the amount realized from the disposition of the section 1245 property (as determined under paragraph (a)(5) of § 1.1245–1) shall be deemed to consist of that portion of the fair market value of each property acquired which bears the same ratio to the fair market value of such acquired property as the amount realized from the disposition of the section 1245 property bears to the total amount realized. The preceding sentence shall be applied solely for purposes of computing the portion of the total gain (determined without regard to section 1245) which shall be recognized as ordinary income under section 1245(a)(1). For determination of the recomputed basis of the section 1245 property in the hands of the transferee, see paragraph (c)(2) of § 1.1245–2. Section 1245(b)(3) does not apply to a disposition of property to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 of the Code.

(2) *Transfers covered.* The transfers referred to in subparagraph (1) of this paragraph are transfers of property in which the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(i) Section 332 (relating to distributions in complete liquidation of an 80-percent-or-more controlled subsidiary corporation). See subparagraph (3) of this paragraph.

(ii) Section 351 (relating to transfer to a corporation controlled by transferor).

(iii) Section 361 (relating to exchanges pursuant to certain corporate reorganizations).

(iv) Section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings).

(v) Section 374(a) (relating to exchanges pursuant to certain railroad reorganizations).

(vi) Section 721 (relating to transfers to a partnership in exchange for a partnership interest).

(vii) Section 731 (relating to distributions by a partnership to a partner). For special carryover basis rule, see section 1245(b)(6)(A) and paragraph (f)(1) of this section.

(3) *Complete liquidation of subsidiary*. In the case of a distribution in complete liquidation of an 80-percent-or-more controlled subsidiary to which section 332 applies, the limitation provided in section 1245(b)(3) is confined to instances in which the basis of the property in the hands of the transferee is determined, under section 334(b)(1), by reference to its basis in the hands of the transferor. Thus, for example, the limitation of section 1245(b)(3) may apply in respect of a liquidating distribution of section 1245 property by an 80-percent-or-more controlled corporation to the parent corporation, but does not apply in respect of a liquidating distribution of section 1245 property to a minority shareholder. Section 1245(b)(3) does not apply to a liquidating distribution of property by an 80-percent-or-more controlled subsidiary to its parent if the parent's basis for the property is determined, under section 334(b)(2), by reference to its basis for the stock of the subsidiary.

(4) *Examples*. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Section 1245 property, which is owned by Smith, has a fair market value of $10,000, a recomputed basis of $8,000, and an adjusted basis of $4,000. Smith transfers the property to a corporation in exchange for stock in the corporation worth $9,000 plus $1,000 in cash in a transaction qualifying under section 351. Without regard to section 1245, Smith would recognize $1,000 gain under section 351(b), and the corporation's basis for the property would be determined under section 362(a) by reference to its basis in the hands of Smith. Since the recomputed basis of the property disposed of ($8,000) is lower than the amount realized ($10,000), the excess of recomputed basis over adjusted basis ($4,000), or $4,000, would be treated as ordinary income under section 1245(a)(1) if the provisions of section 1245(b)(3) did not apply. However, section 1245(b)(3) limits the gain taken into account by Smith under section 1245(a)(1) to $1,000. If, instead, Smith transferred the property to the corporation solely in exchange for stock of the corporation worth $10,000, then, because of the application of section 1245(b)(3), Smith would not take any gain into account under section 1245(a)(1). If, however, Smith transferred the property to the corporation for stock worth $5,000 and $5,000 cash, only $4,000 of the $5,000 gain under section 351(b) would be treated as ordinary income under section 1245(a)(1).

Example 2. Assume the same facts as in example (1) except that Smith contributes the property to a new partnership in which he has a one-half interest. Since, without regard to section 1245, no gain would be recognized to Smith under section 721, and by reason of the application of section 721 the partnership's basis for the property would be determined under section 723 by reference to its basis in the hands of Smith, the application of section 1245(b)(3) results in no gain being taken into account by Smith under section 1245(a)(1).

Example 3. Assume the same facts as in example (2) except that the property is subject to a $9,000 mortgage. Since under section 752(b) (relating to decrease in partner's liabilities) Smith is treated as receiving a distribution in money of $4,500 (one-half of liability assumed by partnership), and since the basis of Smith's partnership interest is $4,000 (the adjusted basis of the contributed property), the $4,500 distribution results in his realizing $500 gain under section 731(a) (relating to distributions by a partnership), determined without regard to section 1245. Accordingly, the application of section 1245(b)(3) limits the gain taken into account by Smith under section 1245(a)(1) to $500.

(d) *Limitation for like kind exchanges and involuntary conversions*—(1) *General rule*. Section 1245(b)(4) provides that if property is disposed of and gain (determined without regard to section 1245) is not recognized in whole or in part under section 1031 (relating to like kind exchanges) or section 1033 (relating to involuntary conversions), then the amount of gain taken into account by the transferor under section 1245(a)(1) shall not exceed the sum of:

(i) The amount of gain recognized on such disposition (determined without regard to section 1245), plus

(ii) The fair market value of property acquired which is not section 1245 property and which is not taken into account under subdivision (i) of this subparagraph (that is, the fair market value of non-section 1245 property acquired which is qualifying property under section 1031 or 1033, as the case may be).

(2) *Examples.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. Smith exchanges machine A for machine B in a like kind exchange as to which no gain is recognized under section 1031(a). Both machines are section 1245 property. No gain is recognized under section 1245(a)(1) because of the limitation contained in section 1245(b)(4). The result would be the same if machine A were involuntarily converted into machine B in a transaction as to which no gain is recognized under section 1033(a)(1).

Example 2. Jones owns property A, which is section 1245 property, with an adjusted basis of $100,000 and a recomputed basis of $116,000. The property is destroyed by fire and Jones receives $117,000 of insurance proceeds. Thus, the amount of gain under section 1245(a)(1), determined without regard to section 1245(b)(4), would be $16,000. He uses $105,000 of the proceeds to purchase section 1245 property similar or related in service or use to property A, and $9,000 of the proceeds to purchase stock in the acquisition of control of a corporation owning property similar or related in service or use to property A. Both acquisitions qualify under section 1033(a)(3)(A). Jones properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain to the amount by which the amount realized from the conversion exceeds the cost of the stock and other property acquired to replace the converted property. Since $3,000 of the gain is recognized (without regard to section 1245) under section 1033(a)(3) (that is, $117,000 minus $114,000), and since the stock purchased for $9,000 is not section 1245 property and was not taken into account in determining the gain under section 1033, section 1245(b)(4) limits the amount of the gain taken into account under section 1245(a)(1) to $12,000 (that is, $3,000 plus $9,000). If, instead of purchasing $9,000 in stock, Jones purchases $9,000 worth of property which is section 1245 property similar or related in use to the destroyed property, section 1245(b)(4) would limit the amount of gain taken into account under section 1245(a)(1) to $3,000.

(3) *Certain tangible property.* If:

(i) A person disposes of section 1245 property in a transaction to which section 1245(b)(4) applies,

(ii) Adjustments are reflected in the adjusted basis (within the meaning of paragraph (a)(2) of § 1.1245–2) of such property which are attributable to the use of such property (or other property) as an integral part of an activity, or as a facility, specified in section 1245(a)(3)(B) (i) or (ii), and

(iii) Property is acquired in the transaction which would be considered as section 1245 property described in section 1245(a)(3)(B) if such person used the acquired property as an integral part of such an activity, or as such a facility, then (regardless of the use of the acquired property) the acquired property shall be considered as section 1245 property described in section 1245(a)(3)(B). For definition of property described in section 1245(a)(3)(B), see paragraph (c) of § 1.1245–3. Thus, for example, if a person's section 1245 property (which is personal property) is involuntarily converted into property A which would qualify as section 1245 property only if it were devoted to a specified use, and if the person had so devoted the section 1245 property disposed of, then the acquired property is considered as section 1245 property described in section 1245(a)(3)(B) and therefore its fair market value is not taken into account under subparagraph (1)(ii) of this paragraph. For recomputed basis of property A, see paragraph (a)(5) of § 1.1245–2. Moreover, if property A is not devoted to a specified use and is subsequently involuntarily converted into property B which would qualify as section 1245 property only if it were so devoted, then property B is also considered as section 1245 property described in section 1245(a)(3)(B).

(4) *Application to disposition of section 1245 property and nonsection 1245 property in one transaction.* For purposes of this paragraph, if both section 1245 property and nonsection 1245 property are acquired as the result of one disposition in which both section 1245 property and nonsection 1245 property are disposed of, then except as provided in subparagraph (7) of this paragraph:

(i) The total amount realized upon the disposition shall be allocated (in a manner consistent with the principles of paragraph (a)(5) of § 1.1245–1) between the section 1245 property and the non-section 1245 property disposed of in proportion to their respective fair market values.

(ii) The amount realized upon the disposition of the section 1245 property shall be deemed to consist of so much of the fair market value of the section 1245 property acquired as is not in excess of the amount realized from the section 1245 property disposed of, and the remaining portion (if any) of the amount realized upon the disposition of the section 1245 property shall be deemed to consist of so much of the fair market value of the non-section 1245 property acquired as is not in excess of the amount of such remaining portion, and

(iii) The amount realized upon the disposition of the non-section 1245 property shall be deemed to consist of so much of the fair market value of all the property acquired which was not taken into account in subdivision (ii) of this subparagraph.

(5) *Example.* The provisions of subparagraph (4) of this paragraph may be illustrated by the following example:

Example: (i) Smith owns section 1245 property A with a fair market value of $30,000, and non-section 1245 property X with a fair market value of $20,000. Properties A and X are destroyed by fire and Smith receives insurance proceeds of $40,000. He uses all the proceeds, plus additional cash of $10,000, to purchase in a single transaction properties B and Y which qualify under section 1033(a)(3)(A), and he properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain to the excess of the amount realized from the conversion over the costs of the qualifying properties acquired. Thus no gain would be recognized (without regard to section 1245) under section 1033(a)(3)(A). Property B is section 1245 property with a fair market value of $15,000, and property Y is non-section 1245 property with a fair market value of $35,000.

(ii) The amount realized upon the disposition of A and X ($40,000) is allocated between A and X in proportion to their respective fair market values. Thus, the amount considered realized in respect of A is $24,000 (that is, 30/50 of $40,000). (The amount considered realized in respect of X is $16,000 (that is, 20/50 of $40,000).)

(iii) The $24,000 realized upon the disposition of A is deemed to consist of the fair market value of B ($15,000) and $9,000 of the fair market value of Y. (The $16,000 realized upon the disposition of X is deemed to consist of $16,000 of the fair market value of Y. Also, $10,000 of the fair market value of Y is attributable to the additional cash of $10,000.)

(iv) Assume that A has an adjusted basis of $5,000, and a recomputed basis of $40,000. Since the amount considered realized upon the disposition of A ($24,000) is lower than its recomputed basis ($40,000), the amount of gain which would be recognized under section 1245(a)(1), determined without regard to section 1245(b)(4), is $19,000, that is, the amount realized ($24,000) minus the adjusted basis ($5,000). Since no gain is recognized (without regard to section 1245) under section 1033(a)(3), and since $9,000 of the property acquired in exchange for section 1245 property A is non-section 1245 property Y, section 1245(b)(4) limits the amount of gain taken into account under section 1245(a)(1) to $9,000.

(6) *Cross references.* For the manner of determining the recomputed basis of property acquired in a transaction to which section 1245(b)(4) applies, see paragraph (c)(4) of § 1.1245–2. For the manner of determining the basis of such property, see paragraph (a) of § 1.1245–5.

(7) *Coordination with section 1250.* For purposes of this paragraph, if section 1245 property and section 1250 property are disposed of in one transaction in which the property acquired includes section 1250 property, the allocation rules of paragraph (d)(6) of § 1.1250–3 shall apply.

(e) *Limitation for section 1071 and 1081 transactions*—(1) *Section 1071 and 1081(b) transactions.* If property is disposed of and gain (determined without regard to section 1245) is not recognized in whole or in part because of the application of section 1071 (relating to gain from sale or exchange to effectuate policies of F.C.C.) or section 1081(b) (relating to gain from sale or exchange in obedience to order of S.E.C.), then the amount of gain taken into account by the transferor under section 1245(a)(1) shall not exceed the sum of:

(i) The amount of gain recognized on such disposition (determined without regard to section 1245),

(ii) In the case of a transaction to which section 1071 applies, the fair market value of property acquired which is not section 1245 property and which is not taken into account under subdivision (i) of this subparagraph, plus

(iii) The amount by which the basis of property, other than section 1245 property, is reduced (pursuant to an election under section 1071 or pursuant to the application of section 1082(a)(2)), and which is not taken into account under subdivision (i) or (ii) of this subparagraph.

(2) *Section 1081(d)(1)(A) transaction.* No gain shall be recognized under section 1245(a)(1) upon an exchange of property as to which gain would not be recognized (without regard to section 1245) because of the application of section 1081(d)(1)(A) (relating to transfers within system group). For recomputed basis of property acquired in a transaction referred to in this subparagraph, see paragraph (c)(2) of § 1.1245–2.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. Corporation X elects under section 1071 to treat a sale of section 1245 property for $100,000 as an involuntary conversion subject to the provisions of section 1033, but does not elect to reduce the basis of depreciable property pursuant to an election under section 1071. The corporation uses $35,000 of the proceeds to purchase section 1245 property and $40,000 to purchase other property. Both properties qualify as replacement property under section 1033. Assuming that the amount of gain under section 1245(a)(1) (determined without regard to this paragraph) would be $70,000, and that $25,000 of gain would be recognized (without regard to section 1245) upon the application of section 1071, the amount of gain taken into account under section 1245(a)(1) is $65,000 ($25,000 plus $40,000).

Example 2. (i) Assume the same facts as in example (1) except that the corporation elects under section 1071 to reduce its basis for property of a character subject to the allowance for depreciation under section 167 by the amount of gain which would be recognized without regard to the application of section 1245, that is, by $25,000. Assume further that under section 1071 the corporation may reduce the basis of depreciable property consisting of property A, which is section 1245 property with an adjusted basis of $30,000, and property B, which is property other than section 1245 property with an adjusted basis of $20,000. Under paragraph (a)(2) of § 1.1071–3, the $25,000 of unrecognized gain is applied to reduce the basis of property A by $15,000 (30,000/50,000 of $25,000) and the basis of property B by $10,000 (20,000/50,000 of $25,000).

(ii) The amount of gain which would be recognized (determined without regard to section 1245) under section 1071 is zero, i.e., the amount determined in example (1) ($25,000), minus the amount of the reduction in basis of depreciable property pursuant to the election ($25,000). The amount of gain taken into account under section 1245(a)(1) is $50,000, i.e., the sum of (*a*) the gain which would be recognized without regard to section 1245 (zero), (*b*) the cost of property acquired which is not section 1245 property ($40,000), plus (c) the amount by which the basis of property B is reduced ($10,000). For method of increasing basis of property B, see paragraph (b)(2) of § 1.1245–5, and for recomputed basis of property A, see paragraph (c)(5) of § 1.1245–2.

(f) *Limitation for property distributed by a partnership*—(1) *In general.* For purposes of section 1245(b)(3) (relating to certain tax-free transactions), the basis of section 1245 property distributed by a partnership to a partner shall be deemed to be determined by reference to the adjusted basis of such property to the partnership.

(2) *Adjustments reflected in the adjusted basis.* If section 1245 property is distributed by a partnership to a partner, then, for purposes of determining the recomputed basis of the property in the hands of the distributee, the amount of the adjustments reflected in the adjusted basis of the property immediately after the distribution shall be an amount equal to:

(i) The potential section 1245 income (as defined in paragraph (c)(4) of § 1.751–1) of the partnership in respect of the property immediatley before the distribution, reduced by

(ii) The portion of such potential section 1245 income which is recognized as ordinary income to the partnership under paragraph (b)(2)(ii) of § 1.751–1.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. (i) A machine, which is section 1245 property owned by partnership ABC, has an adjusted basis of $9,000, a recomputed basis of $18,000, and a fair market value of $15,000. Since the fair market value of the machine is lower than its recomputed basis, the potential section 1245 income in respect of the machine is the excess of fair market value over adjusted basis, or $6,000. The partnership distributes the machine to C in a complete liquidation of his partnership interest to which section 736(a) does not apply.

C, who had originally contributed the machine to the partnership, has a basis for his partnership interest of $10,000. Since section 751(b)(2)(A) provides that section 751(b)(1) does not apply to a distribution of property to the partner who contributed the property, no gain would be recognized to the partnership under section 731(b) (without regard to the application of section 1245). By reason of the application of section 731, C's basis for the property would, under section 732(b), be equal to his basis for his interest in the partnership, or $10,000.

(ii) Since section 731 applies to the distribution, and since subparagraph (1) of this paragraph provides that, for purposes of section 1245(b)(3), C's basis for the property is deemed to be determined by reference to the adjusted basis of the property to the partnership, the gain taken into account under section 1245(a)(1) by the partnership is limited by section 1245(b)(3) so as not to exceed the amount of gain which would be recognized to the partnership if section 1245 did not apply. Accordingly, the partnership does not recognize any gain under section 1245(a)(1) upon the distribution.

(iii) Immediately after the distribution, the amount of the adjustments reflected in the adjusted basis of the property is equal to $6,000 (that is, the potential section 1245 income of the partnership in respect of the property before the distribution, $6,000, minus the gain recognized by the partnership under section 751(b), zero). Accordingly, C's recomputed basis for the property is $16,000 (that is, adjusted basis, $10,000, plus adjustments reflected in the adjusted basis, $6,000).

Example 2. Assume the same facts as in example (1) except that the machine had been purchased by the partnership. Assume further that upon the distribution, the partnership recognizes $4,000 gain as ordinary income under section 751(b). Under section 1245(b)(3), gain to be taken into account under section 1245(a)(1) by the partnership is limited to $4,000. Immediately after the distribution, the amount of adjustments reflected in the adjusted basis of the property is $2,000 (that is, potential section 1245 income of the partnership, $6,000, minus gain recognized to the partnership under section 751(b), $4,000). Thus, if the adjusted basis of the machine in the hands of C were $11,333 (see, for example, the computation in paragraph (d)(2) of example (6) of paragraph (g) of §1.751–1), the recomputed basis of the machine would be $13,333 ($11,333 plus $2,000).

(g) [Reserved]

(h) *Timber property subject to amortization under section 194*—(1) *In general.* For purposes of section 1245(a)(2), in determining the recomputed basis of property with respect to which a deduction under section 194 was allowed for any taxable year, a taxpayer shall not take into account amortization deductions claimed under section 194 to the extent such deductions are attributable to the amortizable basis (within the meaning of section 194(c)(2)) of the taxpayer acquired before the tenth taxable year preceding the taxable year in which gain with respect to the property is recognized.

(2) *Example.* The principles of paragraph (h)(1) of this section are illustrated by the following example:

Example: Assume A owns qualified timber property (as defined in section 194(c)(1)) with a basis of $30,000. In 1981, A incurs $12,000 of qualifying reforestation expenditures and elects to amortize the maximum $10,000 of such expenses under section 194. The $10,000 of deductions are taken during the 8-year period from 1981 to 1988. If A sells the property in 1990 for $60,000 a gain of $28,000 ($60,000—adjusted basis of $32,000) is recognized on the sale. Since the sale took place within 10 years of the taxable year in which the reforestation expenditures were made, $10,000 of the gain is treated as ordinary income, and the remaining $18,000 of gain would be capital gain, if it otherwise qualifies for capital gain treatment. In order to avoid ordinary income treatment of the gain attributable to the reforestation expenditures incurred in 1981, A would have to wait until 1992 to dispose of the property.

[T.D. 6832, 30 FR 8581, July 7, 1965, as amended by T.D. 7084, 36 FR 268, Jan. 8, 1971; T.D. 7207, 37 FR 20799, Oct. 14, 1972; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 7927, 48 FR 55851, Dec. 16, 1983]

§1.1245–5 Adjustments to basis.

In order to reflect gain recognized under section 1245(a)(1), the following adjustments to the basis of property shall be made:

(a) *Property acquired in like kind exchange or involuntary conversion.* (1) If property is acquired in a transaction to which section 1245(b)(4) applies, its basis shall be determined under the rules of section 1031(d) or 1033(c).

(2) The provisions of this paragraph may be illustrated by the following example:

Example: Jones exchanges property A, which is section 1245 property with an adjusted basis of $10,000, for property B, which has a fair market value of $9,000, and property C, which has a fair market value of $3,500, in a like kind exchange as to which no gain would be recognized under section

1031(a). Upon the exchange $2,500 gain is recognized under section 1245(a)(1), since property C is not section 1245 property. See section 1245(b)(4). Under the rules of section 1031(d), the basis of the properties received in the exchange is $12,500 (i.e., the basis of property transferred, $10,000, plus the amount of gain recognized, $2,500), of which the amount allocated to property C is $3,500 (the fair market value thereof), and the residue, $9,000, is allocated to property B.

(b) *Sections 1071 and 1081 transactions.* (1) If property is acquired in a transaction to which section 1071 and paragraph (e)(1) of § 1.1245–4 (relating to limitation for section 1071 transactions, etc.) apply, its basis shall be determined in accordance with the principles of paragraph (a) of this section.

(2) If the basis of property, other than section 1245 property, is reduced pursuant to either an election under section 1071 or the application of section 1082(a)(2), then the basis of the property shall be increased to the extent of the gain recognized under section 1245(a)(1) by reason of the application of paragraph (e)(1)(iii) of § 1.1245–4.

[T.D. 6832, 30 FR 8584, July 7, 1965]

§ 1.1245–6 Relation of section 1245 to other sections.

(a) *General.* The provisions of section 1245 apply notwithstanding any other provision of subtitle A of the Code. Thus, unless an exception or limitation under section 1245(b) applies, gain under section 1245(a)(1) is recognized notwithstanding any contrary nonrecognition provision or income characterizing provision. For example, since section 1245 overrides section 1231 (relating to property used in the trade or business), the gain recognized under section 1245(a)(1) upon a disposition will be treated as ordinary income and only the remaining gain, if any, from the disposition may be considered as gain from the sale or exchange of a capital asset if section 1231 is applicable. See example (2) of paragraph (b)(2) of § 1.1245–1. For effect of section 1245 on basis provisions of the Code, see § 1.1245–5.

(b) *Nonrecognition sections overridden.* The nonrecognition provisions of subtitle A of the Code which section 1245 overrides include, but are not limited to, sections 267(d), 311(a), 336, 337, 501(a), 512(b)(5), and 1039. See section 1245(b) for the extent to which section 1245(a)(1) overrides sections 332, 351, 361, 371(a), 374(a), 721, 731, 1031, 1033, 1071, and 1081 (b)(1) and (d)(1)(A). For limitation on amount of adjustments reflected in adjusted basis of property disposed of by an organization exempt from income taxes (within the meaning of section 501(a)), see paragraph (a)(8) of § 1.1245–2.

(c) *Normal retirement of asset in multiple asset account.* Section 1245(a)(1) does not require recognition of gain upon normal retirements of section 1245 property in a multiple asset account as long as the taxpayer's method of accounting, as described in paragraph (e)(2) of § 1.167(a)–8 (relating to accounting treatment of asset retirements), does not require recognition of such gain.

(d) *Installment method.* (1) Gain from a disposition to which section 1245(a)(1) applies may be reported under the installment method if such method is otherwise available under section 453 of the Code. In such case, the income (other than interest) on each installment payment shall be deemed to consist of gain to which section 1245(a)(1) applies until all such gain has been reported, and the remaining portion (if any) of such income shall be deemed to consist of gain to which section 1245(a)(1) does not apply. For treatment of amounts as interest on certain deferred payments, see section 483.

(2) The provisions of this paragraph may be illustrated by the following example:

Example: Jones contracts to sell an item of section 1245 property for $10,000 to be paid in 10 equal payments of $1,000 each, plus a sufficient amount of interest so that section 483 does not apply. He properly elects under section 453 to report under the installment method gain of $2,000 to which section 1245(a)(1) applies and gain of $1,000 to which section 1231 applies. Accordingly, $300 of each of the first 6 installment payments and $200 of the seventh installment payment is ordinary income under section 1245(a)(1), and $100 of the seventh installment payment and $300 of each of the last 3 installment payments is gain under section 1231.

(e) *Exempt income.* The fact that section 1245 provides for recognition of gain as ordinary income does not change into taxable income any income which is exempt under section 115 (relating to income of states, etc.), 892 (relating to income of foreign governments), or 894 (relating to income exempt under treaties).

(f) *Treatment of gain not recognized under section 1245.* Section 1245 does not prevent gain which is not recognized under section 1245 from being considered as gain under another provision of the Code, such as, for example, section 311(c) (relating to liability in excess of basis), section 341(f) (relating to collapsible corporations), section 357(c) (relating to liabilities in excess of basis), section 1238 (relating to amortization in excess of depreciation), or section 1239 (relating to gain from sale of depreciable property between certain related persons). Thus, for example, if section 1245 property, which has an adjusted basis of $1,000 and a recomputed basis of $1,500, is sold for $1,750 in a transaction to which section 1239 applies, $500 of the gain would be recognized under section 1245(a)(1) and the remaining $250 of the gain would be treated as ordinary income under section 1239.

[T.D. 6832, 30 FR 8584, July 7, 1965, as amended by T.D. 7084, 36 FR 269, Jan. 8, 1971; T.D. 7400, 41 FR 5101, Feb. 4, 1976]

§1.1247–1 Election by foreign investment companies to distribute income currently.

(a) *Election by foreign investment company*—(1) *In general.* If a registered foreign investment company (as defined in paragraph (b) of this section) elects, on or before December 31, 1962, with respect to each of its taxable years beginning after December 31, 1962, to comply with the requirements of subparagraph (2) of this paragraph, then section 1246 (relating to gain on foreign investment company stock) shall not apply with respect to a qualified shareholder (as defined in paragraph (b) of §1.1247–3) of such company who disposes of his stock during any taxable year of the company to which such election applies. See section 1247(a)(1).

(2) *Requirements.* A registered foreign investment company which makes an election under section 1247(a) shall, with respect to each of its taxable years beginning after December 31, 1962, comply with the following requirements:

(i) Under section 1247(a)(1)(A), the company shall distribute to its shareholders, during the taxable year, 90 percent or more of what its taxable income would be for such taxable year if it were a domestic corporation. To the extent elected by the company under section 1247(a)(2)(B), a distribution of taxable income made not later than 2 months and 15 days after the close of the taxable year shall be treated as distributed during such taxable year. For rules relating to computation of taxable income for a taxable year and distributions of such taxable income, see §1.1247–2.

(ii) Under section 1247(a)(1)(B), the company shall designate to each shareholder the amount of his pro rata share of the excess of the net long-term capital gain over the net short-term capital loss for the taxable year and the amount thereof which is being distributed. For the manner of designating and the computation of such amounts, see §1.1247–3.

(iii) Under section 1247(a)(1)(C), the company shall provide the information and maintain the records required by §1.1247–5.

(b) *Definition of registered foreign investment company.* The term *registered foreign investment company* means a foreign corporation which is registered within the time specified in this paragraph under the Investment Company Act of 1940, as amended (15 U.S.C. 80a–1 to 80b–2), either as a management company or as a unit investment trust. Under such Act, a company is deemed registered upon receipt by the Securities and Exchange Commission of Form N–8A entitled *Notification of Registration Filed Pursuant to Section 8(a) of the Investment Company Act of 1940.* See section 8(a) of such Act (15 U.S.C. 80a–8(a)) and 17 CFR 274.10. A company which computes its income on the basis of a calendar year must have registered on or before December 31, 1962, and a company which computes its income on the basis of a fiscal year must have registered on or before the last day of its fiscal year beginning in 1962 and ending in 1963.

(c) *Time and manner of making election*—(1) *In general.* The election provided by paragraph (a) of this section must have been made on or before December 31, 1962, by means of a letter addressed to the Director of Interna-Service, Washington, DC 20225, which clearly stated that the company elects to comply with the provisions of section 1247. The letter must have been signed by an officer of the foreign investment company who was a resident of the United States and who was duly authorized to act on behalf of the company.

(2) *Information furnished.* The following information must have been submitted in connection with the election:

(i) The name, address, and employer identification number, if any, and the taxable year of the company;

(ii) The principal place of business of the company;

(iii) The date and the country under whose laws the company was incorporated;

(iv) The date of filing with the Securities and Exchange Commission, and the file number, of Form N–8A;

(v) The names and addresses of all of the company's directors and officers and of any custodian or agent of the company located in the United States; and

(vi) The name and address of the person (or persons) in the United States having custody of the books of account, records, and other documents of the company, and the location of such books, records, and other documents if different from such address.

(3) *Time information furnished.* (i) If a foreign investment company was registered with the Securities and Exchange Commission on the date of election, all the information required by subparagraph (2) of this paragraph must have been submitted with the election.

(ii) If a foreign investment company made its election before it was so registered, the information required by subparagraph (2) (i), (ii), and (iii) of this paragraph must have been submitted with the election and the information required by subparagraph (2) (iv), (v), and (vi) of this paragraph must have been submitted within 60 days following receipt by the Securities and Exchange Commission of Form N–8A.

(d) *Termination of election*—(1) *General.* Section 1247(b) provides that the election of a foreign investment company under section 1247(a) shall permanently terminate as of the close of the taxable year preceding its first taxable year in which any of the following occurs:

(i) The company fails to comply with the provisions of section 1247(a)(1) (A), (B), or (C), unless it is shown that such failure is due to reasonable cause and not due to willful neglect;

(ii) The company is a foreign personal holding company as defined in section 552; or

(iii) The company ceases to be a registered foreign investment company which is described in paragraph (b) of this section. A company ceases to be a registered company, for example, as of the time the Securities and Exchange Commission revokes its order permitting registration of the company.

(2) *Reasonable cause.* Whether a failure by a foreign investment company to comply with the provisions of section 1247(a)(1) (A), (B), or (C) is due to reasonable cause and not due to willful neglect depends on whether the company exercised ordinary business care and prudence. For example, if in determining its taxable income under section 1247(a) the company relied in good faith upon estimates and opinions of independent certified public accountants or other experts which are also used for purposes of its financial statements filed with the Securities and Exchange Commission under the Investment Company Act of 1940, such reliance would constitute reasonable cause for purposes of this paragraph. In such a case, the company's election under section 1247(a) for the taxable year would not be terminated nor would the company be required to make an additional distribution for such taxable year in order to comply with the provisions of section 1247(a)(1)(A).

[T.D. 6798, 30 FR 1174, Feb. 4, 1965]

§ 1.1247–2 Computation and distribution of taxable income.

(a) *In general.* Taxable income of a foreign investment company means taxable income as defined in section

63(a), computed without regard to subchapter N, chapter 1 of the Code, and in accordance with the following rules:

(1) There shall be excluded the excess, if any, of the company's net long-term capital gain over the net short-term capital loss. See §1.1247–3 for the manner of computing such excess.

(2) The deduction provided in section 172 (relating to net operating losses) shall not be allowed.

(3) Except for the deduction provided in section 248 (relating to organizational expenditures), the special deductions provided for corporations in part VIII (sections 241 and following), subchapter B, chapter 1 of the Code shall not be allowed.

(4) In computing the amount of the deduction allowed under section 164 there shall be included taxes paid or accrued during the taxable year which are imposed by the United States or by the country under the laws of which the company is created or organized. See, however, §1.1247–4.

(b) *Election to distribute taxable income after close of taxable year.* A company may elect under section 1247(a)(2)(B), in respect of taxable income for a taxable year, to treat a distribution made not later than 2 months and 15 days after the close of such taxable year as a distribution made during such taxable year of such taxable income. The company shall make the election by attaching to the information return required by paragraph (c)(1) of §1.1247–5 for such taxable year a statement setting forth the amount of each distribution (or portion thereof) to which the election applies and the date of each such distribution. The election shall be irrevocable after the expiration of the time for filing such information return. The distribution (or portion thereof) to which the election applies shall be considered as paid out of the earnings and profits of the taxable year for which such election is made, and not out of the earnings and profits of the taxable year in which the distribution is actually made. A distribution to which this paragraph applies shall be includible in the gross income of a shareholder of the foreign investment company for his taxable year in which received or accrued.

[T.D. 6798, 30 FR 1175, Feb. 4, 1965]

§1.1247–3 Treatment of capital gains.

(a) *Treatment by the company*—(1) *In general.* If an election to distribute income currently pursuant to section 1247(a) is in effect for a taxable year of a foreign investment company, the company shall designate (in the manner described in subparagraph (3) of this paragraph) to each shareholder his pro rata amount of the excess of the net long-term capital gain over the net short-term capital loss for the company's taxable year, and the portion thereof which is being distributed to each such shareholder. See section 1247(a)(1)(B). Except as provided in subparagraph (2) of this paragraph, the company shall compute such excess (hereinafter referred to as *excess capital gains*) as if such company were a domestic corporation, but without regard to subchapter N, chapter 1 of the Code. See paragraph (d) of §1.1247–1 for rules relating to termination of election under section 1247(a) for failure to properly compute or to properly designate excess capital gains. A company may make an irrevocable election (by notifying its shareholders as provided in subparagraph (3) of this paragraph) to distribute, on or before the 45th day following the close of its taxable year, all or a portion of the excess capital gains and have any such distribution treated as if made during such taxable year.

(2) *Rules for computing capital gains and losses.* Generally, the adjusted basis of property held by a foreign investment company shall be its cost adjusted in accordance with the applicable provisions of the Code. However, in respect of property held by a foreign investment company on the first day of the first taxable year for which the election under section 1247(a) applies, the amounts shown on such day in the permanent books of account, records, and other documents of the company shall, at the option of the company, be accepted as the adjusted basis of such property, if on such day such books, records, and other documents were being maintained in the manner prescribed by regulations under section 30 of the Investment Company Act of 1940 (15 U.S.C. 80a–30). In computing capital gains and losses of a foreign investment company under section 1247, the

provisions of section 1212 (relating to allowance of capital loss carryover) shall not apply to any capital loss incurred in or with respect to taxable years before the first taxable year for which the election under section 1247(a) applies. See section 1247(a)(2)(C).

(3) *Notice to shareholders.* The company shall designate by written notice, mailed on or before the 45th day following the close of its taxable year:

(i) To each person who is a shareholder at the close of such taxable year, his pro rata amount of the portion of the excess capital gains for such year which was not distributed, and

(ii) To each person who received a distribution of excess capital gains with respect to such taxable year, the amount and the date of each such distribution.

Each notice shall show the name and address of the foreign investment company and the taxable year of the company for which the designation is made.

(b) *Treatment of capital gains by qualified shareholder*—(1) *Definition of qualified shareholder.* (i) The term *qualified shareholder* means any shareholder of a registered foreign investment company who is a United States person (as defined in section 7701(a)(30)), other than a shareholder described in subdivision (ii) of this subparagraph.

(ii) A United States person shall not be treated as a qualified shareholder for a taxable year if in his return for such taxable year (or for any prior taxable year) he did not include, in computing his long-term capital gains, his pro rata amount of the undistributed portion of the excess capital gains which the company designated for its taxable year ending within or with such taxable year of the shareholder. Thus, for example, if a shareholder fails to include as long-term capital gain in his return for his taxable year ending December 31, 1966, the amount designated by the company as his pro rata amount of undistributed excess capital gains for the company's taxable year ending June 30, 1966, he would not be a qualified shareholder for his taxable year ending December 31, 1966, or for any subsequent taxable year. However, if the shareholder can show that his failure to include his pro rata amount of the undistributed portion of the excess capital gains in his return was due to reasonable cause and not due to willful neglect, he will continue to be a qualified shareholder. Such shareholder shall, for the year with respect to which such failure occurred, include in his taxable income his previously omitted pro rata amount of the undistributed portion of excess capital gains.

(2) *Treatment of excess capital gains.* A qualified shareholder of a foreign investment company, for any taxable year of the company for which the election under section 1247(a) is in effect, shall include in his return in computing his long-term capital gains:

(i) For his taxable year in which received, his pro rata amount of the distributed portion of the excess capital gains for such taxable year of the company, and

(ii) For his taxable year in which or with which the taxable year of the company ends, his pro rata amount of the undistributed portion of the excess capital gains for such taxable year of the company.

(3) *Sales at end of company's taxable year.* For purposes of determining whether the purchaser or seller of a share of foreign investment company stock is the shareholder at the close of such company's taxable year who is required to include an amount of undistributed excess capital gains in gross income, the amount of the undistributed excess capital gains shall be treated in the same manner as a cash dividend payable to shareholders of record at the close of the company's taxable year. Thus, if a cash dividend paid to shareholders of record as of the close of the foreign investment company's taxable year would be considered income to the purchaser, then the purchaser is also considered to be the shareholder of such company at the close of its taxable year for purposes of including an amount of undistributed excess capital gains in gross income. For rules for determining whether a dividend is income to the purchaser or seller of a share of stock, see paragraph (c) of §1.61–9.

(4) *Partners and partnerships.* If the shareholder required to include an amount of undistributed excess capital

gains in gross income under section 1247(d)(2) and subparagraph (2)(ii) of this paragraph is a partnership, such amount shall be taken into account by the partnership for the taxable year of the partnership in which occurs the last day of the taxable year of the foreign investment company in respect of which the undistributed portion of the excess capital gains were designated. The amount so includible by the partnership shall be taken into account by the partners as distributive shares of the partnership gains and losses from sales or exchanges of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) pursuant to section 702(a)(2) and paragraph (a)(2) of § 1.702–1. The partners shall increase the basis of their partnership interests under section 705(a)(1) by their distributive shares of such gains.

(5) *Effect on earnings and profits of corporate shareholder.* If a shareholder required to include an amount of undistributed excess capital gains in gross income under section 1247(d)(2) and subparagraph (2)(ii) of this paragraph is a corporation, such corporation, in computing its earnings and profits for the taxable year for which such amount is so includible, shall treat such amount as if it had actually been received in that year.

(6) *Example.* The application of this paragraph may be illustrated by the following example:

Example: Smith owns one share of stock in a foreign investment company which he purchased in 1964. In respect of the company's taxable year ending June 30, 1966, during which the election under section 1247(a) was in effect, Smith receives from the company on July 15, 1966, a distribution in the amount of $8. He also receives a notice stating that for such taxable year $9 was being designated as his pro rata amount of the excess capital gains, $8 of which was distributed on July 15, 1966, and $1 of which was being designated as the undistributed portion. In order for Smith to be a qualified shareholder for his taxable year ending December 31, 1966, he must include in computing his long-term capital gains in his return for 1966, his pro rata amount of the undistributed portion of the excess capital gains, that is, $1. Smith must also include in such return his pro rata amount of the distributed portion of excess capital gains, that is, $8. If, however, Smith does not include in income his pro rata amount of the undistributed portion of excess capital gains, he is not a qualified shareholder for 1966 (or for any subsequent year). In such a case, the $8 is not treated under the provisions of section 1247(d)(1) as a distribution of long-term capital gains for such year but as a corporate distribution taxable as ordinary income to the extent provided in subchapter C, chapter 1 of the Code.

(c) *Adjustments relating to undistributed capital gains*—(1) *Adjustments in earnings and profits of the company.* If a foreign investment company, to which the election under section 1247(a) applies, designates an amount as the undistributed portion of excess capital gains for its taxable year, the earnings and profits of the company (within the meaning of subchapter C, chapter 1 of the Code) shall be reduced, and its capital account shall be increased, by such amount.

(2) *Increase in basis of qualified shareholder's stock.* A qualified shareholder, who computes his long-term capital gains for a taxable year by including (in respect of each share of stock which he owns in a foreign investment company) the pro rata amount of the undistributed portion of the excess capital gains which was designated by the company for its taxable year ending with or within such taxable year of the shareholder, shall, as of the day following the close of such taxable year of the company, increase the adjusted basis of each share by such pro rata amount.

(d) *Loss on sale or exchange of certain stock held 1 year or less*—(1) *In general.* If:

(i) A qualified shareholder of a foreign investment company to which the election under section 1247(a) applies treats any amount designated under section 1247(a)(1)(B) with respect to a share of stock as long-term capital gain, and

(ii) Such share is held by the taxpayer for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less,

Then any loss on the sale or exchange of such share shall, to the extent of the amount described in subdivision (i) of this subparagraph, be treated under section 1247(i) as loss from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(2) *Example.* The application of this paragraph may be illustrated by the following example:

Example: On October 1, 1966, B, a calendar year taxpayer, purchases for $100 a share of stock in a foreign investment company to which the election under section 1247(a) applies. On January 20, 1967, the company, in a notice to B, designates for its taxable year ending December 31, 1966, $8 per share as excess capital gains of which $6 was distributed on December 1, 1966, and $2 was designated as undistributed. B includes the $8 in computing his long-term capital gains in his return for 1966 and, under paragraph (c)(2) of this section, B's basis for the share is increased to $102 as of January 1, 1967. On February 1, 1967, B sells the share for $93, incurring a $9 loss of which $8 is treated as a long-term capital loss under section 1247(i) and $1 is treated as a short-term capital loss.

[T.D. 6798, 30 FR 1175, Feb. 4, 1965, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1247–4 Election by foreign investment company with respect to foreign tax credit.

(a) *In general*—(1) *Election.* If an election to distribute income currently pursuant to section 1247(a) is in effect for a taxable year of a foreign investment company, and if at the close of such taxable year more than 50 percent of the value of the total assets of the company consists of stock or securities in foreign corporations, then the company may elect for such taxable year, in the manner provided in paragraph (d) of this section, the application of section 1247(f) in respect of foreign taxes referred to in subparagraph (2) of this paragraph which are paid during such taxable year. For purposes of this section, the term *value* shall have the same meaning as assigned to such term in section 851(c)(4) (relating to definition of regulated investment company). For definition of foreign corporation, see section 7701(a).

(2) *Taxes affected.* The election under section 1247(f) for a taxable year applies with respect to income, war profits, and excess profits taxes described in section 901(b)(1) which are paid by the company to foreign countries and possessions of the United States. A tax paid by a foreign investment company does not include a tax which is paid by the shareholders of the company. Whether a tax is paid by the company, and whether a tax is an income, war profits, or excess profits tax described in section 901(b)(1), shall be determined under the principles of chapter 1 of the Code without regard to the law of any foreign country and without regard to any income tax convention, including any income tax convention to which the United States is a party. Section 1247(f) does not apply with respect to foreign taxes which would be deemed to have been paid by the company under section 902 if the company were a domestic corporation. For purposes of this paragraph, taxes paid to the United States are not considered foreign taxes.

(b) *Effect of election*—(1) *Effect on company.* If a valid election under section 1247(f) is made for a taxable year of a foreign investment company, then, for purposes of determining under section 1247(a)(1)(A) whether the company has distributed to its shareholders with respect to such taxable year 90 percent or more of what the company's taxable income would be for such year if the company were a domestic corporation, the following rules shall apply:

(i) The company shall compute such taxable income without any deduction for the foreign taxes referred to in paragraph (a)(2) of this section which were paid or accrued during the taxable year.

(ii) If the amount of taxable income (computed without regard to subdivision (i) of this subparagraph) is more than zero, the company shall treat the foreign taxes referred to in paragraph (a)(2) of this section which were paid during such taxable year of the company as distributed to its shareholders to the extent of the amount which bears the same ratio to the amount of such foreign taxes as (*a*) the amount actually distributed (or treated as distributed pursuant to an election under section 1247(a)(2)(B)) during such taxable year from such taxable income (determined without regard to subdivision (i) of this subparagraph), bears to (*b*) the amount of such taxable income (also determined without regard to such subdivision (i)). Thus, for example, if for a taxable year a foreign investment company has taxable income of $1,000 (determined after deducting foreign taxes paid of $100), and if $600 of such taxable income is distributed during the taxable year and $350 of such taxable income is distributed not later than 2 months and 15 days after the close of the taxable year, then $950 is treated as distributed for purposes of satisfying the 90-percent distribution requirement of section 1247(a)(1)(A), and the amount of foreign taxes treated as distributed under this subdivision is $95 (that is, $100 multiplied by $950/ $1,000).

(iii) If the amount of taxable income (computed without regard to subdivision (i) of this subparagraph) is zero, then all foreign taxes referred to in paragraph (a)(2) of this section which were paid during the taxable year shall be treated as distributed by the company on the last day of such taxable year. Thus, for example, if for a taxable year a foreign investment company has taxable income of $500 (computed without deducting $800 of foreign taxes paid during such year), the amount of taxable income computed without regard to subdivision (i) of this paragraph is zero, and the $800 of foreign taxes is treated as distributed under this subdivision on the last day of the company's taxable year.

(2) *Effect on qualified shareholders.* The following rules apply to a qualified shareholder of a foreign investment company which makes a valid election under section 1247(f) for a taxable year:

(i) The qualified shareholder shall include in his gross income (in addition to taxable dividends actually received) his proportionate share of the foreign taxes referred to in paragraph (a)(2) of this section which were paid during such taxable year of the company, and shall treat such proportionate share as paid by him for purposes of the deduction under section 164(a) and the foreign tax credit under section 901. See, however, paragraph (c)(1) of this section for a limitation on the amount a shareholder may treat as his proportionate share of foreign taxes.

(ii) In respect of any distribution made (or treated as made under section 1247(a)(2)(B)) during the taxable year of the company and which is received by a qualified shareholder, the term *proportionate share of foreign taxes* means, for purposes of this section, an amount which bears the same ratio to (*a*) the amount of the foreign taxes referred to in paragraph (a)(2) of this section which were paid during such taxable year of the company, as (*b*) the amount of such distribution to the shareholder out of the company's taxable income for such taxable year (determined without regard to subparagraph (1)(i) of this paragraph), bears to (*c*) the amount of such taxable income (also determined without regard to such subparagraph (1)(i)).

(iii) In respect of any distribution of foreign taxes treated as made under subparagraph (1)(iii) of this paragraph on the last day of the taxable year of the company, the term *proportionate share of foreign taxes* means, for purposes of this section, an amount which bears the same ratio to (*a*) the amount of foreign taxes referred to in paragraph (a)(2) of this section which were paid during such taxable year of the company, as (*b*) the fair market value of all shares of stock of the company held by such qualified shareholder on the last day of such taxable year, bears to (*c*) the fair market value of all such shares outstanding on such last day.

(iv) For purposes of the foreign tax credit, the qualified shareholder shall treat his proportionate share of foreign taxes as having been paid by him to the country in which the foreign investment company is created or organized.

(v) For purposes of the foreign tax credit, the qualified shareholder shall treat as gross income from sources within the country in which the foreign investment company is created or organized the sum of (*a*) his proportionate share of foreign taxes, (*b*) any dividend paid to him by such foreign investment company, and (*c*) his pro rata amount of distributed and undistributed portions of excess capital gains referred to in paragraph (a) of §1.1247–3.

(vi)(*a*) In respect of a distribution made (or treated as made under section 1247(a)(2)(B)) during a taxable year of the company, a qualified shareholder shall consider his proportionate share of foreign taxes as having been received, and as having been paid, by him during his taxable year in which the distribution is includible in his gross income.

(*b*) In respect of an amount of foreign taxes treated as distributed under subparagraph (1)(iii) of this paragraph on the last day of a taxable year of the company, the qualified shareholder shall consider his proportionate share of foreign taxes as having been received, and as having been paid, by him during his taxable year in which such last day falls.

(vii) If the qualified shareholder is a corporation, it shall not be deemed under section 902 to have paid any taxes paid by the foreign investment company to which the election under section 1247(f) applied.

(3) *Effect on nonqualified shareholders.* A shareholder who is not a qualified shareholder shall not include his proportionate share of foreign taxes in gross income, and shall not be entitled to treat such proportionate share as having been paid by him to a foreign country for purposes of the deduction under section 164(a) or, except to the extent that section 902 is applicable, for purposes of the foreign tax credit under section 901.

(4) *Example.* The application of paragraph (a) of this section and this paragraph may be illustrated by the following examples:

Example 1. (i) X Corporation, a foreign investment company incorporated in country C with 100,000 shares of stock outstanding, uses the calendar year as its taxable year. For 1964, X Corporation has the following income and pays the following foreign taxes:

Dividend income, minus operating expenses		$675,000
Foreign income taxes paid:		
Withheld by country A	$25,000	
Withheld by country B	50,000	
Income tax of country C	90,000	
Total foreign income tax paid		165,000
Taxable income for purposes of section 1247(a)(1)(A), determined without regard to section 1247(f)		510,000

X Corporation distributes to its shareholders the amount of $459,000 (i.e., 90 percent of $510,000).

(ii) Assume that X Corporation validly elects the application of section 1247(f). Accordingly, X Corporation determines that its taxable income for purposes of section 1247(a)(1)(A) without any deduction for foreign income taxes paid or accrued is $675,000 ($510,000, plus $165,000).

(iii) Assume that X Corporation intends to distribute the least amount which would satisfy the requirements of section 1247(a)(1)(A), as modified by the election under section 1247(f). Thus, the total amount X distributes is $607,500, which consists of the sum of (*a*) $459,000 actually distributed, that is, 90 percent of $510,000 of taxable income (determined after the deduction for foreign taxes), plus (*b*) foreign taxes paid of $148,500 which are treated as distributed, that is, 90 percent of $165,000 of foreign taxes paid by X Corporation.

Example 2. Assume the same facts as in example (1) except that X Corporation distributes the entire $510,000 in the following manner: On December 15, 1964, X Corporation distributes $170,000 as a dividend of $1.70 per share. On February 25, 1965, X Corporation distributes the remaining $340,000 as a dividend of $3.40 per share pursuant to an election under section 1247(a)(2)(B) to treat such distribution as if made in 1964. Assume that Brown, a qualified shareholder, uses the calendar year as his taxable year. The amount of $0.55 per share (that is, $165,000, multiplied by $1.70/$510,000) must be treated by Brown as foreign taxes paid by him in 1964 to country C and the amount of $1.10 per share (that is, $165,000 multiplied by $3.40/$510,000) must be similarly treated by Brown in 1965. The amount of $2.25 per share ($1.70 of dividends actually received plus $0.55 representing foreign taxes paid) must be reported by Brown as income considered received in 1964 from country C, and the amount of $4.50 per share ($3.40 of dividends actually received plus $1.10 representing foreign taxes paid) must be so reported by Brown in 1965.

Example 3. A foreign investment company organized under the laws of country C receives a dividend of $1,000 from X Corporation, which is also organized under the laws of country C. Under the laws of country C, the foreign investment company would, if it so elects, be considered as having paid income tax in the amount of $150 which X Corporation paid to country C with respect to the earnings from which the dividend was paid. If the foreign investment company were a domestic corporation, however, it would not be considered for purposes of section 901(b)(1) as having paid the tax actually paid by X Corporation. Accordingly, the election under section 1247(f) does not apply in respect of the $150. The result would be the same if X Corporation was organized under the laws of any other foreign country to which it paid taxes and if the laws of country C permitted the foreign investment company to be considered as the payor of such taxes.

(c) *Notice to shareholders*—(1) *In general.* If, in the manner provided in paragraph (d) of this section, a foreign investment company makes an election with respect to the foreign tax credit under section 1247(f), the company shall furnish to each shareholder a written notice mailed not later than 45 days after the close of the taxable year of the company for which the election is made, designating the shareholder's proportionate share of the foreign taxes referred to in paragraph (a)(2) of this section which were paid by the company during such taxable year. This notice may be combined with the written notice to shareholders described in paragraph (a)(3) of §1.1247–3 relating to excess capital gains.

(2) *Application to shareholder.* For purposes of paragraph (b)(2) of this section, the amount which a shareholder may treat as his proportionate share of foreign taxes paid by the company shall not exceed the amounts so designated by the company in such written notice. If, however, an amount designated by the company in a notice exceeds the shareholder's proper proportionate share of such foreign taxes, the shareholder is limited to the amount correctly determined.

(d) *Manner of making election*—(1) *In general.* The election of a foreign investment company to have section 1247(f) apply for a taxable year shall be made by filing as part of its information return required by paragraph (c)(1) of §1.1247–5 a Form 1118 modified so that it becomes a statement in support of the election made by the company under section 1247(f).

(2) *Irrevocability of election.* An election under section 1247(f) for a taxable year of a foreign investment company shall be made with respect to all foreign taxes referred to in paragraph (a)(2) of this section which were paid during such taxable year, and must be made not later than the time prescribed for filing the information return under paragraph (c)(1) of §1.1247–5. Such election, if made, shall be irrevocable with respect to the distributions, and the foreign taxes with respect thereto, to which the election applies.

[T.D. 6798, 30 FR 1177, Feb. 4, 1965]

§1.1247–5 Information and recordkeeping requirements.

(a) *General.* In order to carry out the purposes of section 1247, a foreign investment company shall keep the records and comply with the information requirements prescribed by this section for each taxable year of the company for which the election under section 1247(a) is in effect. See section 1247(a)(1)(C).

(b) *Recordkeeping requirements.* The company shall maintain and preserve such permanent books of account, records, and other documents as are sufficient to establish in accordance with the provisions of §1.1247–2 what its taxable income would be if it were a domestic corporation. Generally, if the books and records of the company are maintained in the manner prescribed by regulations under section 30 of the Investment Company Act of 1940 (15 U.S.C. 80a–30), the requirements of the preceding sentence shall be considered satisfied. Such books, records, and other documents shall be available for inspection in the United States by authorized internal revenue officers or employees, and shall be maintained so long as the contents thereof may be material in the administration of section 1247.

(c) *Information returns.* The company shall file, for each taxable year during which the election under section 1247(a) is in effect, on or before the 15th day of the third month following the close of its taxable year or on or before May 1, 1965, whichever is later, with the Director of International Operations, Internal Revenue Service, Washington, DC, 20225:

(1) Form 1120, modified so as to be an annual information return, establishing the amount of its taxable income referred to in paragraph (b) of this section, and

(2) Form 2438, modified so as to be an annual information return, establishing the amount of the company's excess capital gains (referred to in paragraph (a)(1) of §1.1247–3) for the taxable year, the distributed portion thereof, and the amount of the undistributed portion thereof.

[T.D. 6798, 30 FR 1178, Feb. 4, 1965]

§1.1248–1 Treatment of gain from certain sales or exchanges of stock in certain foreign corporations.

(a) *In general.* (1) If a United States person (as defined in section 7701(a)(30)) recognizes gain on a sale or exchange after December 31, 1962, of stock in a foreign corporation, and if in respect of such person the conditions of subparagraph (2) of this paragraph are satisfied, then the gain shall be included in the gross income of such person as a dividend to the extent of the earnings and profits of such corporation attributable to such stock under § 1.1248–2 or 1.1248–3, whichever is applicable, which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, during the period or periods such stock was held (or was considered as held by reason of the application of section 1223) by such person while such corporation was a controlled foreign corporation. See section 1248(a). For computation of earnings and profits attributable to such stock if there are any *lower tier* corporations, see paragraph (a) (3) and (4) of § 1.1248–2 or paragraph (a) of § 1.1248–3, whichever is applicable. In general, the amount of gain to be included in a person's gross income as a dividend under section 1248(a) shall be determined separately for each share of stock sold or exchanged. However, such determination may be made in respect of a block of stock if earnings and profits attributable to the block are computed under § 1.1248–2 or 1.1248–3. See paragraph (b) of § 1.1248–2 and paragraph (a)(5) of § 1.1248–3. For the limitation on the tax attributable to an amount included in an individual's gross income as a dividend under section 1248(a), see section 1248(b) and § 1.1248–4. For the treatment, under certain circumstances, of the sale or exchange of stock in a domestic corporation as the sale or exchange of stock held by the domestic corporation in a foreign corporation, see section 1248(e) and § 1.1248–6. For the nonapplication of section 1248 in certain circumstances, see section 1248(f) and paragraph (e) of this section. For the requirement that the person establish the amount of earnings and profits attributable to the stock sold or exchanged and, for purposes of section 1248(b), the amount of certain taxes, see section 1248(g) and § 1.1248–7.

(2) In respect of a United States person who sells or exchanges stock in a foreign corporation, the conditions referred to in subparagraph (1) of this paragraph are satisfied only if (i) such person owned, within the meaning of section 958(a), or was considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation at any time during the 5-year period ending on the date of the sale or exchange, and (ii) at such time such foreign corporation was a controlled foreign corporation (as defined in section 957).

(3) For purposes of subparagraph (2) of this paragraph, (i) a foreign corporation shall not be considered to be a controlled foreign corporation at any time before the first day of its first taxable year beginning after December 31, 1962, and (ii) the percentage of the total combined voting power of stock of a foreign corporation owned (or considered as owned) by a United States person shall be determined in accordance with the principles of section 951(b) and the regulations thereunder.

(4) The application of this paragraph may be illustrated by the following examples:

Example 1. Corporation F is a foreign corporation which has outstanding 100 shares of one class of stock. F was a controlled foreign corporation for the period beginning on January 1, 1963, and ending on June 30, 1965, but was not a controlled foreign corporation at any time thereafter. On December 31, 1965, Brown, a United States person who has owned 15 shares of F stock since 1962, sells 7 of his 15 shares and recognizes gain with respect to each share sold. Since Brown owned stock representing at least 10 percent of the total combined voting power of F at a time during the 5-year period ending on December 31, 1965, while F was a controlled foreign corporation, the conditions of subparagraph (2) of this paragraph are satisfied. Therefore, section 1248(a) applies to the gain recognized by Brown to the extent of the earnings and profits attributable under § 1.1248–3 to such shares.

Example 2. Assume the same facts as in example (1). Assume further that on February 1, 1970, Brown sells the remainder of his shares in F Corporation and recognizes gain with respect to each share sold. Even though Brown did not own stock representing at least 10 percent of the total combined voting power of F on February 1, 1970, nevertheless, in respect of each of the 8 shares of F stock which he sold on such date, the conditions of subparagraph (2) of this paragraph are satisfied since Brown owned stock representing at least 10 percent of such voting power at a time during the 5-year period ending on February 1, 1970, while F was a controlled foreign corporation. Therefore, section 1248(a) applies to the gain recognized by Brown to the extent of the earnings and profits attributable under §1.1248–3 to such shares. If, however, Brown had sold the reminder of his shares in F on July 1, 1970, since the last date on which Brown owned stock representing at least 10 percent of the total combined voting power of F while F was a controlled foreign corporation was June 30, 1965, a date which is not within the 5-year period ending July 1, 1970, the conditions of subparagraph (2) of this paragraph would not be satisfied and section 1248(a) would not apply.

Example 3. Corporation G, a foreign corporation created in 1950, has outstanding 100 shares of one class of stock and uses the calendar year as its taxable year. Corporation X, a United States person, owns 60 shares of G stock and has owned such stock since G was created. Corporation Y, a United States person, owned 15 shares of the G stock from 1950 until December 1, 1962, on which date it sold 10 of such shares. On December 31, 1963, Y sells its remaining 5 shares of the G stock and recognizes gain on the sale. Since G is not considered to be a controlled foreign corporation at any time before January 1, 1963, and since Y did not own stock representing at least 10 percent of the total combined voting power of G at any time on or after such date, the conditions of subparagraph (2) of this paragraph are not satisfied and section 1248(a) does not apply.

(b) *Sale or exchange.* For purposes of this section and §§1.1248–2 through 1.1248–7, the term *sale or exchange* includes the receipt of a distribution which is treated as in exchange for stock under section 302(a) (relating to distributions in redemption of stock), section 331(a)(1) (relating to distributions in complete liquidation of a corporation), or section 331(a)(2) (relating to distributions in partial liquidation of a corporation).

(c) *Gain recognized.* Section 1248(a) applies to a sale or exchange of stock in a foreign corporation only if gain is recognized in whole or in part upon such sale or exchange. Thus, for example, if a United States person exchanges stock in a foreign corporation, and if under section 332, 351, 354, 355, or 361 no gain is recognized as a result of a determination by the Commissioner under section 367 that the exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes, then no amount is includible in the gross income of such person as a dividend under section 1248(a).

(d) *Credit for foreign taxes.* (1) If a domestic corporation includes an amount in its gross income as a dividend under section 1248(a) upon a sale or exchange of stock in a foreign corporation (referred to as a *first tier* corporation), and if on the date of the sale or exchange the domestic corporation owns directly at least 10 percent of the voting stock of the first tier corporation:

(i) The foreign tax credit provisions of sections 901 through 908 shall apply in the same manner and subject to the same conditions and limitations as if the first tier corporation on such date distributed to the domestic corporation as a dividend that portion of the amount included in gross income under section 1248(a) which does not exceed the earnings and profits of the first tier corporation attributable to the stock under §1.1248–2 or §1.1248–3, as the case may be, and

(ii) If on such date such first tier corporation owns directly 50 percent or more of the voting stock of a *lower tier* corporation described in paragraph (a)(3) of §1.1248–2 or paragraph (a)(3) of §1.1248–3, as the case may be (referred to as a *second tier* corporation), then the foreign tax credit provisions of sections 901 through 905 shall apply in the same manner and subject to the same conditions and limitations as if on such date (*a*) the domestic corporation owned directly that percentage of the stock in the second tier corporation which such domestic corporation is considered to own by reason of the application of section 958(a)(2), and (*b*) the second tier corporation had distributed to the domestic corporation as a dividend that portion of the amount included in gross income under section 1248(a) which does not exceed the earnings and profits of the second tier corporation attributable to such stock under §1.1248–2 or §1.1248–3, as the case may be.

(2) A credit shall not be allowed under subparagraph (1) of this paragraph in respect of taxes which are not actually paid or accrued. For the inclusion as a dividend in the gross income of a domestic corporation of an amount equal to the taxes deemed paid by such

corporation under section 902(a)(1), see section 78.

(3) If subparagraph (1)(ii) of this paragraph applies, and if the amount included in gross income under section 1248(a) upon the sale or exchange of the stock in a first tier corporation described in subparagraph (1)(ii) of this paragraph is less than the sum of the earnings and profits of the first tier corporation attributable to such stock under § 1.1248–2 or § 1.1248–3, as the case may be, plus the earnings and profits of the second tier corporation attributable to such stock under § 1.1248–2 or § 1.1248–3, as the case may be, then the amount considered distributed to the domestic corporation as a dividend shall be determined by multiplying the amount included in gross income under section 1248(a) by:

(i) For purposes of applying subparagraph (1)(i) of this paragraph, the percentage that (*a*) the earnings and profits of the first tier corporation attributable to such stock under § 1.1248–2 or § 1.1248–3, as the case may be, bears to (*b*) the sum of the earnings and profits of the first tier corporation attributable to such stock under § 1.1248–2 or § 1.1248–3, as the case may be, plus the earnings and profits of the second tier corporation attributable to such stock under § 1.1248–2 or § 1.1248–3, as the case may be, and

(ii) For purposes of applying subparagraph (1)(ii) of this paragraph, the percentage that (*a*) the earnings and profits of the second tier corporation attributable to such stock under § 1.1248–2 or § 1.1248–3, as the case may be, bears to (*b*) the sum referred to in subdivision (i)(*b*) of this subparagraph.

(4) The provisions of this paragraph may be illustrated by the following examples:

Example 1. On June 30, 1964, domestic corporation D owns 10 percent of the voting stock of controlled foreign corporation X. On such date, D sells a share of X stock and includes $200 of the gain on the sale in its gross income as a dividend under section 1248(a). X does not own any stock of a lower tier corporation referred to in paragraph (a)(3) of § 1.1248–3. D uses the calendar year as its taxable year and instead of deducting foreign taxes under section 164, D chooses the benefits of the foreign tax credit provisions for 1964. If D had included $200 in its gross income as a dividend with respect to a distribution from X on June 30, 1964, the amount of the foreign income taxes paid by X which D would be deemed to have paid under section 902(a) in respect of such distribution would be $60. Thus, in respect of the $200 included in D's gross income as a dividend under section 1248(a), and subject to the applicable limitations and conditions of sections 901 through 905, D is entitled under this paragraph to a foreign tax credit of $60 for 1964.

Example 2. On June 30, 1965, domestic corporation D owns all of the voting stock of foreign corporation Y, and Y (the first tier corporation) owns all of the voting stock of foreign corporation Z (a second tier corporation). On such date, D sells a block of Y stock and includes $400 of the gain on the sale in its gross income as a dividend under section 1248(a). The earnings and profits attributable under § 1.1248–3 to the block are $600 from Y and $1,800 from Z. D uses the calendar year as its taxable year and instead of deducting foreign taxes under section 164, D chooses the benefits of the foreign tax credit provisions for 1965. For purposes of applying the foreign tax credit provisions, Y is considered under subparagraph (3) of this paragraph to have distributed to D a dividend of $100 ($400×600/2400) and Z is considered to have so distributed to D a dividend of $300 ($400×1800/2400). If D had included $100 in its gross income as a dividend with respect to a distribution from Y on June 30, 1965, the amount of foreign income taxes paid by Y which D would be deemed to have paid under section 902(a) in respect of such distribution is $80. If D had owned the stock in Z directly, and if D had included $300 in its gross income as a dividend with respect to a distribution from Z, the amount of foreign income taxes paid by Z which D would be deemed to have paid under section 902(a) in respect of such distribution is $120. Thus, in respect of the $400 included in D's gross income as a dividend under section 1248(a), and subject to the applicable limitations and conditions of sections 901 through 905, D is entitled under this paragraph to a foreign tax credit of $200 ($80 plus $120) for 1965.

(e) *Exceptions.* Under section 1248(f), this section and §§ 1.1248–2 through 1.1248–7 shall not apply to:

(1) Distributions to which section 303 (relating to distributions in redemption of stock to pay death taxes) applies;

(2) Gain realized on exchanges to which section 356 (relating to receipt of additional consideration in certain reorganizations) applies; or

(3) Any amount to the extent that such amount is, under any other provision of the Code, treated as (i) a dividend, (ii) gain from the sale of an asset which is not a capital asset, or (iii) gain from the sale of an asset held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(f) *Installment method.* (1) Gain from a sale or exchange to which section 1248 applies may be reported under the installment method if such method is otherwise available under section 453 of the Code. In such case, the income (other than interest) on each installment payment shall be deemed to consist of gain which is included in gross income under section 1248 as a dividend until all such gain has been reported, and the remaining portion (if any) of such income shall be deemed to consist of gain to which section 1248 does not apply. For treatment of amounts as interest on certain deferred payments, see section 483.

(2) The application of this paragraph may be illustrated by the following example:

Example: Jones contracts to sell stock in a controlled foreign corporation for $5,000 to be paid in 10 equal payments of $500 each, plus a sufficient amount of interest so that section 483 does not apply. He properly elects under section 453 to report under the installment method gain of $1,000 which is includible in gross income under section 1248 as a dividend and gain of $500 which is a long-term capital gain. Accordingly, $150 of each of the first 6 installment payments and $100 of the seventh installment payment are included in gross income under section 1248 as a dividend, and $50 of the seventh installment payment and $150 of each of the last 3 installment payments are long-term capital gain.

[T.D. 6779, 29 FR 18130, Dec. 22, 1964, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 7961, 49 FR 26225, June 27, 1984]

§1.1248–2 Earnings and profits attributable to a block of stock in simple cases.

(a) *General*—(1) *Manner of computation.* For purposes of paragraph (a)(1) of §1.1248–1, if a United States person sells or exchanges a block of stock (as defined in paragraph (b) of this section) in a foreign corporation, and if the conditions of paragraph (c) of this section are satisfied in respect of the block, then the earnings and profits attributable to the block which were accumulated in taxable years of the corporation beginning after December 31, 1962, during the period such block was held (or was considered to be held by reason of the application of section 1223) by such person while such corporation was a controlled foreign corporation, shall be computed in accordance with the steps set forth in subparagraphs (2), (3), and (4) of this paragraph.

(2) *Step 1.* (i) For each taxable year of the corporation beginning after December 31, 1962, the earnings and profits accumulated for each such taxable year by the corporation shall be computed in the manner prescribed in paragraph (d) of this section, and (ii) for the period the person held (or is considered to have held by reason of the application of section 1223) the block, the amount of earnings and profits attributable to the block shall be computed in the manner prescribed in paragraph (e) of this section.

(3) *Step 2.* If the conditions of paragraph (c)(5)(ii) of this section must be satisfied in respect of stock in a *lower tier* foreign corporation which such person owns within the meaning of section 958(a)(2), then (i) the earnings and profits accumulated for each such taxable year by such lower tier corporation shall be computed in the manner prescribed in paragraph (d) of this section, and (ii) for the period the person held (or is considered to have held by reason of the application of section 1223) the block, the amount of earnings and profits of the lower tier corporation attributable to the block shall be computed in the manner prescribed in paragraph (e) of this section applied as if such person owned directly the percentage of such stock in such lower tier corporation which such person owns within the meaning of section 958(a)(2).

(4) *Step 3.* The amount of earnings and profits attributable to the block shall be the sum of the amounts computed under steps 1 and 2.

(b) *Block of stock.* For purposes of this section, the term *block of stock* means a group of shares sold or exchanged in one transaction, but only if:

(1) The amount realized, basis, and holding period are identical for each such share, and

(2) In case, during the period the person held (or is considered to have held by reason of the application of section 1223) such shares, any amount was included under section 951 in the gross income of the person (or another person) in respect of the shares, the excess under paragraph (e)(3)(ii) of this section (computed as if each share were a block) is identical for each such share.

(c) *Conditions to application.* This section shall apply only if the following conditions are satisfied:

(1)(i) On each day of the period during which the block of stock was held (or is considered as held by reason of the application of section 1223) by the person during taxable years of the corporation beginning after December 31, 1962, the corporation is a controlled foreign corporation, and

(ii) On no such day is the corporation a foreign personal holding company (as defined in section 552) or a foreign investment company (as defined in section 1246(b)).

(2) The corporation had only one class of stock, and the same number of shares of such stock were outstanding, on each day of each taxable year of the corporation beginning after December 31, 1962, any day of which falls within the period referred to in subparagraph (1) of this paragraph.

(3) For each taxable year referred to in subparagraph (2) of this paragraph, the corporation is not a less developed country corporation (as defined in section 902(d)).

(4) For each taxable year referred to in subparagraph (2) of this paragraph, the corporation does not make any distributions out of its earnings and profits other than distributions which, under section 316 (as modified by section 959), are considered to be out of earnings and profits accumulated in taxable years beginning after December 31, 1962, during the period such person held (or is considered to have held by reason of the application of section 1223) the block while such corporation was a controlled foreign corporation.

(5)(i) If (*a*) on the date of the sale or exchange such person, by reason of his ownership of such block, owns within the meaning of section 958(a)(2) stock in another foreign corporation (referred to as a *lower tier* corporation), and (*b*) the conditions of paragraph (a)(2) of §1.1248–1 would be satisfied by such person in respect of such stock in the lower tier corporation if such person were deemed to have sold or exchanged such stock in the lower tier corporation on the date he actually sold or exchanged such block in the first tier corporation, then the conditions of subdivision (ii) of this subparagraph must be satisfied.

(ii) In respect of stock in such lower tier corporation, (*a*) the conditions set forth in subparagraphs (1) through (4) of this paragraph (applied as if such person owned directly such stock in such lower tier corporation) must be met and (*b*) such person must own within the meaning of section 958(a)(2) the same percentage of the shares of such stock on each day which falls within the period referred to in subparagraph (1) of this paragraph.

(d) *Earnings and profits accumulated for a taxable year*—(1) *General.* For purposes of this section, the earnings and profits accumulated for a taxable year of a foreign corporation shall be the earnings and profits for such year computed in accordance with the rules prescribed in §1.964–1 (relating to determination of earnings and profits for a taxable year of a controlled foreign corporation) and reduced by any distributions therefrom. If the stock in the corporation is sold or exchanged before any action is taken by or on behalf of the corporation under paragraph (c) of §1.964–1, the computation of earnings and profits under §1.964–1 for purposes of this section shall be made as if no elections had been made and no accounting method had been adopted.

(2) *Special rules.* (i) The earnings and profits of the corporation accumulated:

(*a*) For any taxable year beginning before January 1, 1967 (computed without any reduction for distributions), shall not include the excess of any item includible in gross income of the foreign corporation under section 882(b) as gross income derived from sources within the United States, and

(*b*) For any taxable year beginning after December 31, 1966 (computed without any reduction for distributions), shall not include the excess of any item includible in gross income of the foreign corporation under section 882(b)(2) as income effectively connected for that year with the conduct by such corporation of a trade or business in the United States, whether derived from sources within or from sources without the United States,

Over any deductions allocable to such item under section 882(c). However, if the sale or exchange of stock in the foreign corporation by the United States person occurs before January 1, 1967, the provisions of (*a*) of this subdivision apply with respect to such sale or exchange even though the taxable year begins after December 31, 1966. See section 1248(d)(4). Any item which is required to be excluded from gross income, or which is taxed at a reduced rate, under an applicable treaty obligation of the United States shall not be excluded under this subdivision from earnings and profits accumulated for a taxable year (computed without any reduction for distributions).

(ii) If a foreign corporation adopts a plan of complete liquidation in a taxable year of the corporation beginning after December 31, 1962, and if because of the application of section 337(a) gain or loss would not be recognized by the corporation from the sale or exchange of property if the corporation were a domestic corporation, then the earnings and profits of the corporation accumulated for the taxable year (computed without any reduction for distributions) shall be determined without regard to the amount of such gain or loss. See section 1248(d)(2). For the nonapplication of section 337(a) to a liquidation by a collapsible corporation (as defined in section 341) and to certain other liquidations, see section 337(c).

(e) *Earnings and profits attributable to block*—(1) *General.* Except as provided in subparagraph (3) of this paragraph, the earnings and profits attributable to a block of stock of a controlled foreign corporation for the period a United States person held (or is considered to have held by reason of the application of section 1223) the block are an amount equal to:

(i) The sum of the earnings and profits accumulated for each taxable year of the corporation beginning after December 31, 1962 (computed under paragraph (d) of this section) during such period, multiplied by

(ii) The percentage that (*a*) the number of shares in the block, bears to (*b*) the total number of shares of the corporation outstanding during such period.

(2) *Special rule.* For purposes of computing the sum referred to in subparagraph (1)(i) of this paragraph, in case the block was held (or is considered as held by reason of the application of section 1223) during a taxable year beginning after December 31, 1962, but not on each day of such taxable year, there shall be included in such sum only that portion which bears the same ratio to (i) the total earnings and profits for such taxable year (computed under paragraph (d) of this section), as (ii) the number of days during such taxable year the block was held (or is considered as so held), bears to (iii) the total number of days in such taxable year.

(3) *Amounts included in gross income under section 951.* (i) If, during the period the person held (or is considered to have held by reason of the application of section 1223) the block, any amount was included under section 951 in the gross income of such person (or of another person whose holding of the stock sold or exchanged is, by reason of the application of section 1223, attributed to such person) in respect of the block, then the earnings and profits attributable to the block for such period shall be an amount equal to (*a*) the earnings and profits attributable to the block which would have been computed under subparagraph (1) of this paragraph if this subparagraph did not apply, reduced by (*b*) the excess computed under subdivision (ii) of this subparagraph. See section 1248(d)(1).

(ii) The excess computed under this subdivision is the excess (if any) of (*a*) amounts included under section 951 in the gross income of such person (or such other person) in respect of the block during such period, over (*b*) the portion of such amounts which, in any taxable year of such person (or such other person), resulted in an exclusion from the gross income of such person (or such other person) under section 959(a)(1) (relating to exclusion from gross income of distributions of previously taxed earnings and profits).

(iii) This subparagraph shall apply notwithstanding an election under section 962 by such person to be subject to tax at corporate rates.

(4) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example 1. On May 26, 1965, Green, a United States person, purchases at its fair market value a block of 25 of the 100 outstanding shares of the only class of stock of controlled foreign corporation F. He sells the block on January 1, 1968. In respect of the block, Green did not include any amount in his gross income under section 951. F uses the calendar year as its taxable year and does not own stock in any lower tier corporation referred to in paragraph (c)(5)(i) of this section. All of the conditions of paragraph (c) of this section are satisfied in respect of the block. The earnings and profits accumulated by F (computed under paragraph (d) of this section) are $10,000 for 1965, $13,000 for 1966, and $11,000 for 1967. The earnings and profits of F attributable to the block are $7,500, determined as follows:

Sum of earnings and profits accumulated by F during period block was held:	
For 1965 (219/365×$10,000)	$6,000
For 1966	$13,000
For 1967	$11,000
Sum	$30,000
Multiplied by:	
Number of shares in block (25), divided by total number of shares outstanding (100)	25%
Earnings and profits attributable to block	$7,500

Example 2. Assume the same facts as in example (1) except that in respect of the block Green includes in his gross income under section 951 the total amount of $2,800 for 1965 and 1966, and because of such inclusion the amount of $2,800 which was distributed to Green by F on January 15, 1967, is excluded from his gross income under section 959(a)(1). Accordingly, the earnings and profits of F attributable to the block are $7,000, determined as follows:

Earnings and profits attributable to the block, as computed in example (1)	$7,500
Minus:	
Excess of amount included in Green's gross income under section 951 ($2,800), over portion thereof which resulted in an exclusion under section 959(a)(1) ($2,300)	500
Earnings and profits attributable to block	7,000

Example 3. Assume the same facts as in example (1) except that on each day beginning on January 1, 1966 (the date controlled foreign corporation G was organized) through January 1, 1968, F owns 80 of the 100 outstanding shares of the only class of G stock. Since, by reason of his ownership of 25 shares of F stock, Green owns within the meaning of section 958(a)(2) the equivalent of 20 shares of G stock ($^{25}/_{100}$ of 80 shares), G is a lower tier corporation referred to in paragraph (c)(5)(i)(*a*) of this section. If Green had sold the 20 shares of G stock on January 1, 1968, the date he actually sold the block of F stock, the conditions of paragraph (a)(2) of § 1.1248–1 would be satisfied in respect of the G stock, and, accordingly, the conditions of paragraph (c)(5)(ii) of this section must be satisfied. Assume further that such conditions are satisfied, that G uses the calendar year as its taxable year, and that the earnings and profits accumulated by G (computed under paragraph (d) of this section) are $19,000 for 1966 and $21,000 for 1967. The earnings and profits of F and of G attributable to the block are $15,500, determined as follows:

Sum of earnings and profits accumulated by G for period Green owned G stock within the meaning of section 958(a)(2) ($19,000 plus $21,000)	$40,000
Multiplied by:	
Number of G shares deemed owned within the meaning of section 958(a)(2) by Green (20), divided by total number of G shares outstanding (100)	20%
Earnings and profits of G attributable to block	$8,000
Earnings and profits of F attributable to block, as determined in example (1)	$7,500
Total earnings and profits attributable to block	$15,000

[T.D. 6779, 29 FR 18131, Dec. 22, 1964, as amended by T.D. 7293, 38 FR 32803, Nov. 28, 1973]

§ 1.1248–3 Earnings and profits attributable to stock in complex cases.

(a) *General*—(1) *Manner of computation.* For purposes of paragraph (a)(1) of § 1.1248–1, if a United States person sells or exchanges stock in a foreign corporation, and if the provisions of § 1.1248–2 do not apply, then the earnings and profits attributable to the stock which were accumulated in taxable years of the corporation beginning after December 31, 1962, during the period or periods such stock was held (or was considered to be held by reason of the application of section 1223) by such person while such corporation was a controlled foreign corporation, shall be computed in accordance with the steps set forth in subparagraphs (2), (3), and (4) of this paragraph.

(2) *Step 1.* For each taxable year of the corporation beginning after December 31, 1962, (i) the earnings and profits accumulated for such taxable year by the corporation shall be computed in the manner prescribed in paragraph (b) of this section, (ii) the person's *tentative ratable share* of such earnings and profits shall be computed in the manner prescribed in paragraph (c) or (d) (whichever is applicable) of this section, and (iii) the person's *ratable share* of such earnings and profits shall be computed by adjusting the tentative ratable share in the manner prescribed in paragraph (e) of this section.

(3) *Step 2.* If the provisions of paragraph (f) of this section (relating to earnings and profits of *lower tier* foreign corporations) apply, the amount of the person's ratable share of the earnings and profits accumulated by each *lower tier* corporation attributable to any such taxable year (i) shall be computed in the manner prescribed by paragraph (f) of this section, and (ii) shall be added to such person's ratable share for such taxable year determined in step 1.

(4) *Step 3.* The amount of earnings and profits attributable to the share shall be the sum of the ratable shares computed for each such taxable year in the manner prescribed in steps 1 and 2.

(5) *Share or block.* In general, the computation under this paragraph shall be made separately for each share of stock sold or exchanged, except that if a group of shares constitute a block of stock the computation may be made in respect of the block. For purposes of this section, the term *block of stock* means a group of shares sold or exchanged in one transaction, but only if (i) the amount realized, basis, and holding period are identical for each such share, and (ii) the adjustments (if any) under paragraphs (e) and (f)(5) of this section of the tentative ratable shares would be identical for each such share if such adjustments were computed separately for each such share.

(6) *Deficit in earnings and profits.* For purposes of this section and §§ 1.1248–4 through 1.1248–7, in respect of a taxable year, the term *earnings and profits accumulated* for a taxable year (but only if computed under paragraph (b) of this section) includes a deficit in earnings and profits accumulated for such taxable year. Similarly, a tentative ratable share, or a ratable share, may be a deficit.

(7) *Examples.* The application of the provisions of this paragraph may be illustrated by the following examples:

Example 1. On December 31, 1967, Brown sells 10 shares of stock in foreign corporation X, which uses the calendar year as its taxable year. The 10 shares constitute a block of stock under subparagraph (5) of this paragraph. Under step 1, Brown's ratable shares of the earnings and profits of X attributable to the block are as follows:

Taxble year of X	Ratable shares
1963	$100
1964	150
1965	[1] 50
1966	50
1967	100
Sum	350

[1] Deficit.

The amount of the earnings and profits attributable to such block under step 3 is $350.

Example 2. Assume the same facts as in example (1), except that in respect of X there are *lower tier* corporations Y and Z to which the provisions of paragraph (f) of this section apply. Brown's ratable shares of the earnings and profits of X, Y, and Z attributable to the block under steps 1 and 2 for each taxable year of X are as follows:

Taxable year of X	Ratable shares			
	X	Y	Z	Total
1963	$100	$40	$20	$160
1964	150	40	−60	130
1965	−50	30	50	30
1966	50	50	30	130
1967	100	−40	40	100
Sum	350	120	80	550

The amount of the earnings and profits attributable to such block under step 3 is $550.

(b) *Earnings and profits accumulated for a taxable year*—(1) *General.* For purposes of this section, the earnings and profits accumulated for a taxable year of a foreign corporation shall be the earnings and profits for such year, computed in accordance with the rules prescribed in § 1.964–1 (relating to determination of earnings and profits for a taxable year of a controlled foreign corporation), except that (i) the special rules of subparagraph (2) of this paragraph shall apply, and (ii) adjustments shall be made under subparagraph (3) of this paragraph for distributions made by the corporation during such taxable year. If the stock in the corporation is sold or exchanged before any action is taken by or on behalf of the corporation under paragraph (c) of § 1.964–1, the computation of earnings and profits under § 1.964–1 for purposes of this section shall be made as if no elections had been made and no accounting method had been adopted. The amount of earnings and profits accumulated for a taxable year of a foreign corporation, as computed under this paragraph, is not necessarily the same amount as the earnings and profits of the taxable year computed under section 316(a)(1) or paragraph (d) of § 1.1248–2. Thus, for example, if a distribution with respect to stock is in excess of the amount of earnings and profits of the taxable year computed under section 316(a)(2), such excess is treated under section 316(a)(2), or paragraph (d) of § 1.1248–2 as made out of any earnings and profits accumulated in prior taxable years, whereas the amount of such excess may create, or increase, a deficit in the earnings and profits accumulated for the taxable year as computed under this paragraph. See subparagraph (3) of this paragraph.

(2) *Special rules.* (i) The earnings and profits of the corporation accumulated:

(*a*) For any taxable year beginning before January 1, 1967, shall not include the excess of any item includible in gross income of the foreign corporation under section 882(b) as gross income derived from sources within the United States, and

(*b*) For any taxable year beginning after December 31, 1966, shall not include the excess of any item includible in gross income of the foreign corporation under section 882(b)(2) as income effectively connected for that year with the conduct by such corporation of a trade or business in the United States, whether derived from sources within or from sources without the United States,

Over any deductions allocable to such item under section 882(c). However, if the sale or exchange of stock in the foreign corporation by the U.S. person occurs before January 1, 1967, the provisions of (*a*) of this subdivision apply with respect to such sale or exchange even though the taxable year begins after December 31, 1966. See section 1248(d)(4). Any item which is required to be excluded from gross income, or which is taxed at a reduced rate, under an applicable treaty obligation of the United States shall not be excluded under this subdivision from earnings and profits accumulated for a taxable year.

(ii) If a foreign corporation adopts a plan of complete liquidation in a taxable year of the corporation beginning after December 31, 1962, and if because of the application of section 337(a) gain or loss would not be recognized by the corporation from the sale or exchange of property if the corporation were a domestic corporation, then the earnings and profits of the corporation accumulated for the taxable year shall be determined without regard to the amount of such gain or loss. See section 1248(d)(2). For the nonapplication of section 337(a) to a liquidation by a collapsible corporation (as defined in section 341) and to certain other liquidations, see section 337(c).

(3) *Adjustment for distributions.* (i) The earnings and profits of a foreign corporation accumulated for a taxable year (computed without regard to this subparagraph) shall be reduced (if necessary below zero so as to create a deficit), or a deficit in such earnings and profits shall be increased, by the amount of the distributions (other than in redemption of stock under section 302(a) or 303) made by the corporation in respect of its stock during such taxable year (*a*) out of such earnings and profits, or (*b*) out of earnings and profits accumulated for prior taxable years beginning after December 31, 1962 (computed under this paragraph). Except for purposes of applying this subparagraph, the application of the preceding sentence shall not affect the amount of earnings and profits accumulated for any such prior taxable year.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example 1. X Corporation, which uses the calendar year as its taxable year, was organized on January 1, 1965, and was a controlled foreign corporation on each day of 1965. The amount of X's earnings and profits accumulated for 1965 (computed under this paragraph without regard to the adjustment for distributions under this subparagraph) is $400,000, of which $100,000 is distributed by X as dividends during 1965. The amount of X's earnings and profits accumulated for 1965 (computed under this paragraph) is $300,000 (that is, $400,000 minus $100,000). The result would be the same even if X was not a controlled foreign corporation on each day of 1965.

Example 2. Assume the same facts as in example (1). Assume further that the amount of X's earnings and profits accumulated for 1966 (computed under this paragraph without regard to the adjustment for distributions under this subparagraph) is $150,000, and that X distributes the amount of $260,000 as dividends during 1966. Since $150,000 of the distribution is from earnings and profits accumulated for 1966 (computed without regard to the adjustment for distributions under this subparagraph), and since $110,000 is from earnings and profits accumulated for 1965, the earnings and profits of X accumulated for 1966 are a deficit of $110,000 (that is, $150,000 minus $260,000). However, the earnings and profits accumulated for 1965 are still $300,000 for purposes of computing in the manner prescribed in paragraph (c) of this section a person's tentative ratable share.

(c) *Tentative ratable share if earnings and profits accumulated for a taxable year not less than zero*—(1) *General rule.* For purposes of paragraph (a)(2)(ii) of this section, in respect of a share (or block) of stock in a foreign corporation, if the amount of the earnings and profits accumulated for a taxable year of the corporation (computed under paragraph (b) of this section), beginning after December 31, 1962, is not less than zero, then the person's tentative ratable share for such taxable year shall be equal to:

(i)(*a*) Such amount (if the computation is made in respect of a block, multiplied by the number of shares in the block), divided by (*b*) the number of shares in the corporation outstanding, or deemed under subparagraph (2) of this paragraph to be outstanding, on each day of such taxable year, multiplied by

(ii) The percentage that (*a*) the number of days in such taxable year of the corporation during the period the person held (or was considered to have held by reason of the application of section 1223) the share (or block) while the corporation was a controlled foreign corporation, bears to (*b*) the total number of days in such taxable year.

(2) *Shares deemed outstanding for a taxable year.* For purposes of this section and §§1.1248–4 through 1.1248–7, if the number of shares of stock in a foreign corporation outstanding on each day of a taxable year of the corporation is not constant, then the number of such shares deemed outstanding on each such day shall be the sum of the fractional amounts in respect of each share outstanding on any day of the taxable year. The fractional amount in respect of a share shall be determined by dividing (i) the number of days in the taxable year during which such share was outstanding (excluding the day the share became outstanding, but including the day the share ceased to be outstanding), by (ii) the total number of days in such taxable year.

(3) *Examples.* The application of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. On each day of 1964, S owns a block consisting of 30 of the 100 shares of the only class of stock outstanding in F Corporation, and on each such day F is a controlled foreign corporation. F uses the calendar year as its taxable year and F's earnings and profits accumulated for 1964 (computed under paragraph (b) of this section) are $10,000. S's tentative ratable share with respect to the block is $3,000, computed as follows:

Earnings and profits accumulated for taxable year	$10,000
Multiplied by:	
Number of shares in block (30), divided by number of shares outstanding (100)	30%
Multiplied by:	
Number of days in 1964 S held block while F was a controlled foreign corporation (365), divided by number of days in 1964 (365)	100%
Tentative ratable share for block	$3,000

Example 2. On December 31, 1964, X Corporation, a controlled foreign corporation which uses the calendar year as its taxable year, had 100 shares of one class of stock outstanding, 15 of which were owned by T. T's 15 shares were redeemed by X on March 14, 1965. On December 31, 1965, in addition to the remaining 85 shares, 10 new shares of stock (which were issued on May 26, 1965) were outstanding. Thus, during 1965, 15 shares were outstanding for 73 days, 10 for 219 days, and 85 for 365 days. The earnings and profits

(computed under paragraph (b) of this section) accumulated for X's taxable year ending on December 31, 1965, are $18,800. T's tentative ratable share with respect to one share of stock is $40, computed as follows:

Earnings and profits accumulated for taxable year		$18,800
Divided by:		
Number of shares deemed outstanding each day of 1965:.		
15 for 73 days (15×73/365)	3	
10 for 219 days (10×219/365)	6	
85 for 365 days (35×365/365)	85	
Total number of shares deemed outstanding each day of 1965		94
Earnings and profits accumulated per share		$200
Multiplied by:		
Number of days in 1965 T held his share while X was a controlled foreign corporation (73), divided by number of days in 1965 (365)		20%
T's tentative ratable share per share of stock		$40

Example 3. Assume the same facts as in example (2) except that X was not a controlled foreign corporation after January 31, 1965. T's tentative ratable share with respect to one share of stock for 1965 is $17, computed as follows:

Earnings and profits accumulated per share, determined in example (2)	$200
Multiplied by:	
Number of days in 1965 T held X stock while X was a controlled foreign corporation (31), divided by number of days in 1965 (365)	8.5%
Tentative ratable share	$17

(4) *More than one class of stock.* If a foreign corporation for a taxable year has more than one class of stock outstanding, then before applying subparagraphs (1) and (2) of this paragraph the earnings and profits accumulated for the taxable year of the corporation (computed under paragraph (b) of this section) shall be allocated to each class of stock in accordance with the principles of paragraph (e) (2) and (3) of § 1.951–1, applied as if the corporation were a controlled foreign corporation on each day of such taxable year.

(d) *Tentative ratable share if deficit in earnings and profits accumulated for taxable year*—(1) *General rule.* For purposes of paragraph (a)(2)(ii) of this section, in respect of a share (or block) of stock in a foreign corporation, if there is a deficit in the earnings and profits accumulated for a taxable year of the corporation (computed under paragraph (b) of this section) beginning after December 31, 1962, the person's tentative ratable share for such taxable year shall be an amount equal to the sum of the partial tentative ratable shares computed under subparagraphs (2) and (3) of this paragraph.

(2) *Operating deficit.* The partial tentative ratable share under this subparagraph is computed in 2 steps. First, compute (under paragraph (b) of this section without regard to the adjustment for distributions under subparagraph (3) thereof) the deficit (if any) in earnings and profits accumulated for such taxable year. Second, compute the partial tentative ratable share in the same manner as the tentative ratable share for such taxable year would be computed under paragraph (c) of this section if such deficit were the amount referred to in paragraph (c)(1)(i)(*a*) of this section.

(3) *Deficit from distributions.* The partial tentative ratable share under this subparagraph is computed in 2 steps. First, compute and treat as a deficit only that portion of the adjustment for distributions under paragraph (b)(3) of this section for such taxable year which is attributable under subparagraph (4) of this paragraph to distributions out of earnings and profits accumulated during prior taxable years of the corporation beginning after December 31, 1962, during the period or periods the corporation was a controlled foreign corporation and the share (or block) of stock was owned by a United States shareholder (as defined in section 951(b) and the regulations thereunder). Second, compute the partial tentative ratable share for such taxable year in the same manner as the tentative ratable share for such taxable year would be computed under paragraph (c) of this section if (i) such deficit were the amount referred to in paragraph (c)(1)(i)(*a*) of this section, and (ii) the corporation were a controlled foreign corporation on each day of such taxable year.

(4) *Order of distributions.* For purposes of applying subparagraph (3) of this paragraph only, the adjustment for distributions under paragraph (b)(3) of

this section for a taxable year of a foreign corporation shall be treated as attributable first to distributions of earnings and profits for the taxable year (computed under paragraph (b) of this section without regard to such adjustment) to the extent thereof, and then to distributions out of the most recent of earnings and profits accumulated during prior taxable years beginning after December 31, 1962 (computed under paragraph (b) of this section). If the foreign corporation was a controlled foreign corporation during a prior taxable year for a period or periods which was only part of such prior taxable year, then for purposes of the preceding sentence (i) such taxable year shall be divided into periods the corporation was or was not a controlled foreign corporation, (ii) distributions of the earnings and profits accumulated during such prior taxable year shall be considered made from the most recent period first, and (iii) the earnings and profits accumulated during such prior taxable year shall be allocated to a period during such year in the same proportion as the number of days in the period bears to the number of days in such year. Except for purposes of applying subparagraph (3) of this paragraph, the application of this subparagraph shall not affect the amount of earnings and profits accumulated for any such prior taxable year (computed under paragraph (b) of this section).

(5) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example 1. On each day of 1965 X Corporation, which uses the calendar year as its taxable year, was a controlled foreign corporation having 100 shares of one class of stock outstanding, a block of 25 of which were owned by T, who acquired them in 1962 and sold them in 1967. The deficit in X's earnings and profits accumulated for 1965 (computed under paragraph (b) of this section without regard to the adjustment for distributions under subparagraph (3) thereof) is $100,000, and thus in respect of the block T's partial tentative ratable share computed under subparagraph (2) of this paragraph is a deficit of $25,000 (that is, $100,000×25/100). During 1965 X does not make any distributions in respect of its stock, and thus in respect of the block T's partial tentative ratable share computed under subparagraph (3) of this paragraph is zero. Accordingly, T's tentative ratable share in respect of the block of X stock for 1965 is a deficit of $25,000. If, however, X was a controlled foreign corporation for only 292 days during 1965, T's tentative ratable share in respect of the block for 1965 would be a deficit of $20,000 (that is, $25,000×292/365).

Example 2. (i) Assume the same facts as in example (1) except that at no time during 1965 is X a controlled foreign corporation and that during 1965 X distributes $80,000 with respect to its stock. Assume further that X was a controlled foreign corporation on each day of 1964, but only for the first 146 days of 1963, and that X's earnings and profits accumulated for prior taxable years computed under paragraph (b) of this section are $70,000 for 1964 and $20,000 for 1963.

(ii) Since X was not a controlled foreign corporation on any day of 1965, in respect of the block T's partial tentative ratable share computed under subparagraph (2) of this paragraph is zero.

(iii) The partial tentative ratable share under subparagraph (3) of this paragraph is computed in the following manner: For 1965 the adjustment for distributions under paragraph (b)(3) of this section is $80,000. Under subparagraph (4) of this paragraph $70,000 of such adjustment is attributable to the distribution of all of the earnings and profits accumulated during 1964, on every day of which X was a controlled foreign corporation, and $10,000 of the adjustment is attributable to the distribution of $10,000 of the earnings and profits accumulated for 1963. The portion of the earnings and profits accumulated by X in 1963 attributable to the first 146 days in 1963 during which X was a controlled foreign corporation is $8,000 (that is, $20,000×146/365), and the portion attributable to the period in 1963 during which X was not a controlled foreign corporation is $12,000 (that is, $20,000×219/365). Under subparagraph (4)(ii) of this paragraph, the distribution in 1965 of $10,000 of earnings and profits accumulated during 1963 is attributable to the more recent period in 1963, that is, the period X was not a controlled foreign corporation. Accordingly, the portion of the adjustment for distributions under paragraph (b)(3) of this section attributable to earnings and profits accumulated during periods X was a controlled foreign corporation is $70,000, and in respect of the block T's partial tentative ratable share under subparagraph (3) of this paragraph is a deficit of $17,500 (that is, $70,000×25/100).

(iv) T's tentative ratable share in respect of the block of X stock for 1965 is a deficit of $17,500 (that is, the sum of the partial tentative ratable share for the block computed under subparagraph (2) of this paragraph, zero, plus the partial tentative ratable share for the block computed under subparagraph (3) of this paragraph, a deficit of $17,500).

(v) Assume that X had 100 shares of one class of stock outstanding on each day of

1964 and 1963. Notwithstanding the distributions in 1965 of earnings and profits accumulated during 1964 and 1963 (computed under paragraph (b) of this section), nevertheless, in respect of the block T's tentative ratable share for 1964 is $17,500 (that is, earnings and profits accumulated during 1964 so computed of $70,000, multiplied by 25 shares/100 shares) and in respect of the block T's tentative ratable share for 1963 is $2,000 (that is, earnings and profits accumulated during 1963 so computed of $20,000, multiplied by 25 shares/100 shares, and multiplied by the percentage that the number of days in 1963 on which X was a controlled foreign corporation bears to the total number of days in 1963, 146/365).

Example 3. Assume the same facts as in example (2) except that X was a controlled foreign corporation on each day of 1965. The tentative ratable share with respect to the block of stock for 1965 is a deficit of $42,500, that is, the sum of the partial tentative ratable share under subparagraph (2) of this paragraph (as determined in example (1)), a deficit of $25,000, plus the partial tentative ratable share under subparagraph (3) of this paragraph (as determined in example (2)), a deficit of $17,500.

(6) *More than one class of stock.* If a foreign corporation for a taxable year has more than one class of stock outstanding, then before applying subparagraph (1) of this paragraph the earnings and profits accumulated for the taxable year of the corporation (computed under paragraph (b) of this section) shall be allocated to each class of stock in accordance with the principles of paragraph (e) (2) and (3) of § 1.951–1, applied as if the corporation were a controlled foreign corporation on each day of such taxable year.

(e) *Ratable share of earnings and profits accumulated for a taxable year*—(1) *In general.* For purposes of paragraph (a)(2)(iii) of this section, in respect of a share (or block) of stock in a foreign corporation, the person's ratable share of the earnings and profits accumulated for a taxable year beginning after December 31, 1962, shall be an amount equal to the tentative ratable share computed under paragraph (c) or (d) (as the case may be) of this section, adjusted in the manner prescribed in subparagraphs (2) through (6) of this paragraph.

(2) *Amounts included in gross income under section 951.* (i) In respect of a share (or block) of stock in a foreign corporation, a person's tentative ratable share for a taxable year of the corporation (computed under paragraph (c) of this section) shall be reduced (but not below zero) by the excess of (*a*) the amount, if any, included (in respect of such corporation for such taxable year) under section 951 in the gross income of such person or (during the period such share, or block, was considered to be held by such person by reason of the application of section 1223) in the gross income of any other person who held such share (or block), over (*b*) the portion of such amount which, in any taxable year of such person or such other person, resulted in an exclusion from the gross income of such person or such other person of an amount under section 959(a)(1) (relating to exclusion from gross income of distributions of previously taxed earnings and profits). See section 1248(d)(1). This subdivision shall apply notwithstanding an election under section 962 by such person to be subject to tax at corporate rates.

(ii) The application of this subparagraph may be illustrated by the following example:

Example: On December 31, 1975, Brown sells one share of stock in X Corporation, a controlled foreign corporation which has never been a less developed country corporation (as defined in section 902(d)). Both Brown and X use the calendar year as the taxable year. In respect of his share, Brown's tentative ratable share for 1971 (computed under paragraph (c) of this section) is $35. In respect of his share, Brown included $4 in his gross income for 1971 under section 951, and the amount of $3, which was distributed to him by X on January 15, 1972, is excluded from Brown's gross income under section 959(a)(1). In respect of the stock, Brown's ratable share for 1971 is $34, determined as follows:

Tentative ratable share	$35
Minus:	
Excess of amount of tentative ratable share included in Brown's gross income under section 951 ($4), over portion thereof which resulted in exclusion under section 959(a)(1) ($3)	1
Ratable share	34

(3) *Amounts included in gross income under section 551.* In respect of a share (or block) of stock in a foreign corporation, a person's tentative ratable share for a taxable year of the corporation (computed under paragraph (c) of this section) shall be reduced (but not below zero) by the amount, if any, included (in respect of such corporation for such taxable year) under section 551 in the

gross income of such person or (during the period such share, or block, was considered to be held by such person by reason of the application of section 1223) in the gross income of any other person who held such share (or block).

(4) *Less developed country corporations.* (i) If the foreign corporation was a less developed country corporation as defined in section 902(d) for a taxable year of the corporation, and if the person who sold or exchanged a share (or block) of stock in such corporation satisfies the requirements of paragraph (a) of §1.1248–5 in respect of such stock, then his ratable share for such taxable year shall be zero. See section 1248(d)(3).

(ii) The application of this subparagraph may be illustrated by the following example:

Example: Assume the same facts as in the example in subparagraph (2)(ii) of this paragraph except that X was a less developed country corporation for 1971. Assume further that Brown satisfies the requirements of paragraph (a) of §1.1248–5. Brown's ratable share in respect of the stock for 1971 is zero.

(5) *Qualified shareholder of foreign investment company.* In respect of a share (or block) of stock in a foreign corporation which was a foreign investment company described in section 1246 (b)(1), if the election under section 1247(a) to distribute income currently was in effect for a taxable year of the company, and if the person who sold or exchanged the stock (or another person who actually owned the stock during such taxable year and whose holding of the stock is attributed by reason of the application of section 1223 to the person who sold or exchanged the stock) was a qualified shareholder (as defined in section 1247(c)) for his taxable year in which or with which such taxable year of the company ends, then the ratable share in respect of the share (or block) for such taxable year of the company shall be zero. See section 1248(d)(5). In case gain is recognized under section 1246 in respect of a share (or block), see section 1248(f)(3)(B).

(6) *Adjustment for certain distributions.* If (i) the person who sold or exchanged the share or block (or another person who actually owned the share or block and whose holding of the share or block is attributed by reason of the application of section 1223 to such person) received a distribution during a taxable year of the corporation, and (ii) such distribution was not included in the gross income of such person (or such other person) by reason of the application of section 959(a)(1) to amounts which were included under section 951(a)(1) in the gross income of a United States shareholder whose holding of the share or block is not attributed by reason of the application of section 1223 to such person (or such other person), then the amount of such distribution shall be added to such person's tentative ratable share for such taxable year. Thus, for example, such tentative ratable share may be increased, or a deficit reduced, by the amount of such distribution.

(f) *Earnings and profits of subsidiaries of foreign corporations*—(1) *Application of paragraph.* (i) In respect of a person who sells or exchanges stock in a foreign corporation (referred to as a *first tier* corporation), the provisions of this paragraph shall apply if the following 3 conditions exist:

(*a*) The conditions of paragraph (a)(2) of §1.1248–1 are satisfied by the person in respect of such stock;

(*b*) By reason of his ownership of such stock, on the date of such sale or exchange such person owned, within the meaning of section 958(a)(2), stock in another foreign corporation (referred to as a *lower tier* corporation); and

(*c*) The conditions of paragraph (a)(2) of §1.1248–1 would be satisfied by such person in respect of such stock in the lower tier corporation if such person were deemed to have sold or exchanged such stock in the lower tier corporation on the date he actually sold or exchanged such stock in the first tier corporation.

(ii) If the provisions of this paragraph apply, (*a*) the person's tentative ratable share (or shares) of the earnings and profits accumulated by the lower tier corporation attributable to a taxable year of the first tier corporation shall be computed under subparagraph (2) or (4) of this paragraph, whichever is applicable, and (*b*) such person's ratable share (or shares) for the lower tier corporation attributable to a taxable year of the first tier corporation shall be computed under subparagraph (5) of this paragraph. For the manner of taking into account the ratable share for a lower tier corporation, see paragraph (a)(3) of this section.

(iii) The application of this subparagraph may be illustrated by the following example:

Example: On each day of 1964 and 1965 corporations X and Y are controlled foreign corporations, and each has outstanding 100 shares of one class of stock. On January 15, 1965, T, a United States person, owns one share of stock in X and X directly owns 20 shares of stock in Y. Thus, T owns, within the meaning of section 958(a)(2), stock in Y. On that date, T sells his share in X and satisfies the conditions of paragraph (a)(2) of § 1.1248–1 in respect of his stock in X. Assuming that the conditions of paragraph (a)(2) of § 1.1248–1 would be satisfied by T in respect of the stock he indirectly owns in Y if, on January 15, 1965, he were deemed to have sold such stock in Y, the provisions of this paragraph apply.

(2) *Tentative ratable share (of lower tier corporation attributable to a taxable year of first tier corporation) not less than zero.* If the provisions of this paragraph apply to a sale or exchange by a United States person of a share (or block) of stock in a first tier corporation, and if the amount of earnings and profits accumulated (computed under paragraph (b) of this section) for a taxable year (beginning after December 31, 1962) of the lower tier corporation is not less than zero, then in respect of the share (or block) such person's tentative ratable share of the earnings and profits accumulated for such taxable year of the lower tier corporation attributable to any taxable year (beginning after December 31, 1962) of such first tier corporation shall be an amount equal to:

(i)(*a*) Such amount of earnings and profits accumulated for such taxable year of the lower tier corporation (if the computation is made in respect of a block in the first tier corporation, multiplied by the number of shares in the block), divided by (*b*) the number of shares in the first tier corporation outstanding, or deemed under paragraph (c)(2) of this section to be outstanding, on each day of such taxable year of the first tier corporation, multiplied by

(ii) The percentage that (*a*) the number of days during the period or periods in such taxable year of the first tier corporation on which such person held (or was considered to have held by reason of the application of section 1223) the share (or block) in the first tier corporation while the first tier corporation owned (within the meaning of section 958(a)) stock of such lower tier corporation at times while such lower tier corporation was a controlled foreign corporation, bears to (*b*) the total number of days in such taxable year of the first tier corporation, multiplied by

(iii) The percentage that (*a*) the average number of shares in the lower tier corporation which were owned within the meaning of section 958(a) by the first tier corporation during such period or periods (referred to in subdivision (ii)(*a*) of this subparagraph), bears to (*b*) the total number of such shares outstanding, or deemed under the principles of paragraph (c)(2) of this section to be outstanding, during such period or periods, multiplied by

(iv) The percentage that (*a*) the number of days in such taxable year of the lower tier corporation which fall within the taxable year of the first tier corporation, bears to (*b*) the total number of days in such taxable year of the lower tier corporation.

(3) *Examples.* The application of subparagraph (2) of this paragraph may be illustrated by the following examples:

Example 1. In a year subsequent to 1969, Brown, a United States person, sells 5 of his shares of stock in X Corporation in a transaction as to which the provisions of this paragraph apply. Brown had purchased the 5 shares prior to 1969. On each day of 1969 X Corporation actually had 100 shares of one class of stock outstanding. On each such day X Corporation directly owned all of the shares of stock in Y Corporation, and Y Corporation directly owned all of the shares of stock in Z Corporation. Z Corporation on each such day was a controlled foreign corporation. Both X and Z use the calendar year as the taxable year. Z's earnings and profits accumulated for 1969 (computed under paragraph (b) of this section) are $2,000. Brown's tentative ratable share of the earnings and profits accumulated by Z attributable to the 1969 calendar year of X is $20 per share, computed as follows:

(i) Z's earnings and profits for 1969 ($2,000), divided by the number of shares in X deemed outstanding each day of 1969 (100)	$20

Multiplied by:	
(ii) Since on each day of 1969 Brown (by reason of owning directly his shares in X) owned, within the meaning of section 958(a)(2), stock in Z while Z was a controlled foreign corporation, the percentage determined under subparagraph (2)(ii) of this paragraph equals	100%
Multiplied by:	
(iii) Since on each day of 1969 X owned 100 percent of the stock of Y while Y owned 100 percent of the stock in Z, the percentage determined under subparagraph (2)(iii) of this paragraph equals	100%
Multiplied by:	
(iv) Since X and Z each use the same taxable year, the percentage determined under subparagraph (2)(iv) of this paragraph equals	100%
Total	$20

Example 2. Assume the same facts as in example (1), except that Brown sold his stock in X on October 19, 1969. Brown's tentative ratable share of the earnings and profits accumulated by Z attributable to the 1969 calendar year of X is $16 per share, computed as follows:

(i) The amount determined in subdivision (i) of example (1)	$20
Multiplied by:	
(ii) The number of days in the period during 1969 Brown (by reason of owning directly his stock in X) owned, within the meaning of section 958(a)(2), his stock in Z while Z was a controlled foreign corporation (292), divided by the number of days in 1969 (365), equals	80%
Multiplied by:	
(iii) The percentage determined in subdivision. (iii) of example (1)	100%
Multiplied by:	
(iv) The percentage determined in subdivision. (iv) of example (1)	100%
Total	$16

Example 3. Assume the same facts as in examples (1) and (2), except that on each day during 1969 Y owned (within the meaning of section 958(a)(2)) 81 of the 100 shares of Z's outstanding stock. Brown's tentative ratable share of the earnings and profits accumulated by Z attributable to the 1969 calendar year of X is $12.96 per share, computed as follows:

(i) The amount determined in subdivision (i) of example (1)	$20
Multiplied by:	
(ii) The percentage determined in subdivision (ii) of example (2)	80%
Multiplied by:	
(iii) The average number of shares in Z which were owned (within the meaning of section 958(a)) by X during the applicable period (81), divided by the total number of shares in Z during such period (100)	81%
Multiplied by:	
(iv) The percentage determined in subdivision (iv) of example (1)	100%
Total	$12.96

The result would be the same if X owned (within the meaning of section 958(a)(2)) 81 percent of the stock in Y while Y so owned 100 percent of the stock in X, or if X so owned 90 percent of the stock in Y while Y so owned 90 percent of the stock in Z.

Example 4. Assume the same facts as in example (3), except that Z Corporation uses a fiscal year ending June 30 as its taxable year. Assume further that Z's earnings and profits accumulated for its fiscal year ending June 30, 1969, and for its fiscal year ending June 30, 1970, are $3,000 and $2,000, respectively. Brown's tentative ratable share of the earnings and profits accumulated by Z attributable to the 1969 calendar year of X is $16.17 per share, computed as follows:

	In respect of Z's taxable year ending	
	June 30, 1969	June 30, 1970
(i) Z's earnings and profits, divided by the number of shares in X deemed outstanding on each day of 1969:		
$3,000/100	$30	
$2,000/100	....	$20
Multiplied by:		
(ii) The percentage determined in subdivision (ii) of example (2)	80%	80%
Multiplied by:		
(iii) The percentage determined in subdivision (iii) of example (3)	81%	81%
Multiplied by:		
(iv) Number of days in Z's taxable year which fall within 1969, divided by total number of days in Z's taxable year:		
181/365	49.6%	
184/365	....	50.4%
Totals	$9.64	$6.53
(v) Sum of tentative ratable shares of Z attributable to X's 1969 calendar year:		
For Z's taxable year ending		
June 30, 1969	....	$9.64
June 30, 1970	....	$6.53
Sum	....	$16.17

(4) *Deficit in tentative ratable share of lower tier corporation attributable to a taxable year of first tier corporation.* (i) If there is a deficit in the earnings and profits accumulated for a taxable year of a lower tier corporation beginning after December 31, 1962 (computed under paragraph (b) of this section), the person's tentative ratable share for such taxable year of such lower tier corporation attributable to a taxable

year of a first tier corporation shall not be computed under subparagraph (2) of this paragraph but shall be an amount equal to the sum of the partial tentative ratable shares computed under subdivisions (ii) and (iii) of this subparagraph.

(ii) The partial tentative ratable share under this subdivision is computed in 2 steps. First, compute (under paragraph (b) of this section without regard to the adjustments for distributions under subparagraph (3) thereof) the deficit (if any) in earnings and profits accumulated for such taxable year of such lower tier corporation. Second, compute the partial tentative ratable share in the same manner as such tentative ratable share would be computed under subparagraph (2) of this paragraph if such deficit were the amount referred to in subparagraph (2)(i)(a) of this paragraph.

(iii) The partial tentative ratable share under this subdivision is computed in 2 steps. First, compute and treat as a deficit the portion of the adjustment for distributions under paragraph (b)(3) of this section for such taxable year which is attributable under paragraph (d)(4) of this section to distributions of earnings and profits accumulated during prior taxable years of the lower tier corporation beginning after December 31, 1962, during the period or periods such lower tier corporation was a controlled foreign corporation and the percentage of the stock of such lower tier corporation (which the person owns within the meaning of section 958(a)(2)) was owned within the meaning of section 958(a) by a United States shareholder (as defined in section 951(b) and the regulations thereunder). Second, compute the partial tentative ratable share in the same manner as such tentative ratable share would be computed under subparagraph (2) of this paragraph if (a) such deficit were the amount referred to in subparagraph (2)(i)(a) of this paragraph, and (b) such lower tier corporation were a controlled foreign corporation on each day of such taxable year.

(5) *Ratable share of lower tier corporation attributable to a first tier corporation*. (i) If the provisions of this paragraph apply in respect of a share of stock in a first tier corporation, a person's ratable share of the earnings and profits accumulated by the lower tier corporation attributable to a taxable year of the first tier corporation shall be an amount equal to the tentative ratable share computed under subparagraph (2) or (4) of this paragraph, adjusted in the manner prescribed in this subparagraph.

(ii) If the first tier corporation and the lower tier corporation use the same taxable year, then in respect of a share (or block) of stock in the first tier corporation the person's tentative ratable share of the accumulated earnings and profits of the lower tier corporation attributable to the taxable year of the first tier corporation (computed under subparagraph (2) of this paragraph) shall be reduced (but not below zero) by the excess of (*a*) the amount, if any, included (in respect of such lower tier corporation for its taxable year) under section 951 in the gross income of such person or (during the period such stock was considered to be held by such person by reason of the application of section 1223) in the gross income of any other person who held such stock, over (b) the portion of such amount which, in any taxable year of such person or such other person, resulted in an exclusion from the gross income of such person or such other person of an amount under section 959(a)(1). For an illustration of the principles in the preceding sentence, see the example in paragraph (e)(2)(ii) of this section.

(iii) If the first tier corporation and the lower tier corporation do not use the same taxable year, and if there would be an excess computed under subdivision (ii) of this subparagraph in respect of a taxable year of the lower tier corporation (were the taxable years of such corporations the same), then such person's tentative ratable share of the accumulated earnings and profits for a taxable year of the lower tier corporation attributable to such taxable year of the first tier corporation shall be reduced (but not below zero) by an amount which bears the same ratio to (*a*) such excess, as (*b*) the number of days in the taxable year of the lower tier corporation which fall within the taxable year of the first tier corporation, bears to (*c*) the total number of days in the taxable year of the first tier corporation.

(iv) If the first tier corporation and the lower tier corporation use the same taxable year, then in respect of a share (or block) of stock in the first tier corporation the person's tentative ratable share of the accumulated earnings and profits of the lower tier corporation attributable to the taxable year of the first tier corporation (computed under subparagraph (2) of this paragraph) shall be reduced (but not below zero) by the amount, if any, included (in respect of such corporation for such taxable year) under section 551, by reason of the application of section 555(b), in the gross income of such person or (during the period such share (or block) was considered to be held by such person by reason of the application of section 1223) in the gross income of any other person who held such share (or block).

(v) If the first tier corporation and the lower tier corporation do not use the same taxable year, and if there would be a reduction in the person's tentative ratable share of the accumulated earnings and profits of the lower tier corporation attributable to the taxable year of the first tier corporation by an amount computed under subdivision (iv) of this subparagraph in respect of a taxable year of the lower tier corporation (were the taxable years of such corporations the same), then such person's tentative ratable share of the accumulated earnings and profits for a taxable year of the lower tier corporation attributable to such taxable year of the first tier corporation shall be reduced by an amount which bears the same ratio to (*a*) such amount, as (*b*) the number of days in the taxable year of the lower tier corporation which fall within the taxable year of the first tier corporation, bears to (*c*) the total number of days in the taxable year of the first tier corporation.

(vi) If the lower tier corporation was a less developed country corporation as defined in section 902(d) for a taxable year of the corporation, see paragraph (g) of this section.

(g) *Lower tier corporation a less developed country corporation*—(1) *General.* If the lower tier corporation was a less developed country corporation as defined in section 902(d) for a taxable year of such corporation, and if the person who sold or exchanged a share (or block) of stock in the first tier corporation satisfies on the date of such sale or exchange:

(i) The requirements of paragraph (a)(1) of § 1.1248–5 with respect to such stock, and

(ii) The requirements of paragraph (d)(1) of § 1.1248–5 with respect to any stock of the lower tier corporation which such person, by reason of his direct ownership of such stock in the first tier corporation, owned within the meaning of section 958(a)(2),

Then such person's ratable share (or a deficit in such ratable share) for such taxable year of the lower tier corporation attributable to a taxable year of the first tier corporation (determined without regard to this paragraph) shall be reduced by an amount computed by multiplying such ratable share (so determined without regard to this paragraph) by the percentage computed under either subparagraph (2) or (4) of this paragraph, whichever is applicable.

(2) *Percentage for second tier corporation.* For purposes of subparagraph (1) of this paragraph, if stock of a lower tier corporation (hereinafter referred to as a *second tier* corporation) is owned directly by the first tier corporation on the date of the sale or exchange referred to in such subparagraph (1), the percentage under this subparagraph shall be computed by dividing (i) the number of shares of stock of the second tier corporation which the first tier corporation has owned directly for an uninterrupted 10-year period ending on such date, by (ii) the total number of shares of the stock of such second tier corporation owned directly by such first tier corporation on such date.

(3) *Examples.* The provisions of subparagraph (2) of this paragraph may be illustrated by the following examples:

Example 1. On January 1, 1966, Smith, a United States person, recognizes gain upon the sale of one share of the only class of stock of F Corporation, which he has owned continuously since 1955. He includes a portion of the gain in his gross income as a dividend under section 1248(a). On January 1, 1966, F owns directly 60 shares of the 100 outstanding shares of the only class of stock of G Corporation, which F acquired in 1955 and owned continuously until such sale. F uses a taxable year ending June 30, and G uses the calendar year as the taxable year. For 1964, G was a less developed country corporation, and on each day of 1964 G was a controlled foreign corporation. Smith's ratable share for G's taxable year ending December 31, 1964, attributable to F's taxable year ending June 30, 1965 (determined without regard to this paragraph) is $6.00. Since the percentage computed under subparagraph (2) of this paragraph is 100 percent (60 shares divided by 60 shares), Smith's ratable share for G's taxable year ending December 31, 1964, attributable to F's taxable year ending June 30, 1965 (after the application of subparagraph (2) of this paragraph) is zero (that is, $6.00 reduced by 100 percent of $6.00).

Example 2. Assume the same facts as in example (1) except that of the 60 shares of G Corporation which F Corporation owned on January 1, 1966, 20 shares were acquired in 1961. The percentage computed under subparagraph (2) of this paragraph is 66⅔ percent (40 shares divided by 60 shares). Accordingly, Smith's ratable share for G's taxable year ending December 31, 1964, attributable to F's taxable year ending June 30, 1965 (after the application of subparagraph (2) or this paragraph) is $2.00 (that is, $6.00 reduced by 66⅔ percent of $6.00).

(4) *Percentage for lower tier corporations other than second tier corporation.* For purposes of subparagraph (1) of this paragraph, if stock of a lower tier corporation (other than a second tier corporation) is owned within the meaning of section 958(a)(2) by the first tier corporation on the date of the sale or exchange referred to in such subparagraph (1), the percentage under this subparagraph shall be computed in the following manner:

(i) First, determine the percentage for the second tier corporation in accordance with subparagraph (2) of this paragraph.

(ii) Second, determine a partial percentage for each other lower tier corporation in the same manner as the percentage for the second tier corporation is determined. Thus, for example, the partial percentage for a third tier corporation is determined by dividing (*a*) the number of shares of stock of the third tier corporation which the second tier corporation has owned directly for an uninterrupted 10-year period ending on the date of the sale or exchange referred to in subparagraph (1) of this paragraph, by (*b*) the total number of shares of stock of such third tier corporation owned directly by such second tier corporation on such date.

(iii) Third, the percentage for a third tier corporation is the percentage for the second tier corporation multiplied by the partial percentage for the third tier corporation. The percentage for a fourth tier corporation is the percentage for the third tier corporation (as determined in the preceding sentence) multiplied by the partial percentage for the fourth tier corporation. In a similar manner, the percentage for any other lower tier corporation may be determined.

(5) *Example.* The application of subparagraph (4) of this paragraph may be illustrated by the following example:

Example: On January 1, 1967, Brown, a United States person recognizes gain upon the sale of one share of the only class of stock of W Corporation, which he has owned continuously since 1955. He includes a portion of the gain in his gross income as a dividend under section 1248(a). W is the first tier corporation of a chain of foreign corporations W, X, Y, and Z. W and Z each use the calendar year as the taxable year. For 1964, Z was a less developed country corporation and on each day of 1964 Z was a controlled foreign corporation. Additional facts are set forth in the table below:

Corporation—(1)	Shares directly owned by preceding tier—		Column (2) divided by column (3) (percent)—(4)
	For uninterrupted 10-year period ending Jan. 1, 1967—(2)	On Jan. 1, 1967—(3)	
X	40	60	66⅔
Y	30	40	75
Z	20	30	66⅔

For 1964, the percentage referred to in subparagraph (4) of this paragraph for Z is 33⅓ percent (66⅔%×75%×66⅔%).

(6) *Special rule.* For purposes of applying the provisions of this paragraph, a lower tier corporation may be treated as a second tier corporation with respect to any of its stock which is owned directly by a first tier corporation whereas such lower tier corporation may be treated as a lower tier corporation other than a second tier corporation with respect to other stock in such lower tier corporation which is

owned (within the meaning of section 958(a)(2)) by such first tier corporation. Thus, for example, if corporations X, Y, and Z are foreign corporations, X is a first tier corporation owning directly 100 percent of the stock of Y and 40 percent of the stock of Z, and in addition Y owns directly 60 percent of the stock of Z, then the 40 percent of the Z stock (which X owns directly) is considered to be stock in a second tier corporation and the 60 percent of the Z stock (which Y owns directly and which X is considered to own within the meaning of section 958(a)(2)) is considered to be stock in a third tier corporation.

[T.D. 6779, 29 FR 18133, Dec. 22, 1964, as amended by T.D. 7293, 38 FR 32803, Nov. 28, 1973; T.D. 7545, 43 FR 19652, May 8, 1978]

§ 1.1248–4 Limitation on tax applicable to individuals.

(a) *General rule*—(1) *Limitation on tax*. Under section 1248(b), if during a taxable year an individual sells or exchanges stock in a foreign corporation, then in respect of the stock the increase in the individual's income tax liability for such taxable year which is attributable (under paragraph (b) of this section) to the amount included in his gross income as a dividend under section 1248(a) shall not be greater than an amount equal to the sum of:

(i) The excess, computed under paragraph (c) of this section in respect of the stock of the United States taxes which would have been paid by the corporation over the taxes (including United States taxes) actually paid by the corporation, plus.

(ii) An amount equal to the increase in the individual's income tax liability which would be attributable to the inclusion in his gross income for such taxable year, as long-term capital gain, of an amount equal to the excess of (*a*) the amount included in the individual's gross income as a dividend under section 1248(a) in respect of such stock, over (*b*) the excess referred to in subdivision (i) of this subparagraph.

(2) *Share or block*. In general, the limitation on tax attributable (under paragraph (b) of this section) to the amount included in an individual's gross income as a dividend under section 1248(a) shall be determined separately for each share of stock sold or exchanged. However, such determination may be made in respect of a block of stock if earnings and profits attributable to the block are computed under § 1.1248–2 or 1.1248–3. See paragraph (b) of § 1.1248–2 and paragraph (a)(5) of § 1.1248–3.

3) *Application of limitation*. The provisions of subparagraph (1) of this paragraph shall not apply unless the individual establishes:

(i) In the manner prescribed in § 1.1248–7, the amount of the earnings and profits of the corporation attributable under paragraph (a)(1) of § 1.1248–2 or under paragraph (a)(1) of § 1.1248–3, whichever is applicable, to the stock, and

(ii) The amount equal to the sum described in subparagraph (1) of this paragraph, computed in accordance with the provisions of this section.

(4) *Example*. The provisions of this paragraph may be illustrated by the following example:

Example: On December 31, 1966, Smith, a United States person, sells a share of stock of X Corporation which he has owned continuously since December 31, 1965, and includes $100 of the gain on the sale in his gross income as a dividend under section 1248(a). Both X and Smith use the calendar year as the taxable year. The increase in Smith's income tax liability for 1966 which is attributable (under paragraph (b) of this section) to the inclusion of the $100 in his gross income as a dividend is $70. X was a controlled foreign corporation on each day of 1966. The excess computed under paragraph (c) of this section in respect of the share, of the United States taxes which X would have paid over the taxes (including United States taxes) actually paid by X is $49. Under section 1248(b), the limitation on the tax attributable to the $100 included by Smith in his gross income as a dividend under section 1248(a) is $61.75, computed as follows:

(i) Excess, computed under paragraph (c) of this section, of United States taxes which X Corporation would have paid in 1966 over the taxes actually paid by X in 1966	....	$49.00
(ii) The amount determined under subparagraph (1)(ii) of this paragraph:		
The amount Smith included in his gross income as a dividend under section 1248(a)	$100.00	
Less the excess referred to in subdivision (i) of this example	49.00	
Difference	51.00	

Increase in Smith's tax liability attributable to including $51 in his gross income as long-term capital gain (25 percent of $51)		12.75
(iii) Limitation on tax		61.75

(b) *Tax attributable to amount treated as dividend*—(1) *General.* For purposes of paragraph (a)(1) of this section, in respect of a share (or block) of stock in a foreign corporation sold or exchanged by an individual during a taxable year, the tax attributable to the amount included in his gross income as a dividend under section 1248(a) shall be the amount which bears the same ratio to (i) the excess of (*a*) his income tax liability for the taxable year determined without regard to section 1248(b) over (*b*) such tax liability determined as if the portion of the total gain recognized during the taxable year which is treated as a dividend under section 1248(a) had not been recognized, as (ii) the amount included as a dividend under section 1248(a) in respect of the share (or block), bears to (iii) the total amount included as a dividend under section 1248(a) in the individual's gross income for such taxable year.

(2) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example 1. (i) During 1963, Brown, an unmarried United States person, sells a block of stock in a controlled foreign corporation. On the sale, he recognizes $22,000 gain, of which $18,000 is treated as a dividend under section 1248(a) and $4,000 as long-term capital gain. Brown computes his income tax liability for his taxable year ending December 31, 1963, under section 1201 (relating to alternative tax) in accordance with the additional facts assumed in the following table:

	Computation of income tax liability without regard to section 1248(b)	Computation of income tax liability as if the gain treated as a divided under section 1248(a) had not been recognized
Income from salary	$300,000	$300,000
Long-term capital gain resulting from sale of stock, less deduction for capital gains under section 1202 ($4,000 less $2,000)	2,000	2,000
Amount treated as a dividend under section 1248(a)	18,000	0
Adjusted gross income	320,000	302,000
Charitable contribution of $100,000 to church (limited under section 170(b) to 30 percent of adjusted gross income)	(96,000)	(90,600)
Other itemized deductions and personal exemption	(7,700)	(7,700)
Taxable income	216,300	203,700
Less 50 percent of $4,000	2,000	2,000
Amount subject to partial tax under section 1201(b)(1)	214,300	201,700
Partial tax	169,833	158,367
25 percent of $4,000	1,000	1,000
Tax liability	170,833	159,367

(ii) The tax attributable to the $18,000 treated as a dividend under section 1248(a) is $11,466 ($170,833 minus $159,367).

Example 2. Assume the same facts as in example (1) except that the $18,000 treated as a dividend under section 1248(a) is attributable to the sale of a block of stock in X Corporation and a block of stock in Y Corporation. Assume further that $10,000 of the gain on the block of X stock was treated as a dividend and that $8,000 of the gain on the block of Y stock was treated as a dividend. Thus, the tax attributable to the amount treated as a dividend in respect of the block of X stock is $6,370 ($10,000/$18,000 of $11,466) and the amount in respect of the block of Y stock is $5,096 ($8,000/$18,000 of $11,466). The result would be the same if both blocks of stock were blocks of stock in the same corporation.

(c) *Excess (of United States taxes which would have been paid over taxes actually paid) attributable to a share (or block)*—(1) *General.* For purposes of paragraph (a)(1)(i) of this section:

(i) The term *taxes* means income, war profits, or excess profits taxes, and

(ii) The excess (and the portion of such excess attributable to an individual's share or block of stock in a foreign corporation) of the United States taxes which would have been paid by the corporation over the taxes (including United States taxes) actually paid by the corporation, for the period or periods the stock was held (or was considered to be held by reason of the application of section 1223) by the individual in taxable years of the corporation beginning after December 31, 1962, while the corporation was a controlled foreign corporation, shall be computed in accordance with the steps set forth in subparagraphs (2), (3), and (4) of this paragraph.

(2) *Step 1.* For each taxable year of the corporation beginning after December 31, 1962, in respect of the individual's share (or block) of such stock (i) the taxable income of the corporation shall be computed in the manner prescribed in paragraph (d) of this section, and (ii) the excess (and the portion of such excess attributable to the stock of the United States taxes which would have been paid by the corporation on such taxable income over the taxes (including United States taxes) actually paid by the corporation shall be computed in the manner prescribed in paragraph (e) of this section.

(3) *Step 2.* If during such taxable year the corporation is a first tier corporation to which paragraph (f) of this section applies, (i) the excess (and the portion of such excess attributable to the individual's share, or block, of stock in the first tier corporation) of the United States taxes which would have been paid by any lower tier corporation over the taxes (including United States taxes) actually paid by such lower tier corporation shall be computed under paragraph (f) of this section, and (ii) such portion shall be added to the portion of the excess attributable to the individual's share (or block) of such stock as determined in step 1 for such taxable year.

(4) *Step 3.* The excess, in respect of the individual's share (or block), of the United States taxes which would have been paid by the corporation over the taxes actually paid by the corporation shall be the sum of the portions computed for each such taxable year in the manner prescribed in steps 1 and 2.

(d) *Taxable income.* For purposes of paragraph (c)(2)(i) of this section, taxable income shall be computed in respect of an individual's share (or block) in accordance with the following rules:

(1) *Application of principles of §1.952–2.* Except as otherwise provided in this paragraph, the principles of paragraphs (a)(1), (b)(1), and (c) of §1.952–2 (other than subparagraphs (2)(iii)(*b*), (2)(v), (5)(i), and (6) of such paragraph (c)) shall apply.

(2) *Effect of elections.* In respect of a taxable year of a foreign corporation, no effect shall be given to an election or an adoption of accounting method unless for such taxable year effect is given to such election or adoption of accounting method under paragraph (d)(1) of §1.1248–2 or paragraph (b)(1) of §1.1248–3, whichever is applicable.

(3) The deductions for certain dividends received provided in sections 243, 244, and 245 shall not be allowed.

(4) *Deduction for taxes.* In computing the amount of the deduction allowed under section 164, there shall be excluded income, war profits, or excess profits taxes paid or accrued which are imposed by the authority of any foreign country or possession of the United States.

(5) *Capital loss carryover.* In determining the amount of a net capital loss to be carried forward under section 1212 to the taxable year:

(i) No net capital loss shall be carried forward from a taxable year beginning before January 1, 1963.

(ii) The portion of a net capital loss or a capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for a taxable year beginning after December 31, 1962, which shall be taken into account shall be the amount of such loss or gain (as the case may be), multiplied by the percentage which (*a*) the number of days in such taxable year during which the individual held (or was considered to have held by reason of the application of section 1223) the share (or block) of stock sold or exchanged while the corporation was a controlled foreign corporation, bears to (*b*) the total number of days in such taxable year.

(iii) The application of this subparagraph may be illustrated by the following examples:

Example 1. Corporation X is a foreign corporation which was created on January 1, 1963, and which uses the calendar year as its taxable year. X was a controlled foreign corporation on each day of the period March 15, 1963, through December 31, 1965, but was not a controlled foreign corporation on any day during the period January 1, 1963, through

March 14, 1963. On December 31, 1965, Smith, a United States person, sells a share of X stock which he has owned continuously since January 1, 1963. A portion of the gain recognized on the sale is includible in Smith's gross income as a dividend under section 1248(a). X had a net capital loss (determined without regard to subchapter N, chapter 1 of the Code) of $200 for 1963. Since, however, X was a controlled foreign corporation for only 292 days in 1963, for purposes of determining the net capital loss carryover to 1964 the portion of the net capital loss of $200 for 1963 which Smith takes into account under subdivision (ii) of this subparagraph is $160 (292/365 of $200), and, accordingly, the amount of the net capital loss carryover to 1964 is $160.

Example 2. Assume the same facts as in example (1), except that X was not a controlled foreign corporation on any day of the period May 26, 1964, through June 30, 1965. Assume further that X had a net capital gain (capital gain net income for taxable years beginning after December 31, 1976) (determined without regard to subchapter N, chapter 1, of the Code) of $160 for 1964. In computing X's taxable income for 1964 under this paragraph, Smith applies the net capital loss carryover of $160 from 1963 to reduce the net capital gain of $160 for 1964 to zero. Since, however, X was a controlled foreign corporation for only 146 days in 1964, for purposes of computing the portion of the 1963 capital loss of $160 which is a net capital loss carryover to 1965, the portion of the 1964 capital gain which Smith takes into account under subdivision (ii) of this subparagraph is $63.83 (146⁄366 of $160). Thus, the net capital loss carryover to 1965 is $96.17 ($160 minus $63.83).

(6) *Net operating loss deduction.* (i) The individual shall reduce the taxable income (computed under subparagraphs (1) through (5) of this paragraph) of the corporation for the taxable year by the amount of the net operating loss deduction of the corporation computed under section 172, as modified in the manner prescribed in this subparagraph.

(ii) The rules of subparagraphs (1) through (5) of this paragraph shall apply for purposes of determining the excess referred to in section 172(c) and the taxable income referred to in section 172(b)(2).

(iii) A net operating loss shall not be carried forward from, or carried back to, a taxable year beginning before January 1, 1963.

(iv) The portion of a net operating loss incurred, or of taxable income earned, in a taxable year beginning after December 31, 1962, which shall be taken into account under section 172(b)(2) shall be the amount of such loss or income (as the case may be), multiplied by the percentage which (*a*) the number of days in such taxable year during which the individual held (or was considered to have held by reason of the application of section 1223) the share (or block) of stock sold or exchanged while the corporation was a controlled foreign corporation, bears to (*b*) the total number of days in such taxable year.

(v) For illustrations of the principles of this subparagraph, see the examples relating to net capital loss carryovers in subparagraph (5)(iii) of this paragraph.

(7) *Adjustment for amount previously included in gross income of United States shareholders.* In respect of the individual's share (or block) of stock sold or exchanged, the taxable income of the corporation for the taxable year (determined without regard to this subparagraph and subparagraph (8) of this paragraph) shall be reduced (but not below zero) by an amount equal to the sum of the amounts included under section 951 in the gross income of United States shareholders (as defined in section 951(b)) of the corporation for the taxable year.

(8) *Adjustment for distributions.* In respect of the individual's share (or block) of stock sold or exchanged, the taxable income of the corporation for the taxable year (determined without regard to this subparagraph) shall be reduced (but not below zero) by the amount of the distributions (other than in redemption of stock under section 302(a) or 303) made by the corporation out of earnings and profits of such taxable year (within the meaning of section 316(a)(2)). For purposes of the preceding sentence, distributions shall be taken into account only to the extent not excluded from the gross income of the United States shareholders of the corporation under section 959.

(e) *Excess attributable to a share (or block) of stock*—(1) *Excess of United States taxes which would have been paid over taxes actually paid.* For purposes of paragraph (c)(2)(ii) of this section, in respect of a taxable year of a foreign corporation, the portion of the excess under this subparagraph which is attributable to an individual's share (or block) of such stock shall be an amount equal to:

(i) The excess (if any) of (*a*) the United States taxes which would have been paid by the corporation on its taxable income (computed under paragraph (d) of this section) for the taxable year had it been taxed as a domestic corporation under chapter 1 of the Code (but without regard to subchapters F, G, H, L, M, N, S, and T thereof) for such taxable year, over (*b*) the income, war profits, or excess profits taxes actually paid by the corporation during such taxable year (including such taxes paid to the United States),

(ii) Multiplied by the percentage that (*a*) the number of days in such taxable year of the corporation during the period or periods the share (or block) was held (or was considered as held by reason of the application of section 1223) by the individual while the corporation was a controlled foreign corporation, bears to (*b*) the total number of days in such taxable year,

(iii) If the computation is made in respect of a block, multiplied by the number of shares in the block, and

(iv) Divided by the number of shares in the corporation outstanding, or deemed under paragraph (c)(2) of § 1.1248–3 to be outstanding, on each day of such taxable year.

(2) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example: (i) Jones, a United States person, owns on each day of 1963 10 shares of the 100 shares of the only class of outstanding stock of X corporation. He sells one of such shares on December 31, 1963. X corporation is a controlled foreign corporation on each day of 1963 and Jones and X each use the calendar year as the taxable year. For 1963, the excess of the United States taxes which would have been paid by X had it been taxable as a domestic corporation over the taxes (including United States taxes) actually paid by X is $23,500, computed as follows:

Amount subject to partial tax under section 1201(a)(1), as computed by Jones:		
Taxable income		$300,000
Less excess of net long-term capital gain over net short-term capital loss		100,000
Amount subject to partial tax		200,000
Excess determined under subparagraph (1)(i) of this paragraph:		
30 percent×$25,000	$7,500	
52 percent×$175,000	91,000	
Partial tax		98,500
25 percent×$100,000		25,000
United States taxes X would have paid (alternative tax computed under section 1201(a))		123,500
Less income taxes X actually paid to:		
United States	$10,000	
Foreign countries	90,000	
Total		$100,000
Excess		23,500
Multiplied by:		
Percentage determined under subparagraph (1)(ii) of this paragraph:		
Since on each day of 1963, Jones held the share of X stock while X was a controlled foreign corporation, the percentage equals		100%
Total		$23,500

(ii) The portion of the excess determined in subdivision (i) of this example which is attributable to the share held by Jones is $235, that is, the amount of such excess ($23,500), divided by the number of shares of X deemed to be outstanding on each day of 1963 (100).

(3) *More than one class of stock.* If a foreign corporation for a taxable year has more than one class of stock outstanding, then before applying subparagraph (1) of this paragraph the excess (if any) which would be determined under subparagraph (1)(i) of this paragraph shall be allocated to each class of stock in accordance with the principles of paragraph (e) (2) and (3) of § 1.951–1, applied as if the corporation were a controlled foreign corporation on each day of such taxable year.

(f) *Subsidiaries of foreign corporations*—(1) *Excess for lower tier corporation attributable to taxable year of first tier corporation.* For purposes of paragraph (c)(3) of this section, if the provisions of paragraph (a)(3) of § 1.1248–2 or paragraph (f) of § 1.1248–3 apply in the case of the sale or exchange by an individual of a share (or block) of stock in a first tier corporation, then in respect of a taxable year of a lower tier corporation (beginning after December 31, 1962) which includes at least one day which falls within a taxable year of the first tier corporation (beginning after December 31, 1962), the portion of the excess under this subparagraph attributable to the share shall be an amount equal to:

(i) The excess (if any) of (*a*) the United States taxes which would have been paid by the lower tier corporation on its taxable income (computed under paragraph (g) of this section) for such taxable year of the lower tier corporation had it been taxed as a domestic corporatin under chapter 1 of the Code (but without regard to subchapters F, G, H, L, M, N, and T thereof) for such taxable year of the lower tier corporation, over (*b*) the income, war profits, or excess profits taxes actually paid by the lower tier corporation during such taxable year (including such taxes paid to the United States),

(ii) Multiplied by each of the percentages described under paragraph (f)(2)(ii), (iii), and (iv) of § 1.1248–3 in respect of such taxable year of the first tier corporation,

(iii) If the computation is made in respect of a block of stock, multiplied by the number of shares in the block, and

(iv) Divided by the number of shares in the first tier corporation outstanding, or deemed under paragraph (c)(2) of § 1.1248–3 to be outstanding, on each day of such taxable year of the first tier corporation.

(2) *More than one class of stock.* If a foreign corporation for a taxable year has more than one class of stock outstanding, then before applying subparagraph (1) of this paragraph the principles of paragraph (e)(3) of this section shall apply.

(g) *Taxable income of lower tier corporations*—(1) *General.* For purposes of paragraph (f)(1)(i) of this section, in respect of the individual's share (or block) the taxable income of a lower tier corporation shall be computed in the manner provided in paragraph (d) of this section, except as provided in this paragraph.

(2) *Capital loss carryover.* For purposes of subparagraph (1) of this paragraph, the provisions of paragraph (d)(5)(ii) of this section shall not apply. In determining the amount of a net capital loss to be carried forward under section 1212 to the taxable year of a lower tier corporation, the portion of a net capital loss or a capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for a taxable year of the lower tier corporation beginning after December 31, 1962, which shall be taken into account shall be the amount of such loss or gain (as the case may be), multiplied by the percentage which (i) the number of days in such taxable year during the period or periods the individual held (or was considered to have held by reason of the application of section 1223) the share (or block) of stock in the first tier corporation sold or exchanged while the first tier corporation owned (within the meaning of section 958 (a)) stock in the lower tier corporation while the lower tier corporation was a controlled foreign corporation, bears to (ii) the total number of days in such taxable year.

(3) *Net operating loss deduction.* For purposes of subparagraph (1) of this paragraph, the provisions of paragraph (d)(6)(iv) of this section shall not apply. In determining the amount of the net operating loss deduction for a taxable year of a lower tier corporation, the portion of a net operating loss incurred, or of taxable income earned, in a taxable year of the lower tier corporation beginning after December 31, 1962, which shall be taken into account under section 172(b)(2) shall be the amount of such loss or income (as the case may be) multiplied by the percentage described in subparagraph (2) of this paragraph for such taxable year.

[T.D. 6779, 29 FR 18139, Dec. 22, 1964, as amended by T.D. 7545, 43 FR 19653, May 8, 1978; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1248–5 Stock ownership requirements for less developed country corporations.

(a) *General rule*—(1) *Requirements.* For purposes of paragraph (e)(4) of § 1.1248–3, a United States person shall be considered as satisfying the requirements of this paragraph with respect to a share (or block) of stock of a foreign corporation if on the date he sells or exchanges such share (or block):

(i) The 10-year stock ownership requirement of paragraph (b) of this section is met with respect to such share (or block), and

(ii) In the case of a United States person which is a domestic corporation, the requirement of paragraph (c) of this section, if applicable, is met.

(2) *Ownership of stock.* For purposes of this section:

(i) The rules for determining ownership of stock prescribed by section 958 (a) and (b) shall apply.

(ii) Stock owned by a United States person who is an individual, estate, or trust which was acquired by reason of the death of the predecessor in interest of such United States person shall be considered as owned by such United States persons during the period such stock was owned by such predecessor in interest, and during the period such stock was owned by any other predecessor in interest if between such United States person and such other predecessor in interest there was no transfer other than by reason of the death of an individual.

(b) *10-year stock ownership requirement*—(1) *General.* A United States person meets the 10-year stock ownership requirement with respect to a share (or block) of stock in a foreign corporation which he sells or exchanges only if the share (or block) was owned (under the rules of paragraph (a)(2) of this section) by such person for a continuous period of at least 10 years ending on the date of the sale or exchange. See the first sentence of section 1248(d)(3). Thus, for example, if Jones, a United States person, sells a share of stock in a foreign corporation on January 1, 1965, the 10-year stock ownership requirement is met with respect to a share only if the share was owned (under the rules of paragraph (a)(2) of this section) by Jones continuously from January 1, 1955, to January 1, 1965. If a foreign corporation has not been in existence for at least 10 years on the date of the sale or exchange of the share, the 10-year stock ownership requirement cannot be met.

(2) *Special rule.* For purposes of this paragraph, a United States person shall be considered to have owned stock during the period he was considered to have held the stock by reason of the application of section 1223.

(c) *Disqualification of domestic corporation as a result of changes in ownership of its stock*—(1) *General.* (i) For purposes of paragraph (a)(1)(ii) of this section, the requirement of this paragraph must be met only if, on at least one day during the 10-year period ending on the date of the sale or exchange by a domestic corporation of a share of stock in a foreign corporation, one or more noncorporate United States shareholders (as defined in subdivision (iii) of this subparagraph) own more than 50 percent of the total combined voting power of all classes of stock entitled to vote of the domestic corporation.

(ii) The requirement of this paragraph is that if one or more persons are noncorporate United States shareholders on the first such day (referred to in subdivision (i) of this subparagraph), such person or persons continue after such first day, at all times during the remainder of such 10-year period, to own in the aggregate more than 50 percent of the total combined voting power of all classes of stock entitled to vote of the domestic corporation. For purposes of determining whether a domestic corporation meets the requirement of this paragraph, the stock owned by a United States person who is a noncorporate United States shareholder of a domestic corporation on such first day shall not be counted at any time after he ceases during such 10-year period to be a noncorporate United States shareholder of such corporation.

(iii) For purposes of this paragraph, the term *noncorporate United States shareholder* means, with respect to a domestic corporation, a United States person who is an individual, estate, or trust and who owns 10 percent or more of the total combined voting power of all classes of stock of such domestic corporation.

(iv) For purposes of this paragraph, the percentage of the total combined voting power of stock of a foreign corporation owned by a United States person shall be determined in accordance with the principles of section 951(b) and the regulations thereunder.

(2) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example 1. During the entire period beginning December 31, 1954, and ending December 31, 1964, domestic corporation N owns all the stock of controlled foreign corporation X, a less developed country corporation. On December 31, 1964, N recognizes gain upon the sale of all its X stock. A, B, and C, who are unrelated individuals, were the only United States persons owning, or considered as owning, 10 percent or more of the total combined voting power of all classes of stock entitled to vote of N at any time during the 10-year period December 31, 1954, through December 31, 1964. The percentages of the total combined voting power in N, which A, B, and C owned during such 10-year period, are as follows:

Owner	Dec. 31, 1954–Apr. 1, 1957 (*Percent*)	Apr. 2, 1957–Oct. 1, 1959 (*Percent*)	Oct. 2, 1959–Dec. 31, 1964 (*Percent*)
A	20	20	20
B	9	30	30
C	30	15	9

Domestic corporation N does not meet the requirement of this paragraph with respect to the stock of controlled foreign corporation X for the following reasons:

(i) April 2, 1957, is the first day (during the 10-year period ending on December 31, 1964, the date N sells the X stock) on which noncorporate United States shareholders of N own more than 50 percent of the total combined voting power in N, and thus the requirement of this paragraph must be met. See subparagraph (1)(i) of this paragraph. Although A, B, and C did own, in the aggregate, more than 50 percent of such voting power before April 2, 1957, the voting power owned by B is not counted because B was not a noncorporate United States shareholder of N before such date.

(ii) Although C is a noncorporate United States shareholder on April 2, 1957, C ceases to own 10 percent or more of the total combined voting power in N on October 2, 1959. Thus, after October 1, 1959, the N stock which C owns is not counted for purposes of determining whether the more-than-50-percent stock ownership test is met. See subparagraph (1)(ii) of this paragraph. Accordingly, after October 1, 1959, the requirement of this paragraph is not met.

Example 2. Assume the same facts as in example (1), except that B's wife owns directly 5 percent of the total combined voting power in N from December 31, 1954, to December 31, 1964. On the basis of the assumed facts, N meets the requirement of this paragraph with respect to the stock of controlled foreign corporation X for the following reasons:

(i) December 31, 1954, is the first day (of the 10-year period ending on the date N sells the X stock) on which noncorporate United States shareholders of N own more than 50 percent of the total combined voting power in N. B is a noncorporate United States shareholder on such date because he owns, and is considered as owning, 14 percent of the total combined voting power in N (9 percent directly, and, under section 958(b), 5 percent constructively). Thus, on December 31, 1954, noncorporate United States shareholders A, B, and C own, in the aggregate, more than 50 percent of the total combined voting power in N.

(ii) A, B, and C, the noncorporate United States shareholders of N on December 31, 1954, own, and are considered as owning, more than 50 percent of the total voting power of N from December 31, 1954, to October 1, 1959. Since beginning on October 2, 1959, A owns 20 percent and B owns, and is considered as owning, 35 percent of the total combined voting power in N, A and B owns, and are considered as owning, more than 50 percent of the total combined voting power in N from October 2, 1959, to December 31, 1964. Therefore, the requirement of this paragraph is met.

(d) *Application of section to lower tier corporation*—(1) *General.* For purposes of paragraph (g)(1)(ii) of § 1.1248–3, a United States person satisfies the requirements of this subparagraph in respect of stock of a lower tier corporation which such person, by reason of his direct ownership of the share (or block) of the first tier corporation sold or exchanged, owned within the meaning of section 958(a)(2) on the date he sold or exchanged such share (or block), if on such date:

(i) The 10-year stock ownership requirement of paragraph (b) of this section is met by such person with respect to any stock in the lower tier corporation which such person so owned, and

(ii) In the case of a United States person which is a domestic corporation, the requirement of paragraph (c) of this section, if applicable, is met.

(2) *Special rule.* For purposes of this paragraph, in applying paragraphs (b) and (c) of this section, the sale or exchange of a share (or block) of stock in a first tier corporation by a United States person shall be deemed to be the sale or exchange of any stock in a lower tier corporation which the person, by reason of his direct ownership of such share (or block) of the first tier corporation, owned within the meaning of section 958(a)(2) on the date he actually sold or exchanged such share (or block) in the first tier corporation.

[T.D. 6779, 29 FR 18142, Dec. 22, 1964]

§ 1.1248–6 Sale or exchange of stock in certain domestic corporations.

(a) *General rule.* If a United States person recognizes gain upon the sale or exchange of a share (or block) of stock of a domestic corporation which was formed or availed of principally for the holding, directly or indirectly, of stock of one or more foreign corporations, and if the conditions of paragraph (a)(2) of §1.1248–1 would be met by such person in respect of the share (or block) if the domestic corporation were a foreign corporation, then section 1248 shall apply in respect of such gain in accordance with the rules provided in paragraph (b) of this section.

(b) *Application.* (1) The gain referred to in paragraph (a) of this section shall be included in the gross income of the United States person as a dividend under section 1248(a) to the extent of the earnings and profits attributable under §1.1248–2 or §1.1248–3, whichever is applicable, to the share (or block), computed, however, in accordance with the following rules:

(i) The domestic corporation shall be treated as if it were a first tier foreign corporation;

(ii) If, after the application of subdivision (i) of this subparagraph, the provisions of paragraph (a)(3) of §1.1248–2 or paragraph (f) of §1.1248–3 (as the case may be) would apply in respect of a foreign corporation the stock of which is owned (within the meaning of section 958(a)) by the domestic corporation treated as the first tier corporation, such foreign corporation shall be considered a lower tier corporation;

(iii) Except to the extent provided in subdivision (iv) of this subparagraph, the earnings and profits of the domestic corporation treated as the first tier corporation accumulated for a taxable year, as computed under paragraph (d) of §1.1248–2 or paragraph (b) of §1.1248–3 (as the case may be), shall be considered to be zero; and

(iv) If, during a taxable year, a domestic corporation treated as the first tier corporation realizes gain upon the sale or exchange of stock in a foreign corporation, and solely by reason of the application of section 337 (relating to certain liquidations) the gain was not recognized, then the earnings and profits of such domestic corporation accumulated for the taxable year, as computed under paragraph (d) of §1.1248–2 or paragraph (b) of §1.1248–3 (as the case may be), shall be considered to be an amount equal to the portion of such gain realized during the taxable year which, if section 337 had not applied, would have been treated as a dividend under section 1248(a).

(2) If the person selling or exchanging the stock in the domestic corporation is an individual, the limitation on tax attributable to the amount included in his gross income as a dividend under subparagraph (1) of this paragraph shall be determined, in accordance with the principles of paragraph (f) of §1.1248–4, by treating the domestic corporation as a first tier corporation.

(3)(i) If the earnings and profits of the foreign corporation or corporations (or of the domestic corporation treated as a first tier corporation) to be taken into account under subparagraph (1) of this paragraph are not established in the manner provided in paragraph (a)(1) of §1.1248–7, all of the gain from the sale or exchange of the share (or block) of the domestic corporation shall be treated as a dividend.

(ii) To the extent that the person does not establish, in the manner provided in paragraph (c) of §1.1248–7, the foreign taxes paid by such foreign corporation or corporations to be taken into account for purposes of computing the limitation on tax attributable to a share, such foreign taxes shall not be taken into account for purposes of such computation.

(c) *Corporation formed or availed of principally for holding stock of foreign corporations.* Whether or not a domestic corporation is formed or availed of principally for the holding, directly or indirectly, of stock of one or more foreign corporations shall be determined on the basis of all the facts and circumstances of each particular case.

[T.D. 6779, 29 FR 18143, Dec. 22, 1964]

§1.1248–7 Taxpayer to establish earnings and profits and foreign taxes.

(a) *In general.* (1) If a taxpayer sells or exchanges stock in a foreign corporation which was a controlled foreign corporation and the Commissioner determines that the taxpayer has not established the amount of the earnings and profits of the corporation attributable to the stock under §1.1248–2 or §1.1248–3, whichever is applicable, all the gain from such sale or exchange shall be treated as a dividend under section 1248(a). See section 1248(g). A taxpayer shall be considered to have established such amount if:

(i) He attaches to his income tax return, filed on or before the last day prescribed by law (including extensions thereof) for his taxable year in which he sold or exchanged the stock, the schedule prescribed by paragraph (b) of this section or, if such last day is before April 1, 1965, he files such schedule before such date with the district director with whom such return was filed, and

(ii) He establishes in the manner prescribed by paragraph (d) of this section the correctness of each amount shown on such schedule.

(2) Notwithstanding an omission of information from, or an error with respect to an amount shown on, the schedule referred to in subparagraph (1)(i) of this paragraph, a taxpayer shall be considered to have complied with such subparagraph (1)(i) if:

(i) He establishes that such omission or error was inadvertent, or due to reasonable cause and not due to willful neglect, and that he has substantially complied with the requirements of this section, and

(ii) The taxpayer corrects such omission or error at the time when he complies with paragraph (d) of this section.

(3) For the requirement to establish the amount of foreign taxes to be taken into account for purposes of section 1248(b), see paragraph (c) of this section.

(b) *Schedule attached to return.* (1) The taxpayer shall attach to his income tax return for his taxable year in which he sold or exchanged the stock, a schedule showing his name, address, and identifying number. Except to the extent provided in paragraph (e) of this section, the schedule shall also show the amount of the earnings and profits attributable under paragraph (a) of §1.1248–2 or paragraph (a) of §1.1248–3 (as the case may be) to the stock, and, in order to support the computation of such amount, any additional information required by subparagraphs (2), (3), (4), and (5) of this paragraph.

(2) The schedule shall also show for the first tier corporation, and for each lower tier corporation as to which information is required under subparagraph (4) of this paragraph, (i) the name of the corporation, (ii) the country under whose laws the corporation is created or organized, and (iii) the last day of the taxable year which the corporation regularly uses in computing its income.

(3) If the amount of earnings and profits attributable to a block of stock sold or exchanged are computed under §1.1248–2, the schedule shall also show:

(i) For each taxable year of the corporation, beginning after December 31, 1962, during the period the taxpayer held (or was considered to have held by reason of the application of section 1223) the block, (a) the earnings and profits accumulated for each such taxable year computed under paragraph (d) of §1.1248–2, and (b) the sum thereof computed under paragraph (e) (1)(i) and (2) of §1.1248–2,

(ii) The number of shares in the block and the total number of shares of the corporation outstanding during such period,

(iii) If during the period the person held (or is considered to have held by reason of the application of section 1223) the block any amount was included under section 951 in the gross income of such person (or another person) in respect of the block, the computation of the excess referred to in paragraph (e)(3)(ii) of §1.1248–2, and

(iv) If the amount of earnings and profits of a lower tier corporation attributable to the block are computed under paragraph (a)(3) of §1.1248–2, (a) the number of shares in the lower tier corporation which the taxpayer owns within the meaning of section 958(a)(2)(b) the total number of shares of such lower tier corporation outstanding during such period, and (c) in respect of such lower tier corporation, the information prescribed in subdivisions (i) and (iii) of this subparagraph.

(4) If the amount of earnings and profits attributable to a share (or block) sold or exchanged are computed under §1.1248–3, the schedule shall also show for each taxable year of the corporation beginning after December 31, 1962, any day of which falls in a period or periods the taxpayer held (or was considered to have held by reason of the application of section 1223) the

stock while the corporation was a controlled foreign corporation:

(i) The number of days in such period or periods, but only if such number is less than the total number of days in such taxable year,

(ii) The earnings and profits accumulated for the taxable year computed under paragraph (b) of §1.1248–3,

(iii) The number of shares in the corporation outstanding, or deemed under paragraph (c)(2) of §1.1248–3 to be outstanding, on each day of the taxable year,

(iv) The taxpayer's tentative ratable share computed under paragraph (c) or (d) (as the case may be) of §1.1248–3,

(v) The amount of, and a short description of each adjustment to, the tentative ratable share under paragraph (e) of §1.1248–3, and

(vi) The amount of the ratable share referred to in paragraph (e)(1) of §1.1248–3.

(5) In respect of a taxable year referred to in subparagraph (4) of this paragraph of a first tier corporation, if the taxpayer is required to compute under paragraph (f)(5) of §1.1248–3 his ratable share of the earnings and profits for a taxable year of the lower tier corporation attributable to such taxable year of such first tier corporation, then for such taxable year of the lower tier corporation the schedule shall show:

(i) The earnings and profits accumulated for the taxable year of the lower tier corporation, computed under paragraph (b) of §1.1248–3,

(ii) Each percentage described in paragraph (f)(2) (ii), (iii), and (iv) of §1.1248–3,

(iii) The amount of the taxpayer's tentative ratable share computed under paragraph (f) (2) or (4) (as the case may be) of §1.1248–3,

(iv) The amount of, and a short description of each adjustment to, the tentative ratable share under paragraph (f)(5) of §1.1248–3, and

(v) The amount of the ratable share referred to in paragraph (f)(5)(i) of §1.1248–3.

(c) *Foreign taxes.* (1) If the taxpayer fails to establish any portion of the amount of any foreign taxes which he is required to establish by subparagraph (2) of this paragraph, then such portion shall not be taken into account under section 1248(b)(1)(B):

(2) The taxpayer shall establish in respect of the stock he sells or exchanges the amount of the foreign taxes described in section 1248(b)(1)(B) paid by the first tier corporation for each taxable year of such corporation for which the information is required under paragraph (b) (3) or (4) of this section, and the amount of such taxes paid by each lower tier corporation for each taxable year (as to which information is required under paragraph (b) (3)(iv) or (5) of this section) of each such lower tier corporation. A taxpayer shall be considered to have established the amount of such foreign taxes if:

(i) He attaches to the schedule described in paragraph (b) of this section a supplementary schedule which, except to the extent provided in paragraph (e) of this section, sets forth the amount of such foreign taxes for each taxable year (of the first tier corporation and of each such lower tier corporation) as to which such amount must be established under this subparagraph, and

(ii) He establishes in the manner prescribed by paragraph (d)(2) of this section the correctness of each amount shown on such supplementary schedule.

(d) *Establishing amounts on schedules.* (1) A taxpayer shall be considered to have established, in respect of the stock he sold or exchanged, the correctness of an amount shown on a schedule described in paragraph (b) of this section only if he produces or provides within 180 days after demand by the district director (or within such longer period to which such director consents):

(i) The books of original entry, or similar systematic accounting records maintained by any person or persons on a current basis as supplements to such books, which establish to the satisfaction of the district director the correctness of each such amount, and

(ii) In respect of any such books or records which are not in the English language, either an accurate English translation of any such records as are demanded, or the services of a qualified interpreter satisfactory to such director.

(2) A shareholder shall be considered to have established in respect of such stock the correctness of an amount shown on a supplementary schedule described in paragraph (c) of this section only if he produces or provides within 180 days after demand by the district director (or within such longer period to which such director consents):

(i) Evidence described in paragraph (a)(2) of § 1.905–2 of such amount, or

(ii) Secondary evidence of such amount, in the same manner and to the same extent as would be permissible under paragraph (b) of § 1.905–2 in the case of a taxpayer who claimed the benefits of the foreign tax credit in respect of such amount.

(e) *Insufficient information at time return is filed.* If stock in a foreign corporation, which was a controlled foreign corporation, is sold or exchanged by a taxpayer during a taxable year of the corporation (or of a lower tier corporation) which ends after the last day of the taxpayer's taxable year in which the sale or exchange occurs, and if:

(1) For the taxpayer's taxable year, the last day referred to in paragraph (a)(1) of this section for filing his income tax return with a schedule prescribed in paragraph (b) of this section, and, if applicable, with a supplemental schedule prescribed in paragraph (c) of this section, or

(2) The last day referred to in paragraph (a)(1) of this section (that is, April 1, 1965) for filing any such schedule or schedules with the district director with whom such return was filed,

Is not later than 90 days after the close of such taxable year of any such corporation, then such return with such schedule or schedules may be filed, or any such schedule or schedules may be filed, on the basis of estimates of amounts or percentages (for any such taxable year of any such corporation) required to be shown on any such schedule or schedules. If any such estimate differs from the actual amount or percentage, the taxpayer shall, within 90 days after the close of any such taxable year of any such corporation, file (or attach to a claim for refund or amended return filed) at the office of the district director with whom he filed the return a new schedule or schedules showing the actual amounts or percentages.

[T.D. 6779, 29 FR 18143, Dec. 22, 1964]

§ 1.1249–1 Gain from certain sales or exchanges of patents, etc., to foreign corporations.

(a) *General rule.* Section 1249 provides that if gain is recognized from the sale or exchange after December 31, 1962, of a patent, an invention, model, or design (whether or not patented), a copyright, a secret formula or process, or any other similar property right (not including property such as goodwill, a trademark, or a trade brand) to any foreign corporation by any United States person (as defined in section 7701(a)(30)) which controls such foreign corporation, and if such gain would (but for the provisions of section 1249) be gain from the sale or exchange of a capital asset or of property described in section 1231, then such gain shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. Section 1249 applies only to gain recognized in taxable years beginning after December 31, 1962.

(b) *Control.* For purposes of paragraph (a) of this section, the term *control* means, with respect to any foreign corporation, the ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote. For purposes of the preceding sentence, the rules for determining ownership of stock provided by section 958 (a) and (b), and the principles for determining percentage of total combined voting power owned by United States shareholders provided by paragraphs (b) and (c) of § 1.957–1, shall apply.

[T.D. 6765, 29 FR 14879, Nov. 3, 1964]

§ 1.1250–1 Gain from dispositions of certain depreciable realty.

(a) *Dispositions after December 31, 1969*—(1) *Ordinary income.* (i) In general, section 1250(a)(1) provides that, upon a disposition of an item of section 1250 property after December 31, 1969, the applicable percentage of the lower of:

(*a*) The additional depreciation (as defined in §1.1250–2) attributable to periods after December 31, 1969 in respect of the property, or

(*b*) The excess of the amount realized on a sale, exchange, or involuntary conversion (or the fair market value of the property on any other disposition) over the adjusted basis of the property,

Shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (that is, shall be recognized as ordinary income). The amount of such gain shall be determined separately for each item (see subparagraph (2)(ii) of this paragraph) of section 1250 property. If the amount determined under (*b*) of this subdivision exceeds the amount determined under (*a*) of this subdivision, then such excess shall be treated as provided in subdivision (ii) of this subparagraph. For relation of section 1250 to other provisions, see paragraph (c) of this section.

(ii) If the amount determined under subdivision (i)(*b*) of this subparagraph exceeds the amount determined under subdivision (i)(*a*) of this subparagraph, then the applicable percentage of the lower of:

(*a*) The additional depreciation attributable to periods before January 1, 1970, or

(*b*) Such excess,

shall also be recognized as ordinary income.

(iii) If gain would be recognized upon a disposition of an item of section 1250 property under subdivisions (i) and (ii) of this subparagraph, and if section 1250(d) applies, then the gain recognized shall be considered as recognized first under subdivision (i) of this subparagraph. (See example (3)(i) of paragraph (c)(4) of §1.1250–3.)

(2) *Meaning of terms.* (i) For purposes of section 1250, the term *disposition* shall have the same meaning as in paragraph (a)(3) of §1.1245–1. *Section 1250 property* is, in general, depreciable real property other than section 1245 property. See paragraph (e) of this section. See paragraph (d)(1) of this section for meaning of the term *applicable percentage.* If, however, the property is considered to have two or more elements with separate periods (for example, because units thereof are placed in service on different dates, improvements are made to the property, or because of the application of paragraph (h) of §1.1250–3), see the special rules of §1.1250–5.

(ii) For purposes of applying section 1250, the facts and circumstances of each disposition shall be considered in determining what is the appropriate item of section 1250 property. In general, a building is an item of section 1250 property, but in an appropriate case more than one building may be treated as a single item. For example, if two or more buildings or structures on a single tract or parcel (or contiguous tracts or parcels) of land are operated as an integrated unit (as evidenced by their actual operation, management, financing, and accounting), they may be treated as a single item of section 1250 property. For the manner of determining whether an expenditure shall be treated as an addition to capital account of an item of section 1250 property or as a separate item of section 1250 property, see paragraph (d)(2)(iii) of §1.1250–5.

(3) *Sale, exchange, or involuntary conversion after December 31, 1969.* (i) In the case of a disposition of section 1250 property by a sale, exchange, or involuntary conversion after December 31, 1969, the gain to which section 1250(a)(1) applies is the applicable percentage for the property (determined under paragraph (d)(1) of this section) multiplied by the lower of (*a*) the additional depreciation in respect of the property attributable to periods after December 31, 1969, or (*b*) the excess (referred to as *gain realized*) of the amount realized over the adjusted basis of the property.

(ii) In addition to gain recognized under section 1250(a)(1) and subdivision (i) of this subparagraph, gain may also be recognized under section 1250(a)(2) and this subdivision if the gain realized exceeds the additional depreciation attributable to periods after December 31, 1969. In such a case, the amount of gain recognized under section 1250(a)(2) and this subdivision is the applicable percentage for the property (determined under paragraph (d)(2) of this section) multiplied by the lower of (*a*) the additional depreciation attributable to periods before January 1, 1970, or (*b*) the excess (referred to as *remaining gain*) of the gain realized over the additional depreciation attributable to periods after December 31, 1969.

(iii) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Section 1250 property which has an adjusted basis of $500,000 is sold for $650,000 after December 31, 1969, and thus the gain realized is $150,000. At the time of the sale the additional depreciation in respect of the property attributable to periods after December 31, 1969, is $190,000 and the applicable percentage is 100 percent (paragraph (d)(1)(i)(*e*) of this section). Since the gain realized ($150,000), is lower than the additional depreciation ($190,000), the amount of gain recognized as ordinary income under section 1250(a)(1) is $150,000 (that is, 100 percent of $150,000). No gain is recognized under section 1250(a)(2).

Example 2. Section 1250 property which has an adjusted basis of $440,000 is sold for $500,000 on December 31, 1974, and thus the gain realized is $60,000. The property was acquired on March 31, 1966. At the time of the sale, the additional depreciation attributable to periods after December 31, 1969, is $20,000, and the additional depreciation attributable to periods before January 1, 1970, is $60,000. The property qualified as residential rental property for each taxable year ending after December 31, 1969, and the applicable percentage is 95 percent (paragraph (d)(1)(i)(*c*) of this section). The applicable percentage under paragraph (d)(2) of this section is 15 percent. Since the additional depreciation attributable to periods after December 31, 1969 ($20,000), is lower than the gain realized ($60,000), the amount of gain recognized as ordinary income under section 1250(a)(1) is $19,000 (that is, 95 percent of $20,000). In addition, gain is recognized under section 1250(a)(2) since there is remaining gain of $40,000 (that is, the gain realized ($60,000) minus the additional depreciation attributable to periods after December 31, 1969 ($20,000)). Since the remaining gain of $40,000 is lower than the additional depreciation attributable to periods before January 1, 1970 ($60,000), the amount of gain recognized as ordinary income under section 1250(a)(2) is $6,000 (that is, 15 percent of $40,000). The remaining $35,000 (that is, gain realized $60,000, minus gain recognized under section 1250(a), $25,000) of the gain may be treated as gain from the sale or exchange of property described in section 1231.

(4) *Other dispositions after December 31, 1969.* (i) In the case of a disposition of section 1250 property after December 31, 1969, other than by way of a sale, exchange, or involuntary conversion, the gain to which section 1250(a)(1) applies is the applicable percentage for the property (determined under paragraph (d)(1) of this section) multiplied by the lower of (*a*) the additional depreciation in respect of the property attributable to periods after December 31, 1969, or (*b*) the excess (referred to as *potential gain*) of the fair market value of the property over its adjusted basis. In addition, if the potential gain exceeds the additional depreciation attributable to periods after December 31, 1969, then the gain to which section 1250(a)(2) applies is the applicable percentage for the property (determined under paragraph (d)(2) of this section) multiplied by the lower of (*c*) the additional depreciation attributable to periods before January 1, 1970, or (*d*) the excess (referred to as *remaining potential gain*) of the potential gain over the additional depreciation attributable to periods after December 31, 1969. If property is transferred by a corporation to a shareholder for an amount less than its fair market value in a sale or exchange, for purposes of applying section 1250 such transfer shall be treated as a disposition other than by way of a sale, exchange, or involuntary conversion.

(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Section 1250 property having an adjusted basis of $500,000 and a fair market value of $550,000 is distributed by a corporation to a stockholder in complete liquidation of the corporation after December 31, 1969, and thus the potential gain is $50,000. At the time of the liquidation, the additional depreciation for the property attributable to periods after December 31, 1969, is $80,000 and the applicable percentage is 100 percent (paragraph (d)(1)(i)(*e*) of this section). Since the potential gain of $50,000 is lower than the additional depreciation attributable to periods after December 31, 1969 ($80,000), the amount of gain recognized as ordinary income under section 1250(a)(1) is $50,000 (that is, 100 percent of $50,000) even though in the absence of section 1250, section 336 would preclude recognition of gain to the corporation.

Example 2. The facts are the same as in example (1) except that the fair market value of the property is $650,000, and thus the potential gain is $150,000. Since the additional depreciation attributable to periods after

December 31, 1969 ($80,000), is lower than the potential gain of $150,000, the amount of gain recognized as ordinary income under section 1250(a)(1) is $80,000 (that is, 100 percent of $80,000). In addition, section 1250(a)(2) applies since there is remaining potential gain of $70,000, that is, potential gain ($150,000) minus additional depreciation attributable to periods after December 31, 1969 ($80,000). The additional depreciation attributable to periods before January 1, 1970, is $90,000 and the applicable percentage under paragraph (d)(2) of this section is 50 percent. Since the remaining potential gain of $70,000 is lower than the additional depreciation attributable to periods before January 1, 1970 ($90,000), the amount of gain recognized as ordinary income under section 1250(a)(2) is $35,000 (that is, 50 percent of $70,000). Thus under section 1250(a), $115,000 (that is, $80,000 under section 1250(a)(1), plus $35,000 under section 1250(a)(2)) is recognized as ordinary income, even though in the absence of section 1250, section 336 would preclude recognition of gain to the corporation.

(5) *Instances of nonapplication.* (i) Section 1250(a)(1) does not apply to losses. Thus, section 1250(a)(1) does not apply if a loss is realized upon a sale, exchange, or involuntary conversion of property, all of which is considered section 1250 property, nor does the section apply to a disposition of such property other than by way of sale, exchange, or involuntary conversion if at the time of the disposition the fair market value of such property is not greater than its adjusted basis.

(ii) In general, in the case of section 1250 property with a holding period under section 1223 of more than 1 year, section 1250(a)(1) does not apply if for periods after December 31, 1969, there are no *depreciation adjustments in excess of straight line* (as computed under section 1250(b) and paragraph (b) of § 1.1250–2).

(6) *Allocation rules.* (i) In the case of a sale, exchange, or involuntary conversion of section 1250 property and nonsection 1250 property in one transaction after December 31, 1969, the total amount realized upon the disposition shall be allocated between the section 1250 property and the other property in proportion to their respective fair market values. Such allocation shall be made in accordance with the principles set forth in paragraph (a)(5) of § 1.1245–1 (relating to allocation between section 1245 property and nonsection 1245 property).

(ii) If an item of section 1250 property has two (or more) applicable percentages because one subdivision of paragraph (d)(1)(i) of this section applies to one portion of the taxpayer's holding period (determined under § 1.1250–4) and another subdivision of such paragraph applies with respect to another such portion, then the gain realized on a sale, exchange, or involuntary conversion, or the potential gain in the case of any other disposition, shall be allocated to each such portion of the taxpayer's holding period after December 31, 1969, in the same proportion as the additional depreciation with respect to such item for such portion bears to the additional depreciation with respect to such item for the entire holding period after December 31, 1969.

(b) *Dispositions before January 1, 1970*—(1) *Ordinary income.* In general, section 1250(a)(2) provides that, upon a disposition of an item of section 1250 property after December 31, 1963, and before January 1, 1970, the applicable percentage of the lower of:

(i) The additional depreciation (as defined in § 1.1250–2) attributable to periods before January 1, 1970, in respect of the property, or

(ii) The excess of the amount realized on a sale, exchange, or involuntary conversion (or the fair market value of the property on any other disposition) over the adjusted basis of the property,

shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (that is, shall be recognized as ordinary income). The amount of such gain shall be determined separately for each item (see subparagraph (2)(ii) of this paragraph) of section 1250 property. For relation of section 1250 to other provisions, see paragraph (c) of this section.

(2) *Meaning of terms.* (i) For purposes of section 1250, the term *disposition* shall have the same meaning as in paragraph (a)(3) of § 1.1245–1. *Section 1250 property* is, in general, depreciable real property other than section 1245 property. See paragraph (e) of this section. For purposes of this paragraph, the term *applicable percentage* means 100 percent minus 1 percentage point for each full month the property was

held after the date on which the property was held 20 full months. See paragraph (d)(2) of this section. If, however, the property is considered to have two or more elements with separate holding periods (for example, because units thereof are placed in service on different dates, or improvements are made to the property), see the special rules of § 1.1250–5.

(ii) For purposes of applying section 1250, the facts and circumstances of each disposition shall be considered in determining what is the appropriate item of section 1250 property. In general, a building is an item of section 1250 property, but in an appropriate case more than one building may be treated as a single item. For manner of determining whether an expenditure shall be treated as an addition to the capital account of an item of section 1250 property or as a separate item of section 1250 property, see paragraph (d)(2)(iii) of § 1.1250–5.

(3) *Sale, exchange, or involuntary conversion before January 1, 1970.* (i) In the case of a disposition of section 1250 property by a sale, exchange, or involuntary conversion before January 1, 1970, the gain to which section 1250(a)(2) applies is the applicable percentage for the property multiplied by the lower of (*a*) the additional depreciation in respect of the property or (*b*) the excess (referred to as *gain realized*) of the amount realized over the adjusted basis of the property.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example: Section 1250 property, which has an adjusted basis of $200,000, is sold for $290,000 before January 1, 1970. At the time of the sale the additional depreciation in respect of the property is $130,000 and the applicable percentage is 60 percent. Since the gain realized ($90,000, that is, amount realized, $290,000, minus adjusted basis, $200,000) is lower than the additional depreciation ($130,000), the amount of gain recognized as ordinary income under section 1250(a)(2) is $54,000 (that is, 60 percent of $90,000). The remaining $36,000 ($90,000 minus $54,000) of the gain may be treated as gain from the sale or exchange of property described in section 1231.

(4) *Other dispositions before January 1, 1970.* (i) In the case of a disposition of section 1250 property before January 1, 1970, other than by way of a sale, exchange, or involuntary conversion, the gain to which section 1250(a)(2) applies is the applicable percentage for the property multiplied by the lower of (*a*) the additional depreciation in respect of the property, or (*b*) the excess (referred to as *potential gain*) of the fair market value of the property on the date of disposition over its adjusted basis. If property is transferred by a corporation to a shareholder for an amount less than its fair market value in a sale or exchange, for purposes of applying section 1250 such transfer shall be treated as a disposition other than by way of a sale, exchange, or involuntary conversion.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example: Assume the same facts as in the example in subparagraph (3)(ii) of this paragraph except that the property is distributed by a corporation to a stockholder before January 1, 1970, in complete liquidation of the corporation, and that at the time of the distribution the fair market value of the property is $370,000. Since the additional depreciation ($130,000) is lower than the potential gain of $170,000 (that is, fair market value, $370,000, minus adjusted basis, $200,000), the amount of gain recognized as ordinary income under section 1250(a)(2) is $78,000 (that is, 60 percent of $130,000) even though, in the absence of section 1250, section 336 would preclude recognition of gain to the corporation.

(5) *Instances of nonapplication.* (i) Section 1250(a)(2) does not apply to losses. Thus, section 1250(a)(2) does not apply if a loss is realized upon a sale, exchange, or involuntary conversion of property, all of which is considered section 1250 property, nor does the section apply to a disposition of such property other than by way of sale, exchange, or involuntary conversion if at the time of the disposition the fair market value of such property is not greater than its adjusted basis.

(ii) In general, in the case of section 1250 property with a holding period under section 1223 of more than one year, section 1250(a)(2) does not apply if for periods after December 1, 1963, there are no *depreciation adjustments in excess of straight line* (as computed under section 1250(b) and paragraph (b) of § 1.1250–2).

(iii) In a case in which section 1250 property (including each element thereof, if any) has a holding period under §1.1250–4 (or paragraph (a)(2)(ii) of §1.1250–5) of at least 10 years, section 1250(a)(2) does not apply. If within the 10-year period preceding the date the property is disposed of, an element is added to the property by reason, for example, of an addition to capital account, see §1.1250–5.

(6) *Allocation rule.* In the case of a sale, exchange, or involuntary conversion of section 1250 property and nonsection 1250 property in one transaction before January 1, 1970, the total amount realized upon the disposition shall be allocated between the section 1250 property and the other property in proportion to their respective fair market values. Such allocation shall be made in accordance with the principles set forth in paragraph (a)(5) of §1.1245–1 (relating to allocation between section 1245 property and nonsection 1245 property).

(c) *Relation of section 1250 to other provisions*—(1) *General.* The provisions of section 1250 apply notwithstanding any other provision of subtitle A of the Code. See section 1250(i). Thus, unless an exception or limitation under section 1250(d) and §1.1250–3 applies, gain under section 1250(a) is recognized notwithstanding any contrary nonrecognition provision or income characterizing provision. For example, since section 1250 overrides section 1231 (relating to property used in the trade or business), the gain recognized under section 1250(a) upon a disposition will be treated as ordinary income and only the remaining gain, if any, from the disposition may be considered as gain from the sale or exchange of a capital asset if section 1231 is applicable. See the example in paragraph (b)(3)(ii) of this section.

(2) *Nonrecognition sections overridden.* The nonrecognition provisions of subtitle A of the Code which section 1250 overrides include, but are not limited to, sections 267(d), 311(a), 336, 337, 501(a), and 512(b)(5). See section 1250(d) for the extent to which section 1250(a) overrides sections 332, 351, 361, 371(a), 374(a), 721, 731, 1031, 1033, 1039, 1071, and 1081 (b)(1) and (d)(1)(A). For amount of additional depreciation in respect of property disposed of by an organization exempt from income taxes (within the meaning of section 501(a)), see paragraph (d)(6) of §1.1250–2.

(3) *Exempt income.* The fact that section 1250 provides for recognition of gain as ordinary income does not change into taxable income any income which is exempt under section 115 (relating to income of States, etc.), 892 (relating to income of foreign governments), or 894 (relating to income exempt under treaties).

(4) *Treatment of gain not recognized under section 1250.* Section 1250 does not prevent gain which is not recognized under section 1250 from being considered as gain under another provision of the Code, such as, for example, section 1239 (relating to gain from sale of depreciable property between certain related persons). Thus, for example, if section 1250 property which has an adjusted basis of $10,000 is sold for $17,500 in a transaction to which section 1239 applies, and if $5,000 of the gain would be recognized under section 1250(a) then the remaining $2,500 of the gain would be treated as ordinary income under section 1239.

(5) *Normal retirement of asset in multiple asset account.* Section 1250(a) does not require recognition of gain upon normal retirements of section 1250 property in a multiple asset account as long as the taxpayer's method of accounting, as described in paragraph (e)(2) of §1.167(a)–8 (relating to accounting treatment of asset retirements), does not require recognition of such gain.

(6) *Installment method.* Gain from a disposition to which section 1250(a) applies may be reported under the installment method if such method is otherwise available under section 453 of the Code. In such case, the income (other than interest) on each installment payment shall be deemed to consist of gain to which section 1250(a) applies until all such gain has been reported, and the remaining portion (if any) of such income shall be deemed to consist of other gain. For treatment of amounts as interest on certain deferred payments, see section 483.

(d) *Applicable percentage*—(1) *Definition for purposes of section 1250(a)(1).* (i)

For purposes of section 1250(a)(1), the term *applicable percentage* means:

(*a*) In the case of property disposed of pursuant to a written contract which was, on July 24, 1969, and at all times thereafter binding on the owner of the property, 100 percent minus 1 percentage point for each full month the property was held after the date on which the property was held 20 full months;

(*b*) In the case of property constructed, reconstructed, or acquired by the taxpayer before January 1, 1975, with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act, or housing is financed or assisted by direct loan or tax abatement under similar provisions of State or local laws, and with respect to which the owner is subject to the restrictions described in section 1039(b)(1)(B) (relating to approved dispositions of certain Government-assisted housing projects), 100 percent minus 1 percentage point for each full month of the taxpayer's holding period for the property (determined under § 1.1250–4) during which the property qualified under this sentence, beginning after the date on which the property so qualified for 20 full months.

(*c*) In the case of residential rental property (as defined in section 167(j)(2)(B)) other than that covered by (*a*) and (*b*) of this subdivision, 100 percent minus 1 percentage point for each full month of the taxpayer's holding period for the property (determined under § 1.1250–4) included within a taxable year for which the property qualified as residential rental property, beginning after the date on which the property so qualified for 100 full months.

(*d*) In the case of property with respect to which a deduction was allowed under section 167(k) (relating to the depreciation of expenditures to rehabilitate low-income rental housing), 100 percent minus 1 percentage point for each full month of the taxpayer's holding period (determined under § 1.1250–4) beginning 100 full months after the date on which the property was placed in service.

(*e*) In the case of all other property, 100 percent.

The provisions of (a), (b), and (c) of this subdivision shall not apply with respect to additional depreciation described in section 1250(b)(4). If the taxpayer's holding period under § 1.1250–4 includes a period before January 1, 1970, such period shall be taken into account in applying each provision of this subdivision.

(ii) A single item of property may have two (or more) applicable percentages under the provisions of subdivision (i) of this subparagraph. For example, if the provision of subdivision (i) of this subparagraph which applies to an item of section 1250 property (or to an element of such property if the property is treated as consisting of more than one element under § 1.1250–5) in the taxable year in which the item (or element) is disposed of did not apply to the item (or element) in a prior taxable year which is included within the taxpayer's holding period under § 1.1250–4 and which ends after December 31, 1969, then each provision of subdivision (i) of this subparagraph shall apply only for the period during which the property qualified under such provision.

(iii) If the taxpayer makes rehabilitation expenditures and elects to compute depreciation under section 167(k) with respect to the property attributable to the rehabilitation expenditures, such property will generally constitute a separate improvement under paragraph (c) of § 1.1250–5 and therefore will constitute an element of section 1250 property. For computation of applicable percentage and gain recognized under section 1250(a) in such a case, see paragraph (a) of § 1.1250–5.

(iv) The principles of this subparagraph may be illustrated by the following examples:

Example 1. Section 1250 property is sold on December 31, 1970, pursuant to a written contract which was binding on the owner of the property on July 24, 1969, and at all times thereafter. The property was acquired on July 31, 1968. The applicable percentage for the property under subdivision (i)(*a*) of this subparagraph is 91 percent, since the property was held 29 full months.

Example 2. Section 1250 property is sold on June 30, 1978. The property was acquired by a calendar year taxpayer on June 30, 1966. Subdivision (i)(*e*) of this subparagraph applies to the property in 1977 and 1978. However, subdivision (i)(*c*) of this subparagraph applied to the property for the taxable years of 1970 through 1976. Thus, the property has two applicable percentages under this subparagraph. The period before January 1, 1970 (42 full months), and the period from 1970 through 1976 (84 full months) are both taken into account in determining the applicable percentage under subdivision (i)(*c*) of this subparagraph. Thus, the applicable percentage is 74 percent (that is, 100 percent minus the excess of the holding period taken into account (126 full months) over 100 full months). The applicable percentage for the years 1977 and 1978 is 100 percent under subdivision (i)(*e*) of this subparagraph.

Example 3. Section 1250 property is sold on December 31, 1978. The property was acquired by a calendar year taxpayer on December 31, 1969. The taxpayer made rehabilitation expenditures in 1973 and properly elected to compute depreciation under section 167(k) on the property attributable to the expenditures for the 60-month period beginning on January 1, 1974, the date such property was placed in service. Subdivision (i)(*c*) applies to the property (other than the property with respect to which a deduction was allowed under section 167(k)) for the taxable years of 1970 through 1978 (108 full months) and the applicable percentage for such property is 92 percent. The applicable percentage for the property with respect to which a deduction under section 167(k) was allowed is 100 percent under subdivision (i)(*d*) of this subparagraph, since the holding period for purposes of such subdivision begins on the date such property is placed in service.

Example 4. Section 1250 property is sold by a calendar year taxpayer on March 31, 1974. The property was transferred to the taxpayer by gift on December 31, 1970, and under section 1250(e)(2), the taxpayer's holding period for the property for purposes of computing the applicable percentage includes the transferor's holding period of 80 full months. Subdivision (i)(*c*) of this subparagraph applies to the property in the years 1970 through 1974. The applicable percentage under subdivision (i) (*c*) of this subparagraph is 81 percent, since the period before January 1, 1970 (68 full months), and that portion of the period after December 31, 1969, during which such subdivision applied (51 full months) are taken into account.

(2) *Definition for purposes of section 1250(a)(2).* For purposes of section 1250(a)(2), the term *applicable percentage* means:

(i) In case of property with a holding period of 20 full months or less, 100 percent;

(ii) In case of property with a holding period of more than 20 full months but less than 10 years, 100 percent minus 1 percentage point for each full month the property is held after the date on which the property is held 20 full months; and

(iii) In case of property with a holding period of at least 10 years, zero.

(3) *Holding period.* For purposes of this paragraph, the holding period of property shall be determined under the rules of §1.1250–4, and not under the rules of section 1223, notwithstanding that the property was acquired on or before December 31, 1963. In the case of a disposition of section 1250 property which consists of 2 or more elements (within the meaning of paragraph (c) of §1.1250–5), the holding period for each element shall be determined under the rules of paragraph (a)(2)(ii) of §1.1250–5.

(4) *Full month.* For purposes of this paragraph, the term *full month* (or *full months*) means the period beginning on a date in 1 month and terminating on the date before the corresponding date in the next succeeding month (or in another succeeding month), or, if a particular succeeding month does not have such a corresponding date, terminating on the last day of such particular succeeding month.

(5) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. Property is purchased on January 17, 1959. Under paragraph (b)(1) of §1.1250–4, its holding period begins on January 18, 1959, and thus at any time during the period beginning on October 17, 1960, and ending on November 16, 1960, the property is considered held 21 full months and has an applicable percentage under section 1250(a)(2) of 99 percent. On and after January 17, 1969, the property has a holding period of at least 120 full months (10 years) and, therefore, the applicable percentage under section 1250(a)(2) for the property is zero. Accordingly, no gain would be recognized under section 1250(a)(2) upon disposition of the property. If, however, the property consists of two or more elements, see the special rules of §1.1250–5.

Example 2. Property is purchased on January 31, 1968. Under paragraph (b)(1) of §1.1250–4 its holding period begins on February 1, 1968, and thus at any time during the period beginning on February 29, 1968, and ending on March 30, 1968, the property is considered held 1 full month. At any time during the period beginning on March 31, 1970, and ending on April 29, 1970, the property is considered held 26 full months. At any time during the period beginning on April 30, 1970, and ending on May 30, 1970, the property is considered held 27 full months.

(e) *Section 1250 property*—(1) *Definition.* The term *section 1250 property* means any real property (other than section 1245 property, as defined in section 1245(a)(3) and § 1.1245–3) which is or has been property of a character subject to the allowance for depreciation provided in section 167. See section 1250(c).

(2) *Character of property.* For purposes of subparagraph (1) of this paragraph, the term *is or has been property of a character subject to the allowance for depreciation provided in section 167* shall have the same meaning as when used in paragraph (a) (1) and (3) of § 1.1245–3. Thus, if a father uses a house in his trade or business during a period after December 31, 1963, and then gives the house to his son as a gift for the son's personal use, the house is section 1250 property in the hands of the son. For exception to the application of section 1250(a) upon disposition of a principal residence, see section 1250(d)(7).

(3) *Real property.* (i) For purposes of subparagraph (1) of this paragraph, the term *real property* means any property which is not personal property within the meaning of paragraph (b) of § 1.1245–3. The term section 1250 property includes three types of depreciable real property. The first type is intangible real property. For purposes of this paragraph, a leasehold of land or of section 1250 property is intangible real property, and accordingly such a leasehold is section 1250 property. However, a fee simple interest in land is not depreciable, and therefore is not section 1250 property. The second type is a building or its structural components within the meaning of paragraph (c) of § 1.1245–3. The third type is all other tangible real property except (*a*) property described in section 1245(a)(3)(B) as defined in paragraph (c)(1) of § 1.1245–3 (relating to property used as an integral part of a specified activity or as a specified facility), and (*b*) property described in section 1245(a)(3)(D). An elevator or escalator (within the meaning of section 1245(a)(3)(C)) is not section 1250 property.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example: A owns and leases to B for a single lump-sum payment of $100,000 property consisting of land and a fully equipped factory building thereon. If 30 percent of the fair market value of such property is properly allocable to the land, 25 percent to section 1250 property (the building and its structural components), and 45 percent to section 1245 property (the equipment), then 55 percent of B's leasehold is section 1250 property.

(4) *Coordination with definition of section 1245 property.* (i) Property may lose its character as section 1250 property and become section 1245 property. Thus, for example, if section 1250 property of the third type described in subparagraph (3)(i)(*a*) of this paragraph is converted to use as an integral part of manufacturing, the property would lose its character as section 1250 property and would become section 1245 property. However, once property in the hands of a taxpayer is section 1245 property, it can never become section 1250 property in the hands of such taxpayer. See also paragraph (a) (4) and (5) of § 1.1245–2.

(f) *Treatment of partnerships and partners.* If a partnership disposes of section 1250 property, the amount of gain recognized under section 1250(a) by the partnership and by a partner shall be determined in a manner consistent with the principles provided in paragraph (e) of § 1.1245–1. Thus, for example, a partner's distributive share of gain recognized by the partnership under section 1250(a) shall be determined in the same manner as his distributive share of gain recognized by the partnership under section 1245(a)(1) is determined, and, if required, additional depreciation in respect of section 1250 property shall be allocated to the partner in the same manner as the adjustments reflected in the adjusted basis of section 1245 property are allocated to the partner. For a further example, if on the date a partner acquires his partnership interest by way of a sale or exchange the partnership owns section 1250 property and an election under section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to the partnership, then such partner's additional depreciation in respect of such property on such date is deemed to be zero. For limitation on the amount of gain recognized under section 1250(a) in respect of a partnership and for the amount of additional depreciation in respect of partnership property after certain transactions, see paragraph (f) of § 1.1250–3. For treatment of section 1250 property as an unrealized receivable, see section 751(c).

(g) *Examples.* The principles of this section may be illustrated by the following examples:

Example 1. Section 1250 property which has an adjusted basis of $350,000 is sold for $630,000 on December 31, 1984. The property was acquired by a calendar year taxpayer on December 31, 1969. For the taxable years from 1970 through 1980, the property qualified as residential rental property and the applicable percentage for those years is 68 percent (paragraph (d)(1)(i)(*c*) of this section). For taxable years from 1981 through 1984, the property did not qualify as residential rental property and the applicable percentage for those years is 100 percent (paragraph (d)(1)(i)(*e*) of this section). The additional depreciation for the years from 1970 through 1980 is $120,000. The additional depreciation for the years from 1981 through 1984 is $20,000. The gain realized is $280,000 (that is, amount realized, $630,000, minus adjusted basis $350,000). The gain recognized as ordinary income under section 1250(a)(1) is computed in two steps. First, since the additional depreciation attributable to the years 1970 through 1980 ($120,000) is lower than the gain realized attributable to such years determined under paragraph (a)(6) of this section ($240,000, that is, gain realized, $280,000, multiplied by 12⁄14), the gain recognized as ordinary income under section 1250(a)(1) in the first step is $81,600, that is, 68 percent of $120,000. Second, since the additional depreciation attributable to the years 1981 through 1984 ($20,000) is lower than the gain realized attributable to those years ($40,000, that is, gain realized, $280,000, multiplied by 2⁄14), the gain recognized as ordinary income under section 1250(a)(1) for the years from 1981 through 1984 is $20,000 (that is, 100 percent of $20,000). The total gain recognized under section 1250(a)(1) is $101,600 (that is, $81,600 plus $20,000).

Example 2. Section 1250 property which has an adjusted basis of $400,000 is sold for $472,000 on December 31, 1978. The property was acquired on December 31, 1966. The additional depreciation attributable to periods before January 1, 1970, is $40,000 and the applicable percentage under paragraph (d)(2) of this section is zero percent. The property qualifies as residential rental property for the years 1970 through 1976, but fails to qualify for 1977 and 1978. Under paragraph (d)(1) of this section, the applicable percentage for the years 1970 through 1976 is 80 percent (paragraph (d)(1)(i)(*c*) of this section), and the applicable percentage for the years 1977 and 1978 is 100 percent (paragraph (d)(1)(i)(*e*) of this section). The additional depreciation attributable to the years 1970 through 1976 is $50,000, and the additional depreciation attributable to the years 1977 and 1978 is $10,000. The gain recognized as ordinary income under section 1250(a)(1) is computed in two steps. First, since the additional depreciation attributable to the years 1970 through 1976 ($50,000) is lower than the gain realized attributable to such years ($60,000, that is, $72,000 multiplied by 5⁄6), the gain recognized under section 1250(a)(1) in the first step is $40,000 (that is, 80 percent of $50,000). Second, since the additional depreciation attributable to 1977 and 1978 ($10,000) is lower than the gain realized attributable to such years ($12,000, that is, $72,000 multiplied by 1⁄6), the gain recognized under section 1250(a)(1) in the second step is $10,000 (that is, 100 percent of $10,000). In addition, section 1250(a)(2) applies. However, since the applicable percentage is zero percent, none of the gain is recognized as ordinary income under section 1250(a)(2). Thus, the remaining $22,000 (that is, gain realized, $72,000, minus gain recognized under section 1250(a), $50,000) of the gain may be treated as gain from the sale or exchange of property described in section 1231.

Example 3. The facts are the same as in example (2) except that the property is disposed of on December 31, 1980. The property qualifies as residential rental property for the years 1979 and 1980. Thus, the applicable percentage for years 1970 through 1976, 1979, and 1980 is 56 percent (paragraph (d)(1)(i)(*c*) of this section). The applicable percentage for the years 1977 and 1978 is 100 percent (paragraph (d)(1)(i)(*e*) of this section). The additional depreciation for the years 1979 and 1980 is $8,000. The gain recognized under section 1250(a)(1) is computed in two steps. First, since the additional depreciation attributable to the years 1970 through 1976, 1979, and 1980 ($58,000) is lower than the gain realized attributable to such years ($61,412, that is, $72,000 multiplied by $58,000/$68,000), the gain recognized under section 1250(a)(1) in the first step is $32,480 (that is, 56 percent of $58,000). Second, since the additional depreciation attributable to 1977 and 1978 ($10,000) is lower than the gain realized attributable to such years ($10,588, that is, $72,000 multiplied by $10,000/$68,000) the gain recognized under section 1250(a)(1) in the second step is $10,000 (that is, 100 percent of $10,000). In addition section 1250(a)(2) applies. However, since the applicable percentage is zero percent, none of the gain is recognized as ordinary income under section 1250(a)(2). Thus, the remaining $29,520 (that is, gain realized, $72,000, minus gain recognized under section 1250(a), $42,480) of the gain may be treated as gain from the sale or exchange of property described in section 1231.

[T.D. 7084, 36 FR 271, Jan. 8, 1971, as amended by T.D. 7193, 37 FR 12953, June 30, 1972]

§ 1.1250–2 Additional depreciation defined.

(a) *In general*—(1) *Definition for purposes of section 1250(b)(1).* Except as otherwise provided in paragraph (e) of this section, for purposes of section 1250(b)(1), the term *additional depreciation* means:

(i) In the case of property which at the time of disposition has a holding period under section 1223 of not more than 1 year, the *depreciation adjustments* (as defined in paragraph (d) of this section) in respect of such property for periods after December 31, 1963, and

(ii) In the case of property which at the time of disposition has a holding period under section 1223 of more than 1 year, the depreciation adjustments in excess of straight line for periods after December 31, 1963, computed under paragraph (b)(1) of this section.

(2) *Definition for purposes of section 1250(b)(4).* Except as otherwise provided in paragraph (e) of this section, for purposes of section 1250(b)(4), the term *additional depreciation* means:

(i) In the case of property with respect to which a deduction under section 167(k) (relating to depreciation of expenditures to rehabilitate low-income rental housing) was allowed, which at the time of disposition has a holding period under section 1223 of not more than 1 year from the time the rehabilitation expenditures were incurred, the *depreciation adjustments* (as defined in paragraph (d) of this section) in respect of the property, and

(ii) In the case of property with respect to which a deduction under section 167(k) (relating to depreciation of expenditures to rehabilitate low-income rental housing) was allowed, which at the time of disposition has a holding period under section 1223 of more than 1 year from the time the rehabilitation expenditures were incurred, the depreciation adjustments in excess of straight line for the property, computed under paragraph (b)(2) of this section. For purposes of this subparagraph, all rehabilitation expenditures which are incurred in connection with the rehabilitation of an element of section 1250 property shall be considered incurred on the date the last such expenditure is considered incurred under the accrual method of accounting, regardless of the method of accounting used by the taxpayer with regard to other items of income and expense. If the property consists of two or more elements (for example, if the property is placed in service at different times), then each element shall be treated as if it were a separate property and the expenditures attributable to each such element shall be considered incurred on the date the last such expenditure is considered incurred.

(3) *Allocation to certain periods.* With respect to a taxable year beginning in 1963 and ending in 1964, or beginning in 1969 and ending in 1970, the amount of depreciation adjustments or of depreciation adjustments in excess of straight line (as the case may be) shall be ascertained by applying the principles of paragraph (c)(3) of § 1.167(a)–8 (relating to determination of adjusted basis of retired asset), and the amount determined in such manner shall be allocated on a daily basis in order to determine the portion thereof which is attributable to a period after December 31, 1963, or after December 31, 1969, as the case may be.

(b) *Computation of depreciation adjustments in excess of straight line*—(1) *General rule.* For purposes of paragraph (a)(1) of this section, depreciation adjustments in excess of straight line shall be, in the case of any property, the excess of (i) the sum of the *depreciation adjustments* (as defined in paragraph (d) of this section) in respect of the property attributable to periods after December 31, 1963, over (ii) the sum such adjustments would have been for such periods if such adjustments had been determined for the entire period the property was held under the straight line method of depreciation (or, if applicable, under the lease-renewal-period provision in paragraph (c) of this section). Depreciation in excess of straight line may arise, for example, if the declining balance method, the sum of the years-digits method, or the units of production method is used, or for another example, if the cost of a leasehold improvement or of a leasehold is depreciated over a period which does not take into account certain renewal periods referred to in paragraph (c) of this section. For computations of depreciation adjustments in excess of straight line (or a deficit therein) both on an annual basis and on the basis of the entire period the property was held, see subparagraph (6) of this paragraph.

(2) *Depreciation under section 167(k).* For purposes of paragraph (a)(2) of this section, depreciation adjustments in excess of straight line shall be, in the case of any property with respect to which a deduction was allowed under section 167(k) (relating to depreciation of expenditures to rehabilitate low-income rental housing), the excess of (i) the sum of the *depreciation adjustments* (as defined in paragraph (d) of this section) allowed in respect of the property, over (ii) the sum such adjustments would have been if such adjustments had been determined for the entire period the property was held under the straight line method of depreciation permitted by section 167(b)(1).

(3) *General rule for computing useful life and salvage value.* For purposes of computing under subparagraph (1)(ii) of this paragraph the sum of the depreciation adjustments would have been under the straight line method, if a useful life (or salvage value) was used in determining the amount allowed as a depreciation adjustment for any taxable year, such life (or value) shall be used in determining the amount such depreciation adjustment would have been for such taxable year under the straight line method. If, however, for any taxable year a method of depreciation was used as to which a useful life was not taken into account such as, for example, the units of production method, or as to which salvage value was not taken into account in determining the annual allowances, such as, for example, the declining balance method or the amortization of a leasehold improvement over the term of a lease, then, for the purpose of determining the amount such depreciation adjustment would have been under the straight line method for such taxable year:

(i) There shall be used the useful life (or salvage value) which would have been proper if depreciation had actually been determined under the straight line method throughout the period the property was held, and

(ii) Such useful life (or such salvage value) shall be determined by taking into account for each taxable year the same facts and circumstances as would have been taken into account if the taxpayer had used such method throughout the period the property was held.

(4) *Special rule for computing useful life and salvage value (section 167(k)).* For purposes of computing under subparagraph (2)(ii) of this paragraph the sum the depreciation adjustments would have been under the straight line method, the useful life and salvage value permitted under section 167(k) shall not apply, the useful life of the property shall be determined under paragraph (b) of §1.167(a)–1 (or, if applicable, under the lease-renewal-period provision of paragraph (c) of this section), and the salvage value of the property shall be determined under paragraph (c) of §1.167(a)–1. Such useful life or salvage value shall be determined by taking into account for each taxable year the same facts and circumstances as would have been taken into account if the taxpayer had used the straight line method permitted under section 167(b)(1) throughout the period the property was held.

(5) *Property held before January 1, 1964.* In the case of property held before January 1, 1964:

(i) For purposes of computing under subparagraph (1)(ii) of this paragraph the sum the depreciation adjustments would have been under the straight line method, the adjusted basis of the property on such date shall be the amount such adjusted basis would have been if depreciation deductions allowed or allowable before such date had been determined under the straight line method computed in accordance with subparagraph (3) of this paragraph, and

(ii) The depreciation adjustments in excess of straight line in respect of the property computed under subparagraph

(1) of this paragraph, but without regard to this subdivision, shall be reduced by the amount of depreciation adjustments less than straight line for periods before January 1, 1964, that is, by the excess (if any) of the sum the depreciation adjustments would have been for periods before January 1, 1964, under the straight line method, over the sum of the depreciation adjustments attributable to periods before such date.

(6) *Determination of additional depreciation in certain cases.* If an item of section 1250 property is subject to two (or more) applicable percentages, a separate computation of additional depreciation shall be made for the portion of the taxpayer's holding period subject to each such percentage. That is, a separate computation shall be made to determine the excess of (i) the depreciation adjustments (as defined in paragraph (d) of this section) for each such portion of the taxpayer's holding period after December 31, 1963, over (ii) the amount such adjustments would have been for each such portion if such adjustments were determined under the straight line method of depreciation (or, if applicable, under the lease-renewal-period provision in paragraph (c) of this section). Thus, for example, in the case of an item of section 1250 property acquired on January 1, 1968, and disposed of on January 1, 1973, if the applicable percentage for the period before January 1, 1970, were determined under paragraph (d)(2) of § 1.1250–1 and the applicable percentage for the period after December 31, 1969, were determined under paragraph (d)(1)(i)(*e*) of § 1.1250–1, the additional depreciation would be computed separately for the period before January 1, 1970, and for the period after December 31, 1969. If the additional depreciation attributable to any such portion of the taxpayer's holding period is a deficit (that is, if the depreciation adjustments for that portion are less than the amount such adjustments would have been for that portion if depreciation adjustments were determined for the entire period the property was held under the straight line method of depreciation, or, if applicable, under the lease-renewal-period provision in paragraph (c) of this section), then such deficit will be applied to reduce the additional depreciation for other portion (or portions) of the taxpayer's holding period. (See examples (4) and (5) of subparagraph (7) of this paragraph.)

(7) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. A calendar year taxpayer sells section 1250 property on January 1, 1968, which he purchased for $10,000 on January 1, 1963. For the period of 1963 through 1967 he computed depreciation deductions in respect of the property under the declining balance method using a rate of 200 percent of the straight line rate and a proper useful life of 10 years. Under such method salvage value is not taken into account in computing annual allowances. For purposes of applying subparagraph (3) of this paragraph, if the taxpayer had used the straight line method for such period, he would have used a salvage value of $1,000, and the depreciation under the straight line method would have been $900 each year, that is, one-tenth of $10,000 minus $1,000. As of January 1, 1968, the additional depreciation for the property is $1,123, as computed in the table below:

Year	Actual depreciation	Straight line	Additional depreciation (deficit)
1963	$2,000	$900	
1964	1,600	900	$700
1965	1,280	900	380
1966	1,024	900	124
1967	819	900	(81)
Sum for periods after Dec. 31, 1963	4,723	3,600	1,123

Example 2. Assume the same facts as in example (1) except that the taxpayer sells the section 1250 property on January 1, 1970. Assume further that as of January 1, 1968, the taxpayer elects under section 167(e)(1) to change to the straight line method. On that date the adjusted basis of the property is $3,277 ($10,000 minus $6,723). He redetermines the remaining useful life of the property to be 8 years and its salvage value to be $77, and thus takes depreciation deductions for 1968 and 1969 of $400 (the amount allowable) for each such year, that is, one-eighth of $3,200 (that is, $3,277 minus $77). For purposes of applying subparagraph (3) of this paragraph, if he had used the straight line method throughout the period he held the property, the adjusted basis of the property on January 1, 1968, would have been $5,500 ($10,000 minus $4,500), and the depreciation which would have resulted under such method for 1968 and 1969 would have been $678 for each such year, that is, one-eighth of $5,423 ($5,500

minus $77). As of January 1, 1970, the additional depreciation for the property is $567, as computed in the table below:

Years	Depreciation	Straight line	Additional depreciation (deficit)
1964 through 1967 ..	$4,723	$3,600	$1,123
1968	400	678	(278)
1969	400	678	(278)
Sum for periods after Dec. 31, 1963	5,523	4,956	567

Example 3. On January 1, 1978, a calendar year taxpayer sells section 1250 property. The property, which is attributable to rehabilitation expenditures of $50,000 incurred in 1970, was placed in service on January 1, 1971. The taxpayer elected to compute depreciation for the period of 1971 through 1975 under section 167(k). Under such section salvage value is not taken into account in computing annual allowances, and the useful life of the property is deemed to be 5 years. For purposes of applying subparagraph (4) of this paragraph, if the taxpayer had used the straight line method permitted under section 167(b)(1) for such period, he would have used a salvage value of $5,000 and a useful life of 15 years. Depreciation under the straight line method would thus have been $3,000 each year, 1/15 of $45,000 (that is, $50,000 minus $5,000). As of January 1, 1978, the additional depreciation for the property is $29,000, as computed in the table below:

Year	Actual depreciation	Straight line	Additional depreciation (deficit)
1971	$10,000	$3,000	$7,000
1972	10,000	3,000	7,000
1973	10,000	3,000	7,000
1974	10,000	3,000	7,000
1975	10,000	3,000	7,000
1976		3,000	(3,000)
1977	....	3,000	(3,000)
Total	50,000	21,000	29,000

Example 4. Section 1250 property which has an adjusted basis of $108,000 is sold for $146,000 on December 31, 1972, and thus the gain realized is $38,000. The property was acquired on December 31, 1963. The applicable percentage for the period before January 1, 1970, is 12 percent (paragraph (d)(2) of § 1.1250–1) and the applicable percentage for the period after December 31, 1969, is 100 percent (paragraph (d)(1)(i)(*e*) of § 1.1250–1). The additional depreciation must be computed separately for the period before January 1, 1970, and for the period after December 31, 1969. Assume that the additional depreciation for the period before January 1, 1970, is $32,000 and that there is a deficit in additional depreciation of $2,000 for the period after December 31, 1969. Accordingly, the additional depreciation for the period before January 1, 1970 ($32,000) is reduced to $30,000 by the $2,000 deficit in additional depreciation for the period after December 31, 1969. Although section 1250(a)(1) applies to the property, none of the gain is recognized as ordinary income under that section since there is a deficit in additional depreciation for the period after December 31, 1969. Gain is recognized under section 1250(a)(2) since there is remaining gain of $38,000 (that is, gain realized, $38,000, minus the additional depreciation attributable to periods after December 31, 1969, zero). Since the additional depreciation attributable to the period before January 1, 1970 ($30,000), is lower than the gain realized ($38,000), the amount of gain recognized under section 1250(a)(2) is $3,600 (that is, 12 percent of $30,000).

Example 5. Section 1250 property which has an adjusted basis of $207,000 is sold for $267,000 on February 24, 1988, and thus the gain realized is $60,000. The property was acquired on April 30, 1970. The applicable percentage for the period from April 30, 1970, through December 31, 1981, is 60 percent (paragraph (d)(1)(i)(c) of § 1.1250–1) and the applicable percentage for the period from January 1, 1982, through February 24, 1988, is 100 percent (paragraph (d)(1)(i)(e) of § 1.1250–1). The additional depreciation must be computed separately for the period before January 1, 1982, and for the period after December 31, 1981. Assume that the additional depreciation for the period before January 1, 1982, is $43,000 and that there is a deficit in additional depreciation of $6,000 for the period after December 31, 1981. Accordingly, the additional depreciation for the period before January 1, 1982 ($43,000), is reduced to $37,000 by the $6,000 deficit for the period after December 31, 1981. There is no gain recognized under section 1250(a)(1) for the period after December 31, 1981, since there is a deficit in additional depreciation for that period. The gain recognized under section 1250(a)(1) for the period before January 1, 1982, is $22,200, that is, the lower of the gain realized attributable to that period ($60,000) or the additional depreciation attributable to that period ($37,000), or $37,000, multiplied by 60 percent, the applicable percentage.

(c) *Property held by lessee*—(1) *Amount depreciation would have been.* For purposes of paragraph (b) of this section, in case of a leasehold which is section 1250 property, in determining the amount the depreciation adjustments would have been under the straight line method in respect of any building or other improvement (which is section 1250 property) erected or made on the leased property, or in respect of any cost of acquiring the lease, the lease period shall be treated as including all renewal periods. See section 1250(b)(2). For determination of the extent to which a leasehold is section 1250 property, see paragraph (e)(3) of § 1.1250–1.

(2) *Renewal period.* (i) For purposes of this paragraph, the term *renewal period* means any period for which the lease may be renewed, extended, or continued pursuant to an option or options exercisable by the lessee (whether or not specifically provided for in the lease) except that the inclusion of one or more renewal periods shall not extend the period taken into account by more than two-thirds of the period on the basis of which the depreciation adjustments were allowed.

(ii) In respect of the cost of any building erected (or other improvement made) on the leased property by the lessee, or in respect of the portion of the cost of acquiring a leasehold which is attributable to an existing building (or other improvement) on the leasehold at the time the lessee acquires the leasehold, the inclusion of one or more renewal periods shall not extend the period taken into account to a period which exceeds the useful life remaining, at the time the leasehold is disposed of, of such building (or such other improvement). Determinations under this subdivision shall be made without regard to the proper period under section 167 or 178 for depreciating or amortizing a leasehold acquisition cost or improvement.

(iii) The provisions of this subparagraph may be illustrated by the following example:

Example: Assume that a leasehold improvement with a useful life of 30 years is properly amortized on the basis of a 10-year initial lease term. The lease is renewable for an additional 9 years. The period taken into account is 16⅔ years, that is, 10 years plus two-thirds of 10 years. If, however, the leasehold improvement were disposed of at the end of 12 years, and if its remaining useful life were only 3 years, then the period taken into account would be 15 years.

(d) *Depreciation adjustments*—(1) *General.* For purposes of this section, the term *depreciation adjustments* means, in respect of any property, all adjustments reflected in the adjusted basis of such property on account of deductions described in subparagraph (2) of this paragraph allowed or allowable (whether in respect of the same or other property) to the taxpayer or to any other person. For cases where the taxpayer can establish that the amount allowed for any period was less than the amount allowable, see subparagraph (4) of this paragraph. For determination of adjusted basis of property in a multiple asset account, see paragraph (c)(3) of § 1.167(a)–8. The term *depreciation adjustments* as used in this section does not have the same meaning as the term *adjustments reflected in the adjusted basis* as defined in paragraph (a)(2) of § 1.1245–2.

(2) *Deductions.* The deductions described in this subparagraph are allowances (and amounts treated as allowances) for depreciation or amortization (other than amortization under section 168, 169 (as enacted by section 704(a), Tax Reform Act of 1969 (83 Stat. 667)), or 185). Thus, for example, such deductions include a reasonable allowance for exhaustion, wear, and tear (including a reasonable allowance for obsolesence) under section 167, the periodic deductions referred to in § 1.162–11 in respect of a specified sum paid for the acquisition of a leasehold and in respect of the cost to a lessee of improvements on property of which he is the lessee. However, such deductions do not include deductions for the periodic payment of rent.

(3) *Depreciation of other taxpayers or in respect of other property.* (i) The depreciation adjustments (reflected in the adjusted basis) referred to in subparagraph (1) of this paragraph (*a*) are not limited to adjustments with respect to the property disposed of, nor to those allowed or allowable to the taxpayer disposing of such property, and (*b*) except as provided in subparagraph (4) of this paragraph, are taken into account, whether allowed or allowable in respect of the same or other property and whether to the taxpayer or to any other person. For manner of determining the amount of additional depreciation after certain dispositions, see paragraph (e) of this section.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example: On January 1, 1966, a calendar year taxpayer purchases for $100,000 a building for use in his trade or business. He takes depreciation deductions of $20,000 (the amount allowable), of which $3,000 is additional depreciation, and transfers the building to his son as a gift on January 1, 1968. Since the exception for gifts in section 1250(d)(1) applies, the taxpayer does not recognize gain under section 1250(a)(2). In the son's adjusted basis of $80,000 for the building there is reflected $3,000 of additional depreciation. On January 1, 1969, after taking a depreciation deduction of $10,000 (the amount allowable), of which $1,000 is additional depreciation, the son sells the building. At the time of the sale the additional depreciation is $4,000 ($3,000 allowed the father plus $1,000 allowed the son).

(4) *Depreciation allowed or allowable.* (i) For purposes of subparagraph (1) of this paragraph, generally all deductions (described in subparagraph (2) of this paragraph) allowed or allowable shall be taken into account. See section 1016(a)(2) and the regulations thereunder for the meaning of *allowed* and *allowable.* However, if a taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for any period was less than the amount allowable for such period, the amount to be taken into account for such period shall be the amount allowed. The preceding sentence shall not apply for purposes of computing under paragraph (b)(1)(ii) of this section the amount such deductions would have been under the straight line method.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

Example: In the year 1969 it becomes necessary to determine the additional depreciation in respect of section 1250 property, the adjusted basis of which reflects a depreciation adjustment of $1,000 with respect to depreciation deductions allowable for the calendar year 1965 under the sum of the years-digits method. Under paragraph (b)(1)(ii) of this section, the depreciation which would have resulted under the straight line method for 1965 is $800. If the taxpayer can establish by adequate records or other sufficient evidence that he did not take, and was not allowed, any deduction for depreciation in respect of the property in 1965, then, for purposes of computing the depreciation adjustments in excess of straight line in respect of the property, the amount to be taken into account for 1965 as allowed or allowable is zero, and the amount to be taken into account in computing deductions which would have resulted under the straight line method in 1965 is $800. Thus, in effect, there is a deficit in additional depreciation for 1965 of $800.

(5) *Retired or demolished property.* Depreciation adjustments referred to in subparagraph (1) of this paragraph generally do not include adjustments in respect of retired or demolished portions of an item of section 1250 property. If a retired or demolished portion is replaced in a disposition described in section 1250(d)(4)(A) (relating to like kind exchanges and involuntary conversions), see paragraph (d)(7) of §1.1250–3.

(6) *Exempt organization.* In respect of property disposed of by an organization which is or was exempt from income taxes (within the meaning of section 501(a), the depreciation adjustments (reflected in the adjusted basis) referred to in subparagraph (1) of this paragraph shall include only adjustments allowed or allowable (i) in computing unrelated business taxable income (as defined in section 512(a)), or (ii) in computing taxable income of the organization for a period during which it was not exempt or, by reason of the application of section 502, 503, or 504, was denied its exemption.

(e) *Additional depreciation immediately after certain acquisitions*—(1) *Zero.* If on the date a person acquires property his basis for the property is determined solely (i) by reference to its cost (within the meaning of section 1012), (ii) by reason of the application of section 301(d) (relating to basis of property received in corporate distribution) or section 334(a) (relating to basis of property received in a liquidation in which gain or loss is recognized), or (iii) under the rules of section 334 (b)(2) or (c) (relating to basis of property received in certain corporate liquidations), then on such date the additional depreciation for the property is zero.

(2) *Transactions referred to in section 1250(d).* In the case of property acquired in a disposition described in section 1250(d) (relating to exceptions and limitations to application of section 1250), additional depreciation shall be computed in accordance with the rules prescribed in §1.1250–3.

(f) *Records to be kept and information to be filed*—(1) *Records to be kept.* In any case in which it is necessary to determine the additional depreciation of an item of section 1250 property, the taxpayer shall have available permanent records of all the facts necessary to determine with reasonable accuracy the amount of such additional depreciation, including the following:

(i) The date, and the manner in which, the property was acquired,

(ii) The taxpayer's basis on the date the property was acquired and the manner in which the basis was determined,

(iii) The amount and date of all adjustments to the basis of the property allowed or allowable to the taxpayer for depreciation adjustments referred to in paragraph (d)(1) of this section and the amount and date of any other adjustments by the taxpayer to the basis of the property, and

(iv) In the case of section 1250 property which has an adjusted basis reflecting depreciation adjustments referred to in paragraph (d)(1) of this section taken by the taxpayer with respect to other property, or by another taxpayer with respect to the same or other property, the information described in subdivisions (i), (ii), and (iii) of this subparagraph with respect to such other property or such other taxpayer.

(2) *Information to be filed.* If a taxpayer acquires in a transaction (other than a like kind exchange or involuntary conversion described in section 1250(d)(4)) section 1250 property which has a basis reflecting depreciation adjustments referred to in paragraph (d)(1) of this section allowed or allowable to another taxpayer, then the taxpayer shall file with its income tax return or information return for the taxable year in which the property is acquired a statement showing all information described in subparagraph (1) of this paragraph. See section 6012 (relating to persons required to make returns of income) and part III of subchapter A of chapter 61 of the Code (relating to information returns).

[T.D. 7084, 36 FR 273, Jan. 8, 1971, as amended by T.D. 7193, 37 FR 12956, June 30, 1972]

§ 1.1250–3 Exceptions and limitations.

(a) *Exception for gifts*—(1) *General rule.* Section 1250(d)(1) provides that no gain shall be recognized under section 1250(a) upon a disposition by gift. For purposes of this paragraph, the term *gift* shall have the same meaning as in paragraph (a) of § 1.1245–4. For reduction in amount of charitable contribution in case of a gift of section 1250 property, see section 170(e) and paragraph (c)(3) of § 1.170–1.

(2) *Disposition in part a sale or exchange and in part a gift.* Where a disposition of property is in part a sale or exchange and in part a gift, the disposition shall be subject to the provisions of § 1.1250–1 and the gain to which section 1250(a) applies, shall be computed under that section.

(3) *Treatment of property in hands of transferee.* If property is disposed of in a transaction which is a gift:

(i) The additional depreciation for the property in the hands of the transferee immediately after the disposition shall be an amount equal to (a) the amount of the additional depreciation for the property in the hands of the transferor immediately before the disposition, minus (b) the amount of any gain (in case the disposition is in part a sale or exchange and in part a gift) which would have been taken into account under section 1250(a) by the transferor upon the disposition if the applicable percentage had been 100 percent.

(ii) For purposes of computing the applicable percentage, the holding period under section 1250(e)(2) of property received as a gift in the hands of the transferee includes the transferor's holding period,

(iii) In case of a disposition which is in part a sale or exchange and in part a gift, if the adjusted basis of the property in the hands of the transferee exceeds its adjusted basis immediately before the transfer, the excess is an addition to capital account under paragraph (d)(2)(ii) of § 1.1250–5 (relating to property with 2 or more elements), and

(iv) If the property disposed of consists of two or more elements within the meaning of paragraph (c) of § 1.1250–5, see paragraph (e)(1) of § 1.1250–5 for the amount of additional depreciation and holding period for each element in the hands of the transferee.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. (i) On May 15, 1967, Smith transfers section 1250 property to his son for $45,000. In the hands of Smith the property had an adjusted basis of $40,000 and a fair market value of $70,000. Thus, the gain realized is $5,000 (amount realized, $45,000, minus adjusted basis, $40,000), and Smith has made a gift of $25,000 (fair market value, $70,000, minus amount realized, $45,000).

(ii) Smith's holding period for the property is 80 full months and, thus, the applicable percentage under section 1250(a)(2) is 40 percent. The additional depreciation for the property is $10,000. Since the gain realized ($5,000) is lower than the additional depreciation ($10,000), Smith recognized as ordinary income under section 1250(a)(2) gain of $2,000 (that is, applicable percentage, 40 percent, multiplied by gain realized, $5,000) and the $3,000 remaining portion of the gain realized may be treated as gain from the sale of property described in section 1231.

(iii) On the date the son receives the property, the additional depreciation for the property in his hands is $5,000, that is, the additional depreciation for the property in the hands of the father immediately before the transfer ($10,000), minus the gain which would have been recognized under section 1250(a)(2) upon the transfer if the applicable percentage had been 100 percent ($5,000); for purposes of computing applicable percentage his holding period is his father's holding period of 80 full months; and under §1.1015–4 his unadjusted basis for the property is $45,000, that is, the amount he paid ($45,000) plus the excess (zero) of his father's adjusted basis over such amount.

(iv) The son sells the property for $80,000 on March 15, 1968, 10 full months after he received it from his father. Thus, his holding period is 90 full months (his father's holding period of 80 full months plus the 10 full months the son actually owned the property) and the applicable percentage under section 1250(a)(2) is 30 percent. Assume that no depreciation was allowed or allowable to the son. Thus, the son's adjusted basis and additional depreciation for the property on the date of the sale is the same as on the date he received it. Accordingly, the gain realized is $35,000 (selling price of $80,000, minus adjusted basis of $45,000). Since the additional depreciation ($5,000) is lower than the gain realized ($35,000), the son recognizes as ordinary income under section 1250(a)(2) gain of $1,500, that is, applicable percentage (30 percent) multiplied by additional depreciation ($5,000).

Example 2. Assume the same facts as in example (1), except that the son sells the property on June 15, 1969, 25 full months after he received it from his father. Thus, his holding period is 105 full months (his father's holding period of 80 full months plus the 25 full months the son actually owned the property) and the applicable percentage under section 1250(a)(2) is 15 percent. Assume further that on the date of the sale the adjusted basis of the property is $39,000, and that for the period the son actually owned the property there is a deficit in additional depreciation of $2,000. Accordingly, the gain realized is $41,000 (selling price of $80,000, minus adjusted basis of $39,000), and the additional depreciation for the property is $3,000 (that is, the additional depreciation for the property in the hands of the son on the date he received it, as determined in example (1), $5,000, minus the amount of the deficit in additional depreciation for the period the son actually owned the property, ($2,000). Since the additional depreciation ($3,000) is lower than the gain realized ($41,000), the son recognizes as ordinary income under section 1250(a)(2) gain of $450, that is, applicable percentage (15 percent) multiplied by additional depreciation ($3,000).

(b) *Exception for transfers at death*—(1) *General rule.* Section 1250(d)(2) provides that, except as provided in section 691 (relating to income in respect of a decedent), no gain shall be recognized under section 1250(a) upon a transfer at death. For purposes of this paragraph, the term *transfer at death* shall have the same meaning as in paragraph (b) of §1.1245–4.

(2) *Treatment of transferee.* (i) If as of the date a person acquires property from a decedent such person's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the property on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), then (*a*) on the date of death the additional depreciation for the property is zero, and (*b*) for purposes of computing applicable percentage the holding period of the property under section 1250(e)(1)(A) is deemed to begin on the day after the date of death.

(ii) If property is acquired in a transfer at death to which section 1250(d)(2) applies, the amount of the additional depreciation for the property in the hands of the transferee immediately after the transfer shall be the amount (if any) of the additional depreciation in respect of the property allowed the transferee before the decedent's death, but only to the extent that the basis of the property (determined under section 1014(a)) is required to be reduced under the second sentence of section 1014(b)(9) (relating to adjustments to basis where property is acquired from a decedent prior to his death) by depreciation adjustments referred to in paragraph (d)(1) of § 1.1250–2 which give rise to such additional depreciation. For treatment of such property as having a special element with additional depreciation so computed, see paragraph (c)(5)(i) of § 1.1250–5 (relating to property with two or more elements). For purposes of determining applicable percentage, such special element shall have a holding period which includes the transferee's holding period for such property for the period before the decedent's death.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. On March 6, 1966, Smith dies owning an item of section 1250 property. On March 7, 1968, the executor distributes the property to Smith's son pursuant to a specific bequest of the property in Smith's will. Under section 1014(a)(2) and paragraph (a)(2) of § 1.1014–4, the unadjusted basis of the property in the hands of the son is its fair market value on March 6, 1966 (the date Smith died), and the son is considered to have acquired the property on such date. Under section 1250(e)(1)(A), the son's holding period for the property begins on March 7, 1966 (the day after the day he is considered to have acquired the property). Thus, on March 7, 1968 (the date the property was distributed to the son), the holding period for the property is 24 full months, and the applicable percentage under section 1250(a)(2) is 96 percent. On such date, the additional depreciation for the property includes any additional depreciation in respect of the property for the period the property was possessed by the estate.

Example 2. H purchases section 1250 property in 1965 which he immediately conveys to himself and W, his wife, as tenants by the entirety. Under local law each spouse is entitled to one-half the income from the property. H and W file joint income tax returns for calendar years 1965, 1966, and 1967. Over the 3 years, depreciation allowed in respect of the property was $4,000 (the amount allowable) of which $500 is additional depreciation. One-half of these amounts are allocable to W. Thus, depreciation deductions of $2,000, of which $250 is additional depreciation, are allowable to W. On January 1, 1968, H dies and the entire value of the property at the date of death is included in H's gross estate. Since W's basis for the property (determined under section 1014(a)) is reduced (under the second sentence of section 1014(b)(9)) by the $2,000 depreciation deductions allowed W before H's death of which $250 is additional depreciation, the additional depreciation for the property in the hands of W immediately after H's death is $250.

(c) *Limitation for certain tax-free transactions*—(1) *General.* Section 1250(d)(3) provides that upon a transfer of property described in subparagraph (2) of this paragraph, the amount of gain taken into account by the transferor under section 1250(a) shall not exceed the amount of gain recognized to the transferor on the transfer (determined without regard to section 1250). For purposes of this subparagraph, in case of a transfer of both section 1250 property and nonsection 1250 property in one transaction, the amount realized from the disposition of the section 1250 property shall be deemed to consist of that portion of the fair market value of each property acquired which bears the same ratio to the fair market value of such acquired property as the amount realized from the disposition of the section 1250 property bears to the total amount realized. The preceding sentence shall be applied solely for purposes of computing the portion of the total gain (determined without regard to section 1250) which shall be recognized as ordinary income under section 1250(a). Section 1250(d)(3) does not apply to a disposition of property to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 of the Code.

(2) *Transfers covered.* The transfers described in this subparagraph are transfers of property in which the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(i) Section 332 (relating to distributions in complete liquidation of an 80 percent or more controlled subsidiary corporation). For application of section 1250(d)(3) to such a complete liquidation, the principles of paragraph (c)(3) of § 1.1245–4 shall apply.

(ii) Section 351 (relating to transfer to a corporation controlled by transferor).

(iii) Section 361 (relating to exchanges pursuant to certain corporate reorganizations).

(iv) Section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings).

(v) Section 374(a) (relating to exchanges pursuant to certain railroad reorganizations).

(vi) Section 721 (relating to transfers to a partnership in exchange for a partnership interest).

(vii) Section 731 (relating to distributions by a partnership to a partner). For special carryover basis rule, see section 1250(d)(6)(A) and paragraph (f)(1) of this section.

(3) *Treatment of property in hands of transferee.* In the case of a transfer described in subparagraph (2) (other than subdivision (vii) thereof) of this paragraph:

(i) The additional depreciation for the property in the hands of the transferee immediately after the disposition shall be an amount equal to (*a*) the amount of the additional depreciation for the property in the hands of the transferor immediately before the disposition, minus (*b*) the amount of additional depreciation necessary to produce an amount equal to the gain taken into account under section 1250(a) by the transferor upon the disposition (taking into account the applicable percentage for the property),

(ii) For purposes of computing applicable percentage, the holding period under section 1250(e)(2) of the property in the hands of the transferee includes the transferor's holding period,

(iii) If the adjusted basis of the property in the hands of the transferee exceeds its adjusted basis immediately before the transferee, the excess is an addition to capital account under paragraph (d)(2)(ii) of §1.1250–5 (relating to property with 2 or more elements), and

(iv) If the property disposed of consists of 2 or more elements within the meaning of paragraph (c) of §1.1250–5, see paragraph (e)(1) of §1.1250–5 for the amount of additional depreciation and the holding period for each element in the hands of the transferee.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. (i) Green transfers section 1250 property on March 1, 1968, to a corporation, which is not exempt from taxation, in exchange for cash of $9,000 and stock in the corporation worth $91,000, in a transaction qualifying under section 351. Thus, the amount realized is $100,000 ($9,000 plus $91,000). The property has an applicable percentage under section 1250(a)(2) of 60 percent, an adjusted basis of $40,000, and additional depreciation of $20,000. The gain realized is $60,000, that is, amount realized ($100,000) minus adjusted basis ($40,000). Since the additional depreciation ($20,000) is lower than the gain realized ($60,000), the amount of gain which would be treated as ordinary income under section 1250(a)(2) would be $12,000 (60 percent of $20,000) if the limitation provided in section 1250(d)(3) did not apply. Since under section 351(b) gain in the amount of $9,000 would be recognized to the transferor without regard to section 1250, the limitation provided in section 1250(d)(3) limits the gain taken into account by the transferor under section 1250(a)(2) to $9,000.

(ii) The amount of additional depreciation for the property in the hands of the transferee immediately after the transfer is $5,000, that is, the amount of additional depreciation before the transfer ($20,000) minus the amount of additional depreciation necessary to produce an amount equal to the gain recognized under section 1250(a)(2) upon the transfer ($15,000, that is, $9,000 of gain recognized divided by 60 percent, the applicable percentage). (If the property is subsequently disposed of, and for the period after the initial transfer there is additional depreciation in respect of the property, then at the time of the subsequent disposition the additional depreciation will exceed $5,000. If, however, for the period after the initial transfer there was a deficit in additional depreciation, then at the time of the subsequent disposition the additional depreciation would be less than $5,000.)

Example 2. (i) Assume the same facts as in example (1) except that the additional depreciation is $10,000. Since additional depreciation ($10,000) is lower than the gain realized ($60,000), the amount of gain which would be treated as ordinary income under section 1250(a)(2) would be $6,000 (60 percent of $10,000) if the limitation provided in section 1250(d)(3) did not apply. Since under section 351(b) gain in the amount of $9,000 would be recognized to the transferor without regard to section 1250, the limitation under section 1250(d)(3) does not prevent treatment of the entire $6,000 as ordinary income under section 1250(a)(2). The $3,000 remaining portion of the $9,000 gain may be treated as gain from the sale of property described in section 1231.

(ii) Immediately after the transfer, the amount of additional depreciation is zero, that is, the amount of additional depreciation before the transfer ($10,000) minus the amount of additional depreciation necessary to produce an amount equal to the gain taken into account under section 1250(a)(2) upon the transfer ($10,000) that is, $6,000 divided by 60 percent.

Example 3. (i) Miller transfers section 1250 property after December 31, 1969, to a corporation, which is not exempt from taxation, in exchange for cash of $9,000 and stock in the corporation worth $31,000, in a transaction qualifying under section 351. Thus, the amount realized is $40,000 ($9,000 plus $31,000). The property has an applicable percentage under paragraph (d)(1)(i)(*e*) of this section of 100 percent and an applicable percentage under paragraph (d)(2) of this section of 50 percent. The adjusted basis of the property on the date of the transfer is $24,000, and the gain realized is $16,000 (that is, amount realized, $40,000, minus adjusted basis, $24,000). The additional depreciation attributable to periods after December 31, 1969, is $8,000 and the additional depreciation attributable to periods before January 1, 1970, is $12,000. Since the additional depreciation attributable to periods after December 31, 1969 ($8,000), is lower than the gain realized ($16,000), the amount of gain which would be recognized as ordinary income under section 1250(a)(1) would be $8,000 (100 percent of $8,000) if the limitation provided in section 1250(d)(3) did not apply. In addition, gain is recognized under section 1250(a)(2) since there is a remaining potential gain of $8,000 (that is, gain realized, $16,000, minus additional depreciation attributable to periods after December 31, 1969 ($8,000)). Since the remaining potential gain ($8,000) is lower than the additional depreciation attributable to periods before January 1, 1970 ($12,000), the amount of gain which would be recognized under section 1250(a)(2) would be $4,000 (50 percent of $8,000) if the limitation in section 1250(d)(3) did not apply. Since under section 351(b) gain in the amount of $9,000 would be recognized to the transferor without regard to section 1250, the limitation in section 1250(d)(3) limits the gain taken into account by the transferor under section 1250(a) to $9,000. Since the section 1250(a)(1) gain is considered as recognized first under paragraph (a)(1)(iii) of § 1.1250–1, of the $9,000 of gain recognized, $8,000 is recognized under section 1250(a)(1) and $1,000 is recognized under section 1250(a)(2).

(ii) The amount of additional depreciation for the property in the hands of the transferee immediately after the transfer is $10,000, the amount of additional depreciation immediately before the transfer ($20,000), minus the sum of (*a*) the amount of additional depreciation necessary to produce an amount equal to the gain recognized under section 1250(a)(1) upon the transfer, $8,000 (that is, gain recognized under section 1250(a)(1), $8,000, divided by 100 percent, the applicable percentage under section 1250(a)(1)), plus (*b*) the amount of additional depreciation necessary to produce an amount equal to the gain recognized under section 1250(a)(2) upon the transfer, $2,000 (that is, gain recognized under section 1250(a)(2), $1,000, divided by 50 percent, the applicable percentage under section 1250(a)(2)). Of this amount, zero (that is, $8,000 minus $8,000) is attributable to periods after December 31, 1969, and $10,000 ($12,000 minus $2,000) is attributable to periods before January 1, 1970.

(d) *Limitation for like kind exchanges and involuntary conversions*—(1) *Limitation on gain.* (i) Under section 1250(d)(4)(A), if property is disposed of and gain (determined without regard to section 1250) is not recognized in whole or in part under section 1031 (relating to like kind exchanges) or section 1033 (relating to involuntary conversions), then the amount of gain taken into account by the transferor under section 1250(a) shall not exceed the greater of the two limitations set forth in subdivisions (ii) and (iii) of this subparagraph. Immediately after the transfer the basis of the acquired property shall be determined under subparagraph (2), (3), or (4) (whichever is applicable) of this paragraph, and its additional depreciation shall be computed under subparagraph (5) of this paragraph. The holding period of the acquired property for purposes of computing applicable percentage, which is determined under section 1250(e)(1), does not include the holding period of the property disposed of. In the case of a disposition of section 1250 property and other property in one transaction, see subparagraph (6) of this paragraph. In case of a disposition described in section 1250(d)(4)(A) of a portion of this item of property, see subparagraph (7) of this paragraph.

(ii) For purposes of this subparagraph, the first limitation is the sum of:

(*a*) The amount of gain recognized on the disposition under section 1031 or 1033 (determined without regard to section 1250), plus

(*b*) An amount equal to the cost of any stock purchased in a corporation which (without regard to section 1250) would result in nonrecognition of gain under section 1033(a)(3)(A).

(iii) For purposes of this subparagraph, the second limitation is the excess (if any) of:

(*a*) The amount of gain which would (without regard to section 1250(d)(4)) be taken into account under section 1250(a), over

(*b*) The fair market value (or cost in the case of a transaction described in section 1033(a)(3)) of the section 1250 property acquired in the transaction.

(iv) The provisions of this subparagraph may be illustrated by the following example:

Example: A taxpayer receives $96,000 of insurance proceeds upon the destruction of section 1250 property by fire. If section 1250(d)(4)(A) did not apply to the disposition, $16,000 of gain would be recognized under section 1250(a). In acquisitions qualifying under section 1033(a)(3)(A), he uses $90,000 of the proceeds to purchase property similar or related in service or use to the property destroyed, of which $42,000 is for one item of section 1250 property and $48,000 is for one piece of land, and $5,000 of the proceeds to purchase stock in the acquisition of control of a corporation owning property similar or related in service or use to the property destroyed. The taxpayer properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain (determined without regard to section 1250) to $1,000, that is, the excess of the amount realized from the conversion ($96,000) over the cost of the property acquired in acquisitions qualifying under section 1033(a)(3)(A) ($95,000, that is, $90,000 plus $5,000). The amount of gain recognized under section 1250(a) is $6,000, determined in the following manner:

The first limitation:	
(*a*) Amount of gain recognized under section 1033(a)(3), determined without regard to section 1250(a)	$1,000
(*b*) Fair market value of stock in a corporation which qualifies under section 1033(a)(3)(A)	5,000
(*c*) Sum of (*a*) plus (*b*)	6,000
The second limitation:	
(*d*) Amount of gain which would be recognized under section 1250(a) if section 1250(d)(4) did not apply	16,000
(*e*) Cost of section 1250 property acquired in transaction	42,000
(*f*) Excess of (*d*) over (*e*)	0

Since the first limitation ($6,000) exceeds the second limitation (zero), the amount of gain recognized under section 1250(a) is $6,000. The balance ($10,000) of the gain realized ($16,000) is not recognized.

(2) *Basis of property purchased upon involuntary conversion into money.* (i) If section 1250 property is purchased in a compulsory or involuntary conversion to which section 1033(a)(3) applies, and if by reason of the application of section 1250(d)(4)(A) all or part of the gain computed under section 1250(a) is not taken into account, then the basis of the section 1250 property and other purchased property shall be determined under the rules prescribed in this subparagraph. See section 1250(d)(4)(D).

(ii) The total basis of all purchased property, the acquisition of which results in the nonrecognition of any part of the gain realized upon the transaction, shall be (*a*) its cost, reduced by (*b*) the portion of the total gain realized which was not recognized. To the extent that section 1250(d)(4)(A)(i) prevents the purchase of stock from resulting in nonrecognition of gain, the basis of purchased stock is its cost.

(iii) If purchased property consists of both section 1250 property and other property, the total basis computed under subdivision (ii) of this subparagraph shall be allocated between the section 1250 property (treated as a class) and the other property (treated as a class) in proportion to their respective costs, except that for purposes of this subdivision (but not subdivision (iv) of this subparagraph) the cost of the section 1250 property shall be deemed to be the excess of (*a*) its actual cost, over (*b*) the gain not taken into account under section 1250(a) by reason of the application of section 1250(d)(4)(A).

(iv) If the property acquired consists of more than one item of section 1250 property (or of more than one item of other property), the total basis of the section 1250 property (or of the other property), as computed under subdivisions (ii) and (iii) of this subparagraph, shall be allocated to each item of section 1250 property (or other property) in proportion to their respective actual costs.

(v) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Assume the same facts as in the example in subparagraph (1)(iv) of this paragraph. Assume further that the portion of the gain realized which was not recognized under section 1033(a)(3) or 1250(a) upon the transaction is $60,000, of which the gain computed under section 1250(a) which is not taken into account by reason of the application of section 1250(d)(4)(A) is $10,000, that is, the excess of the gain which would have been recognized under section 1250(a) if section 1250(d)(4)(A) did not apply ($16,000) over the gain recognized under section 1250(a) ($6,000). In such example $95,000 of proceeds were used to purchase property in acquisitions qualifying under section 1033(a)(3)(A) of which $42,000 was for section 1250 property, $48,000 for land, and $5,000 for stock in a corporation. The basis of each acquired property is determined in the following manner:

(*a*) Under subdivision (ii) of this subparagraph, the total basis of the acquired properties (other than the stock) is $30,000, that is, their cost ($90,000, of which $42,000 is for section 1250 property and $48,000 is for land), reduced by the portion of the total gain realized which was not recognized ($60,000).

(*b*) Under subdivision (iii) of this subparagraph, such total basis is allocated between the section 1250 property and the land in proportion to their respective costs, and for this purpose the cost of the section 1250 property is considered to be $32,000, that is, its actual cost ($42,000) minus the gain not recognized under section 1250(a) by reason of the application of section 1250(d)(4)(A) ($10,000). Thus, the basis of the section 1250 property is $12,000 (32/80 of $30,000), and the basis of the land is $18,000 (48/80 of $30,000).

(*c*) The basis of the purchased stock is its cost of $5,000. See last sentence of subdivision (ii) of this subparagraph.

Example 2. Assume the same facts as in example (1) except that the section 1250 property purchased for $42,000 consists of 2 items of such property ($10,500 for C, and $31,500 for D), and that the land purchased for $48,000 consists of 2 pieces of land ($12,000 for X, and $36,000 for Y). Under subdivision (iv) of this subparagraph, the total basis for each class of property is allocated between the individual properties of such class in proportion to their respective actual costs. Thus, the total basis of $12,000, as determined in example (1), for the section 1250 property is allocated as follows:

To C: $12,000×($10,500/$42,000)	$3,000
To D: $12,000×($31,500/$42,000)	9,000
Total	12,000

The total basis of $18,000, as determined in example (1), for the land is allocated as follows:

To X: $18,000×($12,000/$48,000)	$4,500
To Y: $18,000×($36,000/$48,000)	13,500
Total	18,000

(3) *Basis of property acquired upon involuntary conversion into similar property.* If property is involuntarily converted into property similar or related in service or use in a transaction to which section 1033(a)(1) applies, and if by reason of the application of section 1250(d)(4)(A) all or part of the gain computed under section 1250(a) is not taken into account, then:

(i) The total basis of the acquired property shall be determined under the first sentence of section 1033(c), and

(ii) If more than one item of property is acquired, such total basis shall be allocated to the individual items of property acquired in accordance with the principles prescribed in subparagraph (2) (iii) and (iv) of this paragraph, except that an amount equivalent to the fair market value of each item of property on the date acquired shall be treated as its actual cost.

(4) *Basis of property acquired in like kind exchange.* If section 1250 property is transferred in an exchange described in section 1031 (a) or (b), and if by reason of the application of section 1250(d)(4)(A) all or part of the gain computed under section 1250(a) is not taken into account, then:

(i) The total basis of the property (including nonsection 1250 property) acquired of the type permitted to be received under section 1031 without recognition of gain or loss shall be determined under section 1031(d), and

(ii) If more than one item of property of such type was received, such total basis shall be allocated to the individual items of property of such type in accordance with the principles prescribed in subparagraph (2) (iii) and (iv) of this paragraph, except that an amount equivalent to the fair market value of each such item of property on the date received shall be treated as its actual cost.

(5) *Additional depreciation for property acquired in like kind exchange or involuntary conversion.* (i) If property is disposed of in a transaction described in section 1031 or 1033, and if by reason of the application of section 1250(d)(4)(A) all or part of the gain computed under section 1250(a) is not taken into account, then the additional depreciation for the acquired property immediately after the transaction (as computed under section 1250(d)(4)(E)) shall be an amount equal to the amount of gain computed under section 1250(a) which

was not taken into account by reason of the application of section 1250(d)(4)(A).

(ii) In case more than one item of section 1250 property is acquired in the transaction, the additional depreciation computed under subdivision (i) of this subparagraph shall be allocated to each such item of section 1250 property in proportion to their respective adjusted bases.

(iii) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. (a) On January 15, 1969, section 1250 property X is condemned and proceeds of $100,000 are received. On such date, X's adjusted basis is $25,000, the additional depreciation is $10,000, and the applicable percentage under section 1250(a)(2) is 70 percent. Since the additional depreciation ($10,000) is less than the gain realized ($75,000, that is, $100,000 minus 25,000) the amount of gain computed under section 1250(a)(2) (without regard to section 1250(d)(4)(A)) is $7,000, that is, 70 percent of $10,000.

(b) On March 1, 1969, all the proceeds are used to purchase section 1250 property Y in a transaction qualifying under section 1033(a)(3)(A) for nonrecognition of gain. Accordingly, the gain not recognized by reason of the application of section 1033(a)(3)(A) is $75,000, of which $7,000 is gain computed under section 1250(a)(2) which is not taken into account by reason of the application of section 1250(d)(4)(A). See subparagraph (1) of this paragraph.

(c) Immediately after the transaction, Y's basis is $25,000, that is, its cost ($100,000) minus the total gain realized which was not recognized ($75,000), and the additional depreciation (as computed under section 1250(d)(4)(E)) is $7,000, that is, the amount of gain not taken into account under section 1250(a)(2) by reason of the application of section 1250(d)(4)(A).

(d) On December 15, 1969, before any depreciation deductions were allowed or allowable in respect of Y, Y is sold for $90,000. Under section 1250(e)(1), the holding period of Y is 9 months, and thus, under section 1250(a)(2), the applicable percentage is 100 percent. Since the additional depreciation ($7,000) is less than the gain realized ($65,000, that is $90,000 minus $25,000), the amount of gain recognized under section 1250(a)(2) as ordinary income is $7,000, that is, 100 percent of $7,000.

Example 2. Assume the same facts as in example (1), except that property Y was purchased on June 15, 1962, and that 90 full months thereafter, or December 15, 1969, it is sold for $35,000. Thus the applicable percentage under section 1250(a)(2) is 30 percent. Assume further that at the time of such sale Y's adjusted basis is $5,000 and additional depreciation in respect of Y for periods after it was acquired is $2,500. Thus, the additional depreciation at the time of the sale is $9,500, that is, the sum of the additional depreciation in respect of Y attributable to X as computed under section 1250(d)(4)(E) in (*c*) of example (1) ($7,000), plus the additional depreciation attributable to periods after Y was acquired ($2,500). Since the additional depreciation ($9,500) is less than the gain realized ($30,000, that is, $35,000 minus $5,000), the gain recognized under section 1250(a)(2) as ordinary income is $2,850, that is, 30 percent of $9,500.

(6) *Single disposition of section 1250 property and property of different class.* (i) For purposes of this subparagraph:

(*a*) Section 1250 property, section 1245 property (as defined in section 1245(a)(3)), and other property shall each be treated as a separate class of property, and

(*b*) The term *qualifying property* means property which may be acquired without recognition of gain under the applicable provision of section 1031 or 1033 (applied without regard to section 1250 or 1245) upon the disposition of property.

(ii) If upon a sale of section 1250 property gain would be recognized under section 1250(a) and if such section 1250 property together with property of a different class or classes are disposed of in one transaction in which gain is not recognized in whole or in part under section 1031 or 1033 (without regard to sections 1245 and 1250), then:

(*a*) The total amount realized shall be allocated between the different classes of property disposed of in proportion to their respective fair market values,

(*b*) The amount realized upon the disposition of property of a class shall be deemed to consist of so much of the fair market value of qualifying property of the same class acquired as is not in excess of the amount realized from the property of such class disposed of,

(*c*) The remaining portion (if any) of the amount realized upon the disposition of property of such class shall be deemed to consist of so much of the fair market value of any other property acquired as is not in excess of such remaining portion, and

(*d*) For purposes of applying (*c*) of this subdivision, the fair market value of acquired property shall be taken into account only once and in such manner as the taxpayer determines.

(iii) The amounts determined under this subparagraph in respect of property shall apply for all purposes of the Code.

(iv) The application of this subparagraph may be illustrated by the following example:

Example: (a) Green owns property consisting of land and a fully equipped factory building thereon. The property is condemned and proceeds of $100,000 are received. If the property were sold for $100,000, gain of $40,000 would be recognized of which $10,000 would be recognized as ordinary income under section 1250(a). Proceeds of $95,000 are used to purchase property similar or related in service or use to the condemned property and under section 1033(a)(3)(A) (without regard to sections 1245 and 1250) recognition of gain is limited to $5,000. The fair market values by classes of the property disposed of, and of the property acquired, are summarized in the table below:

	Fair market value of property	
	Disposed of	Acquired
Section 1245 property	$35,000	$55,000
Section 1250 property	45,000	28,000
Land	20,000	12,000
Cash		5,000
	100,000	100,000

(*b*) The allocations under subdivision (ii) of this subparagraph are summarized in the table below:

Property disposed of	Property acquired			Cash Remaining
	Sec. 1245 Property	Sec. 1250 Property	Land	
$35,000 of section 1245 property	$35,000			
$45,000 of section 1250 property	[1] 17,000	$28,000		
$20,000 of land	[1] 3,000		$12,000	[1] $5,000
Total	55,000	28,000	12,000	5,000

[1] Determined by taxpayer pursuant to subdivision (ii)(d) of this subparagraph.

(*c*) Upon the disposition of the section 1245 property, only section 1245 property is acquired, and thus gain (if any) would not be recognized under section 1245(a)(1). See section 1245(b)(4). Upon the disposition of the section 1250 property gain under section 1250(a) would not be recognized by reason of the application of section 1250(d)(4)(A). See subparagraph (1) of this paragraph. If the gain realized on the disposition of the land is not less than $5,000, then under section 1033(a)(3)(A) the gain recognized would be $5,000, that is, an amount equal to the portion of the proceeds from the disposition of the land ($5,000) not invested in qualifying property.

(7) *Disposition of portion of property*. A disposition described in section 1250(d)(4)(A) of a portion of an item of property gives rise to an addition to capital account described in the last sentence of paragraph (d)(2)(i) of § 1.1250–5 (relating to property with 2 or more elements). If the addition to capital account is a separate improvement within the meaning of paragraph (d) of § 1.1250–5, and thus an element, then immediately after the addition is made the amount of additional depreciation for such separate improvement shall be computed under subparagraph (5) of this paragraph by treating such portion and such addition as separate properties. If the addition is not a separate improvement, then immediately after the addition is made such property is considered under paragraph (c)(5)(ii) of § 1.1250–5 as having a special element with the same amount of additional depreciation so computed. For purposes of computing applicable percentage, the holding period of the separate improvement or special element (as the case may be), which is determined under section 1250(e)(1), does not include the holding period of the property disposed of.

(e) *Sections 1071 and 1081 transactions*—(1) *General.* This paragraph prescribes regulations under section 1250(d)(5) which apply in the case of a disposition of section 1250 property in a transaction in which gain (determined without regard to section 1250) is not recognized in whole or in part by reason of the application of section 1071 (relating to gain from sale or exchange to effectuate policies of FCC) or section 1081 (relating to gain from sale or exchange in obedience to order of SEC).

(2) *Involuntary conversion treatment under section 1071.* If section 1250 property is disposed of and gain (determined without regard to section 1250) is not recognized in whole or in part solely by reason of an election under the first sentence of section 1071(a) to treat the transaction as an involuntary conversion, the consequences of the transaction shall be determined under the principles of paragraph (d) of this section.

(3) *Basis reduction under sections 1071 or 1082(a)(2).* (i) If section 1250 property is disposed of and gain (determined without regard to section 1250) is not recognized in whole or in part by reason of a reduction in basis of property pursuant to an election under section 1071(a) or the application of section 1082(a)(2), then the amount of gain taken into account by the transferor under section 1250(a) shall not exceed the sum of:

(*a*) The amount of gain recognized on such disposition (determined without regard to section 1250), plus

(*b*) In case involuntary conversion treatment was also elected under section 1071(a), an amount equal to the cost of any stock purchased in a corporation which (without regard to section 1250) would result in nonrecognition of gain under section 1033(a)(3), as modified by section 1071(a), plus

(*c*) The portion of the gain computed under section 1250(a) (without regard to this paragraph) which is neither taken into account under (*a*) or (*b*) of this subdivision nor applied under subdivision (ii) of this subparagraph to reduce the basis of section 1250 property.

(ii)(*a*) The amount of gain computed under section 1250(a) (without regard to this paragraph) which is not taken into account under subdivision (i) (*a*) or (*b*) of this subparagraph shall be applied to the amount by which the basis of the section 1250 property was reduced under section 1071(a) or 1082(a)(2), as the case may be, before other gain (which is not gain computed under section 1250(a)) is so applied.

(*b*) If the basis of more than one item of section 1250 property was so reduced, the gain applied under (*a*) of this subdivision to all such section 1250 properties shall be applied to such items in proportion to the amounts of their respective basis reductions.

(*c*) Any gain not applied under (*a*) of this subdivision shall be applied to the amount by which the basis of the non-section 1250 property was reduced.

(iii) If gain computed under section 1250 is applied under subdivision (ii) of this subparagraph to reduce the basis of section 1250 property, the amount so applied shall be treated as additional depreciation in respect of such section 1250 property. For treatment of such section 1250 property as having a special element with additional depreciation consisting of such amount, see paragraph (c)(5)(i) of §1.1250–5. For purposes of computing applicable percentage, such special element shall have a holding period beginning on the day after the date as of which the property's basis was so reduced.

(4) *Section 1081(d)(1)(A) transaction.* No gain shall be recognized under section 1250(a) upon an exchange of property as to which gain is not recognized (without regard to section 1250) because of the application of section 1081(d)(1)(A) (relating to transfers within system group). For treatment of property in the hands of a transferee, the principles of paragraph (c)(3) of this section shall apply.

(f) *Property distributed by a partnership to a partner*—(1) *General.* For purposes of section 1250 (d)(3) and (e)(2), the basis of section 1250 property distributed by a partnership to a partner shall be determined by reference to the adjusted basis of such property to the partnership. Thus, if section 731 applies to a distribution of section 1250 property by a partnership to a partner, then even though the partner's basis is not determined for other purposes by reference to the partnership's basis, (i) the amount of gain taken into account by the partnership under section 1250(a) is limited by section 1250(d)(3) to the amount of gain recognized to the partnership upon the distribution (determined without regard to section 1250), and (ii) the holding period of the property in the hands of the partner shall, under section 1250(e)(2), include the holding period of the property in the hands of the partnership. For nonapplication of section 1250(d)(3) to a disposition to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 of the Code, see paragraph (c)(1) of this section.

(2) *Treatment of property distributed by partnership.* (i) If section 1250 property is distributed by a partnership to a partner in a distribution in which no part of the partnership's *potential section 1250 income* in respect of the property was recognized as ordinary income to the partnership under paragraph (b)(2)(ii) of §1.751–1, the additional depreciation for the property in the hands of the distributee attributable to periods before the distribution shall be an amount equal to the total potential section 1250 income of the partnership in respect of the property immediately before the distribution, recomputed as if the applicable percentage for the property had been 100 percent. Under paragraph (c)(4) of §1.751–1, the potential section 1250 income is, in effect, the gain to which section 1250(a) would have applied if the property had been sold by the partnership immediately before the distribution at its fair market value at such time.

(ii) If upon the distribution any potential section 1250 income in respect of the property was recognized to the partnership under paragraph (b)(2)(ii) of §1.751–1, then after the distribution the additional depreciation shall be an amount equal to (*a*) the total potential section 1250 income in respect of the property, as recomputed in subdivision (i) of this subparagraph, minus (*b*) the amount of potential section 1250 income which would have been recognized to the partnership under paragraph (b)(2)(ii) of §1.751–1 if the applicable percentage for the property had been 100 percent.

(iii) If the partner's basis for the property immediately after the transaction exceeds the partnership's adjusted basis for the property immediately before the transaction, the excess may be an addition to capital account under paragraph (d)(2)(ii) of §1.1250–5 (relating to property with two or more elements).

(3) *Examples.* The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. (i) A partnership distributes a building to Smith on January 1, 1969, in a complete liquidation of his partnership interest to which section 736(a) does not apply. On the date of the distribution, the partnership's holding period for the property is 40 full months and, accordingly, the applicable percentage under section 1250(a)(2) is 80 percent. On such date, the partnership's additional depreciation for the building ($6,250) is lower than the excess ($40,000) of its fair market value ($140,000) over adjusted basis ($100,000). Thus, under paragraph (c)(4) of §1.751–1, the partnership's potential section 1250 income in respect of the building is $5,000 (80 percent of $6,250). Assume that section 751(b) does not apply to the distribution. Accordingly, no gain would be recognized to the partnership under section 731(b) (without regard to the application of section 1250). Smith's basis for his partnership interest was $150,000, and under section 732(b) Smith's basis for the building is equal to his basis for his partnership interest. Thus, Smith's basis for the building is not determined by reference to the partnership's basis for the building. Nevertheless, under subparagraph (1) of this paragraph, no gain is recognized to the partnership under section 1250(a)(2) and Smith's holding period for the property includes the partnership's holding period.

(ii) Six full months after Smith received the building in the distribution, or July 1, 1969, he sells it for $153,000. Assume that no depreciation was allowed or allowable to Smith for the building, and that the special rules under §1.1250–5 for property with two or more elements do not apply. Since Smith's holding period for the building includes its holding period in the hands of the partnership, his holding period is 46 full months (40 full months for the partnership plus 6 full months for Smith) and the applicable percentage under section 1250(a)(2) is 74 percent.

(iii) Since no potential section 1250 income was recognized to the partnership under paragraph (b)(2)(ii) of §1.751–1, the additional depreciation for the building attributable to periods before the distribution is determined under the provisions of subparagraph (2)(i) of this paragraph. Under such provisions, the potential section 1250 income to the partnership, which was actually $5,000 (that is, 80 percent of $6,250), is recomputed as if the applicable percentage were 100 percent, and thus such additional depreciation is $6,250 (that is, 100 percent of $6,250). Since no depreciation was allowed or allowable for the building in Smith's hands, the additional depreciation for the building attributable to Smith's total holding period (46 full months) is $6,250. Since the gain realized ($3,000, that is, amount realized, $153,000, minus adjusted basis, $150,000), is lower than the additional depreciation ($6,250), the gain recognized to Smith under section 1250(a)(2) is $2,220 (that is, 74 percent of $3,000).

Example 2. Assume the facts as in example (1) except that as a result of the distribution the partnership recognizes under paragraph (b)(2)(ii) of §1.751–1 potential section 1250 income of $1,000 (that is, 80 percent of $1,250). The additional depreciation attributable to periods before the distribution, as determined under the provisions of subparagraph (2)(ii) of this paragraph, is $5,000, that is, (*a*) the total potential section 1250 income in respect of the property, recomputed in example (1) as if the applicable percentage were 100 percent ($6,250), minus (*b*) the amount of potential section 1250 income which would have been recognized to the partnership under paragraph (b)(2)(ii) of §1.751–1 if the applicable percentage for the property had been 100 percent ($1,250, that is, 100 percent of $1,250).

(4) *Treatment of partnership property after certain transactions.* If under paragraph (b)(3) of §1.751–1 (relating to certain distributions of partnership property other than section 751 property treated as sales or exchanges) a partnership is treated as purchasing section 1250 property (or a portion thereof) from a distributee who relinquishes his interest in such property (or portion), then after the date of such purchase the following rules shall apply:

(i) If only a portion of the property is treated as purchased, there shall be excluded from the additional depreciation for the remaining portion any additional depreciation in respect of the purchased portion for periods before such purchase.

(ii) In respect of the purchased property (or portion), (*a*) as of the date of purchase the amount of additional depreciation shall be zero, and (*b*) for purposes of computing applicable percentage the holding period shall begin on the day after the date of such purchase.

(5) *Cross reference.* See paragraph (f) of §1.1250–1 for the amount of additional depreciation for partnership property in respect of a partner who acquired his partnership interest in certain transactions when an election under section 754 (relating to optional adjustments to basis of partnership property) was in effect.

(g) *Disposition of principal residence*—(1) *In general.* (i) Section 1250(d)(7)(A) provides that section 1250(a) shall not apply to a disposition of property by a taxpayer to the extent the property is used by the taxpayer as his principal residence (within the meaning of section 1034(a) and the regulations thereunder, relating to a sale or exchange of residence). Thus, for example, if a doctor sells a house, of which one portion was used as his principal residence within the meaning of section 1034(a) and the other portion was properly subject to the allowance for depreciation as property used in his trade or business, then, by reason of the application of section 1250(d)(7)(A), section 1250(a) does not apply in respect of the disposition of the portion used as his principal residence. The provisions of this subparagraph shall apply regardless of whether section 1034 applies. Thus, for example, if section 1034 did not apply to the sale because the doctor did not invest in a new principal residence within the period specified in section 1034, nevertheless section 1250(a) would not apply to the disposition of the portion used as a principal residence.

(ii) Section 1250(d)(7)(B) provides that section 1250(a) shall not apply to a disposition of section 1250 property by a taxpayer who, in respect of the property, satisfies the age and ownership requirements of section 121 (relating to exclusion from gross income of gain on sale or exchange of residence of individual who has attained age 65), but only to the extent the taxpayer satisfies the use requirements of section 121 in respect of such property. Thus, if a taxpayer has attained the age of 65 before the date on which he disposes of section 1250 property, and if during the 8-year period ending on the date of the disposition the property has been owned and used by the taxpayer solely as his principal residence for periods aggregating 5 years or more, then section 1250(a) does not apply in respect to the disposition. This result would not be changed even if the taxpayer does not or cannot make the election provided for in section 121 and even if section 121 applies to only a portion of the gain because the adjusted sales price exceeds the $20,000 limitation in section 121(b)(1). If, however, only a portion of the property has been used as his principal residence for such periods aggregating 5 years or more, then, by reason of the application of section

1250(d)(7)(B), section 1250(a) is inapplicable only to the portion so used. For special rules for determining whether the age, ownership, and use requirements of section 121 are treated as satisfied, and for the manner of applying such requirements, see section 121(d) and the regulations thereunder.

(2) *Concurrent operation of section 1250(d)(7) with other provisions.* Upon the disposition of a principal residence, gain computed under section 1250(a) may not be recognized in whole or in part by reason of the application of both the provisions of section 1250(d)(7) and the provisions of one of the other exceptions or limitations enumerated in section 1250(d). Thus, for example, if an entire house is transferred as a gift, and if section 1250(d)(7) applies to only a portion of the house, then section 1250(d)(1) excepts the disposition of the entire house from the application of section 1250(a).

(3) *Special rule.* If by reason of section 1250(d)(7) a disposition is partially excepted from the application of section 1250(a), and if no other paragraph of section 1250(d) excepts the disposition entirely from such application, then the gain to which section 1250(a) applies shall be an amount which bears the same ratio to (i) the gain computed under section 1250(a) (without regard to section 1250(d)(7)), as (ii) the fair market value of the portion of the property to which the exception in section 1250(d)(7) does not apply, bears to (iii) the total fair market value of the property. Thus, for example, if under paragraph (a)(2) of this section gain of $300 would be recognized as ordinary income under section 1250(a) (without regard to section 1250(d)(7)) upon a combined sale and gift of section 1250 property, and if the property has a fair market value of $25,000 of which $10,000 is properly allocable to a portion not used as a principal residence, then the amount of gain recognized as ordinary income under section 1250(a) would be $120 (10/25 of $300).

(4) *Treatment of property in hands of transferee.* If property is disposed of in a transaction to which section 1250(d)(7) applies, and if its basis in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 1250(d)(1) (relating to gifts) or section 1250(d)(3) (relating to certain tax-free transactions), then the treatment of the property in the hands of the transferee shall be determined under paragraph (a)(3) or (c)(3) (whichever is applicable) of this section

(5) *Treatment of property acquired in like kind exchange or involuntary conversion.* If property is disposed of in a transaction to which section 1250(d)(7) (relating to principal residence) and section 1250(d)(4) (relating to like kind exchanges and involuntary conversions) apply, then:

(i) The basis of the property acquired shall be determined under the applicable provisions of paragraph (d) (2), (3), or (4) of this section, applied as if all gain computed under section 1250(a) (except any gain not recognized solely by reason of the application of section 1250(d)(7)) were not taken into account by reason of section 1250(d)(4)(A),

(ii) The additional depreciation for the property acquired shall be determined in the manner prescribed in paragraph (d)(5) of this section, so applied, and

(iii) For purposes of computing the applicable percentage, the holding period of the acquired property shall be determined under section 1250(e)(1).

(6) *Treatment of property acquired in section 1034 transaction.* If a principal residence is disposed of in a transaction to which section 1250(d)(7) applies, and if by reason of the application of section 1034 (relating to sale or exchange of residence) the basis of property acquired in the transaction is determined by reference to the basis in the hands of the taxpayer of the property disposed of, then:

(i) The additional depreciation for the acquired property immediately after the transaction shall be an amount equal to (*a*) the amount of the additional depreciation for the property disposed of, minus (*b*) the amount of any gain which would have been taken into account under section 1250(a) by the transferor upon the disposition if the applicable percentage for the property had been 100 percent,

(ii) For purposes of computing the applicable percentage, the holding period of the acquired property includes the holding period of the disposed of property (see section 1250(e)(3)),

(iii) If the adjusted basis of the acquired property exceeds the adjusted basis immediately before the transfer of the property disposed of, the excess is an addition to capital account under paragraph (d)(2)(ii) of §1.1250–5 (relating to property with more than one element), and

(iv) If the property disposed of consisted of two or more elements within the meaning of paragraph (c) of §1.1250–5, see paragraph (e)(3) of §1.1250–5 for the amount of additional depreciation and the holding period for each element in the hands of the transferee.

(h) *Limitation for disposition of qualified low-income housing*—(1) *Limitation on gain.* (i) Under section 1250(d)(8)(A), if section 1250 property is disposed of and gain (determined without regard to section 1250) is not recognized in whole or in part under section 1039 (relating to certain sales of low-income housing projects), then the amount of gain recognized by the transferor under section 1250(a) shall not exceed the greater of:

(*a*) The amount of gain recognized under section 1039 (determined without regard to section 1250), or

(*b*) The excess, if any, of the amount of gain which would, but for section 1250(d)(8)(A), be taken into account under section 1250(a), over the cost of the section 1250 property acquired in the transaction.

For purposes of this paragraph the term *qualified housing project, approved disposition, reinvestment period,* and *net amount realized* shall have the same meaning as in section 1039 and §1.1039–1.

(ii) The principles of this subparagraph may be illustrated by the following examples:

Example 1. (i) Taxpayer A owns a qualified housing project and makes an approved disposition of the project on January 1, 1971. The net amount realized upon the disposition is $550,000, of which $475,000 is attributable to section 1250 property. The adjusted basis of the section 1250 property is $250,000 and the gain realized on the disposition of section 1250 property is $225,000. The additional depreciation for the property is $100,000, the applicable percentage is 48 percent, and if section 1250(d)(8)(A) did not apply to the disposition, $48,000 of gain would be recognized under section 1250(a). Within the reinvestment period, A purchases a replacement qualified housing project at a cost of $525,000, of which $425,000 is attributable to section 1250 property. A properly elects under section 1039(a) and the regulations thereunder to limit the recognition of gain (determined without regard to section 1250) to $25,000, that is, the excess of the net amount realized ($550,000) over the cost of the replacement housing project ($525,000).

(ii) The amount of gain recognized under section 1250(a) is limited to $25,000, that is, the greater of (*a*) the amount of gain recognized without regard to section 1250(a) ($25,000), or (*b*) the excess of (*1*) the amount of gain which would be taken into account under section 1250(a) if section 1250(d)(8)(A) did not apply ($225,000), over (*2*) the cost of the replacement section 1250 property ($425,000), or zero.

Example 2. The facts are the same as in example (1) except that only $180,000 of the cost of the replacement housing project is attributable to section 1250 property. Thus, the gain recognized under section 1250(a) is limited to $45,000, the greater of (*a*) the excess of (*1*) the amount of gain which would be taken into account under section 1250(a) if section 1250(d)(8)(A) did not apply ($225,000), over (*2*) the cost of the replacement section 1250 property ($180,000), or (*b*) the amount of gain recognized without regard to section 1250 ($25,000).

(2) *Replacement project consisting of more than one element.* (i) If (*a*) section 1250 property is disposed of, (*b*) any portion of the gain which would have been recognized under section 1250(a) is not recognized by reason of section 1250(d)(8)(A), and (*c*) the cost of the replacement section 1250 property constructed, reconstructed, or acquired during the reinvestment period exceeds the net amount realized attributable to the section 1250 property disposed of, then the section 1250 property shall consist of two elements. For purposes of this paragraph, the *reinvestment element* is that portion of the section 1250 property constructed, reconstructed, or acquired during the reinvestment period the cost of which does not exceed the net amount realized attributable to the section 1250 property disposed of, reduced by any gain recognized with respect to such property. The *additional cost element* is that portion of the section 1250 property constructed, reconstructed, or acquired during the reinvestment period whose cost exceeds the net amount realized attributable to the section 1250 property disposed of.

(ii) The principles of this subparagraph may be illustrated by the following example:

Example 1. (i) Taxpayer B disposes of a qualified housing project consisting of section 1250 property with an adjusted basis of $500,000 and land with a basis of $100,000. The amount realized on the disposition is $750,000 of which $650,000 is attributable to the section 1250 property. B constructs a replacement housing project at a cost of $1,000,000 of which $850,000 is attributable to section 1250 property. B elects in accordance with the provisions of section 1039(a) and the regulations there under not to recognize the $150,000 gain realized.

(ii) Under section 1250(d)(8)(A) no gain is recognized under section 1250(a). The replacement section 1250 property consists of the two elements. The reinvestment element has a cost of $650,000, i.e., that portion of the replacement section 1250 property the cost of which does not exceed the amount realized attributable to the section 1250 property disposed of ($650,000), reduced by any gain recognized with respect to such property (zero). The additional cost element has a cost of $200,000, that is, the excess of the cost of the replacement section 1250 property ($850,000) over the amount realized attributable to the section 1250 property disposed of ($650,000).

(3) *Basis of property acquired.* (i) If section 1250 property is disposed of and gain (determined without regard to section 1250) is not recognized in whole or in part under section 1039 (relating to certain sales of low-income housing projects), then the basis of the section 1250 property and other property acquired in the transaction shall be determined in accordance with the rules of this subparagraph. Generally, the basis of the property acquired in a transaction to which section 1039(a) applies is its cost reduced by the amount of any gain not recognized attributable to the property disposed of (see section 1039(d)). In a case where the replacement section 1250 property constructed, reconstructed, or acquired within the reinvestment period is treated as consisting of more than one element under section 1250(d)(8)(e), the aggregate basis of the property determined under section 1039(d) shall be allocated as follows: first, to the reinvestment element of the section 1250 property, in an amount equal to the amount determined under section 1250(d)(8)(E)(i) reduced by the amount of any gain not recognized attributable to the section 1250 property disposed of; second, to the other replacement property (other than section 1250 property) in an amount equal to the amount of its cost reduced (but not below zero) by any remaining amount of gain not recognized; and finally, to the additional cost element of the section 1250 property, in an amount equal to the amount determined under section 1250(d)(8)(E)(ii) reduced by any amount of gain not recognized which has not been taken into account in determining the basis of the reinvestment element and the other replacement property that is not section 1250 property. See paragraph (h)(2) of this section for definition of the terms *reinvestment element* and *additional cost element.*

(ii) The principles of this subparagraph may be illustrated by the following examples:

Example 1. The facts are the same as in example (1) of subparagraph (1)(ii) of this paragraph. The basis of the replacement section 1250 property is $225,000, the amount of the reinvestment element ($425,000) minus the gain not recognized attributable to the section 1250 property disposed of ($200,000).

Example 2. Taxpayer C disposes of a qualified housing project on January 1, 1971. The adjusted basis for the project is $3,800,000, of which $3,000,000 is attributable to section 1250 property and $800,000 is attributable to land. The amount realized on the disposition is $5,000,000, of which $4,000,000 is attributable to the section 1250 property and $1,000,000 is attributable to the land. The gain realized upon the disposition is $1,200,000, that is, amount realized ($5,000,000) minus adjusted basis ($3,800,000), of which $1,000,000 is attributable to the section 1250 property disposed of. Within the reinvestment period, C purchases another qualified housing project at a cost of $5,500,000, of which $4,000,000 is attributable to section 1250 property and $1,500,000 is attributable to other property. C makes an election under section 1039(a) and the regulations thereunder and none of the $1,200,000 gain realized on the disposition is recognized (determined without regard to section 1250). Under section 1250(d)(8)(A), none of the gain realized is recognized under section 1250(a). The basis of the replacement section 1250 property is $3,000,000, that is, the amount of the reinvestment element ($4,000,000) less the amount of gain not recognized attributable to section 1250 property disposed of ($1,000,000). The basis of the other property acquired is $1,300,000, that is, its cost ($1,500,000) reduced by the remaining gain not recognized ($200,000).

Example 3. The facts are the same as in example (2) except that the cost of the replacement section 1250 property is $4,500,000 and the cost of the other property is $1,000,000. Thus, the replacement section 1250 property consists of two elements under section 1250(d)(8)(E). The reinvestment element (section 1250(d)(8)(E)(i)) has a basis of $3,000,000, that is $4,000,000 (that portion of the section 1250 property acquired the cost of which does not exceed the net amount realized attributable to the section 1250 property disposed of), reduced by $1,000,000 (the gain not recognized attributable to the section 1250 property disposed of). The basis of the other property is $800,000, that is, its cost ($1,000,000) reduced by the remaining gain not recognized ($200,000). The additional cost element (section 1250(d)(8)(E)(ii)) has a basis of $500,000, that is, the portion of the section 1250 property acquired the cost of which exceeds the net amount realized attributable to the section 1250 property disposed of. This amount ($500,000) is not reduced by any amount of gain not recognized because all of the gain not recognized has already been taken into account in determining the basis of the reinvestment element and the other replacement property that is not section 1250 property.

(4) *Additional depreciation for property acquired.* (i) If a qualified housing project is disposed of in a transaction to which section 1039(a) applies, the additional depreciation for the replacement property immediately after the transaction shall be an amount equal to (*a*) the amount of additional depreciation for the property disposed of, minus (*b*) the amount of additional depreciation necessary to produce the amount of gain recognized under section 1250(a). Thus, if no gain is recognized upon a disposition of a qualified housing project, the additional depreciation for the property acquired will be the same as for the property disposed of. On the other hand, if upon disposition of a project, gain of $40,000 was recognized under section 1250(a), and if the additional depreciation for the project and the applicable percentage were $100,000 and 80 percent, respectively, the additional depreciation for the replacement housing project would be $50,000, that is, $100,000 minus $50,000, the amount of additional depreciation necessary to produce $40,000 of recognized gain where the applicable percentage is 80 percent.

(ii) If the property acquired in the transaction consists of more than one element of section 1250 property by reason of section 1250(d)(8)(E), the additional depreciation under subdivision (i) of this subparagraph shall be allocated solely to the reinvestment element.

(5) *Additional limitation.* If, in a transaction to which section 1039(a) applies, gain is recognized by the taxpayer, the amount of gain recognized which is attributable to section 1250 property disposed of is, under section 1250(d)(8)(F)(i), limited to an amount equal to the net amount realized attributable to the section 1250 property disposed of reduced by the greater of (i) the adjusted basis of the section 1250 property disposed of, or (ii) the cost of the section 1250 property acquired. The limitation of section 1250(d)(8)(F)(i) may be illustrated by the following example:

Example: Taxpayer D owns property constituting a qualified housing project under section 1039(b)(1). In an approved disposition, the project is sold for $225,000. The net amount realized on the disposition is $225,000 of which $175,000 is attributable to the section 1250 property disposed of. The adjusted basis of such property is $150,000 and thus the gain realized upon the disposition of the section 1250 property is $25,000. Assume that the total gain realized upon disposition of the project is $45,000. Within the reinvestment period, D purchases another qualified housing project at a cost of $200,000, of which $160,000 is attributable to section 1250 property. D elects, in accordance with section 1039(a) and the regulations thereunder, to limit the recognition of gain to $25,000, that is, the net amount realized ($225,000), minus the cost of the replacement housing project ($200,000). Under this subparagraph, $15,000 of the $25,000 gain recognized is attributable to the section 1250 property disposed of, that is, the net amount realized attributable to the section 1250 property disposed of ($175,000), reduced by $160,000, the greater of the adjusted basis of the section 1250 property disposed of ($150,000) or the cost of the section 1250 property acquired ($160,000).

(6) *Allocation rule.* (i) If, in a transaction to which paragraph (h)(1) of this section applies, the section 1250 property disposed of is treated as consisting of more than one element by reason of the application of section 1250(d)(8)(E) with respect to a prior transaction, then the amount of gain recognized, the net amount realized, and the additional depreciation with respect to each such element shall be allocated to

the elements of the replacement section 1250 property in accordance with the provisions of this subparagraph.

(ii) The portion of the net amount realized upon such a disposition which shall be allocated to each element of the section 1250 property disposed of is that amount which bears the same ratio to the net amount realized attributable to all the section 1250 property disposed of in the transaction as the additional depreciation for that element bears to the total additional depreciation for all elements disposed of. If any gain is recognized upon disposition of the section 1250 property, such gain shall be allocated to each element in the same proportion as the gain realized for that element bears to the gain realized for all elements disposed of. The additional depreciation for each reinvestment element of the replacement section 1250 property shall be the same as for the corresponding element of the property disposed of, decreased by the amount of additional depreciation necessary to produce the amount of gain recognized for such element. The additional depreciation for any additional cost element shall be zero.

(iii) The principles of this subparagraph may be illustrated by the following example:

Example: Taxpayer E disposes of a qualified housing project in an approved disposition. The net amount realized is $1,090,000 of which $900,000 is attributable to section 1250 property. The section 1250 property consists of (1) a reinvestment element with an adjusted basis of $300,000, additional depreciation of $100,000, and an applicable percentage of 50 percent, and (2) an additional cost element with an adjusted basis of $200,000, additional depreciation of $50,000, and an applicable percentage of 80 percent. Gain of $400,000 is realized on the disposition of the section 1250 property, that is, amount realized ($900,000) minus adjusted basis ($500,000). Within the reinvestment period, E purchases another qualified housing project at a cost of $1,000,000 of which $840,000 is attributable to section 1250 property. E elects, in accordance with section 1039 and the regulations thereunder, to limit recognition of gain (determined without regard to section 1250) to $90,000, that is, the excess of the net amount realized ($1,090,000) over the cost of the replacement project ($1,000,000). Under section 1250(d)(8)(A), the amount of gain recognized under section 1250(a) is limited to $90,000 (see subparagraph (1) of this paragraph). Under section 1250(d)(8)(F)(ii) and this subparagraph, $600,000 of the $900,000 net amount realized attributable to the section 1250 property is allocated to the reinvestment element, that is, additional depreciation for the element ($100,000) over total additional depreciation ($150,000) times the net amount realized ($900,000). The remaining $300,000 is allocated to the additional cost element. Thus, the gain realized attributable to the reinvestment element is $300,000, that is, net amount realized ($600,000) minus adjusted basis ($300,000). The gain realized attributable to the additional cost element is $100,000, that is, net amount realized ($300,000) minus adjusted basis ($200,000). Under subparagraph (5) of this paragraph, the gain recognized attributable to the section 1250 property is limited to $60,000, that is, the net amount realized attributable to the section 1250 property disposed of ($900,000) minus the greater of the adjusted basis of such property ($500,000) or the cost of the section 1250 property acquired in the transaction ($840,000). Under section 1250(d)(8)(F)(ii) and this subparagraph, $45,000 of the $60,000 gain recognized is attributable to the reinvestment element, that is, $60,000 multiplied by a fraction whose numerator is the gain realized attributable to the reinvestment element ($300,000) and whose denominator is the total gain realized attributable to all the section 1250 property ($400,000). The remaining $15,000 of the gain recognized is attributable to the additional cost element. The new property acquired has no additional cost element. The reinvestment element of the new property acquired consists of 2 subelements corresponding to the reinvestment element and additional cost element of the property disposed of. The subelement corresponding to the reinvestment element has additional depreciation of $10,000, that is, its additional depreciation immediately before the disposition ($100,000), minus $90,000, the amount of additional depreciation necessary to produce $45,000 of section 1250(a) gain where the applicable percentage is 50 percent. The subelement corresponding to the additional cost element has additional depreciation of $31,250, that is, its additional depreciation immediately before the disposition ($50,000), minus $18,750, the amount of additional depreciation necessary to produce $15,000 of section 1250(a) gain where the applicable percentage is 80 percent.

[T.D. 7084, 36 FR 275, Jan. 8, 1971, as amended by T.D. 7193, 37 FR 12957, June 30, 1972; T.D. 7400, 41 FR 5101, Feb. 4, 1976; 41 FR 7095, Feb. 17, 1976]

§ 1.1250–4 Holding period.

(a) *General.* In general, for purposes only of determining the applicable percentage (as defined in section 1250

(1)(C) and (2)(B)) of section 1250 property, the holding period of the property shall be determined under the rules of section 1250(e) and this section and not under the rules of section 1223. If the property is treated as consisting of two or more elements (within the meaning of paragraph (c)(1) of §1.1250–5), see paragraph (a)(2)(ii) of §1.1250–5 for application of this section to determination of holding period of each element. Section 1250(e) does not affect the determination of the amount of additional depreciation in respect of section 1250 property.

(b) *Beginning of holding period.* (1) For the purpose of determining the applicable percentage, in the case of property acquired by the taxpayer (other than by means of a transaction referred to in paragraph (c) or (d) of this section), the holding period of the property shall begin on the day after the date of its acquisition. See section 1250(e)(1)(A). Thus, for example, if a taxpayer purchases section 1250 property on January 1, 1965, the holding period of the property begins on January 2, 1965. If he sells the property on October 1, 1966, the holding period on the day of the sale is 21 full months, and, accordingly, the applicable percentage is 99 percent. This result would not be changed even if the property initially had been used solely as the taxpayer's residence for a portion of the 21-month period. If, however, the property were sold on September 30, 1966, the holding period would be only 20 full months.

(2) For the purpose of determining the applicable percentage in the case of property constructed, reconstructed, or erected by the taxpayer, the holding period of the property shall begin on the first day of the month during which the property is placed in service. See section 1250(e)(1)(B). Thus, for example, if a taxpayer constructs section 1250 property and places it in service on January 15, 1965, its holding period begins on January 1, 1965. If the taxpayer sells the property on December 31, 1966, its holding period on the day of sale is 24 full months, and, accordingly, the applicable percentage is 96 percent. For purposes of this subparagraph, property is placed in service on the date on which it is first used, whether in a trade or business, in the production of income, or in a personal activity. Thus, for example, a residence constructed by a taxpayer for his personal use is placed in service on the date it is occupied as a residence. For purposes of determining the date property is placed in service, it is immaterial when the period begins for depreciation with respect to the property under any depreciation practice under which depreciation begins in any month other than the month in which the property is placed in service. If one or more units of a single property are placed in service on different dates before the completion of the property, see paragraph (c)(3) of §1.1250–5 (relating to treatment of each such unit as an element).

(c) *Property with transferred basis.* Under section 1250(e)(2), if the basis of property acquired in a transaction described in this subparagraph is determined by reference to its basis in the hands of the transferor, then the holding period of the property in the hands of the transferee shall include the holding period of the property in the hands of the transferor. The transactions described in this subparagraph are:

(1) A gift described in section 1250(d)(1).

(2) Certain transfers at death to the extent provided in paragraph (b)(2)(ii) of §1.1250–3.

(3) Certain tax-free transactions to which section 1250(d)(3) applies. For application of section 1250 (d)(3) and (e)(2) to a distribution by a partnership to a partner, see paragraph (f)(1) of §1.1250–3.

(4) A transfer described in paragraph (e)(4) of §1.1250–3 (relating to transaction under section 1081(d)(1)(A)).

(d) *Principal residence acquired in certain transactions.* The holding period of a principal residence acquired in a transaction to which section 1034 and paragraph (g)(6) of §1.1250–3 apply includes the holding period of the principal residence disposed of in such transaction. See section 1250(e)(3). The holding period of a principal residence acquired does not include the period beginning on the day after the date of the disposition and ending on the date of the acquisition.

(e) *Application of transferred basis and principal residence rules.* The determination of holding period under this section shall be made without regard to whether a transaction occurred prior to the effective date of section 1250 and without regard to whether there was any gain upon the transaction. Thus, for example, under paragraph (c) of this section a donee's holding period for property includes his donor's holding period notwithstanding that the gift occurred on or before December 31, 1963, or that there was no additional depreciation in respect of the property at the time of the gift.

(f) *Qualified low-income housing project acquired in certain transactions.* The holding period of a *reinvestment element* (and of subelements thereof) of section 1250 property (as defined in paragraph (h) (2) of § 1.1250–3) acquired in a transaction to which sections 1039(a) and 1250(d)(8)(A) apply includes the holding period of the corresponding element of the section 1250 property disposed of. See section 1250(e)(4). The holding period of the *additional cost element* (as defined in paragraph (h)(2) of § 1.1250–3) begins on the date the replacement project is acquired. The holding period of a *reinvestment element* of section 1250 property does not include the period beginning on the day after the date of the disposition and ending (1) on the date of the acquisition of the replacement housing project, or (2) on the date the replacement housing project constructed or reconstructed by the taxpayer is placed in service.

(g) *Cross reference.* If the adjusted basis of the property in the hands of the transferee immediately after a transaction to which paragraph (c) or (d) of this section applies exceeds its adjusted basis in the hands of the transferor immediately before the transaction, the excess is an addition to capital account under paragraph (d)(2)(ii) of § 1.1250–5 (relating to property with two or more elements).

[T.D. 7084, 36 FR 281, Jan. 8, 1971, as amended by T.D. 7400, 41 FR 5103, Feb. 4, 1976]

§ 1.1250–5 Property with two or more elements.

(a) *Dispositions before January 1, 1970*—(1) *Amount treated as ordinary income.* If section 1250 property consisting of two or more elements (described in paragraph (c) of this section) is disposed of before January 1, 1970, the amount of gain taken into account under section 1250(a)(2) shall be the sum, determined in three steps under subparagraphs (2), (3), and (4) of this paragraph, of the amounts of gain for each element.

(2) *Step 1.* The first step is to make the following computations:

(i) In respect of the property as a whole, compute the additional depreciation (as defined in section 1250(b)), and the gain realized. For purposes of this paragraph, in the case of a transaction other than a sale, exchange or involuntary conversion, the gain realized shall be considered to be the excess of the fair market value of the property over its adjusted basis.

(ii) In respect of each element as if it were a separate property, compute the additional depreciation for the element, and the applicable percentage (as defined in section 1250(a)(2)) for the element. For additional depreciation in respect of an element of property acquired in certain transactions, see paragraph (e) of this section. For purposes of determining additional depreciation, the holding period of an element shall be determined under section 1223, applied by treating the element as a separate property. However, for the purpose of determining applicable percentage, the holding period for an element shall, except to the extent provided in paragraphs (c)(5), (e), and (f) of this section, be determined in accordance with the rules prescribed in § 1.1250–4.

(3) *Step 2.* The second step is to determine the amount of gain for each element in the following manner:

(i) If the amount of additional depreciation in respect of the property as a whole is equal to the sum of the additional depreciation in respect of each element having additional depreciation, and if such amount is not more than the gain realized, then the amount of gain to be taken into account for an element is the product of the additional depreciation for the element, multiplied by the applicable percentage for the element.

(ii) If subdivision (i) of this subparagraph does not apply, the amount of gain to be taken into account for an element is the product of:

(*a*) The additional depreciation for the element, multiplied by

(*b*) The applicable percentage for the element, and multiplied by

(*c*) A ratio, computed by dividing (*1*) the lower of the additional depreciation in respect of the property as a whole or the gain realized, by (*2*) the sum of the additional depreciation in respect of each element having additional depreciation.

(4) *Step 3.* The third step is to compute the sum of the amounts of gain for each element, as determined in step 2.

(5) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1 Gain of $35,000 is realized upon a sale, before January 1, 1970, of section 1250 property which consists of four elements (W, X, Y, and Z). Since on the date of the sale the amount of additional depreciation in respect of the property as a whole ($24,000) is equal to the sum of the additional depreciation in respect of each element having additional depreciation and is less than the gain realized, the additional depreciation for each element is determined under subparagraph (3)(i) of this paragraph. The amount of gain taken into account under section. 1250(a)(2) is $7,500, as determined in the following table in accordance with the additional facts assumed.

Element	Additional deprecia-tion×	Applicable percentage=	Gain for element
W	$12,000×	0=	0
X	6,000×	50=	$3,000
Y	0×	63=	0
Z	6,000×	75=	4,500
Totals	24,000		7,500

Example 2. Assume the same facts as in example (1), except that in respect of the property as a whole the additional depreciation is $20,000 because with respect to element Y additional depreciation allowed was $4,000 less than straight line. Accordingly, the sum of the additional depreciation for each element having additional depreciation is $24,000, that is, $4,000 greater than the additional depreciation in respect of the property as a whole. Thus, the additional depreciation for each element is determined under subparagraph (3)(ii) of this paragraph. The ratio referred to in subparagraph (3)(ii)(c) of this paragraph is twenty twenty-fourths, that is, the lower of additional depreciation in respect of the property as a whole ($20,000) or the gain realized ($35,000), divided by the sum of the additional depreciation in respect of each element having additional depreciation ($24,000). The amount of gain taken into account under section 1250(a)(2) is $6,250, as determined in the following table:

Element	Additional deprecia-tion×	Applica-ble per-cent-age×	Ratio=	Gain for element
W	$12,000×	0×	20:24=	0
X	6,000×	50×	20:24=	$2,500
Y	0×	63×	20:24=	0
Z	6,000×	75×	20:24=	3,750
Totals	24,000			6,250

(b) *Dispositions after December 31, 1969*—(1) *Amount treated as ordinary income.* If section 1250 property consisting of two or more elements (described in paragraph (c) of this section) is disposed of after December 31, 1969, the amount of gain taken into account under section 1250(a) shall be the sum, determined in 5 steps under subparagraphs (2), (3), (4), (5), and (6) of this paragraph, of the amount of gain for each element. Steps 3 and 4 are used only if the gain realized exceeds the additional depreciation attributable to periods after December 31, 1969, in respect of the property as a whole.

(2) *Step 1.* The first step is to make the following computations:

(i) In respect of the property as a whole, compute the additional depreciation (as defined in section 1250(b)) attributable to periods after December 31, 1969, and the gain realized. For purposes of this paragraph, in the case of a transaction other than a sale, exchange, or involuntary conversion, the gain realized shall be considered to be the excess of the fair market value of the property over its adjusted basis.

(ii) In respect of each element as if it were a separate property, compute the additional depreciation for the element attributable to periods after December 31, 1969, and the applicable percentage (as defined in section 1250(a)(1)) for the element. For additional depreciation in respect of an element of property acquired in certain transactions, see paragraph (e) of this section. For purposes of determining additional depreciation, the holding period of an element shall be determined under section 1223, applied by treating the element as a separate property. However, for the purpose of determining applicable percentage, the holding period for an element shall, except to the extent provided in paragraphs (c)(5), (e), and (f) of this section, be determined in accordance with the rules prescribed in § 1.1250–4.

(3) *Step 2.* The second step is to determine the amount of gain recognized for each element under section 1250(a) (1) in the following manner:

(i) If the amount of additional depreciation in respect of the property as a whole attributable to periods after December 31, 1969, is equal to the sum of the additional depreciation in respect of each element having such additional depreciation, and if such amount is not more than the gain realized, then the amount of gain to be taken into account for an element under section 1250(a)(1) is the product of the additional depreciation attributable to periods after December 31, 1960, for the element, multiplied by the applicable percentage for the element determined under section 1250(a)(1).

(ii) If subdivision (i) of this subparagraph does not apply, the amount of gain to be taken into account under section 1250(a)(1) for an element is the product of:

(*a*) The additional depreciation attributable to periods after December 31, 1969, for the element multiplied by

(*b*) The applicable percentage for the element determined under section 1250(a)(1) for the element, and multiplied by

(*c*) A ratio, computed by dividing (*1*) the lower of the additional depreciation in respect of the property as a whole which is attributable to periods after December 31, 1969, or the gain realized, by (*2*) the sum of the additional depreciation attributable to periods after December 31, 1969, in respect of each element having such additional depreciation.

(4) *Step (3).* If the gain realized exceeds the additional depreciation in respect of the property as a whole attributable to periods after December 31, 1969.

(i) Compute the additional depreciation attributable to periods before January 1, 1970, and the remaining gain (or remaining potential gain in the case of a transaction other than a sale, exchange, or involuntary conversion), in respect of the property as a whole.

(ii) Compute the additional depreciation attributable to periods before January 1, 1970, and the applicable percentage determined under section 1250(a)(2) in respect of each element as if it were a separate property. For additional depreciation in respect of an element of property acquired in certain transactions, see paragraph (e) of this section. For purposes of determining additional depreciation, the holding period of an element shall be determined under section 1223, applied by treating the element as a separate property. However, for the purpose of determining applicable percentage, the holding period of an element shall, except to the extent provided in paragraphs (c)(5), (e), and (f) of this section, be determined in accordance with the rules prescribed in § 1.1250–4.

(5) *Step (4).* The fourth step is to compute the gain recognized under section 1250(a)(2) for each element (if computation was required under step (3)) in the following manner:

(i) If the amount of additional depreciation in respect of the property as a whole attributable to periods before January 1, 1970, is equal to the sum of the additional depreciation in respect of each element having such additional depreciation, and if such amount is not more than the remaining gain (or remaining potential gain), then the amount of gain to be taken into account for an element under section 1250(a)(2) is the product of the additional depreciation attributable to periods before January 1, 1970, for the element, multiplied by the applicable percentage determined under section 1250(a)(2) for the element.

(ii) If subdivision (i) of this subparagraph does not apply, the amount of gain to be taken into account for an element under section 1250(a)(2) is the product of:

(*a*) The additional depreciation attributable to periods before January 1, 1970, for the element, multiplied by,

(*b*) The applicable percentage for the element determined under section 1250(a)(2), and multiplied by,

(*c*) A ratio, computed by dividing (*1*) the lower of the additional depreciation in respect of the property as a whole which is attributable to periods before January 1, 1970,

or the remaining gain (or remaining potential gain), by (*2*) the sum of the additional depreciation attributable to periods before January 1, 1970, in respect of each element having additional depreciation.

(6) *Step (5).* The fifth step is to compute the sum of the amount of gain for each element, as determined in steps (2) and (4).

(7) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Gain of $60,000 is realized upon a sale, after the December 31, 1969, of section 1250 property which was constructed by the taxpayer after such date. The property consists of four elements (W, X, Y, and Z). Since on the date of sale the amount of additional depreciation attributable to periods after December 31, 1969, in respect of the property as a whole ($32,000), is equal to the sum of the additional depreciation in respect of each element having such additional depreciation and is less than the gain realized, the gain recognized for each element is determined under subparagraph (3)(i) of this paragraph. The amount of gain taken into account under section 1250(a)(1) is $28,500, as determined in the following table in accordance with the additional facts assumed:

Element	Additional depreciation after Dec. 31, 1969×	Applicable percentage= (1250(a)(1))	Gain for element
W	$14,000×	80=	$11,200
X	6,000×	90=	5,400
Y	2,000×	95=	1,900
Z	10,000×	100=	10,000
Total	32,000		28,500

Example 2. Assume the same facts as in example (1), except that the property was acquired by the taxpayer before January 1, 1970. Since the gain realized ($60,000) exceeds the additional depreciation attributable to periods after December 31, 1969 ($32,000), section 1250(a)(2) applies to the remaining gain of $28,000. Since the additional depreciation in respect of the property as a whole attributable to periods before January 1, 1970 ($21,000), is equal to the sum of the additional depreciation in respect of each element having such additional depreciation and is less than the remaining gain ($28,000), the amount of gain recognized for each element under section 1250(a)(2) is determined under subparagraph (5)(i) of this paragraph. The amount of gain taken into account under section 1250(a)(1) is $28,500 the same as in example (1). The amount of gain taken into account under section 1250(a)(2) is $3,900, as determined in the following table in accordance with the additional facts assumed:

Element	Additional depreciation before Jan. 1, 1970×	Applicable percentage= (1250(a)(2))	Gain for element (1250)(a)(2))
W	$8,000×	0=	$0
X	6,000×	10=	600
Y	2,000×	15=	300
Z	5,000×	60=	3,000
Total	21,000		3,900

Example 3. (i) The facts are the same as in example (2) except that element Y has a deficit in additional depreciation attributable to periods after December 31, 1969, of $6,000 and thus the additional depreciation attributable to periods after December 31, 1969, in respect of the property as a whole is $24,000. The sum of the additional depreciation for each element having additional depreciation is $30,000, or $6,000 more than the additional depreciation in respect of the property as a whole. Thus, the gain recognized for each element under section 1250(a)(1) is determined under subparagraph (3)(ii) of this paragraph. The ratio referred to in subparagraph (3)(ii) (*c*) of this paragraph is 24:30, that is, the lower of the additional depreciation in respect of the property as a whole attributable to periods after December 31, 1969 ($24,000), or the gain realized ($60,000), divided by the sum of the additional depreciation in respect of each element having such additional depreciation ($30,000). The amount of gain taken into account under section 1250(a)(1) is $21,280, as determined in the following table:

Element	Additional depreciation×	Applicable percentage× (1250(a)(1))	Ratio=	Gain for element
W	$14,000×	80×	24:30=	$8,960
X	6,000×	90×	24:30=	4,320
Y	(6,000)×	95×	24:30=	0
Z	10,000×	100×	24:30=	8,000
Total.	24,000			21,280

(ii) In addition, gain is recognized under section 1250(a)(2) since there is a remaining potential gain of $36,000, that is, gain realized ($60,000) minus the additional depreciation attributable to periods after December 31, 1969 ($24,000). The gain recognized in respect of each element and the gain recognized under section 1250(a)(2) ($3,900) are the same as in example (2), since the additional depreciation attributable to periods before January 1, 1970 ($21,000) is less than the remaining gain ($36,000).

(c) *Element*—(1) *General.* For purposes of this section, in the case of section 1250 property there shall be treated as separate elements the separate improvements, units, remaining property, special elements, and low-income housing elements which are respectively referred to in paragraphs (c) (2), (3), (4), (5), and (6) of this section.

(2) *Separate improvements.* There shall be treated as an element each *separate improvement* (as defined in paragraph (d)(1) of this section) to the property.

(3) *Units.* If before completion of section 1250 property one or more units thereof are placed in service, each such unit of the section 1250 property shall be treated as an element.

(4) *Remaining property.* The remaining property which is not taken into account under subparagraph (2) or (3) of this paragraph shall be treated as an element.

(5) *Special elements.* (i) If the basis of section 1250 property is reduced in the manner described in paragraph (b)(2)(ii) of § 1.1250–3 (relating to property acquired from a decedent prior to his death) or in paragraph (e)(3)(iii) of § 1.1250–3 (relating to basis reduction under section 1071 or 1082(a)(2)), then such property shall be considered as having a special element with additional depreciation equal to the amount of additional depreciation included in the depreciation adjustments (referred to in paragraph (d)(1) of § 1.1250–2) to which the basis reduction is attributable. For purposes of computing applicable percentage, the holding period of a special element under this subdivision shall be determined under paragraph (b)(2)(ii) or (e)(3)(iii) (whichever is applicable) of § 1.1250–3.

(ii) If a disposition described in section 1250(d)(4)(A) (relating to like kind exchanges and involuntary conversions) of a portion of an item of property gives rise to an addition to capital account (described in the last sentence of paragraph (d)(2)(i) of this section) which is not a separate improvement, then such property shall be considered as having a special element with additional depreciation and, for purposes of computing applicable percentage, a holding period determined under paragraph (d)(7) of § 1.1250–3.

(6) *Low-income housing elements.* If, in an approved disposition of a qualified housing project, a replacement qualified housing project is treated as consisting of more than one element of section 1250 property by reason of section 1250(d)(8)(E) (see paragraph (h)(2) of § 1.1250–3), the elements determined under such section shall be treated as elements for purposes of this section. For definition of the terms *qualified housing project* and *approved disposition,* see section 1039(b) and the regulations thereunder.

(7) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. A taxpayer constructs an apartment house which he places in service in three stages. The total cost is $1 million, of which $350,000 is allocable to the first stage, $500,000 to the second stage, and $150,000 to the third stage. The first stage, which is placed in service on January 1, 1965, consists of 300 apartments and certain facilities including a central heating system and a common lobby. The second stage, which is placed in service on July 15, 1965, consists of 550 apartments and certain facilities including the motor for a central air-conditioning system. The third stage, which is placed in service on January 19, 1966, consists of the residue of the apartment house. On December 31, 1968, the taxpayer disposes of the apartment house. On such date, the apartment house has three elements which are described in the table below:

Stage	Kind of element	Cost	Full months in holding period	Applicable percentage
1	Unit	$350,000	48	72
2	Unit	500,000	42	78
3	Remaining property.	150,000	36	84

Example 2. Assume the same facts as in example (1) except that on January 1, 1969, two new floors, which were added after the apartment house was completed, are placed in service and that on July 1, 1972, the taxpayer disposes of the building. Assume further that the two new floors are one separate improvement (within the meaning of paragraph (d) of this section). On the date disposed of, the property consists of four elements, that is, the three elements described in example (1) and the separate improvement.

(d) *Separate improvement*—(1) *Definition.* For purposes of this section, with respect to any section 1250 property, the term *separate improvement* means an *addition to capital account* described in subparagraph (2) of this paragraph which qualifies as an *improvement* under the 1-year test prescribed in subparagraph (3) of this paragraph and which satisfies the 36-month test prescribed in subparagraph (4) of this paragraph.

(2) *Addition to capital account.* (i) In the case of any section 1250 property, an addition to capital account described in this subparagraph is any addition to capital account in respect of such property after its initial acquisition or completion by the taxpayer or by any person who held the property during a period included in the taxpayer's holding period (see §1.1250–4) for the property. An addition to the capital account of section 1250 property may arise, for example, if there is an expenditure for section 1250 property which is an improvement, replacement, addition, or alteration to such property (regardless of whether the cost thereof is capitalized or charged against the depreciation reserve). In such a case, the *addition to capital account* is the gross addition, unreduced by amounts attributable to replaced property, to the net capital account and not the net addition to such account. Thus, if a roof has an adjusted basis of $20,000, and is replaced by constructing a new roof at a cost of $50,000, the gross addition of $50,000 is an addition to capital account. (The adjusted basis of the old roof is no longer included in the capital account for the property.) For purposes of this section, the status of an addition to capital account is not affected by whether or not it is treated as a separate property for purposes of determining depreciation adjustments. In case of an addition to the capital account of property arising after December 31, 1963, upon a disposition referred to in section 1250(d)(4) (relating to like kind exchanges and involuntary conversions) of a portion of an item of such property, the amount of such addition (and its basis for all purposes of the Code) shall be the basis thereof determined under paragraph (d) (2), (3), or (4) (whichever is applicable) of §1.1250–3, applied by treating such portion and such addition as separate properties.

(ii) An addition to capital account may be attributable to an excess of the adjusted basis of section 1250 property in the hands of a transferee immediately after a transaction referred to in section 1250(e)(2) (relating to holding period of property with transferred basis) over its adjusted basis in the hands of the transferor immediately before the transaction. Thus, for example, such excess may arise from a gift which is in part a sale or exchange (see paragraph (a)(2) of §1.1250–3), from an increase in basis due to gift tax paid (see section 1015(d)), from a transfer referred to in paragraph (c)(2) of §1.1250–3 (relating to certain tax-free transactions) in which gain is partially recognized, or from a distribution by a partnership to a partner in which no gain is recognized by reason of the application of section 731. Similarly, an addition to capital account may be attributable to an excess of the adjusted basis of a principal residence acquired in a transaction referred to in section 1250(e)(3) over the adjusted basis of the principal residence disposed of, as well as to any increase in the adjusted basis of section 1250 property of a partnership by reason of an optional basis adjustment under section 734(b) or 743(b).

(iii) Whether or not an expenditure shall be treated as an addition to capital account described in this subparagraph, as distinguished from a separate item of property, may depend on how the property or properties are disposed of. Thus, for example, if a taxpayer, who owns a motel consisting of 10 buildings with common heating and plumbing systems, adds to the motel three new buildings which are connected to the common systems, and if the taxpayer sells the motel to one person in one transaction, then for purposes of this subparagraph the cost of the three new buildings shall be treated as an addition to the capital account of the motel and, if the 1-year and 36-month tests of subparagraphs (3) and (4) of this paragraph are satisfied, the motel consists of at least two elements. If, however, the 10-building group and the three-building group were individually sold in separate transactions to two different people each of whom would operate his group as a separate business, the motel would consist of two items of property.

(3) *One-year test for improvement.* (i) An addition to capital account of section 1250 property for any taxable year (including a short taxable year and the entire taxable year in which the disposition occurs) shall be treated as an improvement only if the sum of all additions to the capital account of such property for such taxable year exceeds the greater of:

(*a*) $2,000, or

(*b*) One percent of the unadjusted basis of the property, determined as of the beginning (*1*) of such taxable year, or (*2*) of the holding period (within the meaning of § 1.1250–4) of the property, whichever is the later.

(ii) For purposes of this section, the term *unadjusted basis* means the adjusted basis of the property, determined without regard to the adjustments provided in section 1016(a) (2) and (3) (relating to adjustments for depreciation, amortization, and depletion). For purposes of this paragraph, as of any particular date the unadjusted basis of section 1250 property (*a*) includes the cost of any addition to capital account for the property which arises prior to such date (regardless of whether such addition qualified under this subparagraph as an improvement), and (*b*) does not include the cost of a component retired before such date.

(iii) In respect of a particular disposition of section 1250 property by a person:

(*a*) There shall not be taken into account under the 1-year test for improvements in this subparagraph any addition to capital account which arises by reason of (or after) such disposition or which arises before the beginning of the holding period under § 1.1250–4 of such person for the property, and

(*b*) Such test shall be made in respect of each taxable year of such person (and of any prior transferor) any day of which is included under § 1.1250–4 in such person's holding period for the property, except that (*1*) such test shall be made for a taxable year of such person only if such person actually owned the property on at least 1 day of such taxable year, and (*2*) such test shall be made for a taxable year of such prior transferor only if such prior transferor actually owned the property on at least 1 day of such taxable year.

(iv) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. The unadjusted basis of section 1250 property as of the beginning of January 1, 1960, is $300,000. During the taxable year ending on December 31, 1960, the only additions to the capital account for the property are addition A on January 1, 1960, costing $1,000, and addition B on July 1, 1960, costing $600. Since the sum of the amounts added to capital account for such taxable year is less than $2,000, A and B are not treated as improvements. This result would not be changed if addition C, costing $600, were added on December 15, 1960, since although the sum of the additions ($1,000 plus $600 plus $600, or $2,200) exceeds $2,000, such sum is less than 1 percent of the unadjusted basis of the property as of the beginning of 1960 ($3,000, that is, 1 percent of $300,000). If however, C cost $1,500, then A, B, and C would each be considered an improvement since the sum of the amounts added to capital account $3,100) would exceed $3,000.

Example 2. Green and his son both use the calendar year as the taxable year. On February 1, 1965, Green makes addition A to a piece of section 1250 property. On June 15, 1965, Green transfers such property to his son as a gift which is in part a sale (see paragraph (a) of § 1.1250–3). Addition B arises by reason of the transfer. On August 1, 1965, the son makes addition C to the property. For purposes of determining the amount of gain recognized under section 1250(a) to Green upon the transfer, the determination of whether addition A is an improvement is made without taking into account additions B and C. For purposes of determining the amount of gain recognized under section 1250(a) upon a subsequent disposition of the property by the son, additions B and C would be taken into account in the determination of whether A is an improvement, and A would be taken into account in the determination of whether B and C are improvements.

Example 3. Assume the same facts as in example (2). Assume further that on September 15, 1965, the son transfers the property to a corporation in exchange for cash and stock in the corporation in a transaction qualifying under section 351 (see paragraph (c) of § 1.1250–3), and that the corporation uses a fiscal year ending November 30. For purposes of determining the amount of gain recognized under section 1250(a) upon a subsequent disposition by the corporation, the one-year test under subdivision (i) of this subparagraph is made for the entire taxable year of Green and of the son ending on December 31, 1965, and in respect of the corporation's taxable year ending November 30, 1965. Accordingly, if on December 7, 1965, addition D is made by the corporation, then, upon a subsequent disposition by the corporation, D is taken into account for purposes of the determination in respect of the entire taxable year of Green and of the son ending on December 31, 1965, and for the corporation's taxable year ending November 30, 1966, but not for purposes of the corporation's taxable year ending November 30, 1965. If D were made on January 3, 1966, D would still be taken into account for purposes of the determination in respect of the corporation's taxable year ending November 30, 1966. However, since neither Green nor his son actually owned the property on any day of the taxable year ending December 31, 1966, no determination is made in respect of such taxable year of Green or of the son.

(4) *36-month test for separate improvement.* (i) If, during the 36-month period ending on the last day of any taxable year (including a short taxable year and the entire taxable year in which the disposition occurs), the sum of the amounts treated under subparagraph (3) of this paragraph as improvements for such period exceeds the greatest of:

(*a*) 25 percent of the adjusted basis of the property,

(*b*) 10 percent of the unadjusted basis (determined under subparagraph (3)(ii) of this paragraph) of the property, or

(*c*) $5,000,

Then each such improvement during such period shall be treated as a separate improvement, and thus as an element. For purposes of (*a*) and (*b*) of this subdivision, the adjusted basis (or unadjusted basis) of section 1250 property shall be determined as of the beginning of the 36-month period, or as of the beginning of the holding period of the property (within the meaning of §1.1250–4), whichever is the later.

(ii) In respect of a particular disposition of section 1250 property by a person:

(*a*) There shall not be taken into account under the 36-month test for separate improvements in this subparagraph any amount treated under subparagraph (3) of this paragraph as an improvement which arises by reason of (or after) the disposition or which arises before the beginning of the holding period under §1.1250–4 of such person for the property, and

(*b*) Such test shall be made in respect of each 36-month period ending on the last day of each taxable year of such person (and of any prior transferor) if at least 1 day of such period is included under §1.1250–4 in such person's holding period for the property, except that (*1*) such test shall be made for a 36-month period ending on the last day of a taxable year of such person only if such person actually owned the property on at least 1 day of such period, and (*2*) such test shall be made for a 36-month period ending on the last day of a taxable year of such prior transferor only if such prior transferor actually owned the property on at least 1 day of such period.

(iii) For illustration of the principles of subdivision (ii) of this subparagraph, see examples (2) and (3) in subparagraph (3)(iv) of this paragraph.

(5) *Example.* The application of this paragraph may be illustrated by the following example:

Example: (i) On December 31, 1967, X, a calendar year taxpayer, purchases an item of section 1250 property at a cost of $100,000. In the table below, the adjusted basis and unadjusted basis of the property are shown for the beginning of January 1 of each taxable year and it is assumed that each addition to capital was added on January 1 of the year shown.

Year	Adjusted basis	Unadjusted basis	1 percent of unadjusted basis	Addition
1969	$94,000	$100,000	$1,000	A–$10,000
1970	97,030	110,000	1,100	B–4,000
1971	94,041	114,000	1,140	C–6,000
1972	92,799	120,000	1,200	....
1973	86,158	120,000	1,200	D–18,000

(ii) Since each addition to capital account for the property exceeds the greater of $2,000 or one percent of unadjusted basis, determined as of the beginning of the taxable year in which made, each addition to capital account qualifies as an improvement under subparagraph (2) of this paragraph.

(iii) Since the beginning of the holding period of the property under §1.1250–4 (Jan. 1, 1968) is later than the beginning of the 36-month period ending on December 31, 1969, the determination as to whether there are any separate improvements on the property as of December 31, 1969, is made by examining the adjusted basis (or unadjusted basis) of the property as of the beginning of January 1, 1968. As of December 31, 1969, there were no separate improvements on the property since the only amount treated as an improvement for the period beginning on January 1, 1968, and ending on December 31, 1969, in addition A (costing $10,000), which is less than $25,000, that is, 25 percent of the adjusted basis ($100,000) of the property as of the beginning of January 1, 1968.

(iv) As of December 31, 1970, there were no separate improvements on the property since the sum of the amounts treated as improvements for the 36-month period ending on December 31, 1970, is $14,000 (that is, $10,000 for A, plus $4,000 for B), and this sum is less than $25,000, that is, 25 percent of the adjusted basis ($100,000) of the property as of the beginning of January 1, 1968.

(v) As of December 31, 1971, there were no separate improvements on the property since the sum of the amounts treated as improvements for the 36-month period ending on December 31, 1971, is $20,000 (that is, $10,000 for A, plus $4,000 for B, plus $6,000 for C), and this sum is less than $23,500, that is, 25 percent of the adjusted basis ($94,000) of the property as of the beginning of January 1, 1969.

(vi) As of December 31, 1972, there were no separate improvements on the property since the sum of the amounts treated as improvements for the 36-month period ending on December 31, 1972, is $10,000 (that is, $4,000 for B plus $6,000 for C), and this sum is less than $24,258 that is, 25 percent of the adjusted basis ($97,030) of the property as of the beginning of January 1, 1970.

(vii) As of December 31, 1973, C and D are separate improvements (notwithstanding that as of December 31, 1971 and 1972, C was not a separate improvement) since the sum of the amounts added for the 36-month period ending December 31, 1973, is $24,000 (that is, $6,000 for C plus $18,000 for D), and this sum exceeds the greatest of:

(*a*) $23,510, that is, 25 percent of the adjusted basis ($94,041) of the section 1250 property as of the beginning of January 1, 1971,

(*b*) $11,400, that is, 10 percent of the unadjusted basis ($114,000) of the property as of the beginning of such first day, or

(*c*) $5,000.

(e) *Additional depreciation and holding period of property acquired in certain transactions*—(1) *Transferred basis.* If property consisting of two or more elements is disposed of, and if the holding period of the property in the hands of the transferee for purposes of computing applicable percentage includes the holding period of the transferor by reason of the application of paragraph (c) (other than subparagraph (2) thereof) of § 1.1250–4, then the additional depreciation for each element of the property in the hands of the transferee immediately after the transfer shall be computed in the manner set forth in this subparagraph. First, any element having a deficit in additional depreciation in the hands of the transferor immediately before such transfer shall be considered to have the same deficit in the hands of the transferee. Second, elements having additional depreciation in the hands of the transferor immediately before the transfer shall be considered to have additional depreciation in the hands of the transferee. The sum of the transferee's additional depreciation for all elements of the property having additional depreciation in the hands of the transferor shall be an amount equal to the additional depreciation in respect of the property as a whole immediately after the transfer increased by the sum of the deficits in addition depreciation for all elements having such deficits. In case there is more than one element having additional depreciation, the additional depreciation for any such element in the hands of the transferee shall be computed by multiplying (i) the amount computed under the preceding sentence by (ii) the additional depreciation for such element in the hands of the transferor divided by the sum of the additional depreciation for all such elements having additional depreciation in the hands of the transferor. For purposes of computing applicable percentage, the holding period for an element of such property in the hands of the transferee shall include the holding period of such element in the hands of the transferor.

(2) *Example.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example: Section 1250 property has additional depreciation of $16,000 of which $12,000 is additional depreciation for element X and $4,000 for element Y. The property is transferred to a corporation in exchange for cash of $6,000 and for stock in the corporation. Assume that recognition of gain under section 1250(a) is limited to $6,000 (the amount of cash received) by reason of the application of section 351(b) (relating to transfer to corporation controlled by transferor) and section 1250(d)(3) (relating to limitation on application of section 1250 in certain tax-free transactions). Under paragraph (c)(3)(i) of § 1.1250–3, the additional depreciation for the property in the hands of the corporation immediately after the transfer is $10,000, that is, the additional depreciation for the property in the hands of the transferor immediately before the transfer ($16,000) minus the gain under section 1250(a) recognized upon the transfer ($6,000). Under subparagraph (1) of this paragraph, in the hands of the corporation immediately after the transfer element X has additional depreciation of $7,500 (12⁄16 of $10,000) and element Y as additional depreciation of $2,500 (4⁄16 of $10,000). Under paragraph (d)(2)(ii) of this section there is an addition of $6,000 to the capital account for the property.

(3) *Principal residence.* If a principal residence consisting of two or more elements is disposed of, and if for purposes of computing applicable percentage the holding period of the principal residence acquired includes the holding period of the principal residence disposed of by reason of the application of paragraph (d) of §1.1250–4, then the additional depreciation (or a deficit in additional depreciation) for an element of the principal residence acquired immediately after the transaction shall be determined in a manner consistent with the principles of subparagraph (1) of this paragraph. For purposes of computing applicable percentage, the holding period for an element of the principal residence acquired includes the holding period of such element of the principal residence disposed of, but not the period beginning on the day after the date of the disposition and ending on the date of the acquisition.

(f) *Holding period for small separate improvements*—(1) *General.* This paragraph prescribes a special holding period solely for the purpose of computing the applicable percentage of a separate improvement (as defined in paragraph (d) of this section) which is treated as an element. See paragraph (a)(2)(ii) of this section for determination of holding period under section 1223 for purposes of computing additional depreciation. In respect of section 1250 property, if the amount of a separate improvement does not exceed the greater of:

(i) $2,000, or

(ii) One percent of the unadjusted basis (within the meaning of paragraph (d)(3)(ii) of this section) of such property, determined as of the beginning of the taxable year in which such separate improvement was made,

Then such separate improvement shall be treated for purposes of computing applicable percentage as placed in service on the first day, of a calendar month, which is the closest such first day to the middle of the taxable year. See the last sentence of section 1250(f)(4)(B). If two such first days are equally close to the middle of the taxable year, the earliest of such days is the applicable day.

(2) *Example.* The application of this paragraph may be illustrated by the following example:

Example: (i) The unadjusted basis of section 1250 property as of the beginning of January 1, 1960, is $100,000. During the taxable year ending on December 31, 1960, the only additions to the capital account for the property are addition A on March 10, 1960, costing $1,200 and addition B on September 16, 1960, costing $1,400. Since the sum of the additions ($2,600) exceeds the greater of $2,000 and 1 percent of unadjusted basis ($1,000, that is, 1 percent of $100,000), each addition is an improvement under the 1-year test of paragraph (d)(3) of this section. Assume that the 36-month test of paragraph (d)(4) of this section is satisfied and, therefore, each addition is a separate improvement treated as an element.

(ii) Since each element is less than $2,000, the provisions of this paragraph apply. Since there are 366 days in 1960, the middle of the year is at the end of 183 days, or July 1. Thus, that first day of a calendar month in 1960, which is the closest first day (of a calendar month) to the middle of the taxable year, is July 1, 1960. Accordingly, for purposes of computing applicable percentage, elements A and B are each treated as placed in service on July 1, 1960.

[T.D. 7084, 36 FR 275, Jan. 8, 1971, as amended by T.D. 7193, 37 FR 12957, June 30, 1972; T.D. 7400, 41 FR 5103, Feb. 4, 1976]

§1.1251–1 General rule for treatment of gain from disposition of property used in farming where farm losses offset nonfarm income.

(a) *Applicability.* The provisions of section 1251, this section, and §§1.1251–2 through 1.1251–4 shall apply with respect to any taxable year beginning after December 31, 1969, but only if (1) there is a farm net loss (as defined in section 1251(e)(2) and paragraph (b) of §1.1251–3) for the taxable year, or (2) there is a balance in the excess deductions account (as described in §1251–2) as of the close of the taxable year before subtracting any amount under paragraph (c)(1)(i) of § 1251–2. See section 1251(a). In general, a taxpayer who has a farm net loss and certain other taxpayers are required to establish and maintain an excess deductions account as provided in section 1251(b). Certain additions and subtractions are made to the excess deductions account, and upon the disposition of *farm recapture property* any gain to the extent of the balance in the excess deductions account is recognized as ordinary income under section 1251(c)(1). See paragraph (b)(1) of this section. *Farm recapture property* is, in general, certain farming property (other than section 1250 property) described in paragraph (1), (3), or (4) of section 1231(b). See paragraph (a) of § 1.1251–3.

(b) *Ordinary income*—(1) *General rule.* In general, subject to the provisions of subparagraphs (2), (3), (4), and (5) of this paragraph, upon a disposition of an item of farm recapture property during a taxable year beginning after December 31, 1969, the amount of which:

(i) In the case of a sale, exchange, or involuntary conversion, the amount realized, or

(ii) In the case of any other disposition, the fair market value of such property

exceeds the adjusted basis of such property shall be recognized under section 1251(c)(1) as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (that is, shall be recognized as ordinary income). The amount of gain recognized as ordinary income under section 1251(c)(1) shall be determined separately for each item of farm recapture property in a manner consistent with the principles of subparagraphs (4) and (5) of § 1.1245–1(a) (relating to gain from dispositions of certain depreciable property). Generally, such ordinary income treatment applies even though in the absence of section 1251(c)(1) no gain would be recognized under the Code. For example, if a corporation distributes farm recapture property as a dividend gain may be recognized as ordinary income to the corporation even though, in the absence of section 1251(c)(1), section 311(a) would preclude any recognition of gain to the corporation. For purposes of section 1251, the term *disposition* shall have the same meaning as in paragraph (a)(3) of § 1.1245–1. For the relation of section 1251 to other provisions of the Code, see paragraph (e) of this section.

(2) *Limitation as to dispositions of land*—(i) *In general.* In the case of a disposition of land, gain shall be recognized as ordinary income under section 1251(c)(1) only to the extent of the land's *potential gain.* See section 1251(c)(2)(C).

(ii) *Potential gain.* For purposes of section 1251, the term *potential gain* means in respect of land an amount equal to the excess of its fair market value over its adjusted basis, but limited to the extent of the deductions allowable in respect to such land pursuant to an election (if any) under sections 175 (relating to soil and water conservation expenditures) and 182 (relating to expenditures by farmers for clearing land) for the taxable year of disposition and the four immediately preceding taxable years regardless of whether any such preceding taxable year begins before December 31, 1969. See section (e)(5).

(iii) *Cross reference.* For additional recapture of certain deductions allowed under sections 175 and 182 in respect of farm land, see section 1252.

(3) *Exceptions and special rules.* The amount of gain to be recognized as ordinary income under section 1251(c)(1) after applying subparagraph (2) of this paragraph, if applicable, shall be subject to the exceptions and special rules of section 1251(d) and § 1.1251–4.

(4) *Limitation as to amount in excess deductions account*—(i) *In general.* The aggregate of the amount of gain recognized as ordinary income under section 1251(c)(1) (after applying subparagraphs (2) and (3) of this paragraph, if applicable) shall not exceed the amount in the excess deductions account at the close of the taxable year after subtracting from the account the amount specified in section 1251(b)(3)(A) and paragraph (c)(1)(i) of § 1.1251–2. See section 1251(c)(2)(A). For transfer of amount in an excess deductions account, see section 1251(b)(5).

(ii) *Dispositions taken into account.* If the aggregate of the amount to which section 1251(c)(1) applies is limited for any taxable year by the application of subdivision (i) of this subparagraph, section 1251(c)(1) shall apply in respect of dispositions of items of farm recapture property in the order made. See section 1251(c)(2)(B).

(5) *Relationship to section 1245.* If property is disposed of which qualifies as both section 1245 property (as defined in section 1245(a)(3)) as well as farm recapture property, then gain shall be recognized as ordinary income under section 1251(c)(1) only to the extent that the amount of any gain realized (in the case of a sale, exchange, or involuntary conversion), or to the extent that the excess of the fair market value of the property over its adjusted basis (in the case of any other disposition), was not recognized as ordinary income under section 1245(a)(1). The amount of gain recognized as ordinary income under section 1245(a)(1) upon a disposition of farm recapture property (i) is taken into account under paragraph (b)(2) of §1.1251–3 for purposes of computing farm net loss (or farm net income) and (ii) is not under paragraph (c)(1)(ii) of §1.1251–2 subtracted from the excess deductions account.

(6) *Examples.* The principles of this paragraph may be illustrated by the following examples:

Example 1. A, an unmarried individual who uses the calendar year as his taxable year, makes one disposition of farm recapture property during 1970. On June 30, 1970, he sells for $75,000 farm recapture property (other than land) with an adjusted basis of $43,000 for a realized gain of $32,000 none of which is recognized under section 1245. The balance in A's excess deductions account is $39,000 at the close of 1970 (after making the applicable additions and subtractions under section 1251(b) (2) and (3)(A)). Hence, the entire gain of $32,000 is recognized as ordinary income under section 1251(c)(1), and the balance remaining in A's excess deductions account is $7,000. If, however, the original balance in the excess deductions account were only $15,000, then only $15,000 would be recognized as ordinary income under section 1251(c)(1) and A's excess deductions account balance would be reduced to zero. The remaining gain of $17,000 may be treated as gain from the sale or exchange of property described in section 1231.

Example 2. M, a calendar year corporation makes one disposition of farm recapture property during 1975. On January 15, 1975, M distributes as a dividend to its shareholders land which it had acquired on March 3, 1970. On that date, the excess of the fair market value ($67,500) over the adjusted basis of land ($45,000) is $22,500 and the sum of the deductions allowable in respect of such land under sections 175 and 182 is $5,000 for 1970 and $13,000 for the taxable year of disposition and the four immediately preceding taxable years. Thus, the potential gain (as defined in subparagraph (2)(ii) of this paragraph) is limited to $13,000. At the end of M's taxable year (after making the applicable additions and subtractions under section 1251(b) (2) and (3)(A) there is a balance of $25,000 in the excess deductions account of M. Since such balance exceeds the potential gain, M recognizes $13,000 as ordinary income under section 1251(c)(1) even though, in the absence of that provision, section 311(a) would preclude recognition of gain to M. The balance in M's excess deductions account is reduced by $13,000, from $25,000 to $12,000. With respect to the treatment of the remaining gain ($9,500) from the disposition of the land, see section 1252 and example (2) of paragraph (e) §1.1252–1.

Example 3. Assume the same facts as in example (2), except that M makes a second disposition of farm recapture property during 1975. On June 5, 1975. M sells for $55,000 a breeding herd of cattle having an adjusted basis of $35,000 for a realized gain of $20,000. M had acquired the herd on April 1, 1971. Assume further that $6,000 of the $20,000 gain realized is treated as ordinary income under section 1245(a)(1). Thus, the amount of gain M would recognize as ordinary income under section 1251(c)(1), computed before applying the excess deductions account limitation, is $14,000. In accordance with the computation in example (1) of paragraph (c)(2) of §1.1251–2, the excess deductions account limitations limit the maximum amount of gain which can be recognized as ordinary income under section 1251(c)(1) upon the disposition of the land and the breeding herd to $25,000. Under subparagraph (4)(ii) of this paragraph, the amount of such limitation, $25,000, is assigned to each property in the order of disposition. Thus, the amount of gain recognized as ordinary income under section 1251 is $13,000 (as in example (1) of this subparagraph) on the disposition of the land and $12,000 on the disposition of the breeding herd. The remaining gain of $2,000 (i.e., $14,000 minus $12,000) on the disposition of the breeding herd may be treated as gain from the sale or exchange of property described in section 1231.

(c) *Instances of nonapplication*—(1) *In general.* Section 1251 does not apply with respect to dispositions of farm recapture property by a taxpayer during a taxable year if at the close of such year after making the necessary additions and subtractions under section 1251(b) (2) and (3)(A), there is no balance in the taxpayer's excess deductions account.

(2) *Losses.* Section 1251(c)(1) does not apply to losses. Thus, section 1251(c)(1) does not apply if a loss is realized upon a sale, exchange or involuntary conversion of property, all of which is farm recapture property, nor does the section apply to a disposition of such property other than by way of sale, exchange, or involuntary conversion if at the time of the disposition the fair market value of such property is not greater than its adjusted basis.

(3) *Certain dispositions of interests in land.* Section 1251(c)(1) does not apply to dispositions of interests in land with respect to which no deductions were allowable pursuant to an election under section 175 (relating to soil and water conservation expenditures) and 182 (relating to expenditures by farmers for clearing land) for the taxable year of disposition and the four immediately preceding taxable years. For possible application of section 1252 in such a case, see example (1) of paragraph (e) of § 1.1252–1.

(d) *Partnerships.* [Reserved]

(e) *Relation of section 1251 to other provisions*—(1) *General.* The provisions of section 1251 apply (after applying paragraph (b)(5) of this section, relating to section 1245 property) notwithstanding any other provision of subtitle A of the Code. Thus, unless an exception or special rule under section 1251(d) and § 1.1251–4 applies, gain under section 1251(c)(1) is recognized notwithstanding any contrary nonrecognition provision or income characterizing provision. For example, section 1251 overrides section 1231 (relating to property used in a trade or business). Accordingly, gain recognized under section 1251(c)(1) upon a disposition of farm recapture property will be treated as ordinary income to the extent of the balance in the taxpayer's excess deductions account, and only the remaining gain, if any, from the disposition may be considered as gain from the sale or exchange of a capital asset if section 1231 is applicable. See example (3) of paragraph (d)(6) of this section.

(2) *Nonrecognition sections overridden.* The nonrecognition of gain provisions of subtitle A of the Code which section 1251 overrides include, but are not limited to, sections 267(d), 311(a), 336, 337, and 512(b)(5). See section 1251(d) and § 1.1251–4 for the extent to which 1251(c)(1) overrides sections 332, 351, 361, 371(a), 374(a), 721, 1031, and 1033.

(3) *Treatment of gain not recognized under section 1251(c)(1).* For treatment of gain not recognized under section 1251(c)(1), the principles of paragraph (f) § 1.1251–6 shall be applicable. Thus section 1251 does not prevent gain which is not recognized under section 1251 from being considered as gain under another provision of the Code, such as for example, section 1252(a)(1) (relating to treatment of gain from disposition of farm land). See example (1) of paragraph (e) of § 1.1252–1.

(4) *Exempt income.* With regard to exempt income, the principles of paragraph (e) of § 1.1245–6 shall be applicable.

(5) *Normal retirement of asset in multiple asset account.* Section 1251(c)(1) does not require recognition of gain upon normal retirements of farm recapture property in a multiple asset account as long as the taxpayer's method of accounting, as described in paragraph (e)(2) of § 1.167(a)–8 (relating to accounting treatment of asset retirements), does not require recognition of such gain.

(6) *Installment method*—(i) *In general.* Gain from a disposition to which section 1251(c)(1) applies may be reported under the installment method if such method is otherwise available under section 453 of the Code. In such case, the income (other than interest) on each installment payment shall be deemed to consist of gain to which section 1251(c)(1) applies until all such gain has been reported, and the remaining portion (if any) of such income shall be deemed to consist of gain to which section 1251(c)(1) does not apply. For treatment of amounts as interest on certain deferred payments, see section 483. For adjustments in the excess deductions account, see paragraph (c)(1)(ii) of § 1.1251–2.

(ii) *Special rule.* If a taxpayer disposes of property used in the trade or business of farming which qualifies as both section 1245 property as well as farm recapture property and elects to report the gain from such disposition under the installment method, then the income (other than interest) on each installment payment shall (*a*) first be deemed to consist of gain to which section 1245(a)(1) applies until all such gain has been reported, (*b*) The remaining portion (if any) of such income shall be deemed to consist of gain to which section 1251(e)(1) applies until all such gain has been reported, and (*c*) finally the remaining portion (if any) of such income shall be deemed to consist of gain to which neither section 1245(a)(1) nor 1251 (c)(1) applies. See paragraph (d)(3) of §1.1252–1 with respect to the installment method in regard to the disposition of property which is both farm recapture property as well as farm land (as defined in section 1252(a)(2) and paragraph (a)(3)(i) of §1.1252–1).

[T.D. 7418, 41 FR 18814, May 7, 1976; 41 FR 23669, June 11, 1976]

§1.1251–2 Excess deductions account.

(a) *Establishment and maintenance of account*—(1) *General rule.* With respect to any taxable year beginning after December 31, 1969, any taxpayer who:

(i) Has a farm net loss (as defined in section 1251(e)(2) and in paragraph (b) of §1.1251–3) for such a taxable year, or

(ii) Has an excess deductions account balance as of the close of such a taxable year

shall establish (if not previously established) and maintain for purposes of section 1251 an excess deductions account. See section 1251(b)(1). Once an excess deductions account is established (or succeeded to under paragraph (e) of this section in the case of certain corporate transactions and gifts) all entries (including the entries prescribed by paragraph (f) of this section with respect to married taxpayers who file joint returns) with respect to the account must be part of the taxpayer's permanent records for all taxable years for which the account must be maintained. For purposes of applying section 1251 and this section, the term *taxpayer* in the case of a partnership means each partner of such partnership and in the case of an estate or trust means the estate or trust regardless of whether it is taxable under subpart A or E, subchapter J, chapter 1 of the Code.

(2) *Distributions from estate or trust.* If farm recapture property is distributed from an estate or trust in a transaction to which section 1251(d) (1) or (2) (relating to exceptions for gifts and transfers at death) applies, then the excess deductions account balance of the estate or trust shall be succeeded to by the distributee in the amount, if any, and manner prescribed in paragraph (e)(2) of this section. For purposes of the preceding sentence only, the rules of paragraph (e)(2) of this section shall be applied by treating each distribution as a gift at the time made. Thus; for example, if all of the farm recapture property of an estate or trust is distributed to a distributee on the date the estate or trust terminates, the distributee will succeed on that date to the excess deductions account balance of the estate or trust.

(3) *Exception.* A taxpayer is not required to maintain an excess deductions account under subparagraph (1) of this paragraph for a taxable year if:

(i) For such taxable year there would be no additions to the taxpayer's excess deductions account, and

(ii) For the immediately preceding taxable year the balance in the taxpayer's excess deductions account was reduced to zero by reason of section 1251 (b)(3) (relating to subtractions from the account) or section 1251(b)(5) (relating to transfer of account).

(b) *Additions to account*—(1) *General rule.* For each taxable year, there shall be added to the excess deductions account an amount equal to the taxpayer's farm net loss. See section 1251(b)(2)(A).

(2) *Exceptions.* In the case of an individual and, in the case of an electing small business corporation (as defined in section 1371(b)), subparagraph (1) of this paragraph shall apply for a taxable year:

(i) Only if the taxpayer's nonfarm adjusted gross income (as defined in paragraph (d) of §1.1251–3) for such year exceeds $50,000, and

(ii) Only to the extent the taxpayer's farm net loss for such year exceeds $25,000.

The limitations of this subparagraph apply to a person (other than a trust) to whom the tax rates set forth in section 1 are applicable and as prescribed in subparagraph (3) of this paragraph in respect of an electing small business corporation.

(3) *Electing small business corporation*—(i) *Taxable years ending before December 11, 1971.* For taxable years ending before December 11, 1971, in the case of an electing small business corporation (as defined in section 1371(b):

(*a*) For purposes of subparagraph (2) of this paragraph, the term *the taxpayer* means such corporation or any one of its shareholders, and the term *such year,* in the case of a shareholder, means his taxable year with which or within which the taxable year of the corporation ends (see paragraph (d)(2) of § 1.1251–3 for special rules relating to the computation of nonfarm adjusted gross income of a shareholder of an electing small business corporation), and

(*b*) The limitations in subparagraph (2) of this paragraph shall not apply to the corporation for a taxable year if on any day of such year there is a taxpayer who is a shareholder having, for his taxable year with which or within which the taxable year of such corporation ends, a farm net loss (as defined in paragraph (b) of § 1.1251–3).

For purposes of determining whether a shareholder of such corporation has a farm net loss, there shall not be taken into account his pro rata share of farm net income or loss of any other electing small business corporation for such corporation's taxable year ending with or within his taxable year.

(*c*) The provisions of this subdivision (i) do not apply for purposes of determining whether the shareholder must make an addition to his excess deductions account and the amount of such addition.

(ii) *Taxable years ending after December 10, 1971.* [Reserved]

(4) *Married individuals*—(i) *Lower limitations for separate returns.* If married taxpayers file separate returns, then for purposes of this paragraph each spouse shall be treated as a separate individual. However, in such case, (*a*) the amount specified in subparagraph (2)(i) of this paragraph shall be $25,000 in lieu of $50,000, and (*b*) the amount specified in subparagraph (2)(ii) of this paragraph shall be $12,500 in lieu of $25,000. The lower limitations in the preceding sentence shall not apply if the spouse of the taxpayer does not have any nonfarm adjusted gross income for the taxable year. See section 1251(b)(2)(C).

(ii) *Joint return.* If married taxpayers for a taxable year file a joint return under section 6013, then for purposes of this paragraph they shall for such taxable year be treated as a single taxpayer. For rules applicable to establishing, maintaining, and allocating a joint excess deductions account, see paragraph (f) of this section.

(5) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. For 1971, the M Corporation which uses the claendar year as its taxable year and which is not an electing small business corporation has a farm net loss of $40,000 and nonfarm taxable income of $45,000. Since subparagraph (2) of this paragraph does not apply to M, it is required to make a $40,000 addition to its excess deductions account.

Example 2. For 1971, A, an unmarried individual who uses the calendar year as his taxable year, has a farm net loss of $33,000 and nonfarm adjusted gross income of $65,000. Under subparagraph (2) of this paragraph, A is required to make an addition of $8,000 to his excess deductions account (that is, the excess of the farm net loss, $33,000, over the $25,000 amount referred to in subparagraph (2)(ii) of this paragraph). If, however, A were a trust, the limitation in subparagraph (2) of this paragraph would not apply and such trust would be required to add $33,000 (the amount of the entire farm net loss) to its excess deductions account.

Example 3. H and W each use the calendar year as the taxable year. For 1971, H, a married taxpayer who files a separate return, has a farm net loss of $45,000 and nonfarm adjusted gross income of $60,000. H's spouse W does not have any nonfarm adjusted gross income for 1971. Thus, the lower limitations in subparagraph (4)(i) of this paragraph do not apply. Accordingly, H is required to make an addition of $20,000 to his excess deductions account (that is, the excess of the farm net loss, $45,000, over the $25,000 amount referred to in subparagraph (2)(ii) of this paragraph).

Example 4. Assume the same facts as in example (3), except that for 1971 W has a farm net loss of $10,000 and nonfarm adjusted gross income of $30,000. Thus, the lower limitations in subparagraph (4)(i) of this paragraph do apply and H is required to make an addition of $32,500 to his excess deductions account (that is, the excess of his farm net loss, $45,000, over the $12,500 amount referred to in subparagraph (4)(i)(*b*) of this paragraph). Since, however, W did not have a farm net loss in excess of $12,500, she would not be required to make an addition to her excess deductions account. For the result if H and W were to file a joint return, see example (1) of paragraph (f)(6) of this section.

Example 5. For 1970, the M Corporation, which uses the calendar year as its taxable year and which is an electing small business corporation, has a farm net loss of $35,000 and nonfarm adjusted gross income of $60,000. A, B, and C, the sole equal shareholders of M, are cash method taxpayers and each uses a fiscal year ending on March 31. For the taxable year ending March 31, 1971, A has a farm net loss of $5,000. Thus, as M's taxable year ends within the taxable year of A during which A has a farm net loss, the limitations in subparagraph (2) of this paragraph do not apply with respect to M for 1970. See subparagraph (1) of this paragraph, to add $35,000 to its excess deductions account.

Example 6. Assume the same facts as in example (5), except that A's farm net loss occurred in his fiscal year ending March 31, 1970, and no shareholder of M has a farm net loss for the fiscal year ending March 31, 1971. Thus, the limitations in subparagraph (2) of this paragraph do apply with respect to M for 1970, and accordingly M is required to add $10,000 to its excess deductions account for 1970 (that is, the excess of M's farm net loss $35,000, over the $25,000 amount referred to in subparagraph (2)(ii) of this paragraph).

Example 7. Assume the same facts as in example (6), except that M has $45,000 of nonfarm adjusted gross income for 1970 and A, for his taxable year ending March 31, 1971, has $40,000 of nonfarm adjusted gross income, computed without regard to his interest in M. Assume the M paid no dividends. Since, under paragraph (d)(2) of §1.1251–3, A's income from M under section 1373(b) is computed on the basis of M's nonfarm adjusted gross income, A's gross income from M is $15,000 (⅓ of $45,000), and A's total nonfarm adjusted gross income is $55,000. Accordingly, M would be required to add $10,000 to its excess deductions account for 1970 for the reasons stated in example (6).

Example 8. Assume the same facts as in example (7). Assume further that A is one of two equal shareholders in N, another electing small business corporation with a taxable year ending on January 31, and that N for its taxable year ending on January 31, 1971, has a $42,000 nonfarm loss and farm net income of $23,000. Assume that N paid no dividends. Thus, A for purposes of subparagraph (2)(i) of this paragraph, would only have a total of $34,000 of nonfarm adjusted gross income ($55,000) computed per example (7) minus $21,000 (A's share of N's nonfarm net operating loss (½ of $42,000) computed in accordance with paragraph (d)(2) of §1.1251–3)). Assuming that no other shareholder of M has nonfarm adjusted gross income in excess of $50,000, by reason of the $50,000 limitation in subparagraph (2)(i) of this paragraph, M makes no addition for 1971 to its excess deductions account. (N would make no addition to its excess deductions account as it does not have a farm net loss.) If, however, N were to have a nonfarm loss of only $8,000, A for purposes of subparagraph (2)(i) of this paragraph would have a total of $51,000 of nonfarm adjusted gross income ($51,000 of nonfarm adjusted gross income ($55,000, minus ½ of N's nonfarm loss of $8,000)). Hence, with respect to M the result would be the same as in example (7) (and N would make no addition to its excess deductions account since it does not have a farm net loss).

Example 9. D and E are equal individual shareholders in corporations X, Y, and Z, the stock of each corporation having recently been purchased from a different unrelated person. X, Y, and Z are electing small business corporations. D, E, and the corporations all use the calendar year as the taxable year. For 1970, the farm net income of D and E (determined without regard to their respective pro rata shares of the farm net income or loss of X, Y, and Z) are $100,000 and zero, respectively. For 1970, the farm net income or loss of the corporations are losses of $80,000 and $20,000 for X and Z, respectively, and income of $60,000 for Y. For 1970, the determinations under subparagraph (3)(ii) of this paragraph as to whether a shareholder of corporation X or Z (no determination is necessary with respect to Y since Y does not have a farm net loss) has a farm net loss are made as follows:

DETERMINATIONS AS TO WHETHER D OR E HAS A FARM NET LOSS

	As to X		As to Z	
	D	E	D	E
Farm net income (determined without regard to X, Y, and Z)	$100,000	$0	$100,000	$0
Pro rata (½) share of corporation's farm net income (or loss):				
Of X			(40,000)	(40,000)
Of Y	30,000	30,000	30,000	30,000
Of Z	(10,000)	(10,000)		
Farm net income (or loss) for purposes of determination	$120,000	$20,000	$90,000	($10,000)

Accordingly, since the determination as to X indicates that neither D nor E has a farm net loss, the limitations of subparagraph (2) of this paragraph apply to X. Thus, assuming that X, D, or E has nonfarm adjusted gross income in excess of $50,000, X will add $55,000 to its excess deductions account, i.e., the excess of the farm net loss, $80,000, over the $25,000 amount referred to in subparagraph (2)(ii) of this paragraph. Since, however, the determination as to Z indicates that E has a farm net loss, such limitations do not apply to Z. Thus, the addition for 1970 to Z's excess deductions account is the entire amount of its farm net loss, $20,000.

(c) *Subtractions from account*—(1) *General rule.* Under section 1251(b)(3), if there is any amount in the excess deductions account at the close of a taxable year (determined after making any addition required under paragraph (b) of this section for such year but before making any reduction under this paragraph for such year), then the excess deductions account shall be reduced (but not below zero) by subtracting:

(i) An amount equal to (*a*) the farm net income (as defined in section 1251 (e)(3) and in paragraph (c) of § 1.1251–3) for such year, plus (*b*) the amount (as determined in subparagraph (3) of this paragraph) necessary to adjust the account for deductions for any taxable year which did not result in a reduction of the taxpayer's tax under subtitle A of the Code for such taxable year or any preceding taxable year, and

(ii) After making any addition to the excess deductions account under paragraph (b) of this section and any reduction under subdivision (i) of this subparagraph for the taxable year, an amount equal to the sum of the amounts recognized as ordinary income solely by reason of the application of section 1251(c)(1). See section 1251(b)(3)(B). Thus, no amount shall be subtracted under this subdivision for gain recognized by reason of the application of section 1245(a)(1) or 1252(a)(1). For effect on computation of farm net loss or income of gain recognized under section 1245(a)(1) upon a disposition of farm recapture property, see paragraph (b)(2) of § 1.1251–3. In the case of an installment sale of farm recapture property, the taxpayer's excess deductions account shall be reduced under this subdivision in the year of such sale by an amount equal to the gain (computed in the year of sale) to be recognized as ordinary income under section 1251(c)(1).

(2) *Examples.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples in which it is assumed that there is no subtraction for lack of tax benefit under subparagraph (3) of this paragraph:

Example 1. Assume the same facts as in example (3) of paragraph (b)(6) of § 1.1251–1. M's excess deductions account balance as of the close of 1975 is computed, in accordance with the additional facts assumed, in the table below:

M'S EXCESS DEDUCTIONS ACCOUNT

(1) Balance January 1, 1975		$26,000
(2) Additions for 1975		0
(3) Subtotal		26,000
(4) Subtractions for 1975 (farm net income[1])		1,000
(5) Excess deductions account limitation on gain recognized as ordinary income under section 1251(c)(1) for 1975		25,000
(6) Subtraction for disposition of farm recapture property:.		
(a) Gain from disposition of land to which section 1251(c)(1) applies (computed before applying limitation	$13,000	
(b) Gain from disposition of breeding herd to which section 1251(c)(1) applies (computed before applying limitation)	14,000	
(c) Sum of lines (a) and (b)	27,000	
(d) Excess deductions account limitation (amount in line (5))	25,000	
(e) Gain recognized as ordinary income under section 1251(c)(1) (lower of line (6)(c) or line (6)(d)		25,000
(7) Balance December 31, 1975		0

[1] Computed by treating the section 1245 gain of $6,000 under paragraph (b)(1)(ii) of § 1.1251–3 as gross income derived from the trade or business of farming.

For allocation of the $25,000 of gain recognized as ordinary income to the land and herd, and for treatment of the gain recognized in excess of $25,000 see example (3) of paragraph (b)(6) of §1.1251–1.

Example 2. A is an unmarried individual who uses the calendar year as his taxable year. In 1971, A makes a single disposition of farm recapture property (other than land) realizing a gain of $46,000 of which $15,000 is recognized as ordinary income under section 1245(a)(1). The gain to which section 1251(c)(1) applies (computed before applying the excess deductions account limitation in section 1251(c)(2)(A) and paragraph (b)(4)(i) of §1.1251–1) is $31,000 (i.e., $46,000 minus $15,000). The treatment of the gain realized on the disposition in excess of the $15,000 recognized as ordinary income under section 1245(a)(1) and the balance in A's excess deductions account as of the close of 1971 is computed, in accordance with the facts assumed, in the table below:

A'S EXCESS DEDUCTIONS ACCOUNT

(1) Balance January 1, 1971		$50,000
(2) Additions for 1971:		
(a) Farm net loss for 1971[1]	$5,000	
(b) Less amount in paragraph (b)(2)(ii) of this section	25,000	
(c) Total additions for 1971		0
(3) Subtotal		50,000
(4) Subtractions for 1971		0
(5) Excess deductions account limitation on gain recognized as ordinary income under section 1251(c)(1) for 1971		50,000
(6) Subtraction for dispositions of farm recapture property:		
(a) Gain to which section 1251(c)(1) applies (computed before applying limitation)	31,000	
(b) Limitation (amount in line (5)	50,000	
(c) Gain recognized as ordinary income under section 1251(c)(1) lower of line 6(a) or line 6(b)		31,000
(7) Balance December 31, 1971	19,000	

[1] Computed by treating the section 1245 gain of $15,000 under paragraph (b)(1)(ii) of §1.1251–3 as gross income derived from the trade or business of farming.

(3) *Amount necessary to adjust the excess deductions account with respect to deductions which did not result in a reduction of the taxpayer's tax*—(i) *In general.* Under section 1251(b)(3)(A), a subtraction is made from the excess deductions account to adjust the account for deductions that did not result in a reduction of the taxpayer's tax for the taxable year or any preceding taxable year. The amounts to be subtracted are determined under subdivisions (ii) and (iii) of this subparagraph in accordance with the rules in subdivision (iv) of this subparagraph. This subtraction shall be made before determining the amount of gain to which section 1251(c) applies. The amount subtracted under subdivision (ii) of this subparagraph is a temporary subtraction made solely to determine the amount in the excess deductions account for purposes of the limitation in section 1251(c)(2).

(ii) *Temporary subtraction.* The amount temporarily subtracted from the excess deductions account for a taxable year is the sum of the farm portion of (*a*) any net operating loss for such taxable year which does not reduce taxable income (computed without regard to the deduction under section 172(a)) in a prior year, and (*b*) any net operating loss from a prior taxable year which is carried to such taxable year but which does not reduce taxable income (computed without regard to the deduction under section 172(a)) in such taxable year.

(iii) *Permanent subtraction.* The amount permanently subtracted from the excess deductions account for a taxable year is the excess of the farm portion of any net operating loss which may be carried to the preceding year (reducing by the portion of such loss which reduced taxable income (computed without regard to the deduction under section 172(a)) for such preceding year) over the amount of such loss which may be carried to the taxable year, but the subtraction shall not be made earlier than the taxable year in which the excess deductions account is increased by reason of such loss.

(iv) *Rules of application.* For purposes of this subparagraph, the following rules shall apply:

(*a*) The farm portion of a net operating loss is that portion of such loss attributable to the trade or business of farming. Such portion and the remaining portion (hereinafter referred to as the nonfarm loss) shall be absorbed pro rata. If a farm net loss is not added to the excess deductions account in the year in which such loss occurs, the net operating loss (if any) for such year shall be treated as a nonfarm loss.

(*b*) In the case of an individual (other than a trust), the farm portion of a net operating loss shall be decreased by an amount, if any, equal to the excess of $25,000 (or the amount determined under paragraph (b)(2)(ii) of this section) over the nonfarm adjusted gross income. Such amount shall be added to the nonfarm portion of such net operating loss.

(*c*) The amounts considered as reducing taxable income under subdivision (ii) of this subparagraph in the taxable year shall be determined on the basis of a tentative computation of taxable income for such year in which the gain realized from the disposition of property to which section 1251(c)(1) applied shall be computed without regard to the excess deductions account limitation.

(v) *Example.* The provisions of this subparagraph may be illustrated by the following example:

Example: A is an unmarried individual who uses the calendar year as his taxable year. For the years 1970 through 1974, A's items of income and deductions are as shown in the table below. A's personal deductions are disregarded. A had no income or loss for any year prior to 1970. Based upon such amounts and the computations shown below, A must recognize as ordinary income under section 1251(c)(1), $35,325 for 1971, $10,000 for 1972, $3,925 for 1973, and $150,000 for 1974.

Amounts assumed	1970	1971	1972	1973	1974
(a) Farm net income	($250,000)	$20,000	$5,000	($75,000)	($10,000)
(b) Nonfarm income	55,000	(82,000)	30,000	10,000	200,000
(c) Gain which would be recognized as ordinary income under 1251(c) (computed without regard to the EDA limitation) (hereinafter referred to as *farm property disposition*)		88,000	10,000	2,000	150,000
(d) Personal exemption	625	675	750	750	750
(e) Net operating loss (NOL) (computed per section 172(c))	(195,000)			(45,000)	

I. COMPUTATIONS FOR 1971

1. Excess Deductions Account (EDA) Limitation for 1971:			
a. EDA on December 31, 1970:			
1970 Farm net loss		250,000	
Less		(25,000)	
		225,000	225,000
b. Less farm net income for 1971			(20,000)
c. EDA before temporary subtraction			205,000
d. Less temporary subtraction per subdivision (ii)(*b*):			
Aggregate farm NOL carryover to 1971		195,000	
Less tentative farm NOL deduction for 1971:			
Farm net income	20,000		
Nonfarm income	(82,000)		
Farm property disposition	88,000		
Exemption	(675)		
Tentative taxable income	25,325		
Tentative NOL reducing taxable income	25,325	(25,325)	
		169,675	(169,675)
e. EDA limitation for 1971			35,325
2. 1971 Taxable Income:			
a. Farm net income			20,000
b. Nonfarm income			($82,000)
c. Farm property disposition			88,000
d. Exemption			(675)

Amounts assumed	1970	1971	1972	1973	1974
e. Section 1202 deduction:					
Farm property disposition				$88,000	
Less amount treated as ordinary income under section 1251(c) (lesser of amount of gain on line 1(e))				35,325	
Capital gain				52,675	
Less 50 percent deduction				26,337	(26,338)
f. 1971 Taxable income				....	(1,013)
II. COMPUTATIONS FOR 1972					
1. Excess Deductions Account Limitation for 1972:					
a. EDA (line 1(c) above)					205,000
b. Less recapture in 1971					(35,325)
c. Less farm net income for 1972					(5,000)
d. Less permanent subtraction per subdivision (iii):					
1970 Farm NOL carryover to 1971				195,000	....
Less 1970 farm NOL carryover to 1972 (computed per section 172(b)(2)):					
Farm NOL to 1971			$195,000	....	....
Less 1971 taxable income computed per section 172(b)(2):					
Farm net income		$20,000			
Nonfarm income		(82,000)			
Farm property disposition		88,000			
		26,000	(26,000)		
Farm NOL carryover to 1972		169,000	($169,000)		
				26,000	($26,000)
e. EDA before making temporary subtractions					138,675
f. Less temporary subtraction per subdivision (ii)(*b*):					
Farm NOL carryover to 1972				169,000	
Farm net income			5,000		
Nonfarm income			30,000		
Farm recapture disposition			10,000		
Exemption			(750)		
Tentative taxable income			44,250		
Tentative NOL reducing taxable income			44,250	(44,250)	
				124,750	(124,750)
g. EDA limitation for 1972					13,925
2. Taxable Income for 1972:					
a. Farm net income					5,000
b. Nonfarm income					30,000
c. Farm property disposition					10,000
d. Exemption					(750)
e. Section 1202 deduction:					
Farm property disposition				10,000	
Less amount treated as ordinary income under section 1251(c) (lesser of amount of gain on line 1(g))				10,000	0
f. Taxable income before NOL deduction					44,250
g. Net operating loss deduction					(44,250)
h. Taxable income for 1972					0
III. COMPUTATIONS FOR 1973					
1. Excess Deductions Account Limitation for 1973:					
a. Line 1(e) above					138,675
b. Less recapture in 1972					(10,000)
c. Less permanent subtraction per subdivision (iii):					
1970 Farm NOL carryover to 1972			169,000		
Less 1970 Farm NOL reducing taxable income in 1972			(44,250)		
			124,750	124,750	
Less 1970 Farm NOL carryover to 1973 computed per section 172(b)(2):					
Farm NOL to 1972			169,000		

Amounts assumed	1970	1971	1972	1973	1974
1972 Taxable income computed per section 172(b)(2):					
Farm net income		$5,000			
Nonfarm income		30,000			
Farm recapture disposition		10,000			
		45,000	($45,000)		
Farm NOL carryover to 1973			124,000	($124,000)	
				750	($750)
d. EDA before making temporary subtractions					$127,925
e. Less temporary subtraction per subdivision (ii)(*a*)–zero (since 1973 farm loss treated as nonfarm addition to NOL per subdivision (iv)(*a*))					0
f. Less temporary subtraction per subdivision (ii)(*b*): Aggregate farm NOL carryover to 1973				$124,000	
Less tentative farm NOL deduction for 1973:					
Farm net income			($75,000)		
Nonfarm income			10,000		
Farm property disposition			30,000		
Exemption			(750)		
Tentative taxable income			(44,250)		
Tentative NOL reducing taxable income			0	0	
				124,000	(124,000)
g. EDA limitation for 1973					3,925
2. Taxable Income 1973:					
a. Farm net income					(75,000)
b. Nonfarm income					10,000
c. Farm property disposition					20,000
d. Exemption					(750)
e. Section 1202 deduction:					
Farm property disposition				20,000	
Less amount treated as ordinary income under section 1251(c) (lesser of amount of gain on line 1(g))				3,925	
Capital gain				16,075	
Less 50 percent deduction				8,038	(8,037)
f. Taxable income for 1973					(53,787)
IV. COMPUTATIONS FOR 1974					
1. Excess Deductions Account Limitation for 1974:					
a. Line 1(d) above					127,925
b. Less recapture in 1973					(13,925)
c. Farm loss for 1974			10,000		
Plus farm NOL deduction (see § 1.1251–3(b)(3))			45,000		
			55,000	55,000	
Less				25,000	
				30,000	30,000
d. Less permanent subtraction per subdivision (iii):					
1970 Farm NOL carryover to 1973				124,000	
Less 1970 farm NOL carryover to 1974 per section 172(b)(2)				124,000	
				0	0
e. EDA before making temporary subtractions					154,000
f. Less temporary subtraction per subdivision (ii)(*b*):					
Aggregate farm NOL carryover to 1974				124,000	
Less tentative farm NOL deduction in 1974:					
Farm net income			(10,000)		
Nonfarm income			200,000		
Farm property disposition			150,000		
Exemption			(750)		
Tentative taxable income			339,250		
Tentative NOL deduction			169,000		

Amounts assumed	1970	1971	1972	1973	1974
Farm portion of tentative NOL deduction				124,000	
				0	0
g. EDA limitation for 1974					$154,000
2. Taxable Income 1974:					
a. Farm net income					(10,000)
b. Nonfarm income					200,000
c. Farm property disposition					150,000
d. Exemption					(750)
e. Section 1202 deduction:					
Farm property disposition				$150,000	
Less amount treated as ordinary income under section 1251(c) (lesser of amount of gain on line 1(g))				150,000	0
f. Taxable income before NOL deduction					339,250
g. Net operating loss deduction					(169,000)
h. Taxable income					170,250

(vi) *Electing small business corporation. (a)* In the case of an electing small business corporation, the amounts to be subtracted under subdivisions (ii) and (iii) of this subparagraph, shall be the sum of the amounts under such subdivisions computed with respect to each shareholder of the corporation for the taxable year of the shareholder with which or within which the taxable year of the corporation ends, by applying (*b*) of this subdivision (vi), in lieu of subdivision (iv)(*a*) of this subparagraph.

(*b*) For purposes of (*a*) of this subdivision, the farm portion of a shareholder's net operating loss is that portion of the net operating loss of such shareholder attributable to the corporation's farm net loss, and such portion and the remaining portion shall be considered to be absorbed pro rata. If a corporation's farm net loss is not added to its excess deduction account in the year in which such loss occurs, no portion of a shareholder's net operating loss for the taxable year of the shareholder with which or within which such taxable year of the corporation ends shall be attributable to such corporation's farm net loss.

(d) *Exception for taxpayers using certain accounting methods*—(1) *General rule.* Under section 1251(b)(4), except to the extent that a taxpayer has succeeded to an excess deductions account as provided in paragraph (e) of this section (relating to receipt of farm recapture property in certain corporate and gift transactions), additions to the account shall not be required by a taxpayer who elects to compute taxable income from the trade or business of farming (as defined in paragraph (e)(1) of §1.1251–3:

(i) By using inventories for all property which may be inventoried except as to property to which subdivision (ii) of this subparagraph applies, and

(ii) In accordance with subparagraph (3) of this paragraph, by charging to capital account all expenditures paid or incurred which are properly chargeable to capital account including such expenditures which the taxpayer may, under chapter 1 of the Code or regulations prescribed thereunder, otherwise treat or elect to treat as expenditures which are not chargeable to capital account.

For rules as to procedure of making the election, effect of a change in method of accounting upon making the election, and conditions for revoking the election, see subparagraphs (4), (5), and (6), respectively, of this paragraph.

(2) *Inventories.* The absence of property which may be inventories shall not preclude a taxpayer from making an election under section 3251(b)(4). Any acceptable inventory method will satisfy the requirement of subparagraph (1)(i) of this paragraph.

(3) *Property chargeable to capital account*—(i) *In general.* Property subject to the capitalization requirement prescribed in subparagraph (1)(ii) of this paragraph includes all property described in section 1231(b) (1) and (3),

without regard to any holding period therein provided, which is used in the trade or business of farming. Thus, for example, property subject to the capitalization requirement includes property used in the trade or business of farming of a character subject to the allowance for depreciation and real property so used regardless of the period held, and livestock used in the trade or business of farming which is held for draft, breeding, dairy, or sporting purposes regardless of the period held.

(ii) *Expenditures which must be capitalized.* Expenditures subject to the requirement of subparagraph (1)(ii) of this paragraph are all expenditures, whether direct or indirect, paid or incurred, which are properly chargeable to capital account. For examples of the meaning of the term *properly chargeable to capital account,* see §§ 1.61–4, 1.162–12, 1.263(a)–1, and 1.263(a)–2, and paragraph (a)(4) (ii) and (iii) of § 1.446–1. Other examples of expenditures referred to in subparagraph (1)(ii) of this paragraph are expenditures under sections 175 (relating to soil and water conservation), 180 (relating to fertilizer, etc.), 182 (relating to land clearing), and 266 (relating to certain carrying charges) which (without regard to section 1251) a taxpayer may treat or elect to treat as expenditures which are not chargeable to capital account. Thus, for example, with respect to developing a farm, ranch, orchard, or grove, amounts properly chargeable to capital account include amounts paid or incurred for upkeep, taxes, interest, and other carrying charges, water for irrigation, fertilizing, controlling undergrowth, and the cultivating and spraying of trees. For a further example, with respect to a produced animal, amounts properly chargeable to capital account for the animal include all expenditures paid or incurred for producing the animal, such as for stud, breeding, and veterinary services, as well as all amounts paid or incurred with respect to the brood animal during the gestation period of the produced animal including all amounts paid or incurred for feed, maintenance, utilities, indirect overhead, depreciation, insurance, and carrying charges. Direct and indirect expenditures properly chargeable to capital account with respect to raising an animal may include, in addition to expenditures for feed, maintenance, etc., expenditures for training. Direct and indirect expenditures with respect to feed may include, in the case of a grazing operation, fees for the rental of grazing land, and the portion of all labor, taxes, interest, fencing costs, and carrying charges paid or incurred by the taxpayer allocable to grazing. For purposes of this subparagraph, reasonable allocations shall be made by the taxpayer of items between animals held for different purposes and as to each animal held. However, all amounts allocated to a brood animal during the period of gestation are, for purposes of this subparagraph, entirely chargeable to the capital of the produced animal.

(iii) *Unharvested crops.* With respect to unharvested crops to which section 1231(b)(4) applies, see section 268 and paragraph (g) of § 1.1016–5 (relating, respectively, to disallowance of certain deductions and to adjustments to basis).

(iv) *Changes in character of property.* If, in a taxable year subsequent to the first taxable year to which an election under section 1251(b)(4) applies, property which was not subject to the requirements of subparagraph (1)(ii) of this paragraph becomes subject to such requirements, then the following rules shall apply:

(*a*) The adjusted basis of such property at the beginning of the taxable year in which it becomes subject to the requirements of subparagraph (1)(ii) of this paragraph shall be equal to the amount its adjusted basis would have been on such date had it been accounted for in accordance with such requirements (taking into account, if applicable, the depreciation which would have been allowed as determined by the taxpayer using a period, salvage value, and methods that would have been proper).

(*b*) At the beginning of the taxable year in which such property becomes subject to the requirements of subparagraph (1)(ii) of this paragraph:

(*1*) If such property was not included in the opening inventory, the amount equal to the excess of its adjusted basis as computed in (*a*) of this subdivision over its adjusted basis as of the close of the preceding taxable year, or

(*2*) If such property was included in the opening inventory, such opening inventory shall be reduced by the inventory value of such property included therein and the amount of the difference between the adjusted basis for the property computed in (*a*) of this subdivision and such inventory value,

Shall be added to gross income for such taxable year and shall be treated as gross income derived from the trade or business of farming under paragraph (b)(1)(ii) of §1.1251–3, except that if the difference in (*b)(2*) of this subdivision represents an excess of such inventory value over the adjusted basis for the property computed in (*a*) of this subdivision then such excess shall be subtracted from gross income for such taxable year and shall be treated as a deduction allowed which is directly connected with carrying on the trade or business of farming under paragraph (b)(1)(i) of §1.1251–3.

(*c*) If any deductions for depreciation are treated as amounts which would have been allowed in a prior taxable year or years for purposes of (*a*) of this subdivision, such deduction shall be treated as having been allowed for purposes of applying sections 1245 and 1250 in the same taxable year or years and thus included in the amount of adjustments reflected in adjusted basis within the meaning of paragraph (a)(1)(ii) of §1.1245–2 or depreciation adjustments within the meaning of paragraph (d)(1) of §1.1250–2 (as the case may be).

(*d*) For purposes of this subparagraph (3), if during a taxable year property becomes subject to the requirements of subparagraph (1)(ii) of this paragraph, it shall be considered subject to such requirements on each day it is held during such year.

(*e*) The adjusted basis under (*a*) of this subdivision of property of a character subject to the allowance for depreciation shall be its basis for which deductions may be computed under section 167.

(v) *Example.* The provisions of subdivision (iv) of this subparagraph may be illustrated by the following example:

Example: On January 1, 1974, A, an individual taxpayer who in a previous year had elected under section 1251(b)(4) to compute income from the trade or business of farming by using inventories and by charging to capital account all items properly chargeable to capital under the rules of subdivision (ii) of this subparagraph, purchases a herd of six-month-old feeder calves for $13,000. During 1974, in connection with such herd, A incurred raising costs of $4,000 and carrying charges of $1,600 which would have been properly chargeable to capital account within the meaning of subparagraph (1)(ii) of this paragraph if the herd had not been included in inventory. A determines under his unit-livestock method that on December 31, 1974, the inventory value of the herd is $17,000. On March 1, 1975, A decides to use one-half of the herd for breeding purposes with such part of the herd becoming subject to the capitalization requirements. On January 1, 1975, the adjusted basis for the animals held for breeding purposes, computed under the provisions of subdivision (iv)(a) of this subparagraph, is $9,300 (that is, the aggregate of one-half of the purchase price of $13,000 for the entire herd of feeder calves, $6,500, one-half of the carrying charges of $1,600 incurred during 1974 in connection with the entire herd, $800, and one-half of the $4,000 of raising costs incurred during 1974 for the entire herd, $2,000). There is no adjustment for the depreciation which would have been allowed since no animal in the herd had reached an acceptable breeding age. Therefore, A as of January 1, 1975, must under the provisions of subdivision (iv)(*b)(2*) of this subparagraph subtract $8,500 from his opening inventory value of $17,000. However, A has not changed his method of accounting with respect to such animals. Under the provisions of subdivision (iv)(*b)(2*) of this subparagraph, A for 1975 will add $800 to his gross income (that is, the difference between the adjusted basis for the calves to be used for breeding purposes, $9,300, over the inventory value of such animals, $8,500). Such amount under the provisions of subdivision (iv)(*b*) shall be treated as gross income derived from the trade or business of farming under paragraph (b)(1) of §1.1251–3.

(4) *Time and manner of making election*—(i) *In general.* The election under section 1251(b)(4) for any taxable year beginning after December 31, 1969, shall be filed within the time prescribed by law (including extensions thereof) for filing the return for such taxable year. Such election shall be made and filed by attaching a statement of such election signed by the taxpayer to the return for the first taxable year for which the election is made. The statement shall contain a declaration that the taxpayer is making an election

under section 1251(b)(4) of the Code and that taxable income from the trade or business of farming is computed by using inventories for all property, which may be inventoried and by charging to capital account all expenditures paid or incurred which are properly chargeable to capital account (including such expenditures which the taxpayer may, under chapter 1 of the Code or regulations prescribed thereunder, otherwise treat or elect to treat as expenditures which are not properly chargeable to capital account). Additionally, the statement must contain the information prescribed by subparagraph (5) of this paragraph, if applicable.

(ii) *Joint return.* If for a taxable year taxpayers file a joint return under section 6013, the election referred to in subparagraph (1) of this paragraph must be made by both such taxpayers in accordance with the provisions of subdivision (i) of this subparagraph. If, however, in such case either of such taxpayers has for a previous taxable year made such an election, then only the taxpayer who has not made such election is required to comply with the provisions of subdivision (i) of this subparagraph. The taxpayer who previously made such an election shall attach a statement to the return specifying the taxable year for which the election was made and with whom the election was filed.

(5) *Change in method of accounting, etc.*—(i) *In general.* If, in order to comply with an election made under section 1251(b)(4), a taxpayer must change his method of accounting (in computing taxable income from the trade or business of farming) by placing in inventory a class of items not previously treated as in an inventory or by charging to capital account a class of items which had been consistently treated as an expense or as part of inventory (see paragraph (e)(2)(ii)(*b*) of § 1.446–1), the taxpayer will be deemed to have obtained the consent of the Commissioner as to such change in method of accounting solely as to such items and there shall be taken into account in accordance with section 481 of the Code and the regulations thereunder those adjustments which are determined to be necessary by reason of such change solely as to such items in order to prevent amounts from being duplicated or omitted. For purposes of section 481(a)(2), such change in method of accounting with respect to only such items shall be treated as a change not initiated by the taxpayer and, thus, under paragraph (a)(2) of § 1.481–1, no part of the adjustments required under section 481 with respect to such items shall be based on amounts which are taken into account in computing income (or which should have been taken into account had the new method of accounting been used) for taxable years beginning before January 1, 1954, or ending before August 17, 1954.

(ii) *Additional information.* If, in order to comply with an election made under subparagraph (1) of this paragraph a taxpayer (or in the case of a joint return one or both taxpayers) changes his method of accounting, then in addition to the information required to be filed under subparagraph (4) of this paragraph the taxpayer must file on Form 3115 as part of such election all the information described in paragraph (e)(3) of § 1.446–1 (relating to change in method of accounting), but the time prescribed in paragraph (e)(3) of § 1.446–1 for filing Form 3115 shall not apply.

(iii) *Election made before May 7, 1976.* If an election referred to in subparagraph (1) of this paragraph was made before May 7, 1976, the taxpayer shall file not later than August 5, 1976, such information referred to in subparagraph (4) of this paragraph not previously required by applicable regulations to be filed in order to make such election, and, in addition, if subdivision (ii) of this subparagraph applies, the taxpayer shall file not later than August 5, 1976, on Form 3115 the information referred to in subdivision (ii) of this subparagraph with the district director, or the director of the internal revenue service center, with whom the election was filed. For this purpose, Form 3115 shall be attached to a statement clearly identifying the election referred to in subparagraph (1) of this paragraph and the first taxable year to which it applied.

(6) *Revocability of election*—(i) *In general.* An election referred to in subparagraph (1) of this paragraph is binding on the taxpayer or in the case of a

joint return both taxpayers) for the taxable year of such election and for all subsequent taxable years (regardless of whether they continue to file a joint return) and may not be revoked except with the consent of the Commissioner. Since revocation would constitute a change in method of accounting, in order to secure the Commissioner's consent to the revocation of such an election and to a change of the taxpayer's method of accounting, all the provisions of paragraph (e)(3) of §1.446–1 must be met including the requirement that Form 3115 must be filed within 180 days after the beginning of the taxable year in which it is desired to make the change. See section 481 and the regulations thereunder (relating to certain adjustments required by such changes).

(ii) *Revocation of elections made prior to May 7, 1976.* If on or before May 7, 1976, an election under section 1251(b)(4) has been made, such election may be revoked without permission of the Commissioner by filing on or before August 5, 1976, with the district director or the director of the internal revenue service center with whom the election was filed a statement of revocation of an election under section 1251(b)(4). If such election to revoke is for a period which falls within one or more taxable years for which an income tax returns shall be filed for any such taxable years for which the computation of taxable income is affected by reason of such revocation.

(e) *Transfer of excess deductions account*—(1) *Certain corporate transactions*—(i) *In general.* Under section 1251(b)(5)(A), in the case of a transfer described in section 1251(d)(3) and paragraph (c)(2) of §1.1251–4 to which section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings), 374(a) (relating to exchanges pursuant to certain railroad reorganizations), or 381 (relating to carryovers in certain corporate acquisitions) applies, the acquiring corporation shall succeed to and take into account as of the close of the day of distribution or transfer the excess deductions account of the transferor. Determinations under this subdivision shall be made under subdivisions (ii), (iii), and (iv) of this subparagraph regardless of whether section 381 applies. For treatment as farm recapture property of stock or securities received in certain transfers to controlled corporations to which section 1251(d)(3) (but not section 1251(b)(5)(A)) applies, see section 1251(d)(6) and paragraph (f) of §1.1251–4.

(ii) *Acquiring corporation.* For purposes of subdivision (i) of this subparagraph, determinations as to which corporation is the acquiring corporation shall be made under paragraph (b)(2) of §1.381(a)–1.

(iii) *Certain operating rules.* For purposes of subdivision (i) of this subparagraph, the operating rules of section 381(b) and §1.381(b)–1 shall apply. Thus, for example, except in the case of a reorganization qualifying under section 368(a)(1)(F) (whether or not such reorganization also qualifies under any other provision of section 368(a)(1)), the amount of the excess deductions account of the transferor shall be computed, as of the close of the date of distribution or transfer (as determined under paragraph (b) of §1.381(b)–1), as if the taxable year of the transferor closed on such date (regardless of whether the taxable year actually closed). In the case of a reorganization qualifying under section 368(a)(1)(F) (whether or not such reorganization also qualifies under any other provision of section 368(a)(1)), the acquiring corporation's excess deductions account shall be treated for purposes of section 1251 just as the transferor corporation's excess deductions account would have been treated if there had been no reorganization.

(iv) *Excess deductions account balance.* For purposes of subdivision (i) of this subparagraph, the amount in the transferor's excess deductions account as of the close of the date of distribution or transfer referred to in subdivision (iii) of this subparagraph shall be the amount in such account determined after making all the applicable additions and subtractions under section 1251(b) (other than subtractions under paragraph (5)(A) of section 1251(b) and this subparagraph) for the taxable year ending (or considered ending) on such date including a subtraction by reason of gain (if any) recognized under section 1251(c)(1) by reason of a disposition which is in part a sale or exchange and in part a gift transaction to which section 1251(d)(1) and paragraph (a)(2) of § 1.1251–4 apply.

(2) *Certain gifts*—(i) *In general.* If farm recapture property is disposed of by gift (including for purposes of this paragraph in a transaction which is in part a sale or exchange and in part a gift or a transaction treated under paragraph (a)(2) of this section as a gift), and if such gift is made during any *1-year period* (described in subdivision (ii) of this subparagraph) for which the *potential gain limitation percentage* (as computed in subdivision (iii) of this subparagraph) exceeds 25 percent, then the provisions of subdivision (iv) of this subparagraph shall apply in respect of such gift.

(ii) *One-year period.* For purposes of this subparagraph, a *1-year period* is a period of 365 days beginning on the date a gift is made by the donor.

(iii) *Potential gain limitation percentage.* Under this subdivision, the *potential gain limitation percentage* for any such 1-year period is a percentage equal to (*a*) the sum of the potential gains (determined as of the first day of such period) on each item of farm recapture property held by such taxpayer on such first day disposed of by gift by the taxpayer during such period, divided by (*b*) the sum of the potential gains (determined as of the first day of such period) on all farm recapture property held by such taxpayer on such first day.

(iv) *Allocation ratio.* With respect to each gift of property (to which the provisions of this subdivision apply) made during a taxable year, each donee shall succeed (at the time the first of such gifts is made during such taxable year) to the same proportion of (*a*) the donor's excess deductions account determined, as of the close of such taxable year of the donor, after making all the applicable additions and subtractions under section 1251(b) (other than subtractions under section 1251(b)(5) and this paragraph), as (*b*) the potential gain (determined immediately prior to the time the first of such gifts is made during such taxable year) on the property (held by the donor immediately prior to such time) received by such donee bears to (*c*) The aggregate potential gain (determined immediately prior to such time) on all farm recapture property held by the donor immediately prior to such time.

(v) *Definitions and certain special rules.* For purposes of this subparagraph:

(*a*) The term *potential gain* means an amount equal to the excess of the fair market value of property over its adjusted basis, but, in the case of land, limited under paragraph (b)(2)(ii) of § 1.1251–1 to the extent of the deductions allowable in respect of such land pursuant to an election (if any) under sections 175 (relating to soil and water conservation expenditures) and 182 (relating to expenditures by farmers for clearing land) for the taxable year of disposition and the four immediately preceding taxable years regardless of whether any such preceding taxable year begins before December 31, 1969. See section 1251(e)(5).

(*b*) Property held on the first day of a one-year period shall include property received by gift during such one-year period and the potential gain with respect to such property, for purposes of making the computations under this subparagraph, shall be the potential gain in the hands of the donor reduced by the amount of gain (in the case of an exchange which is part a sale and part a gift) taken into account by the donor.

(*c*) Property held by a taxpayer on the first day of a one-year period which property becomes farm recapture property in the hands of such taxpayer during such one-year period shall be considered to be farm recapture property on each day of such one-year period.

(vi) *Part-sale-part-gift transaction.* If property is disposed of in a transaction which is in part a sale or exchange and in part a gift, then for purposes of subdivisions (iii)(*a*) and (iv)(*b*) of this subparagraph the potential gain with respect to the property transferred shall be reduced by the amount of gain taken into account by the transferor.

(vii) *Joint return.* For application of the provisions of this subparagraph with respect to a taxable year for which a joint return is filed, see paragraph (f)(4) of this section.

(3) *Examples.* The provisions of subparagraph (2) of this paragraph may be illustrated by the following examples

in which it is assumed that all taxpayers are unmarried individuals.

Example 1. The only farm recapture property A owns is a farm, consisting of farm land and certain farm equipment which is farm recapture property. During the period involved, there was no deduction allowable under section 175 or 182 to any person owning an interest in the farm. A, who uses the calendar year as his taxable year, makes a series of gifts of undivided interests in the farm. In these circumstances, computations may be made by reference to percentages of undivided interests in the farm. The potential gain limitation percentages for each applicable 1-year period are computed, in accordance with the additional facts assumed, in the table below:

Date Gift to donee	9/1/70	8/1/71	3/1/72	5/1/73
	C	D	E	F
(1) Percent of undivided interest in entire farm given as gift by A on date indicated	20%	10%	10%	60%
(2) Percent of undivided interest in entire farm held by A immediately before gift	100%	80%	70%	60%
(3) Potential gain:.				
(a) On all property held by A on date of gift	$100,000	$96,000	$140,000	$125,000
(b) Limitation percentage (sum of amounts in line (1) during 1-year period beginning on date of gift divided by line (2))	30%	25%	14.28%	100%

(ii) Under subparagraph (2)(iv) of this paragraph, C, D, and F each succeed to the proportion of A's excess deductions account at each applicable time as computed in accordance with the additional facts assumed, in the table below:

	Taxable year ending—			
	Dec. 31, 1970	Dec. 31, 1971	Dec. 32, 1972	Dec. 31, 1973
Gift to donee to which subparagraph (2)(iv) of this paragraph applies during taxable year	C	D	E	F
(4) Potential gain (determined immediately prior to time first gift to which subparagraph (2)(iv) of this paragraph applies is made):				
(a) On property received by donee to which such subparagraph (2)(iv) applies (line (3)(a) multiplied by line (1) divided by line (2))	$20,000	$12,000	....	$125,000
(b) Aggregate potential gain on all farm recapture property held by donor (line (3)(a))	$100,000	$96,000	....	$125,000
(5) Allocation ratio (line (4)(a), divided by line (4)(b))	20%	12.5%	....	100%
(6) Excess deductions account of A:.				
(a) At end of previous taxable year	0	$160,000	$210,000	$200,000
(b) Net increase (decrease) for taxable year (determined before making any subtractions under section 1251(b)(5) and this paragraph)	$200,000	$80,000	($10,000)	$36,000
(c) At 12/31 (so determined)	$200,000	$240,000	$200,000	$236,000
(d) Less: Portion to which donee succeeds (line (5), multiplied by line (6)(c))	$40,000	$30,000	$0	$236,000
(e) At 12/31 (to line (6)(a) following taxable year)	$160,000	$210,000	$200,000	$0

Since the potential gain limitation percentage for the 1-year period beginning on September 1, 1970, exceeds 25 percent, a portion of A's excess deductions account, under the provisions of subparagraph (2)(iv) of this paragraph, is succeeded to by C and D. Similarly, since such percentage for the 1-year period beginning May 1, 1973, exceeds 25 percent, such provisions apply to the gift made to F. Since, however, such percentage is 25 percent or less for all 1-year periods in which the gift to E falls (i.e., 25 percent and 14.28 percent for the 1-year periods beginning, respectively, on August 1, 1971, and March 1, 1972) such provisions do not apply to the gift to E.

Example: 2. (i) G uses the calendar year as his taxable year and H uses a taxable year ending June 30. As of the close of 1972, G has $100,000 in his excess deductions account, determined before any subtractions under section 1251(b)(5) and this paragraph. G owns only three items of farm recapture property, none of which is land. On May 1, 1972, G makes a gift of farm recapture property No. 1 to his son and on September 1, 1972, G sells to H for $80,000 farm recapture property No. 2 in a transaction which is in part a sale and in part a gift. G owns throughout all relevant periods farm recapture property No. 3. The potential gain limitation percentage for G's one-year period beginning May 1, 1972, is computed in accordance with the additional facts assumed in the table below:

Farm Recapture Property				Total
No. 1	No. 2	No. 3		
(1) Fair market value 5/1/72	$25,000	$100,000	$800,000	
(2) Adjusted basis 5/1/72	$10,000	$60,000	$795,000	
(3) Potential gain (line (1), minus line (2))	$15,000	$40,000	$5,000	$60,000
(4) Sum of potential gains on properties disposed of by gift during period less gain taken into account by transferor on part-sale-part-gift	$15,000	$20,000		$35,000
(5) Potential gain limitation percentage (total line (4), divided by total line (3))				58⅓%

Since the potential gain limitation percentage for the one-year period beginning on May 1, 1972, exceeds 25 percent, the provisions of subparagraph (2)(iv) of this paragraph apply to the gift to the son and that portion of the disposition to H which is a gift.

(ii) The portion of G's excess deductions account determined, as of the close of 1972, before any subtraction under section 1251(b)(5) and this paragraph, allocated to the son and to H as of May 1, 1972, is computed in the table below:

	Property			Total
	No. 1	No. 2	No. 3	
(1) Potential gain under part (i) of this example (since the first day of the one-year period is the same as the time as of which the first gift was made during the taxable year)	$15,000	$40,000	$5,000	$60,000
(2) Potential gain less amount taken into account by transfer on part-sale-part-gift	15,000	20,000		
(3) Allocation percentage (line (2), divided by $60,000)	25%	33⅓%		
(4) Excess deductions account at close of taxable year (determine before making any subtractions under section 1251(b)(5) and this paragraph)				100,000
(5) Portion to which donee succeeds on 5/1/72	25,000	33,333		58,333
(6) G's excess deductions account 12/31/72				$41,667

Accordingly, the amount of G's excess deduction account succeeded to as of May 1, 1972, is $25,000 by the son and $33,333 by H.

(f) *Joint return*—(1) *Joint excess deductions account.* If for a taxable year a taxpayer and his spouse file a joint return under section 6013, then for such taxable year each taxpayer shall (if necessary) establish and maintain a joint excess deductions account. Such joint excess deductions account shall consist of the aggregate of the separately maintained excess deductions account of each spouse. A separately maintained excess deductions account shall be computed under the rules of paragraphs (b) and (c) of this section, except that for each taxable year a joint return is filed:

(i) The $50,000 amount in the nonfarm adjusted gross income limitation in paragraph (b)(2)(i) of this section shall be considered satisfied if the combined nonfarm adjusted gross income of both spouses exceeds $50,000,

(ii) The $25,000 amount in the farm net loss exclusion in paragraph (b)(2)(ii) of this section shall be allocated between the two spouses in proportion to the farm net loss of each spouse having a farm net loss, and

(iii) The separately maintained excess deductions account of each spouse shall be reduced, if necessary, below zero, by the amount of such spouse's farm net income (computed as if a separate return were filed) plus the amount of gain (computed under subparagraph (3) of this paragraph) which is recognized as ordinary income under section 1251(c)(1) in respect of a disposition of farm recapture property owned by the taxpayer.

(2) *Surviving spouse.* For purposes of this paragraph, a joint return does not include a return of a surviving spouse (as defined in section 2 relating to a spouse who died during either of his two taxable years immediate preceding the taxable year) which is treated as a joint return of a husband and wife under section 6013.

(3) *Application of excess deductions account limitation in joint return year.* In the case of a taxable year for which a joint return is filed, the aggregate of the amount of gain recognized as ordinary income under section 1251(c)(1) (after applying paragraph (b) (2)(o) and (3) of §1.125–1, if applicable) shall not exceed the amount in the joint excess deductions account (that is, the aggregate of the separately maintained excess deductions account of each spouse) at the close of the taxable year after subtracting from each such separately maintained account the amount specified in section 1251(b) (3) (A) and paragraph (c) (1) (i) of this section as modified by the rules of this paragraph. For the amount of limitation for a taxable year for which a separate return is filed, see paragraph (b)(4) of this section. For determinations as to which dispositions are taken into account for any taxable year, see paragraph (b)(4) of §1.1251–1.

(4) *Certain gifts*—(i) *In general.* If farm recapture property is transferred as a gift by a spouse to a person other than a spouse during a taxable year for which a joint return is filed, the spouses shall for purposes of applying the provisions of section 1251(b) (5) (B) and paragraph (e)(2) of this section be treated as a single taxpayer. Thus, under paragraph (e)(2) of §1.1251–2, the potential gain limitation percentage and the proportion for allocating the amount in the joint excess deductions account to one or more donees shall be determined by treating the spouses as a single taxpayer. However, with respect to each gift by a spouse, such spouse's separately maintained excess deductions account shall be reduced (below zero, if necessary) by the amount of the joint excess deductions account balance to which the donee of such gift succeeded under paragraph (e)(2)(iv) of this section.

(ii) *Gift between spouses.* If farm recapture property is transferred by gift by one spouse to another spouse during a taxable year for which a joint return is filed, such gift shall not affect the balance in the joint excess deductions account but its effect on the separately maintained excess deductions account of each spouse shall be determined as if separate returns were filed, but only after applying subdivision (i) of this subparagraph.

(5) *Allocation of joint excess deductions account upon filing separate returns*—(i) *In general.* If for any reason a taxpayer and his spouse cease to file a joint return, then except as provided in this subparagraph the amount of the separately maintained excess deductions account of each spouse as of the close of the last taxable year for which a joint return was filed shall be the amount of such spouse's excess deductions account as of the beginning of the first taxable year for which they cease filing a joint return.

(ii) *Deficit.* If under subparagraph (4)(i) of this paragraph one of the spouses has a deficit in his separately maintained excess deductions account as of the close of the last taxable year for which a joint return was filed, then as of the beginning of the first taxable year for which they cease filing a joint return:

(*a*) The spouse who had such deficit shall have an excess deductions account of zero, and

(*b*) The other spouse shall have an excess deductions account equal to the amount prescribed in subdivision (i) of this subparagraph minus the amount of such deficit.

(6) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 3. Assume the same facts as in example (4) of paragraph (b)(5) of this section, except that H and W file a joint return under section 6013 and that H has a farm net loss of only $40,000. Thus, since the nonfarm adjusted gross income for calendar year 1971 was $60,000 for H and $30,000 for W, their combined nonfarm adjusted gross income exceeds $50,000, thereby satisfying under subparagraph (1)(i) of this paragraph the $50,000 limitation of paragraph (b)(2)(i) of this section. Assume further that for 1971 only W makes a dispostion of farm recapture property (other than land and section 1245 property). As a result of such disposition, W realizes a gain of $14,000. Accordingly, for 1971, the separately maintained excess deductions accounts of H and W, their joint excess deductions account, and the treatment of the gain realized by W on the disposition of the farm recapture property are computed, in accordance with the facts assumed in the table below:

EXCESS DEDUCTIONS ACCOUNTS

		H's		W's		Joint
(1) Balance Jan. 1, 1971	....	$10,000	....	$5,000	....	$15,000
(2) Additions for 1971:						
(a) Farm net loss for 1971	$40,000	....	$10,000	....	$50,000	....
(b) Less amount in paragraph (b)(2)(ii) of this section as allocated under subparagraph (1)(ii) of this paragraph	20,000	....	5,000	....	25,000	....
(c) Total additions for 1971	....	20,000	....	5,000	....	25,000
(3) Subtotal	....	30,000		10,000	....	40,000
(4) Subtractions for 1971	....	0	....	0	....	
(5) Excess deductions account limitation on gain recognized as ordinary income under section 1251(e)(1) for 1971	....	30,000	....	10,000	....	40,000
(6) Subtraction for dispositions of farm recapture property:						
(a) Gain to which section 1251(c)(1) applies (computed before applying limitation)	0	....	14,000	....	14,000	....
(b) Limitation (amount in line (5))	30,000	....	10,000	....	40,000	....
(c) Gain recognized as ordinary income under section 1251(c)(1), computed for joint account (lower of line 6(a) or line 6(b) subject to provisions as to separately maintained accounts of subparagraph (1)(iii)	....	....	....	14,000	....	14,000
(7) Balance Dec. 31, 1971	....	30,000	....	(4,000)	....	26,000

If for 1972, H and W were to file separate returns, then the separately maintained excess deductions account balances as of January 1, 1972, would be $26,000 and zero respectively. See subparagraph (5)(ii) of this paragraph.

[T.D. 7418, 41 FR 18816, May 7, 1976; 41 FR 23669, June 11, 1976]

§ 1.1251–3 Definitions relating to section 1251.

(a) *Farm recapture property*—(1) *In general.* (i) The term *farm recapture property* means any property (other than section 1250 property as defined in section 1250(c)) which, in the hands of the taxpayer is or was property:

(*a*) Which is described in section 1231(b)(1) (relating to business property held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), section 1231(b)(3) (relating to livestock), or section 1231(b)(4) (relating to an unharvested crop), and

(*b*) Which, at the time the property qualifies under (*a*) of this subdivision, is used in the trade or business of farming (as defined in paragraph (e) of this section).

(ii) The term *farm recapture property* also includes:

(*a*) Property acquired by gift and property acquired in a transaction to which section 1251(b)(5)(A) applies, if such property was farm recapture property within the meaning of subdivision (i) of this subparagraph in the hands of the transferor, and

(*b*) Property the basis of which in the hands of the taxpayer holding such property is determined by reference to the basis of other property which in the hands of such taxpayer was farm recapture property within the meaning of subdivision (i) of this paragraph. For purposes of (*b*) of this subdivison (ii) property whose basis is determined in accordance with the last sentence of section 1033(c) shall be considered as having as basis determined by reference to the property whose conversion gave rise to the application of such section.

(iii) *Leasehold of farm recapture property.* If property is farm recapture property under this subparagraph, a leasehold of such property is also farm recapture property is also farm recapture property to the same extent as described in, and in accordance with the principles of paragraph (a)(2) of §1.1245–3.

(iv) If property described in subdivision (ii) of this subparagraph is stock or securities received in certain corporate transactions described in section 1251(d)(6), see paragraph (f) of §1.1251–4 for determination as to extent such stock or securities is farm recapture property.

(2) *Examples.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example: On December 15, 1971, A, an individual calendar year taxpayer engaged in the trade or business of farming (as defined in paragraph (e) of this section) exchanges in a transaction which qualifies under section 1031(a) (relating to an exchange of property held for productive use or investment) tractor No. 1 which A acquired on March 1, 1971, for tractor No. 2. Under subparagraph (1)(i) of this paragraph, tractor No. 1 is farm recapture property as the tractor was used in the trade or business of farming and was held for a period in excess of 6 months. Under subparagraph (1)(ii) of this paragraph, tractor No. 2 is farm recapture property as the basis of tractor No. 2 in the hands of A is determined with reference to the adjusted basis of tractor No. 1.

(b) *Farm net loss*—(1) *In general.* The term *farm net loss* means the amount by which:

(i) The deductions allowed or allowable for the taxable year by chapter 1 of subtitle A of the Code which are directly connected with the carrying on of the trade or business of farming, exceed

(ii) The gross income derived from such trade or business.

(2) *Disposition of farm recapture property.* For purposes of subparagraph (1) of this paragraph, no gain or loss (regardless of how treated) resulting from the disposition of farm recapture property shall be taken into account, except that under subparagraph (1)(ii) of this paragraph gain upon disposition of such property which is recognized as ordinary income by reason of section 1245(a)(1) shall be taken into account. Thus, for example, if land used in the trade or business of farming were disposed of and gain of $3,000 was realized, then none of such gain would be taken into account in computing farm net loss and farm net income even if all or a portion of such gain is recognized as ordinary income by reason of section 1251(c)(1), section 1252(a)(1), or both. If such land were disposed of at a loss, the result would be the same. See paragraph (d)(1)(ii) of this section with respect to the exclusion of gain or loss from the disposition of farm recapture property from the computation of nonfarm adjusted gross income.

(3) *Amount of deduction under section 172(a) attributable to farm net loss.* (i) If all or a portion of a net operating loss (within the meaning of section 172(c)) for a taxable year is absorbed in another taxable year as a carryover or carry back, then for purposes of determining the amount of deductions referred to in subparagraph (1)(i) of this paragraph for such other taxable year the portion of the amount absorbed in such other taxable year which is attributable to amounts directly connected with the carrying on of the trade or business of farming shall be an amount equal to the amount absorbed, multiplied by a fraction the numerator of which is the amount of the farm net loss for the taxable year the net operating loss arose (but not in excess of the net operating loss for such year) and the denominator of which is the amount of the net operating loss for such year.

(ii) No portion of a farm net loss added to the excess deductions account in the year a net operating loss arose (or which would have been added to such account but for the application of the $25,000 or $12,500 farm net loss exclusion under paragraph (b) (2)(ii) or (4)(i)(*b*) of §1.1251–2) shall be taken into account under subparagraph (1)(i) of this paragraph in any other taxable year. Accordingly the same farm net loss shall not be added to the excess deductions account more than once and a farm net loss for any taxable year shall not be subject to the $25,000 or $12,500 exclusion more than once.

(iii) If a net operating loss for a current taxable year attributable in whole or part to a farm net loss is carried back and absorbed in a preceding taxable year no redetermination shall be made with respect to (*a*) the amount of gain recognized as ordinary income under section 1251(c)(1) and paragraph

(b) of § 1.1251–1 in any taxable year preceding the current taxable year, and (*b*) the amount of the taxpayer's excess deductions account allocated under paragraph (e)(2) of § 1.1251–2 to a donee as of the close of any taxable year preceding the current taxable year.

(4) *Special rules as to estates and trusts.* In the case of an estate or trust, computations of amounts under this paragraph shall be made without regard to any deductions under section 651 or 661. If on the termination of an estate or trust the beneficiaries succeeding to its property are allowed a deduction under section 642(h) (relating to unused loss carryovers and excess deductions on termination available to beneficiaries), to the extent the carryover or excess deduction is attributable to a farm loss it shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amount of a carryover or of excess deductions from a particular taxable year of an estate or trust succeeded to under section 642(h) shall be allocated between amounts attributable to a farm net loss and other amounts in the same proportion as the farm net loss for such year bears to the amount of such carryover or of excess deductions. If there is more than one beneficiary, the total farm net loss succeeded to by all the beneficiaries shall be allocated to each beneficiary in proportion to the deduction of each under section 642(h).

(c) *Farm net income.* The term *farm net income* means the amount by which the amount referred to in paragraph (b)(1)(ii) of this section exceeds the amount referred to in paragraph (b)(1)(i) of this section.

(d) *Nonfarm adjusted gross income*—(1) *In general.* The term *nonfarm adjusted gross income* means adjusted gross income (taxable income in the case of a taxpayer other than an individual) computed without regard to:

(i) Income or deductions taken into account in computing farm net loss and farm net income,

(ii) Gains and losses (regardless of how treated) resulting from the disposition of farm recapture property, and

(iii) In the case of an estate or trust, the principles of paragraph (b)(4) of this section, to the extent applicable, shall apply.

(2) *Special rules.* The following rules in addition to the rules of subparagraph (1) of this paragraph, shall apply in computing the adjusted gross income of a shareholder of an electing small business corporation:

(i) The amount of any distribution described in section 1373 (c)(2) made by the corporation shall be disregarded,

(ii) For purposes of computing the amount includible in the gross income of a shareholder under section 1373(b), the corporation's undistributable taxable income shall equal the corporation's nonfarm adjusted gross income (as defined in subparagraph (1) of this paragraph) minus the amount described in section 1373(c)(1), and

(iii) For purposes of computing a shareholder's deduction under section 1374, the corporation's net operating loss shall be computed without regard to the items referred to in subparagraph (1) (i) and (ii) of this paragraph.

(e) *Trade or business of farming*—(1) *In general.* For purposes of section 1251, the term *trade or business of farming* includes any trade or business with respect to which the taxpayer may compute gross income under § 1.61–4, expenses under § 1.162–12, make an election under section 175, 180, or 182, or use an inventory method referred to in § 1.471–6. Such term does not include any activity not engaged in for profit within the meaning of section 183 and section 183–2.

(2) *Horse racing.* If a taxpayer is engaged in the raising of horses, including horses which are bred or purchased, then for purposes of section 1251 the term *trade or business of farming* also includes the racing of such horses by the taxpayer. Thus, for example, if a taxpayer purchases a yearling and develops it to the racing stage, the term *trade or business of farming* includes the racing of such horse.

(3) *Several businesses of farming.* If a taxpayer is engaged in more than one trade or business of farming, all such trades and businesses shall be treated as one trade or business.

[T.D. 7418, 41 FR 18826, May 7, 1976, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§1.1251–4 Exceptions and limitations.

(a) *Exception for gifts*—(1) *General rule.* Section 1251(d)(1) provides that no gain shall be recognized under section 1251(c)(1) upon a disposition by gift. For purposes of this paragraph, the term *gift* shall have the same meaning as in paragraph (a) of §1.1245–4 and, with respect to the application of this paragraph, principles illustrated by the examples of paragraph (a)(2) of §1245–4 shall apply. For reduction in amount of charitable contribution in case of a gift of farm recapture property, see section 170(e) and §1.170A–4.

(2) *Disposition in part a sale or exchange and in part a gift.* Where a disposition of farm recpature property is in part a sale or exchange and in part a gift, the amount of gain recognized as ordinary income under section 1251(c)(1) shall not exceed:

(i) In the case of farm recapture property other than land, the excess of the amount realized over adjusted basis, and

(ii) In the case of land, the lower of the amount in subdivision (i) of this subparagraph or the potential gain (as defined in paragraph (b)(2)(ii) of §1.1251–1.

(3) *Treatment of land in hand of transferee.* See paragraph (g) of this section for treatment of transferee in the case of a disposition of land to which this paragraph applies.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. A, a calendar year taxpayer, makes one disposition of farm recapture property during 1976. On March 2, 1976, A makes a gift to B (also a calendar year taxpayer) of a parcel of land which he had on January 15, 1971. On the date of such disposition, the excess of the fair market value ($65,000) over the adjusted basis of the land ($40,000) is $25,000 and the sum of the deductions allowable in respect of such land under sections 175 and 182 is $21,000 for 1971 and $3,000 (attributable to 1975) for the taxable year of disposition and the four immediately preceding taxable years. Thus, the potential gain (as defined in paragraph (b)(2)(ii) of §1.1251–1) is limited to $3,000. At the end of 1976 (after making the applicable additions and subtractions under section 1251(b) (2) and (3)(A)), there is a balance in A's excess deductions account of $25,000. However, upon making the gift, A recognizes no gain under section 1251(c)(1) or section 1252(a)(1). See subparagraph (a)(1) of this paragraph and paragraph (a)(1) of §1.1252–2. For treatment of the land in the hands of B, see example (1) of paragraph (g)(3) of this section. For effect of the gift on the excess deductions accounts of A and B, see paragraph (e)(2) of §1.1251–2.

Example 2. Assume the same facts as in example (1), except that A transfers the land to B for $50,000. Thus, the gain realized is $10,000 (amount realized, $50,000, minus adjusted basis $40,000), and A has made a gift of $15,000 (fair market value, $65,000, minus amount realized, $50,000). Since under subparagraph (2)(ii) of this paragraph, the potential gain ($3,000) is lower than the gain realized ($10,000), the gain to which section 1251(c)(1) could apply is limited by subparagraph (2)(ii) of this paragraph to $3,000. Thus, as A has $25,000 in his excess deductions account, $3,000 is recognized as ordinary income under section 1251(c)(1). See example (2) of paragraph (a)(4) of §1.1252–2 for computation of gain of $7,000 which is recognized as ordinary income by A under section 1252(a)(1). For treatment of the land in the hands of B, see example (2) of paragraph (g)(3) of this section.

(b) *Exception for transfers at death*—(1) *General rule.* Section 1251(d)(2) provides that, except as provided in section 691 (relating to income in respect of a decedent), no gain shall be recognized under section 1251(c)(1) upon a transfer at death. For purposes of this paragraph, the term *transfer at death* shall have the same meaning as in paragraph (b) of §1.1245–4 and, with respect to the application of this paragraph, principles illustrated by the examples of paragraph (b)(2) of §1.1245–4 shall apply.

(2) *Treatment of land in hands of transferee.* If as of the date a person acquires land which is farm recapture property from a decedent such person's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the property on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), then on such date the potential gain in respect to such land is zero.

(c) *Certain corporate transactions*—(1) *Limitation on amount of gain.* Under section 1251(d)(3), upon a transfer of property described in subparagraph (2) of this paragraph, the amount of gain recognized as ordinary income by the transferor under section 1251(c)(1) shall not exceed an amount equal to the excess (if any) of (i) the amount of gain recognized to the transferor on the transfer (determined without regard to section 1251) over (ii) the amount (if any) of gain recognized as ordinary income under section 1245(a)(1). For purposes of this subparagraph, the principles of paragraph (c)(1) of § 1.1245–4 shall apply. Thus, in case of a transfer of both farm recapture property and property other than farm recapture property in a single transaction, the amount realized from the disposition of the farm recapture property (as determined in a manner consistent with the principles of paragraph (a)(5) of § 1.1245–1) shall be deemed to consist of that portion of the fair market value of each property acquired which bears the same ratio to the fair market value of such acquired property as the amount realized from the disposition of farm recapture property bears to the total amount realized. The preceding sentence shall be applied solely for purposes of computing the portion of the total gain (determined without regard to section 1251) which is eligible to be recognized as ordinary income under section 1251(c)(1). Section 1251(d)(3) does not apply to a disposition of property to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 of the Code.

(2) *Transfers covered.* The transfers referred to in subparagraphs (1) of this paragraph are transfers of farm recapture property in which the basis of such property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(i) Section 332 (relating to distributions in complete liquidation of an 80-percent-or-more controlled subsidiary corporation). For the application of section 1251(d)(3) to such a complete liquidation, the principles of paragraph (c)(3) of § 1.1245–4 shall apply. Thus, for example, the provisions of subparagraph (1) of this paragraph do not apply to a liquidating distribution of farm recapture property by an 80-percent-or-more controlled subsidiary to its parent if the parent's basis for the property is determined, under section 334(b)(2), by reference to its basis for the stock of the subsidiary.

(ii) Section 351 (relating to transfer to corporation controlled by transferor).

(iii) Section 351 (relating to exchanges pursuant to certain corporate reorganizations).

(iv) Section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings).

(v) Section 374(a) (relating to exchanges pursuant to certain railroad reorganizations).

(3) *Partnerships.* For the application of section 1251 to partnerships, see paragraph (e) of this section.

(4) *Treatment of land in hands of transferee.* See paragraph (g) of this section for treatment of transferee in the case of a disposition of land to which this paragraph applies.

(5) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. (i) A, an individual calendar year taxpayer, makes one disposition of farm recapture property during 1971. On January 20, 1971. A transfers farm recapture property (other than land and section 1245 property), having an adjusted basis of $22,000, to corporation M in exchange for stock in M worth $35,000 plus $15,000 in cash in a transaction qualifying under section 351. Thus, the amount realized is $50,000, and the gain realized is the excess of the amount realized, $50,000, over the adjusted basis, $22,000, or $28,000. Without regard to section 1251, A would recognize gain of $15,000 under section 351(b), and M's basis for the farm recapture property would be determined under section 362(a) by reference to its basis in the hands of A. Assume further that the balance in A's excess deductions account (after making the applicable additions and subtractions under section 1251(b) (2) and (3)(A)) at the close of 1971 is $20,000. Thus, since such balance in the excess deductions account ($20,000) is lower than the gain realized ($28,000), is subparagraph (1) of this paragraph did not apply, gain of $20,000 would be recognized as ordinary income under section 1251(c)(1). However, subparagraph (1) of this paragraph limits the amount of gain to be recognized as ordinary income under section 1251(c)(1) to $15,000.

(ii) If, however, A transferred the farm recapture property to M solely in exchange for stock worth $50,000, then, because of the application of subparagraph (1) of this paragraph he would not recognize any gain under section 1251(c)(1). If, instead, A transferred the farm recapture property to M in exchange for stock worth $25,000 and $25,000 cash, only $20,000 (the amount of such balance in the excess deductions account) of the gain of $25,000 recognized under section 351(b) would be recognized as ordinary income under section 1251(c)(1). The remaining $5,000 of gain recognized under section 351(b) may be treated as gain from the sale or exchange of property described in section 1231. In the hands of M, the property received from A is farm recapture property under the provisions of paragraph (a)(11)(ii) of §1.1251–3. For treatment of the property received by A in such transaction; see section 1251(d)(6) and paragraph (f) of this section.

Example 2. Assume the same facts as in subdivision (i) of example (1), except that the farm recapture property is section 1245 property. Assume further than $5,000 is recognized as ordinary income under section 1245(a)(1), and that as of the close of 1971, A has a balance of $15,000 in his excess deductions account (after making the applicable additions and subtractions under section 1251(b) (2) and (3)(A) which, under paragraph (b) of §1.1251–3, is computed by treating the $5,000 of gain to which section 1245 applies as gross income derived from the trade or business of farming). The amount of gain recognized as ordinary income under section 1251(c)(1) is $10,000, computed as follows:

(1) Amount of gain under section 1251(c)(1) (determined without regard to subparagraph (1) of this paragraph):.	
(a) Portion of gain realized ($28,000) in excess of amount recognized as ordinary income under section 1245(a)(1) ($5,000)	$23,000
(b) Excess deductions account balance	15,000
(c) Lower of (a) or (b)	15,000
(2) Limitation in subparagraph (1) of this paragraph:	
(a) Gain recognized (determined without regard to section 1251)	15,000
(b) Minus: Gain recognized as ordinary income under section 1245(a)(1)	5,000
(c) Difference	10,000
(3) Lower of line (1)(c) or line (2)(c)	10,000

(d) *Limitation for like kind exchanges and involuntary conversions*—(1) *General rule.* Under section 1251(d)(4), if farm recapture property is disposed of and gain (determined without regard to section 1251) is not recognized in whole or in part under section 1031 (relating to like kind exchanges) or section 1033 (relating to involuntary conversions), then the amount of gain recognized as ordinary income by the transferor under section 1251(c)(1) shall not exceed an amount equal to the excess (if any) of (i) the amount of gain recognized on such disposition (determined without regard to section 1251) or (ii) the amount (if any) of gain recognized as ordinary income under section 1245(a)(1).

(2) *Examples.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. (i) A, an individual calendar year taxpayer, owns a herd of breeding cattle having an adjusted basis of $75,000 which he acquired on March 30, 1970, A receives insurance proceeds of $90,000. Thus, the gain realized is $15,000 (that is, the excess of the amount realized, $75,000), A makes no other disposition of farm recapture property during 1970. Assume that had the herd been sold at its fair market value on March 15, 1970, no gain would have been recognized as ordinary income under section 1245(a)(1). As of the close of 1970, A has a balance of $12,000 in his excess deductions account (after making the applicable additions and subtractions under section 1251(b) (2) and (3)(A)). Thus, since the balance in the excess deductions account, $12,000, is lower than the gain realized, $15,000, the amount of gain which would be recognized under section 1251(c)(1) (determined without regard to subparagraph (1) of this paragraph) would be $12,000.

(ii) Assume further that A spends $72,000 of the insurance proceeds to purchase another breeding herd, $10,000 to purchase stock in the acquisition of control of a corporation which owns property similar or related in service or use to the destroyed breeding herd, and retains cash of $8,000. Both of the acquisitions by A qualify under section 1033(a)(3)(A), and A properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain to $8,000 (that is, the amount by which the amount realized from the conversion, $90,000 exceeds the cost of the stock and other property acquired to replace the converted property, $72,000 plus $10,000). Thus, since $8,000 is the amount of gain which would be recognized under section 1033(a)(3) (determined without regard to section 1251), and since that amount is lower than the gain of $12,000 which would be recognized under section 1251(c)(1) (determined without regard to subparagraph (1) of this paragraph), under subparagraph (1) of this paragraph the amount of gain recognized under section 1251(c)(1) is limited to $8,000. The stock purchased for $10,000 qualifies under paragraph (a)(1)(ii)(*b*) of §1.1251–3 as farm recapture property.

Example 2. (i) A, an individual calendar year taxpayer, owns land which he had acquired on March 7, 1970, having an adjusted basis of $48,000, and a fair market value of $67,500. On January 15, 1975, A, as a result of a condemnation action, receives $67,500 (its fair market value) for the land. The aggregate of the deductions allowable in respect of such land under sections 175 and 182 is

$18,000, with $5,000 of such aggregate attributable to 1970 and $13,000 of such aggregate attributable to 1970 and $13,000 of such aggregate attributable to 1975 and the four preceding taxable years. Thus, the potential gain (as defined in paragraph (b)(2)(ii) of § 1.1251–1) is limited to $13,000, since that amount is lower than $19,500 (the excess of the fair market value of the land, $67,500, over its adjusted basis, $48,000). The gain realized by A is also $19,500. At the end of A's taxable year (after making the applicable additions and subtractions under section 1251(b) (2) and (3)(A)) there is a balance of $21,000 in the excess deductions account of A. Since the potential gain, $13,000, is lower than both the excess deductions account balance, $21,000, and the gain realized, $19,500, A would recognize $13,000 as ordinary income under section 1251(c)(1) (determined without regard to subparagraph (1) of this paragraph).

(ii) Assume further that A spends the entire amount received, $67,500, to purchase stock in the acquisition of control of a corporation which owns property similar or related in service or use to A's condemned land which qualifies under section 1033(a)(3)(A), and A properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain to zero (that is, the amount by which the amount realized from the conversion, $67,500, exceeds the cost of the stock acquired to replace the converted land, $67,500). Thus, since no gain would be recognized under section 1033(a)(3) (determined without regard to section 1251), under subparagraph (1) of this paragraph, no gain is recognized under section 1251(c)(1). The stock purchased for $67,500 qualifies under paragraph (a)(1)(ii)(*b*) of § 1.1251–3 as farm recapture property. See example (1) of paragraph (d)(2) of § 1.1252–2 for a computation of gain recognized as ordinary income under section 1252(a)(1).

Example 3. B, an individual calendar year taxpayer, owns a herd of breeding cattle having an adjusted basis of $25,000 which he acquired on March 30, 1970. On March 15, 1976, the entire herd is destroyed by a blizzard and on March 20, 1976, B receives insurance proceeds of $90,000. Thus, the gain realized is $65,000 (that is, the excess of the amount realized, $90,000, over the adjusted basis, $25,000). B makes no other disposition of farm recapture property during 1976. B spends $60,000 of the insurance proceeds to purchase another breeding herd and retains cash of $30,000. The acquisition by B qualifies under section 1033(a)(3)(A), and B properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain to $30,000 (that is, the amount by which the amount realized from the conversion, $90,000, exceeds the cost of the property acquired to replace the converted property, $60,000). Assume that the amount of gain recognized under section 1245(a)(1) is $20,000, and that as of the close of 1976 B has a balance of $100,000 in his excess deductions account (after making the applicable additions and subtractions under section 1251(b) (2) and (3)(A) which, under paragraph (b) of § 1.1251–3, is computed by treating the $20,000 of gain to which section 1245 applies as gross income derived from the trade or business of farming). The amount of gain recognized as ordinary income under section 1251(c)(1) is $10,000, computed as follows:

(1) Amount of gain under section 1251(c)(1) (determined without regard to subparagraph (1) of this paragraph):	
(a) Portion of gain realized ($65,000) in excess of amount recognized as ordinary income under section 1245(a)(1) ($20,000)	$45,000
(b) Excess deductions account balance	100,000
(c) Lower of (a) or (b)	45,000
(2) Limitation in subparagraph (1) of this paragraph:	
(a) Gain recognized (determined without regard to section 1251)	30,000
(b) Minus: Gain recognized as ordinary income under section 1245(a)(1)	$20,000
(c) Difference	10,000
(3) Lower of line (1)(c) or line (2)(c)	10,000

(3) *Application to single disposition of farm recapture property of one class and property of different class.* (i) If upon a sale of farm recapture property of one class gain would be recognized under section 1251(c)(1), and if such farm recapture property together with property of a different class or classes is disposed of in a single transaction in which gain is not recognized in whole or in part under section 1031 (without regard to section 1251(c)(1), then rules consistent with the principles of paragraph (d)(6) of § 1.1250–3 (relating to gain from disposition of certain depreciable realty) shall apply for purposes of allocating the amount realized to each of the classes of property disposed of and for purposes of determining what property the amount realized for each class consists of.

(ii) For purposes of this subparagraph, the classes of property other than farm recapture property are (*a*) section 1245 property, (*b*) section 1250 property, and (*c*) other property.

(iii) For purposes of this subparagraph, the classes of farm recapture property are (*a*) hand, (*b*) farm recapture property other than land which is section 1245 property and (*c*) farm recapture property other than land which is not section 1245 property.

(4) *Treatment of land received in like kind exchange or involuntary conversion.* The aggregate of the deductions allowed under sections 175 and 182 in respect of land acquired in a transaction described in subparagraph (1) of this paragraph shall include the aggregate of the deductions allowable under sections 175 and 182 in respect of the land transferred or converted (as the case may be) in such transaction minus the amount of gain taken into account under sections 1251(c) and 1252(a) with respect to the land transferred or converted. Upon a subsequent disposition of such land, such deductions shall be treated as having been allowable in the same taxable year as they were allowable with respect to the land transferred or converted.

(e) *Partnerships.* [Reserved]

(f) *Property transferred to controlled corporation.* [Reserved]

(g) *Treatment of land received by a transferee in a disposition by gift and certain tax-free transactions*—(1) *General rule.* If farm recapture property which is land is disposed of in a transaction which is either a gift to which paragraph (a)(1) of this section applies or a completely tax-free transfer to which section 1251(b)(5)(A) applies, then for purposes of section 1251:

(i) The aggregate of the deductions allowable under sections 175 and 182 in respect of the land in the hands of the transferee immediately after the disposition shall be an amount equal to the aggregate of such deductions for the taxable year and the four preceding taxable years in the hands of the transferor immediately before the disposition,

(ii) Upon a subsequent disposition by the transferee (including a computation of potential gain as defined in paragraph (b)(2)(ii) of §1.1251–1), such deductions in the hands of the transferee shall be treated as having been allowable with respect to the transferee in the same taxable year they were allowable to the transferor, and

(iii) If the taxable years of the transferor and transferee regularly end on different dates, then the aggregate of such deductions allowable for taxable year with respect to the transferor shall be treated in the hands of the transferee as allowable in the transferee's taxable year in which the taxable year of the transferor regularly ends.

(2) *Certain partially tax-free transfers.* If farm recapture property which is land is disposed of in a transaction which either is in part a sale or exchange and in part a gift to which paragraph (a)(2) of this section applies, or is a partially tax-free transfer to which section 1251(b)(5)(A) applies, then for purposes of section 1251:

(i) The amount determined under subparagraph (1)(i) of this paragraph shall be reduced by the amount of gain taken into account under sections 1251(c) and 1252(a) to the extent such gain is attributable to the sections 175 and 182 deductions for the taxable year and the preceding four taxable years (determined by attributing gain under section 1252(a) to the oldest years first) by the transferor upon the disposition, and

(ii) For purposes of subparagraph (1)(ii) of this paragraph, the amount of such gain recognized under sections 1251(c) and 1252(a) shall reduce the aggregate of deductions allowable under sections 175 and 182 for the taxable year and each of the preceding four taxable years on a pro rata basis.

(3) *Examples.* The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. Assume the same facts as in example (1) of paragraph (a)(4) of this section. Therefore, on the date B receives the land in the gift transaction, under subparagraph (1) (i) and (ii) of this paragraph, the aggregate of the deductions allowable under sections 175 and 182 in respect of the land in the hands of B is the amount in the hands of A, $24,000, and for purposes of applying section 1251 upon a subsequent disposition by B (including the computation of potential gain) such deductions in the hands of B shall be treated as allowable in the same year as they were allowable to A. Thus, in respect to the land in the hands of B, the allowable section 175 and 182 deductions of $3,000 shall be treated as allowable in 1975.

Example 2. Assume the same facts as in example (2) of Paragraph (a)(4) of this section. Under paragraph (2) of this paragraph, the aggregate of the allowable sections 175 and 182 deductions with respect to the land which pass over to B for purposes of section 1251 is zero ($3,000 deduction allowable under sections 175 and 182 for the taxable year and the four preceding taxable years minus $3,000 gain taken into account by A in accordance with example (2) of paragraph (a)(4) of this section).

[T.D. 7818, 41 FR 18828, May 7, 1976; 41 FR 23669, June 11, 1976]

§ 1.1252–1 General rule for treatment of gain from disposition of farm land.

(a) *Ordinary income*—(1) *General rule.* (i) Except as otherwise provided in this section and § 1.1252–2, if farm land is disposed of during a taxable year beginning after December 31, 1969, then under section 1252(a)(1) there shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (that is, shall be recognized as ordinary income) the lower of:

(*a*) The applicable percentage of the amount computed in subdivision (ii) of this subparagraph, or

(*b*) The amount computed in subdivision (iii) of this subparagraph.

(ii) The amount computed in this subdivision is an amount equal to:

(*a*) The aggregate of the deductions allowed, in any taxable year any day of which falls within the period the taxpayer held (or is considered to have held) the farm land, under sections 175 (relating to soil and water conservation expenditures) and 182 (relating to expenditures by farmers for clearing land) for expenditures paid or incurred after December 31, 1969, with respect to the farm land disposed of, minus

(*b*) The amount of gain recognized as ordinary income under section 1251(c)(1) (relating to gain from disposition of property used in farming where farm losses offset nonfarm income) upon such disposition of such land.

(iii) The amount computed in this subdivision is an amount equal to:

(*a*) The gain realized, that is, the excess of the amount realized (in the case of a sale, exchange, or involuntary conversion) or the fair market value of the farm land (in the case of any other disposition), over the adjusted basis of the farm land, minus

(*b*) The amount of gain recognized as ordinary income under section 1251(c)(1) upon such disposition of such land.

(iv) If a deduction under section 175 is allowed in respect of the farm land disposed of for a taxable year every day of which falls within the period after the taxpayer held (or is considered to have held) the farm land, and if the deduction is attributable to expenditures paid or incurred after December 31, 1969, with respect to such land during the period the taxpayer held (or is considered to have held) the land, then the amount of such deduction shall be applied to increase the amount computed (without regard to this subdivision) under subdivision (ii)(*a*) of this subparagraph.

(2) *Application of section.* Any gain treated as ordinary income under section 1252(a)(1) shall be recognized as ordinary income notwithstanding any other provision of subtitle A of the Code. For special rules with respect to the application of section 1252, see § 1.1252–2. For the relation of section 1252 to other provisions see paragraph (d) of this section.

(3) *Meaning of terms.* For purposes of section 1252:

(i) The term *farm land* means any land with respect to which deductions have been allowed under section 175 or 182. See section 1252(a)(2).

(ii) The period for which farm land shall be considered to be held shall be determined under section 1223.

(iii) The term *disposition* shall have the same meaning as in paragraph (a)(3) of § 1.1245–1.

(iv) The applicable percentage shall be determined as follows:

If the farm land is disposed of—	The applicable percentage is—
Within 5 years after the date it was acquired	100 percent.
Within the sixth year after it was acquired	80 percent.
Within the seventh year after it was acquired	60 percent.
Within the eighth year after it was acquired.	40 percent.
Within the ninth year after it was acquired.	20 percent.
Within the 10th year after it was acquired and thereafter.	0 percent.

(4) *Portion of parcel.* The amount of gain to be recognized as ordinary income under section 1252(a)(1) shall be determined separately for each parcel of farm land in a manner consistent

with the principles of subparagraphs (4) and (5) of §1.1245–1(a) (relating to gain from disposition of certain depreciable property). If (i) only a portion of a parcel of farm land is disposed of in a transaction, or if two or more portions of a single parcel are disposed of in one transaction, and (ii) the aggregate of the deductions allowed under sections 175 and 182 with respect to any such portion cannot be established to the satisfaction of the Commissioner or his delegate, then the aggregate of the deductions in respect of the entire parcel shall be allocated to each portion in proportion to the fair market value of each at the time of the disposition.

(b) *Instances of non-application*—(1) *In general.* Section 1252 does not apply if a taxpayer disposes of farm land for which the holding period is in excess of 9 years or with respect to which no deductions have been allowed under sections 175 and 182.

(2) *Losses.* Section 1252(a)(1) does not apply to losses. Thus, section 1252(a)(1) does not apply if a loss is realized upon a sale, exchange, or involuntary conversion of property, all of which is farm land, nor does the section apply to a disposition of such property other than by way of sale, exchange, or involuntary conversion if at the time of the disposition the fair market value of such property is not greater than its adjusted basis.

(c) *Treatment of partnerships and partners.* [Reserved]

(d) *Relation of section 1252 to other provisions*—(1) *General.* The provisions of section 1252 apply notwithstanding any other provisions of subtitle A of the Code. Thus, unless an exception or limitation under §1.1252–2 applies, gain under section 1252(a)(1) is recognized notwithstanding any contrary nonrecognition provision or income characterizing provision. For example, since section 1252 overrides section 1231 (relating to property used in the trade or business), the gain recognized under section 1252(a)(1) upon a disposition of farm land will be treated as ordinary income and only the remaining gain, if any, from the disposition may be considered as gain from the sale or exchange of a capital asset if section 1231 is applicable. See example (1) of paragraph (e) of this section.

(2) *Nonrecognition sections overridden.* The nonrecognition of gain provisions of subtitle A of the Code which section 1252 overrides include, but are not limited to, sections 267(d), 311(a), 336, 337, and 512(b)(5). See §1.1252–2 for the extent to which section 1252(a)(1) overrides sections 332, 351, 361, 371(a), 374(a), 721, 731, 1031, and 1033.

(3) *Installment method.* Gain from a disposition to which section 1252(a)(1) applies may be reported under the installment method if such method is otherwise available under section 453 of the Code. In such case, the income (other than interest) on each installment payment shall (i) first be deemed to consist of gain to which section 1251(c)(1) applies (if applicable) until all such gain has been reported, (ii) the next portion (if any) of such income shall be deemed to consist of gain to which section 1252(a)(1) applies until all such gain has been reported, and (iii) finally the remaining portion (if any) of such income shall be deemed to consist of gain to which neither section 1251(c)(1) nor 1252(a)(1) applies. For treatment of amounts as interest on certain deferred payments, see section 483.

(4) *Exempt income.* With regard to exempt income, the principles of paragraph (e) of §1.1245–6 shall be applicable.

(5) *Treatment of gain not recognized under section 1252(a)(1).* For treatment of gain not recognized under this section, the principles of paragraph (f) of §1.1245–6 shall be applicable.

(e) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. Individual A uses the calendar year as his taxable year. On April 10, 1975, he sells for $75,000 a parcel of farm land which he had acquired on January 5, 1970, with an adjusted basis of $52,500 for a realized gain of $22,500. The aggregate of the deductions allowed under sections 175 and 182 with respect to such land is $18,000 and all of such amount was allowed for 1970. Under the stated facts, none of the $22,500 gain realized is recognized as ordinary income under section 1251(c)(1) as there is no potential gain (as defined in section 1251(e)(5)) with respect to the farm land. Since no gain is recognized as ordinary income under section 1251(c)(1), and since the applicable percentage, 80 percent, of the aggregate of the deductions allowed under sections 175 and 182, $18,000, or $14,400, is lower than the gain realized, $22,500, the amount of gain recognized as ordinary income under section 1252(a)(1) is $14,400. The remaining $8,100 of the gain may be treated as gain from the sale or exchange of property described in section 1231.

Example 2. Assume the same facts as in example (2) of paragraph (b)(6) of § 1.1251–1. Assume further that the aggregate of the amount of sections 175 and 182 deductions allowable to the M corporation is equal to the amount allowed. Under paragraph (a)(1) of the section, $5,000 is recognized as ordinary income under section 1252(a)(1) upon the disposition of the land as a dividend, computed as follows:

(1) Aggregate of deductions allowed under sections 175 and 182	$18,000
(2) Minus: Gain recognized as ordinary income under section 1251(c)(1)	$13,000
(3) Difference	$5,000
(4) Multiply: Applicable percentage for property disposed of within the fifth year after it was acquired	100%
(5) Amount in paragraph (a)(1)(i)(*a*) of this section	$5,000
(6) Gain realized (fair market value $67,500, less adjusted basis, $45,000)	$22,500
(7) Minus: Amount in line (2)	$13,000
(8) Amount in paragraph (a)(1)(i)(b) of this section	$9,500
(9) Lower of line (5) or line (8)	$5,000

The *gain realized*, $22,500, minus the sum of the gain recognized as ordinary income under section 1251(c)(1), $13,000, and under section 1252(a)(1), $5,000, equals $4,500. Assuming section 311(d) (relating to certain distributions of appreciated property to redeem stock) does not apply, under section 311(a) the corporation does not recognize gain on account of the $4,500.

Example 3. Assume the same facts as in example (2) of this paragraph, except that M contracted to sell the land for $67,500 which would be paid in 10 equal payments of $6,750 each, plus a sufficient amount of interest so that section 483 does not apply. Assume further that the remaining gain of $4,500 is treated as gain from the sale or exchange of property described in section 1231. M properly elects under section 453 to report under the installment method gain of $13,000 to which section 1251(c)(1) applies, gain of $5,000 to which section 1252(a)(1) applies, and gain of $4,500 to which section 1231 applies. Since the total gain realized on the sale was $22,500, the gross profit realized on each installment payment is $2,250, i.e., $6,750×($67,500). Accordingly, the treatment of the income to be reported on each installment payment is as follows:

Payment No.	Applicable sections		
	1251	*1252*	*1231*
1	$2,250		
2	2,250		
3	2,250		
4	2,250		
5	2,250		
6	1,750	$500	
7		2,250	
8		2,250	
9			$2,250
10			2,250
Totals	13,000	5,000	4,500

[T.D. 7418, 41 FR 18831, May 7, 1976; 41 FR 23669, June 11, 1976]

§ 1.1252–2 Special rules.

(a) *Exception for gifts*—(1) *General rule.* In general, no gain shall be recognized under section 1252(a)(1) upon a disposition of farm land by gift. For purposes of section 1252 and this paragraph, the term *gift* shall have the same meaning as in paragraph (a) of § 1.1245–4 and, with respect to the application of this paragraph, principles illustrated by the examples of paragraph (a)(2) of § 1.1245–4 shall apply. For reduction in amount of charitable contribution in case of a gift of farm land, see section 170(e) and § 1.170A–4.

(2) *Disposition in part a sale or exchange and in part a gift.* Where a disposition of farm land is in part a sale or exchange and in part a gift, the amount of gain which shall be recognized as ordinary income under section 1252(a)(1) shall be computed under paragraph (a)(1) of § 1.1252–1, applied by treating the gain realized (for purposes of paragraph (a)(1)(iii)(*a*) of § 1.1252–1) as the excess of the amount realized over the adjusted basis of the farm land.

(3) *Treatment of farm land in hands of transferee.* See paragraph (f) of this section for treatment of the transferee in the case of a disposition to which this paragraph applies.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. On March 2, 1976, A, a calendar year taxpayer, makes a gift to B of a parcel of land having an adjusted basis of $40,000, a fair market value of $65,000, and a holding period of 6 years (A, having purchased the land on January 15, 1971). On the date of such gift, the aggregate of the deductions allowed to A under sections 175 and 182 with respect to the land is $24,000 with $21,000 of such amount attributable to 1971. Upon making the gift, A recognizes no gain under section 1251(c)(1) or section 1252(a)(1). See paragraph (a)(1) of § 1.1251–4 and subparagraph 1 of this paragraph. For treatment of the farm land in the hands of B, see example (1) of paragraph (f)(3) of this section. For effect of the gift on the excess deductions accounts of A and of B, see paragraph (e)(2) of § 1.1251–2.

Example 2. (i) Assume the same facts as in example (1), except that A transfers the land to B for $50,000. Thus, the gain realized is $10,000 (amount realized, $50,000, minus adjusted basis, $40,000), and A has made a gift of $15,000 (fair market value, $65,000, minus amount realized, $50,000).

(ii) Upon the transfer of the land to B, A recognizes $3,000 of gain under section 1251(c)(1). See example (2) of paragraph (a)(4) of § 1.1251–4. Thus, A recognizes $7,000 as ordinary income under section 1252(a)(1), computed under subparagraph (2) of this paragraph as follows:

(1) Aggregate of deductions allowed under sections 175 and 182	$24,000
(2) Minus: Gain recognized as ordinary income under section 1251(c)(1)	$3,000
(3) Difference	$21,000
(4) Multiply: Applicable percentage for land disposed of within sixth year after it was acquired	80%
(5) Amount in paragraph (a)(1)(i)(*a*) of § 1.1252–1	$16,800
(6) Gain realized (see subdivision (i) of this example)	$10,000
(7) Minus: Amount in line (2)	$3,000
(8) Amount in paragraph (a)(1)(i)(*b*) of § 1.1252–1, applied in accordance with subparagraph (2) of this paragraph	$7,000
(9) Lower of line (5) or line (8)	$7,000

Thus, the entire gain realized on the transfer, $10,000, is recognized as ordinary income since that amount is equal to the sum of the gain recognized as ordinary income under section 1251(c)(1), $3,000, and under section 1252(a)(1), $7,000. For treatment of the farm land in the hands of B, see example (2) of paragraph (f)(3) of this section.

(b) *Exception for transfers at death*—(1) *In general.* Except as provided in section 691 (relating to income in respect of a decedent), no gain shall be recognized under section 1252(a)(1) upon a transfer at death. For purposes of section 1252 and this paragraph, the term *transfer at death* shall have the same meaning as in paragraph (b) of § 1.1245–4 and, with respect to the application of this paragraph, principles illustrated by the examples of paragraph (b)(2) of § 1.1245–4 shall apply.

(2) *Treatment of farm land in hands of transferee.* If as of the date a person acquires farm land from a decedent such person's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the property on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternative valuation date), then on such date the aggregate of the sections 175 and 182 deductions allowed with respect to the farm land in the hands of such transferee is zero.

(c) *Limitation for certain tax-free transactions*—(1) *Limitation on amount of gain.* Upon a transfer of farm land described in subparagraph (2) of this paragraph, the amount of gain recognized as ordinary income under section 1252(a)(1) shall not exceed an amount equal to the excess (if any) of (i) the amount of gain recognized to the transferor on the transfer (determined without regard to section 1252) over (ii) the amount (if any) of gain recognized as ordinary income under section 1251(c)(1). For purposes of this subparagraph, the principles of paragraph (c)(1) of § 1.1245–4 shall apply. Thus, in the case of a transfer of farm land and property other than farm land in one transaction, the amount realized from the disposition of the farm land (as determined in a manner consistent with the principles of paragraph (a)(5) of § 1.1245–1) shall be deemed to consist of that portion of the fair market value of each property acquired which bears the same ratio to the fair market value of such acquired property as the amount realized from the disposition of the farm land bears to the total amount realized. The preceding sentence shall be applied solely for purposes of computing the portion of the total gain (determined without regard to section 1252) which is eligible to be recognized as ordinary income under section 1252(a)(1). The provisions of this paragraph do not apply to a disposition of property to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by Chapter 1 of the Code.

(2) *Transfers covered.* The transfers referred to in subparagraph (1) of this paragraph are transfers of farm land in which the basis of such property in the

hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(i) Section 332 (relating to distributions in complete liquidation of an 80-percent-or-more controlled subsidiary corporation). For application of subparagraph (1) of this paragraph to such a complete liquidation, the principles of paragraph (c)(3) of § 1.1245–4 shall apply. Thus, for example, the provisions of subparagraph (1) of this paragraph do not apply to a liquidating distribution of farm land by an 80-percent-or-more controlled subsidiary to its parent if the parent's basis for the property is determined, under section 334(b)(2), by reference to its basis for the stock of the subsidiary.

(ii) Section 351 (relating to transfer to a corporation controlled by transferor).

(iii) Section 361 (relating to exchanges pursuant to certain corporate reorganizations).

(iv) Section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings).

(v) Section 374(a) (relating to exchanges pursuant to certain railroad reorganizations).

(vi) Section 721 (relating to transfers to a partnership in exchange for a partnership interest). See paragraph (e) of this section.

(vii) Section 731 (relating to distributions by a partnership to a partner). For special carryover of basis rule, see paragraph (e) of this section.

(3) *Treatment of farm land in the hands of tranferee.* See paragraph (f) of this section for treatment of the transferee in the case of a disposition to which this paragraph applies.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. On January 4, 1975, A, an individual calendar year taxpayer, owns a parcel of farm land, which he acquired on March 25, 1970, having an adjusted basis of $15,000 and a fair market value of $40,000. On that date he transfers the parcel to corporation M in exchange for stock in the corporation worth $40,000 in a transaction qualifying under section 351. On the date of such transfer, the aggregate of the deductions allowed under sections 175 and 182 with respect to the land is $18,000. Without regard to section 1252, A would recognize no gain under section 351 upon the transfer and M's basis for the land would be determined under section 362(a) by reference to its basis in the hands of A. Thus, as a result of the disposition, no gain is recognized as ordinary income under section 1251(c)(1) or section 1252(a)(1) by A since the amount of gain recognized under such sections is limited to the amount of gain which is recognized under section 351 (determined without regard to sections 1251 and 1252). See paragraph (c)(1) of § 1.1251–4 and subparagraph (1) of this paragraph. For treatment of the farm land in the hands of B, see paragraph (f)(1) of this section. For effect of the transfer on the excess deductions account of A and of B, see paragraph (e)(1) of § 1.1251–2.

Example 2. Assume the same facts in example (1), except that A transferred the land to M for stock in the corporation worth $32,000 and $8,000 cash. The gain realized is $25,000 (amount realized, $40,000, minus adjusted basis, $15,000). Without regard to section 1252, A would recognize $8,000 of gain under section 351(b). Assume further that no gain is recognized as ordinary income under section 1251(c)(1). Therefore, since the applicable percentage, 100 percent, of the aggregate of the deductions allowed under sections 175 and 182, $18,000, is lower than the gain realized, $25,000, the amount of gain to be recognized as ordinary income under section 1252(a)(1) would be $18,000 if the provisions of subparagraph (1) of this paragraph do not apply. Since under section 351(b) gain in the amount of $8,000 would be recognized to the transferor without regard to section 1252, the limitation provided in subparagraph (1) of this paragraph limits the gain taken into account by A under section 1252(a)(1) to $8,000.

Example 3. Assume the same facts as in example (2), except that $5,000 of gain is recognized as ordinary income under section 1251(c)(1). The amount of gain recognized as ordinary income under section 1252(a)(1) is $3,000 computed as follows:

(1) Amount of gain under section 1252(a)(1) (determined without regard to subparagraph (1) of this paragraph):	
(a) Aggregate of deductions allowed under sections 175 and 182	$18,000
(b) Minus: Gain recognized as ordinary income under section 1251(c)(1)	$5,000
(c) Difference	$13,000
(d) Multiply: Applicable percentage for property disposed of within the fifth year after it was acquired	100%
(e) Amount in paragraph (a)(1)(i)*(a)* of § 1.1252–1	$13,000
(f) Gain realized (amount realized $40,000, less adjusted basis, $15,000)	$25,000
(g) Minus: Amount in line (b)	$5,000
(h) Amount in paragraph (a)(1)(i)(*b*) of § 1.1252–1	$20,000
(i) Lower of line (e) or (h)	$13,000

(2) Limitation in subparagraph (1) of this paragraph:	
(a) Gain recognized (determined without regard to section 1252)	$8,000
(b) Minus: Gain recognized as ordinary income under section 1251(c)(1)	$5,000
(c) Difference	$3,000
(3) Lower of line (1)(i) or line (2)(c)	$3,000

Thus, the entire gain recognized under section 351(b) (determined without regard to sections 1251 and 1252), $8,000, is recognized as ordinary income since that amount is equal to the sum of the gain recognized as ordinary income under section 1251(c)(1), $5,000, and under section 1252(a)(1), $3,000.

(d) *Limitation for like kind exchanges and involuntary conversions*—(1) *General rule.* If farm land is disposed of and gain (determined without regard to section 1252) is not recognized in whole or in part under section 1031 (relating to like kind exchanges) or section 1033 (relating to involuntary conversions), then the amount of gain recognized as ordinary income by the transferor under section 1252(a)(1) shall not exceed the sum of:

(i) The excess (if any) of (*a*) the amount of gain recognized on such disposition (determined without regard to section 1252) over (*b*) the amount (if any) of gain recognized as ordinary income under section 1251(c)(1), plus

(ii) The fair market value of property acquired which is not farm land and which is not taken into account under subdivision (i) of this subparagraph (that is, the fair market value of property other than farm land acquired which is qualifying property under section 1031 or 1033, as the case may be).

(2) *Examples.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. (i) Assume the same facts as in example (2)(ii) of paragraph (d)(3) of § 1.1251–4. Assume further that the aggregate of the amount of sections 175 and 182 deductions allowable is equal to the amount allowed. Under paragraph (a)(1) of § 1.1252–1, $18,000 would be recognized as ordinary income under section 1252(a)(1) (determined without regard to subparagraph (1) of this paragraph), computed as follows:

(1) Aggregate of deductions allowed under sections 175 and 182	$18,000
(2) Minus: Gain recognized as ordinary income under section 1251(c)(1)	0
(3) Difference	$18,000
(4) Multiply: Applicable percentage for property disposed of within the fifth year after it was acquired	100%
(5) Amount in paragraph (a)(1)(i)(*a*) of § 1.1252–1	$18,000
(6) Gain realized (amount realized, $67,500, less adjusted basis, $48,000)	$19,500
(7) Minus: Amount in line (2)	0
(8) Amount in paragraph (a)(1)(i)(*b*) of § 1.1252–1	$19,500
(9) Lower of line (5) or line (8)	$18,000

(ii) Although no gain was recognized under section 1251(c)(1) and the stock purchased by A for $67,500 is farm recapture property for purposes of section 1251, it is not farm land for purposes of section 1252. Nevertheless, although no gain would be recognized under sections 1033(a)(3) and 1251(c)(1) (determined without regard to section 1252), the limitation under subparagraph (1) of this paragraph is $67,500 (that is, the fair market value of property other than farm land acquired which is qualifying property under section 1033). Since the amount of gain which would be recognized as ordinary income under section 1252(a)(1) (determined without regard to subparagraph (1) of this paragraph), $18,000 (as computed in subdivision (i) of this example), is lower than the amount of such limitation, $67,500, accordingly, only $18,000 is recognized as ordinary income under section 1252(a)(1). For determination of basis of the stock acquired, see subparagraph (5) of this paragraph.

Example 2. (i) Assume the same facts as in example (1) of this subparagraph, except that the cost of the stock was $62,500 (its fair market value). Thus, the amount of gain recognized on the disposition under section 1033(a)(3) (determined without regard to sections 1251 and 1252) is $5,000, that is, $67,500 minus $62,500. Assume further that $5,000 (the amount of gain recognized under section 1033(a)(3) (so determined)) was recognized as ordinary income under section 1251(c)(1). The amount of gain recognized as ordinary income under section 1252(a)(1) is $13,000, computed as follows:

(1) Amount of gain under section 1252(a)(1) (determined without regard to subparagraph (1) of this paragraph):	
(a) Aggregate of deductions allowed under sections 175 and 182	$18,000
(b) Minus: Gain recognized as ordinary income under section 1251(c)(1)	$5,000
(c) Difference	$13,000
(d) Multiply: Applicable percentage for property disposed of within the fifth year after it was acquired	100%
(e) Amount in paragraph (a)(1)(i)(*a*) of § 1.1252–1	$13,000
(f) Gain realized (amount realized, $67,500 (less adjusted basis, $48,000))	$19,500
(g) Minus: Amount in line (b)	$5,000

(h) Amount in paragraph (a)(1)(i)(*b*) of § 1.1252–1	$14,500
(i) Lower of line (e) or (h)	$13,000
(2) Limitation in subparagraph (1) of this paragraph:	
(a) Gain recognized (determined without regard to section 1252)	$5,000
(b) Minus: Gain recognized as ordinary income under section 1251(c)(1)	$5,000
(c) Difference	0
(d) Plus; The fair market value of property other than farm land acquired which is qualifying property under section 1033	$62,500
(e) Sum of lines (c) and (d)	$62,500
(3) Lower of line (1)(i) or line (2)(e)	$13,000

(3) *Application to single disposition of farm land and property of different class.* (i) If upon a sale of farm land gain would be recognized under section 1252(a)(1), and if such land together with property of a different class or classes is disposed of in one transaction in which gain is not recognized in whole or in part under section 1031 or 1033 (without regard to section 1252(a)(1)), then rules consistent with the principles of paragraph (d)(6) of § 1.1250–3 (relating to gain from disposition of certain depreciable realty) shall apply for purposes of allocating the amount realized to each of the classes of property disposed of and for purposes of determining what property the amount realized for each class consists of.

(ii) For purposes of this subparagraph, the classes of property other than farm recapture property (as defined in section 1251(e) and paragraph (a)(1) of § 1.1251–3) are (*a*) section 1245 property, (*b*) section 1250 property, and (*c*) other property.

(iii) For purposes of this subparagraph, the classes of farm recapture property are (*a*) land, (*b*) section 1245 property, and (*c*) other property.

(4) *Treatment of farm land received in like kind exchange or involuntary conversion.* The aggregate of the deductions allowed under sections 175 and 182 in respect of land acquired in a transaction described in subparagraph (1) of this paragraph shall include the aggregate of the deductions allowed under sections 175 and 182 in respect of the land transferred or converted (as the cr sections 175 and 182 in respect of land acquired in a transaction described in subparagraph (1) of this paragraph shall include the aggregate of the deductions allowed under sections 175 and 182 in respect of the land transferred or converted (as the case may be) in such transaction minus the amount of gain taken into account under sections 1251(c) and 1252(a) with respect to the land transferred or converted. Upon a subsequent disposition of such land, the holding period shall include the holding period with respect to the land transferred or converted.

(5) *Basis adjustment.* In order to reflect gain recognized under section 1252(a)(1) if property is acquired in a transaction to which subparagraph (1) of this paragraph applies, its basis shall be determined under the rules of section 1031(d) or 1033(c).

(e) *Partnerships.* [Reserved]

(f) *Treatment of farm land received by a transferee in a disposition by gift and certain tax-free transactions*—(1) *General rule.* If farm land is disposed of in a transaction which is either a gift to which paragraph (a)(1) of this section applies, or a completely tax-free transfer to which paragraph (c)(1) of this section applies, then for purposes of section 1252:

(i) The aggregate of the deductions allowed under sections 175 and 182 in respect of the land in the hands of the tranferee immediately after the disposition shall be an amount equal to the amount of such aggregate in the hands of the transferor immediately before the disposition, and

(ii) For purposes of applying section 1252 upon a subsequent disposition by the transferee (including a computation of the applicable percentage), the holding period of the transferee shall include the holding period of the transferor.

(2) *Certain partially tax-free transfers.* If farm land is disposed of in a transaction which either is in part a sale or exchange and in part a gift to which paragraph (a)(2)of this section applies, or is a partially tax-free transfer to which paragraph (c)(1) of this section applies, then for purposes of section 1252 the amount determined under subparagraph (1)(i) of this paragraph shallbe reduced by the amount of gain taken into account under sections

1251(c) and 1252(a) by the transferor upon the disposition. Upon a subsequent disposition by the transferee, the holding period for purposes of computing the amount under section 1252(a)(1)(A), with respect to the 175 and 182 deductions taken by the transferor, shall include the holding period of the transferor. With respect to the 1975 and 182 deductions taken by the transferee, the holding period shall not include the holding period of the transferor.

(3) *Examples.* The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. Assume the same facts as in example (1) of paragraph (a)(4) of this section. Therefore, on the date B receives the farm land in the gift transaction, under subparagraph (1) of this paragraph the aggregate of the deductions allowed under sections 175 and 182 in respect of the farm land in the hands of B is the amount in the hands of A, $24,000, and for purposes of applying section 1252 upon a subsequent disposition by B (including a computation of the applicable percentage) the holding period of B includes the holding period of A.

Example 2. Assume the same facts as in example (2) of paragraph (a)(4) of this section. Under subparagraph (2) of this paragraph, the aggregate of the sections 175 and 182 deductions which pass over to B for purposes of section 1252 is $14,000 ($24,000 deductions allowable under sections 175 and 182 minus $3,000 gain recognized under section 1251(c) in accordance with example (2) of paragraph (a)(4) of §1.1251–4, minus $7,000 gain recognized under section 1252(a) in acordance with example (2) of paragraph (a)(4) of this section), B's holding period includes the holding period of A (i.e., the period back to January 15, 1971) with respect to A's deductions.

(g) *Disposition of farm land not specifically covered.* If farm land is disposed of in a transaction not specifically covered under §1.1252–1 and this section, then the principles of section 1245 shall apply.

[T.D. 7418, 41 FR 18832, May 7, 1976; 41 FR 23669, June 11, 1976]

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§ 1.1254–6 Effective date of regulations.

[T.D. 8586, 60 FR 2501, Jan. 10, 1995, as amended by T.D. 8684, 61 FR 53063, Oct. 10, 1996]

§ 1.1254–1 Treatment of gain from disposition of natural resource recapture property.

(a) *In general.* Upon any disposition of section 1254 property or any disposition after December 31, 1975 of oil, gas, or geothermal property, gain is treated as ordinary income in an amount equal to the lesser of the amount of the section 1254 costs (as defined in paragraph (b)(1) of this section) with respect to the property, or the amount, if any, by which the amount realized on the sale, exchange, or involuntary conversion, or the fair market value of the property on any other disposition, exceeds the adjusted basis of the property. However, any amount treated as ordinary income under the preceding sentence is not included in the taxpayer's *gross income from the property* for purposes of section 613. Generally, the lesser of the amounts described in this paragraph (a) is treated as ordinary income even though, in the absence of section 1254(a), no gain would be recognized upon the disposition under any other provision of the Internal Revenue Code. For the definition of the term *section 1254 costs,* see paragraph (b)(1) of this section. For the definition of the terms *section 1254 property, oil, gas, or geothermal property,* and *natural resource recapture property,* see paragraph (b)(2) of this section. For rules relating to the *disposition* of natural resource recapture property, see paragraphs (b)(3), (c), and (d) of this section. For exceptions and limitations to the application of section 1254(a), see § 1.1254–2.

(b) *Definitions*—(1) *Section 1254 costs*—(i) *Property placed in service after December 31, 1986.* With respect to any property placed in service by the taxpayer after December 31, 1986, the term *section 1254 costs* means—

(A) The aggregate amount of expenditures that have been deducted by the taxpayer or any person under section 263, 616, or 617 with respect to such property and that, but for the deduction, would have been included in the adjusted basis of the property or in the adjusted basis of certain depreciable property associated with the property; and

(B) The deductions for depletion under section 611 that reduced the adjusted basis of the property.

(ii) *Property placed in service before January 1, 1987.* With respect to any property placed in service by the taxpayer before January 1, 1987, the term *section 1254 costs* means—

(A) The aggregate amount of costs paid or incurred after December 31, 1975, with respect to such property, that have been deducted as intangible drilling and development costs under section 263(c) by the taxpayer or any other person (except that section 1254 costs do not include costs incurred with respect to geothermal wells commenced before October 1, 1978) and that, but for the deduction, would be reflected in the adjusted basis of the property or in the adjusted basis of certain depreciable property associated with the property; reduced by

(B) The amount (if any) by which the deduction for depletion allowed under section 611 that was computed either under section 612 or sections 613 and 613A, with respect to the property, would have been increased if the costs (paid or incurred after December 31, 1975) had been charged to capital account rather than deducted.

(iii) *Deductions under section 59 and section 291.* Amounts capitalized pursuant to an election under section 59(e) or pursuant to section 291(b) are treated as section 1254 costs in the year in which an amortization deduction is claimed under section 59(e)(1) or section 291(b)(2).

(iv) *Suspended deductions.* If a deduction of a section 1254 cost has been suspended as of the date of disposition of section 1254 property, the deduction is not treated as a section 1254 cost if it is included in basis for determining gain or loss on the disposition. On the other hand, if the deduction will eventually be claimed, it is a section 1254 cost as of the date of disposition. For example, a deduction suspended pursuant to the 65 percent of taxable income limitation of section 613A(d)(1) may either be included in basis upon disposition of the property or may be deducted in a year after the year of disposition. See §1.613A–4(a)(1). If it is included in the basis then it is not a section 1254 cost, but if it is deductible in a later year it is a section 1254 cost as of the date of the disposition.

(v) *Previously recaptured amounts.* If an amount has been previously treated as ordinary income pursuant to section 1254, it is not a section 1254 cost.

(vi) *Nonproductive wells.* The aggregate amount of section 1254 costs paid or incurred on any property includes the amount of intangible drilling and development costs incurred on nonproductive wells, but only to the extent that the taxpayer recognizes income on the foreclosure of a nonrecourse debt the proceeds from which were used to finance the section 1254 costs with respect to the property. For this purpose, the term nonproductive well means a well that does not produce oil or gas in commercial quantities, including a well that is drilled for the purpose of ascertaining the existence, location, or extent of an oil or gas reservoir (e.g., a delineation well). The term *nonproductive well* does not include an injection well (other than an injection well drilled as part of a project that does not result in production in commercial quantities).

(vii) *Calculation of amount described in paragraph (b)(1)(ii)(B) of this section (hypothetical depletion offset)*—(A) *In general.* In calculating the amount described in paragraph (b)(1)(ii)(B) of this section, the taxpayer shall apply the following rules. The taxpayer may use the 65-percent-of-taxable-income limitation of section 613A(d)(1). If the taxpayer uses that limitation, the taxpayer is not required to recalculate the effect of such limitation with respect to any property not disposed of. That is, the taxpayer may assume that the hypothetical capitalization of intangible drilling and development costs with respect to any property disposed of does not affect the allowable depletion with respect to property retained by the taxpayer. Any intangible drilling and development costs that, if they had not been treated as expenses under section 263(c), would have properly been capitalized under §1.612–4(b)(2) (relating to items recoverable through depreciation under section 167 or cost recovery under section 168) are treated as costs described in §1.612–4(b)(1) (relating to items recoverable through depletion). The increase in depletion attributable to the capitalization of intangible drilling and development costs is computed by subtracting the amount of cost or percentage depletion actually claimed from the amount of cost or percentage depletion that would have been allowable if intangible drilling and development costs had been capitalized. If the remainder is zero or less than zero, the entire amount of intangible drilling and development costs attributable to the property is recapturable.

(B) *Example.* The following example illustrates the principles of paragraph (b)(1)(vii)(A).

Example: Hypothetical depletion offset. In 1976, A purchased undeveloped property for $10,000. During 1977, A incurred $200,000 of productive well intangible drilling and development costs with respect to the property. A deducted the intangible drilling and development costs as expenses under section 263(c). Estimated reserves of 150,000 barrels of recoverable oil were discovered in 1977 and production began in 1978. In 1978, A produced and sold 30,000 barrels of oil at $8 per barrel, resulting in $240,000 of gross income. A had no other oil or gas production in 1978. A claimed a percentage depletion deduction of $52,800 (i.e., 22% of $240,000 gross income from the property). If A had capitalized the intangible drilling and development costs, assume that $200,000 of the costs would have been allocated to the depletable property and none to depreciable property. A's cost depletion deduction if the intangible drilling and development costs had been capitalized would have been $42,000 (i.e., (($200,000 intangible drilling and development costs + $10,000 acquisition costs) × 30,000 barrels of production)/ 150,000 barrels of estimated recoverable reserves). Since this amount is less than A's depletion deduction of $52,800 (percentage depletion), no reduction is made to the amount of intangible drilling and development costs ($200,000). On January 1, 1979, A sold the oil property to B for $360,000 and calculated section 1254 recapture without reference to the 65-percent-of-taxable-income limitation. A's gain on the sale is the entire $360,000, because A's basis in the property at the beginning of 1979 is zero (i.e., $10,000 cost less $52,800 depletion deduction for 1978). Since the section 1254 costs ($200,000) are less than A's gain on the sale, $200,000 is treated as ordinary income under section 1254(a). The remaining amount of A's gain ($160,000) is not subject to section 1254(a).

(2) *Natural resource recapture property*—(i) *In general.* The term *natural resource recapture property* means section 1254 property or oil, gas, or geothermal property as those terms are defined in this section.

(ii) *Section 1254 property.* The term *section 1254 property* means any property (within the meaning of section 614) that is placed in service by the taxpayer after December 31, 1986, if any expenditures described in paragraph (b)(1)(i)(A) of this section (relating to costs under section 263, 616, or 617) are properly chargeable to such property, or if the adjusted basis of such property includes adjustments for deductions for depletion under section 611.

(iii) *Oil, gas, or geothermal property.* The term *oil, gas, or geothermal property* means any property (within the meaning of section 614) that was placed in service by the taxpayer before January 1, 1987, if any expenditures described in paragraph (b)(1)(ii)(A) of this section are properly chargeable to such property.

(iv) *Property to which section 1254 costs are properly chargeable.* (A) An expenditure is properly chargeable to property if—

(*1*) The property is an operating mineral interest with respect to which the expenditure has been deducted;

(*2*) The property is a nonoperating mineral interest (e.g., a net profits interest or an overriding royalty interest) burdening an operating mineral interest if the nonoperating mineral interest is carved out of an operating mineral interest described in paragraph (b)(2)(iv)(A)(*1*) of this section;

(*3*) The property is a nonoperating mineral interest retained by a lessor or sublessor if such lessor or sublessor held, prior to the lease or sublease, an operating mineral interest described in paragraph (b)(2)(iv)(A)(*1*) of this section; or

(*4*) The property is an operating or a nonoperating mineral interest held by a taxpayer if a party related to the taxpayer (within the meaning of section 267(b) or section 707(b)) held an operating mineral interest (described in paragraph (b)(2)(iv)(A)(*1*) of this section) in the same tract or parcel of land that terminated (in whole or in part) without being disposed of (e.g., a working interest which terminated after a specified period of time or a given amount of production), but only if there exists between the related parties an arrangement or plan to avoid recapture under section 1254. In such a case, the taxpayer's section 1254 costs with respect to the property include those of the related party.

(B) *Example.* The following example illustrates the provisions of paragraph (2)(iv)(A)(*4*) of this section:

Example: Arrangement or plan to avoid recapture. C, an individual, owns 100% of the stock of both X Co. and Y Co. On January 1, 1998, X Co. enters into a standard oil and gas lease. X Co. immediately assigns to Y Co. 1% of the working interest for one year, and 99% of the working interest thereafter. In 1998, X Co. and Y Co. expend $300 in intangible drilling and development costs developing the tract, of which $297 are deducted by X Co. under section 263(c). On January 1, 1999, Y Co. sells its 99% share of the working interest to an unrelated person. Based on all the facts and circumstances, the arrangement between X Co. and Y Co. is part of a plan or arrangement to avoid recapture under section 1254. Therefore, Y Co. must include in its section 1254 costs the $297 of intangible drilling and development costs deducted by X Co.

(v) *Property the basis of which includes adjustments for depletion deductions.* The adjusted basis of property includes adjustments for depletion under section 611 if—

(A) The basis of the property has been reduced by reason of depletion deductions; or

(B) The property has been carved out of or is a portion of property the basis of which has been reduced by reason of depletion deductions.

(vi) *Property held by a transferee.* Property held by a transferee is natural resource recapture property if the property was natural resource recapture property in the hands of the transferor and the transferee's basis in the property is determined with reference to the transferor's basis in the property (e.g., a gift) or is determined under section 732.

(vii) *Property held by a transferor.* Property held by a transferor of natural resource recapture property is natural resource recapture property if the transferor's basis in the property received is determined with reference to the transferor's basis in the property transferred by the transferor (e.g., a like kind exchange). For purposes of this paragraph (b)(2), property described in this paragraph (b)(2)(vii) is treated as placed in service at the time the property transferred by the transferor was placed in service by the transferor.

(3) *Disposition*—(i) *General rule.* The term *disposition* has the same meaning as in section 1245, relating to gain from dispositions of certain depreciable property.

(ii) *Exceptions.* The term *disposition* does not include—

(A) Any transaction that is merely a financing device, such as a mortgage or a production payment that is treated as a loan under section 636 and the regulations thereunder;

(B) Any abandonment (except that an abandonment is a disposition to the extent the taxpayer recognizes income on the foreclosure of a nonrecourse debt);

(C) Any creation of a lease or sublease of natural resource recapture property;

(D) Any termination or election of the status of an S corporation;

(E) Any unitization or pooling arrangement;

(F) Any expiration or reversion of an operating mineral interest that expires or reverts by its own terms, in whole or in part; or

(G) Any conversion of an overriding royalty interest that, at the option of the grantor or successor in interest, converts to an operating mineral interest after a certain amount of production.

(iii) *Special rule for carrying arrangements.* In a carrying arrangement, liability for section 1254 costs attributable to the entire operating mineral interest held by the carrying party prior to reversion or conversion remains attributable to the reduced operating mineral interest retained by the carrying party after a portion of the operating mineral interest has reverted to the carried party or after the conversion of an overriding royalty interest that, at the option of the grantor or successor in interest, converts to an operating mineral interest after a certain amount of production.

(c) *Disposition of a portion of natural resource recapture property*—(1) *Disposition of a portion (other than an undivided interest) of natural resource recapture property*—(i) *Natural resource recapture property subject to the general rules of §1.1254–1.* For purposes of section

1254(a)(1) and paragraph (a) of this section, except as provided in paragraphs (c) (1)(ii) and (3) of this section, in the case of the disposition of a portion (that is not an undivided interest) of natural resource recapture property, the entire amount of the section 1254 costs with respect to the natural resource recapture property is treated as allocable to that portion of the property to the extent of the amount of gain to which section 1254(a)(1) applies. If the amount of the gain to which section 1254(a)(1) applies is less than the amount of the section 1254 costs with respect to the natural resource recapture property, the balance of the section 1254 costs remaining after allocation to the portion of the property that was disposed of remains subject to recapture by the taxpayer under section 1254(a)(1) upon disposition of the remaining portion of the property. For example, assume that A owns an 80-acre tract of land with respect to which A has deducted intangible drilling and development costs under section 263(c). If A sells the north 40 acres, the entire amount of the section 1254 costs with respect to the 80-acre tract is treated as allocable to the 40-acre portion sold (to the extent of the amount of gain to which section 1254(a)(1) applies).

(ii) *Natural resource recapture property subject to the exceptions and limitations of § 1.1254–2.* For purposes of section 1254(a)(1) and paragraph (a) of this section, except as provided in paragraph (b)(3) of this section, in the case of the disposition of a portion (that is not an undivided interest) of natural resource recapture property to which section 1254(a)(1) does not apply by reason of the application of § 1.1254–2 (certain nonrecognition transactions), the following rule for allocation of costs applies. An amount of the section 1254 costs that bears the same ratio to the entire amount of such costs with respect to the entire natural resource recapture property as the value of the property transferred bears to the value of the entire natural resource recapture property is treated as allocable to the portion of the natural resource recapture property transferred. The balance of the section 1254 costs remaining after allocation to that portion of the transferred property remains subject to recapture by the taxpayer under section 1254(a)(1) upon disposition of the remaining portion of the property. For example, assume that A owns an 80-acre tract of land with respect to which A has deducted intangible drilling and development costs under section 263(c). If A gives away the north 40 acres, and if 60 percent of the value of the 80-acre tract were attributable to the north 40 acres given away, 60 percent of the section 1254 costs with respect to the 80-acre tract is allocable to the north 40 acres given away.

(2) *Disposition of an undivided interest*—(i) *Natural resource recapture property subject to the general rules of § 1.1254–1.* For purposes of section 1254(a)(1), except as provided in paragraphs (b)(2)(ii) and (b)(3) of this section, in the case of the disposition of an undivided interest in natural resource recapture property (or a portion thereof), a proportionate part of the section 1254 costs with respect to the natural resource recapture property is treated as allocable to the transferred undivided interest to the extent of the amount of gain to which section 1254(a)(1) applies. For example, assume that A owns an 80-acre tract of land with respect to which A has deducted intangible drilling and development costs under section 263(c). If A sells an undivided 40 percent interest in the 80-acre tract, 40 percent of the section 1254 costs with respect to the 80-acre tract is allocable to the transferred 40 percent interest in the 80-acre tract. However, if the amount of gain recognized on the sale of the 40 percent undivided interest were equal to only 35 percent of the amount of section 1254 costs attributable to the 80-acre tract, only 35 percent of the section 1254 costs would be treated as attributable to the undivided 40 percent interest. See paragraph (c)(3) of this section for an alternative allocation rule.

(ii) *Natural resource recapture property subject to the exceptions and limitations of § 1.1254–2.* For purposes of section 1254(a)(1) and paragraph (a) of this section, except as provided in paragraph (b)(3) of this section, in the case of a disposition of an undivided interest in natural resource recapture property (or a portion thereof) to which section 1254 (a)(1) does not apply by reason of §1.1254–2, a proportionate part of the section 1254 costs with respect to the natural resource recapture property is treated as allocable to the transferred undivided interest. See paragraph (c)(3) of this section for an alternative allocation rule.

(3) *Alternative allocation rule*—(i) *In general.* The rules for the allocation of costs set forth in section 1254(a)(2) and paragraphs (c) (1) and (2) of this section do not apply with respect to section 1254 costs that the taxpayer establishes to the satisfaction of the Commissioner do not relate to the transferred property. Except as provided in paragraphs (c)(3) (ii) and (iii) of this section, a taxpayer may satisfy this requirement only by receiving a private letter ruling from the Internal Revenue Service that the section 1254 costs do not relate to the transferred property.

(ii) *Portion of property.* Upon the transfer of a portion of a natural resource recapture property (other than an undivided interest) with respect to which section 1254 costs have been incurred, a taxpayer may treat section 1254 costs as not relating to the transferred portion if the transferred portion does not include any part of any deposit with respect to which the costs were incurred.

(iii) *Undivided interest.* Upon the transfer of an undivided interest in a natural resource recapture property with respect to which section 1254 costs have been incurred, a taxpayer may treat costs as not relating to the transferred interest if the undivided interest is an undivided interest in a portion of the natural resource recapture property, and the portion would be eligible for the alternative allocation rule under paragraph (c)(3)(ii) of this section.

(iv) *Substantiation.* If a taxpayer treats section 1254 costs incurred with respect to a natural resource recapture property as not relating to a transferred interest in a portion of the property, the taxpayer must indicate on his or her tax return that the costs do not relate to the transferred portion and maintain the records and supporting evidence that substantiate this position.

(d) *Installment method.* Gain from a disposition to which section 1254(a)(1) applies is reported on the installment method if that method otherwise applies under section 453 or 453A of the Internal Revenue Code and the regulations thereunder. The portion of each installment payment as reported that represents income (other than interest) is treated as gain to which section 1254(a)(1) applies until all of the gain (to which section 1254(a)(1) applies) has been reported, and the remaining portion (if any) of the income is then treated as gain to which section 1254(a)(1) does not apply. For treatment of amounts as interest on certain deferred payments, see sections 483, 1274, and the regulations thereunder.

[T.D. 8586, 60 FR 2502, Jan. 10, 1995]

§1.1254–2 Exceptions and limitations.

(a) *Exception for gifts and section 1041 transfers*—(1) *General rule.* No gain is recognized under section 1254(a)(1) upon a disposition of natural resource recapture property by a gift or by a transfer in which no gain or loss is recognized pursuant to section 1041 (relating to transfers between spouses). For purposes of this paragraph (a), the term *gift* means, except to the extent that paragraph (a)(2) of this section applies, a transfer of natural resource recapture property that, in the hands of the transferee, has a basis determined under the provisions of sections 1015 (a) or (d) (relating to basis of property acquired by gift). For rules concerning the potential reduction in the amount of the charitable contribution in the case of natural resource recapture property, see section 170(e) and §1.170A–4. See §1.1254–3(b)(1) for determination of potential recapture of section 1254 costs on property acquired by gift. See §1.1254–1 (c)(1)(ii) and (c)(2)(ii) for apportionment of section 1254 costs on a gift of a portion of natural resource recapture property.

(2) *Part gift transactions.* If a disposition of natural resource recapture property is in part a sale or exchange and in part a gift, the gain that is treated as ordinary income pursuant to section 1254(a)(1) is the lower of the section 1254 costs with respect to the property or the excess of the amount realized upon the disposition of the

property over the adjusted basis of the property. In the case of a transfer subject to section 1011(b) (relating to bargain sales to charitable organizations), the adjusted basis for purposes of the preceding sentence is the adjusted basis for determining gain or loss under section 1011(b).

(b) *Exception for transfers at death.* Except as provided in section 691 (relating to income in respect of a decedent), no gain is recognized under section 1254(a)(1) upon a transfer at death. For purposes of this paragraph, the term *transfer at death* means a transfer of natural resource recapture property that, in the hands of the transferee, has a basis determined under the provisions of section 1014(a) (relating to basis of property acquired from a decedent) because of the death of the transferor. See § 1.1254–3 (a)(4) and (c) for the determination of potential recapture of section 1254 costs on property acquired in a transfer at death.

(c) *Limitation for certain tax-free transactions*—(1) *General rule.* Upon a transfer of property described in paragraph (c)(3) of this section, the amount of gain treated as ordinary income by the transferor under section 1254(a)(1) may not exceed the amount of gain recognized to the transferor on the transfer (determined without regard to section 1254). In the case of a transfer of both natural resource recapture property and property that is not natural resource recapture property in one transaction, the amount realized from the disposition of the natural resource recapture property is deemed to be equal to the amount that bears the same ratio to the total amount realized as the fair market value of the natural resource recapture property bears to the aggregate fair market value of all the property transferred. The preceding sentence is applied solely for purposes of computing the portion of the total gain (determined without regard to section 1254) that may be recognized as ordinary income under section 1254(a)(1).

(2) *Special rule for dispositions to certain tax-exempt organizations.* Paragraph (c)(1) of this section does not apply to a disposition of natural resource recapture property to an organization (other than a cooperative described in section 521) that is exempt from the tax imposed by chapter I of the Internal Revenue Code. The preceding sentence does not apply to a disposition of natural resource recapture property to an organization described in section 511 (a)(2) or (b)(2) (relating to imposition of tax on unrelated business income of charitable, etc., organizations) if, immediately after the disposition, the organization uses the property in an unrelated trade or business as defined in section 513. If any property with respect to which gain is not recognized by reason of the exception of this paragraph (c)(2) ceases to be used in an unrelated trade or business of the organization acquiring the property, that organization is, for purposes of section 1254, treated as having disposed of the property on the date of the cessation.

(3) *Transfers described.* The transfers referred to in paragraph (c)(1) of this section are transfers of natural resource recapture property in which the basis of the natural resource recapture property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(i) Section 332 (relating to certain liquidations of subsidiaries). See paragraph (c)(4) of this section.

(ii) Section 351 (relating to transfer to a corporation controlled by transferor).

(iii) Section 361 (relating to exchanges pursuant to certain corporate reorganizations).

(iv) Section 721 (relating to transfers to a partnership in exchange for a partnership interest).

(v) Section 731 (relating to distributions by a partnership to a partner). For purposes of this paragraph, the basis of natural resource recapture property distributed by a partnership to a partner is deemed to be determined by reference to the adjusted basis of such property to the partnership.

(4) *Special rules for section 332 transfers.* In the case of a distribution in complete liquidation of a subsidiary to which section 332 applies, the limitation provided in this paragraph (c) is confined to instances in which the basis of the natural resource recapture

property in the hands of the transferee is determined, under section 334(b)(1), by reference to its basis in the hands of the transferor. Thus, for example, the limitation may apply in respect of a liquidating distribution of natural resource recapture property by a subsidiary corporation to the parent corporation, but does not apply in respect of a liquidating distribution of natural resource recapture property to a minority shareholder. This paragraph (c) does not apply to a liquidating distribution of natural resource recapture property by a subsidiary to its parent if the parent's basis for the property is determined under section 334(b)(2) (as in effect before enactment of the Tax Reform Act of 1986), by reference to its basis for the stock of the subsidiary. This paragraph (c) does not apply to a liquidating distribution under section 332 of natural resource recapture property by a subsidiary to its parent if gain is recognized and there is a corresponding increase in the parent's basis in the property (e.g., certain distributions to a tax-exempt or foreign corporation).

(d) *Limitation for like kind exchanges and involuntary conversions*—(1) *General rule.* If natural resource recapture property is disposed of and gain (determined without regard to section 1254) is not recognized in whole or in part under section 1031 (relating to like kind exchanges) or section 1033 (relating to involuntary conversions), the amount of gain taken into account by the transferor under section 1254(a)(1) may not exceed the sum of—

(i) The amount of gain recognized on the disposition (determined without regard to section 1254); plus

(ii) The fair market value of property acquired that is not natural resource recapture property (determined without regard to §1.1254–1(b)(2)(vii)) and is not taken into account under paragraph (d)(1)(i) of this section (that is, qualifying property under section 1031 or 1033 that is not natural resource recapture property).

(2) *Disposition and acquisition of both natural resource recapture property and other property.* For purposes of this paragraph (d), if both natural resource recapture property and property that is not natural resource recapture property are acquired as the result of one disposition in which both natural resource recapture property and property that is not natural resource recapture property are disposed of—

(i) The total amount realized upon the disposition is allocated between the natural resource recapture property and the property that is not natural resource recapture property disposed of in proportion to their respective fair market values;

(ii) The amount realized upon the disposition of the natural resource recapture property is deemed to consist of so much of the fair market value of the natural resource recapture property acquired as is not in excess of the amount realized from the natural resource recapture property disposed of, and the remaining portion (if any) of the amount realized upon the disposition of such property is deemed to consist of so much of the fair market value of the property that is not natural resource recapture property acquired as is not in excess of the remaining portion; and

(iii) The amount realized upon the disposition of the property that is not natural resource recapture property is deemed to consist of so much of the fair market value of all the property acquired which was not taken into account under paragraph (d)(2)(ii) of this section. Except as provided in section 1060 and the regulations thereunder, if a buyer and seller have adverse interests as to such allocation of the amount realized, any arm's-length agreement between the buyer and seller is used to establish the allocation. In the absence of such an agreement, the allocation is made by taking into account the appropriate facts and circumstances.

[T.D. 8586, 60 FR 2505, Jan. 10, 1995, as amended by T.D. 8684, 61 FR 53063, Oct. 10, 1996]

§1.1254–3 Section 1254 costs immediately after certain acquisitions.

(a) *Transactions in which basis is determined by reference to cost or fair market value of property transferred*—(1) *Basis determined under section 1012.* If, on the date a person acquires natural resource recapture property, the person's basis for the property is determined solely by reference to its cost (within the meaning of section 1012), the amount of section 1254 costs with respect to the natural resource recapture property in the person's hands is zero on the acquisition date.

(2) *Basis determined under section 301(d), 334(a), or 358(a)(2).* If, on the date a person acquires natural resource recapture property, the person's basis for the property is determined solely by reason of the application of section 301(d) (relating to basis of property received in a corporate distribution), section 334(a) (relating to basis of property received in a liquidation in which gain or loss is recognized), or section 358(a)(2) (relating to basis of other property received in certain exchanges), the amount of the section 1254 costs with respect to the natural resource recapture property in the person's hands is zero on the acquisition date.

(3) *Basis determined solely under former section 334(b)(2) or former section 334(c).* If, on the date a person acquires natural resource recapture property, the person's basis for the property is determined solely under the provisions of section 334(b)(2) (prior to amendment of that section by the Tax Equity and Fiscal Responsibility Act of 1982) or (c) (prior to repeal of that section by the Tax Reform Act of 1986) (relating to basis of property received in certain corporate liquidations), the amount of section 1254 costs with respect to the natural resource recapture property in the person's hands is zero on the acquisition date.

(4) *Basis determined by reason of the application of section 1014(a).* If, on the date a person acquires natural resource recapture property from a decedent, the person's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the property on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), the amount of section 1254 costs with respect to the natural resource recapture property in the person's hands is zero on the acquisition date. See paragraph (c) of this section for the treatment of certain transfers at death.

(b) *Gifts and certain tax-free transactions*—(1) *General rule.* If natural resource recapture property is transferred in a transaction described in paragraph (b)(2) of this section, the amount of section 1254 costs with respect to the natural resource recapture property in the hands of the transferee immediately after the disposition is an amount equal to—

(i) The amount of section 1254 costs with respect to the natural resource recapture property in the hands of the transferor immediately before the disposition (and in the case of an S corporation or partnership transferor, the section 1254 costs of the shareholders or partners with respect to the natural resource recapture property); minus

(ii) The amount of any gain taken into account as ordinary income under section 1254(a)(1) by the transferor upon the disposition (and in the case of an S corporation or partnership transferor, any such gain taken into account as ordinary income by the shareholders or partners).

(2) *Transactions covered.* The transactions to which paragraph (b)(1) of this section apply are—

(i) A disposition that is a gift or in part a sale or exchange and in part a gift;

(ii) A transaction described in section 1041(a); or

(iii) A disposition described in § 1.1254–2(c)(3) (relating to certain tax-free transactions).

(c) *Certain transfers at death.* If natural resource recapture property is acquired in a transfer at death, the amount of section 1254 costs with respect to the natural resource recapture property in the hands of the transferee immediately after the transfer includes the amount, if any, of the section 1254 costs deducted by the transferee before the decedent's death, to the extent that the basis of the natural resource recapture property (determined under section 1014(a)) is required to be reduced under the second sentence of section 1014(b)(9) (relating to adjustments to basis where the property is acquired from a decedent prior to death).

(d) *Property received in a like kind exchange or involuntary conversion*—(1) *General rule.* If natural resource recapture property is disposed of in a like kind exchange under section 1031 or involuntary conversion under section

1033, then immediately after the disposition the amount of section 1254 costs with respect to any natural resource recapture property acquired for the property transferred is an amount equal to—

(i) The amount of section 1254 costs with respect to the natural resource recapture property disposed of (including the section 1254 costs of the shareholders of an S corporation or of the partners of a partnership with respect to the natural resource recapture property); minus

(ii) The amount of any gain taken into account as ordinary income under section 1254(a)(1) by the transferor upon the disposition (and in the case of an S corporation or partnership transferor, any such gain taken into account as ordinary income by the shareholders or partners).

(2) *Allocation of section 1254 costs among multiple natural resource recapture properties acquired.* If more than one parcel of natural resource recapture property is acquired at the same time from the same person in a transaction referred to in paragraph (d)(1) of this section, the total amount of section 1254 costs with respect to the parcels is allocated to the parcels in proportion to their respective adjusted bases.

(e) *Property transferred in cases to which section 1071 or 1081(b) applies.* Rules similar to the rules of section 1245(b)(5) shall apply under section 1254.

[T.D. 8586, 60 FR 2506, Jan. 10, 1995, as amended by T.D. 8684, 61 FR 53063, Oct. 10, 1996]

§1.1254–4 Special rules for S corporations and their shareholders.

(a) *In general.* This section provides rules for applying the provisions of section 1254 to S corporations and their shareholders upon the disposition by an S corporation (and a corporation that was formerly an S corporation) of natural resource recapture property and upon the disposition by a shareholder of stock of an S corporation that holds natural resource recapture property.

(b) *Determination of gain treated as ordinary income under section 1254 upon a disposition of natural resource recapture property by an S corporation*—(1) *General rule.* Upon a disposition of natural resource recapture property by an S corporation, the amount of gain treated as ordinary income under section 1254 is determined at the shareholder level. Each shareholder must recognize as ordinary income under section 1254 the lesser of—

(i) The shareholder's section 1254 costs with respect to the property disposed of; or

(ii) The shareholder's share of the amount, if any, by which the amount realized on the sale, exchange, or involuntary conversion, or the fair market value of the property upon any other disposition (including a distribution), exceeds the adjusted basis of the property.

(2) *Examples.* The following examples illustrate the provisions of paragraph (b)(1) of this section:

Example 1. Disposition of natural resource recapture property other than oil and gas property. A and B are equal shareholders in X, an S corporation. On January 1, 1997, X acquires for $90,000 an undeveloped mineral property, its sole property. During 1997, X expends and deducts $100,000 in developing the property. On January 15, 1998, X sells the property for $250,000 when X's basis in the property is $90,000. Thus, X recognizes gain of $160,000 on the sale. A and B's share of the $160,000 gain recognized is $80,000 each. Each shareholder has $50,000 of section 1254 costs with respect to the property. Under these circumstances, A and B each are required to recognize $50,000 of the $80,000 of gain on the sale of the property as ordinary income under section 1254.

Example 2. Disposition of oil and gas property the adjusted basis of which is allocated to the shareholders under section 613A(c)(11). C and D are equal shareholders in Y, an S corporation. On January 1, 1997, Y acquires for $150,000 an undeveloped oil and gas property, its sole property. During 1997, Y expends in developing the property $40,000 in intangible drilling costs which it elects to expense under section 263(c). On January 15, 1998, Y sells the property for $200,000. C and D's share of the $200,000 amount realized on the sale is $100,000 each. C and D each have a basis of $75,000 in the property and $20,000 of section 1254 costs with respect to the property. Under these circumstances, C and D each are required to recognize $20,000 of the $25,000 gain on the sale of the property as ordinary income under section 1254.

(c) *Character of gain recognized by a shareholder upon a sale or exchange of S corporation stock*—(1) *General rule.* Except as provided in paragraph (c)(2) of this section, if an S corporation shareholder recognizes gain upon a sale or exchange of stock in the S corporation (determined without regard to section 1254), the gain is treated as ordinary income under section 1254 to the extent of the shareholder's section 1254 costs (with respect to the shares sold or exchanged).

(2) *Exceptions*—(i) *Gain not attributable to section 1254 costs*—(A) *General rule.* Paragraph (c)(1) of this section does not apply to any portion of the gain recognized on the sale or exchange of the stock that the taxpayer establishes is not attributable to section 1254 costs. The portion of the gain recognized that is not attributable to section 1254 costs is that portion of the gain recognized that exceeds the amount of ordinary income that the shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) if, immediately prior to the sale or exchange of the stock, the corporation had sold at fair market value all of the corporation's property the disposition of which would result in the recognition by the shareholder of ordinary income under section 1254.

(B) *Substantiation.* To establish that a portion of the gain recognized is not attributable to a shareholder's section 1254 costs so as to qualify for the exception contained in paragraph (c)(2)(i)(A) of this section, the shareholder must attach to the shareholder's tax return a statement detailing the shareholder's share of the fair market value and basis, and the shareholder's section 1254 costs, for each of the S corporation's natural resource recapture properties held immediately before the sale or exchange of stock.

(ii) *Transactions entered into as part of a plan to avoid recognition of ordinary income under section 1254.* In the case of a contribution of property prior to a sale or exchange of stock pursuant to a plan a principal purpose of which is to avoid recognition of ordinary income under section 1254, paragraph (c)(1) of this section does not apply. Instead, the amount recognized as ordinary income under section 1254 is the amount of ordinary income the selling or exchanging shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) had the S corporation sold its natural resource recapture property the disposition of which would have resulted in the recognition of ordinary income under section 1254. The amount recognized as ordinary income under the preceding sentence reduces the amount realized on the sale or exchange of the stock.

This reduced amount realized is used in determining any gain or loss on the sale or exchange.

(3) *Examples.* The following examples illustrate the provisions of this paragraph (c):

Example 1. Application of general rule upon a sale of S corporation stock. C and D are equal shareholders in Y, an S corporation. As of January 1, 1997, Y holds two mining properties: Blackacre, with an adjusted basis of $5,000 and a fair market value of $35,000, and Whiteacre, with an adjusted basis of $20,000 and a fair market value of $15,000. Y also holds securities with a basis of $5,000 and a fair market value of $10,000. On January 1, 1997, D sells 50 percent of D's Y stock to E for $15,000. As of the date of the sale, D's adjusted basis in the Y stock sold is $7,500, and D has $18,000 of section 1254 costs with respect to Blackacre and $12,000 of section 1254 costs with respect to Whiteacre. Under this paragraph (c), the gain recognized by D upon the sale of Y stock is treated as ordinary income to the extent of D's section 1254 costs with respect to the stock sold, unless D establishes that a portion of such excess is not attributable to D's section 1254 costs. However, because D would recognize $7,500 in ordinary income under section 1254 with respect to the stock sold if Y sold Blackacre (the only asset the disposition of which would result in ordinary income to D under section 1254), the $7,500 of gain recognized by D upon the sale of D's Y stock is attributable to D's section 1254 costs. Therefore, upon the sale of stock to E, D recognizes $7,500 of ordinary income under this paragraph (c).

Example 2. Sale of S corporation stock where gain is not entirely attributable to section 1254 costs. Assume the same facts as in *Example 1*, except that Blackacre has a fair market value of $25,000, and the securities have a fair market value of $20,000. Immediately prior to the sale of stock to E, if Y had sold Blackacre (its only asset the disposition of which would result in the recognition of ordinary income to D under section 1254), D would recognize $5,000 in ordinary income with respect to the stock sold under section 1254. D attaches a statement to D's tax return for 1997 detailing D's share of the fair market values and bases, and D's section 1254 costs with respect to Blackacre and Whiteacre. Therefore, upon the sale of stock to E, of the $7,500 gain recognized by D, $5,000 is ordinary income under this paragraph (c).

Example 3. Contribution of property prior to sale of S corporation stock as part of a plan to avoid recognition of ordinary income under section 1254. H owns all of the stock of Z, an S corporation. As of January 1, 1997, H has $3,000 of section 1254 costs with respect to property P, which is natural resource recapture property and Z's only asset. Property P has an adjusted basis of $5,000 and a fair market value of $8,000. H has a basis of $5,000 in Z stock, which has a fair market value of $8,000. On January 1, 1997, H contributes securities to Z which have a basis of $7,000 and a fair market value of $4,000. On April 15, 1997, H sells all of the Z stock to J for $12,000. On that date, H's adjusted basis in the Z stock is also $12,000. Based on all the facts and circumstances, the sale of stock is part of a plan (along with the contribution by H of the securities to Z) that has a principal purpose to avoid recognition of ordinary income under section 1254. Consequently, under paragraph (c)(2)(ii) of this section, H must recognize $3,000 as ordinary income under section 1254, the amount of ordinary income that H would recognize as ordinary income under section 1254 if property P were sold at fair market value. In addition, H reduces the amount realized on the sale of the stock ($12,000) by $3,000. As a result, H also recognizes a $3,000 capital loss on the sale of the stock ($9,000 amount realized less $12,000 adjusted basis).

(d) *Section 1254 costs of a shareholder.* An S corporation shareholder's section 1254 costs with respect to any natural resource recapture property held by the corporation include all of the shareholder's section 1254 costs with respect to the property in the hands of the S corporation. See §1.1254–1(b)(1) for the definition of section 1254 costs.

(e) *Section 1254 costs of an acquiring shareholder after certain acquisitions*—(1) *Basis determined under section 1012.* If stock in an S corporation that holds natural resource recapture property is acquired and the acquiring shareholder's basis for the stock is determined solely by reference to its cost (within the meaning of section 1012), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands is zero on the acquisition date.

(2) *Basis determined under section 1014(a).* If stock in an S corporation that holds natural resource recapture property is acquired from a decedent and the acquiring shareholder's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the stock on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands is zero on the acquisition date.

(3) *Basis determined under section 1014(b)(9).* If stock in an S corporation that holds natural resource recapture property is acquired before the death of the decedent, the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands includes the amount, if any, of the section 1254 costs deducted by the acquiring shareholder before the decedent's death, to the extent that the basis of the stock (determined under section 1014(a)) is required to be reduced under section 1014(b)(9) (relating to adjustments to basis when the property is acquired before the death of the decedent).

(4) *Gifts and section 1041 transfers.* If stock is acquired in a transfer that is a gift, in a transfer that is a part sale or exchange and part gift, or in a transfer that is described in section 1041(a), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands immediately after the transfer is an amount equal to—

(i) The amount of section 1254 costs with respect to the property held by the corporation in the hands of the transferor immediately before the transfer; minus

(ii) The amount of any gain recognized as ordinary income under section 1254 by the transferor upon the transfer.

(f) *Special rules for a corporation that was formerly an S corporation or formerly a C corporation*—(1) *Section 1254 costs of an S corporation that was formerly a C corporation.* In the case of a C corporation that holds natural resource recapture property and that elects to be an S corporation, each shareholder's section 1254 costs as of the beginning of the corporation's first taxable year as an S corporation include a pro rata share of the section 1254 costs of the corporation as of the close of the last taxable year that the corporation was a C corporation.

(2) *Examples.* The following examples illustrate the application of the provisions of paragraph (f)(1) of this section:

Example 1. Sale of natural resource recapture property held by an S corporation that was formerly a C corporation—(i) Y is a C corporation that elects to be an S corporation effective January 1, 1997. On that date, Y owns Oil Well, which is natural resource recapture property and a capital asset. Y has section 1254 costs of $20,000 as of the close of the last taxable year that it was a C corporation. On January 1, 1997, Oil Well has a value of $200,000 and a basis of $100,000. Thus, under section 1374, Y's net unrealized built-in gain is $100,000. Also on that date, Y's basis in Oil Well is allocated to A, Y's sole shareholder, under section 613A(c)(11) and the section 1254 costs are allocated to A under paragraph (f)(1) of this section. In addition, A has a basis in A's Y stock of $100,000.

(ii) On November 1, 1997, Y sells Oil Well for $250,000. During 1997, Y has taxable income greater than $100,000, and no other transactions or items treated as recognized built-in gain or loss. Under section 1374, Y has net recognized built-in gain of $100,000. Assuming a tax rate of 35 percent on capital gain, Y has a tax of $35,000 under section 1374. The tax of $35,000 is treated as a capital loss under section 1366(f)(2). A has a realized gain on the sale of $150,000 ($250,000 minus $100,000) of which $20,000 is recognized as ordinary income under section 1254, and $130,000 is recognized as capital gain. Consequently, A recognizes ordinary income of $20,000 and net capital gain of $95,000 ($130,000 minus $35,000) on the sale.

Example 2. Sale of stock followed by sale of natural resource recapture property held by an S corporation that was formerly a C corporation—(i) Assume the same facts as in *Example 1*(i). On November 1, 1997, A sells all of A's Y stock to P for $250,000. A has a realized gain on the sale of $150,000 ($250,000 minus $100,000) of which $20,000 is recognized as ordinary income under section 1254, and $130,000 is recognized as capital gain.

(ii) On November 2, 1997, Y sells Oil Well for $250,000. During 1997, Y has taxable income greater than $100,000, and no other transactions or items treated as recognized built-in gain or loss. Under section 1374, Y has net recognized built-in gain of $100,000. Assuming a tax rate of 35 percent on capital gain, Y has a tax of $35,000 under section 1374. The tax of $35,000 is treated as a capital loss under section 1366(f)(2). P has a realized gain on the sale of $150,000 ($250,000 minus $100,000), which is recognized as capital gain. Consequently, P recognizes net capital gain of $115,000 ($150,000 minus $35,000) on the sale.

(3) *Section 1254 costs of a C corporation that was formerly an S corporation.* In the case of an S corporation that becomes a C corporation, the C corporation's section 1254 costs with respect to any natural resource recapture property held by the corporation as of the beginning of the corporation's first taxable year as a C corporation include the sum of its shareholders' section 1254 costs with respect to the property as of the close of the last taxable year that the corporation was an S corporation. In the case of an S termination year as defined in section 1362(e)(4), the shareholders' section 1254 costs are determined as of the close of the S short year as defined in section 1362(e)(1)(A). See paragraph (g)(5) of this section for rules on determining the aggregate amount of the shareholders' section 1254 costs.

(g) *Determination of a shareholder's section 1254 costs upon certain stock transactions*—(1) *Issuance of stock.* Upon an issuance of stock (whether such stock is newly-issued or had been held as treasury stock) by an S corporation in a reorganization described in section 368 or otherwise—

(i) Each recipient of shares must be allocated a pro rata share (determined solely with respect to the shares issued in the transaction) of the aggregate of the S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation immediately before the issuance (as determined pursuant to paragraph (g)(5) of this section); and

(ii) Each pre-existing shareholder must reduce his or her section 1254 costs with respect to natural resource recapture property held by the S corporation immediately before the issuance by an amount equal to the pre-existing shareholder's section 1254 costs immediately before the issuance multiplied by the percentage of stock of the corporation issued in the transaction.

(2) *Natural resource recapture property acquired in exchange for stock.* If natural resource recapture property is transferred to an S corporation in exchange for stock of the S corporation (for example, in a section 351 transaction, or in a reorganization described in section 368), the S corporation must allocate to

its shareholders a pro rata share of the S corporation's section 1254 costs with respect to the property immediately after the transaction (as determined under §1.1254–3(b)(1)).

(3) *Treatment of nonvested stock.* Stock issued in connection with the performance of services that is substantially nonvested (within the meaning of §1.83–3(b)) is treated as issued for purposes of this section at the first time it is treated as outstanding stock of the S corporation for purposes of section 1361.

(4) *Exception.* Paragraph (g)(1) of this section does not apply to stock issued in exchange for stock of the same S corporation (as for example, in a recapitalization described in section 368(a)(1)(E)).

(5) *Aggregate of S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation*—(i) *In general.* The aggregate of S corporation shareholders' section 1254 costs is equal to the sum of each shareholder's section 1254 costs. The S corporation must determine each shareholder's section 1254 costs under either paragraph (g)(5)(ii) (written data) or paragraph (g)(5)(iii) (assumptions) of this section. The S corporation may determine the section 1254 costs of some shareholders under paragraph (g)(5)(ii) of this section and of others under paragraph (g)(5)(iii) of this section.

(ii) *Written data.* An S corporation may determine a shareholder's section 1254 costs by using written data provided by a shareholder showing the shareholder's section 1254 costs with respect to natural resource recapture property held by the S corporation unless the S corporation knows or has reason to know that the written data is inaccurate. If an S corporation does not receive written data upon which it may rely, the S corporation must use the assumptions provided in paragraph (g)(5)(iii) of this section in determining a shareholder's section 1254 costs.

(iii) *Assumptions.* An S corporation that does not use written data pursuant to paragraph (g)(5)(ii) of this section to determine a shareholder's section 1254 costs must use the following assumptions to determine the shareholder's section 1254 costs—

(A) The shareholder deducted his or her share of the amount of deductions under sections 263(c), 616, and 617 in the first year in which the shareholder could claim a deduction for such amounts, unless in the case of expenditures under sections 263(c) or 616 the S corporation elected to capitalize such amounts;

(B) The shareholder was not subject to the following limitations with respect to the shareholder's depletion allowance under section 611, except to the extent a limitation applied at the corporate level: the taxable income limitation of section 613(a); the depletable quantity limitations of section 613A(c); or the limitations of sections 613A(d)(2), (3), and (4) (exclusion of retailers and refiners).

(6) *Examples.* The following examples illustrate the provisions of this paragraph (g):

Example 1. Transfer of natural resource recapture property to an S corporation in a section 351 transaction. As of January 1, 1997, A owns all the stock (20 shares) in X, an S corporation. X holds property that is not natural resource recapture property that has a fair market value of $2,000 and an adjusted basis of $2,000. On January 1, 1997, B transfers natural resource recapture property, Property P, to X in exchange for 80 shares of X stock in a transaction that qualifies under section 351. Property P has a fair market value of $8,000 and an adjusted basis of $5,000. Pursuant to section 351, B does not recognize gain on the transaction. Immediately prior to the transaction, B's section 1254 costs with respect to Property P equaled $6,000. Under §1.1254–2(c)(1), B does not recognize any gain under section 1254 on the section 351 transaction and, under §1.1254–3(b)(1), X's section 1254 costs with respect to Property P immediately after the contribution equal $6,000. Under paragraph (g)(2) of this section, each shareholder is allocated a pro rata share of X's section 1254 costs. The pro rata share of X's section 1254 costs that is allocated to A equals $1,200 (20 percent interest in X multiplied by X's $6,000 of section 1254 costs). The pro rata share of X's section 1254 costs that is allocated to B equals $4,800 (80 percent interest in X multiplied by X's $6,000 of section 1254 costs).

Example 2. Contribution of money in exchange for stock of an S corporation holding natural resource recapture property. As of January 1, 1997, A and B each own 50 percent of the stock (50 shares each) in X, an S corporation. X holds natural resource recapture property, Property P, which has a fair market value of $20,000 and an adjusted basis of

$14,000. A's and B's section 1254 costs with respect to Property P are $4,000 and $1,500, respectively. On January 1, 1997, C contributes $20,000 to X in exchange for 100 shares of X's stock. Under paragraph (g)(1)(i) of this section, X must allocate to C a pro rata share of its shareholders' section 1254 costs. Using the assumptions set forth in paragraph (g)(5)(iii) of this section, X determines that A's section 1254 costs with respect to natural resource recapture property held by X equal $4,500. Using written data provided by B, X determines that B's section 1254 costs with respect to Property P equal $1,500. Thus, the aggregate of X's shareholders' section 1254 costs equals $6,000. C's pro rata share of the $6,000 of section 1254 costs equals $3,000 (C's 50 percent interest in X multiplied by $6,000). Under paragraph (g)(1)(ii) of this section, A's section 1254 costs are reduced by $2,000 (A's actual section 1254 costs ($4,000) multiplied by 50 percent). B's section 1254 costs are reduced by $750 (B's actual section 1254 costs ($1,500) multiplied by 50 percent).

Example 3. Merger involving an S corporation that holds natural resource recapture property. X, an S corporation with one shareholder, A, holds as its sole asset natural resource recapture property that has a fair market value of $120,000 and an adjusted basis of $40,000. A has section 1254 costs with respect to the property of $60,000. For valid business reasons, X merges into Y, an S corporation with one shareholder, B, in a reorganization described in section 368(a)(1)(A). Y holds property that is not natural resource recapture property that has a fair market value of $120,000 and basis of $120,000. Under paragraph (c) of this section, A does not recognize ordinary income under section 1254 upon the exchange of stock in the merger because A did not otherwise recognize gain on the merger. Under paragraph (g)(2) of this section, Y must allocate to A and B a pro rata share of its $60,000 of section 1254 costs. Thus, A and B are each allocated $30,000 of section 1254 costs (50 percent interest in X, each, multiplied by $60,000).

[T.D. 8684, 61 FR 53063, Oct. 10, 1996]

§ 1.1254–5 Special rules for partnerships and their partners.

(a) *In general.* This section provides rules for applying the provisions of section 1254 to partnerships and their partners upon the disposition of natural resource recapture property by the partnership and certain distributions of property by a partnership. See section 751 and the regulations thereunder for rules concerning the treatment of gain upon the transfer of a partnership interest.

(b) *Determination of gain treated as ordinary income under section 1254 upon the disposition of natural resource recapture property by a partnership*—(1) *General rule.* Upon a disposition of natural resource recapture property by a partnership, the amount treated as ordinary income under section 1254 is determined at the partner level. Each partner must recognize as ordinary income under section 1254 the lesser of—

(i) The partner's section 1254 costs with respect to the property disposed of; or

(ii) The partner's share of the amount, if any, by which the amount realized upon the sale, exchange, or involuntary conversion, or the fair market value of the property upon any other disposition, exceeds the adjusted basis of the property.

(2) *Exception to partner level recapture in the case of abusive allocations.* Paragraph (b)(1) of this section does not apply in determining the amount treated as ordinary income under section 1254 upon a disposition of section 1254 property by a partnership if the partnership has allocated the amount realized or gain recognized from the disposition with a principal purpose of avoiding the recognition of ordinary income under section 1254. In such case, the amount of gain on the disposition recaptured as ordinary income under section 1254 is determined at the partnership level.

(3) *Examples.* The provisions of paragraphs (a) and (b) of this section are illustrated by the following examples which assume that capital accounts are maintained in accordance with section 704(b) and the regulations thereunder:

Example 1. Partner level recapture—In general. A, B, and C, have equal interests in capital in Partnership ABC that was formed on January 1, 1985. The partnership acquired an undeveloped domestic oil property on January 1, 1985, for $120,000. The partnership allocated the property's basis to each partner in proportion to the partner's interest in partnership capital, so each partner was allocated $40,000 of basis. In 1985, the partnership incurred $60,000 of productive well intangible drilling and development costs with respect to the property. The partnership elected to deduct the intangible drilling and development costs as expenses under section 263(c). Each partner deducted $20,000 of the intangible drilling and development costs. Assume that depletion allowable under section

613A(c)(7)(D) for each partner for 1985 was $10,000. On January 1, 1986, the partnership sold the oil property to an unrelated third party for $210,000. Each partner's allocable share of the amount realized is $70,000. Each partner's basis in the oil property at the end of 1985 is $30,000 ($40,000 cost—$10,000 depletion deductions claimed). Each partner has a gain of $40,000 on the sale of the oil property ($70,000 amount realized—$30,000 adjusted basis in the oil property). Assume that each partner's depletion allowance would not have been increased if the intangible drilling and development costs had been capitalized. Each partner's section 1254 costs with respect to the property are $20,000. Thus, A, B, and C each must treat $20,000 of gain recognized as ordinary income under section 1254(a).

Example 2. Special allocation of intangible drilling and development costs. K and L form a partnership on January 1, 1997, to acquire and develop a geothermal property as defined under section 613(e)(2). The partnership agreement provides that all intangible drilling and development costs will be allocated to partner K, and that all other items of income, gain, or loss will be allocated equally between the two partners. Assume these allocations have substantial economic effect under section 704(b) and the regulations thereunder. The partnership acquires a lease covering undeveloped acreage located in the United States for $50,000. In 1997, the partnership incurs $50,000 of intangible drilling and development costs that are allocated to partner K. The partnership also has $30,000 of depletion deductions, which are allocated equally between K and L. On January 1, 1998, the partnership sells the geothermal property to an unrelated third party for $160,000 and recognizes a gain of $140,000 ($160,000 amount realized less $20,000 adjusted basis ($50,000 unadjusted basis less $30,000 depletion deductions)). This gain is allocated equally between K and L. Because K's section 1254 costs are $65,000 and L's section 1254 costs are $15,000, K recognizes $65,000 as ordinary income under section 1254(a) and L recognizes $15,000 as ordinary income under section 1254(a). The remaining $5,000 of gain allocated to K and $55,000 of gain allocated to L is characterized without regard to section 1254.

Example 3. Section 59(e) election to capitalize intangible drilling and development costs. Partnership DK has 50 equal partners. On January 1, 1995, the partnership purchases an undeveloped oil and gas property for $100,000. The partnership allocates the property's basis equally among the partners, so each partner is allocated $2,000 of basis. In January 1995, the partnership incurs $240,000 of intangible drilling and development costs with respect to the property. The partnership elects to deduct the intangible drilling and development costs as expenses under section 263(c). Each partner is allocated $4,800 of intangible drilling and development costs. One of the partners, H, elects under section 59(e) to capitalize his $4,800 share of intangible drilling and development costs. Therefore, H is permitted to amortize his $4,800 share of intangible drilling and development costs over 60 months. H takes a $960 amortization deduction in 1995. Each of the remaining 49 partners deducts his $4,800 share of intangible drilling and development costs in 1995. Assume that depletion allowable for each partner under section 613A(c)(7)(D) for 1995 is $1,000. On December 31, 1995, the partnership sells the property for $300,000. Each partner is allocated $6,000 of amount realized. Each partner that deducted the intangible drilling and development costs has a basis in the oil property at the end of 1995 of $1,000 ($2,000 cost − $1,000 depletion deductions claimed). Each of these partners has a gain of $5,000 on the sale of the oil property ($6,000 amount realized − $1,000 adjusted basis in the property). The section 1254 costs of each partner that deducted intangible drilling and development costs are $5,800 ($4,800 intangible drilling and development costs deducted + $1,000 depletion deductions claimed). Because each partner's section 1254 costs ($5,800) exceed each partner's share of amount realized less each partner's adjusted basis ($5,000), each partner must treat his $5,000 gain recognized on the sale of the oil property as ordinary income under section 1254(a). Because H elected under section 59(e) to capitalize the $4,800 of intangible drilling and development costs and amortized only $960 of the costs in 1995, the $3,840 of unamortized intangible drilling and development costs are included in H's basis in the oil property. Therefore, at the end of 1995 H's basis in the oil property is $4,840 (($2,000 cost + $4,800 capitalized intangible drilling and development costs) − ($960 intangible drilling and development costs amortized + $1,000 depletion deduction claimed)). H's gain on the sale of the oil property is $1,160 ($6,000 amount realized − $4,840 adjusted basis). H's section 1254 costs are $1,960 ($960 intangible drilling and development costs amortized + $1,000 depletion deductions claimed). Because H's section 1254 costs ($1,960) exceed H's share of amount realized less H's adjusted basis ($1,160), H must treat the $1,160 of gain recognized as ordinary income under section 1254(a).

(c) *Section 1254 costs of a partner*—(1) *General rule.* A partner's section 1254 costs with respect to property held by a partnership include all of the partner's section 1254 costs with respect to the property in the hands of the partnership. In the case of property contributed to a partnership in a transaction described in section 721, a partner's section 1254 costs include all of the partner's section 1254 costs with respect to the property prior to contribution. Section 1.1254–1(b)(1)(iv), which provides rules concerning the treatment of suspended deductions, applies to amounts not deductible pursuant to section 704(d).

(2) *Section 1254 costs of a transferee partner after certain acquisitions*—(i) *Basis determined under section 1012.* If a person acquires an interest in a partnership that holds natural resource recapture property (transferee partner) and the transferee partner's basis for the interest is determined by reference to its cost (within the meaning of section 1012), the amount of the transferee partner's section 1254 costs with respect to the property held by the partnership is zero on the acquisition date.

(ii) *Basis determined by reason of the application of section 1014(a).* If a transferee partner acquires an interest in a partnership that holds natural resource recapture property from a decedent and the transferee partner's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the partnership interest on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), the amount of the transferee partner's section 1254 costs with respect to property held by the partnership is zero on the acquisition date.

(iii) *Basis determined by reason of the application of section 1014(b)(9).* If an interest in a partnership that holds natural resource recapture property is acquired before the death of the decedent, the amount of the transferee partner's section 1254 costs with respect to property held by the partnership shall include the amount, if any, of the section 1254 costs deducted by the transferee partner before the decedent's death, to the extent that the basis of the partner's interest (determined under section 1014(a)) is required to be reduced under section 1014(b)(9) (relating to adjustments to basis when the property is acquired before the death of the decedent).

(iv) *Gifts and section 1041 transfers.* If an interest in a partnership is transferred in a transfer that is a gift, a part sale or exchange and part gift, or a transfer that is described in section 1041(a), the amount of the transferee partner's section 1254 costs with respect to property held by the partnership immediately after the transfer is an amount equal to—

(A) The amount of the transferor partner's section 1254 costs with respect to the property immediately before the transfer; minus

(B) The amount of any gain recognized as ordinary income under section 1254 by the transferor partner upon the transfer.

(d) *Property distributed to a partner*—(1) *In general.* The section 1254 costs for any natural resource recapture property received by a partner in a distribution with respect to part or all of an interest in a partnership include—

(i) The aggregate of the partners' section 1254 costs with respect to the natural resource recapture property immediately prior to the distribution; reduced by

(ii) The amount of any gain taken into account as ordinary income under section 751 by the partnership or the partners (as constituted after the distribution) on the distribution of the natural resource recapture property.

(2) *Aggregate of partners' section 1254 costs with respect to natural resource recapture property held by a partnership*—(i) *In general.* The aggregate of partners' section 1254 costs is equal to the sum of each partner's section 1254 costs. The partnership must determine each partner's section 1254 costs under either paragraph (d)(2)(i)(A) (written data) or paragraph (d)(2)(i)(B) (assumptions) of this section. The partnership may determine the section 1254 costs of some of the partners under paragraph (d)(2)(i)(A) of this section and of others under paragraph (d)(2)(i)(B) of this section.

(A) *Written data.* A partnership may determine a partner's section 1254 costs by using written data provided by a partner showing the partner's section 1254 costs with respect to natural resource recapture property held by the partnership unless the partnership knows or has reason to know that the written data is inaccurate. If a partnership does not receive written data upon which it may rely, the partnership must use the assumptions provided in paragraph (d)(2)(i)(B) of this section in determining a partner's section 1254 costs.

(B) *Assumptions.* A partnership that does not use written data pursuant to paragraph (d)(2)(i)(A) of this section to determine a partner's section 1254 costs must use the following assumptions to determine the partner's section 1254 costs:

(*1*) The partner deducted his or her share of deductions under section 263(c), 616, or 617 for the first year in which the partner could claim a deduction for such amounts, unless in the case of expenditures under section 263(c) or 616, the partnership elected to capitalize such amounts;

(*2*) The partner was not subject to the following limitations with respect to the partner's depletion allowance under section 611, except to the extent a limitation applied at the partnership level: the taxable income limitation of section 613(a); the depletable quantity limitations of section 613A(c); or the limitations of section 613A(d)(2), (3), and (4) (exclusion of retailers and refiners).

[T.D. 8586, 60 FR 2507, Jan. 10, 1995]

§1.1254–6 Effective date of regulations.

Sections 1.1254–1 through 1.1254–3 and §1.1254–5 are effective with respect to any disposition of natural resource recapture property occurring after March 13, 1995. The rule in §1.1254–1(b)(2)(iv)(A)(*2*), relating to a nonoperating mineral interest carved out of an operating mineral interest with respect to which an expenditure has been deducted, is effective with respect to any disposition occurring after March 13, 1995 of property (within the meaning of section 614) that is placed in service by the taxpayer after December 31, 1986. Section 1.1254–4 applies to dispositions of natural resource recapture property by an S corporation (and a corporation that was formerly an S corporation) and dispositions of S corporation stock occurring on or after October 10, 1996. Sections 1.1254–2(d)(1)(ii) and 1.1254–3 (b)(1) (i) and (ii) and (d)(1) (i) and (ii) are effective for dispositions of property occurring on or after October 10, 1996.

[T.D. 8586, 60 FR 2508, Jan. 10, 1995, as amended by T.D. 8684, 61 FR 53066, Oct. 10, 1996]

§1.1256(e)–1 Identification of hedging transactions.

(a) *Identification and recordkeeping requirements.* Under section 1256(e)(2)(C), a taxpayer that enters into a hedging transaction must identify the transaction as a hedging transaction before the close of the day on which the taxpayer enters into the transaction.

(b) *Requirements for identification.* The identification of a hedging transaction for purposes of section 1256(e)(2)(C) must satisfy the requirements of §1.1221–2(e)(1). Solely for purposes of section 1256(f)(1), however, an identification that does not satisfy all of the requirements of §1.1221–2(e)(1) is nevertheless treated as an identification under section 1256(e)(2)(C).

(c) *Consistency with §1.1221–2.* Any identification for purposes of §1.1221–2(e)(1) is also an identification for purposes of this section. If a taxpayer satisfies the requirements of paragraph (f)(1)(ii) of §1.1221–2, the transaction is treated as if it were not identified as a hedging transaction for purposes of section 1256(e)(2)(C).

(d) *Effective date.* This section applies to transactions entered into on or after October 1, 1994.

[T.D. 8555, 59 FR 36367, July 18, 1994]

§1.1258–1 Netting rule for certain conversion transactions.

(a) *Purpose.* The purpose of this section is to provide taxpayers with a method to net certain gains and losses from positions of the same conversion transaction before determining the amount of gain treated as ordinary income under section 1258(a).

(b) *Netting of gain and loss for identified transactions*—(1) *In general.* If a taxpayer disposes of or terminates all the positions of an identified netting transaction (as defined in paragraph (b)(2) of this section) within a 14-day period in a single taxable year, all gains and losses on those positions taken into account for Federal tax purposes within that period (other than built-in losses as defined in paragraph (c) of this section) are netted solely for purposes of determining the amount of gain treated as ordinary income under section 1258(a). For purposes of the preceding sentence, a taxpayer is treated as disposing of any position that is treated as sold under any provision of the Code or regulations thereunder (for example, under section 1256(a)(1)).

(2) *Identified netting transaction.* For purposes of this section, an identified netting transaction is a conversion transaction (as defined in section 1258(c)) that the taxpayer identifies as an identified netting transaction on its books and records. Identification of each position of the conversion transaction must be made before the close of the day on which the position becomes part of the conversion transaction. No particular form of identification is necessary, but all the positions of a single conversion transaction must be identified as part of the same transaction and must be distinguished from all other positions.

(c) *Definition of built-in loss.* For purposes of this section, built-in loss means—

(1) Built-in loss as defined in section 1258(d)(3)(B); and

(2) If a taxpayer realizes gain or loss on any one position of a conversion transaction (for example, under section 1256), as of the date that gain or loss is realized, any unrecognized loss in any other position of the conversion transaction that is not disposed of, terminated, or treated as sold under any provision of the Code or regulations thereunder within 14 days of and within the same taxable year as the realization event.

(d) *Examples.* These examples illustrate this section:

Example 1. Identified netting transaction with simultaneous actual dispositions. (i) On December 1, 1995, A purchases 1,000 shares of XYZ stock for $100,000 and enters into a forward contract to sell 1,000 shares of XYZ stock on November 30, 1997, for $110,000. The XYZ stock is actively traded as defined in § 1.1092(d)–1(a) and is a capital asset in A's hands. A maintains books and records on which, on December 1, 1995, it identifies the two positions as all the positions of a single conversion transaction. A owns no other XYZ stock. On December 1, 1996, when the applicable imputed income amount for the transaction is $7,000, A sells the 1,000 shares of XYZ stock for $95,000. On the same day, A terminates its forward contract with its counterparty, receiving $10,200. No dividends were received on the stock during the time it was part of the conversion transaction.

(ii) The XYZ stock and forward contract are positions of a conversion transaction. Under section 1258(c)(1), substantially all of A's expected return from the overall transaction is attributable to the time value of the net investment in the transaction. Under section 1258(c)(2)(B), the transaction is an applicable straddle as defined in section 1258(d)(1).

(iii) A disposed of or terminated all the positions of the conversion transaction within 14 days and within the same taxable year as required by paragraph (b)(1) of this section. The transaction is an identified netting transaction because it meets the identification requirement of paragraph (b)(2) of this section. Solely for purposes of section 1258(a), the $5,000 loss realized ($100,000 basis less $95,000 amount realized) on the disposition of the XYZ stock is netted against the $10,200 gain recognized on the disposition of the forward contract. Thus, the net gain from the conversion transaction for purposes of section 1258(a) is $5,200 ($10,200 gain less $5,000 loss). Only the $5,200 net gain is recharacterized as ordinary income under section 1258(a) even though the applicable imputed income amount is $7,000. For Federal tax purposes other than section 1258(a), A has recognized a $10,200 gain on the disposition of the forward contract ($5,200 of which is treated as ordinary income) and realized a separate $5,000 loss on the sale of the XYZ stock.

Example 2. Identified netting transaction with built-in loss. (i) The facts are the same as in *Example 1,* except that A had purchased the XYZ stock for $104,000 on May 15, 1995. The XYZ stock had a fair market value of $100,000 on December 1, 1995, the date it became part of a conversion transaction.

(ii) The results are the same as in *Example 1,* except that A has built-in loss (in addition to the $5,000 loss that arose economically during the period of the conversion transaction), as defined in section 1258(d)(3)(B), of $4,000 on the XYZ stock. That $4,000 built-in loss is not netted against the $10,200 gain on the forward contract for purposes of section 1258(a). Thus, the net gain from the conversion transaction for purposes of section 1258(a) is $5,200, the same as in *Example 1.* The $4,000 built-in loss is recognized and has a character determined without regard to section 1258.

(e) *Effective date and transition rule*—(1) *In general.* These regulations are effective for conversion transactions that are outstanding on or after December 21, 1995.

(2) *Transition rule for identification requirements.* In the case of a conversion transaction entered into before February 20, 1996, paragraph (b)(2) of this section is treated as satisfied if the identification is made before the close of business on February 20, 1996.

[T.D. 8649, 60 FR 66084, Dec. 21, 1995]

§1.1271–0 Original issue discount; effective date; table of contents.

(a) *Effective date.* Except as otherwise provided, §§1.1271–1 through 1.1275–5 apply to debt instruments issued on or after April 4, 1994. Taxpayers, however, may rely on these sections (as contained in 26 CFR part 1 revised April 1, 1996) for debt instruments issued after December 21, 1992, and before April 4, 1994.

(b) *Table of contents.* This section lists captioned paragraphs contained in §§1.1271–1 through 1.1275–7T.

§1.1271–1 Special rules applicable to amounts received on retirement, sale, or exchange of debt instruments.

(a) Intention to call before maturity.
(1) In general.
(2) Exceptions.
(b) Short-term obligations.
(1) In general.
(2) Method of making elections.
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§1.1272–1 Current inclusion of OID in income.

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(2) Debt instruments not subject to OID inclusion rules.
(b) Accrual of OID.
(1) Constant yield method.
(2) Exceptions.
(3) Modifications.
(4) Special rules for determining the OID allocable to an accrual period.
(c) Yield and maturity of certain debt instruments subject to contingencies.
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(4) Consistency rule. [Reserved]
(5) Treatment of certain options.
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(d) Certain debt instruments that provide for a fixed yield.
(e) Convertible debt instruments.
(f) Special rules to determine whether a debt instrument is a short-term obligation.
(1) Counting of either the issue date or maturity date.
(2) Coordination with paragraph (c) of this section for certain sections of the Internal Revenue Code.
(g) Basis adjustment.
(h) Debt instruments denominated in a currency other than the U.S. dollar.
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§1.1272–2 Treatment of debt instruments purchased at a premium.

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(b) Definitions and special rules.
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(2) Premium.
(3) Acquisition premium.
(4) Acquisition premium fraction.
(5) Election to accrue discount on a constant yield basis.
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§1.1272–3 Election by a holder to treat all interest on a debt instrument as OID.

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(b) Scope of election.
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§1.1273–1 Definition of OID.

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(2) Debt instruments subject to contingencies.
(3) Variable rate debt instrument.
(4) Stated interest in excess of qualified stated interest.
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(d) De minimis OID.
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(2) De minimis amount.
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(e) Definitions.
(1) Installment obligation.
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§1.1273–2 Determination of issue price and issue date.

(a) Debt instruments issued for money.

(1) Issue price.
(2) Issue date.
(b) Publicly traded debt instruments issued for property.
(1) Issue price.
(2) Issue date.
(c) Debt instruments issued for publicly traded property.
(1) Issue price.
(2) Issue date.
(d) Other debt instruments.
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(2) Issue date.
(e) Special rule for certain sales to bond houses, brokers, or similar persons.
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(2) Payments from borrower to lender.
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(m) Treatment of amounts representing pre-issuance accrued interest.
(1) Applicability.
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§ 1.1274–1 Debt instruments to which section 1274 applies.

(a) In general.
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(1) Debt instrument with adequate stated interest and no OID .
(2) Exceptions under sections 1274(c)(1)(B), 1274(c)(3), 1274A(c), and 1275(b)(1).
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§ 1.1274–2 Issue price of debt instruments to which section 1274 applies.

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(2) Debt instruments that do not provide for adequate stated interest; imputed principal amount.
(3) Debt instruments issued in a potentially abusive situation; fair market value.
(c) Determination of whether a debt instrument provides for adequate stated interest.
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(2) Stated interest at a single objective rate.
(g) Treatment of contingent payment debt instruments.
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(j) Special rules for tax-exempt obligations.
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(2) Contingent payment debt instruments.
(3) Effective date.

§ 1.1274–3 Potentially abusive situations defined.

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(1) Debt instrument exchanged for nonrecourse financing.
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§ 1.1274–4 Test rate.

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(2) Test rate for certain debt instruments.
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(4) Certain debt instruments that provide for principal payments uncertain as to time.
(d) Foreign currency loans.
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§ 1.1274–5 Assumptions.

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(b) Modifications of debt instruments.
(1) In general.
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§1.1274A–1 Special rules for certain transactions where stated principal amount does not exceed $2,800,000.

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§1.1275–2 Special rules relating to debt instruments.

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(2) Remote contingencies.
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§1.1275–4 Contingent payment debt instruments.

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(5) Remote and incidental contingencies.
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(1) Applicability.
(2) In general.
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(4) Comparable yield and projected payment schedule.
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(7) Adjusted issue price, adjusted basis, and retirement.
(8) Character on sale, exchange, or retirement.
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(6) Treatment of a holder on sale, exchange, or retirement.
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(3) All other tax-exempt obligations.
(4) Basis different from adjusted issue price.
(e) Amounts treated as interest under this section.
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§ 1.1275–5 Variable rate debt instruments.

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(1) In general.
(2) Principal payments.
(3) Stated interest.
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(5) No contingent principal payments.
(6) Special rule for debt instruments issued for nonpublicly traded property.
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(2) Certain rates based on a qualified floating rate.
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(c) Objective rate.
(1) Definition.
(2) Other objective rates to be specified by Commissioner.
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(e) Qualified stated interest and OID with respect to a variable rate debt instrument.
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(2) Variable rate debt instrument that provides for annual payments of interest at a single variable rate.
(3) All other variable rate debt instruments except for those that provide for a fixed rate.
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§ 1.1275–6 Integration of qualifying debt instruments.

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(3) Financial instrument.
(4) Synthetic debt instrument.
(c) Integrated transaction.
(1) Integration by taxpayer.
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(f) Taxation of integrated transactions.
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(2) Issue date.
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(4) Issue price.
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§ 1.1275–7T Inflation-indexed debt instruments (temporary).

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(3) Qualified inflation index.
(4) Inflation-adjusted principal amount.
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(5) Example.
(e) Discount bond method.
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(2) No qualified stated interest.
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(f) Special rules.
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(2) Adjusted basis.
(3) Subsequent holders.
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(5) Temporary unavailability of a qualified inflation index.
(g) Reopenings.
(h) Effective date.

[T.D. 8517, 59 FR 4808, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30139, June 14, 1996; T.D. 8709, 62 FR 617, Jan. 6, 1997; T.D. 8754, 63 FR 1057, Jan. 8, 1998]

§1.1271–1 Special rules applicable to amounts received on retirement, sale, or exchange of debt instruments.

(a) *Intention to call before maturity*—(1) *In general.* For purposes of section 1271(a)(2), all or a portion of gain realized on a sale or exchange of a debt instrument to which section 1271 applies is treated as interest income if there was an intention to call the debt instrument before maturity. An intention to call a debt instrument before maturity means a written or oral agreement or understanding not provided for in the debt instrument between the issuer and the original holder of the debt instrument that the issuer will redeem the debt instrument before maturity. In the case of debt instruments that are part of an issue, the agreement or understanding must be between the issuer and the original holders of a substantial amount of the debt instruments in the issue. An intention to call before maturity can exist even if the intention is conditional (e.g., the issuer's decision to call depends on the financial condition of the issuer on the potential call date) or is not legally binding. For purposes of this section, original holder means the first holder (other than an underwriter or dealer that purchased the debt instrument for resale in the ordinary course of its trade or business).

(2) *Exceptions.* In addition to the exceptions provided in sections 1271(a)(2)(B) and 1271(b), section 1271(a)(2) does not apply to—

(i) A debt instrument that is publicly offered (as defined in §1.1275–1(h));

(ii) A debt instrument to which section 1272(a)(6) applies (relating to certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration); or

(iii) A debt instrument sold pursuant to a private placement memorandum that is distributed to more than ten offerees and that is subject to the sanctions of section 12(2) of the Securities Act of 1933 (15 U.S.C. 77l) or the prohibitions of section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j).

(b) *Short-term obligations*—(1) *In general.* Under sections 1271 (a)(3) and (a)(4), all or a portion of the gain realized on the sale or exchange of a short-term government or nongovernment obligation is treated as interest income. Sections 1271 (a)(3) and (a)(4), however, do not apply to any short-term obligation subject to section 1281. See §1.1272–1(f) for rules to determine if an obligation is a short-term obligation.

(2) *Method of making elections.* Elections to accrue on a constant yield basis under sections 1271 (a)(3)(E) and (a)(4)(D) are made on an obligation-by-obligation basis by reporting the transaction on the basis of daily compounding on the taxpayer's timely filed Federal income tax return for the year of the sale or exchange. These elections are irrevocable.

(3) *Counting conventions.* In computing the ratable share of acquisition discount under section 1271(a)(3) or OID under section 1271(a)(4), any reasonable counting convention may be used (e.g., 30 days per month/360 days per year).

[T.D. 8517, 59 FR 4809, Feb. 2, 1994]

§1.1272–1 Current inclusion of OID in income.

(a) *Overview*—(1) *In general.* Under section 1272(a)(1), a holder of a debt instrument includes accrued OID in gross income (as interest), regardless of the holder's regular method of accounting. A holder includes qualified stated interest (as defined in §1.1273–1(c)) in income under the holder's regular method of accounting. See §§1.446–2 and 1.451–1.

(2) *Debt instruments not subject to OID inclusion rules.* Sections 1272(a)(2) and 1272(c) list exceptions to the general inclusion rule of section 1272(a)(1). For purposes of section 1272(a)(2)(E) (relating to certain loans between natural persons), a loan does not include a stripped bond or stripped coupon within the meaning of section 1286(e), and the rule in section 1272(a)(2)(E)(iii), which treats a husband and wife as 1 person, does not apply to loans made between a husband and wife.

(b) *Accrual of OID*—(1) *Constant yield method.* Except as provided in paragraphs (b)(2) and (b)(3) of this section, the amount of OID includible in the income of a holder of a debt instrument for any taxable year is determined using the constant yield method as described under this paragraph (b)(1).

(i) *Step one: Determine the debt instrument's yield to maturity.* The yield to maturity or yield of a debt instrument is the discount rate that, when used in computing the present value of all principal and interest payments to be made under the debt instrument, produces an amount equal to the issue price of the debt instrument. The yield must be constant over the term of the debt instrument and, when expressed as a percentage, must be calculated to at least two decimal places. See paragraph (c) of this section for rules relating to the yield of certain debt instruments subject to contingencies.

(ii) *Step two: Determine the accrual periods.* An accrual period is an interval of time over which the accrual of OID is measured. Accrual periods may be of any length and may vary in length over the term of the debt instrument, provided that each accrual period is no longer than 1 year and each scheduled payment of principal or interest occurs either on the final day of an accrual period or on the first day of an accrual period. In general, the computation of OID is simplest if accrual periods correspond to the intervals between payment dates provided by the terms of the debt instrument. In computing the length of accrual periods, any reasonable counting convention may be used (e.g., 30 days per month/360 days per year).

(iii) *Step three: Determine the OID allocable to each accrual period.* Except as provided in paragraph (b)(4) of this section, the OID allocable to an accrual period equals the product of the adjusted issue price of the debt instrument (as defined in § 1.1275–1(b)) at the beginning of the accrual period and the yield of the debt instrument, less the amount of any qualified stated interest allocable to the accrual period. In performing this calculation, the yield must be stated appropriately taking into account the length of the particular accrual period. *Example 1* in paragraph (j) of this section provides a formula for converting a yield based upon an accrual period of one length to an equivalent yield based upon an accrual period of a different length.

(iv) *Step four: Determine the daily portions of OID.* The daily portions of OID are determined by allocating to each day in an accrual period the ratable portion of the OID allocable to the accrual period. The holder of the debt instrument includes in income the daily portions of OID for each day during the taxable year on which the holder held the debt instrument.

(2) *Exceptions.* Paragraph (b)(1) of this section does not apply to—

(i) A debt instrument to which section 1272(a)(6) applies (certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration);

(ii) A debt instrument that provides for contingent payments, other than a debt instrument described in paragraph (c) or (d) of this section or except as provided in § 1.1275–4; or

(iii) A variable rate debt instrument to which § 1.1275–5 applies, except as provided in § 1.1275–5.

(3) *Modifications.* The amount of OID includible in income by a holder under paragraph (b)(1) of this section is adjusted if—

(i) The holder purchased the debt instrument at a premium or an acquisition premium (within the meaning of § 1.1272–2); or

(ii) The holder made an election for the debt instrument under § 1.1272–3 to treat all interest as OID.

(4) *Special rules for determining the OID allocable to an accrual period.* The following rules apply to determine the OID allocable to an accrual period under paragraph (b)(1)(iii) of this section.

(i) *Unpaid qualified stated interest allocable to an accrual period.* In determining the OID allocable to an accrual period, if an interval between payments of qualified stated interest contains more than 1 accrual period—

(A) The amount of qualified stated interest payable at the end of the interval (including any qualified stated interest that is payable on the first day of the accrual period immediately following the interval) is allocated on a pro rata basis to each accrual period in the interval; and

(B) The adjusted issue price at the beginning of each accrual period in the interval must be increased by the amount of any qualified stated interest that has accrued prior to the first day of the accrual period but that is not payable until the end of the interval. See *Example 2* of paragraph (j) of this section for an example illustrating the rules in this paragraph (b)(4)(i).

(ii) *Final accrual period.* The OID allocable to the final accrual period is the difference between the amount payable at maturity (other than a payment of qualified stated interest) and the adjusted issue price at the beginning of the final accrual period.

(iii) *Initial short accrual period.* If all accrual periods are of equal length, except for either an initial shorter accrual period or an initial and a final shorter accrual period, the amount of OID allocable to the initial accrual period may be computed using any reasonable method. See *Example 3* in paragraph (j) of this section.

(iv) *Payment on first day of an accrual period.* The adjusted issue price at the beginning of an accrual period is reduced by the amount of any payment (other than a payment of qualified stated interest) that is made on the first day of the accrual period.

(c) *Yield and maturity of certain debt instruments subject to contingencies*—(1) *Applicability.* This paragraph (c) provides rules to determine the yield and maturity of certain debt instruments that provide for an alternative payment schedule (or schedules) applicable upon the occurrence of a contingency (or contingencies). This paragraph (c) applies, however, only if the timing and amounts of the payments that comprise each payment schedule are known as of the issue date and the debt instrument is subject to paragraph (c)(2), (3), or (5) of this section. A debt instrument does not provide for an alternative payment schedule merely because there is a possibility of impairment of a payment (or payments) by insolvency, default, or similar circumstances. See §1.1275–4 for the treatment of a debt instrument that provides for a contingency that is not described in this paragraph (c). See §1.1273–1(c) to determine whether stated interest on a debt instrument subject to this paragraph (c) is qualified stated interest.

(2) *Payment schedule that is significantly more likely than not to occur.* If, based on all the facts and circumstances as of the issue date, a single payment schedule for a debt instrument, including the stated payment schedule, is significantly more likely than not to occur, the yield and maturity of the debt instrument are computed based on this payment schedule.

(3) *Mandatory sinking fund provision.* Notwithstanding paragraph (c)(2) of this section, if a debt instrument is subject to a mandatory sinking fund provision, the provision is ignored for purposes of computing the yield and maturity of the debt instrument if the use and terms of the provision meet reasonable commercial standards. For purposes of the preceding sentence, a mandatory sinking fund provision is a provision that meets the following requirements:

(i) The provision requires the issuer to redeem a certain amount of debt instruments in an issue prior to maturity.

(ii) The debt instruments actually redeemed are chosen by lot or purchased by the issuer either in the open market or pursuant to an offer made to all holders (with any proration determined by lot).

(iii) On the issue date, the specific debt instruments that will be redeemed on any date prior to maturity cannot be identified.

(4) *Consistency rule.* [Reserved]

(5) *Treatment of certain options.* Notwithstanding paragraphs (c) (2) and (3) of this section, the rules of this paragraph (c)(5) determine the yield and maturity of a debt instrument that provides the holder or issuer with an unconditional option or options, exercisable on one or more dates during the term of the debt instrument, that, if exercised, require payments to be made on the debt instrument under an alternative payment schedule or schedules (e.g., an option to extend or an option to call a debt instrument at a fixed premium). Under this paragraph (c)(5), an issuer is deemed to exercise or not exercise an option or combination of options in a manner that minimizes the yield on the debt instrument, and a

holder is deemed to exercise or not exercise an option or combination of options in a manner that maximizes the yield on the debt instrument. If both the issuer and the holder have options, the rules of this paragraph (c)(5) are applied to the options in the order that they may be exercised. See paragraph (j) *Example 5* through *Example 8* of this section.

(6) *Subsequent adjustments.* If a contingency described in this paragraph (c) (including the exercise of an option described in paragraph (c)(5) of this section) actually occurs or does not occur, contrary to the assumption made pursuant to this paragraph (c) (a change in circumstances), then, solely for purposes of sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the change in circumstances for an amount equal to its adjusted issue price on that date. See paragraph (j) *Example 5* and *Example 7* of this section. If, however, the change in circumstances results in a substantially contemporaneous pro-rata prepayment as defined in § 1.1275–2(f)(2), the pro-rata prepayment is treated as a payment in retirement of a portion of the debt instrument, which may result in gain or loss to the holder. See paragraph (j) *Example 6* and *Example 8* of this section.

(7) *Effective date.* This paragraph (c) applies to debt instruments issued on or after August 13, 1996.

(d) *Certain debt instruments that provide for a fixed yield.* If a debt instrument provides for one or more contingent payments but all possible payment schedules under the terms of the instrument result in the same fixed yield, the yield of the debt instrument is the fixed yield. For example, the yield of a debt instrument with principal payments that are fixed in total amount but that are uncertain as to time (such as a demand loan) is the stated interest rate if the issue price of the instrument is equal to the stated principal amount and interest is paid or compounded at a fixed rate over the entire term of the instrument. This paragraph (d) applies to debt instruments issued on or after August 13, 1996.

(e) *Convertible debt instruments.* For purposes of section 1272, an option is ignored if it is an option to convert a debt instrument into the stock of the issuer, into the stock or debt of a related party (within the meaning of section 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of such stock or debt.

(f) *Special rules to determine whether a debt instrument is a short-term obligation*—(1) *Counting of either the issue date or maturity date.* For purposes of determining whether a debt instrument is a short-term obligation (i.e., a debt instrument with a fixed maturity date that is not more than 1 year from the date of issue), the term of the debt instrument includes either the issue date or the maturity date, but not both dates.

(2) *Coordination with paragraph (c) of this section for certain sections of the Internal Revenue Code.* Notwithstanding paragraph (c) of this section, solely for purposes of determining whether a debt instrument is a short-term obligation under sections 871(g)(1)(B)(i), 881, 1271(a)(3), 1271(a)(4), 1272(a)(2)(C), and 1283(a)(1), the maturity date of a debt instrument is the last possible date that the instrument could be outstanding under the terms of the instrument. For purposes of the preceding sentence, the last possible date that the debt instrument could be outstanding is determined without regard to § 1.1275–2(h) (relating to payments subject to remote or incidental contingencies).

(g) *Basis adjustment.* The basis of a debt instrument in the hands of the holder is increased by the amount of OID included in the holder's gross income and decreased by the amount of any payment from the issuer to the holder under the debt instrument other than a payment of qualified stated interest. See, however, § 1.1275–2(f) for rules regarding basis adjustments on a pro rata prepayment.

(h) *Debt instruments denominated in a currency other than the U.S. dollar.* Section 1272 and this section apply to a debt instrument that provides for all payments denominated in, or determined by reference to, the functional currency of the taxpayer or qualified business unit of the taxpayer (even if that currency is other than the U.S.

dollar). See §1.988–2(b) to determine interest income or expense for debt instruments that provide for payments denominated in, or determined by reference to, a nonfunctional currency.

(i) [Reserved]

(j) *Examples.* The following examples illustrate the rules of this section. Each example assumes that all taxpayers use the calendar year as the taxable year. In addition, each example assumes a 30-day month, 360-day year, and that the initial accrual period begins on the issue date and the final accrual period ends on the day before the stated maturity date. Although, for purposes of simplicity, the yield as stated is rounded to two decimal places, the computations do not reflect any such rounding convention.

Example 1. Accrual of OID on zero coupon debt instrument; choice of accrual periods—(i) *Facts.* On July 1, 1994, A purchases at original issue, for $675,564.17, a debt instrument that matures on July 1, 1999, and provides for a single payment of $1,000,000 at maturity.

(ii) *Determination of yield.* Under paragraph (b)(1)(i) of this section, the yield of the debt instrument is 8 percent, compounded semiannually.

(iii) *Determination of accrual period.* Under paragraph (b)(1)(ii) of this section, accrual periods may be of any length, provided that each accrual period is no longer than 1 year and each scheduled payment of principal or interest occurs either on the first or final day of an accrual period. The yield to maturity to be used in computing OID accruals in any accrual period, however, must reflect the length of the accrual period chosen. A yield based on compounding b times per year is equivalent to a yield based on compounding c times per year as indicated by the following formula:

$$r = c\{(1 + i / b)^{b/c} - 1\}$$

In which:

i = The yield based on compounding b times per year expressed as a decimal
r = The equivalent yield based on compounding c times per year expressed as a decimal
b = The number of compounding periods in a year on which i is based (for example, 12, if i is based on monthly compounding)
c = The number of compounding periods in a year on which r is based

(iv) *Determination of OID allocable to each accrual period.* Assume that A decides to compute OID on the debt instrument using semiannual accrual periods. Under paragraph (b)(1)(iii) of this section, the OID allocable to the first semiannual accrual period is $27,022.56: the product of the issue price ($675,564.17) and the yield properly adjusted for the length of the accrual period (8 percent/2), less qualified stated interest allocable to the accrual period ($0). The daily portion of OID for the first semiannual accrual period is $150.13 ($27,022.56/180).

(v) *Determination of OID if monthly accrual periods are used.* Alternatively, assume that A decides to compute OID on the debt instrument using monthly accrual periods. Using the above formula, the yield on the debt instrument reflecting monthly compounding is 7.87 percent, compounded monthly ($12\{(1 + .08 / 2)^{2/12} - 1\}$). Under paragraph (b)(1)(iii) of this section, the OID allocable to the first monthly accrual period is $4,430.48: the product of the issue price ($675,564.17) and the yield properly adjusted for the length of the accrual period (7.87 percent/12), less qualified stated interest allocable to the accrual period ($0). The daily portion of OID for the first monthly accrual period is $147.68 ($4,430.48/30).

Example 2. Accrual of OID on debt instrument with qualified stated interest—(i) *Facts.* On September 1, 1994, A purchases at original issue, for $90,000, B corporation's debt instrument that matures on September 1, 2004, and has a stated principal amount of $100,000, payable on that date. The debt instrument provides for semiannual payments of interest of $3,000, payable on September 1 and March 1 of each year, beginning on March 1, 1995.

(ii) *Determination of yield.* The debt instrument is a 10-year debt instrument with an issue price of $90,000 and a stated redemption price at maturity of $100,000. The semiannual payments of $3,000 are qualified stated interest payments. Under paragraph (b)(1)(i) of this section, the yield is 7.44 percent, compounded semiannually.

(iii) *Accrual of OID if semiannual accrual periods are used.* Assume that A decides to compute OID on the debt instrument using semiannual accrual periods. Under paragraph (b)(1)(iii) of this section, the OID allocable to the first semiannual accrual period equals the product of the issue price ($90,000) and the yield properly adjusted for the length of the accrual period (7.44 percent/2), less qualified stated interest allocable to the accrual period ($3,000). Therefore, the amount of OID for the first semiannual accrual period is $345.78 ($3,345.78–$3,000).

(iv) *Adjustment for accrued but unpaid qualified stated interest if monthly accrual periods are used.* Assume, alternatively, that A decides to compute OID on the debt instrument using monthly accrual periods. The yield, compounded monthly, is 7.32 percent. Under paragraph (b)(1)(iii) of this section, the OID allocable to the first monthly accrual period is the product of the issue price ($90,000) and the yield properly adjusted for the length of the accrual period (7.32 percent/12), less qualified stated interest allocable to the accrual period. Under paragraph (b)(4)(i)(A) of this section, the qualified stated interest allocable to the first monthly accrual period is the pro rata amount of qualified stated interest allocable to the interval between payment dates ($3,000×⅙, or $500). Therefore, the amount of OID for the first monthly accrual period is $49.18 ($549.18–$500). Under paragraph (b)(4)(i)(B) of this section, the adjusted issue price of the debt instrument for purposes of determining the amount of OID for the second monthly accrual period is $90,549.18 ($90,000 + $49.18 + $500). Although the adjusted issue price of the debt instrument for this purpose includes the amount of qualified stated interest allocable to the first monthly accrual period, A includes the qualified stated interest in income based on A's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method).

Example 3. Accrual of OID for debt instrument with initial short accrual period—(i) *Facts.* On May 1, 1994, G purchases at original issue, for $80,000, H corporation's debt instrument maturing on July 1, 2004. The debt instrument provides for a single payment at maturity of $250,000. G computes its OID using 6-month accrual periods ending on January 1 and July 1 of each year and an initial short 2-month accrual period from May 1, 1994, through June 30, 1994.

(ii) *Determination of yield.* The yield on the debt instrument is 11.53 percent, compounded semiannually.

(iii) *Determination of OID allocable to initial short accrual period.* Under paragraph (b)(4)(iii) of this section, G may use any reasonable method to compute OID for the initial short accrual period. One reasonable method is to calculate the amount of OID pursuant to the following formula:

$$OID_{short}=IP\times(i/k)\times f$$

In which:

OID_{short}=The amount of OID allocable to the initial short accrual period
IP=The issue price of the debt instrument
i=The yield to maturity expressed as a decimal
k=The number of accrual periods in a year
f=A fraction whose numerator is the number of days in the initial short accrual period, and whose denominator is the number of days in a full accrual period

(iv) *Amount of OID for the initial short accrual period.* Under this method, the amount of OID for the initial short accrual period is $1,537 ($80,000×(11.53 percent/2) × (60/180)).

(v) *Alternative method.* Another reasonable method is to calculate the amount of OID for the initial short accrual period using the yield based on bi-monthly compounding, computed pursuant to the formula set forth in *Example 1* of paragraph (j) of this section. Under this method, the amount of OID for the initial short accrual period is $1,508.38 ($80,000×(11.31 percent/6)).

Example 4. Impermissible accrual of OID using a method other than constant yield method—(i) *Facts.* On July 1, 1994, B purchases at original issue, for $100,000, C corporation's debt instrument that matures on July 1, 1999, and has a stated principal amount of $100,000. The debt instrument provides for a single payment at maturity of $148,024.43. The yield of the debt instrument is 8 percent, compounded semiannually.

(ii) *Determination of yield.* Assume that C uses 6 monthly accrual periods to compute its OID for 1994. The yield must reflect monthly compounding (as determined using the formula described in *Example 1* of paragraph (j) of this section). As a result, the monthly yield of the debt instrument is 7.87 percent, divided by 12. C may not compute its monthly yield for the last 6 months in 1994 by dividing 8 percent by 12.

Example 5. Debt instrument subject to put option—(i) *Facts.* On January 1, 1995, G purchases at original issue, for $70,000, H corporation's debt instrument maturing on January 1, 2010, with a stated principal amount of $100,000, payable at maturity. The debt instrument provides for semiannual payments of interest of $4,000, payable on January 1 and July 1 of each year, beginning on July 1, 1995. The debt instrument gives G an unconditional right to put the bond back to H, exercisable on January 1, 2005, in return for $85,000 (exclusive of the $4,000 of stated interest payable on that date).

(ii) *Determination of yield and maturity.* Yield determined without regard to the put option is 12.47 percent, compounded semiannually. Yield determined by assuming that the put option is exercised (i.e., by using January 1, 2005, as the maturity date and $85,000 as the stated principal amount payable on that date) is 12.56 percent, compounded semiannually. Thus, under paragraph (c)(5) of this section, it is assumed that G will exercise the put option, because exercise of the option would increase the yield of the debt instrument. Thus, for purposes of calculating OID, the debt instrument is assumed to be a 10-year debt instrument with an issue price of $70,000, a stated redemption price at maturity of $85,000, and a yield of 12.56 percent, compounded semiannually.

(iii) *Consequences if put option is, in fact, not exercised.* If the put option is, in fact, not exercised, then, under paragraph (c)(6) of this section, the debt instrument is treated, solely for purposes of sections 1272 and 1273, as if it were reissued on January 1, 2005, for an amount equal to its adjusted issue price on that date, $85,000. The new debt instrument matures on January 1, 2010, with a stated principal amount of $100,000 payable on that date and provides for semiannual payments of interest of $4,000. The yield of the new debt instrument is 12.08 percent, compounded semiannually.

Example 6. Debt instrument subject to partial call option—(i) *Facts.* On January 1, 1995, H purchases at original issue, for $95,000, J corporation's debt instrument that matures on January 1, 2000, and has a stated principal amount of $100,000, payable on that date. The debt instrument provides for semiannual payments of interest of $4,000, payable on January 1 and July 1 of each year, beginning on July 1, 1995. On January 1, 1998, J has an unconditional right to call 50 percent of the principal amount of the debt instrument for $55,000 (exclusive of the $4,000 of stated interest payable on that date). If the call is exercised, the semiannual payments of interest made after the call date will be reduced to $2,000.

(ii) *Determination of yield and maturity.* Yield determined without regard to the call option is 9.27 percent, compounded semiannually. Yield determined by assuming J exercises its call option is 10.75 percent, compounded semiannually. Thus, under paragraph (c)(5) of this section, it is assumed that J will not exercise the call option because exercise of the option would increase the yield of the debt instrument. Thus, for purposes of calculating OID, the debt instrument is assumed to be a 5-year debt instrument with a single principal payment at maturity of $100,000, and a yield of 9.27 percent, compounded semiannually.

(iii) *Consequences if the call option is, in fact, exercised.* If the call option is, in fact, exercised, then under paragraph (c)(6) of this section, the debt instrument is treated as if the issuer made a pro rata prepayment of $55,000 that is subject to §1.1275–2(f). Consequently, under §1.1275–2(f)(1), the instrument is treated as consisting of two debt instruments, one that is retired on the call date and one that remains outstanding after the call date. The adjusted issue price, adjusted basis in the hands of the holder, and accrued OID of the original debt instrument is allocated between the two instruments based on the portion of the original instrument treated as retired. Since each payment remaining to be made after the call date is reduced by one-half, one-half of the adjusted issue price, adjusted basis, and accrued OID is allocated to the debt instrument that is treated as retired. The adjusted issue price of the original debt instrument immediately prior to the call date is $97,725.12, which equals the issue price of the original debt instrument ($95,000) increased by the OID previously includible in gross income ($2,725.12). One-half of this adjusted issue price is allocated to the debt instrument treated as retired, and the other half is allocated to the debt instrument that is treated as remaining outstanding. Thus, the debt instrument treated as remaining outstanding has an adjusted issue price immediately after the call date of $97,725.12/2, or $48,862.56. The yield of this debt instrument continues to be 9.27 percent, compounded semiannually. In addition, the portion of H's adjusted basis allocated to the debt instrument treated as retired is $97,725.12/2 or $48,862.56. Accordingly, under section 1271, H realizes a gain on the deemed retirement equal to $6,137.44 ($55,000 − $48,862.56).

Example 7. Debt instrument issued at par that provides for payment of interest in kind—(i) *Facts.* On January 1, 1995, A purchases at original issue, for $100,000, X corporation's debt instrument maturing on January 1, 2000, at a stated principal amount of $100,000, payable on that date. The debt instrument provides for annual payments of interest of $6,000 on January 1 of each year, beginning on January 1, 1996. The debt instrument gives X the unconditional right to issue, in lieu of the first interest payment, a second debt instrument (PIK instrument) maturing on January 1, 2000, with a stated principal amount of $6,000. The PIK instrument, if issued, would provide for annual payments of interest of $360 on January 1 of each year, beginning on January 1, 1997.

(ii) *Aggregation of PIK instrument with original debt instrument.* Under §1.1275–2(c)(3), the issuance of the PIK instrument is not considered a payment made on the original debt instrument, and the PIK instrument is aggregated with the original debt instrument. The issue date of the PIK instrument is the same as the original debt instrument.

(iii) *Determination of yield and maturity.* The right to issue the PIK instrument is treated as an option to defer the initial interest payment until maturity. Yield determined without regard to the option is 6 percent, compounded annually, Yield determined by assuming X exercises the option is 6 percent, compounded annually. Thus, under paragraph (c)(5) of this section, it is assumed that X will not exercise the option by issuing the PIK instrument because exercise of the option would not decrease the yield of the debt instrument. For purposes of calculating OID, the debt instrument is assumed to be a 5-year debt instrument with a single principal payment at maturity of $100,000 and ten semiannual interest payments of $6,000, beginning on January 1, 1996. As a result, the debt instrument's yield is 6 percent, compounded annually.

(iv) *Determination of OID.* Under the payment schedule that would result if the option was exercised, none of the interest on the debt instrument would be qualified stated interest. Accordingly, under §1.1273–1(c)(2), no payments on the debt instrument are qualified stated interest payments. Thus, $6,000 of OID accrues during the first annual accrual period. If the PIK instrument is not issued, $6,000 of OID accrues during each annual accrual period.

(v) *Consequences if the PIK instrument is issued.* Under paragraph (c)(6) of this section, if X issues the PIK instrument on January 1, 1996, the issuance of the PIK instrument is not a payment on the debt instrument. Solely for purposes of sections 1272 and 1273, the debt instrument is deemed reissued on January 1, 1996, for an issue price of $106,000. The recomputed yield is 6 percent, compounded annually. The OID for the first annual accrual period after the deemed reissuance is $6,360. The adjusted issue price of the debt instrument at the beginning of the next annual accrual period is $106,000 ($106,000 + $6,360 − $6,360). The OID for each of the four remaining annual accrual periods is $6,360.

Example 8. Debt instrument issued at a discount that provides for payment of interest in kind—(i) *Facts.* On January 1, 1995, T purchases at original issue, for $75,500, U corporation's debt instrument maturing on January 1, 2000, at a stated principal amount of $100,000, payable on that date. The debt instrument provides for annual payments of interest of $4,000 on January 1 of each year, beginning on January 1, 1996. The debt instrument gives U the unconditional right to issue, in lieu of the first interest payment, a second debt instrument (PIK instrument) maturing on January 1, 2000, with a stated principal amount of $4,000. The PIK instrument, if issued, would provide for annual payments of interest of $160 on January 1 of each year, beginning on January 1, 1997.

(ii) *Aggregation of PIK instrument with original debt instrument.* Under § 1.1275–2(c)(3), the issuance of the PIK instrument is not considered a payment made on the original debt instrument, and the PIK instrument is aggregated with the original debt instrument. The issue date of the PIK instrument is the same as the original debt instrument.

(iii) *Determination of yield and maturity.* The right to issue the PIK instrument is treated as an option to defer the initial interest payment until maturity. Yield determined without regard to the option is 10.55 percent, compounded annually. Yield determined by assuming U exercises the option is 10.32 percent, compounded annually. Thus, under paragraph (c)(5) of this section, it is assumed that U will exercise the option by issuing the PIK instrument because exercise of the option would decrease the yield of the debt instrument. For purposes of calculating OID, the debt instrument is assumed to be a 5-year debt instrument with a single principal payment at maturity of $104,000 and four annual interest payments of $4,160, beginning on January 1, 1997. As a result, the yield is 10.32 percent, compounded annually.

(iv) *Consequences if the PIK instrument is not issued.* Assume that T chooses to compute OID accruals on the basis of an annual accrual period. On January 1, 1996, the adjusted issue price of the debt instrument, and T's adjusted basis in the instrument, is $83,295.15. Under paragraph (c)(6) of this section, if U actually makes the $4,000 interest payment on January 1, 1996, the debt instrument is treated as if U made a pro rata prepayment (within the meaning of § 1.1275–2(f)(2)) of $4,000, which reduces the amount of each payment remaining on the instrument by a factor of 4/104, or 1/26. Thus, under § 1.1275–2(f)(1) and section 1271, T realizes a gain of $796.34 ($4,000 − ($83,295.15/26)). The adjusted issue price of the debt instrument and T's adjusted basis immediately after the payment is $80,091.49 ($83,295.15 × 25/26) and the yield continues to be 10.32 percent, compounded annually.

Example 9. Debt instrument with stepped interest rate—(i) *Facts.* On July 1, 1994, G purchases at original issue, for $85,000, H corporation's debt instrument maturing on July 1, 2004. The debt instrument has a stated principal amount of $100,000, payable on the maturity date and provides for semiannual interest payments on January 1 and July 1 of each year, beginning on January 1, 1995. The amount of each payment is $2,000 for the first 5 years and $5,000 for the final 5 years.

(ii) *Determination of OID.* Assume that G computes its OID using 6-month accrual periods ending on January 1 and July 1 of each year. The yield of the debt instrument, determined under paragraph (b)(1)(i) of this section, is 8.65 percent, compounded semiannually. Interest is unconditionally payable at a fixed rate of at least 4 percent, compounded semiannually, for the entire term of the debt instrument. Consequently, under § 1.1273–1(c)(1), the semiannual payments are qualified stated interest payments to the extent of $2,000. The amount of OID for the first 6-month accrual period is $1,674.34 (the issue price of the debt instrument ($85,000) times the yield of the debt instrument for that accrual period (.0865/2) less the amount of any qualified stated interest allocable to that accrual period ($2,000)).

Example 10. Debt instrument payable on demand that provides for interest at a constant rate—(i) *Facts.* On January 1, 1995, V purchases at original issue, for $100,000, W corporation's debt instrument. The debt instrument calls for interest to accrue at a rate of 9 percent, compounded annually. The debt instrument is redeemable at any time at the option of V for an amount equal to $100,000, plus accrued interest. V uses annual accrual periods to accrue OID on the debt instrument.

(ii) *Amount of OID.* Pursuant to paragraph (d) of this section, the yield of the debt instrument is 9 percent, compounded annually. If the debt instrument is not redeemed during 1995, the amount of OID allocable to the year is $9,000.

[T.D. 8517, 59 FR 4810, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30140, June 14, 1996]

§1.1272–2 Treatment of debt instruments purchased at a premium.

(a) *In general.* Under section 1272(c)(1), if a holder purchases a debt instrument at a premium, the holder does not include any OID in gross income. Under section 1272(a)(7), if a holder purchases a debt instrument at an acquisition premium, the holder reduces the amount of OID includible in gross income by the fraction determined under paragraph (b)(4) of this section.

(b) *Definitions and special rules*—(1) *Purchase.* For purposes of section 1272 and this section, purchase means any acquisition of a debt instrument, including the acquisition of a newly issued debt instrument in a debt-for-debt exchange or the acquisition of a debt instrument from a donor.

(2) *Premium.* A debt instrument is purchased at a premium if its adjusted basis, immediately after its purchase by the holder (including a purchase at original issue), exceeds the sum of all amounts payable on the instrument after the purchase date other than payments of qualified stated interest (as defined in §1.1273–1(c)).

(3) *Acquisition premium.* A debt instrument is purchased at an acquisition premium if its adjusted basis, immediately after its purchase (including a purchase at original issue), is—

(i) Less than or equal to the sum of all amounts payable on the instrument after the purchase date other than payments of qualified stated interest (as defined in §1.1273–1(c)); and

(ii) Greater than the instrument's adjusted issue price (as defined in §1.1275–1(b)).

(4) *Acquisition premium fraction.* In applying section 1272(a)(7), the cost of a debt instrument is its adjusted basis immediately after its acquisition by the purchaser. Thus, the numerator of the fraction determined under section 1272(a)(7)(B) is the excess of the adjusted basis of the debt instrument immediately after its acquisition by the purchaser over the adjusted issue price of the debt instrument. The denominator of the fraction determined under section 1272(a)(7)(B) is the excess of the sum of all amounts payable on the debt instrument after the purchase date, other than payments of qualified stated interest, over the instrument's adjusted issue price.

(5) *Election to accrue discount on a constant yield basis.* Rather than applying the acquisition premium fraction, a holder of a debt instrument purchased at an acquisition premium may elect under §1.1272–3 to compute OID accruals by treating the purchase as a purchase at original issuance and applying the mechanics of the constant yield method.

(6) *Special rules for determining basis*—(i) *Debt instruments acquired in exchange for other property.* For purposes of section 1272(a)(7), section 1272(c)(1), and this section, if a debt instrument is acquired in an exchange for other property (other than in a reorganization defined in section 368) and the basis of the debt instrument is determined, in whole or in part, by reference to the basis of the other property, the basis of the debt instrument may not exceed its fair market value immediately after the exchange. For example, if a debt instrument is distributed by a partnership to a partner in a liquidating distribution and the partner's basis in the debt instrument would otherwise be determined under section 732, the partner's basis in the debt instrument may not exceed its fair market value for purposes of this section.

(ii) *Acquisition by gift.* For purposes of this section, a donee's adjusted basis in a debt instrument is the donee's basis for determining gain under section 1015(a).

(c) *Examples.* The following examples illustrate the rules of this section.

Example 1. Debt instrument purchased at an acquisition premium—(i) *Facts.* On July 1, 1994, A purchased at original issue, for $500, a debt instrument issued by Corporation X. The debt instrument matures on July 1, 1999, and calls for a single payment at maturity of $1,000. Under section 1273(a), the debt instrument has a stated redemption price at maturity of $1,000 and, thus, OID of $500. On July 1, 1996, when the debt instrument's adjusted issue price is $659.75, A sells the debt instrument to B for $750 in cash.

(ii) *Acquisition premium fraction.* Because the cost to B of the debt instrument is less than the amount payable on the debt instrument after the purchase date, but is greater than the debt instrument's adjusted issue price, B has paid an acquisition premium for the debt instrument. Accordingly, the daily portion of OID for any day that B holds the debt instrument is reduced by a fraction, the numerator of which is $90.25 (the excess of the cost of the debt instrument over its adjusted issue price) and the denominator of which is $340.25 (the excess of the sum of all payments after the purchase date over its adjusted issue price).

Example 2. Debt-for-debt exchange where holder is considered to purchase new debt instrument at a premium—(i) *Facts.* On January 1, 1995, H purchases at original issue, for $1,000, a debt instrument issued by Corporation X. On July 1, 1997, when H's adjusted basis in the debt instrument is $1,000, Corporation X issues a new debt instrument with a stated redemption price at maturity of $750 to H in exchange for the old debt instrument. Assume that the issue price of the new debt instrument is $600. Thus, under section 1273(a), the debt instrument has OID of $150. The exchange qualifies as a recapitalization under section 368(a)(1)(E), with the consequence that, under sections 354 and 358, H recognizes no loss on the exchange and has an adjusted basis in the new debt instrument of $1,000.

(ii) *Application of section 1272(c)(1).* Under paragraphs (b)(1) and (b)(2) of this section, H purchases the new debt instrument at a premium of $250. Accordingly, under section 1272(c)(1), H is not required to include OID in income with respect to the new debt instrument.

Example 3. Debt-for-debt exchange where holder is considered to purchase new debt instrument at an acquisition premium—(i) *Facts.* The facts are the same as in *Example 2* of paragraph (c) of this section, except that H purchases the old debt instrument from another holder on July 1, 1995, and on July 1, 1997, H's adjusted basis in the old debt instrument is $700. Under section 1273(a), the new debt instrument is issued with OID of $150.

(ii) *Application of section 1272(a)(7).* Under paragraphs (b)(1) and (b)(3) of this section, H purchases the new debt instrument at an acquisition premium of $100. Accordingly, the daily portion of OID that is includible in H's income is reduced by the fraction determined under section 1272(a)(7).

Example 4. Treatment of acquisition premium for debt instrument acquired by gift—(i) *Facts.* On July 1, 1994, D receives as a gift a debt instrument with a stated redemption price at maturity of $1,000 and an adjusted issue price of $800. On that date, the fair market value of the debt instrument is $900 and the donor's adjusted basis in the debt instrument is $950.

(ii) *Application of section 1272(a)(7).* Under paragraphs (b)(1), (b)(3), and (b)(6)(ii) of this section, D is considered to have purchased the debt instrument at an acquisition premium of $150. Accordingly, the daily portion of OID that is includible in D's income is reduced by the fraction determined under section 1272(a)(7).

[T.D. 8517, 59 FR 4814, Feb. 2, 1994]

§ 1.1272–3 Election by a holder to treat all interest on a debt instrument as OID.

(a) *Election.* A holder of a debt instrument may elect to include in gross income all interest that accrues on the instrument by using the constant yield method described in paragraph (c) of this section. For purposes of this election, interest includes stated interest, acquisition discount, OID, de minimis OID, market discount, de minimis market discount, and unstated interest, as adjusted by any amortizable bond premium or acquisition premium.

(b) *Scope of election*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, a holder may make the election for any debt instrument.

(2) *Exceptions, limitations, and special rules*—(i) *Debt instrument with amortizable bond premium (as determined under section 171).* (A) A holder may make the election for a debt instrument with amortizable bond premium only if the instrument qualifies as a bond under section 171(d).

(B) If a holder makes the election under this section for a debt instrument with amortizable bond premium, the holder is deemed to have made the election under section 171(c)(2) for the taxable year in which the instrument was acquired. If the holder has previously made the election under section 171(c)(2), the requirements of that election with respect to any debt instrument are satisfied by electing to amortize the bond premium under the rules provided by this section.

(ii) *Debt instrument with market discount.* (A) A holder may make the election under this section for a debt instrument with market discount only if the holder is eligible to make an election under section 1278(b).

(B) If a holder makes the election under this section for a debt instrument with market discount, the holder is deemed to have made both the election under section 1276(b)(2) for that instrument and the election under section 1278(b) for the taxable year in which the instrument was acquired. If the holder has previously made the election under section 1278(b), the requirements of that election with respect to any debt instrument are satisfied by electing to include the market discount in income in accordance with the rules provided by this section.

(iii) *Tax-exempt debt instrument.* A holder may not make the election for a tax-exempt obligation as defined in section 1275(a)(3).

(c) *Mechanics of the constant yield method*—(1) *In general.* For purposes of this section, the amount of interest that accrues during an accrual period is determined under rules similar to those under section 1272 (the constant yield method). In applying the constant yield method, however, a debt instrument subject to the election is treated as if—

(i) The instrument is issued for the holder's adjusted basis immediately after its acquisition by the holder;

(ii) The instrument is issued on the holder's acquisition date; and

(iii) None of the interest payments provided for in the instrument are qualified stated interest payments.

(2) *Special rules to determine adjusted basis.* For purposes of paragraph (c)(1)(i) of this section—

(i) If the debt instrument is acquired in an exchange for other property (other than in a reorganization defined in section 368) and the basis of the debt instrument is determined, in whole or in part, by reference to the basis of the other property, the adjusted basis of the debt instrument may not exceed its fair market value immediately after the exchange; and

(ii) If the debt instrument was acquired with amortizable bond premium (as determined under section 171), the adjusted basis of the debt instrument is reduced by an amount equal to the value attributable to any conversion feature.

(d) *Time and manner of making the election.* The election must be made for the taxable year in which the holder acquires the debt instrument. A holder makes the election by attaching to the holder's timely filed Federal income tax return a statement that the holder is making an election under this section and that identifies the debt instruments subject to the election. A holder may make the election for a class or group of debt instruments by attaching a statement describing the type or types of debt instruments being designated for the election.

(e) *Revocation of election.* The election may not be revoked unless approved by the Commissioner.

(f) *Effective date.* This section applies to debt instruments acquired on or after April 4, 1994.

[T.D. 8517, 59 FR 4815, Feb. 2, 1994]

§ 1.1273–1 Definition of OID.

(a) *In general.* Section 1273(a)(1) defines OID as the excess of a debt instrument's stated redemption price at maturity over its issue price. Section 1.1273–2 defines issue price, and paragraph (b) of this section defines stated redemption price at maturity. Paragraph (d) of this section provides rules for de minimis amounts of OID. Although the total amount of OID for a debt instrument may be indeterminate, § 1.1272–1(d) provides a rule to determine OID accruals on certain debt instruments that provide for a fixed yield. See *Example 10* in § 1.1272–1(j).

(b) *Stated redemption price at maturity.* A debt instrument's stated redemption price at maturity is the sum of all payments provided by the debt instrument other than qualified stated interest payments. If the payment schedule of a debt instrument is determined under § 1.1272–1(c) (relating to certain debt instruments subject to contingencies), that payment schedule is used to determine the instrument's stated redemption price at maturity.

(c) *Qualified stated interest*—(1) *Definition*—(i) *In general.* Qualified stated interest is stated interest that is unconditionally payable in cash or in property (other than debt instruments of the issuer), or that will be constructively received under section 451, at least annually at a single fixed rate (within the meaning of paragraph (c)(1)(iii) of this section).

(ii) *Unconditionally payable.* Interest is unconditionally payable only if reasonable legal remedies exist to compel timely payment or the debt instrument otherwise provides terms and conditions that make the likelihood of late payment (other than a late payment that occurs within a reasonable grace period) or nonpayment a remote contingency (within the meaning of § 1.1275–2(h)). For purposes of the preceding sentence, remedies or other terms and conditions are not taken into account if the lending transaction does not reflect arm's length dealing and the holder does not intend to enforce the remedies or other terms and conditions. For purposes of determining whether interest is unconditionally payable, the possibility of nonpayment due to default, insolvency, or similar circumstances, or due to the exercise of a conversion option described in § 1.1272–1(e) is ignored. This paragraph (c)(1)(ii) applies to debt instruments issued on or after August 13, 1996.

(iii) *Single fixed rate*—(A) *In general.* Interest is payable at a single fixed rate only if the rate appropriately takes into account the length of the interval between payments. Thus, if the interval between payments varies during the term of the debt instrument, the value of the fixed rate on which a payment is based generally must be adjusted to reflect a compounding assumption that is consistent with the length of the interval preceding the payment. See *Example 1* in paragraph (f) of this section.

(B) *Special rule for certain first and final payment intervals.* Notwithstanding paragraph (c)(1)(iii)(A) of this section, if a debt instrument provides for payment intervals that are equal in length throughout the term of the instrument, except that the first or final payment interval differs in length from the other payment intervals, the first or final interest payment is considered to be made at a fixed rate if the value of the rate on which the payment is based is adjusted in any reasonable manner to take into account the length of the interval. See *Example 2* of paragraph (f) of this section. The rule in this paragraph (c)(1)(iii)(B) also applies if the lengths of both the first and final payment intervals differ from the length of the other payment intervals.

(2) *Debt instruments subject to contingencies.* The determination of whether a debt instrument described in § 1.1272–1(c) (a debt instrument providing for an alternative payment schedule (or schedules) upon the occurrence of one or more contingencies) provides for qualified stated interest is made by analyzing each alternative payment schedule (including the stated payment schedule) as if it were the debt instrument's sole payment schedule. Under this analysis, the debt instrument provides for qualified stated interest to the extent of the lowest fixed rate at which qualified stated interest would be payable under any payment schedule. See *Example (4)* of paragraph (f) of this section.

(3) *Variable rate debt instrument.* In the case of a variable rate debt instrument, qualified stated interest is determined under § 1.1275–5(e).

(4) *Stated interest in excess of qualified stated interest.* To the extent that stated interest payable under a debt instrument exceeds qualified stated interest, the excess is included in the debt instrument's stated redemption price at maturity.

(5) *Short-term obligations.* In the case of a debt instrument with a term that is not more than 1 year from the date of issue, no payments of interest are treated as qualified stated interest payments.

(d) *De minimis OID*—(1) *In general.* If the amount of OID with respect to a debt instrument is less than the de minimis amount, the amount of OID is treated as zero, and all stated interest (including stated interest that would otherwise be characterized as OID) is treated as qualified stated interest.

(2) *De minimis amount.* The de minimis amount is an amount equal to 0.0025 multiplied by the product of the stated redemption price at maturity and the number of complete years to maturity from the issue date.

(3) *Installment obligations.* In the case of an installment obligation (as defined in paragraph (e)(1) of this section), paragraph (d)(2) of this section is applied by substituting for the number of complete years to maturity the weighted average maturity (as defined in paragraph (e)(3) of this section). Alternatively, in the case of a debt instrument that provides for payments of principal no more rapidly than a self-amortizing installment obligation (as defined in paragraph (e)(2) of this section), the de minimis amount defined in paragraph (d)(2) of this section may

be calculated by substituting 0.00167 for 0.0025.

(4) *Special rule for interest holidays, teaser rates, and other interest shortfalls*—(i) *In general.* This paragraph (d)(4) provides a special rule to determine whether a debt instrument with a teaser rate (or rates), an interest holiday, or any other interest shortfall has de minimis OID. This rule applies if—

(A) The amount of OID on the debt instrument is more than the de minimis amount as otherwise determined under paragraph (d) of this section; and

(B) All stated interest provided for in the debt instrument would be qualified stated interest under paragraph (c) of this section except that for 1 or more accrual periods the interest rate is below the rate applicable for the remainder of the instrument's term (e.g., if as a result of an interest holiday, none of the stated interest is qualified stated interest).

(ii) *Redetermination of OID for purposes of the de minimis test.* For purposes of determining whether a debt instrument described in paragraph (d)(4)(i) of this section has de minimis OID, the instrument's stated redemption price at maturity is treated as equal to the instrument's issue price plus the greater of the amount of foregone interest or the excess (if any) of the instrument's stated principal amount over its issue price. The amount of foregone interest is the amount of additional stated interest that would be required to be payable on the debt instrument during the period of the teaser rate, holiday, or shortfall so that all stated interest would be qualified stated interest under paragraph (c) of this section. See *Example 5* and *Example 6* of paragraph (f) of this section. In addition, for purposes of computing the de minimis amount of OID, the weighted average maturity of the debt instrument is determined by treating all stated interest payments as qualified stated interest payments.

(5) *Treatment of de minimis OID by holders*—(i) *Allocation of de minimis OID to principal payments.* The holder of a debt instrument includes any de minimis OID (other than de minimis OID treated as qualified stated interest under paragraph (d)(1) of this section, such as de minimis OID attributable to a teaser rate or interest holiday) in income as stated principal payments are made. The amount includible in income with respect to each principal payment equals the product of the total amount of de minimis OID on the debt instrument and a fraction, the numerator of which is the amount of the principal payment made and the denominator of which is the stated principal amount of the instrument.

(ii) *Character of de minimis OID*—(A) *De minimis OID treated as gain recognized on retirement.* Any amount of de minimis OID includible in income under this paragraph (d)(5) is treated as gain recognized on retirement of the debt instrument. See section 1271 to determine whether a retirement is treated as an exchange of the debt instrument.

(B) *Treatment of de minimis OID on sale or exchange.* Any gain attributable to de minimis OID that is recognized on the sale or exchange of a debt instrument is capital gain if the debt instrument is a capital asset in the hands of the seller.

(iii) *Treatment of subsequent holders.* If a subsequent holder purchases a debt instrument issued with de minimis OID at a premium (as defined in § 1.1272–2(b)(2)), the subsequent holder does not include the de minimis OID in income. Otherwise, a subsequent holder includes any discount in income under the market discount rules (sections 1276 through 1278) rather than under the rules of this paragraph (d)(5).

(iv) *Cross-reference.* See § 1.1272–3 for an election by a holder to treat de minimis OID as OID.

(e) *Definitions*—(1) *Installment obligation.* An installment obligation is a debt instrument that provides for the payment of any amount other than qualified stated interest before maturity.

(2) *Self-amortizing installment obligation.* A self-amortizing installment obligation is an obligation that provides for equal payments composed of principal and qualified stated interest that are unconditionally payable at least annually during the entire term of the debt instrument with no significant additional payment required at maturity.

(3) *Weighted average maturity.* The weighted average maturity of a debt

instrument is the sum of the following amounts determined for each payment under the instrument (other than a payment of qualified stated interest)—

(i) The number of complete years from the issue date until the payment is made; multiplied by

(ii) A fraction, the numerator of which is the amount of the payment and the denominator of which is the debt instrument's stated redemption price at maturity.

(f) *Examples.* The following examples illustrate the rules of this section.

Example 1. Qualified stated interest—(i) *Facts.* On January 1, 1995, A purchases at original issue, for $100,000, a debt instrument that matures on January 1, 1999, and has a stated principal amount of $100,000, payable at maturity. The debt instrument provides for interest payments of $8,000 on January 1, 1996, and January 1, 1997, and quarterly interest payments of $1,942.65, beginning on April 1, 1997.

(ii) *Amount of qualified stated interest.* The annual payments of $8,000 and the quarterly payments of $1,942.65 are payable at a single fixed rate because 8 percent, compounded annually, is equivalent to 7.77 percent, compounded quarterly. Consequently, all stated interest payments under the debt instrument are qualified stated interest payments.

Example 2. Qualified stated interest with short initial payment interval. On October 1, 1994, A purchases at original issue, for $100,000, a debt instrument that matures on January 1, 1998, and has a stated principal amount of $100,000, payable at maturity. The debt instrument provides for an interest payment of $2,000 on January 1, 1995, and interest payments of $8,000 on January 1, 1996, January 1, 1997, and January 1, 1998. Under paragraph (c)(1)(iii)(B) of this section, all stated interest payments on the debt instrument are computed at a single fixed rate and are qualified stated interest payments.

Example 3. Stated interest in excess of qualified stated interest—(i) *Facts.* On January 1, 1995, B purchases at original issue, for $100,000, C corporation's 5-year debt instrument. The debt instrument provides for a principal payment of $100,000, payable at maturity, and calls for annual interest payments of $10,000 for the first 3 years and annual interest payments of $10,600 for the last 2 years.

(ii) *Payments in excess of qualified stated interest.* All of the first three interest payments and $10,000 of each of the last two interest payments are qualified stated interest payments within the meaning of paragraph (c)(1) of this section. Under paragraph (c)(4) of this section, the remaining $600 of each of the last two interest payments is included in the stated redemption price at maturity, so that the stated redemption price at maturity is $101,200. Pursuant to paragraph (e)(3) of this section, the weighted average maturity of the debt instrument is 4.994 years [(4 years×$600/$101,200)+(5 years×$100,600/$101,200)]. The de minimis amount, or one-fourth of 1 percent of the stated redemption price at maturity multiplied by the weighted average maturity, is $1,263.50. Because the actual amount of discount, $1,200, is less than the de minimis amount, the instrument is treated as having no OID, and, under paragraph (d)(1) of this section, all of the interest payments are treated as qualified stated interest payments.

Example 4. Qualified stated interest on a debt instrument that is subject to an option—(i) *Facts.* On January 1, 1997, A issues, for $100,000, a 10-year debt instrument that provides for a $100,000 principal payment at maturity and for annual interest payments of $10,000. Under the terms of the debt instrument, A has the option, exercisable on January 1, 2002, to lower the annual interest payments to $8,000. In addition, the debt instrument gives the holder an unconditional right to put the debt instrument back to A, exercisable on January 1, 2002, in return for $100,000.

(ii) *Amount of qualified stated interest.* Under paragraph (c)(2) of this section, the debt instrument provides for qualified stated interest to the extent of the lowest fixed rate at which qualified stated interest would be payable under any payment schedule. If the payment schedule determined by assuming that the issuer's option will be exercised and the put option will not be exercised were treated as the debt instrument's sole payment schedule, only $8,000 of each annual interest payment would be qualified stated interest. Under any other payment schedule, the debt instrument would provide for annual qualified stated interest payments of $10,000. Accordingly, only $8,000 of each annual interest payment is qualified stated interest. Any excess of each annual interest payment over $8,000 is included in the debt instrument's stated redemption price at maturity.

Example 5. De minimis OID; interest holiday—(i) *Facts.* On January 1, 1995, C purchases at original issue, for $97,561, a debt instrument that matures on January 1, 2007, and has a stated principal amount of $100,000, payable at maturity. The debt instrument provides for an initial interest holiday of 1 quarter and quarterly interest payments of $2,500 thereafter (beginning on July 1, 1995). The issue price of the debt instrument is $97,561. C chooses to accrue OID based on quarterly accrual periods.

(ii) *De minimis amount of OID.* But for the interest holiday, all stated interest on the debt instrument would be qualified stated interest. Under paragraph (d)(4) of this section, for purposes of determining whether the debt instrument has de minimis OID, the stated redemption price at maturity of the instrument is $100,061 ($97,561 (issue price) plus $2,500 (the greater of the amount of foregone interest ($2,500) and the amount equal to the excess of the instrument's stated principal amount over its issue price ($2,439)). Thus, the debt instrument is treated as having OID of $2,500 ($100,061 minus $97,561). Because this amount is less than the de minimis amount of $3,001.83 (0.0025 multiplied by $100,061 multiplied by 12 complete years to maturity), the debt instrument is treated as having no OID, and all stated interest is treated as qualified stated interest.

Example 6. De minimis OID; teaser rate—(i) *Facts.* The facts are the same as in *Example 5* of this paragraph (f) except that C uses an initial semiannual accrual period rather than an initial quarterly accrual period.

(ii) *De minimis amount of OID.* The debt instrument provides for an initial teaser rate because the interest rate for the semiannual accrual period is less than the interest rate applicable to the subsequent quarterly accrual periods. But for the initial teaser rate, all stated interest on the debt instrument would be qualified stated interest. Under paragraph (d)(4) of this section, for purposes of determining whether the debt instrument has de minimis OID, the stated redemption price at maturity of the instrument is $100,123.50 ($97,561 (issue price) plus $2,562.50 (the greater of the amount of foregone interest ($2,562.50) and the amount equal to the excess of the instrument's stated principal amount over its issue price ($2,439)). Thus, the debt instrument is treated as having OID of $2,562.50 ($100,123.50 minus $97,561). Because this amount is less than the de minimis amount of $3,003.71 (0.0025 multiplied by $100,123.50 multiplied by 12 complete years to maturity), the debt instrument is treated as having no OID, and all stated interest is treated as qualified stated interest.

[T.D. 8517, 59 FR 4815, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30141, June 14, 1996]

§1.1273–2 Determination of issue price and issue date.

(a) *Debt instruments issued for money*—(1) *Issue price.* If a substantial amount of the debt instruments in an issue is issued for money, the issue price of each debt instrument in the issue is the first price at which a substantial amount of the debt instruments is sold for money. Thus, if an issue consists of a single debt instrument that is issued for money, the issue price of the debt instrument is the amount paid for the instrument. For example, in the case of a debt instrument evidencing a loan to a natural person, the issue price of the instrument is the amount loaned. See §1.1275–2(d) for rules regarding Treasury securities. For purposes of this paragraph (a), money includes functional currency and, in certain circumstances, nonfunctional currency. See §1.988–2(b)(2) for circumstances when nonfunctional currency is treated as money rather than as property.

(2) *Issue date.* The issue date of an issue described in paragraph (a)(1) of this section is the first settlement date or closing date, whichever is applicable, on which a substantial amount of the debt instruments in the issue is sold for money.

(b) *Publicly traded debt instruments issued for property*—(1) *Issue price.* If a substantial amount of the debt instruments in an issue is traded on an established market (within the meaning of paragraph (f) of this section) and the issue is not described in paragraph (a)(1) of this section, the issue price of each debt instrument in the issue is the fair market value of the debt instrument, determined as of the issue date (as defined in paragraph (b)(2) of this section).

(2) *Issue date.* The issue date of an issue described in paragraph (b)(1) of this section is the first date on which a substantial amount of the traded debt instruments in the issue is issued.

(c) *Debt instruments issued for publicly traded property*—(1) *Issue price.* If a substantial amount of the debt instruments in an issue is issued for property that is traded on an established market (within the meaning of paragraph (f) of this section) and the issue is not described in paragraph (a)(1) or (b)(1) of this section, the issue price of each debt instrument in the issue is the fair market value of the property, determined as of the issue date (as defined in paragraph (c)(2) of this section). For purposes of the preceding sentence, property means a debt instrument, stock, security, contract, commodity, or nonfunctional currency. But see §1.988–2(b)(2) for circumstances when nonfunctional currency is treated as money rather than as property.

(2) *Issue date.* The issue date of an issue described in paragraph (c)(1) of this section is the first date on which a

substantial amount of the debt instruments in the issue is issued for traded property.

(d) *Other debt instruments*—(1) *Issue price.* If an issue of debt instruments is not described in paragraph (a)(1), (b)(1), or (c)(1) of this section, the issue price of each debt instrument in the issue is determined as if the debt instrument were a separate issue. If the issue price of a debt instrument that is treated as a separate issue under the preceding sentence is not determined under paragraph (a)(1), (b)(1), or (c)(1) of this section, and if section 1274 applies to the debt instrument, the issue price of the instrument is determined under section 1274. Otherwise, the issue price of the debt instrument is its stated redemption price at maturity under section 1273(b)(4). See section 1274(c) and § 1.1274–1 to determine if section 1274 applies to a debt instrument.

(2) *Issue date.* The issue date of an issue described in paragraph (d)(1) of this section is the date on which the debt instrument is issued for money or in a sale or exchange.

(e) *Special rule for certain sales to bond houses, brokers, or similar persons.* For purposes of determining the issue price and issue date of a debt instrument under this section, sales to bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters, placement agents, or wholesalers are ignored.

(f) *Traded on an established market (publicly traded)*—(1) *In general.* Property (including a debt instrument described in paragraph (b)(1) of this section) is traded on an established market for purposes of this section if, at any time during the 60-day period ending 30 days after the issue date, the property is described in paragraph (f)(2), (f)(3), (f)(4), or (f)(5) of this section.

(2) *Exchange listed property.* Property is described in this paragraph (f)(2) if it is listed on—

(i) A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);

(ii) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934 (15 U.S.C. 78o–3); or

(iii) The International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited, the Frankfurt Stock Exchange, the Tokyo Stock Exchange, or any other foreign exchange or board of trade that is designated by the Commissioner in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter).

(3) *Market traded property.* Property is described in this paragraph (f)(3) if it is property of a kind that is traded either on a board of trade designated as a contract market by the Commodities Futures Trading Commission or on an interbank market.

(4) *Property appearing on a quotation medium.* Property is described in this paragraph (f)(4) if it appears on a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations (including rates, yields, or other pricing information) of one or more identified brokers, dealers, or traders or actual prices (including rates, yields, or other pricing information) of recent sales transactions (a quotation medium). A quotation medium does not include a directory or listing of brokers, dealers, or traders for specific securities, such as yellow sheets, that provides neither price quotations nor actual prices of recent sales transactions.

(5) *Readily quotable debt instruments*—(i) *In general.* A debt instrument is described in this paragraph (f)(5) if price quotations are readily available from dealers, brokers, or traders.

(ii) *Safe harbors.* A debt instrument is not considered to be described in paragraph (f)(5)(i) of this section if—

(A) No other outstanding debt instrument of the issuer (or of any person who guarantees the debt instrument) is described in paragraph (f)(2), (f)(3), or (f)(4) of this section (other traded debt);

(B) The original stated principal amount of the issue that includes the debt instrument does not exceed $25 million;

(C) The conditions and covenants relating to the issuer's performance with respect to the debt instrument are materially less restrictive than the conditions and covenants included in all of the issuer's other traded debt (e.g., the debt instrument is subject to an economically significant subordination provision whereas the issuer's other traded debt is senior); or

(D) The maturity date of the debt instrument is more than 3 years after the latest maturity date of the issuer's other traded debt.

(6) *Effect of certain temporary restrictions on trading.* If there is any temporary restriction on trading a purpose of which is to avoid the characterization of the property as one that is traded on an established market for Federal income tax purposes, then the property is treated as traded on an established market. For purposes of the preceding sentence, a temporary restriction on trading need not be imposed by the issuer.

(7) *Convertible debt instruments.* A debt instrument is not treated as traded on an established market solely because the debt instrument is convertible into property that is so traded.

(g) *Treatment of certain cash payments incident to lending transactions*—(1) *Applicability.* The provisions of this paragraph (g) apply to cash payments made incident to private lending transactions (including seller financing).

(2) *Payments from borrower to lender*—(i) *Money lending transaction.* In a lending transaction to which section 1273(b)(2) applies, a payment from the borrower to the lender (other than a payment for property or for services provided by the lender, such as commitment fees or loan processing costs) reduces the issue price of the debt instrument evidencing the loan. However, solely for purposes of determining the tax consequences to the borrower, the issue price is not reduced if the payment is deductible under section 461(g)(2).

(ii) *Section 1274 transaction.* In a lending transaction to which section 1274 applies, a payment from the buyer-borrower to the seller-lender that is designated as interest or points reduces the stated principal amount of the debt instrument evidencing the loan, but is included in the purchase price of the property. If the payment is deductible under section 461(g)(2), however, the issue price of the debt instrument (as otherwise determined under section 1274 and the rule in the preceding sentence) is increased by the amount of the payment to compute the buyer-borrower's interest deductions under section 163.

(3) *Payments from lender to borrower.* A payment from the lender to the borrower in a lending transaction is treated as an amount loaned.

(4) *Payments between lender and third party.* If, as part of a lending transaction, a party other than the borrower (the third party) makes a payment to the lender, that payment is treated in appropriate circumstances as made from the third party to the borrower followed by a payment in the same amount from the borrower to the lender and governed by the provisions of paragraph (g)(2) of this section. If, as part of a lending transaction, the lender makes a payment to a third party, that payment is treated in appropriate circumstances as an additional amount loaned to the borrower and then paid by the borrower to the third party. The character of the deemed payment between the borrower and the third party depends on the substance of the transaction.

(5) *Examples.* The following examples illustrate the rules of this paragraph (g).

Example 1. Payments from borrower to lender in a cash transaction—(i) *Facts.* A lends $100,000 to B for a term of 10 years. At the time the loan is made, B pays $4,000 in points to A. Assume that the points are not deductible by B under section 461(g)(2) and that the stated redemption price at maturity of the debt instrument is $100,000.

(ii) *Payment results in OID.* Under paragraph (g)(2)(i) of this section, the issue price of B's debt instrument evidencing the loan is $96,000. Because the amount of OID on the debt instrument ($4,000) is more than a de minimis amount of OID, A accounts for the OID under §1.1272–1. B accounts for the OID under §1.163–7.

Example 2. Payments from borrower to lender in a section 1274 transaction—(i) *Facts.* A sells property to B for $1,000,000 in a transaction that is not a potentially abusive situation (within the meaning of §1.1274–3). In consideration for the property, B gives A $300,000 and issues a 5-year debt instrument that has a stated principal amount of $700,000, payable at maturity, and that calls for semiannual payments of interest at a rate of 8.5 percent. In addition to the cash downpayment, B pays A $14,000 designated as points on the loan. Assume that the points are not deductible under section 461(g)(2).

(ii) *Issue price.* Under paragraph (g)(2)(ii) of this section, the stated principal amount of B's debt instrument is −$686,000 ($700,000 minus $14,000). Assuming a test rate of 9 percent, compounded semiannually, the imputed principal amount of B's debt instrument under § 1.1274–2(c)(1) is $686,153. Under § 1.1274–2(b)(1), the issue price of B's debt instrument is the stated principal amount of $686,000. Because the amount of OID on the debt instrument ($700,000 − $686,000, or $14,000) is more than a de minimis amount of OID, A accounts for the OID under § 1.1272–1 and B accounts for the OID under § 1.163–7. B's basis in the property purchased is $1,000,000 ($686,000 debt instrument plus $314,000 cash payments).

Example 3. Payments between lender and third party (seller-paid points)—(i) *Facts.* A sells real property to B for $500,000 in a transaction that is not a potentially abusive situation (within the meaning of § 1.1274–3). B makes a cash down payment of $100,000 and borrows $400,000 of the purchase price from a lender, L, repayable in annual installments over a term of 15 years calling for interest at a rate of 9 percent, compounded annually. As part of the transaction, A makes a payment of $8,000 to L to facilitate the loan to B.

(ii) *Payment results in a de minimis amount of OID.* Under the provisions of paragraphs (g)(2)(i) and (g)(4) of this section, B is treated as having made an $8,000 payment directly to L and a payment of only $492,000 to A for the property. Thus, B's basis in the property is $492,000. The payment to L reduces the issue price of B's debt instrument to $392,000, resulting in $8,000 of OID ($400,000 − $392,000). Because the amount of OID is de minimis under § 1.1273–1(d), L accounts for the de minimis OID under § 1.1273–1(d)(5). But see § 1.1272–3 (election to treat de minimis OID as OID). B accounts for the de minimis OID under § 1.163–7.

(h) *Investment units*—(1) *In general.* Under section 1273(c)(2), an investment unit is treated as if the investment unit were a debt instrument. The issue price of the investment unit is determined under paragraph (a)(1), (b)(1), or (c)(1) of this section, if applicable. The issue price of the investment unit is then allocated between the debt instrument and the property right (or rights) that comprise the unit based on their relative fair market values. If paragraphs (a)(1), (b)(1), and (c)(1) of this section are not applicable, however, the issue price of the debt instrument that is part of the investment unit is determined under section 1273(b)(4) or 1274, whichever is applicable.

(2) *Consistent allocation by holders and issuer.* The issuer's allocation of the issue price of the investment unit is binding on all holders of the investment unit. However, the issuer's determination is not binding on a holder that explicitly discloses that its allocation is different from the issuer's allocation. Unless otherwise provided by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed Federal income tax return for the taxable year that includes the acquisition date of the investment unit. See § 1.1275–2(e) for rules relating to the issuer's obligation to disclose certain information to holders.

(i) [Reserved]

(j) *Convertible debt instruments.* The issue price of a debt instrument includes any amount paid for an option to convert the instrument into stock (or another debt instrument) of either the issuer or a related party (within the meaning of section 267(b) or 707(b)(1)) or into cash or other property in an amount equal to the approximate value of such stock (or debt instrument).

(k) *Below-market loans subject to section 7872(b).* The issue price of a below-market loan subject to section 7872(b) (a term loan other than a gift loan) is the issue price determined under this section, reduced by the excess amount determined under section 7872(b)(1).

(l) [Reserved]

(m) *Treatment of amounts representing pre-issuance accrued interest*—(1) *Applicability.* Paragraph (m)(2) of this section provides an alternative to the general rule of this section for determining the issue price of a debt instrument if—

(i) A portion of the initial purchase price of the instrument is allocable to interest that has accrued prior to the issue date (pre-issuance accrued interest); and

(ii) The instrument provides for a payment of stated interest on the first payment date within 1 year of the issue date that equals or exceeds the amount of the pre-issuance accrued interest.

(2) *Exclusion of pre-issuance accrued interest from issue price.* If a debt instrument meets the requirements of paragraph (m)(1) of this section, the instrument's issue price may be computed by subtracting from the issue price (as otherwise computed under this section) the amount of pre-issuance accrued interest. If the issue price of the debt instrument is computed in this manner, a portion of the stated interest payable on the first payment date must be treated as a return of the excluded pre-issuance accrued interest, rather than as an amount payable on the instrument.

(3) *Example.* The following example illustrates the rule of paragraph (m) of this section.

Example: (i) *Facts.* On January 15, 1995, A purchases at original issue, for $1,005, B corporation's debt instrument. The debt instrument provides for a payment of principal of $1,000 on January 1, 2005, and provides for semiannual interest payments of $60 on January 1 and July 1 of each year, beginning on July 1, 1995.

(ii) *Determination of pre-issuance accrued interest.* Under paragraphs (m)(1) and (m)(2) of this section, $5 of the $1,005 initial purchase price of the debt instrument is allocable to pre-issuance accrued interest. Accordingly, the debt instrument's issue price may be computed by subtracting the amount of pre-issuance accrued interest ($5) from the issue price otherwise computed under this section ($1,005), resulting in an issue price of $1,000. If the issue price is computed in this manner, $5 of the $60 payment made on July 1, 1995, must be treated as a repayment by B of the pre-issuance accrued interest.

[T.D. 8517, 59 FR 4817, Feb. 2, 1994]

§1.1274–1 Debt instruments to which section 1274 applies.

(a) *In general.* Subject to the exceptions and limitations in paragraph (b) of this section, section 1274 and this section apply to any debt instrument issued in consideration for the sale or exchange of property. For purposes of section 1274, property includes debt instruments and investment units, but does not include money, services, or the right to use property. For the treatment of certain obligations given in exchange for services or the use of property, see sections 404 and 467. For purposes of this paragraph (a), money includes functional currency and, in certain circumstances, nonfunctional currency. See §1.988–2(b)(2) for circumstances when nonfunctional currency is treated as money rather than as property.

(b) *Exceptions*—(1) *Debt instrument with adequate stated interest and no OID.* Section 1274 does not apply to a debt instrument if—

(i) All interest payable on the instrument is qualified stated interest;

(ii) The stated rate of interest is at least equal to the test rate of interest (as defined in §1.1274–4);

(iii) The debt instrument is not issued in a potentially abusive situation (as defined in §1.1274–3); and

(iv) No payment from the buyer-borrower to the seller-lender designated as points or interest is made at the time of issuance of the debt instrument.

(2) *Exceptions under sections 1274(c)(1)(B), 1274(c)(3), 1274A(c), and 1275(b)(1)*—(i) *In general.* Sections 1274(c)(1)(B), 1274(c)(3), 1274A(c), and 1275(b)(1) describe certain transactions to which section 1274 does not apply. This paragraph (b)(2) provides certain rules to be used in applying those exceptions.

(ii) *Special rules for certain exceptions under section 1274(c)(3)*—(A) *Determination of sales price for certain sales of farms.* For purposes of section 1274(c)(3)(A), the determination as to whether the sales price cannot exceed $1,000,000 is made without regard to any other exception to, or limitation on, the applicability of section 1274 (e.g., without regard to the special rules regarding sales of principal residences and land transfers between related persons). In addition, the sales price is determined without regard to section 1274 and without regard to any stated interest. The sales price includes the amount of any liability included in the amount realized from the sale or exchange. See §1.1001–2.

(B) *Sales involving total payments of $250,000 or less.* Under section 1274(c)(3)(C), the determination of the amount of payments due under all debt instruments and the amount of other consideration to be received is made as of the date of the sale or exchange or, if earlier, the contract date. If the precise amount due under any debt instrument or the precise amount of any other consideration to be received cannot be determined as of that date, section 1274(c)(3)(C) applies only if it can be determined that the maximum of the aggregate amount of payments due under the debt instruments and other consideration to be received cannot exceed $250,000. For purposes of section 1274(c)(3)(C), if a liability is assumed or property is taken subject to a liability, the aggregate amount of payments due includes the outstanding principal balance or adjusted issue price (in the case of an obligation originally issued at a discount) of the obligation.

(C) *Coordination with section 1273 and § 1.1273–2.* In accordance with section 1274(c)(3)(D), section 1274 and this section do not apply if the issue price of a debt instrument issued in consideration for the sale or exchange of property is determined under paragraph (a)(1), (b)(1), or (c)(1) of § 1.1273–2.

(3) *Other exceptions to section 1274*—(i) *Holders of certain below-market instruments.* Section 1274 does not apply to any holder of a debt instrument that is issued in consideration for the sale or exchange of personal use property (within the meaning of section 1275(b)(3)) in the hands of the issuer and that evidences a below-market loan described in section 7872(c)(1).

(ii) *Transactions involving certain demand loans.* Section 1274 does not apply to any debt instrument that evidences a demand loan that is a below-market loan described in section 7872(c)(1).

(iii) *Certain transfers subject to section 1041.* Section 1274 does not apply to any debt instrument issued in consideration for a transfer of property subject to section 1041 (relating to transfers of property between spouses or incident to divorce).

(c) *Examples.* The following examples illustrate the rules of this section.

Example 1. Single stated rate paid semiannually. A debt instrument issued in consideration for the sale of nonpublicly traded property in a transaction that is not a potentially abusive situation calls for the payment of a principal amount of $1,000,000 at the end of a 10-year term and 20 semiannual interest payments of $60,000. Assume that the test rate of interest is 12 percent, compounded semiannually. The debt instrument is not subject to section 1274 because it provides for interest equal to the test rate and all interest payable on the instrument is qualified stated interest.

Example 2. Sale of farm for debt instrument with contingent interest—(i) *Facts.* On July 1, 1995, A, an individual, sells to B land used as a farm within the meaning of section 6420(c)(2). As partial consideration for the sale, B issues a debt instrument calling for a single $500,000 payment due in 10 years unless profits from the land in each of the 10 years preceding maturity of the debt instrument exceed a specified amount, in which case B is to make a payment of $1,200,000. The debt instrument does not provide for interest.

(ii) *Total payments may exceed $1,000,000.* Even though the total payments ultimately payable under the contract may be less than $1,000,000, at the time of the sale or exchange it cannot be determined that the sales price cannot exceed $1,000,000. Thus, the sale of the land used as a farm is not an excepted transaction described in section 1274(c)(3)(A).

Example 3. Sale between related parties subject to section 483(e)—(i) *Facts.* On July 1, 1995, A, an individual, sells land (not used as a farm within the meaning of section 6420(c)(2)) to A's child B for $650,000. In consideration for the sale, B issues a 10-year debt instrument to A that calls for a payment of $650,000. No other consideration is given. The debt instrument does not provide for interest.

(ii) *Treatment of debt instrument.* For purposes of section 483(e), the $650,000 debt instrument is treated as two separate debt instruments: a $500,000 debt instrument and a $150,000 debt instrument. The $500,000 debt instrument is subject to section 483(e), and accordingly is covered by the exception from section 1274 described in section 1274(c)(3)(F). Because the amount of the payments due as consideration for the sale exceeds $250,000, however, the $150,000 debt instrument is subject to section 1274.

[T.D. 8517, 59 FR 4820, Feb. 2, 1994]

§ 1.1274–2 Issue price of debt instruments to which section 1274 applies.

(a) *In general.* If section 1274 applies to a debt instrument, section 1274 and this section determine the issue price of the debt instrument. For rules relating to the determination of the amount and timing of OID to be included in income, see section 1272 and the regulations thereunder.

(b) *Issue price*—(1) *Debt instruments that provide for adequate stated interest; stated principal amount.* The issue price of a debt instrument that provides for adequate stated interest is the stated principal amount of the debt instrument. For purposes of section 1274, the stated principal amount of a debt instrument is the aggregate amount of all payments due under the debt instrument, excluding any amount of stated interest. Under §1.1273–2(g)(2)(ii), however, the stated principal amount of a debt instrument is reduced by any payment from the buyer- borrower to the seller-lender that is designated as interest or points. See *Example 2* of §1.1273–2(g)(5).

(2) *Debt instruments that do not provide for adequate stated interest; imputed principal amount.* The issue price of a debt instrument that does not provide for adequate stated interest is the imputed principal amount of the debt instrument.

(3) *Debt instruments issued in a potentially abusive situation; fair market value.* Notwithstanding paragraphs (b)(1) and (b)(2) of this section, in the case of a debt instrument issued in a potentially abusive situation (as defined in §1.1274–3), the issue price of the debt instrument is the fair market value of the property received in exchange for the debt instrument, reduced by the fair market value of any consideration other than the debt instrument issued in consideration for the sale or exchange.

(c) *Determination of whether a debt instrument provides for adequate stated interest*—(1) *In general.* A debt instrument provides for adequate stated interest if its stated principal amount is less than or equal to its imputed principal amount. Imputed principal amount means the sum of the present values, as of the issue date, of all payments, including payments of stated interest, due under the debt instrument (determined by using a discount rate equal to the test rate of interest as determined under §1.1274–4). If a debt instrument has a single fixed rate of interest that is paid or compounded at least annually, and that rate is equal to or greater than the test rate, the debt instrument has adequate stated interest.

(2) *Determination of present value.* The present value of a payment is determined by discounting the payment from the date it becomes due to the date of the sale or exchange at the test rate of interest. To determine present value, a compounding period must be selected, and the test rate must be based on the same compounding period.

(d) *Treatment of certain options.* This paragraph (d) provides rules for determining the issue price of a debt instrument to which section 1274 applies (other than a debt instrument issued in a potentially abusive situation) that is subject to one or more options described in both paragraphs (c)(1) and (c)(5) of §1.1272–1. Under this paragraph (d), an issuer will be deemed to exercise or not exercise an option or combination of options in a manner that minimizes the instrument's imputed principal amount, and a holder will be deemed to exercise or not exercise an option or combination of options in a manner that maximizes the instrument's imputed principal amount. If both the issuer and the holder have options, the rules of this paragraph (d) are applied to the options in the order that they may be exercised. Thus, the deemed exercise of one option may eliminate other options that are later in time. See §1.1272–1(c)(5) to determine the debt instrument's yield and maturity for purposes of determining the accrual of OID with respect to the instrument.

(e) *Mandatory sinking funds.* In determining the issue price of a debt instrument to which section 1274 applies (other than a debt instrument issued in a potentially abusive situation) and that is subject to a mandatory sinking fund provision described in §1.1272–1(c)(3), the mandatory sinking fund provision is ignored.

(f) *Treatment of variable rate debt instruments*—(1) *Stated interest at a qualified floating rate*—(i) *In general.* For purposes of paragraph (c) of this section, the imputed principal amount of a variable rate debt instrument (within the meaning of §1.1275–5(a)) that provides for stated interest at a qualified floating rate (or rates) is determined by assuming that the instrument provides for a fixed rate of interest for each accrual period to which a qualified floating rate applies. For purposes of the preceding sentence, the assumed fixed rate in each accrual period is the greater of—

(A) The value of the applicable qualified floating rate as of the first date on which there is a binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated; or

(B) The value of the applicable qualified floating rate as of the date on which the sale or exchange occurs.

(ii) *Interest rate restrictions.* Notwithstanding paragraph (f)(1)(i) of this section, if, as a result of interest rate restrictions (such as an interest rate cap), the expected yield of the debt instrument taking the restrictions into account is significantly less than the expected yield of the debt instrument without regard to the restrictions, the interest payments on the debt instrument (other than any fixed interest payments) are treated as contingent payments. Reasonably symmetric interest rate caps and floors, or reasonably symmetric governors, that are fixed throughout the term of the debt instrument do not result in the debt instrument being subject to this rule.

(2) *Stated interest at a single objective rate.* For purposes of paragraph (c) of this section, the imputed principal amount of a variable rate debt instrument (within the meaning of § 1.1275–5(a)) that provides for stated interest at a single objective rate is determined by treating the interest payments as contingent payments.

(g) *Treatment of contingent payment debt instruments.* Notwithstanding paragraph (b) of this section, if a debt instrument subject to section 1274 provides for one or more contingent payments, the issue price of the debt instrument is the lesser of the instrument's noncontingent principal payments and the sum of the present values of the noncontingent payments (as determined under paragraph (c) of this section). However, if the debt instrument is issued in a potentially abusive situation, the issue price of the debt instrument is the fair market value of the noncontingent payments. For additional rules relating to a debt instrument that provides for one or more contingent payments, see § 1.1275–4. This paragraph (g) applies to debt instruments issued on or after August 13, 1996.

(h) *Examples.* The following examples illustrate the rules of this section. Each example assumes a 30-day month, 360-day year. In addition, each example assumes that the debt instrument is not a qualified debt instrument (as defined in section 1274A(b)) and is not issued in a potentially abusive situation.

Example 1. Debt instrument without a fixed rate over its entire term—(i) *Facts.* On January 1, 1995, A sells nonpublicly traded property to B for a stated purchase price of $3,500,000. In consideration for the sale, B makes a down payment of $500,000 and issues a 10-year debt instrument with a stated principal amount of $3,000,000, payable at maturity. The debt instrument calls for no interest in the first 2 years and interest at a rate of 15 percent payable annually over the remaining 8 years of the debt instrument. The first interest payment of $450,000 is due on December 31, 1997, and the last interest payment is due on December 31, 2004, together with the $3,000,000 payment of principal. Assume that the test rate of interest applicable to the debt instrument is 10.5 percent, compounded annually.

(ii) *Applicability of section 1274.* Because the debt instrument does not provide for any interest during the first 2 years, none of the interest on the debt instrument is qualified stated interest. Therefore, the issue price of the debt instrument is determined under section 1274. See § 1.1274–1(b)(1). If the debt instrument has adequate stated interest, the issue price of the instrument is its stated principal amount. Otherwise, the issue price of the debt instrument is its imputed principal amount. The debt instrument has adequate stated interest only if the stated principal amount is less than or equal to the imputed principal amount.

(iii) *Determination of imputed principal amount.* To compute the imputed principal amount of the debt instrument, all payments due under the debt instrument are discounted back to the issue date at 10.5 percent, compounded annually, as follows:

(A) The present value of the $3,000,000 principal payment payable on December 31, 2004, is $1,105,346.59, determined as follows:

$$\$1{,}105{,}346.59 = \frac{\$3{,}000{,}000}{(1+.105/1)^{10}}$$

(B) The present value of the eight interest payments of $450,000 as of January 1, 1997, is $2,357,634.55, determined as follows:

$$\$2{,}357{,}634.55 = \$450{,}000 \times \frac{1-(1+.105/1)^{-8}}{(.105/1)}$$

(C) The present value of this interim amount as of January 1, 1995, is $1,930,865.09, determined as follows:

$$\$1{,}930{,}865.09 = \frac{\$2{,}357{,}634.55}{(1+.105/1)^{2}}$$

(iv) *Determination of issue price.* The debt instrument's imputed principal amount (that is, the present value of all payments due under the debt instrument) is $3,036,211.68 ($1,105,346.59+$1,930,865.09). Because the stated principal amount ($3,000,000) is less than the imputed principal amount, the debt instrument provides for adequate stated interest. Therefore, the issue price of the debt instrument is its stated principal amount ($3,000,000).

Example 2. Debt instrument subject to issuer call option—(i) *Facts.* On January 1, 1995, in partial consideration for the sale of nonpublicly traded property, H corporation issues to G a 10-year debt instrument, maturing on January 1, 2005, with a stated principal amount of $10,000,000, payable on that date. The debt instrument provides for annual payments of interest of 8 percent for the first 5 years and 14 percent for the final 5 years, payable on January 1 of each year, beginning on January 1, 1996. In addition the debt instrument provides H with the unconditional option to call (prepay) the debt instrument at the end of 5 years for its stated principal amount of $10,000,000. Assume that the Federal mid-term and long-term rates applicable to the sale based on annual compounding are 9 percent and 10 percent, respectively.

(ii) *Option presumed exercised.* Assuming exercise of the call option, the imputed principal amount as determined under paragraph (d) of this section is $9,611,034.87 (the present value of all of the payments due within a 5-year term discounted at a test rate of 9 percent, compounded annually). Assuming nonexercise of the call option, the imputed principal amount is $10,183,354.78 (the present value of all of the payments due within a 10-year term discounted at a test rate of 10 percent, compounded annually). For purposes of determining the imputed principal amount, the option is presumed exercised because the imputed principal amount, assuming exercise of the option, is less than the imputed principal amount, assuming the option is not exercised. Because the option is presumed exercised, the debt instrument fails to provide for adequate stated interest because the imputed principal amount ($9,611,034.87) is less than the stated principal amount ($10,000,000). Thus, the issue price of the debt instrument is $9,611,034.87.

Example 3. Variable rate debt instrument with a single rate over its entire term—(i) *Facts.* On January 1, 1995, A sells B nonpublicly traded property. In partial consideration for the sale, B issues a debt instrument in the principal amount of $1,000,000, payable in 5 years. The debt instrument calls for interest payable monthly at a rate of 1 percentage point above the average prime lending rate of a major bank for the month preceding the month of the interest payment. Assume that the test rate of interest applicable to the debt instrument is 10.5 percent, compounded monthly. Assume also that 1 percentage point above the prime lending rate of the designated bank on the date of the sale is 12.5 percent, compounded monthly, which is greater than 1 percentage point above the prime lending rate of the designated bank on the first date on which there is a binding written contract that substantially sets forth the terms under which the sale is consummated.

(ii) *Debt instrument has adequate stated interest.* The debt instrument is a variable rate debt instrument (within the meaning of §1.1275–5) that provides for stated interest at a qualified floating rate. Under paragraph (f)(1)(i) of this section, the debt instrument is treated as if it provided for a fixed rate of interest equal to 12.5 percent, compounded monthly. Because the test rate of interest is 10.5 percent, compounded monthly, the debt instrument provides for adequate stated interest.

Example 4. Debt instrument with a capped variable rate. On July 1, 1995, A sells nonpublicly traded property to B in return for a debt instrument with a stated principal amount of $10,000,000, payable on July 1, 2005. Interest is payable on July 1 of each year, beginning on July 1, 1996, at the Federal short-term rate for June of the same year. The debt instrument provides, however, that the interest rate cannot rise above 8.5 percent, compounded annually. Assume that, as of the date the test rate of interest for the debt instrument is determined, the Federal short-term rate is 8 percent, compounded annually. Assume further that, as a result of the interest rate cap of 8.5 percent, compounded annually, the expected yield of the debt instrument is significantly less than the expected yield of the debt instrument if it did not include the interest rate cap. Under paragraph (f)(1)(ii) of this section, the variable payments are treated as contingent payments for purposes of this section.

(i) [Reserved]

(j) *Special rules for tax-exempt obligations*—(1) *Certain variable rate debt instruments.* Notwithstanding paragraph (b) of this section, if a tax-exempt obligation (as defined in section 1275(a)(3)) is a variable rate debt instrument (within the meaning of §1.1275–5) that pays interest at an objective rate and is subject to section 1274, the issue price of the obligation is the greater of the obligation's fair market value and its stated principal amount.

(2) *Contingent payment debt instruments.* Notwithstanding paragraphs (b) and (g) of this section, if a tax-exempt obligation (as defined in section 1275(a)(3)) is subject to section 1274 and § 1.1275–4, the issue price of the obligation is the fair market value of the obligation. However, in the case of a tax-exempt obligation that is subject to § 1.1275–4(d)(2) (an obligation that provides for interest-based or revenue-based payments), the issue price of the obligation is the greater of the obligation's fair market value and its stated principal amount.

(3) *Effective date.* This paragraph (j) applies to debt instruments issued on or after August 13, 1996.

[T.D. 8517, 59 FR 4821, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30141, June 14, 1996]

§ 1.1274–3 Potentially abusive situations defined.

(a) *In general.* For purposes of section 1274, a potentially abusive situation means-—

(1) A tax shelter (as defined in section 6662(d)(2)(C)(ii)); or

(2) Any other situation involving—

(i) A recent sales transaction;

(ii) Nonrecourse financing;

(iii) Financing with a term in excess of the useful life of the property; or

(iv) A debt instrument with clearly excessive interest.

(b) *Operating rules*—(1) *Debt instrument exchanged for nonrecourse financing.* Nonrecourse financing does not include an exchange of a nonrecourse debt instrument for an outstanding recourse or nonrecourse debt instrument.

(2) *Nonrecourse debt with substantial down payment.* Nonrecourse financing does not include a sale or exchange of a real property interest financed by a nonrecourse debt instrument if, in addition to the nonrecourse debt instrument, the purchaser makes a down payment in money that equals or exceeds 20 percent of the total stated purchase price of the real property interest. For purposes of the preceding sentence, a real property interest means any interest, other than an interest solely as a creditor, in real property.

(3) *Clearly excessive interest.* Interest on a debt instrument is clearly excessive if the interest, in light of the terms of the debt instrument and the creditworthiness of the borrower, is clearly greater than the arm's length amount of interest that would have been charged in a cash lending transaction between the same two parties.

(c) *Other situations to be specified by Commissioner.* The Commissioner may designate in the Internal Revenue Bulletin situations that, although described in paragraph (a)(2) of this section, will not be treated as potentially abusive because they do not have the effect of significantly misstating basis or amount realized (see § 601.601(d)(2)(ii) of this chapter).

(d) *Consistency rule.* The issuer's determination that the debt instrument is or is not issued in a potentially abusive situation is binding on all holders of the debt instrument. However, the issuer's determination is not binding on a holder who explicitly discloses a position that is inconsistent with the issuer's determination. Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed Federal income tax return for the taxable year that includes the acquisition date of the debt instrument. See § 1.1275–2(e) for rules relating to the issuer's obligation to disclose certain information to holders.

[T.D. 8517, 59 FR 4822, Feb. 2, 1994]

§ 1.1274–4 Test rate.

(a) *Determination of test rate of interest*—(1) *In general*—(i) *Test rate is the 3-month rate.* Except as provided in paragraph (a)(2) of this section, the test rate of interest for a debt instrument issued in consideration for the sale or exchange of property is the 3-month rate.

(ii) *The 3-month rate.* Except as provided in paragraph (a)(1)(iii) of this section, the 3-month rate is the lower of—

(A) The lowest applicable Federal rate (based on the appropriate compounding period) in effect during the 3-month period ending with the first month in which there is a binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated; or

(B) The lowest applicable Federal rate (based on the appropriate compounding period) in effect during the 3-month period ending with the month in which the sale or exchange occurs.

(iii) *Special rule if there is no binding written contract.* If there is no binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated, the 3-month rate is the lowest applicable Federal rate (based on the appropriate compounding period) in effect during the 3-month period ending with the month in which the sale or exchange occurs.

(2) *Test rate for certain debt instruments*—(i) *Sale-leaseback transactions.* Under section 1274(e) (relating to certain sale-leaseback transactions), the test rate is 110 percent of the 3-month rate determined under paragraph (a)(1) of this section. For purposes of section 1274(e)(3), related party means a person related to the transferor within the meaning of section 267(b) or 707(b)(1).

(ii) *Qualified debt instrument.* Under section 1274A(a), the test rate for a qualified debt instrument is no greater than 9 percent, compounded semiannually, or an equivalent rate based on an appropriate compounding period.

(iii) *Alternative test rate for short-term obligations*—(A) *Requirements.* This paragraph (a)(2)(iii)(A) provides an alternative test rate under section 1274(d)(1)(D) for a debt instrument with a maturity of 1 year or less. This alternative test rate applies, however, only if the debt instrument provides for adequate stated interest using the alternative test rate, the issuer provides on the face of the debt instrument that the instrument qualifies as having adequate stated interest under section 1274(d)(1)(D), and the issuer and holder treat or agree to treat the instrument as having adequate stated interest.

(B) *Alternative test rate.* For purposes of paragraph (a)(2)(iii)(A), the alternative test rate is the market yield on U.S. Treasury bills with the same maturity date as the debt instrument. If the same maturity date is not available, the market yield on U.S. Treasury bills that mature in the same week or month as the debt instrument is used. The alternative test rate is determined as of the date on which there is a binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated or as of the date of the sale or exchange, whichever date results in a lower rate. If there is no binding written contract, however, the alternative test rate is determined as of the date of the sale or exchange.

(b) *Applicable Federal rate.* Except as otherwise provided in this section, the applicable Federal rate for a debt instrument is based on the term of the instrument (i.e., short-term, mid-term, or long-term). See section 1274(d)(1). The Internal Revenue Service publishes the applicable Federal rates for each month in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter). The applicable Federal rates are based on the yield to maturity of outstanding marketable obligations of the United States of similar maturities during the one month period ending on the 14th day of the month preceding the month for which the rates are applicable.

(c) *Special rules to determine the term of a debt instrument for purposes of determining the applicable Federal rate*—(1) *Installment obligation.* If a debt instrument is an installment obligation (as defined in §1.1273–1(e)(1)), the term of the instrument is the instrument's weighted average maturity (as defined in §1.1273–1(e)(3)).

(2) *Certain variable rate debt instruments*—(i) *In general.* Except as otherwise provided in paragraph (c)(2)(ii) of this section, if a variable rate debt instrument (as defined in §1.1275–5(a)) provides for stated interest at a qualified floating rate (or rates), the term of the instrument is determined by reference to the longest interval between interest adjustment dates, or, if the variable rate debt instrument provides for a fixed rate, the interval between the issue date and the last day on which the fixed rate applies, if this interval is longer.

(ii) *Restrictions on adjustments.* If, due to significant restrictions on variations in a qualified floating rate or the use of certain formulae pursuant to §1.1275–5(b)(2) (e.g., 15 percent of 1-year LIBOR, plus 800 basis points), the rate in substance resembles a fixed rate, the applicable Federal rate is determined by reference to the term of the debt instrument.

(3) *Counting of either the issue date or the maturity date.* The term of a debt instrument includes either the issue date or the maturity date, but not both dates.

(4) *Certain debt instruments that provide for principal payments uncertain as to time.* If a debt instrument provides for principal payments that are fixed in total amount but uncertain as to time, the term of the instrument is determined by reference to the latest possible date on which a principal payment can be made or, in the case of an installment obligation, by reference to the longest weighted average maturity under any possible payment schedule.

(d) *Foreign currency loans.* If all of the payments of a debt instrument are denominated in, or determined by reference to, a currency other than the U.S. dollar, the applicable Federal rate for the debt instrument is a foreign currency rate of interest that is analogous to the applicable Federal rate described in this section. For this purpose, an analogous rate of interest is a rate based on yields (with the appropriate compounding period) of the highest grade of outstanding marketable obligations denominated in such currency (excluding any obligations that benefit from special tax exemptions or preferential tax rates not available to debt instruments generally) with due consideration given to the maturities of the obligations.

(e) *Examples.* The following examples illustrate the rules of this section.

Example 1. Variable rate debt instrument that limits the amount of increase and decrease in the rate—(i) *Facts.* On July 1, 1996, A sells nonpublicly traded property to B in return for a 5-year debt instrument that provides for interest to be paid on July 1 of each year, beginning on July 1, 1997, based on the prime rate of a local bank on that date. However, the interest rate cannot increase or decrease from one year to the next by more than .25 percentage points (25 basis points).

(ii) *Significant restriction.* The debt instrument is a variable rate debt instrument (as defined in § 1.1275–5) that provides for stated interest at a qualified floating rate. Assume that based on all the facts and circumstances, the restriction is a significant restriction on the variations in the rate of interest. Under paragraph (c)(2)(ii) of this section, the applicable Federal rate is determined by reference to the term of the debt instrument, and the applicable Federal rate is the Federal mid-term rate.

Example 2. Installment obligation—(i) *Facts.* On January 1, 1996, A sells nonpublicly traded property to B in exchange for a debt instrument that calls for a payment of $500,000 on January 1, 2001, and a payment of $1,000,000 on January 1, 2006. The debt instrument does not provide for any stated interest.

(ii) *Determination of term.* The debt instrument is an installment obligation. Under paragraph (c)(1) of this section, the term of the debt instrument is its weighted average maturity (as defined in § 1.1273–1(e)(3)). The debt instrument's weighted average maturity is 8.33 years, which is the sum of (A) the ratio of the first payment to total payments (500,000/1,500,000), multiplied by the number of complete years from the issue date until the payment is due (5 years), and (B) the ratio of the second payment to total payments (1,000,000/1,500,000), multiplied by the number of complete years from the issue date until the second payment is due (10 years).

(iii) *Applicable Federal rate.* Based on the calculation in paragraph (ii) of this example, the term of the debt instrument is treated as 8.33 years. Consequently, the applicable Federal rate is the Federal mid-term rate.

[T.D. 8517, 59 FR 4823, Feb. 2, 1994]

§ 1.1274–5 Assumptions.

(a) *In general.* Section 1274 does not apply to a debt instrument if the debt instrument is assumed, or property is taken subject to the debt instrument, in connection with a sale or exchange of property, unless the terms of the debt instrument, as part of the sale or exchange, are modified in a manner that would constitute an exchange under section 1001.

(b) *Modifications of debt instruments*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, if a debt instrument is assumed, or property is taken subject to a debt instrument, in connection with a sale or exchange of property, the terms of the debt instrument are modified as part of the sale or exchange, and the modification triggers an exchange under section 1001, the modification is treated as a separate transaction taking place immediately before the sale or exchange and is attributed to the seller of the property. For purposes of this paragraph (b), a debt instrument is not considered to be modified as part of the sale or exchange unless the seller knew or had reason to know about the modification.

(2) *Election to treat buyer as modifying the debt instrument*—(i) *In general.* Rather than having the rules in paragraph (b)(1) of this section apply, the seller and buyer may jointly elect to treat the transaction as one in which the buyer first assumed the original (unmodified) debt instrument and then subsequently modified the debt instrument. For this purpose, the modification is treated as a separate transaction taking place immediately after the sale or exchange.

(ii) *Time and manner of making the election.* The buyer and seller make the election under paragraph (b)(2)(i) of this section by jointly signing a statement that includes the names, addresses, and taxpayer identification numbers of the seller and buyer, and a clear indication that the election is being made under paragraph (b)(2)(i) of this section. Both the buyer and the seller must sign this statement not later than the earlier of the last day (including extensions) for filing the Federal income tax return of the buyer or seller for the taxable year in which the sale or exchange of the property occurs. The buyer and seller should attach this signed statement (or a copy thereof) to their timely filed Federal income tax returns.

(c) *Wraparound indebtedness.* For purposes of paragraph (a) of this section, the issuance of wraparound indebtedness is not considered an assumption.

(d) *Consideration attributable to assumed debt.* If, as part of the consideration for the sale or exchange of property, the buyer assumes, or takes the property subject to, an indebtedness that was issued with OID (including a debt instrument issued in a prior sale or exchange to which section 1274 applied), the portion of the buyer's basis in the property and the seller's amount realized attributable to the debt instrument equals the adjusted issue price of the debt instrument as of the date of the sale or exchange.

[T.D. 8517, 59 FR 4824, Feb. 2, 1994]

§ 1.1274A–1 Special rules for certain transactions where stated principal amount does not exceed $2,800,000.

(a) *In general.* Section 1274A allows the use of a lower test rate for purposes of sections 483 and 1274 in the case of a qualified debt instrument (as defined in section 1274A(b)) and, if elected by the borrower and the lender, the use of the cash receipts and disbursements method of accounting for interest on a cash method debt instrument (as defined in section 1274A(c)(2)). This section provides special rules for qualified debt instruments and cash method debt instruments.

(b) *Rules for both qualified and cash method debt instruments*—(1) *Sale-leaseback transactions.* A debt instrument issued in a sale-leaseback transaction (within the meaning of section 1274(e)) cannot be either a qualified debt instrument or a cash method debt instrument.

(2) *Debt instruments calling for contingent payments.* A debt instrument that provides for contingent payments cannot be a qualified debt instrument unless it can be determined at the time of the sale or exchange that the maximum stated principal amount due under the debt instrument cannot exceed the amount specified in section 1274A(b). Similarly, a debt instrument that provides for contingent payments cannot be a cash method debt instrument unless it can be determined at the time of the sale or exchange that the maximum stated principal amount due under the debt instrument cannot exceed the amount specified in section 1274A(c)(2)(A).

(3) *Aggregation of transactions*—(i) *General rule.* The aggregation rules of section 1274A(d)(1) are applied using a facts and circumstances test.

(ii) *Examples.* The following examples illustrate the application of section 1274A(d)(1) and paragraph (b)(3)(i) of this section.

Example 1. Aggregation of two sales to a single person. In two transactions evidenced by separate sales agreements, A sells undivided half interests in Blackacre to B. The sales are pursuant to a plan for the sale of a 100 percent interest in Blackacre to B. These sales or exchanges are part of a series of related transactions and, thus, are treated as a single sale for purposes of section 1274A.

Example 2. Aggregation of two purchases by unrelated individuals. Pursuant to a plan, unrelated individuals X and Y purchase undivided half interests in Blackacre from A and subsequently contribute these interests to a partnership in exchange for equal interests in the partnership. These purchases are treated as part of the same transaction and, thus, are treated as a single sale for purposes of section 1274A.

Example 3. Aggregation of sales made pursuant to a tender offer. Fifteen unrelated individuals own all of the stock of X Corporation. Y Corporation makes a tender offer to these 15 shareholders. The terms offered to each shareholder are identical. Shareholders holding a majority of the shares of X Corporation elect to tender their shares pursuant to Y Corporation's offer. These sales are part of the same transaction and, thus, are treated as a single sale for purposes of section 1274A.

Example 4. No aggregation for separate sales of similar property to unrelated persons. Pursuant to a newspaper advertisement, X Corporation offers for sale similar condominiums in a single building. The prices of the units vary due to a variety of factors, but the financing terms offered by X Corporation to all buyers are identical. The units are purchased by unrelated buyers who decided whether to purchase units in the building at the price and on the terms offered by X Corporation, without regard to the actions of other buyers. Because each buyer acts individually, the sales are not part of the same transaction or a series of related transactions and, thus, are treated as separate sales.

(4) *Inflation adjustment of dollar amounts.* Under section 1274A(d)(2), the dollar amounts specified in sections 1274A(b) and 1274A(c)(2)(A) are adjusted for inflation. The dollar amounts, adjusted for inflation, are published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter).

(c) *Rules for cash method debt instruments*—(1) *Time and manner of making cash method election.* The borrower and lender make the election described in section 1274A(c)(2)(D) by jointly signing a statement that includes the names, addresses, and taxpayer identification numbers of the borrower and lender, a clear indication that an election is being made under section 1274A(c)(2), and a declaration that the debt instrument with respect to which the election is being made fulfills the requirements of a cash method debt instrument. Both the borrower and the lender must sign this statement not later than the earlier of the last day (including extensions) for filing the Federal income tax return of the borrower or lender for the taxable year in which the debt instrument is issued. The borrower and lender should attach this signed statement (or a copy thereof) to their timely filed Federal income tax returns.

(2) *Successors of electing parties.* Except as otherwise provided in this paragraph (c)(2), the cash method election under section 1274A(c) applies to any successor of the electing lender or borrower. Thus, for any period after the transfer of a cash method debt instrument, the successor takes into account the interest (including unstated interest) on the instrument under the cash receipts and disbursements method of accounting. Nevertheless, if the lender (or any successor thereof) transfers the cash method debt instrument to a taxpayer who uses an accrual method of accounting, section 1272 rather than section 1274A(c) applies to the successor of the lender with respect to the debt instrument for any period after the date of the transfer. The borrower (or any successor thereof), however, remains on the cash receipts and disbursements method of accounting with respect to the cash method debt instrument.

(3) *Modified debt instrument.* In the case of a debt instrument issued in a debt-for-debt exchange that qualifies as an exchange under section 1001, the debt instrument is eligible for the election to be a cash method debt instrument if the other prerequisites to making the election in section 1274A(c) are met. However, if a principal purpose of the modification is to defer interest income or deductions through the use of the election, then the debt instrument is not eligible for the election.

(4) *Debt incurred or continued to purchase or carry a cash method debt instrument.* If a debt instrument is incurred or continued to purchase or carry a cash method debt instrument, rules similar to those under section 1277 apply to determine the timing of the interest deductions for the debt instrument. For purposes of the preceding

sentence, rules similar to those under section 265(a)(2) apply to determine whether a debt instrument is incurred or continued to purchase or carry a cash method debt instrument.

[T.D. 8517, 59 FR 4824, Feb. 2, 1994]

§1.1275–1 Definitions.

(a) *Applicability.* The definitions contained in this section apply for purposes of sections 163(e) and 1271 through 1275 and the regulations thereunder.

(b) *Adjusted issue price*—(1) *In general.* The adjusted issue price of a debt instrument at the beginning of the first accrual period is the issue price. Thereafter, the adjusted issue price of the debt instrument is the issue price of the debt instrument—

(i) Increased by the amount of OID previously includible in the gross income of any holder (determined without regard to section 1272(a)(7) and section 1272(c)(1)); and

(ii) Decreased by the amount of any payment previously made on the debt instrument other than a payment of qualified stated interest. See §1.1275–2(f) for rules regarding adjustments to adjusted issue price on a pro rata prepayment.

(2) *Bond issuance premium.* If a debt instrument is issued with bond issuance premium (as defined in §1.163–13(c)), for purposes of determining the issuer's adjusted issue price, the adjusted issue price determined under paragraph (b)(1) of this section is also decreased by the amount of bond issuance premium previously allocable under §1.163–13(d)(3).

(3) *Adjusted issue price for subsequent holders.* For purposes of calculating OID accruals, acquisition premium, or market discount, a holder (other than a purchaser at original issuance) determines adjusted issue price in any manner consistent with the regulations under sections 1271 through 1275.

(c) *OID.* OID means original issue discount (as defined in section 1273(a) and §1.1273–1).

(d) *Debt instrument.* Except as provided in section 1275(a)(1)(B) (relating to certain annuity contracts; see paragraph (j) of this section), debt instrument means any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law (including, for example, a certificate of deposit or a loan). Nothing in the regulations under sections 163(e), 483, and 1271 through 1275, however, shall influence whether an instrument constitutes indebtedness for Federal income tax purposes.

(e) *Tax-exempt obligations.* For purposes of section 1275(a)(3)(B), exempt from tax means exempt from Federal income tax.

(f) *Issue.* Two or more debt instruments are part of the same issue if they have the same credit and payment terms and are sold reasonably close in time either pursuant to a common plan or as part of a single transaction or a series of related transactions. See §1.1275–2(d)(2) for special rules relating to reopenings of Treasury securities.

(g) *Debt instruments issued by a natural person.* If an entity is a primary obligor under a debt instrument, the debt instrument is considered to be issued by the entity and not by a natural person even if a natural person is a co-maker and is jointly liable for the debt instrument's repayment. A debt instrument issued by a partnership is considered to be issued by the partnership as an entity even if the partnership is composed entirely of natural persons.

(h) *Publicly offered debt instrument.* A debt instrument is publicly offered if it is part of an issue of debt instruments the initial offering of which—

(1) Is registered with the Securities and Exchange Commission; or

(2) Would be required to be registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) but for an exemption from registration—

(i) Under section 3 of the Securities Act of 1933 (relating to exempted securities);

(ii) Under any law (other than the Securities Act of 1933) because of the identity of the issuer or the nature of the security; or

(iii) Because the issue is intended for distribution to persons who are not United States persons.

(i) [Reserved]

(j) *Life annuity exception under section 1275(a)(1)(B)(i)*—(1) *Purpose.* Section

1275(a)(1)(B)(i) excepts an annuity contract from the definition of *debt instrument* if section 72 applies to the contract and the contract depends (in whole or in substantial part) on the life expectancy of one or more individuals. This paragraph (j) provides rules to ensure that an annuity contract qualifies for the exception in section 1275(a)(1)(B)(i) only in cases where the life contingency under the contract is real and significant.

(2) *General rule*—(i) *Rule.* For purposes of section 1275(a)(1)(B)(i), an annuity contract depends (in whole or in substantial part) on the life expectancy of one or more individuals only if—

(A) The contract provides for periodic distributions made not less frequently than annually for the life (or joint lives) of an individual (or a reasonable number of individuals); and

(B) The contract does not contain any terms or provisions that can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants).

(ii) *Terminology.* For purposes of this paragraph (j):

(A) *Contract.* The term *contract* includes all written or unwritten understandings among the parties as well as any person or persons acting in concert with one or more of the parties.

(B) *Annuitant.* The term *annuitant* refers to the individual (or reasonable number of individuals) referred to in paragraph (j)(2)(i)(A) of this section.

(C) *Terminating death.* The phrase *terminating death* refers to the annuitant death that can terminate periodic distributions under the contract. (See paragraph (j)(2)(i)(A) of this section.) For example, if a contract provides for periodic distributions until the later of the death of the last-surviving annuitant or the end of a term certain, the terminating death is the death of the last-surviving annuitant.

(iii) *Coordination with specific rules.* Paragraphs (j) (3) through (7) of this section describe certain terms and conditions that can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). If a term or provision is not specifically described in paragraphs (j) (3) through (7) of this section, the annuity contract must be tested under the general rule of paragraph (j)(2)(i) of this section to determine whether it depends (in whole or in substantial part) on the life expectancy of one or more individuals.

(3) *Availability of a cash surrender option*—(i) *Impact on life contingency.* The availability of a cash surrender option can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). Thus, the availability of any cash surrender option causes the contract to fail to be described in section 1275(a)(1)(B)(i). A cash surrender option is available if there is reason to believe that the issuer (or a person acting in concert with the issuer) will be willing to terminate or purchase all or a part of the annuity contract by making one or more payments of cash or property (other than an annuity contract described in this paragraph (j)).

(ii) *Examples.* The following examples illustrate the rules of this paragraph (j)(3):

Example 1. (i) *Facts.* On March 1, 1998, X issues a contract to A for cash. The contract provides that, effective on any date chosen by A (the annuity starting date), X will begin equal monthly distributions for A's life. The amount of each monthly distribution will be no less than an amount based on the contract's account value as of the annuity starting date, A's age on that date, and permanent purchase rate guarantees contained in the contract. The contract also provides that, at any time before the annuity starting date, A may surrender the contract to X for the account value less a surrender charge equal to a declining percentage of the account value. For this purpose, the initial account value is equal to the cash invested. Thereafter, the account value increases annually by at least a minimum guaranteed rate.

(ii) *Analysis.* The ability to obtain the account value less the surrender charge, if any, is a cash surrender option. This ability can significantly reduce the probability that total distributions under the contract will increase commensurately with A's longevity. Thus, the contract fails to be described in section 1275(a)(1)(B)(i).

Example 2. (i) *Facts.* On March 1, 1998, X issues a contract to B for cash. The contract provides that beginning on March 1, 1999, X will distribute to B a fixed amount of cash each month for B's life. Based on X's advertisements, marketing literature, or illustrations or on oral representations by X's sales personnel, there is reason to believe that an affiliate of X stands ready to purchase B's contract for its commuted value.

(ii) *Analysis.* Because there is reason to believe that an affiliate of X stands ready to purchase B's contract for its commuted value, a cash surrender option is available within the meaning of paragraph (j)(3)(i) of this section. This availability can significantly reduce the probability that total distributions under the contract will increase commensurately with B's longevity. Thus, the contract fails to be described in section 1275(a)(1)(B)(i).

(4) *Availability of a loan secured by the contract*—(i) *Impact on life contingency.* The availability of a loan secured by the contract can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). Thus, the availability of any such loan causes the contract to fail to be described in section 1275(a)(1)(B)(i). A loan secured by the contract is available if there is reason to believe that the issuer (or a person acting in concert with the issuer) will be willing to make a loan that is directly or indirectly secured by the annuity contract.

(ii) *Example.* The following example illustrates the rules of this paragraph (j)(4):

Example: (i) *Facts.* On March 1, 1998, X issues a contract to C for $100,000. The contract provides that, effective on any date chosen by C (the annuity starting date), X will begin equal monthly distributions for C's life. The amount of each monthly distribution will be no less than an amount based on the contract's account value as of the annuity starting date, C's age on that date, and permanent purchase rate guarantees contained in the contract. From marketing literature circulated by Y, there is reason to believe that, at any time before the annuity starting date, C may pledge the contract to borrow up to $75,000 from Y. Y is acting in concert with X.

(ii) *Analysis.* Because there is reason to believe that Y, a person acting in concert with X, is willing to lend money against C's contract, a loan secured by the contract is available within the meaning of paragraph (j)(4)(i) of this section. This availability can significantly reduce the probability that total distributions under the contract will increase commensurately with C's longevity. Thus, the contract fails to be described in section 1275(a)(1)(B)(i).

(5) *Minimum payout provision*—(i) *Impact on life contingency.* The existence of a minimum payout provision can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). Thus, the existence of any minimum payout provision causes the contract to fail to be described in section 1275(a)(1)(B)(i).

(ii) *Definition of minimum payout provision.* A minimum payout provision is a contractual provision (for example, an agreement to make distributions over a term certain) that provides for one or more distributions made—

(A) After the terminating death under the contract; or

(B) By reason of the death of any individual (including distributions triggered by or increased by terminal or chronic illness, as defined in section 101(g)(1) (A) and (B)).

(iii) *Exceptions for certain minimum payouts*—(A) *Recovery of consideration paid for the contract.* Notwithstanding paragraphs (j)(2)(i)(A) and (j)(5)(i) of this section, a contract does not fail to be described in section 1275(a)(1)(B)(i) merely because it provides that, after the terminating death, there will be one or more distributions that, in the aggregate, do not exceed the consideration paid for the contract less total distributions previously made under the contract.

(B) *Payout for one-half of life expectancy.* Notwithstanding paragraphs (j)(2)(i)(A) and (j)(5)(i) of this section, a contract does not fail to be described in section 1275(a)(1)(B)(i) merely because it provides that, if the terminating death occurs after the annuity starting date, distributions under the contract will continue to be made after the terminating death until a date that is no later than the halfway date. This exception does not apply unless the amounts distributed in each contract year will not exceed the amounts that would have been distributed in that year if the terminating death had not occurred until the expected date of the terminating death, determined under paragraph (j)(5)(iii)(C) of this section.

(C) *Definition of halfway date.* For purposes of this paragraph (j)(5)(iii), the halfway date is the date halfway between the annuity starting date and the expected date of the terminating death, determined as of the annuity starting date, with respect to all then-surviving annuitants. The expected date of the terminating death must be determined by reference to the applicable mortality table prescribed under section 417(e)(3)(A)(ii)(I).

(iv) *Examples.* The following examples illustrate the rules of this paragraph (j)(5):

Example 1. (i) *Facts.* On March 1, 1998, X issues a contract to D for cash. The contract provides that, effective on any date D chooses (the annuity starting date), X will begin equal monthly distributions for the greater of D's life or 10 years, regardless of D's age as of the annuity starting date. The amount of each monthly distribution will be no less than an amount based on the contract's account value as of the annuity starting date, D's age on that date, and permanent purchase rate guarantees contained in the contract.

(ii) *Analysis.* A minimum payout provision exists because, if D dies within 10 years of the annuity starting date, one or more distributions will be made after D's death. The minimum payout provision does not qualify for the exception in paragraph (j)(5)(iii)(B) of this section because D may defer the annuity starting date until his remaining life expectancy is less than 20 years. If, on the annuity starting date, D's life expectancy is less than 20 years, the minimum payout period (10 years) will last beyond the halfway date. The minimum payout provision, therefore, can significantly reduce the probability that total distributions under the contract will increase commensurately with D's longevity. Thus, the contract fails to be described in section 1275(a)(1)(B)(i).

Example 2. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (j)(5)(iv) except that the monthly distributions will last for the greater of D's life or a term certain. D may choose the length of the term certain subject to the restriction that, on the annuity starting date, the term certain must not exceed one-half of D's life expectancy as of the annuity starting date. The contract also does not provide for any adjustment in the amount of distributions by reason of the death of D or any other individual, except for a refund of D's aggregate premium payments less the sum of all prior distributions under the contract.

(ii) *Analysis.* The minimum payout provision qualifies for the exception in paragraph (j)(5)(iii)(B) of this section because distributions under the minimum payout provision will not continue past the halfway date and the contract does not provide for any adjustments in the amount of distributions by reason of the death of D or any other individual, other than a guaranteed death benefit described in paragraph (j)(5)(iii)(A) of this section. Accordingly, the existence of this minimum payout provision does not prevent the contract from being described in section 1275(a)(1)(B)(i).

(6) *Maximum payout provision*—(i) *Impact on life contingency.* The existence of a maximum payout provision can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). Thus, the existence of any maximum payout provision causes the contract to fail to be described in section 1275(a)(1)(B)(i).

(ii) *Definition of maximum payout provision.* A maximum payout provision is a contractual provision that provides that no distributions under the contract may be made after some date (the termination date), even if the terminating death has not yet occurred.

(iii) *Exception.* Notwithstanding paragraphs (j)(2)(i)(A) and (j)(6)(i) of this section, an annuity contract does not fail to be described in section 1275(a)(1)(B)(i) merely because the contract contains a maximum payout provision, provided that the period of time from the annuity starting date to the termination date is at least twice as long as the period of time from the annuity starting date to the expected date of the terminating death, determined as of the annuity starting date, with respect to all then-surviving annuitants. The expected date of the terminating death must be determined by reference to the applicable mortality table prescribed under section 417(e)(3)(A)(ii)(I).

(iv) *Example.* The following example illustrates the rules of this paragraph (j)(6):

Example: (i) *Facts.* On March 1, 1998, X issues a contract to E for cash. The contract provides that beginning on April 1, 1998, X will distribute to E a fixed amount of cash each month for E's life but that no distributions will be made after April 1, 2018. On April 1, 1998, E's life expectancy is 9 years.

(ii) *Analysis.* A maximum payout provision exists because if E survives beyond April 1, 2018, E will receive no further distributions under the contract. The period of time from the annuity starting date (April 1, 1998) to the termination date (April 1, 2018) is 20 years. Because this 20-year period is more than twice as long as E's life expectancy on April 1, 1998, the maximum payout provision qualifies for the exception in paragraph (j)(6)(iii) of this section. Accordingly, the existence of this maximum payout provision does not prevent the contract from being described in section 1275(a)(1)(B)(i).

(7) *Decreasing payout provision*—(i) *General rule.* If the amount of distributions during any contract year (other than the last year during which distributions are made) may be less than the amount of distributions during the preceding year, this possibility can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). Thus, the existence of this possibility causes the contract to fail to be described in section 1275(a)(1)(B)(i).

(ii) *Exception for certain variable distributions.* Notwithstanding paragraph (j)(7)(i) of this section, if an annuity contract provides that the amount of each distribution must increase and decrease in accordance with investment experience, cost of living indices, or similar fluctuating criteria, then the possibility that the amount of a distribution may decrease for this reason does not significantly reduce the probability that the distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants).

(iii) *Examples.* The following examples illustrate the rules of this paragraph (j)(7):

Example 1. (i) *Facts.* On March 1, 1998, X issues a contract to F for $100,000. The contract provides that beginning on March 1, 1999, X will make distributions to F each year until F's death. Prior to March 1, 2009, distributions are to be made at a rate of $12,000 per year. Beginning on March 1, 2009, distributions are to be made at a rate of $3,000 per year.

(ii) *Analysis.* If F is alive in 2009, the amount distributed in 2009 ($3,000) will be less than the amount distributed in 2008 ($12,000). The exception in paragraph (j)(7)(ii) of this section does not apply. The decrease in the amount of any distributions made on or after March 1, 2009, can significantly reduce the probability that total distributions under the contract will increase commensurately with F's longevity. Thus, the contract fails to be described in section 1275(a)(1)(B)(i).

Example 2. (i) *Facts.* On March 1, 1998, X issues a contract to G for cash. The contract provides that, effective on any date G chooses (the annuity starting date), X will begin monthly distributions to G for G's life. Prior to the annuity starting date, the account value of the contract reflects the investment return, including changes in the market value, of an identifiable pool of assets. When G chooses the annuity starting date, G must also choose whether the distributions are to be fixed or variable. If fixed, the amount of each monthly distribution will remain constant at an amount that is no less than an amount based on the contract's account value as of the annuity starting date, G's age on that date, and permanent purchase rate guarantees contained in the contract. If variable, the monthly distributions will fluctuate to reflect the investment return, including changes in the market value, of the pool of assets. The monthly distributions under the contract will not otherwise decline from year to year.

(ii) *Analysis.* Because the only possible year-to-year declines in annuity distributions are described in paragraph (j)(7)(ii) of this section, the possibility that the amount of distributions may decline from the previous year does not reduce the probability that total distributions under the contract will increase commensurately with G's longevity. Thus, the potential fluctuation in the annuity distributions does not cause the contract to fail to be described in section 1275(a)(1)(B)(i).

(8) *Effective dates*—(i) *In general.* Except as provided in paragraph (j)(8) (ii) and (iii) of this section, this paragraph (j) is applicable for interest accruals on or after February 9, 1998 on annuity contracts held on or after February 9, 1998.

(ii) *Grandfathered contracts.* This paragraph (j) does not apply to an annuity contract that was purchased before April 7, 1995. For purposes of this paragraph (j)(8), if any additional investment in such a contract is made on or after April 7, 1995, and the additional investment is not required to be made under a binding contractual obligation that was entered into before April 7, 1995, then the additional investment is treated as the purchase of a contract after April 7, 1995.

(iii) *Contracts consistent with the provisions of FI–33–94, published at 1995–1 C.B. 920. See §601.601(d)(2)(ii)(b) of this chapter.* This paragraph (j) does not apply to a contract purchased on or after April 7, 1995, and before February 9, 1998, if all payments under the contract are periodic payments that are made at least annually for the life (or lives) of one or more individuals, do not increase at any time during the term of the contract, and are part of a series of distributions that begins within one year of the date of the initial investment in the contract. An annuity contract that is otherwise described in the preceding sentence does not fail to be described therein merely because it also provides for a payment (or payments) made by reason of the death of one or more individuals.

[T.D. 8517, 59 FR 4825, Feb. 2, 1994, as amended by T.D. 8746, 62 FR 68183, Dec. 31, 1997; T.D. 8754, 63 FR 1057, Jan. 8, 1998]

§ 1.1275–2 Special rules relating to debt instruments.

(a) *Payment ordering rule*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, each payment under a debt instrument is treated first as a payment of OID to the extent of the OID that has accrued as of the date the payment is due and has not been allocated to prior payments, and second as a payment of principal. Thus, no portion of any payment is treated as prepaid interest.

(2) *Exceptions.* The rule in paragraph (a)(1) of this section does not apply to—

(i) A payment of qualified stated interest;

(ii) A payment of points deductible under section 461(g)(2), in the case of the issuer;

(iii) A pro rata prepayment described in paragraph (f)(2) of this section; or

(iv) A payment of additional interest or a similar charge provided with respect to amounts that are not paid when due.

(b) *Debt instruments distributed by corporations with respect to stock*—(1) *Treatment of distribution.* For purposes of determining the issue price of a debt instrument distributed by a corporation with respect to its stock, the instrument is treated as issued by the corporation for property. See section 1275(a)(4). Thus, under section 1273(b)(3), the issue price of a distributed debt instrument that is traded on an established market is its fair market value. The issue price of a distributed debt instrument that is not traded on an established market is determined under section 1274 or section 1273(b)(4).

(2) *Issue date.* The issue date of a debt instrument distributed by a corporation with respect to its stock is the date of the distribution.

(c) *Aggregation of debt instruments*—(1) *General rule.* Except as provided in paragraph (c)(2) of this section, debt instruments issued in connection with the same transaction or related transactions (determined based on all the facts and circumstances) are treated as a single debt instrument for purposes of sections 1271 through 1275 and the regulations thereunder. This rule ordinarily applies only to debt instruments of a single issuer that are issued to a single holder. The Commissioner may, however, aggregate debt instruments that are issued by more than one issuer or that are issued to more than one holder if the debt instruments are issued in an arrangement that is designed to avoid the aggregation rule (e.g., debt instruments issued by or to related parties or debt instruments originally issued to different holders with the understanding that the debt instruments will be transferred to a single holder).

(2) *Exception if separate issue price established.* Paragraph (c)(1) of this section does not apply to a debt instrument if—

(i) The debt instrument is part of an issue a substantial portion of which is traded on an established market within the meaning of § 1.1273–2(f); or

(ii) The debt instrument is part of an issue a substantial portion of which is issued for money (or for property traded on an established market within the meaning of § 1.1273–2(f)) to parties who are not related to the issuer or holder and who do not purchase other debt instruments of the same issuer in connection with the same transaction or related transactions.

(3) *Special rule for debt instruments that provide for the issuance of additional debt instruments.* If, under the terms of a debt instrument (the original debt instrument), the holder may receive one or more additional debt instruments of the issuer, the additional debt instrument or instruments are aggregated with the original debt instrument.

Thus, the payments made pursuant to an additional debt instrument are treated as made on the original debt instrument, and the distribution by the issuer of the additional debt instrument is not considered to be a payment made on the original debt instrument. This paragraph (c)(3) applies regardless of whether the right to receive an additional debt instrument is fixed as of the issue date or is contingent upon subsequent events. See §1.1272–1(c) for the treatment of certain rights to issue additional debt instruments in lieu of cash payments.

(4) *Examples.* The following examples illustrate the rules set forth in paragraphs (c)(1) and (c)(2) of this section.

Example 1. Exception for debt instruments issued separately to other purchasers. On January 1, 1995, Corporation M issues two series of bonds, Series A and Series B. The two series are sold for cash and have different terms. Although some holders purchase bonds from both series, a substantial portion of the bonds is issued to different holders. H purchases bonds from both series. Under the exception in paragraph (c)(2)(ii) of this section, the Series A and Series B bonds purchased by H are not aggregated.

Example 2. Tiered REMICs. Z forms a dual tier real estate mortgage investment conduit (REMIC). In the dual tier structure, Z forms REMIC A to acquire a pool of real estate mortgages and to issue a residual interest and several classes of regular interests. Contemporaneously, Z forms REMIC B to acquire as qualified mortgages all of the regular interests in REMIC A. REMIC B issues several classes of regular interests and a residual interest, and Z sells all of those interests to unrelated parties in a public offering. Under the general rule set out in paragraph (c)(1) of this section, all of the regular interests issued by REMIC A and held by REMIC B are treated as a single debt instrument for purposes of sections 1271 through 1275.

(d) *Special rules for Treasury securities*—(1) *Issue price and issue date.* The issue price of an issue of Treasury securities is the average price of the debt instruments sold. The issue date of an issue of Treasury securities is the first settlement date on which a substantial amount of the securities in the issue is sold.

(2) *Reopenings of Treasury securities*—(i) *Treatment of additional Treasury securities.* Additional Treasury securities issued in a qualified reopening are part of the same issue as the original Treasury securities and have the same issue date as the original Treasury securities. The issue price of both the original Treasury securities and the additional Treasury securities is the average price at which the original Treasury securities were sold. This paragraph (d)(2) applies to qualified reopenings that occur on or after March 25, 1992.

(ii) *Definitions*—(A) *Additional Treasury securities.* Additional Treasury securities are Treasury securities with terms that are in all respects identical to the terms of the original Treasury securities and that are issued (without regard to paragraph (d)(2)(i) of this section) not more than 12 months after the original Treasury securities were first issued to the public.

(B) *Original Treasury securities.* Original Treasury securities are securities comprising any issue of outstanding Treasury securities.

(C) *Qualified reopening.* A qualified reopening is a reopening of Treasury securities intended to alleviate an acute, protracted shortage of the original Treasury securities.

(e) *Disclosure of certain information to holders.* Certain provisions of the regulations under section 163(e) and sections 1271 through 1275 provide that the issuer's determination of an item controls the holder's treatment of the item. In such a case, the issuer must provide the relevant information to the holder in a reasonable manner. For example, the issuer may provide the name or title and either the address or telephone number of a representative of the issuer who will make available to holders upon request the information required for holders to comply with these provisions of the regulations.

(f) *Treatment of pro rata prepayments*—(1) *Treatment as retirement of separate debt instrument.* A pro rata prepayment is treated as a payment in retirement of a portion of a debt instrument, which may result in a gain or loss to the holder. Generally, the gain or loss is calculated by assuming that the original debt instrument consists of two instruments, one that is retired and one that remains outstanding. The adjusted issue price, holder's adjusted basis, and accrued but unpaid OID of the original debt instrument, determined immediately before the pro rata prepayment, are allocated between these two instruments based on the portion of the instrument that is treated as retired by the pro rata prepayment.

(2) *Definition of pro rata prepayment.* For purposes of paragraph (f)(1) of this section, a pro rata prepayment is a payment on a debt instrument made prior to maturity that—

(i) Is not made pursuant to the instrument's payment schedule (including a payment schedule determined under § 1.1272–1(c)); and

(ii) Results in a substantially pro rata reduction of each payment remaining to be paid on the instrument.

(g) *Anti-abuse rule*—(1) *In general.* If a principal purpose in structuring a debt instrument or engaging in a transaction is to achieve a result that is unreasonable in light of the purposes of section 163(e), sections 1271 through 1275, or any related section of the Code, the Commissioner can apply or depart from the regulations under the applicable sections as necessary or appropriate to achieve a reasonable result. For example, if this paragraph (g) applies to a debt instrument that provides for a contingent payment, the Commissioner can treat the contingency as if it were a separate position.

(2) *Unreasonable result.* Whether a result is unreasonable is determined based on all the facts and circumstances. In making this determination, a significant fact is whether the treatment of the debt instrument is expected to have a substantial effect on the issuer's or a holder's U.S. tax liability. In the case of a contingent payment debt instrument, another significant fact is whether the result is obtainable without the application of § 1.1275–4 and any related provisions (e.g., if the debt instrument and the contingency were entered into separately). A result will not be considered unreasonable, however, in the absence of an expected substantial effect on the present value of a taxpayer's tax liability.

(3) *Examples.* The following examples illustrate the provisions of this paragraph (g):

Example 1. A issues a current-pay, increasing-rate note that provides for an early call option. Although the option is deemed exercised on the call date under § 1.1272–1(c)(5), the option is not expected to be exercised by A. In addition, a principal purpose of including the option in the terms of the note is to limit the amount of interest income includible by the holder in the period prior to the call date by virtue of the option rules in § 1.1272–1(c)(5). Moreover, the application of the option rules is expected to substantially reduce the present value of the holder's tax liability. Based on these facts, the application of § 1.1272–1(c)(5) produces an unreasonable result. Therefore, under this paragraph (g), the Commissioner can apply the regulations (in whole or in part) to the note without regard to § 1.1272–1(c)(5).

Example 2. C, a foreign corporation not subject to U.S. taxation, issues to a U.S. holder a debt instrument that provides for a contingent payment. The debt instrument is issued for cash and is subject to the noncontingent bond method in § 1.1275–4(b). Six months after issuance, C and the holder modify the debt instrument so that there is a deemed reissuance of the instrument under section 1001. The new debt instrument is subject to the rules of § 1.1275–4(c) rather than § 1.1275–4(b). The application of § 1.1275–4(c) is expected to substantially reduce the present value of the holder's tax liability as compared to the application of § 1.1275–4(b). In addition, a principal purpose of the modification is to substantially reduce the present value of the holder's tax liability through the application of § 1.1275–4(c). Based on these facts, the application of § 1.1275–4(c) produces an unreasonable result. Therefore, under this paragraph (g), the Commissioner can apply the noncontingent bond method to the modified debt instrument.

Example 3. D issues a convertible debt instrument rather than an economically equivalent investment unit consisting of a debt instrument and a warrant. The convertible debt instrument is issued at par and provides for annual payments of interest. D issues the convertible debt instrument rather than the investment unit so that the debt instrument would not have OID. See § 1.1273–2(j). In general, this is a reasonable result in light of the purposes of the applicable statutes. Therefore, the Commissioner generally will not use the authority under this paragraph (g) to depart from the application of §1.1273-2(j) in this case.

(4) *Effective date.* This paragraph (g) applies to debt instruments issued on or after August 13, 1996.

(h) *Remote and incidental contingencies*—(1) *In general.* This paragraph (h) applies to a debt instrument if one or more payments on the instrument are subject to either a remote or incidental contingency. Whether a contingency is remote or incidental is determined as of the issue date of the debt instrument, including any date there is a deemed reissuance of the debt instrument under paragraph (h)(6) (ii) or (j) of this section or §1.1272–1(c)(6). Except as otherwise provided, the treatment of the contingency under this paragraph (h) applies for all purposes of sections 163(e) (other than sections 163(e)(5)) and 1271 through 1275 and the regulations thereunder. For purposes of this paragraph (h), the possibility of impairment of a payment by insolvency, default, or similar circumstances is not a contingency.

(2) *Remote contingencies.* A contingency is remote if there is a remote likelihood either that the contingency will occur or that the contingency will not occur. If there is a remote likelihood that the contingency will occur, it is assumed that the contingency will not occur. If there is a remote likelihood that the contingency will not occur, it is assumed that the contingency will occur.

(3) *Incidental contingencies*—(i) *Contingency relating to amount.* A contingency relating to the amount of a payment is incidental if, under all reasonably expected market conditions, the potential amount of the payment is insignificant relative to the total expected amount of the remaining payments on the debt instrument. If a payment on a debt instrument is subject to an incidental contingency described in this paragraph (h)(3)(i), the payment is ignored until the payment is made. However, see paragraph (h)(6)(i)(B) of this section for the treatment of the debt instrument if a change in circumstances occurs prior to the date the payment is made.

(ii) *Contingency relating to time.* A contingency relating to the timing of a payment is incidental if, under all reasonably expected market conditions, the potential difference in the timing of the payment (from the earliest date to the latest date) is insignificant. If a payment on a debt instrument is subject to an incidental contingency described in this paragraph (h)(3)(ii), the payment is treated as made on the earliest date that the payment could be made pursuant to the contingency. If the payment is not made on this date, a taxpayer makes appropriate adjustments to take into account the delay in payment. However, see paragraph (h)(6)(i)(C) of this section for the treatment of the debt instrument if the delay is not insignificant.

(4) *Aggregation rule.* For purposes of paragraph (h)(2) of this section, if a debt instrument provides for multiple contingencies each of which has a remote likelihood of occurring but, when all of the contingencies are considered together, there is a greater than remote likelihood that at least one of the contingencies will occur, none of the contingencies is treated as a remote contingency. For purposes of paragraph (h)(3)(i) of this section, if a debt instrument provides for multiple contingencies each of which is incidental but the potential total amount of all of the payments subject to the contingencies is not, under reasonably expected market conditions, insignificant relative to the total expected amount of the remaining payments on the debt instrument, none of the contingencies is treated as incidental.

(5) *Consistency rule.* For purposes of paragraphs (h) (2) and (3) of this section, the issuer's determination that a contingency is either remote or incidental is binding on all holders. However, the issuer's determination is not binding on a holder that explicitly discloses that its determination is different from the issuer's determination. Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed Federal income tax return for the taxable year that includes the acquisition date of the debt instrument. See §1.1275–2(e) for rules relating to the issuer's obligation to disclose certain information to holders.

(6) *Subsequent adjustments*—(i) Applicability. This paragraph (h)(6) applies to a debt instrument when there is a change in circumstances. For purposes of the preceding sentence, there is a change in circumstances if—

(A) A remote contingency actually occurs or does not occur, contrary to the assumption made in paragraph (h)(2) of this section;

(B) A payment subject to an incidental contingency described in paragraph (h)(3)(i) of this section becomes fixed in an amount that is not insignificant relative to the total expected amount of the remaining payments on the debt instrument; or

(C) A payment subject to an incidental contingency described in paragraph (h)(3)(ii) of this section becomes fixed such that the difference between the assumed payment date and the due date of the payment is not insignificant.

(ii) *In general.* If a change in circumstances occurs, solely for purposes of sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the change in circumstances for an amount equal to the instrument's adjusted issue price on that date.

(iii) *Contingent payment debt instruments.* Notwithstanding paragraph (h)(6)(ii) of this section, in the case of a contingent payment debt instrument subject to § 1.1275–4, if a change in circumstances occurs, no retirement or reissuance is treated as occurring, but any payment that is fixed as a result of the change in circumstances is governed by the rules in § 1.1275–4 that apply when the amount of a contingent payment becomes fixed.

(7) *Effective date.* This paragraph (h) applies to debt instruments issued on or after August 13, 1996.

(i) [Reserved]

(j) *Treatment of certain modifications.* If the terms of a debt instrument are modified to defer one or more payments, and the modification does not cause an exchange under section 1001, then, solely for purposes of sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the modification for an amount equal to the instrument's adjusted issue price on that date. This paragraph (j) applies to debt instruments issued on or after August 13, 1996.

[T.D. 8517, 59 FR 4826, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30142, June 14, 1996]

§ 1.1275–3 OID information reporting requirements.

(a) *In general.* This section provides legending and information reporting requirements intended to facilitate the reporting of OID.

(b) *Information required to be set forth on face of debt instruments that are not publicly offered*—(1) *In general.* Except as provided in paragraph (b)(4) or paragraph (d) of this section, this paragraph (b) applies to any debt instrument that is not publicly offered (within the meaning of § 1.1275–1(h)), is issued in physical form, and has OID. The issuer of any such debt instrument must legend the instrument by stating on the face of the instrument that the debt instrument was issued with OID. In addition, the issuer must either—

(i) Set forth on the face of the debt instrument the issue price, the amount of OID, the issue date, the yield to maturity, and, in the case of a debt instrument subject to the rules of § 1.1275–4(b), the comparable yield and projected payment schedule; or

(ii) Provide the name or title and either the address or telephone number of a representative of the issuer who will, beginning no later than 10 days after the issue date, promptly make available to holders upon request the information described in paragraph (b)(1)(i) of this section.

(2) *Time for legending.* An issuer may satisfy the requirements of this paragraph (b) by legending the debt instrument when it is first issued in physical form. Legending is not required, however, before the first holder of the debt instrument disposes of the instrument.

(3) *Legend must survive reissuance upon transfer.* Any new physical security that is issued (for example, upon registration of transfer of ownership) must contain any required legend.

(4) *Exceptions.* Paragraph (b)(1) of this section does not apply to debt instruments described in section 1272(a)(2) (relating to debt instruments not subject to the periodic OID inclusion rules), debt instruments issued by natural persons (as defined in § 1.6049–4(f)(2)), REMIC regular interests or other debt instruments subject to section 1272(a)(6), or stripped bonds and coupons within the meaning of section 1286.

(c) *Information required to be reported to Secretary upon issuance of publicly offered debt instruments*—(1) *In general.* Except as provided in paragraph (c)(3) or paragraph (d) of this section, the information reporting requirements of this paragraph (c) apply to any debt instrument that is publicly offered and has original issue discount. The issuer of any such debt instrument must make an information return on the form prescribed by the Commissioner (Form 8281, as of September 2, 1992). The prescribed form must be filed with the Internal Revenue Service in the manner specified on the form. The taxpayer must use the prescribed form even if other information returns are filed using other methods (e.g., electronic media), unless the Commissioner announces otherwise in a revenue procedure.

(2) *Time for filing information return.* The prescribed form must be filed for each issue of publicly offered debt instruments within 30 days after the issue date of the issue.

(3) *Exceptions.* The rules of paragraph (c)(1) of this section do not apply to debt instruments described in section 1272(a)(2), debt instruments issued by natural persons (as defined in §1.6049–4(f)(2)), certificates of deposit, REMIC regular interests or other debt instruments subject to section 1272(a)(6), or (unless otherwise required by the Commissioner pursuant to a revenue ruling or revenue procedure) stripped bonds and coupons (within the meaning of section 1286).

(d) *Application to foreign issuers and U.S. issuers of foreign-targeted debt instruments.* A foreign or domestic issuer is subject to the rules of this section with respect to an issue of debt instruments unless the issue is not offered for sale or resale in the United States in connection with its original issuance.

(e) *Penalties.* See section 6706 for rules relating to the penalty imposed for failure to meet the information reporting requirements imposed by this section.

(f) *Effective date.* Paragraphs (c), (d), and (e) of this section are effective for an issue of debt instruments issued after September 2, 1992.

[T.D. 8431, 57 FR 40322, Sept. 3, 1992; 57 FR 46243, Oct. 7, 1992, as amended by T.D. 8517, 59 FR 4827, Feb. 2, 1994; T.D. 8674, 61 FR 30143, June 14, 1996]

§1.1275–4 Contingent payment debt instruments.

(a) *Applicability*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, this section applies to any debt instrument that provides for one or more contingent payments. In general, paragraph (b) of this section applies to a contingent payment debt instrument that is issued for money or publicly traded property and paragraph (c) of this section applies to a contingent payment debt instrument that is issued for nonpublicly traded property. Paragraph (d) of this section provides special rules for tax-exempt obligations. See §1.1275–6 for a taxpayer's treatment of a contingent payment debt instrument and a hedge.

(2) *Exceptions.* This section does not apply to—

(i) A debt instrument that has an issue price determined under section 1273(b)(4) (e.g., a debt instrument subject to section 483);

(ii) A variable rate debt instrument (as defined in §1.1275–5);

(iii) A debt instrument subject to §1.1272–1(c) (a debt instrument that provides for certain contingencies) or §1.1272–1(d) (a debt instrument that provides for a fixed yield);

(iv) A debt instrument subject to section 988 (except as provided in section 988 and the regulations thereunder);

(v) A debt instrument to which section 1272(a)(6) applies (certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration);

(vi) A debt instrument (other than a tax-exempt obligation) described in section 1272(a)(2) (e.g., U.S. savings bonds, certain loans between natural persons, and short-term taxable obligations);

(vii) An inflation-indexed debt instrument (as defined in §1.1275–7T); or

(viii) A debt instrument issued pursuant to a plan or arrangement if—

(A) The plan or arrangement is created by a state statute;

(B) A primary objective of the plan or arrangement is to enable the participants to pay for the costs of post-secondary education for themselves or their designated beneficiaries; and

(C) Contingent payments on the debt instrument are related to such objective.

(3) *Insolvency and default.* A payment is not contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances.

(4) *Convertible debt instruments.* A debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt instrument into the stock of the issuer, into the stock or debt of a related party (within the meaning of section 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of such stock or debt.

(5) *Remote and incidental contingencies.* A payment is not a contingent payment merely because of a contingency that, as of the issue date, is either remote or incidental. See § 1.1275–2(h) for the treatment of remote and incidental contingencies.

(b) *Noncontingent bond method*—(1) *Applicability.* The noncontingent bond method described in this paragraph (b) applies to a contingent payment debt instrument that has an issue price determined under § 1.1273–2 (e.g., a contingent payment debt instrument that is issued for money or publicly traded property).

(2) *In general.* Under the noncontingent bond method, interest on a debt instrument must be taken into account whether or not the amount of any payment is fixed or determinable in the taxable year. The amount of interest that is taken into account for each accrual period is determined by constructing a projected payment schedule for the debt instrument and applying rules similar to those for accruing OID on a noncontingent debt instrument. If the actual amount of a contingent payment is not equal to the projected amount, appropriate adjustments are made to reflect the difference.

(3) *Description of method.* The following steps describe how to compute the amount of income, deductions, gain, and loss under the noncontingent bond method:

(i) *Step one: Determine the comparable yield.* Determine the comparable yield for the debt instrument under the rules of paragraph (b)(4) of this section. The comparable yield is determined as of the debt instrument's issue date.

(ii) *Step two: Determine the projected payment schedule.* Determine the projected payment schedule for the debt instrument under the rules of paragraph (b)(4) of this section. The projected payment schedule is determined as of the issue date and remains fixed throughout the term of the debt instrument (except under paragraph (b)(9)(ii) of this section, which applies to a payment that is fixed more than 6 months before it is due).

(iii) *Step three: Determine the daily portions of interest.* Determine the daily portions of interest on the debt instrument for a taxable year as follows. The amount of interest that accrues in each accrual period is the product of the comparable yield of the debt instrument (properly adjusted for the length of the accrual period) and the debt instrument's adjusted issue price at the beginning of the accrual period. See paragraph (b)(7)(ii) of this section to determine the adjusted issue price of the debt instrument. The daily portions of interest are determined by allocating to each day in the accrual period the ratable portion of the interest that accrues in the accrual period. Except as modified by paragraph (b)(3)(iv) of this section, the daily portions of interest are includible in income by a holder for each day in the holder's taxable year on which the holder held the debt instrument and are deductible by the issuer for each day during the issuer's taxable year on which the issuer was primarily liable on the debt instrument.

(iv) *Step four: Adjust the amount of income or deductions for differences between projected and actual contingent payments.* Make appropriate adjustments to the amount of income or deductions attributable to the debt instrument in a taxable year for any differences between projected and actual contingent payments. See paragraph (b)(6) of this section to determine the amount of an adjustment and the treatment of the adjustment.

(4) *Comparable yield and projected payment schedule.* This paragraph (b)(4) provides rules for determining the comparable yield and projected payment schedule for a debt instrument.

The comparable yield and projected payment schedule must be supported by contemporaneous documentation showing that both are reasonable, are based on reliable, complete, and accurate data, and are made in good faith.

(i) *Comparable yield*—(A) *In general.* Except as provided in paragraph (b)(4)(i)(B) of this section, the comparable yield for a debt instrument is the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument (the comparable fixed rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions. For example, if a §1.1275–6 hedge (or the substantial equivalent) is available, the comparable yield is the yield on the synthetic fixed rate debt instrument that would result if the issuer entered into the §1.1275–6 hedge. If a §1.1275–6 hedge (or the substantial equivalent) is not available, but similar fixed rate debt instruments of the issuer trade at a price that reflects a spread above a benchmark rate, the comparable yield is the sum of the value of the benchmark rate on the issue date and the spread. In determining the comparable yield, no adjustments are made for the riskiness of the contingencies or the liquidity of the debt instrument. The comparable yield must be a reasonable yield for the issuer and must not be less than the applicable Federal rate (based on the overall maturity of the debt instrument).

(B) *Presumption for certain debt instruments.* This paragraph (b)(4)(i)(B) applies to a debt instrument if the instrument provides for one or more contingent payments not based on market information and the instrument is part of an issue that is marketed or sold in substantial part to persons for whom the inclusion of interest under this paragraph (b) is not expected to have a substantial effect on their U.S. tax liability. If this paragraph (b)(4)(i)(B) applies to a debt instrument, the instrument's comparable yield is presumed to be the applicable Federal rate (based on the overall maturity of the debt instrument). A taxpayer may overcome this presumption only with clear and convincing evidence that the comparable yield for the debt instrument should be a specific yield (determined using the principles in paragraph (b)(4)(i)(A) of this section) that is higher than the applicable Federal rate. The presumption may not be overcome with appraisals or other valuations of nonpublicly traded property. Evidence used to overcome the presumption must be specific to the issuer and must not be based on comparable issuers or general market conditions.

(ii) *Projected payment schedule.* The projected payment schedule for a debt instrument includes each noncontingent payment and an amount for each contingent payment determined as follows:

(A) *Market-based payments.* If a contingent payment is based on market information (a market-based payment), the amount of the projected payment is the forward price of the contingent payment. The forward price of a contingent payment is the amount one party would agree, as of the issue date, to pay an unrelated party for the right to the contingent payment on the settlement date (e.g., the date the contingent payment is made). For example, if the right to a contingent payment is substantially similar to an exchange-traded option, the forward price is the spot price of the option (the option premium) compounded at the applicable Federal rate from the issue date to the date the contingent payment is due.

(B) *Other payments.* If a contingent payment is not based on market information (a non-market-based payment), the amount of the projected payment is the expected value of the contingent payment as of the issue date.

(C) *Adjustments to the projected payment schedule.* The projected payment schedule must produce the comparable yield. If the projected payment schedule does not produce the comparable yield, the schedule must be adjusted consistent with the principles of this paragraph (b)(4) to produce the comparable yield. For example, the adjusted amounts of non-market-based payments must reasonably reflect the relative expected values of the payments and must not be set to accelerate or defer income or deductions. If the debt instrument contains both market-based and non-market-based payments, adjustments are generally made first to the non-market-based payments because more objective information is available for the market-based payments.

(iii) *Market information.* For purposes of this paragraph (b), market information is any information on which an objective rate can be based under § 1.1275–5(c) (1) or (2).

(iv) *Issuer/holder consistency.* The issuer's projected payment schedule is used to determine the holder's interest accruals and adjustments. The issuer must provide the projected payment schedule to the holder in a manner consistent with the issuer disclosure rules of § 1.1275–2(e). If the issuer does not create a projected payment schedule for a debt instrument or the issuer's projected payment schedule is unreasonable, the holder of the debt instrument must determine the comparable yield and projected payment schedule for the debt instrument under the rules of this paragraph (b)(4). A holder that determines its own projected payment schedule must explicitly disclose this fact and the reason why the holder set its own schedule (e.g., why the issuer's projected payment schedule is unreasonable). Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed Federal income tax return for the taxable year that includes the acquisition date of the debt instrument.

(v) *Issuer's determination respected*—(A) *In general.* If the issuer maintains the contemporaneous documentation required by this paragraph (b)(4), the issuer's determination of the comparable yield and projected payment schedule will be respected unless either is unreasonable.

(B) *Unreasonable determination.* For purposes of paragraph (b)(4)(v)(A) of this section, a comparable yield or projected payment schedule generally will be considered unreasonable if it is set with a purpose to overstate, understate, accelerate, or defer interest accruals on the debt instrument. In a determination of whether a comparable yield or projected payment schedule is unreasonable, consideration will be given to whether the treatment of the debt instrument under this section is expected to have a substantial effect on the issuer's or holder's U.S. tax liability. For example, if a taxable issuer markets a debt instrument to a holder not subject to U.S. taxation, the comparable yield will be given close scrutiny and will not be respected unless contemporaneous documentation shows that the yield is not too high.

(C) *Exception.* Paragraph (b)(4)(v)(A) of this section does not apply to a debt instrument subject to paragraph (b)(4)(i)(B) of this section (concerning a yield presumption for certain debt instruments that provide for non-market-based payments).

(vi) *Examples.* The following examples illustrate the provisions of this paragraph (b)(4). In each example, assume that the instrument described is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes.

Example 1. Market-based payment—(i) *Facts.* On December 31, 1996, X corporation issues for $1,000,000 a debt instrument that matures on December 31, 2006. The debt instrument provides for annual payments of interest, beginning in 1997, at the rate of 6 percent and for a payment at maturity equal to $1,000,000 plus the excess, if any, of the price of 10,000 shares of publicly traded stock in an unrelated corporation on the maturity date over $350,000, or less the excess, if any, of $350,000 over the price of 10,000 shares of the stock on the maturity date. On the issue date, the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $350,000.

(ii) *Comparable yield.* Under paragraph (b)(4)(i) of this section, the debt instrument's comparable yield is the yield on the synthetic debt instrument that would result if X corporation entered into a § 1.1275–6 hedge. A § 1.1275–6 hedge in this case is a forward contract to purchase 10,000 shares of the stock on December 31, 2006. If X corporation entered into this hedge, the resulting synthetic debt instrument would yield 6 percent, compounded annually. Thus, the comparable yield on the debt instrument is 6 percent, compounded annually.

(iii) *Projected payment schedule.* Under paragraph (b)(4)(ii) of this section, the projected payment schedule for the debt instrument consists of 10 annual payments of $60,000 and a projected amount for the contingent payment at maturity. Because the right to the contingent payment is based on market information, the projected amount of the contingent payment is the forward price of the payment. The right to the contingent payment is substantially similar to a right to a payment of $1,000,000 combined with a cash-settled forward contract for the purchase of 10,000 shares of the stock for $350,000 on December 31, 2006. Because the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $350,000, the amount to be received or paid under the forward contract is projected to be zero. As a result, the projected amount of the contingent payment at maturity is $1,000,000, consisting of the $1,000,000 base amount and no additional amount to be received or paid under the forward contract.

(A) Assume, alternatively, that on the issue date the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $370,000. If X corporation entered into a §1.1275–6 hedge (a forward contract to purchase the shares for $370,000), the resulting synthetic debt instrument would yield 6.15 percent, compounded annually. Thus, the comparable yield on the debt instrument is 6.15 percent, compounded annually. The projected payment schedule for the debt instrument consists of 10 annual payments of $60,000 and a projected amount for the contingent payment at maturity. The projected amount of the contingent payment is $1,020,000, consisting of the $1,000,000 base amount plus the excess $20,000 of the forward price of the stock over the purchase price of the stock under the forward contract.

(B) Assume, alternatively, that on the issue date the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $330,000. If X corporation entered into a §1.1275–6 hedge, the resulting synthetic debt instrument would yield 5.85 percent, compounded annually. Thus, the comparable yield on the debt instrument is 5.85 percent, compounded annually. The projected payment schedule for the debt instrument consists of 10 annual payments of $60,000 and a projected amount for the contingent payment at maturity. The projected amount of the contingent payment is $980,000, consisting of the $1,000,000 base amount minus the excess $20,000 of the purchase price of the stock under the forward contract over the forward price of the stock.

Example 2. Non-market-based payments—(i) *Facts.* On December 31, 1996, Y issues to Z for $1,000,000 a debt instrument that matures on December 31, 2000. The debt instrument has a stated principal amount of $1,000,000, payable at maturity, and provides for payments on December 31 of each year, beginning in 1997, of $20,000 plus 1 percent of Y's gross receipts, if any, for the year. On the issue date, Y has outstanding fixed rate debt instruments with maturities of 2 to 10 years that trade at a price that reflects an average of 100 basis points over Treasury bonds. These debt instruments have terms and conditions similar to those of the debt instrument. Assume that on December 31, 1996, 4-year Treasury bonds have a yield of 6.5 percent, compounded annually, and that no §1.1275–6 hedge is available for the debt instrument. In addition, assume that the interest inclusions attributable to the debt instrument are expected to have a substantial effect on Z's U.S. tax liability.

(ii) *Comparable yield.* The comparable yield for the debt instrument is equal to the value of the benchmark rate (i.e., the yield on 4-year Treasury bonds) on the issue date plus the spread. Thus, the debt instrument's comparable yield is 7.5 percent, compounded annually.

(iii) *Projected payment schedule.* Y anticipates that it will have no gross receipts in 1997, but that it will have gross receipts in later years, and those gross receipts will grow each year for the next three years. Based on its business projections, Y believes that it is not unreasonable to expect that its gross receipts in 1999 and each year thereafter will grow by between 6 percent and 13 percent over the prior year. Thus, Y must take these expectations into account in establishing a projected payment schedule for the debt instrument that results in a yield of 7.5 percent, compounded annually. Accordingly, Y could reasonably set the following projected payment schedule for the debt instrument:

Date	Noncontingent payment	Contingent payment
12/31/1997	$20,000	$0
12/31/1998	20,000	70,000
12/31/1999	20,000	75,600
12/31/2000	1,020,000	83,850

(5) *Qualified stated interest.* No amounts payable on a debt instrument to which this paragraph (b) applies are qualified stated interest within the meaning of §1.1273–1(c).

(6) *Adjustments.* This paragraph (b)(6) provides rules for the treatment of positive and negative adjustments under the noncontingent bond method. A taxpayer takes into account only those adjustments that occur during a taxable year while the debt instrument is held by the taxpayer or while the taxpayer is primarily liable on the debt instrument.

(i) *Determination of positive and negative adjustments.* If the amount of a contingent payment is more than the projected amount of the contingent payment, the difference is a positive adjustment on the date of the payment. If the amount of a contingent payment is less than the projected amount of the contingent payment, the difference is a negative adjustment on the date of the payment (or on the scheduled date of the payment if the amount of the payment is zero).

(ii) *Treatment of net positive adjustments.* The amount, if any, by which total positive adjustments on a debt instrument in a taxable year exceed the total negative adjustments on the debt instrument in the taxable year is a net positive adjustment. A net positive adjustment is treated as additional interest for the taxable year.

(iii) *Treatment of net negative adjustments.* The amount, if any, by which total negative adjustments on a debt instrument in a taxable year exceed the total positive adjustments on the debt instrument in the taxable year is a net negative adjustment. A taxpayer's net negative adjustment on a debt instrument for a taxable year is treated as follows:

(A) *Reduction of interest accruals.* A net negative adjustment first reduces interest for the taxable year that the taxpayer would otherwise account for on the debt instrument under paragraph (b)(3)(iii) of this section.

(B) *Ordinary income or loss.* If the net negative adjustment exceeds the interest for the taxable year that the taxpayer would otherwise account for on the debt instrument under paragraph (b)(3)(iii) of this section, the excess is treated as ordinary loss by a holder and ordinary income by an issuer. However, the amount treated as ordinary loss by a holder is limited to the amount by which the holder's total interest inclusions on the debt instrument exceed the total amount of the holder's net negative adjustments treated as ordinary loss on the debt instrument in prior taxable years. The amount treated as ordinary income by an issuer is limited to the amount by which the issuer's total interest deductions on the debt instrument exceed the total amount of the issuer's net negative adjustments treated as ordinary income on the debt instrument in prior taxable years.

(C) *Carryforward.* If the net negative adjustment exceeds the sum of the amounts treated by the taxpayer as a reduction of interest and as ordinary income or loss (as the case may be) on the debt instrument for the taxable year, the excess is a negative adjustment carryforward for the taxable year. In general, a taxpayer treats a negative adjustment carryforward for a taxable year as a negative adjustment on the debt instrument on the first day of the succeeding taxable year. However, if a holder of a debt instrument has a negative adjustment carryforward on the debt instrument in a taxable year in which the debt instrument is sold, exchanged, or retired, the negative adjustment carryforward reduces the holder's amount realized on the sale, exchange, or retirement. If an issuer of a debt instrument has a negative adjustment carryforward on the debt instrument for a taxable year in which the debt instrument is retired, the issuer takes the negative adjustment carryforward into account as ordinary income.

(D) *Treatment under section 67.* A net negative adjustment is not subject to section 67 (the 2-percent floor on miscellaneous itemized deductions).

(iv) *Cross-references.* If a holder has a basis in a debt instrument that is different from the debt instrument's adjusted issue price, the holder may have additional positive or negative adjustments under paragraph (b)(9)(i) of this section. If the amount of a contingent payment is fixed more than 6 months before the date it is due, the amount and timing of the adjustment are determined under paragraph (b)(9)(ii) of this section.

(7) *Adjusted issue price, adjusted basis, and retirement*—(i) *In general.* If a debt instrument is subject to the noncontingent bond method, this paragraph (b)(7) provides rules to determine the adjusted issue price of the debt instrument, the holder's basis in the debt instrument, and the treatment of any scheduled or unscheduled retirements. In general, because any difference between the actual amount of a contingent payment and the projected amount of the payment is taken into account as an adjustment to income or deduction, the projected payments are treated as the actual payments for purposes of making adjustments to issue price and basis and determining the amount of any contingent payment made on a scheduled retirement.

(ii) *Definition of adjusted issue price.* The adjusted issue price of a debt instrument is equal to the debt instrument's issue price, increased by the interest previously accrued on the debt instrument under paragraph (b)(3)(iii) of this section (determined without regard to any adjustments taken into account under paragraph (b)(3)(iv) of this section), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument. See paragraph (b)(9)(ii) of this section for special rules that apply when a contingent payment is fixed more than 6 months before it is due.

(iii) *Adjustments to basis.* A holder's basis in a debt instrument is increased by the interest previously accrued by the holder on the debt instrument under paragraph (b)(3)(iii) of this section (determined without regard to any adjustments taken into account under paragraph (b)(3)(iv) of this section), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument to the holder. See paragraph (b)(9)(i) of this section for special rules that apply when basis is different from adjusted issue price and paragraph (b)(9)(ii) of this section for special rules that apply when a contingent payment is fixed more than 6 months before it is due.

(iv) *Scheduled retirements.* For purposes of determining the amount realized by a holder and the repurchase price paid by the issuer on the scheduled retirement of a debt instrument, a holder is treated as receiving, and the issuer is treated as paying, the projected amount of any contingent payment due at maturity. If the amount paid or received is different from the projected amount, see paragraph (b)(6) of this section for the treatment of the difference by the taxpayer. Under paragraph (b)(6)(iii)(C) of this section, the amount realized by a holder on the retirement of a debt instrument is reduced by any negative adjustment carryforward determined in the taxable year of the retirement.

(v) *Unscheduled retirements.* An unscheduled retirement of a debt instrument (or the receipt of a pro-rata prepayment that is treated as a retirement of a portion of a debt instrument under §1.1275–2(f)) is treated as a repurchase of the debt instrument (or a pro-rata portion of the debt instrument) by the issuer from the holder for the amount paid by the issuer to the holder.

(vi) *Examples.* The following examples illustrate the provisions of paragraphs (b) (6) and (7) of this section. In each example, assume that the instrument described is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes.

Example 1. Treatment of positive and negative adjustments—(i) *Facts.* On December 31, 1996, Z, a calendar year taxpayer, purchases a debt instrument subject to this paragraph (b) at original issue for $1,000. The debt instrument's comparable yield is 10 percent, compounded annually, and the projected payment schedule provides for payments of $500 on December 31, 1997 (consisting of a noncontingent payment of $375 and a projected amount of $125) and $660 on December 31, 1998 (consisting of a noncontingent payment of $600 and a projected amount of $60). The debt instrument is a capital asset in the hands of Z.

(ii) *Adjustment in 1997.* Based on the projected payment schedule, Z's total daily portions of interest on the debt instrument are $100 for 1997 (issue price of $1,000 × 10 percent). Assume that the payment actually made on December 31, 1997, is $375, rather than the projected $500. Under paragraph (b)(6)(i) of this section, Z has a negative adjustment of $125 on December 31, 1997, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Because Z has no positive adjustments for 1997, Z has a net negative adjustment of $125 on the debt instrument for 1997. This net negative adjustment reduces to zero the $100 total daily portions of interest Z would otherwise include in income in 1997. Accordingly, Z has no interest income on the debt instrument for 1997. Because Z had no interest inclusions on the debt instrument for prior taxable years, the remaining $25 of the net negative adjustment is a negative adjustment carryforward for 1997 that results in a negative adjustment of $25 on January 1, 1998.

(iii) *Adjustment to issue price and basis.* Z's total daily portions of interest on the debt instrument are $100 for 1997. The adjusted issue price of the debt instrument and Z's adjusted basis in the debt instrument are increased by this amount, despite the fact that

Z does not include this amount in income because of the net negative adjustment for 1997. In addition, the adjusted issue price of the debt instrument and Z's adjusted basis in the debt instrument are decreased on December 31, 1997, by the projected amount of the payment on that date ($500). Thus, on January 1, 1998, Z's adjusted basis in the debt instrument and the adjusted issue price of the debt instrument are $600.

(iv) *Adjustments in 1998.* Based on the projected payment schedule, Z's total daily portions of interest are $60 for 1998 (adjusted issue price of $600 × 10 percent). Assume that the payment actually made on December 31, 1998, is $700, rather than the projected $660. Under paragraph (b)(6)(i) of this section, Z has a positive adjustment of $40 on December 31, 1998, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Because Z also has a negative adjustment of $25 on January 1, 1998, Z has a net positive adjustment of $15 on the debt instrument for 1998 (the excess of the $40 positive adjustment over the $25 negative adjustment). As a result, Z has $75 of interest income on the debt instrument for 1998 (the $15 net positive adjustment plus the $60 total daily portions of interest that are taken into account by Z in that year).

(v) *Retirement.* Based on the projected payment schedule, Z's adjusted basis in the debt instrument immediately before the payment at maturity is $660 ($600 plus $60 total daily portions of interest for 1998). Even though Z receives $700 at maturity, for purposes of determining the amount realized by Z on retirement of the debt instrument, Z is treated as receiving the projected amount of the contingent payment on December 31, 1998. Therefore, Z is treated as receiving $660 on December 31, 1998. Because Z's adjusted basis in the debt instrument immediately before its retirement is $660, Z recognizes no gain or loss on the retirement.

Example 2. Negative adjustment carryforward for year of sale—(i) *Facts.* Assume the same facts as in *Example 1* of this paragraph (b)(7)(vi), except that Z sells the debt instrument on January 1, 1998, for $630.

(ii) *Gain on sale.* On the date the debt instrument is sold, Z's adjusted basis in the debt instrument is $600. Because Z has a negative adjustment of $25 on the debt instrument on January 1, 1998, and has no positive adjustments on the debt instrument in 1998, Z has a net negative adjustment for 1998 of $25. Because Z has not included in income any interest on the debt instrument, the entire $25 net negative adjustment is a negative adjustment carryforward for the taxable year of the sale. Under paragraph (b)(6)(iii)(C) of this section, the $25 negative adjustment carryforward reduces the amount realized by Z on the sale of the debt instrument from $630 to $605. Thus, Z has a gain on the sale of $5 ($605 − $600). Under paragraph (b)(8)(i) of this section, the gain is treated as interest income.

Example 3. Negative adjustment carryforward for year of retirement—(i) *Facts.* Assume the same facts as in *Example 1* of this paragraph (b)(7)(vi), except that the payment actually made on December 31, 1998, is $615, rather than the projected $660.

(ii) *Adjustments in 1998.* Under paragraph (b)(6)(i) of this section, Z has a negative adjustment of $45 on December 31, 1998, attributable to the difference between the amount of the actual payment and the amount of the projected payment. In addition, Z has a negative adjustment of $25 on January 1, 1998. See *Example 1*(ii) of this paragraph (b)(7)(vi). Because Z has no positive adjustments in 1998, Z has a net negative adjustment of $70 for 1998. This net negative adjustment reduces to zero the $60 total daily portions of interest Z would otherwise include in income for 1998. Therefore, Z has no interest income on the debt instrument for 1998. Because Z had no interest inclusions on the debt instrument for 1997, the remaining $10 of the net negative adjustment is a negative adjustment carryforward for 1998 that reduces the amount realized by Z on retirement of the debt instrument.

(iii) *Loss on retirement.* Immediately before the payment at maturity, Z's adjusted basis in the debt instrument is $660. Under paragraph (b)(7)(iv) of this section, Z is treated as receiving the projected amount of the contingent payment, or $660, as the payment at maturity. Under paragraph (b)(6)(iii)(C) of this section, however, this amount is reduced by any negative adjustment carryforward determined for the taxable year of retirement to calculate the amount Z realizes on retirement of the debt instrument. Thus, Z has a loss of $10 on the retirement of the debt instrument, equal to the amount by which Z's adjusted basis in the debt instrument ($660) exceeds the amount Z realizes on the retirement of the debt instrument ($660 minus the $10 negative adjustment carryforward). Under paragraph (b)(8)(ii) of this section, the loss is a capital loss.

(8) *Character on sale, exchange, or retirement*—(i) *Gain.* Any gain recognized by a holder on the sale, exchange, or retirement of a debt instrument subject to this paragraph (b) is interest income.

(ii) *Loss.* Any loss recognized by a holder on the sale, exchange, or retirement of a debt instrument subject to this paragraph (b) is ordinary loss to the extent that the holder's total interest inclusions on the debt instrument exceed the total net negative adjustments on the debt instrument the holder took into account as ordinary loss. Any additional loss is treated as loss from the sale, exchange, or retirement of the debt instrument. However, any loss that would otherwise be ordinary under this paragraph (b)(8)(ii) and that is attributable to the holder's basis that could not be amortized under section 171(b)(4) is loss from the sale, exchange, or retirement of the debt instrument.

(iii) *Special rule if there are no remaining contingent payments on the debt instrument*—(A) *In general.* Notwithstanding paragraphs (b)(8) (i) and (ii) of this section, if, at the time of the sale, exchange, or retirement of the debt instrument, there are no remaining contingent payments due on the debt instrument under the projected payment schedule, any gain or loss recognized by the holder is gain or loss from the sale, exchange, or retirement of the debt instrument. See paragraph (b)(9)(ii) of this section to determine whether there are no remaining contingent payments on a debt instrument that provides for fixed but deferred contingent payments.

(B) *Exception for certain positive adjustments.* Notwithstanding paragraph (b)(8)(iii)(A) of this section, if a positive adjustment on a debt instrument is spread under paragraph (b)(9)(ii) (F) or (G) of this section, any gain recognized by the holder on the sale, exchange, or retirement of the instrument is treated as interest income to the extent of the positive adjustment that has not yet been accrued and included in income by the holder.

(iv) *Examples.* The following examples illustrate the provisions of this paragraph (b)(8). In each example, assume that the instrument described is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes.

Example 1. Gain on sale—(i) *Facts.* On January 1, 1998, D, a calendar year taxpayer, sells a debt instrument that is subject to paragraph (b) of this section for $1,350. The projected payment schedule for the debt instrument provides for contingent payments after January 1, 1998. On January 1, 1998, D has an adjusted basis in the debt instrument of $1,200. In addition, D has a negative adjustment carryforward of $50 for 1997 that, under paragraph (b)(6)(iii)(C) of this section, results in a negative adjustment of $50 on January 1, 1998. D has no positive adjustments on the debt instrument on January 1, 1998.

(ii) *Character of gain.* Under paragraph (b)(6) of this section, the $50 negative adjustment on January 1, 1998, results in a negative adjustment carryforward for 1998, the taxable year of the sale of the debt instrument. Under paragraph (b)(6)(iii)(C) of this section, the negative adjustment carryforward reduces the amount realized by D on the sale of the debt instrument from $1,350 to $1,300. As a result, D realizes a $100 gain on the sale of the debt instrument, equal to the $1,300 amount realized minus D's $1,200 adjusted basis in the debt instrument. Under paragraph (b)(8)(i) of this section, the gain is interest income to D.

Example 2. Loss on sale—(i) *Facts.* On December 31, 1996, E, a calendar year taxpayer, purchases a debt instrument at original issue for $1,000. The debt instrument is a capital asset in the hands of E. The debt instrument provides for a single payment on December 31, 1998 (the maturity date of the instrument), of $1,000 plus an amount based on the increase, if any, in the price of a specified commodity over the term of the instrument. The comparable yield for the debt instrument is 9.54 percent, compounded annually, and the projected payment schedule provides for a payment of $1,200 on December 31, 1998. Based on the projected payment schedule, the total daily portions of interest are $95 for 1997 and $105 for 1998.

(ii) *Ordinary loss.* Assume that E sells the debt instrument for $1,050 on December 31, 1997. On that date, E has an adjusted basis in the debt instrument of $1,095 ($1,000 original basis, plus total daily portions of $95 for 1997). Therefore, E realizes a $45 loss on the sale of the debt instrument ($1,050–$1,095). The loss is ordinary to the extent E's total interest inclusions on the debt instrument ($95) exceed the total net negative adjustments on the instrument that E took into account as an ordinary loss. Because E has not had any net negative adjustments on the debt instrument, the $45 loss is an ordinary loss.

(iii) *Capital loss.* Alternatively, assume that E sells the debt instrument for $990 on December 31, 1997. E realizes a $105 loss on the sale of the debt instrument ($990 − $1,095). The loss is ordinary to the extent E's total interest inclusions on the debt instrument ($95) exceed the total net negative adjustments on the instrument that E took into account as an ordinary loss. Because E has not had any net negative adjustments on the debt instrument, $95 of the $105 loss is an ordinary loss. The remaining $10 of the $105 loss is a capital loss.

(9) *Operating rules.* The rules of this paragraph (b)(9) apply to a debt instrument subject to the noncontingent bond method notwithstanding any other rule of this paragraph (b).

(i) *Basis different from adjusted issue price.* This paragraph (b)(9)(i) provides rules for a holder whose basis in a debt instrument is different from the adjusted issue price of the debt instrument (e.g., a subsequent holder that purchases the debt instrument for more or less than the instrument's adjusted issue price).

(A) *General rule.* The holder accrues interest under paragraph (b)(3)(iii) of this section and makes adjustments under paragraph (b)(3)(iv) of this section based on the projected payment schedule determined as of the issue date of the debt instrument. However, upon acquiring the debt instrument, the holder must reasonably allocate any difference between the adjusted issue price and the basis to daily portions of interest or projected payments over the remaining term of the debt instrument. Allocations are taken into account under paragraphs (b)(9)(i) (B) and (C) of this section.

(B) *Basis greater than adjusted issue price.* If the holder's basis in the debt instrument exceeds the debt instrument's adjusted issue price, the amount of the difference allocated to a daily portion of interest or to a projected payment is treated as a negative adjustment on the date the daily portion accrues or the payment is made. On the date of the adjustment, the holder's adjusted basis in the debt instrument is reduced by the amount the holder treats as a negative adjustment under this paragraph (b)(9)(i)(B). See paragraph (b)(9)(ii)(E) of this section for a special rule that applies when a contingent payment is fixed more than 6 months before it is due.

(C) *Basis less than adjusted issue price.* If the holder's basis in the debt instrument is less than the debt instrument's adjusted issue price, the amount of the difference allocated to a daily portion of interest or to a projected payment is treated as a positive adjustment on the date the daily portion accrues or the payment is made. On the date of the adjustment, the holder's adjusted basis in the debt instrument is increased by the amount the holder treats as a positive adjustment under this paragraph (b)(9)(i)(C). See paragraph (b)(9)(ii)(E) of this section for a special rule that applies when a contingent payment is fixed more than 6 months before it is due.

(D) *Premium and discount rules do not apply.* The rules for accruing premium and discount in sections 171, 1272(a)(7), 1276, and 1281 do not apply. Other rules of those sections, such as section 171(b)(4), continue to apply to the extent relevant.

(E) *Safe harbor for exchange listed debt instruments.* If the debt instrument is exchange listed property (within the meaning of § 1.1273–2(f)(2)), it is reasonable for the holder to allocate any difference between the holder's basis and the adjusted issue price of the debt instrument pro-rata to daily portions of interest (as determined under paragraph (b)(3)(iii) of this section) over the remaining term of the debt instrument. A pro-rata allocation is not reasonable, however, to the extent the holder's yield on the debt instrument, determined after taking into account the amounts allocated under this paragraph (b)(9)(i)(E), is less than the applicable Federal rate for the instrument. For purposes of the preceding sentence, the applicable Federal rate for the debt instrument is determined as if the purchase date were the issue date and the remaining term of the instrument were the term of the instrument.

(F) *Examples.* The following examples illustrate the provisions of this paragraph (b)(9)(i). In each example, assume that the instrument described is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes. In addition, assume that each instrument is not exchange listed property.

Example 1. Basis greater than adjusted issue price—(i) *Facts.* On July 1, 1998, Z purchases for $1,405 a debt instrument that matures on December 31, 1999, and promises to pay on the maturity date $1,000 plus the increase, if any, in the price of a specified amount of a commodity from the issue date to the maturity date. The debt instrument was originally issued on December 31, 1996, for an issue price of $1,000. The comparable yield for the debt instrument is 10.25 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date) provides for a single payment at maturity of $1,350. At the time of the purchase, the debt instrument has an adjusted issue price of $1,162, assuming semiannual accrual periods ending on December 31 and June 30 of each year. The increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment and not to a decrease in market interest rates. The debt instrument is a capital asset in the hands of Z. Z is a calendar year taxpayer.

(ii) *Allocation of the difference between basis and adjusted issue price.* Z's basis in the debt instrument on July 1, 1998, is $1,405. Under paragraph (b)(9)(i)(A) of this section, Z allocates the $243 difference between basis ($1,405) and adjusted issue price ($1,162) to the contingent payment at maturity. Z's allocation of the difference between basis and adjusted issue price is reasonable because the increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment.

(iii) *Treatment of debt instrument for 1998.* Based on the projected payment schedule, $60 of interest accrues on the debt instrument from July 1, 1998 to December 31, 1998 (the product of the debt instrument's adjusted issue price on July 1, 1998 ($1,162) and the comparable yield properly adjusted for the length of the accrual period (10.25 percent/2)). Z has no net negative or positive adjustments for 1998. Thus, Z includes in income $60 of total daily portions of interest for 1998. On December 31, 1998, Z's adjusted basis in the debt instrument is $1,465 ($1,405 original basis, plus total daily portions of $60 for 1998).

(iv) *Effect of allocation to contingent payment at maturity.* Assume that the payment actually made on December 31, 1999, is $1,400, rather than the projected $1,350. Thus, under paragraph (b)(6)(i) of this section, Z has a positive adjustment of $50 on December 31, 1999. In addition, under paragraph (b)(9)(i)(B) of this section, Z has a negative adjustment of $243 on December 31, 1999, which is attributable to the difference between Z's basis in the debt instrument on July 1, 1998, and the instrument's adjusted issue price on that date. As a result, Z has a net negative adjustment of $193 for 1999. This net negative adjustment reduces to zero the $128 total daily portions of interest Z would otherwise include in income in 1999. Accordingly, Z has no interest income on the debt instrument for 1999. Because Z had $60 of interest inclusions for 1998, $60 of the remaining $65 net negative adjustment is treated by Z as an ordinary loss for 1999. The remaining $5 of the net negative adjustment is a negative adjustment carryforward for 1999 that reduces the amount realized by Z on the retirement of the debt instrument from $1,350 to $1,345.

(v) *Loss at maturity.* On December 31, 1999, Z's basis in the debt instrument is $1,350 ($1,405 original basis, plus total daily portions of $60 for 1998 and $128 for 1999, minus the negative adjustment of $243). As a result, Z realizes a loss of $5 on the retirement of the debt instrument (the difference between the amount realized on the retirement ($1,345) and Z's adjusted basis in the debt instrument ($1,350)). Under paragraph (b)(8)(ii) of this section, the $5 loss is treated as loss from the retirement of the debt instrument. Consequently, Z realizes a total loss of $65 on the debt instrument for 1999 (a $60 ordinary loss and a $5 capital loss).

Example 2. Basis less than adjusted issue price—(i) *Facts.* On January 1, 1999, Y purchases for $910 a debt instrument that pays 7 percent interest semiannually on June 30 and December 31 of each year, and that promises to pay on December 31, 2001, $1,000 plus or minus $10 times the positive or negative difference, if any, between a specified amount and the value of an index on December 31, 2001. However, the payment on December 31, 2001, may not be less than $650. The debt instrument was originally issued on December 31, 1996, for an issue price of $1,000. The comparable yield for the debt instrument is 9.80 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date) provides for semiannual payments of $35 and a contingent payment at maturity of $1,175. On January 1, 1999, the debt instrument has an adjusted issue price of $1,060, assuming semiannual accrual periods ending on December 31 and June 30 of each year. Y is a calendar year taxpayer.

(ii) *Allocation of the difference between basis and adjusted issue price.* Y's basis in the debt instrument on January 1, 1999, is $910. Under paragraph (b)(9)(i)(A) of this section, Y must allocate the $150 difference between basis ($910) and adjusted issue price ($1,060) to daily portions of interest or to projected payments. These amounts will be positive adjustments taken into account at the time the daily portions accrue or the payments are made.

(A) Assume that, because of a decrease in the relevant index, the expected value of the payment at maturity has declined by about 9 percent. Based on forward prices on January 1, 1999, Y determines that approximately $105 of the difference between basis and adjusted issue price is allocable to the contingent payment. Y allocates the remaining $45 to daily portions of interest on a pro-rata basis (i.e., the amount allocated to an accrual period equals the product of $45 and a fraction, the numerator of which is the total daily portions for the accrual period and the denominator of which is the total daily portions remaining on the debt instrument on January 1, 1999). This allocation is reasonable.

(B) Assume alternatively that, based on yields of comparable debt instruments and its purchase price for the debt instrument, Y determines that an appropriate yield for the debt instrument is 13 percent, compounded semiannually. Based on this determination, Y allocates $55.75 of the difference between basis and adjusted issue price to daily portions of interest as follows: $15.19 to the daily portions of interest for the taxable year ending December 31, 1999; $18.40 to the daily portions of interest for the taxable year ending December 31, 2000; and $22.16 to the daily portions of interest for the taxable year ending December 31, 2001. Y allocates the remaining $94.25 to the contingent payment at maturity. This allocation is reasonable.

(ii) *Fixed but deferred contingent payments.* This paragraph (b)(9)(ii) provides rules that apply when the amount of a contingent payment becomes fixed before the payment is due. For purposes of paragraph (b) of this section, if a contingent payment becomes fixed within the 6-month period ending on the due date of the payment, the payment is treated as a contingent payment even after the payment is fixed. If a contingent payment becomes fixed more than 6 months before the payment is due, the following rules apply to the debt instrument.

(A) *Determining adjustments.* The amount of the adjustment attributable to the contingent payment is equal to the difference between the present value of the amount that is fixed and the present value of the projected amount of the contingent payment. The present value of each amount is determined by discounting the amount from the date the payment is due to the date the payment becomes fixed, using a discount rate equal to the comparable yield on the debt instrument. The adjustment is treated as a positive or negative adjustment, as appropriate, on the date the contingent payment becomes fixed. See paragraph (b)(9)(ii)(G) of this section to determine the timing of the adjustment if all remaining contingent payments on the debt instrument become fixed substantially contemporaneously.

(B) *Payment schedule.* The contingent payment is no longer treated as a contingent payment after the date the amount of the payment becomes fixed. On the date the contingent payment becomes fixed, the projected payment schedule for the debt instrument is modified prospectively to reflect the fixed amount of the payment. Therefore, no adjustment is made under paragraph (b)(3)(iv) of this section when the contingent payment is actually made.

(C) *Accrual period.* Notwithstanding the determination under § 1.1272–1(b)(1)(ii) of accrual periods for the debt instrument, an accrual period ends on the day the contingent payment becomes fixed, and a new accrual period begins on the day after the day the contingent payment becomes fixed.

(D) *Adjustments to basis and adjusted issue price.* The amount of any positive adjustment on a debt instrument determined under paragraph (b)(9)(ii)(A) of this section increases the adjusted issue price of the instrument and the holder's adjusted basis in the instrument. Similarly, the amount of any negative adjustment on a debt instrument determined under paragraph (b)(9)(ii)(A) of this section decreases the adjusted issue price of the instrument and the holder's adjusted basis in the instrument.

(E) *Basis different from adjusted issue price.* If a holder's basis in a debt instrument exceeds the debt instrument's adjusted issue price, the amount allocated to a projected payment under paragraph (b)(9)(i) of this section is treated as a negative adjustment on the date the payment becomes fixed. If a holder's basis in a debt instrument is less than the debt instrument's adjusted issue price, the amount allocated to a projected payment under paragraph (b)(9)(i) of this section is treated as a positive adjustment on the date the payment becomes fixed.

(F) *Special rule for certain contingent interest payments.* Notwithstanding paragraph (b)(9)(ii)(A) of this section, this paragraph (b)(9)(ii)(F) applies to contingent stated interest payments that are adjusted to compensate for contingencies regarding the reasonableness of the debt instrument's stated rate of interest. For example, this paragraph (b)(9)(ii)(F) applies to a debt instrument that provides for an increase in the stated rate of interest if the credit quality of the issuer or liquidity of the debt instrument deteriorates. Contingent stated interest payments of this type are recognized over the period to which they relate in a reasonable manner.

(G) *Special rule when all contingent payments become fixed.* Notwithstanding paragraph (b)(9)(ii)(A) of this section, if all the remaining contingent payments on a debt instrument become fixed substantially contemporaneously, any positive or negative adjustments on the instrument are taken into account in a reasonable manner over the period to which they relate. For purposes of the preceding sentence, a payment is treated as a fixed payment if all remaining contingencies with respect to the payment are remote or incidental (within the meaning of §1.1275–2(h)).

(H) *Example.* The following example illustrates the provisions of this paragraph (b)(9)(ii). In this example, assume that the instrument described is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes.

Example: Fixed but deferred payments—(i) *Facts.* On December 31, 1996, B, a calendar year taxpayer, purchases a debt instrument at original issue for $1,000. The debt instrument matures on December 31, 2002, and provides for a payment of $1,000 at maturity. In addition, on December 31, 1999, and December 31, 2002, the debt instrument provides for payments equal to the excess of the average daily value of an index for the 6-month period ending on September 30 of the preceding year over a specified amount. The debt instrument's comparable yield is 10 percent, compounded annually, and the instrument's projected payment schedule consists of a payment of $250 on December 31, 1999, and a payment of $1,439 on December 31, 2002. B uses annual accrual periods.

(ii) *Interest accrual for 1997.* Based on the projected payment schedule, B includes a total of $100 of daily portions of interest in income in 1997. B's adjusted basis in the debt instrument and the debt instrument's adjusted issue price on December 31, 1997, is $1,100.

(iii) *Interest accrual for 1998*—(A) *Adjustment.* Based on the projected payment schedule, B would include $110 of total daily portions of interest in income in 1998. However, assume that on September 30, 1998, the payment due on December 31, 1999, fixes at $300, rather than the projected $250. Thus, on September 30, 1998, B has an adjustment equal to the difference between the present value of the $300 fixed amount and the present value of the $250 projected amount of the contingent payment. The present values of the two payments are determined by discounting each payment from the date the payment is due (December 31, 1999) to the date the payment becomes fixed (September 30, 1998), using a discount rate equal to 10 percent, compounded annually. The present value of the fixed payment is $266.30 and the present value of the projected amount of the contingent payment is $221.91. Thus, on September 30, 1998, B has a positive adjustment of $44.39 ($266.30–$221.91).

(B) *Effect of adjustment.* Under paragraph (b)(9)(ii)(C) of this section, B's accrual period ends on September 30, 1998. The daily portions of interest on the debt instrument for the period from January 1, 1998 to September 30, 1998 total $81.51. The adjusted issue price of the debt instrument and B's adjusted basis in the debt instrument are thus increased over this period by $125.90 (the sum of the daily portions of interest of $81.51 and the positive adjustment of $44.39 made at the end of the period) to $1,225.90. For purposes of all future accrual periods, including the new accrual period from October 1, 1998, to December 31, 1998, the debt instrument's projected payment schedule is modified to reflect a fixed payment of $300 on December 31, 1999. Based on the new adjusted issue price of the debt instrument and the new projected payment schedule, the yield on the debt instrument does not change.

(C) *Interest accrual for 1998.* Based on the modified projected payment schedule, $29.56 of interest accrues during the accrual period that ends on December 31, 1998. Because B has no other adjustments during 1998, the $44.39 positive adjustment on September 30, 1998, results in a net positive adjustment for 1998, which is additional interest for that year. Thus, B includes $155.46 ($81.51+$29.56+$44.39) of interest in income in 1998. B's adjusted basis in the debt instrument and the debt instrument's adjusted issue price on December 31, 1998, is $1,255.46 ($1,225.90 from the end of the prior accrual period plus $29.56 total daily portions for the current accrual period).

(iii) *Timing contingencies.* This paragraph (b)(9)(iii) provides rules for debt instruments that have payments that are contingent as to time.

(A) *Treatment of certain options.* If a taxpayer has an unconditional option to put or call the debt instrument, to exchange the debt instrument for other property, or to extend the maturity date of the debt instrument, the projected payment schedule is determined by using the principles of § 1.1272–1(c)(5).

(B) *Other timing contingencies.* [Reserved]

(iv) *Cross-border transactions*—(A) *Allocation of deductions.* For purposes of § 1.861–8, the holder of a debt instrument shall treat any deduction or loss treated as an ordinary loss under paragraph (b)(6)(iii)(B) or (b)(8)(ii) of this section as a deduction that is definitely related to the class of gross income to which income from such debt instrument belongs. Accordingly, if a U.S. person holds a debt instrument issued by a related controlled foreign corporation and, pursuant to section 904(d)(3) and the regulations thereunder, any interest accrued by such U.S. person with respect to such debt instrument would be treated as foreign source general limitation income, any deductions relating to a net negative adjustment will reduce the U.S. person's foreign source general limitation income. The holder shall apply the general rules relating to allocation and apportionment of deductions to any other deduction or loss realized by the holder with respect to the debt instrument.

(B) *Investments in United States real property.* Notwithstanding paragraph (b)(8)(i) of this section, gain on the sale, exchange, or retirement of a debt instrument that is a United States real property interest is treated as gain for purposes of sections 897, 1445, and 6039C.

(v) *Coordination with subchapter M and related provisions.* For purposes of sections 852(c)(2) and 4982 and § 1.852–11, any positive adjustment, negative adjustment, income, or loss on a debt instrument that occurs after October 31 of a taxable year is treated in the same manner as foreign currency gain or loss that is attributable to a section 988 transaction.

(vi) *Coordination with section 1092.* A holder treats a negative adjustment and an issuer treats a positive adjustment as a loss with respect to a position in a straddle if the debt instrument is a position in a straddle and the contingency (or any portion of the contingency) to which the adjustment relates would be part of the straddle if entered into as a separate position.

(c) *Method for debt instruments not subject to the noncontingent bond method*—(1) *Applicability.* This paragraph (c) applies to a contingent payment debt instrument (other than a tax-exempt obligation) that has an issue price determined under § 1.1274–2. For example, this paragraph (c) generally applies to a contingent payment debt instrument that is issued for nonpublicly traded property.

(2) *Separation into components.* If paragraph (c) of this section applies to a debt instrument (the overall debt instrument), the noncontingent payments are subject to the rules in paragraph (c)(3) of this section, and the contingent payments are accounted for separately under the rules in paragraph (c)(4) of this section.

(3) *Treatment of noncontingent payments.* The noncontingent payments are treated as a separate debt instrument. The issue price of the separate debt instrument is the issue price of the overall debt instrument, determined under § 1.1274–2(g). No interest payments on the separate debt instrument are qualified stated interest payments (within the meaning of § 1.1273–1(c)) and the de minimis rules of section 1273(a)(3) and § 1.1273–1(d) do not apply to the separate debt instrument.

(4) *Treatment of contingent payments*—(i) *In general.* Except as provided in paragraph (c)(4)(iii) of this section, the portion of a contingent payment treated as interest under paragraph (c)(4)(ii) of this section is includible in gross income by the holder and deductible from gross income by the issuer in their respective taxable years in which the payment is made.

(ii) *Characterization of contingent payments as principal and interest*—(A) *General rule.* A contingent payment is treated as a payment of principal in an amount equal to the present value of the payment, determined by discounting the payment at the test rate from the date the payment is made to the issue date. The amount of the payment in excess of the amount treated as principal under the preceding sentence is treated as a payment of interest.

(B) *Test rate.* The test rate used for purposes of paragraph (c)(4)(ii)(A) of this section is the rate that would be the test rate for the overall debt instrument under §1.1274–4 if the term of the overall debt instrument began on the issue date of the overall debt instrument and ended on the date the contingent payment is made. However, in the case of a contingent payment that consists of a payment of stated principal accompanied by a payment of stated interest at a rate that exceeds the test rate determined under the preceding sentence, the test rate is the stated interest rate.

(iii) *Certain delayed contingent payments*—(A) *General rule.* Notwithstanding paragraph (c)(4)(ii) of this section, if a contingent payment becomes fixed more than 6 months before the payment is due, the issuer and holder are treated as if the issuer had issued a separate debt instrument on the date the payment becomes fixed, maturing on the date the payment is due. This separate debt instrument is treated as a debt instrument to which section 1274 applies. The stated principal amount of this separate debt instrument is the amount of the payment that becomes fixed. An amount equal to the issue price of this debt instrument is characterized as interest or principal under the rules of paragraph (c)(4)(ii) of this section and accounted for as if this amount had been paid by the issuer to the holder on the date that the amount of the payment becomes fixed. To determine the issue price of the separate debt instrument, the payment is discounted at the test rate from the maturity date of the separate debt instrument to the date that the amount of the payment becomes fixed.

(B) *Test rate.* The test rate used for purposes of paragraph (c)(4)(iii)(A) of this section is determined in the same manner as the test rate under paragraph (c)(4)(ii)(B) of this section is determined except that the date the contingent payment is due is used rather than the date the contingent payment is made.

(5) *Basis different from adjusted issue price.* This paragraph (c)(5) provides rules for a holder whose basis in a debt instrument is different from the instrument's adjusted issue price (e.g., a subsequent holder). This paragraph (c)(5), however, does not apply if the holder is reporting income under the installment method of section 453.

(i) *Allocation of basis.* The holder must allocate basis to the noncontingent component (i.e., the right to the noncontingent payments) and to any separate debt instruments described in paragraph (c)(4)(iii) of this section in an amount up to the total of the adjusted issue price of the noncontingent component and the adjusted issue prices of the separate debt instruments. The holder must allocate the remaining basis, if any, to the contingent component (i.e., the right to the contingent payments).

(ii) *Noncontingent component.* Any difference between the holder's basis in the noncontingent component and the adjusted issue price of the noncontingent component, and any difference between the holder's basis in a separate debt instrument and the adjusted issue price of the separate debt instrument, is taken into account under the rules for market discount, premium, and acquisition premium that apply to a noncontingent debt instrument.

(iii) *Contingent component.* Amounts received by the holder that are treated as principal payments under paragraph (c)(4)(ii) of this section reduce the holder's basis in the contingent component. If the holder's basis in the contingent component is reduced to zero, any additional principal payments on the contingent component are treated as gain from the sale or exchange of the debt instrument. Any basis remaining on the contingent component on the date the final contingent payment is made increases the holder's adjusted basis in the noncontingent component (or, if there are no remaining noncontingent payments, is treated as loss from the sale or exchange of the debt instrument).

(6) *Treatment of a holder on sale, exchange, or retirement.* This paragraph (c)(6) provides rules for the treatment of a holder on the sale, exchange, or retirement of a debt instrument subject to this paragraph (c). Under this paragraph (c)(6), the holder must allocate the amount received from the sale, exchange, or retirement of a debt instrument first to the noncontingent component and to any separate debt instruments described in paragraph (c)(4)(iii)

of this section in an amount up to the total of the adjusted issue price of the noncontingent component and the adjusted issue prices of the separate debt instruments. The holder must allocate the remaining amount received, if any, to the contingent component.

(i) *Amount allocated to the noncontingent component.* The amount allocated to the noncontingent component and any separate debt instruments is treated as an amount realized from the sale, exchange, or retirement of the noncontingent component or separate debt instrument.

(ii) *Amount allocated to the contingent component.* The amount allocated to the contingent component is treated as a contingent payment that is made on the date of the sale, exchange, or retirement and is characterized as interest and principal under the rules of paragraph (c)(4)(ii) of this section.

(7) *Examples.* The following examples illustrate the provisions of this paragraph (c). In each example, assume that the instrument described is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes.

Example 1. Contingent interest payments—(i) *Facts.* A owns Blackacre, unencumbered depreciable real estate. On January 1, 1997, A sells Blackacre to B. As consideration for the sale, B makes a downpayment of $1,000,000 and issues to A a debt instrument that matures on December 31, 2001. The debt instrument provides for a payment of principal at maturity of $5,000,000 and a contingent payment of interest on December 31 of each year equal to a fixed percentage of the gross rents B receives from Blackacre in that year. Assume that the debt instrument is not issued in a potentially abusive situation. Assume also that on January 1, 1997, the short-term applicable Federal rate is 5 percent, compounded annually, and the mid-term applicable Federal rate is 6 percent, compounded annually.

(ii) *Determination of issue price.* Under § 1.1274–2(g), the issue price of the debt instrument is $3,736,291, which is the present value, as of the issue date, of the $5,000,000 noncontingent payment due at maturity, calculated using a discount rate equal to the mid-term applicable Federal rate. Under § 1.1012–1(g)(1), B's basis in Blackacre on January 1, 1997, is $4,736,291 ($1,000,000 down payment plus the $3,736,291 issue price of the debt instrument).

(iii) *Noncontingent payment treated as separate debt instrument.* Under paragraph (c)(3) of this section, the right to the noncontingent payment of principal at maturity is treated as a separate debt instrument. The issue price of this separate debt instrument is $3,736,291 (the issue price of the overall debt instrument). The separate debt instrument has a stated redemption price at maturity of $5,000,000 and, therefore, OID of $1,263,709.

(iv) *Treatment of contingent payments.* Assume that the amount of contingent interest that is fixed and paid on December 31, 1997, is $200,000. Under paragraph (c)(4)(ii) of this section, this payment is treated as consisting of a payment of principal of $190,476, which is the present value of the payment, determined by discounting the payment at the test rate of 5 percent, compounded annually, from the date the payment is made to the issue date. The remainder of the $200,000 payment ($9,524) is treated as interest. The additional amount treated as principal gives B additional basis in Blackacre on December 31, 1997. The portion of the payment treated as interest is includible in gross income by A and deductible by B in their respective taxable years in which December 31, 1997 occurs. The remaining contingent payments on the debt instrument are accounted for similarly, using a test rate of 5 percent, compounded annually, for the contingent payments due on December 31, 1998, and December 31, 1999, and a test rate of 6 percent, compounded annually, for the contingent payments due on December 31, 2000, and December 31, 2001.

Example 2. Fixed but deferred payment—(i) *Facts.* The facts are the same as in paragraph (c)(7) *Example 1* of this section, except that the contingent payment of interest that is fixed on December 31, 1997, is not payable until December 31, 2001, the maturity date.

(ii) *Treatment of deferred contingent payment.* Assume that the amount of the payment that becomes fixed on December 31, 1997, is $200,000. Because this amount is not payable until December 31, 2001, under paragraph (c)(4)(iii) of this section, a separate debt instrument to which section 1274 applies is treated as issued by B on December 31, 1997 (the date the payment is fixed). The maturity date of this separate debt instrument is December 31, 2001 (the date on which the payment is due). The stated principal amount of this separate debt instrument is $200,000, the amount of the payment that becomes fixed. The imputed principal amount of the separate debt instrument is $158,419, which is the present value, as of December 31, 1997, of the $200,000 payment, computed using a discount rate equal to the test rate of the overall debt instrument (6 percent, compounded annually). An amount equal to the issue price of the separate debt instrument is treated as an amount paid on December 31, 1997, and characterized as interest and principal under the rules of paragraph (c)(4)(ii) of this section. The amount of the deemed payment characterized as principal is equal to $150,875, which is the present value, as of January 1, 1997 (the issue date of the overall debt instrument), of the deemed payment, computed using a discount rate of 5 percent, compounded annually. The amount of the deemed payment characterized as interest is $7,544 ($158,419 − $150,875), which is includible in gross income by A and deductible by B in their respective taxable years in which December 31, 1997 occurs.

(d) *Rules for tax-exempt obligations*—(1) *In general.* Except as modified by this paragraph (d), the noncontingent bond method described in paragraph (b) of this section applies to a tax-exempt obligation (as defined in section 1275(a)(3)) to which this section applies. Paragraph (d)(2) of this section applies to certain tax-exempt obligations that provide for interest-based payments or revenue-based payments and paragraph (d)(3) of this section applies to all other obligations. Paragraph (d)(4) of this section provides rules for a holder whose basis in a tax-exempt obligation is different from the adjusted issue price of the obligation.

(2) *Certain tax-exempt obligations with interest-based or revenue-based payments*—(i) *Applicability.* This paragraph (d)(2) applies to a tax-exempt obligation that provides for interest-based payments or revenue-based payments.

(ii) *Interest-based payments.* A tax-exempt obligation provides for interest-based payments if the obligation would otherwise qualify as a variable rate debt instrument under §1.1275–5 except that—

(A) The obligation provides for more than one fixed rate;

(B) The obligation provides for one or more caps, floors, or governors (or similar restrictions) that are fixed as of the issue date;

(C) The interest on the obligation is not compounded or paid at least annually; or

(D) The obligation provides for interest at one or more rates equal to the product of a qualified floating rate and a fixed multiple greater than zero and less than .65, or at one or more rates equal to the product of a qualified floating rate and a fixed multiple greater than zero and less than .65, increased or decreased by a fixed rate.

(iii) *Revenue-based payments.* A tax-exempt obligation provides for revenue-based payments if the obligation—

(A) Is issued to refinance (including a series of refinancings) an obligation (in a series of refinancings, the original obligation), the proceeds of which were used to finance a project or enterprise; and

(B) Would otherwise qualify as a variable rate debt instrument under §1.1275–5 except that it provides for stated interest payments at least annually based on a single fixed percentage of the revenue, value, change in value, or other similar measure of the performance of the refinanced project or enterprise.

(iv) *Modifications to the noncontingent bond method.* If a tax-exempt obligation is subject to this paragraph (d)(2), the following modifications to the noncontingent bond method described in paragraph (b) of this section apply to the obligation.

(A) *Daily portions and net positive adjustments.* The daily portions of interest determined under paragraph (b)(3)(iii) of this section and any net positive adjustment on the obligation are interest for purposes of section 103.

(B) *Net negative adjustments.* A net negative adjustment for a taxable year reduces the amount of tax-exempt interest the holder would otherwise account for on the obligation for the taxable year under paragraph (b)(3)(iii) of this section. If the net negative adjustment exceeds this amount, the excess is a nondeductible, noncapitalizable loss. If a regulated investment company (RIC) within the meaning of section 851 has a net negative adjustment in a taxable year that would be a nondeductible, noncapitalizable loss under the prior sentence, the RIC must use this loss to reduce its tax-exempt interest income on other tax-exempt obligations held during the taxable year.

(C) *Gains.* Any gain recognized on the sale, exchange, or retirement of the obligation is gain from the sale or exchange of the obligation.

(D) *Losses.* Any loss recognized on the sale, exchange, or retirement of the obligation is treated the same as a net negative adjustment under paragraph (d)(2)(iv)(B) of this section.

(E) *Special rule for losses and net negative adjustments.* Notwithstanding paragraphs (d)(2)(iv) (B) and (D) of this section, on the sale, exchange, or retirement of the obligation, the holder may claim a loss from the sale or exchange of the obligation to the extent the holder has not received in cash or property the sum of its original investment in the obligation and any amounts included in income under paragraph (d)(4)(ii) of this section.

(3) *All other tax-exempt obligations*—(i) *Applicability*. This paragraph (d)(3) applies to a tax-exempt obligation that is not subject to paragraph (d)(2) of this section.

(ii) *Modifications to the noncontingent bond method.* If a tax-exempt obligation is subject to this paragraph (d)(3), the following modifications to the noncontingent bond method described in paragraph (b) of this section apply to the obligation.

(A) *Modification to projected payment schedule.* The comparable yield for the obligation is the greater of the obligation's yield, determined without regard to the contingent payments, and the tax-exempt applicable Federal rate that applies to the obligation. The Internal Revenue Service publishes the tax-exempt applicable Federal rate for each month in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter).

(B) *Daily portions.* The daily portions of interest determined under paragraph (b)(3)(iii) of this section are interest for purposes of section 103.

(C) *Adjustments.* A net positive adjustment on the obligation is treated as gain to the holder from the sale or exchange of the obligation in the taxable year of the adjustment. A net negative adjustment on the obligation is treated as a loss to the holder from the sale or exchange of the obligation in the taxable year of the adjustment.

(D) *Gains and losses.* Any gain or loss recognized on the sale, exchange, or retirement of the obligation is gain or loss from the sale or exchange of the obligation.

(4) *Basis different from adjusted issue price.* This paragraph (d)(4) provides rules for a holder whose basis in a tax-exempt obligation is different from the adjusted issue price of the obligation. The rules of paragraph (b)(9)(i) of this section do not apply to tax-exempt obligations.

(i) *Basis greater than adjusted issue price.* If the holder's basis in the obligation exceeds the obligation's adjusted issue price, the holder, upon acquiring the obligation, must allocate this difference to daily portions of interest on a yield to maturity basis over the remaining term of the obligation. The amount allocated to a daily portion of interest is not deductible by the holder. However, the holder's basis in the obligation is reduced by the amount allocated to a daily portion of interest on the date the daily portion accrues.

(ii) *Basis less than adjusted issue price.* If the holder's basis in the obligation is less than the obligation's adjusted issue price, the holder, upon acquiring the obligation, must allocate this difference to daily portions of interest on a yield to maturity basis over the remaining term of the obligation. The amount allocated to a daily portion of interest is includible in income by the holder as ordinary income on the date the daily portion accrues. The holder's adjusted basis in the obligation is increased by the amount includible in income by the holder under this paragraph (d)(4)(ii) on the date the daily portion accrues.

(iii) *Premium and discount rules do not apply.* The rules for accruing premium and discount in sections 171, 1276, and 1288 do not apply. Other rules of those sections continue to apply to the extent relevant.

(e) *Amounts treated as interest under this section.* Amounts treated as interest under this section are treated as OID for all purposes of the Internal Revenue Code.

(f) *Effective date.* This section applies to debt instruments issued on or after August 13, 1996.

[T.D. 8674, 61 FR 30143, June 14, 1996, as amended by T.D. 8709, 62 FR 618, Jan. 6, 1997]

§ 1.1275–5 Variable rate debt instruments.

(a) *Applicability*—(1) *In general.* This section provides rules for variable rate debt instruments. Except as provided in paragraph (a)(6) of this section, a variable rate debt instrument is a debt instrument that meets the conditions described in paragraphs (a)(2), (3), (4), and (5) of this section. If a debt instrument that provides for a variable rate of interest does not qualify as a variable rate debt instrument, the debt instrument is a contingent payment debt instrument. See §1.1275–4 for the treatment of a contingent payment debt instrument. See §1.1275–6 for a taxpayer's treatment of a variable rate debt instrument and a hedge.

(2) *Principal payments.* The issue price of the debt instrument must not exceed the total noncontingent principal payments by more than an amount equal to the lesser of—

(i) .015 multiplied by the product of the total noncontingent principal payments and the number of complete years to maturity from the issue date (or, in the case of an installment obligation, the weighted average maturity as defined in §1.1273–1(e)(3)); or

(ii) 15 percent of the total noncontingent principal payments.

(3) *Stated interest*—(i) *General rule.* The debt instrument must not provide for any stated interest other than stated interest (compounded or paid at least annually) at—

(A) One or more qualified floating rates;

(B) A single fixed rate and one or more qualified floating rates;

(C) A single objective rate; or

(D) A single fixed rate and a single objective rate that is a qualified inverse floating rate.

(ii) *Certain debt instruments bearing interest at a fixed rate for an initial period.* If interest on a debt instrument is stated at a fixed rate for an initial period of 1 year or less followed by a variable rate that is either a qualified floating rate or an objective rate for a subsequent period, and the value of the variable rate on the issue date is intended to approximate the fixed rate, the fixed rate and the variable rate together constitute a single qualified floating rate or objective rate. A fixed rate and a variable rate will be conclusively presumed to meet the requirements of the preceding sentence if the value of the variable rate on the issue date does not differ from the value of the fixed rate by more than .25 percentage points (25 basis points).

(4) *Current value.* The debt instrument must provide that a qualified floating rate or objective rate in effect at any time during the term of the instrument is set at a current value of that rate. A current value is the value of the rate on any day that is no earlier than 3 months prior to the first day on which that value is in effect and no later than 1 year following that first day.

(5) *No contingent principal payments.* Except as provided in paragraph (a)(2) of this section, the debt instrument must not provide for any principal payments that are contingent (within the meaning of §1.1275–4(a)).

(6) *Special rule for debt instruments issued for nonpublicly traded property.* A debt instrument (other than a tax-exempt obligation) that would otherwise qualify as a variable rate debt instrument under this section is not a variable rate debt instrument if section 1274 applies to the instrument and any stated interest payments on the instrument are treated as contingent payments under §1.1274–2. This paragraph (a)(6) applies to debt instruments issued on or after August 13, 1996.

(b) *Qualified floating rate*—(1) *In general.* A variable rate is a qualified floating rate if variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which the debt instrument is denominated. The rate may measure contemporaneous variations in borrowing costs for the issuer of the debt instrument or for issuers in general. Except as provided in paragraph (b)(2) of this section, a multiple of a qualified floating rate is not a qualified floating rate. If a debt instrument provides for two or more qualified floating rates that can reasonably be expected to have approximately the same values throughout the term of the instrument, the qualified floating rates together constitute a single qualified floating rate. Two or more qualified floating rates will be conclusively presumed to meet the requirements of the preceding sentence if the values of all rates on the issue date are within .25 percentage points (25 basis points) of each other.

(2) *Certain rates based on a qualified floating rate.* For a debt instrument issued on or after August 13, 1996, a variable rate is a qualified floating rate if it is equal to either—

(i) The product of a qualified floating rate described in paragraph (b)(1) of this section and a fixed multiple that is greater than .65 but not more than 1.35; or

(ii) The product of a qualified floating rate described in paragraph (b)(1) of this section and a fixed multiple that is greater than .65 but not more than 1.35, increased or decreased by a fixed rate.

(3) *Restrictions on the stated rate of interest.* A variable rate is not a qualified floating rate if it is subject to a restriction or restrictions on the maximum stated interest rate (cap), a restriction or restrictions on the minimum stated interest rate (floor), a restriction or restrictions on the amount of increase or decrease in the stated interest rate (governor), or other similar restrictions. Notwithstanding the preceding sentence, the following restrictions will not cause a variable rate to fail to be a qualified floating rate—

(i) A cap, floor, or governor that is fixed throughout the term of the debt instrument;

(ii) A cap or similar restriction that is not reasonably expected as of the issue date to cause the yield on the debt instrument to be significantly less than the expected yield determined without the cap;

(iii) A floor or similar restriction that is not reasonably expected as of the issue date to cause the yield on the debt instrument to be significantly more than the expected yield determined without the floor; or

(iv) A governor or similar restriction that is not reasonably expected as of the issue date to cause the yield on the debt instrument to be significantly more or significantly less than the expected yield determined without the governor.

(c) *Objective rate*—(1) *Definition*—(i) *In general.* For debt instruments issued on or after August 13, 1996, an objective rate is a rate (other than a qualified floating rate) that is determined using a single fixed formula and that is based on objective financial or economic information. For example, an objective rate generally includes a rate that is based on one or more qualified floating rates or on the yield of actively traded personal property (within the meaning of section 1092(d)(1)).

(ii) *Exception.* For purposes of paragraph (c)(1)(i) of this section, an objective rate does not include a rate based on information that is within the control of the issuer (or a related party within the meaning of section 267(b) or 707(b)(1)) or that is unique to the circumstances of the issuer (or a related party within the meaning of section 267(b) or 707(b)(1)), such as dividends, profits, or the value of the issuer's stock. However, a rate does not fail to be an objective rate merely because it is based on the credit quality of the issuer.

(2) *Other objective rates to be specified by Commissioner.* The Commissioner may designate in the Internal Revenue Bulletin variable rates other than those described in paragraph (c)(1) of this section that will be treated as objective rates (see § 601.601(d)(2)(ii) of this chapter).

(3) *Qualified inverse floating rate.* An objective rate described in paragraph (c)(1) of this section is a qualified inverse floating rate if—

(i) The rate is equal to a fixed rate minus a qualified floating rate; and

(ii) The variations in the rate can reasonably be expected to inversely reflect contemporaneous variations in the qualified floating rate (disregarding any restrictions on the rate that are described in paragraphs (b)(3)(i), (b)(3)(ii), (b)(3)(iii), and (b)(3)(iv) of this section).

(4) *Significant front-loading or back-loading of interest.* Notwithstanding paragraph (c)(1) of this section, a variable rate of interest on a debt instrument is not an objective rate if it is reasonably expected that the average value of the rate during the first half of the instrument's term will be either significantly less than or significantly greater than the average value of the rate during the final half of the instrument's term.

(5) *Tax-exempt obligations.* Notwithstanding paragraph (c)(1) of this section, in the case of a tax-exempt obligation (within the meaning of section

1275(a)(3)), a variable rate is an objective rate only if it is a qualified inverse floating rate or a qualified inflation rate. A rate is a qualified inflation rate if the rate measures contemporaneous changes in inflation based on a general inflation index.

(d) *Examples.* The following examples illustrate the rules of paragraphs (b) and (c) of this section. For purposes of these examples, assume that the debt instrument is not a tax-exempt obligation. In addition, unless otherwise provided, assume that the rate is not reasonably expected to result in a significant front-loading or back-loading of interest and that the rate is not based on objective financial or economic information that is within the control of the issuer (or a related party) or that is unique to the circumstances of the issuer (or a related party).

Example 1. Rate based on LIBOR. X issues a debt instrument that provides for annual payments of interest at a rate equal to the value of the 1-year London Interbank Offered Rate (LIBOR) at the end of each year. Variations in the value of 1-year LIBOR over the term of the debt instrument can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds over that term. Accordingly, the rate is a qualified floating rate.

Example 2. Rate increased by a fixed amount. X issues a debt instrument that provides for annual payments of interest at a rate equal to 200 basis points (2 percent) plus the current value, at the end of each year, of the average yield on 1-year Treasury securities as published in Federal Reserve bulletins. Variations in the value of this interest rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is a qualified floating rate.

Example 3. Rate based on commercial paper rate. X issues a debt instrument that provides for a rate of interest that is periodically adjusted to equal the current interest rate of Bank's commercial paper. Variations in the value of this interest rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is a qualified floating rate.

Example 4. Rate based on changes in the value of a commodity index. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to the percentage increase, if any, in the value of an index for the year immediately preceding the payment. The index is based on the prices of several actively traded commodities. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is not a qualified floating rate. However, because the rate is based on objective financial information using a single fixed formula, the rate is an objective rate.

Example 5. Rate based on a percentage of S&P 500 Index. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year based on a fixed percentage of the value of the S&P 500 Index. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds and, therefore, the rate is not a qualified floating rate. Although the rate is described in paragraph (c)(1)(i) of this section, the rate is not an objective rate because, based on historical data, it is reasonably expected that the average value of the rate during the first half of the instrument's term will be significantly less than the average value of the rate during the final half of the instrument's term.

Example 6. Rate based on issuer's profits. On January 1, 1997, Z issues a debt instrument that provides for annual interest payments equal to 1 percent of Z's gross profits earned during the year immediately preceding the payment. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is not a qualified floating rate. In addition, because the rate is based on information that is unique to the issuer's circumstances, the rate is not an objective rate.

Example 7. Rate based on a multiple of an interest index. On January 1, 1997, Z issues a debt instrument with annual interest payments at a rate equal to two times the value of 1-year LIBOR as of the payment date. Because the rate is a multiple greater than 1.35 times a qualified floating rate, the rate is not a qualified floating rate. However, because the rate is based on objective financial information using a single fixed formula, the rate is an objective rate.

Example 8. Variable rate based on the cost of borrowed funds in a foreign currency. On January 1, 1997, Y issues a 5-year dollar denominated debt instrument that provides for annual interest payments at a rate equal to the value of 1-year French franc LIBOR as of the payment date. Variations in the value of French franc LIBOR do not measure contemporaneous changes in the cost of newly borrowed funds in dollars. As a result, the rate is not a qualified floating rate for an instrument denominated in dollars. However, because the rate is based on objective financial information using a single fixed formula, the rate is an objective rate.

Example 9. Qualified inverse floating rate. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to 12 percent minus the value of 1-year LIBOR as of the payment date. On the issue date, the value of 1-year LIBOR is 6 percent. Because the rate can reasonably be expected to inversely reflect contemporaneous variations in 1-year LIBOR, it is a qualified inverse floating rate. However, if the value of 1-year LIBOR on the issue date were 11 percent rather than 6 percent, the rate would not be a qualified inverse floating rate because the rate could not reasonably be expected to inversely reflect contemporaneous variations in 1-year LIBOR.

Example 10. Rate based on an inflation index. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to 400 basis points (4 percent) plus the annual percentage change in a general inflation index (e.g., the Consumer Price Index, U.S. City Average, All Items, for all Urban Consumers, seasonally unadjusted). The rate, however, may not be less than zero. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is not a qualified floating rate. However, because the rate is based on objective economic information using a single fixed formula, the rate is an objective rate.

(e) *Qualified stated interest and OID with respect to a variable rate debt instrument*—(1) *In general.* This paragraph (e) provides rules to determine the amount and accrual of OID and qualified stated interest on a variable rate debt instrument. In general, the rules convert the debt instrument into a fixed rate debt instrument and then apply the general OID rules to the debt instrument. The issue price of a variable rate debt instrument, however, is not determined under this paragraph (e). See §§ 1.1273–2 and 1.1274–2 to determine the issue price of a variable rate debt instrument.

(2) *Variable rate debt instrument that provides for annual payments of interest at a single variable rate.* If a variable rate debt instrument provides for stated interest at a single qualified floating rate or objective rate and the interest is unconditionally payable in cash or in property (other than debt instruments of the issuer), or will be constructively received under section 451, at least annually, the following rules apply to the instrument:

(i) All stated interest with respect to the debt instrument is qualified stated interest.

(ii) The amount of qualified stated interest and the amount of OID, if any, that accrues during an accrual period is determined under the rules applicable to fixed rate debt instruments by assuming that the variable rate is a fixed rate equal to—

(A) In the case of a qualified floating rate or qualified inverse floating rate, the value, as of the issue date, of the qualified floating rate or qualified inverse floating rate; or

(B) In the case of an objective rate (other than a qualified inverse floating rate), a fixed rate that reflects the yield that is reasonably expected for the debt instrument.

(iii) The qualified stated interest allocable to an accrual period is increased (or decreased) if the interest actually paid during an accrual period exceeds (or is less than) the interest assumed to be paid during the accrual period under paragraph (e)(2)(ii) of this section.

(3) *All other variable rate debt instruments except for those that provide for a fixed rate.* If a variable rate debt instrument is not described in paragraph (e)(2) of this section and does not provide for interest payable at a fixed rate (other than an initial fixed rate described in paragraph (a)(3)(ii) of this section), the amount of interest and OID accruals for the instrument are determined under this paragraph (e)(3).

(i) *Step one: Determine the fixed rate substitute for each variable rate provided under the debt instrument*—(A) *Qualified floating rate.* The fixed rate substitute for each qualified floating rate provided for in the debt instrument is the value of each rate as of the issue date. If, however, a variable rate debt instrument provides for two or more qualified floating rates with different intervals between interest adjustment dates, the fixed rate substitutes for the rates must be based on intervals that are equal in length. For example, if a 4-year debt instrument provides for 24 monthly interest payments based on the value of the 30-day commercial paper rate on each payment date followed by 8 quarterly interest payments based on the value of quarterly LIBOR on each payment date, the fixed rate substitutes may be based on the values, as of the issue date, of the 90-day commercial paper rate and quarterly LIBOR. Alternatively, the fixed rate substitutes may be based on the values, as of the issue date, of the 30-day commercial paper rate and monthly LIBOR.

(B) *Qualified inverse floating rate.* The fixed rate substitute for a qualified inverse floating rate is the value of the qualified inverse floating rate as of the issue date.

(C) *Objective rate.* The fixed rate substitute for an objective rate (other than a qualified inverse floating rate) is a fixed rate that reflects the yield that is reasonably expected for the debt instrument.

(ii) *Step two: Construct the equivalent fixed rate debt instrument.* The equivalent fixed rate debt instrument has terms that are identical to those provided under the variable rate debt instrument, except that the equivalent fixed rate debt instrument provides for the fixed rate substitutes (determined in paragraph (e)(3)(i) of this section) in lieu of the qualified floating rates or objective rate provided under the variable rate debt instrument.

(iii) *Step three: Determine the amount of qualified stated interest and OID with respect to the equivalent fixed rate debt instrument.* The amount of qualified stated interest and OID, if any, are determined for the equivalent fixed rate debt instrument under the rules applicable to fixed rate debt instruments and are taken into account as if the holder held the equivalent fixed rate debt instrument.

(iv) *Step four: Make appropriate adjustments for actual variable rates.* Qualified stated interest or OID allocable to an accrual period must be increased (or decreased) if the interest actually accrued or paid during an accrual period exceeds (or is less than) the interest assumed to be accrued or paid during the accrual period under the equivalent fixed rate debt instrument. This increase or decrease is an adjustment to qualified stated interest for the accrual period if the equivalent fixed rate debt instrument (as determined under paragraph (e)(3)(ii) of this section) provides for qualified stated interest and the increase or decrease is reflected in the amount actually paid during the accrual period. Otherwise, this increase or decrease is an adjustment to OID for the accrual period.

(v) *Examples.* The following examples illustrate the rules in paragraphs (e) (2) and (3) of this section:

Example 1. Equivalent fixed rate debt instrument—(i) *Facts.* X purchases at original issue a 6-year variable rate debt instrument that provides for semiannual payments of interest. For the first 3 years, the rate of interest is the value of 6-month LIBOR on the payment date. For the final 3 years, the rate is the value of the 6-month T-bill rate on the payment date. On the issue date, the value of 6-month LIBOR is 3 percent, compounded semiannually, and the 6-month T-bill rate is 2 percent, compounded semiannually.

(ii) *Determination of equivalent fixed rate debt instrument.* Under paragraph (e)(3)(i) of this section, the fixed rate substitute for 6-month LIBOR is 3 percent, compounded semiannually, and the fixed rate substitute for the 6-month T-bill rate is 2 percent, compounded semiannually. Under paragraph (e)(3)(ii) of this section, the equivalent fixed rate debt instrument is a 6-year debt instrument that provides for semiannual payments of interest at 3 percent, compounded semiannually, for the first 3 years followed by 2 percent, compounded semiannually, for the final 3 years.

Example 2. Equivalent fixed rate debt instrument with de minimis OID—(i) *Facts.* Y purchases at original issue, for $100,000, a 4-year variable rate debt instrument that has a stated principal amount of $100,000, payable at maturity. The debt instrument provides for monthly payments of interest at the end of each month. For the first year, the interest rate is the monthly commercial paper rate and for the last 3 years, the interest rate is the monthly commercial paper rate plus 100 basis points. On the issue date, the monthly commercial paper rate is 3 percent, compounded monthly.

(ii) *Equivalent fixed rate debt instrument.* Under paragraph (e)(3)(ii) of this section, the equivalent fixed rate debt instrument for the variable rate debt instrument is a 4-year debt instrument that has an issue price and stated principal amount of $100,000. The equivalent fixed rate debt instrument provides for monthly payments of interest at 3 percent, compounded monthly, for the first year ($250 per month) and monthly payments of interest at 4 percent, compounded monthly, for the last 3 years ($333.33 per month).

(iii) *De minimis OID.* Under §1.1273–1(a), because a portion (100 basis points) of each interest payment in the final 3 years is not a qualified stated interest payment, the equivalent fixed rate debt instrument has OID of

$2,999.88 ($102,999.88 −$100,000). However, under § 1.1273–1(d)(4) (the de minimis rule relating to teaser rates and interest holidays), the stated redemption price at maturity of the equivalent fixed rate debt instrument is $100,999.96 ($100,000 (issue price) plus $999.96 (the greater of the amount of foregone interest ($999.96) and the amount equal to the excess of the instrument's stated principal amount over its issue price ($0)). Thus, the equivalent fixed rate debt instrument is treated as having OID of $999.96 ($100,999.96 −$100,000). Because this amount is less than the de minimis amount of $1,010 (0.0025 multiplied by $100,999.96 multiplied by 4 complete years to maturity), the equivalent fixed rate debt instrument has de minimis OID. Therefore, the variable rate debt instrument has zero OID and all stated interest payments are qualified stated interest payments.

Example 3. Adjustment to qualified stated interest for actual payment of interest—(i) *Facts.* On January 1, 1995, Z purchases at original issue, for $90,000, a variable rate debt instrument that matures on January 1, 1997, and has a stated principal amount of $100,000, payable at maturity. The debt instrument provides for annual payments of interest on January 1 of each year, beginning on January 1, 1996. The amount of interest payable is the value of annual LIBOR on the payment date. The value of annual LIBOR on January 1, 1995, and January 1, 1996, is 5 percent, compounded annually. The value of annual LIBOR on January 1, 1997, is 7 percent, compounded annually.

(ii) *Accrual of OID and qualified stated interest.* Under paragraph (e)(2) of this section, the variable rate debt instrument is treated as a 2-year debt instrument that has an issue price of $90,000, a stated principal amount of $100,000, and interest payments of $5,000 at the end of each year. The debt instrument has $10,000 of OID and the annual interest payments of $5,000 are qualified stated interest payments. Under § 1.1272–1, the debt instrument has a yield of 10.82 percent, compounded annually. The amount of OID allocable to the first annual accrual period (assuming Z uses annual accrual periods) is $4,743.25 (($90,000×.1082)− $5,000), and the amount of OID allocable to the second annual accrual period is $5,256.75 ($100,000−$94,743.25). Under paragraph (e)(2)(iii) of this section, the $2,000 difference between the $7,000 interest payment actually made at maturity and the $5,000 interest payment assumed to be made at maturity under the equivalent fixed rate debt instrument is treated as additional qualified stated interest for the period.

(4) *Variable rate debt instrument that provides for a single fixed rate*—(i) *General rule.* If a variable rate debt instrument provides for stated interest either at one or more qualified floating rates or at a qualified inverse floating rate and in addition provides for stated interest at a single fixed rate (other than an initial fixed rate described in paragraph (a)(3)(ii) of this section), the amount of interest and OID are determined using the method of paragraph (e)(3) of this section, as modified by this paragraph (e)(4). For purposes of paragraphs (e)(3)(i) through (e)(3)(iii) of this section, the variable rate debt instrument is treated as if it provided for a qualified floating rate (or a qualified inverse floating rate, if the debt instrument provides for a qualified inverse floating rate), rather than the fixed rate. The qualified floating rate (or qualified inverse floating rate) replacing the fixed rate must be such that the fair market value of the variable rate debt instrument as of the issue date would be approximately the same as the fair market value of an otherwise identical debt instrument that provides for the qualified floating rate (or qualified inverse floating rate) rather than the fixed rate.

(ii) *Example.* The following example illustrates the rule in paragraph (e)(4)(i) of this section.

Example: Variable rate debt instrument that provides for a single fixed rate—(i) *Facts.* On January 1, 1995, X purchases at original issue, for $100,000, a variable rate debt instrument that matures on January 1, 2001, and that has a stated principal amount of $100,000. The debt instrument provides for payments of interest on January 1 of each year, beginning on January 1, 1996. For the first 4 years, the interest rate is 4 percent, compounded annually, and for the last 2 years the interest rate is the value of 1-year LIBOR, as of the payment date, plus 200 basis points. On January 1, 1995, the value of 1-year LIBOR is 2 percent, compounded annually. In addition, assume that on January 1, 1995, the variable rate debt instrument has approximately the same fair market value as an otherwise identical debt instrument that provides for an interest rate equal to the value of 1-year LIBOR, as of the payment date, for the first 4 years.

(ii) *Equivalent fixed rate debt instrument.* Under paragraph (e)(4)(i) of this section, for purposes of paragraphs (e)(3)(i) through (e)(3)(iii) of this section, the variable rate debt instrument is treated as if it provided for an interest rate equal to the value of 1-year LIBOR, as of the payment date, for the first 4 years. Under paragraph (e)(3)(ii) of this section, the equivalent fixed rate debt instrument for the variable rate debt instrument is a 6-year debt instrument that has an issue price and stated principal amount of $100,000. The equivalent fixed rate debt instrument provides for interest payments of $2,000 for the first 4 years and $4,000 for the last 2 years.

(iii) *Accrual of OID and qualified stated interest.* Under §1.1273–1, the equivalent fixed rate debt instrument has OID of $4,000 because a portion (200 basis points) of each interest payment in the last 2 years is not a qualified stated interest payment. The $4,000 of OID is allocable over the 6-year term of the debt instrument under §1.1272–1. Under paragraph (e)(3)(iv) of this section, the difference between the $4,000 payment made in the first 4 years and the $2,000 payment assumed to be made on the equivalent fixed rate debt instrument in those years is an adjustment to qualified stated interest. In addition, any difference between the amount actually paid in each of the last 2 years and the $4,000 payment assumed to be made on the equivalent fixed rate debt instrument is an adjustment to qualified stated interest.

(f) *Special rule for certain reset bonds.* Notwithstanding paragraph (e) of this section, this paragraph (f) provides a special rule for a variable rate debt instrument that provides for stated interest at a fixed rate for an initial interval, and provides that on the date immediately following the end of the initial interval (the effective date) the stated interest rate will be a rate determined under a procedure (such as an auction procedure) so that the fair market value of the instrument on the effective date will be a fixed amount (the reset value). Solely for purposes of calculating the accrual of OID, the variable rate debt instrument is treated as—

(1) Maturing on the date immediately preceding the effective date for an amount equal to the reset value; and

(2) Reissued on the effective date for an amount equal to the reset value.

[T.D. 8517, 59 FR 4827, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30153, June 14, 1996]

§1.1275–6 Integration of qualifying debt instruments.

(a) *In general.* This section generally provides for the integration of a qualifying debt instrument with a hedge or combination of hedges if the combined cash flows of the components are substantially equivalent to the cash flows on a fixed or variable rate debt instrument. The integrated transaction is generally subject to the rules of this section rather than the rules to which each component of the transaction would be subject on a separate basis. The purpose of this section is to permit a more appropriate determination of the character and timing of income, deductions, gains, or losses than would be permitted by separate treatment of the components. The rules of this section affect only the taxpayer who holds (or issues) the qualifying debt instrument and enters into the hedge.

(b) *Definitions*—(1) *Qualifying debt instrument.* A qualifying debt instrument is any debt instrument (including an integrated transaction as defined in paragraph (c) of this section) other than—

(i) A tax-exempt obligation as defined in section 1275(a)(3);

(ii) A debt instrument to which section 1272(a)(6) applies (certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration); or

(iii) A debt instrument that is subject to §1.483–4 or §1.1275–4(c) (certain contingent payment debt instruments issued for nonpublicly traded property).

(2) *Section 1.1275–6 hedge*—(i) *In general.* A §1.1275–6 hedge is any financial instrument (as defined in paragraph (b)(3) of this section) if the combined cash flows of the financial instrument and the qualifying debt instrument permit the calculation of a yield to maturity (under the principles of section 1272), or the right to the combined cash flows would qualify under §1.1275–5 as a variable rate debt instrument that pays interest at a qualified floating rate or rates (except for the requirement that the interest payments be stated as interest). A financial instrument is not a §1.1275–6 hedge, however, if the resulting synthetic debt instrument does not have the same term as the remaining term of the qualifying debt instrument. A financial instrument that hedges currency risk is not a §1.1275–6 hedge.

(ii) *Limitations*—(A) A debt instrument issued by a taxpayer and a debt instrument held by the taxpayer cannot be part of the same integrated transaction.

(B) A debt instrument can be a § 1.1275–6 hedge only if it is issued substantially contemporaneously with, and has the same maturity (including rights to accelerate or delay payments) as, the qualifying debt instrument.

(3) *Financial instrument.* For purposes of this section, a financial instrument is a spot, forward, or futures contract, an option, a notional principal contract, a debt instrument, or a similar instrument, or combination or series of financial instruments. Stock is not a financial instrument for purposes of this section.

(4) *Synthetic debt instrument.* The synthetic debt instrument is the hypothetical debt instrument with the same cash flows as the combined cash flows of the qualifying debt instrument and the § 1.1275–6 hedge.

(c) *Integrated transaction*—(1) *Integration by taxpayer.* Except as otherwise provided in this section, a qualifying debt instrument and a § 1.1275–6 hedge are an integrated transaction if all of the following requirements are satisfied:

(i) The taxpayer satisfies the identification requirements of paragraph (e) of this section on or before the date the taxpayer enters into the § 1.1275–6 hedge.

(ii) None of the parties to the § 1.1275–6 hedge are related within the meaning of section 267(b) or 707(b)(1), or, if the parties are related, the party providing the hedge uses, for Federal income tax purposes, a mark-to-market method of accounting for the hedge and all similar or related transactions.

(iii) Both the qualifying debt instrument and the § 1.1275–6 hedge are entered into by the same individual, partnership, trust, estate, or corporation (regardless of whether the corporation is a member of an affiliated group of corporations that files a consolidated return).

(iv) If the taxpayer is a foreign person engaged in a U.S. trade or business and the taxpayer issues or acquires a qualifying debt instrument, or enters into a § 1.1275–6 hedge, through the trade or business, all items of income and expense associated with the qualifying debt instrument and the § 1.1275–6 hedge (other than interest expense that is subject to § 1.882–5) would have been effectively connected with the U.S. trade or business throughout the term of the qualifying debt instrument had this section not applied.

(v) Neither the qualifying debt instrument, nor any other debt instrument that is part of the same issue as the qualifying debt instrument, nor the § 1.1275–6 hedge was, with respect to the taxpayer, part of an integrated transaction that was terminated or otherwise legged out of within the 30 days immediately preceding the date that would be the issue date of the synthetic debt instrument.

(vi) The qualifying debt instrument is issued or acquired by the taxpayer on or before the date of the first payment on the § 1.1275–6 hedge, whether made or received by the taxpayer (including a payment made to purchase the hedge). If the qualifying debt instrument is issued or acquired by the taxpayer after, but substantially contemporaneously with, the date of the first payment on the § 1.1275–6 hedge, the qualifying debt instrument is treated, solely for purposes of this paragraph (c)(1)(vi), as meeting the requirements of the preceding sentence.

(vii) Neither the § 1.1275–6 hedge nor the qualifying debt instrument was, with respect to the taxpayer, part of a straddle (as defined in section 1092(c)) prior to the issue date of the synthetic debt instrument.

(2) *Integration by Commissioner.* The Commissioner may treat a qualifying debt instrument and a financial instrument (whether entered into by the taxpayer or by a related party) as an integrated transaction if the combined cash flows on the qualifying debt instrument and financial instrument are substantially the same as the combined cash flows required for the financial instrument to be a § 1.1275–6 hedge. The Commissioner, however, may not integrate a transaction unless the qualifying debt instrument either is subject to § 1.1275–4 or is subject to § 1.1275–5 and pays interest at an objective rate. The circumstances under which the Commissioner may require integration include, but are not limited to, the following:

(i) A taxpayer fails to identify a qualifying debt instrument and the

§1.1275–6 hedge under paragraph (e) of this section.

(ii) A taxpayer issues or acquires a qualifying debt instrument and a related party (within the meaning of section 267(b) or 707(b)(1)) enters into the §1.1275–6 hedge.

(iii) A taxpayer issues or acquires a qualifying debt instrument and enters into the §1.1275–6 hedge with a related party (within the meaning of section 267(b) or 707(b)(1)).

(iv) The taxpayer legs out of an integrated transaction and within 30 days enters into a new §1.1275–6 hedge with respect to the same qualifying debt instrument or another debt instrument that is part of the same issue.

(d) *Special rules for legging into and legging out of an integrated transaction*—(1) *Legging into*—(i) *Definition.* Legging into an integrated transaction under this section means that a §1.1275–6 hedge is entered into after the date the qualifying debt instrument is issued or acquired by the taxpayer, and the requirements of paragraph (c)(1) of this section are satisfied on the date the §1.1275–6 hedge is entered into (the leg-in date).

(ii) *Treatment.* If a taxpayer legs into an integrated transaction, the taxpayer treats the qualifying debt instrument under the applicable rules for taking interest and OID into account up to the leg-in date, except that the day before the leg-in date is treated as the end of an accrual period. As of the leg-in date, the qualifying debt instrument is subject to the rules of paragraph (f) of this section.

(iii) *Anti-abuse rule.* If a taxpayer legs into an integrated transaction with a principal purpose of deferring or accelerating income or deductions on the qualifying debt instrument, the Commissioner may—

(A) Treat the qualifying debt instrument as sold for its fair market value on the leg-in date; or

(B) Refuse to allow the taxpayer to integrate the qualifying debt instrument and the §1.1275–6 hedge.

(2) *Legging out*—(i) *Definition*—(A) *Legging out if the taxpayer has integrated.* If a taxpayer has integrated a qualifying debt instrument and a §1.1275–6 hedge under paragraph (c)(1) of this section, legging out means that, prior to the maturity of the synthetic debt instrument, the §1.1275–6 hedge ceases to meet the requirements for a §1.1275–6 hedge, the taxpayer fails to meet any requirement of paragraph (c)(1) of this section, or the taxpayer disposes of or otherwise terminates all or a part of the qualifying debt instrument or §1.1275–6 hedge. If the taxpayer fails to meet the requirements of paragraph (c)(1) of this section but meets the requirements of paragraph (c)(2) of this section, the Commissioner may treat the taxpayer as not legging out.

(B) *Legging out if the Commissioner has integrated.* If the Commissioner has integrated a qualifying debt instrument and a financial instrument under paragraph (c)(2) of this section, legging out means that, prior to the maturity of the synthetic debt instrument, the requirements for Commissioner integration under paragraph (c)(2) of this section are not met or the taxpayer fails to meet the requirements for taxpayer integration under paragraph (c)(1) of this section and the Commissioner agrees to allow the taxpayer to be treated as legging out.

(C) *Exception for certain nonrecognition transactions.* If, in a single nonrecognition transaction, a taxpayer disposes of, or ceases to be primarily liable on, the qualifying debt instrument and the §1.1275–6 hedge, the taxpayer is not treated as legging out. Instead, the integrated transaction is treated under the rules governing the nonrecognition transaction. For example, if a holder of an integrated transaction is acquired in a reorganization under section 368(a)(1)(A), the holder is treated as disposing of the synthetic debt instrument in the reorganization rather than legging out. If the successor holder is not eligible for integrated treatment, the successor is treated as legging out.

(ii) *Operating rules.* If a taxpayer legs out (or is treated as legging out) of an integrated transaction, the following rules apply:

(A) The transaction is treated as an integrated transaction during the time the requirements of paragraph (c) (1) or (2) of this section, as appropriate, are satisfied.

(B) Immediately before the taxpayer legs out, the taxpayer is treated as selling or otherwise terminating the synthetic debt instrument for its fair market value and, except as provided in paragraph (d)(2)(ii)(D) of this section, any income, deduction, gain, or loss is realized and recognized at that time.

(C) If, immediately after the taxpayer legs out, the taxpayer holds or remains primarily liable on the qualifying debt instrument, adjustments are made to reflect any difference between the fair market value of the qualifying debt instrument and the adjusted issue price of the qualifying debt instrument. If, immediately after the taxpayer legs out, the taxpayer is a party to a § 1.1275–6 hedge, the § 1.1275–6 hedge is treated as entered into at its fair market value.

(D) If a taxpayer legs out of an integrated transaction by disposing of or otherwise terminating a § 1.1275–6 hedge within 30 days of legging into the integrated transaction, then any loss or deduction determined under paragraph (d)(2)(ii)(B) of this section is not allowed. Appropriate adjustments are made to the qualifying debt instrument for any disallowed loss. The adjustments are taken into account on a yield to maturity basis over the remaining term of the qualifying debt instrument.

(E) If a holder of a debt instrument subject to § 1.1275–4 legs into an integrated transaction with respect to the instrument and subsequently legs out of the integrated transaction, any gain recognized under paragraph (d)(2)(ii)(B) or (C) of this section is treated as interest income to the extent determined under the principles of § 1.1275–4(b)(8)(iii)(B) (rules for determining the character of gain on the sale of a debt instrument all of the payments on which have been fixed). If the synthetic debt instrument would qualify as a variable rate debt instrument, the equivalent fixed rate debt instrument determined under § 1.1275–5(e) is used for this purpose.

(e) *Identification requirements.* For each integrated transaction, a taxpayer must enter and retain as part of its books and records the following information—

(1) The date the qualifying debt instrument was issued or acquired (or is expected to be issued or acquired) by the taxpayer and the date the § 1.1275–6 hedge was entered into by the taxpayer;

(2) A description of the qualifying debt instrument and the § 1.1275–6 hedge; and

(3) A summary of the cash flows and accruals resulting from treating the qualifying debt instrument and the § 1.1275–6 hedge as an integrated transaction (i.e., the cash flows and accruals on the synthetic debt instrument).

(f) *Taxation of integrated transactions*—(1) *General rule.* An integrated transaction is generally treated as a single transaction by the taxpayer during the period that the transaction qualifies as an integrated transaction. Except as provided in paragraph (f)(12) of this section, while a qualifying debt instrument and a § 1.1275–6 hedge are part of an integrated transaction, neither the qualifying debt instrument nor the § 1.1275–6 hedge is subject to the rules that would apply on a separate basis to the debt instrument and the § 1.1275–6 hedge, including section 1092 or § 1.446–4. The rules that would govern the treatment of the synthetic debt instrument generally govern the treatment of the integrated transaction. For example, the integrated transaction may be subject to section 263(g) or, if the synthetic debt instrument would be part of a straddle, section 1092. Generally, the synthetic debt instrument is subject to sections 163(e) and 1271 through 1275, with terms as set forth in paragraphs (f) (2) through (13) of this section.

(2) *Issue date.* The issue date of the synthetic debt instrument is the first date on which the taxpayer entered into all of the components of the synthetic debt instrument.

(3) *Term.* The term of the synthetic debt instrument is the period beginning on the issue date of the synthetic debt instrument and ending on the maturity date of the qualifying debt instrument.

(4) *Issue price.* The issue price of the synthetic debt instrument is the adjusted issue price of the qualifying debt instrument on the issue date of the synthetic debt instrument. If, as a result of entering into the § 1.1275–6 hedge, the taxpayer pays or receives

one or more payments that are substantially contemporaneous with the issue date of the synthetic debt instrument, the payments reduce or increase the issue price as appropriate.

(5) *Adjusted issue price.* In general, the adjusted issue price of the synthetic debt instrument is determined under the principles of §1.1275–1(b).

(6) *Qualified stated interest.* No amounts payable on the synthetic debt instrument are qualified stated interest within the meaning of §1.1273–1(c).

(7) *Stated redemption price at maturity*—(i) *Synthetic debt instruments that are borrowings.* In general, if the synthetic debt instrument is a borrowing, the instrument's stated redemption price at maturity is the sum of all amounts paid or to be paid on the qualifying debt instrument and the §1.1275–6 hedge, reduced by any amounts received or to be received on the §1.1275–6 hedge.

(ii) *Synthetic debt instruments that are held by the taxpayer.* In general, if the synthetic debt instrument is held by the taxpayer, the instrument's stated redemption price at maturity is the sum of all amounts received or to be received by the taxpayer on the qualifying debt instrument and the §1.1275–6 hedge, reduced by any amounts paid or to be paid by the taxpayer on the §1.1275–6 hedge.

(iii) *Certain amounts ignored.* For purposes of this paragraph (f)(7), if an amount paid or received on the §1.1275–6 hedge is taken into account under paragraph (f)(4) of this section to determine the issue price of the synthetic debt instrument, the amount is not taken into account to determine the synthetic debt instrument's stated redemption price at maturity.

(8) *Source of interest income and allocation of expense.* The source of interest income from the synthetic debt instrument is determined by reference to the source of income of the qualifying debt instrument under sections 861(a)(1) and 862(a)(1). For purposes of section 904, the character of interest from the synthetic debt instrument is determined by reference to the character of the interest income from the qualifying debt instrument. Interest expense is allocated and apportioned under regulations under section 861 or under §1.882–5.

(9) *Effectively connected income.* If the requirements of paragraph (c)(1)(iv) of this section are satisfied, any interest income resulting from the synthetic debt instrument entered into by the foreign person is treated as effectively connected with a U.S. trade or business, and any interest expense resulting from the synthetic debt instrument entered into by the foreign person is allocated and apportioned under §1.882–5.

(10) *Not a short-term obligation.* For purposes of section 1272(a)(2)(C), a synthetic debt instrument is not treated as a short-term obligation.

(11) *Special rules in the event of integration by the Commissioner.* If the Commissioner requires integration, appropriate adjustments are made to the treatment of the synthetic debt instrument, and, if necessary, the qualifying debt instrument and financial instrument. For example, the Commissioner may treat a financial instrument that is not a §1.1275–6 hedge as a §1.1275–6 hedge when applying the rules of this section. The issue date of the synthetic debt instrument is the date determined appropriate by the Commissioner to require integration.

(12) *Retention of separate transaction rules for certain purposes.* This paragraph (f)(12) provides for the retention of separate transaction rules for certain purposes. In addition, by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter), the Commissioner may require use of separate transaction rules for any aspect of an integrated transaction.

(i) *Foreign persons that enter into integrated transactions giving rise to U.S. source income not effectively connected with a U.S. trade or business.* If a foreign person enters into an integrated transaction that gives rise to U.S. source interest income (determined under the source rules for the synthetic debt instrument) not effectively connected with a U.S. trade or business of the foreign person, paragraph (f) of this section does not apply for purposes of sections 871(a), 881, 1441, 1442, and 6049. These sections of the Internal Revenue Code are applied to the qualifying debt instrument and the §1.1275–6 hedge on a separate basis.

(ii) *Relationship between taxpayer and other persons.* Because the rules of this section affect only the taxpayer that enters into an integrated transaction (i.e., either the issuer or a particular holder of a qualifying debt instrument), any provisions of the Internal Revenue Code or regulations that govern the relationship between the taxpayer and any other person are applied on a separate basis. For example, taxpayers must comply with any reporting or disclosure requirements on any qualifying debt instrument as if it were not part of an integrated transaction. Thus, if required under § 1.1275–4(b)(4), an issuer of a contingent payment debt instrument subject to integrated treatment must provide the projected payment schedule to holders. Similarly, if a U.S. corporation enters into an integrated transaction that includes a notional principal contract, the source of any payment received by the counterparty on the notional principal contract is determined under § 1.863–7 as if the contract were not part of an integrated transaction, and, if received by a foreign person who is not engaged in a U.S. trade or business, the payment is non-U.S. source income that is not subject to U.S. withholding tax.

(13) *Coordination with consolidated return rules.* If a taxpayer enters into a § 1.1275–6 hedge with a member of the same consolidated group (the counterparty) and the § 1.1275–6 hedge is part of an integrated transaction for the taxpayer, the § 1.1275–6 hedge is not treated as an intercompany transaction for purposes of § 1.1502–13. If the taxpayer legs out of integrated treatment, the taxpayer and the counterparty are each treated as disposing of its position in the § 1.1275–6 hedge under the principles of paragraph (d)(2) of this section. If the § 1.1275–6 hedge remains in existence after the leg-out date, the § 1.1275–6 hedge is treated under the rules that would otherwise apply to the transaction (including § 1.1502–13 if the transaction is between members).

(g) *Predecessors and successors.* For purposes of this section, any reference to a taxpayer, holder, issuer, or person includes, where appropriate, a reference to a predecessor or successor. For purposes of the preceding sentence, a predecessor is a transferor of an asset or liability (including an integrated transaction) to a transferee (the successor) in a nonrecognition transaction. Appropriate adjustments, if necessary, are made in the application of this section to predecessors and successors.

(h) *Examples.* The following examples illustrate the provisions of this section. In each example, assume that the qualifying debt instrument is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the debt instrument is a debt instrument for Federal income tax purposes.

Example 1. Issuer hedge—(i) *Facts.* On January 1, 1997, V, a domestic corporation, issues a 5-year debt instrument for $1,000. The debt instrument provides for annual payments of interest at a rate equal to the value of 1-year LIBOR and a principal payment of $1,000 at maturity. On the same day, V enters into a 5-year interest rate swap agreement with an unrelated party. Under the swap, V pays 6 percent and receives 1-year LIBOR on a notional principal amount of $1,000. The payments on the swap are fixed and made on the same days as the payments on the debt instrument. On January 1, 1997, V identifies the debt instrument and the swap as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* The debt instrument is a qualifying debt instrument. The swap is a § 1.1275–6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the swap and the debt instrument can be calculated. V has met the identification requirements, and the other requirements of paragraph (c)(1) of this section are satisfied. Therefore, the transaction is an integrated transaction under this section.

(iii) *Treatment of the synthetic debt instrument.* The synthetic debt instrument is a 5-year debt instrument that has an issue price of $1,000 and provides for annual interest payments of $60 and a principal payment of $1,000 at maturity. Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(i) of this section, the synthetic debt instrument has a stated redemption price at maturity of $1,300 (the sum of all amounts to be paid on the qualifying debt instrument and the swap, reduced by amounts to be received on the swap). The synthetic debt instrument, therefore, has $300 of OID.

Example 2. Issuer hedge with an option—(i) *Facts.* On December 31, 1996, W, a domestic corporation, issues for $1,000 a debt instrument that matures on December 31, 1999. The debt instrument has a stated principal amount of $1,000 payable at maturity. The debt instrument also provides for a payment at maturity equal to $10 times the increase, if any, in the value of a nationally known composite index of stocks from December 31, 1996, to the maturity date. On December 31, 1996, W purchases from an unrelated party an option that pays $10 times the increase, if any, in the stock index from December 31, 1996, to December 31, 1999. W pays $250 for the option. On December 31, 1996, W identifies the debt instrument and option as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* The debt instrument is a qualifying debt instrument. The option is a §1.1275–6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the option and the debt instrument can be calculated. W has met the identification requirements, and the other requirements of paragraph (c)(1) of this section are satisfied. Therefore, the transaction is an integrated transaction under this section.

(iii) *Treatment of the synthetic debt instrument.* Under paragraph (f)(4) of this section, the issue price of the synthetic debt instrument is equal to the issue price of the debt instrument ($1,000) reduced by the payment for the option ($250). As a result, the synthetic debt instrument is a 3-year debt instrument with an issue price of $750. Under paragraph (f)(7) of this section, the synthetic debt instrument has a stated redemption price at maturity of $1,000 (the $250 payment for the option is not taken into account). The synthetic debt instrument, therefore, has $250 of OID.

Example 3. Hedge with prepaid swap—(i) *Facts.* On January 1, 1997, H purchases for £1,000 a 5-year debt instrument that provides for semiannual payments based on 6-month pound LIBOR and a payment of the £1,000 principal at maturity. On the same day, H enters into a swap with an unrelated third party under which H receives semiannual payments, in pounds, of 10 percent, compounded semiannually, and makes semiannual payments, in pounds, of 6-month pound LIBOR on a notional principal amount of £1,000. Payments on the swap are fixed and made on the same dates as the payments on the debt instrument. H also makes a £162 prepayment on the swap. On January 1, 1997, H identifies the swap and the debt instrument as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* The debt instrument is a qualifying debt instrument. The swap is a §1.1275–6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the swap and the debt instrument can be calculated. Although the debt instrument is denominated in pounds, the swap hedges only interest rate risk, not currency risk. Therefore, the transaction is an integrated transaction under this section. See §1.988–5(a) for the treatment of a debt instrument and a swap if the swap hedges currency risk.

(iii) *Treatment of the synthetic debt instrument.* Under paragraph (f)(4) of this section, the issue price of the synthetic debt instrument is equal to the issue price of the debt instrument (£1,000) increased by the prepayment on the swap (£162). As a result, the synthetic debt instrument is a 5-year debt instrument that has an issue price of £1,162 and provides for semiannual interest payments of £50 and a principal payment of £1,000 at maturity. Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(ii) of this section, the synthetic debt instrument's stated redemption price at maturity is £1,500 (the sum of all amounts to be received on the qualifying debt instrument and the §1.1275–6 hedge, reduced by all amounts to be paid on the §1.1275–6 hedge other than the £162 prepayment for the swap). The synthetic debt instrument, therefore, has £338 of OID.

Example 4. Legging into an integrated transaction by a holder—(i) *Facts.* On December 31, 1996, X corporation purchases for $1,000,000 a debt instrument that matures on December 31, 2006. The debt instrument provides for annual payments of interest at the rate of 6 percent and for a payment at maturity equal to $1,000,000, increased by the excess, if any, of the price of 1,000 units of a commodity on December 31, 2006, over $350,000, and decreased by the excess, if any, of $350,000 over the price of 1,000 units of the commodity on that date. The projected amount of the payment at maturity determined under §1.1275–4(b)(4) is $1,020,000. On December 31, 1999, X enters into a cash-settled forward contract with an unrelated party to sell 1,000 units of the commodity on December 31, 2006, for $450,000. On December 31, 1999, X also identifies the debt instrument and the forward contract as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* X meets the requirements for integration as of December 31, 1999. Therefore, X legged into an integrated transaction on that date. Prior to that date, X treats the debt instrument under the applicable rules of §1.1275–4.

(iii) *Treatment of the synthetic debt instrument.* As of December 31, 1999, the debt instrument and the forward contract are treated as an integrated transaction. The issue price of the synthetic debt instrument is equal to the adjusted issue price of the qualifying debt instrument on the leg-in date,

$1,004,804 (assuming one year accrual periods). The term of the synthetic debt instrument is from December 31, 1999, to December 31, 2006. The synthetic debt instrument provides for annual interest payments of $60,000 and a principal payment at maturity of $1,100,000 ($1,000,000 + $450,000 − $350,000). Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(ii) of this section, the synthetic debt instrument's stated redemption price at maturity is $1,520,000 (the sum of all amounts to be received by X on the qualifying debt instrument and the § 1.1275–6 hedge, reduced by all amounts to be paid by X on the § 1.1275–6 hedge). The synthetic debt instrument, therefore, has $515,196 of OID.

Example 5. Abusive leg-in—(i) *Facts.* On January 1, 1997, Y corporation purchases for $1,000,000 a debt instrument that matures on December 31, 2001. The debt instrument provides for annual payments of interest at the rate of 6 percent, a payment on December 31, 1999, of the increase, if any, in the price of a commodity from January 1, 1997, to December 31, 1999, and a payment at maturity of $1,000,000 and the increase, if any, in the price of the commodity from December 31, 1999 to maturity. Because the debt instrument is a contingent payment debt instrument subject to § 1.1275–4, Y accrues interest based on the projected payment schedule.

(ii) *Leg-in.* By late 1999, the price of the commodity has substantially increased, and Y expects a positive adjustment on December 31, 1999. In late 1999, Y enters into an agreement to exchange the two commodity based payments on the debt instrument for two payments on the same dates of $100,000 each. Y identifies the transaction as an integrated transaction in accordance with the requirements of paragraph (e) of this section. Y disposes of the hedge in early 2000.

(iii) *Treatment.* The legging into an integrated transaction has the effect of deferring the positive adjustment from 1999 to 2000. Because Y legged into the integrated transaction with a principal purpose to defer the positive adjustment, the Commissioner may treat the debt instrument as sold for its fair market value on the leg-in date or refuse to allow integration.

Example 6. Integration of offsetting debt instruments—(i) *Facts.* On January 1, 1997, Z issues two 10-year debt instruments. The first, Issue 1, has an issue price of $1,000, pays interest annually at 6 percent, and, at maturity, pays $1,000, increased by $1 times the increase, if any, in the value of the S&P 100 Index over the term of the instrument and reduced by $1 times the decrease, if any, in the value of the S&P 100 Index over the term of the instrument. However, the amount paid at maturity may not be less than $500 or more than $1,500. The second, Issue 2, has an issue price of $1,000, pays interest annually at 8 percent, and, at maturity, pays $1,000, reduced by $1 times the increase, if any, in the value of the S&P 100 Index over the term of the instrument and increased by $1 times the decrease, if any, in the value of the S&P 100 Index over the term of the instrument. The amount paid at maturity may not be less than $500 or more than $1,500. On January 1, 1997, Z identifies Issue 1 as the qualifying debt instrument, Issue 2 as a § 1.1275–6 hedge, and otherwise meets the identification requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* Both Issue 1 and Issue 2 are qualifying debt instruments. Z has met the identification requirements by identifying Issue 1 as the qualifying debt instrument and Issue 2 as the § 1.1275–6 hedge. The other requirements of paragraph (c)(1) of this section are satisfied. Therefore, the transaction is an integrated transaction under this section.

(iii) *Treatment of the synthetic debt instrument.* The synthetic debt instrument has an issue price of $2,000, provides for a payment at maturity of $2,000, and, in addition, provides for annual payments of $140. Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(i) of this section, the synthetic debt instrument's stated redemption price at maturity is $3,400 (the sum of all amounts to be paid on the qualifying debt instrument and the § 1.1275–6 hedge, reduced by amounts to be received on the § 1.1275–6 hedge other than the $1,000 payment received on the issue date). The synthetic debt instrument, therefore, has $1,400 of OID.

Example 7. Integrated transaction entered into by a foreign person—(i) *Facts.* X, a foreign person, enters into an integrated transaction by purchasing a qualifying debt instrument that pays U.S. source interest and entering into a notional principal contract with a U.S. corporation. Neither the income from the qualifying debt instrument nor the income from the notional principal contract is effectively connected with a U.S. trade or business. The notional principal contract is a § 1.1275–6 hedge.

(ii) *Treatment of integrated transaction.* Under paragraph (f)(8) of this section, X will receive U.S. source income from the integrated transaction. However, under paragraph (f)(12)(i) of this section, the qualifying debt instrument and the notional principal contract are treated as if they are not part of an integrated transaction for purposes of determining whether tax is due and must be withheld on income. Accordingly, because the § 1.1275–6 hedge would produce foreign source income under § 1.863–7 to X if it were not part of an integrated transaction, any income on the § 1.1275–6 hedge generally will not be subject to tax under sections 871(a) and 881, and the U.S. corporation that is the counterparty will not be required to withhold tax on payments under the §1.1275–6 hedge under sections 1441 and 1442.

(i) [Reserved]

(j) *Effective date.* This section applies to a qualifying debt instrument issued on or after August 13, 1996. This section also applies to a qualifying debt instrument acquired by the taxpayer on or after August 13, 1996, if—

(1) The qualifying debt instrument is a fixed rate debt instrument or a variable rate debt instrument; or

(2) The qualifying debt instrument and the §1.1275–6 hedge are acquired by the taxpayer substantially contemporaneously.

[T.D. 8674, 61 FR 30155, June 14, 1996]

§1.1275–7T Inflation-indexed debt instruments (temporary).

(a) *Overview.* This section provides rules for the Federal income tax treatment of an inflation-indexed debt instrument. If a debt instrument is an inflation-indexed debt instrument, one of two methods will apply to the instrument: the coupon bond method (as described in paragraph (d) of this section) or the discount bond method (as described in paragraph (e) of this section). Both methods determine the amount of OID that is taken into account each year by a holder or an issuer of an inflation-indexed debt instrument.

(b) *Applicability*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, this section applies to an inflation-indexed debt instrument as defined in paragraph (c)(1) of this section. For example, this section applies to Treasury Inflation-Indexed Securities.

(2) *Exceptions.* This section does not apply to an inflation-indexed debt instrument that is also—

(i) A debt instrument (other than a tax-exempt obligation) described in section 1272(a)(2) (for example, U.S. savings bonds, certain loans between natural persons, and short-term taxable obligations); or

(ii) A debt instrument subject to section 529 (certain debt instruments issued by qualified state tuition programs).

(c) *Definitions.* The following definitions apply for purposes of this section:

(1) *Inflation-indexed debt instrument.* An inflation-indexed debt instrument is a debt instrument that satisfies the following conditions:

(i) *Issued for cash.* The debt instrument is issued for U.S. dollars and all payments on the instrument are denominated in U.S. dollars.

(ii) *Indexed for inflation and deflation.* Except for a minimum guarantee payment (as defined in paragraph (c)(5) of this section), each payment on the debt instrument is indexed for inflation and deflation. A payment is indexed for inflation and deflation if the amount of the payment is equal to—

(A) The amount that would be payable if there were no inflation or deflation over the term of the debt instrument, multiplied by

(B) A ratio, the numerator of which is the value of the reference index for the date of the payment and the denominator of which is the value of the reference index for the issue date.

(iii) *No other contingencies.* No payment on the debt instrument is subject to a contingency other than the inflation contingency or the contingencies described in this paragraph (c)(1)(iii). A debt instrument may provide for—

(A) A minimum guarantee payment as defined in paragraph (c)(5) of this section; or

(B) Payments under one or more alternate payment schedules if the payments under each payment schedule are indexed for inflation and deflation and a payment schedule for the debt instrument can be determined under §1.1272–1(c). (For purposes of this section, the rules of §1.1272–1(c) are applied to the debt instrument by assuming that no inflation or deflation will occur over the term of the instrument.)

(2) *Reference index.* The reference index is an index used to measure inflation and deflation over the term of a debt instrument. To qualify as a reference index, an index must satisfy the following conditions:

(i) The value of the index is reset once a month to a current value of a single qualified inflation index (as defined in paragraph (c)(3) of this section). For this purpose, a value of a qualified inflation index is current if the value has been updated and published within the preceding six month period.

(ii) The reset occurs on the same day of each month (the reset date).

(iii) The value of the index for any date between reset dates is determined through straight-line interpolation.

(3) *Qualified inflation index.* A qualified inflation index is a general price or wage index that is updated and published at least monthly by an agency of the United States Government (for example, the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI–U), which is published by the Bureau of Labor Statistics of the Department of Labor).

(4) *Inflation-adjusted principal amount.* For any date, the inflation-adjusted principal amount of an inflation-indexed debt instrument is an amount equal to—

(i) The outstanding principal amount of the debt instrument (determined as if there were no inflation or deflation over the term of the instrument), multiplied by

(ii) A ratio, the numerator of which is the value of the reference index for the date and the denominator of which is the value of the reference index for the issue date.

(5) *Minimum guarantee payment.* In general, a minimum guarantee payment is an additional payment made at maturity on a debt instrument if the total amount of inflation-adjusted principal paid on the instrument is less than the instrument's stated principal amount. The amount of the additional payment must be no more than the excess, if any, of the debt instrument's stated principal amount over the total amount of inflation-adjusted principal paid on the instrument. An additional payment is not a minimum guarantee payment unless the qualified inflation index used to determine the reference index is either the CPI–U or an index designated for this purpose by the Commissioner in the FEDERAL REGISTER or the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter). See paragraph (f)(4) of this section for the treatment of a minimum guarantee payment.

(d) *Coupon bond method*—(1) *In general.* This paragraph (d) describes the method (coupon bond method) to be used to account for qualified stated interest and inflation adjustments (OID) on an inflation-indexed debt instrument described in paragraph (d)(2) of this section.

(2) *Applicability.* The coupon bond method applies to an inflation-indexed debt instrument that satisfies the following conditions:

(i) *Issued at par.* The debt instrument is issued at par. A debt instrument is issued at par if the difference between its issue price and principal amount for the issue date is less than the de minimis amount. For this purpose, the de minimis amount is determined using the principles of § 1.1273–1(d).

(ii) *All stated interest is qualified stated interest.* All stated interest on the debt instrument is qualified stated interest. For purposes of this paragraph (d), stated interest is qualified stated interest if the interest is unconditionally payable in cash, or is constructively received under section 451, at least annually at a single fixed rate. Stated interest is payable at a single fixed rate if the amount of each interest payment is determined by multiplying the inflation adjusted principal amount for the payment date by the single fixed rate.

(3) *Qualified stated interest.* Under the coupon bond method, qualified stated interest is taken into account under the taxpayer's regular method of accounting. The amount of accrued but unpaid qualified stated interest as of any date is determined by using the principles of § 1.446–3(e)(2)(ii) (relating to notional principal contracts). For example, if the interval between interest payment dates spans two taxable years, a taxpayer using an accrual method of accounting determines the amount of accrued qualified stated interest for the first taxable year by reference to the inflation-adjusted principal amount at the end of the first taxable year.

(4) *Inflation adjustments*—(i) *Current accrual.* Under the coupon bond method, an inflation adjustment is taken into account for each taxable year in which the debt instrument is outstanding.

(ii) *Amount of inflation adjustment.* For any relevant period (such as the taxable year or the portion of the taxable year during which a taxpayer holds an inflation-indexed debt instrument), the amount of the inflation adjustment is equal to—

(A) The sum of the inflation-adjusted principal amount at the end of the period and the principal payments made during the period, minus

(B) The inflation-adjusted principal amount at the beginning of the period.

(iii) *Positive inflation adjustments.* A positive inflation adjustment is OID.

(iv) *Negative inflation adjustments.* A negative inflation adjustment is a deflation adjustment that is taken into account under the rules of paragraph (f)(1) of this section.

(5) *Example.* The following example illustrates the coupon bond method:

Example: (i) *Facts.* On October 15, 1997, X purchases at original issue, for $100,000, a debt instrument that is indexed for inflation and deflation. The debt instrument matures on October 15, 1999, has a stated principal amount of $100,000, and has a stated interest rate of 5 percent, compounded semiannually. The debt instrument provides that the principal amount is indexed to the CPI–U. Interest is payable on April 15 and October 15 of each year. The amount of each interest payment is determined by multiplying the inflation-adjusted principal amount for each interest payment date by the stated interest rate, adjusted for the length of the accrual period. The debt instrument provides for a single payment of the inflation-adjusted principal amount at maturity. In addition, the debt instrument provides for an additional payment at maturity equal to the excess, if any, of $100,000 over the inflation-adjusted principal amount at maturity. X uses the cash receipts and disbursements method of accounting and the calendar year as its taxable year.

(ii) *Indexing methodology.* The debt instrument provides that the inflation-adjusted principal amount for any day is determined by multiplying the principal amount of the instrument for the issue date by a ratio, the numerator of which is the value of the reference index for the day the inflation-adjusted principal amount is to be determined and the denominator of which is the value of the reference index for the issue date. The value of the reference index for the first day of a month is the value of the CPI–U for the third preceding month. The value of the reference index for any day other than the first day of a month is determined based on a straight-line interpolation between the value of the reference index for the first day of the month and the value of the reference index for the first day of the next month.

(iii) *Inflation-indexed debt instrument subject to the coupon bond method.* Under paragraph (c)(1) of this section, the debt instrument is an inflation-indexed debt instrument. Because there is no difference between the debt instrument's issue price ($100,000) and its principal amount for the issue date ($100,000) and because all stated interest is qualified stated interest, the coupon bond method applies to the instrument.

(iv) *Reference index values.* Assume the following table lists the relevant reference index values for 1997 through 1999:

Date	Reference index value
Oct. 15, 1997	100
Jan. 1, 1998	101
Apr. 15, 1998	103
Oct. 15, 1998	105
Jan. 1, 1999	99

(v) *Treatment of X in 1997.* X does not receive any payments of interest on the debt instrument in 1997. Therefore, X has no qualified stated interest income for 1997. X, however, must take into account the inflation adjustment for 1997. The inflation-adjusted principal amount for January 1, 1998, is $101,000 ($100,000 × 101/100). Therefore, the inflation adjustment for 1997 is $1,000, the inflation-adjusted principal amount for January 1, 1998 ($101,000) minus the principal amount for the issue date ($100,000). X includes the $1,000 inflation adjustment in income as OID in 1997.

(vi) *Treatment of X in 1998.* In 1998, X receives two payments of interest: On April 15, 1998, X receives a payment of $2,575 ($100,000 × 103/100 × .05/2), and on October 15, 1998, X receives a payment of $2,625 ($100,000 × 105/100 × .05/2). Therefore, X's qualified stated interest income for 1998 is $5,200 ($2,575 + $2,625). X also must take into account the inflation adjustment for 1998. The inflation-adjusted principal amount for January 1, 1999, is $99,000 ($100,000 × 99/100). Therefore, the inflation adjustment for 1998 is negative $2,000, the inflation-adjusted principal amount for January 1, 1999 ($99,000) minus the inflation-adjusted principal amount for January 1, 1998 ($101,000). Because the amount of the inflation adjustment is negative, it is a deflation adjustment. Under paragraph (f)(1)(i) of this section, X uses this $2,000 deflation adjustment to reduce the interest otherwise includible in income by X with respect to the debt instrument in 1998. Therefore, X includes $3,200 in income for 1998, the qualified stated interest income for 1998 ($5,200) minus the deflation adjustment ($2,000).

(e) *Discount bond method*—(1) *In general.* This paragraph (e) describes the method (discount bond method) to be used to account for OID on an inflation-indexed debt instrument that does not qualify for the coupon bond method.

(2) *No qualified stated interest.* Under the discount bond method, no interest on an inflation-indexed debt instrument is qualified stated interest.

(3) *OID.* Under the discount bond method, the amount of OID that accrues on an inflation-indexed debt instrument is determined as follows:

(i) *Step one: Determine the debt instrument's yield to maturity.* The yield of the debt instrument is determined under the rules of § 1.1272–1(b)(1)(i). In calculating the yield under those rules for purposes of this paragraph (e)(3)(i), the payment schedule of the debt instrument is determined as if there were no inflation or deflation over the term of the instrument.

(ii) *Step two: Determine the accrual periods.* The accrual periods are determined under the rules of § 1.1272–1(b)(1)(ii). However, no accrual period can be longer than 1 month.

(iii) *Step three: Determine the percentage change in the reference index during the accrual period.* The percentage change in the reference index during the accrual period is equal to—

(A) The ratio of the value of the reference index at the end of the period to the value of the reference index at the beginning of the period,

(B) Minus one.

(iv) *Step four: Determine the OID allocable to each accrual period.* The OID allocable to an accrual period (n) is determined by using the following formula:

$$OID(_{(n)} = AIP_{(n)} \times [r + inf_{(n)} + (r \times inf_{(n)})]$$

in which,

r = yield of the debt instrument as determined under paragraph (e)(3)(i) of this section (adjusted for the length of the accrual period);

$inf_{(n)}$ = percentage change in the value of the reference index for period (n) as determined under paragraph (e)(3)(iii) of this section; and

$AIP_{(n)}$ = adjusted issue price at the beginning of period (n).

(v) *Step five: Determine the daily portions of OID.* The daily portions of OID are determined and taken into account under the rules of § 1.1272–1(b)(1)(iv). If the daily portions determined under this paragraph (e)(3)(v) are negative amounts, however, these amounts (deflation adjustments) are taken into account under the rules for deflation adjustments described in paragraph (f)(1) of this section.

(4) *Example.* The following example illustrates the discount bond method:

Example: (i) *Facts.* On November 15, 1997, X purchases at original issue, for $91,403, a zero-coupon debt instrument that is indexed for inflation and deflation. The principal amount of the debt instrument for the issue date is $100,000. The debt instrument provides for a single payment on November 15, 2000. The amount of the payment will be determined by multiplying $100,000 by a fraction, the numerator of which is the CPI–U for September 2000, and the denominator of which is the CPI–U for September 1997. The debt instrument also provides that in no event will the payment on November 15, 2000, be less than $100,000. X uses the cash receipts and disbursements method of accounting and the calendar year as its taxable year.

(ii) *Inflation-indexed debt instrument.* Under paragraph (c)(1) of this section, the instrument is an inflation-indexed debt instrument. The debt instrument's principal amount for the issue date ($100,000) exceeds its issue price ($91,403) by $8,597, which is more than the de minimis amount for the debt instrument ($750). Therefore, the coupon bond method does not apply to the debt instrument. As a result, the discount bond method applies to the debt instrument.

(iii) *Yield and accrual period.* Assume X chooses monthly accrual periods ending on the 15th day of each month. The yield of the debt instrument is determined as if there were no inflation or deflation over the term of the instrument. Therefore, based on the issue price of $91,403 and an assumed payment at maturity of $100,000, the yield of the debt instrument is 3 percent, compounded monthly.

(iv) *Percentage change in reference index.* Assume that the CPI–U for September 1997 is 160; for October 1997 is 161.2; and for November 1997 is 161.7. The value of the reference index for November 15, 1997, is 160, the value of the CPI–U for September 1997. Similarly, the value of the reference index for December 15, 1997, is 161.2, and for January 15, 1998, is 161.7. The percentage change in the reference index from November 15, 1997, to December 15, 1997, (inf_1) is 0.0075 (161.2/160–1); the percentage change in the reference index from December 15, 1997, to January 15, 1998, (inf_2) is 0.0031 (161.7/161.2–1).

(v) *Treatment of X in 1997.* For the accrual period ending on December 15, 1997, r is .0025

(.03/12), inf_1 is .0075, and the product of r and inf_1 is .00001875. Under paragraph (e)(3) of this section, the amount of OID allocable to the accrual period ending on December 15, 1997, is $916. This amount is determined by multiplying the issue price of the debt instrument ($91,403) by .01001875 (the sum of r, inf_1, and the product of r and inf_1). The adjusted issue price of the debt instrument on December 15, 1997, is $92,319 ($91,403+$916). For the accrual period ending on January 15, 1998, r is .0025 (.03/12), inf_2 is .0031, and the product of r and inf_2 is .00000775. Under paragraph (e)(3) of this section, the amount of OID allocable to the accrual period ending on January 15, 1998, is $518. This amount is determined by multiplying the adjusted issue price of the debt instrument ($92,319) by .00560775 (the sum of r, inf_2, and the product of r and inf_2). Because the accrual period ending on January 15, 1998, spans two taxable years, only $259 of this amount ($518/30 days×15 days) is allocable to 1997. Therefore, X includes $1,175 of OID in income for 1997 ($916+$259).

(f) *Special rules.* The following rules apply to an inflation-indexed debt instrument:

(1) *Deflation adjustments*—(i) *Holder.* A deflation adjustment reduces the amount of interest otherwise includible in income by a holder with respect to the debt instrument for the taxable year. For purposes of this paragraph (f)(1)(i), interest includes OID, qualified stated interest, and market discount. If the amount of the deflation adjustment exceeds the interest otherwise includible in income by the holder with respect to the debt instrument for the taxable year, the excess is treated as an ordinary loss by the holder for the taxable year. However, the amount treated as an ordinary loss is limited to the amount by which the holder's total interest inclusions on the debt instrument in prior taxable years exceed the total amount treated by the holder as an ordinary loss on the debt instrument in prior taxable years. If the deflation adjustment exceeds the interest otherwise includible in income by the holder with respect to the debt instrument for the taxable year and the amount treated as an ordinary loss for the taxable year, this excess is carried forward to reduce the amount of interest otherwise includible in income by the holder with respect to the debt instrument for subsequent taxable years.

(ii) *Issuer.* A deflation adjustment reduces the interest otherwise deductible by the issuer with respect to the debt instrument for the taxable year. For purposes of this paragraph (f)(1)(ii), interest includes OID and qualified stated interest. If the amount of the deflation adjustment exceeds the interest otherwise deductible by the issuer with respect to the debt instrument for the taxable year, the excess is treated as ordinary income by the issuer for the taxable year. However, the amount treated as ordinary income is limited to the amount by which the issuer's total interest deductions on the debt instrument in prior taxable years exceed the total amount treated by the issuer as ordinary income on the debt instrument in prior taxable years. If the deflation adjustment exceeds the interest otherwise deductible by the issuer with respect to the debt instrument for the taxable year and the amount treated as ordinary income for the taxable year, this excess is carried forward to reduce the interest otherwise deductible by the issuer with respect to the debt instrument for subsequent taxable years. If there is any excess remaining upon the retirement of the debt instrument, the issuer takes the excess amount into account as ordinary income.

(2) *Adjusted basis.* A holder's adjusted basis in an inflation-indexed debt instrument is determined under §1.1272–1(g). However, a holder's adjusted basis in the debt instrument is decreased by the amount of any deflation adjustment the holder takes into account to reduce the amount of interest otherwise includible in income or treats as an ordinary loss with respect to the instrument during the taxable year. The decrease occurs when the deflation adjustment is taken into account under paragraph (f)(1) of this section.

(3) *Subsequent holders.* A holder determines the amount of acquisition premium or market discount on an inflation-indexed debt instrument by reference to the adjusted issue price of the instrument on the date the holder acquires the instrument. A holder determines the amount of bond premium on an inflation-indexed debt instrument by assuming that the amount payable at maturity on the instrument is equal to the instrument's inflation-adjusted principal amount for the day

the holder acquires the instrument. Any premium or market discount is taken into account over the remaining term of the debt instrument as if there were no further inflation or deflation. See section 171 for additional rules relating to the amortization of bond premium and sections 1276 through 1278 for additional rules relating to market discount.

(4) *Minimum guarantee.* Under both the coupon bond method and the discount bond method, a minimum guarantee payment is ignored until the payment is made. If there is a minimum guarantee payment, the payment is treated as interest on the date it is paid.

(5) *Temporary unavailability of a qualified inflation index.* Notwithstanding any other rule of this section, an inflation-indexed debt instrument may provide for a substitute value of the qualified inflation index if and when the publication of the value of the qualified inflation index is temporarily delayed. The substitute value may be determined by the issuer under any reasonable method. For example, if the CPI–U is not reported for a particular month, the debt instrument may provide that a substitute value may be determined by increasing the last reported value by the average monthly percentage increase in the qualified inflation index over the preceding twelve months. The use of a substitute value does not result in a reissuance of the debt instrument.

(g) *Reopenings.* For purposes of § 1.1275–2(d)(2), a reopening of Treasury Inflation-Indexed Securities is a qualified reopening if—

(1) The terms of the securities issued in the reopening are the same as the terms of the original securities; and

(2) The reopening occurs not more than one year after the original securities were first issued to the public.

(h) *Effective date.* This section applies to an inflation-indexed debt instrument issued on or after January 6, 1997.

[T.D. 8709, 62 FR 618, Jan. 6, 1997]

§ 1.1286–1 Tax treatment of certain stripped bonds and stripped coupons.

(a) *De minimis OID.* If the original issue discount determined under section 1286(a) with respect to the purchase of a stripped bond or stripped coupon is less than the amount computed under subparagraphs (A) and (B) of section 1273(a)(3) and the regulations thereunder, then the amount of original issue discount with respect to that purchase (other than any tax-exempt portion thereof, determined under section 1286(d)(2)) shall be considered to be zero. For purposes of this computation, the number of complete years to maturity is measured from the date the stripped bond or stripped coupon is purchased.

(b) *Treatment of certain stripped bonds as market discount bonds*—(1) *In general.* By publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of the Statement of Procedural Rules), the Internal Revenue Service may (subject to the limitation of paragraph (b)(2) of this section) provide that certain mortgage loans that are stripped bonds are to be treated as market discount bonds under section 1278. Thus, any purchaser of such a bond is to account for any discount on the bond as market discount rather than original issue discount.

(2) *Limitation.* This treatment may be provided for a stripped bond only if, immediately after the most recent disposition referred to in section 1286(b)—

(i) The amount of original issue discount with respect to the stripped bond is determined under paragraph (a) of this section (concerning *de minimis* OID); or

(ii) The annual stated rate of interest payable on the stripped bond is no more than 100 basis points lower than the annual stated rate of interest payable on the original bond from which it and any other stripped bond or bonds and any stripped coupon or coupons were stripped.

(c) *Effective date.* This section is effective on and after August 8, 1991.

[T.D. 8463, 57 FR 61812, Dec. 29, 1992]

§ 1.1286–2T Stripped inflation-indexed debt instruments (temporary).

Stripped inflation-indexed debt instruments. If a Treasury Inflation-Indexed Security is stripped under the Department of the Treasury's Separate Trading of Registered Interest and Principal of Securities (STRIPS) program, the holders of the principal and coupon components must use the discount bond method (as described in § 1.1275–7T(e)) to account for the original issue discount on the components.

[T.D. 8709, 62 FR 621, Jan. 6, 1997]

§ 1.1287–1 Denial of capital gains treatment for gains on registration-required obligations not in registered form.

(a) *In general.* Except as provided in paragraph (c) of this section, any gain on the sale or other disposition of a registration-required obligation held after December 31, 1982, that is not in registered form shall be treated as ordinary income unless the issuance of the obligation was subject to tax under section 4701. The term *registration-required obligation* has the meaning given to that term in section 163(f)(2), except that clause (iv) of subparagraph (A) thereof shall not apply. Therefore, although an obligation that is not in registered form is described in § 1.163–5(c)(1), the holder of such an obligation shall be required to treat the gain on the sale or other disposition of such obligation as ordinary income. The term *holder* means the person that would be denied a loss deduction under section 165(j)(1) or denied capital gain treatment under section 1287(a).

(b) *Registered form*—(1) *Obligations issued after September 21, 1984.* With respect to any obligation originally issued after September 21, 1984, the term *registered form* has the meaning given that term in section 103(j)(3) and the regulations thereunder. Therefore, an obligation that would otherwise be in registered form is not considered to be in registered form if it can be transferred at that time or at any time until its maturity by any means not described in § 5f.103–1(c). An obligation that, as of a particular time, is not considered to be in registered form because it can be transferred by any means not described in § 5f.103–1(c) is considered to be in registered form at all times during the period beginning with a later time and ending with the maturity of the obligation in which the obligation can be transferred only by a means described in § 5f.103–1(c).

(2) *Obligations issued after December 31, 1982, and on or before September 21, 1984.* With respect to any obligation originally issued after December 31, 1982, and on or before September 21, 1984, or an obligation originally issued after September 21, 1984, pursuant to the exercise of a warrant or the conversion of a convertible obligation, which warrant or obligation (including conversion privilege) was issued after December 31, 1982, and on or before September 21, 1984, that obligation will be considered to be in registered form if it satisfied § 5f.163–1 or the proposed regulations provided in § 1.163.–5(c) and published in the FEDERAL REGISTER on September 2, 1983 (48 FR 39953).

(c) *Registration-required obligations not in registered form which are not subject to section 1287(c).* Notwithstanding the fact than an obligation is a registration-required obligation that is not in registered form, the holder will not be subject to section 1287(a) if the holder meets the conditions of § 1.165–12(c).

(d) *Effective date.* These regulations apply generally to obligations issued after January 20, 1987. However, a taxpayer may choose to apply the rules of § 1.1287–1 with respect to an obligation issued after December 31, 1982, and on or before January 20, 1987, which obligation is held after January 20, 1987.

[T.D. 8110, 51 FR 45461, Dec. 19, 1986]

§ 1.1291–0 Treatment of shareholders of certain passive foreign investment companies; table of contents.

This section contains a listing of the headings for §§ 1.1291–9 and 1.1291–10.

§ 1.1291–9 Deemed dividend election.

(a) Deemed dividend election.
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(ii) Pro rata share of post-1986 earnings and profits attributable to shareholder's stock.
(A) In general.
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(1) In general.
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(i) In general.
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(i) Election inapplicable to shareholder of former PFIC.

(1) [Reserved]

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(j) Definitions.

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(i) Qualified electing fund (QEF).

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§ 1.1291–10 Deemed sale election.

(a) Deemed sale election.

(b) Who may make the election.

(c) Time for making the election.

(d) Manner of making the election.

(e) Qualification date.

(1) In general.

(2) Elections made after March 31, 1995, and before January 27, 1997.

(i) In general.

(ii) Exception.

(f) Adjustments to basis.

(1) In general.

(2) Adjustment to basis for section 1293 inclusion with respect to deemed sale election made after March 31, 1995, and before January 27, 1997.

(g) Treatment of holding period.

(h) Election inapplicable to shareholder of former PFIC.

(i) Effective date.

[T.D. 8701, 61 FR 68151, Dec. 27, 1996, as amended by T.D. 8750, 63 FR 13, Jan. 2, 1998]

§ 1.1291–1T Taxation of U.S. persons that are shareholders of PFICs that are not pedigreed QEFs (temporary).

(a) through (d) [Reserved]

(e) *Exempt organization as shareholder*—(1) *In general.* If the shareholder of a PFIC is an organization exempt from tax under this chapter, section 1291 and these regulations apply to such shareholder only if a dividend from the PFIC would be taxable to the organization under subchapter F.

(2) *Effective date.* Paragraph (e)(1) of this section is applicable on and after April 1, 1992.

[T.D. 8750, 63 FR 13, Jan. 2, 1998]

§ 1.1291–9 Deemed dividend election.

(a) *Deemed dividend election*—(1) *In general.* This section provides rules for making the election under section 1291(d)(2)(B) (deemed dividend election). Under that section, a shareholder (as defined in paragraph (j)(3) of this section) of a PFIC that is an unpedigreed QEF may elect to include in income as a dividend the shareholder's pro rata share of the post-1986 earnings and profits of the PFIC attributable to the stock held on the qualification date (as defined in paragraph (e) of this section), provided the PFIC is a controlled foreign corporation (CFC) within the meaning of section 957(a) for the taxable year for which the shareholder elects under section 1295 to treat the PFIC as a QEF (section 1295 election). If the shareholder makes the deemed dividend election, the PFIC will become a pedigreed QEF with respect to the shareholder. The deemed dividend is taxed under section 1291 as an excess distribution received on the qualification date. The excess distribution determined under this paragraph (a) is allocated under section 1291(a)(1)(A) only to those days in the shareholder's holding period during which the foreign corporation qualified as a PFIC. For purposes of the preceding sentence, the holding period of the PFIC stock with respect to which the election is made ends on the day before the qualification date. For the definitions of PFIC, QEF, unpedigreed QEF, and pedigreed QEF, see paragraph (j) (1) and (2) of this section.

(2) *Post-1986 earnings and profits defined*—(i) *In general.* For purposes of this section, the term post-1986 earnings and profits means the undistributed earnings and profits, within the meaning of section 902(c)(1), as of the day before the qualification date, that were accumulated and not distributed in taxable years of the PFIC beginning after 1986 and during which it was a PFIC, but without regard to whether the earnings relate to a period during which the PFIC was a CFC.

(ii) *Pro rata share of post-1986 earnings and profits attributable to shareholder's stock*—(A) *In general.* A shareholder's pro rata share of the post-1986 earnings and profits of the PFIC attributable to the stock held by the shareholder on the qualification date is the amount of post-1986 earnings and profits of the PFIC accumulated during any portion of the shareholder's holding period ending at the close of the day before the qualification date and attributable, under the principles of section 1248 and the regulations under that section, to the PFIC stock held on the qualification date.

(B) *Reduction for previously taxed amounts.* A shareholder's pro rata share of the post-1986 earnings and profits of the PFIC does not include any amount that the shareholder demonstrates to the satisfaction of the Commissioner (in the manner provided in paragraph (d)(2) of this section) was, pursuant to another provision of the law, previously included in the income of the shareholder, or of another U.S. person if the shareholder's holding period of the PFIC stock includes the period during which the stock was held by that other U.S. person.

(b) *Who may make the election.* A shareholder of an unpedigreed QEF that is a CFC for the taxable year of the PFIC for which the shareholder makes the section 1295 election may make the deemed dividend election provided the shareholder held stock of that PFIC on the qualification date. A shareholder is treated as holding stock of the PFIC on the qualification date if its holding period with respect to that stock under section 1223 includes the qualification date. A shareholder may make the deemed dividend election without regard to whether the shareholder is a United States shareholder within the meaning of section 951(b). A deemed dividend election may be made by a shareholder whose pro rata share of the post-1986 earnings and profits of the PFIC attributable to the PFIC stock held on the qualification date is zero.

(c) *Time for making the election.* The shareholder makes the deemed dividend election in the shareholder's return for the taxable year that includes the qualification date. If the shareholder and the PFIC have the same taxable year, the shareholder makes the deemed dividend election in either the original return for the taxable year for which the shareholder makes the section 1295 election, or in an amended return for that year. If the shareholder and the PFIC have different taxable years, the deemed dividend election must be made in an amended return for the taxable year that includes the qualification date. If the deemed dividend election is made in an amended return, the amended return must be filed by a date that is within three years of the due date, as extended under section 6081, of the original return for the taxable year that includes the qualification date.

(d) *Manner of making the election*—(1) *In general.* A shareholder makes the deemed dividend election by filing Form 8621 and the attachment to Form 8621 described in paragraph (d)(2) of this section with the return for the taxable year of the shareholder that includes the qualification date, reporting the deemed dividend as an excess distribution pursuant to section 1291(a)(1), and paying the tax and interest due on the excess distribution. A shareholder that makes the deemed dividend election after the due date of the return (determined without regard to extensions) for the taxable year that includes the qualification date must pay additional interest, pursuant to section 6601, on the amount of the underpayment of tax for that year.

(2) *Attachment to Form 8621.* The shareholder must attach a schedule to Form 8621 that demonstrates the calculation of the shareholder's pro rata share of the post-1986 earnings and profits of the PFIC that is treated as distributed to the shareholder on the qualification date pursuant to this section. If the shareholder is claiming an exclusion from its pro rata share of the post-1986 earnings and profits for an amount previously included in its income or the income of another U.S. person, the shareholder must include the following information:

(i) The name, address, and taxpayer identification number of each U.S. person that previously included an amount in income, the amount previously included in income by each such U.S. person, the provision of the law pursuant to which the amount was previously included in income, and the taxable year or years of inclusion of each amount; and

(ii) A description of the transaction pursuant to which the shareholder acquired, directly or indirectly, the stock of the PFIC from another U.S. person, and the provisions of law pursuant to which the shareholder's holding period includes the period the other U.S. person held the CFC stock.

(e) *Qualification date*—(1) *In general.* Except as otherwise provided in this paragraph (e), the qualification date is the first day of the PFIC's first taxable year as a QEF (first QEF year).

(2) *Elections made after March 31, 1995, and before January 27, 1997*—(i) *In general.* The qualification date for deemed dividend elections made after March 31, 1995, and before January 27, 1997, is the first day of the shareholder's election year. The shareholder's election year is the taxable year of the shareholder for which it made the section 1295 election.

(ii) *Exception.* A shareholder who made the deemed dividend election after May 1, 1992, and before January 27, 1997, may elect to change its qualification date to the first day of the first QEF year, provided the periods of limitations on assessment for the taxable year that includes that date and for the shareholder's election year have not expired. A shareholder changes the qualification date by filing amended returns, with revised Forms 8621 and the attachments described in paragraph (d)(2) of this section, for the shareholder's election year and the shareholder's taxable year that includes the first day of the first QEF year, and making all appropriate adjustments and payments.

(3) *Examples.* The rules of this paragraph (e) are illustrated by the following examples:

Example 1. (i) *Eligibility to make deemed dividend election.* A is a U.S. person who files its income tax return on a calendar year basis. On January 2, 1994, A purchased one percent of the stock of M, a PFIC with a taxable year ending November 30. M was both a CFC and a PFIC, but not a QEF, for all of its taxable years. On December 3, 1996, M made a distribution to its shareholders. A received $100, all of which A reported in its 1996 return as an excess distribution as provided in section 1291(a)(1). A decides to make the section 1295 election in A's 1997 taxable year to treat M as a QEF effective for M's taxable year beginning December 1, 1996. Because A did not make the section 1295 election in 1994, the first year in its holding period of M stock that M qualified as a PFIC, M would be an unpedigreed QEF and A would be subject to both sections 1291 and 1293. A, however, may elect under section 1291(d)(2) to purge the years M was not a QEF from A's holding period. If A makes the section 1291(d)(2) election, the December 3 distribution will not be taxable under section 1291(a). Because M is a CFC, even though A is not a U.S. shareholder within the meaning of section 951(b), A may make the deemed dividend election under section 1291(d)(2)(B).

(ii) *Making the election.* Under paragraph (e)(1) of this section, the qualification date, and therefore the date of the deemed dividend, is December 1, 1996. Accordingly, to make the deemed dividend election, A must file an amended return for 1996, and include the deemed dividend in income in that year. As a result, M will be a pedigreed QEF as of December 1, 1996, and the December 3, 1996, distribution will not be taxable as an excess distribution. Therefore, in its amended return, A may report the December 3, 1996, distribution consistent with section 1293 and the general rules applicable to corporate distributions.

Example 2. X, a U.S. person, owned a five percent interest in the stock of FC, a PFIC with a taxable year ending June 30. X never made the section 1295 election with respect to FC. X transferred her interest in FC to her granddaughter, Y, a U.S. person, on February 14, 1996. The transfer qualified as a gift for Federal income tax purposes, and no gain was recognized on the transfer (see Regulation Project INTL–656–87, published in 1992–1 C.B. 1124; see § 601.601(d)(2)(ii)(*b*) of this chapter). As provided in section 1223(2), Y's holding period includes the period that X held the FC stock. Y decides to make the section 1295 election in her 1996 return to treat FC as a QEF for its taxable year beginning July 1, 1995. However, because Y's holding period includes the period that X held the FC stock, and FC was a PFIC but not a QEF during that period, FC will be an unpedigreed QEF with respect to Y unless Y makes a section 1291(d)(2) election. Although Y did not actually own the stock of FC on the qualification date (July 1, 1995), Y's holding period includes that date. Therefore, provided FC is a CFC for its taxable year beginning July 1, 1995, Y may make a section 1291(d)(2)(B) election to treat FC as a pedigreed QEF.

(f) *Adjustment to basis.* A shareholder that makes the deemed dividend election increases its adjusted basis of the stock of the PFIC owned directly by the shareholder by the amount of the deemed dividend. If the shareholder makes the deemed dividend election with respect to a PFIC of which it is an indirect shareholder, the shareholder's adjusted basis of the stock or other property owned directly by the shareholder, through which ownership of the PFIC is attributed to the shareholder, is increased by the amount of the deemed dividend. In addition, solely for purposes of determining the subsequent treatment under the Code and regulations of a shareholder of the stock of the PFIC, the adjusted basis of the direct owner of the stock of the PFIC is increased by the amount of the deemed dividend.

(g) *Treatment of holding period.* For purposes of applying sections 1291 through 1297 to the shareholder after the deemed dividend, the shareholder's holding period of the stock of the PFIC begins on the qualification date. For other purposes of the Code and regulations, this holding period rule does not apply.

(h) *Coordination with section 959(e).* For purposes of section 959(e), the entire deemed dividend is treated as included in gross income under section 1248(a).

(i)(1) [Reserved]

(2) *Former PFIC.* A shareholder may not make the section 1295 and deemed dividend elections if the foreign corporation is a former PFIC (as defined in paragraph (j)(2)(iv) of this section) with respect to the shareholder. For the rules regarding the election by a shareholder of a former PFIC, see §1.1297–3T.

(j) *Definitions*—(1) *Passive foreign investment company (PFIC).* A passive foreign investment company (PFIC) is a foreign corporation that satisfies either the income test of section 1296(a)(1) or the asset test of section 1296(a)(2). A corporation will not be treated as a PFIC with respect to a shareholder for those days included in the shareholder's holding period when the shareholder, or a person whose holding period of the stock is included in the shareholder's holding period, was not a United States person within the meaning of section 7701(a)(30).

(2) *Types of PFICs*—(i) *Qualified electing fund (QEF).* A PFIC is a qualified electing fund (QEF) with respect to a shareholder that has elected, under section 1295, to be taxed currently on its share of the PFIC's earnings and profits pursuant to section 1293.

(ii) *Pedigreed QEF.* A PFIC is a pedigreed QEF with respect to a shareholder if the PFIC has been a QEF with respect to the shareholder for all taxable years during which the corporation was a PFIC that are included wholly or partly in the shareholder's holding period of the PFIC stock.

(iii) *Unpedigreed QEF.* A PFIC is an unpedigreed QEF for a taxable year if—

(A) An election under section 1295 is in effect for that year;

(B) The PFIC has been a QEF with respect to the shareholder for at least one, but not all, of the taxable years during which the corporation was a PFIC that are included wholly or partly in the shareholder's holding period of the PFIC stock; and

(C) The shareholder has not made an election under section 1291(d)(2) and this section or §1.1291–10 with respect to the PFIC to purge the nonQEF years from the shareholder's holding period.

(iv) *Former PFIC.* A foreign corporation is a former PFIC with respect to a shareholder if the corporation satisfies neither the income test of section 1296(a)(1) nor the asset test of section 1296(a)(2), but whose stock, held by that shareholder, is treated as stock of a PFIC, pursuant to section 1297(b)(1), because at any time during the shareholder's holding period of the stock the corporation was a PFIC that was not a QEF.

(3) *Shareholder.* A shareholder is a U.S. person that is a direct or indirect shareholder as defined in Regulation Project INTL–656–87 published in 1992–1 C.B. 1124; see §601.601(d)(2)(ii)(*b*) of this chapter.

(k) *Effective date.* The rules of this section are applicable as of April 1, 1995.

[T.D. 8701, 61 FR 68151, Dec. 27, 1996; 62 FR 7155, Feb. 18, 1997, as amended by T.D. 8750, 63 FR 13, Jan. 2, 1998]

§1.1291–10 Deemed sale election.

(a) *Deemed sale election.* This section provides rules for making the election under section 1291(d)(2)(A) (deemed sale election). Under that section, a shareholder (as defined in §1.1291–9(j)(3)) of a PFIC that is an unpedigreed QEF may elect to recognize gain with respect to the stock of the unpedigreed QEF held on the qualification date (as defined in paragraph (e) of this section). If the shareholder makes the deemed sale election, the PFIC will become a pedigreed QEF with respect to the shareholder. A shareholder that makes the deemed sale election is treated as having sold, for its fair market value, the stock of the PFIC that the shareholder held on the qualification date. The gain recognized on the deemed sale is taxed under section 1291 as an excess distribution received on the qualification date. In the case of an election made by an indirect shareholder, the amount of gain to be recognized and taxed as an excess distribution is the amount of gain that the direct owner of the stock of the PFIC would have realized on an actual sale or other disposition of the stock of the PFIC indirectly owned by the shareholder. Any loss realized on the deemed sale is not recognized. For the definitions of PFIC, QEF, unpedigreed QEF, and pedigreed QEF, see § 1.1291–9(j) (1) and (2).

(b) *Who may make the election.* A shareholder of an unpedigreed QEF may make the deemed sale election provided the shareholder held stock of that PFIC on the qualification date. A shareholder is treated as holding stock of the PFIC on the qualification date if its holding period with respect to that stock under section 1223 includes the qualification date. A deemed sale election may be made by a shareholder that would realize a loss on the deemed sale.

(c) *Time for making the election.* The shareholder makes the deemed sale election in the shareholder's return for the taxable year that includes the qualification date. If the shareholder and the PFIC have the same taxable year, the shareholder makes the deemed sale election in either the original return for the taxable year for which the shareholder makes the section 1295 election, or in an amended return for that year. If the shareholder and the PFIC have different taxable years, the deemed sale election must be made in an amended return for the taxable year that includes the qualification date. If the deemed sale election is made in an amended return, the amended return must be filed by a date that is within three years of the due date, as extended under section 6081, of the original return for the taxable year that includes the qualification date.

(d) *Manner of making the election.* A shareholder makes the deemed sale election by filing Form 8621 with the return for the taxable year of the shareholder that includes the qualification date, reporting the gain as an excess distribution pursuant to section 1291(a), and paying the tax and interest due on the excess distribution. A shareholder that makes the deemed sale election after the due date of the return (determined without regard to extensions) for the taxable year that includes the qualification date must pay additional interest, pursuant to section 6601, on the amount of the underpayment of tax for that year. A shareholder that realizes a loss on the deemed sale reports the loss on Form 8621, but does not recognize the loss.

(e) *Qualification date*—(1) *In general.* Except as otherwise provided in this paragraph (e), the qualification date is the first day of the PFIC's first taxable year as a QEF (first QEF year).

(2) *Elections made after March 31, 1995, and before January 27, 1997*—(i) *In general.* The qualification date for deemed sale elections made after March 31, 1995, and before January 27, 1997, is the first day of the shareholder's election year. The shareholder's election year is the taxable year of the shareholder for which it made the section 1295 election.

(ii) *Exception.* A shareholder who made the deemed sale election after May 1, 1992, and before January 27, 1997, may elect to change its qualification date to the first day of the first QEF year, provided the periods of limitations on assessment for the taxable year that includes that date and for the shareholder's election year have not expired. A shareholder changes the qualification date by filing amended returns, with revised Forms 8621, for the shareholder's election year and the shareholder's taxable year that includes the first day of the first QEF year, and making all appropriate adjustments and payments.

(f) *Adjustments to basis*—(1) *In general.* A shareholder that makes the deemed sale election increases its adjusted basis of the PFIC stock owned directly by the amount of gain recognized on the deemed sale. If the shareholder makes the deemed sale election with respect to a PFIC of which it is an indirect shareholder, the shareholder's adjusted basis of the stock or other property owned directly by the shareholder, through which ownership of the PFIC is attributed to the shareholder, is increased by the amount of gain recognized by the shareholder. In addition, solely for purposes of determining the subsequent treatment under the Code and regulations of a shareholder of the stock of the PFIC, the adjusted basis of the direct owner of the stock of the PFIC is increased by the amount of gain recognized on the deemed sale. A shareholder shall not adjust the basis of any stock with respect to which the shareholder realized a loss on the deemed sale.

(2) *Adjustment of basis for section 1293 inclusion with respect to deemed sale election made after March 31, 1995, and before January 27, 1997.* For purposes of determining the amount of gain recognized with respect to a deemed sale election made after March 31, 1995, and before January 27, 1997, by a shareholder that treats the first day of the shareholder's election year as the qualification date, the adjusted basis of the stock deemed sold includes the shareholder's section 1293(a) inclusion attributable to the period beginning with the first day of the PFIC's first QEF year and ending on the day before the qualification date.

(g) *Treatment of holding period.* For purposes of applying sections 1291 through 1297 to the shareholder after the deemed sale, the shareholder's holding period of the stock of the PFIC begins on the qualification date, without regard to whether the shareholder recognized gain on the deemed sale. For other purposes of the Code and regulations, this holding period rule does not apply.

(h) *Election inapplicable to shareholder of former PFIC.* A shareholder may not make the section 1295 and deemed sale elections if the foreign corporation is a former PFIC (as defined in §1.1291–9(j)(2)(iv)) with respect to the shareholder. For the rules regarding the election by a shareholder of a former PFIC, see §1.1297–3T.

(i) *Effective date.* The rules of this section are applicable as of April 1, 1995.

[T.D. 8701, 61 FR 68153, Dec. 27, 1996]

§1.1293–0 Table of contents.

This section contains a listing of the headings for §1.1293–1T.

§1.1293–1T Current inclusion of income of qualified electing funds (temporary).

(a) In general. [Reserved]

(1) Other rules. [Reserved]

(2) Net capital gain defined.

(i) In general.

(ii) Effective date.

(b) Other rules [Reserved]

(c) Application of rules of inclusion with respect to stock held by a pass through entity.

(1) In general.

(2) QEF stock transferred to a pass through entity.

(i) Pass through entity makes a section 1295 election.

(ii) Pass through entity does not make a section 1295 election.

(3) Effective date.

[T.D. 8750, 63 FR 13, Jan. 2, 1998]

§1.1293–1T Current taxation of income from qualified electing funds (temporary).

(a) *In general.* [Reserved]

(1) *Other rules.* [Reserved]

(2) *Net capital gain defined*—(i) *In general.* This paragraph (a)(2) defines the term net capital gain for purposes of sections 1293 and 1295 and the regulations under those sections. The QEF, as defined in §1.1291–9(j)(2)(i), in determining its net capital gain for a taxable year, may either—

(A) Calculate and report the amount of each category of long-term capital gain provided in section 1(h) that was recognized by the PFIC in the taxable year;

(B) Calculate and report the amount of net capital gain recognized by the PFIC in the taxable year, stating that that amount is subject to the highest capital gain rate of tax applicable to the shareholder; or

(C) Calculate its earnings and profits for the taxable year and report the entire amount as ordinary earnings.

(ii) *Effective date.* Paragraph (a)(2)(i) of this section is applicable to sales by QEFs during their taxable years ending on or after May 7, 1997.

(b) *Other rules.* [Reserved]

(c) *Application of rules of inclusion with respect to stock held by a pass* *through entity*—(1) *In general.* A domestic pass through entity takes into account its pro rata shares of the ordinary earnings and net capital gain attributable to the QEF shares held by the pass through entity. A U.S. person that indirectly owns QEF shares through the domestic pass through entity accounts for its pro rata shares of ordinary earnings and net capital gain attributable to the QEF shares according to the general rules applicable to inclusions of income from the domestic pass through entity. For the definition of pass through entity, see § 1.1295–1T(j).

(2) *QEF stock transferred to a pass through entity*—(i) *Pass through entity makes a section 1295 election.* If a shareholder transfers stock subject to a section 1295 election to a domestic pass through entity of which it is an interest holder and the pass through entity makes a section 1295 election with respect to that stock, as provided in § 1.1295–1T(D)(2), the shareholder takes into account its pro rata shares of the ordinary earnings and net capital gain attributable to the QEF shares under the rules applicable to inclusions of income from the pass through entity.

(ii) *Pass through entity does not make a section 1295 election.* If the pass through entity does not make a section 1295 election with respect to the PFIC, the shares of which were transferred to the pass through entity subject to the 1295 election of the shareholder, the shareholder continues to be subject, in its capacity as an indirect shareholder, to the income inclusion rules of section 1293 and reporting rules required of shareholders of QEFs. Proper adjustments to reflect an inclusion in income under section 1293 by the indirect shareholder must be made, under the principles of § 1.1291–9(f), to the basis of the indirect shareholder's interest in the pass through entity.

(3) *Effective date.* Paragraph (c) of this section is applicable to taxable years of shareholders beginning after December 31, 1997.

[T.D. 8750, 63 FR 14, Jan. 2, 1998]

§ 1.1294–0 Table of contents.

This section contains a listing of the headings for § 1.1294–1T.

§ 1.1294–1T Election to extend the time for payment of tax on undistributed earnings of a qualified electing fund.

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[T.D. 8750, 63 FR 13, Jan. 2, 1998]

§ 1.1294–1T Election to extend the time for payment of tax on undistributed earnings of a qualified electing fund (temporary).

(a) *Purpose and scope.* This section provides rules for making the annual election under section 1294. Under that section, a U.S. person that is a shareholder in a qualified electing fund (QEF) may elect to extend the time for payment of its tax liability which is attributable to its share of the undistributed earnings of the QEF. In general, a QEF is a passive foreign investment company (PFIC), as defined in section 1296, that makes the election under section 1295. Under section 1293, a U.S. person that owns, or is treated as owning, stock of a QEF at any time during the taxable year of the QEF shall include in gross income, as ordinary income, its pro rata share of the ordinary earnings of the QEF for the taxable year and, as long-term capital gain, its pro rata share of the net capital gain of the QEF for the taxable year. The shareholder's share of the earnings shall be included in the shareholder's taxable year in which or with which the taxable year of the QEF ends.

(b) *Election to extend time for payment*—(1) *In general.* A U.S. person that is a shareholder of a QEF on the last day of the QEF's taxable year may elect under section 1294 to extend the time for payment of that portion of its tax liability which is attributable to the inclusion in income pursuant to section 1293 of the shareholder's share of the QEF's undistributed earnings. The election under section 1294 may be made only with respect to undistributed earnings, and interest is imposed under section 6601 on the amount of the tax liability which is subject to the extension. This interest must be paid on the termination of the election.

(2) *Exception.* An election under this § 1.1294–1T cannot be made for a taxable year of the shareholder if any portion of the QEF's earning is includible in the gross income of the shareholder for such year under either section 551 (relating to foreign personal holding companies) or section 951 (relating to controlled foreign corporations).

(3) *Undistributed earnings*—(i) *In general.* For purposes of this § 1.1294–1T the term *undistributed earnings* means the excess, if any, of the amount includible in gross income by reason of section 1293(a) for the shareholder's taxable year (the includible amount) over the sum of (A) the amount of any distribution to the shareholder during the QEF's taxable year and (B) the portion of the includible amount that is attributable to stock in the QEF that the shareholder transferred or otherwise disposed of before the end of the QEF's year. For purposes of this paragraph, a distribution will be treated as made from the most recently accumulated earnings and profits.

(ii) *Effect of a loan, pledge or guarantee.* A loan, pledge, or guarantee described in § 1.1294–1T(e) (2) or (4) will be treated as a distribution of earnings for purposes of paragraph (b)(3)(i)(A). If earnings are treated as distributed in a taxable year by reason of a loan, pledge or guarantee described in § 1.1294–1T(e) (2) or (4), but the amount of the deemed distribution resulting therefrom was less than the amount of the actual loan by the QEF (or the amount of the loan secured by the pledge or guarantee), earnings derived by the QEF in a subsequent taxable year will be treated as distributed in such subsequent year to the shareholder for purposes of paragraph (b)(3)(i)(A) by virtue of such loan, but only to the extent of the difference between the outstanding principal balance on the loan in such subsequent year and the prior years' deemed distributions resulting from the loan. For this purpose, the outstanding principal balance on a loan in a taxable year shall be treated as equal to the greatest amount of the outstanding balance at any time during such year.

Example 1. (i) *Facts. FC* is a PFIC that made the election under section 1295 to be a QEF for its taxable year beginning January 1, 1987. *S* owned 500 shares, or 50 percent, of *FC* throughout the first six months of 1987, but on June 30, 1987 sold 10 percent, or 50 shares, of the *FC* stock that it held. *FC* had $100,000*x* of ordinary earnings but no net capital gain in 1987. No part of *FC*'s earnings is includible in *S*'s income under either section 551 or 951. *FC* made no distributions to its shareholders in 1987. *S's* pro rata share of income is determined by attributing *FC's* income ratably to each day in *FC*'s year. Accordingly, FC's daily earnings are $274*x* ($100,000*x*/365). *S*'s share of the earnings of *FC* is $47,484*x*, determined as follows.

FC's daily earnings × number of days percentage held by *S* × percentage of ownership in *FC*.

Accordingly, *S*'s pro rata share of *FC*'s earnings for the first six months of *FC*'s year deemed earned while *S* held 50 percent of *FC*'s stock is $24,797*x* ($274*x* × 181 days × 50%). *S*'s pro rata share of *FC*'s earnings for remainder of *FC*'s year deemed earned while *S* held 45 percent of *FC*'s stock is $22,687*x* ($274*x* × 184 days × 45%). Therefore, *S*'s total share of *FC*'s earnings to be included in income under section 1293 is $47,484*x* ($24,797*x* + $22,687*x*).

(ii) *Election. S* intends to make the election under section 1294 to defer the payment of its tax liability that is attributable to the undistributed earnings of *FC*. The amount of current year undistributed earnings as defined in § 1.1294–1T(b)(3) with respect to which *S* can make the election is the excess of *S*'s inclusion in gross income under section 1293(a) for the taxable year over the sum of (1) the cash and other property distributed to *S* during *FC*'s tax year out of earnings included in income pursuant to section 1293(a), and (2) the earnings attributable to stock disposed of during *FC*'s tax year. Because *S* sold 10 percent, or 50 shares, of the *FC* stock that it held during the first six months of the year, 10 percent of its share of the earnings for that part of the year, which is $2,480*x* ($24,797*x* × 10%), is attributable to the shares sold. *S* therefore cannot make the election under section 1294 to extend the time for payment of its tax liability on that amount. Accordingly, *S* can make the election under section 1294 with respect to its tax on $45,004*x* ($47,484*x* less $2,480*x*), which is its pro rata share of *FC*'s earnings, reduced by the earnings attributable to the stock disposed of during the year.

Example 2. (i) *Facts.* The facts are the same as in Example 1 with the following exceptions. *S* did not sell any *FC* stock during 1987. Therefore, because *S* held 50 percent of the *FC* stock throughout 1987, *S*'s pro rata share of *FC*'s ordinary earnings was $50,000*x*, no part of which was includible in *S*'s income under either section 551 or 951. There were no actual distributions of earnings to *S* in 1988. On December 31, 1987, *S* pledged the FC stock as security for a bank loan of $75,000*x*. The pledge is treated as a disposition of the *FC* stock and therefore a distribution of *S*'s share of the undistributed earnings of *FC* up to the amount of the loan principal. *S*'s entire share of the undistributed earnings of *FC* are deemed distributed as a result of the pledge of the *FC* stock. *S* therefore cannot make the election under section 1294 to extend the time for payment of its tax liability on its share of *FC*'s earnings for 1987.

(ii) *Deemed distribution.* In 1988, *FC* has ordinary earnings of $100,000*x* but no net capital gain. *S*'s pro rata share of *FC*'s 1988 ordinary earnings was $50,000*x*. *S*'s loan remained outstanding throughout 1988; the highest loan balance during 1988 was $74,000*x*. Of *S*'s share of the ordinary earnings of FC of $50,000*x*, $24,000*x* is deemed distributed to *S*. This is the amount by which the highest loan balance for the year ($74,000*x*) exceeds the portion of the undistributed earnings of *FC* deemed distributed to *S* in 1987 by reason of the pledge ($50,000*x*). *S* may make the election under section 1294 to extend the time for payment of its tax liability on $26,000*x*, which is the amount by which *S*'s includible amount for 1988 exceeds the amount deemed distributed to *S* during 1988.

(c) *Time for making the election*—(1) *In general.* An election under this § 1.1294–1T may be made for any taxable year in which a shareholder reports income pursuant to section 1293. Except as provided in paragraph (c)(2), the election shall be made by the due date, as extended, of the tax return for the shareholder's taxable year for which the election is made.

(2) *Exception.* An election under this section may be made within 60 days of receipt of notification from the QEF of the shareholder's pro rata share of the ordinary earnings and net capital gain if notification is received after the time for filing the election provided in paragraph (c)(1) (and requires the filing of an amended return to report income pursuant to section 1293). If the notification reports an increase in the shareholder's pro rata share of the earnings previously reported to the shareholder by the QEF, the shareholder may make the election under this paragraph (c)(2) only with respect to the amount of such increase.

(d) *Manner of making the election*—(1) *In general.* A shareholder shall make the election by (i) attaching to its return for the year of the election Form 8621 or a statement containing the information and representations required by this section and (ii) filing a copy of Form 8621 or the statement with the Internal Revenue Service Center, P.O. Box 21086, Philadelphia, Pennsylvania 19114.

(2) *Information to be included in the election statement.* If a statement is used in lieu of Form 8621, the statement should be identified, in a heading, as an election under section 1294 of the Code. The statement must include the following information and representations:

(i) The name, address, and taxpayer identification number of the electing shareholder and the taxable year of the shareholder for which the election is being made;

(ii) The name, address and taxpayer identification number of the QEF if provided to the shareholder;

(iii) A statement that the shareholder is making the election under section 1294 of the Code;

(iv) A schedule containing the following information:

(A) The ordinary earnings and net capital gain for the current year included in the shareholder's income under section 1293;

(B) The amount of cash and other property distributed by the QEF during its taxable year with respect to stock held directly or indirectly by the shareholder during that year, identifying the amount of such distributions that is paid out of current earnings and profits and the amount paid out of each prior year's earnings and profits; and

(C) The undistributed PFIC earnings tax liability (as defined in paragraph (f) of this section) for the taxable year, payment of which is being deferred by reason of the election under section 1294;

(v) The number of shares of stock held in the QEF during the QEF's taxable year which gave rise to the section 1293 inclusion and the number of such shares transferred, deemed transferred or otherwise disposed of by the electing shareholder before the end of the QEF's taxable year, and the data of transfer; and

(vi) The representations of the electing shareholder that—

(A) No part of the QEF's earnings for the taxable year is includible in the electing shareholder's gross income under either section 551 or 951 of the Code;

(B) The election is made only with respect to the shareholder's pro rata share of the undistributed earnings of the QEF; and

(C) The electing shareholder, upon termination of the election to extend the date for payment, shall pay the undistributed PFIC earnings tax liability attributable to those earnings to which the termination applies as well as interest on such tax liability pursuant to section 6601. Payment of this tax and interest must be made by the due date (determined without extensions) of the tax return for the taxable year in which the termination occurs.

(e) *Termination of the extension.* The election to extend the date for payment of tax will be terminated in whole or in part upon the occurrence of any of the following events:

(1) The QEF's distribution of earnings to which the section 1294 extension to pay tax is attributable; the extension will terminate only with respect to the tax attributable to the earnings that were distributed.

(2) The electing shareholder's transfer of stock in the QEF (or use thereof as security for a loan) with respect to which an election under this §1.1294–1T was made. The election will be terminated with respect to the undistributed earnings attributable to the shares of the stock transferred. In the case of a pledge of the stock, the election will be terminated with respect to undistributed earnings equal to the amount of the loan for which the stock is pledged.

(3) Revocation of the QEF's election as a QEF or cessation of the QEF's status as a PFIC. A revocation of the QEF election or cessation of PFIC status will result in the complete termination of the extension.

(4) A loan of property by the QEF directly or indirectly to the electing shareholder or related person, or a pledge or guarantee by the QEF with respect to a loan made by another party to the electing shareholder or related person. The election will be terminated with respect to undistributed earnings in an amount equal to the amount of the loan, pledge, or guarantee.

(5) A determination by the District Director pursuant to section 1294(c)(3) that collection of the tax is in jeopardy. The amount of undistributed earnings with respect to which the extension is terminated under this paragraph (d)(5) will be left to the discretion of the District Director.

(f) *Undistributed PFIC earnings tax liability.* The electing shareholder's tax liability attributable to the ordinary earnings and net capital gain included in gross income under section 1293 shall be the excess of the tax imposed under chapter 1 of the Code for the taxable year over the tax that would be imposed for the taxable year without regard to the inclusion in income under section 1293 of the undistributed earnings as defined in paragraph (b)(3) of this section.

Example: The facts are the same as in §1.1294–1T (b)(3), *Example 1,* with the following exceptions. *S,* a domestic corporation, did not dispose of any *FC* stock in 1987. Therefore, because *S* held 50 percent of the *FC* stock throughout 1987, *S*'s pro rata share of *FC*'s ordinary earnings was $50,000*x*. In addition to $50,000*x* of ordinary earnings from *FC, S* had $12,500*x* of domestic source income and $6,000*x* of expenses (other than interest expense) not definitely related to any gross income. These expenses are apportioned, pursuant to §1.861–8(c)(2), on a pro rata basis between the domestic and foreign source income—$1,200*x* of expenses, or one-fifth, to domestic source income, and $4,800*x* of expenses, or four-fifths, to the section 1293 inclusion. *FC* paid foreign taxes of $25,000*x* in 1987. Accordingly, *S* is entitled to claim as an indirect foreign tax credit pursuant to section 1293(f) a proportionate amount of the foreign taxes paid by *FC,* which is $12,500*x* ($25,000*x* × $50,000*x*/$100,000*x*). *S* is taxed in the U.S. at the rate of 34 percent. The amount of tax liability for which *S* may extend the time for payment is determined as follows:

1987 TAX LIABILITY (WITH SECTION 1293 INCLUSION)

Source	U.S.	Foreign
Income	12,500*x*	0
Section 1293	0	50,000*x*

1987 TAX LIABILITY (WITH SECTION 1293 INCLUSION)—Continued

Source	U.S.	Foreign
Expenses	−1,200*x*	−4,800x
Taxable income	11,300*x*	45,200*x*
Total taxable income	56,500*x*	
U.S. income tax rate	x34%	
Pre-credit U.S. tax	19,210*x*	
Foreign tax credit	−12,500x	
1987 Tax Liability	6,710*x*	

1987 TAX LIABILITY (WITHOUT SECTION 1293 INCLUSION)

Source	U.S.	Foreign
Income	12,500*x*	0
Expenses	−6,000x	
Taxable income	6,500*x*	
U.S. tax rate	x34%	
U.S. Tax	2,210*x*	
Foreign tax credit	0	
Hypothetical 1987 Tax Liability	2,210*x*	

The amount of tax, payment of which *S* may defer pursuant to section 1294, is $4,500*x* ($6,710*x* less $2,210*x*).

(g) *Authority to require a bond.* Pursuant to the authority granted in section 6165 and in the manner provided therein, and subject to notification, the District Director may require the electing shareholder to furnish a bond to secure payment of the tax, the time for payment of which is extended under this section. If the electing shareholder does not furnish the bond within 60 days after receiving a request from the District Director, the election will be revoked.

(h) *Annual reporting requirement.* The electing shareholder must attach Form 8621 or a statement to its income tax return for each year during which an election under this section is outstanding. The statement must contain the following information:

(1) The total amount of undistributed earnings as of the end of the taxable year to which the outstanding elections apply;

(2) The total amount of the undistributed PFIC earnings tax liability and accrued interest charge as of the end of the year;

(3) The total amount of distributions received during the taxable year; and

(4) A description of the occurrence of any other termination event described in paragraph (e) of this section that occurred during the taxable year.

The electing shareholder also shall file by the due date, as extended, for its return a copy of Form 8621 or the statement with the Philadelphia Service Center, P.O. Box 21086, Philadelphia, Pennsylvania 19114.

[T.D. 8178, 53 FR 6773, Mar. 2, 1988; 53 FR 11731, Apr. 8, 1988]

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This section contains a listing of the headings for §§ 1.1295–1T and 1.1295–3T.

§ 1.1295–1T Qualified electing funds (temporary).

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(b) Application of section 1295 election. [Reserved]

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(2) Election applicable to specific corporation only.

(i) In general. [Reserved]

(ii) Stock of QEF received in a nonrecognition transfer. [Reserved]

(iii) Exception for options.

(3) Application of general rules to stock held by a pass through entity.

(i) Stock subject to a section 1295 election transferred to a pass through entity.

(ii) Limitation on application of pass through entity's section 1295 election.

(iii) Effect of partnership termination on section 1295 election.

(iv) Characterization of stock held through a pass through entity.

(4) Application of general rules to a taxpayer filing a joint return under section 6013.

(c) Effect of section 1295 election.

(1) In general.

(2) Years to which section 1295 election applies.

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(ii) Effect of PFIC status on election.

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[T.D. 8750, 63 FR 14, Jan. 2, 1998]

§ 1.1295–1T Qualified electing funds (temporary).

(a) *In general.* [Reserved]

(b) *Application of section 1295 election.* [Reserved]

(1) *Election personal to shareholder.* [Reserved]

(2) *Election applicable to specific corporation only—*

(i) *In general.* [Reserved]

(ii) *Stock of QEF received in a nonrecognition transfer.* [Reserved]

(iii) *Exception for options.* A shareholder's section 1295 election does not apply to any option to buy stock of the PFIC.

(3) *Application of general rules to stock held by a pass through entity*—(i) *Stock subject to a section 1295 election transferred to a pass through entity.* A shareholder's section 1295 election will not apply to a domestic pass through entity to which the shareholder transfers stock subject to section 1295 election, or to any other U.S. person that is an interest holder or beneficiary of the domestic pass through entity. However, as provided in paragraph (c)(2)(iv) of this section (relating to a transfer to a domestic pass through entity of stock subject to a section 1295 election), a shareholder that transfers stock subject to a section 1295 election to a pass through entity will continue to be subject to the section 1295 election with respect to the stock indirectly owned through the pass through entity and any other stock of that PFIC owned by the shareholder.

(ii) *Limitation on application of pass through entity's section 1295 election.* Except as provided in paragraph (c)(2)(iv) of this section, a section 1295 election made by a domestic pass through entity does not apply to other stock of the PFIC held directly or indirectly by the interest holder or beneficiary.

(iii) *Effect of partnership termination on section 1295 election.* Termination of a section 1295 election made by a domestic partnership by reason of the termination of the partnership under section 708(b) will not terminate the section 1295 election with respect to partners of the terminated partnership that are partners of the new partnership. Except as otherwise provided, the stock of the PFIC of which the new partners are indirect shareholders will be treated as stock of a QEF only if the new domestic partnership makes a section 1295 election with respect to that stock.

(iv) *Characterization of stock held through a pass through entity.* Stock of a PFIC held through a pass through entity will be treated as stock of a pedigreed QEF with respect to an interest holder or beneficiary only if—

(A) In the case of PFIC stock acquired (other than in a transaction in which gain is not recognized pursuant to regulations under section 1291(f) with respect to that stock), and held by a domestic pass through entity, the pass through entity makes the section 1295 election and the PFIC has been a QEF with respect to the pass through entity for all taxable years that are included wholly or partly in the pass through entity's holding period of the PFIC stock and during which the foreign corporation was a PFIC within the meaning of § 1.1291–9(j)(1); or

(B) In the case of PFIC stock transferred by an interest holder or beneficiary to a pass through entity in a transaction in which gain is not recognized pursuant to regulations under section 1291(f) with respect to that stock and held by the pass through entity, the PFIC stock transferred to the pass through entity was treated as stock of a pedigreed QEF with respect to the interest holder or beneficiary at the time of the transfer and the pass through entity makes a section 1295 election.

(4) *Application of general rules to a taxpayer filing a joint return under section 6013.* A section 1295 election made by a taxpayer in a joint return, within the meaning of section 6013, will be treated as also made by the spouse that joins in the filing of that return.

(c) *Effect of section 1295 election*—(1) *In general.* Except as otherwise provided in this paragraph (c), the effect of a shareholder's section 1295 election is to treat the foreign corporation as a QEF with respect to the shareholder for each taxable year of the foreign corporation ending with or within a taxable year of the shareholder for which the election is effective. A section 1295 election is effective for the shareholder's election year and all subsequent taxable years of the shareholder unless invalidated, terminated or revoked as provided in paragraph (i) of this section. The terms shareholder and shareholder's election year are defined in paragraph (j) of this section.

(2) *Years to which section 1295 election applies*—(i) *In general.* Except as otherwise provided in this paragraph (c), a foreign corporation with respect to which a section 1295 election is made will be treated as a QEF for its taxable year ending with or within the shareholder's election year and all subsequent taxable years of the foreign corporation that are included wholly or partly in the shareholder's holding period (or periods) of stock of the foreign corporation.

(ii) *Effect of PFIC status on election.* A foreign corporation will not be treated as a QEF for any taxable year of the foreign corporation that the foreign corporation is not a PFIC under section 1296(a) and is not treated as a PFIC under section 1297(b)(1). However, cessation of a foreign corporation's status as a PFIC will not terminate a section 1295 election.

(iii) *Effect on election of complete termination of a shareholder's interest in the PFIC.* Complete termination of a shareholder's direct and indirect interest in stock of a foreign corporation will not terminate a shareholder's section 1295 election with respect to the foreign corporation.

(iv) *Effect on section 1295 election of transfer of stock to a domestic pass through entity.* The transfer of a shareholder's direct or indirect interest in stock of a foreign corporation to a domestic pass through entity (as defined in paragraph (j) of this section) will not terminate the shareholder's section 1295 election with respect to the foreign corporation, whether or not the pass through entity makes a section 1295 election. For the rules concerning the application of section 1293 to stock transferred to a domestic pass through entity, see § 1.1293–1T(c).

(v) *Examples.* The following examples illustrate the rules of this paragraph (c)(2).

Example 1. In 1998, C, a U.S. person, purchased stock of FC, a foreign corporation that is a PFIC. Both FC and C are calendar year taxpayers. C made a timely section 1295 election to treat FC as a QEF in C's 1998 return, and FC was therefore a pedigreed QEF. C included its shares of FC's 1998 ordinary earnings and net capital gain in C's 1998 Income and did not make a section 1294 election to defer the time for payment of tax on that income. In 1999, 2000, and 2001, FC did not satisfy either the income or asset test of section 1296(a), and therefore was neither a PFIC nor a QEF. C therefore did not have to include its pro rata shares of the ordinary earnings and net capital gain of FC pursuant to section 1293, or satisfy the section 1295 annual reporting requirements for any of those years. FC qualified as a PFIC again in 2002. Because C had made a section 1295 election in 1998, and the election had not been invalidated, terminated, or revoked, within the meaning of paragraph (i) of this section, C's section 1295 election remains in effect for 2002. C therefore is subject in 2002 to the income inclusion and reporting rules required of shareholders of QEFs.

Example 2. The facts are the same as in Example (1) except that FC did not lose PFIC status in any year and C sold all the FC stock in 1999 and repurchased stock of FC in 2002. Because C had made a section 1295 election in 1998 with respect to stock of FC, and the election had not been invalidated, terminated, or revoked, within the meaning of paragraph (i) of this section, C's section 1295 election remained in effect and therefore applies to the stock of FC purchased by C in 2002. C therefore is subject in 2002 to the income inclusion and reporting rules required of shareholders of QEFs.

Example 3. The facts are the same as in Example (2) except that C is a partner in domestic partnership P and C transferred its FC stock to P in 1999. Because C had made a section 1295 election in 1998 with respect to stock of FC, and the election had not been invalidated, terminated, or revoked, within the meaning of paragraph (i) of this section, C's section 1295 election remains in effect with respect to its indirect interest in the stock of FC. If P does not make the section 1295 election with respect to the FC stock, C will continue to be subject, in C's capacity as an indirect shareholder of FC, to the income inclusion and reporting rules required of shareholders of QEFs in 1999 and subsequent years. If P makes the section 1295 election, C will take into account its pro rata shares of the ordinary earnings and net capital gain of the FC under the rules applicable to inclusions of income from P.

(d) *Who may make a section 1295 election*—(1) *General rule.* Except as otherwise provided in this paragraph (d), any U.S. person that is a shareholder (as defined in paragraph (j) of this section) of a PFIC, including a shareholder that holds stock of a PFIC in bearer form, may make a section 1295 election with respect to that PFIC. The shareholder need not own directly or indirectly any stock of the PFIC at the time the shareholder makes the section 1295 election provided the shareholder is a shareholder of the PFIC during the taxable year of the PFIC that ends with or within the taxable year of the shareholder for which the section 1295 election is made. Except in the case of a shareholder that is an exempt organization that may not make a section 1295 election, as provided in paragraph (d)(5) of this section, in a chain of ownership only the first U.S. person that is a shareholder of the PFIC may make the section 1295 election.

(2) *Application of general rule to pass through entities*—(i) *Partnerships*—(A) *Domestic partnership.* A domestic partnership that holds an interest in stock of a PFIC makes the section 1295 election with request to that PFIC. The partnership election applies only to the stock of the PFIC held directly or indirectly by the partnership and not to any other stock held directly or indirectly by any partner. As provided in § 1.1293–1T(c)(1), shareholders owning stock of a QEF by reason of an interest in the partnership take into account the section 1293 inclusions with respect to the QEF shares owned by the partnership under the rules applicable to inclusions of income from the partnership.

(B) *Foreign partnership.* A U.S. person that holds an interest in a foreign partnership that, in turn, holds an interest in stock of a PFIC makes the section 1295 election with respect to that PFIC. A partner's election applies to the stock of the PFIC owned directly or indirectly by the foreign partnership and to any other stock of the PFIC owned by that partner. A section 1295 election by a partner applies only to that partner.

(ii) *S corporation.* An S corporation that holds an interest in stock of a PFIC makes the section 1295 election with respect to that PFIC. The S corporation election applies only to the stock of the PFIC held directly or indirectly by the S corporation and not to any other stock held directly or indirectly by any S corporation shareholder. As provided in § 1.1293–1T(c)(1), shareholders owning stock of a QEF by reason of an interest in the S corporation take into account the section 1293 inclusions with respect to the QEF shares under the rules applicable to inclusions of income from the S corporation.

(iii) *Trust or estate*—(A) *Domestic trust or estate*—(*1*) *Nongrantor trust or estate.* A domestic nongrantor trust or a domestic estate that holds an interest in stock of a PFIC makes the section 1295 election with respect to that PFIC. The trust or estate's election applies only to the stock of the PFIC held directly or indirectly by the trust or estate and not to any other stock held directly or indirectly by any beneficiary. As provided in § 1.1293–1T(c)(1), shareholders owning stock of a QEF by reason of an interest in a domestic trust or estate take into account the section 1293 inclusions with respect to the QEF shares under the rules applicable to inclusions of income from the trust or estate.

(*2*) *Grantor trust.* A U.S. person that is treated under sections 671 through 678 as the owner of the portion of a domestic trust that owns an interest in stock of a PFIC makes the section 1295 election with respect to that PFIC. If that person ceases to be treated as the owner of the portion of the trust that owns an interest in the PFIC stock and is a beneficiary of the trust, that person's section 1295 election will continue to apply to the PFIC stock indirectly owned by that person under the rules of paragraph (c)(2)(iv) of this section as if the person had transferred its interest in the PFIC stock to the trust. However, the stock will be treated as stock of a PFIC that is not a QEF with respect to other beneficiaries of the trust, unless the trust makes the section 1295 election as provided in paragraph (d)(2)(iii)(A)(*1*) of this section.

(B) *Foreign trust or estate*—(*1*) *Nongrantor trust or estate.* A U.S. person that is a beneficiary of a foreign nongrantor trust or estate that holds an interest in stock of a PFIC makes the section 1295 election with respect to that PFIC. A beneficiary's section 1295 election applies to all the PFIC stock owned directly and indirectly by the trust or estate and to the other PFIC stock owned directly or indirectly by the beneficiary. A section 1295 election by a beneficiary applies only to that beneficiary.

(*2*) *Grantor trust.* A U.S. person that is treated under sections 671 through 679 as the owner of the portion of a foreign trust that owns an interest in stock of a PFIC stock makes the section 1295 election with respect to that PFIC. If that person ceases to be treated as the owner of the portion of the trust that owns an interest in the PFIC stock and is a beneficiary of the trust, that person's section 1295 election will continue to apply to the PFIC stock indirectly owned by that person under the rules of paragraph (c)(2)(iv) of this section. However, as provided in paragraph (d)(2)(iii)(B)(*1*) of this section, any other shareholder that is a beneficiary of the trust and that wishes to treat the PFIC as a QEF must make the section 1295 election.

(iv) *Indirect ownership of the pass through entity or the PFIC.* The rules of this paragraph (d)(2) apply whether or not the shareholder holds its interest in the pass through entity directly or indirectly and whether or not the pass through entity holds its interest in the PFIC directly or indirectly.

(3) *Member of consolidated return group as shareholder.* Pursuant to §1.1502–77(a), the common parent of an affiliated group of corporations that join in filing a consolidated income tax return makes a section 1295 election for all members of the affiliated group. An election by a common parent will be effective for all members of the affiliated group with respect to interests in PFIC stock held at the time the election is made or at any time thereafter. A separate election must be made by the common parent for each PFIC of which a member of the affiliated group is a shareholder.

(4) *Option holder.* A holder of an option to acquire stock of a PFIC may not make a section 1295 election that will apply to the option or to the stock subject to the option.

(5) *Exempt organization.* A tax-exempt organization that is not taxable under section 1291, pursuant to §1.1291–1T(e), with respect to a PFIC may not make a section 1295 election with respect to that PFIC. In addition, such an exempt organization will not be subject to any section 1295 election made by a domestic pass through entity.

(e) *Time for making a section 1295 election.* Except as provided in §1.1295–3T, a shareholder making the section 1295 election must make the election on or before the due date, as extended under section 6081 (election due date), for filing the shareholder's income tax return for the first taxable year to which the election will apply. The section 1295 election must be made in the original return for that year, or in an amended return, provided the amended return is filed on or before the election due date.

(f) *Manner of making a section 1295 election and the annual election requirements of the shareholder*—(1) *Manner of making the election.* A shareholder must make a section 1295 election by—

(i) Completing Form 8621 in the manner required by that form and this section for making the section 1295 election;

(ii) Attaching Form 8621 to its Federal income tax return filed by the election due date for the shareholder's election year;

(iii) Receiving and reflecting in Form 8621 the information provided in the PFIC Annual Information Statement described in paragraph (g)(1) of this section, the Annual Intermediary Statement described in paragraph (g)(3) of this section, or the applicable combined statement described in paragraph (g)(4) of this section, for the taxable year of the PFIC ending with or within the taxable year for which Form 8621 is being filed. If the PFIC Annual Information Statement contains a statement described in paragraph (g)(1)(ii)(C) of this section, the shareholder must attach a statement to Form 8621 that indicates that the shareholder rather than the QEF calculated the QEF's ordinary earnings and net capital gain; and

(iv) Filing a copy of Form 8621 with the Philadelphia Service Center, P.O.

Box 21086, Philadelphia, PA 19114 by the election due date.

(2) *Annual election requirements*—(i) *In general.* A shareholder that makes a section 1295 election with respect to a PFIC held directly or indirectly, for each taxable year to which the section 1295 election applies, must—

(A) Complete Form 8621 in the manner required by that form and this section;

(B) Attach Form 8621 to its Federal income tax return filed by the due date of the return, as extended;

(C) Receive and reflect in Form 8621 the PFIC Annual Information Statement described in paragraph (g)(1) of this section, the Annual Intermediary Statement described in paragraph (g)(3) of this section, or the applicable combined statement described in paragraph (g)(4) of this section, for the MTtaxable year of the PFIC ending with or within the taxable year for which Form 8621 is being filed. If the PFIC Annual Information Statement contains a statement described in paragraph (g)(1)(ii)(C) of this section, the shareholder must attach a statement to its Form 8621 that the shareholder rather than the PFIC provided the calculations of the PFIC's ordinary earnings and net capital gain; and

(D) File a copy of Form 8621 with the Philadelphia Service Center, P.O. Box 21086, Philadelphia, PA 19114 by the election due date.

(ii) *Retention of documents.* For all taxable years subject to the section 1295 election, the shareholder must retain copies of all Forms 8621, with their attachments, and PFIC Annual Information Statements or Annual Intermediary Statements. Failure to produce those documents at the request of the Commissioner in connection with an examination may result in invalidation or termination of the shareholder's section 1295 election.

(g) *Annual election requirements of the PFIC or intermediary*—(1) *PFIC Annual Information Statement.* For each year of the PFIC ending in a taxable year of a shareholder to which the shareholder's section 1295 election applies, the PFIC must provide the shareholder with a PFIC Annual Information Statement. The PFIC Annual Information Statement is a statement of the PFIC, signed by the PFIC or an authorized representative of the PFIC, that contains the following information and representation—

(i) The first and last days of the taxable year of the PFIC to which the PFIC Annual Information Statement applies;

(ii) Either—

(A) The shareholder's pro rata shares of the ordinary earnings and net capital gain (as defined in § 1.1295–1T(a)(2)) of the PFIC for the taxable year indicated in paragraph (g)(1)(i) of this section; or

(B) Sufficient information to enable the shareholder to calculate its pro rata shares of the PFIC's ordinary earnings and net capital gain, for that taxable year; or

(C) A statement that the foreign corporation has permitted the shareholder to examine the books of account, records, and other documents of the foreign corporation for the shareholder to calculate the amounts of the PFIC's ordinary earnings and the net capital gain according to Federal income tax accounting principles and to calculate the shareholder's pro rata shares of the PFIC's ordinary earnings and net capital gain;

(iii) The amount of cash and the fair market value of other property distributed or deemed distributed to the shareholder during the taxable year of the PFIC to which the PFIC Annual Information Statement pertains; and

(iv) Either—

(A) A statement that the PFIC will permit the shareholder to inspect and copy the PFIC's permanent books of account, records, and such other documents as may be maintained by the PFIC to establish that the PFIC's ordinary earnings and net capital gain are computed in accordance with U.S. income tax principles, and to verify these amounts and the shareholder's pro rata shares thereof; or

(B) In lieu of the statement required in paragraph (g)(1)(iv)(A) of this section, a description of the alternative documentation requirements approved by the Commissioner, with a copy of the private letter ruling and the closing agreement entered into by the Commissioner and the PFIC pursuant to paragraph (g)(2) of this section.

(2) *Alternative documentation.* In rare and unusual circumstances, the Commissioner will consider alternative documentation requirements necessary to verify the ordinary earnings and net capital gain of a PFIC other than the documentation requirements described in paragraph (g)(1)(iv)(A) of this section. Alternative documentation requirements will be allowed only pursuant to a private letter ruling and a closing agreement entered into by the Commissioner and the PFIC describing an alternative method of verifying the PFIC's ordinary earnings and net capital gain. If the PFIC has not obtained a private letter ruling from the Commissioner approving an alternative method of verifying the PFIC's ordinary earnings and net capital gain by the time a shareholder is required to make a section 1295 election, the shareholder may not use an alternative method for that taxable year.

(3) *Annual Intermediary Statement.* In the case of a U.S. person that is a shareholder of a PFIC through an intermediary, as defined in paragraph (j) of this section, an Annual Intermediary Statement issued by an intermediary containing the information described in paragraph (g)(1) of this section and reporting the indirect owner's pro rata shares of the ordinary earnings and net capital gain of the QEF as described in paragraph (g)(1)(i)(A) of this section, may be provided to the indirect owner in lieu of the PFIC Annual Information Statement if the following conditions are satisfied—

(i) The intermediary receives a copy of the PFIC Annual Information Statement or the intermediary receives an annual intermediary statement from another intermediary which contains a statement that the other intermediary has received a copy of the PFIC Annual Information Statement and represents that the conditions of paragraphs (g)(3)(ii) and (g)(3)(iii) of this section are met;

(ii) The representations and information contained in the Annual Intermediary Statement reflect the representations and information contained in the PFIC Annual Information Statement; and

(iii) The PFIC Annual Information Statement issued to the intermediary contains either the representation set forth in paragraph (g)(1)(iv)(A) of this section, or, if alternative documentation requirements were approved by the Commissioner pursuant to paragraph (g)(2) of this section, a copy of the private letter ruling and closing agreement between the Commissioner and the PFIC, agreeing to an alternative method of verifying PFIC ordinary earnings and net capital gain as described in paragraph (g)(2) of this section;

(4) *Combined statements*—(i) *PFIC Annual Information Statement.* A PFIC that owns directly or indirectly any stock of one or more PFICs with respect to which a shareholder may make the section 1295 election may prepare a PFIC Annual Information Statement that combines with its own information and representations the information and representations of all the PFICs. The PFIC may use any format for a combined PFIC Annual Information Statement provided the required information and representations are separately stated and identified with the respective corporations.

(ii) *Annual Intermediary Statement.* An intermediary described in paragraph (g)(3) of this section that owns directly or indirectly stock of one or more PFICs with respect to which an indirect shareholder may make the section 1295 election may prepare an Annual Intermediary Statement that combines with its own information and representations the information and representations with respect to all the PFICs. The intermediary may use any format for a combined Annual Intermediary Statement provided the required information and representations are separately stated and identified with the intermediary and the respective corporations.

(h) *Transition rules.* The rules of Notice 88–125, 1988–2 C.B. 535 (see §601.601(d)(2)(ii)(*b*) of this chapter), apply for making elections and maintaining elections for taxable years beginning after December 31, 1986, and before January 1, 1998. Elections made under Notice 88–125 must be maintained as provided in §1.1295–1T for taxable years beginning after December 31,

1997. A section 1295 election made prior to February 2, 1998 that was intended to be effective for the taxable year of the PFIC that began during the shareholder's election year will be effective for that taxable year of the foreign corporation provided that it is clear from all the facts and circumstances that the shareholder intended the election to be effective for that taxable year of the foreign corporation.

(i) *Invalidation, termination, or revocation of section 1295 election*—(1) *Invalidation or termination of election at the discretion of the Commissioner*—(i) *In general.* The Commissioner, in the Commissioner's discretion, may invalidate or terminate a section 1295 election applicable to a shareholder if the shareholder, the PFIC, or any intermediary fails to satisfy the requirements for making a section 1295 election or the annual election requirements of this section to which the shareholder, PFIC, or intermediary is subject, including the requirement to provide, on request, copies of the books and records of the PFIC or other documentation substantiating the ordinary earnings and net capital gain of the PFIC.

(ii) *Deferral of section 1293 inclusion.* The Commissioner may invalidate any pass through entity section 1295 election with respect to an interest holder or beneficiary if the section 1293 inclusion with respect to that interest holder or beneficiary is not included in the gross income of either the pass through entity, an intermediate pass through entity, or the interest holder or beneficiary within two years of the end of the PFIC's taxable year due to nonconforming taxable years of the interest holder and the pass through entity or any intermediate pass through entity.

(iii) *When effective.* Termination of a shareholder's section 1295 election will be effective for the taxable year of the PFIC determined by the Commissioner in the Commissioner's discretion. An invalidation of a shareholder's section 1295 election will be effective for the first taxable year to which the section 1295 election applied, and the shareholder whose election is invalidated will be treated as if the section 1295 election never was made.

(2) *Shareholder revocation*—(i) *In general.* In the Commissioner's discretion, upon a finding of a substantial change in circumstances, the Commissioner may consent to a shareholder's request to revoke a section 1295 election. Request for revocation must be made by the shareholder that made the election and at the time and in the manner provided in paragraph (i)(2)(ii) of this section.

(ii) *Time for and manner of requesting consent to revoke*—(A) *Time.* The shareholder must request consent to revoke the section 1295 election no later than 12 calendar months after the discovery of the substantial change of circumstances that forms the basis for the shareholder's request to revoke the section 1295 election.

(B) *Manner of making request.* A shareholder requests consent to revoke a section 1295 election by filing a ruling request with the Office of the Associate Chief Counsel (International). The ruling request must satisfy the requirements, including payment of the user fee, for filing ruling requests with that office.

(iii) *When effective.* Unless otherwise determined by the Commissioner, revocation of a section 1295 election will be effective for the first taxable year of the PFIC beginning after the date the Commissioner consents to the revocation.

(3) *Effect of invalidation, termination, or revocation.* An invalidation, termination, or revocation of a section 1295 election—

(i) Terminates all section 1294 elections, as provided in §1.1294–1T(e), and the undistributed PFIC earnings tax liability and interest thereon are due by the due date, without regard to extensions, for the return for the last taxable year of the shareholder to which the section 1295 election applies;

(ii) In the Commissioner's discretion, results in a deemed sale of the QEF stock on the last day of the PFIC's last taxable year as a QEF, in which gain, but not loss, will be recognized and with respect to which appropriate basis and holding period adjustments will be made; and

(iii) Subjects the shareholder to any other terms and conditions that the

Commissioner determines are necessary to ensure the shareholder's compliance with sections 1291 through 1297 or any other provisions of the Code.

(4) *Election after invalidation, termination or revocation.* Without the Commissioner's consent a shareholder whose section 1295 election was invalidated, terminated, or revoked under this paragraph (i) may not make the section 1295 election with respect to the PFIC before the sixth taxable year ending after the taxable year in which the invalidation, termination or revocation became effective.

(j) *Definitions.* For purposes of this section—

Intermediary is a nominee or shareholder of record that holds stock on behalf of the shareholder or on behalf of another person in a chain of ownership between the shareholder and the PFIC, and any direct or indirect beneficial owner of PFIC stock (including a beneficial owner that is a pass through entity) in the chain of ownership between the shareholder and the PFIC.

Pass through entity is a partnership, S corporation, trust, or estate.

Shareholder has the same meaning as the term shareholder in §1.1291–9(j)(3), except that for purposes of this section, a partnership and an S corporation also are treated as shareholders. Furthermore, unless otherwise provided, an interest holder of a pass through entity, which is treated as a shareholder of a PFIC, also will be treated as a shareholder of the PFIC.

Shareholder's election year is the taxable year of the shareholder for which it made the section 1295 election.

(k) *Effective date.* Section 1.1295–1T (b)(2)(iii), (b)(3), (b)(4), and (c) through (j) is applicable to taxable years of shareholders beginning after December 31, 1997.

[T.D. 8750, 63 FR 15, Jan. 2, 1998]

§1.1295–3T Retroactive elections (temporary).

(a) *In general.* This section prescribes the exclusive rules under which a shareholder, as defined in §1.1295–1T(j), may make a section 1295 election for a taxable year after the election due date, as defined in §1.1295–1T(e) (retroactive election). Therefore, a shareholder may not seek such relief under any other provision of the law, including §301.9100 of this chapter. Paragraph (b) of this section describes the general rules for a shareholder to preserve the ability to make a retroactive election. These rules require that the shareholder possess reasonable belief as of the election due date that the foreign corporation was not a PFIC for its taxable year that ended in the shareholder's taxable year to which the election due date pertains, and that the shareholder file a Protective Statement to preserve its ability to make a retroactive election. Paragraph (c) of this section establishes the terms, conditions and other requirements with respect to a Protective Statement required to be filed under the general rules. Paragraph (d) of this section sets forth factors that establishes a shareholder's reasonable belief that a foreign corporation was not a PFIC. Paragraph (e) of this section prescribes special rules for certain shareholders that are deemed to satisfy the reasonable belief requirement and therefore are not required to file a Protective Statement. Paragraph (f) of this section describes the limited circumstances under which the Commissioner may permit a shareholder that lacked the requisite reasonable belief or failed to satisfy the requirements of paragraph (b) or (e) of this section to make a retroactive election. Paragraph (g) of this section provides the time for and manner of making a retroactive election. Paragraph (h) of this section provides the effective date of this section.

(b) *General rule.* Except as provided in paragraphs (e) and (f) of this section, a shareholder may make a retroactive election for a taxable year of the shareholder (retroactive election year) only if the shareholder—

(1) Reasonably believed, within the meaning of paragraph (d) of this section, as of the election due date that the foreign corporation was not a PFIC for its taxable year that ended during the retroactive election year;

(2) Filed a Protective Statement with respect to the foreign corporation, applicable to the retroactive election

year, in which the shareholder described the basis for its reasonable belief and extended, in the manner provided in paragraph (c)(4) of this section, the periods of limitations on the assessment of taxes determined under sections 1291 and 1297 with respect to the foreign corporation (PFIC related taxes) for all taxable years of the shareholder to which the Protective Statement applies; and

(3) Complied with the other terms and conditions of the Protective Statement.

(c) *Protective Statement*—(1) *In general.* A Protective Statement is a statement executed under penalties of perjury by the shareholder, or a person authorized to sign a Federal income tax return on behalf of the shareholder, that preserves the shareholder's ability to make a retroactive election. To file a Protective Statement that applies to a taxable year of the shareholder, the shareholder must reasonably believe as of the election due date that the foreign corporation was not a PFIC for the foreign corporation's taxable year that ended during the retroactive election year. The Protective Statement must contain—

(i) The shareholder's reasonable belief statement, as described in paragraph (c)(2) of this section;

(ii) The shareholder's agreement extending the periods of limitations on the assessment of PFIC related taxes for all taxable years to which the Protective Statement applies, as provided in paragraph (c)(4) of this section; and

(iii) The following information and representations—

(A) The shareholder's name, address, taxpayer identification number, and the shareholder's first taxable year to which the Protective Statement applies;

(B) The foreign corporation's name, address, and taxpayer identification number, if any; and

(C) The highest percentage of shares of each class of stock of the foreign corporation held directly or indirectly by the shareholder during the shareholder's first taxable year to which the Protective Statement applies.

(2) *Reasonable belief statement.* The Protective Statement must contain a reasonable belief statement, as described in paragraph (c)(1) of this section. The reasonable belief statement is a description of the shareholder's basis for its reasonable belief that the foreign corporation was not a PFIC for its taxable year that ended with or within the shareholder's first taxable year to which the Protective Statement applies. If the Protective Statement applies to a taxable year or years described in paragraph (c)(5)(ii) of this section, the reasonable belief statement must describe the shareholder's basis for its reasonable belief that the foreign corporation was not a PFIC for the foreign corporation's taxable year or years that ended in such taxable year or years of the shareholder. The reasonable belief statement must discuss the application of the income and asset tests to the foreign corporation and the factors, including those stated in paragraph (d) of this section, that affect the results of those tests.

(3) *Who executes and files the Protective Statement.* The person that executes and files and Protective Statement is the person that makes the section 1295 election, as provided in § 1.1295–1T(d).

(4) *Waiver of the periods of limitations*—(i) *Time for and manner of extending periods of limitations.* (A) *In general.* A shareholder that files the Protective Statement with the Commissioner must extend the periods of limitations on the assessment of all PFIC related taxes for all of the shareholder's taxable years to which the Protective Statement applies, as provided in this paragraph (c)(4). The shareholder is required to execute the waiver on such form as the Commission may prescribe for purposes of this paragraph (c)(4). Until that form is published, the shareholder must execute a statement in which the shareholder agrees to extend the periods of limitations on the assessment of taxes for all the shareholder's taxable years to which the Protective Statement applies, as provided in this paragraph (c)(4), and agrees to the restrictions in paragraph (c)(4)(ii)(A) of this section. The shareholder or a person authorized to sign the shareholder's Federal income tax return must sign the form or statement. A properly executed form or statement authorized by this paragraph (c)(4) will be deemed consented

to and signed by a Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)–1(d) of this chapter.

(B) *Application of general rule to domestic partnerships*— (*1*) *In general.* A domestic partnership that holds an interest in stock of a PFIC satisfies the waiver requirement of paragraph (c)(4) of this section pursuant to the rules of this paragraph (c)(4)(i)(B)(*1*). The partnership must file one or more waivers obtained or arranged under this paragraph (c)(4)(i)(B) as part of the Protective Statement, as provided in paragraph (c)(1) of this section. The partnership must either—

(*i*) Obtain from each partner the partner's waiver of the periods of limitations;

(*ii*) Obtain from each partner a duly executed power of attorney under § 601.501 of this chapter authorizing the partnership to extend that partner's periods of limitations, and execute a waiver on behalf of the partners; or

(*iii*) In the case of a domestic partnership governed by the unified audit and litigation procedures of sections 6221 through 6233 (TEFRA partnership), arrange for the tax matters partner (or any other person authorized to enter into an agreement to extend the periods of limitations), as provided in section 6229(b), to execute a waiver on behalf of all the partners.

(*2*) *Special rules*—(*i*) *Addition of partner to non-TEFRA partnership.* In the case of any individual who becomes a partner in a domestic partnership other than a TEFRA partnership (non-TEFRA partnership) in a taxable year subsequent to the year in which the partnership filed a Protective Statement, the partner and the partnership must comply with the rules applicable to non-TEFRA partnerships, as provided in paragraph (c)(4)(i)(B)(*1*) of this section, by the due date, as extended, for the Federal income tax return of the partnership for the taxable year during which the individual became a partner. Failure to so comply will render the Protective Statement invalid with respect to the partnership and partners.

(*ii*) *Change in status from non-TEFRA partnership to TEFRA partnership.* If a partnership is a non-TEFRA partnership in one taxable year but becomes a TEFRA partnership in a subsequent taxable year, the partnership must file one or more waivers obtained or arranged under this paragraph (c)(4)(i)(B)(*2*)(*ii*), as part of the Protective Statement, as provided in paragraph (c)(1) of this section. The partnership must either—obtain from any new partner the partner's waiver described in this paragraph (c)(4); obtain from the new partner a duly executed power of attorney under § 601.501 of this chapter authorizing the partnership to extend the partner's periods of limitations, and execute a waiver on behalf of the new partner; or arrange for the tax matters partner (or any other person authorized to enter into an agreement to extend the periods of limitations) to execute a waiver on behalf of all the partners. In each case, the partnership must attach any new waiver of a partner's periods of limitations, and a copy of the Protective Statement to its Federal income tax return for that taxable year.

(C) *Application of general rule to domestic nongrantor trusts and domestic estates.* A domestic nongrantor trust or a domestic estate that holds an interest in stock of a PFIC satisfies the waiver requirement of this paragraph (c)(4) at the entity level. For this purpose, such entity must comply with rules similar to those applicable to non-TEFRA partnerships, as provided in paragraph (c)(4)(i)(B)(*1*) of this section.

(D) *Application of general rule to S corporations.* An S corporation that holds an interest in stock of a PFIC satisfies the waiver requirement of this paragraph (c)(4) at the S corporation level. For this purpose, the S corporation must comply with rules similar to those applicable to non-TEFRA partnerships, as provided in paragraph (c)(4)(i)(B)(*1*) of this section. However, in the case of an S corporation that was governed by the unified audit corporate proceedings of sections 6241 through 6245 for any taxable year to which a Protective Statement applies (former TEFRA S corporation), the tax matters person (or any other person authorized to enter into such an agreement), as was provided in sections 6241 through 6245, may execute a waiver described in this paragraph (c)(4) that applies to such taxable year; for any other taxable year, the former TEFRA S corporation must comply with rules similar to those applicable to non-TEFRA partnerships.

(E) *Effect on waiver of complete termination of a pass through entity or pass through entity's business.* The complete termination of a pass through entity described in paragraphs (c)(4)(i) (B) through (D) of this section, or a pass through entity's trade or business, will not terminate a waiver that applies to a partner, shareholder, or beneficiary.

(F) *Application of general rule to foreign partnerships, foreign trusts, domestic or foreign grantor trusts, and foreign estates.* A U.S. person that is a partner or beneficiary of a foreign partnership, foreign trust, or foreign estate that holds an interest in stock of a PFIC satisfies the waiver requirement of this paragraph (c)(4) at the partner or beneficiary level. A U.S. person that is treated under sections 671 through 679 as the owner of the portion of a domestic or foreign trust that owns an interest in PFIC stock also satisfies the waiver requirement at the owner level. A waiver by a partner or beneficiary applies only to that partner or beneficiary, and is not affected by a complete termination of the entity or the entity's trade or business.

(ii) *Terms of waiver*—(A) *Scope of waiver.* The waiver of the periods of limitations is limited to the assessment of PFIC related taxes. If the period of limitations for a taxable year affected by a retroactive election has expired with respect to the assessment of other non-PFIC related taxes, no adjustments, other than consequential changes, may be made by the Internal Revenue Service or by the shareholder to any other item of income, deduction, or credit for that year. If the period of limitations for refunds or credits for a taxable year affected by a retroactive election is open only by virtue of the assessment period extension and section 6511(c), no refund or credit is allowable on grounds other than adjustments to PFIC related taxes and consequential changes.

(B) *Period of Waiver.* The extension of the periods of limitations on the assessment of PFIC related taxes will be effective for all of the shareholder's taxable years to which the Protective Statement applies. In addition, the waiver, to the extent it applies to the period of limitations for a particular year, will terminate with respect to that year no sooner than three years from the date on which the shareholder files an amended return, as provided in paragraph (g) of this section, for that year. For the suspension of the running of the period of limitations for the collection of taxes for which a shareholder has elected under section 1294 to extend the time for payment, as provided in paragraph (g)(3)(ii) of this section, see sections 6503(i) and 6229(h).

(5) *Time for and manner of filing a Protective Statement*—(i) *In general.* Except as provided in paragraph (c)(5)(ii) of this section, a Protective Statement must be attached to the shareholder's Federal income tax return for the shareholder's first taxable year to which the Protective Statement will apply. The shareholder also must file a copy of the Protective Statement with the Philadelphia Service Center, P.O. 21086, Philadelphia, PA 19114. The shareholder must file its return and the copy of the Protective Statement by the due date, as extended, for the return.

(ii) *Special rule for taxable years ended before January 2, 1998.* A shareholder may file a Protective Statement that applies to the shareholder's taxable year or years that ended before January 2, 1998, provided the period of limitations on the assessment of taxes for any such year has not expired (open year). The shareholder must file the Protective Statement applicable to such open year or years, as provided in paragraph (c)(5)(i) of this section, by the due date, as extended, for the shareholder's return for the first taxable year ending after January 2, 1998.

(6) *Applicability of the Protective Statement*—(i) *In general.* Except as otherwise provided in this paragraph (c)(6), a Protective Statement applies to the shareholder's first taxable year for which the Protective Statement was filed and to each subsequent taxable year. The Protective Statement will not apply to any taxable year of the

shareholder during which the shareholder does not own any stock of the foreign corporation or to any taxable year thereafter. Accordingly, if the shareholder has not made a retroactive election with respect to the previously owned stock by the time the shareholder reacquires stock of the foreign corporation, the shareholder must file another Protective Statement to preserve its right to make a retroactive election with respect to the later acquired stock. For the rule that provides that a section 1295 election made with respect to a foreign corporation applies to stock of that corporation acquired after a lapse in ownership, see §1.1295–1T(c)(2)(iii).

(ii) *Invalidity of the Protective Statement.* A shareholder will be treated as if it never filed a Protective Statement if—

(A) The shareholder failed to make a retroactive election by the date prescribed for making the retroactive election in paragraph (g)(1) of this section; or

(B) The waiver of the periods of limitations terminates (by reason of a court decision or other determination) with respect to any taxable year before the expiration of three years from the date of filing of an amended return for that year pursuant to paragraph (g) of this section.

(7) *Retention of Protective Statement and information demonstrating reasonable belief.* A shareholder that files a Protective Statement must retain a copy of the Protective Statement and its attachments and must, for each taxable year of the shareholder to which the Protective Statement applies, retain information sufficient to demonstrate the shareholder's reasonable belief that the foreign corporation was not a PFIC for the taxable year of the foreign corporation ending during each such taxable year of the shareholder.

(d) *Reasonable belief*—(1) *In general.* A foreign corporation is a PFIC for a taxable year if the foreign corporation satisfies either the income or asset test of section 1296(a). To determine whether a shareholder had reasonable belief that the foreign corporation is not a PFIC under section 1296(a), the shareholder must consider all relevant facts and circumstances. Reasonable belief may be based on a variety of factors, including reasonable asset valuations as well as reasonable interpretations of the applicable provisions of the Code, regulations, and administrative guidance regarding the direct and indirect ownership of the income or assets of the foreign corporation, the proper character of that income or those assets, and similar issues. Reasonable belief may be based on reasonable predictions regarding income to be earned and assets to be owned in subsequent years where qualifications of the foreign corporation as a PFIC for the current taxable year will depend on the qualification of the corporation as a PFIC in a subsequent year. Reasonable belief may be based on an analysis of generally available financial information of the foreign corporation. To determine whether a shareholder had reasonable belief that the foreign corporation was not a PFIC, the Commissioner may consider the size of the shareholder's interest in the foreign corporation.

(2) *Knowledge of law required.* Reasonable belief must be based on a good faith effort to apply the Code, regulations, and related administrative guidance. Any person's failure to know or apply these provisions will not form the basis of reasonable belief.

(e) *Special rules for qualified shareholders*—(1) *In general.* A shareholder that is a qualified shareholder, as defined in paragraph (e)(2) of this section, for a taxable year of the shareholder is not required to satisfy the reasonable belief requirement of paragraph (b)(1) of this section or file a Protective Statement to preserve its ability to make a retroactive election with respect to such taxable year. Accordingly, a qualified shareholder may make a retroactive election for any open taxable year in the shareholder's holding period. The retroactive election will be treated as made in the earliest taxable year of the shareholder during which the foreign corporation qualified as a PFIC (including a taxable year ending prior to January 2, 1998) and the shareholder will be treated as a shareholder of a pedigreed QEF, as defined in §1.1291–9(j)(2)(ii), provided the shareholder—

(i) Has been a qualified shareholder with respect to the foreign corporation for all taxable years of the shareholder included in the shareholder's holding period during which the foreign corporation was a PFIC, or in the case of taxable years ending before January 2, 1998, the shareholder satisfies the criteria of a qualified shareholder, for all such years; or

(ii) Has been a qualified shareholder, or in the case of taxable years ending before January 2, 1998 satisfies the criteria of a qualified shareholder, for all taxable years in its holding period before it filed a Protective Statement, which Protective Statement is applicable to all subsequent years, beginning with the first taxable year in which the shareholder is not a qualified shareholder.

(2) *Qualified shareholder.* A shareholder will be treated as a qualified shareholder for a taxable year if the shareholder did not file a Protective Statement applicable to an earlier taxable year included in the shareholder's holding period of the stock of the foreign corporation currently held and—

(i) At all times during the taxable year the shareholder owned, within the meaning of section 958, directly, indirectly, or constructively, less than two percent of the vote and value of each class of stock of the foreign corporation; and

(ii) With respect to the taxable year of the foreign corporation ending within the shareholder's taxable year, the foreign corporation or U.S. counsel for the foreign corporation indicated in a public filing, disclosure statement or other notice provided to U.S. persons that are shareholders of the foreign corporation (corporate filing) that the foreign corporation—

(A) Reasonably believes that it is not or should not constitute a PFIC for the corporation's taxable year; or

(B) Is unable to conclude that it is not or should not be a PFIC (due to certain asset valuation or interpretation issues, or because PFIC status will depend on the income or assets of the foreign corporation in the corporation's subsequent taxable years) but reasonably believes that, more likely than not, it ultimately will not be a PFIC.

(3) *Exceptions.* Notwithstanding paragraph (e)(2)(ii) of this section, a shareholder will not be treated as a qualified shareholder for a taxable year of the shareholder if the shareholder knew or had reason to know that a corporate filing regarding the foreign corporation's PFIC status was inaccurate, or knew that the foreign corporation was a PFIC for the taxable year of the foreign corporation ending with or within such taxable year of the shareholder. For purposes of this paragraph, a shareholder will be treated as knowing that a foreign corporation was a PFIC if the principal activity of the foreign corporation, directly or indirectly, is owning or trading a diversified portfolio of stock, securities, or other financial contracts.

(f) *Special consent*—(1) *In general.* A shareholder that has not satisfied the requirements of paragraph (b) or (e) of this section may request the consent of the Commissioner to make a retroactive election for a taxable year of the shareholder provided the shareholder satisfies the requirements set forth in this paragraph (f). The Commissioner will grant relief under this paragraph (f) only if—

(i) The shareholder reasonably relied on a qualified tax professional, within the meaning of paragraph (f)(2) of this section;

(ii) Granting consent will not prejudice the interests of the United States government, as provided in paragraph (f)(3) of this section;

(iii) The shareholder requests consent under paragraph (f) of this section before a representative of the Internal Revenue Service raises upon audit the PFIC status of the corporation for any taxable year of the shareholder; and

(iv) The shareholder satisfies the procedural requirements set forth in paragraph (f)(4) of this section.

(2) *Reasonable reliance on a qualified tax professional*—(i) *In general.* Except as provided in paragraph (f)(2)(ii) of this section, a shareholder is deemed to have reasonably relied on a qualified tax professional only if the shareholder reasonably relied on a qualified tax professional (including a tax professional employed by the shareholder) who failed to identify the foreign corporation as a PFIC or failed to advise the shareholder of the consequences of making, or failing to make, the section

1295 election. A shareholder will not be considered to have reasonably relied on a qualified tax professional if the shareholder knew, or reasonably should have known, that the foreign corporation was a PFIC and the availability of a section 1295 election, or knew or reasonably should have known that the qualified tax professional—

(A) Was not competent to render tax advice with respect to the ownership of shares of a foreign corporation; or

(B) Did not have access to all relevant facts and circumstances.

(ii) *Shareholder deemed to have not reasonably relied on a qualified tax professional.* For purposes of this paragraph (f)(2), a shareholder is deemed to have not reasonably relied on a qualified tax professional if the shareholder was informed by the qualified tax professional that the foreign corporation was a PFIC and of the availability of the section 1295 election and related tax consequences, but either chose not to make the section 1295 election or was unable to make a valid section 1295 election.

(3) *Prejudice to the interests of the United States government*—(1) *General rule.* Except as otherwise provided in paragraph (f)(3)(ii) of this section, the Commissioner will not grant consent under paragraph (f) of this section if doing so would prejudice the interests of the United States government. The interests of the United States government are prejudiced if granting relief would result in the shareholder having a lower tax liability, taking into account applicable interest charges, in the aggregate for all years affected by the retroactive election (other than by a de minimis amount) than the shareholder would have had if the shareholder had made the section 1295 election by the election due date. The time value of money is taken into account for purposes of this computation.

(ii) *Elimination of prejudice to the interests of the United States government.* Notwithstanding the general rule of paragraph (f)(3)(i) of this section, if granting relief would prejudice the interests of the United States government, the Commissioner may, in the Commissioner's sole discretion, grant consent to make the election provided the shareholder enters into a closing agreement with the Commissioner that requires the shareholder to pay an amount sufficient to eliminate any prejudice to the United States government as a consequence of the shareholder's inability to file amended returns for closed taxable years.

(4) *Procedural requirements*—(i) *Filing instructions.* A shareholder requests consent under paragraph (f) of this section to make a retroactive election by filing with the Office of the Associate Chief Counsel (International) a ruling request that includes the affidavits required by this paragraph (f)(4). The ruling request must satisfy the requirements, including payment of the user fee, for ruling requests filed with that office.

(ii) *Affidavit from shareholder.* The shareholder, or a person authorized to sign a Federal income tax return on behalf of the shareholder, must submit a detailed affidavit describing the events that led to the failure to make a section 1295 election by the election due date, and to the discovery thereof. The shareholder's affidavit must describe the engagement and responsibilities of the qualified tax professional as well as the extent to which the shareholder relied on the tax professional. The shareholder must sign the affidavit under penalties of perjury. An individual who signs for an entity must have personal knowledge of the facts and circumstances at issue.

(iii) *Affidavits from other persons.* The shareholder must submit detailed affidavits from individuals having knowledge or information about the events that led to the failure to make a section 1295 election by the election due date, and to the discovery thereof. These individuals must include the qualified tax professional upon whose advice the shareholder relied, as well as any individual (including an employee of the shareholder) who made a substantial contribution to the return's preparation, and any accountant or attorney, knowledgeable in tax matters, who advised the shareholder with regard to its ownership of the stock of the foreign corporation. Each affidavit must describe the individual's engagement and responsibilities as well as the advice concerning the tax treatment of the foreign corporation that that individual provided to the shareholder. Each affidavit also must include the individual's name, address, and taxpayer identification number, and must be signed by the individual under penalties of perjury.

(iv) *Other information.* In connection with a request for consent under this paragraph (f), a shareholder must provide any additional information requested by the Commissioner.

(v) *Notification of Internal Revenue Service.* The shareholder must notify the branch of the Associate Chief Counsel (International) considering the request for relief under this paragraph (f) if, while the shareholder's request for consent is pending, the Internal Revenue Service begins an examination of the shareholder's return for the retroactive election year or for any subsequent taxable year during which the shareholder holds stock of the foreign corporation.

(vi) *Who requests special consent under this paragraph (f) and who enters into a closing agreement.* The person that requests consent under this paragraph (f) is the person that makes the section 1295 election, as provided in § 1.1295–1T(d). If a shareholder is required to enter into a closing agreement with the Commissioner, as described in paragraph (f)(3)(ii) of this section, rules similar to those under paragraphs (c)(4)(i) (B) through (E) of this section apply for purposes of determining the person that enters into the closing agreement.

(g) *Time for and manner of making a retroactive election*—(1) *Time for making a retroactive election*—(i) *In general.* Except as otherwise provided in paragraph (g)(1)(ii) of this section, a shareholder must make a retroactive election, in the manner provided in paragraph (g)(2) of this section, on or before the due date, as extended, for the shareholder's return—

(A) In the case of a shareholder that makes a retroactive election pursuant to paragraph (b) or (e) of this section, for the taxable year in which the shareholder determines or reasonably should have determined that the foreign corporation was a PFIC; or

(B) In the case of a shareholder that obtains the consent of the Commissioner pursuant to paragraph (f) of this section for the taxable year in which such consent is granted.

(ii) *Transition rule.* A shareholder that files a Protective Statement for a taxable year described in paragraph (c)(5)(ii) of this section may make a retroactive election by the due date, as extended, for the return for the first taxable year ended after January 2, 1998 even if the shareholder determined or should have determined that the foreign corporation was a PFIC for a year described in paragraph (c)(5)(ii) of this section at any time on or before January 2, 1998.

(iii) *Ownership not required at time retroactive election is made.* The shareholder need not own shares of the foreign corporation at the time the shareholder makes a retroactive election with respect to the foreign corporation.

(2) *Manner of making a retroactive election.* A shareholder that has satisfied the requirements of paragraph (b) or (e) of this section, or a shareholder that has been granted consent under paragraph (f) of this section, must make a retroactive election in the manner provided in Form 8621 for making a section 1295 election, and must attach Form 8621 to an amended return for the later of the retroactive election year or the earliest open taxable year of the shareholder. The shareholder also must file an amended return for each of its subsequent taxable years affected by the retroactive election. In each amended return the shareholder must redetermine its income tax liability for that year to take into account the assessment of PFIC related taxes. If the period of limitations for the assessment of taxes for a taxable year affected by the retroactive election has expired except to the extent the waiver of limitations, described in paragraph (c)(4) of this section, has extended such period, no adjustments, other than consequential changes, may be made to any other items of income, deduction, or credit in that year. In addition, the shareholder must pay all taxes and interest owing by reason of the PFIC and QEF status of the foreign corporation in those years (except to the extent a section 1294 election extends the time

to pay the taxes and interest). A shareholder that filed a Protective Statement must attach to Form 8621 filed with each amended return a representation that the shareholder, until the taxable year in which it determined or reasonably should have determined that the foreign corporation was a PFIC, reasonably believed, within the meaning of paragraph (d) of this section, that the foreign corporation was not a PFIC in the taxable year for which the amended return is filed, and in all other taxable years to which the Protective Statement applies. A shareholder that entered into a closing agreement must comply with the terms of that agreement, as provided in paragraph (f)(3)(ii) of this section, to eliminate any prejudice to the United States government's interests, as described in paragraph (f)(3) of this section.

(3) *Who makes the retroactive election.* The person that makes the retroactive election is the person that makes the section 1295 election, as provided in §1.1295–1T(d). A partner, shareholder, or beneficiary for which a pass through entity, as described in paragraphs (c)(4)(i) (B) through (D) of this section, filed a Protective Statement may make a retroactive election, if the pass through entity completely terminates its business or otherwise ceases to exist.

(4) *Other elections*—(i) *Section 1291(d)(2) election.* If the foreign corporation for which the shareholder makes a retroactive election will be treated as an unpedigreed QEF, as defined in §1.1291–9(j)(2)(iii), with respect to the shareholder, the shareholder may make an election under section 1291(d)(2) to purge its holding period of the years or parts of years before the effective date of the retroactive election. If the qualification date, within the meaning of §1.1291–9(e) or 1.1291–10(e), falls in a taxable year for which the period of limitations has expired, the shareholder may treat the first day of the retroactive election year as the qualification date. The shareholder may make a section 1291(d)(2) election at the time that it makes the retroactive election, but no later than two years after the date that the amended return in which the retroactive election is made is filed. For the requirements for making a section 1291(d)(2) election, see §§1.1291–9 and 1.1291–10.

(ii) *Section 1294 election.* A shareholder may make an election under section 1294 to extend the time for payment of tax on the shareholder's pro rata shares of the ordinary earnings and net capital gain of the foreign corporation reported in the shareholder's amended return, and section 6621 interest attributable to such tax, but only to the extent the tax and interest are attributable to earnings that have not been distributed to the shareholder. The shareholder must make a section 1294 election for a taxable year at the time that it files its amended return for that year, as provided in paragraph (g)(1) of this section. For the requirements for making a section 1294 election, see §1.1294–1T.

(h) *Effective date.* The rules of this section are effective as of January 2, 1998.

[T.D. 8750, 63 FR 19, Jan. 2, 1998]

§1.1297–0 Table of contents.

This section contains a listing of the headings for §1.1297–3T.

§1.1297–3T Deemed sale election by a United States person that is a shareholder of a passive foreign investment company.

(a) In general.

(b) Time and manner for making the election.

(1) In general.

(2) Information to be included in the election.

(3) Adjustment to basis; treatment of holding period.

[T.D. 8750, 63 FR 13, Jan. 2, 1998]

§1.1297–3T Deemed sale election by a United States person that is a shareholder of a passive foreign investment company (temporary).

(a) *In general.* Except as indicated below, a shareholder of a foreign corporation that no longer qualifies as a passive foreign investment company (PFIC) shall be treated for tax purposes as holding stock in a PFIC and therefore continue to be subject to taxation under section 1291 unless the shareholder makes the election under section 1297(b)(1). This continuing PFIC taint shall not apply to stock in a PFIC for which an election under section 1295 to be a qualified electing fund (QEF) has been in effect throughout that portion of the shareholder's holding period during which the PFIC qualified as a PFIC. A U.S. person making the election under section 1297(b)(1) shall be treated as having sold its stock in the PFIC on the last day of the last taxable year of the foreign corporation during which it qualified as a PFIC (termination date). The shareholder thereafter shall not be treated as holding stock in a PFIC and shall not be subject to taxation under section 1291. The deemed sale is taxed as a disposition under section 1291. Pursuant to that section, the gain, if any, is considered earned pro rata over the shareholder's holding period in the-stock and is taxed as ordinary income. The tax on the gain is based on the value of the tax deferral and includes an interest charge. Any loss realized in the deemed sale may not be recognized. This section provides rules for making the election under section 1297(b)(1). The election is available to a U.S. person that is a shareholder of a foreign corporation if—

(1) The foreign corporation was a PFIC at any time during the period the U.S. person held the stock;

(2) At any one time during the U.S. person's holding period, the foreign corporation qualified as a PFIC but was not a QEF; and

(3) The foreign corporation is no longer a PFIC within the meaning of section 1296.

(b) *Time and manner of making the election*—(1) *In general.* The shareholder shall make the election under this section and section 1297(b)(1) by filing an amended income tax return for its taxable year that includes the termination date within three years of the due date, as extended, for the shareholder's tax return for such taxable year. The shareholder must attach to the amended tax return either Form 8621 or a statement, prepared in accordance with paragraph (c)(2) of this section, reporting the gain on the deemed sale of the stock as required by section 1291(a)(2) (as if such deemed sale occurred under section 1291(a)(2)), and by paying the tax on the gain as required by section 1291 (including the payment of the deferred tax amount required under sections 1291(a)(1)(C) and 1291(c)). The electing shareholder also shall pay interest, pursuant to section 6601, on the underpayment of tax for the taxable year of termination. An electing shareholder that realizes a loss shall report the loss on Form 8621, but shall not recognize the loss.

(2) *Information to be included in the election.* If a statement is used, the statement should be identified, in a heading, as an election under section 1297(b)(1). The statement must include the following information and representations:

(i) The name, address and taxpayer identification number of the electing shareholder;

(ii) The name, address and taxpayer identification number, if any, of the PFIC;

(iii) A statement that the shareholder is making the election under section 1297(b)(1);

(iv) The period in the electing shareholder's holding period in the stock during which the foreign corporation was a PFIC, the period during which it was a QEF (and whether the shareholder elected under section 1294 to defer payment of its tax liability attributable to any portion of such period), and the termination date;

(v) The manner in which the PFIC lost the characteristics of a PFIC;

(vi) A schedule listing the shares in the PFIC held by the electing shareholder on the termination date, listing the date(s) each share or block of shares was acquired, the number of shares acquired on each date listed, and the tax basis of each share;

(vii) The fair market value of the stock in the PFIC on the termination date; for this purpose, the fair market value of the stock shall be determined according to the rules of § 1.1295–1T(b)(9); and

(viii) A schedule showing the computation of the gain recognized on the deemed sale, and a calculation of the deferred tax amount, as defined in section 1291(c).

(3) *Adjustment to basis; treatment of holding period.* An electing shareholder that recognizes gain on the deemed sale of stock shall increase its adjusted basis in the stock by the amount of gain recognized. An electing shareholder shall not adjust the basis in

stock with respect to which the shareholder realized a loss on the deemed sale. An electing shareholder shall thereafter treat its holding period in the stock, for purposes of sections 1291 through 1297, as beginning on the day following the termination date without regard to whether it recognized gain on the deemed sale; for section 1223 purposes, the holding period in the stock in the PFIC shall include the period prior to the deemed sale.

(c) *Application of deemed dividend election rules*—(1) *In general.* A shareholder of a former PFIC, within the meaning of §1.1291–9(j)(2)(iv), that was a controlled foreign corporation, within the meaning of section 957(a) (CFC), during its last taxable year as a PFIC under section 1296(a), may apply the rules of section 1291(d)(2)(B) and §1.1291–9 to an election under section 1297(b)(1) and this section made by the time and in the manner provided in paragraph (b) of this section.

(2) *Transition rule.* If the time for making an election under this section, as provided in paragraph (b) of this section, expired before January 2, 1998, a shareholder that applied rules similar to the rules of section 1291(d)(2)(A) and §1.1291–10 to an election under this section made with respect to a corporation that was a CFC during its last taxable year as a PFIC under section 1296(a) may file an amended return for the taxable year that includes the termination date, as defined in paragraph (a) of this section, and apply the rules of section 1291(d)(2)(B) and §1.1291–9 at any time before the expiration of the period of limitations for the assessment of taxes for that taxable year.

(3) *Effective date.* The rules of this paragraph are effective as of January 2, 1998.

[T.D. 8178, 53 FR 6779, Mar. 2, 1988, as amended by T.D. 8750, 63 FR 24, Jan. 2, 1998]

READJUSTMENT OF TAX BETWEEN YEARS AND SPECIAL LIMITATIONS

MITIGATION OF EFFECT OF LIMITATIONS AND OTHER PROVISIONS

§1.1311(a)–1 Introduction.

(a) Part II (section 1311 and following), subchapter Q, chapter 1 of the Code, provides certain rules for the correction of the effect of an erroneous treatment of an item in a taxable year which is closed by the statute of limitations or otherwise, in cases where, in connection with the ascertainment of the tax for another taxable year, it has been determined that there was an erroneous treatment of such item in the closed year.

(b) In most situations falling within this part the correction of the effect of the error on a closed year can be made only if either the Commissioner or the taxpayer has taken a position in another taxable year which is inconsistent with the erroneous treatment of the item in the closed year. If a refund or credit would result from the correction of the error in the closed year, then the Commissioner must be the one maintaining the inconsistent position. For example, if the taxpayer erroneously included an item of income on his return for an earlier year which is now closed and the Commissioner successfully requires it to be included in a later year, then the correction of the effect of the erroneous inclusion of that item in the closed year may be made since the Commissioner has maintained a position inconsistent with the treatment of such item in such closed year. On the other hand, if an additional assessment would result from the correction of the error in the closed year, then the taxpayer must be the one maintaining the inconsistent position. For example, if the taxpayer deducted an item in an earlier year which is now closed and he successfully contends that the item should be deducted in a later year, then the correction of the effect of the erroneous deduction of that item in the closed year may be made since the taxpayer has taken a position inconsistent with the treatment of such item in such earlier year.

(c) There are two special circumstances which fall within this part but which do not require that an inconsistent position be maintained. One of these circumstances relates to the inclusion of an item of income in the correct year and the other relates to the allowance of a deduction in the correct year. In the first situation, if the Commissioner takes the position by a deficiency notice or before the Tax Court that an item of income should be included in the gross income of a taxpayer for a particular year and it is ultimately determined that such item was not so includible, then such item can be included in the income of the proper year if that year was not closed at the time the Commissioner took his position. In the second situation, if the taxpayer claims that a deduction should be allowed for a particular year and it is ultimately determined that the deduction was not allowable in that year, then the taxpayer may take the deduction in the proper year if that year was not closed at the time the taxpayer first claimed a deduction.

[T.D. 6500, 25 FR 12031, Nov. 26, 1960]

§ 1.1311(a)–2 Purpose and scope of section 1311.

(a) Section 1311 provides for the correction of the effect of certain errors under circumstances specified in section 1312 when one or more provisions of law, such as the statute of limitations, would otherwise prevent such correction. Section 1311 may be applied to correct the effect of certain errors if, on the date of a determination (as defined in section 1313(a) and the regulations thereunder), correction is prevented by the operation of any provision of law other than sections 1311 through 1315 and section 7122 (relating to compromises) and the corresponding provisions of prior revenue laws. Examples of provisions preventing such corrections are sections 6501, 6511, 6532, and 6901 (c), (d) and (e), relating to periods of limitations; section 6212(c) and 6512 relating to the effect of petition to the Tax Court of the United States on further deficiency letters and on credits or refunds; section 7121 relating to closing agreements; and sections 6401 and 6514 relating to payments, refunds, or credits after the period of limitations has expired. Section 1311 may also be applied to correct the effect of an error if, on the date of the determination, correction of the error is prevented by the operation of any rule of law, such as *res judicata* or *estoppel*.

(b) The determination (including a determination under section 1313 (a)(4)) may be with respect to any of the taxes imposed by subtitle A of the Internal Revenue Code of 1954, by chapter 1 and subchapters A, B, D, and E of chapter 2 of the Internal Revenue Code of 1939, or by the corresponding provisions of any prior revenue act, or by more than one of such provisions. Section 1311 may be applied to correct the effect of the error only as to the tax or taxes with respect to which the error was made which correspond to the tax or taxes with respect to which the determination relates. Thus, if the determination relates to a tax imposed by chapter 1 of the Internal Revenue Code of 1954, the adjustment may be only with respect to the tax imposed by such chapter or by the corresponding provisions of prior law.

(c) Section 1311 is not applicable if, on the date of the determination, correction of the effect of the error is permissible without recourse to said section.

(d) If the tax liability for the year with respect to which the error was made has been compromised under section 7122 or the corresponding provisions of prior revenue laws, no adjustment may be made under section 1311 with respect to said year.

(e) No adjustment may be made under section 1311 for any taxable year beginning prior to January 1, 1932. See section 1314(d).

(f) Section 1311 applies only to a determination (as defined in section 1313(a) and §§ 1.1313(a)–1 to 1.1313 (a)–4, inclusive) made after November 14, 1954. Section 3801 of the Internal Revenue Code of 1939 and the regulations thereunder apply to determinations, as defined therein, made on or before November 14, 1954. See section 1315.

[T.D. 6500, 25 FR 12031, Nov. 26, 1960]

§ 1.1311(b)–1 Maintenance of an inconsistent position.

(a) *In general.* Under the circumstances stated in § 1.1312–1, § 1.1312–2, paragraph (a) of § 1.1312–3, § 1.1312–5, § 1.1312–6, and § 1.1312–7, the maintenance of an inconsistent position is a condition necessary for adjustment. The requirement in such circumstances is that a position maintained with respect to the taxable year of the determination and which is adopted in the determination be inconsistent with the erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, with respect to the taxable year of the error. That is, a position successfully maintained with respect to the taxable year of the determination must be inconsistent with the treatment accorded an item which was the subject of an error in the computation of the tax for the closed taxable year. Adjustments under the circumstances stated in paragraph (b) of § 1.1312–3 and in § 1.1312–4 are made without regard to the maintenance of an inconsistent position.

(b) *Adjustments resulting in refund or credit.* (1) An adjustment under any of the circumstances stated in § 1.1312–1, § 1.1312–5, § 1.1312–6, or § 1.1312–7 which would result in the allowance of a refund or credit is authorized only if (i) the Commissioner, in connection with a determination, has maintained a position which is inconsistent with the erroneous inclusion, omission, disallowance, recognition, or nonrecognition, as the case may be, in the year of the error, and (ii) such inconsistent position is adopted in the determination.

Example: A taxpayer who keeps his books on the cash method erroneously included as income on his return for 1954 an item of accrued interest. After the period of limitations on refunds for 1954 had expired, the district director, on behalf of the Commissioner, proposed an adjustment for the year 1955 on the ground that the item of interest was received in 1955 and, therefore, was properly includible in gross income for that year. The taxpayer and the district director entered into an agreement which meets all of the requirements of § 1.1313(a)–4 and which determines that the interest item was includible in gross income for 1955. The Commissioner has maintained a position inconsistent with the inclusion of the interest item for 1954. As the determination (the agreement pursuant to § 1.1313(a)–4) adopted such inconsistent position, an adjustment is authorized for the year 1954.

(2) An adjustment under circumstances stated in § 1.1312–1, § 1.1312–5, § 1.1312–6, or § 1.1312–7 which would result in the allowance of a refund or credit is not authorized if the taxpayer with respect to whom the determination is made, and not the Commissioner, has maintained such inconsistent position.

Example: In the example in subparagraph (1) of this paragraph, assume that the Commissioner asserted a deficiency for 1955 based upon other items for that year but, in computing the net income upon which such deficiency was based, did not include the item of interest. The taxpayer appealed to the Tax Court and in his petition asserted that the interest item should be included in gross income for 1955. The Tax Court in 1960 included the item of interest in its redetermination of tax for the year 1955. In such case no adjustment would be authorized for 1954 as the taxpayer, and not the Commissioner, maintained a position inconsistent with the erroneous inclusion of the item of interest in the gross income of the taxpayer for that year.

(c) *Adjustments resulting in additional assessments.* (1) An adjustment under any of the circumstances stated in § 1.1312–2, paragraph (a) of § 1.1312–3, § 1.1312–5, § 1.1312–6, or § 1.1312–7 which would result in an additional assessment is authorized only if (i) the taxpayer with respect to whom the determination is made has, in connection therewith, maintained a position which is inconsistent with the erroneous exclusion, omission, allowance, recognition, or nonrecognition, as the case may be, in the year of the error, and (ii) such inconsistent position is adopted in the determination.

Example: A taxpayer in his return for 1950 claimed and was allowed a deduction for a loss arising from a casualty. After the taxpayer had filed his return for 1951 and after the period of limitations upon the assessment of a deficiency for 1950 had expired, it was discovered that the loss actually occurred in 1951. The taxpayer, therefore, filed a claim for refund for the year 1951 based upon the allowance of a deduction for the loss in that year, and the claim was allowed by the Commissioner in 1955. The taxpayer thus has maintained a position inconsistent with the allowance of the deduction for 1950 by filing a claim for refund for 1951 based upon the same deduction. As the determination (the allowance of the claim for refund) adopts such inconsistent position, an adjustment is authorized for the year 1950.

(2) An adjustment under the circumstances stated in § 1.1312–2, paragraph (a) of § 1.1312–3, § 1.1312–5, § 1.1312–6, or § 1.1312–7 which would result in an additional assessment is not authorized if the Commissioner, and not the taxpayer, has maintained such inconsistent position.

Example: In the example in subparagraph (1) of this paragraph, assume that the taxpayer did not file a claim for refund for 1951 but the Commissioner issued a notice of deficiency for 1951 based upon other items. The taxpayer filed a petition with the Tax Court of the United States and the Commissioner in his answer voluntarily proposed the allowance for 1951 of a deduction for the loss previously allowed for 1950. The Tax Court took the deduction into account in its redetermination in 1955 of the tax for the year 1951. In such case no adjustment would be authorized for the year 1950 as the Commissioner, and not the taxpayer, has maintained a position inconsistent with the allowance of a deduction for the loss in that year.

[T.D. 6500, 25 FR 12032, Nov. 26, 1960, as amended by T.D. 6617, 27 FR 10823, Nov. 7, 1962]

§1.1311(b)–2 Correction not barred at time of erroneous action.

(a) An adjustment under the circumstances stated in paragraph (b) of §1.1312–3 (relating to the double exclusion of an item of gross income) which would result in an additional assessment, is authorized only if assessment of a deficiency against the taxpayer or related taxpayer for the taxable year in which the item is includible was not barred by any law or rule of law at the time the Commissioner first maintained, in a notice of deficiency sent pursuant to section 6212 (or section 272(a) of the Internal Revenue Code of 1939) or before the Tax Court of the United States, that the item described in paragraph (b) of §1.1312–3 should be included in the gross income of the taxpayer in the taxable year to which the determination relates.

(b) An adjustment under the circumstances stated in §1.1312–4 (relating to the double disallowance of a deduction or credit), which would result in the allowance of a credit or refund, is authorized only if a credit or refund to the taxpayer or related taxpayer, attributable to such adjustment, was not barred by any law or rule of law when the taxpayer first maintained in writing before the Commissioner or the Tax Court that he was entitled to such deduction or credit for the taxable year to which the determination relates. The taxpayer will be considered to have first maintained in writing before the Commissioner or the Tax Court that he was entitled to such deduction or credit when he first formally asserts his right to such deduction or credit as, for example, in a return, in a claim for refund, or in a petition (or an amended petition) before the Tax Court.

(c) Under the circumstances of adjustment with respect to which the conditions stated in this section are applicable, the conditions stated in §1.1311(b)–1 (maintenance of an inconsistent position) are not required. See paragraph (b) of §1.1312–3 and §1.1312–4 for examples of the application of this section.

[T.D. 6500, 25 FR 12032, Nov. 26, 1960]

§1.1311(b)–3 Existence of relationship in case of adjustment by way of deficiency assessment.

(a) Except for cases described in paragraph (b) of §1.1312–3, no adjustment by way of a deficiency assessment shall be made, with respect to a related taxpayer, unless the relationship existed both at some time during the taxable year with respect to which the error was made and at the time the taxpayer with respect to whom the determination is made first maintained the inconsistent position with respect to the taxable year to which the determination relates. In the case of an adjustment by way of a deficiency assessment under the circumstance described in paragraph (b) of §1.1312–3 (where the maintenance of an inconsistent position is not required), the relationship need exist only at some time during the taxable year in which the error was made.

(b) If the inconsistent position is maintained in a return, claim for refund, or petition (or amended petition) to the Tax Court of the United States for the taxable year in respect to which the determination is made, the requisite relationship must exist on the date of filing such document. If the inconsistent position is maintained in more than one of such documents, the requisite date is the date of filing of the document in which it was first maintained. If the inconsistent position was not thus maintained, then the relationship must exist on the date of the determination as, for example, where at the instance of the taxpayer a deduction is allowed, the right to which was not asserted in a return, claim for refund, or petition to the Tax Court, and a determination is effected by means of a closing agreement or an agreement under section 1313(a)(4).

[T.D. 6500, 25 FR 12033, Nov. 26, 1960]

§1.1312–1 Double inclusion of an item of gross income.

(a) Paragraph (1) of section 1312 applies if the determination requires the inclusion in a taxpayer's gross income of an item which was erroneously included in the gross income of the same taxpayer for another taxable year or of a related taxpayer for the same or another taxable year.

(b) The application of paragraph (a) of this section may be illustrated by the following examples:

Example 1. A taxpayer who keeps his books on the cash method erroneously included in income on his return for 1947 an item of accrued rent. In 1952, after the period of limitation on refunds for 1947 had expired, the Commissioner discovered that the taxpayer received this rent in 1948 and asserted a deficiency for the year 1948 which is sustained by the Tax Court of the United States in 1955. An adjustment in favor of the taxpayer is authorized with respect to the year 1947. If the taxpayer had returned the rent for both 1947 and 1948 and by a determination was denied a refund claim for 1948 on account of the rent item, a similar adjustment is authorized.

Example 2. A husband assigned to his wife salary to be earned by him in the year 1952. The wife included such salary in her separate return for that year and the husband omitted it. The Commissioner asserted a deficiency against the wife for 1952 with respect to a different item; she contested that deficiency, and the Tax Court entered an order in her case which became final in 1955. The wife would therefore be barred by section 6512(a) from claiming a refund for 1952. Thereafter, the Commissioner asserted a deficiency against the husband on account of the omission of such salary from his return for 1952. In 1955 the husband and the Commissioner enter into a closing agreement for the year 1952 in which the salary is taxed to the husband. An adjustment is authorized with respect to the wife's tax for 1952.

[T.D. 6500, 25 FR 12033, Nov. 26, 1960]

§1.1312–2 Double allowance of a deduction or credit.

(a) Paragraph (2) of section 1312 applies if the determination allows the taxpayer a deduction or credit which was erroneously allowed the same taxpayer for another taxable year or a related taxpayer for the same or another taxable year.

(b) The application of paragraph (a) of this section may be illustrated by the following examples:

Example 1. A taxpayer in his return for 1950 claimed and was allowed a deduction for destruction of timber by a forest fire. Subsequently, it was discovered that the forest fire occurred in 1951 rather than 1950. After the expiration of the period of limitations for the assessment of a deficiency for 1950, the taxpayer filed a claim for refund for 1951 based upon a deduction for the fire loss in that year. The Commissioner in 1955 allows the claim for refund. An adjustment is authorized with respect to the year 1950.

Example 2. The beneficiary of a testamentary trust in his return for 1949 claimed, and was allowed, a deduction for depreciation of the trust property. The Commissioner asserted a deficiency against the beneficiary for 1949 with respect to a different item and a final decision of the Tax Court of the United States was rendered in 1951, so that the Commissioner was thereafter barred by section 272(f) of the Internal Revenue Code of 1939 from asserting a further deficiency against the beneficiary for 1949. The trustee thereafter filed a timely refund claim contending that, under the terms of the will, the trust, and not the beneficiary, was entitled to the allowance for depreciation. The court in 1955 sustains the refund claim. An adjustment is authorized with respect to the beneficiary's tax for 1949.

[T.D. 6500, 25 FR 12033, Nov. 26, 1960]

§1.1312–3 Double exclusion of an item of gross income.

(a) *Items included in income or with respect to which a tax was paid.* (1) Paragraph (3)(A) of section 1312 applies if the determination requires the exclusion, from a taxpayer's gross income, of an item included in a return filed by the taxpayer, or with respect to which tax was paid, and which was erroneously excluded or omitted from the gross income of the same taxpayer for another taxable year or of a related taxpayer for the same or another taxable year.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. (i) A taxpayer received payments in 1951 under a contract for the performance of services and included the payments in his return for that year. After the expiration of the period of limitations for the assessment of a deficiency for 1950, the

Commissioner issued a notice of deficiency to the taxpayer for the year 1951 based upon adjustments to other items, and the taxpayer filed a petition with the Tax Court of the United States and maintained in the proceedings before the Tax Court that he kept his books on the accrual basis and that the payments received in 1951 were on income that had accrued and was properly taxable in 1950. A final decision of the Tax Court was rendered in 1955 excluding the payments from 1951 income. An adjustment in favor of the Commissioner is authorized with respect to the year 1950, whether or not a tax had been paid on the income reported in the 1951 return.

(ii) Assume the same facts as in (i), except that the taxpayer had not included the payments in any return and had not paid a tax thereon. No adjustment would be authorized under section 1312(3)(A) with respect to the year 1950. If the taxpayer, however, had paid a deficiency asserted for 1951 based upon the inclusion of the payments in 1951 income and thereafter successfully sued for refund thereof, an adjustment would be authorized with respect to the year 1950. (See paragraph (b) of this section for circumstances under which correction is authorized with respect to items not included in income and on which a tax was not paid.)

Example 2. A father and son conducted a partnership business, each being entitled to one-half of the net profits. The father included the entire net income of the partnership in his return for 1948, and the son included no portion of this income in his return for that year. Shortly before the expiration of the period of limitations with respect to deficiency assessments and refund claims for both father and son for 1948, the father filed a claim for refund of that portion of his 1948 tax attributable to the half of the partnership income which should have been included in the son's return. The court sustains the claim for refund in 1955. An adjustment is authorized with respect to the son's tax for 1948.

(b) *Items not included in income and with respect to which the tax was not paid.* (1) Paragraph (3)(B) of section 1312 applies if the determination requires the exclusion from gross income of an item not included in a return filed by the taxpayer and with respect to which a tax was not paid, but which is includible in the gross income of the same taxpayer for another taxable year, or in the gross income of a related taxpayer for the same or another taxable year. This is one of the two circumstances in which the maintenance of an inconsistent position is not a requirement for an adjustment, but the requirements in paragraph (a) of § 1.1311(b)–2 must be fulfilled (correction not barred at time of erroneous action).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. The taxpayer, A, who computes his income by use of the accrual method of accounting, performed in 1949 services for which he received payments in 1949 and 1950. He did not include in his return for either 1949 or 1950 the payments which he received in 1950, and he paid no tax with respect to such payments. In 1952 the Commissioner sent a notice of deficiency to A with respect to the year 1949, contending that A should have included all of such payments in his return for that year. A contested the deficiency on the basis that in 1949 he had no accruable right to the payments which he received in 1950. In 1955 (after the expiration of the period of limitations for assessing deficiencies with respect to 1950), the Tax Court sustains A's position. The Commissioner may assess a deficiency for 1950, since a deficiency assessment for that year was not barred when he sent the notice of deficiency with respect to 1949.

Example 2. B and C were partners in 1950, each being entitled to one-half of the profits of the partnership business. During 1950, B received an item of income which he treated as partnership income so that his return for that year reflected only 50 percent of such item. C, however, included no part of such item in any return and paid no tax with respect thereto. In 1952, the Commissioner sent to C a notice of deficiency with respect to 1950, contending that his return for that year should have reflected 50 percent of such item. C contested the deficiency on the basis that such item was not partnership income. In 1955, after the expiration of the period of limitations for assessing deficiencies with respect to 1950, the Tax Court sustained C's position. The Commissioner may assess a deficiency against B with respect to 1950 requiring him to include the entire amount of such item in his income since assessment of the deficiency was not barred when the Commissioner sent the notice of deficiency with respect to such item to C.

[T.D. 6500, 25 FR 12034, Nov. 26, 1960]

§ 1.1312–4 Double disallowance of a deduction or credit.

(a) Paragraph (4) of section 1312 applies if the determination disallows a deduction or credit which should have been, but was not, allowed to the same taxpayer for another taxable year or to a related taxpayer for the same or another taxable year. This is one of the two circumstances in which the maintenance of an inconsistent position is not a requirement for an adjustment but the requirements in paragraph (b) of §1.1311(b)–2 must be fulfilled (correction not barred at time of erroneous action).

(b) The application of paragraph (a) of this section may be illustrated by the following examples:

Example 1. The taxpayer, A, who computes his income by use of the accrual method of accounting, deducted in his return for the taxable year 1951 an item of expense which he paid in such year. At the time A filed his return for 1951, the statute of limitations for 1950 had not expired. Subsequently, the Commissioner asserted a deficiency for 1951 based on the position that the liability for such expense should have been accrued for the taxable year 1950. In 1955, after the period of limitations on refunds for 1950 had expired, there was a determination by the Tax Court disallowing such deduction for the taxable year 1951. A is entitled to an adjustment for the taxable year 1950. However, if such liability should have been accrued for the taxable year 1946 instead of 1950, A would not be entitled to an adjustment, if a credit or refund with respect to 1946 was already barred when he deducted such expense for the taxable year 1951.

Example 2. The taxpayer, B, in his return for 1951 claimed a deduction for a charitable contribution. The Commissioner asserted a deficiency for such year contending that 50 percent of the deduction should be disallowed, since the contribution was made from community property 50 percent of which was attributable to B's spouse. The deficiency is sustained by the Tax Court in 1956, subsequent to the period of limitations within which B's spouse could claim a refund with respect to 1951. An adjustment is permitted to B's spouse, a related taxpayer, since a refund attributable to a deduction by her of such contribution was not barred when B claimed the deduction.

[T.D. 6500, 25 FR 12034, Nov. 26, 1960]

§1.1312–5 Correlative deductions and inclusions for trusts or estates and legatees, beneficiaries, or heirs.

(a) Paragraph (5) of section 1312 applies to distributions by a trust or an estate to the beneficiaries, heirs, or legatees. If the determination relates to the amount of the deduction allowed by sections 651 and 661 or the inclusion in taxable income of the beneficiary required by sections 652 and 662 (including amounts falling within subpart D, subchapter J, chapter 1 of the Code, relating to treatment of excess distributions by trusts), or if the determination relates to the additional deduction (or inclusion) specified in section 162 (b) and (c) of the Internal Revenue Code of 1939 (or the corresponding provisions of a prior revenue act), with respect to amounts paid, credited, or required to be distributed to the beneficiaries, heirs, and legatees, and such determination requires:

(1) The allowance to the estate or trust of the deduction when such amounts have been erroneously omitted or excluded from the income of the beneficiaries, heirs, or legatees; or

(2) The inclusion of such amounts in the income of the beneficiaries, heirs, or legatees when the deduction has been erroneously disallowed to or omitted by the estate or trust; or

(3) The disallowance to an estate or trust of the deduction when such amounts have been erroneously included in the income of the beneficiaries, heirs, or legatees; or

(4) The exclusion of such amounts from the income of the beneficiaries, heirs, or legatees when the deduction has been erroneously allowed to the estate or trust.

(b) The application of paragraph (a)(1) of this section may be illustrated by the following example:

Example: For the taxable year 1954, a trustee, directed by the trust instrument to accumulate the trust income, made no distribution to the beneficiary and returned the entire income as taxable to the trust. Accordingly the beneficiary did not include the trust income in his return for the year 1954. In 1957, a State court holds invalid the clause directing accumulation and determines that the income is required to be currently distributed. It also rules that certain extraordinary dividends which the trustee in good faith allocated to corpus in 1954 were properly allocable to income. In 1958, the trustee, relying upon the court decision, files a claim for refund of the tax paid on behalf of the trust for the year 1954 and thereafter files a suit in the District Court. The claim is sustained by the court (except as to the tax on the extraordinary dividends) in 1959 after the expiration of the period of limitations upon deficiency assessments against the beneficiary for the year 1954. An adjustment is authorized with respect to the beneficiary's tax for the year 1954. The treatment of the distribution to the beneficiary of the extraordinary dividends shall be determined under subpart D of subchapter J.

(c) The application of paragraph (a)(2) of this section may be illustrated by the following example:

Example: Assume the same facts as in the example in paragraph (b) of this section, except that, instead of the trustee's filing a refund claim, the Commissioner, relying upon the decision of the State court, asserts a deficiency against the beneficiary for 1954. The deficiency is sustained by final decision of the Tax Court of the United States in 1959, after the expiration of the period for filing claim for refund on behalf of the trust for 1954. An adjustment is authorized with respect to the trust for the year 1954.

(d) The application of paragraph (a)(3) of this section may be illustrated by the following example:

Example: A trustee claimed in the trust return for 1954 for amounts paid to the beneficiary a deduction to the extent of distributable net income. This amount was included by the beneficiary in gross income in his return for 1954. In computing distributable net income the trustee had included short and long-term capital gains. In 1958, the Commissioner asserts a deficiency against the trust on the ground that the capital gains were not includible in distributable net income, and that, therefore, the gains were taxable to the trust, not the beneficiary. The deficiency is sustained by a final decision of the Tax Court in 1960, after the expiration of the period for filing claims for refund by the beneficiary for 1954. An adjustment is authorized with respect to the beneficiary's tax for the year 1954, based on the exclusion from 1954 gross income of the capital gains previously considered distributed by the trust under section 662.

(e) The application of paragraph (a)(4) of this section may be illustrated by the following example:

Example: Assume the same facts as in the example in paragraph (d) of this section, except that, instead of the Commissioner's asserting a deficiency, the beneficiary filed a refund claim for 1954 on the same ground. The claim is sustained by the court in 1960 after the expiration of the period of limitations upon deficiency assessments against the trust for 1954. An adjustment is authorized with respect to the trust for the year 1954.

[T.D. 6500, 25 FR 12034, Nov. 26, 1960]

§ 1.1312–6 Correlative deductions and credits for certain related corporations.

(a) Paragraph (6) of section 1312 applies if the determination allows or disallows a deduction (including a credit) to a corporation, and if a correlative deduction or credit has been erroneously allowed, omitted, or disallowed in respect of a related taxpayer described in section 1313(c)(7).

(b) The application of paragraph (a) of this section may be illustrated by the following examples:

Example 1. X Corporation is a wholly-owned subsidiary of Y Corporation. In 1955, X Corporation paid $5,000 to Y Corporation and claimed an interest deduction for this amount in its return for 1955. Y Corporation included this amount in its gross income for 1955. In 1958, the Commissioner asserted a deficiency against X Corporation for 1955, contending that the deduction for interest paid should be disallowed on the ground that the payment was in reality the payment of a dividend to Y Corporation. X Corporation contested the deficiency, and ultimately in June 1959, a final decision of the Tax Court sustained the Commissioner. Since the amount of the payment is a dividend, Y Corporation should have been allowed for 1955 the corporate dividends-received deduction under section 243 with respect to such payment. However, the Tax Court's decision sustaining the deficiency against X Corporation occurred after the expiration of the period for filing claim for refund by Y Corporation for 1955. An adjustment is authorized with respect to Y Corporation for 1955.

Example 2. Assume the same facts as in example (1) except that, instead of the Commissioner asserting a deficiency against X Corporation for 1955, Y Corporation filed a claim for refund in 1958, alleging that the payment received in 1955 from X Corporation was in reality a dividend to which the corporate dividends-received deduction (section 243) applies. The Commissioner denied the claim, and ultimately in June 1959, the district court, in a final decision, sustained Y Corporation. Since the amount of the payment is a dividend, X Corporation should not have been allowed an interest deduction for the amount paid to Y Corporation. However, the district court's decision sustaining the claim for refund occurred after the expiration of the period of limitations for assessing a deficiency against X Corporation for the year 1955. An adjustment is authorized with respect to X Corporation's tax for 1955.

[T.D. 6617, 27 FR 10823, Nov. 7, 1962]

§1.1312–7 Basis of property after erroneous treatment of a prior transaction.

(a) Paragraph (7) of section 1312 applies if the determination establishes the basis of property, and there occurred one of the following types of errors in respect of a prior transaction upon which such basis depends, or in respect of a prior transaction which was erroneously treated as affecting such basis:

(1) An erroneous inclusion in, or omission from, gross income, or

(2) An erroneous recognition or nonrecognition of gain or loss, or

(3) An erroneous deduction of an item properly chargeable to capital account or an erroneous charge to capital account of an item properly deductible.

(b) For this section to apply, the taxpayer with respect to whom the erroneous treatment occurred must be:

(1) The taxpayer with respect to whom the determination is made, or

(2) A taxpayer who acquired title to the property in the erroneously treated transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title in such a manner that he will have a basis ascertained by reference to the basis in the hands of the taxpayer who acquired title to the property in the erroneously treated transaction, or

(3) A taxpayer who had title to the property at the time of the erroneously treated transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, if the basis of the property in the hands of the taxpayer with respect to whom the determination is made is determined under section 1015(a) (relating to the basis of property acquired by gift).

No adjustment is authorized with respect to the transferor of the property in a transaction upon which the basis of the property depends, when the determination is with respect to the original transferee or a subsequent transferee of such original transferee.

(c) The application of this section may be illustrated by the following examples:

Example 1. In 1949 taxpayer A transferred property which had cost him $5,000 to the X Corporation in exchange for an original issue of shares of its stock having a fair market value of $10,000. In his return for 1949 taxpayer A treated the exchange as one in which the gain or loss was not recognizable:

(i) In 1955 the X Corporation maintains that the gain should have been recognized in the exchange in 1949 and therefore the property it received had a $10,000 basis for depreciation. Its position is adopted in a closing agreement. No adjustment is authorized with respect to the tax of the X Corporation for 1949, as none of the three types of errors specified in paragraph (a) of this section occurred with respect to the X Corporation in the treatment of the exchange in 1949. Moreover, no adjustment is authorized with respect to taxpayer A, as he is not within any of the three classes of taxpayers described in paragraph (b) of this section.

(ii) In 1953 taxpayer A sells the stock which he received in 1949 and maintains that, as gain should have been recognized in the exchange in 1949, the basis for computing the profit on the sale is $10,000. His position is confirmed in a closing agreement executed in 1955. An adjustment is authorized with respect to his tax for the year 1949 as the basis for computing the gain on the sale depends upon the transaction in 1949, and in respect of that transaction there was an erroneous nonrecognition of gain to taxpayer A, the taxpayer with respect to whom the determination is made.

Example 2. In 1950 taxpayer A was the owner of 10 shares of the common stock of the Z Corporation which had a basis of $1,500. In that year he received as a dividend thereon 10 shares of the preferred stock of the same corporation having a fair market value of $1,000. On his books, entries were made reducing the basis of the common stock by allocating $500 of the basis to the preferred stock, and on his return for 1950 he did not include the dividend in gross income.

(i) In 1951 taxpayer A made a gift of the preferred stock of the Z Corporation to taxpayer B, an unrelated individual. Taxpayer B sold the stock in 1953 and on his return for that year he reported the sale and claimed a basis of $1,000, contending that the dividend of preferred stock was taxable to A in 1950 at its fair market value of $1,000. The basis of $1,000 is confirmed by a closing agreement executed in 1955. An adjustment is authorized with respect to taxpayer A's tax for 1950, as the closing agreement determines basis of property, and in a prior transaction upon which such basis depends there was an erroneous omission from gross income of taxpayer A, a taxpayer who acquired title to the property in the erroneously treated transaction and from whom, immediately, the taxpayer with respect to whom the determination is made derived title.

(ii) Assuming the same facts as in (i) except that the common stock instead of the preferred stock was the subject of the gift, and the basis claimed by taxpayer B and confirmed in the closing agreement was $1,500. An adjustment is authorized with respect to taxpayer A's tax for 1950, as the closing agreement determines the basis of property, and in a prior transaction which was erroneously treated as affecting such basis there was an erroneous omission from gross income of taxpayer A, a taxpayer who had title to the property at the time of the erroneously treated transaction, and from whom, immediately, taxpayer B, with respect to whom the determination is made, derived title. The basis of the property in taxpayer B's hands with respect to whom the determination is made is determined under section 1015(a) (relating to the basis of property acquired by gift).

Example 3. In 1950 taxpayer A sold property acquired at a cost of $5,000 to taxpayer B for $10,000. In his return for 1950 taxpayer A failed to include the profit on such sale. In 1953 taxpayer B sold the property for $12,000, and in his return for 1953 reported a gain of $2,000 upon the sale, which is confirmed by a closing agreement executed in 1955. No adjustment is authorized with respect to the tax of taxpayer A for 1950, as he does not come within any of the three classes of taxpayers described in paragraph (b) of this section.

Example 4. In 1950 a taxpayer who owned 100 shares of stock in Corporation Y received $1,000 from the corporation which amount the taxpayer reported on his return for 1950 as a taxable dividend. In 1952 Corporation Y was completely liquidated and the taxpayer received in that year liquidating distributions totalling $8,000. In his return for 1952 the taxpayer reported the receipt of the $8,000 and computed his gain or loss upon the liquidation by using as a basis the amount which he paid for the stock. The Commissioner maintained that the distribution in 1950 was a distribution out of capital and that in computing the taxpayer's gain or loss upon the liquidation in 1952, the basis of the stock should be reduced by the $1,000. This position is adopted in a closing agreement executed in 1955 with respect to the year 1952. An adjustment is authorized with respect to the year 1950 as the basis for computing gain or loss in 1952 depends upon the transaction in 1950, and in respect of the 1950 transaction (upon which the basis of the property depends) there was an erroneous inclusion in gross income of the taxpayer with respect to whom the determination is made.

Example 5. In 1946 a taxpayer received 100 shares of stock of the X Corporation having a fair market value of $5,000, in exchange for shares of stock in the Y Corporation which he had acquired at a cost of $12,000. In his return for 1946 the taxpayer treated the exchange as one in which gain or loss was not recognizable. The taxpayer sold 50 shares of the X Corporation stock in 1947 and in his return for that year treated such shares as having a $6,000 basis. In 1952, the taxpayer sold the remaining 50 shares of stock of the X Corporation for $7,500 and reported $1,500 gain in his return for 1952. After the expiration of the period of limitations on deficiency assessments and on refund claims for 1946 and 1947, the Commissioner asserted a deficiency for 1952 on the ground that the loss realized on the exchange in 1946 was erroneously treated as nonrecognizable, and the basis for computing gain upon the sale in 1952 was $2,500, resulting in a gain of $5,000. The deficiency is sustained by the Tax Court in 1955. An adjustment is authorized with respect to the year 1946 as to the entire $7,000 loss realized on the exchange, as the Court's decision determines the basis of property, and in a prior transaction upon which such basis depends there was an erroneous nonrecognition of loss to the taxpayer with respect to whom the determination was made. No adjustment is authorized with respect to the year 1947 as the basis for computing gain upon the sale of the 50 shares in 1952 does not depend upon the transaction in 1947 but upon the transaction in 1946.

[T.D. 6500, 25 FR 12035, Nov. 26, 1960, as amended by T.D. 6617, 27 FR 10824, Nov. 7, 1962]

§ 1.1312–8 Law applicable in determination of error.

The question whether there was an erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition is determined under the provisions of the internal revenue laws applicable with respect to the year as to which the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, was made. The fact that the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, was in pursuance of an interpretation, either judicial or administrative, accorded such provisions of the internal revenue laws at the time of such action is not necessarily determinative of this question. For example, if a later judicial decision authoritatively alters such interpretation so that such action was contrary to such provisions of the internal revenue laws as later interpreted, the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, is erroneous within the meaning of section 1312.

[T.D. 6500, 25 FR 12036, Nov. 26, 1960. Redesignated by T.D. 6617, 27 FR 10824, Nov. 7, 1962]

§ 1.1313(a)–1 Decision by Tax Court or other court as a determination.

(a) A determination may take the form of a decision by the Tax Court of the United States or a judgment, decree, or other order by any court of competent jurisdiction, which has become final.

(b) The date upon which a decision by the Tax Court becomes final is prescribed in section 7481.

(c) The date upon which a judgment of any other court becomes final must be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari if no such petition is duly filed within such time.

[T.D. 6500, 25 FR 12036, Nov. 26, 1960]

§ 1.1313(a)–2 Closing agreement as a determination.

A determination may take the form of a closing agreement authorized by section 7121. Such an agreement may relate to the total tax liability of the taxpayer for a particular taxable year or years or to one or more separate items affecting such liability. A closing agreement becomes final for the purpose of this section on the date of its approval by the Commissioner.

[T.D. 6500, 25 FR 12036, Nov. 26, 1960]

§ 1.1313(a)–3 Final disposition of claim for refund as a determination.

(a) *In general.* A determination may take the form of a final disposition of a claim for refund. Such disposition may result in a determination with respect to two classes of items, i.e., items included by the taxpayer in a claim for refund and items applied by the Commissioner to offset the alleged overpayment. The time at which a disposition in respect of a particular item becomes final may depend not only upon what action is taken with respect to that item but also upon whether the claim for refund is allowed or disallowed.

(b) *Items with respect to which the taxpayer's claim is allowed.* (1) The disposition with respect to an item as to which the taxpayer's contention in the claim for refund is sustained becomes final on the date of allowance of the refund or credit if:

(i) The taxpayer's claim for refund is unqualifiedly allowed; or

(ii) The taxpayer's contention with respect to an item is sustained and with respect to other items is denied, so that the net result is an allowance of refund or credit; or

(iii) The taxpayer's contention with respect to an item is sustained, but the Commissioner applies other items to offset the amount of the alleged overpayment and the items so applied do not completely offset such amount but merely reduce it so that the net result is an allowance of refund or credit.

(2) If the taxpayer's contention in the claim for refund with respect to an item is sustained but the Commissioner applies other items to offset the amount of the alleged overpayment so that the net result is a disallowance of the claim for refund, the date of mailing, by registered mail, of the notice of disallowance (see section 6532) is the date of the final disposition as to the item with respect to which the taxpayer's contention is sustained.

(c) *Items with respect to which the taxpayer's claim is disallowed.* The disposition with respect to an item as to which the taxpayer's contention in the claim for refund is denied becomes final upon the expiration of the time allowed by section 6532 for instituting suit on the claim for refund, unless the suit is instituted prior to the expiration of such period, if:

(1) The taxpayer's claim for refund is unqualifiedly disallowed; or

(2) The taxpayer's contention with respect to an item is denied and with respect to other items is sustained so that the net result is an allowance of refund or credit; or

(3) The taxpayer's contention with respect to an item is sustained in part

and denied in part. For example, assume that the taxpayer claimed a deductible loss of $10,000 and a consequent overpayment of $2,500 and the Commissioner concedes that a deductible loss was sustained, but only in the amount of $5,000. The disposition of the claim for refund with respect to the allowance of the $5,000 and the disallowance of the remaining $5,000 becomes final upon the expiration of the time for instituting suit on the claim for refund unless suit is instituted prior to the expiration of such period.

(d) *Items applied by the Commissioner in reduction of the refund or credit.* If the Commissioner applies an item in reduction of the overpayment alleged in the claim for refund, and the net result is an allowance of refund or credit, the disposition with respect to the item so applied by the Commissioner becomes final upon the expiration of the time allowed by section 6532 for instituting suit on the claim for refund, unless suit is instituted prior to the expiration of such period. If such application of the item results in the assertion of a deficiency, such action does not constitute a final disposition of a claim for refund within the meaning of § 1.1313(a)–3, but subsequent action taken with respect to such deficiency may result in a determination under §§ 1.1313(a)–1, 1.1313(a)–2, or 1.1313(a)–4.

(e) *Elimination of waiting period.* The necessity of waiting for the expiration of the 2-year period of limitations provided in section 6532 may be avoided in such cases as are described in paragraph (c) or (d) of this section by the use of a closing agreement (see § 1.1313(a)–2) or agreement under § 1.1313(a)–4 to effect a determination.

[T.D. 6500, 25 FR 12036, Nov. 26, 1960]

§ 1.1313(a)–4 Agreement pursuant to section 1313(a)(4) as a determination.

(a) *In general.* (1) A determination may take the form of an agreement made pursuant to this section. This section is intended to provide an expeditious method for obtaining an adjustment under section 1311 and for offsetting deficiencies and refunds whenever possible. The provisions of part II (section 1311 and following), subchapter Q, chapter 1 of the Code, must be strictly complied with in any such agreement.

(2) An agreement made pursuant to this section will not, in itself, establish the tax liability for the open taxable year to which it relates, but it will state the amount of the tax, as then determined, for such open year. The tax may be the amount of tax shown on the return as filed by the taxpayer, but if any changes in the amount have been made, or if any are being made by documents executed concurrently with the execution of said agreement, such changes must be taken into account. For example, an agreement pursuant to this section may be executed concurrently with the execution of a waiver of restrictions on assessment and collection of a deficiency or acceptance of an overassessment with respect to the open taxable year, or concurrently with the execution and filing of a stipulation in a proceeding before the Tax Court of the United States, where an item which is to be the subject of an adjustment under section 1311 is disposed of by the stipulation and is not left for determination by the court.

(b) *Contents of agreement.* An agreement made pursuant to this section shall be so designated in the heading of the agreement, and it shall contain the following:

(1) A statement of the amount of the tax determined for the open taxable year to which the agreement relates, and if said liability is established or altered by a document executed concurrently with the execution of the agreement, a reference to said document.

(2) A concise statement of the material facts with respect to the item that was the subject of the error in the closed taxable year or years, and a statement of the manner in which such item was treated in computing the tax liability set forth pursuant to subparagraph (1) of this paragraph.

(3) A statement as to the amount of the adjustment ascertained pursuant to § 1.1314(a)–1 for the taxable year with respect to which the error was made and, where applicable, a statement as to the amount of the adjustment or adjustments ascertained pursuant to § 1.1314(a)–2 with respect to any other taxable year or years; and

(4) A waiver of restrictions on assessment and collection of any deficiencies set forth pursuant to subparagraph 3 of this paragraph.

(c) *Execution and effect of agreement.* An agreement made pursuant to this section shall be signed by the taxpayer with respect to whom the determination is made, or on the taxpayer's behalf by an agent or attorney acting pursuant to a power of attorney on file with the Internal Revenue Service. If an adjustment is to be made in a case of a related taxpayer, the agreement shall be signed also by the related taxpayer, or on the related taxpayer's behalf by an agent or attorney acting pursuant to a power of attorney on file with the Internal Revenue Service. It may be signed on behalf of the Commissioner by the district director, or such other person as is authorized by the Commissioner. When duly executed, such agreement will constitute the authority for an allowance of any refund or credit agreed to therein, and for the immediate assessment of any deficiency agreed to therein for the taxable year with respect to which the error was made, or any closed taxable year or years affected, or treated as affected, by a net operating loss deduction or capital loss carryover determined with reference to the taxable year with respect to which the error was made.

(d) *Finality of determination.* A determination made by an agreement pursuant to this section becomes final when the tax liability for the open taxable year to which the determination relates becomes final. During the period, if any, that a deficiency may be assessed or a refund or credit allowed with respect to such year, either the taxpayer or the Commissioner may properly pursue any of the procedures provided by law to secure a further modification of the tax liability for such year. For example, if the taxpayer subsequently files a claim for refund, or if the Commissioner subsequently issues a notice of deficiency with respect to such year, either may adopt a position with respect to the item that was the subject of the adjustment that is at variance with the manner in which said item was treated in the agreement. Any assessment, refund, or credit that is subsequently made with respect to the tax liability for such open taxable year, to the extent that it is based upon a revision in the treatment of the item that was the subject of the adjustment, shall constitute an alteration or revocation of the determination for the purpose of a redetermination of the adjustment pursuant to paragraph (d) of §1.1314(b)–1.

[T.D. 6500, 25 FR 12037, Nov. 26, 1960]

§1.1313(c)–1 Related taxpayer.

An adjustment in the case of the taxpayer with respect to whom the error was made may be authorized under section 1311 although the determination is made with respect to a different taxpayer, provided that such taxpayers stand in one of the relationships specified in section 1313(c). The concept of *related taxpayer* has application to all of the circumstances of adjustment specified in §1.1312–1 through §1.1312–5 if the related taxpayer is one described in section 1313(c); it has application to the circumstances of adjustment specified in §1.1312–6 only if the related taxpayer is one described in section 1313(c)(7); it does not apply in the circumstances specified in §1.1312–7. If such relationship exists, it is not essential that the error involve a transaction made possible only by reason of the existence of the relationship. For example, if the error with respect to which an adjustment is sought under section 1311 grew out of an assignment of rents between taxpayer A and taxpayer B, who are partners, and the determination is with respect to taxpayer A, an adjustment with respect to taxpayer B may be permissible despite the fact that the assignment had nothing to do with the business of the partnership. The relationship need not exist throughout the entire taxable year with respect to which the error was made, but only at some time during that taxable year. For example, if a taxpayer on February 15 assigns to his fiancee the net rents of a building which the taxpayer owns, and the two are married before the end of the taxable year, an adjustment may be permissible if the determination relates to such rents despite the fact that they were not husband and wife at the time of the assignment. See §1.1311(b)–3 for the requirement in certain cases that the relationship exist at the time an inconsistent position is first maintained.

[T.D. 6617, 27 FR 10824, Nov. 7, 1962]

§ 1.1314(a)–1 Ascertainment of amount of adjustment in year of error.

(a) In computing the amount of the adjustment under sections 1311 to 1315, inclusive, there must first be ascertained the amount of the tax previously determined for the taxpayer as to whom the error was made for the taxable year with respect to which the error was made. The tax previously determined for any taxable year may be the amount of tax shown on the taxpayer's return, but if any changes in that amount have been made, they must be taken into account. In such cases, the tax previously determined will be the sum of the amount shown as the tax by the taxpayer upon his return and the amounts previously assessed (or collected without assessment) as deficiencies, reduced by the amount of any rebates made. The amount shown as the tax by the taxpayer upon his return and the amount of any rebates or deficiencies shall be determined in accordance with the provisions of section 6211 and the regulations thereunder.

(b)(1) The tax previously determined may consist of tax for any taxable year beginning after December 31, 1931, imposed by subtitle A of the Internal Revenue Code of 1954, by chapter 1 and subchapters A, B, D, and E of chapter 2 of the Internal Revenue Code of 1939, or by the corresponding provisions of prior internal revenue laws, or by any one or more of such provisions.

(2) After the tax previously determined has been ascertained, a recomputation must then be made under the laws applicable to said taxable year to ascertain the increase or decrease in tax, if any, resulting from the correction of the error. The difference between the tax previously determined and the tax as recomputed after correction of the error will be the amount of the adjustment.

(c) No change shall be made in the treatment given any item upon which the tax previously determined was based other than in the correction of the item or items with respect to which the error was made. However, due regard shall be given to the effect that such correction may have on the computation of gross income, taxable income, and other matters under chapter 1 of the Code. If the treatment of any item upon which the tax previously determined was based, or if the application of any provisions of the internal revenue laws with respect to such tax, depends upon the amount of income (e.g. charitable contributions, foreign tax credit, dividends received credit, medical expenses, and percentage depletion), readjustment in these particulars will be necessary as part of the recomputation in conformity with the change in the amount of the income which results from the correct treatment of the item or items in respect of which the error was made.

(d) Any interest or additions to the tax collected as a result of the error shall be taken into account in determining the amount of the adjustment.

(e) The application of this section may be illustrated by the following example:

Example: (1) For the taxable year 1949 a taxpayer with no dependents, who kept his books on the cash receipts and disbursements method, filed a joint return with his wife disclosing adjusted gross income of $42,000 deductions amounting to $12,000, and a net income of $30,000. Included among other items in the gross income were salary in the amount of $15,000 and rents accrued but not yet received in the amount of $5,000. During the taxable year he donated $10,000 to the American Red Cross and in his return claimed a deduction of $6,300 on account thereof, representing the maximum deduction allowable under the 15-percent limitation imposed by section 23(o) of the Internal Revenue Code of 1939 as applicable to the year 1949. In computing his net income he omitted interest income amounting to $6,000 and neglected to take a deduction for interest paid in the amount of $4,500. The return disclosed a tax liability of $7,788, which was assessed and paid. After the expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1949, the Commissioner included the item of rental income amounting to $5,000 in the taxpayer's gross income for the year 1950 and asserted a deficiency for that year. As a result of a final decision of the Tax Court of the United States in 1955 sustaining the deficiency for 1950, an adjustment is authorized for the year 1949.

(2) The amount of the adjustment is computed as follows:

Tax previously determined for 1949	$7,788
Net income for 1949 upon which tax previously determined was based	30,000
Less: Rents erroneously included	5,000
Balance	25,000
Adjustment for contributions (add 15 percent of $5,000)	750
Net income as adjusted	25,750
Tax as recomputed	6,152
Tax previously determined	7,788
Difference	1,636
Amount of adjustment to be refunded or credited	1,636

(3) In accordance with the provisions of paragraph (c) of this section, the recomputation to determine the amount of the adjustment does not take into consideration the item of $6,000 representing interest received, which was omitted from gross income, or the item of $4,500 representing interest paid, for which no deduction was allowed.

[T.D. 6500, 25 FR 12038, Nov. 26, 1960]

§1.1314(a)–2 Adjustment to other barred taxable years.

(a) An adjustment is authorized under section 1311 with respect to a taxable year or years other than the year of the error, but only if all of the following requirements are met:

(1) The tax liability for such other year or years must be affected, or must have been treated as affected, by a net operating loss deduction (as defined in section 172) or by a capital loss carryback or carryover (as defined in section 1212).

(2) The net operating loss deduction or capital loss carryback or carryover must be determined with reference to the taxable year with respect to which the error was made.

(3) On the date of the determination the adjustment with respect to such other year or years must be prevented by some law or rule of law, other than sections 1311 through 1315 and section 7122 and the corresponding provisions of prior revenue laws.

(b) The amount of the adjustment for such other year or years shall be computed in a manner similar to that provided in §1.1314(a)–1. The tax previously determined for such other year or years shall be ascertained. A recomputation must then be made to ascertain the increase or decrease in tax, if any, resulting solely from the correction of the net operating loss deduction or capital loss carryback or carryover. The difference between the tax previously determined and the tax as recomputed is the amount of the adjustment. In the recomputation, no consideration shall be given to items other than the following:

(1) The items upon which the tax previously determined for such other year or years was based, and

(2) The net operating loss deduction or capital loss carryback or carryover as corrected.

In determining the correct net operating loss deduction or capital loss carryback or carryover, no changes shall be made in taxable income (net income in the case of taxable years subject to the provisions of the Internal Revenue Code of 1939 or prior revenue laws), net operating loss or capital loss, for any barred taxable year, except as provided in section 1314. Section 172 and the corresponding provisions of prior revenue laws, and the regulations promulgated thereunder, prescribe the methods of computing the net operating loss deduction. Section 1212 and the corresponding provisions of prior revenue laws, and the regulations promulgated thereunder, prescribe the methods for computing the capital loss carryback and carryover.

(c) A net operating loss deduction or a capital loss carryback or carryover determined with reference to the year of the error may affect, or may have been treated as affecting, a taxable year with respect to which an adjustment is not prevented by the operation of any law or rule of law. In such case, the appropriate adjustment shall be made with respect to such open taxable year. However, the redetermination of the tax for such open taxable year is not made pursuant to part II (section 1311 and following), subchapter Q, chapter 1 of the Code, and the adjustment for such open year and the method of computation are not limited by the provisions of said sections.

(d) The application of this section may be illustrated by the following example:

Example: The taxpayer is a corporation which makes its income tax returns on a calendar year basis. Its net income in 1949, computed without any net operating loss deduction was $10,000, but because of a net operating loss deduction in excess of that amount resulting from a carryback of a net operating loss claimed for 1950, it paid no income tax for 1949. On its return for 1950 it showed an excess of deductions over gross income of $14,000, and it paid no income tax for 1950. For the year 1951 its net income, computed without any net operating loss deduction, was $15,000, and a net operating loss deduction of $13,000 was allowed ($4,000 of which was attributable to the carryover from 1950 and $9,000 of which was attributable to the carryback of a net operating loss of $9,000 sustained in 1952). In 1957 the assessment of deficiencies or the allowance of refunds for all of said years are barred by the statute of limitations.

(i) A Tax Court decision entered in 1957 with respect to the taxable year 1953 constituted a determination under which an adjustment is authorized to the taxable year 1950, the year with respect to which the error was made. This adjustment increases income for said year by $15,000, so that instead of a net operating loss of $14,000, its corrected net income is $1,000 for 1950, and the tax computed on that income will be assessed as a deficiency for 1950. An adjustment is authorized under this section with respect to each of the years 1949 and 1951, as the tax liability for each year was treated as affected by a net operating loss deduction which was determined by a computation in which reference was made to the year 1950. In the recomputation of the tax for 1949, the net operating loss carryback from 1950 will be eliminated, and in the recomputation of the tax for 1951 the net operating loss carryover from 1950 will be eliminated; for each of the years 1949 and 1951 there will be an adjustment which will be treated as a deficiency for said year.

(ii) Assuming the same facts, except that the correction with respect to the year 1950 increases the net operating loss for said year from $14,000 to $20,000. As a result of this correction, there will be no change in the tax due for 1949 and 1950. However, the net operating loss deduction for 1951 is recomputed to be $19,000, the aggregate of the $10,000 carryover from 1950 and the $9,000 carryback from 1952 (the carryover from 1950 is the excess of the $20,000 net operating loss for 1950 over the $10,000 net income for 1949, such 1949 income being determined without any net operating loss deduction). As a result of the correction of the net operating loss deduction for 1951, the tax recomputation will show no tax due for said year, and the adjustment for 1951 will result in a refund or credit of the tax previously paid. Moreover, computations resulting from this adjustment will disclose a net operating loss carryover from 1952 to 1953 of $4,000, that is, the excess of the $9,000 net operating loss for 1952 over the $5,000 net income for 1951 (such net income for 1951 being computed as the $15,000 reduced by the carryover of $10,000 from 1950, the carryback from 1952 not being taken into account). A further adjustment is authorized under section 1311 with respect to any subsequent barred year in which the tax liability is affected by a carryover of the net operating loss from 1952, inasmuch as such carryover from 1952 has been determined by a computation in which reference was made to 1950, the taxable year of the error.

[T.D. 6500, 25 FR 12038, Nov. 26, 1960, as amended by T.D. 7301, 39 FR 972, Jan. 4, 1974]

§ 1.1314(b)–1 Method of adjustment.

(a) If the amount of the adjustment ascertained pursuant to § 1.1314(a)–1 or § 1.1314(a)–2 represents an increase in tax, it is to be treated as if it were a deficiency determined by the Commissioner with respect to the taxpayer as to whom the error was made and for the taxable year or years with respect to which such adjustment was made. The amount of such adjustment is thus to be assessed and collected under the law and regulations applicable to the assessment and collection of deficiencies, subject, however, to the limitations imposed by § 1.1314(c)–1. Notice of deficiency, unless waived, must be issued with respect to such amount or amounts, and the taxpayer may contest the deficiency before the Tax Court of the United States or, if he chooses, may pay the deficiency and later file claim for refund. If the amount of the adjustment ascertained pursuant to § 1.1314(a)–1 or § 1.1314(a)–2 represents a decrease in tax, it is to be treated as if it were an overpayment claimed by the taxpayer with respect to whom the error was made for the taxable year or years with respect to which such adjustment was made. Such amount may be recovered under the law and regulations applicable to overpayments of tax, subject, however, to the limitations imposed by § 1.1314(c)–1. The taxpayer must file a claim for refund thereof, unless the overpayment is refunded without such claim, and if the claim is denied or not acted upon by the Commissioner within the prescribed time, the taxpayer may then file suit for refund.

(b) For the purpose of the adjustments authorized by section 1311, the period of limitations upon the making of an assessment or upon refund or credit, as the case may be, for the taxable year of an adjustment shall be considered as if, on the date of the determination, one year remained before the expiration of such period. The Commissioner thus has one year from the date of the determination within which to mail a notice of deficiency in respect of the amount of the adjustment where such adjustment is treated as if it were a deficiency. The issuance of such notice of deficiency, in accordance with the law and regulations applicable to the assessment of deficiencies will suspend the running of the 1-year period of limitations provided in section 1314(b). In accordance with the applicable law and regulations governing the collection of deficiencies, the period of limitation for collection of the amount of the adjustment will commence to run from the date of assessment of such amount. (See section 6502 and corresponding provisions of prior revenue laws.) Similarly, the taxpayer has a period of one year from the date of the determination within which to file a claim for refund in respect of the amount of the adjustment where such adjustment is treated as if it were an overpayment. Where the amount of the adjustment is treated as if it were a deficiency and the taxpayer chooses to pay such deficiency and contest it by way of a claim for refund, the period of limitation upon filing a claim for refund will commence to run from the date of such payment. See section 6511 and corresponding provisions of prior revenue laws.

(c) The amount of an adjustment treated as if it were a deficiency or an overpayment, as the case may be, will bear interest and be subject to additions to the tax to the extent provided by the internal revenue laws applicable to deficiencies and overpayments for the taxable year with respect to which the adjustment is made. In the case of an adjustment resulting from an increase or decrease in a net operating loss or net capital loss which is carried back to the year of adjustment, interest shall not be collected or paid for any period prior to the close of the taxable year in which the net operating loss or net capital loss arises.

(d) If, as a result of a determination provided for in §1.1313(a)–4, an adjustment has been made by the assessment and collection of a deficiency or the refund or credit of an overpayment, and subsequently such determination is altered or revoked, the amount of the adjustment ascertained under §1.1314(a)–1 and §1.1314(a)–2 shall be redetermined on the basis of such alteration or revocation, and any overpayment or deficiency resulting from such redetermination shall be refunded or credited, or assessed and collected, as the case may be, as an adjustment under section 1311. For the circumstances under which such an agreement can be altered or revoked, see paragraph (d) of §1.1313(a)–4.

[T.D. 6500, 25 FR 12039, Nov. 26, 1960, as amended by T.D. 7301, 39 FR 972, Jan. 4, 1974]

§1.1314(c)–1 Adjustment unaffected by other items.

(a) The amount of any adjustment ascertained under §1.1314(a)–1 or §1.1314(a)–2 shall not be diminished by any credit or set-off based upon any item other than the one that was the subject of the adjustment.

(b) The application of this section may be illustrated by the following examples:

Example 1. In the example set forth in paragraph (e) of §1.1314(a)–1, if, after the amount of the adjustment had been ascertained, the taxpayer, filed a refund claim for the amount thereof, the Commissioner could not diminish the amount of that claim by offsetting against it the amount of tax which should have been paid with respect to the $6,000 interest item omitted from gross income for the year 1949; nor could the court, if suit were brought on such claim for refund, offset against the amount of the adjustment the amount of tax which should have been paid with respect to such interest. Similarly, the amount of the refund could not be increased by any amount attributable to the taxpayer’s failure to deduct the $4,500 interest paid in the year 1949.

Example 2. Assume that a taxpayer included in his gross income for the year 1953 an item which should have been included in his gross income for the year 1952. After the expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1952, the taxpayer filed a claim for refund for the year 1953 on the ground that such item was not properly includible in gross income for that year. The claim for refund was allowed by the Commissioner and as a result of such determination an adjustment was authorized under section 1311 with respect to the tax for 1952. If, in such case, the Commissioner issued a notice of deficiency for the amount of the adjustment and the taxpayer contested the deficiency before the Tax Court of the United States, the taxpayer could not in such proceeding claim an offset based upon his failure to take an allowable deduction for the year 1952; nor could the Tax Court in its decision offset against the amount of the adjustment any overpayment for the year 1952 resulting from the failure to take such deduction.

(c) If the Commissioner has refunded the amount of an adjustment under section 1311, the amount so refunded may not subsequently be recovered by the Commissioner in any suit for erroneous refund based upon any item other than the one that was the subject of the adjustment,

Example: In the example set forth in paragraph (e) of § 1.1314(a)–1, if the Commissioner had refunded the amount of the adjustment, no part of the amount so refunded could subsequently be recovered by the Commissioner by a suit for erroneous refund based on the ground that there was no overpayment for 1949, as the taxpayer had failed to include in gross income the $6,000 item of interest received in that year.

(d) If the Commissioner has assessed and collected the amount of an adjustment under section 1311, no part thereof may be recovered by the taxpayer in any suit for refund based upon any item other than the one that was the subject of the adjustment.

Example: In example (2) of paragraph (b) of this section, if the taxpayer had paid the amount of the adjustment, he could not subsequently recover any part of such payment in a suit for refund based upon the failure to take an allowable deduction for the year 1952.

(e) If the amount of the adjustment is considered an overpayment, it may be credited, under applicable law and regulations, together with any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made such overpayment. Likewise, if the amount of the adjustment is considered as a deficiency, any overpayment by the taxpayer of any internal revenue tax may be credited against the amount of such adjustment in accordance with the applicable law and regulations thereunder. (See section 6402 and the corresponding provisions of prior revenue laws.) Accordingly, it may be possible in one transaction between the Commissioner and the taxpayer to settle the taxpayer's tax liability for the year with respect to which the determination is made and to make the adjustment under section 1311 for the year with respect to which the error was made or for a year which is affected, or treated as affected, by a net operating loss deduction or a capital loss carryover from the year of the error.

[T.D. 6500, 25 FR 12040, Nov. 26, 1960]

INVOLUNTARY LIQUIDATION AND REPLACEMENT OF LIFO INVENTORIES

§ 1.1321–1 Involuntary liquidation of lifo inventories.

(a) Section 22(d)(6)(B) of the Internal Revenue Code of 1939 provides as follows:

Sec. 22. Gross income. * * *

(d) * * *

(6) *Involuntary liquidation and replacement of inventory.* * * *

(B) *Definition of involuntary liquidation.* The term *involuntary liquidation,* as used in this paragraph, means the sale or other disposition of goods inventoried under the method described in this subsection, either voluntary or involuntary, coupled with a failure on the part of the taxpayer to purchase, manufacture, or otherwise produce and have on hand at the close of the taxable year in which such sale or other disposition occurred such goods as would, if on hand at the close of such taxable year, be subject to the application of the provisions of this subsection, if such failure on the part of the taxpayer is due, directly and exclusively, (i) to enemy capture or control of sources of limited foreign supply; (ii) to shipping or other transportation shortages; (iii) to material shortages resulting from priorities or allocations; (iv) to labor shortages; or (v) to other prevailing war conditions beyond the control of the taxpayer.

(b)(1) If, during any taxable year ending after June 30, 1950, and before January 1, 1955, the disruption of normal trade relations between countries, or one or more of the conditions attributable to a state of national preparedness and beyond the control of the taxpayer, as prescribed by section

22(d)(6)(B) of the Internal Revenue Code of 1939, as modified by section 1321(b) of the Internal Revenue Code of 1954, should render it impossible during such period for a taxpayer using the last-in first-out inventory method to have on hand at the close of the taxable year a stock of merchandise in kind and description like that included in the opening inventory for the year, or in a quantity equal to that of the opening inventory, the resulting inventory decrease for the year will be regarded, at the election of the taxpayer, as reflecting an involuntary liquidation subject to replacement. If the taxpayer notifies the Commissioner within the period prescribed below that he intends to effect a replacement of the liquidated stock, in whole or in part, and that he desires to have applied in his case the involuntary liquidation and replacement provisions of section 1321, and if he establishes to the satisfaction of the Commissioner the involuntary character of the liquidation to which his stock has been subjected, effect shall be given, when replacement has been made, in whole or in part, but only to the extent made in taxable years ending before January 1, 1956, to an adjustment of taxable income for the year of liquidation in the amount of the difference between the replacement costs incurred and the original inventory cost of the liquidated base stock inventory that is replaced. The notification is to be given within 6 months after the filing by the taxpayer of his income tax return for the year of the liquidation. However, if the liquidation occurs in a taxable year ending after December 31, 1953, the notification may be given at any time within 3 months after the promulgation of regulations under section 1321, or prior to the expiration of the 6-month period following the filing of the return, whichever expiration date later occurs.

(2) If the replacement costs exceed such inventory costs, the taxable income of the taxpayer otherwise computed for the year of liquidation shall be reduced by an amount equal to such excess. If the replacement costs are less than the inventory costs, taxable income otherwise computed for the year of liquidation shall be increased to the extent of such difference. Any deficiency in the income or excess profits tax of the taxpayer, or any overpayment of such taxes, attributable to such adjustment shall be assessed and collected or credited or refunded to the taxpayer without interest.

(c)(1) A failure on the part of the taxpayer to have on hand in his closing inventory for the taxable year merchandise of the kind, description, and quantity of that reflected in his opening inventory will be considered as an involuntary liquidation only if it is established to the satisfaction of the Commissioner that such failure is due wholly to his inability to purchase, manufacture, or otherwise produce and procure delivery of such merchandise during the taxable year of liquidation by reason of the disruption of normal trade relations between countries or by reason of certain war conditions, described in section 22(d)(6)(B) of the Internal Revenue Code of 1939, as modified by section 1321(b). Such war conditions are (i) shortages in the source of foreign supply by reason of capture or control by an enemy; (ii) shipping or other transportation shortages; (iii) material shortages resulting from priorities or allocations; (iv) labor shortages; and (v) similar war conditions beyond the control of the taxpayer. For the purpose of the preceding sentence, the words *enemy* and *war* shall be interpreted to apply to circumstances, occurrences, and conditions lacking a state of war, which are similar, by reason of a state of national preparedness, to those which would exist under a state of war.

(2) The various directives, orders, regulations, and allotments issued by the Federal Government in connection with national preparedness are among such circumstances and conditions which might be recognized as effecting an involuntary liquidation under this section. Likewise, a voluntary compliance with a request of an authorized representative of the Federal Government made upon an industry or an important segment thereof, or a voluntary allocation of materials by an industry or important segment thereof sanctioned by the Federal Government, if made in connection with the national preparedness program, might be considered as such a circumstance or

condition. Similarly, so much of an inventory decrease as is directly and exclusively attributable to the Federal Government's stockpiling program for periods during which an item is not subject to allotment shall also be considered as subject to the provisions of section 1321. Thus, so much of an inventory decrease as is due wholly to the effect of directives, orders, regulations, or allotments issued pursuant to the Defense Production Act of 1950, as amended (50 U.S.C. App. 2061 et seq.), or to any other circumstance or condition which is solely dependent upon other action taken by the Federal Government in furtherance of the national preparedness program, ordinarily shall be considered as an involuntary liquidation under section 1321 and this section; however, to the extent that such a decrease is due to the disposition of goods acquired in violation of such directives, orders, regulations, or allotments, such decrease shall not be considered as such an involuntary liquidation. An inventory decrease due directly and exclusively to a disruption of normal trade relations between countries shall be considered as an involuntary liquidation subject to the rules and requirements prescribed in this section, including the requirement that the taxpayer establish to the satisfaction of the Commissioner the cause of the involuntary liquidation. A disruption of normal trade relations between countries may be reflected by unusual export limitations imposed by a foreign government, by unusual exchange restrictions, or by other unusual circumstances or conditions beyond the control of the taxpayer.

(3) A voluntary shift by the taxpayer, in the exercise of business judgment, to merchandise of a different character, description, or use, or to merchandise processed out of a substantially different kind of raw materials while raw materials of the type originally used are still available will not be considered as an involuntary liquidation notwithstanding the fact that such a shift in merchandise stocked was prompted by a shifting market demand attributable to the above conditions. The term *involuntary liquidation* presupposes a physical inability to maintain a normal inventory as distinguished from a financial or business disinclination on the part of the taxpayer to do so.

(d) If the taxpayer would have the involuntary liquidation and replacement provisions applicable with respect to any inventory decrease, he must so elect within the time prescribed by this section. In making such election, the taxpayer shall attach to his return and make a part thereof, or he shall furnish separately to the Commissioner, a statement setting forth the following matters:

(1) The desire of the taxpayer to invoke the involuntary liquidation and replacement provisions;

(2) A detailed list or other identifying description of the items of merchandise claimed to have been subjected to involuntary liquidation and the extent to which replacement is intended;

(3) The circumstances relied upon as rendering the taxpayer unable to maintain throughout the taxable year a normal inventory of the items involved, including evidence of the applicable inventory control figures for the beginning and the close of the taxable year submitted to the appropriate Federal agency in control of defense production (or if none, a statement to that effect), allotments applied for, allotments received, and reason for failure to place allotments received;

(4) Detailed proof of such circumstances to the extent that they may not be the subject-matter of common knowledge;

(5) A full description of what efforts were made on the part of the taxpayer to effect replacement during the taxable year and the result of such efforts; and

(6) In the case of an election made pursuant to an extension of time granted by the Commissioner, the circumstances relied upon as justifying the election at such time, together with a disclosure of the extent, if any, to which replacements have already been made.

(e) The election of the taxpayer to treat an involuntary decrease of inventory as subject to the replacement adjustments is to be exercised separately for each taxable year reflecting such a decrease and the election, once exercised with respect to a given year, shall be irrevocable with respect to the particular decrease involved and its replacement, and shall be binding for the year of liquidation, the year of replacement, and all prior, intervening, and subsequent years to the extent that such prior, intervening, and subsequent years are affected by the adjustments authorized. The ultimate replacement and the resulting adjustment for the year of liquidation may have consequences, among others, in the earnings and profits of intervening years and the inventory accounts of subsequent years. They may have consequences in the prior years by reason of adjustments in net operating loss or unused excess profits credit carrybacks, and in intervening and subsequent taxable years by reason of adjustments in carryovers. Adjustments are to be made for the several years affected consistent with the adjustments made for the year of liquidation. Detailed records shall be maintained such as will enable the Commissioner, in his examination of the taxpayer's return for the year of replacement, readily to verify the extent of the inventory decrease claimed to be involuntary in character and the facts upon which such claim is based, all subsequent inventory increases and decreases, and all other facts material to the replacement adjustment authorized. For taxable years subject to the Internal Revenue Code of 1939, an election under 26 CFR (1939) 39.22(d)–7(e) (Regulations 118) or 26 CFR (1939) 29.22(d)–7 (Regulations 111) to have the involuntary liquidation and replacement provisions of section 22(d)(6) of the Internal Revenue Code of 1939 apply with respect to any inventory decrease for taxable years to which such section applies, shall be given the same effect as if such election had been made under this section. (See section 7807(b)(2).)

(f) Notwithstanding the ultimate purchase price or the cost of production ultimately incurred by the taxpayer in effecting replacement of a stock involuntarily liquidated, the merchandise reflecting the replacement shall be taken into purchases and included in the closing inventory for the year of replacement, and shall be included in the inventories of subsequent taxable years, at the inventory cost figure of the merchandise replaced.

(g) The goods reflected in any inventory increase in a year subsequent to a year of involuntary liquidation, to the extent that they constitute items of the kind and description liquidated in prior years, whether or not in a year of involuntary liquidation, shall be deemed, in the order of their acquisition, as having been acquired by the taxpayer in replacement of like goods most recently liquidated and not previously replaced. In a case involving involuntary liquidations of goods of the same class subject to the provisions of both section 22(d)(6)(A) of the Internal Revenue Code of 1939 and section 1321 of the Internal Revenue Code of 1954, the involuntary liquidations of such goods subject to the provisions of section 1321 shall, for the purpose of replacements made in taxable years ending before January 1, 1953, be considered as having occurred prior to the involuntary liquidations of such goods subject to the provisions of section 22(d)(6)(A) of the Internal Revenue Code of 1939. To the extent that the items of increase are allocated to items liquidated voluntarily, no adjustment will be required or permitted. Such replacement merchandise will be carried in the inventory at its actual cost of acquisition. To the extent that replacements are allocated to items involuntarily liquidated, however, the provisions of this section shall apply, both with respect to adjustments for the year of liquidation and other taxable years affected and with respect to inventory computations for the year of replacement and all subsequent taxable years.

(h) In some cases it may appear that, at the time of the filing of the income tax return for the year of replacement, or within three years thereafter, an adjustment with respect to the income or excess profits taxes for the year of the involuntary liquidation, or for some prior, intervening, or subsequent taxable year, is prevented by the running of the statute of limitations, by the execution of a closing agreement, by virtue of a court decision which has become final, or by reason of some other provision or rule of law other than section 7122 (relating to compromises) and other than the inventory replacement provisions. The adjustments provided for in connection with the involuntary liquidation and replacement of inventory shall nevertheless be made, but only if, within a period of three years after the date of the filing of the income tax return for the year of replacement, a notice of deficiency is mailed or a claim for refund is filed. No credit or refund will be allowed under such circumstances, whether within or without such three-year period, in the absence of a claim for refund duly filed; nor will a resulting deficiency be assessed or collected under section 6213(d) relating to waivers of restrictions. The issuance of the statutory notice of deficiency or the filing of a claim for refund are statutory conditions upon which depend the provisions of section 22(d)(6)(E) of the Internal Revenue Code of 1939, referred to in section 1321(c) of the Internal Revenue Code of 1954. The adjustment authorized by section 22(d)(6)(E) of the Internal Revenue Code of 1939 is limited further to the tax attributable solely to the replacement adjustments. The amount of the adjustment shall be computed by reference to the amount of the tax previously determined, and without regard to factors affecting the taxable year involved to which no effect was given in such prior determination. The tax previously determined shall be ascertained in accordance with the principles stated in section 452(d) of the Internal Revenue Code of 1939. Any deficiency paid or any overpayment credited or refunded under these circumstances shall not be subject to recovery on a claim for refund or a suit for the recovery of an erroneous refund in any case in which such claim or suit is based upon factors other than those giving rise to the adjustments made.

[T.D. 6500, 25 FR 12040, Nov. 26, 1960]

§ 1.1321–2 Liquidation and replacement of lifo inventories by acquiring corporations.

For additional rules in the case of certain corporate acquisitions referred to in section 381(a), see section 381(c)(5) and the regulations thereunder.

[T.D. 6500, 25 FR 12042, Nov. 26, 1960]

War Loss Recoveries

§ 1.1331–1 Recoveries in respect of war losses.

(a)(1) The amount of any recovery in respect of *war loss property* must be included in gross income to the extent provided in section 1332 unless, pursuant to the taxpayer's election under section 1335, the provisions of section 1333 are applicable to such recovery. For the treatment of war loss recoveries under section 1333 and the manner of making the election under section 1335, see §§ 1.1333–1 and 1.1335–1.

(2) As used in this part, the term *war loss property* means property considered under section 127(a) of the Internal Revenue Code of 1939 as *destroyed or seized,* including any interest described in section 127(a)(3) of the Internal Revenue Code of 1939.

(3) For regulations governing the treatment of war losses under the Internal Revenue Code of 1939, see 26 CFR (1939) 29.127(a)–1 to 29.127(a)–4, inclusive, 29.127(b)–1, and 29.127(e)–1 (Regulations 111) and 26 CFR (1939) 39.127(a)–1 (Regulations 118).

(b) The recoveries in respect of any war loss property include the recovery of the same war loss property and the recovery of any money or property in lieu of such property or on account of the destruction or seizure of such property. For example, there is a recovery upon the return to the taxpayer after the termination of the war of his property which was treated as war loss property because it was located in a country at war with the United States. An award by a government on account of the seizure of the taxpayer's property by an enemy country is a recovery under this section. The amount obtained upon the sale or other transfer by the taxpayer of his right to any war loss property is also a recovery for the purpose of this section. Similarly, if a taxpayer who sustained a war loss upon the liquidation of a corporation has received the rights to any property of the corporation which was treated as war loss property, any recovery by the taxpayer with respect to such rights is a recovery by him for the purposes of this section.

(c) For the purpose of this section, the recoveries considered are only those with respect to war losses sustained in prior taxable years. Similarly, the only deductions considered are those allowable for prior taxable years, and any allowable deductions for the year of the recovery are ignored for the purposes of applying such section to the recovery.

(d) If a deduction was claimed under section 127(a) of the Internal Revenue Code of 1939 by a taxpayer in computing his tax for any taxable year and if such deduction was disallowed in whole or in part, any recovery in respect of the portion disallowed shall not be subject to the provisions of part IV (section 1331 and following), subchapter Q, chapter 1 of the Code.

[T.D. 6500, 25 FR 12042, Nov. 26, 1960]

§ 1.1332–1 Inclusion in gross income of war loss recoveries.

(a) *Amount of recovery.* Except as provided in section 1333(1), the amount of the recovery in respect of a war loss in a previous taxable year is determined in the same manner for the purpose of either section 1332 or 1333. The amount of the recovery of any money or property in respect of any war loss is the aggregate of the amount of such money and of the fair market value of such property, both determined as of the date of the recovery. But see paragraph (a) of § 1.1333–1 for optional valuation where the taxpayer recovers the same war loss property.

(b) *Amount of gain includible.* (1) A taxpayer who has sustained a war loss described in section 127(a) of the Internal Revenue Code of 1939 and who has not elected to have the provisions of section 1333 apply to any taxable year in which he recovered any money or property in respect of a war loss in any previous taxable year must include in his gross income for each taxable year, to the extent provided in section 1332, the amount of his recoveries of money and property for such taxable year in respect of any war loss in a previous taxable year. Section 1332 provides that such recoveries for any taxable year are not includible in income until the taxpayer has recovered an amount equal to his allowable deductions in prior taxable years on account of such war losses which did not result in a reduction of any tax under chapter 1 or 2 of the Internal Revenue Code of 1939. War loss recoveries are considered as made first on account of war losses allowable but not actually allowed as a deduction, and second on account of war losses allowed as a deduction but which did not result in a reduction of tax under chapter 1 or 2 of the Internal Revenue Code of 1939. If there were deductions allowed on account of war losses for two or more taxable years which did not result in a reduction of any tax under chapter 1 or 2 of the Internal Revenue Code of 1939, a recovery on account of such losses is considered as made on account of such losses in the order of the taxable years for which they were allowed beginning with the latest. See § 1.1337–1 for the determination of the amount of such deductions. Recoveries in excess of such amount are treated as ordinary income until such excess equals the amount of the taxpayer's allowable deductions in prior taxable years on account of war losses which did result in a reduction of any such tax under chapter 1 or 2 of the Internal Revenue Code of 1939. Any further recoveries in excess of all the taxpayer's allowable deductions in prior taxable years for war losses are treated as gain on an involuntary conversion of property as a result of its destruction or seizure, and such gain is recognized or not recognized under the provisions of section 1033. See section 1033 and the regulations thereunder. Such gain, if recognized, is included in gross income as ordinary income unless section 1231(a) applies to cause such gain to be treated as gain from the sale or exchange of a capital asset held for more than six months. See section 1231(a) and the regulations thereunder.

(2) The determination as to whether and to what extent any recoveries are to be included in gross income is made upon the basis of the amount of all the recoveries for each day upon which there are any such recoveries, as follows:

(i) The amount of the recoveries for any day is not included in gross income, and is not considered gain on an involuntary conversion, to the extent, if any, that the aggregate of the allowable deductions in prior taxable years on account of war losses which did not result in a reduction of any tax of the taxpayer under chapter 1 or 2 of the Internal Revenue Code of 1939, as determined under § 1.1337–1, exceeds the amount of all previous recoveries in the same and prior taxable years.

(ii) The amount of the recoveries for any day which is not excluded from gross income under subdivision (i) of this subparagraph is included in gross income as ordinary income, and is not considered gain on an involuntary conversion, to the extent, if any, that the aggregate of all the allowable deductions in prior taxable years on account of war losses (both those which resulted in a reduction of a tax of the taxpayer and those which did not) exceeds the sum of the amount of all previous recoveries in the same and prior taxable years and of that portion, if any, of the amount of the recoveries for such day which is not included in gross income under subdivision (i) of this subparagraph.

(iii) The amount of the recoveries for any day which is not excluded from gross income under subdivision (i) of this subparagraph and is not included in gross income as ordinary income under subdivision (ii) of this subparagraph is considered gain on an involuntary conversion of property as a result of its destruction or seizure. The following provisions then apply to this gain:

(*a*) Such gain is recognized or not recognized under the provisions of section 1033, relating to gain on the involuntary conversion of property. For the purpose of applying section 1033, such gain for any day is deemed to be expended in the manner provided in section 1033 to the extent the recovery for such day is so expended.

(*b*) If such gain is recognized, it is included in gross income as ordinary income or, if the provisions of section 1231(a) apply and require such treatment, as gain on the sale or exchange of a capital asset held for more than six months. For the purpose of applying section 1231(a), such recognized gain for any day is deemed to be derived from property described in that section to the extent of the recovery for such day with respect to such property, except such portion of such recovery as is attributable to the nonrecognized gain for such day.

(*c*) Section 1336 provides that in determining the unadjusted basis of recovered property, the total gain and the recognized gain with respect to such property must be determined. For such purpose, the recognized gain deemed to be derived from properties described in section 1231(a) may be allocated among such properties in the proportion of the recoveries with respect to such properties, reduced for each property by the portion of the recovery attributable to the nonrecognized gain for such day, and the recoveries with respect to properties not described in section 1231(a) may be similarly allocated. The total gain derived from any recovered property is the sum of the nonrecognized gain attributable to the recovery of such property and of the recognized gain allocable to such property.

(3) The foregoing provisions may be illustrated by the following examples:

Example 1. The taxpayer sustained war losses of $3,000 on account of properties A, B, C, and D. Of this amount, $1,000 did not result in a reduction of any income tax of the taxpayer, as determined under the provisions of § 1.1337–1. In a subsequent taxable year, he received an award of $800 from the Government on account of property A. This is not included in income since it is less than the amount by which his allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit ($1,000) exceed $0, the sum of all his previous recoveries. On a later date the taxpayer recovers property B, which is worth $1,500 on the date of recovery. This recovery is not included in gross income to the extent of $200, the amount by which the aggregate of the allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit ($1,000) exceeds the sum of all previous recoveries ($800). The remaining $1,300 of the recovery is included in gross income as ordinary income, and is not considered gain on the involuntary conversion of property, since it is less than the amount by which the aggregate of all the allowable deductions in prior taxable years on account of war losses ($3,000) exceeds $1,000, the sum of the $800 of previous recoveries and of the $200 portion of the recovery with respect to B which is not included in gross income. On a still later date the taxpayer sells for $2,500 his rights to recover C. Since the allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit ($1,000) do not exceed the previous recoveries by the taxpayer ($800 and

$1,500, or $2,300), none of the recovery on account of C is excluded from gross income. This recovery is included in gross income as ordinary income, and is not considered gain on the involuntary conversion of property, to the extent of $700, the amount by which the aggregate of all the allowable deductions for prior taxable years on account of war losses ($3,000) exceeds $2,300, the sum of the $2,300 of previous recoveries and of the $0 portion of the recovery on account of C which is not included in gross income. The remaining $1,800 of the recovery is considered gain on an involuntary conversion of property on account of its destruction or seizure, and is not recognized if forthwith expended in the manner provided in section 1033. Thus, it is not recognized if it is forthwith expended for the acquisition of property related in service or use to C. On a later date the taxpayer recovers D, which has a fair market value of $400 at the time of the recovery. Since the aggregate of all the allowable deductions for prior taxable years on account of war losses ($3,000) does not exceed the previous recoveries by the taxpayer ($800+$1,500+$2,500, or $4,800), all of the recovery with respect to D is considered gain on an involuntary conversion of property as a result of its destruction or seizure. Under the provisions of section 1033, this gain is not recognized if D is used for the same purposes for which it was used before it was deemed destroyed or seized under section 127(a) of the Internal Revenue Code of 1939.

Example 2. The taxpayer on one day recovers $3,000 for property A and $7,000 for property B, both of which were treated as war loss property for a prior taxable year, and $8,000 of such $10,000 recoveries is considered gain on the involuntary conversion of property as a result of its destruction or seizure. The taxpayer forthwith expends $5,000 in the acquisition of property similar in use to B. Therefore, $5,000 of the $8,000 gain is not recognized under section 1033, leaving $3,000 of recognized gain. Property B is within the provisions of section 1231(a), relating to gains and losses on the involuntary conversion of certain described property, but property A is not. Therefore, the provisions of section 1231(a) apply to $2,000 of the $3,000 gain, that is, the amount of the recovery with respect to B which is not attributable to the nonrecognized gain for such day ($7,000 minus $5,000). If the taxpayer forthwith expended $8,000 or more for the acquisition of property similar in use to B, none of the gain would be recognized. If the taxpayer forthwith expended the $5,000 to acquire property related in use to A, the $3,000 recognized gain would be considered derived from B to the extent of the recovery with respect to B ($7,000), not reduced by any nonrecognized gain since none of such recovery is attributable to such nonrecognized gain, and therefore all of the $3,000 recognized gain would be subject to the provisions of section 1231(a).

(4) An allowable deduction with respect to a war loss is any deduction to which the taxpayer is entitled on account of any war loss property, regardless of whether or not such deduction was claimed by the taxpayer or otherwise allowed in computing his tax. If a deduction was claimed by a taxpayer in computing his tax for any taxable year and if such deduction was disallowed, such deduction will not be considered an allowable deduction for such taxable year since the previous determination will not be reconsidered.

[T.D. 6500, 25 FR 12043, Nov. 26, 1960]

§1.1333–1 Tax adjustment measured by prior benefits.

(a) *Amount of recovery.* The amount of recovery for purposes of this section shall be determined in accordance with the provisions of section 1332(a). See paragraph (a) of §1.1332–1. If, pursuant to the taxpayer's election under section 1335, the provisions of section 1333 are applicable to any taxable year in which he recovers the same war loss property, the fair market value of such property shall, at the option of the taxpayer, be considered an amount equal to the adjusted basis (for determining loss) of such property in the hands of the taxpayer on the date such property was considered as destroyed or seized. This option is exercisable by the taxpayer with respect to each separate war loss property. Also, if the provisions of section 1333 are applicable pursuant to the taxpayer's election, the amount of the recovery of any money or property in respect of war loss property shall be reduced for the purpose of section 1333 (2) and (3) by the amount of the obligations or liabilities with respect to such property, if the taxpayer for any previous taxable year chose under section 127(b)(2) of the Internal Revenue Code of 1939 to treat such obligations or liabilities as discharged or satisfied out of such property, and such obligations or liabilities were not so discharged or satisfied before the date of the recovery. See 26 CFR (1939) 29.127(b)–1 (Regulations 111).

(b) *Elective method; tax adjustment measured by prior benefits.* (1) If the taxpayer elects pursuant to section 1335 and in accordance with the provisions of § 1.1335–1 to have the provisions of section 1333 apply to any taxable year in which he recovers any money or property in respect of war loss property, the amount of the recovery in respect of such property for any taxable year shall not be included in income until the taxpayer has recovered an amount equal to his allowable deductions in prior taxable years on account of the destruction or seizure of such property, whether or not such allowable deductions resulted in a reduction of any tax under chapter 1 or 2 of the Internal Revenue Code of 1939. However, for the purposes of section 6012(a)(1), relating to the requirement of individual returns, section 6012(a)(2), relating to the requirement of corporation returns, and section 1312, relating to the mitigation of the effect of the statute of limitations, the entire amount of the recovery shall be deemed to be an item includible in gross income for the taxable year in which the recovery is made. In lieu of including such amount in gross income, there shall be added to, and assessed and collected as a part of, the tax imposed under subtitle A of the Internal Revenue Code of 1954 for the taxable year of the recovery an adjustment on account of any tax benefits in all prior taxable years resulting directly or indirectly from the fact that the loss from the destruction or seizure of such property was an allowable deduction. The amount of such adjustment shall be the total increase in the tax under chapters 1 and 2 of the Internal Revenue Code of 1939 for all taxable years which would result by decreasing such allowable deductions with respect to the destruction or seizure of such property by an amount equal to that portion of the amount of the recovery which is not included in gross income for the taxable year of the recovery. The portion of the amount of the recovery which is in excess of such allowable deductions is included in gross income for the taxable year of the recovery as gain on the involuntary conversion of property as a result of its destruction or seizure and is recognized or not recognized as provided in section 1033. See section 1033 and the regulations thereunder. Such gain, if recognized, is included in gross income as ordinary income unless section 1231(a) applies to cause such gain to be treated as gain on the sale or exchange of capital assets held for more than six months. See section 1231(a) and the regulations thereunder.

(2) The determination as to whether and to what extent the amount of the recovery is to be excluded from gross income is to be made upon the basis of the total amount of the recoveries in each taxable year in respect of the same war loss property, as follows:

(i) The amount of the recovery in any taxable year is excluded from the gross income of such year and is not considered gain on an involuntary conversion to the extent that such amount does not exceed the aggregate of the allowable deductions in prior taxable years on account of the destruction or seizure of such property (whether or not such deductions resulted in a reduction of a tax of the taxpayer) reduced by the aggregate amount of any recoveries in intervening taxable years in respect of the same property.

(ii) The amount of the recovery in any taxable year which is not excluded from gross income under subdivision (i) of this subparagraph is included in gross income and is considered gain on an involuntary conversion of property as a result of its destruction or seizure. The following provisions apply to this gain:

(*a*) Such gain is recognized or not recognized under the provisions of section 1033, relating to gain on the involuntary conversion of property. For the purpose of applying section 1033, such gain for any taxable year is deemed to be expended in the manner provided in section 1033 to the extent the recovery in such taxable year is so expended.

(*b*) If such gain is recognized it is included in gross income as ordinary income or, if the provisions of section 1231(a) apply and require such treatment, as gain on the sale or exchange of a capital asset held for more than six months. In the case of the recovery of the same war loss property, any gain will not be deemed to be recognized under the provisions of section 1231(a) if such property is used for the same purpose for which it was used before it was deemed destroyed or seized under section 127(a) of the Internal Revenue Code of 1939.

(3) The determination of the total increase in the tax under chapters 1 and 2 of the Internal Revenue Code of 1939 for all taxable years which would result by decreasing the deductions allowable in any prior taxable year with respect to the destruction or seizure of the property in respect of which the taxpayer has made a recovery by an amount equal to the part of such recovery not included in gross income for the taxable year of such recovery shall be made as provided in this subparagraph. Such total increase shall include the increases described in subdivisions (i), (ii), (iii), and (iv) of this subparagraph, and shall be added to, and assessed and collected as a part of, the tax under subtitle A for the taxable year of the recovery. Proper adjustment of such increases shall be made on account of the application of the provisions of this subparagraph to intervening taxable years. Proper adjustment shall also be made in the determination of such increases in the case of a taxpayer who has made a valid election under section 1020, relating to the adjustment of basis of property for depreciation, obsolescence, amortization, and depletion. The term *tax previously determined* as used in this subparagraph shall have the same meaning as used in section 1314(a) and shall include any tax under chapter 1 or 2 of the Internal Revenue Code of 1939. In computing the amount of the increase in the tax previously determined under chapter 1 or 2 of the Internal Revenue Code of 1939 for any taxable year, the principles of section 1314(a) shall be applicable. See section 1314(a) and the regulations thereunder. However, the computation of the excess profits credit under chapter 2E of the Internal Revenue Code of 1939 for any taxable year shall not be affected by the adjustment provided in this subparagraph. All credits allowable against the tax for any year shall be taken into account in computing the increase in the tax previously determined. The increases referred to above include the following:

(i) The increase, if any, in the tax previously determined for each prior taxable year in which a deduction was allowable on account of the destruction or seizure of the property in respect of which there is a recovery in the taxable year. After the tax previously determined has been ascertained, such tax shall be recomputed by disregarding such allowable deduction (to the extent that it does not exceed the sum of the amount of such recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and any other deductions allowable on account of other war losses or any other losses, expenditures or accruals in such prior taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127(c)(3) or section 22(b)(12) of the Internal Revenue Code of 1939, or section 1333 or section 111 of the Internal Revenue Code of 1954, or otherwise. The difference between the tax previously determined and the tax as recomputed will be the increase in the tax previously determined for the taxable year.

(ii) The increase, if any, in the tax previously determined for any taxable year (including the taxable year of the recovery) in which a net operating loss deduction was allowable, if all or a part of such deduction was attributable to the carryover or carryback to such taxable year of a net operating loss from another taxable year in which a deduction was allowable on account of the destruction or seizure of the property in respect of which there is a recovery in the taxable year to which such increase is to be added. After the tax previously determined has been ascertained, such tax shall be recomputed by redetermining such net operating loss deduction. In the determination of such net operating loss deduction the net operating loss shall be recomputed by disregarding the deduction allowable on account of the war loss in respect of which there is a recovery in the taxable year to which such increase is to be added (to the extent that such deduction does not exceed the sum of the amount of such recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and by disregarding any other deductions allowable on account of other war losses or any other losses, expenditures, or accruals in the taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127(c)(3) or 22(b)(12) of the Internal Revenue Code of 1939, or section 1333 or 111 of the Internal Revenue Code of 1954, or otherwise. The difference between the tax previously determined and the tax as recomputed will be the increase in the tax previously determined for the taxable year.

(iii) The increase, if any, in the tax previously determined for any taxable year (including the taxable year of recovery) in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment for such taxable year, if all or a part of such adjustment was attributable to the carryover or carryback to such taxable year of an unused excess profits credit from another taxable year in which a deduction was allowable on account of the destruction or seizure of the property in respect of which there is a recovery in the taxable year to which such increase is to be added. After the tax previously determined has been ascertained, such tax shall be recomputed by redetermining such unused excess profits credit carryover or carryback. In the recomputation such carryover or carryback shall be redetermined by disregarding such allowable war loss deduction (to the extent such deduction does not exceed the sum of the amount of the recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and by disregarding any other deductions allowable on account of other war losses or any other losses, expenditures, or accruals in the taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127(c)(3) or 22(b)(12) of the Internal Revenue Code of 1939, or section 1333 or 111 of the Internal Revenue Code of 1954, or otherwise. The difference between the tax previously determined and the tax as recomputed will be the increase in the tax previously determined for the taxable year. In case there is an increase in the excess profits tax under chapter 2E of the Internal Revenue Code of 1939 for the taxable year in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment, and a decrease in the income tax under chapter 1 of the Internal Revenue Code of 1939 for such taxable year, the increase in the tax previously determined shall be considered to be an amount equal to the excess of the increase in the excess profits tax over the decrease in the income tax.

(iv) The increase, if any, in the tax previously determined for any taxable year (including the taxable year of the recovery) in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment for such taxable year, if all or a part of such adjustment was attributable to the carryover or carryback to such taxable year of an unused excess profits credit from another taxable year in which there was allowable a net operating loss deduction attributable to the carryover or carryback to such other taxable year of a net operating loss, and such net operating loss resulted in whole or in part from the deduction allowable on account of the destruction or seizure of the property in respect of which there is a recovery in the taxable year to which such increase is to be added. After the tax previously determined has been ascertained, such tax shall be recomputed by redetermining such net operating loss deduction and such unused excess profits credit carryover or carryback. In the redetermination of such net operating loss deduction the net operating loss carryover or carryback shall be recomputed by disregarding such allowable war loss deduction (to the extent that such deduction does not exceed the sum of the amount of such recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and by disregarding any other deductions allowable on account of other war losses or any other losses, expenditures, or accruals in the taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127(c)(3) or 22(b)(12) of the Internal Revenue Code of 1939, or section 1333 or 111 of the Internal Revenue Code of 1954, or otherwise. The unused excess profits credit carryover or carryback shall then be recomputed to conform to the redetermination of the net operating loss deduction for the taxable year from which the unused credit is carried over or carried back. The difference between the tax previously determined and the tax as recomputed shall be the amount of the increase which shall be added to the tax for the taxable year of the recovery. In case there is an increase in the excess profits tax under chapter 2E of the Internal Revenue Code of 1939 for the taxable year in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment, and a decrease in the income tax under chapter 1 of the Internal Revenue Code of 1939 for such taxable year, the increase which shall be added to the tax for the taxable year of the recovery shall be considered to be an amount equal to the excess of the increase in the excess profits tax over the decrease in the income tax.

[T.D. 6500, 25 FR 12045, Nov. 26, 1960]

§1.1334–1 Restoration of value of investments.

If any interest of the taxpayer in or with respect to property was determined to be worthless and was treated as a war loss under section 127(a)(3) of the Internal Revenue Code of 1939 (see 26 CFR (1939) 29.127(a)–4) (Regulations 111), or if the taxpayer retained an interest in a corporation with respect to which he sustained a war loss under section 127(e) of the Internal Revenue Code of 1939, and if the interest in the hands of the taxpayer is restored in value, in whole or in part, by reason of a recovery with respect to the underlying assets treated as war loss property, then such restoration in value is a recovery by the taxpayer for the purposes of section 1331. In the application of section 1333, such restoration shall be treated as a recovery of the same interest considered as destroyed or seized. War loss property is considered as not being in existence from the date of the loss to the date of its recovery.

[T.D. 6500, 25 FR 12046, Nov. 26, 1960]

§1.1335–1 Elective method; time and manner of making election and effect thereof.

(a) *In general.* If the taxpayer elects to have the provisions of section 1333 applicable to any taxable year in which any money or property is recovered in respect of war loss property, section 1333 will be applicable by virtue of that election to all taxable years of the taxpayer beginning after December 31, 1941. Thus, the taxpayer need not make an election with respect to each separate taxable year in which he had a recovery. An election for any taxable year in which the taxpayer had a recovery in respect of a prior war loss is sufficient to make the provisions of section 1333 applicable not only to war loss recoveries received by the taxpayer in any past taxable year beginning after December 31, 1941, but to any recoveries which may be received by the taxpayer in any future taxable year. Such election once made shall be irrevocable. The election to have the provisions of section 1333 applicable to any taxable year cannot be made unless the taxpayer recovers money or property (in respect of a prior war loss) during the taxable year for which such election is made.

(b) *Manner of election.* In all cases the election to have the provisions of section 1333 apply must be made by the taxpayer not later than six months from the last day prescribed by law for the filing of his income tax return for any taxable year in which a recovery of war loss property has occurred. The election shall be evidenced by a written statement, made within such 6-month period, that the taxpayer elects to have the provisions of section 1333 apply to any taxable year in which any money or property is recovered in respect of war loss property. The statement may be made in (or attached to):

(1) The return or amended return filed for such taxable year;

(2) A claim for refund or credit filed for such taxable year for an overpayment resulting from application of such provisions;

(3) A timely petition or amended petition to The Tax Court of the United States for a redetermination of any deficiency for any taxable year in which a recovery of war loss property occurred; or

(4) A letter addressed to the district director for the district in which the return for such taxable year was required to be filed.

If the written statement of election is made in a letter, it shall be signed by the taxpayer making the election if an individual or, if the taxpayer is not an individual, the letter must be executed in the same manner as required in the case of the income tax return of such taxpayer. The date of the making of the election shall be the date the return, amended return, claim for refund or credit, or letter is filed in the office of the district director, or the date the petition or amended petition is filed with The Tax Court of the United States. In case the election is made in a return filed before the last day prescribed by law for the filing thereof (including any extension of time for such filing), such election shall not be considered made until such last day. See section 7502 and the regulations thereunder with respect to the timeliness of filing an election where filing is done by mail and section 7503 and the regulations thereunder with respect to the timeliness of filing where the last day for filing falls on a Saturday, Sunday, or legal holiday.

(c) *Effect of election.* (1) If the provisions of section 1333 are applicable to any taxable year pursuant to an election made by the taxpayer in accordance with the provisions of paragraph (a) of this section, the period of limitations provided in chapter 66 of the Code on the making of assessments and the beginning of distraint or a proceeding in court for collection with respect to (i) the amount to be added to the tax for such taxable year under the provisions of section 1333 and (ii) any deficiency for such taxable year or for any other taxable year to the extent attributable to the basis of the recovered property being determined under the provisions of section 1336(b), shall not expire prior to the expiration of two years following the date of the making of such election. Such amount or such deficiency may be assessed at any time prior to the expiration of such period, notwithstanding any law or rule of law which would otherwise prevent such assessment and collection.

(2) If the provisions of section 1333 are applicable to any taxable year pursuant to an election made by the taxpayer in accordance with the provisions of paragraph (a) of this section, and refund or credit of any overpayment resulting from the application of such provisions to such taxable year is prevented on the date of the making of such election, or within one year from such date, by the operation of any law or rule of law (other than section 7122 relating to compromises), refund or credit of such overpayment may nevertheless be made or allowed, provided claim therefor is filed within one year from such date. Thus, the amount of such overpayment which may be refunded or credited is not subject to the limitations contained in section 6511 or 6512(b).

(3) In the case of any taxable year ending before the date of the making by the taxpayer of an election under section 1335, no interest shall be paid on any overpayment specified in subparagraph (2) of this paragraph for any period before the expiration of six months following the date of the making of such election by the taxpayer, and no interest shall be assessed or collected with respect to any amount or any deficiency specified in subparagraph (1) of this paragraph for any period before the expiration of six months following the date of the making of such election by the taxpayer.

[T.D. 6500, 25 FR 12047, Nov. 26, 1960]

§ 1.1336–1 Basis of recovered property.

(a) *General rule.* (1) Under section 1336(a), the unadjusted basis of any war loss property which is recovered and the unadjusted basis of any property which is recovered in lieu of or on account of any such war loss property is considered the fair market value of such recovered property upon the date of its recovery with the following adjustments:

(i) If the sum of the recoveries for the day such property is recovered and of all previous recoveries exceeds the aggregate of the allowable deductions for prior taxable years on account of war losses, so that a portion of the recoveries for such day is treated as gain on the involuntary conversion of property, such fair market value of the property is reduced by the total gain, if any, for such day derived from such recovered property as determined under paragraph (b) of §1.1332–1.

(ii) Such fair market value, as reduced under subdivision (i) of this subparagraph, is increased by the portion, if any, of the recognized gain resulting from the recoveries for such day which is allocable to such recovered property, as determined under paragraph (b) of §1.1332–1.

In effect, the unadjusted basis of such property is its fair market value upon the date of its recovery, reduced by the amount of nonrecognized gain attributable to such recovery under the provisions of paragraph (b) of §1.1332–1.

(2) If the respective bases of several properties of a taxpayer determined under section 1336(a) are greatly disproportionate to their adjusted bases immediately before their treatment as war loss properties, the taxpayer may apply to the Commissioner for the allocation of the aggregate of the bases of such properties among them in the proportion of their adjusted bases immediately before the destruction or seizure of such properties determined under section 127(a) of the Internal Revenue Code of 1939. The amount so allocated to any such property, in an application approved by the Commissioner, shall be the unadjusted basis of such property in lieu of the amount determined under subparagraph (1) of this paragraph.

(3) The application to the Commissioner shall set forth a list of all the properties of the taxpayer having an unadjusted basis determined under this section, a description of each such property together with a statement as to the amount of its adjusted basis immediately before the destruction or seizure of such property determined under section 127(a) of the Internal Revenue Code of 1939, and a statement as to whether there has been any substantial change in the use or nature of the property chosen for the allocation from its nature or use immediately before the time it was treated as destroyed or seized. Such application will be allowed unless there has been such a substantial change in the nature or use of such property that the allocation of the bases would produce an arbitrary result, or unless the taxpayer has obtained such tax benefits by reason of the basis determined under subparagraph (1) of this paragraph, that it would be inequitable to change his basis. Thus, the allocation will not be allowed if it would give the taxpayer an unadjusted basis with respect to any property which is less than the amount of the adjustments in reduction of the basis of such property which are allowable after its recovery. For example, when property A is recovered it has an unadjusted basis of $100. After $70 depreciation has been allowed on A, an allocation is sought which would give A an unadjusted basis of $60. Since this is less than the depreciation which is an adjustment against such basis, the allocation will not be permitted.

(4) The amount of any adjustments to the unadjusted basis determined under subparagraph (1) of this paragraph shall, upon the allocation of the bases, be taken as an adjustment to the allocated unadjusted basis. Thus, if $30 depreciation was allowed upon a $100 basis determined under subparagraph (1) of this paragraph and if the unadjusted basis upon allocation is $75, such $30 depreciation is allowed against such allocated unadjusted basis, so that the adjusted basis of the property is then $45.

(5) The taxpayer may choose any group of recovered properties for allocation, except that if any such recovered properties form one economic unit, such properties may not be separated but all or none must be included in the group. For example, a building may not be separated from the land on which it stands if both are recovered property, nor may one block of stock in a corporation be separated from other stock in such corporation or from bonds in such corporation which are also treated as a recovery. If the

taxpayer has once been permitted to allocate the bases of any group of properties, he may obtain another allocation with respect to such properties only if all the properties in the original group are included together with other recovered properties not included in the original group. For example, if the bases of properties A and B are allocated, a second allocation will be made for properties A, B, and C, but not for A and C or B and C.

(b) *Property recovered in taxable year to which section 1333 is applicable.* If, pursuant to an election made by the taxpayer under section 1335 and paragraph (a) of § 1.1335–1, the provisions of section 1333 are applicable to any taxable year in which the taxpayer recovered property in respect of a war loss under section 127(a) of the Internal Revenue Code of 1939, the unadjusted basis of such property shall be the fair market value of such property determined as of the date of the recovery, reduced by the amount of nonrecognized gain attributable to such recovery under the provisions of paragraph (b) of § 1.1333–1. However, if the property recovered is the same war loss property, and if the taxpayer under section 1333(1) includes such property in the amount of the recovery at its adjusted basis (for determining loss) in his hands on the date such property was considered under section 127(a) of the Internal Revenue Code of 1939 as destroyed or seized, the unadjusted basis of such property shall be such adjusted basis, reduced by the amount of nonrecognized gain attributable to such recovery under the provisions of paragraph (b) of § 1.1333–1. The fair market value of any property recovered, or the adjusted basis for determining loss) of such property if the same property treated as war loss property is recovered, shall not be reduced in determining the unadjusted basis of such property by the amount of the obligations or liabilities with respect to such property in respect of which the recovery was received, if the taxpayer for any previous taxable year chose under section 127(b)(2) of the Internal Revenue Code of 1939 to treat such obligations or liabilities as discharged or satisfied out of such property but such obligations or liabilities were not so discharged or satisfied prior to the date of the recovery.

[T.D. 6500, 25 FR 12048, Nov. 26, 1960]

§ 1.1337–1 Determination of tax benefits from allowable deductions.

(a) That part of the aggregate of the deductions allowed a taxpayer for any taxable year on account of war losses under section 127(a) of the Internal Revenue Code of 1939 which, if disallowed, would not result in an increase in the normal tax, surtax (including the tax imposed by section 102 of the Internal Revenue Code of 1939), or victory tax of taxpayer, or of any tax imposed in lieu of such taxes or of any tax imposed by chapter 2 of the Internal Revenue Code of 1939, for the taxable year in which such deductions are allowed or in any other taxable year, such as a taxable year in which the taxpayer's income tax is computed by reference to a carryover or carryback of net operating losses from the taxable year in which such deductions are allowed, is considered, for the purposes of section 127(a) of the Internal Revenue Code of 1939 an allowable deduction for the taxable year which did not result in a reduction of any tax of the taxpayer under chapter 1 or 2 of the Internal Revenue Code of 1939. In the case of recoveries of war losses and other items to which the recovery exclusion provisions of section 111 apply, such as bad debts, the determination of the tax benefit should be made in accordance with section 111(b) and the regulations thereunder. The deductions allowed a taxpayer for any taxable year on account of war losses are all the deductions on account of war losses which were claimed by the taxpayer in a return, in a claim for credit or refund of an overpayment, or in a petition to The Tax Court of the United States with respect to such taxable year and which were not disallowed, and all deductions on account of war losses which, although not so claimed by the taxpayer, were nevertheless allowed (for example, by the Commissioner, a court, or The Tax Court) in computing a tax of the taxpayer.

(b) Any deduction allowable for a taxable year on account of a war loss under section 127(a) of the Internal Revenue Code of 1939 which was not claimed by the taxpayer for such year in a return, a claim for credit or refund of an overpayment, or a petition to the Tax Court of the United States and was not allowed as a deduction (for example, by the Commissioner, a court, or the Tax Court) in computing his tax for such year or for any other year is considered a deduction which did not result in a reduction of any tax of the taxpayer under chapter 1 or 2 of the Internal Revenue Code of 1939, since it is an allowable deduction which was not allowed in computing any tax of the taxpayer. If the taxpayer claimed for any taxable year a deduction on account of a war loss, and if such deduction was disallowed, the taxpayer may not subsequently contend for the purposes of section 1331 that such deduction was an allowable deduction for such taxable year.

(c) If the taxpayer elected under section 127(b) of the Internal Revenue Code of 1939 to decrease the amount of a war loss by treating the obligations and liabilities described in that section as discharged or satisfied out of the property destroyed or seized, and if the taxpayer establishes that any of the obligations and liabilities were not so discharged or satisfied, then the amount by which such continuing obligations and liabilities decreased the war loss shall be considered an allowable deduction for the taxable year in which the war loss was sustained which did not result in a reduction of any tax of the taxpayer under chapter 1 or 2 of the Internal Revenue Code of 1939.

[T.D. 6500, 25 FR 12048, Nov. 26, 1960]

CLAIM OF RIGHT

§1.1341–1 Restoration of amounts received or accrued under claim of right.

(a) *In general.* (1) If, during the taxable year, the taxpayer is entitled under other provisions of chapter 1 of the Internal Revenue Code of 1954 to a deduction of more than $3,000 because of the restoration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the tax provided in paragraph (b) of this section.

(2) For the purpose of this section *income included under a claim of right* means an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to such item, and *restoration to another* means a restoration resulting because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item (or portion thereof).

(3) For purposes of determining whether the amount of a deduction described in section 1341(a)(2) exceeds $3,000 for the taxable year, there shall be taken into account the aggregate of all such deductions with respect to each item of income (described in section 1341(a)(1)) of the same class.

(b) *Determination of tax.* (1) Under the circumstances described in paragraph (a) of this section, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the lesser of:

(i) The tax for the taxable year computed under section 1341(a)(4), that is, with the deduction taken into account, or

(ii) The tax for the taxable year computed under section 1341(a)(5), that is, without taking such deduction into account, minus the decrease in tax (net of any increase in tax imposed by section 56, relating to the minimum tax for tax preferences) (under chapter 1 of the Internal Revenue Code of 1954, under chapter 1 (other than subchapter E) and subchapter E of chapter 2 of the Internal Revenue Code of 1939, or under the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction is attributable. For the purpose of this subdivision, the amount of the decrease in tax is not limited to the amount of the tax for the taxable year. See paragraph (i) of this section where the decrease in tax for the prior taxable year (or years) exceeds the tax for the taxable year.

(iii) For purposes of computing, under section 1341(a)(4) and subdivision (i) of this subparagraph, the tax for a taxable year beginning after December 31, 1961, if the deduction of the amount of the restoration results in a net operating loss for the taxable year of restoration, such net operating loss shall, pursuant to section 1341(b)(4)(A), be carried back to the same extent and in the same manner as is provided under section 172 (relating to the net operating loss deduction) and the regulations thereunder. If the aggregate decrease in tax for the taxable year (or years) to which such net operating loss is carried back is greater than the excess of:

(*a*) The amount of decrease in tax for a prior taxable year (or years) computed under section 1341(a)(5)(B), over

(*b*) The tax for the taxable year computed under section 1341(a)(5)(A),

The tax imposed for the taxable year under chapter 1 shall be the tax determined under section 1341(a)(4) and subdivision (i) of this subparagraph. If the tax imposed for the taxable year is determined under section 1341(a)(4) and subdivision (i) of this subparagraph, the decrease in tax for the taxable year (or years) to which the net operating loss is carried back shall be an overpayment of tax for the taxable year (or years) to which the net operating loss is carried back and shall be refunded or credited as an overpayment for such taxable year (or years). See section 6511(d)(2), relating to special period of limitation with respect to net operating loss carrybacks.

(2) Except as otherwise provided in section 1341(b)(4)(B) and paragraph (d)(1)(ii) and (4)(ii) of this section, if the taxpayer computes his tax for the taxable year under the provisions of section 1341(a)(5) and subparagraph (1)(ii) of this paragraph, the amount of the restoration shall not be taken into account in computing taxable income or loss for the taxable year, including the computation of any net operating loss carryback or carryover or any capital loss carryover. However, the amount of such restoration shall be taken into account in adjusting earnings and profits for the current taxable year.

(3) If the tax determined under subparagraph (1)(i) of this paragraph is the same as the tax determined under subparagraph (1)(ii) of this paragraph, the tax imposed for the taxable year under chapter 1 shall be the tax determined under subparagraph (1)(i) of this paragraph, and section 1341 and this section shall not otherwise apply.

(4) After it has been determined whether the tax imposed for a taxable year of restoration beginning after December 31, 1961, shall be computed under the provisions of section 1341(a)(4) or under the provisions of section 1341(a)(5), the net operating loss, if any, which remains after the application of section 1341(b)(4)(A) or the net operating loss or capital loss, if any, which remains after the application of section 1341(b)(4)(B) shall be taken into account in accordance with the following rules:

(i) If it is determined that section 1341(a)(4) and subparagraph (1)(i) of this paragraph apply, then that portion, if any, of the net operating loss for the taxable year which remains after the application of section 1341(b)(4)(A) and subparagraph (1)(iii) of this paragraph shall be taken into account under section 172 for taxable years subsequent to the taxable year of restoration to the same extent and in the same manner as a net operating loss sustained in such taxable year of restoration. Thus, if the net operating loss for the taxable year of restoration (computed with the deduction referred to in section 1341(a)(4)) exceeds the taxable income (computed with the modifications prescribed in section 172) for the taxable year (or years) to which it is carried back, such excess shall be available as a carryover to taxable years subsequent to the taxable year of restoration.

(ii) If it is determined that section 1341(a)(5) and subparagraph (1)(ii) of this paragraph apply, then that portion, if any, of a net operating loss or capital loss which remains after the application of section 1341(b)(4)(B) and paragraph (d)(4) of this section shall be taken into account under section 172 or 1212, as the case may be, for taxable years subsequent to the taxable year of restoration to the same extent and in the same manner as a net operating loss or capital loss sustained in the prior taxable year (or years). For example, if the net operating loss for the prior taxable year (computed with the exclusion referred to in section 1341(a)(5)(B)) exceeds the taxable income (computed with the modifications prescribed in section 172) for prior taxable years to which such net operating loss is carried back or carried over (including for this purpose the taxable year of restoration), such excess shall be available as a carryover to taxable years subsequent to the taxable year of restoration in accordance with the rules prescribed in section 172 which are applicable to such prior taxable year (or years).

(c) *Application to deductions which are capital in nature.* Section 1341 and this section shall also apply to a deduction which is capital in nature otherwise allowable in the taxable year. If the deduction otherwise allowable is capital in nature, the determination of whether the taxpayer is entitled to the benefits of section 1341 and this section shall be made without regard to the net capital loss limitation imposed by section 1211. For example, if a taxpayer restores $4,000 in the taxable year and such amount is a long-term capital loss, the taxpayer will, nevertheless, be considered to have met the $3,000 deduction requirement for purposes of applying this section, although the full amount of the loss might not be allowable as a deduction for the taxable year. However, if the tax for the taxable year is computed with the deduction taken into account, the deduction allowable will be subject to the limitation on capital losses provided in section 1211, and the capital loss carryover provided in section 1212.

(d) *Determination of decrease in tax for prior taxable years*—(1) *Prior taxable years.* (i) Except as otherwise provided in subdivision (ii) of this subparagraph, the prior taxable year (or years) referred to in paragraph (b) of this section is the year (or years) in which the item to which the deduction is attributable was included in gross income under a claim of right and, in addition, any other prior taxable year (or years) the tax for which will be affected by the exclusion from gross income in such prior taxable year (or years) of such income.

(ii) For purposes of applying section 1341(b)(4)(B) in computing the amount of the decrease referred to in paragraph (b)(1)(ii) of this section for any taxable year beginning after December 31, 1961, the term *prior taxable year (or years)* includes the taxable year of restoration. Under section 1341(b)(4)(B), for taxable years of restoration beginning after December 31, 1961, in any case where the exclusion referred to in section 1341(a)(5)(B) and paragraph (b)(1)(ii) of this section results in a net operating loss or capital loss for the prior taxable year (or years), such loss shall, for purposes of computing the decrease in tax for the prior taxable year (or years) under such section 1341(a)(5)(B) and such paragraph (b)(1)(ii) of this section, be carried back and carried over to the same extent and in the same manner as is provided under section 172 (relating to the net operating loss deduction) or section 1212 (relating to capital loss carryover), except that no carryover beyond the taxable year shall be taken into account. See subparagraph (4) of this paragraph for rules relating to the computation of the amount of decrease in tax.

(2) *Amount of exclusion from gross income in prior taxable years.* (i) The amount to be excluded from gross income for the prior taxable year (or years) in determining the decrease in tax under section 1341(a)(5)(B) and paragraph (b)(1)(ii) of this section shall be the amount restored in the taxable year, but shall not exceed the amount included in gross income in the prior taxable year (or years) under the claim of right to which the deduction for the restoration is attributable, and shall be adjusted as provided in subdivision (ii) of this subparagraph.

(ii) If the amount included in gross income for the prior taxable year (or years) under the claim of right in question was reduced in such year (or years) by a deduction allowed under section 1202 (or section 117 (b) of the Internal Revenue Code of 1939 or corresponding provisions of prior revenue laws), then the amount determined under subdivision (i) of this subparagraph to be excluded from gross income for such year (or years) shall be reduced in the same proportion that the amount included in gross income under a claim of right was reduced.

(iii) The determination of the amount of the exclusion from gross income of the prior taxable year shall be made without regard to the capital loss limitation contained in section 1211 applicable in computing taxable income for the current taxable year. The amount of the exclusion from gross income in a prior taxable year (or years) shall not exceed the amount which would, but for the application of section 1211, be allowable as a deduction in the taxable year of restoration.

(iv) The rule provided in subdivision (iii) of this subparagraph may be illustrated as follows:

Example: For the taxable year 1952, an individual taxpayer had long-term capital gains of $50,000 and long-term capital losses of $10,000, a net long-term gain of $40,000. He also had other income of $5,000. In 1956, taxpayer restored the $50,000 of long-term gain. He had no capital gains or losses in 1956 but had other income of $5,000. If his tax liability for 1956, the taxable year of restoration, is computed by taking the deduction into account, the taxpayer would be entitled to a deduction under section 1211 of only $1,000 on account of the capital loss. However, if the taxpayer computes his tax under section 1341(a)(5) and paragraph (b)(1)(ii) of this section, it is necessary to determine the decrease in tax for 1952. In such a determination, $50,000 is to be excluded from gross income for that year, resulting in a net capital loss for that year of $10,000, and a capital loss deduction of $1,000 under section 117(d) of the Internal Revenue Code of 1939 (corresponding to section 1211 of the Internal Revenue Code of 1954) with carryover privileges. The difference between the tax previously determined and the tax as recomputed after such exclusion for the years affected will be the amount of the decrease.

(3) *Determination of amount of deduction attributable to prior taxable years.* (i) If the deduction otherwise allowable for the taxable year relates to income included in gross income under a claim of right in more than one prior taxable year and the amount attributable to each such prior taxable year cannot be readily identified, then the portion attributable to each such prior taxable year shall be that proportion of the deduction otherwise allowable for the taxable year which the amount of the income included under the claim of right in question for the prior taxable year bears to the total of all such income included under the claim of right for all such prior taxable years.

(ii) The rule provided in subdivision (i) of this subparagraph may be illustrated as follows:

Example: Under a claim of right, A included in his gross income over a period of three taxable years an aggregate of $9,000 for services to a certain employer, in amounts as follows: $2,000 for taxable year 1952, $4,000 for taxable year 1953, and $3,000 for taxable year 1954. In 1955 it is established that A must restore $6,750 of these amounts to his employer, and that A is entitled to a deduction of this amount in the taxable year 1955. The amount of the deduction attributable to each of the prior taxable years cannot be identified. Accordingly, the amount of the deduction attributable to each prior taxable year is:

1952—$6,750×$2,000÷$9,000=$1,500
1953—$6,750×$4,000÷$9,000=$3,000
1954—$6,750×$3,000÷$9,000=$2,250

(4) *Computation of amount of decrease in tax.* (i) In computing the amount of decrease in tax for a prior taxable year (or years) resulting from the exclusion from gross income of the income included under a claim of right, there must first be ascertained the amount of tax previously determined for the taxpayer for such prior taxable year (or years). The tax previously determined shall be the sum of the amounts shown by the taxpayer on his return or returns, plus any amounts which have been previously assessed (or collected without assessment) as deficiencies or which appropriately should be assessed or collected, reduced by the amount of any refunds or credits which have previously been made or which appropriately should be made. For taxable years beginning after December 31, 1961, if the provisions of section 1341(b)(4)(B) are applicable, the tax previously determined shall include the tax for the taxable year of restoration computed without taking the deduction for the amount of the restoration into account. After the tax previously determined has been ascertained, a recomputation must then be made to determine the decrease in tax, if any, resulting from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction otherwise allowable in the taxable year is attributable.

(ii) No item other than the exclusion of the income previously included under a claim of right shall be considered in computing the amount of decrease in tax if reconsideration of such other item is prevented by the operation of any provision of the internal revenue laws or any other rule of law. However, if the amounts of other items in the return are dependent upon the amount of adjusted gross income, taxable income, or net income (such as charitable contributions, foreign tax credit, deductions for depletion, and net operating loss), appropriate adjustment shall be made as part of the computation of the decrease in tax. For the purpose of determining the decrease in tax for the prior taxable year (or years) which would result from the exclusion from gross income of the item included under a claim of right, the exclusion of such item shall be given effect not only in the prior taxable year in which it was included in gross income but in all other prior taxable years (including the taxable year of restoration if such year begins after December 31, 1961, and section 1341(b)(4)(B) applies, see subparagraph (1)(ii) of this paragraph) affected by the inclusion of the item (for example, prior taxable years affected by a net operating loss carryback or carryover or capital loss carryover).

(iii) The rules provided in this subparagraph may be illustrated as follows:

Example 1. For the taxable year 1954, a corporation had taxable income of $35,000, on which it paid a tax of $12,700. Included in gross income for the year was $20,000 received under a claim of right as royalties. In 1957, the corporation is required to return $10,000 of the royalties. It otherwise has taxable income in 1957 of $5,000, so that without the application of section 1341 it has a net operating loss of $5,000 in that year. Facts also come to light in 1957 which entitle the corporation to an additional deduction of $5,000 for 1954. When a computation is made under paragraph (b)(1)(i) of this section, the corporation has no tax for the taxable year 1957. When a computation is made under paragraph (b)(1)(ii) of this section, the tax for 1957, without taking the restoration into account, is $1,500, based on a taxable income of $5,000. The decrease in tax for 1954 is computed as follows:

Tax shown on return for 1954		$12,700
Taxable income for 1954 upon which tax shown on return was based		35,000
Less: Additional deduction (on account of which credit or refund could be made)		5,000
Total		30,000
Tax on $30,000 (adjusted taxable income for 1954)		10,100
Tax on $30,000 (adjusted taxable income for 1954)		10,100
Taxable income for 1954, as adjusted	$30,000	
Less exclusion of amount restored	10,000	
Taxable income for 1954 by applying paragraph (b)(1)(ii) of this section	20,000	
Tax on $20,000		6,000
Decrease in tax for 1954 by applying paragraph (b)(1)(ii) of this section		$4,100
Tax for 1957 without taking the restoration into account		1,500
Amount by which decrease exceeds the tax for 1957 computed without taking restoration into account		$2,600

(The $2,600 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1957 and is available as a refund. In addition the taxpayer has made an overpayment of $2,600 ($12,700 less $10,000) for 1954 because of the additional deduction of $5,000.)

Example 2. Assume the same facts as in example (1) except that, instead of the corporation being entitled to an additional deduction of $5,000 for 1954, it is determined that the corporation failed to include an item of $5,000 in gross income for that year. The decrease in tax for 1954 is computed as follows:

Tax shown on return for 1954		$12,700
Taxable income for 1954 upon which tax shown on return was based		35,000
Plus: Additional income (on account of which deficiency assessment could be made)		$5,000
Total		40,000
Tax on $40,000 (adjusted taxable income for 1954)		15,300
Tax on $40,000 (adjusted taxable income for 1954)		15,300
Taxable income for 1954 as adjusted	$40,000	
Less exclusion of amount restored	10,000	
Taxable income for 1954 by applying paragraph (b)(1)(ii) of this section	30,000	
Tax on $30,000		10,100
Decrease in tax for 1954 by applying paragraph (b)(1)(ii) of this section		5,200
Tax for 1957 without taking the restoration into account		1,500
Amount by which decrease exceeds the tax for 1957 computed without taking the restoration into account		$3,700

(The $3,700 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1957 and is available as a refund. In addition the taxpayer has a deficiency of $2,600 ($15,300 less $12,700) for 1954 because of the additional income of $5,000.)

Example 3. For the taxable year 1954, a corporation had taxable income of $25,000, on which it paid a tax of $7,500. Included in gross income for the year was $10,000 received under a claim of right as commissions. In 1956, the corporation is required to return $5,000 of the commissions. The corporation has a net operating loss of $10,000 for 1956, excluding the deduction for the $5,000 restored. When a computation is made under either paragraph (b)(1)(i) or paragraph (b)(1)(ii) of this section, the corporation has no tax for the taxable year 1956. The decrease in tax for 1954 is computed as follows:

Tax shown on return for 1954		$7,500
Taxable income for 1954 upon which tax shown on return was based		25,000
Less: Additional deduction (on account of net operating loss carryback from 1956)		10,000
Net income as adjusted		15,000
Tax on $15,000 (adjusted taxable income for 1954)		4,500
Tax on $15,000 (adjusted taxable income for 1954)		4,500
Taxable income for 1954, as adjusted	$15,000	
Less: exclusion of amount restored	$5,000	
Taxable income for 1954 by applying paragraph (b)(1)(ii) of this section	10,000	
Tax on $10,000		$3,000
Decrease in tax for 1954 by applying paragraph (b)(1)(ii) of this section		1,500
Tax for 1956 without taking the restoration into account		None
Amount by which decrease exceeds the tax for 1956 computed without taking the restoration into account		$1,500

(The $1,500 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1956 and is available as a refund. In addition, the taxpayer has an overpayment of $3,000 ($7,500 less $4,500) for 1954 because of the net operating loss deduction of $10,000.)

Example 4. For the taxable year 1946 a married man with no dependents, who kept his books on the cash receipts and disbursements basis, filed a return (claiming two exemptions) disclosing adjusted gross income of $42,000, deductions amounting to $12,000, and a net income of $30,000. Gross income included among other items, salary in the amount of $15,000 and rental income in the amount of $5,000. During the taxable year he donated $10,000 to the American Red Cross and in his return claimed a deduction of $6,300 on account thereof, representing the maximum deduction allowable under the 15-percent limitation imposed by section 23(o) of the Internal Revenue Code of 1939 for the year 1946. In computing his net income he omitted interest income amounting to $6,000 and neglected to take a deduction for interest paid in the amount of $4,500. The return disclosed a tax liability of $11,970, which was assessed and paid. In 1955, after the expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1946, the taxpayer had to restore the $5,000 included in his gross income in 1946 as rental income. The amount of the decrease in tax for 1946 is $2,467.62, computed as follows:

Tax previously determined for 1946	$11,970.00
Net income for 1946 upon which tax previously determined was based	30,000.00
Less: Rents included under claim of right	5,000.00
Balance	25,000.00
Adjustment for contributions (add 15 percent of $5,000)	750.00
Net income as adjusted	25,750.00
Tax on $25,750	9,502.38
Amount of decrease in tax for 1946:	
Tax previously determined	$11,970.00
Tax as recomputed	9,502.38
Decrease in tax	$2,467.62

The recomputation to determine the amount of the decrease in tax for 1946 does not take into consideration the barred item of $6,000 representing interest received, which was omitted from gross income, or the barred item of $4,500 representing interest paid for which no deduction was allowed. See subdivision (ii) of this subparagraph.

Example 5. (a) *Facts.* For the taxable year 1959, a corporation reporting income on the calendar year basis had taxable income of $20,000 on which it paid a tax of $6,000. Included in gross income for such year was $100,000 received under a claim of right as royalties. For each of its taxable years 1956, 1957, 1958, 1960, 1961, and 1962, the corporation had taxable income of $10,000 on which it paid tax of $3,000 for each year. In 1963, the corporation returns the entire amount of $100,000 of the royalties. In such taxable year the corporation has taxable income of $25,000 (without taking the deduction of $100,000 into account), and has a net operating loss of $75,000 (taking the deduction of $100,000 into account). In determining whether section 1341(a)(4) or section 1341(a)(5) applies, the corporation will compute the lesser amount of tax referred to in section 1341(a) by applying the rules provided in section 1341(b)(4).

(*b*) *Tax under section 1341 (a)(4) and (b)(4)(A).* The net operating loss of $75,000 for 1963 (taking into account the deduction of $100,000) is carried back to the three taxable years (1960, 1961, and 1962) in the manner provided under section 172. For purposes of this example it is assumed that no modifications under section 172 are necessary. Since the aggregate taxable income for such three taxable years is only $30,000 the entire taxable income for such years is eliminated by the carryback, and the corporation would be entitled to a refund of the tax for such years in the aggregate amount of $9,000. (In addition, the remaining $45,000 of the net operating loss for 1963 would be available as a carryover to taxable years after the taxable year (1963) to the extent and in the manner provided by section 172.)

(*c*) *Tax under section 1341 (a)(5) and (b)(4)(B).* The tax for the taxable year (1963) on $25,000 of taxable income (computed without the deduction of $100,000) is $7,500. The exclusion of $100,000 from gross income for the taxable year 1959 (the year in which the item was included) results in a net operating loss of $80,000 for such year ($20,000 taxable income minus the $100,000 exclusion, no adjustments under section 172 being necessary), thus decreasing the tax for such year by the entire amount of $6,000 paid. The resulting net operating loss of $80,000 for 1959 is available as a carryback to 1956, 1957, and 1958, and as a carryover to 1960, 1961, 1962, and 1963. For purposes of this example it is assumed that no modifications under section 172 are necessary. Since the aggregate taxable income for such taxable years is $85,000, all except $5,000 of the 1963 taxable income is eliminated by such carryback and carryover. The tax on such remaining $5,000 of taxable income for 1963 is $1,500, thus decreasing the tax determined for such year by $6,000 ($7,500 minus $1,500). Under section 1341 (a)(5) and (b)(4)(B), the decrease in tax for the prior taxable years exceeds the tax for the taxable year of restoration computed without the deduction of the amount of the restoration by $22,500, computed as follows:

Tax for taxable year 1963 (on taxable income of $25,000 without the deduction)			$7,500
Decrease in tax for prior taxable years:			
Due to exclusion (1959)		$6,000	
Due to net operating loss carryback:			
1956	$3,000		
1957	3,000		
1958	3,000		
		9,000	
Due to net operating loss carryover:			
1960	$3,000		
1961	3,000		
1962	3,000		
1963	6,000		
		15,000	
			30,000
Excess of the decrease in tax for the prior taxable years over the tax for taxable year 1963 ($30,000 less $7,500 tax for the taxable year)			22,500

(*d*) *Application of section 1341(a)(4) or section 1341(a)(5).* Since the computation under section 1341 (a)(4) and (b)(4)(A) results in an available refund of only $9,000 tax for the taxable years to which the net operating loss for 1963 is carried back, and since the computation under section 1341 (a)(5) and (b)(4)(B) results in an overpayment of $22,500, it is determined that section 1341(a)(5) applies. Accordingly, the $22,500 is treated as having been paid on the last day prescribed by law for the payment of tax for 1963 and is available as a refund.

(e) *Method of accounting.* The provisions of section 1341 and this section shall be applicable in the case of a taxpayer on the cash receipts and disbursements method of accounting only to the taxable year in which the item of income included in a prior year (or years) under a claim of right is actually repaid. However, in the case of a taxpayer on the cash receipts and disbursements method of accounting who constructively received an item of income under a claim of right and included such item of income in gross income in a prior year (or years), the provisions of section 1341 and this section shall be applicable to the taxable year in which the taxpayer is required to relinquish his right to receive such item of income. Such provisions shall be applicable in the case of other taxpayers only to the taxable year which is the proper taxable year (under the method of accounting used by the taxpayer in computing taxable income) for taking into account the deduction resulting from the restoration of the item of income included in a prior year (or years) under a claim of right. For example, if the taxpayer is on an accrual method of accounting, the provisions of this section shall apply to the year in which the obligation properly accrues for the repayment of the item included under a claim of right.

(f) *Inventory items, stock in trade, and property held primarily for sale in the ordinary course of trade or business.* (1) Except for amounts specified in subparagraphs (2) and (3) of this paragraph, the provisions of section 1341 and this section do not apply to deductions attributable to items which were included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. This section is, therefore, not applicable to sales returns and allowances and similar items.

(2)(i) In the case of taxable years beginning after December 31, 1957, the provisions of section 1341 and this section apply to deductions which arise out of refunds or repayments with respect to rates made by a regulated public utility, as defined in section 7701(a)(33) without regard to the limitation contained in the last two sentences thereof (for taxable years beginning before January 1, 1964, as defined in section 1503(c) (1) or (3) and paragraph (g) of § 1.1502–2A (as contained in the 26 CFR edition revised as of April 1, 1996)), if such refunds or repayments are required to be made by the Government, political subdivision, agency, or instrumentality referred to in such section, or are required to be made by an order of a court, or are made in settlement of litigation or under threat or imminence of litigation. Thus, deductions attributable to refunds of charges for the sale of natural gas under rates approved temporarily by a proper governmental authority are, in the case of taxable years beginning after December 31, 1957, eligible for the benefits of section 1341 and this section, if such refunds are required by the governmental authority, or by an order of a court, or are made in settlement of litigation or under threat or imminence of litigation.

(ii) In the case of taxable years beginning before January 1, 1958, the provisions of section 1341 and this section apply to deductions which arise out of refunds or repayments (whether or not with respect to rates) made by a regulated public utility, as defined in section 7701(a)(33) without regard to the limitation contained in the last two sentences thereof (for taxable years beginning before January 1, 1964, as defined in section 1503(c) (1) or (3) and paragraph (g) of § 1.1502–2A), if such refunds or repayments are required to be made by the Government, political subdivision, agency, or instrumentality referred to in such section. Thus, in the case of taxable years beginning before January 1, 1958, deductions attributable to refunds or repayments may be eligible for the benefits of section 1341 and this section, even though such refunds or repayments are not with respect to rates. On the other hand, in the case of such taxable years, section 1341 and this section do not apply to any deduction which arises out of a refund or repayment (whether or not with respect to rates) which is required to be made by an order of a court, or which is made in settlement of litigation or under threat or imminence of litigation.

(3) The provisions of section 1341 and this section apply to a deduction which arises out of a payment or repayment made pursuant to a price redetermination provision in a subcontract:

(i) If such subcontract was entered into before January 1, 1958, between persons other than those bearing a relationship set forth in section 267(b);

(ii) If such subcontract is subject to statutory renegotiation; and

(iii) If section 1481 (relating to mitigation of effect of renegotiation of Government contracts) does not apply to such payment or repayment solely because such payment or repayment is not paid or repaid to the United States or any agency thereof.

Thus, a taxpayer who enters into a subcontract to furnish items to a prime contractor with the United States may, pursuant to a price redetermination provision in the subcontract, be required to refund an amount to the prime contractor or to another subcontractor. Since the refund would be made directly to the prime contractor or to another subcontractor, and not directly to the United States, the taxpayer would be unable to avail himself of the benefits of section 1481. However, the provisions of section 1341 and this section will apply in such a case, if the conditions set forth in subdivisions (i), (ii), and (iii) of this subparagraph are met. For provisions relating to the mitigation of the effect of a redetermination of price with respect to subcontracts entered into after December 31, 1957, when repayment is made to a party other than the United States or any agency thereof, see section 1482.

(g) *Bad debts.* The provisions of sections 1341 and this section do not apply to deductions attributable to bad debts.

(h) *Legal fees and other expenses.* Section 1341 and this section do not apply to legal fees or other expenses incurred by a taxpayer in contesting the restoration of an item previously included in income. This rule may be illustrated by the following example:

Example: A sold his personal residence to B in a prior taxable year and realized a capital gain on the sale. C claimed that under an agreement with A he was entitled to a 5-percent share of the purchase price since he brought the parties together and was instrumental in closing the sale. A rejected C's demand and included the entire amount of the capital gain in gross income for the year of sale. C instituted action and in the taxable year judgment is rendered against A who pays C the amount involved. In addition, A pays legal fees in the taxable year which were incurred in the defense of the action. Section 1341 applies to the payment of the 5-percent share of the purchase price to C. However, the payment of the legal fees, whether or not otherwise deductible, does not constitute an item restored for purposes of section 1341(a) and paragraph (a) of this section.

(i) *Refunds.* If the decrease in tax for the prior taxable year (or years) determined under section 1341(a)(5)(B) and paragraph (b)(1)(ii) of this section exceeds the tax imposed by chapter 1 of the Code for the taxable year computed without the deduction, and for taxable years beginning after December 31, 1961, if such excess is greater than the decrease in tax for the taxable year (or years) to which the net operating loss described in section 1341(b)(4)(A) and paragraph (b)(1)(iii) of this section is carried back, such excess shall be considered to be a payment of tax for the taxable year of restoration. Such payment is deemed to have been made on the last day prescribed by law for the payment of tax for the taxable year and shall be refunded or credited in the same manner as if it were an overpayment of tax for such taxable year. However, no interest shall be allowed or paid if such an excess results from the application of section 1341(a)(5)(B) in the case of a deduction described in paragraph (f)(3) of this section (relating to payments or repayments pursuant to price redetermination). If the tax for the taxable year of restoration is computed under section 1341(a)(4) and results in a decrease in tax for the taxable year (or years) to which a net operating loss described in section 1341(b)(4)(A) is carried back, see paragraph (b)(1)(iii) of this section.

[T.D. 6500, 25 FR 12049, Nov. 26, 1960, as amended by T.D. 6617, 27 FR 10824, Nov. 7, 1962; T.D. 6747, 29 FR 9790, July 21, 1964; T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7564, 43 FR 40496, Sept. 12, 1978; T.D. 8677, 61 FR 33323, June 27, 1996]

§ 1.1342–1 Computation of tax where taxpayer recovers substantial amount held by another under claim of right; effective date.

Section 1342 shall apply with respect to taxable years beginning after December 31, 1954.

[T.D. 6500, 25 FR 12052, Nov. 26, 1960]

OTHER LIMITATIONS

§ 1.1346–1 Recovery of unconstitutional taxes.

(a) *In general.* (1) A taxpayer who recovers unconstitutional Federal taxes which were paid or accrued and for which a deduction was allowed in a prior taxable year may elect, as provided in paragraph (b) of this section, to exclude the income (exclusive of interest) attributable to such recovery from his gross income in the taxable year of recovery. Any such exclusion of income is subject to the requirements of section 1346 and this section.

(2) If a taxpayer elects to receive the benefits of section 1346, the income (exclusive of interest) attributable to the recovery of the unconstitutional Federal tax will be treated as an offset to the deduction allowed therefor in a prior taxable year (or years). The taxpayer's return for the prior taxable year (or years) with respect to which the statutory period for the assessment of a deficiency has expired will be opened only for the purpose of reducing the deduction allowed for the unconstitutional Federal tax and assessing the resulting deficiency or deficiencies, if any. (An election under section 1346 may be made only if the taxpayer consents in writing to such assessment. See paragraph (b) of this section.) No other adjustment will be allowed.

(3) If the disallowance of the deduction allowed in respect of a prior taxable year results in a deficiency for that year, the deficiency will be assessed against the taxpayer within the period agreed upon between the taxpayer and the district director with respect to the taxable year of the prior deduction, even though the statutory period for the assessment may have expired prior to the filing of the consent.

(4) If a taxpayer does not elect under the provisions of section 1346 and this section to exclude the tax recovered from gross income in the taxable year of recovery, the tax recovered shall, from the standpoint of its inclusion in or exclusion from gross income, be governed by the provisions of section 111.

(b) *Manner of making election.* (1) The election provided for in paragraph (a) of this section shall be made by the taxpayer filing a statement in writing that he elects to treat the deduction allowed in a prior taxable year for the unconstitutional tax as not having been allowable for such taxable year. Such a statement must be filed with the taxpayer's return for the taxable year in which the recovery of the unconstitutional tax or taxes occurs. No other method of making the election is permitted. The statement of election must contain a description of the tax recovered, the date of recovery, the taxable year in which paid or accrued, and the taxable year for which the deduction was allowed. The statement of election must also contain a statement signifying the taxpayer's consent (i) to treat the deduction or portion thereof allowed in a prior year with respect to the unconstitutional tax as not allowable for that year and (ii) to the assessment, in respect of the taxable year for which the deduction was allowed, of any deficiency, together with interest thereon as provided by law, resulting from disallowance of the deduction or portion thereof, even though the statutory period for the assessment of any such deficiency may have expired before the filing of such consent.

(2) The term *recovery,* as used in this section, includes not only refund or credit of taxes previously paid, but also the cancellation of a purported tax liability which was accrued and deducted for a prior taxable year but never actually paid.

[T.D. 6500, 25 FR 12052, Nov. 26, 1960]

§ 1.1347–1 Tax on certain amounts received from the United States.

(a) In the case of an amount (other than interest) received from the United States by an individual under a claim involving acquisition of property and remaining unpaid for more than 15 years, the tax (or, in the case of taxable years beginning before January 1, 1971, the surtax) imposed by section 1 attributable to such amount shall not exceed 33 percent of the amount (other than interest) so received (30 percent for taxable years beginning before January 1, 1971). For the purpose of section 1347 and this section, such amount shall not include any amount received from the United States which constitutes interest, whether such interest was included in the claim or in any judgment thereon or has accrued on such judgment. Section 1347 and this section shall only apply with respect to amounts received under a claim filed with the United States before January 1, 1958.

(b) To determine the application of section 1347 and this section to a particular amount, the taxpayer shall first compute the tax (or, in the case of taxable years beginning before January 1, 1971, the surtax) imposed by section 1 upon his entire taxable income, including the amount specified in paragraph (a) of this section, without regard to the limitation on tax provided in section 1347. The proportion of the tax (or surtax), so computed, indicated by the ratio which the taxpayer's taxable income attributable to the amount specified in paragraph (a) of this section, computed as prescribed in paragraph (c) of this section, bears to his total taxable income, is the portion of the tax (or surtax) attributable to such amount. If this portion of the tax (or surtax) exceeds 33 percent (30 percent for taxable years beginning before January 1, 1971) of the amount specified in paragraph (a) of this section, that portion of the tax (or surtax) shall be reduced to 33 percent (or 30 percent) of such amount.

(c) In determining the portion of the taxable income attributable to any amount specified in paragraph (a) of this section, the taxpayer shall allocate to such amount received and to the gross income derived from all other sources, the expenses, losses, and other deductions properly attributable thereto, and shall apply any general expenses, losses, and other deductions (which cannot be properly apportioned otherwise) ratably to the gross income from all sources. The amount specified in paragraph (a) of this section, less the deductions properly attributable thereto and less its proportion of any general deductions, shall be the taxable income attributable to such amount. The taxpayer shall submit with his return a statement fully explaining the manner in which such expenses, losses, and deductions are allocated or apportioned.

[T.D. 6500, 25 FR 12052, Nov. 26, 1960, as amended by T.D. 7117, 36 FR 9422, May 25, 1971; 36 FR 11434, June 12, 1971]

§1.1348–1 Fifty-percent maximum tax on earned income.

Section 1348 provides generally that for taxable years beginning after December 31, 1971, the maximum tax rate applicable to the earned taxable income of an individual, estate, or trust is not to exceed 50 percent. In the case of an estate or trust, earned income includes only amounts which constitute income in respect of a decedent within §1.1348–3(a)(4). For taxable years beginning after December 31, 1970, and before January 1, 1972, the maximum rate is 60 percent. Section 1348 does not apply if the taxpayer chooses the benefits of income averaging under sections 1301 through 1305. Section 1348 does not apply to a married individual who does not file a joint return with his spouse for the taxable year. For purposes of section 1348, an individual's marital status shall be determined under section 153 and the regulations thereunder.

[T.D. 7446, 41 FR 55337, Dec. 20, 1976]

§1.1348–2 Computation of the fifty-percent maximum tax on earned income.

(a) *Computation of tax for taxable years beginning after 1971.* If, for a taxable year beginning after December 31, 1971, an individual has earned taxable income (as defined in paragraph (d) of this section) which exceeds the applicable amount in column (1) of table A, the tax imposed by section 1 for such year shall be the sum of:

(1) The applicable amount in column (2) of table A.

(2) 50 percent of the amount by which earned taxable income exceeds the applicable amount in column (1) of table A, and

(3) The amount by which the tax imposed by chapter 1 on the entire taxable income exceeds a tax so computed on earned taxable income, such computations to be made without regard to section 1348 or 1301.

TABLE A

Status	(1)	(2)
Married individuals filing joint returns and surviving spouses	$52,000	$18,060
Heads of households	38,000	12,240
Unmarried individuals other than surviving spouses and heads of households	38,000	13,290
Trusts and estates	26,000	9,030

(b) *Computation of tax for taxable years beginning in 1971.* If, for a taxable year beginning after December 31, 1970, and before January 1, 1972, an individual has earned taxable income (as defined in paragraph (d) of this section) which exceeds the applicable amount in column (1) of table B, the tax imposed by section 1 for such year shall be the sum of:

(1) The applicable amount in column (2) of table B,

(2) 60 percent of the amount by which earned taxable income exceeds the applicable amount in column (1) of table B, and

(3) The amount by which the tax imposed by chapter 1 on the entire taxable income exceeds a tax so computed on earned taxable income, such computations to be made without regard to section 1348 or 1301.

TABLE B

Status	(1)	(2)
Married individuals filing joint returns and surviving spouses	$100,000	$45,180
Heads of households	70,000	30,260
Unmarried individuals other than surviving spouses and heads of households	50,000	20,190

TABLE B—Continued

Status	(1)	(2)
Trusts and estates	50,000	22,590

(c) *Short taxable periods.* If a taxpayer is required under section 443(a)(1) to make a return for a period of less than 12 months, the tax under section 1348 and this section shall be determined by placing his taxable income, earned net income, adjusted gross income, and items of tax preference on an annual basis in accordance with section 443 and the regulations thereunder. If a taxable year referred to in paragraph (d)(3)(i)(*a*) of this section is a period of less than 12 months for which a return is required under section 443(a)(1), the average described in such paragraph shall also be determined by placing the items of tax preference for such period on an annual basis in accordance with section 443 and the regulations thereunder. If a return for a period of less than 12 months is required under section 443(a)(3) for any taxable year referred to in paragraph (d)(3)(i)(*a*) of this section, section 1348 and this section shall not apply unless such period is reopened by the taxpayer as provided by section 6851(b).

(d) *Earned taxable income*—(1) *In general.* For purposes of section 1348 and this section, the term *earned taxable income* means the excess of (i) the portion of taxable income which, under subparagraph (2) of this paragraph, is attributable to earned net income over (ii) the tax preference offset (as defined in subparagraph (3) of this paragraph). For purposes of computing the alternative tax under section 1201, earned taxable income shall not exceed the excess of taxable income over 50 percent of the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977).

(2) *Taxable income attributable to earned net income.* The portion of taxable income which is attributable to earned net income shall be determined by multiplying taxable income by a fraction (not exceeding one), the numerator of which is earned net income, and the denominator of which is adjusted gross income. For purposes of this subparagraph the term *earned net income* means the excess of the total of earned income (as defined in § 1.1343–(a)) over the total of any deductions which are required to be taken into account under section 62 in determining adjusted gross income and are properly allocable to or chargeable against earned income. Deductions are properly allocable to or chargeable against earned income if, and to the extent that, they are allowable in respect of expenses paid or incurred in connection with the production of earned income and have not been taken into account in determining the net profits of a trade or business in which both personal services and capital are material income producing factors (as defined in § 1.1348–3(a)(3)). Except as otherwise provided, deductions properly allocable to or chargeable against earned income include:

(i) Deductions attributable to a trade or business from which earned income is derived, except that if less than all the gross income from a trade or business constitutes earned income, only a ratable portion of the deductions attributable to such trade or business is allowable in respect of expenses paid or incurred in connection with the production of earned income,

(ii) Deductions consisting of expenses paid or incurred in connection with the performance of services as an employee,

(iii) The deductions described in section 62(7) and allowable by sections 404 and 405(c),

(iv) The deduction allowable by section 217,

(v) The deduction allowable by section 1379(b)(3), and

(vi) A net operating loss deduction to the extent that the net operating losses carried to the taxable year are properly allocable to or chargeable against earned income.

A net operating loss carried to the taxable year is properly allocable to or chargeable against earned income in such year to the extent of the excess (if any) of the deductions for the loss year which are properly allocable to or chargeable against earned income and which are allowable under section 172(d) in determining a net operating loss, over the earned income for the loss year. If the excess described in the preceding sentence is less than the entire net operating loss, such excess and the balance of such loss shall be deemed to reduce taxable income ratably for any taxable year to which such loss may be carried. See examples (3) and (4) in subparagraph (4) of this paragraph.

(3) *Tax preference offset.* (i) For purposes of subparagraph (1) of this paragraph, the *tax preference offset* is the amount by which the greater of:

(A) The average of the taxpayer's items of tax preference for the taxable year and the four preceding taxable years, or

(B) The taxpayer's items of tax preference for the taxable year,

exceeds $30,000.

(ii) The items of tax preference to be taken into account under subdivision (i) of this subparagraph for any taxable year shall be those items of tax preference referred to in section 57(a) and the regulations thereunder for the taxable year, but excluding any amount not taken into account in computing the tax under section 56(a) and the regulations thereunder for such taxable year. The items of tax preference to be taken into account by an individual for any taxable year in which such individual is or was a nonresident alien shall not include items of tax preference which are not effectively connected with the conduct of a trade or business within the United States.

(iii) Taxable years ending before January 1, 1970 shall not be included in computing the average described in subdivision (i)(A) of this subparagraph. Thus, for example, the tax preference offset for a taxable year ending on December 31, 1973, is the amount by which the average of the taxpayer's items of tax preference for 1970, 1971, 1972, and 1973, or the taxpayer's items of tax preference for 1973, whichever is greater, exceeds $30,000. Taxable years during which the taxpayer was not in existence shall not be included in computing the average described in subdivision (i)(A) of this subparagraph. A fractional part of a year which is treated as a taxable year under sections 441(b) and 7701(a)(23) shall be treated as a taxable year for purposes of this section for special rules if a taxable year referred to in subdivision (i)(A) of this subparagraph is a period of less than 12 months for which a return is required under section 443(a)(1).

(iv) If for the current taxable year the taxpayer and his spouse (or the estate of such spouse) file a joint return together, the items of tax preference for a preceding taxable year taken into account under subdivision (i)(A) of this subparagraph shall be the sum of the items of tax preference of the taxpayer and his spouse for such preceding year even though a joint return was not, or could not have been, filed by the taxpayer and such spouse for such preceding taxable year. If for the current taxable year the taxpayer (A) is no longer married to a spouse to whom he was married for a preceding taxable year taken into account under subdivision (i)(A) of this subparagraph and files a return as a single person, head of household, or surviving spouse for such current taxable year, or (B) is married to a spouse other than the spouse to whom he was married for a preceding taxable year taken into account under subdivision (i)(A) of this subparagraph, his items of tax preference shall be computed as if he were not married during such preceding taxable year.

(v) The sum of the items of tax preference of an estate or trust shall, for purposes of this paragraph, be apportioned between the estate or trust and the beneficiary in the manner and to the extent provided by section 58(c)(1) and the regulations thereunder.

(vi) If an item of gross income in respect of a decedent is includible in the gross income of a taxpayer and is treated as earned income in the hands of the taxpayer by reason of §1.1348–3(a)(4), the items of tax preference for a taxable year taken into account under subdivision (i) of this subparagraph shall be the sum of the taxpayer's items of tax preference for such taxable year and the decedent's items of tax preference for any taxable year of the decedent (including a short taxable year described in section 441(b)(3)) which ends with or within such taxable year of the taxpayer. For purposes of this subdivision, if a taxpayer (such as the estate of the decedent or a testamentary trust created by the decedent) has not been in existence for the number of preceding taxable years specified in subdivision (i)(A) or (iii) of this subparagraph, the items of tax preference for preceding taxable years taken into account shall be the taxpayer's items of tax preference for each of its preceding taxable years plus the decedent's items of tax preference for that number of the most recent taxable years of the decedent ending prior to the taxpayer's earliest taxable year which, when added to the taxpayer's preceding taxable years, equals such number of preceding taxable years specified in subdivision (i)(A), or (iii). The increase, if any, in the taxpayer's tax preference offset computed under this subdivision shall not exceed the amount by which the taxpayer's taxable income attributable to earned net income, computed as provided in § 1.1348–2(d)(2) and including the item of gross income in respect of a decedent, exceeds the taxpayer's taxable income attributable to earned net income computed without regard to such item of gross income.

(4) *Illustrations.* The provisions of this section may be illustrated by the following examples:

Example 1. (i) H and W, married calendar-year taxpayers filing a joint return, have the following items of income, deductions, and tax preference for 1976:

(a) Salary	$155,000	
(b) Dividends and interest	60,000	
Total	215,000	
(c) Deductible travel expenses of employee allocable to earned income	5,000	
(d) Adjusted gross income		$210,000
(e) Exemptions and itemized deductions		38,000
(f) Taxable income		172,000

In addition, the taxpayers have tax preference items for 1976 of $80,000 attributable to the exercise of a qualified stock option and total tax preference items of $300,000 for the years 1972 through 1975. Since the items of tax preference for 1976 exceed the average of the items of tax preference for the years 1972 through 1976, the tax preference offset for 1976 is $50,000 ($80,000 − $30,000).

(ii) H and W have earned taxable income of $72,857 determined in the following manner:

(a) Earned income		$155,000
(b) Earned net income ($155,000 − $5,000)		150,000
(c) Taxable income		172,000
(d) Adjusted gross income		210,000
(e) Taxable income attributable to earned net income: $172,000(c) × ($150,000(b) / $210,000(d)	$122,857	
(f) Tax preference offset	50,000	
(g) Earned taxable income		72,857

(iii) The tax imposed by section 1 is $90,938, determined pursuant to section 1348 in the following manner:

(a) Applicable amount from col. (2) of table A, § 1.1348–2(a)		$18,060
(b) 50 pct of amount by which $72,857 (earned taxable income) exceeds $52,000 (applicable amount from col. (1) of table A, § 1.1348–2(a))		10,429
(c) Tax computed under section 1 on $172,000 (taxable income)	$91,740	
(d) Tax computed under section 1 on $72,857 (earned taxable income)	29,291	
(e) Item (c) minus item (d)		962,449
(f) Tax (total of items (a), (b), and (e))		90,938

Example 2. (i) H and W, married calendar-year taxpayers filing a joint return, have the following items of income, deductions, and tax preference for 1976:

(a) Salary	$210,000	
(b) Dividends and interest	20,000	
(c) Net long-term capital gains	100,000	
Total	330,000	
(d) Sec. 1202 deduction (½ of net long-term capital gains)	50,000	
(e) Adjusted gross income		$280,000
(f) Exemptions and itemized deductions		40,000
(g) Taxable income		240,000

The taxpayers' tax preference item for 1976 is one-half of the net long-term capital gains of $100,000, or $50,000. The taxpayers have no items of tax preference for the years 1972 through 1975. Accordingly, their tax preference offset for 1976 is $20,000 ($50,000 − $30,000).

(ii) H and W have earned taxable income of $160,000, determined in the following manner:

(a) Earned net income		$210,000
(b) Taxable income		240,000
(c) Adjusted gross income		280,000
(d) Taxable income attributable to earned net income: $240,000(b) × ($210,000(a) / $280,000(c))	180,000	
(e) Tax preference offset	$20,000	
(f) Earned taxable income		$160,000

(iii) The tax imposed by section 1 is $122,560, determined pursuant to section 1348 in the following manner:

(a) Applicable amount from col. (2) of table A, § 1.1348–2(a)		$18,060
(b) 50 pct of amount by which $160,000 (earned taxable income) exceeds $52,000 (applicable amount from col. (1) of table A, § 1.1348–2(a))		54,000

(c) Tax computed under section 1201(b) on $240,000 (taxable income):		
(1) Tax under section 1201(b)(1) (tax under section 1 on $190,000 (taxable income excluding capital gains))	$104,080	
(2) Tax under section 1201(b)(2) (25 pct of subsection (d) gain of $50,000)	12,500	
(3) Tax under section 1201(b)(3) (tax under section 1 on $240,000 (taxable income) less tax under section 1 on $215,000 (amount subject to tax under section 1201(b)(1) plus 50 pct of subsection (d) gain)) ($138,980 − $121,480)	17,500	
Total	134,080	
(d) Tax computed under section 1 on $160,000 (earned taxable income)	83,580	
(e) Item (c) through item (d)		50,500
(f) Tax (total of items (a), (b), and (e))		$122,560

Example 3. (i) A, an unmarried calendar year taxpayer engaged in the practice of law, has the following items of income and deductions for 1973 and 1976:

	1973	1976
Gross income from law practice	$240,000	$100,000
Dividends	60,000	20,000
Expense paid in law practice	50,000	160,000
Investment interest	30,000	10,000
Casualty loss on personal residence (amount in excess of $100)		50,000

(ii) For 1976, A's deductions exceed his gross income, and his taxable income is therefore zero. In addition, A has a net operating loss of $100,000 (i.e., the excess of his deductions of $220,000 over his gross income of $120,000), which may be carried back to 1973. In computing his taxable income and earned taxable income for 1973, $60,000 (i.e., the excess of the expenses paid in A's law practice of $160,000, over his gross income from his law practice of $100,000) of the net operating loss deduction is properly allocable to or chargeable against earned income.

(iii) A's recomputed taxable income and earned taxable income for 1973 are $119,250 and $103,350 respectively, determined in the following manner:

Gross income ($240,000 + $60,000)	$300,000
Adjusted gross income ($300,000 − $50,000 − $100,000)	150,000
Taxable income ($150,000 − $30,000 − $750)	119,250
Earned net income ($240,000 − $50,000 − $60,000)	130,000
Earned taxable income ($130,000 / $150,000 × $119,250)	$103,350

Example 4. The facts are the same as in example (3) except that A's gross income from his law practice for 1973 is $40,000. Thus, for 1973, A's deductions (including the net operating loss deduction) exceed his gross income, and his recomputed taxable income is therefore zero. The taxable income subtracted from the net operating loss to determine the carryback to 1974 is $20,000 (i.e., $40,000 + $60,000 − $50,000 − $30,000), and thus the net operating loss carryback to 1974 is $20,000 (i.e., $40,000 + $60,000 − $50,000 − $30,000), and thus the net operating loss carryback from 1976 to 1974 is $80,000 (i.e., $100,000 − $20,000). Of this amount, $48,000 ($80,000 × [$60,000 (the excess of the expenses paid in 1976 in A's law practice over his gross income from his law practice) ÷ $100,000 (A's net operating loss for 1976)]) is properly allocable to or chargeable against earned income, and must be taken into account in recomputing A's taxable income and earned taxable income for 1974.

Example 5. A, an unmarried calendar year taxpayer, receives a salary of $80,000 from Corporation X in 1975 and also owns and operates a laundry in which both his capital and services are material income producing factors. A incurs no section 62 expenses with respect to the salary income. In 1975 the laundry, a sole proprietorship, has gross income of $100,000 and business expenses deductible under section 62 of $80,000. A reasonable allowance as compensation for A's personal services rendered by him in his laundry business would be $12,000. The net profits of the laundry business were $20,000.

A's earned income from the laundry business is limited to $6,000 (30 percent of $20,000). A's total earned income is $36,000 ($80,000+$60,000). Since the section 62 deductions of the laundry business have already been taken into account in computing net profits, they are not again taken into account in computing earned net income. Accordingly, A's earned net income for 1975 is $86,000.

Example 6. The facts are the same as example (5) except that the gross income of the laundry is $130,000 and the net profits from the laundry are $50,000. A's earned income from the laundry is $12,000. Even though the 30-percent-of-net profits limitation has not resulted in a reduction of A's earned income from the laundry, the expenses deducted in computing net profits do not reduce earned income. Accordingly, both the earned income and the earned net income of A for 1975 are $92,000.

Example 7. The facts are the same as example (5) except that the gross income of the laundry is $60,000 and the laundry has a net loss of $20,000. A's earned income from the laundry is $12,000. Since the laundry does not have net profits, the expenses of the laundry have not been taken into account in computing the net profits limitation. Accordingly, a ratable portion of deductible expenses of the laundry must be allocated to the earned income from the laundry in accordance with §1.1348–2(d)(2); $16,000 of the expenses are allocated to the earned income

($12,000/$60,000×$80,000). A's total earned income for 1975 is $92,000, and his earned net income is $76,000 ($92,000 minus $16,000).

[T.D. 7446, 41 FR 55337, Dec. 20, 1976, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1348–3 Definitions.

(a) *Earned income*—(1) *In general.* (i) For purposes of section 1348 and the regulations thereunder, the term *earned income* means any item of gross income which is earned income within the meaning of section 401(c)(2)(C) or 911(b) unless the item constitutes deferred compensation as defined in paragraph (b) of this section or is otherwise excluded by application of this paragraph. Thus, subject to such exceptions, the term includes:

(A) Wages, salaries, professional fees, bonuses, amounts includible in gross income under section 83, commissions on sales or on insurance premiums, tips, and other amounts received, actually or constructively, as compensation for personal services actually rendered regardless of the medium or basis of payment.

(B) Compensatory payments for personal services made prior to the time such services are actually rendered, provided such advance payments are not made for a purpose of minimizing Federal income taxes by reason of the application of section 1348, and are either customary in the particular profession, trade, or business, or are made for a bona fide business purpose.

(C) Prizes and awards in recognition of personal services includible in gross income under section 74, amounts includible in gross income under section 79 (relating to group-term life insurance purchased for employees), and amounts includible in gross income under section 1379(b) (relating to contributions to qualified pension plans in the case of certain shareholder-employees); and

(D) Gains (other than gain which is treated as capital gain under any provision of chapter 1) and net earnings derived from the sale or other disposition of, the transfer of any interest in, or the licensing of the use of property (other than good will) by an individual whose personal efforts created such property.

The term does not include such income as dividends (including an amount treated as a dividend by reason of section 1373(b) and § 1.1373–1), other distributions of corporate earnings and profits, gambling gains, or gains which are treated as capital gains under any provision of chapter 1. The term also does not include amounts received for refraining from rendering personal services or engaging in competitive activity or amounts received as consideration for the cancellation of an employment contract.

(ii) In the case of a nonresident alien individual, earned income includes only earned income from sources within the United States which is effectively connected with the conduct of a trade or business within the United States.

(2) *Earned income and employed assistants.* The entire amount received as professional fees shall be treated as earned income if the taxpayer is engaged in a professional occupation, such as a doctor, dentist, lawyer, architect, or accountant, even though he employs assistants to perform part or all of the services, provided the patients or clients are those of the taxpayer and look to the taxpayer as the person responsible for the services performed.

(3) *Earned income from business in which capital is material.* (i) If an individual is engaged in a trade or business (other than in corporate form) in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for the personal services actually rendered by the individual shall be considered earned income, but the total amount which shall be treated as the earned income of the individual from such a trade or business shall in no case exceed 30 percent of his share of the net profits of such trade or business (which share shall include any guaranteed payment (as defined by § 1.707–1(c)) received from a partnership). For purpose of the preceding sentence, the term *net profits of the trade or business* means the excess of gross income from such trade or business (including income from all sources,

whether or not subject to Federal income tax, and without taking into account any deductions which may be allowable under section 1202) over the deductions attributable to such trade or business.

(ii) Whether capital is a material income-producing factor must be determined by reference to all the facts of each case. Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business, as reflected, for example, by a substantial investment in inventories, plant, machinery, or other equipment. In general, capital is not a material income-producing factor where gross income of the business consists principally of fees, commissions, or other compensation for personal services performed by an individual. Thus, the practice of his profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which he conducts his practice since his capital investment is regarded as only incidental to his professional practice.

(iii) This subparagraph does not apply to gains and net earnings derived from the sale or other disposition of, the transfer of any interest in, or the licensing of the use of property by an individual whose personal efforts created such property which are, by reason of subparagraph (1)(i) of this paragraph, treated as earned income. Thus, for example, a research chemist's substantial capital investment in laboratory facilities which he uses to produce patentable chemical processes from which he derives gains within the meaning of this subdivision would not be considered a material income-producing factor.

(4) *Income in respect of a decedent.* An item of gross income in respect of a decedent includible in the gross income of a person described in section described in section 691(a)(1) shall be treated as earned income in the hands of such person for purposes of subparagraph (1) of this paragraph if such item of gross income would have constituted earned income of the decedent had he lived and received such amount. See §1.1348–2(d)(3)(vi) for rules relating to attribution of tax preferences by reason of an item of income in respect of a decedent.

(5) *Exceptions to definition of earned income.* For purposes of section 1348 and the regulations thereunder, the term *earned income* does not include:

(i) Any distribution to which section 72(m)(5), relating to certain amounts received by owner-employees from a trust described in section 401(a) or under a plan described in section 403(a), applies,

(ii) Any distribution to which section 402(e), relating to the treatment of certain total distributions from a trust described in section 401(a) or under a plan described in section 403(a), applies,

(iii) Any distribution to which section 402(a)(2), relating to capital gains treatment of certain total distributions from a trust described in section 401(a), applies,

(iv) Any distribution to which section 403(a)(2)(A), relating to capital gains treatment for certain distributions under a plan described in section 404(a)(2), applies, or

(v) Any deferred compensation within the meaning of paragraph (b) of this section.

(6) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example 1. A owns and operates an unincorporated laundering and dry cleaning business. A, assisted by his employees, devotes his entire time and attention to this business. Substantial capital is invested in the plant and equipment utilized in the laundering and dry cleaning of clothing for A's customers. Although personal services performed by A and his employees are a material income-producing factor in A's business, the capital investment in plant and equipment is not merely incidental to the performance of such services but is, as such, material to the production of business income. Therefore, A's laundering and dry cleaning business is one in which both personal services and capital are material income-producing factors within the meaning of paragraph (a)(3) of this section. A may treat as earned income for a taxable year a reasonable allowance as compensation for the personal services rendered by him in his business, but the amount so treated shall not exceed 30% of the net profits of his business for such year.

Example 2. In his unincorporated business as a real estate broker, which he conducts on a full-time basis, A performs substantial personal services, including solicitation of home buyers and sellers, escorting prospective buyers on house visits, arranging appraisal, financing, and legal services, and other related tasks. In the course of conducting such business, A often finances sales of real estate with his own capital, makes all the necessary arrangements incident to such financing, and a substantial portion of the gross income of the business consists of interest income from such financing. Under these facts and circumstances, both personal services and capital are material income-producing factors in A's real estate business within the meaning of paragraph (a)(3) of this section since the financing of real estate sales is an integral part of the entire business. Accordingly, A's earned income from his real estate business is limited to a reasonable allowance as compensation for the personal services A actually renders, but not in excess of 30% of the net profits from the business, including the interest income derived from financing sales of real estate.

Example 3. For his taxable year ending on December 31, 1973, A, a radiologist, reports fees of $100x for professional services rendered to his own patients during 1973. Since 1970, A has maintained his own office in a small building that he purchased for $60x. In addition, A owns X-ray equipment with an original cost of $300x which he uses in his professional practice. The entire $100x of professional fees earned by A during 1973 is treated as earned income, notwithstanding that A has a substantial capital investment in professional equipment and the office from which he conducts his medical practice, because such capital investment is only incidental to the rendition of personal services in A's professional practice.

(b) *Deferred compensation*—(1) *In general.* For purposes of section 1348 and the regulations thereunder, the term *deferred compensation* means, except as otherwise provided in subparagraph (2) of this paragraph, any compensation which is deferred within the meaning of that concept in section 404, including any deferred compensation to which the provisions of section 404 and the regulations thereunder apply and any other compensation taxation of which is deferred in a manner similar to the treatment applicable to deferred compensation to which such provisions apply. Thus, the term includes any amounts includable in gross income as compensation for personal services pursuant to a plan, or method having the effect of a plan, deferring the taxation of such payment to a taxable year later than that in which such services were rendered. For purposes of section 1348, the term *deferred compensation* is not limited to payments to common-law employees but also includes payments to self-employed individuals: nor is it material that no deduction is allowable in respect of all or part of such payments or that a deduction in respect thereof is allowable under some provision of the Code other than section 404. For example, amounts received by a retired partner pursuant to a written plan of the partnership of the kind described in section 1402(a)(10) constitute deferred compensation except as otherwise provided in subparagraph (2) of this paragraph. The term *deferred compensation,* as defined in this paragraph, shall have no application to a determination of the deductibility of any amount under section 162, 404, or any other provision of the Code.

(2) *Amounts not treated as deferred compensation.* Notwithstanding the provisions of subparagraph (1) of this paragraph, any amount includible in gross income as compensation before the end of the taxable year following the first taxable year of the taxpayer in which his right to receive such amount is not subject to any requirement or condition which would be treated as resulting in a substantial risk of forfeiture within the meaning of section 83 and the regulations thereunder does not constitute deferred compensation for purposes of section 1348 and the regulations thereunder. For purposes of this subparagraph, a fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) shall be treated as a taxable year.

(3) *Application to certain compensation*—(i) *In general.* This subparagraph provides rules for the application of the principles of subparagraphs (1) and (2) of this paragraph to certain types of compensation.

(ii) *Pension, etc., plans.* (A) In accordance with subparagraph (1) of this paragraph, the taxable portion of distributions under a pension, annuity, profit-sharing, or stock bonus plan, whether or not such plan meets the requirements of section 401(a), or pursuant to a method having the effect of such a plan, generally constitutes deferred compensation. However, under subparagraph (2) of this paragraph, such portion constitutes earned income if includible in gross income before the end of the taxable year following the first taxable year of the taxpayer in which his right to receive such amount is not subject to a substantial risk of forfeiture. In the case of a distribution under a contributory plan, the preceding sentence applies only to that part of the taxable portion of the distribution which is attributable to employer contributions to the plan. For purposes of the preceding sentence, that part of the taxable portion of a distribution which is attributable to employer contributions is the amount of such part, multiplied by a fraction, the numerator of which is the employer contributions to the plan on behalf of the employee (determined in accordance with the principles of §1.402(a)–2), and the denominator of which is the sum of such employer contributions and the net employee contributions to the plan (as defined in paragraph (a)(2) of §1.402(a)–2). Thus, if the employer does not contribute to the plan, no part of any distribution thereunder constitutes earned income. Amounts included in gross income under section 402(b), 403(c), or 1379(b)(1) in respect of employer contributions to a plan described in this subdivision do not constitute deferred compensation.

(B) If a recipient's rights to receive amounts pursuant to a plan cease to be subject to a substantial risk of forfeiture in more than one of his taxable years, each payment pursuant to such plan shall be considered to consist of a ratable portion of all of the amounts which are not subject to a substantial risk of forfeiture at the time of such payment. Thus, for example, if an employment contract provides in part that an employee or his estate is to receive in each of the fifteen years after the year in which he attains or would have attained age 65 an amount equal to $2,000 times his years of service with the employer and if he had eighteen years of service with the employer, each $36,000 payment would be considered to consist of 18 payments of $2,000, his right to receive one of which ceased to be subject to a substantial risk of forfeiture upon completing his first year of service with the employer, his right to receive another of which ceased to be subject to a substantial risk of forfeiture upon completing his second year of service with the employer, etc. Therefore, if the employee's last year of service with the employer was completed in the year in which he attained age 65, $2,000 of the first payment in the next year would not be deferred compensation under subparagraph (2) of this paragraph, and the remaining $34,000 of that payment and all of the other fourteen payments of $36,000 would be deferred compensation. If the employee's last year of service was completed in an earlier year, all fifteen payments would constitute deferred compensation in full.

iii) *Income attributable to options.* (A) Ordinary income realized by a taxpayer upon a disqualifying disposition of stock acquired pursuant to the exercise of a statutory option (as defined in §1.421–7(b)) is not deferred compensation for purposes of subparagraph (1) of this paragraph and, therefore, constitutes earned income.

(B) Ordinary income realized by a taxpayer upon the transfer of property pursuant to the exercise, or sale or other disposition, of an option which is not a statutory option (as defined in §1.421–7(b)) and which was granted on or before December 15, 1971, is not deferred compensation for purposes of subparagraph (1) of this paragraph and, therefore, constitutes earned income. Ordinary income realized by a taxpayer upon the transfer of property pursuant to the exercise, or sale or other disposition, of an option which is not a statutory option (as defined in §1.421–(b)) and which is granted after December 15, 1971 constitutes earned income rather than deferred compensation if such option cannot, by its terms, be exercised more than three months after termination (for any reason other than death) of the grantee's employment by the grantor of the option. If the terms of such an option granted after December 15, 1971 permit the exercise of the option more than three months after termination (for any reason other than death) of the grantee's employment by the grantor, ordinary income realized by a taxpayer upon the transfer of property pursuant to exercise, or sale or other disposition, of the option constitutes earned income rather than deferred compensation only if such income is realized in a taxable year no later than that following the taxable year in which the option was granted. In the case of the grantee's death within a period during which ordinary income realized upon the transfer of property pursuant to his exercise, or sale or other disposition, of an option described in this subdivision would have constituted earned income as provided in this subdivision had the grantee lived, ordinary income realized subsequently upon the transfer of property pursuant to exercise, or sale or other disposition, of an option described in this subdivision, by the grantee's legal represedntatives or beneficiary constitutes earned income only if such exercise or sale or other disposition, occurs on a date no later than the date twelve months following that of the grantee's death. For purposes of this subdivision, the term *employment by the grantor* includes employment by a related corporation as defined in § 1.421–7(i), and by a corporation which is considered a related corporation under § 1.421–7(h)(3). Therefore, the transfer of an employee from the grantor corporation to such a related corporation or from one related corporation to another related corporation or to the grantor corporation will not be treated as a termination of employment by the grantor.

(C) For purposes of (B) of this subdivision, if an option described therein and granted after December 15, 1971 is exercisable only following completion of a specified period of employment, the taxable year in which such period of employment is completed shall be treated as the taxable year in which the option was granted. Further, if the terms of an option described in (B) of this subdivision and granted after December 15, 1971 are modified, such modification shall not be considered as the granting of a new option for purposes of (B) in determining the taxable year in which such option was granted.

(D) For purposes of (B) of this subdivision, an option will not be considered exercisable by its terms more than three months following termination (for any reason other than death) of the grantee's employment by the grantor solely because the terms of such option permit, in the event of such grantee's death within three months following termination of such employment, exercise of the option by the grantee's legal representative or beneficiary during or following such three-month period.

(4) *Examples.* The application of this paragraph may be illustrated by the following examples, in each of which it is assumed that any amounts paid as described therein constitute salaries or other compensation for personal services actually rendered rather than a distribution of earnings and profits:

Example 1. (i) On January 1, 1965, Corporation X and E, an individual, execute an employment contract under which E is to be employed by X for a period of 10 years. Under the contract, E is entitled to a stated annual salary and to additional compensation of $10x for each year. This additional compensation is to be credited as of December 31 of each year to a bookkeeping reserve account and will be deferred, accumulated, and paid only upon termination of the employment contract, E's becoming a part-time employee of X, or E's becoming partially or totally incapacitated. Under the terms of the contract, X is merely under a contractual obligation to make the payments when due, and neither X nor E intends that the amounts in the reserve be held by X in trust for E. The contract provides that if E shall fall or refuse to perform his duties, X will be relieved of any obligation to make further credits to the reserve but not of the obligation to distribute amounts previously credited to the reserve. In the event E should die prior to his receipt in full of the balance in the account, the remaining balance is distributed to his personal representative.

(ii) Having completed the terms of his employment contract, E retires from the employment of X on December 31, 1974, and on January 15, 1975, receives a total distribution of $100x from his reserve account. Of this distribution of $100x to E, only $10x, representing the credit made to E's reserve account in 1974, constitutes earned income. No other credits to E's reserve account are taken into account for this purpose because they were made to the reserve account and became nonforfeitable in a year earlier than the year preceding that in which the $100x distribution was made to E.

Example 2. (i) Corporation X follows a policy of permitting employees to elect before the beginning of any calendar year to defer the receipt of either 5 percent or 10 percent of their stated annual salary to be earned in that year. E, an employee, elects for each of 10 years of employment to defer receipt of $5x of his stated annual salary. The total so deferred, or $50x, is paid to E on January 15, 1974.

(ii) Since the salary which E elects to defer is includible in his gross income only in the taxable year in which actually received by him, then to the extent E receives any such deferred salary payment after the end of the taxable year following the taxable year from which such payment was deferred, such payment does not constitute earned income since such payment is deferred compensation under this paragraph (b). Accordingly, of the $50x distribution to E, only $5x, representing the salary deferral from 1973, constitutes earned income.

Example 3. (i) E is an officer of Corporation X, which has a plan for making future payments of additional compensation for current services to certain employees. The plan provides that a fixed percentage of the annual net earnings in excess of $400x is to be designated for division among the participants. This amount is not currently paid to the participants; but X has set up on its books a separate account for each participant, including E, and each year it credits thereto the dollar amount of his participation for the year. Distributions are to be made from the account when the employee reaches the age of 60, is no longer employed by X, including cessation of employment due to death, or becomes totally unable to perform his duties, whichever occurs first. X's liability to make these distributions is contingent upon the employee's refraining from engaging in any business competitive to that of X, making himself available to X for consultation and advice after retirement or termination of his services, unless disabled, and retaining unencumbered any interest or benefit under the plan. In the event of his death, either before or after the beginning of payments, amounts in an employee's account are distributable to his designated beneficiaries of heirs-at-law. Under the facts and circumstances, E's rights to distributions from his account pursuant to the terms of the plan are not subject to a substantial risk of forfeiture within the meaning of section 83(c)(1). Under the terms of the compensation plan, X is under a merely contractual obligation to make the payments when due, and the parties did not intend that the amounts in each account be held by X in trust for the participants.

(ii) Cash or property includable in gross income by E which is attributable to a credit to his account in a taxable year earlier than the year immediately preceding the year on onclusion does not constitute earned income since it is deferred compensation within the meaning of this paragraph (b). See subparagraph (3) of this paragraph (b) for rules for determining that portion of distributions from E's acount which are attributable to credits to his account in a taxable year immediately preceding the year in which such distributions are made.

Example 4. (i) Corporation X has an annual incentive bonus plan for its employees. Under this plan, X has the sole discretion to defer all or any part of any employee's incentive bonus award. In addition, no employee has any right to receive any incentive bonus for any year (whether to be paid currently or to be deferred) until such time, if any, as X makes an award to him. No employee has any election as to the amount or time of payment of his award for any year. Furthermore, the last of any payments under an award must be paid no later than 10 years from the normal retirement date of the employee. In addition, the obligations of X under the plan are merely contractual and are not funded or secured. The awards are nonassignable. However, in the case of death the awards are payable to the employee's designated beneficiary. Once made, a bonus award under the plan is not subject to any substantial risk of forfeiture.

(ii) In each of the years 1967, 1968, 1969, and 1970, X awards E a deferred bonus of $100x. E retires on June 30, 1971. Beginning in 1971, X pays to E the total of $400x of deferred bonus awards in 5 annual installments of $80x each. With respect to the $80x payment made to E in 1971, $20x, representing the ratable portion of the payment ($100x/$400x×$80x) allocable to the 1970 bonus award, is earned income because it was received in a year no later than the year following that (1970) in which E's right to receive such amount was no longer subject to a substantial risk of forfeiture. The balance of the $80x payment made in 1971 and all payments made subsequently constitute deferred compensation.

Example 5. (i) Under the terms of a nonqualified bonus planfor its executive employees, Corporation M contributes each year to a bonus reserve a given percentage of its net earnings for the year. M makes bonus awards each year from the reserve in cash or stock of M, or a combination of both, to such executive employees, and in such amounts, as M may determine. The bonus award so determined to be made to a beneficiary is paid to him in installments: 20 percent of the award at the time that the award is made and the remaining installments in January of each succeeding year (until the full amount of the award is paid). Such amounts are payable in succeeding years but only if earned out by the employee by continuing service to M, at the rate of 1⁄12th of the amount of the first installment for each complete month of service beginning with the year of determination. If the beneficiary voluntarily terminates his employment, is discharged for cause, or conducts himself in a manner inimical to the best interests of M, he forfeits the rights to receive any portion of his bonus award previously earned out but undelivered to him and to continue earning out his bonus award. Upon retirement a beneficiary retains the right to earn out an unearned bonus award but forfeits the right to continue earning out the award if he conducts himself in a manner inimical to M's best interests or engages in an activity which is in competition with an activity of M. If a beneficiary dies while earning out a bonus award, any unpaid and undelivered portion of his award is paid and delivered to his estate or heirs at such time and in such manner as if the beneficiary were living.

(ii) On January 1, 1971, M makes a cash bonus award to A of $100x. On January 15, 1971, $20x, representing representing the first installment of the award, is paid to A. On January 15, 1972, $20x, representing the portion of the award earned out by A during the calendar year 1971 is paid to him. On January 1, 1972, A retires from employment with M and, having satisfied the conditions to continue earning out his bonus award, receives $20x on January 15, 1975.

(iii) Under the facts and circumstances, the conditions that A not conduct himself in a manner inimical to the best interests of M and refrain from activity competitive to that of M are not considered to result in a substantial risk of forfeiture of the bonus award. The total installments of $40x paid to A in 1971 and 1972 constitute earned income. The installment of $20x earned out by A in 1972 and paid to him in 1973 also constitutes earned income for the taxable year 1973 because it was includible in gross income by A before the end of the taxable year of A following the first taxable year (the year of his retirement, i.e., 1972) in which his right to receive the installment was not subject to a substantial risk of forfeiture. The installments paid to A in 1974 and 1975, however, do not constitute earned income because they were paid in a year later than the year following the year of A's retirement. Had the conditions that A not conduct himself in a manner inimical to the best interests of M and refrain from activity competitive to that of M constituted a substantial risk of forfeiture, the installments paid to A in 1974 and 1975 would have constituted earned income.

Example 6. On January 15, 1968, Corporation M, under the terms of a nonqualified bonus plan for its employees, grants to A, an employee, 5,000 *dividend units,* which entitle A to receive, for the period during which the award remains in effect, a cash payment equal to the dividends declared andpaid by M on the equivalent of 5,000 shares of its capital stock. The award remains in effect for A's lifetime but is subject to forfeiture if A is dismissed or leaves the service of M for any reason other than his death or retirement, or if A, following his retirement, engages in any activity which is harmful to the interests of M. Under the particular facts and circumstances, the condition that A not engage in any harmful activity is not considered to amount to a substantial risk of forfeiture within the meaning of section 83(c)(1). A retires on January 1, 1971. In each of the calendar years 1971, 1972, 1973, and 1974. A receives cash payments of $5x under his bonus award. The payments totaling $10x to A in the years 1971 and 1972 constitute earned income because A received them before the end of the taxable year following the first taxable year (i.e., 1971, the year in which A retired) in which his right to receive such payments was not subject to a substantial risk of forfeiture. Payments totaling $10x to A in 1973 and 1974, however, constitute deferred compensation under paragraph (b) of this section.

Example 7. Corporation M maintains an employees' profit sharing trust which is not exempt from tax under section 501(a). Under the terms of the trust agreement, the interest of the trust beneficiaries in each contribution made to the trust by M is subject to asubstantial risk of forfeiture for a period of 2 years from the date on which the particular contribution is made, except that upon a beneficiary's retirement, his entire interest in the trust vests immediately. Contributions are made on December 30 of each year. As of August 1, 1969, the total interest, forfeitable and nonforfeitable, of A, an employee of M, in the trust is $320x. On December 30 in each of the years 1969, 1970, and 1971, M makes a further contribution to the trust allocable to A's account equal to $60x. A retires on December 31, 1971, and becomes entitled to a total distribution from the trust of $500x, of which $320x represents M's contributions made prior to August 1, 1969, and $180x represents contributions made subsequent to such date. Beginning in 1972, the trust distributes to A $500x in 5 equal annual installments. Because M's contributions to A's account for the years subsequent to August 1, 1969, totaling $180x vested as of his retirement date, such contributions of $180x constitute earned income of A for the year 1971 by reason of § 1.402(b)–1(b). No portion of any annual installment of $100x which is includible in A's gross income constitutes earned income since it is attributable to the $320x, in all of which A's rights became nonforfeitable no later than December 30, 1970.

Example 8. Corporation M maintains a qualified noncontributory pension plan for the benefit of its employees. Under the terms of the plan, no employee has a vested right to receive any distribution under the plan prior to his retirement from the employment of M upon reaching the age of 65. A, an employee of M, reaches age 65 on June 15, 1972, and retires on June 30, 1972. Under the terms of the pension plan, A becomes entitled to receive a monthly pension of $5x, beginning on July 1, 1972. A receives pension payments totalling $30x in 1972, $60x in 1973, $60x in 1974, $60x in 1975, and $60x in 1976. The pension payments received by A in 1972 and 1973 constitute earned income within paragraph (b)(3)(ii) of this section. The pension payments received by A in 1974, 1975, and 1976 constitute deferred compensation.

Example 9. (i) A is a participant in X Corporation's noncontributory qualified pension plan. The plan provides an annual benefit upon attaining age 65 of 2 percent of average compensation for each calendar year of participation in the plan. Average compensation is defined as the average of an employee's annual compensation over the last 5 calendar years of service. The plan provides that an employee's rights in his accrued benefit are nonforfeitable after 15 years of participation in the plan. A attains age 65 on June 20, 1975 and begins to receive a pension on July 1, 1975. A's pension is based upon 30 years of participation in the plan. A's annual compensation for the period 1969 through 1974, is as follows:

Year	Annual Compensation
1969	$75,000
1970	80,000
1971	80,000
1972	85,000
1973	85,000
1974	90,000

(ii) Under the terms of the plan, A's accrued benefit as of December 31, 1974, and his pension are $50,400 (0.02 × 30 × 1/5 ($80,000 + $80,000 + $85,000 + $90,000)). A's accrued benefit as of December 31, 1973, is $46,980 (0.02 × 29 × 1/5 $85,000)). Since A's rights in $46,980 of his accrued benefit had ceased to be subject to a substantial risk of forfeiture before 1974, only $285 (1/12 × ($50,400 − $46,980)) of each payment received during 1975 does not constitute deferred compensation. The balance of the amounts received during 1975 and all amounts received in 1976 constitute deferred compensation since they are paid after the end of the taxable year following A's first taxable year in which his right to receive any such amount was not subject to a substantial risk of forfeiture.

Example 10. On January 15, 1971, Corporation M grants to A, an employee, an option to purchase 100 shares of stock of M at a price of $10x per share. Such option constitutes a qualified stock option constitutes a qualified stock option as defined in section 422(b). On August 1, 1971, A exercises his option, at which time the fair market value of the 100 shares of M Stock is $15x per share. On April 24, 1972, A sells the 100 shares of M stock acquired pursuant to exercise of his option at a price of $25x per share. Because the sale constitutes a disqualifying disposition within the meaning of section 421(b), A realizes ordinary income of $500x and a capital gain of $1,000x in the taxable year 1972. The $500x of ordinary income so realized by A constitutes earned income.

Example 11. On November 30, 1072, Corporation M grants to A, an employee, a nonqualified stock option to which section 421 does not apply and which has no readily ascertainable fair market value on that date. The option may, by its terms, be exercised by A at any time during, or following termination of, his employment. On March 30, 1974, A, while still employed by M, exercises his option and realizes compensation income at that time. Such compensation does not constitute earned income because the option is exercisable within a period that may extend beyond three months after A's termination of employment (other than by reason of death). See paragraph (b)(3)(iii)(B) of this section. Had A exercised his option at any time prior to January 1, 1974, the compensation realized by him by reason of such exercise would have constituted earned income.

Example 12. On November 30, 1972, Corporation N grants to B, an employee, a nonqualified stock option to which section 421 does not apply and which has no readily ascertainable fair market value on that date. The option may by its terms, be exercised only within the period during which B is employed by N or within three months thereafter. On March 30, 1974, B exercises his option and realizes compensation at that time. Such compensation so realized by B constitutes earned income. See paragraph (b)(3)(iii)(B) of this section.

Example 13. On May 9, 1973, and in connection with the performance of services by E, an employee, Corporation X transfers to E 100 shares of X stock. Under the terms of the transfer, E is subject to a binding commitment to return the stock to X if E leaves X's employment for any reason prior to the expiration of a 3-year period beginning on the date of transfer. Since E must perform substantial services for X before he may keep the X stock, E's rights in the stock are subject to a substantial risk of forfeiture under section 83(c)(1). Consequently, if such restriction lapses on May 9, 1976, the compensation realized at such time constitutes earned income. Had E elected to include an amount in his gross income in 1973 pursuant to section 83(b) and the regulations thereunder, the amount so included would also have constituted earned income.

Example 14. On October 1, 1971, A, an author, and Corporation M, a publisher, executed an agreement under which A granted to M the exclusive right to print, publish and sell a book he had written. The agreement provides that M will pay to A specified royalties based on the actual cash received from the sale of the published work, render semiannual statements of the sales, and at the time of rendering each statement make settlement for the amount due. On the same day, another agreement was signed by A and M, mutually agreeing that, in consideration of, and notwithstanding, any contrary provisions contained in the first contract, M shall not pay A more than $100x in any one calendar year. Under this supplemental contract, sums in excess of $100x accruing in any one calendar year are to be carried over by M into succeeding years. For the calendar year 1971, royalties payable to A under the basic agreement amount to $100x and this sum is paid to A. For the calendar year 1972, royalties of $120x are payable to A under the basic agreement, but by reason of the supplemental agreement, only $100x of this sum is actually paid to A. For each of the calendar years 1973 and 1974, royalties of $100x are payable to A under the basic agreement, and this sum is paid to A. For the calendar year 1975, royalties of $80x are payable to A under the basic agreement, and this sum, plus $20x carried over from 1972, or $100x, is paid to A. The $100x paid to A in each of the years 1971, 1972, 1973, and 1974, and $80x of the $100x paid to A in 1975 constitute earned income. The additional $20x carried over from 1972 and paid to A in 1975 constitutes deferred compensation under this paragraph (b) because it was paid to A later than the end of the year following the year (i.e., 1972) in which A's right to receive the amount was not subject to a substantial risk of forfeiture.

Example 15. Corporation M is the producer and owner of a feature length motion picture which is distributed to exhibitors by Corporation N pursuant to a distribution agreement between M and N providing for current payments to M of a given percentage of the current net profits derived by N from the exhibition and exploitation of the picture. A was employed by M as the leading actor in the picture for fixed compensation payable at the rate of $10x per week during the production period plus additional compensation equal to a given percentage of the net profits derived from the exhibition and exploitation of the picture. A's additional compensation is payable at the time that M receives payments from N under the terms of the distribution agreement. The additional compensation paid to A does not constitute deferred compensation since it is attributable to and measured by current net profits derived from the use of property created in part by A's efforts.

Example 16. A, a boxer entered into an agreement with M boxing club to fight a particular opponent on June 19, 1971. The agreement provided in part, that for his performance A was to receive 16 percent of the gross receipts derived from the match. Simultaneously, A and M executed a separate agreement providing for payment of A's share of the receipts from the match as follows: 25 percent thereof not later than August 15, 1971, and 25 percent thereof during each of the years 1972, 1973, and 1974 in equal semiannual installments. A's share of the gross receipts derived from the match was $100x, of which 25 percent was paid to him in 1971 and a total of $25x in each of the years 1972, 1973, and 1974. Under the particular facts and circumstances, A and M are not acting as partners or joint venturers. Thus, A is taxable upon his share of such gross receipts only in the years in which such share is actually paid to him under the terms of the separate agreement. The payments of $25x in each of the years 1971 and 1972 constitute earned income. The payments of $25x in each of the years 1973 and 1974 would not constitute earned income because they constitute deferred compensation received later than the end of the first taxable year (i.e., 1972) following the year in which A's right to receive such amounts was not subject to a substantial risk of forfeiture.

[T.D. 7446, 41 FR 55339, Dec. 20, 1976]

SMALL BUSINESS CORPORATIONS AND THEIR SHAREHOLDERS

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[T.D. 8600, 60 FR 37581, July 21, 1995]

§1.1361–1 S corporation defined.

(a) *In general.* For purposes of this title, with respect to any taxable year—

(1) The term *S corporation* means a small business corporation (as defined in paragraph (b) of this section) for which an election under section 1362(a) is in effect for that taxable year.

(2) The term *C corporation* means a corporation that is not an S corporation for that taxable year.

(b) *Small business corporation defined*—(1) *In general.* For purposes of subchapter S, chapter 1 of the Code and the regulations thereunder, the term *small business corporation* means a domestic corporation that is not an ineligible corporation (as defined in section 1361(b)(2)) and that does not have—

(i) More than 35 shareholders;

(ii) As a shareholder, a person (other than an estate and other than certain trusts described in section 1361(c)(2)) who is not an individual;

(iii) A nonresident alien as a shareholder; or

(iv) More than one class of stock.

(2) *Estate in bankruptcy.* The term *estate*, for purposes of this paragraph, includes the estate of an individual in a case under title 11 of the United States Code.

(3) *Treatment of restricted stock.* For purposes of subchapter S, stock that is issued in connection with the performance of services (within the meaning of § 1.83–3(f)) and that is substantially nonvested (within the meaning of § 1.83–3(b)) is not treated as outstanding stock of the corporation, and the holder of that stock is not treated as a shareholder solely by reason of holding the stock, unless the holder makes an election with respect to the stock under section 83(b). In the event of such an election, the stock is treated as outstanding stock of the corporation, and the holder of the stock is treated as a shareholder for purposes of subchapter S. See paragraphs (l) (1) and (3) of this section for rules for determining whether substantially nonvested stock with respect to which an election under section 83(b) has been made is treated as a second class of stock.

(4) *Treatment of deferred compensation plans.* For purposes of subchapter S, an instrument, obligation, or arrangement is not outstanding stock if it—

(i) Does not convey the right to vote;

(ii) Is an unfunded and unsecured promise to pay money or property in the future;

(iii) Is issued to an individual who is an employee in connection with the performance of services for the corporation or to an individual who is an independent contractor in connection with the performance of services for the corporation (and is not excessive by reference to the services performed); and

(iv) Is issued pursuant to a plan with respect to which the employee or independent contractor is not taxed currently on income.

A deferred compensation plan that has a current payment feature (e.g., payment of dividend equivalent amounts that are taxed currently as compensation) is not for that reason excluded from this paragraph (b)(4).

(5) *Treatment of straight debt.* For purposes of subchapter S, an instrument or obligation that satisfies the definition of straight debt in paragraph (l)(5) of this section is not treated as outstanding stock.

(6) *Effective date provision.* Section 1.1361–1(b) generally applies to taxable years of a corporation beginning on or after May 28, 1992. However, a corporation and its shareholders may apply this §1.1361–1(b) to prior taxable years. In addition, substantially nonvested stock issued on or before May 28, 1992, that has been treated as outstanding by the corporation is treated as outstanding for purposes of subchapter S, and the fact that it is substantially nonvested and no section 83(b) election has been made with respect to it will not cause the stock to be treated as a second class of stock.

(c) *Domestic corporation.* For purposes of paragraph (b) of this section, the term *domestic corporation* means a domestic corporation as defined in §301.7701–5 of this chapter, and the term *corporation* includes an entity that is classified as an association taxable as a corporation under §301.7701–2 of this chapter.

(d) *Ineligible corporation*—(1) *General rule.* Except as otherwise provided in this paragraph (d), the term *ineligible corporation* means a corporation that is—

(i) A member of an affiliated group (determined under section 1504 without regard to any exception contained in section 1504(b)), whether or not that affiliated group has ever filed a consolidated return;

(ii) A financial institution to which section 585 applies (or would apply but for section 585(c)) or to which section 593 applies;

(iii) An insurance company subject to tax under subchapter L;

(iv) A corporation to which an election under section 936 applies; or

(v) A DISC or former DISC.

(2) *Exceptions.* See the special rules and exceptions provided in sections 6(c) (2), (3) and (4) of Public Law 97–354 that are applicable for certain casualty insurance companies and qualified oil corporations.

(3) *Inactive corporation exception.* (i) For purposes of paragraph (d)(1)(i) of this section, a corporation (parent corporation) will not be treated as a member of an affiliated group during any period within a taxable year by reason of the ownership of stock in another corporation (subsidiary corporation) if the subsidiary corporation—

(A) Has not begun business at any time on or before the close of that period; and

(B) Does not have gross income for that period.

(ii) The determination under paragraph (d)(3)(i) of this section of the date on which a subsidiary corporation begins business is made by taking into account all the facts and circumstances of the particular case. A corporation has not begun business, however, merely because it is in existence. Ordinarily, a corporation begins business when it starts the business operations for which it was organized. Mere organizational activities, such as the obtaining of the corporate charter, are not alone sufficient to constitute the beginning of business. An example of a corporation that has not begun business is a corporation incorporated for the sole purpose of reserving a corporate name in a state or states in which the parent corporation is not doing business. If the activities of a corporation have advanced to the extent necessary to establish the nature of its business operations, however, the corporation is deemed to have begun business. For example, a corporation that acquires operating assets necessary for the type of business contemplated may be deemed to have begun business.

(iii) If a subsidiary corporation ceases to be an inactive corporation as defined in paragraph (d)(3)(i) of this section, then the parent corporation's election under section 1362(a) will terminate on the earlier of the first day that the subsidiary corporation begins business, or the first day, determined under the subsidiary corporation's method of accounting, that the subsidiary corporation realizes gross income.

(iv) The application of paragraph (d)(3) of this section is illustrated by the following examples:

Example 1. In 1996, Corporation P, a C corporation, owns all of the stock of Corporation Q. P and Q both use the calendar year as their taxable year. For purposes of paragraph (d)(1)(i) of this section, P would not be considered at any time during 1996 to be a member of an affiliated group solely by reason of its ownership of Q's stock if Q has not begun business at any time on or before January 1, 1997, and has no gross income for calendar year 1996 or any prior calendar year. Thus, P could qualify as a small business corporation during 1996 if it meets the other requirements provided in section 1361(b). Assuming that P's ownership of Q stock remains unchanged, P would cease to be a small business corporation on the day that Q either begins business or realizes gross income (determined under Q's method of accounting), whichever day occurs earlier.

Example 2. Assume the same facts as in *Example 1,* except that Corporation Q had begun business prior to 1995, but became inactive in 1995. For purposes of paragraph (d)(1)(i) of this section, P is considered to be a member of an affiliated group because Q had begun business prior to becoming inactive in 1995. Therefore, even though Q was inactive in 1996, P is not eligible to make the S election until P liquidates Q.

(e) *Number of shareholders*—(1) *General rule.* A corporation does not qualify as a small business corporation if it has more than 35 shareholders. Ordinarily, the person who would have to include in gross income dividends distributed with respect to the stock of the corporation (if the corporation were a C corporation) is considered to be the shareholder of the corporation. For example, if stock (owned other than by a husband and wife) is owned by tenants in common or joint tenants, each tenant in common or joint tenant is generally considered to be a shareholder of the corporation. (For special rules relating to stock owned by husband and wife, see paragraph (e)(2) of this section; for special rules relating to restricted stock, see paragraphs (b) (3) and (6) of this section.) The person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation for purposes of this paragraph (e) and paragraphs (f) and (g) of this section. For example, a partnership may be a nominee of S corporation stock for a person who qualifies as a shareholder of an S corporation. However, if the partnership is the beneficial owner of the stock, then the partnership is the shareholder, and the corporation does not qualify as a small business corporation. In addition, in the case of stock held for a minor under a uniform gifts to minors or similar statute, the minor and not the custodian is the shareholder. For purposes of this paragraph (e) and paragraphs (f) and (g) of this section, if stock is held by a decedent's estate, the estate (and not the beneficiaries of the estate) is considered to be the shareholder; however, if stock is held by a subpart E trust (which includes voting trusts), the deemed owner is considered to be the shareholder.

(2) *Special rules relating to stock owned by husband and wife.* For purposes of paragraph (e)(1) of this section, stock owned by a husband and wife (or by either or both of their estates) is treated as if owned by one shareholder, regardless of the form in which they own the stock. For example, if husband and wife are owners of a subpart E trust, they will be treated as one individual. Both husband and wife must be U.S. citizens or residents, and a decedent spouse's estate must not be a foreign estate as defined in section 7701(a)(31). The treatment described in this paragraph (e)(2) will cease upon dissolution of the marriage for any reason other than death.

(f) *Shareholder must be an individual or estate.* Except as otherwise provided in paragraph (e)(1) (relating to nominees and paragraph (h) (relating to certain trusts) of this section, a corporation in which any shareholder is a corporation, partnership, or trust does not qualify as a small business corporation.

(g) *Nonresident alien shareholder*—(1) *General rule.* (i) A corporation having a shareholder who is a nonresident alien as defined in section 7701(b)(1)(B) does not qualify as a small business corporation. If a U.S. shareholder's spouse is a nonresident alien who has a current ownership interest (as opposed, for example, to a survivorship interest) in the stock of the corporation by reason of any applicable law, such as a state community property law or a foreign country's law, the corporation does not qualify as a small business corporation from the time the nonresident alien spouse acquires the interest in the stock. If a corporation's S election is inadvertently terminated as a result of a nonresident alien spouse being considered a shareholder, the corporation may request relief under section 1362(f).

(ii) The following examples illustrate this paragraph (g)(1)(i):

Example 1. In 1990, W, a U.S. citizen, married H, a citizen of a foreign country. At all times H is a nonresident alien under section 7701(b)(1)(B). Under the foreign country's law, all property acquired by a husband and wife during the existence of the marriage is community property and owned jointly by the husband and wife. In 1996 while residing in the foreign country, W formed X, a U.S. corporation, and X simultaneously filed an election to be an S corporation. X issued all of its outstanding stock in W's name. Under the foreign country's law, X's stock became the community property of and jointly owned by H and W. Thus, X does not meet the definition of a small business corporation and therefore could not file a valid S election because H, a nonresident alien, has a current interest in the stock.

Example 2. Assume the same facts as *Example 1,* except that in 1991, W and H filed a section 6013(g) election allowing them to file a joint U.S. tax return and causing H to be treated as a U.S. resident for purposes of chapters 1, 5, and 24 of the Internal Revenue Code. The section 6013(g) election applies to the taxable year for which made and to all subsequent taxable years until terminated. Because H is treated as a U.S. resident under section 6013(g), X does meet the definition of a small business corporation. Thus, the election filed by X to be an S corporation is valid.

(2) *Special rule for dual residents.* [Reserved]

(h) *Special rules relating to trusts*—(1) *General rule.* In general, a trust is not a permitted small business corporation shareholder. However, except as provided in paragraph (h)(2) of this section, the following trusts are permitted shareholders:

(i) *Qualified subpart E trust.* A trust all of which is treated (under subpart E, part I, subchapter J, chapter 1) as owned by an individual (whether or not the grantor) who is a citizen or resident of the United States (a qualified subpart E trust). This requirement applies only during the period that the trust holds S corporation stock.

(ii) *Subpart E trust ceasing to be a qualified subpart E trust after the death of deemed owner.* A trust which was a qualified subpart E trust immediately before the death of the deemed owner and which continues in existence after the death of the deemed owner, but only for the 60-day period beginning on the day of the deemed owner's death. However, if a trust is described in the preceding sentence and the entire corpus of the trust is includible in the gross estate of the deemed owner, the trust is a permitted shareholder for the 2-year period beginning on the day of the deemed owner's death. A trust is considered to continue in existence if the trust continues to hold the stock of the S corporation during the period of administration of the decedent's estate or if, after the period of administration, the trust continues to hold the stock pursuant to the terms of the will or the trust agreement. See §1.641(b)–3 for rules concerning the termination of estates and trusts for Federal income tax purposes. If the trust consists of community property, and the decedent's community property interest in the trust is includible in the decedent's gross estate under chapter 11 (section 2001 and following, relating to estate tax), then the entire corpus of the trust will be deemed includible in the decedent's gross estate. Further, for the purpose of determining whether the entire corpus of the trust is includible in the gross estate of the deemed owner, if the decedent's spouse was treated as an owner of a portion of the trust under subpart E immediately before the decedent's death, the surviving spouse's portion is disregarded.

(iii) *Electing qualified subchapter S trusts.* A qualified subchapter S trust (QSST) that has a section 1361(d)(2) election in effect (an electing QSST). See paragraph (j) of this section for rules concerning QSSTs including the manner for making the section 1361(d)(2) election.

(iv) *Testamentary trusts.* A trust (other than a qualified subpart E trust or an electing QSST) to which S corporation stock is transferred pursuant to the terms of a will, but only for the 60-day period beginning on the day the stock is transferred to the trust.

(v) *Qualified voting trusts.* A trust created primarily to exercise the voting power of S corporation stock transferred to it. To qualify as a voting trust for purposes of this section (a qualified voting trust), the beneficial owners must be treated as the owners of their respective portions of the trust under subpart E and the trust must have been created pursuant to a written trust agreement entered into by the shareholders, that—

(A) Delegates to one or more trustees the right to vote;

(B) Requires all distributions with respect to the stock of the corporation held by the trust to be paid to, or on behalf of, the beneficial owners of that stock;

(C) Requires title and possession of that stock to be delivered to those beneficial owners upon termination of the trust; and

(D) Terminates, under its terms or by state law, on or before a specific date or event.

(2) *Foreign trust.* For purposes of paragraph (h)(1) of this section, in any case where stock is held by a foreign trust as defined in section 7701(a)(31), the trust is considered to be the shareholder and is an ineligible shareholder. Thus, even if a foreign trust qualifies as a subpart E trust (e.g., a qualified voting trust), any corporation in which the trust holds stock does not qualify as a small business corporation.

(3) *Determination of shareholders*—(i) *General rule.* For purposes of paragraph (b) of this section (qualification as a small business corporation), and, except as provided in paragraph (h)(3)(ii) of this section, for purposes of sections 1366 (relating to the pass-through of items of income, loss, deduction, or credit), 1367 (relating to adjustments to basis of shareholder's stock), and 1368 (relating to distributions), the shareholder of S corporation stock held by a trust that is a permitted shareholder under paragraph (h)(1) of this section is determined as follows:

(A) If stock is held by a qualified subpart E trust, the deemed owner of the trust is treated as the shareholder.

(B) If stock is held by a trust defined in paragraph (h)(1)(ii) of this section, the estate of the deemed owner is generally treated as the shareholder as of the day of the deemed owner's death. However, if stock is held by such a trust in a community property state, the decedent's estate is the shareholder only of the portion of the trust included in the decedent's gross estate (and the surviving spouse continues to be the shareholder of the portion of the trust owned by that spouse under the applicable state's community property law). The estate ordinarily will cease to be treated as the shareholder upon the earlier of the transfer of the stock by the trust or the expiration of the 60-day period (or, if applicable, the 2-year period) beginning on the day of the deemed owner's death. If the trust qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of the QSST election, and the rules provided in paragraph (j)(7) of this section apply.

(C) If stock is held by an electing QSST, see paragraph (j)(7) of this section for the rules on who is treated as the shareholder.

(D) If stock is transferred to a testamentary trust (other than a qualified subpart E trust or an electing QSST), the estate of the testator is treated as the shareholder until the earlier of the transfer of that stock by the trust or the expiration of the 60-day period beginning on the day that the stock is transferred to the trust.

(E) If stock is held by a qualified voting trust, each beneficial owner of the stock, as determined under subpart E, is treated as a shareholder with respect to the owner's proportionate share of the stock held by the trust.

(ii) *Exceptions.* Solely for purposes of section 1366, 1367, and 1368 the shareholder of S corporation stock held by a trust is determined as follows—

(A) If stock is held by a trust (as defined in paragraph (h)(1)(ii) of this section) that does not qualify as a QSST, the trust is treated as the shareholder. If the trust continues to own the stock after the expiration of the 60-day period (or, if applicable, the 2-year period), the corporation's S election will terminate unless the trust is otherwise a permitted shareholder. If the trust is a QSST described in section 1361(d) and the income beneficiary of the trust makes a timely QSST election, the beneficiary and not the trust is treated as the shareholder from the effective date of the QSST election; and

(B) If stock is transferred to a testamentary trust described in paragraph (h)(1)(iii) of this section (other than a qualified subpart E trust or a trust that has a QSST election in effect), the trust is treated as the shareholder. If the trust continues to own the stock after the expiration of the 60-day period, the corporation's S election will terminate unless the trust otherwise qualifies as a permitted shareholder.

(i) [Reserved]

(j) *Qualified subchapter S trust*—(1) *Definition*. A qualified subchapter S trust (QSST) is a trust (whether intervivos or testamentary), other than a foreign trust described in section 7701(a)(31), that satisfies the following requirements:

(i) All of the income (within the meaning of §1.643(b)–1) of the trust is distributed (or is required to be distributed) currently to one individual who is a citizen or resident of the United States. For purposes of the preceding sentence, unless otherwise provided under local law (including pertinent provisions of the governing instrument that are effective under local law), income of the trust includes distributions to the trust from the S corporation for the taxable year in question, but does not include the trust's pro rata share of the S corporation's items of income, loss, deduction, or credit determined under section 1366. See §§1.651(a)–2(a) and 1.663(b)–1(a) for rules relating to the determination of whether all of the income of a trust is distributed (or is required to be distributed) currently. If under the terms of the trust income is not required to be distributed currently, the trustee may elect under section 663(b) to consider a distribution made in the first 65 days of a taxable year as made on the last day of the preceding taxable year. See section 663(b) and §1.663(b)–2 for rules on the time and manner for making the election. The income distribution requirement must be satisfied for the taxable year of the trust or for that part of the trust's taxable year during which it holds S corporation stock.

(ii) The terms of the trust must require that—

(A) During the life of the current income beneficiary, there will be only one income beneficiary of the trust;

(B) Any corpus distributed during the life of the current income beneficiary may be distributed only to that income beneficiary;

(C) The current income beneficiary's income interest in the trust will terminate on the earlier of that income beneficiary's death or the termination of the trust; and

(D) Upon termination of the trust during the life of the current income beneficiary, the trust will distribute all of its assets to that income beneficiary.

(iii) The terms of the trust must satisfy the requirements of paragraph (j)(1)(ii) of this section from the date the QSST election is made or from the effective date of the QSST election, whichever is earlier, throughout the entire period that the current income beneficiary and any successor income beneficiary is the income beneficiary of the trust. If the terms of the trust do not preclude the possibility that any of the requirements stated in paragraph (j)(1)(ii) of this section will not be met, the trust will not qualify as a QSST. For example, if the terms of the trust are silent with respect to corpus distributions, and distributions of corpus to a person other than the current income beneficiary are permitted under local law during the life of the current income beneficiary, then the terms of the trust do not preclude the possibility that corpus may be distributed to a person other than the current income beneficiary and, therefore, the trust is not a QSST.

(2) *Special rules*—(i) If a husband and wife are income beneficiaries of the same trust, the husband and wife file a joint return, and each is a U.S. citizen or resident, the husband and wife are treated as one beneficiary for purposes of paragraph (j) of this section. If a husband and wife are treated by the preceding sentence as one beneficiary, any action required by this section to be taken by an income beneficiary requires joinder of both of them. For example, each spouse must sign the QSST election, continue to be a U.S. citizen or resident, and continue to file joint returns for the entire period that the QSST election is in effect.

(ii)(A) *Terms of the trust and applicable local law*. The determination of whether the terms of a trust meet all of the requirements under paragraph (j)(1)(ii) of this section depends upon the terms of the trust instrument and the applicable local law. For example, a trust whose governing instrument provides that A is the sole income beneficiary of the trust is, nevertheless, considered to have two income beneficiaries if, under the applicable local law, A and B are considered to be the income beneficiaries of the trust.

(B) *Legal obligation to support.* If under local law a distribution to the income beneficiary is in satisfaction of the grantor's legal obligation of support to that income beneficiary, the trust will not qualify as a QSST as of the date of distribution because, under section 677(b), if income is distributed, the grantor will be treated as the owner of the ordinary income portion of the trust or, if trust corpus is distributed, the grantor will be treated as a beneficiary under section 662. See §1.677(b)–1 for rules on the treatment of trusts for support and §1.662(a)–4 for rules concerning amounts used in discharge of a legal obligation.

(C) *Example.* The following example illustrates the rules of paragraph (j)(2)(ii)(B) of this section:

Example: F creates a trust for the benefit of F's minor child, G. Under the terms of the trust, all income is payable to G until the trust terminates on the earlier of G's attaining age 35 or G's death. Upon the termination of the trust, all corpus must be distributed to G or G's estate. The trust includes all of the provisions prescribed by section 1361(d)(3)(A) and paragraph (j)(1)(ii) of this section, but does not preclude the trustee from making income distributions to G that will be in satisfaction of F's legal obligation to support G. Under the applicable local law, distributions of trust income to G will satisfy F's legal obligation to support G. If the trustee distributes income to G in satisfaction of F's legal obligation to support G, the trust will not qualify as a QSST because F will be treated as the owner of the ordinary income portion of the trust. Further, the trust will not be a qualified subpart E trust because the trust will be subject to tax on the income allocable to corpus.

(iii) If, under the terms of the trust, a person (including the income beneficiary) has a special power to appoint, during the life of the income beneficiary, trust income or corpus to any person other than the current income beneficiary, the trust will not qualify as a QSST. However, if the power of appointment results in the grantor being treated as the owner of the entire trust under the rules of subpart E, the trust may be a permitted shareholder under section 1361 (c)(2)(A)(i) and paragraph (h)(1)(i) of this section.

(iv) If the terms of a trust or local law do not preclude the current income beneficiary from transferring the beneficiary's interest in the trust or do not preclude a person other than the current income beneficiary named in the trust instrument from being treated as a beneficiary of the trust under §1.643(c)–1, the trust will still qualify as a QSST. However, if the income beneficiary transfers or assigns the income interest or a portion of the income interest to another, the trust may no longer qualify as a QSST, depending on the facts and circumstances, because any transferee of the current income beneficiary's income interest and any person treated as a beneficiary under §1.643(c)–1 will be treated as a current income beneficiary for purposes of paragraph (j)(1)(ii) of this section and the trust may no longer meet the QSST requirements.

(v) If the terms of the trust do not preclude a person other than the current income beneficiary named in the trust instrument from being awarded an interest in the trust by the order of a court, the trust will qualify as a QSST assuming the trust meets the requirements of paragraphs (j)(1) (i) and (ii) of this section. However, if as a result of such court order, the trust no longer meets the QSST requirements, the trust no longer qualifies as a QSST and the corporation's S election will terminate.

(vi) A trust may qualify as a QSST even though a person other than the current income beneficiary is treated under subpart E as the owner of a part or all of that portion of a trust which does not consist of the S corporation stock, provided the entire trust meets the QSST requirements stated in paragraphs (j)(1) (i) and (ii) of this section.

(3) *Separate and independent shares of a trust.* For purposes of sections 1361 (c) and (d), a substantially separate and independent share of a trust, within the meaning of section 663(c) and the regulations thereunder, is treated as a separate trust. For a separate share which holds S corporation stock to qualify as a QSST, the terms of the trust applicable to that separate share must meet the QSST requirements

stated in paragraphs (j)(1) (i) and (ii) of this section.

(4) *Qualified terminable interest property trust.* If property, including S corporation stock, or stock of a corporation that intends to make an S election, is transferred to a trust and an election is made to treat all or a portion of the transferred property as qualified terminable interest property (QTIP) under section 2056(b)(7), the income beneficiary may make the QSST election if the trust meets the requirements set out in paragraphs (j)(1) (i) and (ii) of this section. However, if property is transferred to a QTIP trust under section 2523(f), the income beneficiary may not make a QSST election even if the trust meets the requirements set forth in paragraph (j)(1)(ii) of this section because the grantor would be treated as the owner of the income portion of the trust under section 677. In addition, if property is transferred to a QTIP trust under section 2523(f), the trust does not qualify as a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section (a qualified subpart E trust), unless under the terms of the QTIP trust, the grantor is treated as the owner of the entire trust under sections 671 to 677. If the grantor ceases to be the income beneficiary's spouse, the trust may qualify as a QSST if it otherwise satisfies the requirements under paragraphs (j)(1) (i) and (ii) of this section.

(5) *Ceasing to meet the QSST requirements.* If a QSST for which an election under section 1361(d)(2) has been made (as described in paragraph (j)(6) of this section) ceases to meet any of the requirements specified in paragraph (j)(1)(ii) of this section, the provisions of this paragraph (j) will cease to apply as of the first day on which that requirement ceases to be met. If such a trust ceases to meet the income distribution requirement specified in paragraph (j)(1)(i) of this section, but continues to meet all of the requirements in paragraph (j)(1)(ii) of this section, the provisions of this paragraph (j) will cease to apply as of the first day of the first taxable year beginning after the first taxable year for which the trust ceased to meet the income distribution requirement of paragraph (j)(1)(i) of this section. If a corporation's S election is inadvertently terminated as a result of a trust ceasing to meet the QSST requirements, the corporation may request relief under section 1362(f).

(6) *Qualified subchapter S trust election*—(i) *In general.* This paragraph (j)(6) applies to the election provided in section 1361(d)(2) (the QSST election) to treat a QSST (as defined in paragraph (j)(1) of this section) as a trust described in section 1361(c)(2)(A)(i), and thus a permitted shareholder. This election must be made separately with respect to each corporation whose stock is held by the trust. The QSST election does not itself constitute an election as to the status of the corporation; the corporation must make the election provided by section 1362(a) to be an S corporation. Until the effective date of a corporation's S election, the beneficiary is not treated as the owner of the stock of the corporation for purposes of section 678. Any action required by this paragraph (j) to be taken by a person who is under a legal disability by reason of age may be taken by that person's guardian or other legal representative, or if there be none, by that person's natural or adoptive parent.

(ii) *Filing the QSST election.* The current income beneficiary of the trust must make the election by signing and filing with the service center with which the corporation files its income tax return the applicable form or a statement that—

(A) Contains the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation;

(B) Identifies the election as an election made under section 1361(d)(2);

(C) Specifies the date on which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed);

(D) Specifies the date (or dates) on which the stock of the corporation was transferred to the trust; and

(E) Provides all information and representations necessary to show that:

(*1*) Under the terms of the trust and applicable local law—

(*i*) During the life of the current income beneficiary, there will be only one income beneficiary of the trust (if husband and wife are beneficiaries, that they will file joint returns and that both are U.S. residents or citizens);

(*ii*) Any corpus distributed during the life of the current income beneficiary may be distributed only to that beneficiary;

(*iii*) The current beneficiary's income interest in the trust will terminate on the earlier of the beneficiary's death or upon termination of the trust; and

(*iv*) Upon the termination of the trust during the life of such income beneficiary, the trust will distribute all its assets to such beneficiary.

(*2*) The trust is required to distribute all of its income currently, or that the trustee will distribute all of its income currently if not so required by the terms of the trust.

(*3*) No distribution of income or corpus by the trust will be in satisfaction of the grantor's legal obligation to support or maintain the income beneficiary.

(iii) *When to file the QSST election.* (A) If S corporation stock is transferred to a trust, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust. If a C corporation has made an election under section 1362(a) to be an S corporation (S election) and, before that corporation's S election is in effect, stock of that corporation is transferred to a trust, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust.

(B) If a trust holds C corporation stock and that C corporation makes an S election effective for the first day of the taxable year in which the S election is made, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the S election is effective. If a trust holds C corporation stock and that C corporation makes an S election effective for the first day of the taxable year following the taxable year in which the S election is made, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the S election is made. If a trust holds C corporation stock and that corporation makes an S election intending the S election to be effective for the first day of the taxable year in which the S election is made but, under §1.1362–6(a)(2), such S election is subsequently treated as effective for the first day of the taxable year following the taxable year in which the S election is made, the fact that the QSST election states that the effective date of the QSST election is the first day of the taxable year in which the S election is made will not cause the QSST election to be ineffective for the first year in which the corporation's S election is effective.

(C) If a trust ceases to be a qualified subpart E trust but also satisfies the requirements of a QSST, the QSST election must be filed within the 16-day-and-2-month period beginning on the date on which the trust ceases to be a qualified subpart E trust. If the estate of the deemed owner of the trust is treated as the shareholder under paragraph (h)(3)(ii) of this section, the QSST election may be filed at any time but no later than the end of the 16-day-and-2-month period beginning on the date on which the estate of the deemed owner ceases to be treated as a shareholder.

(D) If a corporation's S election terminates because of a late QSST election, the corporation may request inadvertent termination relief under section 1362(f). See §1.1362–4 for rules concerning inadvertent terminations.

(iv) *Protective QSST election when a person is an owner under subpart E.* If the grantor of a trust is treated as the owner under subpart E of all of the trust, or of a portion of the trust which consists of S corporation stock, and the current income beneficiary is not the grantor, the current income beneficiary may not make the QSST election, even if the trust meets the QSST requirements stated in paragraph (j)(1)(ii) of this section. See paragraph (j)(6)(iii)(C) of this section as to when the QSST election may be made. See also paragraph (j)(2)(vi) of this section. However, if the current income beneficiary (or beneficiaries who are husband and wife, if both spouses are U.S.

citizens or residents and file a joint return) of a trust is treated under subpart E as owning all or a portion of the trust consisting of S corporation stock, the current income beneficiary (or beneficiaries who are husband and wife, if both spouses are U.S. citizens or residents and file a joint return) may make the QSST election. See *Example 8* of paragraph (k)(1) of this section.

(7) *Treatment as shareholder.* (i) The income beneficiary who makes the QSST election and is treated (for purposes of section 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) If, upon the death of an income beneficiary, the trust continues in existence, continues to hold S corporation stock but no longer satisfies the QSST requirements, and is not a qualified subpart E trust, then, solely for purposes of section 1361(b)(1), as of the date of the income beneficiary's death, the estate of that income beneficiary is treated as the shareholder of the S corporation with respect to which the income beneficiary made the QSST election. The estate ordinarily will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of that stock by the trust or the expiration of the 60-day period beginning on the day of the income beneficiary's death. However, if the entire corpus of the trust is includible in the gross estate of that income beneficiary, the estate will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day of the income beneficiary's death. For the purpose of determining whether the entire trust corpus is includible in the gross estate of the income beneficiary, any community property interest in the trust held by the income beneficiary's spouse which arises by reason of applicable U.S. state law is disregarded. During the period that the estate is treated as the shareholder for purposes of section 1361(b)(1), the trust is treated as the shareholder for purposes of sections 1366, 1367, and 1368. If, after the 60-day period, or the 2-year period, if applicable, the trust continues to hold S corporation stock, the corporation's S election terminates. If the termination is inadvertent, the corporation may request relief under section 1362(f).

(8) *Coordination with grantor trust rules.* If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made. However, solely for purposes of applying the preceding sentence to a QSST, an income beneficiary who is a deemed section 678 owner only by reason of section 1361(d)(1) will not be treated as the owner of the S corporation stock in determining and attributing the Federal income tax consequences of a disposition of the stock by the QSST. For example, if the disposition is a sale, the QSST election terminates as to the stock sold and any gain or loss recognized on the sale will be that of the trust, not the income beneficiary. Similarly, if a QSST distributes its S corporation stock to the income beneficiary, the QSST election terminates as to the distributed stock and the consequences of the distribution are determined by reference to the status of the trust apart from the income beneficiary's terminating ownership status under sections 678 and 1361(d)(1). The portions of the trust other than the portion consisting of S corporation stock are subject to subparts A through D of subchapter J of chapter 1, except as otherwise required by subpart E of the Internal Revenue Code.

(9) *Successive income beneficiary.* (i) If the income beneficiary of a QSST who made a QSST election dies, each successive income beneficiary of that trust is treated as consenting to the election unless a successive income beneficiary affirmatively refuses to consent to the election. For this purpose, the term *successive income beneficiary* includes a beneficiary of a trust whose interest is a separate share within the meaning of section 663(c), but does not include any beneficiary of a trust that is created upon the death of the income beneficiary of the QSST and which is a new trust under local law.

(ii) The application of this paragraph (j)(9) is illustrated by the following examples:

Example 1. Shares of stock in Corporation X, an S corporation, are held by Trust A, a QSST for which a QSST election was made. B is the sole income beneficiary of Trust A. On B's death, under the terms of Trust A, J and K become the current income beneficiaries of Trust A. J and K each hold a separate and independent share of Trust A within the meaning of section 663(c). J and K are successive income beneficiaries of Trust A, and they are treated as consenting to B's QSST election.

Example 2. Assume the same facts as in *Example 1,* except that on B's death, under the terms of Trust A and local law, Trust A terminates and the principal is to be divided equally and held in newly created Trust B and Trust C. The sole income beneficiaries of Trust B and Trust C are J and K, respectively. Because Trust A terminated, J and K are not successive income beneficiaries of Trust A. J and K must make QSST elections for their respective trusts to qualify as QSSTs, if they qualify. The result is the same whether or not the trustee of Trusts B and C is the same as the trustee of trust A.

(10) *Affirmative refusal to consent*—(i) *Required statement.* A successive income beneficiary of a QSST must make an affirmative refusal to consent by signing and filing with the service center where the corporation files its income tax return a statement that—

(A) Contains the name, address, and taxpayer identification number of the successive income beneficiary, the trust, and the corporation for which the election was made;

(B) Identifies the refusal as an affirmative refusal to consent under section 1361(d)(2); and

(C) Sets forth the date on which the successive income beneficiary became the income beneficiary.

(ii) *Filing date and effectiveness.* The affirmative refusal to consent must be filed within 15 days and 2 months after the date on which the successive income beneficiary becomes the income beneficiary. The affirmative refusal to consent will be effective as of the date on which the successive income beneficiary becomes the current income beneficiary.

(11) *Revocation of QSST election.* A QSST election may be revoked only with the consent of the Commissioner. The Commissioner will not grant a revocation when one of its purposes is the avoidance of Federal income taxes or when the taxable year is closed. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter ruling request under the appropriate revenue procedure. The application must be signed by the current income beneficiary and must—

(i) Contain the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation with respect to which the QSST election was made;

(ii) Identify the election being revoked as an election made under section 1361(d)(2); and

(iii) Explain why the current income beneficiary seeks to revoke the QSST election and indicate that the beneficiary understands the consequences of the revocation.

(k)(1) *Examples.* The provisions of paragraphs (h) and (j) of this section are illustrated by the following examples in which it is assumed that all noncorporate persons are citizens or residents of the United States:

Example 1. (i) *Terms of the trust.* In 1996, A and A's spouse, B, created an intervivos trust and each funded the trust with separately owned stock of an S corporation. Under the terms of the trust, A and B designated themselves as the income beneficiaries and each, individually, retained the power to amend or revoke the trust with respect to the trust assets attributable to their respective trust contributions. Upon A's death, the trust is to be divided into two separate parts; one part attributable to the assets A contributed to the trust and one part attributable to B's contributions. Before the trust is divided, and during the administration of A's estate, all trust income is payable to B. The part of the trust attributable to B's contributions is to continue in trust under the terms of which B is designated as the sole income beneficiary and retains the power to amend or revoke the trust. The part attributable to A's contributions is to be divided into two separate trusts both of which have B as the sole income beneficiary for life. One trust, the *Credit Shelter Trust,* is to be funded with an amount that can pass free of estate tax by reason of A's available estate tax unified credit. The terms of the Credit Shelter Trust meet the requirements of section 1361(d)(3) as a QSST. The balance of the property passes to a Marital Trust, the terms of which satisfy the requirements of section 1361(d)(3) as a QSST and section 2056(b)(7) as QTIP. The appropriate fiduciary under §20.2056(b)–7(b)(3) is directed to make an election under section 2056(b)(7).

(ii) *Results after deemed owner's death.* On February 3, 1997, A dies and the portion of the trust assets attributable to A's contributions including the S stock contributed by A, is includible in A's gross estate under sections 2036 and 2038. During the administration of A's estate, the trust holds the S corporation stock. Under section 1361(c)(2)(B)(ii), A's estate is treated as the shareholder of the S corporation stock that was included in A's gross estate for purposes of section 1361(b)(1); however, for purposes of sections 1366, 1367, and 1368, the trust is treated as the shareholder. B's part of the trust continues to be a qualified subpart E trust of which B is the owner under sections 676 and 677. B, therefore, continues to be treated as the shareholder of the S corporation stock in that portion of the trust. On May 13, 1997, during the continuing administration of A's estate, the trust is divided into separate trusts in accordance with the terms of the trust instrument. The S corporation stock that was included in A's gross estate is distributed to the Marital Trust and to the Credit Shelter Trust. A's estate will cease to be treated as the shareholder of the S corporation under section 1361(c)(2)(B)(ii) on May 13, 1997 (the date on which the S corporation stock was transferred to the trusts). B, as the income beneficiary of the Marital Trust and the Credit Shelter Trust, must make the QSST election for each trust by July 28, 1997 (the end of the 16-day-and-2-month period beginning on the date the estate ceases to be treated as a shareholder) to have the trusts become permitted shareholders of the S corporation.

Example 2. (i) *Qualified subpart E trust as shareholder.* In 1997, A, an individual established a trust and transferred to the trust A's shares of stock of Corporation M, an S corporation. A has the power to revoke the entire trust. The terms of the trust require that all income be paid to B and otherwise meet the requirements of a QSST under section 1361(d)(3). The trust will continue in existence after A's death. The trust is a qualified subpart E trust described in section 1361(c)(2)(A)(i) during A's life, and A (not the trust) is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *Trust ceasing to be a qualified subpart E trust on deemed owner's death.* Assume the same facts as paragraph (i) of this *Example 2*, except that A dies without having exercised A's power to revoke. Upon A's death, the trust ceases to be a qualified subpart E trust described in section 1361(c)(2)(A)(i). A's estate (and not the trust) is treated as the shareholder for purposes of section 1361(b)(1). Because the entire corpus of the trust is includible in A's gross estate under section 2038, A's estate will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of the Corporation M stock by the trust (other than to A's estate), the expiration of the 2-year period beginning on the day of A's death, or the effective date of a QSST election if the trust qualifies as a QSST. However, until that time, because the trust continues in existence after A's death and will receive any distributions with respect to the stock it holds, the trust is treated as the shareholder for purposes of sections 1366, 1367, and 1368. After the 2-year period, if no QSST election is made, the corporation ceases to be an S corporation, but the trust continues as the shareholder of a C corporation.

(iii) *Trust continuing to be a qualified subpart E trust on deemed owner's death.* Assume the same facts as paragraph (ii) of this *Example 2*, except that the terms of the trust also provide that if A does not exercise the power to revoke before A's death, B will have the sole power to withdraw all trust property at any time after A's death. The trust continues to qualify as a qualified subpart E trust after A's death because, upon A's death, B is deemed to be the owner of the entire trust under section 678. Because the trust does not cease to be a qualified subpart E trust upon A's death, B (and not A's estate) is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368. Since the trust qualifies as a QSST, B may make a protective QSST election under paragraph (j)(6)(iv) of this section.

Example 3. 60-day rule under section 1361(c)(2)(A) (ii) and (iii). F owns stock of Corporation P, an S corporation. In addition, F is the deemed owner of a qualified subpart E trust that holds stock in Corporation O, an S corporation. F dies on July 1, 1996. The trust continues in existence after F's death but is no longer a qualified subpart E trust. The entire corpus of the trust is not includible in F's gross estate. On August 1, 1996, F's shares of stock in Corporation P are transferred to the trust pursuant to the terms of F's will. Because the stock of Corporation P was not held by the trust when F died, section 1361(c)(2)(A)(ii) does not apply with respect to that stock. Under section 1361(c)(2)(A)(iii), the last day on which F's estate could be treated as a permitted shareholder of Corporation P is September 29, 1996 (that is, the last day of the 60-day period that begins on the date of the transfer from the estate to the trust). With respect to the shares of stock in Corporation O held by the trust at the time of F's death, section 1361(c)(2)(A)(ii) applies and the last day on which F's estate could be treated as a permitted shareholder of Corporation O is August 29, 1996 (that is, the last day of the 60-day period that begins on the date of F's death).

Example 4. (i) *QSST when terms do not require current distribution of income.* Corporation Q, a calendar year corporation, makes an election to be an S corporation effective for calendar year 1996. On July 1, 1996, G, a shareholder of Corporation Q, transfers G's shares of Corporation Q stock to a trust with H as its current income beneficiary. The terms of the trust otherwise satisfy the QSST requirements, but authorize the trustee in its discretion to accumulate or distribute the trust income. However, the trust, which uses the calendar year as its taxable year, initially satisfies the income distribution requirement because the trustee is currently distributing all of the income. On August 1, 1996, H makes a QSST election with respect to Corporation Q that is effective as of July 1, 1996. Accordingly, as of July 1, 1996, the trust is a QSST and H is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *QSST when trust income is not distributed currently.* Assume the same facts as in paragraph (i) of this *Example 4,* except that, for the taxable year ending on December 31, 1997, the trustee accumulates some trust income. The trust ceases to be a QSST on January 1, 1998, because the trust failed to distribute all of its income for the taxable year ending December 31, 1997. Thus, Corporation Q ceases to be an S corporation as of January 1, 1998, because the trust is not a permitted shareholder.

(iii) *QSST when a person other than the current income beneficiary may receive trust corpus.* Assume the same facts as in paragraph (i) of this *Example 4,* except that H dies on November 1, 1996. Under the terms of the trust, after H's death, L is the income beneficiary of the trust and the trustee is authorized to distribute trust corpus to L as well as to J. The trust ceases to be a QSST as of November 1, 1996, because corpus distributions may be made to someone other than L, the current (successive) income beneficiary. Under section 1361(c)(2)(A)(ii), H's estate (and not the trust) is considered to be the shareholder for purposes of section 1361(b)(1) for the 60-day period beginning on November 1, 1996. However, because the trust continues in existence after H's death and will receive any distributions from the corporation, the trust (and not H's estate) is treated as the shareholder for purposes of sections 1366, 1367, and 1368, during that 60-day period. After the 60-day period, the S election terminates and the trust continues as a shareholder of a C corporation. If the termination is inadvertent, Corporation Q may request relief under section 1362(f). However, the S election would not terminate if the trustee distributed all Corporation Q shares to L, J, or both before December 30, 1996, (the last day of the 60-day period) assuming that neither L nor J becomes the 36th shareholder of Corporation Q as a result of the distribution.

Example 5. QSST when current income beneficiary assigns the income interest to a person not named in the trust. On January 1, 1996, stock of Corporation R, a calendar year S corporation, is transferred to a trust that satisfies all of the requirements to be a QSST. Neither the terms of the trust nor local law preclude the current income beneficiary, K, from assigning K's income interest in the trust. K files a timely QSST election that is effective January 1, 1996. On July 1, 1996, K assigns the income interest in the trust to N. Under applicable state law, the trustee is bound as a result of the assignment to distribute the trust income to N. Thus, the QSST will cease to qualify as a QSST under section 1361(d)(3)(A)(iii) because N's interest will terminate on K's death (rather than on N's death). Accordingly, as of the date of the assignment, the trust ceases to be a QSST and Corporation R ceases to be an S corporation.

Example 6. QSST when terms fail to provide for distribution of trust assets upon termination during life of current income beneficiary. A contributes S corporation stock to a trust the terms of which provide for one income beneficiary, annual distributions of income, discretionary invasion of corpus only for the benefit of the income beneficiary, and termination of the trust only upon the death of the current income beneficiary. Since the trust can terminate only upon the death of the income beneficiary, the governing instrument fails to provide for any distribution of trust assets during the income beneficiary's life. The governing instrument's silence on this point does not disqualify the trust under section 1361(d)(3)(A) (ii) or (iv).

Example 7. QSST when settlor of trust retains a reversion in the trust. On January 10, 1996, M transfers to a trust shares of stock in corporation X, an S corporation. D, who is 13 years old and not a lineal descendant of M, is the sole income beneficiary of the trust. On termination of the trust, the principal (including the X shares) is to revert to M. The trust instrument provides that the trust will terminate upon the earlier of D's death or D's 21st birthday. The terms of the trust satisfy all of the requirements to be a QSST except those of section 1361(d)(3)(A)(ii) (that corpus may be distributed during the current income beneficiary's life only to that beneficiary) and (iv) (that, upon termination of the trust during the life of the current income beneficiary, the corpus, must be distributed to that beneficiary). On February 10, 1996, M makes a gift of M's reversionary interest to D. Until M assigns M's reversion in the trust to D, M is deemed to own the entire trust under section 673(a) and the trust is a qualified subpart E trust. For purposes of section 1361(b)(1), 1366, 1367, and 1368, M is the shareholder of X. The trust ceases to be a qualified subpart E trust on February 10,

1996. Assuming that, by virtue of the assignment to D of M's reversionary interest, D (upon his 21st birthday) or D's estate (in the case of D's death before reaching age 21) is entitled under local law to receive the trust principal, the trust will be deemed as of February 10, 1996, to have satisfied the conditions of section 1361(d)(3)(A) (ii) and (iv) even though the terms of the trust do not explicitly so provide. D must make a QSST election by no later than April 25, 1996 (the end of the 16-day-and-2-month period that begins on February 10, 1996, the date on which the X stock is deemed transferred to the trust by M). See example (5) of §1.1001–2(c) of the regulations.

Example 8. QSST when the income beneficiary has the power to withdraw corpus. On January 1, 1996, F transfers stock of an S corporation to an irrevocable trust whose income beneficiary is F's son, C. Under the terms of the trust, C is given the noncumulative power to withdraw from the corpus of the trust the greater of $5,000 or 5 percent of the value of the corpus on a yearly basis. The terms of the trust meet the QSST requirements. Assuming the trust distributions are not in satisfaction of F's legal obligation to support C, the trust qualifies as a QSST. C (or if C is a minor, C's legal representative) must make the QSST election no later than March 16, 1996 (the end of the 16-day-and-2-month period that begins on the date the stock is transferred to the trust).

Example 9. (i) *Filing the QSST election.* On January 1, 1996, stock of Corporation T, a calendar year C corporation, is transferred to a trust that satisfies all of the requirements to be a QSST. On January 31, 1996, Corporation T files an election to be an S corporation that is to be effective for its taxable year beginning on January 1, 1996. In order for the S election to be effective for the 1996 taxable year, the QSST election must be effective January 1, 1996, and must be filed within the period beginning on January 1, 1996, and ending March 16, 1996 (the 16-day-and-2-month period beginning on the first day of the first taxable year for which the election to be an S corporation is intended to be effective).

(ii) *QSST election when the S election is filed late.* Assume the same facts as in paragraph (i) of this *Example 9,* except that Corporation T's election to be an S corporation is filed on April 1, 1996 (after the 15th day of the 3rd month of the first taxable year for which it is to be effective but before the end of that taxable year). Because the election to be an S corporation is not timely filed for the 1996 taxable year, under section 1362(b)(3), the S election is treated as made for the taxable year beginning on January 1, 1997. The QSST election must be filed within the 16-day-and-2-month period beginning on April 1, 1996, the date the S election was made, and ending on June 16, 1996.

Example 10. (i) *Transfers to QTIP trust.* On June 1, 1996, A transferred S corporation stock to a trust for the benefit of A's spouse B, the terms of which satisfy the requirements of section 2523(f)(2) as qualified terminable interest property. Under the terms of the trust, B is the sole income beneficiary for life. In addition, corpus may be distributed to B, at the trustee's discretion, during B's lifetime. However, under section 677(a), A is treated as the owner of the trust. Accordingly, the trust is a permitted shareholder of the S corporation under section 1361(c)(2)(A)(i), and A is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *Transfers to QTIP trust where husband and wife divorce.* Assume the same facts as in paragraph (i) of this *Example 10,* except that A and B divorce on May 2, 1997. Under section 682, A ceases to be treated as the owner of the trust under section 677(a) because A and B are no longer husband and wife. Under section 682, after the divorce, B is the income beneficiary of the trust and corpus of the trust may only be distributed to B. Accordingly, assuming the trust otherwise meets the requirements of section 1361(d)(3), B must make the QSST election within 2 months and 15 days after the date of the divorce.

(iii) *Transfers to QTIP trust where no corpus distribution is permitted.* Assume the same facts as in paragraph (i) of this *Example 10,* except that the terms of the trust do not permit corpus to be distributed to B and require its retention by the trust for distribution to A and B's surviving children after the death of B. Under section 677, A is treated as the owner of the ordinary income portion of the trust, but the trust will be subject to tax on gross income allocable to corpus. Accordingly, the trust does not qualify as an eligible shareholder of the S corporation because it is neither a qualified subpart E trust nor a QSST.

(2) *Effective date*—(i) *In general.* Paragraph (a), and paragraphs (c) through (k) of this section apply to taxable years of a corporation beginning after July 21, 1995. For taxable years beginning on or before July 21, 1995, to which paragraph (a), and paragraphs (c) through (k) do not apply, see §18.1361–1 of this chapter (as contained in the 26 CFR edition revised April 1, 1995).

(ii) *Exception.* If a QSST has sold or otherwise disposed of all or a portion of its S corporation stock in a tax year that is open for the QSST and the income beneficiary but on or before July 21, 1995, the QSST and the income beneficiary may both treat the transaction as if the beneficiary was the owner of the stock sold or disposed of, and thus recognize any gain or loss, or as if the QSST was the owner of the stock sold or disposed of as described in paragraph (j)(8) of this section. This exception applies only if the QSST and the income beneficiary take consistent reporting positions. The QSST and the income beneficiary must disclose by a statement on their respective returns (or amended returns), that they are taking consistent reporting positions.

(l) *Classes of stock*—(1) *General rule.* A corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in paragraph (l)(4) of this section (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

(2) *Determination of whether stock confers identical rights to distribution and liquidation proceeds*—(i) *In general.* The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

(ii) *State law requirements for payment and withholding of income tax.* State laws may require a corporation to pay or withhold state income taxes on behalf of some or all of the corporation’s shareholders. Such laws are disregarded in determining whether all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds, within the meaning of paragraph (l)(1) of this section, provided that, when the constructive distributions resulting from the payment or withholding of taxes by the corporation are taken into account, the outstanding shares confer identical rights to distribution and liquidation proceeds. A difference in timing between the constructive distributions and the actual distributions to the other shareholders does not cause the corporation to be treated as having more than one class of stock.

(iii) *Buy-sell and redemption agreements*—(A) *In general.* Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation’s outstanding shares of stock confer identical distribution and liquidation rights unless—

(*1*) A principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l), and

(*2*) The agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.

Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock and, thus, are disregarded in determining whether the outstanding shares of stock confer identical rights. For purposes of this paragraph (l)(2)(iii)(A), a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence. Although an agreement may be disregarded in determining whether shares of stock confer identical distribution and liquidation rights, payments pursuant to the agreement may have income or transfer tax consequences.

(B) *Exception for certain agreements.* Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights. In addition, if stock that is substantially nonvested (within the meaning of §1.83–3(b)) is treated as outstanding under these regulations, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded. Furthermore, the Commissioner may provide by Revenue Ruling or other published guidance that other types of bona fide agreements to redeem or purchase stock are disregarded.

(C) *Safe harbors for determinations of book value.* A determination of book value will be respected if—

(*1*) The book value is determined in accordance with Generally Accepted Accounting Principles (including permitted optional adjustments); or

(*2*) The book value is used for any substantial nontax purpose.

(iv) *Distributions that take into account varying interests in stock during a taxable year.* A governing provision does not, within the meaning of paragraph (l)(2)(i) of this section, alter the rights to liquidation and distribution proceeds conferred by an S corporation's stock merely because the governing provision provides that, as a result of a change in stock ownership, distributions in a taxable year are to be made on the basis of the shareholders' varying interests in the S corporation's income in the current or immediately preceding taxable year. If distributions pursuant to the provision are not made within a reasonable time after the close of the taxable year in which the varying interests occur, the distributions may be recharacterized depending on the facts and circumstances, but will not result in a second class of stock.

(v) *Examples.* The application of paragraph (l)(2) of this section may be illustrated by the following examples. In each of the examples, the S corporation requirements of section 1361 are satisfied except as otherwise stated, the corporation has in effect an S election under section 1362, and the corporation has only the shareholders described.

Example 1. Determination of whether stock confers identical rights to distribution and liquidation proceeds. (i) The law of State A requires that permission be obtained from the State Commissioner of Corporations before stock may be issued by a corporation. The Commissioner grants permission to S, a corporation, to issue its stock subject to the restriction that any person who is issued stock in exchange for property, and not cash, must waive all rights to receive distributions until the shareholders who contributed cash for stock have received distributions in the amount of their cash contributions.

(ii) The condition imposed by the Commissioner pursuant to state law alters the rights to distribution and liquidation proceeds conferred by the outstanding stock of S so that those rights are not identical. Accordingly, under paragraph (l)(2)(i) of this section, S is treated as having more than one class of stock and does not qualify as a small business corporation.

Example 2. Distributions that differ in timing. (i) S, a corporation, has two equal shareholders, A and B. Under S's bylaws, A and B are entitled to equal distributions. S distributes $50,000 to A in the current year, but does not distribute $50,000 to B until one year later. The circumstances indicate that the difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds.

(ii) Under paragraph (l)(2)(i) of this section, the difference in timing of the distributions to A and B does not cause S to be treated as having more than one class of stock. However, section 7872 or other recharacterization principles may apply to determine the appropriate tax consequences.

Example 3. Treatment of excessive compensation. (i) S, a corporation, has two equal shareholders, C and D, who are each employed by S and have binding employment agreements with S. The compensation paid by S to C under C's employment agreement is reasonable. The compensation paid by S to

D under D's employment agreement, however, is found to be excessive. The facts and circumstances do not reflect that a principal purpose to D's employment agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the employment agreements are not governing provisions. Accordingly, S is not treated as having more than one class of stock by reason of the employment agreements, even though S is not allowed a deduction for the excessive compensation paid to D.

Example 4. Agreement to pay fringe benefits. (i) S, a corporation, is required under binding agreements to pay accident and health insurance premiums on behalf of certain of its employees who are also shareholders. Different premium amounts are paid by S for each employee-shareholder. The facts and circumstances do not reflect that a principal purpose of the agreements is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the agreements are not governing provisions. Accordingly, S is not treated as having more than one class of stock by reason of the agreements. In addition, S is not treated as having more than one class of stock by reason of the payment of fringe benefits.

Example 5. Below-market corporation-shareholder loan. (i) E is a shareholder of S, a corporation. S makes a below-market loan to E that is a corporation-shareholder loan to which section 7872 applies. Under section 7872, E is deemed to receive a distribution with respect to S stock by reason of the loan. The facts and circumstances do not reflect that a principal purpose of the loan is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the loan agreement is not a governing provision. Accordingly, S is not treated as having more than one class of stock by reason of the below-market loan to E.

Example 6. Agreement to adjust distributions for state tax burdens. (i) S, a corporation, executes a binding agreement with its shareholders to modify its normal distribution policy by making upward adjustments of its distributions to those shareholders who bear heavier state tax burdens. The adjustments are based on a formula that will give the shareholders equal after-tax distributions.

(ii) The binding agreement relates to distribution or liquidation proceeds. The agreement is thus a governing provision that alters the rights conferred by the outstanding stock of S to distribution proceeds so that those rights are not identical. Therefore, under paragraph (l)(2)(i) of this section, S is treated as having more than one class of stock.

Example 7. State law requirements for payment and withholding of income tax. (i) The law of State X requires corporations to pay state income taxes on behalf of nonresident shareholders. The law of State X does not require corporations to pay state income taxes on behalf of resident shareholders. S is incorporated in State X. S's resident shareholders have the right (for example, under the law of State X or pursuant to S's bylaws or a binding agreement) to distributions that take into account the payments S makes on behalf of its nonresident shareholders.

(ii) The payment by S of state income taxes on behalf of its nonresident shareholders are generally treated as constructive distributions to those shareholders. Because S's resident shareholders have the right to equal distributions, taking into account the constructive distributions to the nonresident shareholders, S's shares confer identical rights to distribution proceeds. Accordingly, under paragraph (l)(2)(ii) of this section, the state law requiring S to pay state income taxes on behalf of its nonresident shareholders is disregarded in determining whether S has more than one class of stock.

(iii) The same result would follow if the payments of state income taxes on behalf of nonresident shareholders are instead treated as advances to those shareholders and the governing provisions require the advances to be repaid or offset by reductions in distributions to those shareholders.

Example 8. Redemption agreements. (i) F, G, and H are shareholders of S, a corporation. F is also an employee of S. By agreement, S is to redeem F's shares on the termination of F's employment.

(ii) On these facts, under paragraph (l)(2)(iii)(B) of this section, the agreement is disregarded in determining whether all outstanding shares of S's stock confer identical rights to distribution and liquidation proceeds.

Example 9. Analysis of redemption agreements. (i) J, K, and L are shareholders of S, a corporation. L is also an employee of S. L's shares were not issued to L in connection with the performance of services. By agreement, S is to redeem L's shares for an amount significantly below their fair market value on the termination of L's employment or if S's sales fall below certain levels.

(ii) Under paragraph (l)(2)(iii)(B) of this section, the portion of the agreement providing for redemption of L's stock on termination of employment is disregarded. Under paragraph (l)(2)(iii)(A), the portion of the agreement providing for redemption of L's stock if S's sales fall below certain levels is disregarded unless a principal purpose of that portion of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(3) *Stock taken into account.* Except as provided in paragraphs (b) (3), (4), and (5) of this section (relating to restricted stock, deferred compensation plans, and straight debt), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account. For example, substantially nonvested stock with respect to which an election under section 83(b) has been made is taken into account in determining whether a corporation has a second class of stock, and such stock is not treated as a second class of stock if the stock confers rights to distribution and liquidation proceeds that are identical, within the meaning of paragraph (l)(1) of this section, to the rights conferred by the other outstanding shares of stock.

(4) *Other instruments, obligations, or arrangements treated as a second class of stock*—(i) *In general.* Instruments, obligations, or arrangements are not treated as a second class of stock for purposes of this paragraph (l) unless they are described in paragraph (l)(5) (ii) or (iii) of this section. However, in no event are instruments, obligations, or arrangements described in paragraph (b)(4) of this section (relating to deferred compensation plans), paragraphs (l)(4)(iii) (B) and (C) of this section (relating to the exceptions and safe harbor for options), paragraph (l)(4)(ii)(B) of this section (relating to the safe harbors for certain short-term unwritten advances and proportionally-held debt), or paragraph (l)(5) of this section (relating to the safe harbor for straight debt), treated as a second class of stock for purposes of this paragraph (l).

(ii) *Instruments, obligations, or arrangements treated as equity under general principles*—(A) *In general.* Except as provided in paragraph (l)(4)(i) of this section, any instrument, obligation, or arrangement issued by a corporation (other than outstanding shares of stock described in paragraph (l)(3) of this section), regardless of whether designated as debt, is treated as a second class of stock of the corporation—

(*1*) If the instrument, obligation, or arrangement constituters equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law; and

(*2*) A principal purpose of issuing or entering into the instrument, obligation, or arrangement is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders contained in paragraph (b)(1) of this section.

(B) *Safe harbor for certain short-term unwritten advances and proportionately held obligations*—(*1*) *Short-term unwritten advances.* Unwritten advances from a shareholder that do not exceed $10,000 in the aggregate at any time during the taxable year of the corporation, are treated as debt by the parties, and are expected to be repaid within a reasonable time are not treated as a second class of stock for that taxable year, even if the advances are considered equity under general principles of Federal tax law. The failure of an unwritten advance to meet this safe harbor will not result in a second class of stock unless the advance is considered equity under paragraph (l)(4)(ii)(A)(*1*) of this section and a principal purpose of the advance is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders under paragraph (l)(4)(ii)(A)(*2*) of this section.

(*2*) *Proportionately-held obligations.* Obligations of the same class that are considered equity under general principles of Federal tax law, but are owned solely by the owners of, and in the same proportion as, the outstanding stock of the corporation, are not treated as a second class of stock. Furthermore, an obligation or obligations owned by the sole shareholder of a corporation are always held proportionately to the corporation's outstanding stock. The obligations that are considered equity that do not meet this safe harbor will not result in a second class of stock unless a principal purpose of the obligations is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders under paragraph (l)(4)(ii)(A)(*2*) of this section.

(iii) *Certain call options, warrants or similar instruments*—(A) *In general.* Except as otherwise provided in this paragraph (l)(4)(iii), a call option, warrant, or similar instrument (collectively, call option) issued by a corporation is treated as a second class of stock of the corporation if, taking into account all the facts and circumstances, the call option is substantially certain to be exercised (by the holder or a potential transferee) and has a strike price substantially below the fair market value of the underlying stock on the date that the call option is issued, transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section, or materially modified. For purposes of this paragraph (l)(4)(iii), if an option is issued in connection with a loan and the time period in which the option can be exercised is extended in connection with (and consistent with) a modification of the terms of the loan, the extension of the time period in which the option may be exercised is not considered a material modification. In addition, a call option does not have a strike price substantially below fair market value if the price at the time of exercise cannot, pursuant to the terms of the instrument, be substantially below the fair market value of the underlying stock at the time of exercise.

(B) *Certain exceptions.* (*1*) A call option is not treated as a second class of stock for purposes of this paragraph (l) if it is issued to a person that is actively and regularly engaged in the business of lending and issued in connection with a commercially reasonable loan to the corporation. This paragraph (l)(4)(iii)(B)(*1*) continues to apply if the call option is transferred with the loan (or if a portion of the call option is transferred with a corresponding portion of the loan). However, if the call option is transferred without a corresponding portion of the loan, this paragraph (l)(4)(iii)(B)(*1*) ceases to apply. Upon that transfer, the call option is tested under paragraph (l)(4)(iii)(A) (notwithstanding anything in that paragraph to the contrary) if, but for this paragraph, the call option would have been treated as a second class of stock on the date it was issued.

(*2*) A call option that is issued to an individual who is either an employee or an independent contractor in connection with the performance of services for the corporation or a related corporation (and that is not excessive by reference to the services performed) is not treated as a second class of stock for purposes of this paragraph (l) if—

(*i*) The call option is nontransferable within the meaning of §1.83–3(d); and

(*ii*) The call option does not have a readily ascertainable fair market value as defined in §1.83–7(b) at the time the option is issued.

If the call option becomes transferable, this paragraph (l)(4)(iii)(B)(*2*) ceases to apply. Solely for purposes of this paragraph (l)(4)(iii)(B)(*2*), a corporation is related to the issuing corporation if more than 50 percent of the total voting power and total value of its stock is owned by the issuing corporation.

(*3*) The Commissioner may provide other exceptions by Revenue Ruling or other published guidance.

(C) *Safe harbor for certain options.* A call option is not treated as a second class of stock if, on the date the call option is issued, transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section, or materially modified, the strike price of the call option is at least 90 percent of the fair market value of the underlying stock on that date. For purposes of this paragraph (l)(4)(iii)(C), a good faith determination of fair market value by the corporation will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence to obtain a fair value. Failure of an option to meet this safe harbor will not necessarily result in the option being treated as a second class of stock.

(iv) *Convertible debt.* A convertible debt instrument is considered a second class of stock if—

(A) It would be treated as a second class of stock under paragraph (l)(4)(ii) of this section (relating to instruments, obligations, or arrangements treated as equity under general principles); or

(B) It embodies rights equivalent to those of a call option that would be treated as a second class of stock under paragraph (l)(4)(iii) of this section (relating to certain call options, warrants, and similar instruments).

(v) *Examples.* The application of this paragraph (l)(4) may be illustrated by the following examples. In each of the examples, the S corporation requirements of section 1361 are satisfied except as otherwise stated, the corporation has in effect an S election under section 1362, and the corporation has only the shareholders described.

Example 1. Transfer of call option by eligible shareholder to ineligible shareholder. (i) S, a corporation, has 10 shareholders. S issues call options to A, B, and C, individuals who are U.S. residents. A, B, and C are not shareholders, employees, or independent contractors of S. The options have a strike price of $40 and are issued on a date when the fair market value of S stock is also $40. A year later, P, a partnership, purchases A's option. On the date of transfer, the fair market value of S stock is $80.

(ii) On the date the call option is issued, its strike price is not substantially below the fair market value of the S stock. Under paragraph (l)(4)(iii)(A) of this section, whether a call option is a second class of stock must be redetermined if the call option is transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section. In this case, A is an eligible shareholder of S under paragraph (b)(1) of this section, but P is not. Accordingly, the option is retested on the date it is transferred to D.

(iii) Because on the date the call option is transferred to P its strike price is 50% of the fair market value, the strike price is substantially below the fair market value of the S stock. Accordingly, the call option is treated as a second class of stock as of the date it is transferred to P if, at that time, it is determined that the option is substantially certain to be exercised. The determination of whether the option is substantially certain to be exercised is made on the basis of all the facts and circumstances.

Example 2. Call option issued in connection with the performance of services. (i) E is a bona fide employee of S, a corporation. S issues to E a call option in connection with E's performance of services. At the time the call option is issued, it is not transferable and does not have a readily ascertainable fair market value. However, the call option becomes transferable before it is exercised by E.

(ii) While the option is not transferable, under paragraph (l)(4)(iii)(B)(*2*) of this section, it is not treated as a second class of stock, regardless of its strike price. When the option becomes transferable, that paragraph ceases to apply, and the general rule of paragraph (l)(4)(iii)(A) of this section applies. Accordingly, if the option is materially modified or is transferred to a person who is not an eligible shareholder under paragraph (b)(1) of this section, and on the date of such modification or transfer, the option is substantially certain to be exercised and has a strike price substantially below the fair market value of the underlying stock, the option is treated as a second class of stock.

(iii) If E left S's employment before the option became transferable, the exception provided by paragraph (l)(4)(iii)(B)(*2*) would continue to apply until the option became transferable.

(5) *Straight debt safe harbor*—(i) *In general.* Notwithstanding paragraph (l)(4) of this section, straight debt is not treated as a second class of stock. For purposes of section 1361(c)(5) and this section, the term straight debt means a written unconditional obligation, regardless of whether embodied in a formal note, to pay a sum certain on demand, or on a specified due date, which—

(A) Does not provide for an interest rate or payment dates that are contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock, or similar factors;

(B) Is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation; and

(C) Is held by an individual (other than a nonresident alien), an estate, or a trust described in section 1361(c)(2).

(ii) *Subordination.* The fact that an obligation is subordinated to other debt of the corporation does not prevent the obligation from qualifying as straight debt.

(iii) *Modification or transfer.* An obligation that originally qualifies as straight debt ceases to so qualify if the obligation—

(A) Is materially modified so that it no longer satisfies the definition of straight debt; or

(B) Is transferred to a third party who is not an eligible shareholder under paragraph (b)(1) of this section.

(iv) *Treatment of straight debt for other purposes.* An obligation of an S corporation that satisfies the definition of straight debt in paragraph (l)(5)(i) of this section is not treated as a second class of stock even if it is considered equity under general principles of Federal tax law. Such an obligation is generally treated as debt and when so treated is subject to the applicable rules governing indebtedness for other purposes of the Code. Accordingly, interest paid or accrued with respect to a straight debt obligation is generally treated as interest by the corporation and the recipient and does not constitute a distribution to which section 1368 applies. However, if a straight debt obligation bears a rate of interest that is unreasonably high, an appropriate portion of the interest may be recharacterized and treated as a payment that is not interest. Such a recharacterization does not result in a second class of stock.

(v) *Treatment of C corporation debt upon conversion to S status.* If a C corporation has outstanding an obligation that satisfies the definition of straight debt in paragraph (l)(5)(i) of this section, but that is considered equity under general principles of Federal tax law, the obligation is not treated as a second class of stock for purposes of this section if the C corporation converts to S status. In addition, the conversion from C corporation status to S corporation status is not treated as an exchange of debt for stock with respect to such an instrument.

(6) *Inadvertent terminations.* See section 1362(f) and the regulations thereunder for rules relating to inadvertent terminations in cases where the one class of stock requirement has been inadvertently breached.

(7) *Effective date.* Section 1.1361–1(l) generally applies to taxable years of a corporation beginning on or after May 28, 1992. However, §1.1361–1(l) does not apply to: an instrument, obligation, or arrangement issued or entered into before May 28, 1992, and not materially modified after that date; a buy-sell agreement, redemption agreement, or agreement restricting transferability entered into before May 28, 1992, and not materially modified after that date; or a call option or similar instrument issued before May 28, 1992, and not materially modified after that date. In addition, a corporation and its shareholders may apply this §1.1361–1(l) to prior taxable years.

[T.D. 8419, 57 FR 22649, May 29, 1992; 57 FR 28613, June 26, 1992, as amended by T.D. 8600, 60 FR 37581, July 21, 1995; 60 FR 49976, Sept. 27, 1995; 60 FR 58234, Nov. 27, 1995; 61 FR 2869, Jan. 29, 1996]

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[T.D. 8449, 57 FR 55448, Nov. 25, 1992; 58 FR 3330, Jan. 8, 1993]

§ 1.1362–1 Election to be an S corporation.

(a) *In general.* Except as provided in § 1.1362–5, a small business corporation as defined in section 1361 may elect to be an S corporation under section 1362(a). An election may be made only with the consent of all of the shareholders of the corporation at the time of the election. See § 1.1362–6(a) for rules concerning the time and manner of making this election.

(b) *Years for which election is effective.* An election under section 1362(a) is effective for the entire taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, until the election is terminated.

[T.D. 8449, 57 FR 55449, Nov. 25, 1992]

§ 1.1362–2 Termination of election.

(a) *Termination by revocation*—(1) *In general.* An election made under section 1362(a) is terminated if the corporation revokes the election for any taxable year of the corporation for which the election is effective, including the first taxable year. A revocation may be made only with the consent of shareholders who, at the time the revocation is made, hold more than one-half of the number of issued and outstanding shares of stock (including non-voting stock) of the corporation. See §1.1362–6(a) for rules concerning the time and manner of revoking an election made under section 1362(a).

(2) *When effective*—(i) *In general.* Except as provided in paragraph (a)(2)(ii) of this section, a revocation made during the taxable year and before the 16th day of the third month of the taxable year is effective on the first day of the taxable year and a revocation made after the 15th day of the third month of the taxable year is effective for the following taxable year. If a corporation makes an election to be an S corporation that is to be effective beginning with the next taxable year and revokes its election on or before the first day of the next taxable year, the corporation is deemed to have revoked its election on the first day of the next taxable year.

(ii) *Revocations specifying a prospective revocation date.* If a corporation specifies a date for revocation and the date is expressed in terms of a stated day, month, and year that is on or after the date the revocation is filed, the revocation is effective on and after the date so specified.

(3) *Effect on taxable year of corporation.* In the case of a corporation that revokes its election to be an S corporation effective on the first day of the first taxable year for which its election is to be effective, any statement made with the election regarding a change in the corporation's taxable year has no effect.

(4) *Rescission of a revocation.* A corporation may rescind a revocation made under paragraph (a)(2) of this section at any time before the revocation becomes effective. A rescission may be made only with the consent of each person who consented to the revocation and by each person who became a shareholder of the corporation within the period beginning on the first day after the date the revocation was made and ending on the date on which the rescission is made. See §1.1362–6(a) for rules concerning the time and manner of rescinding a revocation.

(b) *Termination by reason of corporation ceasing to be a small business corporation*—(1) *In general.* If a corporation ceases to be a small business corporation, as defined in section 1361(b), at any time on or after the first day of the first taxable year for which its election under section 1362(a) is effective, the election terminates. In the event of a termination under this paragraph (b)(1), the corporation should attach to its return for the taxable year in which the termination occurs a notification that a termination has occurred and the date of the termination.

(2) *When effective.* If an election terminates because of a specific event that causes the corporation to fail to meet the definition of a small business corporation, the termination is effective as of the date on which the event occurs. If a corporation makes an election to be an S corporation that is effective beginning with the following taxable year and is not a small business corporation on the first day of that following taxable year, the election is treated as having terminated on that first day. If a corporation is a small business corporation on the first day of the taxable year for which its election is effective, its election does not terminate even if the corporation was not a small business corporation during all or part of the period beginning after the date the election was made and ending before the first day of the taxable year for which the election is effective.

(3) *Effect on taxable year of corporation.* In the case of a corporation that fails to meet the definition of a small business corporation on the first day of the first taxable year for which its election to be an S corporation is to be effective, any statement made with the election regarding a change in the corporation's taxable year has no effect.

(c) *Termination by reason of excess passive investment income*—(1) *In general.* A corporation's election under section 1362(a) terminates if the corporation has subchapter C earnings and profits at the close of each of three consecutive taxable years and, for each of those taxable years, has passive investment income in excess of 25 percent of gross receipts. See section 1375 for the tax imposed on excess passive investment income.

(2) *When effective.* A termination under this paragraph (c) is effective on the first day of the first taxable year beginning after the third consecutive

year in which the S corporation had excess passive investment income.

(3) *Subchapter C earnings and profits.* For purposes of this paragraph (c), *subchapter C earnings and profits* of a corporation are the earnings and profits of any corporation, including the S corporation or an acquired or predecessor corporation, for any period with respect to which an election under section 1362(a) (or under section 1372 of prior law) was not in effect. The subchapter C earnings and profits of an S corporation are modified as required by section 1371(c).

(4) *Gross receipts*—(i) *In general.* For purposes of this paragraph (c), *gross receipts* generally means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income and is not reduced by returns and allowances, cost of goods sold, or deductions.

(ii) *Special rules for sales of capital assets, stock and securities*—(A) *Sales of capital assets.* For purposes of this paragraph (c), gross receipts from the sales or exchanges of capital assets (as defined in section 1221), other than stock and securities, are taken into account only to the extent of capital gain net income (as defined in section 1222).

(B) *Sales of stock or securities*—(*1*) *In general.* For purposes of this paragraph (c), gross receipts from the sales or exchanges of stock or securities are taken into account only to the extent of gains therefrom. In addition, for purposes of computing gross receipts from sales or exchanges of stock or securities, losses do not offset gains.

(*2*) *Treatment of certain liquidations.* Gross receipts from the sales or exchanges of stock or securities do not include amounts described in section 1362(d)(3)(D)(iv), relating to the treatment of certain liquidations. For purposes of section 1362(d)(3)(D)(iv), stock of the liquidating corporation owned by an S corporation shareholder is not treated as owned by the S corporation.

(*3*) *Definition of stock or securities.* For purposes of this paragraph (c), *stock or securities* includes shares or certificates of stock, stock rights or warrants, or an interest in any corporation (including any joint stock company, insurance company, association, or other organization classified as a corporation under section 7701); an interest as a limited partner in a partnership; certificates of interest or participation in any profit-sharing agreement, or in any oil, gas, or other mineral property, or lease; collateral trust certificates; voting trust certificates; bonds; debentures; certificates of indebtedness; notes; car trust certificates; bills of exchange; or obligations issued by or on behalf of a State, Territory, or political subdivision thereof.

(*4*) *General partner interests*—(*i*) *In general.* Except as provided in paragraph (c)(4)(ii)(B)(*4*)(*ii*) of this section, if an S corporation disposes of a general partner interest, the gain on the disposition is treated as gain from the sale of stock or securities to the extent of the amount the S corporation would have received as a distributive share of gain from the sale of stock or securities held by the partnership if all of the stock and securities held by the partnership had been sold by the partnership at fair market value at the time the S corporation disposes of the general partner interest. In applying this rule, the S corporation's distributive share of gain from the sale of stock or securities held by the partnership is not reduced to reflect any loss that would be recognized from the sale of stock or securities held by the partnership. In the case of tiered partnerships, the rules of this section apply by looking through each tier.

(*ii*) *Exception.* An S corporation that disposes of a general partner interest may treat the disposition, for purposes of this paragraph (c), in the same manner as the disposition of an interest as a limited partner.

(iii) *Other exclusions from gross receipts.* For purposes of this paragraph (c), gross receipts do not include—

(A) Amounts received in nontaxable sales or exchanges except to the extent that gain is recognized by the corporation on the sale or exchange; or

(B) Amounts received as a loan, as a repayment of a loan, as a contribution to capital, or on the issuance by the corporation of its own stock.

(5) *Passive investment income*—(i) *In general.* In general, *passive investment income* means gross receipts (as defined

in paragraph (c)(4) of this section) derived from royalties, rents, dividends, interest, annuities, and gains from the sales or exchanges of stock or securities.

(ii) *Definitions.* For purposes of this paragraph (c)(5), the following definitions apply:

(A) *Royalties*—(*1*) *In general. Royalties* means all royalties, including mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trademarks, tradebrands, franchises, and other like property. The gross amount of royalties is not reduced by any part of the cost of the rights under which the royalties are received or by any amount allowable as a deduction in computing taxable income.

(*2*) *Royalties derived in the ordinary course of a trade or business. Royalties* does not include royalties derived in the ordinary course of a trade or business of franchising or licensing property. Royalties received by a corporation are derived in the ordinary course of a trade or business of franchising or licensing property only if, based on all the facts and circumstances, the corporation—

(*i*) Created the property; or

(*ii*) Performed significant services or incurred substantial costs with respect to the development or marketing of the property.

(*3*) *Copyright, mineral, oil and gas, and active business computer software royalties. Royalties* does not include copyright royalties, nor mineral, oil and gas royalties if the income from those royalties would not be treated as personal holding company income under sections 543 (a)(3) and (a)(4) if the corporation were a C corporation; amounts received upon disposal of timber, coal, or domestic iron ore with respect to which the special rules of sections 631 (b) and (c) apply; and active business computer software royalties as defined under section 543(d) (without regard to paragraph (d)(5) of section 543).

(B) *Rents*—(*1*) *In general. Rents* means amounts received for the use of, or right to use, property (whether real or personal) of the corporation.

(*2*) *Rents derived in the active trade or business of renting property. Rents* does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

(*3*) *Produced film rents. Rents* does not include produced film rents as defined under section 543(a)(5).

(*4*) *Income from leasing self-produced tangible property. Rents* does not include compensation, however designated, for the use of, or right to use, any real or tangible personal property developed, manufactured, or produced by the taxpayer, if during the taxable year the taxpayer is engaged in substantial development, manufacturing, or production of real or tangible personal property of the same type.

(C) *Dividends. Dividends* includes dividends as defined in section 316, amounts to be included in gross income under section 551 (relating to foreign personal holding company income taxed to U.S. shareholders), and consent dividends as provided in section 565. See paragraphs (c)(5)(iii) (B) and (C) of this section for special rules for the treatment of certain dividends and certain payments to a patron of a cooperative.

(D) *Interest*—(*1*) *In general. Interest* means any amount received for the use of money (including tax-exempt interest and amounts treated as interest under section 483, 1272, 1274, or 7872). See paragraph (c)(5)(iii)(B) of this section for a special rule for the treatment of interest derived in certain businesses.

(*2*) *Interest on obligations acquired in the ordinary course of a trade or business. Interest* does not include interest on any obligation acquired from the sale of property described in section 1221(1) or the performance of services in the ordinary course of a trade or business of selling the property or performing the services.

(E) *Annuities. Annuities* means the entire amount received as an annuity under an annuity, endowment, or life insurance contract, if any part of the amount would be includible in gross income under section 72.

(F) *Gross receipts from the sale of stock or securities.* Gross receipts from the sales or exchanges of stock or securities, as described in paragraph (c)(4)(ii)(B) of this section, are passive investment income to the extent of gains therefrom. See paragraph (c)(5)(iii)(B) of this section for a special rule for the treatment of gains derived in certain businesses.

(G) *Identified income. Passive investment income* does not include income identified by the Commissioner by regulations, revenue ruling, or revenue procedure as income derived in the ordinary course of a trade or business for purposes of this section.

(iii) *Special rules.* For purposes of this paragraph (c)(5), the following special rules apply:

(A) *Options or commodities dealers.* In the case of an options dealer or commodities dealer, *passive investment income* does not include any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading section 1256 contracts) from any section 1256 contract or property related to the contract. *Options dealer, commodities dealer,* and *section 1256 contract* have the same meaning as in section 1362(d)(3)(E)(ii).

(B) *Treatment of certain lending, financing and other business*—(*1*) *In general. Passive investment income* does not include gross receipts that are directly derived in the ordinary course of a trade or business of—

(*i*) Lending or financing;

(*ii*) Dealing in property;

(*iii*) Purchasing or discounting accounts receivable, notes, or installment obligations; or

(*iv*) Servicing mortgages.

(*2*) *Directly derived.* For purposes of this paragraph (c)(5)(iii)(B), gross receipts directly derived in the ordinary course of business includes gain (as well as interest income) with respect to loans originated in a lending business, or interest income (as well as gain) from debt obligations of a dealer in such obligations. However, interest earned from the investment of idle funds in short-term securities does not constitute gross receipts directly derived in the ordinary course of business. Similarly, a dealer's income or gain from an item of property is not directly derived in the ordinary course of its trade or business if the dealer held the property for investment at any time before the income or gain is recognized.

(C) *Payment to a patron of a cooperative. Passive investment income* does not include amounts included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2) (A) or (C) of section 1381(a)) by reason of any payment or allocation to the patron based on patronage occurring in the case of a trade or business of the patron.

(6) *Examples.* The principles of paragraphs (c)(4) and (c)(5) of this section are illustrated by the following examples. Unless otherwise provided in an example, *S* is an S corporation with subchapter C earnings and profits, and *S*'s gross receipts from operations are gross receipts not derived from royalties, rents, dividends, interest, annuities, or gains from the sales or exchanges of stock or securities. *S* is a calendar year taxpayer and its first taxable year as an S corporation is 1993.

Example 1. Sales of capital assets, stock and securities. (i) *S* uses an accrual method of accounting and sells:

(1) A depreciable asset, held for more than 6 months, which is used in the corporation's business;

(2) A capital asset (other than stock or securities) for a gain;

(3) A capital asset (other than stock or securities) for a loss; and

(4) Securities.

S receives payment for each asset partly in money and partly in the form of a note payable at a future time, and elects not to report the sales on the installment method.

(ii) The amount of money and the face amount (or issue price if different) of the note received for the business asset are considered gross receipts in the taxable year of sale and are not reduced by the adjusted basis of the property, costs of sale, or any other amount. With respect to the sales of the capital assets, gross receipts include the cash down payment and face amount (or issue price if different) of any notes, but only to the extent of *S*'s capital gain net income. In the case of the sale of the securities, gross receipts include the cash down payment and face amount (or issue price if different) of the notes, but only to the extent of gain on the sale. In determining gross receipts from sales of securities, losses are not netted against gains.

Example 2. Long-term contract reported on percentage-of-completion method. S has a long-term contract as defined in §1.451–3(b) with respect to which it reports income according to the percentage-of-completion method as described in §1.451–3(c)(1). The portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year is included in *S*'s gross receipts for the year.

Example 3. Income reported on installment sale method. For its 1993 taxable year, S sells personal property on the installment plan and elects to report its taxable income from the sale of the property (other than property qualifying as a capital asset or stock or securities) on the installment method in accordance with section 453. The installment payment actually received in a given taxable year of S is included in gross receipts for the year.

Example 4. Partnership interests. In 1993, S and two of its shareholders contribute cash to form a general partnership, PRS. S receives a 50 percent interest in the capital and profits of PRS. S formed PRS to indirectly invest in marketable stocks and securities. The only assets of PRS are the stock and securities, and certain real and tangible personal property. In 1994, S needs cash in its business and sells its partnership interest at a gain rather than having PRS sell the marketable stock or securities that have appreciated. Under paragraph (c)(4)(ii)(B)(*4*) of this section, the gain on S's disposition of its interest is PRS is treated as gain from the sale or exchange of stock or securities to the extent of the amount the distributive share of gain S would have received from the sale of stock or securities held by PRS if PRS had sold all of its stock or securities at fair market value at the time S disposed of its interest in PRS.

Example 5. Royalties derived in ordinary course of trade or business. (i) In 1993, S has gross receipts of $75,000. Of this amount, $5,000 is from royalty payments with respect to Trademark A, $8,000 is from royalty payments with respect to Trademark B, and $62,000 is gross receipts from operations. S created Trademark A, but S did not create Trademark B or perform significant services or incur substantial costs with respect to the development or marketing of Trademark B.

(ii) Because S created Trademark A, the royalty payments with respect to Trademark A are derived in the ordinary course of S's business and are not included within the definition of *royalties* for purposes of determining S's passive investment income. However, the royalty payments with respect to Trademark B are included within the definition of *royalties* for purposes of determining S's passive investment income. See paragraph (c)(5)(ii)(A) of this section. S's passive investment income for the year is $8,000, and S's passive investment income percentage for the taxable year is 10.67% ($8,000/$75,000). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

Example 6. Dividends; gain on sale of stock derived in the ordinary course of trade or business. (i) In 1993, S receives dividends of $10,000 on stock of corporations P and O, recognizes a gain of $25,000 on sale of the P stock, and recognizes a loss of $12,000 on sale of the O stock. S held the P and O stock for investment, rather than for sale in the ordinary course of a trade or business. S has gross receipts from operations and from gain on the sale of stock in the ordinary course of its trade or business of $110,000.

(ii) S's gross receipts are calculated as follows:

$110,000	Gross receipts from operations and from gain on the sale of stock in the ordinary course of a trade or business
10,000	Gross dividend receipts
25,000	Gain on sale of P stock (Loss on O stock not taken into account
145,000	Total gross receipts

(iii) S's passsive investment income is determined as follows:

$10,000	Gross dividend receipts
25,000	Gain on sale of P stock (Loss on O stock not taken into account
35,000	Total passive investment income

(iv) S's passive investment income percentage for its first year as an S corporation is 24.1% ($35,000/$145,000). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

Example 7. Interest on accounts receivable; netting of gain on sale of real property investments. (i) In 1993, S receives $6,000 of interest on accounts receivable arising from S's sales of inventory property. S also received dividends with respect to stock held for investment of $1,500. In addition, *S* sells two parcels of real property (Property J and Property K) that S had purchased and held for investment. S sells Property J, in which S has a basis of $5,000, for $10,000 (a gain of $5,000). S sells Property K, in which S has a basis of $12,000, for $9,000 (a loss of $3,000). S has gross receipts from operations of $90,000.

(ii) S's gross receipts are calculated as follows:

$90,000	Gross receipts from operations
6,000	Gross interest receipts
1,500	Gross dividend receipts
2,000	Net gain on sale of real property investments
$99,500	Total gross receipts

(iii) Under paragraph (c)(5)(ii)(D) of this section, S's gross interest receipts are not passive investment income. In addition, gain on the sale of real property ($2,000) is not passive investment income. S's passive investment income includes only the $1,500 of gross dividend receipts. Accordingly, S's passive investment income percentage for its first year as an S corporation is 1.51% ($1,500/ $99,500). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

Example 8. Interest received in the ordinary course of a lending business. (i) In 1993, S has gross receipts of $100,000 from loans and investments made in the ordinary course of S's mortgage banking business. This includes, for example, mortgage servicing fees, interest earned on mortgages prior to sale of the mortgages, and gain on sale of mortgages. In addition, S receives, from the investment of idle funds in short-term securities, $15,000 of gross interest income and $5,000 of gain.

(ii) S's gross receipts are calculated as follows:

$100,000	Gross receipts from operations
15,000	Gross interest receipts
5,000	Gain on sale of securities
120,000	Total gross receipts

(iii) *S*'s passive investment income is determined as follows:

$15,000	Gross interest receipts
5,000	Gain on sale of securities,
20,000	Total passive investment income

(iv) S's passive investment income percentage for its first year as an S corporation is 16.67% ($20,000/$120,000). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

[T.D. 8449, 57 FR 55449, Nov. 25, 1992; 58 FR 15274, Mar. 22, 1993]

§ 1.1362–3 Treatment of S termination year.

(a) *In general.* If an S election terminates under section 1362(d) on a date other than the first day of a taxable year of the corporation, the corporation's taxable year in which the termination occurs is an S termination year. The portion of the S termination year ending at the close of the day prior to the termination is treated as a short taxable year for which the corporation is an S corporation (the *S short year*). The portion of the S termination year beginning on the day the termination is effective is treated as a short taxable year for which the corporation is a C corporation (the *C short year*). Except as provided in paragraphs (b) and (c)(1) of this section, the corporation allocates income or loss for the entire year on a pro rata basis as described in section 1362(e)(2). To the extent that income or loss is not allocated on a pro rata basis under this section, items of income, gain, loss, deduction, and credit are assigned to each short taxable year on the basis of the corporation's normal method of accounting as determined under section 446.

(b) *Allocations other than pro rata*—(1) *Elections under section 1362(e)(3).* The pro rata allocation rules of section 1362(e)(2) do not apply if the corporation elects to allocate its S termination year income on the basis of its normal tax accounting method. This election may be made only with the consent of each person who is a shareholder in the corporation at any time during the S short year and of each person who is a shareholder in the corporation on the first day of the C short year. See § 1.1362–6(a) for rules concerning the time and manner of making this election.

(2) *Purchase of stock treated as an asset purchase.* The pro rata allocation rules of section 1362(e)(2) do not apply with respect to any item resulting from the application of section 338.

(3) *50 percent change in ownership during S termination year.* The pro rata allocation rules of section 1362(e)(2) do not apply if at any time during the S termination year, as a result of sales or exchanges of stock in the corporation during that year, there is a change in ownership of 50 percent or more of the

issued and outstanding shares of stock of the corporation. If stock has already been sold or exchanged during the S termination year, subsequent sales or exchanges of that stock are not taken into account for purposes of this paragraph (b)(3).

(c) *Special rules*—(1) *S corporation that is a partner in a partnership.* For purposes of section 706(c) only, the termination of the election of an S corporation that is a partner in a partnership during any portion of the S short year under §1.1362–2 (a) or (b), is treated as a sale or exchange of the corporation's entire interest in the partnership on the last day of the S short year, if—

(i) The pro rata allocation rules do not apply to the corporation; and

(ii) Any taxable year of the partnership ends with or within the C short year.

(2) *Tax for the C short year.* The taxable income for the C short year is determined on an annualized basis as described in section 1362(e)(5).

(3) *Each short year treated as taxable year.* Except as otherwise provided in paragraph (c)(4) of this section, the S and C short years are treated as two separate years for purposes of all provisions of the Internal Revenue Code.

(4) *Year for carryover purposes.* The S and C short years are treated as one year for purposes of determining the number of taxable years to which any item may be carried back or forward by the corporation.

(5) *Due date for S short year return.* The date by which the return for the S short year must be filed is the same as the date by which the return for the C short year must be filed (including extensions).

(6) *Year in which income from S short year is includible.* A shareholder must include in taxable income the shareholder's pro rata share of the items described in section 1366(a) for the S short year for the taxable year with or within which the S termination year ends.

(d) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. S termination year not created. (i) On January 1, 1993, the first day of its taxable year, a subchapter C corporation had three eligible shareholders. During 1993, the corporation properly elected to be treated as an S corporation effective January 1, 1994, the first day of the succeeding taxable year. Subsequently, a transfer of some of the stock in the corporation was made to an ineligible shareholder. The ineligible shareholder still holds the stock on January 1, 1994.

(ii) The corporation fails to meet the definition of a small business corporation on January 1, 1994, and its election is treated as having terminated on that date. See §1.1362–2(b)(2) for the termination rules. Because the corporation ceases to be a small business corporation on the first day of a taxable year, an S termination year is not created. In addition, if the corporation in the future meets the definition of a small business corporation and desires to elect to be treated as an S corporation, the corporation is automatically granted consent to reelect before the expiration of the 5-year waiting period. See §1.1362–5 for special rules concerning automatic consent to reelect.

Example 2. More than 50 percent change in ownership during S short year. A, an individual, owns all 100 outstanding shares of stock of S, a calendar year S corporation. On January 31, 1993, A sells 60 shares of S stock to B, an individual. On June 1, 1993, A sells 5 shares of S stock to PRS, a partnership. S ceases to be a small business corporation on June 1, 1993, and pursuant to section 1362(d)(2), its election terminates on that date. Because there was a more than 50 percent change in ownership of the issued and outstanding shares of S stock, S must assign the items of income, loss, deduction, or credit for the S termination year to the two short taxable years on the basis of S's normal method of accounting under the rules of paragraph (b)(3) of this section.

Example 3. More than 50 percent change in ownership during C short year. A, an individual, owns all 100 outstanding shares of stock of S, a calendar year S corporation. On June 1, 1993, A sells 5 shares of S stock to PRS, a partnership. S ceases to be a small business corporation on that date and pursuant to section 1362(d)(3), its election terminates on that date. On July 1, 1993, A sells 60 shares of S stock to B, an individual. Since there was a more than 50 percent change in ownership of the issued and outstanding shares of S stock during the S termination year, S must assign the items of income, loss, deduction, or credit for the S termination year to the two short taxable years on the basis of S's normal method of accounting under the rules of paragraph (b)(3) of this section.

Example 4. Stock acquired other than by sale or exchange. C and D are shareholders in S, a calendar year S corporation. Each owns 50 percent of the issued and outstanding shares of the corporation on December 31, 1993. On March 1, 1994, C makes a gift of his entire shareholder interest to T, a trust not permitted as a shareholder under section 1361(c)(2). S ceases to be a small business corporation on March 1, 1994, and pursuant to section 1362(d)(2), its S corporation election terminates effective on that date. As a result of the gift, T owns 50 percent of S's issued and outstanding stock. However, because T acquired the stock by gift from C rather than by sale or exchange, there has not been a more than 50 percent change in ownership by sale or exchange of S that would cause the rules of paragraph (b)(3) of this section to apply.

[T.D. 8449, 57 FR 55452, Nov. 25, 1992]

§1.1362–4 Inadvertent terminations.

(a) *In general.* A corporation is treated as continuing to be an S corporation during the period specified by the Commissioner if—

(1) The corporation made a valid election under section 1362(a) and the election terminated;

(2) The Commissioner determines that the termination was inadvertent;

(3) Steps were taken by the corporation to return to small business corporation status within a reasonable period after discovery of the terminating event; and

(4) The corporation and shareholders agree to adjustments that the Commissioner may require for the period.

(b) *Inadvertent termination.* For purposes of paragraph (a) of this section, the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

(c) *Corporation's request for determination of an inadvertent termination.* A corporation that believes its election was terminated inadvertently may request a determination of inadvertent termination from the Commissioner. The request is made in the form of a ruling request and should set forth all relevant facts pertaining to the event including, but not limited to, the facts described in paragraph (b) of this section, the date of the corporation's election under section 1362(a), a detailed explanation of the event causing termination, when and how the event was discovered, and the steps taken to return the corporation to small business corporation status.

(d) *Adjustments.* The Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner. In the case of a transfer of stock to an ineligible shareholder that causes an inadvertent termination under section 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of an S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent any loss of revenue due to a transfer of stock to an ineligible shareholder (e.g., a transfer to a nonresident alien).

(e) *Corporation and shareholder consents.* The corporation and all persons who were shareholders of the corporation at any time during the period specified by the Commissioner must consent to any adjustments that the Commissioner may require. Each consent should be in the form of a statement agreeing to make the adjustments. The statement must be signed by the shareholder (in the case of shareholder consent) or a person authorized to sign the return required by section 6037 (in the case of corporate consent). See §1.1362–6(b)(2) for persons required to sign consents. A shareholder's consent statement should include the name, address, and taxpayer identification numbers of the corporation and shareholder, the number of shares of stock owned by the shareholder, and the dates on which the shareholder owned any stock. The corporate consent statement should include the name, address, and taxpayer identification numbers of the corporation and each shareholder.

(f) *Status of corporation.* The status of the corporation after the terminating event and before the determination of inadvertence is determined by the Commissioner. Inadvertent termination relief may be granted retroactive for all years for which the terminating event was effective, in which case the corporation is treated as if its election had not terminated. Alternatively, relief may be granted only for the period in which the corporation again became eligible for subchapter S treatment, in which case the corporation is treated as a C corporation during the period for which the corporation was not eligible to be an S corporation.

[T.D. 8449, 57 FR 55453, Nov. 25, 1992]

§1.1362–5 Election after termination.

(a) *In general.* Absent the Commissioner's consent, an S corporation whose election has terminated (or a successor corporation) may not make a new election under section 1362(a) for five taxable years as described in section 1362(g). However, the Commissioner may permit the corporation to make a new election before the 5-year period expires. The corporation has the burden of establishing that under the relevant facts and circumstances, the Commissioner should consent to a new election. The fact that more than 50 percent of the stock in the corporation is owned by persons who did not own any stock in the corporation on the date of the termination tends to establish that consent should be granted. In the absence of this fact, consent ordinarily is denied unless the corporation shows that the event causing termination was not reasonably within the control of the corporation or shareholders having a substantial interest in the corporation and was not part of a plan on the part of the corporation or of such shareholders to terminate the election.

(b) *Successor corporation.* A corporation is a *successor corporation* to a corporation whose election under section 1362 has been terminated if—

(1) 50 percent or more of the stock of the corporation (the new corporation) is owned, directly or indirectly, by the same persons who, on the date of the termination, owned 50 percent or more of the stock of the corporation whose election terminated (the old corporation); and

(2) Either the new corporation acquires a substantial portion of the assets of the old corporation, or a substantial portion of the assets of the new corporation were assets of the old corporation.

(c) *Automatic consent after certain terminations.* A corporation may, without requesting the Commissioner's consent, make a new election under section 1362(a) before the 5-year period described in section 1362(g) expires if the termination occurred because the corporation—

(1) Revoked its election effective on the first day of the first taxable year for which its election was to be effective (see §1.1362–2(a)(2)); or

(2) Failed to meet the definition of a small business corporation on the first day of the first taxable year for which its election was to be effective (see §1.1362–2(b)(2)).

[T.D. 8449, 57 FR 55454, Nov. 25, 1992]

§1.1362–6 Elections and consents.

(a) *Time and manner of making elections*—(1) *In general.* An election statement made under this section must identify the election being made, set forth the name, address, and taxpayer identification number of the corporation, and be signed by a person authorized to sign the return required to be filed under section 6037.

(2) *Election to be an S corporation*—(i) *Manner of making election.* A small business corporation makes an election under section 1362(a) to be an S corporation by filing a completed Form 2553. The election form must be filed with the service center designated in the instructions applicable to Form 2553. The election is not valid unless all shareholders of the corporation at the time of the election consent to the election in the manner provided in paragraph (b) of this section. However, once a valid election is made, new shareholders need not consent to that election.

(ii) *Time of making election*—(A) *In general.* The election described in paragraph (a)(2)(i) of this section may be made by a small business corporation at any time during the taxable year that immediately precedes the taxable year for which the election is to be effective, or during the taxable year for which the election is to be effective provided that the election is made before the 16th day of the third month of the year. If a corporation makes an election for a taxable year, and the election meets all the requirements of this section but is made during the period beginning after the 15th day of the third month of the taxable year, the election is treated as being made for the following taxable year provided that the corporation meets all the requirements of section 1361(b) at the time the election is made. For taxable years of 2½ months or less, an election made before the 16th day of the third month after the first day of the taxable year is treated as made during that year.

(B) *Elections made during the first 2½ months treated as made for the following taxable year.* A timely election made by a small business corporation during the taxable year for which it is intended to be effective is nonetheless treated as made for the following taxable year if—

(*1*) The corporation is not a small business corporation during the entire portion of the taxable year which occurs before the date the election is made; or

(*2*) Any person who held stock in the corporation at any time during the portion of the taxable year which occurs before the time the election is made, and who does not hold stock at the time the election is made, does not consent to the election.

(C) *Definition of month and beginning of the taxable year. Month* means a period commencing on the same numerical day of any calendar month as the day of the calendar month on which the taxable year began and ending with the close of the day preceding the numerically corresponding day of the succeeding calendar month or, if there is no corresponding day, with the close of the last day of the succeeding calendar month. In addition, the taxable year of a new corporation begins on the date that the corporation has shareholders, acquires assets, or begins doing business, whichever is the first to occur. The existence of incorporators does not necessarily begin the taxable year of a new corporation.

(iii) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. Effective election; no prior taxable year. A calendar year small business corporation begins its first taxable year on January 7, 1993. To be an S corporation beginning with its first taxable year, the corporation must make the election set forth in this section during the period that begins January 7, 1993, and ends before March 22, 1993. Because the corporation had no taxable year immediately preceding the taxable year for which the election is to be effective, an election made earlier than January 7, 1993, will not be valid.

Example 2. Effective election; taxable year less than 2 ½ months. A calendar year small business corporation begins its first taxable year on November 8, 1993. To be an S corporation beginning with its first taxable year, the corporation must make the election set forth in this section during the period that begins November 8, 1993, and ends before January 23, 1994.

Example 3. Election effective for the following taxable year; ineligible shareholder. On January 1, 1993, two individuals and a partnership own all of the stock of a calendar year subchapter C corporation. On January 31, 1993, the partnership dissolved and distributed its shares in the corporation to its five partners, all individuals. On February 28, 1993, the seven shareholders of the corporation consented to the corporation's election of subchapter S status. The corporation files a properly completed Form 2533 on March 2, 1993. The corporation is not eligible to be a subchapter S corporation for the 1993 taxable year because during the period of the taxable year prior to the election it had an ineligible shareholder. However, under paragraph (a)(2)(ii)(B) of this section, the election is treated as made for the corporation's 1994 taxable year.

(3) *Revocation of S election*—(i) *Manner of revoking election.* To revoke an election, the corporation files a statement that the corporation revokes the election made under section 1362(a). The statement must be filed with the service center where the election was properly filed. The revocation statement must include the number of shares of stock (including non-voting stock) issued and outstanding at the time the revocation is made. A revocation may be made only with the consent of shareholders who, at the time the revocation is made, hold more than one-

half of the number of issued and outstanding shares of stock (including non-voting stock) of the corporation. Each shareholder who consents to the revocation must consent in the manner required under paragraph (b) of this section. In addition, each consent should indicate the number of issued and outstanding shares of stock (including non-voting stock) held by each shareholder at the time of the revocation.

(ii) *Time of revoking election.* For rules concerning when a revocation is effective, see §1.1362–2(a)(2).

(iii) *Examples.* The principles of this paragraph (a)(3) are illustrated by the following examples:

Example 1. Revocation; consent of shareholders owning more than one-half of issued and outstanding shares. A calendar year S corporation has issued an outstanding 40,000 shares of class A voting common stock and 20,000 shares of class B non-voting common stock. The corporation wishes to revoke its election of subchapter S status. Shareholders owning 11,000 shares of class A stock sign revocation consents. Shareholders owning 20,000 shares of class B stock sign revocation consents. The corporation has obtained the required shareholder consent to revoke its subchapter S election because shareholders owning more than one-half of the total number of issued and outstanding shares of stock of the corporation consented to the revocation.

Example 2. Effective prospective revocation. In June 1993, a calendar year S corporation determines that it will revoke its subchapter S election effective August 1, 1993. To do so it must file its revocation statement with consents attached on or before August 1, 1993, and the statement must indicate that the revocation is intended to be effective August 1, 1993.

(4) *Rescission of revocation*—(i) *Manner of rescinding a revocation.* To rescind a revocation, the corporation files a statement that the corporation rescinds the revocation made under section 1362(d)(1). The statement must be filed with the service center where the revocation was properly filed. A rescission may be made only with the consent (in the manner required under paragraph (b)(1) of this section) of each person who consented to the revocation and of each person who became a shareholder of the corporation within the period beginning on the first day after the date the revocation was made and ending on the date on which the rescission is made.

(ii) *Time of rescinding a revocation.* If the rescission statement is filed before the revocation becomes effective and is filed with proper service center, the rescission is effective on the date it is so filed.

(5) *Election not to apply pro rata allocation.* To elect not to apply the pro rata allocation rules to an S termination year, a corporation files a statement that it elects under section 1362(e)(3) not to apply the rules provided in section 1362(e)(2). In addition to meeting the requirements of paragraph (a)(1) of this section, the statement must set forth the cause of the termination and the date thereof. The statement must be filed with the corporation's return for the C short year. This election may be made only with the consent of all persons who are shareholders of the corporation at any time during the S short year and all persons who are shareholders of the corporation on the first day of the C short year (in the manner required under paragraph (b)(1) of this section).

(b) *Shareholders' consents*—(1) *Manner of consents in general.* A shareholder's consent required under paragraph (a) of this section must be in the form of a written statement that sets forth the name, address, and taxpayer identification number of the shareholder, the number of shares of stock owned by the shareholder, the date (or dates) on which the stock was acquired, the date on which the shareholder's taxable year ends, the name of the S corporation, the corporation's taxpayer identification number, and the election to which the shareholder consents. The statement must be signed by the shareholder under penalties of perjury. Except as provided in paragraph (b)(3)(iii) of this section, the election of the corporation is not valid if any required consent is not filed in accordance with the rules contained in this paragraph (b). The consent statement should be attached to the corporation's election statement.

(2) *Persons required to consent.* The following rules apply in determining persons required to consent:

(i) *Community interest in stock.* When stock of the corporation is owned by husband and wife as community property (or the income from the stock is community property), or is owned by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest in the stock or income therefrom and each tenant in common, joint tenant and tenant by the entirety must consent to the election.

(ii) *Minor.* The consent of a minor must be made by the minor or by the legal representative of the minor (or by a natural or an adoptive parent of the minor if no legal representative has been appointed).

(iii) *Estate.* The consent of an estate must be made by an executor or administrator thereof, or by any other fiduciary appointed by testamentary instrument or appointed by the court having jurisdiction over the administration of the estate.

(iv) *Trust.* In the case of a trust described in section 1361(c)(2)(A) (including a trust treated under section 1361(d)(1)(A) as a trust described in section 1361(c)(2)(A)(i)), only the person treated as the shareholder for purposes of section 1361(b)(1) must consent to the election. When stock of the corporation is held by a trust, both husband and wife must consent to any election if the husband and wife have a community interest in the trust property. See paragraph (b)(2)(i) of this section for rules concerning community interests in S corporation stock.

(3) *Special rules for consent of shareholder to election to be an S corporation*—(i) *In general.* The consent of a shareholder to an election by a small business corporation under section 1362(a) may be made on Form 2553 or on a separate statement in the manner described in paragraph (b)(1) of this section. In addition, the separate statement must set forth the name, address, and taxpayer identification number of the corporation. A shareholder's consent is binding and may not be withdrawn after a valid election is made by the corporation. Each person who is a shareholder (including any person who is treated as a shareholder under section 1361(c)(2)(B)) at the time the election is made) must consent to the election. If the election is made before the 16th day of the third month of the taxable year and is intended to be effective for that year, each person who was a shareholder (including any person who was treated as a shareholder under section 1361(c)(2)(B)) at any time during the portion of that year which occurs before the time the election is made, and who is not a shareholder at the time the election is made, must also consent to the election. If the election is to be effective for the following taxable year, no consent need be filed by any shareholder who is not a shareholder on the date of the election. Any person who is considered to be a shareholder under applicable State law solely by virtue of his or her status as an incorporator is not treated as a shareholder for purposes of this paragraph (b)(3)(i).

(ii) *Examples.* The principles of this section are illustrated by the following examples:

Example 1. Effective election; shareholder consents. On January 1, 1993, the first day of its taxable year, a subchapter C corporation had 15 shareholders. On January 30, 1993, two of the C corporation's shareholders, A and B, both individuals, sold their shares in the corporation to P, Q, and R, all individuals. On March 1, 1993, the corporation filed its election to be an S corporation for the 1993 taxable year. The election will be effective (assuming the other requirements of section 1361(b) are met) provided that all of the shareholders as of March 1, 1993, as well as former shareholders A and B, consent to the election.

Example 2. Consent of new shareholder unnecessary. On January 1, 1993, three individuals own all of the stock of a calendar year subchapter C corporation. On April 15, 1993, the corporation, in accordance with paragraph (a)(2) of this section, files a properly completed Form 2553. The corporation anticipates that the election will be effective beginning January 1, 1994, the first day of the succeeding taxable year. On October 1, 1993, the three shareholders collectively sell 75% of their shares in the corporation to another individual. On January 1, 1994, the corporation's shareholders are the three original individuals and the new shareholder. Because the election was valid and binding when made, it is not necessary for the new shareholder to consent to the election. The corporation's subchapter S election is effective on January 1, 1994 (assuming the other requirements of section 1361(b) are met).

(iii) *Extension of time for filing consents to an election*—(A) *In general.* An election that is timely filed for any taxable year and that would be valid except for the failure of any shareholder to file a timely consent is not invalid if consents are filed as required under paragraph (b)(3)(iii)(B) of this section and it is shown to the satisfaction of the district director or director of the service center with which the corporation files its income tax return that—

(*1*) There was reasonable cause for the failure to file the consent;

(*2*) The request for the extension of time to file a consent is made within a reasonable time under the circumstances; and

(*3*) The interests of the Government will not be jeopardized by treating the election as valid.

(B) *Required consents.* Consents must be filed within the extended period of time as may be granted by the Internal Revenue Service, by all persons who—

(*1*) Were shareholders of the corporation at any time during the period beginning as of the date of the invalid election and ending on the date on which an extension of time is granted in accordance with this paragraph (b)(3)(iii); and

(*2*) Have not previously consented to the election.

[T.D. 8449, 57 FR 55454, Nov. 25, 1992]

§1.1362–7 Effective date.

(a) *In general.* The provisions of §§1.1362–1 through 1.1362–6 apply to taxable years of corporations beginning after December 31, 1992. For taxable years to which these regulations do not apply, corporations and shareholders subject to the provisions of section 1362 must take reasonable return positions taking into consideration the statute; its legislative history; the provisions of §§18.1362–1 through 18.1362–5 (see 26 CFR part 18 as contained in the CFR edition revised as of April 1, 1992). In addition, following these regulations is a reasonable return position. See Notice 92–56, 1992–49 I.R.B. (see §601.601(d)(2)(ii)(*b*) of this chapter), for additional guidance regarding reasonable return positions for years to which §§1.362–1 through 1.1362–6 do not apply.

(b) *Special effective date for passive investment income provisions.* For taxable years of an S corporation and all affected shareholders that are not closed, the S corporation and all affected shareholders may elect to apply the provisions of §1.1362–2(c)(5). To make the election, the corporation and all affected shareholders must file a return or an amended return that is consistent with these rules for the taxable year for which the election is made and each subsequent taxable year. For purposes of this section, *affected shareholders* means all shareholders who received distributive shares of S corporation items in the taxable year for which the election is made and all shareholders of the S corporation for all subsequent taxable years. However, the Commissioner may, in appropriate circumstances, permit taxpayers to make this election even if all affected shareholders cannot file consistent returns.

[T.D. 8449, 57 FR 55456, Nov. 25, 1992]

§1.1363–1 Effect of election on corporation.

(a) *Exemption of corporation from income tax*—(1) *In general.* Except as provided in this paragraph (a), a small business corporation that makes a valid election under section 1362(a) is exempt from the taxes imposed by chapter 1 of the Internal Revenue Code with respect to taxable years of the corporation for which the election is in effect.

(2) *Corporate level taxes.* An S corporation is not exempt from the tax imposed by section 1374 (relating to the tax imposed on certain built-in gains), or section 1375 (relating to the tax on excess passive investment income). See also section 1363(d) (relating to the recapture of LIFO benefits) for the rules regarding the payment by an S corporation of LIFO recapture amounts.

(b) *Computation of corporate taxable income.* The taxable income of an S corporation is computed as described in section 1363(b).

(c) *Elections of the S corporation*—(1) *In general.* Any elections (other than those described in paragraph (c)(2) of this section) affecting the computation of items derived from an S corporation are made by the corporation. For example, elections of methods of accounting, of computing depreciation, of treating soil and water conservation expenditures, and the option to deduct as expenses intangible drilling and development costs, are made by the corporation and not by the shareholders separately. All corporate elections are applicable to all shareholders.

(2) *Exceptions.* (i) Each shareholder's pro rata share of expenses described in section 617 paid or accrued by the S corporation is treated according to the shareholder's method of treating those expenses, notwithstanding the treatment of the expenses by the corporation.

(ii) Each shareholder may elect to amortize that shareholder's pro rata share of any qualified expenditure described in section 59(e) paid or accrued by the S corporation.

(iii) Each shareholder's pro rata share of taxes described in section 901 paid or accrued by the S corporation to foreign countries or possessions of the United States (according to its method of treating those taxes) is treated according to the shareholder's method of treating those taxes, and each shareholder may elect to use the total amount either as a credit against tax or as a deduction from income.

(d) *Effective date.* This section applies to taxable years of corporations beginning after December 31, 1992. For taxable years to which this section does not apply, corporations and shareholders subject to the provisions of section 1363 must take reasonable return positions taking into consideration the statute, its legislative history and these regulations. See Notice 92–56, 1992–49 I.R.B. (see § 601.601(d)(2)(ii)(*b*) of this chapter), for additional guidance regarding reasonable return positions for taxable years to which this section does not apply.

[T.D. 8449, 57 FR 55456, Nov. 25, 1992]

§ 1.1363–2 Recapture of LIFO benefits.

(a) *In general.* A C corporation must include the LIFO recapture amount (as defined in section 1363(d)(3)) in its gross income—

(1) In its last taxable year as a C corporation if the corporation inventoried assets under the LIFO method for its last taxable year before its S corporation election becomes effective; or

(2) In the year of transfer by the C corporation to an S corporation of the LIFO inventory assets if paragraph (a)(1) of this section does not apply and the C corporation—

(i) Inventoried assets under the LIFO method during the taxable year of the transfer of those LIFO inventory assets; and

(ii) Transferred the LIFO inventory assets to the S corporation in a nonrecognition transaction (within the meaning of section 7701(a)(45)) in which the transferred assets constitute transferred basis property (within the meaning of section 7701(a)(43)).

(b) *Payment of tax.* Any increase in tax caused by including the LIFO recapture amount in the gross income of the C corporation is payable in four equal installments. The C corporation must pay the first installment of this payment by the due date of its return, determined without regard to extensions, for the last taxable year it operated as a C corporation if paragraph (a)(1) of this section applies, or for the taxable year of the transfer if paragraph (a)(2) of this section applies. The three succeeding installments must be paid—

(1) For a transaction described in paragraph (a)(1) of this section, by the corporation (that made the election under section 1362(a) to be an S corporation) on or before the due date for the corporation's returns (determined without regard to extensions) for the succeeding three taxable years; and

(2) For a transaction described in paragraph (a)(2) of this section, by the transferee S corporation on or before the due date for the transferee corporation's returns (determined without regard to extensions) for the succeeding three taxable years.

(c) *Basis adjustments.* Appropriate adjustments to the basis of inventory are to be made to reflect any amount included in income under this section.

(d) *Effective dates.* (1) The provisions of paragraph (a)(1) of this section apply to S elections made after December 17, 1987. For an exception, see section 10227(b)(2) of the Revenue Act of 1987.

(2) The provisions of paragraph (a)(2) of this section apply to transfers made after August 18, 1993.

[T.D. 8567, 59 FR 51106, Oct. 7, 1994]

§1.1366–1 [Reserved]

§1.1366–2 Special rules on requirement to separately state meal, travel, and entertainment expenses.

Each shareholder shall take into account separately his or her pro rata share of meal, travel, and entertainment expenses paid or incurred after December 31, 1986, by S corporations that have taxable years beginning before January 1, 1987, and ending with or within shareholders' taxable years beginning on or after January 1, 1987. In addition, with respect to skybox rentals under section 274 (l) (2), each shareholder shall take into account separately his or her pro rata share of rents paid or incurred after December 31, 1986, by S corporations that have taxable years beginning before January 1, 1989, and ending with or within shareholders' taxable years beginning on or after January 1, 1987.

[T.D. 8247, 54 FR 13680, Apr. 5, 1989]

§1.1367–0 Table of contents.

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(e) Examples.

§1.1367–3 Effective date and transition rule.

[T.D. 8508, 59 FR 15, Jan. 3, 1994]

§1.1367–1 Adjustments to basis of shareholder's stock in an S corporation.

(a) *In general*—(1) *Adjustments under section 1367.* This section provides rules relating to adjustments required by section 1367 to the basis of a shareholder's stock in an S corporation. Paragraph (b) of this section provides rules concerning increases in the basis of a shareholder's stock, and paragraph (c) of this section provides rules concerning decreases in the basis of a shareholder's stock.

(2) *Applicability of other Internal Revenue Code provisions.* In addition to the adjustments required by section 1367 and this section, the basis of stock is determined or adjusted under other applicable provisions of the Internal Revenue Code.

(b) *Increase in basis of stock*—(1) *In general.* Except as provided in §1.1367–2(c) (relating to restoration of basis of indebtedness to the shareholder), the basis of a shareholder's stock in an S corporation is increased by the sum of the items described in section 1367(a)(1). The increase in basis described in section 1367(a)(1)(C) for the excess of the deduction for depletion over the basis of the property subject to depletion does not include the depletion deduction attributable to oil or gas property. See section 613(A)(c)(11).

(2) *Amount of increase in basis of individual shares.* The basis of a shareholder's share of stock is increased by an amount equal to the shareholder's pro rata portion of the items described in section 1367(a)(1) that is attributable to that share, determined on a per share, per day basis in accordance with section 1377(a).

(c) *Decrease in basis of stock*—(1) *In general.* The basis of a shareholder's stock in an S corporation is decreased (but not below zero) by the sum of the items described in section 1367(a)(2).

(2) *Noncapital, nondeductible expenses.* For purposes of section 1367(a)(2)(D), expenses of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account (*noncapital, nondeductible expenses*) are only those items for which no loss or deduction is allowable and do not include items the deduction for which is deferred to a later taxable year. Examples of noncapital, nondeductible expenses include (but are not limited to) the following: Illegal bribes, kickbacks, and other payments not deductible under section 162(c); fines and penalties not deductible under section 162(f); expenses and interest relating to tax-exempt income under section 265; losses for which the deduction is disallowed under section 267(a)(1); the portion of meals and entertainment expenses disallowed under section 274; and the two-thirds portion of treble damages paid for violating antitrust laws not deductible under section 162.

(3) *Amount of decrease in basis of individual shares.* The basis of a shareholder's share of stock is decreased by an amount equal to the shareholder's pro rata portion of the passthrough items and distributions described in section 1367(a)(2) attributable to that share, determined on a per share, per day basis in accordance with section 1377(a). If the amount attributable to a share exceeds its basis, the excess is applied to reduce (but not below zero) the remaining bases of all other shares of stock in the corporation owned by the shareholder in proportion to the remaining basis of each of those shares.

(d) *Time at which adjustments to basis of stock are effective*—(1) *In general.* The adjustments described in section 1367(a) to the basis of a shareholder's stock are determined as of the close of the corporation's taxable year, and the adjustments generally are effective as of that date. However, if a shareholder disposes of stock during the corporation's taxable year, the adjustments with respect to that stock are effective immediately prior to the disposition.

(2) *Adjustment for nontaxable item.* An adjustment for a nontaxable item is determined for the taxable year in which the item would have been includible or deductible under the corporation's method of accounting for Federal income tax purposes if the item had been subject to Federal income taxation.

(3) *Effect of election under section 1377(a)(2) or § 1.1368–1(g)(2).* If an election under section 1377(a)(2) (to terminate the year in the case of the termination of a shareholder's interest) or under § 1.1368–1(g)(2) (to terminate the year in the case of a qualifying disposition) is made with respect to the taxable year of a corporation, this paragraph (d) applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which either the shareholder's interest is terminated or a qualifying disposition occurs, whichever the case may be.

(e) *Ordering rules.* For any taxable year, except as provided in paragraph (f) of this section, the adjustments required by section 1367(a) are made in the following order:

(1) Any increase in basis attributable to the income items described in section 1367(a)(1) (A) and (B) and the excess of the deductions for depletion described in section 1367(a)(1)(C);

(2) Any decrease in basis attributable to noncapital, nondeductible expenses described in section 1367(a)(2)(D) and the oil and gas depletion deduction described in section 1367(a)(2)(E);

(3) Any decrease in basis attributable to items of loss or deduction described in section 1367(a)(2) (B) and (C); and

(4) Any decrease in basis attributable to a distribution by the corporation described in section 1367(a)(2)(A).

(f) *Elective ordering rule.* A shareholder may elect to decrease basis under paragraph (e)(3) of this section prior to decreasing basis under paragraph (e)(2) of this section. If a shareholder makes this election, any amount described in paragraph (e)(2) of this section that is in excess of the shareholder's basis in stock and indebtedness is treated, solely for purposes of this section, as an amount described in paragraph (e)(2) of this section in the succeeding taxable year. A shareholder makes the election under this paragraph by attaching a statement to the shareholder's timely filed original or amended return that states that the shareholder agrees to the carryover rule of the preceding sentence. Once a shareholder makes an election under this paragraph with respect to an S corporation, the shareholder must continue to use the rules of this paragraph for that S corporation in future taxable years unless the shareholder receives the permission of the Commissioner.

(g) *Examples.* The following examples illustrate the principles of § 1.1367–1. In each example, the corporation is a calendar year S corporation:

Example 1. Adjustments to basis of stock in general. (i) On December 31, 1994, A owns a block of 50 shares of stock with an adjusted basis per share of $6 in Corporation S. On December 31, 1994, A purchases for $400 an additional block of 50 shares of stock with an adjusted basis of $8 per share. Thus, A holds 100 shares of stock for each day of the 1995 taxable year. For S's 1995 taxable year, A's pro rata share of the amount of the items described in section 1367(a)(1)(A) (relating to increases in basis of stock) is $300, and A's pro rata share of the amount of the items described in section 1367(a)(2) (B) and (D) (relating to decreases in basis of stock) is $500. S makes a distribution to A in the amount of $100 during 1995.

(ii) Pursuant to the ordering rules of paragraph (e) of this section, A increases the basis of each share of stock by $3 ($300/100 shares) and decreases the basis of each share of stock by $5 ($500/100 shares). Then A reduces the basis of each share by $1 ($100/100 shares) for the distribution. Thus, on January 1, 1996, A has a basis of $3 per share in his original block of 50 shares ($6+$3−$5−$1) and a basis of $5 per share in the second block of 50 shares ($8+$3−$5−$1).

Example 2. Adjustments attributable to basis of individual shares of stock. (i) On December 31, 1993, B owns one share of S corporation's 10 outstanding shares of stock. The basis of B's share is $30. On July 2, 1994, B purchases from another shareholder two shares for $25 each. During 1994, S corporation has no income or deductions but incurs a loss of $365. Under section 1377(a)(1)(A) and paragraph (c)(3) of this section, the amount of the loss assigned to each day of S's taxable year is $1.00 ($365/365 days). For each day, $.10 is allocated to each outstanding share ($1.00 amount of loss assigned to each day/10 shares).

(ii) B owned one share for 365 days and, therefore, reduces the basis of that share by the amount of loss attributable to it, i.e., $36.50 ($.10 × 365 days). B owned two shares for 182 days and, therefore, reduces the basis of each of those shares by the amount of the loss attributable to each, i.e., $18.20 ($.10 × 182 days).

(iii) The bases of the shares are decreased as follows:

Share	Original basis	Decrease	Adjusted basis	Excess basis reduction
No. 1	$30.00	$36.50	$0	$6.50
No. 2	25.00	18.20	6.80	0
No. 3	25.00	18.20	6.80	0
Total remaining basis			13.60	

(iv) Because the decrease in basis attributable to share No. 1 exceeds the basis of share No. 1 by $6.50 ($36.50 − $30.00), the excess is applied to reduce the bases of shares No. 2 and No. 3 in proportion to their remaining bases. Therefore, the bases of share No. 2 and share No. 3 are each decreased by an additional $3.25 ($6.50 × $6.80/$13.60). After this decrease, Share No. 1 has a basis of zero, Share No. 2 has a basis of $3.55, and Share No. 3 has a basis of $3.55.

Example 3. Effects of section 1377(a)(2) election and distribution on basis of stock. (i) On January 1, 1994, individuals B and C each own 50 of the 100 shares of issued and outstanding stock of Corporation S. B's adjusted basis in each share of stock is $120, and C's is $80. On June 30, 1994, S distributes $6,000 to B and $6,000 to C. On June 30, 1994, B sells all of her S stock for $10,000 to D. S elects under section 1377(a)(2) to treat its 1994 taxable year as consisting of two taxable years, the first of which ends at the close of June 30, the date on which B terminates her interest in S.

(ii) For the period January 1, 1994, through June 30, 1994, S has nonseparately computed income of $6,000 and a separately stated deduction item of $4,000. Therefore, on June 30, 1994, B and C, pursuant to the ordering rules of paragraph (e) of this section, increase the basis of each share by $60 ($6,000/100 shares) and decrease the basis of each share by $40 ($4,000/100 shares). Then B and C reduce the basis of each share by $120 ($12,000/100 shares) for the distribution.

(iii) The basis of B's stock is reduced from $120 to $20 per share ($120+$60−$40−$120). The basis of C's stock is reduced from $80 to $0 per share ($80+$60−$40−$120). See section 1368 and § 1.1368–1 (c) and (d) for rules relating to the tax treatment of the distributions.

(iv) Pursuant to paragraph (d)(3) of this section, the net reduction in the basis of B's shares of the S stock required by section 1367 and this section is effective immediately prior to B's sale of her stock. Thus, B's basis for determining gain or loss on the sale of the S stock is $20 per share, and B has a gain on the sale of $180 ($200 − $20) per share.

[T.D. 8508, 59 FR 15, Jan. 3, 1994]

§ 1.1367–2 Adjustments to basis of indebtedness to shareholder.

(a) *In general.* This section provides rules relating to adjustments required by subchapter S to the basis of indebtedness of an S corporation to a shareholder. For purposes of this section, shareholder advances not evidenced by separate written instruments and repayments on the advances (*open account debt*) are treated as a single indebtedness. The basis of indebtedness of the S corporation to a shareholder is reduced as provided in paragraph (b) of this section and restored as provided in paragraph (c) of this section.

(b) *Reduction in basis of indebtedness*—(1) *General rule.* If, after making the adjustments required by section 1367(a)(1) for any taxable year of the S corporation, the amounts specified in section 1367(a)(2) (B), (C), (D), and (E) (relating to losses, deductions, noncapital, nondeductible expenses, and certain oil and gas depletion deductions) exceed the basis of a shareholder's stock in the corporation, the excess is applied to reduce (but not below zero) the basis of any indebtedness of the S corporation to the shareholder held by the shareholder at the close of the corporation's taxable year. Any such indebtedness that has been satisfied by the corporation, or disposed of or forgiven by the shareholder, during the taxable year, is not held by the shareholder at the close of that year and is not subject to basis reduction.

(2) *Termination of shareholder's interest in corporation during taxable year.* If a shareholder terminates his or her interest in the corporation during the taxable year, the rules of this paragraph (b) are applied with respect to any indebtedness of the S corporation held by the shareholder immediately prior to the termination of the shareholder's interest in the corporation.

(3) *Multiple indebtedness.* If a shareholder holds more than one indebtedness at the close of the corporation's taxable year or, if applicable, immediately prior to the termination of the shareholder's interest in the corporation, the reduction in basis is applied to each indebtedness in the same proportion that the basis of each indebtedness bears to the aggregate bases of the indebtedness to the shareholder.

(c) *Restoration of basis*—(1) *General rule.* If, for any taxable year of an S corporation beginning after December 31, 1982, there has been a reduction in the basis of an indebtedness of the S corporation to a shareholder under section 1367(b)(2)(A), any *net increase* in any subsequent taxable year of the corporation is applied to restore that reduction. For purposes of this section, *net increase* with respect to a shareholder means the amount by which the shareholder's pro rata share of the items described in section 1367(a)(1) (relating to income items and excess deduction for depletion) exceed the items described in section 1367(a)(2) (relating to losses, deductions, noncapital, nondeductible expenses, certain oil and gas depletion deductions, and certain distributions) for the taxable year. These restoration rules apply only to indebtedness held by a shareholder as of the beginning of the taxable year in which the net increase arises. The reduction in basis of indebtedness must be restored before any net increase is applied to restore the basis of a shareholder's stock in an S corporation. In no event may the shareholder's basis of indebtedness be restored above the adjusted basis of the indebtedness under section 1016(a), excluding any adjustments under section 1016(a)(17) for prior taxable years, determined as of the beginning of the taxable year in which the net increase arises.

(2) *Multiple indebtedness.* If a shareholder holds more than one indebtedness as of the beginning of a corporation's taxable year, any net increase is applied first to restore the reduction of basis in any indebtedness repaid (in whole or in part) in that taxable year to the extent necessary to offset any gain that would otherwise be realized on the repayment. Any remaining net increase is applied to restore each outstanding indebtedness in proportion to the amount that the basis of each outstanding indebtedness has been reduced

under section 1367(b)(2)(A) and paragraph (b) of this section and not restored under section 1367(b)(2)(B) and this paragraph (c).

(d) *Time at which adjustments to basis of indebtedness are effective*—(1) *In general.* The amounts of the adjustments to basis of indebtedness provided in section 1367(b)(2) and this section are determined as of the close of the corporation's taxable year, and the adjustments are generally effective as of the close of the corporation's taxable year. However, if the shareholder is not a shareholder in the corporation at that time, these adjustments are effective immediately before the shareholder terminates his or her interest in the corporation. If a debt is disposed of or repaid in whole or in part before the close of the taxable year, the basis of that indebtedness is restored under paragraph (c) of this section, effective immediately before the disposition or the first repayment on the debt during the taxable year.

(2) *Effect of election under section 1377(a)(2) or § 1.1368–1(g)(2).* If an election is made under section 1377(a)(2) (to terminate the year in the case of the termination of a shareholder's interest) or under § 1.1368–1(g)(2) (to terminate the year in the case of a qualifying disposition), this paragraph (d) applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which the shareholder either terminates his or her interest in the corporation or disposes of a substantial amount of stock, whichever the case may be.

(e) *Examples.* The following examples illustrate the principles of § 1.1367–2. In each example, the corporation is a calendar year S corporation. The lending transactions described in the examples do not result in foregone interest (within the meaning of section 7872(e)(2)), original issue discount (within the meaning of section 1273), or total unstated interest (within the meaning of section 483(b)).

Example 1. Reduction in basis of indebtedness. (i) A has been the sole shareholder in Corporation S since 1992. In 1993, A loans S $1,000 (Debt No. 1), which is evidenced by a ten-year promissory note in the face amount of $1,000. In 1996, A loans S $5,000 (Debt No. 2), which is evidenced by a demand promissory note. On December 31, 1996, the basis of A's stock is zero; the basis of Debt No. 1 has been reduced under paragraph (b) of this section to $0; and the basis of Debt No. 2 has been reduced to $1,000. On January 1, 1997, A loans S $4,000 (Debt No. 3), which is evidenced by a demand promissory note. For S's 1997 taxable year, the sum of the amounts specified in section 1367(a)(1) (in this case, nonseparately computed income and the excess deduction for depletion) is $6,000, and the sum of the amounts specified in section 1367(a)(2) (B), (D), and (E) (in this case, items of separately stated deductions and losses, noncapital, nondeductible expenses, and certain oil and gas depletion deductions—there is no nonseparately computed loss) is $10,000. Corporation S makes no payments to A on any of the loans during 1997.

(ii) The $4,000 excess of loss and deduction items is applied to reduce the basis of each indebtedness in proportion to the basis of that indebtedness over the aggregate bases of the indebtedness to the shareholder (determined immediately before any adjustment under section 1367(b)(2)(A) and paragraph (b) of this section is effective for the taxable year). Thus, the basis of Debt No. 2 is reduced in an amount equal to $800 ($4,000 (excess)×$1,000 (basis of Debt No. 2)/$5,000 (total basis of all debt)). Similarly, the basis in Debt No. 3 is reduced in an amount equal to $3,200 ($4,000×$4,000/$5,000). Accordingly, on December 31, 1997, A's basis in his stock is zero and his bases in the three debts are as follows:

Debt	1/1/96 basis	12/31/96 reduction	1/1/97 basis	12/31/97 reduction	1/1/98 basis
No. 1	$1,000	$1,000	$0	$0	$0
No. 2	5,000	4,000	1,000	800	200
No. 3	....	....	4,000	3,200	800

Example 2. Restoration of basis of indebtedness. (i) The facts are the same as in *Example 1.* On July 1, 1998, S completely repays Debt No. 3, and, for S's 1998 taxable year, the net increase (within the meaning of paragraph (c) of this section) with respect to A equals $4,500.

(ii) The net increase is applied first to restore the bases in the debts held on January 1, 1998, before any of the net increase is applied to increase A's basis in his shares of S stock. The net increase is applied to restore first the reduction of basis in indebtedness repaid in 1998. Any remaining net increase is applied to restore the bases of the outstanding debts in proportion to the amount that each of these outstanding debts have been reduced previously under paragraph (b) of this section and have not been restored. As of December 31, 1998, the total reduction in A's debts held on January 1, 1998 equals $9,000. Thus, the basis of Debt No. 3 is restored by $3,200 (the amount of the previous reduction) to $4,000. A's basis in Debt No. 3 is treated as restored immediately before that debt is repaid. Accordingly, A does not realize any gain on the repayment. The remaining net increase of $1,300 ($4,500−$3,200) is applied to restore the bases of Debt No. 1 and Debt No. 2. As of December 31, 1998, the total reduction in these outstanding debts is $5,800 ($9,000−$3,200). The basis of Debt No. 1 is restored in an amount equal to $224 ($1,300×$1,000/$5,800). Similarly, the basis in Debt No. 2 is restored in an amount equal to $1,076 ($1,300×$4,800/$5,800). On December 31, 1998, A's basis in his S stock is zero and his bases in the two remaining debts are as follows:

Original basis	Amount reduced	1/1/98 basis	Amount restored	12/31/98 basis
$1,000	$1,000	$0	$224	$224
5,000	4,800	200	1,076	1,276

Example 3. Full restoration of basis in indebtedness when debt is repaid in part during the taxable year. (i) C has been a shareholder in Corporation S since 1992. In 1997, C loans S $1,000. S issues its note to C in the amount of $1,000, of which $950 is payable on March 1, 1998, and $50 is payable on March 1, 1999. On December 31, 1997, C's basis in all her shares of S stock is zero and her basis in the note has been reduced under paragraph (b) of this section to $900. For 1998, the net increase (within the meaning of paragraph (c) of this section) with respect to C is $300.

(ii) Because C's basis of indebtedness was reduced in a prior taxable year under § 1.1367–2(b), the net increase for 1998 is applied to restore this reduction. The restored basis cannot exceed the adjusted basis of the debt as of the beginning of the first day of 1998, excluding prior adjustments under section 1367, or $1,000. Therefore, $100 of the $300 net increase is applied to restore the basis of the debt from $900 to $1,000 effective immediately before the repayment on March 1, 1998. The remaining net increase of $200 increases C's basis in her stock.

Example 4. Determination of net increase—distribution in excess of increase in basis. (i) D has been the sole shareholder in Corporation S since 1990. On January 1, 1996, D loans S $10,000 in return for a note from S in the amount of $10,000 of which $5,000 is payable on each of January 1, 2000, and January 1, 2001. On December 31, 1997, the basis of D's shares of S stock is zero, and his basis in the note has been reduced under paragraph (b) of this section to $8,000. During 1998, the sum of the items under section 1367(a)(1) (relating to increases in basis of stock) with respect to D equals $10,000 (in this case, nonseparately computed income), and the sum of the items under section 1367(a)(2)(B), (C), (D), and (E) (relating to decreases in basis of stock) with respect to D equals $0. During 1998, S also makes distributions to D totaling $11,000. This distribution is an item that reduces basis of stock under section 1367(a)(2)(A) and must be taken into account for purposes of determining whether there is a net increase for the taxable year. Thus, for 1998, there is no net increase with respect to D because the amount of the items provided in section 1367(a)(1) do not exceed the amount of the items provided in section 1367(a)(2).

(ii) Because there is no net increase with respect to D for 1998, none of the 1997 reduction in D's basis in the indebtedness is restored. The $10,000 increase in basis under section 1367(a)(1) is applied to increase D's basis in his S stock. Under section 1367(a)(2)(A), the $11,000 distribution with respect to D's stock reduces D's basis in his shares of S stock to $0. See section 1368 and § 1.1368–1 (c) and (d) for the tax treatment of the $1,000 distribution in excess of D's basis.

Example 5. Distributions less than increase in basis. (i) The facts are the same as in *Example 4*, except that in 1998 S makes distributions to D totaling $8,000. On these facts, for 1998, there is a net increase with respect to D of $2,000 (the amount by which the items provided in section 1367(a)(1) exceed the amount of the items provided in section 1367(a)(2)).

(ii) Because there is a net increase of $2,000 with respect to D for 1998, $2,000 of the $10,000 increase in basis under section 1367(a)(1) is first applied to restore D's basis in the indebtedness to $10,000 ($8,000 + $2,000). Accordingly, on December 31, 1998, D has a basis in his shares of S stock of $0 ($0 + $8,000 (increase in basis remaining after restoring basis in indebtedness)—$8,000 (distribution)) and a basis in the note of $10,000.

[T.D. 8508, 59 FR 16, Jan. 3, 1994]

§ 1.1367–3 Effective date and transition rule.

Sections 1.1367–1 and 1.1367–2 apply to taxable years of a corporation beginning on or after January 1, 1994. For taxable years beginning before January 1, 1994, the adjustments to the basis of a shareholder's stock and the basis of indebtedness of an S corporation to a shareholder must be determined in a reasonable manner, taking into account the statute and the legislative history. Return positions consistent with §§1.1367–1 and 1.1367–2 are reasonable.

[T.D. 8508, 59 FR 18, Jan. 3, 1994]

§1.1368–0 Table of contents.

The following table of contents is provided to facilitate the use of §§1.1368–1 through 1.1368–4.

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[T.D. 8508, 59 FR 18, Jan. 3, 1994, as amended by T.D. 8696, 61 FR 67455, Dec. 23, 1996]

§1.1368–1 Distributions by S corporations.

(a) *In general.* This section provides rules for distributions made by an S corporation with respect to its stock which, but for section 1368(a) and this section, would be subject to section 301(c) and other rules of the Internal Revenue Code that characterize a distribution as a dividend.

(b) *Date distribution made.* For purposes of section 1368, a distribution is taken into account on the date the corporation makes the distribution, regardless of when the distribution is treated as received by the shareholder.

(c) *S corporation with no earnings and profits.* A distribution made by an S corporation that has no accumulated earnings and profits as of the end of the taxable year of the S corporation in which the distribution is made is treated in the manner provided in section 1368(b).

(d) *S corporation with earnings and profits*—(1) *General treatment of distribution.* Except as provided in paragraph (d)(2) of this section, a distribution made with respect to its stock by an S corporation that has accumulated earnings and profits as of the end of the taxable year of the S corporation in which the distribution is made is treated in the manner provided in section 1368(c)(1), (2), and (3). See section 316 and §1.316–2 for provisions relating to the allocation of earnings and profits among distributions.

(2) *Previously taxed income.* This paragraph (d)(2) applies to distributions by

a corporation that has both accumulated earnings and profits and previously taxed income (within the meaning of section 1375(d)(2), as in effect prior to its amendment by the Subchapter S Revision Act of 1982, and the regulations thereunder) with respect to one or more shareholders. In the case of such a distribution, that portion remaining after the application of section 1368(c)(1) (relating to distributions from the accumulated adjustments account (AAA) as defined in § 1.1368–2(a)) is treated in the manner provided in section 1368(b) (relating to S corporations without earnings and profits) to the extent that portion is a distribution of money and does not exceed the shareholder's net share immediately before the distribution of the corporation's previously taxed income. The AAA and the earnings and profits of the corporation are not decreased by that portion of the distribution. Any distribution remaining after the application of this paragraph (d)(2) is treated in the manner provided in section 1368(c) (2) and (3).

(e) *Certain adjustments taken into account.* Paragraphs (c) and (d) of this section are applied only after taking into account—

(1) The adjustments to the basis of the shares of a shareholder's stock described in section 1367 (without regard to section 1367(a)(2)(A)) (relating to decreases attributable to distributions not includible in income) for the S corporation's taxable year; and

(2) The adjustments to the AAA required by section 1368(e)(1)(A) (but without regard to the adjustments for distributions under § 1.1368–2(a)(3)(iii)) for the S corporation's taxable year.

(f) *Elections relating to source of distributions*—(1) *In general.* An S corporation may modify the application of paragraphs (c) and (d) of this section by electing (pursuant to paragraph (f)(5) of this section)—

(i) To distribute earnings and profits first as described in paragraph (f)(2) of this section;

(ii) To make a deemed dividend as described in paragraph (f)(3) of this section; or

(iii) To forego previously taxed income as described in paragraph (f)(4) of this section.

(2) *Election to distribute earnings and profits first*—(i) *In general.* An S corporation with accumulated earnings and profits may elect under this paragraph (f)(2) for any taxable year to distribute earnings and profits first as provided in section 1368(e)(3). Except as provided in paragraph (f)(2)(ii) of this section, distributions made by an S corporation making this election are treated as made first from earnings and profits under section 1368(c)(2) and second from the AAA under section 1368(c)(1). Any remaining portion of the distribution is treated in the manner provided in section 1368(b). This election is effective for all distributions made during the year for which the election is made.

(ii) *Previously taxed income.* If a corporation to which paragraph (d)(2) of this section (relating to corporations with previously taxed income) applies makes the election provided in this paragraph (f)(2) for the taxable year, and does not make the election to forego previously taxed income under paragraph (f)(4) of this section, distributions by the S corporation during the taxable year are treated as made first, from previously taxed income under paragraph (d)(2) of this section; second, from earnings and profits under section 1368(c)(2); and third, from the AAA under section 1368(c)(1). Any portion of a distribution remaining after the previously taxed income, earnings and profits, and the AAA are exhausted is treated in the manner provided in section 1368(b).

(iii) *Corporation with subchapter C and subchapter S earnings and profits.* If an S corporation that makes the election provided in this paragraph (f)(2) has both subchapter C earnings and profits (as defined in section 1362(d)(3)(B)) and subchapter S earnings and profits in a taxable year of the corporation in which the distribution is made, the distribution is treated as made first from subchapter C earnings and profits, and second from subchapter S earnings and profits. *Subchapter S earnings and profits* are earnings and profits accumulated in a taxable year beginning before January 1, 1983 (or in the case of a qualified casualty insurance electing small business corporation or a qualified oil corporation, earnings and profits accumulated in any taxable year), for which an election under subchapter S of chapter 1 of the Internal Revenue Code was in effect.

(3) *Election to make a deemed dividend.* An S corporation may elect under this paragraph (f)(3) to distribute all or part of its subchapter C earnings and profits through a deemed dividend. If an S corporation makes the election provided in this paragraph (f)(3), the S corporation will be considered to have made the election provided in paragraph (f)(2) of this section (relating to the election to distribute earnings and profits first). The amount of the deemed dividend may not exceed the subchapter C earnings and profits of the corporation on the last day of the taxable year, reduced by any actual distributions of subchapter C earnings and profits made during the taxable year. The amount of the deemed dividend is considered, for all purposes of the Internal Revenue Code, as if it were distributed in money to the shareholders in proportion to their stock ownership, received by the shareholders, and immediately contributed by the shareholders to the corporation, all on the last day of the corporation's taxable year.

(4) *Election to forego previously taxed income.* An S corporation may elect to forego distributions of previously taxed income. If such an election is made, paragraph (d)(2) of this section (relating to corporations with previously taxed income) does not apply to any distribution made during the taxable year. Thus, distributions by a corporation that makes the election to forego previously taxed income for a taxable year under this paragraph (f)(4) and does not make the election to distribute earnings and profits first under paragraph (f)(2) of this section are treated in the manner provided in section 1368(c) (relating to distributions by corporations with earnings and profits). Distributions by a corporation that makes both the election to distribute earnings and profits first under paragraph (f)(2) of this section and the election to forego previously taxed income under this paragraph (f)(4), are treated in the manner provided in paragraph (f)(2)(i) of this section.

(5) *Time and manner of making elections*—(i) *For earnings and profits.* If an election is made under paragraph (f)(2) of this section to distribute earnings and profits first, see section 1368(e)(3) regarding the consent required by shareholders.

(ii) *For previously taxed income and deemed dividends.* If an election is made to forego previously taxed income under paragraph (f)(4) of this section or to make a deemed dividend under paragraph (f)(3) of this section, consent by each ‘‘affected shareholder,’’ as defined in section 1368(e)(3)(B), is required.

(iii) *Corporate statement regarding elections.* A corporation makes an election for a taxable year under this paragraph (f) by attaching a statement to a timely filed original or amended return required to be filed under section 6037 for that taxable year. In the statement, the corporation must identify the election it is making under §1.1368–1(f) and must state that each shareholder consents to the election. An officer of the corporation must sign under penalties of perjury the statement on behalf of the corporation. A statement of election to make a deemed dividend under this paragraph must include the amount of the deemed dividend that is distributed to each shareholder.

(iv) *Irrevocable elections.* The elections under this paragraph (f) are irrevocable and are effective only for the taxable year for which they are made. In applying the preceding sentence to elections under this paragraph (f), an election to terminate the taxable year under section 1377(a)(2) or §1.1368–1(g)(2) is disregarded.

(g) *Special rule*—(1) *Election to terminate year under §1.1368–1(g)(2).* If an election is made under paragraph (g)(2) of this section to terminate the year when there is a qualifying disposition, this section applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which there is a qualifying disposition of stock.

(2) *Election in case of a qualifying disposition*—(i) *In general.* In the case of a qualifying disposition, a corporation may elect under this paragraph (g)(2)(i) to treat the year as if it consisted of

separate taxable years, the first of which ends at the close of the day on which the qualifying disposition occurs. A *qualifying disposition* is—

(A) A disposition by a shareholder of 20 percent or more of the outstanding stock of the corporation in one or more transactions during any thirty-day period during the corporation's taxable year;

(B) A redemption treated as an exchange under section 302(a) or section 303(a) of 20 percent or more of the outstanding stock of the corporation from a shareholder in one or more transactions during any thirty-day period during the corporation's taxable year; or

(C) An issuance of an amount of stock equal to or greater than 25 percent of the previously outstanding stock to one or more new shareholders during any thirty-day period during the corporation's taxable year.

(ii) *Effect of the election.* A corporation making an election under paragraph (g)(2)(i) of this section must treat the taxable year as separate taxable years for purposes of allocating items of income and loss; making adjustments to the AAA, earnings and profits, and basis; and determining the tax effect of distributions under section 1368 (b) and (c). An election made under paragraph (g)(2)(i) of this section may be made upon the occurrence of any qualifying disposition. Dispositions of stock that are taken into account as part of a qualifying disposition are not taken into account in determining whether a subsequent qualifying disposition has been made.

(iii) *Time and manner of making election.* A corporation makes an election under paragraph (g)(2)(i) of this section for a taxable year by attaching a statement to a timely filed original or amended return required to be filed under section 6037 for a taxable year (without regard to the election under paragraph (g)(2)(i) of this section). In the statement, the corporation must state that it is electing for the taxable year under § 1.1368–1(g)(2)(i) to treat the taxable year as if it consisted of separate taxable years. The corporation also must set forth facts in the statement relating to the qualifying disposition (e.g., sale, gift, stock issuance, or redemption), and state that each shareholder who held stock in the corporation during the taxable year (without regard to the election under paragraph (g)(2)(i) of this section) consents to this election. An officer of the corporation must sign under penalties of perjury the statement on behalf of the corporation. For purposes of this election, a shareholder of the corporation for the taxable year is a shareholder as described in section 1362(a)(2). A single election statement may be filed for all elections made under paragraph (g)(2)(i) of this section for the taxable year. An election made under paragraph (g)(2)(i) of this section is irrevocable.

(iv) *Coordination with election under section 1377(a)(2).* If the event resulting in a qualifying disposition also results in a termination of a shareholder's entire interest as described in § 1.1377–1(b)(4), the election under this paragraph (g)(2) cannot be made. Rather, the election under section 1377(a)(2) and § 1.1377–1(b) may be made. See § 1.1377–1(b) (concerning the election under section 1377(a)(2)).

[T.D. 8508, 59 FR 19, Jan. 3, 1994, as amended by T.D. 8696, 61 FR 67455, Dec. 23, 1996]

§ 1.1368–2 Accumulated adjustments account (AAA).

(a) *Accumulated adjustments account*—(1) *In general.* The accumulated adjustments account is an account of the S corporation and is not apportioned among shareholders. The AAA is relevant for all taxable years beginning on or after January 1, 1983, for which the corporation is an S corporation. On the first day of the first year for which the corporation is an S corporation, the balance of the AAA is zero. The AAA is increased in the manner provided in paragraph (a)(2) of this section and is decreased in the manner provided in paragraph (a)(3) of this section. For the adjustments to the AAA in the case of redemptions, reorganizations, and corporate separations, see paragraph (d) of this section.

(2) *Increases to the AAA.* The AAA is increased for the taxable year of the corporation by the sum of the following items with respect to the corporation for the taxable year:

(i) The items of income described in section 1366(a)(1)(A) other than income that is exempt from tax;

(ii) Any nonseparately computed income determined under section 1366(a)(1)(B); and

(iii) The excess of the deductions for depletion over the basis of property subject to depletion unless the property is an oil or gas property the basis of which has been allocated to shareholders under section 613A(c)(11).

(3) *Decreases to the AAA*—(i) *In general.* The AAA is decreased for the taxable year of the corporation by the sum of the following items with respect to the corporation for the taxable year—

(A) The items of loss or deduction described in section 1366(a)(1)(A);

(B) Any nonseparately computed loss determined under section 1366(a)(1)(B);

(C) Any expense of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account, other than—

(*1*) Federal taxes attributable to any taxable year in which the corporation was a C corporation; and

(*2*) Expenses related to income that is exempt from tax; and

(D) The sum of the shareholders' deductions for depletion for any oil or gas property held by the corporation described in section 1367(a)(2)(E).

(ii) *Extent of allowable reduction.* The AAA may be decreased under paragraph (a)(3)(i) of this section below zero. The AAA is decreased by noncapital, nondeductible expenses under paragraph (a)(3)(i)(C) of this section even though a portion of the noncapital, nondeductible expenses is not taken into account by a shareholder under §1.1367–1(f) (relating to the elective ordering rule). The AAA is also decreased by the entire amount of any loss or deduction even though a portion of the loss or deduction is not taken into account by a shareholder under section 1366(d)(1) or is otherwise not currently deductible under the Internal Revenue Code. However, in any subsequent taxable year in which the loss or deduction or noncapital, nondeductible expense is treated as incurred by the corporation with respect to the shareholder under section 1366(d)(2) or §1.1367–1(f) (or in which the loss or deduction is otherwise allowed to the shareholder), no further adjustment is made to the AAA.

(iii) *Decrease to the AAA for distributions.* The AAA is decreased (but not below zero) by any portion of a distribution to which section 1368 (b) or (c)(1) applies.

(4) *Ordering rules for the AAA.* For any taxable year, the adjustments to the AAA are made in the following order:

(i) The AAA is increased under paragraph (a)(2) of this section before it is decreased under paragraph (a)(3) of this section for the taxable year;

(ii) The AAA is decreased under paragraph (a)(3)(i) of this section before it is decreased under paragraph (a)(3) (iii) of this section;

(iii) The AAA is decreased (but not below zero) by any portion of an ordinary distribution to which section 1368 (b) or (c)(1) applies; and

(iv) The AAA is adjusted (whether negative or positive) for redemption distributions under paragraph (d)(1) of this section.

(b) *Distributions in excess of the AAA*—(1) *In general.* A portion of the AAA (determined under paragraph (b)(2) of this section) is allocated to each of the distributions made for the taxable year if—

(i) An S corporation makes more than one distribution of property with respect to its stock during the taxable year of the corporation (including an S short year as defined under section 1362(e)(1)(A));

(ii) The AAA has a positive balance at the close of the year; and

(iii) The sum of the distributions made during the corporation's taxable year exceeds the balance of the AAA at the close of the year.

(2) Amount of the AAA allocated to each distribution. The amount of the AAA allocated to each distribution is determined by multiplying the balance of the AAA at the close of the current taxable year by a fraction, the numerator of which is the amount of the distribution and the denominator of which is the amount of all distributions made during the taxable year. For purposes of this paragraph (b)(2), the term *all distributions made during the taxable year* does not include any distribution treated as from earnings and profits or previously taxed income

pursuant to an election made under section 1368(e)(3) and § 1.1368–1(f)(2). See paragraph (d)(1) of this section for rules relating to the adjustments to the AAA for redemptions and distributions in the year of a redemption.

(c) *Distribution of money and loss property*—(1) *In general.* The amount of the AAA allocated to a distribution under this section must be further allocated (under paragraph (c)(2) of this section) if the distribution—

(i) Consists of property the adjusted basis of which exceeds its fair market value on the date of the distribution and money;

(ii) Is a distribution to which § 1.1368–1(d)(1) applies; and

(iii) Exceeds the amount of the corporation's AAA properly allocable to that distribution.

(2) *Allocating the AAA to loss property.* The amount of the AAA allocated to the property other than money is equal to the amount of the AAA allocated to the distribution multiplied by a fraction, the numerator of which is the fair market value of the property other than money on the date of distribution and the denominator of which is the amount of the distribution. The amount of the AAA allocated to the money is equal to the amount of the AAA allocated to the distribution reduced by the amount of the AAA allocated to the property other than money.

(d) *Adjustment in the case of redemptions, reorganizations, and divisions*—(1) *Redemptions*—(i) *General rule.* In the case of a redemption distribution by an S corporation that is treated as an exchange under section 302(a) or section 303(a) (a *redemption distribution*), the AAA of the corporation is adjusted in an amount equal to the ratable share of the corporation's AAA (whether negative or positive) attributable to the redeemed stock as of the date of the redemption.

(ii) *Special rule for years in which a corporation makes both ordinary and redemption distributions.* In any year in which a corporation makes one or more distributions to which section 1368(a) applies (*ordinary distributions*) and makes one or more redemption distributions, the AAA of the corporation is adjusted first for any ordinary distributions and then for any redemption distributions.

(iii) *Adjustments to earnings and profits.* Earnings and profits are adjusted under section 312 independently of any adjustments made to the AAA.

(2) *Reorganizations.* An S corporation acquiring the assets of another S corporation in a transaction to which section 381(a)(2) applies will succeed to and merge its AAA (whether positive or negative) with the AAA (whether positive or negative) of the distributor or transferor S corporation as of the close of the date of distribution or transfer. Thus, the AAA of the acquiring corporation after the transaction is the sum of the AAAs of the corporations prior to the transaction.

(3) *Corporate separations to which section 368(a)(l)(D) applies.* If an S corporation with accumulated earnings and profits transfers a part of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(l)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, the AAA of the distributing corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation in a manner similar to the manner in which the earnings and profits of the distributing corporation are allocated under section 312 (h). See § 1.312–10(a).

(e) *Election to terminate year under section 1377(a)(2) or § 1.1368–1(g)(2).* If an election is made under section 1377(a)(2) (to terminate the year in the case of termination of a shareholder's interest) or § 1.1368–1(g)(2) (to terminate the year in the case of a qualifying disposition), this section applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which the shareholder terminated his or her interest in the corporation or makes a substantial disposition of stock, whichever the case may be.

[T.D. 8508, 59 FR 20, Jan. 3, 1994]

§1.1368–3 Examples.

The principles of §§1.1368–1 and 1.1368–2 are illustrated by the examples below. In each example Corporation S is a calendar year corporation:

Example 1. Distributions by S corporations without C corporation earnings and profits. (i) Corporation S, an S corporation, has no earnings and profits as of January 1, 1996, the first day of its 1996 taxable year. S's sole shareholder, A, holds 10 shares of S stock with a basis of $1 per share as of that date. On March 1, 1996, S makes a distribution of $38 to A. For S's 1996 taxable year, A's pro rata share of the amount of the items described in section 1367(a)(1) (relating to increases in basis of stock) is $50 and A's pro rata share of the amount of the items described in section 1367(a)(2) (B) through (D) (relating to decreases in basis of stock for items other than distributions) is $26.

(ii) Under section 1368(d)(1) and §1.1368–1(e)(1), the adjustments to the bases of A's stock in S described in section 1367 are made before the distribution rules of section 1368 are applied. Thus, A's basis per share in the stock is $3.40 ($1 + [($50–$26) / 10 shares]) before taking into account the distribution. Under section 1367(a)(2)(A), the basis of A's stock is decreased by distributions to A that are not includible in A's income. Under §1.1367–1(c)(3), the amount of the distribution that is attributable to each share of A's stock is $3.80 ($38 distribution / 10 shares). However, A only has a basis of $3.40 in each share, and basis may not be reduced below zero. Therefore, the basis of each share of his stock is reduced by $3.40 to zero, and the remaining $4.00 of the distribution ([$3.80–$3.40] × 10 shares) is treated as gain from the sale or exchange of property. As of January 1, 1997, A has a basis of $0 in his shares of S stock.

Example 2. Distributions by S corporations with C corporation earnings and profits. (i) Corporation S properly elects to be an S corporation beginning January 1, 1997, and as of that date has accumulated earnings and profits of $30. B, an individual and sole shareholder of Corporation S, has 10 shares of S stock with a basis of $12 per share. In addition, B lends $30 to S evidenced by a demand note.

(ii) During 1997, S has a nonseparately computed loss of $150. S makes no distributions to B during 1997. Under section 1366(d)(1), B is allowed a loss equal to $150, the amount equal to the sum of B's bases in his shares of stock and his basis in the debt. Under section 1367, the loss reduces B's adjusted basis in his stock and debt to $0. Under §1.1368–2(a)(3), S's AAA as of December 31, 1997, has a deficit of $150 as a result of S's loss for the year.

(iii) For 1998, S has $220 of separately stated income and distributes $110 to B. The balance in the AAA (negative $150 from 1997) is increased by $220 for S's income for the year and decreased to $0 for the portion of the distribution that is treated as being from the AAA ($70). Under §1.1367–2(c), B's net increase is $150, determined by reducing the $220 of income by the $70 of the distribution not includible in income by B. Thus, B's basis in the debt is fully restored to $30, and B's basis in S stock (before accounting for the distribution) is increased from zero to $19 per share ([$220–$30 applied to the debt] / 10). Thirty dollars of the distribution is considered a dividend to the extent of S's $30 of earnings and profits, and the remaining $10 of the distribution reduces B's basis in the S stock. Thus, B's basis in the S stock as of December 31, 1998, is $11 per share ($19–[$70 AAA distribution / 10]–[10 distribution treated as a reduction in basis / 10]). The balance in the AAA is $0, S's earnings and profits are $0, and B's basis in the loan is $30.

Example 3. Election in case of disposition of substantial amount of stock. (i) Corporation S, an S corporation, has earnings and profits of $3,000 and a balance in the AAA of $1,000 on January 1, 1997. C, an individual and the sole shareholder of Corporation S, has 100 shares of S stock with a basis of $10 per share. On July 3, 1997, C sells 50 shares of his S stock to D, an individual, for $250. For 1997, S has taxable income of $1,000, of which $500 was earned on or before July 3, 1997, and $500 earned after July 3, 1997. During its 1997 taxable year, S distributes $1,000 to C on February 1 and $1,000 to each of C and D on August 1. S does not make the election under section 1368(e)(3) and §1.1368–1(f)(2) to distribute its earnings and profits before its AAA. S makes the election under §1.1368–1(g)(2) to treat its taxable year as if it consisted of separate taxable years, the first of which ends at the close of July 3, 1997, the date of the qualifying disposition.

(ii) Under section §1.1368–1(g)(2), for the period ending on July 3, 1997, S's AAA is $500 ($1,000 (AAA as of January 1, 1997) + $500 (income earned from January 1, 1997 through July 3, 1997)–$1,000 (distribution made on February 1, 1997)). C's bases in his shares of stock is decreased to $5 per share ($10 (original basis) + $5 (increase per share for income)–$10 (decrease per share for distribution)).

(iii) The AAA is adjusted at the end of the taxable year for the period July 4 through December 31, 1997. It is increased from $500 (AAA as of the close of July 3, 1997) to $1,000 for the income earned during this period and is decreased by $1,000, the portion of the distribution ($2,000 in total) made to C and D on August 1 that does not exceed the AAA. The $1,000 portion of the distribution that remains after the AAA is reduced to zero is attributable to earnings and profits. Therefore

C and D each have a dividend of $500, which does not affect their basis or S's AAA. The earnings and profits account is reduced from $3,000 to $2,000.

(iv) As of December 31, 1997, C and D have bases in their shares of stock of zero ($5 (basis as of July 4)+$5 ($500 income/100 shares)–$10 ($1,000 distribution/100 shares)). C and D each will report $500 as dividend income, which does not affect their basis or S's AAA.

Example 4. Election to distribute earnings and profits first. (i) Corporation S has been a calendar year C corporation since 1975. For 1982, S elects for the first time to be taxed under subchapter S, and during 1982 has $60 of earnings and profits. As of December 31, 1995, S has an AAA of $10 and earnings and profits of $160, consisting of $100 of subchapter C earnings and profits and $60 of subchapter S earnings and profits. For 1996, S has $200 of taxable income and the AAA is increased to $210 (before taking distributions into account). During 1996, S distributes $240 to its shareholders. With its 1996 tax return, S properly elects under section 1368(e)(3) and § 1.1368–1(f)(2) to distribute its earnings and profits before its AAA.

(ii) Because S elected to distribute its earnings and profits before its AAA, the first $100 of the distribution is characterized as a distribution from subchapter C earnings and profits; the next $60 of the distribution is characterized as a distribution from subchapter S earnings and profits. Because $160 of the distribution is from earnings and profits, the shareholders of S have a $160 dividend. The remaining $80 of the distribution is a distribution from S's AAA and is treated by the shareholders as a return of capital or gain from the sale or exchange of property, as appropriate, under § 1.1368–1(d)(1). S's AAA, as of December 31, 1996, equals $130 ($210–$80).

Example 5. Distributions in excess of the AAA. (i) On January 1, 1995, Corporation S has $40 of earnings and profits and a balance in the AAA of $100. S has two shareholders, E and F, each of whom own 50 shares of S's stock. For 1995, S has taxable income of $50, which increases the AAA to $150 as of December 31, 1995 (before taking into account distributions made during 1995). On February 1, 1995, S distributes $60 to each shareholder. On September 1, 1995, S distributes $30 to each shareholder. S does not make the election under section 1368(e)(3) and § 1.1368–1(f)(2) to distribute its earnings and profits before its AAA.

(ii) The sum of the distributions exceed S's AAA. Therefore, under § 1.1368–2(b), a portion of S's $150 balance in the AAA as of December 31, 1995, is allocated to each of the February 1 and September 1 distributions based on the respective sizes of the distributions. Accordingly, S must allocate $100 ($150 (AAA)×($120 (February 1 distribution)/$180 (the sum of the distributions))) of the AAA to the February 1 distribution, and $50 ($150×($60/$180)) to the September 1 distribution. The portions of the distributions to which the AAA is allocated are treated by the shareholder as a return of capital or gain from the sale or exchange of property, as appropriate. The remainder of the two distributions is treated as a dividend to the extent that it does not exceed S's earnings and profits. E and F must each report $10 of dividend income for the February 1 distribution. For the September 1 distribution, E and F must each report $5 of dividend income.

Example 6. Ordinary and redemption distributions in the same taxable year. (i) On January 1, 1995, Corporation S, an S corporation, has $20 of earnings and profits and a balance in the AAA of $10. S has two shareholders, G and H, each of whom owns 50 shares of S's stock. For 1995, S has taxable income of $16, which increases the AAA to $26 as of December 31, 1995 (before taking into account distributions made during 1995). On February 1, 1995, S distributes $10 to each shareholder. On December 31, 1995, S redeems for $13 all of shareholder G's stock in a redemption that is treated as a sale or exchange under section 302(a).

(ii) The sum of the ordinary distributions does not exceed S's AAA. Therefore, S must reduce the $26 balance in the AAA by $20 for the February 1 ordinary distribution. The portions of the distribution by which the AAA is reduced are treated by the shareholders as a return of capital or gain from the sale or exchange of property. S must adjust the remaining AAA, $6, in an amount equal to the ratable share of the remaining AAA attributable to the redeemed stock, or $3 (50%×$6).

(iii) S also must adjust the earnings and profits of $20 in an amount equal to the ratable share of the earnings and profits attributable to the redeemed stock. Therefore, S adjusts the earnings and profits by $10 (50%×$20), the ratable share of the earnings and profits attributable to the redeemed stock.

[T.D. 8508, 59 FR 22, Jan. 3, 1994; 59 FR 10675, Mar. 7, 1994]

§ 1.1368–4 Effective date and transition rule.

Sections 1.1368–1, 1.1368–2, and 1.1368–3 apply to taxable years of a corporation beginning on or after January 1, 1994. For taxable years beginning before January 1, 1994, the treatment of distributions by an S corporation to its shareholders must be determined in a reasonable manner, taking into account the statute and the legislative history. Except with regard to the deemed dividend rule under §1.1368–1(f)(3), return positions consistent with §§1.1368–1, 1.1368–2, and 1.1368–3 are reasonable.

[T.D. 8508, 59 FR 23, Jan. 3, 1994]

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[T.D. 8579, 59 FR 66463, Dec. 27, 1994]

§1.1374–1 General rules and definitions.

(a) *Computation of tax.* The tax imposed on the income of an S corporation by section 1374(a) for any taxable year during the recognition period is computed as follows—

(1) Step One: Determine the net recognized built-in gain of the corporation for the taxable year under section 1374(d)(2) and §1.1374–2;

(2) Step Two: Reduce the net recognized built-in gain (but not below zero) by any net operating loss and capital loss carryforward allowed under section 1374(b)(2) and §1.1374–5;

(3) Step Three: Compute a tentative tax by applying the rate of tax determined under section 1374(b)(1) for the taxable year to the amount determined under paragraph (a)(2) of this section;

(4) Step Four: Compute the final tax by reducing the tentative tax (but not below zero) by any credit allowed under section 1374(b)(3) and §1.1374–6.

(b) *Anti-trafficking rules.* If section 382, 383, or 384 would have applied to limit the use of a corporation's recognized built-in loss or section 1374 attributes at the beginning of the first day of the recognition period if the corporation had remained a C corporation, these sections apply to limit their use in determining the S corporation's pre-limitation amount, taxable income limitation, net unrealized built-in gain limitation, deductions against net recognized built-in gain, and credits against the section 1374 tax.

(c) *Section 1374 attributes.* Section 1374 attributes are the loss carryforwards allowed under section 1374(b)(2) as a deduction against net recognized built-in gain and the credit and credit carryforwards allowed under section 1374(b)(3) as a credit against the section 1374 tax.

(d) *Recognition period.* The recognition period is the 10-year (120-month) period beginning on the first day the corporation is an S corporation or the day an S corporation acquires assets in a section 1374(d)(8) transaction. For example, if the first day of the recognition period is July 14, 1996, the last day of the recognition period is July 13, 2006. If the recognition period for certain assets ends during an S corporation's taxable year (for example, because the corporation was on a fiscal year as a C corporation and changed to a calendar year as an S corporation or because an S corporation acquired assets in a section 1374(d)(8) transaction during a taxable year), the S corporation must determine its pre-limitation amount (as defined in § 1.1374–2(a)(1)) for the year as if the corporation's books were closed at the end of the recognition period.

(e) *Predecessor corporation.* For purposes of section 1374(c)(1), if the basis of an asset of the S corporation is determined (in whole or in part) by reference to the basis of the asset (or any other property) in the hands of another corporation, the other corporation is a predecessor corporation of the S corporation.

[T.D. 8579, 59 FR 66463, Dec. 27, 1994]

§ 1.1374–2 Net recognized built-in gain.

(a) *In general.* An S corporation's net recognized built-in gain for any taxable year is the least of—

(1) Its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover (pre-limitation amount);

(2) Its taxable income determined by using all rules applying to C corporations as modified by section 1375(b)(1)(B) (taxable income limitation); and

(3) The amount by which its net unrealized built-in gain exceeds its net recognized built-in gain for all prior taxable years (net unrealized built-in gain limitation).

(b) *Allocation rule.* If an S corporation's pre-limitation amount for any taxable year exceeds its net recognized built-in gain for that year, the S corporation's net recognized built-in gain consists of a ratable portion of each item of income, gain, loss, and deduction included in the pre-limitation amount.

(c) *Recognized built-in gain carryover.* If an S corporation's net recognized built-in gain for any taxable year is equal to its taxable income limitation, the amount by which its pre-limitation amount exceeds its taxable income limitation is a recognized built-in gain carryover included in its pre-limitation amount for the succeeding taxable year. The recognized built-in gain carryover consists of that portion of each item of income, gain, loss, and deduction not included in the S corporation's net recognized built-in gain for the year the carryover arose, as determined under paragraph (b) of this section.

(d) *Accounting methods.* In determining its taxable income for pre-limitation amount and taxable income limitation purposes, a corporation must use the accounting method(s) it uses for tax purposes as an S corporation.

(e) *Example.* The rules of this section are illustrated by the following example.

Example: Net recognized built-in gain. X is a calendar year C corporation that elects to become an S corporation on January 1, 1996. X has a net unrealized built-in gain of $50,000 and no net operating loss or capital loss carryforwards. In 1996, X has a pre-limitation amount of $20,000, consisting of ordinary income of $15,000 and capital gain of $5,000, a taxable income limitation of $9,600, and a net unrealized built-in gain limitation of $50,000. Therefore, X's net recognized built-in gain for 1996 is $9,600, because that is the least of the three amounts described in paragraph (a) of this section. Under paragraph (b) of this section, X's net recognized built-in gain consists of recognized built-in ordinary income of $7,200 [$15,000×($9,600/$20,000)=$7,200] and recognized built-in capital gain of $2,400 [$5,000×($9,600/$20,000)=$2,400]. Under paragraph (c) of this section, X has a recognized built-in gain carryover to 1997 of $10,400 ($20,000−$9,600=$10,400), consisting of $7,800 ($15,000−$7,200=$7,800) of recognized built-in ordinary income and $2,600 ($5,000−$2,400=$2,600) of recognized built-in capital gain.

[T.D. 8579, 59 FR 66463, Dec. 27, 1994]

§ 1.1374–3 Net unrealized built-in gain.

(a) *In general.* An S corporation's net unrealized built-in gain is the total of the following—

(1) The amount that would be the amount realized if, at the beginning of the first day of the recognition period, the corporation had remained a C corporation and had sold all its assets at fair market value to an unrelated party that assumed all its liabilities; decreased by

(2) Any liability of the corporation that would be included in the amount realized on the sale referred to in paragraph (a)(1) of this section, but only if the corporation would be allowed a deduction on payment of the liability; decreased by

(3) The aggregate adjusted bases of the corporation's assets at the time of the sale referred to in paragraph (a)(1) of this section; increased or decreased by

(4) The corporation's section 481 adjustments that would be taken into account on the sale referred to in paragraph (a)(1) of this section; and increased by

(5) Any recognized built-in loss that would not be allowed as a deduction under section 382, 383, or 384 on the sale referred to in paragraph (a)(1) of this section.

(b) *Example.* The rules of this section are illustrated by the following example.

Example: Net unrealized built-in gain. (i) (a) X, a calendar year C corporation using the cash method, elects to become an S corporation on January 1, 1996. On December 31, 1995, X has assets and liabilities as follows:

Assets	FMV	Basis
Factory	$500,000	$900,000
Accounts Receivable	300,000	0
Goodwill	250,000	0
Total	1,050,000	900,000
Liabilities	Amount	
Mortgage	$200,000	
Accounts Payable	100,000	
Total	300,000	

(b) Further, X must include a total of $60,000 in taxable income in 1996, 1997, and 1998 under section 481(a).

(ii) If, on December 31, 1995, X sold all its assets to a third party that assumed all its liabilities, X's amount realized would be $1,050,000 ($750,000 cash received+$300,000 liabilities assumed=$1,050,000). Thus, X's net unrealized built-in gain is determined as follows:

Amount realized –	$1,050,000
Deduction allowed–	(100,000)
Basis of X's assets—	(900,000)
Section 481 adjustments	60,000
Net unrealized built-in gain–	110,000

[T.D. 8579, 59 FR 66464, Dec. 27, 1994]

§ 1.1374–4 Recognized built-in gain or loss.

(a) *Sales and exchanges*—(1) *In general.* Section 1374(d)(3) or 1374(d)(4) applies to any gain or loss recognized during the recognition period in a transaction treated as a sale or exchange for Federal income tax purposes.

(2) *Oil and gas property.* For purposes of paragraph (a)(1) of this section, an S corporation's adjusted basis in oil and gas property equals the sum of the shareholders' adjusted bases in the property as determined in section 613A(c)(11)(B).

(3) *Examples.* The rules of this paragraph (a) are illustrated by the following examples.

Example 1. Production and sale of oil. X is a C corporation that purchased a working interest in an oil and gas property for $100,000 on July 1, 1993. X elects to become an S corporation effective January 1, 1996. On that date, the working interest has a fair market value of $250,000 and an adjusted basis of $50,000, but no oil has as yet been extracted. In 1996, X begins production of the working interest, sells oil that it has produced to a refinery for $75,000, and includes that amount in gross income. Under paragraph (a)(1) of this section, the $75,000 is not recognized built-in gain because as of the beginning of the recognition period X held only a working interest in the oil and gas property (since the oil had not yet been extracted from the ground), and not the oil itself.

Example 2. Sale of oil and gas property. Y is a C corporation that elects to become an S corporation effective January 1, 1996. Y has two shareholders, A and B. A and B each own 50 percent of Y's stock. In addition, Y owns a royalty interest in an oil and gas property with a fair market value of $300,000 and an adjusted basis of $200,000. Under section 613A(c)(11)(B), Y's $200,000 adjusted basis in the royalty interest is allocated $100,000 to A and $100,000 to B. During 1996, A and B take depletion deductions with respect to the royalty interest of $10,000 and $15,000, respectively. As of January 1, 1997, A and B have a basis in the royalty interest of $90,000 and $85,000, respectively. On January 1, 1997, Y sells the royalty interest for $250,000. Under paragraph (a)(1) of this section, Y has gain recognized and recognized built-in gain of $75,000 ($250,000 − ($90,000+$85,000)=$75,000) on the sale.

(b) *Accrual method rule*—(1) *Income items.* Except as otherwise provided in this section, any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been properly included in gross income before the beginning of the recognition period by an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation).

(2) *Deduction items.* Except as otherwise provided in this section, any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period to an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation). In determining whether an item would have been properly allowed as a deduction against gross income by an accrual method taxpayer for purposes of this paragraph, section 461(h)(2)(C) and § 1.461–4(g) (relating to liabilities for tort, worker's compensation, breach of contract, violation of law, rebates, refunds, awards, prizes, jackpots, insurance contracts, warranty contracts, service contracts, taxes, and other liabilities) do not apply.

(3) *Examples.* The rules of this paragraph (b) are illustrated by the following examples.

Example 1. Accounts receivable. X is a C corporation using the cash method that elects to become an S corporation effective January 1, 1996. On January 1, 1996, X has $50,000 of accounts receivable for services rendered before that date. On that date, the accounts receivable have a fair market value of $40,000 and an adjusted basis of $0. In 1996, X collects $50,000 on the accounts receivable and includes that amount in gross income. Under paragraph (b)(1) of this section, the $50,000 included in gross income in 1996 is recognized built-in gain because it would have been included in gross income before the beginning of the recognition period if X had been an accrual method taxpayer. However, if X instead disposes of the accounts receivable for $45,000 on July 1, 1996, in a transaction treated as a sale or exchange for Federal income tax purposes, X would have recognized built-in gain of $40,000 on the disposition.

Example 2. Contingent liability. Y is a C corporation using the cash method that elects to become an S corporation effective January 1, 1996. In 1995, a lawsuit was filed against Y claiming $1,000,000 in damages. In 1996, Y loses the lawsuit, pays a $500,000 judgment, and properly claims a deduction for that amount. Under paragraph (b)(2) of this section, the $500,000 deduction allowed in 1996 is not recognized built-in loss because it would not have been allowed as a deduction against gross income before the beginning of the recognition period if Y had been an accrual method taxpayer (even disregarding section 461(h)(2)(C) and § 1.461–4(g)).

Example 3. Deferred payment liabilities. X is a C corporation using the cash method that elects to become an S corporation on January 1, 1996. In 1995, X lost a lawsuit and became obligated to pay $150,000 in damages. Under section 461(h)(2)(C), this amount is not allowed as a deduction until X makes payment. In 1996, X makes payment and properly claims a deduction for the amount of the payment. Under paragraph (b)(2) of this section, the $150,000 deduction allowed in 1996 is recognized built-in loss because it would have been allowed as a deduction against gross income before the beginning of the recognition period if X had been an accrual method taxpayer (disregarding section 461(h)(2)(C) and § 1.461–4(g)).

Example 4. Deferred prepayment income. Y is a C corporation using an accrual method that elects to become an S corporation effective January 1, 1996. In 1995, Y received $2,500 for services to be rendered in 1996, and properly elected to include the $2,500 in gross income in 1996 under Rev. Proc. 71–21, 1971–2

C.B. 549 (see §601.601(d)(2)(ii)(*b*) of this chapter). Under paragraph (b)(1) of this section, the $2,500 included in gross income in 1996 is not recognized built-in gain because it would not have been included in gross income before the beginning of the recognition period by an accrual method taxpayer using the method that Y actually used before the beginning of the recognition period.

Example 5. Change in method. X is a C corporation using an accrual method that elects to become an S corporation effective January 1, 1996. In 1995, X received $5,000 for services to be rendered in 1996, and properly included the $5,000 in gross income. In 1996, X properly elects to include the $5,000 in gross income in 1996 under Rev. Proc. 71–21, 1971–2 C.B. 549 (see §601.601(d)(2)(ii)(*b*) of this chapter). As a result of the change in method of accounting, X has a $5,000 negative section 481(a) adjustment. Under paragraph (b)(1) of this section, the $5,000 included in gross income in 1996 is recognized built-in gain because it would have been included in gross income before the beginning of the recognition period by an accrual method taxpayer using the method that X actually used before the beginning of the recognition period. In addition, the $5,000 negative section 481(a) adjustment is recognized built-in loss because it relates to an item (the $5,000 X received for services in 1995) attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section. See paragraph (d) of this section for rules regarding section 481(a) adjustments.

(c) *Section 267(a)(2) and 404(a)(5) deductions*—(1) *Section 267(a)(2).* Notwithstanding paragraph (b)(2) of this section, any amount properly deducted in the recognition period under section 267(a)(2), relating to payments to related parties, is recognized built-in loss to the extent—

(i) All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and

(ii) The amount is paid—

(A) In the first two and one-half months of the recognition period; or

(B) To a related party owning, under the attribution rules of section 267, less than 5 percent, by voting power and value, of the corporation's stock, both as of the beginning of the recognition period and when the amount is paid.

(2) *Section 404(a)(5).* Notwithstanding paragraph (b)(2) of this section, any amount properly deducted in the recognition period under section 404(a)(5), relating to payments for deferred compensation, is recognized built-in loss to the extent—

(i) All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and

(ii) The amount is not paid to a related party to which section 267(a)(2) applies.

(3) *Examples.* The rules of this paragraph (c) are illustrated by the following examples.

Example 1. Fixed annuity. X is a C corporation that elects to become an S corporation effective January 1, 1996. On December 31, 1995, A is age 60, has provided services to X as an employee for 20 years, and is a vested participant in X's unfunded nonqualified retirement plan. Under the plan, A receives $1,000 per month upon retirement until death. The plan provides no additional benefits. A retires on December 31, 1997, after working for X for 22 years. A at no time is a shareholder of X. X's deductions under section 404(a)(5) in the recognition period on paying A the $1,000 per month are recognized built-in loss because all events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period.

Example 2. Increase in annuity for working beyond 20 years. The facts are the same as *Example 1,* except that under the plan A receives $1,000 per month, plus $100 per month for each year A works for X beyond 20 years, upon retirement until death. X's deductions on paying A the $1,000 per month are recognized built-in loss. However, X's deductions on paying A the $200 per month for the two years A worked for X beyond 20 years are not recognized built-in loss because all events have not occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability cannot be determined, as of the beginning of the recognition period.

Example 3. Cost of living adjustment. The facts are the same as *Example 1,* except that under the plan A receives $1,000 per month, plus annual cost of living adjustments, upon retirement until death. X's deductions under section 404(a)(5) on paying A the $1,000 per month are recognized built-in loss. However, X's deductions under section 404(a)(5) on paying A the annual cost of living adjustment are not recognized built-in loss because all events have not occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability cannot be determined, as of the beginning of the recognition period.

(d) *Section 481(a) adjustments*—(1) *In general.* Any section 481(a) adjustment taken into account in the recognition period is recognized built-in gain or loss to the extent the adjustment relates to items attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section. The principles for determining recognized built-in gain or loss in this section include, for example, the accrual method rule under paragraph (b) of this section.

(2) *Examples.* The rules of this paragraph (d) are illustrated by the following examples.

Example 1. Omitted item attributable to prerecognition period. X is a C corporation that elects to become an S corporation effective January 1, 1996. X improperly capitalizes repair costs and recovers the costs through depreciation of the related assets. In 1999, X properly changes to deducting repair costs as they are incurred. Under section 481(a), the basis of the related assets are reduced by an amount equal to the excess of the repair costs incurred before the year of change over the repair costs recovered through depreciation before the year of change. In addition, X has a negative section 481(a) adjustment equal to the basis reduction. Under paragraph (d)(1) of this section, the portion of X's negative section 481(a) adjustment relating to the repair costs incurred before the recognition period is recognized built-in loss because those repair costs are items attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section.

Example 2. Duplicated item attributable to prerecognition period. Y is a C corporation that elects to become an S corporation effective January 1, 1996. Y improperly uses an accrual method without regard to the economic performance rules of section 461(h) to account for worker's compensation claims. As a result, Y takes deductions when claims are filed. In 1999, Y properly changes to an accrual method with regard to the economic performance rules under section 461(h)(2)(C) for worker's compensation claims. As a result, Y takes deductions when claims are paid. The positive section 481(a) adjustment resulting from the change is equal to the amount of claims filed, but unpaid, before the year of change. Under paragraph (b)(2) of this section, the deduction allowed in the recognition period for claims filed, but unpaid, before the recognition period is recognized built-in loss because a deduction was allowed for those claims before the recognition period under an accrual method without regard to section 461(h)(2)(C). Under paragraph (d)(1) of this section, the portion of Y's positive section 481(a) adjustment relating to claims filed, but unpaid, before the recognition period is recognized built-in gain because those claims are items attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section.

(e) *Section 995(b)(2) deemed distributions.* Any item of income properly taken into account during the recognition period under section 995(b)(2) is recognized built-in gain if the item results from a DISC termination or disqualification occurring before the beginning of the recognition period.

(f) *Discharge of indebtedness and bad debts.* Any item of income or deduction properly taken into account during the first year of the recognition period as discharge of indebtedness income under section 61(a)(12) or as a bad debt deduction under section 166 is recognized built-in gain or loss if the item arises from a debt owed by or to an S corporation at the beginning of the recognition period.

(g) *Completion of contract.* Any item of income properly taken into account during the recognition period under the completed contract method (as described in § 1.451–3(d)) where the corporation began performance of the contract before the beginning of the recognition period is recognized built-in gain if the item would have been included in gross income before the beginning of the recognition period under the percentage of completion method (as described in § 1.451–3(c)). Any similar item of deduction is recognized built-in loss if the item would have been allowed as a deduction against gross income before the beginning of the recognition period under the percentage of completion method.

(h) *Installment method*—(1) *In general.* If a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method under section 453 during or after the recognition period, that income is subject to tax under section 1374.

(2) *Limitation on amount subject to tax.* For purposes of paragraph (h)(1) of this section, the taxable income limitation under §1.1374–2(a)(2) is equal to the amount by which the S corporation's net recognized built-in gain would have been increased from the year of the sale to the earlier of the year the income is reported under the installment method or the last year of the recognition period, assuming all income from the sale had been reported in the year of the sale and all provisions of section 1374 applied. For purposes of the preceding sentence, if the corporation sells the asset before the recognition period, the income from the sale that is not reported before the recognition period is treated as having been reported in the first year of the recognition period.

(3) *Rollover rule.* If the limitation in paragraph (h)(2) of this section applies, the excess of the amount reported under the installment method over the amount subject to tax under the limitation is treated as if it were reported in the succeeding taxable year(s), but only for succeeding taxable year(s) in the recognition period. The amount reported in the succeeding taxable year(s) under the preceding sentence is reduced to the extent that the amount not subject to tax under the limitation in paragraph (h)(2) of this section was not subject to tax because the S corporation had an excess of recognized built-in loss over recognized built-in gain in the taxable year of the sale and succeeding taxable year(s) in the recognition period.

(4) *Use of losses and section 1374 attributes.* If income is reported under the installment method by an S corporation for a taxable year after the recognition period and the income is subject to tax under paragraph (h)(1) of this section, the S corporation's section 1374 attributes may be used to the extent their use is allowed under all applicable provisions of the Code in determining the section 1374 tax. However, the S corporation's loss recognized for a taxable year after the recognition period that would have been recognized built-in loss if it had been recognized in the recognition period may not be used in determining the section 1374 tax.

(5) *Examples.* The rules of this paragraph (h) are illustrated by the following examples.

Example 1. Rollover rule. X is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, X sells Blackacre with a basis of $0 and a value of $100,000 in exchange for a $100,000 note bearing a market rate of interest payable on January 1, 2001. X does not make the election under section 453(d) and, therefore, reports the $100,000 gain using the installment method under section 453. In the year 2001, X has income of $100,000 on collecting the note, unexpired C year attributes of $0, recognized built-in loss of $0, current losses of $100,000, and taxable income of $0. If X had reported the $100,000 gain in 1996, X's net recognized built-in gain from 1996 through 2001 would have been $75,000 greater than otherwise. Under paragraph (h) of this section, X has $75,000 net recognized built-in gain subject to tax under section 1374. X also must treat the $25,000 excess of the amount reported, $100,000, over the amount subject to tax, $75,000, as income reported under the installment method in the succeeding taxable year(s) in the recognition period, except to the extent X establishes that the $25,000 was not subject to tax under section 1374 in the year 2001 because X had an excess of recognized built-in loss over recognized built-in gain in the taxable year of the sale and succeeding taxable year(s) in the recognition period.

Example 2. Use of losses. Y is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, Y sells Whiteacre with a basis of $0 and a value of $250,000 in exchange for a $250,000 note bearing a market rate of interest payable on January 1, 2006. Y does not make the election under section 453(d) and, therefore, reports the $250,000 gain using the installment method under section 453. In the year 2006, Y has income of $250,000 on collecting the note, unexpired C year attributes of $0, loss of $100,000 that would have been recognized built-in loss if it had been recognized in the recognition period, current losses of $150,000, and taxable income of $0. If Y had reported the $250,000 gain in 1996, X's net recognized built-in gain from 1996 through 2005 (that is, during the recognition period) would have been $225,000 greater than otherwise. Under paragraph (h) of this section, X has $225,000 net recognized built-in gain subject to tax under section 1374.

Example 3. Use of section 1374 attribute. Z is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, Z sells Greenacre with a basis of $0 and a value of $500,000 in exchange for a $500,000 note bearing a market rate of interest payable on January 1, 2011. Z does not make the election under section 453(d) and, therefore, reports the $500,000 gain using the installment method under section 453. In the year 2011, Z has income of $500,000 on collecting the note, loss of $0 that would have been recognized built-in loss if it had been recognized in the recognition period, current losses of $0, taxable income of $500,000, and a minimum tax credit of $60,000 arising in 1995. None of Z's minimum tax credit is limited under sections 53(c) or 383. If Z had reported the $500,000 gain in 1996, Z's net recognized built-in gain from 1996 through 2005 (that is, during the recognition period) would have been $350,000 greater than otherwise. Under paragraph (h) of this section, Z has $350,000 net recognized built-in gain subject to tax under section 1374, a tentative section 1374 tax of $122,500 ($350,000 × .35 = $122,500), and a section 1374 tax after using its minimum tax credit arising in 1995 of $62,250 ($122,500 − $60,000 = $62,250).

(i) *Partnership interests*—(1) *In general.* If an S corporation owns a partnership interest at the beginning of the recognition period or transfers property to a partnership in a transaction to which section 1374(d)(6) applies during the recognition period, the S corporation determines the effect on net recognized built-in gain from its distributive share of partnership items as follows—

(i) Step One: Apply the rules of section 1374(d) to the S corporation's distributive share of partnership items of income, gain, loss, or deduction included in income or allowed as a deduction under the rules of subchapter K to determine the extent to which it would have been treated as recognized built-in gain or loss if the partnership items had originated in and been taken into account directly by the S corporation (partnership 1374 items);

(ii) Step Two: Determine the S corporation's net recognized built-in gain without partnership 1374 items;

(iii) Step Three: Determine the S corporation's net recognized built-in gain with partnership 1374 items; and

(iv) Step Four: If the amount computed under Step Three (paragraph (i)(1)(iii) of this section) exceeds the amount computed under Step Two (paragraph (i)(1)(ii) of this section), the excess (as limited by paragraph (i)(2)(i) of this section) is the S corporation's partnership RBIG, and the S corporation's net recognized built-in gain is the sum of the amount computed under Step Two (paragraph (i)(1)(ii) of this section) plus the partnership RBIG. If the amount computed under Step Two (paragraph (i)(1)(ii) of this section) exceeds the amount computed under Step Three (paragraph (i)(1)(iii) of this section), the excess (as limited by paragraph (i)(2)(ii) of this section) is the S corporation's partnership RBIL, and the S corporation's net recognized built-in gain is the remainder of the amount computed under Step Two (paragraph (i)(1)(ii) of this section) after subtracting the partnership RBIL.

(2) *Limitations*—(i) *Partnership RBIG.* An S corporation's partnership RBIG for any taxable year may not exceed the excess (if any) of the S corporation's RBIG limitation over its partnership RBIG for prior taxable years. The preceding sentence does not apply if a corporation forms or avails of a partnership with a principal purpose of avoiding the tax imposed under section 1374.

(ii) *Partnership RBIL.* An S corporation's partnership RBIL for any taxable year may not exceed the excess (if any) of the S corporation's RBIL limitation over its partnership RBIL for prior taxable years.

(3) *Disposition of partnership interest.* If an S corporation disposes of its partnership interest, the amount that may be treated as recognized built-in gain may not exceed the excess (if any) of the S corporation's RBIG limitation over its partnership RBIG during the recognition period. Similarly, the amount that may be treated as recognized built-in loss may not exceed the excess (if any) of the S corporation's RBIL limitation over its partnership RBIL during the recognition period.

(4) *RBIG and RBIL limitations*—(i) *Sale of partnership interest.* An S corporation's RBIG or RBIL limitation is the total of the following—

(A) The amount that would be the amount realized if, at the beginning of the first day of the recognition period, the corporation had remained a C corporation and had sold its partnership interest (and any assets the corporation contributed to the partnership during the recognition period) at fair market value to an unrelated party; decreased by

(B) The corporation's adjusted basis in the partnership interest (and any assets the corporation contributed to the partnership during the recognition period) at the time of the sale referred to in paragraph (i)(4)(i)(A) of this section; and increased or decreased by

(C) The corporation's allocable share of the partnership's section 481(a) adjustments at the time of the sale referred to in paragraph (i)(4)(i)(A) of this section.

(ii) *Amounts of limitations.* If the result in paragraph (i)(4)(i) of this section is a positive amount, the S corporation has a RBIG limitation equal to that amount and a RBIL limitation of $0, but if the result in paragraph (i)(4)(i) of this section is a negative amount, the S corporation has a RBIL limitation equal to that amount and a RBIG limitation of $0.

(5) *Small interest exception*—(i) *In general.* Paragraph (i)(1) of this section does not apply to a taxable year in the recognition period if the S corporation's partnership interest represents less than 10 percent of the partnership's capital and profits at all times during the taxable year and prior taxable years in the recognition period, and the fair market value of the S corporation's partnership interest as of the beginning of the recognition period is less than $100,000.

(ii) *Contributed assets.* For purposes of paragraph (i)(5)(i) of this section, if the S corporation contributes any assets to the partnership during the recognition period and the S corporation held the assets as of the beginning of the recognition period, the fair market value of the S corporation's partnership interest as of the beginning of the recognition period is determined as if the assets were contributed to the partnership before the beginning of the recognition period (using the fair market value of each contributed asset as of the beginning of the recognition period). The contribution does not affect whether paragraph (i)(5)(i) of this section applies for taxable years in the recognition period before the taxable year in which the contribution was made.

(iii) *Anti-abuse rule.* Paragraph (i)(5)(i) of this section does not apply if a corporation forms or avails of a partnership with a principal purpose of avoiding the tax imposed under section 1374.

(6) *Section 704(c) gain or loss.* Solely for purposes of section 1374, an S corporation's section 704(c) gain or loss amount with respect to any asset is not reduced during the recognition period, except for amounts treated as recognized built-in gain or loss with respect to that asset under this paragraph.

(7) *Disposition of distributed partnership asset.* If on the first day of the recognition period an S corporation holds an interest in a partnership that holds an asset and during the recognition period the partnership distributes the asset to the S corporation that thereafter disposes of the asset, the asset is treated as having been held by the S corporation on the first day of the recognition period and as having the fair market value and adjusted basis in the hands of the S corporation that it had in the hands of the partnership on that day.

(8) *Examples.* The rules of this paragraph (i) are illustrated by the following examples.

Example 1. Pre-conversion partnership interest. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a 50 percent interest in partnership P and P owns (among other assets) Blackacre with a basis of $25,000 and a value of $45,000. In 1996, P buys Whiteacre for $50,000. In 1999, P sells Blackacre for $55,000 and recognizes a gain of $30,000 of which $15,000 is included in X's distributive share. P also sells Whiteacre in 1999 for $42,000 and recognizes a loss of $8,000 of which $4,000 is included in X's distributive share. Under this paragraph and section 1374(d)(3), X's $15,000 gain is presumed to be recognized built-in gain and thus treated as a partnership 1374 item, but this presumption is rebutted if X establishes that P's gain would have been only $20,000 ($45,000 − $25,000=$20,000) if Blackacre had been sold on the first day of the recognition period. In such a case, only X's distributive share of the $20,000 built-in gain, $10,000, would be treated as a partnership 1374 item. Under this paragraph and section 1374(d)(4), X's $4,000 loss is not treated as a partnership 1374 item because P did not hold Whiteacre on the first day of the recognition period.

Example 2. Post-conversion contribution. Y is a C corporation that elects to become an S corporation on January 1, 1996. On that date, Y owns (among other assets) Blackacre with a basis of $100,000 and a value of $200,000. On

January 1, 1998, when Blackacre has a basis of $100,000 and a value of $200,000, Y contributes Blackacre to partnership P for a 50 percent interest in P. On January 1, 2000, P sells Blackacre for $300,000 and recognizes a gain of $200,000 on the sale ($300,000−$100,000=$200,000). P is allocated $100,000 of the gain under section 704(c), and another $50,000 of the gain for its fifty percent share of the remainder, for a total of $150,000. Under this paragraph and section 1374(d)(3), if Y establishes that P's gain would have been only $100,000 ($200,000−$100,000=$100,000) if Blackacre had been sold on the first day of the recognition period, Y would treat only $100,000 as a partnership 1374 item.

Example 3. RBIG limitation of $100,000 or $50,000. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a 50 percent interest in partnership P with a RBIG limitation of $100,000 and a RBIL limitation of $0. P owns (among other assets) Blackacre with a basis of $50,000 and a value of $200,000. In 1996, P sells Blackacre for $200,000 and recognizes a gain of $150,000 of which $75,000 is included in X's distributive share and treated as a partnership 1374 item. X's net recognized built-in gain for 1996 computed without partnership 1374 items is $35,000 and with partnership 1374 items is $110,000. Thus, X has a partnership RBIG of $75,000 except as limited under paragraph (i)(2)(i) of this section. Because X's RBIG limitation is $100,000, X's partnership RBIG of $75,000 is not limited and X's net recognized built-in gain for the year is $110,000 ($35,000+$75,000=$110,000). However, if X had a RBIG limitation of $50,000 instead of $100,000, X's partnership RBIG would be limited to $50,000 under paragraph (i)(2)(i) of this section and X's net recognized built-in gain would be $85,000 ($35,000+$50,000=$85,000).

Example 4. RBIL limitation of $60,000 or $40,000. Y is a C corporation that elects to become an S corporation on January 1, 1996. On that date, Y owns a 50 percent interest in partnership P with a RBIG limitation of $0 and a RBIL limitation of $60,000. P owns (among other assets) Blackacre with a basis of $225,000 and a value of $125,000. In 1996, P sells Blackacre for $125,000 and recognizes a loss of $100,000 of which $50,000 is included in Y's distributive share and treated as a partnership 1374 item. Y's net recognized built-in gain for 1996 computed without partnership 1374 items is $75,000 and with partnership 1374 items is $25,000. Thus, Y has a partnership RBIL of $50,000 for the year except as limited under paragraph (i)(2)(ii) of this section. Because Y's RBIL limitation is $60,000, Y's partnership RBIL for the year is not limited and Y's net recognized built-in gain for the year is $25,000 ($75,000−$50,000=$25,000). However, if Y had a RBIL limitation of $40,000 instead of $60,000, Y's partnership RBIL would be limited to $40,000 under paragraph (i)(2)(ii) of this section and Y's net recognized built-in gain for the year would be $35,000 ($75,000−$40,000=$35,000).

Example 5. RBIG limitation of $0. (i) X is a C corporation that elects to become an S corporation on January 1, 1996. X owns a 50 percent interest in partnership P with a RBIG limitation of $0 and a RBIL limitation of $25,000.

(a) In 1996, P's partnership 1374 items are—

(1) Ordinary income of $25,000; and

(2) Capital gain of $75,000.

(b) X itself has—

(1) Recognized built-in ordinary income of $40,000; and

(2) Recognized built-in capital loss of $90,000.

(ii) X's net recognized built-in gain for 1996 computed without partnership 1374 items is $40,000 and with partnership 1374 items is $65,000 ($40,000+$25,000=$65,000). Thus, X's partnership RBIG is $25,000 for the year except as limited under paragraph (i)(2)(i) of this section. Because X's RBIG limitation is $0, X's partnership RBIG of $25,000 is limited to $0 and X's net recognized built-in gain for the year is $40,000.

Example 6. RBIL limitation of $0. (i) Y is a C corporation that elects to become an S corporation on January 1, 1996. Y owns a 50 percent interest in partnership P with a RBIG limitation of $60,000 and a RBIL limitation of $0.

(a) In 1996, P's partnership 1374 items are—

(1) Ordinary income of $25,000; and

(2) Capital loss of $90,000.

(b) Y itself has—

(1) recognized built-in ordinary income of $40,000; and

(2) recognized built-in capital gain of $75,000.

(ii) Y's net recognized built-in gain for 1996 computed without partnership 1374 items is $115,000 ($40,000+$75,000=$115,000) and with partnership 1374 items is $65,000 ($40,000+$25,000=$65,000). Thus, Y's partnership RBIL is $50,000 for the year except as limited under paragraph (i)(2)(ii) of this section. Because Y's RBIL limitation is $0, Y's partnership RBIL of $50,000 is limited to $0 and Y's net recognized built-in gain is $115,000.

Example 7. Disposition of partnership interest. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a 50 percent interest in partnership P with a RBIG limitation of $200,000 and a RBIL limitation of $0. P owns (among other assets) Blackacre with a basis of $20,000 and a value of $140,000. In 1996, P sells Blackacre for $140,000 and recognizes a gain of $120,000 of which $60,000 is included in X's distributive share and treated as a partnership 1374 item. X's net recognized built-in gain for 1996 computed without partnership 1374 items is $95,000 and with partnership 1374 items is $155,000. Thus, X has a partnership

RBIG of $60,000. In 1999, X sells its entire interest in P for $350,000 and recognizes a gain of $250,000. Under paragraph (i)(3) of this section, X's recognized built-in gain on the sale is limited by its RBIG limitation to $140,000 ($200,000 − $60,000=$140,000).

Example 8. Section 704(c) case. Y is a C corporation that elects to become an S corporation on January 1, 1996. On that date, Y contributes Asset 1, 5-year property with a value of $40,000 and a basis of $0, and an unrelated party contributes $40,000 in cash, each for a 50 percent interest in partnership P. The partnership adopts the traditional method under §1.704–3(b). If P sold Asset 1 for $40,000 immediately after it was contributed by Y, P's $40,000 gain would be allocated to Y under section 704(c). Instead, Asset 1 is sold by P in 1999 for $36,000 and P recognizes gain of $36,000 ($36,000 − $0=$36,000) on the sale. However, because book depreciation of $8,000 per year has been taken on Asset 1 in 1996, 1997, and 1998, Y is allocated only $16,000 of P's $36,000 gain ($40,000 − (3×$8,000)=($16,000 − $0)=$16,000) under section 704(c). The remaining $20,000 of P's $36,000 gain ($36,000 − $16,000=$20,000) is allocated 50 percent to each partner under section 704(b). Thus, a total of $26,000 ($16,000+$10,000=$26,000) of P's $36,000 gain is allocated to Y. However, under paragraph (i)(6) of this section, Y treats $36,000 as a partnership 1374 item on P's sale of Asset 1.

Example 9. Disposition of distributed partnership asset. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a fifty percent interest in partnership P and P owns (among other assets) Blackacre with a basis of $20,000 and a value of $40,000. On January 1, 1998, P distributes Blackacre to X, when Blackacre has a basis of $20,000 and a value of $50,000. Under section 732(a)(1), X has a transferred basis of $20,000 in Blackacre. On January 1, 1999, X sells Blackacre for $60,000 and recognizes a gain of $40,000. Under paragraph (i)(7) of this section and section 1374(d)(3), X has recognized built-in gain from the sale of $20,000, the amount of built-in gain in Blackacre on the first day of the recognition period.

[T.D. 8579, 59 FR 66464, Dec. 27, 1994]

§1.1374–5 Loss carryforwards.

(a) *In general.* The loss carryforwards allowed as deductions against net recognized built-in gain under section 1374(b)(2) are allowed only to the extent their use is allowed under the rules applying to C corporations. Any other loss carryforwards, such as charitable contribution carryforwards under section 170(d)(2), are not allowed as deductions against net recognized built-in gain.

(b) *Example.* The rules of this section are illustrated by the following example.

Example: Section 382 limitation. X is a C corporation that has an ownership change under section 382(g)(1) on January 1, 1994. On that date, X has a fair market value of $500,000, NOL carryforwards of $400,000, and a net unrealized built-in gain under section 382(h)(3)(A) of $0. Assume X's section 382 limitation under section 382(b)(1) is $40,000. X elects to become an S corporation on January 1, 1998. On that date, X has NOL carryforwards of $240,000 (having used $160,000 of its pre-change net operating losses in its 4 preceding taxable years) and a section 1374 net unrealized built-in gain of $250,000. In 1998, X has net recognized built-in gain of $100,000. X may use $40,000 of its NOL carryforwards as a deduction against its $100,000 net recognized built-in gain, because X's section 382 limitation is $40,000.

[T.D. 8579, 59 FR 66469, Dec. 27, 1994]

§1.1374–6 Credits and credit carryforwards.

(a) *In general.* The credits and credit carryforwards allowed as credits against the section 1374 tax under section 1374(b)(3) are allowed only to the extent their use is allowed under the rules applying to C corporations. Any other credits or credit carryforwards, such as foreign tax credits under section 901, are not allowed as credits against the section 1374 tax.

(b) *Limitations.* The amount of business credit carryforwards and minimum tax credit allowed against the section 1374 tax are subject to the limitations described in section 38(c) and section 53(c), respectively, as modified by this paragraph. The tentative tax determined under paragraph (a)(3) of §1.1374–1 is treated as the regular tax liability described in sections 38(c)(1) and 53(c)(1), and as the net income tax and net regular tax liability described in section 38(c)(1). The tentative minimum tax described in section 55(b) is determined using the rate of tax applicable to corporations and without regard to any alternative minimum tax foreign tax credit described in that section and by treating the net recognized built-in gain determined under §1.1374–2, modified to take into account the adjustments of sections 56 and 58 applicable to corporations and the preferences of section 57, as the alternative minimum taxable income described in section 55(b)(2).

(c) *Examples.* The rules of this section are illustrated by the following examples.

Example 1. Business credit carryforward. X is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, X has a $500,000 business credit carryforward from a C year and Asset #1 with a fair market value of $400,000, a basis for regular tax purposes of $95,000, and a basis for alternative minimum tax purposes of $150,000. In 1996, X has net recognized built-in gain of $305,000 from selling Asset #1 for $400,000. Thus, X's tentative tax under paragraph (a)(3) of § 1.1374–1 and regular tax liability under paragraph (b) of this section is $106,750 ($400,000 − $95,000=$305,000 × .35= $106,750, assuming a 35 percent tax rate). Also, X's tentative minimum tax determined under paragraph (b) of this section is $47,000 [$400,000 − $150,000=$250,000 − $15,000 ($40,000 corporate exemption amount −$25,000 phase-out=$15,000)=$235,000 × .20=$47,000, assuming a 20 percent tax rate]. Thus, the business credit limitation under section 38(c) is $59,750 [$106,750 − $47,000 (the greater of $47,000 or $20,438 (.25 × $81,750 ($106,750 − $25,000=$81,750))) = $59,750]. As a result, X's section 1374 tax is $47,000 ($106,750 − $59,750= $47,000) for 1996 and X has $440,250 ($500,000 − $59,750 = $440,250) of business credit carryforwards for succeeding taxable years.

Example 2. Minimum tax credit. Y is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, Asset#1 has a fair market value of $5,000,000, a basis for regular tax purposes of $4,000,000, and a basis for alternative minimum tax purposes of $4,750,000. Y also has a minimum tax credit of $310,000 from 1995. Y has no other assets, no net operating or capital loss carryforwards, and no business credit carryforwards. In 1996, Y's only transaction is the sale of Asset #1 for $5,000,000. Therefore, Y has net recognized built-in gain in 1996 of $1,000,000 ($5,000,000 − $4,000,000=$1,000,000) and a tentative tax under paragraph (a)(3) of § 1.1374–1 of $350,000 ($1,000,000×.35=$350,000, assuming a 35 percent tax rate). Also, Y's tentative minimum tax determined under paragraph (b) of this section is $47,000 [$5,000,000 − $4,750,000=$250,000 − $15,000 ($40,000 corporate exemption amount −$25,000 phase-out = $15,000) = $235,000×.20 = $47,000, assuming a 20 percent tax rate]. Thus, Y may use its minimum tax credit in the amount of $303,000 ($350,000 − $47,000=$303,000) to offset its section 1374 tentative tax. As a result, Y's section 1374 tax is $47,000 ($350,000 − $303,000=$47,000) in 1996 and Y has a minimum tax credit attributable to years for which Y was a C corporation of $7,000 ($310,000 − $303,000=$7,000).

[T.D. 8579, 59 FR 66469, Dec. 27, 1994]

§ 1.1374–7 Inventory.

(a) *Valuation.* The fair market value of the inventory of an S corporation on the first day of the recognition period equals the amount that a willing buyer would pay a willing seller for the inventory in a purchase of all the S corporation's assets by a buyer that expects to continue to operate the S corporation's business. For purposes of the preceding sentence, the buyer and seller are presumed not to be under any compulsion to buy or sell and to have reasonable knowledge of all relevant facts.

(b) *Identity of dispositions.* The inventory method used by an S corporation for tax purposes must be used to identify whether the inventory it disposes of during the recognition period is inventory it held on the first day of that period. Thus, a corporation using the LIFO method does not dispose of inventory it held on the first day of the recognition period unless the carrying value of its inventory for a taxable year during that period is less than the carrying value of its inventory on the first day of the recognition period (determined using the LIFO method as described in section 472). However, if a corporation changes its method of accounting for inventory (for example, from the FIFO method to the LIFO method or from the LIFO method to the FIFO method) with a principal purpose of avoiding the tax imposed under section 1374, it must use its former method to identify its dispositions of inventory.

[T.D. 8579, 59 FR 66469, Dec. 27, 1994]

§ 1.1374–8 Section 1374(d)(8) transactions.

(a) *In general.* If any S corporation acquires any asset in a transaction in which the S corporation's basis in the asset is determined (in whole or in part) by reference to a C corporation's basis in the assets (or any other property) (a section 1374(d)(8) transaction), section 1374 applies to the net recognized built-in gain attributable to the assets acquired in any section 1374(d)(8) transaction.

(b) *Separate determination of tax.* For purposes of the tax imposed under section 1374(d)(8), a separate determination of tax is made with respect to the assets the S corporation acquires in one section 1374(d)(8) transaction from the assets the S corporation acquires in another section 1374(d)(8) transaction and from the assets the corporation held when it became an S corporation. Thus, an S corporation's section 1374 attributes when it became an S corporation may only be used to reduce the section 1374 tax imposed on dispositions of assets the S corporation held at that time. Similarly, an S corporation's section 1374 attributes acquired in a section 1374(d)(8) transaction may only be used to reduce a section 1374 tax imposed on dispositions of assets the S corporation acquired in the same transaction.

(c) *Taxable income limitation.* For purposes of paragraph (a) of this section, an S corporation's taxable income limitation under §1.1374–2(a)(2) for any taxable year is allocated between or among each of the S corporation's separate determinations of net recognized built-in gain for that year (determined without regard to the taxable income limitation) based on the ratio of each of those determinations to the sum of all of those determinations.

(d) *Examples.* The rules of this section are illustrated by the following examples.

Example 1. Separate determination of tax. (i) X is a C corporation that elected to become an S corporation effective January 1, 1986 (before section 1374 was amended in the Tax Reform Act of 1986). X has a net operating loss carryforward of $20,000 arising in 1985 when X was a C corporation. On January 1, 1996, Y (an unrelated C corporation) merges into X in a transaction to which section 368(a)(1)(A) applies. Y has no loss carryforwards, credits, or credit carryforwards. The assets X acquired from Y are subject to tax under section 1374 and have a net unrealized built-in gain of $150,000.

(ii) In 1996, X has a pre-limitation amount of $50,000 on dispositions of assets acquired from Y and a taxable income limitation of $100,000 (because only one group of assets is subject to section 1374, there is no allocation of the taxable income limitation). As a result, X has a net recognized built-in gain on those assets of $50,000. X's $20,000 net operating loss carryforward may not be used as a deduction against its $50,000 net recognized built-in gain on the assets X acquired from Y. Therefore, X has a section 1374 tax of $17,500 ($50,000 × .35 = $17,500, assuming a 35 percent tax rate) for its 1996 taxable year.

Example 2. Allocation of taxable income limitation. (i) Y is a C corporation that elects to become an S corporation effective January 1, 1996. The assets Y holds when it becomes an S corporation have a net unrealized built-in gain of $5,000. Y has no loss carryforwards, credits, or credit carryforwards. On January 1, 1997, Z (an unrelated C corporation) merges into Y in a transaction to which section 368(a)(1)(A) applies. Z has no loss carryforwards, credits, or credit carryforwards. The assets Y acquired from Z are subject to tax under section 1374 and have a net unrealized built-in gain of $80,000.

(ii) In 1997, Y has a pre-limitation amount on the assets it held when it became an S corporation of $15,000, a pre-limitation amount on the assets Y acquired from Z of $15,000, and a taxable income limitation of $10,000. However, because the assets Y held on becoming an S corporation have a net unrealized built-in gain of $5,000, its net recognized built-in gain on those assets is limited to $5,000 before taking into account the taxable income limitation. Y's taxable income limitation of $10,000 is allocated between the assets Y held on becoming an S corporation and the assets Y acquired from Z for purposes of determining the net recognized built-in gain from each pool of assets. Thus, Y's net recognized built-in gain on the assets Y held on becoming an S corporation is $2,500 [$10,000 × ($5,000/$20,000) = $2,500]. Y's net recognized built-in gain on the assets Y acquired from Z is $7,500 [$10,000 × ($15,000/$20,000) = $7,500]. Therefore, Y has a section 1374 tax of $3,500 [($2,500 + $7,500) × .35 = $3,500, assuming a 35 percent tax rate] for its 1997 taxable year.

[T.D. 8579, 59 FR 66469, Dec. 27, 1994]

§1.1374–9 Anti-stuffing rule.

If a corporation acquires an asset before or during the recognition period with a principal purpose of avoiding the tax imposed under section 1374, the asset and any loss, deduction, loss carryforward, credit, or credit carryforward attributable to the asset is disregarded in determining the S corporation's pre-limitation amount, taxable income limitation, net unrealized built-in gain limitation, deductions against net recognized built-in gain, and credits against the section 1374 tax.

[T.D. 8579, 59 FR 66470, Dec. 27, 1994]

§ 1.1374–10 Effective date and additional rules.

(a) *In general.* Sections 1.1374–1 through 1.1374–9 apply for taxable years ending on or after December 27, 1994, but only in cases where the S corporation's return for the taxable year is filed pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994.

(b) *Additional rules.* This paragraph (b) provides rules applicable to certain S corporations, assets, or transactions to which §§ 1.1374–1 through 1.1374–9 do not apply.

(1) *Certain transfers to partnerships.* If a corporation transfers an asset to a partnership in a transaction to which section 721(a) applies and the transfer is made in contemplation of an S election or during the recognition period, section 1374 applies on a disposition of the asset by the partnership as if the S corporation had disposed of the asset itself. This paragraph (b)(1) applies as of the effective date of section 1374, unless the recognition period with respect to the contributed asset is pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994.

(2) *Certain inventory dispositions.* For purposes of section 1374(d)(2)(A), the inventory method used by the taxpayer for tax purposes (FIFO, LIFO, etc.) must be used to identify whether goods disposed of following conversion to S corporation status were held by the corporation at the time of conversion. Thus, for example, a corporation using the LIFO inventory method will not be subject to the built-in gain tax with respect to sales of inventory except to the extent that a LIFO layer existing prior to the beginning of the first taxable year as an S corporation is invaded after the beginning of that year. This paragraph (b)(2) applies as of the effective date of section 1374, unless the recognition period with respect to the inventory is pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994.

(3) *Certain contributions of built-in loss assets.* If a built-in loss asset (that is, an asset with an adjusted tax basis in excess of its fair market value) is contributed to a corporation within 2 years before the earlier of the beginning of its first taxable year as an S corporation, or the filing of its S election, the loss inherent in the asset will not reduce net unrealized built-in gain, as defined in section 1374(d)(1), unless the taxpayer demonstrates a clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprises. This paragraph (b)(3) applies as of the effective date of section 1374, unless the recognition period with respect to the contributed asset is pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994.

(4) *Certain installment sales*—(i) *In general.* If a taxpayer sells an asset either prior to or during the recognition period and recognizes income either during or after the recognition period from the sale under the installment method, the income will, when recognized, be taxed under section 1374 to the extent it would have been so taxed in prior taxable years if the selling corporation had made the election under section 453(d) not to report the income under the installment method. For purposes of determining the extent to which the income would have been subject to tax if the section 453(d) election had not been made, the taxable income limitation of section 1374(d)(2)(A)(ii) and the built-in gain carryover rule of section 1374(d)(2)(B) will be taken into account. This paragraph (b)(4) applies for installment sales occurring on or after March 26, 1990, and before December 27, 1994.

(ii) *Examples.* The rules of this paragraph (b)(4) are illustrated by the following examples.

Example 1. In year 1 of the recognition period under section 1374, a corporation realizes a gain of $100,000 on the sale of an asset with built-in gain. The corporation is to receive full payment for the asset in year 11. Because the corporation does not make an election under section 453(d), all $100,000 of the gain from the sale is reported under the installment method in year 11. If the corporation had made an election under section 453(d) with respect to the sale, the gain would have been recognized in year 1 and, taking into account the corporation's income and gains from other sources, application of the taxable income limitation of section 1374(d)(2)(A)(ii) and the built-in gain carryover rule of section 1374(d)(2)(B) would have resulted in $40,000 of the gain being subject to tax during the recognition period under section 1374. Therefore, $40,000 of the gain recognized in year 11 is subject to tax under section 1374.

Example 2. In year 1 of the recognition period under section 1374, a corporation realizes a gain of $100,000 on the sale of an asset with built-in gain. The corporation is to receive full payment for the asset in year 6. Because the corporation does not make an election under section 453(d), all $100,000 of the gain from the sale is reported under the installment method in year 6. If the corporation had made an election under section 453(d) with respect to the sale, the gain would have been recognized in year 1 and, taking into account the corporation's income and gains from other sources, application of the taxable income limitation of section 1374(d)(2)(A)(ii) and the built-in gain carryover rule of section 1374(d)(2)(B) would have resulted in all of the gain being subjected to tax under section 1374 in years 1 through 5. Therefore, notwithstanding that the taxable income limitation of section 1374(d)(2)(A)(ii) might otherwise limit the taxation of the gain recognized in year 6, the entire $100,000 of gain will be subject to tax under section 1374 when it is recognized in year 6.

[T.D. 8579, 59 FR 66470, Dec. 27, 1994]

§1.1375–1 Tax imposed when passive investment income of corporation having subchapter C earnings and profits exceed 25 percent of gross receipts.

(a) *General rule.* For taxable years beginning after 1981, section 1375(a) imposes a tax on the income of certain S corporations that have passive investment income. In the case of a taxable year beginning during 1982, an electing small business corporation may elect to have the rules under this section not apply. See the regulations under section 1362 for rules on the election. For purposes of this section, the term *S corporation* shall include an electing small business corporation under prior law. This tax shall apply to an S corporation for a taxable year if the S corporation has—

(1) Subchapter C earnings and profits at the close of such taxable year, and

(2) Gross receipts more than 25 percent of which are passive investment income.

If the S corporation has no subchapter C earnings and profits at the close of the taxable year (because, for example, such earnings and profits were distributed in accordance with section 1368), the tax shall not be imposed even though the S corporation has passive investment income for the taxable year. If the tax is imposed, the tax shall be computed by multiplying the excess net passive income (as defined in paragraph (b) of this section) by the highest rate of tax specified in section 11(b).

(b) *Definitions*—(1) *Excess net passive income*—(i) *In general.* The term *excess net passive income* is defined in section 1375(b)(1), and can be expressed by the following formula:

$$\mathrm{ENPI} = \mathrm{NPI} \times \frac{\mathrm{PII} - (.25 \times \mathrm{GR})}{\mathrm{PII}}$$

Where:

ENPI=excess net passive income
NPI=net passive income
PII=passive investment income
GR=total gross receipts

(ii) *Limitation.* The amount of the excess net passive income for any taxable year shall not exceed the corporation's taxable income for the taxable year (determined in accordance with section 1374(d) and §1.1374–1(d)).

(2) *Net passive income.* The term *net passive income* means—

(i) Passive investment income, reduced by

(ii) The deductions allowable under chapter 1 of the Internal Revenue Code of 1954 which are directly connected (within the meaning of paragraph (b)(3) of this section) with the production of such income (other than deductions allowable under section 172 and part VIII of subchapter B).

(3) *Directly connected*—(i) *In general.* For purposes of paragraph (b)(2)(ii) of this section to be directly connected with the production of income, an item of deduction must have proximate and primary relationship to the income. Expenses, depreciation, and similar items attributable solely to such income qualify for deduction.

(ii) *Allocation of deduction.* If an item of deduction is attributable (within the meaning of paragraph (b)(3)(i) of this section) inpart to passive investment income and in part to income other than passive investment income, the deduction shall be allocated between the two types of items on a reasonable basis. The portion of any deduction so allocated to passive investment income shall be treated as proximately and primarily related to such income.

(4) *Other definitions.* The terms *subchapter C earnings and profits, passive investment income,* and *gross receipts* shall have the same meaning given these terms in section 1362(d)(3) and the regulations thereunder.

(c) *Special rules*—(1) *Disallowance of credits.* No credit is allowed under part IV of subchapter A of chapter 1 of the Code (other than section 34) against the tax imposed by section 1375(a) and this section.

(2) *Coordination with section 1374.* If any gain—

(i) Is taken into account in determining passive income for purposes of this section, and

(ii) Is taken into account under section 1374,

the amount of such gain taken into account under section 1374(b) and § 1.1374–1(b) (1) and (2) in determining the amount of tax shall be reduced by the portion of the excess net passive income for the taxable year which is attributable (on a pro rata basis) to such gain. For purposes of the preceding sentence, the portion of excess net passive income for the taxable year which is attributable to such capital gain is equal to the amount determined by multiplying the excess net passive income by the following fraction:

$$\frac{NCG - E}{NPI}$$

Where:

NCG=net capital gain
NPI=net passive income.
E=Expense attributable to net capital gain.

(d) *Waiver of tax in certain cases*—(1) *In general.* If an S corporation establishes to the satisfaction of the Commissioner that—

(i) It determined in good faith that it had no subchapter C earnings and profits at the close of the taxable year, and

(ii) During a reasonable period of time after it was determined that it did have subchapter C earnings and profits at the close of such taxable year such earnings and profits were distributed,

the Commissioner may waive the tax imposed by section 1375 for such taxable year. The S corporation has the burden of establishing that under the relevant facts and circumsances the Commissioner should waive the tax.

For example, if an S corporation establishes that in good faith and using due diligence it determined that it had no subchapter C earnings and profits at the close of a taxable year, but it was later determined on audit that it did have subchapter C earnings and profits at the close of such taxable year, and if the corporation establishes that it distributed such earnings and profits within a reasonable time after the audit, it may be appropriate for the Commissioner to waive the tax on passive income for such taxable year.

(2) *Corporation's request for a waiver.* A request for waiver of the tax imposed by section 1375 shall be made in writing to the district director and shall contain all relevant facts to establish that the requirements of paragraph (d)(1) of this section are met. Such request shall contain a description of how and on what date the S corporation in good faith and using due diligence determined that it had no subchapter C earnings and profits at the close of the taxable year, a description of how and on what date it was determined that the S corporation had subchapter C earnings and profits at the close of the year and a description (including dates) of any steps taken to distribute such earnings and profits. If the earnings and profits have not yet been distributed, the request shall contain a timetable for distribution and an explanation of why such timetable is reasonable. On the date the waiver is to become effective, all subchapter C earnings and profits must have been distributed.

(e) *Reduction in pass-thru for tax imposed on excess net passive income.* See section 1366(f)(3) for a special rule reducing each item of the corporation's passive investment income for purposes of section 1366(a) if a tax is imposed on the corporation under section 1375.

(f) *Examples.* The following examples illustrate the principles of this section:

Example 1. Assume Corporation M, an S corporation, has for its taxable year total gross receipts of $200,000, passive investment income of $100,000, $60,000 of which is interest income, and expenses directly connected with the production of such interest income in the amount of $10,000. Assume also that at the end of the taxable year Corporation M has subchapter C earnings and profits. Since more than 25 percent of the Corporation M's total gross receipts are passive investment income, and since Corporation M has subchapter C earnings and profits at the end of the taxable year, Corporation M will be subject to the tax imposed by section 1375. The amount of excess net passive investment income is $45,000 ($90,000 × (50,000 / 100,000)). Assume that the other $40,000 of passive investment income is attributable to net capital gain and that there are no expenses directly connected with such gain. Under these facts, $20,000 of the excess net passive income is attributable to the net capital gain ($45,000 × ($40,000 / $90,000)). Accordingly, the amount of gain taken into account under section 1374(b)(1) and the taxable income of Corporation M under section 1374(b)(2) shall be reduced by $20,000.

Example 2. Assume an S corporation with subchapter C earnings and profits has tax-exempt income of $400, its only passive income, gross receipts of $1,000 and taxable income of $250 and there are no expenses associated with the tax-exempt income. The corporation's excess net income for the taxable year would total $150 (400 × ((400 − 250 / 400)). This amount is subject to the tax imposed by section 1375, notwithstanding that such amount is otherwise tax-exempt income.

[T.D. 8104, 51 FR 34203, Sept. 26, 1986; 52 FR 9162, Mar. 23, 1987. Redesignated and amended by T.D. 8419, 57 FR 22653, May 29, 1992]

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(3) Implied agreement.

§1.1377–3 Effective date.

[T.D. 8696, 61 FR 67455, Dec. 23, 1996]

§1.1377–1 Pro rata share.

(a) *Computation of pro rata shares*—(1) *In general.* For purposes of subchapter S of chapter 1 of the Internal Revenue Code and this section, each shareholder's pro rata share of any S corporation item described in section 1366(a) for any taxable year is the sum of the amounts determined with respect to the shareholder by assigning an equal portion of the item to each day of the S corporation's taxable year, and then dividing that portion pro rata among the shares outstanding on that day. See paragraph (b) of this section for rules pertaining to the computation of each shareholder's pro rata share when an election is made under section 1377(a)(2) to treat the taxable year of an S corporation as if it consisted of two taxable years in the case of a termination of a shareholder's entire interest in the corporation.

(2) *Special rules*—(i) *Days on which stock has not been issued.* Solely for purposes of determining a shareholder's pro rata share of an item for a taxable year under section 1377(a) and this section, the beneficial owners of the corporation are treated as the shareholders of the corporation for any day on which the corporation has not issued any stock.

(ii) *Determining shareholder for day of stock disposition.* A shareholder who disposes of stock in an S corporation is treated as the shareholder for the day of the disposition. A shareholder who dies is treated as the shareholder for the day of the shareholder's death.

(b) *Election to terminate year*—(1) *In general.* If a shareholder's entire interest in an S corporation is terminated during the S corporation's taxable year and the corporation and all affected shareholders agree, the S corporation may elect under section 1377(a)(2) and this paragraph (b) (terminating election) to apply paragraph (a) of this section to the affected shareholders as if the corporation's taxable year consisted of two separate taxable years, the first of which ends at the close of the day on which the shareholder's entire interest in the S corporation is terminated. If the event resulting in the termination of the shareholder's entire interest also constitutes a qualifying disposition as described in § 1.1368–1(g)(2)(i), the election under § 1.1368–1(g)(2) cannot be made. An S corporation may not make a terminating election if the cessation of a shareholder's interest occurs in a transaction that results in a termination under section 1362(d)(2) of the corporation's election to be an S corporation. (See section 1362(e)(3) for an election to have items assigned to each short taxable year under normal tax accounting rules in the case of a termination of a corporation's election to be an S corporation.) A terminating election is irrevocable and is effective only for the terminating event for which it is made.

(2) *Affected shareholders.* For purposes of the terminating election under section 1377(a)(2) and paragraph (b) of this section, the term *affected shareholders* means the shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the taxable year. If such shareholder has transferred shares to the corporation, the term *affected shareholders* includes all persons who are shareholders during the taxable year.

(3) *Effect of the terminating election*—(i) *In general.* An S corporation that makes a terminating election for a taxable year must treat the taxable year as separate taxable years for all affected shareholders for purposes of allocating items of income (including tax-exempt income), loss, deduction, and credit; making adjustments to the accumulated adjustments account, earnings and profits, and basis; and determining the tax effect of a distribution. An S corporation that makes a terminating election must assign items of income (including tax-exempt income), loss, deduction, and credit to each deemed separate taxable year using its normal method of accounting as determined under section 446(a).

(ii) *Due date of S corporation return.* A terminating election does not affect the due date of the S corporation's return required to be filed under section 6037(a) for a taxable year (determined without regard to a terminating election).

(iii) *Taxable year of inclusion by shareholder.* A terminating election does not affect the taxable year in which an affected shareholder must take into account the affected shareholder's pro rata share of the S corporation's items of income, loss, deduction, and credit.

(iv) *S corporation that is a partner in a partnership.* A terminating election by an S corporation that is a partner in a partnership is treated as a sale or exchange of the corporation's entire interest in the partnership for purposes of section 706(c) (relating to closing the partnership taxable year), if the taxable year of the partnership ends after the shareholder's interest is terminated and within the taxable year of the S corporation (determined without regard to any terminating election) for which the terminating election is made.

(4) *Determination of whether an S shareholder's entire interest has terminated.* For purposes of the terminating election under section 1377(a)(2) and paragraph (b) of this section, a shareholder's entire interest in an S corporation is terminated on the occurrence of any event through which a shareholder's entire stock ownership in the S corporation ceases, including a sale, exchange, or other disposition of all of the stock held by the shareholder; a gift under section 102(a) of all the shareholder's stock; a spousal transfer under section 1041(a) of all the shareholder's stock; a redemption, as defined in section 317(b), of all the shareholder's stock, regardless of the tax treatment of the redemption under section 302; and the death of the shareholder. A shareholder's entire interest in an S corporation is not terminated if the shareholder retains ownership of

any stock (including an interest treated as stock under §1.1361–1(l)) that would result in the shareholder continuing to be considered a shareholder of the corporation for purposes of section 1362(a)(2). Thus, in determining whether a shareholder's entire interest in an S corporation has been terminated, any interest held by the shareholder as a creditor, employee, director, or in any other non-shareholder capacity is disregarded.

(5) *Time and manner of making a terminating election*—(i) *In general.* An S corporation makes a terminating election by attaching a statement to its timely filed original or amended return required to be filed under section 6037(a) (that is, a Form 1120S) for the taxable year during which a shareholder's entire interest is terminated. A single election statement may be filed by the S corporation for all terminating elections for the taxable year. The election statement must include—

(A) A declaration by the S corporation that it is electing under section 1377(a)(2) and this paragraph (b) to treat the taxable year as if it consisted of two separate taxable years;

(B) Information setting forth when and how the shareholder's entire interest was terminated (for example, a sale or gift);

(C) The signature on behalf of the S corporation of an authorized officer of the corporation under penalties of perjury; and

(D) A statement by the corporation that the corporation and each affected shareholder consent to the S corporation making the terminating election.

(ii) *Affected shareholders required to consent.* For purposes of paragraph (b)(5)(i)(D) of this section, a shareholder of the S corporation for the taxable year is a shareholder as described in section 1362(a)(2). For example, the person who under §1.1362–6(b)(2) must consent to a corporation's S election in certain special cases is the person who must consent to the terminating election. In addition, an executor or administrator of the estate of a deceased affected shareholder may consent to the terminating election on behalf of the deceased affected shareholder.

(iii) *More than one terminating election.* A shareholder whose entire interest in an S corporation is terminated in an event for which a terminating election was made is not required to consent to a terminating election made with respect to a subsequent termination within the same taxable year unless the shareholder is an affected shareholder with respect to the subsequent termination.

(c) *Examples.* The following examples illustrate the provisions of this section:

Example 1. Shareholder's pro rata share in the case of a partial disposition of stock. (i) On January 6, 1997, X incorporates as a calendar year corporation, issues 100 shares of common stock to each of A and B, and files an election to be an S corporation for its 1997 taxable year. On July 24, 1997, B sells 50 shares of X stock to C. Thus, in 1997, A owned 50 percent of the outstanding shares of X on each day of X's 1997 taxable year, B owned 50 percent on each day from January 6, 1997, to July 24, 1997 (200 days), and 25 percent from July 25, 1997, to December 31, 1997 (160 days), and C owned 25 percent from July 25, 1997, to December 31, 1997 (160 days).

(ii) Because B's entire interest in X is not terminated when B sells 50 shares to C on July 24, 1997, X cannot make a terminating election under section 1377(a)(2) and paragraph (b) of this section for B's sale of 50 shares to C. Although B's sale of 50 shares to C is a qualifying disposition under §1.1368–1(g)(2)(i), X does not make an election to terminate its taxable year under §1.1368–1(g)(2). During its 1997 taxable year, X has nonseparately computed income of $720,000.

(iii) For each day in X's 1997 taxable year, A's daily pro rata share of X's nonseparately computed income is $1,000 ($720,000/360 days×50%). Thus, A's pro rata share of X's nonseparately computed income for 1997 is $360,000 ($1,000×360 days). B's daily pro rata share of X's nonseparately computed income is $1,000 ($720,000/360×50%) for the first 200 days of X's 1997 taxable year, and $500 ($720,000/360×25%) for the following 160 days in 1997. Thus, B's pro rata share of X's nonseparately computed income for 1997 is $280,000 (($1,000×200 days) + ($500×160 days)). C's daily pro rata share of X's nonseparately computed income is $500 ($720,000/360×25%) for 160 days in 1997. Thus, C's pro rata share of X's nonseparately computed income for 1997 is $80,000 ($500×160 days).

Example 2. Shareholder's pro rata share when an S corporation makes a terminating election under section 1377(a)(2). (i) On January 6, 1997, X incorporates as a calendar year corporation, issues 100 shares of common stock to each of A and B, and files an election to be an S corporation for its 1997 taxable year. On July 24, 1997, B sells B's entire 100 shares of X stock to C. With the consent of B and C, X makes an election under section 1377(a)(2) and paragraph (b) of this section for the termination of B's entire interest arising from B's sale of 100 shares to C. As a result of the election, the pro rata shares of B and C are determined as if X's taxable year consisted of two separate taxable years, the first of which ends on July 24, 1997, the date B's entire interest in X terminates. Because A is not an affected shareholder as defined by section 1377(a)(2)(B) and paragraph (b)(2) of this section, the treatment as separate taxable years does not apply to A.

(ii) During its 1997 taxable year, X has nonseparately computed income of $720,000. Under X's normal method of accounting, $200,000 of the $720,000 of nonseparately computed income is allocable to the period of January 6, 1997, through July 24, 1997 (the first deemed taxable year), and the remaining $520,000 is allocable to the period of July 25, 1997, through December 31, 1997 (the second deemed taxable year).

(iii) B's pro rata share of the $200,000 of nonseparately computed income for the first deemed taxable year is determined by assigning the $200,000 of nonseparately computed income to each day of the first deemed taxable year ($200,000/200 days = $1,000 per day). Because B held 50% of X's authorized and issued shares on each day of the first deemed taxable year, B's daily pro rata share for each day of the first deemed taxable year is $500 ($1,000 per day × 50%). Thus, B's pro rata share of the $200,000 of nonseparately computed income for the first deemed taxable year is $100,000 ($500 per day × 200 days). B must report this amount for B's taxable year with or within which X's full taxable year ends (December 31, 1997).

(iv) C's pro rata share of the $520,000 of nonseparately computed income for the second deemed taxable year is determined by assigning the $520,000 of nonseparately computed income to each day of the second deemed taxable year ($520,000/160 days = $3,250 per day). Because C held 50% of X's authorized and issued shares on each day of the second deemed taxable year, C's daily pro rata shares for each day of the second deemed taxable year is $1,625 ($3,250 per day × 50%). Therefore, C's pro rata share of the $520,000 of nonseparately computed income is $260,000 ($1,625 per day × 160 days). C must report this amount for C's taxable year with or within which X's full taxable year ends (December 31, 1997).

[T.D. 8696, 61 FR 67456, Dec. 23, 1996]

§ 1.1377–2 Post-termination transition period.

(a) *In general.* For purposes of subchapter S of chapter 1 of the Internal Revenue Code (Code) and this section, the term *post-termination transition period* means—

(1) The period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of—

(i) The day which is 1 year after such last day; or

(ii) The due date for filing the return for the last taxable year as an S corporation (including extensions);

(2) The 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer which follows the termination of the corporation's election and which adjusts a subchapter S item of income, loss, or deduction of the corporation arising during the S period (as defined in section 1368(e)(2)); and

(3) The 120-day period beginning on the date of a determination that the corporation's election under section 1362(a) had terminated for a previous taxable year.

(b) *Special rules for post-termination transition period.* Pursuant to section 1377(b)(1) and paragraph (a)(1) of this section, a post-termination transition period arises the day after the last day that an S corporation was in existence if a C corporation acquires the assets of the S corporation in a transaction to which section 381(a)(2) applies. However, if an S corporation acquires the assets of another S corporation in a transaction to which section 381(a)(2) applies, a post-termination transition period does not arise. (See § 1.1368–2(d)(2) for the treatment of the acquisition of the assets of an S corporation by another S corporation in a transaction to which section 381(a)(2) applies.) The special treatment under section 1371(e)(1) of distributions of money by a corporation with respect to its stock during the post-termination transition period is available only to those shareholders who were shareholders in the S corporation at the time of the termination.

(c) *Determination defined.* For purposes of section 1377(b)(1) and paragraph (a) of this section, the term *determination* means—

(1) A determination as defined in section 1313(a);

(2) A written agreement between the corporation and the Commissioner (including a statement acknowledging that the corporation's election to be an S corporation terminated under section 1362(d)) that the corporation failed to qualify as an S corporation;

(3) For a corporation subject to the audit and assessment provisions of subchapter C of chapter 63 of subtitle A of the Code, the expiration of the period specified in section 6226 for filing a petition for readjustment of a final S corporation administrative adjustment finding that the corporation failed to qualify as an S corporation, provided that no petition was timely filed before the expiration of the period; and

(4) For a corporation not subject to the audit and assessment provisions of subchapter C of chapter 63 of subtitle A of the Code, the expiration of the period for filing a petition under section 6213 for the shareholder's taxable year for which the Commissioner has made a finding that the corporation failed to qualify as an S corporation, provided that no petition was timely filed before the expiration of the period.

(d) *Date a determination becomes effective*—(1) *Determination under section 1313(a).* A determination under paragraph (c)(1) of this section becomes effective on the date prescribed in section 1313 and the regulations thereunder.

(2) *Written agreement.* A determination under paragraph (c)(2) of this section becomes effective when it is signed by the district director having jurisdiction over the corporation (or by another Service official to whom authority to sign the agreement is delegated) and by an officer of the corporation authorized to sign on its behalf. Neither the request for a written agreement nor the terms of the written agreement suspend the running of any statute of limitations.

(3) *Implied agreement.* A determination under paragraph (c) (3) or (4) of this section becomes effective on the day after the date of expiration of the period specified under section 6226 or 6213, respectively.

[T.D. 8696, 61 FR 67457, Dec. 23, 1996]

§1.1377–3 Effective date.

Sections 1.1377–1 and 1.1377–2 apply to taxable years of an S corporation beginning after December 31, 1996.

[T.D. 8696, 61 FR 67458, Dec. 23, 1996]

SECTION 1374 BEFORE THE TAX REFORM ACT OF 1986

§1.1374–1A Tax imposed on certain capital gains.

(a) *General rule.* Except as otherwise provided in paragraph (c) of this section, if for a taxable year beginning after 1982 of an S corporation—

(1) The net capital gain of such corporation exceeds $25,000, and

(2) The net capital gain of such corporation exceeds 50 percent of its taxable income (as defined in paragraph (d) of this section) for such year, and

(3) The taxable income of such corporation (as defined in paragraph (d) of this section) for such year exceeds $25,000,

section 1374 imposes a tax (computed under paragraph (b) of this section) on the income of such corporation. The tax is imposed on the S corporation and not on the shareholders.

(b) *Amount of tax.* The amount of tax shall be the lower of—

(1) An amount equal to the tax, determined as provided in section 1201(a)(2), on the amount by which the net capital gain of the corporation for the taxable year exceeds $25,000, or

(2) An amount equal to the tax which would be imposed by section 11 on the taxable income of the corporation (as defined in paragraph (d) of this section) for the taxable year were it not an S corporation.

No credit shall be allowable under part IV of subchapter A of chapter 1 of the Internal Revenue Code of 1954 (other than under section 34) against the tax imposed by section 1374(a) and this section. See section 1375(c)(2) and §1.1375–1(c)(2) for a special rule that reduces the amount of the net capital gain of the corporation for purposes of this paragraph (b) in cases where a net capital gain is taxed as excess net passive income under section 1375. See section 1374(c)(3) and paragraph (c)(1)(ii) of this section for a special rule that limits the amount of tax on property with a substituted basis in certain cases.

(c) *Exceptions to taxation*—(1) *New corporations and corporations with election in effect for 3 immediately preceding years*—(i) *In general.* If an S corporation would be subject to the tax imposed by section 1374 for a taxable year pursuant to paragraph (a) of this section, the corporation shall, nevertheless, not be subject to such tax for such year, if:

(A) The election under section 1362(a) which is in effect with respect to such corporation for such year has been in effect for the corporation's three immediately preceding taxable years, or

(B) An election under section 1362(a) has been in effect with respect to such corporation for each of its taxable years for which it has been in existence, unless there is a net capital gain for the taxable year which is attributable to property with a substituted basis within the meaning of paragraph (c)(1)(iii) of this section.

(ii) *Amount of tax on net capital gain attributable to property with a substituted basis.* If for a taxable year of an S corporation either paragraph (c)(1)(i) (A) or (B) of this section is satisfied, but the S corporation has a net capital gain for such taxable year which is attributable to property with a substituted basis (within the meaning of paragraph (c)(1)(iii) of this section), then paragraph (a) of this section shall apply for the taxable year, but the amount of tax determined under paragraph (b) of this section shall not exceed a tax, determined as provided in section 1201 (a), on the net capital gain attributable to property with a substituted basis.

(iii) *Property with substituted basis.* For purposes of this section, the term *property with a substituted basis* means:

(A) Property acquired by a corporation (*the acquiring corporation*) during the period beginning 36 months before the first day of the acquiring corporation's taxable year and ending on the last day of such year;

(B) The basis of such property in the hands of the acquiring corporation is determined in whole or in part by reference to the basis of any property in the hands of another corporation; and

(C) Such other corporation was not an S corporation throughout the period beginning the later of:

(*1*) 36 months before the first day of the acquiring corporation's taxable year, or

(*2*) The time such other corporation came into existence,

and ending on the date such other corporation transferred the property, the basis of which is used to determine, in whole or in part, the basis of the property in the hands of the acquiring corporation. An S corporation and any predecessor corporation shall not be treated as one corporation for purposes of this paragraph (c) (1).

(iv) *Existence of a corporation.* For purposes of this section, a corporation shall not be considered to be in existence for any month which precedes the first month in which such corporation has shareholders or acquires assets or begins business, whichever is first to occur.

(v) *References to prior law included.* For purposes of this paragraph (c), the term *S corporation* shall include an electing small business corporation under prior subchapter S law, and the term *election under section 1362 (a)* shall include an election under section 1372 of prior subchapter S law.

(iv) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. M Corporation was organized and began business in 1977. M subsequently made an election under section 1362 (a) which was effective for its 1984 taxable year. If such election does not terminate under section 1362 for its taxable years 1984, 1985, and 1986, M is not subject to the tax imposed by section 1374 for its taxable year 1987, or for any subsequent year for which such election remains in effect, unless it has, for any such year, an excess of net long-term capital gain over net short-term capital loss attributable to property with a substituted basis. If there is such an excess for any such year, and the requirements of paragraph (a) of this section are met, M will be subject to the tax for such year. If there is no such excess for any year after 1986, M will not be subject to the tax for any such year even though the requirements of paragraph (a) of this section are met.

Example 2. N corporation was organized in 1983, and was an S corporation for its first taxable year, N is not subject to the tax imposed by section 1374 for 1983, or for any subsequent year for which its orginal election under section 1362 (a) has not terminated under section 1362(d), unless, for any such year, it has an excess of net long-term capital gain over net short-term capital loss attributable to property with a substituted basis and the requirements of paragraph (a) of this section are met.

(2) *Treatment of certain gains of options and commodities dealers*—(i) *Exclusion of certain capital gains.* For purposes of this section, the net capital gain of any options dealer or commodities dealer shall be determined by not taking into account any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading section 1256 contracts) from any section 1256 contract or property related to such a contract.

(ii) *Definitions.* For purposes of this paragraph (c)(2)—

(A) *Options dealer.* The term *options dealer* has the meaning given to such term by section 1256(g)(8).

(B) *Commodities dealer.* The term *commodities dealer* means a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission.

(C) *Section 1256 contracts.* The term *section 1256 contracts* has the meaning given to such term by section 1256(b).

(iii) *Effective dates*—(A) *In general.* Except as otherwise provided in this paragraph (c)(2)(iii), this paragraph (c)(2) shall apply to positions established after July 18, 1984, in taxable years ending after such date.

(B) *Special rule for options on regulated futures contracts.* In the case of any option with respect to a regulated futures contract (within the meaning of section 1256), this paragraph (c)(2) shall apply to positions established after October 31, 1983, in taxable years ending after such date.

(C) *Elections with respect to property held on or before July 18, 1984.* See §§1.1256 (h)–1T and 1.1256(h)–2T for rules concerning an election to have this paragraph (c)(2) apply to certain property held on or before July 18, 1984.

(d) *Determination of taxable income*—(1) *General rule.* For purposes of this section, taxable income of the corporation shall be determined under section 63(a) as if the corporation were a C corporation rather than an S corporation, except that the following deductions shall not apply in the computation—

(i) The deduction allowed by section 172 (relating to net operating loss deduction), and

(ii) The deductions allowed by part VIII of subchapter B (other than the deduction allowed by section 248, relating to organization expenditures).

For any taxable year in which a tax under this section is imposed on an S corporation, the S corporation shall attach a Form 1120 completed in accordance with this paragraph (d) and the instructions to Form 1120S to its tax return filed for such taxable year.

(2) *Special rule for net capital gains taxed as excess net passive income under section 1375.* See section 1375 (c) (2) and §1.1375–1(c)(2) for a special rule that reduces the taxable income of the corporation for purposes of section 1374(b)(2) and §1.1374–1(b)(2) in cases where a net capital gain is taxed as excess net passive income under section 1375.

(e) *Reduction in pass-thru for tax imposed on capital gain.* See section 1366(f)(2) for a special rule reducing the S corporation's long-term capital gains and the corporation's gain from sales or exchanges of property described in section 1231 for purposes of section 1366(a) by an amount of tax imposed under section 1374 and this section.

(f) *Examples.* The following examples illustrate the principles of this section and assume that a tax will not be imposed under section 1375:

Example 1. Corporation M is an S corporation for its taxable year beginning January 1, 1983. For 1983, M has an excess of net long-term capital gain over net short-term capital loss in the amount of $30,000. However, its taxable income for the year is only $20,000 as a result of other deductions in excess of other income. Thus, although the excess of the net long-term capital gain over the net short-term capital loss exceeds $25,000 and also exceeds 50 percent of taxable income, M is not subject to the tax imposed by section 1374 for 1983 because its taxable income does not exceed $25,000.

Example 2. Corporation N is an S Corporation for its 1983 taxable year. For 1983, N has an excess of net long-term capital gain over net short-term capital loss in the amount of $30,000, and taxable income of $65,000. Thus, although N's net capital gain ($30,000) exceeds $25,000, it does not exceed 50 percent of the corporation's taxable income for the year (50 percent of $65,000, or $32,500), and therefore N is not subject to the tax imposed by section 1374 for such year.

Example 3. Assume that Corporation O, an S corporation, is subject to the tax imposed by section 1374 for its taxable year 1983. For 1983, O has an excess of net long-term capital gain over net short-term capital loss in the amount of $73,000, and taxable income within the meaning of section 1374, which includes capital gains and losses, of $100,000. The amount of tax computed under paragraph (b)(1) of this section is 28 percent of $48.00 ($73,000—$25,000), or $13,440. Since this is lower than the amount computed under paragraph (b)(2) of this section, which is $25,750 ($3,750+$4,500+$7,500+$10,000), $13,440 is the amount of tax imposed by section 1374.

Example 4. Assume that in example (3) the taxable income of O for 1983 is $35,000. This results from an excess of deductions over income with respect to items which were not included in determining the excess of the net long-term capital gain over the net short-term capital loss. In such case, the amount of tax, computed under paragraph (b)(2) of this section, is $5,550. Since this is lower than the amount computed under paragraph (b)(1) of this section, $5,550 is the amount of tax imposed by section 1374.

Example 5. Corporation P, an S corporation, for its taxable year 1983 has an excess of net long-term capital gain over net short-term capital loss in the amount of $65,000 and has taxable income of $80,000. P's election under section 1362 has been in effect for its three immediately preceding taxable years, but P, nevertheless, is subject to the tax imposed by section 1374 for 1983 since it has an excess of net long-term capital gain over net short-term capital loss (in the amount of $20,000) attributable to property with a substituted basis. The tax computed under paragraph (b)(1) of this section, $11,200 (28 percent of $40,000 ($65,000−$25,000)), is less than the tax computed under paragraph (b)(2) of this section, $17,750. However, under the limitation provided in paragraph (c) of this section which is applicable in this factual situation, the tax imposed by section 1374 for 1983 may not exceed $5,600 (28 percent of $20,000, the excess of net long-term capital gain over net short-term capital loss attributable to property with a substituted basis).

[T.D. 8104, 51 FR 34201, Sept. 26, 1986; 52 FR 9162, Mar. 23, 1987. Redesignated and amended by T.D. 8419, 57 FR 22653, May 29, 1992. Further redesignated by T.D. 8579, 59 FR 66462, Dec. 27, 1994]

COOPERATIVES AND THEIR PATRONS

Tax Treatment of Cooperatives

§ 1.1381–1 Organizations to which part applies.

(a) *In general.* Except as provided in paragraph (b) of this section, part I, subchapter T, chapter 1 of the Code, applies to any corporation operating on a cooperative basis and allocating amounts to patrons on the basis of the business done with or for such patrons.

(b) *Exceptions.* Part I of such subchapter T does not apply to:

(1) Any organization which is exempt from income taxes under chapter 1 of the Code (other than an exempt farmers' cooperative described in section 521);

(2) Any organization which is subject to the provisions of part II (section 591 and following), subchapter H, chapter 1 of the Code (relating to mutual savings banks, etc.);

(3) Any organization which is subject to the provisions of subchapter L (section 801 and following), chapter 1 of the Code (relating to insurance companies); or

(4) Any organization which is engaged in generating, transmitting, or otherwise furnishing electric energy, or which provides telephone service, to persons in rural areas. The terms *rural areas* and *telephone service* shall have the meaning assigned to them in section 5 of the Rural Electrification Act of 1936, as amended (7 U.S.C. 924).

[T.D. 6643, 28 FR 3153, Apr. 2, 1963]

§ 1.1381–2 Tax on certain farmers' cooperatives.

(a) *In general.* (1) For taxable years beginning after December 31, 1962, farmers', fruit growers', or like associations, organized and operated in compliance with the requirements of section 521 and § 1.521–1, shall be subject to the taxes imposed by section 11 or section 1201. Although such associations are subject to both normal tax and surtax, as in the case of corporations generally, certain special deductions are provided for them in section 1382(c) and § 1.1382–3. For the purpose of any law which refers to organizations exempt from income taxes such an association shall, however, be considered as an organization exempt under section 501. Thus, the provisions of section 243, providing a credit for dividends received from a domestic corporation subject to taxation, are not applicable to dividends received from a cooperative association organized and operated in compliance with the requirements of section 521 and §1.521–1. The provisions of section 1501, relating to consolidated returns, are likewise not applicable.

(2) Rules governing the manner in which amounts paid as patronage dividends are allowable as deductions in computing the taxable income of such an association are set forth in section 1382(b) and §1.1382–2. For the tax treatment, as to patrons, of amounts received during the taxable year as patronage dividends, see section 1385 and the regulations thereunder.

(b) *Cross references.* For tax treatment of exempt cooperative associations for taxable years beginning before January 1, 1963, or for taxable years beginning after December 31, 1962, with respect to payments attributable to patronage occurring during taxable years beginning before January 1, 1963, see section 522 and the regulations thereunder. For requirements of annual returns by such associations, see sections 6012 and 6072(d) and paragraph (f) of §1.6012–2.

[T.D. 6643, 28 FR 3153, Apr. 2, 1963]

§1.1382–1 Taxable income of cooperatives; gross income.

(a) *Introduction.* Section 1382(b) provides that the amount of certain patronage dividends (and amounts paid in redemption of nonqualified written notices of allocation) shall not be taken into account by a cooperative organization in determining its taxable income. Such section also provides that, for purposes of the Internal Revenue Code, an amount not taken into account is to be treated in the same manner as an item of gross income and as a deduction therefrom. Therefore, such an amount is treated as a deduction for purposes of applying the Internal Revenue Code and the regulations thereunder and, for simplicity, is referred to as a deduction in the regulations under such Code. However, this should not be regarded as a determination of the character of the amount for other purposes.

(b) *Computation of gross income.* Any cooperative organization to which part I, subchapter T, chapter 1 of the Code, applies shall not, for any purpose under the Code, exclude from its gross income (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) the amount of any allocation or distribution to a patron out of the net earnings of such organization with respect to patronage occurring during a taxable year beginning after December 31, 1962. See, however, section 1382(b) and §1.1382–2 for deductions for certain amounts paid to patrons out of net earnings.

[T.D. 6643, 28 FR 3154, Apr. 2, 1963]

§1.1382–2 Taxable income of cooperatives; treatment of patronage dividends.

(a) *In general.* (1) In determining the taxable income of any cooperative organization to which part I, subchapter T, chapter 1 of the Code, applies, there shall be allowed as deductions from gross income, in addition to the other deductions allowable under chapter 1 of the Code, the deductions with respect to patronage dividends provided in section 1382(b) and paragraphs (b) and (c) of this section.

(2) For the definition of terms used in this section see section 1388 and §1.1388–1; to determine the payment period for a taxable year, see section 1382(d) and §1.1382–4.

(b) *Deduction for patronage dividends*—(1) *In general.* In the case of a taxable year beginning after December 31, 1962, there is allowed as a deduction from the gross income of any cooperative organization to which part I of subchapter T applies, amounts paid to patrons during the payment period for the taxable year as patronage dividends with respect to patronage occurring during such taxable year, but only to the extent that such amounts are paid in money, qualified written notices of allocation, or other property (other than non qualified written notices of allocation). See section 1382 (e) and (f) and §§1.1382–5 and 1.1382–6 for special rules relating to the time when patronage is deemed to occur where products are marketed under a pooling arrangement or where earnings are includible in the gross income of the cooperative organization for a taxable year after the year in which the patronage occurred. For purposes of this paragraph, a written notice of allocation is considered paid when it is issued to the patron. A patronage dividend shall be treated as paid in money during the payment period for the taxable year to the extent it is paid by a qualified check which is issued during the payment period for such taxable year and endorsed and cashed on or before the ninetieth day after the close of such payment period. In determining the amount paid which is allowable as a deduction under this paragraph, property (other than written notices of allocation) shall be taken into account at its fair market value when paid, and a qualified written notice of allocation shall be taken into account at its stated dollar amount.

(2) *Special rule for certain taxable years.* No deduction is allowed under this section for amounts paid during taxable years beginning before January 1, 1963, or for amounts paid during taxable years beginning after December 31, 1962, with respect to patronage occurring during taxable years beginning before January 1, 1963. With respect to such amounts, the Internal Revenue Code of 1954 (including section 522 and the regulations thereunder) shall be applicable without regard to subchapter T.

(c) *Deduction for amounts paid in redemption of certain nonqualified written notices of allocation.* In the case of a taxable year beginning after December 31, 1962, there is allowed as a deduction from the gross income of a cooperative organization to which part I of subchapter T applies, amounts paid by such organization during the payment period for such taxable year in redemption of a nonqualified written notice of allocation which was previously paid as a patronage dividend during the payment period for the taxable year during which the patronage occurred, but only to the extent such amounts (1) are paid in money or other property (other than written notices of allocation) and (2) do not exceed the stated dollar amount of such written notice of allocation. No deduction shall be allowed under this paragraph, however, for amounts paid in redemption of nonqualified written notices of allocation which were paid with respect to patronage occurring during a taxable year beginning before January 1, 1963. For purposes of this paragraph, if an amount is paid within the payment period for two or more taxable years, it will be allowable as a deduction only for the earliest of such taxable years. Thus, if a cooperative which reports its income on a calendar year basis pays an amount in redemption of a nonqualified written notice of allocation on January 15, 1966, it will be allowed a deduction for such amount only for its 1965 taxable year. In determining the amount paid which is allowable as a deduction under this paragraph, property (other than written notices of allocation) shall be taken into account at its fair market value when paid. Amounts paid in redemption of a nonqualified written notice of allocation in excess of its stated dollar amount shall be treated under the applicable provisions of the Code. For example, if such excess is in the nature of interest, its deductibility will be governed by section 163 and the regulations thereunder.

[T.D. 6643, 28 FR 3154, Apr. 2, 1963]

§ 1.1382–3 Taxable income of cooperatives; special deductions for exempt farmers' cooperatives.

(a) *In general.* (1) Section 1382(c) provides that in determining the taxable income of a farmers', fruit growers', or like association, described in section 1381(a)(1) and organized and operated in compliance with the requirements of section 521 and § 1.521–1, there shall be allowed as deductions from the gross income of such organization, in addition to the other deductions allowable under chapter 1 of the Code (including the deductions allowed by section 1382(b)) the special deductions provided in section 1382(c) and paragraphs (b), (c), and (d) of this section.

(2) For the definition of terms used in this section, see section 1388 and § 1.1388–1; to determine the payment period for a taxable year, see section 1382(d) and § 1.1382–4.

(b) *Deduction for dividends paid on capital stock.* In the case of a taxable year beginning after December 31, 1962, there is allowed as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 521 and §1.521–1, amounts paid as dividends during the taxable year on the capital stock of such cooperative association. For the purpose of the preceding sentence, the term *capital stock* includes common stock (whether voting or nonvoting), preferred stock, or any other form of capital represented by capital retain certificates, revolving fund certificates, letters of advice, or other evidence of a proprietary interest in a cooperative association. Such deduction is applicable only to the taxable year in which the dividends are actually or constructively paid to the holder of capital stock or other proprietary interest in the cooperative association. If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mail, in a cover properly stamped and addressed to the shareholder at his last known address, at such time that in the ordinary handling of the mails the check would be received by such holder within the taxable year, a presumption arises that the dividend was paid to such holder in such year. The determination of whether a dividend has been paid to such holder by the corporation during its taxable year is in no way dependent upon the method of accounting regularly employed by the corporation in keeping its books. For further rules as to the determination of the right to a deduction for dividends paid, under certain specific circumstances, see section 561 and the regulations thereunder.

(c) *Deduction for amounts allocated from income not derived from patronage*—(1) *In general.* In the case of a taxable year beginning after December 31, 1962, there is allowed as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 521 and §1.521–1, amounts paid to patrons, during the payment period for the taxable year, on a patronage basis with respect to its income derived during such taxable year either from business done with or for the United States or any of its agencies or from sources other than patronage, but only to the extent such amounts are paid in money, qualified written notices of allocation, or other property (other than nonqualified written notices of allocation). For purposes of this subparagraph a written notice of allocation is considered paid when it is issued to the patron. An amount shall be treated as paid in money during the payment period for the taxable year to the extent it is paid by a qualified check which is issued during the payment period for such taxable year and endorsed and cashed on or before the ninetieth day after the close of such payment period. In determining the amount paid which is allowable as a deduction under this paragraph, property (other than written notices of allocation) shall be taken into account at its fair market value when paid, and a qualified written notice of allocation shall be taken into account at its stated dollar amount.

(2) *Definition.* As used in this paragraph, the term *income derived from sources other than patronage* means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets, constitutes income derived from sources other than patronage.

(3) *Basis of distribution.* In order that the deduction for amounts paid with respect to income derived from business done with or for the United States or any of its agencies or from sources other than patronage may be applicable, it is necessary that the amount sought to be deducted be paid on a patronage basis in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such income is attributable. For example, if capital gains are realized from the sale or exchange of capital assets acquired and disposed of during the taxable year, income realized from such gains must be paid to patrons of such year in proportion to the amount of business done by such patrons during the taxable year. Similarly, if capital gains are realized by

the association from the sale or exchange of capital assets held for a period extending into more than one taxable year income realized from such gains must be paid, insofar as is practicable, to the persons who were patrons during the taxable years in which the asset was owned by the association in proportion to the amount of business done by such patrons during such taxable years.

(4) *Special rules for certain taxable years.* No deduction is allowable under this paragraph for amounts paid during taxable years beginning before January 1, 1963, or for amounts paid during taxable years beginning after December 31, 1962, with respect to income derived during taxable years beginning before January 1, 1963. With respect to such amounts, the Internal Revenue Code of 1954 (including section 522 and the regulations thereunder) shall be applicable without regard to subchapter T.

(d) *Deduction for amounts paid in redemption of certain nonqualified written notices of allocation.* In the case of a taxable year beginning after December 31, 1962, there is allowed as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 521 and § 1.521–1, amounts paid by such association during the payment period for such taxable year in redemption of certain nonqualified written notices of allocation, but only to the extent such amounts (1) are paid in money or other property (other than written notices of allocation) and (2) do not exceed the stated dollar amount of such nonqualified written notices of allocation. The nonqualified written notices of allocation referred to in the preceding sentence are those which were previously paid to patrons on a patronage basis with respect to earnings derived either from business done with or for the United States or any of its agencies or from sources other than patronage, provided that such nonqualified written notices of allocation were paid during the payment period for the taxable year during which such earnings were derived. No deduction shall be allowed under this paragraph, however, for amounts paid in redemption of nonqualified written notices of allocation which were paid with respect to earnings derived during a taxable year beginning before January 1, 1963. For purposes of this paragraph, if an amount is paid within the payment period for two or more taxable years, it will be allowable as a deduction only for the earliest of such taxable years. In determining the amount paid which is allowable as a deduction under this paragraph, property (other than written notices of allocation) shall be taken into account at its fair market value when paid. Amounts paid in redemption of a nonqualified written notice of allocation in excess of its stated dollar amount shall be treated under the applicable provisions of the Code.

[T.D. 6643, 28 FR 3155, Apr. 2, 1963]

§ 1.1382–4 Taxable income of cooperatives; payment period for each taxable year.

The payment period for a taxable year is the period beginning with the first day of such taxable year and ending with the fifteenth day of the ninth month following the close of such year.

[T.D. 6643, 28 FR 3156, Nov. 26, 1963]

§ 1.1382–5 Taxable income of cooperatives; products marketed under pooling arrangements.

For purposes of section 1382(b) and § 1.1382–2, in the case of a pooling arrangement for the marketing of products the patronage under such pool shall be treated as occurring during the taxable year in which the pool closes. The determination of when a pool is closed will be made on the basis of the facts and circumstances in each case, but generally the practices and operations of the cooperative organization shall control. This section may be illustrated by the following example:

Example: Farmer A delivers to the X Cooperative 100 bushels of wheat on August 15, 1963, at which time he receives a *per bushel* advance. (Both farmer A and the X Cooperative file returns on a calendar year basis.) On October 15, 1963 farmer A receives an additional *per bushel* payment. The pool sells some of its wheat in 1963 and the remainder in January of 1964. The pool is closed on February 15, 1964. For purposes of section 1382(b), A's patronage is considered as occurring in 1964.

[T.D. 6643, 28 FR 3156, Apr. 2, 1963]

§1.1382–6 Taxable income of cooperatives; treatment of earnings received after patronage occurred.

If earnings derived from business done with or for patrons are includible in the gross income of the cooperative organization for a taxable year after the taxable year during which the patronage occurred, then, for purposes of determining whether the cooperative is allowed a deduction under section 1382(b) and §1.1382–2, the patronage to which these earnings relate shall be considered to have occurred during the taxable year for which such earnings are includible in the cooperative's gross income. Thus, if the cooperative organization pays these earnings out as patronage dividends during the payment period for the taxable year for which the earnings are includible in its gross income, it will be allowed a deduction for such payments under section 1382(b)(1) and paragraph (b) of §1.1382–2, to the extent they are paid in money, qualified written notices of allocation, or other property (other than written notices of allocation).

[T.D. 6643, 28 FR 3156, Apr. 2, 1963]

§1.1382–7 Special rules applicable to cooperative associations exempt from tax before January 1, 1952.

(a) *Basis of property.* The adjustments to the cost or other basis provided in sections 1011 and 1016 and the regulations thereunder, are applicable for the entire period since the acquisition of the property. Thus, proper adjustment to basis must be made under section 1016 for depreciation, obsolescence, amortization, and depletion for all taxable years beginning prior to January 1, 1952, although the cooperative association was exempt from tax under section 521 or corresponding provisions of prior law for such years. However, no adjustment for percentage or discovery depletion is to be made for any year during which the association was exempt from tax. If a cooperative association has made a proper election in accordance with section 1020 and the regulations prescribed thereunder with respect to a taxable year beginning before 1952 in which the association was not exempt from tax, the adjustment to basis for depreciation for such years shall be limited in accordance with the provisions of section 1016(a)(2).

(b) *Amortization of bond premium.* In the case of tax exempt and partially taxable bonds purchased at a premium and subject to amortization under section 171, proper adjustment to basis must be made to reflect amortization with respect to such premium from the date of acquisition of the bond. (For principles governing the method of computation, see the example in paragraph (b) of §1.1016–9, relating to mutual savings banks, building and loan associations, and cooperative banks.) The basis of a fully taxable bond purchased at a premium shall be adjusted from the date of the election to amortize such premium in accordance with the provisions of section 171 except that no adjustment shall be allowable for such portion of the premium attributable to the period prior to the election.

(c) *Amortization of mortgage premium.* In the case of a mortgage acquired at a premium where the principal of such mortgage is payable in installments, adjustments to the basis for the premium must be made for all taxable years (whether or not the association was exempt from tax under section 521 during such years) in which installment payments are received. Such adjustments may be made on an individual mortgage basis or on a composite basis by reference to the average period of payments of the mortgage loans of such association. For the purpose of this adjustment, the term *premium* includes the excess of the acquisition value of the mortgage over its maturity value. The acquisition value of the mortgage is the cost including buying commissions, attorneys' fees, or brokerage fees, but such value does not include amounts paid for accrued interest.

[T.D. 6643, 28 FR 3156, Apr. 2, 1963]

§1.1383–1 Computation of tax where cooperative redeems nonqualified written notices of allocation.

(a) *General rule.* (1) If, during the taxable year, a cooperative organization is entitled to a deduction under section 1382 (b)(2) or (c)(2)(B) for amounts paid in redemption of nonqualified written notices of allocation, the tax imposed for the taxable year by chapter 1 of the Code shall be the lesser of:

(i) The tax for the taxable year computed under section 1383(a)(1), that is, with such deduction taken into account, or

(ii) The tax for the taxable year computed under section 1383(a)(2), that is, without taking such deduction into account, minus the decrease in tax (under chapter 1 of the Code) for any prior taxable year (or years) which would result solely from treating all such nonqualified written notices of allocation redeemed during the taxable year as qualified written notices of allocation when paid. For the purpose of this subdivision, the amount of the decrease in tax is not limited to the amount of the tax for the taxable year. See paragraph (c) of this section for rules relating to a refund of tax where the decrease in tax for the prior taxable year (or years) exceeds the tax for the taxable year.

(2) If the cooperative organization computes its tax for the taxable year under the provisions of section 1383(a)(2) and subparagraph (1)(ii) of this paragraph, then no deduction under section 1382 (b)(2) or (c)(2)(B) shall be taken into account in computing taxable income or loss for the taxable year, including the computation of any net operating loss carryback or carryover. However, the amount of the deduction shall be taken into account in adjusting earnings and profits for the taxable year.

(3) If the tax determined under subparagraph (1)(i) of this paragraph is the same as the tax determined under subparagraph (1)(ii) of this paragraph, the tax imposed for the taxable year under chapter 1 of the Code shall be the tax determined under subparagraph (1)(l) of this paragraph, and section 1383 and this section shall not otherwise apply. The tax imposed for the taxable year shall be the tax determined under subparagraph (1)(ii) of this paragraph in any case when a credit or refund would be allowable for the taxable year under section 1383(b)(1).

(b) *Determination of decrease in tax for prior taxable years*—(1) *Prior taxable years.* The prior taxable year (or years) referred to in paragraph (a) of this section is the year (or years) within the payment period for which the nonqualified written notices of allocation were paid and, in addition, any other prior taxable year (or years) which is affected by the adjustment to income by reason of treating such nonqualified written notices of allocation as qualified written notices of allocation when paid.

(2) *Adjustment to income in prior taxable years.* The deduction for the prior taxable year (or years) in determining the decrease in tax under section 1383(a)(2)(B) and paragraph (a)(1)(ii) of this section shall be the amount paid in redemption of the nonqualified written notices of allocation which, without regard to section 1383, is allowable as a deduction under section 1382 (b)(2) or (c)(2)(B) for the current taxable year.

(3) *Computation of decrease in tax for prior taxable years.* In computing the amount of decrease in tax for a prior taxable year (or years) resulting under this section, there must first be ascertained the amount of tax previously determined for the taxpayer for such prior taxable year (or years). The tax previously determined shall be the sum of the amounts shown as such tax by the taxpayer on his return or returns, plus any amounts which have been previously assessed (or collected without assessment) as deficiencies, reduced by the amount of any rebates which have previously been made. The amount shown as the tax by the taxpayer on his return and the amount of any rebates or deficiencies shall be determined in accordance with the provisions of section 6211 and the regulations thereunder. After the tax previously determined has been ascertained, a recomputation must then be made to determine the decrease in tax, if any, resulting under this section. In determining the decrease in tax for the prior taxable year (or years), appropriate adjustment shall be made to any item which is dependent upon the amount of gross income or taxable income (such as charitable contributions, net operating losses, the foreign tax credit, and the dividends received credit).

(c) *Refunds.* If the decrease in tax for the prior taxable year (or years) determined under section 1383(a)(2)(B) and paragraph (a)(1)(ii) of this section exceeds the tax imposed by chapter 1 of the Code for the taxable year computed without the deduction under section 1382 (b) or (c)(2)(B), the excess shall be considered to be a payment of tax for the taxable year of the deduction. Such payment is deemed to have been made on the last day prescribed by law for the payment of tax for the taxable year and shall be refunded or credited in the same manner as if it were an overpayment of tax for such taxable year. See section 6151 and the regulations thereunder, for rules relating to time and place for paying tax shown on returns.

(d) *Example.* The application of section 1383 may be illustrated by the following example:

Example: The X Cooperative (which reports its income on a calendar year basis) pays patronage dividends of $100,000 in nonqualified written notices of allocation on February 1, 1964, with respect to patronage occurring in 1963. Since the patronage dividends of $100,000 were paid in nonqualified written notices of allocation the X Cooperative is not allowed a deduction for that amount for 1963. On December 1, 1966, the X Cooperative redeems these nonqualified written notices of allocation for $50,000. Under section 1382(b)(2), a deduction of $50,000 is allowable in computing its taxable income for 1966. However, the X Cooperative has a loss for 1966 determined without regard to this deduction. The X Cooperative, therefore, makes the computation under the alternative method provided in section 1383(a)(2). Under this alternative method, it will claim a credit or refund (as an overpayment of tax for 1966) of the decrease in tax for 1963 and for such other years prior to 1966 as are affected which results from recomputing its tax for 1963 and such other years affected) as if patronage dividends of $50,000 had been paid on February 1, 1964, in qualified written notices of allocation. In addition, under this alternative method the X Cooperative cannot use the $50,000 as a deduction for 1966 so as to increase its net operating loss for such year for purposes of computing a net operating loss carryback or carryover. If the X Cooperative also redeems on December 1, 1966, nonqualified written notices of allocation which were paid as patronage dividends on February 1, 1965, with respect to patronage occurring in 1964, it will claim a credit or refund (as an overpayment of tax for 1966) of the decrease in tax for 1964 and for such other years prior to 1966 as are affected. It shall not, however, apply one method for computing the tax with respect to the redemptions in 1966 of the nonqualified written notices of allocation paid in 1964 and the other method with respect to the redemption in 1966 of the nonqualified written notices of allocation paid in 1965.

[T.D. 6643, 28 FR 3156, Apr. 2, 1963]

Tax Treatment by Patrons of Patronage Dividends

§1.1385–1 Amounts includible in patron's gross income.

(a) *General rules.* Section 1385(a) requires every person to include in gross income the following amounts received by him during the taxable year, to the extent paid by the organization in money, a qualified written notice of allocation, or other property (other than a nonqualified written notice of allocation):

(1) The amount of any patronage dividend received from an organization subject to the provisions of part I, subchapter T, chapter 1 of the Code, unless such amount is excludable from gross income under the provisions of section 1385(b) and paragraph (c) of this section, and

(2) The amount of any distribution received from a farmers', fruit growers', or like association, organized and operated in compliance with the requirements of section 521 and §1.521–1, which is paid on a patronage basis with respect to earnings derived by such association either from business done with or for the United States or any of its agencies or from sources other than patronage.

The amounts described in subparagraphs (1) and (2) of this paragraph are includible in gross income for the taxable year in which they are received even though the cooperative organization was allowed a deduction for such amounts for its preceding taxable year because they were paid during the payment period for such preceding taxable year. Similarly, such amounts are includible in gross income even though the cooperative organization is not permitted any deduction for such amounts under the provisions of section 1382 because such amounts were not paid within the time prescribed by such section.

(b) *Treatment of certain nonqualified written notices of allocation.* (1) Except as provided in paragraph (c) of this section, any gain on the redemption, sale, or other disposition of a nonqualified written notice of allocation described in subparagraph (2) of this paragraph shall, to the extent that the stated dollar amount of such written notice of allocation exceeds its basis, be considered as gain from the sale or exchange of property which is not a capital asset, whether such gain is realized by the patron who received the nonqualified written notice of allocation initially or by any subsequent holder. Any amount realized on the redemption, sale, or other disposition of such a nonqualified written notice of allocation in excess of its stated dollar amount will be treated under the applicable provisions of the Code. For example, amounts received in redemption of a nonqualified written notice of allocation which are in excess of the stated dollar amount of such written notice of allocation and which, in effect, constitute interest shall be treated by the recipient as interest.

(2) The nonqualified written notices of allocation to which subparagraph (1) of this paragraph applies are the following:

(i) A nonqualified written notice of allocation which was paid as a patronage dividend (within the meaning of section 1388(a) and paragraph (a) of § 1.1388–1), by a cooperative organization subject to the provisions of part I of subchapter T, and

(ii) A nonqualified written notice of allocation which was paid by a farmers', fruit growers', or like association, organized and operated in compliance with the requirements of section 521 and § 1.521–1, to patrons on a patronage basis with respect to earnings derived either from business done with or for the United States or any of its agencies or from sources other than patronage.

(3) The basis of any nonqualified written notice of allocation described in subparagraph (2) of this paragraph, in the hands of the patron to whom such written notice of allocation was initially paid shall be zero, and the basis of such a written notice of allocation which was acquired from a decedent shall be its basis in the hands of the decedent.

(4) The application of this paragraph may be illustrated by the following example:

Example: A, a farmer, receives a patronage dividend from the X Cooperative, in the form of a nonqualified written notice of allocation, which is attributable to the sale of his crop to that cooperative organization. The stated dollar amount of the nonqualified written notice of allocation is $100. The basis of the written notice of allocation in the hands of A is zero and he must report any amount up to $100 received by him on its redemption, sale, or other disposition, as ordinary income. If A gives the written notice of allocation to his son B, B takes A's (the donor's) basis which is zero, and any gain up to $100 which B later realizes on its redemption, sale, or other disposition is ordinary income. Similarly, if A dies before realizing any gain on the nonqualified written notice of allocation, B, his legatee, has a zero basis for such written notice of allocation and any gain up to $100 which he then realizes on its redemption, sale, or other disposition is also ordinary income. Such gain is income in respect of a decedent within the meaning of section 691(a) and § 1.691(a)–1.

(c) *Treatment of patronage dividends received with respect to certain property*—(1) *Exclusions from gross income.* Except as provided in subparagraph (2) of this paragraph, gross income shall not include:

(i) Any amount of a patronage dividend described in paragraph (a)(1) of this section which is received with respect to the purchase of supplies, equipment, or services, which were not used in the trade or business and the cost of which was not deductible under section 212, or which is received with respect to the marketing or purchasing of a capital asset (as defined in section 1221) or property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167; and

(ii) Any amount (to the extent treated as ordinary income under paragraph (b) of this section) received on the redemption, sale, or other disposition of a nonqualified written notice of allocation which was received as a patronage dividend with respect to the purchase of supplies, equipment, or services, which were not used in the trade or business and the cost of which was not deductible under section 212, or which was received as a patronage dividend with respect to the marketing or purchasing of a capital asset (as defined in section 1221) or property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167.

(2) *Special rules.* (i) If an amount described in subparagraph (1) of this paragraph relates to the purchase of a capital asset (as defined in section 1221), or property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167, and the person receiving such amount owned such asset or property at any time during the taxable year in which such amount is received, then such amount shall be taken into account as an adjustment to the basis of such property or asset as of the first day of the taxable year in which such amount is received. To the extent that such amount exceeds the adjusted basis of such property it shall be taken into account as ordinary income.

(ii) If an amount described in subparagraph (1) of this paragraph relates to the marketing or purchasing of a capital asset (as defined in section 1221), or property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167, and the person receiving such amount did not own the asset or property at any time during the taxable year in which such amount is received, then such amount shall be included in gross income as ordinary income except that:

(*a*) If such amount relates to a capital asset (as defined in section 1221) which was held by the recipient for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and with respect to which a loss was or would have been deductible under section 165, such amount shall be taken into account as gain from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977);

(*b*) If such amount relates to a capital asset (as defined in section 1221) with respect to which a loss was not or would not have been deductible under section 165, such amount shall not be taken into account.

(iii) If an amount described in subparagraph (1) of this paragraph relates to the marketing of a capital asset (as defined in section 1221) or property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167, and such amount is received by the patron in the same taxable year during which he marketed the asset to which it relates, such amount shall be treated as an additional amount received on the sale or other disposition of such asset.

(iv) If a person receiving a patronage dividend or an amount on the redemption, sale, or other disposition of a nonqualified written notice of allocation which was received as a patronage dividend is unable to determine the item to which it relates, he shall include such patronage dividend or such amount in gross income as ordinary income in the manner and to the extent provided in paragraph (a) or (b) of this section, whichever is applicable.

(3) The application of this paragraph may be illustrated by the following examples:

Example 1. On July 1, 1964, P, a patron of a cooperative association, purchases an implement for use in his farming business from such association for $2,900. The implement has an estimated useful life of three years and has an estimated salvage value of $200 which P chooses to take into account in the computation of depreciation. P files his income tax returns on a calendar year basis. For 1964 P claims depreciation of $450 with respect to the implement pursuant to his use of the straight-line method at the rate of $900 per year. On July 1, 1965, the cooperative association pays a patronage dividend to P of $300 in cash with respect to his purchase of the farm implement. P will adjust the basis of the implement and will compute his depreciation deduction for 1965 (and subsequent taxable years) as follows:

Cost of farm implement, July 1, 1964	$2,900
Less:	
Salvage value	200
Depreciation for 1964 (6 months)	450
Adjustment as of January 1, 1965 for cash patronage dividend	300
Total	950
Basis for depreciation for the remaining 2½ years of estimated life	1,950
Depreciation deduction for 1965 ($1,950 divided by the 2½ years of remaining life)	700

Example 2. Assume the same facts as in example (1), except that on July 1, 1965, the cooperative association paid a patronage dividend to P with respect to his purchase of the implement in the form of a nonqualified

written notice of allocation having a stated dollar amount of $300. Since such written notice of allocation was not qualified, no amount of the patronage dividend was taken into account by P as an adjustment to the basis of the implement, or in computing his depreciation deduction, for the year 1965. In 1968, P receives $300 cash from the association in full redemption of the written notice of allocation. Prior to 1968, he had recovered through depreciation $2,700 of the cost of the implement, leaving an adjusted basis of $200 (the salvage value). For the year 1968, the redemption proceeds of $300 are applied against the adjusted basis of $200, reducing the basis of the implement to zero, and the balance of the redemption proceeds, $100, is includable as ordinary income in P's gross income for the calendar year 1968. If the patronage dividend paid to P on July 1, 1965, had been in the form of $60 cash (20 percent of $300) and a qualified written notice of allocation with a stated dollar amount of $240, then the tax treatment of such patronage dividend would be that illustrated in example (1).

Example 3. Assume the same facts as in example (2), except that the nonqualified written notice of allocation is redeemed in cash on July 1, 1966. The full $300 received on redemption will reduce the adjusted basis of the implement as of January 1, 1966, and the depreciation allowances for 1966 and 1967 are computed as follows:

Cost of farm implement, July 1, 1964	$2,900
Less:	
Salvage value	200
Depreciation for 1964 (6 months)	450
Depreciation for 1965	900
Adjustment as of January 1, 1966 for proceeds of the redemption	300
Total	1,850
Basis for depreciation on Jan. 1, 1966	1,050
If P uses the implement in his business until fully depreciated, he would be entitled to the following depreciation allowances with respect to such implement:	
For 1966	700
For 1967	350
Total	1,050
Balance to be depreciated	0

Example 4. Assume the same facts as in example (3), except that P sells the implement in 1965. The entire $300 received in 1966 in redemption of the nonqualified written notice of allocation is includible as ordinary income in P's gross income for the year 1966.

(d) *Determination of amount received.* In determining the amount received for purposes of this section:

(1) Property (other than written notices of allocation) shall be taken into account at its fair market value when received;

(2) A qualified written notice of allocation shall be taken into account at its stated dollar amount; and

(3) The amount of a qualified check shall be considered an amount received in money during the taxable year in which such check is received if the check is endorsed and cashed on or before the ninetieth day after the close of the payment period for the taxable year of the cooperative organization in which the patronage to which such amount relates occurred.

(e) *Effective date.* This section shall not apply to any distribution or allocation received from a cooperative organization, or to any gain or loss on the redemption, sale, or other disposition of any allocation received from such an organization, if such distribution or allocation was received with respect to patronage occurring in a taxable year of the organization beginning before January 1, 1963. See § 1.61–5 for the tax treatment by patrons of such distributions or allocations.

[T.D. 6643, 28 FR 3157, Apr. 2, 1963, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

DEFINITIONS; SPECIAL RULES

§ 1.1388–1 Definitions and special rules.

(a) *Patronage dividend*—(1) *In general.* The term *patronage dividend* means an amount paid to a patron by a cooperative organization subject to the provisions of part I, subchapter T, chapter 1 of the Code, which is paid:

(i) On the basis of quantity or value of business done with or for such patron,

(ii) Under a valid enforceable written obligation of such organization to the patron to pay such amount, which obligation existed before the cooperative organization received the amount so paid, and

(iii) Which is determined by reference to the net earnings of the cooperative organization from business done with or for its patrons.

For the purpose of subdivision (ii) of this subparagraph, amounts paid by a cooperative organization are paid under a valid enforceable written obligation if such payments are required by State law or are paid pursuant to provisions of the bylaws, articles of incorporation, or other written contract, whereby the organization is obligated to make such payment. The term *net earnings,* for purposes of subdivision (iii) of this subparagraph, includes the excess of amounts retained (or assessed) by the organization to cover expenses or other items over the amount of such expenses or other items. For purposes of such subdivision (iii), net earnings shall not be reduced by any taxes imposed by subtitle A of the Code, but shall be reduced by dividends paid on capital stock or other proprietary capital interests.

(2) *Exceptions.* The term *patronage dividend* does not include the following:

(i) An amount paid to a patron by a cooperative organization to the extent that such amount is paid out of earnings not derived from business done with or for patrons.

(ii) An amount paid to a patron by a cooperative organization to the extent that such amount is paid out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. Thus, if a cooperative organization does not pay any patronage dividends to nonmembers, any portion of the amounts paid to members which is out of net earnings from patronage with nonmembers, and which would have been paid to the nonmembers if all patrons were treated alike, is not a patronage dividend.

(iii) An amount paid to a patron by a cooperative organization to the extent that such amount is paid in redemption of capital stock, or in redemption or satisfaction of certificates of indebtedness, revolving fund certificates, retain certificates, letters of advice, or other similar documents, even if such documents were originally paid as patronage dividends.

(iv) An amount paid to a patron by a cooperative organization to the extent that such amount is fixed without reference to the net earnings of the cooperative organization from business done with or for its patrons.

(3) *Examples.* The application of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. (i) Cooperative A, a marketing association operating on a pooling basis, receives the products of patron W on January 5, 1964. On the same day cooperative A advances to W 45 cents per unit for the products so delivered and allocates to him a *retain certificate* having a face value calculated at the rate of 5 cents per unit. During the operation of the pool, and before substantially all the products in the pool are disposed of, cooperative A advances to W an additional 40 cents per unit, the amount being determined by reference to the market price of the products sold and the anticipated price of the unsold products. At the close of the pool on November 10, 1964, cooperative A determines the excess of its receipts over the sum of its expenses and its previous advances to patrons, and allocates to W an additional 3 cents per unit and shares of the capital stock of A having an aggregate stated dollar amount calculated at the rate of 2 cents per unit. Under the provisions of section 1382(e), W's patronage is deemed to occur in 1964, the year in which the pool is closed.

(ii) The patronage dividend paid to W during 1964 amounts to 5 cents per unit, consisting of the aggregate of the following per-unit allocations: The amount of the cash distribution (3 cents), and the stated dollar amount of the capital stock of A (2 cents), which are fixed with reference to the net earnings of A. The amount of the two distributions in cash (85 cents) and the face amount of the *retain certificate* (5 cents), which are fixed without reference to the net earnings of A, do not constitute patronage dividends.

Example 2. Cooperative B, a marketing association operating on a pooling basis, receives the products of patron X on March 5, 1964. On the same day cooperative B pays to X $1.00 per unit for such products, this amount being determined by reference to the market price of the product when received, and issues to him a participation certificate having no face value but which entitles X on the close of the pool to the proceeds derived from the sale of his products less the previous payment of $1.00 and the expenses and other charges attributable to such products. On March 5, 1967, cooperative B, having sold the products in the pool, having deducted the previous payments for such products, and having determined the expenses and other charges of the pool pays to X, in cash, 10 cents per unit pursuant to the participation certificate. Under the provisions of section 1382(e), X's patronage is deemed to occur in 1967, the year in which the pool is closed. The payment made to X during 1967, amounting to 10 cents per unit, is a patronage dividend. Neither the payment to X in 1964 of $1.00 nor the issuance to him of the participation certificate in that year constitutes a patronage dividend.

Example 3. Cooperative C, a purchasing association, obtains supplies for patron Y on May 1, 1964, and receives in return therefor $100. On February 1, 1965, cooperative C, having determined the excess of its receipts over its costs and expenses, pays to Y a cash distribution of $1.00 and a revolving fund certificate with a stated dollar amount of $1.00. The amount of patronage dividend paid to Y in 1965 is $2.00, the aggregate of the cash distribution ($1.00) and the stated dollar amount of the revolving fund certificate ($1.00).

Example 4. Cooperative D, a service association, sells the products of members on a fee basis. It receives the products of patron Z under an agreement not to pool his products with those of other members, to sell his products, and to deliver to him the proceeds of the sale. Patron Z makes payments to cooperative D during 1964 aggregating $75 for service rendered him by cooperative D during that year. On May 15, 1965, cooperative D, having determined the excess of its receipts over its costs and expenses, pays to Z a cash distribution of $2.00. Such amount is a patronage dividend paid by cooperative D during 1965.

(b) *Written notice of allocation.* The term *written notice of allocation* means any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice, which discloses to the patron the stated dollar amount allocated to him on the books of the cooperative organization, and the portion thereof, if any, which constitutes a patronage dividend. Thus, a mere credit to the account of a patron on the books of the organization without disclosure to the patron, is not a written notice of allocation. A written notice of allocation may disclose to the patron the amount of the allocation which constitutes a patronage dividend either as a dollar amount or as a percentage of the stated dollar amount of the written notice of allocation.

(c) *Qualified written notice of allocation*—(1) *In general.* The term *qualified written notice of allocation* means a written notice of allocation:

(i) Which meets the requirements of subparagraphs (2) or (3) of this paragraph, and

(ii) Which is paid as part of a patronage dividend, or as part of a payment by a cooperative association organized and operated in compliance with the provisions of section 521 and § 1.521–1 to patrons on a patronage basis with respect to earnings derived from business done with or for the United States or any of its agencies or from sources other than patronage, that also includes a payment in money or by qualified check equal to at least 20 percent of such patronage dividend or such payment.

In determining, for purposes of subdivision (ii) of this subparagraph, whether 20 percent of a patronage dividend or a payment with respect to nonpatronage earnings is paid in money or by qualified check, any portion of such dividend or payment which is paid in nonqualified written notices of allocation may be disregarded. Thus, if a cooperative pays a patronage dividend of $100 in the form of a nonqualified written notice of allocation with a stated dollar amount of $50, a written notice of allocation with a stated dollar amount of $40, and money in the amount of $10, the written notice of allocation with a stated dollar amount of $40 will constitute a qualified written notice of allocation if it meets the requirements of subparagraph (2) or (3) of this paragraph. A *payment in money,* as that term is used in subdivision (ii) of this subparagraph, includes a payment by a check drawn on a bank but does not include a credit against amounts owed by the patron to the cooperative organization, a credit against the purchase price of a share of stock or of a membership in such organization, nor does it include a payment by means of a document redeemable by such organization for money.

(2) *Written notice of allocation redeemable in cash.* The term *qualified written notice of allocation* includes a written notice of allocation which meets the requirement of subparagraph (1)(ii) of this paragraph and which may be redeemed in cash at its stated dollar amount at any time within a period beginning on the date such written notice of allocation is paid and ending not earlier than 90 days from such date, but only if the distributee receives written notice of the right of redemption at the time he receives such written notice of allocation. The written notice of the right of redemption referred to in the preceding sentence shall be given separately to each patron. Thus, a written notice of the

right of redemption which is published in a newspaper or posted at the cooperative's place of business would not be sufficient to qualify a written notice of allocation which is otherwise described in this subparagraph.

(3) *Consent of patron.* The term *qualified written notice of allocation* also includes written notice of allocation which meets the requirement of subparagraph (1)(ii) of this paragraph and which the distributee has consented, in a manner provided in this subparagraph, to take into account at its stated dollar amount as provided in section 1385 and §1.1385–1.

(i) *Consent in writing.* A distributee may consent to take the stated dollar amount of written notices of allocation into account under section 1385 by signing and furnishing a written consent to the cooperative organization. No special form is required for the written consent so long as the document on which it is made clearly discloses the terms of the consent. Thus, the written consent may be made on a signed invoice, sales slip, delivery ticket, marketing agreement, or other document, on which appears the appropriate consent. Unless the written consent specifically provides to the contrary, it shall be effective with respect to all patronage occurring during the taxable year of the cooperative organization in which such consent is received by such organization and, unless revoked under section 1388(c)(3)(B), for all subsequent taxable years. Section 1388(c)(3)(B)(i) provides that a written consent may be revoked by the patron at any time. Thus, any written consent which is, by its terms, irrevocable is not a consent that would qualify a written notice of allocation. A revocation, to be effective, must be in writing, signed by the patron, and furnished to the cooperative organization. Such a revocation shall be effective only with respect to patronage occurring after the close of the taxable year of the cooperative organization during which the revocation is filed with it. In the case of a pooling arrangement described in section 1382(e) and §1.1382–5, a written consent which is made at any time before the close of the taxable year of the cooperative organization during which the pool closes shall be effective with respect to all patronage under that pool. In addition, any subsequent revocation of such consent by the patron will not be effective for that pool or any other pool with respect to which he has been a patron before such revocation.

(ii) *Consent by membership. (a)* A distributee may consent to take the stated dollar amount of written notices of allocation into account under section 1385 by obtaining or retaining membership in the cooperative organization after such organization has adopted a valid bylaw providing that membership in such cooperative organization constitutes such consent, but such consent shall take effect only after the distributee has received a written notification of the adoption of the bylaw provision and a copy of such bylaw. The bylaw must have been adopted by the cooperative organization after October 16, 1962, and must contain a clear statement that membership in the cooperative organization constitutes the prescribed consent. The written notification from the cooperative organization must inform the patron that this bylaw has been adopted and of its significance. The notification and copy of the bylaw shall be given separately to each member (or prospective member); thus, a written notice and copy of the bylaw which are published in a newspaper or posted at the cooperative's place of business are not sufficient to qualify a written notice of allocation under this subdivision. A member (or prospective member) is presumed to have received the notification and copy of the bylaw if they were sent to his last known address by ordinary mail. A prospective member must receive the notification and copy of the bylaw before he becomes a member of the organization in order to have his membership in the organization constitute consent. A consent made in the manner described in this subdivision shall be effective only with respect to patronage occurring after the patron has received a copy of the bylaw and the prerequisite notice and while he is a member of the organization. Thus, any such consent shall not be effective with respect to any patronage occurring after the patron ceases to be a member of the cooperative organization or after the bylaw provision is repealed by such organization. In the case of a pooling arrangement described in section 1382(e) and § 1.1382–5, a consent made under this subdivision will be effective only with respect to the patron's actual patronage occurring after he receives the notification and copy of the bylaw and while he is a member of the cooperative organization. Thus such a consent shall not be effective with respect to any patronage under a pool after the patron ceases to be a member of the cooperative organization or after the bylaw provisions is repealed by the organization.

(*b*) The following is an example of a bylaw provision which would meet the requirements prescribed in (*a*) of this subdivision.

Example: Each person who hereafter applies for and is accepted to membership in this cooperative and each member of this cooperative on the effective date of this bylaw who continues as a member after such date shall, by such act alone, consent that the amount of any distributions with respect to his patronage occurring after ————, which are made in written notices of allocation (as defined in 26 U.S.C. 1388) and which are received by him from the cooperative, will be taken into account by him at their stated dollar amounts in the manner provided in 26 U.S.C. 1385(a) in the taxable year in which such written notices of allocation are received by him.

(*c*) For purposes of this subdivision the term *member* means a person who is entitled to participate in the management of the cooperative organization.

(iii) *Consent by qualified check. (a)* A distributee may consent to take the stated dollar amount of a written notice of allocation into account under section 1385 by endorsing and cashing a qualified check which is paid as a part of the same patronage dividend or payment described in subparagraph (1)(ii) of this paragraph of which the written notice of allocation is also a part. In order to constitute an effective consent under this subdivision, however, the qualified check must be endorsed and cashed by the payee on or before the ninetieth day after the close of the payment period for the taxable year of the cooperative organization with respect to which the patronage dividend or payment is paid (or on or before such earlier day as may be prescribed by the cooperative organization). The endorsing and cashing of a qualified check shall be considered a consent only with respect to written notices of allocation which are part of the same patronage dividend or payment as the qualified check and for which a consent under subdivision (i) or (ii) of this subparagraph is not in effect. A qualified check is presumed to be endorsed and cashed within the 90-day period if the earliest bank endorsement which appears thereon bears a date no later than 3 days after the end of such 90-day period (excluding Saturdays, Sundays, and legal holidays).

(*b*) The term *qualified check* means a check, or other instrument redeemable in money, which is paid as a part of a patronage dividend or payment described in subparagraph (1)(ii) of this paragraph, on which there is clearly imprinted a statement that the endorsement and cashing of the check or other instrument constitutes the consent of the payee to take into account, as provided in the Federal income tax laws, the stated dollar amount of any written notices of allocation which are paid as a part of the patronage dividend or payment of which such check or other instrument is also a part. A qualified check need not be in the form of an ordinary check which is payable through the banking system. It may, for example, be in the form of an instrument which is redeemable in money by the cooperative organization. The term *qualified check* does not include a check or other instrument paid as part of a patronage dividend or payment with respect to which a consent under subdivision (i) or (ii) of this subparagraph is in effect. In addition, the term *qualified check* does not include a check or other instrument which is paid as part of a patronage dividend or payment, if such patronage dividend or payment does not also include a written notice of allocation (other than a written notice of allocation that may be redeemed in cash at its stated dollar amount which meets the requirements of section 1388(c)(1)(A) and subparagraph (2) of this paragraph). Thus, a check which is paid as part of a patronage dividend is not a qualified check (even though it has the required statement imprinted on it) if the remaining portion of such patronage dividend is paid in cash or if the only written notices of allocation included in the payment are qualified under section 1388(c)(1)(A) and subparagraph (2) of this paragraph (relating to certain written notices of allocation which are redeemable by the patron within a period of at least 90 days).

(*c*) The provisions of this subdivision may be illustrated by the following example.

Example: (1) The A Cooperative is a cooperative organization filing its income tax returns on a calendar year basis. None of its patrons have consented in the manner prescribed in section 1388(c)(2) (A) or (B). On August 1, 1964, the A Cooperative pays patronage dividends to its patrons with respect to their 1963 patronage, and the payment to each such patron is partly by a qualified check and partly in the form of a written notice of allocation which is not redeemable for cash. Each patron who endorses and cashes his qualified check on or before December 14, 1964 (the ninetieth day following the close of the 1963 payment period) shall be considered to have consented with respect to the accompanying written notice of allocation and the amount of such check is treated as a patronage dividend paid in money on August 1, 1964.

(*2*) As to any patron who has not endorsed and cashed his qualified check by December 14, 1964, there is no consent and both the written notice of allocation and the qualified check constitute nonqualified written notices of allocation within the meaning of section 1388(d) and paragraph (d) of this section. If such a patron then cashes his check on January 2, 1965, he shall treat the amount received as an amount received on January 2, 1965, in redemption of a nonqualified written notice of allocation. Likewise, the cooperative shall treat the amount of the check as an amount paid on January 2, 1965, in redemption of a nonqualified written notice of allocation.

(*d*) *Nonqualified written notice of allocation.* The term *nonqualified written notice of allocation* means a written notice of allocation which is not a qualified written notice of allocation described in section 1388(c) and paragraph (c) of this section, or a qualified check which is not cashed on or before the ninetieth day after the close of the payment period for the taxable year of the cooperative organization for which the payment of which it is a part is paid.

(*e*) *Patron.* The term *patron* includes any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association.

[T.D. 6643, 28 FR 3160, Apr. 2, 1963]

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[T.D. 8673, 61 FR 27259, May 31, 1996]

§ 1.1394–1 Enterprise zone facility bonds.

(a) *Scope.* This section contains rules relating to tax-exempt bonds under section 1394 (enterprise zone facility bonds) to provide enterprise zone facilities in both empowerment zones and enterprise communities (zones). See sections 1394, 1397B, and 1397C for other rules and definitions.

(b) *Period of compliance*—(1) *In general.* Except as provided in paragraphs (b)(2) and (c) of this section, the requirements under sections 1394 (a) and (b) applicable to enterprise zone facility bonds must be complied with throughout the greater of the following—

(i) The remainder of the period during which the zone designation is in effect under section 1391 (zone designation period); and

(ii) The period that ends on the weighted average maturity date of the enterprise zone facility bonds.

(2) *Compliance after an issue is retired.* Except as provided in paragraph (c)(3) of this section, the requirements applicable to enterprise zone facility bonds do not apply to an issue after the date on which no enterprise zone facility bonds of the issue are outstanding.

(3) *Deemed compliance*—(i) *General rule.* An issue is deemed to comply with the requirements of sections 1394 (a) and (b) if—

(A) The issuer and the principal user in good faith attempt to meet the requirements of sections 1394 (a) and (b) throughout the period of compliance required under this section; and

(B) Any failure to meet these requirements is corrected within a one-year period after the failure is first discovered.

(ii) *Exception.* The provisions of paragraph (b)(3)(i) of this section do not apply to the requirements of section 1397B(d)(5)(A) (relating to certain prohibited business activities).

(iii) *Good faith.* In order to satisfy the good faith requirement of paragraph (b)(3)(i)(A) of this section, the principal user must at least annually demonstrate to the issuer the principal user's monitoring of compliance with the requirements of sections 1394 (a) and (b).

(c) *Special rules for requirements of sections 1397B and 1397C*—(1) *Start of compliance period.* Except as provided in paragraph (c)(2) of this section, the requirements of sections 1397B (relating to qualification as an enterprise zone business) and 1397C (relating to satisfaction of the rules for qualified zone property) do not apply prior to the *initial testing date* (as defined in paragraph (c)(4) of this section) if—

(i) The issuer and the principal user reasonably expect on the issue date of the enterprise zone facility bonds that those requirements will be met by the principal user on or before the initial testing date; and

(ii) The issuer and the principal user exercise due diligence to meet those requirements prior to the initial testing date.

(2) *Compliance period for certain prohibited activities.* The requirements of section 1397B(d)(5)(A) (relating to certain prohibited business activities) must be complied with throughout the term of the enterprise zone facility bonds.

(3) *Minimum compliance period.* The requirements of sections 1397B (b) or (c) and 1397C must be satisfied for a continuous period of at least three years after the initial testing date, notwithstanding that—

(i) The period of compliance required under paragraph (b)(1) of this section expires before the end of the three-year period; or

(ii) The enterprise zone facility bonds are retired before the end of the three-year period.

(4) *Initial testing date*—(i) *In general.* Except as otherwise provided in paragraph (c)(4)(ii) of this section, the initial testing date is the date that is 18 months after the later of the issue date of the enterprise zone facility bonds or the date on which the financed property is placed in service; provided, however, it is not later than—

(A) Three years after the issue date; or

(B) Five years after the issue date, if the issue finances a construction project for which both the issuer and a licensed architect or engineer certify on or before the issue date of the enterprise zone facility bonds that more than three years after the issue date is necessary to complete construction of the project.

(ii) *Alternative initial testing date.* If the issuer identifies as the initial testing date a date after the issue date of the enterprise zone facility bonds and prior to the initial testing date that would have been determined under paragraph (c)(4)(i) of this section, that earlier date is treated as the initial testing date.

(d) *Testing on an average basis.* Compliance with each of the requirements of section 1397B (b) or (c) is tested each taxable year. Compliance with any of the requirements may be tested on an average basis, taking into account up to four immediately preceding taxable years plus the current taxable year. The earliest taxable year that may be taken into account for purposes of the preceding sentence is the taxable year that includes the initial testing date. A taxable year is disregarded if the part of the taxable year that falls in a required compliance period does not exceed 90 days.

(e) *Resident employee requirements*—(1) *Determination of employee status.* For purposes of the requirement of section 1397B (b)(6) or (c)(5) that at least 35 percent of the employees are residents of the zone, the issuer and the principal user may rely on a certification, signed under penalties of perjury by the employee, provided—

(i) The certification provides to the principal user the address of the employee's principal residence;

(ii) The employee is required by the certification to notify the principal user of a change of the employee's principal residence; and

(iii) Neither the issuer nor the principal user has actual knowledge that the principal residence set forth in the certification is not the employee's principal residence.

(2) *Employee treated as zone resident.* If an issue fails to comply with the requirement of section 1397B (b)(6) or (c)(5) because an employee who initially resided in the zone moves out of the zone, that employee is treated as still residing in the zone if—

(i) That employee was a bona fide resident of the zone at the time of the certification described in paragraph (e)(1) of this section;

(ii) That employee continues to perform services for the principal user in an enterprise zone business and substantially all of those services are performed in the zone; and

(iii) A resident of the zone meeting the requirements of section 1397B (b)(5) or (c)(4) is hired by the principal user for the next available comparable (or lesser) position.

(3) *Resident employee percentage.* For purposes of meeting the requirement of section 1397B (b)(6) or (c)(5) that at least 35 percent of the employees of an enterprise zone business are residents of a zone, paragraphs (e)(3) (i) and (ii) of this section apply.

(i) The term *employee* includes a self-employed individual within the meaning of section 401(c)(1).

(ii) The resident employee percentage is determined on any reasonable basis consistently applied throughout the period of compliance required under this section. The per-employee fraction (as defined in paragraph (e)(3)(ii)(A) of this section) or the employee actual work hour fraction (as defined in paragraph (e)(3)(ii)(B) of this section) are both reasonable methods.

(A) The term *per-employee fraction* means the fraction, the numerator of which is, during the taxable year, the number of employees who work at least 15 hours a week for the principal user, who reside in the zone, and who are employed for at least 90 days, and the denominator of which is, during the same taxable year, the aggregate number of all employees who work at least 15 hours a week for the principal user and who are employed for at least 90 days.

(B) The term *employee actual work hour fraction* means the fraction, the numerator of which is the aggregate total actual hours of work for the principal user of employees who reside in the zone during a taxable year, and the denominator of which is the aggregate total actual hours of work for the principal user of all employees during the same taxable year.

(f) *Application to pooled financing bond and loan recycling programs.* In the case of a pooled financing bond program described in paragraph (g)(2) of this section or a loan recycling program described in paragraph (m)(2)(ii) of this section, the requirements of paragraphs (b) through (e) of this section apply on a loan-by-loan basis. See also paragraphs (g)(2) (relating to limitation on amount of bonds), (m)(2) (relating to maturity limitations), (m)(3) (relating to volume cap), and (m)(4) (relating to remedial actions) of this section.

(g) *Limitation on amount of bonds*—(1) *Determination of outstanding amount.* Whether an issue satisfies the requirements of section 1394(c) (relating to the $3 million and $20 million aggregate limitations on the amount of outstanding enterprise zone facility bonds) is determined as of the issue date of that issue, based on the issue price of that issue and the adjusted issue price of outstanding enterprise zone facility bonds. Amounts of outstanding enterprise zone facility bonds allocable to any entity are determined under rules contained in section 144(a)(10)(C) and the underlying regulations. Thus, the definition of *principal user* for purposes of section 1394(c) is different from the definition of principal user for purposes of paragraph (j) of this section.

(2) *Pooled financing bond programs*—(i) *In general.* The limitations of section 1394(c) for an issue for a pooled financing bond program are determined with regard to the amount of the actual loans to enterprise zone businesses rather than the amount lent to *intermediary lenders* as defined in paragraph (g)(2)(ii) of this section. This paragraph (g)(2) applies only to the extent the proceeds of those enterprise zone facility bonds are loaned to one or more enterprise zone businesses within 42 months of the issue date of the enterprise zone facility bonds or are used to redeem enterprise zone facility bonds of the issue within that 42-month period.

(ii) *Pooled financing bond program defined.* For purposes of this section, *a pooled financing bond program* is a program in which the issuer of enterprise zone facility bonds, in order to provide loans to enterprise zone businesses, lends the proceeds of the enterprise zone facility bonds to a bank or similar intermediary (intermediary lender) which must then relend the proceeds to two or more enterprise zone businesses.

(h) *Original use requirement for purposes of qualified zone property.* In general, for purposes of section 1397C(a)(1)(B), the term *original use* means the first use to which the property is put within the zone. For purposes of section 1394, if property is vacant for at least a one-year period including the date of zone designation, use prior to that period is disregarded for purposes of determining original use. For this purpose, de minimis incidental uses of property, such as renting the side of a building for a billboard, are disregarded.

(i) *Land.* The determination of whether land is functionally related and subordinate to qualified zone property is made in a manner consistent with the rules for exempt facilities under section 142.

(j) *Principal user*—(1) *In general.* Except as provided in paragraph (j)(2) of this section, the term *principal user* means the owner of financed property.

(2) *Rental of real property*—(i) *A lessee as the principal user.* If an owner of real property financed with enterprise zone facility bonds is not an enterprise zone business within the meaning of section 1397B, but the rental of the property is a qualified business within the meaning of section 1397B(d)(2), the term *principal user* for purposes of sections 1394 (b) and (e) means the lessee or lessees.

(ii) *Allocation of enterprise zone facility bonds.* If a lessee is the principal user of real property under paragraph (j)(2)(i) of this section, then proceeds of enterprise zone facility bonds may be allocated to expenditures for real property only to the extent of the property allocable to the lessee’s leased space, including expenditures for common areas.

(3) *Pooled financing bond program.* An intermediary lender in a pooled financing bond program described in paragraph (g)(2) of this section is not treated as the principal user.

(k) *Treatment as separately incorporated business.* For purposes of section 1394(b)(3)(B), a trade or business may be treated as separately incorporated if allocations of income and activities attributable to the business conducted within the zone are made using a reasonable allocation method and if that trade or business has evidence of those allocations sufficient to establish compliance with the requirements of paragraphs (b) through (f) of this section. Whether an allocation method is reasonable will depend upon the facts and circumstances. An allocation method will not be considered to be reasonable unless the allocation method is applied consistently by the trade or business and is consistent with the purposes of section 1394.

(l) *Substantially all.* For purposes of sections 1397B and 1397C(a), the term *substantially all* means 85 percent.

(m) *Application of sections 142 and 146 through 150*—(1) *In general.* Except as provided in this paragraph (m), enterprise zone facility bonds are treated as exempt facility bonds that are described in section 142(a), and all regulations generally applicable to exempt facility bonds apply to enterprise zone facility bonds. For this purpose, enterprise zone businesses are treated as meeting the public use requirement. Sections 147(c)(1)(A) (relating to limitations on financing the acquisition of land), 147(d) (relating to financing the acquisition of existing property), and 142(b)(2) (relating to limitations on financing office space) do not apply to enterprise zone facility bonds. See also paragraph (n)(4) of this section.

(2) *Maturity limitation*—(i) *Requirements.* An issue of enterprise zone facility bonds, the proceeds of which are to be used as part of a loan recycling program, satisfies the requirements of section 147(b) if—

(A) Each loan satisfies the requirements of section 147(b) (determined by treating each separate loan as a separate issue); and

(B) The term of the issue does not exceed 30 years.

(ii) *Loan recycling program defined.* A *loan recycling program* is a program in which—

(A) The issuer reasonably expects as of the issue date of the enterprise zone facility bonds that loan repayments from principal users will be used to make additional loans during the zone designation period;

(B) Repayments of principal on loans (including prepayments) received during the zone designation period are used within six months of the date of receipt either to make new loans to enterprise zone businesses or to redeem enterprise zone facility bonds that are part of the issue; and

(C) Repayments of principal on loans (including prepayments) received after the zone designation period are used to redeem enterprise zone facility bonds that are part of the issue within six months of the date of receipt.

(3) *Volume cap.* For purposes of applying section 146(f)(5)(A) (relating to elective carryforward of unused volume limitation), issuing enterprise zone facility bonds is a carryforward purpose.

(4) *Remedial actions.* In the case of a pooled financing bond program described in paragraph (g)(2) of this section or a loan recycling program described in paragraph (m)(2)(ii) of this section, if a loan fails to meet the requirements of paragraphs (b) through (f) of this section, within six months of noncompliance (after taking into account the deemed compliance provisions of paragraph (b)(3) of this section, if applicable), an amount equal to the outstanding loan principal must be prepaid and the issuer must—

(i) Reloan the amount of the prepayment; or

(ii) Use the prepayment to redeem an amount of outstanding enterprise zone facility bonds equal to the outstanding principal amount of the loan that no longer meets those requirements.

(n) *Continuing compliance and change of use penalties*—(1) *In general.* The penalty provisions of section 1394(e) apply throughout the period of compliance required under paragraph (b)(1) of this section.

(2) *Coordination with deemed compliance provisions.* Section 1394(e)(2) does not apply during any period during which the issue is deemed to comply with the requirements of section 1394 under the deemed compliance provisions of paragraph (b)(3) of this section.

(3) *Application to pooled financing bond and loan recycling programs.* In the case

of a pooled financing bond program described in paragraph (g)(2) of this section or a loan recycling program described in paragraph (m)(2)(ii) of this section, section 1394(e) applies on a loan-by-loan basis.

(4) *Section 150(b)(4) inapplicable.* Section 150(b)(4) does not apply to enterprise zone facility bonds.

(o) *Refunding bonds*—(1) *In general.* An issue of bonds issued after the zone designation period to refund enterprise zone facility bonds (other than in an advance refunding) are treated as enterprise zone facility bonds if the refunding issue and the prior issue, if treated as a single combined issue, would meet all of the requirements for enterprise zone facility bonds, except the requirements in section 1394(c). For example, the compliance period described in paragraph (b)(1) of this section is calculated taking into account any extension of the weighted average maturity of the refunding issue compared to the remaining weighted average maturity of the prior issue. The proceeds of the refunding issue are allocated to the same expenditures and purpose investments as the prior issue.

(2) *Maturity limitation.* The maturity limitation of section 147(b) is applied to a refunding issue by taking into account the issuer's reasonable expectations about the economic life of the financed property as of the issue date of the prior issue and the actual weighted average maturity of the combined refunding issue and prior issue.

(p) *Examples.* The following examples illustrate paragraphs (a) through (o) of this section:

Example 1. Averaging of enterprise zone business requirements. City C issues enterprise zone facility bonds, the proceeds of which are loaned by C to Corporation B to finance the acquisition of equipment for its existing business located in a zone. On the issue date of the enterprise zone facility bonds, B meets all of the requirements of section 1397B(b), except that only 25% of B's employees reside in the zone. C and B reasonably expect on the issue date to meet all requirements of section 1397B(b) by the date that is 18 months after the equipment is placed in service (the initial testing date). In each of the first, second, and third taxable years after the initial testing date, 35%, 40% and 45%, respectively, of B's employees are zone residents. In the fourth year after the testing date, only 25% of B's employees are zone residents. B continues to meet the 35% resident employee requirement, because the average of zone resident employees for those four taxable years is approximately 36%. The percentage of zone residents employed by B before the initial testing date is not included in determining whether B continues to comply with the 35% resident employee requirement.

Example 2. Measurement of resident employee percentage. Authority D issues enterprise zone facility bonds, the proceeds of which are loaned to Sole Proprietor F to establish an accounting business in a zone. In the first year after the initial testing date, the staff working for F includes F, who works 40 hours per week and does not live in the zone, one employee who resides in the zone and works 40 hours per week, one employee who does not reside in the zone and works 20 hours per week, and one employee who does not reside in the zone and works 10 hours per week. F meets the 35% resident employee test by calculating the percentage on the basis of employee actual work hours as described in paragraph (e)(3)(ii)(B) of this section. If F uses the per-employee basis as described in paragraph (e)(3)(ii)(A) of this section to determine if the resident employee test is met, the percentage of employees who are zone residents on a per-employee basis is only 33% because F must exclude from the numerator and the denominator the employee who works only 10 hours per week. If F calculates the resident employee test as a percentage of employee actual work hours as described in paragraph (e)(3)(ii)(B) of this section in the first year, F must calculate the resident employee test as a percentage of employee actual work hours each year.

Example 3. Active conduct of business within the zone. State G issues enterprise zone facility bonds and loans the proceeds to Corporation H to finance the acquisition of equipment for H's mail order clothing business, which is located in a zone. H purchases the supplies for its clothing business from suppliers located both within and outside of the zone and expects that orders will be received both from customers who will reside or work within the zone and from others outside the zone. All orders are received and filled at, and are shipped from, H's clothing business located in the zone. H meets the requirement that at least 80% of its gross income is derived from the active conduct of business within the zone.

Example 4. Enterprise zone business definition. City J issues enterprise zone facility bonds, the proceeds of which are loaned to Partnership K to finance the acquisition of equipment for its printing operation located in the zone. All orders are taken and completed, and all billing and accounting activities are performed, at the print shop located in the zone. K, on occasion, uses its equipment (including its trucks) and employees to deliver large print jobs to customers who reside outside of the zone. So long as K is able to establish that its trucks are used in the zone at least 85% of the time and its employees perform at least 85% of services for K in the zone, K meets the requirements of sections 1397B(b) (3) and (5).

Example 5. Treatment as a separately incorporated business. The facts are the same as in *Example 4* except that six years after the issue date of the enterprise zone facility bonds, K determines to expand its operations to a second location outside of the boundaries of the zone. Although the expansion would result in the failure of K to meet the tests of 1397B(b), K, using a reasonable allocation method, allocates income and activities to its operations within the zone and has evidence of these allocations sufficient to establish compliance with the requirements of paragraphs (b) through (f) of this section. The bonds will not fail to be enterprise zone facility bonds merely because of the expansion.

Example 6. Treatment of pooled financing bond programs. Authority L issues bonds in the aggregate principal amount of $5,000,000 and loans the proceeds to Bank M pursuant to a loans-to-lenders program. M does not meet the definition of enterprise zone business contained in section 1397B. Prior to the issue date of the bonds, L held a public hearing regarding issuance of the bonds for the loans-to-lenders program, describing the projects of identified borrowers to be financed initially with $4,000,000 of the proceeds of the bonds. The applicable elected representative of L approved issuance of the bonds subsequent to the public hearing. The loan agreement between L and M provides that the other proceeds of the bonds will be held by M and loaned to borrowers that qualify as enterprise zone businesses, following a public hearing and approval by the applicable elected representative of L of each loan by M to an enterprise zone business. None of the loans will be in principal amounts in excess of $3,000,000. The loans by M will otherwise meet the requirements of section 1394. The bonds will be enterprise zone facility bonds.

Example 7. Original use requirement for purposes of qualified zone property. City N issues enterprise zone facility bonds, the proceeds of which are loaned to Corporation P to finance the acquisition of equipment. P uses the proceeds after the zone designation date to purchase used equipment located outside of the zone and places the equipment in service at its location in the zone. Substantially all of the use of the equipment is in the zone and is in the active conduct of a qualified business by P. The equipment is treated as qualified enterprise zone property under section 1397C because P makes the first use of the property within the zone after the zone designation date.

Example 8. Principal user. State R issues enterprise zone facility bonds and loans the proceeds to Partnership S to finance the construction of a small shopping center to be located in a zone. S is in the business of commercial real estate. S is not an enterprise zone business, but has secured one anchor lessee, Corporation T, for the shopping center. T would qualify as an enterprise zone business. S will derive 60% of its gross rental income of the shopping center from T. S does not anticipate that the remaining rental income will come from enterprise zone businesses. T will occupy 60% of the total rentable space in the shopping center. S can use enterprise zone facility bond proceeds to finance the portion of the costs of the shopping center allocable to T (60%) because T is treated as the principal user of the enterprise zone facility bond proceeds.

Example 9. Remedial actions. State W issues pooled financing enterprise zone facility bonds, the proceeds of which will be loaned to several enterprise zone businesses in the two enterprise communities and one empowerment zone in W. Proceeds of the pooled financing bonds are loaned to Corporation X, an enterprise zone business, for a term of 10 years. Six years after the date of the loan, X expands its operations beyond the empowerment zone and is no longer able to meet the requirements of section 1394. X does not reasonably expect to be able to cure the noncompliance. The loan documents provide that X must prepay its loan in the event of noncompliance. W does not expect to be able to reloan the prepayment by X within six months of noncompliance. X's noncompliance will not affect the qualification of the pooled financing bonds as enterprise zone facility bonds if W uses the proceeds from the loan prepayment to redeem outstanding enterprise zone facility bonds within six months of noncompliance in an amount comparable to the outstanding amount of the loan immediately prior to prepayment. X will be denied an interest expense deduction for the interest accruing from the first day of the taxable year in which the noncompliance began.

(q) *Effective dates*—(1) *In general.* Except as otherwise provided in this section, the provisions of this section apply to all issues issued after July 30, 1996, and subject to section 1394.

(2) *Elective retroactive application in whole.* An issuer may apply the provisions of this section in whole, but not in part, to any issue that is outstanding on July 30, 1996, and is subject to section 1394.

[T.D. 8673, 61 FR 27259, May 31, 1996]

EMPOWERMENT ZONE EMPLOYMENT CREDIT

§ 1.1396–1 Qualified zone employees.

(a) *In general.* A qualified zone employee of an employer is an employee who satisfies the location-of-services requirement and the abode requirement with respect to the same empowerment zone and is not otherwise excluded by section 1396(d).

(1) *Location-of-services requirement.* The location-of-services requirement is satisfied if substantially all of the services performed by the employee for the employer are performed in the empowerment zone in a trade or business of the employer.

(2) *Abode requirement.* The abode requirement is satisfied if the employee's principal place of abode while performing those services is in the empowerment zone.

(b) *Period for applying location-of-services requirement.* In applying the location-of-services requirement, an employer may use either the pay period method described in paragraph (b)(1) of this section or the calendar year method described in paragraph (b)(2) of this section. For each taxable year of an employer, the employer must either use the pay period method with respect to all of its employees or use the calendar year method with respect to all of its employees. The employer may change the method applied to all of its employees from one taxable year to the next.

(1) *Pay period method*—(i) *Relevant period.* Under the pay period method, the relevant period for applying the location-of-services requirement is each pay period in which an employee provides services to the employer during the calendar year with respect to which the credit is being claimed (*i.e.*, the calendar year that ends with or within the relevant taxable year). If an employer has one pay period for certain employees and a different pay period for other employees (e.g., a weekly pay period for hourly wage employees and a bi-weekly pay period for salaried employees), the pay period actually applicable to a particular employee is the relevant pay period for that employee under this method.

(ii) *Application of method.* Under this method, an employee does not satisfy the location-of-services requirement during a pay period unless substantially all of the services performed by the employee for the employer during that pay period are performed within the empowerment zone in a trade or business of the employer.

(2) *Calendar year method*—(i) *Relevant period.* Under the calendar year method, the relevant period for an employee is the entire calendar year with respect to which the credit is being claimed. However, for any employee who is employed by the employer for less than the entire calendar year, the relevant period is the portion of that calendar year during which the employee is employed by the employer.

(ii) *Application of method.* Under this method, an employee does not satisfy the location-of-services requirement during any part of a calendar year unless substantially all of the services performed by the employee for the employer during that calendar year (or, if the employee is employed by the employer for less than the entire calendar year, the portion of that calendar year during which the employee is employed by the employer) are performed within the empowerment zone in a trade or business of the employer.

(3) *Examples.* This paragraph (b) may be illustrated by the following examples. In each example, the following assumptions apply. The employees satisfy the abode requirement at all relevant times and all services performed by the employees for their employer are performed in a trade or business of the employer. The employees are not precluded from being qualified zone employees by section 1396(d)(2) (certain employees ineligible). No portion of the employees' wages is precluded from being qualified zone wages by section 1396(c)(2) (only first $15,000 of wages taken into account) or section 1396(c)(3) (coordination with targeted jobs credit and work opportunity credit). The examples are as follows:

Example 1. (i) Employer X has a weekly pay period for all its employees. Employee A works for X throughout 1997. During each of the first 20 weekly pay periods in 1997, substantially all of A's work for X is performed within the empowerment zone in which A resides. A also works in the zone at various times during the rest of the year, but there is no other pay period in which substantially all of A's work for X is performed within the empowerment zone. Employer X uses the pay period method.

(ii) For each of the first 20 pay periods of 1997, A is a qualified zone employee, all of A's wages from X are qualified zone wages, and X may claim the empowerment zone employment credit with respect to those wages. X cannot claim the credit with respect to any of A's wages for the rest of 1997.

Example 2. (i) Employer Y has a weekly pay period for its factory workers and a bi-weekly pay period for its office workers. Employee B works for Y in various factories and Employee C works for Y in various offices. Employer Y uses the pay period method.

(ii) Y must use B's weekly pay periods to determine the periods (if any) in which B is a qualified zone employee. Y may claim the empowerment zone employment credit with respect to B's wages only for the weekly pay periods for which B is a qualified zone employee, because those are B's only wages that are qualified zone wages. Y must use C's bi-weekly pay periods to determine the periods (if any) in which C is a qualified zone employee. Y may claim the credit with respect to C's wages only for the bi-weekly pay periods for which C is a qualified zone employee, because those are C's only wages that are qualified zone wages.

Example 3. (i) Employees D and E work for Employer Z throughout 1997. Although some of D's work for Z in 1997 is performed outside the empowerment zone in which D resides, substantially all of it is performed within that empowerment zone. E's work for Z is performed within the empowerment zone in which E resides for several weeks of 1997 but outside the zone for the rest of the year so that, viewed on an annual basis, E's work is not substantially all performed within the empowerment zone. Employer Z uses the calendar year method.

(ii) D is a qualified zone employee for the entire year, all of D's 1997 wages from Z are qualified zone wages, and Z may claim the empowerment zone employment credit with respect to all of those wages, including the portion attributable to work outside the zone. Under the calendar year method, E is not a qualified zone employee for any part of 1997, none of E's 1997 wages are qualified zone wages, and Z cannot claim any empowerment zone employment credit with respect to E's wages for 1997. Z cannot use the calendar year method for D and the pay period method for E because Z must use the same method for all employees. For 1998, however, Z can switch to the pay period method for E if Z also switches to the pay period method for D and all of Z's other employees.

(c) *Effective date.* This section applies with respect to wages paid or incurred on or after December 21, 1994.

[T.D. 8747, 62 FR 67727, Dec. 30, 1997]

§1.1397E–1T Qualified zone academy bonds (temporary).

(a) *Overview.* In general, a qualified zone academy bond is a taxable bond issued by a state or local government the proceeds of which are used to improve certain eligible public schools. An eligible taxpayer that holds a qualified zone academy bond generally is allowed annual Federal income tax credits in lieu of periodic interest payments. These credits compensate the eligible taxpayer for lending money to the issuer and function as payments of interest on the bond. Accordingly, this section generally treats the allowance of a credit as if it were a payment of interest on the bond. In addition, this section provides rules to determine the credit rate, the present value of qualified contributions from private entities, and the maximum term of a qualified zone academy bond.

(b) *Credit rate.* The credit rate for a qualified zone academy bond is equal to 110 percent of the long-term applicable Federal rate (AFR), compounded annually, for the month in which the bond is issued. The Internal Revenue Service publishes this figure each month in a revenue ruling that is published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(b) of this chapter.

(c) *Private business contribution requirement.* To determine the present value (as of the issue date) of qualified contributions from private entities under section 1397E(d)(2), the issuer must use a reasonable discount rate. The credit rate determined under paragraph (b) of this section is a reasonable discount rate.

(d) *Maximum term.* The maximum term for a qualified zone academy bond is determined under section 1397E(d)(3) by using a discount rate equal to 110 percent of the long-term adjusted AFR, compounded semi-annually, for the month in which the bond is issued. The Internal Revenue Service publishes this figure each month in a revenue ruling that is published in the Internal

Revenue Bulletin. See § 601.601(d)(2)(ii)(b) of this chapter.

(e) *Tax credit*—(1) *Eligible taxpayer.* An eligible taxpayer (within the meaning of section 1397E(d)(6)) that holds a qualified zone academy bond on a credit allowance date is allowed a tax credit against the Federal income tax imposed on the taxpayer for the taxable year that includes the credit allowance date. The amount of the credit is equal to the product of the credit rate and the outstanding principal amount of the bond on the credit allowance date. The credit is subject to a limitation based on the eligible taxpayer's income tax liability. See section 1397E(c).

(2) *Ineligible taxpayer.* A taxpayer that is not an eligible taxpayer is not allowed a credit.

(f) *Treatment of the allowance of the credit as a payment of interest*—(1) *General rule.* The holder of a qualified zone academy bond must treat the bond as if it pays qualified stated interest (within the meaning of § 1.1273–1(c)) on each credit allowance date. The amount of the deemed payment of interest on each credit allowance date is equal to the product of the credit rate and the outstanding principal amount of the bond on that date. Thus, for example, if the holder uses an accrual method of accounting, the holder must accrue as interest income the amount of the credit over the one-year accrual period that ends on the credit allowance date.

(2) *Adjustment if the holder cannot use the credit to offset a tax liability.* If a holder holds a qualified zone academy bond on the credit allowance date but cannot use all or a portion of the credit to reduce its income tax liability (for example, because the holder is not an eligible taxpayer or because the limitation in section 1397E(c) applies), the holder is allowed a deduction for the taxable year that includes the credit allowance date. The amount of the deduction is equal to the amount of the unused credit deemed paid on the credit allowance date.

(g) *Not a tax-exempt obligation.* A qualified zone academy bond is not an obligation the interest on which is excluded from gross income under section 103(a).

(h) *Cross-references.* See section 171 and the regulations thereunder for rules relating to amortizable bond premium. See § 1.61–7(c) for the seller s treatment of a bond sold between interest payment dates (credit allowance dates) and § 1.61–7(d) for the buyer s treatment of a bond purchased between interest payment dates (credit allowance dates).

(i) [Reserved]

(j) *Effective date.* This section applies to a qualified zone academy bond issued on or after January 1, 1998.

[T.D. 8755, 63 FR 673, Jan. 7, 1998; 63 FR 8528, Feb. 19, 1998]

RULES RELATING TO INDIVIDUALS' TITLE 11 CASES

SOURCE: Sections 1.1398–1 and 1.1398–2 appear at T.D. 8537, 59 FR 24937, May 13, 1994, unless otherwise noted.

§ 1.1398–1 Treatment of passive activity losses and passive activity credits in individuals' title 11 cases.

(a) *Scope.* This section applies to cases under chapter 7 or chapter 11 of title 11 of the United States Code, but only if the debtor is an individual.

(b) *Definitions and rules of general application.* For purposes of this section—

(1) *Passive activity* and *former passive activity* have the meanings given in section 469 (c) and (f)(3);

(2) The unused passive activity loss (determined as of the first day of a taxable year) is the passive activity loss (as defined in section 469(d)(1)) that is disallowed under section 469 for the previous taxable year; and

(3) The unused passive activity credit (determined as of the first day of a taxable year) is the passive activity credit (as defined in section 469(d)(2)) that is disallowed under section 469 for the previous taxable year.

(c) *Estate succeeds to losses and credits upon commencement of case.* The bankruptcy estate (estate) succeeds to and takes into account, beginning with its first taxable year, the debtor's unused passive activity loss and unused passive activity credit (determined as of the first day of the debtor's taxable year in which the case commences).

(d) *Transfers from estate to debtor*—(1) *Transfer not treated as taxable event.* If, before the termination of the estate, the estate transfers an interest in a passive activity or former passive activity to the debtor (other than by sale or exchange), the transfer is not treated as a disposition for purposes of any provision of the Internal Revenue Code assigning tax consequences to a disposition. The transfers to which this rule applies include transfers from the estate to the debtor of property that is exempt under section 522 of title 11 of the United States Code and abandonments of estate property to the debtor under section 554(a) of such title.

(2) *Treatment of passive activity loss and credit.* If, before the termination of the estate, the estate transfers an interest in a passive activity or former passive activity to the debtor (other than by sale or exchange)—

(i) The estate must allocate to the transferred interest, in accordance with §1.469–1(f)(4), part or all of the estate's unused passive activity loss and unused passive activity credit (determined as of the first day of the estate's taxable year in which the transfer occurs); and

(ii) The debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the transfer occurs, the unused passive activity loss and unused passive activity credit (or part thereof) allocated to the transferred interest.

(e) *Debtor succeeds to loss and credit of the estate upon its termination.* Upon termination of the estate, the debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the termination occurs, the passive activity loss and passive activity credit disallowed under section 469 for the estate's last taxable year.

(f) *Effective date*—(1) *Cases commencing on or after November 9, 1992.* This section applies to cases commencing on or after November 9, 1992.

(2) *Cases commencing before November 9, 1992*—(i) *Election required.* This section applies to a case commencing before November 9, 1992, and terminating on or after that date if the debtor and the estate jointly elect its application in the manner prescribed in paragraph (f)(2)(v) of this section (the election). The caption ''ELECTION PURSUANT TO §1.1398–1'' must be placed prominently on the first page of each of the debtor's returns that is affected by the election (other than returns for taxable years that begin after the termination of the estate) and on the first page of each of the estate's returns that is affected by the election. In the case of returns that are amended under paragraph (f)(2)(iii) of this section, this requirement is satisfied by placing the caption on the amended return.

(ii) *Scope of election.* This election applies to the passive and former passive activities and unused passive activity losses and passive activity credits of the taxpayers making the election.

(iii) *Amendment of previously filed returns.* The debtor and the estate making the election must amend all returns (except to the extent they are for a year that is a closed year within the meaning of paragraph (f)(2)(iv)(D) of this section) they filed before the date of the election to the extent necessary to provide that no claim of a deduction or credit is inconsistent with the succession under this section to unused losses and credits. The Commissioner may revoke or limit the effect of the election if either the debtor or the estate fails to satisfy the requirement of this paragraph (f)(2)(iii).

(iv) *Rules relating to closed years*—(A) Estate succeeds to debtor's passive activity loss and credit as of the commencement date. If, by reason of an election under this paragraph (f), this section applies to a case that was commenced in a closed year, the estate, nevertheless, succeeds to and takes into account the unused passive activity loss and unused passive activity credit of the debtor (determined as of the first day of the debtor's taxable year in which the case commenced).

(B) *No reduction of unused passive activity loss and credit for passive activity loss and credit not claimed for a closed year.* In determining a taxpayer's carryover of a passive activity loss or credit to its taxable year following a closed year, a deduction or credit that the taxpayer failed to claim in the closed year, if attributable to an unused passive activity loss or credit to which the taxpayer succeeded under this section, is treated as a deduction or credit that was disallowed under section 469.

(C) *Passive activity loss and credit to which taxpayer succeeds reflects deductions of prior holder in a closed year.* A loss or credit to which a taxpayer would otherwise succeed under this section is reduced to the extent the loss or credit was allowed to its prior holder for a closed year.

(D) *Closed year.* For purposes of this paragraph (f)(2)(iv), a taxable year is closed to the extent the assessment of a deficiency or refund of an overpayment is prevented, on the date of the election and at all times thereafter, by any law or rule of law.

(v) *Manner of making election*—(A) *Chapter 7 cases.* In a case under chapter 7 of title 11 of the United States Code, the election is made by obtaining the written consent of the bankruptcy trustee and filing a copy of the written consent with the returns (or amended returns) of the debtor and the estate for their first taxable years ending after November 9, 1992.

(B) *Chapter 11 cases.* In a case under chapter 11 of title 11 of the United States Code, the election is made by incorporating the election into a bankruptcy plan that is confirmed by the bankruptcy court or into an order of such court and filing the pertinent portion of the plan or order with the returns (or amended returns) of the debtor and the estate for their first taxable years ending after November 9, 1992.

(vi) *Election is binding and irrevocable.* Except as provided in paragraph (f)(2)(iii) of this section, the election, once made, is binding on both the debtor and the estate and is irrevocable.

§ 1.1398–2 Treatment of section 465 losses in individuals' title 11 cases.

(a) *Scope.* This section applies to cases under chapter 7 or chapter 11 of title 11 of the United States Code, but only if the debtor is an individual.

(b) *Definition and rules of general application.* For purposes of this section—

(1) *Section 465 activity* means an activity to which section 465 applies; and

(2) For each section 465 activity, the unused section 465 loss from the activity (determined as of the first day of a taxable year) is the loss (as defined in section 465(d)) that is not allowed under section 465(a)(1) for the previous taxable year.

(c) *Estate succeeds to losses upon commencement of case.* The bankruptcy estate (the estate) succeeds to and takes into account, beginning with its first taxable year, the debtor's unused section 465 losses (determined as of the first day of the debtor's taxable year in which the case commences).

(d) *Transfers from estate to debtor*—(1) *Transfer not treated as taxable event.* If, before the termination of the estate, the estate transfers an interest in a section 465 activity to the debtor (other than by sale or exchange), the transfer is not treated as a disposition for purposes of any provision of the Internal Revenue Code assigning tax consequences to a disposition. The transfers to which this rule applies include transfers from the estate to the debtor of property that is exempt under section 522 of title 11 of the United States Code and abandonments of estate property to the debtor under section 554(a) of such title.

(2) *Treatment of section 465 losses.* If, before the termination of the estate, the estate transfers an interest in a section 465 activity to the debtor (other than by sale or exchange) the debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the transfer occurs, the transferred interest's share of the estate's unused section 465 loss from the activity (determined as of the first day of the estate's taxable year in which the transfer occurs). For this purpose, the transferred interest's share of such loss is the amount, if any, by which such loss would be reduced if the transfer had occurred as of the close of the preceding taxable year of the estate and been treated as a disposition on which gain or loss is recognized.

(e) *Debtor succeeds to losses of the estate upon its termination.* Upon termination of the estate, the debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the termination occurs, the losses not allowed under section 465 for the estate's last taxable year.

(f) *Effective date*—(1) *Cases commencing on or after November 9, 1992.* This section applies to cases commencing on or after November 9, 1992.

(2) *Cases commencing before November 9, 1992*—(i) *Election required.* This section applies to a case commencing before November 9, 1992, and terminating on or after that date if the debtor and the estate jointly elect its application in the manner prescribed in paragraph (f)(2)(v) of this section (the election). The caption ''ELECTION PURSUANT TO § 1.1398–2'' must be placed prominently on the first page of each of the debtor's returns that is affected by the election (other than returns for taxable years that begin after the termination of the estate) and on the first page of each of the estate's returns that is affected by the election. In the case of returns that are amended under paragraph (f)(2)(iii) of this section, this requirement is satisfied by placing the caption on the amended return.

(ii) *Scope of election.* This election applies to the section 465 activities and unused losses from section 465 activities of the taxpayers making the election.

(iii) *Amendment of previously filed returns.* The debtor and the estate making the election must amend all returns (except to the extent they are for a year that is a closed year within the meaning of paragraph (f)(2)(iv)(D) of this section) they filed before the date of the election to the extent necessary to provide that no claim of a deduction is inconsistent with the succession under this section to unused losses from section 465 activities. The Commissioner may revoke or limit the effect of the election if either the debtor or the estate fails to satisfy the requirement of this paragraph (f)(2)(iii).

(iv) *Rules relating to closed years*—(A) *Estate succeeds to debtor's section 465 loss as of the commencement date.* If, by reason of an election under this paragraph (f), this section applies to a case that was commenced in a closed year, the estate, nevertheless, succeeds to and takes into account the section 465 losses of the debtor (determined as of the first day of the debtor's taxable year in which the case commenced).

(B) *No reduction of unused section 465 loss for loss not claimed for a closed year.* In determining a taxpayer's carryover of an unused section 465 loss to its taxable year following a closed year, a deduction that the taxpayer failed to claim in the closed year, if attributable to an unused section 465 loss to which the taxpayer succeeds under this section, is treated as a deduction that was not allowed under section 465.

(C) *Loss to which taxpayer succeeds reflects deductions of prior holder in a closed year.* A loss to which a taxpayer would otherwise succeed under this section is reduced to the extent the loss was allowed to its prior holder for a closed year.

(D) *Closed year.* For purposes of this paragraph (f)(2)(iv), a taxable year is closed to the extent the assessment of a deficiency or refund of an overpayment is prevented, on the date of the election and at all times thereafter, by any law or rule of law.

(v) *Manner of making election*—(A) *Chapter 7 cases.* In a case under chapter 7 of title 11 of the United States Code, the election is made by obtaining the written consent of the bankruptcy trustee and filing a copy of the written consent with the returns (or amended returns) of the debtor and the estate for their first taxable years ending after November 9, 1992.

(B) *Chapter 11 cases.* In a case under chapter 11 of title 11 of the United States Code, the election is made by incorporating the election into a bankruptcy plan that is confirmed by the bankruptcy court or into an order of such court and filing the pertinent portion of the plan or order with the returns (or amended returns) of the debtor and the estate for their first taxable years ending after November 9, 1992.

(vi) *Election is binding and irrevocable.* Except as provided in paragraph (f)(2)(iii) of this section, the election, once made, is binding on both the debtor and the estate and is irrevocable.

SUBCHAPTER A—INCOME TAX (Continued)

PART 1—INCOME TAXES (Continued)

NORMAL TAXES AND SURTAXES (CONTINUED)

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1.9200–1 Deduction for motor carrier operating authority.
1.9200–2 Manner of taking deduction.

AUTHORITY: 26 U.S.C. 7805, unless otherwise noted.

Section 1.1402 (e)–5T also is issued under 26 U.S.C. 1402(e)(1) and (2).

Section 1.1441–2 also issued under 26 U.S.C. 1441(c)(4) and 26 U.S.C. 3401(a)(6).

Section 1.1441–3 also issued under 26 U.S.C. 1441(c)(4), 26 U.S.C. 3401(a)(6) and 26 U.S.C. 7701(l).

Section 1.1441–4 also issued under 26 U.S.C. 1441(c)(4) and 26 U.S.C. 3401(a)(6).

Section 1.1441–5 also issued under 26 U.S.C. 1441(c)(4), 26 U.S.C. 3401(a)(6) and 26 U.S.C. 7701(b)(11).

Section 1.1441–6 also issued under 26 U.S.C. 1441(c)(4) and 26 U.S.C. 3401(a)(6).

Section 1.1441–7 also issued under 26 U.S.C. 1441(c)(4), 26 U.S.C. 3401(a)(6) and 26 U.S.C. 7701(l).

Section 1.1443–1 also issued under 26 U.S.C. 1443(a).

Section 1.1445–5 also issued under 26 U.S.C. 1445(e)(6).

Section 1.1445–8 also issued under 26 U.S.C. 1445(e)(6).

Section 1.1461–1 also issued under 26 U.S.C. 1441(c)(4) and 26 U.S.C. 3401(a)(6).

Section 1.1461–2 also issued under 26 U.S.C. 1441(c)(4) and 26 U.S.C. 3401(a)(6).

Section 1.1462–1 also issued under 26 U.S.C. 1441(c)(4) and 26 U.S.C. 3401(a)(6).

Section 1.1502–0 also issued under 26 U.S.C. 1502.

Section 1.1502–1 also issued under 26 U.S.C. 1502.

Section 1.1502–2 also issued under 26 U.S.C. 1502.

Section 1.1502–3T also issued under 26 U.S.C. 1502.

Section 1.1502–9T also issued under 26 U.S.C. 1502.

Section 1.1502–11 also issued under 26 U.S.C. 1502.

Section 1.1502–13 also issued under 26 U.S.C. 1502.

Section 1.1502–15T also issued under 26 U.S.C. 1502.

Section 1.1502–17 also issued under 26 U.S.C. 446 and 1502.

Section 1.1502–18 also issued under 26 U.S.C. 1502.

Section 1.1502–19 also issued under 26 U.S.C. 301, 1502, and 1503.

Section 1.1502–20 also issued under 26 U.S.C. 337(d) and 1502.

Section 1.1502–21 also issued under 26 U.S.C. 1502 and 6402(i).

Section 1.1502–21T also issued under 26 U.S.C. 1502.

Section 1.1502–22T also issued under 26 U.S.C. 1502.

Section 1.1502–23T also issued under 26 U.S.C. 1502.

Section 1.1502–26 also issued under 26 U.S.C. 1502.

Section 1.1502–30 also issued under 26 U.S.C. 1502.

Section 1.1502–31 also issued under 26 U.S.C. 1502.

Section 1.1502–32 also issued under 26 U.S.C. 301, 1502, and 1503.

Section 1.1502–33 also issued under 26 U.S.C. 1502.

Section 1.1502–55T also issued under 26 U.S.C. 1502.

Section 1.1502–75 also issued under 26 U.S.C. 1502.

Section 1.1502–76 also issued under 26 U.S.C. 1502.

Section 1.1502–77(e) also issued under 26 U.S.C. 1502 and 6402(i).

Section 1.1502–78(b) also issued under 26 U.S.C. 1502, 6402(i), and 6411(c).

Section 1.1502–79 also issued under 26 U.S.C. 1502.

Section 1.1502–80 also issued under 26 U.S.C. 1502.
Section 1.1502–81T also issued under 26 U.S.C. 1502.
Section 1.1502–91T also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.
Section 1.1502–92T also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.
Section 1.1502–93T also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.
Section 1.1502–94T also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.
Section 1.1502–95T also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.
Section 1.1502–96T also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.
Section 1.1502–98T also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.
Section 1.1502–99T also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.
Section 1.1503–2T also issued under 26 U.S.C. 1503(d).
Section 1.1504–4 also issued under 26 U.S.C. 1504(a)(5).
Section 1.1502–15A also issued under 26 U.S.C. 1502.
Section 1.1502–21A also issued under 26 U.S.C. 1502.
Section 1.1502–22A also issued under 26 U.S.C. 1502.
Section 1.1502–23A also issued under 26 U.S.C. 1502.
Section 1.1502–41A also issued under 26 U.S.C. 1502.
Section 1.1502–79A also issued under 26 U.S.C. 1502.
Section 1.6013–6 also issued under 26 U.S.C. 7701(b)(11).
Sections 1.6035–1 through 1.6035–3 also issued under 26 U.S.C. 6035 (a), (d), and (e).
Section 1.6038A–1 also issued under 26 U.S.C. 6038A.
Section 1.6038A–2 also issued under 26 U.S.C. 6038A.
Section 1.6038A–3 also issued under 26 U.S.C. 6038A and 7701(l).
Section 1.6038A–4 also issued under 26 U.S.C. 6038A.
Section 1.6038A–5 also issued under 26 U.S.C. 6038A.
Section 1.6038A–6 also issued under 26 U.S.C. 6038A.
Section 1.6038A–7 also issued under 26 U.S.C. 6038A.
Section 1.6038B–1 also issued under 26 U.S.C. 6038B.
Section 1.6038B–1T also issued under 26 U.S.C 6038B.
Section 1.6038B–2 also issued under 26 U.S.C. 6038B.
Section 1.6041–3 also issued under 26 U.S.C. 62 and 6041(a).
Section 1.6042–3 also issued under 26 U.S.C. 6045.
Section 1.6045–1 also issued under 26 U.S.C. 6045.
Section 1.6045–2 also issued under 26 U.S.C. 6045.
Section 1.6045–4 also issued under 26 U.S.C. 6045.
Section 1.6049–4 also issued under 26 U.S.C. 6049 (a), (b), and (d).
Section 1.6049–5 also issued under 26 U.S.C. 6049 (a), (b), and (d).
Section 1.6049–5T also issued under 26 U.S.C. 6049.
Section 1.6049–6 also issued under 6049(a), (b), and (d).
Section 1.6049–7 also issued under 26 U.S.C. 860G(e), 1275(c) and 26 U.S.C. 6049(d)(7)(D).
Section 1.6050E–1 also issued under 26 U.S.C. 6050E.
Section 1.6050H–1 also issued under 26 U.S.C. 6050H.
Section 1.6050H–1T also issued under 26 U.S.C. 6050H.
Section 1.6050H–2 also issued under 26 U.S.C. 6050H.
Section 1.6050I–1 also issued under 26 U.S.C. 6050I.
Section 1.6050I–2 also issued under 26 U.S.C. 6050I.
Section 1.6050K–1 also issued under 26 U.S.C. 6050K.
Section 1.6050M–1 also issued under 26 U.S.C. 6050M.
Section 1.6050P–1 also issued under 26 U.S.C. 6050P.
Section 1.6061–2T also issued under 26 U.S.C. 6061.
Section 1.6065–2T also issued under 26 U.S.C. 6065.
Section 1.6081–2 also issued under 26 U.S.C. 6081(a).
Section 1.6081–4 also issued under 26 U.S.C. 6081(a).
Section 1.6081–6 also issued under 26 U.S.C. 6081(a).
Section 1.6081–7 also issued under 26 U.S.C. 6081(a).
Section 1.6302–1 also issued under 26 U.S.C. 6302(c) and (h).
Section 1.6302–2 also issued under 26 U.S.C. 6302(h).
Section 1.6302–3 also issued under 26 U.S.C. 6302(h).
Section 1.6302–4 also issued under 26 U.S.C. 6302(a) and (c).
Section 1.6411–4 also issued under 26 U.S.C. 6402(i) and 6411(c).
Section 1.6662–6 also issued under 26 U.S.C. 6662.
Section 1.6695–1 also issued under 26 U.S.C. 6695(b).
Section 1.6695–1T also issued under 26 U.S.C. 6695(b).
Section 1.6695–2T also issued under 26 U.S.C. 6695(g).
Section 1.6851–2 also issued under 26 U.S.C 6851(d).
Section 1.7520–1 also issued under 26 U.S.C. 7520(c)(2).

Section 1.7520–2 also issued under 26 U.S.C. 7520(c)(2).
Section 1.7520–3 also issued under 26 U.S.C. 7520(c)(2).
Section 1.7520–4 also issued under 26 U.S.C. 7520(c)(2).
Section 1.7701(l)–1 also issued under 26 U.S.C. 7701(l).
Section 1.7872–5T also issued under 26 U.S.C. 7872.

TAX ON SELF-EMPLOYMENT INCOME

SOURCE: Sections 1.1401–1 to 1.1403–1 contained in T.D. 6691, 28 FR 12796, Dec. 3, 1963, unless otherwise noted.

§1.1401–1 Tax on self-employment income.

(a) There is imposed, in addition to other taxes, a tax upon the self-employment income of every individual at the rates prescribed in section 1401(a) (old-age, survivors, and disability insurance) and (b) (hospital insurance). (See subparagraphs (1) and (2) of paragraph (b) of this section.) This tax shall be levied, assessed, and collected as part of the income tax imposed by subtitle A of the Code and, except as otherwise expressly provided, will be included with the tax imposed by section 1 or 3 in computing any deficiency or overpayment and in computing the interest and additions to any deficiency, overpayment, or tax. Since the tax on self-employment income is part of the income tax, it is subject to the jurisdiction of the Tax Court of the United States to the same extent and in the same manner as the other taxes under subtitle A of the Code. Furthermore, with respect to taxable years beginning after December 31, 1966, this tax must be taken into account in computing any estimate of the taxes required to be declared under section 6015.

(b) The rates of tax on self-employment income are as follows:

(1) For old-age, survivors, and disability insurance:

Taxable year	Percent
Beginning before January 1, 1957	3
Beginning after December 31, 1956 and before January 1, 1959	3.375
Beginning after December 31, 1958 and before January 1, 1960	3.75
Beginning after December 31, 1959 and before January 1, 1962	4.5
Beginning after December 31, 1961 and before January 1, 1963	4.7
Beginning after December 31, 1962 and before January 1, 1966	5.4
Beginning after December 31, 1965 and before January 1, 1967	5.8
Beginning after December 31, 1966 and before January 1, 1968	5.9
Beginning after December 31, 1967 and before January 1, 1969	5.8
Beginning after December 31, 1968 and before January 1, 1971	6.3
Beginning after December 31, 1970 and before January 1, 1973	6.9
Beginning after December 31, 1972	7.0

(2) For hospital insurance:

Taxable year	Percent
Beginning after December 31, 1965 and before January 1, 1967	0.35
Beginning after December 31, 1966 and before January 1, 1968	.50
Beginning after December 31, 1967 and before January 1, 1973	.60
Beginning after December 31, 1972 and before January 1, 1974	1.0
Beginning after December 31, 1973 and before January 1, 1978	.90
Beginning after December 31, 1977 and before January 1, 1981	1.10
Beginning after December 31, 1980 and before January 1, 1986	1.35
Beginning after December 31, 1985	1.50

(c) In general, self-employment income consists of the net earnings derived by an individual (other than a nonresident alien) from a trade or business carried on by him as sole proprietor or by a partnership of which he is a member, including the net earnings of certain employees as set forth in §1.1402(c)–3, and of crew leaders, as defined in section 3121(o) (see such section and the regulations thereunder in part 31 of this chapter (Employment Tax Regulations)). See, however, the exclusions, exceptions, and limitations set forth in §§1.1402(a)–1 through 1.1402(h)–1.

[T.D. 6993, 34 FR 828, Jan. 18, 1969, as amended by T.D. 7333, 39 FR 44445, Dec. 24, 1974]

§1.1402(a)–1 Definition of net earnings from self-employment.

(a) Subject to the special rules set forth in §§1.1402(a)–3 to 1.1402(a)–17, inclusive, and to the exclusions set forth in §§1.1402(c)–2 to 1.1402(c)–7, inclusive, the term ‘‘net earnings from self-employment’’ means:

(1) The gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by chapter 1 of the Code which are attributable to such trade or business, plus

(2) His distributive share (whether or not distributed), as determined under section 704, of the income (or minus the loss), described in section 702(a)(9) and as computed under section 703, from any trade or business carried on by any partnership of which he is a member.

(b) Gross income derived by an individual from a trade or business includes payments received by him from a partnership of which he is a member for services rendered to the partnership or for the use of capital by the partnership, to the extent the payments are determined without regard to the income of the partnership. However, such payments received from a partnership not engaged in a trade or business within the meaning of section 1402(c) and § 1.1402(c)–1 do not constitute gross income derived by an individual from a trade or business. See section 707(c) and the regulations thereunder, relating to guaranteed payments to a member of a partnership for services or the use of capital. See also section 706(a) and the regulations thereunder, relating to the taxable year of the partner in which such guaranteed payments are to be included in computing taxable income.

(c) Gross income derived by an individual from a trade or business includes gross income received (in the case of an individual reporting income on the cash receipts and disbursements method) or accrued (in the case of an individual reporting income on the accrual method) in the taxable year from a trade or business even though such income may be attributable in whole or in part to services rendered or other acts performed in a prior taxable year as to which the individual was not subject to the tax on self-employment income.

[T.D. 6691, 28 FR 12796, Dec. 3, 1963, as amended by T.D. 7333, 39 FR 44445, Dec. 24, 1974]

§ 1.1402(a)–2 Computation of net earnings from self-employment.

(a) *General rule.* In general, the gross income and deductions of an individual attributable to a trade or business (including a trade or business conducted by an employee referred to in paragraphs (b), (c), (d), or (e) of § 1.1402(c)–3), for the purpose of ascertaining his net earnings from self-employment, are to be determined by reference to the provisions of law and regulations applicable with respect to the taxes imposed by sections 1 and 3. Thus, if an individual uses the accrual method of accounting in computing taxable income from a trade or business for the purpose of the tax imposed by section 1 or 3, he must use the same method in determining net earnings from self-employment. Likewise, if a taxpayer engaged in a trade or business of selling property on the installment plan elects, under the provisions of section 453, to use the installment method in computing income for purposes of the tax under section 1 or 3, he must use the same method in determining net earnings from self-employment. Income which is excludable from gross income under any provision of subtitle A of the Internal Revenue Code is not taken into account in determining net earnings from self-employment except as otherwise provided in § 1.1402(a)–9, relating to certain residents of Puerto Rico, in § 1.1402(a)–11, relating to ministers or members of religious orders, and in § 1.1402(a)–12, relating to the term ‘‘possession of the United States’’ as used for purposes of the tax on self-employment income. Thus, in the case of a citizen of the United States conducting, in a foreign country, a trade or business in which both personal services and capital are material income-producing factors, any part of the income therefrom which is excluded from gross income as earned income under the provisions of section 911 and the regulations thereunder is not taken into account in determining net earnings from self-employment.

(b) *Trade or business carried on.* The trade or business must be carried on by the individual, either personally or through agents or employees. Accordingly, income derived from a trade or business carried on by an estate or trust is not included in determining the net earnings from self-employment of the individual beneficiaries of such estate or trust.

(c) *Aggregate net earnings.* Where an individual is engaged in more than one trade or business within the meaning of section 1402(c) and §1.1402(c)–1, his net earnings from self-employment consist of the aggregate of the net income and losses (computed subject to the special rules provided in §§1.1402(a)–1 to 1.1402(a)–17 inclusive) of all such trades or businesses carried on by him. Thus, a loss sustained in one trade or business carried on by an individual will operate to offset the income derived by him from another trade or business.

(d) *Partnerships.* The net earnings from self-employment of an individual include, in addition to the earnings from a trade or business carried on by him, his distributive share of the income or loss, described in section 702(a)(9), from any trade or business carried on by each partnership of which he is a member. An individual's distributive share of such income or loss of a partnership shall be determined as provided in section 704, subject to the special rules set forth in section 1402(a) and in §§1.1402(a)–1 to 1.1402(a)–17, inclusive, and to the exclusions provided in section 1402(c) and §§1.1402(c)–2 to 1.1402(c)–7, inclusive. For provisions relating to the computation of the taxable income of a partnership, see section 703.

(e) *Different taxable years.* If the taxable year of a partner differs from that of the partnership, the partner shall include, in computing net earnings from self-employment, his distributive share of the income or loss, described in section 702(a)(9), of the partnership for its taxable year ending with or within the taxable year of the partner. For the special rule in case of the termination of a partner's taxable year as result of death, see §§1.1402(f) and 1.1402(f)–1.

(f) *Meaning of partnerships.* For the purpose of determining net earnings from self-employment, a partnership is one which is recognized as such for income tax purposes. For income tax purposes, the term ''partnership'' includes not only a partnership as known at common law, but, also a syndicate, group, pool, joint venture, or other unincorporated organization which carries on any trade or business, financial operation, or venture, and which is not, within the meaning of the Code, a trust, estate, or a corporation. An organization described in the preceding sentence shall be treated as a partnership for purposes of the tax on self-employment income even though such organization has elected, pursuant to section 1361 and the regulations thereunder, to be taxed as a domestic corporation.

(g) *Nature of partnership interest.* The net earnings from self-employment of a partner include his distributive share of the income or loss, described in section 702(a)(9), of the partnership of which he is a member, irrespective of the nature of his membership. Thus, in determining his net earnings from self-employment, a limited or inactive partner includes his distributive share of such partnership income or loss. In the case of a partner who is a member of a partnership with respect to which an election has been made pursuant to section 1361 and the regulations thereunder to be taxed as a domestic corporation, net earnings from self-employment include his distributive share of the income or loss, described in section 702(a)(9), from the trade or business carried on by the partnership computed without regard to the fact that the partnership has elected to be taxed as a domestic corporation.

(h) *Proprietorship taxed as domestic corporation.* A proprietor of an unincorporated business enterprise with respect to which an election has been made pursuant to section 1361 and the regulations thereunder to be taxed as a domestic corporation shall compute his net earnings from self-employment without regard to the fact that such election has been made.

[T.D. 6691, 28 FR 12796, Dec. 3, 1963, as amended by T.D. 7333, 39 FR 44445, Dec. 24, 1974]

§1.1402(a)–3 Special rules for computing net earnings from self-employment.

For the purpose of computing net earnings from self-employment, the gross income derived by an individual from a trade or business carried on by him, the allowable deductions attributable to such trade or business, and the individual's distributive share of the income or loss, described in section 702(a)(9), from any trade or business carrier on by a partnership of which he is a member shall be computed in accordance with the special rules set forth in §§ 1.1402(a)–4 to 1.1402(a)–17, inclusive.

[T.D. 7333, 39 FR 44445, Dec. 24, 1974]

§ 1.1402(a)–4 Rentals from real estate.

(a) *In general.* Rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) and the deductions attributable thereto, unless such rentals are received by an individual in the course of a trade or business as a real-estate dealer, are excluded. Whether or not an individual is engaged in the trade or business of a real-estate dealer is determined by the application of the principles followed in respect of the taxes imposed by sections 1 and 3. In general, an individual who is engaged in the business of selling real estate to customers with a view to the gains and profits that may be derived from such sales is a real-estate dealer. On the other hand, an individual who merely holds real estate for investment or speculation and receives rentals therefrom is not considered a real-estate dealer. Where a real-estate dealer holds real estate for investment or speculation in addition to real estate held for sale to customers in the ordinary course of his trade or business as a real-estate dealer, only the rentals from the real estate held for sale to customers in the ordinary course of his trade or business as a real-estate dealer, and the deductions attributable thereto, are included in determining net earnings from self-employment; the rentals from the real estate held for investment or speculation, and the deductions attributable thereto, are excluded. Rentals paid in crop shares include income derived by an owner or lessee of land under an agreement entered into with another person pursuant to which such other person undertakes to produce a crop or livestock on such land and pursuant to which (1) the crop or livestock, or the proceeds thereof, are to be divided between such owner or lessee and such other person, and (2) the share of the owner or lessee depends on the amount of the crop or livestock produced. See, however, paragraph (b) of this section.

(b) *Special rule for ''includible farm rental income''*—(1) *In general.* Notwithstanding the rules set forth in paragraph (a) of this section, there shall be included in determining net earnings from self-employment for taxable years ending after 1955 any income derived by an owner or tenant of land, if the following requirements are met with respect to such income:

(i) The income is derived under an arrangement between the owner or tenant of land and another person which provides that such other person shall produce agricultural or horticultural commodities on such land, and that there shall be material participation by the owner or tenant in the production or the management of the production of such agricultural or horticultural commodities; and

(ii) There is material participation by the owner or tenant with respect to any such agricultural or horticultural commodity.

Income so derived shall be referred to in this section as ''includible farm rental income''.

(2) *Requirement that income be derived under an arrangement.* In order for rental income received by an owner or tenant of land to be treated as includible farm rental income, such income must be derived pursuant to a share-farming or other rental arrangement which contemplates material participation by the owner or tenant in the production or management of production of agricultural or horticultural commodities.

(3) *Nature of arrangement.* (i) The arrangement between the owner or tenant and the person referred to in subparagraph (1) of this paragraph may be either oral or written. The arrangement must impose upon such other person the obligation to produce one or more agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on the land of the owner or tenant. In addition, it must be within the contemplation of the parties that the owner or tenant will participate in the production or the management of the production of the agricultural or horticultural commodities required to be produced by the other person under such arrangement to an extent which is material with respect either to the

production or to the management of production of such commodities or is material with respect to the production and management of production when the total required participation in connection with both is considered.

(ii) The term ‘‘production’’, wherever used in this paragraph, refers to the physical work performed and the expenses incurred in producing a commodity. It includes such activities as the actual work of planting, cultivating, and harvesting crops, and the furnishing of machinery, implements, seed, and livestock. An arrangement will be treated as contemplating that the owner or tenant will materially participate in the ‘‘production’’ of the commodities required to be produced by the other person under the arrangement if under the arrangement it is understood that the owner or tenant is to engage to a material degree in the physical work related to the production of such commodities. The mere undertaking to furnish machinery, implements, and livestock and to incur expenses is not, in and of itself, sufficient. Such factors may be significant, however, in cases where the degree of physical work intended of the owner or tenant is not material. For example, if under the arrangement it is understood that the owner or tenant is to engage periodically in physical work to a degree which is not material in and of itself and, in addition, to furnish a substantial portion of the machinery, implements, and livestock to be used in the production of the commodities or to furnish or advance funds or assume financial responsibility for a substantial part of the expense involved in the production of the commodities, the arrangement will be treated as contemplating material participation of the owner or tenant in the production of such commodities.

(iii) The term ‘‘management of the production’’, wherever used in this paragraph, refers to services performed in making managerial decisions relating to the production, such as when to plant, cultivate, dust, spray, or harvest the crop, and includes advising and consulting, making inspections, and making decisions as to matters such as rotation of crops, the type of crops to be grown, the type of livestock to be raised, and the type of machinery and implements to be furnished. An arrangement will be treated as contemplating that the owner or tenant is to participate materially in the ‘‘management of the production’’ of the commodities required to be produced by the other person under the arrangement if the owner or tenant is to engage to a material degree in the management decisions related to the production of such commodities. The services which are considered of particular importance in making such management decisions are those services performed in making inspections of the production activities and in advising and consulting with such person as to the production of the commodities. Thus, if under the arrangement it is understood that the owner or tenant is to advise or consult periodically with the other person as to the production of the commodities required to be produced by such person under the arrangement and to inspect periodically the production activities on the land, a strong inference will be drawn that the arrangement contemplates participation by the owner or tenant in the management of the production of such commodities. The mere undertaking to select the crops or livestock to be produced or the type of machinery and implements to be furnished or to make decisions as to the rotation of crops generally is not, in and of itself, sufficient. Such factors may be significant, however, in making the overall determination of whether the arrangement contemplates that the owner or tenant is to participate materially in the management of the production of the commodities. Thus, if in addition to the understanding that the owner or tenant is to advise or consult periodically with the other person as to the production of the commodities and to inspect periodically the production activities on the land, it is also understood that the owner is to select the type of crops and livestock to be produced and the type of machinery and implements to be furnished and to make decisions as to the rotation of crops, the arrangement will be treated as contemplating material participation of the owner or tenant in the management of production of such commodities.

(4) *Actual participation.* In order for the rental income received by the owner or tenant of land to be treated as includible farm rental income, not only must it be derived pursuant to the arrangement described in subparagraph (1) of this paragraph, but also the owner or tenant must actually participate to a material degree in the production or in the management of the production of any of the commodities required to be produced under the arrangement, or he must actually participate in both the production and the management of the production to an extent that his participation in the one when combined with his participation in the other will be considered participation to a material degree. If the owner or tenant shows that he periodically advises or consults with the other person, who under the arrangement produces the agricultural or horticultural commodities, as to the production of any of these commodities and also shows that he periodically inspects the production activities on the land, he will have presented strong evidence of the existence of the degree of participation contemplated by section 1402(a)(1). If, in addition to the foregoing, the owner or tenant shows that he furnishes a substantial portion of the machinery, implements, and livestock used in the production of the commodities or that he furnishes or advances funds, or assumes financial responsibility, for a substantial part of the expense involved in the production of the commodities, he will have established the existence of the degree of participation contemplated by section 1402(a)(1) and this paragraph.

(5) *Employees or agents.* An agreement entered into by an employee or agent of an owner or tenant and another person is considered to be an arrangement entered into by the owner or tenant for purposes of satisfying the requirement set forth in paragraph (b)(2) that the income must be derived under an arrangement between the owner or tenant and another person. For purposes of determining whether the arrangement satisfies the requirement set forth in paragraph (b)(3) that the parties contemplate that the owner or tenant will materially participate in the production or management of production of a commodity, services which will be performed by an employee or agent of the owner or tenant are not considered to be services which the arrangement contemplates will be performed by the owner or tenant. Services actually performed by such employee or agent are not considered services performed by the owner or tenant in determining the extent to which the owner or tenant has participated in the production or management of production of a commodity. For taxable years beginning before January 1, 1974, contemplated or actual services of an agent or an employee of the owner or tenant are deemed to be contemplated or actual services of the owner or tenant under paragraphs (b)(3) and (b)(4) of this section.

(6) *Examples.* Application of the rules prescribed in this paragraph may be illustrated by the following examples:

Example (1). After the death of her husband, Mrs. A rents her farm, together with its machinery and equipment, to B for one-half of the proceeds from the commodities produced on such farm by B. It is agreed that B will live in the tenant house on the farm and be responsible for the over-all operation of the farm, such as planting, cultivating, and harvesting the field crops, caring for the orchard and harvesting the fruit and caring for the livestock and poultry. It also is agreed that Mrs. A will continue to live in the farm residence and help B operate the farm. Under the agreement it is contemplated that Mrs. A will regularly operate and clean the cream separator and feed the poultry flock and collect the eggs. When possible she will assist B in such work as spraying the fruit trees, penning livestock, culling the poultry, and controlling weeds. She will also assist in preparing the meals when B engages seasonal workers. The agreement between Mrs. A and B clearly provides that she will materially participate in the over-all production operations to be conducted on her farm by B. In actual practice, Mrs. A performs such regular and intermittent services. The regularly performed services are material to the production of an agricultural commodity, and the intermittent services performed are material to the production operations to which they relate. The furnishing of a substantial portion of the farm machinery and equipment also adds support to a conclusion that Mrs. A has materially participated. Accordingly, the rental income

Mrs. A receives from her farm should be included in net earnings from self-employment.

Example (2). D agrees to produce a crop on C's cotton farm under an arrangement providing that C and D will each receive one-half of the proceeds from such production. C agrees to furnish all the necessary equipment, and it is understood that he is to advise D when to plant the cotton and when it needs to be chopped, plowed, sprayed, and picked. It is also understood that during the growing season C is to inspect the crop every few days to determine whether D is properly taking care of the crop. Under the arrangement, D is required to furnish all labor needed to grow and harvest the crop. C, in fact, renders such advice, makes such inspections, and furnishes such equipment. C's contemplated participation in management decisions is considered material with respect to the management of the cotton production operation. C's actual participation pursuant to the arrangement is also considered to be material with respect to the management of the production of cotton. Accordingly, the income C receives from his cotton farm is to be included in computing his net earnings from self-employment.

Example (3). E owns a grain farm and turns its operation over to his son, F. By the oral rental arrangement between E and F, the latter agrees to produce crops of grain on the farm, and E agrees that he will be available for consultation and advice and will inspect and help to harvest the crops. E furnishes most of the equipment, including a tractor, a combine, plows, wagons, drills, and harrows; he continues to live on the farm and does some of the work such as repairing barns and farm machinery, going to town for supplies, cutting weeds, etc.; he regularly inspects the crops during the growing season; and he helps F to harvest the crops. Although the final decisions are made by F, he frequently consults with his father regarding the production of the crops. An evaluation of all of E's actual activities indicates that they are sufficiently substantial and regular to support a conclusion that he is materially participating in the crop production operations and the management thereof. If it can be shown that the degree of E's actual participation was contemplated by the arrangement, E's income from the grain farm will be included in computing net earnings from self-employment.

Example (4). G owns a fully-equipped farm which he rents to H under an arrangement which contemplates that G shall materially participate in the management of the production of crops raised on the farm pursuant to the arrangement. G lives in town about 5 miles from the farm. About twice a month he visits the farm and looks over the buildings and equipment. G may occasionally, in an emergency, discuss with H some phase of a crop production activity. In effect, H has complete charge of the management of farming operations regardless of the understanding between him and G. Although G pays one-half of the cost of the seed and fertilizer and is charged for the cost of materials purchased by H to make all necessary repairs, G's activities do not constitute material participation in the crop production activities. Accordingly, G's income from the crops is not included in computing net earnings from self-employment.

Example (5). I owned a farm several miles from the town in which he lived. He rented the farm to J under an arrangement which contemplated I's material participation in the management of production of wheat. I furnished one-half of the seed and fertilizer and all the farm equipment and livestock. He employed K to perform all the services in advising, consulting, and inspecting contemplated by the arrangement. I is not materially participating in the management of production of wheat by J. The work done by I's employee, K, is not attributable to I in determining the extent of I's participation. I's rental income from the arrangement is, therefore, not to be included in computing his net earnings from self-employment. For taxable years beginning before January 1, 1974, however, I's rental income would be includible in those earnings.

Example (6). L, a calendar-year taxpayer, appointed M as his agent to rent his fully equipped farm for 1974. M entered into a rental arrangement with N under which M was to direct the planting of crops, inspect them weekly during the growing season, and consult with N on any problems that might arise in connection with irrigation, etc., while N furnished all the labor needed to grow and harvest the crops. M did in fact fulfill its responsibilities under the arrangement. Although the arrangement entered into by M and N is considered to have been made by L, M's services are not attributable to L, and L's furnishing of a fully equipped farm is insufficient by itself to constitute material participation in the production of the crops. Accordingly, L's rental income from the arrangement is not included in his net earnings from self-employment for that year. For taxable years beginning before January 1, 1974, however, L's rental income would be includible in those earnings.

(c) *Rentals from living quarters*—(1) *No services rendered for occupants.* Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple-housing units are generally rentals from real estate. Except in the case of real-estate dealers, such payments are excluded in determining net earnings from self-employment even though such payments are in part attributable to personal property furnished under the lease.

(2) *Services rendered for occupants.* Payments for the use or occupancy of rooms or other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, or payments for the use or occupancy of space in parking lots, warehouses, or storage garages, do not constitute rentals from real estate; consequently, such payments are included in determining net earnings from self-employment. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, and so forth, are not considered as services rendered to the occupant.

(3) *Example.* The application of this paragraph may be illustrated by the following example:

Example. A, an individual, owns a building containing four apartments. During the taxable year, he receives $1,400 from apartments numbered 1 and 2, which are rented without services rendered to the occupants, and $3,600 from apartments numbered 3 and 4, which are rented with services rendered to the occupants. His fixed expenses for the four apartments aggregate $1,200 during the taxable year. In addition, he has $500 of expenses attributable to the services rendered to the occupants of apartments 3 and 4. In determining his net earnings from self-employment, A includes the $3,600 received from apartments 3 and 4, and the expenses of $1,100 ($500 plus one-half of $1,200) attributable thereto. The rentals and expenses attributable to apartments 1 and 2 are excluded. Therefore, A has $2,500 of net earnings from self-employment for the taxable year from the building.

(d) *Treatment of business income which includes rentals from real estate.* Except in the case of a real-estate dealer, where an individual or a partnership is engaged in a trade or business the income of which is classifiable in part as rentals from real estate, only that portion of such income which is not classifiable as rentals from real estate, and the expenses attributable to such portion, are included in determining net earnings from self-employment.

[T.D. 6691, 28 FR 12796, Dec. 3, 1963, as amended by T.D. 7710, 45 FR 50739, July 31, 1980]

§ 1.1402(a)–5 Dividends and interest.

(a) All dividends on shares of stock are excluded unless they are received by an individual in the course of his trade or business as a dealer in stocks or securities.

(b) Interest on any bond, debenture, note, or certificate, or other evidence of indebtedness, issued with interest coupons or in registered form by any corporation (including one issued by a government or political subdivision thereof) is excluded unless such interest is received in the course of a trade or business as a dealer in stocks or securities. However, interest with respect to which a credit against tax is allowable as provided in section 35, that is, interest on certain obligations of the United States and its instrumentalities, is not included in net earnings from self-employment even though received in the course of a trade or business as a dealer in stocks or securities. Only interest on bonds, debentures, notes, or certificates, or other evidence of indebtedness, issued with interest coupons or in registered form by a corporation, is excluded in the case of all persons other than dealers in stocks or securities; other interest received in the course of any trade or business (such as interest received by a pawnbroker on his loans or interest received by a merchant on his accounts or notes receivable) is not excluded.

(c) Dividends and interest of the character excludable under paragraphs (a) and (b) of this section received by an individual on stocks or securities held for speculation or investment are excluded whether or not the individual is a dealer in stocks or securities.

(d) A dealer in stocks or securities is a merchant of stocks or securities with an established place of business, regularly engaged in the business of purchasing stocks or securities and reselling them to customers; that is, he is one who as a merchant buys stocks or securities and sells them to customers with a view to the gains and profits that may be derived therefrom. Persons who buy and sell or hold stocks or securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, are not dealers in stocks or securities.

§1.1402(a)–6 Gain or loss from disposition of property.

(a) There is excluded any gain or loss: (1) Which is considered as gain or loss from the sale or exchange of a capital asset; (2) from the cutting of timber or the disposal of timber, coal, or iron ore, even though held primarily for sale to customers, if section 631 is applicable to such gain or loss; and (3) from the sale, exchange, involuntary conversion, or other disposition of property if such property is neither (i) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, nor (ii) property held primarily for sale to customers in the ordinary course of a trade or business. For the purpose of the special rule in subparagraph (3) of this paragraph, it is immaterial whether a gain or loss is treated as a capital gain or loss or as an ordinary gain or loss for purposes other than determining net earnings from self-employment. For instance, where the character of a loss is governed by the provisions of section 1231, such loss is excluded in determining net earnings from self-employment even though such loss is treated under section 1231 as an ordinary loss. For the purposes of this special rule, the term ‘‘involuntary conversion’’ means a compulsory or involuntary conversion of property into other property or money as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof; and the term ‘‘other dispostion’’ includes the destruction or loss, in whole or in part, of property by fire, storm, shipwreck, or other casualty, or by theft, even though there is no conversion of such property into other property or money.

(b) The application of this section may be illustrated by the following example:

Example. During the taxable year 1954, A, who owns a grocery store, realized a net profit of $1,500 from the sale of groceries and a gain of $350 from the sale of a refrigerator case. During the same year, he sustained a loss of $2,000 as a result of damage by fire to the store building. In computing taxable income, all of these items are taken into account. In determining net earnings from self-employment, however, only the $1,500 of profit derived from the sale of groceries is included. The $350 gain and the $2,000 loss are excluded.

[T.D. 6691, 28 FR 12796, Dec. 3, 1963, as amended by T.D. 6841, 30 FR 9309, July 27, 1965]

§1.1402(a)–7 Net operating loss deduction.

The deduction provided by section 172, relating to net operating losses sustained in years other than the taxable year, is excluded.

§1.1402(a)–8 Community income.

(a) *In case of an individual.* If any of the income derived by an individual from a trade or business (other than a trade or business carried on by a partnership) is community income under community property laws applicable to such income, all of the gross income, and the deductions attributable to such income, shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which case all of such gross income and deductions shall be treated as the gross income and deductions of the wife. For the purpose of this special rule, the term ‘‘management and control’’ means management and control in fact, not the management and control imputed to the husband under the community property laws. For example, a wife who operates a beauty parlor without any appreciable collaboration on the part of her husband will be considered as having substantially all of the management and control of such business despite the provision of any community property law vesting in the husband the right of management and control of community property; and the income and deductions attributable to the operation of such beauty parlor will be considered the income and deductions of the wife.

(b) *In case of a partnership.* Even though a portion of a partner's distributive share of the income or loss, described in section 702(a)(9), from a trade or business carried on by a partnership is community income or loss under the community property laws applicable to such share, all of such distributive share shall be included in computing the net earnings from self-employment of such partner; no part of such share shall be taken into account in computing the net earnings from self-employment of the spouse of such partner. In any case in which both spouses are members of the same partnership, the distributive share of the income or loss of each spouse is included in computing the net earnings from self-employment of that spouse.

§ 1.1402(a)–9 Puerto Rico.

(a) *Residents.* A resident of Puerto Rico, whether or not a bona fide resident thereof during the entire taxable year, and whether or not an alien, a citizen of the United States, or a citizen of Puerto Rico, shall compute his net earnings from self-employment in the same manner as would a citizen of the United States residing in the United States. See paragraph (d) of § 1.1402(b)–1 for regulations relating to nonresident aliens. For the purpose of the tax on self-employment income, the gross income of such a resident of Puerto Rico also includes income from Puerto Rican sources. Thus, under this special rule, income from Puerto Rican sources will be included in determining net earnings from self-employment of a resident of Puerto Rico engaged in the active conduct of a trade or business in Puerto Rico despite the fact that, under section 933, such income may not be taken into account for purposes of the tax under section 1 or 3.

(b) *Nonresidents.* A citizen of Puerto Rico who is also a citizen of the United States and who is not a resident of Puerto Rico will compute his net earnings from self-employment in the same manner and subject to the same provisions of law and regulations as other citizens of the United States.

§ 1.1402(a)–10 Personal exemption deduction.

The deduction provided by section 151, relating to personal exemptions, is excluded.

§ 1.1402(a)–11 Ministers and members of religious orders.

(a) *In general.* For each taxable year ending after 1954 in which a minister or member of a religious order is engaged in a trade or business, within the meaning of section 1402(c) and § 1.1402(c)–5, with respect to service performed in the exercise of his ministry or in the exercise of duties required by such order, net earnings from self-employment from such trade or business include the gross income derived during the taxable year from any such service, less the deductions attributable to such gross income. For each taxable year ending on or after December 31, 1957, such minister or member of a religious order shall compute his net earnings from self-employment derived from the performance of such service without regard to the exclusions from gross income provided by section 107 (relating to rental value of parsonages) and section 119 (relating to meals and lodging furnished for the convenience of the employer). Thus, a minister who is subject to self-employment tax with respect to his services as a minister will include in the computation of his net earnings from self-employment for a taxable year ending on or after December 31, 1957, the rental value of a home furnished to him as remuneration for services performed in the exercise of his ministry or the rental allowance paid to him as remuneration for such services irrespective of whether such rental value or rental allowance is excluded from gross income by section 107. Similarly, the value of any meals or lodging furnished to a minister or to a member of a religious order in connection with service performed in the exercise of his ministry or as a member of such order will be included in the computation of his net earnings from self-employment for a taxable year ending on or after December 31, 1957, notwithstanding the exclusion of such value from gross income by section 119.

(b) *In employ of American employer.* If a minister or member of a religious order engaged in a trade or business described in section 1402(c) and §1.1402(c)–5 is a citizen of the United States and performs service, in his capacity as a minister or member of a religious order, as an employee of an American employer, as defined in section 3121(h) and the regulations thereunder in Part 31 of this chapter (Employment Tax Regulations), his net earnings from self-employment derived from such service shall be computed as provided in paragraph (a) of this section but without regard to the exclusions from gross income provided in section 911, relating to earned income from sources without the United States, and section 931, relating to income from sources within possessions of the United States. Thus, even though all the income of the minister or member for service of the character to which this paragraph is applicable was derived from sources without the United States, or from sources within possessions of the United States, and therefore may be excluded from gross income, such income is included in computing net earnings from self-employment.

(c) *Minister in a foreign country whose congregation is composed predominantly of citizens of the United States*—(1) *Taxable years ending after 1956.* For any taxable year ending after 1956, a minister of a church, who is engaged in a trade or business within the meaning of section 1402(c) and §1.1402(c)–5, is a citizen of the United States, is performing service in the exercise of his ministry in a foreign country, and has a congregation composed predominantly of United States citizens, shall compute his net earnings from self-employment derived from his services as a minister for such taxable year without regard to the exclusion from gross income provided in section 911, relating to earned income from sources without the United States. For taxable years ending on or after December 31, 1957, such minister shall also disregard sections 107 and 119 in the computation of his net earnings from self-employment. (See paragraph (a) of this section.) For purposes of section 1402(a)(8) and this paragraph a ‘‘congregation composed predominantly of citizens of the United States’’ means a congregation the majority of which throughout the greater portion of its minister’s taxable year were United States citizens.

(2) *Election for taxable years ending after 1954 and before 1957.* (i) A minister described in subparagraph (1) of this paragraph who, for a taxable year ending after 1954 and before 1957, had income from service described in such subparagraph which would have been included in computing net earnings from self-employment if such income had been derived in a taxable year ending after 1956 by an individual who had filed a waiver certificate under section 1402(e), may elect to have section 1402(a)(8) and subparagraph (1) of this paragraph apply to his income from such service for his taxable years ending after 1954 and before 1957. If such minister filed a waiver certificate prior to August 1, 1956, in accordance with §1.1402(e)(1)–1, or he files such a waiver certificate on or before the due date of his return (including any extensions thereof) for his last taxable year ending before 1957, he must make such election on or before the due date of his return (including any extensions thereof) for such taxable year or before April 16, 1957, whichever is the later. If the waiver certificate is not so filed, the minister must make his election on or before the due date of the return (including any extensions thereof) for his first taxable year ending after 1956. Notwithstanding the expiration of the period prescribed by section 1402(e)(2) for filing such waiver, the minister may file a waiver certificate at the time he makes the election. In no event shall an election be valid unless the minister files prior to or at the time of the election a waiver certificate in accordance with §1.1402(e)(1)–1.

(ii) The election shall be made by filing with the district director of internal revenue with whom the waiver certificate, Form 2031, is filed a written statement indicating that, by reason of the Social Security Amendments of 1956, the minister desires to have the Federal old-age, survivors, and disability insurance system established by title II of the Social Security Act extended to his services performed in a foreign country as a minister of a congregation composed predominantly of United States citizens beginning with the first taxable year ending after 1954 and prior to 1957 for which he had income from such services. The statement shall be dated and signed by the minister and shall clearly state that it is an election for retroactive self-employment tax coverage under the Self-Employment Contributions Act of 1954. In addition, the statement shall include the following information:

(a) The name and address of the minister.

(b) His social security account number, if he has one.

(c) That he is a duly ordained, commissioned, or licensed minister of a church.

(d) That he is a citizen of the United States.

(e) That he is performing services in the exercise of his ministry in a foreign country.

(f) That his congregation is composed predominantly of citizens of the United States.

(g)(1) That he has filed a waiver certificate and, if so, where and under what circumstances the certificate was filed and the taxable year for which it is effective; or *(2)* that he is filing a waiver certificate with his election for retroactive coverage and, if so, the taxable year for which it is effective.

(h) That he has or has not filed income tax returns for his taxable years ending after 1954 and before 1957. If he has filed such returns, he shall state the years for which they were filed and indicate the district director of internal revenue with whom they were filed.

(iii) Notwithstanding section 1402(e)(3), a waiver certificate filed pursuant to § 1.1402(e)(1)–1 by a minister making an election under this paragraph shall be effective (regardless of when such certificate is filed) for such minister's first taxable year ending after 1954 in which he had income from service described in subparagraph (1) of this paragraph or for the taxable year of the minister prescribed by section 1402(e)(3), if such taxable year is earlier, and for all succeeding taxable years.

(iv) No interest or penalty shall be assessed or collected for failure to file a return within the time prescribed by law if such failure arises solely by reason of an election made by a minister pursuant to this paragraph or for any underpayment of self-employment income tax arising solely by reason of such election, for the period ending with the date such minister makes an election pursuant to this paragraph.

(d) *Treatment of certain remuneration paid in 1955 and 1956 as wages.* For treatment of remuneration paid to an individual for service described in section 3121(b)(8)(A) which was erroneously treated by the organization employing him as employment with-in the meaning of chapter 21 of the Internal Revenue Code, see § 1.1402(e)(4)–1.

§ 1.1402(a)–12 Possession of the United States.

For purposes of the tax on self-employment income, the term ''possession of the United States,'' as used in section 931 (relating to income from sources within possessions of the United States) and section 932 (relating to citizens of possessions of the United States) shall be deemed not to include the Virgin Islands, Guam, or American Samoa. The provisions of section 1402(a)(9) and of this section insofar as they involve nonapplication of sections 931 and 932 to Guam or American Samoa, shall apply only in the case of taxable years beginning after 1960. For definition of the term ''United States'' and for other geographical definitions relating to the Continental Shelf see section 638 and § 1.638–1.

[T.D. 7277, 38 FR 12742, May 15, 1973]

§ 1.1402(a)–13 Income from agricultural activity.

(a) *Agricultural trade or business.* (1) An agricultural trade or business is one in which, if the trade or business were carried on exclusively by employees, the major portion of the services would constitute agricultural labor as defined in section 3121(g) and the regulations thereunder in part 31 of this chapter (Employment Tax Regulations). In case the services are in part agricultural and in part nonagricultural, the time devoted to the performance of each type of service is the test to be used to determine whether the major portion of the services would constitute agricultural labor. If more than half of the time spent in performing all the services is spent in performing services which would constitute agricultural labor under section 3121(g), the trade or business is agricultural. If only half, or less, of the time spent in performing all the services is spent in performing services which would constitute agricultural labor under section 3121(g), the trade or business is not agricultural. In every case the time spent in performing the services will be computed by adding the time spent in the trade or business during the taxable year by every individual (including the individual carrying on such trade or business and the members of his family) in performing such services. The operation of this special rule is not affected by section 3121(c), relating to the included-excluded rule for determining employment.

(2) The rules prescribed in subparagraph (1) of this paragraph have no application where the nonagricultural services are performed in connection with an enterprise which constitutes a trade or business separate and distinct from the trade or business conducted as an agricultural enterprise. Thus, the operation of a roadside automobile service station on farm premises constitutes a trade or business separate and distinct from the agricultural enterprise, and the gross income derived from such service station, less the deductions attributable thereto, is to be taken into account in determining net earnings from self-employment.

(b) *Farm operator's income for taxable years ending before 1955.* Income derived in a taxable year ending before 1955 from any agricultural trade or business (see paragraph (a) of this section), and all deductions attributable to such income, are excluded in computing net earnings from self-employment.

(c) *Farm operator's income for taxable years ending after 1954.* Income derived in a taxable year ending after 1954 from an agricultural trade or business (see paragraph (a) of this section) is includible in computing net earnings from self-employment. Income derived from an agricultural trade or business includes income derived by an individual under an agreement entered into by such individual with another person pursuant to which such individual undertakes to produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on land owned or leased by such other person and pursuant to which the agricultural or horticultural commodities produced by such individual, or the proceeds therefrom, are to be divided between such individual and such other person, and the amount of such individual's share depends on the amount of the agricultural or horticultural commodities produced. However, except as provided in paragraph (d) of this section, relating to arrangements involving material participation, the income derived under such an agreement by the owner or lessee of the land is not includible in computing net earnings from self-employment. See §1.1402(a)–4. For options relating to the computation of net earnings from self-employment, see §§1.1402(a)–14 and 1.1402(a)–15.

(d) *Includible farm rental income for taxable years ending after 1955.* For taxable years ending after 1955, income derived from an agricultural trade or business (see paragraph (a) of this section) includes also income derived by the owner or tenant of land under an arrangement between such owner or tenant and another person, if such arrangement provides that such other person shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant in the production or the management of the production of such agricultural or horticultural commodities, and if there is material participation by the owner or tenant with respect to any such agricultural or horticultural commodity. See paragraph (b) of §1.1402(a)–4. For options relating to the computation of net earnings from self-employment, see §§1.1402(a)–14 and 1.1402(a)–15.

(e) *Income from service performed after 1956 as a crew leader.* Income derived by a crew leader (see section 3121(o) and the regulations thereunder in Part 31 of this chapter (Employment Tax Regulations)) from service performed after

1956 in furnishing individuals to perform agricultural labor for another person and from service performed after 1956 in agricultural labor as a member of the crew is considered to be income derived from a trade or business for purposes of § 1.1402(c)–1. Whether such trade or business is an agricultural trade or business shall be determined by applying the rules set forth in this section.

§ 1.1402(a)–14 Options available to farmers in computing net earnings from self-employment for taxable years ending after 1954 and before December 31, 1956.

(a) *Computation of net earnings.* In the case of any trade or business which is carried on by an individual who reports his income on the cash receipts and disbursements method, and in which, if it were carried on exclusively by employees, the major portion of the services would constitute agricultural labor as defined in section 3121(g) (see paragraph (a) of § 1.1402(a)–13), net earnings from self-employment may, for a taxable year ending after 1954, at the option of the taxpayer, be computed as follows:

(1) *Gross income $1,800 or less.* If the gross income, computed as provided in paragraph (b) of this section, from such trade or business is $1,800 or less, the taxpayer may, at his option, treat as net earnings from self-employment from such trade or business an amount equal to 50 percent of such gross income. If the taxpayer so elects, the amount equal to 50 percent of such gross income shall be used in computing his self-employment income in lieu of his actual net earnings from such trade or business, if any.

(2) *Gross income in excess of $1,800.* If the gross income, computed as provided in paragraph (b) of this section, from such trade or business is more than $1,800, and the actual net earnings from self-employment from such trade or business are less than $900, the taxpayer may, at his option, treat $900 as net earnings from self-employment. If the taxpayer so elects, $900 shall be used in computing his self-employment income in lieu of his actual net earnings from such trade or business, if any. However, if the taxpayer's actual net earnings from such trade or business, as computed in accordance with §§ 1.1402(a)–1 through 1.1402(a)–3 are $900 or more, such actual net earnings shall be used in computing his self-employment income.

(b) *Computation of gross income.* For purposes of paragraph (a) of this section, gross income shall consist of the gross receipts from such trade or business reduced by the cost or other basis of property which was purchased and sold in carrying on such trade or business, adjusted (after such reduction) in accordance with the provisions of § 1.1402(a)–3, relating to income and deductions not included in computing net earnings from self-employment.

(c) *Two or more agricultural activities.* If an individual is engaged in more than one agricultural trade or business within the meaning of paragraph (a) of § 1.1402(a)–13 (for example, the business of ordinary farming and the business of cotton ginning), the gross income derived from each agricultural trade or business shall be aggregated for purposes of the optional method provided in paragraph (a) of this section for computing net earnings from self-employment.

(d) *Examples.* Application of the regulations prescribed in paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). F, a farmer, uses the cash receipts and disbursements method of accounting in making his income tax returns. F's books and records show that during the calendar year 1955 he received $1,200 from the sale of produce raised on the farm, $200 from the sale of livestock raised on the farm and not held for breeding or dairy purposes, and $600 from the sale of a tractor. The income from the sale of the tractor is of a type which is excluded from net earnings from self-employment by section 1402(a). F's actual net earnings from self-employment, computed in accordance with the provisions of §§ 1.1402(a)–1 through 1.1402(a)–3, are $450. F may report $450 as his net earnings from self-employment or he may elect to report $700 (one-half of $1,400).

Example (2). C, a cattleman, uses the cash receipts and disbursements method of accounting in making his income tax returns. C had actual net earnings from self-employment, computed in accordance with the provisions of §§ 1.1402(a)–1 through 1.1402(a)–3, of $725. His gross receipts were $1,000 from the sale of produce raised on the farm and $1,200 from the sale of feeder cattle, which C bought for $500. The income from the sale of the feeder cattle is of a type which is included in computing net earnings from self-employment. Therefore, C may report $725 as his net earnings from self-employment or he may elect to report $850, one-half of $1,700 ($2,200 minus $500).

Example (3). R, a rancher, has gross income of $3,000 from the operation of his ranch, computed as provided in paragraph (b) of this section. His actual net earnings from self-employment from farming activities are less than $900. R, nevertheless, may elect to report $900 as net earnings from self-employment from such trade or business. If R had actual net earnings from self-employment from his farming activities in the amount of $900 or more, he would be required to report such amount in computing his self-employment income.

(e) *Members of farm partnerships.* The optional method provided by paragraph (a) of this section for computing net earnings from self-employment is not available to a member of a partnership with respect to his distributive share of the income or loss from any trade or business carried on by any partnership of which he is a member.

§ 1.1402(a)–15 Options available to farmers in computing net earnings from self-employment for taxable years ending on or after December 31, 1956.

(a) *Computation of net earnings.* In the case of any trade or business which is carried on by an individual or by a partnership and in which, if such trade or business were carried on exclusively by employees, the major portion of the services would constitute agricultural labor as defined in section 3121(g) (see paragraph (a) of § 1.1402(a)–13), net earnings from self-employment may, for a taxable year ending on or after December 31, 1956, at the option of the taxpayer, be computed as follows:

(1) *In case of an individual*—(i) *Gross income of less than specified amount.* If the gross income, computed as provided in paragraph (b) of this section, from such trade or business is $2,400 or less ($1,800 or less for a taxable year ending on or after December 31, 1956, and beginning before January 1, 1966), the taxpayer may, at his option, treat as net earnings from self-employment from such trade or business an amount equal to 66⅔ percent of such gross income. If the taxpayer so elects, the amount equal to 66⅔ percent of such gross income shall be used in computing his self-employment income in lieu of his actual net earnings from such trade or business, if any.

(ii) *Gross income in excess of specified amount.* If the gross income, computed as provided in paragraph (b) of this section, from such trade or business is more than $2,400 ($1,800 for a taxable year ending on or after December 31, 1956, and beginning before January 1, 1966), and the net earnings from self-employment from such trade or business (computed without regard to this section) are less than $1,600 ($1,200 for a taxable year ending on or after December 31, 1956, and beginning before January 1, 1966), the taxpayer may, at his option, treat $1,600 ($1,200 for a taxable year ending on or after December 31, 1956, and beginning before January 1, 1966) as net earnings from self-employment. If the taxpayer so elects, $1,600 ($1,200 for a taxable year ending on or after December 31, 1956, and beginning before January 1, 1966) shall be used in computing his self-employment income in lieu of his actual net earnings from such trade or business, if any. However, if the taxpayer's actual net earnings from such trade or business, as computed in accordance with the applicable provisions of §§ 1.1402(a)–1 to 1.1402(a)–13, inclusive, are $1,600 or more ($1,200 or more for a taxable year ending on or after December 31, 1956, and beginning before January 1, 1966) such actual net earnings shall be used in computing his self-employment income.

(2) *In case of a member of a partnership*—(i) *Distributive share of gross income of less than specified amount.* If a taxpayer's distributive share of the gross income of a partnership (as such gross income is computed under the provisions of paragraph (b) of this section) derived from such trade or business (after such gross income has been reduced by the sum of all payments to which section 707(c) applies) is $2,400 or less ($1,800 or less for a taxable year ending on or after December 31, 1956, and beginning before January 1, 1966), the taxpayer may, at his option, treat as his distributive share of income described in section 702(a)(9) derived from such trade or business an amount equal to 66⅔ percent of his distributive share

of such gross income (after such gross income has been reduced by the sum of all payments to which section 707(c) applies). If the taxpayer so elects, the amount equal to 66⅔ percent of his distributive share of such gross income shall be used by him in the computation of his net earnings from self-employment in lieu of the actual amount of his distributive share of income described in section 702(a)(9) from such trade or business, if any.

(ii) *Distributive share of gross income in excess of specified amount.* If a taxpayer's distributive share of the gross income of the partnership (as such gross income is computed under the provisions of paragraph (b) of this section) derived from such trade or business (after such gross income has been reduced by the sum of all payments to which section 707(c) applies) is more than $2,400 ($1,800 for a taxable year ending on or after December 31, 1956, and beginning before January 1, 1966) and the actual amount of his distributive share (whether or not distributed) of income described in section 702(a)(9) derived from such trade or business (computed without regard to this section) is less than $1,600 ($1,200 for a taxable year ending on or after December 31, 1956, and beginning before January 1, 1966), the taxpayer may, at his option, treat $1,600 ($1,200 for a taxable year ending on or after December 31, 1956, and beginning before January 1, 1966) as his distributive share of income described in section 702(a)(9) derived from such trade or business. If the taxpayer so elects, $1,600 ($1,200 for a taxable year ending on or after December 31, 1956, and beginning before January 1, 1966) shall be used by him in the computation of his net earnings from self-employment in lieu of the actual amount of his distributive share of income described in section 702(a)(9) from such trade or business, if any. However, if the actual amount of the taxpayer's distributive share of income described in section 702(a)(9) from such trade or business, as computed in accordance with the applicable provisions of §§ 1.1402(a)–1 to 1.1402(a)–13, inclusive, is $1,600 or more ($1,200 or more for a taxable year ending on or after December 31, 1956, and beginning before January 1, 1966), such actual amount of the taxpayer's distributive share shall be used in computing his net earnings from self-employment.

(iii) *Cross reference.* For a special rule in the case of certain deceased partners, see paragraph (c) of § 1.1402(f)–1.

(b) *Computation of gross income.* For purposes of this section gross income has the following meanings:

(1) In the case of any such trade or business in which the income is computed under a cash receipts and disbursements method, the gross receipts from such trade or business reduced by the cost or other basis of property which was purchased and sold in carrying on such trade or business (see paragraphs (a) and (c), other than paragraph (a)(5), of § 1.61–4), adjusted (after such reduction) in accordance with the applicable provisions of §§ 1.1402(a)–3 to 1.1402(a)–13, inclusive.

(2) In the case of any such trade or business in which the income is computed under an accrual method (see paragraphs (b) and (c), other than paragraph (b)(5), of § 1.61–4), the gross income from such trade or business, adjusted in accordance with the applicable provisions of §§ 1.1402(a)–3 to 1.1402(a)–13, inclusive.

(c) *Two or more agricultural activities.* If an individual (including a member of a partnership) derives gross income (as defined in paragraph (b) of this section) from more than one agricultural trade or business, such gross income (including his distributive share of the gross income of any partnership derived from any such trade or business) shall be deemed to have been derived from one trade or business. Thus, such an individual shall aggregate his gross income derived from each agricultural trade or business carried on by him (which includes, under paragraph (b) of § 1.1402(a)–1, any guaranteed payment, within the meaning of section 707(c), received by him from a farm partnership of which he is a member) and his distributive share of partnership gross income (after such gross income has been reduced by any guaranteed payment within the meaning of section 707(c)) derived from each farm partnership of which he is a member. Such gross income is the amount to be considered for purposes of the optional method provided in this section for computing net earnings from self-employment. If the aggregate gross income of an individual includes income derived from an agricultural trade or business carried on by him and a distributive share of partnership income derived from an agricultural trade or business carried on by a partnership of which he is a member, such aggregate gross income shall be treated as income derived from a single trade or business carried on by him, and such individual shall apply the optional method applicable to individuals set forth in paragraph (a)(1) of this section for purposes of computing his net earnings from self-employment.

(d) *Examples.* The application of this section may be illustrated by the following examples:

Example (1). F is engaged in the business of farming and computes his income under the cash receipts and disbursements method. He files his income tax returns on the basis of the calendar year. During the year 1966, F's gross income from the business of farming (computed in accordance with paragraph (b)(1) of this section) is $2,325. His actual net earnings from self-employment derived from such business are $1,250. As his net earnings from self-employment, F may report $1,250 or, by the optional computation method, he may report $1,550 (66⅔ percent of $2,325).

Example (2). G is engaged in the business of farming and computes his income under the accrual method. His income tax returns are filed on the calendar year basis. For the year 1966, G's gross income from the operation of his farm (computed in accordance with paragraph (b)(2) of this section) is $2,800. He has actual net earnings from self-employment derived from such farm in the amount of $1,250. As his net earnings from self-employment derived from his farm, G may report his actual net earnings of $1,250, or by the optional method he may report $1,600. If G's actual net earnings from self-employment from his farming activities for 1966 were in an amount of $1,600 or more, he would be required to report such amount in computing his self-employment income.

Example (3). M, who files his income tax returns on a calendar year basis, is one of the three partners of the XYZ Company, a partnership, engaged in the business of farming. The taxable year of the partnership is the calendar year, and its income is computed under the cash receipts and disbursements method. For M's services in connection with the planting, cultivating, and harvesting of the crops during the year 1966 the partnership agrees to pay him $500, the full amount of which is determined without regard to the income of the partnership and constitutes a guaranteed payment within the meaning of section 707(c). This guaranteed payment to M is the only such payment made during such year. The gross income derived from the business for the year 1966 computed in accordance with paragraph (b)(1) of this section and after being reduced by the guaranteed payment of $500 made to M, is $3,000. One-third of the $3,000 ($1,000), is M's distributive share of such gross income. Under paragraph (c) of this section, the guaranteed payment ($500) received by M and his distributive share of the partnership gross income ($1,000) are deemed to have been derived from one trade or business, and such amounts must be aggregated for purposes of the optional method of computing net earnings from self-employment. Since M's combined gross income from his two agricultural businesses ($1,000 and $500) is not more than $2,400 and since such income is deemed to be derived from one trade or business, M's net earnings from self-employment derived from such farming business may, at his option, be deemed to be $1,000 (66⅔ percent of $1,500).

Example (4). A is one of the two partners of the AB partnership which is engaged in the business of farming. The taxable year of the partnership is the calendar year and its income is computed under the accrual method. A files his income tax returns on the calendar year basis. The partnership agreement provides for an equal sharing in the profits and losses of the partnership by the two partners. A is an experienced farmer and for his services as manager of the partnership's farm activities during the year 1966 he receives $6,000 which amount constitutes a guaranteed payment within the meaning of section 707(c). The gross income of the partnership derived from such business for the year 1966, computed in accordance with paragraph (b)(2) of this section and after being reduced by the guaranteed payment made to A, is $9,600. A's distributive share of such gross income is $4,800 and his distributive share of income described in section 702(a)(9) derived from the partnership's business is $1,900. Under paragraph (c) of this section, the guaranteed payment received by A and his distributive share of the partnership gross income are deemed to have been derived from one trade or business, and such amounts must be aggregated for purposes of the optional method of computing his net earnings from self-employment. Since the aggregate of A's guaranteed payment ($6,000) and his distributive share of partnership gross income ($4,800) is more than $2,400 and since the aggregate of A's guaranteed payment ($6,000) and his distributive share ($1,900) of partnership income described in section 702(a)(9) is not less than $1,600, the optional method of computing net earnings from self-employment is not available to A.

Example (5). F is a member of the EFG partnership which is engaged in the business of farming. F files his income tax returns on the calendar year basis. The taxable year of the partnership is the calendar year, and its income is computed under a cash receipts and disbursements method. Under the partnership agreement the partners are to share equally the profits or losses of the business. The gross income derived from the partnership business for the year 1966, computed in accordance with paragraph (b)(1) of this section is $7,500. F's share of such gross income is $2,500. Due to drought and an epidemic among the livestock, the partnership sustains a net loss of $7,800 for the year 1966 of which loss F's share is $2,600. Since F's distributive share of gross income derived from such business is in excess of $2,400 and since F does not receive income described in section 702(a)(9) of $1,600 or more from such business, he may, at his option, be deemed to have received $1,600 as his distributive share of income described in section 702(a)(9) from such business.

[T.D. 6691, 28 FR 12796, Dec. 3, 1963, as amended by T.D. 6993, 34 FR 828, Jan. 18, 1969]

§ 1.1402(a)–16 Exercise of option.

A taxpayer shall, for each taxable year with respect to which he is eligible to use the optional method described in § 1.1402(a)–14 or § 1.1402(a)–15, make a determination as to whether his net earnings from self-employment are to be computed in accordance with such method. If the taxpayer elects the optional method for a taxable year, he shall signify such election by computing net earnings from self-employment under the optional method as set forth in Schedule F (Form 1040) of the income tax return filed by the taxpayer for such taxable year. If the optional method is not elected at the time of the filing of the return for a taxable year with respect to which the taxpayer is eligible to elect such optional method, such method may be elected on an amended return (or on such other form as may be prescribed for such use) filed within the period prescribed by section 6501 and the regulations thereunder for the assessment of the tax for such taxable year. If the optional method is elected on a return for a taxable year, the taxpayer may revoke such election by filing an amended return (or such other form as may be prescribed for such use) for the taxable year within the period prescribed by section 6501 and the regulations thereunder for the assessment of the tax for such taxable year. If the taxpayer is deceased or unable to make an election, the person designated in section 6012(b) and the regulations thereunder may, within the period prescribed in this section elect the optional method for any taxable year with respect to which the taxpayer is eligible to use the optional method and revoke an election previously made by or for the taxpayer.

§ 1.1402(a)–17 Retirement payments to retired partners.

(a) *In general.* There shall be excluded, in computing net earnings from self-employment for taxable years ending on or after December 31, 1967, certain payments made on a periodic basis by a partnership, pursuant to a written plan of the partnership, to a retired partner on account of his retirement. The exclusion applies only if the payments are made pursuant to a plan which meets the requirements prescribed in paragraph (b) of this section, and, in addition, the conditions set forth in paragraph (c) of this section are met.

(b) *Retirement plan of partnership.* (1) To meet the requirements of section 1402(a)(10), the written plan of the partnership must set forth the terms and conditions of the program or system established by the partnership for the purpose of making payments to retired partners on account of their retirement. To qualify as payments on account of retirement, the payments must constitute bona fide retirement income. Thus, payments of benefits not customarily included in a pension or retirement plan such as layoff benefits are not payments on account of retirement. Eligibility for retirement generally is established on the basis of age, physical condition, or a combination of age or physical condition and years of service. Generally, retirement benefits are measured by, and based on, such factors as years of service and compensation received. In determining whether the plan of the partnership provides for payments on account of retirement, factors, formulas, etc., reflected in public, and in broad based private, pension or retirement plans in prescribing eligibility requirements and in computing benefits may be taken into account.

(2) The plan of the partnership must provide for payments on account of retirement:

(i) To partners generally or to a class or classes of partners,

(ii) On a periodic basis, and

(iii) Which continue at least until the partner's death.

For purposes of subdivision (i) of this subparagraph, a class of partners may, in an appropriate case, contain only one member. Payments are made on a periodic basis if made at regularly recurring intervals (usually monthly) not exceeding one year.

(c) *Conditions relating to exclusion*—(1) *In general.* A payment made pursuant to a written plan of a partnership which meets the requirements of paragraph (b) of this section shall be excluded, in computing net earnings from self-employment, only if:

(i) The retired partner to whom the payment is made rendered no service with respect to any trade or business carried on by the partnership (or its successors) during the taxable year of the partnership (or its successors), which ends within or with the taxable year of the retired partner and in which the payment was received by him;

(ii) No obligation (whether certain in amount or contingent on a subsequent event) exists (as of the close of the partnership's taxable year referred to in subdivision (i) of this subparagraph) from the other partners to the retired partner except with respect to retirement payments under the plan or rights such as benefits payable on account of sickness, accident, hospitalization, medical expenses, or death; and

(iii) The retired partner's share (if any) of the capital of the partnership has been paid to him in full before the close of the partnership's taxable year referred to in subdivision (i) of this subparagraph.

By application of the conditions set forth in this subparagraph, either all payments on account of retirement received by a retired partner during the taxable year of the partnership ending within or with his taxable year are excluded or none of the payments are excluded. Subdivision (ii) of this subparagraph has application only to obligations from other partners in their capacity as partners as distinguished from an obligation which arose and exists from a transaction unrelated to the partnership or to a trade or business carried on by the partnership. The effect of the conditions set forth in subdivisions (ii) and (iii) of this subparagraph is that the exclusion may apply with respect to payments received by a retired partner during the taxable year of the partnership ending within or with his taxable year only if at the close of the partnership's taxable year the retired partner had no financial interest in the partnership except for the right to retirement payments.

(2) *Examples.* The application of subparagraph (1) of this paragraph may be illustrated by the following examples. Each example assumes that the partnership plan pursuant to which the payments are made meets the requirements of paragraph (b) of this section.

Example (1). A, who files his income tax returns on a calendar year basis, is a partner in the ABC partnership. The taxable year of the partnership is the period July 1 to June 30, inclusive. A retired from the partnership on January 1, 1973, and receives monthly payments on account of his retirement. As of June 30, 1973, no obligation existed from the other partners to A (except with respect to retirement payments under the plan) and A's share of the capital of the partnership had been paid to him in full. The monthly retirement payments received by A from the partnership in his taxable year ending on December 31, 1973, are not excluded from net earnings from self-employment since A rendered service to the partnership during a portion of the partnership's taxable year (July 1, 1972, through June 30, 1973) which ends within A's taxable year ending on December 31, 1973.

Example (2). D, a partner in the DEF partnership, retired from the partnership as of the close of December 31, 1972. The taxable year of both D and the partnership is the calendar year. During the partnership's taxable year ending December 31, 1973, D rendered no service with respect to any trade or business carried on by the partnership. On or before December 31, 1973, all obligations (other than with respect to retirement payments under the plan) from the other partners to D have been liquidated, and D's share of the capital of the partnership has been paid to him. Retirement payments received by D pursuant to the partnership's plan in his taxable year ending December 31, 1973, are excluded in determining his net earnings from self-employment (if any) for that taxable year.

Example (3). Assume the same facts as in example (2) except that as of the close of December 31, 1973, D has a right to a fixed percentage of any amounts collected by the partnership after that date which are attributable to services rendered by him prior to his retirement for clients of the partnership. The monthly payments received by D in his taxable year ending December 31, 1973, are not excluded from net earnings from self-employment since as of the close of the partnership's taxable year which ends with D's taxable year, an obligation (other than an obligation with respect to retirement payments) exists from the other partners to D.

[T.D. 7333, 39 FR 44446, Dec. 24, 1974]

§ 1.1402(b)–1 Self-employment income.

(a) *In general.* Except for the exclusions in paragraphs (b) and (c) of this section and the exception in paragraph (d) of this section, the term ''self-employment income'' means the net earnings from self-employment derived by an individual during a taxable year.

(b) *Maximum self-employment income*—(1) *General rule.* Subject to the special rules described in subparagraph (2) of this paragraph, the maximum self-employment income of an individual for a taxable year (whether a period of 12 months or less) is:

(i) For any taxable year beginning in a calendar year after 1974, an amount equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) which is effective for such calendar year; and

(ii) For any taxable year:

Ending before 1955	$3,600
Ending after 1954 and before 1959	4,200
Ending after 1958 and before 1966	4,800
Ending after 1965 and before 1968	6,600
Ending after 1967 and beginning before 1972	7,800
Beginning after 1971 and before 1973	9,000
Beginning after 1972 and before 1974	10,800
Beginning after 1973 and before 1975	13,200

(2) *Special rules.* (i) If an individual is paid wages as defined in subparagraph (3) of this paragraph in a taxable year, the maximum self-employment income for such taxable year is computed as provided in subdivision (ii) or (iii) of this subparagraph.

(ii) If an individual is paid wages as defined in subparagraph (3) (i) or (ii) of this paragraph in a taxable year, the maximum self-employment income of such individual for such taxable year is the excess of the amounts indicated in subparagraph (1) of this paragraph over the amount of the wages, as defined in subparagraph (3) (i) and (ii) of this paragraph, paid to him during the taxable year. For example, if for his taxable year beginning in 1974, an individual has $15,000 of net earnings from self-employment and during such taxable year is paid $1,000 of wages as defined in section 3121(a) (see subparagraph (3)(i) of this paragraph), he has $12,200 ($13,200 −$1,000) of self-employment income for the taxable year.

(iii) For taxable years ending on or after December 31, 1968, wages, as defined in subparagraph (3)(iii) of this paragraph, are taken into account in determining the maximum self-employment income of an individual for purposes of the tax imposed under section 1401(b) (hospital insurance), but not for purposes of the tax imposed under section 1401(a) (old-age survivors, and disability insurance). If an individual is paid wages as defined in subparagraph (3)(iii) of this paragraph in a taxable year, his maximum self-employment income for such taxable year for purposes of the tax imposed under section 1401(a) is computed under subparagraph (1) of this paragraph or subdivision (ii) of this subparagraph (whichever is applicable), and his maximum self-employment income for such taxable year for purposes of the tax imposed under section 1401(b) is the excess of his section 1401(a) maximum self-employment income over the amount of wages, as defined in subparagraph (3)(iii) of this paragraph, paid to him during the taxable year. For purposes of this subdivision, wages as defined in subparagraph (3)(iii) of this paragraph are deemed paid to an individual in the period with respect to which the payment is made, that is, the period in which the compensation was earned or deemed earned within the meaning of section 3231(e). For an explanation of the term ''compensation'' and for provisions relating to when compensation is earned, see the regulations under section 3231(e) in part 31 of this chapter (Employment Tax Regulations). The application of the rules set forth in this subdivision may be illustrated by the following example:

Example. M, a calendar-year taxpayer, has $15,000 of net earnings from self-employment for 1974 and during the taxable year is paid $1,000 of wages as defined in section 3121(a) (see subparagraph (3)(i) of this paragraph) and $1,600 of compensation subject to tax under section 3201 (see subparagraph (3)(iii) of this paragraph). Of the $1,600 of taxable compensation, $1,200 represents compensation for services rendered in 1974 and the balance ($400) represents compensation which pursuant to the provisions of section 3231(e) is earned or deemed earned in 1973. M's maximum self-employment income for 1974 for purposes of the tax imposed under section 1401(a), computed as provided in subdivision (ii) of this subparagraph, is $12,200 ($13,200−$1,000), and for purposes of the tax imposed under section 1401(b) is $11,000 ($12,200−$1,200). However, M may recompute his maximum self-employment income for 1973 for purposes of the tax imposed under section 1401(b) by taking into account the $400 of compensation which is deemed paid in 1973.

(3) *Meaning of term ''wages''.* For the purpose of the computation described in subparagraph (2) of this paragraph, the term ''wages'' includes:

(i) Wages as defined in section 3121(a);

(ii) Such remuneration paid to an employee for services covered by:

(a) An agreement entered into pursuant to section 218 of the Social Security Act (42 U.S.C. 418), which section provides for extension of the Federal old-age, survivors and disability insurance system to State and local government employees under voluntary agreements between the States and the Secretary of Health, Education, and Welfare (Federal Security Administrator before April 11, 1953), or

(b) An agreement entered into pursuant to the provisions of section 3121(1), relating to coverage of citizens of the United States who are employees of foreign subsidiaries of domestic corporations,

as would be wages under section 3121(a) if such services constituted employment under section 3121(b). For an explanation of the term ''wages'', see the regulations under section 3121(a) in part 31 of this chapter (Employment Tax Regulations); and

(iii) Compensation, as defined in section 3231(e), which is subject to the employee tax imposed by section 3201 or the employee representative tax imposed by section 3211.

(c) *Minimum net earnings from self-employment.* Self-employment income does not include the net earnings from self-employment of an individual when the amount of such earnings for the taxable year is less than $400. Thus, an individual having only $300 of net earnings from self-employment for the taxable year would not have any self-employment income. However, an individual having net earnings from self-employment of $400 or more for the taxable year may, by application of paragraph (b)(2) of this section, have less than $400 of self-employment income for purposes of the tax imposed under section 1401(a) and the tax imposed under section 1401(b) or may have self-employment income of $400 or more for purposes of the tax imposed under section 1401(a) and of less than $400 for purposes of the tax imposed under section 1401(b). This could occur in a case in which the amount of the individual's net earnings from self-employment is $400 or more for a taxable year and the amount of such net earnings from self-employment plus the amount of wages, as defined in paragraph (b)(3) of this section, paid to him during the taxable year exceed the maximum self-employment income, as set forth in paragraph (b)(1) of this section, for the taxable year. However, the result occurs only if such maximum self-employment income exceeds the amount of such wages. The application of this paragraph may be illustrated by the following example:

Example. For 1974 M, a calendar-year taxpayer, has net earnings from self-employment of $2,000 and wages (as defined in paragraph (b)(3) (i) and (ii) of this section) of $12,500. Since M's net earnings from self-employment plus his wages exceed the maximum self-employment income for 1974 ($13,200), his self-employment income for 1974 is $700 ($13,200−$12,500). If M also had wages, as defined in paragraph (b)(3)(iii) of this section, of $200, his self-employment income would be $700 for purposes of the tax imposed under section 1401(a) and $500 ($13,200−$12,700 ($12,500+$200)) for purposes of the tax imposed under section 1401(b).

For provisions relating to when wages as defined in paragraph (b)(3)(iii) of this section are treated as paid, see paragraph (b)(2)(iii) of this section.

(d) *Nonresident aliens.* A nonresident alien individual never has self-employment income. While a nonresident alien individual who derives income from a trade or business carried on within the United States, Puerto Rico, the Virgin Islands, Guam, or American Samoa (whether by agents or employees, or by a partnership of which he is a member) may be subject to the applicable income tax provisions on such income, such nonresident alien individual will not be subject to the tax on self-employment income, since any net earnings which he may have from self-employment do not constitute self-employment income. For the purpose of the tax on self-employment income, an individual who is not a citizen of the United States but who is a resident of the Commonwealth of Puerto Rico, the Virgin Islands, or, for taxable years beginning after 1960, of Guam or American Samoa is not considered to be a nonresident alien individual.

[T.D. 6691, 28 FR 12796, Dec. 3, 1963, as amended by T.D. 7333, 39 FR 44447, Dec. 24, 1974]

§ 1.1402(c)–1 Trade or business.

In order for an individual to have net earnings from self-employment, he must carry on a trade or business, either as an individual or as a member of a partnership. Except for the exclusions discussed in §§ 1.1402(c)–2 to 1.1402(c)–7, inclusive, the term ''trade or business'', for the purpose of the tax on self-employment income, shall have the same meaning as when used in section 162. An individual engaged in one of the excluded activities specified in such sections of the regulations may also be engaged in carrying on activities which constitute a trade or business for purposes of the tax on self-employment income. Whether or not he is also engaged in carrying on a trade or business will be dependent upon all of the facts and circumstances in the particular case. An individual who is a crew leader, as defined in section 3121(o) (see such section and the regulations thereunder in part 31 of this chapter (Employment Tax Regulations)), is considered to be engaged in carrying on a trade or business with respect to services performed by him after 1956 in furnishing individuals to perform agricultural labor for another person or services performed by him after 1956 as a member of the crew.

[T.D. 6978, 33 FR 15937, Oct. 30, 1968]

§ 1.1402(c)–2 Public office.

(a) *In general*—(1) *General rule.* Except as otherwise provided in subparagraph (2) of this paragraph, the performance of the functions of a public office does not constitute a trade or business.

(2) *Fee basis public officials*—(i) *In general.* If an individual receives fees after 1967 for the performance of the functions of a public office of a State or a political subdivision thereof for which he is compensated solely on a fee basis, and if the service performed in such office is eligible for (but is not made the subject of) an agreement between the State and the Secretary of Health, Education, and Welfare pursuant to section 218 of the Social Security Act to extend social security coverage thereto, the service for which such fees are received constitutes a trade or business within the meaning of section 1402(c) and § 1.1402(c)–1. If an individual performs service for a State or a political subdivision thereof in any period in more than one position, each position is treated separately for purposes of the preceding sentence. See also paragraph (f) of § 1.1402(c)–3 relating to the performance of service by an individual as an employee of a State or a political subdivision thereof in a position compensated solely on a fee basis.

(ii) *Election with respect to fees received in 1968.* (A) Any individual who in 1968 receives fees for service performed by him with respect to the functions of a public office of a State or a political subdivision thereof in any period in which the functions are performed in a position compensated solely on a fee basis may elect, if the performance of the service for which such fees are received constitutes a trade or business pursuant to the provisions of subdivision (i) of this subparagraph, to have such performance of service treated as excluded from the term ''trade or business'' for the purpose of the tax on self-employment income, pursuant to the provisions of section 122(c)(2) of the Social Security Amendments of 1967 (as quoted in § 1.1402(c)). Such election shall not be limited to service to which the fees received in 1968 are attributable but must also be applicable to service (if any) in subsequent years which, except for the election, would constitute a trade or business pursuant to the provisions of subdivision (i) of this subparagraph. An election made pursuant to the provisions of this subparagraph is irrevocable.

(B) The election referred to in subdivision (ii)(A) of this subparagraph shall be made by filing a certificate of election of exemption (Form 4415) on or before the due date of the income tax return (see section 6072), including any extension thereof (see section 6081), for the taxable year of the individual making the election which begins in 1968. The certificate of election of exemption shall be filed with an internal revenue office in accordance with the instructions on the certificate.

(b) *Meaning of public office.* The term ‘‘public office’’ includes any elective or appointive office of the United States or any possession thereof, of the District of Columbia, of a State or its political subdivisions, or a wholly-owned instrumentality of any one or more of the foregoing. For example, the President, the Vice President, a governor, a mayor, the Secretary of State, a member of Congress, a State representative, a county commissioner, a judge, a justice of the peace, a county or city attorney, a marshal, a sheriff, a constable, a registrar of deeds, or a notary public performs the functions of a public office. (However, the service of a notary public could not be made the subject of a section 218 agreement under the Social Security Act because notaries are not ‘‘employees’’ within the meaning of that section. Accordingly, such service does not constitute a trade or business.)

[T.D. 7333, 39 FR 44448, Dec. 24, 1974, as amended by T.D. 7372, 40 FR 30945, July 24, 1975]

§1.1402(c)–3 Employees.

(a) *General rule.* Generally, the performance of service by an individual as an employee, as defined in the Federal Insurance Contributions Act (Chapter 21 of the Internal Revenue Code) does not constitute a trade or business within the meaning of section 1402(c) and §1.1402(c)–1. However, in six cases set forth in paragraphs (b) to (g), inclusive, of this section, the performance of service by an individual is considered to constitute a trade or business within the meaning of section 1402(c) and §1.1402(c)–1. (As to when an individual is an employee, see section 3121 (d) and (o) and section 3506 and the regulations under those sections in part 31 of this chapter (Employment Tax Regulations).)

(b) *Newspaper vendors.* Service performed by an individual who has attained the age of 18 constitutes a trade or business for purposes of the tax on self-employment income within the meaning of section 1402(c) and §1.1402(c)–1 if performed in, and at the time of, the sale of newspapers or magazines to ultimate consumers, under an arrangement under which the newspapers or magazines are to be sold by him at a fixed price, his compensation being based on the retention of the excess of such price over the amount at which the newspapers or magazines are charged to him, whether or not he is guaranteed a minimum amount of compensation for such service, or is entitled to be credited with the unsold newspapers or magazines turned back.

(c) *Sharecroppers.* Service performed by an individual under an arrangement with the owner or tenant of land pursuant to which:

(1) Such individual undertakes to produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land,

(2) The agricultural or horticultural commodities produced by such individual, or the proceeds therefrom, are to be divided between such individual and such owner or tenant, and

(3) The amount of such individual’s share depends on the amount of the agricultural or horticultural commodities produced, constitutes a trade or business within the meaning of section 1402(c) and §1.1402(c)–1.

(d) *Employees of foreign government, instrumentality wholly owned by foreign government, or international organization.* Service performed in the United States, as defined in section 3121(e)(2) (see such section and the regulations thereunder in part 31 of this chapter

(Employment Tax Regulations)), by an individual who is a citizen of the United States constitutes a trade or business within the meaning of section 1402(c) and § 1.1402(c)–1 if such service is excepted from employment, for purposes of the Federal Insurance Contributions Act (chapter 21 of the Code), by:

(1) Section 3121(b)(11), relating to service in the employ of a foreign government (for regulations under section 3121(b)(11), see § 31.3121(b)(11)–1 of this chapter);

(2) Section 3121(b)(12), relating to service in the employ of an instrumentality wholly owned by a foreign government (for regulations under section 3121(b)(12), see § 31.3121(b)(12)–1 of this chapter); or

(3) Section 3121(b)(15), relating to service in the employ of an international organization (for regulations under section 3121(b)(15), see § 31.3121(b)(15)–1 of this chapter).

This paragraph is applicable to service performed in any taxable year ending on or after December 31, 1960, except that it does not apply to service performed before 1961 in Guam or American Samoa.

(e) *Ministers and members of religious orders*—(1) *Taxable years ending before 1968.* Service described in section 1402(c)(4) performed by an individual during taxable years ending before 1968 for which a certificate filed pursuant to section 1402(e) is in effect constitutes a trade or business within the meaning of section 1402(c) and § 1.1402(c)–1. See also § 1.1402(c)–5.

(2) *Taxable years ending after 1967.* Service described in section 1402(c)(4) performed by an individual during taxable years ending after 1967 constitutes a trade or business within the meaning of section 1402(c) and § 1.1402(c)–1 unless an exemption under section 1402(e) (see §§ 1.1402(e)–1A through 1.1402(e)–4A) is effective with respect to such individual for the taxable year during which the service is performed. See also § 1.1402(c)–5.

(f) *State and local government employees compensated on fee basis*—(1) *In general.* (i) Section 1402(c)(2)(E) and this paragraph are applicable only with respect to fees received by an individual after 1967 for service performed by him as an employee of a State or a political subdivision thereof in a position compensated solely on a fee basis. If an individual performs service for a State or a political subdivision thereof in more than one position, each position is treated separately for purposes of determining whether the service performed in such position is performed by an employee and whether compensation for service performed in the position is solely on a fee basis.

(ii) If an individual receives fees after 1967 for service performed by him as an employee of a State or a political subdivision thereof in a position compensated solely on a fee basis, the service for which such fees are received constitutes a trade or business within the meaning of section 1402(c) and § 1.1402(c)–1 except that if service performed in such position is covered under an agreement entered into by the State and the Secretary of Health, Education, and Welfare pursuant to section 218 of the Social Security Act at the time a fee is received, the service to which such fee relates does not constitute a trade or business. See also paragraph (a) of § 1.1402(c)–2, relating, in part, to the performance of the functions of a public office of a State or a political subdivision thereof by an individual.

(2) *Election with respect to fees received in 1968.* (i) Any individual who in 1968 receives fees for service as an employee of a State or a political subdivision thereof in a position compensated solely on a fee basis may elect, if the performance of the service for which such fees are received constitutes a trade or business pursuant to the provisions of subparagraph (1) of this paragraph, to have such performance of service treated as excluded from the term ‘‘trade or business’’ for the purpose of the tax on self-employment income, pursuant to the provisions of section 122(c)(2) of the Social Security Amendments of 1967 (as quoted in § 1.1402(c)). Such election shall not be limited to service to which the fees received in 1968 are attributable but must also be applicable to service (if any) in subsequent years which, except for the election, would constitute a trade or business pursuant to the provisions of subparagraph (1) of

this paragraph. An election made pursuant to the provisions of this subparagraph is irrevocable.

(ii) The election referred to in subdivision (i) of this subparagraph shall be made by filing a certificate of election of exemption (Form 4415) on or before the due date of the income tax return (see section 6072), including any extension thereof (see section 6081), for the taxable year of the individual making the election which begins in 1968. The certificate of election of exemption shall be filed with an internal revenue office in accordance with the instructions on the certificate.

(g) *Individuals engaged in fishing.* For taxable years ending after December 31, 1954, service performed by an individual on a boat engaged in catching fish or other forms of aquatic animal life (hereinafter ''fish'') constitutes a trade or business within the meaning of section 1402(c) and §1.1402(c)–1 if the service is excepted from the definition of employment by section 3121(b)(20) and §31.3121(b)(20)–1(a). However, the preceding sentence does not apply to services performed after December 31, 1954, and before October 4, 1976, on a boat engaged in catching fish if the owner or operator of the boat treated the individual as an employee in the manner described in §31.3121(b)(20)–1(b).

[T.D. 6691, 28 FR 12796, Dec. 3, 1963, as amended by T.D. 6978, 33 FR 15937, Oct. 30, 1968; T.D. 7333, 39 FR 44448, Dec. 24, 1974; T.D. 7691, 45 FR 24129, Apr. 9, 1980; T.D. 7716, 45 FR 57123, Aug. 27, 1980]

§1.1402(c)–4 Individuals under Railroad Retirement System.

The performance of service by an individual as an employee or employee representative as defined in section 3231(b) and (c), respectively (see §§31.3231(b)–1 and 31.3231(c)–1 of Part 31 of this chapter (Employment Tax Regulations)), that is, an individual covered under the railroad retirement system, does not constitute a trade or business.

§1.1402(c)–5 Ministers and members of religious orders.

(a) *In general*—(1) *Taxable years ending before 1968.* For taxable years ending before 1955, a duly ordained, commissioned, or licensed minister of a church or a member of a religious order is not engaged in carrying on a trade or business with respect to service performed by him in the exercise of his ministry or in the exercise of duties required by such order. However, for taxable years ending after 1954 and before 1968, any individual who is a duly ordained, commissioned, or licensed minister of a church or a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) may elect, as provided in §1.1402(e)(1)–1, to have the Federal old-age, survivors, and disability insurance system established by title II of the Social Security Act extended to service performed by him in his capacity as such a minister or member. If such a minister or a member of a religious order makes an election pursuant to §1.1402(e)(1)–1 he is, with respect to service performed by him in such capacity, engaged in carrying on a trade or business for each taxable year to which the election is effective. An election by a minister or member of a religious order has no application to service performed by such minister or member which is not in the exercise of his ministry or in the exercise of duties required by such order.

(2) *Taxable years ending after 1967.* For any taxable year ending after 1967, a duly ordained, commissioned, or licensed minister of a church or a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) is engaged in carrying on a trade or business with respect to service performed by him in the exercise of his ministry or in the exercise of duties required by such order unless an exemption under section 1402(e) (see §§1.1402(e)–1A through 1.1402(e)–4A) is effective with respect to such individual for the taxable year during which the service is performed. An exemption which is effective with respect to a minister or a member of a religious order has no application to service performed by such minister or member which is not in the exercise of his ministry or in the exercise of duties required by such order.

(b) *Service by a minister in the exercise of his ministry.* (1)(i) A certificate of election filed by a duly ordained, commissioned, or licensed minister of a church under the provisions of § 1.1402(e)(1)–1 has application only to service performed by him in the exercise of his ministry.

(ii) An exemption under section 1402(e) (see §§ 1.1402(e)–1A through 1.1402(e)–4A) which is effective with respect to a duly ordained, commissioned, or licensed minister of a church has application only to service performed by him in the exercise of his ministry.

(2) Except as provided in paragraph (c)(3) of this section, service performed by a minister in the exercise of his ministry includes the ministration of sacerdotal functions and the conduct of religious worship, and the control, conduct, and maintenance of religious organizations (including the religious boards, societies, and other integral agencies of such organizations), under the authority of a religious body constituting a church or church denomination. The following rules are applicable in determining whether services performed by a minister are performed in the exercise of his ministry:

(i) Whether service performed by a minister constitutes the conduct of religious worship or the ministration of sacerdotal functions depends on the tenets and practices of the particular religious body constituting his church or church denomination.

(ii) Service performed by a minister in the control, conduct, and maintenance of a religious organization relates to directing, managing, or promoting the activities of such organization. Any religious organization is deemed to be under the authority of a religious body constituting a church or church denomination if it is organized and dedicated to carrying out the tenets and principles of a faith in accordance with either the requirements or sanctions governing the creation of institutions of the faith. The term ‘‘religious organization’’ has the same meaning and application as is given to the term for income tax purposes.

(iii) If a minister is performing service in the conduct of religious worship or the ministration of sacerdotal functions, such service is in the exercise of his ministry whether or not it is performed for a religious organization. The application of this rule may be illustrated by the following example:

Example. M, a duly ordained minister, is engaged to perform service as chaplain at N University. M devotes his entire time to performing his duties as chaplain which include the conduct of religious worship, offering spiritual counsel to the university students, and teaching a class in religion. M is performing service in the exercise of his ministry.

(iv) If a minister is performing service for an organization which is operated as an integral agency of a religious organization under the authority of a religious body constituting a church or church denomination, all service performed by the minister in the conduct of religious worship, in the ministration of sacerdotal functions, or in the control, conduct, and maintenance of such organization (see subparagraph (2)(ii) of this paragraph) is in the exercise of his ministry. The application of this rule may be illustrated by the following example:

Example. M, a duly ordained minister, is engaged by the N Religious Board to serve as director of one of its departments. He performs no other service. The N Religious Board is an integral agency of O, a religious organization operating under the authority of a religious body constituting a church denomination. M is performing service in the exercise of his ministry.

(v) If a minister, pursuant to an assignment or designation by a religious body constituting his church, performs service for an organization which is neither a religious organization nor operated as an integral agency of a religious organization, all service performed by him, even though such service may not involve the conduct of religious worship or the ministration of sacerdotal functions, is in the exercise of his ministry. The application of this rule may be illustrated by the following example:

Example. M, a duly ordained minister, is assigned by X, the religious body constituting his church, to perform advisory service to Y Company in connection with the publication of a book dealing with the history of M's church denomination. Y is neither a religious organization nor operated as an integral agency of a religious organization. M performs no other service for X or Y. M is performing service in the exercise of his ministry.

(c) *Service by a minister not in the exercise of his ministry.* (1)(i) A certificate filed by a duly ordained, commissioned, or licensed minister of a church under the provisions of §1.1402(e)(1)–1 has no application to service performed by him which is not in the exercise of his ministry.

(ii) An exemption under section 1402(e) (see §§1.1402(e)–1A through 1.1402(e)–4A) which is effective with respect to a duly ordained, commissioned, or licensed minister of a church has no application to service performed by him which is not in the exercise of his ministry.

(2) If a minister is performing service for an organization which is neither a religious organization nor operated as an integral agency of a religious organization and the service is not performed pursuant to an assignment or designation by his ecclesiastical superiors, then only the service performed by him in the conduct of religious worship or the ministration of sacerdotal functions is in the exercise of his ministry. See, however, subparagraph (3) of this paragraph. The application of the rule in this subparagraph may be illustrated by the following example:

Example. M, a duly ordained minister, is engaged by N University to teach history and mathematics. He performs no other service for N although from time to time he performs marriages and conducts funerals for relatives and friends. N University is neither a religious organization nor operated as an integral agency of a religious organization. M is not performing the service for N pursuant to an assignment or designation by his ecclesiastical superiors. The service performed by M for N University is not in the exercise of his ministry. However, service performed by M in performing marriages and conducting funerals is in the exercise of his ministry.

(3) Service performed by a duly ordained, commissioned, or licensed minister of a church as an employee of the United States, or a State, Territory, or possession of the United States, or the District of Columbia, or a foreign government, or a political subdivision of any of the foregoing, is not considered to be in the exercise of his ministry for purposes of the tax on self-employment income, even though such service may involve the ministration of sacerdotal functions or the conduct of religious worship. Thus, for example, service performed by an individual as a chaplain in the Armed Forces of the United States is considered to be performed by a commissioned officer in his capacity as such, and not by a minister in the exercise of his ministry. Similarly, service performed by an employee of a State as a chaplain in a State prison is considered to be performed by a civil servant of the State and not by a minister in the exercise of his ministry.

(d) *Service in the exercise of duties required by a religious order*—(1) *Certificate of election.* A certificate of election filed by a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) under the provisions of §1.1402(e)(1)–1 has application to all duties required of him by such order.

(2) *Exemption.* An exemption under section 1402(e) (see §§1.1402(e)–1A through 1.1402(e)–4A) which is effective with respect to a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) has application only to the duties required of him by such order.

(3) *Service.* For purposes of subparagraphs (1) and (2) of this paragraph, the nature or extent of the duties required of the member by the order is immaterial so long as it is a service which he is directed or required to perform by his ecclesiastical superiors.

[T.D. 6691, 28 FR 12796, Dec. 3, 1963, as amended by T.D. 6978, 33 FR 15937, Oct. 30, 1968]

§1.1402(c)–6 Members of certain professions.

(a) *Periods of exclusion*—(1) *Taxable years ending before 1955.* For taxable years ending before 1955, an individual is not engaged in carrying on a trade or business with respect to the performance of service in the exercise of his profession as a physician, lawyer, dentist, osteopath, veterinarian, chiropractor, naturopath, optometrist, Christian Science practitioner, architect, certified public accountant, accountant registered or licensed as an accountant under State or municipal law, full-time practicing public accountant, funeral director, or professional engineer.

(2) *Taxable years ending in 1955.* Except as provided in paragraph (b) of this section, for a taxable year ending in 1955 an individual is not engaged in carrying on a trade or business with respect to the performance of service in the exercise of his profession as a physician, lawyer, dentist, osteopath, veterinarian, chiropractor, naturopath, optometrist, or Christian Science practitioner.

(3) *Taxable years ending after 1955*—(i) *Doctors of medicine.* For taxable years ending after 1955 and before December 31, 1965, and individual is not engaged in carrying on a trade or business with respect to the performance of service in the exercise of his profession as a doctor of medicine. For taxable years ending after December 30, 1965, an individual is engaged in carrying on a trade or business with respect to the performance of service in the exercise of his profession as a doctor of medicine.

(ii) *Christian Science practitioners.* Except as provided in paragraph (b)(1) of this section, for taxable years ending after 1955 and before 1968, an individual is not engaged in carrying on a trade or business with respect to the performance of service in the exercise of his profession as a Christian Science practitioner. For provisions relating to the performance of service in taxable years ending after 1967 by an individual in the exercise of his profession as a Christian Science practitioner, see paragraph (b)(2) of this section.

(b) *Christian Science practitioner*—(1) *Certain taxable years ending before 1968; election.* For taxable years ending after 1954 and before 1968, a Christian Science practitioner may elect, as provided in § 1.1402(e)(1)–1, to have the Federal old-age, survivors, and disability insurance system established by title II of the Social Security Act extended to service performed by him in the exercise of his profession as a Christian Science practitioner. If an election is made pursuant to § 1.1402(e)(1)–1, the Christian Science practitioner is, with respect to the performance of service in the exercise of such profession, engaged in carrying on a trade or business for each taxable year for which the election is effective. An election by a Christian Science practitioner has no application to service performed by him which is not in the exercise of his profession as a Christian Science practitioner.

(2) *Taxable years ending after 1967; exemption.* For a taxable year ending after 1967, a Christian Science practitioner is, with respect to the performance of service in the exercise of his profession as a Christian Science practitioner, engaged in carrying on a trade or business unless an exemption under section 1402(e) (see §§ 1.1402(e)–1A through 1.1402(e)–4A) is effective with respect to him for the taxable year during which the service is performed. An exemption which is effective with respect to a Christian Science practitioner has no application to service performed by him which is not in the exercise of his profession as a Christian Science practitioner.

(c) *Meaning of terms.* The designations in this section are to be given their commonly accepted meanings. For taxable years ending after 1955, an individual who is a doctor of osteopathy, and who is not a doctor of medicine within the commonly accepted meaning of that term, is deemed, for purposes of this section, not to be engaged in carrying on a trade or business in the exercise of the profession of doctor of medicine.

(d) *Legal requirements.* The exclusions specified in paragraph (a) of this section apply only if the individuals meet the legal requirements, if any, for practicing their professions in the place where they perform the service.

(e) *Partnerships.* In the case of a partnership engaged in the practice of any of the designated excluded professions, the partnership shall not be considered as carrying on a trade or business for the purpose of the tax on self-employment income, and none of the distributive shares of the income or loss, described in section 702(a)(9), of such partnership shall be included in computing net earnings from self-employment of any member of the partnership. On the other hand, where a partnership is engaged in a trade or business not within any of the designated excluded professions, each partner must include his distributive share of the income or loss, described in section 702(a)(9), of such partnership in computing his net earnings from self-employment, irrespective of whether such partner is engaged in the practice of one or more of such professions and contributes his professional services to the partnership.

[T.D. 6691, 28 FR 12796, Dec. 3, 1963, as amended by T.D. 6978, 33 FR 15938, Oct. 30, 1968]

§1.1402(c)–7 Members of religious groups opposed to insurance.

The performance of service by an individual:

(a) Who is a member of a recognized religious sect or division thereof, and

(b) Who is an adherent of established tenets or teachings of such sect or division by reason of which he is conscientiously opposed to acceptance of the benefits of any private or public insurance which makes payments in the event of death, disability, old age, or retirement or makes payments toward the cost of, or provides services for, medical care (including the benefits of any insurance system established by the Social Security Act),

during any taxable year for which he is granted a tax exemption, pursuant to section 1402(h), does not constitute a trade or business within the meaning of section 1402(c) and §1.1402(c)–1. See also §§1.1402(h) and 1.1402(h)–1.

[T.D. 6993, 34 FR 830, Jan. 18, 1969]

§1.1402(d)–1 Employee and wages.

For the purpose of the tax on self-employment income, the term ‘‘employee’’ and the term ‘‘wages’’ shall have the same meaning as when used in the Federal Insurance Contributions Act. For an explanation of these terms, see Subpart B of Part 31 of this chapter (Employment Tax Regulations).

§1.1402(e)–1A Application of regulations under section 1402(e).

The regulations in §§1.1402(e)–2A through 1.1402(e)–4A relate to section 1402(e) as amended by section 115(b)(2) of the Social Security Amendments of 1967 (81 Stat. 839) and apply to taxable years ending after 1967. Section 1.1402(e)–5A reflects changes made by section 1704(a) of the Tax Reform Act of 1986 (100 Stat. 2085, 2779) and applies to applications for exemption under section 1402(e) filed after December 31, 1986. For regulations under section 1402(e) (as in effect prior to amendment by the Social Security Amendments of 1967) applicable to taxable years ending before 1968, see §§1.1402(e)(1)–1 through 1.1402(e)(6)–1.

[T.D. 8221, 53 FR 33461, Aug. 31, 1988]

§1.1402(e)–2A Ministers, members of religious orders and Christian Science practitioners; application for exemption from self-employment tax.

(a) *In general.* (1) Subject to the limitations set forth in subparagraphs (2) and (3) of this paragraph, any individual who is (i) a duly ordained, commissioned, or licensed minister of a church or a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) or (ii) a Christian Science practitioner may request an exemption from the tax on self-employment income (see section 1401 and §1.1401–1) with respect to services performed by him in his capacity as a minister or member, or as a Christian Science practitioner, as the case may be. Such a request shall be made by filing an application for exemption on Form 4361 in the manner provided in paragraph (b) of this section and within the time specified in §1.1402(e)–3A. For provisions relating to the taxable year or years for which an exemption from the tax on self-employment income with respect to service performed by a minister or member or a Christian Science practitioner in his capacity as such is effective, see §1.1402(e)–4A. For additional provisions applicable to services performed by individuals referred to in this subparagraph, see paragraph (e) of §1.1402(c)–3 and §1.1402(c)–5 relating to ministers and members of religious orders, and paragraphs (a)(3)(ii) and (b) of §1.1402(c)–6 relating to Christian Science practitioners.

(2) The application for exemption shall contain, or there shall be filed with such application, a statement to the effect that the individual making

application for exemption is conscientiously opposed to, or because of religious principles is opposed to, the acceptance (with respect to services performed by him in his capacity as a minister, member, or Christian Science practitioner) of any public insurance which makes payments in the event of death, disability, old age, or retirement or makes payments toward the cost of, or provides services for, medical care (including the benefits of any insurance system established by the Social Security Act). Thus, ministers, members of religious orders, and Christian Science practitioners requesting exemption from social security coverage must meet either of two alternative tests: (1) A religious principles test which refers to the institutional principles and discipline of the particular religious denomination to which he belongs, or (2) a conscientious opposition test which refers to the opposition because of religious considerations of individual ministers, members of religious orders, and Christian Science practitioners (rather than opposition based upon the general conscience of any such individual or individuals). The term ''public insurance'', as used in section 1402(e) and this paragraph, refers to governmental, as distinguished from private, insurance and does not include insurance carried with a commercial insurance carrier. To be eligible to file an application for exemption on Form 4361, a minister, member, or Christian Science practitioners need not be opposed to the acceptance of all public insurance making payments of this specified type; he must, however, be opposed on religious grounds to the acceptance of any such payment which, in whole or in part, is based on, or measured by earnings from, services performed by in his capacity as a minister or member (see §1.1402(c)–5) or in his capacity as a Christian Science practitioner (see paragraph (b)(2) of §1.1402(c)–6). For example, a minister performing service in the exercise of his ministry may be eligible to file an application for exemption on Form 4361 even though he is not opposed to the acceptance of benefits under the Social Security Act with respect to service performed by him which is not in the exercise of his ministry.

(3) An exemption from the tax imposed on self-employment income with respect to service performed by a minister, member, or Christian Science practitioner in his capacity as such may not be granted to a minister, member, or practitioner who (in accordance with the provisions of section 1402(e) as in effect prior to amendment by section 115(b)(2) of the Social Security Amendments of 1967 (81 Stat. 839)) filed a valid waiver certificate on Form 2031 electing to have the Federal old-age, survivors, and disability insurance system establish by title II of the Social Security Act extended to service performed by him in the exercise of his ministry or in the exercise of duties required by the order of which he is a member, or in the exercise of his profession as a Christian Science practitioner. For provisions relating to waiver certificates on Form 2031, see §§1.1402(e)(1)–1 through 1.1402(e)(6)–1.

(b) *Application for exemption.* An application for exemption on Form 4361 shall be filed in triplicate with the internal revenue officer or the internal revenue office, as the case may be, designated in the instructions relating to the application for exemption. The application for exemption must be filed within the time prescribed in §1.1402(e)–3A. If the last original Federal income tax return of an individual to whom paragraph (a) of this section applies which was filed before the expiration of such time limitation for filing an application for exemption shows no liability for tax on self-employment income, such return will be treated as an application for exemption, provided that before February 28, 1975 such individual also files a properly executed Form 4361.

(c) *Approval of application for exemption.* The filing of an application for exemption on Form 4361 by a minister, a member of a religious order, or a Christian Science practitioner does not constitute an exemption from the tax on self-employment income with respect to services performed by him in his capacity as a minister, member, or practitioner. The exemption is granted only if the application is approved by an appropriate internal revenue officer. See

§1.1402(e)–4A relating to the period for which an exemption is effective.

[T.D. 7333, 39 FR 44448, Dec. 24, 1974; 39 FR 45216, Dec. 31, 1974]

§1.1402(e)–3A Time limitation for filing application for exemption.

(a) *General rule.* (1) Any individual referred to in paragraph (a) of §1.1402(e)–2A who desires an exemption from the tax on self-employment income with respect to service performed by him in his capacity as a minister or member of a religious order or as a Christian Science practitioner must file the application for exemption (Form 4361) prescribed by §1.1402(e)–2A on or before whichever of the following dates is later:

(i) The due date of the income tax return (see section 6072), including any extension thereof (see section 6081), for his second taxable year ending after 1967, or

(ii) The due date of the income tax return, including any extension thereof, for his second taxable year beginning after 1953 for which he has net earnings from self-employment of $400 or more, any part of which:

(a) In the case of a duly ordained, commissioned, or licensed minister of a church, consists of remuneration for service performed in the exercise of his ministry,

(b) In the case of a member of a religious order who has not taken a vow of poverty as a member of such order, consists of remuneration for service performed in the exercise of duties required by such order, or

(c) In the case of a Christian Science practitioner, consists of remuneration for service performed in the exercise of his profession as a Christian Science practitioner.

See paragraph (c) of this section for provisions relating to the computation of net earnings from self-employment.

(2) If a minister, a member of a religious order, or a Christian Science practitioner derives gross income in a taxable year both from service performed in such capacity and from the conduct of another trade or business, and the deductions allowed by Chapter 1 of the Internal Revenue Code which are attributable to the gross income derived from service performed in such capacity equal or exceed the gross income derived from service performed in such capacity, no part of the net earnings from self-employment (computed as prescribed in paragraph (c) of this section) for the taxable year shall be considered as derived from service performed in such capacity.

(3) The application of the rules set forth in subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example (1). M, who makes his income tax returns on a calendar year basis, was ordained as a minister in January 1960. During each of two or more taxable years ending before 1968 M has net earnings from self-employment in excess of $400 some part of which is from service performed in the exercise of his ministry. M has not filed an effective waiver certificate on Form 2031 (see paragraph (a)(3) of §1.1402(e)–2A). If M desires an exemption from the tax on self-employment income with respect to service performed in the exercise of his ministry, he must file an application for exemption on or before the due date of his income tax return for 1969 (his second taxable year ending after 1967), or any extension thereof.

Example (2). M, who makes his income tax returns on a calendar year basis, was ordained as a minister in January 1966. M has net earnings of $350 for the taxable year 1966 and has net earnings in excess of $400 for each of his taxable years 1967 and 1968 (some part or all of which is derived from service performed in the exercise of his ministry). M has not filed an effective waiver certificate on Form 2031 (see paragraph (a)(3) of §1.1402(e)–2A). If M desires an exemption from the tax on self-employment income with respect to service performed in the exercise of his ministry, he must file an application for exemption on or before the due date of his income tax return for 1969 (his second taxable year ending after 1967), or any extension thereof.

Example (3). Assume the same facts as in example (2) except that M has net earnings in excess of $400 for each of his taxable years 1967 and 1969 (but less than $400 in 1968). The application for exemption must be filed on or before the due date of his income tax return for 1969, or any extension thereof.

Example (4). M was ordained as a minister in May 1973. During each of the taxable years 1973 and 1975, M, who makes his income tax returns on a calendar year basis, derives net earnings in excess of $400 from his activities as a minister. M has net earnings of $350 for the taxable year 1974, $200 of which is derived from service performed by him in the exercise of his ministry. If M desires an exemption from the tax on self-employment income with respect to service performed in the exercise of his ministry, he must file an application for exemption on or before the due date of his income tax return for 1975, or any extension thereof.

Example (5). M, who was ordained a minister in January 1973, is employed as a toolmaker by the XYZ Corporation for the taxable years 1973 and 1974 and also engages in activities as a minister on weekends. M makes his income tax returns on the basis of a calendar year. During each of the taxable years 1973 and 1974 M receives wages of $14,000 from the XYZ Corporation and derives net earnings of $400 from his activities as a minister. If M desires an exemption from the tax on self-employment income with respect to service performed in the exercise of his ministry, he must file an application for exemption on or before the due date of his income tax return for 1974, or any extension thereof. It should be noted that although by reason of section 1402(b)(1) (G) and (H) no part of the $400 represents ''self-employment income'', nevertheless the entire $400 constitutes ''net earnings from self-employment'' for purposes of fulfilling the requirements of section 1402(e)(2).

Example (6). M, who files his income tax returns on a calendar year basis, was ordained as a minister in March 1973. During 1973 he receives $410 for service performed in the exercise of his ministry. In addition to his ministerial services, M is engaged during the year 1973 in a mercantile venture from which he derives net earnings from self-employment in the amount of $4,000. The expenses incurred by him in connection with his ministerial services during 1973 and which are allowable deductions under Chapter 1 of the Internal Revenue Code amount to $410. During 1974 and 1975, M has net earnings from self-employment in amounts of $4,600 and $4,800, respectively, and some part of each of these amounts is from the exercise of his ministry. The deductions allowed in each of the years 1974 and 1975 by Chapter 1 which are attributable to the gross income derived by M from the exercise of his ministry in each of such years, respectively, do not equal or exceed such gross income in such year. If M desires an exemption from the tax on self-employment income with respect to service performed in the exercise of his ministry, he must file an application for exemption on or before the due date of his income tax return for 1975, or an extension thereof.

(b) *Effect of death.* The right of an individual to file an application for exemption shall cease upon his death. Thus, the surviving spouse, administrator, or executor of a decedent shall not be permitted to file an application for exemption for such decedent.

(c) *Computation of net earnings*—(1) *Taxable years ending before 1968.* For purposes of this section net earnings from self-employment for taxable years ending before 1968 shall be determined without regard to the fact that, without an election under section 1402(e) (as in effect prior to amendment by section 115(b)(2) of the Social Security Amendments of 1967, see § 1.1402(e)–1A), the performance of services by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry, or by a member of a religious order in the exercise of duties required by such order, or the performance of service by an individual in the exercise of his profession as a Christian Science practitioner, does not constitute a trade or business for purposes of the tax on self-employment income.

(2) *Taxable years ending after 1967.* For purposes of this section and § 1.1402(e)–4A net earnings from self-employment for taxable years ending after 1967 shall be determined without regard to section 1402(c) (4) and (5). See § 1.1402(c)–3(e)(2) and § 1.1402(c)–5 relating to ministers and members of religious orders, and paragraphs (a)(3)(ii) and (b) of § 1.1402(c)–6 relating to Christian Science practitioners.

[T.D. 7333, 39 FR 44449, Dec. 24, 1974]

§ 1.1402(e)–4A Period for which exemption is effective.

(a) *In general.* If an application for exemption on Form 4361:

(1) Is filed by a minister, a member of a religious order, or a Christian Science practitioner eligible to file such an application (see particularly paragraph (a) (2) and (3) of § 1.1402(e)–2A), and

(2) Is approved (see paragraph (c) of § 1.1402(e)–2A),

the exemption from the tax on self-employment income shall be effective for the first taxable year ending after 1967 for which such minister, member, or practitioner has net earnings from self-employment of $400 or more any part of which was derived from the performance of service in his capacity as a minister, member, or practitioner, and for all succeeding taxable years. See, however, paragraphs (b)(1)(ii) and (d)(2) of § 1.1402(c)–5 relating to ministers and members of religious orders and paragraph (b)(2) of § 1.1402(c)–6 relating to Christian Science practitioners.

(b) *Exemption irrevocable.* An exemption granted to a minister, a member of a religious order, or a Christian Science practitioner pursuant to the provisions of section 1402(e) is irrevocable.

[T.D. 7333, 39 FR 44450, Dec. 24, 1974]

§1.1402(e)–5A Applications for exemption from self-employment taxes filed after December 31, 1986, by ministers, certain members of religious orders, and Christian Science practitioners.

(a) *In general.* (1) Except as provided in paragraph (a)(2) of this section, this section applies to any individual who is a duly ordained, commissioned, or licensed minister of a church, member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order), or a Christian Science practitioner who files an application after December 31, 1986, for exemption from the tax on self-employment income (see section 1401 and 1.1401–1) with respect to services performed by him or her in his or her capacity as a minister, member, or practitioner pursuant to §§1.1402(e)–2A through 1.1402(e)–4A. This section does not apply to applications for exemption under section 1402(e) that are filed before January 1, 1987.

(2) *Application of this section to Christian Science practitioners.* Paragraph (b) of this section does not apply to Christian Science practitioners. Thus, Christian Science practitioners filing applications for exemption from self-employment taxes under section 1402(e) should follow the procedures set forth in §§1.1402(e)–2A through 1.1402(e)–4A, and are not required to include the statement described in paragraph (b)(1)(ii) of this section. However, see paragraph (c) of this section for verification procedures with respect to applications for exemption from self-employment taxes filed after December 31, 1986, by Christian Science practitioners.

(b) *Church or order must be informed*—(1) *In general.* Any individual, other than a Christian Science practitioner, who files an application for exemption from the tax on self-employment income under section 1402(e) after December 31, 1986:

(i) Shall file such application in accordance with the procedures set forth in §§1.1402(e)–2A through 1.1402(e)–4A, and

(ii) Shall include with such application a statement to the effect that the individual making application for exemption has informed the ordaining, commissioning, or licensing body of the church or order that he or she is opposed to the acceptance (for services performed as a minister or member of a religious order not under a vow of poverty) of any public insurance that makes payments in the event of death, disability, old age, or retirement, or that makes payments toward the cost of, or provides services for, medical care (including the benefits of any insurance system established by the Social Security Act).

(2) *Statement to be filed with form.* If the form provided by the Service for applying for exemption under 1402(e) does not contain the statement set forth in paragraph (b)(1)(ii) of this section, any individual required to include this statement with his or her application under this paragraph (b) shall file such statement with the individual's application at the time and place prescribed for filing such application under §§1.1402(e)–2A and 1.1402(e)–3A. The statement shall contain the information set forth in paragraph (b)(1)(ii) of this section and shall be signed by such individual under penalties of perjury.

(c) *Verification of application*—(1) *In general.* The Service will approve an application for an exemption filed by an individual to whom this section applies only after verifying that the individual applying for the exemption is aware of the grounds on which the individual may receive an exemption under section 1402(e) (See §1.1402(e)–2A) and that the individual seeks exemption on such grounds in accordance with the procedures set forth in paragraph (c)(2) of this section.

(2) *Verification procedure.* Upon receipt of an application for exemption from self-employment taxes under section 1402(e) and this section, the Service will mail to the applicant a statement that describes the grounds on

which an individual may receive an exemption under section 1402(e). The individual filing the application shall certify that he or she has read the statement and that he or she seeks exemption from self-employment taxes on the grounds listed in the statement. The certification shall be made by signing a copy of the statement under penalties of perjury and mailing the signed copy to the Service Center from which the statement was issued not later than 90 days after the date on which the statement was mailed to the individual. If the signed copy of the statement is not mailed to the Service Center within 90 days of the date on which the statement was mailed to the individual, that individual's exemption will not be effective until the date that the signed copy of the statement is received at the Service Center.

[T.D. 8136, 52 FR 12162, Apr. 15, 1987, redesignated and amended at T.D. 8221, 53 FR 33461, Aug. 31, 1988]

§ 1.1402(e)(1)–1 Election by ministers, members of religious orders, and Christian Science practitioners for self-employment coverage.

(a) *In general.* Any individual who is (1) a duly ordained, commissioned, or licensed minister of a church or a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) or (2) a Christian Science practitioner may elect to have the Federal old-age, survivors, and disability insurance system established by title II of the Social Security Act extended to service performed by him in the exercise of his ministry or in the exercise of duties required by such order, or in the exercise of his profession as a Christian Science practitioner, as the case may be. Such an election shall be made by filing a certificate on Form 2031 in the manner provided in paragraph (b) of this section and within the time specified in § 1.1402(e)(2)–1. If a minister or member to whom this section has application, or a Christian Science practitioner, makes an election by filing Form 2031 such individual shall, for each taxable year for which the election is effective (see § 1.1402(e)(3)–1), be considered as carrying on a trade or business with respect to the performance of service in his capacity as a minister or member, or as a Christian Science practitioner, as the case may be.

(b) *Waiver certificate.* The certificate on Form 2031 shall be filed in triplicate with the district director of internal revenue for the internal revenue district in which is located the legal residence or principal place of business of the individual who executes the certificate. If such individual has no legal residence or principal place of business in any internal revenue district, the certificate shall be filed with the Director of International Operations, Internal Revenue Service, Washington, DC 20225, or at such other address as is designated in the instructions relating to the certificate. The certificate must be filed within the time prescribed in § 1.1402(e)(2)–1. If an individual to whom paragraph (a) of this section has application submits to a district director of internal revenue a dated and signed statement indicating that he desires to have the Federal old-age, survivors, and disability insurance system established by title II of the Social Security Act extended to his services, such statement will be treated as a waiver certificate, if filed within the time specified in § 1.1402(e)(2)–1, provided that without unnecessary delay such statement is supplemented by a properly executed Form 2031. An application for a social security account number filed on Form SS–5 or the filing of an income tax return showing an amount representing self-employment income or self-employment tax shall not be construed to constitute an election referred to in § 1.1402(e)(1)–1.

§ 1.1402(e)(2)–1 Time limitation for filing waiver certificate.

(a) *General rule.* (1) Any individual referred to in § 1.1402(e)(1)–1 who desires to have the Federal old-age, survivors, and disability insurance system established by title II of the Social Security Act extended to his services must file the waiver certificate (Form 2031) prescribed by § 1.1402(e)(1)–1 on or before whichever of the following dates is later:

(i) The due date of the income tax return (see section 6072), including any extension thereof (see section 6081), for his second taxable year ending after 1963; or

(ii) The due date of the income tax return, including any extension thereof, for his second taxable year ending after 1954 for which he has net earnings from self-employment (computed as prescribed in paragraph (c) of this section) of $400 or more, any part of which:

(a) In the case of a duly ordained, commissioned, or licensed minister of a church, consists of remuneration for service performed in the exercise of his ministry,

(b) In the case of a member of a religious order who has not taken a vow of poverty as a member of such order, consists of remuneration for service performed in the exercise of duties required by such order, or

(c) In the case of a Christian Science practitioner, consists of remuneration for service performed in the exercise of his profession as a Chrsitian Science practitioner.

(2) If a minister, a member of a religious order, or a Christian Science practitioner derives gross income in a taxable year both from service performed in such capacity and from the conduct of another trade or business, and the deductions allowed by chapter 1 of the Internal Revenue Code which are attributable to the gross income derived from service performed in such capacity equal or exceed the gross income derived from service performed in such capacity, no part of the net earnings from self-employment (computed as prescribed in paragraph (c) of this section) for the taxable year shall be considered as derived from service performed in such capacity.

(3) The application of the rules set forth in subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example (1). M was ordained as a minister in May 1963. During each of the taxable years 1963 and 1966, M, who makes his income tax returns on a calendar year basis, derives net earnings in excess of $400 from his activities as a minister. M has net earnings of $350 for each of the taxable years 1964 and 1965, $200 of which is derived from service performed by him as a minister. If M wishes to have the Federal old-age, survivors, and disability insurance system established by title II of the Social Security Act extended to his service as a minister, he must file the waiver certificate on or before the due date of his income tax return for 1966, or any extension thereof.

Example (2). M, who was ordained a minister in January 1965, is employed as a toolmaker by the XYZ Corporation for the taxable years 1965 and 1966 and also engages in activities as a minister on weekends. M makes his income tax return on the basis of a calendar year. During each of the taxable years 1965 and 1966, M receives wages of $4,800 from the XYZ Corporation and derives $400 (all of which constitutes net earnings from self-employment computed as prescribed in paragraph (c) of this section) from his activities as a minister. In such case if M wishes to have the Federal old-age, survivors, and disability insurance system established by title II of the Social Security Act extended to his services as a minister, he must file the waiver certificate on or before the due date of his income tax return for 1966, or any extension thereof. A waiver certificate filed after such date will be invalid. It should be noted that although by reason of section 1402(b)(1)(C) no part of the $400 for the taxable year 1965 represents ‘‘self-employment income’’, nevertheless the entire $400 constitutes ‘‘net earnings from self-employment’’ for purposes of fulfilling the requirements of section 1402(e)(2).

Example (3). M, who files his income tax returns on a calendar year basis, was ordained as a minister in June 1964. During 1964 he receives $410 for services performed in the exercise of his ministry. In addition to his ministerial services, M is engaged during the year 1964 in a mercantile venture from which he derives net earnings from self-employment in the amount of $1,000. The expenses incurred by him in connection with his ministerial services during 1964 and which are allowable deductions under Chapter 1 of the Internal Revenue Code amount to $410. During 1965 and 1966, M has net earnings from self-employment in amounts of $1,200 and $1,500, respectively, and some part of each of these amounts is from the exercise of his ministry. The deductions allowed in each of the years 1965 and 1966 by Chapter 1 which are attributable to the gross income derived by M from the exercise of his ministry in each of such years, respectively, do not equal or exceed such gross income in such year. If M wishes to have the Federal old-age, survivors, and disability insurance system established by Title II of the Social Security Act extended to his service as a minister, he must file a waiver certificate on or before the due date of his income tax return (including any extension thereof) for 1966.

Example (4). M, a licensed minister who makes his income tax returns on the basis of a calendar year, derived net earnings of $400 or more from the exercise of his ministry for two or more of the taxable years 1955 to 1965, inclusive. In such case, if M wishes to have the Federal old-age, survivors, and disability insurance system established by Title II of the Social Security Act extended to his services as a minister, he must file the waiver certificate on or before the due date (April 15, 1966) prescribed for filing his income tax return for 1965, or any extension thereof. A waiver certificate filed after such date will be invalid.

(b) *Effect of death.* Except as provided in §§ 1.1402(e)(5)–1, 1.1402(e) (5)–2, and 1.1402(e)(6)–1, the right of an individual to file a waiver certificate shall cease from his death. Thus, except as provided in such sections, the surviving spouse, administrator, or executor of a decedent shall not be permitted to file a waiver certificate for such decedent.

(c) *Computation of net earnings without regard to election.* For the purpose of this section net earnings from self-employment shall be determined without regard to the fact that, without an election under section 1402(e), the performance of services by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry, or by a member of a religious order in the exercise of duties required by such order, or the performance of service by an individual in the exercise of his profession as a Christian Science practitioner, does not constitute a trade or business for purposes of the tax on self-employment income.

[T.D. 6691, 28 FR 12796, Dec. 3, 1963, as amended by T.D. 6978, 33 FR 15938, Oct. 30, 1968]

§ 1.1402(e)(3)–1 Effective date of waiver certificate.

(a) *Filed before August 31, 1957*—(1) *In general.* A certificate on Form 2031 filed by an individual before August 31, 1957, in accordance with the provisions of section 1402(e) in effect at the time the certificate is filed, shall be effective for the first taxable year with respect to which it is filed, and all subsequent taxable years. In order for a certificate filed by an individual before August 31, 1957, to be effective under section 1402(e), the certificate must be made effective for either the first or second taxable year ending after 1954 in which the individual has net earnings from self-employment of $400 or more (determined as provided in paragraph (c) of § 1.1402(e)(2)–1) some part of which is derived from service of the character with respect to which an election may be made. However, a certificate on Form 2031, filed before August 31, 1957, even though filed within the time specified in paragraph (a)(1)(ii) of § 1.1402(e)(2)–1, may not be effective, except as provided in subparagraph (2) of this paragraph, for any taxable year with respect to which the due date for filing the individual's income tax return (including any extension thereof) has expired at the time such certificate is filed. Further, a certificate on Form 2031 may not be effective for any taxable year ending before 1955. In order for a certificate filed before August 31, 1957, except for the filing of a supplemental certificate, to be effective for the first or second taxable year ending after 1954 in which the individual has net earnings from self-employment (determined as provided in paragraph (c) of § 1.1402(e)(2)–1) some part of which is derived from service of the character with respect to which an election may be made, the certificate on Form 2031 must be filed on or before the due date for filing the income tax return of the individual for such first or second taxable year, respectively, or any extension thereof.

(2) *Supplemental certificates*—(i) *Filed before due date of 1958 return.* If under subparagraph (1) of this paragraph the certificate is effective only for the individual's third or fourth taxable year ending after 1954 and all succeeding taxable years, the individual may make such a certificate effective for his first taxable year ending after 1955 and all succeeding taxable years by filing a supplemental certificate on Form 2031. To be valid the supplemental certificate must be filed after August 30, 1957, and on or before the due date of the return (including any extension thereof) for his second taxable year ending after 1956 and must be otherwise in accordance with § 1.1402(e)(1)–1.

Example. M, who files his income tax returns on a calendar year basis, was ordained as a minister in 1956, and his net earnings from service performed in the exercise of his ministry during such year were $400 or more. M had no net earnings from the exercise of his ministry during 1957. On July 15, 1957, M filed a waiver certificate and indicated thereon that it was to become effective for the taxable year 1958. At the time of filing, the certificate was effective for 1958 and all succeeding taxable years. Since the certificate was not filed on or before April 15, 1957 (the due date of M's income tax return for the taxable year 1956), and since there was no extension of time for filing his 1956 income tax return, the certificate was not, at the time of filing, effective for the taxable year 1956. M files a supplemental certificate on April 15, 1958. By the filing of the supplemental certificate, the certificate filed by M on July 15, 1957, was made effective for the year 1956 and all succeeding taxable years.

(ii) *Filed after September 13, 1960, and on or before April 16, 1962.* If under subparagraph (1) of this paragraph the certificate is effective only for the individual's first taxable year ending after 1956 and all succeeding taxable years, the individual may make such certificate effective for his first taxable year ending after 1955 and all succeeding taxable years by:

(a) Filing a supplemental certificate on Form 2031 after September 13, 1960, and before April 17, 1962;

(b) Paying on or before April 16, 1962, the tax under section 1401 in respect of all the individual's self-employment income (except for underpayments of tax attributable to errors made in good faith) for his first taxable year ending after 1955; and

(c) By repaying on or before April 16, 1962, the amount of any refund (including any interest paid under section 6611) that has been made of any such tax which (but for section 1402(e)(3)(B)) is an overpayment.

Any payment or repayment described in section 1402(e)(3)(B) and in this subparagraph shall not constitute an overpayment within the meaning of section 6401 which relates to amounts treated as overpayments. See section 6401 and the regulations thereunder in part 301 of this chapter (Regulations on Procedure and Administration).

Example. M, who files his income tax returns on a calendar year basis, was ordained as a minister in 1956, and his net earnings from service performed in the exercise of his ministry during each of the years 1956 and 1957 were $400 or more. On July 15, 1957, M filed a waiver certificate which became effective, at the time of filing, for 1957 and all succeeding taxable years. Since the certificate was not filed on or before April 15, 1957 (the due date of M's income tax return for the taxable year 1956), and since there was no extension of time for filing his 1956 income tax return, the certificate was not, at the time of filing, effective for the taxable year 1956. M files a supplemental certificate on April 17, 1961. If, in addition to the filing of the supplemental certificate, M pays on or before April 16, 1962, the self-employment tax in respect of all his self-employment income (except for underpayments of tax attributable to errors made in good faith) for his taxable year 1956, and repays, on or before April 16, 1962, the amount of any refund (including any interest paid under section 6611) that has been made of any such tax which (but for section 1402(e)(3)(B)) is an overpayment, the certificate filed by M on July 15, 1957, becomes effective for the year 1956 and all succeeding taxable years.

(b) *Filed after August 30, 1957, and before the due date of the 1958 return.* A certificate on Form 2031 filed by an individual after August 30, 1957, but on or before the due date of the return (including any extension thereof) for his second taxable year ending after 1956, in accordance with the provisions of section 1402(e) in effect at the time the certificate is filed, shall be effective for his first taxable year ending after 1955, and all subsequent taxable years.

(c) *Filed after due date of 1958 return*—(1) *In general.* Except as otherwise provided in §1.1402(e)(5)–1 (applicable to certificates filed within the period September 14, 1960, to April 16, 1962, inclusive) and in subparagraphs (2) and (3) of this paragraph, a certificate on Form 2031 filed by an individual in accordance with the provisions of §§1.1402(e)(1)–1 and 1.1402(e)(2)–1, inclusive, after the due date of the return (including any extension thereof) for his second taxable year ending after 1956 shall be effective for the taxable year immediately preceding the earliest taxable year for which, at the time the certificate is filed, the period for filing a return (including any extension thereof) has not expired, and for all succeeding taxable years.

Example. M, a duly ordained minister of a church, makes his income tax returns on the basis of a calendar year. M has not been granted an extension of time for filing any return. On April 15, 1963, the due date of his income tax return for 1962, M files a waiver certificate pursuant to §1.1402(e)(1)–1 and within the time limitation set forth in §1.1402(e)(2)–1. On April 15, 1963, the year 1962 is the earliest taxable year for which the period for filing a return has not expired. Consequently, M's certificate is effective for 1961 and all succeeding taxable years. M must report and pay any self-employment tax due for 1961 and 1962. (The tax, if any, for 1962 is due on April 15, 1963.) Inasmuch as the due date of the tax for 1961 is April 16, 1962, M must pay interest on any tax due for 1961. For provisions relating to such interest, see § 301.6601–1 of Part 301 of this chapter (Regulations on Procedure and Administration).

(2) *Filed after October 13, 1964, and on or before the due date of return for second taxable year ending after 1962.* A certificate on Form 2031 filed by an individual in accordance with the provisions of §§ 1.1402(e)(1)–1 and 1.1402(e)(2)–1, inclusive, after October 13, 1964, and on or before the due date of the return (including any extension thereof) for his second taxable year ending after 1962 (April 15, 1965, in the case of a calendar year taxpayer who has not been granted an extension of time for filing his income tax return for 1964) shall be effective for his first taxable year ending after 1961 and all succeeding taxable years.

Example. M, a duly ordained minister of a church, makes his income tax returns on the basis of a calendar year. M has not been granted an extension of time for filing any return. On April 15, 1965, the due date of his income tax return for 1964, M files a waiver certificate pursuant to § 1.1402(e)(1)–1 and within the time limitation set forth in § 1.1402(e)(2)–1. M's certificate is effective for 1962 and all succeeding taxable years, and he must report and pay any self-employment tax due for 1962, 1963, and 1964. (The tax, if any, for 1964 is due on April 15, 1965.) Inasmuch as the due dates of the tax for 1962 and 1963 are April 15, 1963, and April 15, 1964, respectively, M must pay interest on any tax due for 1962 or 1963. For provisions relating to such interest, see § 301.6601–1 of Part 301 of this chapter (Regulations on Procedure and Administration).

(3) *Filed after July 30, 1965, and on or before the due date of return for second taxable year ending after 1963.* A certificate on Form 2031 filed by an individual in accordance with the provisions of §§ 1.1402(e)(1)–1 and 1.1402(e)(2)–1, inclusive, after July 30, 1965, and on or before the due date of the return (including any extension thereof) for his second taxable year ending after 1963 (Apr. 15, 1966, in the case of a calendar year taxpayer who has not been granted an extension of time for filing his income tax return for 1965) shall be effective for his first taxable year ending after 1962 and all succeeding taxable years.

Example. M, a duly ordained minister of a church, makes his income tax returns on the basis of a calendar year. M has not been granted an extension of time for filing any return. On April 15, 1966, the due date of his income tax return for 1965, M files a waiver certificate pursuant to § 1.1402(e)(1)–1 and within the time limitation set forth in § 1.1402(e)(2)–1. M's certificate is effective for 1963 and all succeeding taxable years, and he must report and pay any self-employment tax due for 1963, 1964, and 1965. (The tax, if any, for 1965 is due on April 15, 1966.) Inasmuch as the due dates of the tax for 1963 and 1964 are April 15, 1964, and April 15, 1965, respectively, M must pay interest on any tax due for 1963 or 1964. For provisions relating to such interest, see § 301.6601–1 of Part 301 of this chapter (Regulations on Procedure and Administration).

(d) *Election irrevocable.* An election which has become effective pursuant to this section is irrevocable. A certificate may not be withdrawn after June 30, 1961.

[T.D. 6691, 28 FR 12796, Dec. 3, 1963, as amended by T.D. 6978, 33 FR 15939, Oct. 30, 1968]

§ 1.1402(e)(4)–1 Treatment of certain remuneration paid in 1955 and 1956 as wages.

If in 1955 or 1956 an individual was paid remuneration for service described in section 3121(b)(8)(A) which was erroneously treated by the organization employing him (under a certificate filed by such organization pursuant to section 3121(k) or the corresponding section of prior law) as employment, within the meaning of the Federal Insurance Contributions Act (Chapter 21 of the Internal Revenue Code), and if on or before August 30, 1957, the taxes imposed by sections 3101 and 3111 were paid (in good faith and upon the assumption that the insurance system established by title II of the Social Security Act had been extended to such service) with respect to any part of the remuneration paid to such individual for such service, then the remuneration with respect to which such taxes were paid, and with respect to which no credit or refund of such taxes (other than a credit or refund which would be allowable if such service had constituted employment) has been obtained either by the employer or the employee on or before August 30, 1957, shall be deemed, for purposes of the Self-Employment Contributions Act of

1954 and the Federal Insurance Contributions Act, to constitute remuneration paid for employment and not net earnings from self-employment. For regulations relating to section 3121(b)(8)(A) and (k), see §§31.3121(b)(8)–1 and 31.3121(k)–1 of subpart B of part 31 of this chapter (Employment Tax Regulations).

§1.1402(e)(5)–1 Optional provision for certain certificates filed before April 15, 1962.

(a) *Certificates.* (1) The optional provision contained in section 1402(e)(5)(A) may be applied to a certificate on Form 2031 filed within the period September 14, 1960, to April 16, 1962, inclusive, in the case of a duly ordained, commissioned, or licensed minister of a church, a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order), or a Christian Science practitioner, who has derived net earnings, in any taxable year ending after 1954 and before 1960, from the performance of service in the exercise of his ministry, in the exercise of duties required by his religious order, or in the exercise of his profession as a Christian Science practitioner, respectively, and who has reported such earnings as self-employment income on a return filed before September 14, 1960, and on or before the date prescribed for filing such return (including any extension thereof). The certificate may be filed by such minister, member of a religious order, or Christian Science practitioner or by a fiduciary acting for such individual or his estate, or by his survivor within the meaning of section 205(c)(1)(C) of the Social Security Act, and it must be filed after September 13, 1960, and on or before April 16, 1962. Subject to the conditions stated in subparagraph (2) of this paragraph, such certificate may be effective at the election of the person filing it, for the first taxable year ending after 1954 and before 1960 for which a return, as described in the first sentence of this subparagraph, was filed, and for all succeeding taxable years, rather than for the period prescribed in §1.1402(e)(3)–1. The election for retroactive application of the certificate may be made by indicating on the certificate the first taxable year for which it is to be effective and that such year is the first taxable year ending after 1954 and before 1960 for which the minister, member of a religious order, or Christian Science practitioner filed an income tax return on which he reported net earnings for such year from the exercise of his ministry, the exercise of duties required by his religious order, or the exercise of his profession as a Christian Science practitioner, as the case may be, and by fulfilling the conditions prescribed in subparagraph (2) of this paragraph.

(2) A certificate to which subparagraph (1) of this paragraph relates may be effective for a taxable year prior to the taxable year immediately preceding the earliest taxable year for which, at the time the certificate is filed, the period for filing a return (including any extension thereof) has not expired, only if the following conditions are met:

(i) The tax under section 1401 is paid on or before April 16, 1962, in respect of all self-employment income (whether or not derived from the performance of service by the individual in the exercise of his ministry, in the exercise of duties required by his religious order, or in the exercise of his profession as a Christian Science practitioner, as the case may be) for the first taxable year ending after 1954 and before 1960 for which such individual has filed a return, as described in subparagraph (1) of this paragraph, and for each succeeding taxable year ending before 1960; and

(ii) In any case where refund has been made of any such tax which (but for section 1402(e)(5)) is an overpayment, the amount refunded (including any interest paid under section 6611) is repaid on or before April 16, 1962. For regulations under section 6611 (relating to interest on overpayments), see §301.6611–1 of part 301 of this chapter (Regulations on Procedure and Administration).

(b) *Supplemental certificates.* (1) Subject to the conditions stated in subparagraph (2) of this paragraph, a certificate on Form 2031 filed on or before September 13, 1960, by a minister, member of a religious order, or a Christian Science practitioner described in paragraph (a)(1) of this section and which (but for section 1402(e)(5)(B)) is ineffective for the first taxable year ending after 1954 and before 1959 for which such a return as described in paragraph (a)(1) of this section was filed by such individual, shall be effective for such first taxable year and for all succeeding taxable years, provided a supplemental certificate is filed by such individual or by a fiduciary acting for him or his estate, or by his survivor (within the meaning of section 205(c)(1)(C) of the Social Security Act), after September 13, 1960 and on or before April 16, 1962.

(2) The filing of a supplemental certificate pursuant to subparagraph (1) of this paragraph will give retroactive effect to a certificate to which such subparagraph applies only if the following conditions are met:

(i) The tax under section 1401 is paid on or before April 16, 1962, in respect of all self-employment income (whether or not attributable to earnings as a minister, member of a religious order, or Christian Science practitioner) for the first taxable year for which the certificate is retroactively effective and for each subsequent year ending before 1959; and

(ii) In any case where refund has been made of any such tax which (but for section 1402(d)(5)) is an overpayment, the amount refunded (including any interest paid under section 6611) is repaid on or before April 16, 1962.

(c) *Underpayment of tax.* For purposes of this section, any underpayment of the tax which is attributable to an error made in good faith will not invalidate an election which is otherwise valid.

(d) *Nonapplicability of section 6401.* Any payment or repayment described in paragraph (a)(2) or paragraph (b)(2) of this section shall not constitute an overpayment within the meaning of section 6401 which relates to amounts treated as overpayments. For the provisions of section 6401 and the regulations thereunder, see section 6401 and §301.6401–1 of part 301 of this chapter (Regulations on Procedure and Administration).

§1.1402(e)(5)–2 Optional provisions for certain certificates filed on or before April 17, 1967.

(a) *In general*—(1) *General rule.* Section 1402(e)(5), as amended by the Social Security Amendments of 1965, applies only in the case of a duly ordained, commissioned, or licensed minister of a church, a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order), or a Christian Science practitioner, who has derived net earnings in any taxable year ending after 1954 from the performance of service in the exercise of his ministry, in the exercise of duties required by his religious order, or in the exercise of his profession as a Christian Science practitioner, respectively, and who has reported such earnings as self-employment income on a return filed on or before the date prescribed for filing such return (including any extension thereof).

(2) *Supplemental certificate.* Subject to the conditions stated in subparagraph (4) of this paragraph, a certificate on Form 2031 filed on or before April 15, 1966, by a minister, member of a religious order, or a Christian Science practitioner described in subparagraph (1) of this paragraph and which (but for section 1402(e)(5)(A)) is ineffective for the first taxable year ending after 1954 for which a return described in subparagraph (1) of this paragraph was filed by such individual, shall be effective for such first taxable year and for all succeeding taxable years, provided a supplemental certificate is filed by such individual or by a fiduciary acting for him or his estate, or by his survivor (within the meaning of section 205(c)(1)(C) of the Social Security Act), after July 30, 1965 (the date of enactment of the Social Security Amendments of 1965), and on or before April 17, 1967.

(3) *Certificate filed by survivor.* A survivor (within the meaning of section 205(c)(1)(C) of the Social Security Act) of an individual who:

(i) Died on or before April 15, 1966,

(ii) Was a minister, member of a religious order, or a Christian Science practitioner described in subparagraph (1) of this paragraph,

(iii) Has filed a return as described in subparagraph (1) of this paragraph for a taxable year ending after 1954, and

(iv) Had not filed a valid waiver certificate on Form 2031,

may file a certificate on Form 2031 on behalf of such individual. The certificate must be filed after July 30, 1965 (the date of enactment of the Social Security Amendments of 1965), and on or before April 17, 1967. Subject to the conditions stated in subparagraph (4) of this paragraph, such certificate shall be effective for the first taxable year ending after 1954 for which a return, as described in subparagraph (1) of this paragraph, was filed by such individual and for all succeeding taxable years.

(4) *Applicable conditions.* A supplemental certificate referred to in subparagraph (2) of this paragraph and a certificate referred to in subparagraph (3) of this paragraph shall be effective only if the following conditions are met:

(i) The tax under section 1401 is paid on or before April 17, 1967, in respect of all self-employment income (whether or not attributable to earnings as a minister, member of a religious order, or Christian Science practitioner) for the first taxable year ending after 1954 for which the individual (by or in respect of whom the supplemental certificate or certificate is filed) has filed a return, as described in paragraph (1) of this paragraph, and for each succeeding taxable year ending before January 1, 1966; and

(ii) In any case where refund has been made of any such tax which (but for section 1402(e)(5)) is an overpayment, the amount refunded (including any interest paid under section 6611) is repaid on or before April 17, 1967. For regulations under section 6611 (relating to interest on overpayments), see § 301.6611–1 of part 301 of this chapter (Regulations on Procedure and Administration).

(b) *Underpayment of tax.* For purposes of this section, any underpayment of the tax which is attributable to an error made in good faith will not invalidate an election which is otherwise valid.

(c) *Nonapplicability of section 6401.* Any payment or repayment described in paragraph (a)(4) of this section shall not constitute an overpayment within the meaning of section 6401 which relates to amounts treated as overpayments. For the provisions of section 6401 and the regulations thereunder, see section 6401 and § 301.6401–1 of part 301 of this chapter (Regulations on Procedure and Administration).

(d) *Applicability of §§ 1.1402(e) (5)–1 and 1.1402(e)(6)–1.* The provisions of section 1402(e) (5) and (6) (in effect prior to July 30, 1965, the date of enactment of the Social Security Amendments of 1965) and §§ 1.1402(e) (5)–1 and 1.1402(e)(6)–1 shall apply with respect to any certificate filed pursuant to such sections if a supplemental certificate is not filed with respect to such certificate as provided in this section.

[T.D. 6978, 33 FR 15939, Oct. 30, 1968]

§ 1.1402(e)(6)–1 Certificates filed by fiduciaries or survivors on or before April 15, 1962.

In any case in which an individual whose death has occurred after September 12, 1960, and before April 16, 1962, derived earnings from the performance of services as a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry, as a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) in the exercise of duties required by such order, or in the exercise of his profession as a Christian Science practitioner, a waiver certificate on Form 2031 may be filed after June 30, 1961 (the date of enactment of the Social Security Amendments of 1961), and on or before April 16, 1962, by a fiduciary acting for such individual's estate or by such individual's survivor within the meaning of section 205(c)(1)(C) of the Social Security Act. Such certificates shall be effective for the period prescribed in section 1402(e)(3)(A) (see § 1.1402(e)(3)–1(c)) as if filed by the individual on the date of his death.

§ 1.1402(f)–1 Computation of partner's net earnings from self-employment for taxable year which ends as result of his death.

(a) *Taxable years ending after August 28, 1958*—(1) *In general.* The rules for the computation of a partner's net earnings from self-employment are set forth in paragraphs (d) to (g), inclusive, of § 1.1402(a)–2. In addition to the net earnings from self-employment computed under such rules for the last taxable year of a deceased partner, if a partner's taxable year ends after August 28, 1958, solely because of death, and on a day other than the last day of the partnership's taxable year, the deceased partner's net earnings from self-employment for such year shall also include so much of the deceased partner's distributive share of partnership ordinary income or loss (see subparagraph (3) of this paragraph) for the taxable year of the partnership in which his death occurs as is attributable to an interest in the partnership prior to the month following the month of his death.

(2) *Computation.* (i) The deceased partner's distributive share of partnership ordinary income or loss for the partnership taxable year in which he died shall be determined by applying the rules contained in paragraphs (d) to (g), inclusive, of § 1.1402(a)–2, except that paragraph (e) shall not apply.

(ii) The portion of such distributive share to be included under this section in the deceased partner's net earnings from self-employment for his last taxable year shall be determined by treating the ordinary income or loss constituting such distributive share as having been realized or sustained ratably over the period of the partnership taxable year during which the deceased partner had an interest in the partnership and during which his estate, or any other person succeeding by reason of his death to rights with respect to his partnership interest, held such interest in the partnership or held a right with respect to such interest. The amount to be included under this section in the deceased partner's net earnings from self-employment for his last taxable year will, therefore, be determined by multiplying the deceased partner's distributive share of partnership ordinary income or loss for the partnership taxable year in which he died, as determined under subdivision (i) of this subparagraph, by a fraction, the denominator of which is the number of calendar months in the partnership taxable year over which the ordinary income or loss constituting the deceased partner's distributive share of partnership income or loss for such year is treated as having been realized or sustained under the preceding sentence and the numerator of which is the number of calendar months in such partnership taxable year that precede the month following the month of his death.

(3) *Definition of ''deceased partner's distributive share''.* For the purpose of this section, the term ''deceased partner's distributive share'' includes the distributive share of his estate or of any other person succeeding, by reason of his death, to rights with respect to his partnership interest. It does not include any share attributable to a partnership interest which was not held by the deceased partner at the time of his death. Thus, if a deceased partner's estate should acquire an interest in a partnership additional to the interest to which it succeeded upon the death of the deceased partner, the amount of the distributive share attributable to such additional interest acquired by the estate would not be included in computing the ''deceased partner's distributive share'' of the partnership's ordinary income or loss for the partnership taxable year.

(4) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). B, an individual who files his income tax returns on the calendar year basis, is a member of the ABC partnership, the taxable year of which ends on June 30. B dies on October 17, 1958, and his estate succeeds to his partnership interest and continues as a partner in its own right under local law until June 30, 1959. B's distributive share of the partnership's ordinary income, as determined under paragraphs (d) to (g), inclusive, of § 1.1402(a)–2, for the taxable year of the partnership ended June 30, 1958 is $2,400. His distributive share, including the share of his estate, of such partnership's ordinary income, as determined under paragraphs (d) to (g), inclusive, of § 1.1402(a)–2 (with the exception of paragraph (e)), for the taxable year of the partnership ended June 30, 1959 is $4,500. The portion of such $4,500 attributable to an interest in the partnership prior to the month following the month in which he died is $4,500×4/12 (4 being the number of months in the partnership taxable year in which B died which precede the month following the month of his death and 12 being the number of months in such partnership taxable year in which B and his estate had an interest in the partnership) or $1,500. The amount to be included in the deceased partner's net earnings from self-employment for his last taxable year is $3,900 ($2,400 plus $1,500).

Example (2). If in the preceding example B's estate is entitled to only $1,000, the amount of B's distributive share of partnership ordinary income for the period July 1, 1958 through October 17, 1958, such $1,000 is considered to have been realized ratably over the period preceding B's death and will be included in B's net earnings from self-employment for his last taxable year.

Example (3). X, who reports his income on a calendar year basis, is a member of a partnership which also reports its income on a calendar year basis. X dies on June 30, 1959, and his estate succeeds to his partnership interest and continues as a partner in its own right under local law. On September 15, 1959, X's estate sells the partnership interest to which it succeeded on the death of X. X's distributive share of partnership income for 1959 is $5,500. $600 of such amount is X's share of the gain from the sale of a capital asset which occurs on May 1, 1959, and $400 of such amount is the estate's share of the gain from the sale of a capital asset which occurs on July 15, 1959. The remainder of such amount is income from services rendered. X's distributive share of partnership ordinary income for 1959, as determined under paragraphs (d) to (g), inclusive, of §1.1402(a)–2 (with the exception of paragraph (e)), is $4,500 ($5,500 minus $1,000). The portion of such share attributable to an interest in the partnership prior to the month following the month of his death is $4,500×6/8.5 (6 being the number of months in the partnership taxable year in which X died as precede the month following the month of his death and 8.5 being the number of months in such partnership taxable year in which X and his estate had an interest in the partnership) or $3,176.47.

(b) *Options available to farmers*—(1) *Special rule.* In determining whether the optional method available to a member of a farm partnership in computing his net earnings from self-employment may be applied, and in applying such method, it is necessary to determine the partner's distributive share of partnership gross income and the partner's distributive share of income described in section 702(a)(9). See section 1402(a) and §1.1402(a)–15. If section 1402(f) and this section apply, or may be made applicable under section 403(b)(2) of the Social Security Amendments of 1958 and paragraph (c) of this section, for the last taxable year of a deceased partner, such partner's distributive share of income described in section 702(a)(9) for his last taxable year shall be determined by including therein any amount which is included under section 1402(f) and this section in his net earnings from self-employment for such taxable year. Such a partner's distributive share of partnership gross income for his last taxable year shall be determined by including therein so much of the deceased partner's distributive share (see paragraph (a)(3) of this section) of partnership gross income, as defined in section 1402(a) and paragraph (b) of §1.1402(a)–15, for the partnership taxable year in which he died as is attributable to an interest in the partnership prior to the month following the month of his death. Such allocation shall be made in the same manner as is prescribed in paragraph (a)(2) of this section for determining the portion of a deceased partner's distributive share of partnership ordinary income or loss to be included under section 1402(f) and this section in his net earnings from self-employment for his last taxable year.

(2) *Examples.* The principles set forth in this paragraph may be illustrated by the following examples:

Example (1). X, an individual who files his income tax returns on a calendar year basis, is a member of the XYZ farm partnership, the taxable year of which ends on March 31. X dies on May 31, 1967, and his estate succeeds to his partnership interest and continues as a partner in its own right under local law until March 31, 1968. X's distributive share of the partnership's ordinary income, determined under paragraphs (d) to (g), inclusive, of §1.1402(a)–2, for the taxable year of the partnership ended March 31, 1967, is $1,600. His distributive share, including the share of his estate, of such partnership's ordinary loss as determined under paragraphs (d) to (g), inclusive, of §1.1402(a)–2 (with the exception of paragraph (e)), for the taxable year of the partnership ended March 31, 1968, is $1,200. The portion of such $1,200 attributable to an interest in the partnership prior to the month following the month in which he died is $1,200×2/12 (2 being the number of months in the partnership taxable year in which X died which precede the month following the month of his death and 12 being the number of months in such partnership taxable year in which X and his estate had an interest in the partnership) or $200. X is also a member of the ABX farm partnership, the taxable year of which ends on May 31. His distributive share of the partnership loss described in section 702(a)(9) for the partnership taxable year ending May 31, 1967, is $300. Section 1402(f) and this section do not apply with respect to such $300 since X's last taxable year ends, as a result of his death, with the taxable year of the ABX partnership. Under this paragraph the $200 loss must be included in determining X's distributive share of XYZ partnership income described in section 702(a)(9) for the purpose of applying the optional method available to farmers for computing net earnings from self-employment. Further, the resulting $1,400 of income must be aggregated, pursuant to paragraph (c) of § 1.1402(a)–15, with the $300 loss, X's distributive share of ABX partnership loss described in section 702(a)(9), for purposes of applying such option. The representative of X's estate may exercise the option described in paragraph (a)(2)(ii) of § 1.1402(a)–15, provided the portion of X's distributive share of XYZ partnership gross income for the taxable year ended March 31, 1968, attributable to an interest in the partnership prior to the month following the month in which he died (the allocation being made in the manner prescribed for allocating his $1,200 distributive share of XYZ partnership loss for such year), when aggregated with his distributive share of XYZ partnership gross income for the partnership taxable year ended March 31, 1967, and with his distributive share of ABX partnership gross income for the partnership taxable year ended May 31, 1967, results in X having more than $2,400 of gross income from the trade or business of farming. If such aggregate amount of gross income is not more than $2,400, the option described in paragraph (a)(2)(i) of § 1.1402(a)–15, is available.

Example (2). A, a sole proprietor engaged in the business of farming, files his income tax returns on a calendar year basis. A is also a member of a partnership engaged in an agricultural activity. The partnership files its returns on the basis of a fiscal year ending March 31. A dies June 29, 1967. A's gross income from farming as a sole proprietor for the 6-month period comprising his taxable year which ends because of death is $1,600 and his actual net earnings from self-employment based thereon are $400. As of March 31, 1967, A's distributive share of the gross income of the farm partnership is $2,200 and his distributive share of income described in section 702(a)(9) based thereon is $1,000. The amount of A's distributive share of the partnership's ordinary income for its taxable year ended March 31, 1968, which may be included in his net earnings from self-employment under section 1402(f) and paragraph (a) of this section is $300. The amount of the deceased partner's distributive share of partnership gross income attributable to an interest in the partnership prior to the month following the month of his death as is determined, pursuant to subparagraph (1) of this paragraph, under paragraph (a) of this section is $2,000. An aggregation of the above figures produces a gross income from farming of $5,800 and actual net earnings from self-employment of $1,700. Under these circumstances none of the options provided by section 1402(a) may be used. If the actual net earnings from self-employment had been less than $1,600, the option described in paragraph (a)(2)(ii) of § 1.1402(a)–15 would have been available.

(c) *Taxable years ending after 1955 and on or before August 28, 1958*—(1) *Requirement of election.* If a partner's taxable year ended, as a result of his death, after 1955 and on or before August 28, 1958, the rules set forth in paragraph (a) of this section may be made applicable in computing the deceased partner's net earnings from self-employment for his last taxable year provided that:

(i) Before January 1, 1960, there is filed, by the person designated in section 6012(b)(1) and paragraph (b)(1) of § 1.6012–3, a return (or amended return) of the tax imposed by chapter 2 for the taxable year ending as a result of death, and

(ii) Such return, if filed solely for the purpose of reporting net earnings from self-employment resulting from the enactment of section 1402(f), is accompanied by the amount of tax attributable to such net earnings.

(2) *Administrative rule of special application.* Notwithstanding the provisions of sections 6601, 6651, and 6653 (see such sections and the regulations thereunder) no interest or penalty shall be assessed or collected on the amount of any self-employment tax due solely by reason of the operation of section 1402(f) in the case of an individual who died after 1955 and before August 29, 1958.

[T.D. 6691, 28 FR 12796, Dec. 3, 1963, as amended by T.D. 6993, 34 FR 830, Jan. 18, 1969]

§ 1.1402(g)–1 Treatment of certain remuneration erroneously reported as net earnings from self-employment.

(a) *General rule.* If an amount is erroneously paid as self-employment tax, for any taxable year ending after 1954 and before 1962, with respect to remuneration for service (other than service described in section 3121(b)(8)(A)) performed in the employ of an organization described in section 501(c)(3) and exempt from income tax under section 501(a), and if such remuneration is reported as self-employment income on a return filed on or before the due date prescribed for filing such return (including any extension thereof), the individual who paid such amount (or a fiduciary acting for such individual or his estate, or his survivor (within the meaning of section 205(c)(1)(C) of the Social Security Act)), may request that such remuneration be deemed to constitute net earnings from self-employment. If such request is filed during the period September 14, 1960, to April 16, 1962, inclusive, and on or after the date on which the organization which paid such remuneration to such individual for services performed in its employ has filed, pursuant to section 3121(k), a certificate waiving exemption from taxes under the Federal Insurance Contributions Act, and if no credit or refund of any portion of the amount erroneously paid for such taxable year as self-employment tax (other than a credit or refund which would be allowable if such tax were applicable with respect to such remuneration) has been obtained before the date on which such request is filed or, if obtained, the amount credited or refunded (including any interest under section 6611) is repaid on or before such date, then, for purposes of the Self-Employment Contributions Act of 1954 and the Federal Insurance Contributions Act, any amount of such remuneration which is paid to such individual before the calendar quarter in which such request is filed (or before the succeeding quarter if such certificate first becomes effective with respect to services performed by such individual in such succeeding quarter) and with respect to which no tax (other than an amount erroneously paid as tax) has been paid under the Federal Insurance Contributions Act, shall be deemed to constitute net earnings from self-employment and not remuneration for employment. If the certificate filed by such organization pursuant to section 3121(k) is not effective with respect to services performed by such individual on or before the first day of the calendar quarter in which the request is filed, then, for purposes of section 3121(b)(8)(B) (ii) and (iii), such individual shall be deemed to have become an employee of such organization (or to have become a member of a group, described in section 3121(k)(1)(E), of employees of such organization) on the first day of the succeeding quarter.

(b) *Request for validation.* (1) No particular form is prescribed for making a request under paragraph (a) of this section. The request should be in writing, should be signed and dated by the person making the request, and should indicate clearly that it is a request that, pursuant to section 1402(g) of the Code, remuneration for service described in section 3121(b)(8) (other than service described in section 3121(b)(8)(A)) erroneously reported as self-employment income for one or more specified years be deemed to constitute net earnings from self-employment and not remuneration for employment. In addition, the following information shall be shown in connection with the request:

(i) The name, address, and social security account number of the individual with respect to whose remuneration the request is made.

(ii) The taxable year or years (ending after 1954 and before 1962) to which the request relates.

(iii) A statement that the remuneration was erroneously reported as self-employment income on the individual’s return for each year specified and that the return was filed on or before its due date (including any extension thereof).

(iv) Location of the office of the district director with whom each return was filed.

(v) A statement that no portion of the amount erroneously paid by the individual as self-employment tax with respect to the remuneration has been credited or refunded (other than a credit or refund which would have been allowable if the tax had been applicable with respect to the remuneration); or, if a credit or refund of any portion of such amount has been obtained, a statement identifying the credit or refund and showing how and when the amount credited or refunded, together with any interest received in connection therewith, was repaid.

(vi) The name and address of the organization which paid the remuneration to the individual.

(vii) The date on which the organization filed a waiver certificate on Form SS–15, and the location of the office of the district director with whom it was filed.

(viii) The date on which the certificate became effective with respect to services performed by the individual.

(ix) If the request is made by a person other than the individual to whom the remuneration was paid, the name and address of that person and evidence which shows the authority of such person to make the request.

(2) The request should be filed with the district director of internal revenue with whom the latest of the returns specified in the request pursuant to subparagraph (1)(iii) of this paragraph was filed.

(c) *Cross references.* For regulations relating to section 3121 (b)(8) and (k), see §§ 31.3121(b)(8)–2 and 31.3121(k)–1 of subpart B of part 31 of this chapter (Employment Tax Regulations). For regulations relating to exemption from income tax of an organization described in section 501(c)(3), see § 1.501(c)(3)–1.

§ 1.1402(h)–1 Members of certain religious groups opposed to insurance.

(a) *In general.* An individual—(1) Who is a member of a recognized religious sect or division thereof and,

(2) Who is an adherent of established tenets or teachings of such sect or division and by reason thereof is conscientiously opposed to acceptance of the benefits of any private or public insurance which makes payments in the event of death, disability, old age, or retirement or makes payments toward the cost of, or provides services for, medical care (including the benefits of any insurance system established by the Social Security Act),

may file an application for exemption from the tax under section 1401. The form of insurance to which section 1402(h) and this section refer does not include liability insurance of a kind that provides only for the protection of other persons, or property of other persons, who may be injured or damaged by or on property belonging to, or by an action of, an individual who otherwise meets the requirements of this section. An application for exemption under section 1402(h) and this section shall be made in the manner provided in paragraph (b) of this section and within the time specified in paragraph (c) of this section. For provisions relating to the filing of an application for exemption by a fiduciary or survivor, see paragraph (d) of this section.

(b) *Application for exemption.* The application for exemption shall be filed on Form 4029 in duplicate with the internal revenue official or office designated on the form. The filing of a return by a member of a religious group opposed to insurance showing no self-employment income or self-employment tax shall not be construed as an application for exemption referred to in paragraph (a) of this section.

(c) *Time limitation for filing application for exemption*—(1) *Taxable years ending before December 31, 1967.* A member of a religious group opposed to insurance within the meaning of paragraph (a) of this section:

(i) Who has self-employment income (determined without regard to subsections (c)(6) and (h) of section 1402 and this section) for one or more taxable years ending before December 31, 1967, and

(ii) Who desires to be exempt from the payment of the self-employment tax under section 1401,

must file the application for exemption on or before December 31, 1968.

(2) *Taxable year ending on or after December 31, 1967*—(i) *General rule.* Except as provided in subdivision (ii) of this subparagraph, a member of a religious group opposed to insurance within the meaning of paragraph (a) of this section:

(a) Who has no self-employment income (determined without regard to subsections (c)(6) and (h) of section 1402 and this section) for any taxable year ending before December 31, 1967, and

(b) Who desires to be exempt from the payment of the self-employment tax under section 1401 for any taxable year ending on or after December 31, 1967,

must file the application for exemption on or before the due date of the income tax return (see section 6072), including any extension thereof (see section 6081), for the first taxable year ending on or after December 31, 1967, for which he has self-employment income (determined without regard to subsections (c)(6) and (h) of section 1402 and this section.

(ii) *Exception to general rule.* If an individual to whom subdivision (i) of this subparagraph applies:

(a) Is notified in writing by a district director of internal revenue or the Director of International Operations that he has not filed the application for exemption on or before the date specified in such subdivision (i), and

(b) Files the application for exemption on or before the last day of the third calendar month following the calendar month in which he is so notified,

such application shall be considered a timely filed application for exemption.

(d) *Application by fiduciary or survivor.* If an individual who was a member of a religious group opposed to insurance dies before the expiration of the time prescribed in section 1402(h)(2) and paragraph (c) of this section during which an application could have been filed by him, an application for exemption with respect to such deceased individual may be filed by a fiduciary acting for such individual's estate or by such individual's survivor within the meaning of section 205(c)(1)(C) of the Social Security Act. An application for exemption with respect to a deceased individual executed by a fiduciary or survivor may be approved only if it could have been approved if the individual were not deceased and had filed the application on the date the application was filed by the fiduciary or executor.

(e) *Approval of application for exemption*—(1) *In general.* The filing of an application for exemption on Form 4029 by a member of a religious group opposed to insurance does not constitute an exemption from the payment of the tax on self-employment income. An individual who files such an application is exempt from the payment of the tax only if the application is approved by the official with whom the application is required to be filed (see paragraph (b) of this section).

(2) *Conditions relating to approval or disapproval of application.* An application for exemption on Form 4029 will not be approved unless the Secretary of Health, Education, and Welfare finds with respect to the religious sect or division thereof of which the individual filing the application is a member:

(i) That the sect or division thereof has the established tenets or teachings by reason of which the individual applicant is conscientiously opposed to the benefits of insurance of the type referred to in section 1402(h) (see paragraph (a) of this section),

(ii) That it is the practice, and has been for a period of time which the Secretary of Health, Education, and Welfare deems to be substantial, for members of such sect or division thereof to make provisions for their dependent members which, in the judgment of such Secretary, is reasonable in view of the general level of living of the members of the sect or division thereof; and

(iii) That the sect or division thereof has been in existence continuously since December 31, 1950.

In addition, an application for exemption on Form 4029 will not be approved if any benefit or other payment under title II of title XVIII of the Social Security Act became payable (or, but for section 203, relating to reduction of insurance benefits, or 222(b), relating to reduction of insurance benefits on account of refusal to accept rehabilitation services, of the Social Security Act would have been payable) at or before the time of the filing of the application for exemption. Any determination required to be made pursuant to the preceding sentence will be made by the Secretary of Health, Education, and Welfare.

(f) *Period for which exemption is effective*—(1) *General rule.* An application for exemption shall be in effect (if approved as provided in paragraph (e) of this section) for all taxable years beginning after December 31, 1950, except as otherwise provided in subparagraph (2) of this paragraph.

(2) *Exceptions.* An application for exemption referred to in subparagraph (1) of this paragraph shall not be effective for any taxable year which:

(i) Begins *(a)* before the taxable year in which the individual filing the application first met the requirements of subparagraphs (1) and (2) of paragraph (a) of this section, or *(b)* before the time as of which the Secretary of Health, Education, and Welfare finds that the sect or division thereof of which the individual is a member met the requirements of subparagraphs (C) and (D) of section 1402(h)(1) (see subdivisions (i) and (ii) of paragraph (e)(2) of this section), or

(ii) Ends *(a)* after the time at which the individual filing the application ceases to meet the requirements of subparagraphs (1) and (2) of paragraph (a) of this section, or *(b)* after the time as of which the Secretary of Health, Education, and Welfare finds that the sect or division thereof of which the individual is a member ceases to meet the requirements of subparagraphs (C) and (D) of section 1402(h)(1) (see subdivisions (i) and (ii) of paragraph (e)(2) of this section).

(g) *Refund or credit.* An application for exemption on Form 4029 filed on or before December 31, 1968 (if approved as provided in paragraph (e) of this section), shall constitute a claim for refund or credit of any tax on self-employment income under section 1401 (or under section 480 of the Internal Revenue Code of 1939) paid or incurred in respect of any taxable year beginning after December 31, 1950, and ending before December 31, 1967, for which an exemption is granted. Refund or credit of any tax referred to in the preceding sentence may be made, pursuant to the provisions of section 501(c) of the Social Security Amendments of 1967 (81 Stat. 933), notwithstanding that the refund or credit would otherwise be prevented by operation of any law or rule of law. No interest shall be allowed or paid in respect of any refund or credit made or allowed in connection with a claim for refund or credit made on Form 4029.

[T.D. 6993, 34 FR 831, Jan. 18, 1969]

§1.1403–1 Cross references.

For provisions relating to the requirement for filing returns with respect to net earnings from self-employment, see §1.6017–1. For provisions relating to declarations of estimated tax on self-employment income, see §§1.6015(a) to 1.6015(j)–1, inclusive. For other administrative provisions relating to the tax on self-employment income, see the applicable sections of the regulations in this part (§1.6001–1 *et seq.*) and the applicable sections of the regulations in part 301 of this chapter (Regulations on Procedure and Administration).

[T.D. 7427, 41 FR 34026, Aug. 12, 1976]

Withholding of Tax on Nonresident Aliens and Foreign Corporations and Tax-Free Covenant Bonds

NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

§1.1441–0 Outline of regulation provisions for section 1441.

This section lists captions contained in §§1.1441–1 through 1.1441–9.

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(C) Withholding certificate for effectively connected income.
(D) Change in circumstances.
(iii) Retention of withholding certificate.
(iv) Electronic transmission of information.
(v) Electronic confirmation of taxpayer identifying number on withholding certificate.
(vi) Acceptable substitute form.
(vii) Requirement of taxpayer identifying number.
(viii) Reliance rules.
(A) Classification.
(B) Status of payee as an intermediary or as a person acting for its own account.
(ix) Certificates to be furnished for each account unless exception applies.

(A) Coordinated account information system in effect.
(B) Family of mutual funds.
(C) Special rule for brokers.
(5) Qualified intermediaries.
(i) General rule.
(ii) Definition of qualified intermediary.
(iii) Withholding agreement.
(A) In general.
(B) Terms of the withholding agreement.
(iv) Assignment of primary withholding responsibility.
(v) Information to withholding agent regarding applicable withholding rates.
(A) General rule.
(B) Categories of assets.
(C) Updating the information.
(f) Effective date.
(1) In general.
(2) Transition rules.
(i) Special rules for existing documentation.
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§ 1.1441–2 Amounts subject to withholding.

(a) In general.
(b) Fixed or determinable annual or periodical income.
(1) In general.
(i) Definition.
(ii) Manner of payment.
(iii) Determinability of amount.
(2) Exceptions.
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(i) General rule.
(ii) Amounts actually known to the withholding agent.
(iii) Amounts for which certain documentation is not furnished.
(iv) Exceptions to withholding.
(4) Securities lending transactions and equivalent transactions.
(c) Other income subject to withholding.
(d) Exceptions to withholding where no money or property is paid or lack of knowledge.
(1) General rule.
(2) Cancellation of debt.
(3) Satisfaction of liability following underwithholding by withholding agent.
(e) Payment.
(1) General rule.
(2) Income allocated under section 482.
(3) Blocked income.
(4) Special rules for dividends.
(5) Certain interest accrued by a foreign corporation.
(6) Payments other than in U.S. dollars.
(f) Effective date.

§ 1.1441–3 Determination of amounts to be withheld.

(a) Withholding on gross amount.
(b) Withholding on payments on certain obligations.
(1) Withholding at time of payment of interest.
(2) No withholding between interest payment dates.
(i) In general.
(ii) Anti-abuse rule.
(c) Corporate distributions.
(1) General rule.
(2) Exception to withholding on distributions.
(i) In general.
(ii) Reasonable estimate of accumulated and current earnings and profits on the date of payment.
(A) General rule.
(B) Procedures in case of underwithholding.
(C) Reliance by intermediary on reasonable estimate.
(D) Example.
(3) Special rules in the case of distributions from a regulated investment company.
(i) General rule
(ii) Reliance by intermediary on reasonable estimate.
(4) Coordination with withholding under section 1445.
(i) In general.
(A) Withholding under section 1441.
(B) Withholding under both sections 1441 and 1445.
(C) Coordination with REIT withholding.
(ii) Intermediary reliance rule.
(d) Withholding on payments that include an undetermined amount of income.
(1) In general.
(2) Withholding on certain gains.
(e) Payments other than in U.S. dollars.
(1) In general.
(2) Payments in foreign currency.
(f) Tax liability of beneficial owner satisfied by withholding agent.
(1) General rule.
(2) Example.
(g) Conduit financing arrangements
(h) Effective date.

§ 1.1441–4 Exemptions from withholding for certain effectively connected income and other amounts.

(a) Certain income connected with a U.S. trade or business.
(1) In general.
(2) Withholding agent's reliance on a claim of effectively connected income.
(i) In general.
(ii) Special rules for U.S. branches of foreign persons.
(A) U.S. branches of certain foreign banks or foreign insurance companies.
(B) Other U.S. branches.
(3) Income on notional principal contracts.
(i) General rule.
(ii) Exception for certain payments.
(b) Compensation for personal services of an individual.
(1) Exemption from withholding.
(2) Manner of obtaining withholding exemption under tax treaty.
(i) In general.

(ii) Withholding certificate claiming withholding exemption.
(iii) Review by withholding agent.
(iv) Acceptance by withholding agent.
(v) Copies of Form 8233.
(3) Withholding agreements.
(4) Final payments exemption.
(i) General rule.
(ii) Final payment of compensation for personal services.
(iii) Manner of applying for final payment exemption.
(iv) Letter to withholding agent.
(5) Requirement of return.
(6) Personal exemption.
(i) In general.
(ii) Multiple exemptions.
(iii) Special rule where both certain scholarship and compensation income are received.
(c) Special rules for scholarship and fellowship income.
(1) In general.
(2) Alternate withholding election.
(d) Annuities received under qualified plans.
(e) Per diem of certain alien trainees.
(f) Failure to receive withholding certificates timely or to act in accordance with applicable presumptions.
(g) Effective date.
(1) General rule.
(2) Transition rules.

§1.1441–5 Withholding on payments to partnerships, trusts, and estates.

(a) Rules of withholding applicable to payments to partnerships.
(b) Domestic partnerships.
(1) Exemption from withholding on payment to domestic partnerships.
(2) Withholding by a domestic partnership.
(i) In general.
(ii) Determination by the domestic partnership of partners' status.
(iii) Reliance on a partner's claim for reduced withholding.
(iv) Rules for reliably associating a payment with documentation.
(v) Coordination with chapter 61 of the Internal Revenue Code and section 3406.
(c) Foreign partnerships.
(1) Determination of payee.
(i) Payments treated as made to partners.
(ii) Payments treated as made to the partnership.
(iii) Rules for reliably associating a payment with documentation.
(iv) Example.
(2) Withholding foreign partnerships.
(i) Reliance on claim of withholding foreign partnership status.
(ii) Withholding agreement.
(A) In general.
(B) Terms of withholding agreement.
(iii) Withholding responsibility.
(iv) Withholding certificate from a withholding foreign partnership.
(3) Other foreign partnerships.
(i) Reliance on claim of foreign partnership status.
(ii) Reliance on claim of reduced withholding by a partnership for its partners.
(iii) Withholding certificate from a foreign partnership that is not a withholding foreign partnership.
(iv) Information to withholding agent regarding each partner's distributive share.
(v) Withholding by a foreign partnership.
(d) Presumptions regarding payee's status in the absence of documentation.
(1) In general.
(2) Determination of partnership's status as domestic or foreign in the absence of documentation.
(3) Determination of partners' status in the absence of certain documentation.
(i) Documentation regarding the status of a partner is lacking or unreliable.
(ii) Information regarding the allocation of payment is lacking or unreliable.
(iii) Certification that the foreign partnership has furnished documentation for all of the persons to whom the intermediary certificate relates is lacking or unreliable.
(iv) Determination by a withholding foreign partnership of the status of its partners.
(4) Examples.
(e) Trusts and estates. [Reserved]
(f) Failure to receive withholding certificate timely or to act in accordance with applicable presumptions.
(g) Effective date.
(1) General rule.
(2) Transition rules.

§1.1441–6 Claim of reduced withholding under an income tax treaty.

(a) In general.
(b) Reliance on claim of reduced withholding under an income tax treaty.
(1) In general.
(2) Exemption from requirement to furnish a taxpayer identifying number and special documentary evidence rules for certain income.
(i) General rule.
(ii) Income to which special rules apply.
(3) Competent authority agreements.
(4) Eligibility for reduced withholding under an income tax treaty in the case of a payment to a person other than an individual.
(i) General rule.
(ii) Withholding certificates.
(A) In general.
(B) Certification by qualified intermediary.
(iii) Multiple claims of treaty benefits.
(iv) Examples.
(5) Claim of benefits under an income tax treaty by a U.S. person.
(c) Proof of tax residence in a treaty country and certification of entitlement to treaty benefits. (1) In general.

(2) Certification of taxpayer identifying number.
(i) In general.
(ii) IRS-certified TIN.
(iii) Special rules for qualified intermediaries.
(3) Certificate of residence.
(4) Documentary evidence establishing residence in the treaty country.
(i) Individuals.
(ii) Persons other than individuals.
(5) Certifications regarding entitlement to treaty benefits.
(i) Certification regarding conditions under a Limitation on Benefits Article.
(ii) Certification regarding whether the taxpayer is deriving the income.
(d) Joint owners.
(e) Related party dividends under U.S.-Denmark income tax treaty.
(f) Failure to receive withholding certificate timely.
(g) Effective date.
(1) General rule.
(2) Transition rules.

§ 1.1441–7 General provisions relating to withholding agents.

(a) Withholding agent defined.
(b) Standards of knowledge.
(1) In general.
(2) Reason to know.
(i) In general.
(ii) Limits on reason to know in certain cases.
(3) Coordinated account information systems.
(c) Authorized agent.
(1) In general.
(2) Authorized foreign agent.
(3) Notification.
(4) Liability of U.S. withholding agent.
(5) Filing of returns.
(d) United States obligations.
(e) Assumed obligations.
(f) Conduit financing arrangements.
(g) Effective date.

§ 1.1441–8 Exemption from withholding for payments to foreign governments, international organizations, foreign central banks of issue, and the Bank for International Settlements.

(a) Foreign governments.
(b) Reliance on claim of exemption by foreign government.
(c) Income of a foreign central bank of issue or the Bank for International
Settlements.
(1) Certain interest income.
(2) Bankers' acceptances.
(d) Exemption for payments to international organizations.
(e) Failure to receive withholding certificate timely and other applicable procedures.
(f) Effective date.
(1) In general.
(2) Transition rules.

§ 1.1441–9 Exemption from withholding on exempt income of a foreign tax-exempt organization, including foreign private foundations.

(a) Exemption from withholding for exempt income.
(b) Reliance on foreign organization's claim of exemption from withholding.
(1) General rule.
(2) Withholding certificate.
(3) Presumptions in the absence of documentation.
(4) Reason to know.
(c) Failure to receive withholding certificate timely and other applicable procedures.
(d) Effective date.
(1) In general.
(2) Transition rules.

[T.D. 8734, 62 FR 53421, Oct. 14, 1997]

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§ 1.1441–1 Requirement for the deduction and withholding of tax on payments to foreign persons.

(a) *Purpose and scope.* This section, §§ 1.1441–2 through 1.1441–9, and 1.1443–1 provide rules for withholding under sections 1441, 1442, and 1443 when a payment is made to a foreign person. This section provides definitions of terms used in chapter 3 of the Internal Revenue Code (Code) and regulations thereunder. It prescribes procedures to determine whether an amount must be withheld under chapter 3 of the Code and documentation that a withholding agent may rely upon to determine the status of a payee or a beneficial owner as a U.S. person or as a foreign person and other relevant characteristics of the payee that may affect a withholding agent's obligation to withhold under chapter 3 of the Code and the regulations thereunder. Special procedures regarding payments to foreign persons that act as intermediaries are also provided. Section 1.1441–2 defines the income subject to withholding under section 1441, 1442, and 1443 and the regulations under these sections. Section 1.1441–3 provides rules regarding the amount subject to withholding. Section 1.1441–4 provides exemptions from withholding for, among other things, certain income effectively connected with the conduct of a trade or business in the United States, including certain compensation for the personal services of an individual. Section 1.1441–5 provides rules for withholding on payments made to flow-through entities and other similar arrangements. Section 1.1441–6 provides rules for claiming a reduced rate of withholding under an income tax treaty. Section 1.1441–7 defines the term *withholding agent* and provides due diligence rules governing a withholding agent's obligation to withhold. Section 1.1441–8 provides rules for relying on claims of exemption from withholding for payments to a foreign government, an international organization, a foreign central bank of issue, or the Bank for International Settlements. Sections 1.1441–9 and 1.1443–1 provide rules for relying on claims of exemption from withholding for payments to foreign tax exempt organizations and foreign private foundations.

(b) *General rules of withholding*—(1) *Requirement to withhold on payments to foreign persons.* A withholding agent must withhold 30-percent of any payment of an amount subject to withholding made to a payee that is a foreign person unless it can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a beneficial owner that is a U.S. person or as made to a beneficial owner that is a foreign person entitled to a reduced rate of withholding. However, a withholding agent making a payment to a foreign person need not withhold where the foreign person assumes responsibility for withholding on the payment under chapter 3 of the Code and the regulations thereunder as a qualified intermediary (see paragraph (e)(5) of this section), as a U.S. branch of a foreign person (see paragraph (b)(2)(iv) of this section), as a withholding foreign partnership (see §1.1441–5(c)(2)(i)), or as an authorized foreign agent (see §1.1441–7(c)(1)). This section (dealing with general rules of withholding and claims of foreign or U.S. status by a payee or a beneficial owner), and §§1.1441–4, 1.1441–5, 1.1441–6, 1.1441–8, 1.1441–9, and 1.1443–1 provide rules for determining whether documentation is required as a condition for reducing the rate of withholding on a payment to a foreign beneficial owner or to a U.S. payee and if so, the nature of the documentation upon which a withholding agent may rely in order to reduce such rate. Paragraph (b)(2) of this section prescribes the rules for determining who the payee is, the extent to which a payment is treated as made to a foreign payee, and reliable association of a payment with documentation. Paragraph (b)(3) of this section describes the applicable presumptions for determining the payee's status as U.S. or foreign and the payee's other characteristics (i.e., as an owner or intermediary, as an individual, partnership, corporation, etc.). Paragraph (b)(4) of this section lists the types of payments for which the 30-percent withholding rate may be reduced. Because the treatment of a payee as a U.S. or a foreign person also has consequences for purposes of making an information return under the provisions of chapter 61 of the Code and for withholding under other provisions of the Code, such as sections 3402, 3405 or 3406, paragraph (b)(5) of this section lists applicable provisions outside chapter 3 of the Code that require certain payees to establish their foreign status (e.g., in order to be exempt from information reporting). Paragraph (b)(6) of this section describes the withholding obligations of a foreign person making a payment that it has received in its capacity as an intermediary. Paragraph (b)(7) of this section describes the liability of a withholding agent that fails to withhold at the required 30-percent rate in the absence of documentation. Paragraph (b)(8) of this section deals with adjustments and refunds in the case of overwithholding. Paragraph (b)(9) of this section deals with determining the status of the payee when the payment is jointly owned. See paragraph (c)(6) of this section for a definition of beneficial owner. See §1.1441–7(a) for a definition of withholding agent. See §1.1441–2(a) for the determination of an amount subject to withholding. See §1.1441–2(e) for the definition of a payment and when it is considered made. Except as otherwise provided, the provisions of this section apply only for purposes of determining a withholding agent's obligation to withhold under chapter 3 of the Code and the regulations thereunder.

(2) *Determination of payee and payee's status*—(i) *In general.* Except as otherwise provided in this paragraph (b)(2), a payee is the person to whom a payment is made, regardless of whether such person is the beneficial owner of the amount (as defined in paragraph (c)(6) of this section). A foreign payee is a payee who is a foreign person. A U.S. payee is a payee who is a U.S. person. Generally, the determination by a withholding agent of the U.S. or foreign status of a payee and of its other relevant characteristics (e.g., as a beneficial owner or intermediary, or as an individual, corporation, or flow-through entity) is made on the basis of a withholding certificate that is a Form W–8 or a Form 8233 (indicating foreign status of the payee or beneficial owner) or a Form W–9 (indicating U.S. status of the payee). The provisions of this paragraph (b)(2), paragraph (b)(3) of this section, and § 1.1441–5 (c), (d), and (e) dealing with determinations of payee and applicable presumptions in the absence of documentation, apply only to payments of amounts subject to withholding under chapter 3 of the Code (within the meaning of § 1.1441–2(a)). Similar payee and presumption provisions are set forth under § 1.6049–5(d) for payments of amounts that are not subject to withholding under chapter 3 of the Code (or the regulations thereunder) but that may be reportable under provisions of chapter 61 of the Code (and the regulations thereunder). See paragraph (d) of this section for documentation upon which the withholding agent may rely in order to treat the payee or beneficial owner as a U.S. person. See paragraph (e) of this section for documentation upon which the withholding agent may rely in order to treat the payee or beneficial owner as a foreign person. For applicable presumptions of status in the absence of documentation, see paragraph (b)(3) of this section and § 1.1441–5(d). For definitions of a foreign person and U.S. person, see paragraph (c)(2) of this section.

(ii) *Payments to a U.S. agent of a foreign person.* A withholding agent making a payment to a U.S. person (other than to a U.S. branch that is treated as a U.S. person pursuant to paragraph (b)(2)(iv) of this section) and who has actual knowledge that the U.S. person receives the payment as an agent of a foreign person must treat the payment as made to the foreign person. However, the withholding agent may treat the payment as made to the U.S. person if the U.S. person is a financial institution and the withholding agent has no reason to believe that the financial institution will not comply with its obligation to withhold. See paragraph (c)(5) of this section for the definition of a financial institution.

(iii) *Payments to wholly-owned entities*—(A) *Foreign-owned domestic entity.* A payment to a wholly-owned domestic entity that is disregarded for federal tax purposes under § 301.7701–2(c)(2) of this chapter as an entity separate from its owner and whose single owner is a foreign person shall be treated as a payment to the owner of the entity, subject to the provisions of paragraph (b)(2)(iv) of this section. For purposes of this paragraph (b)(2)(iii)(A), a domestic entity means a person that would be treated as a U.S. person if it had an election in effect under § 301.7701–3(c)(1)(i) of this chapter to be treated as a corporation. For example, a limited liability company, A, organized under the laws of the State of Delaware, opens an account at a U.S. bank. Upon opening of the account, the bank requests A to furnish a Form W–9 as required under section 6049(a) and the regulations under that section. A does not have an election in effect under § 301.7701–3(c)(1)(i) of this chapter and, therefore, is not treated as an organization taxable as a corporation, including for purposes of the exempt recipient provisions in § 1.6049–4(c)(1). If A has a single owner and the owner is a foreign person (as defined in paragraph (c)(2) of this section), then A may not furnish a Form W–9 because it may not represent that it is a U.S. person for purposes of the provisions of chapters 3 and 61 of the Code, and section 3406. Therefore, A must furnish a Form W–8 with the name, address, and taxpayer identifying number (TIN) (if required) of the foreign person who is the single owner in the same manner as if the account were opened directly by the foreign single owner. See §§ 1.894–1T(d) and

1.1441–6(b)(4) for special rules where the entity's owner is claiming a reduced rate of withholding under an income tax treaty.

(B) *Foreign entity.* A payment to a wholly-owned foreign entity that is disregarded under §301.7701–2(c)(2) of this chapter as an entity separate from its owner shall be treated as a payment to the single owner of the entity, subject to the provisions of paragraph (b)(2)(iv) of this section if the foreign entity has a U.S. branch in the United States. For purposes of this paragraph (b)(2)(iii)(B), a foreign entity means a person that would be treated as a foreign person if it had an election in effect under §301.7701–3(c)(1)(i) of this chapter to be treated as a corporation. See §§1.894–1T(d) and 1.1441–6(b)(4) for special rules where the foreign entity or its owner is claiming a reduced rate of withholding under an income tax treaty. Thus, for example, if the foreign entity's single owner is a U.S. person, the payment shall be treated as a payment to a U.S. person. Therefore, based on the saving clause in U.S. income tax treaties, such an entity may not claim benefits under an income tax treaty even if the entity is organized in a country with which the United States has an income tax treaty in effect and treats the entity as a non-fiscally transparent entity. See §1.894–1T(d)(6), *Example 10.* Unless it has actual knowledge or reason to know that the foreign entity to whom the payment is made is disregarded under §301.7701–2(c)(2) of this chapter, a withholding agent may treat a foreign entity as an entity separate from its owner unless it can reliably associate the payment with a withholding certificate from the entity's owner.

(iv) *Payments to a U.S. branch of certain foreign banks or foreign insurance companies*—(A) *U.S. branch treated as a U.S. person in certain cases.* A payment to the U.S. branch of a foreign person is a payment to the foreign person. However, a U.S. branch described in this paragraph (b)(2)(iv)(A) and a withholding agent (including another U.S. branch described in this paragraph (b)(2)(iv)(A)) may agree to treat the branch as a U.S. person for purposes of withholding on specified payments to the U.S. branch. Such agreement must be evidenced by a U.S. branch withholding certificate described in paragraph (e)(3)(v) of this section furnished by the U.S. branch to the withholding agent. A U.S. branch described in this paragraph (b)(2)(iv)(A) is any U.S. branch of a foreign bank subject to regulatory supervision by the Federal Reserve Board or a U.S. branch of a foreign insurance company required to file an annual statement on a form approved by the National Association of Insurance Commissioner with the Insurance Department of a State, a Territory, or the District of Columbia. The Internal Revenue Service (IRS) may approve a list of U.S. branches that may qualify for treatment as a U.S. person under this paragraph (b)(2)(iv)(A) (see §601.601(d)(2) of this chapter).

(B) *Consequences to the withholding agent.* Any person that is otherwise a withholding agent regarding a payment to a U.S. branch described in paragraph (b)(2)(iv)(A) of this section shall treat the payment in one of the following ways—

(*1*) As a payment to a U.S. person, in which case the withholding agent is not responsible for withholding on such payment to the extent it can reliably associate the payment with a withholding certificate described in paragraph (e)(3)(v) of this section that has been furnished by the U.S. branch under its agreement with the withholding agent to be treated as a U.S. person;

(*2*) As a payment directly to the persons whose names are on withholding certificates or other appropriate documentation forwarded by the U.S. branch to the withholding agent when no agreement is in effect to treat the U.S. branch as a U.S. person for such payment, to the extent the withholding agent can reliably associate the payment with such certificates or documentation; or

(*3*) As a payment to a foreign person of income that is effectively connected with the conduct by that foreign person of a trade or business in the United States if the withholding agent cannot reliably associate the payment with a certificate from the U.S. branch or any other certificate or other appropriate documentation from another person.

(C) *Consequences to the U.S. branch.* A U.S. branch that is treated as a U.S. person under paragraph (b)(2)(iv)(A) of this section shall be treated as a person for purposes of section 1441(a) and all other provisions of chapter 3 of the Code and the regulations thereunder for any payment that it receives as such. Thus, the U.S. branch shall be responsible for withholding on the payment in accordance with the provisions under chapter 3 of the Code and the regulations thereunder and other applicable withholding provisions of the Code. For this purpose, it shall obtain and retain documentation from payees or beneficial owners of the payments that it receives as a U.S. person in the same manner as if it were a separate entity. For example, if a U.S. branch receives a payment on behalf of its home office and the home office is a qualified intermediary, the U.S. branch must obtain a withholding certificate described in paragraph (e)(3)(ii) of this section from its home office. In addition, a U.S. branch that has not provided documentation to the withholding agent for a payment that is, in fact, not effectively connected income is a withholding agent with respect to that payment. See paragraph (b)(6) of this section.

(D) *Definition of payment to a U.S. branch.* A payment is treated as a payment to a U.S. branch of a foreign bank or foreign insurance company if the payment is credited to an account maintained in the United States in the name of a U.S. branch of the foreign person, or the payment is made to an address in the United States where the U.S. branch is located and the name of the U.S. branch appears on documents (in written or electronic form) associated with the payment (e.g., the check mailed or a letter addressed to the branch).

(E) *Payments to other U.S. branches.* Similar withholding procedures may apply to payments to U.S. branches that are not described in paragraph (b)(2)(iv)(A) of this section to the extent permitted by the district director or the Assistant Commissioner (International). Any such branch must establish that its situation is analogous to that of a U.S. branch described in paragraph (b)(2)(iv)(A) of this section regarding its registration with, and regulation by, a U.S. governmental institution, the type and amounts of assets it is required to, or actually maintains in the United States, and the personnel who carry out the activities of the branch in the United States. In the alternative, the branch must establish that the withholding and reporting requirements under chapter 3 of the Code and the regulations thereunder impose an undue administrative burden and that the collection of the tax imposed by section 871(a) or 881(a) on the foreign person (or its members in the case of a foreign partnership) will not be jeopardized by the exemption from withholding. Generally, an undue administrative burden will be found to exist in a case where the person entitled to the income, such as a foreign insurance company, receives from the withholding agent income on securities issued by a single corporation, some of which is, and some of which is not, effectively connected with conduct of a trade or business within the United States and the criteria for determining the effective connection are unduly difficult to apply because of the circumstances under which such securities are held. No exemption from withholding shall be granted under this paragraph (b)(2)(iv)(E) unless the person entitled to the income complies with such other requirements as may be imposed by the district director or the Assistant Commissioner (International) and unless the district director or the Assistant Commissioner (International) is satisfied that the collection of the tax on the income involved will not be jeopardized by the exemption from withholding. The IRS may prescribe such procedures as are necessary to make these determinations (see § 601.601(d)(2) of this chapter).

(v) *Payments to a foreign intermediary*—(A) *Payments treated as made to persons for whom the intermediary collects the payment.* Except as otherwise provided in paragraph (b)(2)(v)(B) of this section, a payment to a person that the withholding agent may treat as a foreign intermediary in accordance with the provisions of paragraph (b)(3)(v)(A) of this section is treated as a payment made directly to the person or persons for whom the intermediary collects the payment. Thus, for example, a payment that the withholding agent can reliably associate with a withholding certificate from a qualified intermediary (defined in paragraph (e)(5)(ii) of this section) and that is allocable to the category of assets described in paragraph (e)(5)(v)(B)(*3*) of this section (i.e., assets allocable to persons for whom the foreign qualified intermediary does not hold documentation as specified under its agreement with the IRS) is treated as a payment to the persons holding assets in that category. See paragraph (b)(3)(v)(B) of this section for applicable presumptions in such a case. For similar rules for payments to flow-through entities, see §1.1441–5 (c)(1)(i) and (e).

(B) *Payments treated as made to foreign intermediary.* A payment to a person that the withholding agent can reliably associate with a withholding certificate described in paragraph (e)(3)(ii) of this section from a qualified intermediary that has elected to assume primary withholding responsibility in accordance with paragraph (e)(5)(iv) of this section is treated as a payment to the qualified intermediary, except to the extent of the portion of the payment that the withholding agent can reliably associate with Forms W–9. See paragraphs (b)(1) and (e)(5)(iv) of this section for consequences to the withholding agent.

(vi) *Other payees.* A payment to a person described in §1.6049–4(c)(1)(ii) that the withholding agent would treat as a payment to a foreign person without obtaining documentation for purposes of information reporting under section 6049 (if the payment were interest) is treated as a payment to a foreign payee for purposes of chapter 3 of the Code and the regulations thereunder (or to a foreign beneficial owner to the extent provided in paragraph (e)(1)(ii)(A) (*6*) or (*7*) of this section). Further, payments that the withholding agent can reliably associate with documentary evidence described in §1.6049–5(c)(4) relating to the payee is treated as a payment to a foreign payee. A payment that the withholding agent may treat as a payment to an authorized foreign agent (as defined in §1.1441–7(c)(2)) is treated as a payment to the agent and not to the persons for whom the agent collects the payment. See §1.1441–5 (b)(1) and (c)(1) for payee determinations for payments to partnerships. See §1.1441–5(e) for payee determinations for payments to foreign trusts or foreign estates.

(vii) *Rules for reliably associating a payment with documentation.* Generally, a withholding agent can reliably associate a payment with documentation if, for that payment, it holds valid documentation to which the payment relates, it can reliably determine how much of the payment relates to the valid documentation (e.g., based on information furnished in accordance with paragraph (e)(3)(iv) or (5)(v) of this section in the case of a payment to a foreign intermediary or in accordance with §1.1441–5(c)(3)(iv) in the case of a payment to a foreign partnership), and it has no actual knowledge or reason to know that any of the information or certifications stated in the documentation are incorrect. The documentation referred to in this paragraph (b)(2)(vii) is documentation described in paragraph (d) or (e) of this section upon which a withholding agent may rely in order to treat the payment as a payment made to a payee or beneficial owner that is a U.S. or a foreign person, and to ascertain the characteristics of the payee or beneficial owner, as may be relevant to withholding or reporting under chapter 3 of the Code and the regulations thereunder (e.g., beneficial owner or intermediary, corporation or partnership). For purposes of this paragraph (b)(2)(vii), documentation also includes a withholding certificate described in paragraph (e)(3)(ii) of this section from a person representing to be a qualified intermediary that has assumed primary withholding responsibility, a withholding certificate described in paragraph (e)(3)(v) of this section from a person representing to be a U.S. branch described in paragraph (b)(2)(iv)(A) of this section, a withholding certificate described in §1.1441–5(c)(2)(iv) from a person representing to be a withholding foreign partnership, and the agreement that the withholding agent has in effect with an authorized foreign agent in accordance with §1.1441–7(c)(2)(i). A withholding agent that is not required to obtain documentation with respect to a payment is considered to lack documentation for purposes of this paragraph (b)(2)(vii). For example, a withholding agent paying U.S. source interest to a person that is an exempt recipient, as defined in § 1.6049–4(c)(1)(ii), is not required to obtain documentation from that person in order to determine whether an amount paid to that person is reportable under an applicable information reporting provision under chapter 61 of the Code. Therefore, the withholding agent may rely on the provisions of paragraph (b)(3)(iii)(A) of this section to determine whether the person is presumed to be a U.S. person (in which case, no withholding is required under this section), or whether the person is presumed to be a foreign person (in which case 30-percent withholding is required under this section). See paragraph (b)(3)(v)(A) of this section for special reliance rules in the case of a payment to a foreign intermediary and § 1.1441–5(d)(3) for special reliance rules in the case of a payment to a foreign partnership.

(3) *Presumptions regarding payee's status in the absence of documentation*—(i) *General rules.* A withholding agent that cannot reliably associate a payment with documentation may rely on the presumptions of this paragraph (b)(3) in order to determine the status of the payee as a U.S. or a foreign person and the payee's other relevant characteristics (e.g., as an owner or intermediary, as an individual, trust, partnership, or corporation). The determination of withholding and reporting requirements applicable to payments to a person presumed to be a foreign person is governed only by the provisions of chapter 3 of the Code and the regulations thereunder. For the determination of withholding and reporting requirements applicable to payments to a person presumed to be a U.S. person, see chapter 61 of the Code, section 3402, 3405, or 3406, and the regulations under these provisions. A presumption that a payee is a foreign payee is not a presumption that the payee is a foreign beneficial owner. Therefore, the provisions of this paragraph (b)(3) have no effect for purposes of reducing the withholding rate if associating the payment with documentation of foreign beneficial ownership is required as a condition for such rate reduction. See paragraph (b)(3)(ix) of this section for consequences to a withholding agent that fails to withhold in accordance with the presumptions set forth in this paragraph (b)(3) or if the withholding agent has actual knowledge or reason to know of facts that are contrary to the presumptions set forth in this paragraph (b)(3). See paragraph (b)(2)(vii) of this section for rules regarding the extent which a withholding agent can reliably associate a payment with documentation.

(ii) *Presumptions of status as individual, corporation, partnership, etc.* A withholding agent that cannot reliably associate a payment with documentation must presume that the payee is an individual, a trust, or an estate, if the payee appears to be such person (i.e., based on the payee's name or other indications). In the absence of reliable indications that the payee is an individual, estate, or trust, the withholding agent must presume that the payee is a corporation or one of the persons enumerated under § 1.6049–4(c)(1)(ii) (B) through (Q) if it can be so treated under § 1.6049–4(c)(1)(ii)(A)(*1*) or any one of the paragraphs under § 1.6049–4(c)(1)(ii) (B) through (Q) without the need to furnish documentation. If the withholding agent cannot treat a payee as a person described in § 1.6049–4(c)(1)(ii) (A)(*1*) through (Q), then the payee shall be presumed to be a partnership. The fact that a payee is presumed to have a certain status under the provisions of this paragraph (b)(3)(ii) does not mean that it is excused from furnishing documentation, if documentation is otherwise required in order to obtain a reduced rate of withholding under this section. For example, if, for purposes of this paragraph (b)(3)(ii), a payee is presumed to be a tax-exempt organization based on § 1.6049–4(c)(1)(ii)(B), the withholding agent cannot rely on this presumption to reduce the rate of withholding on payments to such person (if such person is also presumed to be a foreign person under paragraph (b)(3)(iii)(A) of this section) because a reduction in the rate of withholding for payments to a foreign tax-exempt organization generally requires that a valid Form W–8 described in §1.1441–9(b)(2) be furnished to the withholding agent.

(iii) *Presumption of U.S. or foreign status.* A payment that the withholding agent cannot reliably associate with documentation is presumed to be made to a U.S. person, except as otherwise provided in this paragraph (b)(3)(iii), in paragraphs (b)(3) (iv) and (v) of this section, or in §1.1441–5 (d) or (e).

(A) *Payments to exempt recipients.* If a withholding agent cannot reliably associate a payment with documentation from the payee and the payee is an exempt recipient (as determined under the provisions of §1.6049–4(c)(1)(ii) in the case of interest, or under similar provisions under chapter 61 of the Code applicable to the type of payment involved, but not including a payee that the withholding agent may treat as a foreign intermediary in accordance with paragraph (b)(3)(v) of this section), the payee is presumed to be a foreign person and not a U.S. person—

(*1*) If the withholding agent has actual knowledge of the payee's employer identification number and that number begins with the two digits ''98'';

(*2*) If the withholding agent's communications with the payee are mailed to an address in a foreign country;

(*3*) If the name of the payee indicates that the entity is the type of entity that is on the per se list of foreign corporations contained in §301.7701–2(b)(8)(i) of this chapter; or

(*4*) If the payment is made outside the United States (as defined in §1.6049–5(e)).

(B) *Scholarships and grants.* A payment representing taxable scholarship or fellowship grant income that does not represent compensation for services (but is not excluded from tax under section 117) and that a withholding agent cannot reliably associate with documentation is presumed to be made to a foreign person if the withholding agent has a record that the payee has a U.S. visa that is not an immigrant visa. See section 871(c) and §1.1441–4(c) for applicable tax rate and withholding rules.

(C) *Pensions, annuities, etc.* A payment from a trust described in section 401(a), an annuity plan described in section 401(a), an annuity plan described in section 403(a), or a payment with respect to any annuity, custodial account, or retirement income account described in section 403(b) that a withholding agent cannot reliably associate with documentation is presumed to be made to a U.S. person only if the withholding agent has a record of a Social Security number for the payee and relies on a mailing address described in the following sentence. A mailing address is an address used for purposes of information reporting or otherwise communicating with the payee that is an address in the United States or in a foreign country with which the United States has an income tax treaty in effect that provides that the payee, if an individual resident in that country, would be entitled to an exemption from U.S. tax on amounts described in this paragraph (b)(3)(iii)(C). Any payment described in this paragraph (b)(3)(iii)(C) that is not presumed made to a U.S. person is presumed to be made to a foreign person. A withholding agent making a payment to a person presumed to be a foreign person may not reduce the 30-percent amount of withholding required on such payment unless it receives a withholding certificate described in paragraph (e)(2)(i) of this section furnished by the beneficial owner. For basis of reduction in the 30-percent rate, see §1.1441–4(d) or §1.1441–6(b).

(D) *Certain payments to offshore accounts.* A payment that would be subject to withholding under section 1441, 1442, or 1443 if made to a foreign person and is exempt from backup withholding under section 3406 by reason of §31.3406(g)–1(e) of this chapter (relating to exemption from backup withholding under section 3406 for certain payments to offshore accounts) is presumed to be made to a foreign payee.

(iv) *Grace period in the case of indicia of a foreign payee.* A withholding agent may choose, in its discretion, to apply the provisions of §1.6049–5(d)(2)(ii) regarding a 90-day grace period for purposes of this paragraph (b)(3) (by substituting the term *withholding agent* for the term *payor*) to amounts described in §1.1441–6(b)(2)(ii) and to amounts covered by a Form 8233 described in §1.1441–4(b)(2)(ii). Thus, for these amounts, a withholding agent may, in its discretion, choose to treat an account holder as a foreign person and withhold under chapter 3 of the Code (and the regulations thereunder) while awaiting documentation. For purposes of determining the rate of withholding under this section, the withholding agent must withhold at the unreduced 30-percent rate at the time that the amounts are credited to the account. However, a withholding agent who can reliably associate the payment with a withholding certificate that is otherwise valid within the meaning of the applicable provisions except for the fact that it is transmitted by facsimile may rely on that facsimile form for purposes of withholding at the claimed reduced rate. For reporting of amounts credited both before and after the grace period, see § 1.1461–1(c)(7). The following adjustments shall be made at the expiration of the grace period:

(A) If, at the end of the grace period, the documentation is not furnished in the manner required under this section and the account holder is presumed to be a U.S. person who is not an exempt recipient, then backup withholding applies to amounts credited to the account after the expiration of the grace period only. Amounts credited to the account during the grace period shall be treated as owned by a foreign payee and adjustments must be made to correct any underwithholding on such amounts in the manner described in § 1.1461–2.

(B) If, at the end of the grace period, the documentation is not furnished in the manner required under this section and the account holder is presumed to be a foreign person, or if documentation is furnished that does not support the claimed rate reduction, then adjustments must be made to correct the underwithholding on amounts credited to the account during the grace period, based on adjustment procedures described in § 1.1461–2.

(v) *Special rules applicable to payments to foreign intermediaries*—(A) *Reliance on claim of status as foreign intermediary.* A withholding agent that can reliably associate a payment with a withholding certificate described in paragraph (e)(3) (ii) or (iii) of this section may treat the payment as made to a foreign intermediary, as represented in the certificate. For this purpose, a U.S. person's foreign branch that is a qualified intermediary defined in paragraph (e)(5)(ii) of this section shall be treated as a foreign intermediary. For purposes of this section, a payment that the withholding agent can reliably associate with a withholding certificate described in paragraph (e)(3) (ii) or (iii) of this section that would be valid except for the fact that some or all of the withholding certificates or other appropriate documentation required to be attached are lacking or are unreliable or that information for allocating the payment among the various persons for whom the intermediary is acting is lacking or is unreliable shall nevertheless be treated as a payment to a foreign intermediary and the rules of this paragraph (b)(3)(v) shall apply accordingly. A payee that the withholding agent may not reliably treat as a foreign intermediary under this paragraph (b)(3)(v)(A) is presumed to be an owner whose status as an individual, trust, estate, etc., must be determined in accordance with paragraph (b)(3)(ii) of this section, to the extent relevant. In addition, such payee is presumed to be a U.S. or a foreign payee based upon the presumptions described in paragraph (b)(3)(iii) of this section. The provisions of paragraphs (b)(3)(v) (B), (C), and (D) of this section are not relevant to a withholding agent that can reliably associate a payment with a withholding certificate from a person representing to be a qualified intermediary that has assumed primary withholding responsibility in accordance with paragraph (e)(5)(iv) of this section.

(B) *Beneficial owner documentation is lacking or unreliable.* Any portion of a payment that the withholding agent may treat as made to a foreign intermediary in accordance with paragraph (b)(3)(v)(A) of this section but cannot reliably associate with a beneficial owner due to the lack of a withholding certificate or other appropriate documentation for that beneficial owner is presumed to be made to a foreign payee for whom the foreign intermediary collects the payment (see paragraph (b)(2)(v) of this section). For purposes of this paragraph (b)(2)(v)(B), any payment that a foreign qualified intermediary represents to be allocable to the category of assets described in paragraph (e)(5)(v)(B)(*3*) of this section (i.e., assets allocable to persons for whom the qualified intermediary does not hold documentation as specified under its agreement with the IRS) is treated as a payment that the withholding agent cannot reliably associate with beneficial owners. As a result, any payment allocable to such category of assets is presumed to be made to an unidentified foreign payee. Under paragraph (b)(1) of this section, a payment to a foreign payee is subject to withholding at a 30-percent rate.

(C) *Information regarding allocation of payment is lacking or unreliable.* If a withholding agent can reliably associate a payment with a group of beneficial owners or payees but lacks reliable information to determine how much of the payment is allocable to one or more of the beneficial owners or payees in the group (because, for example, the statement described in paragraph (e)(3)(iv) of this section has not been furnished), the payment, to the extent it cannot reliably be allocated, is presumed to be allocable entirely to the beneficial owner or payee in the group with the highest applicable withholding rate or, if the rates are equal, to the beneficial owner or payee in the group with the highest U.S. tax liability, as the withholding agent shall estimate, based on its knowledge and available information. If a withholding certificate attached to an intermediary certificate is another intermediary certificate or a certificate from a foreign partnership described in §1.1441–5(c)(3)(iii), the rules of this paragraph (b)(3)(v)(C) apply by treating the share of the payment allocable to the other intermediary or to the foreign partnership as if the payment were made directly to the other intermediary or to the foreign partnership.

(D) *Certification that the foreign intermediary has furnished documentation for all of the persons to whom the intermediary certificate relates is lacking or unreliable.* If the certification required under paragraph (e)(3)(iii)(D) of this section (that the attached withholding certificates and other appropriate documentation represent all of the persons to whom the intermediary withholding certificate relates) is lacking or is unreliable and, as a result, the withholding agent cannot reliably determine how much of the payment is allocable to each of the persons or group of persons for which the withholding agent holds a withholding certificate or other appropriate documentation, then none of the payment can reliably be associated with any one person and the entire payment is presumed to be made to an unidentified foreign payee for whom the intermediary collects the payment and from which a 30-percent amount must be withheld in accordance with paragraph (b)(1) of this section.

(vi) *U.S. branches and foreign flow-through entities.* The rules of paragraphs (b)(3)(v) (B), (C), and (D) of this section shall apply to payments to a U.S. branch described in paragraph (b)(2)(iv)(A) of this section that has agreed to assume withholding responsibility in the same manner that they apply to payments to a foreign intermediary. See §1.1441–5(d) for similar rules in the case of payments to foreign partnerships. See §1.1441–5(e) for similar rules in the case of payments to foreign trusts or foreign estates.

(vii) *Joint payees.* A payment made to joint payees for whom the withholding agent cannot reliably associate documentation for all joint payees or can reliably associate the payment with a Form W–9 furnished in accordance with the procedures described in §§31.3406(d)–1 through 31.3406(d)–5 of this chapter from one of the joint payees is presumed to be made to U.S. persons. For purposes of applying this paragraph (b)(3), the grace period rules in paragraph (b)(3)(iv) of this section shall apply only if each payee qualifies for the conditions described in paragraph (b)(3)(iv) of this section. However, as provided in paragraph (b)(3)(iii)(D) of this section, a payment of an amount that would be subject to withholding under section 1441, 1442, or 1443 if paid to a foreign person and is exempt from the application of the provisions of section 3406 by reason of §31.3406(g)–1(e) of this chapter (relating to exemption from backup withholding under section 3406 of the Code for certain payments made with respect to offshore accounts), is presumed to be made to foreign persons.

(viii) *Rebuttal of presumptions.* A payee or beneficial owner may rebut the presumptions described in this paragraph (b)(3) by providing reliable documentation to the withholding agent or, if applicable, to the IRS.

(ix) *Effect of reliance on presumptions and of actual knowledge or reason to know otherwise*—(A) *General rule.* Except as otherwise provided in paragraph (b)(3)(ix)(B) of this section, a withholding agent that withholds on a payment under section 3402, 3405 or 3406 in accordance with the presumptions set forth in this paragraph (b)(3) shall not be liable for withholding under this section even it is later established that the beneficial owner of the payment is, in fact, a foreign person. Similarly, a withholding agent that withholds on a payment under this section in accordance with the presumptions set forth in this paragraph (b)(3) shall not be liable for withholding under section 3402 or 3405 or for backup withholding under section 3406 even if it is later established that the payee or beneficial owner is, in fact, a U.S. person. A withholding agent that, instead of relying on the presumptions described in this paragraph (b)(3), relies on its own actual knowledge to withhold a lesser amount, not withhold, or not report a payment, even though reporting of the payment or withholding a greater amount would be required if the withholding agent relied on the presumptions described in this paragraph (b)(3) shall be liable for tax, interest, and penalties to the extent provided under section 1461 and the regulations under that section. See paragraph (b)(7) of this section for provisions regarding such liability if the withholding agent fails to withhold in accordance with the presumptions described in this paragraph (b)(3).

(B) *Actual knowledge or reason to know that amount of withholding is greater than is required under the presumptions or that reporting of the payment is required.* Notwithstanding the provisions of paragraph (b)(3)(ix)(A) of this section, a withholding agent may not rely on the presumptions described in this paragraph (b)(3) to the extent it has actual knowledge or reason to know that the status or characteristics of the payee or of the beneficial owner are other than what is presumed under this paragraph (b)(3) and, if based on such knowledge or reason to know, it should withhold (under this section or another withholding provision of the Code) an amount greater than would be the case if it relied on the presumptions described in this paragraph (b)(3) or it should report (under this section or under another provision of the Code) an amount that would not otherwise be reportable if it relied on the presumptions described in this paragraph (b)(3). In such a case, the withholding agent must rely on its actual knowledge or reason to know rather than on the presumptions set forth in this paragraph (b)(3). Failure to do so and, as a result, failure to withhold the higher amount or to report the payment, shall result in liability for tax, interest, and penalties to the extent provided under sections 1461 and 1463 and the regulations under those sections.

(x) *Examples.* The provisions of this paragraph (b)(3) are illustrated by the following examples:

Example 1. A withholding agent, W, makes a payment of U.S. source dividends to person X, Inc. at an address outside the United States. W cannot reliably associate the payment to X with documentation. Under §§ 1.6042–3(b)(1)(vii) and 1.6049–4(c)(1)(ii)(A)(*1*), W may treat X as a corporation. Thus, under the presumptions described in paragraph (b)(3)(iii) of this section, W must presume that X is a foreign person (because the payment is made outside the United States). However, W knows that X is a U.S. person who is an exempt recipient. W may not rely on its actual knowledge to not withhold under this section. If W's knowledge is, in fact, incorrect, W would be liable for tax, interest, and, if applicable, penalties, under section 1461. W would be permitted to reduce or eliminate its liability for the tax by establishing, in accordance with paragraph (b)(7) of this section, that the tax is not due or has been satisfied. If W's actual knowledge is, in fact, correct, W may nevertheless be liable for tax, interest, or penalties under section 1461 for the amount that W should have withheld based upon the presumptions. W would be permitted to reduce or eliminate its liability for the tax by establishing, in accordance with paragraph (b)(7) of this section, that its actual knowledge was, in fact, correct and that no tax or a lesser amount of tax was due.

Example 2. A withholding agent, W, makes a payment of U.S. source dividends to Y who does not qualify as an exempt recipient under §§1.6042–3(b)(1)(vii) and 1.6049–4(c)(1)(ii). W cannot reliably associate the payment to Y with documentation. Under the presumptions described in paragraph (b)(3)(iii) of this section, W must presume that Y is a U.S. person who is not an exempt recipient for purposes of section 6042. However, W knows that Y is a foreign person. W may not rely on its actual knowledge to withhold under this section rather than backup withhold under section 3406. If W's knowledge is, in fact, incorrect, W would be liable for tax, interest, and, if applicable, penalties, under section 3403. If W's actual knowledge is, in fact, correct, W may nevertheless be liable for tax, interest, or penalties under section 3403 for the amount that W should have withheld based upon the presumptions. Paragraph (b)(7) of this section does not apply to provide relief from liability under section 3403.

Example 3. A withholding agent, W, makes a payment of U.S. source dividends to X, Inc. W cannot reliably associate the payment to X, Inc. with documentation. X, Inc. presents none of the indicia of foreign status described in paragraph (b)(3)(iii)(A) of this section, but W has actual knowledge that X, Inc. is a foreign corporation. W may treat X, Inc. as an exempt recipient under §1.6042–3(b)(1)(vii). Because there are no indicia of foreign status, W would, absent actual knowledge or reason to know otherwise, be permitted to treat X, Inc. as a domestic corporation in accordance with the presumptions of paragraph (b)(3)(iii) of this section. However, under paragraph (b)(3)(ix)(B) of this section, W may not rely on the presumption of U.S. status since reliance on its actual knowledge requires that it withhold an amount greater than would be the case under the presumptions.

Example 4. A withholding agent, W, is a plan administrator who makes pension payments to person X with a mailing address in a foreign country with which the United States has an income tax treaty in effect. Under that treaty, the type of pension income paid to X is taxable solely in the country of residence. The plan administrator has a record of X's U.S. social security number. W has no actual knowledge or reason to know that X is a foreign person. W may rely on the presumption of paragraph (b)(3)(iii)(C) of this section in order to treat X as a U.S. person. Therefore, any withholding and reporting requirements for the payment are governed by the provisions of section 3405 and the regulations under that section.

(4) *List of exemptions from, or reduced rates of, withholding under chapter 3 of the Code.* A withholding agent that has determined that the payee is a foreign person for purposes of paragraph (b)(1) of this section must determine whether the payee is entitled to a reduced rate of withholding under section 1441, 1442, or 1443. This paragraph (b)(4) identifies items for which a reduction in the rate of withholding may apply and whether the rate reduction is conditioned upon documentation being furnished to the withholding agent. Documentation required under this paragraph (b)(4) is documentation that a withholding agent must be able to associate with a payment upon which it can rely to treat the payment as made to a foreign person that is the beneficial owner of the payment in accordance with paragraph (e)(1)(ii) of this section. This paragraph (b)(4) also cross-references other sections of the Code and applicable regulations in which some of these exceptions, exemptions, or reductions are further explained. See, for example, paragraph (b)(4)(viii) of this section, dealing with effectively connected income, that cross-references §1.1441–4(a); see paragraph (b)(4)(xv) of this section, dealing with exemptions from, or reductions of, withholding under an income tax treaty, that cross-references §1.1441–6. This paragraph (b)(4) is not an exclusive list of items to which a reduction of the rate of withholding may apply and, thus, does not preclude an exemption from, or reduction in, the rate of withholding that may otherwise be allowed under the regulations under the provisions of chapter 3 of the Code for a particular item of income identified in this paragraph (b)(4).

(i) Portfolio interest described in section 871(h) or 881(c) and substitute interest payments described in §1.871–7(b)(2) or 1.881–2(b)(2) are exempt from withholding under section 1441(a). See §1.871–14 for regulations regarding portfolio interest and section 1441(c)(9) for exemption from withholding. Documentation establishing foreign status is required for interest on an obligation in registered form to qualify as portfolio interest. See section 871(h)(2)(B)(ii) and §1.871–14(c)(1)(ii)(C). For special documentation rules regarding foreign-targeted registered obligations described in §1.871–14(e)(2), see § 1.871–14(e) (3) and (4) and, in particular, § 1.871–14(e)(4)(i)(A) and (ii)(A) regarding the time when the withholding agent must receive the documentation. The documentation furnished for purposes of qualifying interest as portfolio interest serves as the basis for the withholding exemption for purposes of this section and for purposes of establishing foreign status for purposes of section 6049. See § 1.6049–5(b)(8). Documentation establishing foreign status is not required for qualifying interest on an obligation in bearer form described in § 1.871–14(b)(1) as portfolio interest. However, in certain cases, documentation for portfolio interest on a bearer obligation may have to be furnished in order to establish foreign status for purposes of the information reporting provisions of section 6049 and backup withholding under section 3406. See § 1.6049–5(b)(7).

(ii) Bank deposit interest and similar types of deposit interest (including original issue discount) described in section 871(i)(2)(A) or 881(d) that are from sources within the United States are exempt from withholding under section 1441(a). See section 1441(c)(10). Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6049 and backup withholding under section 3406. See § 1.6049–5(d)(3)(iii) for exceptions to the foreign payee and exempt recipient rules regarding this type of income. See also § 1.6049–5(b)(11) for applicable documentation exemptions for certain bank deposit interest paid on obligations in bearer form.

(iii) Bank deposit interest (including original issue discount) described in section 861(a)(1)(B) is exempt from withholding under sections 1441(a) as income that is not from U.S. sources. Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6049 and backup withholding under section 3406. Reporting requirements for payments of such interest are governed by section 6049 and the regulations under that section. See § 1.6049–5(b)(12) and alternative documentation rules under § 1.6049–5(c)(4).

(iv) Interest or original issue discount from sources within the United States on certain short-term obligations described in section 871(g)(1)(B) or 881(a)(3) is exempt from withholding under sections 1441(a). Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6049 and backup withholding under section 3406. See § 1.6049–5(b)(12) for applicable documentation for establishing foreign status and § 1.6049–5(d)(3)(iii) for exceptions to the foreign payee and exempt recipient rules regarding this type of income. See also § 1.6049–5(b)(10) for applicable documentation exemptions for certain obligations in bearer form.

(v) Income from sources without the United States is exempt from withholding under sections 1441(a). Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6049 or other applicable provisions of chapter 61 of the Code and backup withholding under section 3406. See, for example, § 1.6049–5(b) (6) and (12) and alternative documentation rules under § 1.6049–5(c)(4). See also paragraph (b)(5) of this section for cross references to other applicable provisions of the regulations under chapter 61 of the Code.

(vi) Distributions from certain domestic corporations described in section 871(i)(2)(B) or 881(d) are exempt from withholding under section 1441(a). See section 1441(c)(10). Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6042 and backup withholding under section 3406. See § 1.6042–3(b)(1) (iii) through (vi).

(vii) Dividends paid by certain foreign corporations that are treated as income from sources within the United States by reason of section 861(a)(2)(B) are exempt from withholding under section 884(e)(3) to the extent that the distributions are paid out of earnings and profits in any taxable year that the corporation was subject to branch profits tax for that year. Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6042 and backup withholding under section 3406. See §1.6042–3(b)(1) (iii) through (vii).

(viii) Certain income that is effectively connected with the conduct of a U.S. trade or business is exempt from withholding under section 1441(a). See section 1441(c)(1). Documentation establishing foreign status and status of the income as effectively connected must be furnished for purposes of this withholding exemption to the extent required under the provisions of §1.1441–4(a). Documentation furnished for this purpose also serves as documentation establishing foreign status for purposes of applicable information reporting provisions under chapter 61 of the Code and for backup withholding under section 3406. See, for example, §1.6041–4(a)(1).

(ix) Certain income with respect to compensation for personal services of an individual that are performed in the United States is exempt from withholding under section 1441(a). See section 1441(c)(4) and §1.1441–4(b). However, such income may be subject to withholding as wages under section 3402. Documentation establishing foreign status must be furnished for purposes of any withholding exemption or reduction to the extent required under §1.1441–4(b) or 31.3401(a)(6)–1 (e) and (f) of this chapter. Documentation furnished for this purpose also serves as documentation establishing foreign status for purposes of information reporting under section 6041. See §1.6041–4(a)(1).

(x) Amounts described in section 871(f) that are received as annuities from certain qualified plans are exempt from withholding under section 1441(a). See section 1441(c)(7). Documentation establishing foreign status must be furnished for purposes of the withholding exemption as required under §1.1441–4(d). Documentation furnished for this purpose also serves as documentation establishing foreign status for purposes of information reporting under section 6041. See §1.6041–4(a)(1).

(xi) Payments to a foreign government (including a foreign central bank of issue) that are excludable from gross income under section 892(a) are exempt from withholding under section 1442. See §1.1441–8(b). Documentation establishing status as a foreign government is required for purposes of this withholding exemption. Payments to a foreign government are exempt from information reporting under chapter 61 of the Code (see §1.6049–4(c)(1)(ii)(F)).

(xii) Payments of certain interest income to a foreign central bank of issue or the Bank for International Settlements that are exempt from tax under section 895 are exempt from withholding under section 1442. Documentation establishing eligibility for such exemption is required to the extent provided in §1.1441–8(c)(1). Payments to a foreign central bank of issue or to the Bank for International Settlements are exempt from information reporting under chapter 61 of the Code (see §1.6049–4(c)(1)(ii) (H) and (M)).

(xiii) Amounts derived by a foreign central bank of issue from bankers' acceptances described in section 871(i)(2)(C) or 881(d) are exempt from tax and, therefore, from withholding. See section 1441(c)(10). Documentation establishing foreign status is not required for purposes of this withholding exemption if the name of the payee and other facts surrounding the payment reasonably indicate that the beneficial owner of the payment is a foreign central bank of issue as defined in §1.861–2(b)(4). See §1.1441–8(c)(2) for withholding procedures. See also §§1.6049–4(c)(1)(ii)(H) and 1.6041–3(q)(8) for a similar exemption from information reporting.

(xiv) Payments to an international organization from investments in the United States of stocks, bonds, or other domestic securities or from interest on deposits in banks in the United States of funds belonging to such international organization are exempt from tax under section 892(b) and, thus, from withholding. Documentation establishing status as an international organization is not required if the name of the payee and other facts surrounding the payment reasonably indicate that the beneficial owner of the payment is an international organization within the meaning of section 7701(a)(18). See § 1.1441–8(d). Payments to an international organization are exempt from information reporting under chapter 61 of the Code (see § 1.6049–4(c)(1)(ii)(G)).

(xv) Amounts may be exempt from, or subject to a reduced rate of, withholding under an income tax treaty. Documentation establishing eligibility for benefits under an income tax treaty is required for this purpose as provided under §§ 1.1441–6. Documentation furnished for this purpose also serves as documentation establishing foreign status for purposes of applicable information reporting provisions under chapter 61 of the Code and for backup withholding under section 3406. See, for example, § 1.6041–4(a)(1).

(xvi) Amounts of scholarships and grants paid to certain exchange or training program participants that do not represent compensation for services but are not excluded from tax under section 117 are subject to a reduced rate of withholding of 14-percent under section 1441(b). Documentation establishing foreign status is required for purposes of this reduction in rate as provided under § 1.1441–4(c). This income is not subject to information reporting under chapter 61 of the Code nor to backup withholding under section 3406. The compensatory portion of a scholarship or grant is reportable as wage income. See § 1.6041–3(o).

(xvii) Amounts paid to a foreign organization described in section 501(c) are exempt from withholding under section 1441 to the extent that the amounts are not income includible under section 512 in computing the organization's unrelated business taxable income and are not subject to the tax imposed by section 4948(a). Documentation establishing status as a tax-exempt organization is required for purposes of this exemption to the extent provided in § 1.1441–9. Amounts includible under section 512 in computing the organization's unrelated business taxable income are subject to withholding to the extent provided in section 1443(a) and § 1.1443–1(a). Gross investment income (as defined in section 4940(c)(2)) of a private foundation is subject to withholding at a 4-percent rate to the extent provided in section 1443(b) and § 1.1443–1(b). Payments to a tax-exempt organization are exempt from information reporting under chapter 61 of the Code and the regulations thereunder (see § 1.6049–4(c)(1)(ii)(B)(1)).

(xviii) Per diem amounts for subsistence paid by the U.S. government to a nonresident alien individual who is engaged in any program of training in the United States under the Mutual Security Act of 1954 are exempt from withholding under section 1441(a). See section 1441(c)(6). Documentation of foreign status is required under § 1.1441–4(e) for purposes of establishing eligibility for this exemption. See § 1.6041–3(p).

(xix) Interest with respect to tax-free covenant bonds issued prior to 1934 is subject to special withholding procedures set forth in § 1.1461–1 in effect prior to January 1, 2000 (see § 1.1461–1 as contained in 26 CFR part 1, revised April 1, 1998).

(xx) Income from certain gambling winnings of a nonresident alien individual is exempt from tax under section 871(j) and from withholding under section 1441(a). See section 1441(c)(11). Documentation establishing foreign status is not required for purposes of this exemption but may have to be furnished for purposes of the information reporting provisions of section 6041 and backup withholding under section 3406. See §§ 1.6041–1 and 1.6041–4(a)(1).

(xxi) Any payments not otherwise mentioned in this paragraph (b)(4) shall be subject to withholding at the rate of 30-percent if it is an amount subject to withholding (as defined in § 1.1441–2(a)) unless and to the extent the IRS may otherwise prescribe in published guidance (see § 601.601(d)(2) of this chapter) or unless otherwise provided in regulations under chapter 3 of the Code.

(5) *Establishing foreign status under applicable provisions of chapter 61 of the Code.* This paragraph (b)(5) identifies relevant provisions of the regulations under chapter 61 of the Code that exempt payments from information reporting, and therefore, from backup withholding under section 3406, based on the payee's status as a foreign person. Many of these exemptions require

that the payee's foreign status be established in order for the exemption to apply. The regulations under applicable provisions of chapter 61 of the Code generally provide that the documentation described in this section may be relied upon for purposes of determining foreign status.

(i) Payments to a foreign person that are governed by section 6041 (dealing with certain trade or business income) are exempt from information reporting under §1.6041–4(a).

(ii) Payments to a foreign person that are governed by section 6041A (dealing with remuneration for services and certain sales) are exempt from information reporting under §1.6041A–1(d)(3).

(iii) Payments to a foreign person that are governed by section 6042 (dealing with dividends) are exempt from information reporting under §1.6042–3(b)(1) (iii) through (vi).

(iv) Payments to a foreign person that are governed by section 6044 (dealing with patronage dividends) are exempt from information reporting under §1.6044–3(c)(1).

(v) Payments to a foreign person that are governed by section 6045 (dealing with broker proceeds) are exempt from information reporting under §1.6045–1(g).

(vi) Payments to a foreign person that are governed by section 6049 (dealing with interest) to a foreign person are exempt from information reporting under §1.6049–5(b) (6) through (15).

(vii) Payments to a foreign person that are governed by section 6050N (dealing with royalties) are exempt from information reporting under §1.6050N–1(c).

(viii) Payments to a foreign person that are governed by section 6050P (dealing with income from cancellation of debt) are exempt from information reporting under section 6050P or the regulations under that section except to the extent provided in Notice 96–61 (1996–2 C.B. 227); see also §601.601(b)(2) of this chapter.

(6) *Rules of withholding for payments by a foreign intermediary or certain U.S. branches.* A foreign intermediary described in paragraph (e)(3)(i) of this section or a U.S. branch described in paragraph (b)(2)(iv) of this section that receives an amount subject to withholding (as defined in §1.1441–2(a)) shall be deemed to have satisfied any obligation it has under chapter 3 of the Code and the regulations thereunder to withhold and report the amount when it, in turn, pays such amount to another person (whether or not the beneficial owner) to the extent that the payment is associated with a valid withholding certificate described in paragraph (e)(3) (ii), (iii), or (v) of this section that it has furnished to another withholding agent and the intermediary does not know and has no reason to know that the correct amount has not been withheld under chapter 3 of the Code and the regulations thereunder. See §1.1441–5(c)(3)(v) for a similar rule for payments by certain foreign partnerships.

(7) *Liability for failure to obtain documentation timely or to act in accordance with applicable presumptions*—(i) *General rule.* A withholding agent that cannot reliably associate a payment with documentation on the date of payment and that does not withhold under this section, or withholds at less than the 30-percent rate prescribed under section 1441(a) and paragraph (b)(1) of this section, is liable under section 1461 for the tax required to be withheld under chapter 3 of the Code and the regulations thereunder, without the benefit of a reduced rate unless—

(A) The withholding agent has appropriately relied on the presumptions described in paragraph (b)(3) of this section (including the grace period described in paragraph (b)(3)(iv) of this section) in order to treat the payee as a U.S. person or, if applicable, on the presumptions described in §1.1441–4(a)(2)(i) or (3) to treat the payment as effectively connected income; or

(B) The withholding agent can demonstrate to the satisfaction of the district director or the Assistant Commissioner (International) that the proper amount of tax, if any, was in fact paid to the IRS; or

(C) No documentation is required under section 1441 or this section in order for a reduced rate of withholding to apply.

(ii) *Proof that tax liability has been satisfied.* Proof of payment of tax may be established for purposes of paragraph (b)(7)(i)(B) of this section on the basis of a Form 4669 (or such other form as the IRS may prescribe in published guidance (see § 601.601(d)(2) of this chapter)), establishing the amount of tax, if any, actually paid by or for the beneficial owner on the income. Proof that a reduced rate of withholding was, in fact, appropriate under the provisions of chapter 3 of the Code and the regulations thereunder may also be established after the date of payment by the withholding agent on the basis of a valid withholding certificate or other appropriate documentation furnished after that date. However, in the case of a withholding certificate or other appropriate documentation received after the date of payment (or after the grace period specified in paragraph (b)(3)(iv) of this section), the district director or the Assistant Commissioner (International) may require additional proof if it is determined that the delays in obtaining the withholding certificate affect its reliability.

(iii) *Liability for interest and penalties.* A withholding agent that has failed to withhold other than based on appropriate reliance on the presumptions described in paragraph (b)(3) of this section or in § 1.1441–4(a) (2)(i) or (3) is not relieved from liability for interest under section 6601. Such liability exists even if there is no underlying tax liability due. The interest on the amount that should have been withheld shall be imposed as prescribed under section 6601 beginning on the last date for paying the tax due under section 1461 (which, under section 6601, is the due date for filing the withholding agent's return of tax). The interest shall stop accruing on the earlier of the date that the required withholding certificate or other documentation is provided to the withholding agent and to the extent of the amount of tax that is determined not to be due based on documentation provided, or the date, and to the extent, that the unpaid tax liability under section 871, 881 or under section 1461 is satisfied. Further, in the event that a tax liability is assessed against the beneficial owner under section 871, 881, or 882 and interest under section 6601(a) is assessed against, and collected from, the beneficial owner, the interest charge imposed on the withholding agent shall be abated to that extent so as to avoid the imposition of a double interest charge. However, the withholding agent is not relieved of any applicable penalties. See section 1464.

(iv) *Special effective date.* See paragraph (f)(2)(ii) of this section for the special effective date applicable to this paragraph (b)(7).

(v) *Examples.* The provisions of paragraph (b)(7) of this section are illustrated by the following examples:

Example 1. On June 15, 2000, a withholding agent pays U.S. source interest on an obligation in registered form (issued after July 18, 1984) to a foreign corporation that it cannot reliably associate with a Form W–8 or other appropriate documentation upon which to rely to treat the beneficial owner as a foreign person. The withholding agent does not withhold from the payment. On September 30, 2002, the withholding agent receives from the foreign corporation a valid Form W–8 described in paragraph (e)(2)(ii) of this section. Thus, the interest qualifies as portfolio interest retroactively to June 15, 2000 (the date of payment). See § 1.871–14(c)(3). The foreign corporation does not file a U.S. federal income tax return and does not pay the tax owed. The withholding agent is not liable under section 1461 for the 30-percent tax on the interest income because the receipt of the Form W–8 exempts the interest from tax for purposes of sections 881(a) and 1461. The withholding agent, however, is liable for interest on the amount of withholding that should have been deducted from the payment on June 15, 2000 and deposited. Under paragraph (b)(7)(iii) of this section, the period during which interest may be assessed against the withholding agent runs from March 15, 2001 (the due date for the Form 1042 relating to the payment) until September 30, 2002 (i.e., the date that appropriate documentation is furnished to the withholding agent).

Example 2. On June 15, 2000, a withholding agent pays U.S. source dividends to a foreign corporation that it cannot reliably associate with a Form W–8 or other appropriate documentation upon which to rely to treat the beneficial owner as a foreign person. The withholding agent does not withhold from the payment. On September 30, 2002, the withholding agent receives from the foreign corporation a valid Form W–8 described in paragraph (e)(2)(ii) of this section claiming a reduced 15-percent rate of withholding under a U.S. income tax treaty. The dividend qualifies for the reduced treaty rate retroactively to June 15, 2000 (the date of payment). The foreign corporation does not file a U.S. federal income tax return and does not pay the tax owed. Under section 1461, the withholding agent is liable only for a 15-percent tax on the dividend income because the receipt of the Form W–8 allows the tax rate to be reduced for purposes of sections 881(a) and 1461 from 30 percent to 15 percent. The withholding agent, however, is liable for interest on the full 30-percent amount that should have been deducted and withheld from the payment on June 15, 2000, and deposited, over a period running from March 15, 2001 (the due date for the Form 1042 relating to the payment) until September 30, 2002 (the date that the appropriate documentation is furnished to the withholding agent supporting a reduction in rate under a tax treaty). Additional interest may be assessed relating to the outstanding 15-percent tax liability (i.e., the portion of the 30-percent total tax liability that is not reduced under the treaty). Such additional interest runs from March 15, 2001, until such date as that 15-percent tax liability is satisfied by the withholding agent or the taxpayer (subject to abatement in order to avoid a double interest charge).

(8) *Adjustments, refunds, or credits of overwithheld amounts.* If the amount withheld under section 1441, 1442, or 1443 is greater than the tax due by the withholding agent or the taxpayer, adjustments may be made in accordance with the procedures described in §1.1461–2(a). Alternatively, refunds or credits may be claimed in accordance with the procedures described in §1.1464–1, relating to refunds or credits claimed by the beneficial owner, or §1.6414–1, relating to refunds or credits claimed by the withholding agent. If an amount was withheld under section 3406 or is subsequently determined to have been paid to a foreign person, see paragraph (b)(3)(vii) of this section and §31.6413(a)–3(a)(1) of this chapter.

(9) *Payments to joint owners.* A payment to joint owners that requires documentation in order to reduce the rate of withholding under chapter 3 of the Code and the regulations thereunder does not qualify for such reduced rate unless the withholding agent can reliably associate the payment with documentation from each owner. Notwithstanding the preceding sentence, a payment to joint owners qualifies as a payment exempt from withholding under this section if any one of the owners provides a certificate of U.S. status on a Form W–9 in accordance with paragraph (d) (2) or (3) of this section or the withholding agent can associate the payment with a withholding certificate upon which it can rely to treat the payment as made to a U.S. beneficial owner under paragraph (d)(4) of this section. See §31.3406(h)–2(a)(3)(i)(B) of this chapter.

(c) *Definitions*—(1) *Withholding.* The term *withholding* means the deduction and withholding of tax at the applicable rate from the payment.

(2) *Foreign and U.S. person.* The term *foreign person* means a nonresident alien individual, a foreign corporation, a foreign partnership, a foreign trust, a foreign estate, and any other person that is not a U.S. person described in the next sentence. For purposes of the regulations under chapter 3 of the Code, the term *foreign person* also means, with respect to a payment by a withholding agent, a foreign branch of a U.S. person that furnishes an intermediary withholding certificate described in paragraph (e)(3)(ii) of this section. A U.S. person is a person described in section 7701(a)(30), the U.S. government (including an agency or instrumentality thereof), a State (including an agency or instrumentality thereof), or the District of Columbia (including an agency or instrumentality thereof).

(3) *Individual*—(i) *Alien individual.* The term *alien individual* means an individual who is not a citizen or a national of the United States. See §1.1–1(c).

(ii) *Nonresident alien individual.* The term *nonresident alien individual* means a person described in section 7701(b)(1)(B), an alien individual who is a resident of a foreign country under the residence article of an income tax treaty and §301.7701(b)–7(a)(1) of this chapter, or an alien individual who is a resident of Puerto Rico, Guam, the Commonwealth of Northern Mariana Islands, the U.S. Virgin Islands, or American Samoa as determined under §301.7701(b)–1(d) of this chapter. An alien individual who has made an election under section 6013 (g) or (h) to be treated as a resident of the United States is nevertheless treated as a nonresident alien individual for purposes of withholding under chapter 3 of the Code and the regulations thereunder.

(4) *Certain foreign corporations.* For purposes of this section, a corporation created or organized in Guam, the

Commonwealth of Northern Mariana Islands, the U.S. Virgin Islands, and American Samoa, is not treated as a foreign corporation if the requirements of sections 881(b)(1) (A), (B), and (C) are met for such corporation. Further, a payment made to a foreign government or an international organization shall be treated as a payment made to a foreign corporation for purposes of withholding under chapter 3 of the Code and the regulations thereunder.

(5) *Financial institution and foreign financial institution.* For purposes of the regulations under chapter 3 of the Code, the term *financial institution* means a person described in § 1.165–12(c)(1)(iv) (not including a person providing pension or other similar benefits or a regulated investment company or other mutual fund, unless otherwise indicated) and the term *foreign financial institution* means a financial institution that is a foreign person, as defined in paragraph (c)(2) of this section.

(6) *Beneficial owner*—(i) *General rule.* In the case of a payment of income, the term *beneficial owner* means the person who is the owner of the income for tax purposes and who beneficially owns that income. A person shall be treated as the owner of the income to the extent that it is required under U.S. tax principles to include the amount paid in gross income under section 61 (determined without regard to an exclusion or exemption from gross income under the Code). Beneficial ownership of income is determined under the provisions of section 7701(l) and the regulations under that section and any other applicable general U.S. tax principles, including principles governing the determination of whether a transaction is a conduit transaction. Thus, a person receiving income in a capacity as a nominee, agent, custodian for another person is not the beneficial owner of the income. In the case of a scholarship, the student receiving the scholarship is the beneficial owner of that scholarship. In the case of a payment of an amount that is not income, the beneficial owner determination shall be made under this paragraph (c)(6) as if the amount was income.

(ii) *Special rules for flow-through entities and arrangements*—(A) *General rule.* The beneficial owners of income paid to a partnership or other flow-through arrangements described in paragraph (c)(6)(ii)(C) of this section are those persons who, under U.S. tax principles, are the owners of the income for tax purposes in their separate or individual capacities and who beneficially own that income. For example, a partnership (first tier) that is a partner in another partnership (second tier) is not the beneficial owner of income paid to the second tier partnership since the first tier partnership is not the owner of the income under U.S. tax principles. Rather, the partners of the first tier partnership are the beneficial owners (to the extent they are not themselves partnerships and are not conduits within the meaning of section 7701(l) and the regulations under that section). See § 1.1441–5(b) for applicable withholding procedures for payments to a domestic partnership. See also § 1.1441–5(c)(3)(ii) for applicable withholding procedures for payments to a foreign partnership where one of the partners (at any level in the chain of tiers) is a domestic partnership. See § 1.1441–6(b)(4) for rules governing the eligibility of a payment to an entity or other arrangement for a reduced rate of withholding under an income tax treaty.

(B) *Trusts and estates.* The provisions of paragraphs (c)(6)(i) and (ii)(A) of this section shall not apply to a trust or an estate, whether domestic or foreign. The beneficial owner of income paid to a trust or to an estate shall be determined under the provisions of § 1.1441–3(f) and (g) in effect prior to January 1, 2000 (see § 1.1441–3(f) and (g) as contained in 26 CFR part 1, revised April 1, 1998).

(C) *Definition of a flow-through entity or arrangement.* For purposes of this paragraph (c)(6)(ii), a flow-through entity means a partnership, estate, or trust. A flow-though arrangement is a contractual arrangement that does not involve an entity and is treated as a partnership for U.S. tax purposes or is a wholly-owned entity that is disregarded for federal tax purposes under § 301.7701–2(c)(2) of this chapter as an entity separate from its owner. The term *partnership* means any entity or arrangement (as defined in § 301.7701–

2(c)(1) of this chapter) whose tax regime is governed by subchapter K of chapter 1 of the Code.

(7) *Withholding agent.* For a definition of the term *withholding agent* and applicable rules, see §1.1441–7.

(8) *Person.* For purposes of the regulations under chapter 3 of the Code, the term *person* shall mean a person described in section 7701(a)(1) and the regulations under that section and a U.S. branch to the extent treated as a U.S. person under paragraph (b)(2)(iv) of this section. For purposes of the regulations under chapter 3 of the Code, the term *person* does not include a wholly-owned entity that is disregarded for federal tax purposes under §301.7701–2(c)(2) of this chapter as an entity separate from its owner. See paragraph (b)(2)(iii) of this section for procedures applicable to payments to such entities.

(9) *Source of income.* The source of income is determined under the provisions of part I (section 861 and following) , subchapter N, chapter 1 of the Code and the regulations under those provisions.

(10) *Chapter 3 of the Code.* For purposes of the regulations under sections 1441, 1442, and 1443, any reference to chapter 3 of the Code shall not include references to sections 1445 and 1446, unless the context indicates otherwise.

(11) *Reduced rate.* For purposes of regulations under chapter 3 of the Code, and other withholding provisions of the Code, the term *reduced rate,* when used in regulations under chapter 3 of the Code, shall include an exemption from tax.

(d) *Beneficial owner's or payee's claim of U.S. status*—(1) *In general.* Under paragraph (b)(1) of this section, a withholding agent is not required to withhold under chapter 3 of the Code on payments to a U.S. payee, to a person presumed to be a U.S. payee in accordance with the provisions of paragraph (b)(3) of this section, or to a person that the withholding agent may treat as a U.S. beneficial owner of the payment. Absent actual knowledge or reason to know otherwise, a withholding agent may rely on the provisions of this paragraph (d) in order to determine whether to treat a payee or beneficial owner as a U.S. person.

(2) *Payments for which a Form W–9 is otherwise required.* A withholding agent may treat as a U.S. person a payee who is required to furnish a Form W–9 and who furnishes it in accordance with the procedures described in §§31.3406(d)–1 through 31.3406(d)–5 of this chapter (including the requirement that the payee furnish its taxpayer identifying number (TIN)) if the withholding agent meets all the requirements described in §31.3406(h)–3(e) of this chapter regarding reliance by a payor on a Form W–9.

(3) *Payments for which a Form W–9 is not otherwise required.* In the case of a payee who is not required to furnish a Form W–9 under section 3406, the withholding agent may rely on a certificate of U.S. status described in this paragraph (d)(3). A certificate of U.S. status is a certificate described in §31.3406(h)–3(c)(2) of this chapter (relating to forms for exempt recipients) or a Form W–9 (or a substitute form or such other form as the IRS may prescribe) that is signed under penalties of perjury by the payee and contains the name, permanent residence address, and TIN of the payee. The procedures described in §31.3406(h)–2(a) of this chapter shall apply to payments to joint payees. A withholding agent that receives a Form W–9 in order to satisfy this paragraph (d)(3) must retain the form in accordance with the provisions of §31.3406(h)–3(g) of this chapter, if applicable, or of paragraph (e)(4)(iii) of this section (relating to the retention of withholding certificates) if §31.3406(h)–3(g) of this chapter does not apply. The rules of this paragraph (d)(3) are only intended to provide a method by which a withholding agent may determine that a payee is not a foreign person and do not otherwise impose a requirement that documentation be furnished by a person who is otherwise treated as an exempt recipient for purposes of the applicable information reporting provisions under chapter 61 of the Code (e.g., §1.6049–4(c)(1)(ii) for payments of interest).

(4) *Other payments.* This paragraph (d)(4) describes the documentation upon which a withholding agent may rely in order to treat a payment as made to a U.S. person that is a beneficial owner for purposes of paragraph

(b)(1) of this section. The withholding agent may treat the payment as made to a U.S. beneficial owner only if it can reliably associate the payment with documentation prior to the payment, if it complies with the electronic confirmation procedures described in paragraph (e)(4)(v) of this section, if required, and if it has not been notified by the IRS that any of the information on the withholding certificate or other documentation is incorrect or unreliable. In the case of a Form W–9 that is required to be furnished for a reportable payment that may be subject to backup withholding, the payor may be notified in accordance with section 3406(a)(1)(B) and the regulations under that section. See applicable procedures under that section and the regulations under that section for payors who have been notified with regard to such a Form W–9. Payors who have been notified in relation to other Forms W–9, including under section 6724(b) pursuant to section 6721, may rely on the withholding certificate or other documentation only to the extent provided under procedures as prescribed by the IRS (see § 601.601(d)(2) of this chapter). A withholding agent may treat a payment as made to a U.S. beneficial owner—

(i) To the extent the withholding agent can reliably associate the payment with a Form W–9 described in paragraph (d) (2) or (3) of this section attached to a valid intermediary, flow-through, or U.S. branch withholding certificate described in paragraph (e)(3)(i) of this section;

(ii) To the extent the withholding agent can reliably associate a payment to a qualified intermediary with the category of assets described in paragraph (e)(5)(v)(B)(*2*) of this section that the qualified intermediary has represented, in accordance with paragraphs (e) (3)(ii)(E) and (5)(v) of this section as being allocable to U.S. persons based on the Forms W–9 that they have furnished; or

(iii) To the extent the withholding agent can reliably associate the payment with a Form W–8 from a U.S. branch described in paragraph (e)(3)(v) of this section that evidences an agreement between the U.S. branch and the withholding agent to treat the U.S. branch as U.S. person.

(e) *Beneficial owner's claim of foreign status*—(1) *Withholding agent's reliance*—(i) *In general.* Absent actual knowledge or reason to know otherwise, a withholding agent may treat a payment as made to a foreign beneficial owner in accordance with the provisions of paragraph (e)(1)(ii) of this section. See paragraph (e)(4)(viii) of this section for applicable reliance rules. See paragraph (b)(4) of this section for a description of payments for which a claim of foreign status is relevant for purposes of claiming a reduced rate of withholding for purposes of section 1441, 1442, or 1443. See paragraph (b)(5) of this section for a list of payments for which a claim of foreign status is relevant for other purposes, such as claiming an exemption from information reporting under chapter 61 of the Code.

(ii) *Payments that a withholding agent may treat as made to a foreign person that is a beneficial owner*—(A) *General rule.* The withholding agent may treat a payment as made to a foreign person that is a beneficial owner if it complies with the requirements described in paragraph (e)(1)(ii)(B) of this section and, then, only to the extent—

(*1*) That the withholding agent can reliably associate the payment with a beneficial owner withholding certificate described in paragraph (e)(2) of this section furnished by the person whose name is on the certificate or attached to a valid foreign intermediary, flow-through entity, or U.S. branch withholding certificate described in paragraph (e)(3)(v) of this section;

(*2*) That the payment is made outside the United States (within the meaning of § 1.6049–5(e)) with respect to an offshore account (within the meaning of § 1.6049–5(c)(1)) and the withholding agent can reliably associate the payment with documentary evidence described in §§ 1.1441–6(c)(3) or (4), or 1.6049–5(c)(1) relating to the beneficial owner;

(*3*) That the withholding agent can reliably associate the payment with the category of assets described in paragraph (e)(5)(v)(B)(*1*) of this section that the qualified intermediary has represented, in accordance with paragraphs (e) (3)(ii)(E) and (5)(v) of this section as being allocable to foreign persons for whom the qualified intermediary is holding valid documentation;

(*4*) That the withholding agent can reliably associate the payment with a withholding certificate described in §1.1441–5(c)(3)(iii) from a foreign partnership claiming that the payment is effectively connected income;

(*5*) That the withholding agent identifies the payee as a U.S. branch described in paragraph (b)(2)(iv) of this section, the payment to which it treats as effectively connected income in accordance with §1.1441–4(a) (2)(ii) or (3);

(*6*) That the withholding agent identifies the payee as an international organization (or any wholly-owned agency or instrumentality thereof) as defined in section 7701(a)(18) that has been designated as such by executive order (pursuant to 22 U.S.C. 288 through 288(f)); or

(*7*) That the withholding agent pays interest from bankers' acceptances and identifies the payee as a foreign central bank of issue (as defined in §1.861–2(b)(4)).

(B) *Additional requirements.* In order for a payment described in paragraph (e)(1)(ii)(A) of this section to be treated as made to a foreign beneficial owner, the withholding agent must hold the documentation (if required) prior to the payment, comply with the electronic confirmation procedures described in paragraph (e)(4)(v) of this section (if required), and must not have been notified by the IRS that any of the information on the withholding certificate or other documentation is incorrect or unreliable. If the withholding agent has been so notified, it may rely on the withholding certificate or other documentation only to the extent provided under procedures prescribed by the IRS (see §601.601(d)(2) of this chapter). See paragraph (b)(2)(vii) of this section for rules regarding reliable association of a payment with a withholding certificate or other appropriate documentation.

(2) *Beneficial owner withholding certificate*—(i) *In general.* A beneficial owner withholding certificate is a statement by which the beneficial owner of the payment represents that it is a foreign person and, if applicable, claims a reduced rate of withholding under section 1441. A separate withholding certificate must be submitted to each withholding agent. If the beneficial owner receives more than one type of payment from a single withholding agent, the beneficial owner may have to submit more than one withholding certificate to the single withholding agent for the different types of payments as may be required by the applicable forms and instructions, or as the withholding agent may require (such as to facilitate the withholding agent's compliance with its obligations to determine withholding under this section or the reporting of the amounts under §1.1461–1 (b) and (c)). For example, if a beneficial owner claims that some but not all of the income it receives is effectively connected with the conduct of a trade or business in the United States, it may be required to submit two separate withholding certificates, one for income that is not effectively connected and one for income that is so connected. See §1.1441–6(b)(4)(ii) for special rules for determining who must furnish a beneficial owner withholding certificate when a benefit is claimed under an income tax treaty. See paragraph (e)(4)(ix) of this section for reliance rules in the case of certificates held by another person or at a different branch location of the same person.

(ii) *Requirements for validity of certificate.* A beneficial owner withholding certificate is valid only if it is provided on a Form W–8, or a Form 8233 in the case of personal services income described in §1.1441–4(b) or certain scholarship or grant amounts described in §1.1441–4(c) (or a substitute form described in paragraph (e)(4)(vi) of this section, or such other form as the IRS may prescribe). A Form W–8 is valid only if its validity period has not expired, it is signed under penalties of perjury by the beneficial owner, and it contains all of the information required on the form. The required information is the beneficial owner's name, permanent residence address, and TIN (if required), the country under the laws of which the beneficial owner is created, incorporated, or governed (if a person other than an individual), the classification of the entity, and such other information as may be required by the regulations under section 1441 or by the form or accompanying instructions in addition to, or in lieu of, the information described in this paragraph (e)(2)(ii). A person's permanent residence address is an address in the country where the person claims to be a resident for purposes of that country's income tax. In the case of a certificate furnished in order to claim a reduced rate of withholding under an income tax treaty, the residence must be determined in the manner prescribed under the applicable treaty. See §1.1441–6(b)(4)(i). The address of a financial institution with which the beneficial owner maintains an account, a post office box, or an address used solely for mailing purposes is not a residence address for this purpose. If the beneficial owner is an individual who does not have a tax residence in any country, the permanent residence address is the place at which the beneficial owner normally resides. If the beneficial owner is not an individual and does not have a tax residence in any country, then the permanent residence address is the place at which the person maintains its principal office. See paragraph (e)(4)(vii) of this section for circumstances in which a TIN is required on a beneficial owner withholding certificate. See paragraph (f)(2)(i) of this section for continued validity of certificates during a transition period.

(3) *Intermediary, flow-through, or U.S. branch withholding certificate*—(i) *In general.* An intermediary withholding certificate is a Form W–8 by which a payee represents that it is a foreign person and that it is an intermediary with respect to a payment and not the beneficial owner. A flow-through withholding certificate is a Form W–8 furnished by a flow-through entity under §1.1441–5(c)(2) or (3) for a partnership or under §1.1441–5(e) for a foreign estate or trust. See paragraph (c)(6)(ii)(C) of this section for a definition of a flow-through entity. A U.S. branch certificate is a Form W–8 by which the payee represents that it is a U.S. branch described in paragraph (b)(2)(iv) (A) or (E) of this section and that the payment is not effectively connected with the conduct of its trade or business in the United States. An intermediary withholding certificate is used by an intermediary either to make representations regarding the status of beneficial owners of the amount paid or to transmit appropriate documentation to the withholding agent. A flow-through certificate is used by a flow-through entity to establish its status as a foreign person or the status of its partners or beneficiaries, if required, and, if applicable, to claim a reduced rate of withholding. An intermediary means, with respect to a payment that it receives, a person that, for that payment, acts as a custodian, broker, nominee, or otherwise as an agent for another person, regardless of whether such other person is the beneficial owner of the amount paid, a flow-through entity, or another intermediary. See paragraph (e)(4)(viii) of this section for applicable reliance rules.

(ii) *Intermediary withholding certificate from a qualified intermediary.* An intermediary withholding certificate from a person representing to be a qualified intermediary (described in paragraph (e)(5)(ii) of this section) is valid only if it is furnished on a Form W–8 (or an acceptable substitute form or such other form as the IRS may prescribe), it is signed under penalties of perjury by an officer of the qualified intermediary with authority to sign for the intermediary, its validity has not expired, and it contains the following information, statement, and certifications:

(A) The name, permanent residence address (as described in paragraph (e)(2)(ii) of this section), and the employer identification number of the intermediary, and the country under the laws of which the intermediary is created, incorporated, or governed.

(B) A certification that the person whose name is on the Form W–8 is not acting for its own account and is acting as a qualified intermediary within the meaning of paragraph (e)(5)(ii) of this section.

(C) A certification that the intermediary has obtained the appropriate certificates (such as Forms W–8 or W–9) or other appropriate documentation in the manner required in its withholding agreement with the IRS for those account holders that are covered by the certificate and whose assets are identified as being allocable to the categories described in paragraph (e)(5)(v)(B) (*1*) or (*2*) (in accordance with paragraph (e)(5)(v) of this section or otherwise).

(D) A certification whether the qualified intermediary is assuming primary withholding responsibility for the amounts to which the certificate relates.

(E) A statement attached to the certificate that provides such information as may be required by the form and accompanying instructions, including sufficient information for the withholding agent to determine the amount required to be withheld from amounts paid to the intermediary and reported to the IRS. See paragraph (e)(5)(v) of this section for requirement of a statement and rules applicable thereto.

(F) Any other information or certification as may be required by the form or accompanying instructions in addition to, or in lieu of, the information and certifications described in this paragraph (e)(3)(ii).

(iii) *Intermediary withholding certificate from an intermediary that is not a qualified intermediary.* An intermediary withholding certificate from a person that does not represent to be a qualified intermediary within the meaning of paragraph (e)(5)(ii) of this section is valid only if it is furnished on a Form W–8 (or an acceptable substitute form, or such other form as the IRS may prescribe), it is signed under penalties of perjury by a person authorized to sign for the intermediary, it contains the information, statement, and certifications described in this paragraph (e)(3)(iii), its validity has not expired, and the withholding certificates and other appropriate documentation for all the persons to whom the certificate relates are attached to the certificate. Appropriate documentation consists of beneficial owner withholding certificates described in paragraph (e)(2)(i) of this section, intermediary withholding certificates described in paragraph (e)(3)(i) of this section, flow-through certificates described in §1.1441–5(c)(2)(iv), (3)(iii), and (e), documentary evidence described in §1.1441–6(b)(2)(i) or in §1.6049–5(c)(1) related to the beneficial owner (or documentary evidence described in §1.6049–5(c)(4) for purposes of information reporting under chapter 61 of the Code), and other documentation or certificate applicable under other provisions of the Code or regulations that certify or establish the status of the payee or beneficial owner as a U.S. or a foreign person. If the intermediary is acting on behalf of another intermediary that is not a qualified intermediary or on behalf of a partnership that is not a withholding foreign partnership described in §1.1441–5(c)(2)(i), then the intermediary must attach to its own withholding certificate the intermediary withholding certificate or the partnership withholding certificate to which all the withholding certificates and other appropriate documentation required to be attached under this paragraph (e)(3)(iii) or in §1.1441–5(c)(3)(iii) or (e) are also attached. Nothing in this paragraph (e)(3)(iii) shall require an intermediary to furnish original documentation. Copies of certificates or documentary evidence may be passed up to the U.S. withholding agent, in which case the intermediary must retain the original documentation for the same time period that the copy is required to be retained by the withholding agent under paragraph (e)(4)(iii) of this section and must provide it to the withholding agent upon request. For purposes of this paragraph (e)(3)(iii), a valid intermediary withholding certificate also includes a statement described in §1.871–14(c)(2)(v) furnished in order for interest to qualify as portfolio interest for purposes of sections 871(h) and 881(c) or in order for amounts described in §1.1441–6(b)(2)(ii) to qualify as amounts paid to a foreign person. The information and certification required on a Form W–8 described in this paragraph (e)(3)(iii) (or on an acceptable substitute form or such other form as the IRS may prescribe) are as follows:

(A) The name and permanent resident address (as described in paragraph (e)(2)(ii) of this section) of the intermediary, and the country under the laws of which the intermediary is created, incorporated, or governed.

(B) A certification that the person whose name is on the Form W–8 is not acting for its own account and is using the certificate as a form to transmit withholding certificates and other appropriate documentation for the payment to which the form relates.

(C) If furnishing an intermediary certificate to transmit withholding certificates or other appropriate documentation for more than one person, a statement attached to the Form W–8 that provides such information as may be required by the form and accompanying instructions, including sufficient information for the withholding agent to determine the amount required to be withheld from amounts paid to the intermediary. See paragraph (e)(3)(iv) of this section for rules applicable to such a statement.

(D) A certification either that the attached withholding certificates and other appropriate documentation represent all of the persons to whom the intermediary withholding certificate relates or that the amounts allocable to persons covered by the intermediary withholding certificate and for whom withholding certificates or other appropriate documentation are lacking or unreliable are separately identified.

(E) Any other information or certification as may be required by the form or accompanying instructions in addition to, or in lieu of, the information and certification described in this paragraph (e)(3)(iii).

(iv) *Information to the withholding agent regarding assets owned by beneficial owners, etc.*—(A) *General rule.* An intermediary that has not represented that it is acting as a qualified intermediary within the meaning of paragraph (e)(5)(ii) of this section must provide information sufficient for the withholding agent to determine the proportion of each payment of reportable amounts (as described in paragraph (e)(3)(vi) of this section) that is allocable to each person to whom the intermediary withholding certificate relates, including persons for whom the intermediary has not attached a withholding certificate or other appropriate documentation. The withholding agent may rely on such information in order to determine the amount of withholding on the payment and how to report this payment under chapter 3 or 61 of the Code and the regulations thereunder. The sum of all the proportions indicated by the intermediary, expressed as a percentage, must equal, but not exceed, one hundred percent of the payment. The information for persons for whom a withholding certificate or other appropriate documentation is lacking or unreliable may be provided in the aggregate and need not be provided separately for each such person. The foreign intermediary is not required to disclose the names of the persons for whom it collects the payment, unless it has actual knowledge that any such person is a U.S. person that is not an exempt recipient. In such a case, the intermediary must state separately the information for such U.S. person even though such person has not provided a Form W–9 to the intermediary in the manner described in paragraph (d)(2) of this section. The information may be furnished in any manner that the parties choose. For example, if the withholding agent maintains separate accounts for different types of income or withholding rates, the intermediary must provide sufficient information so that the withholding agent may allocate assets appropriately among the relevant accounts. If the withholding agent does not maintain separate accounts, it may require the intermediary to attach a statement to the intermediary withholding certificate under paragraphs (e)(3)(iii)(C) and (D) of this section providing the information described in this paragraph (e)(3)(iv).

(B) *Updating the information.* The intermediary must update the information furnished to the withholding agent in accordance with paragraph (e)(3)(iv)(A) of this section as often as is necessary in order to enable the withholding agent to withhold at the appropriate rate on each payment and to report such income for purposes of chapter 3 or 61 of the Code and sections 3402, 3405 and 3406 (and the regulations under those provisions). Any update of the information as required under this paragraph (e)(3)(iv)(B) shall be treated as an integral part of the intermediary withholding certificate with which it is associated. See paragraph (e)(4)(ii)(D) of this section regarding how changes in the information described in this paragraph (e)(3)(iv) may affect the validity of withholding certificates. See paragraph (b)(3)(v)(C) of this section for consequences if the information is not updated as required.

(C) *Examples.* The rules of paragraph (e)(3)(iii) of this section and of this paragraph (e)(3)(iv) are illustrated by the following examples:

Example 1. A U.S. withholding agent, W, pays U.S. source dividends to foreign intermediary X who, in turn, pays to foreign intermediary Y, who collects on behalf of foreign beneficial owners, A and B. A and B have each furnished a beneficial owner Form W–8 to Y. Y must furnish to X an intermediary Form W–8 described in paragraph (e)(3)(iii) of this section, to which it must attach the original or copies of A's and B's Forms W–8. X, in turn, must furnish to W its own intermediary Form W–8 described in paragraph (e)(3)(iii) of this section, to which it must attach the original or copies of the intermediary Form W–8 received from Y and A's and B's Forms W–8.

Example 2. A foreign bank, X, acts as an intermediary for five different persons, A, B, C, D, and E, who each own securities from which they receive U.S. source dividends. The distributions are paid by a U.S. financial institution, W, as custodian of the securities for X. A's, B's, C's, D's, and E's respective claimed ownership interest in the securities is 20-percent each. X has furnished to W an intermediary Form W–8 described in paragraph (e)(3)(iii) of this section, to which it has attached a statement described in this paragraph (e)(3)(iv) stating each of A', B's, and C's interest in the securities with respect to which distributions are made periodically. The respective ownership interests of D and E are not stated separately because X has not received a valid withholding certificate or other appropriate documentation from D or E. Therefore, on the statement, D's and E's interest in the securities is stated in the aggregate (i.e., 40-percent attributable to undocumented owners). X has attached a Form W–8 for A and documentary evidence for B (who each claim a reduced rate of withholding under an income tax treaty), and a Form W–9 for C. In determining the amount to be withheld from the amount paid to X, W may rely on X's intermediary Form W–8, the allocation statement attached to the Form W–8, and the attached Form W–8, documentary evidence, and Form W–9 for each of A, B, and C. Based on paragraphs (b)(1), (b)(2)(v), (b)(2)(vii), (d)(4)(i), and (e)(1)(ii)(A)(*1*) of this section, W may withhold as follows on the payment to X: no withholding on 20-percent of the payment on the basis of C's Form W–9, withholding at the reduced treaty rate on 40-percent of the payment on the basis of A's Form W–8 and B's documentary evidence, and 30-percent on 40-percent of the payment to the undocumented owners group formed by D and E in accordance with the presumptions described in paragraph (b)(3)(v)(B) of this section (i.e., due to the lack of documentation for D and E). Under paragraph (e)(3)(iii) of this section, X is not required to identify D or E to W. For purposes of making a return under §1.1461–1(c), W would prepare a single Form 1042–S for the group of undocumented owners, D and E (if the names are undisclosed, the Form 1042–S should be made in the name of X and state that the return is made for unknown owners (see §1.1461–1(c)(4)(iv)). Because X has not furnished required documentation for D and E, X does not qualify under paragraph (b)(6) of this section for relief from an obligation to make a report on a Form 1042–S (to the extent D and E are presumed to be foreign persons under paragraph (b)(3)(iii) of this section) when X makes the payment to D and E (however, because a full 30-percent amount was withheld under this section, X does not have to withhold an additional amount under the facts of this example). In contrast, under paragraph (b)(6) of this section, X is not required to make a report on Form 1042–S for its payments to A or B. Under §1.6042–3(b)(1)(vi), X is not required to report C's share of the payment on Form 1099 (unless X has actual knowledge that W has not reported the portion of payment allocable to C in accordance with §1.6042–2).

Example 3. The facts are the same as in *Example 2*, except that D's name is D Insurance Company whom X knows is a U.S. person. Because of D's name, X may treat D as an exempt recipient on an eyeball test basis under §§1.6042–3(b)(1)(vii) and 1.6049–4(c)(1)(ii)(A)(*1*). However, even if those facts are disclosed to W, W must withhold 30-percent of the portion of the payment allocable to D because W is making a payment to a foreign person (X). Under paragraph (b)(1) of this section, W may reduce the rate of withholding only if it can associate the payment with documentation upon which it can rely to treat the beneficial owner as a U.S. person or as a foreign person entitled to a reduced rate of withholding. Because X has not furnished documentation for D, W does not have the proper documentation with which it can associate the payment allocable to D. Thus, insofar as W is concerned, the portion of the payment allocable to D is treated as a payment to an undocumented owner that W must presume to be a foreign person under paragraph (b)(3)(v)(B) of this section. Accordingly, under this paragraph (e)(3)(iv), W need not identify the information for D separately and can aggregate the portion of the payment allocable to D and E. W's reporting requirements for the portion of the payment allocable to D and E are the same as under *Example 2*. When X makes the payment to D, X does not benefit from the relief from reporting under §1.6042–3(b)(1)(vi). However, X is not required to report the payment to D on Form 1099 under section 6042 because, under § 1.6042–3(b)(1)(vii), X can treat D as an exempt recipient.

(v) *Withholding certificate from certain U.S. branches.* A U.S. branch certificate is a representation by the U.S. branch whose name is on the certificate that the payment it receives is not effectively connected with the conduct of a trade or business in the United States and that it is using the certificate either to transmit the appropriate documentation for the persons for whom the branch receives the payment (i.e., as an intermediary) or as evidence of its agreement with the withholding agent to be treated as a U.S. person with respect to any payment associated with the certificate. A U.S. branch withholding certificate is valid only if it is furnished on a Form W–8 (or an acceptable substitute form, or such other form as the IRS may prescribe), it is signed under penalties of perjury by a person authorized to sign for the branch, its validity has not expired, and it contains the information, statement, and certifications described in this paragraph (e)(3)(v). If the certificate is furnished to transmit withholding certificates and other documentation, it must contain the information and certifications described in paragraphs (e)(3)(v) (A) through (C) of this section and in paragraphs (e)(3)(iii) (C) and (D) of this section. If the certificate is furnished pursuant to an agreement to treat the U.S. branch as a U.S. person, the information and certification required on the Form W–8 (or an acceptable substitute form or such other form as the IRS may prescribe) are limited to the following—

(A) The name of the person of which the branch is a part and the address of the branch in the United States;

(B) A certification that the payments associated with the certificate are not effectively connected with the conduct of its trade or business in the United States; and

(C) Any other information or certification as may be required by the form or accompanying instructions in addition to, or in lieu of, the information and certification described in this paragraph (e)(3)(v).

(vi) *Reportable amounts.* For purposes of this section, the term reportable amount means an amount subject to withholding within the meaning of § 1.1441–2(a), bank deposit interest (including original issue discount) and similar types of deposit interest described in section 871(i)(2)(A) or 881(d) that are from sources within the United States, and any amount of interest or original issue discount from sources within the United States on certain short-term obligations described in section 871(g)(1)(B) or 881(a)(3). For purposes of this paragraph (e)(3)(vi), however, reportable amounts do not include payments with respect to deposits with banks and other financial institutions that remain on deposit for a period of two weeks or less, to amounts of original issue discount arising from a sale and repurchase transaction that is completed within a period of two weeks or less, or to amounts described in § 1.6049–5(b) (7), (10) or (11) (relating to certain obligations issued in bearer form). While short-term OID and bank deposit interest are not subject to withholding under chapter 3 of the Code, such amounts may be subject to information reporting under section 6049 if paid to a U.S. person who is not an exempt recipient described in § 1.6049–4(c)(1)(ii) and to backup withholding under section 3406 in the absence of documentation. See § 1.6049–5(d)(3)(iii) for applicable procedures when such amounts are paid to a foreign intermediary.

(4) *Applicable rules.* The provisions in this paragraph (e)(4) describe procedures applicable to withholding certificates on Form W–8 or Form 8233 (or a substitute form) or documentary evidence furnished to establish foreign status. These provisions do not apply to Forms W–9 (or their substitutes). For corresponding provisions regrading Form W–9 (or a substitute form), see section 3406 and the regulations under that section.

(i) *Who may sign the certificate.* A withholding certificate (or other acceptable substitute) may be signed by any person authorized to sign a declaration under penalties of perjury on behalf of the person whose name is on the certificate as provided in section

6061 and the regulations under that section (relating to who may sign generally for an individual, estate, or trust, which includes certain agents who may sign returns and other documents), section 6062 and the regulations under that section (relating to who may sign corporate returns), and section 6063 and the regulations under that section (relating to who may sign partnership returns).

(ii) *Period of validity*—(A) *Three-year period.* A withholding certificate described in paragraph (e)(2)(i) of this section, a certificate described in §1.871–14(c)(2)(v) (furnished to qualify interest as portfolio interest for purposes of sections 871(h) and 881(c) or to qualify amounts paid on certain securities described in §1.1441–6(b)(2)(ii) as paid to a foreign person), or documentary evidence described in §1.1441–6(b)(2)(i) or in §1.6049–5(c)(1) shall remain valid until the earlier of the last day of the third calendar year following the year in which the certificate is signed or the documentary evidence is created or the day that a change of circumstances occurs that makes any information on the certificate or documentary evidence incorrect. For example, a certificate signed on September 30, 2000, remains valid through December 31, 2003, unless circumstances change that make the information on the form no longer correct.

(B) *Indefinite validity period.* Notwithstanding paragraph (e)(4)(ii)(A) of this section, the following certificates or parts of certificates shall remain valid until the status of the person whose name is on the certificate is changed in a way relevant to the certificate or circumstances change that make the information on the certificate no longer correct:

(*1*) A beneficial owner withholding certificate described in paragraph (e)(2)(ii) of this section that is furnished with a TIN if the income for which such certificate is furnished is required to be reported under §1.1461–1(c)(2)(i) or the TIN furnished on the certificate is reported to the IRS under the procedures described in §1.1461–1(d).

(*2*) A certificate described in paragraph (e)(3)(ii) of this section (dealing with a certificate from a person representing to be a qualified intermediary).

(*3*) A certificate described in paragraph (e)(3)(iii) of this section (dealing with a certificate from a person representing to be a non-qualified intermediary), but not including the withholding certificates or documentary evidence required to be attached to the certificate.

(*4*) A certificate described in paragraph (e)(3)(v) of this section (dealing with a certificate from a person representing to be a U.S. branch), but not the withholding certificates or documentary evidence required to be attached to the certificate.

(*5*) A certificate described in §1.1441–5(c)(2)(iv) (dealing with a certificate from a person representing to be a withholding foreign partnership).

(*6*) A certificate described in §1.1441–5(c)(3)(iii) (dealing with a certificate from a person representing to be a foreign partnership that is not a withholding foreign partnership), but not including the withholding certificates or documentary evidence required to be attached to the certificate.

(*7*) A certificate furnished by a person representing to be an integral part of a foreign government (within the meaning of §1.892–2T(a)(2)) in accordance with §1.1441–8(b), or by a person representing to be a foreign central bank of issue (within the meaning of §1.861–2(b)(4)) or the Bank for International Settlements in accordance with §1.1441–8(c)(1).

(C) *Withholding certificate for effectively connected income.* Notwithstanding paragraph (e)(4)(ii)(B)(*1*) of this section, the period of validity of a withholding certificate furnished to a withholding agent to claim a reduced rate of withholding for income that is effectively connected with the conduct of a trade or business within the United States shall be limited to the three-year period described in paragraph (e)(4)(ii)(A) of this section.

(D) *Change in circumstances.* If a change in circumstances makes any information on a certificate or other documentation incorrect, then the person whose name is on the certificate or other documentation must inform the withholding agent within 30 days of the change and furnish a new certificate or new documentation. A certificate or documentation becomes invalid from the date that the withholding agent holding the certificate or documentation knows or has reason to know that circumstances affecting the correctness of the certificate or documentation have changed. However, a withholding agent may choose to apply the provisions of paragraph (b)(3)(iv) of this section regarding the 90-day grace period as of that date while awaiting a new certificate or documentation or while seeking information regarding changes, or suspected changes, in the person's circumstances. If an intermediary (including a U.S. branch described in paragraph (b)(2)(iv)(A) of this section that passes through certificates to a withholding agent) or a flow-through entity becomes aware that a certificate or other appropriate documentation it has furnished to the person from whom it collects the payment is no longer valid because of a change in the circumstances of the person who issued the certificate or furnished the other appropriate documentation, then the intermediary or flow-through entity must notify the person from whom it collects the payment of the change of circumstances. It must also obtain a new withholding certificate or new appropriate documentation to replace the existing certificate or documentation whose validity has expired due to the change in circumstances. If a beneficial owner withholding certificate is used to claim foreign status only (and not, also, residence in a particular foreign country for purposes of an income tax treaty), a change of address is a change in circumstances for purposes of this paragraph (e)(4)(ii)(D) only if it changes to an address in the United States. Further, a change of address within the same foreign country is not a change in circumstances for purposes of this paragraph (e)(4)(ii)(D). A change in the circumstances affecting the withholding information provided to the withholding agent in accordance with the provisions in paragraph (e) (3)(iv) or (5)(v) of this section or in § 1.1441–5(c)(3)(iv) shall terminate the validity of the withholding certificate with respect to the information that is no longer reliable unless the information is updated. A withholding agent may rely on a certificate without having to inquire into possible changes of circumstances that may affect the validity of the statement, unless it knows or has reason to know that circumstances have changed. A withholding agent may require a new certificate at any time prior to a payment, even though the withholding agent has no actual knowledge or reason to know that any information stated on the certificate has changed.

(iii) *Retention of withholding certificate.* A withholding agent must retain each withholding certificate and other documentation for as long as it may be relevant to the determination of the withholding agent's tax liability under section 1461 and § 1.1461–1.

(iv) *Electronic transmission of information.* Under procedures issued by the IRS (see § 601.601(d)(2) of this chapter), a withholding agent may be permitted to receive in electronic form the information required to be included on a withholding certificate.

(v) *Electronic confirmation of taxpayer identifying number on withholding certificate.* The Commissioner may prescribe procedures in a revenue procedure (see § 601.601(d)(2) of this chapter) or other appropriate guidance to require a withholding agent to confirm electronically with the IRS information concerning any TIN stated on a withholding certificate.

(vi) *Acceptable substitute form.* A withholding agent may substitute its own form instead of an official Form W–8 or 8233 (or such other official form as the IRS may prescribe). Such a substitute for an official form will be acceptable if it contains provisions that are substantially similar to those of the official form, it contains the same certifications relevant to the transactions as are contained on the official form and these certifications are clearly set forth, and the substitute form includes a signature-under-penalties-of-perjury statement identical to the one stated on the official form. The substitute form is acceptable even if it does not contain all of the provisions contained on the official form, so long as it contains those provisions that are relevant to the transaction for which it is furnished. For example, a withholding agent that pays no income for which treaty benefits are claimed may develop a substitute form that is identical to the official form, except that it does not include information regarding claim of benefits under an income tax treaty. A withholding agent who uses a substitute form must furnish instructions relevant to the substitute form only to the extent and in the manner specified in the instructions to the official form. A withholding agent may refuse to accept a certificate from a payee or beneficial owner (including the official Form W–8 or 8233) if the certificate is not provided on the acceptable substitute form provided by the withholding agent. However, a withholding agent may refuse to accept a certificate provided by a payee or beneficial owner only if the withholding agent furnishes the payee or beneficial owner with an acceptable substitute form immediately upon receipt of an unacceptable form or within 5 business days of receipt of an unacceptable form from the payee or beneficial owner. In that case, the substitute form is acceptable only if it contains a notice that the withholding agent has refused to accept the form submitted by the payee or beneficial owner and that the payee or beneficial owner must submit the acceptable form provided by the withholding agent in order for the payee or beneficial owner to be treated as having furnished the required withholding certificate.

(vii) *Requirement of taxpayer identifying number.* A TIN must be stated on a withholding certificate when required by this paragraph (e)(4)(vii). A TIN is required to be stated on a beneficial owner certificate if the beneficial owner is claiming the benefit of a reduced rate under an income tax treaty (other than for amounts described in §1.1441–6(b)(2)(ii)), an exemption from withholding because income is effectively connected with a U.S. trade or business, an exemption under section 871(f) for certain annuities received under qualified plans, or an exemption solely based on a foreign organization's claim of tax exempt status under section 501(c) or private foundation status. Thus, a TIN is not required from a foreign private foundation that is subject to the 4-percent tax under section 4948(a) on income if that income is otherwise exempt under the Code. In addition, a TIN is required to be stated on the withholding certificate from a person representing to be a qualified intermediary described in paragraph (e)(5)(ii) of this section, on the withholding certificate from a person representing to be a withholding foreign partnership described in §1.1441–5(c)(2)(i)), on the withholding certificate from a person representing to be a foreign trust or foreign estate, or from a fiduciary thereof, and on the withholding certificate from a person representing to be a U.S. branch described in paragraph (e)(3)(v) of this section. A TIN is an IRS individual taxpayer identification number, an employer identification number, or a social security number as described in section 6109 and §301.6109–1 of this chapter, or any other identifier that the Commissioner may designate.

(viii) *Reliance rules.* A withholding agent may rely on the information and certifications stated on withholding certificates or other documentation without having to inquire into the truthfulness of this information or certification, unless it has actual knowledge or reason to know that the same is untrue. In the case of amounts described in §1.1441–6(b)(2)(ii), a withholding agent described in §1.1441–7(b)(2)(ii) has reason to know that the information or certifications on a certificate are untrue only to the extent provided in §1.1441–7(b)(2)(ii). See §1.1441–6(b)(4)(ii) for reliance on representations regarding eligibility for a reduced rate under an income tax treaty. Paragraphs (e)(4)(viii) (A) and (B) of this section provide examples of such reliance.

(A) *Classification.* A withholding agent may rely on the claim of entity classification indicated on the withholding certificate that it receives from or for the beneficial owner, unless it has actual knowledge or reason to know that the classification claimed is incorrect. A withholding agent may not rely on a person's claim of classification other than as a corporation if the name of the corporation indicates that the person is a per se corporation described in §301.7701–2(b)(8)(i) of this chapter unless the certificate contains a statement that the person is a grandfathered per se corporation described in §301.7701–2(b)(8) of this chapter and that its grandfathered status has not been terminated. In the absence of reliable representation or information regarding the classification of the payee or beneficial owner, see §1.1441–1(b)(3)(ii) for applicable presumptions.

(B) *Status of payee as an intermediary or as a person acting for its own account.* A withholding agent may rely on the type of certificate furnished as indicative of the payee's status as an intermediary or as an owner, unless the withholding agent has actual knowledge or reason to know otherwise. For example, a withholding agent that receives a beneficial owner withholding certificate from a foreign financial institution may treat the institution as the beneficial owner, unless it has information in its records that would indicate otherwise or the certificate contains information that is not consistent with beneficial owner status (e.g., sub-account numbers or names). If the financial institution also acts as an intermediary, the withholding agent may request that the institution furnish two certificates, i.e., a beneficial owner certificate described in paragraph (e)(2)(i) of this section for the amounts that it receives as a beneficial owner, and an intermediary withholding certificate described in paragraph (e)(3)(i) of this section for the amounts that it receives as an intermediary. In the absence of reliable representation or information regarding the status of the payee as an owner or as an intermediary, see paragraph (b)(3)(v)(A) for applicable presumptions.

(ix) *Certificates to be furnished for each account unless exception applies.* Unless otherwise provided in this paragraph (e)(4)(ix), a withholding agent that is a financial institution with which a customer may open an account shall obtain withholding certificates or other appropriate documentation on an account-by-account basis.

(A) *Coordinated account information system in effect.* A withholding agent may rely on the withholding certificate or other appropriate documentation furnished by a customer for a pre-existing account under any one or more of the circumstances described in this paragraph (e)(4)(ix)(A).

(*1*) A withholding agent may rely on documentation furnished by a customer for another account if all such accounts are held at the same branch location.

(*2*) A withholding agent may rely on documentation furnished by a customer for an account held at another branch location of the same withholding agent or at a branch location of a person related to the withholding agent if the withholding agent and the related person are part of a universal account system that uses a customer identifier that can be used to retrieve systematically all other accounts of the customer. See §31.3406(c)(3)(ii) and (iii)(C) of this chapter for an identical procedure for purposes of backup withholding. For purposes of this paragraph (e)(4)(ix)(A), a withholding agent is related to another person if it is related within the meaning of section 267(b) or 707(b).

(*3*) A withholding agent may rely on documentation furnished by a customer for an account held at another branch location of the same withholding agent or at a branch location of a person related to the withholding agent if the withholding agent and the related person are part of an information system other than a universal account system and the information system is described in this paragraph (e)(4)(ix)(A)(*3*). The system must allow the withholding agent to easily access data regarding the nature of the documentation, the information contained in the documentation, and its validity status, and must allow the withholding agent to easily transmit data into the system regarding any facts of which it becomes aware that may affect the reliability of the documentation. The withholding agent must be able to establish how and when it has accessed the data regarding the documentation and, if applicable, how and when it has transmitted data regarding any facts of which it became aware that may affect the reliability of the documentation. In addition, the withholding agent or the related party must be able to establish that any data it has transmitted to the information system has been processed and appropriate due diligence has been exercised regarding the validity of the documentation.

(B) *Family of mutual funds.* An interest in a mutual fund that has a common investment advisor or common principal underwriter with other mutual funds (within the same family of funds) may, in the discretion of the mutual fund, be represented by one single withholding certificate where shares are acquired or owned in any of the funds. See §31.3406(h)–3(a)(2) of this chapter for an identical procedures for purposes of backup withholding.

(C) *Special rule for brokers.* A withholding agent may rely on the certification of a broker acting as the agent of a beneficial owner that the broker holds a valid beneficial owner withholding certificate described in paragraph (e)(2)(i) of this section or other documentation for that beneficial owner. The certification must contain the date of expiration of the certificate or documentation and be in writing or in electronic form. For purposes of this paragraph (e)(4)(ix)(C), the term *broker* shall have the same meaning as in §31.3406(h)–3(d) of this chapter.

(5) *Qualified intermediaries*—(i) *General rule.* A qualified intermediary, as defined in paragraph (e)(5)(ii) of this section, may furnish an intermediary withholding certificate to a withholding agent. Such a certificate certifies on behalf of other persons (such as beneficial owners, intermediaries, flow-through entities described in §1.1441–5, or U.S. payees) for the purpose of claiming and verifying reduced rates of withholding under section 1441 or 1442 and for the purpose of reporting and withholding under other provisions of the Code, such as the provisions under chapter 61 of the Code and section 3406 (and the regulations under those provisions). Furnishing such a certificate is in lieu of transmitting to a withholding agent withholding certificates or other appropriate documentation for the persons for whom the qualified intermediary receives the payment or for its shareholders (in the case of claims of benefits under an income tax treaty by a reverse hybrid entity). Although the qualified intermediary is required to obtain withholding certificates or other appropriate documentation from beneficial owners, payees, or shareholders pursuant to its agreement with the IRS, it is not required to attach such documentation to the intermediary withholding certificate. However, the qualified intermediary must disclose the names of those U.S. persons for whom the qualified intermediary receives reportable amounts (within the meaning of paragraph (e)(3)(vi) of this section) and who are not exempt recipients (as defined in §1.6049–4(c)(1)(ii) or an applicable provision under section 6041, 6042, 6045, or 6050N), irrespective of local secrecy laws. A person may claim qualified intermediary status before an agreement is executed with the IRS if it has applied for such status and the IRS authorizes such status on an interim basis under such procedures as the IRS may prescribe.

(ii) *Definition of qualified intermediary.* With respect to a payment to a foreign person, the term *qualified intermediary* means a person that is a party to a withholding agreement with the IRS and such person is—

(A) A foreign financial institution or a foreign clearing organization (as defined in §1.163–5(c)(2)(i)(D)(*8*), without regard to the requirement that the organization hold obligations for members), other than a U.S. branch or U.S. office of such institution or organization;

(B) A foreign branch or office of a U.S. financial institution or a foreign branch or office of a U.S. clearing organization (as defined in §1.163–5(c)(2)(i)(D)(*8*), without regard to the requirement that the organization hold obligations for members);

(C) A foreign corporation for purposes of presenting claims of benefits under an income tax treaty on behalf of its shareholders; or

(D) Any other person acceptable to the IRS.

(iii) *Withholding agreement*—(A) *In general.* The IRS may, upon request, enter into a withholding agreement with a foreign person described in paragraph (e)(5)(ii) of this section pursuant to such procedures as the IRS may prescribe in published guidance (see §1A601.601(d)(2) of this chapter). Under such withholding agreement, a qualified intermediary shall be generally subject to the applicable withholding and reporting provisions applicable to withholding agents and payors under chapters 3 and 61 of the Code, and section 3406, and the regulations under those provisions, and other withholding provisions of the Code, except to the extent provided under the agreement. A withholding agreement may apply to the entity as a whole or to certain specified branches of the institution. The determination of the scope of the agreement shall be made on a branch-by-branch basis.

(B) *Terms of the withholding agreement.* Generally, the agreement shall specify the type of certification and documentation upon which the qualified intermediary may rely to ascertain the nationality and residence of beneficial owners and U.S. payees who receive payments collected by the qualified intermediary and, if necessary, entitlement to the benefits of a reduced rate under an income tax treaty. It shall specify if the qualified intermediary may assume primary withholding responsibility in accordance with paragraph (e)(5)(iv) of this section. It shall specify the extent to which applicable return filing and information reporting requirements are modified so that, in appropriate cases, the qualified intermediary may report payments to the IRS on an aggregated basis, without having to disclose the identity of individual customers. However, the qualified intermediary may be required to provide to the IRS the name and address of those foreign customers who benefit from a reduced rate under an income tax treaty pursuant to the qualified intermediary arrangement for purposes of verifying entitlement to such benefits, particularly under an applicable Limitation on Benefits provision. Under the agreement, a qualified intermediary may agree to act as an acceptance agent to perform the duties described in § 301.6109–1(d)(3)(iv)(A) of this chapter. The agreement may specify the manner in which applicable procedures for adjustments for underwithholding and overwithholding, including refund procedures apply in the context of a qualified intermediary arrangement and the extent to which applicable procedures may be modified. In particular, a withholding agreement may allow a qualified intermediary to claim refunds of overwithheld amounts on behalf of its customers. If relevant, the agreement shall specify the manner in which the qualified intermediary may deal with payments to other intermediaries. In addition, the agreement must specify the manner in which the IRS will verify compliance with the agreement. In appropriate cases, the IRS may agree to rely on audits performed by an intermediary's approved auditor. In such a case, the IRS' audit may be limited to the audit of the auditor's records (including work papers of the auditor and reports prepared by the auditor indicating the methodology employed to verify the entity's compliance with the agreement). For this purpose, the agreement shall specify which auditor or class of auditors is approved. Generally, an auditor will be approved if it is subject to regulatory supervision under the laws of the country in which a significant part of the intermediary activities under the agreement are expected to occur, its internal procedures require it to verify that the intermediary complies with the terms of the withholding agreement and to report non-compliance findings under the agreement in the same manner as it is required to report other findings of non-compliance with applicable local laws and regulatory requirements, and its relevant records (i.e., work papers and reports) are available to the IRS. The agreement must include provisions for the assessment and collection of tax in the event that failure to comply with the terms of the agreement results in the failure by the withholding agent or the qualified intermediary to withhold and deposit the required amount of tax. Further, the agreement shall specify the procedures by which deposits of amounts withheld are to be deposited, if different from normally applicable deposit procedures under the Code and applicable regulations. The agreement shall also specify the assets that the qualified intermediary has in the United States or alternative means of collection, if necessary. To determine the terms of any particular withholding agreement, the IRS will consider appropriate factors including whether or not the foreign person agrees to assume primary responsibility as a withholding agent, the type of local know-your-customer laws and practices to which it is subject, the extent and nature of supervisory and regulatory control exercised under the laws of the foreign country over the foreign person, the volume of investments in U.S. securities (determined in dollar amounts and number of account holders), and financial condition of the foreign person.

(iv) *Assignment of primary withholding responsibility.* A withholding agent making a payment to a qualified intermediary must presume that the withholding agent has full withholding responsibility for that payment, except as otherwise specified in this paragraph (e)(5)(iv). For this purpose, withholding responsibility means the obligation to withhold as required under the provisions of section 1441, 1442, or 1443, and the regulations under those sections, and the related reporting obligations under §1.1461–1(b)(2)(ii) and (c)(4)(ii) for payments identified or treated as made to foreign persons. Withholding responsibility also means obligations imposed on payors under chapter 61 of the Code (and the regulations under those provisions) and, if applicable, under section 3405 or 3406 (and the regulations under those sections). A qualified intermediary that assumes primary withholding responsibility vis-a-vis a withholding agent must assume such responsibility for all payments made to any one account. Any qualified intermediary may agree with the withholding agent to assume primary withholding responsibility, but only if expressly permitted to do so under its agreement with the IRS. Generally, reporting or withholding liability arising from a payment to a U.S. person (or treated as or presumed to be made to a U.S. person) under any provision of the Code or applicable regulations thereunder may not be assigned to a qualified intermediary except where the qualified intermediary is a foreign branch of a U.S. financial institution or except to the extent that the qualified intermediary has a branch in the United States and establishes to the satisfaction of the IRS that its U.S. branch can adequately fulfill the qualified intermediary's obligations on behalf of the qualified intermediary regarding information reporting under chapter 61 of the Code and the regulations under the applicable provisions of that chapter and, if necessary, backup withholding under section 3406 and the regulations under that section (even though the U.S. branch is not a qualified intermediary).

(v) *Information to withholding agent regarding applicable withholding rates*—(A) *General rule.* The qualified intermediary must separate the assets that generate payments of reportable amounts (as described in paragraph (e)(3)(vi) of this section) that are associated with its withholding certificate furnished to the withholding agent into the categories described in paragraph (e)(5)(v)(B) of this section, and provide that information to the withholding agent so that the withholding agent may determine the applicable withholding rate applicable to each category. The information may be furnished in any manner that the parties choose. For example, if the withholding agent maintains separate accounts for each category of assets described in paragraph (e)(5)(v)(B) of this section, the qualified intermediary must provide information sufficient for the withholding agent to allocate assets appropriately among the various accounts. If the withholding agent does not maintain separate accounts, it may require the qualified intermediary to attach a statement to the intermediary withholding certificate under paragraph (e)(3)(ii)(E) of this section providing the information described in this paragraph (e)(5)(v).

(B) *Categories of assets.* A payment of a reportable amount (as defined in paragraph (e)(3)(vi) of this section) must be associated with one of the three categories of assets set forth in paragraphs (e)(5)(v)(B) (*1*) through (*3*) of this section and may be associated with only one of these three categories. Additional or different categories of assets may be specified, however, under procedures prescribed by the IRS (see §602.602–1(d) of this chapter) or in the qualified intermediary agreement. No information is required regarding assets that do not generate a reportable amount described in paragraph (e)(3)(vi) of this section. The information provided to the withholding agent, and any update thereof, shall be considered an integral part of the intermediary withholding certificate. The three categories of assets required to be identified to the withholding agent are as follows:

(*1*) The first category of assets consists of assets that are associated with non-U.S. payees to which the intermediary certificate relates, and the applicable withholding rate. If different withholding rates apply, the qualified intermediary must indicate the applicable rate for each class of non-U.S. payees to which different withholding rates apply and the assets associated with each class. In the case of a qualified intermediary that has assumed primary withholding responsibility, the intermediary must simply certify the amount of assets for which it assumes primary withholding responsibility because they are assets for which it holds the appropriate documentation and are not described in the other two categories.

(*2*) The second category of assets consists of assets that are associated with all U.S. payees to which the certificate relates. The qualified intermediary must furnish a Form W–9 (or an acceptable substitute form) for each U.S. payee described in paragraph (d)(2) of this section or, in the absence of a Form W–9, the name and address of the U.S. payee or such information it has available regarding the payee. The identity of U.S. payees described in paragraph (d)(3) of this section need not be disclosed to the withholding agent.

(*3*) The third category of assets consists of assets that are associated with payees for whom the qualified intermediary holds no documentation, or holds documentation that it knows or has reason to know is unreliable and for which it has no actual knowledge that the payees are U.S. persons. A qualified intermediary that has assumed primary withholding responsibility need not furnish information regarding this category of assets.

(C) *Updating the information.* The qualified intermediary must update the information furnished to the withholding agent in accordance with this paragraph (e)(5)(v) as often as is necessary in order to enable the withholding agent to withhold at the appropriate rate on each payment and to report such income for purposes of chapter 3 or 61 of the Code and sections 3402, 3405 and 3406 (and the regulations under those provisions). See paragraph (e)(4)(ii)(D) of this section regarding how changes in the information affect the validity of a withholding certificate. See § 1.1441–1(b)(3)(v)(C) for consequences if the information is not updated as required.

(f) *Effective date*—(1) *In general.* This section applies to payments made after December 31, 1999.

(2) *Transition rules*—(i) *Special rules for existing documentation.* For purposes of paragraphs (d)(3) and (e)(2)(i) of this section, the validity of a withholding certificate (namely, Form W–8, 8233, 1001, 4224, or 1078 , or a statement described in § 1.1441–5 in effect prior to January 1, 2000 (see § 1.1441–5 as contained in 26 CFR part 1, revised April 1, 1998)) that was valid on January 1, 1998 under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) and expired, or will expire, at any time during 1998, is extended until December 31, 1998. The validity of a withholding certificate that is valid on or after January 1, 1999, remains valid until its validity expires under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) or, if earlier, until December 31, 2000. The rule in this paragraph (f)(2)(i), however, does not apply to extend the validity period of a withholding certificate that expires solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the first three sentences of this paragraph (f)(2)(i), a withholding agent may choose to not take advantage of the transition rule in this paragraph (f)(2)(i) with respect to one or more withholding certificates valid under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) and, therefore, to require withholding certificates conforming to the requirements described in this section (new withholding certificates). For purposes of

this section, a new withholding certificate is deemed to satisfy the documentation requirement under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998). Further, a new withholding certificate remains valid for the period specified in paragraph (e)(4)(ii) of this section, regardless of when the certificate is obtained.

(ii) *Lack of documentation for past years.* A taxpayer may elect to apply the provisions of paragraphs (b)(7)(i)(B), (ii), and (iii) of this section, dealing with liability for failure to obtain documentation timely, to all of its open tax years, including tax years that are currently under examination by the IRS. The election is made by simply taking action under those provisions in the same manner as the taxpayer would take action for payments made after December 31, 1999.

[T.D. 8734, 62 FR 53424, Oct. 14, 1997, as amended by T.D. 8804, 63 FR 72184, 72187, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53424, Oct. 14, 1997, §1.1441–1 was revised, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.1441–1 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.1441–1 Requirement for withholding of tax on nonresident aliens, foreign partnerships, and foreign corporations.

Except as otherwise provided in §§1.1441–3, 1.1441–4, and 1.1441–6, to the extent that the items specified in §1.1441–2 constitute gross income from sources within the United States, withholding of a tax of 30 percent is required in the case of items of income specified in paragraphs (a) and (b) of §1.1441–2 when such income is paid to a nonresident alien individual, a foreign partnership, or a foreign corporation, except that with respect to payments made after March 4, 1964, withholding of a tax of 14 percent is required in the case of items of income specified in paragraph (c) of §1.1441–2. The rate of 30 percent or 14 percent shall be reduced as may be provided by a treaty with any country. See §§1.894–1 and 1.1441–6 relating to income affected by treaty. For purposes of this section, the term ‘‘nonresident alien individual’’ includes an alien resident of Puerto Rico. In the case of payments occurring after October 31, 1972, the term ‘‘foreign corporation’’ does not include a corporation created or organized in Guam or under the law of Guam. The rules of chapter 3 of the Code and §§1.1441–1 through 1.1441–6 and §§1.1461–1 through 1.1464–1 apply to a nonresident alien individual even though the individual has an election in effect under section 6013 (g) or (h) of the Code.

[T.D. 7385, 40 FR 50263, Oct. 29, 1975, as amended by T.D. 7670, 45 FR 6932, Jan. 31, 1980]

§1.1441–2 Amounts subject to withholding.

(a) *In general.* For purposes of the regulations under chapter 3 of the Internal Revenue Code (Code), the term *amounts subject to withholding* means amounts from sources within the United States that constitute either fixed or determinable annual or periodical income described in paragraph (b) of this section or other amounts subject to withholding described in paragraph (c) of this section. For purposes of this paragraph (a), an amount shall not be treated as not being from sources within the United States merely because the source of the amount cannot be determined at the time of payment. See §1.1441–3(d)(1) for determining the amount to be withheld from a payment in the absence of information at the time of payment regarding the source of the amount. Amounts subject to withholding include amounts that are not fixed or determinable annual or periodical income and upon which withholding is specifically required under a provision of this section or another section of the regulations under chapter 3 of the Code (such as corporate distributions that do not constitute dividend income upon which withholding is required under §1.1441–3(c)(1)). Amounts subject to withholding do not include amounts described in §1.1441–1(b)(4)(i) to the extent they involve interest on obligations in bearer form or on foreign-targeted registered obligations (but, in the case of a foreign-targeted registered obligation, only to the extent of those amounts paid to a registered owner that is a financial institution within the meaning of section 871(h)(5)(B) or a member of a clearing organization which member is the beneficial owner of the obligation), amounts described in §1.1441–1(b)(4)(ii) (dealing with bank deposit interest and similar types of interest (including original issue discount) described in section 871(i)(2)(A) or 881(d)), amounts described in § 1.1441–1(b)(4)(iv) (dealing with interest or original issue discount on certain short-term obligations described in section 871(g)(1)(B) or 881(a)(3)), and amounts described in § 1.1441–1(b)(4)(xx) (dealing with income from certain gambling winnings exempt from tax under section 871(j)).

(b) *Fixed or determinable annual or periodical income*—(1) *In general*—(i) *Definition.* For purposes of chapter 3 of the Code and the regulations thereunder, fixed or determinable annual or periodical income is all income included in gross income under section 61 (including original issue discount), except for the items specified in paragraph (b)(2) of this section. Therefore, items of U.S. source income that are excluded from gross income under any provision of law without regard to the identity of the holder, such as interest excluded from gross income under section 103(a), are not fixed or determinable annual or periodical income. See § 1.306–3(h) for treating income from the disposition of section 306 stock as fixed or determinable annual or periodical income.

(ii) *Manner of payment.* The term *fixed or determinable annual or periodical* is merely descriptive of the character of a class of income. If an item of income falls within the class of income contemplated in the statute and described in paragraph (a) of this section, it is immaterial whether payment of that item is made in a series of payments or in a single lump sum. Further, the income need not be paid annually if it is paid periodically; that is to say, from time to time, whether or not at regular intervals. The fact that a payment is not made annually or periodically does not, however, prevent it from being fixed or determinable annual or periodical income (e.g., a lump sum payment). In addition, the fact that the length of time during which the payments are to be made may be increased or diminished in accordance with someone's will or with the happening of an event does not disqualify the payment as determinable or periodical. For this purpose, the share of the fixed or determinable annual or periodical income of an estate or trust from sources within the United States which is required to be distributed currently, or which has been paid or credited during the taxable year, to a nonresident alien beneficiary of such estate or trust constitutes fixed or determinable annual or periodical income.

(iii) *Determinability of amount.* An item of income is fixed when it is to be paid in amounts definitely pre-determined. An item of income is determinable if the amount to be paid is not known but there is a basis of calculation by which the amount may be ascertained at a later time. For example, interest is determinable even if it is contingent in that its amount cannot be determined at the time of payment of an amount with respect to a loan because the calculation of the interest portion of the payment is contingent upon factors that are not fixed at the time of the payment. For purposes of this section, an amount of income does not have to be determined at the time that the payment is made in order to be determinable. An amount of income described in paragraph (a) of this section which the withholding agent knows is part of a payment it makes but which it cannot calculate exactly at the time of payment, is nevertheless determinable if the determination of the exact amount depends upon events expected to occur at a future date. In contrast, a payment which may be income in the future based upon events that are not anticipated at the time the payment is made is not determinable. For example, loan proceeds may become income to the borrower when and to the extent the loan is canceled without repayment. While the cancellation of the debt is income to the borrower when it occurs, it is not determinable at the time the loan proceeds are disbursed to the borrower if the lack of repayment leading to the cancellation of part or all of the debt was not anticipated at the time of disbursement. The fact that the source of an item of income cannot be determined at the time that the payment is made does not render a payment not determinable. See § 1.1441–3(d)(1) for determining the amount to be withheld from a payment in the absence of information at the time of payment regarding the source of the amount.

(2) *Exceptions.* For purposes of chapter 3 of the Code and the regulations

thereunder, the items of income described in this paragraph (b)(2) are not fixed or determinable annual or periodical income—

(i) Gains derived from the sale of property (including market discount and option premiums), except for gains described in paragraph (b)(3) or (c) of this section;

(ii) Insurance premiums within the meaning of section 4372 paid to a foreign insurer or reinsurer; and

(iii) Any other income that the Internal Revenue Service (IRS) may determine, in published guidance (see §601.601(d)(2) of this chapter), is not fixed or determinable annual or periodical income.

(3) *Original issue discount*—(i) *General rule.* An amount representing original issue discount is fixed or determinable annual or periodical income that is subject to withholding to the extent provided in this paragraph (b)(3) if not otherwise excluded under paragraph (a) of this section. Under sections 871(a)(1)(C) and 881(a)(3), an amount of original issue discount is subject to tax to a foreign beneficial owner of an obligation carrying original issue discount upon a taxable sale or exchange of the obligation or when a payment is made on such obligation. The amount taxable is the amount of original issue discount that accrued while the foreign person held the obligation up to the time that the obligation is sold or exchanged or that a payment is made on the obligation, reduced by any amount of original issue discount that was taken into account prior to that time (due to a payment made on the obligation). In the case of a taxable event due to a payment made on the obligation, the tax due on the amount of taxable original issue discount may not exceed the payment less the tax imposed thereon. A person who is a withholding agent with respect to a payment that, under section 871(a)(1)(C) or 881(a)(3), is taxable to a foreign person holding or disposing of an original issue discount obligation must withhold to the extent provided in this paragraph (b)(3).

(ii) *Amounts actually known to the withholding agent.* A withholding agent must withhold on the taxable amount of original issue discount to the extent that it has actual knowledge of the proportion of the payment that is taxable to the beneficial owner under section 871(a)(1)(C) or 881(a)(3)(A). A withholding agent has actual knowledge if it knows how long the beneficial owner has held the obligation, the terms of the obligation, and the extent to which the beneficial owner purchased the obligation at a premium. A withholding agent is treated as having knowledge if the information is reasonably available. The information is not considered reasonably available if the withholding agent does not have a direct customer relationship with the foreign beneficial owner or such other person who has actual knowledge of the facts relevant to the determination of the amount taxable to the foreign beneficial owner, and has no access to such information in the ordinary course of its business due to the manner in which the obligation is held (e.g., in street name or through intermediaries). In the case of a withholding agent maintaining a direct account relationship with the beneficial owner, knowledge regarding the beneficial owner's holding period and acquisition premium is considered to be reasonably available to the withholding agent. A withholding agent may rely on the most recently published List of Original Issue Discount Instruments (IRS Publication 1212 (available from the IRS Forms Distribution Centers) or similar list) published by the IRS in order to determine the amount of taxable OID in any particular transaction.

(iii) *Amounts for which certain documentation is not furnished.* Notwithstanding lack of knowledge (within the meaning of paragraph (b)(3)(ii) of this section), withholding is required on the entire amount of stated interest, if any, and original issue discount on the obligation as determined as of the date of original issue if the withholding agent, pursuant to the provisions in §1.1441–1(b)(3), treats the payment as made to a foreign payee because it cannot reliably associate the payment with documentation and the amount would qualify as portfolio interest if the withholding agent held documentation described in §1.871–14(c)(2). A withholding agent may rely on the most recently published List of Original Issue Discount Instruments (IRS Publication

1212 (available from the IRS Forms Distribution Centers) or similar list) published by the IRS in order to determine the amount of taxable OID in any particular transaction. See § 1.1441–1(b)(8) for adjustments to any amount that has been overwithheld.

(iv) *Exceptions to withholding.* The obligation to withhold under this paragraph (b)(3) shall apply only to obligations issued after December 31, 1999, and payable more than 183 days from the date of original issue. Any exemption from withholding pursuant to this paragraph (b)(3) applies without a requirement that documentation be furnished to the withholding agent. However, documentation may have to be furnished for purposes of the information reporting provisions under section 6049 and backup withholding under section 3406. See § 1.6049–5(b) (7) through (15).

(4) *Securities lending transactions and equivalent transactions.* See §§ 1.871–7(b)(2) and 1.881–2(b)(2) regarding the character of substitute payments as fixed and determinable annual or periodical income. Such amounts constitute income subject to withholding to the extent they are from sources within the United States, as determined under section §§ 1.861–2(a)(7) and 1.861–3(a)(6). See §§ 1.6042–3(a)(2) and 1.6049–5(a)(5) for reporting requirements applicable to substitute dividend and interest payments, respectively.

(c) *Other income subject to withholding.* Withholding is also required on the following items of income—

(1) Gains described in sections 631 (b) or (c), relating to treatment of gain on disposal of timber, coal, or domestic iron ore with a retained economic interest; and

(2) Gains subject to the 30-percent tax under section 871(a)(1)(D) or 881(a)(4), relating to contingent payments received from the sale or exchange of patents, copyrights, and similar intangible property.

(d) *Exceptions to withholding where no money or property is paid or lack of knowledge*—(1) *General rule.* A withholding agent who is not related to the recipient or beneficial owner has an obligation to withhold under section 1441 only to the extent that, at any time between the date that the obligation to withhold would arise (but for the provisions of this paragraph (d)) and the due date for the filing of return on Form 1042 (including extensions) for the year in which the payment occurs, it has control over, or custody of money or property owned by the recipient or beneficial owner from which to withhold an amount and has knowledge of the facts that give rise to the payment. The exemption from the obligation to withhold under this paragraph (d) shall not apply, however, to distributions with respect to stock or if the lack of control or custody of money or property from which to withhold is part of a pre-arranged plan known to the withholding agent to avoid withholding under section 1441, 1442, or 1443. For purposes of this paragraph (d), a withholding agent is related to the recipient or beneficial owner if it is related within the meaning of section 482. Any exemption from withholding pursuant to this paragraph (d) applies without a requirement that documentation be furnished to the withholding agent. However, documentation may have to be furnished for purposes of the information reporting provisions under chapter 61 of the Code and backup withholding under section 3406. The exemption from withholding under this paragraph (d) is not a determination that the amounts are not fixed or determinable annual or periodical income, nor does it constitute an exemption from reporting the amount under § 1.1461–1 (b) and (c).

(2) *Cancellation of debt.* A lender of funds who forgives any portion of the loan is deemed to have made a payment of income to the borrower under § 1.61–12 at the time the event of forgiveness occurs. However, based on the rules of paragraph (d)(1) of this section, the lender shall have no obligation to withhold on such amount to the extent that it does not have custody or control over money or property of the borrower at any time between the time that the loan is forgiven and the due date (including extensions) of the Form 1042 for the year in which the payment is deemed to occur. A payment received by the lender from the borrower

in partial settlement of the debt obligation does not, for this purpose, constitute an amount of money or property belonging to the borrower from which the withholding tax liability can be satisfied.

(3) *Satisfaction of liability following underwithholding by withholding agent.* A withholding agent who, after failing to withhold the proper amount from a payment, satisfies the underwithheld amount out of its own funds may cause the beneficial owner to realize income to the extent of such satisfaction or may be considered to have advanced funds to the beneficial owner. Such determination depends upon the contractual arrangements governing the satisfaction of such tax liability (e.g., arrangements in which the withholding agent agrees to pay the amount due under section 1441 for the beneficial owner) or applicable laws governing the transaction. If the satisfaction of the tax liability is considered to constitute an advance of funds by the withholding agent to the beneficial owner and the withholding agent fails to collect the amount from the beneficial owner, a cancellation of indebtedness may result, giving rise to income to the beneficial owner under §1.61–12. While such income is annual or periodical fixed or determinable, the withholding agent shall have no liability to withhold on such income to the extent the conditions set forth in paragraphs (d) (1) and (2) of this section are satisfied with respect to this income. Contrast the rules of this paragraph (d)(3) with the rules in §1.1441–3(f)(1) dealing with a situation in which the satisfaction of the beneficial owner's tax liability itself constitutes additional income to the beneficial owner. See, also, §1.1441–3(c)(2)(ii)(B) for a special rule regarding underwithholding on corporate distributions due to underestimating an amount of earnings and profits.

(e) *Payment*—(1) *General rule.* A payment is considered made to a person if that person realizes income whether or not such income results from an actual transfer of cash or other property. For example, realization of income from cancellation of debt results in a deemed payment. A payment is considered made when the amount would be includible in the income of the beneficial owner under the U.S. tax principles governing the cash basis method of accounting. A payment is considered made whether it is made directly to the beneficial owner or to another person for the benefit of the beneficial owner (e.g., to the agent of the beneficial owner). Thus, a payment of income is considered made to a beneficial owner if it is paid in complete or partial satisfaction of the beneficial owner's debt to a creditor. In the event of a conflict between the rules of this paragraph (e)(1) governing whether a payment has occurred and its timing and the rules of §31.3406(a)–4 of this chapter, the rules in §31.3406(a)–4 of this chapter shall apply to the extent that the application of section 3406 is relevant to the transaction at issue.

(2) *Income allocated under section 482.* A payment is considered made to the extent income subject to withholding is allocated under section 482. Further, income arising as a result of a secondary adjustment made in conjunction with a reallocation of income under section 482 from a foreign person to a related U.S. person is considered paid to a foreign person unless the taxpayer to whom the income is reallocated has entered into a repatriation agreement with the IRS and the agreement eliminates the liability for withholding under this section. For purposes of determining the liability for withholding, the payment of income is deemed to have occurred on the last day of the taxable year in which the transactions that give rise to the allocation of income and the secondary adjustments, if any, took place.

(3) *Blocked income.* Income is not considered paid if it is blocked under executive authority, such as the President's exercise of emergency power under the Trading with the Enemy Act (50 U.S.C. App. 5), or the International Emergency Economic Powers Act (50 U.S.C. 1701 et seq). However, on the date that the blocking restrictions are removed, the income that was blocked is considered constructively received by the beneficial owner (and therefore paid for purposes of this section) and subject to withholding under §1.1441–1. Any exemption from withholding pursuant to this paragraph (e)(3) applies

without a requirement that documentation be furnished to the withholding agent. However, documentation may have to be furnished for purposes of the information reporting provisions under chapter 61 of the Code and backup withholding under section 3406. The exemption from withholding granted by this paragraph (e)(3) is not a determination that the amounts are not fixed or determinable annual or periodical income.

(4) *Special rules for dividends.* For purposes of sections 1441 and 6042, in the case of stock for which the record date is earlier than the payment date, dividends are considered paid on the payment date. In the case of a corporate reorganization, if a beneficial owner is required to exchange stock held in a former corporation for stock in a new corporation before dividends that are to be paid with respect to the stock in the new corporation will be paid on such stock, the dividend is considered paid on the date that the payee or beneficial owner actually exchanges the stock and receives the dividend. See § 31.3406(a)–4(a)(2) of this chapter.

(5) *Certain interest accrued by a foreign corporation.* For purposes of sections 1441 and 6049, a foreign corporation shall be treated as having made a payment of interest as of the last day of the taxable year if it has made an election under § 1.884–4(c)(1) to treat accrued interest as if it were paid in that taxable year.

(6) *Payments other than in U.S. dollars.* For purposes of section 1441, a payment includes amounts paid in a medium other than U.S. dollars. See § 1.1441–3(e) for rules regarding the amount subject to withholding in the case of such payments.

(f) *Effective date.* This section applies to payments made after December 31, 1999.

[T.D. 8734, 62 FR 53444, Oct. 14, 1997, as amended by T.D. 8804, 63 FR 72187, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53444, Oct. 14, 1997, § 1.1441–2 was revised, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.1441–2 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.1441–2 Income subject to withholding.

(a) *Fixed or determinable annual or periodical income.* (1) The gross amount of fixed or determinable annual or periodical income is subject to withholding. Section 1441(b) specifically includes in such income interest, dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments; but other kinds of income are included, as, for instance, royalties. For purposes of the preceding sentence, the term ‘‘interest’’ includes interest on certain deferred payments, as provided in section 483 and the regulations thereunder. The term ‘‘fixed or determinable annual or periodical’’ income is merely descriptive of the character of a class of income. If an item of income falls within the class of income contemplated by the statute, it is immaterial whether payment of that item is made in a series of repeated payments or in a single lump sum. Thus, $5,000 in royalty income would come within the meaning of the term, whether paid in 10 payments of $500 each or in one payment of $5,000.

(2) Income is fixed when it is to be paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The income need not be paid annually if it is paid periodically; that is to say, from time to time, whether or not at regular intervals. The fact that a payment is not made annually or periodically does not, however, necessarily prevent its being fixed or determinable annual or periodical income. That the length of time during which the payments are to be made may be increased or diminished in accordance with someone’s will or with the happening of an event does not make the payments any the less determinable or periodical. A salesman working by the month for a commission on sales which is paid or credited monthly receives determinable periodical income. The share of the fixed or determinable annual or periodical income of an estate or trust from sources within the United States which is required to be distributed currently, or which has been paid or credited during the taxable year, to a nonresident alien beneficiary of such estate or trust constitutes fixed or determinable annual or periodical income. Such items as taxes, interest on mortgages, or premiums on insurance paid to or for the account of a nonresident alien landlord by a tenant, pursuant to the terms of the lease, constitute fixed or determinable annual or periodical income.

(3) Income derived from the sale in the United States of property, whether real or personal, is not fixed or determinable annual or periodical income.

(b) *Other income subject to withholding*—(1) *Payments in taxable years of recipients beginning before January 1, 1967.* For payments made in taxable years of recipients beginning before January 1, 1967, withholding at 30 percent is also required on the gross amount of the items described in section 402(a)(2), relating to treatment of total distributions from certain employees' trusts; in sections 631 (b) and (c), relating to treatment of gain on disposal of timber, coal, or domestic iron ore with a retained economic interest; in section 1235, relating to treatment of gain on sale or exchange of patents; and, after September 2, 1958, in section 403(a)(2), relating to treatment of payments under certain employee annuities, each of which items is considered to be gain from the sale or exchange of a capital asset.

(2) *Payments in taxable years of recipients beginning after December 31, 1966.* For payments made in taxable years of recipients beginning after December 31, 1966, withholding at 30 percent is also required on the gross amount of the following items:

(i) Gains described in section 402(a)(2), relating to the treatment of total distributions from certain employees' trusts; section 403(a)(2), relating to treatment of payments under certain employee annuities; and section 631 (b) or (c), relating to treatment of gain on disposal of timber, coal, or domestic iron ore with a retained economic interest;

(ii) [Reserved]

(iii) Gains subject to the 30-percent tax under section 871(a)(1)(D) or section 881(a)(4), relating to contingent payments received from the sale or exchange after October 4, 1966, of patents, copyrights, and similar intangible property; and

(iv) Gains on transfers described in section 1235, relating to treatment of gain on sale or exchange of patents, if the transfers are made on or before October 4, 1966.

(c) *Amounts received by participants in certain exchange or training programs*—(1) *Scholarship or fellowship grants.* Withholding of tax shall be at the rate of 14 percent (rather than 30 percent) on that portion of a scholarship or fellowship grant paid after March 4, 1964, to a nonresident alien individual who is temporarily present in the United States as a nonimmigrant under subparagraph (F) or (J) of section 101(a)(15) of the Immigration and Nationality Act, as amended (8 U.S.C. 1101(a)(15)(F) or (J)), which is not excludible from such nonresident alien's gross income under section 117(a)(1) and paragraph (a) of §1.117–1 because it exceeds the limitations set forth in section 117(b)(2)(B) and paragraph (b)(2) of §1.117–2. Thus, if a nonresident alien scientist who was admitted to the United States under subparagraph (J) of section 101(a)(15) of the Immigration and Nationality Act, as amended, to engage in postdoctoral scientific studies received a fellowship grant from a grantor specified in section 117(b)(2)(A) which exceeded the $300-per-month-for-36- months limitation determined under paragraph (b) (2) and (3) of §1.117–2, a tax at the rate of 14 percent rather than 30 percent must be withheld from the amount of the grant includible in the scientist's gross income.

(2) *Expenses for travel, research, etc.* Withholding shall also be at the rate of 14 percent on amounts paid after March 4, 1964, to nonresident alien individuals described in subparagraph (1) of this paragraph to cover expenses for travel, research, clerical help, or equipment which are incident to a scholarship or fellowship grant to which section 117(a)(1) applies, but only to the extent that such amounts are not excludible from gross income under paragraph (b)(1) of §1.117–1 because they pertain to a portion of a scholarship or fellowship grant which is not excludible, or because the amount received is not specifically designated to cover such expenses under paragraph (b)(2)(i) of §1.117–1.

(3) *Exchange visitors.* A nonresident alien individual who is temporarily present in the United States as a nonimmigrant under subparagraph (J) of section 101(a)(15) of the Immigration and Nationality Act, as amended, includes a nonresident alien individual admitted to the United States as an ''exchange visitor'' under section 201 of the U.S. Information and Educational Exchange Act of 1948, as amended (22 U.S.C. 1446), which section was repealed by section 111 of the Mutual Educational and Cultural Exchange Act of 1961 (Pub. L. 87–256, 75 Stat. 538).

(Approved by the Office of Management and Budget under control number 1545–0795)

(Sec. 1441(c)(4) (80 Stat. 1553; 26 U.S.C. 1441(c)(4)), 3401(a)(6) (80 Stat. 1554; 26 U.S.C. 3401(a)(6)), and 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 6500, 25 FR 12073, Nov. 26, 1960, as amended by T.D. 6908, 31 FR 16770, Dec. 31, 1966; T.D. 7977, 49 FR 36831, Sept. 20, 1984]

§1.1441–3 Determination of amounts to be withheld.

(a) *Withholding on gross amount.* Except as otherwise provided in regulations under section 1441, the amount subject to withholding under §1.1441–1 is the gross amount of income subject to withholding that is paid to a foreign person. The gross amount of income subject to withholding may not be reduced by any deductions, except to the extent that one or more personal exemptions are allowed as provided under §1.1441–4(b)(6).

(b) *Withholding on payments on certain obligations*—(1) *Withholding at time of payment of interest.* When making a payment on an interest-bearing obligation, a withholding agent must withhold under § 1.1441–1 upon the gross amount of stated interest payable on the interest payment date, regardless of whether the payment constitutes a return of capital or the payment of income within the meaning of section 61. To the extent an amount was withheld on an amount of capital rather than interest, see the rules for adjustments, refunds, or credits under § 1.1441–1(b)(8).

(2) *No withholding between interest payment dates*—(i) *In general.* A withholding agent is not required to withhold under § 1.1441–1 upon interest accrued on the date of a sale of debt obligations when that sale occurs between two interest payment dates (even though the amount is treated as interest under § 1.61–7 (c) or (d) and is subject to tax under section 871 or 881). See § 1.6045–1(c) for reporting requirements by brokers with respect to sale proceeds. See § 1.61–7(c) regarding the character of payments received by the acquirer of an obligation subsequent to such acquisition (that is, as a return of capital or interest accrued after the acquisition). Any exemption from withholding pursuant to this paragraph (b)(2)(i) applies without a requirement that documentation be furnished to the withholding agent. However, documentation may have to be furnished for purposes of the information reporting provisions under section 6045 or 6049 and backup withholding under section 3406. The exemption from withholding granted by this paragraph (b)(2) is not a determination that the accrued interest is not fixed or determinable annual or periodical income under section 871(a) or 881(a) nor does it constitute an exemption from reporting under § 1.1461–1 (b) and (c) the amount of accrued interest paid.

(ii) *Anti-abuse rule.* The exemption in paragraph (b)(2)(i) of this section does not apply if the sale of securities is part of a plan the principal purpose of which is to avoid tax by selling and repurchasing securities and the withholding agent has actual knowledge or reason to know of such plan.

(c) *Corporate distributions*—(1) *General rule.* A corporation making a distribution with respect to its stock or any intermediary (described in § 1.1441–1(e)(3)(i)) making a payment of such a distribution is required to withhold under section 1441, 1442, or 1443 on the entire amount of the distribution, unless it elects to reduce the amount of withholding under the provisions of paragraph (c)(2) of this section. The exemption from withholding provided by this paragraph (c) applies without any requirement to furnish documentation to the withholding agent. However, documentation may have to be furnished for purposes of the information reporting provisions under section 6042 or 6045 and backup withholding under section 3406. The exemption from withholding granted by this paragraph (c) does not constitute a determination that the exempted amounts are not fixed or determinable annual or periodical income under sections 871(a) or 881(a) nor does it constitute an exemption from reporting under § 1.1461–1 (b) and (c) the amount of the distribution.

(2) *Exception to withholding on distributions*—(i) *In general.* An election described in paragraph (c)(1) of this section is made by actually reducing the amount of withholding at the time that the payment is made. An intermediary that makes a payment of a distribution is not required to reduce the withholding based on the distributing corporation's estimate of earnings and profits, even if the distributing corporation itself elects to reduce the withholding on payments of distributions that it itself makes to foreign persons. Conversely, an intermediary may elect to reduce the amount of withholding with respect to the payment of a distribution even if the distributing corporation does not so elect for the payments of distributions that it itself makes of distributions to foreign persons. The amounts with respect to which a distributing corporation or intermediary may elect to reduce the withholding are as follows:

(A) A distributing corporation or intermediary may elect to not withhold on a distribution to the extent it represents a nontaxable distribution payable in stock or stock rights.

(B) A distributing corporation or intermediary may elect to not withhold on a distribution to the extent it represents a distribution in part or full payment in exchange for stock.

(C) A distributing corporation or intermediary may elect to not withhold on a distribution (actual or deemed) to the extent it is not paid out of accumulated earnings and profits or current earnings and profits, based on a reasonable estimate determined under paragraph (c)(2)(ii) of this section.

(D) A regulated investment company or intermediary may elect to not withhold on a distribution representing a capital gain dividend (as defined in section 852(b)(3)(C)) or an exempt interest dividend (as defined in section 852(b)(5)(A)) based on the applicable procedures described under paragraph (c)(3) of this section.

(E) A U.S. Real Property Holding Corporation (defined in section 897(c)(2)) or a real estate investment trust (defined in section 856) or intermediary may elect to not withhold on a distribution to the extent it is subject to withholding under section 1445 and the regulations under that section. See paragraph (c)(4) of this section for applicable procedures.

(ii) *Reasonable estimate of accumulated and current earnings and profits on the date of payment*—(A) *General rule.* A reasonable estimate for purposes of paragraph (c)(2)(i)(C) of this section is a determination made by the distributing corporation at a time reasonably close to the date of payment of the extent to which the distribution will constitute a dividend, as defined in section 316. The determination is based upon the anticipated amount of accumulated earnings and profits and current earnings and profits for the taxable year in which the distribution is made, the distributions made prior to the distribution for which the estimate is made and all other relevant facts and circumstances. A reasonable estimate may be made based on the procedures described in §31.3406(b)(2)–4(c)(2) of this chapter.

(B) *Procedures in case of underwithholding.* A distributing corporation or intermediary that is a withholding agent with respect to a distribution and that determines at the end of the taxable year in which the distribution is made that it underwithheld under section 1441 on the distribution shall be liable for the amount underwithheld as a withholding agent under section 1461. However, for purposes of this section and §1.1461–1, any amount underwithheld paid by a distributing corporation, its paying agent, or an intermediary shall not be treated as income subject to additional withholding even if that amount is treated as additional income to the shareholders unless the additional amount is income to the shareholder as a result of a contractual arrangement between the parties regarding the satisfaction of the shareholder's tax liabilities. In addition, no penalties shall be imposed for failure to withhold and deposit the tax if—

(*1*) The distributing corporation made a reasonable estimate as provided in paragraph (c)(2)(ii)(A) of this section; and

(*2*) Either—

(*i*) The corporation or intermediary pays over the underwithheld amount on or before the due date for filing a Form 1042 for the calendar year in which the distribution is made, pursuant to §1.1461–2(b); or

(*ii*) The corporation or intermediary is not a calendar year taxpayer and it files an amended return on Form 1042X (or such other form as the Commissioner may prescribe) for the calendar year in which the distribution is made and pays the underwithheld amount and interest within 60 days after the close of the taxable year in which the distribution is made.

(C) *Reliance by intermediary on reasonable estimate.* For purposes of determining whether the payment of a corporate distribution is a dividend, a withholding agent that is not the distributing corporation may, absent actual knowledge or reason to know otherwise, rely on representations made by the distributing corporation regarding the reasonable estimate of the anticipated accumulated and current earnings and profits made in accordance with paragraph (c)(2)(ii)(A) of this section. Failure by the withholding agent to withhold the required amount due to a failure by the distributing corporation to reasonably estimate the portion of the distribution treated as a dividend or to properly communicate the information to the withholding agent shall be imputed to the distributing corporation. In such a case, the Internal Revenue Service (IRS) may collect from the distributing corporation any underwithheld amount and subject the distributing corporation to applicable interest and penalties as a withholding agent.

(D) *Example.* The rules of this paragraph (c)(2) are illustrated by the following example:

Example. (i) *Facts.* Corporation X, a publicly traded corporation with both U.S. and foreign shareholders and a calendar year taxpayer, has an accumulated deficit in earnings and profits at the close of 2000. In 2001, Corporation X generates $1 million of current earnings and profits each month and makes an $18 million distribution, resulting in a $12 million dividend. Corporation X plans to make an additional $18 million distribution on October 1, 2002. Approximately one month before that date, Corporation X's management receives an internal report from its legal and accounting department concerning Corporation X's estimated current earnings and profits. The report states that Corporation X should generate only $5.1 million of current earnings and profits by the close of the third quarter due to costs relating to substantial organizational and product changes, but these changes will enable Corporation X to generate $1.3 million of earnings and profits monthly for the last quarter of the 2002 fiscal year. Thus, the total amount of current and earnings and profits for 2002 is estimated to be $9 million.

(ii) *Analysis.* Based on the facts in paragraph (i) of this *Example,* including the fact that earnings and profits estimate was made within a reasonable time before the distribution, Corporation X can rely on the estimate under paragraph (c)(2)(ii)(A) of this section. Therefore, Corporation X may treat $9 million of the $18 million of the October 1, 2002, distribution to foreign shareholders as a nondividend distribution.

(3) *Special rules in the case of distributions from a regulated investment company*—(i) *General rule.* If the amount of any distributions designated as being subject to section 852(b)(3)(C) or (5)(A) exceeds the amount that may be designated under those sections for the taxable year, then no penalties will be asserted for any resulting underwithholding if the designations were based on a reasonable estimate (made pursuant to the same procedures as are described in paragraph (c)(2)(ii)(A) of this section) and the adjustments to the amount withheld are made within the time period described in paragraph (c)(2)(ii)(B) of this section. Any adjustment to the amount of tax due and paid to the IRS by the withholding agent as a result of underwithholding shall not be treated as a distribution for purposes of section 562(c) and the regulations thereunder. Any amount of U.S. tax that a foreign shareholder is treated as having paid on the undistributed capital gain of a regulated investment company under section 852(b)(3)(D) may be claimed by the foreign shareholder as a credit or refund under § 1.1464–1.

(ii) *Reliance by intermediary on reasonable estimate.* For purposes of determining whether a payment is a distribution designated as subject to section 852(b) (3)(C) or (5)(A), a withholding agent that is not the distributing regulated investment company may, absent actual knowledge or reason to know otherwise, rely on the designations that the distributing company represents have been made in accordance with paragraph (c)(3)(i) of this section. Failure by the withholding agent to withhold the required amount due to a failure by the regulated investment company to reasonably estimate the required amounts or to properly communicate the relevant information to the withholding agent shall be imputed to the distributing company. In such a case, the IRS may collect from the distributing company any underwithheld amount and subject the company to applicable interest and penalties as a withholding agent.

(4) *Coordination with withholding under section 1445*—(i) *In general.* A distribution from a U.S. Real Property Holding Corporation (USRPHC) (or from a corporation that was a USRPHC at any time during the five-year period ending on the date of distribution) with respect to stock that is a U.S. real property interest under section 897(c) or from a Real Estate Investment Trust (REIT) with respect to its stock is subject to the withholding provisions under section 1441 (or section 1442 or 1443) and section 1445. A USRPHC making a distribution shall be treated as satisfying its withholding obligations under both sections if it withholds in accordance with one of the procedures described in either paragraph (c)(4)(i)

(A) or (B) of this section. A USRPHC must apply the same withholding procedure to all the distributions made during the taxable year. However, the USRPHC may change the applicable withholding procedure from year to year. For rules regarding distributions by REITs, see paragraph (c)(4)(i)(C) of this section.

(A) *Withholding under section 1441.* The USRPHC may choose to withhold on a distribution only under section 1441 (or 1442 or 1443) and not under section 1445. In such a case, the USRPHC must withhold under section 1441 (or 1442 or 1443) on the full amount of the distribution, whether or not any portion of the distribution represents a return of basis or capital gain. If a reduced tax rate under an income tax treaty applies to the distribution by the USRPHC, then the applicable rate of withholding on the distribution shall be no less than 10-percent, unless the applicable treaty specifies an applicable lower rate for distributions from a USRPHC, in which case the lower rate may apply.

(B) *Withholding under both sections 1441 and 1445.* As an alternative to the procedure described in paragraph (c)(4)(i)(A) of this section, a USRPHC may choose to withhold under both sections 1441 (or 1442 or 1443) and 1445 under the procedures set forth in this paragraph (c)(4)(i)(B). The USRPHC must make a reasonable estimate of the portion of the distribution that is a dividend under paragraph (c)(2)(ii)(A) of this section, and must—

(*1*) Withhold under section 1441 (or 1442 or 1443) on the portion of the distribution that is estimated to be a dividend under paragraph (c)(2)(ii)(A) of this section; and

(*2*) Withhold under section 1445(e)(3) and §1.1445–5(e) on the remainder of the distribution or on such smaller portion based on a withholding certificate obtained in accordance with §1.1445–5(e)(2)(iv).

(C) *Coordination with REIT withholding.* Withholding is required under section 1441 (or 1442 or 1443) on the portion of a distribution from a REIT that is not designated as a capital gain dividend or return of basis. Withholding is required under section 1445 on the portion of the distribution designated by a REIT as a capital gain dividend. See §1.1445–8.

(ii) *Intermediary reliance rule.* A withholding agent that is not the distributing USRPHC must withhold under paragraph (c)(4)(i) of this section, but may, absent actual knowledge or reason to know otherwise, rely on representations made by the USRPHC regarding the determinations required under paragraph (c)(4)(i) of this section. Failure by the withholding agent to withhold the required amount due to a failure by the distributing USRPHC to make these determinations in a reasonable manner or to properly communicate the determinations to the withholding agent shall be imputed to the distributing USRPHC. In such a case, the IRS may collect from the distributing USRPHC any underwithheld amount and subject the distributing USRPHC to applicable interest and penalties as a withholding agent.

(d) *Withholding on payments that include an undetermined amount of income*—(1) *In general.* Where the withholding agent makes a payment and does not know at the time of payment the amount that is subject to withholding because the determination of the source of the income or the calculation of the amount of income subject to tax depends upon facts that are not known at the time of payment, then the withholding agent must withhold an amount under §1.1441–1 based on the entire amount paid that is necessary to assure that the tax withheld is not less than 30 percent (or other applicable percentage) of the amount that will subsequently be determined to be from sources within the United States or to be income subject to tax. The amount so withheld shall not exceed 30 percent of the amount paid. In the alternative, the withholding agent may make a reasonable estimate of the amount from U.S. sources or of the taxable amount and set aside a corresponding portion of the amount due under the transaction and hold such portion in escrow until the amount from U.S. sources or the taxable amount can be determined, at which point withholding becomes due under §1.1441–1. See §1.1441–1(b)(8) regarding adjustments in the case of overwithholding. The provisions of this paragraph (d)(1) shall not apply to the extent that other provisions of the regulations under chapter 3 of the Internal Revenue Code (Code) specify the amount to be withheld, if any, when the withholding agent lacks knowledge at the time of payment (e.g., lack of reliable knowledge regarding the status of the payee or beneficial owner, addressed in § 1.1441–1(b)(3), or lack of knowledge regarding the amount of original issue discount under § 1.1441–2(b)(3)).

(2) *Withholding on certain gains.* Absent actual knowledge or reason to know otherwise, a withholding agent may rely on a claim regarding the amount of gain described in § 1.1441–2(c) if the beneficial owner withholding certificate, or other appropriate withholding certificate, states the beneficial owner's basis in the property giving rise to the gain. In the absence of a reliable representation on a withholding certificate, the withholding agent must withhold an amount under § 1.1441–1 that is necessary to assure that the tax withheld is not less than 30 percent (or other applicable percentage) of the recognized gain. For this purpose, the recognized gain is determined without regard to any deduction allowed by the Code from the gains. The amount so withheld shall not exceed 30 percent of the amount payable by reason of the transaction giving rise to the recognized gain. See § 1.1441–1(b)(8) regarding adjustments in the case of overwithholding.

(e) *Payments other than in U.S. dollars*—(1) *In general.* The amount of a payment made in a medium other than U.S. dollars is measured by the fair market value of the property or services provided in lieu of U.S. dollars. The withholding agent may liquidate the property prior to payment in order to withhold the required amount of tax under section 1441 or obtain payment of the tax from an alternative source. However, the obligation to withhold under section 1441 is not deferred even if no alternative source can be located. Thus, for purposes of withholding under chapter 3 of the Code, the provisions of § 31.3406(h)–2(b)(2)(ii) of this chapter (relating to backup withholding from another source) shall not apply. If the withholding agent satisfies the tax liability related to such payments, the rules of paragraph (f) of this section apply.

(2) *Payments in foreign currency.* If the amount subject to withholding tax is paid in a currency other than the U.S. dollar, the amount of withholding under section 1441 shall be determined by applying the applicable rate of withholding to the foreign currency amount and converting the amount withheld into U.S. dollars on the date of payment at the spot rate (as defined in § 1.988–1(d)(1)) in effect on that date. A withholding agent making regular or frequent payments in foreign currency may use a month-end spot rate or a monthly average spot rate. A spot rate convention must be used consistently for all non-dollar amounts withheld and from year to year. Such convention cannot be changed without the consent of the Commissioner. The U.S. dollar amount so determined shall be treated by the beneficial owner as the amount of tax paid on the income for purposes of determining the final U.S. tax liability and, if applicable, claiming a refund or credit of tax.

(f) *Tax liability of beneficial owner satisfied by withholding agent*—(1) *General rule.* In the event that the satisfaction of a tax liability of a beneficial owner by a withholding agent constitutes income to the beneficial owner and such income is of a type that is subject to withholding, the amount of the payment deemed made by the withholding agent for purposes of this paragraph (f) shall be determined under the gross-up formula provided in this paragraph (f)(1). Whether the payment of the tax by the withholding agent constitutes a satisfaction of the beneficial owner's tax liability and whether, as such, it constitutes additional income to the beneficial owner, must be determined under all the facts and circumstances surrounding the transaction, including any agreements between the parties and applicable law. The formula described in this paragraph (f)(1) is as follows:

$$\text{Payment} = \frac{\text{Gross payment without withholding}}{1-(\text{tax rate})}$$

(2) *Example.* The following example illustrates the provisions of this paragraph (f):

Example. College X awards a qualified scholarship within the meaning of section 117(b) to foreign student, FS, who is in the United States on an F visa. FS is a resident of a country that does not have an income tax treaty with the United States. The scholarship is $20,000 to be applied to tuition, mandatory fees and books, plus benefits in kind consisting of room and board and roundtrip air transportation. College X agrees to pay any U.S. income tax owed by FS with respect to the scholarship. The fair market value of the room and board measured by the amount College X charges nonscholarship students is $6,000. The cost of the roundtrip air transportation is $2,600. Therefore, the total fair market value of the scholarship received by FS is $28,600. However, the amount taxable is limited to the fair market value of the benefits in kind ($8,600) because the portion of the scholarship amount for tuition, fees, and books is not included in gross income under section 117. The applicable rate of withholding is 14 percent under section 1441(b). Therefore, under the gross-up formula, College X is deemed to make a payment of $10,000 ($8,600 divided by (1–.14). The U.S. tax that must be deducted and withheld from the payment under section 1441(b) is $1,400 (.14×$10,000). College X reports scholarship income of $30,000 and $1,400 of U.S. tax withheld on Forms 1042 and 1042–S.

(g) *Conduit financing arrangements*—(1) *Duty to withhold.* A financed entity or other person required to withhold tax under section 1441 with respect to a financing arrangement that is a conduit financing arrangement within the meaning of §1.881–3(a)(2)(iv) shall be required to withhold under section 1441 as if the district director had determined, pursuant to §1.881–3(a)(3), that all conduit entities that are parties to the conduit financing arrangement should be disregarded. The amount of tax required to be withheld shall be determined under §1.881–3(d). The withholding agent may withhold tax at a reduced rate if the financing entity establishes that it is entitled to the benefit of a treaty that provides a reduced rate of tax on a payment of the type deemed to have been paid to the financing entity. Section 1.881–3(a)(3)(ii)(E) shall not apply for purposes of determining whether any person is required to deduct and withhold tax pursuant to this paragraph (g), or whether any party to a financing arrangement is liable for failure to withhold or entitled to a refund of tax under sections 1441 or 1461 to 1464 (except to the extent the amount withheld exceeds the tax liability determined under §1.881–3(d)). See §1.1441–7(f) relating to withholding tax liability of the withholding agent in conduit financing arrangements subject to §1.881–3.

(2) *Effective date.* This paragraph (g) is effective for payments made by financed entities on or after September 11, 1995. This paragraph shall not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest payments with respect to other debt obligations issued prior to October 15, 1984 (whether or not such debt was issued by a Netherlands Antilles corporation).

(h) *Effective date.* Except as otherwise provided in paragraph (g) of this section, this section applies to payments made after December 31, 1999.

[T.D. 6500, 25 FR 12074, Nov. 26, 1960, as amended by T.D. 6908, 31 FR 16771, Dec. 31, 1966; T.D. 7378, 40 FR 45436, Oct. 2, 1975; T.D. 7977, 49 FR 36831, Sept. 20, 1984; T.D. 8611, 60 FR 41014, Aug. 11, 1995; T.D. 8734, 62 FR 53446, Oct. 14, 1997; T.D. 8804, 63 FR 72187, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53446, Oct. 14, 1997, §1.1441–3 was amended by revising the section heading, and paragraphs (a) through (f) and (h); by removing paragraphs (g) and (i); by redesignating paragraph (j) as paragraph (g); by removing ''(j)'' and inserting ''(g)'' in its place in the fourth sentence of newly designated paragraph (g)(1) and in the first sentence of newly designated paragraph (g)(2); by removing ''§1.1441–7(d)'' in the last sentence of newly designated paragraph (g)(1) and inserting ''1.1441–7(f)'' in its place; and by removing the authority citation at the end of the section, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.1441–3 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.1441–3 Exceptions and rules of special application.

(a) *Income from sources without the United States.* To the extent that items of income constitute gross income from sources without the United States, they are not subject to withholding under §1.1441–1. For rules governing the determination of the sources of income, see part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

(b) *Corporate distributions*—(1) *Nontaxable portion.* The tax shall be withheld at the source under § 1.1441–1 on the gross amount of any distribution made by a corporation other than:

(i) A nontaxable distribution payable in stock or stock rights, and

(ii) A distribution which is treated as a distribution in part or full payment in exchange for stock.

This rule shall apply without regard to any claim that all or a portion of the distribution is not taxable under section 871 or 881. The tax shall be withheld on the gross amount of the distribution even though the payee may be entitled to the benefits of section 116, relating to partial exclusion of dividends received by individuals. Appropriate adjustment, if any, will be made upon the payee's filing of a claim for refund, together with appropriate supporting evidence, in accordance with paragraph (h) of this section.

(2) *Dividends paid by a foreign corporation*—(i) *Payments in taxable years of recipients beginning before January 1, 1967.* In the case of dividends paid in taxable years of recipients beginning before January 1, 1967, no withholding under § 1.1441–1 is required in the case of dividends paid by a foreign corporation unless *(a)* the corporation is engaged in trade or business within the United States and *(b)* more than 85 percent of the gross income of the corporation for the 3-year period ending with the close of its taxable year preceding the declaration of the dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of Part I (section 861 and following), Subchapter N, Chapter 1 of the Code, and the regulations thereunder.

(ii) *Payments in taxable years of recipients beginning after December 31, 1966.* In the case of dividends paid in taxable years of recipients beginning after December 31, 1966, all dividends paid by a foreign corporation which are treated as income from sources within the United States are subject to withholding under § 1.1441–1.

(3) *Dividends paid to shareholder whose status is not definite.* When a payer corporation or any other person, including a nominee, having the control, receipt, custody, disposal, or payment of dividends has no definite knowledge of the status of a shareholder, the tax shall be withheld under § 1.1441–1 if the shareholder's address is outside the United States. If the shareholder's address is within the United States, it may be assumed for the purpose of withholding on dividends that, in the case of an individual, the shareholder is a citizen or resident of the United States; and, in the case of a partnership or corporation, the shareholder is a domestic partnership or a domestic corporation, as the case may be. Unless the facts and circumstances indicate clearly that the shareholder is a nonresident alien individual, foreign partnership, or foreign corporation, an address in care of another person in the United States does not of itself warrant treating the shareholder as a person who is subject to withholding upon dividends under § 1.1441–1. If a shareholder changes his address from a place outside the United States to a place within the United States, the tax shall be withheld on dividends unless (i) proof is furnished showing that, in the case of an individual, he is a citizen or resident of the United States or, in the case of a partnership or corporation, it is a domestic partnership or corporation, or (ii) the withholding agent is otherwise satisfied that the shareholder is not a person who is subject to withholding under § 1.1441–1. For general provisions for claiming to be a person not subject to withholding under § 1.1441–1, see § 1.1441–5.

(c) *Interest*—(1) *Government obligations.* Withholding is required under § 1.1441–1 in the case of interest paid on obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof. See section 103 and the regulations thereunder, relating to the taxation of such interest, and § 1.1461–1, relating to ownership certificates.

(2) *Assumed obligations.* If, in connection with the sale of a corporation's property, payment of the bonds or other obligations of the corporation is assumed by the assignee, the assignee, whether an individual, partnership, or corporation, shall deduct and withhold such taxes under § 1.1441–1 as would be required to be withheld by the assignor had no such sale or transfer been made.

(3) *Defaulted interest coupons.* The tax shall be withheld at the source under § 1.1441–1 on the gross amount of interest without regard to whether or not the payment constitutes a return of capital or the payment of income within the meaning of section 61. Thus, for example, the tax shall be withheld in accordance with § 1.1441–1 from defaulted interest payments upon bonds which were purchased flat at quotations representing the price of both the bonds and the defaulted matured interest coupons. Appropriate adjustments, if any, will be made upon the payee's filing of a claim for refund, together with appropriate supporting evidence, in accordance with paragraph (h) of this section.

(4) *Unknown owner.* Withholding is required under § 1.1441–1 in the case of interest upon all bonds or securities the owners of which are not known to the withholding agent unless such bonds or securities were issued by a corporation before January 1, 1934, contain a tax-free covenant, and do not have a maturity date which was extended on or after that date. For withholding under section 1451 in the case of unknown owners, see paragraph (a)(2) of § 1.1451–1.

(5) *Tax-free covenant bonds*—(i) *Issued on or after January 1, 1934.* Withholding is required under §1.1441–1 in the case of interest upon bonds or other corporate obligations issued on or after January 1, 1934, and containing a tax-free covenant.

(ii) *Issued before January 1, 1934.* Withholding is not required under §1.1441–1 in the case of interest upon bonds or other corporate obligations issued before January 1, 1934, containing a tax-free covenant, and not having a maturity date which was extended on or after that date. A domestic or resident fiduciary is required, however, to withhold tax under §1.1441–1 in the case of so much of such interest as is properly allocable under section 652 or 662 to a nonresident alien beneficiary. See paragraph (f) of this section and of §1.1451–1. For general rules respecting the withholding of tax under section 1451 in the case of such interest, see §1.1451–1.

(iii) *Extended maturity date.* Withholding is required under §1.1441–1 in the case of interest upon bonds or other corporate obligations issued before January 1, 1934, and containing a tax-free covenant, if the maturity date of the bonds or obligations has been extended on or after that date. See paragraph (c) of §1.1451–1.

(iv) *Special rate of 27½ percent.* The rate of tax to be withheld at the source under §1.1441–1 shall not exceed 27½ percent in the case of interest on bonds, mortgages, or deeds of trust, or other similar obligations of a corporation if:

(a) The liability assumed by the debtor exceeds 27½ percent of the interest, and

(b) The interest would be subject to withholding under the provisions of subsections (a), (b), and (c) of section 1451 except for the fact that the maturity date of the obligations has been extended on or after January 1, 1934. See paragraph (c) of §1.1451–1.

(d) *Special rules applicable to certain income*—(1) *Determination of amount to be withheld.* If in the case of amounts described in paragraph (b) of §1.1441–2, other than amounts described in subparagraph (2)(ii) of such paragraph, the withholding agent does not know the amount of recognized gain, he is required to deduct and withhold such amount under §1.1441–1 as may be necessary to assure that the tax withheld will not be less than 30 percent of the recognized gain. For this purpose, the recognized gain shall be determined without regard to the deduction allowed by section 1202 with respect to capital gains. The amount so withheld shall not exceed 30 percent of the amount payable by reason of the transaction giving rise to the recognized gain, except that the amount payable may be determined by excluding the net unrealized appreciation described in section 402(a)(2). Appropriate adjustment, if any, will be made by the payee's filing of a claim for refund, together with appropriate supporting evidence, in accordance with paragraph (h) of this section.

(2) *Statement showing recognized gain.* The withholding agent may, unless he has reason to believe to the contrary, rely on the statement of the person entitled to the gain described in subparagraph (1) of this paragraph as to the amount of gain which is recognized on the transaction involved and subject to withholding under §1.1441–1. This statement shall be filed with the withholding agent in duplicate. It shall show the computation of the amount of gain subject to withholding, shall be dated, shall be signed by the person entitled to the income, shall contain the taxpayer's identifying number, if any, and shall contain, or be verified by, a written declaration that it is made under the penalties of perjury. No particular form is prescribed for this statement. The duplicate copy of each statement filed during any calendar year pursuant to this subparagraph shall be forwarded by the withholding agent with, and attached to, the Form 1042S required by paragraph (c) of §1.1461–2 with respect to such gain for such calendar year.

(e) *Personal exemption*—(1) The taxation of nonresident alien individuals is provided for in part II (section 871 and following), subchapter N, chapter 1 of the Code. Section 874(a) makes the filing of a return a prerequisite to the allowance of deductions, including deductions of personal exemptions. Except in the circumstances described in subparagraph (2) of this paragraph, personal exemptions do not serve to reduce the amount of tax to be withheld under §1.1441–1.

(2) In the determination of the tax to be withheld at the source under §1.1441–1 from remuneration paid for labor or personal services performed within the United States by a nonresident alien individual, the benefit of the deduction for personal exemptions provided in section 151, to the extent allowable under section 873(b)(3) and the regulations thereunder, shall be allowed, prorated upon a daily basis for the period during which labor or personal services are performed within the United States by the alien individual. The benefit of the deduction for such personal exemptions shall also be allowed in the determination of the tax of 14 percent to be withheld at the source under §1.1441–1 and paragraph (c) of §1.1441–2 from amounts paid after March 4, 1964, to nonresident alien individuals who are temporarily present in the United States as nonimmigrants under subparagraph (F) or (J) of the Immigration and Nationality Act, as amended, and such personal exemptions shall be prorated upon a daily basis for the period during which the described nonresident alien student or scholar receives the payments. The proration is on a basis of $1.70 per day for each exemption to which the nonresident alien individual is entitled. Thus, if A, a married nonresident

alien individual without dependents is paid remuneration subject to withholding under § 1.1441–1 for performing personal services during a stay of 100 days in the United States, the amount of $170 will be allocated as the portion of the deduction to be allowed against the remuneration for personal services performed within the United States during that period; and withholding at 30 percent shall be applied against the balance, if any, of the remuneration. If, for example, the total remuneration paid to A for that period is $2,000, a total tax in the amount of $549 [($2,000 − $170)×0.30] is required to be withheld under § 1.1441–1. However, if A is a resident of Canada or Mexico, and his spouse has no gross income from sources within the United States, which is subject to income tax under chapter 1 of the Code, and is not the dependent of another taxpayer subject to such tax, an amount of $340 will be allocated as the portion of the deduction to be allowed against the remuneration for personal services performed within the United States. Thus, in such case, a total tax in the amount of $498 [($2,000 − $340)×0.30] is required to be withheld under § 1.1441–1. As to what constitutes remuneration for labor or personal services performed within the United States see section 861(a)(3) and the regulations thereunder.

(f) *Partnerships and fiduciaries.* Domestic partnerships are required to withhold the tax at source under § 1.1441.1 on items of income described in paragraphs (a) and (b) of § 1.1441–2 that are included in the distributive share (including amounts that are not actually distributed) of a member of such partnership who is a nonresident alien individual, nonresident alien or foreign fiduciary of a trust or estate, foreign partnership, or foreign corporation. Resident or domestic fiduciaries of trusts and estates are required to withhold the tax at source under § 1.1441–1 on all items of income described in paragraphs (a) and (b) of § 1.1441–2 that constitute gross income from sources within the United States (including amounts that are not actually distributed) of beneficiaries who are nonresident alien individuals, foreign partnerships, or foreign corporations. Because the gross income allocable to a partner and the income includable in the gross income of the beneficiary cannot be determined until the end of a taxable year of the partnership, trust, or estate, the partnership and the fiduciary of a trust or estate shall withhold under this section on all distributions to such partners and beneficiaries during the taxable years to the extent such distributions include items of income described in paragraphs (a) and (b) of § 1.1441–2. If the tax on actual distributions exceeds the tax on amounts includable in the gross income of the partner or beneficiary, the partner or beneficiary may file a claim for refund together with appropriate supporting evidence in accordance with paragraph (h) of this section. If a partnership or a fiduciary withholds under this section on a distributive partnership share or distributable net income of a trust or estate before the income is actually distributed to a partner or beneficiary, then withholding is not required when such income is subsequently distributed. Income described in paragraphs (a) and (b) of § 1.1441–2 that is paid to a foreign partnership or to a nonresident alien or foreign fiduciary is subject to withholding under § 1.1441–1 even though the members of the partnership or the beneficiaries of the trust or estate are individuals who are citizens or residents of the United States or are domestic corporations.

(g) *Trust income taxable to grantor.* The income of a trust created by a nonresident alien individual and taxable to the grantor under the provisions of subpart E, part I, subchapter J, chapter 1 of the Code, is subject to withholding under § 1.1441–1, even though the fiduciary or beneficiaries of the trust are citizens or residents of the United States and regardless of whether the beneficiaries are exempt from income tax.

(h) *Claims for refund.* A claim for refund referred to in paragraph (b) (1), (c) (3), (d) (1), or (f) of this section shall be made in accordance with the provisions of §§ 301.6402–2 and 301.6402–3 of this chapter (Regulations on Procedure and Administration).

(i) *Rents paid to foreign tax-exempt organizations.* For the rule for withholding on rents paid to foreign tax- exempt organizations, see § 1.1443–1.

* * * * *

(Secs. 1441(c)(4) (80 Stat. 1553; 26 U.S.C. 1441(c)(4)), 3401(a)(6) (80 Stat. 1554; 26 U.S.C. 3401(a)(6)), and 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

§ 1.1441–4 Exemptions from withholding for certain effectively connected income and other amounts.

(a) *Certain income connected with a U.S. trade or business*—(1) *In general.* No withholding is required under section 1441 on income otherwise subject to withholding if the income is (or is deemed to be) effectively connected with the conduct of a trade or business within the United States and is includible in the beneficial owner's gross income for the taxable year. For purposes of this paragraph (a), an amount is not deemed to be includible in gross income if the amount is (or is deemed to be) effectively connected with the conduct of a trade or business within the United States and the beneficial owner claims an exemption from tax under an income tax treaty because the income is not attributable to a permanent establishment in the United States. To claim a reduced rate of withholding because the income is not attributable to a permanent establishment, see §1.1441–6(b)(1). This paragraph (a) does not apply to income of a foreign corporation to which section 543(a)(7) applies for the taxable year or to compensation for personal services performed by an individual. See paragraph (b) of this section for compensation for personal services performed by an individual.

(2) *Withholding agent's reliance on a claim of effectively connected income*—(i) *In general.* Absent actual knowledge or reason to know otherwise, a withholding agent may rely on a claim of exemption based upon paragraph (a)(1) of this section if, prior to the payment to the foreign person, the withholding agent can reliably associate the payment with a Form W–8 upon which it can rely to treat the payment as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii). For purposes of this paragraph (a), a withholding certificate is valid only if, in addition to other applicable requirements, it includes the taxpayer identifying number of the person whose name is on the Form W–8 and represents, under penalties of perjury, that the amounts for which the certificate is furnished are effectively connected with the conduct of a trade or business in the United States and is includable in the beneficial owner's gross income for the taxable year. In the absence of a reliable claim that the income is effectively connected with the conduct of a trade or business in the United States, the income is presumed not to be effectively connected, except as otherwise provided in paragraph (a) (2)(ii) or (3) of this section. See §1.1441–1(e)(4)(ii)(C) for the period of validity applicable to a certificate provided under this section and §1.1441–1(e)(4)(ii)(D) for changes in circumstances arising during the taxable year indicating that the income to which the certificate relates is not, or is no longer expected to be, effectively connected with the conduct of a trade or business within the United States. A withholding certificate shall be effective only for the item or items of income specified therein. The provisions of §1.1441–1(b)(3)(iv) dealing with a 90-day grace period shall apply for purposes of this section.

(ii) *Special rules for U.S. branches of foreign persons*—(A) *U.S. branches of certain foreign banks or foreign insurance companies.* A payment to a U.S. branch described in §1.1441–1(b)(2)(iv)(A) is presumed to be effectively connected with the conduct of a trade or business in the United States without the need to furnish a certificate, unless the U.S. branch provides a U.S. branch withholding certificate described in §1.1441–1(e)(3)(v) that represents otherwise. If no certificate is furnished but the income is not, in fact, effectively connected income, then the branch must withhold whether the payment is collected on behalf of other persons or on behalf of another branch of the same entity. See §1.1441–1(b) (2)(iv) and (6) for general rules applicable to payments to U.S. branches of foreign persons.

(B) *Other U.S. branches.* See §1.1441–1(b)(2)(iv)(E) for similar procedures for other U.S. branches to the extent provided in a determination letter from the district director or the Assistant Commissioner (International).

(3) *Income on notional principal contracts*—(i) *General rule.* A withholding agent that pays amounts attributable to a notional principal contract described in §1.863–7(a) or 1.988–2(e) shall have no obligation to withhold on the amounts paid under the terms of the notional principal contract regardless of whether a withholding certificate is provided. However, a withholding agent must file returns under §1.1461–1(b) and (c) reporting the income that it must treat as paid to a foreign person and as effectively connected with the conduct of a trade or business in the United States under the provisions of this paragraph (a)(3). Except as otherwise provided in paragraph (a)(3)(ii) of this section, a withholding agent must so treat the income unless it can reliably associate the payment with a withholding certificate upon which it can rely to treat the payment as an amount that is not effectively connected. Income on a notional principal

contract does not include the amount characterized as interest under the provisions of §1.446–3(g)(4).

(ii) *Exception for certain payments.* A payment to a foreign financial institution (within the meaning of §1.165–12(c)(1)(iv)) shall not be treated as effectively connected with the conduct of a trade or business within the United States for purposes of paragraph (a)(3)(i) of this section even if no withholding certificate is furnished if the payee provides a representation in a master agreement that governs the transactions in notional principal contracts between the parties (for example an International Swaps and Derivatives Association (ISDA) Agreement, including the Schedule thereto) or in the confirmation on the particular notional principal contract transaction that the counterparty is a U.S. person or a non-U.S. branch of a foreign person.

(b) *Compensation for personal services of an individual*—(1) *Exemption from withholding.* Withholding is not required under §1.1441–1 from salaries, wages, remuneration, or any other compensation for personal services of a nonresident alien individual if such compensation is effectively connected with the conduct of a trade or business within the United States and—

(i) Such compensation is subject to withholding under section 3402 (relating to withholding on wages) and the regulations under that section;

(ii) Such compensation would be subject to withholding under section 3402 but for the provisions of section 3401(a) (not including paragraph (a)(6) of that section) and the regulations under that section. This paragraph (b)(1)(ii) does not apply to payments to a nonresident alien individual from any trust described in section 401(a), any annuity plan described in section 403(a), or any annuity, custodial account, or retirement income account described in section 403(b). Instead, these payments are subject to withholding under this section to the extent they are exempted from the definition of wages under section 3401(a)(12) or to the extent they are from an annuity, custodial account, or retirement income account described in section 403(b). Thus, for example, payments to a nonresident alien individual from a trust described in section 401(a) are subject to withholding under section 1441 and not under section 3405 or 3406;

(iii) Such compensation is for services performed by a nonresident alien individual who is a resident of Canada or Mexico and who enters and leaves the United States at frequent intervals;

(iv) Such compensation is, or will be, exempt from the income tax imposed by chapter 1 of the Code by reason of a provision of the Internal Revenue Code or a tax treaty to which the United States is a party;

(v) Such compensation is paid after January 3, 1979 as a commission or rebate paid by a ship supplier to a nonresident alien individual, who is employed by a nonresident alien individual, foreign partnership, or foreign corporation in the operation of a ship or ships of foreign registry, for placing orders for supplies to be used in the operation of such ship or ships with the supplier. See section 162(c) and the regulations thereunder for denial of deductions for illegal bribes, kickbacks, and other payments; or

(vi) Compensation that is exempt from withholding under section 3402 by reason of section 3402(e), provided that the employee and his employer enter into an agreement under section 3402(p) to provide for the withholding of income tax upon payments of amounts described in §31.3401(a)–3(b)(1) of this chapter. An employee who desires to enter into such an agreement should furnish his employer with Form W–4 (withholding exemption certificate) (or such other form as the Internal Revenue Service (IRS) may prescribe). See section 3402(f) and the regulations thereunder and §31.3402(p)-1 of this chapter.

(2) *Manner of obtaining withholding exemption under tax treaty*—(i) *In general.* In order to obtain the exemption from withholding by reason of a tax treaty, provided by paragraph (b)(1)(iv) of this section, a nonresident alien individual must submit a withholding certificate (described in paragraph (b)(2)(ii) of this section) to each withholding agent from whom amounts are to be received. A separate withholding certificate must be filed for each taxable year of

the alien individual. If the withholding agent is satisfied that an exemption from withholding is warranted (see paragraph (b)(2)(iii) of this section), the withholding certificate shall be accepted in the manner set forth in paragraph (b)(2)(iv) of this section. The exemption from withholding becomes effective for payments made at least ten days after a copy of the accepted withholding certificate is forwarded to the Assistant Commissioner (International). The withholding agent may rely on an accepted withholding certificate only if the IRS has not objected to the certificate. For purposes of this paragraph (b)(2)(i), the IRS will be considered to have not objected to the certificate if it has not notified the withholding agent within a 10-day period beginning from the date that the withholding certificate is forwarded to the IRS pursuant to paragraph (b)(2)(v) of this section. After expiration of the 10-day period, the withholding agent may rely on the withholding certificate retroactive to the date of the first payment covered by the certificate. The fact that the IRS does not object to the withholding certificate within the 10-day period provided in this paragraph (b)(2)(i) shall not preclude the IRS from examining the withholding agent at a later date in light of facts that the withholding agent knew or had reason to know regarding the payment and eligibility for a reduced rate and that were not disclosed to the IRS as part of the 10-day review process.

(ii) *Withholding certificate claiming withholding exemption.* The statement claiming an exemption from withholding shall be made on Form 8233 (or an acceptable substitute or such other form as the IRS may prescribe). Form 8233 shall be dated, signed by the beneficial owner under penalties of perjury, and contain the following information—

(A) The individual's name, permanent residence address, taxpayer identifying number (or a copy of a completed Form W–7 or SS–5 showing that a number has been applied for), and the U.S. visa number, if any;

(B) The individual's current immigration status and visa type;

(C) The individual's original date of entry into the United States;

(D) The country that issued the individual's passport and the number of such passport, or the individual's permanent address if a citizen of Canada or Mexico;

(E) The taxable year for which the statement is to apply, the compensation to which it relates, and the amount (or estimated amount if exact amount not known) of such compensation;

(F) A statement that the individual is not a citizen or resident of the United States;

(G) The number of personal exemptions claimed by the individual;

(H) A statement as to whether the compensation to be paid to him or her during the taxable year is or will be exempt from income tax and the reason why the compensation is exempt;

(I) If the compensation is exempt from withholding by reason of an income tax treaty to which the United States is a party, the tax treaty and provision under which the exemption from withholding is claimed and the country of which the individual is a resident;

(J) Sufficient facts to justify the claim in exemption from withholding; and

(K) Any other information as may be required by the form or accompanying instructions in addition to, or in lieu of, the information described in this paragraph (b)(2)(ii).

(iii) *Review by withholding agent.* The exemption from withholding provided by paragraph (b)(1)(iv) of this section shall not apply unless the withholding agent accepts (in the manner provided in paragraph (b)(2)(iv) of this section) the statement on Form 8233 supplied by the nonresident alien individual. Before accepting the statement the withholding agent must examine the statement. If the withholding agent knows or has reason to know that any of the facts or assertions on Form 8233 may be false or that the eligibility of the individual's compensation for the exemption cannot be readily determined, the withholding agent may not accept the statement on Form 8233 and is required to withhold under this section. If the withholding agent accepts the statement and subsequently finds that any of the facts or assertions contained on

Form 8233 may be false or that the eligibility of the individual's compensation for the exemption can no longer be readily determined, then the withholding agent shall promptly so notify the Assistant Commissioner (International) by letter, and the withholding agent is not relieved of liability to withhold on any amounts still to be paid. If the withholding agent is notified by the Assistant Commissioner (International) that the eligibility of the individual's compensation for the exemption is in doubt or that such compensation is not eligible for the exemption, the withholding agent is required to withhold under this section. The rules of this paragraph are illustrated by the following examples.

Example 1. C, a nonresident alien individual, submits Form 8233 to W, a withholding agent. The statement on Form 8233 does not include all the information required by paragraph (b)(2)(ii) of this section. Therefore, W has reason to know that he or she cannot readily determine whether C's compensation for personal services is eligible for an exemption from withholding and, therefore, W must withhold.

Example 2. D, a nonresident alien, is performing services for W, a withholding agent. W has accepted a statement on Form 8233 submitted by D, according to the provisions of this section. W receives notice from the Internal Revenue Service that the eligibility of D's compensation for a withholding exemption is in doubt. Therefore, W has reason to know that the eligibility of the compensation for a withholding exemption cannot be readily determined, as of the date W receives the notification, and W must withhold tax under section 1441 on amounts paid after receipt of the notification.

Example 3. E, a nonresident alien individual, submits Form 8233 to W, a withholding agent for whom E is to perform personal services. The statement contains all the information requested on Form 8233. E claims an exemption from withholding based on a personal exemption amount computed on the number of days E will perform personal services for W in the United States. If W does not know or have reason to know that any statement on the Form 8233 is false or that the eligibility of E's compensation for the withholding exemption cannot be readily determined, W can accept the statement on Form 8233 and exempt from withholding the appropriate amount of E's income.

(iv) *Acceptance by withholding agent.* If after the review described in paragraph (b)(2)(iii) of this section the withholding agent is satisfied that an exemption from withholding is warranted, the withholding agent may accept the statement by making a certification, verified by a declaration that it is made under the penalties of perjury, on Form 8233. The certification shall be—

(A) That the withholding agent has examined the statement,

(B) That the withholding agent is satisfied that an exemption from withholding is warranted, and

(C) That the withholding agent does not know or have reason to know that the individual's compensation is not entitled to the exemption or that the eligibility of the individual's compensation for the exemption cannot be readily determined.

(v) *Copies of Form 8233.* The withholding agent shall forward one copy of each Form 8233 that is accepted under paragraph (b)(2)(iv) of this section to the Assistant Commissioner (International), within five days of such acceptance. The withholding agent shall retain a copy of Form 8233.

(3) *Withholding agreements.* Compensation for personal services of a nonresident alien individual who is engaged during the taxable year in the conduct of a trade or business within the United States may be wholly or partially exempted from the withholding required by § 1.1441–1 if an agreement is reached between the Assistant Commissioner (International) and the alien individual with respect to the amount of withholding required. Such agreement shall be available in the circumstances and in the manner set forth by the Internal Revenue Service, and shall be effective for payments covered by the agreement that are made after the agreement is executed by all parties. The alien individual must agree to timely file an income tax return for the current taxable year.

(4) *Final payment exemption*—(i) *General rule.* Compensation for independent personal services of a nonresident alien individual who is engaged during the taxable year in the conduct of a trade or business within the United States may be wholly or partially exempted from the withholding required by § 1.1441–1 from the final payment of compensation for independent personal

services. This exemption does not apply to wages. This exemption from withholding is available only once during an alien individual's taxable year and is obtained by the alien individual presenting to the withholding agent a letter in duplicate from a district director stating the amount of compensation subject to the exemption and the amount that would otherwise be withheld from such final payment under section 1441 that shall be paid to the alien individual due to the exemption. The alien individual shall attach a copy of the letter to his or her income tax return for the taxable year for which the exemption is effective.

(ii) *Final payment of compensation for personal services.* For purposes of this paragraph, final payment of compensation for personal services means the last payment of compensation, other than wages, for personal services rendered within the United States that the individual expects to receive from any withholding agent during the taxable year.

(iii) *Manner of applying for final payment exemption.* In order to obtain the final payment exemption provided by paragraph (b)(4)(i) of this section, the nonresident alien individual (or his or her agent) must file the forms and provide the information required by the district director. Ordinary and necessary business expenses may be taken into account if substantiated to the satisfaction of the district director. The alien individual must submit a statement, signed by him or her and verified by a declaration that it is made under the penalties of perjury, that all the information provided is true and that to his or her knowledge no relevant information has been omitted. The information required to be submitted includes, but is not limited to—

(A) A statement by each withholding agent from whom amounts of gross income effectively connected with the conduct of a trade or business within the United States have been received by the alien individual during the taxable year, of the amount of such income paid and the amount of tax withheld, signed and verified by a declaration that it is made under penalties of perjury;

(B) A statement by the withholding agent from whom the final payment of compensation for personal services will be received, of the amount of such final payment and the amount which would be withheld under § 1.1441–1 if a final payment exemption under paragraph (b)(4)(i) of this section is not granted, signed and verified by a declaration that it is made under penalties of perjury;

(C) A statement by the individual that he or she does not intend to receive any other amounts of gross income effectively connected with the conduct of a trade or business within the United States during the current taxable year;

(D) The amount of tax which has been withheld (or paid) under any other provision of the Code or regulations with respect to any income effectively connected with the conduct of a trade or business within the United States during the current taxable year;

(E) The amount of any outstanding tax liabilities (and interest and penalties relating thereto) from the current taxable year or prior taxable periods; and

(F) The provision of any income tax treaty under which a partial or complete exemption from withholding may be claimed, the country of the individual's residence, and a statement of sufficient facts to justify an exemption pursuant to such treaty.

(iv) *Letter to withholding agent.* If the district director is satisfied that the information provided under paragraph (b)(4)(iii) of this section is sufficient, the district director will, after coordination with the Director of the Foreign Operations District, ascertain the amount of the alien individual's tentative income tax for the taxable year with respect to gross income that is effectively connected with the conduct of a trade or business within the United States. After the tentative tax has been ascertained, the district director will provide the alien individual with a letter to the withholding agent stating the amount of the final payment of compensation for personal services that is exempt from withholding, and the amount that would otherwise be withheld under section 1441 that shall be paid to the alien individual due to the exemption. The amount of compensation for personal services exempt from withholding under this paragraph (b)(4) shall not exceed $5,000.

Example 1. On July 15, 1983, B, a nonresident alien individual, appears before a district director with the information required by paragraph (b)(4)(iii) of this section. B has received personal service income in 1983 from which $3,000 has been withheld under section 1441. On August 1, 1983, B will receive $5,000 in personal service income from W. B does not intend to receive any other income subject to U.S. tax during 1983. Taking into account B's substantiated deductible business expenses, the district director computes the tentative tax liability on B's income effectively connected with the conduct of a trade or business in the United States during 1983 (including the $5,000 payment to be made on August 1, 1983) to be $3,300. B does not owe U.S. tax for any other taxable periods. The amount of B's final payment exemption is determined as follows:

(*1*) The amount of total withholding is $4,500 ($3,000 previously withheld plus $1,500, 30% of the $5,000 final payment);

(*2*) The amount of tentative excess withholding is $1,200 (total withholding of $4,500 minus B's tentative tax liability of $3,300); and

(*3*) To allow B to receive $1,200 of the amount which would otherwise have been withheld from the final payment, the district director allows a withholding exemption for $4,000 of B's final payment. W must withhold $300 from the final payment.

Example 2. The facts are the same as in Example 1 except B will receive a final payment of compensation on August 1, 1983, in the amount of $10,000 and B's tentative tax liability is $3,900. The amount of B's final payment exemption is determined as follows:

(*1*) The amount of total withholding is $6,000 ($3,000 previously withheld plus $3,000, 30% of the $10,000 final payment);

(*2*) The amount of tentative excess withholding is $2,100 (total withholding of $6,000 minus B's tentative tax liability of $3,900); and

(*3*) To allow B to receive $2,100 of the amount which would otherwise be withheld from the final payment, $7,000 of the final payment would have to be exempt from withholding; however, as no more than $5,000 of the final payment can be exempt from withholding under this paragraph (b)(4), the district director allows a withholding exemption for $5,000 of B's final payment. B must file a claim for refund at the end of the taxable year to obtain a refund of $600. W must withhold $1,500 from the final payment.

(5) *Requirement of return.* The tentative tax determined by the district director under paragraph (b)(4)(iv) of this section or by the Director of the Foreign Operations District under the withholding agreement procedure of paragraph (b)(3) of this section shall not constitute a final determination of the income tax liability of the nonresident alien individual, nor shall such determination constitute a tax return of the nonresident alien individual for any taxable period. An alien individual who applies for or obtains an exemption from withholding under the procedures of paragraphs (b) (2), (3), or (4) of this section is not relieved of the obligation to file a return of income under section 6012.

(6) *Personal exemption*—(i) *In general.* To determine the tax to be withheld at source under § 1.1441–1 from remuneration paid for personal services performed within the United States by a nonresident alien individual and from scholarship and fellowship income described in paragraph (c) of this section, a withholding agent may take into account one personal exemption pursuant to sections 873(b)(3) and 151 regardless of whether the income is effectively connected. For purposes of withholding under section 1441 on remuneration for personal services, the exemption must be prorated upon a daily basis for the period during which the personal services are performed within the United States by the nonresident alien individual by dividing by 365 the number of days in the period during which the individual is present in the United States for the purpose of performing the services and multiplying the result by the amount of the personal exemption in effect for the taxable year. See § 31.3402(f)(6)–1 of this chapter.

(ii) *Multiple exemptions.* More than one personal exemption may be claimed in the case of a resident of a contiguous country or a national of the United States under section 873(b)(3). In addition, residents of a country with which the United States has an income tax treaty in effect may be eligible to claim more than one personal exemption if the treaty so provides. Claims for more than one personal exemption shall be made on the withholding certificate furnished to the withholding agent. The exemption must be prorated on a daily basis in the same manner as described in paragraph (b)(6)(i) of this section.

(iii) *Special rule where both certain scholarship and compensation income are received.* The fact that both non-compensatory scholarship income and compensation income (including compensatory scholarship income) are received during the taxable year does not entitle the taxpayer to claim more than one personal exemption amount (or more than the additional amounts permitted under paragraph (b)(6)(ii) of this section). Thus, if a nonresident alien student receives non-compensatory taxable scholarship income from one withholding agent and compensation income from another withholding agent, no more than the total personal exemption amount permitted under the Internal Revenue Code or under an income tax treaty may be taken into account by both withholding agents. For this purpose, the withholding agent may rely on a representation from the beneficial owner that the exemption amount claimed does not exceed the amount permissible under this section.

(c) *Special rules for scholarship and fellowship income*—(1) *In general.* Under section 871(c), certain amounts paid as a scholarship or fellowship for study, training, or research in the United States to a nonresident alien individual temporarily present in the United States as a nonimmigrant under section 101(a)(15) (F), (J), (M), or (Q) of the Immigration and Nationality Act are treated as income effectively connected with the conduct of a trade or business within the United States. The amounts described in the preceding sentence are those amounts that do not represent compensation for services. Such amounts (as described in the second sentence of section 1441(b)) are subject to withholding under section 1441, but at the lower rate of 14 percent. That rate may be reduced under the provisions of an income tax treaty. Claims of a reduced rate under an income tax treaty shall be made under the procedures described in §1.1441–6(b)(1). Therefore, claims for reduction in withholding under an income tax treaty on amounts described in this paragraph (c)(1) may not be made on a Form 8233. However, if the payee is receiving both compensation for personal services (including compensatory scholarship income) and non-compensatory scholarship income described in this paragraph (c)(1) from the same withholding agent, claims for reduction of withholding on both types of income may be made on Form 8233.

(2) *Alternate withholding election.* A withholding agent may elect to withhold on the amounts described in paragraph (c)(1) of this section at the rates applicable under section 3402, as if the income were wages. Such election shall be made by obtaining a Form W–4 (or an acceptable substitute or such other form as the IRS may prescribe) from the beneficial owner. The fact that the withholding agent asks the beneficial owner to furnish a Form W–4 for such fellowship or scholarship income or to take such income into account in preparing such Form W–4 shall serve as notice to the beneficial owner that the income is being treated as wages for purposes of withholding tax under section 1441.

(d) *Annuities received under qualified plans.* Withholding is not required under section §1.1441–1 in the case of any amount received as an annuity if the amount is exempt from tax under section 871(f) and the regulations under that section. The withholding agent may exempt the payment from withholding if, prior to payment, it can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a beneficial owner in accordance with §1.1441–1(e)(1)(ii). A beneficial owner withholding certificate furnished for purposes of claiming the benefits of the exemption under this paragraph (d) is valid only if, in addition to other applicable requirements, it contains a taxpayer identifying number.

(e) *Per diem of certain alien trainees.* Withholding is not required under section 1441(a) and §1.1441–1 on per diem amounts paid for subsistence by the United States Government (directly or by contract) to any nonresident alien individual who is engaged in any program of training in the United States under the Mutual Security Act of 1954, as amended (22 U.S.C. chapter 24). This rule shall apply even though such amounts are subject to tax under section 871. Any exemption from withholding pursuant to this paragraph (e) applies without a requirement that documentation be furnished to the withholding agent. However, documentation may have to be furnished for purposes of the information reporting provisions under section 6041 and backup withholding under section 3406. The exemption from withholding granted by this paragraph (e) is not a determination that the amounts are not fixed or determinable annual or periodical income.

(f) *Failure to receive withholding certificates timely or to act in accordance with applicable presumptions.* See applicable procedures described in § 1.1441–1(b)(7) in the event the withholding agent does not hold an appropriate withholding certificate or other appropriate documentation at the time of payment or does not act in accordance with applicable presumptions described in paragraph (a) (2)(i), (2)(ii), or (3) of this section.

(g) *Effective date*—(1) *General rule.* This section applies to payments made after December 31, 1999.

(2) *Transition rules.* The validity of a Form 4224 or 8233 that was valid on January 1, 1998, under the regulations in effect prior to January 1, 2000 (see 26 CFR part 1, revised April 1, 1998) and expired, or will expire, at any time during 1998, is extended until December 31, 1998. The validity of a Form 4224 or 8233 that is valid on or after January 1, 1999, remains valid until its validity expires under the regulations in effect prior to January 1, 2000 (see 26 CFR part 1, revised April 1, 1998) or, if earlier, until December 31, 2000. The rule in this paragraph (g)(2), however, does not apply to extend the validity period of a Form 4224 or 8223 that expires solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the first three sentences of this paragraph (g)(2), a withholding agent may choose to not take advantage of the transition rule in this paragraph (g)(2) with respect to one or more withholding certificates valid under the regulations in effect prior to January 1, 2000 (see 26 CFR part 1, revised April 1, 1998) and, therefore, to require withholding certificates conforming to the requirements described in this section (new withholding certificates). For purposes of this section, a new withholding certificate is deemed to satisfy the documentation requirement under the regulations in effect prior to January 1, 2000 (see 26 CFR part 1, revised April 1, 1998). Further, a new withholding certificate remains valid for the period specified in § 1.1441–1(e)(4)(ii), regardless of when the certificate is obtained.

[T.D. 6500, 25 FR 12075, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.1441–4, see the List of Sections Affected in the Finding Aids section of this volume.

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53450, Oct. 14, 1997, § 1.1441–4 was amended by revising the section heading and paragraph (a); by revising paragraphs (b)(1) (i) and (ii); by removing the period at the end of paragraph (b)(1)(iii) and adding a semicolon in its place; by removing the language ‘‘or’’ at the end of paragraph (b)(1)(iv) and adding a semicolon in its place; by removing the period at the end of paragraph (b)(1)(v) and adding ‘‘ or’’ in its place; by adding paragraph (b)(1)(vi); by adding four sentences at the end of pargraph (b)(2)(i); by revising paragraph (b)(2)(ii) heading and introductory text, and paragraph (b)(2)(ii)(A); by redesignating paragraph (b)(2)(ii)(H) as paragraph (b)(2)(ii)(J) and amending newly designated paragraph (b)(2)(ii)(J) by removing the period at the end of the paragraph and adding ‘‘; and’’ in its place; by redesignating pargraphs (b)(2)(ii) (B), (C), (D), (E), (F), and (G) as paragraphs (b)(2)(ii) (D), (E), (F), (G), (H), and (I), respectively; by adding new paragraphs (b)(2)(ii) (B), (C), and (K); by removing the period at the end of newly designated paragraph (b)(2)(ii)(D) and the comma at the end of newly designated paragaphs (b)(2)(ii) (E), (F), (G), and (H) and adding a semicolon in each place; by removing ‘‘, and’’ and adding a semicolon in its place in newly designated paragraph (b)(2)(ii)(I); by removing the concluding text immediately following paragraph (b)(2)(iv)(C); by revising paragraph (b)(2)(v); by removing the word ‘‘statement’’ and inserting the words ‘‘withholding certificate’’ in each place in paragraph (b)(2)(i); by removing the words ‘‘Director of the Foreign Operations District’’ and inserting in their place the words ‘‘Assistant Commissioner (International)’’ in the fourth sentence of paragraph (b)(2)(i), in the fourth and fifth sentences of paragraph (b)(2)(iii), and in the first sentence of paragraph (b)(3); by adding paragraph (b)(6); by revising paragraphs (c), (d), (e), (f), and (g); by removing paragraphs

(h) and (i); and by removing the OMB parenthetical and the authority citation at the end of the section, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.1441–4 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.1441–4 Exemptions from withholding.

(a) *Income connected with a U.S. business*—(1) *In general.* No withholding is required under §1.1441–1 in the case of any item of income if such income is effectively connected with the conduct of a trade or business within the United States by the person entitled to such income and is includible in the person's gross income under section 871(b)(2), section 842, or section 882(a)(2) for the taxable year and if the person has filed the statement prescribed by paragraph (a)(2) of this section. This paragraph (a)(1) shall apply to income for services performed by a foreign partnership or a foreign corporation (other than a foreign corporation which has income to which section 543(a)(7) applies for the taxable year) but shall not apply to compensation for personal services performed by an individual. In determining whether services are performed by a foreign corporation or by an individual, see Revenue Ruling 74–330, 1974–2 C.B. 278, and Revenue Ruling 74–331, 1974–2 C.B. 282. For rules with respect to compensation for personal services performed by an individual, see paragraph (b) of this section. In determining whether an item of income from sources within the United States is, or is deemed to be, effectively connected with the conduct of a trade or business within the United States by the person entitled to the income, see section 864(c)(2), section 871(d), and sections 882 (d) and (e), and the regulations thereunder.

(2) *Statement claiming exemption.* In order for the exemption provided by paragraph (a)(1) of this section to apply for any taxable year, the person entitled to the income must file with the withholding agent a statement in duplicate that the income described in the statement is, or is expected to be, effectively connected with the conduct of a trade or business within the United States and that such income is includible in his gross income for the taxable year. This statement shall show (i) the name and address of the withholding agent and of the person entitled to the income, (ii) the taxpayer's identifying number, (iii) the nature of the item or items of income with respect to which the statement is filed, (iv) the trade or business with which such income is, or is expected to be, effectively connected, and (v) the taxable year in respect of which the statement is made. This statement shall be filed with the withholding agent for each taxable year of the person entitled to the income, and before payment of the income in respect of which it applies. Any statement so filed shall be effective only with respect to the item or items of income specified therein and shall constitute authorization to the withholding agent to pay such income during the taxable year without deduction of the tax at source under §1.1441–1. The statement shall be amended by the person entitled to the income if subsequent circumstances arising during the taxable year indicate that the income is not, or is not expected to be, effectively connected with the conduct of a trade or business within the United States. Any statement required by this subparagraph may be made on a properly executed Form 4224, which shall be filed in duplicate with the withholding agent. The duplicate copy of each statement or form filed during any calendar year pursuant to this subparagraph shall be forwarded by the withholding agent with, and attached to, any Form 1042S required by paragraph (c) of §1.1461–2 with respect to such income for such calendar year.

* * * * *

(b) * * * (1) * * *

(i) Such compensation is subject to withholding under section 3402, relating to withholding of tax at source on wages, and the regulations thereunder.

(ii) [Reserved] For guidance, see §1.1441–4T(b)(1)(ii).

* * * * *

(2) * * * (i) * * * (ii) *Statement claiming withholding exemption.* The statement claiming an exemption from withholding shall be made on Form 8233. Form 8233 may be used for claiming exemption from withholding under tax treaties to which the United States is a party or with respect to the personal exemption amount described in §1.1441–3(e)(2). Form 8233 shall be dated, signed by the person claiming the exemption from withholding, and verified by a declaration that the statements are made under the penalties of perjury. Form 8233 shall contain—

(A) The individual's name, address, United States taxpayer identification number, and United States visa number, if any,

* * * * *

(iv) * * * (C) * * *

The exemption from withholding becomes effective for payments made at least ten days after a copy of the accepted statement is mailed in a proper manner by the withholding agent to the Director of the Foreign Operations District, pursuant to paragraph (b)(2)(v) of this section.

(v) *Copies of Form 8233.* The withholding agent shall forward one copy of each Form 8233 that is accepted by him or her to the Director of the Foreign Operations District, Internal Revenue Service, Washington, DC

20225, within five days of his or her acceptance. The Director of the Foreign Operations District may review the forms so submitted. The withholding agent shall retain a copy of Form 8233.

*   *   *   *   *

(c) *Dividends paid by China Trade Act corporations.* Withholding is not required under §1.1441–1 upon dividends distributed by a corporation organized under the China Trade Act of 1922 (15 U.S.C., chapter 4) to or for the benefit of a resident of Formosa or Hong Kong and which are exempt from taxation by section 943.

(d) *Inhabitants of the Virgin Islands*—(1) *Allowance of exemption.* This paragraph shall not apply after June 22, 1981. No withholding is required under §1.1441–1 upon any item of income paid to any person who at the time of payment reasonably expects to satisfy his income tax obligations with respect to that item under section 28(a) of the Revised Organic Act of the Virgin Islands. That section provides that all persons whose permanent residence is in the Virgin Islands ‘‘shall satisfy their income tax obligations under applicable taxing statutes of the United States by paying their tax on income derived from all sources both within and outside the Virgin Islands into the Treasury of the Virgin Islands.’’ For the purpose of this paragraph, the term ‘‘person’’ shall include an individual, partnership, and corporation.

(2) *Claiming exemption.* To avoid withholding of tax at source under §1.1441–1, the payee of the income shall notify the withholding agent by letter in duplicate that he expects to satisfy his income tax obligations under section 28(a) of the Revised Organic Act of the Virgin Islands with respect to all income to be paid to him by the withholding agent during the current calendar year. This letter of notification shall constitute authorization to the payer of the income to pay income to the payee during that year without deduction of the tax at source under §1.1441–1.

(3) *Disposition of letter.* The duplicate copy of each letter of notification filed pursuant to subparagraph (2) of this paragraph shall be forwarded with a letter of transmittal to the Director of International Operations, Internal Revenue Service, Washington, DC 20225.

(e) *Per diem of certain alien trainees.* Effective with respect to payments made on and after July 18, 1956, withholding is not required under section 1441(a) or §1.1441–1 in the case of amounts of per diem for subsistence paid by the United States Government (directly or by contract) to any nonresident alien individual who is engaged in any program of training in the United States under the Mutual Security Act of 1954, as amended (22 U.S.C. chapter 24). This rule shall apply even though such amounts are subject to tax under section 871.

(f) *Exemption of certain foreign partnerships and foreign corporations*—(1) *In general.* No withholding is required under §1.1441–1 upon any item of income paid to a foreign partnership, or foreign corporation, engaged in trade or business in the United States at any time during the taxable year, if it is established to the satisfaction of the district director in whose district the related books and records are kept that the requirements of section 1441(a), or 1442(a), and §1.1441–1 impose an undue administrative burden for such taxable year and that the collection of the tax imposed by section 871(a) or section 881 on the members of such partnership, or by section 881 on such corporation, as the case may be, will not be jeopardized by the exemption from withholding. As a general rule, the requirements of section 1441(a), or 1442(a), and §1.1441–1 will be considered to impose an undue administrative burden only in a case where (i) the person entitled to the income, such as a foreign insurance company, receives from the withholding agent income on securities issued by a single corporation, some of which is, and some of which is not, effectively connected with the conduct of a trade or business within the United States and (ii) the criteria for determining the effective connection are unduly difficult to apply because of the circumstances under which such securities are held. Thus, for example, if a foreign corporation carrying on a life insurance business in the United States finds that, because of the requirements of State law which cause its U.S. reserves to fluctuate frequently, it is unduly difficult with respect to any class of income to identify the income which is, and the income which is not, effectively connected with its conduct of business in the United States during the taxable year, the corporation will be considered to have satisfied the requirements of subdivision (ii) of this subparagraph. No exemption from withholding shall be granted under this paragraph unless the person entitled to the income complies with such other requirements as may be imposed by the district director and unless the district director is satisfied that the collection of the tax on the income involved will not be jeopardized by the exemption from withholding.

(2) *Claiming exemption*—(i) *Statement required.* In order for the exemption provided by paragraph (f)(1) of this section to apply for any taxable year the foreign partnership or the foreign corporation must file with the district director in whose district the related books and records are kept a statement indicating the reasons why specific classes of income should be exempted from the withholding requirements of §1.1441–1 for such year. This statement shall show the name and address of the withholding agent and of

the person entitled to the income, the taxpayer's identifying number, the class or classes of income to be exempted from withholding, the trade or business with which such income is in part effectively connected, the taxable year during which such exemption is to apply, and, in such form and to such extent as shall satisfy the district director, the identity of the securities or other underlying property involved.

(ii) *Notification of determination.* The district director shall notify the partnership or corporation by letter in duplicate of his or her determination in respect of the application for exemption. If the exemption from withholding is granted, the duplicate copy of the notice from the district director shall be filed with the withholding agent and shall constitute authorization to pay the specified class or classes of income during the specified taxable year without deduction of the tax at source under §1.1441–1.

(iii) *Bond requirement.* The district director may, as a condition precedent to the allowance of the exemption from withholding for the taxable year, require a bond in such sum as the Commissioner may prescribe, conditioned upon the payment of the tax on the income involved and such further conditions as the district director may require. This bond shall be executed by the foreign partnership or foreign corporation and shall conform to the requirements of §301.7101–1 as to form of bond and surety required. No bond shall be required pursuant to this subparagraph from a foreign corporation which is required to file a declaration of estimated income tax under section 6016 for the taxable year in respect of which the exemption from withholding applies.

(g) *Annuities received under qualified plans.* Withholding is not required under §1.1441–1 in the case of any amount received as an annuity if such amount is exempt under section 871(f) and the regulations thereunder from the tax imposed by section 871(a). In order for the exemption provided by this paragraph to apply for any taxable year in those cases where the withholding agent is not the employer by whom the annuity plan or qualified trust under or from which such annuity is paid was established, the person entitled to the annuity must file with the withholding agent a statement in duplicate setting forth his or her name, address, and taxpayer identifying number, if any, and certifying that he or she is not a citizen or resident of the United States and that the annuity in respect of which the statement is filed is excluded from gross income by reason of section 871(f). This statement shall be dated, shall identify the taxable year to which it relates, shall be signed by the person entitled to the annuity, and shall contain, or be verified by, a written declaration that it is made under the penalties of perjury. No particular form is prescribed for the statement. The duplicate copy of each statement filed during any calendar year pursuant to this paragraph shall be forwarded by the withholding agent with, and attached to, the Form 1042S required by paragraph (c) of §1.1461–2 with respect to such annuity for such calendar year.

(h) *Interest on bonds sold between interest dates.* Except as provided by paragraph (b)(2)(ii) of §1.1441–2, the tax is not required to be withheld under §1.1441–1 on accrued interest paid by the buyer in connection with the sale of bonds between interest dates, even though the interest is subject to tax under section 871 or section 881. The exemption from withholding granted by this paragraph is not a determination that the accrued interest is not fixed or determinable annual or periodical income.

(i) *Income of foreign central bank of issue or Bank for International Settlements.* (1) Section 895 provides for the exclusion from gross income of certain income derived by a foreign central bank of issue, or by the Bank for International Settlements, from obligations of the United States or of any agency or instrumentality thereof or from bank deposits. In the absence of knowledge that a foreign central bank of issue, or the Bank for International Settlements, is operating without the scope of the exclusion granted by section 895, the withholding agent is not required to withhold under §1.1441–1 upon income derived by such bank from obligations of the United States or of any agency or instrumentality thereof, or upon interest derived from deposits with persons carrying on the banking business, if the withholding agent receives from the bank a statement certifying that the bank—

(i) Is a foreign central bank of issue, or the Bank for International Settlements, as the case may be,

(ii) Is the owner of the obligations of the United States or of any agency or instrumentality thereof, or the owner of such bank deposits, as the case may be, and

(iii) Does not, and will not, hold such obligations or such bank deposits for, or use them in connection with, the conduct of a commercial banking function or other commercial activity.

(2) A copy of the statement filed pursuant to paragraph (i)(1) of this section shall be forwarded by the withholding agent with, and attached to, the Form 1042S required by paragraph (c) of §1.1461–2 with respect to payments of income made on such obligations or bank deposits during the calendar year.

(Approved by the Office of Management and Budget under control number 1545–0795)

(Secs. 1441(c)(4) (80 Stat. 1553; 26 U.S.C. 1441(c)(4)), 3401(a)(6) (80 Stat. 1554; 26 U.S.C. 3401(a)(6)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954; secs.

1441, 1442, and 7805, Internal Revenue Code (80 Stat. 1553, 26 U.S.C. 1441; 80 Stat. 1558, 26 U.S.C. 1442; 68A Stat. 917, 26 U.S.C. 7805))

§ 1.1441–4T Exemption from withholding (temporary).

(a) [Reserved]

(b) *Compensation for personal services of an individual*—(1) *Exemption from withholding.*

(i) [Reserved]

(ii) Withholding is not required under § 1.1441–1 from salaries, wages, remuneration, or any other compensation for personal services of a nonresident alien individual if such compensation is effectively connected with the conduct of a trade or business within the United States and such compensation would be subject to withholding under section 3402 but for the provisions of section 3401(a) (other than paragraph (a)(6) thereof) and the regulations under that section, provided that an election of no withholding under section 3405 (a)(2) or (b)(3) is not in effect.

(b) (1)(iii)–(5) [Reserved]

(c)–(i) [Reserved]

[T.D. 8288, 55 FR 3716, Feb. 5, 1990]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53452, Oct. 14, 1997, § 1.1441–4T was removed, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of the removal of § 1.1441–4T was delayed until Jan. 1, 2000.

§ 1.1441–5 Withholding on payments to partnerships, trusts, and estates.

(a) *Rules of withholding applicable to payments to partnerships.* This paragraph (a) describes the determinations that a withholding agent must make when making a payment to a person that may be a partnership (as defined in § 1.1441–1(c)(6)(ii)(C)). Such determinations are made in order to determine a withholding agent's obligations under chapters 3 and 61 of the Internal Revenue Code (Code) and sections 3402, 3405, and 3406 (and applicable regulations under those provisions) to withhold and report payments of amounts subject to withholding under chapter 3 of the Code and the regulations thereunder. The reliance provisions stated in this paragraph (a) are subject to the presumptions described in § 1.1441–1(b)(3) and paragraph (d) of this section, including § 1.1441–1(b)(3)(ix) regarding the withholding agent's actual knowledge or reason to know that the presumptions are not correct. For similar presumptions for reporting and withholding on amounts not subject to withholding under chapter 3 of the Code (e.g., foreign source income, broker proceeds) that may be paid to a foreign partnership, see § 1.6049–5(d) (2) through (5).

(1) The withholding agent must determine whether the payee is a U.S. or a foreign person. For this purpose, the withholding agent may treat the payee as U.S. or foreign if it can reliably associate the payment with a Form W–9 described in § 1.1441–1(d) or a Form W–8 described in § 1.1441–1(e)(2)(i) or (3)(i). In the absence of documentation, see § 1.1441–1(b)(3) and paragraph (d) of this section for applicable presumptions of foreign or U.S. status and other relevant characteristics.

(2) If the payee is determined to be a foreign person, the withholding agent must determine whether the foreign payee is acting for its own account or for the account of others (i.e., as an intermediary, as defined in § 1.1441–1(e)(3)(i)). The withholding agent may treat the payee as a foreign intermediary if it can reliably associate the payment with a Form W–8 described in § 1.1441–1(e)(3) (ii), (iii), or (v), within the meaning of § 1.1441-1(b)(3)(v)(A).

(3) If the foreign payee is determined to act as an intermediary described in § 1.1441–1(e)(3)(i), the withholding agent must determine whether or not the payee is a qualified intermediary. The withholding agent may treat the payee as a qualified intermediary only if it can reliably associate the payment with a Form W–8 described in § 1.1441–1(e)(3)(ii). A foreign payee that is treated as an intermediary with respect to a payment is subject to the provisions applicable to intermediaries in § 1.1441–1(e) (3) or (5). In such a case, the provisions of paragraph (c) of this section do not apply to the payment.

(4) If the foreign payee is determined to act for its own account (or is so presumed), the withholding agent must determine the status of the payee as a partnership. The withholding agent

may treat the payee as a domestic or as a foreign partnership if it can reliably associate the payment with a Form W–9 furnished in accordance with §1.1441–1(d) (2) or (4) (for a domestic partnership) or a Form W–8 described in paragraph (c) (2)(iv) or (3)(iii) of this section (for a foreign partnership). See §1.1441–1(e)(4)(viii) for reliance on the payee's representations on a Form W–8. In the absence of documentation, see §1.1441–1(b)(3)(ii) and paragraph (d)(2) of this section for applicable presumptions of status.

(5) If the foreign payee is determined to be a foreign partnership and the withholding agent has determined (or presumes) that the partnership is acting for the account of its partners, then the withholding agent must determine whether the payment represents income effectively connected with the partnership's conduct of a U.S. trade or business. The withholding agent may treat the payment as effectively connected if it can reliably associate the payment with a Form W–8 described in paragraph (c)(3)(iii) of this section representing that the income is effectively connected or if it so presumes in accordance with the provisions in §1.1441–4(a) (2)(ii) or (3). In the absence of documentation, the payment is generally presumed to be non-effectively connected. See §1.1441–4(a)(2)(i). See §§1.1461–1(c)(2)(ii)(A), 1.6031–1 and 1.6031(b)–1T for reporting requirements applicable to the withholding agent and to the partnership.

(6) If the withholding agent cannot reliably treat the payment as effectively connected income nor presume that it is so connected, then the withholding agent must determine whether the partnership is a withholding foreign partnership described in paragraph (c)(2)(i) of this section. The withholding agent may treat the foreign partnership as a withholding foreign partnership if it can reliably associate the payment with a Form W–8 described in paragraph (c)(2)(iv) of this section. In the absence of a reliable Form W–8, the foreign partnership is presumed to be a non-withholding foreign partnership described in paragraph (c)(3)(i) of this section. In such a case, under paragraph (c)(1)(i) of this section, the withholding agent must treat the partners, rather than the partnership, as payees. See paragraph (d) of this section for determining the status of the partners as U.S. or foreign persons in the absence of documentation. See §1.1461–1(c)(2)(ii)(A), 1.6031–1 and 1.6031(b)–1T for reporting requirements applicable to the withholding agent and to the partnership.

(7) If the withholding agent determines that the payee is a U.S. partnership, or so presumes in accordance with paragraph (d)(2) of this section in the absence of documentation, the withholding agent is not required to withhold under paragraph (b)(1) of this section because the partnership is treated as a U.S. payee. See paragraph (b)(2) of this section for withholding requirements applicable to a domestic partnership with foreign partners. See §§1.1461–1(c)(2)(ii)(A), 1.6031–1 and 1.6031(b)–1T for reporting requirements applicable to the withholding agent and to the partnership.

(8) In order to determine whether to rely on a claim for a reduced rate under a tax treaty by a person that the withholding agent treats as a partnership or as a partner in a partnership, the withholding agent must apply the provisions of §1.894–1T(d). For applicable procedures regarding reliance by a withholding agent on a claim for benefits under a tax treaty in such a situation, see §1.1441–6(b)(4).

(b) *Domestic partnerships*—(1) *Exemption from withholding on payment to domestic partnerships.* A payment to a person that the withholding agent may treat as a domestic partnership is treated as a payment to a U.S. payee. Therefore, a payment to a domestic partnership is not subject to withholding under section 1441 even though it may have partners that are foreign persons. A withholding agent may treat the person to whom the payment is made as a domestic partnership if it can reliably associate the payment with a Form W–9 furnished by the partnership in accordance with the procedures under §1.1441–1(d) (2) or (4) or based upon the presumptions described in paragraph (d)(2) of this section.

(2) *Withholding by a domestic partnership*—(i) *In general.* A domestic partnership is required to withhold under §1.1441–1 as a withholding agent on the

gross amount of items of income subject to withholding that are includible in the distributive share of income of a partner that is a foreign person. Pursuant to the authority provided under section 702(a), each partner shall take into account separately its distributive share of amounts subject to withholding, and thus the partnership, pursuant to section 703(a)(1), shall separately state these amounts when computing its taxable income. A partnership shall withhold when any distributions that include amounts subject to withholding are made or when guaranteed payments are made. To the extent a foreign partner's distributive share of an amount subject to withholding has not been actually distributed, the partnership is required to withhold on the partner's distributive share of that amount on the earlier of the date that the statement required under section 6031(b) and § 1.6031(b)–1T to be provided to that partner is mailed or otherwise furnished to the partner or the due date for furnishing that statement as provided under § 1.6031(b)–1T. If a partnership withholds on a distributive share before the amount is actually distributed to the partner, then withholding is not required when the amount is subsequently distributed. Withholding on items of income that are effectively connected income in the hands of the partners who are foreign persons is governed by section 1446 and not by this section. In such a case, partners in a domestic partnership are not required to furnish a withholding certificate in order to claim an exemption from withholding under section 1441(c)(1) and § 1.1441–4.

(ii) *Determination by the domestic partnership of the partners' status.* For purposes of determining whether the partners or some other persons are the payees of the partners' distributive shares of any payment made to the partnership and the status of the partners, the partnership shall apply the rules of § 1.1441–1(b) (2) and (3), and of paragraphs (c)(1) and (d) of this section (in the case of a partner that is a foreign partnership) and of paragraph (e) of this section (in the case of a partner that is a foreign estate or a foreign trust) in the same manner as if the partnership were making a payment directly to the partners other than in their capacity as partners.

(iii) *Reliance on a partner's claim for reduced withholding.* Absent actual knowledge or reason to know otherwise, a domestic partnership may rely on a claim for reduced withholding under chapter 3 of the Code by a partner, if prior to the time the partnership is required to withhold, the partnership can reliably associate the partner's distributive share of the partnership items with documentation upon which it may rely to treat the partner or another person as a U.S. person under § 1.1441–1(d) (2) or (3), as a U.S. beneficial owner under § 1.1441–1(d)(4), or as a foreign beneficial owner under § 1.1441–1(e)(1)(ii).

(iv) *Rules for reliably associating a payment with documentation.* For rules regarding the reliable association of a payment with documentation, see § 1.1441–1(b)(2)(vii).

(v) *Coordination with chapter 61 of the Internal Revenue Code and section 3406.* A domestic partnership is not a payor for purposes of chapter 61 of the Code or section 3406 with respect to payments to its partners in their capacity as partners. Thus, it is not required to make an information return on Form 1099 nor to backup withhold with respect to its partners' distributive share of partnership items. However, it must file returns under section 6031. Such returns are in lieu of making returns under § 1.1461–1 (b) and (c). See § 1.1461–1(c)(2)(ii)(A).

(c) *Foreign partnerships*—(1) *Determination of payee*—(i) *Payments treated as made to partners.* Except as otherwise provided in paragraph (c)(1)(ii) of this section, a payment to a person that the withholding agent may treat as a foreign partnership in accordance with paragraph (c)(2)(i), (3)(i), or (d)(2) of this section is treated as a payment to the partners (looking through partners that are foreign flow-through entities) as follows—

(A) If the withholding agent can reliably associate the partner's distributive share of the payment with a Form W–9, a Form W–8, or other appropriate documentation upon which it can rely to treat the payment as made to a U.S. or foreign beneficial owner under § 1.1441–1 (d)(4) or (e)(1)(ii), then the beneficial owner so identified is treated as the payee;

(B) If the withholding agent can reliably associate the partner's distributive share with an intermediary certificate described in §1.1441–1(e)(3) (ii), (iii), or (v), then the rules of §1.1441–1(b)(2)(v) shall apply to determine who the payee is in the same manner as if the partner's distributive share of the payment had been paid directly to such intermediary;

(C) If the withholding agent can reliably associate the partner's distributive share with a partnership certificate described in paragraph (c)(2)(iv) or (3)(iii) of this section, then the rules of paragraph (c)(1) (i) or (ii) of this section shall apply to determine whether the payment is treated as made to the partners of the higher-tier partnership under this paragraph (c)(1)(i) or to the higher tier partnership (under the rules of paragraph (c)(1)(ii) of this section), in the same manner as if the partner's distributive share of the payment had been paid directly to such foreign partnership;

(D) If the withholding agent can reliably associate the partner's distributive share with a withholding certificate described in §1.1441–1(e)(3)(i) regarding a foreign trust or estate, then the rules of paragraph (e) of this section shall apply to determine who the payees are; and

(E) If the withholding agent cannot reliably associate the partner's distributive share with a withholding certificate or other appropriate documentation, the partners are considered to be the payees and the presumptions described in paragraph (d)(3) of this section shall apply to determine the status of the partners.

(ii) *Payments treated as made to the partnership.* A payment to a person that the withholding agent may treat as a foreign partnership in accordance with paragraph (c) (2)(i), (3)(i), or (d)(2) of this section is treated as a payment to the foreign partnership and not to its partners only if—

(A) The withholding agent can reliably associate the payment with a withholding certificate described in paragraph (c)(2)(iv) of this section (dealing with a certificate from a person representing to be a withholding foreign partnership); or

(B) The withholding agent can reliably associate the payment with a withholding certificate described in paragraph (c)(3)(iii) of this section certifying that the payment is income that is effectively connected with the conduct of a trade or business in the United States.

(iii) *Rules for reliably associating a payment with documentation.* For rules regarding the reliable association of a payment with documentation, see §1.1441–1(b)(2)(vii). In the absence of documentation, see §1.1441–1(b)(3) and paragraph (d) of this section for applicable presumptions.

(iv) *Example.* The rules of paragraphs (c)(1) (i) and (ii) of this section are illustrated by the following example:

Example. (i) *Facts.* A foreign partnership, P, has two partners, a corporation, C, and a partnership, P1, both organized in country X. P1 has three partners, a foreign pension fund, a domestic partnership, P2, and a foreign partnership, P3, organized in country Y. P2's partners are foreign pension funds. P holds U.S. Treasury obligations in registered form, on which it receives interest from U.S. custodian, Z. P1 is not a withholding foreign partnership and it does not certify that the interest is effectively connected with the conduct of a U.S. trade or business. P3 is a withholding foreign partnership. P has furnished a valid withholding certificate described in paragraph (c)(3)(iii) of this section to which it has attached valid withholding certificates for C (beneficial owner Form W–8 described in §1.1441–1(e)(2)(i)), P1, and P1's three partners (a Form W–9 for P2, a withholding certificate described in paragraph (c)(2)(iv) of this section for P3 and a beneficial owner Form W–8 described in §1.1441–1(e)(2)(i) for the foreign pension fund). P has furnished appropriate information in accordance with paragraph (c)(3)(iv) of this section upon which the withholding agent can rely to determine which portion of the payment is associated with each withholding certificate.

(ii) *Analysis.* The payment to P is treated as a payment to its partners because none of the conditions described in paragraph (c)(1)(ii) exist under the facts to treat P as the payee (i.e., it is not a withholding foreign partnership and, although it has furnished a withholding certificate described under paragraph (c)(3)(iii) of this section, it is not claiming that the interest is effectively connected with the conduct of a U.S. trade or business). Under paragraph (c)(1)(i)(A) of this section, C, as a partner of

P, is treated as a payee because it is not a flow-through entity or an intermediary (based on the documentation furnished for C). Under paragraph (c)(1)(i)(C) of this section, P1 is not treated as a payee because it is a foreign partnership and none of the conditions described under paragraph (c)(1)(ii) of this section exist under the facts to treat P as the payee. Instead, P2 (under paragraph (c)(1)(i)(A) of this section), P3 (under paragraph (c)(1)(ii)(A) of this section), and the foreign pension fund that is a partner of P1 (under paragraph (c)(1)(i)(A) of this section), are treated as the payees of P1's distributive share of the payment to P. P2 is a payee because, although a flow-through entity, it is a domestic partnership (see paragraph (b)(1) of this section). P3 is treated as a payee under paragraph (c)(1)(ii)(A) of this section, irrespective of who its partners are, because it has furnished a valid withholding certificate as a withholding foreign partnership. The foreign pension fund is treated as a payee under paragraph (c)(1)(i)(A) of this section because it has furnished a beneficial owner Form W–8 described in § 1.1441–1(e)(2)(i).

(2) *Withholding foreign partnerships*—(i) *Reliance on claim of withholding foreign partnership status.* A withholding foreign partnership is a foreign partnership that has entered into an agreement with the Internal Revenue Service (IRS), as described in paragraph (c)(2)(ii) of this section. A withholding agent that can reliably associate a payment with a certificate described in paragraph (c)(2)(iv) of this section may treat the person to whom it makes the payment as a withholding foreign partnership for purposes of withholding under chapter 3 of the Code, information reporting under chapter 61 of the Code, backup withholding under section 3406, and withholding under other provisions of the Internal Revenue Code. Furnishing such a certificate is in lieu of transmitting to a withholding agent withholding certificates or other appropriate documentation for its partners. Although the withholding foreign partnership generally will be required to obtain withholding certificates or other appropriate documentation from its partners pursuant to its agreement with the IRS, it is not required to attach such documentation to the partnership withholding certificate.

(ii) *Withholding agreement*—(A) *In general.* A foreign partnership may claim withholding foreign partnership status before an agreement is executed with the IRS if it has applied for such status and the IRS authorizes such status on an interim basis under such procedures as the IRS may issue. A withholding foreign partnership must file a partnership return under section 6031(a) to the extent required under the regulations under that section and furnish statements on Form K–1 to its partners under section 6031(b) to the extent required under the regulations under that section. See §§ 1.6031–1 and 1.6031(b)–1T. See § 1.1461–1(c)(2)(ii)(A) for an exemption from filing Forms 1042 and 1042–S. A foreign withholding partnership that wishes to also be a qualified intermediary under § 1.1441–1(e)(5) for payments it receives for persons other than its partners may combine both agreements into one single agreement.

(B) *Terms of withholding agreement.* The IRS may, upon request, enter into a withholding agreement with a foreign partnership pursuant to such procedures as the IRS may prescribe in published guidance (see § 601.601(d)(2) of this chapter). Under such withholding agreement, a foreign partnership shall generally be subject to the applicable withholding and reporting provisions applicable to withholding agents and payors under chapters 3 and 61 of the Code, and section 3406, and the regulations under those provisions, and other withholding provisions of the Code, except to the extent provided under the agreement. In particular, the agreement must include provisions for reporting of information on Form 1065 and furnishing K–1 statements to the partners in the manner required under section 6031 and the regulations under that section. Under the agreement, a foreign partnership may agree to act as an acceptance agent to perform the duties described in § 301.6109–1(d)(3)(iv)(A) of this chapter. The agreement may specify the manner in which applicable procedures for adjustments for underwithholding and overwithholding, including refund procedures apply to the foreign partnership and its partners and the extent to which applicable procedures may be modified. In particular, a withholding agreement may allow a withholding foreign partnership to claim refunds of overwithheld amounts on behalf of its partners. In addition, the agreement must specify the manner in which the IRS will audit the foreign partnership's books and records in order to verify the accuracy of the Forms 1065 filed by the partnership and K–1 statements furnished to the partners as required under section 6031 and the regulations under that section. The agreement shall also specify the assets that the foreign partnership has in the United States or alternative means of collection, if necessary.

(iii) *Withholding responsibility.* A withholding foreign partnership must assume primary withholding responsibility for all payments that are made to it and, therefore, is not required to provide information to the withholding agent regarding each partner's distributive share of the payment (see paragraph (c)(3)(iv) of this section for the requirement to provide distributive share information to the withholding agent in the case of other foreign partnerships). The partnership shall be a withholding agent with respect to each of its partner's distributive share of income subject to withholding that is paid to the partnership. Therefore, the withholding agent is not required to withhold any amount under chapter 3 of the Code on a payment to a foreign partnership that has furnished a withholding certificate representing that it is a withholding foreign partnership, unless it has actual knowledge or reason to know that the certificate is incorrect. The foreign partnership shall withhold the payments under the same procedures and at the same time as is prescribed for withholding by a domestic partnership under paragraph (b)(2) of this section, except that, for purposes of determining the partner's status, the provisions of paragraph (d)(4)(iv) of this section shall apply and paragraph (b)(2)(ii) of this section shall not apply.

(iv) *Withholding certificate from a withholding foreign partnership.* The rules of §1.1441–1(e)(4) shall apply to withholding certificates described in this paragraph (c)(2)(iv). A withholding certificate furnished by a withholding foreign partnership is valid with regard to any partner on whose behalf the certificate is furnished only if it is furnished on a Form W–8 (or an acceptable substitute form or such other form as the IRS may prescribe), it is signed under penalties of perjury by a partner with authority to sign for the partnership, its validity has not expired, and it contains the information, statement, and certifications described in this paragraph (c)(2)(iv) as follows—

(A) The name, permanent residence address (as described in §1.1441–1(e)(2)(ii)), and the employer identification number of the partnership, and the country under the laws of which the partnership is created or governed;

(B) A certification that the partnership is a withholding foreign partnership within the meaning of paragraph (c)(2)(i) of this section; and

(C) Any other information or certification as may be required by the form or accompanying instructions in addition to, or in lieu of, the information and certifications described in this paragraph (c)(2)(iv).

(3) *Other foreign partnerships*—(i) *Reliance on claim of foreign partnership status.* A withholding agent that can reliably associate a payment with a certificate described in paragraph (c)(3)(iii) of this section may treat the person to whom it makes the payment as a foreign partnership that is not a withholding foreign partnership. Such reliance is permitted for purposes of withholding under chapter 3 of the Code, information reporting under chapter 61 of the Code, backup withholding under section 3406, and withholding under other provisions of the Internal Revenue Code. For purposes of this paragraph (c)(3)(i), a payment that the withholding agent can reliably associate with a withholding certificate described in paragraph (c)(3)(iii) of this section that would be valid except for the fact that some or all of the withholding certificates or other appropriate documentation required to be attached are lacking or are unreliable, or that information for allocating the payment among the partners is lacking or is unreliable, shall nevertheless be treated as a payment to a foreign partnership.

(ii) *Reliance on claim of reduced withholding by a partnership for its partners.* This paragraph (c)(3)(ii) describes the manner in which a withholding agent may rely on a claim of reduced withholding when making a payment to a foreign partnership that is not a withholding foreign partnership. To the extent that a withholding agent treats a payment to a foreign partnership as a payment to its partners in accordance with paragraph (c)(1) of this section, it may rely on a claim for reduced withholding by a partner if, prior to the payment, the withholding agent can reliably associate the payment with a withholding certificate described in paragraph (c)(3)(iii) of this section pertaining to the partner unless the withholding agent has actual knowledge or reason to know that the withholding certificate is unreliable. The certificate will be considered to pertain to the partner if the appropriate withholding certificate for the partner is attached to the partnership's withholding certificate. An appropriate withholding certificate for a partner includes a beneficial owner withholding certificate described in § 1.1441–1(e)(2)(i) or, if applicable, documentary evidence described in § 1.1441–6(b)(2)(i) or in § 1.6049–5(c)(1) (for a partner claiming to be a foreign person and a beneficial owner, determined under the provisions of § 1.1441–1(c)(6)), the applicable certificates described in § 1.1441–1(d)(2) or (3) (for a partner claiming to be a U.S. payee), an intermediary withholding certificate described in § 1.1441–1(e)(3)(ii) or (iii), a U.S. branch withholding certificate described in § 1.1441–1(e)(3)(v), or a partnership withholding certificate described in paragraph (c)(2)(iv) or (3)(iii) of this section. Except where the partnership certificate is provided for income claimed to be effectively connected with the conduct of a trade or business in the United States, a claim must be presented for each portion of the payment that represents an item of income includible in the distributive share of the partner as required under paragraph (c)(3)(iii)(C) of this section. When making a claim for several partners, the partnership may present a single partnership withholding certificate to which the partners' certificates are attached. Where the partnership certificate is provided for income claimed to be effectively connected with the conduct of a trade or business in the United States, the claim may be presented without having to identify the partner's distributive share of the payment if the certificate contains the certification described in paragraph (c)(3)(iii)(E) of this section.

(iii) *Withholding certificate from a foreign partnership that is not a withholding foreign partnership.* A withholding certificate furnished by a foreign partnership that is not a withholding foreign partnership is valid only if it is furnished on a Form W–8 (or an acceptable substitute form or such other form as the IRS may prescribe), it is signed under penalties of perjury by a partner with authority to sign for the partnership, its validity has not expired, it contains the information, statement, and certifications described in this paragraph (c)(3)(iii), and the withholding certificates or other appropriate documentation for all of the partners are attached (except that certificates for partners are not required to be attached for a certificate furnished solely for income claimed to be effectively connected with the conduct of a trade or business in the United States, regardless of any partner's status as a U.S. person). The rules of § 1.1441–1(e)(4) shall apply to withholding certificates described in this paragraph (c)(3)(iii). The information, statement, and certifications required on the withholding certificate are as follows:

(A) The name, permanent residence address (as described in § 1.1441–1(e)(2)(ii)), and the employer identification number of the partnership, and the country under the laws of which the partnership is created or governed.

(B) A representation that the person whose name is on the certificate is a foreign partnership.

(C) A statement attached to the certificate that provides such information as may be required by the form and accompanying instructions, including sufficient information to the withholding agent to determine the amount required to be withheld from amounts paid to the partnership, such as each partner's distributive share of amounts to which the certificate relates, prepared in the manner described in paragraph (c)(3)(iv) of this section. No statement is required for a certificate furnished for income claimed to be effectively connected with the conduct of a trade or business in the United States.

(D) If the withholding certificates are required to be attached to the partnership's withholding certificate, a statement either that the attached withholding certificates represent all of the partners or that the amounts allocatable to the partners for whom withholding certificates are lacking are separately identified in the statement required under paragraph (c)(3)(iv) of this section.

(E) A certification that the income is effectively connected with the conduct of a trade or business in the United States, if applicable.

(F) Any other information or certification as may be required by the form or accompanying instructions in addition to, or in lieu of, the information and certifications described in this paragraph (c)(3)(iii).

(iv) *Information to the withholding agent regarding each partner's distributive share.* The partnership must furnish information sufficient for the withholding agent to determine each partner's distributive share of reportable amounts (described in §1.1441–1(e)(3)(vi)). The sum of all partners' distributive shares, expressed as a percentage, must equal, but not exceed one hundred percent. For purposes of this paragraph (c)(3)(iv), the rules of §1.1441–1(e)(3)(iv) regarding the information to furnish to the withholding agent shall apply.

(v) *Withholding by a foreign partnership.* A foreign partnership described in this paragraph (c)(3) that receives an amount subject to withholding under chapter 3 of the Code shall be deemed to have satisfied any obligation under such chapter to withhold on the amount with respect to any partner to the extent that the partner's distributive share of the payment can be reliably associated with a withholding certificate described in paragraph (c)(3)(iii) of this section pertaining to the partner that the partnership has furnished to a withholding agent and the partnership does not know and has no reason to know that the correct amount has not been withheld under chapter 3 of the Code and the regulations under such chapter.

(d) *Presumptions regarding payee's status in the absence of documentation*—(1) *In general.* This paragraph (d) contains the applicable presumptions for determining the status of the partnership and its partners in the absence of documentation. The provisions of §1.1441–1(b)(3)(iv) (regarding the 90-day grace period) and §1.1441–1(b)(3) (vii) through (ix) shall apply for purposes of this paragraph (d).

(2) *Determination of partnership status as domestic or foreign in the absence of documentation.* In the absence of a valid representation of domestic partnership status in accordance with paragraph (b)(1) of this section and of foreign partnership status in accordance with paragraph (c)(2)(i) or (3)(i) of this section, the withholding agent shall determine the status of the payee as a corporation, a partnership or otherwise, based upon the presumptions set forth in §1.1441–1(b)(3)(ii). If, based upon these presumptions, the withholding agent treats the payee as a partnership, the partnership shall be presumed to be a foreign partnership if the withholding agent has actual knowledge of the payee's employer identification number and that number begins with the two digits "98," if the withholding agent's communications with the payee are mailed to an address in a foreign country, or if the payment is made outside the United States (as defined in §1.6049–5(e)). For rules regarding reliable association with a withholding certificate from a domestic or a foreign partnership, see §1.1441–1(b)(2)(vii).

(3) *Determination of partners' status in the absence of certain documentation.* If the withholding agent treats the payee as a foreign partnership in accordance with paragraph (c)(2)(i), (3)(i), or (d)(2) of this section, the presumptions described in this paragraph (d)(3) shall apply when the withholding agent cannot reliably associate a payment with partner documentation. The provisions of paragraphs (d) (3)(i), (ii), and (iii) of this section are not relevant to a payment that a withholding agent can reliably associate with a withholding certificate described in paragraph (c)(2)(iv) of this section.

(i) *Documentation regarding the status of a partner is lacking or unreliable.* Any portion of a payment that the withholding agent cannot reliably associate with a partner because a withholding certificate or other appropriate documentation for that partner is lacking or unreliable is presumed to be made to foreign payee. Therefore, under § 1.1441–1(b)(1), the withholding agent must withhold 30 percent from payments to the partnership of amounts subject to withholding that are allocable to such partner or group of partners.

(ii) *Information regarding the allocation of payment is lacking or unreliable.* If a withholding agent can reliably associate a payment with a group of partners but lacks reliable information to determine how much of the payment is allocable to each partner in the group, the payment, to the extent it cannot reliably be allocated, is presumed to be allocable entirely to the partner in the group with the highest applicable withholding rate or, if the rates are equal, to the partner in the group with the highest U.S. tax liability, as the withholding agent shall estimate, based on its knowledge and available information. If a withholding certificate attached to the partnership certificate is another partnership certificate or an intermediary certificate described in § 1.1441–1(e)(3)(iii), the rules of this paragraph (d)(3)(ii) apply by treating the share of the payment allocable to the other partnership or the intermediary certificate as if the payment were made directly to the foreign partnership or intermediary.

(iii) *Certification that the foreign partnership has furnished documentation for all of the persons to whom the intermediary certificate relates is lacking or unreliable.* If the certification required under paragraph (c)(3)(iii)(D) of this section (that the attached withholding certificates and other appropriate documentation represent all of the partners in the partnership) is lacking or is unreliable and, as a result, the withholding agent cannot reliably determine how much of the payment is allocable to each of the partners or group of partners for which the withholding agent holds a withholding certificate or other appropriate documentation, then none of the payment can reliably be associated with any one partner and the entire payment is presumed to be made to a foreign payee.

(iv) *Determination by a withholding foreign partnership of the status of its partners.* For purposes of determining whether the partners or some other persons are the payees of the partners' distributive shares of any payment made to a withholding foreign partnership, the partnership shall apply the rules of § 1.1441–1(b)(2), and of paragraph (c)(1) of this section (in the case of a partner that is a foreign partnership) and of paragraph (e) (in the case of a partner that is a foreign estate or a foreign trust), in the same manner as if the partnership were making a payment directly to the partners other than in their capacity as partners. Further, the provisions of paragraphs (d)(3)(i), (ii), and (iii) of this section shall apply to determine the status of partners and the applicable withholding rates to the extent that, at the time the foreign partnership is required to withhold on the amount, it cannot reliably associate the amount with documentation for any one or more of its partners. See §§ 1.6031–1 and 1.6031–1T for reporting and filing requirements applicable to a withholding foreign partnership.

(4) Examples. The rules of this paragraph (d) may be illustrated by the following examples:

Example 1. (i) *Facts.* FP is a foreign partnership receiving U.S. source interest that would qualify as portfolio interest described in section 871(h)(2)(B) if the statement described in section 871(h)(5) were furnished. FP has three partners, A, B, and C. FP furnishes to the withholding agent a partnership withholding certificate described in paragraph (c)(3)(iii) of this section to which it attaches a Form W–9 for A and a beneficial owner Form W–8 for B. Nothing on A's Form W–9 indicates that A is an exempt recipient within the meaning of § 1.6049–4(c)(1)(i). No documentation is attached for C. The partnership has one single account with the withholding agent. It furnishes a statement to the withholding agent under paragraph (c)(3)(iv) of this section indicating that A's, B's, and C's respective distributive shares of the payments are 40%, 40%, and 20% and represents, in accordance with paragraph (c)(3)(iii)(D) of this section, that there are only three partners.

(ii) *Analysis.* Absent actual knowledge or reason to know otherwise, the withholding agent may rely on FP's withholding certificate and A's Form W–9 to treat A as a U.S.

beneficial owner under § 1.1441–1(d)(4)(i) and as a U.S. payee under paragraph (c)(1)(i)(A) of this section to the extent of 40 percent of the payment. Under § 1.1441–1(b)(1), the withholding agent is not required to withhold on A's share of the payment. Under § 1.6049–4(a), the withholding agent must comply with information reporting obligations (i.e., file a Form 1099) with respect to A who is treated as a U.S. payee under paragraph (c)(1)(i)(A) of this section and § 1.6049–5(d)(1) for purposes of the information reporting provisions of chapter 61 of the Code and the regulations thereunder. Absent actual knowledge or reason to know otherwise, the withholding agent may also rely on FP's withholding certificate and B's Form W–8 to treat B as a foreign beneficial owner under § 1.1441–1(e)(1)(ii)(A)(1) and paragraph (c)(1)(i)(A) of this section. Thus, under § 1.1441–1(b)(1), the withholding agent may rely on B's claim for portfolio interest treatment for B's share of the payment. Under § 1.1461–1(b)(1) and (c)(1), the withholding agent must report the payment to B on Forms 1042 and 1042–S unless, under section 6031 and the regulations under that section, the partnership is required to file a return. Because the withholding agent cannot associate the documentation (as defined in § 1.1441–1(b)(3)(vii)) for C's share of the interest income, the withholding agent must, under paragraph (d)(3)(i) of this section, treat that amount as a payment made to an unidentified foreign partner and withhold 30 percent under section 1441 in accordance with § 1.1441–1(b)(1).

Example 2. The facts are the same as in *Example 1,* but the partnership has furnished no information under paragraph (c)(3)(iv) of this section regarding how much of the payment to the foreign partnership is attributable to A and C. Under paragraph (d)(3)(ii) of this section, the payment allocable to group A–C is presumed made entirely to A or to C, depending on who of A or C is subject to the highest withholding rate. A is not subject to withholding because it has furnished a valid Form W–9. C is subject to a 30-percent withholding rate under § 1.1441–1(b)(1) because it is presumed to be an unidentified foreign partner under paragraph (d)(3)(i) of this section. Therefore, under paragraph (d)(3)(ii) of this section, the portion of the payment that the withholding agent can associate with A and C is subject to withholding at a 30-percent rate. The withholding agent may ignore the fact that A has furnished a valid Form W–9 supporting his claim of exemption from withholding as a U.S. person because it has no reliable information on how much of the payment is allocable to A. Because the withholding agent has a Form W–9 for the U.S. individual partner, it must also report A's distributive share on a Form 1099. To the extent that A's exact share is not known, the entire amount should be reported on the Form 1099.

(e) *Trusts and estates.* [Reserved]

(f) *Failure to receive withholding certificate timely or to act in accordance with applicable presumptions.* See applicable procedures described in § 1.1441–1(b)(7) in the event the withholding agent does not hold an appropriate withholding certificate or other appropriate documentation at the time of payment or fails to rely on the presumptions set forth in § 1.1441–1(b)(3) or in paragraph (d) or (e) of this section.

(g) *Effective date*—(1) *General rule.* This section applies to payments made after December 31, 1999.

(2) *Transition rules.* The validity of a withholding certificate that was valid on January 1, 1998, under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) and expired, or will expire, at any time during 1998, is extended until December 31, 1998. The validity of a withholding certificate that is valid on or after January 1, 1999, remains valid until its validity expires under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) or, if earlier, until December 31, 2000. The rule in this paragraph (g)(2), however, does not apply to extend the validity period of a withholding certificate that expires solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the first three sentences of this paragraph (g)(2), a withholding agent may choose to not take advantage of the transition rule in this paragraph (g)(2) with respect to one or more withholding certificates valid under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) and, therefore, to require withholding certificates conforming to the requirements described in this section (new withholding certificates). For purposes of this section, a new withholding certificate is deemed to satisfy the documentation requirement under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998). Further, a new withholding certificate remains valid for the period

specified in § 1.1441–1(e)(4)(ii), regardless of when the certificate is obtained.

[T.D. 8734, 62 FR 53452, Oct. 14, 1997, as amended by T.D. 8804, 63 FR 72185, 72188, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53452, Oct. 14, 1997, § 1.1441–5 was revised, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.1441–5 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.1441–5 Claiming to be a person not subject to withholding.

(a) *Individuals.* For purposes of chapter 3 of the Code, an individual's written statement that he or she is a citizen or resident of the United States may be relied upon by the payer of the income as proof that such individual is a citizen or resident of the United States. This statement shall be furnished to the withholding agent in duplicate. An alien may claim residence in the United States by filing Form 1078 with the withholding agent in duplicate in lieu of the above statement.

(b) *Partnerships and corporations.* For purposes of chapter 3 of the Code a written statement from a partnership or corporation claiming that it is not a foreign partnership or foreign corporation may be relied upon by the withholding agent as proof that such partnership or corporation is domestic. This statement shall be furnished to the withholding agent in duplicate. It shall contain the address of the taxpayer's office or place of business in the United States and shall be signed by a member of the partnership or by an officer of the corporation. The official title of the corporate officer shall also be given.

(c) *Disposition of statement and form.* The duplicate copy of each statement and form filed pursuant to this section shall be forwarded with a letter of transmittal to Internal Revenue Service Center, Philadelphia, PA 19255. The original statement shall be retained by the withholding agent.

(d) *Definitions.* For determining whether an alien individual is a resident of the United States see §§ 301.7701(b)–1 through 301.7701(b)–9 of this chapter. An individual with respect to whom an election to be treated as a resident under section 6013(g) is in effect is not, in accordance with § 1.1441–1, a resident for purposes of this section. For definition of the terms ''foreign partnership'' and ''foreign corporation'' see section 7701(a) (4) and (5) and § 301.7701–5 of this chapter. For definition of the term ''United States'' and for other geographical definitions relating to the Continental Shelf see section 638 and § 1.638–1.

(Approved by the Office of Management and Budget under control number 1545–0795)

(Secs. 1441(c)(4) (80 Stat. 1553; 26 U.S.C. 1441(c)(4)), 3401(a)(6) (80 Stat. 1554; 26 U.S.C. 3401(a)(6)), and 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 6500, 25 FR 12076, Nov. 26, 1960, as amended by T.D. 6908, 31 FR 16773, Dec. 31, 1966; T.D. 7277, 38 FR 12742, May 15, 1973; T.D. 7842, 47 FR 49842, Nov. 3, 1982; T.D. 7977, 49 FR 36834, Sept. 20, 1984; T.D. 8160, 52 FR 33933, Sept. 9, 1987; T.D. 8411, 57 FR 15241, Apr. 27, 1992]

§ 1.1441–6 Claim of reduced withholding under an income tax treaty.

(a) *In general.* The rate of withholding on a payment of income subject to withholding may be reduced to the extent provided under an income tax treaty in effect between the United States and a foreign country. Most benefits under income tax treaties are to foreign persons who reside in the treaty country. In some cases, benefits are available under an income tax treaty to U.S. citizens or U.S. residents or to residents of a third country.

See paragraph (b)(5) of this section for claims of benefits by U.S. persons. If the requirements of this section are met, the amount withheld from the payment may be reduced at source to account for the treaty benefit. See also § 1.1441–4(b)(2) for rules regarding claims of reduced rate of withholding under an income tax treaty in the case of compensation from personal services.

(b) *Reliance on claim of reduced withholding under an income tax treaty*—(1) *In general.* Absent actual knowledge or reason to know otherwise, a withholding agent may rely on a claim that a beneficial owner is entitled to a reduced rate of withholding based upon an income tax treaty if, prior to the payment, the withholding agent can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a foreign beneficial owner in accordance with § 1.1441–1(e)(1)(ii) (not including 1.1441–1(e)(1)(ii)(A)(*2*) relating to documentary evidence). Except as otherwise provided in paragraph (b)(2) or (3) of this section, for purposes of this paragraph (b)(1), a beneficial owner withholding certificate described in § 1.1441–1(e)(2)(i) is valid only if it includes the beneficial owner's taxpayer identifying number and certifies that the taxpayer has complied with the advance ruling requirements described in paragraph (e) of this section (if applicable), and, if the beneficial owner is a person related to the withholding agent within the meaning of section 482, that the beneficial owner will file the statement required under §301.6114–1(d) of this chapter (if applicable). The requirement to file an information statement under section 6114 for income subject to withholding applies only to amounts received during the calendar year that, in the aggregate, exceed $500,000. See §301.6114–1(d) of this chapter. The Internal Revenue Service (IRS) may apply the provisions of §1.1441–1(e)(1)(ii)(B) to notify the withholding agent that the certificate cannot be relied upon to grant benefits under an income tax treaty. A beneficial owner's taxpayer identifying number on a withholding certificate is valid for purposes of establishing proof of residence in a treaty country only if the taxpayer identifying number is certified by the IRS in accordance with the procedures set forth in paragraph (c) of this section. However, absent actual knowledge or reason to know otherwise, a withholding agent may rely on a taxpayer identifying number without having to inquire as to whether the taxpayer identifying number is certified, if the number appears correct on its face and the permanent residence address on the certificate is in the country whose tax treaty with the United States is invoked. See 1.1441–1(e)(4)(viii) regarding reliance on a withholding certificate by a withholding agent. The provisions of §1.1441–1(b)(3)(iv) dealing with a 90-day grace period shall apply for purposes of this section.

(2) *Exemption from requirement to furnish a taxpayer identifying number and special documentary evidence rules for certain income*—(i) *General rule.* In the case of income described in paragraph (b)(2)(ii) of this section, a withholding agent may rely on a beneficial owner withholding certificate described in paragraph (b)(1) of this section even if the person whose name is on the certificate has not provided a taxpayer identifying number. In the case of payments made outside the United States (as defined in §1.6049–5(e)) with respect to an offshore account (as defined in §1.6049–5(c)(1)), a withholding agent may, as an alternative to a withholding certificate described in paragraph (b)(1) of this section, rely on a certificate of residence described in paragraph (c)(3) of this section or documentary evidence described in paragraph (c)(4) of this section, relating to the beneficial owner, that the withholding agent has reviewed and maintains in its records in accordance with §1.1441–1(e)(4)(iii). In the case of a payment to a person other than an individual, the certificate of residence or documentary evidence must be accompanied by the certifications described in paragraphs (c)(5) (i) and (ii) of this section regarding limitation on benefits and whether the amount paid is derived by such person or by one of its interest holders. The withholding agent maintains the reviewed documents by retaining either the documents viewed or a photocopy thereof and noting in its records the date on which, and by whom, the documents were received and reviewed. This paragraph (b)(2)(i) shall not apply to amounts that are exempt from withholding based on a claim that the income is effectively connected with the conduct of a trade or business in the United States.

(ii) *Income to which special rules apply.* The income to which paragraph (b)(2)(i) of this section applies is dividends and interest from stocks and debt obligations that are actively traded, dividends from any redeemable security issued by an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1), dividends, interest, or royalties from units of beneficial interest in a unit investment trust that are (or were, upon issuance) publicly offered and are registered with the Securities and Exchange Commission under the Securities Act of 1933 (15 U.S.C. 77a) and amounts paid with respect to loans of securities described in this paragraph (b)(2)(ii). For purposes of this paragraph (b)(2)(ii), a stock or debt obligation is actively traded if it is actively traded within the meaning of section 1092(d) and §1.1092(d)–1 when documentation is provided.

(3) *Competent authority agreements.* The procedures described in this section may be modified to the extent the

U.S. competent authority may agree with the competent authority of a country with which the United States has an income tax treaty in effect.

(4) *Eligibility for reduced withholding under an income tax treaty in the case of a payment to a person other than an individual*—(i) *General rule.* The withholding imposed under section 1441, 1442, or 1443 on any payment to a foreign person is eligible for reduction under the terms of an income tax treaty only to the extent that such payment is treated as derived by a resident of an applicable treaty jurisdiction, such resident is a beneficial owner of the payment, and all other applicable requirements for benefits under the treaty are satisfied. A payment received by an entity is treated as derived by a resident of an applicable treaty jurisdiction to the extent that the payment is subject to tax in the hands of a resident of that jurisdiction. For this purpose, a payment received directly by an entity that is treated as fiscally transparent by the applicable treaty jurisdiction shall be considered a payment subject to tax in the hands of a resident of the jurisdiction to the extent that the interest holders in the entity are residents of the jurisdiction. For purposes of the preceding sentence, interest holders do not include any direct or indirect interest holders that are themselves treated as fiscally transparent entities by the applicable treaty jurisdiction. A payment received by an entity that is not treated as fiscally transparent by the applicable treaty jurisdiction shall be considered a payment subject to tax in the hands of a resident of such jurisdiction only if the entity is itself a resident of that jurisdiction. If the entity is a wholly-owned entity that is disregarded for federal tax purposes under § 301.7701–2(c)(2) of this chapter as an entity separate from its owner and whose single member is a foreign person, amounts paid to such entity may nevertheless be treated as derived by a resident of a treaty country if the entity is treated by the applicable treaty country as deriving the income as a resident of that country. The provisions of § 1.894–1T(d) (1) through (4) shall apply for purposes of determinations made under this paragraph (b)(4).

(ii) *Withholding certificates*—(A) *In general.* The type of withholding certificate or other appropriate documentation that must be furnished by a person claiming a reduced rate of withholding under an income tax treaty depends upon the status of the entity under the laws of the applicable treaty jurisdiction. For example, if the person receiving the payment is a foreign entity but the persons eligible for benefits under the applicable income tax treaty are the entity's interest holders in the foreign entity receiving the payment, rather than the entity itself, then the entity shall be treated as a foreign partnership for purposes of determining which withholding certificate is appropriate irrespective of the fact that the entity may be treated as a corporation for U.S. tax purposes. If, conversely, the person eligible for benefits under an income tax treaty is the entity rather than the interest holders, then the entity shall be treated as a corporation for purposes of determining which withholding certificate is appropriate irrespective of the fact that the entity may be treated as a partnership for U.S. tax purposes. In the event of a claim for dual treatment described in paragraph (b)(4)(iii) of this section, multiple withholding certificates may have to be furnished. Multiple withholding certificates may also have to be furnished if the entity receives income for which a reduction of withholding is claimed under a provision of the Internal Revenue Code (e.g., portfolio interest) and income for which a reduction of withholding is claimed under an income tax treaty. Absent actual knowledge or reason to know otherwise, a withholding agent may rely on the representations on the certificate that the beneficial owner derives the income and is a resident of the applicable treaty country, within the meaning of § 1.894–1T(d) and the applicable income tax treaty, without having to inquire into the truthfulness of these representations or to research foreign law.

(B) *Certification by qualified intermediary.* A foreign corporation that is a qualified intermediary described in § 1.1441–1(e)(5)(ii)(C) for purposes of claiming reduced rates of withholding under an income tax treaty for its shareholders (who are treated as deriving the income paid to the corporation as resident of an applicable treaty jurisdiction) may furnish a single Form W–8 for its shareholders for amounts for which it claims the benefit of a reduced rate of withholding under an applicable income tax treaty. The Form W–8 shall be one described under §1.1441–1(e)(3)(ii).

(iii) *Multiple claims of treaty benefits.* A withholding agent may make a payment to a foreign entity that is simultaneously claiming a reduced rate of tax on its own behalf for a portion of the payment and a reduced rate on behalf of persons in their capacity as interest holders in that entity for the same or for another portion of the payment. In the case of concurrent and inconsistent claims of treaty benefits for the same amount, the withholding agent may choose to reject the claim and request that a consistent claim be submitted or it may choose which reduction to apply. In the case of concurrent and consistent claims (e.g., the entity that is paid the amount claims a reduced rate for a portion of the payment and an interest holder claims a different reduced rate for the balance of the payment), the withholding agent may, at its option, accept such dual claim based, as appropriate, on withholding certificates furnished by such persons with respect to their respective shares of such payment, even though the withholding agent holds different withholding certificates that requires it to treat the entity inconsistently with respect to different payments or with respect to different portions of the same payment. See paragraph (b)(4)(iv) *Example 2* of this section. If the withholding agent does not accept claims of reduced rate presented by any one or more of the interest holders, or by the entity, any interest holder or the entity may subsequently claim a refund or credit of any amount so withheld to the extent the holder's or entity's share of such withholding exceeds the amount of tax due under section 894 (in the case of a foreign person) or under section 1 or 11 (in the case of a U.S. person).

(iv) *Examples.* This paragraph (b)(4) is illustrated by the following examples:

Example 1. (i) *Facts.* Entity A is a business organization formed under the laws of country Y that has an income tax treaty with the United States. A receives U.S. source royalties from withholding agent R and claims a reduced rate of withholding under the U.S.-Y tax treaty on its own behalf (rather than on behalf of its interest holders). A furnishes a beneficial owner withholding certificate described in paragraph (b)(1) of this section that represents that A is a resident of country Y (within the meaning of the U.S.-Y tax treaty) and the beneficial owner of the royalties (within the meaning of the U.S.-Y tax treaty).

(ii) *Analysis.* Absent actual knowledge or reason to know otherwise, R may rely on the representation that A is a resident of country Y and a beneficial owner of the royalty income within the meaning of the U.S.-Y tax treaty.

Example 2. (i) *Facts.* The facts are the same as under *Example 1,* except that one of A's interest holders, T, is an entity organized in country Z. The U.S.-Z tax treaty reduces the rate on royalties to zero whereas the rate on royalties under the U.S.-Y tax treaty is only reduced to 5 percent. T furnishes a beneficial owner withholding certificate to A that represents that T is deriving its distributive share of the royalty income paid to A as a resident of country Z (within the meaning of §1.894–1T(d)(1) and the U.S.-Z tax treaty) and is the beneficial owner of the royalty income (within the meaning of the U.S.-Z tax treaty). A furnishes to R an intermediary withholding certificate described in §1.1441–1(e)(3)(iii) to which it attaches T's beneficial owner withholding certificate for the portion of the payment that T claims as its distributive share of the royalty income. A also furnishes to R a beneficial owner withholding certificate for itself for the portion of the payment that T does not claim as its distributive share.

(ii) *Analysis.* Absent actual knowledge or reason to know otherwise, R may rely on the documentation furnished by A in order to treat the royalty payment to a single foreign entity (A) as derived by different residents of tax treaty countries as a result of concurrent and consistent claims presented under different treaties. R may, at its option, grant dual treatment, that is, a reduced rate of zero percent under the U.S.-Z treaty on the portion of the royalty payment that T claims to derive as a resident of country Z and a reduced rate of 5 percent under the U.S.-Y treaty for the balance. However, under paragraph (b)(4)(iii) of this section, R may, at its option, treat A as the only relevant person deriving the royalty and grant benefits under the U.S.-Y treaty only.

Example 3. (i) *Facts.* Entity A is a business organization formed under the laws of the United States and is classified as a partnership for U.S. tax purposes. A's partners are S and T. S is an entity organized in country Z. T is an entity organized in country X. Under the laws of country Z, A is treated as an entity taxable at the entity level. Therefore, S is treated as a shareholder for purposes of the laws of country Z and is not required to take A's income into account for purposes of determining its tax liability under those laws. Distributions from A are treated as distributions from a corporate entity for purposes of the tax laws of Country Z. Under the laws of country X, A is treated as a fiscally transparent entity and T is required to take into account its distributive share of A's income for purposes of determining its tax liability under those laws. A receives U.S. source royalties that are not connected with a trade or business. The United States has a tax treaty with countries Z and X under which the rate on royalties is reduced to zero. Both S and T furnish a beneficial owner certificate to A representing that they are resident of their respective countries and a beneficial owner of their respective distributive share of royalty income. A has actual knowledge of the tax treatment of S and T in their respective countries.

(ii) *Analysis.* Because A is a partnership for U.S. tax purposes, S and T are each taxable on their respective distributive share of the royalty income under section 881(a). However, under § 1.1441–5(b)(1), the payment of royalty to A is not a payment subject to withholding. Instead, under § 1.1441–5(b)(2), A must withhold on each partner's distributive share of U.S. source royalty income and may apply the rules of this section to determine the extent to which the 30-percent withholding rate under section 1442 should be reduced under the income tax treaties with countries Z and X. Because A has actual knowledge of the tax treatment of S in country Z as a shareholder of A and not as a partner (or owner of a fiscally transparent entity), A may not rely on the certificate furnished by S in order to reduce the rate of withholding under the U.S.-Z tax treaty. Therefore, it withholds 30 percent of S's distributive share of royalty income. A may rely on T's certificate to treat T as deriving its distributive share of A's royalty income as a resident of country X and as a beneficial owner. Therefore, A withholds on T's distributive share of royalty income at the reduced rate under the U.S.-X tax treaty.

Example 4. (i) *Facts.* Entity A is a business organization formed under the laws of country Y. A receives from withholding agent R U.S. source royalties and U.S. source interest income that is potentially eligible for the portfolio interest exemption under section 871(h) and 881(c). A's interest holders are S, an individual who resides in country Y, T, an individual who resides in country Z, and U, an individual resident in the United States. The United States has a tax treaty with both country Y and country Z. The U.S.-Y tax treaty reduces the rate on royalties to 5 percent, and the U.S.-Z tax treaty reduces the rate to zero. A is classified as a partnership under U.S. tax principles. Under the tax laws of country Y, A is treated as a fiscally transparent entity and S is required to include in income his distributive share of A's income. A furnishes to R an intermediary withholding certificate described in § 1.1441–5(c)(3)(iii) to which it attaches—

(A) A Form W–9 for U; and

(B) Beneficial owner withholding certificates for S and T that represent that S and T are foreign persons. For purposes of claiming the reduced rate under each applicable tax treaty, each of S's and T's certificates represents that S and T are deriving their distributive share of the royalty income as a resident of their respective countries (within the meaning of § 1.894–1T(d)(1) and of the applicable tax treaty) and as a beneficial owner (within the meaning of the applicable tax treaty).

(ii) *Analysis.* Absent actual knowledge or reason to know otherwise, R may rely on the representations that S and T derive a distributive share of the royalty income as resident of their respective countries and are the beneficial owners of the income. Therefore, R may withhold on S's distributive share of the royalty income paid to A at the 5-percent rate under the U.S.–Y tax treaty. R may withhold on T's distributive share of the royalty income paid to A at the zero rate under the U.S.-Z tax treaty, even though A is not organized in, or a resident of, country Z. R may rely on U's Form W–9 to treat U as a U.S. person. Therefore, R does not withhold on U's share of the royalty payment. R also does not withhold on any portion of the interest paid to A because S and T have furnished beneficial owner certificates and U has furnished a Form W–9.

Example 5. (i) *Facts.* The facts are the same as in *Example 4,* except that A represents that it derives the royalty income it receives from R as a resident of country Y (within the meaning of § 1.894–1T(d)(1) and the U.S.-Y tax treaty) and as a beneficial owner of the income (within the meaning of the U.S.-Y tax treaty). Neither T nor S represent to derive the royalty income as resident of their respective country. A furnishes an intermediary withholding certificate described in § 1.1441–1(e)(3)(iii) to which it attaches a Form W–9 for U and beneficial owner withholding certificates for S and T. No claims of reduced rate under a tax treaty are made on S's or T's certificates. A also furnishes to R its own beneficial withholding certificate in order to claim the reduced rate under the U.S.-Y tax treaty for the royalty income.

(ii) *Analysis.* Absent actual knowledge or reason to know otherwise, R may rely on A's intermediary certificate and the certificates attached thereto in order to treat S and T as foreign beneficial owners for purposes of treating the interest as portfolio interest and to treat U as a U.S. payee. Therefore, R does not withhold on the payment of interest to A. In addition, absent actual knowledge or reason to know otherwise, R may rely on A's beneficial owner certificate in order to reduce the rate of withholding on the royalty income under the U.S.-Y tax treaty.

(5) *Claim of benefits under an income tax treaty by a U.S. person.* In certain cases, a U.S. person may claim the benefit of an income tax treaty. For example, under certain treaties, a U.S. citizen residing in the treaty country may claim a reduced rate of U.S. tax on certain amounts representing a pension or an annuity from U.S. sources. Claims of treaty benefits by a U.S. person may be made by furnishing a Form W–9 to the withholding agent or such other form as the IRS may prescribe in published guidance (see §601.601(d)(2) of this chapter).

(c) *Proof of tax residence in a treaty country and certification of entitlement to treaty benefits*—(1) *In general.* A beneficial owner establishes proof of its tax residence in a treaty country for purposes of its claim to the withholding agent that a reduced rate of tax applies under an income tax treaty by complying with the procedures described in this paragraph (c) or with such other procedures as the IRS may prescribe in published guidance (see §601.601(d)(2) of this chapter). For purposes of this section, the residence of a beneficial owner must be determined in accordance with the provisions of the applicable U.S. income tax treaty as may be clarified by any applicable regulations thereunder, or technical explanations thereof, or other published guidance.

(2) *Certification of taxpayer identifying number*—(i) *In general.* A taxpayer may certify its taxpayer identifying number as required under paragraph (b)(1) of this section by having the number certified by the IRS either directly as provided under paragraph (c)(2)(ii) of this section or through a qualified intermediary as provided in paragraph (c)(2)(iii) of this section.

(ii) *IRS-certified TIN.* The IRS shall certify a taxpayer identifying number (TIN) upon receipt of a certificate of residence described in paragraph (c)(3) of this section to which it shall attach the certifications described in paragraphs (c)(5) (i) and (ii) of this section, if applicable. The taxpayer may provide documentary evidence described in paragraph (c)(4) of this section instead of a certificate of residence. However, a taxpayer (other than a person organized as a corporate body in the applicable treaty jurisdiction) may furnish documentary evidence instead of a certificate of residence only if a certificate of residence is not available to the taxpayer. A certificate of residence is not available for purposes of this paragraph (c)(2)(ii) if the tax administration of the country where the taxpayer claims to be a resident does not have a procedure in effect by which such certificates are routinely issued or the taxpayer establishes that obtaining such certificate would require an unreasonable amount of time or costs relative to the taxpayer's circumstances (e.g., amount of investments in the United States). A person organized as a corporate body in the applicable treaty jurisdiction may, instead of a certificate of residence, furnish a certificate of incorporation, articles of incorporation, or other official document reflecting the taxpayer's status as a corporate body in that jurisdiction, regardless of whether a certificate of residence described in paragraph (c)(3) of this section is otherwise available. The certificate or documentary evidence must be furnished to the IRS by, or on behalf of, the beneficial owner upon application for the taxpayer identifying number or at any other time, as permitted under such procedures as the IRS may prescribe in published guidance (see §601.601(d)(2) of this chapter). If the tax residence of the beneficial owner changes, the beneficial owner shall notify the IRS of that change within 30 days thereof. This requirement is in addition to the notification requirements described in §1.1441–1(e)(4)(ii)(D) regarding notification to a withholding agent in the event of changes in the beneficial owner s circumstances. The IRS may, under the exchange of information provisions of an applicable income tax treaty, exchange information with the relevant foreign competent authority for the purpose of confirming with appropriate tax officials of the other country that the beneficial owner continues to be a tax resident of that country. The IRS may from time to time, in its discretion, request that the beneficial owner reconfirm its residence in the treaty country.

(iii) *Special rules for qualified intermediaries.* The IRS may certify a taxpayer identifying number based upon the certification of a qualified intermediary described in § 1.1441–1(e)(5)(ii) regarding the tax residence of any of its account holders, under procedures agreed upon with the IRS. If a new account holder has a TIN at the time it opens an account, the qualified intermediary may rely on a statement by the account or interest holder that appropriate proof of tax residence in the treaty jurisdiction was previously provided to the IRS. In such case, the qualified intermediary must notify the IRS each time that the account or interest holder's address changes to another country or when the account or interest holder terminates its relationship with the qualified intermediary within 30 days of that change.

(3) *Certificate of residence.* A certificate of residence referred to in paragraph (b)(2)(i) or (c)(2)(ii) of this section is a certification issued by the competent authority (or another appropriate tax official) of the treaty country of which the taxpayer claims to be a resident that the taxpayer has filed its most recent income tax return as a resident of that country (within the meaning of the applicable tax treaty). A certificate of residence is valid for a period of three years or such longer period as the IRS may prescribe in published guidance (see § 601.601(d)(2) of this chapter). The competent authorities may agree to a different procedure for certifying residence, in which case such procedure shall govern for payments made to a person claiming to be a resident of the country with which such an agreement is in effect.

(4) *Documentary evidence establishing residence in the treaty country*—(i) *Individuals.* For purposes of this paragraph (c)(4), documentary evidence establishes the residence of an individual in a treaty country if it includes the name, address, and photograph of the person seeking to prove residence, is an official document issued by an authorized governmental body (i.e., a government or agency thereof, or a municipality), and has been issued no more than three years prior to presentation to the IRS or the withholding agent. A document older than three years may be relied upon as proof of residence only if it is accompanied by additional evidence of the person's residence in the treaty country (e.g., a bank statement, utility bills, or medical bills). Documentary evidence must be in the form of original documents or certified copies thereof. Documentary evidence must be accompanied by an affidavit of the taxpayer signed under penalties of perjury that the documentary evidence submitted is true and complete.

(ii) *Persons other than individuals.* For purposes of this paragraph (c)(4), documentary evidence establishes the residence in a treaty country of a person other than an individual if it includes the name of the entity and the address of its principal office in the treaty country, and is an official document issued by an authorized governmental body (e.g., a government or agency thereof, or a municipality).

(5) *Certifications regarding entitlement to treaty benefits*—(i) *Certification regarding conditions under a Limitation on Benefits Article.* A taxpayer that is not an individual must certify to the IRS by way of an affidavit attached to its request for certification of its employer identification number that it meets one or more of the conditions set forth in the Limitation on Benefits Article (if any, or in a similar provision) contained in the applicable tax treaty. The affidavit must describe sufficient facts for the IRS to determine which condition the taxpayer claims to satisfy. The affidavit must be signed by the taxpayer under penalties of perjury.

(ii) *Certification regarding whether the taxpayer derives the income.* A taxpayer that is not an individual shall certify to the IRS by way of an affidavit attached to its request for certification of its employer identification number that any income for which it intends to claim benefits under an applicable income tax treaty is income that will properly be treated as derived by itself as a resident of the applicable treaty jurisdiction within the meaning of § 1.894–1T(d)(1). The affidavit must be signed under penalties of perjury. This requirement does not apply if the taxpayer furnishes a certificate of residence that certifies that fact.

(d) *Joint owners.* In the case of a payment to joint owners, each owner must furnish a withholding certificate or, if applicable, documentary evidence or a certificate of residence. The applicable rate of withholding on a payment of income to joint owners shall be the highest applicable rate.

(e) *Related party dividends under U.S.-Denmark income tax treaty.* Article VI(3) of the income tax treaty between the United States and Denmark (see 1950–1 C.B. 77; see also §601.601(d)(2) of this chapter) reduces the rate of tax on dividends between related corporations to 5 percent subject to the condition that the relationship between the domestic and foreign corporations was not arranged or maintained for the purpose of securing the reduced rate. A domestic corporation that makes a distribution derived by a resident of Denmark may treat this condition as satisfied if, prior to the payment, a request has been made to the IRS for a private letter ruling determining that the relationship between the corporation and the Danish resident was not arranged or maintained for such purpose and the IRS has either issued a favorable ruling (and the ruling has not been revoked) or is considering the ruling request.

(f) *Failure to receive withholding certificate timely.* See applicable procedures described in §1.1441–1(b)(7) in the event the withholding agent does not hold an appropriate withholding certificate or other appropriate documentation at the time of payment.

(g) *Effective date*—(1) *General rule.* This section applies to payments made after December 31, 1999.

(2) *Transition rules.* For purposes of this section, the validity of a Form 1001 or 8233 that was valid on January 1, 1998, under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) and expired, or will expire, at any time during 1998, is extended until December 31, 1998. The validity of a Form 1001 or 8233 is valid on or after January 1, 1999, remains valid until its validity expires under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) or, if earlier, until December 31, 2000. The rule in this paragraph (g)(2), however, does not apply to extend the validity period of a Form 1001 or 8233 that expires solely by reason of changes in the circumstances of the person whose name is on the certificate or in interpretation of the law under the regulations under §1.894–1T(d). Notwithstanding the first three sentences of this paragraph (g)(2), a withholding agent may choose to not take advantage of the transition rule in this paragraph (g)(2) with respect to one or more withholding certificates valid under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) and, therefore, to require withholding certificates conforming to the requirements described in this section (new withholding certificates). For purposes of this section, a new withholding certificate is deemed to satisfy the documentation requirement under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998). Further, a new withholding certificate remains valid for the period specified in §1.1441–1(e)(4)(ii), regardless of when the certificate is obtained.

[T.D. 8734, 62 FR 53458, Oct. 14, 1997, as amended by T.D. 8804, 63 FR 72185, 72188, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53458, Oct. 14, 1997, §1.1441–6 was revised, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.1441–6 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.1441–6 Withholding pursuant to the application of a tax treaty which confers a reduced rate of, or an exemption from, United States income tax.

(a) *In general.* The rate of 30 percent or 14 percent shall be reduced as may be provided by a treaty with any country. In case of payments of any of the items specified in §1.1441–2 (other than dividends) made on or before December 31, 1971, and in the case of payments of dividends made at any time, the withholding agent shall determine the applicable rate pursuant to the appropriate tax treaty and the regulations issued thereunder. In case of payments on or after January 1, 1972, of any of the items specified in §1.1441–2 (other than dividends), the requirements of paragraphs (b) and (c) of this section shall apply in lieu of the ownership certificate or the exemption (or reduced rate) certificate (or corresponding letter) required by the regulations under the various income tax conventions in effect to which the United States is a party.

(b) *Coupon bond interest.* To secure the reduced rate of, or exemption from, U.S. income tax at source in the case of coupon bond interest, the recipient shall, if entitled to such treatment pursuant to a tax convention, for each issue of bonds file Form 1001 (Ownership, Exemption, or Reduced Rate Certificate) with the withholding agent when presenting the interest coupons for payment. This form shall be completed and signed by either the owner of the interest, his trustee, or his agent, and shall include such information as is required by the form and accompanying instructions. The form shall contain a statement that the owner of the income is entitled to a reduced rate of, or an exemption from, tax pursuant to a tax convention. The Form 1001 shall be retained by the withholding agent for at least 4 years after the close of the calendar year in which the interest is paid.

(c) *Income other than coupon bond interest or dividends.* (1) To secure the reduced rate of, or exemption from, U.S. income tax at source in case of items of income specified in §1.1441–2 other than coupon bond interest and dividends, the recipient shall, if entitled to such treatment pursuant to a tax convention, file Form 1001 (Ownership, Exemption, or Reduced Rate Certificate) with the withholding agent. This form shall be completed and signed by either the owner of the income, his trustee, or his agent, and shall include such information as is required by the form and accompanying instructions. A separate Form 1001 shall be used for each type of income. For this purpose, all income from a trust, estate, or investment account shall be considered as a single type of income. Each form shall also contain a statement that the owner of the income is entitled to a reduced rate of, or exemption from, tax pursuant to a tax convention. If, after filing such form, the owner ceases to be eligible for the benefits of the tax convention for such income, he shall promptly notify the withholding agent by letter. Form 1001 shall not be used to secure a reduced rate of, or exemption from, withholding on independent personal services income. See §1.1441–4(b)(2).

(2) Form 1001 shall be effective for the successive 3-calendar-year period during which the income to which the form applies is paid. Each such form filed with any withholding agent shall be filed as soon as practicable. Once a form has been filed for a type of income (other than coupon bond interest) with respect to such a 3-year period, no additional Form 1001 for such income need be filed with respect to such period unless the Commissioner of Internal Revenue notifies the withholding agent that the taxpayer shall file another form. If any change occurs in the ownership of income subject to a Form 1001 recorded on the books of the withholding agent, the Form 1001 shall no longer be effective. The Form 1001 shall be retained by the withholding agent for at least 4 years after the end of the last calendar year in which income subject to the form is paid.

(3) Form 1001 need not be filed with respect to payments (other than payments of coupon bond interest) made prior to December 31, 1974, if an exemption (or reduced rate) certificate (or corresponding letter) required by the regulations under the applicable income tax convention has been filed with respect to such payments prior to December 31, 1971.

(d) *Section 6013(g) election.* A nonresident alien individual with respect to whom a section 6013(g) election to be treated as a resident is in effect may not, in accordance with §1.6013–6(a)(2)(v), claim a reduced rate of, or exemption from, United States income tax under an income tax treaty.

(Approved by the Office of Management and Budget under control number 1545–0795)

(Secs. 1441(c)(4) (80 Stat. 1553; 26 U.S.C. 1441(c)(4)), 3401(a)(6) (80 Stat. 1554; 26 U.S.C. 3401(a)(6)), and 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 7157, 36 FR 25227, Dec. 30, 1971, as amended by T.D. 7842, 47 FR 49842, Nov. 3, 1982; T.D. 7977, 49 FR 36834, Sept. 20, 1984]

§1.1441–7 General provisions relating to withholding agents.

(a) *Withholding agent defined.* For purposes of chapter 3 of the Internal Revenue Code (Code) and the regulations under such chapter, the term *withholding agent* means any person, U.S. or foreign, that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding, including (but not limited to) a foreign intermediary described in §1.1441–1(e)(3)(i), a foreign partnership, or a U.S. branch described in §1.1441–1(b)(2)(iv) (A) or (E). See §1.1441–1(b) (1) and (2) for determining whether a payment is considered made to a foreign person. Any person who meets the definition of a withholding agent is required to deposit any tax withheld under §1.1461–1(a) and to make the returns prescribed by §1.1461–1 (b) and (c), as modified by the terms of an agreement with a qualified intermediary (in the case of a qualified intermediary) or, in the case of a foreign partnership, to make the returns prescribed under section 6031 and the regulations thereunder. When several persons qualify as withholding agents with respect to a single payment, only one tax is required to be withheld and, generally, only one return (on Form 1042, as required under §1.1461–1(b)), is required to be made. See §1.1461–1(b)(2) and (c)(4) for filing procedures when multiple withholding agents are involved. In the case of a withholding agent paying to partners of a withholding foreign partnership described in §1.1441–5(c)(2)(i), the withholding agent may arrange with the partnership to withhold if it is provided the information by the partnership, in which case the partnership does not have to withhold. However, the partnership must still file a partnership return under section 6031(a) and the regulations under that section. The withholding agent does not have to file Forms 1042–S (but does have to file a Form 1042) since the withholding foreign partnership furnishes Forms K–1 to its partners pursuant to section 6031(b) and §1.6031(b)–1T. For purposes of this section and any requirement to withhold under chapter 3 of the Code and the regulations thereunder, a person who, as a nominee described in §1.6031(c)–1T, has furnished to a partnership all of the information required to be furnished under §1.6031(c)–1T(a) shall not be treated as a withholding agent if it has notified the partnership that it is treating the provision of information to the partnership as a discharge of its obligations as a withholding agent.

(b) *Standards of knowledge*—(1) *In general.* A withholding agent must withhold at the full 30-percent rate under section 1441, 1442, or 1443(a) or at the full 4-percent rate under section 1443(b) if it has actual knowledge or reason to know that a claim of U.S. status or of a reduced rate of withholding under section 1441, 1442, or 1443 is incorrect. A withholding agent shall be liable for tax, interest, and penalties to the extent provided under sections 1461 and 1463 and the regulations under those sections if it fails to withhold the correct amount despite its actual knowledge or reason to know the amount required to be withheld. For purposes of the regulations under sections 1441, 1442, and 1443, a withholding agent may rely on information or certifications contained in, or attached to, a withholding certificate or other documentation furnished by or for a beneficial owner or payee unless the withholding agent has actual knowledge or reason to know that the information or certifications are not correct and, if based on such knowledge or reason to know, it should withhold (under chapter 3 of the Code or another withholding provision of the Code) an amount greater than would be the case if it relied on the information or certifications, or it should report (under chapter 3 of the Code or under another provision of the Code) an amount that would not otherwise be reportable if it relied on the information or certifications. See §1.1441–1(e)(4)(viii) for applicable reliance rules. A withholding agent that has received notification by the Internal Revenue Service (IRS) that a claim of U.S. status or of a reduced rate is incorrect has actual knowledge beginning on the date that is 30 calendar days after the date the notice is received. A withholding agent that fails to act in accordance with the presumptions set forth in §§1.1441–1(b)(3), 1.1441–4(a), 1.1441–5 (d) and (e), or 1.1441–9(b)(3) may also be liable for tax, interest, and penalties. See §1.1441–1(b)(3)(ix) and (7).

(2) *Reason to know*—(i) *In general.* A withholding agent shall be considered to have reason to know if its knowledge of relevant facts or statements contained in the withholding certificates or other documentation is such that a reasonably prudent person in the position of the withholding agent would question the claims made.

(ii) *Limits on reason to know in certain cases.* Except as otherwise provided in paragraph (b)(3) of this section, a withholding agent that is a financial institution (including a regulated investment company) with which a customer may open an account has a reason to know with respect to payments of amounts described in §1.1441–6(b)(2)(ii) that a beneficial owner withholding certificate or documentary evidence for a beneficial owner is not reliable only if any one or more of the circumstances described in this paragraph (b)(2)(ii) exist for a withholding certificate. In such a case, the withholding agent may require a new withholding certificate. In the absence of a new certificate, a withholding agent may rely on the withholding certificate only after documentation is provided in support of the claim of foreign status, classification, or reduced rate of tax under a tax treaty.

(A) The permanent residence address on the withholding certificate is an address in the United States. In the case of an individual, trust, or estate, the withholding agent may rely on information in its files that is less than three years old and that supports the beneficial owner's claim of foreign status, despite a U.S. address (for example, a bank has evidence of the diplomatic status of a customer). In the absence of evidence in the withholding agent's files, the agent meets its due diligence obligation for purposes of this paragraph (b)(2)(ii)(A) if it contacts the beneficial owner or its agent in the United States and obtains an explanation in writing supporting the foreign status of the beneficial owner (for example, the beneficial owner is a nonresident alien individual temporarily present in the United States as a teacher; see § 301.7701(b)–3(b)(3) of this chapter) and documentation supporting the claim of foreign status is attached to the beneficial owner's statement (for example, in the case of a nonresident alien individual teacher, a copy of the relevant pages of the beneficial owner's passport showing the individual's U.S. visa status or a copy of relevant INS documents). In the case of a beneficial owner other than an individual, trust, or estate, the withholding agent must inquire as to whether the person whose name is on the certificate is actually organized or created under the laws of a foreign country.

(B) The payment is directed to a P.O. Box, an in-care-of address, or a U.S. address. In the case of an individual, the withholding agent may rely, for example, on documentary evidence of a type described in § 1.1441–6(c) (3) or (4) supporting the beneficial owner's claim of residence in a foreign country to ascertain that the individual is a nonresident alien individual. In the case of a person other than an individual, the withholding agent may rely on other evidence to ascertain that the person whose name is on the certificate is not a U.S. person.

(C) In the case of income for which benefits are claimed under an income tax treaty, the permanent residence address or mailing address is not in the corresponding treaty country. In such a case, the withholding agent may rely, for example, on documentary evidence of a type described in § 1.1441–6(c) (3) or (4) supporting the beneficial owner's claim of residence in the country whose benefits under an income tax treaty with the United States are invoked.

(D) The mailing address on the withholding certificate is in the United States or the beneficial owner notifies the withholding agent of a new address for mailing or residential purposes that is in the United States, a P.O. box, or an in-care-address, or, in the case of income for which benefits are claimed under an income tax treaty, the mailing address on the certificate or the new mailing or residential address notified to the withholding agent is not in the treaty country. The withholding agent may, however, rely on documentary evidence of a type described in § 1.1441–6(c) (3) or (4) supporting the beneficial owner's claim of residence in a foreign country.

(E) The name of the person on the withholding certificate or documentary evidence indicates that the person's status is a corporation, partnership, trust, estate, or an individual, and the person's claim of status is not consistent with such indication. For example, a person whose name indicates that it is a per se corporation described in § 301.7701–2(b)(8)(i) of this chapter represents on a Form W–8 that it is a partnership.

(F) Such other circumstances as the IRS may prescribe in published guidance (see § 601.601(d)(2) of this chapter).

(3) *Coordinated account information systems.* See § 1.1441–1(e)(4)(ix) for application of these rules other than on an account-by-account basis so that a withholding agent that relies on a coordinated account information system for documentation is considered to know or have reason to know the facts recorded in the system.

(c) *Authorized agent*—(1) *In general.* The acts of an agent of a withholding agent (including the receipt of withholding certificates, the payment of amounts of income subject to withholding, and the deposit of tax withheld) are imputed to the withholding agent on whose behalf it is acting. However, if the agent is a foreign person, a withholding agent that is a U.S. person may treat the acts of the foreign agent as its own for purposes of determining whether it has complied with the provisions of this section, but only if the agent is an authorized foreign agent, as defined in paragraph (c)(2) of this section. An authorized foreign agent cannot apply the provisions of this paragraph (c) to appoint another person its authorized foreign agent with respect to the payments it receives from the withholding agent.

(2) *Authorized foreign agent.* An agent is an authorized foreign agent only if—

(i) There is a written agreement between the withholding agent and the foreign person acting as agent;

(ii) The notification procedures described in paragraph (c)(3) of this section have been complied with;

(iii) Books and records and relevant personnel of the foreign agent are available (on a continuous basis, including after termination of the relationship) for examination by the IRS in order to evaluate the withholding agent's compliance with the provisions of chapters 3 and 61 of the Code, section 3406, and the regulations under those provisions; and

(iv) The U.S. withholding agent remains fully liable for the acts of its agent and does not assert any of the defenses that may otherwise be available, including under common law principles of agency in order to avoid tax liability under the Internal Revenue Code.

(3) *Notification.* A withholding agent that appoints an authorized agent to act on its behalf for purposes of §1.871–14(c)(2), the withholding provisions of chapter 3 of the Code, section 3406 or other withholding provisions of the Internal Revenue Code, or the reporting provisions of chapter 61 of the Code, is required to file notice of such appointment with the Office of the Assistant Commissioner (International). Such notice shall be filed before the first payment for which the authorized agent acts as such. Such notice shall acknowledge the withholding agent liability as provided in paragraph (c)(2)(iv) of this section.

(4) *Liability of U.S. withholding agent.* An authorized foreign agent is subject to the same withholding and reporting obligations that apply to any withholding agent under the provisions of chapter 3 of the Code and the regulations thereunder. In particular, an authorized foreign agent does not benefit from the special procedures or exceptions that may apply to a qualified intermediary. A withholding agent acting through an authorized foreign agent is liable for any failure of the agent, such as failure to withhold an amount or make payment of tax, in the same manner and to the same extent as if the agent's failure had been the failure of the U.S. withholding agent. For this purpose, the foreign agent's actual knowledge or reason to know shall be imputed to the U.S. withholding agent. The U.S. withholding agent's liability shall exist irrespective of the fact that the authorized foreign agent is also a withholding agent and is itself separately liable for failure to comply with the provisions of the regulations under section 1441, 1442, or 1443. However, the same tax, interest, or penalties shall not be collected more than once.

(5) *Filing of returns.* See §1.1461–1(b)(2)(iii) and (c)(4)(iii) regarding returns required to be made where a U.S. withholding agent acts through an authorized foreign agent.

(d) *United States obligations.* If the United States is a withholding agent for an item of interest, including original issue discount, on obligations of the United States or of any agency or instrumentality thereof, the withholding obligation of the United States is assumed and discharged by—

(1) The Commissioner of the Public Debt, for interest paid by checks issued through the Bureau of the Public Debt;

(2) The Treasurer of the United States, for interest paid by him or her, whether by check or otherwise;

(3) Each Federal Reserve Bank, for interest paid by it, whether by check or otherwise; or

(4) Such other person as may be designated by the IRS.

(e) *Assumed obligations.* If, in connection with the sale of a corporation's property, payment on the bonds or other obligations of the corporation is assumed by a person, then that person shall be a withholding agent to the extent amounts subject to withholding are paid to a foreign person. Thus, the person shall withhold such amounts under § 1.1441–1 as would be required to be withheld by the seller or corporation had no such sale or assumption been made.

(f) *Conduit financing arrangements*—(1) *Liability of withholding agent.* Subject to paragraph (f)(2) of this section, any person that is required to deduct and withhold tax under § 1.1441–3(g) is made liable for that tax by section 1461. A person that is required to deduct and withhold tax but fails to do so is liable for the payment of the tax and any applicable penalties and interest.

(2) *Exception for withholding agents that do not know of conduit financing arrangement*—(i) *In general.* A withholding agent will not be liable under paragraph (f)(1) of this section for failing to deduct and withhold with respect to a conduit financing arrangement unless the person knows or has reason to know that the financing arrangement is a conduit financing arrangement. This standard shall be satisfied if the withholding agent knows or has reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement, including facts sufficient to establish that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan. A withholding agent that knows only of the financing transactions that comprise the financing arrangement will not be considered to know or have reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement.

(ii) *Examples.* The following examples illustrate the operation of paragraph (d)(2) of this section.

Example 1. (i) DS is a U.S. subsidiary of FP, a corporation organized in Country N, a country that does not have an income tax treaty with the United States. FS is a special purpose subsidiary of FP that is incorporated in Country T, a country that has an income tax treaty with the United States that prohibits the imposition of withholding tax on payments of interest. FS is capitalized with $10,000,000 in debt from BK, a Country N bank, and $1,000,000 in capital from FS.

(ii) On May 1, 1995, C, a U.S. person, purchases an automobile from DS in return for an installment note. On July 1, 1995, DS sells a number of installment notes, including C's, to FS in exchange for $10,000,000. DS continues to service the installment notes for FS and C is not notified of the sale of its obligation and continues to make payments to DS. But for the withholding tax on payments of interest by DS to BK, DS would have borrowed directly from BK, pledging the installment notes as collateral.

(iii) The C installment note is a financing transaction, whether held by DS or by FS, and the FS note held by BK also is a financing transaction. After FS purchases the installment note, and during the time the installment note is held by FS, the transactions constitute a financing arrangement, within the meaning of § 1.881–3(a)(2)(i). BK is the financing entity, FS is the intermediate entity, and C is the financed entity. Because the participation of FS in the financing arrangement reduces the tax imposed by section 881 and because there was a tax avoidance plan, FS is a conduit entity.

(iv) Because C does not know or have reason to know of the tax avoidance plan (and by extension that the financing arrangement is a conduit financing arrangement), C is not required to withhold tax under section 1441. However, DS, who knows that FS's participation in the financing arrangement is pursuant to a tax avoidance plan and is a withholding agent for purposes of section 1441, is not relieved of its withholding responsibilities.

Example 2. Assume the same facts as in *Example, 1* except that C receives a new payment booklet on which DS is described as ''agent''. Although C may deduce that its installment note has been sold, without more C has no reason to know of the existence of a financing arrangement. Accordingly, C is not liable for failure to withhold, although DS still is not relieved of its withholding responsibilities.

Example 3. (i) DC is a U.S. corporation that is in the process of negotiating a loan of $10,000,000 from BK1, a bank located in Country N, a country that does not have an income tax treaty with the United States. Before the loan agreement is signed, DC's tax lawyers point out that interest on the loan would not be subject to withholding tax if the loan were made by BK2, a subsidiary of BK1 that is incorporated in Country T, a country that has an income tax treaty with the United States that prohibits the imposition of withholding tax on payments of interest. BK1 makes a loan to BK2 to enable BK2 to make the loan to DC. Without the loan from BK1 to BK2, BK2 would not have been able to make the loan to DC.

(ii) The loan from BK1 to BK2 and the loan from BK2 to DC are both financing transactions and together constitute a financing arrangement within the meaning of §1.881–3(a)(2)(i). BK1 is the financing entity, BK2 is the intermediate entity, and DC is the financed entity. Because the participation of BK2 in the financing arrangement reduces the tax imposed by section 881 and because there is a tax avoidance plan, BK2 is a conduit entity.

(iii) Because DC is a party to the tax avoidance plan (and accordingly knows of its existence), DC must withhold tax under section 1441. If DC does not withhold tax on its payment of interest, BK2, a party to the plan and a withholding agent for purposes of section 1441, must withhold tax as required by section 1441.

Example 4. (i) DC is a U.S. corporation that has a long-standing banking relationship with BK2, a U.S. subsidiary of BK1, a bank incorporated in Country N, a country that does not have an income tax treaty with the United States. DC has borrowed amounts of as much as $75,000,000 from BK2 in the past. On January 1, 1995, DC asks to borrow $50,000,000 from BK2. BK2 does not have the funds available to make a loan of that size. BK2 considers asking BK1 to enter into a loan with DC but rejects this possibility because of the additional withholding tax that would be incurred. Accordingly, BK2 borrows the necessary amount from BK1 with the intention of on-lending to DC. BK1 does not make the loan directly to DC because of the withholding tax that would apply to payments of interest from DC to BK1. DC does not negotiate with BK1 and has no reason to know that BK1 was the source of the loan.

(ii) The loan from BK2 to DC and the loan from BK1 to BK2 are both financing transactions and together constitute a financing arrangement within the meaning of §1.881–3(a)(2)(i). BK1 is the financing entity, BK2 is the intermediate entity, and DC is the financed entity. The participation of BK2 in the financing arrangement reduces the tax imposed by section 881. Because the participation of BK2 in the financing arrangement reduces the tax imposed by section 881 and because there was a tax avoidance plan, BK2 is a conduit entity.

(iii) Because DC does not know or have reason to know of the tax avoidance plan (and by extension that the financing arrangement is a conduit financing arrangement), DC is not required to withhold tax under section 1441. However, BK2, who is also a withholding agent under section 1441 and who knows that the financing arrangement is a conduit financing arrangement, is not relieved of its withholding responsibilities.

(3) *Effective date.* This paragraph (f) is effective for payments made by financed entities on or after September 11, 1995. This paragraph shall not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest payments with respect to other debt obligations issued prior to October 15, 1984 (whether or not such debt was issued by a Netherlands Antilles corporation).

(g) *Effective date.* Except as otherwise provided in paragraph (f)(3) of this section, this section applies to payments made after December 31, 1999.

[T.D. 7977, 49 FR 36834, Sept. 20, 1984, as amended by T.D. 8611, 60 FR 41014, Aug. 11, 1995; 60 FR 55312, Oct. 31, 1995; T.D. 8734, 62 FR 53462, Oct. 14, 1997; T.D. 8804, 63 FR 72188, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53462, Oct. 14, 1997, §1.1441–7 was amended by revising paragraphs (a) through (c); by redesignating paragraph (d) as paragraph (f); by adding new paragraphs (d), (e), and (g); by removing the language ‘‘(j)’’ and inserting ‘‘(g)’’ in the first sentence of newly designated paragraph (f)(1); by removing the language ‘‘(d)’’ and inserting ’’(f)’’ in the first sentence of newly designated paragraph (f)(1), in the first sentence of newly designated paragraph (f)(2)(i), and in the first sentence of newly designated paragraph (f)(3); and by removing the authority citation at the end of the section, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.1441–7 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.1441–7 General provisions relating to withholding agents.

(a) *Withholding agent defined*—(1) *In general.* For purposes of Chapter 3 of the Code, the term ‘‘withholding agent’’ means any person who pays or causes to be paid an item of income specified in §1.1441–2 to (or to the agent of) a nonresident alien individual, a foreign partnership, a nonresident alien or foreign fiduciary of a trust or estate, or a foreign corporation, and who is required to withhold tax under sections 1441, 1442, 1443, or 1451 from such item of income. Any person who meets the definition of a withholding agent is required to file the returns prescribed by §1.1461–1. For example, an employer (as defined in §31.3401(d)–1 of this chapter), to the extent the employer pays remuneration for services performed by a nonresident alien individual in the United States and such remuneration is excepted from the term ‘‘wages’’ under § 31.3401(a)(6)–(1) (c) or (e) of this chapter, must file a return as required by § 1.1461–2(c)(1).

(2) *United States obligations.* If the United States is a withholding agent for an item of interest, including original issue discount, on obligations of the United States or of any agency or instrumentality thereof, the withholding obligation of the United States shall be assumed and discharged by:

(i) The Commissioner of the Public Debt, for interest paid by checks issued through the Bureau of the Public Debt.

(ii) The Treasurer of the United States, for interest paid by him or her, whether by check or otherwise,

(iii) Each Federal Reserve Bank, for interest paid by it, whether by check or otherwise, or

(iv) Such other person as may be designated by the Commissioner.

(b) *Person designated to act for withholding agent*—(1) *Notice of duly authorized agent.* A withholding agent (including a state or possession of the United States or any agency or instrumentality thereof) that appoints a duly authorized agent to act on its behalf under the withholding provisions of chapter 3 of the Code is required to file a notice of such appointment with the Director of the Foreign Operations District, Internal Revenue Service, Washington, DC 20225. Such notice must be filed before the first payment with respect to which the authorized agent acts as such.

(2) *In general—liability of withholding agent.* If a duly authorized agent has become insolvent or for any other reason fails to make payment of money deposited with it by the withholding agent to pay tax required to be withheld under Chapter 3 of the Code, or of money withheld under such chapter, the withholding agent is not discharged of its liability under such chapter since the authorized agent is merely the agent of the withholding agent.

(3) *Tax-free covenant bonds—liability of withholding agent.* If the duly authorized agent designated by a withholding agent to act for it has not withheld any tax from the income nor received any funds from the withholding agent to pay the tax which the withholding agent assumed in connection with its tax-free covenant bonds, then that authorized agent cannot be held liable for the tax assumed by the withholding agent merely by reason of the appointment as duly authorized agent. The withholding agent remains liable under chapter 3 of the Code since the duly authorized agent is merely the agent of the withholding agent.

(c) *Payments other than money.* In any case where income is payable in any medium other than money the withholding agent shall not release the property so received until the property has been converted into funds sufficient to enable the withholding agent to pay over in money the tax required to be withheld under chapter 3 of the Code with respect to such income.

* * * * *

(Secs. 1441(c)(4) (80 Stat. 1553; 26 U.S.C. 1441(c)(4)), 3401(a)(6) (80 Stat. 1554; 26 U.S.C. 3401(a)(6)), and 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

§ 1.1441–8 Exemption from withholding for payments to foreign governments, international organizations, foreign central banks of issue, and the Bank for International Settlements.

(a) *Foreign governments.* Under section 892, certain specific types of income received by foreign governments are excluded from gross income and are exempt from taxation, unless derived from the conduct of a commercial activity or received from or by a controlled commercial entity. Accordingly, withholding is not required under § 1.1441.1 with regard to any item of income which is exempt from taxation under section 892.

(b) *Reliance on claim of exemption by foreign government.* Absent actual knowledge or reason to know otherwise, the withholding agent may rely upon a claim of exemption made by the foreign government if, prior to the payment, the withholding agent can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a beneficial owner in accordance with § 1.1441–1(e)(1)(ii). A Form W–8 furnished by a foreign government for purposes of claiming an exemption under this paragraph (b) is valid only if, in addition to other applicable requirements, it certifies that the income is, or will be, exempt from taxation under section 892 and the regulations under that section and whether the person whose name is on the certificate is an integral part of a foreign government (as defined in § 1.892–2T(a)(2)) or a controlled entity (as defined in § 1.892–2T(a)(3)).

(c) *Income of a foreign central bank of issue or the Bank for International Settlements*—(1) *Certain interest income.* Section 895 provides for the exclusion from gross income of certain income derived by a foreign central bank of issue, or by the Bank for International

Settlements, from obligations of the United States or of any agency or instrumentality thereof or from interest on deposits with persons carrying on the banking business if the bank is the owner of the obligations or deposits and does not hold the obligations or deposits for, or use them in connection with, the conduct of a commercial banking function or other commercial activity by such bank. See §1.895–1. Absent actual knowledge or reason to know that a foreign central bank of issue, or the Bank for International Settlements, is operating outside the scope of the exclusion granted by section 895 and the regulations under that section, the withholding agent may rely on a claim of exemption if, prior to the payment, the withholding agent can reliably associate the payment with documentation upon which it can rely to treat the foreign central bank of issue or the Bank for International Settlements as the beneficial owner of the payment in accordance with §1.1441–1(e)(1)(ii). A Form W–8 furnished by a foreign central bank of issue or the Bank for International Settlements for purposes of claiming an exemption under this paragraph (c)(1) is valid only if, in addition to other applicable requirements, it certifies that the person whose name is on the certificate is a foreign central bank of issue, or the Bank for International Settlements, and that the bank does not, and will not, hold the obligations or the bank deposits covered by the Form W–8 for, or use them in connection with, the conduct of a commercial banking function or other commercial activity.

(2) *Bankers acceptances.* Interest derived by a foreign central bank of issue from bankers acceptances is exempt from tax under sections 871(i)(2)(C) and 881(d) and §1.861–2(b)(4). With respect to bankers' acceptances, a withholding agent may treat a payee as a foreign central bank of issue without requiring a withholding certificate if the name of the payee and other facts surrounding the payment reasonably indicate that the payee or beneficial owner is a foreign central bank of issue, as defined in §1.861–2(b)(4).

(d) *Exemption for payments to international organizations.* A payment to an international organization (within the meaning of section 7701(a)(18)) is exempt from withholding on any payment. A withholding agent may treat a payee as an international organization without requiring a withholding certificate if the name of the payee is one that is designated as an international organization by executive order (pursuant to 22 U.S.C. 288 through 288(f)) and other facts surrounding the transaction reasonably indicate that the international organization is the beneficial owner of the payment.

(e) *Failure to receive withholding certificate timely and other applicable procedures.* See applicable procedures described in §1.1441–1(b)(7) in the event the withholding agent does not hold a valid withholding certificate described in paragraph (b) or (c)(1) of this section or other appropriate documentation at the time of payment. Further, the provisions of §1.1441–1(e)(4) shall apply to withholding certificates and other documents related thereto furnished under the provisions of this section.

(f) *Effective date*—(1) *In general.* This section applies to payments made after December 31, 1999.

(2) *Transition rules.* For purposes of this section, the validity of a Form 8709 that was valid on January 1, 1998, under the regulations in effect prior to January 1, 2000 (see 26 CFR part 1, revised April 1, 1998) and expired, or will expire, at any time during 1998, is extended until December 31, 1998. The validity of a Form 8709 that is valid on or after January 1, 1999, remains valid until its validity expires under the regulations in effect prior to January 1, 2000 (see 26 CFR part 1, revised April 1, 1998) or, if earlier, until December 31, 2000. The rule in this paragraph (f)(2), however, does not apply to extend the validity period of a Form 8709 that expires solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the first three sentences of this paragraph (f)(2), a withholding agent may choose to not take advantage of the transition rule in this paragraph (f)(2) with respect to one or more withholding certificates valid under the regulations in effect prior to January 1, 2000 (see 26 CFR part 1, revised April 1, 1998) and, therefore, to require

withholding certificates conforming to the requirements described in this section (new withholding certificates). For purposes of this section, a new withholding certificate is deemed to satisfy the documentation requirement under the regulations in effect prior to January 1, 2000 (see 26 CFR part 1, revised April 1, 1998). Further, a new withholding certificate remains valid for the period specified in § 1.1441–1(e)(4)(ii), regardless of when the certificate is obtained.

[T.D. 8211, 53 FR 24066, June 27, 1988, as amended at T.D. 8211, 53 FR 27595, July 21, 1988; Redesignated and amended by T.D. 8734, 62 FR 53464, Oct. 14, 1997; T.D. 8804, 63 FR 72185, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53464, Oct. 14, 1997, § 1.1441–8T was redesignated as § 1.1441–8; the section heading and paragraph (b) were revised; and paragraphs (c), (d), (e), and (f), were added, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.1441–8T was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.1441–8T Foreign government exemption from withholding (temporary).

* * * * *

(b) *Statement claiming exemption.* To avoid withholding of tax at source under § 1.1441–1, a foreign government which is entitled to the income must file with each withholding agent from whom amounts of income are to be received, a statement under penalties of perjury (in duplicate) indicating the extent to which such income described in the statement is exempt from taxation under section 892. This statement should contain (i) the name and address of the foreign government entitled to the income, (ii) the items of income and their amount with respect to which the statement is filed, (iii) an explanation indicating why the specific items of income are exempt from taxation under section 892, and (iv) the taxable year during which such exemption is to apply. This statement shall be filed with the withholding agent for each taxable year the foreign government is entitled to the income, and before payment of the income in respect of which it applies. Any statement so filed shall be effective only with respect to the item or items of income specified therein and only with respect to the types of income specified in § 1.892–3T(a)(1) (i), (ii) or (iii). The statement shall constitute authorization to the withholding agent to pay such income during the taxable year without deduction of the tax at source under § 1.1441–1. Any statement required by this subparagraph may be made on a form prescribed by the Internal Revenue Service.

* * * * *

§ 1.1441–9 Exemption from withholding on exempt income of a foreign tax-exempt organization, including foreign private foundations.

(a) *Exemption from withholding for exempt income.* No withholding is required under section 1441(a) or 1442, and the regulations under those sections, on amounts paid to a foreign organization that is described in section 501(c) to the extent that the amounts are not income includable under section 512 in computing the organization's unrelated business taxable income. See, however, § 1.1443–1 for withholding on payments of unrelated business income to foreign tax-exempt organizations and on payments subject to tax under section 4948. For a foreign organization to claim an exemption from withholding under section 1441(a) or 1442 based on its status as an organization described in section 501(c), it must furnish the withholding agent with a withholding certificate described in paragraph (b)(2) of this section. A foreign organization described in section 501(c) may choose to claim a reduced rate of withholding under the procedures described in other sections of the regulations under section 1441 and not under this section. In particular, if an organization chooses to claim benefits under an income tax treaty, the withholding procedures applicable to claims of such a reduced rate are governed solely by the provisions of § 1.1441–6 and not of this section.

(b) *Reliance on foreign organization's claim of exemption from withholding*—(1) *General rule.* A withholding agent may rely on a claim of exemption under this section only if, prior to the payment, the withholding agent can reliably associate the payment with a valid withholding certificate described in paragraph (b)(2) of this section.

(2) *Withholding certificate.* A withholding certificate under this paragraph (b)(2) is valid only if it is a Form W–8 and if, in addition to other applicable requirements, the Form W–8 includes the taxpayer identifying number

of the organization whose name is on the certificate, and it certifies that the Internal Revenue Service (IRS) has issued a favorable determination letter (and the date thereof) that is currently in effect, what portion, if any, of the amounts paid constitute income includable under section 512 in computing the organization's unrelated business taxable income, and, if the organization is described in section 501(c)(3), whether it is a private foundation described in section 509. Notwithstanding the preceding sentence, if the organization cannot certify that it has been issued a favorable determination letter that is still in effect, its withholding certificate is nevertheless valid under this paragraph (b)(2) if the organization attaches to the withholding certificate an opinion that is acceptable to the withholding agent from a U.S. counsel concluding that the organization is described in section 501(c). If the determination letter or opinion of counsel to which the withholding certificate refers concludes that the organization is described in section 501(c)(3), and the certificate further certifies that the organization is not a private foundation described in section 509, an affidavit of the organization setting forth sufficient facts concerning the operations and support of the organization for the Internal Revenue Service (IRS) to determine that such organization would be likely to qualify as an organization described in section 509(a) (1), (2), (3), or (4) must be attached to the withholding certificate. An organization that provides an opinion of U.S. counsel or an affidavit may provide the same opinion or affidavit to more than one withholding agent provided that the opinion is acceptable to each withholding agent who receives it in conjunction with a withholding certificate. Any such opinion of counsel or affidavit must be renewed whenever the certificate to which it is attached is required to be renewed.

(3) *Presumptions in the absence of documentation.* Notwithstanding paragraph (b)(1) of this section, if the organization's certification with respect to whether amounts paid constitute income includable under section 512 in computing the organization's unrelated business taxable income is not reliable or is lacking but all other certifications are reliable, the withholding agent may rely on the certificate but the amounts paid are presumed to be income includable under section 512 in computing the organization's unrelated business taxable income. If the certification regarding private foundation status is not reliable, the withholding agent may rely on the certificate but the amounts paid are presumed to be paid to a foreign beneficial owner that is a private foundation.

(4) *Reason to know.* Reliance by a withholding agent on the information and certifications stated on a withholding certificate is subject to the agent's actual knowledge or reason to know that such information or certification is incorrect as provided in §1.1441–7(b). For example, a withholding agent must cease to treat a foreign organization's claim for exemption from withholding based on the organization's tax-exempt status as valid beginning on the earlier of the date on which such agent knows that the IRS has given notice to such foreign organization that it is not an organization described in section 501(c) or the date on which the IRS gives notice to the public that such foreign organization is not an organization described in section 501(c). Similarly, a withholding agent may no longer rely on a certification that an amount is not subject to tax under section 4948 beginning on the earlier of the date on which such agent knows that the IRS has given notice to such foreign organization that it is subject to tax under section 4948 or the date on which the IRS gives notice that such foreign organization is a private foundation within the meaning of section 509(a).

(c) *Failure to receive withholding certificate timely and other applicable procedures.* See applicable procedures described in §1.1441–1(b)(7) in the event the withholding agent does not hold a valid withholding certificate or other appropriate documentation at the time of payment. Further, the provisions of §1.1441–1(e)(4) shall apply to withholding certificates and other documents related thereto furnished under the provisions of this section.

(d) *Effective date*—(1) *In general.* This section applies to payments made after December 31, 1999.

(2) *Transition rules.* For purposes of this section, the validity of a Form W–8, 1001, or 4224 or a statement that was valid on January 1, 1998, under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) and expired, or will expire, at any time during 1998, is extended until December 31, 1998. The validity of a Form W–8, 1001, or 4224 or a statement that is valid on or after January 1, 1999 remains valid until its validity expires under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) or, if earlier, until December 31, 2000. The rule in this paragraph (d)(2), however, does not apply to extend the validity period of a Form W–8, 1001, or 4224 or a statement that expires solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the first three sentences of this paragraph (d)(2), a withholding agent may choose to not take advantage of the transition rule in this paragraph (d)(2) with respect to one or more withholding certificates valid under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) and, therefore, to require withholding certificates conforming to the requirements described in this section (new withholding certificates). For purposes of this section, a new withholding certificate is deemed to satisfy the documentation requirement under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998). Further, a new withholding certificate remains valid for the period specified in § 1.1441–1(e)(4)(ii), regardless of when the certificate is obtained.

[T.D. 8734, 62 FR 53465, Oct. 14, 1997, as amended by T.D. 8804, 63 FR 72185, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53465, Oct. 14, 1997, § 1.1441–9 was added, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.1441–9 was delayed until Jan. 1, 2000.

§ 1.1442–1 Withholding of tax on foreign corporations.

For regulations concerning the withholding of tax at source under section 1442 in the case of foreign corporations, foreign governments, international organizations, foreign tax-exempt corporations, or foreign private foundations, see §§ 1.1441–1 through 1.1441–9.

[T.D. 8734, 62 FR 53466, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53466, Oct. 14, 1997, § 1.1442–1 was revised, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.1442–1 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.1442–1 Withholding of tax on foreign corporations.

For regulations respecting the withholding of tax at source under section 1442 in the case of foreign corporations, see §§ 1.1441–1 and 1.1451–1.

[T.D. 6908, 31 FR 16773, Dec. 31, 1966]

§ 1.1442–2 Exemption under a tax treaty.

For regulations providing for a claim of reduced withholding tax under section 1442 by certain foreign corporations pursuant to the provisions of an income tax treaty, see § 1.1441–6.

[T.D. 8734, 62 FR 53466, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53466, Oct. 14, 1997, § 1.1442–2 was revised, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.1442–2 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.1442–2 Exemption from withholding of tax on foreign corporations.

For regulations exempting certain foreign corporations from the withholding requirements of section 1442 in a case where an undue administrative burden is imposed, see paragraph (f) of § 1.1441–4.

[T.D. 6908, 31 FR 16773, Dec. 31, 1966]

§ 1.1442–3 Tax exempt income of a foreign tax-exempt corporations.

For regulations providing for a claim of exemption for income exempt from tax under section 501(a) of a foreign tax-exempt corporation, see § 1.1441–9. See § 1.1443–1 for withholding rules applicable to foreign private foundations and to the unrelated business income of foreign tax-exempt organizations.

[T.D. 8734, 62 FR 53466, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53466, Oct. 14, 1997, §1.1442–3 was added, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.1442–3 was delayed until Jan. 1, 2000.

§1.1443–1 Foreign tax-exempt organizations.

(a) *Income includible under section 512 in computing unrelated business taxable income.* In the case of a foreign organization that is described in section 501(c), amounts paid to the organization includible under section 512 in computing the organization's unrelated business taxable income are subject to withholding under §§1.1441–1, 1.1441–4, and 1.1441–6 in the same manner as payments of the same amounts to any foreign person that is not a tax-exempt organization. Therefore, a foreign organization receiving amounts includible under section 512 in computing the organization's unrelated business taxable income may claim an exemption from withholding or a reduced rate of withholding with respect to that income in the same manner as a foreign person that is not a tax-exempt organization. See §1.1441–9(b)(3) for presumption that amounts are includible under section 512 in computing the organization's unrelated business taxable income in the absence of a reliable certification.

(b) *Income subject to tax under section 4948*—(1) *In general.* The gross investment income (as defined in section 4940(c)(2)) of a foreign private foundation is subject to withholding under section 1443(b) at the rate of 4 percent to the extent that the income is from sources within the United States and is subject to the tax imposed by section 4948(a) and the regulations under that section. Withholding under this paragraph (b) is required irrespective of the fact that the income may be effectively connected with the conduct of a trade or business in the United States by the foreign organization. See §1.1441–9(b)(3) for applicable presumptions that amounts are subject to tax under section 4948. The withholding imposed under this paragraph (b)(1) does not obviate a private foundation's obligation to file any return required by law with respect to such organization, such as the form that the foundation is required to file under section 6033 for the taxable year.

(2) *Reliance on a foreign organization's claim of foreign private foundation status.* For reliance by a withholding agent on a foreign organization's claim of foreign private foundation status, see §1.1441–9 (b) and (c).

(3) *Applicable procedures.* A withholding agent withholding the 4-percent amount pursuant to paragraph (b)(1) of this section shall treat such withholding as withholding under section 1441(a) or 1442(a) for all purposes, including reporting of the payment on a Form 1042 and a Form 1042–S pursuant to §1.1461–1 (b) and (c). Similarly, the foreign private foundation shall treat the 4-percent withholding as withholding under section 1441(a) or 1442(a), including for purposes of claims for refunds and credits.

(4) *Claim of benefits under an income tax treaty.* The withholding procedures applicable to claims of a reduced rate under an income tax treaty are governed solely by the provisions of §1.1441–6 and not by this section.

(c) *Effective date*—(1) *In general.* This section applies to payments made after December 31, 1999.

(2) *Transition rules.* For purposes of this section, the validity of an affidavit or opinion of counsel described in §1.1443–1(b)(4)(i) in effect prior to January 1, 2000 (see §1.1443–1(b)(4)(i) as contained in 26 CFR part 1, revised April 1, 1998) that is valid on December 31, 1998 is extended until December 31, 2000. However, a withholding agent may choose to not take advantage of the transition rule in this paragraph (c)(2) with respect to one or more withholding certificates valid under the regulations in effect prior to January 1, 2000 (see 26 CFR part 1, revised April 1, 1998) and, therefore, to require withholding certificates conforming to the requirements described in this section (new withholding certificates). For purposes of this section, a new withholding certificate is deemed to satisfy the documentation requirement under the regulations in effect prior to January 1, 2000 (see 26 CFR part 1, revised April 1, 1998). Further, a new withholding certificate remains valid for

the period specified in § 1.1441–1(e)(4)(ii), regardless of when the certificate is obtained.

[T.D. 8734, 62 FR 53466, Oct. 14, 1997, as amended by T.D. 8804, 63 FR 72186, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53466, Oct. 14, 1997, § 1.1443–1 was revised, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.1443–1 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.1443–1 Foreign tax-exempt organizations.

(a) *Income subject to section 511*—(1) *Taxable years beginning after December 31, 1966, and before January 1, 1970.* In the case of a foreign tax-exempt organization which is subject to the tax imposed by section 511, any rents paid to such organization in a taxable year beginning after December 31, 1966, and before January 1, 1970, which are includible under section 512 in determining its unrelated business taxable income, shall not be subject to withholding under § 1.1441–1. See paragraph (a)(2) of § 1.1441–4 for rules for claiming the exemption from withholding in the case of such rents.

(2) *Taxable years beginning after December 31, 1969.* In the case of a foreign tax-exempt organization which is subject to the tax imposed by section 511, any income received by such organization in a taxable year beginning after December 31, 1969, which is includible under section 512 in determining its unrelated business taxable income, shall be subject to withholding under § 1.1441–1 unless such income is, or may be expected to be, effectively connected with the conduct of a trade or business within the United States. See paragraph (a)(2) of § 1.1441–4 for rules for claiming the exemption from withholding in the case of such income.

(b) *Income subject to section 4948*— (1) *In general*—(i) *Application of withholding provisions.* Except as provided in subdivision (ii) of this subparagraph, in the case of a foreign private foundation which is subject to the tax imposed by section 4948(a) and the regulations thereunder, the withholding provisions of chapter 3 of the Code and the regulations thereunder shall apply with respect to the gross investment income (as defined in section 4940(c)(2)) of such foundation from sources within the United States (within the meaning of section 861 and the regulations thereunder) as if the excise tax imposed by section 4948(a) were a tax imposed by chapter 3 of the Code, except that the deduction and withholding shall be at the rate of 4 percent. The withholding requirements imposed by this paragraph are in addition to the requirements otherwise applicable to a withholding agent, such as the depositary requirements of section 6302 and the regulations thereunder. Similarly, the requirements of this paragraph do not obviate a private foundation's obligation to file any return required by law with respect to such an organization, such as the form the foundation is required to file under section 6033 for the taxable year.

(ii) *Special rule with respect to certain tax treaties.* Whenever there exists a tax treaty between the United States and a foreign country, and a foreign private foundation which is subject to the tax imposed by section 4948(a) and the regulations thereunder is a resident of such country or is otherwise entitled to the benefits of such treaty (whether or not such benefits are available to all residents), if the treaty provides that any item or items (or all items with respect to an organization exempt from income taxation) of gross investment income (within the meaning of section 4940(c)(2)) shall be exempt from income tax, the withholding provisions of chapter 3 of the Code and the regulations thereunder shall not apply to such item or items.

(2) *Return on Form 1042.* Every withholding agent required to deduct and withhold any amount by virtue of the provisions of this paragraph shall make a return of the amount required to be deducted and withheld by completing and filing a Form 1042 with the Internal Revenue Service in accordance with the instructions accompanying that form and submitting the balance due (if any). In addition, in any case in which any amount is so withheld, the withholding agent shall prepare and submit to the foreign private foundation one of the copies of the Form 1042S showing the tax withheld under this paragraph in addition to any tax otherwise shown on such form.

(3) *Claims for refund and credits.* Claims for refund of or credit for amounts overpaid shall be made on a Form 843 or 1042 or other appropriate form, which shall be filed with the Mid-Atlantic Service Center on or after January 1, 1973. Claims filed prior to January 1, 1973, shall be filed with the Director of International Operations. In determining whether a claim for refund is appropriate and, if appropriate, who should make the claim, the provisions of section 1464 and the regulations thereunder shall apply.

(4) *Identification of foreign private foundations; general rule.* (i) Except as provided in subparagraph (6) of this paragraph, where a foreign organization does not have a ruling or determination letter that it is an organization described in section 509(a) (1), (2), (3), or (4), any person required under section 1443(b) and this paragraph to deduct and withhold any tax imposed by section 4948(a) on such foreign organization (if it were a private foundation) shall not be liable for such tax if prior to the day on which the person deposits or pays to the Internal Revenue

Service any amount required to be withheld, such person has made a good faith determination that the foreign organization is an organization described in section 509(a) (1), (2), (3), or (4). For purposes of this subdivision, such a ‘‘good faith determination’’ ordinarily will be considered as made where the determination is based on an affidavit of the foreign organization or an opinion of counsel (of the withholding agent or the foreign organization) that the foreign organization is an organization described in section 509(a) (1), (2), (3), or (4). Such an affidavit or opinion must set forth sufficient facts concerning the operations and support of the foreign organization for the Internal Revenue Service to determine that such organization would be likely to qualify as an organization described in section 509(a) (1), (2), (3), or (4).

(ii) For special transitional rules relating to the identification of foreign private foundations, see subparagraph (5) of this paragraph.

(iii) Nothing in this paragraph relieves any foreign private foundation of the liability for the tax (including interest and penalties) imposed by section 4948(a).

(5) *Special transitional rules relating to identification of foreign private foundations.* (i) Any person required under section 1443(b) and this paragraph to deduct and withhold any tax imposed by section 4948(a) on any foreign organization for any period after December 31, 1969, and before the 90th day after publication of final regulations under section 508 in the FEDERAL REGISTER shall not be liable for such tax if such person receives a certified statement from the foreign organization prior to the day on which the person deposits or pays to the Internal Revenue Service any amount required to be withheld stating that either:

(a) Such foreign organization has properly filed the notice described in section 508(b) and the regulations thereunder and has not been notified by the Commissioner or his delegate by the 30th day after the day on which the notice is filed that such notice has failed to establish that such foreign organization is not a private foundation, or

(b) The presumption contained in section 508(b) does not apply to such foreign organization by reason of section 508(c) and the regulations thereunder.

(ii) If a certified statement described in subdivision (i) of this subparagraph is not received prior to the day on which a deposit or payment of any amount withheld in accordance with the provisions of this paragraph must be made by any person required to deduct and withhold any tax imposed by section 4948(a) with respect to any foreign organization, except as provided in subparagraph (4) of this paragraph such person shall be liable for all such tax imposed (including interest and penalties) for the period being returned by such person on Form 1042, to the extent that such person incurs liability to the foreign organization for gross investment income, as defined in section 4940(c)(2).

(iii) Any foreign organization to which section 508 by reason of section 4948(b) does not apply because such organization has received substantially all of its support (other than gross investment income, as defined in section 4940(c)(2)) from sources outside the United States may nevertheless receive the benefits of subdivision (i) of this subparagraph by following the procedure set forth in such subdivision.

(6) *Effect of notice by Internal Revenue Service concerning organization's statement.* Subparagraphs (4) and (5) of this paragraph shall have no effect with respect to a withholding agent as to a particular foreign organization on or after the earlier (i) the date on which such agent acquires knowledge that the Internal Revenue Service has given notice to such foreign organization that its notice or statement has failed to establish that it is not a private foundation, (ii) the date on which the Internal Revenue Service makes notice to the public that such foreign organization has failed to establish that it is not a private foundation, or (iii) the date on which the Internal Revenue Service makes notice to the public that such foreign organization is a private foundation.

[T.D. 7229, 37 FR 28157, Dec. 21, 1972, as amended by T.D. 7247, 38 FR 767, Jan. 4, 1973]

§1.1445–1 Withholding on dispositions of U.S. real property interests by foreign persons: In general.

(a) *Purpose and scope of regulations.* These regulations set forth rules relating to the withholding requirements of section 1445. In general, section 1445(a) provides that any person who acquires a U.S. real property interest from a foreign person must withhold a tax of 10 percent from the amount realized by the transferor foreign person (or a lesser amount established by agreement with the Internal Revenue Service). Section 1445(e) provides special rules requiring withholding on distributions and certain other transactions by corporations, partnerships, trusts, and estates. This §1.1445–1 provides general rules concerning the withholding requirement of sections 1445(a), as well as definitions applicable under both section 1445(a) and 1445(e). Section 1.1445–2 provides for various situations in which withholding is not required under section 1445(a). Section 1.1445–3 provides for adjustments to the amount required to be withheld by transferees under section 1445(a). Section 1.1445–4 prescribes the duties of agents in transactions subject to withholding under either section 1445(a) or 1445(e). Section 1.1445–5 provides rules concerning the withholding required under section 1445(e), while § 1.1445–6 provides for adjustments to the amount required to be withheld under section 1445(e). Finally, § 1.1445–7 provides rules concerning the treatment of a foreign corporation that has made an election under section 897(i) to be treated as a domestic corporation.

(b) *Duty to withhold*—(1) *In general.* Transferees of U.S. real property interests are required to deduct and withhold a tax equal to 10 percent of the amount realized by the transferor, if the transferor is a foreign person and the disposition takes place on or after January 1, 1985. Neither the transferee's duty to withhold nor the amount required to be withheld is affected by the amount of cash to be paid by the transferee. Amounts withheld must be reported and paid over in accordance with the requirements of paragraph (c) of this section. Failures to withhold and pay over are subject to the liabilities set forth in paragraph (e) of this section. If two or more persons are joint transferees of a U.S. real property interest, each such person is subject to the obligation to withhold. That obligation is fulfilled with respect to each such person if any one of them withholds and pays over the required amount in accordance with the rules of this section. If the amount realized (as defined in paragraph (g)(5) of this section) by the transferor is zero, then no withholding is required. For example, if a real property interest is transferred as a gift (i.e, the recipient does not assume any liabilities or furnish any other consideration to the transferor) then no withholding is required. Withholding is not required with respect to dispositions that takes place before January 1, 1985, even if the first payment of consideration is made after December 31, 1984.

(2) *U.S. real property interest owned jointly by foreign and non-foreign transferors.* The amount subject to withholding under paragraph (b)(1) of this section with respect to the transfer of a U.S. real property interest owned by one or more foreign persons (as defined in § 1.897–1(k)) and one or more non-foreign persons shall be determined by allocating the amount realized from the transfer between (or among) such transferors based upon the capital contribution of each transferor with respect to the property and by aggregating the amounts allocated to any foreign person (or persons). For this purpose, a husband and wife will each be deemed to have contributed 50 percent of the aggregate capital contributed by such husband and wife. See § 1.1445–1(f)(3)(iv) with respect to the crediting of the amount withheld between or among joint foreign transferors.

(3) *Options to acquire a U.S. real property interest*—(i) *No withholding on grant of option.* No withholding is required under section 1445 with respect to any amount realized by the grantor on the grant of an option to acquire a U.S. real property interest.

(ii) *No withholding upon lapse of option.* No withholding is required under section 1445 with respect to any amount realized by the grantor upon the lapse of an option to acquire a U.S. real property interest.

(iii) *Withholding required upon the sale or exchange of option.* A transferee of an option to acquire a U.S. real property interest must deduct and withhold a tax equal to 10 percent of the amount realized by the transferor upon the disposition. This § 1.1445–1(b)(3)(iii) does not apply to require withholding upon the initial grant of an option.

(iv) *Withholding required on exercise of option.* If the holder exercises an option to purchase a U.S. real property interest, the amount paid for the option shall be considered an amount realized by the grantor/transferor upon the transfer of the property with respect to which the option was granted, and shall thus be subject to withholding on the day that such underlying property is transferred. The preceding sentence applies regardless of whether or not the terms of the option specifically provide that the option price is applied to the purchase price.

(4) Exceptions and modifications. The duty to withhold under section 1445(a) is subject to the exceptions and modifications contained in §§ 1.1445–2 and

1.1445–3. Generally, §1.1445–2 provides rules for determining that withholding is not required because either the transferor is not a foreign person or the interest transferred is not a U.S. real property interest. In addition, §1.1445–2 provides exceptions to the withholding requirement, including a rule that exempts from withholding any person who acquires a U.S. real property interest for use as a residence for a contract price of $300,000 or less. If withholding is required under section 1445(a), §1.1445–3 allows the amount withheld to be modified pursuant to a withholding certificate issued by the Internal Revenue Service. If a transferee cannot withhold the full amount required because the first payment of consideration for the transfer does not involve sufficient cash (or other liquid assets convertible into cash, such as foreign currency), then a withholding certificate must be obtained pursuant to §1.1445–3.

(c) *Reporting and paying over of withheld amounts*—(1) *In general.* A transferee must report and pay over any tax withheld by the 20th day after the date of the transfer. Forms 8288 and 8288–A are used for this purpose, and must be filed with the Internal Revenue Service Center, Philadelphia, PA, 19255. Pursuant to section 7502 and regulations thereunder, the timely mailing of Forms 8288 and 8228–A will be treated as their timely filing. Form 8288–A will be stamped by the IRS to show receipt, and a stamped copy will be mailed by the IRS to the transferor (at the address reported on the form) for the transferor's use. See §§1.1445–1(f) and 1.1445–3(f).

(2) *Pending application for withholding certificate*—(i) *In general. (A) Delayed reporting and payment with respect to application submitted by transferee.* If an application for a withholding certificate with respect to a transfer of a U.S. real property interest is submitted to the Internal Revenue Service by the transferee on the day of or at any time prior to the transfer, the transferee must withhold 10 percent of the amount realized as required by paragraph (b) of this section. However, the amount withheld, or a lesser amount as determined by the Service, need not be reported and paid over to the Service until the 20th day following the Service's final determination with respect to the application for a withholding certificate. For this purpose, the Service's final determination occurs on the day when the withholding certificate is mailed to the transferee by the Service or when a notification denying the request for a withholding certificate is mailed to the transferee by the Service. An application is submitted to the Service on the day it is actually received by the Service at the address provided in §1.1445–1(g)(10) or, under the rules of section 7502, on the day it is mailed to the Service at the address provided in §1.1445–1(g)(10).

(B) *Delayed reporting and payment with respect to application submitted by transferor.* If an application for a withholding certificate with respect to a transfer of a U.S. real property interest is submitted to the Internal Revenue Service by the Transferor on the day of or any time prior to the transfer, such transferor must provide notice to the transferee prior to the transfer. No particular form is required but the notice must set forth the name, address, and taxpayer identification number, if any, of the transferor, a brief description of the property which is the subject of the application, and the date the application was submitted to the Service. The transferee must withhold 10 percent of the amount realized as required in paragraph (b) of this section but need not report or pay over to the Service such amount (or a lesser amount as determined by the Service) until the 20th day following the Service's final determination with respect to the application. The Service will send a copy of the withholding certificate or copy of the notification denying the request for a withholding certificate to the transferee. For this purpose, the Service's final determination will be deemed to occur on the day when the copy of the withholding certificate or the copy of the notification denying the request for a withholding certificate is mailed by the Service to the transferee (or transferees). An application is submitted to the Service on the day it is actually received by the Service at the address provided in §1.1445–1(g)(10) or, under the rules of §7502, on the day it is mailed to the Service at the address provided in § 1.1445–1(g)(10).

(ii) *Anti-abuse rule*—(A) *In general.* A transferee that in reliance upon the rules of this paragraph (c)(2) fails to report and pay over amounts withheld by the 20th day following the date of the transfer, shall be subject to the payment of interest and penalties if the relevant application for a withholding certificate (or an amendment to the application for a withholding certificate) was submitted for a principal purpose of delaying the transferee's payment to the IRS of the amount withheld. Interest and penalties shall be assessed on the amount that is ultimately paid over (or collected pursuant to the agreement) with respect to the period between the 20th day after the date of the transfer and the date on which payment is made (or collected).

(B) *Presumption.* A principal purpose of delaying payment of the amount withheld shall be presumed if—

(*1*) The transferee applies for a withholding certificate pursuant to § 1.1445–3(c) based on a determination of the transferor's maximum tax liability, and

(*2*) Such liability is ultimately determined to be equal to 90 percent or more of the amount that was otherwise required to be withheld and paid over. However, the presumption created by the previous sentence may be rebutted by evidence establishing that delaying payment of the amount withheld was not a principal purpose of the transaction.

(d) *Contents of Forms 8288 and 8288–A*—(1) *Transactions subject to section 1445(a).* Any person that is required to file Forms 8288 and 8288–A pursuant to section 1445(a) and the rules of this section must set forth thereon the following information:

(i) The name, identifying number (if any), and home address (in the case of an individual) or office address (in the case of any entity) of the transferee(s) filing the return;

(ii) The name, identifying number (if any), and home address (in the case of an individual) or office address (in the case of any entity) of the transferor(s);

(iii) A brief description of the U.S. real property interest transferred, including its location and the nature of any substantial improvements in the case of real property, and the class or type and amount of interests transferred in the case of interests in a corporation that constitute U.S. real property interests;

(iv) The date of the transfer;

(v) The amount realized by the transferor, as defined in paragraph (g)(5) of this section;

(vi) The amount withheld by the transferee and whether withholding is at the statutory or reduced rate; and

(vii) Such other information as the Commissioner may require.

For purposes of paragraph (d)(1) (i) and (ii), mailing addresses may be provided in addition to, but not in lieu of, home addresses or office addresses.

(2) *Transactions subject to section 1445(e).* Any person that is required to file Forms 8288 and 8288–A pursuant to the rules of § 1.1445–5 must set forth thereon the following information:

(i) The name, identifying number (if any), and office address of the entity or fiduciary filing the return;

(ii) The amount withheld by the entity or fiduciary;

(iii) The date of the transfer;

(iv) In the case of a transaction subject to withholding pursuant to section 1445(e)(1) and § 1.1445–5(c):

(A) A brief description of the U.S. real property interest transferred, as described in paragraph (d)(1)(iii) of this section;

(B) The name, identifying number (if any), and home address (in the case of an individual) or office address (in the case of an entity) of each holder of an interest in the entity that is a foreign person; and

(C) Each such interest-holder's pro rata share of the amount withheld;

(v) In the case of a distribution subject to withholding pursuant to section 1445(e)(2) and § 1.1445–5(d):

(A) A brief description of the U.S. real property interest transferred, as described in paragraph (d)(1)(iii) of this section; and

(B) The amount of gain recognized upon the distribution by the corporation.

(vi) In the case of a distribution subject to withholding pursuant to section 1445(e)(3) and § 1.1445–5(e):

(A) A brief description of the property distributed by the corporation;

(B) The name, identifying number (if any), and home address (in case of an individual) or office address (in the case of an entity) of each holder of an interest in the entity that is a foreign person;

(C) The amount realized upon the distribution by each such foreign interest holder; and

(D) Each foreign interest-holder's pro rata share of the amount withheld; and

(vii) Such other information as the Commissioner may require.

(e) *Liability of transferee upon failure to withhold*—(1) *In general.* Every person required to deduct and withhold tax under section 1445 is made liable for that tax by section 1461. Therefore, a person that is required to deduct and withhold tax but fails to do so may be held liable for the payment of the tax and any applicable penalties and interest.

(2) *Transferor's liability not otherwise satisfied*—(i) *Tax and penalties.* Except as provided in paragraph (e)(3) of this section, if a transferee is required to deduct and withhold tax under section 1445 but fails to do so, then the tax shall be assessed against and collected from that transferee. Such person may also be subject to any of the civil and criminal penalties that apply. Corporate officers or other responsible persons may be subject to a civil penalty under section 6672 equal to the amount that should have been withheld and paid over.

(ii) *Interest.* If a transferee is required to deduct and withhold tax under section 1445 but fails to do so, then such transferee shall be liable for the payment of interest pursuant to section 6601 and the regulations thereunder. Interest shall be payable with respect to the period between—

(A) The last date on which the tax imposed under section 1445 was required to be paid over by the transferee, and

(B) The date on which such tax is actually paid. Interest shall be payable with respect to the entire amount that is required to be deducted and withheld. However, if the Service issues a withholding certificate providing for withholding of a reduced amount, then, for the period after the issuance of the certificate, interest shall be payable with respect to that reduced amount.

(3) *Transferor's liability otherwise satisfied*—(i) *Tax and penalties.* If a transferee is required to deduct and withhold tax under section 1445 but fails to do so, and the transferor's tax liability with respect to the transfer was satisfied (or was established to be zero) by—

(A) The transferor's filing of an income tax return (and payment of any tax due) with respect to the transfer, or

(B) The issuance of a withholding certificate by the Internal Revenue Service establishing that the transferor's maximum tax liability is zero,

then the tax required to be withheld under section 1445 shall not be collected from the transferee. Such transferee's liability for tax, and the requirement that such person file Forms 8288 and 8288–A, shall be deemed to have been satisfied as of the date on which the transferor's income tax return was filed or the withholding certificate was issued. No penalty shall be imposed on or collected from such person for failure to return or pay the tax, unless such failure was fraudulent and for the purpose of evading payment. A transferee that seeks to avoid liability for tax and penalties pursuant to the rule of paragraph (e)(3)(i) must provide sufficient information for the Service to determine whether the transferor's tax liability was satisfied (or was established to be zero).

(ii) *Interest.* If a transferee is required to deduct and withhold tax under section 1445 but fails to do so, then such person shall be liable for the payment of interest under section 6601 and regulations thereunder. Such transferee's liability for the payment of interest shall not be excused by reason of the deemed satisfaction, pursuant to subdivision (i) of this paragraph (e)(3), of the transferee's liability under section 1445, because the deemed satisfaction of that liability is the equivalent of the late payment of a liability, on which interest must be paid. Interest shall be payable with respect to the period between—

(A) The last date on which the tax imposed under section 1445 was required to be paid over, and

(B) The date (established from information supplied to the Service by the transferee) on which any tax due is paid with respect to the transferor's relevant income tax return, or the date the withholding certificate is issued establishing that the transferor's maximum tax liability is zero.

Interest shall be payable with respect to the entire amount that is required to be deducted and withheld. However, if the Service issues a withholding certificate providing for withholding of a reduced amount, then for the period after the issuance of the certificate interest shall be payable with respect to that reduced amount.

(4) *Coordination with entity with holding rules.* For purposes of section 1445(e) and §§ 1.1445–5, 1.1445–6, 1.1445–7, and 1.1445–8T, the rules of this paragraph (e) shall be applied by—

(i) Substituting the words ''person required to withhold'' for the word ''transferee'' each place it appears in this paragraph (e), and

(ii) Substituting the words ''person subject to withholding'' for the word ''transferor'' each place it appears in this paragraph (e).

(f) *Effect of withholding on transferor*—(1) *In general.* The withholding of tax under section 1445(a) does not excuse a foreign person that disposes of a U.S. real property interest from filing a U.S. tax return with respect to the income arising from the disposition. Form 1040NR, 1041, or 1120F, as appropriate, must be filed, and any tax due must be paid, by the filing deadline generally applicable to such person. (The return may be filed by such later date as is provided in an extension granted by the Internal Revenue Service.) Any tax withheld under section 1445(a) shall be credited against the amount of income tax as computed in such return.

(2) *Manner of obtaining credit or refund.* A stamped copy of Form 8288–A will be provided to the transferor by the Service (under paragraph (c) of this section), and must be attached to the transferor's return to establish the amount withheld that is available as a credit. If the amount withheld under section 1445(a) constitutes less than the full amount of the transferor's U.S. tax liability for that taxable year, then a payment of estimated tax may be required to be made pursuant to section 6154 or 6654 prior to the filing of the income tax return for that year. Alternatively, if the amount withheld under section 1445(a) exceeds the transferor's maximum tax liability with respect to the disposition (as determined by the IRS), then the transferor may seek an early refund of the excess pursuant to § 1.1445–3(g), or a normal refund upon the filing of a tax return.

(3) *Special rules*—(i) *Failure to receive Form 8288–A.* If a stamped copy of Form 8288–A has not been provided to the transferor by the Service, the transferor may establish the amount of tax withheld by the transferee by attaching to its return substantial evidence (*e.g.*, closing documents) of such amount. Such a transferor must attach to its return a statement which supplies all of the information required by § 1.1445–1(d) (except such information that was not obtained after a diligent effort).

(ii) *U.S. persons subjected to withholding.* If a transferee withholds tax under section 1445(a) with respect to a person who is not a foreign person, such person may credit the amount of any tax withheld against his income tax liability in accordance with the provisions of this § 1.1145–1(f) or apply for an early refund under §1.1445–3(g).

(iii) *Refund in case of installment sale.* A transferor that takes gain into account in accordance with the provisions of section 453 shall not be entitled to a refund of the amount withheld, unless a withholding certificate providing for such a refund is obtained from the Internal Revenue Service pursuant to the provisions of § 1.1445–3.

(iv) *Joint foreign transferors.* If two or more foreign persons jointly transfer a U.S. real property interest, each transferor shall be credited with such portion of the amount withheld as such transferors mutually agree. Such transferors must request that the transferee reflect the agreed-upon crediting of the amount withheld on the Forms 8288–A filed by the transferee. If the foreign transferors fail to request that the transferee reflect the agreed-upon crediting of the amount withheld by the 10th day after the date of transfer, the transferee must credit the amount withheld equally between (or among) the foreign transferors. In such case, the transferee is indemnified pursuant to section 1461 against any claim by a transferor objecting to the resulting division of credits. For rules regarding the amount realized allocated to joint foreign and non-foreign transferors, see §1.1445–1(b)(2).

(g) *Definitions*—(1) *In general.* Unless otherwise specified, the definitions of terms provided in §1.897–1 shall apply for purposes of this section and §§1.1445–2 through 1.1445–7. For purposes of section 1445 and the regulations thereunder, definitions of other relevant terms are provided in this paragraph (g). In addition, the term ''residence'' is defined in 1.1445–2(d)(1), the terms ''transferor's agent'' and ''transferee's agent'' are defined in 1.1445–4(f), and the term ''relevant taxpayer'' is defined in 1.1445–6(a)(2).

(2) *Transfer.* The term ''transfer'' means any transaction that would constitute a disposition for any purpose, of the Internal Revenue Code and regulations thereunder. For purposes of §§1.1445–5 and 1.1445–6, the term includes distribution to shareholders of a corporation, partners of a partnership and beneficiaries of a trust or estate.

(3) *Transferor.* The term ''transferor'' means any person, foreign or domestic, that disposes of a U.S. real property interest by sale, exchange, gift, or any other transfer. The term ''U.S. real property interest'' is defined in §1.897–1(c).

(4) *Transferee.* The term ''transferee'' means any person, foreign or domestic, that acquires a U.S. real property interest by purchase, exchange, gift, or any other transfer.

(5) *Amount realized.* The amount realized by the transferor for the transfer of a U.S. real property interest is the sum of.

(i) The cash paid, or to be paid.

(ii) The fair market value of other property transferred, or to be transferred, and

(iii) The outstanding amount of any liability assumed by the transferee or to which the U.S. real property interest is subject immediately before and after the transfer.

The term ''cash paid or to be paid'' does not include stated or unstated interest or original issue discount (as determined under the rules of sections 1271 through 1275).

(6) *Contract price.* The contract price of a U.S. real property interest is the sum that is agreed to by the transferee and transferor as the total amount of consideration to be paid for the property. That amount will generally be equal to the amount realized by the transferor, as defined in paragraph (b)(5) of this section.

(7) *Fair market value.* The fair market value of property means the price at which the property would change hands between an unrelated willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts.

(8) *Date of transfer.* The date of transfer of a U.S. real property interest is the first date on which consideration is paid (or a liability assumed) by the transferee. However, for purposes of section 1445(e) (2), (3), and (4) and §§1.1445–5(c)(1)(iii) and 1.1445–5(c)(3) only, the date of transfer is the date of the distribution that gives rise to the obligation to withhold. For purposes of this paragraph (g)(8), the payment of consideration does not include the payment, prior to the passage of legal or equitable title (other than pursuant to an initial contract for purchase), of earnest money, a good-faith deposit, or any similar sum that is primarily intended to bind the transferee or transferor to the entering or performance of a contract. Such a payment will not constitute a payment of consideration solely because it may ultimately be applied against the amount owed to the transferor by the transferee. Such a payment is presumed to be earnest money, a good faith deposit, or a similar sum if it is subject to forfeiture in the event of a failure to enter into a contract or a breach of contract. However, a payment that is not forefeitable may nevertheless be found to constitute earnest money, a good faith deposit, or a similar sum.

(9) *Identifying number.* Pursuant to §1.897–1(p), an individual's identifying number is the social security number (or the identification numbers assigned by the Internal Revenue Service). The identifying number of any other person

is its United States employer identification number.

(10) *Address of the Assistant Commissioner International.* Any written communication directed to the Assistant Commissioner (International) is to be addressed as follows: Director, Philadelphia Service Center; 11601 Roosevelt Blvd.; Philadelphia, PA 19255; ATTN: Drop Point 543X.

[T.D. 8113, 51 FR 46629, Dec. 24, 1986; 52 FR 3796, 3916, Feb. 6, 1987, as amended by T.D. 8647, 60 FR 66076, Dec. 21, 1995]

§ 1.1445–2 Situations in which withholding is not required under section 1445(a).

(a) *Purpose and scope of section.* This section provides rules concerning various situations in which withhold is not required under section 1445(a). In general, a transferee has a duty to withhold under section 1445(a) only if both of the following are true:

(1) The transferor is a foreign person; and

(2) The transferee is acquiring a U.S. real property interest.

Thus, paragraphs (b) and (c) of this section provide rules under which a transferee of property can ascertain that he has no duty to withhold because one or the other of the two key elements is missing. Under paragraph (b), a transferee may determine that no withholding is required because the transferor is not a foreign person. Under paragraph (c), a transferee may determine that no withholding is required because the property acquired is not a U.S. real property interest. Finally, paragraph (d) of this section provides rules concerning exceptions to the withholding requirement.

(b) *Transferor not a foreign person*—(1) *In general.* No withholding is required under section 1445 if the transferor of a U.S. real property interest is not a foreign person. Therefore, paragraph (b)(2) of this section provides rules pursuant to which the transferor can provide a certification of non-foreign status to inform the transferee that withholding is not required. A transferee that obtains such a certification must retain that document for five years, as provided in paragraph (b)(3) of this section. Except to the extent provided in paragraph (b)(4) of this section, the obtaining of this certification excuses the transferee from any liability otherwise imposed by section 1445 and § 1.1445–1(e). However, section 1445 and the rules of this section do not impose any obligation upon a transferee to obtain a certification from the transferor, thus, a transferee may instead rely upon other means to ascertain the non-foreign status of the transferor. If, however, the transferee relies upon other means and the transferor was, in fact, a foreign person, then the transferee is subject to the liability imposed by section 1445 and § 1.1445–1(e).

A transferee is in no event required to rely upon other means to ascertain the non-foreign status of the transferor and may demand a certification of non-foreign status. If the certification is not provided, the transferee may withhold tax under section 1445 and will be considered, for purposes of sections 1461 through 1463, to have been required to withhold such tax.

(2) *Transferor's certification of non-foreign status*—(i) *In general.* A transferee of a U.S. real property interest is not required to withhold under section 1445(a) if, prior to or at the time of the transfer, the transferor furnishes to the transferee a certification that—

(A) States that the transferor is not a foreign person.

(B) Sets forth the transferor's name, identifying number and home address (in the case of an individual) or office address (in the case of an entity), and

(C) Is signed under penalties of perjury.

In general, a foreign person is a nonresident alien individual, foreign corporation, foreign partnership, foreign trust, or foreign estate, but not a resident alien individual. In this regard, see § 1.897–1(k). However, a foreign corporation that has made a valid election under section 897(i) is generally not treated as a foreign person for purposes of section 1445. In this regard, see § 1.1445–7. Pursuant to § 1.897–1(p), an individual's identifying number is the individual's Social Security number and any other person's identifying number is its U.S. employer identification number. A certification pursuant to this paragraph (b) must be vertified as true and signed under penalties of perjury by a responsible officer in the case of a corporation, by a general partner in the case of a partnership, and by a trustee, executor, or equivalent fiduciary in the case of a trust or estate. No particular form is needed for a certification pursuant to this paragraph (b), nor is any particular language required, so long as the document meets the requirements of this paragraph (b)(2)(i). Samples of acceptable certifications are provided in paragraph(b)(2)(iii) of this section.

(ii) *Foreign corporation that ''has made election under section 897(i).* A foreign corporation that has made a valid election under section 897(i) to be treated as a domestic corporation for purposes of section 897 may provide a certification of non-foreign status pursuant to this paragraph (b)(2). However, an electing foreign corporation must attach to such certification a copy of the acknowledgment of the election provided to the corporation by the Internal Revenue Service pursuant to §1.897–3(d)(4).

An acknowledgment is valid for this purpose only if it states that the information required by §1.897–3 has been determined to be complete.

(iii) *Sample certifications*—(A) *Individual transferor.*

''Section 1445 of the Internal Revenue Code provides that a transferee (buyer) of a U.S. real property interest must withhold tax if the transferor (seller) is a foreign person. To inform the transferee (buyer) that withholding of tax is not required upon my disposition of a U.S. real property interest, I, [*name of transferor*], hereby certify the following:

1. I am not a nonresident alien for purposes of U.S. income taxation;

2. My U.S. taxpayer identifying number [Social Security number] is _______; and

3. My home address is:

____

____

I understand that this certification may be disclosed to the Internal Revenue Service by the transferee and that any false statement I have made here could be punished by fine, imprisonment, or both.

Under penalties of perjury I declare that I have examined this certification and to the best of my knowledge and belief it is true, correct, and complete. [Signature and Date]''

(B) *Entity transferor.*

''Section 1445 of the Internal Revenue Code provides that a transferee of a U.S. real property interest must withhold tax if the transferor is a foreign person. To inform the transferee that withholding of tax is not required upon the disposition of a U.S. real property interest by [*name of transferor*], the undersigned hereby certifies the following on behalf of [*name of transferor*]:

1. [*Name of transferor*] is not a foreign corporation, foreign partnership, foreign trust, or foreign estate (as those terms are defined in the Internal Revenue Code and Income Tax Regulations]:

2. [*Name of transferor*]'s U.S. employer identification number is _______, and

3. [*Name of transferor*]'s office address is

____

[*Name of transferor*] understands that this certification may be disclosed to the Internal Revenue Service by transferee and that any false statement contained herein could be punished by fine, imprisonment or both.

Under penalties of perjury I declare that I have examined this certification and to the best of my knowledge and belief it is true, correct and complete, and I further declare that I have authority to sign this document on behalf of [*name of transferor*].

[Signature and date]

[Title _______]

(3) *Transferee must retain certification.* If a transferee obtains a transferor's certification pursuant to the rules of this paragraph (b), then the transferee must retain that certification until the end of the fifth taxable year following the taxable year in which the transfer takes place. The transferee must retain the certification, and make it avaliable to the Internal Revenue Service when requested in accordance with the requirements of section 6001 and regulations thereunder.

(4) *Reliance upon certification not permitted*—(i) *In general.* A transferee may not rely upon a transferor's certification pursuant to this paragraph (b) under the circumstances set forth in either subdivision (ii) or (iii) of this paragraph (b)(4). In either of those circumstances, a transferee's withholding obligation shall apply as if a certification had never been obtained, and the transferee is fully liable pursuant to section 1445 and §1.1445–1(e) for any failure to withhold.

(ii) *Failure to attach IRS acknowledgment of election.* A transferee that knows that the transferor is a foreign corporation may not rely upon a certification of non-foreign status provided by the corporation on the basis of election under section 897(i), unless there is attached to the certification a copy of the acknowledgment by the Internal Revenue Service of the corporation's election, as required by paragraph (b)(2)(ii) of this section.

(iii) *Knowledge of falsity.* A transferee is not entitled to rely upon a transferor's certification if prior to or at the time of the transfer the transferee either—

(A) Has actual knowledge that the transferor's certification is false; or

(B) Receives a notice that the certification is false from a transferor's or transferee's agent, pursuant to §1.1445–4.

(iv) *Belated notice of false certification.* If after the date of the transfer a transferee receives a notice that a certification is false, then that transferee is entitled to rely upon the certification only with respect to consideration that was paid prior to receipt for the notice. Such a transferee is required to withhold a full 10 percent of the amount realized from the consideration that remains to be paid to the transferor if possible. Thus, if 10 percent or more of the amount reailzed remains to be paid to the transferor then the transferee is required to withhold and pay over the full 10 percent. The transferee must do so by withholding and paying over the entire amount of each successive payment of consideration to the transferor until the full 10 percent of the amount realized has been withheld and paid over. Amounts so withheld must be reported and paid over by the 20th day following the date on which each such payment of consideration is made. A transferee that is subject to the rules of this paragraph (b)(4)(iv) may not obtain a withholding certificate pursuant to §1.1445–3, but must instead withhold and pay over the amounts required by this paragraph.

(c) *Transferred property not a U.S. real property interest*—(1) *In general.* No withholding is required under section 1445 if the transferee acquires only property that is not a U.S. real property interest. As defined in section 897(c) and §1.897–1(c), a U.S. real property interest includes certain interests in U.S. corporations, as well as direct interests in real property and certain associated personal property. This paragraph (c) provides rules pursuant to which a person acquiring an interest in a U.S. corporation may determine that withholding is not required because that interest is not a U.S. real property interest. To determine whether an interest in tangible property constitutes a U.S. real property interest the acquisition of which would be subject to withholding, see §1.897–1 (b) and (c).

(2) *Interests in publicly traded entities.* No withholding is required under section 1445(a) upon the acquisition of an interest in a domestic corporation if any class of stock of the corporation is regularly traded on an established securities market.

This exemption shall apply if the disposition is incident to an initial public offering of stock pursuant to a registration statement filed with the Securities and Exchange Commission. Similarly, no withholding is required under section 1445(a) upon the acquisition of an interest in a publicly traded partnership or trust. However, the rule of this paragraph (c)(2) shall not apply to the acquisition, from a single transferor in a single (or related transferors (as defined in §1.897–1(i)) transaction (or related transactions), of an interest described in §1.897–1(c)(2)(iii)(B) (relating to substantial amounts of non-publicly traded interests in publicly traded corporations) or to similar interests in publicly traded partnerships or trusts. The person making an acquisition described in the preceding sentence must otherwise determine whether withholding is required, pursuant to section 1445 and the regulations thereunder. Transactions shall be deemed to be related if they are undertaken within 90 days of one another or if it can otherwise be shown that they were undertaken in pursuance of a prearranged plan.

(3) *Transferee receives statement that interest in corporation is not a U.S. real property interest*—(i) *In general.* No withholding is required under section 1445(a) upon the acquisition of an interest in a domestic corporation, if the tranferor provides the transferee with a copy of a statement, issued by the corporation pursuant to §1.897–2(h), certifying that the interest is not a U.S. real property interest. In general,

a corporation may issue such a statement only if the corporation was not a U.S. real property holding corporation at any time during the previous five years (or the period in which the interest was held by its present holder, if shorter) or if interests in the corporation ceased to be United States real property interests under section 897(c)(1)(B). (A corporation may not provide such a statement based on its determination that the interest in question is an interest solely as a creditor). See §1.897–2 (f) and (h). The corporation may provide such a statement directly to the transferee at the transferor's request. The transferor must request such a statement prior to the transfer, and shall, to the extent possible, specify the anticipated date of the transfer. A corporation's statement may be relied upon for purposes of this paragraph (c)(3) only if the statement is dated not more than 30 days prior to the date of the transfer. A transferee may also rely upon a corporation's statement that is voluntarily provided by the corporation in response to a request from the transferee, if that statement otherwise complies with the requirements of this paragraph (c)(3) and §1.897–2(h).

(ii) *Reliance on statement not permitted.* A transferee is not entitled to rely upon a statement that a corporation is not a U.S. real property holding corporation if, prior to or at the time of the transfer, the transferee either—

(A) Has actual knowledge that the statement is false, or

(B) Receives a notice that the statement is false from a transferor's or transferee's agent, pursuant to §1.1445–4.

Such a transferee's withholding obligations shall apply as if a statement had never been given, and such a transferee may be held fully liable pursuant to §1.1445–1(e) for any failure to withhold.

(iii) *Belated notice of false statement.* If after the date of the transfer, a transferee receives notice that a statement provided under §1.1445–2(c)(3)(i) (that an interest in a corporation is not a U.S. real property interest) is false, then such transferee may rely on the statement only with respect to consideration that was paid prior to the receipt of the notice. Such a transferee is required to withhold a full 10 percent of the amount realized from the consideration that remains to be paid to the transferor, if possible. Thus, if 10 percent or more of the amount realized remains to be paid to the transferor, then the transferee is required to withhold and pay over the full 10 percent. The transferee must do so by withholding and paying over the entire amount of each successive payment of consideration to the transferor, until the full 10 percent of the amount realized has been withheld and paid over. Amounts so withheld must be reported and paid over by the 20th day following the date on which each such payment of consideration is made. A transferee that is subject to the rules of this §1.1445–2(c)(3)(iii) may not obtain a withholding certificate pursuant to §1.1445–3, but must instead withhold and pay over the amounts required by this paragraph.

(d) *Exceptions to requirement of withholding*—(1) *Purchase of residence for $300,000 or less.* No withholding is required under section 1445(a) if one or more individual transferees acquire a U.S. real property interest for use as a residence and the amount realized on the transaction is $300,000 or less. For purposes of this section, a U.S. real property interest is acquired for use as a residence if on the date of the transfer the transferee (or transferees) has definite plans to reside at the property for at least 50 percent of the number of days that the property is used by any person during each of the first two 12-month periods following the date of the transfer. The number of days that the property will be vacant is not taken into account in determining the number of days such property is used by any person. A transferee shall be considered to reside at a property on any day on which a member of the transferee's family, as defined in section 267(c)(4), resides at the property. No form or other document need be filed with the Internal Revenue Service to establish a transferee's entitlement to rely upon the exception provided by this paragraph (d)(1). A transferee who fails to withhold in reliance upon this exception, but who does not in fact reside at the property for the minimum number of days set forth above, shall be liable for the failure to withhold (if the transferor was a foreign person and did not pay the full U.S. tax due on any gain recognized upon the transfer). However, if the transferee establishes that the failure to reside the minimum number of days was caused by a change in circumstances that could not reasonably have been anticipated at the time of the transfer, then the transferee shall not be liable for the failure to withhold.

The exception provided by paragraph (d)(1) does not apply in any case where the transferee is other than an individual even if the property is acquired for or on behalf of an individual who will use the property as a residence. However, this exception applies regardless of the organizational structure of the transferor (i.e., regardless of whether the transferor is an individual, partnership, trust, corporation, etc.).

(2) *Coordination with nonrecognition provisions*—(i) *In general.* A transferee shall not be required to withhold under section 1445(a) with respect to the transfer of a U.S. real property interest if—

(A) The transferor notifies the transferee, in the manner described in paragraph (d)(2)(iii) of this section, that by reason of the operation of a nonrecognition provision of the Internal Revenue Code or the provisions of any United States treaty the transferor is not required to recognize any gain or loss with respect to the transfer, and

(B) By the 20th day after the date of the transfer the transferee provides a copy of the transferor's notice to the Assistant Commissioner (International), at the address provided in § 1.1445–1(g)(10), together with a cover letter setting forth the name, identifying number (if any), and home address (in the case of an individual) or office address (in the case of an entity) of the transferee providing the notice to the Service. The rule of this paragraph (d)(2)(i) is subject to the exceptions set forth in paragraph (d)(2)(ii). For purposes of this paragraph (d)(2) a nonrecognition provision is any provision of the Internal Revenue Code for not recognizing gain or loss.

(ii) *Exceptions.* A transferee may not rely upon the rule of paragraph (d)(2)(i) of this section, and must therefore withhold under section 1445(a) with respect to the transfer of a U.S. real property interest, if either:

(A) The transferor qualifies for nonrecognition treatment with respect to part, but not all, of the gain realized by the transferor upon the transfer, or

(B) The transferee knows or has reason to know that the transferor is not entitled to the nonrecognition treatment claimed by the transferor.

In either of the above circumstances the transferee or transferor may request a withholding certificate from the Internal Revenue Service pursuant to the rules of § 1.1445–3.

(3) *Special procedural rules applicable to foreclosures*—(i) *Amount to be withheld*—(A) *foreclosures.* A transferee that acquires a U.S. real property interest pursuant to a repossession or foreclosure on such property under a mortgage, security agreement, deed of trust or other instrument securing a debt must withhold tax under section 1445(a) equal to 10 percent of the amount realized on such sale. Such amount must be reported and paid over to the Service under the general rules of § 1.1445–1. However, if the transferee complies with the notice requirements of § 1.1445–2(d)(3) (ii) and (iii), such transferee may report and pay over to the Service on or before the 20th day following the final determination by a court or trustee with jurisdiction over the foreclosure action, the lesser of:

(*1*) The amount otherwise required to be withheld under section 1445(a), or

(*2*) The ''alternative amount'' as defined in the succeeding sentence. The alternative amount is the entire amount, if any, determined by a court or trustee with jurisdiction over the matter, that accrues to the debtor/transferor out of the amount realized from the foreclosure sale. The amount of any mortgage, lien, or other security agreement secured by the property, that is terminated, assumed by another person, or otherwise extinguished (as to the debtor/transferor) shall not be treated as an amount that accrues to the debtor/transferor for purposes of this § 1.1445–2(d)(3)(i)(A). If the alternative amount is zero, no withholding is required. Any difference between the amount withheld at the time of the foreclosure sale and the amount to be reported and paid over to the Service must be transferred to the court or trustee with jurisdiction over the foreclosure action. Amounts withheld, if any, are to be reported and paid to the Service by using Forms 8288 and 8288–A in conformity with §1.1445–1(d).

(B) *Deeds in lieu of foreclosures.* A transferee of a U.S. real property interest pursuant to a deed in lieu of foreclosure must withhold tax equal to 10 percent of the amount realized by the debtor/transferor on the transfer. However, no withholding is required if:

(*1*) The transferee is the only person with a security interest in the property,

(*2*) No cash or other property (other than incidental fees incurred with respect to the transfer) is paid, directly or indirectly, to any person with respect to the transfer, and

(*3*) The notice requirement of §1.1445–2(d)(3) are satisfied.

The amount withheld, if any, must be reported and paid over to the Service not later than the 20th day following the date of transfer. In a case where withholding would otherwise be required, a withholding certificate may be requested in accordance with §1.1445–3.

(ii) *Notice to the court or trustee in a foreclosure action*—(A) *Notice on day of purchase.* A transferee in a foreclosure sale that chooses to use the special rules applicable to foreclosures must provide notice to the court or trustee with jurisdiction over the foreclosure action on the day the property is transferred with respect to such transferee's withholding obligation. No particular form is necessary but the notice must set forth the transferee's name, home address in the case of an individual, office address in the case of an entity, a brief description of the property, the date of the transfer, the amount realized on the sale of the foreclosed property and the amount withheld under section 1445(a).

(B) *Notice whether amount withheld or alternative amount is reported and paid over to the Service.* A purchaser/transferee in a foreclosure that chooses to use the special rules applicable to foreclosures must provide notice to the court or trustee with jurisdiction over the foreclosure action regarding whether the amount withheld or the alternative amount will be (or has been) reported and paid over to the Service. The notice should set forth all the information required by the preceding paragraph (d)(3)(ii)(A), the amount withheld or alternative amount that will be (or has been) reported and paid over to the Service, and the amount that will be (or has been) paid over to the court or trustee.

(iii) *Notice to the Service*—(A) *General rule.* A transferee that in reliance upon the rules of this paragraph (d)(3) withholds an alternative amount (or does not withhold because the alternative amount is zero) must, on or before the 20th day following the final determination by a court or trustee in a foreclosure action or on or before the 20th day following the date of the transfer with respect to a transfer pursuant to a deed in lieu of foreclosure, provide notice thereof to the Assistant Commissioner (International) at the address provided in §1.1445–1(g)(10). (The filing of such a notice shall not relieve a creditor of any obligation it may have to file a notice pursuant to section 6050J and the regulations thereunder.) No particular form is required but the following information must be set forth in paragraphs labelled to correspond with the numbers set forth below.

(*1*) A statement that the notice constitutes a notice of foreclosure action or transfer pursuant to a deed in lieu of foreclosure under §1.1445–2(d)(3).

(*2*) The name, identifying number (if any) and home address (in the case of an individual) or office address (in the case of an entity) of the purchaser/transferee.

(*3*) The name, identifying number (if any), and home address (in the case of an individual) or office address (in the case of an entity) of the debor/transferor.

(*4*) In a foreclosure action, the date of the final determination by a court or trustee regarding the distribution of the amount realized from the foreclosure sale. In a transfer pursuant to a deed in lieu of foreclosure, the date the property is transferred to the purchaser/transferee.

(*5*) A brief description of the property.

(*6*) The amount realized from the foreclosure sale or with respect to the transfer pursuant to a deed in lieu of foreclosure.

(*7*) The alternative amount.

(B) *Special rule for lenders required to file Form 1099–A where the alternative amount is zero.* A person required under section 6050J to file Form 1099–A does not have to comply with the notice requirement of § 1.1445–2(d)(3)(iii)(A) if the alternative amount is zero. In such case, the filing of the Form 1099–A will be deemed to satisfy the notice requirments of § 1.1445–2(d)(3)(iii)(A).

(iv) *Requirements not applicable.* A transferee is not required to withhold tax or provide notice pursuant to the rules of this paragraph (d)(3) if no substantive withholding liability applies to the transfer of the property by the debtor/transferor. For example, if the debtor/transferor provides the transferee with a certification of non-foreign status pursuant to paragraph (b) of this section, then no substantive withholding liability would exist with respect to the acquisition of the property from the debtor transferor. In such a case, no withholding of tax or notice to the Internal Revenue Service is required of the transferee with respect to the repossession or foreclosure.

(v) *Anti-abuse rule.* If a U.S. real property interest is transferred in foreclosure or pursuant to a deed in lieu of foreclosure for a principal purpose of avoiding the requirements of section 1445(a), then the provisions of this paragraph (d)(3) shall not apply to the transfer and the transferee shall be fully liable for any failure to withhold with respect to the transfer. A principal purpose to avoid section 1445(a) will be presumed (subject to rebuttal on the basis of all relevant facts and circumstances) if:

(A) The transferee acquires property in which it, or a related party, has a security interest;

(B) The security interest did not arise in connection with the debtor/transferor's or a related party's or predecessor in interest's acquisition, improvement, or maintenance of the property; and

(C) The total amount of all debts secured by the property exceeds 90 percent of the fair market value of the property.

(4) *Installment payments.* A transferee of a U.S. real property interest is not required to withhold under section 1445 when making installment payments on an obligation arising out of a dispositions that took place before January 1, 1985. With respect to disposition that take place after December 31, 1984, the transferee shall be required to satisfy its entire withholding obligation within the time specified in § 1.1445–1(c) regardless of the amount actually paid by the transferee. Thereafter, no withholding is required upon further installment payments on an obligation arising out of the transfer. A transferee that is unable to satisfy its entire withholding obligation within the time specified in § 1.1445–1(c) may request a withholding certificate pursuant to § 1.1445–3.

(5) *Acquisitions by governmental bodies.* No withholding of tax is required under section 1445 with respect to any acquisition of property by the United States, a state or possession of the United States, a political subdivision thereof, or the District of Columbia.

(6) [Reserved]

(7) *Withholding certificate obtained by transferee or transferor.* No withholding is required under section 1445(a) if the transferee is provided with a withholding cerfiticate that so specifies. Either the transferor or the transferee may seek a withholding certificate from the Internal Revenue Service, pursuant to the provisions of § 1.1445–3.

(8) *Amount realized by transferor is zero.* If the amount realized by transferor on a transfer of a U.S. real property interest is zero, no withholding is required.

[T.D. 8113, 51 FR 46633, Dec. 24, 1986; 52 FR 3917, Feb. 6, 1987; as amended at T.D. 8198, 53 FR 16230, May 5, 1988]

§ 1.1445–3 Adjustments to amount required to be withheld pursuant to withholding certificate.

(a) *In general.* Withholding under section 1445(a) may be reduced or eliminated pursuant to a withholding certificate issued by the Internal Revenue Service in accordance with the rules of this section. A withholding certificate may be issued by the Service in cases where reduced withholding is appropriate (see paragraph (c) of this section), where the transferor is exempt from U.S. tax (see paragraph (d) of this section), or where an agreement for the payment of tax is entered into with the Service (see paragraph (e) of this section). A withholding certificate that is obtained prior to a transfer notifies the transferee that no withholding is required. A withholding certificate that is obtained after a transfer has been made may authorize a normal refund or an early refund pursuant to paragraph (g) of this section. Either a transferee or transferor may apply for a withholding certificate. The Internal Revenue Service will act upon an application for a withholding certificate not later than the 90th day after it is received. Solely for this purpose (i.e., determining the day upon which the 90-day period commences), an application is received by the Service on the date that all information necessary for the Service to make a determination is provided by the applicant. (For rules regarding whether an application for a withholding certificate has been timely submitted, see §1.445–1(c)(2).) The Service may deny a request for a withholding certificate where, after due notice, an applicant fails to provide information necessary for the Service to make a determination. The Service will act upon an application for an early refund not later than the 90th day after it is received. An application for an early refund must either (1) include a copy of a withholding certificate issued by the Service with respect to the transaction or, (2) be combined with an application for a withholding certificate. Where an application for an early refund is combined with an application for a withholding certificate, the Service will act upon both applications not later than the 90th day after receipt. In the case of an application for a certificate based on non-conforming secuirty under paragraph (e)(3)(v) of this section, and in unusually complicated cases, the Service may be unable to provide a final withholding certificate by the 90th day. In such a case the Service will notify the applicant, by the 45th day after receipt of the application, that additional processing time will be necessary. The Service's notice may request additional information or explanation concerning particular aspects of the application, and will provide a target date for final action (contingent upon the application's timely submission of any requested information). A withholding certificate issued pursuant to the provisions of this section serves to fulfill the requirements of section 1445(b)(4) concerning qualifying statements, section 1445(c)(1) concerning the transferor's maximum tax liability, or section 1445(c)(2) concerning the Secretary's authority to prescribe reduced withholding.

(b) *Applications for withholding certificates*—(1) *In general.* An application for a withholding certificate must be submitted to the Assistant Commissioner (International), at the address provided in §1.1445–1(g)(10). An application for a withholding certificate must be signed by a responsible officer in the case of a corporation, by a general partner in the case of a partnership, by a trustee, executor, or equivalent fiduciary in the case of a trust or estate, and in the case of an individual by the individual himself. A duly authorized agent may sign the application but the application must contain a valid power of attorney authorizing the agent to sign the application on behalf of the applicant. The person signing the application must verify under penalties of perjury that all representations made in connection with the application are true, correct, and complete to his knowledge and belief. No particular form is required for an application, but the application must set forth the information described in paragraphs (b), (2), (3), and (4) of this section.

(2) *Parties to the transaction.* The application must set forth the name, address, and identifying number (if any) of the person submitting the application (specifying whether that person is the transferee or transferor), and the name, address, and identifying number (if any) of other parties to the transaction (specifying whether each such party is a transferee or transferor). The applicant must determine if an identifying number exists for each party concerned and if none exists for a particular party the application must so state. The address provided in the case

of an individual must be that individual's home address, and the address provided in the case of an entity must be that entity's office address. A mailing address may be provided in addition to, but not in lieu of, a home address or office address.

(3) *Real property interest to be transferred.* The application must set forth information concerning the U.S. real property interest with respect to which the withholding certificate is sought, including the type of interest, the contract price, and, in the case of an interest in real property, its location and general description, or in the case of an interest in a U.S. real property holding corporation, the class or type and amount of the interest.

(4) *Basis for certificate*—(i) *Reduced withholding.* If a withholding certificate is sought on the basis of a claim that reduced withholding in appropriate, the application must include:

(A) A calculation of the maximum tax that may be imposed on the disposition in accordance with paragraph (c)(2) of this section. Such calculation must be accompanied by a copy of the relevant contract and depreciation schedules or other evidence that confirms the contract price and adjusted basis of the property. If no depreciation schedules are provided, the application must state the nature of the use of the property and why depreciation was not allowable. Evidence that supports any claimed adjustment to the maximum tax on the disposition must also be provided;

(B) A calculation of the transferor's unsatisfied withholding liability, or evidence supporting the claim that no such liability exists, in accordance with paragraph (c)(3) of this section; and

(C) In the case of a request for a special reduction of withholding pursuant to paragraph (c)(4) of this section, a statement of law and facts in support of the request.

(ii) *Exemption.* If a withholding certificate is sought on the basis of the transferor's exemption from U.S. tax, the application must set forth a brief statement of the law and facts that support the claimed exemption. In this regard, see paragraph (d) of this section.

(iii) *Agreement.* If a withholding certificate is sought on the basis of an agreement for the payment of tax, the application must include a signed copy of the agreement proposed by the applicant and a copy of the security instrument (if any) proposed by the applicant. In this regard, see paragraph (e) of this section.

(c) *Adjustment of amount required to be withheld*—(1) *In general.* The Internal Revenue Service may issue a withholding certificate that excuses withholding or that permits the transferee to withhold an adjusted amount reflecting the transferor's maximum tax liability. The transferor's maximum tax liability is the sum of—

(i) The maximum amount which could be imposed as tax under section 871 or 882 upon the transferor's disposition of the subject real property interest, as determined under paragraph (c)(2) of this section, and

(ii) The transferor's unsatisfied withholding liability with respect to the subject real property interest, as determined under paragraph (c)(3) of this section.

In addition, the Internal Revenue Service may issue a withholding certificate that permits the transferee to withhold a reduced amount if the Service determines pursuant to paragraph (c)(4) of this section that reduced withholding will not jeopardize the collection of tax.

(2) *Maximum tax imposed on disposition.* The first element of the transferor's maximum tax liability is the maximum amount which the transferor could be required to pay as tax upon the disposition of the subject real property interest. In the case of an individual transferor that amount will generally be the contract price of the property minus its adjusted basis, multiplied by the maximum individual income tax rate applicable to long term capital gain. In the case of a corporate transferor, that amount will generally be the contract price of the property minus its adjusted basis, multiplied by the maximum corporate income tax rate applicable to long term capital gain. However, that amount must be adjusted to take into account the following:

(i) Any reduction of tax to which the transferor is entitled under the provisions of a U.S. income tax treaty;

(ii) The effect of any nonrecognition provision that is applicable to the transaction;

(iii) Any losses realized and recognized upon the previous disposition of U.S. real property interests during the taxable year;

(iv) Any amount that is required to be treated as ordinary income; and

(v) Any other factor that may increase or reduce the tax upon the disposition.

(3) *Transferor's unsatisfied withholding liability*—(i) *In general.* The second element of the transferor's maximum tax liability is the transferor's unsatisfied withholding liability. That liability is the amount of any tax that the transferor was required to but did not withhold and pay over under section 1445 upon the acquisition of the subject U.S. real property interest or a predecessor interest. The transferor's unsatisfied withholding liability is included in the calculation of maximum tax liability so that such prior withholding liability can be satisfied by the transferee's withholding upon the current transfer. Alternatively, the transferor's unsatisfied withholding liability may be disregarded for purposes of calculating the maximum tax liability, if either—

(A) Such prior withholding liability is fully satisfied by a payment that is made with the application submitted pursuant to this section; or

(B) An agreement is entered into for the payment of that liability pursuant to the rules of paragraph (e) of this section.

Because section 1445 only requires withholding after December 31, 1984, no transferor's unsatisfied withholding liability can exist unless the transferor acquired the subject or predecessor real property interest after that date. For purposes of this paragraph (c), a predecessor interest is one that was exchanged for the subject U.S. real property interest in a transaction in which the transferor was not required to recognize the full amount of the gain or loss realized upon the transfer.

(ii) *Evidence that no unsatisfied withholding liability exists.* For purposes of paragraph (b)(4)(i)(B) of this section (concerning information that must be submitted with an application for a withholding certificate), evidence that the transferor has no unsatisfied withholding liability includes any one of the following documents:

(A) Evidence that the transferor acquired the subject or predecessor real property interest prior to January 1, 1985;

(B) A copy of the Form 8288 that was filed by the transferor, and proof of payment of the amount shown due thereon, with respect to the transferor's acquisition of the subject or predecessor real property interest;

(C) A copy of a withholding certificate with respect to the transferor's acquisition of the subject or predecessor real property interest, plus a copy of Form 8288 and proof of payment with respect to any withholding required under that certificate;

(D) A copy of the non-foreign certification furnished by the person from whom the subject or predecessor U.S. real property interest was acquired, executed at the time of that acquisition;

(E) Evidence that the transferor purchased the subject or predecessor real property for $300,000 or less, and a statement signed by the transferor under penalties of perjury, that the transferor purchased the property for use as a residence within the meaning of § 1.1445–2(d)(1);

(F) Evidence that the person from whom the transferor acquired the subject or predecessor U.S. real property interest fully paid any tax imposed on that transaction pursuant to section 897.

(G) A copy of a notice of nonrecognition treatment provided to the transferor pursuant to § 1.1445–2(d)(2) by person from whom the transferor acquired the subject or predecessor U.S. real property interest; and

(H) A statement, signed by the transferor under penalties of perjury, setting forth the facts and circumstances that supported the transferor's conclusion that no withholding was required under section 1445(a) with respect to the transferor's acquisition of the subject or predecessor real property interest.

(4) *Special reduction of amount required to be withheld.* The Internal Revenue Service may, in its discretion, issue a withholding certificate that permits the transferee to withhold a reduced amount based upon a determination that reduced withholding will not jeopardize the collection of tax. A transferor that requests a withholding certificate pursuant to this paragraph (c)(4) is required pursuant to paragraph (b)(4)(i)(C) of this section to submit a statement of law and facts in support of the request. That statement must explain why the transferor is unable to enter into an agreement for the payment of tax pursuant to paragraph (e) of this section.

(d) *Transferor's exemption from U.S. tax*—(1) *In general.* The Internal Revenue Service will issue a withholding certificate that excuses all withholding by a transferee if it is established that:

(i) The transferor's gain from the disposition of the subject U.S. real property interest will be exempt from U.S. tax, and

(ii) The transferor has no unsatisfied withholding liability.

For the available exemptions, see paragraph (d)(2) of this section. The transferor's unsatisfied withholding liability shall be determined in accordance with the provisions of paragraph (c)(3) of this section. A transferor that is entitled to a reduction of (rather than an exemption from) U.S. tax may obtain a withholding certificate to that effect pursuant to the provisions of paragraph (c) of this section.

(2) *Available exemptions.* A transferor's gain from the disposition of a U.S. real property interest may be exempt from U.S. tax because either:

(i) The transferor is an integral part or controlled entity of a foreign government and the disposition of the subject property is not a commercial activity, as determined pursuant to section 892 and the regulations thereunder; or

(ii) The transferor is entitled to the benefits of an income tax treaty that provides for such an exemption (subject to the limitations imposed by section 1125(c) of Pub. L. 96–499, which, in general, overrides such benefits as of January 1, 1985).

(e) *Agreement for the payment of tax*—(1) *In general.* The Internal Revenue Service will issue a withholding certificate that excuses withholding or that permits a transferee to withhold a reduced amount, if either the transferee or the transferor enters into an agreement for the payment of tax pursuant to the provisions of this paragraph (e). An agreement for the payment of tax is a contract between the Service and any other person that consists of two necessary elements. Those elements are—

(i) A contract between the Service and the other person, setting forth in detail the rights and obligations of each; and

(ii) A security instrument or other form of security acceptable to the Director, Foreign Operations District.

(2) *Contents of agreement*—(i) *In general.* An agreement for the payment of tax must cover an amount described in subdivision (ii) or (iii) of this paragraph (e)(2). The agreement may either provide adequate security for the payment of the chosen amount in accordance with paragraph (e)(3) of this section, or provide for the payment of that amount through a combination of security and withholding of tax by the transferee.

(ii) *Tax that would otherwise be withheld.* An agreement for the payment of tax may cover the amount of tax that would otherwise be required to be withheld pursuant to section 1445(a). In addition to the amount computed pursuant to section 1445(a), the applicant must agree to pay interest upon that amount, at the rate established under section 6621, with respect to the period between the date on which the tax imposed by section 1445(a) would otherwise be due (*i.e.*, the 20th day after the date of transfer) and the date on which the transferor's payment of tax with respect to the disposition will be due under the agreement. The amount of interest agreed upon must be paid by the applicant regardless of whether or not the Service is required to draw upon any security provided pursuant to the agreement. The interest may be paid either with the return or by the Service drawing upon the security.

(iii) *Maximum tax liability.* An agreement for the payment of tax may cover the transferor's maximum tax liability, determined in accordance with paragraph (c) of this section. The agreement must also provide for the payment of an additional amount equal to 25 percent of the amount determined under paragraph (c) of this section. This additional amount secures the interest and penalties that would accrue between the date of a failure to file a return and pay tax with respect to the disposition, and the date on which the Service collects upon that liability pursuant to the agreement. Such additional amount will only be collected if the Service finds it necessary to draw upon any security provided due to the transferor's failure to file a return and pay tax with respect to the relevant disposition.

(3) *Major types of security*—(i) *In general.* The following are the major types of security acceptable to the Service. Further details with respect to the terms and conditions of each type may be specified by Revenue Procedure.

(ii) *Bond with surety or guarantor.* The Service may accept as security with respect to a transferor's tax liability a bond that is executed with a satisfactory surety or guarantor. Only the following persons may act as surety or guarantor for this purpose

(A) A surety company holding a certificate of authority from the Secretary as an acceptable surety on Federal bonds, as listed in Treasury Department Circular No. 570, published annually in the FEDERAL REGISTER on the first working day of July;

(B) A person that is engaged within or without the United States in the conduct of a banking, financing, or similar business under the principles of §1.864–4(c)(5), and that is subject to U.S. or foreign local or national regulation of such business, if that person is otherwise acceptable to the Service; and

(C) A person that is engaged within or without the United States in the conduct of an insurance business that is subject to U.S. or foreign local or national regulation, if that person is otherwise acceptable to the Service.

(iii) *Bond with collateral.* The Service may accept as security with respect to a transferor's tax liability a bond that is secured by acceptable collateral. All collateral must be deposited with a responsible financial institution acting as escrow agent, or, in the Service's discretion, with the Service. Only the following types of collateral are acceptable:

(A) Bonds, notes, or other public debt obligations of the United States, in accordance with the rules of 31 CFR part 225; and

(B) A certified cashier's, or treasurer's check, drawn on an entity acceptable to the Service that is engaged within or without the United States in the conduct of a banking, financing, or similar business under the principles of §1.864–4(c)(5) and that is subject to U.S. or foreign local or national regulation of such business.

(iv) *Letter of credit.* The Service may accept as security with respect to a transferor's tax liability an irrevocable letter of credit. The Service may accept a letter of credit issued by an entity acceptable to the Service that is engaged within or without the United States in the conduct of a banking, financing, or similar business under the principles of §1.864–4(c)(5) and that is subject to U.S. or foreign local or national regulation of such business. However, the Director will accept a letter of credit from an entity that is not engaged in trade or business in the United States only if such letter may be drawn on an advising bank within the United States.

(v) *Guarantees and other non-conforming security*—(A) *Guarantee.* The Service may in its discretion accept as security with respect to a transferor's tax liability the applicant's guarantee that it will pay such liability. The Service will in general accept such a guarantee only from a corporation, foreign or domestic, any class of stock of which is regularly traded on an established securities market on the date of the transfer.

(B) *Other forms of security.* The Service may in unusual circumstances and at its discretion accept any form of security that if finds to be adequate. An application for a withholding certificate that proposes a form of security that does not conform with any of the preferred types set forth in paragraph (e)(3) (ii) through (iv) of this section or any relevant Revenue Procedure must include:

(*1*) A detailed statement of the facts and circumstances supporting the use of the proposed form of security, and

(*2*) A memorandum of law concerning the validity and enforceability of the proposed form of security.

(4) *Terms of security instrument.* Any security instrument that is furnished pursuant to this section must provide that—

(i) The amount of each deposit of estimated tax that will be required with respect to the gain realized on the subject disposition may be collected by levy upon the security as of the date following the date on which each such deposit is due (unless such deposit is timely made);

(ii) The entire amount of the liability may be collected by levy upon the security at any time during the nine months following the date on which the payment of tax with respect to the subject disposition is due, subject to release of the security upon the full payment of the tax and any interest and penalties due. If the transferor requests an extension of time to file a return with respect to the disposition, then the Director may require that the term of the security instrument be extended until the date that is nine months after the filing deadline as extended.

(f) *Amendments to application for withholding certificate*—(1) *In general.* An applicant for a withholding certificate may amend an otherwise complete application by submitting an amending statement to the Assistant Commissioner (International), at the address provided in § 1.1445–1(g)(10). The amending statement shall provide the information required by § 1.1445–3(f)(3) and must be signed and accompanied by a penalties of perjury statement in accordance with § 1.1445–3(b)(1).

(2) *Extension of time for the Service to process reqests for withholding certificates*—(i) *In general.* If an amending statement is submitted, the time in which the Internal Revenue Service must act upon the amended application shall be extended by 30 days.

(ii) *Substantial amendments.* If an amending statement is submitted and the Service finds that the statement substantially amends the facts of the underlying application or substantially alters the terms of the withholding certificate as requested in the initial application, the time within which the Service must act upon the amended application shall be extended by 60 days. The applicant shall be so notified.

(iii) *Amending statement received after the requested withholding certificate has been signed by the Assistant Commissioner (International).* If an amending statement is received after the withholding certificate, drafted in response to the underlying application, has been signed by the Assistant Commissioner (International) or his delegate and prior to the day such certificate is mailed to the applicant, the time in which the Service must act upon the amended application shall be extended by 90 days. The applicant will be so notified.

(3) *Information required to be submitted.* No particular form is required for an amending statement but the statement must provide the following information:

(i) *Identification of applicant.* The amending statement must set forth the name, address and identifying number (if any) of the person submitting the amending statement (specifying whether that person is the transferee or transferor).

(ii) *Date of underlying application.* The amending statement must set forth the date of the underlying application for a withholding certificate.

(iii) *Real property interest to be (or that has been) transferred.* The amending statement must set forth a brief description of the real property interest with respect to which the underlying application for a withholding certificate was submitted.

(iv) *Amending information.* The amending statement must fully set forth the basis for the amendment including any modification of the facts supporting the application for a withholding certificate and any change sought in the terms of the withholding certificate.

(g) *Early refund of overwithheld amounts.* If a transferor receives a withholding certificate pursuant to this section, and an amount greater than that specified in the certificate was withheld by the transferee, then pursuant to the rules of this paragraph (g) the transferor may apply for a refund (without interest) of the excess amount prior to the date on which the transferor's tax return is due (without extensions). (Any interest payable on refunds issued after the filing of a tax return shall be determined in accordance with the provisions of section 6611 and regulations thereunder.) An application for an early refund must be addressed to the Assistant Commissioner (International), at the address provided in §1.1445–1(g)(10). No particular form is required for the application, but the following information must be set forth in separate paragraphs numbered to correspond with the number given below:

(1) Name, address, and identifying number (if any) of the transferor seeking the refund;

(2) Amount required to be withheld pursuant to the withholding certificate issued by Internal Revenue Service;

(3) Amount withheld by the transferee (attach a copy of Form 8288–A stamped by IRS pursuant to §1.1445–1(c));

(4) Amount to be refunded to the transferor. An application for an early refund cannot be processed unless the required copy of Form 8288–A (or substantial evidence of the amount withheld in the case of a failure to receive Form 8288–A as provided in §1.1445–1(f)(3)) is attached to the application. If an application for a withholding certificate based upon the transferor's maximum tax liability is submitted after the transfer takes place, then that application may be combined with an application for an early refund. The Service will act upon a claim for refund within the time limits set forth in paragraph (a) of this section.

[T.D. 8113, 51 FR 46637, Dec. 24, 1986; 52 FR 3796, Feb. 6, 1987]

§1.1445–4 Liability of agents.

(a) *Duty to provide notice of false certification or statement to transferee.* A transferee's or transferor's agent must provide notice to the transferee if either—

(1) The transferee is furnished with a non-U.S. real property interest statement pursuant to §1.1445-2(c)(3) and the agent knows that the statement is false; or

(2) The transferee is furnished with a non-foreign certification pursuant to §1.1445–2(b)(2) and either (i) the agent knows that the certification is false, or (ii) the agent represents a transferor that is a foreign corporation. An agent that represents a transferor that is a foreign corporation is not required to provide notice to the transferee if the foreign corporation provided a non-foreign certification to the transferee prior to such agent's employment and the agent does not know that the corporation did so.

(b) *Duty to provide notice of false certification or statement to entity or fiduciary.* A transferee's or transferor's agent must provide notice to an entity or fiduciary that plans to carry out a transaction described in section 1445(e) (1), (2), (3), or (4) if either—

(1) The entity or fiduciary is furnished with a non-U.S. real property interest statement pursuant to §1.1445–5(b)(4)(iii) and the agent knows that such statement is false; or

(2) The entity or fiduciary is furnished with a non-foreign certification pursuant to §1.1445–5(b)(3) (ii) and either (i) the agent knows that such certification is false, or (ii) the agent represents a foreign corporation that made such a certification.

(c) *Procedural requirements*—(1) *Notice to transferee, entity, or fiduciary.* An agent who is required by this section to provide notice must do so in writing as soon as possible after learning of the false certification or statement, but not later than the date of the transfer (prior to the transferee's payment of consideration). If an agent first learns of a false certification or statement after the date of the transfer, notice must be given by the third day following that discovery. The notice must state that the certification or statement is false and may not be relied upon. The notice must also explain the possible consequences to the recipient of a failure to withhold. The notice need not disclose the information on which the agent's statement is based. The following is an example of an acceptable notice.''This is to notify you that you may be required to withhold tax in connection with *(describe transaction).* You have been provided with a certification of non-foreign status (or a non-U.S. real property interest statement) in connection with that transaction. I have learned that that document is false. Therefore, you may not rely upon it as a basis for failing to withhold under section 1445 of the Internal Revenue Code. Section 1445 provides that any person who acquires a U.S. real property interest from a foreign person must withhold a tax equal to 10 percent of the total purchase price. (The term 'U.S. real property interest' includes real property, stock in U.S. corporations whose assets are primarily real property, and some personal property associated with realty.) Any person who is required to withhold but fails to do so can be held liable for the tax. Thus, if you do not withhold the 10 percent tax from the total that you pay on this transaction you could be required to pay the tax yourself, if what you are acquiring is a U.S. real property interest and the transferor is a foreign person. Tax that is withheld must be promptly paid over to the IRS using Form 8288. For further information see sections 897 and 1445 of the Internal Revenue Code and the related regulations.''

(2) *Notice to be filed with IRS.* An agent who is required by paragraph (a) or (b) of this section to provide notice to a transferee, entity, or fiduciary must furnish a copy of that notice to the Internal Revenue Service by the date on which the notice is required to be given to the transferee, entity, or fiduciary. The copy of the notice must be delivered to the Assistant Commissioner (International) at the address provided in §1.1445–1(g)(10) and must be accompanied by a cover letter stating that the copy is being filed pursuant to the requirements of this §1.1445–4(c)(2).

(d) *Effect on recipient.* A transferee, entity, or fiduciary that receives a notice pursuant to this section prior to the date of the transfer from any agent of the transferor or transferee may not rely upon the subject certification or statement for purposes of excusing withholding pursuant to §1.1445–2 or §1.1445–5. Therefore, the recipient of a notice may be held liable for any failure to deduct and withhold tax under section 1445 as if such certification or statement had never been given. For special rules concerning the effect of the receipt of a notice after the date of the transfer, see §§1.1445–2(b)(4)(iv) and 1.1445–5 (c), (d) and (e).

(e) *Failure to provide notice.* Any agent who is required to provide notice but who fails to do so in the manner required by paragraph (a) or (b) of this section shall be held liable for the tax that the recipient of the notice would have been required to withhold under section 1445 if such notice had been given. However, an agent's liability under this paragraph (e) is limited to the amount of compensation that that agent derives from the transaction. In addition, an agent who assists in the preparation of, or fails to disclose knowledge of, a false certification or statement may be liable for civil or criminal penalties.

(f) *Definition of transferor's or transferee's agent*—(1) *In general.* For purposes of this section, the terms ''transferor's agent'' and ''transferee's agent'' means any person who represents the transferor or transferee (respectively)—

(i) In any negotiation with another person (or another person's agent) relating to the transaction; or

(ii) In settling the transaction.

(2) *Transactions subject to section 1445(e).* In the case of transactions subject section 1445(e), the following definitions apply.

(i) The term ''transferor's agent'' means any person that represents or advises an entity or fiduciary with respect to the planning, arrangement, or consummation by the entity of a transaction described in section 1445(e) (1), (2), (3), or (4).

(ii) The term ''transferee's agent'' means any person that represents or advises the holder of an interest in an entity with respect to the planning, arrangement or consummation by the entity of a transaction described in section 1445(e) (1), (2), (3), or (4).

(3) *Exclusion of settlement officers and clerical personnel.* For purposes of this section, a person shall not be treated as a transferor's agent or transferee's agent with respect to any transaction solely because such person performs one or more of the following activities.

(i) The receipt and disbursement of any portion of the consideration for the transaction;

(ii) The recording of any document in connection with the transaction;

(iii) Typing, copying, and other clerical tasks;

(iv) The obtaining of title insurance reports and reports concerning the condition of the real property that is the subject of the transaction; or

(v) The transmission or delivery of documents between the parties.

(4) *Exclusion for governing body of a condominium association and the board of directors of a cooperative housing corporation.* The members of a board, committee or other governing body of a condominium association and the board of directors and officers of a cooperative housing corporation will not be deemed agents of the transferor or transferee if such individuals function exclusively in their capacity as representatives of such association or corporation with respect to the transaction. In addition, the managing agent of a cooperative housing corporation or condominium association will not be deemed to be an agent of the transferee or transferor if such person functions exclusively in its capacity as a managing agent. If a person's activities include advising the transferee or transferor with respect to the transfer, this exclusion shall not apply.

[T.D. 8113, 51 FR 46641, Dec. 24, 1986; 52 FR 3796, 3917, Feb. 6, 1987]

§1.1445–5 Special rules concerning distributions and other transactions by corporations, partnerships, trusts, and estates.

(a) *Purpose and scope.* This section provides special rules concerning the withholding that is required under section 1445(e) upon distributions and other transactions involving domestic or foreign corporations, partnerships, trusts, and estates. Paragraph (b) of this section provides rules that apply generally to the various withholding requirements set forth in this section. Under section 1445(e)(1) and paragraph (c) of this section, a domestic partnership or the fiduciary of a domestic trust or estate is required to withhold tax upon the entity's disposition of a U.S. real property interest if any foreign persons are partners or beneficiaries of the entity. Paragraph (d) provides rules concerning the requirement of section 1445(e)(2) that a foreign corporation withhold tax upon its distribution of a U.S. real property interest to its interest-holders. Finally, under section 1445(e)(3) and paragraph (e) of this section a domestic U.S. real property holding corporation is required to withhold tax upon certain distributions to interest-holders that are foreign persons. Paragraphs (f) and (g) of this section are reserved to provide rules concerning transactions involving interests in partnerships, trusts, and estates that will be subject to withholding pursuant to sections 1445(e) (4) and (5).

(b) *Rules of general application*—(1) *Double withholding not required.* If tax is required to be withheld with respect to a transfer of property in accordance with the rules of this section, then no additional tax is required to be withheld by the transferee of the property with respect to that transfer pursuant to the general rules of section 1445(a) and §1.1445–1. For rules coordinating the withholding under section 1441 (or section 1442 or 1443) and under section 1445 on distributions from a corporation, see §1.1441–3(b)(4). If a transfer of a U.S. real property interest described in section 1445(e) is exempt from withholding under the rules of this section, then no withholding is required under the general rules of section 1445(a) and §1.1445–1.

(2) *Coordination with nonrecognition provisions*—(i) *In general.* Withholding shall not be required under the rules of this section with respect to a transfer described in section 1445(e) of a U.S. real property interest if—

(A) By reason of the operation of a nonrecognition provision of the Internal Revenue Code or the provisions of any treaty of the United States no gain or loss is required to be recognized by the foreign person with respect to which withholding would otherwise be required; and

(B) The entity or fiduciary that is otherwise required to withhold complies with the notice requirements of paragraph (b)(2)(ii) of this section. The entity or fiduciary must determine whether gain or loss is required to be recognized pursuant to the rules of section 897 and the applicable nonrecognition provisions of the Internal Revenue

Code. An entity or fiduciary may obtain a withholding certificate from the Internal Revenue Service that confirms the applicability of a nonrecognition provision, but is not required to do so. For purposes of this paragraph (b)(2), a nonrecognition provision is any provision of the Internal Revenue Code for not recognizing gain or loss. If nonrecognition treatment is available only with respect to part of the gain realized on a transfer, the exemption from withholding provided by this paragraph (b)(2) shall not apply. In such cases a withholding certificate may be sought pursuant to the provisions of § 1.1445–6.

(ii) *Notice of nonrecognition transfer.* An entity or fiduciary that fails to withhold tax with respect to a transfer in reliance upon the rules of this paragraph (b)(2) must by the 20th day after the date of the transfer deliver a notice thereof to the Assistant Commissioner, (International), at the address provided in § 1.1445–1(g)(10). No particular form is required for a notice of transfer, but the following information must be set forth in paragraphs labelled to correspond with the letter set forth below:

(A) A statement that the document submitted constitutes a notice of a nonrecognition transfer pursuant to the requirements of § 1.1445–5(b)(2)(ii);

(B) The name, office address, and identifying number (if any) of the entity of fiduciary submitting the notice;

(C) The name, identifying number (if any), and home address (in the case of an individual) or office address (in the case of an entity) of each foreign person with respect to which withholding would otherwise be required;

(D) A brief description of the transfer; and

(E) A brief statement of the law and facts supporting the claim that recognition of gain or loss is not required with respect to the transfer.

(3) *Interest-holder not a foreign person*—(i) *In general.* Pursuant to the provisions of paragraphs (c) and (e) of this section, an entity or fiduciary is required to withhold with respect to certain transfers of property if a holder of an interest in the entity is a foreign person. For purposes of determining whether a holder of an interest is a foreign person, and entity or fiduciary may rely upon a certification of non-foreign status provided by that person in accordance with paragraph (b)(3)(ii) of this section. Except to the extent provided in paragraph (b)(3)(iii) of this section, such a certification excuses the entity or fiduciary from any liability otherwise imposed pursuant to section 1445(e) and regulations thereunder. However, no obligation is imposed upon an entity or fiduciary to obtain certifications from interest-holders; an entity or fiduciary may instead rely upon other means to ascertain the nonforeign status of an interest-holder. If the entity or fiduciary does rely upon other means but the interest-holder proves, in fact, to be a foreign person, then the entity or fiduciary is subject to any liability imposed pursuant to section 1445 and regulations thereunder.

An entity or fiduciary is not required to rely upon other means to ascertain the non-foreign status of an interest-holder and may demand a certification of non-foreign status. If the certification is not provided, the entity or fiduciary may withhold tax under section 1445 and will be considered, for purposes of sections 1461 through 1463, to have been required to withhold such tax.

(ii) *Interest-holder's certification of non-foreign status*—(A) *In general.* For purposes of this section, an entity or fiduciary may treat any holder of an interest in the entity as a U.S. person if that interest-holder furnishes to the entity or fiduciary a certification stating that the interest-holder is not a foreign person, in accordance with the provisions of paragraph (b)(3)(ii)(B) of this section. In general, a foreign person is a nonresident alien individual, foreign corporation, foreign partnership, foreign trust, or foreign estate, but not a resident alien individual. In this regard, see § 1.897–1(k).

(B) *Procedural rules.* An interest-holder's certification of non-foreign status must—

(*1*) State that the interest-holder is not a foreign person;

(*2*) Set forth the interest-holder's name, identifying number, home address (in the case of an individual), or office address (in the case of an entity), and place of incorporation (in the case of a corporation); and

(*3*) Be signed under penalties of perjury.

Pursuant to §1.897–1(p), an individual's identifying number is the individual's Social Security number and any other person's identifying number is its U.S. employer identification number. The certification must be signed by a responsible officer in the case of a corporation, by a general partner in the case of a partnership, and by a trustee, executor, or equivalent fiduciary in the case of a trust or estate. No particular form is needed for a certification pursuant to this paragraph (b)(3)(ii)(B), nor is any particular language required, so long as the document meets the requirements of this paragraph. Samples of acceptable certifications are provided in paragraph (b)(3)(ii)(D) of this section. An entity may rely upon a certification pursuant to this paragraph (b)(3)(ii)(B) for a period of two calendar years following the close of the calendar year in which the certification was given.

If an interest holder becomes a foreign person within the period described in the preceding sentence, the interest-holder must notify the entity prior to any further dispositions or distributions and upon receipt of such notice (or any other notification of the foreign status of the interest-holder) the entity may no longer rely upon the prior certification. An entity that obtains and relies upon a certification must retain that certification with its books and records for a period of three calendar years following the close of the last calendar year in which the entity relied upon the certification.

(C) *Foreign corporation that has made an election under section 897(i).* A foreign corporation that has made a valid election under section 897(i) to be treated as a domestic corporation for purposes of section 897 may provide a certification of non-foreign status pursuant to this paragraph (b)(3)(ii). However, an electing foreign corporation must attach to such certification a copy of the acknowledgment of the election provided to the corporation by the Internal Revenue Service pursuant to §1.897–3(d)(4).

An acknowledgment is valid for this purpose only if it states that the information required by §1.897–3 has been determined to be complete.

(D) *Sample certifications*—(*1*) *Individual interest-holder.*

"Under section 1445(e) of the Internal Revenue Code, a corporation, partnership, trust or estate must withhold tax with respect to certain transfers of property if a holder of an interest in the entity is a foreign person. To inform (*name of entity*) that no withholding is required with respect to my interest in it, I, (*name of interest-holder*), hereby certify the following:

1. I am not a nonresident alien for purposes of U.S. income taxation;

2. My U.S. taxpayer identifying number (Social Security number) is _______; and

3. My home address is

____

____

I agree to inform [name of entity] promptly if I become a nonresident alien at any time during the three years immediately following the date of this notice.

I understand that this certification may be disclosed to the Internal Revenue Service by (*name of entity*) and that any false statement I have made here could be punished by fine, imprisonment, or both.

Under penalties of perjury I declare that I have examined this certification and to the best of my knowledge and belief it is true, correct, and complete.

[*Signature and date*]"

(*2*) *Entity interest-holder.* "Under section 1445(e) of the Internal Revenue Code, a corporation, partnership, trust, or estate must withhold tax with respect to certain transfers of property if a holder of an interest in the entity is a foreign person. To inform [*name of entity*] that no withholding is required with respect to [*name of interest-holder*]'s interest in it, the undersigned hereby certifies the following on behalf of [*name of interest-holder*]:

1. [*Name of interest-holder*] is not a foreign corporation, foreign partnership, foreign trust, or foreign estate (as those terms are defined in the Internal Revenue Code and Income Tax Regulations);

2. [*Name of interest-holder*]'s U.S. employer identification number is _______; and

3. [*Name of interest-holder*]'s office address is

____

and place of incorporation (if applicable) is

____

[*Name of interest holder*] agrees to inform [*name of entity*] if it becomes a foreign person at any time during the three year period immediately following the date of this notice.

[*Name of interest-holder*] understands that this certification may be disclosed to the Internal Revenue Service by [*name of entity*] and that any false statement contained herein could be punished by fine, imprisonment, or both.

Under penalties of perjury I declare that I have examined this certification and to the best of my knowledge and belief it is true, correct, and complete, and I further declare that I have authority to sign this document on behalf of [*name of interest-holder*].

[*Signature and date*]

[*Title*]''

(iii) *Reliance upon certification not permitted.* An entity or fiduciary may not rely upon an interest-holder's certification of non-foreign status if, prior to or at the time of the transfer with respect to which withholding would be required, the entity or fiduciary either—

(A) Has actual knowledge that the certification is false;

(B) Has received a notice that the certification is false from a transferor's or transferee's agent, pursuant to § 1.1445–4; or

(C) Has received from a corporation that it knows to be a foreign corporation a certification that does not have attached to it a copy of the IRS acknowledgment of the corporation's election under section 897(i), as required by paragraph (b)(3)(ii)(C) of this section. Such an entity's or fiduciary's withholding obligations shall apply as if a statement had never been given, and such an entity or fiduciary may be held fully liable pursuant to § 1.1445–1(e) for any failure to withhold. For special rules concerning an entity's belated receipt of a notice concerning a false certification, see paragraphs (c)(2)(ii) and (e)(2)(iii) of this section.

(4) *Property transferred not a U.S. real property interest*—(i) *In general.* Pursuant to the provisions of paragraphs (c) and (d) of this section, an entity or fiduciary is required to withhold with respect to certain transfers of property, if the property transferred is a U.S. real property interest. (In addition, taxable distributions of U.S. real property interests by domestic or foreign partnerships, trusts, and estates will be subject to withholding pursuant to section 1445(e)(4) and paragraph (f) of this section after publication of a Treasury decision under sections 897 (e)(2) and (g). As defined in section 897(c) and § 1.897–1(c), a U.S. real property interest includes certain interests in U.S. corporations, as well as direct interests in real property and certain associated personal property. This paragraph (b)(4) provides rules pursuant to which an entity (or fiduciary thereof) that transfers an interest in a U.S. corporation may determine that withholding is not required because the interest transferred is not a U.S. real property interest. To determine whether an interest in tangible property constitutes a U.S. real property interest the transfer of which would be subject to withholding, see § 1.897–1 (b) and (c).

(ii) *Interests in publicly traded entities.* Withholding is not required under paragraph (c) or (d) of this section upon an entity's transfer of an interest in a domestic corporation if any class of stock of the corporation is regularly traded on an established securities market. This exemption shall apply to a disposition incident to an initial public offering of stock pursuant to a registration statement filed with the Securities and Exchange Commission.

Similarly, no withholding is required under paragraph (c) or (d) of this section upon an entity's transfer of an interest in a publicly traded partnership or trust. However, the rule of this paragraph (b)(4)(ii) shall not apply to the transfer, to a single transferee (or related transferees as defined in § 1.897–1(i)) in a single transaction (or related transactions), of an interest described in § 1.897–1(c)(2)(iii)(B) (relating to substantial amounts of non-publicly traded interests in publicly traded corporations) or of similar interests in publicly traded partnerships or trusts. The entity making a transfer described in the preceding sentence must otherwise determine whether withholding is required, pursuant to section 1445(e) and the regulations thereunder. Transactions shall be deemed to be related if they are undertaken within 90 days of one another or if it can otherwise be shown that they were undertaken in pursuance of a prearranged plan.

(iii) *Corporation's statement that interest is not a U.S. real property interest.* (A) *In general.* No withholding is required under paragraph (c) or (d) of this section upon an entity's transfer of an interest in a domestic corporation if, prior to the transfer, the entity or fiduciary obtains a statement, issued by the corporation pursuant to §1.897–2(h), certifying that the interest is not a U.S. real property interest. In general, a corporation may issue such a statement only if the corporation was not a U.S. real property holding corporation at any time during the previous five years (or the period in which the interest was held by its present holder, if shorter) or if interests in the corporation ceased to be United States real property interests under section 897(c)(1)(B). (A corporation may not provide such a statement based on its determination that the interest in question is an interest solely as a creditor.) See §1.897–2 (f) and (h). A corporation's statement may be relied upon for purposes of this paragraph (b)(4)(iii) only if the statement is dated not more than 30 days prior to the date of the transfer.

(B) *Reliance on statement not permitted.* An entity or fiduciary is not entitled to rely upon a statement that an interest in a corporation is not a U.S. real property interest, if, prior to or at the time of the transfer, the entity or fiduciary either—

(*1*) Has actual knowledge that the statement is false, or

(*2*) Receives a notice that the statement is false from a transferor's or transferee's agent, pursuant to §1.1445–4.

Such an entity's or fiduciary's withholding obligations shall apply as if a statement had never been given, and such an entity or fiduciary may be held fully liable pursuant to §1.1445–1(e) for any failure to withhold. For special rules concerning an entity's belated receipt of a notice concerning a false statement, see paragraphs (c)(2)(iii) and (d)(2)(i) of this section.

(5) *Reporting and paying over of withheld amounts*—(i) *In General.* An entity or fiduciary must report and pay over to the Internal Revenue Service any tax withheld pursuant to section 1445(e) and this section by the 20th day after the date of the transfer (as defined in §1.1445–1(g)(8). Forms 8288 and 8288–A are used for this purpose and must be filed with the Internal Revenue Service Center, Philadephia, PA 19255. The contents of Forms 8288 and 8288–A are described in §1.1445–1(d). Pursuant to section 7502 and regulations thereunder, the timely mailing of Forms 8288 and 8288–A by U.S. mail will be treated as their timely filing. Form 8288–A will be stamped by the Internal Revenue Service to show receipt, and a stamped copy will be mailed by the Service to the interest-holder, at the address shown on the form, for the interest-holder's use. See paragraph (b)(7) of this section. If an application for a withholding certificate with respect to a transfer of a U.S. real property interest was submitted to the Internal Revenue Service on the day of or at any time prior to the transfer, the entity or fiduciary must withold the amount required under section 1445(e) and the rules of this section. However, the amount withheld, or a lesser amount as determined by the Service, need not be reported and paid over to the Service until the 20th day following the Service's final determination. For this purpose, the Service's final determination occurs on the day when the withholding certificate is mailed to the applicant by the Service or when a notification denying the request for a withholding certificate is mailed to the applicant by the Service. An application is submitted to the Service on the day it is actually received by the Service at the address provided in §1.1445–1(g)(10) or, under the rules of section 7502, on the day it is mailed to the Service at the address provided in §1.1445–1(g)(10). For rules concerning the issuance of withholding certificates, see §1.1445–6.

(ii) *Anti-abuse rule.* An entity or fiduciary that in reliance upon the rules of this paragraph (b)(5)(ii) fails to report and pay over amounts withheld by the 20th day following the date of the transfer, shall be subject to the payment of interest and penalties if the relevant application for a withholding certificate (or an amendment of the application for a withholding certificate) was submitted for a principle purpose of delaying the payment to the IRS of the amount withheld. Interest and penalties shall be assessed on the amount that is ultimately paid over, with respect to the period between the 20th day after the date of the transfer and the date on which payment is made.

(6) *Liability upon failure to withhold.* For rules regarding liability upon failure to withhold under section 1445(e) and this § 1.1445–5, see § 1.1445–1(e).

(7) *Effect of withholding by entity or fiduciary upon interest holder.* The withholding of tax under section 1445(e) does not excuse a foreign person that is subject to U.S. tax by reason of the operation of section 897 from filing a U.S. tax return. Thus, Form 1040NR. 1041. or 1120F, as appropriate must be filed and any tax due must be paid, by the filing date otherwise applicable to such person (or any extension thereof). The tax withheld with respect to the foreign person under section 1445(e) (as shown on Form 8288–A) shall be credited against the amount of income tax as computed in such return, but only if the stamped copy of Form 8288–A provided to the entity or fiduciary (under paragraph (b)(5) of this section) is attached to the return or substantial evidence of the amount of tax withheld is attached to the return in accordance with the succeeding sentence. If a stamped copy of Form 8288–A has not been provided to the interest-holder by the Service, the interest-holder may establish the amount of tax withheld by the entity or fiduciary by attaching to its return substantial evidence of such amount. Such an interestholder must attach to its return a statement which supplies all of the information required by § 1.1445–1(d) (2) (expect such information that was not obtained by a diligent effort.) If the amount withheld under section 1445(e) constitutes less than the full amount of the foreign person's U.S. tax liability for that taxable year, then a payment of estimated tax may be required to be made pursuant to section 6154 or 6654 prior to the filing of the income tax return for the year. Alternatively, if the amount withheld under section 1445(e) exceeds the foreign person's maximum tax liability with respect to the transaction (*as reflected* in a withholding certificate issued by the Internal Revenue Service pursuant to § 1.1445–6), then the foreign person may seek an early refund of the excess pursuant to § 1.1445–6(g). A foreign person that takes gain into account in accordance with the provisions of section 453 shall not be entitled to a refund to the amount withheld, unless a withholding certificate providing for such a refund is obtained pursuant to § 1.1445–6. If an entity or fiduciary withholds tax under section 1445(e) with respect to a beneficial owner of an interest who is not a foreign person, such beneficial owner may credit the amount of any tax withheld against his income tax liability in accordance with the provisions of this § 1.1445–5(b)(7) or apply for an early refund under § 1.1445–6(g).

(8) *Effective dates*—(i) *Partnership, trust, and estate dispositions of U.S. real property interests.* The provisions of section 1445(e)(1) and paragraph (c) of this section, requiring withholding upon certain dispositions of U.S. real property interests by domestic partnerships, trusts, and estates, shall apply to any disposition on or after January 1, 1985.

(ii) *Certain distributions by foreign corporations.* The provisions of section 1445(e)(2) and paragraph (d) of this section, requiring withholding upon distributions of U.S. real property interests by foreign corporations shall apply to distributions made on or after January 1, 1985.

(iii) *Distributions by certain domestic corporations to foreign shareholders.* The provisions of section 1445(e)(3) and paragraph (e) of this section, requiring withholding upon distributions by U.S. real property holding corporations to foreign shareholders, shall apply to distributions made on or after January 1. 1985.

(iv) *Taxable distributions by domestic or foreign partnerships, trusts, and estates.* The provisions of section 1445(e)(4), requiring withholding upon certain taxable distributions by domestic or foreign partnerships, trusts, and estates, shall apply to distributions made on or after the effective date of a Treasury decision under section 897 (e)(2)(B)(ii) and (g).

(v) [Reserved]

(vi) *Tiered Partnerships.* No withholding is required upon the disposition of a U.S. real property interest by a partnership which is directly owned, in whole or in part, by another domestic partnership (but only to the extent that the amount realized is attributable to the partnership interest of that other partnership) until the effective date of a Treasury Decision published under section 1445(e) providing rules governing this matter.

(c) *Dispositions of U.S. real property interests by domestic partnerships, trusts, and estates*—(1) *Withholding required*—(i) *In general.* If a domestic partnership, trust, or estate disposes of a U.S. real property interest and any partner, beneficiary, or owner of the entity is a foreign person, then the partnership or the trustee, executor, or equivalent fiduciary of the trust or estate must withhold tax with respect to each such foreign person in accordance with the provisions of subdivision (ii), (iii), or (iv), of this paragraph (c)(1) (as applicable). The withholding obligation imposed by this paragraph (c) applies to the fiduciary of a trust even if the grantor of the trust or another person is treated as the owner of the trust or any portion thereof for purposes of the Internal Revenue Code. Thus, the withholding obligation imposed by this paragraph (c) applies to the trustee of a land trust or similar arrangement, even if such a trustee is not ordinarily treated under the applicable provisions of local law as a true fiduciary.

(ii) *Disposition by partnership.* A partnership must withhold a tax equal to 35 percent (or the highest rate specified in section 1445(e)(1)) of each foreign partner's distributive share of the gain realized by the partnership upon the disposition of each U.S. real property interest. Such distributive share of the gain must be determined pursuant to the principles of section 704 and the regulations thereunder. For the rules applicable to partnerships, interests in which are regularly traded on an established securities market, see §1.1445–8.

(iii) *Disposition by trust or estate.*—(A) *In general.* A trustee, fiduciary, executor or equivalent fiduciary (hereafter collectively referred to as the fiduciary) of a trust or estate having one or more foreign beneficiaries must withhold tax in accordance with the rules of this §1.1445–5(c)(1)(iii). Such a fiduciary must establish a U.S. real property interest account and must enter in such account all gains and losses realized during the taxable year of the trust or estate from dispositions of U.S. real property interests. The fiduciary must withhold 35 percent (or the highest rate specified in section 1445(e)(1)) of any distribution to a foreign beneficiary that is attributable to the balance in the U.S. real property interest account on the day of the distribution. A distribution from a trust or estate to a beneficiary (domestic or foreign) shall, solely for purposes of section 1445(e)(1), be deemed to be attributable first to any balance in the U.S. real property interest account and then to other amounts. However, a distribution that occurs prior to the transfer of a U.S. real property interest in a taxable year or at any other time when the amount contained in the U.S. real property interest account is zero, is not subject to withholding under this §1.1445–5(c)(1)(iii). The U.S. real property interest account is reduced by the amount distributed to all beneficiaries (domestic and foreign) attributable to such account during the taxable year of the trust or estate. Any ending balance of the U.S. real property interest account not distributed by the close of the taxable year of the trust or estate is cancelled and is not carried over (or carried back) to any other year. Thus, the beginning balance of such account in any taxable year of the trust or estate is always zero. For rules applicable to grantor trusts see §1.1445–5(c)(1)(iv). For rules applicable to trusts, interests in which are regularly traded on an established securities market and real estate investment trusts, see §1.1445–8.

(B) *Example.*The following example illustrates the rules of paragraph (c)(1)(iii)(A) of this section.

On January 1, 1994, A establishes a domestic trust (which has as its taxable year, the calendar year) for the benefit of B, a nonresident alien, and C, a U.S. citizen. The trust is not a trust subject to sections 671 through 679. Under the terms of the trust, the trustee, T, is given discretion to distribute income and corpus of the trust to provide for the reasonable needs of B and C. During the trust's 1994 tax year, T disposes of three parcels of vacant land located in the United States. The following chart illustrates the computation of the amount subject to withholding under section 1445 with respect to distributions made by T to B and C during 1994.

Date	Parcel sold	Gains or (loss) realized	Distributions to C	Distributions to B (before withholding)	Section 1445 withholding 35% rate	U.S. real property interest account
1/01/94						-0-
3/01/94	Parcel 1	140,000				140,000
3/05/94			5,000	10,000	3,500	125,000
3/15/94			10,000	5,000	1,750	110,000
5/01/94	Parcel 2	300,000				410,000
5/15/94	Parcel 3	(50,000)				360,000
12/01/94			170,000	170,000	59,500	20,000
1/01/95						-0-

(iv) *Disposition by grantor trust.* The trustee or equivalent fiduciary of a trust that is subject to the provisions of subpart E of part 1 of subchapter J (sections 671 through 679) must withhold a tax equal to 35 percent (or the highest rate specified in section 1445(e)(1)) of the gain realized from each disposition of a U.S. real property interest to the extent such gain is allocable to a portion of the trust treated as owned by a foreign person under subpart E of part 1 of subchapter J.

(2) *Withholding not required under paragraph (c)*—(i) [Reserved]

(ii) *Interest-holder not a foreign person*—(A) *In general.* A domestic partnership, trust, or estate that disposes of a U.S. real property interest shall not be required to withhold with respect to any partner or beneficiary that it determines, pursuant to the rules of paragraph (b)(3) of this section, not to be a foreign person.

(B) *Belated notice of false certification.* If after the date of the transfer a partnership or fiduciary learns that a partner's or beneficiary's certification of non-foreign status is false, then that partnership or fiduciary shall be required to withhold, with respect to the foreign partner or beneficiary that gave the false certification, the lessor of—

(*1*) The amount otherwise required to be withheld under the rules of this paragraph (c), or

(*2*) An amount equal to that partner's or beneficiary's remaining interests in the income or assets of the partnership, trust, or estate. Amounts so withheld must be reported and paid over by the 60th day following the date on which the partnership or fiduciary learns that the certification is false. For rules concerning the notifications of false certifications that may be required to be given to partnerships and fiduciaries, see § 1.1445–4(b).

(iii) *Property disposed of not a U.S. real property interest*—(A) *In general.* No withholding is required under this paragraph (c) if a domestic partnership, trust, or estate that disposes of property determines pursuant to the rules of paragraph (b)(4) of this section that the property disposed of is not a U.S. real property interest.

(B) *Belated notice of false statement.* If after the date of the transfer a partnership or fiduciary learns that a corporation's statement (that an interest in the corporation is not a U.S. real property interest) is false, then that partnership or fiduciary shall be required to withhold, with respect to each foreign partner or beneficiary, the lesser of—

(*1*) The amount otherwise required to be withheld under the rules of this paragraph (c), or

(*2*) An amount equal to that partner's or beneficiary's remaining interests in the income or assets of the parnership, trust, or estate.

Amounts so withheld must be reported and paid over by the 60th day following the date on which the partnership or fiduciary learns that the statement is false. For rules concerning the notifications of false statements that may be required to be given to partnerships or fiduciaries, see § 1.1445–4(b).

(iv) *Withholding certificate.* No withholding is required under this paragraph (c) with respect to the transfer of a U.S. real property interest if the Internal Revenue Service issues a withholding certificate that so provides. For rules concerning the issuance of withholding certificates, see § 1.1445–6.

(v) *Nonrecognition transactions.* For special rules concerning transactions entitled to nonrecognition of gain or loss, see paragraph (b)(2) of this section.

(3) *Large partnerships or trusts*—(i) *In general.* If a partnership or trust has more than 100 partners or beneficiaries, then the partnership or fiduciary of the trust may elect to withhold in accordance with the provisions of this §1.1445–5(c)(3) in lieu of withholding in the manner required by §1.1445–5(c)(1). However, the rules of this §1.1445–5(c)(3) shall not apply to any partnership or trust interests in which are regularly traded on an established securities market except as described in §1.1445–8(c)(1). The rules of this §1.1445–5(c)(3) shall not apply to any real estate investment trust. See §1445–8.

(ii) *Amount to be withheld.* A partnership or trust electing to withhold under this §1.1445–5(c)(3) shall withhold from each distribution to a foreign person an amount equal to 35 percent (or the highest rate specified in section 1445(e)(1)) of the amount attributable to section 1445(e)(1) transfers.

(iii) *Amounts attributable to section 1445(e)(1) transfers.* A distribution is attributable to section 1445(e)(1) transfers to the extent of the partner's or beneficiary's proportionate share of the current balance of the entity's section 1445(e)(1) account. A distribution from a partnership or trust that has made an election under this §1.1445–5(c)(3) shall be deemed first to be attributable to a section 1445(e)(1) transfer to the extent of the balance in the section 1445(e)(1) account. An entity's section 1445(e)(1) account shall be equal to—

(A) The total amount of net gain realized by the entity upon all transfers of U.S. real property interests carried out by the entity after the date of its election under this §1.1445–5(c)(3); minus

(B) The total amount of all distributions by the entity to domestic and foreign distributees from such account.

(iv) *Special rules for entities that make recurring sales of growing crops and timber.* An entity that makes an election under §1.1445–5(c)(3) and that makes recurring sales of growing crops and timber may further elect to determine the amount subject to withholding under the rules of this §1.1445–5(c)(3)(iv). Such an entity must withhold from each distribution to a foreign partner or beneficiary an amount equal to 10 percent of such partner's or beneficiary's proportionate share of the current balance of the entity's gross section 1445(e)(1) account. An entity's gross section 1445(e)(1) account equals—

(A) The total amount realized by the entity upon all transfers of U.S. real property interests carried out by the entity after the date of its election under this §1.1445–5(c)(3)(iv); minus

(B) The total amount of all distributions to domestic and foreign distributees from such account.

An entity that elects to compute the amount subject to withholding under this §1.1445–5(c)(3)(iv), shall make such election in accordance with §1.1445–5(c)(3)(vi) and shall be subject to the provisions otherwise applicable under §1.1445–5(c)(3).

(v) *Procedural rules.* An election under paragraph (c)(3) may be made by filing a notice thereof with the Assistant Commissioner (International), at the address provided in §1.1445–1(g)(10). The notice must be submitted by a general partner (in the case of a partnership) or the trustee or equivalent fiduciary (in the case of a trust). The notice must set forth the name, office address, and identifying number of the partnership or fiduciary making the election, and, in the case of a partnership, must include the name, office address, and identifying number of the general partner submitting the election. An election under this paragraph (c)(3) may be revoked only with the consent of the Internal Revenue Service. Consent of the Service may be requested by filing an application to revoke the election with the Assistant Commissioner (International) at the address stated above. This application must include all information provided to the Service with the election notice and must provide an explanation of the reasons for revoking the election. The application to revoke an election must also specify the amount remaining to be distributed in the section 1445(e)(1) account or the gross section 1445(e)(1) account.

An entity that ceases to qualify under section 1.1445–5(c)(3) because such entity does not have more than 100 partners or beneficiaries may revoke its election only with the consent of the Internal Revenue Service.

(d) *Distributions of U.S. real property interests by foreign corporations*—(1) *In general.* A foreign corporation that distributes a U.S. real property interest must deduct and withhold a tax equal to 35 percent (or the rate specified in section 1445(e)(2)) of the amount of gain recognized by the corporation on the distribution. The amount of gain required to be recognized by the corporation must be determined pursuant to the rules of section 897 and any other applicable section. For special rules concerning the applicability of a nonrecognition provision to a distribution, see paragraph (b)(2) of this section. The withholding liability imposed by this paragraph (d) applies to the same taxpayer that owes the related substantive income tax liability pursuant to the operation of section 897. Only one such liability will be assessed and collected from a foreign corporation, but separate penalties for failures to comply with the two requirements will be asserted.

(2) *Withholding not required*—(i) *Property distributed not a U.S. real property interest*—(A) *In general.* No withholding is required under this paragraph (d) if a foreign corporation that distributes property determines pursuant to the rules of paragraph (b)(3) of this section that the property distributed is not a U.S. real property interest.

(B) *Belated notice of false statement.* If after the date of a distribution described in paragraph (d)(1) of this section a foreign corporation learns that another corporation's statement (that an interest in that other corporation is not a U.S. real property interest) is false, then the foreign corporation may not rely upon that statement for any purpose. Such a foreign corporation's withholding obligations under this paragraph (d) shall apply if a statement had never been given, and such a corporation may be held fully liable pursuant to § 1.1445–5(b)(5) for any failure to withhold. Amounts withheld pursuant to the rule of this paragraph (d)(2)(i)(B) must be reported and paid over by the 60th day following the date on which the foreign corporation learns that the statement is false. No penalties or interest will be assessed for failures to withhold prior to that date. For rules concerning the notifications of false statements that may be required to be given to foreign corporations, see § 1.1445–4(b).

(ii) *Withholding certificate.* No withholding is required under this paragraph (d) with respect to a foreign corporation's distribution of a U.S. real property interest if the distributing corporation obtains a withholding certificate from the Internal Revenue Service that so provides. For rules concerning the issuance of withholding certificates, see § 1.1445–6.

(e) *Distributions to foreign persons by U.S. real property holding corporations*—(1) *In general.* A domestic corporation that distributes any property to a foreign person that holds an interest in the corporation must deduct and withhold a tax equal to 10 percent of the fair market value of the property distributed to the foreign person, if—

(i) The foreign person's interest in the corporation constitutes a U.S. real property interest under the provisions of section 897 and regulations thereunder; and

(ii) The property is distributed either—

(A) In redemption of stock under section 302; or

(B) In liquidation of the corporation pursuant to the provisions of part II of subchapter C (sections 331 through 341). For the treatment of a domestic corporation's transfer of a U.S. real property interest to a foreign interest-holder in a distribution to which section 301 applies, see sections 897(f), 1441, and 1442.

(2) *Withholding not required*—(i) *Foreign person's interest not a U.S. real property interest.* Withholding is required under this paragraph (e) only with respect to distributions to foreign persons holding interests in the corporation that constitute U.S. real property interests. In general, a foreign person's interest in a domestic corporation constitutes a U.S. real property interest if the corporation was a U.S real property holding corporation at any time during the shorter of (A) the period in which the foreign person held the interest or (B) the previous five years (but not earlier than June 19, 1980). See section 897(c) and §§ 1.897–1(c) and 1.897–2 (b) and (h). However, an interest in such a corporation ceases to be a U.S.

real property interest after all of the U.S. real property interests held by the corporation itself are disposed of in transactions on which gain or loss is recognized. See section 897(c)(1)(B) and §1.897–2(f)(2). Thus, if a U.S. real property holding corporation in the process of liquidation does not elect section 337 nonrecognition treatment upon its sale of all U.S. real property interests held by the corporation, and recognizes gain or loss upon such sales, interests in that corporation cease to be U.S. real property interests. Therefore, no withholding would be required with respect to that corporation's subsequent liquidating distribution to a foreign shareholder of property other than a U.S. real property interest.

(ii) *Nonrecognition transactions.* For special rules concerning the applicability of a nonrecognition provision to a distribution described in paragraph (e)(1) of this section, see paragraph (b)(2) of this section.

(iii) *Interest-holder not a foreign person*—(A) *In general.* A domestic corporation shall not be required to withhold under this paragraph (e) with respect to a distribution of property to any distributee that it determines, pursuant to the rules of paragraph (b)(3) of this section, not to be a foreign person.

(B) *Belated notice of false certification.* If after the date of a distribution described in paragraph (e)(1) of this section a domestic corporation learns that an interest-holder's certification of non-foreign status is false, then the corporation may rely upon that certification only if the person providing the false certification holds (or held) less than 10 percent of the value of the outstanding stock of the corporation. With respect to less than 10 percent interest-holders, no withholding is required under this paragraph (e) upon receipt of a belated notice of false certification. With respect to 10 percent or greater interest-holders, the corporation's withholding obligations under this paragraph (e) shall apply as if a certification had never been given, and such a corporation may be held fully liable pursuant to §1.1445–5(b)(6) for any failure to withhold as of the date specified in this §1.1445–5(e)(2)(iii)(B). Amounts withheld pursuant to the rule of this paragraph (e)(2)(iii)(B) must be reported and paid over by the 60th day following the date on which the corporation learns that the certification is false. No penalties or interest for failures to withhold will be assessed prior to that date. For rules concerning the notifications of false certifications that may be required to be given to U.S. real property holding corporations, see §1.1445–4(b).

(iv) *Withholding certificate.* No withholding, or reduced withholding, is required under this paragraph (e) with respect to a domestic corporation's distribution of property if the distributing corporation obtains a withholding certificate from the Internal Revenue Service that so provides. For rules concerning the issuance of withholding certificates, see §1.1445–6.

(f) *Taxable distributions by domestic or foreign partnerships, trusts, or estates.* [Reserved]

(g) *Dispositions of interests in partnerships, trusts, and estates.* [Reserved]

[T.D. 8113, 51 FR 46642, Dec. 24, 1986; 52 FR 3796, 3917, Feb. 6, 1987, as amended at T.D. 8198, 53 FR 16230, May 5, 1988; T.D. 8321, 55 FR 50553, Dec. 7, 1990; T.D. 8647, 60 FR 66076, Dec. 21, 1995; 61 FR 7157, Feb. 26, 1996; T.D. 8734, 62 FR 53467, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53467, Oct. 14, 1997, §1.1445–5 was amended in paragraph (b)(1), by revising the second sentence, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.1445–5 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.1445–5 Special rules concerning distributions and other transactions by corporations, partnerships, trusts, and estates.

* * * * *

(b) * * * (1) * * * If tax is required to be withheld under section 1441 or 1442 with respect to a transfer of property, withholding shall not be required under section 1445 or §1.1445–5. * * *

* * * * *

§1.1445–6 Adjustments pursuant to withhold certificate of amount required to be withheld under section 1445(e).

(a) *Withholding certificate for purposes of section 1445(e)*—(1) *In general.* Pursuant to the provisions of §1.1445–5 (c)(2)(iv), (d)(2)(ii), and (e)(2)(iv), withholding under section 1445(e) may be reduced or eliminated pursuant to a withholding certificate issued by the Internal Revenue Service in accordance with the rules of this § 1.1445–6. A withholding certificate may be issued in cases where adjusted withholding is appropriate (e.g., because of the applicability of a nonrecognition provision—see paragraph (c) of this section), where the relevant taxpayers are exempt from U.S. tax (see paragraph (d) of this section), or where an agreement for the payment of tax is entered into with the Service (see paragraph (e) of this section). A withholding certificate that is obtained prior to a transfer allows the entity or fiduciary to withhold a reduced amount or excuses withholding entirely. A withholding certificate that is obtained after a transfer has been made may authorize a normal refund or an early refund pursuant to paragraph (g) of this section. The Internal Revenue Service will act upon an application for a withholding certificate not later than the 90th day after it is received. (The Service may deny a request for a withholding certificate where, after due notice, an applicant fails to provide the information necessary to make a determination.) Solely for this purpose (i.e., determining the day upon which the 90 day period commences), an application is received by the Service on the date when all information necessary for the Service to make a determination is provided by the applicant. (For rules regarding whether an application has been timely submitted, see § 1.1445–5(b)(5)). The Internal Revenue Service will act upon an application for an early refund not later than the 90th day after it is received. An application for an early refund must either (i) include a copy of a withholding certificate issued by the Service with respect to the transaction, or (ii) be combined with an application for a withholding certificate. Where an application for an early refund is combined with an application for a withholding certificate, the Service will act upon both applications not later than the 90th day after receipt. Either an entity, a fiduciary, or a relevant taxpayer (as defined in paragraph (a)(2) of this section) may apply for a withholding certificate. An entity or fiduciary may apply for a withholding certificate with respect to all or less than all relevant taxpayers. For special rules concerning the issuance of a withholding certificate to a foreign corporation that has made an election under section 897(i), see § 1.1445–7(d).

(2) *Relevant taxpayer.* For purposes of this section, the term ‘‘relevant taxpayer’’ means any foreign person that will bear substantive income tax liability by reason of the operation of section 897 with respect to a transaction upon which withholding is required under section 1445(e).

(b) *Applications for withholding certificates*—(1) *In general.* An application for a withholding certificate pursuant to this § 1.1445–6 must be submitted in the manner provided in § 1.1445—3 (b). However, in lieu of the information required to be submitted pursuant to § 1.1445–3(b)(4), the applicant must provide the information required by paragraph (b)(2) of this section. In addition, the information required by paragraph (b)(3) of this section must be submitted with the application.

(2) *Basis for certificate*—(i) *Adjusted withholding.* If a withholding certificate is sought on the basis of a claim that adjusted withholding is appropriate, the application must include a calculation, in accordance with paragraph (c) of this section, of the maximum tax that may be imposed on each relevant taxpayer with respect to which adjusted withholding is sought. The application must also include all evidence necessary to substantiate the claimed calculation, such as records of adjustments to basis or appraisals of fair market value.

(ii) *Exemption.* If a withholding certificate is sought on the basis of a relevant taxpayer’s exemption from U.S. tax, the application must set forth a brief statement of the law and facts that support the claimed exemption. See paragraph (d) of this section.

(iii) *Agreement.* If a withholding certificate is sought on the basis of an agreement for the payment of tax, the application must include a copy of the agreement proposed by the applicant and a copy of the security instrument (if any) proposed by the applicant. In this regard, see paragraph (e) of this section.

(3) *Relevant taxpayers.* An application for withholding certificate pursuant to this section must set forth the name, identifying number (if any) and home address (in the case of an individual) or office address (in the case of an entity) of each relevant taxpayer with respect to which adjusted withholding is sought.

(c) *Adjustment of amount required to be withheld.* The Internal Revenue Service may issue a withhold certificate that excuses withholding or that permits an entity or fiduciary to withhold an adjusted amount reflecting the relevant taxpayers' maximum tax liability. A relevant taxpayer's maximum tax liability is the maximum amount which that taxpayer could be required to pay as tax by reason of the transaction upon which withholding is required. In the case of an individual taxpayer that amount will generally be the gain realized by the individual, multiplied by the maximum individual income tax rate applicable to long term capital gain. In the case of a corporate taxpayer, that amount will generally be the gain realized by the corporation, multiplied by the maximum corporate income tax rate applicable to long term capital gain. However, that amount must be adjusted to take into account the following:

(1) Any reduction of tax to which the relevant taxpayer is entitled under the provisions of a U.S. income tax treaty;

(2) The effect of any nonrecognition provision that is applicable to the transaction;

(3) Any losses previously realized and recognized by the relevant taxpayer during the taxable year by reason of the operation of section 897;

(4) Any amount realized upon the subject transfer by the relevant taxpayer that is required to be treated as ordinary income under any provision of the Code; and

(5) Any other factor that may increase or reduce the tax upon the transaction.

(d) *Relevant taxpayer's exemption from U.S. tax*—(1) *In general.* The Internal Revenue Service will issue a withholding certificate that excuses withholding by an entity or fiduciary if it is established that a relevant taxpayer's income from the transaction will be exempt from U.S. tax. For the available exemptions, see paragraph (d)(2) of this section. If a relevant taxpayer is entitled to a reduction of (rather than an exemption from) U.S. tax, then the entity or fiduciary may obtain a withholding certificate to that effect pursuant to the provisions of paragraph (c) of this section.

(2) *Available exemptions.* A relevant taxpayer's income from a transaction with respect to which withholding is required under section 1445(e) may be exempt from U.S. tax because either:

(i) The relevant taxpayer is an integral part or controlled entity of a foreign government and the subject income is exempt from U.S. tax pursuant to section 892 and the regulations thereunder; or

(ii) The relevant taxpayer is entitled to the benefits of an income tax treaty that provides for such an exemption (subject to the limitations imposed by section 1125(c) of Pub. L. 96–499, which, in general overrides such benefits as of January 1, 1985).

(e) *Agreement for the payment of tax*—(1) *In general.* The Internal Revenue Service will issue a withholding certificate that excuses withholding or that permits an entity or fiduciary to withhold a reduced amount, if the entity, fiduciary, or a relevant taxpayer enters into an agreement for the payment of tax pursuant to the provisions of this paragraph (e). An agreement for the payment of tax is a contract between the Service and the entity, fiduciary, or relevant taxpayer that consists of two necessary elements. Those elements are—

(i) A contract between the Service and the other person, setting forth in detail the rights and obligations of each; and

(ii) A security instrument or other form of security acceptable to the Assistant Commissioner (International).

(2) *Contents of agreement*—(i) *In general.* An agreement for the payment of tax must cover an amount described in subdivision (ii) or (iii) of this paragraph (e)(2). The agreement may either

provide adequate security for the payment of the chosen amount with respect to the relevant taxpayer in accordance with paragraph (e)(3) of this section or provide for the payment of that amount through a combination of security and withholding of tax by the entity or fiduciary.

(ii) *Tax that would otherwise be withheld.* An agreement for the payment of tax may cover the amount of tax that would otherwise be required to be withheld with respect to the relevant taxpayer pursuant to section 1445(e). In addition to the amount computed pursuant to section 1445(e), the applicant must agree to pay interest upon that amount, at the rate established under section 6621, with respect to the period between the date on which withholding tax under section 1445(e) would otherwise be due and the date on which the relevant taxpayer's payment of tax with respect to the disposition will be due. The amount of interest agreed upon must be paid by the applicant regardless of whether or not the Service is required to draw upon any security provided pursuant to the agreement. The interest may be paid either with the return or by the Service drawing upon the security.

(iii) *Maximum tax liability.* An agreement for the payment of tax may cover the relevant taxpayer's maximum tax liability, determined in accordance with paragraph (c) of this section. The agreement must also provide for the payment of an additional amount equal to 25 percent of the amount determined under paragraph (c) of this section. This additional amount secures the interest and penalties that would accrue between the date of the relevant taxpayer's failure to file a return and pay tax with respect to the disposition, and the date of which the Service collects upon that liability pursuant to the agreement.

(iv) *Allocation of payment.* An agreement for the payment of tax pursuant to this section must set forth an allocation of the payment provided for by the agreement among the relevant taxpayers with respect to which the withholding certificate is sought. In the case of an agreement that covers an amount described in subdivision (ii) of this paragraph (e)(2), such allocation must be based upon the amount that would otherwise be required to be withheld with respect to each relevant taxpayer. In the case of an agreement that covers an amount described in subdivision (iii) of this paragraph (e)(2), such allocation must be based upon each relevant taxpayer's maximum tax liability.

(3) *Major types of security.* The major types of security that are acceptable to the Internal Revenue Service for purposes of this section are described in § 1.1445–3(e)(3).

(4) *Terms of security instrument.* Any security instrument that is furnished pursuant to this section must contain the terms described in § 1.1445–3(e)(4).

(f) *Amendments to application for withholding certificates*—(1) *In general.* An applicant for a withholding certificate may amend an otherwise complete application by submitting an amending statement to the Assistant Commissioner (International) at the address provided in § 1.1445–1(g)(10). The amending statement shall provide the information required by § 1.1445–6(f)(3) and must be signed and accompanied by a penalties of perjury statement in accordance with § 1.1445–6(b).

(2) *Extension of time for the Service to process requests for withholding certificates*—(i) *In general.* If an amending statement is submitted, the time in which the Internal Revenue Service must act upon the amended application shall be extended by 30 days.

(ii) *Substantial amendments.* If an amending statement is submitted and the Service finds that the statement substantially amends to the facts of the underlying application or substantially alters the terms of the withholding certificate as requested in the initial application, the time within which the Service must act upon the amended application shall be extended by 60 days. The applicant shall be so notified.

(iii) *Amending statement received after the requested withholding certificate has been signed by the Assistant Commissioner (International).* If an amending statement is received after the withholding certificate, drafted in response to the underlying application, has been signed by the Assistant Commissioner (International) or his delegate and prior to the day such certificate is mailed to the applicant, the time in which the Service must act upon the amended application shall be extended by 90 days.

(3) *Information required to be submitted.* No particular form is required for an amending statement but the statement must provide the following information:

(i) *Identification of applicant.* The amending statement must set forth the name, address, and identifying number (if any) of the person submitting the amending statement.

(ii) *Date of application.* The amending statement must set forth the date of the underlying application for a withholding certificate.

(iii) *Real property interest to be (or that has been) transferred.* The amending statement must set forth a brief description of the real property interest with respect to which the underlying application for a withholding certificate was submitted.

(iv) *Amending information.* The amending statement must fully set forth the basis for the amendment including any modification of the facts supporting the application for a withholding certificate and any change sought in the terms of the withholding certificate.

(g) *Early refund of overwithheld amounts.* If the Internal Revenue Service issues a withholding certificate pursuant to this section, and an amount greater than that specified in the certificate was withheld by the entity or fiduciary, then pursuant to the rules of this paragraph (g) a relevant taxpayer may apply for an early refund of a proportionate share of the excess amount (without interest) prior to the date on which the relevant taxpayer's return is due (without extensions). An application for an early refund must be addressed to the Assistant Commissioner (International), at the address provided in §1.1445–1(g)(10). No particular form is required for the application, but the following information must be set forth in separate paragraphs numbered to correspond with the numbers given below:

(1) Name, address, and identifying number (if any) of the relevant taxpayer seeking the refund;

(2) Amount required to be withheld pursuant to withholding certificate;

(3) Amount withheld by entity or fiduciary (attach a copy of Form 8288–A stamped by IRS pursuant to §1.1445–5(b)(4) or provide substantial evidence of the amount withheld in the case of a failure to receive Form 8288–A, as provided in §1.1445–5(b)(7)); and

(4) Amount to be refunded to the relevant taxpayer.

An application for an early refund cannot be processed unless the required copy of Form 8288–A or substantial evidence of the amount withheld in the case of a failure to receive Form 8288–A (as provided in §1.1445–5(b)(7)) is attached to the application. If an application for a withholding certificate is submitted after the transfer takes place, then that application may be combined with an application for an early refund. The Service will act upon a claim for refund within the time limits set forth in §1.1445–6(a)(1).

[T.D. 8113, 51 FR 46648, Dec. 24, 1986; 52 FR 3796, 3917, Feb. 6, 1987]

§1.1445–7 Treatment of foreign corporation that has made an election under section 897(i) to be treated as a domestic corporation.

(a) *In general.* Pursuant to section 897(i) a foreign corporation may elect to be treated as a domestic corporation for purposes of sections 897 and 6039C. A foreign corporation that has made such an election shall also be treated as a domestic corporation for purposes of the withholding required under section 1445, in accordance with the provisions of this section.

(b) *Withholding under section 1445(a)*—(1) *Dispositions by corporation.* A foreign corporation that has made an election under section 897(i) may provide a transferee with a certification of non-foreign status in connection with the corporation's disposition of a U.S. real property interest. However, in accordance with the provisions of §§1.1445–2(b)(2)(ii) and 1.1445–5(b)(3)(ii)(C), such an electing foreign corporation must attach to such certification a copy of the acknowledgment of the election provided to the corporation by the Internal Revenue Service pursuant to

§ 1.897–3(d)(4) which states that the information required by § 1.897–3 has been determined to be complete.

(2) *Dispositions of interests in corporation.* Dispositions of interests in electing foreign corporations shall be subject to the withholding requirements of section 1445(a) and the rules of §§ 1.1445–1 through 1.1445–4. Therefore, if a foreign person disposes of an interest in such a corporation, and that interest is a U.S. real property interest under the provisions of section 897 and regulations thereunder, then the transferee is required to withhold under section 1445(a).

(c) *Withholding under section 1445(e).* Because a foreign corporation that has made an election under section 897(i) is treated as a domestic corporation for purposes of determining withholding obligations under section 1445, such a corporation is not subject to the requirement of section 1445(e)(2) that a foreign corporation withhold at the corporate capital gain rate from the gain recognized upon the distribution of a U.S. real property interest. Such a corporation is subject to the provisions of section 1445(e)(3). Thus, if interests in an electing corporation constitute U.S. real property interests, then the corporation is required to withhold with respect to the non-dividend distribution of any property to an interest-holder that is a foreign person. See § 1.1445–5(e). Dividend distributions (distributions that are described in section 301) shall be treated as provided in sections 897(f), 1441 and 1442. In addition, if interests in an electing foreign corporation do not constitute U.S. real property interests, then distributions by such corporation shall be treated as provided in sections 897(f) (if applicable), 1441 and 1442.

(Approved by the Office of Management and Budget under control number 545–0902)

[T.D. 8113, 51 FR 46650, Dec. 24, 1986; 52 FR 3796, Feb. 6, 1987]

§ 1.1445–8 Special rules regarding publicly traded partnerships, publicly traded trusts and real estate investment trusts (REITs).

(a) *Entities to which this section applies.* The rules of this section apply to—

(1) Any partnership or trust, interests in which are regularly traded on an established securities market (regardless of the number of its partners or beneficiaries), and

(2) Any REIT (regardless of the form of its organization).

For purposes of paragraph (a)(1) of this section, the rules of section 1445 (e)(1) and this section shall not apply to a publicly traded partnership (as defined in section 7704) which is treated as a corporation under section 7704(a), or to those entities that are classified as ‘‘associations’’ and taxed as corporations. See § 301.7701–2.

(b) *Obligation to withhold*—(1) *In general.* An entity described in paragraph (a) of this section is not required to withhold under the provisions of § 1.1445–5(c), which states the withholding requirements of domestic partnerships, trusts and estates upon the disposition of U.S. real property interests. Except as otherwise provided in this paragraph (b), an entity described in paragraph (a) of this section shall be liable to withhold tax upon the distribution of any amount attributable to the disposition of a U.S. real property interest, with respect to each holder of an interest in the entity that is a foreign person. The amount to be withhold is described in paragraph (c) of this section.

(2) *Publicly traded partnerships.* Publicly traded partnerships which comply with the withholding procedures under section 1446 will be deemed to have satisfied their withholding obligations under this paragraph (b).

(3) *Special rule for certain distributions to nominees.* In the case of a person that—

(i) Is a nominee (as defined in paragraph (d) of this section),

(ii) Receives a distribution attributable to the disposition of a U.S. real property interest directly from an entity described in paragraph (a) of this section or indirectly from such entity through a nominee,

(iii) Receives the distribution for payment to any foreign person, or the account of any foreign person, and

(iv) Receives a qualified notice pursuant to paragraph (f) of this section, then the obligation to withhold in accordance with the general rules of section 1445(e)(1) and this paragraph (b) shall be imposed solely on that person to the extent of the amount specified by the qualified notice. A person obligated to withhold by reason of this paragraph (b)(3) is referred to as a withholding agent.

(4) *Person designated to act for withholding agent.* The rules stated in §1.1441–7(b) (1) and (2) regarding a person designated to act for a withholding agent shall apply for purposes of this section.

(5) *Effect of withholding exemption granted under §1.1441–4(f).* A letter issued by a district director under the provisions of §1.1441–4(f), which exempts a person from withholding under section 1441 or section 1442, shall also exempt that person from withholding under this paragraph (b), if—

(i) The letter identifies another person as the withholding agent for purposes of section 1441 or 1442, and

(ii) Such other person enters into a written agreement, with the district director who issued the letter, to be the withholding agent for purposes of this paragraph (b).

The exemption granted, and the corresponding withholding obligation imposed, by this paragraph (b)(5) shall apply with respect to the first distribution made after execution of the agreement described in the preceding sentence and shall continue to apply to all distributions made during the period in which the exemption granted under §1.1441–4(f) is in effect.

(6) *Payment other than in money.* The rule stated in §1.1441–7(c) regarding payment other than in money shall apply for purposes of this section.

(c) *Amount to be withheld*—(1) *Distribution from a publicly traded partnership or publicly traded trust.* The amount to be withheld under this section with respect to a distribution by a publicly traded partnership or publicly traded trust shall be computed in the manner described in §1.1445–5(c)(3) (ii) and (iii), subject to the rules of this section.

(2) *REITs*—(i) *In general.* The amount to be withheld with respect to a distribution by a REIT, under this section shall be equal to 35 percent (or the highest rate specified in section 1445(e)(1)) of the amount described in paragraph (c)(2)(ii) of this section.

(ii) *Amount subject to withholding*—(A) *In general.* Except as otherwise provided in paragraph (c)(2)(ii)(C) of this section, the amount subject to withholding is the amount of any distribution, determined with respect to each share or certificate of beneficial interest, designated by a REIT as a capital gain dividend, multiplied by the number of shares or certificates of beneficial interest owned by the foreign person. Solely for purposes of this paragraph, the largest amount of any distribution occurring after March 7, 1991 that could be designated as a capital gain dividend under section 857(b)(3)(C) shall be deemed to have been designated by a REIT as a capital gain dividend regardless of the amount actually designated.

(B) *Distribution attributable to net short-term capital gain from the disposition of a U.S. real property interest.* [Reserved]

(C) *Designation of prior distribution as capital gain dividend.* If a REIT makes an actual designation of a prior distribution, in whole or in part, as a capital gain dividend, such prior distribution shall not be subject to withholding under this section. Rather, a REIT must characterize and treat as a capital gain dividend distribution (solely for purposes of section 1445(e)(1)) each distribution, determined with respect to each share or certificate of beneficial interest, made on the day of, or any time subsequent to, such designation as a capital gain dividend until such characterized amounts equal the amount of the prior distribution designated as a capital gain dividend. The provisions of this paragraph shall not be applicable in any taxable year in which the REIT adopts a formal or informal resolution or plan of complete liquidation.

(iii) *Example.* The following example illustrates the rules of paragraph (c)(2)(ii)(C) of this section.

In the first quarter of 1988, XYZ REIT makes a dividend distribution of $2X. In the second quarter of 1988, XYZ sells real property, recognizing a long term capital gain of $15X, and makes a dividend distribution of $5X. In the third quarter of 1988, XYZ makes a distribution of $3X. In the fourth quarter of 1988, XYZ sells real property recognizing a long term capital loss of $2X. Within 30 days after the close of the taxable year, XYZ designates a capital gain dividend for the year of $13X. It subsequently makes a fourth quarter distribution of $7X. Since XYZ has made an actual designation of prior distributions during the taxable year as capital gain dividends, withholding on those prior distributions will not be required. However, the REIT must characterize, solely for purposes of section 1445(e)(1), a total amount of $13X of dividend distributions as capital gain dividends. Therefore, the fourth quarter dividend distribution of $7X must be characterized as a capital gain dividend subject to withholding under this section. In addition, XYZ will be required to characterize an additional $6X of subsequent dividend distributions as capital gain dividends.

(d) *Definition of nominee.* For purposes of this section, the term ''nominee'' means a domestic person that holds an interest in an entity described in paragraph (a) of this section on behalf of another domestic or foreign person.

(e) *Determination of non-foreign status by withholding agent.* A withholding agent may rely on a certificate of non-foreign status pursuant to § 1.1445–2(b) or on the statements and address provided to it on Form W–9 or a form that is substantailly similar to such form, to determine whether an interest holder is a domestic person. Reliance on these documents will excuse the withholding agent from liability imposed under section 1445(e)(1) in the absence of actual knowledge that the interest holder is a foreign person. A withholding agent may also employ other means to determine the status of an interest holder, but, if the agent relies on such other means and the interest holder proves, in fact, to be a foreign person, then the withholding agent is subject to any liability imposed pursuant to section 1445 and the regulations thereunder for failure to withhold.

(f) *Qualified notice.* A qualified notice for purposes of paragraph (b)(3)(iv) of this section is a notice given by a partnership, trust or REIT regarding a distribution that is attributable to the disposition of a U.S. real property interest in accordance with the notice requirements with respect to dividends described in 17 CFR 240.10b–17(b) (1) or (3) issued pursuant to the Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.* In the case of a REIT, a qualified notice is only a notice of a distribution, all or any portion of which the REIT actually designates, or characterizes in accordance with paragraph (c)(2)(ii)(C) of this section, as a capital gain dividend in accordance with 17 CFR 240.10b–17(b) (1) or (3), with respect to each share or certificate of beneficial interest. A deemed designation under paragraph (c)(2)(ii)(A) of this section may not be the subject of a qualified notice under this paragraph (f). A person described in paragraph (b)(3) of this section shall be treated as receiving a qualified notice at the time such notice is published in accordance wtih 17 CFR 240.10b–17(b) (1) or (3).

(g) *Reporting and paying over withheld amounts.* With respect to an amount withheld under this section, a withholding agent is not required to conform to the requirements of § 1.1445–5(b)(5) but is required to report and pay over to the Internal Revenue Service any amount required to be withheld pursuant to the rules and procedures of section 1461, the regulations thereunder and § 1.6302–2. Forms 1042 and 1042S are to be used for this purpose.

(h) *Early refund procedure not available.* The early refund procedure set forth in § 1.1445–6(g) shall not apply to amounts withheld under the rules of this section. For adjustment of overwithheld amounts, see § 1.1461.4.

(i) *Liability upon failure to withhold.* For rules regarding liability upon failure to withhold under § 1445(e) and this section, see § 1.1445–1(e).

[T.D. 8321, 55 FR 50553, Dec. 7, 1990; 56 FR 4542, Feb. 5, 1991, as amended by T.D. 8647, 60 FR 66077, Dec. 21, 1995]

§ 1.1445–9T Special rule for section 1034 nonrecognition (temporary).

(a) *Purpose and scope.* This section provides a temporary regulation that, if and when adopted as a final regulation, will add a new paragraph (d)(2)(iii) to § 1.1445–2. Paragraph (b) of this section would then appear as paragraph (d)(2)(iii) of § 1.1445–2.

(b) No particular form is required for a transferor's notice to a transferee that the transferor is not required to recognize gain or loss with respect to a transfer. The notice must be verified as true and signed under penalties of perjury by a responsible officer in the case of a corporation, by a general partner in the case of a partnership, and by a trustee or equivalent fiduciary in the case of a trust or estate. The following information must be set forth in paragraphs labeled to correspond with the designation set forth below:

(1) A statement that the document submitted constitutes a notice of a nonrecognition transfer pursuant to the requirements of §1.1445–2(d)(2);

(2) The name, identifying number (if any), and home address (in the case of an individual) or office address (in the case of an entity) of the transferor submitting the notice;

(3) A statement that the transferor is not required to recognize any gain or loss with respect to the transfer;

(4) A brief description of the transfer;

(5) A brief summary of the law and facts supporting the claim that recognition of gain or loss is not required with respect to the transfer; and

(6) If the transferor claims nonrecognition on the sale or exchange of a principal residence under section 1034(a) and another principal residence in the United States has not been purchased as of the date of sale of the principal residence, either (i) a copy of an executed binding contract for purchase by the transferor of a further principal residence in the United States with a purchase price exceeding the adjusted sales price of the old principal residence or (ii) an affidavit by the transferor signed under penalties of perjury stating that the transferor intends to complete purchase of another principal residence within the United States with a purchase price exceeding the adjusted sales price of the old principal residence by April 15 of the year following the taxable year of the sale of the principal residence, and that the transferor is expected to continue to be employed or stationed in the United States for a period of two years from the sale of the principal residence. If the transferor's adjusted sales price of the old principal residence exceeds the transferor's cost of purchasing another principal residence in the United States, withholding shall be required at the rate of ten percent on the portion of the gross amount realized on the sale or exchange of the principal residence equal to such excess.

(c) *Effective Date.* The rules of this section are effective with respect to sale of a principal residence after August 3, 1988.

[T.D. 8198, 53 FR 16230, May 5, 1988]

§1.1445–10T Special rule for Foreign governments (temporary).

(a) This section provides a temporary regulation that, if and when adopted as a final regulation will add a new paragraph (d)(6) to §1.1445–2. Paragraph (b) of this section would then appear as paragraph (d)(6) of §1.1445–2.

(b) *Foreign government*—(1) *As transferor.* A foreign government is subject to U.S. taxation under section 897 on the disposition of a U.S. real property interest except to the extent specifically otherwise provided in the regulations issued under section 892. A foreign government that disposes of a U.S. real property interest that is not subject to taxation as specifically provided by the regulations under section 892 may present a notice of nonrecognition treatment pursuant to paragraph (d)(2) of this section that specifically cites the provision of such regulation, and thereby avoids withholding by the transferee of the property. A foreign government that disposes of a U.S. real property interest or the transferee of the property may obtain a withholding certificate from the Internal Revenue Service that confirms the applicability of section 892, but neither is required to do so. Rules concerning the issuance of withholding certificates are provided in §1.1445–3.

(2) *As transferee.* A foreign government or international organization that acquires a U.S. real property interest is fully subject to section 1445 and the regulations thereunder. Therefore, such an entity is required to withhold tax upon the acquisition of a U.S. real property interest from a foreign person.

(c) *Effective date.* The rules of this section shall be effective for transfers, exchanges, distributions and other dispositions occuring on or after June 6, 1988.

[T.D. 8198, 53 FR 16230, May 5, 1988]

§ 1.1445–11T Special rules requiring withholding under § 1.1445–5 (temporary).

(a) *Purpose and scope.* This section provides temporary regulations that, if and when adopted as a final regulation will add certain new paragraphs within § 1.1445–5 (b) and (c). The paragraphs of this section would then appear as set forth below. Paragraph (b) of this section would then appear as paragraph (b)(8)(v) of § 1.1445–5. Paragraph (c) of this section would then appear as paragraph (c)(2)(i) of § 1.1445–5. Paragraph (d) of this section would then appear as paragraph (g) of § 1.1445–5.

(b) *Dispositions of interests in partnerships, trusts, and estates.* The provisions of section 1445(e)(5), requiring withholding upon certain dispositions of interests in partnerships, trusts, and estates, that own directly or indirectly a U.S. real property interest shall apply to dispositions on or after the effective date of a later Treasury decision under section 897(g) of the Code except in the case of dispositions of interests in partnerships in which fifty percent of the value of the gross assets consist of U.S. real property interests and ninety percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents. The provisions of section 1445(e)(5), shall apply, however, to dispositions after June 6, 1988, of interests in partnerships in which fifty percent or more of the value of the gross assets consist of U.S. real property interests, and ninety percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents. See paragraph (d) of this section.

(c) *Transactions covered elsewhere.* No withholding is required under this paragraph (c) with respect to the distribution of a U.S. real property interest by a partnership, trust, or estate. Such distributions shall be subject to withholding under section 1445(e)(4) and paragraph (f) of this § 1.1445–5 on the effective date of a later Treasury decision published under section 897(g) of the Code. No withholding is required at this time for distributions described in the preceding sentence. See paragraph (b)(8)(iv) of this § 1.1445–5. No withholding is required under this paragraph with respect to the disposition of an interest in a trust, estate, or partnership except in the case of a partnership in which fifty percent or more of the value of the gross assets consist of U.S. real property interests, and ninety percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents. See paragraph (b)(8)(v) of § 1.1445–5. Withholding shall be required as provided in section 1445(e)(5) and paragraph (g) of this section with respect to the disposition after June 6, 1988, of an interest in a partnership in which fifty percent or more of the value of the gross assets consist of U.S. real property interests, and ninety percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents.

(d) *Dispositions of interests in partnerships, trusts or estates*—(1) *Withholding required on disposition of certain partnership interests.* Withholding is required under section 1445(e)(5) and this paragraph with respect to the disposition by a foreign partner of an interest in a domestic or foreign partnership in which fifty percent or more of the value of the gross assets consist of U.S. real property interests, and ninety percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents. For purposes of this paragraph cash equivalents mean any asset readily convertible into cash (whether or not denominated in U.S. dollars), including, but not limited to, bank accounts, certificates of deposit, money market accounts, commercial paper, U.S. and foreign treasury obligations and bonds, corporate obligations and bonds, precious metals or commodities, and publicly traded instruments. The taxpayer on filing an income tax return for the year of the disposition may demonstrate the extent to which the gain on the disposition of the interest is not attributable to U.S. real property interests. A taxpayer is also permitted by § 1.1445–3 to apply for a withholding certificate in instances where reduced withholding is approporiate.

(2) *Withholding not required*—(i) *Transferee receives statement that interest in*

partnership is not described in paragraph (d)(1). No withholding is required under paragraph (d)(1) of this section upon the disposition of a partnership interest otherwise described in that paragraph if the transferee is provided a statement, issued by the partnership and signed by a general partner under penalties of perjury no earlier than 30 days before the transfer, certifying that fifty percent or more of the value of the gross assets does not consist of U.S. real property interests, or that ninety percent or more of the value of the gross assets of the partnership does not consist of U.S. real property interests plus cash or cash equivalents.

(ii) *Reliance on statement not permitted.* A transferee is not entitled to rely upon a statement described in paragraph (d)(2)(i) of this section if, prior to or at the time of the transfer, the transferee either—

(A) Has actual knowledge that the statement is false, or

(B) Receives a notice, pursuant to §1.1445–4.

Such a transferee's withholding obligations shall apply as if the statement had never been given, and such a transferee may be held fully liable pursuant to §1.1445–1(e) for any failure to withhold.

(iii) *Belated notice of false statement.* If, after the date of the transfer, a transferee receives notice that a statement provided under paragraph (d)(2)(i) of this section is false, then such transferee may rely on the statement only with respect to consideration that was paid prior to the receipt of the notice. Such a transferee is required to withhold a full 10 percent of the amount realized from the consideration that remains to be paid to the transferor. Thus, if 10 percent or more of the amount realized remains to be paid to the transferor, then the transferee is required to withhold and pay over the full 10 percent. The transferee must do so by withholding and paying over the entire amount of each successive payment of consideration to the transferor, until the full 10 percent of the amount realized has been withheld and paid over. Amounts so withheld must be reported and paid over by the 20th day following the date on which each such payment of consideration is made. A transferee that is subject to the rules of this §1.1445–10T(d)(2)(iii) may not obtain a withholding certificate pursuant to §1.1445–3, but must instead withhold and pay over the amounts required by this paragraph.

(e) *Effective date.* The rules of this section are effective for transactions after June 6, 1988.

[T.D. 8198, 53 FR 16231, May 5, 1988]

TAX–FREE COVENANT BONDS

§1.1451–1 Tax-free covenant bonds issued before January 1, 1934.

(a) *Rates of withholding*—(1) *Rate of 2 percent.* Withholding of a tax equal to 2 percent is required in the case of interest upon bonds or other corporate obligations containing a tax-free covenant and issued before January 1, 1934, paid to an individual, a fiduciary, or a partnership, whether resident or nonresident, or to a nonresident foreign corporation, regardless of whether the liability assumed by the obligor is less than, equal to, or greater than 2 percent.

(2) *Rate of 30 percent.* Notwithstanding subparagraph (1) of this paragraph, if the liability assumed by the obligor does not exceed 2 percent of the interest, withholding is required at the rate of 30 percent in the case of payments to a nonresident alien individual, a nonresident partnership composed in whole or in part of nonresident aliens, a nonresident foreign corporation, or an owner who is unknown to the withholding agent.

(3) *Obligations of resident payers.* The rates of withholding specified in subparagraphs (1) and (2) of this paragraph are applicable to interest on such tax-free covenant bonds issued by a domestic corporation or by a resident foreign corporation.

(4) *Obligations of nonresident payers.* A nonresident foreign corporation having a fiscal or paying agent in the United States is required to withhold a tax of 2 percent in the case of interest upon its tax-free covenant bonds issued before January 1, 1934, which is paid to an individual or fiduciary who is a citizen or resident of the United States, to a partnership any member of which is a citizen or resident, or to an unknown owner.

(5) *Interest from sources without the United States.* Withholding is not required under section 1451 in the case of interest upon bonds or other corporate obligations issued before January 1, 1934, and containing a tax-free covenant if the interest is not to be treated as income from sources within the United States and the payments are made to a nonresident alien, a partnership composed wholly of nonresident aliens, or a nonresident foreign corporation.

(6) *Tax treaties.* The rates of tax to be withheld in accordance with this paragraph shall be reduced as may be provided by treaty with any country. See section 894 and § 1.1441–6 relating to income subject to a reduced rate of, or an exemption from, income tax pursuant to an income tax convention.

(b) *Date of issue.* The withholding provisions of section 1451 are applicable only to bonds, mortgages, or deeds of trust, or other similar obligations of a corporation which were issued before January 1, 1934, and which contain a tax-free covenant. For the purpose of section 1451, bonds, mortgages, or deeds of trust, or other similar obligations of a corporation, are issued when delivered. If a broker or other person acts as selling agent of the obligor, the obligation is issued when delivered by the agent to the purchaser. If a broker or other person purchases the obligation outright for the purpose of holding or reselling it, the obligation is issued when delivered to such broker or other person.

(c) *Extended maturity date.* In cases where on or after January 1, 1934, the maturity date of bonds or other obligations of a corporation is extended, the bonds or other obligations shall be considered to have been issued on or after January 1, 1934. The interest on such obligations is not subject to the withholding provisions of section 1451 but falls within the class of interest described in section 1441. See paragraph (c)(5)(iii) of § 1.1441–3.

(d) *Covenant in trust deed.* Bonds issued under a trust deed containing a tax-free covenant are treated as if they contain such a covenant. If neither the bonds nor the trust deeds given by the obligor to secure them contained a tax-free covenant, but the original trust deeds were modified before January 1, 1934, by supplemental agreements containing a tax-free covenant executed by the obligor corporation and the trustee, the bonds issued before January 1, 1934, are subject to the provisions of section 1451, provided appropriate authority existed for the modification of the trust deeds in this manner. The authority must have been contained in the original trust deeds or actually secured from the bondholders.

(e) *Notation showing date of issue.* In order that the date of issue of bonds, mortgages, deeds of trust, or other similar corporate obligations containing a tax-free covenant may be readily determined by the owner for the purpose of preparing the ownership certificates required by § 1.1461–1, the issuing or debtor corporation shall indicate the date of issue by an appropriate notation, or use the phrase ‘‘issued on or after January 1, 1934,’’ on each such obligation or in a statement accompanying the delivery of the obligation.

(f) *Effect of withholding on income taxes of bondholder and issuing corporation*—(1) *Federal tax.* In the case of corporate bonds or other corporate obligations issued before January 1, 1934, and containing a tax-free covenant, the corporation paying a Federal tax, or any part of it, for someone else pursuant to its agreement is not entitled to deduct such payment from its gross income on any ground; nor shall the tax so paid be included in the gross income of the bondholder. The amount of the tax so paid may, nevertheless, be claimed by the bondholder in accordance with paragraph (a) of § 1.1462–1 as a credit against the total amount of income tax due. See also section 32. The tax so paid by the corporation upon tax-free covenant bond interest payable to a domestic or resident fiduciary and allocable to any nonresident alien beneficiary under section 652 or 662 is allowable, pro rata, as a credit against:

(i) The tax required to be withheld by the fiduciary in accordance with paragraph (f) of § 1.1441–3 from the income of the beneficiary, and

(ii) The total income tax computed in the return of the beneficiary, as indicated in paragraph (a) of § 1.1462–1.

(2) *State taxes.* In the case of corporate bonds or other obligations containing an appropriate tax-free covenant, the corporation paying for someone else, pursuant to its agreement, a State tax or any tax other than a Federal tax may deduct such payment as interest paid on indebtedness.

(g) *Alien resident of Puerto Rico.* For purposes of this section the term ''nonresident alien individual'' includes an alien resident of Puerto Rico.

(h) *Other rules for withholding of tax under section 1451.* The rules for withholding stated in paragraphs (c) (2) and (3), (f), and (g) of §1.1441–3 shall also apply for purposes of withholding the tax under this section.

[T.D. 6500, 25 FR 12076, Nov. 26, 1960, as amended by T.D. 7157, 36 FR 25228, Dec. 30, 1971]

§1.1451–2 Exemptions from withholding under section 1451.

(a) *Claiming personal exemptions.* Withholding under §1.1451–1 from interest on bonds or other obligations of corporations issued before January 1, 1934, and containing a tax-free covenant shall not be required if there is filed with the withholding agent when presenting coupons for payment, or not later than February 1 of the following year, an ownership certificate on Form 1000 stating:

(1) In the case of a citizen or resident of the United States, that his taxable income does not exceed his deductions for personal exemptions allowed under section 151; or

(2) In the case of an estate or trust the fiduciary of which is a citizen or resident of the United States, that its taxable income does not exceed the deduction for the personal exemption allowed under section 642(b).

(b) *Claiming residence in United States.* To claim residence in the United States for purposes of section 1451, see §1.1441–5.

(c) *Other exemptions.* The exemptions allowed by paragraphs (d) and (h) of §1.1441–4 shall also apply for purposes of section 1451.

[T.D. 6500, 25 FR 12077, Nov. 26, 1960, as amended by T.D. 6908, 31 FR 16774, Dec. 31, 1966]

APPLICATION OF WITHHOLDING PROVISIONS

§1.1461–1 Payment and returns of tax withheld.

(a) *Payment of withheld tax*—(1) *Deposits of tax.* Every withholding agent who withholds tax pursuant to chapter 3 of the Internal Revenue Code (Code) and the regulations under such chapter shall deposit such amount of tax with a Federal reserve bank or authorized financial institution as provided in §1.6302–2(a). If for any reason the total amount of tax required to be returned for any calendar year pursuant to paragraph (b) of this section has not been deposited pursuant to §1.6302–2, the withholding agent shall pay the balance of tax due for such year at such place as the Internal Revenue Service (IRS) shall specify. The tax shall be paid when filing the return required under paragraph (b)(1) of this section for such year, unless the IRS specifies otherwise. See paragraph (b)(2) of this section when there are multiple withholding agents.

(2) *Penalties for failure to pay tax.* For penalties and additions to the tax for failure to timely pay the tax required to be withheld under chapter 3 of the Code, see sections 6656, 6672, and 7202 and the regulations under those sections.

(b) *Income tax return*—(1) *General rule.* A withholding agent shall make an income tax return on Form 1042 (or such other form as the IRS may prescribe) for income paid during the preceding calendar year that the withholding agent is required to report on an information return on Form 1042–S (or such other form as the IRS may prescribe) under paragraph (c)(1) of this section. See section 6011 and §1.6011–1(c). The withholding agent must file the return on or before March 15 of the calendar year following the year in which the income was paid. The return must show the aggregate amount of income paid and tax withheld required to be reported on all the Forms 1042–S for the preceding calendar year by the withholding agent, in addition to such information as is required by the form and accompanying instructions. Withholding certificates or other statements or information provided to a withholding agent are not required to be attached to the return. A return must be filed under this paragraph (b)(1) even though no tax was required to be withheld during the preceding calendar year. The withholding agent must retain a copy of Form 1042 for the applicable statute of limitations on assessments and collection with respect to the amounts required to be reported on the Form 1042. See section 6501 and the regulations thereunder for the applicable statute of limitations. Adjustments to the total amount of tax withheld, as described in § 1.1461–2, shall be stated on the return as prescribed by the form and accompanying instructions.

(2) *Multiple withholding agents*—(i) *General rule.* Except as otherwise provided in paragraph (b)(2) (ii), (iii), (iv), or (v) of this section, no Form 1042 is required to be filed under paragraph (b)(1) of this section if a return is filed by another withholding agent reporting the same income in compliance with the provisions of this paragraph (b) and any remaining tax due is paid by such other withholding agent with the return in accordance with the provisions of paragraph (a) of this section.

(ii) *Payment to a qualified intermediary.* A U.S. withholding agent making a payment to a qualified intermediary (as defined in § 1.1441–1(e)(5)(ii)) must file a return under paragraph (b)(1) of this section, regardless of whether the qualified intermediary assumes primary withholding responsibility for the payment, as described in § 1.1441–1(e)(5)(iv) and regardless of whether the qualified intermediary is also required to file a return under the terms of its agreement with the IRS. A qualified intermediary's agreement with the IRS shall specify the extent, if any, to which the intermediary is subject to filing requirements under this section.

(iii) *Payment to a non-qualified intermediary.* A withholding agent making a payment to a foreign intermediary that is not a qualified intermediary described in § 1.1441–1(e)(5)(ii) must file a return under paragraph (b)(1) of this section to report such payments. The foreign intermediary is not required to make a return to report the payments that it itself makes to the persons for whom it collects the payments to the extent that the withholding agent represents to the intermediary that it will file such a return or that it has done so.

(iv) *Payment to or through an authorized foreign agent.* Both the U.S. withholding agent making a payment to or through an authorized foreign agent (defined in § 1.1441–7(c)) and the authorized foreign agent are required to file a return under paragraph (b)(1) of this section.

(v) *Payments to foreign partnerships.* A withholding agent making a payment to a foreign partnership (whether or not a withholding foreign partnership) shall file a return under paragraph (b)(1) of this section in the same manner as is required for a withholding agent making a payment to a qualified intermediary.

(vi) *Payments to a U.S. branch of certain foreign banks, or insurance companies.* A withholding agent making a payment to a U.S. branch described in § 1.1441–1(b)(2)(iv) must file a return under paragraph (b)(1) of this section, irrespective of the fact that the branch is treated as a U.S. person or is presumed to receive income that is effectively connected with its conduct of a trade or business in the United States.

(3) *Payments to wholly-owned entities.* A withholding agent making a payment to a wholly-owned entity that is disregarded for Federal tax purposes under § 301.7701–2(c)(2) of this chapter as an entity separate from its owner and whose single owner is a foreign person shall file a return under paragraph (b)(1) of this section.

(4) *Amended returns.* An amended return may be filed on a Form 1042X or such other form as the IRS may prescribe. An amended return must include such information as the form or accompanying instructions shall require, including, with respect to any information that has changed from the time of the filing of the return, the information that was shown on the original return and the corrected information.

(c) *Information returns*—(1) *Filing requirement*—(i) *In general.* A withholding agent (other than an individual who is not acting in the course of a trade or business with respect to the payment) must make an information return on Form 1042–S (or such other form as the IRS may prescribe) to report the amounts specified in paragraph (c)(2) of this section that were paid during the preceding calendar year. One Form 1042–S shall be prepared for each beneficial owner (except as otherwise provided in paragraph (c)(4) of this section regarding multiple withholding agents). The Form 1042–S shall be prepared in such manner as the form and accompanying instructions prescribe. One copy of the Form 1042–S shall be filed with the IRS on or before March 15 of the calendar year following the year in which the item of income was paid. It shall be filed with a transmittal form as provided in the instructions to the Form 1042–S and to the transmittal form. Withholding certificates or other statements or documentation provided to a withholding agent are not required to be attached to the information return. Another copy of the Form 1042–S shall be furnished to the payee on or before March 15 of the calendar year following the year in which the item of income was paid.

The withholding agent shall retain a copy of each Form 1042–S for the statute of limitations on assessment and collection applicable to the Form 1042 to which the Form 1042–S relates.

(ii) *Joint owners.* In the case of joint owners, a single Form 1042–S may be prepared. However, upon request of any one of the owners, the withholding agent shall furnish to such owner its own Form 1042–S. Where more than one Form 1042–S is issued with respect to a single payment to joint owners, the aggregate amount of items paid and tax withheld reported on the Forms 1042–S cannot exceed the amounts paid to the joint owners and tax withheld thereon. If a single Form 1042–S is prepared, the form shall state the name of only one owner and that name shall be that of any person whose status the withholding agent relied upon to determine the applicable rate of withholding tax.

(2) *Amounts subject to reporting*—(i) *In general.* Subject to the exceptions described in paragraph (c)(2)(ii) of this section, the amounts required to be reported on a Form 1042–S are amounts paid to foreign persons (including persons who are presumed to be foreign) that consist of amounts subject to withholding (as defined in §1.1441–2(a)) under section 1441, 1442, or 1443. This includes (but is not limited to)—

(A) The entire amount of corporate distributions (whether deemed or actual) paid to a foreign person, irrespective of any estimate of the portion of the distribution that represents a taxable dividend;

(B) Amounts deemed paid to a foreign person as described in §1.1441–2(d) (dealing with exceptions to withholding where no money or property is paid), except where the amount is exempt from withholding due to lack of knowledge;

(C) Amounts that are (or are presumed to be) effectively connected with the conduct of a trade or business in the United States, irrespective of the fact that no withholding certificate is required to be furnished by the payee or beneficial owner. In the case of amounts paid on a notional principal contract described in §1.1441–4(a)(3) that are presumed to be effectively connected with the conduct of a trade or business in the United States, the amount required to be reported is limited to the net income from the notional principal contract as described in §1.446–3(d). Effectively connected non-periodic payments are reportable for the year in which an actual payment is made;

(D) Interest (including original issue discount) that is not exempt from reporting as provided under §1.6049–8, dealing with certain interest on deposits with banks paid to Canadian residents;

(E) Amounts representing interest paid on an obligation that is sold between interest payment dates;

(F) Amounts paid to foreign governments, international organizations, or the Bank for International Settlements, whether or not documentation must be provided;

(G) Interest (including original issue discount) paid with respect to foreign-targeted registered obligations described in §1.871–14(e)(2) to the extent the documentation requirements described in §1.871–14(e)(3) and (4) are satisfied (taking into account the provisions of §1.871–14(e)(4)(ii), if applicable).

(ii) *Exceptions to reporting.* The amounts listed in paragraphs (c)(2)(ii)(A) through (G) of this section are not required to be reported on a Form 1042–S—

(A) Any item paid by a partnership, trust or estate to the extent the item is required to be reported by the partnership under section 6031 or by the trust or estate under sections 6012(a) and 6034A, and the regulations under those sections;

(B) Any item required to be reported on a Form W–2, including an item required to be shown on Form W–2 solely by reason of § 1.6041–2 (relating to return of information as to payments to employees) or § 1.6052–1 (relating to information regarding payment of wages in the form of group-term life insurance);

(C) Any item required to be reported on Form 1099, and such other forms as are prescribed pursuant to the information reporting provisions of sections 6041 through 6050P and the regulations under these sections;

(D) Amounts paid on a notional principal contract described in § 1.1441–4(a)(3)(i) that are not effectively connected with the conduct of a trade or business in the United States (or treated as not effectively connected pursuant to § 1.1441–4(a)(3)(ii));

(E) Amounts required to be reported on Form 8288 (U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests) or Form 8804 (Annual Return for Partnership Withholding Tax (Section 1446)). A withholding agent that must report a distribution partly on a Form 8288 or 8804 and partly on a Form 1042–S may elect to report the entire amount on a Form 8288 or 8804;

(F) Original issue discount for which no withholding is required under § 1.1441–2(b)(3); and

(G) Amounts described in § 1.1441–1(b)(4)(xviii) (dealing with certain amounts paid by the U.S. government).

(3) *Required information.* The information required to be furnished under this paragraph (c)(3) shall be based upon the information provided by or on behalf of the beneficial owner (e.g., a beneficial owner withholding certificate or documentary evidence), as corrected and supplemented based on the withholding agent's actual knowledge. The Form 1042-S must include the following information, if applicable—

(i) The name, address, and taxpayer identifying number of the withholding agent;

(ii) A description of each category of income paid (e.g., interest, dividends, royalties, etc.) and the aggregate amount in each category expressed in U.S. dollars;

(iii) The rate of withholding applied;

(iv) The name and permanent residence address of the beneficial owner (or of the payee if the beneficial owner is unknown, or of the person receiving the amount if the payee is also unknown);

(v) The taxpayer identifying number of the beneficial owner if required under § 1.1441–1(e)(4)(vii) to be stated on a beneficial owner withholding certificate (or if actually known to the withholding agent making the return). In the case of a financial institution, actual knowledge exists with respect to accounts maintained for customers only if such taxpayer identifying number was stated on a Form W–8 furnished for another payment made through the same account or through another account, the information for which can be retrieved through a centralized account information system (as described in § 1.1441–1(e)(4)(ix)) containing both accounts; and

(vi) Such information as the form or the instructions may require in addition to, or in lieu of, information required under this paragraph (c)(3).

(4) *Multiple withholding agents*—(i) *In general.* Except as otherwise provided in this paragraph (c)(4), no information return is required to be made under paragraph (c)(1)(i) of this section if a return is filed by another withholding agent reporting the same amount pursuant to the provisions of this paragraph (c).

(ii) *Payments to a qualified intermediary or a withholding foreign partnership.* A withholding agent making a payment to a qualified intermediary (described in § 1.1441–1(e)(5)(ii)) or to a withholding foreign partnership (described in § 1.1441–5(c)(2)(i)) must report the payment on a single Form 1042–S or as otherwise directed by the form or the accompanying instructions to the form and must provide a copy of the Form 1042–S to the intermediary or partnership (but is not required to provide the Form 1042–S to the beneficial owners or partners). The Form 1042-S must report the different categories of payments based on different types of income and applicable withholding rates.

(iii) *Payments to an authorized foreign agent*—(A) *Filing obligation of foreign authorized agent.* An authorized foreign agent (as described in §1.1441–7(c)(2)) is subject to the filing requirements described in paragraph (c)(1)(i) of this section because it is a withholding agent. Therefore, to the extent the U.S. withholding agent for which it is acting is not reporting the information required under this paragraph (c), it must report the information required to be reported under paragraph (c)(3) or (4)(vi) of this section.

(B) *Filing obligations of the U.S. withholding agent.* A U.S. withholding agent making a payment to an authorized foreign agent is exempted from the requirement under paragraph (c)(4)(iv) of this section to make a return on Form 1042–S for each beneficial owner and may, instead, make a return on a single Form 1042–S to report the payment made to the authorized foreign agent. The exemption in this paragraph (c)(4)(iii)(B) shall apply only to the extent the authorized foreign agent complies with the filing requirements under paragraph (c)(4)(iii)(A) of this section.

(iv) *Payments to other intermediaries or foreign partnerships.* Payment of an amount to a foreign intermediary described in §1.1441–1(e)(3)(i) that is not a qualified intermediary or to a foreign partnership that is not a withholding foreign partnership described in §1.1441–5(c)(2)(i) may not be shown on a single Form 1042–S but must be reported on separate Forms 1042–S for each beneficial owner or payee whose name appears on a withholding certificate or documentary evidence attached to the intermediary's or partnership withholding certificate that is from a qualified intermediary or a withholding foreign partnership. Payments to an intermediary for the account of undocumented owners or to a foreign partnership for the account of undocumented partners should be reported on a single Form 1042–S made out to the intermediary and bearing the mention ‘‘unknown owners’’.

(v) *Payments to a U.S. branch of certain foreign entities.* Payment of an amount to the U.S. branch of a foreign entity described in §1.1441–1(b)(2)(iv) shall be reported—

(A) On a single Form 1042–S as effectively connected income if the withholding agent cannot reliably associate documentation with the payment to the U.S. branch;

(B) On a single Form 1042–S as an amount paid to an intermediary if the withholding agent can reliably associate the payment with a U.S. branch withholding certificate described in §1.1441–1(e)(3)(v) furnished as evidence of an agreement between the branch and the withholding agent to treat the branch as a U.S. person; or

(C) On separate Forms 1042–S for each beneficial owner or payee whose name appears on a withholding certificate or other appropriate documentation attached to the U.S. branch withholding certificate.

(vi) *Required information.* An information return on a Form 1042–S by a withholding agent reporting payments to an intermediary, to a foreign partnership, or to a U.S. branch must contain the information contained in this paragraph (c)(4)(vi). The information on the Form 1042–S must be based upon the withholding certificates furnished by the payee, as corrected and supplemented by the withholding agent based on its actual knowledge or reason to know other facts:

(A) The name, address, and taxpayer identifying number of the withholding agent.

(B) A description of each category of income paid (e.g., interest, dividends, royalties, etc.) and the aggregate amount in each category expressed in U.S. dollars.

(C) The rate of withholding applied.

(D) The basis for not withholding or withholding at a reduced rate.

(E) The name, address, and taxpayer identifying number of the payee.

(F) In the case of payments described in paragraph (c)(4)(iv) of this section, the information described in paragraphs (c)(3)(iv) and (v) of this section regarding the person for whom a Form 1042–S is required to be prepared under paragraph (c)(4)(iv).

(G) Such information as the form or instructions may require in addition to, or in lieu of, the information required under this paragraph (c)(4)(vi).

(5) *Payments to single-member entity.* A withholding agent that, upon reliance on a valid withholding certificate, treats a payment as made to a wholly-owned entity that is disregarded to federal tax purposes under § 301.7701–2(c)(2) of this chapter as an entity separate from its owner and whose single owner is a foreign person shall make an information return on Form 1042–S in the name of the foreign single owner, using the owner's taxpayer identifying number if such a number is required to be stated on the form.

(6) *Special rules in the case of claims of treaty benefits by hybrid entities or their interest holders.* A withholding agent must make an information return on a Form 1042–S for each beneficial owner (within the meaning of the applicable tax treaty) upon whose withholding certificate or other appropriate documentation the withholding agent relies to reduce the rate of withholding under a tax treaty. Therefore, in the case of concurrent and consistent claims of reduced rates under several tax treaties by the entity and by one or more interest holders, the withholding agent must make an information return for the entity and for each of the interest holders claiming to derive an allocable share of amounts paid to the entity as a resident of an applicable treaty country.

(7) *Effect of grace period on filing requirements.* A withholding agent who relies on the provisions of § 1.1441–1(b)(3)(iv) to treat the payee as a foreign person during a 90-day grace period while awaiting the documentation must make an information return on a Form 1042–S to report all payments to such person during the grace period even if such person is (or is presumed to be) a U.S. person based upon documentation furnished to the withholding agent when the grace period expired or subsequently, or based upon applicable presumptions in § 1.1441–1(b)(3).

(8) *Magnetic media reporting.* A withholding agent that makes 250 or more Form 1042–S information returns for a taxable year must file Form 1042–S returns on magnetic media. See § 301.6011–2 of this chapter for requirements applicable to a withholding agent that files Forms 1042–S with the IRS on magnetic media and publications of the IRS relating to magnetic media filing.

(d) *Report of taxpayer identifying numbers.* When so required under procedures that the IRS may prescribe in published guidance (see § 601.601(d)(2) of this chapter), a withholding agent must attach to the Form 1042 a list of all the taxpayer identifying numbers (and corresponding names) that have been furnished to the withholding agent and upon which the withholding agent has relied to grant a reduced rate of withholding and that are not otherwise required to be reported on a Form 1042–S under the provisions of this section.

(e) *Indemnification of withholding agent.* A withholding agent is indemnified against the claims and demands of any person for the amount of any tax it deducts and withholds in accordance with the provisions of chapter 3 of the Code and the regulations under that chapter. A withholding agent that withholds based on a reasonable belief that such withholding is required under chapter 3 of the Code and the regulations under that chapter is treated for purposes of section 1461 and this paragraph (e) as having withheld tax in accordance with the provisions of chapter 3 of the Code and the regulations under that chapter. In addition, a withholding agent is indemnified against the claims and demands of any person for the amount of any payments made in accordance with the grace period provisions set forth in § 1.1441–1(b)(3)(iv). This paragraph (e) does not apply to relieve a withholding agent from tax liability under chapter 3 of the Code or the regulations under that chapter.

(f) *Amounts paid not constituting gross income.* Any amount withheld in accordance with § 1.1441–3 shall be reported and paid in accordance with this section, even though the amount paid to the beneficial owner may not constitute gross income in whole or in part. For this purpose, a reference in this section and §1.1461–2 to an amount shall, where appropriate, be deemed to refer to the amount subject to withholding under §1.1441–3.

(g) *Extensions of time to file Forms 1042 and 1042–S.* The IRS may grant an extension of time in which to file a Form 1042 or a Form 1042–S. Form 2758, Application for Extension of Time to File Certain Excise, Income, Information, and Other Returns (or such other form as the IRS may prescribe), must be used to request an extension of time for a Form 1042. Form 8809, Request for Extension of Time to File Information Returns (or such other form as the IRS may prescribe) must be used to request an extension of time for a Form 1042–S. The request must contain a statement of the reasons for requesting the extension and such other information as the forms or instructions may require. It must be mailed or delivered not later than March 15 of the year following the end of the calendar year for which the return will be filed.

(h) *Penalties.* For penalties and additions to the tax for failure to file returns or furnish statements in accordance with this section, see sections 6651, 6662, 6663, 6721, 6722, 6723, 6724(c), 7201, 7203, and the regulations under those sections.

(i) *Effective date.* This section shall apply to returns required for payments made after December 31, 1999.

[T.D. 8734, 62 FR 53467, Oct. 14, 1997, as amended by T.D. 8804, 63 FR 72188, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53467, Oct. 14, 1997, §1.1461–1 was revised, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.1461–1 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.1461–1 Ownership certificates for bond interest.

(a) *Tax-free covenant bond interest of citizens and residents of the United States.* Citizens, resident individuals, fiduciaries, and partnerships, and nonresident partnerships all of the members of which are citizens or residents, owning bonds, mortgages, or deeds of trust, or other similar obligations issued by a domestic corporation, a resident foreign corporation, or a nonresident foreign corporation having a fiscal or paying agent in the United States, shall, when presenting interest coupons for payment, file ownership certificates for each issue of such obligations issued before January 1, 1934, and containing a tax-free covenant. This rule shall apply without regard to the amount of the interest coupons.

(b) *Nonresident aliens and foreign corporations.* (1) Nonresident alien individuals, foreign partnerships, foreign corporations, and unknown owners, owning bonds, mortgages, or deeds of trust, or other similar obligations of a corporation, shall, when presenting interest coupons for payment, file ownership certificates for each issue of all such obligations whether or not the obligation contains a tax-free covenant. This rule shall apply without regard to the amount of the interest coupons and without regard to the date on which the obligations were issued.

(2) Ownership certificates shall also be filed in the case of interest paid on obligations of the United States or of any agency or instrumentality thereof, irrespective of the date on which the obligations are issued or of the amount of the interest, if the obligations are owned by a nonresident alien individual, foreign partnership, foreign corporation, or an unknown owner.

(3) Notwithstanding subparagraphs (1) and (2) of this paragraph, ownership certificates are not required to be filed by:

(i) A nonresident alien individual, foreign partnership, or foreign corporation, engaged in a trade or business in the United States during the taxable year, if the interest is effectively connected with the conduct of a trade or business within the United States by such person and is exempted from withholding under section 1441 or section 1442 by reason of paragraph (a) of §1.1441–4,

(ii) A nonresident alien individual, a foreign corporation, or a foreign partnership composed wholly of nonresident alien individuals and foreign corporations, if the interest is treated under section 861(a)(1) and the regulations thereunder as income not from sources within the United States, or

(iii) A foreign partnership or foreign corporation engaged in trade or business in the United States during the taxable year, with respect to interest which is exempted from withholding under section 1441 or 1442 by reason of paragraph (f) of §1.1441–4.

(4) See §1.1441–6 in case of coupon bond interest which is subject to a reduced rate of, or an exemption from, tax pursuant to a tax convention.

(c) *Overdue coupon bonds.* In the case of interest payments on overdue coupon bonds, the interest coupons of which have been exhausted, ownership certificates are required to be filed when collecting the interest in the same manner as if interest coupons were presented for collection.

(d) *Information shown on ownership certificate.* The ownership certificate shall include such information as is required by the form and accompanying instructions. This paragraph shall apply to all special variations of Form 1001 referred to in paragraph (i) of this section.

(e) *Ownership certificates not required.* Ownership certificates are not required to be filed in the case of interest payments on:

(1) Obligations of a State, Territory, or possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia;

(2) Bonds, mortgages, or deeds of trust, or other similar obligations issued by an individual or a partnership; and

(3) Obligations owned by a domestic corporation or foreign government.

(f) *Interest coupons unaccompanied by ownership certificates.* (1) When interest coupons detached from corporate bonds, or from obligations of the United States or of any agency or instrumentality thereof, are received unaccompanied by ownership certificates, the first bank to which the coupons are presented for payment shall require of the payee a statement showing the name and address of the person from whom the coupons were received by the payee and alleging that the owner of the bonds is unknown to the payee. This rule shall not apply if the owner of the bonds is known to the bank and the bank is satisfied that the owner is a person who is not required to file an ownership certificate.

(2) The bank shall also require the payee to prepare an ownership certificate on Form 1001, which shall be modified by crossing out ''owner,'' inserting ''payee,'' stamping or writing across the face of the certificate ''Statement furnished,'' and adding the name of the bank.

(3) The statement furnished pursuant to this paragraph shall be forwarded to the Internal Revenue Service Center, Philadelphia, PA 19255 with the annual return on Form 1042.

(g) *Noncoupon bonds*—(1) *General rule.* Ownership certificates on Form 1000 or, in case of payments made on or before December 31, 1971, on Form 1001, are required in connection with interest payments on noncoupon bonds as in the case of coupon bonds. If an ownership certificate is not furnished by the owner of a noncoupon bond, the certificate shall be prepared by the withholding agent but is not required to be signed by the owner.

(2) *Application of tax treaties.* Ownership certificates are not required when claiming the benefit of an exemption from tax, or reduced rate of tax, granted by an applicable tax convention in respect of interest payments on noncoupon bonds. Regulations under the various income tax conventions require, in lieu of an ownership certificate, the use of an exemption (or reduced rate) certificate (or corresponding letter) in the case of such interest payments. These regulations are effective with respect to payments made prior to December 31, 1974, if such certificate was filed with respect to such income prior to December 31, 1971. Such a certificate may not be prepared by the withholding agent but must be signed by the owner of the interest, or by his trustee or agent in accordance with the applicable tax treaty regulation. See § 1.1441–6 for requirements with respect to payments to which such certificates do not apply.

(h) *Form of ownership certificate for citizens and residents.* Form 1000 shall be used in preparing ownership certificates of individuals or fiduciaries who are citizens or residents of the United States, of resident partnerships, and of nonresident partnerships all of the members of which are citizens or residents. If the obligations are issued by a nonresident foreign corporation having a fiscal or paying agent in the United States, Form 1000 shall be modified to show the name and address of the fiscal agent or the paying agent in addition to the name and address of the debtor corporation. Duplicate copies of Form 1000 are not required.

(i) *Form of ownership certificate for nonresident aliens and foreign corporations.* Form 1001 shall be used in preparing ownership certificates of nonresident alien individuals, foreign partnerships, foreign corporations, and unknown owners. For payments of interest made prior to December 31, 1971, a special variation of Form 1001 (designated by a letter or letters following the number 1001) shall be used, however, in preparing ownership certificates of persons claiming the benefit of an exemption from tax, or reduced rate of tax, granted by an applicable income tax convention in respect of interest payments on coupon bonds. See the applicable tax treaty regulation and paragraph (d) of this section. Form 1001, and the special variations of such form, for payments of interest made before December 31, 1971, shall be filed in duplicate. Form 1001, for payments of interest made on or after January 1, 1972, shall be retained by the withholding agent for at least 4 years after the interest is paid.

(j) *Ownership certificates in the case of fiduciaries and joint owners.* (1) Fiduciaries having the control and custody of more than one estate or trust, the assets of which include bonds of corporations and other securities, shall execute a certificate of ownership for each estate or trust even though the bonds are of the same issue. The ownership certificate shall show both the name of the estate or trust and the name and address of the fiduciary.

(2) Separate ownership certificates shall be executed in behalf of each person owning bonds jointly with another.

(k) *Inconsistent regulations.* All regulations inconsistent with the provisions of this section shall be deemed to have been modified accordingly.

(Approved by the Office of Management and Budget under control number 1545–0795)

(Secs. 1441(c)(4) (80 Stat. 1553; 26 U.S.C. 1441(c)(4)), 3401(a)(6) (80 Stat. 1554; 26 U.S.C. 3401(a)(6)), and 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 6500, 25 FR 12077, Nov. 26, 1960, as amended by T.D. 6908, 31 FR 16774, Dec. 31, 1966; T.D. 7157, 36 FR 25228, Dec. 30, 1971; T.D. 7977, 49 FR 36835, Sept. 20, 1984]

§1.1461–2 Adjustments for overwithholding or underwithholding of tax.

(a) *Adjustments of overwithheld tax*—(1) *In general.* A withholding agent that has overwithheld under chapter 3 of the Internal Revenue Code (Code) and made a deposit of the tax as provided in §1.6302–2(a) may adjust the overwithheld amount either pursuant to the reimbursement procedure described in paragraph (a)(2) of this section or pursuant to the set-off procedure described in paragraph (a)(3) of this section. Adjustments under this paragraph (a) may only be made within the time prescribed under paragraph (a) (2) or (3) of this section. After such time, a refund of the amount overwithheld can only be claimed by the beneficial owner with the Internal Revenue Service (IRS) pursuant to the procedures described in chapter 65 of the Code. For purposes of this section, the term overwithholding means any amount actually withheld (determined before application of the adjustment procedures under this section) from an item of income pursuant to chapter 3 of the Code or the regulations thereunder in excess of the actual tax liability due, regardless of whether such overwithholding was in error or appeared correct at the time it occurred.

(2) *Reimbursement of tax*—(i) *General rule.* Under the reimbursement procedure, the withholding agent repays the beneficial owner or payee for the amount overwithheld. In such a case, the withholding agent may reimburse itself by reducing, by the amount of tax actually repaid to the beneficial owner or payee, the amount of any deposit of tax made by the withholding agent under §1.6302–2(a)(1)(iii) for any subsequent payment period occurring before the end of the calendar year following the calendar year of overwithholding. Any such reduction that occurs for a payment period in the calendar year following the calendar year of overwithholding shall be allowed only if—

(A) The withholding agent states, on a timely filed (not including extensions) Form 1042–S for the calendar year of overwithholding, the amount of tax withheld and the amount of any actual repayment; and

(B) The withholding agent states on a timely filed (not including extensions) Form 1042 for the calendar year of overwithholding, that the filing of the Form 1042 constitutes a claim for credit in accordance with §1.6414–1.

(ii) *Record maintenance.* If the beneficial owner is repaid an amount of withholding tax under the provisions of this paragraph (a)(2), the withholding agent shall keep as part of its records a receipt showing the date and amount of repayment and the withholding agent must provide a copy of such receipt to the beneficial owner. For this purpose, a canceled check or an entry in a statement is sufficient provided that the check or statement contains a specific notation that it is a refund of tax overwithheld.

(3) *Set-offs.* Under the set-off procedure, the withholding agent may repay the beneficial owner or payee by applying the amount overwithheld against any amount which otherwise would be required under chapter 3 of the Code or the regulations thereunder to be withheld from income paid by the withholding agent to such person before the earlier of the due date (without regard to extensions) for filing the Form 1042–S for the calendar year of overwithholding or the date that the Form 1042–S is actually filed with the IRS. For purposes of making a return on Form 1042 or 1042–S (or an amended form) for the calendar year of overwithholding and for purposes of making a deposit of the amount withheld, the reduced amount shall be considered the amount required to be withheld from such income under chapter 3 of the Code and the regulations thereunder.

(4) *Examples.* The principles of this paragraph (a) are illustrated by the following examples:

Example 1. (i) N is a nonresident alien individual who is a resident of the United Kingdom. In December 2000, a domestic corporation C pays a dividend of $100 to N, at which time C withholds $30 and remits the balance of $70 to N. On February 10, 2001, prior to the time that C files its Form 1042, N furnishes a valid Form W–8 described in § 1.1441–1(e)(2)(i) upon which C may rely to reduce the rate of withholding to 15 percent under the provisions of the U.S.–U.K. tax treaty. Consequently, N advises C that its tax liability is only $15 and not $30 and requests reimbursement of $15. Although C has already deposited the $30 that was withheld, as required by § 1.6302–2(a)(1)(iv), C repays N in the amount of $15.

(ii) During 2000, C makes no other payments upon which tax is required to be withheld under chapter 3 of the Code; accordingly, its return on Form 1042 for such year, which is filed on March 15, 2001, shows total tax withheld of $30, an adjusted total tax withheld of $15, and $30 previously paid for such year. Pursuant to § 1.6414–1(b), C claims a credit for the overpayment of $15 shown on the Form 1042 for 2000. Accordingly, it is permitted to reduce by $15 any deposit required by § 1.6302–2 to be made of tax withheld during the calendar year 2001. The Form 1042–S required to be filed by C with respect to the dividend of $100 paid to N in 2000 is required to show tax withheld of $30 and tax released of $15.

Example 2. The facts are the same as in *Example 1.* In addition, during 2001, C makes payments to N upon which it is required to withhold $200 under chapter 3 of the Code, all of which is withheld in June 2001. Pursuant to § 1.6302–2(a)(1)(iii), C deposits the amount of $185 on July 15, 2001 ($200 less the $15 for which credit is claimed on the Form 1042 for 2000). On March 15, 2002, C Corporation files its return on Form 1042 for calendar year 2001, which shows total tax withheld of $200, $185 previously deposited by C, and $15 allowable credit.

Example 3. The facts are the same as in *Example 1.* Under § 1.6032–2(a)(1)(ii)), C is required to deposit on a quarter-monthly basis the tax withheld under chapter 3 of the Code. C withholds tax of $100 between February 8 and February 15, 2001, and deposits $75 [($100 x 90 percent) less $15] of the withheld tax within 3 banking days after February 15, 2001, and by depositing $10 [($100 − $15) less $75] within 3 banking days after March 15, 2001.

(b) *Withholding of additional tax when underwithholding occurs.* A withholding agent may withhold from future payments made to a beneficial owner the tax that should have been withheld from previous payments to such beneficial owner. In the alternative, the withholding agent may satisfy the tax from property that it holds in custody for the beneficial owner or property over which it has control. Such additional withholding or satisfaction of the tax owed may only be made before the date that the Form 1042 is required to be filed (not including extensions) for the calendar year in which the underwithholding occurred. See § 1.6302–2 for making deposits of tax or § 1.1461–1(a) for making payment of the balance due for a calendar year.

(c) *Definition.* For purposes of this section, the term *payment period* means the period for which the withholding agent is required by § 1.6302–2(a)(1) to make a deposit of tax withheld under chapter 3 of the Code.

(d) *Effective date.* This section applies to payments made after December 31, 1999.

[T.D. 8734, 62 FR 53470, Oct. 14, 1997, as amended by T.D. 8804, 63 FR 72188, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53467, Oct. 14, 1997, § 1.1461–2 was revised, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.1461–2 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.1461–2 Return of tax withheld.

(a) *Effective date.* This section shall apply only with respect to payments of income occurring after December 31, 1966.

(b) *Form 1042*—(1) *Filing requirement.* Every withholding agent shall make on or before March 15 an annual return on Form 1042 of the tax required to be withheld under chapter 3 of the Code during the preceding calendar year. Form 1042 is required to be made in respect of a calendar year, even though no tax was required to be withheld under such chapter during such year, if the withholding agent is required by paragraph (c)(1) of this section to make an information return on Form 1042S with respect to any payments made during such year. Form 1042 shall be filed with the Internal Revenue Service Center, Philadelphia, PA. 19255. The return shall be prepared in duplicate and shall include such information as is required by the form and accompanying instructions. If an adjustment is required on Form 1042 because of repayments of withheld tax pursuant to paragraph (a)(1) of § 1.1461–4, only the aggregate amount of such adjustment shall be shown thereon and no itemized explanation of such aggregate amount shall be required to accompany such form. See paragraph (b) of §1.1461–4. If, pursuant to paragraph (a)(2) of §1.1461–3, any additional amount of tax is required to be paid to the Internal Revenue Service Center, Philadelphia, PA. for the preceding calendar year when filing Form 1042, no itemized explanation of such additional payment of tax shall be required to accompany such form. The duplicate copy of Form 1042 shall be retained by the withholding agent.

(2) *Summary of accompanying forms.* Form 1042 shall be accompanied by the original copies of all Forms 1042S which were prepared by the withholding agent during the previous calendar year, including such forms upon which income exempt from withholding of tax is reported. The forms so forwarded with Form 1042 are not required to be listed thereon; but they shall be summarized on Form 1042 in the manner prescribed thereon and in the instructions applicable thereto. The exemption and reduced rate certificates, such as Form 1001A–D or Form 1001A–J, referred to in paragraph (g)(2) of §1.1461–1 are not required to accompany, or to be summarized on, Form 1042.

(c) *Form 1042S*—(1) *Filing requirement.* Every withholding agent shall make on or before March 15 an annual information return on Form 1042S of all items of income specified in §1.1441–2 paid during the previous calendar year to nonresident alien individuals, foreign partnerships, nonresident alien or foreign fiduciaries of a trust or estate, or foreign corporations if such items consist of—

(i) Amounts upon which tax would have been required to be withheld under chapter 3 of the Code,

(ii) Amounts upon which tax would have been required to be withheld under such chapter but for an exclusion from gross income applicable under any income tax treaty to which the United States is a party,

(iii) Amounts upon which tax would have been required to be withheld under such chapter but for the provisions of any specific complete or partial exemption from withholding applicable under the authority of any regulation under this title or any ruling or procedure of the Commissioner, or

(iv) Amounts in respect of which tax withheld under such chapter has, pursuant to such authority, been released or refunded to the payee by the withholding agent.

All amounts shall be shown in U.S. currency. Notwithstanding subdivisions (i) through (iv) of this subparagraph (1), income paid to nonresident alien individual, foreign partnerships, nonresident alien or foreign fiduciaries of a trust or estate, or foreign corporations and required to be shown on Form W–2, or in the case of income paid prior to January 1, 1972, on Form 1001 (or on any special variation of Form 1001 referred to in paragraph (i) of §1.1461–1, or the substitute thereof) is not required to be shown on Form 1042S. However, a return under this subparagraph is required on Form 1042S (rather than on Form W–2) in respect of amounts which otherwise would be required to be shown on Form W–2 solely by reason of §1.6041–2 (relating to return of information as to payments to employees) or §1.6052–1 (relating to information regarding payment of wages in the form of group-term life insurance). The original Form 1042S shall accompany Form 1042 and shall be filed with the Internal Revenue Service Center, Philadelphia, PA 19255.

(2) *Information to be furnished.* (i) Form 1042S shall include such information as is required by the form and accompanying instructions.

(ii) If a Form 1042S is prepared in respect of an item of income upon which tax has not been withheld under chapter 3 of the Code, a brief statment as to the authority for such failure to withhold shall be made upon the form itself. If necessary, however, a separate statement as to such authority may be attached to the original copy of the Form 1042S.

(iii) If a Form 1042S is prepared in respect of compensation from which the personal exemption is deducted in accordance with paragraph (e) of §1.1441–3, the amount of the compensation allocable to labor or personal services performed within the United States, together with the amount of the deduction for the prorated personal exemption, shall be shown on a separate statement attached to the original copy of that form.

(iv) If any certificate, statement, letter, or form relating to an exemption (as described in §1.1441–4) is filed with or presented to a withholding agent, such certificate, statement, letter, or form shall be attached to each Form 1042S relating to the income subject to the exemption.

(3) *Manner of preparing Form 1042S.* (i) Form 1042S shall be prepared with respect to all payments of any item of income made during the calendar year to the same payee in the manner prescribed by the form and accompanying instructions. Payment of an item of income to a nominee or representative for the benefit of other persons in respect of whom Form 1042S are required may not be shown on a single Forms 1042S but must be identified with the ultimate recipients of the income if such information is known to the payer of the income.

(ii) The duplicate copy of Form 1042S shall be furnished to the payee indicated thereon, and a copy shall be retained by the withholding agent.

(4) *Alternative methods.* To the extent that the withholding agent's system of record keeping makes impractical the use of Form 1042S in the manner prescribed by paragraph (c)(3) of this section, he may devise and submit for the prior annual approval of the

Commissioner a variation of Form 1042S which will include the information required by paragraph (c)(2) of this section and which will substantially comply with the requirements of paragraph (c)(3) of this section. Request for such approval shall be sent to: Internal Revenue Service, Attn: Substitute Forms Program, 1111 Constitution Avenue, NW., Washington, DC 20224 and shall be accompanied by an explanation as to why such variation is necessary.

(d) *Information to be furnished by Commissioner.* If a foreign country has entered into an income tax treaty with the United States which provides for the mutual exchange of information, the Commissioner shall, as soon as practicable after the close of a calendar year during which the treaty is in effect, transmit to the appropriate authority designated in the treaty with that country the information contained in Forms 1042S showing a payee with an address in the country. This information is not to be furnished to any such foreign country, however, if the Commissioner ascertains through appropriate channels that the information is not required by that country.

(e) *Penalties.* For penalties and additions to the tax attaching upon failure to comply with this section, see sections 6651, 6656, 6676, and 7203.

(f) *Special items.* The tax withheld in accordance with paragraphs (b)(1), (c)(3), and (d)(1) of § 1.1441–3 shall be returned and paid in accordance with this section even though the items involved may not constitute gross income in whole or in part. For such purpose, a reference in this section to an item or amount of income shall, where appropriate, be deemed to refer also to the items specified in such paragraphs or the amount thereof.

(g) *Inconsistent regulations.* All regulations inconsistent with the provisions of this section shall be deemed to have been modified accordingly.

(Approved by the Office of Management and Budget under control number 1545–0795)

(Secs. 1441(c)(4) (80 Stat. 1553; 26 U.S.C. 1441(c)(4)), 3401(a)(6) (80 Stat. 1554; 26 U.S.C. 3401(a)(6)), and 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 6500, 25 FR 12078, Nov. 26, 1960, as amended by T.D. 6922, 32 FR 8711, June 17, 1967; T.D. 7157, 36 FR 25228, Dec. 30, 1971; T.D. 7977, 49 FR 36835, Sept. 20, 1984]

§ 1.1461–3 Payment of withheld tax.

(a) *Payments of tax*—(1) *Quarterly payments*—(i) *Years prior to 1973.* Every withholding agent who, pursuant to chapter 3 of the Code, withholds tax during any calendar quarter beginning after December 31, 1966, and ending on or before December 31, 1972, shall, to the extent such amounts have not been deposited pursuant to § 1.6302–2 with a Federal Reserve bank or an authorized commercial bank, pay such withheld tax to the Internal Revenue Service Center, Philadelphia, PA 19255, on or before the last day of the first calendar month following the close of the calendar quarter. Any amounts required to be paid to the Director pursuant to this subdivision shall be made with quarterly transmittal Form 4277, even though the withholding agent has made no deposits pursuant to paragraph (a)(2) of § 1.6302–2 and has no validated depositary receipts to accompany that transmittal form.

(ii) *1973 and subsequent years.* Payments are not required to be made for calendar quarters ending after December 31, 1972.

(2) *Payment of balance of tax with Form 1042.* If for any reason the total amount of tax required to be returned for any calendar year pursuant to paragraph (b) of § 1.1461–2 has not been deposited pursuant to § 1.6302–2 (or, for years prior to 1973 deposited pursuant to § 1.6302–2 or paid pursuant to subparagraph (1) of this paragraph), the withholding agent shall pay the balance of tax due for such year to the Internal Revenue Service Center, Philadelphia, PA 19255, when filing Form 1042 for such year.

(b) *Penalties for failure to pay tax.* For penalties and additions to the tax for failure to pay the tax required to be withheld under chapter 3 of the Code, see sections 6653 and 7202.

(c) *Deposits of tax.* For provisions relating to the use of Federal Reserve banks or authorized financial institutions for the deposit of tax required to be withheld under chapter 3 of the Code, see § 1.6302–2.

(Approved by the Office of Management and Budget under control number 1545–0257)

[T.D. 6922, 32 FR 8712, June 17, 1967, as amended by T.D. 7243, 38 FR 21, Jan. 3, 1973; T.D. 7953, 49 FR 19644, May 9, 1984; T.D. 7977, 49 FR 36836, Sept. 20, 1984]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53471, Oct. 14, 1997, § 1.1461–3 was removed, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of the removal of § 1.1461–3 was delayed until Jan. 1, 2000.

§1.1461–4 Adjustments for overwithholding of tax.

(a) *Repayment of erroneously withheld tax after payment of tax by withholding agent*—(1) *Repayment of tax to payee.* If, in any payment period (as defined in paragraph (c) of this section) occurring in a calendar year, a withholding agent (i) withholds from amounts paid to any person more than the correct amount of tax required to be withheld under chapter 3 of the Code and (ii) makes a deposit of the amount of such overwithholding as provided in §1.6302–2 (or, for years prior to 1973, makes a payment or deposit of the amount of such overwithholding as provided in §1.1461–3 or §1.6302–2), the withholding agent may repay such amount, at any time before filing Form 1042 for such calendar year, to the person from whose income such amount was withheld.

(2) *Reimbursement of payee.* If the withholding agent does not repay the amount of the overwithholding pursuant to subparagraph (1) of this paragraph, the withholding agent may reimburse the person entitled to such amount by applying the amount of the overwithholding against any tax which otherwise would be required under chapter 3 of the Code to be withheld from income paid by the withholding agent to such person before filing Form 1042 for the calendar year in which such overwithholding occurred. For purposes of making a return on Form 1042 and for purposes of making a payment or deposit of the amount withheld, the reduced amount so withheld shall be considered the amount required to be withheld from such income under chapter 3 of the Code.

(b) *Adjustment of tax payments or deposits.* If, pursuant to paragraph (a)(1) of this section, a withholding agent repays a person the amount of tax overwithheld from such person under Chapter 3 of the Code during any payment period of the calendar year, the withholding agent may reduce, by the amount so overwithheld, the amount of any deposit of tax required by paragraph (a) of §1.6302–2 (or, for years prior to 1973, the amount of any payment or deposit of tax required by §1.1461–3 or paragraph (a) of §1.6302–2) to be made by the withholding agent for any subsequent payment period occurring before the end of the calendar year following the calendar year of overwithholding. The reduction of a payment or deposit of tax for a payment period occurring in the calendar year following the calendar year of overwithholding shall be made only if the withholding agent files, on his Form 1042 for the calendar year of overwithholding, a claim for credit in accordance with paragraph (b) of §1.6414–1. The application of this paragraph may be illustrated by the following examples:

Example (1). (a) A is a nonresident alien individual who is a resident of the United Kingdom. In December 1973, a domestic corporation M pays a dividend of $100 to A, at which time M Corporation withholds $30 and remits the balance of $70 to A. On February 16, 1974, A advises M Corporation that, pursuant to the income tax convention with the United Kingdom, only $15 tax should have been withheld from the $100 dividend and requests repayment of the $15 which was erroneously withheld. Although M Corporation has already deposited the $30 which was withheld, as permitted by paragraph (a)(1)(iv) of §1.6302–2, such corporation repays A in the amount of $15.

(b) During 1973 M Corporation makes no other payments upon which tax is required to be withheld under Chapter 3 of the Code; accordingly, its return on Form 1042 for such year, which is filed on March 15, 1974, shows total tax withheld of $30, which is reduced by an adjustment of $15 for the amount repaid to A, an adjusted total tax withheld of $15, and $30 previously paid for such year. Pursuant to paragraph (b) of §1.6414–1, M Corporation claims credit for the overpayment of $15 shown on the Form 1042 for 1973. Accordingly, it is permitted to reduce by $15 any deposit required by §1.6302–2 to be made of tax withheld during 1974. The Form 1042S required to be filed by M Corporation with respect to the dividend of $100 paid to A in 1973 is required to show tax withheld of $30 and tax released of $15. The Form 1042S (or authorized substitute) is required to accompany the Form 1042 for 1973 which is filed on March 15, 1974. No additional explanation is required to be filed with the Form 1042 for 1973 in support of the $15 adjustment claimed thereon.

(c) During 1974 M Corporation is required to withhold under chapter 3 of the Code $200, all of such amount being withheld in June of that year. Pursuant to §1.6302–2, M Corporation deposits on July 15, 1974, the amount of $185, that is, $200 less the $15 for which credit is claimed on the Form 1042 for 1973. On March 17, 1975, M Corporation files its return on Form 1042 for 1974, which shows total tax withheld of $200, $185 previously deposited by M Corporation, and $15 allowable credit.

Example (2). The facts are the same as in example (1) except that paragraph (c) of such example does not apply and that M Corporation is required to deposit on a quarter-monthly basis the tax withheld under chapter 3 of the Code. M Corporation withholds tax of $100 between February 22, and February 28, 1974, and complies with the quarter-monthly deposit requirement of paragraph (a)(1)(ii) of § 1.6302–2 by depositing $75 [(100×90 percent) less $15] of the withheld tax by March 5, 1974 (3 banking days after February 28, 1974) and by depositing $10 [($100 − $15) less $75] by March 20, 1974 (3 banking days after March 15, 1974).

(c) *Definition*—(1) *1973 and subsequent years.* For purposes of this section, for calendar years beginning on or after January 1, 1973, the term *payment period* means a calendar month or a quarter-monthly period (as the case may be) in such a calendar year with respect to which the withholding agent is required by paragraph (a)(1) of § 1.6302–2 to make a deposit of tax withheld under Chapter 3 of the Code.

(2) *Years prior to 1973.* For the purposes of this section, for calendar years ending on or before December 31, 1972, the term *payment period* means (i)*(a)* a calendar month or *(b)* a semimonthly period (as the case may be) in such a calendar year with respect to which the withholding agent is required by paragraph (a)(2) of § 1.6302–2 to make a deposit of tax withheld under Chapter 3 of the Code, or (ii) a calendar quarter in such a calendar year with respect to which he is required by paragraph (a)(1) of § 1.1461–3 to make a payment of such tax.

[T.D. 6922, 32 FR 8712, June 17, 1967, as amended by T.D. 7243, 38 FR 22, Jan. 3, 1973]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53471, Oct. 14, 1997, § 1.1461–4 was removed, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of the removal of § 1.1461–4 was delayed until Jan. 1, 2000.

§ 1.1462–1 Withheld tax as credit to recipient of income.

(a) *Creditable tax.* The entire amount of the income from which the tax is required to be withheld (including amounts calculated under the gross-up formula in § 1.1441–3(f)(1)) shall be included in gross income in the return required to be made by the beneficial owner of the income, without deduction for the amount required to be or actually withheld, but the amount of tax actually withheld shall be allowed as a credit against the total income tax computed in the beneficial owner's return.

(b) *Amounts paid to persons who are not the beneficial owner.* Amounts withheld at source under chapter 3 of the Internal Revenue Code (Code) on payments to a fiduciary, partnership, or intermediary is deemed to have been paid by the taxpayer ultimately liable for the tax upon such income. Thus, for example, if a beneficiary of a trust is subject to the taxes imposed by section 1, 2, 3, or 11 upon any portion of the income received from a foreign trust, the part of any amount withheld at source which is properly allocable to the income so taxed to such beneficiary shall be credited against the amount of the income tax computed upon the beneficiary's return, and any excess shall be refunded. Further, if a partnership withholds an amount under chapter 3 of the Code with respect to the distributive share of a partner that is a partnership or with respect to the distributive share of partners in an upper tier partnership, such amount is deemed to have been withheld by the upper tier partnership.

(c) *Effective date.* This section applies to payments made after December 31, 1999.

[T.D. 8734, 62 FR 53471, Oct. 14, 1997, as amended by T.D. 8804, 63 FR 72188, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53471, Oct. 14, 1997, § 1.1462–1 was revised, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.1462–1 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.1462–1 Withheld tax as credit to recipient of income.

(a) *Return of income from which tax was withheld.* The entire amount of the income from which the tax is required to be withheld shall be included in gross income in the return required to be made by the recipient of the income, without deduction for the amount required to be withheld, but the tax so withheld shall be allowed as a credit against the total income tax computed in the taxpayer's return.

(b) *Amounts paid to fiduciaries.* Tax withheld at the source under chapter 3 of the Code upon income paid to any fiduciary is deemed to have been paid by the taxpayer ultimately liable for the tax upon such income. Thus, for example, if any taxpayer is subject to the taxes imposed by section 1, 2, 3, or 11 upon any portion of the income of a nonresident alien estate or trust, the part of any tax withheld at the source which is properly allocable to the income so taxed to such taxpayer shall be credited against the amount of the income tax computed upon the taxpayer's return, and any excess shall be credited against any income, war profits, or excess profits tax, or installment thereof, then due from the taxpayer, and any balance shall be refunded.

(Approved by the Office of Management and Budget under control number 1545–0795)

(Secs. 1441(c)(4) (80 Stat. 1553; 26 U.S.C. 1441(c)(4)), 3401(a)(6) (80 Stat. 1554; 26 U.S.C. 3401(a)(6)), and 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 6500, 25 FR 12080, Nov. 26, 1960, as amended by T.D. 7977, 49 FR 36836, Sept. 20, 1984]

§1.1463–1 Tax paid by recipient of income.

(a) *Tax paid.* If the tax required to be withheld under chapter 3 of the Internal Revenue Code is paid by the beneficial owner of the income or by the withholding agent, it shall not be recollected from the other, regardless of the original liability therefor. However, this section does not relieve the person that did not withhold tax from liability for interest or any penalties or additions to tax otherwise applicable. See §1.1441–7(b) for additional applicable rules.

(b) *Effective date.* This section applies to failures to withhold occurring after December 31, 1999.

[T.D. 8734, 62 FR 53471, Oct. 14, 1997, as amended by T.D. 8804, 63 FR 72188, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53471, Oct. 14, 1997, §1.1463–1 was revised, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.1463–1 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.1463–1 Tax paid by recipient of income.

If the tax required to be withheld under chapter 3 of the Code is paid by the recipient of the income or by the withholding agent, it shall not be recollected from the other, regardless of the original liability therefor; and, in such event, no penalty will be asserted against either person for failure to return or pay the tax where no fraud or purpose to evade payment is involved.

[T.D. 6500, 25 FR 12081, Nov. 26, 1960]

§1.1464–1 Refunds or credits.

(a) *In general.* The refund or credit under chapter 65 of the Code of an overpayment of tax which has actually been withheld at the source under chapter 3 of the Code shall be made to the taxpayer from whose income the amount of such tax was in fact withheld. To the extent that the overpayment under chapter 3 was not in fact withheld at the source, but was paid, by the withholding agent the refund or credit under chapter 65 of the overpayment shall be made to the withholding agent. Thus, where a debtor corporation assumes liability pursuant to its tax-free covenant for the tax required to be withheld under chapter 3 upon interest and pays the tax in behalf of its bondholder, and it can be shown that the bondholder is not in fact liable for any tax, the overpayment of tax shall be credited or refunded to the withholding agent in accordance with chapter 65 since the tax was not actually deducted and withheld from the interest paid to the bondholder. In further illustration, where a withholding agent who is required by chapter 3 to withhold $300 tax from rents paid to a nonresident alien individual mistakenly withholds $320 and mistakenly pays $350 as internal revenue tax, the amount of $30 shall be credited or refunded to the withholding agent in accordance with chapter 65 and the amount of $20 shall be credited or refunded in accordance with such chapter to the person from whose income such amount has been withheld.

(b) *Tax repaid to payee.* For purposes of this section and §1.6414–1, any amount of tax withheld under chapter 3 of the Code, which, pursuant to paragraph (a)(1) of §1.1461–2, is repaid by the withholding agent to the person from whose income such amount was erroneously withheld shall be considered as tax which, within the meaning of sections 1464 and 6414, was not actually withheld by the withholding agent.

[T.D. 6922, 32 FR 8713, June 17, 1967, as amended by T.D. 8804, 63 FR 72188, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8804, 63 FR 72188, Dec. 31, 1998, in § 1.1464–1 paragraph (b) was amended by removing ''§ 1.1461–4'' and inserting in its place ''1.1461–2'', effective Jan. 1, 2000.

Rules Applicable to Recovery of Excessive Profits on Government Contracts

RECOVERY OF EXCESSIVE PROFITS ON GOVERNMENT CONTRACTS

§ 1.1471–1 Recovery of excessive profits on government contracts.

The inclusion of the statutory provisions of section 1471 in this part does not supersede the provisions of 26 CFR (1939) part 17 (Treasury Decision 4906) and 26 CFR (1939) part 16 (Treasury Decision 4909) as made applicable to section 1471 by Treasury Decision 6091 (19 FR 5167, C.B. 1954–2, 47).

[T.D. 6500, 25 FR 12081, Nov. 26, 1960]

EDITORIAL NOTE: For the convenience of the user, the text of parts 16 and 17 (not entirely superseded) of 26 CFR (1939) referred to above is set forth below:

PART 16—EXCESS PROFITS ON ARMY CONTRACTS FOR AIRCRAFT

REGULATIONS UNDER SECTION 14 OF THE ACT OF APRIL 3, 1939, AND OTHER PROVISIONS

AUTHORITY: Sections 16.1 to 16.18 issued under 52 Stat. 467; 26 U.S.C. 3791. Interpret or apply sec. 3, 48 Stat. 505, as amended, sec. 14, 53 Stat. 560; 34 U.S.C. 496, 10 U.S.C. 311, 312.2206

SOURCE: Sections 16.1 to 16.18 contained in T.D. 4909, 4 FR 2733, July 1, 1939, except as otherwise noted.

§ 16.1 *Definitions.* As used in the regulations in this part the term:

(a) ''Act'' means the act of April 3, 1939 (53 Stat. 560; 10 U.S.C. 311, 312, 34 U.S.C. 496), together with the applicable provisions of section 3 of the act of March 27, 1934, 48 Stat. 505; 34 U.S.C. 496, as amended by the act of June 25, 1936, 49 Stat. 1926; 34 U.S.C., Sup. IV, 496, and as further amended by the act of April 3, 1939 (53 Stat. 560; 34 U.S.C. 496).

(b) ''Person'' includes an individual, a corporation, a partnership, a trust or estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture or other unincorporated organization or group, through or by means of which any business, financial operation or venture is carried on.

(c) ''Contract'' means an agreement made by authority of the Secretary of the Army for the construction or manufacture of any complete aircraft or any portion thereof for the Army.

(d) ''Contractor'' means a person entering into a direct contract with the Secretary of the Army or his duly authorized representative.

(e) ''Subcontract'' means an agreement entered into by one person with another person for the construction or manufacture of any complete aircraft or any portion thereof for the Army, the prime contract for such aircraft or portion thereof having been entered into between a contractor and the Secretary of the Army or his duly authorized representative.

(f) ''Subcontractor'' means any person other than a contractor entering into a subcontract.

(g) ''Contracting party'' means a contractor or subcontractor as the case may be.

(h) ''Contract price'' or ''total contract price'' means the amount or total amount to be received under a contract or subcontract as the case may be.

(i) ''Income-taxable year'' means the calendar year, the fiscal year ending during such calendar year, or the fractional part of such calendar or fiscal year, upon the basis of which the contracting party's net income is computed and for which its income tax returns are made for Federal income tax purposes.

§ 16.2 *Contracts and subcontracts under which excess profit liability may be incurred.* Except as otherwise provided with respect to contracts or subcontracts for certain scientific equipment (see § 16.3), every contract awarded for an amount exceeding $10,000 and entered into after the enactment of the act of April 3, 1939 for the construction or manufacture of any complete aircraft or any portion thereof for the Army, is subject to the provisions of the act relating to excess profit liability. Any subcontract made with respect to such a contract and involving an amount in excess of $10,000 is also within the scope of the act. If a contracting party places orders with another party, aggregating an amount in excess of $10,000, for articles or materials which constitute a part of the cost of performing the contract or subcontract, the placing of such orders shall constitute a subcontract within the scope of the act, unless it is clearly shown that each of the orders involving $10,000 or less is a bona fide separate and distinct subcontract and not a subdivision made for the purpose of evading the provisions of the act.

§ 16.3 *Contracts or subcontracts for scientific equipment.* No excess profit liability is incurred upon a contract or subcontract entered into after the enactment of the act of April 3, 1939, if at the time or prior to the time such contract or subcontract is made it is designated by the Secretary of the Army as being exempt under the provisions of the act pertaining to scientific equipment used for communication, target detection, navigation, and fire control.

§ 16.4 *Completion of contract defined.* The date of delivery of the aircraft or portion thereof covered by the contract or subcontract shall be considered the date of completion of the contract or subcontract unless otherwise determined jointly by the Secretary of the Army and the Secretary of the Treasury or their duly authorized representatives. Except as otherwise provided in the preceding sentence, the replacement of defective parts or delivered articles or the performance of other guarantee work in respect of such articles will not operate to extend the date of completion. As to the treatment of the cost of such work as a cost of performing a contract or subcontract, see § 16.8(h). As to a refund in case of adjustment due to any subsequently incurred additional costs, see § 16.18. If a contract or subcontract is at any time cancelled or terminated, it is completed at the time of the cancellation or termination.

§ 16.5 *Manner of determining liability.* (a) The first step in the determination of the excess profit to be paid to the United States by a contracting party with respect to contracts and subcontracts completed within an income-taxable year is to ascertain the total contract prices of all contracts and subcontracts completed by the contracting party within the income-taxable year. As to total contract prices, see § 16.7.

(b) The second step is to ascertain the cost of performing such contracts and subcontracts and to deduct such cost from the total contract prices of such contracts and subcontracts as computed in the first step. See § 16.8. The amount remaining after such subtraction is the amount of net profit or net loss upon the contracts and subcontracts completed within the income-taxable year.

(c) The third step, in case there is a net profit upon such contracts and subcontracts, is to subtract from the amount of such net profit as computed in the second step the sum of:

(1) An amount equal to 12 percent of the total contract prices of the contracts and subcontracts completed within the income-taxable year;

(2) The amount of any net loss allowable as a credit in determining the excess profit for the income-taxable year (see § 16.9); and

(3) The amount of any deficiency in profit allowable as a credit in determining the excess profit for the income-taxable year (see § 16.9). The amount remaining after such subtraction is the amount of excess profit for the income-taxable year.

(d) The fourth step is to ascertain the amount of credit allowed for Federal income taxes paid or remaining to be paid upon the amount of such excess profit (see § 16.10) and then subtract from the amount of such excess profit the amount of credit for Federal income taxes. The amount remaining after this subtraction is the amount of excess profit to be paid to the United States by the contracting party for the income-taxable year.

[T.D. 4909, 4 FR 2733, July 1, 1939, as amended by T.D. 6511, 25 FR 12442, Dec. 6, 1960]

§ 16.6 *Computation of excess profit liability.* The application of the provisions of § 16.5 may be illustrated by the following example:

Example. On September 1, 1939, the B Corporation, which keeps its books and makes its Federal income tax returns on a calendar year basis, entered into a contract for the construction of Army aircraft coming within the scope of the act, the total contract price of which was $200,000. On March 10, 1940, the corporation entered into another such contract, the total contract price of which was $40,000. Both contracts were completed within the calendar year 1940, the first at a cost of $155,000 and the second at a cost of $45,000. During the year 1940, the B Corporation also completed at a deficiency in profit of $2,000 a contract entered into after April 3, 1939, for the construction of naval aircraft coming within the scope of 10 U.S.C. 2382 (formerly section 3 of the Act of March 27, 1934 (48 Stat. 505)). For the year 1939, the B Corporation sustained a net loss of $1,500 and a deficiency in profit of $1,000 on all contracts and subcontracts entered into after April 3, 1939, for Army aircraft coming within the scope of the act and completed within the calendar year 1939. For the year 1939, the B Corporation also sustained a net loss of $1,000 on a contract, entered into after April 3, 1939, and completed within the calendar year 1939, for naval aircraft coming within the scope of 10 U.S.C. 2382 (formerly section 3 of the Act of March 27, 1934 (48 Stat. 505)). For purposes of the Federal income tax, the net income of the B Corporation for the year 1940, on which the tax was paid, amounted to $96,000, which included the total net profit of $40,000 upon the two contracts entered into on September 1, 1939, and March 10, 1940. The excess profit liability is $4,332, computed as follows:

Total contract prices:		
Contract No. 1	$200,000	
Contract No. 2	40,000	
		$240,000
Less: Cost of performing contracts:		
Contract No. 1	155,000	
Contract No. 2	45,000	

		$200,000
Net profit on contracts		$40,000
Less:		
12 percent of total contract prices (12 percent of $240,000)	$28,800	
Deficiency in profit (in naval aircraft contracts) in 1940	2,000	
Net loss (in Army aircraft contracts) from 1939	1,500	
Net loss (in naval aircraft contracts) from 1939	1,000	
Deficiency in profit (in Army aircraft contracts) from 1939	1,000	....
Excess profit for year 1940		5,700
Less: Credit for Federal income taxes (Federal income tax on $5,700 at rates for 1940)		1,368
		34,300
Amount of excess profit payable to the United States		4,332

[T.D. 4909, 4 FR 2733, July 1, 1939, as amended by T.D. 6511, 25 FR 12442, Dec. 6, 1960]

§ 16.7 *Total contract price.* The total contract price of a particular contract or subcontract (see § 16.1) may be received in money or its equivalent. If something other than money is received, only the fair market value of the thing received, at the date of receipt, is to be included in determining the amount received. Bonuses earned for bettering performance and penalties incurred for failure to meet the contract guarantees are to be regarded as adjustments of the original contract price. Trade or other discounts granted by a contracting party in respect of a contract or subcontract performed by such party are also to be deducted in determining the true total contract price of such contract or subcontract.

§ 16.8 *Cost of performing a contract or subcontract.*—(a) *General rule.* The cost of performing a particular contract or subcontract shall be the sum of (1) the direct costs, including therein expenditures for materials, direct labor and direct expenses, incurred by the contracting party in performing the contract or subcontract; and (2) the proper proportion of any indirect costs (including therein a reasonable proportion of management expenses) incident to and necessary for the performance of the contract or subcontract.

(b) *Elements of cost.* No definitions of the elements of cost may be stated which are of invariable application to all contractors and subcontractors. In general, the elements of cost may be defined for purposes of the act as follows:

(1) Manufacturing cost, which is the sum of factory cost (see paragraph (c) of this section) and other manufacturing cost (see paragraph (d) of this section);

(2) Miscellaneous direct expenses (see paragraph (e) of this section);

(3) General expenses, which are the sum of indirect engineering expenses, usually termed ‘‘engineering overhead’’ (see paragraph (f) of this section) and expenses of distribution, servicing and administration (see paragraph (g) of this section); and

(4) Guarantee expenses (see paragraph (h) of this section).

(c) *Factory cost.* Factory cost is the sum of the following:

(1) *Direct materials.* Materials, such as those purchased for stock and subsequently issued for contract operations and those acquired under subcontracts, which become a component part of the finished product or which are used directly in fabricating, converting or processing such materials or parts.

(2) *Direct productive labor.* Productive labor, usually termed ‘‘shop labor,’’ which is performed on and is properly chargeable directly to the article manufactured or constructed pursuant to the contract or subcontract, but which ordinarily does not include direct engineering labor (see subparagraph (3) of this paragraph).

(3) *Direct engineering labor.* The compensation of professional engineers and other technicists (including reasonable advisory fees), and of draftsmen, properly chargeable directly to the cost of the contract or subcontract.

(4) *Miscellaneous direct factory charges.* Items which are properly chargeable directly to the factory cost of performing the contract or subcontract but which do not come within the classifications in subparagraphs (1), (2), and (3) of this paragraph, as for example, royalties which the contracting party pays to another party and which are properly chargeable to the cost of performing the contract or subcontract (but see paragraph (d) of this section).

(5) *Indirect factory expenses.* Items, usually termed ‘‘factory overhead,’’ which are not directly chargeable to the factory cost of performing the contract or subcontract but which are properly incident to and necessary for the performance of the contract or subcontract and consist of the following:

(i) *Labor.* Amounts expended for factory labor, such as supervision and inspection, clerical labor, timekeeping, packing and shipping, stores supply, services of tool crib attendants, and services in the factory employment bureau, which are not chargeable directly to productive labor of the contract or subcontract.

(ii) *Materials and supplies.* The cost of materials and supplies for general use in the factory in current operations, such as shop fuel, lubricants, heat-treating, plating, cleaning and anodizing supplies, nondurable tools and gauges, stationery (such as time tickets and other forms), and boxing and wrapping materials.

(iii) *Service expenses.* Factory expenses of a general nature, such as those for power, heat and light (whether purchased or produced), ventilation and air-conditioning and operation and maintenance of general plant assets and facilities.

(iv) *Fixed charges and obsolescence.* Recurring charges with respect to property used for manufacturing purposes of the contract or subcontract, such as premiums for fire and elevator insurance, property taxes, rentals and allowances for depreciation of such property, including maintenance and depreciation of reasonable stand-by equipment; and depreciation and obsolescence of special equipment and facilities necessarily acquired primarily for the performance of the contract or subcontract. In making allowances for depreciation, consideration shall be given to the number and length of shifts.

(v) *Miscellaneous indirect factory expenses.* Miscellaneous factory expenses not directly chargeable to the factory cost of performing the contract or subcontract, such as purchasing expenses; ordinary and necessary expenses of rearranging facilities within a department or plant; employees' welfare expenses; premiums or dues on compensation insurance; employers' payments to unemployment, old age and social security Federal and State funds not including payments deducted from or chargeable to employees or officers; pensions and retirement payments to factory employees; factory accident compensation (as to self-insurance, see paragraph (g) of this section); but not including any amounts which are not incident to services, operations, plant, equipment or facilities involved in the performance of the contract or subcontract.

(d) *Other manufacturing cost.* Other manufacturing cost as used in paragraph (b) of this section includes items of manufacturing costs which are not properly or satisfactorily chargeable to factory costs (see paragraph (c) of this section) but which upon a complete showing of all pertinent facts are properly to be included as a cost of performing the contract or subcontract, as for instance, payments of royalties and amortization of the cost of designs purchased and patent rights over their useful life; and ‘‘deferred’’ or ‘‘unliquidated’’ experimental and development charges. For example, in case experimental and development costs have been properly deferred or capitalized and are amortized in accordance with a reasonably consistent plan, a proper portion of the current charge, determined by a ratable allocation which is reasonable in consideration of the pertinent facts, may be treated as a cost of performing the contract or subcontract. In the case of general experimental and development expenses which may be charged off currently, a reasonable portion thereof may be allocated to the cost of performing the contract or subcontract. If a special experimental or development project is carried on in pursuance of a contract, or in anticipation of a contract which is later entered into, and the expense is not treated as a part of general experimental and development expenses or is not otherwise allowed as a cost of performing the contract, there clearly appearing no reasonable prospect of an additional contract for the type of article involved, the entire cost of such project may be allowed as a part of the cost of performing the contract.

(e) *Miscellaneous direct expenses.* Miscellaneous direct expenses as used in paragraph (b) of this section include:

(1) *Cost of installation and construction.* Cost of installation and construction includes the cost of materials, labor and expenses necessary for the erection and installation prior to the completion of the contract and after the delivery of the product or material manufactured or constructed pursuant to the contract or subcontract.

(2) *Sundry direct expenses.* Items of expense which are properly chargeable directly to the cost of performing a contract or subcontract and which do not constitute guarantee expenses (see paragraph (h) of this section) or direct costs classified as factory cost or other manufacturing cost (see paragraphs (c) and (d) of this section), such as premiums on performance or other bonds required under the contract or subcontract; State sales taxes imposed on the contracting party; freight on outgoing shipments; fees paid for wind tunnel and model basin tests; demonstration and test expenses; crash insurance premiums; traveling expenses. In order for any such item to be allowed as a charge directly to the cost of performing a contract or subcontract, (i) a detailed record shall be kept by the contracting party of all items of a similar character, and (ii) no item of a similar character which is properly a direct charge to other work shall be allowed as a part of any indirect expenses in determining the proper proportion thereof chargeable to the cost of performing the contract or subcontract. As to allowable indirect expenses, see paragraphs (c)(5), (f), (g) and (j) of this section.

(f) *Indirect engineering expenses.* Indirect engineering expenses, usually termed ‘‘engineering overhead,’’ which are treated in this section as a part of general expenses in determining the cost of performing a contract or subcontract (see paragraph (b) of this section), comprise the general engineering expenses which are incident to and necessary for the performance of the contract or subcontract, such as the following:

(1) *Labor.* Reasonable fees of engineers employed in a general consulting capacity, and compensation of employees for personal services to the engineering department, such as supervision, which is properly chargeable to the contract or subcontract, but which is not chargeable as direct engineering labor (see paragraph (c)(3) of this section).

(2) *Material.* Supplies for the engineering department, such as paper and ink for drafting and similar supplies.

(3) *Miscellaneous expenses.* Expenses of the engineering department, such as (i) maintenance and repair of engineering equipment, and (ii) services purchased outside of the engineering department for blue printing, drawing, computing, and like purposes.

(g) *Expenses of distribution, servicing and administration.* Expenses of distribution, servicing and administration, which are treated in this section as a part of general expenses in determining the cost of performing a contract or subcontract (see paragraph (b) of this section), comprehend the expenses incident to and necessary for the performance of the contract or subcontract, which are incurred in connection with the distribution and general servicing of the contracting party's products and the general administration of the business, such as:

(1) *Compensation for personal services of employees.* The salaries of the corporate and general executive officers and the salaries and wages of administrative clerical employees and of the office services employees such as telephone operators, janitors, cleaners, watchmen and office equipment repairmen.

(2) *Bidding and general selling expenses.* Bidding and general selling expenses which by reference to all the pertinent facts and circumstances reasonably constitute a part of the cost of performing a contract or subcontract. The treatment of bidding and general selling expenses as a part of general expenses in accordance with this paragraph is in lieu of any direct charges which otherwise might be made for such expenses. The term ''bidding expenses'' as used in this section includes all expenses in connection with preparing and submitting bids.

(3) *General servicing expenses.* Expenses which by reference to all the pertinent facts and circumstances reasonably constitute a part of the cost of performing a contract or subcontract and which are incident to delivered or installed articles and are due to ordinary adjustments or minor defects; but including no items which are treated as a part of guarantee expenses (see paragraph (h) of this section) or as a part of direct costs, such as direct materials, direct labor, and other direct expense.

(4) *Other expenses.* Miscellaneous office and administrative expenses, such as stationery and office supplies; postage; repair and depreciation of office equipment; contributions to local charitable or community organizations to the extent constituting ordinary and necessary business expenses; employees' welfare expenses; premiums and dues on compensation insurance; employers' payments to unemployment, old age and social security Federal and State funds not including payments deducted from or chargeable to employees or officers; pensions and retirement payments to administrative office employees and accident compensation to office employees (as to self-insurance, see subdivision (i) of this subparagraph.

(i) Subject to the exception stated in this subdivision, in cases where a contracting party assumes its own insurable risks (usually termed ''self-insurance''), losses and payments will be allowed in the cost of performing a contract or subcontract only to the extent of the actual losses suffered or payments incurred during, and in the course of, the performance of the contract or subcontract and properly chargeable to such contract or subcontract. If however, a contracting party assumes its own insurable risks (a) for compensation paid to employees for injuries received in the performance of their duties, or (b) for unemployment risks in States where insurance is required, there may be allowed as a part of the cost of performing a contract or subcontract a reasonable portion of the charges set up for purposes of self-insurance under a system of accounting regularly employed by the contracting party, as determined by the Commissioner of Internal Revenue, at rates not exceeding the lawful or approved rates of insurance companies for such insurance, reduced by amounts representing the acquisition cost in such companies, provided the contracting party adopts and consistently follows this method with respect to self-insurance in connection with all contracts and subcontracts subsequently performed by him.

(ii) Allowances for interest on invested capital are not allowable as costs of performing a contract or subcontract.

(iii) Among the items which shall not be included as a part of the cost of performing a contract or subcontract or considered in determining such cost, are the following: Entertainment expenses; dues and memberships other than of regular trade associations; donations except as otherwise provided above; losses on other contracts; profits or losses from sales or exchanges of capital assets; extraordinary expenses due to strikes or lockouts; fines and penalties; amortization of unrealized appreciation of values of assets; expenses, maintenance and depreciation of excess facilities (including idle land and building, idle parts of a building, and excess machinery and equipment) vacated or abandoned, or not adaptable for future use in performing contracts or subcontracts; increases in reserve accounts for contingencies, repairs, compensation insurance (except as above provided with respect to self-insurance) and guarantee work; Federal and State income and excess-profits taxes and surtaxes; cash discount earned up to one percent of the amount of the purchase, except that all discounts on subcontracts subject to the act will be considered; interest incurred or earned; bond discount or finance charges;

premiums for life insurance on the lives of officers; legal and accounting fees in connection with reorganizations, security issues, capital stock issues and the prosecution of claims against the United State (including income tax matters); taxes and expenses on issues and transfers of capital stock; losses on investments; bad debts; and expenses of collection and exchange.

(iv) In order that the cost of performing a contract or subcontract may be accounted for clearly, the amount of any excess profits repayable to the United States pursuant to the act should not be charged to or included in such cost.

(h) *Guarantee expenses.* Guarantee expenses include the various items of factory cost, other manufacturing cost, cost of installation and construction, indirect engineering expenses and other general expenses (see paragraphs (c) to (g), of this section) which are incurred after delivery or installation of the article manufactured or constructed pursuant to the particular contract or subcontract and which are incident to the correction of defects or deficiencies which the contracting party is required to make under the guarantee provisions of the particular contract or subcontract. If the total amount of such guarantee expenses is not ascertainable at the time of filing the report required to be filed with the district director of internal revenue (see §16.15) and the contracting party includes any estimated amount of such expenses as part of the claimed total cost of performing the contract or subcontract, such estimated amount shall be separately shown on the report and the reasons for claiming such estimated amount shall accompany the report; but only the amount of guarantee expenses actually incurred will be allowed. If the amount of guarantee expenses actually incurred is greater than the amount (if any) claimed on the report and the contracting party has made an overpayment of excess profit, a refund of the overpayment shall be made in accordance with the provisions of §16.18. If the amount of guarantee expenses actually incurred is less than the amount claimed on the report and an additional amount of excess profit is determined to be due, the additional amount of excess profit shall be assessed and paid in accordance with the provisions of §16.18.

(i) *Unreasonable compensation.* (1) The salaries and compensation for services which are treated as a part of the cost of performing a contract or subcontract include reasonable payments for salaries, bonuses, or other compensation for services. As a general rule, bonuses paid to employees (and not to officers) in pursuance of a regularly established incentive bonus system may be allowed as a part of the cost of performing a contract or subcontract.

(2) The test of allowability is whether the aggregate compensation paid to each individual is for services actually rendered incident to, and necessary for, the performance of the contract or subcontract, and is reasonable. Excessive or unreasonable payments, whether in cash, stock or other property ostensibly as compensation for services shall not be included in the cost of performing a contract or subcontract.

(j) *Allocation of indirect costs.* No general rule applicable to all cases may be stated for ascertaining the proper proportion of the indirect costs to be allocated to the cost of performing a particular contract or subcontract. Such proper proportion depends upon all the facts and circumstances relating to the performance of the particular contract or subcontract. Subject to a requirement that all items which have no relation to the performance of the contract or subcontract shall be eliminated from the amount to be allocated, the following methods of allocation are outlined as acceptable in a majority of cases:

(1) *Factory indirect expenses.* The allowable indirect factory expenses (see paragraph (c)(5) of this section) shall ordinarily be allocated or ''distributed'' to the cost of the contract or subcontract on the basis of the proportion which the direct productive labor (see paragraph (c)(2) of this section) attributable to the contract or subcontract bears to the total direct productive labor of the production department or particular section thereof during the period within which the contract or subcontract is performed, except that if the indirect factory expenses are incurred in different amounts and in different proportions by the various producing departments consideration shall be given to such circumstances to the extent necessary to make a fair and reasonable determination of the true profit and excess profit.

(2) *Engineering indirect expenses.* The allowable indirect engineering expenses (see paragraph (f) of this section) shall ordinarily be allocated or ''distributed'' to the cost of the contract or subcontract on the basis of the proportion which the direct engineering labor attributable to the contract or subcontract (see paragraph (c)(3) of this section) bears to the total direct engineering labor of the engineering department or particular section thereof during the period within which the contract or subcontract is performed. If the expenses of the engineering department are not sufficient in amount to require the maintenance of separate accounts, the engineering indirect costs may be included in the indirect factory expenses (see paragraph (c)(5) of this section) and allocated or distributed to the cost of performing the contract or subcontract as a part of such expenses, provided the proportion so allocated or distributed is proper under the facts and circumstances relating to the performance of the particular contract or subcontract.

(3) *Administrative expenses (or ''overhead'').* The allowable expenses of administration (see paragraph (g) of this section) or other general expenses except indirect engineering expenses, bidding and general selling expenses, and general servicing expenses shall ordinarily be allocated or distributed to the cost of performing a contract or subcontract on the basis of the proportion which the sum of the manufacturing cost (see paragraph (b) of this section) and the cost of installation and construction (see paragraph (e) of this section) attributable to the particular contract or subcontract bears to the sum of the total manufacturing cost and the total cost of installation and construction during the period within which the contract or subcontract is performed.

(4) *Bidding, general selling, and general servicing expenses.* The allowable bidding and general selling expenses and general servicing expenses (see paragraph (g) (2) and (3) of this section) shall ordinarily be allocated or distributed to the cost of performing a contract or subcontract on the basis of:

(i) The proportion which the contract price of the particular contract or subcontract bears to the total sales made(including contracts or subcontracts completed) during the period within which the particular contract or subcontracts is performed, or

(ii) The proportion which the sum of the manufacturing cost (see paragraph (b) of this section) and the cost of installation and construction (see paragraph (e) of this section) attributable to the particular contract or subcontract bears to the sum of the total manufacturing cost and the total cost of installation and construction during the period within which the contract or subcontract is performed,

except that special consideration shall be given to the relation which certain classes of such expenses bear to the various classes of articles produced by the contracting party in each case in which such consideration is necessary in order to make a fair and reasonable determination of the true profit and excess profit. See §16.13.

§16.9 *Credit for net loss or for deficiency in profit in computing excess profit.* (a) The term ''net loss'' as used in the act and as applied to contracts and subcontracts for aircraft or portions thereof coming within the regulations prescribed under the act or under 10 U.S.C. 2382 (formerly section 3 of the Act of March 27, 1934 (48 Stat. 505)) means the amount by which the total cost of performing all such contracts and subcontracts for aircraft entered into after April 3, 1939, and completed by a particular contracting party within the income-taxable year exceeds the total contract prices of such contracts and subcontracts. As to the meaning of income-taxable year, see §16.1.

(b) The term ''deficiency in profit'', as used in the act and as applied to contracts and subcontracts for aircraft or portions thereof coming within the regulations prescribed under the act or under 10 U.S.C. 2882 (formerly section 3 of the Act of March 27, 1934 (48 Stat. 505)), means the amount by which 12 percent of the total contract prices of all such contracts and subcontracts for aircraft entered into after April 3, 1939, and completed by a particular contracting party within the income-taxable year exceeds the net profit upon all such contracts and subcontracts.

(c) A net loss or a deficiency in profit sustained by a contracting party for an income-taxable year is allowable as a credit in computing the contracting party's excess profit on contracts and subcontracts for aircraft coming within the regulations prescribed under the act or under 10 U.S.C. 2382 (formerly section 3 of the Act of March 27, 1934 (48 Stat. 505)) and completed during the four next succeeding income-taxable years. Credit for such a net loss or deficiency in profit may be claimed in the contracting party's annual report of profit filed with the district director of internal revenue (see §16.15), but it shall be supported by separate schedules for each contract or subcontract involved showing total contract prices, costs of performance and pertinent facts relative thereto, together with a summarized computation of the net loss or deficiency in profit. The net loss or deficiency in profit claimed is subject to verification and adjustment. As to preservation of books and records, see §16.13.

(d) Net loss or deficiency in profit sustained on contracts and subcontracts completed within one income-taxable year may not be considered in computing net loss or deficiency in profit sustained on contracts and subcontracts completed within another income-taxable year.

(e) The provisions of this section may be illustrated by the following example:

Example. For the calendar year 1939, the A Corporation, which keeps its books and makes its Federal income tax returns on a calendar year basis, sustained a net loss of $30,000 on the contracts and subcontracts for Army aircraft and portions thereof coming within the scope of the act and completed within that year. During the year 1939, the A Corporation also completed contracts for naval aircraft coming within the scope of 10 U.S.C. 2382 (formerly section 3 of the Act of March 27, 1934 (48 Stat. 505)) at a deficiency in profit of $10,000. In 1940, the A Corporation completed similar contracts for Army aircraft totaling $175,000 at a cost of $155,000, whereby the A Corporation realized a net profit of $20,000 but sustained a deficiency in profit of $1,000 (i.e., 12 percent of $175,000, or $21,000, less $20,000. During the year 1940, the A Corporation also completed contracts for naval aircraft coming within the scope of 10 U.S.C. 2382 (formerly section 3 of the Act of March 27, 1934 (48 Stat. 505)) at a net loss of

$2,000. In 1941, the A Corporation completed contracts for Army aircraft coming within the scope of the act totaling $400,000 at a cost of $300,000, or at a net profit of $100,000. After deducting from the net profit of $100,000 for the year 1941 the amount of $48,000 (i.e., 12 percent of the total contract price of $400,000), there remains $52,000 in excess profit on the contracts completed in the year 1941. The A Corporation may deduct from such $52,000, in determining the amount of excess profit it must pay for the year 1941 with respect to the contracts completed in such year, the net loss of $30,000 and the deficiency in profit of $10,000 sustained in 1939 on Army and naval aircraft contracts, respectively, and the net loss of $2,000 and the deficiency in profit of $1,000 sustained in 1940 on naval and Army aircraft contracts, respectively.

[T.D. 4909, 4 FR 2733, July 1, 1939, as amended by T.D. 6511, 25 FR 12442, Dec. 6, 1960]

§16.10 *Credit for Federal income taxes.* For the purpose of computing the amount of excess profit to be paid to the United States, a credit is allowable against the excess profit for the amount of Federal income taxes paid or remaining to be paid on the amount of such excess profit. The ''Federal income taxes'' in respect of which this credit is allowable include the income taxes imposed by Titles I and IA of the Revenue Act of 1938, and Chapter 1 and Subchapter A of Chapter 2 of the Internal Revenue Code, and the excess-profits taxes imposed by section 602 of the Revenue Act of 1938 and Subchapter B of Chapter 2 of the Internal Revenue Code. This credit is allowable for these taxes only to the extent that it is affirmatively shown that they have been finally determined and paid or remain to be paid and that they were imposed upon the excess profit against which the credit is to be made. In case such a credit has been allowed and the amount of Federal income taxes imposed upon the excess profit is redetermined, the credit previously allowed shall be adjusted accordingly.

§16.11 *Failure of contractor to require agreement by subcontractor.* (a) Every contract or subcontract coming within the scope of the act and the regulations in this part is required by the act to contain, among other things, an agreement by the contracting party to make no subcontract unless the subcontractor agrees:

(1) To make a report, as described in the act, under oath to the Secretary of War upon the completion of the subcontract;

(2) To pay into the Treasury excess profit, as determined by the Treasury Department, in the manner and amounts specified in the act;

(3) To make no subdivision of the subcontract for the same article or articles for the purpose of evading the provisions of the act;

(4) That the manufacturing spaces and books of its own plant, affiliates, and subdivisions shall at all times be subject to inspection and audit as provided in the act.

(b) If a contracting party enters into a subcontract with a subcontractor who fails to make such agreement, such contracting party shall, in addition to its liability for excess profit determined on contracts or subcontracts performed by it, be liable for any excess profit determined to be due the United States on the subcontract entered into with such subcontractor. In such event, however, the excess profit to be paid to the United States in respect of the subcontract entered into with such subcontractor shall be determined separately from any contracts or subcontracts performed by the contracting party entering into the subcontract with such subcontractor.

§16.12 *Evasion of excess profit.* Section 3 of the act of March 27, 1934, as amended, provides that the contracting party shall agree to make no subdivisions of any contract or subcontract for the same article or articles for the purpose of evading the provisions of the act. If any such subdivision or subcontract is made it shall constitute a violation of the agreement provided for in the act, and the cost of completing a contract or subcontract by a contracting party which violates such agreement shall be determined in a manner necessary clearly to reflect the true excess profit of such contracting party.

§16.13 *Books of account and records.* (a) It is recognized that no uniform method of accounting can be prescribed for all contracting parties subject to the provisions of the act. Each contracting party is required by law to make a report of its true profits and excess profit. Such party must, therefore, maintain such accounting records as will enable it to do so. See §16.8. Among the essentials are the following:

(1) The profit or loss upon a particular contract or subcontract shall be accounted for and fully explained in the books of account separately on each contract or subcontract.

(2) Any cost accounting methods, however standard they may be and regardless of long continued practice, shall be controlled by, and be in accord with, the objectives and purposes of the act and of any regulations prescribed thereunder.

(3) The accounts shall clearly disclose the nature and amount of the different items of cost of performing a contract or subcontract.

(b) In cases where it has been the custom priorly to use so-called ''normal'' rates of overhead expense or administrative expenses, or ''standard'' or ''normal'' prices of material or labor charges, no objection will be made to the use temporarily during the period of performing the contract or subcontract of such methods in charging the contract or subcontract, if the method of accounting employed is such as clearly to reflect, in the final determination upon the books of account, the actual profit derived from the performance of the contract or subcontract and if the necessary adjusting entries are entered upon the books and they explain in full detail the revisions necessary to accord with the facts. As to the elements of cost, see § 16.8.

(c) All books, records, and original evidences of costs (including, among other things, production orders, bills or schedules of materials, purchase requisitions, purchase orders, vouchers, requisitions for materials, standing expense orders, inventories, labor time cards, pay rolls, cost distribution sheets) pertinent to the determination of the true profit, excess profit, deficiency in profit or net loss from the performance of a contract or subcontract shall be kept at all times available for inspection by internal-revenue officers, and shall be carefully preserved and retained so long as the contents thereof may become material in the administration of the act. This provision is not confined to books, records, and original evidences pertaining to items which may be considered to be a part of the cost of performing a contract or subcontract. It is applicable to all books, records, and original evidences of costs of each plant, branch or department involved in the performance of a contract or subcontract or in the allocation or distribution of costs to the contract or subcontract.

§ 16.14 *Report to Secretary of the Army.* (a) Upon the completion of a contract or subcontract coming within the scope of the act and the regulations in this part, the contracting party is required to make a report, under oath, to the Secretary of the Army. As to the date of completion of a contract or subcontract, see § 16.4. Such report shall be in the form prescribed by the Secretary of the Army and shall state the total contract price, the cost of performing the contract, the net income from such contract, and the per centum such income bears to the contract price. The contracting party shall also include as a part of such report a statement showing:

(1) The manner in which the indirect costs were determined and allocated to the cost of performing the contract or subcontract (see § 16.8);

(2) The name and address of every subcontractor with whom a subcontract was made, the object of such subcontract, the date when completed and the amount thereof; and

(3) The name and address of each affiliate or other organization, trade or business owned or controlled directly or indirectly by the same interests as those who so own or control the contracting party, together with a statement showing in detail all transactions which were made with such affiliate or other organization, trade or business and are pertinent to the determination of the excess profit.

(b) A copy of the report required to be made to the Secretary of the Army is required to be transmitted by the contracting party to the Secretary of the Treasury. Such copy shall not be transmitted directly to the Secretary of the Treasury but shall be filed as a part of the annual report. See § 16.15.

§ 16.15 *Annual reports for income-taxable years*—(a) *General requirements.* Every contracting party completing a contract or subcontract within the contracting party's income-taxable year ending after April 3, 1939 shall file with the district director of internal revenue for the internal revenue district in which the contracting party's Federal income tax returns are required to be filed an annual report on the prescribed form of the profit and excess profit on all contracts and subcontracts coming within the scope of the act and the regulations in this part and completed within the particular income-taxable year. There shall be included as a part of such a report a statement, preferably in columnar form, showing separately for each such contract or subcontract completed by the contracting party within the income-taxable year the total contract price, the cost of performing the contract or subcontract and the resulting profit or loss on each contract or subcontract together with a summary statement showing in detail the computation of the net profit or net loss upon all contracts and subcontracts completed within the income-taxable year and the amount of the excess profit, if any, for the income-taxable year covered by the report. A copy of the report made to the Secretary of the Army (see § 16.14) with respect to each contract or subcontract covered in the annual report, shall be filed as a part of such annual report. In case the income-taxable year of the contracting party is a period of less than twelve months (see § 16.1), the report required by this section shall be made for such period and not for a full year.

(b) *Time for filing annual reports.* Annual reports of contracts and subcontracts coming within the scope of the act and the regulations in this part completed by a contracting party within an income-taxable year must be filed on or before the 15th day of the ninth month following the close of the contracting party's income-taxable year. It is important that the contracting party render on or before the due date an annual report as nearly complete and final as it is possible for the contracting party to prepare. An extension of time granted the contracting party for filing its Federal income tax return does not serve to extend the time for filing the annual report required by this section. Authority consistent with authorizations for granting extensions of time for filing Federal income tax returns is hereby delegated to the various collectors of internal revenue for granting extensions of time for filing the reports required by this section. Application for extensions of time for filing such reports should be addressed to the district director of internal revenue for the district in which the contracting party files its Federal income tax returns and must contain a full recital of the causes for the delay.

§16.16 *Payment of excess profit liability.* The amount of the excess profit liability to be paid to the United States shall be paid on or before the due date for filing the report with the district director of internal revenue. See §16.15. At the option of the contracting party, the amount of the excess profit liability may be paid in four equal installments instead of in a single payment, in which case the first installment is to be paid on or before the date prescribed for the payment of the excess profit as a single payment, the second installment on or before the 15th day of the third month, the third installment on or before the 15th day of the sixth month, and the fourth installment on or before the 15th day of the ninth month, after such date.

§16.17 *Liability of surety.* The surety under contracts entered into with the Secretary of the Army for the construction or manufacture of any complete aircraft or any portion thereof for the Army shall not be liable for payment of excess profit due the United States in respect of such contracts.

§16.18 *Determination of liability for excess profit, interest and penalties; assessment, collection, payment, refunds.* (a) The duty of determining the correct amount of excess profit liability on contracts and subcontracts coming within the scope of the act and the regulations in this part is upon the Commissioner of Internal Revenue. Under section 3(b) of the act of March 27, 1934, as last amended, all provisions of law (including the provisions of law relating to interest, penalties and refunds) applicable with respect to the taxes imposed by Title I of the Revenue Act of 1934 and not inconsistent with section 3 of the act of March 27, 1934, as last amended, are applicable with respect to the assessment, collection, or payment of excess profits on contracts and subcontracts coming within the scope of the act and the regulations in this part and to refunds of overpayments of profits into the Treasury under the act. Claims by a contracting party for the refund of an amount of excess profit, interest, penalties, and additions to such excess profit shall conform to the general requirements prescribed with respect to claims for refund of overpayments of taxes imposed by Title I of the Revenue Act of 1934 and, if filed on account of any additional costs incurred pursuant to guarantee provisions in a contract, shall be supplemented by a statement under oath showing the amount and nature of such costs and all facts pertinent thereto.

(b) Administrative procedure for the determination, assessment and collection of excess profit liability under the act and the regulations in this part and the examination of reports and claims in connection therewith will be prescribed from time to time by the Commissioner of Internal Revenue.

PART 17—EXCESS PROFITS ON NAVY CONTRACTS

REGULATIONS FOR INCOME-TAXABLE YEARS ENDING AFTER APRIL 3, 1939

AUTHORITY: Sections 17.1 to 17.19 issued under 52 Stat. 467; 26 U.S.C. 3791. Interpret or apply sec. 3, 48 Stat. 505, as amended, 53 Stat. 112; 34 U.S.C. 496, 26 U.S.C. 650, 651.

SOURCE: Sections 17.1 to 17.19 contained in T.D. 4906, 4 FR 2492, June 27, 1939, except as otherwise noted.

§17.1 *Definitions.* As used in the regulations in this part the term:

(a) *Act* means the act of March 27, 1934 (48 Stat. 505; 34 U.S.C. 496), as originally enacted, as amended by the act of June 25, 1936 (49 Stat. 1926; 34 U.S.C. 496), and as further amended by the act of April 3, 1939 (53 Stat. 560; 34 U.S.C. 496).

(b) *Person* includes an individual, a corporation, a partnership, a trust or estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture or other unincorporated organization or group, through or by means of which any business, financial operation or venture is carried on.

(c) *Contract* means an agreement made by authority of the Secretary of the Navy for the construction or manufacture of any complete naval vessel or aircraft or any portion thereof.

(d) *Contractor* means a person entering into a direct contract with the Secretary of the Navy or his duly authorized representative.

(e) *Subcontract* means an agreement entered into by one person with another person for the construction or manufacture of a complete naval vessel or aircraft or any portion thereof, the prime contract for such vessel or aircraft or portion thereof having been entered into between a contractor and the Secretary of the Navy or his duly authorized representative.

(f) *Subcontractor* means any person other than a contractor entering into a subcontract.

(g) *Contracting party* means a contractor or subcontractor as the case may be.

(h) *Contract price* or *contract price* means the amount or total amount to be received under a contract or subcontract as the case may be.

(i) *Income-taxable year* means the calendar year, the fiscal year ending during such calendar year or the fractional part of such calendar or fiscal year, upon the basis of which the contracting party's net income is computed and for which its income tax returns are made for Federal income tax purposes.

§ 17.2 *Scope of this part.* The regulations in this part deal with liability for excess profit on contracts and subcontracts for the construction or manufacture of any complete naval vessel or aircraft or any portion thereof completed within income-taxable years ending after April 3, 1939. As to the date of the completion of a contract or subcontract, see § 17.5.

§ 17.3 *Contracts and subcontracts under which excess profit liability may be incurred.* Except as otherwise provided with respect to contracts or subcontracts for certain scientific equipment (see § 17.4), every contract awarded for an amount exceeding $10,000 and entered into after the enactment of the act of March 27, 1934 for the construction or manufacture of any complete naval vessel or aircraft, or any portion thereof, is subject to the provisions of the act relating to excess profit liability. Any subcontract made with respect to such a contract and involving an amount in excess of $10,000 is also within the scope of the act. If a contracting party places orders with another party, aggregating an amount in excess of $10,000, for articles or materials which constitute a part of the cost of performing the contract or subcontract, the placing of such orders shall constitute a subcontract within the scope of the act, unless it is clearly shown that each of the orders involving $10,000 or less is a bona fide separate and distinct subcontract and not a subdivision made for the purpose of evading the provisions of the act.

§ 17.4 *Contracts or subcontracts for scientific equipment.* No excess profit liability is incurred upon a contract or subcontract entered into after the amendment of section 3(b) of the act of June 25, 1936, if at the time or prior to the time such contract or subcontract is made it is designated by the Secretary of the Navy as being exempt under the provisions of the act pertaining to scientific equipment used for communication, target detection, navigation, or fire control. The exemption of contracts or subcontracts for scientific equipment does not extend to any contract or subcontract entered into prior to the enactment of such amendment of section 3(b) of the act.

§ 17.5 *Completion of contract defined.* The date of delivery of the vessel, aircraft or portion thereof covered by the contract or subcontract shall be considered the date of completion of the contract or subcontract unless otherwise determined jointly by the Secretary of the Navy and the Secretary of the Treasury or their duly authorized representatives. Except as otherwise provided in the preceding sentence, the replacement of defective parts of delivered articles or the performance of other guarantee work in respect to such articles will not operate to extend the date of completion. As to the treatment of the cost of such work as a cost of performing a contract or subcontract, see § 17.9(h). As to a refund in case of adjustment due to any subsequently incurred additional costs, see § 17.19. If a contract or subcontract is at any time cancelled or terminated, it is completed at the time of the cancellation or termination.

§ 17.6 *Manner of determining liability with respect to contracts or subcontracts for complete naval vessles or portions thereof.* If in an income-taxable year ending after April 3, 1939 a contracting party completes one or more contracts or subcontracts coming within the scope of the act and entered into for the construction or manufacture of any complete naval vessel or any portion thereof, the amount of excess profit to be paid to the United States with respect to all such contracts and subcontracts completed within the income-taxable year shall be computed as follows:

(a) The first step is to ascertain the total contract prices of all such contracts and subcontracts completed by the contracting party within the income-taxable year. As to total contract prices, see §§ 17.1 and 17.8.

(b) The second step is to ascertain the cost of performing such contracts and subcontracts (see § 17.9) and to deduct such cost from the total contract prices of such contracts and subcontracts as computed in the first step.

The amount remaining after such subtraction is the amount of net profit or net loss upon such contracts and subcontracts completed within the income-taxable year.

(c) The third step, in case there is a new profit upon such contracts and subcontracts, is to subtract from the amount of such net profit as computed in the second step the sum of:

(1) An amount equal to 10 percent of the total contract prices of such contracts and subcontracts completed within the income-taxable year; and

(2) The amount of any net loss which was sustained in the preceding income-taxable year with respect to contracts or subcontracts entered into for the construction or manufacture of any complete naval vessel or any portion thereof, and which is allowable as a credit in determining the excess profit for the income-taxable year with respect to contracts and subcontracts entered into for the construction or manufacture of any complete naval vessel or any portion thereof (see § 17.10(a)).

The amount remaining after such subtraction is the amount of excess profit for the income-taxable year with respect to contracts and subcontracts entered into for the construction or manufacture of any complete naval vessel or any portion thereof.

(d) The fourth step is to ascertain the amount of credit allowed for Federal income taxes paid or remaining to be paid upon the amount of such excess profit as computed in the third step (see §17.11) and then subtract from the amount of such excess profit the amount of credit for Federal income taxes. The amount remaining after this subtraction is the amount of excess profit to be paid to the United States by the contracting party for the income-taxable year with respect to contracts and subcontracts entered into for the construction or manufacture of any complete naval vessel or any portion thereof and completed within the income- taxable year.

(e) The application of the provisions of this section of the regulations may be illustrated by the following example:

Example: On September 1, 1939 the A Corporation, which keeps its books and makes its Federal income tax returns on a calendar year basis, entered into a contract with the Secretary of the Navy for the construction of portions of a naval vessel coming within the scope of the act, the total contract price of which $200,000. On March 10, 1940 the A Corporation entered into another such contract, the total contract price of which was $40,000. Both contracts were completed within the calendar year 1940, the first at a cost of $155,000 and the second at a cost of $45,000. During the year 1940 the A Corporation also completed at a loss of $10,000 two contracts entered into for the construction or manufacture of naval aircraft coming within the scope of the act. For the year 1939 the A Corporation sustained a net loss of $2,500 on all contracts and subcontracts for any complete naval vessel or any portion thereof coming within the scope of the act and completed within the calendar year 1939. For the year 1939 the A Corporation also sustained a net loss of $1,800 on all other contracts and subcontracts coming within the scope of the act which were completed within the calendar year 1939. For purposes of Federal income tax, the net income of the A Corporation for the year 1940 amounted to $96,000, which amount included the net profit of $40,000 upon the contracts entered into on September 1, 1939 and March 10, 1940. For the year 1940 the A Corporation paid Federal income taxes amounting to $19,200. The excess profit liability of the A Corporation for 1940 is payable with respect to the contracts for portions of a naval vessel which were completed in 1940. The loss of $10,000 on other contracts completed in 1940 and the net loss of $1,800 for 1939 on contracts and subcontracts for naval aircraft do not enter into the computation of such liability. Accordingly, the excess profit liability of the A Corporation for 1940 is $10,800 computed as follows:

Total contract prices:		
Contract No. 1	$200,000	
Contract No. 2	40,000	
		$240,000
Less cost of performing contracts:		
Contract No. 1	155,000	
Contract No. 2	45,000	
		200,000
Net profit on contracts		40,000
Less:		
10 percent of total contract prices (10 percent of $240,000)	24,000	
Net loss from 1939	2,500	
		26,500
Excess profit for year 1940		13,500
Less credit for Federal income taxes (Federal income tax on $13,500 at rates for 1940)		2,700
Amount of excess profit payable to the United States		10,800

§17.7 *Manner of determining liability with respect to contracts or subcontracts for complete naval aircraft or portions thereof.* If in an income-taxable year ending after April 3, 1939 a contracting party completes one or more contracts or subcontracts coming within the scope of the act and entered into for the construction or manufacture of any complete naval aircraft or any portion thereof, the amount of excess profit to be paid to the United States with respect to all such contracts and subcontracts completed within the income-taxable year shall be computed as follows:

(a) The first step is to ascertain the total contract prices of all such contracts and subcontracts completed by the contracting party within the income-taxable year. As to total contract prices, see §§17.1 and 17.8.

(b) The second step is to ascertain the cost of performing such contracts and subcontracts (see §17.9) and to deduct such cost from the total contract prices of such contracts and subcontracts as computed in the first step.

The amount remaining after such subtraction is the amount of net profit or net loss upon such contracts and subcontracts completed within the income-taxable year.

(c) The third step, in case there is a net profit upon such contracts and subcontracts, is to subtract from the amount of such net profit as computed in the second step the sum of:

(1) An amount equal to 12 percent of the total contract prices of such contracts and subcontracts completed within the income-taxable year;

(2) The amount of any net loss which was sustained in the same or a prior income- taxable year with respect to contracts or subcontracts for the construction or manufacture of any complete aircraft or any portion

thereof, and which is allowable as a credit in determining the excess profit for the income-taxable year with respect to contracts and subcontracts entered into for the construction or manufacture of complete aircraft or any portion thereof (see § 17.10(b)); and

(3) The amount of any deficiency in profit which was sustained in the same or a prior income-taxable year with respect to contracts or subcontracts for the construction or manufacture of any complete aircraft or any portion thereof, and which is allowable as a credit in determining the excess profit for the income-taxable year with respect to contracts and subcontracts entered into for the construction or manufacture of complete aircraft or any portion thereof (see § 17.10(c)).

The amount remaining after such subtraction is the amount of excess profit for the income-taxable year with respect to contracts and subcontracts entered into for the construction or manufacture of complete naval aircraft or any portion thereof.

(d) The fourth step is to ascertain the amount of credit allowed for Federal income taxes paid or remaining to be paid upon the amount of such excess profit as computed in the third step (see § 17.11) and then subtract from the amount of such excess profit the amount of credit for Federal income taxes. The amount remaining after this subtraction is the amount of excess profit to be paid to the United States by the contracting party for the income-taxable year with respect to contracts and subcontracts entered into for the construction or manufacture of complete naval aircraft or any portion thereof and completed within the income-taxable year.

(e) The application of the provisions of this section of the regulations may be illustrated by the following example:

Example. On September 1, 1939, the B Corporation, which keeps its books and makes its Federal income tax returns on a calendar year basis, entered into a contract with the Secretary of the Navy for the construction of naval aircraft coming within the scope of the act, the total contract price of which was $200,000. On March 10, 1940, the B Corporation entered into another such contract, the total contract price of which was $40,000. Both contracts were completed within the calendar year 1940, the first at a cost of $155,000 and the second at a cost of $45,000. During the year 1940, the B Corporation also completed at a deficiency in profit of $2,000 a contract entered into for the construction of Army aircraft coming within the scope of the act. During the year 1940, the B Corporation also completed at a loss of $10,000 two contracts entered into for the construction or manufacture of portions of a naval vessel coming within the scope of the act. For the year 1939, the B Corporation sustained a net loss of $2,500 and a deficiency in profit of $1,000 on all contracts and subcontracts for naval aircraft coming within the scope of the act and completed within the calendar year 1939. For the year 1939, the B Corporation also sustained a net loss of $1,800 on a contract for the construction of Army aircraft coming within the scope of the act which was completed within the calendar year 1939. For the purposes of the Federal income tax, the net income of the B Corporation for the year 1940, on which the tax was paid, amounted to $96,000, which included the net profit of $40,000 upon the contracts entered into on September 1, 1939, and March 10, 1940. The excess profit liability of the B Corporation for 1940 is payable with respect to the contracts for naval aircraft which were completed in 1940. The loss of $10,000 on the contracts for portions of a naval vessel completed in 1940 does not enter into the computation of such liability. Accordingly, the excess profit liability of the B Corporation for 1940 is $2,964 computed as follows:

Total contract prices:		
Contract No. 1	$200,000	
Contract No. 2	40,000	
		$240,000
Less: Cost of performing contracts:		
Contract No. 1	155,000	
Contract No. 2	45,000	
		200,000
Net profit on contracts		40,000
Less:		
12 percent of total contract prices (12 percent of $240,000)	28,800	
Deficiency in profit (in Army aircraft contracts) in 1940	2,000	
Net loss (in naval aircraft contracts) from 1939	2,500	
Net loss (in Army aircraft contracts) from 1939	1,800	
Deficiency in profit (in naval aircraft contracts) from 1939	1,000	
		36,100
Excess profit for year 1940		3,900
Less: Credit for Federal income taxes (Federal income tax on $3,900 at rates for 1940)		936
Amount of excess profit payable to the United States		2,964

[T.D. 4906, 4 FR 2492, June 27, 1939, as amended by T.D. 6512, 25 FR 12443, Dec. 6, 1960]

§ 17.8 *Total contract price.* The total contract price of a particular contract or subcontract (see § 17.1) may be received in money or its equivalent. If something other than money is received, only the fair market value of the thing received, at the date of receipt, is to be included in determining the amount received. Bonuses earned for bettering performance and penalties incurred for failure to meet the contract guarantees are to be regarded as adjustments of the original contract price. Trade or other discounts granted by a contracting party in respect of a contract or subcontract performed by such party are also to be deducted in determining the true total contract price of such contract or subcontract.

§17.9 *Cost of performing a contract or subcontract*—(a) *General rule.* The cost of performing a particular contract or subcontract shall be the sum of (1) the direct costs, including therein expenditures for materials, direct labor and direct expenses, incurred by the contracting party in performing the contract or subcontract; and (2) the proper proportion of any indirect costs (including therein a reasonable proportion of management expenses) incident to and necessary for the performance of the contract or subcontract.

(b) *Elements of cost.* No definitions of the elements of cost may be stated which are of invariable application to all contractors and subcontractors. In general, the elements of cost may be defined for purposes of the act as follows:

(1) Manufacturing cost, which is the sum of factory cost (see paragraph (c) of this section) and other manufacturing cost (see paragraph (d) of this section);

(2) Miscellaneous direct expenses (see paragraph (e) of this section);

(3) General expenses, which are the sum of indirect engineering expenses, usually termed ‘‘engineering overhead’’ (see paragraph (f) of this section) and expenses of distribution, servicing and administration (see paragraph (g) of this section); and

(4) Guarantee expenses (see paragraph (h) of this section).

(c) *Factory cost.* Factory cost is the sum of the following:

(1) *Direct materials.* Materials, such as those purchased for stock and subsequently issued for contract operations and those acquired under subcontracts, which become a component part of the finished product or which are used directly in fabricating, converting or processing such materials or parts.

(2) *Direct productive labor.* Productive labor, usually termed ‘‘shop labor,’’ which is performed on and is properly chargeable directly to the article manufactured or constructed pursuant to the contract or subcontract, but which ordinarily does not include direct engineering labor (see subparagraph (3) of this paragraph).

(3) *Direct engineering labor.* The compensation of professional engineers and other technicists (including reasonable advisory fees), and of draftsmen, properly chargeable directly to the cost of the contract or subcontract.

(4) *Miscellaneous direct factory charges.* Items which are properly chargeable directly to the factory cost of performing the contract or subcontract but which do not come within the classifications in subparagraphs (1), (2), and (3) of this paragraph, as for example, royalties which the contracting party pays to another party and which are properly chargeable to the cost of performing the contract or subcontract (but see paragraph (d) of this section).

(5) *Indirect factory expenses.* Items, usually termed ‘‘factory overhead,’’ which are not directly chargeable to the factory cost of performing the contract or subcontract but which are properly incident to and necessary for the performance of the contract or subcontract and consist of the following:

(i) *Labor.* Amounts expended for factory labor, such as supervision and inspection, clerical labor, timekeeping, packing and shipping, stores supply, services of tool crib attendants, and services in the factory employment bureau, which are not chargeable directly to productive labor of the contract or subcontract.

(ii) *Materials and supplies.* The cost of materials and supplies for general use in the factory in current operations, such as shop fuel, lubricants, heat-treating, plating, cleaning and anodizing supplies, nondurable tools and gauges, stationery (such as time tickets and other forms), and boxing and wrapping materials.

(iii) *Service expenses.* Factory expenses of a general nature, such as those for power, heat and light (whether purchased or produced), ventilation and air conditioning and operation and maintenance of general plant assets and facilities.

(iv) *Fixed charges and obsolescence.* Recurring charges with respect to property used for manufacturing purposes of the contract or subcontract, such as premiums for fire and elevator insurance, property taxes, rentals and allowances for depreciation of such property, including maintenance and depreciation of reasonable standby equipment; and depreciation and obsolescence of special equipment and facilities necessarily acquired primarily for the performance of the contract or subcontract. In making allowances for depreciation, consideration shall be given to the number and length of shifts.

(v) *Miscellaneous indirect factory expenses.* Miscellaneous factory expenses not directly chargeable to the factory cost of performing the contract or subcontract, such as purchasing expenses; ordinary and necessary expenses of rearranging facilities within a department or plant; employees’ welfare expenses; premiums or dues on compensation insurance; employers’ payments to unemployment, old age and social security, Federal and State funds not including payments deducted from or chargeable to employees or officers; pensions and retirement payments to factory employees; factory accident compensation (as to self-insurance, see paragraph (g) of this section); but not including any amounts which are not incident to services, operations, plant, equipment or facilities involved in the performance of the contract or subcontract.

(d) *Other manufacturing cost.* Other manufacturing cost as used in paragraph (b) of this section includes items of manufacturing costs which are not properly or satisfactorily chargeable to factory costs (see paragraph (c) of this section) but which upon a complete showing of all pertinent facts are properly to be included as a cost of performing the contract or subcontract, as for instance, payments of royalties and amortization of the cost of designs purchased and patent rights over their useful life; and ''deferred'' or ''unliquidated'' experimental and development charges. For example, in case experimental and development costs have been properly deferred or capitalized and are amortized in accordance with a reasonably consistent plan, a proper portion of the current charge, determined by a ratable allocation which is reasonable in consideration of the pertinent facts, may be treated as a cost of performing the contract or subcontract. In the case of general experimental and development expenses which may be charged off currently, a reasonable portion thereof may be allocated to the cost of performing the contract or subcontract. If a special experimental or development project is carried on in pursuance of a contract, or in anticipation of a contract which is later entered into, and the expense is not treated as a part of general experimental and development expenses or is not otherwise allowed as a cost of performing the contract, there clearly appearing no reasonable prospect of an additional contract for the type of article involved, the entire cost of such project may be allowed as a part of the cost of performing the contract.

(e) *Miscellaneous direct expenses.* Miscellaneous direct expenses as used in paragraph (b) of this section include:

(1) *Cost of installation and construction.* Cost of installation and construction includes the cost of materials, labor and expenses necessary for the erection and installation prior to the completion of the contract and after the delivery of the product or material manufactured or constructed pursuant to the contract or subcontract.

(2) *Sundry direct expenses.* Items of expense which are properly chargeable directly to the cost of performing a contract or subcontract and which do not constitute guarantee expenses (see paragraph (h) of this section) or direct costs classified as factory cost or other manufacturing cost (see paragraphs (c) and (d) of this section), such as premiums on performance or other bonds required under the contract or subcontract; State sales taxes imposed on the contracting party; freight on outgoing shipments; fees paid for wind tunnel and model basin tests; demonstration and test expenses; crash insurance premiums; traveling expenses. In order for any such item to be allowed as a charge directly to the cost of performing a contract or subcontract, (i) a detailed record shall be kept by the contracting party of all items of a similar character, and (ii) no item of a similar character which is properly a direct charge to other work shall be allowed as a part of any indirect expenses in determining the proper proportion thereof chargeable to the cost of performing the contract or subcontract. As to allowable indirect expenses, see paragraphs (c)(5), (f), (g), and (j) of this section.

(f) *Indirect engineering expenses.* Indirect engineering expenses, usually termed ''engineering overhead,'' which are treated in this section as a part of general expenses in determining the cost of performing a contract or subcontract (see paragraph (b) of this section), comprise the general engineering expenses which are incident to and necessary for the performance of the contract or subcontract, such as the following:

(1) *Labor.* Reasonable fees of engineers employed in a general consulting capacity, and compensation of employees for personal services to the engineering department, such as supervision, which is properly chargeable to the contract or subcontract, but which is not chargeable as direct engineering labor (see paragraph (c)(3) of this section).

(2) *Material.* Supplies for the engineering department, such as paper and ink for drafting and similar supplies.

(3) *Miscellaneous expenses.* Expenses of the engineering department, such as (i) maintenance and repair of engineering equipment, and (ii) services purchased outside of the engineering department for blue- printing, drawing, computing, and like purposes.

(g) *Expenses of distribution, servicing and administration.* Expenses of distribution, servicing and administration, which are treated in this section as a part of general expenses in determining the cost of performing a contract or subcontract (see paragraph (b) of this section), comprehend the expenses incident to and necessary for the performance of the contract or subcontract, which are incurred in connection with the distribution and general servicing of the contracting party's products and the general administration of the business, such as:

(1) *Compensation for personal services of employees.* The salaries of the corporate and general executive officers and the salaries and wages of administrative clerical employees and of the office services employees such as telephone operators, janitors, cleaners, watchmen and office equipment repairmen.

(2) *Bidding and general selling expenses.* Bidding and general selling expenses which by reference to all the pertinent facts and circumstances reasonably constitute a part of

the cost of performing a contract or subcontract. The treatment of bidding and general selling expenses as a part of general expenses in accordance with this paragraph is in lieu of any direct charges which otherwise might be made for such expenses. The term ‘‘bidding expenses’’ as used in this section includes all expenses in connection with preparing and submitting bids.

(3) *General servicing expenses.* Expenses which by reference to all the pertinent facts and circumstances reasonably constitute a part of the cost of performing a contract or subcontract and which are incident to delivered or installed articles and are due to ordinary adjustments or minor defects; but including no items which are treated as a part of guarantee expenses (see paragraph (h) of this section) or as a part of direct costs, such as direct materials, direct labor, and other direct expense.

(4) *Other expenses.* Miscellaneous office and administrative expenses, such as stationery and office supplies; postage; repair and depreciation of office equipment; contributions to local charitable or community organizations to the extent constituting ordinary and necessary business expenses; employees’ welfare expenses; premiums and dues on compensation insurance; employers’ payments to unemployment, old age and social security Federal and State funds not including payments deducted from or chargeable to employees or officers; pensions and retirement payments to administrative office employees and accident compensation to office employees (as to self-insurance, see subdivision (i) of this subparagraph).

(i) Subject to the exception stated in this subdivision, in cases where a contracting party assumes its own insurable risks (usually termed ‘‘self-insurance’’), losses and payments will be allowed in the cost of performing a contract or subcontract only to the extent of the actual losses suffered or payments incurred during, and in the course of, the performance of the contract or subcontract and properly chargeable to such contract or subcontract. If, however, a contracting party assumes its own insurable risks *(a)* for compensation paid to employees for injuries received in the performance of their duties, or *(b)* for unemployment risks in States where insurance is required, there may be allowed as a part of the cost of performing a contract or subcontract a reasonable portion of the charges set up for purposes of self-insurance under a system of accounting regularly employed by the contracting party, as determined by the Commissioner of Internal Revenue, at rates not exceeding the lawful or approved rates of insurance companies for such insurance, reduced by amounts representing the acquisition cost in such companies, provided the contracting party adopts and consistently follows this method with respect to self-insurance in connection with all contracts and subcontracts subsequently performed by him.

(ii) Allowances for interest on invested capital are not allowable as costs of performing a contract or subcontract.

(iii) Among the items which shall not be included as a part of the cost of performing a contract or subcontract or considered in determining such cost, are the following: Entertainment expenses; dues and memberships other than of regular trade associations; donations except as otherwise provided above; losses on other contracts; profits or losses from sales or exchanges of capital assets; extraordinary expenses due to strikes or lockouts; fines and penalties; amortization of unrealized appreciation of values of assets; expenses, maintenance and depreciation of excess facilities (including idle land and building, idle parts of a building, and excess machinery and equipment) vacated or abandoned, or not adaptable for future use in performing contracts or subcontracts; increases in reserve accounts for contingencies, repairs, compensation insurance (except as above provided with respect to self-insurance) and guarantee work; Federal and State income and excess-profits taxes and surtaxes; cash discount earned up to one percent of the amount of the purchase, except that all discounts on subcontracts subject to the act will be considered; interest incurred or earned; bond discount or finance charges; premiums for life insurance on the lives of officers; legal and accounting fees in connection with reorganizations, security issues, capital stock issues and the prosecution of claims against the United States (including income tax matters); taxes and expenses on issues and transfers of capital stock; losses on investments; bad debts; and expenses of collection and exchange.

(iv) In order that the cost of performing a contract or subcontract may be accounted for clearly, the amount of any excess profits repayable to the United States pursuant to the act should not be charged to or included in such cost.

(h) *Guarantee expenses.* Guarantee expenses include the various items of factory, cost, other manufacturing cost, cost of installation and construction, indirect engineering expenses and other general expenses (see paragraphs (c) to (g) of this section) which are incurred after delivery or installation of the article manufactured or constructed pursuant to the particular contract or subcontract and which are incident to the correction of defects or deficiencies which the contracting party is required to make under the guarantee provisions of the particular contract or subcontract. If the total amount of such guarantee expenses is not ascertainable at the time of filing the report required to be filed with the district director of internal revenue (see §17.16) and the contracting party includes any estimated amount of such expenses as part of the claimed total cost of performing the contract or subcontract, such estimated amount shall be separately shown on the report and the reasons for claiming such estimated amount shall accompany the report; but only the amount of guarantee expenses actually incurred will be allowed. If the amount of guarantee expenses actually incurred is greater than the amount (if any) claimed on the report and the contracting party has made an overpayment of excess profit, a refund of the overpayment shall be made, in accordance with the provisions of § 17.19. If the amount of guarantee expenses actually incurred is less than the amount claimed on the report and an additional amount of excess profit is determined to be due, the additional amount of excess profit shall be assessed and paid in accordance with the provisions of § 17.19.

(i) *Unreasonable compensation.* (1) The salaries and compensation for services which are treated as a part of the cost of performing a contract or subcontract include reasonable payments for salaries, bonuses, or other compensation for services. As a general rule, bonuses paid to employees (and not to officers) in pursuance of a regularly established incentive bonus system may be allowed as a part of the cost of performing a contract or subcontract.

(2) The test of allowability is whether the aggregate compensation paid to each individual is for services actually rendered incident to, and necessary for, the performance of the contract or subcontract, and is reasonable. Excessive or unreasonable payments whether in cash, stock or other property ostensibly as compensation for services shall not be included in the cost of performing a contract or subcontract.

(j) *Allocation of indirect costs.* No general rule applicable to all cases may be stated for ascertaining the proper proportion of the indirect costs to be allocated to the cost of performing a particular contract or subcontract. Such proper proportion depends upon all the facts and circumstances relating to the performance of the particular contract or subcontract. Subject to a requirement that all items which have no relation to the performance of the contract or subcontract shall be eliminated from the amount to be allocated, the following methods of allocation are outlined as acceptable in a majority of cases:

(1) *Factory indirect expenses.* The allowable indirect factory expenses (see paragraph (c)(5) of this section) shall ordinarily be allocated or ‘‘distributed’’ to the cost of the contract or subcontract on the basis of the proportion which the direct productive labor (see paragraph (c)(2) of this section) attributable to the contract or subcontract bears to the total direct productive labor of the production department or particular section thereof during the period within which the contract or subcontract is performed, except that if the indirect factory expenses are incurred in different amounts and in different proportions by the various producing departments consideration shall be given to such circumstances to the extent necessary to make a fair and reasonable determination of the true profit and excess profit.

(2) *Engineering indirect expenses.* The allowable indirect engineering expenses (see paragraph (f) of this section) shall ordinarily be allocated or ‘‘distributed’’ to the cost of the contract or subcontract on the basis of the proportion which the direct engineering labor attributable to the contract or subcontract (see paragraph (c)(3) of this section) bears to the total direct engineering labor of the engineering department or particular section thereof during the period within which the contract or subcontract is performed. If the expenses of the engineering department are not sufficient in amount to require the maintenance of separate accounts, the engineering indirect costs may be included in the indirect factory expenses (see paragraph (c)(5) of this section) and allocated or distributed to the cost of performing the contract or subcontract as a part of such expenses, provided the proportion so allocated or distributed is proper under the facts and circumstances relating to the performance of the particular contract or subcontract.

(3) *Administrative expenses (or ‘‘overhead’’).* The allowable expenses of administration (see paragraph (g) of this section) or other general expenses except indirect engineering expenses, bidding and general selling expenses, and general servicing expenses shall ordinarily be allocated or distributed to the cost of performing a contract or subcontract on the basis of the proportion which the sum of the manufacturing cost (see paragraph (b) of this section) and the cost of installation and construction (see paragraph (e) of this section) attributable to the particular contract or subcontract bears to the sum of the total manufacturing cost and the total cost of installation and construction during the period within which the contract or subcontract is performed.

(4) *Bidding, general selling, and general servicing expenses.* The allowable bidding and general selling expenses and general servicing expenses (see paragraph (g) (2) and (3) of this section) shall ordinarily be allocated or distributed to the cost of performing a contract or subcontract on the basis of:

(i) The proportion which the contract price of the particular contract or subcontract bears to the total sales made (including contracts or subcontracts completed) during the period within which the particular contract or subcontract is performed, or

(ii) The proportion which the sum of the manufacturing cost (see paragraph (b) of this section) and the cost of installation and construction (see paragraph (e) of this section) attributable to the particular contract or subcontract bears to the sum of the total manufacturing cost and the total cost of installation and construction during the period within which the contract or subcontract is performed.

except that special consideration shall be given to the relation which certain classes of such expenses bear to the various classes of article produced by the contracting party in each case in which such consideration is necessary in order to make a fair and reasonable determination of the true profit and excess profit. See §17.14.

§17.10 *Credits for net loss and deficiency in profit in computing excess profit—(a) Net loss on contracts and subcontracts for naval vessels or portions thereof.* In the case of contracts or subcontracts for the construction or manufacture of any complete naval vessel or any portion thereof coming within the scope of the act which are completed within an income-taxable year ending after April 3, 1939, the term ''net loss'' as used in the act and in this part means the amount by which the total costs of performing all such contracts and subcontracts completed within such income-taxable year exceeds the total contract prices of such contracts and subcontracts. Such net loss sustained by a contracting party for an income-taxable year ending after April 3, 1939, is allowable as a credit in computing the contracting party's excess profit on contracts and subcontracts for the construction or manufacture of any complete naval vessel or any portion thereof which are completed within the next succeeding income-taxable year.

(b) *Net loss on contracts and subcontracts for aircraft or portions thereof.* In the case of contracts or subcontracts for the construction or manufacture of any complete aircraft or any portion thereof coming within the scope of the act, which are completed within an income-taxable year ending after April 3, 1939, the term ''net loss'' as used in the act and in these regulations means the amount by which the total costs of performing all such contracts and subcontracts completed within such income-taxable year exceeds the total contract prices of such contracts and subcontracts. Such net loss sustained by a contracting party for an income-taxable year ending after April 3, 1939, is allowable as a credit in computing the contracting party's excess profit on contracts and subcontracts for the construction or manufacture of any complete aircraft or any portion thereof which are completed within the four next succeeding income-taxable years.

(c) *Deficiency in profit.* The term ''deficiency in profit'' as used in the act and in this part relates to contracts and subcontracts coming within the scope of the act which are for the construction or manufacture of any complete aircraft or any portion thereof and are completed within an income-taxable year ending after April 3, 1939. As so used, the term ''deficiency in profit'' means the amount by which 12 percent of the total contract prices of such contracts and subcontracts which are completed by a particular contracting party within the income-taxable year exceeds the net profit upon such contracts and subcontracts. A deficiency in profit sustained by a contracting party with respect to such contracts and subcontracts for the construction or manufacture of complete aircraft or any portion thereof and completed within any income-taxable year ending after April 3, 1939, is allowable as a credit in computing the contracting party's excess profit on contracts and subcontracts for the construction or manufacture of complete aircraft or any portion thereof which are completed within the same or the four next succeeding income-taxable years.

(d) *Claim for credit.* Credit for a deficiency in profit or a net loss may be claimed in the contracting party's annual report of profit filed with the district director of internal revenue (see §17.16), but it shall be supported by separate schedules for each contract or subcontract involved showing total contract prices, costs of performance and pertinent facts relative thereto, together with a summarized computation of the deficiency in profit or net loss. The deficiency in profit or net loss claimed is subject to verification and adjustment. As to preservation of books and records, see §17.14. A deficiency in profit or net loss sustained on contracts and subcontracts completed within one income-taxable year may not be considered in computing a net loss or deficiency in profit sustained on contracts and subcontracts completed within another income- taxable year.

(e) *Examples.* The provisions of this section of the regulations may be illustrated by the following examples:

Example (1) For the calendar year 1939 the A Corporation, which keeps its books and makes its Federal income tax returns on a calendar year basis, sustained a net loss of $50,000 upon all contracts and subcontracts coming within the scope of the act which were entered into for the construction or manufacture of any complete naval vessel or any portion thereof and were completed within the calendar year 1939. For the calendar year 1940 the A Corporation had a net profit of $30,000 upon all such contracts and subcontracts completed within the year 1940. It also had a net profit of $10,000 upon other contracts completed within that year all such contracts being for naval aircraft coming within the scope of the act. For the calendar year 1941 the corporation had a net profit of $25,000 upon contracts completed within that year. The net loss of $50,000 sustained in 1939 may be taken as a credit against the net profit of $30,000 realized in

1940 upon the contracts for the construction or manufacture of complete naval vessels or portions thereof completed within that year; but the excess of $20,000 ($50,000 minus $30,000) may not be taken as a credit in computing the excess profit realized upon the other contracts completed in 1940 at a net profit of $10,000 or as a credit in computing the excess profit upon the contracts completed within the year 1941 at a net profit of $25,000.

Example (2). For the calendar year 1939, the B Corporation, which keeps its books and makes its Federal income tax returns on a calendar year basis, sustained a net loss of $10,000 and a deficiency in profit of $35,000 upon all contracts and subcontracts for naval aircraft and portions thereof coming within the scope of the act and completed within that year. During the year 1939, the B Corporation also completed contracts for Army aircraft coming within the scope of the Act at a net profit which was $15,000 in excess of 12 percent of the total contract prices of such contracts. On all contracts and subcontracts for naval aircraft coming within the scope of the act and completed within the calendar year 1940, the B Corporation realized a net profit which was $25,000 in excess of 12 percent of the total contract prices of such contracts and subcontracts while sustaining a deficiency in profit of $10,000 on like contracts and subcontracts for Army aircraft. On all contracts and subcontracts for naval aircraft coming within the scope of the act and completed within the calendar year 1941, the B Corporation realized a net profit which was $20,000 in excess of 12 percent of the total contract prices of such contracts. The net loss of $10,000 and deficiency in profit of $35,000 (or a total of $45,000) sustained in 1939 with respect to contracts and subcontracts for naval aircraft completed within that year may be taken as a credit to the extent of $15,000 in computing the excess profit on the contracts and subcontracts for Army aircraft completed in 1939. The remainder of such net loss and such deficiency in profit ($45,000 minus $15,000, or $30,000) may be combined with the deficiency in profit of $10,000 sustained in 1940 on contracts for Army aircraft and taken as a credit to the extent of $25,000 in computing the excess profit on the contracts and subcontracts for aircraft completed during 1940. The sum of such net loss and such deficiency in profit then remaining ($40,000 minus $25,000, or $15,000) may be taken as a credit in computing the excess profit realized on the contracts and subcontracts for aircraft completed in the year 1941.

[T.D. 4906, 4 FR 2492, June 27, 1939, as amended by T.D. 6512, 25 FR 12444, Dec. 6, 1960]

§ 17.11 *Credit for Federal income taxes.* For the purpose of computing the amount of excess profit to be paid to the United States, a credit is allowable against the excess profit for the amount of Federal income taxes paid or remaining to be paid on the amount of such excess profit. The ''Federal income taxes'' in respect of which this credit is allowable include the income taxes imposed by Titles I and IA of the Revenue Act of 1938, and Chapter 1 and Subchapter A of Chapter 2 of the Internal Revenue Code, and the excess-profits taxes imposed by section 602 of the Revenue Act of 1938, and Subchapter B of Chapter 2 of the Internal Revenue Code. This credit is allowable for these taxes only to the extent that it is affirmatively shown that they have been finally determined and paid or remain to be paid and that they were imposed upon the excess profit against which the credit is to be made. In case such a credit has been allowed and the amount of Federal income taxes imposed upon the excess profit is redetermined, the credit previously allowed shall be accordingly adjusted.

§ 17.12 *Failure of contractor to require agreement by subcontractor.* (a) Every contract or subcontract coming within the scope of the act is required by the act to contain, among other things, an agreement by the contracting party to make no subcontract unless the subcontractor agrees:

(1) To make a report, as described in the act, under oath to the Secretary of the Navy upon the completion of the subcontract;

(2) To pay into the Treasury excess profit, as determined by the Treasury Department, in the manner and amounts specified in the act;

(3) To make no subdivision of the subcontract for the same article or articles for the purpose of evading the provisions of the act;

(4) That the manufacturing spaces and books of its own plant, affiliates, and subdivisions shall at all times be subject to inspection and audit as provided in the act.

(b) If a contracting party enters into a subcontract with a subcontractor who fails to make such agreement, such contracting party shall, in addition to its liability for excess profit determined on contracts or subcontracts performed by it, be liable for any excess profit determined to be due the United States on the subcontract entered into with such subcontractor. In such event, however, the excess profit to be paid to the United States in respect of the subcontract entered into with such subcontractor shall be determined separately from any contracts or subcontracts performed by the contracting party entering into the subcontract with such subcontractor.

§ 17.13 *Evasion of excess profit.* Section 3 of the act provides that the contracting party shall agree to make no subdivisions of any contract or subcontract for the same article or articles for the purpose of evading the provisions of the act. If any such subdivision or subcontract is made it shall constitute a violation of the agreement provided for in the act, and the cost of completing a contract or subcontract by a contracting party which violates such agreement shall be determined in a manner necessary clearly to reflect the true excess profit of such contracting party.

§17.14 *Books of account and records.* (a) It is recognized that no uniform method of accounting can be prescribed for all contracting parties subject to the provisions of the act. Each contracting party is required by law to make a report of its true profit and excess profit. Such party must, therefore, maintain such accounting records as will enable it to do so. See §17.9. Among the essentials are the following:

(1) The profit or loss upon a particular contract or subcontract shall be accounted for and fully explained in the books of account separately on each contract or subcontract.

(2) Any cost accounting methods, however standard they may be and regardless of long continued practice, shall be controlled by, and be in accord with, the objectives and purposes of the act and of any regulations prescribed thereunder.

(3) The accounts shall clearly disclose the nature and amount of the different items of cost of performing a contract or subcontract.

(b) In cases where it has been the custom priorly to use so-called ''normal'' rates of overhead expense or administrative expenses, or ''standard'' or ''normal'' prices of material or labor charges, no objection will be made to the use temporarily during the period of performing the contract or subcontract of such methods in charging the contract or subcontract, if the method of accounting employed is such as clearly to reflect, in the final determination upon the books of account, the actual profit derived from the performance of the contract or subcontract and if the necessary adjusting entries are entered upon the books and they explain in full detail the revisions necessary to accord with the facts. As to the elements of cost, see §17.9.

(c) All books, records, and original evidences of costs (including, for example, production orders, bills or schedules of materials, purchase requisitions, purchase orders, vouchers, requisitions for materials, standing expense orders, inventories, labor time cards, payrolls, cost distribution sheets) pertinent to the determination of the true profit, excess profit, deficiency in profit, or net loss from the performance of a contract or subcontract shall be kept at all times available for inspection by internal revenue officers, and shall be carefully preserved and retained so long as the contents thereof may become material in the administration of the act. This provision is not confined to books, records and original evidences pertaining to items which may be considered to be a part of the cost of performing a contract or subcontract. It is applicable to all books, records and original evidences of costs of each plant, branch or department involved in the performance of a contract or subcontract or in the distribution of costs to the contract or subcontract.

§17.15 *Report to Secretary of the Navy.* (a) Upon the completion of a contract or a subcontract coming within the scope of the act and this part, the contracting party is required to make a report, under oath, to the Secretary of the Navy. As to the date of completion of a contract or subcontract, see §17.5. The act requires that such report shall be in the form prescribed by the Secretary of the Navy and shall state the total contract price, the cost of performing the contract, the net income from such contract, and the per centum such income bears to the contract price. The contracting party shall also include as a part of such report a statement showing:

(1) The manner in which the indirect costs were determined and allocated to the cost of performing the contract or subcontract (see §17.9);

(2) The name and address of every subcontractor with whom a subcontract was made, the object of such subcontract, the date when completed and the amount thereof; and

(3) The name and address of each affiliate or other organization, trade or business owned or controlled directly or indirectly by the same interests as those who so own or control the contracting party, together with a statement showing in detail all transactions which were made with such affiliate or other organization, trade or business and are pertinent to the determination of the excess profit.

(b) A copy of the report required to be made to the Secretary of the Navy is required to be transmitted by the contracting party to the Secretary of the Treasury. Such copy shall not be transmitted directly to the Secretary of the Treasury but shall be filed as a part of the annual report. See §17.16.

§17.16 *Annual reports for income-taxable years*—(a) *General requirements.* Every contracting party completing a contract or subcontract within the contracting party's income-taxable year ending after April 3, 1939 shall file, with the district director of internal revenue for the internal revenue district in which the contracting party's Federal income tax return is required to be filed, annual reports on the prescribed forms of the profit and excess profit on all contracts and subcontracts coming within the scope of the act. If any contracts or subcontracts so completed by the contracting party were entered into for the construction or manufacture of any complete naval vessel or any portion thereof, the profit and excess profit on all such contracts and subcontracts completed within the income-taxable year ending after April 3, 1939 shall be computed in accordance with the provisions of § 17.6. If any contracts or subcontracts so completed by the contracting party were entered into for the construction or manufacture of any complete naval aircraft or any portion thereof, the profit and excess profit on all such contracts and subcontracts completed within the income-taxable year ending after April 3, 1939 shall be computed in accordance with the provisions of § 17.7. There shall be included as a part of the annual report a statement, preferably in columnar form, showing separately for each contract or subcontract completed by the contracting party within the income-taxable year and covered by the report, the total contract price, the cost of performing the contract or subcontract and resulting profit or loss on each contract or subcontract together with a summary statement showing in detail the computation of the net profit or net loss upon each group of contracts and subcontracts covered by the report and the amount of the excess profit, if any, with respect to each group of contracts and subcontracts covered by the report. A copy of the report made to the Secretary of the Navy (see § 17.15) with respect to each contract or subcontract covered in the annual report, shall be filed as a part of such annual report. In case the income-taxable year of the contracting party is a period of less than twelve months (see § 17.1), the reports required by this section shall be made for such period and not for a full year.

(b) *Time for filing annual reports.* Annual reports of contracts and subcontracts completed by a contracting party within an income-taxable year ending after April 3, 1939 shall be filed on or before the 15th day of the ninth month following the close of the contracting party's income-taxable year. It is important that the contracting party render on or before the due date annual reports as nearly complete and final as it is possible for the contracting party to prepare. An extension of time granted the contracting party for filing its Federal income tax return does not serve to extend the time for filing the annual reports required by this section. Authority consistent with authorizations for granting extensions of time for filing Federal income tax returns is hereby delegated to the various district directors of internal revenue for granting extensions of time for filing the reports required by this section. Application for extensions of time for filing such reports should be addressed to the district director of internal revenue for the district in which the contracting party files its Federal income tax returns and must contain a full recital of the causes for the delay.

§ 17.17 *Payment of excess profit liability.* The amount of the excess profit liability to be paid to the United States shall be paid on or before the due date for filing the report with the district director of internal revenue. See § 17.16. At the option of the contracting party, the amount of the excess profit liability may be paid in four equal installments instead of in a single payment, in which case the first installment is to be paid on or before the date prescribed for the payment of the excess profit as a single payment, the second installment on or before the 15th day of the third month, the third installment on or before the 15th day of the sixth month, and the fourth installment on or before the 15th day of the ninth month, after such date.

§ 17.18 *Liability of surety.* The surety under contracts entered into after the amendment of section 3(b) of the act of June 25, 1936 shall not be liable for payment of excess profit due the United States in respect of such contracts.

§ 17.19 *Determination of liability for excess profit, interest and penalties; assessment, collection, payment, refunds.* (a) The duty of determining the correct amount of excess profit liability on contracts and subcontracts coming within the scope of the act is upon the Commissioner of Internal Revenue. Under section 3(b) of the act, as amended, and section 651 of the Internal Revenue Code, all provisions of law (including the provisions of law relating to interest, penalties and refunds) applicable with respect to the taxes imposed by Title I of the Revenue Act of 1934 and not inconsistent with section 3 of the act are applicable with respect to the assessment, collection, or payment of excess profits on contracts and subcontracts coming within the scope of the act and to refunds of overpayments of profits into the Treasury under the act. Claims by a contracting party for the refund of an amount of excess profit, interest, penalties, and additions to such excess profit shall conform to the general requirements prescribed with respect to claims for refund of overpayments of taxes imposed by Title I of the Revenue Act of 1934 and, if filed on account of any additional costs incurred pursuant to guarantee provisions in a contract, shall be supplemented by a statement under oath showing the amount and nature of such costs and all facts pertinent thereto.

(b) Administrative procedure for the determination, assessment and collection of excess profit liability under section 3 of the act, sections 650 and 651 of the Internal Revenue Code, and this part, and the examination of reports and claims in connection therewith will be prescribed from time to time by the Commissioner of Internal Revenue.

MITIGATION OF EFFECT OF RENEGOTIATION OF GOVERNMENT CONTRACTS

§1.1481–1 [Reserved]

Tax on Transfers To Avoid Income Tax

§1.1491–1 Imposition of tax.

Section 1491 imposes an excise tax upon transfers of stock or securities by a citizen or resident of the United States, or by a domestic corporation or partnership, or by a trust which is not a foreign trust, to a foreign corporation as paid-in surplus or as a contribution to capital, or to a foreign trust, or to a foreign partnership. The tax is in an amount equal to 27½ percent of the excess of (a) the value of the stock or securities so transferred over (b) its adjusted basis, as provided in section 1011, for determining gain in the hands of the transferor.

[T.D. 6500, 25 FR 12082, Nov. 26, 1960]

§1.1492–1 Nontaxable transfers.

(a) The tax imposed by section 1491 does not apply:

(1) If the transferee is an organization (other than an organization described in section 401(a) exempt from income tax under the provisions of sections 501 to 504, inclusive; or

(2) If before the transfer it has been established to the satisfaction of the Commissioner that the transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

(b) Whether a transfer of stock or securities is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes is a question to be determined from the facts and circumstances of each particular case. In any such case where a transferor desires to establish that the transfer is not in pursuance of such a plan, a statement of the facts relating to the plan under which the transfer is to be made or was made, together with a copy of the plan if in writing, shall be forwarded to the Commissioner of Internal Revenue, Washington, DC 20225, for a ruling. This statement shall contain, or be verified by, a written declaration that it is made under the penalties of perjury. A letter notifying the transferor of the Commissioner's determination will be mailed to the transferor.

[T.D. 6500, 25 FR 12082, Nov. 26, 1960]

§1.1493–1 Definition of foreign trust.

For taxable years beginning before January 1, 1967, a trust is to be considered a ''foreign trust'' within the meaning of chapter 5 of the Code, if, assuming a subsequent sale by the trustee, outside the United States and for cash, of the property transferred to the trust, the profit, if any, from such sale (being income from sources without the United States under the provisions of part I (section 861 and following), subchapter N, chapter 1 of the Code), would not be included in the gross income of the trust under subtitle A of the Code. For taxable years beginning after December 31, 1966, the term ''foreign trust,'' as used in chapter 5 of the Code, shall have the meaning prescribed by section 7701(a)(31).

[T.D. 7332, 39 FR 44230, Dec. 23, 1974]

§1.1494–1 Returns; payment and collection of tax.

(a) *Returns and payment.* Every person making a transfer described in section 1491 shall make a return to the district director on the day on which the transfer is made and, unless the transfer is nontaxable under section 1492, pay the tax due on such transfer. This return, which shall contain, or be verified by, a written declaration that it is made under the penalties of perjury, shall be made on Form 926 and shall be filed with the district director to whom the transferor's return of income is required to be made. The return shall set forth in detail the following information:

(1) Name and address of transferor, and place of organization or creation, if a corporation, partnership, or trust.

(2) Name and address of transferee, place of organization or creation, and whether the transferee is a foreign corporation, a foreign trust, or a foreign partnership. If the transferee is a foreign trust or a foreign partnership, the name and address of the fiduciary and each beneficiary, in the case of a trust,

or of each partner, in the case of a partnership, must be shown.

(3) Description and amount of stock or securities transferred, the date of transfer, and a complete statement showing all the facts relating to the transfer, accompanied by a copy of the plan under which the transfer was made.

(4) The fair market value of the stock or securities transferred as of the date of transfer, and the adjusted basis provided in section 1011 for determining gain in the hands of the transferor.

(5) Whether the transfer was made in pursuance of a plan submitted to and approved by the Commissioner as not having as one of its principal purposes the avoidance of Federal income taxes. If the plan has been so approved, a copy of the Commissioner's letter approving the plan shall accompany the return.

(6) Such other information as may be required by the return form.

(b) *Certificate.* (1) If the transferee of the stock or securities, the transfer of which is reported in the return, is a foreign organization meeting the tests of exemption from income tax provided in part I (section 501 and following), subchapter F, chapter 1 of the Code, and the transferor on that account claims that no liability for tax is imposed by section 1491, such transferor must file with Form 926 a certificate establishing the exemption of the transferee under such part I. This certificate, which shall contain, or be verified by, a written declaration that it is made under the penalties of perjury, shall contain complete information showing the character of the transferee, the purpose for which it was organized, its actual activities, the source of its income and the disposition of such income, whether or not any of its income is credited to surplus or may inure to the benefit of any private shareholder or individual, and in general all facts relating to its operations which affect its right to exemption. To such certificate shall be attached a copy of the charter or articles of incorporation, the by-laws of the organization, and the latest financial statement showing the assets, liabilities, receipts, and disbursements of the organization.

(2) If the transferee is a foreign organization which has been held to be exempt from income tax under such part I (or corresponding provisions of prior law), a copy of the Commissioner's letter so holding shall be filed with Form 926 in lieu of the above certificate and attachments.

(c) *Assessment and collection.* The determination, assessment, and collection of the tax and the examination of returns and claims filed pursuant to chapter 5 of the Code will be made under such procedure as may be prescribed from time to time by the Commissioner.

[T.D. 6500, 25 FR 12082, Nov. 26, 1960]

§ 1.1494–2 Effective date.

Chapter 5 (section 1491 and following) of the Internal Revenue Code of 1954 and the regulations prescribed thereunder apply with respect to transfers occurring after December 31, 1954. (See section 7851(a)(1)(B).) Chapter 7 (section 1250 and following) of the Internal Revenue Code of 1939 and the regulations applicable thereto apply with respect to transfers occurring prior to January 1, 1955.

[T.D. 6500, 25 FR 12083, Nov. 26, 1960]

Consolidated Returns

RETURNS AND PAYMENT OF TAX

CONSOLIDATED RETURN REGULATIONS

§ 1.1502–0 Effective dates.

(a) The regulations under section 1502 are applicable to taxable years beginning after December 31, 1965, except as otherwise provided therein.

(b) The provisions of §§ 1.1502–0A through 1.1502–3A, 1.1502–10A through 1.1502–19A, and 1.1502–30A through 1.1502–51A (as contained in the 26 CFR part 1 edition revised April 1, 1996) are applicable to taxable years beginning before January 1, 1966.

[T.D. 8677, 61 FR 33325, June 27, 1996]

§ 1.1502–1 Definitions.

(a) *Group.* The term *group* means an affiliated group of corporations as defined in section 1504. See § 1.1502–75(d) as to when a group remains in existence. Except as the context otherwise requires, references to a group are references to a consolidated group (as defined in paragraph (h) of this section).

(b) *Member.* The term *member* means a corporation (including the common parent) that is included in the group, or as the context may require, a corporation that is included in a subgroup.

(c) *Subsidiary.* The term *subsidiary* means a corporation other than the common parent which is a member of such group.

(d) *Consolidated return year.* The term *consolidated return year* means a taxable year for which a consolidated return is filed or required to be filed by such group.

(e) *Separate return year.* The term *separate return year* means a taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return by another group.

(f) *Separate return limitation year*—(1) *In general.* Except as provided in paragraphs (f)(2) and (3) of this section, the term *separate return limitation year* (or *SRLY*) means any separate return year of a member or of a predecessor of a member.

(2) *Exceptions.* The term *separate return limitation year* (or *SRLY*) does not include:

(i) A separate return year of the corporation which is the common parent for the consolidated return year to which the tax attribute is to be carried (except as provided in §1.1502–75(d)(2)(ii) and subparagraph (3) of this paragraph),

(ii) A separate return year of any corporation which was a member of the group for each day of such year, or

(iii) A separate return year of a predecessor of any member if such predecessor was a member of the group for each day of such year,

Provided that an election under section 1562(a) (relating to the privilege to elect multiple surtax exemptions) was never effective (or is no longer effective as a result of a termination of such election) for such year. An election under section 1562(a) which is effective for a taxable year beginning in 1963 and ending in 1964 shall be disregarded.

(3) *Reverse acquisitions.* In the event of an acquisition to which §1.1502–75(d)(3) applies, all taxable years of the first corporation and of each of its subsidiaries ending on or before the date of the acquisition shall be treated as separate return limitation years, and the separate return years (if any) of the second corporation and each of its subsidiaries shall not be treated as separate return limitation years (unless they were so treated immediately before the acquisition). For example, if corporation P merges into corporation T, and the persons who were stockholders of P immediately before the merger, as a result of owning the stock of P, own more than 50 percent of the fair market value of the outstanding stock of T, then a loss incurred before the merger by T (even though it is the common parent), or by a subsidiary of T, is treated as having been incurred in a separate return limitation year. Conversely, a loss incurred before the merger by P, or by a subsidiary of P in a separate return year during all of which such subsidiary was a member of the group of which P was the common parent and for which section 1562 was not effective, is treated as having been incurred in a year which is not a separate return limitation year.

(4) *Predecessors and successors.* The term *predecessor* means a transferor or distributor of assets to a member (the *successor*) in a transaction—

(i) To which section 381(a) applies; or

(ii) That occurs on or after January 1, 1997, in which the successor's basis for the assets is determined, directly or indirectly, in whole or in part, by reference to the basis of the assets of the transferor or distributor, but only if the amount by which basis differs from value, in the aggregate, is material. In the case of such a transaction, only one member may be considered a predecessor to or a successor of one other member.

(g) *Consolidated return change of ownership*—(1) *In general.* A consolidated return change of ownership occurs during any taxable year (referred to in this subparagraph as the ''year of change'') of the corporation which is the common parent for the taxable year to which the tax attribute is to be carried, if, at the end of the year of change:

(i) Any one or more of the persons described in section 382(a)(2) own a percentage of the fair market value of the outstanding stock of such corporation which is more than 50 percentage points greater than such person or persons owned at:

(a) The beginning of such taxable year, or

(b) The beginning of the preceding taxable year, and

(ii) The increase in percentage points at the end of such year is attributable to:

(a) A purchase (within the meaning of section 382(a)(4)) by such person or persons of such stock, the stock of another corporation owning stock in such corporation, or an interest in a partnership or trust owning stock in such corporation, or

(b) A decrease in the amount of such stock outstanding or the amount of stock outstanding of another corporation owning stock in such corporation, except a decrease resulting from a redemption to pay death taxes to which section 303 applies.

For purposes of subdivision (i) *(a)* and *(b)* of this subparagraph, the beginning of the taxable years specified therein shall be the beginning of such taxable years or October 1, 1965, whichever occurs later.

(2) *Operating rules.* For purposes of this paragraph:

(i) The term *stock* means all shares except nonvoting stock which is limited and preferred as to dividends, and

(ii) Section 318 (relating to constructive ownership of stock) shall apply in determining the ownership of stock, except that section 318(a) (2)(C) and (3)(C) shall be applied without regard to the 50-percent limitation contained therein.

(3) *Old members.* The term *old members* of a group means:

(i) Those corporations which were members of such group immediately preceding the first day of the taxable year in which the consolidated return change of ownership occurs, or

(ii) If the group was not in existence prior to the taxable year in which the consolidated return change of ownership occurs, the corporation which is the common parent for the taxable year to which the tax attribute is to be carried.

(4) *Reverse acquisitions.* If there has been a consolidated return change of ownership of a corporation under subparagraph (1) of this paragraph and the stock or assets of such corporation are subsequently acquired by another corporation in an acquisition to which § 1.1502–75(d)(3) applies so that the group of which the former corporation is the common parent is treated as continuing in existence, then the ‘‘old members’’, as defined in subparagraph (3) of this paragraph, of such group immediately before the acquisition shall continue to be treated as ‘‘old members’’ immediately after the acquisition. For example, assume that corporations P and S comprise group PS, and PS undergoes a consolidated return change of ownership. Subsequently, the stock of P, the common parent, is acquired by corporation T, the common parent of group TU, in an acquisition to which section 368(a)(1)(B) and § 1.1502–75(d)(3) apply. The PS group is treated as continuing in existence with T as the common parent. P and S continue to be treated as old members, as defined in subparagraph (3) of this paragraph.

(h) *Consolidated group.* The term ‘‘consolidated group’’ means a group filing (or required to file) consolidated returns for the tax year.

(i) [Reserved]

(j) *Affiliated.* Corporations are affiliated if they are members of a group with each other.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 7246, 38 FR 758, Jan. 4, 1973; T.D. 8294, 55 FR 9434, Mar. 14, 1990; T.D. 8319, 55 FR 49038, Nov. 26, 1990; T.D. 8560, 59 FR 41675, Aug. 15, 1994; T.D. 8677, 61 FR 33325, June 27, 1996]

CONSOLIDATED TAX LIABILITY

§ 1.1502–2 Computation of tax liability.

The tax liability of a group for a consolidated return year shall be determined by adding together:

(a) The tax imposed by section 11 on the consolidated taxable income for such year (see § 1.1502–11 for the computation of consolidated taxable income);

(b) The tax imposed by section 541 on the consolidated undistributed personal holding company income;

(c) If paragraph (b) of this section does not apply, the aggregate of the taxes imposed by section 541 on the separate undistributed personal holding company income of the members which are personal holding companies;

(d) If paragraph (b) of this section does not apply, the tax imposed by section 531 on the consolidated accumulated taxable income (see §1.1502–43);

(e) The tax imposed by section 594(a) in lieu of the taxes imposed by section 11 or 1201 on the taxable income of a life insurance department of the common parent of a group which is a mutual savings bank;

(f) The tax imposed by section 802(a) on consolidated life insurance company taxable income;

(g) The tax imposed by section 831(a) on the consolidated insurance company taxable income of the members which are subject to such tax;

(h) The tax imposed by section 1201, instead of the taxes computed under paragraphs (a) and (g) of this section, computed by reference to the net capital gain of the group (see §1.1502–22T) (or, for consolidated return years to which §1.1502–22T does not apply, computed by reference to the excess of the consolidated net long-term capital gain over the consolidated net short-term capital loss (see §1.1502–41A for the determination of the consolidated net long-term capital gain and the consolidated net short-term capital loss));

(i) [Reserved]

(j) The tax imposed by section 1333 on war loss recoveries; and

by allowing as a credit against such taxes the investment credit under section 38 (see §1.1502–3), and the foreign tax credit under section 33 (see §1.1502–4). For purposes of this section, the surtax exemption of the group for a consolidated return year is $25,000, or if a lesser amount is allowed under section 1561, such lesser amount. See §1.1561–2(a)(2). For increase in tax due to the application of section 47, see §1.1502–3(f). For amount of tax surcharge, see section 51 and §1.1502–7.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 7093, 36 FR 4871, Mar. 13, 1971; T.D. 7937, 49 FR 3462, Jan. 27, 1984; T.D. 8677, 61 FR 33326, June 27, 1996]

§1.1502–3 Consolidated investment credit.

(a) *Determination of amount of consolidated credit*—(1) *In general.* The credit allowed by section 38 for a consolidated return year of a group shall be equal to the consolidated credit earned. The consolidated credit earned is equal to the aggregate of the credit earned (as determined under subparagraph (2) of this paragraph) by all members of the group for the consolidated return year.

(2) *Determination of credit earned.* The credit earned of a member is an amount equal to 7 percent of such member's qualified investment (determined under section 46(c)). For purposes of computing a member's qualified investment, the basis of property shall not include any gain or loss realized with respect to such property by another member in an intercompany transaction (as defined in §1.1502–13(b)), whether or not such gain or loss is deferred. Thus, if section 38 property acquired in an intercompany transaction has a basis of $100 to the purchasing member, and if the selling member has a $20 gain with respect to such property, the basis of such property for purposes of computing the purchaser's qualified investment is only $80. Such $80 basis shall also be used for purposes of applying section 47 to such property. See paragraph (f) of this section.

(3) *Consolidated limitation based on amount of tax.* (i) Notwithstanding the amount of the consolidated credit earned for the taxable year, the consolidated credit allowed by section 38 to the group for the consolidated return year is limited to:

(a) So much of the consolidated liability for tax as does not exceed $25,000, plus

(b) For taxable years ending on or before March 9, 1967, 25 percent of the consolidated liability for tax in excess of $25,000, or

(c) For taxable years ending after March 9, 1967, 50 percent of the consolidated liability for tax in excess of $25,000.

The $25,000 amount referred to in the preceding sentence shall be reduced by any part of such $25,000 amount apportioned under § 1.46–1 to component members of the controlled group (as defined in section 46(a)(5)) which do not join in the filing of the consolidated return. For further rules for computing the limitation based on amount of tax with respect to the suspension period (as defined in section 48(j)), see section 46(a)(2). The amount determined under this subparagraph is referred to in this section as the ''consolidated limitation based on amount of tax.''

(ii) If an organization to which section 593 applies or a cooperative organization described in section 1381(a) joins in the filing of the consolidated return, the $25,000 amount referred to in subdivision (i) of this subparagraph (reduced as provided in such subdivision) shall be apportioned equally among the members of the group filing the consolidated return. The amount so apportioned equally to any such organization shall then be decreased in accordance with the provisions of section 46(d). Finally, the sum of all such equal portions (as decreased under section 46(d)) of each member of the group shall be substituted for the $25,000 amount referred to in subdivision (i) of this subparagraph.

(4) *Consolidated liability for tax.* For purposes of subparagraph (3) of this paragraph, the consolidated liability for tax shall be the income tax imposed for the taxable year upon the group by chapter 1 of the Code, reduced by the consolidated foreign tax credit allowable under § 1.1502–4. The tax imposed by section 56 (relating to minimum tax for tax preferences), section 531 (relating to accumulated earnings tax), section 541 (relating to personal holding company tax), and any additional tax imposed by section 1351(d)(1) (relating to recoveries of foreign expropriation losses), shall not be considered tax imposed by chapter 1 of the Code. In addition, any increase in tax resulting from the application of section 47 (relating to certain dispositions, etc., of section 38 property) shall not be treated as tax imposed by chapter 1 for purposes of computing the consolidated liability for tax.

(b) *Carryback and carryover of unused credits*—(1) *Allowance of unused credit as consolidated carryback or carryover.* A group shall be allowed to add to the amount allowable as a credit under paragraph (a)(1) of this section for any consolidated return year an amount equal to the aggregate of the consolidated investment credit carryovers and carrybacks to such year. The consolidated investment credit carryovers and carrybacks to the taxable year shall consist of any consolidated unused credits of the group, plus any unused credits of members of the group arising in separate return years of such members, which may be carried over or back to the taxable year under the principles of section 46(b). However, such consolidated carryovers and carrybacks shall not include any consolidated unused credits apportioned to a corporation for a separate return year pursuant to paragraph (c) of § 1.1502–79 and shall be subject to the limitations contained in paragraphs (c) and (e) of this section. A consolidated unused credit for any consolidated return year is the excess of the consolidated credit earned over the consolidated limitation based on amount of tax for such year.

(2) *Absorption rules.* For purposes of determining the amount, if any, of an unused credit (whether consolidated or separate) which can be carried to a taxable year (consolidated or separate), the amount of such unused credit which is absorbed in a prior consolidated return year under section 46(b) shall be determined by:

(i) Applying all unused credits which can be carried to such prior year in the order of the taxable years in which such unused credits arose, beginning with the taxable year which ends earliest, and

(ii) Applying all such unused credits which can be carried to such prior year from taxable years ending on the same date on a pro rata basis.

(c) *Limitation on investment credit carryovers and carrybacks from separate return limitation years*—(1) *General rule.* In the case of an unused credit of a member of the group arising in a separate return limitation year (as defined in paragraph (f) of §1.1502–1) of such member (and in a separate return limitation year of any predecessor of such member), the amount which may be included under paragraph (b) of this section (computed without regard to the limitation contained in paragraph (e) of this section) shall not exceed the amount determined under subparagraph (2) of this paragraph.

(2) *Computation of limitation.* The amount referred to in subparagraph (1) of this paragraph with respect to a member of the group is the excess, if any, of:

(i) The limitation based on amount of tax of the group, minus such limitation recomputed by excluding the items of income, deduction, and foreign tax credit of such member, over

(ii) The sum of *(a)* the investment credit earned by such member for such consolidated return year, and *(b)* the unused credits attributable to such member which may be carried to such consolidated return year arising in unused credit years ending prior to the particular separate return limitation year.

(3) *Special effective date.* This paragraph (c) applies to consolidated return years for which the due date of the income tax return (without extensions) is on or before March 13, 1998. See §1.1502-3T(c) for the rule that limits the group's use of a section 38 credit carryover or carryback from a SRLY for a consolidated return year for which the due date of the income tax return (without extensions) is after March 13, 1998. For taxable years not subject to §1.1502–3T(c), prior law applies. See §1.1502–3(c) in effect prior to January 12, 1998 (§1.1502–3(c) as contained in the 26 CFR part 1 edition revised April 1, 1997) for prior law. See also §1.1502–3T(c)(4) for an optional effective date rule (generally making the rules of this paragraph (c) inapplicable to a consolidated return year beginning after December 31, 1996, if the due date of the income tax return (without extensions) for such year is on or before March 13, 1998).

(d) *Examples.* (1) *Examples.* The provisions of paragraphs (a), (b), and (c) of this section may be illustrated by the following examples:

Example (1). Corporation P is incorporated on January 1, 1966. On that same day P incorporates corporation S, a wholly owned subsidiary. P and S file consolidated returns for calendar years 1966 and 1967. P's and S's credit earned, the consolidated credit earned, and the consolidated limitation based on amount of tax for 1966 and 1967 are as follows:

	Credit earned	Consolidated credit earned	Consolidated limitation based on amount of tax
1966:			
P	$60,000		
S	30,000	$90,000	$100,000
1967:			
P	40,000		
S	25,000	65,000	50,000

(i) P's and S's credit earned for 1966 are aggregated and the group's consolidated credit earned, $90,000, is allowable in full to the group as a credit under section 38 for 1966 since such amount is less than the consolidated limitation based on amount of tax for 1966, $100,000.

(ii) Since the consolidated limitation based on amount of tax for 1967 is $50,000, only $50,000 of the $65,000 consolidated credit earned for such year is allowable to the group under section 38 as a credit for 1967. The consolidated unused credit for 1967 of $15,000 ($65,000 less $50,000) is a consolidated investment credit carryback and carryover to the years prescribed in section 46(b). In this case the consolidated unused credit is a consolidated investment credit carryback to 1966 (since P and S were not in existence in 1964 and 1965) and a consolidated investment credit carryover to 1968 and subsequent years. The portion of the consolidated unused credit for 1967 which is allowable as a credit for 1966 is $10,000. This amount shall be added to the amount allowable as a credit to the group for 1966. The balance of the consolidated unused credit for 1967 to be carried to 1968 is $5,000. These amounts are computed as follows:

Consolidated carryback to 1966			$15,000
1966 consolidated limitation based on tax		$100,000	
Less: Consolidated credit earned for 1966	$90,000		
Consolidated unused credits attributable to years preceding 1967 ...	0	90,000	

Limit on amount of 1967 consolidated unused credit which may be added as a credit for 1966	10,000
Balance of 1967 consolidated unused credit to be carried to 1968	5,000

Example (2) (i) Assume the same facts as in example (1), except that all the stock of corporation T, also a calendar year taxpayer, is acquired by P on January 1, 1968, and that P, S, and T file a consolidated return for 1968. In 1966 T had an unused credit of $10,000 which has not been absorbed and is available as an investment credit carryover to 1968. Such carryover is from a separate return limitation year. P's and S's credit earned for 1968 is $10,000 each and T's credit earned is $8,000; the consolidated credit earned is therefore $28,000. The group's consolidated limitation based on amount of tax for 1968 is $50,000. Such limitation recomputed by excluding the items of income, deduction, and foreign tax credit of T is $30,000. Thus, the amount determined under paragraph (c)(2)(i) of this section is $20,000 ($50,000 minus $30,000). Accordingly, the limitation on the carryover of T's unused credit is $12,000, the excess of $20,000 over $8,000 (the sum of T's credit earned for the taxable year and any carryovers from prior unused credit years (none in this case)). Therefore T's $10,000 unused credit from 1966 may be carried over to the consolidated return year without limitation.

(ii) The group's consolidated credit earned for 1968, $28,000, is allowable in full as a credit under section 38 since such amount is less than the consolidated limitation based on amount of tax, $50,000.

(iii) The group's consolidated investment credit carryover to 1968 is $15,000, consisting of the consolidated unused credits of the group ($5,000), plus T's separate return year unused credit ($10,000). The entire $15,000 consolidated carryover shall be added to the amount allowable to the group as a credit under section 38 for 1968, since such amount is less than $22,000 (the excess of the consolidated limitation based on tax, $50,000, over the sum of the consolidated credit earned for 1968, $28,000, and unused credits arising in prior unused credit years, zero).

Example (3). Assume the same facts as in example (2), except that the amount determined under paragraph (c)(2)(i) of this section is $12,000. Therefore, the limitation on the carryover of T's unused credit is $4,000. Accordingly, the consolidated investment credit carryover is only $9,000 since the amount of T's separate return year unused credit which may be added to the group's $5,000 consolidated unused credit is $4,000. These amounts are computed as follows:

T's carryover to 1968			$10,000
Consolidated limitation based on amount of tax minus recomputed limitation		$12,000	
Less: T's credit earned for 1968	$8,000		
Unused credits attributable to T arising in unused credit years preceding 1966	0	8,000	
Limit on amount of 1966 unused credit of T which may be added to consolidated investment credit carryover			4,000
Balance of 1966 unused credit of T to be carried to 1969 (subject to the limitation contained in paragraph (c) of this section)			6,000

(2) *Example (2)* and *Example (3)* of this paragraph (d) do not apply to consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998. For consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998, see § 1.1502–3T(d).

(e) *Limitation on investment credit carryovers where there has been a consolidated return change of ownership*— (1) *General rule.* If a consolidated return change of ownership (as defined in paragraph (g) of § 1.1502–1) occurs during the taxable year or an earlier taxable year, the amount which may be included under paragraph (b) of this section in the consolidated investment credit carryovers to the taxable year with respect to the aggregate unused credits attributable to old members of the group (as defined in paragraph (g)(3) of § 1.1502–1) arising in taxable years (consolidated or separate) ending on the same day and before the taxable year in which the consolidated return change of ownership occurred shall not exceed the amount determined under subparagraph (2) of this paragraph.

(2) *Computation of limitation.* The amount referred to in subparagraph (1) of this paragraph shall be the excess of the consolidated limitation based on the amount of tax for the taxable year, recomputed by including only the items of income, deduction, and foreign tax credit of the old members, over the sum of:

(i) The aggregate investment credits earned by the old members for the taxable year, and

(ii) The aggregate unused investment credits attributable to the old members which may be carried to the taxable year arising in unused credit years ending prior to the particular unused credit year or years.

(3) *Special effective date.* This paragraph (e) applies only to a consolidated return change of ownership that occurred during a consolidated return year for which the due date of the income tax return (without extensions) is on or before March 13, 1998. See §1.1502–3T(c)(4) for an optional effective date rule (generally making the rules of this paragraph (e) inapplicable if the consolidated return change of ownership occurred on or after January 1, 1997, and during a consolidated return year for which the due date of the income tax return (without extensions) is on or before March 13, 1998).

(f) *Early dispositions, etc., of section 38 property*—(1) *Dispositions of section 38 property during and after consolidated return year.* If property is subject to section 47(a) (1) or (2) with respect to a member during a consolidated return year, any increase in tax shall be added to the tax liability of the group under §1.1502–2 (regardless of whether the property was placed in service in a consolidated or separate return year). Also, if property is subject to section 47(a) (1) or (2) with respect to a corporation during a taxable year for which such corporation files on a separate return basis, any increase in tax shall be added to the tax liability of such corporation (regardless of whether such property was placed in service in a consolidated or separate return year).

(2) *Exception for transfer to another member.* (i) Except as provided in subdivisions (ii) and (iii) of this subparagraph, a transfer of section 38 property from one member of the group to another member of such group during a consolidated return year shall not be treated as a disposition or cessation within the meaning of section 47(a)(1). If such section 38 property is disposed of, or otherwise ceases to be section 38 property or becomes public utility property with respect to the transferee, before the close of the estimated useful life which was taken into account in computing qualified investment, then section 47(a) (1) or (2) shall apply to the transferee with respect to such property (determined by taking into account the period of use, qualified investment, other dispositions, etc., of the transferor). Any increase in tax due to the application of section 47(a) (1) or (2) shall be added to the tax liability of such transferee (or the tax liability of a group, if the transferee joins in the filing of a consolidated return).

(ii) Except as provided in subdivision (iii) of this subparagraph, if section 38 property is disposed of during a consolidated return year by one member of the group to another member of such group which is an organization to which section 593 applies or a cooperative organization described in section 1381(a), the tax under chapter 1 of the Code for such consolidated return year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would result solely from treating such property, for purposes of determining qualified investment, as placed in service by such organization to which section 593 applies or such cooperative organization described in section 1381(a), as the case may be, but with due regard to the use of the property before such transfer.

(iii) Section 47(a)(1) shall apply to a transfer of section 38 property by a corporation during a consolidated return year if such corporation is liquidated in a transaction to which section 334(b)(2) applies.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). P, S, and T file a consolidated return for calendar year 1967. In such year S places in service section 38 property having an estimated useful life of more than 8 years. In 1968, P, S, and T file a consolidated return and in such year S sells such property to T. Such sale will not cause section 47(a)(1) to apply.

Example (2). Assume the same facts as in example (1), except that P, S, and T filed separate returns for 1967. The sale from S to T will not cause section 47(a)(1) to apply.

Example (3). Assume the same facts as in example (1), except that P, S, and T continue to file consolidated returns through 1971 and in such year T disposes of the property to individual A. Section 47(a)(1) will apply to the group and any increase in tax shall be added to the tax liability of the group. For the purposes of determining the actual period of use by T, such period shall include S's period of use.

Example (4). Assume the same facts as in example (3), except that T files a separate return in 1971. Again, the actual periods of use by S and T will be combined in applying section 47. If the disposition results in an increase in tax under section 47(a)(1), such additional tax shall be added to the separate tax liability of T.

Example (5). Assume the same facts as in example (1), except that in 1969, P sells all the stock of T to a third party. Such sale will not cause section 47(a)(1) to apply.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 7246, 38 FR 758, Jan. 4, 1973; T.D. 8597, 60 FR 36679, July 18, 1995; T.D. 8751, 63 FR 1742, Jan. 12, 1998; T.D. 8766, 63 FR 12642, Mar. 16, 1998]

§ 1.1502–3T Consolidated investment credit (temporary).

(a) and (b) [Reserved]. For further guidance, see § 1.1502–3 (a) and (b).

(c) *Limitation on tax credit carryovers and carrybacks from separate return limitation years*—(1) *General rule.* The aggregate of a member's unused section 38 credits arising in SRLYs that are included in the consolidated section 38 credits for all consolidated return years of the group may not exceed—

(i) The aggregate for all consolidated return years of the member's contributions to the consolidated section 38(c) limitation for each consolidated return year; reduced by—

(ii) The aggregate of the member's section 38 credits arising and absorbed in all consolidated return years (whether or not absorbed by the member).

(2) *Computational rules*—(i) *Member's contribution to the consolidated section 38(c) limitation.* If the consolidated section 38(c) limitation for a consolidated return year is determined by reference to the consolidated tentative minimum tax (see section 38(c)(1)(A)), then a member's contribution to the consolidated section 38(c) limitation for such year equals the member's share of the consolidated net income tax minus the member's share of the consolidated tentative minimum tax. If the consolidated section 38(c) limitation for a consolidated return year is determined by reference to the consolidated net regular tax liability (see section 38(c)(1)(B)), then a member's contribution to the consolidated section 38(c) limitation for such year equals the member's share of the consolidated net income tax minus 25 percent of the quantity which is equal to so much of the member's share of the consolidated net regular tax liability less its portion of the $25,000 amount specified in section 38(c)(1)(B). The group computes the member's shares by applying to the respective consolidated amounts the principles of section 1552 and the percentage method under § 1.1502–33(d)(3), assuming a 100% allocation of any decreased tax liability. The group must make proper adjustments so that taxes and credits not taken into account in computing the limitation under section 38(c) are not taken into account in computing the member's share of the consolidated net income tax, etc. (See, for example, the taxes described in section 26(b) that are disregarded in computing regular tax liability.) Also, the group may apportion all or a part of the $25,000 amount (or lesser amount if reduced by section 38(c)(3)) for any year to one or more members.

(ii) *Years included in computation.* For purposes of computing the limitation under this paragraph (c), the consolidated return years of the group include only those years, including the year to which a credit is carried, that the member has been continuously included in the group's consolidated return, but exclude—

(A) For carryovers, any years ending after the year to which the credit is carried; and

(B) For carrybacks, any years ending after the year in which the credit arose.

(iii) *Subgroups and successors.* The SRLY subgroup principles under § 1.1502–21T(c)(2) apply for purposes of this paragraph (c). The predecessor and successor principles under § 1.1502–21T(f) also apply for purposes of this paragraph (c).

(3) *Effective date.* This paragraph (c) applies to consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998. However, a group does not take into account a consolidated taxable year for which the due date of the income tax return (without extensions) is on or before March 13, 1998, in

determining a member's (or subgroup's) contributions to the consolidated section 38(c) limitation under this paragraph (c). See also §1.1502–3(c).

(4) *Optional effective date of January 1, 1997.* In lieu of paragraphs (c)(3) and (d)(2) of this section and §§1.1502–3(c)(3), (d)(2) and (e)(3) (relating to the general business credit), 1.1502–4(f)(3) and (g)(3), 1.1502–4T(f) and (g)(3) (relating to the foreign tax credit), 1.1502–9(a) (the next to last sentence), 1.1502–9T(b)(1)(v) (relating to overall foreign losses), and 1.1502–55T(h)(4)(iii)(C) (relating to the alternative minimum tax credit), a consolidated group may apply such paragraphs as they appear in 1998–10 I.R.B. 23 (see §601.601(d)(2) of this chapter). A consolidated group making this choice generally must apply all such paragraphs for all relevant years. However, a consolidated group making the election provided in §1.1502–9T(b)(1)(vi) (electing not to apply §1.1502–9T(b)(1)(v) to years beginning before January 1, 1998) may nevertheless choose to apply all such paragraphs other than §1.1502–9T(b)(1)(v) for all relevant years.

(d) *Example.* (1) The following example illustrates the provisions of paragraph (c) of this section:

Example. (i) P, the common parent of the P group, acquires all the stock of T at the beginning of Year 2. T carries over an unused section 38 general business credit from Year 1 of $100,000. The table below shows the group's net consolidated income tax, consolidated tentative minimum tax, and consolidated net regular tax liabilities, and T's share of such taxes computed under the principles of section 1552 and the percentage method under §1.1502–33(d)(3), assuming a 100% allocation of any decreased tax liability, for Year 2. (The effects of the lower section 11 brackets are ignored, there are no other tax credits affecting a group amount or member's share, and $1,000s are omitted.)

Year 2	Group	P's share of col. 1	T's share of col. 1
1. consolidated taxable income	$2,000	$1,200	$800
2. consolidated net regular tax	$700	$420	$280
3. consolidated alternative minimum taxable income	$4,000	$3,200	$800
4. consolidated tentative minimum tax	$800	$640	$160
5. consolidated net income tax	$800	$520	$280
6. greater of line 4 or 25% of (line 2 minus $25,000) for the group	$800		
7. consolidated §38(c) limitation (line 5 minus line 6)	$0		

(ii) The amount of T's unused section 38 credits from Year 1 that are included in the consolidated section 38 credits for Year 2 may not exceed T's contribution to the consolidated section 38(c) limitation. For Year 2, the group determines the consolidated section 38(c) limitation by reference to consolidated tentative minimum tax for Year 2. Therefore, T's contribution to the consolidated section 38(c) limitation for Year 2 equals its share of consolidated net income tax minus its share of consolidated tentative minimum tax. T's contribution is $280,000 minus $160,000, or $120,000. However, because the group has a consolidated section 38 limitation of zero, it may not include any of T's unused section 38 credits in the consolidated section 38 credits for Year 2.

(iii) The following table shows similar information for the group for Year 3:

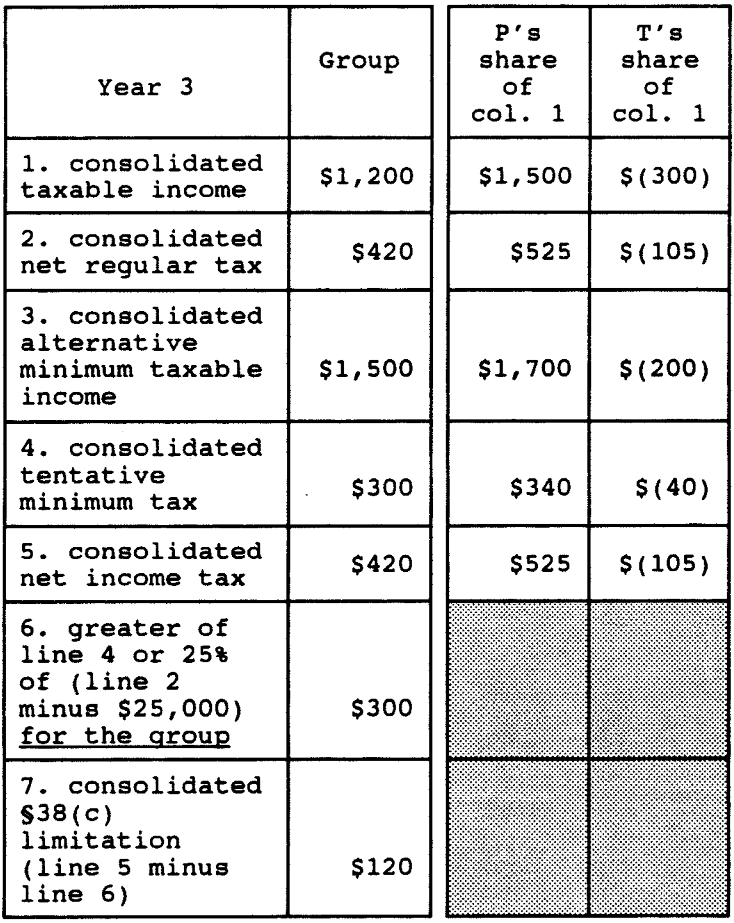

Year 3	Group	P's share of col. 1	T's share of col. 1
1. consolidated taxable income	$1,200	$1,500	$(300)
2. consolidated net regular tax	$420	$525	$(105)
3. consolidated alternative minimum taxable income	$1,500	$1,700	$(200)
4. consolidated tentative minimum tax	$300	$340	$(40)
5. consolidated net income tax	$420	$525	$(105)
6. greater of line 4 or 25% of (line 2 minus $25,000) for the group	$300	▨	▨
7. consolidated §38(c) limitation (line 5 minus line 6)	$120	▨	▨

(iv) The amount of T's unused section 38 credits from Year 1 that are included in the consolidated section 38 credits for Year 3 may not exceed T's aggregate contribution to the consolidated section 38(c) limitation for Years 2 and 3. For Year 3, the group determines the consolidated section 38(c) limitation by reference to the consolidated tentative minimum tax for Year 3. Therefore, T's contribution to the consolidated section 38(c) limitation for Year 3 equals its share of consolidated net income tax minus its share of consolidated tentative minimum tax. Applying the principles of section 1552 and §1.1502–33(d) (taking into account, for example, that T's positive earnings and profits adjustment under §1.1502–33(d) reflects its losses actually absorbed by the group), T's contribution is $(105,000) minus $(40,000), or $(65,000). T's aggregate contributions to the consolidated section 38(c) limitation for Years 2 and 3 is $120,000 + $(65,000), or $55,000. The group may include $55,000 of T's Year 1 unused section 38 credits in its consolidated section 38 tax credit in Year 3.

(2) This paragraph (d) applies to consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998. See also §1.1502–3(d) for years for which the due date of the income tax return (without extensions) is on or before March 13, 1998.

(e) and (f) [Reserved]. For further guidance, see § 1.1502–3 (e) and (f).

[T.D. 8751, 63 FR 1742, Jan. 12, 1998, as amended by T.D. 8766, 63 FR 12642, Mar. 16, 1998; T.D. 8800, 63 FR 71590, Dec. 29, 1998]

§ 1.1502–4 Consolidated foreign tax credit.

(a) *In general.* The credit under section 901 for taxes paid or accrued to any foreign country or possession of the United States shall be allowed to the group only if the common parent corporation chooses to use such credit in the computation of the tax liability of the group for the consolidated return year. If this choice is made, no deduction may be taken on the consolidated return for such taxes paid or accrued by any member of the group. See section 275(a)(4).

(b) *Limitation effective under section 904(a) for the group*—(1) *Common parent's limitation effective for group.* The determination of whether the overall limitation or the per-country limitation applies for a consolidated return year shall be made by reference to the limitation effective with respect to the common parent corporation for such year. If the limitation effective with respect to a member for its immediately preceding separate return year differs from the limitation effective with respect to the common parent corporation for the consolidated return year, then such member shall, if the overall limitation is effective with respect to the common parent, be deemed to have made an election to use such overall limitation, or, if the per-country limitation is effective with respect to the common parent, be deemed to have revoked its election to use the overall limitation. Consent of the Secretary or his delegate (if otherwise required) is hereby given to such member for such election or revocation. Any such election or revocation shall apply only prospectively beginning with such consolidated return year.

(2) *Limitation effective for subsequent years.* The limitation effective with respect to a member for the last year for which it joins in the filing of a consolidated return with a group shall remain in effect for a subsequent separate return year and may be changed by such corporation for such subsequent year only in accordance with the provisions of section 904(b) (and this paragraph if it joins in the filing of a consolidated return with another group). Any retroactive change in the limitation by the common parent corporation for such member's last consolidated return year shall change the election effective with respect to such member for such last period. Thus, if the common parent (P) elects the overall limitation with respect to calendar year 1966, such election would be effective with respect to its subsidiary S for 1966. If S leaves the group at the beginning of calendar year 1967, such election shall be effective for 1967 with respect to S (unless S revokes such election for 1967 or a subsequent year in accordance with section 904(b), or this paragraph if it joins in the filing of a consolidated return with another group). However, if P retroactively changes back to the per-country limitation with respect to 1966, such limitation would be effective with respect to S for 1966 and subsequent years (unless S elects the overall limitation for any such subsequent year).

(c) *Computation of consolidated foreign tax credit.* The foreign tax credit for the consolidated return year shall be determined on a consolidated basis under the principles of sections 901 through 905 and section 960. For example, if the per-country limitations applies to the consolidated return year, taxes paid or accrued for such year (including those deemed paid or accrued under sections 902 and 960(a) and paragraph (e) of this section) to each foreign country or possession by the members of the group shall be aggregated. If the overall limitation applies, taxes paid or accrued for such year (including those deemed paid or accrued) to all foreign countries and possessions by members of the group shall be aggregated. If the overall limitation applies and a member of the group qualifies as a Western Hemisphere trade corporation, see section 1503(b).

(d) *Computation of limitation on credit.* For purposes of computing the group's applicable limitation under section 904(a), the following rules shall apply:

(1) *Computation of taxable income from foreign sources.* The numerator of the applicable limiting fraction under section 904(a) shall be an amount (not in

excess of the amount determined under subparagraph (2) of this paragraph) equal to the aggregate of the separate taxable incomes of the members from sources within each foreign country or possession of the United States (if the per-country limitation is applicable), or from sources without the United States (if the overall limitation is applicable), determined under §1.1502–12, adjusted for the following items taken into account in the computation of consolidated taxable income:

(i) The portion of the consolidated net operating loss deduction, the consolidated charitable contributions deduction, the consolidated dividends received deduction, and the consolidated section 922 deduction, attributable to such foreign source income;

(ii) Any such foreign source capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (determined without regard to any net capital loss carryover or carryback);

(iii) Any such foreign source net capital loss and section 1231 net loss, reduced by the portion of the consolidated net capital loss attributable to such foreign source loss; and

(iv) The portion of any consolidated net capital loss carryover or carryback attributable to such foreign source income which is absorbed in the taxable year.

(2) *Computation of entire taxable income.* The denominator of the applicable limiting fraction under section 904(a) (that is, the entire taxable income of the group) shall be the consolidated taxable income of the group computed in accordance with §1.1502–11.

(3) *Computation of tax against which credit is taken.* The tax against which the limiting fraction under section 904(a) is applied shall be the consolidated tax liability of the group determined under §1.1502–2, but without regard to paragraphs (b), (c), (d), and (j) thereof, and without regard to any credit against such liability.

(e) *Carryover and carryback of unused foreign tax*—(1) *Allowance of unused foreign tax as consolidated carryover or carryback.* The aggregate of the consolidated unused foreign tax carryovers and carrybacks to the taxable year, to the extent absorbed for such year under the principles of section 904(d), shall be deemed to be paid or accrued to a foreign country or possession for such year. The consolidated unused foreign tax carryovers and carrybacks to the taxable year shall consist of any consolidated unused foreign tax, plus any unused foreign tax of members for separate return years of such members, which may be carried over or back to the taxable year under the principles of section 904 (d) and (e). However, such consolidated carryovers and carrybacks shall not include any consolidated unused foreign taxes apportioned to a corporation for a separate return year pursuant to §1.1502–79(d) and shall be subject to the limitations contained in paragraphs (f) and (g) of this section. A consolidated unused foreign tax is the excess of the foreign taxes paid or accrued by the group (or deemed paid or accrued by the group, other than by reason of section 904(d) over the applicable limitation for the consolidated return year.

(2) *Absorption rules.* For purposes of determining the amount, if any, of an unused foreign tax (consolidated or separate) which can be carried to a taxable year (consolidated or separate), the amount of such unused tax which is absorbed in a prior consolidated return year under section 904(d) shall be determined by:

(i) Applying all unused foreign taxes which can be carried to such prior year in the order of the taxable years in which such unused taxes arose, beginning with the taxable year which ends earliest, and

(ii) Applying all such unused taxes which can be carried to such prior year from taxable years ending on the same date on a pro rata basis.

(f) *Limitation on unused foreign tax carryover or carryback from separate return limitation years*—(1) General rule. In the case of an unused foreign tax of a member of the group arising in a separate return limitation year (as defined in paragraph (f) of §1.1502–1) of such member, the amount which may be included under paragraph (e) of this section (computed without regard to the limitation contained in paragraph (g) of this section) shall not exceed the amount determined under subparagraph (2) of this paragraph.

(2) *Computation of limitation.* The amount referred to in subparagraph (1) of this paragraph with respect to a member of the group is the excess, if any, of:

(i) The section 904(a) limitation of the group, minus such limitation recomputed by excluding the items of income and deduction of such member, over

(ii) The sum of *(a)* the foreign taxes paid (or deemed paid, other than by reason of section 904(d)) by such member for the consolidated return year, and *(b)* the unused foreign tax attributable to such member which may be carried to such consolidated return year arising in taxable years ending prior to the particular separate return limitation year.

(3) *Special effective date ending SRLY limitation.* See § 1.1502–4T(f) for the rule that ends the SRLY limitation with respect to foreign tax credits for consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998. See also § 1.1502–3T(c)(4) for an optional effective date rule (generally making the rules of this paragraph (f) inapplicable to a consolidated return year beginning after December 31, 1996, if the due date of the income tax return (without extensions) for such year is on or before March 13, 1998).

(g) *Limitation on unused foreign tax carryover where there has been a consolidated return change of ownership*—(1) *General rule.* If a consolidated return change of ownership (as defined in paragraph (g) of § 1.1502–1) occurs during the taxable year or an earlier taxable year, the amount which may be included under paragraph (e) of this section in the consolidated unused foreign tax carryovers to the taxable year with respect to the aggregate unused credits attributable to the old members of the group (as defined in paragraph (g)(3) of § 1.1502–1) arising in taxable years (consolidated or separate) ending on the same day and before the taxable year in which the consolidated return change of ownership occurred shall not exceed the amount determined under subparagraph (2) of this paragraph.

(2) *Computation of limitation.* The amount referred to in subparagraph (1) of this paragraph shall be the excess of the section 904(a) limitation of the group for the taxable year, recomputed by including only the items of income and deduction of the old members of the group, over the sum of:

(i) The aggregate foreign taxes paid (or deemed paid, other than by reason of section 904(d)) by the old members for the taxable year, and

(ii) The aggregate unused foreign tax attributable to the old members which can be carried to the taxable year arising in taxable years ending prior to the particular unused foreign tax year or years.

(3) *Special effective date for CRCO limitation.* See § 1.1502–4T(g)(3) for the rule that ends the CRCO limitation with respect to a consolidated return change of ownership that occurs on or after the first day of a taxable year for which the due date of the income tax return (without extensions) is after March 13, 1998. See also § 1.1502–3T(c)(4) for an optional effective date rule (generally making the rules of this paragraph (g) inapplicable if the consolidated return change of ownership occurred on or after January 1, 1997, and during a consolidated return year for which the due date of the income tax return (without extensions) is on or before March 13, 1998).

(h) *Amount of credit with respect to interest income.* If any member of the group has interest income described in section 904(f)(2) (for a year for which it filed on a consolidated or separate basis), the group's foreign tax credit with respect to such interest shall be computed separately in accordance with the principles of section 904(f) and this section.

(i) [Reserved]

(j) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). Domestic corporation P is incorporated on January 1, 1966. On that same day it also incorporates domestic corporations S and T, wholly owned subsidiaries. P, S, and T file consolidated returns for 1966 and 1967 on the basis of a calendar year. T engages in business solely in country A. S transacts business solely in countries A and B. P does business solely in the United States. During 1966 T sold an item of inventory to P at a profit of $2,000. Under § 1.1502–13 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995) such profit is deferred and none of the circumstances of restoration contained in paragraph (d), (e), or (f) of §1.1502–13 have occurred as of the close of 1966. The taxable income for 1966 from foreign and United States sources, and the foreign taxes paid on such foreign income are as follows:

Corporation	U.S. taxable income	Country A		Country B		Total taxable income
		Taxable income	Foreign tax paid	Taxable income	Foreign tax paid	
P	$40,000	....	....	....	....	$40,000
T	....	$20,000	$12,000	....	....	20,000
S	....	10,000	6,000	$10,000	$3,000	20,000
						$80,000

Such taxable income was computed by taking into account the rules provided in §1.1502–12. Thus, the $2,000 deferred profit is not included in T's taxable income for 1966 (but will be included for the taxable year for which one of the events specified in paragraph (d), (e), or (f) of §1.1502–13 occurs). The consolidated taxable income of the group (computed in accordance with §1.1502–11) is $80,000. The consolidated tax liability against which the credit may be taken (computed in accordance with paragraph (d)(3) of this section) is $31,900.

(i) Assuming P chooses to use the foreign taxes paid as a credit and the group is subject to the per-country limitation, the group may take as a credit against the consolidated tax liability $11,962.50 of the amount paid to country A, plus the $3,000 paid to country B. Such amounts are computed as follows: The aggregate taxes paid to country A of $18,000 is limited to $11,962.50 ($31,900 times $30,000/$80,000). The unused foreign tax with respect to country A is $6,037.50 ($18,000 less $11,962.50), and is a consolidated unused foreign tax which shall be carried to the years prescribed by section 904(d). A credit of $3,000 is available with respect to the taxes paid to country B since such amount is less than the limitation of $3,987.50 ($31,900 times $10,000/$80,000).

(ii) Assuming the overall limitation is in effect for the taxable year, the group may take $15,950 as a credit, computed as follows: The aggregate taxes paid to all foreign countries of $21,000 is limited to $15,950 ($31,900 times $40,000/$80,000). The unused foreign tax is $5,050 ($21,000 less $15,950), and is a consolidated unused foreign tax which shall be carried to the years prescribed by section 904(d).

Example (2). Assume the same facts as in example (1), except that T has a $10,000 long-term capital gain (derived from a sale to a nonmember in country A) and P has a $10,000 long-term capital loss (derived from a sale to a nonmember in the United States). Notwithstanding that the consolidated net capital gain (capital gain net income for taxable years beginning after December 31, 1976) of the group is zero, T's capital gain shall be reflected in full in the computation of taxable income from foreign sources.

Example (3). Assume the same facts as in example (1), except that the group had a consolidated section 172 deduction of $8,000 which is attributable to a net operating loss sustained by T. The $8,000 consolidated net operating loss deduction is offset against T's income from country A, thus reducing T's taxable income from country A to $12,000.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 8597, 60 FR 36679, July 18, 1995; T.D. 8766, 63 FR 12642, Mar. 16, 1998]

§1.1502–4T Consolidated foreign tax credit (temporary).

(a) through (e) [Reserved]. For further guidance, see §1.1502–4 (a) through (e).

(f) *Limitation on unused foreign tax carryover or carryback from separate return limitation years.* Section 1.1502–4(f) does not apply for consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998. For consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998, a group shall include an unused foreign tax of a member arising in a SRLY without regard to the contribution of the member to consolidated tax liability for the consolidated return year. See also §1.1502–3T(c)(4) for an optional effective date rule (generally making the rules of this paragraph (f) applicable to a consolidated return year beginning after December 31, 1996, if the due date of the income tax return (without extensions) for such year is on or before March 13, 1998).

(g) (1) and (2) [Reserved]. For further guidance, see §1.1502–4(g) (1) and (2).

(g)(3) *Special effective date for CRCO limitation.* Section 1.1502–4(g) applies only to a consolidated return change of ownership that occurred during a consolidated return year for which the due date of the income tax return (without extensions) is on or before March 13, 1998. See also § 1.1502–3T(c)(4) for an optional effective date rule (generally making the rules of this paragraph (g)(3) applicable if the consolidated return change of ownership occurred on or after January 1, 1997, and during a consolidated return year for which the due date of the income tax return (without extensions) is on or before March 13, 1998).

[T.D. 8751, 63 FR 1744, Jan. 12, 1998, as amended by T.D. 8766, 63 FR 12643, Mar. 16, 1998]

§ 1.1502–5 Estimated tax.

(a) *General rule*—(1) *Consolidated estimated tax.* If a group files a consolidated return for two consecutive taxable years, it must make payments of estimated tax on a consolidated basis for each subsequent taxable year, until such time as separate returns are properly filed. Until such time, the group is treated as a single corporation for purposes of section 6154 (relating to payment of estimated tax by corporations). If separate returns are filed by the members for a taxable year, the amount of any estimated tax payments made with respect to a consolidated payment of estimated tax for such year shall be credited against the separate tax liabilities of the members in any manner designated by the common parent which is satisfactory to the Commissioner. The consolidated payments of estimated tax shall be deposited with the authorized commercial dispositary or Federal Reserve Bank with which the common parent deposits its estimated tax payments. A statement should be attached to the payment setting forth the name, address, employer identification number, and internal revenue service center of each member.

(2) *First two consolidated return years.* For the first 2 years for which a group files a consolidated return, it may make payments of estimated tax on either a consolidated or separate basis. If a consolidated return is filed for such year, the amount of any estimated tax payments made for such year by any member shall be credited against the tax liability of the group.

(3) *Effective date.* This section applies to taxable years for which the due date (without extensions) for filing returns is after August 6, 1979. For prior taxable years see 26 CFR 1.1502–5 (Revised as of April 1, 1978).

(b) *Addition to tax for failure to pay estimated tax under section 6655*—(1) *Consolidated return filed.* For the first two taxable years for which a group files a consolidated return, the group may compute the amount of the penalty (if any) under section 6655 on a consolidated basis or separate member basis, regardless of the method of payment. Thereafter, for a taxable year for which the group files a consolidated return, the group must compute the penalty on a consolidated basis.

(2) *Computation of penalty on consolidated basis.* (i) This paragraph (b)(2) gives the rules for computing the penalty under section 6655 on a consolidated basis.

(ii) The tax and facts shown on the return for the preceding taxable year referred to in section 6655(d) (1) and (2) are, if a consolidated return was filed for that preceding year, such items shown on the consolidated return for that preceding year or, if one was not filed for that preceding year, the aggregate taxes and the facts shown on the separate returns of the common parent and any other corporation that was a member of the same affiliated group as the common parent for that preceding year.

(iii) If estimated tax was not paid on a consolidated basis, then the amount of the group's payments of estimated tax for the taxable year is the aggregate of the payments made by all members for the year.

(iv) Section 6655(d)(1) applies only if the common parent's consolidated return, or each member's separate return, for the preceding taxable year (as the case may be) was a taxable year of 12 months.

(3) *Computation of penalty on separate member basis.* To compute any penalty under section 6655 on a separate member basis, for purposes of section 6655(b)(1), the ''tax shown on the return for the taxable year'' is the portion of

the tax shown on the consolidated return allocable to the member under paragraph (b)(5) of this section. If the member was included in the consolidated return filed by the group for the preceding taxable year then:

(i) For purposes of section 6655(d)(1), the ''tax shown on the return'' for any member shall be the portion of the tax shown on the consolidated return for the preceding year allocable to the member under paragraph (b)(5) of this section.

(ii) For purposes of section 6655(d)(2), the ''facts shown on the return'' shall be the facts shown on the consolidated return for the preceding year and the tax computed under that section shall be allocated under the rules of paragraph (b)(5) of this section.

(4) *Consolidated payments if separate returns filed.* If the group does not file a consolidated return for the taxable year, but makes payments of estimated tax on a consolidated basis, for purposes of section 6655(b)(2), the ''amount, if any of the installment paid'' by any member is an amount apportioned to the member in a manner designated by the common parent that is satisfactory to the Commissioner. If the member was included in the consolidated return filed by the group for the preceding taxable year, the amount of a member's penalty under section 6655 is computed on the separate member basis described in paragraph (b)(3) (i) and (ii) of this section.

(5) *Rules for allocation of consolidated tax liability.* For purposes of subparagraphs (1) and (2) of this paragraph, the tax shown on a consolidated return shall be allocated to the members of the group under the method which the group has elected pursuant to section 1552 and 1.1502–33(d)(2).

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). Corporations P and S–1 file a consolidated return for the first time for calendar year 1978. P and S–1 also file consolidated returns for 1979 and 1980. For 1978 and 1979, P and S–1 may make payments of estimated tax on either a separate or consolidated basis. For 1980, however, the group must pay its estimated tax on a consolidated basis. In determining whether P and S–1 come within the exception provided in section 6655(d)(1) for 1980, the ''tax shown on the return'' is the tax shown on the consolidated return for 1979.

Example (2). Assume the same facts as in example (1). Assume further that corporation S–2 was a member of the group during 1979, and joins in the filing of the consolidated return for such year but ceases to be a member of the group on September 15, 1980. In determining whether the group (which no longer includes S–2) comes within the exception provided in section 6655(d)(1) for 1980, the ''tax shown on the return'' is the tax shown on the consolidated return for 1979.

Example (3). Assume the same facts as in example (1). Assume further that corporation S–2 becomes a member of the group on July 1, 1980, and joins in the filing of the consolidated return for 1968. In determining whether the group (which now includes S–2) comes within the exception provided in section 6655(d)(1) for 1980, the ''tax shown on the return'' is the tax shown on the consolidated return for 1979. Any tax of S–2 for any separate return year is not included as a part of the ''tax shown on the return'' for purposes of applying section 6655(d)(1).

Example (4). Corporations X and Y filed consolidated returns for the calendar years 1977 and 1978 and separate returns for 1979. In determining whether X and Y comes within the exception provided in section 6655(d)(1) for 1979, the ''tax shown on the return'' is the amount of tax shown on the consolidated return for 1978 allocable to X and Y in accordance with paragraph (b)(5) of this section.

(d) *Cross reference.* For provisions relating to quick refunds of corporate estimated tax payments, see §1.1502–78, and §§1.6425–1 through 1.6425–3.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 7059, 35 FR 14549, Sept. 17, 1970; T.D. 7637, 44 FR 46840, Aug. 9, 1979; 62 FR 23657, May 1, 1997]

§1.1502–6 Liability for tax.

(a) *Several liability of members of group.* Except as provided in paragraph (b) of this section, the common parent corporation and each subsidiary which was a member of the group during any part of the consolidated return year shall be severally liable for the tax for such year computed in accordance with the regulations under section 1502 prescribed on or before the due date (not including extensions of time) for the filing of the consolidated return for such year.

(b) *Liability of subsidiary after withdrawal.* If a subsidiary has ceased to be a member of the group and in such cessation resulted from a bona fide sale or exchange of its stock for fair value and occurred prior to the date upon which any deficiency is assessed, the district director may, if he believes that the assessment or collection of the balance of the deficiency will not be jeopardized, make assessment and collection of such deficiency from such former subsidiary in an amount not exceeding the portion of such deficiency which the district director may determine to be allocable to it. If the district director makes assessment and collection of any part of a deficiency from such former subsidiary, then for purposes of any credit or refund of the amount collected from such former subsidiary the agency of the common parent under the provisions of § 1.1502–77 shall not apply.

(c) *Effect of intercompany agreements.* No agreement entered into by one or more members of the group with any other member of such group or with any other person shall in any case have the effect of reducing the liability prescribed under this section.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966]

§ 1.1502–9 Application of overall foreign loss recapture rules to corporations filing consolidated returns.

(a) *In general.* An affiliated group of corporations filing a consolidated return sustains an overall foreign loss (a consolidated overall foreign loss) in any taxable year in which its gross income from sources without the United States subject to a separate limitation (as defined in § 1.904(f)–1(c)(2)) is exceeded by the sum of the deductions properly allocated and apportioned thereto. However, for taxable years prior to 1983, affiliated groups may have determined their overall foreign losses for income subject to the passive interest limitation, DISC dividend limitation, and general limitation on a combined basis in accordance with the rules in § 1.904(f)–1(c)(1). The rules contained in §§ 1.904(f)–1 through 1.904(f)–6 are applicable to affiliated groups filing consolidated returns. This section provides special rules for applying those sections to such groups. Paragraph (b) provides rules for additions and subtractions of a portion of overall foreign losses to and from consolidated overall foreign loss accounts. Paragraph (c) requires that separate notional overall foreign loss accounts be kept for each member of the group that contributes to a consolidated overall foreign loss account and provides for allocation of a portion of the group's overall foreign loss account to a member when the member leaves the group prior to recapture of the entire amount of the loss account. These rules are similar to the rules provided in § 1.1502–21T(b)(2) (or § 1.1502-79A, as appropriate) concerning the apportionment of consolidated net operating losses to a member who leaves the group. However, the rules differ somewhat because the absorption rule of § 1.1502–21T(b)(1) (or § 1.1502-79A, as appropriate) is applied year-by-year, consistently with the sequence rules of section 172(b), and recapture of overall foreign losses is based on overall foreign loss accounts that may consist of losses in more than one year. Paragraph (d) provides rules for recapture of amounts in consolidated overall foreign loss accounts. Paragraph (e) provides special rules pertaining to section 904(f)(3) dispositions between members of a group. Paragraphs (b), (c), and (e) also contain special rules that apply to overall foreign losses that arise in separate return limitation years; the principles therein also apply to overall foreign losses when there has been a consolidated return change of ownership (as defined in § 1.1502–1(g)). See § 1.1502–9T(b)(1)(v) for the rule that ends the separate return limitation year limitation for consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998, and § 1.1502–9T(b)(1)(vi) for an election to continue the separate return limitation year limitation for consolidated return years beginning before January 1, 1998. See also § 1.1502–3T(c)(4) for an optional effective date rule (generally making the rules of paragraphs (b)(1)(iii) and (iv) of this section inapplicable for a consolidated return year beginning after December 31, 1996, if the due date of the income tax return (without extensions) for such year is on or before March 13, 1998).

(b) *Consolidated overall foreign loss accounts.* Any group that sustains an overall foreign loss (or acquires a member with a balance in an overall foreign loss account) must establish a consolidated overall foreign loss account for such loss, and amounts shall be added to and subtracted from such account as provided in §§1.904(f)–1 through 1.904(f)–6 and this section.

(1) *Additions to the consolidated overall foreign loss accounts*—(i) *Consolidated overall foreign losses.* Any consolidated overall foreign loss shall be added to the applicable consolidated overall foreign loss account for such separate limitation, to the extent that the overall foreign loss has reduced United States source income, in accordance with the rules of §§1.904(f)–1 and 1.904(f)–3.

(ii) *Overall foreign losses from separate return years.* If a corporation joins in the filing of a consolidated return in a taxable year in which such corporation has a balance in an overall foreign loss account from a prior separate return year that is not a separate return limitation year, such balance shall be added to the applicable consolidated overall foreign loss account in such year and treated as a consolidated overall foreign loss incurred in the previous year (and shall therefore be subject to recapture, in accordance with paragraph (d) of this section, beginning in the same year in which it is added to the consolidated overall foreign loss account).

(iii) *Overall foreign losses from separate return limitation years.* If a corporation joins in the filing of a consolidated return in a taxable year in which such corporation has a balance in an overall foreign loss account from a prior separate return limitation year, such balance shall be added to the applicable consolidated overall foreign loss account in such consolidated return year to the extent of the lesser of the balance in the overall foreign loss account from the separate return limitation year or 50 percent (or such larger percentage as the taxpayer may elect) of the difference between the consolidated foreign source taxable income subject to the same separate limitation (computed in accordance with §§1.904(f)–2(b) and 1.1502–4(d)(1)) minus such consolidated foreign source taxable income recomputed by excluding the items of income and deduction of such corporation (but not less than zero). The amount added to a consolidated overall foreign loss account in any taxable year under this paragraph (b)(1)(iii) shall be treated as a consolidated overall foreign loss in the previous year (and shall therefore be subject to recapture, in accordance with paragraph (d) of this section, beginning in the same year in which it is added to the consolidated overall foreign loss account).

(iv) *Overall foreign losses that are part of a net operating loss or net capital loss carried over from a separate return limitation year.* Overall foreign losses that are part of a net operating loss or net capital loss carryover from a separate return limitation year of a member that is absorbed in a consolidated return year shall be treated as though they were added to an overall foreign loss account in a separate return limitation year of such member and will be subject to the limitation on recapture of SRLY losses contained in paragraph (b)(1)(iii) of this section. See paragraph (c)(2) of this section for rules regarding the addition of such losses to the applicable overall foreign loss account of such member.

(2) *Reductions of the consolidated overall foreign loss accounts*—(i) *Amounts allocated to members leaving the group.* When a member leaves the group, each applicable consolidated overall foreign loss account shall be reduced by the amount allocated from such account to such member in accordance with paragraph (c)(3)(i) of this section.

(ii) *Amounts recaptured.* A consolidated overall foreign loss account shall be reduced by the amount of any overall foreign loss under the same separate limitation that is recaptured from consolidated income in accordance with §1.904(f)–2.

(c) *Allocation of overall foreign losses among members of an affiliated group*—(1) *Notional overall foreign loss accounts.* Separate notional overall foreign loss accounts shall be established for each member of a group that contributes to a consolidated overall foreign loss account. Additions to and reductions of such notional accounts shall be made when additions or reductions are made to consolidated overall foreign loss accounts in accordance with paragraph (b) of this section and § 1.904(f)–1.

(i) *Additions to notional accounts*—(A) *Consolidated overall foreign losses.* When a consolidated overall foreign loss is added to a consolidated overall foreign loss account, each member shall add its pro rata share of the amount of such loss to the member's notional overall foreign loss account. A member's pro rata share of a consolidated overall foreign loss for any taxable year is determined by multiplying the consolidated loss by a fraction.The numerator of this fraction is the amount by which the member's separate gross income for the taxable year from sources without the United States subject to the applicable separate limitation is exceeded by the sum of the deductions properly allocated and apportioned thereto (including such member's share of any consolidated net operating loss deduction and consolidated net capital loss carryovers and carrybacks to the taxable year), for each member with such deductions in excess of such income. The denominator of this fraction is the sum of the numerators of this fraction for all such members of the group.

(B) *Overall foreign losses from separate return years and separate return limitation years.* When an amount from a member's overall foreign loss account from a separate return year or separate return limitation year is added to a consolidated overall foreign loss account in accordance with paragraph (b)(1) (ii) or (iii) of this section, such amount shall also be added to that member's notional overall foreign loss account for such separate limitation.

(ii) *Reductions of notional accounts.* When a consolidated overall foreign loss account is reduced by recapture, in accordance with paragraph (b)(2)(ii) of this section, each member of the group shall reduce its notional overall foreign loss account for that separate limitation by its pro rata share of the amount by which the consolidated overall foreign loss account is reduced. A member's pro rata share of the amount by which a consolidated overall foreign loss account is reduced and determined by multiplying the amount recaptured by a fraction, the numerator of which is the amount in such member's notional account under such separate limitation, and the denominator of which is the amount in the consolidated overall foreign loss account under such separate limitation before reduction for the amount recaptured for that taxable year.

(2) *Overall foreign losses that are part of a net operating loss or net capital loss from a separate return limitation year.* An overall foreign loss that is part of a net operating loss or net capital loss carryover from a separate return limitation year of a member that is absorbed in a consolidated return year shall be treated as an overall foreign loss of such member (rather than the group) and shall be added to such member's separate overall foreign loss account to the extent it reduces United States source income, in accordance with § 1.904(f)–1(d)(5). Such overall foreign losses shall be added to the appropriate consolidated overall foreign loss account in later years in accordance with paragraph (b)(1)(iii) of this section.

(3) *Allocation of a portion of overall foreign loss accounts to a member leaving the group*—(i) *Consolidated overall foreign losses.* When a corporation ceases to be a member of an affiliated group filing consolidated returns, a portion of the balance in each applicable consolidated overall foreign loss account shall be allocated to such corporation. The amount allocated to such corporation shall be equal to the amount, if any, in such member's notional overall foreign loss account under the same separate limitation.

(ii) *Overall foreign losses from separate return limitation years.* When a corporation ceases to be a member of an affiliated group filing consolidated returns, it shall take with it the remaining portion of each separate overall foreign loss account for overall foreign losses from separate return limitation years (including amounts added to such accounts under paragraph (c)(2) of this section).

(d) *Recapture of consolidated overall foreign losses.* The amount in any consolidated overall foreign loss account shall be recaptured under §§ 1.904(f)–1 through 1.904(f)–6 by recharacterizing consolidated foreign source taxable income subject to the separate limitation under which the loss arose as

United States source taxable income. For purposes of recapture, consolidated foreign source taxable income subject to the separate limitation under which the loss arose shall be determined in accordance with §§1.904(f)–2 and 1.1502–4. Amounts in a member's excess loss account that are included in income under §1.1502–19 shall be subject to recapture to the extent that they are included in consolidated foreign source taxable income subject to the separate limitation under which the loss arose.

(e) *Dispositions of property between members of the same affiliated group during a consolidated return year*—(1) *In general*. Except as provided in paragraph (2) with respect to overall foreign losses of a selling member from a separate return limitation year, the rules of §1.1502–13 with respect to intercompany transactions will apply to dispositions of property to which section 904(f)(3)(A) applies.

(2) *Recapture of overall foreign loss from a separate return limitation year*. Paragraph (1) will not apply and gain will be recognized to the extent that the selling member has a balance in its overall foreign loss account from a separate return limitation year unless the selling member adds the entire amount of its overall foreign loss account from separate return limitation years to the applicable consolidated overall foreign loss account and treats such amount as an overall foreign loss incurred in the previous year. Such loss shall be subject to recapture, in accordance with paragraph (d) of §1.1502–9, beginning in the same year in which it is added to the consolidated overall foreign loss account.

(f) *Illustrations*. The provisions of this section are illustrated by the following examples. All foreign source income or loss in these examples is subject to the general limitation.

Example (1). A, B, and C are the members of an affiliated group of corporations (as defined in section 1504), and all use the calendar year as their taxable year. For 1983, A, B, and C file a consolidated return. ABC has United States source income of $1,000 and foreign source losses (overall foreign loss) of $400. In accordance with paragraph (b)(1)(i) of this section, ABC adds $400 to its consolidated overall foreign loss account at the end of 1983. For 1983, the separate foreign source taxable income (or loss) of A is $400, of B is ($200), and of C is ($600). Under paragraph (c)(1) of this section, B and C must establish separate notional overall foreign loss accounts. Under paragraph (c)(1)(i)(A) of this section, the amount added to each notional account is the pro rata share of the consolidated overall foreign loss of each member contributing to such loss. The pro rata share is determined by multiplying the consolidated loss by the member's proportionate share of the total foreign source losses of all members having such losses. B's foreign source loss if $200 and C's foreign source loss is $600, totaling $800. B must add $400x200/800, or $100, to its notional overall foreign loss account. C must add $400x600/800, or $300, to its notional overall foreign loss account.

Example (2). The facts are the same as in example (1). In 1984, ABC has consolidated foreign source taxable income of $200. Under paragraph (d) of this section and §1.904(f)–2, ABC is required to recapture $100 of the amount in its consolidated overall foreign loss account, which reduces that account by $100 under paragraph (b)(2)(ii) of this section. In accordance with paragraph (c)(1)(ii) of this section, B reduces its notional account by $100x100/400, or $25, and C reduces it notional account by $100x300/400, or $75. At the end of 1984 ABC has $300 in its consolidated overall foreign loss account, B has $75 in its notional account, and C has $225 in its notional account.

Example (3). D and E are members of an affiliated group and file separate returns using the calendar year as their taxable year for 1980. In 1980, D has an overall foreign loss of $200, which it adds to its overall foreign loss account, and E has no overall foreign losses. For 1981, D and E file a consolidated return, and DE must establish a consolidated overall foreign loss account, to which D's overall foreign loss from 1980 is added under paragraph (b)(1)(ii) of this section. D also adds the same amount $200 to its notional account under paragraph (c)(1)(i)(B) of this section. In 1981, DE has consolidated foreign source taxable income of $300. Since the amount added to the consolidated overall foreign loss account in 1981 is treated as a consolidated overall foreign loss from 1980, DE must recapture $150 in 1981 under paragraph (d) of this section and §1.904(f)–2. DE's consolidated overall foreign loss account is reduced by $150 under paragraph (b)(2)(ii) of this section, and D's notional account is reduced by $150 under paragraph (c)(1)(ii) of this section, leaving balances of $50 in each of those accounts at the end of 1981.

Example (4). F and G are not members of an affiliated group in 1980, and G has an overall foreign loss of $200, which it adds to its overall foreign loss account. F has no overall foreign loss. On January 1, 1981, F acquires G, and FG files a consolidated return for the calendar year 1981. In 1981, F has no foreign source taxable income or loss, and G has $100 of foreign source taxable income. FG's consolidated foreign source taxable income, $100, minus such income without G's items of income and deduction, $0, is $100. Therefore 50% of that amount, $50, of G's overall foreign loss from its 1980 separate return limitation year is added to FG's consolidated overall foreign loss account under paragraph (b)(1)(iii) of this section, and the same amount is added to G's notional account under paragraph (c)(1)(i)(B) of this section. In accordance with paragraph (d) of this section and § 1.904(f)–2, FG must recapture the $50 balance in its consolidated overall foreign loss account in 1981 because the amount added from G's separate return limitation year is treated as a 1980 consolidated overall foreign loss. At the end of 1981, FG has a balance of $0 in its consolidated overall foreign loss account, G has $0 in its notional account, and G also has $150 remaining from its 1980 overall foreign loss that has not yet been added to the consolidated overall foreign loss account.

On January 1, 1982, F sells G and G leaves the affiliated group. Under paragraph (c)(3)(i) of this section, G takes with it the balance in its overall foreign loss account from 1980 (its prior separate return limitation year) that has not been added to the consolidated account. G has $150 of overall foreign loss in its overall foreign loss account. Because the amount in the consolidated overall foreign loss account is zero, no amount from that account is allocated to G.

Example (5). (i) In 1982 corporation H has United States source income of $300 and foreign source losses of $500, resulting in a net operating loss of $200 and a balance in H's overall foreign loss account at the end of 1982 of $300.

(ii) On January 1, 1983, H is acquired by J, and for the calendar year 1983 JH files a consolidated return. JH has consolidated taxable income of $700 in 1983, including a consolidated net operating loss deduction of $100. This net operating loss deduction is $100 of H's $200 net operating loss from 1982 (a separate return limitation year), which is limited by § 1.1502–21A(c). For 1983, H has separate taxable income of $100, comprised of $100 of United States source taxable income and zero foreign source taxable income, and J has separate taxable income of $700, comprised of $700 of United States source taxable income and zero foreign source taxable income. Under paragraph (c)(2) of this section, H adds $100 to its separate overall foreign loss account, since that amount of its net operating loss has reduced United States source income. H has $400 in its separate overall foreign loss account at the end of 1983, none of which has been added to a consolidated overall foreign loss account.

(iii) In 1984, H has separate taxable income of $400, comprised of $100 of United States source taxable income and $300 of foreign source taxable income. J has separate taxable income of $900, comprised of $700 of United States source taxable income and $200 of foreign source taxable income. JH has consolidated taxable income of $1200, which includes $100 of consolidated net operating loss deduction from H's 1982 net operating loss. Since this net operating loss deduction is allocated to foreign source income, it does not reduce United States source income and will not be added to an overall foreign loss account. Under paragraph (b)(1)(iii) of this section, $100, from H's overall foreign loss is added to the consolidated overall foreign loss account computed as follows:

Consolidated foreign source taxable income	$400
Consolidated foreign source taxable income recomputed by excluding H's foreign source income and deduction	−200
$200.	
× 50%	$100
Amount from H's separate return limitation year overall foreign loss account added to the consolidated overall foreign loss account	$100

This amount is subject to recapture beginning in the same taxable year, as it is treated as a consolidated overall foreign loss incurred in a previous year. Therefore, under paragraph (d) of this section and § 1.904(f)–2 JH also recaptures this $100, reducing the consolidated overall foreign loss account to $0. H has $300 remaining in its separate overall foreign loss account at the end of 1984.

(iv) In 1985, H has separate taxable income of $400, comprised of $100 of United States source taxable income and $300 of foreign source taxable income. J has separate taxable income of $300 comprised of $600 of United States source taxable income and $300 of foreign source losses. JH has consolidated taxable income of $700, all of which is United States source. Under paragraph (b)(1)(iii) of this section an additional $150 from H's separate overall foreign loss is added to the consolidated overall foreign loss account, computed as follows:

Consolidated foreign source taxable income	$0
Consolidated foreign source taxable income recomputed by excluding H's foreign source income and deductions	−(300)
300.	
× 50%	$150
Amount from H's separate return limitation year overall foreign loss account added to the consolidated overall foreign loss account	$150

Thus, an additional $150 of H's separate overall foreign loss is added to the consolidated overall foreign loss account, and, under paragraph (c)(1)(i)(B) of this section, the same amount is added to J's notional account. While this amount is subject to recapture beginning in the same taxable year, JH has no consolidated foreign source taxable income in 1985, so no overall foreign loss is recaptured. H has a remaining balance of $150 in its separate return limitation year overall foreign loss account and HJ has $150 in its consolidated overall foreign loss account.

Example (6). A, B, and C are members of an affiliated group of corporations (as defined in section 1504), and all use the calendar year as their taxable year. For 1986, A, B, and C file a consolidated return. A has an overall foreign loss account which arose in a separate return limitation year. The amount in the overall foreign loss account is $2,000. A makes a disposition of all its assets to B on January 1, 1986. The gain on the transfer is $1,500, all of which would be recognized under section 904(f)(3). However, if A adds the total amount of its overall foreign loss from separate return limitation years to ABC's consolidated overall foreign loss account, no gain will be recognized on the transfer until the intercompany gain is taken into account under §1.1502–13. In the interim, any foreign source gain of the purchasing member (or any other member of the consolidated group) may be used to recapture on a consolidated basis the amount in ABC's consolidated overall foreign loss account.

[T.D. 8153, 52 FR 32005, Aug. 25, 1987; 52 FR 43434, Nov. 12, 1987, as amended by T.D. 8597, 60 FR 36679, July 18, 1995; T.D. 8677, 61 FR 33323, June 27, 1996; T.D. 8766, 63 FR 12643, Mar. 16, 1998; T.D. 8800, 63 FR 71590, Dec. 29, 1998]

§1.1502–9T Application of overall foreign loss recapture rules to corporations filing consolidated returns (temporary).

(a) and (b) introductory text through (b)(1)(iv) [Reserved]. For further guidance, see §1.1502–9 (a) and (b) introductory text through (b)(1)(iv).

(b)(1)(v) *Special effective date for SRLY limitation.* Except as provided in paragraph (b)(1)(vi) of this section, §1.1502–9(b)(1)(iii) and (iv) apply only to consolidated return years for which the due date of the income tax return (without extensions) is on or before March 13, 1998. For consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998, the rules of §1.1502–9(b)(1)(ii) shall apply to overall foreign losses from separate return years that are separate return limitation years. For purposes of applying §1.1502–9(b)(1)(ii) in such years, the group treats a member with a balance in an overall foreign loss account from a separate return limitation year on the first day of the first consolidated return year for which the due date of the income tax return (without extensions) is after March 13, 1998, as a corporation joining the group on such first day. An overall foreign loss that is part of a net operating loss or net capital loss carryover from a separate return limitation year of a member that is absorbed in a consolidated return year for which the due date of the income tax return (without extensions) is after March 13, 1998, shall be added to the appropriate consolidated overall foreign loss account in the year that it is absorbed. For consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998, similar principles apply to overall foreign losses when there has been a consolidated return change of ownership (regardless of when the change of ownership occurred). See also §1.1502–3T(c)(4) for an optional effective date rule (generally making this paragraph (b)(1)(v) applicable to a consolidated return year beginning after December 31, 1996, if the due date of the income tax return (without extensions) for such year is on or before March 13, 1998).

(vi) *Election to defer application of special effective date.* A consolidated group may elect not to apply paragraph (b)(1)(v) of this section to consolidated return years beginning before January 1, 1998. To make this election, a consolidated group must write ‘‘Election Pursuant to Notice 98–40’’ across the top of page 1 of an original or amended tax return for each consolidated return year subject to the election. For the first consolidated return year to which the overall foreign loss provisions of paragraph (b)(1)(v) of this section apply (i.e., the first year beginning on or after January 1, 1998), such consolidated group must write ‘‘Notice 98–40 Election in Effect in Prior Years’’ across the top of page 1 of the consolidated tax return for that year. For purposes of applying §1.1502–9(b)(1)(ii) with respect to such year, any member with a balance in an overall foreign loss account from a separate return limitation year on the first day of such year shall be treated as joining the group on such first day.

(b)(2) through (f) [Reserved]. For further guidance, see § 1.1502–9(b)(2) through (f).

[T.D. 8751, 63 FR 1745, Jan. 12, 1998, as amended by T.D. 8766, 63 FR 12643, Mar. 16, 1998; T.D. 8800, 63 FR 71590, Dec. 29, 1998]

COMPUTATION OF CONSOLIDATED TAXABLE INCOME

§ 1.1502–11 Consolidated taxable income.

(a) *In general.* The consolidated taxable income for a consolidated return year shall be determined by taking into account:

(1) The separate taxable income of each member of the group (see § 1.1502–12 for the computation of separate taxable income);

(2) Any consolidated net operating loss deduction (see §§ 1.1502–21T (or 1.1502-21A, as appropriate) for the computation of the consolidated net operating loss deduction);

(3) Any consolidated capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (see §§ 1.1502–22T (or 1.1502-22A, as appropriate) for the computation of the consolidated capital gain net income (net capital gain for taxable years beginning before January 1, 1977));

(4) Any consolidated section 1231 net loss (see §§ 1.1502–23T (or 1.1502-23A, as appropriate) for the computation of the consolidated section 1231 net loss);

(5) Any consolidated charitable contributions deduction (see § 1.1502–24 for the computation of the consolidated charitable contributions deduction);

(6) Any consolidated section 922 deduction (see § 1.1502–25 for the computation of the consolidated section 922 deduction);

(7) Any consolidated dividends received deduction (see § 1.1502–26 for the computation of the consolidated dividends received deduction); and

(8) Any consolidated section 247 deduction (see § 1.1502–27 for the computation of the consolidated section 247 deduction).

(b) *Elimination of circular stock basis adjustments*—(1) *In general.* If one member (P) disposes of the stock of another member (S), this paragraph (b) limits the use of S's deductions and losses in the year of disposition and the carryback of items to prior years. The purpose of the limitation is to prevent P's income or gain from the disposition of S's stock from increasing the absorption of S's deductions and losses, because the increased absorption would reduce P's basis (or increase its excess loss account) in S's stock under § 1.1502–32 and, in turn, increase P's income or gain. See paragraph (b)(3) of this section for the application of these principles to P's deduction or loss from the disposition of S's stock, and paragraph (b)(4) of this section for the application of these principles to multiple stock dispositions. See § 1.1502–19(c) for the definition of disposition.

(2) *Limitation on deductions and losses*—(i) *Determination of amount of limitation.* If P disposes of one or more shares of S's stock, the extent to which S's deductions and losses for the tax year of the disposition (and its deductions and losses carried over from prior years) may offset income and gain is subject to limitation. The amount of S's deductions and losses that may offset income and gain is determined by tentatively computing taxable income (or loss) for the year of disposition (and any prior years to which the deductions or losses may be carried) without taking into account P's income and gain from the disposition.

(ii) *Application of limitation.* S's deductions and losses offset income and gain only to the extent of the amount determined under paragraph (b)(2)(i) of this section. To the extent S's deductions and losses in the year of disposition cannot offset income or gain because of the limitation under this paragraph (b), the items are carried to other years under the applicable provisions of the Internal Revenue Code and regulations as if they were the only items incurred by S in the year of disposition. For example, to the extent S incurs an operating loss in the year of disposition that is limited, the loss is treated as a separate net operating loss attributable to S arising in that year.

The tentative computation does not affect the manner in which S's unlimited deductions and losses are absorbed or the manner in which deductions and losses of other members are absorbed. (If the amount of S's unlimited deductions and losses actually absorbed is less than the amount absorbed in the tentative computation, P's stock basis adjustments under §1.1502–32 reflect only the amounts actually absorbed.)

(iii) *Examples.* For purposes of the examples in this paragraph (b), unless otherwise stated, P owns all of the only class of S's stock for the entire year, S owns no stock of lower-tier members, the tax year of all persons is the calendar year, all persons use the accrual method of accounting, the facts set forth the only corporate activity, all transactions are between unrelated persons, and tax liabilities are disregarded. The principles of this paragraph (b)(2) are illustrated by the following examples.

Example 1. Limitation on losses with respect to stock gain. (a) P has a $500 basis in S's stock. For Year 1, P has ordinary income of $30 (determined without taking P's gain or loss from the disposition of S's stock into account) and S has an $80 ordinary loss. P sells S's stock for $520 at the close of Year 1.

(b) To determine the amount of the limitation on S's loss under paragraph (b)(2)(i) of this section, and the effect under §1.1502–32(b) of the absorption of S's loss on P's basis in S's stock, P's gain or loss from the disposition of S's stock is not taken into account. The group is tentatively treated as having a consolidated net operating loss of $50 (P's $30 of income minus S's $80 loss). Thus, $50 of S's loss is limited under this paragraph (b).

(c) Because $30 of S's loss is absorbed in the determination of consolidated taxable income under paragraph (b)(2)(ii) of this section, P's basis in S's stock is reduced under §1.1502–32(b) from $500 to $470 immediately before the disposition. Consequently, P recognizes a $50 gain from the sale of S's stock and the group has consolidated taxable income of $50 for Year 1 (P's $30 of ordinary income and $50 gain from the sale of S's stock, less the $30 of S's loss). In addition, S's limited loss of $50 is treated as a separate net operating loss attributable to S and, because S ceases to be a member, the loss is apportioned to S under §1.1502–21T (or §1.1502-79A, as appropriate) and carried to its first separate return year.

Example 2. Carrybacks and carryovers. (a) For Year 1, the P group has consolidated taxable income of $30, and a consolidated net capital loss of $100 ($50 attributable to P and $50 to S). At the beginning of Year 2, P has a $300 basis in S's stock. For Year 2, P has ordinary income of $30, and a $20 capital gain (determined without taking the $100 consolidated net capital loss carryover or P's gain or loss from the disposition of S's stock into account), and S has a $100 ordinary loss. P sells S's stock for $280 at the close of Year 2.

(b) To determine the amount of the limitation under paragraph (b)(2)(i) of this section on S's losses, and the effect of the absorption of S's losses on P's basis in S's stock under §1.1502–32(b), P's gain or loss from the disposition of S's stock is not taken into account. For Year 2, the P group is tentatively treated as having a $70 consolidated net operating loss (S's $100 ordinary loss, less P's $30 of ordinary income). The P group is also treated as having no consolidated net capital gain in Year 2, because P's $20 capital gain is reduced by $20 of the consolidated net capital loss carryover from Year 1 under section 1212(a) (the absorption of which is attributed equally to P and S). In addition, of the $70 consolidated net operating loss, $30 is carried back to Year 1 and offsets P's ordinary income in that year, and $40 is carried forward. Consequently, $40 of S's operating loss from Year 2, and $40 of the consolidated net capital loss carryover from Year 1 attributable to S, are limited under this paragraph (b).

(c) Under paragraph (b)(2)(ii) of this section, the limitation under this paragraph (b) does not affect the absorption of any deductions and losses attributable to P, $60 of S's operating loss from Year 2, and $10 of the consolidated net capital loss from Year 1 attributable to S. Consequently, P's basis in S's stock is reduced under §1.1502–32(b) by $70, from $300 to $230, and P recognizes a $50 gain from the sale of S's stock in Year 2. Thus, the P group is treated as having a $20 unlimited net operating loss that is carried back to Year 1:

Ordinary income:	
P	$30
S (excluding the $40 limited loss)	(60)
Sub Total	$(30)
Consolidated net capital gain:	
P ($20 + $50 from S stock − $50 from Year 1)	$20
S (−$10 from Year 1)	(10)
Sub Total	$10
Consolidated taxable income	$(20)

(d) Under paragraph (b)(2)(ii) of this section, S's $40 ordinary loss from Year 2 that is limited under this paragraph (b) is treated as a separate net operating loss arising in Year 2. Similarly, $40 of the consolidated net capital loss from Year 1 attributable to S is treated as a separate net capital loss carried over from Year 1. Because S ceases to be a member, the $40 net operating loss from Year

2 and the $40 consolidated net capital loss from Year 1 are allocated to S under §§ 1.1502–21T and 1.1502–22T, respectively (or § 1.1502-79A, as appropriate) and are carried to S's first separate return year.

Example 3. Allocation of basis adjustments. (a) For Year 1, the P group has consolidated taxable income of $100. At the beginning of Year 2, P has a $40 basis in each of the 10 shares of S's stock. For Year 2, P has an $80 ordinary loss (determined without taking into account P's gain or loss from the disposition of S's stock) and S has an $80 ordinary loss. P sells 2 shares of S's stock for $85 each at the close of Year 2.

(b) Under paragraph (b)(2)(i) of this section, the amount of the limitation on S's loss is determined by tentatively treating the P group as having a $160 consolidated net operating loss for Year 2. Of this amount, $100 is carried back under section 172 and absorbed in Year 1 ($50 attributable to S and $50 attributable to P). Consequently, $30 of S's loss is limited under this paragraph (b).

(c) Under paragraph (b)(2)(ii) of this section, the limitation under this paragraph (b) does not affect the absorption of P's $80 ordinary loss or $50 of S's ordinary loss. Consequently, P's basis in each share of S's stock is reduced from $40 to $35 under § 1.1502–32(b), and P recognizes a $100 gain from the sale of the 2 shares. Thus, the P group is treated as having a $30 unlimited net operating loss:

Ordinary loss:	
P	$ (80)
S (excluding the $30 limited loss)	(50)
Sub Total	$(130)
Consolidated net capital gain:	
P	$100
S	0
Sub Total	$100
Unlimited consolidated net operating loss	$(30)

(d) A portion of the $130 of unlimited operating losses for Year 2 is fully absorbed in that year, and a portion is carried back to Year 1. Thus, $61.50 of P's $80 loss ($100 multiplied by $80/$130) and $38.50 of S's $50 unlimited loss ($100 multiplied by $50/$130) are absorbed in Year 2. P's remaining $18.50 of loss and S's remaining $11.50 of loss are not subject to limitation and are carried back and absorbed in Year 1.

(e) Under paragraph (b)(2)(ii) of this section, S's $30 of loss limited under this paragraph (b) is treated as a separate net operating loss.

(3) *Loss dispositions*—(i) *General rule.* The principles of paragraph (b)(2) of this section apply to the extent necessary to carry out the purposes of paragraph (b)(1) of this section if P recognizes a deduction or loss from the disposition of S's stock.

(ii) *Example.* The principles of this paragraph (b)(3) are illustrated by the following example.

Example. (a) P has a $400 basis in S's stock. For Year 1, P has a capital gain of $100 (determined without taking P's gain or loss from the disposition of S's stock into account) and S has both a $60 capital loss and a $200 ordinary loss. P sells S's stock for $140 at the close of Year 1.

(b) Under paragraph (b)(3) of this section, the amount of S's ordinary and capital losses that may offset income and gain is determined by tentatively computing the group's consolidated net operating loss and consolidated net capital loss without taking into account P's loss from the disposition of S's stock. The limitation is necessary to prevent P's loss from the disposition of S's stock from affecting the absorption of S's losses and thereby the adjustments to P's basis in S's stock under § 1.1502–32(b) (which would, in turn, affect P's loss).

(c) Under the principles of paragraph (b)(2)(i) of this section, the amount of the limitation on S's loss is determined by tentatively treating the P group as having a $40 consolidated net capital gain and a $200 ordinary loss, which results in a $160 consolidated net operating loss for Year 1, all of which is attributable to S. Thus, $160 of S's ordinary loss is limited under this paragraph (b). See also § 1.1502–20 for rules applicable to losses from the sale of stock of subsidiaries.

(4) *Multiple dispositions*—(i) *Stock of a member.* To the extent income, gain, deduction, or loss from a prior disposition of S's stock is deferred under any rule of law, the limitation under paragraph (b)(2) of this section is determined by treating the year the deferred amount is taken into account as the year of the disposition.

(ii) *Stock of different members.* If S is a higher-tier corporation with respect to another member (T), and all of T's items of income, gain, deduction, and loss (including the absorption of T's deduction or loss) would be fully reflected in P's basis in S's stock under § 1.1502–32, the limitation under paragraph (b)(2)(i) of this section with respect to T's deductions and losses is determined without taking into account any income, gain, deduction, or loss from the disposition of the stock of S or T (or of the stock of members owned in the chain connecting S and T). However, this paragraph (b) does not otherwise limit the absorption of one member's deduction or loss with respect to the disposition of another member's stock.

(iii) *Examples.* The principles of this paragraph (b)(4) are illustrated by the following examples.

Example 1. Chain of subsidiaries. (a) P owns all of S's stock with a $500 basis, and S owns all of T's stock with a $500 basis. For Year 1, P has ordinary income of $30, S has no income or loss, and T has an $80 ordinary loss. P sells S's stock for $520 at the close of Year 1.

(b) Under paragraph (b)(4) of this section, to determine the amount of the limitation under paragraph (b) of this section on T's loss, and the effect of the absorption of T's loss on P's basis in S's stock under §1.1502–32(b), P's gain or loss from the disposition of S's stock is not taken into account. The group is tentatively treated as having a consolidated net operating loss of $50 (P's $30 of income minus T's $80 loss). Because only $30 of T's loss offsets income or gain, P's basis in S's stock is reduced under §1.1502–32(b) from $500 to $470 immediately before the disposition of S's stock. Thus, P takes into account a $50 gain from the sale of S's stock.

(c) The facts are the same as in paragraph (a) of this *Example 1,* except that S has a $10 excess loss account in T's stock (rather than a $500 basis). Under paragraph (b)(4) of this section, neither P's gain or loss from the disposition of S's stock nor S's gain or loss from the disposition of T's stock (under §1.1502–19) are taken into account for purposes of the tentative computations and the effect of any absorption under §1.1502–32(b) on P's basis in S's stock and S's excess loss account in T's stock. The group is tentatively treated as having a consolidated net operating loss of $50 (P's $30 of income minus T's $80 loss), and only $30 of T's loss may offset the group's income or gain. Under §1.1502–32(b), the absorption of $30 of T's loss increases S's excess loss account in T's stock to $40 and, under §1.1502–19, the excess loss account is taken into account. Moreover, under §1.1502–32(b), P's basis in S's stock is increased immediately before the sale by $10 (S's $40 gain under §1.1502–19(b) minus T's $30 loss absorbed and tiered up under §1.1502–32(b)), from $500 to $510. Thus, P takes into account a $10 gain from the sale of S's stock, and S takes into account a $40 gain from its excess loss account in T's stock.

Example 2. Brother-sister subsidiaries. (a) P owns all of the stock of S1 and S2, each with a $50 basis. For Year 1, the group has a $100 consolidated net operating loss ($50 of which is attributable to S1, and $50 to S2) determined without taking gain or loss from the disposition of member stock into account. At the close of Year 1, P sells the stock of S1 and S2 for $100 each.

(b) Paragraph (b)(4) of this section does not limit the loss of S1 or S2 with respect to the disposition of stock of the other. Consequently, each subsidiary's loss may offset P's gain from the disposition of the stock of the other subsidiary. Because this absorption results in a $50 reduction in P's basis in the stock of each subsidiary under §1.1502–32(b), P's aggregate gain from the stock dispositions is increased from $100 to $200, $100 of which is offset by the losses of the subsidiaries.

(5) *Effective date.* This paragraph (b) applies to stock dispositions occurring in consolidated return years beginning on or after January 1, 1995. For prior years, see §1.1502–11(b) as contained in the 26 CFR part 1 edition revised as of April 1, 1994.

(c) *Disallowance of loss attributable to pre-1966 distributions.* No loss shall be allowed upon the sale or other disposition of stock, bonds, or other obligations of a member or former member to the extent that such loss is attributable to a distribution made in an affiliated year beginning before January 1, 1966, out of earnings and profits accumulated before the distributing corporation became a member.

[T.D. 7246, 38 FR 759, Jan. 4, 1973, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 8560, 59 FR 41675, Aug. 15, 1994; T.D. 8677, 61 FR 33323, 33326, June 27, 1996; T.D. 8560, 62 FR 12097, Mar. 14, 1997]

COMPUTATION OF SEPARATE TAXABLE INCOME

§1.1502–12 Separate taxable income.

The separate taxable income of a member (including a case in which deductions exceed gross income) is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations, subject to the following modifications:

(a) Transactions between members and transactions with respect to stock, bonds, or other obligations of members shall be reflected according to the provisions of §1.1502–13;

(b) Any deduction which is disallowed under §§1.1502–15A or 1.1502–15T shall be taken into account as provided in those sections;

(c) The limitation on deductions provided in section 615(c) or section 617(h) shall be taken into account as provided in § 1.1502–16;

(d) The method of accounting under which such computation is made and the adjustments to be made because of any change in method of accounting shall be determined under § 1.1502–17;

(e) Inventory adjustments shall be made as provided in § 1.1502–18;

(f) Any amount included in income under § 1.1502–19 shall be taken into account;

(g) In the computation of the deduction under section 167, property shall not lose its character as new property as a result of a transfer from one member to another member during a consolidated return year if:

(1) The transfer occurs on or before January 4, 1973, or

(2) The transfer occurs after January 4, 1973, and the transfer is an intercompany transaction as defined in § 1.1502–13 or the basis of the property in the hands of the transferee is determined (in whole or in part) by reference to its basis in the hands of the transferor;

(h) No net operating loss deduction shall be taken into account;

(i) [Reserved]

(j) No capital gains or losses shall be taken into account;

(k) No gains and losses subject to section 1231 shall be taken into account;

(l) No deduction under section 170 with respect to charitable contributions shall be taken into account;

(m) No deduction under section 922 (relating to the deduction for Western Hemisphere trade corporations) shall be taken into account;

(n) No deductions under section 243(a)(1), 244(a), 245, or 247 (relating to deductions with respect to dividends received and dividends paid) shall be taken into account;

(o) Basis shall be determined under §§ 1.1502–31 and 1.1502–32, and earnings and profits shall be determined under § 1.1502–33; and

(p) The limitation on deductions provided in section 613A shall be taken into account for each member's oil and gas properties as provided in § 1.1502–44.

(q) A thrift institution's deduction under section 593(b)(2) (relating to the addition to the reserve for bad debts of a thrift institution under the percentage of taxable income method) shall be determined under § 1.1502–42.

(r) For rules relating to loss disallowance or basis reduction on the disposition or deconsolidation of stock of a subsidiary, see §§ 1.337(d)–1, 1.337(d)–2 and § 1.1502–20.

(Secs. 1502 and 7805 of the Internal Revenue Code of 1954 (68A Stat. 637; 917; 26 U.S.C. 1502, 7805))

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 7191, 37 FR 12949, June 30, 1972; T.D. 7246, 38 FR 760, Jan. 4, 1973; T.D. 7725, 45 FR 65561, Oct. 3, 1980; T.D. 7876, 48 FR 11258, Mar. 17, 1983; T.D. 8294, 55 FR 9434, Mar. 14, 1990; T.D. 8319, 55 FR 49038, Nov. 26, 1990; T.D. 8364, 56 FR 47401, Sept. 19, 1991; T.D. 8597, 60 FR 36679, July 18, 1995; T.D. 8677, 61 FR 33323, June 27, 1996]

§ 1.1502–13 Intercompany transactions.

(a) *In general*—(1) *Purpose.* This section provides rules for taking into account items of income, gain, deduction, and loss of members from intercompany transactions. The purpose of this section is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).

(2) *Separate entity and single entity treatment.* Under this section, the selling member (S) and the buying member (B) are treated as separate entities for some purposes but as divisions of a single corporation for other purposes. The *amount* and *location* of S's intercompany items and B's corresponding items are determined on a separate entity basis (separate entity treatment). For example, S determines its gain or loss from a sale of property to B on a separate entity basis, and B has a cost basis in the property. The *timing,* and the *character, source,* and other *attributes* of the intercompany items and corresponding items, although initially determined on a separate entity basis, are redetermined under this section to produce the effect of transactions between divisions of a single corporation (single entity treatment). For example, if S sells land to B at a gain and B sells the land to a nonmember, S does not

take its gain into account until B's sale to the nonmember.

(3) *Timing rules as a method of accounting*—(i) *In general.* The timing rules of this section are a method of accounting for intercompany transactions, to be applied by each member in addition to the member's other methods of accounting. See §1.1502–17. To the extent the timing rules of this section are inconsistent with a member's otherwise applicable methods of accounting, the timing rules of this section control. For example, if S sells property to B in exchange for B's note, the timing rules of this section apply instead of the installment sale rules of section 453. S's or B's application of the timing rules of this section to an intercompany transaction clearly reflects income only if the effect of that transaction as a whole (including, for example, related costs and expenses) on consolidated taxable income is clearly reflected.

(ii) *Automatic consent for joining and departing members*—(A) *Consent granted.* Section 446(e) consent is granted under this section to the extent a change in method of accounting is necessary solely by reason of the timing rules of this section—

(*1*) For each member, with respect to its intercompany transactions, in the first consolidated return year which follows a separate return year and in which the member engages in an intercompany transaction; and

(*2*) For each former member, with respect to its transactions with members that would otherwise be intercompany transactions if the former member were still a member, in the first separate return year in which the former member engages in such a transaction.

(B) *Cut-off basis.* Any change in method of accounting described in paragraph (a)(3)(ii)(A) of this section is to be effected on a cut-off basis for transactions entered into on or after the first day of the year for which consent is granted under paragraph (a)(3)(ii)(A) of this section.

(4) *Other law.* The rules of this section apply in addition to other applicable law (including nonstatutory authorities). For example, this section applies in addition to sections 267(f) (additional rules for certain losses), 269 (acquisitions to evade or avoid income tax), and 482 (allocations among commonly controlled taxpayers). Thus, an item taken into account under this section can be deferred, disallowed, or eliminated under other applicable law, for example, section 1091 (losses from wash sales).

(5) *References.* References in other sections to this section include, as appropriate, references to prior law. For effective dates and prior law see paragraph (l) of this section.

(6) *Overview*—(i) *In general.* The principal rules of this section that implement single entity treatment are the matching rule and the acceleration rule of paragraphs (c) and (d) of this section. Under the matching rule, S and B are generally treated as divisions of a single corporation for purposes of taking into account their items from intercompany transactions. The acceleration rule provides additional rules for taking the items into account if the effect of treating S and B as divisions cannot be achieved (for example, if S or B becomes a nonmember). Paragraph (b) of this section provides definitions. Paragraph (e) of this section provides simplifying rules for certain transactions. Paragraphs (f) and (g) of this section provide additional rules for stock and obligations of members. Paragraphs (h) and (j) of this section provide anti-avoidance rules and miscellaneous operating rules.

(ii) *Table of examples.* Set forth below is a table of the examples contained in this section.

Matching rule. (§1.1502–13(c)(7)(ii))

Example 1. Intercompany sale of land.

Example 2. Dealer activities.

Example 3. Intercompany section 351 transfer.

Example 4. Depreciable property.

Example 5. Intercompany sale followed by installment sale.

Example 6. Intercompany sale of installment obligation.

Example 7. Performance of services.

Example 8. Rental of property.

Example 9. Intercompany sale of a partnership interest.

Example 10. Net operating losses subject to section 382 or the SRLY rules.

Example 11. Section 475.

Example 12. Section 1092.

Example 13. Manufacturer incentive payments.

Example 14. Source of income under section 863.
Example 15. Section 1248.

Acceleration rule. (§ 1.1502–13(d)(3))

Example 1. Becoming a nonmember—timing.
Example 2. Becoming a nonmember—attributes.
Example 3. Selling member's disposition of installment note.
Example 4. Cancellation of debt and attribute reduction under section 108(b).
Example 5. Section 481.

Simplifying rules—inventory. (§ 1.1502–13(e)(1)(v))

Example 1. Increment averaging method.
Example 2. Increment valuation method.
Example 3. Other reasonable inventory methods.

Stock of members. (§ 1.1502–13(f)(7))

Example 1. Dividend exclusion and property distribution.
Example 2. Excess loss accounts.
Example 3. Intercompany reorganization.
Example 4. Stock redemptions and distributions.
Example 5. Intercompany stock sale followed by section 332 liquidation.
Example 6. Intercompany stock sale followed by section 355 distribution.

Obligations of members. (§ 1.1502–13(g)(5))

Example 1. Interest on intercompany debt.
Example 2. Intercompany debt becomes nonintercompany debt.
Example 3. Loss or bad debt deduction with respect to intercompany debt.
Example 4. Nonintercompany debt becomes intercompany debt.
Example 5. Notional principal contracts.

Anti-avoidance rules. (§ 1.1502–13(h)(2))

Example 1. Sale of a partnership interest.
Example 2. Transitory status as an intercompany obligation.
Example 3. Corporate mixing bowl.
Example 4. Partnership mixing bowl.
Example 5. Sale and leaseback.

Miscellaneous operating rules. (§ 1.1502–13(j)(9))

Example 1. Intercompany sale followed by section 351 transfer to member.
Example 2. Intercompany sale of member stock followed by recapitalization.
Example 3. Back-to-back intercompany transactions—matching.
Example 4. Back-to-back intercompany transactions—acceleration.
Example 5. Successor group.
Example 6. Liquidation—80% distributee.
Example 7. Liquidation—no 80% distributee.

(b) *Definitions.* For purposes of this section—

(1) *Intercompany transactions*—(i) *In general.* An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction. S is the member transferring property or providing services, and B is the member receiving the property or services. Intercompany transactions include—

(A) S's sale of property (or other transfer, such as an exchange or contribution) to B, whether or not gain or loss is recognized;

(B) S's performance of services for B, and B's payment or accrual of its expenditure for S's performance;

(C) S's licensing of technology, rental of property, or loan of money to B, and B's payment or accrual of its expenditure; and

(D) S's distribution to B with respect to S stock.

(ii) *Time of transaction.* If a transaction occurs in part while S and B are members and in part while they are not members, the transaction is treated as occurring when performance by either S or B takes place, or when payment for performance would be taken into account under the rules of this section if it were an intercompany transaction, whichever is earliest. Appropriate adjustments must be made in such cases by, for example, dividing the transaction into two separate transactions reflecting the extent to which S or B has performed.

(iii) *Separate transactions.* Except as otherwise provided in this section, each transaction is analyzed separately. For example, if S simultaneously sells two properties to B, one at a gain and the other at a loss, each property is treated as sold in a separate transaction. Thus, the gain and loss cannot be offset or netted against each other for purposes of this section. Similarly, each payment or accrual of interest on a loan is a separate transaction. In addition, an accrual of premium is treated as a separate transaction, or as an offset to interest that is not a separate transaction, to the extent required under separate entity treatment. If two members exchange property, each member is S with respect to the property it transfers and B with respect to the property it receives. If two members enter into a notional principal contract, each payment under the contract is a separate transaction and the member making the payment is B with respect to that payment and the member receiving the payment is S. See paragraph (j)(4) of this section for rules aggregating certain transactions.

(2) *Intercompany items*—(i) *In general.* S's income, gain, deduction, and loss from an intercompany transaction are its intercompany items. For example, S's gain from the sale of property to B is intercompany gain. An item is an intercompany item whether it is directly or indirectly from an intercompany transaction.

(ii) *Related costs or expenses.* S's costs or expenses related to an intercompany transaction are included in determining its intercompany items. For example, if S sells inventory to B, S's direct and indirect costs properly includible under section 263A are included in determining its intercompany income. Similarly, related costs or expenses that are not capitalized under S's separate entity method of accounting are included in determining its intercompany items. For example, deductions for employee wages, in addition to other related costs, are included in determining S's intercompany items from performing services for B, and depreciation deductions are included in determining S's intercompany items from renting property to B.

(iii) *Amounts not yet recognized or incurred.* S's intercompany items include amounts from an intercompany transaction that are not yet taken into account under its separate entity method of accounting. For example, if S is a cash method taxpayer, S's intercompany income might be taken into account under this section even if the cash is not yet received. Similarly, an amount reflected in basis (or an amount equivalent to basis) under S's separate entity method of accounting that is a substitute for income, gain, deduction or loss from an intercompany transaction is an intercompany item.

(3) *Corresponding items*—(i) *In general.* B's income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items. For example, if B pays rent to S, B's deduction for the rent is a corresponding deduction. If B buys property from S and sells it to a nonmember, B's gain or loss from the sale to the nonmember is a corresponding gain or loss; alternatively, if B recovers the cost of the property through depreciation, B's depreciation deductions are corresponding deductions. An item is a corresponding item whether it is directly or indirectly from an intercompany transaction (or from property acquired in an intercompany transaction).

(ii) *Disallowed or eliminated amounts.* B's corresponding items include amounts that are permanently disallowed or permanently eliminated, whether directly or indirectly. Thus, corresponding items include amounts disallowed under section 265 (expenses relating to tax-exempt income), and amounts not recognized under section 311(a) (nonrecognition of loss on distributions), section 332 (nonrecognition on liquidating distributions), or section 355(c) (certain distributions of stock of a subsidiary). On the other hand, an amount is not permanently disallowed or permanently eliminated (and therefore is not a corresponding item) to the extent it is not recognized in a transaction in which B receives a successor asset within the meaning of paragraph (j)(1) of this section. For example, B's corresponding items do not include amounts not recognized from a transaction with a nonmember to which section 1031 applies or from another transaction in which B receives exchanged basis property.

(4) *Recomputed corresponding items.* The recomputed corresponding item is the corresponding item that B would take into account if S and B were divisions of a single corporation and the intercompany transaction were between those divisions. For example, if S sells property with a $70 basis to B for $100, and B later sells the property to a nonmember for $90, B's corresponding item is its $10 loss, and the recomputed corresponding item is $20 of gain (determined by comparing the $90 sales price with the $70 basis the

property would have if S and B were divisions of a single corporation). Although neither S nor B actually takes the recomputed corresponding item into account, it is computed as if B did take it into account (based on reasonable and consistently applied assumptions, including any provision of the Internal Revenue Code or regulations that would affect its timing or attributes).

(5) *Treatment as a separate entity.* Treatment as a separate entity means treatment without application of the rules of this section, but with the application of the other consolidated return regulations. For example, if S sells the stock of another member to B, S's gain or loss on a separate entity basis is determined with the application of § 1.1502–80(b) (non-applicability of section 304), but without redetermination under paragraph (c) or (d) of this section.

(6) *Attributes.* The attributes of an intercompany item or corresponding item are all of the item's characteristics, except *amount, location,* and *timing,* necessary to determine the item's effect on taxable income (and tax liability). For example, attributes include character, source, treatment as excluded from gross income or as a noncapital, nondeductible amount, and treatment as built-in gain or loss under section 382(h) or 384. In contrast, the characteristics of property, such as a member's holding period, or the fact that property is included in inventory, are not attributes of an item, but these characteristics might affect the determination of the attributes of items from the property.

(c) *Matching rule.* For each consolidated return year, B's corresponding items and S's intercompany items are taken into account under the following rules:

(1) *Attributes and holding periods*—(i) *Attributes.* The separate entity attributes of S's intercompany items and B's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions. Thus, the activities of both S and B might affect the attributes of both intercompany items and corresponding items. For example, if S holds property for sale to unrelated customers in the ordinary course of its trade or business, S sells the property to B at a gain and B sells the property to an unrelated person at a further gain, S's intercompany gain and B's corresponding gain might be ordinary because of S's activities with respect to the property. Similar principles apply if S performs services, rents property, or engages in any other intercompany transaction.

(ii) *Holding periods.* The holding period of property transferred in an intercompany transaction is the aggregate of the holding periods of S and B. However, if the basis of the property is determined by reference to the basis of other property, the property's holding period is determined by reference to the holding period of the other property. For example, if S distributes stock to B in a transaction to which section 355 applies, B's holding period in the distributed stock is determined by reference to B's holding period in the stock of S.

(2) *Timing*—(i) *B's items.* B takes its corresponding items into account under its accounting method, but the redetermination of the attributes of a corresponding item might affect its timing. For example, if B's sale of property acquired from S is treated as a dealer disposition because of S's activities, section 453(b) prevents any corresponding income of B from being taken into account under the installment method.

(ii) *S's items.* S takes its intercompany item into account to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item.

(3) *Divisions of a single corporation.* As divisions of a single corporation, S and B are treated as engaging in their actual transaction and owning any actual property involved in the transaction (rather than treating the transaction as not occurring). For example, S's sale of land held for investment to B for cash is not disregarded, but is treated

as an exchange of land for cash between divisions (and B therefore succeeds to S's basis in the property). Similarly, S's issuance of its own stock to B in exchange for property is not disregarded, B is treated as owning the stock it receives in the exchange, and section 1032 does not apply to B on its subsequent sale of the S stock. Although treated as divisions, S and B nevertheless are treated as:

(i) Operating separate trades or businesses. See, e.g., §1.446–1(d) (accounting methods for a taxpayer engaged in more than one business).

(ii) Having any special status that they have under the Internal Revenue Code or regulations. For example, a bank defined in section 581, a domestic building and loan association defined in section 7701(a)(19), and an insurance company to which section 801 or 831 applies are treated as divisions having separate special status. On the other hand, the fact that a member holds property for sale to customers in the ordinary course of its trade or business is not a special status.

(4) *Conflict or allocation of attributes.* This paragraph (c)(4) provides special rules for redetermining and allocating attributes under paragraph (c)(1)(i) of this section.

(i) *Offsetting amounts*—(A) *In general.* To the extent B's corresponding item offsets S's intercompany item in amount, the attributes of B's corresponding item, determined based on both S's and B's activities, control the attributes of S's offsetting intercompany item. For example, if S sells depreciable property to B at a gain and B depreciates the property, the attributes of B's depreciation deduction (ordinary deduction) control the attributes of S's offsetting intercompany gain. Accordingly, S's gain is ordinary.

(B) *B controls unreasonable.* To the extent the results under paragraph (c)(4)(i)(A) are inconsistent with treating S and B as divisions of a single corporation, the attributes of the offsetting items must be redetermined in a manner consistent with treating S and B as divisions of a single corporation. To the extent, however, that B's corresponding item on a separate entity basis is excluded from gross income, is a noncapital, nondeductible amount, or is otherwise permanently disallowed or eliminated, the attributes of B's corresponding item always control the attributes of S's offsetting intercompany item.

(ii) *Allocation.* To the extent S's intercompany item and B's corresponding item do not offset in amount, the attributes redetermined under paragraph (c)(1)(i) of this section must be allocated to S's intercompany item and B's corresponding item by using a method that is reasonable in light of all the facts and circumstances, including the purposes of this section and any other rule affected by the attributes of S's intercompany item and B's corresponding item. A method of allocation or redetermination is unreasonable if it is not used consistently by all members of the group from year to year.

(5) *Special status.* Notwithstanding the general rule of paragraph (c)(1)(i) of this section, to the extent an item's attributes determined under this section are permitted or not permitted to a member under the Internal Revenue Code or regulations by reason of the member's special status, the attributes required under the Internal Revenue Code or regulations apply to that member's items (but not the other member). For example, if S is a bank to which section 582(c) applies, and sells debt securities at a gain to B, a nonbank, the character of S's intercompany gain is ordinary as required under section 582(c), but the character of B's corresponding item as capital or ordinary is determined under paragraph (c)(1)(i) of this section without the application of section 582(c). For other special status issues, see, for example, sections 595(b) (foreclosure on property securing loans), 818(b) (life insurance company treatment of capital gains and losses), and 1503(c) (limitation on absorption of certain losses).

(6) *Treatment of intercompany items if corresponding items are excluded or nondeductible*—(i) *In general.* Under paragraph (c)(1)(i) of this section, S's intercompany item might be redetermined to be excluded from gross income or treated as a noncapital, nondeductible amount. For example, S's intercompany loss from the sale of property to

B is treated as a noncapital, nondeductible amount if B distributes the property to a nonmember shareholder at no further gain or loss (because, if S and B were divisions of a single corporation, the loss would not have been recognized under section 311(a)). Paragraph (c)(6)(ii) of this section, however, provides limitations on the application of this rule to intercompany income or gain. See also §§ 1.1502–32 and 1.1502–33 (adjustments to S's stock basis and earnings and profits to reflect amounts so treated).

(ii) *Limitation on treatment of intercompany items as excluded from gross income.* Notwithstanding the general rule of paragraph (c)(1)(i) of this section, S's intercompany income or gain is redetermined to be excluded from gross income only to the extent one of the following applies:

(A) *Disallowed amounts.* B's corresponding item is a deduction or loss and, in the taxable year the item is taken into account under this section, it is permanently and explicitly disallowed under another provision of the Internal Revenue Code or regulations. For example, deductions that are disallowed under section 265 are permanently and explicitly disallowed. An amount is not permanently and explicitly disallowed, for example, to the extent that—

(*1*) The Internal Revenue Code or regulations provide that the amount is not recognized (for example, a loss that is realized but not recognized under section 332 or section 355(c) is not permanently and explicitly disallowed, notwithstanding that it is a corresponding item within the meaning of paragraph (b)(3)(ii) of this section (certain disallowed or eliminated amounts));

(*2*) A related amount might be taken into account by B with respect to successor property, such as under section 280B (demolition costs recoverable as capitalized amounts);

(*3*) A related amount might be taken into account by another taxpayer, such as under section 267(d) (disallowed loss under section 267(a) might result in nonrecognition of gain for a related person);

(*4*) A related amount might be taken into account as a deduction or loss, including as a carryforward to a later year, under any provision of the Internal Revenue Code or regulations (whether or not the carryforward expires in a later year); or

(*5*) The amount is reflected in the computation of any credit against (or other reduction of) Federal income tax (whether allowed for the taxable year or carried forward to a later year).

(B) *Section 311.* The corresponding item is a loss that is realized, but not recognized under section 311(a) on a distribution to a nonmember (even though the loss is not a permanently and explicitly disallowed amount within the meaning of paragraph (c)(6)(ii)(A) of this section).

(C) *Other amounts.* The Commissioner determines that treating S's intercompany item as excluded from gross income is consistent with the purposes of this section and other applicable provisions of the Internal Revenue Code and regulations.

(7) *Examples*—(i) *In general.* For purposes of the examples in this section, unless otherwise stated, P is the common parent of the P consolidated group, P owns all of the only class of stock of subsidiaries S and B, X is a person unrelated to any member of the P group, the taxable year of all persons is the calendar year, all persons use the accrual method of accounting, tax liabilities are disregarded, the facts set forth the only corporate activity, no member has any special status, and the transaction is not otherwise subject to recharacterization. If a member acts as both a selling member and a buying member (e.g., with respect to different aspects of a single transaction, or with respect to related transactions), the member is referred to as M, M1, or M2 (rather than as S or B).

(ii) *Matching rule.* The matching rule of this paragraph (c) is illustrated by the following examples.

Example 1. Intercompany sale of land followed by sale to a nonmember. (a) *Facts.* S holds land for investment with a basis of $70. S has held the land for more than one year. On January 1 of Year 1, S sells the land to B for $100. B also holds the land for investment. On July 1 of Year 3, B sells the land to X for $110.

(b) *Definitions.* Under paragraph (b)(1) of this section, S's sale of the land to B is an intercompany transaction, S is the selling member, and B is the buying member. Under paragraphs (b)(2) and (3) of this section, S's $30 gain from the sale to B is its intercompany item, and B's $10 gain from the sale to X is its corresponding item.

(c) *Attributes.* Under the matching rule of paragraph (c) of this section, S's $30 intercompany gain and B's $10 corresponding gain are taken into account to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation. In addition, the holding periods of S and B for the land are aggregated. Thus, the group's entire $40 of gain is long-term capital gain. Because both S's intercompany item and B's corresponding item on a separate entity basis are long-term capital gain, the attributes are not redetermined under paragraph (c)(1)(i) of this section.

(d) *Timing.* For each consolidated return year, S takes its intercompany item into account under the matching rule to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item. If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's $70 basis in the land and would have a $40 gain from the sale to X in Year 3, instead of a $10 gain. Consequently, S takes no gain into account in Years 1 and 2, and takes the entire $30 gain into account in Year 3, to reflect the $30 difference in that year between the $10 gain B takes into account and the $40 recomputed gain (the recomputed corresponding item). Under §§1.1502–32 and 1.1502–33, P's basis in its S stock and the earnings and profits of S and P do not reflect S's $30 gain until the gain is taken into account in Year 3. (Under paragraph (a)(3) of this section, the results would be the same if S sold the land to B in an installment sale to which section 453 would otherwise apply, because S must take its intercompany gain into account under this section.)

(e) *Intercompany loss followed by sale to a nonmember at a gain.* The facts are the same as in paragraph (a) of this *Example 1,* except that S's basis in the land is $130 (rather than $70). The attributes and timing of S's intercompany loss and B's corresponding gain are determined under the matching rule in the manner provided in paragraphs (c) and (d) of this *Example 1.* If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's $130 basis in the land and would have a $20 loss from the sale to X instead of a $10 gain. Thus, S takes its entire $30 loss into account in Year 3 to reflect the $30 difference between B's $10 gain taken into account and the $20 recomputed loss. (The results are the same under section 267(f).) S's $30 loss is long-term capital loss, and B's $10 gain is long-term capital gain.

(f) *Intercompany gain followed by sale to a nonmember at a loss.* The facts are the same as in paragraph (a) of this *Example 1,* except that B sells the land to X for $90 (rather than $110). The attributes and timing of S's intercompany gain and B's corresponding loss are determined under the matching rule. If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's $70 basis in the land and would have a $20 gain from the sale to X instead of a $10 loss. Thus, S takes its entire $30 gain into account in Year 3 to reflect the $30 difference between B's $10 loss taken into account and the $20 recomputed gain. S's $30 gain is long-term capital gain, and B's $10 loss is long-term capital loss.

(g) *Intercompany gain followed by distribution to a nonmember at a loss.* The facts are the same as in paragraph (a) of this *Example 1,* except that B distributes the land to X, a minority shareholder of B, and at the time of the distribution the land has a fair market value of $90. The attributes and timing of S's intercompany gain and B's corresponding loss are determined under the matching rule. Under section 311(a), B does not recognize its $10 loss on the distribution to X. If S and B were divisions of a single corporation and the intercompany sale were a transfer between divisions, B would succeed to S's $70 basis in the land and would have a $20 gain from the distribution to X instead of an unrecognized $10 loss. Under paragraph (b)(3)(ii) of this section, B's loss that is not recognized under section 311(a) is a corresponding item. Thus, S takes its $30 gain into account under the matching rule in Year 3 to reflect the difference between B's $10 corresponding unrecognized loss and the $20 recomputed gain. B's $10 corresponding loss offsets $10 of S's intercompany gain and, under paragraph (c)(4)(i) of this section, the attributes of B's corresponding item control the attributes of S's intercompany item. Paragraph (c)(6) of this section does not prevent the redetermination of S's intercompany item as excluded from gross income. (See paragraph (c)(6)(ii)(B) of this section). Thus, $10 of S's $30 gain is redetermined to be excluded from gross income.

(h) *Intercompany sale followed by section 1031 exchange with nonmember.* The facts are the same as in paragraph (a) of this *Example 1,* except that, instead of selling the land to X, B exchanges the land for land owned by X in a transaction to which section 1031 applies. There is no difference in Year 3 between B's $0 corresponding item taken into account and the $0 recomputed corresponding item. Thus, none of S's intercompany gain is taken into account under the matching rule as a result of the section 1031 exchange. Instead, B's gain is preserved in the land received from X and, under the successor asset rule of paragraph (j)(1) of this section, S's intercompany gain is taken into account by reference to the replacement property. (If B takes gain into account as a result of boot received in the exchange, S's intercompany gain is taken into account under the matching rule to the extent the boot causes a difference between B's gain taken into account and the recomputed gain.)

(i) *Intercompany sale followed by section 351 transfer to nonmember.* The facts are the same as in paragraph (a) of this *Example 1,* except that, instead of selling the land to X, B transfers the land to X in a transaction to which section 351(a) applies and X remains a nonmember. There is no difference in Year 3 between B's $0 corresponding item taken into account and the $0 recomputed corresponding item. Thus, none of S's intercompany gain is taken into account under the matching rule as a result of the section 351(a) transfer. However, S's entire gain is taken into account in Year 3 under the acceleration rule of paragraph (d) of this section (because X, a nonmember, reflects B's $100 cost basis in the land under section 362).

Example 2. Dealer activities. (a) *Facts.* S holds land for investment with a basis of $70. On January 1 of Year 1, S sells the land to B for $100. B develops the land as residential real estate, and sells developed lots to customers during Year 3 for an aggregate amount of $110.

(b) *Attributes.* S and B are treated under the matching rule as divisions of a single corporation for purposes of determining the attributes of S's intercompany item and B's corresponding item. Thus, although S held the land for investment, whether the gain is treated as from the sale of property described in section 1221(1) is based on the activities of both S and B. If, based on both S's and B's activities, the land is described in section 1221(1), both S's gain and B's gain are ordinary income.

Example 3. Intercompany section 351 transfer. (a) *Facts.* S holds land with a $70 basis and a $100 fair market value for sale to customers in the ordinary course of business. On January 1 of Year 1, S transfers the land to B in exchange for all of the stock of B in a transaction to which section 351 applies. S has no gain or loss under section 351(a), and its basis in the B stock is $70 under section 358. Under section 362, B's basis in the land is $70. B holds the land for investment. On July 1 of Year 3, B sells the land to X for $100. Assume that if S and B were divisions of a single corporation, B's gain from the sale would be ordinary income because of S's activities.

(b) *Timing and attributes.* Under paragraph (b)(1) of this section, S's transfer to B is an intercompany transaction. Under paragraph (c)(3) of this section, S is treated as transferring the land in exchange for B's stock even though, as divisions, S could not own stock of B. S has no intercompany item, but B's $30 gain from its sale of the land to X is a corresponding item because the land was acquired in an intercompany transaction. B's $30 gain is ordinary income that is taken into account under B's method of accounting.

(c) *Intercompany section 351 transfer with boot.* The facts are the same as in paragraph (a) of this *Example 3,* except that S receives $10 cash in addition to the B stock in the transfer. S recognizes $10 of gain under section 351(b), and its basis in the B stock is $70 under section 358. Under section 362, B's basis in the land is $80. S takes its $10 intercompany gain into account in Year 3 to reflect the $10 difference between B's $20 corresponding gain taken into account and the $30 recomputed gain. Both S's $10 gain and B's $20 gain are ordinary income.

(d) *Partial disposition.* The facts are the same as in paragraph (c) of this *Example 3,* except B sells only a one- half, undivided interest in the land to X for $50. The timing and attributes are determined in the manner provided in paragraph (b) of this *Example 3,* except that S takes only $5 of its gain into account in Year 3 to reflect the $5 difference between B's $10 gain taken into account and the $15 recomputed gain.

Example 4. Depreciable property. (a) *Facts.* On January 1 of Year 1, S buys 10-year recovery property for $100 and depreciates it under the straight-line method. On January 1 of Year 3, S sells the property to B for $130. Under section 168(i)(7), B is treated as S for purposes of section 168 to the extent B's $130 basis does not exceed S's adjusted basis at the time of the sale. B's additional basis is treated as new 10-year recovery property for which B elects the straight-line method of recovery. (To simplify the example, the half-year convention is disregarded.)

(b) *Depreciation through Year 3; intercompany gain.* S claims $10 of depreciation for each of Years 1 and 2 and has an $80 basis at the time of the sale to B. Thus, S has a $50 intercompany gain from its sale to B. For Year 3, B has $10 of depreciation with respect to $80 of its basis (the portion of its $130 basis not exceeding S's adjusted basis). In addition, B has $5 of depreciation with respect to the $50 of its additional basis that exceeds S's adjusted basis.

(c) *Timing.* S's $50 gain is taken into account to reflect the difference for each consolidated return year between B's depreciation taken into account with respect to the property and the recomputed depreciation. For Year 3, B takes $15 of depreciation into account. If the intercompany transaction were a transfer between divisions of a single corporation, B would succeed to S's adjusted basis in the property and take into account only $10 of depreciation for Year 3. Thus, S takes $5 of gain into account in Year 3. In each subsequent year that B takes into account $15 of depreciation with respect to the property, S takes into account $5 of gain.

(d) *Attributes.* Under paragraph (c)(1)(i) of this section, the attributes of S's gain and B's depreciation must be redetermined to the extent necessary to produce the same effect on consolidated taxable income as if the intercompany transaction were between divisions of a single corporation (the group must have a net depreciation deduction of $10). In each year, $5 of B's corresponding depreciation deduction offsets S's $5 intercompany gain taken into account and, under paragraph (c)(4)(i) of this section, the attributes of B's corresponding item control the attributes of S's intercompany item. Accordingly, S's intercompany gain that is taken into account as a result of B's depreciation deduction is ordinary income.

(e) *Sale of property to a nonmember.* The facts are the same as in paragraph (a) of this *Example 4,* except that B sells the property to X on January 1 of Year 5 for $110. As set forth in paragraphs (c) and (d) of this *Example 4,* B has $15 of depreciation with respect to the property in each of Years 3 and 4, causing S to take $5 of intercompany gain into account in each year as ordinary income. The $40 balance of S's intercompany gain is taken into account in Year 5 as a result of B's sale to X, to reflect the $40 difference between B's $10 gain taken into account and the $50 of recomputed gain ($110 of sale proceeds minus the $60 basis B would have if the intercompany sale were a transfer between divisions of a single corporation). Treating S and B as divisions of a single corporation, $40 of the gain is section 1245 gain and $10 is section 1231 gain. On a separate entity basis, S would have more than $10 treated as section 1231 gain, and B would have no amount treated as section 1231 gain. Under paragraph (c)(4)(ii) of this section, all $10 of the section 1231 gain is allocated to S. S's remaining $30 of gain, and all of B's $10 gain, is treated as section 1245 gain.

Example 5. Intercompany sale followed by installment sale. (a) *Facts.* S holds land for investment with a basis of $70x. On January 1 of Year 1, S sells the land to B for $100x. B also holds the land for investment. On July 1 of Year 3, B sells the land to X in exchange for X's $110x note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for principal payments of $55x in Year 4 and $55x in Year 5. The interest charge under section 453A(c) applies to X's note.

(b) *Timing and attributes.* S takes its $30x gain into account to reflect the difference in each consolidated return year between B's gain taken into account for the year and the recomputed gain. Under section 453, B takes into account $5x of gain in Year 4 and $5x of gain in Year 5. Thus, S takes into account $15x of gain in Year 4 and $15x of gain in Year 5 to reflect the $15x difference in each of those years between B's $5x gain taken into account and the $20x recomputed gain. Both S's $30x gain and B's $10x gain are subject to the section 453A(c) interest charge beginning in Year 3.

(c) *Election out under section 453(d).* If, under the facts in paragraph (a) of this *Example 5,* the P group wishes to elect not to apply section 453 with respect to S's gain, an election under section 453(d) must be made for Year 3 with respect to B's gain. This election will cause B's $10x gain to be taken into account in Year 3. Under the matching rule, this will result in S's $30x gain being taken into account in Year 3. (An election by the P group solely with respect to S's gain has no effect because the gain from S's sale to B is taken into account under the matching rule, and therefore must reflect the difference between B's gain taken into account and the recomputed gain.)

(d) *Sale to a nonmember at a loss, but overall gain.* The facts are the same as in paragraph (a) of this *Example 5,* except that B sells the land to X in exchange for X's $90x note (rather than $110x note). If S and B were divisions of a single corporation, B would succeed to S's basis in the land, and the sale to X would be eligible for installment reporting under section 453, because it resulted in an overall gain. However, because only gains may be reported on the installment method, B's $10x corresponding loss is taken into account in Year 3. Under paragraph (b)(4) of this section the recomputed corresponding item is $20x gain that would be taken into account under the installment method, $0 in Year 3 and $10x in each of Years 4 and 5. Thus, in Year 3 S takes $10x of gain into account to reflect the difference between B's $10x loss taken into account and the $0 recomputed gain for Year 3. Under paragraph (c)(4)(i) of this section, B's $10x corresponding loss offsets $10x of S's intercompany gain, and B's attributes control. S takes $10x of gain into account in each of Years 4 and 5 to reflect the difference in those years between B's $0 gain taken into account and the $10x recomputed gain that would be taken into account under the installment method. Only the $20x of S's gain taken into account in Years 4 and 5 is subject to the interest charge under section 453A(c) beginning in Year 3. (If P elects under section 453(d) for Year 3 not to apply section 453 with respect to the gain, all of S's $30x gain will be taken into account in Year 3 to reflect the difference between B's $10x loss taken into account and the $20x recomputed gain.)

(e) *Intercompany loss, installment gain.* The facts are the same as in paragraph (a) of this *Example 5,* except that S has a $130x (rather than $70x) basis in the land. Under paragraph (c)(1)(i) of this section, the separate entity attributes of S's and B's items from the intercompany transaction must be redetermined to produce the same effect on consolidated taxable income (and tax liability) as if the transaction had been a transfer between divisions. If S and B were divisions of a single corporation, B would succeed to S's basis in the land and the group would have $20x loss from the sale to X, installment reporting would be unavailable, and the interest charge under section 453A(c) would not apply. Accordingly, B's gain from the transaction is not eligible for installment treatment under section 453. B takes its $10x gain into account in Year 3, and S takes its $30x of loss into account in Year 3 to reflect the difference between B's $10x gain and the $20x recomputed loss.

(f) *Recapture income.* The facts are the same as in paragraph (a) of this *Example 5,* except that S bought depreciable property (rather than land) for $100x, claimed depreciation deductions, and reduced the property's basis to $70x before Year 1. (To simplify the example, B's depreciation is disregarded.) If the intercompany sale of property had been a transfer between divisions of a single corporation, $30x of the $40x gain from the sale to X would be section 1245 gain (which is ineligible for installment reporting) and $10x would be section 1231 gain (which is eligible for installment reporting). On a separate entity basis, S would have $30x of section 1245 gain and B would have $10x of section 1231 gain. Accordingly, the attributes are not redetermined under paragraph (c)(1)(i) of this section. All of B's $10x gain is eligible for installment reporting and is taken into account $5x each in Years 4 and 5 (and is subject to the interest charge under section 453A(c)). S's $30x gain is taken into account in Year 3 to reflect the difference between B's $0 gain taken into account and the $30x of recomputed gain. (If S had bought the depreciable property for $110x and its recomputed basis under section 1245 had been $110x (rather than $100x), B's $10x gain and S's $30x gain would both be recapture income ineligible for installment reporting.)

Example 6. Intercompany sale of installment obligation. (a) *Facts.* S holds land for investment with a basis of $70x. On January 1 of Year 1, S sells the land to X in exchange for X's $100x note, and S reports its gain on the installment method under section 453. X's note bears interest at a market rate of interest in excess of the applicable Federal rate, and provides for principal payments of $50x in Year 5 and $50x in Year 6. Section 453A applies to X's note. On July 1 of Year 3, S sells X's note to B for $100x, resulting in $30x gain from S's prior sale of the land to X under section 453B(a).

(b) *Timing and attributes.* S's sale of X's note to B is an intercompany transaction, and S's $30x gain is intercompany gain. S takes $15x of the gain into account in each of Years 5 and 6 to reflect the $15x difference in each year between B's $0 gain taken into account and the $15x recomputed gain. S's gain continues to be treated as its gain from the sale to X, and the deferred tax liability remains subject to the interest charge under section 453A(c).

(c) *Worthlessness.* The facts are the same as in paragraph (a) of this *Example 6,* except that X's note becomes worthless on December 1 of Year 3 and B has a $100x short-term capital loss under section 165(g) on a separate entity basis. Under paragraph (c)(1)(ii) of this section, B's holding period for X's note is aggregated with S's holding period. Thus, B's loss is a long- term capital loss. S takes its $30x gain into account in Year 3 to reflect the $30x difference between B's $100x loss taken into account and the $70x recomputed loss. Under paragraph (c)(1)(i) of this section, S's gain is long-term capital gain.

(d) *Pledge.* The facts are the same as in paragraph (a) of this *Example 6,* except that, on December 1 of Year 3, B borrows $100x from an unrelated bank and secures the indebtedness with X's note. X's note remains subject to section 453A(d) following the sale to B. Under section 453A(d), B's $100x of proceeds from the secured indebtedness is treated as an amount received on December 1 of Year 3 by B on X's note. Thus, S takes its entire $30x gain into account in Year 3.

Example 7. Performance of services. (a) *Facts.* S is a driller of water wells. B operates a ranch in a remote location, and B's taxable income from the ranch is not subject to section 447. B's ranch requires water to maintain its cattle. During Year 1, S drills an artesian well on B's ranch in exchange for $100 from B, and S incurs $80 of expenses (e.g., for employees and equipment). B capitalizes its $100 cost for the well under section 263, and takes into account $10 of cost recovery deductions in each of Years 2 through 11. Under its separate entity method of accounting, S would take its income and expenses into account in Year 1. If S and B were divisions of a single corporation, the costs incurred in drilling the well would be capitalized.

(b) *Definitions.* Under paragraph (b)(1) of this section, the service transaction is an intercompany transaction, S is the selling member, and B is the buying member. Under paragraph (b)(2)(ii) of this section, S's $100 of income and $80 of related expenses are both included in determining its intercompany income of $20.

(c) *Timing and attributes.* S's $20 of intercompany income is taken into account under the matching rule to reflect the $20 difference between B's corresponding items taken into account (based on its $100 cost basis in the well) and the recomputed corresponding items (based on the $80 basis that B would have if S and B were divisions of a single corporation and B's basis were determined by reference to S's $80 of expenses). In

Year 1, S takes into account $80 of its income and the $80 of expenses. In each of Years 2 through 11, S takes $2 of its $20 intercompany income into account to reflect the annual $2 difference between B's $10 of cost recovery deductions taken into account and the $8 of recomputed cost recovery deductions. S's $100 income and $80 expenses, and B's cost recovery deductions, are ordinary items (because S's and B's items would be ordinary on a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section). If S's offsetting $80 of income and expense would not be taken into account in the same year under its separate entity method of accounting, they nevertheless must be taken into account under this section in a manner that clearly reflects consolidated taxable income. See paragraph (a)(3)(i) of this section.

(d) *Sale of capitalized services.* The facts are the same as in paragraph (a) of this *Example 7,* except that B sells the ranch before Year 11 and recognizes gain attributable to the well. To the extent of S's income taken into account as a result of B's cost recovery deductions, as well as S's offsetting $80 of income and expense, the timing and attributes are determined in the manner provided in paragraph (c) of this *Example 7.* The attributes of the remainder of S's $20 of income and B's gain from the sale are redetermined to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation. Accordingly, S's remaining intercompany income is treated as recapture income or section 1231 gain, even though it is from S's performance of services.

Example 8. Rental of property. B operates a ranch that requires grazing land for its cattle. S owns undeveloped land adjoining B's ranch. On January 1 of Year 1, S leases grazing rights to B for Year 1. B's $100 rent expense is deductible for Year 1 under its separate entity accounting method. Under paragraph (b)(1) of this section, the rental transaction is an intercompany transaction, S is the selling member, and B is the buying member. S takes its $100 of income into account in Year 1 to reflect the $100 difference between B's rental deduction taken into account and the $0 recomputed rental deduction. S's income and B's deduction are ordinary items (because S's intercompany item and B's corresponding item would both be ordinary on a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section).

Example 9. Intercompany sale of a partnership interest. (a) *Facts.* S owns a 20% interest in the capital and profits of a general partnership. The partnership holds land for investment with a basis equal to its value, and operates depreciable assets which have value in excess of basis. S's basis in its partnership interest equals its share of the adjusted basis of the partnership's land and depreciable assets. The partnership has an election under section 754 in effect. On January 1 of Year 1, S sells its partnership interest to B at a gain. During Years 1 through 10, the partnership depreciates the operating assets, and B's depreciation deductions from the partnership reflect the increase in the basis of the depreciable assets under section 743(b).

(b) *Timing and attributes.* S's gain is taken into account during Years 1 through 10 to reflect the difference in each year between B's depreciation deductions from the partnership taken into account and the recomputed depreciation deductions from the partnership. Under paragraphs (c)(1)(i) and (c)(4)(i) of this section, S's gain taken into account is ordinary income. (The acceleration rule does not apply to S's gain as a result of the section 743(b) adjustment, because the adjustment is solely with respect to B and therefore no nonmember reflects any part of the intercompany transaction.)

(c) *Partnership sale of assets.* The facts are the same as in paragraph (a) of this *Example 9,* and the partnership sells some of its depreciable assets to X at a gain on December 31 of Year 4. In addition to the intercompany gain taken into account as a result of the partnership's depreciation, S takes intercompany gain into account in Year 4 to reflect the difference between B's partnership items taken into account from the sale (which reflect the basis increase under section 743(b)) and the recomputed partnership items. The attributes of S's additional gain are redetermined to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation (recapture income or section 1231 gain).

(d) *B's sale of partnership interest.* The facts are the same as in paragraph (a) of this *Example 9,* and on December 31 of Year 4, B sells its partnership interest to X at no gain or loss. In addition to the intercompany gain taken into account as a result of the partnership's depreciation, the remaining balance of S's intercompany gain is taken into account in Year 4 to reflect the difference between B's $0 gain taken into account from the sale of the partnership interest and the recomputed gain. The character of S's remaining intercompany item and B's corresponding item are determined on a separate entity basis under section 751, and then redetermined to the extent necessary to produce the same effect as treating the intercompany transaction as occurring between divisions of a single corporation.

(e) *No section 754 election.* The facts are the same as in paragraph (d) of this *Example 9,* except that the partnership does not have a section 754 election in effect, and B recognizes a capital loss from its sale of the partnership interest to X on December 31 of Year 4. Because there is no difference between B's depreciation deductions from the partnership taken into account and the recomputed depreciation deductions, S does not take any of its gain into account during Years 1 through 4 as a result of B's partnership's items. Instead, S's entire intercompany gain is taken into account in Year 4 to reflect the difference between B's loss taken into account from the sale to X and the recomputed gain or loss.

Example 10. Net operating losses subject to section 382 or the SRLY rules. (a) *Facts.* On January 1 of Year 1, P buys all of S's stock. S has net operating loss carryovers from prior years. P's acquisition results in an ownership change under section 382 with respect to S's loss carryovers, and S has a net unrealized built-in gain (within the meaning of section 382(h)(3)). S owns nondepreciable property with a $70 basis and $100 value. On July 1 of Year 3, S sells the property to B for $100, and its $30 gain is recognized built-in gain (within the meaning of section 382(h)(2)) on a separate entity basis. On December 1 of Year 5, B sells the property to X for $90.

(b) *Timing and attributes.* S's $30 gain is taken into account in Year 5 to reflect the $30 difference between B's $10 loss taken into account and the recomputed $20 gain. S and B are treated as divisions of a single corporation for purposes of applying section 382 in connection with the intercompany transaction. Under a single entity analysis, the single corporation has losses subject to limitation under section 382, and this limitation may be increased under section 382(h) if the single corporation has recognized built-in gain with respect to those losses. B's $10 corresponding loss offsets $10 of S's intercompany gain, and thus, under paragraph (c)(4)(i) of this section, $10 of S's intercompany gain is redetermined not to be recognized built-in gain. S's remaining $20 intercompany gain continues to be treated as recognized built-in gain.

(c) *B's recognized built-in gain.* The facts are the same as in paragraph (a) of this *Example 10,* except that the property declines in value after S becomes a member of the P group, S sells the property to B for its $70 basis, and B sells the property to X for $90 during Year 5. Treating S and B as divisions of a single corporation, S's sale to B does not cause the property to cease to be built-in gain property. Thus, B's $20 gain from its sale to X is recognized built-in gain that increases the section 382 limitation applicable to S's losses.

(d) *SRLY limitation.* The facts are the same as in paragraph (a) of this *Example 10,* except that S's net operating loss carryovers are subject to the separate return limitation year (SRLY) rules. See §1.1502–21T(c). The application of the SRLY rules depends on S's status as a separate corporation having losses from separate return limitation years. Under paragraph (c)(5), the attribute of S's intercompany item as it relates to S's SRLY limitation is not redetermined, because the SRLY limitation depends on S's special status. Accordingly, S's $30 intercompany gain is included in determining its SRLY limitation for Year 5.

Example 11. Section 475. (a) *Facts.* S, a dealer in securities within the meaning of section 475(c), owns a security with a basis of $70. The security is held for sale to customers and is not identified under section 475(b) as within an exception to marking to market. On July 1 of Year 1, S sells the security to B for $100. B is not a dealer and holds the security for investment. On December 31 of Year 1, the fair market value of the security is $100. On July 1 of Year 2, B sells the security to X for $110.

(b) *Attributes.* Under section 475, a dealer in securities can treat a security as within an exception to marking to market under section 475(b) only if it timely identifies the security as so described. Under the matching rule, attributes must be redetermined by treating S and B as divisions of a single corporation. As a result of S's activities, the single corporation is treated as a dealer with respect to securities, and B must continue to mark to market the security acquired from S. Thus, B's corresponding items and the recomputed corresponding items are determined by continuing to treat the security as not within an exception to marking to market. Under section 475(d)(3), it is possible for the character of S's intercompany items to differ from the character of B's corresponding items.

(c) *Timing and character.* S has a $30 gain when it disposes of the security by selling it to B. This gain is intercompany gain that is taken into account in Year 1 to reflect the $30 difference between B's $0 gain taken into account from marking the security to market under section 475 and the recomputed $30 gain that would be taken into account. The character of S's gain and B's gain are redetermined as if the security were transferred between divisions. Accordingly, S's gain is ordinary income under section 475(d)(3)(A)(i), but under section 475(d)(3)(B)(ii) B's $10 gain from its sale to X is capital gain that is taken into account in Year 2.

(d) *Nondealer to dealer.* The facts are the same as in paragraph (a) of this Example 11, except that S is not a dealer and holds the security for investment with a $70 basis, B is a dealer to which section 475 applies and, immediately after acquiring the security from S for $100, B holds the security for sale to customers in the ordinary course of its trade or business. Because S is not a dealer and held the security for investment, the security is treated as properly identified as held for investment under section 475(b)(1) until it is sold to B. Under section 475(b)(3), the security thereafter ceases to be described in section 475(b)(1) because B holds the security for sale to customers. The mark-to-market requirement applies only to changes in the value of the security after B's acquisition. B's mark-to-market gain taken into account and the recomputed mark-to-market gain are both determined based on changes from the $100 value of the security at the time of B's acquisition. There is no difference between B's $0 mark-to-market gain taken into account in Year 1 and the $0 recomputed mark-to-market gain. Therefore, none of S's gain is taken into account in Year 1 as a result of B's marking the security to market in Year 1. In Year 2, B has a $10 gain when it disposes of the security by selling it to X, but would have had a $40 gain if S and B were divisions of a single corporation. Thus, S takes its $30 gain into account in Year 2 under the matching rule. Under section 475(d)(3), S's gain is capital gain even though B's subsequent gain or loss from marking to market or disposing of the security is ordinary gain or loss. If B disposes of the security at a $10 loss in Year 2, S's gain taken into account in Year 2 is still capital because on a single entity basis section 475(d)(3) would provide for $30 of capital gain and $10 of ordinary loss. Because the attributes are not redetermined under paragraph (c)(1)(i) of this section, paragraph (c)(4)(i) of this section does not apply. Furthermore, if B held the security for investment, and so identified the security under section 475(b)(1), the security would continue to be excepted from marking to market.

Example 12. Section 1092. (a) *Facts.* On July 1 of Year 1, S enters into offsetting long and short positions with respect to actively traded personal property. The positions are not section 1256 contracts, and they are the only positions taken into account for purposes of applying section 1092. On August 1 of Year 1, S sells the long position to B at an $11 loss, and there is $11 of unrealized gain in the offsetting short position. On December 1 of Year 1, B sells the long position to X at no gain or loss. On December 31 of Year 1, there is still $11 of unrealized gain in the short position. On February 1 of Year 2, S closes the short position at an $11 gain.

(b) *Timing and attributes.* If the sale from S to B were a transfer between divisions of a single corporation, the $11 loss on the sale to X would have been deferred under section 1092(a)(1)(A). Accordingly, there is no difference in Year 1 between B's corresponding item of $0 and the recomputed corresponding item of $0. S takes its $11 loss into account in Year 2 to reflect the difference between B's corresponding item of $0 taken into account in Year 2 and the recomputed loss of $11 that would have been taken into account in Year 2 under section 1092(a)(1)(B) if S and B had been divisions of a single corporation. (The results are the same under section 267(f)).

Example 13. Manufacturer incentive payments. (a) *Facts.* B is a manufacturer that sells its products to independent dealers for resale. S is a credit company that offers financing, including financing to customers of the dealers. S also purchases the product from the dealers for lease to customers of the dealers. During Year 1, B initiates a program of incentive payments to the dealers' customers. Under B's program, S buys a product from an independent dealer for $100 and leases it to a nonmember. S pays $90 to the dealer for the product, and assigns to the dealer its $10 incentive payment from B. Under their separate entity accounting methods, B would deduct the $10 incentive payment in Year 1 and S would take a $90 basis in the product. Assume that if S and B were divisions of a single corporation, the $10 payment would not be deductible and the basis of the property would be $100.

(b) *Timing and attributes.* Under paragraph (b)(1) of this section, the incentive payment transaction is an intercompany transaction. Under paragraph (b)(2)(iii) of this section, S has a $10 intercompany item not yet taken into account under its separate entity method of accounting. Under the matching rule, S takes its intercompany item into account to reflect the difference between B's corresponding item taken into account and the recomputed corresponding item. In Year 1 there is a $10 difference between B's $10 deduction taken into account and the $0 recomputed deduction. Accordingly, under the matching rule S must take the $10 incentive payment into account as intercompany income in Year 1. S's $10 of income and B's $10 deduction are ordinary items. S's basis in the product is $100 rather than the $90 it would be under S's separate entity method of accounting. S's additional $10 of basis in the product is recovered based on subsequent events (e.g., S's cost recovery deductions or its sale of the product).

Example 14. Source of income under section 863. (a) *Intercompany sale with no independent factory price.* S manufactures inventory in the United States, and recognizes $75 of income on sales to B in Year 1. B distributes the inventory in Country Y and recognizes $25 of income on sales to X, also in Year 1. Title passes from S to B, and from B to X, in Country Y. There is no independent factory price (as defined in regulations under section 863) for the sale from S to B. Under the matching rule, S's $75 intercompany income and B's $25 corresponding income are taken into account in Year 1. In determining the source of income, S and B are treated as divisions of a single corporation, and section 863 applies as if $100 of income were recognized from producing in the United States and selling in Country Y. Assume that applying the section 863 regulations on a single entity basis, $50 is treated as foreign source income and $50 as U.S. source income. Assume further that on a separate entity basis, S would have $37.50 of foreign source income and $37.50 of U.S. source income, and that all of B's $25 of income would be foreign source income. Thus, on a separate entity basis, S and B would have $62.50 of combined foreign source income and $37.50 of U.S. source income. Accordingly, under single entity treatment, $12.50 that would be treated as foreign source income on a separate entity basis is redetermined to be U.S. source income. Under paragraph (c)(1)(i) of this section, attributes are redetermined only to the extent of the $12.50 necessary to achieve the same effect as a single entity determination. Under paragraph (c)(4)(ii) of this section, the redetermined attribute must be allocated between S and B using a reasonable method. For example, it may be reasonable to recharacterize only S's foreign source income as U.S. source income because only S would have any U.S. source income on a separate entity basis. However, it may also be reasonable to allocate the redetermined attribute between S and B in proportion to their separate entity amounts of foreign source income (in a 3:2 ratio, so that $7.50 of S's foreign source income is redetermined to be U.S. source and $5 of B's foreign source income is redetermined to be U.S. source), provided the same method is applied to all similar transactions within the group.

(b) *Intercompany sale with independent factory price.* The facts are the same as in paragraph (a) of this *Example 14,* except that an independent factory price exists for the sale by S to B such that $70 of S's $75 of income is attributable to the production function. Assume that on a single entity basis, $70 is treated as U.S. source income (because of the existence of the independent factory price) and $30 is treated as foreign source income. Assume that on a separate entity basis, $70 of S's income would be treated as U.S. source, $5 of S's income would be treated as foreign source income, and all of B's $25 income would be treated as foreign source income. Because the results are the same on a single entity basis and a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section.

(c) *Sale of property reflecting intercompany services or intangibles.* S earns $10 of income performing services in the United States for B. B capitalizes S's fees into the basis of property that it manufactures in the United States and sells to an unrelated person in Year 1 at a $90 profit, with title passing in Country Y. Under the matching rule, S's $10 income and B's $90 income are taken into account in Year 1. In determining the source of income, S and B are treated as divisions of a single corporation, and section 863 applies as if $100 were earned from manufacturing in the United States and selling in Country Y. Assume that on a single entity basis $50 is treated as foreign source income and $50 is treated as U.S. source income. Assume that on a separate entity basis, S would have $10 of U.S. source income, and B would have $45 of foreign source income and $45 of U.S. source income. Accordingly, under single entity treatment, $5 of income that would be treated as U.S. source income on a separate entity basis is redetermined to be foreign source income. Under paragraph (c)(1)(i) of this section, attributes are redetermined only to the extent of the $5 necessary to achieve the same effect as a single entity determination. Under paragraph (c)(4)(ii) of this section, the redetermined attribute must be allocated between S and B using a reasonable method. (If instead of performing services, S licensed an intangible to B and earned $10 that would be treated as U.S. source income on a separate entity basis, the results would be the same.)

Example 15. Section 1248. (a) *Facts.* On January 1 of Year 1, S forms FT, a wholly owned foreign subsidiary, with a $10 contribution. During Years 1 through 3, FT has earnings and profits of $40. None of the earnings and profits is taxed as subpart F income under section 951, and FT distributes no dividends to S during this period. On January 1 of Year 4, S sells its FT stock to B for $50. While B owns FT, FT has a deficit in earnings and profits of $10. On July 1 of Year 6, B sells its FT stock for $70 to X, an unrelated foreign corporation.

(b) *Timing.* S's $40 of intercompany gain is taken into account in Year 6 to reflect the difference between B's $20 of gain taken into account and the $60 recomputed gain.

(c) *Attributes.* Under the matching rule, the attributes of S's intercompany gain and B's corresponding gain are redetermined to have the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation. On a single entity basis, there is $60 of gain and the portion which is characterized as a dividend under section 1248 is determined on the basis of FT's $30 of earnings and profits at the time of the sale of FT to X (the sum of FT's $40 of earnings and profits while held by S and FT's $10 deficit in earnings and profits while held by B). Therefore, $30 of the $60 gain is treated as a dividend under section 1248. The remaining $30 is treated as capital gain. On a separate entity basis, all of S's $40 gain would be treated as a dividend under section 1248 and all of B's $20 gain would be treated as capital gain. Thus, as a result of the single entity determination, $10 that would be treated as a dividend under section 1248 on a separate entity basis is redetermined to be capital gain. Under paragraph (c)(4)(ii) of this section, this redetermined attribute must be allocated between S's intercompany item and B's corresponding item by using a reasonable method. On a separate entity basis, only S would have any amount treated as a dividend under section 1248 available for redetermination. Accordingly, $10 of S's income is redetermined to be not subject to section 1248, with the result that $30 of S's intercompany gain is treated as a dividend and the remaining $10 is treated as capital gain. All of B's corresponding gain is treated as capital gain, as it would be on a separate entity basis.

(d) *B has loss.* The facts are the same as in paragraph (a) of this *Example 15,* except that FT has no earnings and profits or deficit in earnings and profits while B owns FT, and B sells the FT stock to X for $40. On a single entity basis, there is $30 of gain, and section 1248 is applied on the basis of FT's $40 earnings and profits at the time of the sale of FT to X. Under section 1248, the amount treated as a dividend is limited to $30 (the amount of the gain). On a separate entity basis, S's entire $40 gain would be treated as a dividend under section 1248, and B's $10 loss would be a capital loss. B's $10 corresponding loss offsets $10 of S's intercompany gain and, under paragraph (c)(4)(i) of this section, the attributes of B's corresponding item control. Accordingly, $10 of S's gain must be redetermined to be capital gain. B's $10 loss remains a capital loss. (If, however, S sold FT to B at a loss and B sold FT to X at a gain, it may be unreasonable for the attributes of B's corresponding gain to control S's offsetting intercompany loss. If B's attributes were to control, for example, the group could possibly claim a larger foreign tax credit than would be available if S and B were divisions of a single corporation.)

(d) *Acceleration rule.* S's intercompany items and B's corresponding items are taken into account under this paragraph (d) to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation. For this purpose, the following rules apply:

(1) *S's items*—(i) *Timing.* S takes its intercompany items into account to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation. The items are taken into account immediately before it first becomes impossible to achieve this effect. For this purpose, the effect cannot be achieved—

(A) To the extent an intercompany item or corresponding item will not be taken into account in determining the group's consolidated taxable income (or consolidated tax liability) under the matching rule (for example, if S or B becomes a nonmember, or if S's intercompany item is no longer reflected in the difference between B's basis (or an amount equivalent to basis) in property and the basis (or equivalent amount) the property would have if S and B were divisions of a single corporation); or

(B) To the extent a nonmember reflects, directly or indirectly, any aspect of the intercompany transaction (e.g., if B's cost basis in property purchased from S is reflected by a nonmember under section 362 following a section 351 transaction).

(ii) *Attributes.* The attributes of S's intercompany items taken into account under this paragraph (d)(1) are determined as follows:

(A) *Sale, exchange, or distribution.* If the item is from an intercompany sale, exchange, or distribution of property, its attributes are determined under the principles of the matching rule as if B sold the property, at the time the item is taken into account under paragraph (d)(1)(i) of this section, for a cash payment equal to B's adjusted basis in the property (i.e., at no net gain or loss), to the following person:

(*1*) *Property leaves the group.* If the property is owned by a nonmember immediately after S's item is taken into account, B is treated as selling the property to that nonmember. If the nonmember is related for purposes of any provision of the Internal Revenue Code or regulations to any party to the intercompany transaction (or any related transaction) or to the common parent, the nonmember is treated as related to B for purposes of that provision. For example, if the nonmember is related to P within the meaning of section 1239(b), the deemed sale is treated as being described in section 1239(a). See paragraph (j)(6) of this section, under which property is not treated as being owned by a nonmember if it is owned by the common parent after the common parent becomes the only remaining member.

(*2*) *Property does not leave the group.* If the property is not owned by a nonmember immediately after S's item is taken into account, B is treated as selling the property to an affiliated corporation that is not a member of the group.

(B) *Other transactions.* If the item is from an intercompany transaction other than a sale, exchange, or distribution of property (e.g., income from S's services capitalized by B), its attributes are determined on a separate entity basis.

(2) *B's items*—(i) *Attributes.* The attributes of B's corresponding items continue to be redetermined under the principles of the matching rule, with the following adjustments:

(A) If S and B continue to join with each other in the filing of consolidated returns, the attributes of B's corresponding items (and any applicable holding periods) are determined by continuing to treat S and B as divisions of a single corporation.

(B) Once S and B no longer join with each other in the filing of consolidated returns, the attributes of B's corresponding items are determined as if the S division (but not the B division) were transferred by the single corporation to an unrelated person. Thus, S's activities (and any applicable holding period) before the intercompany transaction continue to affect the attributes of the corresponding items (and any applicable holding period).

(ii) *Timing.* If paragraph (d)(1) of this section applies to S, B nevertheless continues to take its corresponding items into account under its accounting method. However, the redetermination of the attributes of a corresponding item under this paragraph (d)(2) might affect its timing.

(3) *Examples.* The acceleration rule of this paragraph (d) is illustrated by the following examples.

Example 1. Becoming a nonmember—timing. (a) *Facts.* S owns land with a basis of $70. On January 1 of Year 1, S sells the land to B for $100. On July 1 of Year 3, P sells 60% of S's stock to X for $60 and, as a result, S becomes a nonmember.

(b) *Matching rule.* Under the matching rule, none of S's $30 gain is taken into account in Years 1 through 3 because there is no difference between B's $0 gain or loss taken into account and the recomputed gain or loss.

(c) *Acceleration of S's intercompany items.* Under the acceleration rule of paragraph (d) of this section, S's $30 gain is taken into account in computing consolidated taxable income (and consolidated tax liability) immediately before the effect of treating S and B as divisions of a single corporation cannot be produced. Because the effect cannot be produced once S becomes a nonmember, S takes its $30 gain into account in Year 3 immediately before becoming a nonmember. S's gain is reflected under § 1.1502–32 in P's basis in the S stock immediately before P's sale of the stock. Under § 1.1502–32, P's basis in the S stock is increased by $30, and therefore P's gain is reduced (or loss is increased) by $18 (60% of $30). See also §§ 1.1502–33 and 1.1502–76(b). (The results would be the same if S sold the land to B in an installment sale to which section 453 would otherwise apply, because S must take its intercompany gain into account under this section.)

(d) *B's corresponding items.* Notwithstanding the acceleration of S's gain, B continues to take its corresponding items into account under its accounting method. Thus, B's items from the land are taken into account based on subsequent events (e.g., its sale of the land).

(e) *Sale of B's stock.* The facts are the same as in paragraph (a) of this *Example 1,* except that P sells 60% of B's stock (rather than S stock) to X for $60 and, as a result, B becomes a nonmember. Because the effect of treating S and B as divisions of a single corporation cannot be produced once B becomes a nonmember, S takes its $30 gain into account under the acceleration rule immediately before B becomes a nonmember. (The results would be the same if S sold the land to B in an installment sale to which section 453 would otherwise apply, because S must take its intercompany gain into account under this section.)

(f) *Discontinue filing consolidated returns.* The facts are the same as in paragraph (a) of this *Example 1,* except that the P group receives permission under § 1.1502–75(c) to discontinue filing consolidated returns beginning in Year 3. Under the acceleration rule, S takes its $30 gain into account on December 31 of Year 2.

(g) *No subgroups.* The facts are the same as in paragraph (a) of this *Example 1,* except that P simultaneously sells all of the stock of both S and B to X (rather than 60% of S's stock), and S and B become members of the X consolidated group. Because the effect of treating S and B as divisions of a single corporation in the P group cannot be produced once S and B become nonmembers, S takes its $30 gain into account under the acceleration rule immediately before S and B become nonmembers. (Paragraph (j)(5) of this section does not apply to treat the X consolidated group as succeeding to the P group because the X group acquired only the stock of S and B.) However, so long as S and B continue to join with each other in the filing of consolidated returns, B continues to treat S and B as divisions of a single corporation for purposes of determining the attributes of B's corresponding items from the land.

Example 2. Becoming a nonmember—attributes. (a) *Facts.* S holds land for investment with a basis of $70. On January 1 of

Year 1, S sells the land to B for $100. B holds the land for sale to customers in the ordinary course of business, and expends substantial resources over a two-year period subdividing, developing, and marketing the land. On July 1 of Year 3, before B has sold any of the land, P sells 60% of S's stock to X for $60 and, as a result, S becomes a nonmember.

(b) *Attributes.* Under the acceleration rule, the attributes of S's gain are redetermined under the principles of the matching rule as if B sold the land to an affiliated corporation that is not a member of the group for a cash payment equal to B's adjusted basis in the land (because the land continues to be held within the group). Thus, whether S's gain is capital gain or ordinary income depends on the activities of both S and B. Because S and B no longer join with each other in the filing of consolidated returns, the attributes of B's corresponding items (e.g., from its subsequent sale of the land) are redetermined under the principles of the matching rule as if the S division (but not the B division) were transferred by the single corporation to an unrelated person at the time of P's sale of the S stock. Thus, B continues to take into account the activities of S with respect to the land before the intercompany transaction.

(c) *Depreciable property.* The facts are the same as in paragraph (a) of this *Example 2*, except that the property sold by S to B is depreciable property. Section 1239 applies to treat all of S's gain as ordinary income because it is taken into account as a result of B's deemed sale of the property to a affiliated corporation that is not a member of the group (a related person within the meaning of section 1239(b)).

Example 3. Selling member's disposition of installment note. (a) *Facts.* S owns land with a basis of $70. On January 1 of Year 1, S sells the land to B in exchange for B's $110 note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for principal payments of $55 in Year 4 and $55 in Year 5. On July 1 of Year 3, S sells B's note to X for $110.

(b) *Timing.* S's intercompany gain is taken into account under this section, and not under the rules of section 453. Consequently, S's sale of B's note does not result in its intercompany gain from the land being taken into account (e.g., under section 453B). The sale does not prevent S's intercompany items and B's corresponding items from being taken into account in determining the group's consolidated taxable income under the matching rule, and X does not reflect any aspect of the intercompany transaction (X has its own cost basis in the note). S will take the intercompany gain into account under the matching rule or acceleration rule based on subsequent events (e.g., B's sale of the land). See also paragraph (g) of this section for additional rules applicable to B's note as an intercompany obligation.

Example 4. Cancellation of debt and attribute reduction under section 108(b). (a) *Facts.* S holds land for investment with a basis of $0. On January 1 of Year 1, S sells the land to B for $100. B also holds the land for investment. During Year 3, B is insolvent and B's nonmember creditors discharge $60 of B's indebtedness. Because of insolvency, B's $60 discharge is excluded from B's gross income under section 108(a), and B reduces the basis of the land by $60 under sections 108(b) and 1017.

(b) *Acceleration rule.* As a result of B's basis reduction under section 1017, $60 of S's intercompany gain will not be taken into account under the matching rule (because there is only a $40 difference between B's $40 basis in the land and the $0 basis the land would have if S and B were divisions of a single corporation). Accordingly, S takes $60 of its gain into account under the acceleration rule in Year 3. S's gain is long-term capital gain, determined under paragraph (d)(1)(ii) of this section as if B sold the land to an affiliated corporation that is not a member of the group for $100 immediately before the basis reduction.

(c) *Purchase price adjustment.* Assume instead that S sells the land to B in exchange for B's $100 purchase money note, B remains solvent, and S subsequently agrees to discharge $60 of the note as a purchase price adjustment to which section 108(e)(5) applies. Under applicable principles of tax law, $60 of S's gain and $60 of B's basis in the land are eliminated and never taken into account. Similarly, the note is not treated as satisfied and reissued under paragraph (g) of this section.

Example 5. Section 481. (a) *Facts.* S operates several trades or businesses, including a manufacturing business. S receives permission to change its method of accounting for valuing inventory for its manufacturing business. S increases the basis of its ending inventory by $100, and the related $100 positive section 481(a) adjustment is to be taken into account ratably over six taxable years, beginning in Year 1. During Year 3, S sells all of the assets used in its manufacturing business to B at a gain. Immediately after the transfer, B does not use the same inventory valuation method as S. On a separate entity basis, S's sale results in an acceleration of the balance of the section 481(a) adjustment to Year 3.

(b) *Timing and attributes.* Under paragraph (b)(2) of this section, the balance of S's section 481(a) adjustment accelerated to Year 3 is intercompany income. However, S's $100 basis increase before the intercompany transaction eliminates the related difference for this amount between B's corresponding items taken into account and the recomputed corresponding items in subsequent periods. Because the accelerated section 481(a) adjustment will not be taken into account in determining the group's consolidated taxable income (and consolidated tax liability) under the matching rule, the balance of S's section 481 adjustment is taken into account under the acceleration rule as ordinary income at the time of the intercompany transaction. (If S's sale had not resulted in accelerating S's section 481(a) adjustment on a separate entity basis, S would have no intercompany income to be taken into account under this section.)

(e) *Simplifying rules*—(1) *Dollar-value LIFO inventory methods*—(i) *In general.* This paragraph (e)(1) applies if either S or B uses a dollar-value LIFO inventory method to account for intercompany transactions. Rather than applying the matching rule separately to each intercompany inventory transaction, this paragraph (e)(1) provides methods to apply an aggregate approach that is based on dollar-value LIFO inventory accounting. Any method selected under this paragraph (e)(1) must be applied consistently.

(ii) *B uses dollar-value LIFO*—(A) *In general.* If B uses a dollar-value LIFO inventory method to account for its intercompany inventory purchases, and includes all of its inventory costs incurred for a year in its cost of goods sold for the year (that is, B has no inventory increment for the year), S takes into account all of its intercompany inventory items for the year. If B does not include all of its inventory costs incurred for the year in its cost of goods sold for the year (that is, B has an inventory increment for the year), S does not take all of its intercompany inventory income or loss into account. The amount not taken into account is determined under either the increment averaging method of paragraph (e)(1)(ii)(B) of this section or the increment valuation method of paragraph (e)(1)(ii)(C) of this section. Separate computations are made for each pool of B that receives intercompany purchases from S, and S's amount not taken into account is layered based on B's LIFO inventory layers.

(B) *Increment averaging method.* Under this paragraph (e)(1)(ii)(B), the amount not taken into account is the amount of S's intercompany inventory income or loss multiplied by the ratio of the LIFO value of B's current-year costs of its layer of increment to B's total inventory costs incurred for the year under its LIFO inventory method. If B includes more than its inventory costs incurred during any subsequent year in its cost of goods sold (a decrement), S takes into account the intercompany inventory income or loss layers in the same manner and proportion as B takes into account its inventory decrements.

(C) *Increment valuation method.* Under this paragraph (e)(1)(ii)(C), the amount not taken into account is the amount of S's intercompany inventory income or loss for the appropriate period multiplied by the ratio of the LIFO value of B's current-year costs of its layer of increment to B's total inventory costs incurred in the appropriate period under its LIFO inventory method. The principles of paragraph (e)(1)(ii)(B) of this section otherwise apply. The appropriate period is the period of B's year used to determine its current-year costs.

(iii) *S uses dollar-value LIFO.* If S uses a dollar-value LIFO inventory method to account for its intercompany inventory sales, S may use any reasonable method of allocating its LIFO inventory costs to intercompany transactions. LIFO inventory costs include costs of prior layers if a decrement occurs. For example, a reasonable allocation of the most recent costs incurred during the consolidated return year can be used to compute S's intercompany inventory income or loss for the year if S has an inventory increment and uses the earliest acquisitions costs method, but S must apportion costs from the most recent appropriate layers of increment if an inventory decrement occurs for the year.

(iv) *Other reasonable methods.* S or B may use a method not specifically provided in this paragraph (e)(1) that is expected to reasonably take into account intercompany items and corresponding items from intercompany inventory transactions. However, if the method used results, for any year, in a cumulative amount of intercompany inventory items not taken into account by S that significantly exceeds the cumulative amount that would not be taken into account under paragraph (e)(1)(ii) or (iii) of this section, S must take into account for that year the amount necessary to eliminate the excess. The method is thereafter applied with appropriate adjustments to reflect the amount taken into account.

(v) *Examples.* The inventory rules of this paragraph (e)(1) are illustrated by the following examples.

Example 1. Increment averaging method. (a) *Facts.* Both S and B use a double-extension, dollar-value LIFO inventory method, and both value inventory increments using the earliest acquisitions cost valuation method. During Year 2, S sells 25 units of product Q to B on January 15 at $10/unit. S sells another 25 units on April 15, on July 15, and on September 15, at $12/unit. S's earliest cost of product Q is $7.50/unit and S's most recent cost of product Q is $8.00/unit. Both S and B have an inventory increment for the year. B's total inventory costs incurred during Year 2 are $6,000 and the LIFO value of B's Year 2 layer of increment is $600.

(b) *Intercompany inventory income.* Under paragraph (e)(1)(iii) of this section, S must use a reasonable method of allocating its LIFO inventory costs to intercompany transactions. Because S has an inventory increment for Year 2 and uses the earliest acquisitions cost method, a reasonable method of determining its intercompany cost of goods sold for product Q is to use its most recent costs. Thus, its intercompany cost of goods sold is $800 ($8.00 most recent cost, multiplied by 100 units sold to B), and its intercompany inventory income is $350 ($1,150 sales proceeds from B minus $800 cost).

(c) *Timing.* (i) Under the increment averaging method of paragraph (e)(1)(ii)(B) of this section, $35 of S's $350 of intercompany inventory income is not taken into account in Year 2, computed as follows:

$$\frac{\begin{array}{c}\text{LIFO value of B's Year}\\ \text{2 layer of increment}\end{array}}{\begin{array}{c}\text{B's total inventory}\\ \text{costs for Year 2}\end{array}} = \frac{\$600}{\$6{,}000} = 10\%$$

$$\frac{10\% \times \text{S's \$350 intercompany}}{\text{inventory income}} = \$35$$

(ii) Thus, $315 of S's intercompany inventory income is taken into account in Year 2 ($350 of total intercompany inventory income minus $35 not taken into account).

(d) *S incurs a decrement.* The facts are the same as in paragraph (a) of this *Example 1,* except that in Year 2, S incurs a decrement equal to 50% of its Year 1 layer. Under paragraph (e)(1)(iii) of this section, S must reasonably allocate the LIFO cost of the decrement to the cost of goods sold to B to determine S's intercompany inventory income.

(e) *B incurs a decrement.* The facts are the same as in paragraph (a) of this *Example 1,* except that B incurs a decrement in Year 2. S must take into account the entire $350 of Year 2 intercompany inventory income because all 100 units of product Q are deemed sold by B in Year 2.

Example 2. Increment valuation method. (a) The facts are the same as in Example 1. In addition, B's use of the earliest acquisition's cost method of valuing its increments results in B valuing its year-end inventory using costs incurred from January through March. B's costs incurred during the year are: $1,428 in the period January through March; $1,498 in the period April through June; $1,524 in the period July through September; and $1,550 in the period October through December. S's intercompany inventory income for these periods is: $50 in the period January through March ((25×$10) − (25×$8)); $100 in the period April through June ((25×$12) − (25×$8)); $100 in the period July through September ((25×$12) − (25×$8)); and $100 in the period October through December ((25×$12) − (25×$8)).

(b) *Timing.* (i) Under the increment valuation method of paragraph (e)(1)(ii)(C) of this section, $21 of S's $350 of intercompany inventory income is not taken into account in Year 2, computed as follows:

$$\frac{\text{LIFO value of B' s Year 2 layer of increment}}{\text{B' s total inventory costs from January through March of Year 2}} = \frac{\$600}{\$1{,}428} = 42\%$$

$$42\% \times \text{S' s \$50 intercompany inventory income for the period from January through March} = \$21$$

(ii) Thus, $329 of S's intercompany inventory income is taken into account in Year 2 ($350 of total intercompany inventory income minus $21 not taken into account).

(c) *B incurs a subsequent decrement.* The facts are the same as in paragraph (a) of this *Example 2.* In addition, assume that in Year 3, B experiences a decrement in its pool that receives intercompany purchases from S. B's decrement equals 20% of the base-year costs for its Year 2 layer. The fact that B has incurred a decrement means that all of its inventory costs incurred for Year 3 are included in cost of goods sold. As a result, S takes into account its entire amount of intercompany inventory income from its Year 3 sales. In addition, S takes into account $4.20 of its Year 2 layer of intercompany inventory income not already taken into account (20% of $21).

Example 3. Other reasonable inventory methods. (a) *Facts.* Both S and B use a dollar-value LIFO inventory method for their inventory transactions. During Year 1, S sells inventory to B and to X. Under paragraph (e)(1)(iv) of this section, to compute its intercompany inventory income and the amount of this income not taken into account, S computes its intercompany inventory income using the transfer price of the inventory items less a FIFO cost for the goods, takes into account these items based on a FIFO cost flow assumption for B's corresponding items, and the LIFO methods used by S and B are ignored for these computations. These computations are comparable to the methods used by S and B for financial reporting purposes, and the book methods and results are used for tax purposes. S adjusts the amount of intercompany inventory items not taken into account as required by section 263A.

(b) *Reasonable method.* The method used by S is a reasonable method under paragraph (e)(1)(iv) of this section if the cumulative amount of intercompany inventory items not taken into account by S is not significantly greater than the cumulative amount that would not be taken into account under the methods specifically described in paragraph (e)(1) of this section. If, for any year, the method results in a cumulative amount of intercompany inventory items not taken into account by S that significantly exceeds the cumulative amount that would not be taken into account under the methods specifically provided, S must take into account for that year the amount necessary to eliminate the excess. The method is thereafter applied with appropriate adjustments to reflect the amount taken into account (e.g., to prevent the amount from being taken into account more than once).

(2) *Reserve accounting*—(i) *Banks and thrifts.* Except as provided in paragraph (g)(3)(iv) of this section (deferral of items from an intercompany obligation), a member's addition to, or reduction of, a reserve for bad debts that is maintained under section 585 or 593 is taken into account on a separate entity basis. For example, if S makes a loan to a nonmember and subsequently sells the loan to B, any deduction for an addition to a bad debt reserve under section 585 and any recapture income (or reduced bad debt deductions) are taken into account on a separate entity basis rather than as intercompany items or corresponding items taken into account under this section. Any gain or loss of S from its sale of the loan to B is taken into account under this section, however, to the extent it is not attributable to recapture of the reserve.

(ii) *Insurance companies*—(A) *Direct insurance.* If a member provides insurance to another member in an intercompany transaction, the transaction is taken into account by both members on a separate entity basis. For example, if one member provides life insurance coverage for another member with respect to its employees, the premiums, reserve increases and decreases, and death benefit payments are determined and taken into account by both members on a separate entity basis rather than taken into account under this section as intercompany items and corresponding items.

(B) *Reinsurance*—(*1*) *In general.* Paragraph (e)(2)(ii)(A) of this section does not apply to a reinsurance transaction that is an intercompany transaction. For example, if a member assumes all or a portion of the risk on an insurance contract written by another member, the amounts transferred as reinsurance premiums, expense allowances, benefit reimbursements, reimbursed policyholder dividends, experience rating adjustments, and other similar items are taken into account under the matching rule and the acceleration rule. For purposes of this section, the assuming company is treated as B and the ceding company is treated as S.

(*2*) *Reserves determined on a separate entity basis.* For purposes of determining the amount of a member's increase or decrease in reserves, the amount of any reserve item listed in section 807(c) or 832(b)(5) resulting from a reinsurance transaction that is an intercompany transaction is determined on a separate entity basis. But see section 845, under which the Commissioner may allocate between or among the members any items, recharacterize any such items, or make any other adjustments necessary to reflect the proper source and character of the separate taxable income of a member.

(3) *Consent to treat intercompany transactions on a separate entity basis*—(i) *General rule.* The common parent may request consent to take into account on a separate entity basis items from intercompany transactions other than intercompany transactions with respect to stock or obligations of members. Consent may be granted for all items, or for items from a class or classes of transactions. The consent is effective only if granted in writing by the Internal Revenue Service. Unless revoked with the written consent of the Internal Revenue Service, the separate entity treatment applies to all affected intercompany transactions in the consolidated return year for which consent is granted and in all subsequent consolidated return years. Consent under this paragraph (e)(3) does not apply for purposes of taking into account losses and deductions deferred under section 267(f).

(ii) *Time and manner for requesting consent.* The request for consent described in paragraph (e)(3)(i) of this section must be made in the form of a ruling request. The request must be signed by the common parent, include any information required by the Internal Revenue Service, and be filed on or before the due date of the consolidated return (not including extensions of time) for the first consolidated return year to which the consent is to apply. The Internal Revenue Service may impose terms and conditions for granting consent. A copy of the consent must be attached to the group's consolidated returns (or amended returns) as required by the terms of the consent.

(iii) *Effect of consent on methods of accounting.* A consent for separate entity accounting under this paragraph (e)(3), and a revocation of that consent, may require changes in members' methods of accounting for intercompany transactions. Because the consent, or a revocation of the consent, is effective for all intercompany transactions occurring in the consolidated return year for which the consent or revocation is first effective, any change in method is effected on a cut-off basis. Section 446(e) consent is granted for any changes in methods of accounting for intercompany transactions that are necessary solely to conform a member's methods to a binding consent with respect to the group under this paragraph (e)(3) or the revocation of that consent, provided the changes are made in the first consolidated return year for which the consent or revocation under this paragraph (e)(3) is effective. Therefore, section 446(e) consent must be separately requested under applicable administrative procedures if a member has failed to conform its practices to the separate entity accounting provided under this paragraph (e)(3) or the revocation of that treatment in the first consolidated return year for which the consent to use separate entity accounting or revocation of that consent is effective.

(iv) *Consent to treat intercompany transactions on a separate entity basis* *under prior law.* A group that has received consent that is in effect as of the first day of the first consolidated return year beginning on or after July 12, 1995 to treat certain intercompany transactions as provided in § 1.1502–13(c)(3) of the regulations (as contained in the 26 CFR part 1 edition revised as of April 1, 1995) will be considered to have obtained the consent of the Commissioner to take items from intercompany transactions into account on a separate entity basis as provided in paragraph (e)(3)(i) of this section. This treatment is applicable only to the items, class or classes of transactions for which consent was granted under prior law.

(f) *Stock of members*—(1) *In general.* In addition to the general rules of this section, the rules of this paragraph (f) apply to stock of members.

(2) *Intercompany distributions to which section 301 applies*—(i) *In general.* This paragraph (f)(2) provides rules for intercompany transactions to which section 301 applies (intercompany distributions). For purposes of determining whether a distribution is an intercompany distribution, it is treated as occurring under the principles of the entitlement rule of paragraph (f)(2)(iv) of this section. A distribution is not an intercompany distribution to the extent it is deducted by the distributing member. See, for example, section 1382(c)(1).

(ii) *Distributee member.* An intercompany distribution is not included in the gross income of the distributee member (B). However, this exclusion applies to a distribution only to the extent there is a corresponding negative adjustment reflected under § 1.1502–32 in B's basis in the stock of the distributing member (S). For example, no amount is included in B's gross income under section 301(c)(3) from a distribution in excess of the basis of the stock of a subsidiary that results in an excess loss account under § 1.1502–32(a) which is treated as negative basis under § 1.1502–19. B's dividend received deduction under section 243(a)(3) is determined without regard to any intercompany distributions under this paragraph (f)(2) to the extent they are not included in gross income. See § 1.1502–26(b) (applicability of the dividends received deduction to distributions not excluded from gross income, such as a distribution from the common parent to a subsidiary owning stock of the common parent).

(iii) *Distributing member.* The principles of section 311(b) apply to S's loss, as well as gain, from an intercompany distribution of property. Thus, S's loss is taken into account under the matching rule if the property is subsequently sold to a nonmember. However, section 311(a) continues to apply to distributions to nonmembers (for example, loss is not recognized).

(iv) *Entitlement rule*—(A) *In general.* For all Federal income tax purposes, an intercompany distribution is treated as taken into account when the shareholding member becomes entitled to it (generally on the record date). For example, if B becomes entitled to a cash distribution before it is made, the distribution is treated as made when B becomes entitled to it. For this purpose, B is treated as entitled to a distribution no later than the time the distribution is taken into account under the Internal Revenue Code (e.g., under section 305(c)). To the extent a distribution is not made, appropriate adjustments must be made as of the date it was taken into account.

(B) *Nonmember shareholders.* If nonmembers own stock of the distributing corporation at the time the distribution is treated as occurring under this paragraph (f)(2)(iv), appropriate adjustments must be made to prevent the acceleration of the distribution to members from affecting distributions to nonmembers.

(3) *Boot in an intercompany reorganization*—(i) *Scope.* This paragraph (f)(3) provides additional rules for an intercompany transaction in which the receipt of money or other property (nonqualifying property) results in the application of section 356. For example, the distribution of stock of a lower-tier member to a higher-tier member in an intercompany transaction to which section 355 would apply but for the receipt of nonqualifying property is a transaction to which this paragraph (f)(3) applies. This paragraph (f)(3) does not apply if a party to the transaction becomes a member or nonmember as part of the same plan or arrangement.

For example, if S merges into a nonmember in a transaction described in section 368(a)(1)(A), this paragraph (f)(3) does not apply.

(ii) *Treatment.* Nonqualifying property received as part of a transaction described in this paragraph (f)(3) is treated as received by the member shareholder in a separate transaction. See, for example, sections 302 and 311 (rather than sections 356 and 361). The nonqualifying property is treated as taken into account immediately after the transaction if section 354 would apply but for the fact that nonqualifying property is received. It is treated as taken into account immediately before the transaction if section 355 would apply but for the fact that nonqualifying property is received. The treatment under this paragraph (f)(3)(ii) applies for all Federal income tax purposes.

(4) *Acquisition by issuer of its own stock.* If a member acquires its own stock, or an option to buy or sell its own stock, in an intercompany transaction, the member's basis in that stock or option is treated as eliminated for all purposes. Accordingly, S's intercompany items from the stock or options of B are taken into account under this section if B acquires the stock or options in an intercompany transaction (unless, for example, B acquires the stock in exchange for successor property within the meaning of paragraph (j)(1) of this section in a nonrecognition transaction). For example, if B redeems its stock from S in a transaction to which section 302(a) applies, S's gain from the transaction is taken into account immediately under the acceleration rule.

(5) *Certain liquidations and distributions*—(i) *Netting allowed.* S's intercompany item from a transfer to B of the stock of another corporation (T) is taken into account under this section in certain circumstances even though the T stock is never held by a nonmember after the intercompany transaction. For example, if S sells all of T's stock to B at a gain, and T subsequently liquidates into B in a separate transaction to which section 332 applies, S's gain is taken into account under the matching rule. Under paragraph (c)(6)(ii) of this section, S's intercompany gain taken into account as a result of a liquidation under section 332 or a comparable nonrecognition transaction is not redetermined to be excluded from gross income. Under this paragraph (f)(5)(i), if S has both intercompany income or gain and intercompany deduction or loss attributable to stock of the same corporation having the same material terms, only the income or gain in excess of the deduction or loss is subject to paragraph (c)(6)(ii) of this section. This paragraph (f)(5)(i) applies only to a transaction in which B's basis in its T stock is permanently eliminated in a liquidation under section 332 or any comparable nonrecognition transaction, including—

(A) A merger of B into T under section 368(a);

(B) A distribution by B of its T stock in a transaction described in section 355; or

(C) A deemed liquidation of T resulting from an election under section 338(h)(10).

(ii) *Elective relief*—(A) *In general.* If an election is made pursuant to this paragraph (f)(5)(ii), certain transactions are recharacterized to prevent S's items from being taken into account or to provide offsets to those items. This paragraph (f)(5)(ii) applies only if T is a member throughout the period beginning with S's transfer and ending with the completion of the nonrecognition transaction.

(B) *Section 332*—(*1*) *In general.* If section 332 applies to T's liquidation into B, and B transfers T's assets to a new member (new T) in a transaction not otherwise pursuant to the same plan or arrangement as the liquidation, the transfer is nevertheless treated for all Federal income tax purposes as pursuant to the same plan or arrangement as the liquidation. For example, if T liquidates into B, but B forms new T by transferring substantially all of T's former assets to new T, S's intercompany gain or loss generally is not taken into account solely as a result of the liquidation if the liquidation and transfer would qualify as a reorganization described in section 368(a). (Under paragraph (j)(1) of this section, B's stock in new T would be a successor asset to B's stock in T, and S's gain would be taken into account based on the new T stock.)

(*2*) *Time limitation and adjustments.* The transfer of an asset to new T not otherwise pursuant to the same plan or arrangement as the liquidation is treated under this paragraph (f)(5)(ii)(B) as pursuant to the same plan or arrangement only if B transfers it to new T pursuant to a written plan, a copy of which is attached to a timely filed original return (including extensions) for the year of T's liquidation, and the transfer is completed within 12 months of the filing of that return. Appropriate adjustments are made to reflect any events occurring before the formation of new T and to reflect any assets not transferred to new T as part of the same plan or arrangement. For example, if B retains an asset in the reorganization, the asset is treated under paragraph (f)(3) of this section as acquired by new T but distributed to B immediately after the reorganization.

(*3*) *Downstream merger, etc.* The principles of this paragraph (f)(5)(ii)(B) apply, with appropriate adjustments, if B's basis in the T stock is eliminated in a transaction similar to a section 332 liquidation, such as a transaction described in section 368 in which B merges into T. For example, if S and B are subsidiaries, and S sells all of T's stock to B at a gain followed by B's merger into T in a separate transaction described in section 368(a), S's gain is not taken into account solely as a result of the merger if T (as successor to B) forms new T with substantially all of T's former assets.

(C) *Section 338(h)(10)—*(*1*) *In general.* This paragraph (f)(5)(ii)(C) applies to a deemed liquidation of T under section 332 as the result of an election under section 338(h)(10). This paragraph (f)(5)(ii)(C) does not apply if paragraph (f)(5)(ii)(B) of this section is applied to the deemed liquidation. Under this paragraph, B is treated with respect to each share of its T stock as recognizing as a corresponding item any loss or deduction it would recognize (determined after adjusting stock basis under § 1.1502–32) if section 331 applied to the deemed liquidation. For all other Federal income tax purposes, the deemed liquidation remains subject to section 332.

(*2*) *Limitation on amount of loss.* The amount of B's loss or deduction under this paragraph (f)(5)(ii)(C) is limited as follows—

(*i*) The aggregate amount of loss recognized with respect to T stock cannot exceed the amount of S's intercompany income or gain that is in excess of S's intercompany deduction or loss with respect to shares of T stock having the same material terms as the shares giving rise to S's intercompany income or gain; and

(*ii*) The aggregate amount of loss recognized under this paragraph (f)(5)(ii)(C) from T's deemed liquidation cannot exceed the net amount of deduction or loss (if any) that would be taken into account from the deemed liquidation if section 331 applied with respect to all T shares.

(*3*) *Asset sale, etc.* The principles of this paragraph (f)(5)(ii)(C) apply, with appropriate adjustments, if T transfers all of its assets to a nonmember and completely liquidates in a transaction comparable to the section 338(h)(10) transaction described in paragraph (f)(5)(ii)(C)(*1*) of this section. For example, if S sells all of T's stock to B at a gain followed by T's merger into a nonmember in exchange for a cash payment to B in a transaction treated for Federal income tax purposes as T's sale of its assets to the nonmember and complete liquidation, the merger is ordinarily treated as a comparable transaction.

(D) *Section 355.* If B distributes the T stock in an intercompany transaction to which section 355 applies (including an intercompany transaction to which 355 applies because of the application of paragraph (f)(3) of this section), the redetermination of the basis of the T stock under section 358 could cause S's gain or loss to be taken into account under this section. This paragraph (f)(5)(ii)(D) applies to treat B's distribution as subject to sections 301 and 311 (as modified by this paragraph (f)), rather than section 355. The election will prevent S's gain or loss from being taken into account immediately to the extent matching remains possible, but B's gain or loss from the distribution will also be taken into account under this section.

(E) *Election.* An election to apply this paragraph (f)(5)(ii) is made in a separate statement entitled ''[Insert Name and Employer Identification Number of Common Parent] HEREBY ELECTS THE APPLICATION OF §1.1502–13(f)(5)(ii).'' The election must include a description of S's intercompany transaction and T's liquidation (or other transaction). It must specify which provision of §1.1502–13(f)(5)(ii) applies and how it alters the otherwise applicable results under this section (including, for example, the amount of S's intercompany items and the amount deferred or offset as a result of this §1.1502–13(f)(5)(ii)). A separate election must be made for each application of this paragraph (f)(5)(ii). The election must be signed by the common parent and filed with the group's income tax return for the year of T's liquidation (or other transaction). The Commissioner may impose reasonable terms and conditions to the application of this paragraph (f)(5)(ii) that are consistent with the purposes of this section.

(6) *Stock of common parent.* In addition to the general rules of this section, this paragraph (f)(6) applies to parent stock (P stock) and positions in P stock held or entered into by another member. For this purpose, P stock is any stock of the common parent held (directly or indirectly) by another member or any stock of a member (the issuer) that was the common parent if the stock was held (directly or indirectly) by another member while the issuer was the common parent.

(i) *Loss stock*—(A) *Recognized loss.* Any loss recognized, directly or indirectly, by a member with respect to P stock is permanently disallowed and does not reduce earnings and profits. See §1.1502–32(b)(3)(iii)(A) for a corresponding reduction in the basis of the member's stock.

(B) *Other cases.* If a member, M, owns P stock, the stock is subsequently owned by a nonmember, and, immediately before the stock is owned by the nonmember, M's basis in the share exceeds its fair market value, then, to the extent paragraph (f)(6)(i)(A) of this section does not apply, M's basis in the share is reduced to the share's fair market value immediately before the share is held by the nonmember. For example, if M owns shares of P stock with a $100x basis and M becomes a nonmember at a time when the P shares have a value of $60x, M's basis in the P shares is reduced to $60x immediately before M becomes a nonmember. Similarly, if M contributes the P stock to a nonmember in a transaction subject to section 351, M's basis in the shares is reduced to $60x immediately before the contribution. See §1.1502–32(b)(3)(iii)(B) for a corresponding reduction in the basis of M's stock.

(C) *Waiver of built-in loss on P stock*—(*1*) *In general.* If a nonmember that owns P stock with a basis in excess of its fair market value becomes a member of the P consolidated group in a qualifying cost basis transaction, the group may make an irrevocable election to reduce the basis of the P stock to its fair market value immediately before the nonmember becomes a member of the P group. If the nonmember was a member of another consolidated group immediately before becoming a member of the P group, the reduction in basis is treated as occurring immediately after it ceases to be a member of the prior group. A qualifying cost basis transaction is the purchase (i.e., a transaction in which basis is determined under section 1012) by members of the P consolidated group (while they are members) in a 12-month period of an amount of the nonmember's stock satisfying the requirements of section 1504(a)(2).

(*2*) *Election.* The election described in this paragraph (6)(i)(C) must be made in a separate statement entitled ''ELECTION TO REDUCE BASIS OF P STOCK UNDER §1.1502–13(f)(6).'' The statement must be filed with the P consolidated group's return for the year in which the nonmember becomes a member, and it must be signed by both P and the nonmember. The statement must identify the fair market value of, and the amount of the basis reduction in, the P stock.

(ii) *Gain stock.* If a member, M, would otherwise recognize gain on a qualified disposition of P stock, then immediately before the qualified disposition, M is treated as purchasing the P stock from P for fair market value with cash contributed to M by P (or, if necessary, through any intermediate members). A disposition is a qualified disposition only if—

(A) The member acquires the P stock directly from the common parent (P) through a contribution to capital or a transaction qualifying under section 351(a) (or, if necessary, through a series of such transactions involving only members);

(B) Pursuant to a plan, the member transfers the stock immediately to a nonmember that is not related, within the meaning of section 267(b) or 707(b), to any member of the group;

(C) No nonmember receives a substituted basis in the stock within the meaning of section 7701(a)(42);

(D) The P stock is not exchanged for P stock;

(E) P neither becomes nor ceases to be the common parent as part of, or in contemplation of, the disposition or plan; and

(F) M is neither a nonmember that becomes a member nor a member that becomes a nonmember as part of, or in contemplation of, the disposition or plan.

(iii) *Mark-to-market of P stock.* Paragraphs (f)(6)(i) and (ii) of this section shall not apply to any gain or loss from a share of P stock held by a member, M, if—

(A) M regularly trades in P stock (of the same class) with customers in the ordinary course of its business as a dealer;

(B) The gain or loss on the share is taken into account by M pursuant to section 475(a);

(C) M's basis in the share is not adjusted by reference to the basis of any other property or by reference to income, gain, deduction, or loss from other property; and

(D) Neither M nor any other member of the group has structured or engaged in any transaction while a member (or in anticipation of becoming a member), during the taxable year or in any year within the preceding five taxable years that is open for assessment under section 6501, with a principal purpose of avoiding gain or creating loss on P stock subject to section 475(a).

(iv) *Options, warrants, and other positions*—(A) *In general.* This paragraph (f)(6) applies with appropriate adjustments to positions in P stock to the extent that P's gain or loss from an equivalent position would not be recognized under section 1032. Thus, if M purchases an option to buy or sell P stock and sells the option at a loss, the loss is permanently disallowed under paragraph (f)(6)(i)(A) of this section. Similarly, if M is the grantor of such an option and becomes a nonmember, then the principles of paragraph (f)(6)(i)(B) of this section apply to the extent that M would recognize loss from cash settlement of the option at its fair market value immediately before M becomes a nonmember, and proper adjustments must be made in the amount of any gain or loss subsequently realized from the position by M. If P grants M an option to acquire P stock in a transaction meeting the requirements of paragraph (f)(6)(ii) of this section, M is treated as having purchased the option from P for fair market value with cash contributed to M by P.

(B) *Mark-to-market of positions in P stock.* For purposes of paragraph (f)(6)(iii) of this section, gain or loss with respect to a position taken into account under section 1256(a) is treated as taken into account under section 475(a) to the extent that the gain or loss would be taken into account under the principles of section 475.

(v) *Effective date.* This paragraph (f)(6) applies to gain or loss taken into account on or after July 12, 1995, and to transactions occurring on or after July 12, 1995. For example, if S sells P stock to B at a loss prior to July 12, 1995, and B sells the P stock to a nonmember after July 12, 1995, S's loss is disallowed because it is taken into account after July 12, 1995. If a taxpayer takes a gain or loss into account or engages in a transaction on or after July 12, 1995, during a tax year ending prior to December 31, 1995, the taxpayer may treat the gain or loss or the transaction under the rules published in 1995–32 I.R.B. 47, instead of under the rules of this paragraph (f)(6).

(7) *Examples.* The application of this section to intercompany transactions with respect to stock of members is illustrated by the following examples.

Example 1. Dividend exclusion and property distribution. (a) *Facts*. S owns land with a $70 basis and $100 value. On January 1 of Year 1, P's basis in S's stock is $100. During Year 1, S declares and makes a dividend distribution of the land to P. Under section 311(b), S has a $30 gain. Under section 301(d), P's basis in the land is $100. On July 1 of Year 3, P sells the land to X for $110.

(b) *Dividend elimination and stock basis adjustments*. Under paragraph (b)(1) of this section, S's distribution to P is an intercompany distribution. Under paragraph (f)(2)(ii) of this section, P's $100 of dividend income is not included in gross income. Under §1.1502–32, P's basis in S's stock is reduced from $100 to $0 in Year 1.

(c) *Matching rule and stock basis adjustments*. Under the matching rule (treating P as the buying member and S as the selling member), S takes its $30 gain into account in Year 3 to reflect the $30 difference between P's $10 gain taken into account and the $40 recomputed gain. Under §1.1502–32, P's basis in S's stock is increased from $0 to $30 in Year 3.

(d) *Loss property*. The facts are the same as in paragraph (a) of this *Example 1*, except that S has a $130 (rather than $70) basis in the land. Under paragraph (f)(2)(iii) of this section, the principles of section 311(b) apply to S's loss from the intercompany distribution. Thus, S has a $30 loss that is taken into account under the matching rule in Year 3 to reflect the $30 difference between P's $10 gain taken into account and the $20 recomputed loss. (The results are the same under section 267(f).) Under §1.1502–32, P's basis in S's stock is reduced from $100 to $0 in Year 1, and from $0 to a $30 excess loss account in Year 3. (If P had distributed the land to its shareholders, rather than selling the land to X, P would take its $10 gain under section 311(b) into account, and S would take its $30 loss into account under the matching rule with $10 offset by P's gain and $20 recharacterized as a noncapital, nondeductible amount.)

(e) *Entitlement rule*. The facts are the same as in paragraph (a) of this *Example 1*, except that, after P becomes entitled to the distribution but before the distribution is made, S issues additional stock to the public and becomes a nonmember. Under paragraph (f)(2)(i) of this section, the determination of whether a distribution is an intercompany distribution is made under the entitlement rule of paragraph (f)(2)(iv) of this section. Treating S's distribution as made when P becomes entitled to it results in the distribution being an intercompany distribution. Under paragraph (f)(2)(ii) of this section, the distribution is not included in P's gross income. S's $30 gain from the distribution is intercompany gain that is taken into account under the acceleration rule immediately before S becomes a nonmember. Thus, there is a net $70 decrease in P's basis in its S stock under §1.1502–32 ($100 decrease for the distribution and a $30 increase for S's $30 gain). See also §1.1502–20(b) (additional stock basis reductions applicable to certain deconsolidations). Under paragraph (f)(2)(iv) of this section, P does not take the distribution into account again under separate return rules when received, and P is not entitled to a dividends received deduction.

Example 2. Excess loss accounts. (a) *Facts*. S owns all of T's only class of stock with a $10 basis and $100 value. S has substantial earnings and profits, and T has $10 of earnings and profits. On January 1 of Year 1, S declares and distributes a dividend of all of the T stock to P. Under section 311(b), S has a $90 gain. Under section 301(d), P's basis in the T stock is $100. During Year 3, T borrows $90 and declares and makes a $90 distribution to P to which section 301 applies, and P's basis in the T stock is reduced under §1.1502–32 from $100 to $10. During Year 6, T has $5 of earnings that increase P's basis in the T stock under §1.1502–32 from $10 to $15. On December 1 of Year 9, T issues additional stock to X and, as a result, T becomes a nonmember.

(b) *Dividend exclusion*. Under paragraph (f)(2)(ii) of this section, P's $100 of dividend income from S's distribution of the T stock, and its $10 of dividend income from T's $90 distribution, are not included in gross income.

(c) *Matching and acceleration rules*. Under §1.1502–19(b)(1), when T becomes a nonmember P must include in income the amount of its excess loss account (if any) in T stock. P has no excess loss account in the T stock. Therefore P's corresponding item from the deconsolidation of T is $0. Treating S and P as divisions of a single corporation, the T stock would continue to have a $10 basis after the distribution, and the adjustments under §1.1502–32 for T's $90 distribution and $5 of earnings would result in a $75 excess loss account. Thus, the recomputed corresponding item from the deconsolidation is $75. Under the matching rule, S takes $75 of its $90 gain into account in Year 9 as a result of T becoming a nonmember, to reflect the difference between P's $0 gain taken into account and the $75 recomputed gain. S's remaining $15 of gain is taken into account under the matching and acceleration rules based on subsequent events (for example, under the matching rule if P subsequently sells its T stock, or under the acceleration rule if S becomes a nonmember).

(d) *Reverse sequence*. The facts are the same as in paragraph (a) of this *Example 2*, except that T borrows $90 and makes its $90 distribution to S before S distributes T's stock to P. Under paragraph (f)(2)(ii) of this section, T's $90 distribution to S ($10 of which is a dividend) is not included in S's gross income. The corresponding negative adjustment under §1.1502–32 reduces S's basis in the

T stock from $10 to an $80 excess loss account. Under section 311(b), S has a $90 gain from the distribution of T stock to P. Under section 301(d) P's initial basis in the T stock is $10 (the stock's fair market value), and the basis increases to $15 under § 1.1502–32 as a result of T's earnings in Year 6. The timing and attributes of S's gain are determined in the manner provided in paragraph (c) of this *Example 2.* Thus, $75 of S's gain is taken into account under the matching rule in Year 9 as a result of T becoming a nonmember, and the remaining $15 is taken into account under the matching and acceleration rules based on subsequent events.

(e) *Partial stock sale.* The facts are the same as in paragraph (a) of this *Example 2,* except that P sells 10% of T's stock to X on December 1 of Year 9 for $1.50 (rather than T's issuing additional stock and becoming a nonmember). Under the matching rule, S takes $9 of its gain into account to reflect the difference between P's $0 gain taken into account ($1.50 sale proceeds minus $1.50 basis) and the $9 recomputed gain ($1.50 sale proceeds plus $7.50 excess loss account).

(f) *Loss, rather than cash distribution.* The facts are the same as in paragraph (a) of this *Example 2,* except that T retains the loan proceeds and incurs a $90 loss in Year 3 that is absorbed by the group. The timing and attributes of S's gain are determined in the same manner provided in paragraph (c) of this *Example 2.* Under § 1.1502–32, the loss in Year 3 reduces P's basis in the T stock from $100 to $10, and T's $5 of earnings in Year 6 increase the basis to $15. Thus, $75 of S's gain is taken into account under the matching rule in Year 9 as a result of T becoming a nonmember, and the remaining $15 is taken into account under the matching and acceleration rules based on subsequent events. (The timing and attributes of S's gain would be determined in the same manner provided in paragraph (d) of this *Example 2* if T incurred the $90 loss before S's distribution of the T stock to P.)

(g) *Stock sale, rather than stock distribution.* The facts are the same as in paragraph (a) of this *Example 2,* except that S sells the T stock to P for $100 (rather than distributing the stock). The timing and attributes of S's gain are determined in the same manner provided in paragraph (c) of this *Example 2.* Thus, $75 of S's gain is taken into account under the matching rule in Year 9 as a result of T becoming a nonmember, and the remaining $15 is taken into account under the matching and acceleration rules based on subsequent events.

Example 3. Intercompany reorganization. (a) *Facts.* P forms S and B by contributing $200 to the capital of each. During Years 1 through 4, S and B each earn $50, and under § 1.1502–32 P adjusts its basis in the stock of each to $250. (See § 1.1502–33 for adjustments to earnings and profits.) On January 1 of Year 5, the fair market value of S's assets and its stock is $500, and S merges into B in a tax-free reorganization. Pursuant to the plan of reorganization, P receives B stock with a fair market value of $350 and $150 of cash.

(b) *Treatment as a section 301 distribution.* The merger of S into B is a transaction to which paragraph (f)(3) of this section applies. P is treated as receiving additional B stock with a fair market value of $500 and, under section 358, a basis of $250. Immediately after the merger, $150 of the stock received is treated as redeemed, and the redemption is treated under section 302(d) as a distribution to which section 301 applies. Because the $150 distribution is treated as not received as part of the merger, section 356 does not apply and no basis adjustments are required under section 358(a)(1)(A) and (B). Because B is treated under section 381(c)(2) as receiving S's earnings and profits and the redemption is treated as occurring after the merger, $100 of the distribution is treated as a dividend under section 301 and P's basis in the B stock is reduced correspondingly under § 1.1502–32. The remaining $50 of the distribution reduces P's basis in the B stock. Section 301(c)(2) and § 1.1502–32. Under paragraph (f)(2)(ii) of this section, P's $100 of dividend income is not included in gross income. Under § 1.302–2(c), proper adjustments are made to P's basis in its B stock to reflect its basis in the B stock redeemed, with the result that P's basis in the B stock is reduced by the entire $150 distribution.

(c) *Depreciated property.* The facts are the same as in paragraph (a) of this *Example 3,* except that property of S with a $200 basis and $150 fair market value is distributed to P (rather than cash of B). As in paragraph (b) of this *Example 3,* P is treated as receiving additional B stock in the merger and a $150 distribution to which section 301 applies immediately after the merger. Under paragraph (f)(2)(iii) of this section, the principles of section 311(b) apply to B's $50 loss and the loss is taken into account under the matching and acceleration rules based on subsequent events (e.g., under the matching rule if P subsequently sells the property, or under the acceleration rule if B becomes a nonmember). The results are the same under section 267(f).

(d) *Divisive transaction.* Assume instead that, pursuant to a plan, S distributes the stock of a lower-tier subsidiary in a spin-off transaction to which section 355 applies together with $150 of cash. The distribution of stock is a transaction to which paragraph (f)(3) of this section applies. P is treated as receiving the $150 of cash immediately before the section 355 distribution, as a distribution to which section 301 applies. Section 356(b) does not apply and no basis adjustments are required under section 358(a)(1) (A) and (B). Because the $150 distribution is treated as made before the section 355 distribution, the distribution reduces P's basis in the S stock under §1.1502–32, and the basis allocated under section 358(c) between the S stock and the lower-tier subsidiary stock received reflects this basis reduction.

Example 4. Stock redemptions and distributions. (a) *Facts.* Before becoming a member of the P group, S owns P stock with a $30 basis. On January 1 of Year 1, P buys all of S's stock. On July 1 of Year 3, P redeems the P stock held by S for $100 in a transaction to which section 302(a) applies.

(b) *Gain under section 302.* Under paragraph (f)(4) of this section, P's basis in the P stock acquired from S is treated as eliminated. As a result of this elimination, S's intercompany item will never be taken into account under the matching rule because P's basis in the stock does not reflect S's intercompany item. Therefore, S's $70 gain is taken into account under the acceleration rule in Year 3. The attributes of S's item are determined under paragraph (d)(1)(ii) of this section by applying the matching rule as if P had sold the stock to an affiliated corporation that is not a member of the group at no gain or loss. Although P's corresponding item from a sale of its stock would have been excluded from gross income under section 1032, paragraph (c)(6)(ii) of this section prevents S's gain from being treated as excluded from gross income; instead S's gain is capital gain.

(c) *Gain under section 311.* The facts are the same as in paragraph (a) of this *Example 4*, except that S distributes the P stock to P in a transaction to which section 301 applies (rather than the stock being redeemed), and S has a $70 gain under section 311(b). The timing and attributes of S's gain are determined in the manner provided in paragraph (b) of this *Example 4*.

(d) *Loss stock.* The facts are the same as in paragraph (a) of this *Example 4*, except that S has a $130 (rather than $30) basis in the P stock and has a $30 loss under section 302(a). The limitation under paragraph (c)(6)(ii) of this section does not apply to intercompany losses. Thus, S's loss is taken into account in Year 3 as a noncapital, nondeductible amount.

Example 5. Intercompany stock sale followed by section 332 liquidation. (a) *Facts.* S owns all of the stock of T, with a $70 basis and $100 value, and T's assets have a $10 basis and $100 value. On January 1 of Year 1, S sells all of T's stock to B for $100. On July 1 of Year 3, when T's assets are still worth $100, T distributes all of its assets to B in an unrelated complete liquidation to which section 332 applies.

(b) *Timing and attributes.* Under paragraph (b)(3)(ii) of this section, B's unrecognized gain or loss under section 332 is a corresponding item for purposes of applying the matching rule. In Year 3 when T liquidates, B has $0 of unrecognized gain or loss under section 332 because B has a $100 basis in the T stock and receives a $100 distribution with respect to its T stock. Treating S and B as divisions of a single corporation, the recomputed corresponding item would have been $30 of unrecognized gain under section 332 because B would have succeeded to S's $70 basis in the T stock. Thus, under the matching rule, S's $30 intercompany gain is taken into account in Year 3 as a result of T's liquidation. Under paragraph (c)(1)(i) of this section, the attributes of S's gain and B's corresponding item are redetermined as if S and B were divisions of a single corporation. Although S's gain ordinarily would be redetermined to be treated as excluded from gross income to reflect the nonrecognition of B's gain under section 332, S's gain remains capital gain because B's unrecognized gain under section 332 is not permanently and explicitly disallowed under the Code. See paragraph (c)(6)(ii) of this section. However, relief may be elected under paragraph (f)(5)(ii) of this section.

(c) *Intercompany sale at a loss.* The facts are the same as in paragraph (a) of this *Example 5*, except that S has a $130 (rather than $70) basis in the T stock. The limitation under paragraph (c)(6)(ii) of this section does not apply to intercompany losses. Thus, S's intercompany loss is taken into account in Year 3 as a noncapital, nondeductible amount. However, relief may be elected under paragraph (f)(5)(ii) of this section.

Example 6. Intercompany stock sale followed by section 355 distribution. (a) *Facts.* S owns all of the stock of T with a $70 basis and a $100 value. On January 1 of Year 1, S sells all of T's stock to M for $100. On June 1 of Year 6, M distributes all of its T stock to its nonmember shareholders in a transaction to which section 355 applies. At the time of the distribution, M has a basis in T stock of $100 and T has a value of $150.

(b) *Timing and attributes.* Under paragraph (b)(3)(ii) of this section, M's $50 gain not recognized on the distribution under section 355 is a corresponding item. Treating S and M as divisions of a single corporation, the recomputed corresponding item would be $80 of unrecognized gain under section 355 because M would have succeeded to S's $70 basis in the T stock. Thus, under the matching rule, S's $30 intercompany gain is taken into account in Year 6 as a result of the distribution. Under paragraph (c)(1)(i) of this section, the attributes of S's intercompany item and M's corresponding item are redetermined to produce the same effect on consolidated taxable income as if S and M were divisions of a single corporation. Although S's gain ordinarily would be redetermined to be treated as excluded from gross income to reflect the nonrecognition of M's gain under section 355(c), S's gain remains capital gain because M's unrecognized gain under section 355(c) is not permanently and explicitly disallowed under the Code. See paragraph (c)(6)(ii) of this section. Because M's distribution of the T stock is not an intercompany transaction, relief is not available under paragraph (f)(5)(ii) of this section.

(c) *Section 355 distribution within the group.* The facts are the same as under paragraph (a) of this *Example 6*, except that M distributes the T stock to B (another member of the group), and B takes a $75 basis in the T stock under section 358. Under paragraph (j)(2) of this section, B is a successor to M for purposes of taking S's intercompany gain into account, and therefore both M and B might have corresponding items with respect to S's intercompany gain. To the extent it is possible, matching with respect to B's corresponding items produces the result most consistent with treating S, M, and B as divisions of a single corporation. See paragraphs (j)(3) and (j)(4) of this section. However, because there is only $5 difference between B's $75 basis in the T stock and the $70 basis the stock would have if S, M, and B were divisions of a single corporation, only $5 can be taken into account under the matching rule with respect to B's corresponding items. (This $5 is taken into account with respect to B's corresponding items based on subsequent events.) The remaining $25 of S's $30 intercompany gain is taken into account in Year 6 under the matching rule with respect to M's corresponding item from its distribution of the T stock. The attributes of S's remaining $25 of gain are determined in the same manner as in paragraph (b) of this *Example 6*.

(d) *Relief elected.* The facts are the same as in paragraph (c) of this *Example 6* except that P elects relief pursuant to paragraph (f)(5)(ii)(D) of this section. As a result of the election, M's distribution of the T stock is treated as subject to sections 301 and 311 instead of section 355. Accordingly, M recognizes $50 of intercompany gain from the distribution, B takes a basis in the stock equal to its fair market value of $150, and S and M take their intercompany gains into account with respect to B's corresponding items based on subsequent events. (None of S's gain is taken into account in Year 6 as a result of M's distribution of the T stock.)

(g) *Obligations of members*—(1) *In general.* In addition to the general rules of this section, the rules of this paragraph (g) apply to intercompany obligations.

(2) *Definitions.* For purposes of this section—

(i) *Obligation of a member.* An obligation of a member is—

(A) Any obligation of the member constituting indebtedness under general principles of Federal income tax law (for example, under nonstatutory authorities, or under section 108, section 163, section 171, or section 1275), but not an executory obligation to purchase or provide goods or services; and

(B) Any security of the member described in section 475(c)(2)(D) or (E), and any comparable security with respect to commodities, but not if the security is a position with respect to the member's stock. See paragraphs (f)(4) and (6) of this section for special rules applicable to positions with respect to a member's stock.

(ii) *Intercompany obligations.* An intercompany obligation is an obligation between members, but only for the period during which both parties are members.

(3) *Deemed satisfaction and reissuance of intercompany obligations*—(i) *Application*—(A) *In general.* If a member realizes an amount (other than zero) of income, gain, deduction, or loss, directly or indirectly, from the assignment or extinguishment of all or part of its remaining rights or obligations under an intercompany obligation, the intercompany obligation is treated for all Federal income tax purposes as satisfied under paragraph (g)(3)(ii) of this section and, if it remains outstanding, reissued under paragraph (g)(3)(iii) of this section. Similar principles apply under this paragraph (g)(3) if a member realizes any such amount, directly or indirectly, from a comparable transaction (for example, a marking-to-market of an obligation or a bad debt deduction), or if an intercompany obligation becomes an obligation that is not an intercompany obligation.

(B) *Exceptions.* This paragraph (g)(3) does not apply to an obligation if any of the following applies:

(*1*) The obligation became an intercompany obligation by reason of an event described in § 1.108–2(e) (exceptions to the application of section 108(e)(4)).

(*2*) The amount realized is from reserve accounting under section 585 or section 593 (see paragraph (g)(3)(iv) of this section for special rules).

(*3*) The amount realized is from the conversion of an obligation into stock of the obligor.

(*4*) Treating the obligation as satisfied and reissued will not have a significant effect on any person's Federal income tax liability for any year. For this purpose, obligations issued in connection with the same transaction or related transactions are treated as a single obligation. However, this paragraph (g)(3)(i)(B)(*4*) does not apply to any obligation if the aggregate effect of this treatment for all obligations in a year would be significant.

(ii) *Satisfaction*—(A) *General rule.* If a creditor member sells intercompany debt for cash, the debt is treated as satisfied by the debtor immediately before the sale for the amount of the cash. For other transactions, similar principles apply to treat the intercompany debt as satisfied immediately before the transaction. Thus, if the debt is transferred for property, it is treated as satisfied for an amount consistent with the amount for which the debt is deemed reissued under paragraph (g)(3)(iii) of this section, and the basis of the property is also adjusted to reflect that amount. If this paragraph (g)(3) applies because the debtor or creditor becomes a nonmember, the obligation is treated as satisfied for cash in an amount equal to its fair market value immediately before the debtor or creditor becomes a nonmember. Similar principles apply to intercompany obligations other than debt.

(B) *Timing and attributes.* For purposes of applying the matching rule and the acceleration rule—

(*1*) Paragraph (c)(6)(ii) of this section (limitation on treatment of intercompany income or gain as excluded from gross income) does not apply to prevent any intercompany income or gain from being excluded from gross income; and

(*2*) Any gain or loss from an intercompany obligation is not subject to section 108(a), section 354 or section 1091.

(iii) *Reissuance.* If a creditor member sells intercompany debt for cash, the debt is treated as a new debt (with a new holding period) issued by the debtor immediately after the sale for the amount of cash. For other transactions, if the intercompany debt remains outstanding, similar principles apply to treat the debt as reissued immediately after the transaction. Thus, if the debt is transferred for property, it is treated as new debt issued for the property. See, for example, section 1273(b)(3) or section 1274. If this paragraph (g)(3) applies because the debtor or creditor becomes a nonmember, the debt is treated as new debt issued for an amount of cash equal to its fair market value immediately after the debtor or creditor becomes a nonmember. Similar principles apply to intercompany obligations other than debt.

(iv) *Bad debt reserve.* A member's deduction under section 585 or section 593 for an addition to its reserve for bad debts with respect to an intercompany obligation is not taken into account, and is not treated as realized under this paragraph (g)(3) until the intercompany obligation becomes an obligation that is not an intercompany obligation, or, if earlier, the redemption or cancellation of the intercompany obligation.

(4) *Deemed satisfaction and reissuance of obligations becoming intercompany obligations*—(i) *Application*—(A) *In general.* This paragraph (g)(4) applies if an obligation that is not an intercompany obligation becomes an intercompany obligation.

(B) *Exceptions.* This paragraph (g)(4) does not apply to an obligation if—

(*1*) The obligation becomes an intercompany obligation by reason of an event described in §1.108–2(e) (exceptions to the application of section 108(e)(4)); or

(*2*) Treating the obligation as satisfied and reissued will not have a significant effect on any person's Federal income tax liability for any year. For this purpose, obligations issued in connection with the same transaction or related transactions are treated as a single obligation. However, this paragraph (g)(4)(i)(B)(*2*) does not apply to any obligation if the aggregate effect of this treatment for all obligations in a year would be significant.

(ii) *Intercompany debt.* If this paragraph (g)(4) applies to an intercompany debt—

(A) Section 108(e)(4) does not apply;

(B) The debt is treated for all Federal income tax purposes, immediately after it becomes an intercompany debt, as satisfied and a new debt issued to the holder (with a new holding period) in an amount determined under the principles of §1.108–2(f);

(C) The attributes of all items taken into account from the satisfaction are determined on a separate entity basis, rather than by treating S and B as divisions of a single corporation;

(D) Any intercompany gain or loss taken into account is treated as not subject to section 354 or section 1091; and

(E) Solely for purposes of § 1.1502–32(b)(4) and the effect of any election under that provision, any loss taken into account under this paragraph (g)(4) by a corporation that becomes a member as a result of the transaction in which the obligation becomes an intercompany obligation is treated as a loss carryover from a separate return limitation year.

(iii) *Other intercompany obligations.* If this paragraph (g)(4) applies to an intercompany obligation other than debt, the principles of paragraph (g)(4)(ii) of this section apply to treat the intercompany obligation as satisfied and reissued for an amount of cash equal to its fair market value immediately after the obligation becomes an intercompany obligation.

(5) *Examples.* The application of this section to obligations of members is illustrated by the following examples.

Example 1. Interest on intercompany debt. (a) *Facts.* On January 1 of Year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of Year 5. B fully performs its obligations. Under their separate entity methods of accounting, B accrues a $10 interest deduction annually under section 163, and S accrues $10 of interest income annually under section 61(a)(4).

(b) *Matching rule.* Under paragraph (b)(1) of this section, the accrual of interest on B's note is an intercompany transaction. Under the matching rule, S takes its $10 of income into account in each of Years 1 through 5 to reflect the $10 difference between B's $10 of interest expense taken into account and the $0 recomputed expense. S's income and B's deduction are ordinary items. (Because S's intercompany item and B's corresponding item would both be ordinary on a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section.)

(c) *Original issue discount.* The facts are the same as in paragraph (a) of this *Example 1,* except that B borrows $90 (rather than $100) from S in return for B's note providing for $10 of interest annually and repayment of $100 at the end of Year 5. The principles described in paragraph (b) of this *Example 1* for stated interest also apply to the $10 of original issue discount. Thus, as B takes into account its corresponding expense under section 163(e), S takes into account its intercompany income. S's income and B's deduction are ordinary items.

(d) *Tax-exempt income.* The facts are the same as in paragraph (a) of this *Example 1,* except that B's borrowing from S is allocable under section 265 to B's purchase of state and local bonds to which section 103 applies. The timing of S's income is the same as in paragraph (b) of this *Example 1.* Under paragraph (c)(4)(i) of this section, the attributes of B's corresponding item of disallowed interest expense control the attributes of S's offsetting intercompany interest income. Paragraph (c)(6)(ii) of this section does not prevent the redetermination of S's intercompany item as excluded from gross income, because section 265 permanently and explicitly disallows B's corresponding deduction. Accordingly, S's intercompany income is treated as excluded from gross income.

Example 2. Intercompany debt becomes nonintercompany debt. (a) *Facts.* On January 1 of Year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of Year 20. As of January 1 of Year 3, B has paid the interest accruing under the note and S sells B's note to X for $70, reflecting a change in the value of the note as a result of increases in prevailing market interest rates. B is never insolvent within the meaning of section 108(d)(3).

(b) *Deemed satisfaction.* Under paragraph (g)(3) of this section, B's note is treated as satisfied for $70 immediately before S's sale to X. As a result of the deemed satisfaction of the obligation for less than its adjusted issue price, B takes into account $30 of discharge of indebtedness income under section 61(a)(12). On a separate entity basis, S's $30 loss would be a capital loss under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. B's corresponding item completely offsets S's intercompany item in amount. Accordingly, under paragraph (c)(4)(i) of this section, the attributes of B's $30 of discharge of indebtedness income control the attributes of S's loss. Thus, S's loss is treated as ordinary loss.

(c) *Deemed reissuance.* Under paragraph (g)(3) of this section, B is also treated as reissuing, directly to X, a new note with a $70 issue price and a $100 stated redemption price at maturity. The new note is not an intercompany obligation, it has a $70 issue price and $100 stated redemption price at maturity, and the $30 of original issue discount will be taken into account by B and X under sections 163(e) and 1272.

(d) *Creditor deconsolidation.* The facts are the same as in paragraph (a) of this *Example 2*, except that P sells S's stock to X (rather than S's selling the note of B). Under paragraph (g)(3) of this section, the note is treated as satisfied by B for its $70 fair market value immediately before S becomes a nonmember, and B is treated as reissuing a new note to S immediately after S becomes a nonmember. The results for S's $30 of loss and B's discharge of indebtedness income are the same as in paragraph (b) of this *Example 2*. The new note is not an intercompany obligation, it has a $70 issue price and $100 stated redemption price at maturity, and the $30 of original issue discount will be taken into account by B and S under sections 163(e) and 1272.

(e) *Debtor deconsolidation.* The facts are the same as in paragraph (a) of this *Example 2*, except that P sells B's stock to X (rather than S's selling the note of B). The results are the same as in paragraph (d) of this *Example 2*.

(f) *Appreciated note.* The facts are the same as in paragraph (a) of this *Example 2*, except that S sells B's note to X for $130 (rather than $70), reflecting a decline in prevailing market interest rates. Under paragraph (g)(3) of this section, B's note is treated as satisfied for $130 immediately before S's sale of the note to X. Under §1.163–7(c), B takes into account $30 of repurchase premium. On a separate entity basis, S's $30 gain would be a capital gain under section 1271(a)(1), and B's $30 premium deduction would be an ordinary deduction. Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's corresponding premium deduction control the attributes of S's intercompany gain. Accordingly, S's gain is treated as ordinary income. B is also treated as reissuing a new note directly to X which is not an intercompany obligation. The new note has a $130 issue price and a $100 stated redemption price at maturity. Under §1.61–12(c), B's $30 premium income under the new note is taken into account over the life of the new note.

Example 3. Loss or bad debt deduction with respect to intercompany debt. (a) *Facts.* On January 1 of Year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of Year 5. In Year 3, S sells B's note to P for $60. B is never insolvent within the meaning of section 108(d)(3). Assume B's note is not a security within the meaning of section 165(g)(2).

(b) *Deemed satisfaction and reissuance.* Under paragraph (g)(3) of this section, B is treated as satisfying its note for $60 immediately before the sale, and reissuing a new note directly to P with a $60 issue price and a $100 stated redemption price at maturity. On a separate entity basis, S's $40 loss would be a capital loss, and B's $40 income would be ordinary income. Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's corresponding discharge of indebtedness income control the attributes of S's intercompany loss. Accordingly, S's loss is treated as ordinary loss.

(c) *Partial bad debt deduction.* The facts are the same as in paragraph (a) of this *Example 3*, except that S claims a $40 partial bad debt deduction under section 166(a)(2) (rather than selling the note to P). The results are the same as in paragraph (b) of this *Example 3*. B's note is treated as satisfied and reissued with a $60 issue price. S's $40 intercompany deduction and B's $40 corresponding income are both ordinary.

(d) *Insolvent debtor.* The facts are the same as in paragraph (a) of this *Example 3*, except that B is insolvent within the meaning of section 108(d)(3) at the time that S sells the note to P. On a separate entity basis, S's $40 loss would be capital, B's $40 income would be excluded from gross income under section 108(a), and B would reduce attributes under section 108(b) or section 1017. However, under paragraph (g)(3)(ii)(B) of this section, section 108(a) does not apply to B's income to characterize it as excluded from gross income. Accordingly, the attributes of S's intercompany loss and B's corresponding income are redetermined in the same manner as in paragraph (b) of this *Example 3*.

Example 4. Nonintercompany debt becomes intercompany debt. (a) *Facts.* On January 1 of Year 1, B borrows $100 from X in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of Year 5. As of January 1 of Year 3, B has fully performed its obligations, but the note's fair market value is $70. On January 1 of Year 3, P buys all of X's stock. B is solvent within the meaning of section 108(d)(3).

(b) *Deemed satisfied and reissuance.* Under paragraph (g)(4) of this section, B is treated as satisfying its indebtedness for $70 (determined under the principles of §1.108–2(f)(2)) immediately after X becomes a member. Both X's $30 capital loss under section 1271(a)(1) and B's $30 of discharge of indebtedness income under section 61(a)(12) are taken into account in determining consolidated taxable income for Year 3. Under paragraph (g)(4)(ii)(C) of this section, the attributes of items resulting from the satisfaction are determined on a separate entity basis. But see section 382 and § 1.1502–15T (or § 1.1502-15A, as appropriate) (limitations on the absorption of built-in losses). B is also treated as reissuing a new note. The new note is an intercompany obligation, it has a $70 issue price and $100 stated redemption price at maturity, and the $30 of original issue discount will be taken into account by B and X in the same manner as provided in paragraph (c) of *Example 1* of this paragraph (g)(5).

(c) *Election to file consolidated returns.* Assume instead that B borrows $100 from S during Year 1, but the P group does not file consolidated returns until Year 3. Under paragraph (g)(4) of this section, B's indebtedness is treated as satisfied and a new note reissued immediately after the debt becomes intercompany debt. The satisfaction and reissuance are deemed to occur on January 1 of Year 3, for the fair market value of the note (determined under the principles of § 1.108–2(f)(2)) at that time.

Example 5. Notional principal contracts. (a) *Facts.* On April 1 of Year 1, M1 enters into a contract with counterparty M2 under which, for a term of five years, M1 is obligated to make a payment to M2 each April 1, beginning in Year 2, in an amount equal to the London Interbank Offered Rate (LIBOR), as determined on the immediately preceding April 1, multiplied by a $1,000 notional principal amount. M2 is obligated to make a payment to M1 each April 1, beginning in Year 2, in an amount equal to 8% multiplied by the same notional principal amount. LIBOR is 7.80% on April 1 of Year 1. On April 1 of Year 2, M2 owes $2 to M1.

(b) *Matching rule.* Under § 1.446–3(d), the net income (or net deduction) from a notional principal contract for a taxable year is included in (or deducted from) gross income. Under § 1.446–3(e), the ratable daily portion of M2's obligation to M1 as of December 31 of Year 1 is $1.50 ($2 multiplied by 275/365). Under the matching rule, M1's net income for Year 1 of $1.50 is taken into account to reflect the difference between M2's net deduction of $1.50 taken into account and the $0 recomputed net deduction. Similarly, the $.50 balance of the $2 of net periodic payments made on April 1 of Year 2 is taken into account for Year 2 in M1's and M2's net income and net deduction from the contract. In addition, the attributes of M1's intercompany income and M2's corresponding deduction are redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of M2's corresponding deduction control the attributes of M1's intercompany income. (Although M1 is the selling member with respect to the payment on April 1 of Year 2, it might be the buying member in a subsequent period if it owes the net payment.)

(c) *Dealer.* The facts are the same as in paragraph (a) of this *Example 5*, except that M2 is a dealer in securities, and the contract with M1 is not inventory in the hands of M2. Under section 475, M2 must mark its securities to market at year-end. Assume that under section 475, M2's loss from marking to market the contract with M1 is $100. Under paragraph (g)(3) of this section, M2 is treated as making a $100 payment to M1 to terminate the contract immediately before section 475 is applied. M1's $100 of income from the termination payment is taken into account under the matching rule to reflect M2's deduction under § 1.446–3(h). The attributes of M1's intercompany income and M2's corresponding deduction are redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of M2's corresponding deduction control the attributes of M1's intercompany income. Accordingly, M1's income is treated as ordinary income. Paragraph (g)(3) of this section also provides that, immediately after section 475 would apply, a new contract is treated as reissued with an upfront payment of $100. Under § 1.446–3(f), the deemed $100 up front payment by M1 to M2 is taken into account over the term of the new contract in a manner reflecting the economic substance of the contract (for example, allocating the payment in accordance with the forward rates of a series of cash-settled forward contracts that reflect the specified index and the $1,000 notional principal amount). (The timing of taking items into account is the same if M1, rather than M2, is the dealer subject to the mark-to-market requirement of section 475 at year-end. However in this case, because the attributes of the corresponding deduction control the attributes of the intercompany income, M1's income from the deemed termination payment might be ordinary or capital.)

(h) *Anti-avoidance rules*—(1) *In general.* If a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this section.

(2) *Examples.* The anti-avoidance rules of this paragraph (h) are illustrated by the following examples. The examples set forth below do not address common law doctrines or other authorities that might apply to recast a transaction or to otherwise affect the tax treatment of a transaction. Thus, in addition to adjustments under this paragraph (h), the Commissioner can,

for example, apply the rules of section 269 or §1.701–2 to disallow a deduction or to recast a transaction.

Example 1. Sale of a partnership interest. (a) *Facts.* S owns land with a $10 basis and $100 value. B has net operating losses from separate return limitation years (SRLYs) subject to limitation under §1.1502–21T(c). Pursuant to a plan to absorb the losses without limitation by the SRLY rules, S transfers the land to an unrelated, calendar-year partnership in exchange for a 10% interest in the capital and profits of the partnership in a transaction to which section 721 applies. The partnership does not have a section 754 election in effect. S later sells its partnership interest to B for $100. In the following year, the partnership sells the land to X for $100. Because the partnership does not have a section 754 election in effect, its $10 basis in the land does not reflect B's $100 basis in the partnership interest. Under section 704(c), the partnership's $90 built-in gain is allocated to B, and B's basis in the partnership interest increases to $190 under section 705. In a later year, B sells the partnership interest to a nonmember for $100.

(b) *Adjustments.* Under §1.1502–21T(c), the partnership's $90 built-in gain allocated to B ordinarily increases the amount of B's SRLY limitation, and B's $90 loss from its sale of the partnership interest ordinarily is not subject to limitation under the SRLY rules. Because the contribution of property to the partnership and the sale of the partnership interest were part of a plan a principal purpose of which was to achieve a reduction in consolidated tax liability by creating offsetting gain and loss for B while deferring S's intercompany gain, B's allocable share of the partnership's gain from its sale of the land is treated under paragraph (h)(1) of this section as not increasing the amount of B's SRLY limitation.

Example 2. Transitory status as an intercompany obligation. (a) *Facts.* P historically has owned 70% of X's stock and the remaining 30% is owned by unrelated shareholders. On January 1 of Year 1, S borrows $100 from X in return for S's note requiring $10 of interest annually at the end of each year, and repayment of $100 at the end of Year 20. As of January 1 of Year 3, the P group has substantial net operating loss carryovers, and the fair market value of S's note falls to $70 due to an increase in prevailing market interest rates. X is not permitted under section 166(a)(2) to take into account a $30 loss with respect to the note. Pursuant to a plan to permit X to take into account its $30 loss without disposing of the note, P acquires an additional 10% of X's stock, causing X to become a member, and P subsequently resells the 10% interest. X's $30 loss with respect to the note is a net unrealized built-in loss within the meaning of §1.1502–15T.

(b) *Adjustments.* Under paragraph (g)(4) of this section, X ordinarily would take into account its $30 loss as a result of the note becoming an intercompany obligation, and S would take into account $30 of discharge of indebtedness income. Under §1.1502–22T, X's loss is not combined with items of the other members and the loss would be carried to X's separate return years as a result of X becoming a nonmember. However, the transitory status of S's indebtedness to X as an intercompany obligation is structured with a principal purpose to accelerate the recognition of X's loss. Thus, S's note is treated under paragraph (h)(1) of this section as not becoming an intercompany obligation.

Example 3. Corporate mixing bowl. (a) *Facts.* M1 and M2 are subsidiaries of P. M1 operates a manufacturing business on land it leases from M2. The land is the only asset held by M2. P intends to dispose of the M1 business, including the land owned by M2; P's basis in the M1 stock is equal to the stock's fair market value. M2's land has a value of $20 and a basis of $0 and P has a $0 basis in the stock of M2. In Year 1, with a principal purpose of avoiding gain from the sale of the land (by transferring the land to M1 with a carry-over basis without affecting P's basis in the stock of M1 or M2), M1 and M2 form corporation T; M1 contributes cash in exchange for 80% of the T stock and M2 contributes the land in exchange for 20% of the stock. In Year 3, T liquidates, distributing $20 cash to M2 and the land (plus $60 cash) to M1. Under §1.1502–34, section 332 applies to both M1 and M2. Under section 337, T recognizes no gain or loss from its liquidating distribution of the land to M1. T has neither gain nor loss on its distribution of cash to M2. In Year 4, P sells all of the stock of M1 to X and liquidates M2.

(b) *Adjustments.* A principal purpose for the formation and liquidation of T was to avoid gain from the sale of M2's land. Thus, under paragraph (h)(1) of this section, M2 must take $20 of gain into account when the stock of M1 is sold to X.

Example 4. Partnership mixing bowl. (a) *Facts.* M1 owns a self-created intangible asset with a $0 basis and a fair market value of $100. M2 owns land with a basis of $100 and a fair market value of $100. In Year 1, with a principal purpose of creating basis in the intangible asset (which would be eligible for amortization under section 197), M1 and M2 form partnership PRS; M1 contributes the intangible asset and M2 contributes the land. X, an unrelated person, contributes cash to PRS in exchange for a substantial interest in the partnership. PRS uses the contributed assets in legitimate business activities. Five years and six months later, PRS liquidates, distributing the land to M1, the intangible to M2, and cash to X. The group reports no gain under sections 707(a)(2)(B) and 737(a) and claims that M2's basis in the intangible asset is $100 under section 732 and that the asset is eligible for amortization under section 197.

(b) *Adjustments.* A principal purpose of the formation and liquidation of PRS was to create additional amortization without an offsetting increase in consolidated taxable income by avoiding treatment as an intercompany transaction. Thus, under paragraph (h)(1) of this section, appropriate adjustments must be made.

Example 5. Sale and leaseback. (a) *Facts.* S operates a factory with a $70 basis and $100 value, and has loss carryovers from SRLYs. Pursuant to a plan to take into account the $30 unrealized gain while continuing to operate the factory, S sells the factory to X for $100 and leases it back on a long-term basis. In the transaction, a substantial interest in the factory is transferred to X. The sale and leaseback are not recharacterized under general principles of Federal income tax law. As a result of S's sale to X, the $30 gain is taken into account and increases S's SRLY limitation.

(b) *No adjustments.* Although S's sale was pursuant to a plan to accelerate the $30 gain, it is not subject to adjustment under paragraph (h)(1) of this section. The sale is not treated as engaged in or structured with a principal purpose to avoid the purposes of this section.

(i) [Reserved]

(j) *Miscellaneous operating rules.* For purposes of this section—

(1) *Successor assets.* Any reference to an asset includes, as the context may require, a reference to any other asset the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of the first asset.

(2) *Successor persons*—(i) *In general.* Any reference to a person includes, as the context may require, a reference to a predecessor or successor. For this purpose, a predecessor is a transferor of assets to a transferee (the successor) in a transaction—

(A) To which section 381(a) applies;

(B) In which substantially all of the assets of the transferor are transferred to members in a complete liquidation;

(C) In which the successor's basis in assets is determined (directly or indirectly, in whole or in part) by reference to the basis of the transferor, but the transferee is a successor only with respect to the assets the basis of which is so determined; or

(D) Which is an intercompany transaction, but only with respect to assets that are being accounted for by the transferor in a prior intercompany transaction.

(ii) *Intercompany items.* If the assets of a predecessor are acquired by a successor member, the successor succeeds to, and takes into account (under the rules of this section), the predecessor's intercompany items. If two or more successor members acquire assets of the predecessor, the successors take into account the predecessor's intercompany items in a manner that is consistently applied and reasonably carries out the purposes of this section and applicable provisions of law.

(3) *Multiple triggers.* If more than one corresponding item can cause an intercompany item to be taken into account under the matching rule, the intercompany item is taken into account in connection with the corresponding item most consistent with the treatment of members as divisions of a single corporation. For example, if S sells a truck to B, its intercompany gain from the sale is not taken into account by reference to B's depreciation if the depreciation is capitalized under section 263A as part of B's cost for a building; instead, S's gain relating to the capitalized depreciation is taken into account when the building is sold or as it is depreciated. Similarly, if B purchases appreciated land from S and transfers the land to a lower-tier member in exchange for stock, thereby duplicating the basis of the land in the basis of the stock, items with respect to both the stock and the land can cause S's intercompany gain to be taken into account; if the lower-tier member becomes a nonmember as a result of the sale of its stock, the attributes of S's intercompany gain are determined with respect to the land rather than the stock.

(4) *Multiple or successive intercompany transactions.* If a member's intercompany item or corresponding item affects the accounting for more than one intercompany transaction, appropriate adjustments are made to treat all of the intercompany transactions as transactions between divisions of a single corporation. For example, if S sells property to M, and M sells the property to B, then S, M, and B are treated as divisions of a single corporation for purposes of applying the rules of this

section. Similar principles apply with respect to intercompany transactions that are part of the same plan or arrangement. For example, if S sells separate properties to different members as part of the same plan or arrangement, all of the participating members are treated as divisions of a single corporation for purposes of determining the attributes (which might also affect timing) of the intercompany items and corresponding items from each of the properties.

(5) *Acquisition of group*—(i) *Scope.* This paragraph (j)(5) applies only if a consolidated group (the terminating group) ceases to exist as a result of—

(A) The acquisition by a member of another consolidated group of either the assets of the common parent of the terminating group in a reorganization described in section 381(a)(2), or the stock of the common parent of the terminating group; or

(B) The application of the principles of §1.1502–75(d)(2) or (d)(3).

(ii) *Application.* If the terminating group ceases to exist under circumstances described in paragraph (j)(5)(i) of this section, the surviving group is treated as the terminating group for purposes of applying this section to the intercompany transactions of the terminating group. For example, intercompany items and corresponding items from intercompany transactions between members of the terminating group are taken into account under the rules of this section by the surviving group. This treatment does not apply, however, to members of the terminating group that are not members of the surviving group immediately after the terminating group ceases to exist (for example, under section 1504(a)(3) relating to reconsolidation, or section 1504(c) relating to includible insurance companies).

(6) *Former common parent treated as continuation of group.* If a group terminates because the common parent is the only remaining member, the common parent succeeds to the treatment of the terminating group for purposes of applying this section so long as it neither becomes a member of an affiliated group filing separate returns nor becomes a corporation described in section 1504(b). For example, if the only subsidiary of the group liquidates into the common parent in a complete liquidation to which section 332 applies, or the common parent merges into the subsidiary and the subsidiary is treated as the common parent's successor under paragraph (j)(2)(i) of this section, the taxable income of the surviving corporation is treated as the group's consolidated taxable income in which the intercompany and corresponding items must be included. See §1.267(f)–1 for additional rules applicable to intercompany losses or deductions.

(7) *Becoming a nonmember.* For purposes of this section, a member is treated as becoming a nonmember if it has a separate return year (including another group's consolidated return year). A member is not treated as having a separate return year if its items are treated as taken into account in computing the group's consolidated taxable income under paragraph (j)(5) or (6) of this section.

(8) *Recordkeeping.* Intercompany and corresponding items must be reflected on permanent records (including work papers). See also section 6001, requiring records to be maintained. The group must be able to identify from these permanent records the amount, location, timing, and attributes of the items, so as to permit the application of the rules of this section for each year.

(9) *Examples.* The operating rules of this paragraph (j) are illustrated generally throughout this section, and by the following examples.

Example 1. Intercompany sale followed by section 351 transfer to member. (a) *Facts.* S holds land for investment with a basis of $70. On January 1 of Year 1, S sells the land to M for $100. M also holds the land for investment. On July 1 of Year 3, M transfers the land to B in exchange for all of B's stock in a transaction to which section 351 applies. Under section 358, M's basis in the B stock is $100. B holds the land for sale to customers in the ordinary course of business and, under section 362(b), B's basis in the land is $100. On December 1 of Year 5, M sells 20% of the B stock to X for $22. In an unrelated transaction on July 1 of Year 8, B sells 20% of the land for $22.

(b) *Definitions.* Under paragraph (b)(1) of this section, S's sale of the land to M and M's transfer of the land to B are both intercompany transactions. S is the selling member and M is the buying member in the first intercompany transaction, and M is the selling member and B is the buying member in the second intercompany transaction. M has no intercompany items under paragraph (b)(2) of this section. Because B acquired the land in an intercompany transaction, B's items from the land are corresponding items to be taken into account under this section. Under the successor asset rule of paragraph (j)(1) of this section, references to the land include references to M's B stock. Under the successor person rule of paragraph (j)(2) of this section, references to M include references to B with respect to the land.

(c) *Timing and attributes resulting from the stock sale.* Under paragraph (c)(3) of this section, M is treated as owning and selling B's stock for purposes of the matching rule even though, as divisions, M could not own and sell stock in B. Under paragraph (j)(3) of this section, both M's B stock and B's land can cause S's intercompany gain to be taken into account under the matching rule. Thus, S takes $6 of its gain into account in Year 5 to reflect the $6 difference between M's $2 gain taken into account from its sale of B stock and the $8 recomputed gain. Under paragraph (j)(4) of this section, the attributes of this gain are determined by treating S, M, and B as divisions of a single corporation. Under paragraph (c)(1) of this section, S's $6 gain and M's $2 gain are treated as long-term capital gain. The gain would be capital on a separate entity basis (assuming that section 341 does not apply), and this treatment is not inconsistent with treating S, M, and B as divisions of a single corporation because the stock sale and subsequent land sale are unrelated transactions and B remains a member following the sale.

(d) *Timing and attributes resulting from the land sale.* Under paragraph (j)(3) of this section, S takes $6 of its gain into account in Year 8 under the matching rule to reflect the $6 difference between B's $2 gain taken into account from its sale of an interest in the land and the $8 recomputed gain. Under paragraph (j)(4) of this section, the attributes of this gain are determined by treating S, M, and B as divisions of a single corporation and taking into account the activities of S, M, and B with respect to the land. Thus, both S's gain and B's gain might be ordinary income as a result of B's activities. (If B subsequently sells the balance of the land, S's gain taken into account is limited to its remaining $18 of intercompany gain.)

(e) *Sale of successor stock resulting in deconsolidation.* The facts are the same as in paragraph (a) of this *Example 1,* except that M sells 60% of the B stock to X for $66 on December 1 of Year 5 and B becomes a nonmember. Under the matching rule, M's sale of B stock results in $18 of S's gain being taken into account (to reflect the difference between M's $6 gain taken into account and the $24 recomputed gain). Under the acceleration rule, however, the entire $30 gain is taken into account (to reflect B becoming a nonmember, because its basis in the land reflects M's $100 cost basis from the prior intercompany transaction). Under paragraph (j)(4) of this section, the attributes of S's gain are determined by treating S, M, and B as divisions of a single corporation. Because M's cost basis in the land will be reflected by B as a nonmember, all of S's gain is treated as from the land (rather than a portion being from B's stock), and B's activities with respect to the land might therefore result in S's gain being ordinary income.

Example 2. Intercompany sale of member stock followed by recapitalization. (a) *Facts.* Before becoming a member of the P group, S owns P stock with a basis of $70. On January 1 of Year 1, P buys all of S's stock. On July 1 of Year 3, S sells the P stock to M for $100. On December 1 of Year 5, P acquires M's original P stock in exchange for new P stock in a recapitalization described in section 368(a)(1)(E).

(b) *Timing and attributes.* Although P's basis in the stock acquired from M is eliminated under paragraph (f)(4) of this section, the new P stock received by M is exchanged basis property (within the meaning of section 7701(a)(44)) having a basis under section 358 equal to M's basis in the original P stock. Under the successor asset rule of paragraph (j)(1) of this section, references to M's original P stock include references to M's new P stock. Because it is still possible to take S's intercompany item into account under the matching rule with respect to the successor asset, S's gain is not taken into account under the acceleration rule as a result of the basis elimination under paragraph (f)(4) of this section. Instead, the gain is taken into account based on subsequent events with respect to M's new P stock (for example, a subsequent distribution or redemption of the new stock).

Example 3. Back-to-back intercompany transactions—matching. (a) *Facts.* S holds land for investment with a basis of $70. On January 1 of Year 1, S sells the land to M for $90. M also holds the land for investment. On July 1 of Year 3, M sells the land for $100 to B, and B holds the land for sale to customers in the ordinary course of business. During Year 5, B sells all of the land to customers for $105.

(b) *Timing.* Under paragraph (b)(1) of this section, S's sale of the land to M and M's sale of the land to B are both intercompany transactions. S is the selling member and M is the buying member in the first intercompany transaction, and M is the selling member and B is the buying member in the second intercompany transaction. Under paragraph (j)(4) of this section, S, M and B are treated as divisions of a single corporation for purposes of determining the timing of their items from the intercompany transactions. See also paragraph (j)(2) of this section (B is treated as a successor to M for purposes of taking S's intercompany gain into account). Thus, S's $20 gain and M's $10 gain are both taken into account in Year 5 to reflect the difference between B's $5 gain taken into account with respect to the land and the $35 recomputed gain (the gain that B would have taken into account if the intercompany sales had been transfers between divisions of a single corporation, and B succeeded to S's $70 basis).

(c) *Attributes.* Under paragraphs (j)(4) of this section, the attributes of the intercompany items and corresponding items of S, M, and B are also determined by treating S, M, and B as divisions of a single corporation. For example, the attributes of S's and M's intercompany items are determined by taking B's activities into account.

Example 4. Back-to-back intercompany transactions—acceleration. (a) *Facts.* During Year 1, S performs services for M in exchange for $10 from M. S incurs $8 of employee expenses. M capitalizes the $10 cost of S's services under section 263 as part of M's cost to acquire real property from X. Under its separate entity method of accounting, S would take its income and expenses into account in Year 1. M holds the real property for investment and, on July 1 of Year 5, M sells it to B at a gain. B also holds the real property for investment. On December 1 of Year 8, while B still owns the real property, P sells all of M's stock to X and M becomes a nonmember.

(b) *M's items.* M takes its gain into account immediately before it becomes a nonmember. Because the real property stays in the group, the acceleration rule redetermines the attributes of M's gain under the principles of the matching rule as if B sold the real property to an affiliated corporation that is not a member of the group for a cash payment equal to B's adjusted basis in the real property, and S, M, and B were divisions of a single corporation. Thus, M's gain is capital gain.

(c) *S's items.* Under paragraph (b)(2)(ii) of this section, S includes the $8 of expenses in determining its $2 intercompany income. In Year 1, S takes into account $8 of income and $8 of expenses. Under paragraph (j)(4) of this section, appropriate adjustments must be made to treat both S's performance of services for M and M's sale to B as occurring between divisions of a single corporation. Thus, S's $2 of intercompany income is not taken into account as a result of M becoming a nonmember, but instead will be taken into account based on subsequent events (e.g., under the matching rule based on B's sale of the real property to a nonmember, or under the acceleration rule based on P's sale of the stock of S or B to a nonmember). See the successor person rules of paragraph (j)(2) of this section (B is treated as a successor to M for purposes of taking S's intercompany income into account).

(d) *Sale of S's stock.* The facts are the same as in paragraph (a) of this *Example 4,* except that P sells all of S's stock (rather than M's stock) and S becomes a nonmember on July 1 of Year 5. S's remaining $2 of intercompany income is taken into account immediately before S becomes a nonmember. Because S's intercompany income is not from an intercompany sale, exchange, or distribution of property, the attributes of the intercompany income are determined on a separate entity basis. Thus, S's $2 of intercompany income is ordinary income. M does not take any of its intercompany gain into account as a result of S becoming a nonmember.

(e) *Intercompany income followed by intercompany loss.* The facts are the same as in paragraph (a) of this *Example 4,* except that M sells the real property to B at a $1 loss (rather than a gain). M takes its $1 loss into account under the acceleration rule immediately before M becomes a nonmember. But see §1.267(f)–1 (which might further defer M's loss if M and B remain in a controlled group relationship after M becomes a nonmember). Under paragraph (j)(4) of this section appropriate adjustments must be made to treat the group as if both intercompany transactions occurred between divisions of a single corporation. Accordingly, P's sale of M stock also results in S taking into account $1 of intercompany income as capital gain to offset M's $1 of corresponding capital loss. The remaining $1 of S's intercompany income is taken into account based on subsequent events.

Example 5. Successor group. (a) *Facts.* On January 1 of Year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of Year 20. As of January 1 of Year 3, B has paid the interest accruing under the note. On that date, X acquires all of P's stock and the former P group members become members of the X consolidated group.

(b) *Successor.* Under paragraph (j)(5) of this section, although B's note ceases to be an intercompany obligation of the P group, the note is not treated as satisfied and reissued under paragraph (g) of this section as a result of X's acquisition of P stock. Instead, the X consolidated group succeeds to the treatment of the P group for purposes of paragraph (g) of this section, and B's note is treated as an intercompany obligation of the X consolidated group.

(c) *No subgroups.* The facts are the same as in paragraph (a) of this *Example 5,* except that X simultaneously acquires the stock of S and B from P (rather than X acquiring all of P's stock). Paragraph (j)(5) of this section does not apply to X's acquisitions. Unless an exception described in paragraph (g)(3)(i)(B) applies, B's note is treated as satisfied immediately before S and B become nonmembers, and reissued immediately after they become members of the X consolidated group. The amount at which the note is satisfied and reissued under paragraph (g)(3) of this section is based on the fair market value of the note at the time of P's sales to X. Paragraph (g)(4) of this section does not apply to the reissued B note in the X consolidated group, because the new note is always an intercompany obligation of the X consolidated group.

Example 6. Liquidation—80% distributee. (a) *Facts.* X has had preferred stock described in section 1504(a)(4) outstanding for several years. On January 1 of Year 1, S buys all of X's common stock for $60, and B buys all of X's preferred stock for $40. X's assets have a $0 basis and $100 value. On July 1 of Year 3, X distributes all of its assets to S and B in a complete liquidation. Under § 1.1502–34, section 332 applies to both S and B. Under section 337, X has no gain or loss from its liquidating distribution to S. Under sections 336 and 337(c), X has a $40 gain from its liquidating distribution to B. B has a $40 basis under section 334(a) in the assets received from X, and S has a $0 basis under section 334(b) in the assets received from X.

(b) *Intercompany items from the liquidation.* Under the matching rule, X's $40 gain from its liquidating distribution to B is not taken into account under this section as a result of the liquidation (and therefore is not yet reflected under §§ 1.1502–32 and 1.1502–33). Under the successor person rule of paragraph (j)(2)(i) of this section, S and B are both successors to X. Under section 337(c), X recognizes gain or loss only with respect to the assets distributed to B. Under paragraph (j)(2)(ii) of this section, to be consistent with the purposes of this section, S succeeds to X's $40 intercompany gain. The gain will be taken into account by S under the matching and acceleration rules of this section based on subsequent events. (The allocation of the intercompany gain to S does not govern the allocation of any other attributes.)

Example 7. Liquidation—no 80% distributee. (a) *Facts.* X has only common stock outstanding. On January 1 of Year 1, S buys 60% of X's stock for $60, and B buys 40% of X's stock for $40. X's assets have a $0 basis and $100 value. On July 1 of Year 3, X distributes all of its assets to S and B in a complete liquidation. Under § 1.1502–34, section 332 applies to both S and B. Under sections 336 and 337(c), X has a $100 gain from its liquidating distributions to S and B. Under section 334(b), S has a $60 basis in the assets received from X and B has a $40 basis in the assets received from X.

(b) *Intercompany items from the liquidation.* Under the matching rule, X's $100 intercompany gain from its liquidating distributions to S and B is not taken into account under this section as a result of the liquidation (and therefore is not yet reflected under §§ 1.1502–32 and 1.1502–33). Under the successor person rule of paragraph (j)(2)(i) of this section, S and B are both successors to X. Under paragraph (j)(2)(ii) of this section, to be consistent with the purposes of this section, S succeeds to X's $40 intercompany gain with respect to the assets distributed to B, and B succeeds to X's $60 intercompany gain with respect to the assets distributed to S. The gain will be taken into account by S and B under the matching and acceleration rules of this section based on subsequent events. (The allocation of the intercompany gain does not govern the allocation of any other attributes.)

(k) *Cross references*—(1) *Section 108.* See § 1.108–3 for the treatment of intercompany deductions and losses as subject to attribute reduction under section 108(b).

(2) *Section 263A(f).* See section 263A(f) and § 1.263A–9(g)(5) for special rules regarding interest from intercompany transactions.

(3) *Section 267(f).* See section 267(f) and § 1.267(f)–1 for special rules applicable to certain losses and deductions from transactions between members of a controlled group.

(4) *Section 460.* See § 1.460–4(j) for special rules regarding the application of section 460 to intercompany transactions.

(5) *Section 469.* See § 1.469–1(h) for special rules regarding the application of section 469 to intercompany transactions.

(6) *§ 1.1502–80.* See § 1.1502–80 for the non-application of certain Internal Revenue Code rules.

(l) *Effective dates*—(1) *In general.* This section applies with respect to transactions occurring in years beginning on or after July 12, 1995. If both this section and prior law apply to a transaction, or neither applies, with the result that items may be duplicated, omitted, or eliminated in determining taxable income (or tax liability), or items may be treated inconsistently, prior law (and not this section) applies to the transaction. For example, S's and B's items from S's sale of property to B which occurs in a consolidated return year beginning before July 12, 1995, are taken into account under prior law, even though B may dispose of the property in a consolidated return year beginning on or after July 12,

1995. Similarly, an intercompany distribution to which a shareholder becomes entitled in a consolidated return year beginning before July 12, 1995, but which is distributed in a consolidated return year beginning on or after that date is taken into account under prior law (generally when distributed), because this section generally takes dividends into account when the shareholder becomes entitled to them but this section does not apply at that time. If application of prior law to S's deferred gain or loss from a deferred intercompany transaction (as defined under prior law) occurring in a consolidated return year beginning prior to July 12, 1995, would be affected by an intercompany transaction (as defined under this section) occurring in a consolidated return year beginning on or after July 12, 1995, S's deferred gain or loss continues to be taken into account as provided under prior law, and the items from the subsequent intercompany transaction are taken into account under this section. Appropriate adjustments must be made to prevent items from being duplicated,omitted, or eliminated in determining taxable income as a result of the application of both this section and prior law to the successive transactions, and to ensure the proper application of prior law.

(2) *Avoidance transactions.* This paragraph (l)(2) applies if a transaction is engaged in or structured on or after April 8, 1994, with a principal purpose to avoid the rules of this section (and instead to apply prior law). If this paragraph (l)(2) applies, appropriate adjustments must be made in years beginning on or after July 12, 1995, to prevent the avoidance, duplication, omission, or elimination of any item (or tax liability), or any other inconsistency with the rules of this section. For example, if S is a dealer in real property and sells land to B on March 16, 1995 with a principal purpose of converting any future appreciation in the land to capital gain, B's gain from the sale of the land on May 11, 1997 might be characterized as ordinary income under this paragraph (l)(2).

(3) *Election for certain stock elimination transactions*—(i) *In general.* A group may elect pursuant to this paragraph (l)(3) to apply this section (including the elections available under paragraph (f)(5)(ii) of this section) to stock elimination transactions to which prior law would otherwise apply. If an election is made, this section, and not prior law, applies to determine the timing and attributes of S's and B's gain or loss from stock with respect to all stock elimination transactions.

(ii) *Stock elimination transactions.* For purposes of this paragraph (l)(3), a stock elimination transaction is a transaction in which stock transferred from S to B—

(A) Is cancelled or redeemed on or after July 12, 1995;

(B) Is treated as cancelled in a liquidation pursuant to an election under section 338(h)(10) with respect to a qualified stock purchase with an acquisition date on or after July 12, 1995;

(C) Is distributed on or after July 12, 1995; or

(D) Is exchanged on or after July 12, 1995 for stock of a member (determined immediately after the exchange) in a transaction that would cause S's gain or loss from the transfer to be taken into account under prior law.

(iii) *Time and manner of making election.* An election under this paragraph (l)(3) is made by attaching to a timely filed original return (including extensions) for the consolidated return year including July 12, 1995 a statement entitled ''[Insert Name and Employer Identification Number of Common Parent] HEREBY ELECTS THE APPLICATION OF §1.1502–13(l)(3).'' See paragraph (f)(5)(ii)(E) of this section for the manner of electing the relief provisions of paragraph (f)(5)(ii) of this section.

(4) *Prior law.* For transactions occurring in S's years beginning before July 12, 1995, see the applicable regulations issued under section 1502. See §§1.1502–13, 1.1502–13T, 1.1502–14, 1.1502–14T, 1.1502–31, and 1.1502–32 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

(5) *Consent to adopt method of accounting.* For intercompany transactions occurring in a consolidated group's first taxable year beginning on or after July 12, 1995, the Commissioner's consent under section 446(e) is hereby granted for any changes in methods of accounting that are necessary solely by reason of the timing rules of this section.

Changes in method of accounting for these transactions are to be effected on a cut-off basis.

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§ 1.1502–15T SRLY limitation on built-in losses (temporary).

(a) *SRLY limitation.* Built-in losses are subject to the SRLY limitation under §§ 1.1502–21T(c) and 1.1502–22T(c) (including applicable subgroup principles). Built-in losses are treated as deductions or losses in the year recognized, except for the purpose of determining the amount of, and the extent to which the built-in loss is limited by, the SRLY limitation for the year in which it is recognized. Solely for such purpose, a built-in loss is treated as a hypothetical net operating loss carryover or net capital loss carryover arising in a SRLY, instead of as a deduction or loss in the year recognized. To the extent that a built-in loss is allowed as a deduction under this section in the year it is recognized, it offsets any consolidated taxable income for the year before any loss carryovers or carrybacks are allowed as a deduction. To the extent not so allowed, it is treated as a separate net operating loss or net capital loss carryover or carryback arising in the year of recognition and, under § 1.1502–21T(c) or § 1.1502–22T(c), the year of recognition is treated as a SRLY.

(b) *Built-in losses*—(1) *Defined.* If a corporation has a net unrealized built-in loss under section 382(h)(3) (as modified by this section) on the day it becomes a member of the group (whether or not the group is a consolidated group), its deductions and losses are built-in losses under this section to the extent they are treated as recognized built-in losses under section 382(h)(2)(B) (as modified by this section). This paragraph (b) generally applies separately with respect to each member, but see paragraph (c) of this section for circumstances in which it is applied on a subgroup basis.

(2) *Operating rules.* Solely for purposes of applying paragraph (b)(1) of this section, the principles of § 1.1502–94T(c) apply with appropriate adjustments, including the following:

(i) *Ownership change.* A corporation is treated as having an ownership change under section 382(g) on the day the corporation becomes a member of a group, and no other events (e.g., a subsequent ownership change under section 382(g) while it is a member) are treated as causing an ownership change. In the case of an asset acquisition by a group, the assets and liabilities acquired directly from the same transferor pursuant to the same plan are treated as the assets and liabilities of a corporation that becomes a member of the group (and has an ownership change) on the date of the acquisition. –

(ii) *Recognized built-in gain or loss.* A loss that is included in the determination of net unrealized built-in gain or loss and that is recognized but disallowed or deferred (e.g., under § 1.1502–20 or section 267) is not treated as a built-in loss unless and until the loss would be allowed during the recognition period without regard to the application of this section. Section 382(h)(1)(B)(ii) does not apply to the extent it limits the amount of recognized built-in loss that may be treated as a pre-change loss to the amount of the net unrealized built-in loss.

(c) *Built-in losses of subgroups*—(1) *In general.* In the case of a subgroup, the principles of paragraph (b) of this section apply to the subgroup, and not separately to its members. Thus, the net unrealized built-in loss and recognized built-in loss for purposes of paragraph (b) of this section are based on the aggregate amounts for each member of the subgroup. –

(2) *Members of subgroups.* A subgroup is composed of those members that have been continuously affiliated with each other for the 60 consecutive month period ending immediately before they become members of the group in which the loss is recognized. A member remains a member of the subgroup until it ceases to be affiliated with the loss member. For this purpose, the principles of § 1.1502–21T(c)(2) (iv) through (vi) apply with appropriate adjustments.

(3) *Built-in amounts.* Solely for purposes of determining whether the subgroup has a net unrealized built-in loss

or whether it has a recognized built-in loss, the principles of §§ 1.1502–91T (g) and (h) apply with appropriate adjustments.

(d) *Examples.* For purposes of the examples in this section, unless otherwise stated, all groups file consolidated returns, all corporations have calendar taxable years, the facts set forth the only corporate activity, value means fair market value and the adjusted basis of each asset equals its value, all transactions are with unrelated persons, and the application of any limitation or threshold under section 382 is disregarded. The principles of this section are illustrated by the following examples:

Example 1. Determination of recognized built-in loss. (a) P buys all the stock of T during Year 1 for $100, and T becomes a member of the P group. T has three depreciable assets. Asset 1 has an unrealized loss of $20 (basis $45, value $25), asset 2 has an unrealized loss of $25 (basis $50, value $25), and asset 3 has an unrealized gain of $25 (basis $25, value $50).

(b) Under paragraph (b)(2)(i) of this section, T is treated as having an ownership change under section 382(g) on becoming a member of the P group. This treatment does not depend on whether P's acquisition of the T stock actually constitutes an ownership change under section 382(g), or whether T is subject to any limitation under section 382. Under paragraph (b)(1) of this section, none of T's $45 of unrealized loss is treated as a built-in loss unless T has a net unrealized built-in loss under section 382(h)(3) on becoming a member of the P group.

(c) Under section 382(h)(3)(A), T has a $20 net unrealized built-in loss on becoming a member of the P group (($20)+($25)+$25=($20)). Assume that this amount exceeds the threshold requirement in section 382(h)(3)(B). Under section 382(h)(2)(B), the entire amount of T's $45 unrealized loss is treated as a built-in loss to the extent it is recognized during the 5-year recognition period described in section 382(h)(7). Under paragraph (b)(2)(ii) of this section, the restriction under section 382(h)(1)(B)(ii), which limits the amount of recognized built-in loss that is treated as pre-change loss to the amount of the net unrealized built-in loss, is inapplicable for this purpose. Consequently, the entire $45 of unrealized loss (not just the $20 net unrealized loss) is treated under paragraph (b)(1) of this section as a built-in loss to the extent it is recognized within 5 years of T's becoming a member of the P group. Under paragraph (a) of this section, a built-in loss is subject to the SRLY limitation under § 1.1502–21T(c)(1).

(d) Under paragraph (b)(2)(i) of this section, the results would be the same if T transferred all of its assets and liabilities to a subsidiary of the P group in a single transaction described in section 351.

Example 2. Actual application of section 382 not relevant. (a) The facts are the same as in *Example 1,* except that P buys 55 percent of the stock of T during Year 1, resulting in an ownership change of T under section 382(g). During Year 2, P buys the 45 percent balance of the T stock, and T becomes a member of the P group.

(b) Although T has an ownership change for purposes of section 382 in Year 1 and not Year 2, T's joining the P group in Year 2 is treated as an ownership change under section 382(g) for purposes of this section. Consequently, for purposes of this section, whether T has a net unrealized built-in loss under section 382(h)(3) is determined as if the day T joined the P group were a change date. Thus, the results are the same as in *Example 1.*

Example 3. Determination of a recognized built-in loss of a subgroup. (a) During Year 1, P buys all of the stock of S for $100, and S becomes a member of the P group. M is the common parent of another group. At the beginning of Year 7, M acquires all of the stock of P, and P and S become members of the M group. At the time of M's acquisition of the P stock, P has (disregarding the stock of S) a $10 net unrealized built-in gain (two depreciable assets, asset 1 with a basis of $35 and a value of $55, and asset 2 with a basis of $55 and a value of $45), and S has a $75 net unrealized built-in loss (two depreciable assets, asset 3 with a basis of $95 and a value of $10, and asset 4 with a basis of $10 and a value of $20).

(b) Under paragraph (c) of this section, P and S compose a subgroup on becoming members of the M group because P and S were continuously affiliated for the 60 month period ending immediately before they became members of the M group. Consequently, paragraph (b) of this section does not apply to P and S separately. Instead, their separately computed unrealized gains and losses are aggregated for purposes of determining whether and the extent to which any unrealized loss is treated as built-in loss under this section and is subject to the SRLY limitation under § 1.1502–21T(c).

(c) Under paragraph (c) of this section, the P subgroup has a net unrealized built-in loss on the day P and S become members of the M group determined by treating the day they become members as a change date. The net unrealized built-in loss is the aggregate of P's net unrealized built-in gain of $10 and S's net unrealized built-in loss of $75, or an aggregate net unrealized built-in loss of $65. (The stock of S owned by P is disregarded for purposes of determining the net unrealized built-in loss. However, any loss allowed on the sale of the stock within the recognition period is taken into account in determining recognized built-in loss.) Assume that the $65 net unrealized built-in loss exceeds the threshold requirement under section 382(h)(3)(B).

(d) Under paragraphs (b)(1), (b)(2)(ii), and (c) of this section, a loss recognized during the 5-year recognition period on an asset of P or S held on the day that P and S became members of the M group is a built-in loss except to the extent the group establishes that such loss exceeds the amount by which the adjusted basis of such asset on the day the member became a member exceeded the fair market value of such asset on that same day. If P sells asset 2 for $45 in Year 7 and recognizes a $10 loss, the entire $10 loss is treated as a built-in loss under paragraphs (b)(2)(ii) and (c) of this section. If S sells asset 3 for $10 in Year 7 and recognizes an $85 loss, the entire $85 loss is treated as a built-in loss under paragraphs (b)(2)(ii) and (c) of this section (not just the $55 balance of the P subgroup's $65 net unrealized built-in loss).

(e) The determination of whether P and S constitute a SRLY subgroup for purposes of loss carryovers and carrybacks, and the extent to which built-in losses are not allowed under the SRLY limitation, is made under § 1.1502–21T(c).

Example 4. Computation of SRLY limitation. (a) During Year 1, individual A forms T by contributing $300 and T sustains a $100 net operating loss. During Year 2, T's assets decline in value to $100. At the beginning of Year 3, P buys all the stock of T for $100, and T becomes a member of the P group with a net unrealized built-in loss of $100. Assume that $100 exceeds the threshold requirements of section 382(h)(3)(B). During Year 3, T recognizes its unrealized built-in loss as a $100 ordinary loss. The members of the P group contribute the following net income to the consolidated taxable income of the P group (disregarding T's recognized built-in loss and any consolidated net operating loss deduction under § 1.1502–21T) for Years 3 and 4:

	Year 3	Year 4	Total
P group (without T)	$100	$100	$200
T	60	40	100
CTI	160	140	300

(b) Under paragraph (b) of this section, T's $100 ordinary loss in Year 3 (not taken into account in the consolidated taxable income computations above) is a built-in loss. Under paragraph (a) of this section, the built-in loss is treated as a net operating loss carryover for purposes of determining the SRLY limitation under § 1.1502–21T(c).

(c) For Year 3, § 1.1502–21T(c) limits T's $100 built-in loss and $100 net operating loss carryover from Year 1 to the aggregate of the P group's consolidated taxable income through Year 3 determined by reference to only T's items. For this purpose, consolidated taxable income is determined without regard to any consolidated net operating loss deductions under § 1.1502–21T(a).

(d) The P group's consolidated taxable income through Year 3 is $60 when determined by reference to only T's items. Under § 1.1502–21T(c), the SRLY limitation for Year 3 is therefore $60.

(e) Under paragraph (a) of this section, the $100 built-in loss is treated as a current deduction for all purposes other than determination of the SRLY limitation under § 1.1502–21T(c). Consequently, a deduction for the built-in loss is allowed in Year 3 before T's loss carryover from Year 1 is allowed, but only to the extent of the $60 SRLY limitation. None of T's Year 1 loss carryover is allowed because the built-in loss ($100) exceeds the SRLY limitation for Year 3.

(f) The $40 balance of the built-in loss that is not allowed in Year 3 because of the SRLY limitation is treated as a $40 net operating loss arising in Year 3 that is carried to other years in accordance with the rules of § 1.1502–21T(b). The $40 net operating loss is treated under paragraph (a) of this section and § 1.1502–21T(c)(1)(ii) as a loss carryover or carryback from Year 3 that arises in a SRLY, and is subject to the rules of § 1.1502–21T (including § 1.1502–21T(c)) rather than this section.

(g) The facts are the same as in paragraphs (a) through (f) of this *Example 4,* except that T also recognizes additional built-in losses in Year 4. For purposes of determining the SRLY limitation for these additional losses in Year 4 (or any subsequent year), the $60 of built-in loss allowed as a deduction in Year 3 is treated under paragraph (a) of this section as a deduction in Year 3 that reduces the P group's consolidated taxable income when determined by reference to only T's items.

Example 5. Built-in loss exceeding consolidated taxable income in the year recognized. (a) P buys all the stock of T during Year 1, and T becomes a member of the P group. At the time of acquisition, T has a depreciable asset with an unrealized loss of $45 (basis $100, value $55), which exceeds the threshold requirements of section 382(h)(3)(B). During Year 2, T sells its asset for $55 and recognizes the unrealized built-in loss. The P group has $10 of consolidated taxable income in Year 2, computed by disregarding T's recognition of the $45 built-in loss and the consolidated net operating loss deduction, while the consolidated taxable income would be $25 if determined by reference to only T's items (other than the $45 loss).

(b) T's $45 loss is recognized in Year 2 and, under paragraph (b) of this section, constitutes a built-in loss. Under paragraph (a) of this section and § 1.1502–21T(c)(1)(ii), the loss is treated as a net operating loss carryover to Year 2 for purposes of applying the SRLY limitation under §1.1502–21T(c).

(c) For Year 2, T's SRLY limitation is the aggregate of the P group's consolidated taxable income through Year 2 determined by reference to only T's items. For this purpose, consolidated taxable income is determined by disregarding any built-in loss that is treated as a net operating loss carryover, and any consolidated net operating loss deductions under §1.1502–21T(a). Consolidated taxable income so determined is $25.

(d) Under §1.1502–21T(c), $25 of the $45 built-in loss could be deducted in Year 2. Because the P group has only $10 of consolidated taxable income (determined without regard to the $45), the $25 loss creates a consolidated net operating loss of $15. This loss is carried back or over under the rules of §1.1502–21T(b) and absorbed under the rules of §1.1502–21T(a). This loss is not treated as arising in a SRLY (see §1.1502–21T(c)(1)(ii)) and therefore is not subject to the SRLY limitation under §1.1502–21T(c) in any consolidated return year of the group to which it is carried. The remaining $20 is treated as a loss carryover arising in a SRLY and is subject to the limitation of §1.1502–21T(c) in the year to which it is carried.

(e) *Predecessors and successors.* For purposes of this section, any reference to a corporation or member includes, as the context may require, a reference to a successor or predecessor, as defined in §1.1502–1(f)(4).

(f) *Effective date*—(1) *In general.* This section applies to built-in losses recognized in consolidated return years beginning on or after January 1, 1997.

(2) *Application to prior periods.* See §1.1502–21T(g)(3) for rules generally permitting a group to apply the rules of this section to consolidated return years ending on or after January 29, 1991, and beginning before January 1, 1997. A group must treat all corporations that were affiliated on January 1, 1987, and continuously thereafter as having met the 60 consecutive month requirement of paragraph (c)(2) of this section on any day before January 1, 1992, on which the determination of net unrealized built-in gain or loss of a subgroup is made.

[T.D. 8677, 61 FR 33326, June 27, 1996]

§1.1502–16 Mine exploration expenditures.

(a) *Section 617*—(1) *In general.* If the aggregate amount of the expenditures to which section 617(a) applies, paid or incurred with respect to mines or deposits located outside the United States (as defined in section 638 and the regulations thereunder), does not exceed:

(i) $400,000 minus

(ii) All amounts deducted or deferred during the taxable year and all preceding taxable years under section 617 or section 615 of the Internal Revenue Code of 1954 and section 23(ff) of the Internal Revenue Code of 1939 by corporations which are members of the group during the taxable year (and individuals or corporations which have transferred any mineral property to any such member within the meaning of section 617(g)(2)(B)) for taxable years ending after December 31, 1950 and prior to the taxable year, then the deduction under section 617 with respect to such foreign expenditures and paragraph (c) of §1.1502–12 for each member shall be no greater than an allocable portion of such amount hereinafter referred to as the ‘‘consolidated foreign exploration limitation.’’ Such allocable portion shall be determined under subparagraph (2) of this paragraph. If the amount of such expenditures exceeds the consolidated foreign exploration limitation, no deduction shall be allowed with respect to such excess.

(2) *Allocable portion of limitation.* A member's allocable portion of the consolidated foreign exploration limitation for a consolidated return year shall be:

(i) The amount allocated by the common parent pursuant to an allocation plan adopted by the consolidated group, but in no event shall a member be allocated more than the amount it could have deducted had it filed a separate return. Such allocation plan must include a statement which also contains the total foreign exploration expenditures of each member which could have been deducted under section 617 if the member had filed a separate return. Such plan must be attached to a consolidated return filed on or before the due date of such return (including extensions of time), and may not be changed after such date, or

(ii) If no plan is filed in accordance with subdivision (i) of this subparagraph, then the portion of the consolidated foreign exploration limitation allocable to each member incurring such expenditures is an amount equal to such limitation multiplied by a fraction, the numerator of which is the amount of foreign exploration expenditures which could have been deducted under section 617 by such member had it filed a separate return and the denominator of which is the aggregate of such amounts for all members of the group.

(b) *Section 615*—(1) *In general.* If the aggregate amount of the expenditures, to which section 615(a) applies, which are paid or incurred by the members of the group during any consolidated return year exceeds the lesser of:

(i) $100,000, or

(ii) $400,000 minus all such expenditures deducted (or deferred) by corporations which are members of the group during the taxable year (and individuals or corporations which have transferred any mineral property to any such member within the meaning of section 615(c)(2)(B)) for taxable years ending after December 31, 1950, and prior to the taxable year, then the deduction (or amount deferrable) under section 615 and paragraph (c) of § 1.1502–12 for each member shall be no greater than an allocable portion of such lesser amount, hereinafter referred to as the ‘‘consolidated exploration limitation’’. Such allocable portion shall be determined under subparagraph (2) of this paragraph.

(2) *Allocable portion of limitation.* A member’s allocable portion of the consolidated exploration limitation for a consolidated return year shall be:

(i) The amount allocated by the common parent pursuant to an allocation plan adopted by the consolidated group, but in no event shall a member be allocated more than the amount it could have deducted (or deferred) had it filed a separate return. Such allocation plan must include a statement which also contains the total exploration expenditures of each member for the taxable year, and the expenditures of each member which could have been deducted (or deferred) under section 615 if the member had filed a separate return. Such plan must be attached to a consolidated return filed on or before the due date of such return (including extensions of time), and may not be changed after such date, or

(ii) If no plan is filed in accordance with subdivision (i) of this subparagraph, then the portion of the consolidated exploration limitation allocable to each member incurring such expenditures is an amount equal to such limitation multiplied by a fraction, the numerator of which is the amount which could have been deducted (or deferred) under section 615 by such member had it filed a separate return and the denominator of which is the aggregate of such amounts for all members of the group.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). Corporation X and its wholly owned subsidiaries, corporations Y and Z, file a consolidated return for the calendar year 1971. None of the corporations have incurred exploration expenditures described in section 617 in previous years. During 1971, X incurred foreign exploration expenditures of $30,000, Y of $20,000, and Z of $40,000. The amount of foreign exploration expenditures deductible under section 617 for purposes of computing separate taxable income under § 1.1502–12 will be the amount actually expended by each corporation.

Example (2). Assume the same facts as in example (1) except that prior to 1971, X, Y, and Z had deducted (or deferred) under section 615 and 617 a total of $300,000 of exploration expenditures. During 1971, with respect to deposits located outside the United States X incurred exploration expenditures of $25,000, Y of $75,000, and Z of $125,000. The consolidated exploration limitation under paragraph (a) of this section with respect to the foreign deposits (there is no limitation with respect to the domestic expenditures) is $100,000. X may allocate the $100,000 in any manner among the three members, except that X may not be allocated more than $25,000 nor Y more than $75,000, the amount actually expended by X and Y and which they could have deducted had they each filed a separate return. If the allocation is not made in accordance with paragraph (a)(2)(i) of this section, the $100,000 limitation will be allocated under paragraph (a)(2)(ii) of this section as follows:

Corporation	Expenditure	Fraction	Limitation	Allocable portion
X	$25,000	$\frac{25,000}{200,000}$	×$100,000=	$12,500
Y	$75,000	$\frac{75,000}{200,000}$	×$100,000=	$37,500
Z	$125,000	$\frac{100,000}{200,000}$	×$100,000=	$50,000

The denominator of $200,000 was calculated as follows:

X=$25,000
Y=$75,000
Z=$100,000 (maximum amount allowed if filed separately)
Total $200,000.

Example (3). Assume the same facts as in example (2) and that on January 1, 1971, X acquired all of the stock of corporation T which prior to its taxable year beginning January 1, 1971, had previously deducted (or deferred) $310,000 of exploration expenditures. Assume further that in 1971 X incurred $25,000 of foreign exploration expenditures, Y $50,000, T $50,000, and Z none. A consolidated return is filed for 1971. None of the expenditures may be deducted under section 617 since the consolidated exploration limitation is zero. The limitation is zero since the aggregate amount of previously deducted (or deferred) exploration expenditures by the members of the group exceeds $400,000. (The total of such expenditures is $410,000, of which $310,000 is attributable to T and, assuming the allocation of the limitation in example (2) is made under paragraph (a)(2)(ii) of this section, $12,500 is attributable to X, $37,500 to Y, and $50,000 to Z.

Example (4). Assume the same facts as in example (3) except that on December 31, 1971, X sold all of the stock in Z to an unrelated party. The consolidated exploration limitation for 1972 will be $40,000, computed by subtracting from $400,000, the aggregate amount of previously deducted (or deferred) exploration expenditures incurred by the members of the group prior to 1972. (The total of such expenditures is $360,000, of which $12,500 is attributable to X, $37,500 to Y and $310,000 to T.) Amounts previously deducted (or deferred) by Z are not taken into account since it was not a member of the group at any time during 1972. Amounts previously deducted (or deferred) by Z shall be taken into account by it for subsequent separate return years.

[T.D. 7192, 37 FR 12949, June 30, 1972]

§1.1502–17 Methods of accounting.

(a) *General rule.* The method of accounting to be used by each member of the group shall be determined in accordance with the provisions of section 446 as if such member filed a separate return. For treatment of depreciable property after a transfer within the group, see paragraph (g) of §1.1502–12.

(b) *Adjustments required if method of accounting changes*—(1) *General rule.* If a member of a group changes its method of accounting for a consolidated return year, the terms and conditions prescribed by the Commissioner under section 446(e), including section 481(a) where applicable, shall apply to the member. If the requirements of section 481(b) are met because applicable adjustments under section 481(a) are substantial, the increase in tax for any prior year shall be computed upon the basis of a consolidated return or a separate return, whichever was filed for such prior year.

(2) *Changes in method of accounting for intercompany transactions.* If a member changes its method of accounting for intercompany transactions for a consolidated return year, the change in method generally will be effected on a cut-off basis.

(c) *Anti-avoidance rules*—(1) *General rule.* If one member (B) directly or indirectly acquires an activity of another member (S), or undertakes S's activity, with the principal purpose to avail the group of an accounting method that would be unavailable (or would be unavailable without securing consent from the Commissioner) if S and B were treated as divisions of a single corporation, B must use the accounting method for the acquired or undertaken activity determined under paragraph (c)(2) of this section or must secure consent from the Commissioner under applicable administrative procedures to use a different method.

(2) *Treatment as divisions of a single corporation.* B must use the method of accounting that would be required if B acquired the activity from S in a transaction to which section 381 applied. Thus, the principles of section 381 (c)(4) and (c)(5) apply to resolve any conflicts between the accounting methods of S and B, and the acquired or undertaken activity is treated as having the accounting method used by S. Appropriate adjustments are made to treat all acquisitions or undertakings that are part of the same plan or arrangement as a single acquisition or undertaking.

(d) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. Separate return treatment generally. X and its wholly-owned subsidiary Y filed separate returns for their calendar years ending December 31, 1965. During calendar year 1965, X employed an accrual method of accounting, established a reserve for bad debts, and elected under section 171 to amortize bond premiums with respect to its fully taxable bonds. During calendar year 1965, Y employed the cash receipts and disbursements method, used the specific charge-off method with respect to its bad debts, and did not elect to amortize bond premiums under section 171 with respect to its bonds. X and Y filed a consolidated return for 1966. For 1966 X and Y must continue to compute income under their respective methods of accounting (unless a change in method under section 446 is made).

Example 2. Adopting methods. Corporation P is a member of a consolidated group. P provides consulting services to customers under various agreements. For one type of customer, P's agreements require payment only when the contract is completed (payment-on-completion contracts). P uses an overall accrual method of accounting. Accordingly, P takes its income from consulting contracts into account when earned, received, or due, whichever is earlier. With the principal purpose to avoid seeking the consent of the Commissioner to change its method of accounting for the payment-on-completion contracts to the cash method, P forms corporation S, and S begins to render services to those customers subject to the payment-on-completion contracts. P continues to render services to those customers not subject to these contracts.

(b) Under paragraph (c) of this section, S must account for the consulting income under the payment-on-completion contracts on an accrual method rather than adopting the cash method contemplated by P.

Example 3. Changing inventory sub-method. (a) Corporation P is a member of a consolidated group. P operates a manufacturing business that uses dollar-value LIFO, and has built up a substantial LIFO reserve. P has historically manufactured all its inventory and has used one natural business unit pool. P begins purchasing goods identical to its own finished goods from a foreign supplier, and is concerned that it must establish a separate resale pool under § 1.472–8(c). P anticipates that it will begin to purchase, rather than manufacture, a substantial portion of its inventory, resulting in a recapture of most of its LIFO reserve because of decrements in its manufacturing pool. With the principal purpose to avoid the decrements, P forms corporation S in Year 1. S operates as a distributor to nonmembers, and P sells all of its existing inventories to S. S adopts LIFO, and elects dollar-value LIFO with one resale pool. Thereafter, P continues to manufacture and purchase inventory, and to sell it to S for resale to nonmembers. P's intercompany gain from sales to S is taken into account under § 1.1502–13. S maintains its Year 1 base dollar value of inventory so that P will not be required to take its intercompany items (which include the effects of the LIFO reserve recapture) into account.

(b) Under paragraph (c) of this section, S must maintain two pools (manufacturing and resale) to the same extent that P would be required to maintain those pools under § 1.472–8 if it had not formed S.

(e) *Effective dates.* Paragraph (b) of this section applies to changes in method of accounting effective for years beginning on or after July 12, 1995. For changes in method of accounting effective for years beginning before that date, see § 1.1502–17 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995). Paragraphs (c) and (d) apply with respect to acquisitions occurring or activities undertaken in years beginning on or after July 12, 1995.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 8597, 60 FR 36708, July 18, 1995]

§ 1.1502–18 Inventory adjustment.

(a) *Definition of intercompany profit amount.* For purposes of this section, the term ''intercompany profit amount'' for a taxable year means an amount equal to the profits of a corporation (other than those profits which such corporation has elected not to defer pursuant to § 1.1502– 13(c)(3) or which have been taken into account pursuant to §1.1502–13(f)(1)(viii)) arising in transactions with other members of the group with respect to goods which are, at the close of such corporation's taxable year, included in the inventories of any member of the group. See §1.1502–13(c)(2) with respect to the determination of profits. See the last sentence of §1.1502–13(f)(1)(i) for rules for determining which goods are considered to be disposed of outside the group and therefore not included in inventories of members.

(b) *Addition of initial inventory amount to taxable income.* If a corporation:

(1) Is a member of a group filing a consolidated return for the taxable year,

(2) Was a member of such group for its immediately preceding taxable year, and

(3) Filed a separate return for such preceding year,

then the intercompany profit amount of such corporation for such separate return year (hereinafter referred to as the ''initial inventory amount'') shall be added to the income of such corporation for the consolidated return year (or years) in which the goods to which the initial inventory amount is attributable are disposed of outside the group or such corporation becomes a nonmember. Such amount shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

(c) *Recovery of initial inventory amount*—(1) *Unrecovered inventory amount.* The term ''unrecovered inventory amount'' for any consolidated return year means the lesser of:

(i) The intercompany profit amount for such year, or

(ii) The initial inventory amount.

However, if a corporation ceases to be a member of the group during a consolidated return year, its unrecovered inventory amount for such year shall be considered to be zero.

(2) *Recovery during consolidated return years.* (i) To the extent that the unrecovered inventory amount of a corporation for a consolidated return year is less than such amount for its immediately preceding year, such decrease shall be treated for such year by such corporation as a loss from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

(ii) To the extent that the unrecovered inventory amount for a consolidated return year exceeds such amount for the preceding year, such increase shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

(3) *Recovery during first separate return year.* For the first separate return year of a member following a consolidated return year, the unrecovered inventory amount for such consolidated return year (minus any part of the initial inventory amount which has not been added to income pursuant to paragraph (b) of this section) shall be treated as a loss from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

(4) *Acquisition of group.* For purposes of this section, a member of a group shall not become a nonmember or be considered as filing a separate return solely because of a termination of the group (hereinafter referred to as the ''terminating group'') resulting from:

(i) The acquisition by a nonmember corporation of *(a)* the assets of the common parent in a reorganization described in subparagraph (A), (C), or (D) (but only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met) of section 368 (a)(1), or (b) stock of the common parent, or

(ii) The acquisition (in a transaction to which §1.1502–75(d)(3) applies) by a member of *(a)* the assets of a nonmember corporation in a reorganization referred to in subdivision (i) of this subparagraph, or *(b)* stock of a nonmember corporation,

if all the members of the terminating group (other than such common parent if its assets are acquired) immediately before the acquisition are members immediately after the acquisition of another group (hereinafter referred to as the ''succeeding group'') which files a consolidated return for the first taxable year ending after the date of acquisition. The members of the succeeding group shall succeed to any initial inventory amount and to any unrecovered inventory amount of members of the terminating group. This subparagraph shall not apply with respect to acquisitions occurring before August 25, 1971.

(d) *Examples.* The provisions of paragraphs (a), (b), and (c) of this section may be illustrated by the following examples:

Example (1). Corporations P, S, and T report income on the basis of a calendar year. Such corporations file separate returns for 1965. P manufactures widgets which it sells to both S and T, who act as distributors. The inventories of S and T at the close of 1965 are comprised of widgets which they purchased from P and with respect to which P derived profits of $5,000 and $8,000, respectively. P, S, and T file a consolidated return for 1966. During 1966, P sells widgets to S and T with respect to which it derives profits of $7,000 and $10,000, respectively. The inventories of S and T as of December 31, 1966, are comprised of widgets on which P derived net profits of $4,000 and $8,000, respectively. P's initial inventory amount is $13,000, P's intercompany profit amount for 1965 (such $13,000 amount is the profits of P with respect to goods sold to S and T and included in their inventories at the close of 1965). Assuming that S and T identify their goods on a first-in, first-out basis, the entire opening inventory amount of $13,000 is added to P's income for 1966 as gain from the sale or exchange of property which is neither a capital asset nor properly described in section 1231, since the goods to which the initial inventory amount is attributable were disposed of in 1966 outside the group. However, since P's unrecovered inventory amount for 1966, $12,000 (the intercompany profit amount for the year, which is less than the initial inventory amount), is less than the unrecovered inventory amount for 1965, $13,000, this decrease of $1,000 is treated by P for 1966 as a loss from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

Example (2). Assume the same facts as in example (1) and that at the close of 1967, a consolidated return year, the inventories of S and T are comprised of widgets on which P derived profits of $5,000 and $3,000, respectively. Since P's unrecovered inventory amount for 1967, $8,000, is less than $12,000, the unrecovered inventory amount for 1966, this decrease of $4,000 is treated by P for 1967 as a loss from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

Example (3). Assume the same facts as in examples (1) and (2) and that in 1968, a consolidated return year, P's intercompany profit amount is $11,000. P will report $3,000 (the excess of $11,000, P's unrecovered inventory amount for 1968, over $8,000, P's unrecovered inventory amount for 1967) for 1968 as a gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

Example (4). Assume the same facts as in examples (1), (2), and (3) and that in 1969 P, S, and T file separate returns. P will report $11,000 (its unrecovered inventory amount for 1968, $11,000, minus the portion of the initial inventory amount which has not been added to income during 1966, 1967, and 1968, zero) as a loss from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

Example (5). Corporations P and S file a consolidated return for the first time for the calendar year 1966. P manufactures machines and sells them to S, which sells them to users throughout the country. At the close of 1965, S has on hand 20 machines which it purchased from P and with respect to which P derived profits of $3,500. During 1966, P sells 6 machines to S on which it derives profits of $1,300, and S sells 5 machines which it had on hand at the beginning of the year (S specifically identifies the machines which it sells) and on which P had derived profits of $900. P's initial inventory amount is $3,500, of which $900 is added to P's income in 1966 as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231, since such $900 amount is attributable to goods disposed of in 1966 outside the group, which goods were included in S's inventory at the close of 1965. If P and S continue to file consolidated returns, the remaining $2,600 of the initial inventory amount will be added to P's income as the machines on which such profits were derived are disposed of outside the group.

Example (6). Assume that in example (5) S had elected to inventory its goods under section 472 (relating to last-in, first-out inventories). None of P's initial inventory amount of $3,500 would be added to P's income in 1966, since none of the goods to which such amount is attributable would be considered to be disposed of during such year under the last-in, first-out method of identifying inventories.

(e) *Section 381 transfer.* If a member of the group is a transferor or distributor of assets to another member of the group within the meaning of section 381(a), then the acquiring corporation shall be treated as succeeding to the initial inventory amount of the transferor or distributor corporation to the extent that as of the date of distribution or transfer such amount has not yet been added to income. Such amount shall then be added to the acquiring corporation's income under the provisions of paragraph (b) of this section. For purposes of applying paragraph (c) of this section:

(1) The initial inventory amount of the transferor or distributor corporation shall be added to such amount of the acquiring corporation as of the close of the acquiring corporation's taxable year in which the date of distribution or transfer occurs, and

(2) The unrecovered inventory amount of the transferor or distributor corporation for its taxable year preceding the taxable year of the group in which the date of distribution or transfer occurs shall be added to such amount of the acquiring corporation.

(f) *Transitional rules for years before 1966*—(1) *In general.* If:

(i) A group filed a consolidated return for the taxable year immediately preceding the first taxable year to which this section applies,

(ii) Any member of such group made an opening adjustment to its inventory pursuant to paragraph (b) of §1.1502–39A (as contained in the 26 CFR edition revised as of April 1, 1996), and

(iii) Paragraph (c) of §1.1502–39A (as contained in the 26 CFR edition revised as of April 1, 1996), has not been applicable for any taxable year subsequent to the taxable year for which such adjustment was made,

then subparagraphs (2) and (3) of this paragraph shall apply.

(2) *Closing adjustment to inventory.* (i) For the first consolidated return year to which this section applies, the increase in inventory prescribed in paragraph (c) of §1.1502–39A (as contained in the 26 CFR edition revised as of April 1, 1996), shall be made as if such year were a separate return year.

(ii) For the first separate return year of a member to which this section applies, the adjustment to inventory (whether an increase or a decrease) prescribed in paragraph (c) of §1.1502–39A (as contained in the 26 CFR edition revised as of April 1, 1996), minus any adjustment already made pursuant to subdivision (i) of this subparagraph, shall be made to the inventory of such member.

(3) *Addition and recovery of initial inventory amount.* Each selling member shall treat as an initial inventory amount its share of the net amount by which the inventories of all members are increased pursuant to subparagraph (2)(i) of this paragraph for the first taxable year to which this section applies. A member's share shall be such net amount multiplied by a fraction, the numerator of which is its initial inventory amount (computed under paragraph (b) as if such taxable year were its first consolidated return year), and the denominator of which is the sum of such initial inventory amounts of all members. Such initial inventory amount shall be added to the income of such selling member and shall be recovered at the time and in the manner prescribed in paragraphs (b) and (c) of this section.

(4) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. (i) Corporations P, S, and T file consolidated returns for calendar 1966, having filed consolidated returns continuously since 1962. P is a wholesale distributor of groceries selling to chains of supermarkets, including those owned by S and T. The opening inventories of S and T for 1962 were reduced by $40,000 and $80,000, respectively, pursuant to paragraph (b) of §1.1502–39A (as contained in the 26 CFR edition revised as of April 1, 1996). At the close of 1965, S and T have on hand in their inventories goods on which P derived profits of $80,000 and $90,000, respectively. The inventories of S and T at the close of 1966 include goods which they purchased from P during the year on which P derived profits of $85,000 and $105,000, respectively.

(ii) The opening inventories of S and T for 1966, the first year to which this section applies, are increased by $40,000 and $80,000, respectively, pursuant to the provisions of subparagraph (2)(i) of this paragraph. P will take into account (as provided in paragraphs (b) and (c) of this section) an initial inventory amount of $120,000 as of the beginning of 1966, the net amount by which the inventories of S and T were increased in such year. Since the increases in the inventories of S and T are the maximum allowable under paragraph (c) of §1.1502–39A (as contained in the 26 CFR edition revised as of April 1, 1996) (i.e., the amount by which such inventories were originally decreased), no further adjustments will be made pursuant to subparagraph (2)(ii) of this paragraph to such inventories in the event that separate returns are subsequently filed.

(5) *Election not to eliminate.* If a group filed a consolidated return for the taxable year immediately preceding the

first taxable year to which this section applies, and for such preceding year the members of the group did not eliminate gain or loss on intercompany inventory transactions pursuant to the adoption under § 1.1502–31A(b)(1) (as contained in the 26 CFR edition revised as of April 1, 1996) of a consistent accounting practice taking into account such gain or loss, then for purposes of this section each member shall be treated as if it had filed a separate return for such immediately preceding year.

(g) *Transitional rules for years beginning on or after July 12, 1995.* Paragraphs (a) through (f) of this section do not apply for taxable years beginning on or after July 12, 1995. Any remaining unrecovered inventory amount of a member under paragraph (c) of this section is recovered in the first taxable year beginning on or after July 12, 1995, under the principles of paragraph (c)(3) of this section by treating the first taxable year as the first separate return year of the member. The unrecovered inventory amount can be recovered only to the extent it was previously included in taxable income. The principles of this section apply, with appropriate adjustments, to comparable amounts under paragraph (f) of this section.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 7246, 38 FR 762, Jan. 4, 1973; T.D. 8597, 60 FR 36709, July 18, 1995: T.D. 8677, 61 FR 33323, June 27, 1996]

§ 1.1502–19 Excess loss accounts.

(a) *In general*—(1) *Purpose.* This section provides rules for a member (P) to include in income its excess loss account in the stock of another member (S). The purpose of the excess loss account is to recapture in consolidated taxable income P's negative adjustments with respect to S's stock (e.g., under § 1.1502–32 from S's deductions, losses, and distributions), to the extent the negative adjustments exceed P's basis in the stock.

(2) *Excess loss accounts*—(i) *In general.* P's basis in S's stock is adjusted under the consolidated return regulations and other rules of law. Negative adjustments may exceed P's basis in S's stock. The resulting negative amount is P's excess loss account in S's stock. For example:

(A) Once P's negative adjustments under § 1.1502–32 exceed its basis in S's stock, the excess is P's excess loss account in the S stock. If P has further adjustments, they first increase or decrease the excess loss account.

(B) If P forms S by transferring property subject to liabilities in excess of basis, § 1.1502–80(d) provides for the nonapplicability of section 357(c) and the resulting negative basis under section 358 is P's excess loss account in the S stock.

(ii) *Treatment as negative basis.* P's excess loss account is treated for all Federal income tax purposes as basis that is a negative amount, and a reference to P's basis in S's stock includes a reference to P's excess loss account.

(3) *Application of other rules of law.* The rules of this section are in addition to other rules of law. See, e.g., §§ 1.1502–32 (investment adjustment rules establishing and adjusting excess loss accounts) and 1.1502–80(d) (nonapplicability of section 357(c)). The provisions of this section and other rules of law must not be applied to recapture the same amount more than once. For purposes of this section, the definitions in § 1.1502–32 apply.

(b) *Excess loss account taken into account as income or gain*—(1) *General rule.* If P is treated under this section as disposing of a share of S's stock, P takes into account its excess loss account in the share as income or gain from the disposition. Except as provided in paragraph (b)(4) of this section, the disposition is treated as a sale or exchange for purposes of determining the character of the income or gain.

(2) *Nonrecognition or deferral*—(i) *In general.* P's income or gain under paragraph (b)(1) of this section is subject to any nonrecognition or deferral rules applicable to the disposition. For example, if S liquidates and the exchange of P's stock in S is subject to section 332, or P transfers all of its assets (including S's stock) to S in a reorganization to which section 361(a) applies, P's income or gain from the excess loss account is not recognized under these rules.

(ii) *Nonrecognition or deferral inapplicable.* If P's income or gain under paragraph (b)(1) of this section is from a disposition described in paragraph (c)(1) (ii) or (iii) of this section (relating to deconsolidations and worthlessness), the income or gain is taken into account notwithstanding any nonrecognition or deferral rules (even if the disposition is also described in paragraph (c)(1)(i) of this section). For example, if P transfers S's stock to a nonmember in a transaction to which section 351 applies, P's income or gain from the excess loss account is taken into account.

(3) *Tiering up in chains.* If the stock of more than one subsidiary is disposed of in the same transaction, the income or gain under this section is taken into account in the order of the tiers, from the lowest to the highest.

(4) *Insolvency*—(i) *In general.* Gain under this section is treated as ordinary income to the extent of the amount by which S is insolvent (within the meaning of section 108(d)(3)) immediately before the disposition. For this purpose S's liabilities include any amount to which preferred stock would be entitled if S were liquidated immediately before the disposition, and any former liabilities that were discharged to the extent the discharge was treated as tax-exempt income under §1.1502–32(b)(3)(ii)(C) (special rule for discharges).

(ii) *Reduction for amount of distributions.* The amount treated as ordinary income under this paragraph (b)(4) is reduced to the extent it exceeds the amount of P's excess loss account redetermined without taking into account S's distributions to P to which §1.1502–32(b)(2)(iv) applies.

(c) *Disposition of stock.* For purposes of this section:

(1) *In general.* P is treated as disposing of a share of S's stock:

(i) *Transfer, cancellation, etc.* At the time—

(A) P transfers or otherwise ceases to own the share for Federal income tax purposes, even if no gain or loss is taken into account; or

(B) P takes into account gain or loss (in whole or in part) with respect to the share.

(ii) *Deconsolidation.* At the time—

(A) P becomes a nonmember, or a nonmember determines its basis in the share (or any other asset) by reference to P's basis in the share, directly or indirectly, in whole or in part (e.g., under section 362); or

(B) S becomes a nonmember, or P's basis in the share is reflected, directly or indirectly, in whole or in part, in the basis of any asset other than member stock (e.g., under section 1071).

(iii) *Worthlessness.* At the time—

(A) Substantially all of S's assets are treated as disposed of, abandoned, or destroyed for Federal income tax purposes (e.g., under section 165(a) or §1.1502–80(c), or, if S's asset is stock of a lower-tier member, the stock is treated as disposed of under this paragraph (c)). An asset of S is not considered to be disposed of or abandoned to the extent the disposition is in complete liquidation of S or is in exchange for consideration (other than relief from indebtedness);

(B) An indebtedness of S is discharged, if any part of the amount discharged is not included in gross income and is not treated as tax-exempt income under §1.1502–32(b)(3)(ii)(C); or

(C) A member takes into account a deduction or loss for the uncollectibility of an indebtedness of S, and the deduction or loss is not matched in the same tax year by S's taking into account a corresponding amount of income or gain from the indebtedness in determining consolidated taxable income.

(2) *Becoming a nonmember.* A member is treated as becoming a nonmember if it has a separate return year (including another group's consolidated return year). For example, S may become a nonmember if it issues additional stock to nonmembers, but S does not become a nonmember as a result of its complete liquidation. A disposition under paragraph (c)(1)(ii) of this section must be taken into account in the consolidated return of the group. For example, if a group ceases under §1.1502–75(c) to file a consolidated return as of the close of its consolidated return year, the disposition under paragraph (c)(1)(ii) of this section is treated as occurring immediately before the close of the year. If S becomes a nonmember because P sells S's stock to a nonmember, P's sale is a disposition under both paragraphs (c)(1) (i) and (ii) of this section. If a group terminates under §1.1502–75(d) because the

common parent is the only remaining member, the common parent is not treated as having a deconsolidation event under paragraph (c)(1)(ii) of this section.

(3) *Exception for acquisition of group*—(i) *Application.* This paragraph (c)(3) applies only if a consolidated group (the terminating group) ceases to exist as a result of—

(A) The acquisition by a member of another consolidated group of either the assets of the common parent of the terminating group in a reorganization described in section 381(a)(2), or the stock of the common parent of the terminating group; or

(B) The application of the principles of § 1.1502–75(d)(2) or (d)(3).

(ii) *General rule.* Paragraph (c)(1)(ii) of this section does not apply solely by reason of the termination of a group in a transaction to which this paragraph (c)(3) applies, if there is a surviving group that is, immediately thereafter, a consolidated group. Instead, the surviving group is treated as the terminating group for purposes of applying this section to the terminating group. This treatment does not apply, however, to members of the terminating group that are not members of the surviving group immediately after the terminating group ceases to exist (e.g., under section 1504(a)(3) relating to reconsolidation, or section 1504(c) relating to includible insurance companies).

(d) *Special allocation of basis adjustments or determinations.* If a member has an excess loss account in shares of a class of S's stock at the time of a basis adjustment or determination under the Internal Revenue Code with respect to other shares of the same class of S's stock owned by the member, the adjustment or determination is allocated first to equalize and eliminate that member's excess loss account. For example, if P owns 50 shares of S's only class of stock with a $100 basis and 50 shares with a $100 excess loss account, and P contributes $200 to S without receiving additional shares, the contribution first eliminates P's excess loss account, then increases P's basis in each share by $1. (If P transfers the $200 in exchange for an additional 100 shares of S's stock in a transaction to which section 351 applies, P's excess loss account is first eliminated, and P's basis in the additional shares is $100.) See § 1.1502–32(c) for similar allocations of investment adjustments to prevent or eliminate excess loss accounts.

(e) *Anti-avoidance rule.* If any person acts with a principal purpose contrary to the purposes of this section, to avoid the effect of the rules of this section or apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section.

(f) *Predecessors and successors.* For purposes of this section, any reference to a corporation (or to a share of the corporation's stock) includes a reference to a successor or predecessor (or to a share of stock of a predecessor or successor), as the context may require.

(g) *Examples.* For purposes of the examples in this section, unless otherwise stated, P owns all 100 shares of the only class of S's stock and S owns all 100 shares of the only class of T's stock, the stock is owned for the entire year, T owns no stock of lower-tier members, the tax year of all persons is the calendar year, all persons use the accrual method of accounting, the facts set forth the only corporate activity, all transactions are between unrelated persons, and tax liabilities are disregarded. The principles of this section are illustrated by the following examples.

Example 1. Taxable disposition of stock. (a) *Facts.* P has a $150 basis in S's stock, and S has a $100 basis in T's stock. For Year 1, P has $500 of ordinary income, S has no income or loss, and T has a $200 ordinary loss. S sells T's stock to a nonmember for $60 at the close of Year 1.

(b) *Analysis.* Under paragraph (c) of this section, the sale is a disposition of T's stock at the close of Year 1 (the day of the sale). Under § 1.1502–32(b), T's loss results in S having a $100 excess loss account in T's stock immediately before the sale. Under paragraph (b)(1) of this section, S takes into account the $100 excess loss account as an additional $100 of gain from the sale. Consequently, S takes into account a $160 gain from the sale in determining the group's consolidated taxable income. Under § 1.1502–32(b), T's $200 loss and S's $160 gain result in a net $40 decrease in P's basis in S's stock as of the close of Year 1, from $150 to $110.

(c) *Intercompany sale followed by sale to nonmember.* The facts are the same as in paragraph (a) of this *Example 1*, except that S sells T's stock to P for $60 at the close of Year 1, and P sells T's stock to a nonmember at a gain at the beginning of Year 5. Under paragraph (c) of this section, S's sale is treated as a disposition of T's stock at the close of Year 1 (the day of the sale). Under §1.1502–13 and paragraph (b)(2) of this section, S's $160 gain from the sale is deferred and taken into account in Year 5 as a result of P's sale of the T stock. Under §1.1502–32(b), the absorption of T's $200 loss in Year 1 results in P having a $50 excess loss account in S's stock at the close of Year 1. In Year 5, S's $160 gain taken into account eliminates P's excess loss account in S's stock and increases P's basis in the stock to $110.

(d) *Intercompany distribution followed by sale to a nonmember.* The facts are the same as in paragraph (a) of this *Example 1*, except that the value of the T stock is $60 and S declares and distributes a dividend of all of the T stock to P at the close of Year 1, and P sells the T stock to a nonmember at a gain at the beginning of Year 5. Under paragraph (c) of this section, S's distribution is treated as a disposition of T's stock at the close of Year 1 (the day of the distribution). S's $100 excess loss account in T's stock is treated as additional gain under section 311(b) from the distribution. Under section 301(d), P's basis in the T stock is $60. Under §1.1502–13, and paragraph (b)(2) of this section, S's $160 gain from the distribution is deferred and taken into account in Year 5 as a result of P's sale of the T stock. Under §1.1502–32(b), T's $200 loss and S's $60 distribution result in P having a $110 excess loss account in S's stock at the close of Year 1. In Year 5, S's $160 gain taken into account eliminates P's excess loss account in S's stock and increases P's basis in the stock to $50.

Example 2. Basis determinations under the Internal Revenue Code in intercompany reorganizations. (a) *Facts.* P owns all of the stock of S and T. P has a $150 basis in S's stock and a $100 excess loss account in T's stock. P transfers T's stock to S without receiving additional S stock, in a transaction to which section 351 applies.

(b) *Analysis.* Under paragraph (c) of this section, P's transfer is treated as a disposition of T's stock. Under section 351 and paragraph (b)(2) of this section, P does not recognize gain from the disposition. Under section 358 and paragraph (a)(2)(ii) of this section, P's $100 excess loss account in T's stock decreases P's $150 basis in S's stock to $50. In addition, S takes a $100 excess loss account in T's stock under section 362. (If P had received additional S stock, paragraph (d) of this section would not apply to shift basis from P's original S stock because the basis of the original stock is not adjusted or determined as a result of the contribution; but paragraph (d) would apply to shift basis if P had transferred S's stock to T in exchange for additional T stock, because the basis of the additional T stock would be determined when P has an excess loss account in its original T stock.)

(c) *Intercompany merger.* The facts are the same as in paragraph (a) of this *Example 2*, except that T merges into S in a reorganization described in section 368(a)(1)(A) (and in section 368(a)(1)(D)), and P receives no additional S stock in the reorganization. Under section 354 and paragraph (b)(2) of this section, P does not recognize gain. Under section 358 and paragraph (a)(2)(ii) of this section, P's $100 excess loss account in T's stock decreases P's $150 basis in the S stock to $50. (Similarly, if S merges into T and P does not receive additional T stock, P's $150 basis in S's stock eliminates P's excess loss account in T's stock, and increases P's basis in T's stock to $50.)

(d) *Liquidation of only subsidiary.* Assume instead that P and S are the only members of the P group, P has a $100 excess loss account in S's stock, and S liquidates in a transaction to which section 332 applies. Under paragraph (c)(2) of this section, the liquidation is not a deconsolidation event under paragraph (c)(1)(ii) of this section merely because P is the only remaining member. Under section 332 and paragraph (b)(2) of this section, P does not recognize gain. Under section 334(b), P succeeds to S's basis in the assets it receives from S in the liquidation. (P would also not recognize gain if P transferred all of its assets (including S's stock) to S in a reorganization to which section 361(a) applied, because S would be a successor to P under paragraph (f) of this section.)

Example 3. Section 355 distribution of stock with an excess loss account. (a) *Facts.* P has a $30 excess loss account in S's stock, and S has a $90 excess loss account in T's stock. S distributes the T stock to P in a transaction to which section 355 applies, and neither P nor S recognizes any gain or loss. At the time of the distribution, the T stock represents 33% of the value of the S stock. Following the distribution, P's basis in the S stock is allocated under §1.358–2 in proportion to the fair market values of the S stock and the T stock.

(b) *Analysis.* Under paragraph (c) of this section, S's distribution of the T stock is treated as a disposition. Under section 355(c) and paragraph (b)(2) of this section, S does not recognize any gain from the distribution. Under section 358, S's excess loss account in the T stock is eliminated, and P's $30 excess loss account in the S stock is treated as basis allocated between the S stock and the T stock based on their relative values. Consequently, P has a $20 excess loss account in the S stock and a $10 excess loss account in the T stock. (If P had a $30 basis rather than a $30 excess loss account in the S stock, S would not recognize gain, its excess loss account in the T stock would be eliminated, and P's basis in the stock of S and T would be $20 and $10, respectively.)

(c) *Section 355 distribution to nonmember.* The facts are the same as in paragraph (a) of this *Example 3,* except that P also distributes the T stock to its shareholders in a transaction to which section 355 applies. Under paragraph (c) of this section, P's distribution is treated as a disposition of T's stock. Under paragraph (b)(2) of this section, because P's disposition is described in paragraph (c)(1)(ii) of this section, P's $10 excess loss account in the T stock must be taken into account at the time of the distribution, notwithstanding the nonrecognition rules of section 355(c).

Example 4. Deconsolidation of a member. (a) *Facts.* P has a $50 excess loss account in S's stock, and S has a $100 excess loss account in T's stock. T issues additional stock to a nonmember and, as a consequence, T becomes a nonmember.

(b) *Analysis.* Under paragraph (c)(2) of this section, S is treated as disposing of each of its shares of T's stock immediately before T becomes a nonmember. Under paragraph (b)(1) of this section, S takes into account its $100 excess loss account as gain from the sale or exchange of T's stock. Under § 1.1502–32(b) of this section, S's $100 gain eliminates P's excess loss account in S's stock and increases P's basis in S's stock to $50.

(c) *Deconsolidation of a higher-tier member.* The facts are the same as in paragraph (a) of this *Example 4,* except that S (rather than T) issues the stock and, as a consequence, both S and T become nonmembers. Under paragraph (c)(2) of this section, P is treated as disposing of S's stock and S is treated as disposing of T's stock immediately before S and T become nonmembers. Under § 1.1502–32(b) and paragraph (b)(3) of this section, because S and T become nonmembers in the same transaction and T is the lower-tier member, S is first treated under paragraph (b)(1) of this section as taking into account its $100 excess loss account as gain from the sale or exchange of T's stock. Under § 1.1502–32(b), S's $100 gain eliminates P's excess loss account in S's stock and increases P's basis in S's stock to $50 immediately before S becomes a nonmember. Thus, only S's $100 gain is taken into account in the determination of the group's consolidated taxable income.

(d) *Intercompany gain and deconsolidation.* The facts are the same as in paragraph (c) of this *Example 4,* except that T has $30 of gain that is deferred under § 1.1502–13 and taken into account in determining consolidated taxable income immediately before T becomes a nonmember. Under § 1.1502–32(b), T's $30 gain decreases S's excess loss account in T's stock from $100 to $70 immediately before S is treated as disposing of T's stock. Under paragraph (b)(1) of this section, S is treated as taking into account its $70 excess loss account as gain from the disposition of T's stock. Under § 1.1502–32(b), S's $70 gain from the excess loss account and T's $30 deferred gain that is taken into account eliminate P's $50 excess loss account in S's stock and increase P's basis in S's stock to $50 immediately before S becomes a nonmember.

Example 5. Worthlessness. (a) *Facts.* P forms S with a $150 contribution, and S borrows $150. For Year 1, S has a $50 ordinary loss that is carried over as part of the group's consolidated net operating loss. For Year 2, P has $160 of ordinary income, and S has a $160 ordinary loss. Under § 1.1502–32(b), S's loss results in P having a $10 excess loss account in S's stock. During Year 3, the value of S's assets (without taking S's liabilities into account) continues to decline and S's stock becomes worthless within the meaning of section 165(g) (without taking into account § 1.1502–80(c)). For Year 4, S has $10 of ordinary income.

(b) *Analysis.* Under paragraph (c)(1)(iii)(A) of this section, P is not treated as disposing of S's stock in Year 3 solely because S's stock becomes worthless within the meaning of section 165(g) (taking S's liabilities into account). In addition, because S's stock is not treated as worthless, section 382(g)(4)(D) does not prevent the Year 1 consolidated net operating loss carryover from offsetting S's $10 of income in Year 4.

(c) *Discharge of indebtedness.* The facts are the same as in paragraph (a) of this *Example 5,* except that, instead of S's stock becoming worthless within the meaning of section 165(g), S's creditor discharges $40 of S's indebtedness during Year 3, S is insolvent by more than $40 before the discharge, the discharge is excluded from the P group's gross income under section 108(a), and $40 of the $50 consolidated net operating loss carryover attributable to S is eliminated under section 108(b). Under § 1.1502- 32(b)(3)(ii)(C), S's $40 of discharge income is treated as tax-exempt income because there is a corresponding decrease under § 1.1502–32(b)(3)(iii) for elimination of the loss carryover. Under paragraph (c)(1)(iii)(B) of this section, P is treated as disposing of S's stock if the amount discharged is not included in gross income and is not treated as tax-exempt income under § 1.1502–32(b)(3)(ii)(C). Because the discharge is treated as tax-exempt income, P is not treated as disposing of S's stock by reason of the discharge.

Example 6. Avoiding worthlessness. (a) *Facts.* P forms S with a $100 contribution and S borrows $150. For Years 1 through 5, S has a $210 ordinary loss that is absorbed by the group. Under § 1.1502–32(b), S's loss results in P having a $110 excess loss account in S's stock. S defaults on the indebtedness, but the creditor does not discharge the debt (or initiate collection procedures). At the beginning of

Year 6, S ceases any substantial operations with respect to the assets, but maintains their ownership with a principal purpose to avoid P's taking into account its excess loss account in S's stock.

(b) *Analysis.* Under paragraph (c)(1)(iii)(A) of this section, P's excess loss account on each of its shares of S's stock ordinarily is taken into account at the time substantially all of S's assets are treated as disposed of, abandoned, or destroyed for Federal income tax purposes. Under paragraph (e) of this section, however, S's assets are not taken into account at the beginning of Year 6 for purposes of applying paragraph (c)(1)(iii)(A) of this section. Consequently, S is treated as worthless at the beginning of Year 6, and P's $110 excess loss account is taken into account.

(h) *Effective date*—(1) *Application.* This section applies with respect to determinations of the basis of (including an excess loss account in) the stock of a member in consolidated return years beginning on or after January 1, 1995. If this section applies, basis (and excess loss accounts) must be determined or redetermined as if this section were in effect for all years (including, for example, the consolidated return years of another consolidated group to the extent adjustments during those consolidated return years are still reflected). Any such determination or redetermination does not, however, affect any prior period.

(2) *Dispositions of stock before effective date*—(i) *In general.* If P was treated as disposing of stock of S in a tax year beginning before January 1, 1995 (including, for example, a deemed disposition because S was worthless) under the rules of this section then in effect, the amount of P's income, gain, deduction, or loss, and the stock basis reflected in that amount, are not redetermined under paragraph (h)(1) of this section. See paragraph (h)(3) of this section for the applicable rules.

(ii) *Intercompany amounts.* For purposes of this paragraph (h)(2), a disposition does not include a transaction to which §1.1502–13, §1.1502–13T, §1.1502–14, or §1.1502–14T applies. Instead, the transaction is deemed to occur as the income, gain, deduction, or loss (if any) is taken into account.

(3) *Prior law.* For prior determinations, see prior regulations under section 1502 as in effect with respect to the determination. See, e.g., §1.1502–19 as contained in the 26 CFR part 1 edition revised as of April 1, 1994.

[T.D. 8560, 59 FR 41677, Aug. 15, 1994, as amended by T.D. 8597, 62 FR 12097, Mar. 14, 1997]

§1.1502–20 Disposition or deconsolidation of subsidiary stock.

(a) *Loss disallowance*—(1) *General rule.* No deduction is allowed for any loss recognized by a member with respect to the disposition of stock of a subsidiary. See also §§1.1502–11(c) (stock losses attributable to certain pre-1966 distributions) and 1.1502–80(c) (deferring the treatment of stock of members as worthless under section 165(g)).

(2) *Disposition. Disposition* means any event in which gain or loss is recognized, in whole or in part.

(3) *Coordination with loss deferral and other disallowance rules*—(i) *In general.* Loss with respect to the stock of a subsidiary may be deferred or disallowed under other applicable provisions of the Code and regulations, including section 267(f). Paragraph (a)(1) of this section does not apply to loss that is disallowed under any other provision. If loss is deferred under any other provision, paragraph (a)(1) of this section applies when the loss is taken into account. However, if an overriding event described in paragraph (a)(3)(ii) of this section occurs before the deferred loss is taken into account, paragraph (a)(1) of this section applies to the loss immediately before the event occurs even though the loss may not be taken into account until a later time. Any loss not disallowed under paragraph (a)(1) of this section is subject to disallowance or deferral under other applicable provisions of the Code and regulations.

(ii) *Overriding events.* For purposes of paragraph (a)(3)(i) of this section, the following are overriding events:

(A) The stock ceases to be owned by a member of the consolidated group.

(B) The stock is canceled or redeemed (regardless of whether it is retired or held as treasury stock).

(C) The stock is treated as disposed of under §1.1502–19(c)(1)(ii)(B) or (c)(1)(iii).

(4) *Netting.* Paragraph (a) (1) of this section does not apply to loss with respect to the disposition of stock of a

subsidiary, to the extent that, as a consequence of the same plan or arrangement, gain is taken into account by members with respect to stock of the same subsidiary having the same material terms. If the gain to which this paragraph (a)(4) applies is less than the amount of the loss with respect to the disposition of the subsidiary's stock, the gain is applied to offset loss with respect to each share disposed of as a consequence of the same plan or arrangement in proportion to the amount of the loss deduction that would have been disallowed under paragraph (a)(1) of this section with respect to such share before the application of this paragraph (a)(4). If the same item of gain could be taken into account more than once in limiting the application of paragraphs (a)(1) and (b)(1) of this section, the item is taken into account only once.

(5) *Examples.* For purposes of the examples in this section, unless otherwise stated, all corporations have only one class of stock outstanding, all groups file consolidated returns on a calendar-year basis, the facts set forth the only corporate activity, all transactions are between unrelated persons, and tax liabilities are disregarded. The basis of each asset is the same for determining earnings and profits adjustments and taxable income. References to the investment adjustment system are references to the rules of §§ 1.1502–19, 1.1502–32 and 1.1502–33. The principles of this paragraph (a) are illustrated by the following examples.

Example 1. Loss attributable to recognized built-it gain. P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases to $200. Five years later, P sells all the T stock for $100 and recognizes a loss of $100. Under paragraph (a)(1) of this section, no deduction is allowed to P for the $100 loss.

Example 2. Effect of post-acquisition appreciation. P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases to $200. T reinvests the proceeds of the sale in an asset that appreciates in value to $180. Five years after the sale, P sells all the stock of T for $180 and recognizes a $20 loss. Under paragraph (a)(1) of this section, no deduction is allowed to P for the $20 loss.

Example 3. Disallowance of duplicated loss. P forms S with a contribution of $100 in exchange for all of the S stock, and S becomes a member of the P group. S has an operating loss of $60. The group is unable to use the loss, and the loss becomes a consolidated net operating loss carryover attributable to S. Five years later, P sells the stock of S for $40, recognizing a $60 loss. Under paragraph (a)(1) of this section, P's $60 loss on the sale of the S stock is disallowed. (See paragraph (g) of this section for the elective reattribution of S's $60 net operating loss to P in connection with the sale.)

Example 4. Deemed asset sale election. (i) P forms S with a contribution of $100 in exchange for all of the S stock, and S becomes a member of the P group. S buys an asset for $100, and the value of the asset declines to $40. P sells all the S stock to P1 for $40. Under paragraph (a)(1) of this section, P's $60 loss on the sale of the S stock is disallowed.

(ii) If P and P1 instead elect deemed asset sale treatment under section 338 (h) (10), S is treated as selling all of its assets, and no loss is recognized by P on its sale of the S stock. As a result of the recharacterization of the stock sale as an asset sale, the $60 loss in the asset is recognized. Under section 338 (h)(10), S's $60 loss is included in the consolidated return of the P group, and S is treated as liquidating into P under section 332 following the deemed asset sale. Paragraph (a)(1) of this section does not apply to S's $60 loss.

Example 5. Gain and loss recognized with respect to stock as a consequence of the same plan or arrangement. P, the common parent of a group, owns 50 shares of the stock of T with an aggregate basis of $50, and S, a wholly owned subsidiary of P, owns the remaining 50 shares of T's stock with an aggregate basis of $100. All of the stock has the same terms. P and S sell all the T stock to the public for $140 pursuant to a single public offering. P therefore recognizes a gain of $20 and S recognizes a loss of $30. For purposes of paragraph (a)(4) of this section, the gain and loss recognized by P and S is considered to be a consequence of the same plan or arrangement. Accordingly, the amount of S's $30 loss disallowed under paragraph (a)(1) of this section is limited to $10 (the $30 reduced by P's $20 gain).

Example 6. Deferred loss and recognized gain. (i) P is the common parent of a consolidated group, S is a wholly owned subsidiary of P, and T is a recently purchased, wholly owned subsidiary of S. S has a $100 basis in the T stock, and T has an asset with a basis of $40 and a value of $100. T sells the asset for $100, recognizing a $60 gain. Under the investment adjustment system, S's basis in the T stock increases from $100 to $160. S sells its T stock to P for $100 in an intercompany transaction, recognizing a $60 intercompany loss that is deferred under section 267(f) and §1.1502–13. P subsequently sells all the stock of T for $100 to X, a member of the same controlled group (as defined in section 267(f)) as P but not a member of the P consolidated group.

(ii) Under paragraph (a)(3)(i) of this section, the application of paragraph (a)(1) of this section to S's $60 intercompany loss on the sale of its T stock to P is deferred, because S's intercompany loss is deferred under section 267(f) and §1.1502–13. P's sale of the T stock to X ordinarily would result in S's intercompany loss being taken into account under the matching rule of §1.1502–13(c). The deferred loss is not taken into account under §1.267(f)–1, however, because P's sale to X (a member of the same controlled group as P) is a second intercompany transaction for purposes of section 267(f). Nevertheless, paragraph (a)(3)(ii) of this section provides that paragraph (a)(1) of this section applies to the intercompany loss as a result of P's sale to X because the T stock ceases to be owned by a member of the P consolidated group. Thus, the loss is disallowed under paragraph (a)(1) of this section immediately before P's sale and is therefore never taken into account under section 267(f).

(iii) The facts are the same as in (i) of this *Example,* except that S is liquidated after its sale of the T stock to P, but before P's sale of the T stock to X, and P sells the T stock to X for $110. Under §§1.1502–13(j) and 1.267(f)–1(b), P succeeds to S's intercompany loss as a result of S's liquidation. Thus, paragraph (a)(3)(i) of this section continues to defer the application of paragraph (a)(1) of this section until P's sale to X. Under paragraph (a)(4) of this section, the amount of S's $60 intercompany loss disallowed under paragraph (a)(1) of this section is limited to $50 because P's $10 gain on the disposition of the T stock is taken into account as a consequence of the same plan or arrangement.

(iv) The facts are the same as in (i) of this *Example,* except that P sells the T stock to A, a person related to P within the meaning of section 267(b)(2). Although S's intercompany loss is ordinarily taken into account under the matching rule of §1.1502–13(c) as a result of P's sale, §1.267(f)–1(c)(2)(ii) provides that none of the intercompany loss is taken into account because A is a nonmember that is related to P under section 267(b). Under paragraph (a)(3)(i) of this section, paragraph (a)(1) of this section does not apply to loss that is disallowed under any other provision. Because §1.267(f)–1(c)(2)(ii) and section 267(d) provide that the benefit of the intercompany loss is retained by A if the property is later disposed of at a gain, the intercompany loss is not disallowed for purposes of paragraph (a)(3)(i) of this section. Thus, the intercompany loss is disallowed under paragraph (a)(1) of this section immediately before P's sale and is therefore never taken into account under section 267(d).

(b) *Basis reduction on deconsolidation*—(1) *General rule.* If a member's basis in a share of stock of a subsidiary exceeds its value immediately before a deconsolidation of the share, the basis of the share is reduced at that time to an amount equal to its value. If both a disposition and a deconsolidation occur with respect to a share in the same transaction, paragraph (a) of this section applies and, to the extent necessary to effectuate the purposes of this section, this paragraph (b) applies following the application of paragraph (a) of this section.

(2) *Deconsolidation.* Deconsolidation means any event that causes a share of stock of a subsidiary that remains outstanding to be no longer owned by a member of any consolidated group of which the subsidiary is also a member.

(3) *Value. Value* means fair market value.

(4) *Netting.* Paragraph (b)(1) of this section does not apply to reduce the basis of stock of a subsidiary, to the extent that, as a consequence of the same plan or arrangement as that giving rise to the deconsolidation, gain is taken into account by members with respect to stock of the same subsidiary having the same material terms. If the gain to which this paragraph (b)(4) applies is less than the amount of basis reduction with respect to shares of the subsidiary's stock, the gain is applied to offset basis reduction with respect to each share deconsolidated as a consequence of the same plan or arrangement in proportion to the amount of the reduction that would have been required under paragraph (b)(1) of this section with respect to such share before the application of this paragraph (b)(4). If the same item of gain could be taken into account more than once in limiting the application of paragraphs (a)(1) and (b)(1) of this section, the time is taken into account only once.

(5) *Loss within 2 years after basis reduction*—(i) *In general.* If a share is deconsolidated and a direct or indirect disposition of the share occurs within 2 years after the date of the deconsolidation, a separate statement entitled ‘‘Statement Pursuant to Section §1.1502–20(b)(5)'' must be filed with

the taxpayer's return for the year of disposition. If the taxpayer fails to file the statement as required, no deduction is allowed for any loss recognized with respect to the disposition. A disposition after the 2-year period described in this paragraph (b)(5) that is pursuant to an agreement, option, or other arrangement entered into within the 2-year period is treated as a disposition within the 2-year period for purposes of this section.

(ii) *Contents of statement.* The statement required under paragraph (b)(5)(i) of this section must contain—

(A) The name and employer identification number (E.I.N.) of the subsidiary.

(B) The amount of prior basis reduction (if any) with respect to the stock of the subsidiary under paragraph (b)(1) of this section.

(C) The basis of the stock of the subsidiary immediately before the disposition.

(D) The amount realized on the disposition.

(E) The amount of the loss recognized on the disposition.

(6) *Examples.* The principles of this paragraph (b) are illustrated by the following examples.

Example 1. Simultaneous application of loss disallowance rule and basis reduction rule to stock of the same subsidiary. (i) P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases to $200. Five years later, P sells 60 shares of T stock for $60 and recognizes $60 loss on the sale. The sale causes a deconsolidation of the remaining 40 shares of T stock held by P.

(ii) P's $60 loss on the sale of T stock is disallowed under paragraph (a)(1) of this section. Under paragraph (b)(1) of this section, P must reduce the basis of the 40 shares of T stock it continues to own from $80 to $40, the value of the shares immediately before the deconsolidation.

(iii) Although P's disposition of the 60 shares also causes a deconsolidation of these shares, paragraph (b)(1) of this section provides that, if both paragraph (a) and paragraph (b) of this section apply to a share in the same transaction, paragraph (a) of this section applies first and this paragraph (b) applies only to the extent necessary to effectuate the purposes of this section. Under paragraph (a)(1) of this section, P's $60 loss on the sale of the 60 shares is disallowed. Under the facts of this example, it is not necessary to also apply this paragraph (b) to the 60 shares in order to effectuate the purposes of this section.

Example 2. Deconsolidation of subsidiary stock on contribution to a partnership. (i) P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases to $200. Five years later, P transfers all the stock of T to partnership M in exchange for a partnership interest in M, in a transaction to which section 721 applies.

(ii) At the time of the exchange, P's basis in the T stock is $200 and the T stock's value is $100. Under paragraph (b) of this section, the transfer to M causes a deconsolidation of the T stock, and P must reduce its basis in the T stock, immediately before the transfer to M, from $200 to the stock's $100 value at the time of the transfer. As a result, P has a basis of $100 in its interest in M, and M has a basis of $100 in the stock of T.

Example 3. Simultaneous application of loss disallowance and basis reduction to stock of different subsidiaries. (i) P owns all the stock of S, which in turn owns all the stock of S1, and S and S1 are members of the P group. P's basis in the S stock is $100 and S's basis in the S1 stock is $100. S1 buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, S1's basis in the T stock, S's basis in the S1 stock, and P's basis in the S stock each increase from $100 to $200. S then sells all the S1 stock for $100 and recognizes a loss of $100.

(ii) Under paragraph (a)(1) of this section, S's $100 loss on the sale of the S1 stock is disallowed.

(iii) If S1 and T are not members of a consolidated group immediately after the sale of the stock of S1, the T stock is deconsolidated and, under paragraph (b)(1) of this section, S1 must reduce the basis of the T stock to its $100 value immediately before the sale.

(iv) If S1 and T are members of a consolidated group immediately after the sale of the S1 stock, the T stock is not deconsolidated, and no reduction is required under paragraph (b)(1) of this section.

Example 4. Extending the time period for dispositions. (i) In Year 1, P, the common parent of a group, buys all 100 shares of the stock of T for $100. T's only asset has a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases from $100 to $200. At the beginning of Year 5, P causes T to issue 30 additional shares of stock to the public for $30. This issuance causes a deconsolidation of the T stock owned by P, and paragraph (b)(1) of this section requires

P to reduce its basis in the T stock from $200 to $100.

(ii) Within 2 years after the date of the basis reduction, P agrees to sell all of its T stock for $90 at the end of Year 7. Under paragraph (b)(5) of this section, P's disposition of the T stock at the end of Year 7 is treated as occurring within the 2-year period following the basis reduction, because the disposition is pursuant to an agreement reached within 2 years after the basis reduction. Accordingly, P's $10 loss may not be deducted unless P files the statement required under paragraph (b)(5) of this section. This result is reached whether or not the agreement is in writing. P's disposition would also have been treated as occurring within the 2-year period if the disposition were pursuant to an option issued within the period.

Example 5. Deferred loss and subsequent basis reduction. (i) P is the common parent of a consolidated group, S is a wholly owned subsidiary of P, and T is a recently purchased, wholly owned subsidiary of S. S has a $100 basis in the T stock, and T has an asset with a basis of $40 and a value of $100. T sells the asset for $100, recognizing $60 of gain. Under the investment adjustment system, S's basis in the T stock increases from $100 to $160. S sells its T stock to P for $100 in an intercompany transaction, recognizing a $60 intercompany loss that is deferred under section 267(f) and §1.1502–13. T issues 30 additional shares of stock to the public for $30 which causes a deconsolidation of the T stock owned by P.

(ii) Under paragraph (a)(3)(i) of this section, the application of paragraph (a)(1) of this section to S's intercompany loss on the sale of its T stock to P is deferred because S's loss is deferred under section 267(f) and §1.1502–13. Because the fair market value of the T stock owned by P is $100 immediately before the deconsolidation and P has a $100 basis in the stock at that time, no basis reduction is required under paragraph (b)(1) of this section.

(iii) T's issuance of additional shares to the public results in S's intercompany loss being taken into account under the acceleration rule of §1.1502–13(d) because there is no difference between P's $100 basis in the T stock and the $100 basis the T stock would have had if P and S had been divisions of a single corporation. S's loss taken into account is disallowed under paragraph (a)(1) of this section.

Example 6. Gain and basis reduction with respect to the same plan or arrangement. (i) P, the common parent of a group, owns 50 shares of T stock with an aggregate basis of $50, and S, a wholly owned subsidiary of P, owns the remaining 50 shares of T stock with an aggregate basis of $100. All of the stock has the same terms. P sells all of its T stock to the public for $70 and recognizes a $20 gain. The sale causes a deconsolidation of S's 50 shares of T stock.

(ii) Under paragraph (b)(1) of this section, S must reduce the basis of its 50 shares of T stock from $100 to $70, the value of the shares immediately before the deconsolidation. However, under paragraph (b)(4) of this section, because P's $20 gain is recognized as a consequence of the same plan or arrangement as that giving rise to the deconsolidation, S's basis reduction is eliminated to the extent of $20. Thus, S must reduce the basis of its T stock from $100 to $90.

Example 7. Netting allocated between loss disallowance and basis reduction. (i) P is the common parent of a group and S is its wholly owned subsidiary. P and S each own 50 shares of T stock and each has an aggregate basis of $50. All of the stock has the same terms. S recently purchased its T stock from S1, a lower tier subsidiary, in an intercompany transaction in which S1 recognized a $30 intercompany gain that was deferred under §1.1502–13. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100, recognizing $100 of gain. Under the investment adjustment system, P and S each increase the basis of their T stock to $100. S sells all of its T stock to the public for $50 and recognizes a $50 loss. The sale causes a deconsolidation of P's T stock.

(ii) S's $50 loss on the sale of T stock is disallowed under paragraph (a)(1) of this section. Under paragraph (b)(1) of this section, P must reduce its $100 basis in the T stock to the $50 value immediately before the deconsolidation.

(iii) Under the matching rule of §1.1502–13, S's sale of its T stock results in S1's $30 intercompany gain being taken into account. Under paragraphs (a)(4) and (b)(4) of this section, the gain may be taken into account by P and S in limiting the application of paragraphs (a)(1) and (b)(1) of this section, but it may be taken into account only once. Under paragraph (a)(4) of this section, S may apply the gain to decrease the amount of loss disallowed under paragraph (a)(1) of this section from $50 to $20. None of the gain remains to decrease the $50 of P's basis reduction under paragraph (b)(1) of this section. (P may instead apply the gain to decrease the basis reduction under paragraph (b)(1) of this section instead of S decreasing its disallowed loss, but if the T stock is sold within 2 years, the statement described in paragraph (b)(5) of this section must be filed if a deduction is to be allowed for any loss recognized on the disposition.)

(c) *Allowable loss*—(1) *General rule.* The amount of loss disallowed under paragraph (a)(1) of this section and the amount of basis reduction under paragraph (b)(1) of this section with respect to a share of stock shall not exceed the sum of the following amounts—

(i) *Extraordinary gain dispositions.* The amount of income or gain (or its equivalent), net of directly related expenses, that is allocated to the share from extraordinary gain dispositions.

(ii) *Positive investment adjustments.* The amount of the positive adjustment (if any) with respect to the share under § 1.1502–32 for each consolidated return year, but only to the extent the amount exceeds the amount described in paragraph (c)(1)(i) of this section for the year.

(iii) *Duplicated loss.* The amount of duplicated loss with respect to the share.

(2) *Operating rules.* For purposes of applying paragraph (c)(1) of this section—

(i) *Extraordinary gain dispositions.* An ‘‘extraordinary gain disposition’’ is—

(A) An actual or deemed disposition of—

(*1*) A capital asset as defined in section 1221 (determined without the application of any other rules of law).

(*2*) Property used in a trade or business as defined in section 1231(b) (determined without the application of any holding period requirement).

(*3*) An asset described in section 1221 (1), (3), (4), or (5), if substantially all the assets in such category from the same trade or business are disposed of in one transaction (or series of related transactions).

(*4*) Assets disposed of in an applicable asset acquisition under section 1060(c).

(B) A positive section 481(a) adjustment.

(C) A discharge of indebtedness.

(D) Any other event (or item) identified in guidance published in the Internal Revenue Bulletin.

An extraordinary gain disposition is taken into account under paragraph (c)(1)(i) of this section only if it occurs on or after November 19, 1990. For this purpose, federal income taxes may be directly related to extraordinary gain dispositions only to the extent of the excess (if any) of the group's income tax liability actually imposed under subtitle A of the Internal Revenue Code for the taxable year of the extraordinary gain dispositions over the group's income tax liability for the taxable year redetermined by not taking into account the extraordinary gain dispositions. For this purpose, the group's income tax liability actually imposed and its redetermined income tax liability are determined without taking into account the foreign tax credit under section 27(a) of the Code.

(ii) *Positive investment adjustments.* For purposes of paragraph (c)(1)(ii) of this section, a positive adjustment under § 1.1502–32 is the sum of the amounts under § 1.1502–32(b)(2) (i) through (iii) for the consolidated return year (the adjustment determined without taking distributions into account). However, amounts included in any loss carryover are taken into account in the year they arise rather than the year absorbed.

(iii) *Applicable amounts.* Amounts are described in paragraphs (c)(1)(i) and (ii) of this section only to the extent they are reflected in the basis of the share, directly or indirectly, immediately before the disposition or deconsolidation. For this purpose, an amount is reflected in the basis of a share if the share's basis would have been different without the amount. However, amounts included in any loss carryover are taken into account in the year they arise rather than the year absorbed.

(iv) *Related party rule.* The amounts described in paragraphs (c)(1) (i) and (ii) of this section are not reduced or eliminated by reason of an acquisition of the share from a person related within the meaning of section 267(b) or section 707(b)(1), substituting ‘‘10 percent’’ for ‘‘50 percent’’ each place that it appears, even if the share is not transferred basis property as defined in section 7701 (a)(43).

(v) *Pre-September 13, 1991 positive investment adjustments—(A) In general.* The amount determined under paragraph (c)(1)(ii) of this section is limited for tax years of the subsidiary ending on or before September 13, 1991. The amount may not exceed the net increase, if any, in the basis of the share from—

(*1*) The date the share was first acquired by a member (whether or not a member at that time); to

(*2*) The end of the last taxable year ending on or before September 13, 1991 (or, if earlier, the date of the disposition or deconsolidation). If the share is transferred basis property (within the meaning of section 7701 (a)(43) from a prior consolidated group, the date under paragraph (c)(2)(v)(A)(*1*) of this section is the date the share was first acquired by a member of the prior group. For purposes of this paragraph (c)(2)(v)(A), an increase in an excess loss account is treated as a decrease in stock basis and a decrease in an excess loss account is treated as an increase in stock basis.

(B) *Cessation of netting.* If a lower amount would result under paragraph (c)(1)(ii) of this section by determining the amount under this paragraph (c)(2)(v) as of the end of an earlier taxable year ending after December 31, 1986—

(*1*) The amount under this paragraph (c)(2)(v) is determined as of the earlier year end; and

(*2*) The amount determined under paragraph (c)(1)(ii) of this section is not limited for tax years of the subsidiary ending after the earlier year end.

(vi) *Duplicated loss.* ''Duplicated loss'' is determined immediately after a disposition or deconsolidation, and equals the excess (if any) of—

(A) The sum of—

(*1*) The aggregate adjusted basis of the assets of the subsidiary other than any stock and securities that the subsidiary owns in another subsidiary, and

(*2*) Any losses attributable to the subsidiary and carried to the subsidiary's first taxable year following the disposition or deconsolidation, and

(*3*) Any deferred deductions (such as deductions deferred under section 469) of the subsidiary, over

(B) The sum of—

(*1*) The value of the subsidiary's stock, and

(*2*) Any liabilities of the subsidiary, and

(*3*) Any other relevant items.

The amounts determined under this paragraph (c)(2)(vi) with respect to a subsidiary include its allocable share of corresponding amounts with respect to all lower tier subsidiaries. If 80 percent or more in value of the stock of a subsidiary is acquired by purchase in a single transaction (or in a series of related transactions during any 12-month period), the value of the subsidiary's stock may not exceed the purchase price of the stock divided by the percentage of the stock (by value) so purchased. For this purpose, stock is acquired by purchase if the transferee is not related to the transferor within the meaning of sections 267(b) and 707(b)(1), substituting ''10 percent'' for ''50 percent'' each place that it appears, and the transferee's basis in the stock is determined wholly by reference to the consideration paid for such stock.

(vii) *Disallowance amounts applied only once.* The amounts described in paragraph (c)(1) of this section are not applied more than once to disallow a loss, reduce basis, or reattribute loss under this section.

(3) *Statement of allowed loss.* Paragraph (c)(1) of this section applies only if the separate statement required under this paragraph (c)(3) is filed with the taxpayer's return for the year of the disposition or deconsolidation. The statement must be entitled ''ALLOWED LOSS UNDER SECTION 1.1502–20(c)'' and must contain—

(i) The name and employer identification number (E.I.N.) of the subsidiary.

(ii) The basis of the stock of the subsidiary immediately before the disposition or deconsolidation.

(iii) The amount realized on the disposition and the amount of fair market value on the deconsolidation.

(iv) The amount of the deduction not disallowed under paragraph (a)(1) of this section by reason of this paragraph (c) and the amount of basis not reduced under paragraph (b)(1) of this section by reason of this paragraph (c).

(v) The amount of loss disallowed under paragraph (a)(1) of this section and the amount of basis reduced under paragraph (b)(1) of this section.

(4) *Examples.* For purposes of the examples in this paragraph, unless otherwise stated, the group files the statement required under paragraph (c)(3) of this section. The principles of this paragraph (c) are illustrated by the following examples.

Example 1. Allowable loss attributable to lost built-in gain. (i) Individual A forms T. P buys all the stock of T from A for $100, and T becomes a member of the P group. T has a capital asset with a basis of $0 and a value of $100. The value of the asset declines, and T sells the asset for $40. Under the investment adjustment system, P's basis in the T stock increases to $140. P then sells all the stock of T for $40 and recognizes a loss of $100.

(ii) The amount of the $100 loss disallowed under paragraph (a)(1) of this section may not exceed the amount determined under paragraph (c)(1) of this section. Under paragraphs (c)(2) (i) and (iii) of this section, T's $40 gain is from an extraordinary gain disposition and the amount is reflected in the basis of the T stock under § 1.1502–32 immediately before the disposition. Thus, the gain is described in paragraph (c)(1)(i) of this section. Because this amount is the only amount described in paragraph (c)(1) of this section, the amount of P's $100 loss that is disallowed under paragraph (a)(1) of this section is limited to $40. (No amount is described in paragraph (c)(1)(ii) of this section because the amount of T's positive investment adjustments does not exceed the amount included under paragraph (c)(1)(i) of this section.)

(iii) The results would be the same if the asset, instead of being owned by T, is owned by a partnership in which T is a partner and T is allocated the $40 of gain under section 704(b). Under paragraphs (c)(2) (i) and (iii) of this section, T's $40 gain is from an extraordinary gain disposition, and the gain is reflected in the basis of the T stock under § 1.1502–32 immediately before the disposition.

Example 2. Extraordinary gain dispositions. (i) Individual A forms T. P buys all the stock of T from A for $100 in Year 1, and T becomes a member of the P group. T owns a capital asset, asset 1, with a basis of $0 and a value of $100. T sells asset 1 for $100 in Year 1 and invests the proceeds in a trade or business asset, asset 2. For Year 2, asset 2 produces $30 of gross operating income and $20 of cost recovery deductions. On December 31 of Year 2, asset 2 has an $80 adjusted basis and T disposes of asset 2 for $85; however, because T incurs $20 of expenses directly related to the sale of asset 2, the disposition produces a $15 loss that is taken into account in the determination of taxable income or loss under § 1.1502–32(b)(2)(i) (the loss offsets T's $10 of operating income for Year 2, as well as $5 of operating income of P in that year). Under the investment adjustment system, P's basis in the T stock increases by $95, to $195, because T has $110 of income and a $15 loss. P sells the T stock for $95 in Year 5 and recognizes a $100 loss.

(ii) Under paragraphs (c)(2) (i) and (iii) of this section, the $100 gain from the disposition of asset 1 is from an extraordinary gain disposition and is reflected in the basis of the T stock. Thus, the gain is described in paragraph (c)(1)(i) of this section. The sale of asset 2 is not taken into account under paragraph (c)(1)(i) of this section because, net of directly related expenses, T does not have income or gain from the sale. (No amount is described under paragraph (c)(1)(ii) of this section because T's positive investment adjustments are taken into account under paragraph (c)(1)(i) of this section.) Because the $100 amount described under paragraph (c)(1)(i) of this section equals P's $100 loss from the disposition of the T stock, all of the loss is disallowed.

Example 3. Positive investment adjustments. (i) Individual A forms T. S, a member of the P group, buys all the stock of T from A for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. The asset earns $100 of operating income in Year 1 and declines in value to $0. T invests the operating income in another asset that produces a $25 operating loss for Year 2. Under the investment adjustment system, S's basis in the T stock increases to $200 at the end of Year 1, and decreases to $175 at the end of Year 2. S sells all the stock of T for $75 in Year 5 and recognizes a loss of $100.

(ii) Under paragraph (c)(1)(ii) of this section, the $100 of income from Year 1 is a positive investment adjustment. The amount is not reduced by the $25 operating loss for Year 2. Because the $100 amount described under paragraph (c)(1)(ii) of this section equals S's $100 loss from the disposition of the T stock, all of the loss is disallowed.

Example 4. Treatment of net operating income as attributable to built-in gain. (i) Individual A forms T. P buys all the stock of T from A for $100, and T becomes a member of the P group. T has a capital asset with a basis of $0 and a value of $100. The asset declines in value to $40. The asset earns $100 of operating income unrelated to its $60 decline in value. Under the investment adjustment system, P's basis in the T stock increases to $200. P then sells all the stock of T for $140 (the asset worth $40 and $100 cash) and recognizes a loss of $60.

(ii) The $100 adjustment to the basis of the T stock is an amount described in paragraph (c)(1)(ii) of this section. Because this amount exceeds the amount of loss otherwise disallowed under paragraph (a)(1) of this section, P's entire $60 loss from the disposition of T stock is disallowed.

Example 5. Carryover basis transactions—amounts attributable to separate return years. (i) Individual A forms T. S purchases all the stock of T from A for $100, and T becomes a member of the S group. T has a capital asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, S's basis in the T stock increases to $200. P buys all of the stock of S for $100, and both S and T become members of the P group. S then sells the T stock for $100 and recognizes a loss of $100.

(ii) Under paragraph (c)(2)(iii) of this section, the $100 adjustment to S's basis in the T stock while a member of the S group is an amount described in paragraph (c)(1)(i) of this section with respect to the P group because it continues to be reflected in the basis of the T stock immediately before the stock is disposed of. Because this amount equals the loss otherwise disallowed under paragraph (a)(1) of this section, S's $100 loss from the disposition of T stock is disallowed.

Example 6. Cost basis for subsidiary stock. (i) In Year 1, individual A forms T. T's assets appreciate in value from $0 to $100, and T recognizes $100 of gain in an extraordinary gain disposition. T reinvests the sale proceeds in assets that appreciate in value to $150. In Year 3, A sells all of the T stock to P for $150, and T becomes a member of the P group. While a member of the P group, T's assets decline in value to $130 and P sells the T stock in Year 7 for $130 and recognizes a $20 loss.

(ii) Although T has a $100 gain from extraordinary gain dispositions, the gain is not reflected in P's basis in the T stock within the meaning of paragraph (c)(2)(iii) of this section. P's basis reflects the stock's value at the time of P's purchase, and is determined without regard to whether T recognized the gain before the purchase. Thus, no part of T's gain is described in paragraph (c)(1) of this section, and no part of the $20 loss is disallowed under paragraph (a) of this section. (For rules that apply if A and P are related persons, see paragraph (c)(2)(iv) of this section.)

Example 7. Adjustments to stock basis under applicable rules of law. (i) Individual A forms T, and T's assets subsequently appreciate. T borrows $100 on a nonrecourse basis secured by the appreciated assets. P buys all of the stock of T from A for $150. After becoming a member of the P group, T has a $100 operating loss that is absorbed in the determination of consolidated taxable income and P's basis in the T stock is reduced to $50 under §1.1502–32. Because T's assets have declined in value, T's creditors discharge $60 of T's indebtedness. The $60 discharge is not included in T's gross income under section 108(a), but no attributes are reduced under section 108(b).

(ii) Under paragraph (c)(2)(i) of this section, the discharge of indebtedness is an extraordinary gain disposition. Under §1.1502–32(b)(3)(ii), however, the $60 discharge of indebtedness is not treated as tax-exempt income that increases P's basis in the T stock. Consequently, under paragraph (c)(2)(iii) of this section, T's discharge of indebtedness income is not reflected in P's basis in the T stock. Thus, there is no amount under paragraph (c)(1) of this section.

(iii) The facts are the same as in paragraph (i) of this *Example,* except that $60 of T's operating loss is not absorbed and is included in a consolidated net operating loss that is carried over under §§1.1502–21A or 1.1502–21T, and the $60 is eliminated from the carryover under section 108(b) as a result of T's discharge of indebtedness. The absorption of $40 of T's loss reduces P's basis in the T stock from $150 to $110. The $60 discharge of indebtedness is treated as tax-exempt income that increases P's basis in the T stock, and the $60 attribute reduction is treated as a noncapital, nondeductible expense that reduces P's basis in the T stock. Thus, P's basis in T's stock remains $110 following the discharge and attribute reduction. Because P's basis is $110, rather than $50, the discharge of indebtedness income is reflected in P's basis for purposes of paragraph (c)(2)(iii) of this section. Thus, the amount under paragraph (c)(1)(i) of this section is $60.

Example 8. Duplicated loss. (i) Individual A forms T with a contribution of $100 in exchange for all of the T stock. Individual B forms T1 with a contribution of land that has a $90 basis and $100 value. T buys all the stock of T1 from B for $100. P buys all the stock of T from A for $100, and both T and T1 become members of the P group. The value of T1's land declines to $40. P sells all of the T stock for $40 and recognizes a loss of $60.

(ii) Under paragraph (c)(1)(iii) of this section, P's amount of duplicated loss is $50. This is computed under paragraph (c)(2)(vi) of this section immediately after the disposition as the excess of—

(A) The $90 aggregate adjusted basis of the assets of T and T1 (other than stock and securities of T1 owned by T), over

(B) The $40 fair market value of the T stock (determined under paragraph (c)(2)(vi) of this section). Because this amount is the only amount described in paragraph (c)(1) of this section, the amount of P's $60 loss disallowed under paragraph (a)(1) of this section is limited to $50.

(iii) The result would be the same if the value of T1's property did not decline and T1 instead had an operating loss of $60 (attributable to borrowed funds) which the P group was unable to use. In that case, the $50 excess of the sum of—

(A) The $90 aggregate adjusted basis of the assets of T and T1 (other than stock and securities of members of the P group), plus the $60 net operating loss attributable to T1 and carried to its first taxable year following the disposition, over

(B) The sum of the $40 fair market value of the T stock, plus the $60 of T1 liabilities, is an amount described in paragraph (c)(2)(vi) of this section. (See paragraph (g) of this section for the elective reattribution of T1's $60 net operating loss to P in connection with the sale.)

Example 9. Intercompany stock sales.

(i) P is the common parent of a consolidated group, S is a wholly owned subsidiary of P, and T is a wholly owned recently purchased subsidiary of S. S has a $100 basis in the T stock, and T has a capital asset with a basis of $0 and a value of $100. T's asset declines in value to $60. Before T has any positive investment adjustments or extraordinary gain dispositions, S sells its T stock to P for $60. T's asset reappreciates and is sold for $100, and T recognizes $100 of gain. Under the investment adjustment system, P's basis in the T stock increases to $160. P then sells all of the T stock for $100 and recognizes a loss of $60.

(ii) S's sale of the T stock to P is an intercompany transaction. Thus, S's $40 loss is deferred under section 267(f) and § 1.1502–13. Under paragraph (a)(3) of this section, the application of paragraph (a)(1) of this section to S's $40 loss is deferred until the loss is taken into account. Under the matching rule of § 1.1502–13(c), the loss is taken into account to reflect the difference for each year between P's corresponding items taken into account and P's recomputed corresponding items (the corresponding items that P would take into account for the year if S and P were divisions of a single corporation). If S and P were divisions of a single corporation and the intercompany sale were a transfer between the divisions, P would succeed to S's $100 basis and would have a $200 basis in the T stock at the time it sells the T stock ($100 of initial basis plus $100 under the investment adjustment system). S's $40 loss is taken into account at the time of P's sale of the T stock to reflect the $40 difference between the $60 loss P takes into account and P's recomputed $100 loss.

(iii) Under the matching rule of § 1.1502–13(c), the attributes of S's $40 loss and P's $60 loss are redetermined to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and P were divisions of a single corporation. Under § 1.1502–13(b)(6), attributes of the losses include whether they are disallowed under this section. Because the amount described in paragraph (c)(1) of this section is $100, both S's $40 loss and P's $60 loss are disallowed.

(d) *Successors*—(1) *General rule.* This section applies, to the extent necessary to effectuate the purposes of this section, to any property the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of a subsidiary's stock.

(2) *Examples.* The principles of this paragraph (d) are illustrated by the following examples.

Example 1. Status of successor as member. (i) P, the common parent of a group, buys all the stock of T for $100. T's only asset has a basis of $0 and a value of $100. T sells the asset for $100, and buys another asset for $100. Under the investment adjustment system, P's basis in the T stock increases to $200, and the earnings and profits of P increase by $100. P later transfers all the stock of T to an unrelated consolidation group in exchange for 10 percent of the stock of X, the common parent of that group, in a transaction described in section 368(a)(1)(B). At the time of the exchange, the value of the X stock received by P is $80.

(ii) Under section 358, P has a basis of $200 in the X stock it receives in exchange for T. Under section 362, X has a $200 basis in the T stock.

(iii) Neither paragraph (a)(1) nor (b)(1) of this section applies to the stock of T on P's transfer of the stock to the X group, because no gain or loss is recognized on the transfer, and the transfer is not a deconsolidation of the stock of T under paragraph (b)(2) of this section.

(iv) The X stock owned by P after the reorganization is a successor interest to the T stock because P's basis in the X stock is determined by reference to P's basis in the T stock. The purposes of this section require that the reorganization exchange be treated as a deconsolidation event with respect to P's interest in the X stock. Because X is not a member of the P group, a failure to reduce the basis of the X stock owned by P to its fair market value would permit the P group to recognize and deduct the loss attributable to the T stock. However, because T is a member of the X group, a reduction in the basis of the T stock is not necessary to prevent the X group from recognizing and deducting the loss arising in the P group. The transfer of T stock to X therefore constitutes a deconsolidation of the X stock but not the T stock. Therefore, P must reduce its basis in the X stock from $200 to its $80 value at that time. However, X's basis in the T stock remains $200.

Example 2. Continued application after deconsolidation. (i) P, the common parent of a group, buys all the stock of T for $100. T's only asset has a basis of $0 and a value of $100. T sells the asset for $100, and buys another asset for $100. Under the investment adjustment system, P's basis in the T stock increases to $200. P later transfers all the stock of T to partnership M in exchange for a partnership interest in M, in a transaction to which section 721 applies. The value of the T stock immediately before the transfer to M is $100. Less than 2 years later, P sells its interest in M for $80.

(ii) Under paragraph (b)(1) of this section, because the stock of T is deconsolidated on the transfer to M, immediately before the transfer to M, P reduces its basis in the T stock to the stock's $100 value immediately before the transfer. As a result, P has a basis of $100 in its interest in M, and M has a basis of $100 in the T stock.

(iii) When P sells its interest in M for $80, it recognizes a $20 loss. Because the basis of P's interest in M is determined by reference to P's basis in the T stock, and the reporting requirements could otherwise be circumvented, P's partnership interest in M is a successor interest to the T stock. Under paragraph (b)(5) of this section, P is required to file a statement with its return for the year of its disposition of its interest in M in order to deduct its loss. If P does not file the required statement described in paragraph (b)(5) of this section, P's loss on the disposition of its interest in M is disallowed.

(e) *Anti-avoidance rules*—(1) *General rule.* The rules of §1.1502–20 must be applied in a manner that is consistent with and reasonably carries out their purposes. If a taxpayer acts with a view to avoid the effect of the rules of this section, adjustments must be made as necessary to carry out their purposes.

(2) *Anti-stuffing rule*—(i) *Application.* This paragraph (e)(2) applies if—

(A) A transfer of any asset (including stock and securities) on or after March 9, 1990 is followed within 2 years by a direct or indirect disposition or a deconsolidation of stock, and

(B) The transfer is with a view to avoiding, directly or indirectly, in whole or in part—

(*1*) The disallowance of loss on the disposition or the basis reduction on the deconsolidation of stock of a subsidiary, or

(*2*) The recognition of unrealized gain following the transfer.

A disposition or deconsolidation after the 2-year period described in this paragraph (e)(2)(i) that is pursuant to an agreement, option, or other arrangement entered into within the 2-year period is treated as a disposition or deconsolidation within the 2-year period for purposes of this section.

(ii) *Basis reduction.* If this paragraph (e)(2) applies, the basis of the stock is reduced, immediately before the disposition or deconsolidation, to cause the disallowance of loss, the reduction of basis, or the recognition of gain, otherwise avoided by reason of the transfer.

(3) *Examples.* The principles of this paragraph (e) are illustrated by the following examples.

Example 1. Shifting of value. (i) P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. With the view described in paragraph (e)(1) of this section, P transfers land with a value of $100 and a basis of $100 to T in exchange for preferred stock with a $200 redemption price and liquidation preference. The $100 redemption premium (the excess of the $200 redemption price over the $100 issue price) ultimately increases the value of the preferred stock from $100 to $200 (and decreases the value of the common stock). T sells the built-in gain asset for $100, and P's aggregate basis in S's common and preferred stock increases to $300. In addition, as a result of a cumulative redetermination under §1.1502–32(c)(4), P's basis in the T preferred stock increases from $100 to $200 and P's basis in the common stock remains $100. P subsequently sells the common stock at a loss.

(ii) Under section 305, the redemption premium is treated as a distribution of property to which section 301 and §1.1502–13(f)(2) apply. Under §§1.1502–13 and 1.1502–32, P's aggregate basis in the preferred and common stock is unaffected by the deemed distributions.

(iii) P's loss on the sale of the common stock is disallowed under paragraph (e)(1) of this section. This disallowance prevents the preferred stock from shifting value and stock basis adjustments from the common stock to avoid the disallowance of loss under this section.

Example 2. Basic stuffing case. (i) In Year 1, P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases from $100 to $200. In Year 5, P transfers to T an asset with a basis of $0 and a value of $100 in a transaction to which section 351 applies, with the view described in paragraph (e)(2)(i) of this section. In Year 6, P sells all the stock of T for $200.

(ii) Under paragraph (e)(2)(ii) of this section, P must reduce the basis in its T stock by $100 immediately before the sale. This basis reduction causes a $100 gain to be recognized on the sale.

(iii) The $100 basis reduction also would be required if the T stock is deconsolidated in Year 6 instead of being sold. P must reduce the basis in its T stock by $100 immediately before the deconsolidation.

(iv) The $100 basis reduction also would be required if the P stock were acquired at the beginning of Year 6 by the M consolidated group, even though the asset transfer took place outside the M group. Paragraph (e)(2)(i) of this section requires only that the transferor have the view at the time of the transfer.

Example 3. Stacking rules. (i) In Year 1, P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases from $100 to $200. In Year 5, when the value of the T stock remains $100, P transfers to T an asset with a basis of $0 and a value of $100 in a transaction to which section 351 applies, with the view described in paragraph (e)(2)(i) of this section. Thereafter, the value of the contributed asset declines to $10. In Year 6, P sells all the T stock for $110 and recognizes a $90 loss.

(ii) Because the transferred asset declined in value by $90, the transfer enabled P to avoid the disallowance of loss by the sale of T only to the extent of $10. Under paragraph (e)(2)(ii) of this section, P must reduce the basis in its T stock immediately before the sale to cause recognition of gain in an amount equal to the loss disallowance otherwise avoided by reason of the transfer. The amount of this basis reduction is $100, causing a $10 gain to be recognized on the sale.

(iii) The facts are the same as in (i) of this *Example*, except that the transferred asset does not decline in value and that T reinvests the $100 in proceeds from the asset sale in another asset that appreciates in value to $190. In Year 6, P sells T for $290. Because the new asset appreciated in value by $90, the transfer enabled P to avoid the disallowance of loss on the sale of T only to the extent of $10. Under paragraph (e)(2)(ii) of this section, P must reduce the basis in its T stock immediately before the sale to cause recognition of gain in an amount equal to the loss disallowance otherwise avoided by reason of the transfer. The amount of this basis reduction is $10, causing a $100 gain to be recognized on the sale.

Example 4. Contribution of built-in loss asset. (i) In Year 1, P forms S with a contribution of $100 in exchange for all of S's stock, and S becomes a member of the P group. S buys an asset for $100, and the asset appreciates in value to $200. P then buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100, and under the investment adjustment system P's basis in the T stock increases from $100 to $200. In Year 5, when the value of the T stock remains $100, P transfers the T stock to S in a transaction to which section 351 applies, with the view described in paragraph (e)(2)(i) of this section. The transfer causes P's basis in the S stock to increase from $100 to $300 and the value of S to increase from $200 to $300. In Year 6, P sells the S stock for $300.

(ii) Under paragraph (e)(2)(ii) of this section, P must reduce the basis in its S stock immediately before the sale to cause recognition of gain in an amount equal to the gain recognition otherwise avoided by reason of the transfer. The amount of this basis reduction is $100, causing a $100 gain to be recognized on the sale.

Example 5. Absence of a view. (i) In Year 1, P buys all the stock of T for $100, and T becomes a member of the P group. T has 2 historic assets, asset 1 with a basis of $40 and value of $90, and asset 2 with a basis of $60 and value of $10. In Year 2, T sells asset 1 for $90. Under the investment adjustment system, P's basis in the T stock increases from $100 to $150. Asset 2 is not essential to the operation of T's business, and T distributes asset 2 to P in Year 5 with a view to having the group retain its $50 loss inherent in the asset. Under § 1.1502–13(f)(2), and the application of the principles of this rule in section 267(f), T has a $50 intercompany loss that is deferred. Under § 1.1502–32(b)(3)(iv), the distribution reduces P's basis in the T stock by $10 to $140 in Year 5. In Year 6, P sells all the T stock for $90. Under the acceleration rule of § 1.1502–13(d), and the application of the principles of this rule in section 267(f), T's intercompany loss is ordinarily taken into account immediately before P's sale of the T stock. Assuming that the loss is absorbed by the group, P's basis in T's stock would be reduced from $140 to $90 under § 1.1502–32(b)(3)(i), and there would be no gain or loss from the stock disposition. (Alternatively, if the loss is not absorbed and the loss is reattributed to P under paragraph (g) of this section, the reattribution would reduce P's basis in T's stock from $140 to $90.)

(ii) A $50 loss is reflected both in T's basis in asset 2 and in P's basis in the T stock. Because the distribution results in the loss with respect to asset 2 being taken into account before the corresponding loss reflected in the T stock, and asset 2 is an historic asset of T, the distribution is not with the view described in paragraph (e)(2) of this section.

Example 6. Extending the time period for dispositions. (i) In Year 1, P buys all the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment system, P's basis in the T stock increases from $100 to $200. At the beginning of Year 5, P transfers to T an asset with a basis of $0 and a value of $100 in a transaction to which section 351 applies, with the view described in paragraph (e)(2)(i) of this section. Within 2 years, P agrees to sell all the stock of T for $200 at the end of Year 7.

(ii) Under paragraph (e)(2) (i) of this section, P's disposition of the T stock at the end of Year 7 is treated as occurring within the 2-year period following P's transfer of the asset to T, because the disposition is pursuant to an agreement reached within 2 years after the transfer. Accordingly, under paragraph (e)(2)(ii) of this section, P must reduce the basis in its T stock by $100 immediately before the sale. This result is reached whether or not the agreement is in writing. P's disposition would also have been treated as occurring within the 2-year period if the disposition were pursuant to an option issued within the period.

(f) *No tiering up of certain adjustments*—(1) *General rule.* If the basis of stock of a subsidiary (S) owned by a another member (P) is reduced under this section on the deconsolidation of the S stock, no corresponding adjustment is made under §1.1502–32 to the basis of the stock of P if there is a disposition or deconsolidation of the P stock in the same transaction. If there is a disposition or deconsolidation in the same transaction of less than all the stock of P, appropriate adjustments must be made under §1.1502–32 with respect to P (and any higher-tier members).

(2) *Example.* The principles of this paragraph (f) are illustrated by the following example.

Example. (i) P, the common parent of a group, owns all the stock of S, S owns all the stock of S1, and S1 owns all the stock of S2. P's basis in the S stock is $100, S's basis in the S1 stock is $100, and S1's basis in the S2 stock is $100. In Year 1, S2 buys all the stock of T for $100. T has an asset with a basis of $0 and a value of $100. In Year 2, T sells the asset for $100. Under the investment adjustment system, the basis of each subsidiary's stock increases from $100 to $200. In Year 6, S sells all the stock of S1 for $100 to A, an individual, and recognizes a loss of $100. S1, S2, and T are not members of a consolidated group immediately after the sale because the new S1 group does not file a consolidated return for its first tax year.

(ii) Under paragraph (a)(1) of this section, no deduction is allowed to S for its loss from the sale of the S1 stock. Under §1.1502–32(b)(3)(iii), S's disallowed loss is treated as a noncapital, nondeductible expense for Year 6 that reduces P's basis in the S stock. (Under §1.1502–33, S's earnings and profits for Year 6 are reduced by the amount of S's disallowed loss for earnings and profits purposes and, under §1.1502–33(b), this reduction is reflected in P's earnings and profits.)

(iii) Under paragraphs (b)(1) and (f)(1) of this section, because the stock of T and S2 are deconsolidated as a result of S's sale of the S1 stock, the basis of their stock must be reduced immediately before the sale from $200 to $100 (the value immediately before the deconsolidation). Under §1.1502–32(b)(3)(iii), the basis reductions are treated as noncapital, nondeductible expenses for Year 6. Under paragraph (f)(2) of this section, however, because the S2 stock is deconsolidated in the same transaction, the basis reduction to the T stock does not tier up under §1.1502–32(a)(3). Similarly, because the S1 stock is disposed of in the same transaction, the basis reduction to the S2 stock also does not tier up. (Comparable treatment applies for purposes of earnings and profits under §1.1502–33.)

(g) *Reattribution of subsidiary's losses to common parent*—(1) *Reattribution rule.* If a member disposes of stock of a subsidiary and the member's loss would be disallowed under paragraph (a)(1) of this section, the common parent may make an irrevocable election to reattribute to itself any portion of the net operating loss carryovers and net capital loss carryovers attributable to the subsidiary (and any lower tier subsidiary) without regard to the order in which they were incurred. The amount reattributed may not exceed the amount of loss that would be disallowed if no election is made under this paragraph (g). For this purpose, the amount of loss that would be disallowed is determined by applying paragraph (c)(1) of this section (without taking into account the requirement under paragraph (c)(3) of this section that a statement be filed) and by not taking the reattribution into account. The amount of loss that would be disallowed and the losses that may be reattributed are determined immediately after the disposition, but the reattribution is deemed to be made immediately before the disposition. The common parent succeeds to the reattributed losses as if the losses were succeeded to in a transaction described in section 381(a). Any owner shift of the subsidiary (including any deemed owner shift resulting from section 382(g)(4)(D) or 382(l)(3)) in connection with the disposition is not taken into account under section 382 with respect to the reattributed losses.

(2) *Insolvency limitation.* If the subsidiary whose losses are to be reattributed, or any higher tier subsidiary, is insolvent within the meaning of section 108(d)(3) at the time of the disposition, losses of the subsidiary may be reattributed only to the extent they exceed the sum of the separate insolvencies of any subsidiaries (taking into account only the subsidiary and its

higher tier subsidiaries) that are insolvent. For purposes of determining insolvency, liabilities owed to higher tier members are not taken into account, and stock of a subsidiary that is limited and preferred as to dividends and that is not owned by higher tier members is treated as a liability to the extent of the amount of preferred distributions to which the stock would be entitled if the subsidiary were liquidated on the date of the disposition.

(3) *Examples.* The principles of this paragraph (g) are illustrated by the following examples.

Example 1. Basic reattribution case. (i) P, the common parent of a group, forms S with a $100 contribution. For Year 1, S has a $60 operating loss that is not absorbed and is included in the group's consolidated net operating loss that is carried over under §§ 1.1502–21A or 1.1502–21T. Under § 1.1502–32(b)(3)(i), P's basis in the S stock is not reduced to reflect S's loss because the loss is not absorbed. Under § 1.1502–33(b), S's deficit in earnings and profits is reflected in P's earnings and profits even though the loss is not absorbed for tax purposes. During Year 2, S's remaining assets appreciate in value and P sells the S stock for $55. But for an election to reattribute losses under paragraph (g) of this section, P would have a $45 loss from the sale that would be disallowed.

(ii) P elects under paragraph (g)(1) of this section to reattribute to itself $45 of S's losses (the maximum amount permitted). As a result, $45 of the $60 net operating loss carryover attributable to S is reattributed to P. This reattributed loss may be included in the net operating loss carryover to subsequent consolidated return years of the P group. P succeeds to these losses as if the losses were succeeded to in a transaction described in section 381(a) and they retain their character as ordinary losses. The remaining $15 of net operating loss carryover attributable to S is carried over to the first separate return year of S.

(iii) Under § 1.1502–32(b)(3)(iii), the reattribution of $45 of loss is a noncapital, nondeductible expense that reduces P's basis in the S stock from $100 to $55 immediately before the disposition. Consequently, P does not recognize any gain or loss from the disposition.

(iv) Assume that $20 of S's losses arose in Year 1 and $40 in Year 2, and that P elects to reattribute all $40 from Year 2 and $5 from Year 1. P succeeds to these losses as if the losses were succeeded to in a transaction described in section 381(a), and the losses retain their character as ordinary losses arising in Years 1 and 2. The losses continue to be subject to any limitations originally applicable to S, but P succeeds to them and may absorb the losses independently of S. (For example, P's use of the Year 2 losses does not depend on S's use of the Year 1 losses that were not reattributed to P.)

Example 2. Lower tier subsidiary. (i) P, the common parent of a group, forms S with a $100 contribution. S then forms T with a $40 contribution and T borrows $60. For Year 1, S has a $30 operating loss and T has a $55 operating loss. The losses are not absorbed and are included in the group's consolidated net operating loss that is carried over under §§ 1.1502–21A or 1.1502–21T. Under § 1.1502–32(b)(3)(i), P's basis in the S stock, and S's basis in the T stock, are not reduced to reflect the S and T losses because the group is unable to absorb the losses. (Under § 1.1502–33(b), the deficits in earnings and profits of S and T are tiered up for earnings and profits purposes even though not absorbed for tax purposes.) During Year 2, P sells the S stock for $30 ($100 invested, minus S's $30 loss and $40 unrealized loss from its investment in the T stock). But for an election to reattribute losses under paragraph (g) of this section, P would have a $70 loss from the sale, which would be disallowed.

(ii) S's $30 portion of the net operating loss carryover may be reattributed to P under paragraph (g)(1) of this section. Because T is insolvent by $15, paragraph (g)(2) of this section provides that only $40 of its $55 portion of the net operating loss carryover may be reattributed to P under paragraph (g)(1) of this section. There is no limitation, however, on which $40 of T's $55 loss may be reattributed.

(iii) P elects under paragraph (g)(1) of this section to reattribute to itself $40 of T's losses (the maximum amount permitted). P does not elect, however, to reattribute to itself any of S's losses. As a result, $40 of the $85 net operating loss carryover is reattributed to P. This reattributed loss may be included in the net operating loss carryover to subsequent consolidated return years of the P group. Of the $45 remaining net operating loss carryover, the $15 attributable to T and $30 attributable to S are carried over to their first separate return years.

(iv) Under § 1.1502–32(b)(3)(iii), the reattribution of loss is a noncapital, nondeductible expense that reduces P's basis in the S stock to $60 immediately before the disposition. Consequently, P recognizes only a $30 loss from the disposition of its S stock ($30 sale proceeds and $60 basis), and this loss is disallowed.

Example 3. Separate return limitation year losses. (i) P, the common parent of a group, buys the stock of S for $100. S has a net operating loss carryover of $40 from a separate return limitation year, and assets with a value and basis of $100. The assets of S decline in value by $40, and P sells all the stock of S for $60. But for an election to reattribute losses under this paragraph (g), P would have a $40 loss on the sale of S that would be disallowed.

(ii) S's $40 loss carryover from a separate return limitation year may be reattributed to P under paragraph (g)(1) of this section.

(iii) P elects under paragraph (g)(1) of this section to reattribute to itself S's $40 (loss the maximum amount permitted). Following the reattribution, the loss is included in the net operating loss carryover to subsequent consolidated return years of the P group.

(iv) Under §1.1502–32(b)(3)(iii), the reattribution of loss is a noncapital, nondeductible expense that reduces P's basis in the S stock to $60 immediately before the disposition. Consequently, P recognizes no gain or loss from the disposition of its S stock. For P's treatment of the $40 reattributed loss, see §1.1502–1(f).

(4) [Reserved]

(5) *Time and manner of making the election*—(i) *In general.* The election described in paragraph (g)(1) of this section must be made in a separate statement entitled ‘‘this is an election under §1.1502–20(g)(1) To reattribute losses of [insert names and employer identification numbers (E.I.N.) of each subsidiary whose losses are reattributed] to [insert name and employer identification number of common parent].'' The statement must include the following information—

(A) For each subsidiary, the amount of each net operating loss and net capital loss, and the year in which each arose, that is reattributed to the common parent, and

(B) If a subsidiary ceases to be a member, the name and employer identification number of the person acquiring the subsidiary's stock.

The statement must be signed by the common parent, and by each subsidiary with respect to which loss is reattributed under this paragraph (g) that does not remain a member of the common parent's group immediately following the disposition. The statement must be filed with the group's income tax return for the tax year of the disposition and a copy of the statement must be retained by the subsidiary. If the acquirer is a subsidiary in a consolidated group, the name and employer identification number of the common parent of the group must be included in the statement, and a copy of the statement must also be delivered to the common parent.

(ii) *Filing of subsidiary's copy of statement.* The subsidiary whose losses are reattributed (or the common parent of any consolidated group that acquires the subsidiary or lower tier subsidiary) must attach its copy of the statement described in paragraph (g)(5)(i) of this section to its income return for the first tax year ending after the due date, including extensions, of the return in which the election required by paragraph (g)(5)(i) of this section is to be filed.

(h) *Effective dates*—(1) *General rule.* Except as otherwise provided in this paragraph (h), this section applies with respect to dispositions and deconsolidations on or after February 1, 1991. For this purpose, dispositions deferred under §1.1502–13 are deemed to occur at the time the deferred gain or loss is taken into account unless the stock was deconsolidated before February 1, 1991. If stock of a subsidiary became worthless during a taxable year including February 1, 1991, the disposition with respect to the stock is treated as occurring on the date the stock became worthless.

(2) *Election to accelerate effective date*—(i) *In general.* A group may make an irrevocable election to apply this section to all its members, instead of §1.337(d)–2, with respect to all dispositions and deconsolidations on or after November 19, 1990.

(ii) *Time and manner of making the election—in general.* The election described in paragraph (h)(2)(i) of this section must be made in a separate statement entitled ‘‘this is an election under §1.1502–20(h)(2) to accelerate the application of §1.1502–20 to the consolidated group of which [insert name and employer identification number of common parent] is the common parent.'' The statement must be signed by the common parent and filed with the group's income tax return for the tax year of the first disposition or deconsolidation to which the election applies. If the separate statement required under this paragraph (h) (2) (ii) is to be filed with a return the due date (including extensions) of which is before April 16, 1991, the statement may be filed with an amended return for the year of the disposition or deconsolidation. Any other filings required under this § 1.1502–20, such as the statement required under § 1.1502–20(c)(3), which ordinarily cannot be made with an amended return, must be made at such time and in such manner as permitted by the Commissioner.

(3) *Binding contract rule.* For purposes of this paragraph (h), if a disposition or deconsolidation is pursuant to a binding written contract entered into before March 9, 1990, and in continuous effect until the disposition or deconsolidation, the date the contract became binding is treated as the date of the disposition or deconsolidation.

(4) *Application of § 1.1502–20T to certain transactions*—(i) *In general.* If a group files the certification described in paragraph (h)(4)(ii) of this section, it may apply § 1.1502–20T (as contained in the CFR edition revised as of April 1, 1990), to all of its members with respect to all dispositions and deconsolidations by the certifying group to which § 1.1502–20T otherwise applied by its terms occurring—

(A) On or after March 9, 1990 (but only if not pursuant to a binding contract described in § 1.337(d)–1T(e)(2) (as contained in the CFR edition revised as of April 1, 1990) that was entered into before March 9, 1990); and

(B) Before November 19, 1990 (or thereafter, if pursuant to a binding contract described in § 1.1502–20T(g)(3) that was entered into on or after March 9, 1990 and before November 19, 1990).

The certification under this paragraph (h)(4)(i) with respect to the application of § 1.1502–20T to any transaction described in this paragraph (h)(4)(i) may not be withdrawn and, if the certification is filed, § 1.1502–20T must be applied to all such transactions on all returns (including amended returns) on which such transactions are included.

(ii) *Time and manner of filing certification.* The certification described in paragraph (h)(4)(i) of this section must be made in a separate statement entitled ‘‘[insert name and employer identification number of common parent] hereby certifies under § 1.1502–20 (h)(4) that the group of which it is the common parent is applying § 1.1502–20T to all transactions to which that section otherwise applied by its terms.’’ The statement must be signed by the common parent and filed with the group’s income tax return for the taxable year of the first disposition or deconsolidation to which the certification applies. If the separate statement required under this paragraph (h)(4) is to be filed with a return the due date (including extensions) of which is before November 16, 1991, the statement may be filed with an amended return for the year of the disposition or deconsolidation that is filed within 180 days after September 13, 1991. Any other filings required under § 1.1502–20T, such as the statement required under § 1.1502–20T(f)(5), may be made with the amended return, regardless of whether § 1.1502–20T permits such filing by amended return.

(5) *Cross reference.* For transitional loss limitation rules, see §§ 1.337(d)–1 and 1.337(d)–2.

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COMPUTATION OF CONSOLIDATED ITEMS

§ 1.1502–21T Net operating losses (temporary).

(a) *Consolidated net operating loss deduction.* The consolidated net operating loss deduction (or CNOL deduction) for any consolidated return year is the aggregate of the net operating loss carryovers and carrybacks to the year. The net operating loss carryovers and carrybacks consist of—

(1) Any CNOLs (as defined in paragraph (e) of this section) of the consolidated group; and

(2) Any net operating losses of the members arising in separate return years.

(b) *Net operating loss carryovers and carrybacks to consolidated return and separate return years.* Net operating losses of members arising during a consolidated return year are taken into account in determining the group’s CNOL under paragraph (e) of this section for that year. Losses taken into account in determining the CNOL may be carried to other taxable years (whether consolidated or separate) only under this paragraph (b).

(1) *Carryovers and carrybacks generally*. The net operating loss carryovers and carrybacks to a taxable year are determined under the principles of section 172 and this section. Thus, losses permitted to be absorbed in a consolidated return year generally are absorbed in the order of the taxable years in which they arose, and losses carried from taxable years ending on the same date, and which are available to offset consolidated taxable income for the year, generally are absorbed on a pro rata basis. See *Example 2* of paragraph (c)(1)(iii) of this section for an illustration of pro rata absorption of losses subject to a SRLY limitation. Additional rules provided under the Code or regulations also apply. See, e.g., section 382(l)(2)(B).

(2) *Carryovers and carrybacks of CNOLs to separate return years*—(i) *In general*. If any CNOL that is attributable to a member may be carried to a separate return year of the member, the amount of the CNOL that is attributable to the member is apportioned to the member (apportioned loss) and carried to the separate return year. If carried back to a separate return year, the apportioned loss may not be carried back to an equivalent, or earlier, consolidated return year of the group; if carried over to a separate return year, the apportioned loss may not be carried over to an equivalent, or later, consolidated return year of the group. For rules permitting the reattribution of losses of a subsidiary to the common parent when loss is disallowed on the disposition of subsidiary stock, see § 1.1502–20(g).

(ii) *Special rules*—(A) *Year of departure from group*. If a corporation ceases to be a member during a consolidated return year, net operating loss carryovers attributable to the corporation are first carried to the consolidated return year, and only the amount so attributable that is not absorbed by the group in that year is carried to the corporation's first separate return year.

(B) *Offspring rule*. In the case of a member that has been a member continuously since its organization, the CNOL attributable to the member is included in the carrybacks to consolidated return years before the member's existence. See paragraph (f) of this section for applications to predecessors and successors. If the group did not file a consolidated return for a carryback year, the loss may be carried back to a separate return year of the common parent under paragraph (b)(2)(i) of this section, but only if the common parent was not a member of a different consolidated group or of an affiliated group filing separate returns for the year to which the loss is carried or any subsequent year in the carryback period. Following an acquisition described in § 1.1502–75(d) (2) or (3), references to the common parent are to the corporation that was the common parent immediately before the acquisition.

(iii) *Equivalent years*. Taxable years are equivalent if they bear the same numerical relationship to the consolidated return year in which a CNOL arises, counting forward or backward from the year of the loss. For example, in the case of a member's third taxable year (which was a separate return year) that preceded the consolidated return year in which the loss arose, the equivalent year is the third consolidated return year preceding the consolidated return year in which the loss arose. See paragraph (b)(3)(iii) of this section for certain short taxable years that are disregarded in making this determination.

(iv) *Amount of CNOL attributable to a member*. The amount of a CNOL that is attributable to a member is determined by a fraction the numerator of which is the separate net operating loss of the member for the year of the loss and the denominator of which is the sum of the separate net operating losses for that year of all members having such losses. For this purpose, the separate net operating loss of a member is determined by computing the CNOL by reference to only the member's items of income, gain, deduction, and loss, including the member's losses and deductions actually absorbed by the group in the taxable year (whether or not absorbed by the member).

(v) *Examples*. For purposes of the examples in this section, unless otherwise stated, all groups file consolidated returns, all corporations have calendar taxable years, the facts set forth the only corporate activity, value means fair market value and the adjusted basis of each asset equals its value, all transactions are with unrelated persons, and the application of any limitation or threshold under section 382 is disregarded. The principles of this paragraph (b)(2) are illustrated by the following examples:

Example 1. Offspring rule. (a) P is formed at the beginning of Year 1 and files a separate return. P forms S on March 15 of Year 2, and P and S file a consolidated return. P purchases all the stock of T at the beginning of Year 3, and T becomes a member of the P group. T was formed in Year 2 and filed a separate return for that year. P, S, and T sustain a $1,100 CNOL in Year 3 and, under paragraph (b)(2)(iv) of this section, the loss is attributable $200 to P, $300 to S, and $600 to T.

(b) Of the $1,100 CNOL in Year 3, the $500 amount of the CNOL that is attributable to P and S ($200 + $300) may be carried to P's separate return in Year 1. Even though S was not in existence in Year 1, the $300 amount of the CNOL attributable to S may be carried back to P's separate return in Year 1 because S (unlike T) has been a member of the P group since its organization and P is a qualified parent under paragraph (b)(2)(ii)(B) of this section. To the extent not absorbed in that year, the loss may then be carried to the P group's return in Year 2. The $600 amount of the CNOL attributable to T is a net operating loss carryback to T's separate return in Year 2.

Example 2. Departing members. (a) The facts are the same as in *Example 1.* In addition, on June 15 of Year 4, P sells all the stock of T. The P group's consolidated return for Year 4 includes the income of T through June 15. T files a separate return for the period from June 16 through December 31.

(b) $600 of the Year 3 CNOL attributable to T is apportioned to T and is carried back to its separate return in Year 2. To the extent the $600 is not absorbed in T's separate return in Year 2, it is carried to the consolidated return in Year 4 before being carried to T's separate return in Year 4. Any portion of the loss not absorbed in T's Year 2 or in the P group's Year 4 is then carried to T's separate return in Year 4.

(3) *Special rules*—(i) *Election to relinquish carryback.* A group may make an irrevocable election under section 172(b)(3) to relinquish the entire carryback period with respect to a CNOL for any consolidated return year. The election may not be made separately for any member (whether or not it remains a member), and must be made in a separate statement entitled ''THIS IS AN ELECTION UNDER SECTION 1.1502–21T(b)(3)(i) TO WAIVE THE ENTIRE CARRYBACK PERIOD PURSUANT TO SECTION 172(b)(3) FOR THE [insert consolidated return year] CNOLs OF THE CONSOLIDATED GROUP OF WHICH [insert name and employer identification number of common parent] IS THE COMMON PARENT.'' The statement must be signed by the common parent and filed with the group's income tax return for the consolidated return year in which the loss arises.

(ii) *Special election for groups that include insolvent financial institutions.* For rules applicable to relinquishing the entire carryback period with respect to losses attributable to insolvent financial institutions, see § 301.6402–7 of this chapter.

(iii) *Short years in connection with transactions to which section 381(a) applies.* If a member distributes or transfers assets to a corporation that is a member immediately after the distribution or transfer in a transaction to which section 381(a) applies, the transaction does not cause the distributor or transferor to have a short year within the consolidated return year of the group in which the transaction occurred that is counted as a separate year for purposes of determining the years to which a net operating loss may be carried.

(iv) *Special status losses.* [Reserved]

(c) *Limitations on net operating loss carryovers and carrybacks from separate return limitation years*—(1) *SRLY limitation*—(i) *General rule.* The aggregate of the net operating loss carryovers and carrybacks of a member arising (or treated as arising) in SRLYs that are included in the CNOL deductions for all consolidated return years of the group under paragraph (a) of this section may not exceed the aggregate consolidated taxable income for all consolidated return years of the group determined by reference to only the member's items of income, gain, deduction, and loss. For this purpose—

(A) Consolidated taxable income is computed without regard to CNOL deductions;

(B) Consolidated taxable income takes into account the member's losses and deductions (including capital losses) actually absorbed by the group in consolidated return years (whether or not absorbed by the member);

(C) In computing consolidated taxable income, the consolidated return years of the group include only those years, including the year to which the loss is carried, that the member has been continuously included in the group's consolidated return, but exclude:

(*1*) For carryovers, any years ending after the year to which the loss is carried; and

(*2*) For carrybacks, any years ending after the year in which the loss arose; and

(D) The treatment under §1.1502–15T of a built-in loss as a hypothetical net operating loss carryover in the year recognized is solely for purposes of determining the limitation under this paragraph (c) with respect to the loss in that year and not for any other purpose. Thus, for purposes of determining consolidated taxable income for any other losses, a built-in loss allowed under this section in the year it arises is taken into account.

(ii) *Losses treated as arising in SRLYs.* If a net operating loss carryover or carryback did not arise in a SRLY but is attributable to a built-in loss (as defined under §1.1502–15T), the carryover or carryback is treated for purposes of this paragraph (c) as arising in a SRLY if the built-in loss was not allowed, after application of the SRLY limitation, in the year it arose. For an illustration, see §1.1502–15T(d), *Example 5.*

(iii) *Examples.* The principles of this paragraph (c)(1) are illustrated by the following examples:

Example 1. Determination of SRLY limitation. (a) In Year 1, individual A forms T and T sustains a $100 net operating loss that is carried forward. P buys all the stock of T at the beginning of Year 2, and T becomes a member of the P group. The P group has $300 of consolidated taxable income in Year 2 (computed without regard to the CNOL deduction). Such consolidated taxable income would be $70 if determined by reference to only T's items.

(b) T's $100 net operating loss carryover from Year 1 arose in a SRLY. See §1.1502–1(f)(2)(iii). Thus, the $100 net operating loss carryover is subject to the SRLY limitation in paragraph (c)(1) of this section. The SRLY limitation for Year 2 is consolidated taxable income determined by reference to only T's items, or $70. Thus, $70 of the loss is included under paragraph (a) of this section in the P group's CNOL deduction for Year 2.

(c) The facts are the same as in paragraph (a) of this *Example 1*, except that such consolidated taxable income (computed without regard to the CNOL deduction and by reference to only T's items) is a loss (a CNOL) of $370. Because the SRLY limitation may not exceed the consolidated taxable income determined by reference to only T's items, and such items aggregate to a CNOL, T's $100 net operating loss carryover from Year 1 is not allowed under the SRLY limitation in Year 2. Moreover, if consolidated taxable income (computed without regard to the CNOL deduction and by reference to only T's items) did not exceed $370 in Year 3, the carryover would still be restricted under §1.1502–21T(c) in Year 3, because the aggregate consolidated taxable income for all consolidated return years of the group computed by reference to only T's items would not be a positive amount.

Example 2. Net operating loss carryovers. (a) In Year 1, individual A forms P and P sustains a $40 net operating loss that is carried forward. P has no income in Year 2. Unrelated corporation T sustains a net operating loss of $50 in Year 2 that is carried forward. P buys the stock of T during Year 3, but T is not a member of the P group for each day of the year. P and T file separate returns and sustain net operating losses of $120 and $60, respectively, for Year 3. The P group files consolidated returns beginning in Year 4. During Year 4, the P group has $160 of consolidated taxable income (computed without regard to the CNOL deduction). Such consolidated taxable income would be $70 if determined by reference to only T's items. These results are summarized as follows:

	Separate year 1	Separate year 2	Separate affiliated year 3	Consolidated year 4
P	$(40)	$0	$(120)	$90
T	0	(50)	(60)	70
CTI				160

(b) P's Year 1, Year 2, and Year 3 are not SRLYs with respect to the P group. See § 1.1502–1(f)(2)(i). Thus, P's $40 net operating loss arising in Year 1 and $120 net operating loss arising in Year 3 are not subject to the SRLY limitation under paragraph (c) of this section. Under the principles of section 172, paragraph (b) of this section requires that the loss arising in Year 1 be the first loss absorbed by the P group in Year 4. Absorption of this loss leaves $120 of the group's consolidated taxable income available for offset by other loss carryovers.

(c) T's Year 2 and Year 3 are SRLYs with respect to the P group. See § 1.1502–1(f)(2)(ii). Thus, T's $50 net operating loss arising in Year 2 and $60 net operating loss arising in Year 3 are subject to the SRLY limitation. Under paragraph (c)(1) of this section, the SRLY limitation for Year 4 is $70, and under paragraph (b) of this section, T's $50 loss from Year 2 must be included under paragraph (a) of this section in the P group's CNOL deduction for Year 4. The absorption of this loss leaves $70 of the group's consolidated taxable income available for offset by other loss carryovers.

(d) P and T each carry over net operating losses to Year 4 from a taxable year ending on the same date (Year 3). The losses carried over from Year 3 total $180. Under paragraph (b) of this section, the losses carried over from Year 3 are absorbed on a pro rata basis, even though one arises in a SRLY and the other does not. However, the group cannot absorb more than $20 of T's $60 net operating loss arising in Year 3 because its $70 SRLY limitation for Year 4 is reduced by T's $50 Year 2 SRLY loss already included in the CNOL deduction for Year 4. Thus, the absorption of Year 3 losses is as follows:

Amount of P's Year 3 losses absorbed = $120/($120 + $20) x $70 = $60.

Amount of T's Year 3 losses absorbed = § 20/ ($120 + $20) x $70 = $10.

(e) The absorption of $10 of T's Year 3 loss further reduces T's SRLY limitation to $10 ($70 of initial SRLY limitation, reduced by the $60 net operating loss already included in the CNOL deductions for Year 4 under paragraph (a) of this section).

(f) P carries its remaining $60 Year 3 net operating loss and T carries its remaining $50 Year 3 net operating loss over to Year 5. Assume that, in Year 5, the P group has $90 of consolidated taxable income (computed without regard to the CNOL deduction). The group's CTI determined by reference to only T's items is a CNOL of $4. For Year 5, the CNOL deduction includes $60 of P's Year 3 loss but only $6 of T's Year 3 loss (the aggregate consolidated taxable income for Years 4 and 5 determined by reference to T's items, or $66, reduced by T's SRLY losses actually absorbed by the group in Year 4, or $60).

Example 3. Net operating loss carrybacks. (a)(1) P owns all of the stock of S and T. The members of the P group contribute the following to the consolidated taxable income of the P group for Years 1, 2, and 3:

	Year 1	Year 2	Year 3	Total
P	$100	$60	$80	$240
S	20	20	30	70
T	30	10	(50)	(10)
CTI	150	90	60	300

(2) P sells all of the stock of T to individual A at the beginning of Year 4. For its Year 4 separate return year, T has a net operating loss of $30.

(b) T's Year 4 is a SRLY with respect to the P group. See § 1.1502–1(f)(1). T's $30 net operating loss carryback to the P group from Year 4 is not allowed under § 1.1502–21T(c) to be included in the CNOL deduction under paragraph (a) of this section for Year 1, 2, or 3, because the P group's consolidated taxable income would not be a positive amount if determined by reference to only T's items for all consolidated return years through Year 4 (without regard to the $30 net operating loss). However, the $30 loss is carried forward to T's Year 5 and succeeding taxable years as provided under the Code.

Example 4. Computation of SRLY limitation for built-in losses treated as net operating loss carryovers. (a) In Year 1, individual A forms T by contributing $300 and T sustains a $100 net operating loss. During Year 2, T's assets decline in value by $100. At the beginning of Year 3, P buys all the stock of T for $100, and T becomes a member of the P group. At the time of the acquisition, T has a $100 net unrealized built-in loss, which exceeds the threshold requirements of section 382(h)(3)(B). During Year 3, T recognizes its unrealized loss as a $100 ordinary loss. The members of the P group contribute the following to the consolidated taxable income of the P group for Years 3 and 4 (computed without regard to T's recognition of its unrealized loss and any CNOL deduction under § 1.1502–21T):

	Year 3	Year 4	Total
P group (without T)	$100	$100	$200
T	60	40	100
CTI	160	140	300

(b) Under § 1.1502–15T(a), T's $100 of ordinary loss in Year 3 constitutes a built-in loss that is subject to the SRLY limitation under § 1.1502–21T(c). The amount of the limitation is determined by treating the deduction as a net operating loss carryover from a SRLY. The built-in loss is therefore subject to a $60 SRLY limitation for Year 3. The built-in loss is treated as a net operating loss carryover solely for purposes of determining the extent to which the loss is not allowed by reason of the SRLY limitation, and for all other purposes the loss remains a loss arising in Year 3. Consequently, under paragraph (b) of this section, the $60 allowed under the SRLY limitation is absorbed by the P group before T's $100 net operating loss carryover from Year 1 is allowed.

(c) Under § 1.1502–15T(a), the $40 balance of the built-in loss that is not allowed in Year 3 because of the SRLY limitation is treated as a $40 net operating loss arising in Year 3 that is subject to the SRLY limitation because, under § 1.1502–21T(c)(1)(ii), Year 3 is treated as a SRLY, and is carried to other years in accordance with the rules of paragraph (b) of this section. The SRLY limitation for Year 4 is the P group's consolidated taxable income for Year 3 and Year 4 determined by reference to only T's items and without regard to the group's CNOL deductions ($60+$40), reduced by T's loss actually absorbed by the group in Year 3 ($60). The SRLY limitation for Year 4 is $40.

(d) Under paragraph (c) of this section and the principles of section 172(b), $40 of T's $100 net operating loss carryover from Year 1 is included in the CNOL deduction under paragraph (a) of this section in Year 4.

Example 5. Dual SRLY registers and accounting for SRLY losses actually absorbed. (i) In Year 1, T sustains a $100 net operating loss and a $50 net capital loss. At the beginning of Year 2, T becomes a member of the P group. Both of T's carryovers from Year 1 are subject to SRLY limits under this paragraph (c) and § 1.1502–22T(c). The members of the P group contribute the following to the consolidated taxable income for Years 2 and 3 (computed without regard to T's CNOL deduction under § 1.1502–21T or net capital loss carryover under § 1.1502–22T):

		P	T
Year 1 (SRLY)	Ordinary	....	(100)
	Capital	....	(50)
Year 2	Ordinary	30	60
	Capital	0	(20)
Year 3	Ordinary	10	40
	Capital	0	30

(ii) For Year 2, the group computes separate SRLY limits for each of T's SRLY carryovers from Year 1. Under normal Internal Revenue Code rules, it determines its ability to use its capital loss carryover before it determines its ability to use its ordinary loss carryover. Under section 1211, because the group has no Year 2 capital gain, it cannot absorb any capital losses in Year 2. T's Year 1 net capital loss and the group's Year 2 consolidated net capital loss (all of which is attributable to T) are carried over to Year 3.

(iii) Under this section, the aggregate amount of T's $100 NOL carryover from Year 1 that may be included in the CNOL deduction of the group for Year 2 may not exceed $60—the amount of the consolidated taxable income computed by reference only to T's items, including losses and deductions to the extent actually absorbed (i.e., $60 of T's ordinary income for Year 2). Thus, the group may include $60 of T's ordinary loss carryover from Year 1 in its Year 2 CNOL deduction. T carries over its remaining $40 of its Year 1 loss to Year 3.

(iv) For Year 3, the group again computes separate SRLY limits for each of T's SRLY carryovers from Year 1. The group has consolidated net capital gain (without taking into account a net capital loss carryover deduction) of $30. Under § 1.1502–22T(c), the aggregate amount of T's $50 capital loss carryover from Year 1 that may be included in computing the group s consolidated net capital gain for all years of the group (here Years 2 and 3) may not exceed $30 (the aggregate consolidated net capital gain computed by reference only to T's items, including losses and deductions actually absorbed (i.e., $30 of capital gain in Year 3)). Thus, the group may include $30 of T's Year 1 capital loss carryover in its computation of consolidated net capital gain for Year 3, which offsets the group's capital gains for Year 3. T carries over its remaining $20 of its Year 1 loss to Year 4. The group carries over the Year 2 consolidated net capital loss to Year 4.

(v) Under this section, the aggregate amount of T's NOL carryover from Year 1 that may be included in the CNOL deduction of the group for Years 2 and 3 may not exceed $100, which is the amount of the aggregate consolidated taxable income for Years 2 and 3 determined by reference only to T's items, including losses and deductions actually absorbed (i.e., $60 of ordinary income in Year 2 plus $40 of ordinary income, $30 of capital gain, and $30 of SRLY capital losses actually absorbed in Year 3). The group included $60 of T's ordinary loss carryover in its Year 2 CNOL deduction. It may include the remaining $40 of the carryover in its Year 3 CNOL deduction.

(2) *SRLY subgroup limitation.* In the case of a net operating loss carryover or carryback for which there is a SRLY subgroup, the principles of paragraph (c)(1) of this section apply to the SRLY subgroup, and not separately to its

members. Thus, the contribution to consolidated taxable income and the net operating loss carryovers and carrybacks arising (or treated as arising) in SRLYs that are included in the CNOL deductions for all consolidated return years of the group under paragraph (a) of this section are based on the aggregate amounts of income, gain, deduction, and loss of the members of the SRLY subgroup for the relevant consolidated return years (as provided in paragraph (c)(1)(i)(C) of this section). For an illustration of aggregate amounts during the relevant consolidated return years following the year in which a member of a SRLY subgroup ceases to be a member of the group, see paragraph (c)(2)(vii) *Example 4* of this section. A SRLY subgroup may exist only for a carryover or carryback arising in a year that is not a SRLY (and is not treated as a SRLY under paragraph (c)(1)(ii) of this section) with respect to another group (the former group), whether or not the group is a consolidated group. A separate SRLY subgroup is determined for each such carryover or carryback. A consolidated group may include more than one SRLY subgroup and a member may be a member of more than one SRLY subgroup. Solely for purposes of determining the members of a SRLY subgroup with respect to a loss:

(i) *Carryovers.* In the case of a carryover, the SRLY subgroup is composed of the member carrying over the loss (the loss member) and each other member that was a member of the former group that becomes a member of the group at the same time as the loss member. A member remains a member of the SRLY subgroup until it ceases to be affiliated with the loss member. The aggregate determination described in paragraph (c)(1) of this section and this paragraph (c)(2) includes the amounts of income, gain, deduction, and loss of each member of the SRLY subgroup for the consolidated return years during which it remains a member of the SRLY subgroup. For an illustration of the aggregate determination of a SRLY subgroup, see paragraph (c)(2)(vii) *Example 2* of this section.

(ii) *Carrybacks.* In the case of a carryback, the SRLY subgroup is composed of the member carrying back the loss (the loss member) and each other member of the group from which the loss is carried back that has been continuously affiliated with the loss member from the year to which the loss is carried through the year in which the loss arises.

(iii) *Built-in losses.* In the case of a built-in loss, the SRLY subgroup is composed of the member recognizing the loss (the loss member) and each other member that was part of the subgroup with respect to the loss determined under § 1.1502–15T(c)(2) immediately before the members became members of the group. The principles of paragraphs (c)(2)(i) and (ii) of this section apply to determine the SRLY subgroup for the built-in loss that is, under paragraph (c)(1)(ii) of this section, treated as arising in a SRLY with respect to the group in which the loss is recognized. For this purpose and as the context requires, a reference in those paragraphs to a group or former group is a reference to the subgroup determined under § 1.1502–15T(c)(2).

(iv) *Principal purpose of avoiding or increasing a SRLY limitation.* The members composing a SRLY subgroup are not treated as a SRLY subgroup if any of them is formed, acquired, or availed of with a principal purpose of avoiding the application of, or increasing any limitation under, this paragraph (c). Any member excluded from a SRLY subgroup, if excluded with a principal purpose of so avoiding or increasing any SRLY limitation, is treated as included in the SRLY subgroup.

(v) *Coordination with other limitations.* This paragraph (c)(2) does not allow a net operating loss to offset income to the extent inconsistent with other limitations or restrictions on the use of losses, such as a limitation based on the nature or activities of members. For example, any dual consolidated loss may not reduce the taxable income to an extent greater than that allowed under section 1503(d) and § 1.1503–2. See also § 1.1502–47(q) (relating to preemption of rules for life-nonlife groups).

(vi) *Anti-duplication.* If the same item of income or deduction could be taken into account more than once in determining a limitation under this paragraph (c), or in a manner inconsistent with any other provision of the Code or regulations incorporating this paragraph (c), the item of income or deduction is taken into account only once and in such manner that losses are absorbed in accordance with the ordering rules in paragraph (b) of this section and the underlying purposes of this section.

(vii) *Examples.* The principles of this paragraph (c)(2) are illustrated by the following examples:

Example 1. Members of SRLY subgroups. (a) During Year 1, P sustains a $50 net operating loss. At the beginning of Year 2, P buys all the stock of S at a time when the aggregate basis of S's assets exceeds their aggregate value by $70 (as determined under § 1.1502–15T). At the beginning of Year 3, P buys all the stock of T, T has a $60 net operating loss carryover at the time of the acquisition, and T becomes a member of the P group. During Year 4, S forms S1 and T forms T1, each by contributing assets with built-in gains which are, in the aggregate, material. S1 and T1 become members of the P group. M is the common parent of another group. During Year 7, M acquires all of the stock of P, and the members of the P group become members of the M group for the balance of Year 7. The $50 and $60 loss carryovers of P and T are carried to Year 7 of the M group, and the value and basis of S's assets did not change after it became a member of the former P group.

(b) Under paragraph (c)(2) of this section, a separate SRLY subgroup is determined for each loss carryover and built-in loss. In the P group, P's $50 loss carryover is not treated as arising in a SRLY. See § 1.1502–1(f). Consequently, the carryover is not subject to limitation under paragraph (c) of this section in the P group.

(c) In the M group, P's $50 loss carryover is treated as arising in a SRLY and is subject to the limitation under paragraph (c) of this section. A SRLY subgroup with respect to that loss is composed of members which were members of the P group, the group as to which the loss was not a SRLY. The SRLY subgroup is composed of P, the member carrying over the loss, and each other member of the P group that became a member of the M group at the same time as P. A member of the SRLY subgroup remains a member until it ceases to be affiliated with P. For Year 7, the SRLY subgroup is composed of P, S, T, S1, and T1.

(d) In the P group, S's $70 unrealized loss, if recognized within the 5-year recognition period after S becomes a member of the P group, is subject to limitation under paragraph (c) of this section. See § 1.1502–15T and paragraph (c)(1)(ii) of this section. Because S was not continuously affiliated with P, T, or T1 for 60 consecutive months prior to joining the P group, these corporations cannot be included in a SRLY subgroup with respect to S's unrealized loss in the P group. See paragraph (c)(2)(iii) of this section. As a successor to S, S1 is included in a subgroup with S in the P group. Because S did not cease to exist, however, S1's contribution to consolidated taxable income may not be used to increase the consolidated taxable income of the P group that may be offset by the built-in loss. See paragraph (f) of this section.

(e) In the M group, S's $70 unrealized loss, if recognized within the 5-year recognition period after S becomes a member of the M group, is subject to limitation under paragraph (c) of this section. Prior to becoming a member of the M group, S had been continuously affiliated with P (but not T or T1) for 60 consecutive months and S1 is a successor that has remained continuously affiliated with S. Those members had a net unrealized built-in loss immediately before they became members of the group under § 1.1502–15T(c). Consequently, in Year 7, S, S1, and P compose a subgroup in the M group with respect to S's unrealized loss. S1's contribution to consolidated taxable income may not be used to increase the consolidated taxable income of the M group that may be offset by the recognized built-in loss. See paragraph (f) of this section.

(f) In the P group, T's $60 loss carryover arose in a SRLY and is subject to limitation under paragraph (c) of this section. P, S, and S1 were not members of the group in which T's loss arose and cannot be members of a SRLY subgroup with respect to the carryover in the P group. See paragraph (c)(2)(i) of this section. As a successor to T, T1 is included in a SRLY subgroup with T in the P group; however, because T did not cease to exist, T1's contribution to consolidated taxable income may not be used to increase the consolidated taxable income of the P group that may be offset by the carryover. See paragraph (f) of this section.

(g) In the M group, T's $60 loss carryover arose in a SRLY and is subject to limitation under paragraph (c) of this section. T and T1 remain the only members of a SRLY subgroup with respect to the carryover, but T1's contribution to consolidated taxable income may not be used to increase consolidated taxable income of the M group that may be offset by the carryover. See paragraph (f) of this section.

Example 2. Computation of SRLY subgroup limitation. (a) Individual A forms S. Individual B forms T. In Year 2, P buys all the stock of S and T from A and B, and S and T become members of the P group. For Year 3, the P group has a $45 CNOL, which is attributable to P, and which P carries forward. M is the common parent of another group. At the beginning of Year 4, M acquires all of the stock of P and the former members of the P group become members of the M group.

(b) P's year to which the loss is attributable, Year 3, is a SRLY with respect to the M group. See § 1.1502–1(f)(1). However, P, S, and T compose a SRLY subgroup with respect to the Year 3 loss under paragraph (c)(2)(i) of this section because Year 3 is not a SRLY (and is not treated as a SRLY) with respect to the P group. P's loss is carried over to the M group's Year 4 and is therefore subject to the SRLY subgroup limitation in paragraph (c)(2) of this section.

(c) In Year 4, the M group has $10 of consolidated taxable income (computed without regard to the CNOL deduction for Year 4). However, such consolidated taxable income would be $45 if determined by reference to only the items of P, S, and T, the members included in the SRLY subgroup with respect to P's loss carryover. Therefore, the SRLY subgroup limitation under paragraph (c)(2) of this section for P's net operating loss carryover from Year 3 is $45. Because the M group has only $10 of consolidated taxable income in Year 4, however, only $10 of P's net operating loss carryover is included in the CNOL deduction under paragraph (a) of this section in Year 4.

(d) In Year 5, the M group has $100 of consolidated taxable income (computed without regard to the CNOL deduction for Year 5). Neither P, S, nor T has any items of income, gain, deduction, or loss in Year 5. Although the members of the SRLY subgroup do not contribute to the $100 of consolidated taxable income in Year 5, the SRLY subgroup limitation for Year 5 is $35 (the sum of SRLY subgroup consolidated taxable income of $45 in Year 4 and $0 in Year 5, less the $10 net operating loss carryover actually absorbed by the M group in Year 4). Therefore, $35 of P's net operating loss carryover is included in the CNOL deduction under paragraph (a) of this section in Year 5.

Example 3. Inclusion in more than one SRLY subgroup. (a) At the beginning of Year 1, S buys all the stock of T, and T becomes a member of the S group. For Year 1, the S group has a CNOL of $10, all of which is attributable to S and is carried over to Year 2. At the beginning of Year 2, P buys all the stock of S, and S and T become members of the P group. For Year 2, the P group has a CNOL of $35, all of which is attributable to P and is carried over to Year 3. At the beginning of Year 3, M acquires all of the stock of P and the former members of the P group become members of the M group.

(b) P's and S's net operating losses arising in SRLYs with respect to the M group are subject to limitation under paragraph (c) of this section. P, S, and T compose a SRLY subgroup for purposes of determining the limitation for P's $35 net operating loss carryover arising in Year 2 because, under paragraph (c)(2)(i) of this section, Year 2 is not a SRLY with respect to the P group. Similarly, S and T compose a SRLY subgroup for purposes of determining the limitation for S's $10 net operating loss carryover arising in Year 1 because Year 1 is not a SRLY with respect to the S group.

(c) S and T are members of both the SRLY subgroup with respect to P's losses and the SRLY subgroup with respect to S's losses. Under paragraph (c)(2) of this section, S's and T's items cannot be included in the determination of the SRLY subgroup limitation for both SRLY subgroups for the same consolidated return year; paragraph (c)(2)(vi) of this section requires the M group to consider the items of S and T only once so that the losses are absorbed in the order of the taxable years in which they were sustained. Because S's loss was incurred in Year 1, while P's loss was incurred in Year 2, the items will be added in the determination of the consolidated taxable income of the S and T SRLY subgroup to enable S's loss to be absorbed first. The taxable income of the P, S, and T SRLY subgroup is then computed by including the consolidated taxable income for the S and T SRLY subgroup less the amount of any net operating loss carryover of S that is absorbed after applying this section to the S subgroup for the year.

Example 4. Corporation ceases to be affiliated with a SRLY subgroup. (a) P and S are members of the P group and the P group has a CNOL of $30 in Year 1, all of which is attributable to P and carried over to Year 2. At the beginning of Year 2, M acquires all of the stock of P, and P and S become members of the M group. P and S compose a SRLY subgroup with respect to P's net operating loss carryover. For Year 2, consolidated taxable income of the M group determined by reference to only the items of P (and without regard to the CNOL deduction for Year 2) is $40. However, such consolidated taxable income of the M group determined by reference to the items of both P and S is a loss of $20. Thus, the SRLY subgroup limitation under paragraph (c)(2) of this section prevents the M group from including any of P's net operating loss carryover in the CNOL deduction under paragraph (a) of this section in Year 2, and P carries the loss to Year 3.

(b) At the end of Year 2, P sells all of the S stock and S ceases to be a member of the M group and, in turn, ceases to be affiliated with the P subgroup. For Year 3, consolidated taxable income of the M group is $50 (determined without regard to the CNOL deduction for Year 3), and such consolidated taxable income would be $10 if determined by reference to only items of P. However, the limitation under paragraph (c) of this section for Year 3 for P's net operating loss carryover still prevents the M group from including any of P's loss in the CNOL deduction under paragraph (a) of this section. The limitation results from the inclusion of S's items for Year 2 in the determination of the SRLY subgroup limitation for Year 3 even though S ceased to be a member of the M group (and the P subgroup) at the end of Year 2. Thus, the M group's consolidated taxable income determined by reference to only the SRLY subgroup members' items for all consolidated return years of the group through Year 3 (determined without regard to the CNOL deduction) is not a positive amount.

(d) *Coordination with consolidated return change of ownership limitation and transactions subject to old section 382*—(1) *Consolidated return changes of ownership.* If a consolidated return change of ownership occurred before January 1, 1997, the principles of §1.1502–21A(d) apply to determine the amount of the aggregate of the net operating losses attributable to old members of the group that may be included in the consolidated net operating loss deduction under paragraph (a) of this section. For this purpose, §1.1502–1(g) is applied by treating that date as the end of the year of change.

(2) *Old section 382.* The principles of §1.1502–21A(e) apply to disallow or reduce the amount of a net operating loss carryover of a member as a result of a transaction subject to old section 382.

(e) *Consolidated net operating loss.* Any excess of deductions over gross income, as determined under §1.1502–11(a) (without regard to any consolidated net operating loss deduction), is also referred to as the consolidated net operating loss (or CNOL).

(f) *Predecessors and successors*—(1) *In general.* For purposes of this section, any reference to a corporation, member, common parent, or subsidiary, includes, as the context may require, a reference to a successor or predecessor, as defined in §1.1502–1(f)(4).

(2) *Limitation on SRLY subgroups.* Except as the Commissioner may otherwise determine, any increase in the consolidated taxable income of a SRLY subgroup that is attributable to a successor is disregarded unless the successor acquires substantially all the assets and liabilities of its predecessor and the predecessor ceases to exist.

(g) *Effective date.*—(1) *In general.* This section generally applies to consolidated return years beginning on or after January 1, 1997.

(2) *SRLY limitation.* Except in the case of those members (including members of a SRLY subgroup) described in paragraph (g)(3)(iii) of this section, a group does not take into account a consolidated taxable year beginning before January 1, 1997, in determining the aggregate of the consolidated taxable income under paragraph (c)(1) of this section (including for purposes of §1.1502–15T and §1.1502–22T(c)) for the members (or SRLY subgroups).

(3) *Application to prior periods.* A consolidated group may apply the rules of this section to all consolidated return years ending on or after January 29, 1991, and beginning before January 1, 1997, provided that—

(i) The group's tax liability as shown on an original or an amended return is consistent with the application of the rules of this section (other than this paragraph (g)) and §§1.1502–15T, 1.1502–22T, 1.1502–23T, 1.1502–91T through 1.1502–96T, and 1.1502–98T for each such year for which the statute of limitations does not preclude the filing of an amended return on January 1, 1997;

(ii) Each section described in paragraph (g)(3)(i) of this section and §1.1502–1(f)(4)(ii) is applied by substituting ''taxable years ending on or after January 29, 1991'' for ''taxable years beginning on or after January 1, 1997'' (and ''before January 29, 1991'' for ''before January 1, 1997'' in the case of consolidated return changes of ownership) as the context requires;

(iii) The rules of paragraph (c) of this section and §§1.1502–15T and 1.1502–22T(c) are applied only with respect to the losses and deductions of those corporations that became members of the group (including members of a subgroup), and to acquisitions occurring, on or after January 29, 1991, (and only with respect to such losses and deductions);

(iv) The rules of §§1.1502–15A, 1.1502–21A(c) and 1.1502–22A(c) are applied with respect to the losses and deductions of those corporations that became members of the group, and to acquisitions occurring, before January 29, 1991; and

(v) Appropriate adjustments are made in the earliest subsequent open year to reflect any inconsistency in a year for which the statute of limitations precludes the filing of an amended return on January 1, 1997.

(4) *Waiver of carrybacks.* Paragraph (b)(3)(i) of this section (relating to the waiver of carrybacks) applies to net operating losses arising in a consolidated return year for which the due date of the income tax return (without regard to extensions) is on or after August 26, 1996.

[T.D. 8677, 61 FR 33328, June 27, 1996, as amended by T.D. 8751, 63 FR 1745, Jan. 12, 1998]

§ 1.1502–22T Consolidated capital gain and loss (temporary).

(a) *Capital gain.* The determinations under section 1222, including capital gain net income, net long-term capital gain, and net capital gain, with respect to members during consolidated return years are not made separately. Instead, consolidated amounts are determined for the group as a whole. The consolidated capital gain net income for any consolidated return year is determined by reference to—

(1) The aggregate gains and losses of members from sales or exchanges of capital assets for the year (other than gains and losses to which section 1231 applies);

(2) The consolidated net section 1231 gain for the year (determined under § 1.1502–23T); and

(3) The net capital loss carryovers or carrybacks to the year.

(b) *Net capital loss carryovers and carrybacks.*—(1) *In general.* The determinations under section 1222, including net capital loss and net short-term capital loss, with respect to members during consolidated return years are not made separately. Instead, consolidated amounts are determined for the group as a whole. Losses included in the consolidated net capital loss may be carried to consolidated return years, and, after apportionment, may be carried to separate return years. The net capital loss carryovers and carrybacks consist of—

(i) Any consolidated net capital losses of the group; and

(ii) Any net capital losses of the members arising in separate return years.

(2) *Carryovers and carrybacks generally.* The net capital loss carryovers and carrybacks to a taxable year are determined under the principles of section 1212 and this section. Thus, losses permitted to be absorbed in a consolidated return year generally are absorbed in the order of the taxable years in which they were sustained, and losses carried from taxable years ending on the same date, and which are available to offset consolidated capital gain net income, generally are absorbed on a pro rata basis. Additional rules provided under the Code or regulations also apply, as well as the SRLY limitation under paragraph (c) of this section. See, e.g., section 382(l)(2)(B).

(3) *Carryovers and carrybacks of consolidated net capital losses to separate return years.* If any consolidated net capital loss that is attributable to a member may be carried to a separate return year under the principles of § 1.1502–21T(b)(2), the amount of the consolidated net capital loss that is attributable to the member is apportioned and carried to the separate return year (apportioned loss).

(4) *Special rules*—(i) *Short years in connection with transactions to which section 381(a) applies.* If a member distributes or transfers assets to a corporation that is a member immediately after the distribution or transfer in a transaction to which section 381(a) applies, the transaction does not cause the distributor or transferor to have a short year within the consolidated return year of the group in which the transaction occurred that is counted as a separate year for purposes of determining the years to which a net capital loss may be carried.

(ii) *Special status losses.* [Reserved]

(c) *Limitations on net capital loss carryovers and carrybacks from separate return limitation years.* The aggregate of the net capital losses of a member arising (or treated as arising) in SRLYs that are included in the determination of consolidated capital gain net income for all consolidated return years of the group under paragraph (a) of this section may not exceed the aggregate of the consolidated capital gain net income for all consolidated return years of the group determined by reference to only the member's items of gain and loss from capital assets as defined in section 1221 and trade or business assets defined in section 1231(b), including the member's losses actually absorbed by the group in the taxable year (whether or not absorbed by the member). The principles of §1.1502–21T(c)(including the SRLY subgroup principles under §1.1502–21T(c)(2)) apply with appropriate adjustments for purposes of applying this paragraph (c).

(d) *Coordination with respect to consolidated return change of ownership limitation occurring in consolidated return years beginning before January 1, 1997.* If a consolidated return change of ownership occurred before January 1, 1997, the principles of §1.1502–22A(d) apply to determine the amount of the aggregate of the net capital loss attributable to old members of the group (as those terms are defined in §1.1502–1(g)), that may be included in the net capital loss carryover under paragraph (b) of this section. For this purpose, §1.1502–1(g) is applied by treating that date as the end of the year of change.

(e) *Consolidated net capital loss.* Any excess of losses over gains, as determined under paragraph (a) of this section (without regard to any carryovers or carrybacks), is also referred to as the consolidated net capital loss.

(f) *Predecessors and successors.* For purposes of this section, the principles of §1.1502–21T(f) apply with appropriate adjustments.

(g) *Effective date*—(1) *In general.* This section applies to consolidated return years beginning on or after January 1, 1997.

(2) *Application to prior periods.* See §1.1502–21T(g)(3) for rules generally permitting a group to apply the rules of this section to consolidated return years ending on or after January 29, 1991, and beginning before January 1, 1997.

[T.D. 8677, 61 FR 33333, June 27, 1996]

§1.1502–23T Consolidated net section 1231 gain or loss (temporary).

(a) *In general.* Net section 1231 gains and losses of members arising during consolidated return years are not determined separately. Instead, the consolidated net section 1231 gain or loss is determined under this section for the group as a whole.

(b) *Example.* The following example illustrates the provisions of this section:

Example. Use of SRLY registers with net gains and net losses under section 1231. (i) In Year 1, T sustains a $20 net capital loss. At the beginning of Year 2, T becomes a member of the P group. T's capital loss carryover from Year 1 is subject to SRLY limits under §1.1502–22T(c). The members of the P group contribute the following to the consolidated taxable income for Year 2 (computed without regard to T's net capital loss carryover under §1.1502–22T):

		P	T
Year 1 (SRLY)	Ordinary	....	....
	Capital	....	(20)
Year 2	Ordinary	10	20
	Capital	70	0
	§1231	(60)	30

(ii) Under section 1231, if the section 1231 losses for any taxable year exceed the section 1231 gains for such taxable year, such gains and losses are treated as ordinary gains or losses. Because the P group's section 1231 losses, $(60), exceed the section 1231 gains, $30, the P group's net loss is treated as an ordinary loss. T's net section 1231 gain has the same character as the P group's consolidated net section 1231 loss, so T's $30 of section 1231 income is treated as ordinary income for purposes of applying §1.1502–22T(c). Under §1.1502–22T(c), the group's consolidated net capital gain determined by reference only to T's items is $0. None of T's capital loss carryover from Year 1 may be taken into account in Year 2.

(c) *Recapture of ordinary loss.* [Reserved]

(d) *Effective date*—(1) *In general.* This section applies to gains and losses arising in the determination of consolidated net section 1231 gain or loss for taxable years beginning on or after January 1, 1997.

(2) *Application to prior periods.* See §1.1502–21T(g)(3) for rules generally permitting a group to apply the rules of this section to consolidated return years ending on or after January 29, 1991, and beginning before January 1, 1997.

[T.D. 8677, 61 FR 33334, June 27, 1996, as amended by T.D. 8751, 63 FR 1745, Jan. 12, 1998]

§1.1502–24 Consolidated charitable contributions deduction.

(a) *Determination of amount of consolidated charitable contributions deduction.* The deduction allowed by section 170 for the taxable year shall be the lesser of:

(1) The aggregate deductions of the members of the group allowable under section 170 (determined without regard to section 170(b)(2)), plus the consolidated charitable contribution carryovers to such year, or

(2) Five percent of the adjusted consolidated taxable income as determined under paragraph (c) of this section.

(b) *Carryover of excess charitable contributions.* The consolidated charitable contribution carryovers to any consolidated return year shall consist of any excess consolidated charitable contributions of the group, plus any excess charitable contributions of members of the group arising in separate return years of such members, which may be carried over to the taxable year under the principles of section 170(b) (2) and (3). However, such consolidated carryovers shall not include any excess charitable contributions apportioned to a corporation for a separate return year pursuant to paragraph (e) of § 1.1502–79.

(c) *Adjusted consolidated taxable income.* For purposes of this section, the adjusted consolidated taxable income of the group for any consolidated return year shall be the consolidated taxable income computed without regard to this section, section 242, section 243(a) (2) and (3), § 1.1502–25, § 1.1502–26, and § 1.1502–27, and without regard to any consolidated net operating or net capital loss carrybacks to such year.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966]

§ 1.1502–26 Consolidated dividends received deduction.

(a) *In general.* (1) The consolidated dividends received deduction for the taxable year shall be the lesser of:

(i) The aggregate of the deduction of the members of the group allowable under sections 243(a)(1), 244(a), and 245 (computed without regard to the limitations provided in section 246(b)), or

(ii) 85 percent of the consolidated taxable income computed without regard to the consolidated net operating loss deduction, consolidated section 247 deduction, the consolidated dividends received deduction, and any consolidated net capital loss carryback to the taxable year.

Subdivision (ii) of this subparagraph shall not apply for any consolidated return year for which there is a consolidated net operating loss. (See §§ 1.1502–21T(e) or 1.1502–21A(f), as appropriate for the definition of a consolidated net operating loss.)

(2) If any member computes a deduction under section 593(b)(2) for a taxable year beginning after July 11, 1969, and ending before August 30, 1975, the deduction otherwise computed under this section shall be reduced by an amount determined by multiplying the deduction (determined without regard to this sentence and without regard to dividends received by the common parent if such parent does not use the percentage of income method provided by section 593(b)(2)) by the applicable percentage of the member with the highest applicable percentage (determined under subparagraphs (A) and (B) of section 593(b)(2)).

(3) For taxable years ending on or after August 30, 1975, the deduction otherwise computed under this section shall be reduced by the sum of the amounts determined under paragraph (a)(4) of this section for each member that is a thrift institution that computes a deduction under section 593(b)(2).

(4) For each thrift institution, the amount determined under this subparagraph is the product of:

(i) The portion of the deduction determined with regard to the sum of the dividends received by: (A) The thrift institution, and (B) any member in which that thrift institution owns, directly and with the application of paragraph (a)(5) of this section, 5 percent or more of the stock on any day during the consolidated return year, and

(ii) The thrift institution's applicable percentage determined under subparagraphs (A) and (B) of section 593(b)(2).

For purposes of this subparagraph, dividends allocated to a thrift institution under § 1.596–1(c) shall be considered received by the thrift institution.

(5) For purposes of paragraph (a)(4)(i) of this section, a member owning stock of another member (the ''second member'') shall be considered as owning its proportionate share of any stock of a member owned by the second member. Stock considered as being owned by

reason of the preceding sentence shall, for purposes of applying that sentence, be treated as actually owned. The proportionate share of stock in a member owned by another member is the proportion which the value of the stock so owned bears to the value of all the outstanding stock in the member. For purposes of this paragraph the term ''stock'' includes nonvoting stock which is limited and preferred as to dividends.

(6) For purposes of paragraph (a)(4)(i) of this section, if two or more thrift institutions that are both members of the group each owns 5 percent or more of the same member's stock, the member's stock will be considered to be owned only by the thrift institution with the highest applicable percentage.

(b) *Intercompany dividends.* The deduction determined under paragraph (a) of this section is determined without taking into account intercompany dividends to the extent that, under §1.1502–13(f)(2), they are not included in gross income. See §1.1502–13 for additional rules relating to intercompany dividends.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). Corporations P, S, and S–1 filed a consolidated return for the calendar year 1966 showing consolidated taxable income of $100,000 (determined without regard to the consolidated net operating loss deduction, consolidated dividends received deduction, and the consolidated section 247 deduction). Such corporations received dividends during such year from nonmember domestic corporations as follows:

	Dividends
Corporation:	
P	$6,000
S	10,000
S–1	34,000
Total	50,000

The dividends received deduction allowable to each member under section 243(a)(1) (computed without regard to the limitation in section 246(b)) is as follows: P has $5,100 (85 percent of $6,000), S has $8,500 (85 percent of $10,000), and S–1 has $28,900 (85 percent of $34,000), or a total of $42,500. Since $42,500 is less than $85,000 (85 percent of $100,000), the consolidated dividends received deduction is $42,500.

Example (2). Assume the same facts as in example (1) except that consolidated taxable income (computed without regard to the consolidated net operating loss deduction, consolidated dividends received deduction, and the consolidated section 247 deduction) was $40,000. The aggregate of the dividends received deductions, $42,500, computed without regard to section 246(b), results in a consolidated net operating loss of $2,500. See section 172(d)(6). Therefore, paragraph (a)(2) of this section does not apply and the consolidated dividends received deduction is $42,500.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 7631, 44 FR 40497, July 11, 1979; T.D. 8597, 60 FR 36710, July 18, 1995; T.D. 8677, 61 FR 33323, June 27, 1996]

§1.1502–27 Consolidated section 247 deduction.

(a) *Amount of deduction.* The consolidated section 247 deduction for the taxable year shall be an amount computed as follows:

(1) First, determine the amount which is the lesser of:

(i) The aggregate of the dividends paid (within the meaning of section 247(a)) during such year by members of the group which are public utilities (within the meaning of section 247(b)(1)) on preferred stock (within the meaning of section 247(b)(2)), other than dividends paid to other members of the group, or

(ii) The aggregate of the taxable income (or loss) (as determined under paragraph (b) of this section) of each such member which is a public utility.

(2) Then, multiply the amount determined under subparagraph (1) of this paragraph by the fraction specified in section 247(a)(2).

(b) *Computation of taxable income.* For purposes of paragraph (a)(1)(ii) of this section, the taxable income (or loss) of a member of the group described in paragraph (a)(1)(i) shall be determined under §1.1502–12, adjusted for the following items taken into account in the computation of consolidated taxable income:

(1) The portion of the consolidated net operating loss deduction, the consolidated charitable contributions deduction, and the consolidated dividends received deduction, attributable to such member;

(2) Such member's capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (determined without regard to any net

capital loss carryover or carryback attributable to such member);

(3) Such member's net capital loss and section 1231 net loss, reduced by the portion of the consolidated net capital loss attributable to such member; and

(4) The portion of any consolidated net capital loss carryover or carryback attributable to such member which is absorbed in the taxable year.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

BASIS, STOCK OWNERSHIP, AND EARNINGS AND PROFITS RULES

§ 1.1502–30 Stock basis after certain triangular reorganizations.

(a) *Scope.* This section provides rules for determining the basis of the stock of an acquiring corporation as a result of a triangular reorganization. The definitions and nomenclature contained in § 1.358–6 apply to this section.

(b) *General rules*—(1) *Forward triangular merger, triangular C reorganization, or triangular B reorganization. P* adjusts its basis in the stock of S as a result of a forward triangular merger, triangular C reorganization, or triangular B reorganization under § 1.358–6(c) and (d), except that § 1.358–6 (c)(1)(ii) and (d)(2) do not apply. Instead, *P* adjusts such basis by taking into account the full amount of—

(i) *T* liabilities assumed by *S* or the amount of liabilities to which the *T* assets acquired by *S* are subject, and

(ii) The fair market value of any consideration not provided by *P* pursuant to the plan of reorganization.

(2) *Reverse triangular merger.* If *P* adjusts its basis in the *T* stock acquired as a result of a reverse triangular merger under § 1.358–6 (c)(2)(i) and (d), § 1.358–6 (c)(1)(ii) and (d)(2) do not apply. Instead, *P* adjusts such basis by taking into account the full amount of—

(i) *T* liabilities deemed assumed by *S* or the amount of liabilities to which the *T* assets deemed acquired by *S* are subject, and

(ii) The fair market value of any consideration not provided by *P* pursuant to the plan of reorganization.

(3) *Excess loss accounts.* Negative adjustments under this section may exceed *P*'s basis in its *S* or *T* stock. The resulting negative amount is *P*'s excess loss account in its *S* or *T* stock. See § 1.1502–19 for rules treating excess loss accounts as negative basis, and treating references to stock basis as including references to excess loss accounts.

(4) *Application of other rules of law.* The rules for this section are in addition to other rules of law. See § 1.1502–80(d) for the non-application of section 357(c) to *P*.

(5) *Examples.* The rules of this paragraph (b) are illustrated by the following examples. For purposes of these examples, *P*, *S*, and *T* are domestic corporations, *P* and *S* file consolidated returns, *P* owns all of the only class of *S* stock, the *P* stock exchanged in the transaction satisfies the requirements of the applicable triangular reorganization provisions, the facts set forth the only corporate activity, and tax liabilities are disregarded.

Example 1. Liabilities.(a) *Facts. T* has assets with an aggregate basis of $60 and fair market value of $100. *T*'s assets are subject to $70 of liabilities. Pursuant to a plan, *P* forms *S* with $5 of cash (which S retains), and *T* merges into *S*. In the merger, the *T* shareholders receive *P* stock worth $30 in exchange for their *T* stock. The transaction is a reorganization to which sections 368 (a)(1)(A) and (a)(2)(D) apply.

(b) *Basis adjustment.* Under § 1.358–6, *P* adjusts its $5 basis in the *S* stock as if *P* had acquired the *T* assets with a carryover basis under section 362 and transferred these assets to *S* in a transaction in which *P* determines its basis in the *S* stock under section 358. Under the rules of this section, the limitation described in § 1.358–6(c)(1)(ii) does not apply. Thus, *P* adjusts its basis in the *S* stock by –$10 (the aggregate adjusted basis of *T*'s assets decreased by the amount of liabilities to which the *T* assets are subject). Consequently, as a result of the reorganization, *P* has an excess loss account of $5 in its *S* stock.

Example 2. Consideration not provided by P. (a) *Facts. T* has assets with an aggregate basis of $10 and fair market value of $100 and no liabilities. *S* is an operating company with substantial assets that has been in existence for several years. *P* has a $5 basis in its *S* stock. Pursuant to a plan, *T* merges into *S* and the *T* shareholders receive $70 of *P* stock provided by *P* pursuant to the plan of reorganization and $30 of cash provided by *S* in exchange for their *T* stock. The transaction is a reorganization to which sections 368 (a)(1)(A) and (a)(2)(D) apply.

(b) *Basis adjustment.* Under §1.358–6, *P* adjusts its $5 basis in the *S* stock as if *P* had acquired the *T* assets with a carryover basis under section 362 and transferred these assets to *S* in a transaction in which *P* determines its basis in the *S* stock under section 358. Under the rules of this section, the limitation described in §1.358–6(d)(2) does not apply. Thus, *P* adjusts its basis in the *S* stock by –$20 (the aggregate adjusted basis of *T*'s assets decreased by the fair market value of the consideration provided by *S*). As a result of the reorganization, *P* has an excess loss account of $15 in its *S* stock.

(c) *Appreciated asset.* The facts are the same as in paragraph (a) of this *Example 2,* except that in the reorganization *S* provides an asset with a $20 adjusted basis and $30 fair market value instead of $30 cash. The basis is adjusted in the same manner as in paragraph (b) of this *Example 2.* In addition, because *S* recognizes a $10 gain from the asset under section 1001, *P*'s basis in its *S* stock is increased under §1.1502–32(b) by *S*'s $10 gain. Consequently, as a result of the reorganization, *P* has an excess loss account of $5 in its *S* stock. (The results would be the same if the appreciated asset provided by *S* was *P* stock with respect to which *S* recognized gain. See §1.1032–2(c)).

Example 3. Reverse triangular merger. (a) *Facts. T* has assets with an aggregate basis of $60 and fair market value of $100. *T*'s assets are subject to $70 of liabilities. *P* owns all of the only class of *S* stock. *P* has a $5 basis in its *S* stock. Pursuant to a plan, *S* merges into *T* with *T* surviving. In the merger, the *T* shareholders exchange their *T* stock for $2 cash from *P* and $28 worth of *P* stock provided by *P* pursuant to the plan. The transaction is a reorganization to which sections 368 (a)(1)(A) and (a)(2)(E) apply.

(b) *Basis adjustment.* Under §1.358–6, *P*'s basis in the *T* stock acquired equals its $5 basis in its *S* stock immediately before the transaction adjusted by the $60 basis in the *T* assets deemed transferred, and the $70 of liabilities to which the *T* assets are subject. Under the rules of this section, the limitation described in §1.358–6(c)(1)(ii) does not apply. Consequently, *P* has an excess loss account of $5 in its *T* stock as a result of the transaction.

(c) *Effective date.* This section applies to reorganizations occurring on or after December 21, 1995.

[T.D. 8648, 60 FR 66082, Dec. 21, 1995]

§1.1502–31 Stock basis after a group structure change.

(a) *In general*—(1) *Overview.* If one corporation (P) succeeds another corporation (T) under the principles of §1.1502–75(d) (2) or (3) as the common parent of a consolidated group in a group structure change, the basis of members in the stock of the former common parent (or the stock of a successor) is adjusted or determined under this section. See §1.1502–33(f)(1) for the definition of group structure change. For example, if P owns all of the stock of another corporation (S), and T merges into S in a group structure change that is a reorganization described in section 368(a)(2)(D) in which P becomes the common parent of the T group, P's basis in S's stock must be adjusted to reflect the change in S's assets and liabilities. The rules of this section coordinate with the earnings and profits adjustments required under §1.1502–33(f)(1), generally conforming the results of transactions in which the T group continues under §1.1502–75 with P as the common parent. By preserving in P the relationship between T's earnings and profits and asset basis, these adjustments limit possible distortions under section 1502 (e.g., in the deconsolidation rules for earnings and profits under §1.1502–33(e), and the continued filing requirements under §1.1502–75(a)). This section applies whether or not T continues to exist after the group structure change.

(2) *Application of other rules of law.* The rules of this section are in addition to other rules of law. The provisions of this section and other rules of law must not have the effect of duplicating an amount in P's basis in S's stock.

(b) *General rules.* Except as otherwise provided in this section—

(1) *Asset acquisitions.* If a corporation acquires the former common parent's assets (and any liabilities assumed or to which the assets are subject) in a group structure change, the basis of members in the stock of the acquiring corporation is adjusted immediately after the group structure change to reflect the acquiring corporation's allocable share of the former common parent's net asset basis as determined under paragraph (c) of this section. For example, if S acquires all of T's assets in a group structure change that is a reorganization described in section 368(a)(2)(D), P's basis in S's stock is adjusted to reflect T's net asset basis. If P owned some of T's stock before the group structure change, the results

would be the same because P's basis in the T stock is not taken into account in determining P's basis in S's stock. If T's net asset basis is a negative amount, it reduces P's basis in S's stock and, if the reduction exceeds P's basis in S's stock, the excess is P's excess loss account in S's stock. See § 1.1502–19 for rules treating P's excess loss account as negative basis, and treating a reference to P's basis in S's stock as including an excess loss account.

(2) *Stock acquisitions.* If a corporation acquires stock of the former common parent in a group structure change, the basis of the members in the former common parent's stock immediately after the group structure change (including any stock of the former common parent owned before the group structure change) is redetermined in accordance with the results for an asset acquisition described in paragraph (b)(1) of this section. For example, if all of T's stock is contributed to P in a group structure change to which section 351 applies, P's basis in T's stock is T's net asset basis, rather than the amount determined under section 362. Similarly, if S merges into T in a group structure change described in section 368(a)(2)(E), P's basis in T's stock is the basis that P would have in S's stock under paragraph (b)(1) of this section if T had merged into S in a group structure change described in section 368(a)(2)(D).

(c) *Net asset basis.* The former common parent's net asset basis is the basis it would have in the stock of a newly formed subsidiary, if—

(1) The former common parent transferred its assets (and any liabilities assumed or to which the assets are subject) to the subsidiary in a transaction to which section 351 applies;

(2) The former common parent and the subsidiary were members of the same consolidated group (see § 1.1502–80(d) for the non-application of section 357(c) to the transfer); and

(3) The asset basis taken into account is each asset's basis immediately after the group structure change (e.g., taking into account any income or gain recognized in the group structure change and reflected in the asset's basis).

(d) *Additional adjustments.* In addition to the adjustments in paragraph (b) of this section, the following adjustments are made:

(1) *Consideration not provided by P.* The basis is reduced to reflect the fair market value of any consideration not provided by the member. For example, if S acquires T's assets in a group structure change described in section 368(a)(2)(D), and S provides an appreciated asset (e.g., stock of P) as partial consideration in the transaction, P's basis in S's stock is reduced by the fair market value of the asset.

(2) *Allocable share*—(i) *Asset acquisitions.* If a corporation receives less than all of the former common parent's assets and liabilities in the group structure change, the former common parent's net asset basis taken into account under paragraph (b)(1) of this section is adjusted accordingly.

(ii) *Stock acquisitions.* If a corporation owns less than all of the former common parent's stock immediately after a group structure change described in paragraph (b)(2) of this section, the percentage of the former common parent's net asset basis taken into account equals the percentage (by fair market value) of the former common parent's stock owned immediately after the group structure change. For example, if P owns less than all of the former common parent's stock immediately after the group structure change, only an allocable part of the basis determined under this section is reflected in the shares owned by P (and the amount allocable to shares owned by nonmembers has no effect on the basis of their shares).

(3) *Allocation among shares of stock.* The basis determined under this section is allocated among shares under the principles of section 358. For example, if P owns multiple classes of the former common parent's stock immediately after the group structure change, only an allocable part of the basis determined under this section is reflected in the basis of each share. See § 1.1502–19(d), for special allocations with respect to excess loss accounts.

(4) *Higher-tier members.* To the extent that the former common parent is owned by members other than the new common parent, the basis of members

in the stock of all subsidiaries owning, directly or indirectly, in whole or in part, an interest in the former common parent's assets or liabilities is adjusted in accordance with the principles of this section. The adjustments are applied in the order of the tiers, from the lowest to the highest.

(e) *Waiver of loss carryovers of former common parent* —(1) *General rule.* An irrevocable election may be made to treat all or any portion of a loss carryover attributable to the common parent as expiring for all Federal income tax purposes immediately before the group structure change. Thus, if the loss carryover is treated as expiring under the election, it will not result in a negative adjustment to the basis of P's stock under §1.1502–32(b).

(2) *Election.* The election described in this paragraph (e) must be made in a separate statement entitled ''ELECTION TO TREAT LOSS CARRYOVER AS EXPIRING UNDER §1.1502–31(e).'' The statement must be filed with the consolidated group's return for the year that includes the group structure change, and it must be signed by the former and the new common parent. The statement must identify the amount of each loss carryover deemed to expire (or the amount of each loss carryover deemed not to expire, with any balance of any loss carryovers being deemed to expire).

(f) *Predecessors and successors.* For purposes of this section, any reference to a corporation includes a reference to a successor or predecessor as the context may require. See §1.1502–32(f) for definitions of predecessor and successor.

(g) *Examples.* For purposes of the examples in this section, unless otherwise stated, all corporations have only one class of stock outstanding, the tax year of all persons is the calendar year, all persons use the accrual method of accounting, the facts set forth the only corporate activity, all transactions are between unrelated persons, and tax liabilities are disregarded. The principles of this section are illustrated by the following examples.

Example 1. Forward triangular merger. (a) *Facts.* P is the common parent of one group and T is the common parent of another. T has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. T's shareholders have an aggregate basis of $50 in T's stock. In Year 1, pursuant to a plan, P forms S and T merges into S with the T shareholders receiving $100 of P stock in exchange for their T stock. The transaction is a reorganization described in section 368(a)(2)(D). The transaction is also a reverse acquisition under §1.1502- 75(d)(3) because the T shareholders, as a result of owning T's stock, own more than 50% of the value of P's stock immediately after the transaction. Thus, the transaction is a group structure change under §1.1502–33(f)(1), and P's earnings and profits are adjusted to reflect T's earnings and profits immediately before T ceases to be the common parent of the T group.

(b) *Analysis.* Under paragraph (b)(1) of this section, P's basis in S's stock is adjusted to reflect T's net asset basis. Under paragraph (c) of this section, T's net asset basis is $60, the basis T would have in the stock of a subsidiary under section 358 if T had transferred all of its assets and liabilities to the subsidiary in a transaction to which section 351 applies. Thus, P has a $60 basis in S's stock.

(c) *Pre-existing S.* The facts are the same as in paragraph (a) of this *Example 1,* except that P has owned the stock of S for several years and P has a $50 basis in the S stock before the merger with T. Under paragraph (b)(1) of this section, P's $50 basis in S's stock is adjusted to reflect T's net asset basis. Thus, P's basis in S's stock is $110 ($50 plus $60).

(d) *Excess loss account included in former common parent's net asset basis.* The facts are the same as in paragraph (a) of this *Example 1,* except that T has two assets, an operating asset with an $80 basis and $90 fair market value, and stock of a subsidiary with a $20 excess loss account and $10 fair market value. Under paragraph (c) of this section, T's net asset basis is $60 ($80 minus $20). See sections 351 and 358, and §1.1502–19. Consequently, P has a $60 basis in S's stock. Under section 362 and §1.1502–19, S has an $80 basis in the operating asset and a $20 excess loss account in the stock of the subsidiary.

(e) *Liabilities in excess of basis.* The facts are the same as in paragraph (a) of this *Example 1,* except that T's assets have a fair market value of $170 (and $60 basis) and are subject to $70 of liabilities. Under paragraph (c) of this section, T's net asset basis is ($10) ($60 minus $70). See sections 351 and 358, and §§1.1502–19 and 1.1502–80(d). Thus, P has a $10 excess loss account in S's stock. Under section 362, S has a $60 basis in its assets (which are subject to $70 of liabilities). (Under paragraph (a)(2) of this section, because the liabilities are taken into account in determining net asset basis under paragraph (c) of this section, the liabilities are not also taken into account as consideration not provided by P under paragraph (d)(1) of this section.)

(f) *Consideration provided by S.* The facts are the same as in paragraph (a) of this *Example 1,* except that P forms S with a $100 contribution at the beginning of Year 1, and during Year 6, pursuant to a plan, S purchases $100 of P stock and T merges into S with the T shareholders receiving P stock in exchange for their T stock. Under paragraph (b)(1) of this section, P's $100 basis in S's stock is increased by $60 to reflect T's net asset basis. Under paragraph (d)(1) of this section, P's basis in S's stock is decreased by $100 (the fair market value of the P stock) because the P stock purchased by S and used in the transaction is consideration not provided by P.

(g) *Appreciated asset provided by S.* The facts are the same as in paragraph (a) of this *Example 1,* except that P has owned the stock of S for several years, and the shareholders of T receive $60 of P stock and an asset of S with a $30 adjusted basis and $40 fair market value. S recognizes a $10 gain from the asset under section 1001. Under paragraph (b)(1) of this section, P's basis in S's stock is increased by $60 to reflect T's net asset basis. Under paragraph (d)(1) of this section, P's basis in S's stock is decreased by $40 (the fair market value of the asset provided by S). In addition, P's basis in S's stock is increased under § 1.1502–32(b) by S's $10 gain.

(h) *Depreciated asset provided by S.* The facts are the same as in paragraph (a) of this *Example 1,* except that P has owned the stock of S for several years, and the shareholders of T receive $60 of P stock and an asset of S with a $50 adjusted basis and $40 fair market value. S recognizes a $10 loss from the asset under section 1001. Under paragraph (b)(1) of this section, P's basis in S's stock is increased by $60 to reflect T's net asset basis. Under paragraph (d)(1) of this section, P's basis in S's stock is decreased by $40 (the fair market value of the asset provided by S). In addition, S's $10 loss is taken into account under § 1.1502–32(b) in determining P's basis adjustments under that section.

Example 2. Stock acquisition. (a) *Facts.* P is the common parent of one group and T is the common parent of another. T has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. T's shareholders have an aggregate basis of $50 in T's stock. Pursuant to a plan, P forms S and S acquires all of T's stock in exchange for P stock in a transaction described in section 368(a)(1)(B). The transaction is also a reverse acquisition under § 1.1502–75(d)(3). Thus, the transaction is a group structure change under § 1.1502–33(f)(1), and the earnings and profits of P and S are adjusted to reflect T's earnings and profits immediately before T ceases to be the common parent of the T group.

(b) *Analysis.* Under paragraph (d)(4) of this section, although S is not the new common parent of the T group, adjustments must be made to S's basis in T's stock in accordance with the principles of this section. Although S's basis in T's stock would ordinarily be determined under section 362 by reference to the basis of T's shareholders in T's stock immediately before the group structure change, under the principles of paragraph (b)(2) of this section, S's basis in T's stock is determined by reference to T's net asset basis. Thus, S's basis in T's stock is $60.

(c) *Higher-tier adjustments.* Under paragraph (d)(4) of this section, P's basis in S's stock is adjusted to $60 (to be consistent with the adjustment to S's basis in T's stock).

(d) *Cross ownership.* The facts are the same as in paragraph (a) of this *Example 2,* except that S has owned 10% of T's stock for several years and, pursuant to the plan, S acquires the remaining 90% of T's stock in exchange for P stock. The results are the same as in paragraphs (b) and (c) of this *Example 2,* because S's basis in the initial 10% of T's stock is redetermined under this section.

(e) *Allocable share.* The facts are the same as in paragraph (a) of this *Example 2,* except that P owns only 90% of S's stock immediately after the group structure change. S's basis in T's stock is the same as in paragraph (b) of this *Example 2.* Under paragraph (d)(2) of this section, P's basis in its S stock is adjusted to $54 (90% of S's $60 adjustment).

Example 3. Taxable stock acquisition. (a) *Facts.* P is the common parent of one group and T is the common parent of another. T has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. T's shareholders have an aggregate basis of $50 in T's stock. Pursuant to a plan, P acquires all of T's stock in exchange for $70 of P's stock and $30 in a transaction that is a group structure change under § 1.1502–33(f)(1). P's acquisition of T's stock is a taxable transaction. (Because of P's use of cash, the acquisition is not a transaction described in section 368(a)(1)(B).)

(b) *Analysis.* Under paragraph (b)(2) of this section, P's basis in T's stock is adjusted to reflect T's net asset basis. Thus, although P's basis in T's stock would ordinarily be a cost basis of $100, P's basis in T's stock under this section is $60.

(h) *Effective date*—(1) *General rule.* This section applies to group structure changes occurring in consolidated return years beginning on or after January 1, 1995.

(2) *Prior law.* For prior years, see prior regulations under section 1502 as

in effect with respect to the transaction. See, e.g., §1.1502–31T as contained in the 26 CFR part 1 edition revised as of April 1, 1994.

[T.D. 8560, 59 FR 41683, Aug. 15, 1994]

§1.1502–32 Investment adjustments.

(a) *In general*—(1) *Purpose.* This section provides rules for adjusting the basis of the stock of a subsidiary (S) owned by another member (P). These rules modify the determination of P's basis in S's stock under applicable rules of law by adjusting P's basis to reflect S's distributions and S's items of income, gain, deduction, and loss taken into account for the period that S is a member of the consolidated group. The purpose of the adjustments is to treat P and S as a single entity so that consolidated taxable income reflects the group's income. For example, if P forms S with a $100 contribution, and S takes into account $10 of income, P's $100 basis in S's stock under section 358 is increased by $10 under this section to prevent S's income from being taken into account a second time on P's disposition of S's stock. Comparable adjustments are made for tax-exempt income and noncapital, nondeductible expenses that S takes into account, to preserve their treatment under the Internal Revenue Code.

(2) *Application of other rules of law.* The rules of this section are in addition to other rules of law. See, e.g., section 358 (basis determinations for distributees), section 1016 (adjustments to basis), §1.1502–11(b) (limitations on the use of losses), §1.1502–19 (treatment of excess loss accounts), §1.1502–20 (additional rules relating to stock loss), and §1.1502–31 (basis after a group structure change). P's basis in S's stock must not be adjusted under this section and other rules of law in a manner that has the effect of duplicating an adjustment. See also paragraph (h)(5) of this section for basis reductions applicable to certain former subsidiaries.

(3) *Overview*—(i) *In general.* The amount of the stock basis adjustments and their timing are determined under paragraph (b) of this section. Under paragraph (c) of this section, the amount of the adjustment is allocated among the shares of S's stock. Paragraphs (d) through (g) of this section provide definitions, an anti-avoidance rule, successor rules, and record-keeping requirements.

(ii) *Excess loss account.* Negative adjustments under this section may exceed P's basis in S's stock. The resulting negative amount is P's excess loss account in S's stock. See §1.1502–19 for rules treating excess loss accounts as negative basis, and treating references to stock basis as including references to excess loss accounts.

(iii) *Tiering up of adjustments.* The adjustments to S's stock under this section are taken into account in determining adjustments to higher-tier stock. The adjustments are applied in the order of the tiers, from the lowest to the highest. For example, if P is also a subsidiary, P's adjustment to S's stock is taken into account in determining the adjustments to stock of P owned by other members.

(b) *Stock basis adjustments*—(1) *Timing of adjustments*—(i) *In general.* Adjustments under this section are made as of the close of each consolidated return year, and as of any other time (an interim adjustment) if a determination at that time is necessary to determine a tax liability of any person. For example, adjustments are made as of P's sale of S's stock in order to measure P's gain or loss from the sale, and if P's interest in S's stock is not uniform throughout the year (e.g., because P disposes of a portion of its S stock, or S issues additional shares to another person), the adjustments under this section are made by taking into account the varying interests. An interim adjustment may be necessary even if tax liability is not affected until a later time. For example, if P sells only 50% of S's stock and S becomes a nonmember, adjustments must be made for the retained stock as of the disposition (whether or not P has an excess loss account in that stock). Similarly, if S liquidates during a consolidated return year, adjustments must be made as of the liquidation (even if the liquidation is tax free under section 332).

(ii) *Allocation of items.* If §1.1502–76(b) applies to S for purposes of an adjustment before the close of the group's consolidated return year, the amount of the adjustment is determined under that section. If § 1.1502–76(b) does not apply to the interim adjustment, the adjustment is determined under the principles of § 1.1502–76(b), consistently applied, and ratable allocation under the principles of § 1.1502–76(b)(2)(ii) or (iii) may be used without filing an election under § 1.1502–76(b)(2). The principles would apply, for example, if P becomes a nonmember but S remains a member.

(2) *Amount of adjustments.* P's basis in S's stock is increased by positive adjustments and decreased by negative adjustments under this paragraph (b)(2). The amount of the adjustment, determined as of the time of the adjustment, is the net amount of S's—

(i) Taxable income or loss;

(ii) Tax-exempt income;

(iii) Noncapital, nondeductible expenses; and

(iv) Distributions with respect to S's stock.

(3) *Operating rules.* For purposes of determining P's adjustments to the basis of S's stock under paragraph (b)(2) of this section—

(i) *Taxable income or loss.* S's taxable income or loss is consolidated taxable income (or loss) determined by including only S's items of income, gain, deduction, and loss taken into account in determining consolidated taxable income (or loss), treating S's deductions and losses as taken into account to the extent they are absorbed by S or any other member. For this purpose:

(A) To the extent that S's deduction or loss is absorbed in the year it arises or is carried forward and absorbed in a subsequent year (e.g., under section 172, 465, or 1212), the deduction or loss is taken into account under paragraph (b)(2) of this section in the year in which it is absorbed.

(B) To the extent that S's deduction or loss is carried back and absorbed in a prior year (whether consolidated or separate), the deduction or loss is taken into account under paragraph (b)(2) of this section in the year in which it arises and not in the year in which it is absorbed.

(ii) *Tax-exempt income*—(A) *In general.* S's tax-exempt income is its income and gain which is taken into account but permanently excluded from its gross income under applicable law, and which increases, directly or indirectly, the basis of its assets (or an equivalent amount). For example, S's dividend income to which § 1.1502–13(f)(2)(ii) applies, and its interest excluded from gross income under section 103, are treated as tax-exempt income. However, S's income not recognized under section 1031 is not treated as tax- exempt income because the corresponding basis adjustments under section 1031(d) prevent S's nonrecognition from being permanent. Similarly, S's tax-exempt income does not include gain not recognized under section 332 from the liquidation of a lower-tier subsidiary, or not recognized under section 118 or section 351 from a transfer of assets to S.

(B) *Equivalent deductions.* To the extent that S's taxable income or gain is permanently offset by a deduction or loss that does not reduce, directly or indirectly, the basis of S's assets (or an equivalent amount), the income or gain is treated as tax-exempt income and is taken into account under paragraph (b)(3)(ii)(A) of this section. In addition, the income and the offsetting item are taken into account under paragraph (b)(3)(i) of this section. For example, if S receives a $100 dividend with respect to which a $70 dividends received deduction is allowed under section 243, $70 of the dividend is treated as tax-exempt income. Accordingly, P's basis in S's stock increases by $100 because the $100 dividend and $70 deduction are taken into account under paragraph (b)(3)(i) of this section (resulting in $30 of the increase), and $70 of the dividend is also taken into account under paragraph (b)(3)(ii)(A) of this section as tax-exempt income (resulting in $70 of the increase). (See paragraph (b)(3)(iii) of this section if there is a corresponding negative adjustment under section 1059.) Similarly, income from mineral properties is treated as tax-exempt income to the extent it is offset by deductions for depletion in excess of the basis of the property.

(C) *Discharge of indebtedness income*—(*1*) *In general.* Discharge of indebtedness income of S that is excluded from gross income under section 108 is treated as tax-exempt income only to the extent the discharge is applied to reduce tax attributes (e.g., under section 108 or 1017). Discharge of S's indebtedness is treated as applied to reduce tax attributes only to the extent the attribute reduction is taken into account as a reduction under paragraph (b)(3)(iii) of this section.

(*2*) *Expired loss carryovers.* If the amount of the discharge exceeds the amount of the attribute reduction, the excess is nevertheless treated as applied to reduce tax attributes to the extent a loss carryover expired without tax benefit, the expiration was taken into account as a noncapital, nondeductible expense under paragraph (b)(3)(iii) of this section, and the loss carryover would have been reduced had it not expired.

(D) *Basis shifts.* An increase in the basis of S's assets (or an equivalent as described in paragraph (b)(3)(iv)(B) of this section) is treated as tax-exempt income to the extent that the increase is not otherwise taken into account in determining stock basis, it corresponds to a negative adjustment that is taken into account by the group under this paragraph (b) (or incurred by the common parent), and it has the effect (viewing the group in the aggregate) of a permanent recovery of the reduction. For example, S's basis increase under section 50(c)(2) is treated as tax-exempt income to the extent the preceding basis reduction under section 50(c)(1) is reflected in the basis of a member's stock. On the other hand, if S increases the basis of an asset as the result of an accounting method change, and the related positive section 481(a) adjustment is taken into account over time, the basis increase is not treated as tax-exempt income.

(iii) *Noncapital, nondeductible expenses*—(A) *In general.* S's noncapital, nondeductible expenses are its deductions and losses that are taken into account but permanently disallowed or eliminated under applicable law in determining its taxable income or loss, and that decrease, directly or indirectly, the basis of its assets (or an equivalent amount). For example, S's Federal taxes described in section 275 and loss not recognized under section 311(a) are noncapital, nondeductible expenses. Similarly, if a loss carryover (e.g., under section 172 or 1212) attributable to S expires or is reduced under section 108(b), it becomes a noncapital, nondeductible expense at the close of the last tax year to which it may be carried. However, if S sells and repurchases a security subject to section 1091, the disallowed loss is not a noncapital, nondeductible expense because the corresponding basis adjustments under section 1091(d) prevent the disallowance from being permanent.

(B) *Nondeductible basis recovery.* Any other decrease in the basis of S's assets (or an equivalent as described in paragraph (b)(3)(iv)(B) of this section) may be a noncapital, nondeductible expense to the extent that the decrease is not otherwise taken into account in determining stock basis and is permanently eliminated for purposes of determining S's taxable income or loss. Whether a decrease is so treated is determined by taking into account both the purposes of the Code or regulatory provision resulting in the decrease and the purposes of this section. For example, S's noncapital, nondeductible expenses include any basis reduction under section 50(c)(1), section 1017, section 1059, §1.1502–20(b), or §1.1502–20(g). Also included as a noncapital, nondeductible expense is the amount of any gross-up for taxes paid by another taxpayer that S is treated as having paid (e.g., income included under section 78, or the portion of an undistributed capital gain dividend that is treated as tax deemed to have been paid by a shareholder under section 852(b)(3)(D)(ii), whether or not any corresponding amount is claimed as a tax credit). In contrast, a decrease generally is not a noncapital, nondeductible expense if it results because S redeems stock in a transaction to which section 302(a) applies, S receives assets in a liquidation to which section 332 applies and its basis in the assets is less than its basis in the stock canceled, or S distributes the stock of a subsidiary in a distribution to which section 355 applies.

(iv) *Special rules for tax-exempt income and noncapital, nondeductible expenses.* For purposes of paragraphs (b)(3)(ii) and (iii) of this section:

(A) *Treatment as permanent.* An amount is permanently excluded from gross income, or permanently disallowed or eliminated, if it is so treated by S even though another person may take a corresponding amount into account. For example, if S sells property to a nonmember at a loss that is disallowed under section 267(a), S's loss is a noncapital, nondeductible expense even though under section 267(d) the nonmember may treat a corresponding amount of gain as not recognized. (If the nonmember is a subsidiary in another consolidated group, its gain not recognized under section 267(d) is tax-exempt income under paragraph (b)(3)(ii)(A) of this section.)

(B) *Amounts equivalent to basis and adjustments to basis.* Amounts equivalent to basis include the amount of money, the amount of a loss carryover, and the amount of an adjustment to gain or loss under section 475(a) for securities described in section 475(a)(2). An equivalent to a basis increase includes a decrease in an excess loss account, and an equivalent to a basis decrease includes the denial of basis for taxable income.

(C) *Timing.* An amount is taken into account in the year in which it would be taken into account under paragraph (b)(3)(i) of this section if it were subject to Federal income taxation.

(D) *Tax sharing agreements.* Taxes are taken into account by applying the principles of section 1552 and the percentage method under § 1.1502–33(d)(3) (and by assuming a 100% allocation of any decreased tax liability). The treatment of amounts allocated under this paragraph (b)(3)(iv)(D) is analogous to the treatment of allocations under § 1.1552–1(b)(2). For example, if one member owes a payment to a second member, the first member is treated as indebted to the second member. The right to receive payment is treated as a positive adjustment under paragraph (b)(3)(ii) of this section, and the obligation to make payment is treated as a negative adjustment under paragraph (b)(3)(iii) of this section. If the obligation is not paid, the amount not paid generally is treated as a distribution, contribution, or both, depending on the relationship between the members.

(v) *Distributions.* Distributions taken into account under paragraph (b)(2) of this section are distributions with respect to S's stock to which section 301 applies and all other distributions treated as dividends (e.g., under section 356(a)(2)). See § 1.1502–13(f)(2)(iv) for taking into account distributions to which section 301 applies (but not other distributions treated as dividends) under the entitlement rule.

(4) *Waiver of loss carryovers from separate return limitation years*—(i) *General rule.* If S has a loss carryover from a separate return limitation year when it becomes a member of a consolidated group, the group may make an irrevocable election to treat all or any portion of the loss carryover as expiring for all Federal income tax purposes immediately before S becomes a member of the consolidated group (deemed expiration). If S was a member of another group immediately before it became a member of the consolidated group, the expiration is also treated as occurring immediately after it ceases to be a member of the prior group.

(ii) *Stock basis adjustments from a waiver*—(A) *Qualifying transactions.* If S becomes a member of the consolidated group in a qualifying cost basis transaction and an election under this paragraph (b)(4) is made, the noncapital, nondeductible expense resulting from the deemed expiration does not result in a corresponding stock basis adjustment for any member under this section. A qualifying cost basis transaction is the purchase (i.e., a transaction in which basis is determined under section 1012) by members of the acquiring consolidated group (while they are members) in a 12-month period of an amount of S's stock satisfying the requirements of section 1504(a)(2).

(B) *Nonqualifying transactions.* If S becomes a member of the consolidated group other than in a qualifying cost basis transaction and an election under this paragraph (b)(4) is made, the basis of its stock that is owned by members immediately after it becomes a member is subject to reduction under the principles of this section to reflect the deemed expiration. The reduction occurs immediately before S becomes a member, but after it ceases to be a member of any prior group, and it therefore does not result in a corresponding stock basis adjustment for any higher-tier member of the transferring or acquiring consolidated group. Any basis reduction under this paragraph (b)(4)(ii)(B) is taken into account in making determinations of basis under the Code with respect to S's stock (e.g., a determination under section 362 because the stock is acquired in a transaction described in section 368(a)(1)(B)), but it does not result in corresponding stock basis adjustments under this section for any higher-tier member. If the basis reduction exceeds the basis of S's stock, the excess is treated as an excess loss account to which the members owning S's stock succeed.

(C) *Higher-tier corporations.* If S becomes a member of the consolidated group as a result, in whole or in part, of a higher-tier corporation becoming a member (whether or not in a qualifying cost basis transaction), additional adjustments are required. The highest-tier corporation (T) whose becoming a member resulted in S becoming a member, and T's chain of lower-tier corporations that includes S, are subject to the adjustment. The deemed expiration of S's loss carryover that results in a negative adjustment for the first higher-tier corporation is treated as an expiring loss carryover of that higher-tier corporation for purposes of applying paragraph (b)(4)(ii)(B) of this section to that corporation. For example, if P purchases all of the stock of T, T owns all of the stock of T1, T1 owns all of the stock of S, S becomes a member as a result of T becoming a member, and the election under this paragraph (b)(4) is made, the basis of the S stock is reduced and the reduction tiers up to T1, T1 treats the negative adjustment to its basis in S's stock as an expiring loss carryover of T1, and T then adjusts its basis in T1's stock. In addition, if T becomes a member of the acquiring group in a transaction other than a qualifying cost basis transaction, the amount that tiers up to T also reduces the basis of its stock under paragraph (b)(4)(ii)(B) of this section (but the amount does not tier up to higher-tier members).

(iii) *Net asset basis limitation.* Basis reduced under this paragraph (b)(4) is restored before S becomes a member (and before the basis of S's stock is taken into account in determining basis under the Code) to the extent necessary to conform a share's basis to its allocable portion of net asset basis. In the case of higher-tier corporations under paragraph (b)(4)(ii)(C) of this section, the restoration does not tier up but is instead applied separately to each higher-tier corporation. For purposes of determining each corporation's net asset basis (including the basis of stock in lower-tier corporations), the restoration is applied in the order of tiers, from the lowest to the highest. For purposes of the restoration:

(A) A member's net asset basis is the positive or negative difference between the adjusted basis of its assets (and the amount of any of its loss carryovers that are not deemed to expire) and its liabilities. Appropriate adjustments must be made, for example, to disregard liabilities that subsequently will give rise to deductions (e.g., liabilities to which section 461(h) applies).

(B) Within a class of stock, each share has the same allocable portion of net asset basis. If there is more than one class of common stock, the net asset basis is allocated to each class by taking into account the terms of each class and all other facts and circumstances relating to the overall economic arrangement.

(iv) *Election.* The election described in this paragraph (b)(4) must be made in a separate statement entitled ''ELECTION TO TREAT LOSS CARRYOVER AS EXPIRING UNDER §1.1502–32(b)(4).'' The statement must be filed with the consolidated group's return for the year S becomes a member, and it must be signed by the common parent and S. A separate statement must be made for each member whose loss carryover is deemed to expire. The statement must identify the amount of each loss carryover deemed to expire (or the amount of each loss carryover deemed not to expire, with any balance of any loss carryovers being deemed to expire), the basis of any stock reduced as a result of the deemed expiration, and the computation of the basis reduction.

(5) *Examples*—(i) *In general.* For purposes of the examples in this section, unless otherwise stated, P owns all of

the only class of S's stock, the stock is owned for the entire year, S owns no stock of lower-tier members, the tax year of all persons is the calendar year, all persons use the accrual method of accounting, the facts set forth the only corporate activity, preferred stock is described in section 1504(a)(4), all transactions are between unrelated persons, and tax liabilities are disregarded.

(ii) *Stock basis adjustments.* The principles of this paragraph (b) are illustrated by the following examples.

Example 1. Taxable income. (a) *Current taxable income.* For Year 1, the P group has $100 of taxable income when determined by including only S's items of income, gain, deduction, and loss taken into account. Under paragraph (b)(1) of this section, P's basis in S's stock is adjusted under this section as of the close of Year 1. Under paragraph (b)(2) of this section, P's basis in S's stock is increased by the amount of the P group's taxable income determined by including only S's items taken into account. Thus, P's basis in S's stock is increased by $100 as of the close of Year 1.

(b) *Intercompany gain that is not taken into account.* The facts are the same as in paragraph (a) of this *Example 1,* except that S also sells property to another member at a $25 gain in Year 1, the gain is deferred under § 1.1502–13 and taken into account in Year 3, and P sells 10% of S's stock to nonmembers in Year 2. Under paragraph (b)(3)(i) of this section, S's deferred gain is not additional taxable income for Year 1 or 2 because it is not taken into account in determining the P group's consolidated taxable income for either of those years. The deferred gain is not tax-exempt income under paragraph (b)(3)(ii) of this section because it is not permanently excluded from S's gross income. The deferred gain does not result in a basis adjustment until Year 3, when it is taken into account in determining the P group's consolidated taxable income. Consequently, P's basis in the S shares sold is not increased to reflect S's gain from the intercompany sale of the property. In Year 3, the deferred gain is taken into account, but the amount allocable to the shares sold by P does not increase their basis because these shares are held by nonmembers.

(c) *Intercompany gain taken into account.* The facts are the same as in paragraph (b) of this *Example 1,* except that P sells all of S's stock in Year 2 (rather than only 10%). Under § 1.1502–13, S takes the $25 gain into account immediately before S becomes a nonmember. Thus, P's basis in S's stock is increased to reflect S's gain from the intercompany sale of the property.

Example 2. Tax loss. (a) *Current absorption.* For Year 2, the P group has a $50 consolidated net operating loss when determined by taking into account only S's items of income, gain, deduction, and loss. S's loss is absorbed by the P group in Year 2, offsetting P's income for that year. Under paragraph (b)(3)(i)(A) of this section, because S's loss is absorbed in the year it arises, P has a $50 negative adjustment with respect to S's stock. Under paragraph (b)(2) of this section, P reduces its basis in S's stock by $50. Under paragraph (a)(3)(ii) of this section, if the decrease exceeds P's basis in S's stock, the excess is P's excess loss account in S's stock.

(b) *Interim determination from stock sale.* The facts are the same as in paragraph (a) of this *Example 2,* except that S's Year 2 loss arises in the first half of the calendar year, P sells 50% of S's stock on July 1 of Year 2, and P's income for Year 2 does not arise until after the sale of S's stock. P's income for Year 2 (exclusive of the sale of S's stock) is offset by S's loss, even though the income arises after the stock sale, and no loss remains to be apportioned to S. See §§ 1.1502–11 and 1.1502–21T(b). Under paragraph (b)(3)(i)(A) of this section, because S's $50 loss is absorbed in the year it arises, it reduces P's basis in the S shares sold by $25 immediately before the stock sale. Because S becomes a nonmember, the loss also reduces P's basis in the retained S shares by $25 immediately before S becomes a nonmember. See also § 1.1502–20(b) (possible stock basis reduction on the deconsolidation of S).

(c) *Loss carryback.* The facts are the same as in paragraph (a) of this *Example 2,* except that P has no income or loss for Year 2, S's $50 loss is carried back and absorbed by the P group in Year 1 (offsetting the income of P or S), and the P group receives a $17 tax refund in Year 2 that is paid to S. Under paragraph (b)(3)(i)(B) of this section, because the $50 loss is carried back and absorbed in Year 1, it is treated as a tax loss for Year 2 (the year in which it arises). Under paragraph (b)(3)(ii) of this section, the refund is treated as tax-exempt income of S. Under paragraph (b)(3)(iv)(C) of this section, the tax- exempt income is taken into account in Year 2 because that is the year it would be taken into account under S's method of accounting if it were subject to Federal income taxation. Thus, under paragraph (b)(2) of this section, P reduces its basis in S's stock by $33 as of the close of Year 2 (the $50 tax loss, less the $17 tax refund).

(d) *Loss carryforward.* The facts are the same as in paragraph (a) of this *Example 2,* except that P has no income or loss for Year 2, and S's loss is carried forward and absorbed by the P group in Year 3 (offsetting the income of P or S). Under paragraph (b)(3)(i)(A) of this section, the loss is not treated as a tax loss under paragraph (b)(2) of this section until Year 3.

Example 3. Tax-exempt income and noncapital, nondeductible expenses. (a) *Facts.* For Year 1, the P group has $500 of consolidated taxable income. However, the P group has a $100 consolidated net operating loss when determined by including only S's items of income, gain, deduction, and loss taken into account. Also for Year 1, S has $80 of interest income that is permanently excluded from gross income under section 103, and S incurs $60 of related expense for which a deduction is permanently disallowed under section 265.

(b) *Analysis.* Under paragraph (b)(3)(i)(A) of this section, S has a $100 tax loss for Year 1. Under paragraph (b)(3)(ii)(A) of this section, S has $80 of tax-exempt income. Under paragraph (b)(3)(iii)(A) of this section, S has $60 of noncapital, nondeductible expense. Under paragraph (b)(3)(iv)(C) of this section, the tax-exempt income and noncapital, nondeductible expense are taken into account in Year 1 because that is the year they would be taken into account under S's method of accounting if they were subject to Federal income taxation. Thus, under paragraph (b) of this section, P reduces its basis in S's stock as of the close of Year 1 by an $80 net amount (the $100 tax loss, less $80 of tax-exempt income, plus $60 of noncapital, nondeductible expenses).

Example 4. Discharge of indebtedness. (a) *Facts.* P forms S on January 1 of Year 1 and S borrows $200. During Year 1, S's assets decline in value and the P group has a $100 consolidated net operating loss when determined by including only S's items of income, gain, deduction, and loss taken into account. None of the loss is absorbed by the group in Year 1, and S is discharged from $100 of indebtedness at the close of Year 1. Under section 108(a), S's $100 of discharge of indebtedness income is excluded from gross income because of insolvency. Under section 108(b), S's $100 net operating loss is reduced to zero at the close of Year 1.

(b) *Analysis.* Under paragraph (b)(3)(iii)(B) of this section, the reduction of the net operating loss is treated as a noncapital, nondeductible expense in Year 1 because the net operating loss is permanently disallowed by section 108(b). Under paragraph (b)(3)(ii)(C) of this section, all $100 of S's discharge of indebtedness income is treated as tax-exempt income in Year 1 because the discharge results in a $100 reduction to S's net operating loss. Consequently, the loss and the cancellation of the indebtedness result in no net adjustment to P's basis in S's stock under paragraph (b) of this section. (If the basis of assets were reduced under section 1017, rather than S's loss, the reduction would not occur until the beginning of Year 2 and the discharge would not be treated as tax-exempt income until that time.)

(c) *Insufficient attributes.* The facts are the same as in paragraph (a) of this *Example 4*, except that $70 of S's net operating loss is absorbed in Year 1, offsetting P's income for that year, and the indebtedness is discharged at the beginning of Year 2. Under paragraph (b) of this section, the $70 of S's loss absorbed in Year 1 reduces P's basis in S's stock by $70 as of the close of Year 1. Under section 108(a), S's discharge of indebtedness income in Year 2 is excluded from the P group's gross income because of insolvency. Under section 108(b), the remaining $30 of S's net operating loss carryover from Year 1 is reduced to zero at the close of Year 2. No other attributes are reduced. Under paragraph (b)(3)(iii)(B) of this section, the elimination of the remaining $30 net operating loss by section 108(b) is treated as a noncapital, nondeductible expense. Under paragraph (b)(3)(ii)(C) of this section, only $30 of the discharge is treated as tax-exempt income because only that amount is applied to reduce tax attributes. See also §1.1502–19(c)(1)(iii) (taking into account any excess loss account of P in S's stock). The remaining $70 of discharge income excluded under section 108(a) has no effect on P's basis in S's stock.

(d) *Purchase price adjustment.* Assume instead that S buys land in Year 1 in exchange for S's $100 purchase money note (bearing interest at a market rate of interest in excess of the applicable Federal rate, and providing for a principal payment at the end of Year 10), and the seller agrees with S in Year 4 to discharge $60 of the note as a purchase price adjustment to which section 108(e)(5) applies. S has no discharge of indebtedness income that is treated as tax-exempt income under paragraph (b)(3)(ii) of this section. In addition, the $60 purchase price adjustment is not a noncapital, nondeductible expense under paragraph (b)(3)(iii) of this section. A purchase price adjustment is not equivalent to a discharge of indebtedness that is offset by a deduction or loss. Consequently, the purchase price adjustment results in no net adjustment to P's basis in S's stock under paragraph (b) of this section.

Example 5. Distributions. (a) *Amounts declared and distributed.* For Year 1, the P group has $120 of consolidated taxable income when determined by including only S's items of income, gain, deduction, and loss taken into account. S declares and makes a $10 dividend distribution to P at the close of Year 1. Under paragraph (b) of this section, P increases its basis in S's stock as of the close of Year 1 by a $110 net amount ($120 of taxable income, less a $10 distribution).

(b) *Distributions in later years.* The facts are the same as in paragraph (a) of this *Example 5*, except that S does not declare and distribute the $10 until Year 2. Under paragraph (b) of this section, P increases its basis in S's stock by $120 as of the close of Year 1, and decreases its basis by $10 as of the close of Year 2. (If P were also a subsidiary, the basis of its stock would also be increased in Year

1 to reflect P's $120 adjustment to basis of S's stock; the basis of P's stock would not be changed as a result of S's distribution in Year 2, because P's $10 of tax-exempt dividend income under paragraph (b)(3)(ii) of this section would be offset by the $10 negative adjustment to P's basis in S's stock for the distribution.)

(c) *Amounts declared but not distributed.* The facts are the same as in paragraph (a) of this *Example 5,* except that, during December of Year 1, S declares (and P becomes entitled to) another $70 dividend distribution with respect to its stock, but P does not receive the distribution until after it sells all of S's stock at the close of Year 1. Under §1.1502–13(f)(2)(iv), S is treated as making a $70 distribution to P at the time P becomes entitled to the distribution. (If S is distributing an appreciated asset, its gain under section 311 is also taken into account under paragraph (b)(3)(i) of this section at the time P becomes entitled to the distribution.) Consequently, under paragraph (b) of this section, P increases its basis in S's stock as of the close of Year 1 by only a $40 net amount ($120 of taxable income, less two distributions totalling $80). Any further adjustments after S ceases to be a member and the $70 distribution is made would be duplicative, because the stock basis has already been adjusted for the distribution. Accordingly, the distribution will not result in further adjustments or gain, even if the distribution is a payment to which section 301(c)(2) or (3) applies.

Example 6. Reorganization with boot. (a) *Facts.* P owns all of the stock of S and T. On January 1 of Year 1, P has a $100 basis in the S stock and a $60 basis in the T stock. S and T have no items of income, gain, deduction, or loss for Year 1. S and T each have substantial earnings and profits. At the close of Year 1, T merges into S in a reorganization described in section 368(a)(1)(A) (and in section 368(a)(1)(D)). P receives no additional S stock, but does receive $10 which is treated as a dividend under section 356(a)(2).

(b) *Analysis.* Under section 358, P's basis in the S stock is increased by its basis in the T stock. Under §1.1502–13(f)(3) the money received is treated as being taken into account immediately after the transaction. Thus, the $10 is treated as a dividend distribution under section 301 and under paragraph (b)(3)(v) of this section, the $10 is a distribution to which paragraph (b)(2)(iv) of this section applies. Accordingly, P's basis in the S stock is $160 immediately after the merger, which is then decreased by the $10 distribution taken into account immediately after the transaction, resulting in a basis of $150.

Example 7. Tiering up of basis adjustments. P owns all of S's stock, and S owns all of T's stock. For Year 1, the P group has $100 of consolidated taxable income when determined by including only T's items of income, gain, deduction, and loss taken into account, and $50 of consolidated taxable income when determined by including only S's items taken into account. S increases its basis in T's stock by $100 under paragraph (b) of this section. Under paragraph (a)(3) of this section, this $100 basis adjustment is taken into account in determining P's adjustments to its basis in S's stock. Thus, P increases its basis in S's stock by $150 under paragraph (b) of this section.

Example 8. Allocation of items. (a) *Acquisition in mid-year.* P is the common parent of a consolidated group, and S is an unaffiliated corporation filing separate returns on a calendar-year basis. P acquires all of S's stock and S becomes a member of the P group on July 1 of Year 1. For the entire calendar Year 1, S has $100 of ordinary income and under §1.1502–76(b) $60 is allocated to the period from January 1 to June 30 and $40 to the period from July 1 to December 31. Under paragraph (b) of this section, P increases its basis in S's stock by $40.

(b) *Sale in mid-year.* The facts are the same as in paragraph (a) of this *Example 8,* except that S is a member of the P group at the beginning of Year 1 but ceases to be a member on June 30 as a result of P's sale of S's stock. Under paragraph (b) of this section, P increases its basis in S's stock by $60 immediately before the stock sale. (P's basis increase would be the same if S became a nonmember because S issued additional shares to nonmembers.)

(c) *Absorption of loss carryovers.* Assume instead that S is a member of the P group at the beginning of Year 1 but ceases to be a member on June 30 as a result of P's sale of S's stock, and a $100 consolidated net operating loss attributable to S is carried over by the P group to Year 1. The consolidated net operating loss may be apportioned to S for its first separate return year only to the extent not absorbed by the P group during Year 1. Under paragraph (b)(3)(i) of this section, if the loss is absorbed by the P group in Year 1, whether the offsetting income arises before or after P's sale of S's stock, the absorption of the loss carryover is included in the determination of S's taxable income or loss for Year 1. Thus, P's basis in S's stock is adjusted under paragraph (b) of this section to reflect any absorption of the loss by the P group.

Example 9. Gross-ups. (a) *Facts.* P owns all of the stock of S, and S owns all of the stock of T, a newly formed controlled foreign corporation that is not a passive foreign investment company. In Year 1, T has $100 of subpart F income and pays $34 of foreign income tax, leaving T with $66 of earnings and profits. The P group has $100 of consolidated taxable income when determined by taking into account only S's items (the inclusion under section 951(a), taking into account the section 78 gross-up). As a result of the section

951(a) inclusion, S increases its basis in T's stock by $66 under section 961(a).

(b) *Analysis.* Under paragraph (b)(3)(i) of this section, S has $100 of taxable income. Under paragraph (b)(3)(iii)(B) of this section, the $34 gross-up for taxes paid by T that S is treated as having paid is a noncapital, nondeductible expense (whether or not any corresponding amount is claimed by the P group as a tax credit). Thus, P increases its basis in S's stock under paragraph (b) of this section by the net adjustment of $66.

(c) *Subsequent distribution.* The facts are the same as in paragraph (a) of this *Example 9,* except that T distributes its $66 of earnings and profits in Year 2. The $66 distribution received by S is excluded from S's income under section 959(a) because the distribution represents earnings and profits attributable to amounts that were included in S's income under section 951(a) for Year 1. In addition, S's basis in T's stock is decreased by $66 under section 961(b). The excluded distribution is not tax-exempt income under paragraph (b)(3)(ii) of this section because of the corresponding reduction to S's basis in T's stock. Consequently, P's basis in S's stock is not adjusted under paragraph (b) of this section for Year 2.

Example 10. Recapture of tax-exempt items. (a) *Facts.* S is a life insurance company. For Year 1, the P group has $200 of consolidated taxable income, determined by including only S's items of income, gain, deduction, and loss taken into account (including a $300 small company deduction under section 806). In addition, S has $100 of tax-exempt interest income, $60 of which is S's *company share.* The remaining $40 of tax-exempt income is the *policyholders' share* that reduces S's deduction for increase in reserves.

(b) *Tax-exempt items generally.* Under paragraph (b)(3)(i) of this section, S has $200 of taxable income for Year 1. Also for Year 1, S has $100 of tax-exempt income under paragraph (b)(3)(ii)(A) of this section, and another $300 is treated as tax-exempt income under paragraph (b)(3)(ii)(B) of this section because of the deduction under section 806. Under paragraph (b)(3)(iii) of this section, S has $40 of noncapital, nondeductible expenses for Year 1 because S's deduction under section 807 for its increase in reserves has been permanently reduced by the $40 policyholders' share of the tax-exempt interest income. Thus, P increases its basis in S's stock by $560 under paragraph (b) of this section.

(c) *Recapture.* Assume instead that S is a property and casualty company and, for Year 1, S accrues $100 of estimated salvage recoverable under section 832. Of this amount, $87 (87% of $100) is excluded from gross income because of the ''fresh start'' provisions of Sec. 11305(c) of P.L. 101–508 (the Omnibus Budget Reconciliation Act of 1990). Thus, S has $87 of tax-exempt income under paragraph (b)(3)(ii)(A) of this section that increases P's basis in S's stock for Year 1. (S also has $13 of taxable income over the period of inclusion under section 481.) In Year 5, S determines that the $100 salvage recoverable was overestimated by $30 and deducts $30 for the reduction of the salvage recoverable. However, S has $26.10 (87% of $30) of taxable income in Year 5 due to the partial recapture of its fresh start. Because S has no basis corresponding to this income, S is treated under paragraph (b)(3)(iii)(B) of this section as having a $26.10 noncapital, nondeductible expense in Year 5. This treatment is necessary to reflect the elimination of the erroneous fresh start in S's stock basis and causes a decrease in P's basis in S's stock by $30 for Year 5 (a $3.90 taxable loss and a $26.10 special adjustment).

(c) *Allocation of adjustments among shares of stock*—(1) *In general.* The portion of the adjustment under paragraph (b) of this section that is described in paragraph (b)(2)(iv) of this section (negative adjustments for distributions) is allocated to the shares of S's stock to which the distribution relates. The remainder of the adjustment, described in paragraphs (b)(2)(i) through (iii) of this section (adjustments for taxable income or loss, tax-exempt income, and noncapital, nondeductible expenses), is allocated among the shares of S's stock as provided in paragraphs (c)(2) through (4) of this section. If the remainder of the adjustment is positive, it is allocated first to any preferred stock to the extent provided in paragraph (c)(3) of this section, and then to the common stock as provided in paragraph (c)(2) of this section. If the remainder of the adjustment is negative, it is allocated only to common stock as provided in paragraph (c)(2) of this section. An adjustment under this section allocated to a share for the period the share is owned by a nonmember has no effect on the basis of the share. See paragraph (c)(4) of this section for the reallocation of adjustments, and paragraph (d) of this section for definitions. See §1.1502-19(d) for special allocations of basis determined or adjusted under the Code with respect to excess loss accounts.

(2) *Common stock*—(i) *Allocation within a class.* The portion of the adjustment described in paragraphs (b)(2)(i) through (iii) of this section (the adjustment determined without taking distributions into account) that is allocable to a class of common stock is

generally allocated equally to each share within the class. However, if a member has an excess loss account in shares of a class of common stock at the time of a positive adjustment, the portion of the adjustment allocable to the member with respect to the class is allocated first to equalize and eliminate that member's excess loss accounts and then to increase equally its basis in the shares of that class. Similarly, any negative adjustment is allocated first to reduce the member's positive basis in shares of the class before creating or increasing its excess loss account. Distributions and any adjustments or determinations under the Internal Revenue Code (e.g., under section 358, including any modifications under § 1.1502–19(d)) are taken into account before the allocation is made under this paragraph (c)(2)(i).

(ii) *Allocation among classes*—(A) *General rule.* If S has more than one class of common stock, the extent to which the adjustment described in paragraphs (b)(2)(i) through (iii) of this section (the adjustment determined without taking distributions into account) is allocated to each class is determined, based on consistently applied assumptions, by taking into account the terms of each class and all other facts and circumstances relating to the overall economic arrangement. The allocation generally must reflect the manner in which the classes participate in the economic benefit or burden (if any) corresponding to the items of income, gain, deduction, or loss allocated. In determining participation, any differences in voting rights are not taken into account, and the following factors are among those to be considered—

(*1*) The interest of each share in economic profits and losses (if different from the interest in taxable income);

(*2*) The interest of each share in cash flow and other non-liquidating distributions; and

(*3*) The interest of each share in distributions in liquidation.

(B) *Distributions and Code adjustments.* Distributions and any adjustments or determinations under the Internal Revenue Code are taken into account before the allocation is made under this paragraph (c)(2)(ii).

(3) *Preferred stock.* If the adjustment under paragraphs (b)(2)(i) through (iii) of this section (the adjustment determined without taking distributions into account) is positive, it is allocated to preferred stock to the extent required (when aggregated with prior allocations to the preferred stock during the period that S is a member of the consolidated group) to reflect distributions described in section 301 (and all other distributions treated as dividends) to which the preferred stock becomes entitled, and arrearages arising, during the period that S is a member of the consolidated group. For this purpose, the preferred stock is treated as entitled to a distribution no later than the time the distribution is taken into account under the Internal Revenue Code (e.g., under section 305). If the amount of distributions and arrearages exceeds the positive amount (when aggregated with prior allocations), the positive amount is first allocated among classes of preferred stock to reflect their relative priorities, and the amount allocated to each class is then allocated pro rata within the class. An allocation to a share with respect to arrearages and distributions for the period the share is owned by a nonmember is not reflected in the basis of the share under paragraph (b) of this section. However, if P and S cease to be members of one consolidated group and remain affiliated as members of another consolidated group, P's ownership of S's stock during consolidated return years of the prior group is treated for this purpose as ownership by a member to the extent that the adjustments during the prior consolidated return years are still reflected in the basis of the preferred stock.

(4) *Cumulative redetermination*—(i) *General rule.* A member's basis in each share of S's preferred and common stock must be redetermined whenever necessary to determine the tax liability of any person. See paragraph (b)(1) of this section. The redetermination is made by reallocating S's net adjustment described in paragraphs (b)(2)(i) through (iii) of this section (the adjustment determined without taking distributions into account) for each consolidated return year (or other applicable period) of the group by taking into

account all of the facts and circumstances affecting allocations under this paragraph (c) as of the redetermination date with respect to all of S's shares. For this purpose:

(A) Amounts may be reallocated from one class of S's stock to another class, but not from one share of a class to another share of the same class.

(B) If there is a change in the equity structure of S (e.g., as the result of S's issuance, redemption, or recapitalization of shares), a cumulative redetermination is made for the period before the change. If a reallocation is required by another redetermination after a change, amounts arising after the change are reallocated before amounts arising before the change.

(C) If S becomes a nonmember as a result of a change in its equity structure, any reallocation is made only among the shares of S's stock immediately before the change. For example, if S issues stock to a nonmember creditor in exchange for its debt, and the exchange results in S becoming a nonmember, any reallocation is only among the shares of S's stock immediately before the exchange.

(D) Any reallocation is treated for all purposes after it is made (including subsequent redeterminations) as the original allocation of an amount under this paragraph (c), but the reallocation does not affect any prior period.

(ii) *Prior use of allocations.* An amount may not be reallocated under paragraph (c)(4)(i) of this section to the extent that the amount has been used before the reallocation. For this purpose, an amount has been used to the extent it has been taken into account, directly or indirectly, by any member in determining income, gain, deduction, or loss, or in determining the basis of any property that is not subject to this section (e.g., stock of a corporation that has become a nonmember). For example, if P sells a share of S stock, an amount previously allocated to the share cannot be reallocated to another share of S stock, but an amount allocated to another share of S stock can still be reallocated to the sold share because the reallocated amount has not been taken into account; however, any adjustment reallocated to the sold share may effectively be eliminated, because the reallocation was not in effect when the share was previously sold and P's gain or loss from the sale is not redetermined. If, however, P sells the share of S stock to another member, the amount is not used until P's gain or loss is taken into account under §1.1502–13.

(5) *Examples.* The principles of this paragraph (c) are illustrated by the following examples.

Example 1. Ownership of less than all the stock. (a) *Facts.* P owns 80% of S's only class of stock with an $800 basis. For Year 1, S has $100 of taxable income.

(b) *Analysis.* Under paragraph (c)(1) of this section, the $100 positive adjustment under paragraph (b) of this section for S's taxable income is allocated among the shares of S's stock, including shares owned by nonmembers. Under paragraph (c)(2)(i) of this section, the adjustment is allocated equally to each share of S's stock. Thus, P increases its basis in S's stock under paragraph (b) of this section as of the close of Year 1 by $80. (The basis of the 20% of S's stock owned by nonmembers is not adjusted under this section.)

(c) *Varying interest.* The facts are the same as in paragraph (a) of this *Example 1,* except that P buys the remaining 20% of S's stock at the close of business on June 30 of Year 1 for $208. Under paragraph (b)(1) of this section and the principles of §1.1502–76(b), S's $100 of taxable income is allocable $40 to the period from January 1 to June 30 and $60 to the period from July 1 to December 31. Thus, for the period ending June 30, P is treated as having a $32 adjustment with respect to the S stock that P has owned since January 1 (80% of $40) and, under paragraph (c)(2)(i) of this section, the adjustment is allocated equally among those shares. For the period ending December 31, P is treated as having a $60 adjustment (100% of $60) that is also allocated equally among P's shares of S's stock owned after June 30. P's basis in the shares owned as of the beginning of the year therefore increases by $80 (the sum of 80% of $40 and 80% of $60), from $800 to $880, and P's basis in the shares purchased on June 30 increases by $12 (20% of $60), from $208 to $220. Thus, P's aggregate basis in S's stock as of the end of Year 1 is $1,100.

(d) *Tax liability.* The facts are the same as in paragraph (a) of this *Example 1,* except that P pays S's $34 share of the group's consolidated tax liability resulting from S's taxable income, and S does not reimburse P. S's $100 of taxable income results in a positive adjustment under paragraph (b)(3)(i) of this section, and S's $34 of tax liability results in a negative adjustment under paragraph (b)(3)(iv)(D) of this section and the principles of section 1552. Because S does not make any payment in recognition of the additional tax liability, by analogy to the treatment under § 1.1552–1(b)(2), S is treated as having made a $34 payment that is described in paragraph (b)(3)(iii) of this section (noncapital, nondeductible expenses) and as having received an equal amount from P as a capital contribution. Thus, P increases its basis in its S stock by $52.80 (80% of the $100 of taxable income, less 80% of the $34 tax payment). In addition, P increases its basis in S's stock by $34 under the Internal Revenue Code and paragraph (a)(2) of this section to reflect the capital contribution. In the aggregate, P increases its basis in S's stock by $86.80. (If, as in paragraph (c) of this *Example 1,* P buys the remaining 20% of S's stock at the close of business on June 30, P increases its basis in S's stock by another $7.90 for the additional 20% interest in S's income after June 30 ($60 multiplied by 20%, less 20% of the $20.40 tax payment on $60); the $34 capital contribution by P is reflected in all of its S shares (not just the original 80%), and P's aggregate basis adjustment under this section is $94.70 ($86.80 plus $7.90).)

Example 2. Preferred stock. (a) *Facts.* P owns all of S's common stock with an $800 basis, and nonmembers own all of S's preferred stock. The preferred stock was issued for $200, has a $20 annual, cumulative preference as to dividends, and has an initial liquidation preference of $200. For Year 1, S has $50 of taxable income and no distributions are declared or made.

(b) *Analysis of arrearages.* Under paragraphs (c) (1) and (3) of this section, $20 of the $50 positive adjustment under paragraph (b) of this section is allocated first to the preferred stock to reflect the dividend arrearage arising in Year 1. The remaining $30 of the positive adjustment is allocated to the common stock, increasing P's basis from $800 to $830 as of the close of Year 1. (The basis of the preferred stock owned by nonmembers is not adjusted under this section.)

(c) *Current distribution.* The facts are the same as in paragraph (a) of this *Example 2,* except that S declares and makes a $20 distribution with respect to the preferred stock during Year 1 in satisfaction of its preference. The results are the same as in paragraph (b) of this *Example 2.*

(d) *Varying interest.* The facts are the same as in paragraph (a) of this *Example 2,* except that S has no income or loss for Years 1 and 2, P purchases all of S's preferred stock at the beginning of Year 3 for $240, and S has $70 of taxable income for Year 3. Under paragraph (c)(3) of this section, $60 of the $70 positive adjustment under paragraph (b) of this section is allocated to the preferred stock to reflect the dividends arrearages for Years 1 through 3, but only the $20 for Year 3 is reflected in the basis of the preferred stock under paragraph (b) of this section. (The remaining $40 is not reflected because the preferred stock was owned by nonmembers during Years 1 and 2.) Thus, P increases its basis in S's preferred stock from $240 to $260, and its basis in S's common stock from $800 to $810, as of the close of Year 3. (If P had acquired all of S's preferred stock in a transaction to which section 351 applies, and P's initial basis in S's preferred stock was $200 under section 362, P's basis in S's preferred stock would increase from $200 to $220.)

(e) *Varying interest with current distributions.* The facts are the same as in paragraph (d) of this *Example 2,* except that S declares and makes a $20 distribution with respect to the preferred stock in each of Years 1 and 2 in satisfaction of its preference, and P purchases all of S's preferred stock at the beginning of Year 3 for $200. Under paragraph (c)(3) of this section, $40 of the $70 positive adjustment under paragraph (b) of this section is allocated to the preferred stock to reflect the distributions in Years 1 and 2, and $20 of the $70 is allocated to the preferred stock to reflect the arrearage for Year 3. However, as in paragraph (d) of this *Example 2,* only the $20 attributable to Year 3 is reflected in the basis of the preferred stock under paragraph (b) of this section. Thus, P increases its basis in S's preferred stock from $200 to $220, and P increases its basis in S's common stock from $800 to $810.

Example 3. Cumulative redetermination. (a) *Facts.* P owns all of S's common and preferred stock. The preferred stock has a $100 annual, cumulative preference as to dividends. For Year 1, S has $200 of taxable income, the first $100 of which is allocated to the preferred stock and the remaining $100 of which is allocated to the common stock. For Year 2, S has no adjustment under paragraph (b) of this section, and P sells all of S's common stock at the close of Year 2.

(b) *Analysis.* Under paragraph (c)(4) of this section, P's basis in S's common stock must be redetermined as of the sale of the stock. The redetermination is made by reallocating the $200 positive adjustment under paragraph (b) of this section for Year 1 by taking into account all of the facts and circumstances affecting allocations as of the sale. Thus, the $200 positive adjustment for Year 1 is reallocated entirely to the preferred stock to reflect the dividend arrearages for Years 1 and 2. The reallocation away from the common stock reflects the fact that, because of the additional amount of arrearage in Year 2, the common stock is not entitled to any part of the $200 of taxable income from Year 1. Thus, the common stock has no positive or negative adjustment, and the preferred stock has a $200 positive adjustment. These reallocations are treated as the original allocations for Years 1 and 2. (The results for the common stock would be the same if the common and preferred stock were not owned by the same member, or the preferred stock were owned by nonmembers.)

(c) *Preferred stock issued after adjustment arises.* The facts are the same as in paragraph (a) of this *Example 3,* except that S does not issue its preferred stock until the beginning of Year 2, S has no further adjustment under paragraph (b) of this section for Years 2 and 3, and P sells S's common stock at the close of Year 3. Under paragraphs (c) (1) and (2) of this section, the $200 positive adjustment for Year 1 is initially allocated entirely to the common stock. Under paragraph (c)(4) of this section, the $200 adjustment is reallocated to the preferred stock to reflect the arrearages for Years 2 and 3. Thus, the common stock has no positive or negative adjustment.

(d) *Common stock issued after adjustment arises.* The facts are the same as in paragraph (a) of this *Example 3,* except that S has no preferred stock, S issues additional common stock of the same class at the beginning of Year 2, S has no further adjustment under paragraph (b) of this section in Years 2 and 3, and P sells its S common stock at the close of Year 3. Under paragraphs (c) (1) and (2) of this section, the $200 positive adjustment for Year 1 is initially allocated entirely to the original common stock. Under paragraph (c)(4)(i)(A) of this section, the $200 adjustment is not reallocated among the original common stock and the additional stock. Unlike the preferred stock in paragraph (c) of this *Example 3,* the additional common stock is of the same class as the original stock, and there is no reallocation between shares of the same class.

(e) *Positive and negative adjustments.* The facts are the same as in paragraph (a) of this *Example 3,* except that S has a $200 loss for Year 2 that results in a negative adjustment to the common stock before any redetermination. For purposes of the basis redetermination under paragraph (c)(4) of this section, the Year 1 and 2 adjustments under paragraph (b) of this section are not netted. Thus, as in paragraph (b) of this *Example 3,* the redetermination is made by reallocating the $200 positive adjustment for Year 1 entirely to the preferred stock. The $200 negative adjustment for Year 2 is allocated entirely to the common stock. Consequently, the preferred stock has a $200 positive cumulative adjustment, and the common stock has a $200 negative cumulative adjustment. (The results would be the same if there were no other adjustments described in paragraph (b) of this section, P sells S's common stock at the close of Year 3 rather than Year 2, and an additional $100 arrearage arises in Year 3; only adjustments under paragraph (b) of this section may be reallocated, and there is no additional adjustment for Year 3.)

(f) *Current distributions.* The facts are the same as in paragraph (a) of this *Example 3,* except that, during Year 1, S declares and makes a distribution to P of $100 as a dividend on the preferred stock and $100 as a dividend on the common stock. The taxable income and distributions result in no Year 1 adjustment under paragraph (b) of this section for either the common or preferred stock. For example, if T merges into S, S is treated, as the context may require, as a successor to T and as becoming a member of the group. However, as in paragraph (b) of this *Example 3,* the redetermination under paragraph (c)(4) of this section is made by reallocating a $200 positive adjustment for Year 1 (S's net adjustment described in paragraph (b) of this section, determined without taking distributions into account) to the preferred stock. Consequently, the preferred stock has a $100 positive cumulative adjustment ($200 of taxable income, less a $100 distribution with respect to the preferred stock) and the common stock has a $100 negative cumulative adjustment (for the distribution).

(g) *Convertible preferred stock.* The facts are the same as in paragraph (a) of this *Example 3,* except that the preferred stock is convertible into common stock that is identical to the common stock already outstanding, the holders of the preferred stock convert the stock at the close of Year 2, and no stock is sold until the close of Year 5. Under paragraph (c)(4) of this section, the $200 positive adjustment for Year 1 is reallocated entirely to the preferred stock immediately before the conversion. The newly issued common stock is treated as a second class of S common stock, and adjustments under paragraph (b) of this section are allocated between the original and the new common stock under paragraph (c)(2)(ii) of this section. Although the preferred stock is converted to common stock, the $200 adjustment to the preferred stock is not subsequently reallocated between the original and the new common stock. Because the original and the new stock are equivalent, adjustments under paragraph (b) of this section for subsequent periods are allocated equally to each share.

(h) *Prior use of allocations.* The facts are the same as in paragraph (a) of this *Example 3,* except that P sells 10% of S's common stock at the close of Year 1, and the remaining 90% at the close of Year 2. P's basis in the common stock sold in Year 1 reflects $10 of the adjustment allocated to the common stock for Year 1. Under paragraph (c)(4)(ii) of this section, because $10 of the Year 1 adjustment was used in determining P's gain or loss, only $90 is reallocated to the preferred stock, and $10 remains allocated to the common stock sold.

(i) *Lower-tier members.* The facts are the same as in paragraph (a) of this *Example 3,* except that P owns only S's common stock, and P is also a subsidiary. If there is a redetermination under paragraph (c)(4) of this section by a member owning P's stock, a redetermination with respect to S's stock must be made first, and the effect of that redetermination on P's adjustments is taken into account under paragraph (b) of this section. However, as in paragraph (h) of this *Example 3,* to the extent an amount of the initial adjustments with respect to S's common stock have already been tiered up and used by a member owning P's stock, that amount remains with S's common stock (and the higher-tier member using the adjustment with respect to P's stock), and may not be reallocated to S's preferred stock.

Example 4. Allocation to preferred stock between groups. (a) *Facts.* P owns all of S's only class of stock, and S owns all of T's common and preferred stock. The preferred stock has a $100 annual, cumulative preference as to dividends. For Year 1, T has $200 of taxable income, the first $100 of which is allocated to the preferred stock and the remaining $100 of which is allocated to the common stock, and S has no adjustments other than the amounts tiered up from T. S and T have no adjustments under paragraph (b) of this section for Years 2 and 3. X, the common parent of another consolidated group, purchases all of S's stock at the close of Year 3, and S and T become members of the X group. For Year 4, T has $200 of taxable income, and S has no adjustments other than the amounts tiered up from T.

(b) *Analysis for Years 1 through 3.* Under paragraph (c)(4) of this section, the allocation of S's adjustments under paragraph (b) of this section (determined without taking distributions into account) must be redetermined as of the time P sells S's stock. As a result of this redetermination, T's common stock has no positive or negative adjustment and the preferred stock has a $200 positive adjustment.

(c) *Analysis for Year 4.* Under paragraph (c)(3) of this section, the allocation of T's $200 positive adjustment in Year 4 to T's preferred stock with respect to arrearages is made by taking into account the consolidated return years of both the P group and the X group. Thus, the allocation of the $200 positive adjustment for Year 4 to T's preferred stock is not treated as an allocation for a period for which the preferred stock is owned by a nonmember. Thus, the $200 adjustment is reflected in S's basis in T's preferred stock under paragraph (b) of this section.

(d) *Definitions.* For purposes of this section—

(1) *Class.* The shares of a member having the same material terms (without taking into account voting rights) are treated as a single class of stock.

(2) *Preferred stock.* Preferred stock is stock that is limited and preferred as to dividends and has a liquidation preference. A class of stock that is not described in section 1504(a)(4), however, is not treated as preferred stock for purposes of paragraph (c) of this section if members own less than 80% of each class of common stock (determined without taking this paragraph (d)(2) into account).

(3) *Common stock.* Common stock is stock that is not preferred stock.

(4) *Becoming a nonmember.* A member is treated as becoming a nonmember if it has a separate return year (including another group's consolidated return year). For example, S may become a nonmember if it issues additional stock to nonmembers, but S does not become a nonmember as a result of its complete liquidation.

(e) *Anti-avoidance rule*—(1) *General rule.* If any person acts with a principal purpose contrary to the purposes of this section, to avoid the effect of the rules of this section or apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section.

(2) *Examples.* The principles of this paragraph (e) are illustrated by the following examples.

Example 1. Preferred stock treated as common stock. (a) *Facts.* S has 100 shares of common stock and 100 shares of preferred stock described in section 1504(a)(4). P owns 80 shares of S's common stock and all of S's preferred stock. The shareholders expect that S will have negative adjustments under paragraph (b) of this section for Years 1 and 2 (all of which will be allocable to S's common stock), the negative adjustments will have no significant effect on the value of S's stock, and S will have offsetting positive adjustments thereafter. When the preferred stock was issued, P intended to cause S to recapitalize the preferred stock into additional common stock at the end of Year 2 in a transaction described in section 368(a)(1)(E). P's temporary ownership of the preferred stock is with a principal purpose to limit P's basis reductions under paragraph (b) of this section to 80% of the anticipated negative adjustments. The recapitalization is intended to cause significantly more than 80% of the anticipated positive adjustments to increase P's basis in S's stock because of P's increased ownership of S's common stock immediately after the recapitalization.

(b) *Analysis.* S has established a transitory capital structure with a principal purpose to enhance P's basis in S's stock under this section. Under paragraph (e)(1) of this section, all of S's common and preferred stock is treated as a single class of common stock in

Years 1 and 2 for purposes of this section. Thus, S's items are allocated under the principles of paragraph (c)(2)(ii) of this section, and P decreases its basis in both the common and preferred stock accordingly.

Example 2. Contribution of appreciated property. (a) *Facts.* P owns all of the stock of S and T, and S and T each own 50% of the stock of U. P's S stock has a $150 basis and $200 value, and P's T stock has a $200 basis and $200 value. With a principal purpose to eliminate P's gain from an anticipated sale of S's stock, T contributes to U an asset with a $100 value and $0 basis, and S contributes $100 cash. U sells T's asset and recognizes a $100 gain that results in a $100 positive adjustment under paragraph (b) of this section.

(b) *Analysis.* Under paragraph (c)(2) of this section, U's adjustment ordinarily would be allocated equally to each share of U's stock. If so allocated, P's basis in S's stock would increase from $150 to $200 and P would recognize no gain from the sale of S's stock for $200. Under paragraph (e)(1) of this section, however, because T transferred an appreciated asset to U with a principal purpose to shift a portion of the stock basis increase from P's stock in T to P's stock in S, the allocation of the $100 positive adjustment under paragraph (c) of this section between the shares of U's stock must take into account the contribution. Consequently, all $100 of the positive adjustment is allocated to the U stock owned by T, rather than $50 to the U stock owned by S and $50 to the U stock owned by T. P's basis in S's stock remains $150, and its basis in T's stock increases to $300. Thus, P recognizes a $50 gain from its sale of S's stock for $200.

Example 3. Reorganizations. (a) *Facts.* P forms S with an $800 contribution, $200 of which is in exchange for S's preferred stock described in section 1504(a)(4) and the balance of which is for S's common stock. For Years 1 through 3, S has a total of $160 of ordinary income, $60 of which is distributed with respect to the preferred stock in satisfaction of its $20 annual preference as to dividends. Under this section, P's basis in S's preferred stock is unchanged, and its basis in S's common stock is increased from $600 to $700. To reduce its gain from an anticipated sale of S's preferred stock, P forms T at the close of Year 3 with a contribution of all of S's stock in exchange for corresponding common and preferred stock of T in a transaction to which section 351 applies. At the time of the contribution, the fair market value of the common stock is $700 and the fair market value of the preferred stock is $300 (due to a decrease in prevailing market interest rates). P subsequently sells T's preferred stock for $300.

(b) *Analysis.* Under section 358(b), P ordinarily has a $630 basis in T's common stock (70% of the $900 aggregate stock basis) and a $270 basis in T's preferred stock (30% of the $900 aggregate stock basis). However, because P transferred S's stock to T with a principal purpose to shift the allocation of basis adjustments under this section, adjustments are made under paragraph (e)(1) of this section to preserve the allocation under this section. Thus, P has a $700 basis in T's common stock and a $200 basis in T's preferred stock. Consequently, P recognizes a $100 gain from the sale of T's preferred stock.

Example 4. Post-deconsolidation basis adjustments. (a) *Facts.* For Year 1, the P group has $40 of taxable income when determined by including only S's items of income, gain, deduction, and loss taken into account, and P increases its basis in S's stock by $40 under paragraph (b) of this section. P anticipates that S will have a $40 ordinary loss for Year 2 that will be carried back and offset S's income in Year 1 and result in a $40 reduction to P's basis in S's stock for Year 2 under paragraph (b) of this section. With a principal purpose to avoid the reduction, P causes S to issue voting preferred stock that results in S becoming a nonmember at the beginning of Year 2. (Section 1.1502–20(b) does not reduce P's basis in the S stock as a result of S's deconsolidation.) As anticipated, S has a $40 loss for Year 2, which is carried back to Year 1 and offsets S's income from Year 1.

(b) *Analysis.* Under paragraph (e)(1) of this section, because P caused S to become a nonmember with a principal purpose to absorb S's loss but avoid the corresponding negative adjustment under this section, and P bears a substantial portion of the loss because of its continued ownership of S common stock, the basis of P's common stock in S is decreased by $40 for Year 2. (If P has less than a $40 basis in the retained S stock, P must recognize income for Year 2 to the extent of the excess.) Section 1504(a)(3) limits the ability of S to subsequently rejoin the P group's consolidated return.

(c) *Carryback to pre-consolidation year.* The facts are the same as in paragraph (a) of this *Example 4*, except that P anticipates that S's loss will be carried back and absorbed in a separate return year of S before Year 1 (rather than to the P group's consolidated return for Year 1). Although P causes S to become a nonmember with a principal purpose to avoid the negative adjustment under this section, and P bears a substantial portion of the loss because of its continued ownership of S common stock, both S's income and loss are taken into account under the separate return rules. Consequently, no one has acted with a principal purpose contrary to the purposes of this section, and no adjustments are necessary to carry out the purposes of this section.

Example 5. Pre-consolidation basis adjustments. (a) *Facts.* P forms S with a $100 contribution, and S becomes a member of the P affiliated group which does not file consolidated returns. For Years 1 through 3, S earns $300. P anticipates that it will elect under section 1501 for the P group to begin filing consolidated returns in Year 5. In anticipation of filing consolidated returns, and to avoid the negative stock basis adjustment that would result under paragraph (b) of this section from distributing S's earnings after Year 5, P causes S to distribute $300 during Year 4 as a qualifying dividend within the meaning of section 243(b). There is no plan or intention to recontribute the funds to S after the distribution.

(b) *Analysis.* Although S's distribution of $300 is with a principal purpose to avoid a corresponding negative adjustment under this section, the $300 was both earned and distributed entirely under the separate return rules. Consequently, P and S have not acted with a principal purpose contrary to the purposes of this section, and no adjustments are necessary to carry out the purposes of this section.

(f) *Predecessors and successors.* For purposes of this section, any reference to a corporation or to a share of stock includes a reference to a successor or predecessor as the context may require. A corporation is a successor if the basis of its assets is determined, directly or indirectly, in whole or in part, by reference to the basis of another corporation (the predecessor). For example, if T merges into S, S is treated, as the context may require, as a successor to T and as becoming a member of the group. A share is a successor if its basis is determined, directly or indirectly, in whole or in part, by reference to the basis of another share (the predecessor).

(g) *Recordkeeping.* Adjustments under this section must be reflected annually on permanent records (including work papers). See also section 6001, requiring records to be maintained. The group must be able to identify from these permanent records the amount and allocation of adjustments, including the nature of any tax-exempt income and noncapital, nondeductible expenses, so as to permit the application of the rules of this section for each year.

(h) *Effective date*—(1) *General rule.* This section applies with respect to determinations of the basis of the stock of a subsidiary (e.g., for determining gain or loss from a disposition of stock) in consolidated return years beginning on or after January 1, 1995. If this section applies, basis must be determined or redetermined as if this section were in effect for all years (including, for example, the consolidated return years of another consolidated group to the extent adjustments from those years are still reflected). For example, if the portion of a consolidated net operating loss carryover attributable to S expired in 1990 and is treated as a noncapital, nondeductible expense under paragraph (b) of this section, it is taken into account in tax years beginning on or after January 1, 1995 as a negative adjustment for 1990. Any such determination or redetermination does not, however, affect any prior period. Thus, the negative adjustment for S's noncapital, nondeductible expense is not taken into account for tax years beginning before January 1, 1995.

(2) *Dispositions of stock before effective date*—(i) *In general.* If P disposes of stock of S in a consolidated return year beginning before January 1, 1995, the amount of P's income, gain, deduction, or loss, and the basis reflected in that amount, are not redetermined under this section. See § 1.1502–19 as contained in the 26 CFR part 1 edition revised as of April 1, 1994 for the definition of disposition, and paragraph (h)(5) of this section for the rules applicable to such dispositions.

(ii) *Lower-tier members.* Although P disposes of S's stock in a tax year beginning before January 1, 1995, S's determinations or adjustments with respect to the stock of a lower-tier member with which it continues to file a consolidated return are redetermined in accordance with the rules of this section (even if they were previously taken into account by P and reflected in income, gain, deduction, or loss from the disposition of S's stock). For example, assume that P owns all of S's stock, S owns all of T's stock, and T owns all of U's stock. If S sells 80% of T's stock in a tax year beginning before January 1, 1995 (the effective date), the amount of S's income, gain, deduction, or loss from the sale, and the stock basis adjustments reflected in that amount, are not redetermined if P sells S's stock after the effective date. If S sells the remaining 20% of T's stock after the effective date, S's stock basis adjustments with respect to that

T stock are also not redetermined because T became a nonmember before the effective date. However, if T and U continue to file a consolidated return with each other and T sells U's stock after the effective date, T's stock basis adjustments with respect to U's stock are redetermined (even though some of those adjustments may have been taken into account by S in its prior sale of T's stock before the effective date).

(iii) *Deferred amounts.* For purposes of this paragraph (h)(2), a disposition does not include a transaction to which §1.1502–13, §1.1502–13T, §1.1502–14, or §1.1502–14T applies. Instead, the transaction is deemed to occur as the income, gain, deduction, or loss (if any) is taken into account.

(3) *Distributions*—(i) *Deemed dividend elections.* If there is a deemed distribution and recontribution pursuant to §1.1502–32(f)(2) as contained in the 26 CFR part 1 edition revised as of April 1, 1994 in a consolidated return year beginning before January 1, 1995, the deemed distribution and recontribution under the election are treated as an actual distribution by S and recontribution by P as provided under the election.

(ii) *Affiliated earnings and profits.* This section does not apply to reduce the basis in S's stock as a result of a distribution of earnings and profits accumulated in separate return years, if the distribution is made in a consolidated return year beginning before January 1, 1995, and the distribution does not cause a negative adjustment under the investment adjustment rules in effect at the time of the distribution. See paragraph (h)(5) of this section for the rules in effect with respect to the distribution.

(4) *Expiring loss carryovers.* If S became a member of a consolidated group in a consolidated return year beginning before January 1, 1995, and S had a loss carryover from a separate return limitation year at that time, the group does not treat any expiration of the loss carryover (even if in a tax year beginning on or after January 1, 1995) as a noncapital, nondeductible expense resulting in a negative adjustment under this section. If S becomes a member of a consolidated group in a consolidated return year beginning on or after January 1, 1995, and S has a loss carryover from a separate return limitation year at that time, adjustments with respect to the expiration are determined under this section.

(5) *Prior law*—(i) *In general.* For prior determinations, see prior regulations under section 1502 as in effect with respect to the determination. See, e.g., §§1.1502–32 and 1.1502–32T as contained in the 26 CFR part 1 edition revised as of April 1, 1994.

(ii) *Continuing basis reductions for certain deconsolidated subsidiaries.* If a subsidiary ceases to be a member of a group in a consolidated return year beginning before January 1, 1995, and its basis was subject to reduction under §1.1502–32T or §1.1502–32(g) as contained in the 26 CFR part 1 edition revised as of April 1, 1994, its basis remains subject to reduction under those principles. For example, if S ceased to be a member in 1990, and P's basis in any retained S stock was subject to a basis reduction account, the basis remains subject to reduction. Similarly, if an election could be made to apply §1.1502–32T instead of §1.1502–32(g), the election remains available. However, §§1.1502–32T and 1.1502–32(g) do not apply as a result of a subsidiary ceasing to be a member in tax years beginning on or after January 1, 1995.

[T.D. 8560, 59 FR 41685, Aug. 15, 1994, as amended by T.D. 8677, 61 FR 33323, June 27, 1996; T.D. 8560, 62 FR 12098, Mar. 14, 1997]

§1.1502–33 Earnings and profits.

(a) *In general*—(1) *Purpose.* This section provides rules for adjusting the earnings and profits of a subsidiary (S) and any member (P) owning S's stock. These rules modify the determination of P's earnings and profits under applicable rules of law, including section 312, by adjusting P's earnings and profits to reflect S's earnings and profits for the period that S is a member of the consolidated group. The purpose for modifying the determination of earnings and profits is to treat P and S as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent. References in this section to earnings and profits include deficits in earnings and profits.

(2) *Application of other rules of law.* The rules of this section are in addition to other rules of law. For example, the allowance for depreciation is determined in accordance with section 312(k). P's earnings and profits must not be adjusted under this section and other rules of law in a manner that has the effect of duplicating an adjustment. For example, if S's earnings and profits are reflected in P's earnings and profits under paragraph (b) of this section, and S transfers its assets to P in a liquidation to which section 332 applies, S's earnings and profits that P succeeds to under section 381 must be adjusted to prevent duplication.

(b) *Tiering up earnings and profits*—(1) *General rule.* P's earnings and profits are adjusted under this section to reflect changes in S's earnings and profits in accordance with the applicable principles of § 1.1502–32, consistently applied, and an adjustment to P's earnings and profits for a tax year under this paragraph (b)(1) is treated as earnings and profits of P for the tax year in which the adjustment arises. Under these principles, for example, the adjustments are made as of the close of each consolidated return year, and as of any other time if a determination at that time is necessary to determine the earnings and profits of any person. Similarly, S's earnings and profits are allocated under the principles of § 1.1502–32(c), and the adjustments are applied in the order of the tiers, from the lowest to the highest. However, modifications to the principles include:

(i) The amount of P's adjustment is determined by reference to S's earnings and profits, rather than S's taxable and tax-exempt items (and therefore, for example, the deferral of a negative adjustment for S's unabsorbed losses does not apply).

(ii) The tax sharing rules under paragraph (d) of this section apply rather than those of § 1.1502–32(b)(3)(iv)(D).

(2) *Affiliated earnings and profits.* The reduction in S's earnings and profits under section 312 from a distribution of earnings and profits accumulated in separate return years of S that are not separate return limitation years does not tier up to P's earnings and profits. Thus, the increase in P's earnings and profits under section 312 from receipt of the distribution is not offset by a corresponding reduction.

(3) *Examples*—(i) *In general.* For purposes of the examples in this section, unless otherwise stated, P owns all of the only class of S's stock, the stock is owned for the entire year, S owns no stock of lower-tier members, the tax year of all persons is the calendar year, all persons use the accrual method of accounting, the facts set forth the only corporate activity, preferred stock is described in section 1504(a)(4), all transactions are between unrelated persons, and tax liabilities are disregarded.

(ii) *Tiering up earnings and profits.* The principles of this paragraph (b) are illustrated by the following examples.

Example 1. Tier-up and distribution of earnings and profits. (a) *Facts.* P forms S in Year 1 with a $100 contribution. S has $100 of earnings and profits for Year 1 and no earnings and profits for Year 2. During Year 2, S declares and distributes a $50 dividend to P.

(b) *Analysis.* Under paragraph (b)(1) of this section, S's $100 of earnings and profits for Year 1 increases P's earnings and profits for Year 1. P has no additional earnings and profits for Year 2 as a result of the $50 distribution in Year 2, because there is a $50 increase in P's earnings and profits as a result of the receipt of the dividend and a corresponding $50 decrease in S's earnings and profits under section 312(a) that is reflected in P's earnings and profits under paragraph (b)(1) of this section.

(c) *Distribution of current earnings and profits.* The facts are the same as in paragraph (a) of this *Example 1,* except that S distributes the $50 dividend at the end of Year 1 rather than during Year 2. Under paragraph (b)(1) of this section, P's earnings and profits are increased by $100 (S's $50 of undistributed earnings and profits, plus P's receipt of the $50 distribution). Thus, S's earnings and profits increase by $50 and P's earnings and profits increase by $100.

(d) *Affiliated earnings and profits.* The facts are the same as in paragraph (a) of this *Example 1,* except that P and S do not begin filing consolidated returns until Year 2. Because P and S file separate returns for Year 1, P's basis in S's stock remains $100 under § 1.1502–32 and this section, S has $100 of earnings and profits, and none of S's earnings and profits is reflected in P's earnings and profits under paragraph (b) of this section. S's distribution in Year 2 ordinarily would reduce S's earnings and profits but not increase P's earnings and profits. (P's $50 of earnings and profits from the dividend would be offset by S's $50 reduction in earnings and profits that tiers up under paragraph (b) of this section.) However, under paragraph (b)(2) of this section, the negative adjustment for S's distribution to P does not apply. Thus, S's distribution reduces its earnings and profits by $50 but increases P's earnings and profits by $50. (If S's earnings and profits had been accumulated in a separate return limitation year, paragraph (b)(2) of this section would not apply and the distribution would reduce S's earnings and profits but not increase P's earnings and profits.)

(e) *Earnings and profits deficit.* Assume instead that after P forms S in Year 1 with a $100 contribution, S borrows additional funds and has a $150 deficit in earnings and profits for Year 1. The corresponding loss for tax purposes is not absorbed in Year 1, and is included in the group's consolidated net operating loss carried forward to Year 2. Under paragraph (b)(1) of this section, however, S's $150 deficit in earnings and profits decreases P's earnings and profits for Year 1 by $150. (Absorption of the loss in a later tax year has no effect on the earnings and profits of P and S.)

Example 2. Section 355 distribution. (a) *Facts.* P owns all of S's stock and S owns all of T's stock. For Year 1, T has $100 of earnings and profits. Under paragraph (b)(1) of this section, the earnings and profits of T tier up to S and to P. S and P have no other earnings and profits for Year 1. S distributes T's stock to P at the end of Year 1 in a distribution to which section 355 applies.

(b) *Analysis.* Because S's distribution of T's stock is a distribution to which section 355 applies, the applicable principles of §1.1502–32(b)(2)(iv) do not require P's earnings and profits to be adjusted by reason of the distribution. In addition, although S's earnings and profits may be reduced under section 312(h) as a result of the distribution, the applicable principles of §1.1502–32(b)(3)(iii) do not require P's earnings and profits to be adjusted to reflect this reduction in S's earnings and profits.

Example 3. Allocating earnings and profits among shares. P owns 80% of S's stock throughout Year 1. For Year 1, S has $100 of earnings and profits. Under paragraph (b)(1) of this section, $80 of S's earnings and profits is allocated to P based on P's ownership of S's stock. Accordingly, $80 of S's earnings and profits for Year 1 is reflected in P's earnings and profits for Year 1.

(c) *Special rules.* For purposes of this section—

(1) *Stock of members.* For purposes of determining P's earnings and profits from the disposition of S's stock, P's basis in S's stock is adjusted to reflect S's earnings and profits determined under paragraph (b) of this section, rather than under §1.1502–32. For example, P's basis in S's stock is increased by positive earnings and profits and decreased by deficits in earnings and profits. Similarly, P's basis in S's stock is not reduced for distributions to which paragraph (b)(2) of this section applies (affiliated earnings and profits). P may have an excess loss account in S's stock for earnings and profits purposes (whether or not there is an excess loss account under §1.1502–32), and the excess loss account is determined, adjusted, and taken into account in accordance with the principles of §§1.1502–19 and 1.1502–32.

(2) *Intercompany transactions.* Intercompany items and corresponding items are not reflected in earnings and profits before they are taken into account under §1.1502–13. See §1.1502–13 for the applicable rules and definitions.

(3) *Example.* The principles of this paragraph (c) are illustrated by the following example.

Example. Adjustments to stock basis. (a) *Facts.* P forms S in Year 1 with a $100 contribution. For Year 1, S has $75 of taxable income and $100 of earnings and profits. For Year 2, S has no taxable income or earnings and profits, and S declares and distributes a $50 dividend to P. P sells all of S's stock for $150 at the end of Year 2.

(b) *Analysis.* Under paragraph (c)(1) of this section, P's basis in S's stock for earnings and profits purposes immediately before the sale is $150 (the $100 initial basis, plus S's $100 of earnings and profits for Year 1, minus the $50 distribution of earnings and profits in Year 2). Thus, P recognizes no gain or loss from the sale of S's stock for earnings and profits purposes.

(c) *Earnings and profits deficit.* Assume instead that S has a $100 tax loss and earnings and profits deficit for Year 1. The tax loss is not absorbed in Year 1 and is included in the group's consolidated net operating loss carried forward to Year 2. Under paragraph (b) of this section, S's $100 deficit in earnings and profits decreases P's earnings and profits for Year 1. Under paragraph (c) of this section, P decreases its basis in S's stock for purposes of determining earnings and profits from $100 to $0. (If S had borrowed an additional $50 that it also lost in Year 1, P would have decreased its earnings and profits for Year 1 by the additional $50, and P would have had a $50 excess loss account in S's stock for earnings and profits purposes, which would be taken into account in determining P's earnings and profits from its sale of S's stock.)

(d) *Affiliated earnings and profits.* Assume instead that P and S do not begin filing consolidated returns until Year 2. Under paragraph (b) of this section, the negative adjustment under § 1.1502–32(b) for distributions does not apply to S's distribution of earnings and profits accumulated in a separate return year that is a not separate return limitation year. Thus, P's basis in S's stock for earnings and profits purposes remains $100, and P has $50 of earnings and profits from the sale of S's stock.

(d) *Federal income tax liability*—(1) *In general*—(i) *Extension of tax allocations.* Section 1552 allocates the tax liability of a consolidated group among its members for purposes of determining the amounts by which their earnings and profits are reduced for taxes. Section 1552 does not reflect the absorption by one member of another member's tax attributes (e.g., losses, deductions and credits). For example, if P's $100 of income is offset by S's $100 of deductions, consolidated tax liability is $0 and no amount is allocated under section 1552. However, the group may elect under this paragraph (d) to allocate additional amounts to reflect the absorption by one member of the tax attributes of another member. Permissible methods are set forth in paragraphs (d)(2) through (4) of this section, and election procedures are provided in paragraph (d)(5) of this section. Allocations under this paragraph (d) must be reflected annually on permanent records (including work papers). Any computations of separate return tax liability are subject to the principles of section 1561.

(ii) *Effect of extended tax allocations.* The amounts allocated under this paragraph (d) are treated as allocations of tax liability for purposes of § 1.1552–1(b)(2). For example, if P's taxable income is offset by S's loss, and tax liability is allocated under the percentage method of paragraph (d)(3) of this section, P's earnings and profits are reduced as if its income were subject to tax, P is treated as liable to S for the amount of the tax, and corresponding adjustments are made to S's earnings and profits. If the liability of one member to another is not paid, the amount not paid generally is treated as a distribution, contribution, or both, depending on the relationship between the members.

(2) *Wait-and-see method.* The wait-and-see method under this paragraph (d)(2) is derived from Securities and Exchange Commission procedures. In the year that a member's tax attribute is absorbed, the group's consolidated tax liability is allocated in accordance with the group's method under section 1552. When, in effect, the member with the tax attribute could have absorbed the attribute on a separate return basis in a later year, a portion of the group's consolidated tax liability for the later year that is otherwise allocated to members under section 1552 is reallocated. The reallocation takes into account all consolidated return years to which this paragraph (d) applies (the computation period), and is determined by comparing the tax allocated to a member during the computation period with the member's tax liability determined as if it had filed separate returns during the computation period.

(i) *Cap on allocation under section 1552.* A member's allocation under section 1552 for a tax year may not exceed the excess, if any, of—

(A) The total of the tax liabilities of the member for the computation period (including the current year), determined as if the member had filed separate returns; over

(B) The total amount allocated to the member under section 1552 and this paragraph (d) for the computation period (except the current year).

(ii) *Reallocation of capped amounts.* To the extent that the amount allocated to a member under section 1552 exceeds the limitation under paragraph (d)(2)(i) of this section, the excess is allocated among the remaining members in proportion to (but not to exceed the amount of) each member's excess, if any, of—

(A) The total of the tax liabilities of the member for the computation period (including the current year), determined as if the member had filed separate returns; over

(B) The total amount allocated to the member under section 1552 and this paragraph (d) for the computation period (including for the current year only the amount allocated under section 1552).

(iii) *Reallocation of excess capped amounts.* If the reductions under paragraph (d)(2)(i) of this section exceed the amounts allocable under paragraph (d)(2)(ii) of this section, the excess is allocated among the members in accordance with the group's method under section 1552 without taking this paragraph (d)(2) into account.

(3) *Percentage method.* The percentage method under this paragraph (d)(3) allocates tax liability based on the absorption of tax attributes, without taking into account the ability of any member to subsequently absorb its own tax attributes. The allocation under this method is in addition to the allocation under section 1552.

(i) *Decreased earnings and profits.* A member's allocation under section 1552 for any year is increased, thereby decreasing its earnings and profits, by a fixed percentage (not to exceed 100%) of the excess, if any, of—

(A) The member's separate return tax liability for the consolidated return year as determined under §1.1552–1(a)(2)(ii); over

(B) The amount allocated to the member under section 1552.

(ii) *Increased earnings and profits.* An amount equal to the total decrease in earnings and profits under paragraph (d)(3)(i) of this section (including amounts allocated as a result of a carryback) increases the earnings and profits of the members whose attributes are absorbed, and is allocated among them in a manner that reasonably reflects the absorption of the tax attributes.

(4) *Additional methods.* The absorption by one member of the tax attributes of another member may be reflected under any other method approved in writing by the Commissioner.

(5) *Election of allocation method*—(i) *In general.* Tax liability may be allocated under this paragraph (d) only if an election is filed with the group's first return. The election must—

(A) Be made in a separate statement entitled ‘‘ELECTION TO ALLOCATE TAX LIABILITY UNDER §1.1502–33(d)’’;

(B) State the allocation method elected under §1.1502–33(d) and under section 1552;

(C) If the percentage method is elected, state the percentage (not to exceed 100%) to be used; and

(D) If a method is permitted under paragraph (d)(4) of this section, attach evidence of approval of the method by the Commissioner.

(ii) *Consent*—(A) *Electing or changing methods.* An election for a later year, or an election to change methods, may be made only with the written consent of the Commissioner.

(B) *Prior law elections.* An election in effect for the last tax year beginning before January 1, 1995, remains in effect under this section. However, a group may elect to conform its earnings and profits computations to the method described in §1.1502–32(b)(3)(iv)(D) (the percentage method, using a 100% allocation), whether or not it has previously made an election for earnings and profits purposes. If a conforming election is made, the group must make all adjustments necessary to prevent amounts from being duplicated or omitted. The conforming election is made by attaching a statement entitled ‘‘ELECTION TO CONFORM TAX ALLOCATIONS UNDER §§1.1502–32 and 1.1502–33(d)’’ to the consolidated group's return for its first tax year beginning on or after January 1, 1995. The statement must be signed by the common parent, and must specify whether the method is conformed only for years beginning on or after January 1, 1995 or as if the method were in effect for all prior years. The statement must also describe the adjustments made by reason of the change (e.g., to reflect prior use of earnings and profits).

(6) *Examples.* The principles of this paragraph (d) are illustrated by the following examples.

Example 1. Wait-and-see method. (a) *Facts.* P owns all of the stock of S1 and S2. The P group uses the wait-and-see method of allocation under paragraph (d)(2) of this section in conjunction with §1.1552–1(a)(1). For Year 1, each member's taxable income, both for purposes of §1.1552–1(a)(1) and redetermined as if the member had filed separate returns, is as follows: P $0, S1 $2,000, and S2 ($1,000). Thus, the P group's consolidated tax liability for Year 1 is $340 (assuming a 34% tax rate).

(b) *Analysis.* Under § 1.1552–1(a)(1)(i), the tax liability of the P group is allocated among the members in accordance with the portion of the consolidated taxable income attributable to each member having taxable income. Thus, all of the P group's $340 consolidated tax liability is allocated to S1. As a result, S1 decreases its earnings and profits under section 1552 by $340 (even if S1 does not pay the tax liability). No further allocations are made under paragraph (d)(2) of this section because S2 cannot yet absorb its loss on a separate return basis.

(c) *Payment of tax liability.* If S1 pays the $340 tax liability, there is no further effect on the income, earnings and profits, or stock basis of any member. If P pays the $340 tax liability (and the payment is not a loan from P to S1), P is treated as making a $340 contribution to the capital of S1; if S2 pays the $340 tax liability (and the payment is not a loan from S2 to S1), S2 is treated as making a $340 distribution to P with respect to its stock, and P is treated as making a $340 contribution to the capital of S1. See § 1.1552–1(b)(2).

(d) *Year 2.* For Year 2, each member's taxable income, under § 1.1552–1(a)(1)(ii) and redetermined as if the member had filed separate returns, without taking into account any carryover from Year 1, is as follows: P $0, S1 $1,000, and S2 $3,000. Thus, the P group's consolidated tax liability for Year 2 is $1,360 (assuming a 34% tax rate). Of this amount, section 1552 would allocate $340 to S1 and $1,020 to S2. However, under paragraph (d)(2)(i) of this section, no more than $680 may be allocated to S2. This is because S2 would have had an aggregate tax liability of $680 if it had filed separate returns for Years 1 and 2 (a $0 tax liability for Year 1, and a $680 tax liability for Year 2, taking into account a $1,000 net operating loss carryover from Year 1). Under paragraph (d)(2)(ii) of this section, the entire excess of $340 which would otherwise be allocated to S2 under § 1.1552–1(a)(1) is allocated to S1. This is because S1 would have had an additional $340 of aggregate tax liability if it had filed separate returns for Years 1 and 2 (a $680 tax liability for Year 1, and a $340 tax liability for Year 2, not taking into account S2's $1,000 net operating loss for Year 1). The effect of the allocation of $680 to S1 and $680 to S2 is determined under § 1.1552–1(b)(2).

Example 2. Percentage method. (a) *Facts.* The facts are the same as in *Example 1,* but the P group uses the percentage method of allocation under paragraph (d)(3) of this section, with a percentage of 100%. In addition, the taxable incomes and losses of the members are the same if computed as provided in § 1.1552–1(a)(2)(ii).

(b) *Analysis.* Under § 1.1552–1(a)(2)(ii), $340 of tax liability is allocated to S1 for Year 1. Under paragraph (d)(3)(i) of this section, S1 is allocated another $340 of tax liability because S1 would have had a $680 tax liability if it had filed separate returns but only $340 is allocated to S1 under section 1552. Thus, S1's earnings and profits are decreased by the $680 total. Under paragraph (d)(3)(ii) of this section, S2's earnings and profits are increased by $340 because the additional $340 allocated to S1 under paragraph (d)(3)(i) of this section is attributable to the absorption of S2's losses.

(c) *Payment of tax liability.* If S1 pays the $340 tax liability of the P group and pays $340 to S2, the Year 1 tax liability results in no further adjustments to the income, earnings and profits, or basis of any member's stock. If S1 pays the $340 tax liability of the P group and pays the other $340 to P instead of S2 because, for example, of an agreement among the members, S2 is treated as distributing $340 to P with respect to its stock in the year that S1 makes the payment to P. See § 1.1552–1(b)(2).

(d) *Year 2.* For Year 2, $340 is allocated to S1 and $1,020 is allocated to S2 under section 1552. No additional amounts are allocated under paragraph (d)(3) of this section.

(e) *Deconsolidations*—(1) *In general.* Immediately before it becomes a nonmember, S's earnings and profits are eliminated to the extent they were taken into account by any member under this section. If S's earnings and profits are eliminated under this paragraph (e)(1), no corresponding adjustment is made to the earnings and profits of P (or any other member) under paragraph (b) of this section or to any basis in a member's stock under paragraph (c) of this section. For this purpose, S is treated as becoming a nonmember on the first day of its first separate return year (including another group's consolidated return year).

(2) *Acquisition of group*—(i) *Application.* This paragraph (e)(2) applies only if a consolidated group (the terminating group) ceases to exist as a result of—

(A) The acquisition by a member of another consolidated group of either the assets of the common parent of the terminating group in a reorganization described in section 381(a)(2), or the stock of the common parent of the terminating group; or

(B) The application of the principles of § 1.1502–75(d)(2) or (d)(3).

(ii) *General rule.* Paragraph (e)(1) of this section does not apply solely by reason of the termination of a group because it is acquired, if there is a surviving group that is, immediately thereafter, a consolidated group. Instead, the surviving group is treated as the terminating group for purposes of applying this paragraph (e) to the terminating group. This treatment does not apply, however, to members of the terminating group that are not members of the surviving consolidated group immediately after the terminating group ceases to exist (e.g., under section 1504(a)(3) relating to reconsolidation, or section 1504(c) relating to includible insurance companies).

(3) *Certain corporate separations and reorganizations.* The adjustments under paragraph (e)(1) of this section must be modified to the extent necessary to effectuate the principles of section 312(h). Thus, P's earnings and profits rather than S's earnings and profits may be eliminated immediately before S becomes a nonmember. P's earnings and profits are eliminated to the extent that its earnings and profits reflect S's earnings and profits after applying section 312(h) immediately after S becomes a nonmember (determined without taking this paragraph (e) into account).

(4) *Special uses of earnings and profits.* Paragraph (e)(1) of this section does not apply for purposes of determining—

(i) The extent to which a distribution is charged to reserve accounts under section 593(e);

(ii) The extent to which a distribution is taxable to the recipient under sections 805(a)(4) and 832; and

(iii) Any other special use identified in guidance published in the Internal Revenue Bulletin.

(5) *Example.* The principles of this paragraph (e) are illustrated by the following example.

Example. (a) *Facts.* Individuals A and B own all of P's stock, and P owns all of the stock of S and T, each with a $500 basis. For Year 1, S has $100 of earnings and profits and T has $50 of earnings and profits. Under paragraph (b)(1) of this section, the earnings and profits of S and T tier up to P, and P has $150 of earnings and profits for Year 1. P sells all of S's stock for $600 at the close of Year 1.

(b) *Analysis.* Under paragraph (e)(1) of this section, S's $100 of earnings and profits is eliminated immediately before S becomes a nonmember because the earnings and profits are taken into account under paragraph (b) of this section in P's earnings and profits. However, no corresponding adjustment is made to P's earnings and profits or to P's basis in S's stock for purposes of earnings and profits. P's earnings and profits for Year 1 remain $150 following the sale of S's stock.

(c) *Forward merger.* The facts are the same as in paragraph (a) of this *Example,* except that, rather than P selling S's stock, S merges into a nonmember in a transaction described in section 368(a)(2)(D). Under paragraph (h) of this section, the nonmember is treated as a successor to S. Thus, as in paragraph (b) of this *Example,* S's $100 of earnings and profits is eliminated immediately before S ceases to be a member.

(d) *Acquisition of entire group.* The facts are the same as in paragraph (a) of this *Example,* except that X, the common parent of another consolidated group, purchases all of P's stock at the close of Year 1, and P sells S's stock during Year 3. Under paragraph (e)(2) of this section, the earnings and profits of S and T are not eliminated as a result of X purchasing P's stock. However, S's earnings and profits from consolidated return years of both the P group and the X group are eliminated immediately before S becomes a nonmember of the X group.

(e) *Earnings and profits deficit.* The facts are the same as in paragraph (d) of this *Example,* except that S has a $550 deficit in earnings and profits for Year 1. The effect of paragraph (e)(1) of this section is the same. Under paragraph (c)(1) of this section, P would have an excess loss account in S's stock for earnings and profits purposes under the principles of §§1.1502–19 and 1.1502–32, and, under the principles of §1.1502–19(c)(2), the excess loss account is not taken into account as a result of X's purchase of P's stock. Under paragraph (e)(2) of this section, S's deficit is not eliminated under paragraph (e)(1) of this section immediately before X's purchase of P's stock. However, S's earnings and profits (or deficit) is eliminated immediately before S becomes a nonmember of the X group.

(f) *Section 355 distribution.* The facts are the same as in paragraph (a) of this *Example,* except that, rather than selling S's stock, P distributes S's stock to A at the close of Year 1 in a distribution to which section 355 applies. Under paragraph (e)(3) of this section, P's earnings and profits may be reduced under section 312(h) as a result of the distribution. To the extent that P's earnings and profits are reduced, S's earnings and profits are not eliminated under paragraph (e)(1) of this section.

(f) *Changes in the structure of the group*—(1) *Changes in the common parent*—(i) *General rule.* If P succeeds another corporation under the principles of §1.1502–75(d) (2) or (3) as the common parent of a consolidated group (a group structure change), the earnings and profits of P are adjusted immediately after P becomes the new common parent to reflect the earnings and profits of the former common parent immediately before the former common parent ceases to be the common parent. The adjustment is made as if P succeeds to the earnings and profits of the former common parent in a transaction described in section 381(a). See § 1.1502–31 for the basis of the stock of members following a group structure change.

(ii) *Minority shareholders.* If the former common parent's stock is not wholly owned by members of the consolidated group immediately after the former common parent ceases to be the common parent, appropriate adjustments must be made to reflect in the new common parent only an allocable part of the former common parent's earnings and profits.

(iii) *Higher-tier members.* To the extent that earnings and profits are adjusted under this paragraph (f)(1), and the former common parent is owned by members other than P, the earnings and profits of the intermediate subsidiaries must be adjusted in accordance with the principles of this section.

(iv) *Example.* The principles of this paragraph (f)(1) are illustrated by the following example.

Example. (a) *Facts.* X is the common parent of a consolidated group with $100 of earnings and profits, and P is the common parent of another consolidated group with $20 of earnings and profits. P acquires all of X's stock at the close of Year 1 in exchange for 70% of P's stock. The exchange is a reverse acquisition under § 1.1502–75(d)(3), and the X group is treated as remaining in existence with P as its new common parent.

(b) *Adjustments for X group earnings and profits.* Under paragraph (f)(1) of this section, P's earnings and profits are adjusted immediately after P becomes the new common parent, to reflect X's $100 of earnings and profits immediately before X ceases to be the common parent. The adjustment is made as if P succeeds to X's earnings and profits in a transaction described in section 381(a). Thus, immediately after the acquisition, P has $120 of accumulated earnings and profits and X continues to have $100 of accumulated earnings and profits.

(c) *Adjustments for P group earnings and profits.* Although the P group terminates on P's acquisition of X's stock, under paragraph (e)(2) of this section, no adjustments are made to the earnings and profits of any subsidiaries in the terminating P group.

(d) *Acquisition of separate return corporation.* The facts are the same as in paragraph (a) of this *Example,* except that, immediately before the acquisition of its stock by P, X is not affiliated with any other corporation. The exchange is a reverse acquisition under § 1.1502–75(d)(3), and P is treated as the common parent of the X group. Consequently, the results are the same as in paragraphs (b) and (c) of this *Example.*

(2) *Change in the location of subsidiaries.* If the location of a member within a group changes, appropriate adjustments must be made to the earnings and profits of the members to prevent the earnings and profits from being eliminated. For example, if P transfers all of S's stock to another member in a transaction to which section 351 and § 1.1502–13 apply, the transferee's earnings and profits are adjusted immediately after the transfer to reflect S's earnings and profits immediately before the transfer from consolidated return years. On the other hand, if the transferee purchases S's stock from P, the transferee's earnings and profits are not adjusted.

(g) *Anti-avoidance rule.* If any person acts with a principal purpose contrary to the purposes of this section, to avoid the effect of the rules of this section or apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section.

(h) *Predecessors and successors.* For purposes of this section, any reference to a corporation or to a share includes a reference to a successor or predecessor as the context may require. A corporation is a successor if its earnings and profits are determined, directly or indirectly, in whole or in part, by reference to the earnings and profits of another corporation (the predecessor). A share is a successor if its basis is determined, directly or indirectly, in whole or in part, by reference to the basis of another share (the predecessor).

(i) [Reserved]

(j) *Effective date*—(1) *General rule.* This section applies with respect to determinations of the earnings and profits of a member (e.g., for purposes of a characterizing a distribution to which section 301 applies) in consolidated return years beginning on or after January 1, 1995. If this section applies, earnings and profits must be determined or redetermined as if this section were in effect for all years (including, for example, the consolidated return years of another consolidated group to the extent the earnings and profits from those years are still reflected). For example, if a distribution by P to a nonmember shareholder in 1990 was a dividend because of an unabsorbed loss carryover attributable to S, P's earnings and profits in tax years beginning after January 1, 1995 are redetermined by taking into account a negative adjustment in the tax year S's loss arose and in 1990 for P's distribution, and any subsequent absorption of the loss has no effect on earnings and profits. Any such determination or redetermination does not, however, affect any prior period. Thus, the shareholder's treatment in 1990 of the distribution as a dividend (and the effect of the distribution on stock basis) is not redetermined under this section.

(2) *Dispositions of stock before effective date*—(i) *In general.* If P disposes of stock of S in a consolidated return year beginning before January 1, 1995, the amount of P's earnings and profits with respect to S are not redetermined under paragraph (j)(1) of this section. See §1.1502–19 as contained in the 26 CFR part 1 edition revised as of April 1, 1994 for the definition of disposition, and paragraph (j)(5) of this section for the rules applicable to such dispositions.

(ii) *Lower-tier members.* Although P disposes of S's stock in a tax year beginning before January 1, 1995, S's determinations or adjustments with respect to lower-tier members with which it continues to file a consolidated return are redetermined in accordance with the rules of this section (even if S's earnings and profits were previously taken into account by P). For example, assume that P owns all of S's stock, S owns all of T's stock, and T owns all of U's stock. If S sells 80% of T's stock in a tax year beginning before January 1, 1995 (the effective date), the amount of S's earnings and profits from the sale, and the adjustments to stock basis for earnings and profits purposes that are reflected in that amount, are not redetermined if P sells S's stock after the effective date. If S sells the remaining 20% of T's stock after the effective date, S's stock basis adjustments with respect to that T stock are also not redetermined because T became a nonmember before the effective date. However, if T and U continue to file a consolidated return with each other, paragraph (e)(1) of this section did not apply, and T sells U's stock after the effective date, T's earnings and profits with respect to U are redetermined (even though some of the earnings and profits may have been taken into account by S in its prior sale of T's stock before the effective date).

(iii) *Deferred amounts.* For purposes of this paragraph (j)(2), a disposition does not include a transaction to which §1.1502–13, §1.1502–13T, §1.1502–14, or §1.1502–14T applies. Instead, the transaction is deemed to occur as the earnings and profits (if any) are taken into account.

(3) *Deconsolidations and group structure changes*—(i) *In general.* Paragraphs (e) and (f) of this section apply with respect to deconsolidations and group structure changes occurring in consolidated return years beginning on or after January 1, 1995.

(ii) *Prior period group structure changes.* If there was a group structure change in a consolidated return year beginning before January 1, 1995, and earnings and profits were not determined under §1.1502–33T(a) as contained in the 26 CFR part 1 edition revised as of April 1, 1994, a distribution in a tax year ending after September 7, 1988, of earnings and profits that are not reflected in the earnings and profits of the distributee member, but would have been so reflected if §1.1502–33T(a) as contained in the 26 CFR part 1 edition revised as of April 1, 1994 had applied, the negative adjustment under paragraph (b) of this section for distributions does not apply (and there is therefore no offset to the increase in the earnings and profits of the distributee).

(4) *Deemed dividend elections.* If there is a deemed distribution and recontribution pursuant to §1.1502–32(f)(2) as contained in the 26 CFR part 1 edition

revised as of April 1, 1994 in a consolidated return year beginning before January 1, 1995, the deemed distribution and recontribution under the election are treated as an actual distribution by S and recontribution by P as provided under the election.

(5) *Prior law.* For prior determinations, see prior regulations under section 1502 as in effect with respect to the determination. See, e.g., §§ 1.1502–33 and 1.1502–33T as contained in the 26 CFR part 1 edition revised as of April 1, 1994.

[T.D. 8560, 59 FR 41695, Aug. 15, 1994, as amended by T.D. 8597, 60 FR 36710, July 18, 1995]

§ 1.1502–34 Special aggregate stock ownership rules.

For purposes of §§ 1.1502–1 through 1.1502–80, in determining the stock ownership of a member of a group in another corporation (the ''issuing corporation'') for purposes of determining the application of section 165(g)(3)(A), 332(b)(1), 333(b), 351(a), or 904(f), in a consolidated return year, there shall be included stock owned by all other members of the group in the issuing corporation. Thus, assume that members A, B, and C each own 33⅓ percent of the stock issued by D. In such case, A, B, and C shall each be treated as meeting the 80-percent stock ownership requirement for purposes of section 332, and no member can elect to have section 333 apply. Furthermore, the special rule for minority shareholders in section 337(d) cannot apply with respect to amounts received by A, B, or C in liquidation of D.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966

SPECIAL TAXES AND TAXPAYERS

§ 1.1502–42 Mutual savings banks, etc.

(a) *In general.* This section applies to mutual savings banks and other institutions described in section 593(a).

(b) *Total deposits.* In computing for purposes of section 593(b)(1)(B)(ii) total deposits or withdrawable accounts at the close of the taxable year, the total deposits or withdrawable accounts of other members shall be excluded.

(c) *Taxable income; taxable years for which the due date (without extensions) for filing returns is before March 15, 1983.* For taxable years for which the due date (without extensions) for filing returns is before March 15, 1983, a member's taxable income for purposes of section 593(b)(2) is determined under § 1.1502–27(b) (computed without regard to any deduction under section 593(b)(2)). In addition, for taxable years beginning after July 11, 1969, taxable income as computed under the preceding sentence is subject to the adjustments provided in section 593(b)(2)(E). See § 1.593–6A(b)(5).

(d) *Taxable income; taxable years for which the due date (without extensions) for filing returns is after March 14, 1983*—(1) *In general.* For a taxable year for which the due date (without extensions) for filing returns is after March 14, 1983, a thrift's taxable income for purposes of section 593(b)(2) is its tentative taxable income (as defined in paragraph (e)(1) of this section).

(2) *Definitions.* For purposes of this section:

(i) A *thrift* is a member described in section 593(a).

(ii) A *nonthrift* is a member that is not a thrift.

(e) *Tentative taxable income (or loss)*—(1) *Thrift.* For purposes of this section, a thrift's tentative taxable income (or loss) is its separate taxable income (determined under § 1.1502–12 without paragraph (q) thereof and without any deduction under section 593(b)), subject to the following adjustments in the following order:

(i) The adjustments described in paragraph (e)(3) of this section;

(ii) The adjustments described in section 593(b)(2)(E) for those thrifts with separate taxable income greater than zero (determined after the adjustments under paragraph (e)(3) of this section); and

(iii) The adjustments described in paragraph (f) of this section.

(2) *Nonthrift.* For purposes of this section, a nonthrift's tentative taxable income (or loss) is its separate taxable income (determined under § 1.1502–12), adjusted for the portion of the consolidated net operating loss deduction attributable to the member, the portion of the consolidated net capital loss carryover or carryback attributable to the

member, and further adjusted as described in paragraph (e)(3) of this section.

(3) *Adjustments for all members.* For each member, the following adjustments taken into account in the computation of consolidated taxable income are included in determining its tentative taxable income (or loss) in order to adjust separate taxable income of the member to take into account certain consolidated items:

(i) The portions of the consolidated charitable contributions deduction and the consolidated dividends received deduction attributable to the member.

(ii) The member's capital gain net income, determined without any net capital loss carryover or carryback attributable to the member.

(iii) The member's net capital loss and section 1231 net loss, reduced by the portion of the consolidated net capital loss attributable to the member.

(f) *Adjustments for thrifts*—(1) *Reductions.* A thrift's separate taxable income (as adjusted under paragraph (e)(3) of this section) is reduced (but not below zero) by losses of thrifts and to the extent attributable to functionally related activities, losses of a nonthrift. Certain operating rules for determining the amount of the reductions are provided in paragraph (f)(4) of this section. The reductions are made in the following amounts in the following order:

(i) The thrift's allocable share (as determined under paragraph (h)(2) of this section) of another thrift's tentative taxable loss. That tentative taxable loss is determined by including a deduction under section 593(b) (other than paragraph (2) thereof) for the year in which the loss arises.

(ii) The thrift's allocable share (as determined under paragraph (h)(3) of this section) of the portion of the consolidated net operating loss deduction attributable to it or another thrift. That consolidated net operating loss deduction is determined by including a deduction under section 593(b) (other than paragraph (2) thereof) for the year in which the loss arose. The portion of a consolidated net operating loss deduction attributable to another thrift is computed by excluding losses arising in taxable years for which the due date (without extensions) for filing returns is before March 15, 1983.

(iii) The thrift's allocable share (as determined under paragraph (h)(4) of this section) of the loss attributable to functionally related activities of a nonthrift (as determined under paragraph (g) of this section). For a rule netting that share against certain income attributable to functionally related activities of that nonthrift, see paragraph (f)(4)(iv) of this section.

(iv) The thrift's allocable share (as determined under paragraph (h)(3) of this section) of the portion of the consolidated net operating loss deduction attributable to functionally related activities of a nonthrift (as determined under paragraph (h)(5) of this section). That consolidated net operating loss deduction is determined by excluding losses arising in taxable years for which the due date (without extensions) for filing returns is before March 15, 1983. For a rule netting that share against certain income attributable to functionally related activities of that nonthrift, see paragraph (f)(4)(iv) of this section.

(2) *Increases.* (i) A thrift's separate taxable income (as adjusted under paragraphs (e)(3) and (f)(1) of this section) is increased in a subsequent consolidated return year to restore reductions made in a prior consolidated return year to a thrift's separate taxable income by reason of losses of a nonthrift. This increase is the amount of the thrift's allocable share (as determined under paragraph (h)(6) of this section) of the income attributable to functionally related activities of a nonthrift in a consolidated return year and is made only in that year. This increase is made only if both the thrift and the nonthrift were members of the group in the consolidated return years in which both the reduction and increase are made.

(ii) This subdivision (ii) limits the increases to a thrift's separate taxable income to assure that income of a particular nonthrift is used to restore reductions of a thrift only to the extent that such nonthrift's losses reduced the thrift's income. Therefore, as of the end of a consolidated return year, the cumulative increases to a thrift's tentative taxable income (by reason of income attributable to functionally related activities of a nonthrift) may not exceed the cumulative reductions to the thrift's separate taxable income made (by reason of the nonthrift's functionally related activities) under paragraph (f)(1) (iii) and (iv) of this section in the current and all prior consolidated return years during which both the thrift institution and the nonthrift institution were members of the group.

(iii) For a netting rule, see paragraph (f)(4)(iv) of this section.

(3) *Special Rule.* (i) If a carryback to a thrift's separate taxable income diminishes the reduction to a thrift's separate taxable income for a prior consolidated return year otherwise required by paragraph (f)(1) (iii) or (iv) of this section, then any increases to a thrift's separate taxable income under paragraph (f)(2) of this section for an intervening consolidated return year must be recomputed to take into account the effect of such carryback. Thus, if a net operating loss attributable to a thrift is carried back and completely offsets the thrift's separate taxable income (before the reductions under paragraph (f)(1) (iii) or (iv) or this section), any increase to the thrift's separate taxable income under paragraph (f)(2) of this section (attributable to a reduction in the year to which the loss is carried) for an intervening consolidated return year will be eliminated. The recomputation required by this subparagraph (3) must be reflected on an amended return for the intervening consolidated return year for which the increase was previously reported. See example (2) in paragraph (j) of this section.

(ii) If a deficiency for an intervening consolidated return year results from the application of paragraph (f)(3)(i) of this section with respect to an item to which section 6501(h) applies, the deficiency may be assessed at any time within the period described in section 6501(h).

(iii) For purposes of chapter 67 of the Code (relating to interest), the last date prescribed for payment of any tax owed as a result of the application of paragraph (f)(3)(i) of this section is deemed to be the last day of the taxable year for which the item carried back arose.

(4) *Operating rules.* For purposes of paragraphs (d) through (j) of this section:

(i) The portion of a consolidated net operating loss deduction attributable to a member is determined as follows:

(A) First, determine under §§ 1.1502–21T(b) (or § 1.1502–79A(a)(3), as appropriate) the portion of each consolidated net operating loss attributable to the member for the particular year in which the loss arose.

(B) Second, apply the anti-double-counting rule in paragraph (h)(3)(iii) of this section so as not to take the same loss into account twice.

(C) Finally, apply the loss absorption limit in paragraph (f)(4)(iii) of this section to the total amount of the consolidated net operating loss deduction from a particular loss year.

(ii) Capital loss carryovers and carrybacks shall be taken into account in a manner consistent with the principles of paragraphs (d) through (j) of this section.

(iii) This subdivision (iii) prescribes a loss absorption limit. The total amount of the consolidated net operating loss deduction from a given year (loss year) taken into account as reductions under paragraph (f)(1) of this section for another year (absorption year) shall not exceed the amount of the consolidated net operating loss deduction attributable to the loss year absorbed in computing consolidated taxable income for the absorption year. For this purpose, consolidated taxable income for the absorption year shall include a deduction under section 593(b) (other than paragraph (2) thereof) for each thrift member.

(iv) This subdivision (iv) prescribes a rule for netting in certain cases income attributable to functionally related activities of a nonthrift in a consolidated return year ("income year") against losses attributable to functionally related activities of that nonthrift which arise in a consolidated return year ("loss year"). That nonthrift's income is netted against the portion of that nonthrift's loss which would otherwise be applied in a consolidated return year (“reduction year”) under paragraph (f)(1) (iii) or (iv) of this section to reduce a thrift’s tentative taxable income, but:

(A) Only if the income year is not later than the loss year and the reduction year, and

(B) Only to the extent the income had not previously been taken into account under paragraph (f)(2) of this section or this subdivision (iv) as of the close of the later of the loss year and the reduction year.

(g) *Income (or loss) attributable to functionally related activities of a nonthrift*—(1) *In general.* For purposes of this section, the income (or loss) attributable to functionally related activities of a nonthrift is the income (or loss) of the nonthrift:

(i) Attributable to the provision of assets or the rendition of services to a thrift (such as the leasing of office space or providing computer or financial services), or

(ii) Derived from the assets described in section 7701(a)(19)(C) (iii) through (x), but only if such assets comprise 5 percent or more of the gross assets of the nonthrift.

(2) *Amount of income (or loss).*The amount of income (or loss) from such activities is the excess of (i) gross income from such activities over (ii) the deductions of the nonthrift allocable and apportionable to that gross income under the principles of §1.861–8. The loss attributable to functionally related activities of a nonthrift is the excess (if any) of such deductions over such gross income. That loss, however, may not exceed the amount of the tentative taxable loss of that nonthrift (determined by excluding losses arising in taxable years for which the due date (without extensions) for filing returns is before March 15, 1983).

(h) *Allocation of income and losses*—(1) *In general.* Paragraphs (h)(2) through (5) of this section provides rules for allocating different losses among thrifts that have tentative taxable income greater than zero. Generally, these allocations are made in the order listed in paragraph (f)(1) of this section and are based upon the relative tentative taxable income of the thrifts to which the particular loss is allocated. For purposes of each allocation under a subdivision of such paragraph (f)(1), the tentative taxable income of the thrifts used in making this allocation is reduced by the thrift’s allocable share of losses allocated to the thrift under a prior subdivision of such paragraph (f)(1). Accordingly, for purposes of this paragraph (h), tentative taxable income is determined without regard to paragraph (f) of this section, except as otherwise provided. Paragraph (h)(6) of this section provides rules for allocating income attributable to functionally related activities of a nonthrift based upon the relative reductions to thrift income made on account of that nonthrift.

(2) *Allocation of tentative taxable loss of other thrifts.* For purposes of paragraph (f)(1)(i) of this section, a thrift’s allocable share of another thrift’s tentative taxable loss is the loss multiplied by a fraction. The numerator of the fraction is the tentative taxable income (if greater than zero) of the thrift, and the denominator is the aggregate of such tentative taxable income of each thrift.

(3) *Allocation of portions of a consolidated net operating loss deduction.* (i) For purposes of paragraph (f)(1)(ii) of this section, a first thrift’s allocable share of the portion of the consolidated net operating loss deduction attributable to another thrift is determined under paragraph (h)(2) of this section as if that portion were a tentative taxable loss of that other thrift and by computing tentative taxable income under such paragraph (h)(2) by taking into account paragraph (f)(1)(i) of this section. A thrift’s allocable share of the portion of the consolidated net operating loss deduction attributable to that thrift is equal to that entire portion.

(ii) For purposes of paragraph (f)(1)(iv) of this section, a thrift’s allocable share of the portion of a consolidated net operating loss deduction attributable to functionally related activities of a nonthrift (determined under paragraph (h)(5) of this section) is determined under paragraph (h)(4) of this section as if that portion were a loss attributable to functionally related activities of the nonthrift and by computing tentative taxable income under such paragraph (h)(4) by taking into account paragraph (f)(1) (i), (ii), and (iii) of this section.

(iii) This subdivision (iii) prevents the ''double-counting'' of losses. The reduction to the tentative taxable income of a thrift is diminished to the extent the loss that gave rise to the reduction has previously been taken into account in reducing a thrift's tentative taxable income. Thus, any loss taken into account as a reduction to a thrift's separate taxable income under any subdivision of paragraph (f)(1) of this section shall be reduced (but not below zero) to the extent taken into account:

(A) In a prior consolidated return year under any subdivision of such paragraph (f)(1) or

(B) In the current consolidated return year under a previous subdivision of such paragraph (f)(1).

(4) *Allocation of loss attributable to functionally related activities of a nonthrift.* For purposes of paragraph (f)(1)(iii) of this section, a thrift's allocable share of a loss attributable to functionally related activities of a nonthrift is determined by multiplying the loss by a fraction. The numerator of the fraction is the tentative taxable income (if greater than zero) of the thrift (taking into account paragraph (f)(1) (i) and (ii) of this section) and the denominator is the aggregate of such tentative taxable income (so determined) of each thrift.

(5) *Portion of the consolidated net operating loss deduction attributable to functionally related activities of a particular nonthrift.* The portion of the consolidated net operating loss deduction attributable to functionally related activities of a particular nonthrift is the lesser of the following two amounts:

(i) The portion of the consolidated net operating loss deduction attributable to that nonthrift.

(ii) The aggregate of the losses attributable to functionally related activities of that nonthrift for the taxable years in which the consolidated net operating loss deduction arose.

(6) *Allocation of income attributable to functionally related activities of a nonthrift.* For purposes of paragraph (f)(2) of this section, a thrift institution's allocable share of the income attributable to functionally related activities of a nonthrift is determined by multiplying that income by a fraction. The numerator of the fraction is the amount of the cumulative reductions referred to in paragraph (f)(2)(ii) of this section (minus the cumulative increases under paragraph (f)(2) of this section) made on account of that nonthrift for the thrift and the denominator is the sum of such cumulative reductions (minus such cumulative increases) made on account of that nonthrift for all thrifts.

(7) *Proper accounting* The provisions of section 482 apply in determining a thrift institution's tentative taxable income, and in determining the gross income and deductions attributable to functionally related activities. For example, an expense such as the salary of an individual who performs services for both a thrift and a nonthrift must be allocated in a manner that fairly reflects the value of the services rendered to each.

(i) [Reserved]

(j) *Examples.* The provisions of this section may be illustrated by the following examples. In each example the letter ''T'' for a member denotes a thrift and the letters ''NT'' denote a nonthrift. Also, in each example, a thrift loss includes a bad debt deduction under section 593(b) (other than paragraph (2) thereof) for such year and a thrift with income would have such a bad debt deduction of zero.

Example (1). (a) In 1983, corporations T1, T2, NT1, and NT2 are formed. These corporations constitute an affiliated group that files a consolidated return on the basis of a calendar year. For 1983, 1984, and 1985, the tentative taxable income (or loss) of each member (before the application of paragraph (f) of this section) is as follows:

	1983	1984	1985
NT1	$(60)	$(140)	$15
T1	1,000	500	750
NT2	(90)	(220)	150
T2	(300)	400	250

In 1983, NT1, in addition to its other business activities, acted as a collection agency for T1. Deductions attributable to those activities exceeded gross income attributable to those activities by $70. NT1's other activities generated a $10 gain. In 1984 and 1985, NT1 acted as a collection agency for T1 as its sole activity.

(b) The tentative taxable incomes of T1 and T2 for 1983 (determined under paragraph (e) of this section) as of the close of that year are adjusted by paragraph (f) of this section as follows:

(i) T1's tentative taxable income:		
T1's tentative taxable income (before the application of paragraph (f) of this section	....	$1,000
Less:		
T2's tentative taxable loss	$300	....
NT1's functionally related loss (limited by NT1's overall loss)	60	360
T1's tentative taxable income for 1983	....	640

(ii) T2's tentative taxable income for 1983 is zero.

(c) The tentative taxable incomes of T1 and T2 for 1984 (determined under paragraph (e) of this section as of the close of that year) are adjusted by paragraph (f) of this section as follows:

(i) T1's tentative taxable income:

T1's tentative taxable income (before the application of paragraph (f) of this section)	$500
Less:	
T1's allocable portion of NT1's functionally related loss (140x500/(500+400))	78
T1's tentative taxable income for 1984	422

(ii) T2's tentative taxable income:	
T2's tentative taxable income (before the application of paragraph (f) of this section	400
Less:	
T2's allocable portion of NT1's functionally related loss (140x400/(500+400))	62
T2's tentative taxable income for 1984	338

(d) For 1985, the amount under paragraph (f) (2) of this section for both T1 and T2 is $15 (NT1's tentative taxable income from functionally related activities for 1985). For 1983 and 1984, T1's tentative taxable income was reduced by a total of $138 (*i.e.*, $60 + $78) due to NT1‘s losses from functionally related activities. For 1984, T2's tentative taxable income was reduced by $62 due to those losses. Accordingly, under paragraph (f)(2) of this section, T1's tentative taxable income for 1983 is increased by $10 (*i.e.*, $15x$138/($138+$62)) and T2's tentative taxable income is increased by $5 (*i.e.*, $15x$62/($138+$62)).

Example (2). (a) In 1983, corporations T, NT1, and NT2 are formed. these corporations constitute an affiliated group. NT2 provides computer services to T as its sole activity. For the calendar years 1983, 1984, and 1985, the group files a consolidated return. The tentative taxable income of each member (before the application of paragraph (f) of this section) is as follows:

	1983	1984	1985
T	$100	$0	$(200)
NT1	200	0	100
NT2	(20)	20	0

(b) Under paragraph (f)(1) of this section, T's tentative taxable income for 1983 (determined at the close of that year) is reduced to $80 (*i.e.*, $100 less NT2's $20 loss). For 1984, under paragraph (f)(2) of this section, T's tentative taxable income is increased by $20. For 1985, the consolidated net operating loss of $100 (all of which is attributable to T) is carried back to 1983. That $100 carryback is not limited by paragraph (f)(4)(iii) of this section, since consolidated taxable income for 1983 available for absorption after a bad debt deduction of $0 under section 593(b) (other than paragraph (2) thereof) for that year is $280. Accordingly, under paragraph (f)(1)(ii) of this section, T's tentative taxable income is reduced by the full $100, which is taken into account before the previous reduction of T's tentative taxable income under paragraph (f)(1)(iii) of this section. In addition, under paragraph (f)(3)(i) of this section, the group must file an amended return for 1984 to eliminate the increase to T's bad debt deduction for 1984 by reason of the consolidated net operating loss carryback to 1983.

Example (3) . (a) T and NT are formed in 1983 and are the only members of an affiliated group filing a consolidated return on a calendar year basis. NT provided computer services to T as its sole activity. For 1983, 1984, and 1985, the tentative taxable income of T and NT (before the application of paragraph (f) of this section) is as follows:

	1983	1984	1985
T	$100	$0	$0
NT	0	40	(40)

(b) At the close of 1983, T's tentative taxable income is $100. For 1985, however, the group has a consolidated net operating loss of $40, all of which is attributable to NT's functionally related activities and which is carried back to 1983. However, T's tentative taxable income for 1983 is not reduced under paragraph (f)(1)(iv) of this section, since, under paragraph (f)(4)(iv) of this section, NT's 1984 income attributable to functionally related activities of $40 is netted against that $40 carryback.

Example (4). (a) In 1983, corporations T1, T2, NT1, and NT2 are formed. For calendar years 1983, 1984, and 1985, the affiliated group consisting of T1, T2, NT1, and NT2 filed a consolidated return. NT1 provided computer services to T1 as its sole activity. The tentative taxable income of each member (before the application of paragraph (f) of this section) is as follows:

	1983	1984	1985
T1	(50)	100	30
T2	(50)	(80)	(25)
NT1	(50)	(40)	(99)

	1983	1984	1985
NT2	120	30	100

(b) For 1983, the group has a consolidated net operating loss of $30, apportioned $10 each to T1, T2, and NT1 under § 1.1502–79A(a)(3). For 1984, the only thrift with tentative taxable income greater than zero (before applying paragraph (f) of this section) is T1. That tentative taxable income of $100 is first reduced to $20 by T2's $80 1984 loss under paragraph (f)(1)(i) of this section. Next, T1's remaining tentative taxable income of $20 is reduced to $10 by the portions attributable to T1 and T2 of the 1983 consolidated net operating loss carryover to 1984 under paragraph (f)(1)(ii) of this section. The sum of those portions is limited to $10 (*i.e.*, $5 each) by paragraph (f)(4)(iii) of this section because 1984 consolidated taxable income available for absorption after a bad debt deduction under section 593(b) (other than paragraph (2) thereof) for each thrift member for that year is $10. For that reason, paragraph (f)(4)(iii) of this section also prevents any further portion of that carryover from being taken into account in 1984 as a reduction under paragraph (f)(1) of this section. T1's remaining tentative taxable income of $10 is reduced to zero, under paragraph (f)(1)(iii) of this section, by NT1's 1984 tentative taxable loss.

(c) For 1985, the only thrift with tentative taxable income greater than zero (before applying paragraph (f) of this section) is T1. T1's tentative taxable income for 1985 of $30 is reduced to $5 by T2's 1985 loss of $25 under paragraph (f)(1)(i) of this section. Next, the portions attributable to T1 and T2 of the consolidated net operating loss carryover from 1983 to 1985 for purposes of paragraph (f)(1)(ii) of this section must be determined. That determination is made without applying the rules for loss absorption in computing consolidated taxable income under § 1.1502–21A(b)(3). Those portions are instead determined in 3 steps under paragraph (f)(4)(i) of this section. The first of those steps is to determine each of T1's and T2's attributable portions of the 1983 consolidated net operating loss which under § 1.1502–79A (a)(3) is $10 or $20 for both thrifts. The second of those steps is to apply the anti-double counting rule under paragraph (h)(3)(iii) of this section to reduce that $20 amount by the $10 total of the two $5 portions attributable to T1 and T2 of the consolidated net operating loss carryover from 1983 to 1984 taken into account as reductions to T1's tentative taxable income for 1984 under paragraph (f)(1)(ii) of this section. That leaves a $10 total amount available to be taken into account as reductions to T1's remaining tentative taxable income of $5 for 1985 under paragraph (f)(1)(ii) of this section. Under the third of those steps that $10 amount, however, is limited, under the loss absorption limit of paragraph (f)(4)(iii) of this section, to the $6 of the 1983 consolidated net operating loss carryover to 1985 which is absorbed in computing consolidated taxable income for 1985 since 1985 consolidated taxable income available for absorption after a bad debt deduction under section 593(b) (other than paragraph (2) thereof) for that year is $6 (*i.e.*, $30+$100−$99−$25). Because separate taxable income cannot be reduced below zero under paragraph (f)(1) of this section, T1's remaining tentative taxable income of $5 is thus reduced to zero by the portions attributable to T1 and T2, respectively, of the consolidated net operating loss carryover from 1983 to 1985 under paragraph (f)(1)(ii) of this section.

(Sec. 1502, 7805, Internal Revenue Code of 1954 (68A Stat. 367 and 917; (26 U.S.C. 1502 and 7805))

[T.D. 7637, 44 FR 46841, Aug. 9, 1979, as amended by T.D. 7815, 47 FR 11516, Mar. 17, 1982; T.D. 7876, 48 FR 11258, Mar. 17, 1983; 48 FR 13165, Mar. 30, 1983; T.D. 8677, 61 FR 33324, June 27, 1996]

§ 1.1502–43 Consolidated accumulated earnings tax.

(a) *Group subject to tax*—(1) *General rule.* For a group filing a consolidated return for the taxable year, the accumulated earnings tax under section 531 is imposed on consolidated accumulated taxable income (as defined in paragraph (b) of this section). This tax applies to any group that is formed or availed of to avoid or prevent the imposition of the individual income tax on the shareholders of either any of its members or any other corporation by permitting earnings and profits to accumulate instead of dividing or distributing them. Section 531 and this section do not apply to a group that is treated as a ''personal holding company'' under section 542(a)(1) as a result of the application of section 542(b)(1). Special rules are provided in this section for other groups which include one or more personal holding companies.

(2) *Evidence of purpose to avoid income tax.* (i) Under section 533(a), the fact that the group's earnings and profits are permitted to accumulate beyond the reasonable needs of its business is determinative of the purpose to avoid

the income tax with respect to shareholders, unless the group by the preponderance of the evidence proves to the contrary.

(ii) The fact that a group is a mere holding or investment group is prima facie evidence of the group's purpose to avoid the income tax with respect to the shareholders. The activities of a member which is a personal holding company are not taken into account in determining if the group is a mere holding or investment group.

(3) *Earnings and profits.* For purposes of this paragraph (a) and paragraph (d) of this section, the following rules apply:

(i) If no member of the group is a personal holding company, the group's earnings and profits are the aggregate of the earnings and profits (or deficit) of each corporation that is a member at the close of the taxable year, determined in accordance with §1.1502–33.

(ii) Earnings and profits resulting from the application of §1.1502–33(b) are not taken into account.

(iii) Earnings and profits resulting from the disposition of a member's stock are determined without regard to the stock basis adjustments under §§1.1502–32 and 1.1502–33(c)(1).

(4) *Reasonable needs of the business.* The reasonable needs of the group's business include the reasonable needs of the business of any corporation (other than a personal holding company) that is a member at the close of the taxable year. Thus, the earnings and profits of one member may be accumulated with respect to the reasonable business needs of another member. If under §1.537–3(b) the business of a nonmember corporation is considered the business of a member, then the earnings and profits of any member may be accumulated with respect to such nonmember's reasonable business needs.

(5) *Burden of proof.* The notification described in section 534(b) and the statement described in section 534(c) are made to or by the common parent corporation in accordance with §1.1502–77.

(b) *Consolidated accumulated taxable income*—(1) *In general.* ‘‘Consolidated accumulated taxable income'' is the group's consolidated taxable income determined under §1.1502–11 adjusted in the manner provided in paragraph (b)(2) of this section, minus the sum of—

(i) The consolidated dividends paid deduction determined under paragraph (c) of this section and

(ii) The consolidated accumulated earnings credit determined under paragraph (d) of this section.

(2) *Adjustments to consolidated taxable income.* For purposes of paragraph (b)(1) of this section, consolidated taxable income is adjusted as follows:

(i) Under section 535(b)(1), the deduction for taxes is the excess of—

(A) The consolidated liability for tax determined without §1.1502–2 (b) through (d) and without the foreign tax credit provided by section 33, over

(B) The consolidated foreign tax credit determined pursuant to §1.1502–4. Foreign taxes deductible under §1.535–2(a)(2) are also allowed as a deduction under section 535(b)(1).

(ii) The consolidated charitable contributions deduction under §1.1502–24 does not apply. Under section 535(b)(2), there shall be allowed the aggregate charitable contributions of the members allowable under section 170, determined without section 170 (b)(2) and (d)(2).

(iii) Under section 535(b)(3), the deductions provided in §§1.1502–26 and 1.1502–27 are not allowed.

(iv) Under section 535(b)(4), the consolidated net operating loss deduction described in §§1.1502–21T(a) or 1.1502–21A(a), as appropriate is not allowed.

(v) Under section 535(b)(5), there is allowed as a deduction the consolidated net capital loss, determined under §§1.1502–22T(a) or 1.1502–22A(a), as appropriate .

(vi) Under section 535(b)(6), there is allowed as a deduction an amount equal to (A) the excess of the consolidated net long-term capital gain (determined under §§1.1502–22T(a) or 1.1502–41A, as appropriate over the consolidated net short-term capital loss (determined under §§1.1502–22T(a) or 1.1502–41A, as appropriate), minus (B) the taxes attributable to this excess. This consolidated net short-term capital loss is determined without the consolidated net capital loss carryovers or carrybacks to the taxable year.

(vii) Under section 535(b)(7), the consolidated net capital loss carryovers and carrybacks are not allowed. See §§ 1.1502–22T(b) or 1.1502–22A(b), as appropriate.

(viii) Sections 1.1502–15A (Limitations on built-in deductions not subject to § 1.1502–15T) and 1.1502–15T (SRLY limitation on built-in losses (temporary)) do not apply.

(3) *Personal holding company a member.* If a member is a personal holding company for the taxable year—

(i) [Reserved]

(ii) In applying paragraph (b)(2)(i) of this section, consolidated liability for tax (as determined under that paragraph (b)(2)(i)) is reduced by the portion thereof allocable to that member under section 1552(a) (1), (2), (3), or (4) (or § 1.1502–33(d)), whichever is applicable. The consolidated foreign tax credit is computed by excluding the taxable income and any foreign taxes paid or accrued by that member, and foreign taxes deductible under § 1.535–2(a)(2) do not include foreign taxes attributable to that member.

(c) *Consolidated dividends paid deduction*—(1) *General rule.* For purposes of this section, the consolidated dividends paid deduction is the aggregate of the members' deductions under section 561(a) (1) and (2). This deduction is determined by excluding deductions for dividends paid to other members.

(2) *Exception for certain personal holding companies.* [Reserved]

(3) *Dividends paid defined.* For purposes of this paragraph (c), ''dividends paid'' and ''dividend (or portion thereof) paid'' include amounts treated as dividends paid during the taxable year under sections 562(b)(1), 563, and 565 (relating respectively to liquidating distributions, dividends paid after year end, and consent dividends).

(4) *Examples.* This paragraph (c) can be illustrated by the following examples:

Example (1). Corporations P and S constitute an affiliated group which files a consolidated return on a calendar year basis for 1984 and 1985. P owns all of S's stock and two individuals own all of P's stock. Neither member of the group is a personal holding company for 1984. Assume that on December 15, 1984, S pays a dividend (as defined in section 316 (a)) of $2,000 to P, and P pays a dividend (as so defined) of $3,000 on January 15, 1985, to its individual shareholders. All dividends are paid in cash and are pro rata with no preference as to any shares or class of stock. For purposes of this paragraph (c), the consolidated dividends paid deduction for 1984 is $3,000, *i.e.*, the dividend paid on January 15, 1985, by P to its nonmember shareholders. See section 563 (a). The $2,000 dividend paid by S to P is not taken into account in computing the consolidated dividends paid deduction.

Example (2) [Reserved]

(d) *Consolidated accumulated earnings credit.* [Reserved]

[T.D. 7937, 49 FR 3462, Jan. 27, 1984, as amended by T.D. 8560, 59 FR 41674, Aug. 15, 1994; T.D. 8677, 61 FR 33324, June 27, 1996; T.D. 8560, 62 FR 12098, Mar. 14, 1997]

§ 1.1502–44 Percentage depletion for independent producers and royalty owners.

(a) *In general.* The sum of the percentage depletion deductions for the taxable year for all oil or gas property owned by all members, plus any carryovers under section 613A(d)(1) or paragraph (d) of this section from a prior taxable year, may not exceed 65 percent of the group's adjusted consolidated taxable income (under paragraph (b) of this section) for the consolidated return year.

(b) *Adjusted consolidated taxable income.* For purposes of this section, adjusted consolidated taxable income is an amount (not less than zero) equal to the group's consolidated taxable income determined without:

(1) Any depletion with respect to an oil or gas property (other than a gas property with respect to which the depletion allowance for all production is determined pursuant to section 613A(b)) for which percentage depletion would exceed cost depletion in the absence of the depletable quantity limitations contained in section 613A(c) (1) and (6) and the consolidated taxable income limitation contained in paragraph (a) of this section.

(2) Any consolidated net operating loss carryback to the consolidated return year under §§ 1.1502–21T or 1.1502-21A (as appropriate) and

(3) Any consolidated net capital loss carryback to the consolidated return year under §§ 1.1502–22T or 1.1502-22A (as appropriate).

(c) *Allocation to oil and gas properties.* The maximum amount allowable as a deduction under section 613A(c), after the application of paragraph (a) of this section, is allocated to properties held by members in accordance with the regulations under section 613A(d). Those regulations provide for an initial allocation and possible reallocation of the maximum allowable percentage depletion deduction among oil and gas properties. Thus, if, after the initial allocation, cost depletion exceeds the percentage depletion that would be allowable for a particular oil or gas property, cost depletion must be used for that property and the maximum amount of percentage depletion allowable as a deduction for the group is reallocated among only the remaining properties held by all members.

(d) *Carryover for disallowed amounts.* (1) If any amount is disallowed as a deduction for the taxable year by reason of section 613A(d)(1) or paragraph (a) of this section, the disallowed amount for each oil or gas property is treated as an amount allowed as a deduction under section 613A(c), for the following taxable year for the member that owned the property, in accordance with the regulations under section 613A and paragraphs (a) and (d)(2) of this section.

(2) Any amount that was disallowed as a deduction in a separate return limitation year of a member may be carried to a consolidated return year only to the extent that 65 percent of the excess determined under paragraph (d)(3) of this section exceeds the sum of the otherwise allowable percentage depletion deductions for the member's oil and gas properties for the year.

(3) The excess determined in this subparagraph (3) for a member is the excess, if any, of adjusted consolidated taxable income for the year under paragraph (b) of this section over that income recomputed by excluding the items of income and deductions of the member.

(e) *Effective date.* This section applies to taxable years for which the due date (without extensions) for filing returns is after September 30, 1980.

[T.D. 7725, 45 FR 65561, Oct. 3, 1980, as amended by T.D. 8677, 61 FR 33324, June 27, 1996]

§1.1502–47 Consolidated returns by life- nonlife groups.

(a) *Scope*—(1) *In general.* Under section 1504(b)(2), insurance companies that are taxed under section 802 or 821 (relating respectively to life insurance companies and to certain mutual insurance companies) are not treated as includible corporations for purposes of determining under section 1504(a) the existence of an affiliated group and the composition of its membership. Section 1504(c)(2) provides an election whereby certain life insurance companies and mutual insurance companies may be treated as includible corporations, and thus members, of a group composed of other includible corporations. This section provides regulations for the making of this election and for the determination of an electing group's composition and its consolidated tax liability.

(2) *General method of consolidation*—(i) *Subgroup method.* The regulations adopt a subgroup method to determine consolidated taxable income. One subgroup is the group's nonlife companies (including those taxable under section 821). The other subgroup is the group's life insurance companies. Initially, the nonlife subgroup computes nonlife consolidated taxable income and the life subgroup computes consolidated partial life insurance company taxable income. A subgroup's income may in effect be reduced by a loss of the other subgroup. The life subgroup losses consist of consolidated loss from operations and life consolidated net capital loss. The nonlife ubgroup losses consist of nonlife consolidated net operating loss and nonlife consolidated net capital loss. Consolidated taxable income is therefore defined in pertinent part as the sum of nonlife consolidated taxable income and consolidated partial life insurance company taxable income reduced by life subgroup losses or nonlife subgroup losses.

(ii) *Subgroup loss.* A subgroup loss does not actually affect the computation of nonlife consolidated taxable income or consolidated partial life insurance company taxable income. It merely constitutes a bottom-line adjustment in reaching consolidated taxable income. Furthermore, one subgroup's loss must first be carried back against income of the same subgroup before it may be used as a setoff against the second subgroup income in the taxable year the loss arose. (See section 1503(c)(1)). The carryback of the losses from one subgroup may not be used to offset income of the other subgroup in the year to which the loss is to be carried. This carryback of the first subgroup's loss may ''bump'' the second subgroup's loss that in effect previously reduced the income of the first subgroup. The second subgroup's loss that is bumped in appropriate cases may in effect reduce a succeeding year's income of the second or first subgroup. This approach gives the group the tax savings of the use of losses but the bumping rule assures that insofar as possible life deductions will be matched against life income and nonlife deductions against nonlife income.

(iii) *Carryover of subgroup loss.* A subgroup's loss may be used in a succeeding year, but in any particular succeeding year the loss must be used to reduce the income of the same subgroup before it may be used as a setoff against the other subgroup's income.

(3) *Authority.* This section is prescribed under the authority of sections 1502, 1503(c), 1504(c)(2), and 7805(b).

(4) *Other provisions.* The provisions of §§ 1.1502–1 through 1.1502–80 apply unless this section provides otherwise. Further, unless otherwise indicated in this section, a term used in this section has the same meaning as in sections 801–844.

(b) *Effective date.* This section is effective for taxable years for which the due date (without extensions) for filing returns is after March 14, 1983.

(c) *Cross references.* The following table provides cross references for some of the definitions and operating rules that are relevant in making the election and determining the group's composition and its tax liability:

Item and Paragraph

General definitions (d).

Eligible corporation (Five-year rules) (d)(12).

Election (e).

Consolidated taxable income (g).

Nonlife consolidated taxable income (h).

Consolidated partial life insurance company taxable income (j).

Nonlife subgroup losses (m).

Life subgroup losses (n).

Alternative tax (o).

(d) *Definitions.* For purposes of this section:

(1) *Life insurance company.* The term ''life company'' means a life insurance company as defined in section 801. Section 801 applies to each company separately.

(2) *Mutual insurance company.* The term ''mutual company'' means a mutual insurance company taxable under section 821(a)(1).

(3) *Life insurance company taxable income.* The term ''life insurance company taxable income'' is referred to as LICTI. The terms ''TII'', ''GO'', and ''LO'' refer, respectively, to taxable investment income (section 804), gain from operations (section 809), and loss from operations (section 812). The term ''consolidated partial LICTI'' refers to consolidated LICTI without section 802(b)(3).

(4) *Group.* The term ''group'' means an affiliated group of corporations (as defined in section 1504(a)). Unless otherwise indicated in this section, a group's composition is determined without section 1504(b)(2).

(5) *Member.* The term ''member'' means a corporation (including the common parent) that is an includible corporation in the group. A life company or mutual company is tentatively treated as a member for any taxable year for purposes of determining if it is an eligible corporation under paragraph (d)(12) of this section and therefore if it is an includible corporation under section 1504(c)(2). If such a company is eligible and includible (under section 1504(c)(2)), it will actually be treated as a member of the group.

(6) *Life member.* A life member is a member of the group that is a life company.

(7) *Nonlife member.* A nonlife member is a member of the group that is not a life company.

(8) *Life subgroup.* A life subgroup is composed of those members that are life members. If the group has only one life member, it constitutes a life subgroup.

(9) *Nonlife subgroup.* A nonlife subgroup is composed of those members that are nonlife members. If the group

has only one nonlife member, it constitutes a nonlife subgroup.

(10) *Separate return year.* The term ‘‘separate return year’’ means a taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return by another group. For purposes of this subparagraph (10), the term ‘‘group’’ is defined with regard to section 1504(b)(2) for years in which an election under section 1504(c)(2) is not in effect. Thus, a separate return year includes a taxable year for which that election is not in effect.

(11) *Separate return limitation year.* Section 1.1502–1(f)(2) provides exceptions to the definition of the term ‘‘separate return limitation year’’. For purposes of applying those exceptions to this section, for taxable years ending after December 31, 1980, the term ‘‘group’’ is defined without regard to section 1504(b)(2) and the definition in this subparagraph (11) applies separately to the nonlife subgroup in determining nonlife consolidated taxable income under paragraph (h) of this section and to the life subgroup in determining consolidated partial LICTI under paragraph (j) of this section. Paragraph (m)(3)(ix) of this section defines the term ‘‘separate return limitation year’’ for purposes of determining whether the losses of one subgroup may be used against the income of the other subgroup.

(12) *Eligible corporations*—(i) *In general.* A corporation is an eligible corporation for a taxable year of a group only if, throughout every day of the base period the corporation:

(A) Was in existence and a member of the group determined without the exclusions in section 1504(b)(2) (see paragraphs (d)(12) (iii) through (vi) of this section),

(B) Was engaged in the active conduct of a trade or business (‘‘active business’’),

(C) Did not experience a change in tax character (see paragraph (d)(12)(vii) of this section), and

(D) Did not undergo disproportionate asset acquisitions (see paragraph (d)(12)(viii) of this section).

(ii) *Base period.* The base period consists of the common parent’s five taxable years immediately preceding the group’s taxable year for which the consolidated return and the determination of eligibility are made. Eligibility is determined for each consolidated return year beginning with the first year for which the election under section 1504(c)(2) is effective.

(iii) *In existence.* Except as provided in paragraphs (d)(12) (v) and (vi) of this section, a corporation organized after the base period begins is not eligible even though it is a member of the group immediately after its organization. For purposes of this subdivision (iii), a corporation that was a party to a reorganization described in section 368(a)(1)(F) shall be treated as the same entity both before and after the reorganization.

(iv) *Membership period.* Except as provided in paragraphs (d)(12) (v) and (vi) of this section, a corporation must have been a member of the group throughout the base period to be eligible. Thus, an ineligible corporation includes one whose stock was acquired from outside the group at any time during the base period or one which was a member of a different group (whether by application of reverse acquistion rules in §1.1502–75(d)(3) or otherwise) at any time during the base period. For purposes of this subdivision (iv), the common parent of a group is treated as constituting a group (and hence is a member) during any period when it was not a member of an affiliated group within the meaning of section 1504(a) (applied without section 1504(b)(2)).

(v) *Tacking rule.* The period during which an ‘‘old’’ corporation is in existence and a member of the group engaged in active business is included in (or ‘‘tacks’’ onto) the period for the ‘‘new’’ corporation if the following five conditions listed in this subdivision (v) are met. For purposes of this subparagraph (12), a ‘‘new’’ corporation is a corporation (whether or not newly organized) during the period its eligibility depends upon the tacking rule. The five conditions are as follows:

(A) The first condition is that, at any time, 80 percent or more of the new corporation’s assets it acquired (other than in the ordinary course of its trade or business) where acquired from the old corporation in one or more transactions described in section 351(a) or 381(a). This asset test is applied by using the fair market values of assets on the date they were acquired and without regard to liabilities. Assets acquired in the ordinary course of business will be excluded from total assets only if they were acquired after the new corporation became a member of the group (determined without section 1504(b)(2)). In addition, assets that the old corporation acquired from outside the group in transactions not conducted in the ordinary course of its trade or business are not included in the 80 percent (but are included in total assets) if the old corporation acquired those assets within five calendar years before the date of their transfer to the new corporation.

(B) The second condition is that at the end of the taxable year during which the first condition is first met, the old corporation and the new corporation must both have the same tax character. For purposes of this paragraph (d)(12), a corporation's tax character is the section under which it would be taxed (*i.e.,* sections 11, 802, 821, or 831) if it filed a separate return. If the old corporation is not in existence (or adopts a plan of complete liquidation) at the end of that taxable year, this subdivision (v)(B) will apply to the old corporation's taxable year immediately preceding the beginning of the taxable year during which the first condition is first met.

(C) The third condition is that, if the old and new corporation are life insurance companies, the transfer (or transfers) is not reasonably expected (at the time of the transfer) to result in the separation of profitable activities from loss activities.

(D) The fourth condition is that, at the end of the taxable year during which the first condition is first met, the new corporation does not undergo a disproportionate asset acquisition under paragraph (d)(12)(viii) of this section.

(E) The fifth condition is that, if there is more than one old corporation, the first three conditions apply to all of the corporations. Thus, the second condition (tax character) must be met by all of the old corporations transferring assets taken into account in meeting the test in paragraph (d)(12)(v)(A) of this section.

(vi) *Old group remaining in existence.* If the common parent of a group (or a new common parent) became the common parent in a transaction described in § 1.1502–75 (d)(2) or (d)(3) where a group remained in existence, then paragraph (d)(12) (ii) through (iv) of this section apply by treating that common parent as if it were also the previous common parent of the group that remains in existence. If this paragraph (d)(12)(vi) applies to a transaction, the tacking rule in paragraph (d)(12)(v) of this section does not apply to the transaction.

(vii) *Change in tax character.* A corporation must not experience during the base period a change in tax character (as defined in paragraph (d)(12)(v)(B) of this section) if the change is attributable to an acquisition of assets from outside the group in transactions not conducted in the ordinary course of its trade or business. However, if a new corporation relies on the tacking rules in paragraph (d)(12)(v) of this section, this paragraph (d)(12)(vii) shall apply during the base period and the current consolidated return year and even if the change in tax character is attributable to an asset acquisition from within the group.

(viii) *Disproportionate asset acquisition.* To be eligible, a corporation must not undergo during the base period disproportionate asset acquisitions which are attributable to an acquisition (or a series of acquisitions) of assets from outside the group in transactions not conducted in the ordinary course of its trade or business (special acquisition). Whether special acquisitions are disproportionate is determined at the end of each base period. Whether an acquisition results in a disproportionate asset acquisition depends on all of the facts and circumstances including the following factors and rules:

(A) One factor is the portion of the insurance reserves (*i.e.,* total reserves in section 801 (c)) of the acquiring company at the end of the base period which is attributable to special acquisitions.

(B) A second factor is the portion of the fair market value of the assets (without reduction for liabilities) of the acquiring company at the end of the base period that is attributable to special acquisitions.

(C) A third factor is the portion of the premiums generated during the last taxable year of the base period which are attributable to special acquisitions.

(D) A corporation will not experience a disproportionate asset acquisition unless 75 percent of one factor (whether or not listed in this subdivision (viii)) is attributable to special acquisitions.

(E) Money or other property contributed to a corporation by a shareholder that is not a member of the group (without section 1504(b)(2)) is not a special acquisition.

(F) If a new corporation relies on the tacking rules in paragraph (d)(12)(v) of this section, this subdivision (viii) applies to that corporation during a consolidated return year. Thus, if at any time during a consolidated return year, a new corporation undergoes a disproportionate asset acquisition, the corporation becomes ineligible at that time.

(13) *Ineligible corporation*. A corporation that is not an eligible corporation is ineligible. If a life company or mutual company is ineligible, it is not treated under section 1504(c)(2) as an includible corporation. Losses of a nonlife member arising in years when it is ineligible may not be used under section 1503(c)(2) and paragraph (m) of this section to set off the income of a life member. If a life or mutual company is ineligible and is the common parent of the group (without section 1504(b)(2)), the election under section 1504(c)(2) may not be made.

(14) *Illustrations.* The following examples illustrate this paragraph (d). In each example, L indicates a life company, another letter indicates a nonlife company, and each corporation uses the calendar year as its taxable year.

Example (1). P has owned all of the stock of S since 1913. On January 1, 1980, P purchased all of the stock of L_1 which owns all of the stock of L_2 and S_2. L_1 and L_2 are treated as members for purposes of determining if they are eligible for 1982. However, for 1982, L_1, L_2, and S_2 are ineligible because none of them has been a member of the group for P's five taxable years preceding 1982. For 1982, L_1 and L_2 may elect to file a consolidated return because they constitute an affiliated group under section 1504(c)(1), and P and S may file a consolidated return.

Example (2). Since 1974, P has been a mutual insurance company owning all the stock of L_1. In 1980, P transfers assets to S_1., a new stock casualty company subject to taxation under section 831(a). For 1982, only P and L_1 are eligible corporations. The tacking rule in paragraph (d)(12)(v) of this section does not apply in 1982 because the old corporation (P) and the new corporation (S_1) do not have the same tax character. The result would be the same if P were a life company.

Example (3). Since 1974, L has owned all the stock of L_1 which has owned all the stock of S_1, a stock casualty company. L_1 writes some accident and health insurance business. In 1980, L_1 transfers this business, and S_1 transfers some of its business, to a new stock casualty company, S_2., in a transaction described in section 351 (a). The property transferred to S_2. by L_1 had a fair market value of $50 million. The property transferred by S_1 had a fair market value of $40 million. S_2. is ineligible for 1982 because the tacking rule in paragraph (d)(12)(v) of this section does not apply. The old corporations (L_1 and S_1) and the new corporation (S_2.) do not all have the same tax character. See subparagraph (d)(12)(v)(B) and (E) of this section. The result would be the same if L_1 transferred other property (*e.g.*, stock and securities) with the same value, rather than accident and health insurance contracts, to S_2.

Example (4). Since 1974, P has owned all the stock of S and L_1. L_1 is a large life company engaged in active business since 1974. On January 1, 1982, L_1 transfers in a section 351 (a) transaction assets (not acquired from outside the group) to a new life company, L_2. For 1982, L_2 is eligible because under paragraph (d)(12)(v) of this section, L_2 is considered to have been in existence and a member of the group engaged in the active business since 1974 which is the period L_1, the old corporation, was in existence and a member of the group so engaged.

Example (5). The facts are the same as in example (4). Assume that the fair market value of the assets L_1 transferred to L_2 was $10 million on January 1, 1982 and that L_2 acquired no other assets prior to June 30, 1983. Assume further that on January 1, 1983, L_1 acquires (other than in the ordinary course of its trade or business) assets having a fair market value of $40 million from L_3, an unrelated life company. On June 30, 1983, L_1 transfers those assets to L_2. L_2 becomes ineligible on June 30, 1983. Since by fair market values, 80 percent (*i.e.*, 40/50) of L_2's assets are attributable to special acquisitions, L_2 has undergone a disproportionate asset acquisition at that time. See paragraph (d)(12)(viii)(B), (D), and (F) of this section.

Example (6). The facts are the same as in example (5) except that L_1 transfers assets (other than life insurance contracts) having a fair market value of $40 million to L_2 and L_2 purchases the assets of L_3 on June 30, 1983. the result of the 1983 acquisition is the same as in example (5).

Example (7). The facts are the same as in example (5) except the acquired assets acquired by L_2 in 1983 from L_1 have a fair market value of $20 million. In 1983, L_2 had $1 million of premiums on its pre-existing contracts but premiums generated by the acquired business for the entire year would have been $2 million. L_2 is eligible in 1983 because it did not experience a disproportionate asset acquisition on June 30, 1983.

Example (8). Since 1974, L, a State A corporation, has owned all of the stock of L_1 and S_1. On January 1, 1982, L merges into L_3, a smaller State B corporation, which owns the stock of S_2. The transaction is a reverse acquisition described in § 1.1502–75(d)(3) and the group of which L was the common parent remains in existence. Under paragraph (d)(12)(vi) of this section, L_3 is eligible for 1982. However, S_2 is ineligible in 1982 under paragraph (d)(12)(iv) of this section.

Example (9). The facts are the same as in example (8) except that L acquires the stock of L_3. L_3 and S_2 are both ineligible for 1982. On January 1, 1983, the fair market value of L_3's assets are $5 million (without liabilities) and on that date L transfers assets (not acquired from outside the group) having a fair market value of $95 million (without liabilities) to L_3. L and L_3 are life companies at the end of 1983. L_3 is eligible in 1983 under the tacking rule in paragraph (d)(12)(v) of this section. S_2 is ineligible in that year. The result would be the same if L_3 was not a life company prior to January 1, 1983. See paragraph (d)(12)(v)(B) of this section.

Example (10). Since 1974, P has owned all of the stock of S_1 and L_1. On January 1, 1982, L_1 incorporates L_2 and transfers cash and securities to L_2. L_2 begins writing a new line of specialty life insurance products and it qualifies as a life company for calendar year 1982. L_2 generates a loss from operations (section 812) attributable to its writing of new business. For 1982, L_2 is ineligible under paragraph (d)(12)(v)(C) of this section.

Example (11). The facts are the same as in example (10) except that L_1 transfers to L_2 a block of insurance contracts that generated losses for L_1 and continued to generate losses for L_2, producing a loss from operations. L_2 is ineligible in 1982 under paragraph (d)(12)(v)(C) of this section.

Example (12). Since 1974, X, a foreign corporation, has owned all the stock of S_2 and S_1, and S_1 has owned all of the stock of L_1. On January 1, 1982, X incorporates a new U.S. company P, and transfers the stock of S_1 and S_2 to P. Assume that under § 1.1502–75(d)(3) (relating to reverse acquisitions), the S_1–L_1 affiliated group remains in existence. Under paragraph (d)(12)(vi) of this section, P, S_1, and L_1 are eligible but S_2 is ineligible. The result would be the same if X were an individual.

Example (13). The facts are the same as in example (12) except that X owns all of the stock of S_1, L_1, and S_2. In addition, on January 1, 1982, X transfers the stock of S_1 and S_2 to L_1. L_1 is eligible in 1982 under paragraph (d)(12)(iv) of this section. L_1 would still be eligible even if it owned a subsidiary during the base period but sold the subsidiary prior to January 1, 1982. S_1 and S_2 are ineligible in 1982.

Example (14). Since 1974, S_1 has owned all of the stock of L_1. S_2, an unrelated company, has owned all of the stock of L_2 and S_3 for 10 years. S_1 and S_2 are active stock casualty companies and not holding companies. On January 1, 1982, S_1 and S_2 merge into a new casualty company, S, in a transaction described in § 1.1502–75(d)(3) so that the group of which S_1 was the common parent remains in existence. S and L_1 are eligible in 1982 under paragraph (d)(12)(vi) of this section. L_2 and S_3 are ineligible.

Example (15). The facts are the same as in example (14) except that S_2 (the first corporation in § 1.1502–75(d)(3)) acquires the stock of S_1 in exchange for the stock of S_2. The result is that only S_2, S_1, and L_1 are eligible in 1982.

Example (16). Since 1974, S had owned all of the stock of L_1. L_1 is a large life company. On January 1, 1982, L_1 incorporates L_2 and transfers $40 million in cash and securities to L_2 in a transaction described in section 351(a). On March 1, 1982, L_2 purchases the assets of L_3, an unrelated life company. The purchased assets have a fair market value (without liabilities) of $30 million on March 1, 1982. L_2 is ineligible for 1982 because the tacking rule in paragraph (d)(12)(v) of this section does not apply. L_2 experienced a disproportionate asset acquisition in 1982. See paragraph (d)(12)((v)(D) of this section.

(e) *Election*—(1) *In general.* The election under section 1504(c)(2) may not be made if the group's common parent is an ineligible life company or an ineligible mutual company. The election under section 1504(c)(2) may only be made by the common parent of the group (as defined in section 1504(c)(2) without the exclusions in section 1504(b)(2)). For example, assume that P owns all of the stock of L_1, an eligible life company, which owns the stock of S_1. Assume further that P also owns the stock of L_2, an ineligible life member, which (for more than five years) has owned the stock of a nonlife company, S_2. Only P may make the election and, if it does so, P, L_1, and S_1 may file a consolidated return under this section. L_2 may not make the election under section 1504(c)(2) and may not file a consolidated return with S_2.

(2) *How election is made*—(i) *General rule.* The election under section 1504(c)(2) is generally made by the group's common parent in the same manner (and it has the same effect) as the election to file a consolidated return is made under §1.1502–75 (a) and (b) for a group which did not file a consolidated return for the immediately preceding taxable year. The procedure for making the election under section 1504(c)(2) is the same whether or not a consolidated return was filed by the life members or the nonlife members for the immediately preceding taxable year.

(ii) *Special rule.* Notwithstanding the general rule, however, if the nonlife members in the group filed a consolidated return for the immediately preceding taxable year and had executed and filed a Form 1122 that is effective for the preceding year, then such members will be treated as if they filed a Form 1122 when they join in the filing of a consolidated return under section 1504(c)(2) and they will be deemed to consent to the regulations under this section. However, an affiliation schedule (Form 851) must be filed by the group and the life members must execute a Form 1122 in the manner prescribed in §1.1502–75(h)(2).

(3) *Irrevocability.* Except as provided in §1.1502–75(c) and paragraph (e)(4) of this section, the election under section 1504(c)(2) is irrevocable.

(4) *Permission to discontinue*—(i) *General rule.* A ''section 1504(c)(2) group'' with a common parent that has made the election to file a consolidated return under section 1504(c)(2) in a previous taxable year is granted permission to elect (under §1.1502–75(c)(2)(ii)) to discontinue filing such a consolidated return for that group's first taxable year for which the regulations under this section are effective. This election to discontinue shall be exercised in the time and manner prescribed in §1.1502–75(c)(3), except that the group's common parent shall exercise this election to discontinue (and the other members of the section 1504(c)(2) group must comply with this election) by filing appropriate returns. For purposes of this paragraph (e)(4), an appropriate return is either a separate return or a consolidated return that is filed by newly exercising the privilege under §1.1502–75(a)(1).

(ii) *Types of groups.* (A) A ''section 1504(c)(2) group'' is an affiliated group which files or filed a consolidated return pursuant to an election under section 1504(c)(2).

(B) A ''limited group'' is an affiliated group (determined without section 1504(c)(2)) having at least one member which was a member of a section 1504(c)(2) group on the date that the section 1504(c)(2) group elected to discontinue under paragraph (e)(4)(i) of this section.

(iii) *Effect on restoration rules.* If a group ceases to file a consolidated return or terminates or if a member leaves the group, certain items of income, gain, or loss on transactions between members are taken into account under §§1.1502–13, 1.1502–18, and 1.1502–19 (''restoration rules''). For purposes of applying these restoration rules solely by reason of an election under paragraph (e)(4)(i) or (e)(4)(v)(A) of this section to discontinue filing consolidated returns as a section 1504(c)(2) group, the following rules apply:

(A) The section 1504(c)(2) group shall not be considered to terminate and no member of that group shall be treated as ceasing to be a member.

(B) Members of that section 1504(c)(2) group that are included in the consolidated return of a limited group for the first taxable year for which the discontinuance is effective shall be considered to be filing a consolidated return as a continuation of the section 1504(c)(2) group. However, a corporation that is not a member of a particular limited group for that taxable year is considered to have a separate return year (and, for purposes of §1.1502–19(c), not to be a member of a group filing a consolidated return) with respect to that limited group's members.

(C) Section 1.1502–13 shall be applied without regard to paragraph (f)(1)(vii).

(iv) *Illustrations.* The following examples illustrate paragraph (e)(4)(i)–(iii) of this section. In these examples, L indicates a life company and another letter indicates a nonlife company. All corporations use the calendar year as the taxable year. For all taxable years involved, P owns all the stock of L_1 and of S, L_1 owns all the stock of L_2, L_2 owns all the stock of L_3, and S owns all the stock of L_4. For 1981, P makes the life-nonlife election of section 1504(c)(2) and L_4 is an eligible corporation. For 1982, P makes the election to discontinue filing consolidated returns under section 1504(c)(2) in accordance with the permission granted in this paragraph (e)(4).

Example (1). L_1, L_2, and L_3 were eligible members. For 1982, P and S may either file separate returns or may file, as a limited group, a consolidated return. Similarly, L_1, L_2, and L_3 may either file separate returns or may file a consolidated return as a limited group under section 1504(c)(1). L_4 must file a separate return.

Example (2). For 1981, L_1 was an ineligible member and L_1, L_2, and L_3 filed a consolidated return under section 1504(c)(1). For 1982, L_1, L_2, and L_3 must continue filing a consolidated return under section 1504(c)(1).

Example (3). For 1981, L_1 was an eligible member and L_2 and L_3 were ineligible members. For 1982, L_1, L_2, and L_3 either must each file a separate return or must file a consolidated return as a limited group under section 1504(c)(1) having L_1 as a common parent.

Example (4). The facts are the same as in example (3). Assume further that for 1981, L_2 and L_3 file a consolidated return. During 1981, intercompany transactions (see § 1.1502–13) occur in the life-nonlife group between P and L_1, between P and S, and between S and L_4 and occur in the ineligible life subgroup between L_2 and L_3. For 1982, the restoration rules of § 1.1502–13, as modified by paragraph (e)(4)(iii)(B) of this section, will be applicable as indicated in the following table:

Intercompany transactions between	§ 1.1502–13
P and L_1	Yes.
P and S, if they file:	
Separate returns	Yes.
A consolidated return	No.
S and L_4	Yes.
L_2 and L_3, if L_1, L_2, and L_3 file:	
Separate returns	Yes.
A consolidated return	No.

(v) *Additional rules.* (A) If a group with a taxable year ending in the month of December, 1982, had made the election under section 1504(c)(2) for a taxable year ending prior to December 1, 1982, and if that group meets the conditions of subdivision (vi) of this paragraph (e)(4), then the common parent may elect to discontinue filing a consolidated return for its taxable year ending in the month of December, 1982 (and other members of the section 1504(c)(2) group must comply with this election) by filing appropriate returns (see paragraph (e)(4)(i) of this section) before September 16, 1983.

(B) If a group made the election under section 1504(c)(2) for its taxable year ending in the month of December, 1982, and if that group meets the conditions of subdivision (vi) of this paragraph (e)(4), then the common parent may elect to withdraw the section 1504(c)(2) election (and all other members of the group determined without section 1504(b)(2) comply with the election) by filing before September 16, 1983, any returns for the appropriate taxable years that would have been filed had the section 1504(c)(2) election never been made.

(vi) A group referred to at subdivision (v)(A) or (B) of this (e)(4) meets the conditions of this subdivision (vi) if it—

(A) filed before March 16, 1983, a return for its taxable year ending in the month of December, 1982, and

(B) had not been granted an extension of time beyond March 15, 1983, for the filing of that return.

(vii) *Interest.* For purposes of section 6601(a), interest runs from the original due date (without extensions) for the filing of such returns as are filed pursuant to an election (to discontinue or withdraw as the case may be) under this paragraph (e)(4).

(5) *Consent to regulations.* If a group does not discontinue filing a consolidated return under paragraph (e)(4) of this section but continues to file a consolidated return for the group's first taxable year for which the regulations under this section are first effective, the members of the group will be deemed to have consented to the regulations under this section.

(6) *Cross reference.* If an election is made under section 1504(c)(2), see § 1.1502–75 (e) and (f) for rules that apply for not including (or including) a member or a nonmember in the consolidated return.

(f) *Effect of election.* If the common parent makes the election under section 1504(c)(2), the following rules apply:

(1) *Termination of group.* A mere election under section 1504(c)(2) will not cause the creation of a new group or the termination of an affiliated group that files a consolidated return in the immediately preceding taxable year.

(2) *Effect of eligibility.* If a life member is eligible after an election under section 1504(c)(2), it may not be included as a member of an affiliated group as defined in section 1504(c)(1).

(3) *Eligible and ineligible life companies.* If any life company was a member of an affiliated group of life companies (as defined in section 1504(c)(1)) but is ineligible for a taxable year for which the election under section 1504(c)(2) is effective, that year is not a separate return year merely by reason of the election under section 1504(c)(2) in applying §§1.1502–13, 1.1502–18, and 1.1502–19 to transactions occurring in prior consolidated return years of that affiliated group. In addition, if more than one ineligible life member of the group (as defined in section 1504(c)(1)) joined in the filing of a consolidated return in the taxable year immediately preceding the year for which the election under section 1504(c)(2) is effective and, solely as a result of the election, one of the ineligible life members becomes the common parent of such a group (section 1504(c)(1)), the group must continue to file a consolidated return. For example, assume that L_1 owns all of the stock of S_1 and all of the stock of L_2. L_2 owns the stock of L_3. L_1, L_2, and L_3 are life companies and S_1 is a nonlife company. Assume further that in 1981, L_1, L_2, and L_3 file a consolidated return but L_1 makes the election under section 1504(c)(2) for 1982 and L_2 and L_3 are ineligible. L_2 and L_3 must continue to file a consolidated return in 1982. Moreover, L_2 could elect in 1982 to file a consolidated return (section 1504(c)(1)) with L_3 even if they did not file a consolidated return in 1981 with L_1.

(4) *Inclusion of life company.* If a life company is ineligible in the consolidated return year for which the election is effective, it will be treated as an includible corporation for the common parent's first taxable year in which the company becomes eligible.

(5) *Dividends received deduction.* Section 243(b)(5) defines the term affiliated group for purposes of the election to deduct 100 percent of the qualifying dividends received by a member from another member of the group. Section 246(b)(6) limits certain multiple tax benefits and the deduction itself. Section 243(b) (5) and (6) do not apply to the mutual companies and life companies that are eligible corporations. See section 1504(c)(2)(B)(i). Thus, the common parent of the group may elect to deduct 100 percent of the qualifying dividends received from an ineligible life company.

(6) *Controlled group.* Sections 1563 (a)(4), (b)(2)(D), and (b)(3)(C) (insofar as it applies to corporations described in section 1563(b)(2)(D)) do not apply to any eligible or ineligible life company that is a member of the group for a taxable year during which the election is effective. See paragraph (d)(4) of this section for the definition of group.

(7) *Consolidated tax.* The tax liability of a group for a consolidated return year (before application of credits against that tax) is computed on a consolidated basis by adding together the following taxes:

(i) The tax imposed under section 11 on consolidated taxable income (as determined under paragraph (g) of this section). The taxes imposed under sections 802(a), 821(a), and 831(a) will each be treated as a tax imposed under section 11.

(ii) The tax imposed by section 1201 on consolidated net capital gain (as determined under paragraph (o) of this section) in lieu of the tax imposed under paragraph (f)(7)(i) of this section on that gain.

(iii) Any taxes described in §1.1502–2 (other than by paragraphs (a), (f), and (h) thereof).

(g) *Consolidated taxable income.* The consolidated taxable income is the sum of the following three amounts:

(1) *Nonlife consolidated taxable income.* The nonlife consolidated taxable income (as defined in paragraph (h) of this section) of the nonlife subgroup, as set off by the life subgroup losses as provided in paragraph (n) of this section. The amount in this paragraph (g)(1) may not be less than zero.

(2) *Consolidated partial LICTI.* The consolidated partial LICTI (as defined in paragraph (j) of this section) of the

life subgroup, as set off by the nonlife subgroup losses as provided in paragraph (m) of this section. The amount in this paragraph (g)(2) may not be less than zero.

(3) *Surplus accounts.* The sum of the amounts subtracted under section 815 from the policyholders' surplus accounts of the life members.

(h) *Nonlife consolidated taxable income*—(1) *In general.* Nonlife consolidated taxable income is the consolidated taxable income of the nonlife subgroup, computed under § 1.1502–11 as modified by this paragraph (h). For this purpose, separate taxable income of a member includes separate mutual insurance company taxable income (as defined in section 821(b)) and insurance company taxable income (as defined in section 832).

(2) *Nonlife consolidated net operating loss deduction*—(i) *In general.* In applying §§ 1.1502–21T or 1.1502-21A (as appropriate), the rules in this subparagraph (2) apply in determining for the nonlife subgroup the nonlife net operating loss and the portion of the nonlife net operating loss carryovers and carrybacks to the taxable year.

(ii) *Nonlife CNOL.* The nonlife consolidated net operating loss is determined under §§ 1.1502–21(A)(f) or 1.1502-21T(e) (as appropriate) by treating the nonlife subgroup as the group.

(iii) *Carryback.* The nonlife consolidated net operating loss for the nonlife subgroup is carried back under §§ 1.1502–21A or 1.1502-21T (as appropriate) to the appropriate years (whether consolidated or separate) before the loss may be used as a nonlife subgroup loss under paragraphs (g)(2) and (m) of this section to set off consolidated partial LICTI in the year the loss arose. The election under section 172(b)(3)(C) to relinquish the entire carryback period for the net operating loss of the nonlife subgroup may be made by the common parent of the group. Furthermore, the election may be made even though the election under section 812(b)(3) and paragraph (l)(3)(iii) of this section is not made.

(iv) *Subgroup rule.* In determining the portion of the nonlife consolidated net operating loss that is absorbed when the loss is carried back to a consolidated return year beginning after December 31, 1981, §§ 1.1502–21A or 1.1502-21T (as appropriate) is applied by treating the nonlife subgroup as the group. Therefore, the absorption is determined without taking into account any life subgroup losses that were previously reported on a consolidated return as setting off nonlife consolidated taxable income for the year to which the nonlife loss is carried back.

(v) *Carryover.* The portion of the nonlife consolidated net operating loss that is not absorbed in a prior year as a carryback, or as a nonlife subgroup loss that set off consolidated partial LICTI for the year the loss arose, constitutes a nonlife carryover under this subparagraph (2) to reduce nonlife consolidated taxable income before that portion may constitute a nonlife subgroup loss that sets off consolidated partial LICTI for a particular year.

(vi) *Transitional rules.* The nonlife consolidated net operating loss deduction is subject to a transitional rule limitation in paragraph (h)(3) of this section.

(vii) *Example.* The following example illustrates this paragraph (h)(2). In the example, L indicates a life company, another letter indicates a nonlife company, and each corporation uses the calendar year as its taxable year.

Example. P owns all of the stock of S and L_1. L_1 owns all of the stock of L_2. For 1982, the group first files a consolidated return for which the election under section 1504(c)(2) is effective. P and S filed consolidated returns for 1979 through 1981. In 1982, the P–S group sustains a nonlife consolidated net operating loss. The loss is carried back to the consolidated return years 1979, 1980, and 1981 of P and S by using the principles of §§ 1.1502–21A and 1.1502–79A and, because the election in 1982 under section 1504(c)(2) does not result under paragraph (f)(1) of this section in the creation of a new group or the termination of the P–S nonlife group, the loss is absorbed on the consolidated return in those years without regard to whether the loss in 1982 is attributable to P or S and without regard to their contribution to consolidated taxable income in 1979, 1980, or 1981. The portion of the loss not absorbed in 1979, 1980, and 1981 may serve as a nonlife subgroup loss in 1982 that may set off the consolidated partial LICTI of L_1 and L_2 under paragraphs (g)(2) and (m) of this section.

(3) *Transitional rule*—(i) *In general.* The portion of the nonlife consolidated

net operating loss deduction in a consolidated return year beginning after December 31, 1980 (referred to as ''post-1980 year'') attributable to net operating losses sustained in separate return years ending before January 1, 1981 (referred to as ''pre-1981 year''), is subject to the rules and limitations in this subparagraph (3).

(ii) *Separate nonlife groups.* To determine the limitation, first, identify for the post-1980 year one or more separate affiliated groups of nonlife companies (as defined in section 1504 without section 1504(c)(2)). For this purpose, a single nonlife company may constitute a separate affiliated group if (A) it is not otherwise a member of a separate group or (B) it has a net operating loss sustained in the pre-1981 year that may be carried over and that year is a separate return limitation year (determined under §1.1502–1(f) without paragraph (d)(11) of this section).

(iii) *Carryover.* Second, identify the pre-1981 year net operating losses that may be carried over and that are attributable to each separate affiliated group of nonlife companies. The separate return limitation year rules in §§1.1502–21A(c) or 1.1502-21T(c) (as appropriate) do not apply to any of these carryovers.

(iv) *Limitation.* Third, treat the last taxable year ending before January 1, 1981, as if in that year there was a consolidated return change of ownership of each such separate affiliated group of nonlife companies and apply the consolidated return change of ownership limitation in §1.1502–21A(d) to the losses of each group by treating the members of each separate group as old members.

(v) *Examples.* The following examples illustrate this paragraph (h)(3). In the examples L indicates a life company, another letter indicates a nonlife company, and each corporation uses the calendar year as its taxable year.

Example (1). Throughout all of 1982, P owns all of the stock of S and L_1 and L_1 owns all of the stock of L_2 which in turn owns all of the stock of S_1. Thus, for 1982, there are two nonlife subgroups under this subparagraph (3), P–S and S_1. For 1981, P and S did not file a consolidated return and for 1980 P has a net operating loss of $200,000. Assume that P had no income in 1981. For 1982, the group makes an election under section 1504(c)(2) to file a consolidated return and all corporations are eligible corporations. The consolidated taxable income for the nonlife subgroup for 1982 (determined without the consolidated net operating loss deduction) recomputed by including only items of income and deduction of P and S is $120,000. If $120,000 is the §1.1502–21(d)(2) amount for P and S, then the amount of P's net operating loss for 1980 that may be carried over to P and S for 1982 cannot exceed $120,000.

Example (2). (a) P owns all of the stock of S_1. On January 1, 1979, P purchased all of the stock of L_1 which owns all of the stock of L_2 and S_2. Prior to 1984, all of the corporations filed separate returns. For 1984, the group makes an election under section 1504(c)(2) to file a consolidated return.

(b) 1981, 1982, and 1983 are not treated under paragraph (d)(11) of this section as separate return limitation years of the P, S_1, and S_2 nonlife subgroup. However, P and S_1 will be treated as old members under paragraph (h)(3)(iv) of this section and under §1.1502–21A(d) with respect to their losses in 1979 and 1980 (whether a consolidated return was filed or separate returns were filed) so that the portion of nonlife consolidated taxable income attributable to S_2 may not absorb the losses of P or S_1. The rules that apply to the P–S_1 nonlife subgroup for 1979 and 1980 apply in an identical way to S_2 by treating S_2 as a subgroup separate from the P–S_1 nonlife subgroup. See section 1507(c)(2)(A) of the Tax Reform Act of 1976.

(c) Similarly, L_1 and L_2 are treated as old members under paragraphs (l)(3) and (h)(3)(iv) of this section for losses arising in 1979 and 1980. However, since the L_1—L_2 subgroup is also the life subgroup under paragraph (d)(8) of this section, the limitation in paragraph (h)(3)(iv) of this section does not affect the computation of consolidated partial LICTI for the life subgroup.

(4) *Nonlife consolidated capital gain net income or loss*—(i) *In general.* In applying §§1.1502–22T or 1.1502-22A (as appropriate),the rules in this subparagraph (4) apply in determining for the nonlife subgroup the nonlife consolidated capital gain net income or loss and the portion of the nonlife net capital loss carryovers and carrybacks to the taxable year. In particular, the nonlife consolidated capital gain net income and nonlife consolidated net capital loss are determined under the principles of §§1.1502–22T or 1.1502-22A(a) (as appropriate) by treating the nonlife subgroup as the group.

(ii) *Additional principles.* In applying §§1.1502–22A or 1.1502-22T to nonlife consolidated net capital loss carryovers and carrybacks, the principles set forth in paragraphs (h)(2) (iii) through (v) for applying §§ 1.1502–21T or 1.1502-21A (as appropriate) to nonlife consolidated net operating loss carryovers and carrybacks shall also apply. Further, the portion of nonlife consolidated net capital loss carryovers attributable to losses sustained in taxable years ending before January 1, 1981, is subject to the limitations in paragraph (h)(3) of this section applied by substituting ''net capital loss'' for the term ''net operating loss'' and ''§ 1.1502–22A(d)'' for ''§ 1.1502–21A(d)''.

(iii) *Special rules.* The nonlife consolidated net capital loss is reduced, for purposes of determining the carryovers and carrybacks under §§ 1.1502–22A(b)(1) or 1.1502-22T(b) by the lesser of:

(A) The aggregate of the additional capital loss deductions allowed under section 822(c)(6) or section 832(c)(5), or

(B) The nonlife consolidated taxable income computed without capital gains and losses.

(i) [Reserved]

(j) *Consolidated partial LICTI.* [Reserved]

(k) *Consolidated TII*—(1) *General rule.* [Reserved]

(2) *Separate TII.* [Reserved]

(3) *Company's share of investment yield.* [Reserved]

(4) *Life consolidated capital gain net income.* [Reserved]

(5) *Life consolidated net capital loss carryovers and carrybacks.* The life consolidated net capital loss carryovers and carrybacks for the life subgroup are determined by applying the principles of §§ 1.1502–22T or 1.1502–22A (as appropriate) as modified by the following rules in this subparagraph (5):

(i) Life consolidated net capital loss is first carried back (or apportioned to the life members for separate return years) to be absorbed by life consolidated capital gain net income without regard to any nonlife subgroup capital losses and before the life consolidated net capital loss may serve as a life subgroup capital loss that sets off nonlife consolidated capital gain net income in the year the life consolidated net capital loss arose.

(ii) If a life consolidated net capital loss is not carried back or is not a life subgroup loss that sets off nonlife consolidated capital gain net income in the year the life consolidated net capital loss arose, then it is carried over to the particular year under this paragraph (k)(5) first against life consolidated capital gain net income before it may serve as a life subgroup capital loss that sets off nonlife consolidated capital gain net income in that particular year.

(iii) *Section 818(f).* Capital losses may not be deducted more than once and capital gain will not be included more than once. See section 818(e) and also section 818(f).

(iv) Capital loss carryovers are subject to the transitional rule in paragraph (k)(6) of this section.

(6) *Transitional rule.* The portion of the life consolidated capital loss carryovers attributable to the net capital losses of the life members sustained in separate return years ending before January 1, 1981, is subject to the same limitations as the capital losses of nonlife members in paragraph (h)(4)(iii) of this section by applying the principles of paragraph (h)(3) of this section to each separate affiliated group of life companies.

(l) *Consolidated GO or LO*—(1) *General rule.* [Reserved]

(2) *Separate GO.* [Reserved]

(3) *Consolidated operations loss deduction*—(i) *General rule.* The consolidated operations loss deduction is an amount equal to the consolidated operations loss carryovers and carrybacks to the taxable year. The provisions of §§ 1.1502–21T or 1.1502–21A (as appropriate) and section 812 apply to the extent not inconsistent with this paragraph (l)(3).

(ii) *Consolidated offset.* For purposes of applying section 812 (b) and (d), the term ''consolidated offset'' means the increase in the consolidated operations loss deduction which reduces consolidated partial LICTI to zero. For setoff of consolidated LO against nonlife consolidated taxable income, see paragraph (n)(2) of this section.

(iii) *Carrybacks.* A consolidated LO is first carried back to be absorbed by GO of a life member under section 809(d)(4) or consolidated partial LICTI (as the case may be under section 818(f)(2)) for prior consolidated return years (or apportioned to the life members for prior separate return years) without regard to any nonlife subgroup losses that were set off against consolidated partial LICTI and before the consolidated LO may serve as a life subgroup loss to be set off against nonlife consolidated taxable income in the year the consolidated LO arose. The election to relinquish the entire carryback period for the consolidated LO of the life subgroup may be made by the common parent of the group. See section 812(b)(3). Furthermore, the election may be made even though the election under section 172(b)(3)(C) and paragraph (h)(2)(iii) of this section is not made.

(iv) *Carryovers.* If a consolidated LO is not carried back or is not applied as a life subgroup loss that set off nonlife consolidated taxable income in the year the consolidated LO arose, then it is carried over to a particular year under this paragraph (l)(3) first against the GO of a life member under section 809(d)(4) or consolidated partial LICTI (as the case may be under section 818(f)(2)) before it may serve as a life subgroup loss that may be set off against nonlife consolidated taxable income for that particular year.

(v) *Transitional rule.* The portion of a consolidated operations loss deduction that is attributable to LOs sustained in separate return years ending before January 1, 1981, is subject to the same rules and limitations that the nonlife consolidated net operating loss deduction is subject to in paragraph (h)(3) of this section as applied by identifying separate affiliated groups of life companies.

(4) *Life consolidated capital gain net income or loss.* Life consolidated capital gain net income or loss is determined in the same manner as under paragraph (k)(4) of this section. However, a life member's company share is determined under section 809 (a) and (b)(3).

(m) *Consolidated partial LICTI setoff by nonlife subgroup losses*—(1) *In general.* The nonlife subgroup losses consist of the nonlife consolidated net operating loss and the nonlife consolidated net capital loss. Under paragraph (g)(2) of this section, consolidated partial LICTI is set off by the amounts of these two consolidated losses specified in paragraph (m)(2) of this section. The setoff is subject to the rules and limitations in paragraph (m)(3) of this section.

(2) *Amount of setoff*—(i) *Current year.* Consolidated partial LICTI for the current taxable year is set off by the portion of the nonlife consolidated net operating loss and nonlife consolidated net capital loss arising in that year that cannot be carried back under paragraph (h) of this section to prior taxable years (whether consolidated or separate return years) of the nonlife subgroup.

(ii) *Carryovers.* The portion of the offsettable nonlife consolidated net operating loss or nonlife consolidated net capital loss that has not been used as a nonlife subgroup loss setoff against consolidated partial LICTI in the year it arose may be carried over to succeeding taxable years under the principles of §§1.1502–21T or 1.1502–21A (as appropriate) (relating to net operating loss deduction) or §§1.1502–22T or 1.1502–22A (as appropriate) (relating to net capital loss carryovers). However, in any particular succeeding year, the losses will be used under paragraph (h) of this section in computing nonlife consolidated taxable income before being used in that year as a nonlife subgroup loss that sets off consolidated partial LICTI.

(3) *Nonlife subgroup loss rules and limitations.* The nonlife subgroup losses are subject to the following operating rules and limitations:

(i) *Separate return years.* The carryovers in paragraph (m)(2)(ii) of this section may include net operating losses and net capital losses of the nonlife members arising in separate return years ending after December 31, 1980, that may be carried over to a succeeding year under the principles (including limitations) of §§1.1502–21T and 1.1502–22T (or §§1.1502–21A and 1.1502–22A, as appropriate). But see subdivision (ix) of this paragraph (m)(3).

(ii) *Capital loss.* Nonlife consolidated net capital loss sets off consolidated partial LICTI only to the extent of life consolidated capital gain net income (as determined under paragraph (l)(4) of this section) and this setoff applies before any nonlife consolidated net operating loss sets off consolidated partial LICTI.

(iii) *Capital gain.* Life consolidated capital gain net income is zero in any taxable year in which the life subgroup has a consolidated LO and, in any taxable year, it may not exceed consolidated partial LICTI.

(iv) *Ordering rule.* Consolidated partial LICTI for a consolidated return year is set off by nonlife subgroup losses for that year before being set off (under paragraph (m)(2)(ii) of this section) by a carryover of a nonlife subgroup loss to that year.

(v) *Setoff at bottom line.* The setoff of nonlife subgroup losses against consolidated partial LICTI does not affect life member deductions that depend in whole or in part on GO or TII. Thus, the setoff does not affect the amount of consolidated partial LICTI (as determined under paragraph (j) of this section) for any taxable year but it merely constitutes an adjustment in arriving at the group's consolidated taxable income under paragraph (g) of this section.

(vi) *Ineligible nonlife member.* (A) The offsetable nonlife consolidated net operating loss that arises in any consolidated return year (that may be set off against consolidated partial LICTI in the current taxable year or in a succeeding taxable year) is the amount computed under paragraph (h)(2)(ii) of this section reduced by the ineligible NOL. For purposes of this subparagraph (3), the ''ineligible NOL'' is in the year the loss arose the amount of the separate net operating loss (determined under §§ 1.1502–21T(b) or 1.1502–79A(a)(3) (as appropriate) of any nonlife member that is ineligible in that year (and not the portion of the nonlife consolidated net operating loss attributable under §§ 1.1502–21T(b) or 1.1502–79A(a)(3) (as appropriate) to such a member). (B) The carryovers of offsetable nonlife net operating losses under paragraph (m)(2)(ii) of this section do not include an ineligible NOL arising in a consolidated return year or a loss attributable to an ineligible member arising in a separate return year. See section 1503(c)(2). (C) For absorption within the nonlife subgroup of an ineligible NOL arising in a consolidated return year or a loss of an ineligible member arising in a separate return year which is not a separate return limitation year under paragraph (m)(3)(ix) of this section, see paragraph (m)(3)(vii) of this section.

(vii) *Absorption of ineligible NOL.* (A) If all or a portion of a nonlife member's ineligible NOL (determined under paragraph (m)(3)(vi)(A) of this section) may be carried back or carried over under paragraph (h)(2) of this section to a particular consolidated return year of the nonlife subgroup (absorption year), then notwithstanding § 1.1502–21A(b)(3)(ii), the amount carried to the absorption year will be absorbed by that member's contribution (to the extent thereof) to nonlife consolidated taxable income for that year.

(B) For purposes of (A) of this subdivision (vii), a member's contribution to nonlife consolidated taxable income for an absorption year is the amount of such income (computed without the portion of the nonlife consolidated net operating loss deduction attributable to taxable years subsequent to the year the loss arose), minus such consolidated taxable income recomputed by excluding both that member's items of income and deductions for the absorption year. The deductions of the member include the prior application of this paragraph (m)(3)(vii) to the absorption of the nonlife consolidated net operating loss deduction for losses arising in taxable years prior to the particular loss year.

(viii) *Election to relinquish carryback.* The offsetable nonlife consolidated net operating loss does not include the amount that could be carried back under paragraph (h) (2) of this section but for the common parent's election under section 172(b)(3)(C) to relinquish the carryback. See section 1503(c)(1).

(ix) *Separate return limitation year.* The offsetable nonlife consolidated net operating and capital loss carryovers do not include any losses attributable to a nonlife member that were sustained (A) in a separate return limitation year (determined without section 1504(b)(2)) of that member (or a predecessor), or (B) in a separate return year ending after December 31, 1980, in which an election was in effect under neither section 1504(c)(2) nor section

243(b)(2). For purposes of this paragraph (m), a separate return limitation year includes a taxable year ending before January 1, 1981. See section 1507(c)(2)(A) of the Tax Reform Act of 1976 and §§1.1502–15T and 1.1502–15A (including applicable exceptions thereto).

(x) *Percentage limitation.* The offsetable nonlife consolidated net operating losses that may be set off against consolidated partial LICTI in a particular year may not exceed a percentage limitation. This limitation is the applicable percentage in section 1503(c)(1) of the lesser of two amounts. The first amount is the sum of the offsetable nonlife consolidated net operating losses under paragraph (m)(2) of this section that may serve in the particular year (determined without this limitation) as a setoff against consolidated partial LICTI. The second amount is consolidated partial LICTI (as defined in paragraph (j) of this section) in the particular year reduced by any nonlife consolidated net capital loss that sets off consolidated partial LICTI in that year.

(xi) *Further limitation.* Any offsetable nonlife consolidated net operating loss remaining after applying the percentage limitation that is carried over to a succeeding taxable year may not be set off against the consolidated partial LICTI attributable to a life member that was not an eligible life member in the year the loss arose. See section 1503(c)(2).

(xii) *Restoration rule.* The carryback of a consolidated LO or life consolidated net capital loss under paragraph (l) of this section that reduces consolidated partial LICTI (or life consolidated capital gain net income) for a prior year may reduce the amount of nonlife subgroup losses that would offset consolidated partial LICTI in that prior year. Thus, that amount may be carried over under paragraph (h) (2) or (4) of this section from that prior year in determining nonlife consolidated taxable income in a succeeding year or serve as offsetable nonlife subgroup losses in a succeeding year.

(4) *Acquired groups.* [Reserved]

(5) *Illustrations.* The following examples illustrates this paragraph (m). In the examples, L indicates a life company, another letter indicates a nonlife company, and each corporation uses the calendar year as its taxable year.

Example (1). P owns all of the stock of L and S. S owns all of the stock of I, a nonlife member that is an ineligible corporation for 1982 under paragraph (d)(13) of this section. For 1982, the group elects under section 1504(c)(2) to file a consolidated return. For 1982, assume that any nonlife consolidated net operating loss may not be carried back to a prior taxable year. Other facts are summarized in the following table.

	Separate taxable income (loss)
P	$100
S	(100)
I	(100)
Nonlife consolidated net operating loss	(100)

Under paragraph (m)(3)(vi) of this section, P's separate income is considered to absorb the loss of S, an eligible member, first and the offsetable nonlife consolidated net operating loss is zero, *i.e.*, the consolidated net operating loss ($100) reduced by I's loss ($100). The consolidated net operating loss ($100) may be carried over, but since it is entirely attributable to I (an ineligible member) its use is subject to the restrictions in paragraph (m)(3)(vi) of this section. The result would be the same if the group contained two additional members, S_1, an eligible member, and I_1, an ineligible member, where S_1 had a loss of ($100) and I_1 had income of $100.

Example (2). The facts are the same as in example (1) except that for 1982 S's separate net operating loss is $200. Assume further that L's consolidated partial LICTI is $200. Under paragraph (m)(3)(vi) of this section, the offsetable nonlife consolidated net operating loss is $100, *i.e.*, the nonlife consolidated net operating loss computed under paragraph (h)(2)(ii) of this section ($200), reduced by the separate net operating loss of I ($100). The offsetable nonlife consolidated net operating loss that may be set off against consolidated partial LICTI in 1982 is $30, *i.e.*, 30 percent of the lesser of the offsetable $100 or consolidated partial LICTI of $200. See paragraph (m)(3)(x) of this section. The nonlife subgroup may carry $170 to 1983 under paragraph (h)(2) of this section against nonlife consolidated taxable income, *i.e.*, consolidated net operating loss ($200) less amount used in 1982 ($30). Under paragraph (m)(2)(ii) of this section, the offsetable nonlife consolidated net operating loss that may be carried to 1983 is $70, *i.e.*, $100 minus $30. The facts and results are summarized in the table below.

	(Dollars omitted)			
	Facts	Offsetable	Limit	Unused loss
	(a)	(b)	(c)	(d)
1. P	100			
2. S.	(200)	(100)		(70)
3. I	(100)			(100)
4. Nonlife subgroup	(200)	(100)	(100)	(170)
5. L	200		200	
6. 30% of lower of line 4(c) or 5(c)			30	
7. Unused offsetable loss				(70)

Accordingly, under paragrah (g) of this section (assuming no amount is withdrawn from L's surplus accounts), consolidated taxable income is $170, *i.e.*, line 5 (a) minus line 6(c)).

Example (3). The facts are the same as in example (2) with the following additions for 1983. The nonlife subgroup has nonlife consolidated taxable income of $50 (all of which is attributable to I) before the nonlife consolidated net operating loss deduction under paragraph (h)(2) of this section. Consolidated partial LICTI is $100. Under paragraph (h)(2) of this section, $50 of the nonlife consolidated net operating loss carryover ($170) is used in 1983 and, under paragraph (m)(3) (vi) and (vii) of this section, the portion used in 1982 is attributable to I, the ineligible nonlife member. Accordingly, the offsetable nonlife consolidated net operating loss from 1982 under paragraph (m)(3)(ii) of this section is $70, *i.e.*, the unused loss from 1982. The offsetable nonlife consolidated net operating loss in 1983 is $24.50, *i.e.*, 35 percent of the lesser of the offsetable loss of $70 or consolidated partial LICTI of $100. Accordingly, under paragraph (g) of this section (assuming no amount is withdrawn from L's surplus accounts), consolidated taxable income is $75.50, *i.e.*, consolidated partial LICTI of $100 minus the offsetable loss of $24.50.

Example (4). P owns all of the stock of S and L. For 1982, all corporations are eligible corporations, and the group elects under section 1504(c)(2) to file a consolidated return, the nonlife consolidated net operating loss is $100, and the nonlife consolidated net capital loss is $50. Assume that the losses may not be carried back and the capital losses are not attributable to built-in deductions under paragraph (m)(3)(ix) of this section or under § 1.1502–15A. Other facts and the results are set forth in the following table:

	P–S	L
1. Nonlife consolidated net operating loss	($100)	
2. Nonlife consolidated capital loss	(50)	
3. Consolidated partial LICTI		$100
4. Life consolidated capital gain net income included in line 3		50
5. Offsetable:		
(a) 30% of lower of line (1) or line (3)–(4)	(15)	
(b) Line 2	(50)	
(c) Total	(65)	
6. Unused losses available to be carried over:		
(a) From line 1 (line 1 minus line 5 (a))	(85)	
(b) From line 2 (line 2 minus line 5 (b))	0	

Accordingly, under paragraph (g) of this section consolidated taxable income is $35, *i.e.*, line 3 minus line 5(c).

Example (5). The facts are the same as in example (4). Assume further that for 1983 L has an LO that is carried back to 1982 and the LO is large enough to reduce consolidated partial LICTI for 1982 to zero as determined before any setoff for nonlife losses. Under paragraph (m)(3)(xii) of this section, the nonlife consolidated net operating loss of $15 and the nonlife consolidated net capital loss of $50 that were set off in 1982 respectively against consolidated partial LICTI and life consolidated capital gain net income are restored. These restored amounts may consititute part of the nonlife consolidated net operating loss carryover to 1983 under paragraph (h)(2) of this section or part of the nonlife net capital loss carryover to 1983 under paragraph (h)(4) of this section.

Example (6). The facts are the same as in example (5) except that L's LO for 1983 as carried back reduces consolidated partial LICTI in 1982 from $100 to $25. Since consolidated partial LICTI of $100 in 1982 (before the carryback) included life consolidated capital gain net income of $50, under paragraph (m)(3)(iii) of this section, the life consolidated capital gain net income is $25, *i.e.*, $50 but not more than $25. Therefore, under paragraph (m)(3)(ii) of this section, the offsetable nonlife capital loss in 1982 is $25 and, under paragraph (m) (3)(xii) of this section, $25 of the $50 nonlife consolidated net capital loss in 1982 may be carried under paragraph (h)(4) of this section to 1983. No nonlife consolidated net operating loss is used as a setoff against consolidated partial LICTI in 1982 under paragraph (m)(3)(xii) of this section by reason of the carryback of the consolidated LO from 1983 to 1982.

(n) *Nonlife consolidated taxable income set off by life subgroup losses*—(1) *In general.* The life subgroup losses consist of the consolidated LO and the life consolidated net capital loss (as determined under paragraph (l)(4) of this section). Under paragraph (g)(1) of this section, nonlife consolidated taxable income is set off by the amounts of these two consolidated losses specified in paragraph (n)(2) of this section.

(2) *Amount of setoff.* The portion of the consolidated LO or life consolidated net capital loss that may be set off against nonlife consolidated taxable income (determined under paragraph (h) of this section) is determined by applying the rules prescribed in paragraphs (m) (2) and (3) of this section in the following manner:

(i) Substitute the term ''life'' for ''nonlife'', and vice versa.

(ii) Substitute the term ''nonlife consolidated taxable income'' for ''consolidated partial LICTI'', and vice versa.

(iii) Substitute the term ''consolidated LO'' for ''non-life consolidated net operating loss'', ''paragraph (l)'' or ''paragraph (j)'' for ''paragraph (h)'', and ''section 812(b)(3)'' for ''section 172(b)(3)(C)''.

(iv) Paragraphs (m)(3)(vi), (vii), (x), and (xi) of this section do not apply to a consolidated LO.

(v) Capital losses may not be deducted more than once. See section 818(e) and also the requirements in section 818(f).

(vi) The setoff of life subgroup losses against nonlife consolidated taxable income does not affect nonlife member deductions that depend in whole or in part on taxable income.

(3) *Illustrations.* The following examples illustrate this paragraph (n). In the examples, L indicates a life company, another letter indicates a nonlife company, and each corporation uses the calendar year as its taxable year.

Example (1). P, S, L_1 and L_2 constitute a group that elects under section 1504(c)(2) to file a consolidated return for 1982. In 1982, the nonlife subgroup consolidated taxable income is $100 and there is $20 of nonlife consolidated net capital loss that cannot be carried back under paragraph (h) of this section to taxable years (whether consolidated or separate) preceding 1982. The nonlife subgroup has no carryover from years prior to 1982. Consolidated LO is $150 which under paragraph (l) of this section includes life consolidated capital gain net income of $25. The $150 LO is carried back under paragraph (l)(3) of this section to taxable years (whether consolidated or separate) preceding 1982 before it may offset in 1982 nonlife consolidated taxable income. Since life consolidated capital gain net income is zero for 1982, the nonlife capital loss offset is zero.

Example (2). The facts are the same as in example (1). Assume further that no part of the $150 consolidated LO for 1982 can be used by L_1 and L_2 in years prior to 1982. For 1982, $100 of consolidated LO sets off the $100 nonlife consolidated taxable income. The life subgroup carries under paragraph (l)(3) of this section to 1983 $50 of the consolidated LO ($150 minus $100). See paragraph (l)(3)(ii) of this section. The $50 carryover will be used in 1983 against life subgroup income before it may be used in 1983 to setoff nonlife consolidated taxable income.

Example (3). (a) The facts are the same as in example (1), except that for 1982 the nonlife consolidated taxable income is $150 and includes nonlife consolidated capital gain net income of $50, consolidated partial LICTI is $200, and a life consolidated net capital loss is $50. Assume that the $50 life consolidated net capital loss sets off the $50 nonlife consolidated capital gain net income. Consolidated taxable income under paragraph (g) of this section is $300, *i.e.*, nonlife consolidated taxable income ($150) minus the setoff of the life consolidated net capital loss ($50), plus consolidated partial LICTI ($200).

(b) Assume that for 1983 the nonlife consolidated net operating loss is $150. Under paragraph (h)(2) of this section, the loss may be carried back to 1982 against nonlife consolidated taxable income. If P, the common parent, does not elect to relinquish the carryback under section 172(b)(3)(C), the entire $150 must be carried back reducing 1982 nonlife consolidated taxable income to zero and nonlife consolidated capital gain net income to zero. Under paragraph (m)(3)(xii) of this section, the setoff in 1982 of the nonlife consolidated capital gain net income ($50) by the life consolidated net capital loss ($50) is restored. Accordingly, the 1982 life consolidated net capital loss may be carried over by the life subgroup to 1983. Under paragraph (g) of this section, after the carryback consolidated taxable income for 1982 is $200, *i.e.*, nonlife consolidated taxable income ($0) plus consolidated partial LICTI ($200).

Example (4). The facts are the same as in example (3), except that P elects under section 172 (b)(3)(C) to relinquish the carryback of $150 arising in 1983. The setoff in part (a) of example (3) is not restored. However, the offsetable nonlife consolidated net operating loss for 1983 (or that may be carried forward from 1983) is zero. See paragraph (m)(3)(viii) of this section. Nevertheless, the $150 nonlife consolidated net operating loss may be carried forward to be used by the nonlife group.

Example (5). P owns all of the stock of S_1 and of L_1. On January 1, 1978, L_1 purchases all of the stock of L_2. For 1982, the group elects under section 1504(c)(2) to file a consolidated return. For 1982, L_1 is an eligible corporation under paragraph (d)(12) of this section but L_2 is ineligible. Thus, L_1 but not L_2 is a member for 1982. For 1982, L_2 sustains an LO that cannot be carried back. For 1982, L_2 is treated under paragraph (f)(6) of this section as a member of a controlled group of corporations under section 1563 with P, S, and L_1. For 1983, L_2 is eligible and is included on the group's consolidated return. L_2's LO for 1982 that may be carried to 1983 is not treated under paragraph (d)(11) of this section as having been sustained in a separate return limitation year for purposes of computing consolidated partial LICTI of the L_1–L_2 life subgroup for 1983. Furthermore, the portion of L_2's LO not used under paragraph (l)(3) of this section against life subgroup income in 1983 may be included in offsetable consolidated operations loss under paragraph (n)(2) and (m)(3)(i) of this section that reduces in 1983 nonlife consolidated taxable income because L_2's loss in 1982 was not sustained in a separate return limitation year under paragraph (n)(2) and (m)(3)(ix)(A) of this section or in a separate return year (1982) when an election was in effect neither under section 1504(c)(2) nor section 243(b)(2).

(o) *Alternative tax*—(1) *In general.* For purposes of the alternative tax under paragraph (f)(7)(ii) of this section, consolidated net capital gain is the sum of the following two amounts:

(i) The nonlife consolidated net capital gain reduced by any setoff of a life consolidated net capital loss.

(ii) The life consolidated net capital gain reduced by any setoff of a nonlife consolidated net capital loss.

(2) *Net capital gain.* For purposes of this paragraph (o):

(i) Nonlife consolidated net capital gain is computed under §§ 1.1502–41A or 1.1502–22T (as appropriate) except that it may not exceed nonlife consolidated taxable income (computed under paragraph (h) of this section).

(ii) Life consolidated net capital gain is computed under §§ 1.1502–41A or 1.1502–22T (as appropriate), applied in a manner consistent with paragraph (l)(4) of this section, except that it may not exceed consolidated partial LICTI (as determined under paragraph (j) of this section).

(iii) *Setoffs.* Setoffs are determined under paragraphs (m) or (n) of this section (as the case may be).

(p) *Transitional rule for credit carryovers.* For limitations on credits arising in taxable years ending before January 1, 1981, that may be carried over to taxable years beginning on or after that date, section 1507(c)(2)(A) of the Tax Reform Act of 1976 and the principles in paragraph (h)(3) of this section (relating to limitations on loss carryovers) apply.

(q) *Preemption.* The rules in this section preempt any inconsistent rules in other sections (§ 1.1502–1 through 1.1502–80) of the consolidated return regulations. For example, the rules in paragraph (m)(3)(vi) apply notwithstanding §§ 1.1502–21A(b)(3) and 1.1502–79A(a)(3) (or § 1.1502–21T, as appropriate).

(r) *Other consolidation principles.* The fact that this section treats the life and nonlife members as separate groups in computing, respectively, consolidated partial LICTI (or LO) and nonlife consolidated taxable income (or loss) does not affect the usual rules in §§ 1.1502–0—1.1502–80 unless this section provides otherwise. Thus, the usual rules in § 1.1502–13 (relating to intercompany transactions) apply to both the life and nonlife members by treating them as members of one affiliated group.

(s) *Filing requirements.* Nonlife consolidated taxable income or loss under paragraph (h) of this section shall be determined on a separate Form 1120 or 1120 M and consolidated partial LICTI under paragraph (j) of this section shall be determined on a separate Form 1120 L. The consolidated return shall be made on a separate Form 1120, 1120 M, or 1120 L by the common parent (if the group includes a life company), which shows the set-offs under paragraphs (g), (m), and (n) of this section and clearly indicates by notation on the face of the return that it is a life-nonlife consolidated return (if the group includes a life company). See also §1.1502–75(j), relating to statements and schedules for subsidiaries.

(Secs. 1502 and 7805 of the Internal Revenue Code of 1954 (68A Stat. 637, 917; 26 U.S.C. 1502, 7805))

[T.D. 7877, 48 FR 11441, Mar. 18, 1983, as amended by T.D. 7912, 48 FR 40215, Sept. 6, 1983; T.D. 8560, 59 FR 41674, Aug. 15, 1994; T.D. 8597, 60 FR 36679–36680, July 18, 1995; T.D. 8677, 61 FR 33324, June 27, 1996]

§1.1502–55T Computation of alternative minimum tax of consolidated groups (temporary).

(a) through (h)(3) [Reserved].

(h)(4) *Separate return year minimum tax credit.*

(i) and (ii) [Reserved].

(iii)(A) *Limitation on portion of separate return year minimum tax credit arising in separate return limitation years.* The aggregate of a member's minimum tax credits arising in SRLYs that are included in the consolidated minimum tax credits for all consolidated return years of the group may not exceed—

(*1*) The aggregate for all consolidated return years of the member's contributions to the consolidated section 53(c) limitation for each consolidated return year; reduced by

(*2*) The aggregate of the member's minimum tax credits arising and absorbed in all consolidated return years (whether or not absorbed by the member).

(B) *Computational rules*—(*1*) *Member's contribution to the consolidated section 53(c) limitation.* Except as provided in the special rule of paragraph (h)(4)(iii)(B)(*2*) of this section, a member's contribution to the consolidated section 53(c) limitation for a consolidated return year equals the member's share of the consolidated net regular tax liability minus its share of consolidated tentative minimum tax. The group computes the member's shares by applying to the respective consolidated amounts the principles of section 1552 and the percentage method under §1.1502–33(d)(3), assuming a 100% allocation of any decreased tax liability. The group makes proper adjustments so that taxes and credits not taken into account in computing the limitation under section 53(c) are not taken into account in computing the member's share of the consolidated net regular tax, etc. (See, for example, the taxes described in section 26(b) that are disregarded in computing regular tax liability.)

(*2*) *Adjustment for year in which alternative minimum tax is paid.* For a consolidated return year for which consolidated tentative minimum tax is greater than consolidated regular tax liability, the group reduces the member's share of the consolidated tentative minimum tax by the member's share of the consolidated alternative minimum tax for the year. The group determines the member's share of consolidated alternative minimum tax for a year using the same method it uses to determine the member's share of the consolidated minimum tax credits for the year.

(*3*) *Years included in computation.* For purposes of computing the limitation under this paragraph (h)(4)(iii), the consolidated return years of the group include only those years, including the year to which a credit is carried, that the member has been continuously included in the group's consolidated return, but exclude any years after the year to which the credit is carried.

(*4*) *Subgroup principles.* The SRLY subgroup principles under §1.1502–21T(c)(2) apply for purposes of this paragraph (h)(4)(iii). The predecessor and successor principles under §1.1502–21T(f) also apply for purposes of this paragraph (h)(4)(iii).

(C) *Effective date.* This paragraph (h)(4)(iii) applies to consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998. However, a group does not take into account a consolidated taxable year for which the due date of the income tax return (without extensions) is on or before March 13, 1998, in determining a member's (or subgroup's) contributions to the consolidated section 53(c) limitation under this paragraph (h)(4)(iii). See §1.1502–3T(c)(4) for an optional effective date rule (generally making this paragraph (h)(4)(iii) applicable to a consolidated return year beginning after December 31, 1996, if the due date of the income tax return (without extensions) for such year is on or before March 13, 1998).

[T.D. 8751, 63 FR 1745, Jan. 12, 1998, as amended by T.D. 8766, 63 FR 12643, Mar. 16, 1998]

ADMINISTRATIVE PROVISIONS AND OTHER RULES

§ 1.1502–75 Filing of consolidated returns.

(a) *Privilege of filing consolidated returns*—(1) *Exercise of privilege for first consolidated return year.* A group which did not file a consolidated return for the immediately preceding taxable year may file a consolidated return in lieu of separate returns for the taxable year, provided that each corporation which has been a member during any part of the taxable year for which the consolidated return is to be filed consents (in the manner provided in paragraph (b) of this section) to the regulations under section 1502. If a group wishes to exercise its privilege of filing a consolidated return, such consolidated return must be filed not later than the last day prescribed by law (including extensions of time) for the filing of the common parent's return. Such consolidated return may not be withdrawn after such last day (but the group may change the basis of its return at any time prior to such last day).

(2) *Continued filing requirement.* A group which filed (or was required to file) a consolidated return for the immediately preceding taxable year is required to file a consolidated return for the taxable year unless it has an election to discontinue filing consolidated returns under paragraph (c) of this section.

(b) *How consent for first consolidated year exercised*—(1) *General rule.* The consent of a corporation referred to in paragraph (a)(1) of this section shall be made by such corporation joining in the making of the consolidated return for such year. A corporation shall be deemed to have joined in the making of such return for such year if it files a Form 1122 in the manner specified in paragraph (h)(2) of this section.

(2) *Consent under facts and circumstances.* If a member of the group fails to file Form 1122, the Commissioner may under the facts and circumstances determine that such member has joined in the making of a consolidated return by such group. The following circumstances, among others, will be taken into account in making this determination:

(i) Whether or not the income and deductions of the member were included in the consolidated return;

(ii) Whether or not a separate return was filed by the member for that taxable year; and

(iii) Whether or not the member was included in the affiliations schedule, Form 851.

If the Commissioner determines that the member has joined in the making of the consolidated return, such member shall be treated as if it had filed a Form 1122 for such year for purposes of paragraph (h)(2) of this section.

(3) *Failure to consent due to mistake.* If any member has failed to join in the making of a consolidated return under either subparagraph (1) or (2) of this paragraph, then the tax liability of each member of the group shall be determined on the basis of separate returns unless the common parent corporation establishes to the satisfaction of the Commissioner that the failure of such member to join in the making of the consolidated return was due to a mistake of law or fact, or to inadvertence. In such case, such member shall be treated as if it had filed a Form 1122 for such year for purposes of paragraph (h)(2) of this section, and thus joined in the making of the consolidated return for such year.

(c) *Election to discontinue filing consolidated returns*—(1) *Good cause*—(i) *In general.* Notwithstanding that a consolidated return is required for a taxable year, the Commissioner, upon application by the common parent, may for good cause shown grant permission to a group to discontinue filing consolidated returns. Any such application shall be made to the Commissioner of Internal Revenue, Washington, DC 20224, and shall be made not later than the 90th day before the due date for the filing of the consolidated return (including extensions of time). In addition, if an amendment of the Code, or other law affecting the computation of tax liability, is enacted and the enactment is effective for a taxable year ending before or within 90 days after the date of enactment, then application for such a taxable year may be made not later than the 180th day after the date of enactment, and if the application is approved the permission to discontinue filing consolidated returns will apply to such taxable year notwithstanding that a consolidated return has already been filed for such year.

(ii) *Substantial adverse change in law affecting tax liability.* Ordinarily, the Commissioner will grant a group permission to discontinue filing consolidated returns if the net result of all amendments to the Code or regulations with effective dates commencing within the taxable year has a substantial adverse effect on the consolidated tax liability of the group for such year relative to what the aggregate tax liability would be if the members of the group filed separate returns for such year. Thus, for example, assume P and S filed a consolidated return for the calendar year 1966 and that the provisions of the Code have been amended by a bill which was enacted by Congress in 1966, but which is first effective for taxable years beginning on or after January 1, 1967. Assume further that P makes a timely application to discontinue filing consolidated returns. In order to determine whether the amendments have a substantial adverse effect on the consolidated tax liability for 1967, relative to what the aggregate tax liability would be if the members of the group filed separate returns for 1967, the difference between the tax liability of the group computed on a consolidated basis and taking into account the changes in the law effective for 1967 and the aggregate tax liability of the members of the group computed as if each such member filed separate returns for such year (also taking into account such changes) shall be compared with the difference between the tax liability of such group for 1967 computed on a consolidated basis without regard to the changes in the law effective in such year and the aggregate tax liability of the members of the group computed as if separate returns had been filed by such members for such year without regard to the changes in the law effective in such year.

(iii) *Other factors.* In addition, the Commissioner will take into account other factors in determining whether good cause exists for granting permission to discontinue filing consolidated returns beginning with the taxable year, including:

(a) Changes in law or circumstances, including changes which do not affect Federal income tax liability,

(b) Changes in law which are first effective in the taxable year and which result in a substantial reduction in the consolidated net operating loss (or consolidated unused investment credit) for such year relative to what the aggregate net operating losses (or investment credits) would be if the members of the group filed separate returns for such year, and

(c) Changes in the Code or regulations which are effective prior to the taxable year but which first have a substantial adverse effect on the filing of a consolidated return relative to the filing of separate returns by members of the group in such year.

(2) *Discretion of Commissioner to grant blanket permission*—(i) *Permission to all groups.* The Commissioner, in his discretion, may grant all groups permission to discontinue filing consolidated returns if any provision of the Code or regulations has been amended and such amendment is of the type which could have a substantial adverse effect on the filing of consolidated returns by substantially all groups, relative to the filing of separate returns. Ordinarily, the permission to discontinue shall apply with respect to the taxable year of each group which includes the effective date of such an amendment.

(ii) *Permission to a class of groups.* The Commissioner, in his discretion, may grant a particular class of groups permission to discontinue filing consolidated returns if any provision of the Code or regulations has been amended and such amendment is of the type which could have a substantial adverse effect on the filing of consolidated returns by substantially all such groups relative to the filing of separate returns. Ordinarily, the permission to discontinue shall apply with respect to the taxable year of each group within the class which includes the effective date of such an amendment.

(3) *Time and manner for exercising election.* If, under subparagraph (1) or (2) of this paragraph, a group has an election to discontinue filing consolidated returns for any taxable year and such group wishes to exercise such election, then the common parent must file a separate return for such year on or before the last day prescribed by law (including extensions of time) for the filing of the consolidated return for such year. See section 6081 (relating to extensions of time for filing returns).

(d) *When group remains in existence*—(1) *General rule.* A group remains in existence for a tax year if the common parent remains as the common parent and at least one subsidiary that was affiliated with it at the end of the prior year remains affiliated with it at the beginning of the year, whether or not one or more corporations have ceased to be subsidiaries at any time after the group was formed. Thus, for example, assume that individual A forms corporation P. P acquires 100 percent of the stock of corporation S on January 1, 1965, and P and S file a consolidated return for the calendar year 1965. On May 1, 1966, P acquires 100 percent of the stock of S–1, and on July 1, 1966, P sells the stock of S. The group (consisting originally of P and S) remains in existence in 1966 since P has remained as the common parent and at least one subsidiary (now S–1) remains affiliated with it.

(2) *Common parent no longer in existence*—(i) *Mere change in identity.* For purposes of this paragraph, the common parent corporation shall remain as the common parent irrespective of a mere change in identity, form, or place of organization of such common parent corporation (see section 368(a)(1)(F)).

(ii) *Transfer of assets to subsidiary.* The group shall be considered as remaining in existence notwithstanding that the common parent is no longer in existence if the members of the affiliated group succeed to and become the owners of substantially all of the assets of such former parent and there remains one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation and which was a member of the group prior to the date such former parent ceases to exist. For purposes of applying paragraph (f)(2)(i) of § 1.1502–1 to separate return years ending on or before the date on which the former parent ceases to exist, such former parent, and not the new common parent, shall be considered to be the corporation described in such paragraph.

(iii) *Taxable years.* If a transfer of assets described in subdivision (ii) of this subparagraph is an acquisition to which section 381(a) applies and if the group files a consolidated return for the taxable year in which the acquisition occurs, then for purposes of section 381:

(a) The former common parent shall not close its taxable year merely because of the acquisition, and all taxable years of such former parent ending on or before the date of acquisition shall be treated as taxable years of the acquiring corporation, and

(b) The corporation acquiring the assets shall close its taxable year as of the date of acquisition, and all taxable years of such corporation ending on or before the date of acquisition shall be treated as taxable years of the transferor corporation.

(iv) *Exception.* With respect to acquisitions occurring before January 1, 1971, subdivision (iii) of this subparagraph shall not apply if the group, in its income tax return, treats the taxable year of the former common parent as having closed as of the date of acquisition.

(3) *Reverse acquisitions*—(i) *In general.* If a corporation (hereinafter referred to as the ‘‘first corporation’’) or any member of a group of which the first corporation is the common parent acquires after October 1, 1965:

(a) Stock of another corporation (hereinafter referred to as the second corporation), and as a result the second corporation becomes (or would become but for the application of this subparagraph) a member of a group of which the first corporation is the common parent, or

(b) Substantially all the assets of the second corporation,

in exchange (in whole or in part) for stock of the first corporation, and the stockholders (immediately before the acquisition) of the second corporation, as a result of owning stock of the second corporation, own (immediately after the acquisition) more than 50 percent of the fair market value of the outstanding stock of the first corporation, then any group of which the first corporation was the common parent immediately before the acquisition shall cease to exist as of the date of acquisition, and any group of which the second corporation was the common parent immediately before the acquisition shall be treated as remaining in existence (with the first corporation becoming the common parent of the group). Thus, assume that corporations P and S comprised group PS (P being the common parent), that P was merged into corporation T (the common parent of a group composed of T and corporation U), and that the shareholders of P immediately before the merger, as a result of owning stock in P, own 90 percent of the fair market value of T's stock immediately after the merger. The group of which P was the common parent is treated as continuing in existence with T and U being added as members of the group, and T taking the place of P as the common parent.

For purposes of determining under *(a)* of this subdivision whether the second corporation becomes (or would become) a member of the group of which the first corporation is the common parent, and for purposes of determining whether the former stockholders of the second corporation own more than 50 percent of the outstanding stock of the first corporation, there shall be taken into account any acquisitions or redemptions of the stock of either corporation which are pursuant to a plan of acquisition described in *(a)* or *(b)* of this subdivision.

(ii) *Prior ownership of stock.* For purposes of subdivision (i) of this subparagraph, if the first corporation, and any members of a group of which the first corporation is the common parent, have continuously owned for a period of at least 5 years ending on the date of the acquisition an aggregate of at least 25 percent of the fair market value of the outstanding stock of the second corporation, then the first corporation (and any subsidiary which owns stock of the second corporation immediately before the acquisition) shall, as a result of owning such stock, be treated as owning (immediately after the acquisition) a percentage of the fair market value of the first corporation's outstanding stock which bears the same ratio to *(a)* the percentage of the fair market value of all the stock of the second corporation owned immediately before the acquisition by the first corporation and its subsidiaries as *(b)* the fair market value of the total outstanding stock of the second corporation immediately before the acquisition bears to *(c)* the sum of *(1)* the fair market value, immediately before the acquisition, of the total outstanding stock of the first corporation, and *(2)* the fair market value, immediately before the acquisition, of the total outstanding stock of the second corporation (other than any such stock owned by the first corporation and any of its subsidiaries). For example, assume that corporation P owns stock in corporation T having a fair market value of $100,000, that P acquires the remaining stock of T from individuals in exchange for stock of P, that immediately before the acquisition the total outstanding stock of T had a fair market value of $150,000, and that immediately before the acquisition the total outstanding stock of P had a fair market value of $200,000. Assuming P owned at least 25 percent of the fair market value of T's stock for 5 years, then for purposes of this subparagraph, P is treated as owning (immediately after the acquisition) 40 percent of the fair market value of its own outstanding stock, determined as follows:

[$150,000/($200,000+$50,000)]×662/3%=40%.

Thus, if the former individual stockholders of T own, immediately after the acquisition more than 10 percent of the fair market value of the outstanding stock of P as a result of owning stock of T, the group of which T was the common parent is treated as continuing in existence with P as the common parent, and the group of which P was the common parent before the acquisition ceases to exist.

(iii) *Election.* The provisions of subdivision (ii) of this subparagraph shall not apply to any acquisition occurring in a taxable year ending after October 7, 1969, unless the first corporation elects to have such subdivision apply. The election shall be made by means of a statement, signed by any officer who is duly authorized to act on behalf of the first corporation, stating that the corporation elects to have the provisions of §1.1502–75(d)(3)(ii) apply and identifying the acquisition to which such provisions will apply. The statement shall be filed, on or before the due date (including extensions of time) of the return for the group's first consolidated return year ending after the date of the acquisition, with the internal revenue officer with whom such return is required to be filed.

(iv) *Transfer of assets to subsidiary.* This subparagraph shall not apply to a transaction to which subparagraph (2)(ii) of this paragraph applies.

(v) *Taxable years.* If, in a transaction described in subdivision (i) of this subparagraph, the first corporation files a consolidated return for the first taxable year ending after the date of acquisition, then:

(a) The first corporation, and each corporation which, immediately before the acquisition, is a member of the group of which the first corporation is the common parent, shall close its taxable year as of the date of acquisition, and each such corporation shall, immediately after the acquisition, change to the taxable year of the second corporation, and

(b) If the acquisition is a transaction described in section 381(a)(2), then for purposes of section 381:

(1) All taxable years ending on or before the date of acquisition, of the first corporation and each corporation which, immediately before the acquisition, is a member of the group of which the first corporation is the common parent, shall be treated as taxable years of the transferor corporation, and

(2) The second corporation shall not close its taxable year merely because of such acquisition, and all taxable years ending on or before the date of acquisition, of the second corporation and each corporation which, immediately before the acquisition, is a member of any group of which the second corporation is the common parent, shall be treated as taxable years of the acquiring corporation.

(vi) *Exception.* With respect to acquisitions occurring before April 17, 1968, subdivision (v) of this subparagraph shall not apply if the parties to the transaction, in their income tax returns, treat subdivision (i) as not affecting the closing of taxable years or the operation of section 381.

(4) [Reserved]

(5) *Coordination with section 833*—(i) *Election to continue old group.* If, solely by reason of the enactment of section 833 (relating to certain Blue Cross or Blue Shield organizations and certain other health insurers), an organization to which section 833 applies (a ‘‘section 833 organization’’) became the new common parent of an old group on January 1, 1987, the old group may elect to continue in existence with that section 833 organization as its new common parent, provided all the old groups having the same section 833 organization as their new common parent elect to continue in existence. To revoke this election, see paragraph (d)(5)(x) of this section. To file as a new group, see paragraph (d)(5)(v) of this section.

(ii) *Old group.* For purposes of this paragraph (d)(5), an old group is a group which, for its last taxable year ending in 1986, either filed a consolidated return or was eligible to (but did not) file a consolidated return.

(iii) *Manner of electing to continue*—(A) *Deemed election.* If all the members of all the old groups having the same section 833 organization as their new common parent are included for the first taxable year beginning after December 31, 1986, on the same consolidated (or amended consolidated) return and a Form 1122 was not filed, the old groups are deemed to have elected under paragraph (d)(5)(i) of this section to continue in existence.

(B) *Delayed election.* If a deemed election to continue in existence was not made under paragraph (d)(5)(iii)(A) of this section, all the members of all the old groups having the same section 833 organization as their new common parent may make a delayed election under paragraph (d)(5)(i) of this section to continue in existence by:

(*1*) Filing an appropriate consolidated (or amended consolidated) return or returns for each taxable year beginning after December 31, 1986, (notwithstanding §1.1502–75(a)(1)) on or before January 3, 1991, and

(*2*) On the top of any such return prominently affixing a statement containing the following declaration: ‘‘THIS RETURN’’ (or, if applicable, ‘‘AMENDED RETURN’’) ‘‘REFLECTS A DELAYED ELECTION TO CONTINUE UNDER §1.1502–75T(d)(5)(iii)(B)’’. A delayed election to continue in existence automatically revokes a deemed election to file as a new group which was made under paragraph (d)(5)(vi) of this section.

(iv) *Effects of election to continue in existence.* If an old group or groups elect to continue in existence under paragraph (d)(5)(i) of this section, the following rules apply:

(A) *Taxable years.* Each member that filed returns other than on a calendar year basis shall close its taxable year on December 31, 1986, and change to a calendar year beginning on January 1, 1987. See section 843 and §1.1502–76(a)(1).

(B) *Carryovers from separate return limitation years.* For purposes of applying the separate return limitation year rules to carryovers from taxable years beginning before 1987 to taxable years beginning after 1986, the following rules apply:

(*1*) Any taxable year beginning before 1987 of a corporation that was not a member of an old group (including a section 833 organization) will be treated as a separate return limitation year;

(*2*) Any taxable year beginning before 1987 of a corporation that was a member of an old group that, without regard to this section and the enactment of section 833, was a separate return limitation year will continue to be treated as a separate return limitation year;

(*3*) Any taxable year beginning before 1987 of a member of an old group (other than a separate return limitation year described in paragraph (d)(5)(iv)(B)(*2*) of this section) will not be treated as a separate return limitation year with respect to any corporation that was a member of such group for each day of that taxable year; and

(*4*) Any taxable year beginning before 1987 of a member of an old group will be treated as a separate return limitation year with respect to any corporation that was not a member of such group for each day of that taxable year (*e.g.*, a corporation that was not a member of an old group, including a section 833 organization, or a corporation that was a member of another old group).

(C) *Five-year rules for life-nonlife groups.* Any life-nonlife election under section 1504(c)(2) in effect for an old group remains in effect. Any old group which was eligible to make a life-nonlife election will remain eligible to make the election. For purposes of section 1503(c), a nonlife member is treated as ineligible under §1.1502–47(d)(13) with respect to a life member, unless both were members of the same affiliated group (determined without regard to the exclusions in section 1504(b) (1) and (2)) for five taxable years immediately preceding the taxable year in which the loss arose. See paragraph (d)(5)(ix) of this section for a tacking rule.

(v) *Election to file as a new group.* If, solely by reason of the enactment of section 833, a section 833 organization became the new common parent of an old group on January 1, 1987, the application of the five-year prohibition on reconsolidation in section 1504(a)(3)(A) to the old group is waived and the old group together with the new section 833 organization common parent may elect to file as a new group provided that all includible corporations elect to file a consolidated (or amended consolidated) return as a new group for the first taxable year beginning after December 31, 1986. To revoke this election, see paragraph (d)(5)(x) of this section.

(vi) *Manner of electing to file as a new group*—(A) *Deemed election.* The old group or groups and the section 833 organization are deemed to have elected under paragraph (d)(5)(v) of this section to file as a new group by filing, for the first taxable year beginning after December 31, 1986, a Form 1122 and a consolidated (or amended consolidated) tax return.

(B) *Delayed election.* If a deemed election to file as a new group was not made pursuant to paragraph (d)(5)(vi)(A) of this section, the old group or groups and the section 833 organization may make a delayed election under paragraph (d)(5)(v) of this section to file as a new group by

(*1*) Filing an appropriate consolidated (or amended consolidated) return or returns for each taxable year beginning after December 31, 1986 (notwithstanding § 1.1502–75(a)(1)) on or before January 3, 1991, and

(*2*) On the top of any such return prominently affixing a statement containing the following declaration: ''THIS RETURN'' (or, if applicable, ''AMENDED RETURN'') ''REFLECTS A DELAYED ELECTION TO FILE AS A NEW GROUP UNDER § 1.1502–75T (d)(5)(vi)(B)''. A delayed election to file as a new group automatically revokes any deemed election to continue in existence which was made under paragraph (d)(5)(iii) of this section.

(vii) *Effects of election to file as a new group.* If an old group or groups elect to file as a new group under paragraph (d)(5)(v) of this section, the following rules apply:

(A) *Termination.* Each old group is treated as if it terminated on January 1, 1987, and the termination is not treated as resulting from the acquisition by a nonmember of all of the stock of the common parent.

(B) *Taxable years.* Each member that filed returns other than on a calendar year basis shall close its taxable year on December 31, 1986, and change to a calendar year beginning on January 1, 1987. See section 843 and § 1.1502–76(a)(1).

(C) *Separate return limitation year and life-nonlife groups.* For purposes of § 1.1502–1(f), sections 1503(c) and 1504(c), and § 1.1502–47, the group is treated as coming into existence as a new group on January 1, 1987. Thus, for example, paragraphs (d)(5)(iv) (B) and (C) of this section do not apply.

(viii) *Earnings and profits.* All distributions after January 1, 1987 by a corporation, whether or not such corporation was a member of an old group, to an existing Blue Cross or Blue Shield organization (as defined in section 833(c)(2)) out of earnings and profits accumulated before 1987 are deemed made out of earnings and profits accumulated in pre-affiliation years. See § 1.1502–32(h)(5).

(ix) *Five-year tacking rules for certain life-nonlife groups.* For purposes of applying § 1.1502–47(d) (5) and (12) to any taxable year ending after 1986 to a corporation, whether or not the corporation was a member of an old group,

(A) The determination of whether the corporation was in existence and a member or tentatively treated as a member of a group, for taxable years ending before 1987, is made without regard to the exclusions under section 1504(b) (1) and (2) of any section 833 organization or life insurance company (as the case may be) and

(B) A section 833 organization is not treated as having a change in tax character solely by reason of the loss of its tax-exempt status due to the enactment of section 833.

This paragraph (d)(5)(ix) does not apply if an election to file as a new group under paragraph (d)(5)(v) of this section is made.

(x) *Time to revoke elections made before September 5, 1990.* An election by an old group to continue in existence or to file as a new group that was made (or deemed made) before September 5, 1990, may be revoked by filing an appropriate return (or returns) on or before January 3, 1991. For purposes of this paragraph (d)(5)(x), appropriate returns include separate returns filed by each member of the group or consolidated returns filed in accordance with a delayed election either under paragraph (d)(5)(iii)(B) or (vi)(B) of this section.

(xi) *Examples.* The following examples illustrate this paragraph (d)(5). In these examples, each corporation uses the calendar year as its taxable year.

Example 1. B is a section 833 organization. For several years, B has owned all of the outstanding stock of X, Y, and Z. X has owned all the outstanding stock of X_1 throughout X_1's existence and Y has owned all of the outstanding stock of Y_1 throughout Y_1's existence. For 1986 X and X_1 filed a consolidated federal income tax return but Y and Y_1 filed separate returns. Under paragraph (d)(5)(ii) of this section, X and X_1 and Y and Y_1 each constitute an old group because they either filed a consolidated return or were eligible to file a consolidated return for 1986. The X and Y groups may elect under paragraph (d)(5)(i) of this section to continue in existence. If they elect to continue, under paragraph (d)(5)(iv)(B) of this section, the separate return limitation year rules apply as follows: any taxable year of B or Z beginning before 1987 is treated as a separate return limitation year with respect to each other and to all other members of the group; any taxable year of X or X_1 beginning before 1987 is treated as a separate return limitation year with respect to B, Z, Y and Y_1, but not with respect to each other; and any taxable year of Y or Y_1 beginning before 1987 is treated as a separate return limitation year with respect to B, Z, X and X_1, but not with respect to each other.

Example 2. The facts are the same as in Example 1 except that B is owned by C, another section 833 organization. If the X and Y groups elect to continue, the results are the same as in Example 1, except that, under paragraph (d)(5)(iv)(B)(*1*) of this section, for purposes of applying the separate return limitation year rules, any taxable year of C beginning before 1987 is also treated as a separate return limitation year with respect to all other members of the group.

Example 3. The facts are the same as in Example 1 except that Y purchased Y_1 on January 1, 1985. If the X and Y groups elect to continue, the results are the same as in Example 1, except that, under paragraph (d)(5)(iv)(B)(*2*) of this section, for purposes of applying the separate return limitation year rules, any taxable year of Y_1 beginning before 1985 is treated as a separate return limitation year with respect to Y as well as with respect to all other members of the group.

Example 4. B, a section 833 organization, has owned all the stock of X since November 1984. X has owned all the stock of L, a life insurance company, throughout L's existence. In 1986, X and L properly filed a life-nonlife consolidated return. Under paragraph (d)(5)(i) of this section, the X group elects to continue in existence. Under paragraph (d)(5)(iv)(C) of this section, the life-nonlife election will remain in effect. However, losses of B which arise before 1990 cannot be used to offset the income of L. See section 1503(c)(2) and §1.1502–47(d)(13) and paragraph (d)(5)(iv)(C) of this section. Under paragraph (d)(5)(iv)(B) of this section, the separate return limitation year rules apply as follows: any taxable year of B beginning before 1987 is treated as a separate return limitation year with respect to all other members of the group; and any taxable year of X or L beginning before 1987 is treated as a separate return limitation year with respect to B, but not with respect to each other.

Example 5. The facts are the same as Example 4 except that, on January 1, 1984, B formed L_1, a life insurance company. Under paragraph (d)(5)(ix) of this section and section 1504(c), the first year L_1 is eligible to join in B's life-nonlife election is 1989.

Example 6. The facts are the same as in Example 4 except that B and the X group elect under paragraph (d)(5)(v) of this section to file as a new group. The X group will be considered to have terminated under §1.1502–75(d)(1) on December 31, 1986. X and L are each separately subject to the separate return limitation year rules of §1.1502–1(f). The first year L and L_1 are eligible to join the new group in a life-nonlife election is 1992 (five years after the new group is formed). See section 1504(c)(2) and paragraphs (d)(5)(vii)(C) and (ix) of this section.

The provisions contained in this Treasury decision are needed to immediately amend the consolidated return regulations in response to changes made by section 1012 of the Tax Reform Act of 1986. It is therefore found impracticable and contrary to the public interest to issue this Treasury decision with notice and public procedure under section 553(b) of title 5 of the United States Code or subject to the effective date limitations of section 553(d) of title 5, United States Code.

(e) *Failure to include subsidiary.* If a consolidated return is required for the taxable year under the provisions of paragraph (a)(2) of this section, the tax liability of all members of the group for such year shall be computed on a consolidated basis even though:

(1) Separate returns are filed by one or more members of the group, or

(2) There has been a failure to include in the consolidated return the income of any member of the group.

If subparagraph (1) of this paragraph applies, the amounts assessed or paid upon the basis of separate returns shall be considered as having been assessed or paid upon the basis of a consolidated return.

(f) *Inclusion of one or more corporations not members of the group*—(1) *Method of determining tax liability.* If a consolidated return includes the income of a corporation which was not a member of the group at any time during the consolidated return year, the tax liability of such corporation will be determined upon the basis of a separate return (or a consolidated return of another group, if paragraph (a)(2) or (b)(3) of this section applies), and the consolidated return will be considered as including only the income of the corporations which were members of the group during that taxable year. If a consolidated return includes the income of two or more corporations which were not members of the group but which constitute another group, the tax liability of such corporations will be computed in the same manner as if separate returns had been made by such corporations unless the Commissioner upon application approves the making of a consolidated return for the other group or unless under paragraph (a)(2) of this section a consolidated return is required for the other group.

(2) *Allocation of tax liability.* In any case in which amounts have been assessed and paid upon the basis of a consolidated return and the tax liability of one or more of the corporations included in the consolidated return is to be computed in the manner described in subparagraph (1) of this paragraph, the amounts so paid shall be allocated between the group composed of the corporations properly included in the consolidated return and each of the corporations the tax liability of which is to be computed on a separate basis (or on the basis of a consolidated return of another group) in such manner as the corporations which were included in the consolidated return may, subject to the approval of the Commissioner, agree upon or in the absence of an agreement upon the method used in allocating the tax liability of the members of the group under the provisions of section 1552(a).

(g) *Computing periods of limitation*—(1) *Income incorrectly included in consolidated return.* If:

(i) A consolidated return is filed by a group for the taxable year, and

(ii) The tax liability of a corporation whose income is included in such return must be computed on the basis of a separate return (or on the basis of a consolidated return with another group), then for the purpose of computing any period of limitation with respect to such separate return (or such other consolidated return), the filing of such consolidated return by the group shall be considered as the making of a return by such corporation.

(2) *Income incorrectly included in separate returns.* If a consolidated return is required for the taxable year under the provisions of paragraph (a)(2) of this section, the filing of separate returns by the members of the group for such year shall not be considered as the making of a return for the purpose of computing any period of limitation with respect to such consolidated return unless there is attached to each such separate return a statement setting forth:

(i) The most recent taxable year of the member for which its income was included in a consolidated return, and

(ii) The reasons for the group's belief that a consolidated return is not required for the taxable year.

(h) *Method of filing return and forms*—(1) *Consolidated return made by common parent corporation.* The consolidated return shall be made on Form 1120 for the group by the common parent corporation. The consolidated return, with Form 851 (affiliations schedule) attached, shall be filed with the district director with whom the common parent would have filed a separate return.

(2) *Filing of Form 1122 for first year.* If, under the provisions of paragraph (a)(1) of this section, a group wishes to exercise its privilege of filing a consolidated return, then a Form 1122 must be executed by each subsidiary and must be attached to the consolidated return for such year. Form 1122 shall not be required for a taxable year if a consolidated return was filed (or was required to be filed) by the group for the immediately preceding taxable year.

(3) *Persons qualified to execute returns and forms.* Each return or form required to be made or prepared by a corporation must be executed by the person authorized under section 6062 to execute returns of separate corporations.

(i) [Reserved]

(j) *Statements and schedules for subsidiaries.* The statement of gross income and deductions and the schedules required by the instructions on the return shall be prepared and filed in columnar form so that the details of the items of gross income, deductions, and credits for each member may be readily audited. Such statements and schedules shall include in columnar form a reconciliation of surplus for each corporation, and a reconciliation of consolidated surplus. Consolidated balance sheets as of the beginning and close of the taxable year of the group, taken from the books of the members, shall accompany the consolidated return and shall be prepared in a form similar to that required for reconciliation of surplus.

(k) *Cross–reference.* See §1.338(h)(10)–1(e)(6) for special rules regarding filing consolidated returns when a section 338(h)(10) election is made for a target acquired from a selling consolidated group.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 7016, 34 FR 15556, Oct. 7, 1969; T.D. 7024, 35 FR 2774, Feb. 10, 1970; T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7246, 38 FR 766, Jan. 4, 1973; T.D. 8438, 57 FR 44333, Sept. 25, 1992; T.D. 8515, 59 FR 2984, Jan. 20, 1994; T.D. 8560, 59 FR 41675, 41700, Aug. 15, 1994]

§1.1502–76 Taxable year of members of group.

(a) *Taxable year of members of group*—(1) *Change to parent's taxable year.* The consolidated return of a group must be filed on the basis of the common parent's taxable year, and each subsidiary must adopt the common parent's annual accounting period for the first consolidated return year for which the subsidiary's income is includible in the consolidated return. If any member is on a 52–53-week taxable year, the rule of the preceding sentence shall, with the advance consent of the Commissioner, be deemed satisfied if the taxable years of all members of the group end within the same 7-day period. Any request for such consent shall be filed with the Commissioner of Internal Revenue, Washington, DC 20224, not later than the 30th day before the due date (not including extensions of time) for the filing of the consolidated return.

(2) *Includible insurance company as member of group.* If an includible insurance company required by section 843 to file its return on the basis of a calendar year is a member of the group and if the common parent of such group files its return on the basis of a fiscal year, then the first consolidated return which includes the income of such insurance company may be filed on the basis of the common parent's fiscal year, provided, however, that if such insurance company is a member of the group on the last day of the common parent's taxable year, all members other than such insurance company change to a calendar year or to a 52–53-week taxable year ending within a 7-day period which includes December 31, effective immediately after the close of the common parent's taxable year. If any member changes to a 52–53-week taxable year, the advance consent of the Commissioner shall be obtained in accordance with subparagraph (1) of this paragraph.

(b) *Items included in the consolidated return*—(1) *General rules*—(i) *In general.* A consolidated return must include the common parent's items of income, gain, deduction, loss, and credit for the entire consolidated return year, and each subsidiary's items for the portion of the year for which it is a member. If the consolidated return includes the items of a corporation for only a portion of its tax year determined without taking this section into account, items for the portion of the year not included in the consolidated return must be included in a separate return (including the consolidated return of another group). The rules of this paragraph (b) must be applied to prevent the duplication or elimination of the corporation's items.

(ii) *The day a corporation becomes or ceases to be a member*—(A) *End of the day rule.* If a corporation (S) becomes or ceases to be a member during a consolidated return year, it becomes or ceases to be a member at the end of the day on which its status as a member changes, and its tax year ends for all Federal income tax purposes at the end of that day. Appropriate adjustments must be made if another provision of the Internal Revenue Code or the regulations thereunder contemplates the event occurring before or after S's change in status. For example, S's items restored under §1.1502–13 immediately before it becomes a nonmember are taken into account in determining the basis of S's stock under §1.1502–32. On the other hand, if a section 338(g) election is made in connection with S becoming a member, the deemed asset sale under that section takes place before S becomes a member. See §1.338–1(e)(5) (deemed sale excluded from purchasing corporation's consolidated return.)

(B) *Next day rule.* If, on the day of S's change in status as a member, a transaction occurs that is properly allocable to the portion of S's day after the event resulting in the change, S and all persons related to S under section 267(b) immediately after the event must treat the transaction for all Federal income tax purposes as occurring at the beginning of the following day. A determination as to whether a transaction is properly allocable to the portion of S's day after the event will be respected if it is reasonable and consistently applied by all affected persons. In determining whether an allocation is reasonable, the following factors are among those to be considered—

(*1*) Whether income, gain, deduction, loss, and credit are allocated inconsistently (e.g., to maximize a seller's stock basis adjustments under § 1.1502–32);

(*2*) If the item is from a transaction with respect to S stock, whether it reflects ownership of the stock before or after the event (e.g., if a member transfers encumbered land to nonmember S in exchange for additional S stock in a transaction to which section 351 applies and the exchange results in S becoming a member of the consolidated group, the applicability of section 357(c) to the exchange must be determined under § 1.1502–80(d) by treating the exchange as occurring after the event; on the other hand, if S is a member but has a minority shareholder and becomes a nonmember as a result of its redemption of stock with appreciated property, S's gain under section 311 is treated as from a transaction occurring before the event);

(*3*) Whether the allocation is inconsistent with other requirements under the Internal Revenue Code (e.g., if a section 338(g) election is made in connection with a group's acquisition of S, the deemed asset sale must take place before S becomes a member and S's gain or loss with respect to its assets must be taken into account by S as a nonmember); and

(*4*) Whether other facts exist, such as a prearranged transaction or multiple changes in S's status, indicating that the transaction is not properly allocable to the portion of S's day after the event resulting in S's change.

(C) *Successor corporations.* For purposes of this paragraph (b)(1)(ii), any reference to a corporation includes a reference to a successor or predecessor as the context may require. A corporation is a successor if the basis of its assets is determined, directly or indirectly, in whole or in part, by reference to the basis of the assets of another corporation (the predecessor). For example, if a member forms S, S is treated as a member from the beginning of its existence.

(iii) *Group structure changes.* If the common parent ceases to be the common parent but the group remains in existence, adjustments must be made in accordance with the principles of § 1.1502–75(d)(2) and (3).

(2) *Determination of items included in separate and consolidated returns*—(i) *In general.* The returns for the years that end and begin with S becoming (or ceasing to be) a member are separate tax years for all Federal income tax purposes. The returns are subject to the rules of the Internal Revenue Code applicable to short periods, as if S ceased to exist on becoming a member (or first existed on becoming a nonmember). For example, cost recovery deductions under section 168 must be allocated for short periods. On the other hand, annualization under section 443 is not required of S solely because it has a short year as a result of becoming a member. (Similarly, section 443 applies with respect to a consolidated return only to the extent that the group's return is for a short period and section 443 applies without taking this paragraph (b) into account.)

(ii) *Ratable allocation of a year's items*—(A) *Application.* Although the periods ending and beginning with S's change in status are different tax years, items (other than extraordinary items) may be ratably allocated between the periods if—

(*1*) S is not required to change its annual accounting period or its method of accounting as a result of its change in status (e.g., because its stock is sold between consolidated groups that have the same annual accounting periods); and

(*2*) An irrevocable ratable allocation election is made under paragraph (b)(2)(ii)(D) of this section.

(B) *General rule*—(*1*) *Allocation within original year.* Under a ratable allocation election, paragraph (b)(2) of this section applies by allocating to each day of S's original year (S's tax year determined without taking this section into account) an equal portion of S's items taken into account in the original year, except that extraordinary items must be allocated to the day that they are taken into account. All persons affected by the election must take into account S's extraordinary items and the ratable allocation of S's remaining items in a manner consistent with the election.

(*2*) *Items to be allocated.* Under ratable allocation, the items to be allocated and their timing, location, character, and source are generally determined by treating the original year as a single tax year, and the items are not subject to the rules of the Internal Revenue Code applicable to short periods (unless the original year is a short period). However, the years ending and beginning with S's change in status are treated as different tax years (and as short periods) with respect to any item carried to or from these years (e.g., a net operating loss carried under section 172) and with respect to the application of section 481.

(*3*) *Multiple applications.* If this paragraph (b) applies more than once with respect to an original year, adjustments must be made in accordance with the principles of this paragraph (b). For example, if S becomes a member of two different consolidated groups during the same original year and ratable allocation is elected with respect to both groups, ratable allocation is generally determined for both groups by treating the original year as a single tax year; however, if ratable allocation is elected only with respect to the first group, the ratable allocation is determined by treating the original year as a short period that does not include the period that S is a member of the second group. Ratable allocation is not a method of accounting, and ratable allocation with respect to one application of this paragraph (b) to S does not require ratable allocation to be subsequently applied with respect to S.

(C) *Extraordinary items.* An extraordinary item is—

(*1*) Any item from the disposition or abandonment of a capital asset as defined in section 1221 (determined without the application of any other rules of law);

(*2*) Any item from the disposition or abandonment of property used in a trade or business as defined in section 1231(b) (determined without the application of any holding period requirement);

(*3*) Any item from the disposition or abandonment of an asset described in section 1221(1), (3), (4), or (5), if substantially all the assets in the same category from the same trade or business are disposed of or abandoned in one transaction (or series of related transactions);

(*4*) Any item from assets disposed of in an applicable asset acquisition under section 1060(c);

(*5*) Any item carried to or from any portion of the original year (e.g., a net operating loss carried under section 172), and any section 481(a) adjustment;

(*6*) The effects of any change in accounting method initiated by the filing of the appropriate form after S's change in status;

(*7*) Any item from the discharge or retirement of indebtedness (e.g., cancellation of indebtedness income or a deduction for retirement at a premium);

(*8*) Any item from the settlement of a tort or similar third-party liability;

(*9*) Any compensation-related deduction in connection with S's change in status (including, for example, deductions from bonus, severance, and option cancellation payments made in connection with S's change in status);

(*10*) Any dividend income from a nonmember that S controls within the meaning of section 304 at the time the dividend is taken into account;

(*11*) Any deemed income inclusion from a foreign corporation, or any deferred tax amount on an excess distribution from a passive foreign investment company under section 1291;

(*12*) Any interest expense allocable under section 172(h) to a corporate equity reduction transaction causing this paragraph (b) to apply;

(*13*) Any credit, to the extent it arises from activities or items that are not ratably allocated (e.g., the rehabilitation credit under section 47, which is based on placement in service); and

(*14*) Any item which, in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income in any consolidated return or separate return in which the item is included.

(D) *Election.* The election to ratably allocate items under this paragraph (b)(2)(ii) must be made in a separate statement entitled ''THIS IS AN ELECTION UNDER § 1.1502–76(b)(2)(ii) TO RATABLY ALLOCATE THE YEAR'S ITEMS OF [insert name and employer identification number of the member].'' The statement must be signed by the member and by the common parent of each affected group, and must be filed with the returns including the items for the year's ending and beginning with S's change in status. If two or more members of the same consolidated group, as a consequence of the same plan or arrangement, cease to be members of that group and remain affiliated as members of another consolidated group, an election under this paragraph (b)(2)(ii)(D) may be made only if it is made by each such member. The statement must provide all of the following:

(*1*) Identify the extraordinary items, their amounts, and the separate or consolidated returns in which they are included.

(*2*) Identify the aggregate amount to be ratably allocated, and the portion of the amount included in the separate and consolidated returns.

(*3*) Include the name and employer identification number of the common parent (if any) of each group that must take the items into account.

(iii) *Ratable allocation of a month's items.* If ratable allocation under paragraph (b)(2)(ii) of this section is not elected (e.g., because S is required to change its annual accounting period), this paragraph (b)(2)(iii) may be applied to ratably allocate only S's items taken into account in the month of its change in status, but only if the allocation is consistently applied by all affected persons. The ratable allocation is made by applying the principles of paragraph (b)(2)(ii) of this section under any reasonable method. For example, S may close its books both at the end of the preceding month and at the end of the month of the change, and allocate only its items (other than extraordinary items) from the month of the change. See paragraph (b)(1)(ii)(B) of this section for factors to be considered in determining whether the method is reasonable.

(iv) *Taxes.* To the extent properly taken into account during the member's tax year (determined without the application of this paragraph (b)), Federal, state, local, and foreign taxes are allocated under paragraph (b)(2) of this section on the basis of the items or activities to which the taxes relate. Thus, income tax is allocated based on the inclusion of the income (determined under the principles of this paragraph (b)) to which the tax relates. For example, if a calendar-year domestic corporation has $100 of foreign source dividend income (determined in accordance with United States tax accounting principles but without taking this paragraph (b) into account) that is passive income for purposes of section 904, and $60 of the income is allocated under this paragraph (b) to the period of the calendar year after it becomes a member of a consolidated group, then 60% of the corporation's deemed paid foreign tax credit associated with its dividend income for the calendar year is taken into account in computing the group's passive basket consolidated foreign tax credit. Similarly, property taxes relate to the ownership of property and are allocated over the period that the property is owned. This paragraph (b)(2)(iv) applies without regard to any determination or allocation by another taxing jurisdiction.

(v) *Passthrough entities*—(A) *In general.* If S is a partner in a partnership or an owner of a similar interest with respect to which items of the entity are taken into account by S, S is treated, solely for purposes of determining the year to which the entity's items are allocated under paragraph (b)(2) of this section, as selling or exchanging its entire interest in the entity immediately before S's change in status.

(B) *Treatment as a conduit.* For purposes of this paragraph (b)(2), if a member (together with other members) would be treated under section 318(a)(2) as owning an aggregate of at least 50% of any stock owned by the passthrough entity, the method that is used to determine the inclusion of the entity's items in the consolidated or separate return must be the same method that is used to determine the inclusion of the member's items in the consolidated or separate return.

(C) *Exception for certain foreign entities.* This paragraph (b)(2)(v) does not apply to any foreign corporation generating the deemed inclusion of income, or to any passive foreign investment company generating a deferred tax amount on an excess distribution under section 1291.

(3) *Anti-avoidance rule.* If any person acts with a principal purpose contrary to the purposes of this paragraph (b), to substantially reduce the Federal income tax liability of any person, adjustments must be made as necessary to carry out the purposes of this section.

(4) *Examples.* For purposes of the examples in this paragraph (b), unless otherwise stated, P and X are common parents of calendar-year consolidated groups, P owns all of the only class of T's stock, T owns no stock of lower-tier members, all persons use the accrual method of accounting, the facts set forth the only corporate activity, all transactions are between unrelated persons, tax liabilities are disregarded, and any election required under paragraph (b)(2) of this section is properly made. The principles of this paragraph (b) are illustrated by the following examples.

Example 1. Items allocated between consolidated and separate returns. (a) *Facts.* P and S are the only members of the P group. P sells all of S's stock to individual A on June 30, and therefore S becomes a nonmember on July 1 of Year 2.

(b) *Analysis.* Under paragraph (b)(1) of this section, the P group's consolidated return for Year 2 includes P's income for the entire tax year and S's income for the period from January 1 to June 30, and S must file a separate return for the period from July 1 to December 31.

(c) *Acquisition of another subsidiary before end of tax year.* The facts are the same as in paragraph (a) of this *Example 1,* except that on July 31 P acquires all the stock of T (which filed a separate return for its year ending on November 30 of Year 1) and T therefore becomes a member on August 1 of Year 2. Under §1.1502–75(d) and paragraph (b)(1) of this section, the P group's consolidated return for Year 2 includes P's income for the entire year, S's income from January 1 to June 30, and T's income from August 1 to December 31. S must file a separate return that includes its income from July 1 to December 31, and T must file a separate return that includes its income from December 1 of Year 1 to July 31 of Year 2. (If P had acquired T after December 31, the P group that included S is a different group from the P group that includes T, and, for example, the P group that includes T must make a separate election under section 1501 and §1.1502–75 if consolidated returns are to be filed.)

Example 2. Group structure change. (a) *Facts.* P owns all of the stock of S and T. Shortly after the beginning of Year 1, P merges into T in a reorganization described in section 368(a)(1)(A) (and in section 368(a)(1)(D)), and P's shareholders receive T's stock in exchange for all of P's stock. The P group is treated under §1.1502–75(d)(2)(ii) as remaining in existence with T as its common parent.

(b) *Analysis.* Under paragraph (b)(1) of this section, the P group's return must include the common parent's items for the entire consolidated return year and, if the common parent ceases to be the common parent but the group remains in existence, appropriate adjustments must be made. Consequently, although P did not exist for all of Year 1, P's items for the portion of Year 1 ending with the merger are treated as the items of the common parent that must be included in the P group's return for Year 1.

(c) *Reverse acquisition.* Assume instead that X acquires all of P's assets in exchange for more than 50% of X's stock in a reorganization described in section 368(a)(1)(D). The reorganization constitutes a reverse acquisition under §1.1502–75(d)(3), with the X group terminating and the P group surviving with X as its common parent. Consequently, P's items for the portion of Year 1 ending with the acquisition are treated as the items of the common parent that must be included in the P group's return for Year 1, and X's items are treated for purposes of paragraph (b)(1) of this section as the items of a subsidiary included in the P group's return for the portion of Year 1 for which X is a member.

Example 3. Ratable allocation. (a) *Facts.* P sells all of T's stock to X, and T becomes a nonmember on July 1 of Year 1. T engages in the production and sale of merchandise throughout Year 1 and is required to use inventories. The sale is treated as causing T's tax year to end on June 30, and the periods beginning and ending with the sale are treated as two tax years for Federal income tax purposes.

(b) *Analysis.* If ratable allocation under paragraph (b)(2)(ii) of this section is not elected, T must perform an inventory valuation as of the acquisition and also as of the end of Year 1. If ratable allocation is elected, T must perform an inventory valuation only as of the close of Year 1, and T's income from inventory is ratably allocated, along with T's other items that are not extraordinary items, between the P and X consolidated returns.

(c) *Merger into nonmember.* Assume instead that T merges into a wholly owned subsidiary of X in a reorganization described in section 368(a)(2)(D), and P receives 10% of X's stock in exchange for all of T's stock. Under paragraph (b)(2)(ii)(B) of this section, because T's tax year ends on June 30 under section 381(b)(1), T's original year determined without taking paragraph (b) of this section into account also ends on June 30. Consequently, a ratable allocation under paragraph (b)(2)(ii) of this section is the same as an allocation based on closing the books.

Example 4. Net operating loss. P sells all of T's stock to X, T becomes a nonmember on June 30 of Year 1, and ratable allocation under paragraph (b)(2)(ii) of this section is elected. Under ratable allocation, the X group has a $100 consolidated net operating loss for Year 1, all of which is attributable to T. However, because of extraordinary items, T has $100 of income for the portion of Year 1 that T is a member of the P group. Under paragraph (b)(2)(ii)(B)(*2*) of this section, T's loss may be carried back from the X group to the portion of Year 1 that T was a member of the P group. See also section 172 and § 1.1502–21(b). Under paragraph (b)(2)(ii)(C)(*5*) of this section, any item carried to or from any portion of the original year is an extraordinary item, and the loss therefore is not taken into account again in determining the ratable allocation under paragraph (b)(2)(ii) of this section.

Example 5. Employee benefit plans. (a) *Facts.* P sells all of T's stock to X, and T becomes a nonmember on June 30 of Year 1. On March 15 of Year 2, T contributes $100 to its retirement plan, which is a qualified plan under section 401(a). T is not required to make quarterly contributions to the plan for Year 1 under section 412(m). The contribution is made on account of T's taxable period beginning on July 1 of Year 1, and is deemed in accordance with section 404(a)(6) to have been made on the last day of T's taxable period beginning on July 1 of Year 1. Ratable allocation under paragraph (b)(2)(ii) of this section is not elected.

(b) *Analysis.* Under paragraph (b) of this section, the sale is treated as causing T's tax year to end on June 30, and the period beginning on July 1 is treated as a separate annual accounting period for all Federal income tax purposes. T's income from January 1 to June 30 is included in the P group's Year 1 return, and T's income from July 1 to December 31 is included in the X group's Year 1 return. Thus, the $100 contribution is deductible by T for the period of Year 1 that it is a member of the X group, subject to the applicable limitations of section 404, if a contribution on the last day of that period would otherwise be deductible.

(c) The facts are the same as in paragraph (a) of this *Example 5,* except that, in accordance with section 404(a)(6), $40 of the $100 contribution is made on account of T's taxable period beginning on January 1 of Year 1 and is deemed to be made on the last day of T's taxable period beginning on January 1 of Year 1. The remaining $60 is made on account of T's taxable period beginning on July 1 of Year 1 and is deemed to be made on the last day of T's taxable period beginning on July 1 of Year 1. As in paragraph (b) of this *Example 5,* under paragraph (b) of this section, the sale is treated as causing T's tax year to end on June 30, and the period beginning on July 1 is treated as a separate annual accounting period for all Federal income tax purposes. The $40 portion of the contribution is deductible by T for the period of Year 1 that it is a member of the P group, subject to the applicable limitations of section 404 and provided that a $40 contribution on the last day of that period would otherwise be deductible for that period, and the $60 portion is deductible by T for the period of Year 1 that it is a member of the X group, subject to the same conditions.

(d) *Ratable allocation.* The facts are the same as in paragraph (a) of this *Example 5,* except that P, T, and X elect ratable allocation under paragraph (b)(2)(ii) of this section and T's deduction for the retirement plan contribution is not an extraordinary item. T's deduction may be ratably allocated, subject to the applicable limitations of section 404, and is allowable only if a contribution on the last day of Year 1 otherwise would be deductible for any period in the year. (The results would be the same if S were an unaffiliated corporation when acquired by X, and the due date of its last separate return (including extensions) were before the pension contribution was made on March 15 of Year 2.)

Example 6. Allocation of partnership items. (a) *Facts.* P sells all of T's stock to X, and T becomes a nonmember on June 30 of Year 1. T has a 10% interest in the capital and profits of a calendar-year partnership.

(b) *Analysis.* Under paragraph (b)(2)(v)(A) of this section, T is treated, solely for purposes of determining T's tax year in which the partnership's items are included, as selling or exchanging its entire interest in the partnership as of P's sale of T's stock. Thus, the deemed disposition is not taken into account under section 708, it does not result in gain or loss being recognized by T, and T's holding period is unaffected. However, under section 706(a), in determining T's income, T is required to include its distributive share of partnership items for the partnership's year ending within or with T's tax year. Under section 706(c)(2), the partnership's tax year is treated as closing with respect to T for this purpose as of P's sale of T's stock. The allocation of T's distributive share of partnership items must be made under §1.706–1(c)(2)(ii).

(c) *Controlled partnership.* The facts are the same as in paragraph (a) of this *Example 6,* except that T has a 75% interest in the capital and profits of the partnership. Under paragraph (b)(2)(v)(B) of this section, T's distributive share of the partnership's items is treated as T's items for purposes of paragraph (b)(2) of this section. Thus, if ratable allocation under paragraph (b)(2)(ii) of this section is not elected, T's distributive share of the partnership's items must be determined under §1.706–1(c)(2)(ii) by an interim closing of the partnership's books. Similarly, if ratable allocation is elected for T's items that are not extraordinary items, T's distributive share of the partnership's non-extraordinary items must also be ratably allocated under §1.706–1(c)(2)(ii).

(5) *Effective date*—(i) *General rule.* This paragraph (b) applies to corporations becoming or ceasing to be members of consolidated groups on or after January 1, 1995.

(ii) *Prior law.* For prior transactions, see prior regulations under section 1502 as in effect with respect to the transaction. See, e.g., §1.1502–76(b) and (d) as contained in the 26 CFR part 1 edition revised as of April 1, 1994. However, §1.1502–76(b)(5) and (6) as contained in the 26 CFR part 1 edition revised as of April 1, 1994 do not apply with respect to corporations becoming or ceasing to be members of consolidated groups on or after January 1, 1995. If both this paragraph (b) and prior law may apply to determine the inclusion of any amount in a return, appropriate adjustments must be made to prevent the omission or duplication of the amount.

(c) *Time for making separate returns for periods not included in consolidated return*—(1) *Consolidated return filed by due date for separate return.* If the group has filed a consolidated return on or before the due date for the filing of a subsidiary's separate return (including extensions of time and determined without regard to any change of its taxable year required under paragraph (a) of this section), then the separate return for any portion of the subsidiary's taxable year for which its income is not included in the consolidated return of the group must be filed no later than the due date of such consolidated return (including extensions of time).

(2) *Consolidated return not filed by due date for separate return.* If the group has not filed a consolidated return on or before the due date for the filing of a subsidiary corporation's separate return (including extensions of time and determined without regard to any change of its taxable year required under paragraph (a) of this section), then on or before such due date such subsidiary shall file a separate return either for the portion of its taxable year for which its income would not be included in a consolidated return if such a return were filed, or for its complete taxable year. However, if a separate return is filed for such portion of its taxable year and the group subsequently does not file a consolidated return, such subsidiary corporation shall file a substituted return for its complete taxable year not later than the due date (including extensions of time) prescribed for the filing of the common parent's return. On the other hand, if the return is filed for the subsidiary's complete taxable year and the group later files a consolidated return, such subsidiary must file an amended return not later than the due date (including extensions of time) for the filing of the consolidated return of the group. Such amended return shall be for that portion of such subsidiary's taxable year which is not included in the consolidated return. If, under this subparagraph, a substituted return must be filed, then the return previously filed shall not be considered a return within the meaning of section 6011. If, under this subparagraph, a substituted or amended return must be filed, then, for purposes of sections 6513(a) and 6601(a), the last date prescribed for payment of tax shall be the due date (not including extensions of time) for the filing of the subsidiary's separate return (determined without regard to this subparagraph and without regard to any change of its taxable year required under paragraph (a) of this section).

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). Corporation P, which filed a separate return for the calendar year 1966, acquires all of the stock of corporation S as of the close of December 31, 1966. Corporation S reports its income on the basis of a fiscal year ending March 31. On June 15, 1967, the due date for the filing of a separate return by S (assuming no extensions of time), a consolidated return has not been filed for the group (P and S). On such date S may either file a return for the period April 1, 1966, through December 31, 1966, or it may file a return for the complete fiscal year ending March 31, 1967. If S files a return for the short period ending December 31, 1966, and if the group elects not to file a consolidated return for the calendar year 1967, S, on or before March 15, 1968 (the due date of P's return, assuming no extensions of time), must file a substituted return for the complete fiscal year ending March 31, 1967, in lieu of the return previously filed for the short period. Interest is computed from June 15, 1967. If, however, S files a return for the complete fiscal year ending March 31, 1967, and the group elects to file a consolidated return for the calendar year 1967, then S must file an amended return covering the period from April 1, 1966, through December 31, 1966, in lieu of the return previously filed for the complete fiscal year. Interest is computed from June 15, 1967.

Example (2). Assume the same facts as in example (1) except that corporation P acquires all of the stock of corporation S at the close of September 30, 1967, and that P files a consolidated return for the group for 1967 on March 15, 1968 (not having obtained any extensions of time). Since a consolidated return has been filed on or before the due date (June 15, 1968) for the filing of the separate return for the taxable year ending March 31, 1968, the return of S for the short taxable year beginning April 1, 1967, and ending September 30, 1967, should be filed no later than March 15, 1968.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7246, 38 FR 766, Jan. 4, 1973; T.D. 8560, 59 FR 41700, Aug. 15, 1994; T.D. 8560, 62 FR 12098, Mar. 14, 1997]

§ 1.1502–77 Common parent agent for subsidiaries.

(a) *Scope of agency of common parent corporation.* The common parent, for all purposes (other than the making of the consent required by paragraph (a)(1) of § 1.1502–75, the making of an election under section 936(e), the making of an election to be treated as a DISC under § 1.992–2, and a change of the annual accounting period pursuant to paragraph (b)(3)(ii) of § 1.991–1) shall be the sole agent for each subsidiary in the group, duly authorized to act in its own name in all matters relating to the tax liability for the consolidated return year. Except as provided in the preceding sentence, no subsidiary shall have authority to act for or to represent itself in any such matter. For example, any election available to a subsidiary corporation in the computation of its seperate taxable income must be made by the common parent, as must any change in an election previously made by the subsidiary corporation; all correspondence will be carried on directly with the common parent; the common parent shall file for all extensions of time including extensions of time for payment of tax under section 6164; notices of deficiencies will be mailed only to the common parent, and the mailing to the common parent shall be considered as a mailing to each subsidiary in the group; notice and demand for payment of taxes will be given only to the common parent and such notice and demand will be considered as a notice and demand to each subsidiary; the common parent will file petitions and conduct proceedings before the Tax Court of the United States, and any such petition shall be considered as also having been filed by each such subsidiary. The common parent will file claims for refund or credit, and any refund will be made directly to and in the name of the common parent and will discharge any liability of the Government in respect thereof to any such subsidiary; and the common parent in its name will give waivers, give bonds, and execute closing agreements, offers in compromise, and all other documents, and any waiver or bond so given, or agreement, offer in compromise, or any other document so executed, shall be considered as having also been given or executed by each such subsidiary. Notwithstanding the provisions of this paragraph, any notice of deficiency, in respect of the tax for a consolidated return year, will name each corporation which was a member of the group during any part of such period (but a failure to include the name of any such member will not affect the validity of the notice of deficiency as to the other members); any notice and demand for payment will name each corporation which was a member of the group during any part of such period (but a failure to include the name of any such member will not affect the validity of the notice and demand as to the other members); and any levy, any notice of a lien, or any other proceeding to collect the amount of any assessment, after the assessment has been made, will name the corporation from which such collection is to be made. The provisions of this paragraph shall apply whether or not a consolidated return is made for any subsequent year, and whether or not one or more subsidiaries have become or have ceased to be members of the group at any time. Notwithstanding the provisions of this paragraph, the district director may, upon notifying the common parent, deal directly with any member of the group in respect of its liability, in which event such member shall have full authority to act for itself.

(b) *Notification of deficiency to corporation which has ceased to be a member of the group.* If a subsidiary has ceased to be a member of the group and if such subsidiary files written notice of such cessation with the district director with whom the consolidated return is filed, then such district director upon request of such subsidiary will furnish it with a copy of any notice of deficiency in respect of the tax for a consolidated return year for which it was a member and a copy of any notice and demand for payment of such deficiency. The filing of such written notification and request by a corporation shall not have the effect of limiting the scope of the agency of the common parent provided for in paragraph (a) of this section and a failure by such district director to comply with such written request shall not have the effect of limiting the tax liability of such corporation provided for in §1.1502–6.

(c) *Effect of waiver given by common parent.* Unless the district director agrees to the contrary, an agreement entered into by the common parent extending the time within which an assessment may be made or levy or proceeding in court begun in respect of the tax for a consolidated return year shall be applicable:

(1) To each corporation which was a member of the group during any part of such taxable year, and

(2) To each corporation the income of which was included in the consolidated return for such taxable year, notwithstanding that the tax liability of any such corporation is subsequently computed on the basis of a separate return under the provisions of §1.1502–75.

(d) *Effect of dissolution of common parent corporation.* If the common parent corporation contemplates dissolution, or is about to be dissolved, or if for any other reason its existence is about to terminate, it shall forthwith notify the district director with whom the consolidated return is filed of such fact and designate, subject to the approval of such district director, another member to act as agent in its place to the same extent and subject to the same conditions and limitations as are applicable to the common parent. If the notice thus required is not given by the common parent, or the designation is not approved by the district director, the remaining members may, subject to the approval of such district director, designate another member to act as such agent, and notice of such designation shall be given to such district director. Until a notice in writing designating a new agent has been approved by such district director, any notice of deficiency or other communication mailed to the common parent shall be considered as having been properly mailed to the agent of the group; or, if such district director has reason to believe that the existence of the common parent has terminated, he may, if he deems it advisable, deal directly with any member in respect of its liability.

(e) *Cross-references*—(1) *Alternative agents.* For rules relating to alternative agents of the group, see §1.1502–77.

(2) *Groups that include insolvent financial institutions.* For further rules applicable to groups that include insolvent financial institutions, see §301.6402–7 of this chapter.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 7323, 39 FR 34409, Sept. 25, 1974; T.D. 7673, 45 FR 8588, Feb. 8, 1980; T.D. 8226, 53 FR 34733, Sept. 8, 1988; T.D. 8446, 57 FR 53034, Nov. 6, 1992]

§ 1.1502–77T Alternative agents of the group (temporary).

(a) *General rules*—(1) *Scope.* This section applies if the corporation that is the common parent of the group ceases to be the common parent, whether or not the group remains in existence under § 1.1502–75(d).

(2) *Notice of deficiency.* A notice of deficiency mailed to any one or more corporations referred to in paragraph (a)(4) of this section is deemed for purposes of § 1.1502–77 to be mailed to the agent of the group. If the group has designated an agent that has been approved by the district director under § 1.1502–77(d), a notice of deficiency shall be mailed to that designated agent in addition to any other corporation referred to in paragraph (a)(4) of this section. However, failure by the district director to mail a notice of deficiency to that designated agent shall not invalidate the notice of deficiency mailed to any other corporation referred to in paragraph (a)(4) of this section.

(3) *Waiver of statute of limitations.* A waiver of the statute of limitations with respect to the group given by any one or more corporations referred to in paragraph (a)(4) of this section is deemed to be given by the agent of the group.

(4) *Alternative agents.* The corporations referred to in paragraph (a) (2) and (3) of this section are—

(i) The common parent of the group for all or any part of the year to which the notice or waiver applies,

(ii) A successor to the former common parent in a transaction to which section 381(a) applies,

(iii) The agent designated by the group under § 1.1502–77(d), or

(iv) If the group remains in existence under § 1.1502–75(d) (2) or (3), the common parent of the group at the time the notice is mailed or the waiver given.

(b) *Effective date.* Paragraph (a) of this section applies to statutory notices and waivers of the statute of limitations for taxable years for which the due date (without extensions) of the consolidated return is after September 7, 1988.

[T.D. 8226, 53 FR 34733, Sept. 8, 1988]

§ 1.1502–78 Tentative carryback adjustments.

(a) *General rule.* If a group has a consolidated net operating loss, a consolidated net capital loss, or a consolidated unused investment credit for any taxable year, then any application under section 6411 for a tentative carryback adjustment of the taxes for a consolidated return year or years preceding such year shall be made by the common parent corporation to the extent such loss or unused investment credit is not apportioned to a corporation for a separate return year pursuant to §§ 1.1502–21T(b), 1.1502–22T(b), or 1.1502–79(c) (or §§ 1.1502–79A(a), 1.1502–79A(b), or 1.1502–79(c), as appropriate. In the case of the portion of a consolidated net operating loss or consolidated net capital loss or consolidated unused investment credit to which the preceding sentence does not apply, and in the case of a net capital or net operating loss or unused investment credit arising in a separate return year which may be carried back to a consolidated return year, the corporation or corporations to which any such loss or credit is attributable shall make any application under section 6411.

(b) *Special rules*—(1) *Payment of refund.* Any refund allowable under an application referred to in paragraph (a) of this section shall be made directly to and in the name of the corporation filing the application, except that in all cases where a loss is deducted from the consolidated taxable income or a credit is allowed in computing the consolidated tax liability for a consolidated return year, any refund shall be made directly to and in the name of the common parent corporation. The payment of any such refund shall discharge any liability of the Government with respect to such refund.

(2) *Several liability.* If a group filed a consolidated return for a taxable year for which there was an adjustment by reason of an application under section 6411, and if a deficiency is assessed against such group under section 6213(b)(2), then each member of such group shall be severally liable for such deficiency including any interest or penalty assessed in connection with such deficiency.

(3) *Groups that include insolvent financial institutions.* For further rules applicable to groups that include insolvent financial institutions, see §301.6402–7 of this chapter.

(c) *Examples.* The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). Corporations P, S, and S–1 filed a consolidated return for the calendar year 1966. P, S, and S–1 also filed a consolidated return for the calendar year 1969. The group incurred a consolidated net operating loss in 1969 attributable to S–1 which may be carried back to 1966 as a consolidated net operating loss carryback. If a tentative carryback adjustment is desired, P, the common parent, must file an application under section 6411 and any refund will be made to P.

Example (2). Assume the same facts as in example (1) except that P, S, and S–1 filed separate returns for the calendar year 1969, even though they were members of the same group for such year. S–1 incurred a net operating loss in 1969 which may be carried back to 1966. If a tentative carryback adjustment is desired, S–1 must file an application under section 6411 and any refund from such application will be made to P.

Example (3). Corporations X, Y, and Z filed a consolidated return for the calendar year 1966. Z ceased to be a member of the group in 1967. Z filed a separate return for 1968 while X and Y filed a consolidated return for such year. The group incurred a consolidated net operating loss in 1968 attributable to Y, which may be carried back to 1966. Z also incurred a net operating loss for 1968 which may be carried back to 1966. If a tentative carryback adjustment is claimed with respect to the consolidated net operating loss, X, the common parent, must file an application under section 6411. If a tentative carryback adjustment is desired with respect to Z's loss, Z must file an application. Any refunds attributable to either application will be made to X. If an assessment is made under section 6213(b)(2) to recover an excessive tentative allowance made with respect to calendar year 1966, X, Y, and Z are severally liable for such assessment.

Example (4). Corporations L and M filed a consolidated return for the calendar year 1966. Corporation N filed a separate return for such year. Later, N became a member of the group and filed a consolidated return with the group for the calendar year 1968. The group incurred a consolidated net operating loss in 1968 attributable to N which may be carried back to N's separate return for 1966. If a tentative carryback adjustment is desired, N must file an application under section 6411 and any refund will be made directly to N.

(d) *Adjustments of overpayments of estimated income tax.* If a group paid its estimated income tax on a consolidated basis, then any application under section 6425 for an adjustment of overpayment of estimated income tax shall be made by the common parent corporation. If the members of a group paid estimated income taxes on a separate basis, then any application under section 6425 shall be made by the member of the group which claims an overpayment on a separate basis. Any refund allowable under an application under section 6425 shall be made directly to and in the name of the corporation filing the application.

[T.D. 6894, 31 FR 11794, Sept. 3, 1966, as amended by T.D. 7059, 35 FR 14546, Sept. 17, 1970; T.D. 7246, 38 FR 767, Jan. 4, 1973; T.D. 8387, 56 FR 67489, Dec. 31, 1991; T.D. 8446, 57 FR 53034, Nov. 6, 1992; T.D. 8677, 61 FR 33324, June 27, 1996]

§1.1502–79 Separate return years.

(a) *Carryover and carryback of consolidated net operating losses to separate return years.* For losses arising in consolidated return years beginning before January 1, 1997, see §1.1502–79A(a). For later years, see §1.1502–21T(b).

(b) *Carryover and carryback of consolidated net capital loss to separate return years.* For losses arising in consolidated return years beginning before January 1, 1997, see §1.1502–79A(b). For later years, see §1.1502–22T(b).

(c) *Carryover and carryback of consolidated unused investment credit to separate return years*—(1) *In general.* If a consolidated unused investment credit can be carried under the principles of section 46(b) and paragraph (b) of §1.1502–3 to a separate return year of a corporation (or could have been so carried if such corporation were in existence) which was a member of the group in the year in which such unused credit arose, then the portion of such consolidated unused credit attributable to such corporation (as determined under subparagraph (2) of this paragraph) shall be apportioned to such corporation (and any successor to such corporation in a transaction to which section 381(a) applies) under the principles of §1.1502–21T(b) (or §§1.1502–79A(a)(1) and (2), as appropriate) and shall be an investment credit carryover or carryback to such separate return year.

(2) *Portion of consolidated unused investment credit attributable to a member*—(i) *Investment credit carryback.* In the case of a consolidated unused credit which is an investment credit carryback, the portion of such consolidated unused credit attributable to a member of the group is an amount equal to such consolidated unused credit multiplied by a fraction, the numerator of which is the credit earned of such member for the consolidated unused credit year, and the denominator of which is the consolidated credit earned for such unused credit year.

(ii) *Investment credit carryover.* In the case of a consolidated unused credit which is an investment credit carryover, the portion of such consolidated unused credit attributable to a member of the group is an amount equal to such consolidated unused credit multiplied by a fraction, the numerator of which is the credit earned with respect to any section 38 property placed in service in the consolidated unused credit year and owned by such member (whether or not placed in service by such member) at the close of the last day as of which the taxable income of such member is included in a consolidated return filed by the group, and the denominator of which is the consolidated credit earned for such unused credit year.

(d) *Carryover and carryback of consolidated unused foreign tax*—(1) *In general.* If a consolidated unused foreign tax can be carried under the principles of section 904(d) and paragraph (e) of § 1.1502–4 to a separate return year of a corporation (or could have been so carried if such corporation were in existence) which was a member of the group in the year in which such unused foreign tax arose, then the portion of such consolidated unused foreign tax attributable to such corporation (as determined under subparagraph (2) of this paragraph) shall be apportioned to such corporation (and any successor to such corporation in a transaction to which section 381(a) applies) under the principles of § 1.1502–21T(b) (or §§ 1.1502–79A(a)(1) and (2), as appropriate) and shall be deemed paid or accrued in such separate return year to the extent provided in section 904(d).

(2) *Portion of consolidated unused foreign tax attributable to a member.* The portion of a consolidated unused foreign tax for any year attributable to a member of a group is an amount equal to such consolidated unused foreign tax multipled by a fraction, the numerator of which is the foreign taxes paid or accrued for such year (including those taxes deemed paid or accrued, other than by reason of section 904(d)) to each foreign country or possession (or to all foreign countries or possessions if the overall limitation is effective) by such member, and the denominator of which is the aggregate of all such taxes paid or accrued for such year (including those taxes deemed paid or accrued, other than by reason of section 904(d)) to each such foreign country or possession (or to all foreign countries or possessions if the overall limitation is effective) by all the members of the group.

(e) *Carryover of consolidated excess charitable contributions to separate return years*—(1) *In general.* If the consolidated excess charitable contributions for any taxable year can be carried under the principles of section 170(b)(2) and paragraph (b) of § 1.1502–24 to a separate return year of a corporation (or could have been so carried if such corporation were in existence) which was a member of the group in the year in which such excess contributions arose, then the portion of such consolidated excess charitable contributions attributable to such corporation (as determined under subparagraph (2) of this paragraph) shall be apportioned to such corporation (and any successor to such corporation in a transaction to which section 381(a) applies) under the principles of § 1.1502–21T(b) (or §§ 1.1502–79A(a)(1) and (2), as appropriate) and shall be a charitable contribution carryover to such separate return year.

(2) *Portion of consolidated excess charitable contributions attributable to a member.* The portion of the consolidated excess charitable contributions attributable to a member of a group is an amount equal to such consolidated excess contributions multiplied by a fraction, the numerator of which is the

charitable contributions paid by such member for the taxable year, and the denominator of which is the aggregate of all such charitable contributions paid for such year by all the members of the group.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 8294, 55 FR 9438, Mar. 14, 1990; T.D. 8319, 55 FR 49038, Nov. 26, 1990; T.D. 8364, 56 FR 47402, Sept. 19, 1991; T.D. 8597, 60 FR 36710, July 18, 1995; T.D. 8677, 61 FR 33324, 33325, 33334, June 27, 1996]

§1.1502–80 Applicability of other provisions of law.

(a) *In general.* The Internal Revenue Code, or other law, shall be applicable to the group to the extent the regulations do not exclude its application. Thus, for example, in a transaction to which section 381(a) applies, the acquiring corporation will succeed to the tax attributes described in section 381(c). Furthermore, sections 269 and 482 apply for any consolidated year. Section 304 applies except as provided in paragraph (b) of this section.

(b) *Non-applicability of section 304.* Section 304 does not apply to any acquisition of stock of a corporation in an intercompany transaction or to any intercompany item from such transaction occurring on or after July 24, 1991.

(c) *Deferral of section 165.* For consolidated return years beginning on or after January 1, 1995, stock of a member is not treated as worthless under section 165 before the stock is treated as disposed of under the principles of §1.1502–19(c)(1)(iii). See §§1.1502–11(c) and 1.1502–20 for additional rules relating to stock loss.

(d) *Non-applicability of section 357(c)*—(1) *In general.* Section 357(c) does not apply to any transaction to which §1.1502–13, §1.1502–13T, §1.1502–14, or §1.1502–14T applies, if it occurs in a consolidated return year beginning on or after January 1, 1995. For example, P, S, and T are members of a consolidated group, P owns all of the stock of S and T with bases of $30 and $20, respectively, S has a $30 basis in its assets and $40 of liabilities, and S merges into T in a transaction described in section 368(a)(1)(A) (and in section 368(a)(1)(D)); section 357(c) does not apply to the merger, P's basis in T's stock increases to $50 ($30 plus $20), and T succeeds to S's $30 basis in the assets transferred subject to the $40 liability. Similarly, if S instead transferred its assets and liabilities to a newly formed subsidiary in a transaction to which section 351 applies, section 357(c) does not apply and S's basis in the subsidiary's stock is a $10 excess loss account. This paragraph (d) does not apply to a transaction if the transferor or transferee becomes a nonmember as part of the same plan or arrangement. The transferor (or transferee) is treated as becoming a nonmember once it is no longer a member of a consolidated group that includes the transferee (or transferor). For purposes of this paragraph (d), any reference to a transferor or transferee includes, as the context may require, a reference to a successor or predecessor.

(2) *Prior period transactions.* If, in a tax year beginning before January 1, 1995, a member's stock with an excess loss account is transferred in a transaction to which §1.1502–13, §1.1502–13T, §1.1502–14, or §1.1502–14T applies, paragraph (d)(1) of this section applies to the stock transfer to the extent that the income, gain, deduction, or loss (if any) is not taken into account in a tax year beginning before January 1, 1995. For example, if P, S, and T, are members of a consolidated group, T's stock has an excess loss account, and P transfers the T stock to S in 1993 in a transaction to which section 351 and §1.1502–13 apply, section 357(c) applies to the transfer only to the extent P's gain is taken into account in tax years beginning before January 1, 1995.

(e) *Non-applicability of section 163(e)(5).* Section 163(e)(5) does not apply to any intercompany obligation (within the meaning of §1.1502–13(g)) issued in a consolidated return year beginning on or after July 12, 1995.

(f) *Non-applicability of section 1031.* Section 1031 does not apply to any intercompany transaction occurring in consolidated return years beginning on or after July 12, 1995.

[T.D. 8402, 57 FR 9385, Mar. 18, 1992, as amended by T.D. 8560, 59 FR 41703, Aug. 15, 1994; T.D. 8597, 60 FR 36710, July 18, 1995; T.D. 8677, 61 FR 33325, June 27, 1996; T.D. 8597, 62 FR 12098, Mar. 14, 1997]

§ 1.1502–81T Alaska Native Corporations.

(a) *General Rule.* The application of section 60(b)(5) of the Tax Reform Act of 1984 and section 1804(e)(4) of the Tax Reform Act of 1986 (relating to Native Corporations established under the Alaska Native Claims Settlement Act (43 U.S.C. 1601 *et seq.*)) is limited to the use on a consolidated return of losses and credits of a Native Corporation, and of a corporation all of whose stock is owned directly by a Native Corporation, during any taxable year (beginning after the effective date of such sections and before 1992), or any part thereof, against the income and tax liability of a corporation affiliated with the Native Corporation. Thus, no other tax saving, tax benefit, or tax loss is intended to result from the application of section 60(b)(5) of the Tax Reform Act of 1984 and section 1804(e)(4) of the Tax Reform Act of 1986 to any person (whether or not such person is a member of an affiliated group of which a Native Corporation is the common parent). In particular, except as approved by the Secretary, no positive adjustment under § 1.1502–32(b) will be made with respect to the basis of stock of a corporation that is affiliated with a Native Corporation through application of section 60(b)(5) of the Tax Reform Act of 1984 and section 1804(e)(4) of the Tax Reform Act of 1986.

(b) *Effective Dates.* This section applies to taxable years beginning after December 31, 1984.

[T.D. 8130, 52 FR 8448, Mar. 18, 1987, as amended by T.D. 8560, 59 FR 41675, Aug. 15, 1994]

§ 1.1502–90T Table of contents (temporary).

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(4) Principal purpose of avoiding a limitation.
(5) Special rules.
(6) Examples.
(e) Pre-change consolidated attribute.
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[T.D. 8678, 61 FR 33336, June 27, 1996]

§1.1502–91T Application of section 382 with respect to a consolidated group (temporary).

(a) *Determination and effect of an ownership change*—(1) *In general.* This section and §§1.1502–92T and 1.1502–93T set forth the rules for determining an ownership change under section 382 for members of consolidated groups and the section 382 limitations with respect to attributes described in paragraphs (e) and (f) of this section. These rules generally provide that an ownership change and the section 382 limitation are determined with respect to these attributes for the group (or loss subgroup) on a single entity basis and not for its members separately. Following an ownership change of a loss group (or a loss subgroup) under § 1.1502–92T, the amount of consolidated taxable income for any post-change year which may be offset by pre-change consolidated attributes (or pre-change subgroup attributes) shall not exceed the consolidated section 382 limitation (or subgroup section 382 limitation) for such year as determined under § 1.1502–93T.

(2) *Special rule for post-change year that includes the change date.* If the post-change year includes the change date, section 382(b)(3)(A) is applied so that the consolidated section 382 limitation (or subgroup section 382 limitation) does not apply to the portion of consolidated taxable income that is allocable to the period in the year on or before the change date. See generally § 1.382–6 (relating to the allocation of income and loss). The allocation of consolidated taxable income for the post-change year that includes the change date must be made before taking into account any consolidated net operating loss deduction (as defined in § 1.1502–21T(a)).

(3) *Cross reference.* See §§ 1.1502–94T and 1.1502–95T for rules that apply section 382 to a corporation that becomes or ceases to be a member of a group or loss subgroup.

(b) *Definitions and nomenclature.* For purposes of this section and §§ 1.1502–92T through 1.1502–99T, unless otherwise stated:

(1) The definitions and nomenclature contained in section 382 and the regulations thereunder (including the nomenclature and assumptions relating to the examples in § 1.382–2T(b)) and this section and §§ 1.1502–92T through 1.1502–99T apply; and

(2) In all examples, all groups file consolidated returns, all corporations file their income tax returns on a calendar year basis, the only 5-percent shareholder of a corporation is a public group, the facts set forth the only owner shifts during the testing period, and each asset of a corporation has a value equal to its adjusted basis.

(c) *Loss group*—(1) *Defined.* A loss group is a consolidated group that:

(i) Is entitled to use a net operating loss carryover to the taxable year that did not arise (and is not treated under § 1.1502–21T(c) as arising) in a SRLY;

(ii) Has a consolidated net operating loss for the taxable year in which a testing date of the common parent occurs (determined by treating the common parent as a loss corporation); or

(iii) Has a net unrealized built-in loss (determined under paragraph (g) of this section by treating the date on which the determination is made as though it were a change date).

(2) *Coordination with rule that ends separate tracking.* A consolidated group may be a loss group because a member's losses that arose in (or are treated as arising in) a SRLY are treated as described in paragraph (c)(1)(i) of this section. See § 1.1502–96T(a).

(3) *Example.* The following example illustrates the principles of this paragraph (c).

Example. Loss group. (a) L and L1 file separate returns and each has a net operating loss carryover arising in Year 1 that is carried over to Year 2. A owns 40 shares and L owns 60 shares of the 100 outstanding shares of L1 stock. At the close of Year 1, L buys the 40 shares of L1 stock from A. For Year 2, L and L1 file a consolidated return. The following is a graphic illustration of these facts:

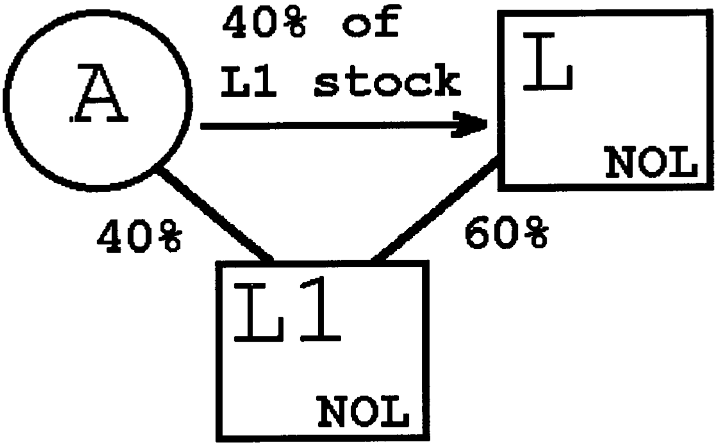

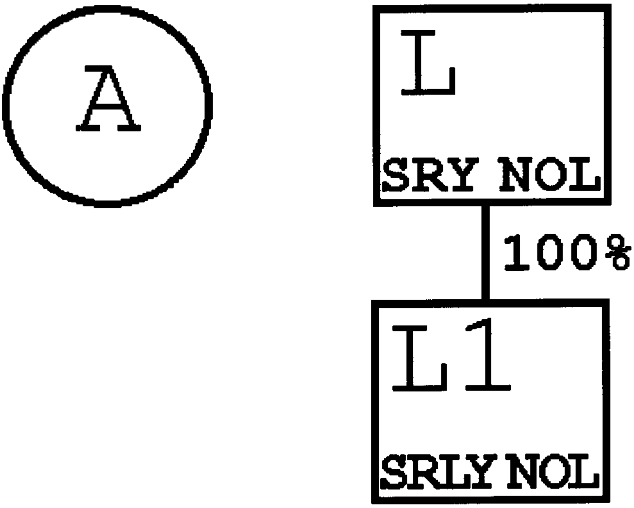

(b) L and L1 become a loss group at the beginning of Year 2 because the group is entitled to use the Year 1 net operating loss carryover of L, the common parent, which did not arise (and is not treated under §1.1502–21T(c) as arising) in a SRLY. See §1.1502–94T for rules relating to the application of section 382 with respect to L1's net operating loss carryover from Year 1 which did arise in a SRLY.

(d) *Loss subgroup*—(1) *Net operating loss carryovers.* Two or more corporations that become members of a consolidated group (the current group) compose a loss subgroup if:

(i) They were affiliated with each other in another group (the former group), whether or not the group was a consolidated group;

(ii) They bear the relationship described in section 1504(a)(1) to each other through a loss subgroup parent immediately after they become members of the current group; and

(iii) At least one of the members carries over a net operating loss that did not arise (and is not treated under § 1.1502–21T(c) as arising) in a SRLY with respect to the former group.

(2) *Net unrealized built-in loss.* Two or more corporations that become members of a consolidated group compose a loss subgroup if they:

(i) Have been continuously affiliated with each other for the 5 consecutive year period ending immediately before they become members of the group;

(ii) Bear the relationship described in section 1504(a)(1) to each other through a loss subgroup parent immediately after they become members of the current group; and

(iii) Have a net unrealized built-in loss (determined under paragraph (g) of this section on the day they become members of the group by treating that day as though it were a change date).

(3) *Loss subgroup parent.* A loss subgroup parent is the corporation that bears the same relationship to the other members of the loss subgroup as a common parent bears to the members of a group.

(4) *Principal purpose of avoiding a limitation.* The corporations described in paragraph (d)(1) or (2) of this section do not compose a loss subgroup if any one of them is formed, acquired, or availed of with a principal purpose of avoiding the application of, or increasing any limitation under, section 382. Instead, § 1.1502–94T applies with respect to the attributes of each such corporation. This paragraph (d)(4) does not apply solely because, in connection with becoming members of the group, the members of a group (or loss subgroup) are rearranged to bear a relationship to the other members described in section 1504(a)(1).

(5) *Special rules.* See § 1.1502–95T(d) for rules concerning when a corporation ceases to be a member of a loss subgroup. See also § 1.1502–96T(a) for a special rule regarding the end of separate tracking of SRLY losses of a member that has an ownership change or that has been a member of a group for at least 5 consecutive years.

(6) *Examples.* The following examples illustrate the principles of this paragraph (d).

Example 1. Loss subgroup. (a) P owns all the L stock and L owns all the L1 stock. The P group has a consolidated net operating loss arising in Year 1 that is carried to Year 2. On May 2, Year 2, P sells all the stock of L to A, and L and L1 thereafter file consolidated returns. A portion of the Year 1 consolidated net operating loss is apportioned under § 1.1502–21T(b) to each of L and L1, which they carry over to Year 2. The following is a graphic illustration of these facts:

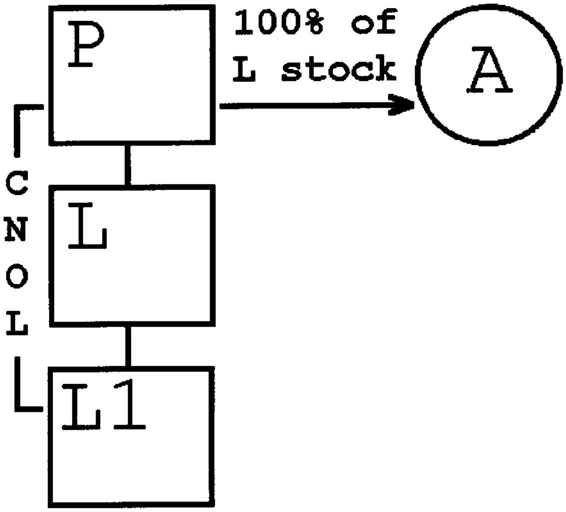

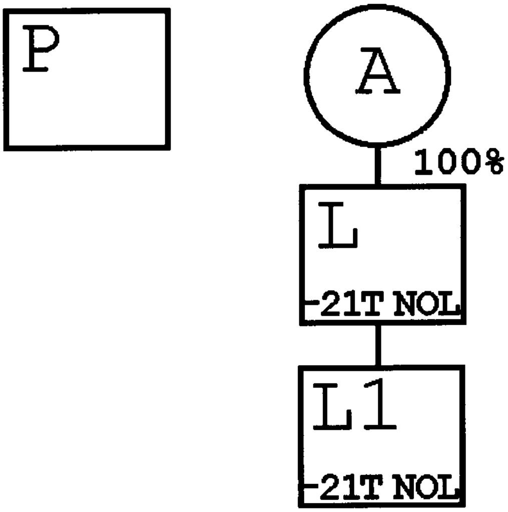

(b) (1) L and L1 compose a loss subgroup within the meaning of paragraph (d)(1) of this section because—

(i) They were affiliated with each other in the P group (the former group);

(ii) They bear a relationship described in section 1504(a)(1) to each other through a loss subgroup parent (L) immediately after they became members of the L group; and

(iii) At least one of the members (here, both L and L1) carries over a net operating loss to the L group (the current group) that did not arise in a SRLY with respect to the P group.

(2) Under paragraph (d)(3) of this section, L is the loss subgroup parent of the L loss subgroup.

Example 2. Loss subgroup—section 1504(a)(1) relationship. (a) P owns all the stock of L and

L1. L owns all the stock of L2. L1 and L2 own 40 percent and 60 percent of the stock of L3, respectively. The P group has a consolidated net operating loss arising in Year 1 that is carried over to Year 2. On May 22, Year 2, P sells all the stock of L and L1 to P1, the common parent of another consolidated group. The Year 1 consolidated net operating loss is apportioned under § 1.1502–21T(b), and each of L, L1, L2, and L3 carries over a portion of such loss to the first consolidated return year of the P1 group ending after the acquisition. The following is a graphic illustration of these facts:

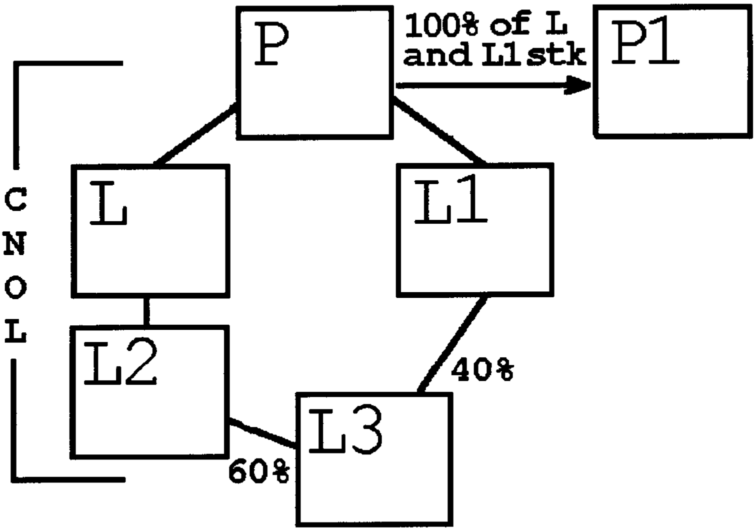
P
100% of L
and L1 stk
P1
C
N
O
L
L
L1
L2
40%
L3
60%

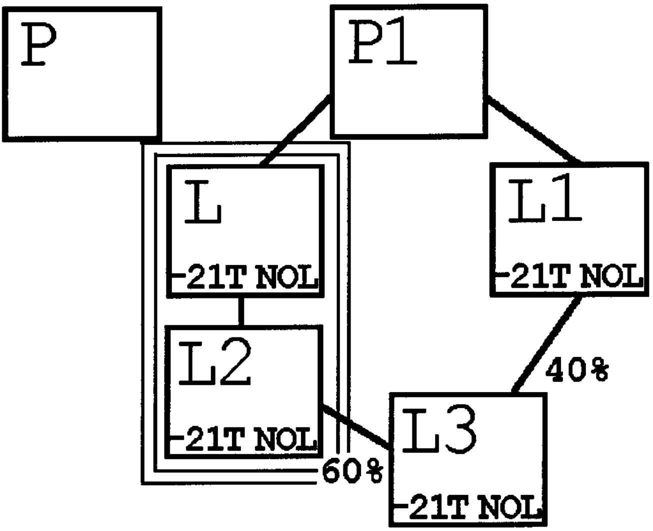
P
P1
L
-21T NOL
L1
-21T NOL
L2
-21T NOL
40%
60%
L3
-21T NOL

(b) L and L2 compose a loss subgroup within the meaning of paragraph (d)(1) of this section. Neither L1 nor L3 is included in a loss subgroup because neither bears a relationship described in section 1504(a)(1) through a loss subgroup parent to any other member of the former group immediately after becoming members of the P1 group.

Example 3. Loss subgroup—section 1504(a)(1) relationship. The facts are the same as in *Example 2,* except that the stock of L1 is transferred to L in connection with the sale of the

L stock to P1. L, L1, L2, and L3 compose a loss subgroup within the meaning of paragraph (d)(1) of this section because—

(1) They were affiliated with each other in the P group (the former group);

(2) They bear a relationship described in section 1504(a)(1) to each other through a loss subgroup parent (L) immediately after they become members of the P1 group; and

(3) At least one of the members (here, each of L, L1, L2, and L3) carries over to the P1 group (the current group) a net operating loss that did not arise in a SRLY with respect to the P group (the former group).

(e) *Pre-change consolidated attribute*—(1) *Defined.* A pre-change consolidated attribute of a loss group is—

(i) Any loss described in paragraph (c)(1) (i) or (ii) of this section (relating to the definition of loss group) that is allocable to the period ending on or before the change date; and

(ii) Any recognized built-in loss of the loss group.

(2) *Example.* The following example illustrates the principle of this paragraph (e).

Example. Pre-change consolidated attribute. (a) The L group has a consolidated net operating loss arising in Year 1 that is carried over to Year 2. The L loss group has an ownership change at the beginning of Year 2.

(b) The net operating loss carryover of the L loss group from Year 1 is a pre-change consolidated attribute because the L group was entitled to use the loss in Year 2, the loss did not arise in a SRLY with respect to the L group, and therefore the loss was described in paragraph (c)(1)(i) of this section. Under paragraph (a) of this section, the amount of consolidated taxable income of the L group for Year 2 that may be offset by this loss carryover may not exceed the consolidated section 382 limitation of the L group for that year. See §1.1502–93T for rules relating to the computation of the consolidated section 382 limitation.

(f) *Pre-change subgroup attribute*—(1) *Defined.* A pre-change subgroup attribute of a loss subgroup is—

(i) Any net operating loss carryover described in paragraph (d)(1)(iii) of this section (relating to the definition of loss subgroup); and

(ii) Any recognized built-in loss of the loss subgroup.

(2) *Example.* The following example illustrates the principle of this paragraph (f).

Example. Pre-change subgroup attribute. (a) P is the common parent of a consolidated group. P owns all the stock of L, and L owns all the stock of L1. L2 is not a member of an affiliated group, and has a net operating loss arising in Year 1 that is carried over to Year 2. On December 11, Year 2, L1 acquires all the stock of L2, causing an ownership change of L2. During Year 2, the P group has a consolidated net operating loss that is carried over to Year 3. On November 2, Year 3, M acquires all the L stock from P. M, L, L1, and L2 thereafter file consolidated returns. All of the P group Year 2 consolidated net operating loss is apportioned under §1.1502–21T(b) to L and L2, which they carry over to the M group.

(b)(1) L, L1, and L2 compose a loss subgroup because—

(i) They were affiliated with each other in the P group (the former group);

(ii) They bore a relationship described in section 1504(a)(1) to each other through a loss subgroup parent (L) immediately after they became members of the L group; and

(iii) At least one of the members (here, both L and L2) carries over a net operating loss to the M group (the current group) that is described in paragraph (d)(1)(iii) of this section.

(2) For this purpose, L2's loss from Year 1 that was a SRLY loss with respect to the P group (the former group) is treated as described in paragraph (d)(1)(iii) of this section because of the application of the principles of §1.1502–96T(a). See paragraph (d)(5) of this section. M's acquisition results in an ownership change of L, and therefore the L loss subgroup under §1.1502–92T(a)(2). See §1.1502–93T for rules governing the computation of the subgroup section 382 limitation.

(c) In the M group, L2's Year 1 loss continues to be subject to a section 382 limitation resulting from the ownership change that occurred on December 11, Year 2. See §1.1502–96T(c).

(g) *Net unrealized built-in gain and loss*—(1) *In general.* The determination whether a consolidated group (or loss subgroup) has a net unrealized built-in gain or loss under section 382(h)(3) is based on the aggregate amount of the separately computed net unrealized built-in gains or losses of each member that is included in the group (or loss subgroup) under paragraph (g)(2) of this section, including items of built-in income and deduction described in section 382(h)(6). Thus, for example, amounts deferred under section 267, or under §1.1502–13 (other than amounts deferred with respect to the stock of a member (or an intercompany obligation) included in the group (or loss subgroup) under paragraph (g)(2) of this section) are built-in items. The threshold requirement under section 382(h)(3)(B) applies on an aggregate basis and not on a member-by-member basis. The separately computed amount of a member included in a group or loss subgroup does not include any unrealized built-in gain or loss on stock (including stock described in section 1504(a)(4) and §1.382–2T(f)(18)(ii) and (iii)) of another member included in the group or loss subgroup (or on an intercompany obligation). However, a member of a group or loss subgroup includes in its separately computed amount the unrealized built-in gain or loss on stock of another member (or on an intercompany obligation) not included in the group or loss subgroup. If a member is not included in a group (or loss subgroup) under paragraph (g)(2) of this section, the determination of whether the member has a net unrealized built-in gain or loss under section 382(h)(3) is made on a separate entity basis. See §1.1502–94(c) (relating to built-in gain or loss of a new loss member) and §1.1502–96(a) (relating to the end of separate tracking of certain losses).

(2) *Members included*—(i) *Consolidated group*. The members included in the determination whether a consolidated group has a net unrealized built-in gain or loss are all members of the group on the day that the determination is made other than—

(A) A new loss member with a net unrealized built-in loss described in §1.1502–94T(a)(1)(ii); and

(B) Members included in a loss subgroup described in §1.1502–91T(d)(2).

(ii) *Loss subgroup*. The members included in the determination whether a loss subgroup has a net unrealized built-in gain or loss are those members described in paragraphs (d)(2)(i) and (ii) of this section.

(3) *Acquisitions of built-in gain or loss assets*. A member of a consolidated group (or loss subgroup) may not, in determining its separately computed net unrealized built-in gain or loss, include any gain or loss with respect to assets acquired with a principal purpose to affect the amount of its net unrealized built-in gain or loss. A group (or loss subgroup) may not, in determining its net unrealized built-in gain or loss, include any gain or loss of a member acquired with a principal purpose to affect the amount of its net unrealized built-in gain or loss.

(4) *Indirect ownership*. A member's separately computed net unrealized built-in gain or loss is adjusted to the extent necessary to prevent any duplication of unrealized gain or loss attributable to the member's indirect ownership interest in another member through a nonmember if the member has a 5-percent or greater ownership interest in the nonmember.

(h) *Recognized built-in gain or loss*—(1) *In general*. [Reserved]

(2) *Disposition of stock or an intercompany obligation of a member*. Gain or loss recognized by a member on the disposition of stock (including stock described in section 1504(a)(4) and §1.382–2T(f)(18)(ii) and (iii)) of another member or an intercompany obligation is treated as a recognized built-in gain or loss under section 382(h)(2) (unless disallowed under §1.1502–20 or otherwise), even though gain or loss on such stock or obligation was not included in the determination of a net unrealized built-in gain or loss under paragraph (g)(1) of this section.

(3) *Deferred gain or loss*. Gain or loss that is deferred under provisions such as section 267 and §1.1502–13 is treated as recognized built-in gain or loss only to the extent taken into account by the group during the recognition period.

(4) *Exchanged basis property*. If the adjusted basis of any asset is determined, directly or indirectly, in whole or in part, by reference to the adjusted basis of another asset held by the member at the beginning of the recognition period, the asset is treated, with appropriate adjustments, as held by the member at the beginning of the recognition period.

(i) [Reserved]

(j) Predecessor and successor corporations. A reference in this section and §§1.1502–92T through 1.1502–99T to a corporation, member, common parent, loss subgroup parent, or subsidiary includes, as the context may require, a reference to a predecessor or successor corporation. For example, the determination whether a successor satisfies the continuous affiliation requirement of paragraph (d)(2)(i) of this section is made by reference to its predecessor.

[T.D. 8678, 61 FR 33337, June 27, 1996]

§ 1.1502–92T Ownership change of a loss group or a loss subgroup (temporary).

(a) *Scope.* This section provides rules for determining if there is an ownership change for purposes of section 382 with respect to a loss group or a loss subgroup. See § 1.1502–94T for special rules for determining if there is an ownership change with respect to a new loss member and § 1.1502–96T(b) for special rules for determining if there is an ownership change of a subsidiary.

(b) *Determination of an ownership change*—(1) *Parent change method*—(i) *Loss group.* A loss group has an ownership change if the loss group's common parent has an ownership change under section 382 and the regulations thereunder. Solely for purposes of determining whether the common parent has an ownership change—

(A) The losses described in § 1.1502–91T(c) are treated as net operating losses (or a net unrealized built-in loss) of the common parent; and

(B) The common parent determines the earliest day that its testing period can begin by reference to only the attributes that make the group a loss group under § 1.1502–91T(c).

(ii) *Loss subgroup.* A loss subgroup has an ownership change if the loss subgroup parent has an ownership change under section 382 and the regulations thereunder. The principles of § 1.1502–95T(b) (relating to ceasing to be a member of a consolidated group) apply in determining whether the loss subgroup parent has an ownership change. Solely for purposes of determining whether the loss subgroup parent has an ownership change—

(A) The losses described in § 1.1502–91T(d) are treated as net operating losses (or a net unrealized built-in loss) of the loss subgroup parent;

(B) The day that the members of the loss subgroup become members of the group (or a loss subgroup) is treated as a testing date within the meaning of § 1.382–2(a)(4); and

(C) The loss subgroup parent determines the earliest day that its testing period can begin under § 1.382–2T(d)(3) by reference to only the attributes that make the members a loss subgroup under § 1.1502–91T(d).

(2) *Examples.* The following examples illustrate the principles of this paragraph (b).

Example 1. Loss group—ownership change of the common parent. (a) A owns all the L stock. L owns 80 percent and B owns 20 percent of the L1 stock. For Year 1, the L group has a consolidated net operating loss that resulted from the operations of L1 and that is carried over to Year 2. The value of the L stock is $1000. The total value of the L1 stock is $600 and the value of the L1 stock held by B is $120. The L group is a loss group under § 1.1502–91T(c)(1) because it is entitled to use its net operating loss carryover from Year 1. On August 15, Year 2, A sells 51 percent of the L stock to C. The following is a graphic illustration of these facts:

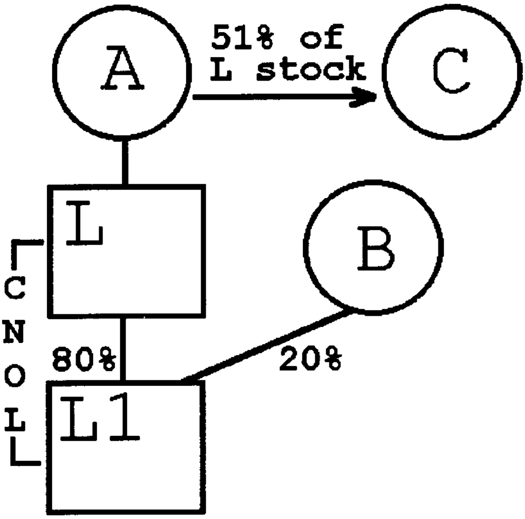

(b) Under paragraph (b)(1)(i) of this section, section 382 and the regulations thereunder are applied to L to determine whether it (and therefore the L loss group) has an ownership change with respect to its net operating loss carryover from Year 1 attributable to L1 on August 15, Year 2. The sale of the L stock to C causes an ownership change of L under §1.382–2T and of the L loss group under paragraph (b)(1)(i) of this section. The amount of consolidated taxable income of the L loss group for any post-change taxable year that may be offset by its pre-change consolidated attributes (that is, the net operating loss carryover from Year 1 attributable to L1) may not exceed the consolidated section 382 limitation for the L loss group for the taxable year.

Example 2. Loss group—owner shifts of subsidiaries disregarded. (a) The facts are the same as in *Example 1,* except that on August 15, Year 2, A sells only 49 percent of the L stock to C and, on December 12, Year 3, in an unrelated transaction, B sells the 20 percent of the L1 stock to D. A's sale of the L stock to C does not cause an ownership change of L under §1.382–2T nor of the L loss group under paragraph (b)(1)(i) of this section. The following is a graphic illustration of these facts:

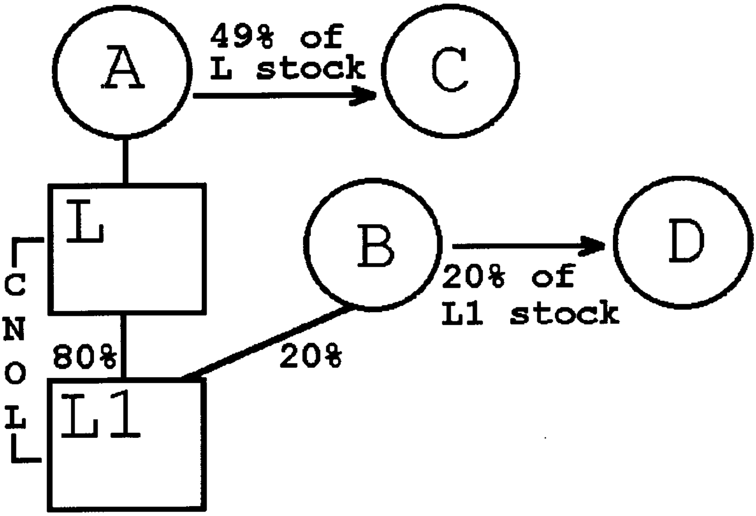

(b) B's subsequent sale of L1 stock is not taken into account for purposes of determining whether the L loss group has an ownership change under paragraph (b)(1)(i) of this section, and, accordingly, there is no ownership change of the L loss group. See paragraph (c) of this section, however, for a supplemental ownership change method that would apply to cause an ownership change if the purchases by C and D were pursuant to a plan or arrangement.

Example 3. Loss subgroup—ownership change of loss subgroup parent controls. (a) P owns all the L stock. L owns 80 percent and A owns 20 percent of the L1 stock. The P group has a consolidated net operating loss arising in Year 1 that is carried over to Year 2. On September 9, Year 2, P sells 51 percent of the L stock to B, and L1 is apportioned a portion of the Year 1 consolidated net operating loss under § 1.1502–21T(b), which it carries over to its next taxable year. L and L1 file a consolidated return for their first taxable year ending after the sale to B. The following is a graphic illustration of these facts:

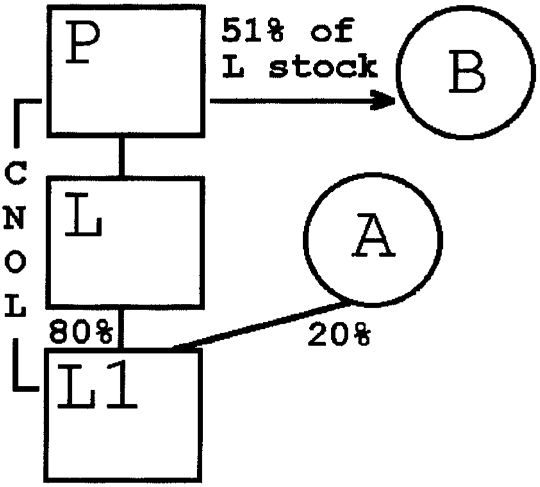

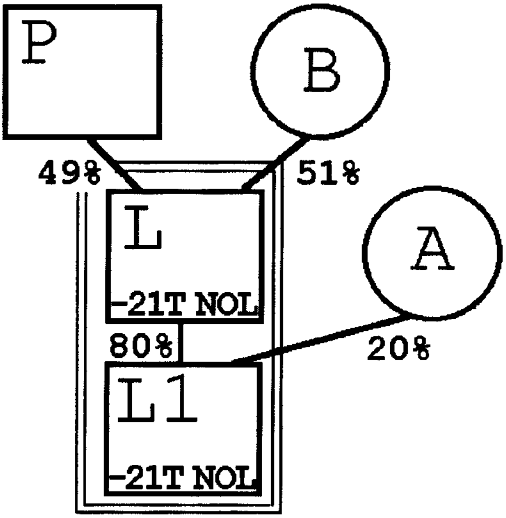

(b) Under §1.1502–91T(d)(1), L and L1 compose a loss subgroup on September 9, Year 2, the day that they become members of the L group. Under paragraph (b)(1)(ii) of this section, section 382 and the regulations thereunder are applied to L to determine whether it (and therefore the L loss subgroup) has an ownership change with respect to the portion of the Year 1 consolidated net operating loss that is apportioned to L1 on September 9, Year 2. L has an ownership change resulting from P's sale of 51 percent of the L stock to A. Therefore, the L loss subgroup has an ownership change with respect to that loss.

Example 4. Loss group and loss subgroup—contemporaneous ownership changes. (a) A owns all the stock of corporation M, M owns 35 percent and B owns 65 percent of the L stock, and L owns all the L1 stock. The L group has a consolidated net operating loss arising in Year 1 that is carried over to Year 2. On May 19, Year 2, B sells 45 percent of the L stock to M for cash. M, L, and L1 thereafter file consolidated returns. L and L1 are each apportioned a portion of the Year 1 consolidated net operating loss, which they carry over to the M group's Year 2 and Year 3 consolidated return years. The M group has a consolidated net operating loss arising in Year 2 that is carried over to Year 3. On June 9, Year 3, A sells 70 percent of the M stock to C. The following is a graphic illustration of these facts:

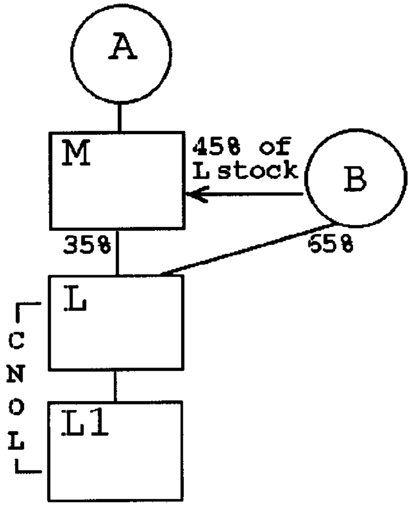
A
M
45% of
L stock
B
35%
65%
L
L1
CNOL

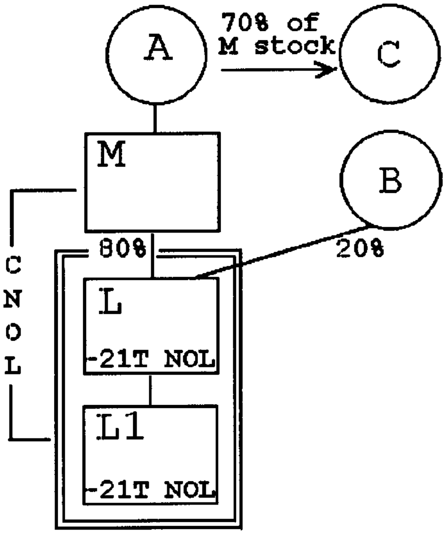
A
70% of
M stock
C
M
B
80%
20%
L
-21T NOL
L1
-21T NOL
CNOL

(b) Under §1.1502–91T(d)(1), L and L1 compose a loss subgroup on May 19, Year 2, the day they become members of the M group. Under paragraph (b)(1)(ii) of this section, section 382 and the regulations thereunder are applied to L to determine whether L (and therefore the L loss subgroup) has an ownership change with respect to the loss carryovers from Year 1 on May 19, Year 2, a testing date because of B's sale of L stock to M. The sale of L stock to M results in only a 45 percentage point increase in A's ownership of L stock. Thus, there is no ownership change of L (or the L loss subgroup) with respect to those loss carryovers under paragraph (b)(1)(ii) of this section on that day.

(c) June 9, Year 3, is also a testing date with respect to the L loss subgroup because of A's sale of M stock to C. The sale results in a 56 percentage point increase in C's ownership of L stock, and L has an ownership change. Therefore, the L loss subgroup has an ownership change on that day with respect to the loss carryovers from Year 1.

(d) Paragraph (b)(1)(i) of this section requires that section 382 and the regulations thereunder be applied to M to determine whether M (and therefore the M loss group) has an ownership change with respect to the net operating loss carryover from Year 2 on June 9, Year 3, a testing date because of A's sale of M stock to C. The sale results in a 70 percentage point increase in C's ownership of M stock, and M has an ownership change. Therefore, the M loss group has an ownership change on that day with respect to that loss carryover.

(3) *Special adjustments*—(i) *Common parent succeeded by a new common parent.* For purposes of determining if a loss group has an ownership change, if the common parent of a loss group is succeeded or acquired by a new common parent and the loss group remains in existence, the new common parent is treated as a continuation of the former common parent with appropriate adjustments to take into account shifts in ownership of the former common parent during the testing period (including shifts that occur incident to the common parent's becoming the former common parent).

(ii) *Newly created loss subgroup parent.* For purposes of determining if a loss subgroup has an ownership change, if the member that is the loss subgroup parent has not been the loss subgroup parent for at least 3 years as of a testing date, appropriate adjustments must be made to take into account owner shifts of members of the loss subgroup so that the structure of the loss subgroup does not have the effect of avoiding an ownership change under section 382. (See paragraph (b)(3)(iii) *Example 3* of this section.)

(iii) *Examples.* The following examples illustrate the principles of this paragraph (b)(3).

Example 1. New common parent acquires old common parent. (a) A, who owns all the L stock, sells 30 percent of the L stock to B on August 26, Year 1. L owns all the L1 stock. The L group has a consolidated net operating loss arising in Year 1 that is carried over to Year 3. On July 16, Year 2, A and B transfer their L stock to a newly created holding company, HC, in exchange for 70 percent and 30 percent, respectively, of the HC stock. HC, L, and L1 thereafter file consolidated returns. Under the principles of §1.1502–75(d), the L loss group is treated as remaining in existence, with HC taking the place of L as the new common parent of the loss group. The following is a graphic illustration of these facts:

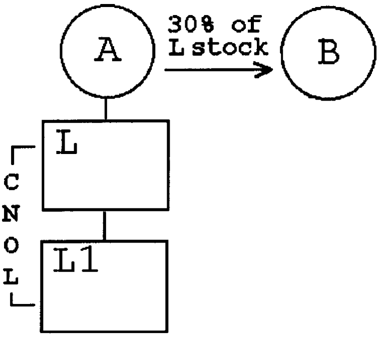
A
30% of
L stock
B
L
L1
CNOL

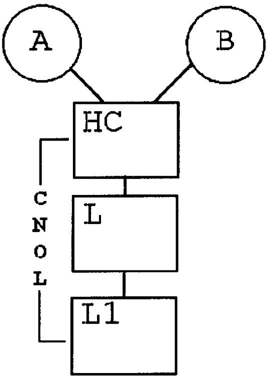
A
B
HC
L
L1
CNOL

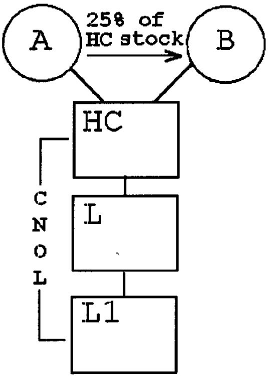
A
25% of
HC stock
B
HC
L
L1
CNOL

(b) On November 11, Year 3, A sells 25 percent of the HC stock to B. For purposes of determining if the L loss group has an ownership change under paragraph (b)(1)(i) of this section on November 11, Year 3, HC is treated as a continuation of L under paragraph (b)(3)(i) of this section because it acquired L and became the common parent without terminating the L loss group. Accordingly, HC's testing period commences on January 1, Year 1, the first day of the taxable year of the L loss group in which the consolidated net operating loss that is carried over to Year 3 arose (see §1.382–2T(d)(3)(i)). Immediately after the close of November 11, Year 3, B's percentage ownership interest in the common parent of the loss group (HC) has increased by 55 percentage points over its lowest percentage ownership during the testing period (zero percent). Accordingly, HC and the L loss group have an ownership change on that day.

Example 2. common parent in case in which common parent ceases to exist. (a) A, B, and C each own one-third of the L stock. L owns all the L1 stock. The L group has a consolidated net operating loss arising in Year 2 that is carried over to Year 3. On November 22, Year 3, L is merged into P, a corporation owned by D, and L1 thereafter files consolidated returns with P. A, B, and C, as a result of owning stock of L, own 90 percent of P's stock after the merger. D owns the remaining 10 percent of P's stock. The merger of L into P qualifies as a reverse acquisition of the L group under §1.1502–75(d)(3)(i), and the L loss group is treated as remaining in existence, with P taking the place of L as the new common parent of the L group. The following is a graphic illustration of these facts:

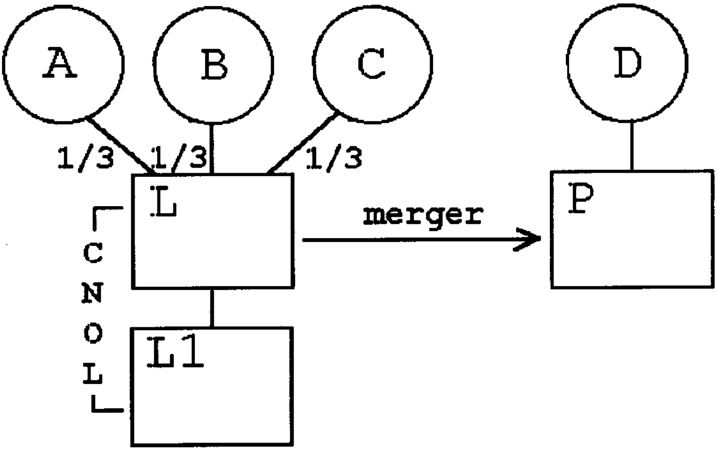

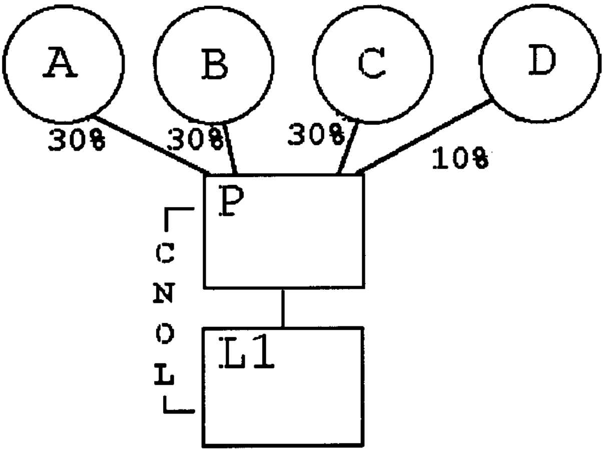

(b) For purposes of determining if the L loss group has an ownership change on November 22, Year 3, the day of the merger, P is treated as a continuation of L so that the testing period for P begins on January 1, Year 2, the first day of the taxable year of the L loss group in which the consolidated net operating loss that is carried over to Year 3 arose. Immediately after the close of November 22, Year 3, D is the only 5-percent shareholder that has increased his ownership interest in P during the testing period (from zero to 10 percentage points).

(c) The facts are the same as in paragraph (a) of this *Example 2*, except that A has held 23⅓ shares (23⅓ percent) of L's stock for five years, and A purchased an additional 10 shares of L stock from E two years before the merger. Immediately after the close of the day of the merger (a testing date), A's ownership interest in P, the common parent of the L loss group, has increased by 6⅔ percentage points over her lowest percentage ownership during the testing period (23⅓ percent to 30 percent).

(d) The facts are the same as in (a) of this *Example 2,* except that P has a net operating loss arising in Year 1 that is carried to the first consolidated return year ending after the day of the merger. Solely for purposes of determining whether the L loss group has an ownership change under paragraph (b)(1)(i) of this section, the testing period for P commences on January 1, Year 2. P does not determine the earliest day for its testing period by reference to its net operating loss carryover from Year 1, which §§1502–1(f)(3) and 1.1502–75(d)(3)(i) treat as arising in a SRLY. See §1.1502–94T to determine the application of section 382 with respect to P's net operating loss carryover.

Example 3. Newly acquired loss subgroup parent. (a) P owns all the L stock and L owns all the L1 stock. The P group has a consolidated net operating loss arising in Year 1 that is carried over to Year 3. On January 19, Year 2, L issues a 20 percent stock interest to B. On February 5, Year 3, P contributes its L stock to a newly formed subsidiary, HC, in exchange for all the HC stock, and distributes the HC stock to its sole shareholder A. HC, L, and L1 thereafter file consolidated returns. A portion of the P group's Year 1 consolidated net operating loss is apportioned to L and L1 under §1.1502–21T(b) and is carried over to the HC group's year ending after February 5, Year 3. HC, L, and L1 compose a loss subgroup within the meaning of §1.1502–91T(d) with respect to the net operating loss carryovers from Year 1. The following is a graphic illustration of these facts:

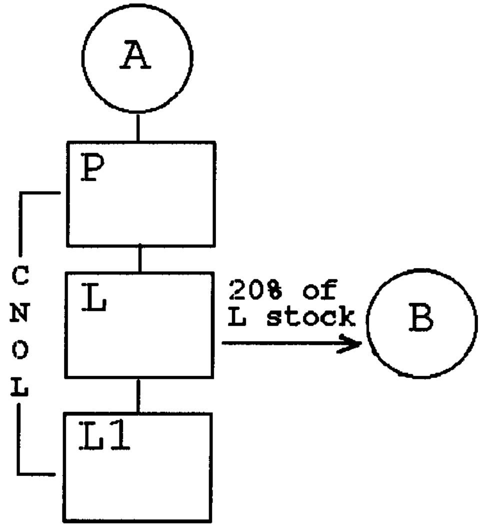

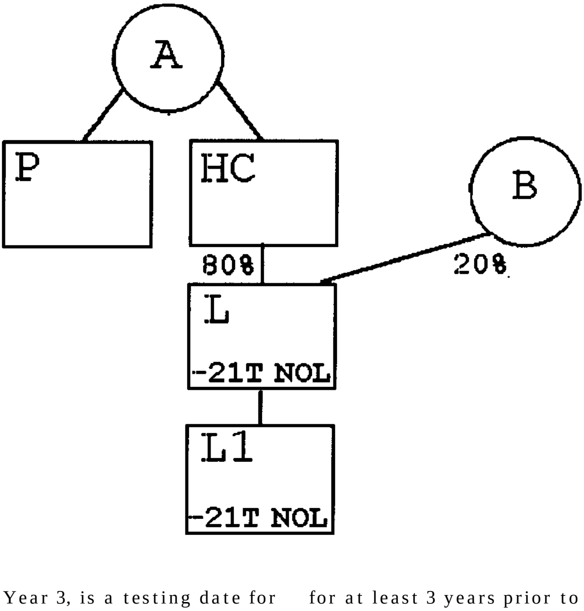

(b) February 5, Year 3, is a testing date for HC as the loss subgroup parent with respect to the net operating loss carryovers of L and L1 from Year 1. See paragraph (b)(1)(ii)(B) of this section. For purposes of determining whether HC has an ownership change on the testing date, appropriate adjustments must be made with respect to the changes in the percentage ownership of the stock of HC because HC was not the loss subgroup parent for at least 3 years prior to the day on which it became a member of the HC loss subgroup (a testing date). The appropriate adjustments include adjustments so that HC succeeds to the owner shifts of other members of the former group. Thus, HC succeeds to the owner shift of L that resulted from the sale of the 20 percent interest to B in determining whether the HC loss subgroup has an ownership change on February 5, Year 3, and on any subsequent testing date that includes January 19, Year 2.

(4) *End of separate tracking of certain losses.* If §1.1502–96T(a) (relating to the end of separate tracking of attributes) applies to a loss subgroup, then, while one or more members that were included in the loss subgroup remain members of the consolidated group, there is an ownership change with respect to their attributes described in §1.1502–96T(a)(2) only if the consolidated group is a loss group and has an ownership change under paragraph (b)(1)(i) of this section (or such a member has an ownership change under §1.1502–96T(b) (relating to ownership changes of subsidiaries)). If, however, the loss subgroup has had an ownership change before §1.1502–96T(a) applies, see §1.1502–96T(c) for the continuing application of the subgroup's section 382 limitation with respect to its prechange subgroup attributes.

(c) *Supplemental rules for determining ownership change*—(1) *Scope.* This paragraph (c) contains a supplemental rule for determining whether there is an ownership change of a loss group (or loss subgroup). It applies in addition to, and not instead of, the rules of paragraph (b) of this section. Thus, for example, if the common parent of the loss group has an ownership change under paragraph (b) of this section, the loss group has an ownership change even if, by applying this paragraph (c), the common parent would not have an ownership change.

(2) *Cause for applying supplemental rule.* This paragraph (c) applies to a loss group (or loss subgroup) if—

(i) Any 5-percent shareholder of the common parent (or loss subgroup parent) increases its percentage ownership interest in the stock of both—

(A) A subsidiary of the loss group (or loss subgroup) other than by a direct or indirect acquisition of stock of the common parent (or loss subgroup parent); and

(B) The common parent (or loss subgroup parent); and

(ii) Those increases occur within a 3 year period ending on any day of a consolidated return year or, if shorter, the period beginning on the first day following the most recent ownership change of the loss group (or loss subgroup).

(3) *Operating rules.* Solely for purposes of this paragraph (c)—

(i) A 5-percent shareholder of the common parent (or loss subgroup parent) is treated as increasing its percentage ownership interest in the common parent (or loss subgroup parent) or a subsidiary to the extent, if any, that any person acting pursuant to a plan or arrangement with the 5-percent shareholder increases its percentage ownership interest in the stock of that entity;

(ii) The rules in section 382(l)(3) and §§1.382–2T(h) and 1.382–4(d) (relating to constructive ownership) apply with respect to the stock of the subsidiary by treating such stock as stock of a loss corporation; and

(iii) In the case of a loss subgroup, a subsidiary includes any member of the loss subgroup other than the loss subgroup parent. (The loss subgroup parent is, however, a subsidiary of the loss group of which it is a member.)

(4) *Supplemental ownership change rules.* The determination whether the common parent (or loss subgroup parent) has an ownership change is made by applying paragraph (b)(1) of this section as modified by the following additional rules—

(i) *Additional testing dates for the common parent (or loss subgroup parent).* A testing date for the common parent (or loss subgroup parent) also includes—

(A) Each day on which there is an increase in the percentage ownership of stock of a subsidiary as described in paragraph (c)(2) of this section; and

(B) The first day of the first consolidated return year for which the group is a loss group (or the members compose a loss subgroup);

(ii) *Treatment of subsidiary stock as stock of the common parent (or loss subgroup parent).* The common parent (or loss subgroup parent) is treated as though it had issued to the person acquiring (or deemed to acquire) the subsidiary stock an amount of its own stock (by value) that equals the value of the subsidiary stock represented by the percentage increase in that person's ownership of the subsidiary (determined on a separate entity basis). A similar principle applies if the increase in percentage ownership interest is effected by a redemption or similar transaction; and

(iii) *5-percent shareholder of the common parent (or loss subgroup parent).* Any person described in paragraph (c)(3)(i) of this section who is acting pursuant to the plan or arrangement is treated as a 5-percent shareholder of the common parent (or loss subgroup parent).

(5) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. Stock of the common parent under supplemental rules. (a) A owns all the L stock. L is not a member of an affiliated group and has a net operating loss carryover arising in Year 1 that is carried over to Year 6. On September 20, Year 6, L transfers all of its assets and liabilities to a newly created subsidiary, S, in exchange for S stock. L and S thereafter file consolidated returns. On November 23, Year 6, B contributes cash to L in exchange for a 45 percent ownership interest in L and contributes cash to S for a 20 percent ownership interest in S.

(b) B is a 5-percent shareholder of L who increases his percentage ownership interest in L and S during the 3 year period ending on November 23, Year 6. Under paragraph (c)(4)(ii) of this section, the determination whether L (the common parent of a loss group) has an ownership change on November 23, Year 6 (or on any testing date in the testing period which includes November 23, Year 6), is made by applying paragraph (b)(1)(i) of this section and by treating the value of B's 20 percent ownership interest in S as if it were L stock issued to B.

Example 2. Plan or arrangement—public offering of subsidiary stock. (a) A owns all the stock of L and L owns all the stock of L1. The L group has a consolidated net operating loss arising in Year 1 that resulted from the operations of L1 and that is carried over to Year 2. As part of a plan, A sells 49 percent of the L stock to B on October 7, Year 2, and L1 issues new stock representing a 20 percent ownership interest in L1 to the public on November 6, Year 2. The following is a graphic illustration of these facts:

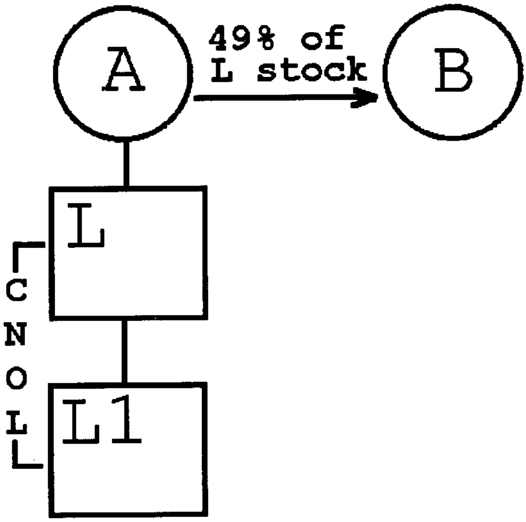

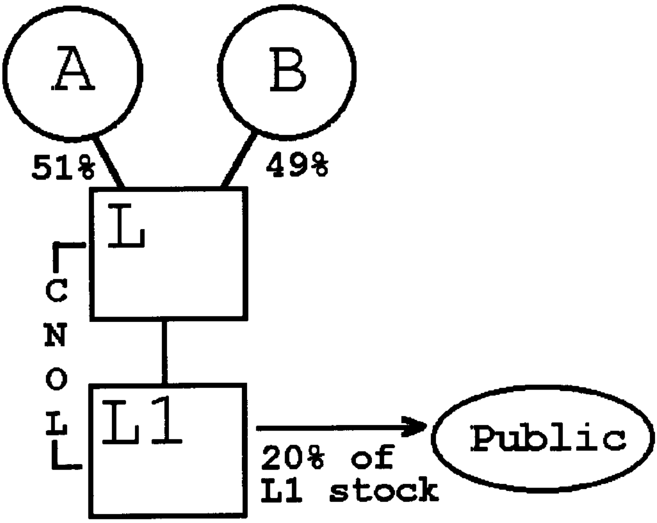

(b) A's sale of the L stock to B does not cause an ownership change of the L loss group on October 7, Year 2, under the rules of §1.382–2T and paragraph (b)(1)(i) of this section.

(c) Because the issuance of L1 stock to the public occurs in connection with B's acquisition of L stock pursuant to a plan, paragraph (c)(4) of this section applies to determine whether the L loss group has an ownership change on November 6, Year 2 (or on any testing date for which the testing period includes November 6, Year 2).

(d) *Testing period following ownership change under this section.* If a loss group (or a loss subgroup) has had an ownership change under this section, the testing period for determining a subsequent ownership change with respect to pre-change consolidated attributes (or pre-change subgroup attributes) begins no earlier than the first day following the loss group's (or loss subgroup's) most recent change date.

(e) *Information statements.*—(1) *Common parent of a loss group.* The common parent of a loss group must file the information statement required by § 1.382–2T(a)(2)(ii) for a consolidated return year because of any owner shift, equity structure shift, or the issuance or transfer of an option—

(i) With respect to the common parent and with respect to any subsidiary stock subject to paragraph (c) of this section; and

(ii) With respect to an ownership change described in § 1.1502–96T(b) (relating to ownership changes of subsidiaries).

(2) *Abbreviated statement with respect to loss subgroups.* The common parent of a consolidated group that has a loss subgroup during a consolidated return year must file the information statement required by § 1.382–2T(a)(2)(ii) because of any owner shift, equity structure shift, or issuance or transfer of an option with respect to the loss subgroup parent and with respect to any subsidiary stock subject to paragraph (c) of this section. Instead of filing a separate statement for each loss subgroup parent, the common parent (which is treated as a loss corporation) may file the single statement described in paragraph (e)(1) of this section. In addition to the information concerning stock ownership of the common parent, the single statement must identify each loss subgroup parent and state which loss subgroups, if any, have had ownership changes during the consolidated return year. The loss subgroup parent is, however, still required to maintain the records necessary to determine if the loss subgroup has an ownership change. This paragraph (e)(2) applies with respect to the attributes of a loss subgroup until, under § 1.1502–96T(a), the attributes are no longer treated as described in § 1.1502–91T(d) (relating to the definition of loss subgroup). After that time, the information statement described in paragraph (e)(1) of this section must be filed with respect to those attributes.

[T.D. 8678, 61 FR 33341, June 27, 1996]

§ 1.1502–93T Consolidated section 382 limitation (or subgroup section 382 limitation) (temporary).

(a) *Determination of the consolidated section 382 limitation (or subgroup section 382 limitation)*—(1) *In general.* Following an ownership change, the consolidated section 382 limitation (or subgroup section 382 limitation) for any post-change year is an amount equal to the value of the loss group (or loss subgroup), as defined in paragraph (b) of this section, multiplied by the long-term tax-exempt rate that applies with respect to the ownership change, and adjusted as required by section 382 and the regulations thereunder. See, for example, section 382(b)(2) (relating to the carryforward of unused section 382 limitation), section 382(b)(3)(B) (relating to the section 382 limitation for the post-change year that includes the change date), section 382(m)(2) (relating to short taxable years), and section 382(h) (relating to recognized built-in gains and section 338 gains).

(2) *Coordination with apportionment rule.* For special rules relating to apportionment of a consolidated section 382 limitation (or a subgroup section 382 limitation) when one or more corporations cease to be members of a loss group (or a loss subgroup) and to aggregation of amounts so apportioned, see § 1.1502–95T(c).

(b) *Value of the loss group (or loss subgroup)*—(1) *Stock value immediately before ownership change.* Subject to any adjustment under paragraph (b)(2) of this section, the value of the loss group (or loss subgroup) is the value, immediately before the ownership change, of the stock of each member, other than stock that is owned directly or indirectly by another member. For this purpose—

(i) Ownership is determined under § 1.382–2T;

(ii) A member is considered to indirectly own stock of another member through a nonmember only if the member has a 5-percent or greater ownership interest in the nonmember; and

(iii) Stock includes stock described in section 1504(a)(4) and §1.382–2T(f)(18)(ii) and (iii).

(2) *Adjustment to value.* The value of the loss group (or loss subgroup), as determined under paragraph (b)(1) of this section, is adjusted under any rule in section 382 or the regulations thereunder requiring an adjustment to such value for purposes of computing the amount of the section 382 limitation. See, for example, section 382(e)(2) (redemptions and corporate contractions), section 382(l)(1) (certain capital contributions) and section 382(l)(4) (ownership of substantial nonbusiness assets). The value of the loss group (or loss subgroup) determined under this paragraph (b) is also adjusted to the extent necessary to prevent any duplication of the value of the stock of a member. For example, the principles of §1.382–8T (relating to controlled groups of corporations) apply in determining the value of a loss group (or loss subgroup) if, under §1.1502–91T(g)(2), members are not included in the determination whether the group (or loss subgroup) has a net unrealized built-in loss.

(3) *Examples.* The following examples illustrate the principles of this paragraph (b).

Example 1. Basic case. (a) L, L1, and L2 compose a loss group. L has outstanding common stock, the value of which is $100. L1 has outstanding common stock and preferred stock that is described in section 1504(a)(4). L owns 90 percent of the L1 common stock, and A owns the remaining 10 percent of the L1 common stock plus all the preferred stock. The value of the L1 common stock is $40, and the value of the L1 preferred stock is $30. L2 has outstanding common stock, 50 percent of which is owned by L and 50 percent by L1. The L group has an ownership change. The following is a graphic illustration of these facts:

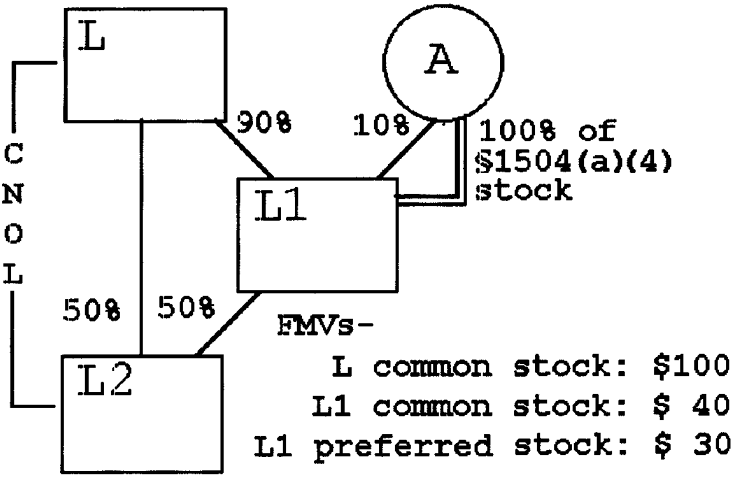

(b) Under paragraph (b)(1) of this section, the L group does not include the value of the stock of any member that is owned directly or indirectly by another member in computing its consolidated section 382 limitation. Accordingly, the value of the stock of the loss group is $134, the sum of the value of—

(1) The common stock of L ($100);

(2) the 10 percent of the L1 common stock ($4) owned by A; and

(3) The L1 preferred stock ($30) owned by A.

Example 2. Indirect ownership. (a) L and L1 compose a consolidated group. L's stock has a value of $100. L owns 80 shares (worth $80) and corporation M owns 20 shares (worth $20) of the L1 stock. L also owns 79 percent of the stock of corporation M. The L group has an ownership change. The following is a graphic illustration of these facts:

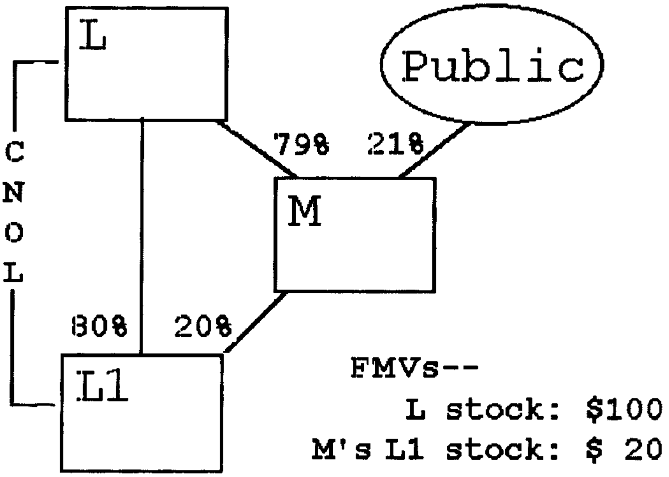

(b) Under paragraph (b)(1) of this section, because of L's more than 5 percent ownership interest in M, a nonmember, L is considered to indirectly own 15.8 shares of the L1 stock held by M (79% x 20 shares). The value of the L loss group is $104.20, the sum of the values of—

(1) The L stock ($100); and

(2) The L1 stock not owned directly or indirectly by L (21% x $20, or $4.20).

(c) *Recognized built-in gain of a loss group or loss subgroup.* If a loss group (or loss subgroup) has a net unrealized built-in gain, any recognized built-in gain of the loss group (or loss subgroup) is taken into account under section 382(h) in determining the consolidated section 382 limitation (or subgroup section 382 limitation).

(d) *Continuity of business*—(1) *In general.* A loss group (or a loss subgroup) is treated as a single entity for purposes of determining whether it satisfies the continuity of business enterprise requirement of section 382(c)(1).

(2) *Example.* The following example illustrates the principle of this paragraph (d).

Example. Continuity of business enterprise. L owns all the stock of two subsidiaries, L1 and L2. The L group has an ownership change. It has pre-change consolidated attributes attributable to L2. Each of the members has historically conducted a separate line of business. Each line of business is approximately equal in value. One year after the ownership change, L discontinues its separate business and the business of L2. The separate business of L1 is continued for the remainder of the 2 year period following the ownership change. The continuity of business enterprise requirement of section 382(c)(1) is met even though the separate businesses of L and L2 are discontinued.

(e) *Limitations of losses under other rules.* If a section 382 limitation for a post-change year exceeds the consolidated taxable income that may be offset by pre-change attributes for any reason, including the application of the limitation of § 1.1502–21T(c), the amount of the excess is carried forward under section 382(b)(2) (relating to the carryforward of unused section 382 limitation).

[T.D. 8678, 61 FR 33351, June 27, 1996]

§ 1.1502–94T Coordination with section 382 and the regulations thereunder when a corporation becomes a member of a consolidated group (temporary).

(a) *Scope*—(1) *In general.* This section applies section 382 and the regulations thereunder to a corporation that is a new loss member of a consolidated group. A corporation is a new loss member if it—

(i) Carries over a net operating loss that arose (or is treated under § 1.1502–21T(c) as arising) in a SRLY with respect to the current group, and that is not described in § 1.1502–91T(d)(1); or

(ii) Has a net unrealized built-in loss (determined under paragraph (c) of this section on the day it becomes a member of the current group by treating that day as a change date) that is not taken into account under §1.1502–91T(d)(2) in determining whether two or more corporations compose a loss subgroup.

(2) *Successor corporation as new loss member.* A new loss member also includes any successor to a corporation that has a net operating loss carryover arising in a SRLY and that is treated as remaining in existence under §1.382–2(a)(1)(ii) following a transaction described in section 381(a).

(3) *Coordination in the case of a loss subgroup.* For rules regarding the determination of whether there is an ownership change of a loss subgroup with respect to a net operating loss or a net unrealized built-in loss described in §1.1502–91T(d) (relating to the definition of loss subgroup) and the computation of a subgroup section 382 limitation following such an ownership change, see §§1.1502–92T and 1.1502–93T.

(4) *End of separate tracking of certain losses.* If §1.1502–96T(a) (relating to the end of separate tracking of attributes) applies to a new loss member, then, while that member remains a member of the consolidated group, there is an ownership change with respect to its attributes described in §1.1502–96T(a)(2) only if the consolidated group is a loss group and has an ownership change under §1.1502–92T(b)(1)(i) (or that member has an ownership change under §1.1502–96T(b) (relating to ownership changes of subsidiaries)). If, however, the new loss member has had an ownership change before §1.1502–96T(a) applies, see §1.1502–96T(c) for the continuing application of the section 382 limitation with respect to the member's pre-change losses.

(5) *Cross-reference.* See section 382(a) and §1.1502–96T(c) for the continuing effect of an ownership change after a corporation becomes or ceases to be a member.

(b) *Application of section 382 to a new loss member*—(1) *In general.* Section 382 and the regulations thereunder apply to a new loss member to determine, on a separate entity basis, whether and to what extent a section 382 limitation applies to limit the amount of consolidated taxable income that may be offset by the new loss member's pre-change separate attributes. For example, if an ownership change with respect to the new loss member occurs under section 382 and the regulations thereunder, the amount of consolidated taxable income for any post-change year that may be offset by the new loss member's pre-change separate attributes shall not exceed the section 382 limitation as determined separately under section 382(b) with respect to that member for such year. If the post-change year includes the change date, section 382(b)(3)(A) is applied so that the section 382 limitation of the new loss member does not apply to the portion of the taxable income for such year that is allocable to the period in such year on or before the change date. See generally §1.382–6 (relating to the allocation of income and loss).

(2) *Adjustment to value.* The value of the new loss member is adjusted to the extent necessary to prevent any duplication of the value of the stock of a member. For example, the principles of §1.382–8T (relating to controlled groups of corporations) apply in determining the value of a new loss member.

(3) *Pre-change separate attribute defined.* A pre-change separate attribute of a new loss member is—

(i) Any net operating loss carryover of the new loss member described in paragraph (a)(1) of this section; and

(ii) Any recognized built-in loss of the new loss member.

(4) *Examples.* The following examples illustrate the principles of this paragraph (b).

Example 1. Basic case. (a) A and P each own 50 percent of the L stock. On December 19, Year 6, P purchases 30 percent of the L stock from A for cash. L has net operating losses arising in Year 1 and Year 2 that it carries over to Year 6 and Year 7. The following is a graphic illustration of these facts:

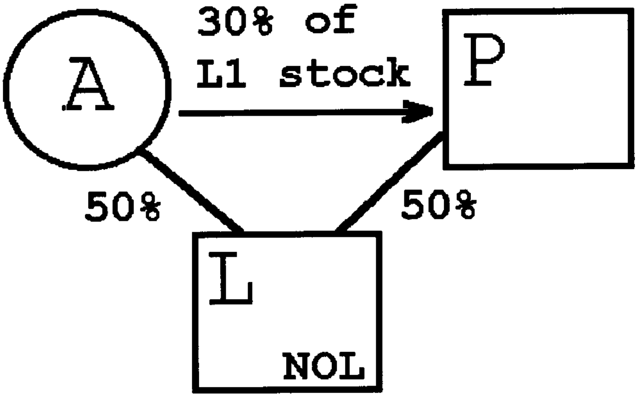

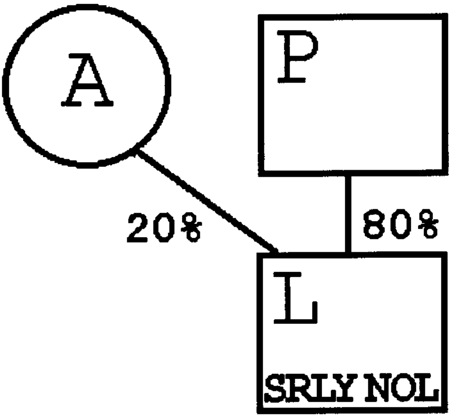

(b) L is a new loss member because it has net operating loss carryovers that arose in a SRLY with respect to the P group and L is not a member of a loss subgroup under § 1.1502–91T(d). Under section 382 and the regulations thereunder, L is a loss corporation on December 19, Year 6, that day is a testing date for L, and the testing period for L commences on December 20, Year 3. –

(c) P's purchase of L stock does not cause an ownership change of L on December 19, Year 6, with respect to the net operating loss carryovers from Year 1 and Year 2 under section 382 and § 1.382–2T. The use of the loss carryovers, however, is subject to limitation under § 1.1502–21T(c). –

Example 2. Multiple new loss members. (a) The facts are the same as in *Example 1*, and, on December 31, Year 6, L purchases all the stock of L1 from B for cash. L1 has a net operating loss of $40 arising in Year 3 that it carries over to Year 7. The following is a graphic illustration of these facts:

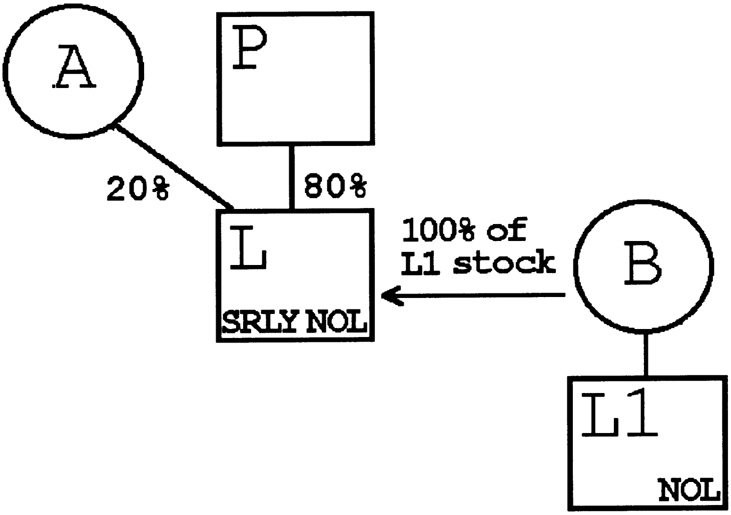

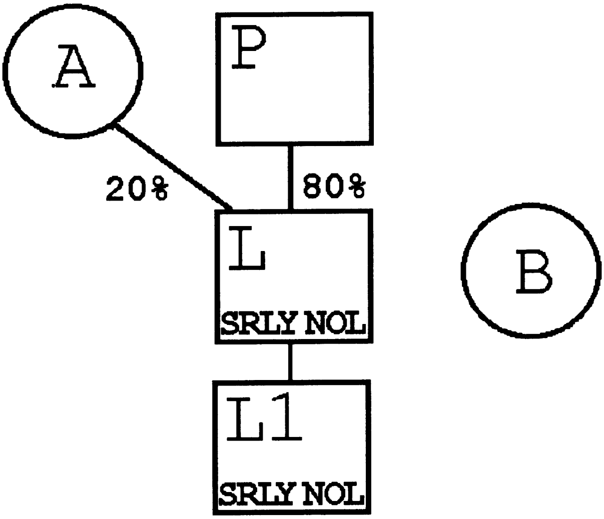

(b) L1 is a new loss member because it has a net operating loss carryover from Year 3 that arose in a SRLY with respect to the P group and L1 is not a member of a loss subgroup under §1.1502–91T(d)(1).

(c) L's purchase of all the stock of L1 causes an ownership change of L1 on December 31, Year 6, under section 382 and §1.382–2T. Accordingly, a section 382 limitation based on the value of the L1 stock immediately before the ownership change limits the amount of consolidated taxable income of the P group for any post-change year that may be offset by L1's loss from Year 3.

(d) L1's ownership change in connection with its becoming a member of the P group is an ownership change described in §1.1502–96T(a). Thus, starting on January 1, Year 7, the P group no longer separately tracks owner shifts of the stock of L1 with respect to L1's loss from Year 3. Instead, the P group is a loss group because of such loss under § 1.1502–91T(c).

Example 3. Ownership changes of new loss members. (a) The facts are the same as in *Example 2*, and, on April 30, Year 7, C purchases all the stock of P for cash.

(b) L is a new loss member on April 30, Year 7, because its Year 1 and Year 2 losses arose in SRLYs with respect to the P group and it is not a member of a loss subgroup under § 1.1502–91T(d)(1). The testing period for L commences on May 1, Year 4. C's purchase of all the P stock causes an ownership change of L on April 30, Year 7, under section 382 and § 1.382–2T with respect to its Year 1 and Year 2 losses. Accordingly, a section 382 limitation based on the value of the L stock immediately before the ownership change limits the amount of consolidated taxable income of the P group for any post-change year that may be offset by L's Year 1 and Year 2 losses. The use of those carryovers is also subject to limitation under § 1.1502–21T(c).

(c) The P group is a loss group on April 30, Year 7, because it is entitled to use L1's loss from Year 3, and such loss is no longer treated as a loss of a new loss member starting the day after L1's ownership change on December 31, Year 6. See §§ 1.1502–96T(a) and 1.1502–91T(c)(2). C's purchase of all the P stock causes an ownership change of P, and therefore the P loss group, on April 30, Year 7, with respect to L1's Year 3 loss. Accordingly, a consolidated section 382 limitation based on the value of the P stock immediately before the ownership change limits the amount of consolidated taxable income of the P group for any post-change year that may be offset by L1's Year 3 loss.

(c) *Built-in gains and losses.* As the context may require, the principles of §§ 1.1502–91T(g) and (h) and 1.1502–93T(c) (relating to built-in gains and losses) apply to a new loss member on a separate entity basis. See § 1.1502–91T(g)(3).

(d) *Information statements.* The common parent of a consolidated group that has a new loss member subject to paragraph (b)(1) of this section during a consolidated return year must file the information statement required by § 1.382–2T(a)(2)(ii) because of any owner shift, equity structure shift, or issuance or transfer of an option with respect to the new loss member. Instead of filing a separate statement for each new loss member the common parent may file a single statement described in § 1.382–2T(a)(2)(ii) with respect to the stock ownership of the common parent (which is treated as a loss corporation). In addition to the information concerning stock ownership of the common parent, the single statement must identify each new loss member and state which new loss members, if any, have had ownership changes during the consolidated return year. The new loss member is, however, required to maintain the records necessary to determine if it has an ownership change. This paragraph (d) applies with respect to the attributes of a new loss member until an event occurs which ends separate tracking under § 1.1502–96T(a). After that time, the information statement described in § 1.1502–92T(e)(1) must be filed with respect to these attributes.

[T.D. 8678, 61 FR 33352, June 27, 1996]

§ 1.1502–95T Rules on ceasing to be a member of a consolidated group (or loss subgroup) (temporary).

(a) *In general*—(1) *Consolidated group.* This section provides rules for applying section 382 on or after the day that a member ceases to be a member of a consolidated group (or loss subgroup). The rules concern how to determine whether an ownership change occurs with respect to losses of the member, and how a consolidated section 382 limitation (or subgroup section 382 limitation) is apportioned to the member. As the context requires, a reference in this section to a loss group, a member, or a corporation also includes a reference to a loss subgroup, and a reference to a consolidated section 382 limitation also includes a reference to a subgroup section 382 limitation.

(2) *Election by common parent.* Only the common parent (not the loss subgroup parent) may make the election under paragraph (c) of this section to apportion either a consolidated section 382 limitation or a subgroup section 382 limitation.

(3) *Coordination with §§ 1.1502–91T through 1.1502–93T.* For rules regarding the determination of whether there is an ownership change of a loss subgroup and the computation of a subgroup section 382 limitation following such an ownership change, see §§ 1.1502–91T through 1.1502–93T.

(b) *Separate application of section 382 when a member leaves a consolidated group*—(1) *In general.* Except as provided in §§ 1.1502–91T through 1.1502–93T (relating to rules applicable to loss groups and loss subgroups), section 382 and the regulations thereunder apply to a corporation on a separate entity basis after it ceases to be a member of a consolidated group (or loss subgroup). Solely for purposes of determining whether a corporation has an ownership change—

(i) Any portion of a consolidated net operating loss that is apportioned to the corporation under §1.1502–21T(b) is treated as a net operating loss of the corporation beginning on the first day of the taxable year in which the loss arose;

(ii) The testing period may include the period during which (or before which) the corporation was a member of the group (or loss subgroup); and

(iii) Except to the extent provided in §1.1502–20(g) (relating to reattributed losses), the day it ceases to be a member of a consolidated group is treated as a testing date of the corporation within the meaning of §1.382–2(a)(4).

(2) *Effect of a prior ownership change of the group.* If a loss group has had an ownership change under §1.1502–92T before a corporation ceases to be a member of a consolidated group (the former member)—

(i) Any pre-change consolidated attribute that is subject to a consolidated section 382 limitation continues to be treated as a pre-change loss with respect to the former member after the attribute is apportioned to the former member;

(ii) The former member's section 382 limitation with respect to such attribute is zero except to the extent the common parent apportions under paragraph (c) of this section all or a part of the consolidated section 382 limitation to the former member;

(iii) The testing period for determining a subsequent ownership change with respect to such attribute begins no earlier than the first day following the loss group's most recent change date; and

(iv) As generally provided under section 382, an ownership change of the former member that occurs on or after the day it ceases to be a member of a loss group may result in an additional, lesser limitation amount with respect to such loss.

(3) *Application in the case of a loss subgroup.* If two or more former members are included in the same loss subgroup immediately after they cease to be members of a consolidated group, the principles of paragraphs (b) and (c) of this section apply to the loss subgroup. Therefore, for example, an apportionment by the common parent under paragraph (c) of this section is made to the loss subgroup rather than separately to its members. –

(4) *Examples.* The following examples illustrate the principles of this paragraph (b).

Example 1. Treatment of departing member as a separate corporation throughout the testing period. (a) A owns all the L stock. L owns all the stock of L1 and L2. The L group has a consolidated net operating loss arising in Year 1 that is carried over to Year 3. On January 12, Year 2, A sells 30 percent of the L stock to B. On February 7, Year 3, L sells 40 percent of the L2 stock to C, and L2 ceases to be a member of the group. A portion of the Year 1 consolidated net operating loss is apportioned to L2 under §1.1502–21T(b) and is carried to L2's first separate return year, which ends December 31, Year 3. The following is a graphic illustration of these facts:

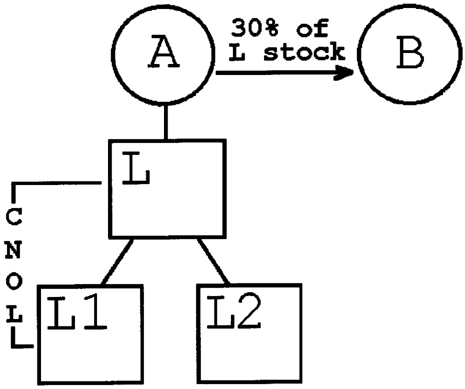
A
30% of
L stock
B
L
CNOL
L1
L2

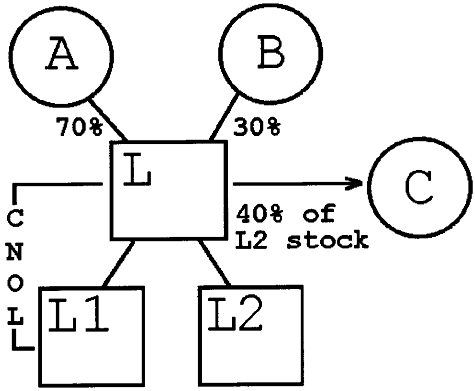
A
B
70%
30%
L
C
40% of
L2 stock
CNOL
L1
L2

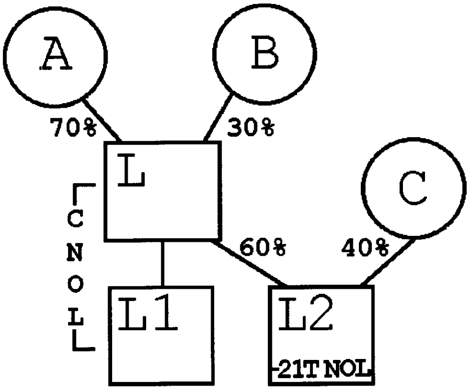
A
B
70%
30%
L
C
CNOL
60%
40%
L1
L2
-21T NOL

(b) Under paragraph (b)(1) of this section, L2 is a loss corporation on February 7, Year 3. Under paragraph (b)(1)(iii) of this section, February 7, Year 3, is a testing date. Under paragraph (b)(1)(ii) of this section, the testing period for L2 with respect to this testing date commences on January 1, Year 1, the first day of the taxable year in which the portion of the consolidated net operating loss apportioned to L2 arose. Therefore, in determining whether L2 has an ownership change on February 7, Year 3, B's purchase of 30 percent of the L stock and C's purchase of 40 percent of the L2 stock are each owner shifts. L2 has an ownership change under section 382(g) and §1.382–2T because B and C have increased their ownership interests in L2 by 18 and 40 percentage points, respectively, during the testing period.

Example 2. Effect of prior ownership change of loss group. (a) L owns all the L1 stock and L1 owns all the L2 stock. The L loss group had an ownership change under §1.1502–92T in Year 2 with respect to a consolidated net operating loss arising in Year 1 and carried over to Year 2 and Year 3. The consolidated section 382 limitation computed solely on the basis of the value of the stock of L is $100. On December 31, Year 2, L1 sells 25 percent of the stock of L2 to B. L2 is apportioned a portion of the Year 1 consolidated net operating loss which it carries over to its first separate return year ending after December 31, Year 2. L2's separate section 382 limitation with respect to this loss is zero unless L elects to apportion all or a part of the consolidated section 382 limitation to L2. (See paragraph (c) of this section for rules regarding the apportionment of a consolidated section 382 limitation.) L apportions $50 of the consolidated section 382 limitation to L2.

(b) On December 31, Year 3, L1 sells its remaining 75 percent stock interest in L2 to C, resulting in an ownership change of L2. L2's section 382 limitation computed on the change date with respect to the value of its stock is $30. Accordingly, L2's section 382 limitation for post-change years ending after December 31, Year 3, with respect to its prechange losses, including the consolidated net operating losses apportioned to it from the L group, is $30, adjusted as required by section 382 and the regulations thereunder.

(c) *Apportionment of a consolidated section 382 limitation*—(1) *In general.* The common parent may elect to apportion all or any part of a consolidated section 382 limitation to a former member (or loss subgroup). See paragraph (e) of this section for the time and manner of making the election to apportion.

(2) *Amount of apportionment.* The common parent may apportion all or part of each element of the consolidated section 382 limitation determined under §1.1502–93T. For this purpose, the consolidated section 382 limitation consists of two elements—

(i) The value element, which is the element of the limitation determined under section 382(b)(1) (relating to value multiplied by the long-term tax-exempt rate) without regard to such adjustments as those described in section 382(b)(2) (relating to the carryforward of unused section 382 limitation), section 382(b)(3)(B) (relating to the section 382 limitation for the post-change year that includes the change date), section 382(h) (relating to built-in gains and section 338 gains), and section 382(m)(2) (relating to short taxable years); and

(ii) The adjustment element, which is so much (if any) of the limitation for the taxable year during which the former member ceases to be a member of the consolidated group that is attributable to a carryover of unused limitation under section 382(b)(2) or to recognized built-in gains under 382(h).

(3) *Effect of apportionment on the consolidated section 382 limitation.* The value element of the consolidated section 382 limitation for any post-change year ending after the day that a former member (or loss subgroup) ceases to be a member(s) is reduced to the extent that it is apportioned under this paragraph (c). The consolidated section 382 limitation for the post-change year in which the former member (or loss subgroup) ceases to be a member(s) is also reduced to the extent that the adjustment element for that year is apportioned under this paragraph (c).

(4) *Effect on corporations to which the consolidated section 382 limitation is apportioned.* The amount of the value element that is apportioned to a former member (or loss subgroup) is treated as the amount determined under section 382(b)(1) for purposes of determining the amount of that corporation's (or loss subgroup's) section 382 limitation for any taxable year ending after the former member (or loss subgroup) ceases to be a member(s). Appropriate adjustments must be made to the limitation based on the value element so apportioned for a short taxable year, carryforward of unused limitation, or any other adjustment required under section 382. The adjustment element apportioned to a former member (or loss subgroup) is treated as an adjustment under section 382(b)(2) or section

382(h), as appropriate, for the first taxable year after the member (or members) ceases to be a member (or members).

(5) *Deemed apportionment when loss group terminates.* If a loss group terminates, to the extent the consolidated section 382 limitation is not apportioned under paragraph (c)(1) of this section, the consolidated section 382 limitation is deemed to be apportioned to the loss subgroup that includes the common parent, or, if there is no loss subgroup that includes the common parent immediately after the loss group terminates, to the common parent. A loss group terminates on the first day of the first taxable year that is a separate return year with respect to each member of the former loss group.

(6) *Appropriate adjustments when former member leaves during the year.* Appropriate adjustments are made to the consolidated section 382 limitation for the consolidated return year during which the former member (or loss subgroup) ceases to be a member(s) to reflect the inclusion of the former member in the loss group for a portion of that year.

(7) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. Consequence of apportionment. (a) L owns all the L1 stock and L1 owns all the L2 stock. The L group has a $200 consolidated net operating loss arising in Year 1 that is carried over to Year 2. At the close of December 31, Year 1, the group has an ownership change under § 1.1502–92T. The ownership change results in a consolidated section 382 limitation of $10 based on the value of the stock of the group. On August 29, Year 2, L1 sells 30 percent of the stock of L2 to A. L2 is apportioned $90 of the group's $200 consolidated net operating loss under § 1.1502–21T(b). L, the common parent, elects to apportion $6 of the consolidated section 382 limitation to L2. The following is a graphic illustration of these facts:

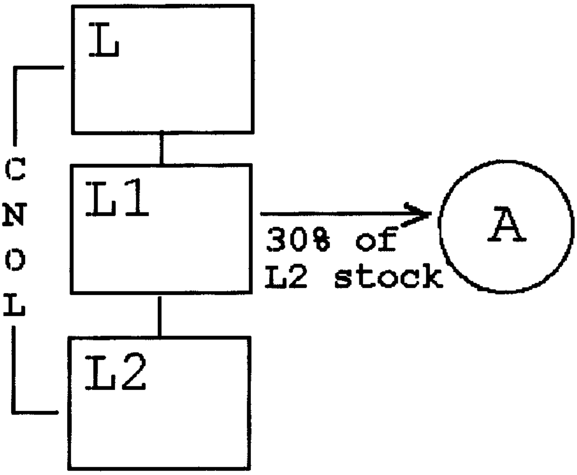

(b) For its separate return years ending after August 29, Year 2 (other than the taxable year ending December 31, Year 2), L2's section 382 limitation with respect to the $90 of the group's net operating loss apportioned to it is $6, adjusted, as appropriate, for any short taxable year, unused section 382 limitation, or other adjustment. For its consolidated return years ending after August 29, Year 2, (other than the year ending December 31, Year 2) the L group's consolidated section 382 limitation with respect to the remaining $110 of pre-change consolidated attribute is $4 ($10 minus the $6 value element apportioned to L2), adjusted, as appropriate, for any short taxable year, unused section 382 limitation, or other adjustment.

(c) For the L group's consolidated return year ending December 31, Year 2, the value element of its consolidated section 382 limitation is increased by $4 (rounded to the nearest dollar), to account for the period during which L2 was a member of the L group ($6, the consolidated section 382 limitation apportioned to L2, times 241/365, the ratio of the number of days during Year 2 that L2 is a member of the group to the number of days in the group's consolidated return year). See paragraph (c)(6) of this section. Therefore, the value element of the consolidated section 382 limitation for Year 2 of the L group is $8 (rounded to the nearest dollar).

(d) The section 382 limitation for L2's short taxable year ending December 31, Year 2, is $2 (rounded to the nearest dollar), which is the amount that bears the same relationship to $6, the value element of the consolidated section 382 limitation apportioned to L2, as the number of days during that short taxable year, 124 days, bears to 365. See §1.382–4(c).

Example 2. Consequence of no apportionment. The facts are the same as in *Example 1,* except that L does not elect to apportion any portion of the consolidated section 382 limitation to L2. For its separate return years ending after August 29, Year 2, L2's section 382 limitation with respect to the $90 of the group's pre-change consolidated attribute apportioned to L2 is zero under paragraph (b)(2)(ii) of this section. Thus, the $90 consolidated net operating loss apportioned to L2 cannot offset L2's taxable income in any of its separate return years ending after August 29, Year 2. For its consolidated return years ending after August 29, Year 2, the L group's consolidated section 382 limitation with respect to the remaining $110 of pre-change consolidated attribute is $10, adjusted, as appropriate, for any short taxable year, unused section 382 limitation, or other adjustment.

Example 3. Apportionment of adjustment element. The facts are the same as in *Example 1,* except that L2 ceases to be a member of the L group on August 29, Year 3, and the L group has a $4 carryforward of an unused consolidated section 382 limitation (under section 382(b)(2)) to the 1993 consolidated return year.

The carryover of unused limitation increases the consolidated section 382 limitation for the Year 3 consolidated return year from $10 to $14. L may elect to apportion all or any portion of the $10 value element and all or any portion of the $4 adjustment element to L2.

(d) *Rules pertaining to ceasing to be a member of a loss subgroup*—(1) *In general.* A corporation ceases to be a member of a loss subgroup—

(i) On the first day of the first taxable year for which it files a separate return; or

(ii) The first day that it ceases to bear a relationship described in section 1504(a)(1) to the loss subgroup parent (treating for this purpose the loss subgroup parent as the common parent described in section 1504(a)(1)(A)).

(2) *Examples.* The principles of this paragraph (d) are illustrated by the following examples.

Example 1. Basic case. (a) P owns all the L stock, L owns all the L1 stock and L1 owns all the L2 stock. The P group has a consolidated net operating loss arising in Year 1 that is carried over to Year 2. On December 11, Year 2, P sells all the stock of L to corporation M. Each of L, L1, and L2 is apportioned a portion of the Year 1 consolidated net operating loss, and thereafter each joins with M in filing consolidated returns. Under §1.1502–92T, the L loss subgroup has an ownership change on December 11, Year 2. The L loss subgroup has a subgroup section 382 limitation of $100. The following is a graphic illustration of these facts:

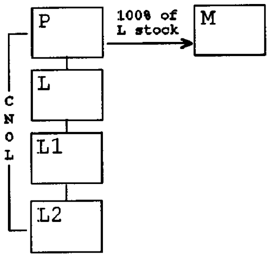
P
100% of
L stock
M
L
L1
L2
C
N
O
L

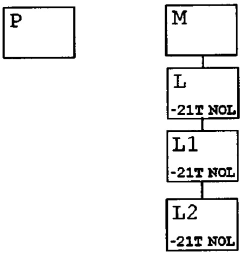
P
M
L
-21T NOL
L1
-21T NOL
L2
-21T NOL

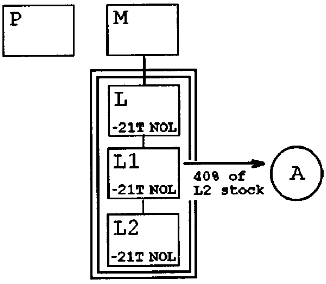
P
M
L
-21T NOL
L1
-21T NOL
40% of
L2 stock
A
L2
-21T NOL

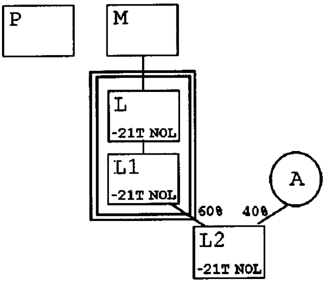
P
M
L
-21T NOL
L1
-21T NOL
60%
40%
A
L2
-21T NOL

(b) On May 22, Year 3, L1 sells 40 percent of the L2 stock to A. L2 carries over a portion of the P group's net operating loss from Year 1 to its separate return year ending December 31, Year 3. Under paragraph (d)(1) of this section, L2 ceases to be a member of the L loss subgroup on May 22, Year 3, which is both (1) the first day of the first taxable year for which it files a separate return and (2) the day it ceases to bear a relationship described in section 1504(a)(1) to the loss subgroup parent, L. The net operating loss of L2 that is carried over from the P group is treated as a pre-change loss of L2 for its separate return years ending after May 22, Year 3. Under paragraphs (a)(2) and (b)(2) of this section, the separate section 382 limitation with respect to this loss is zero unless M elects to apportion all or a part of the subgroup section 382 limitation of the L loss subgroup to L2.

Example 2. Formation of a new loss subgroup. The facts are the same as in *Example 1*, except that A purchases 40 percent of the L1 stock from L rather than purchasing L2 stock from L1. L1 and L2 file a consolidated return for their first taxable year ending after May 22, Year 3, and each of L1 and L2 carries over a part of the net operating loss of the P group that arose in Year 1. Under paragraph (d)(1) of this section, L1 and L2 cease to be members of the L loss subgroup on May 22, Year 3. The net operating losses carried over from the P group are treated as pre-change subgroup attributes of the loss subgroup composed of L1 and L2. The subgroup section 382 limitation with respect to those losses is zero unless M elects to apportion all or part of the subgroup section 382 limitation of the L loss subgroup to the L1 loss subgroup. The following is a graphic illustration of these facts:

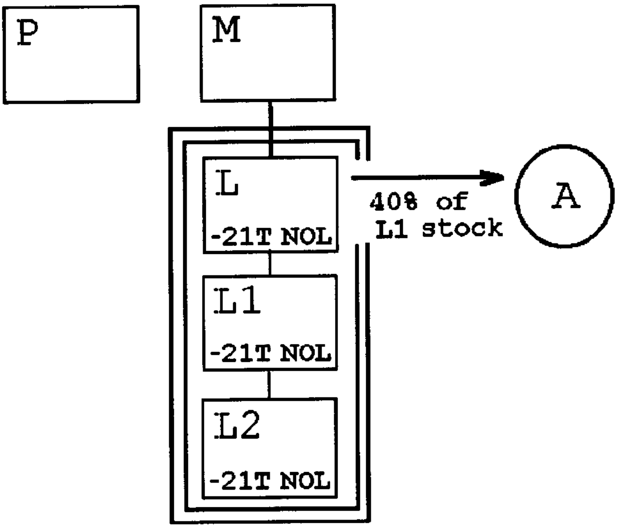
P
M
L
-21T NOL
L1
-21T NOL
L2
-21T NOL
40% of
L1 stock
A

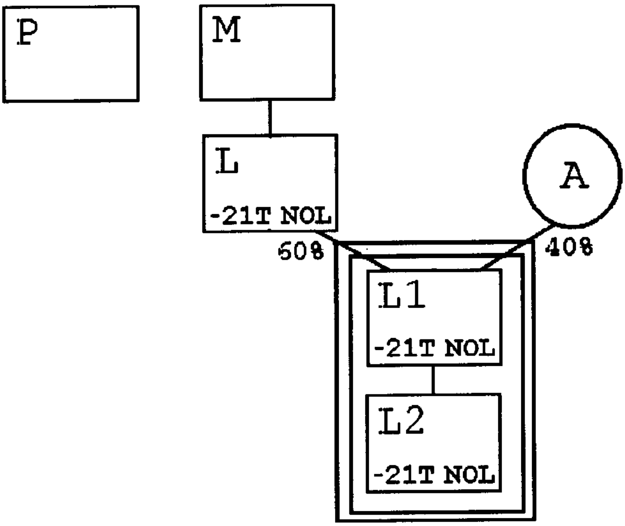
P
M
L
-21T NOL
A
60%
40%
L1
-21T NOL
L2
-21T NOL

Example 3. Ceasing to bear a section 1504(a)(1) relationship to a loss subgroup parent. (a) A owns all the stock of P, and P owns all the stock of L1 and L2. The P group has a consolidated net operating loss arising in Year 1 that is carried over to Year 3 and Year 4. Corporation M acquires all the stock of P on November 11, Year 3, and P, L1, and L2 thereafter file consolidated returns with M. M's acquisition results in an ownership change of the P loss subgroup under § 1.1502–92T(b)(1)(ii). The following is a graphic illustration of these facts:

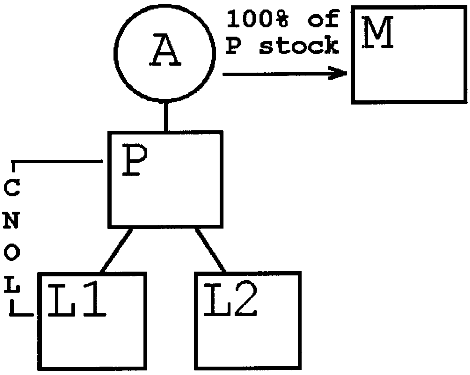
A
100% of
P stock
M
P
C
N
O
L
L1
L2

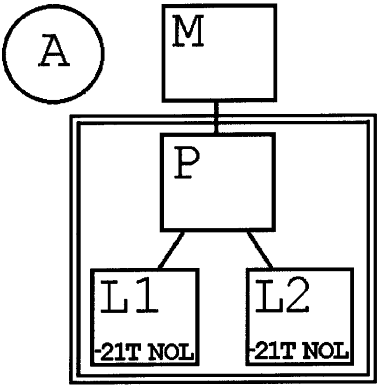
A
M
P
L1
-21T NOL
L2
-21T NOL

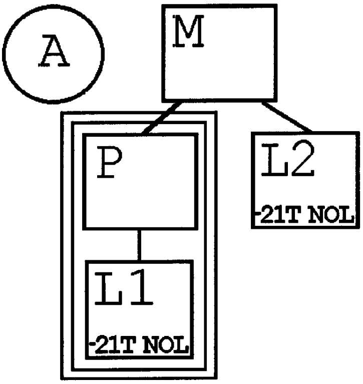
A
M
P
L1
-21T NOL
L2
-21T NOL

(b) P distributes the L2 stock to M on October 7, Year 4. L2 ceases to be a member of the P loss subgroup on October 7, Year 4, the first day that it ceases to bear the relationship described in section 1504(a)(1) to P, the P loss subgroup parent. See paragraph (d)(1)(ii) of this section. Thus, the section 382 limitation with respect to the pre-change subgroup attributes attributable to L2 is zero except to the extent M elects to apportion all or a part of the subgroup section 382 limitation of the P loss subgroup to L2.

Example 4. Relationship through a successor. The facts are the same as in *Example 3*, except that, instead of P's distributing the stock of L2, L2 merges into L1 on October 7, Year 4. L1 (as successor to L2 in the merger within the meaning of § 1.382–2T(f)(4)) continues to bear a relationship described in section 1504(a)(1) to P, the loss subgroup parent. Thus, L2 does not cease to be a member of the P loss subgroup as a result of the merger.

(e) *Filing the election to apportion*—(1) *Form of the election to apportion.* An election under paragraph (c) of this section must be made by the common parent. The election must be made in the form of the following statement: "THIS IS AN ELECTION UNDER § 1.1502–95T OF THE INCOME TAX REGULATIONS TO APPORTION ALL OR PART OF THE [insert either CONSOLIDATED SECTION 382 LIMITATION or SUBGROUP SECTION 382 LIMITATION, as appropriate] TO [insert name and E.I.N. of the corporation (or the corporations that compose a new loss subgroup) to which allocation is made]. The declaration must also include the following information, as appropriate—

(i) The date of the ownership change that resulted in the consolidated section 382 limitation (or subgroup section 382 limitation);

(ii) The amount of the consolidated section 382 limitation (or subgroup section 382 limitation) for the taxable year during which the former member (or new loss subgroup) ceases to be a member of the consolidated group (determined without regard to any apportionment under this section;

(iii) The amount of the value element and adjustment element of the consolidated section 382 limitation (or subgroup section 382 limitation) that is apportioned to the former member (or new loss subgroup) pursuant to paragraph (c) of this section; and

(iv) The name and E.I.N. of the common parent making the apportionment.

(2) *Signing of the election.* The election statement must be signed by both the common parent and the former member (or, in the case of a loss subgroup, the common parent and the loss subgroup parent) by persons authorized to sign their respective income tax returns.

(3) *Filing of the election.* The election statement must be filed by the common parent of the group that is apportioning the consolidated section 382 limitation (or the subgroup section 382 limitation) with its income tax return for the taxable year in which the former member (or new loss subgroup) ceases to be a member. The common parent must also deliver a copy of the statement to the former member (or the members of the new loss subgroup) on or before the day the group files its income tax return for the consolidated return year that the former member (or new loss subgroup) ceases to be a member. A copy of the statement must be attached to the first return of the former member (or the first return in which the members of a new loss subgroup join) that is filed after the close of the consolidated return year of the group of which the former member (or the members of a new loss subgroup) ceases to be a member.

(4) *Revocation of election.* An election statement made under paragraph (c) of this section is revocable only with the consent of the Commissioner.

[T.D. 8678, 61 FR 33355, June 27, 1996]

§ 1.1502–96T Miscellaneous rules (temporary).

(a) *End of separate tracking of losses*—(1) *Application.* This paragraph (a) applies to a member (or a loss subgroup) with a net operating loss carryover that arose (or is treated under § 1.1502–21T(c) as arising) in a SRLY (or a net unrealized built-in gain or loss determined at the time that the member (or loss subgroup) becomes a member of the consolidated group if there is—

(i) An ownership change of the member (or loss subgroup in connection with, or after, becoming a member of the group; or

(ii) A period of 5 consecutive years following the day that the member (or loss subgroup) becomes a member of a group during which the member (or loss subgroup) has not had an ownership change.

(2) *Effect of end of separate tracking.* If this paragraph (a) applies with respect

to a member (or loss subgroup), then, starting on the day after the earlier of the change date (but not earlier than the day the member (or loss subgroup) becomes a member of the consolidated group) or the last day of the 5 consecutive year period described in paragraph (a)(1)(ii) of this section, the member's net operating loss carryover that arose (or is treated under §1.1502–21T(c) as arising) in a SRLY, is treated as described in §1.1502–91T(c)(1)(i). Also, the member's separately computed net unrealized built-in gain or loss is included in the determination whether the group has a net unrealized built-in gain or loss. The preceding sentences also apply for purposes of determining whether there is an ownership change with respect to such attributes following such change date (or earlier day) or 5 consecutive year period. Thus, for example, starting the day after the change date or the end of the 5 consecutive year period—

(i) The consolidated group which includes the new loss member or loss subgroup is no longer required to separately track owner shifts of the stock of the new loss member or loss subgroup parent to determine if an ownership change occurs with respect to the attributes of the new loss member or members included in the loss subgroup;

(ii) The group includes the member's attributes in determining whether it is a loss group under §1.1502–91T(c);

(iii) There is an ownership change with respect to such attributes only if the group is a loss group and has an ownership change; and

(iv) If the group has an ownership change, such attributes are pre-change consolidated attributes subject to the loss group's consolidated section 382 limitation.

(3) *Continuing effect of end of separate tracking.* As the context may require, a current group determines which of its members are included in a loss subgroup on any testing date by taking into account the application of this section in the former group. See the example in §1.1502–91T(f)(2).

(4) *Special rule for testing period.* For purposes of determining the beginning of the testing period for a loss group, the member's (or loss subgroup's) net operating loss carryovers (or net unrealized built-in gain or loss) described in paragraph (a)(2) of this section are considered to arise—

–(i) in a case described in paragraph (a)(1)(i) of this section, in a taxable year that begins not earlier than the later of the day following the change date or the day that the member becomes a member of the group; and –(ii) in a case described in paragraph (a)(1)(ii) of this section, in a taxable year that begins 3 years before the end of the 5 consecutive year period.

(5) *Limits on effects of end of separate tracking.* The rule contained in this paragraph (a) applies solely for purposes of §§1.1502–91T through 1.1502–95T and this section (other than paragraph (b)(2)(ii)(B) of this section (relating to the definition of pre-change attributes of a subsidiary)) and §1.1502–98T, and not for purposes of other provisions of the consolidated return regulations, including, for example, §§1.1502–15T and 1.1502–21T (relating to the consolidated net operating loss deduction). See also paragraph (c) of this section for the continuing effect of an ownership change with respect to pre-change attributes.

(b) *Ownership change of subsidiary*—(1) *Ownership change of a subsidiary because of options or plan or arrangement.* Notwithstanding §1.1502–92T, a subsidiary may have an ownership change for purposes of section 382 with respect to its attributes which a group or loss subgroup includes in making a determination under §1.1502–91T(c)(1) (relating to the definition of loss group) or §1.1502–91T(d) (relating to the definition of loss subgroup). The subsidiary has such an ownership change if it has an ownership change under the principles of §1.1502–95T(b) and section 382 and the regulations thereunder (determined on a separate entity basis by treating the subsidiary as not being a member of a consolidated group) in the event of—

(i) The deemed exercise under §1.382–4(d) of an option or options (other than an option with respect to stock of the common parent) held by a person (or persons acting pursuant to a plan or arrangement) to acquire more than 20 percent of the stock of the subsidiary; or

(ii) An increase by 1 or more 5-percent shareholders, acting pursuant to a plan or arrangement to avoid an ownership change of a subsidiary, in their percentage ownership interest in the subsidiary by more than 50 percentage points during the testing period of the subsidiary through the acquisition (or deemed acquisition pursuant to § 1.382–4(d)) of ownership interests in the subsidiary and in higher-tier members with respect to the subsidiary.

(2) *Effect of the ownership change*—(i) *In general.* If a subsidiary has an ownership change under paragraph (b)(1) of this section, the amount of consolidated taxable income for any post-change year that may be offset by the pre-change losses of the subsidiary shall not exceed the section 382 limitation for the subsidiary. For purposes of this limitation, the value of the subsidiary is determined solely by reference to the value of the subsidiary's stock.

(ii) *Pre-change losses.* The pre-change losses of a subsidiary are—

(A) Its allocable part of any consolidated net operating loss which is attributable to it under § 1.1502–21T(b) (determined on the last day of the consolidated return year that includes the change date) that is not carried back and absorbed in a taxable year prior to the year including the change date;

(B) Its net operating loss carryovers that arose (or are treated under § 1.1502–21T(c) as having arisen) in a SRLY; and

(C) Its recognized built-in loss with respect to its separately computed net unrealized built-in loss, if any, determined on the change date.

(3) *Coordination with §§ 1.1502–91T, 1.1502–92T, and 1.1502–94T.* If an increase in percentage ownership interest causes an ownership change with respect to an attribute under this paragraph (b) and under § 1.1502–92T on the same day, the ownership change is considered to occur only under § 1.1502–92T and not under this paragraph (b). See § 1.1502–94T for anti-duplication rules relating to value.

(4) *Example.* The following example illustrates paragraph (b)(1)(ii) of this section.

Example. Plan to avoid an ownership change of a subsidiary. (a) L owns all the stock of L1, L1 owns all the stock of L2, L2 owns all the stock of L3, and L3 owns all the stock of L4. The L group has a consolidated net operating loss arising in Year 1 that is carried over to Year 2. L has assets other than its L1 stock with a value of $900. L1, L2, and L3 own no assets other than their L2, L3, and L4 stock. L4 has assets with a value of $100. During Year 2, A, B, C, and D, acting pursuant to a plan to avoid an ownership change of L4, acquire the following ownership interests in the members of the L loss group: (A) on September 11, Year 2, A acquires 20 percent of the L1 stock from L and B acquires 20 percent of the L2 stock from L1; and (B) on September 20, Year 2, C acquires 20 percent of the stock of L3 from L2 and D acquires 20 percent of the stock of L4 from L3. The following is a graphic illustration of these facts:

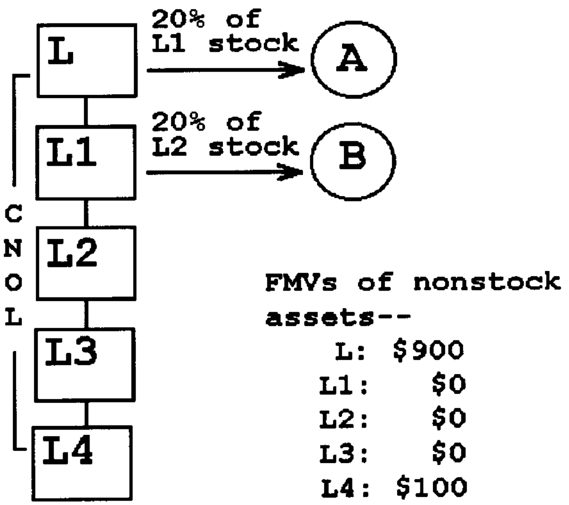
L
L1
L2
L3
L4
CNOL
20% of L1 stock
20% of L2 stock
A
B
FMVs of nonstock assets--
L: $900
L1: $0
L2: $0
L3: $0
L4: $100

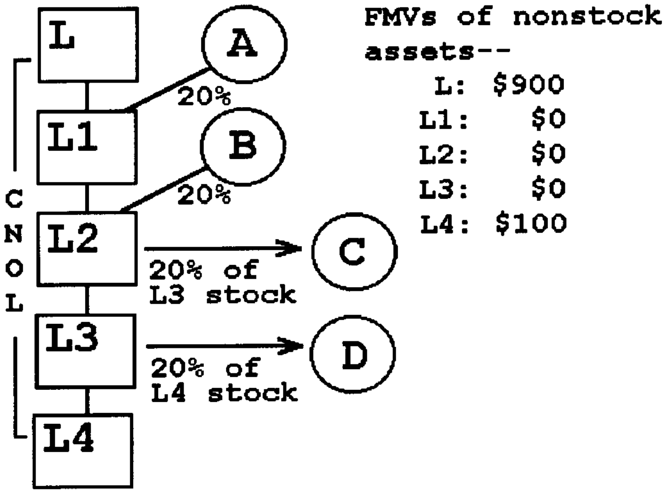
L
L1
L2
L3
L4
CNOL
A
B
20%
20%
20% of L3 stock
20% of L4 stock
C
D
FMVs of nonstock assets--
L: $900
L1: $0
L2: $0
L3: $0
L4: $100

(b) The acquisitions by A, B, C, and D pursuant to the plan have increased their respective percentage ownership interests in L4 by approximately 10, 13, 16, and 20 percentage points, for a total of approximately 59 percentage points during the testing period. This more than 50 percentage point increase in the percentage ownership interest in L4 causes an ownership change of L4 under paragraph (b)(2) of this section.

(c) *Continuing effect of an ownership change.* A loss corporation (or loss subgroup) that is subject to a limitation under section 382 with respect to its pre-change losses continues to be subject to the limitation regardless of whether it becomes a member or ceases to be a member of a consolidated group. See § 1.382–5T(d) (relating to successive ownership changes and absorption of a section 382 limitation).

[T.D. 8678, 61 FR 33362, June 27, 1996]

§ 1.1502–97T Special rules under section 382 for members under the jurisdiction of a court in a title 11 or similar case (temporary). [Reserved]

[T.D. 8678, 61 FR 33364, June 27, 1996]

§ 1.1502–98T Coordination with section 383 (temporary).

The rules contained in §§ 1.1502–91T through 1.1502–96T also apply for purposes of section 383, with appropriate adjustments to reflect that section 383 applies to credits and net capital losses. Similarly, in the case of net capital losses, general business credits, and excess foreign taxes that are pre-change attributes, § 1.383–1 applies the principles of §§ 1.1502–91T through 1.1502–96T. For example, if a loss group has an ownership change under § 1.1502–92T and has a carryover of unused general business credits from a pre-change consolidated return year to a post-change consolidated return year, the amount of the group's regular tax liability for the post-change year that can be offset by the carryover cannot exceed the consolidated section 383 credit limitation for that post-change year, determined by applying the principles of §§ 1.383–1(c)(6) and 1.1502–93T (relating to the computation of the consolidated section 382 limitation).

[T.D. 8678, 61 FR 33364, June 27, 1996]

§ 1.1502–99T Effective dates (temporary).

(a) *Effective date.* Sections 1.1502–91T through 1.1502–96T and 1.1502–98T apply to any testing date on or after January 1, 1997. Sections 1.1502–94T through 1.1502–96T also apply on any date on or after January 1, 1997, on which a corporation becomes a member of a group or on which a corporation ceases to be a member of a loss group (or a loss subgroup).

(b) *Testing period may include a period beginning before January 1, 1997.* A testing period for purposes of §§ 1.1502–91T through 1.1502–96T and 1.1502–98T may include a period beginning before January 1, 1997. Thus, for example, in applying § 1.1502–92T(b)(1)(i) (relating to the determination of an ownership change of a loss group), the determination of the lowest percentage ownership interest of any 5-percent shareholder of the common parent during a testing period ending on a testing date occurring on or after January 1, 1997, takes into account the period beginning before January 1, 1997, except to the extent that the period is more than 3 years before the testing date or is otherwise before the beginning of the testing period. See § 1.1502–92T(b)(1).

(c) *Transition rules*—(1) *Methods permitted*—(i) *In general.* For the period ending before January 1, 1997, a consolidated group is permitted to use any method described in paragraph (c)(2) of this section which is consistently applied to determine if an ownership change occurred with respect to a consolidated net operating loss, a net operating loss carryover (including net operating loss carryovers arising in SRLYs), or a net unrealized built-in loss. If an ownership change occurred during that period, the group is also permitted to use any method described in paragraph (c)(2) of this section which is consistently applied to compute the amount of the section 382 limitation that applies to limit the use of taxable income in any post-change year ending before, on, or after January 1, 1997. The preceding sentence does not preclude the imposition of an additional, lesser limitation due to a subsequent ownership change nor, except as provided in paragraph (c)(1)(iii) of this section, does it permit the beginning of a new testing period for the loss group.

(ii) *Adjustments to offset excess limitation.* If an ownership change occurred during the period ending before January 1, 1997, and a method described in paragraph (c)(2) of this section was not used for a post-change year, the members (or group) must reduce the section 382 limitation for post-change years for which an income tax return is filed after January 1, 1997, to offset, as quickly as possible, the effects of any section 382 limitation that members took into account in excess of the amount that would have been allowable under §§1.1502–91T through 1.1502–96T and 1.1502–98T.

(iii) *Coordination with effective date.* Notwithstanding that a group may have used a method described in paragraph (c)(2)(ii) or (iii) of this section for the period before January 1, 1997, §§1.1502–91T through 1.1502–96T and 1.1502–98T apply to any testing date occurring on or after January 1, 1997, for purposes of determining whether there is an ownership change with respect to any losses and, if so, the collateral consequences. Any ownership change of a member other than the common parent pursuant to a method described in paragraph (c)(2)(ii) or (iii) of this section does not cause a new testing period of the loss group to begin for purposes of applying §1.1502–92T on or after January 1, 1997.

(2) *Permitted methods.* The methods described in this paragraph (c)(2) are:

(i) A method that does not materially differ from the rules in §§1.1502–91T through 1.1502–96T and 1.1502–98T (other than those in §1.1502–95T(c) (relating to the apportionment of a section 382 limitation) as they would apply to a corporation that ceases to be a member of the group before January 1, 1997). As the context requires, the method must treat references to rules in current regulations as references to rules in regulations generally effective for taxable years before January 1, 1997. Thus, for example, the taxpayer must treat a reference to §1.382–4(d) (relating to options) as a reference to §1.382–2T(h)(4) for any testing date to which §1.382–2T(h)(4) applies. Similarly, a reference to §1.1502–21T(c) may be a reference to §1.1502–21A(c), as appropriate. Furthermore, the method must treat all corporations that were affiliated on January 1, 1987, and continuously thereafter as having met the 5 consecutive year requirement of §1.1502–91T(d)(2)(i) on any day before January 1, 1992, on which the determination of net unrealized built-in gain or loss of a loss subgroup is made;

(ii) A reasonable application of the rules in section 382 and the regulations thereunder applied to each member on a separate entity basis, treating each member's allocable part of a consolidated net operating loss which is attributable to it under §1.1502–21T(b) as a net operating loss of that member and applying rules similar to §1.382–8T to avoid duplication of value in computing the section 382 limitation for the member (see §1.382–8T(h) (relating to the effective date and transition rules regarding controlled groups)); or

(iii) A method approved by the Commissioner upon application by the common parent.

(d) *Amended returns.* A group may file an amended return in connection with an ownership change occurring before January 1, 1997, to modify the amount of a section 382 limitation with respect to a consolidated net operating loss, a net operating loss carryover (including net operating loss carryovers arising in SRLYs), or a recognized built-in loss (or gain) only if it files amended returns:

(1) For the earliest taxable year ending after December 31, 1986, in which it had an ownership change, if any, under §1.1502–92T;

(2) For all subsequent taxable years for which returns have already been filed as of the date of the amended return;

(3) The modification with respect to all members for all taxable years ending in 1987 and thereafter complies with §§1.1502–91T through 1.1502–96T and 1.1502–98T; and

(4) The amended return(s) permitted by the applicable statute of limitations is/are filed before March 26, 1997.

(e) *Section 383.* This section also applies for the purposes of section 383, with appropriate adjustments to reflect that section 383 applies to credits and net capital losses.

[T.D. 8678, 61 FR 33364, June 27, 1996]

§1.1502–100 Corporations exempt from tax.

(a) *In general*—(1) *Computation of tax liability.* The tax liability for a consolidated return year of a group of two or more corporations described in section 1504(e) which are exempt from taxation under section 501 (hereinafter referred to in this section as ‘‘exempt group’’) shall be determined on a consolidated basis by applying the provisions of subchapter F of chapter 1 of the code in the manner provided in this section. See section 1504(e) for tax-exempt corporations eligible to file a consolidated return.

(2) *Applicability of other consolidated return provisions.* The provisions of § 1.1502–1 through § 1.1502–80 shall be applicable to an exempt group to the extent they are not inconsistent with the provisions of this section or the provisions of subchapter F of chapter 1 of the Code. For purposes of applying the provisions of § 1.1502–1 through § 1.1502–80 to an exempt group, the following substitutions shall be made:

(i) The term ‘‘exempt group’’ shall be substituted for the term ‘‘group’’,

(ii) The terms ‘‘unrelated business taxable income’’, ‘‘separate unrelated business taxable income’’, and ‘‘consolidated unrelated business taxable income’’ shall be substituted for the terms ‘‘taxable income’’, ‘‘separate taxable income’’, and ‘‘consolidated taxable income’’, and

(iii) The term ‘‘consolidated liability for tax determined under § 1.1502–2’’ (or an equivalent term) shall mean the consolidated liability for tax of an exempt group determined under paragraph (b) of this section.

(b) *Consolidated liability for tax.* The tax liability for a consolidated return year of an exempt group is the tax imposed by section 511(a) or section 1201(a) on the consolidated unrelated business taxable income for the year (determined under paragraph (c) of this section), and by allowing the credits and surtax exemption provided in § 1.1502–2.

(c) *Consolidated unrelated business taxable income.* The consolidated unrelated business taxable income for a consolidated return year shall be determined by taking into account:

(1) The separate unrelated business taxable income of each member of the exempt group (determined under paragraph (d) of this section);

(2) Any consolidated net operating loss deduction (determined under §§ 1.1502–21A or 1.1502–21T (as appropriate) subject to the limitations provided in section 512(b)(6);

(3) Any consolidated charitable contribution deduction (determined under § 1.1502–24) subject to the limitations provided in section 512(b)(10); and

(4) Any consolidated net gain or net loss from the disposition of debt-financed property (as defined in section 514(b)) taken into account as provided by section 514(a), or from the cutting of timber to which section 631 applies.

(d) *Separate unrelated business taxable income.* The separate unrelated business taxable income of a member of an exempt group shall be computed in accordance with the provisions of section 512 covering the determination of unrelated business taxable income of separate corporations, except that:

(1) The provisions of paragraphs (a) through (k) and (o) of § 1.1502–12 shall apply; and

(2) No charitable contributions deduction shall be taken into account under section 512(b)(10).

See sections 511(c) and 512(a)(3)(C) for special rules applicable to organizations described in section 501(c)(2).

[T.D. 7595, 44 FR 10382, Feb. 20, 1979, as amended by T.D. 8677, 61 FR 33325, June 27, 1996]

§ 1.1503–1 Computation and payment of tax.

(a) *General rule.* In any case in which a consolidated return is filed or required to be filed, the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations prescribed under section 1502 promulgated prior to the last date prescribed by law for the filing of such return.

(b) *Limitation.* If the affiliated group includes one or more Western Hemisphere trade corporations (as defined in section 921) or one or more regulated public utilities (as defined in section 1503 (c)), the increase in tax described in section 1503 (a) shall be applied in a manner provided in the regulations under section 1502.

[T.D. 6500, 25 FR 12105, Nov. 26, 1960, as amended by T.D. 7244, 37 FR 28897, Dec. 30, 1972]

§ 1.1503–2 Dual consolidated loss.

(a) *Purpose and scope.* This section provides rules for the application of section 1503(d), concerning the determination and use of dual consolidated losses. Paragraph (b) of this section provides a general rule prohibiting a dual consolidated loss from offsetting the taxable income of a domestic affiliate. Paragraph (c) of this section provides definitions of the terms used in this section. Paragraph (d) of this section provides rules for calculating the amount of a dual consolidated loss and for adjusting the basis of stock of a dual resident corporation. Paragraph (e) of this section contains an anti-avoidance provision. Paragraph (f) of this section applies the rules of paragraph (d) of this section to the computation of foreign tax credit limitations. Paragraph (g) of this section provides certain exceptions to the limitation rule of paragraph (b) of this section. Finally, paragraph (h) of this section provides the effective date of the regulations and a provision for the retroactive application of the regulations to qualifying taxpayers.

(b) *In general*—(1) *Limitation on the use of a dual consolidated loss to offset income of a domestic affiliate.* Except as otherwise provided in this section, a dual consolidated loss of a dual resident corporation cannot offset the taxable income of any domestic affiliate in the taxable year in which the loss is recognized or in any other taxable year, regardless of whether the loss offsets income of another person under the income tax laws of a foreign country and regardless of whether the income that the loss may offset in the foreign country is, has been, or will be subject to tax in the United States. Pursuant to paragraph (c) (1) and (2) of this section, the same limitation shall apply to a dual consolidated loss of a separate unit of a domestic corporation as if the separate unit were a wholly owned subsidiary of such corporation.

(2) *Limitation on the use of a dual consolidated loss to offset income of a successor-in-interest.* A dual consolidated loss of a dual resident corporation also cannot be used to offset the taxable income of another corporation by means of a transaction in which the other corporation succeeds to the tax attributes of the dual resident corporation under section 381 of the Code. Similarly, a dual consolidated loss of a separate unit of a domestic corporation cannot be used to offset income of the domestic corporation following the termination, liquidation, sale, or other disposition of the separate unit. However, if a dual resident corporation transfers its assets to another corporation in a transaction subject to section 381, and the acquiring corporation is a dual resident corporation of the same foreign country of which the transferor dual resident corporation is a resident, or a domestic corporation that carries on the business activities of the transferor dual resident corporation as a separate unit, then income generated by the transferee dual resident corporation, or separate unit, may be offset by the carryover losses of the transferor dual resident corporation. In addition, if a domestic corporation transfers a separate unit to another domestic corporation in a transaction subject to section 381, the income generated by the separate unit following the transfer may be offset by the carryover losses of the separate unit.

(3) *Application of rules to multiple tiers of separate units.* If a separate unit of a domestic corporation is owned indirectly through another separate unit, the principles of paragraph (b) (1) and (2) of this section shall apply as if the upper-tier separate unit were a subsidiary of the domestic corporation and the lower-tier separate unit were a lower-tier subsidiary.

(4) *Examples.* The following examples illustrate the application of this paragraph (b).

EXAMPLE 1. P, a domestic corporation, owns all of the outstanding stock of DRC, a domestic corporation. P and DRC file a consolidated U.S. income tax return. DRC is managed and controlled in Country W, a country that determines the tax residence of corporations according to their place of management and control. Therefore, DRC is a dual resident corporation and any net operating loss it incurs is a dual consolidated loss. In Years 1 through 3, DRC incurs dual consolidated losses. Under this paragraph (b), the dual consolidated losses may not be used to offset P's income on the group's consolidated U.S. income tax return. At the end of Year 3, DRC sells all of its assets and discontinues its business operations. DRC is then liquidated into P, pursuant to the provisions of section 332. Normally, under section 381, P would succeed to, and be permitted to utilize, DRC's net operating loss carryovers. However, this paragraph (b) prohibits the dual consolidated losses of DRC from reducing P's income for U.S. tax purposes. Therefore, DRC's net operating loss carryovers will not be available to offset P's income.

EXAMPLE 2. The facts are the same as in *Example 1,* except that DRC does not sell its assets and, following the liquidation of DRC, P continues to operate DRC's business as a separate unit (*e.g.*, a branch). DRC's loss carryovers are available to offset P's income generated by the assets previously owned by DRC and now held by the separate unit.

(c) *Definitions.* The following definitions shall apply for purposes of this section.

(1) *Domestic corporation.* The term ''domestic corporation'' has the meaning assigned to it by section 7701(a) (3) and (4). The term also includes any corporation otherwise treated as a domestic corporation by the Code, including, but not limited to, sections 269B, 953(d), and 1504 (d). For purposes of this section, any separate unit of a domestic corporation, as defined in paragraph (c) (3) and (4) of this section, shall be treated as a separate domestic corporation.

(2) *Dual resident corporation.* A dual resident corporation is a domestic corporation that is subject to the income tax of a foreign country on its worldwide income or on a residence basis. A corporation is taxed on a residence basis if it is taxed as a resident under the laws of the foreign country. An S corporation, as defined in section 1361, is not a dual resident corporation. For purposes of this section, any separate unit of a domestic corporation, as defined in paragraph (c) (3) and (4) of this section, shall be treated as a dual resident corporation. Unless otherwise indicated, any reference in this section to a dual resident corporation refers also to a separate unit.

(3) *Separate unit*—(i) The term ''separate unit'' shall mean any of the following:

(A) A foreign branch, as defined in § 1.367(a)-6T(g) (or a successor regulation), that is owned either directly by a domestic corporation or indirectly by a domestic corporation through ownership of a partnership or trust interest (regardless of whether the partnership or trust is a United States person);

(B) an interest in a partnership; or

(C) an interest in a trust.

(ii) If two or more foreign branches located in the same foreign country are owned by a single domestic corporation and the losses of each branch are made available to offset the income of the other branches under the tax laws of the foreign country, within the meaning of paragraph (c)(15)(ii) of this section, then the branches shall be treated as one separate unit.

(4) *Hybrid entity separate unit.* The term ''separate unit'' includes an interest in an entity that is not taxable as an association for U.S. income tax purposes but is subject to income tax in a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis.

(5) *Dual consolidated loss*—(i) *In general.* The term ''dual consolidated loss'' means the net operating loss (as defined in section 172(c) and the regulations thereunder) of a domestic corporation incurred in a year in which the corporation is dual resident corporation. The dual consolidated loss shall be computed under paragraph (d)(1) of this section. The fact that a particular item taken into account in computing a dual resident corporation's net operating loss is not taken into account in computing income subject to a foreign country's income tax shall not cause such item to be excluded from the calculation of the dual consolidated loss.

(ii) *Exceptions.* A dual consolidated loss shall not include the following—

(A) A net operating loss incurred by a dual resident corporation in a foreign country whose income tax laws—

(*1*) Do not permit the dual resident corporation to use its losses, expenses or deductions to offset the income of any other person that is recognized in the same taxable year in which the losses, expenses or deductions are incurred; and

(*2*) Do not permit the losses, expenses or deductions of the dual resident corporation to be carried over or back to be used, by any means, to offset the income of any other person in other taxable years; or

(B) A net operating loss incurred during that portion of the taxable year prior to the date on which the domestic corporation becomes a dual resident corporation or subsequent to the date on which the domestic corporation ceases to be a dual resident corporation. For purposes of determining the amount of the net operating loss incurred in that portion of the taxable year prior to the date on which the domestic corporation becomes a dual resident corporation or subsequent to the date on which the domestic corporation ceases to be a dual resident corporation, in no event shall more than the aggregate of the equal daily portion of the net operating loss commensurate with the portion of the taxable year during which the domestic corporation was not a dual resident corporation be allocated to that portion of the taxable year in which the domestic corporation was not a dual resident corporation.

(iii) *Dual consolidated losses of separate units that are partnership interests, including interests in hybrid entities.* [Reserved]

(6) *Subject to tax.* For purposes of determining whether a domestic corporation is subject to the income tax of a foreign country on its income, the fact that the corporation has no actual income tax liability to the foreign country for a particular taxable year shall not be taken into account.

(7) *Foreign country.* For purposes of this section, possessions of the United States shall be considered foreign countries.

(8) *Consolidated group.* The term ‘‘consolidated group’’ means an affiliated group, as defined in section 1504(a), with which a dual resident corporation or domestic owner files a consolidated U.S. income tax return.

(9) *Domestic owner.* The term ‘‘domestic owner’’ means a domestic corporation that owns one or more separate units.

(10) *Affiliated dual resident corporation or affiliated domestic owner.* The term ‘‘affiliated dual resident corporation’’ or ‘‘affiliated domestic owner’’ means a dual resident corporation or domestic owner that is a member of a consolidated group.

(11) *Unaffiliated dual resident corporation or unaffiliated domestic owner.* The term ‘‘unaffiliated dual resident corporation’’ or ‘‘unaffiliated domestic owner’’ means a dual resident corporation or domestic owner that is an unaffiliated domestic corporation.

(12) *Successor-in-interest.* The term ‘‘successor-in-interest’’ means an acquiring corporation that succeeds to the tax attributes of an acquired corporation by means of a transaction subject to section 381.

(13) *Domestic affiliate.* The term ‘‘domestic affiliate’’ means any member of an affiliated group, without regard to the exceptions contained in section 1504(b) (other than section 1504(b)(3)) relating to includible corporations.

(14) *Unaffiliated domestic corporation.* The term ‘‘unaffiliated domestic corporation’’ means a domestic corporation that is not a member of an affiliated group.

(15) *Use of loss to offset income of a domestic affiliate or another person*—(i) A dual consolidated loss shall be deemed to offset income of a domestic affiliate in the year it is included in the computation of the consolidated taxable income of a consolidated group. The fact that no tax benefit results from the inclusion of the dual consolidated loss in the computation of the group’s consolidated taxable income in the taxable year shall not be taken into account.

(ii) Except as provided in paragraph (c)(15)(iii) of this section, a loss, expense, or deduction taken into account in computing a dual consolidated loss shall be deemed to offset income of another person under the income tax laws of a foreign country in the year it is made available for such offset. The fact that the other person does not have sufficient income in that year to benefit from such an offset shall not be taken into account. However, where the laws of a foreign country provide an election that would enable a dual resident corporation or separate unit to use its losses, expenses, or deductions to offset income of another person, the losses, expenses, or deductions shall be considered to offset such income only if the election is made.

(iii) The losses, expenses, or deductions taken into account in computing a dual resident corporation’s or separate unit’s dual consolidated loss shall not be deemed to offset income of another person under the income tax laws of a foreign country for purposes of this section, if under the laws of the foreign country the losses, expenses, or deductions of the dual resident corporation or separate unit are used to offset the income of another dual resident corporation or separate unit within the same consolidated group (or income of another separate unit that is owned by the unaffiliated domestic owner of the first separate unit). If the losses, expenses, or deductions of a dual resident corporation or separate unit are made available under the laws of a foreign country to offset the income of other dual resident corporations or separate units within the same consolidated group (or other separate units owned by the unaffiliated domestic owner of the first separate unit), as well as the income of another person, and the laws of the foreign country do not provide applicable rules for determining which person's income is offset by the losses, expenses, or deductions, then for purposes of this section, the losses, expenses or deductions shall be deemed to offset the income of the other dual resident corporations or separate units, to the extent of such income, before being considered to offset the income of the other person.

(iv) Except to the extent paragraph (g)(1) of this section applies, where the income tax laws of a foreign country deny the use of losses, expenses, or deductions of a dual resident corporation to offset the income of another person because the dual resident corporation is also subject to income taxation by another country on its worldwide income or on a residence basis, the dual resident corporation shall be treated as if it actually had offset its dual consolidated loss against the income of another person in such foreign country.

(16) *Examples.* The following examples illustrate this paragraph (c).

EXAMPLE 1. X, a member of a consolidated group, conducts business through a branch in Country Y. Under Country Y's income tax laws, the branch is taxed as a permanent establishment and its losses may be used under the Country Y form of consolidation to offset the income of Z, a Country Y affiliate of X. In Year 1, the branch of X incurs an overall loss that would be treated as a net operating loss if the branch were a separate domestic corporation. Under paragraph (c)(3) of this section, the branch of X is treated as a separate domestic corporation and a dual resident corporation. Thus, under paragraph (c)(5), its loss constitutes a dual consolidated loss. Unless X qualifies for an exception under paragraph (g) of this section, paragraph (b) of this section precludes the use of the branch's loss to offset any income of X not derived from the branch operations or any income of a domestic affiliate of X.

EXAMPLE 2. A and B are members of a consolidated group. FC is a Country X corporation that is wholly owned by B. A and B organize a partnership, P, under the laws of Country X. P conducts business in Country X and its business activity constitutes a foreign branch within the meaning of paragraph (c)(3)(i)(A) of this section. P also earns U.S. source income that is unconnected with the branch operations and, therefore, is not subject to tax by Country X. Under the laws of Country X, the branch can consolidate with FC. The interests in P held by A and B are each treated as a dual resident corporation. The branch is also treated as a separate dual resident corporation. Unless an exception under paragraph (g) of this section applies, any dual consolidated loss incurred by P's branch cannot offset the U.S. source income earned by P or any other income of A or B.

EXAMPLE 3. X is classified as a partnership for U.S. income tax purposes. A, B, and C are the sole partners of X. A and B are domestic corporations and C is a Country Y corporation. For U.S. income tax purposes, each partner has an equal interest in each item of partnership profit or loss. Under Country Y's law, X is classified as a corporation and its income and losses may be used under the Country Y form of consolidation to offset the income of companies that are affiliates of X. Under paragraph (c)(3) and (4) of this section, the partnership interests held by A and B are treated as separate domestic corporations and as dual resident corporations. Unless an exception under paragraph (g) of this section applies, losses allocated to A and B can only be used to offset profits of X allocated to A and B, respectively.

EXAMPLE 4. P, a domestic corporation, files a consolidated U.S. income tax return with its two wholly-owned domestic subsidiaries, DRC1 and DRC2. Each subsidiary is also treated as a Country Y resident for Country Y tax purposes. Thus, DRC1 and DRC2 are dual resident corporations. DRC1 owns FC, a Country Y corporation. Country Y's tax laws permit affiliated resident corporations to file a form of consolidated return. In Year 1, DRC1 incurs a $200 net operating loss for both U.S. and Country Y tax purposes, while DRC2 recognizes $200 of income under the tax laws of each country. FC also earns $200 of income for Country Y tax purposes. DRC1, DRC2, and FC file a Country Y consolidated return. However, Country Y has no applicable rules for determining which income is offset by DRC1's $200 loss. Under paragraph (c)(15)(iii) of this section, the loss shall be treated as offsetting DRC2's $200 of income. Because DRC1 and DRC2 are members of the same consolidated group, for purposes of this section, the offset of DRC1's loss against the income of DRC2 is not considered a use of the loss against the income of another person under the laws of a foreign country.

EXAMPLE 5. DRC, a domestic corporation, files a consolidated U.S. income tax return with its parent, P. DRC is also subject to tax in Country Y on its worldwide income. Therefore, DRC is a dual resident corporation and any net operating loss incurred by DRC is a dual consolidated loss. Country Y's tax laws permit corporations that are subject to tax on their worldwide income to use the Country Y form of consolidation, thus enabling eligible corporations to use their losses to offset income of affiliates. However, to prevent corporations like DRC from offsetting losses against income of affiliates in Country Y and then again offsetting the losses against income of foreign affiliates under the tax laws of another country, Country Y prevents a corporation that is also subject to the income tax of another country on its worldwide income or on a residence basis from using the Country Y form of consolidation. There is no agreement, as described in paragraph (g)(1) of this section, between the United States and Country Y. Because of Country Y's statute, DRC will be treated as having actually offset its losses against the income of affiliates in Country Y under paragraph (c)(15)(iv) of this section. Therefore, DRC will not be able to file an agreement described in paragraph (g)(2) of this section and offset its losses against the income of P or any other domestic affiliate.

(d) *Special rules for accounting for dual consolidated losses*—(1) *Determination of amount of dual consolidated loss*—(i) *Dual resident corporation that is a member of a consolidated group.* For purposes of determining whether a dual resident corporation that is a member of a consolidated group has a dual consolidated loss for the taxable year, the dual resident corporation shall compute its taxable income (or loss) in accordance with the rules set forth in the regulations under section 1502 governing the computation of consolidated taxable income, taking into account only the dual resident corporation's items of income, gain, deduction, and loss for the year. However, for purposes of this computation, the following items shall not be taken into account:

(A) Any net capital loss of the dual resident corporation; and

(B) Any carryover or carryback losses.

(ii) *Dual resident corporation that is a separate unit of a domestic corporation.* For purposes of determining whether a separate unit has a dual consolidated loss for the taxable year, the separate unit shall compute its taxable income (or loss) as if it were a separate domestic corporation and a dual resident corporation in accordance with the provisions of paragraph (d)(1)(i) of this section, using only those items of income, expense, deduction, and loss that are otherwise attributable to such separate unit.

(2) *Effect of a dual consolidated loss.* For any taxable year in which a dual resident corporation or separate unit has a dual consolidated loss to which paragraph (b) of this section applies, the following rules shall apply.

(i) If the dual resident corporation is a member of a consolidated group, the group shall compute its consolidated taxable income without taking into account the items of income, loss, or deduction taken into account in computing the dual consolidated loss. The dual consolidated loss may be carried over or back for use in other taxable years as a separate net operating loss carryover or carryback of the dual resident corporation arising in the year incurred. It shall be treated as a loss incurred by the dual resident corporation in a separate return limitation year and (without regard to whether the dual resident corporation is a common parent) shall be subject to all of the limitations of §§1.1502–21A(c) or 1.1502–21T(c), as appropriate (relating to limitations on net operating loss carryovers and carrybacks from separate return limitation years).

(ii) The unaffiliated domestic owner of a separate unit, or the consolidated group of an affiliated domestic owner, shall compute its taxable income without taking into account the items of income, loss or deduction taken into account in computing the separate unit's dual consolidated loss. The dual consolidated loss shall be treated as a loss incurred by a separate corporation and its use shall be subject to all of the limitations of §§1.1502–21A(c) or 1.1502–21T(c), as appropriate, as if the separate unit were filing a consolidated return with the unaffiliated domestic owner or with the consolidated group of the affiliated domestic owner.

(3) *Basis adjustments for dual consolidated losses*—(i) *Dual resident corporation that is a member of an affiliated*

group. When a dual resident corporation is a member of a consolidated group, each other member owning stock in the dual resident corporation shall adjust the basis of the stock in the following manner.

(A) *Positive adjustments.* Positive adjustments shall be made in accordance with the principles of § 1.1502–32(b)(1), except that there shall be no positive adjustment under § 1.1502–32(b)(1)(ii) for any amount of the dual consolidated loss that is not absorbed as a result of the application of paragraph (b) of this section. In addition, there shall be no positive adjustment for any amount included in income pursuant to paragraph (g)(2)(vii) of this section.

(B) *Negative adjustments.* Negative adjustments shall be made in accordance with the principles of § 1.1502–32(b)(2), except that there shall be no negative adjustment under § 1.1502–32(b)(2)(ii) for the amount of the dual consolidated loss subject to paragraph (b) of this section that is absorbed in a carryover year.

(ii) *Dual resident corporation that is a separate unit arising from an interest in a partnership.* Where a separate unit is an interest in a partnership, the domestic owner shall adjust its basis in the separate unit in accordance with section 705, except that no increase in basis shall be permitted for any amount included as income pursuant to paragraph (g)(2)(vii) of this section.

(4) *Examples.* The following examples illustrate this paragraph (d).

EXAMPLE 1. (i) P, S1, S2, and T are domestic corporations. P owns all of the stock of S1 and S2. S2 owns all of the stock of T. T is a resident of Country FC for Country FC income tax purposes. Therefore, T is a dual resident corporation. P, S1, S2, and T file a consolidated U.S. income tax return. X and Y are corporations that are not members of the consolidated group.

(ii) At the beginning of Year 1, P has a basis of $1000 in the stock of S2. S2 has a $500 basis in the stock of T.

(iii) In Year 1, T incurs interest expense in the amount of $100. In addition, T sells a noncapital asset, *u*, in which it has a basis of $10, to S1 for $50. T also sells a noncapital asset, *v*, in which it has a basis of $200, to S1 for $100. The sales of *u* and *v* are intercompany transactions described in § 1.1502–13. T also sells a capital asset, *z*, in which it has a basis of $180, to Y for $90. In Year 1, S1 earns $200 of separate taxable income, calculated in accordance with § 1.1502–12, as well as $90 of capital gain from a sale of an asset to X. P and S2 have no items of income, loss, or deduction for Year 1.

(iv) In Year 1, T has a dual consolidated loss of $100 (attributable to its interest expense). T's $90 capital loss is not included in the computation of the dual consolidated loss. Instead, T's capital loss is included in the computation of the consolidated group's capital gain net income under § 1.1502–22T(c) and is used to offset S1's $90 capital gain.

(v) No elective agreement, as described in paragraph (g)(1) of this section, exists between the United States and Country FC. For Country FC tax purposes, T's $100 loss is offset against the income of a Country FC affiliate. Therefore, T is not eligible for the exception provided in paragraph (g)(2) of this section.

(vi) Because T has a dual consolidated loss for the year, the consolidated taxable income of the consolidated group is calculated without regard to T's items of income, loss or deduction taken into account in computing the dual consolidated loss. Therefore, the consolidated taxable income of the consolidated group is $200 (the sum of $200 of separate taxable income earned by S1 plus $90 of capital gain earned by S1 minus $90 of capital loss incurred by T). The $40 gain recognized by T upon the sale of item *u* to S1 and the $100 loss recognized by T upon the sale of item *v* to S1 are deferred pursuant to § 1.1502–13(c)(1).

(vii) S2 may not make the positive adjustment provided for in § 1.1502–32(b)(1)(ii) to its basis in the stock of T for the $100 dual consolidated loss incurred by T. In addition, no positive adjustment in the basis of the stock is required for T's $90 capital loss because the loss has been absorbed by the consolidated group. S2, however, must make the negative adjustment provided for in § 1.1502–32(b)(2)(i) for its allocable part of T's deficit in earnings and profits for the taxable year attributable to both T's $100 dual consolidated loss and T's $90 capital loss. Thus, as provided in § 1.1502–32(e)(1), S2 must make a $190 net negative adjustment to its basis in the stock of T, reducing its basis to $310. As provided in § 1.1502–33(c)(4)(ii)(*a*), S2's earnings and profits for Year 1 will reflect S2's decrease in its basis in T stock for the taxable year. Since S2 has no other earnings and profits for the taxable year, S2 has a $190 deficit in earnings and profits for the year. As provided in § 1.1502–32(b)(2)(i), P must make a negative adjustment to its basis in the stock of S2 for its allocable part of S2's deficit in earnings and profits for the taxable year. Thus, P must make a $190 net negative adjustment to its basis in S2 stock, reducing its basis to $810.

EXAMPLE 2. (i) The facts are the same as in *Example 1,* except that in Year 2, S1 sells items *u* and *v* to X for no gain or loss. The disposition of items *u* and *v* outside of the consolidated group restores the deferred loss and gain to T. T also incurs $100 of interest expense in Year 2. In addition, T sells a non-capital asset, *r*, in which it has a basis of $100, to Y for $300. P and S2 have no items of income, loss, or deduction for Year 2.

(ii) T has $40 of separate taxable income in Year 2, computed as follows:

($100)	interest expense
($100)	sale of item *v* to S1
$ 40	sale of item *u* to S1
$200	sale of item *r* to Y
$ 40	

Thus, T has no dual consolidated loss for the year.

(iii) Since T does not have a dual consolidated loss for the taxable year, the group's consolidated taxable income is calculated in accordance with the general rule of §1.1502–11 and not in accordance with paragraph (d)(2) of this section. T is the only member of the consolidated group that has any income or loss for the taxable year. Thus, the consolidated taxable income of the group, computed without regard to T's dual consolidated loss carryover, is $40.

(iv) As provided by §1.1502–21A(c), the amount of the dual consolidated loss arising in Year 1 that is included in the group's consolidated net operating loss deduction for Year 2 is $40 (that is, the consolidated taxable income computed without regard to the consolidated net operating loss deduction minus such consolidated taxable income recomputed by excluding the items of income and deduction of T). Thus, the group has no consolidated taxable income for the year.

(v) S2 must make the positive adjustment provided for in §1.502–32(b)(1)(i) to its basis in T stock for its allocable part of T's undistributed earnings and profits for the taxable year. S2 cannot make the negative adjustment provided for in §1.1502–32(b)(2)(ii) for the dual consolidated loss of T incurred in Year 1 and absorbed in Year 2. Thus, as provided in §1.1502–32(e)(2), S2 must make a $40 net positive adjustment to its basis in T stock, increasing its basis to $350. As provided in §1.1502–33(c)(4)(ii)(*a*), S2's earnings and profits for Year 2 will reflect S2's increase in its basis in T stock for the taxable year. Since S2 has no other earnings and profits for the taxable year, S2 has $40 of earnings and profits for the year. As provided in §1.1502–32(b)(1)(i), P must make a positive adjustment to its basis in the stock of S2 for its allocable part of the undistributed earnings and profits of S2 for the taxable year. Thus, P must make a $40 net positive adjustment to its basis in S2 stock, increasing its basis to $850.

(e) *Special rule for use of dual consolidated loss to offset tainted income*—(1) *In general.* The dual consolidated loss of any dual resident corporation that ceases to be a dual resident corporation shall not be used to offset income of such corporation to the extent that such income is tainted income, as defined in paragraph (e)(2) of this section.

(2) *Tainted income defined.* Tainted income is any income derived from tainted assets, as defined in paragraph (e)(3) of this section, beginning on the date such assets are acquired by the dual resident corporation. In the absence of evidence establishing the actual amount of income that is attributable to the tainted assets, the portion of a corporation's income in a particular taxable year that is treated as tainted income shall be an amount equal to the corporation's taxable income for the year multiplied by a fraction, the numerator of which is the fair market value of the tainted asset at the end of the taxable year and the denominator of which is the fair market value of the total assets owned by the corporation at the end of the taxable year. Documentation submitted to establish the actual amount of income that is attributable to the tainted assets must be attached to the consolidated group's or unaffiliated dual resident corporation's timely filed tax return for the taxable year in which the income is recognized.

(3) *Tainted assets defined.* Tainted assets are any asset acquired by a dual resident corporation in a non-recognition transaction, as defined in section 7701(a)(45), or any assets otherwise transferred to the corporation as a contribution to capital, at any time during the three taxable years immediately preceding the taxable year in which the corporation ceases to be a dual resident corporation or at any time thereafter. Tainted assets shall not include assets that were acquired by such dual resident corporation on or before December 31, 1986.

(4) *Exceptions.* Income derived from assets acquired by a dual resident corporation shall not be subject to the limitation described in paragraph (e)(1) of this section, if—

(i) For the taxable year in which the assets were acquired, the corporation did not have a dual consolidated loss (or a carry forward of a dual consolidated loss to such year); or

(ii) The assets were acquired as replacement property in the ordinary course of business.

(f) *Computation of foreign tax credit limitations.* If a dual resident corporation or separate unit is subject to paragraph (d)(2) of this section, the consolidated group or unaffiliated domestic owner shall compute its foreign tax credit limitation by applying the limitations of paragraph (d)(2). Thus, the dual consolidated loss is not taken into account until the year in which it is absorbed.

(g) *Exception*—(1) *Elective agreement in place between the United States and a foreign country.* Paragraph (b) of this section shall not apply to a dual consolidated loss to the extent the dual resident corporation, or domestic owner of a separate unit, elects to deduct the loss in the United States pursuant to an agreement entered into between the United States and a foreign country that puts into place an elective procedure through which losses offset income in only one country.

(2) *Elective relief provision*—(i) *In general.* Paragraph (b) of this section shall not apply to a dual consolidated loss if the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner elects to be bound by the provisions of this paragraph (g)(2). In order to elect relief under this paragraph (g)(2), the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner must attach to its timely filed U.S. income tax return for the taxable year in which the dual consolidated loss is incurred an agreement described in this paragraph (g)(2)(i). The agreement must be signed under penalties of perjury by the person who signs the return and must include the following items, in paragraphs labeled to correspond with the items set forth below:

(A) A statement that the document submitted is an election and an agreement under the provisions of § 1.1503–2(g)(2) of the Income Tax Regulations;

(B) The name, address, identifying number, and place and date of incorporation of the dual resident corporation, and the country or countries that tax the dual resident corporation on its worldwide income or on a residence basis, or, in the case of a separate unit, identification of the separate unit, including the name under which it conducts business, its principal activity, and the country in which its principal place of business is located;

(C) An agreement by the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner to comply with all of the provisions of paragraphs (g)(2) (iii) through (vii) of § 1.1503–2;

(D) A statement of the amount of the dual consolidated loss covered by the agreement;

(E) A certification that no portion of the dual resident corporation’s or separate unit’s loss, expenses, or deductions taken into account in computing the dual consolidated loss has been, or will be, used to offset the income of any other person under the income tax laws of a foreign country; and

(F) A certification that arrangements have been made to ensure that no portion of the dual consolidated loss will be used to offset the income of another person under the laws of a foreign country and that the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner will be informed of any such foreign use of any portion of the dual consolidated loss.

(ii) *Consistency rule*—(A) If any loss, expense, or deduction taken into account in computing the dual consolidated loss of a dual resident corporation or separate unit is used under the laws of a foreign country to offset the income of another person, then the following other dual consolidated losses (if any) shall be treated as also having been used to offset income of another person under the laws of such foreign country, but only if the income tax laws of the foreign country permit any loss, expense, or deduction taken into account in computing the other dual consolidated loss to be used to offset the income of another person in the same taxable year;

(*1*) Any dual consolidated loss of a dual resident corporation that is a member of the same consolidated group of which the first dual resident corporation or domestic owner is a member, if any loss, expense, or deduction taken into account in computing such dual consolidated loss is recognized under the income tax laws of such country in the same taxable year; and

(*2*) Any dual consolidated loss of a separate unit that is owned by the same domestic owner that owns the first separate unit, or that is owned by any member of the same consolidated group of which the first dual resident corporation or domestic owner is a member, if any loss, expense, or deduction taken into account in computing such dual consolidated loss is recognized under the income tax laws of such country in the same taxable year.

(B) The following examples illustrate the application of this paragraph (g)(2)(ii).

EXAMPLE 1. P, a domestic corporation, owns A and B, which are domestic corporations, and C, a Country X corporation. A is subject to the income tax laws of Country X on a residence basis and, thus, is a dual resident corporation. B conducts business in Country X through a branch, which is a separate unit under paragraph (c)(3) of this section. The income tax laws of Country X permit branches of foreign corporations to elect to file consolidated returns with Country X affiliates. In Year 1, A incurs a dual consolidated loss, which is used to offset the income of C under the Country X form of consolidation. The branch of B also incurs a net operating loss. However, B elects not to use the loss on a Country X consolidated return to offset the income of foreign affiliates. The use of A's loss to offset the income of C in Country X will cause the separate unit of B to be treated as if it too had used its dual consolidated loss to offset the income of an affiliate in Country X. Therefore, an election and agreement under this paragraph (g)(2) cannot be made with respect to the separate unit's dual consolidated loss.

EXAMPLE 2. The facts are the same as in *Example 1*, except that the income tax laws of Country X do not permit branches of foreign corporations to file consolidated income tax returns with Country X affiliates. Therefore, an election and agreement described in this paragraph (g)(2) may be made for the dual consolidated loss incurred by the separate unit of B.

(iii) *Triggering events requiring the recapture of dual consolidated losses*—(A) The consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner must agree that, if there is a triggering event described in this paragraph (g)(2)(iii), and no exception applies under paragraph (g)(2)(iv) of this section, the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner will recapture and report as income the amount of the dual consolidated loss provided in paragraph (g)(2)(vii) of this section on its tax return for the taxable year in which the triggering event occurs (or, when the triggering event is a use of the loss for foreign purposes, the taxable year that includes the last day of the foreign tax year during which such use occurs). In addition, the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner must pay any applicable interest charge required by paragraph (g)(2)(vii) of this section. For purposes of this section, any of the following events shall constitute a triggering event:

(*1*) In any taxable year up to and including the 15th taxable year following the year in which the dual consolidated loss that is the subject of the agreement filed under this paragraph (g)(2) was incurred, any portion of the losses, expenses, or deductions taken into account in computing the dual consolidated loss is used by any means to offset the income of any other person under the income tax laws of a foreign country;

(*2*) An affiliated dual resident corporation or affiliated domestic owner ceases to be a member of the consolidated group that filed the election. For purposes of this paragraph (g)(2)(iii)(A)(*2*), a dual resident corporation or domestic owner shall be considered to cease to be a member of the consolidated group if it is no longer a member of the group within the meaning of § 1.1502–1(b), or if the group ceases to exist because the common parent is no longer in existence or is no longer a common parent or the group no longer files on the basis of a consolidated return. Such disaffiliation, however, shall not constitute a triggering event if the taxpayer demonstrates, to the satisfaction of the Commissioner, that the dual resident corporation's or separate unit's losses, expenses, or deductions cannot be used to offset income of another person under the laws of a foreign country at any time after the affiliated dual resident corporation or affiliated domestic owner ceases to be a member of the consolidated group;

(*3*) An unaffiliated dual resident corporation or unaffiliated domestic owner becomes a member of a consolidated group. Such affiliation of the dual resident corporation or domestic owner, however, shall not constitute a triggering event if the taxpayer demonstrates, to the satisfaction of the Commissioner, that the losses, expenses, or deductions of the dual resident corporation or separate unit cannot be used to offset the income of another person under the laws of a foreign country at any time after the dual resident corporation or domestic owner becomes a member of the consolidated group.

(*4*) A dual resident corporation transfers assets in a transaction that results, under the laws of a foreign country, in a carryover of its losses, expenses, or deductions. For purposes of this paragraph (g)(2)(iii)(A)(*4*), a transfer, either in a single transaction or a series of transactions within a twelve-month period, of 50% or more of the dual resident corporation's assets (measured by the fair market value of the assets at the time of such transfer (or for multiple transactions, at the time of the first transfer)) shall be deemed a triggering event, unless the taxpayer demonstrates, to the satisfaction of the Commissioner, that the transfer of assets did not result in a carryover under foreign law of the dual resident corporation's losses, expenses, or deductions to the transferee of the assets;

(*5*) A domestic owner of a separate unit transfers assets of the separate unit in a transaction that results, under the laws of a foreign country, in a carryover of the separate unit's losses, expenses, or deductions. For purposes of this paragraph (g)(2)(iii)(A)(*5*), a transfer, either in a single transaction or a series of transactions over a twelve-month period, of 50% or more of the separate unit's assets (measured by the fair market value of the assets at the time of the transfer (or for multiple transfers, at the time of the first transfer)), shall be deemed a triggering event, unless the taxpayer demonstrates, to the satisfaction of the Commissioner, that the transfer of assets did not result in a carryover under foreign law of the separate unit's losses, expenses, or deductions to the transferee of the assets;

(*6*) An unaffiliated dual resident corporation or unaffiliated domestic owner becomes a foreign corporation by means of a transaction (*e.g.*, a reorganization) that, for foreign tax purposes, is not treated as involving a transfer of assets (and carryover of losses) to a new entity. Such a transaction, however, shall not constitute a triggering event if the taxpayer demonstrates, to the satisfaction of the Commissioner, that the dual resident corporation's or separate unit's losses, expenses, or deductions cannot be used to offset income of another person under the laws of the foreign country at any time after the unaffiliated dual resident corporation or unaffiliated domestic owner becomes a foreign corporation.

(*7*) A domestic owner of a separate unit, either in a single transaction or a series of transactions within a twelve-month period, sells, or otherwise disposes of, 50% or more of the interest in the separate unit (measured by voting power or value) owned by the domestic owner on the last day of the taxable year in which the dual consolidated loss was incurred. For purposes of this paragraph (g)(2)(iii)(A)(*7*), the domestic owner shall be deemed to have disposed of its entire interest in a hybrid entity separate unit if such hybrid entity becomes classified as a foreign corporation for U.S. tax purposes. The disposition of 50% or more of the interest in a separate unit, however, shall not constitute a triggering event if the taxpayer demonstrates, to the satisfaction of the Commissioner, that the losses, expenses, or deductions of the separate unit cannot be used to offset income of another person under the laws of the foreign country at any time after the disposition of the interest in the separate unit; or

(*8*) The consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner fails to file a certification required under paragraph (g)(2)(vi)(B) of this section.

(B) A taxpayer wishing to rebut the presumption of a triggering event described in paragraphs (g)(2)(iii)(A)(*2*) through (*7*) of this section, by demonstrating that the losses, expenses, or deductions of the dual resident corporation or separate unit cannot be carried over or otherwise used under the laws of the foreign country, must attach documents demonstrating such facts to its timely filed U.S. income tax return for the year in which the presumed triggering event occurs.

(C) The following example illustrates this paragraph (g)(2)(iii).

EXAMPLE. DRC, a domestic corporation, is a member of CG, a consolidated group. DRC is a resident Country Y for Country Y income tax purposes. Therefore, DRC is a dual resident corporation. In Year 1, DRC incurs a dual consolidated loss of $100. CG files an agreement described in paragraph (g)(2) of this section and, thus, the $100 dual consolidated loss is included in the computation of CG's consolidated taxable income. In Year 6, all of the stock of DRC is sold to P, a domestic corporation that is a member of NG, another consolidated group. The sale of DRC to P is a triggering event under paragraph (g)(2)(iii)(A) of this section, requiring the recapture of the dual consolidated loss. However, the laws of Country Y provide for a five-year carryover period for losses. At the time of DRC's disaffiliation from CG, the losses, expenses and deductions that were included in the computation of the dual consolidated loss had expired for Country Y purposes. Therefore, upon adequate documentation that the losses, expenses, or deductions have expired for Country Y purposes, CG can rebut the presumption that a triggering event has occurred.

(iv) *Exceptions*—(A) *Acquisition by a member of the consolidated group.* The following events shall not constitute triggering events, requiring the recapture of the dual consolidated loss under paragraph (g)(2)(vii) of this section:

(*1*) An affiliated dual resident corporation or affiliated domestic owner ceases to be a member of a consolidated group solely by reason of a transaction in which a member of the same consolidated group succeeds to the tax attributes of the dual resident corporation or domestic owner under the provisions of section 381;

(*2*) Assets of an affiliated dual resident corporation or assets of a separate unit of an affiliated domestic owner are acquired by a member of its consolidated group in any other transaction; or

(*3*) An affiliated domestic owner of a separate unit transfers its interest in the separate unit to another member of its consolidated group.

(B) *Acquisition by an unaffiliated domestic corporation or a new consolidated group—(1)* If the requirements of paragraph (g)(2)(iv)(B)(*2*) of this section are met, the following events shall not constitute triggering events, requiring the recapture of the dual consolidated loss under paragraph (g)(2)(vii) of this section:

(*i*) An affiliated dual resident corporation or affiliated domestic owner becomes an unaffiliated domestic corporation or a member of a new consolidated group;

(*ii*) An unaffiliated dual resident corporation or unaffiliated domestic owner becomes a member of a consolidated group;

(*iii*) Assets of a dual resident corporation or a separate unit are acquired by an unaffiliated domestic corporation or a member of a new consolidated group; or

(*iv*) A domestic owner of a separate unit transfers its interest in the separate unit to an unaffiliated domestic corporation or to a member of a new consolidated group.

(*2*) If all of the following requirements are satisfied, the events listed in paragraph (g)(2)(iv)(B)(*1*) of this section shall not constitute triggering events requiring recapture under paragraph (g)(2)(vii) of this section.

(*i*) The consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner that filed the agreement under this paragraph (g)(2) and the unaffiliated domestic corporation or new consolidated group must enter into a closing agreement with the Internal Revenue Service providing that the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner and the unaffiliated domestic corporation or new consolidated group will be jointly and severally liable for the total amount of the recapture of dual consolidated loss and interest charge required in paragraph (g)(2)(vii) of this section, if there is a triggering event described in paragraph (g)(2)(iii) of this section;

(*ii*) The unaffiliated domestic corporation or new consolidated group must agree to treat any potential recapture amount under paragraph (g)(2)(vii) of this section as unrealized built-in gain for purposes of section 384(a), subject to any applicable exceptions thereunder;

(*iii*) The unaffiliated domestic corporation or new consolidated group must file an agreement described in paragraph (g)(2)(i) of this section with its timely filed income tax return for the taxable year in which the event described in paragraph (g)(2)(iv)(B)(*1*) of this section occurs. The agreement must be signed under penalties of perjury by the person who signs the tax return of the unaffiliated domestic corporation or new consolidated group.

(C) *Subsequent triggering events.* Any triggering event described in paragraph (g)(2)(iii) of this section that occurs subsequent to one of the transactions described in paragraph (g)(2)(iv) (A) or (B) of this section and does not fall within the exceptions provided in paragraph (g)(2)(iv) (A) or (B) of this section shall require recapture under paragraph (g)(2)(vii) of this section.

(v) *Ordering rules for determining the foreign use of losses.* If the laws of a foreign country provide for the use of losses of a dual resident corporation to offset the income of another person but do not provide applicable rules for determining the order in which such losses are used to offset the income of another person in a taxable year, then for purposes of this section, the following rules shall govern:

(A) If under the laws of the foreign country the dual resident corporation has losses from different taxable years, the dual resident corporation shall be deemed to use first the losses from the earliest taxable year from which a loss may be carried forward or back for foreign law purposes.

(B) Any net loss, or income, that the dual resident corporation has in a taxable year shall first be used to offset net income, or loss, recognized by affiliates of the dual resident corporation in the same taxable year before any carryover of the dual resident corporation's losses is considered to be used to offset any income from the taxable year.

(C) Where different losses, expenses, or deductions (*e.g.,* capital losses and ordinary losses) of a dual resident corporation incurred in the same taxable year are available to offset the income of another person, the different losses shall be deemed to offset such income on a pro rata basis.

EXAMPLE. DRC, a domestic corporation, is taxed as a resident under the tax laws of Country Y. Therefore, DRC is a dual resident corporation. FA is a Country Y affiliate of DRC. Country Y's tax laws permit affiliated corporations to file a form of consolidated return. In Year 1, DRC incurs a capital loss of $80 which, for Country Y purposes, offsets completely $30 of capital gain recognized by FA. Neither corporation has any other taxable income or loss for the year. In Year 1 (and in other years), DRC recognizes the same amount of income for U.S. purposes as it does for Country Y purposes. Under paragraph (d)(1)(i) of this section, however, DRC's $80 capital loss is not a dual consolidated loss. In Year 2, DRC incurs a net operating loss of $100, while FA incurs a net operating loss of $50. DRC's $100 loss is a dual consolidated loss. Since the dual consolidated loss is not used to offset the income of another person under Country Y law, DRC is permitted to file an agreement described in this paragraph (g)(2). In Year 3, DRC has a net operating loss of $10 and FA has capital gains of $60. For Country Y purposes, DRC's $10 net operating loss is used to offset $10 of FA's $60 capital gain. DRC's $10 loss is a dual consolidated loss. Because the loss is used to offset FA's income, DRC will not be able to file an agreement under this paragraph (g)(2) with respect to the loss. Country Y permits FA's remaining $50 of Year 3 income to be offset by carryover losses. However, Country Y has no applicable rules for determining which carryover losses from Years 1 and 2 are used to offset such income. Under the ordering rules of paragraph (g)(2)(v)(A) of this section, none of DRC's $100 Year 2 loss will be deemed to offset FA's remaining $50 of Year 3 income. Instead, the $50 of capital loss carryover from Year 1 will be considered to offset the income.

(vi) *Reporting requirements*—(A) *In general.* The consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner must answer the applicable questions regarding dual consolidated losses on its U.S. income tax return filed for the year in which the dual consolidated loss is incurred and for each of the following fifteen taxable years.

(B) *Annual certification.* Except as provided in paragraph (g)(2)(vi)(C) of this section, until and unless Form 1120 (or the Schedules thereto) contains questions pertaining to dual consolidated losses, the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner must file with its income tax return for each of the fifteen taxable years following the taxable year in which the dual consolidated loss is incurred a certification that the losses, expenses, or deductions that make up the dual consolidated loss have not been used to offset the income of another person under the tax laws of a foreign country. The annual certification must be signed under penalties of perjury by a person authorized to sign the agreement described in paragraph (g)(2)(i) of this section. The certification must identify the dual consolidated loss to which it pertains by setting forth the taxpayer's year in which the loss was incurred and the amount of such loss. In addition, the certification must warrant that arrangements have been made to ensure that the loss will not be used to offset the income of another person under the laws of a foreign country and that the taxpayer will be informed of any such foreign use of any portion of the loss. If dual consolidated losses of more than one taxable year are subject to the rules of this paragraph (g)(2)(vi)(B), the certifications for those years may be combined in a single document but each dual consolidated loss must be separately identified.

(C) *Exception.* A consolidated group or unaffiliated domestic owner is not required to file annual certifications under paragraph (g)(2)(vi)(B) of this section with respect to a dual consolidated loss of any separate unit other than a hybrid entity separate unit.

(vii) *Recapture of loss and interest charge*—(A) *Presumptive rule—(1) Amount of recapture.* Except as otherwise provided in this paragraph (g)(2)(vii), upon the occurrence of a triggering event described in paragraph (g)(2)(iii) of this section, the taxpayer shall recapture and report as gross income the total amount of the dual consolidated loss to which the triggering event applies on its income tax return for the taxable year in which the triggering event occurs (or, when the triggering event is a use of the loss for foreign tax purposes, the taxable year that includes the last day of the foreign tax year during which such use occurs).

(*2*) *Interest charge.* In connection with the recapture, the taxpayer shall pay an interest charge. Except as otherwise provided in this paragraph (g)(2)(vii), such interest shall be determined under the rules of section 6601(a) as if the additional tax owed as a result of the recapture had accrued and been due and owing for the taxable year in which the losses, expenses, or deductions taken into account in computing the dual consolidated loss gave rise to a tax benefit for U.S. income tax purposes. For purposes of this paragraph (g)(2)(vii)(A)(*2*), a tax benefit shall be considered to have arisen in a taxable year in which such losses, expenses or deductions reduced U.S. taxable income.

(B) *Rebuttal of presumptive rule*—(*1*) *Amount of recapture.* The amount of dual consolidated loss that must be recaptured under this paragraph (g)(2)(vii) may be reduced if the taxpayer demonstrates, to the satisfaction of the Commissioner, the offset permitted by this paragraph (g)(2)(vii)(B). The reduction in the amount of recapture is the amount by which the dual consolidated loss would have offset other taxable income reported on a timely filed U.S. income tax return for any taxable year up to and including the year of the triggering event if such loss had been subject to the restrictions of paragraph (b) of this section (and therefore had been subject to the separate return limitation year restrictions of §§1.1502–21A(c) or 1.1502–21T(c) (as appropriate) commencing in the taxable year in which the loss was incurred. A taxpayer utilizing this rebuttal rule must attach to its timely filed U.S. income tax return a separate accounting showing that the income for each year that offsets the dual resident corporation's or separate unit's recapture amount is attributable only to the dual resident corporation or separate unit.

(*2*) *Interest charge.* The interest charge imposed under this paragraph (g)(2)(vii) may be appropriately reduced if the taxpayer demonstrates, to the satisfaction of the Commissioner, that the net interest owed would have been less than that provided in paragraph (g)(2)(vii)(A)(*2*) of this section if the taxpayer had filed an amended return for the year in which the loss was incurred, and for any other affected years up to and including the year of recapture, treating the dual consolidated loss as a loss subject to the restrictions of paragraph (b) of this section (and therefore subject to the separate return limitation year restrictions of §§ 1.1502–21A(c) or 1.1502–21T(c) (as appropriate). A taxpayer utilizing this rebuttal rule must attach to its timely filed U.S. income tax return a computation demonstrating the reduction in the net interest owed as a result of treating the dual consolidated loss as a loss subject to the restrictions of paragraph (b) of this section.

(C) *Computation of taxable income in year of recapture—(1) Presumptive rule.* Except as otherwise provided in paragraph (g)(2)(vii)(C)(*2*) of this section, for purposes of computing the taxable income for the year of recapture, no current, carryover or carryback losses of the dual resident corporation or separate unit, of other members of the consolidated group, or of the domestic owner that are not attributable to the separate unit, may offset and absorb the recapture amount.

(*2*) *Rebuttal of presumptive rule.* The recapture amount included in gross income may be offset and absorbed by that portion of the taxpayer's (consolidated or separate) net operating loss carryover that is attributable to the dual consolidated loss being recaptured, if the taxpayer demonstrates, to the satisfaction of the Commissioner, the amount of such portion of the carryover. A taxpayer utilizing this rebuttal rule must attach to its timely filed U.S. income tax return a computation demonstrating the amount of net operating loss carryover that, under this paragraph (g)(2)(vii)(C)(*2*), may absorb the recapture amount included in gross income.

(D) *Character and source of recapture income.* The amount recaptured under this paragraph (g)(2)(vii) shall be treated as ordinary income in the year of recapture. The amount recaptured shall be treated as income having the same source and falling within the same separate category for purposes of section 904 as the dual consolidated loss being recaptured.

(E) *Reconstituted net operating loss.* Commencing in the taxable year immediately following the year in which the dual consolidated loss is recaptured, the dual resident corporation or separate unit shall be treated as having a net operating loss in an amount equal to the amount actually recaptured under paragraph (g)(2)(vii) (A) or (B) of this section. This reconstituted net operating loss shall be subject to the restrictions of paragraph (b) of this section (and therefore, the separate return limitation year restrictions of §§ 1.1502–21A(c) or 1.1502–21T(c) (as appropriate). The net operating loss shall be available only for carryover, under section 172(b), to taxable years following the taxable year of recapture. For purposes of determining the remaining carryover period, the loss shall be treated as if it had been recognized in the taxable year in which the dual consolidated loss that is the basis of the recapture amount was incurred.

(F) *Consequences of failing to comply with recapture provisions*—(*1*) *In general.* If the taxpayer fails to comply with the recapture provisions of this paragraph (g)(2)(vii) upon the occurrence of a triggering event, then the dual resident corporation or separate unit that incurred the dual consolidated loss (or a successor-in-interest) shall not be eligible for the relief provided in paragraph (g)(2) of this section with respect to any dual consolidated losses incurred in the five taxable years beginning with the taxable year in which recapture is required.

(*2*) *Exceptions.* In the case of a triggering event other than a use of the losses, expenses, or deductions taken into account in computing the dual consolidated loss to offset income of another person under the income tax laws of a foreign country, this rule shall not apply in the following circumstances:

(*i*) The failure to recapture is due to reasonable cause; or

(*ii*) A taxpayer seeking to rebut the presumption of a triggering event satisfies the filing requirements of paragraph (g)(2)(iii)(B) of this section.

(G) *Examples.* The following examples illustrate this paragraph (g)(2)(vii).

EXAMPLE 1. P, a domestic corporation, files a consolidated return with DRC, a dual resident corporation. In Year 1, DRC incurs a dual consolidated loss of $100 and P earns $100. P files an agreement under this paragraph (g)(2). Therefore, the consolidated group is permitted to offset P's $100 of income with DRC's $100 loss. In Year 2, DRC earns $30, which is completely offset by a $30 net operating loss incurred by P. In Year 3, DRC earns income of $25 while P recognizes no income or loss. In addition, there is a triggering event in Year 3. Therefore, under the presumptive rule of paragraph (g)(2)(vii)(A) of this section, DRC must recapture $100. However, the $100 recapture amount may be reduced by $25 (the amount by which the dual consolidated loss would have offset other taxable income if it had been subject to the separate return limitation year restrictions from Year 1) upon adequate documentation of such offset under paragraph (g)(2)(vii)(B)(*1*) of this section. Commencing in Year 4, the $100 (or $75) recapture amount is treated as a loss incurred by DRC in a separate return limitation year, subject to the restrictions of §§ 1.1502–21A(c) or 1.1502–21T(c), as appropriate. The carryover period of the loss, for purposes of section 172(b), will start from Year 1, when the dual consolidated loss was incurred.

EXAMPLE 2. The facts are the same as in EXAMPLE 1, except that in Year 2, DRC earns $75 and P earns $50. In Year 3, DRC earns $25 while P earns $30. A triggering event occurs in Year 3. The $100 presumptive amount of recapture can be reduced to zero by the $75 and $25 earned by DRC in Years 2 and 3, respectively, upon adequate documentation of such offset under paragraph (g)(2)(vii)(B)(*1*) of this section. Nevertheless, an interest charge will be owed. Under the presumptive rule of paragraph (g)(2)(vii)(A)(*2*) of this section, interest will be charged on the additional tax owed on the $100 of recapture income as if the tax had accrued in Year 1 (the year in which the dual consolidated loss reduced the income of P). However, the net interest will be reduced to the amount that would have been owed if the consolidated group had filed amended returns, treating the dual consolidated loss as a loss subject to the separate return limitation year restrictions of §§ 1.1502–21A(c) or 1.1502–21T(c), as appropriate, upon adequate documentation of such reduction of interest under paragraph (g)(2)(vii)(B)(*2*) of this section.

EXAMPLE 3. P, a domestic corporation, owns DRC, a domestic corporation that is subject to the income tax laws of Country Z on a residence basis. DRC owns FE, a Country Z corporation. In Year 1, DRC incurs a net operating loss for U.S. tax purposes. Under the tax laws of Country Z, the loss is not recognized until Year 3. The Year 1 net operating loss is a dual consolidated loss under paragraph (c)(5) of this section. The consolidated group elects relief under paragraph (g)(2) of this section by filing the appropriate agreement and uses the dual consolidated loss on its U.S. income tax return. In Year 3, the dual consolidated loss is used under the laws of Country Z to offset the income of FE, which is a triggering event under paragraph (g)(2)(iii) of this section. However, the consolidated group does not recapture the dual consolidated loss. The consolidated group's failure to comply with the recapture provisions of this paragraph (g)(2)(vii) prevents DRC from being eligible for the relief provided under paragraph (g)(2) of this section for any dual consolidated losses incurred in Years 3 through 7, inclusive.

(h) *Effective date*—(1) *In general.* These regulations are effective for taxable years beginning on or after October 1, 1992. Section 1.1503–2A is effective for taxable years beginning after December 31, 1986, and before October 1, 1992.

(2) *Taxpayers that have filed for relief under § 1.1503–2A*—(i) *In general.* Except as provided in paragraph (h)(ii)(b) of this section, taxpayers that have filed agreements described in § 1.1503–2A(c)(3) or certifications described in § 1.1503–2A(d)(3) shall continue to be subject to the provisions of such agreements or certifications, including the amended return or recapture requirements applicable in the event of a triggering event, for the remaining term of such agreements or certifications.

(ii) *Special transition rule.* A taxpayer that has filed an agreement described in § 1.1503–2A(c)(3) or a certification described in § 1.1503–2A(d)(3) and that is in compliance with the provisions of § 1.1503–2A may elect to replace such agreement or certification with an agreement described in paragraph (g)(2)(i) of this section. However, a taxpayer making this election must replace all agreements and certifications filed under § 1.1503–2A. If the taxpayer is a consolidated group, the election must be made with respect to all dual resident corporations or separate units within the group. Likewise, if the taxpayer is an unaffiliated domestic owner, the election must be made with respect to all separate units of the domestic owner. The taxpayer must file the replacement agreement with its timely filed income tax return for its first taxable year commencing on or after October 1, 1992, stating that such agreement is a replacement for the agreement filed under § 1.1503–2A(c)(3) or the certification filed under § 1.1503–2A(d)(3) and identifying the taxable year for which the original agreement or certification was filed. A single agreement described in paragraph (g)(2)(i) of this section may be filed to replace more than one agreement or certification filed under § 1.1503–2A; however, each dual consolidated loss must be separately identified. A taxpayer may also elect to apply § 1.1503–2 for all open years, with respect to agreements filed under § 1.1503–2A(c)(3) or certifications filed under § 1.1503–2A(d)(3), in cases where the agreement or certification is no longer in effect and the taxpayer has complied with the provisions of § 1.1503–2A. For example, a taxpayer may have had a triggering event under § 1.1503–2A that is not a triggering event under § 1.1503–2. If the taxpayer fully complied with the requirements of the agreement entered into under § 1.1503–2A(c)(3) and filed amended U.S. income tax returns within the time required under § 1.1503–2A(c)(3), the taxpayer may file amended U.S. income tax returns consistent with the position that the earlier triggering event is no longer a triggering event.

(3) *Taxpayers that are in compliance with § 1.1503–2A but have not filed for relief thereunder.* A taxpayer that is in compliance with the provisions of § 1.1503–2A but has not filed an agreement described in § 1.1503–2A(c)(3) or a certification described in § 1.1503–2A(d)(3) may elect to have the provisions of § 1.1503–2 apply for any open year. In particular, a taxpayer may elect to apply the provisions of § 1.1503–2 in a case where the dual consolidated loss has been subjected to the separate return limitation year restrictions of §§ 1.1502–21A(c) or 1.1502–21T(c) (as appropriate) but the losses, expenses, or deductions taken into account in computing the dual consolidated loss have not been used to offset the income of another person for foreign tax purposes. However, if a taxpayer is a consolidated group, the election must be made with respect to all dual resident corporations or separate units within the group. Likewise, if the taxpayer is an unaffiliated domestic owner, the election must be made with respect to all separate units of the domestic owner.

[T.D. 8434, 57 FR 41084, Sept. 9, 1992; 57 FR 48722, Oct. 28, 1992; 57 FR 57280, Dec. 3, 1992; 58 FR 13413, Mar. 11, 1993, as amended by T.D. 8597, 60 FR 36680, July 18, 1995; T.D. 8677, 61 FR 33325, June 27, 1996]

§ 1.1504–0 Outline of provisions.

In order to facilitate the use of §§ 1.1504–1 through 1.1504–4, this section lists the captions contained in §§ 1.1504–1 through 1.1504–4.

§ 1.1504–1 Definitions.

§ 1.1504–2 [Reserved]

§ 1.1504–3 [Reserved]

§ 1.1504–4 Treatment of warrants, options, convertible obligations, and other similar interests.

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[T.D. 8462, 57 FR 61800, Dec. 29, 1992]

§1.1504–1 Definitions.

The privilege of filing consolidated returns is extended to all includible corporations constituting affiliated groups as defined in section 1504. See the regulations under §1.1502 for a description of an affiliated group and the corporations which may be considered as includible corporations.

[T.D. 6500, 25 FR 12106, Nov. 26, 1960]

§§1.1504–2—1.1504–3 [Reserved]

§1.1504–4 Treatment of warrants, options, convertible obligations, and other similar interests.

(a) *Introduction*—(1) *General rule.* This section provides regulations under section 1504(a)(5) (A) and (B) regarding the circumstances in which warrants, options, obligations convertible into stock, and other similar interests are treated as exercised for purposes of determining whether a corporation is a member of an affiliated group. The fact that an instrument may be treated as an option under these regulations does not prevent such instrument from being treated as stock under general principles of law. Except as provided in paragraph (a)(2) of this section, this section applies to all provisions under the Internal Revenue Code and the regulations to which affiliation within the meaning of section 1504(a) (with or without the exceptions in section 1504(b)) is relevant, including those provisions that refer to section 1504(a)(2) (with or without the exceptions in section 1504(b)) without referring to affiliation, provided that the 80 percent voting power and 80 percent value requirements of section 1504(a)(2) are not modified therein.

(2) *Exceptions.* This section does not apply to sections 163(j), 864(e), or 904(i) or to the regulations thereunder. This section also does not apply to any other provision specified by the Internal Revenue Service in regulations, a revenue ruling, or revenue procedure. See §601.601(d)(2)(ii)(*b*) of this chapter.

(b) *Options not treated as stock or as excerised*—(1) *General rule.* Except as provided in paragraph (b)(2) of this section, an option is not considered either as stock or as exercised. Thus, options are disregarded in determining whether a corporation is a member of an affiliated group unless they are described in paragraph (b)(2) of this section.

(2) *Options treated as exercised*—(i) *In general.* Solely for purposes of determining whether a corporation is a member of an affiliated group, an option is treated as exercised if, on a measurement date with respect to such option—

(A) It could reasonably be anticipated that, if not for this section, the issuance or transfer of the option in lieu of the issuance, redemption, or transfer of the underlying stock would result in the elimination of a substantial amount of federal income tax liability (as described in paragraphs (e) and (f) of this section); and

(B) It is reasonably certain that the option will be exercised (as described in paragraph (g) of this section).

(ii) *Aggregation of options.* All options with the same measurement date are aggregated in determining whether the issuance or transfer of an option in lieu of the issuance, redemption, or transfer of the underlying stock would result in the elimination of a substantial amount of federal income tax liability.

(iii) *Effect of treating option as exercised*—(A) *In general.* An option that is treated as exercised is treated as exercised for purposes of determining the percentage of the value of stock owned by the holder and other parties, but is not treated as exercised for purposes of determining the percentage of the voting power of stock owned by the holder and other parties.

(B) *Cash settlement options, phantom stock, stock appreciation rights, or similar interests.* If a cash settlement option, phantom stock, stock appreciation right, or similar interest is treated as exercised, the option is treated as having been converted into stock of the issuing corporation. If the amount to be received upon the exercise of such an option is determined by reference to a multiple of the increase in the value of a share of the issuing corporation's stock on the exercise date over the value of a share of the stock on the date the option is issued, the option is treated as converted into a corresponding number of shares of such stock. Appropriate adjustments must be made in any situation in which the amount to be received upon exercise of the option is determined in another manner.

(iv) *Valuation.* For purposes of section 1504(a)(2)(B) and this section, all shares of stock within a single class are considered to have the same value. Thus, control premiums and minority and blockage discounts within a single class are not taken into account.

(3) *Example.* The provisions of paragraph (b)(2) of this section may be illustrated by the following example:

Example. (i) Corporation P owns all 100 shares of the common stock of Corporation S, the only class of S stock outstanding. Each share of S stock has a fair market value of $10 and has one vote. On June 30, 1992, P issues to Corporation X an option to acquire 80 shares of the S stock from P.

(ii) If, under the provisions of this section, the option is treated as exercised, then, solely for purposes of determining affiliation, P is treated as owning only 20 percent of the value of the outstanding S stock and X is treated as owing the remaining 80 percent of the value of the S stock. P is still treated as owning all of the voting power of S. Accordingly, because P is treated as owning less than 80 percent of the value of the outstanding S stock, P and S are no longer affiliated. However, because X is not treated as owning any of the voting power of S, X and S are also not affiliated.

(c) *Definitions.* For purposes of this section—

(1) *Issuing corporation.* ''Issuing corporation'' means the corporation whose stock is subject to an option.

(2) *Related or sequential option.* ''Related or sequential option'' means an option that is one of a series of options issued to the same or related persons. For purposes of this section, any options issued to the same person or related persons within a two-year period are presumed to be part of a series of options. This presumption may be rebutted if the facts and circumstances clearly establish that the options are not part of a series of options. Any options issued to the same person or related persons more than two years apart are presumed not to be part of a series of options. This presumption may be rebutted if the facts and circumstances clearly establish that the options are part of a series of options.

(3) *Related persons.* Persons are related if they are related within the meaning of section 267(b) (without the application of sections 267(c) and 1563(e)(1)) or 707(b)(1), substituting ''10 percent'' for ''50 percent'' wherever it appears.

(4) *Measurement date*—(i) *General rule.* ''Measurement date'' means a date on which an option is issued or transferred or on which the terms of an existing option or the underlying stock are adjusted (including an adjustment pursuant to the terms of the option or the underlying stock).

(ii) *Issuances, transfers, or adjustments not treated as measurement dates.* A measurement date does not include a date on which—

(A) An option is issued or transferred by gift, at death, or between spouses or former spouses under section 1041;

(B) An option is issued or transferred—

(*1*) Between members of an affiliated group (determined with the exceptions in section 1504(b) and without the application of this section); or

(*2*) Between persons none of which is a member of the affiliated group (determined without the exceptions in section 1504(b) and without the application of this section), if any, of which the issuing corporation is a member, unless—

(*i*) Any such person is related to (or acting in concert with) the issuing corporation or any member of its affiliated group; and

(*ii*) The issuance or transfer is pursuant to a plan a principal purpose of which is to avoid the application of section 1504 and this section;

(C) An adjustment occurs in the terms or pursuant to the terms of an option or the underlying stock that does not materially increase the likelihood that the option will be exercised; or

(D) A change occurs in the exercise price of an option or in the number of shares that may be issued or transferred pursuant to the option as determined by a bona fide, reasonable, adjustment formula that has the effect of preventing dilution of the interests of the holders of the options.

(iii) *Transactions increasing likelihood of exercise.* If a change or alteration referred to in this paragraph (c)(4)(iii) is made for a principal purpose of increasing the likelihood that an option will be exercised, a measurement date also includes any date on which—

(A) The capital structure of the issuing corporation is changed; or

(B) The fair market value of the stock of the issuing corporation is altered through a transfer of assets to or from the issuing corporation (other than regular, ordinary dividends) or by any other means.

(iv) *Measurement date for options issued pursuant to a plan.* In the case of options issued pursuant to a plan, a measurement date for any of the options constitutes a measurement date for all options issued pursuant to the plan that are outstanding on the measurement date.

(v) *Measurement date for related or sequential options.* In the case of related or sequential options, a measurement date for any of the options constitutes a measurement date for all related or sequential options that are outstanding on the measurement date.

(vi) *Example.* The provisions of paragraph (c)(4)(v) of this section may be illustrated by the following example.

Example. (i) Corporation P owns all 80 shares of the common stock of Corporation S, the only class of S stock outstanding. On January 1, 1992, S issues a warrant, exercisable within 3 years, to U, an unrelated corporation, to acquire 10 newly issued shares of S common stock. On July 1, 1992, S issues a second warrant to U to acquire 10 additional newly issued shares of S common stock. On January 1, 1993, S issues a third warrant to T, a wholly owned subsidiary of U, to acquire 10 newly issued shares of S common stock. Assume that the facts and circumstances do not clearly establish that the options are not part of a series of options.

(ii) January 1, 1992, July 1, 1992, and January 1, 1993, constitute measurement dates for the first warrant, the second warrant, and the third warrant, respectively, because the warrants were issued on those dates.

(iii) Because the first and second warrants were issued within two years of each other, and both warrants were issued to U, the warrants constitute related or sequential options. Accordingly, July 1, 1992, constitutes a measurement date for the first warrant as well as for the second warrant.

(iv) Because the first, second, and third warrants were all issued within two years of each other, and were all issued to the same or related persons, the warrants constitute related or sequential options. Accordingly, January 1, 1993, constitutes a measurement date for the first and second warrants, as well as for the third warrant.

(5) *In-the-money.* ''In-the-money'' means the exercise price of the option is less than (or in the case of an option to sell stock, greater than) the fair market value of the underlying stock.

(d) *Options*—(1) *Instruments treated as options.* For purposes of this section, except to the extent otherwise provided in this paragraph (d), the following are treated as options:

(i) A call option, warrant, convertible obligation, put option, redemption agreement (including a right to cause the redemption of stock), or any other instrument that provides for the right to issue, redeem, or transfer stock (including an option on an option); and

(ii) A cash settlement option, phantom stock, stock appreciation right, or any other similar interest (except for stock).

(2) *Instruments generally not treated as options.* For purposes of this section,

the following will not be treated as options:

(i) *Options on section 1504(a)(4) stock.* Options on stock described in section 1504(a)(4);

(ii) *Certain publicly traded options*—(A) *General rule.* Options which on the measurement date are traded on (or subject to the rules of) a qualified board or exchange as defined in section 1256(g)(7), or on any other exchange, board of trade, or market specified by the Internal Revenue Service in regulations, a revenue ruling, or revenue procedure. See § 601.601(d)(2)(ii)(*b*) of this chapter;

(B) *Exception.* Paragraph (d)(2)(ii)(A) of this section does not apply to options issued, transferred, or listed with a principal purpose of avoiding the application of section 1504 and this section. For example, a principal purpose of avoiding the application of section 1504 and this section may exist if warrants, convertible or exchangeable debt instruments, or other similar instruments have an exercise price (or, in the case of convertible or exchangeable instruments, a conversion or exchange premium) that is materially less than, or a term that is materially longer than, those that are customary for publicly traded instruments of their type. A principal purpose may also exist if a large percentage of an issuance of an instrument is placed with one investor (or group of investors) and a very small percentage of the issuance is traded on a qualified board or exchange;

(iii) *Stock purchase agreements.* Stock purchase agreements or similar arrangements whose terms are commercially reasonable and in which the parties' obligations to complete the transaction are subject only to reasonable closing conditions;

(iv) *Escrow, pledge, or other security agreements.* Agreements for holding stock in escrow or under a pledge or other security agreement that are part of a typical commercial transaction and that are subject to customary commercial conditions;

(v) *Compensatory options*—(A) *General rule.* Stock appreciation rights, warrants, stock options, phantom stock, or other similar instruments provided to employees, directors, or independent contractors in connection with the performance of services for the corporation or a related corporation (and that is not excessive by reference to the services performed) and which—

(*1*) Are nontransferable within the meaning of § 1.83–3(d); and

(*2*) Do not have a readily ascertainable fair market value as defined in § 1.83–7(b) on the measurement date;

(B) *Exceptions.* (*1*) Paragraph (d)(2)(v)(A) of this section does not apply to options issued or transferred with a principal purpose of avoiding the application of section 1504 and this section; and

(*2*) Paragraph (d)(2)(v)(A) of this section ceases to apply to options that become transferable;

(vi) *Options granted in connection with a loan.* Options granted in connection with a loan if the lender is actively and regularly engaged in the business of lending and the options are issued in connection with a loan to the issuing corporation that is commercially reasonable. This paragraph (d)(2)(vi) continues to apply if the option is transferred with the loan (or if a portion of the option is transferred with a corresponding portion of the loan). However, if the option is transferred without a corresponding portion of the loan, this paragraph (d)(2)(vi) ceases to apply;

(vii) *Options created pursuant to a title 11 or similar case.* Options created by the solicitation or receipt of acceptances to a plan of reorganization in a title 11 or similar case (within the meaning of section 368(a)(3)(A)), the option created by the confirmation of the plan, and any option created under the plan prior to the time the plan becomes effective;

(viii) *Convertible preferred stock.* Convertible preferred stock, provided the terms of the conversion feature do not permit or require the tender of any consideration other than the stock being converted; and

(ix) *Other enumerated instruments.* Any other instruments specified by the Internal Revenue Service in regulations, a revenue ruling, or revenue procedure. See § 601.601(d)(2)(ii)(*b*) of this chapter.

(e) *Elimination of federal income tax liability.* For purposes of this section, the elimination of federal income tax liability includes the elimination or deferral of federal income tax liability. In determining whether there is an elimination of federal income tax liability, the tax consequences to all involved parties are considered. Examples of elimination of federal income tax liability include the use of a loss or deduction that would not otherwise be utilized, the acceleration of a loss or deduction to a year earlier than the year in which the loss or deduction would otherwise be utilized, the deferral of gain or income to a year later than the year in which the gain or income would otherwise be reported, and the acceleration of gain or income to a year earlier than the year in which the gain or income would otherwise be reported, if such gain or income is offset by a net operating loss or net capital loss that would otherwise expire unused. The elimination of federal income tax liability does not include the deferral of gain with respect to the stock subject to the option that would be recognized if such stock were sold on a measurement date.

(f) *Substantial amount of federal income tax liability.* The determination of what constitutes a substantial amount of federal income tax liability is based on all the facts and circumstances, including the absolute amount of the elimination, the amount of the elimination relative to overall tax liability, and the timing of items of income and deductions, taking into account present value concepts.

(g) *Reasonable certainty of exercise*—(1) *Generally.* The determination of whether, as of a measurement date, an option is reasonably certain to be exercised is based on all the facts and circumstances, including:

(i) *Purchase price.* The purchase price of the option in absolute terms and in relation to the fair market value of the stock or the exercise price of the option;

(ii) *In-the-money option.* Whether and to what extent the option is in-the-money on the measurement date;

(iii) *Not in-the-money option.* If the option is not in-the-money on the measurement date, the amount or percentage by which the exercise price of the option is greater than (or in the case of an option to sell stock, is less than) the fair market value of the underlying stock;

(iv) *Exercise price.* Whether the exercise price of the option is fixed or fluctuates depending on the earnings, value, or other indication of economic performance of the issuing corporation;

(v) *Time of exercise.* The time at which, or the period of time during which, the option can be exercised;

(vi) *Related or sequential options.* Whether the option is one in a series of related or sequential options;

(vii) *Stockholder rights.* The existence of an arrangement (either within the option agreement or in a related agreement) that, directly or indirectly, affords managerial or economic rights in the issuing corporation that ordinarily would be afforded to owners of the issuing corporation's stock (e.g., voting rights, dividend rights, or rights to proceeds on liquidation) to the person who would acquire the stock upon exercise of the option or a person related to such person. For this purpose, managerial or economic rights in the issuing corporation possessed because of actual stock ownership in the issuing corporation are not taken into account;

(viii) *Restrictive covenants.* The existence of restrictive covenants or similar arrangements (either within the option agreement or in a related agreement) that, directly or indirectly, prevent or limit the ability of the issuing corporation to undertake certain activities while the option is outstanding (e.g., covenants limiting the payment of dividends or borrowing of funds);

(ix) *Intention to alter value.* Whether it was intended that through a change in the capital structure of the issuing corporation or a transfer of assets to or from the issuing corporation (other than regular, ordinary dividends) or by any other means, the fair market value of the stock of the issuing corporation would be altered for a principal purpose of increasing the likelihood that the option would be exercised; and

(x) *Contingencies.* Any contingency (other than the mere passage of time) to which the exercise of the option is subject (e.g., a public offering of the issuing corporation's stock or reaching a certain level of earnings).

(2) *Cash settlement options, phantom stock, stock appreciation rights, or similar interests.* A cash settlement option, phantom stock, stock appreciation right, or similar interest is treated as reasonably certain to be exercised if it is reasonably certain that the option will have value at some time during the period in which the option may be exercised.

(3) *Safe harbors*—(i) *Options to acquire stock.* Except as provided in paragraph (g)(3)(iv) of this section, an option to acquire stock is not considered reasonably certain, as of a measurement date, to be exercised if—

(A) The option may be exercised no more than 24 months after the measurement date and the exercise price is equal to or greater than 90 percent of the fair market value of the underlying stock on the measurement date; or

(B) The terms of the option provide that the exercise price of the option is equal to or greater than the fair market value of the underlying stock on the exercise date.

(ii) *Options to sell stock.* Except as provided in paragraph (g)(3)(iv) of this section, an option to sell stock is not considered reasonably certain, as of a measurement date, to be exercised if—

(A) The option may be exercised no more than 24 months after the measurement date and the exercise price is equal to or less than 110 percent of the fair market value of the underlying stock on the measurement date; or

(B) The terms of the option provide that the exercise price of the option is equal to or less than the fair market value of the underlying stock on the exercise date.

(iii) *Options exercisable at fair market value.* For purposes of paragraphs (g)(3)(i)(B) and (g)(3)(ii)(B) of this section, an option whose exercise price is determined by a formula is considered to have an exercise price equal to the fair market value of the underlying stock on the exercise date if the formula is agreed upon by the parties when the option is issued in a bona fide attempt to arrive at fair market value on the exercise date and is to be applied based upon the facts in existence on the exercise date.

(iv) *Exceptions.* The safe harbors of this paragraph (g)(3) do not apply if—

(A) An arrangement exists that provides the holder or a related party with stockholder rights described in paragraph (g)(1)(vii) of this section (except for rights arising upon a default under the option or a related agreement);

(B) It is intended that through a change in the capital structure of the issuing corporation or a transfer of assets to or from the issuing corporation (other than regular, ordinary dividends) or by any other means, the fair market value of the stock of the issuing corporation will be altered for a principal purpose of increasing the likelihood that the option will be exercised; or

(C) The option is one in a series of related or sequential options, unless all such options satisfy paragraph (g)(3) (i) or (ii) of this section.

(v) *Failure to satisfy safe harbor.* Failure of an option to satisfy one of the safe harbors of this paragraph (g)(3) does not affect the determination of whether an option is treated as reasonably certain to be exercised.

(h) *Examples.* The provisions of this section may be illustrated by the following examples. These examples assume that the measurement dates set forth in the examples are the only measurement dates that have taken place or will take place.

Example 1. (i) P is the common parent of a consolidated group, consisting of P, S, and T. P owns all 100 shares of S's only class of stock, which is voting common stock. P also owns all the stock of T. On June 30, 1992, when the fair market value of the S stock is $40 per share, P sells to U, an unrelated corporation, an option to acquire 40 shares of the S stock that P owns at an exercise price of $30 per share, exercisable at any time within 3 years after the granting of the option. P and T have had substantial losses for 5 consecutive years while S has had substantial income during the same period. Because P, S, and T have been filing consolidated returns, P and T have been able to use all of their losses to offset S's income. It is anticipated that P, S, and T will continue their earnings histories for several more years. On July 31, 1992, S declares and pays a dividend of $1 per share to P.

(ii) If P, S, and T continue to file consolidated returns after June 30, 1992, it could reasonably be anticipated that P, S, and T would eliminate a substantial amount of federal income tax liability by using P's and T's future losses to offset S's income in consolidated returns. Furthermore, based on the difference between the exercise price of the option and the fair market value of the S stock, it is reasonably certain, on June 30, 1992, a measurement date, that the option will be exercised. Therefore, the option held by U is treated as exercised. As a result, for purposes of determining whether P and S are affiliated, P is treated as owning only 60 percent of the value of outstanding shares of S stock and U is treated as owning the remaining 40 percent. P is still treated as owning 100 percent of the voting power. Because members of the P group are no longer treated as owning stock possessing 80 percent of the total value of the S stock as of June 30, 1992, S is no longer a member of the P group. Additionally, P is not entitled to a 100 percent dividends received deduction under section 243(a)(3) because P and S are also treated as not affiliated for purposes of section 243. P is only entitled to an 80 percent dividends received deduction under section 243(c).

Example 2. (i) The facts are the same as in *Example 1* except that rather than P issuing an option to acquire 40 shares of S stock to U on June 30, 1992, P, pursuant to a plan, issues an option to U1 on July 1, 1992, to acquire 20 shares of S stock, and issues an option to U2 on July 2, 1992, to acquire 20 shares of S stock.

(ii) Because the options issued to U1 and U2 were issued pursuant to a plan, July 2, 1992, constitutes a measurement data for both options. Therefore, both options are aggregated in determining whether the issuance of the options, rather than the sale of the S stock, would result in the elimination of a substantial amount of federal income tax liability. Accordingly, as in *Example 1*, because the continued affiliation of P, S, and T could reasonably be anticipated to result in the elimination of a substantial amount of federal income tax liability and the options are reasonably certain to be exercised, the options are treated as exercised for purposes of determining whether P and S are affiliated, and P and S are no longer affiliated as of July 2, 1992.

Example 3. (i) The facts are the same as in *Example 1* except that the option gives U the right to acquire all 100 shares of the S stock, and U is the common parent of a consolidated group. The U group has had substantial losses for 5 consecutive years and it is anticipated that the U group will continue its earnings history for several more years.

(ii) If P sold the S stock, in lieu of the option, to U, S would become a member of the U group. Because the U group files consolidated returns, if P sold the S stock to U, U would be able to use its future losses to offset future income of S. When viewing the transaction from the effect on all parties, the sale of the option, in lieu of the underlying S stock, does not result in the elimination of federal income tax liability because S's income would be offset by the losses of members of either the P or U group. Accordingly, the option is disregarded and S remains a member of the P group.

Example 4. (i) P is the common parent of a consolidated group, consisting of P and S. P owns 90 of the 100 outstanding shares of S's only class of stock, which is voting common stock, and U, an unrelated corporation, owns the remaining 10 shares. On August 31, 1992, when the fair market value of the S stock is $100 per share, P sells a call option to U that entitles U to purchase 20 shares of S stock from P, at any time before August 31, 1993, at an exercise price of $115 per share. The call option does not provide U with any voting rights, dividend rights, or any other managerial or economic rights ordinarily afforded to owners of the S stock. There is no intention on August 31, 1992, to alter the value of S to increase the likelihood of the exercise of the call option.

(ii) Because the exercise price of the call option is equal to or greater than 90 percent of the fair market value of the S stock on August 31, 1992, a measurement date, the option may be exercised no more than 24 months after the measurement date, and none of the items described in paragraph (g)(3)(iv) of this section that preclude application of the safe harbor are present, the safe harbor of paragraph (g)(3)(i) of this section applies and the call option is treated as if it is not reasonably certain to be exercised. Therefore, regardless of whether the continued affiliation of P and S would result in the elimination of a substantial amount of federal income tax liability, the call option is disregarded in determining whether S remains a member of the P group.

Example 5. (i) The facts are the same as in *Example 4* except that the call option gives U the right to vote similar to that of a shareholder.

(ii) Under paragraph (g)(3)(iv) of this section, the safe harbor of paragraph (g)(3)(i) of this section does not apply because the call option entitles U to voting rights equivalent to that of a shareholder. Accordingly, all of the facts and circumstances surrounding the sale of the call option must be taken into consideration in determining whether it is reasonably certain that the call option will be exercised.

Example 6. (i) In 1992, two unrelated corporations, X and Y, decide to engage jointly in a new business venture. To accomplish this purpose, X organizes a new corporation, S, on September 30, 1992. X acquires 100 shares of the voting common stock of S, which are the only shares of S stock outstanding. Y acquires a debenture of S which is convertible, on September 30, 1995, into 100 shares of S common stock. If the conversion right is not exercised, X will have the right, on September 30, 1995, to put 50 shares of its S stock to Y in exchange for 50 percent of the debenture held by Y. The likelihood of the success of the venture is uncertain. It is anticipated that S will generate substantial losses in its early years of operation. X expects to have substantial taxable income during the three years following the organization of S.

(ii) Under the terms of this arrangement, it is reasonably certain on September 30, 1992, a measurement date, that on September 30, 1995, either through Y's exercise of its conversion right or X's right to put S stock to Y, that Y will own 50 percent of the S stock. Additionally, it could reasonably be anticipated, on September 30, 1992, a measurement date, that the affiliation of X and S would result in the elimination of a substantial amount of federal income tax liability. Accordingly, for purposes of determining whether X and S are affiliated, X is treated as owning only 50 percent of the value of the S stock as of September 30, 1992, a measurement date, and S is not a member of the X affiliated group.

Example 7. (i) The facts are the same as in *Example 6* except that rather than acquiring 100 percent of the S stock and the right to put S stock to Y, X acquires only 80 percent of the S stock, while S, rather than acquiring a convertible debenture, acquires 20 percent of the S stock, and an option to acquire an additional 30 percent of the S stock. The terms of the option are such that the option will only be exercised if the new business venture succeeds.

(ii) In contrast to *Example 6*, because of the true business risks involved in the start-up of S and whether the business venture will ultimately succeed, along with the fact that X does not have an option to put S stock to Y, it is not reasonably certain on September 30, 1992, a measurement date, that the option will be exercised and that X will only own 50 percent of the S stock on September 30, 1995. Accordingly, the option is disregarded in determining whether S is a member of the X group.

(i) *Effective date.* This section applies, generally, to options with a measurement date on or after February 28, 1992. This section does not apply to options issued prior to February 28, 1992, which have a measurement date on or after February 28, 1992, if the measurement date for the option occurs solely because of an adjustment in the terms of the option pursuant to the terms of the option as it existed on February 28, 1992. Paragraph (b)(2)(iv) of this section applies to stock outstanding on or after February 28, 1992.

[T.D. 8462, 57 FR 61801, Dec. 29, 1992; 58 FR 7041, Feb. 3, 1993]

REGULATIONS APPLICABLE TO TAXABLE YEARS BEFORE JANUARY 1, 1997

§ 1.1502–15A Limitations on the allowance of built-in deductions for consolidated return years beginning before January 1, 1997.

(a) *Limitation on built-in deductions*—(1) *General rule.* Built-in deductions (as defined in subparagraph (2) of this paragraph) for a taxable year shall be subject to the limitation of § 1.1502–21A(c) (determined without regard to such deductions and without regard to net operating loss carryovers to such year) and the limitation of § 1.1502–22A(c) (determined without regard to such deductions and without regard to capital loss carryovers to such year). If as a result of applying such limitations, built-in deductions are not allowable in such consolidated return year, such deductions shall be treated as a net operating loss or net capital loss (as the case may be) sustained in such year and shall be carried to those taxable years (consolidated or separate) to which a consolidated net operating loss or a consolidated net capital loss could be carried under §§ 1.1502–21A, 1.1502–22A and 1.1502–79A, (or §§ 1.1502-21T and 1.1502-22T, as appropriate) except that such losses shall be treated as losses subject to the limitations contained in §§ 1.1502–21T(c) or 1.1502-22T(c) (or §§ 1.1502-21A(c), 1.1502–22A(c), as appropriate), as the case may be. Thus, for example, if member X sells a capital asset during a consolidated return year at a $1,000 loss and such loss is treated as a built-in deduction, then such loss shall be subject to the limitation contained in § 1.1502–22(c), which, in general, would allow such loss to be offset only against X's own capital gain net income (net capital gain for taxable years beginning before January 1, 1977). Assuming X had no capital gain net income (net capital gain for taxable years beginning before January 1, 1977) reflected in such year (after taking into account its capital losses, other than capital loss carryovers and the built-in deduction), such $1,000 loss shall be treated as a net capital loss and shall be carried over for 5 years under § 1.1502–22, subject to the limitation contained in § 1.1502–22(c) for consolidated return years.

(2) *Built-in deductions.* (i) For purposes of this paragraph, the term ‘‘built-in deductions’’ for a consolidated return year means those deductions or losses of a corporation which are recognized in such year, or which are recognized in a separate return year and carried over in the form of a net operating or net capital loss to such year, but which are economically accrued in a separate return limitation year (as defined in §1.1502–1(f)). Such term does not include deductions or losses incurred in rehabilitating such corporation. Thus, for example, assume P is the common parent of a group filing consolidated returns on the basis of a calendar year and that P purchases all of the stock of S on December 31, 1966. Assume further that on December 31, 1966, S owns a capital asset with an adjusted basis of $100 and a fair market value of $50. If the group files a consolidated return for 1967, and S sells the asset for $30, $50 of the $70 loss is treated as a built-in deduction, since it was economically accrued in a separate return limitation year. If S sells the asset for $80 instead of $30, the $20 loss is treated as a built-in deduction. On the other hand, if such asset is a depreciable asset and is not sold by S, depreciation deductions attributable to the $50 difference between basis and fair market value are treated as built-in deductions.

(ii) In determining, for purposes of subdivision (i) of this subparagraph, whether a deduction or loss with respect to any asset is economically accrued in a separate return limitation year, the term ‘‘predecessor’’ as used in §1.1502–1(f)(1) shall include any transferor of such asset if the basis of the asset in the hands of the transferee is determined (in whole or in part) by reference to its basis in the hands of such transferor.

(3) *Transitional rule.* If the assets which produced the built-in deductions were acquired (either directly or by acquiring a new member) by the group on or before January 4, 1973, and the separate return limitation year in which such deductions were economically accrued ended before such date, then at the option of the taxpayer, the provisions of this paragraph before amendment by T.D. 7246 shall apply, and, in addition, if such assets were acquired on or before April 17, 1968, and the separate return limitation year in which the built-in deductions were economically accrued ended on or before such date, then at the option of the taxpayer, the provisions of §1.1502–31A(b)(9)(as contained in the 26 C.F.R. edition revised as of April 1, 1996) shall apply in lieu of this paragraph.

(4) *Exceptions.* (i) Subparagraphs (1), (2), and (3) of this paragraph shall not limit built-in deductions in a taxable year with respect to assets acquired (either directly or by acquiring a new member) by the group if:

(a) The group acquired the assets more than 10 years before the first day of such taxable year, or

(b) Immediately before the group acquired the assets, the aggregate of the adjusted basis of all assets (other than cash, marketable securities, and goodwill) acquired from the transferor or owned by the new member did not exceed the fair market value of all such assets by more than 15 percent.

(ii) For purposes of subdivision (i)*(b)* of this subparagraph, a security is not a marketable security if immediately before the group acquired the assets:

(a) The fair market value of the security is less than 95 percent of its adjusted basis, or

(b) The transferor or new member had held the security for at least 24 months, or

(c) The security is stock in a corporation at least 50 percent of the fair market value of the outstanding stock of which is owned by the transferor or new member.

(b) *Effective date.* This section applies to any consolidated return years to which §1.1502–21T does not apply. See §1.1502–21T(g) for effective dates of that section.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 6909, 31 FR 16695, Dec. 30, 1966; T.D. 7246, 37 FR 761, Jan. 4, 1972; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 8677, 61 FR 33323, June 27, 1996. Redesignated and amended by T.D. 8677, 61 FR 33326, June 27, 1996]

§ 1.1502–21A Consolidated net operating loss deduction generally applicable for consolidated return years beginning before January 1, 1997.

(a) *In general.* The consolidated net operating loss deduction shall be an amount equal to the aggregate of the consolidated net operating loss carryovers and carrybacks to the taxable year (as determined under paragraph (b) of this section).

(b) *Consolidated net operating loss carryovers and carrybacks*—(1) *In general.* The consolidated net operating loss carryovers and carrybacks to the taxable year shall consist of any consolidated net operating losses (as determined under paragraph (f) of this section) of the group, plus any net operating losses sustained by members of the group in separate return years, which may be carried over or back to the taxable year under the principles of section 172(b). However, such consolidated carryovers and carrybacks shall not include any consolidated net operating loss apportioned to a corporation for a separate return year pursuant to § 1.1502–79A(a), and shall be subject to the limitations contained in paragraphs (c), (d), and (e) of this section and to the limitation contained in § 1.1502–15A (or § 1.1502–11(c), as appropriate).

(2) *Rules for applying section 172(b)(1)*—(i) *Regulated transportation corporations.* For purposes of applying section 172(b)(1)(C) (relating to net operating losses sustained by regulated transportation corporations), in the case of a consolidated net operating loss sustained in a taxable year for which a member of the group was a regulated transportation corporation (as defined in section 172(j)(1)), the portion, if any, of such consolidated net operating loss which is attributable to such corporation (as determined under this paragraph shall be a carryover to the sixth taxable year following the loss year only if such corporation is a regulated transportation corporation for such sixth year, and shall be a carryover to the seventh taxable year following the loss year only if such corporation is a regulated transportation corporation for both such sixth and seventh years.

(ii) *Trade expansion losses.* In the case of a carryback of a consolidated net operating loss from a taxable year for which a member of the group has been issued a certification under section 317 of the Trade Expansion Act of 1962 and with respect to which the requirements of section 172(b)(3)(A) have been met, section 172(b)(1)(A)(ii) shall apply only to the portion of such consolidated net operating loss attributable to such member.

(iii) *Foreign expropriation losses.* An election under section 172(b)(3)(C) (relating to 10-year carryover of portion of net operating loss attributable to a foreign expropriation loss) may be made for a consolidated return year only if the sum of the foreign expropriation losses (as defined in section 172(k)) of the members of the group for such year equals or exceeds 50 percent of the consolidated net operating loss for such year. If such election is made, the amount which may be carried over under section 172(b)(1)(D) is the smaller of *(a)* the sum of such foreign expropriation losses, or *(b)* the consolidated net operating loss.

(3) *Absorption rules.* For purposes of determining the amount, if any, of a net operating loss (whether consolidated or separate) which can be carried to a taxable year (consolidated or separate), the amount of such net operating loss which is absorbed in a prior consolidated return year under section 172(b)(2) shall be determined by:

(i) Applying all net operating losses which can be carried to such prior year in the order of the taxable years in which such losses were sustained, beginning with the taxable year which ends earliest, and

(ii) Applying all such losses which can be carried to such prior year from taxable years ending on the same date on a pro rata basis, except that any portion of a net operating loss attributable to a foreign expropriation loss to which section 172(b)(1)(D) applies shall be applied last.

(c) *Limitation on net operating loss carryovers and carrybacks from separate return limitation years*—(1) *General rule.* In the case of a net operating loss of a member of the group arising in a separate return limitation year (as defined in paragraph (f) of § 1.1502–1) of such member (and in a separate return limitation year of any predecessor of such member), the amount which may be included under paragraph (b) of this section (computed without regard to the limitation contained in paragraph (d) of this section) in the consolidated net operating loss carryovers and carrybacks to a consolidated return year of the group shall not exceed the amount determined under subparagraph (2) of this paragraph.

(2) *Computation of limitation.* The amount referred to in subparagraph (1) of this paragraph with respect to a member of the group is the excess, if any, of:

(i) Consolidated taxable income (computed without regard to the consolidated net operating loss deduction), minus such consolidated taxable income recomputed by excluding the items of income and deduction of such member, over

(ii) The net operating losses attributable to such member which may be carried to the consolidated return year arising in taxable years ending prior to the particular separate return limitation year.

(3) *Examples.* The provisions of this paragraph and paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). (i) Corporation P formed corporations S and T on January 1, 1965. P, S, and T filed separate returns for the calendar year 1965, a year for which an election under section 1562 was effective. T's return for that year reflected a net operating loss of $10,000. The group filed a consolidated return for 1966 reflecting consolidated taxable income of $30,000 (computed without regard to the consolidated net operating loss deduction). Among the transactions occurring during 1966 were the following:

(a) P sold goods to T deriving deferred profits of $7,000 on such sales, $2,000 of which was restored to consolidated taxable income on the sale of such goods to outsiders;

(b) T sold a machine to S deriving a deferred profit of $5,000, $1,000 of which was restored to consolidated taxable income as a result of S's depreciation deductions;

(c) T distributed a $3,000 dividend to P; and

(d) In addition to the transactions described above, T had other taxable income of $6,000.

(ii) The carryover of T's 1965 net operating loss to 1966 is subject to the limitation contained in this paragraph, since 1965 was a separate return limitation year (an election under section 1562 was effective for such year). Thus, only $7,000 of T's $10,000 net operating loss is a consolidated net operating loss carryover to 1966, since such carryover is limited to consolidated taxable income (computed without regard to the consolidated net operating loss deduction), $30,000, minus such consolidated taxable income recomputed by excluding the items of income and deduction of T, $23,000 (*i.e.*, consolidated taxable income computed without regard to the $1,000 restoration of T's deferred gain and T's $6,000 of other income). In making such recomputation, no change is made in the effect on consolidated taxable income of P's sale to T, or of the dividend from T to P.

Example (2). (i) Corporation P was formed on January 1, 1966. P filed separate returns for the calendar years 1966 and 1967 reflecting net operating losses of $4,000 and $12,000, respectively. P purchased corporation S on March 15, 1967. S was formed on February 1, 1966, and filed a separate return for the taxable year ending January 31, 1967. S also filed a short period return for the period from February 1 to December 31, 1967, and joined with P in filing a consolidated return for 1968. S sustained net operating losses of $5,000 and $6,000 for its taxable years ending January 31, 1967, and December 31, 1967, respectively. An election under section 1562 was not effective for P and S during the period involved. Consolidated taxable income for 1968 (computed without regard to the consolidated net operating loss deduction) was $16,000; such consolidated taxable income recomputed by disregarding the items of income and deduction of S was $9,000.

(ii) In order of time, the following losses are absorbed in 1968:

(a) P's $4,000 net operating loss for the calendar year 1966 (such loss is not subject to the limitation contained in this paragraph since P is the common parent corporation for 1968);

(b) S's $5,000 net operating loss for the year ended January 31, 1967. Such loss is subject to the limitation contained in this paragraph, since S was not a member of the group on each day of such year. However, such loss can be carried over and absorbed in full since such limitation is $7,000 (consolidated taxable income computed without regard to the consolidated net operating loss deduction, $16,000, minus such consolidated taxable income recomputed, $9,000); and

(c) $6,000 of P's net operating loss and $1,000 of S's net operating loss for the taxable years ending December 31, 1967. This is determined by applying the losses from such year which can be carried to 1968 (P's $12,000 loss and $2,000 of S's $6,000 loss, since such $6,000 loss is limited under this paragraph) on a pro rata basis against the amount of such losses which can be absorbed in that year, $7,000 (consolidated taxable income of $16,000 less the $9,000 of losses absorbed from prior

years). The carryover of S's loss to 1968 is subject to the limitation contained in that paragraph, since S was not a member of the group on each day of its taxable year ending December 31, 1967. Such loss is limited to $2,000, the excess of $7,000 (as determined under (ii)*(b))* over $5,000 (S's carryover from the year ended January 31, 1967). If a consolidated return is filed in 1969, the consolidated net operating loss carryovers will consist of P's unabsorbed loss of $6,000 ($12,000 minus $6,000) from 1967 and, subject to the limitation contained in this paragraph, S's unabsorbed loss of $5,000 ($6,000 minus $1,000) from its year ended December 31, 1967.

(d) *Limitation on carryovers where there has been a consolidated return change of ownership*—(1) *General rule.* If a consolidated return change of ownership (as defined in paragraph (g) of §1.1502–1) occurs during the taxable year or an earlier taxable year, the amount which may be included under paragraph (b) of this section in the consolidated net operating loss carryovers to the taxable year with respect to the aggregate of the net operating losses attributable to old members of the group (as defined in paragraph (g)(3) of §1.1502–1) arising in taxable years (consolidated or separate) ending on the same day and before the taxable year in which the consolidated return change of ownership occurred shall not exceed the amount determined under subparagraph (2) of this paragraph.

(2) *Computation of limitation.* The amount referred to in subparagraph (1) of this paragraph shall be the excess of:

(i) The consolidated taxable income for the taxable year (determined without regard to the consolidated net operating loss deduction) recomputed by including only the items of income and deduction of the old members of the group, over

(ii) The sum of the net operating losses attributable to the old members of the group which may be carried to the taxable year arising in taxable years ending prior to the particular loss year or years.

(3) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. (i) Corporation P is formed on January 1, 1967, and on the same day it forms corporation S. P and S file a consolidated return for the calendar year 1967, reflecting a consolidated net operating loss of $500,000. On January 1, 1968, individual X purchases all of the outstanding stock of P. X subsequently contributes $1,000,000 to P and P purchases the stock of corporation T. P, S, and T file a consolidated return for 1968 reflecting consolidated taxable income of $600,000 (computed without regard to the consolidated net operating loss deduction). Such consolidated taxable income recomputed by including only the items of income and deduction of P and S is $350,000.

(ii) Since a consolidated return change of ownership took place in 1968 (there was more than a 50 percent change of ownership of P), the amount of the consolidated net operating loss from 1967 which can be carried over to 1968 is limited to $350,000, the excess of $350,000 (consolidated taxable income recomputed by including only the items of income and deduction of the old members of the group, P and S) over zero (the amount of the consolidated net operating loss carryovers attributable to the old members of the group arising in taxable years ending before 1967).

(4) *Cross-reference.* See §1.1502–21T(d)(1) for the rule that applies the principles of this paragraph (d) in consolidated return years beginning on or after January 1, 1997, with respect to a consolidated return change of ownership occurring before January 1, 1997.

(e) *Limitations on net operating loss carryovers under section 382*—(1) *Section 382(a).* (i) If at the end of a taxable year (consolidated or separate) there has been an increase in ownership of the stock of the common parent of a group (within the meaning of section 382(a)(1) (A) and (B)), and any member of the group has not continued to carry on a trade or business substantially the same as that conducted before any such increase (within the meaning of section 382(a)(1)(C)), then the portion of any consolidated net operating loss sustained in prior taxable years attributable to such member (as determined under this paragraph shall not be allowed as a carryover to such taxable year or to any subsequent taxable year.

(ii) If the provisions of section 382(a) disallow the deduction of a net operating loss carryover from a separate return year of a member of the group to a subsequent taxable year, no amount shall be included under paragraph (b) of this section as a consolidated net operating loss carryover to such a subsequent consolidated return year with respect to such separate return year of such member.

(iii) The provisions of this subparagraph may be illustrated by the following example:

Example. P, S, and T file a consolidated return for the calendar year 1969, reflecting a consolidated net operating loss attributable in part to each member. P owns 80 percent of S's stock and S owns 80 percent of T's stock. On January 1, 1970, A purchases 50 percent of P's stock. During 1970 T's business is discontinued. Since there has been a 50 percentage point increase in ownership of P, the common parent of the group, and since T has not continued to carry on the same trade or business after such increase, the portion of the 1969 consolidated net operating loss attributable to T shall not be included in any net operating loss deduction for 1970 or for any subsequent taxable years, whether consolidated or separate.

(2) *Section 382(b).* If a net operating loss carryover from a separate return year of a predecessor of a member of the group to the taxable year is reduced under the provisions of section 382(b), the amount included under paragraph (b) of this section with respect to such predecessor shall be so reduced.

(3) *Effective date.* This paragraph (e) disallows or reduces the net operating loss carryovers of a member as a result of a transaction to which old section 382 (as defined in §1.382–2T(f)(21)) applies. See §1.1502–21T(d)(2) for the rule that applies the principles of this paragraph (e) in consolidated return years beginning on or after January 1, 1997, with respect to such a transaction.

(f) *Consolidated net operating loss.* The consolidated net operating loss shall be determined by taking into account the following:

(1) The separate taxable income (as determined under §1.1502–12) of each member of the group, computed without regard to any deduction under section 242;

(2) Any consolidated capital gain net income (net capital gain for taxable years beginning before January 1, 1977);

(3) Any consolidated section 1231 net loss;

(4) Any consolidated charitable contributions deduction;

(5) Any consolidated dividends received deduction (determined under §1.1502–26 without regard to paragraph (a)(2) of that section); and

(6) Any consolidated section 247 deduction (determined under §1.1502–27 without regard to paragraph (a)(1)(ii) of that section).

(g) *Groups that include insolvent financial institutions.* For rules applicable to relinquishing the entire carryback period with respect to losses attributable to insolvent financial institutions, see §301.6402–7 of this chapter.

(h) *Effective date.* Except as provided in §1.1502–21T (d)(1), (d)(2), and (g)(3), this section applies to consolidated return years beginning before January 1, 1997.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 8387, 56 FR 67489, Dec. 31, 1991; T.D. 8446, 57 FR 53034, Nov. 6, 1992; T.D. 8677, 61 FR 33323, June 27, 1996. Redesignated and amended by T.D. 8677, 61 FR 33328, June 27, 1996]

§1.1502–22A Consolidated net capital gain or loss generally applicable for consolidated return years beginning before January 1, 1997.

(a) *Computation*—(1) *Consolidated capital gain net income.* The consolidated capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for the taxable year shall be determined by taking into account:

(i) The aggregate of the capital gains and losses (determined without regard to gains or losses to which section 1231 applies or net capital loss carryovers or carrybacks) of the members of the group for the consolidated return year,

(ii) The consolidated section 1231 net gain for such year (computed in accordance with §§1.1502–23A or 1.1502–23T), and

(iii) The consolidated net capital loss carryovers or carrybacks to such year (as determined under paragraph (b) of this section).

(2) *Consolidated net capital loss.* The consolidated net capital loss shall be determined under subparagraph (1) of this paragraph but without regard to subdivision (iii) thereof.

(3) *Special rules.* For purposes of this section, capital gains and losses on intercompany transactions and transactions with respect to stock, bonds, and other obligations of a member of the group shall be reflected as provided in §§1.1502–13, and 1.1502–19, and capital losses shall be limited as provided in §§1.1502–15A and 1.1502-11(c).

(4) [Reserved]

(5) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. (i) Corporations P, S, and T file consolidated returns on a calendar year basis for 1966 and 1967. The members had the following transactions involving capital assets during 1967: P sold an asset with a $10,000 basis to S for $17,000 and none of the circumstances of restoration described in § 1.1502–13 occurred by the end of the consolidated return year; S sold an asset to individual A for $7,000 which S had purchased during 1966 from P for $10,000, and with respect to which P had deferred a gain of $2,000; T sold an asset with a basis of $10,000 to individual B for $25,000. The group has a consolidated net capital loss carryover to the taxable year of $10,000.

(ii) The consolidated net capital gain of the group is $4,000, determined as follows: P's net capital gain of $2,000, representing the deferred gain on the sale to S during the taxable year 1966, restored into income during taxable year 1967 (the $7,000 gain on P's deferred intercompany transaction is not taken into account for the current year), plus T's net capital gain of $15,000, minus S's net capital loss of $3,000 and the consolidated net capital loss carryover of $10,000.

(b) *Consolidated net capital loss carryovers and carrybacks*—(1) *In general.* The consolidated net capital loss carryovers and carrybacks to the taxable year shall consist of any consolidated net capital losses of the group, plus any net capital losses of members of the group arising in separate return years of such members, which may be carried to the taxable year under the principles of section 1212(a). However, such consolidated carryovers and carrybacks shall not include any consolidated net capital loss apportioned to a corporation for a separate return year pursuant to § 1.1502–79A(b) (or § 1.1502–22T(b), as appropriate) and shall be subject to the limitations contained in paragraphs (c) and (d) of this section. For purposes of section 1212(a)(1), the portion of any consolidated net capital loss for any taxable year attributable to a foreign expropriation capital loss is the amount of the foreign expropriation capital losses of all the members for such year (but not in excess of the consolidated net capital loss for such year).

(2) *Absorption rules.* For purposes of determining the amount, if any, of a net capital loss (whether consolidated or separate) which can be carried to a taxable year (consolidated or separate), the amount of such net capital loss which is absorbed in a prior consolidated return year under section 1212(a)(1) shall be determined by:

(i) Applying all net capital losses which can be carried to such prior year in the order of the taxable years in which such losses were sustained, beginning with the taxable year which ends earliest, and

(ii) Applying all such losses which can be carried to such prior year from taxable years ending on the same date on a prorata basis, except that any portion of a net capital loss attributable to a foreign expropriation capital loss to which section 1212(a)(1)(B) applies shall be applied last.

(c) *Limitation on net capital loss carryovers and carrybacks from separate return limitation years*—(1) *General rule.* In the case of a net capital loss of a member of the group arising in a separate return limitation year (as defined in paragraph (f) of § 1.1502–1) of such member (and in a separate return limitation year of any predecessor of such member), the amount that may be included under paragraph (b) of this section (computed without regard to the limitation contained in paragraph (d) of this section) shall not exceed the amount determined under subparagraph (2) of this paragraph.

(2) *Computation of limitation.* The amount referred to in subparagraph (1) of this paragraph with respect to a member of the group is the excess, if any, of:

(i) The consolidated capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for the taxable year (computed without regard to any net capital loss carryovers and carrybacks), minus such consolidated capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for the taxable year recomputed by excluding the capital gains and losses and the gains and losses to which section 1231 applies of such member, over

(ii) The net capital losses attributable to such member which can be carried to the taxable year arising in taxable years ending prior to the particular separate return limitation year.

(d) *Limitation on capital loss carryovers where there has been a consolidated return change of ownership*—(1) *General rule.* If a consolidated return change of ownership (as defined in paragraph (g) of §1.1502–1) occurs during the taxable year or an earlier taxable year, the amount which may be included under paragraph (b) of this section in the consolidated net capital loss carryovers to the taxable year with respect to the aggregate of the net capital losses attributable to old members of the group (as defined in paragraph (g)(3) of §1.1502–1) arising in taxable years (consolidated or separate) ending on the same day and before the taxable year in which the consolidated return change of ownership occurred shall not exceed the amount determined under subparagraph (2) of this paragraph.

(2) *Computation of limitation.* The amount referred to in subparagraph (1) of this paragraph shall be the excess of:

(i) The consolidated capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (determined without regard to any net capital loss carryovers for the taxable year) recomputed by including only capital gains and losses and gains and losses to which section 1231 applies of the old members of the group, over

(ii) The aggregate net capital losses attributable to the old members of the group which may be carried to the taxable year arising in taxable years ending prior to the particular loss year or years.

(3) *Cross-reference.* See §1.1502–22T(d) for the rule that applies the principles of this paragraph (d) in consolidated return years beginning on or after January 1, 1997, with respect to a consolidated return change of ownership occurring before January 1, 1997.

(e) *Effective date.* This section applies to any consolidated return years to which §1.1502–21T(g) does not apply. See §1.1502–21T(g) for effective dates of that section.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 8597, 60 FR 36679, July 18, 1995; T.D. 8677, 33323, June 27, 1996. Redesignated and amended by T.D. 8677, 61 FR 33333, June 27, 1996]

§1.1502–23A Consolidated net section 1231 gain or loss generally applicable for consolidated return years beginning before January 1, 1997.

(a) The consolidated section 1231 net gain or loss for the taxable year shall be determined by taking into account the aggregate of the gains and losses to which section 1231 applies of the members of the group for the consolidated return year. Section 1231 gains and losses on intercompany transactions shall be reflected as provided in §1.1502–13. Section 1231 losses that are ‘‘built-in deductions’’ shall be subject to the limitations of §§1.1502–21A(c) and 1.1502–22A(c), as provided in §1.1502–15A(a) (or §§1.1502–21T(c) and 1.1502–22T(c), as provided in §1.1502–15T(a), as appropriate).

(b) *Effective date.* This section applies to any consolidated return years to which §1.1502–21T(g) does not apply. See §1.1502–21T(g) for effective dates of that section.

[T.D. 7246, 38 FR 763, Jan. 4, 1973, as amended by T.D. 8677, 33323, June 27, 1996. Redesignated and amended by T.D. 8677, 61 FR 33334, June 27, 1996]

§1.1502–41A Determination of consolidated net long-term capital gain and consolidated net short-term capital loss generally applicable for consolidated return years beginning before January 1, 1997.

(a) *Consolidated net long-term capital gain.* The consolidated net long-term capital gain shall be determined by taking into account (1) those gains and losses to which §1.1502–22A(a) applies which are treated as long term under section 1222, and (2) the consolidated section 1231 net gain (computed in accordance with §1.1502–23A).

(b) *Consolidated net short-term capital loss.* The consolidated net short-term capital loss shall be determined by taking into account (1) those gains and losses to which §1.1502–22A(a) applies which are treated as short term under section 1222, and (2) the consolidated net capital loss carryovers and carrybacks to the taxable year (as determined under §1.1502–22A(b)).

(c) *Effective date.* This section applies to any consolidated return years to which §1.1502–21T(g) does not apply.

See §1.1502–21T(g) for effective dates of that section.

[T.D, 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 8677, 61 FR 33323, June 27, 1996. Redesignated and amended by T.D. 8677, 61 FR 33334, June 27, 1996]

§1.1502–79A Separate return years generally applicable for consolidated return years beginning before January 1, 1997.

(a) *Carryover and carryback of consolidated net operating losses to separate return years*—(1) *In general.* (i) If a consolidated net operating loss can be carried under the principles of section 172(b) and paragraph (b) of §1.1502–21A to a separate return year of a corporation (or could have been so carried if such corporation were in existence) which was a member in the year in which such loss arose, then the portion of such consolidated net operating loss attributable to such corporation (as determined under subparagraph (3) of this paragraph) shall be apportioned to such corporation (and any successor to such corporation in a transaction to which section 381(a) applies) and shall be a net operating loss carryover or carryback to such separate return year; accordingly, such portion shall not be included in the consolidated net operating loss carryovers or carrybacks to the equivalent consolidated return year. Thus, for example, if a member filed a separate return for the third year preceding a consolidated return year in which a consolidated net operating loss was sustained and if any portion of such loss is apportioned to such member for such separate return year, such portion may not be carried back by the group to its third year preceding such consolidated return year.

(ii) If a corporation ceases to be a member during a consolidated return year, any consolidated net operating loss carryover from a prior taxable year must first be carried to such consolidated return year, notwithstanding that all or a portion of the consolidated net operating loss giving rise to the carryover is attributable to the corporation which ceases to be a member. To the extent not absorbed in such consolidated return year, the portion of the consolidated net operating loss attributable to the corporation ceasing to be a member shall then be carried to such corporation's first separate return year.

(iii) For rules permitting the reattribution of losses of a subsidiary to the common parent in the case of loss disallowance or basis reduction on the disposition or deconsolidation of stock of the subsidiary, see §1.1502–20.

(2) *Nonapportionment to certain members not in existence.* Notwithstanding subparagraph (1) of this paragraph, the portion of a consolidated net operating loss attributable to a member shall not be apportioned to a prior separate return year for which such member was not in existence and shall be included in the consolidated net operating loss carrybacks to the equivalent consolidated return year of the group (or, if such equivalent year is a separate return year, then to such separate return year), provided that such member was a member of the group immediately after its organization.

(3) *Portion of consolidated net operating loss attributable to a member.* The portion of a consolidated net operating loss attributable to a member of a group is an amount equal to the consolidated net operating loss multiplied by a fraction, the numerator of which is the separate net operating loss of such corporation, and the denominator of which is the sum of the separate net operating losses of all members of the group in such year having such losses. For purposes of this subparagraph, the separate net operating loss of a member of the group shall be determined under §1.1502–12 (except that no deduction shall be allowed under section 242), adjusted for the following items taken into account in the computation of the consolidated net operating loss:

(i) The portion of the consolidated dividends received deduction, the consolidated charitable contributions deductions, and the consolidated section 247 deduction, attributable to such member;

(ii) Such member's capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (determined without regard to any net capital loss carryover attributable to such member);

(iii) Such member's net capital loss and section 1231 net loss, reduced by the portion of the consolidated net capital loss attributable to such member (as determined under paragraph (b)(2) of this section); and

(iv) The portion of any consolidated net capital loss carryover attributable to such member which is absorbed in the taxable year.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). (i) Corporation P was formed on January 1, 1966. P filed a separate return for the calendar year 1966. On March 15, 1967, P formed corporation S. P and S filed a consolidated return for 1967. On January 1, 1968, P purchased all the stock of corporation T, which had been formed in 1967 and had filed a separate return for its taxable year ending December 31, 1967.

(ii) P, S, and T join in the filing of a consolidated return for 1968, which return reflects a consolidated net operating loss of $11,000. $2,000 of such consolidated net operating loss is attributable to P, $3,000 to S, and $6,000 to T. Such apportionment of the consolidated net operating loss was made on the basis of the separate net operating losses of each member as determined under subparagraph (3) of this paragraph.

(iii) $5,000 of the 1968 consolidated net operating loss can be carried back to P's separate return for 1966. Such amount is the portion of the consolidated net operating loss attributable to P and S. Even though S was not in existence in 1966, the portion attributable to S can be carried back to P's separate return year, since S (unlike T) was a member of the group immediately after its organization. The 1968 consolidated net operating loss can be carried back against the group's income in 1967 except to the extent (i.e., $6,000) that it is apportioned to T for its 1967 separate return year and to the extent that it was absorbed in P's 1966 separate return year. The portion of the 1968 consolidated net operating loss attributable to T ($6,000) is a net operating loss carryback to its 1967 separate return.

Example (2). (i) Assume the same facts as in example (1). Assume further that on June 15, 1969, P sells all the stock of T to an outsider, that P and S file a consolidated return for 1969 (which includes the income of T for the period January 1 through June 15), and that T files a separate return for the period June 16 through December 31, 1969.

(ii) The 1968 consolidated net operating loss, to the extent not absorbed in prior years, must first be carried to the consolidated return year 1969. Any portion of the $6,000 amount attributable to T which is not absorbed in T's 1967 separate return year or in the 1969 consolidated return year shall then be carried to T's separate return year ending December 31, 1969.

(b) *Carryover and carryback of consolidated net capital loss to separate return years*—(1) *In general.* If a consolidated net capital loss can be carried under the principles of section 1212(a) and paragraph (b) of §1.1502–22A to a separate return year of a corporation (or could have been so carried if such corporation were in existence) which was a member of the group in the year in which such consolidated net capital loss arose, then the portion of such consolidated net capital loss attributable to such corporation (as determined under subparagraph (2) of this paragraph) shall be apportioned to such corporation (and any successor to such corporation in a transaction to which section 381(a) applies) under the principles of paragraph (a) (1), (2) and (3) of this section and shall be a net capital loss carryback or carryover to such separate return year.

(2) *Portion of consolidated net capital loss attributable to a member.* The portion of a consolidated net capital loss attributable to a member of a group is an amount equal to such consolidated net capital loss multiplied by a fraction, the numerator of which is the net capital loss of such member, and the denominator of which is the sum of the net capital losses of those members of the group having net capital losses. For purposes of this subparagraph, the net capital loss of a member of the group shall be determined by taking into account the following:

(i) Such member's capital gain net income (net capital gain for taxable years beginning before January 1, 1977) or loss (determined without regard to any net capital loss carryover or carryback); and

(ii) Such member's section 1231 net loss, reduced by the portion of the consolidated section 1231 net loss attributable to such member.

(c) through (e) [Reserved]

(f) *Effective date.* Paragraphs (a) and (b) of this section apply to losses arising in consolidated return years to which §1.1502–21T(g) does not apply. For this purpose net operating loss deductions, carryovers, and carrybacks arise in the year from which they are carried. See § 1.1502–21T(g) for effective dates of that section.

[T.D. 8677, 61 FR 33334, June 27, 1996]

DUAL CONSOLIDATED LOSSES INCURRED IN TAXABLE YEARS BEGINNING BEFORE OCTOBER 1, 1992

§ 1.1503–2A Dual consolidated loss.

(a) *In general.* This section applies for purposes of determining whether and to what extent the net operating loss of a dual resident corporation incurred in tax years beginning after December 31, 1986, shall be allowed to reduce the taxable income of any other member of the affiliated group. Except as provided in paragraph (c) of this section, any dual consolidated loss of a domestic corporation incurred in taxable years beginning after December 31, 1986, cannot reduce the taxable income of any affiliate of such domestic corporation for that or any other taxable year, regardless of whether those losses offset income of another corporation under the income tax laws of the foreign country and regardless of whether any of the income of any corporation that the loss may reduce in the foreign country is, has been, or will be subject to tax in the United States. This rule shall also apply to preclude the use of a dual consolidated loss to offset any income of an affiliate (whether or not an election to file a consolidated return has been made) by means of a transaction subject to section 381 of the Code. For purposes of the preceding sentence, an ‘‘affiliate’’ means any member of the affiliated group as determined under section 1504(a) without regard to the exceptions contained in section 1504(b) (other than section 1504(b)(3)) relating to includible corporations. Further, this rule shall also apply to preclude the use of a dual consolidated loss of a separate unit by a domestic corporation upon or as a result of the termination, liquidation, or sale of the separate unit. The following example illustrates the application of this paragraph (a).

Example. P, a domestic corporation, owns all of the outstanding stock of DRC, a domestic corporation. DRC is managed and controlled in Country W, a country which determines the tax residence of corporations according to place of management and control. Therefore, the income of DRC is subject to tax in both the United States and in Country W. There are currently no other corporations in Country W which could use the losses of DRC to offset income under the income tax laws of Country W. P no longer wishes to operate DRC as a separate corporation. Therefore DRC will be liquidated into P under section 332 of the Code. Normally, P, under section 381, would succeed to and take into account DRC’s net operating loss carryovers. However, this paragraph (a) prohibits the net operating loss of DRC from reducing P’s income (including income of P generated by assets previously held by DRC) for U.S. tax purposes. Therefore, DRC’s net operating loss carryovers will not be available to offset P’s income unless one of the exceptions described in paragraph (c) of this section applies.

(b) *Definitions.* The following definitions apply for purposes of this section.

(1) *Domestic corporation.* For purposes of this section, the term ‘‘domestic corporation’’ has the meaning assigned to it by sections 7701 (a)(3) and (a)(4) and shall also include any corporation treated as a domestic corporation by the Internal Revenue Code, including, but not limited to, section 269B and section 1504(d). Subject to the rules of paragraph (d) of this section, any separate unit (as defined in paragraph (b)(4) of this section) of a domestic corporation will be treated as a separate domestic corporation (and as a dual resident corporation) for purposes of this section. The following example illustrates the application of this paragraph (b)(1).

Example. A is a domestic corporation with a branch operation in Country X. A is owned by FP, a Country X corporation. Country X allows the Country X branch income and losses of A to be used to offset FP’s losses or income. Under paragraph (d) of this section, the branch operations of A in Country X will be treated as a separate domestic corporation and as a dual resident corporation for purposes of this section. See paragraph (d) of this section for the treatment of any dual consolidated loss of the branch operations of A.

(2) *Dual consolidated loss.* The term ‘‘dual consolidated loss’’ means the net operating loss (as defined in section 172(c) and the regulations thereunder) of a domestic corporation incurred in a year in which the corporation is a dual resident corporation. The fact that a

particular item taken into account in computing such net operating loss deduction is not taken into account in computing income subject to income tax in a foreign country shall not cause such item to be excluded from the calculation of the dual consolidated loss. A dual consolidated loss shall arise even though no other person, corporation, or entity is permitted, under the income tax laws of the foreign country, to use by any means the losses, expenses or deductions of the dual resident corporation to offset income. A dual consolidated loss shall not include—

(i) The net operating loss incurred during that portion of the taxable year prior to the date on which the domestic corporation becomes a dual resident corporation or subsequent to the date on which the domestic corporation ceases to be a dual resident corporation. For purposes of determining the amount of the net operating loss incurred in that portion of the taxable year prior to the date on which the domestic corporation becomes a dual resident corporation or subsequent to the date on which the domestic corporation ceases to be a dual resident corporation, in no event shall more than a pro rata portion of the net operating loss commensurate with the portion of the taxable year during which the domestic corporation was not a dual resident corporation be allocated to that portion of the taxable year in which the domestic corporation was not a dual resident corporation; or

(ii) Losses incurred in taxable years beginning on or before December 31, 1986.

(3) *Dual resident corporation.* For purposes of this section, a domestic corporation shall be a dual resident corporation if the worldwide income of such corporation is subject to the income tax of a foreign country, or such corporation is subject to the income tax of a foreign country on a residence basis (and not on a source basis).

(4) *Separate unit.* Solely for purposes of this section, the term ''separate unit'' shall mean any of the following:

(i) A foreign branch as defined in §1.367 (a)–6T(g);

(ii) A partnership interest; or

(iii) A trust interest.

(5) *Subject to tax.* For purposes of determining whether a domestic corporation is subject to the income tax of a foreign country on its income, the fact that the corporation has no actual tax liability to the foreign country for a particular taxable year shall not be taken into consideration.

(c) *Exceptions*—(1) *No ability to use dual consolidated loss under foreign law*—(i) *In general.* Paragraph (a) of this section shall not apply to a dual consolidated loss if—

(A) At no time after December 31, 1986, has there been any other person, corporation, or entity which, under the income tax laws of the foreign country, is permitted to use by any means the losses, expenses, or deductions of the dual resident corporation to offset income; and

(B) Under the income tax laws of the foreign country, the losses, expenses, or deductions of the dual resident corporation incurred in taxable years beginning after December 31, 1986, cannot be carried over or back to be used, by any means, to offset the income of any other person, corporation, or entity in other years.

(ii) *Limitations.* For purposes of paragraph (c)(1)(i) of this section, none of the following circumstances shall constitute a satisfaction of paragraph (c)(1)(i)(A) of this section—

(A) The failure to make use of an election (including, but not limited to, the ability to surrender losses, expenses or deductions) that would enable another person, corporation, or entity to use the losses, expenses, or deductions of the dual resident corporation to offset income under the income tax laws of the foreign country;

(B) The fact that the income tax laws of the foreign country deny the use of losses, expenses, or deductions of its corporate residents that are also residents for tax purposes of another country to offset income of another person, corporation, or entity;

(C) The fact that the other person, corporation, or entity does not have sufficient income to benefit from an offset permitted under the income tax laws of the foreign country for a particular taxable year; or

(D) The fact that the dual resident corporation has no losses, expenses, or deductions during a particular taxable year.

(iii) *Examples.* The following examples illustrate this paragraph (c)(1).

Example (1). DRC, a domestic corporation, is also subject to tax in Country Y on its worldwide income. DRC has been filing a consolidated return for U.S. income tax purposes with DP, its domestic parent. DRC has also been able to use its losses to offset income of its affiliates in Country Y by using Country Y's form of consolidation. In order to prevent companies like DRC from taking losses against income of affiliates under Country Y law and then again using the losses of DRC to offset income of affiliates for U.S. tax purposes. Country Y law prevents a company which is also subject to tax on its worldwide income in another country, or is subject to tax on a residence basis in another country, from using the Country Y form of consolidation. DRC is a dual resident corporation as defined in paragraph (b)(3) of this section. DRC's losses are dual consolidated losses as defined in paragraph (b)(2) of this section which under paragraph (a) of this section may not be used to offset income of any other U.S. affiliate of DRC. The Country Y statute does not cause the exception provided by this paragraph (c)(1) to apply.

Example (2). P, a domestic corporation, owns DRC, a domestic corporation which is also subject to the income tax laws of Country Z on a residence basis, and FS, a Country Z corporation. Under Country Z laws, income or losses of DRC may not be consolidated with income or losses of P or FS. There is, however, a provision under Country Z's law by which DRC's unused losses could be carried forward, acquired, and used by FS if DRC is merged into FS. DRC's dual consolidated loss does not qualify for the exception from application of paragraph (a) provided by this paragraph (c)(1) because of the loss carryforward provisions under Country Z's income tax laws. However, DRC may qualify for an exemption from paragraph (a) of this section under the provisions of paragraph (c)(3) of this section.

Example (3). DRC is a dual resident corporation subject to tax on a residence basis in foreign country Y. Under the income tax laws of Y, DRC could elect to use its losses to offset the income of foreign entity FE on a Country Y consolidated income tax return for the taxable year ending December 31, 1987. Regardless of whether such election is made, DRC fails to satisfy the requirement of paragraph (c)(1)(i)(A) of this section.

Example (4). The same facts apply as in *Example* (3), except that Country Y changes its income tax law, effective as of January 1, 1987, to prevent the consolidation of losses by dual resident corporations. Under paragraph (c)(1)(ii)(B) of this section, the fact that this Country Y legislation prevents DRC from using its losses to offset the income of FE is disregarded and DRC fails to satisfy the requirement of paragraph (c)(1)(i)(A) of this section.

Example (5). The same facts apply as in *Example* (4), except that FE has no taxable income in taxable years 1987 through 1989. Moreover, DRC is profitable throughout this period and consequently has no losses which it could share with FE. Under paragraphs (c)(1)(ii) (C) and (D) of this section, the fact that FE would not receive a tax benefit from consolidation with DRC on a Country Y return is disregarded and DRC fails to satisfy the requirement of paragraph (c)(1)(i)(A) of this section. Because DRC does not have a net operating loss during 1987 through 1989, section 1503(d) does not affect the consolidation of DRC on a U.S. return for these years. However, DRC's failure to satisfy paragraph (c)(1)(i)(A) of this section at all times after December 31, 1986 will make it ineligible for the exception described in paragraph (c)(1) of this section with respect to any future taxable year in which it incurs a net operating loss.

Example (6). The same facts apply as in *Example* (5). In 1990, FE is transferred and is no longer eligible for consolidation on a Country Y return. There are no other entities with which DRC could consolidate under the income tax laws of Y. Nevertheless, since FE and DRC could have consolidated on a Country Y return during the period after December 31, 1986 and before the transfer of FE, DRC fails to satisfy the requirement of paragraph (c)(1)(i)(A) of this section in 1990 and in all future taxable years.

(2) *Elective agreement in place between United States and the foreign country.* Paragraph (a) of this section shall not apply to a dual consolidated loss to the extent such loss is subject to an election by the dual resident corporation to deduct the loss in the United States pursuant to an agreement entered into between the United States and the foreign country which puts into place an elective procedure through which losses would offset income in only one country.

(3) *Agreement to amend returns upon later use of losses, expenses, or deductions of a dual resident corporation*—(i) *In general.* Notwithstanding that, under the income tax laws of the foreign country, the losses, expenses, or deductions of the dual resident corporation can be carried over or back to offset, by some means, the income of any other person, corporation, or entity in other taxable years, paragraph (a) of this section shall not apply to a dual consolidated

loss of that dual resident corporation if the requirements described in this paragraph (c)(3)(i) are satisfied.

(A) At no time after December 31, 1986, has there been any other person, corporation, or entity which, under the income tax laws of the foreign country, is permitted to use by any means the losses, expenses, or deductions of the dual resident corporation to offset income. For purposes of the preceding sentence, none of the circumstances described in paragraphs (c)(1)(ii) (A) through (D) of this section shall constitute a satisfaction of this paragraph (c)(3)(i)(A).

(B) The affiliated group or, if there is no affiliated group filing a consolidated return, the dual resident corporation which incurs the loss, files with its U.S. tax return for the taxable year in which the dual consolidated loss arises a binding agreement described in paragraphs (c)(3) (ii) and (iii) of this section. The agreement must be filed under this paragraph (c)(3) even if the only effect of the dual consolidated loss is to increase a net operating loss for U.S. tax purposes.

(ii) *Description of agreement.* Except as otherwise provided in paragraph (c)(3)(viii) of this section, the agreement described in this paragraph (c)(3)(ii) must be attached to, and filed by the due date (including extensions) of, the tax return of the affiliated group or dual resident corporation for the taxable year in which the dual consolidated loss arises. The agreement must be signed under penalties of perjury by the person who signs the tax return of the group or dual resident corporation. The agreement must include the following items, in paragraphs labeled to correspond with the subdivisions set forth below:

(A) The name, address, identifying number, and place and date of incorporation of the dual resident corporation and the country or countries which tax the dual resident corporation on a residence basis or which tax the worldwide income of the dual resident corporation;

(B) A statement that the document submitted constitutes the agreement of the affiliated group or dual resident corporation in accordance with the requirements of §1.1503–2T(c)(3);

(C) A statement of the amount of the dual consolidated loss to be covered by the agreement and the year in which it arose;

(D) The agreement of the group or dual resident corporation to amend returns, as described in paragraph (c)(3)(iii) of this section;

(E) A waiver of the period of limitations, as described in paragraph (c)(3)(iv) of this section; and

(F) An agreement to file with the tax returns of the group or dual resident corporation for each of the fifteen years following the year the dual consolidated loss arose a waiver of the period of limitation, as described in paragrapah (c)(3)(iv) of this section, and a certification as described in paragraph (c)(3)(v) of this section.

(iii) *Terms of agreement.* The affiliated group or dual resident corporation must agree that if there is a ‘‘triggering event’’ described in this paragraph (c)(3)(iii), then, the affiliated group filing a consolidated return, or if there is no affiliated group filing a consolidated return, the dual resident corporation, shall, within 90 days after the date of occurrence of the triggering event, file an amended U.S. income tax return for the taxable year in which the dual consolidated loss arose reporting the dual consolidated loss on the amended return as a loss to which paragraph (a) of this section applies. An amended U.S. income tax return must also be filed for any other taxable year in which the tax liability increases as a result of such applications of paragraph (a) of this section. In addition, upon examination, the group or dual resident corporation must provide to the District Director a schedule of the amended carryforward and carryback losses and credits for each of the group's or dual resident corporation's taxable years for which no amended return is required to be filed pursuant to this paragraph (c)(3)(iii). For purposes of section 6601, the last date prescribed for payment of the additional amount of tax shown on an amended return filed pursuant to this paragraph (c)(3)(iii) shall be the same date as the date prescribed for the payment of tax for the taxable year with respect to which the amended return is filed. Any of the following events shall constitute a ‘‘triggering event’’ for purposes of this section—

(A) There is a failure for any taxable year to file the annual waiver or certification described in paragraphs (c)(3)(iv) and (v) of this section.

(B) Prior to the close of the fifteenth taxable year following the taxable year in which the dual consolidated loss arose, any of the following events—

(*1*) There is a failure to satisfy both the requirement of paragraph (c)(3)(i)(A) of this section and the requirements of paragraph (c)(4) of this section;

(*2*) Where the agreement is made by an affiliated group filing a consolidated return, the dual resident corporation (or its successor-in-interest) ceases to be a member of the affiliated group;

(*3*) Where the agreement is made by a dual resident corporation that is not a member of an affiliated group filing a consolidated return, the dual resident corporation is no longer in existence; or

(*4*) Where the dual resident corporation is a separate unit of a domestic corporation, the domestic corporation sells or transfers the dual resident corporation.

(iv) *Waiver of period of limitation.* The affiliated group or the dual resident corporation (or the successor-in-interest of such group or dual resident corporation) must file, with the agreement to amend returns and with the tax return for each of the fifteen taxable years following the taxable year in which the dual consolidated loss arose, a waiver of the limitation on assessment of any tax resulting from the amendment of any return as described in paragraph (c)(3)(iii) of this section. The waiver shall extend the period for assessment of such tax to a date not earlier than three years after the return is filed for the fifteenth taxable year following the taxable year in which the dual consolidated loss arose. The waiver shall also contain such other terms with respect to assessment as may be considered by the Commissioner to be necessary to insure the assessment and collection of the correct tax liability for each year for which the waiver is required. The waiver must be signed by a person authorized to sign the agreement described in paragraph (c)(3)(ii) of this section. A failure, at any time, to comply with the requirements of this paragraph (c)(3) or with the terms of any agreement filed pursuant to this paragraph (c)(3) shall extend the period of assessment of such tax until three years after the date on which the Internal Revenue Service receives actual notice of the use of or of the ability to use the losses, expenses, or deductions of the dual resident corporation to offset the income of another person, corporation, or entity under the income tax laws of the foreign country.

(v) *Annual certification.* The affiliated group or the dual resident corporation (or the successor-in-interest of such group or dual resident corporation) must file with its income tax return for each of the fifteen taxable years following the taxable year in which the dual consolidated loss arose a certification that the losses, expenses, or deductions of the dual resident corporation were not used or permitted to be used to offset the income of another person, corporation, or entity under the income tax laws of a foreign country. The annual certification pursuant to this paragraph (c)(3)(v) must be signed under penalties of perjury by a person authorized to sign the agreement described in paragraph (c)(3)(ii) of this section. The certification must identify the dual consolidated loss with respect to which it is given by setting forth the taxpayer’s year in which the loss arose and the amount of such loss and must warrant that arrangements have been made to insure that the group or dual resident corporation will be informed of any subsequent use of or ability to use the losses, expenses, or deductions of the dual resident corporation to offset the income of another person, corporation, or entity under the income tax laws of the foreign country. If dual consolidated losses of more than one taxable year are subject to the rules of this paragraph (c)(3), the certifications for those years may be combined in a single document, but each dual consolidated loss must be separately identified.

(vi) *Special rules for a succeeding group or a successor-in-interest*—(A) *Ceasing to be a member of the affiliated group.* For purposes of this paragraph (c)(3), and except as otherwise provided in this paragraph (c)(3)(vi), a dual resident corporation shall be deemed to have ceased to be a member of the affiliated group that filed the agreement described in paragraph (c)(3)(ii) of this section if it is no longer a member of that group, as defined in §1.1502–1(b), or if the group ceases to exist because the common parent is no longer in existence or is no longer a common parent or the group no longer files on the basis of a consolidated return. However, the obligation to file an amended return pursuant to the agreement described in paragraph (c)(3)(ii) of this section shall not apply and the dual resident corporation shall not be deemed to have ceased to be a member of the group for purposes of this paragraph (c)(3) where the dual resident corporation ceases to be a member of the group solely by reason of an acquisition of its assets by a member of the group in a transaction to which section 381(a) applies provided the successor-in-interest of the dual resident corporation continues to be a member of the group.

(B) *Special rules for a succeeding group.* The obligation to file an amended return pursuant to the agreement described in paragraph (c)(3)(ii) of this section shall not apply where the dual resident corporation becomes a member of a succeeding group as a result of an acquisition described in §1.1502–13(f)(2)(i) (*a*) or (*b*) (relating generally to the acquisition of assets of, by, or from a member of the affiliated group in a tax-free reorganization) and the succeeding group attaches to, and files with, its timely filed (including extensions) tax return for the taxable year in which the acquisition takes place a binding agreement—

(*1*) Which sets forth the same terms as are described in paragraph (c)(3)(ii) of this section,

(*2*) In which the group agrees to be bound by the terms of the agreement previously filed by the terminating group, and

(*3*) In which the group agrees to all the terms set forth in paragraph (c)(3)(iii) of this section.

The agreement must be signed under penalties of perjury by the person who signs the tax return of the succeeding group.

(C) *Special rules for a successor-in-interest.* In the case of a dual resident corporation that was not a member of an affiliated group filing a consolidated return in the taxable year in which the dual consolidated loss arose and that filed an agreement described in paragraph (c)(3)(ii) of this section, the assets of which are acquired in a transaction described in section 381(a), such corporation shall not be required to file an amended return pursuant to paragraph (c)(3)(iii)(B)(*3*) of this section provided its successor-in-interest attaches a binding agreement to its timely filed (including extensions) tax return for the taxable year in which the acquisition takes place. The agreement must be signed under penalties of perjury by the person who signs the tax return of the successor-in-interest. The agreement must:

(*1*) Set forth the same terms as are described in paragraph (c)(3)(ii) of this section,

(*2*) State the agreement of the successor-in-interest to be bound by the terms of the agreement previously filed by the dual resident corporation, and

(*3*) State the agreement of the successor-in-interest to all the terms set forth in paragraph (c)(3)(iii) of this section.

(vii) *Definitions.* For purposes of this section—

(A) The terms *succeeding group* and *terminating group* shall have the same meaning as in §1.1502.13(f)(2)(i); and

(B) The term *successor-in-interest* shall mean an acquiring corporation that succeeds to the tax attributes of an acquired corporation under the provisions of section 381 by reason of a transaction described in section 381(a).

(viii) *Transition rules.* An affiliated group or a dual resident corporation (or a succeeding group or a successor-in-interest of a dual resident corporation) that meets the eligibility requirements described in paragraph (c)(3)(ix) of this section will be permitted to apply the transition rules in this paragraph (c)(3)(viii) for taxable years ending before December 31, 1989.

(A) The agreement in satisfaction of paragraph (c)(3) (ii) or (vi) of this section may be attached to the timely filed (including extensions) tax return of the affiliated group or of the dual resident corporation (or the succeeding group or the successor-in-interest of such dual resident corporation) for the first taxable year which ends on or after December 31, 1989. The agreement required for each of the taxable years ending before December 31, 1989 and for the first taxable year ending on or after December 31, 1989 may be combined on a single document.

(B) The requirement of paragraphs (c)(3)(iv) and (c)(3)(v) of this section regarding the filing of an annual waiver of the period of limitation and certification shall be satisfied for the taxable years ending before December 31, 1989, and no failure to file shall be deemed to have occurred with respect to such taxable years for purposes of paragraph (c)(3)(iii)(A) of this section if the waivers and certifications required under paragraphs (c)(3)(iv) and (c)(3)(v) of this section are filed with the tax return for the first taxable year ending on or after December 31, 1989.

(ix) *Eligibility for transition rules.* The rules in paragraph (c)(3)(viii) of this section shall apply only if, as of the date of the agreement in satisfaction of paragraph (c)(3) (ii) or (vi) of this section and filed pursuant to paragraph (c)(3)(viii) of this section, none of the triggering events described in paragraph (c)(3)(iii)(B) of this section has occurred.

(4) *No ability to use dual consolidated loss under foreign law after restructuring*—(i) *In general.* Notwithstanding that a dual resident corporation fails to satisfy either paragraph (c)(1)(i)(A) or (c)(3)(i)(A) of this section, paragraph (a) of this section shall not apply to any dual consolidated loss (or portion of a dual consolidated loss) described in paragraph (c)(4)(iii) of this section provided the requirements of either paragraph (c)(1)(i)(B) or (c)(3)(i)(B) of this section are satisfied and a restructuring that meets the requirements of paragraph (c)(4)(ii) of this section has been completed.

(ii) *Qualified restructuring.* A restructuring meets the requirements of this paragraph (c)(4)(ii) if it is completed on or before December 31, 1989, in the foreign country so that at all times from the date of such restructuring to the close of the taxable year in which the dual consolidated loss arises, there is no other person, corporation, or entity which, under the income tax laws of the foreign country, is permitted to use by any means the losses, expenses, or deductions of the dual resident corporation to offset income. For purposes of the preceding sentence, none of the circumstances described in paragraphs (c)(1)(ii) (A) through (D) of this section shall constitute a satisfaction of this paragraph (c)(4)(ii).

(iii) *Qualified losses.* Losses to which paragraph (c)(4)(i) of this section applies are the dual consolidated losses of a dual resident corporation that arise in a taxable year beginning after the restructuring described in paragraph (c)(4)(ii) of this section (or the portion of any dual consolidated loss that arises during that portion of the taxable year following the restructuring described in paragraph (c)(4)(ii) of this section). For purposes of determining the amount of the dual consolidated loss which arises in that portion of the taxable year following the restructuring, in no event shall more than a pro rata portion of the dual consolidated loss commensurate with the portion of the taxable year beginning with the date of completion of the restructuring and ending on the last day of that same taxable year be allocated to that portion of the taxable year following the restructuring.

(d) *Special rule for separate units*—(1) *Separate units characterized as corporations under foreign law.* If a separate unit of a domestic corporation consists of an interest in an entity (including a foreign branch) that for U.S. tax purposes is not taxable as an association, but the entity is subject to income tax in a foreign jurisdiction as a corporation either on its worldwide income or on a residence basis (and not on a source basis), then for purposes of this section such separate unit of the domestic corporation will be treated as if it were a dual resident corporation and a wholly-owned domestic subsidiary of the domestic corporation. For purposes of paragraphs (c) (3) and (4) of this section, any agreement, waiver and certification required to be filed with respect to such dual resident corporation shall be filed with the federal income tax return of the domestic corporation owning the separate unit or by the affiliated group with which the domestic corporation files a consolidated return.

(2) *Other separate units.* Except as provided in paragraph (d)(3) of this section, if a separate unit of a domestic corporation (other than a separate unit described in paragraph (d)(1) of this section) is permitted under the income tax laws of a foreign country—

(i) To use its losses, expenses, or deductions to offset the income of any other person, corporation, or entity in the taxable year in which the dual consolidated loss arises; or

(ii) To carry over or back its losses, expenses, or deductions so that they may offset the income of any other person, corporation, or entity in other years, then such separate unit will be treated for purposes of this section as if it were a dual resident corporation and a wholly-owned domestic subsidiary of the domestic corporation. For purposes of the preceding sentence, none of the circumstances described in paragraphs (c)(1)(ii) (A) through (D) of this section shall preclude a separate unit from being treated as a dual resident corporation and a separate domestic corporation under this paragraph (d)(2). This paragraph (d)(2) applies regardless of whether the domestic corporation is a member of an affiliated group, and, if it is, regardless of whether the group files a consolidated return.

(3) *Certification.* Paragraph (d)(2) of this section shall not apply with respect to any taxable year for which the domestic corporation owning the separate unit (or the affiliated group of which the domestic corporation is a member) files a certification as described in this paragraph (d)(3). The certification must be attached to, and filed by the due date (including extensions) of, the federal income tax return of the domestic corporation owning the separate unit (or the affiliated group with which the domestic corporation files a consolidated return) for the taxable year to which it applies. With respect to returns filed without an attached certification for taxable years ending before December 31, 1989, the certification in satisfaction of this paragraph (d)(3) may be attached to the return for the first taxable year ending on or after December 31, 1989. The certification must be signed under penalties of perjury by the person who signs the return. The certification must include the following items, in paragraphs labeled to correspond with the subdivisions set forth below:

(i) A statement that the document submitted constitutes the certification required under the provisions of §1.1503–2T(d)(3);

(ii) Identification of the separate unit, including the name under which it conducts business and its principal activity;

(iii) Identification of the total losses, expenses, and deductions incurred by the separate unit and included on the tax return for the taxable year;

(iv) Certification that no portion of the separate unit's losses, expenses or deductions identified above has been or will be used to offset the income of any other person, corporation, or entity under the income tax laws of the foreign country; and

(v) An agreement to comply with the recapture and interest charge requirements of paragraph (d)(4) of this section.

If the domestic corporation has more than one separate unit, the certification described above may be made on a single document, but the total losses, expenses, and deductions must be separately identified for each separate unit to which the certification applies.

(4) *Recapture upon subsequent use.* If in any taxable year any portion of the losses, expenses, or deductions of a separate unit which were the subject of a certification filed under paragraph (d)(3) of this section are used by any means to offset the income of any other person, corporation, or entity under the income tax laws of a foreign country, then the total amount of the dual consolidated loss shall be recaptured and reported as income on the tax return of the domestic corporation (or the affiliated group with which the domestic corporation files a consolidated return) for the taxable year that includes the last day of the taxable year for foreign tax purposes during which such use occurred. In addition, the domestic corporation owning the separate unit (or the affiliated group

with which the domestic files a consolidated return) shall pay an interest charge on the amount of additional tax owed as a result of the recapture described in the preceding sentence. Such interest shall be determined under the rules of section 6601(a) as if the additional amount of tax had accrued and been due and owing for the taxable year in which the losses, expenses, or deductions giving rise to the recapture gave rise to a tax benefit for U.S. income tax purposes. For purposes of this paragraph (d)(4), a tax benefit will be considered to have arisen in a taxable year in which a loss that would have been considered a dual consolidated loss if paragraph (d)(3) of this section had not applied has reduced the U.S. income tax liability of the domestic corporation or of the affiliated group with which it files a consolidated return.

(5) *Treatment of separate units as separate entities*—(i) *In general.* A separate unit of a domestic corporation will be treated as a separate entity for purposes of determining under this section whether losses of one entity are permitted under the income tax laws of the foreign country to offset the income of another entity.

(ii) *Exception for separate units in same country.* If two or more separate units (not described in paragraph (d)(1) of this section) located in the same foreign country are owned by a single domestic corporation and the income and losses of such units are consolidated on an income tax return in that foreign country, then the separate units will be treated as one separate unit for purposes of paragraph (d)(2) of this section.

(6) *Examples.* The following examples illustrate this paragraph (d).

Example (1). X, a member of a U.S. affiliated group, has a foreign branch (as defined in § 1.367(a)–6T(g)) in Country Y. Under the Country Y income tax laws, the branch will be taxed as a permanent establishment and its income and losses may be used (on an elective basis) in the Country Y form of consolidation to offset the income of Z, an affiliate of X, under Country Y law. The branch of X incurs a net operating loss during the taxable year ending December 31, 1987. The foreign branch of X will be treated as a separate domestic corporation and a dual resident corporation under paragraph (d)(2) of this section, and its net operating loss will constitute a dual consolidated loss. Consequently, under paragraph (a) of this section, the branch's net operating loss may not be used to offset the income of any other U.S. affiliate or any income of X other than income derived from the branch operations. However, the branch will not be treated as a dual resident corporation if X (or the affiliated group of which X is a member) files a certification for the taxable year as described in paragraph (d)(3) of this section that its net operating loss was not in fact used by Z (or any other entity) to offset income under the Country Y income tax laws, and that such loss will be recaptured if it is so used in the future.

Example (2). X is classified as a partnership for U.S. tax purposes under Code section 7701 and applicable regulations. A, B and C are the sole partners of X. A and B are domestic corporations and C is a resident of foreign country Y. Under Country Y's law, X is classified as a corporation and its income and losses may be used in the Country Y form of consolidation to offset the income of the companies that are affiliates of X. X generates net operating losses. The partnership interests held by A and B are each treated as separate domestic corporations and dual resident corporations under paragraph (d)(1) of this section. A's and B's pro rata share of the losses of X are dual consolidated losses as defined in paragraph (b)(2) of this section. Under paragraph (a) of this section, the losses of X may not be used to offset the income of any other U.S. affiliate. A's pro rata share of losses of X may be used by A only to offset A's pro rata share of income of X. However, paragraph (a) of this section shall not apply to A's pro rata share of losses of X if A meets one of the exceptions described in paragraph (c) of this section. The same principles apply to limit the use of losses allocated to B.

Example (3). Domestic corporation W owns two unincorporated business operations in Country Y. The two businesses, A and B, constitute separate foreign branches (as defined in § 1.367(a)–6T(g)). Under the tax laws of Country Y, A is treated as a separate corporation and taxed on a residence basis. Thus, A is a separate unit described in paragraph (d)(1) of this section. B is not a separate unit described in paragraph (d)(1) of this section. W is a calendar year taxpayer for both United States and Country Y purposes. During the calendar year ending December 31, 1987, A operated at a loss and B was profitable. Country Y allows both of W's branches to report their combined operations on a single income tax return. Thus, the losses incurred by A may be used on the 1987 Country Y return to offset the income of B. A will be treated as a dual resident corporation under paragraph (d)(1) of this section. Because A is a separate unit described in paragraph (d)(1) of this section, paragraph (d)(5)(i) of this section treats A and B as separate entities for purposes of determining whether the losses, expenses, or deductions of A may be used to offset the income of another person, corporation, or entity and the exception in paragraph (d)(5)(ii) of this section does not apply. Since the loss incurred by A may be used to offset B's income under foreign tax laws, W will not qualify for the exceptions described in paragraph (c) of this section. Accordingly, W will report the income from B on its 1987 U.S. tax return, but will not be allowed to use the losses from A to offset that income or the income from any source other than from the operations of A.

(e) *Special rule for use of dual consolidated loss to offset tainted income*—(1) *In general.* The dual consolidated loss of any dual resident corporation that ceases to be a dual resident corporation shall not be used to offset income of such corporation to the extent that such income is tainted income as defined in paragraph (e)(2) of this section.

(2) *Tainted income defined.* Tainted income is any income derived from tainted assets (as defined in paragraph (e)(3) of this section), during the period beginning on the date of the transfer or acquisition of tainted assets and ending at the close of the fifteenth taxable year following the taxable year in which the dual resident corporation ceased to be a dual resident corporation.

(3) *Tainted assets defined.* Tainted assets are any assets transferred to or acquired by a dual resident corporation in a non-recognition transaction (as defined in section 7701(a)(45)) at any time during the three taxable years immediately preceding the taxable year in which such dual resident corporation ceased to be a dual resident corporation or at any time during the 15 taxable years immediately following the taxable year in which a dual resident corporation ceased to be a dual resident corporation. Tainted assets shall not include assets that were transferred to or acquired by such dual resident corporation on or before December 31, 1986.

(4) *Exception.* For assets transferred to or acquired by a dual resident corporation prior to the time it ceased to be a dual resident corporation, if it can be shown that, for the year in which assets were transferred to or acquired by such corporation, the corporation did not incur a dual consolidated loss (or carry forward a dual consolidated loss to such year) and that there was a valid business reason for the transfer or acquisition of such assets, the income derived from such assets shall not be subject to the limitation described in paragraph (e)(1) of this section.

(f) *Special rules for accounting for dual consolidated losses*—(1) *Determination of amount of dual consolidated loss*—(i) *Dual resident corporation that is a member of an affiliated group.* For purposes of determining whether a dual resident corporation that is a member of an affiliated group filing a consolidated return has a dual consolidated loss for the taxable year, the dual resident corporation shall compute its taxable income (or loss) in accordance with the provisions of §1.1502–12 (relating to computation of separate taxable income of a member of an affiliated group filing a consolidated return), determined by taking into account the adjustments provided in §1.1502–21T(b), that is:

(A) The portion of the consolidated dividends received deduction, the consolidated charitable contributions deductions, and the consolidated section 247 deduction, attributable to such member;

(B) Such member's capital gain net income (determined without regard to any net capital loss carryover attributable to such member);

(C) Such member's net capital loss and section 1231 net loss, reduced by the portion of the consolidated net capital loss attributable to such member (as determined under paragraph (b)(2) of §1.1502–22T(b); and

(D) The portion of any consolidated net capital loss carryover attributable to such member which is absorbed in the taxable year.

For purposes of this paragraph (f), any income, gain, or loss of a dual resident corporation shall not be deferred or eliminated under §1.1502–13 (b)(2) or (c), or §1.1502–14. Further, sections 267 and 163(e)(3) shall not apply.

(ii) *Dual resident corporation that is a separate unit of a domestic corporation.* For purposes of determining whether a dual resident corporation that is a separate unit of a domestic corporation has a dual consolidated loss for the taxable year, the dual resident corporation shall compute its taxable income (or loss) as if it were a separate domestic corporation and a dual resident corporation, using only those items of income, expenses, and deductions which are otherwise attributable to such separate unit.

(2) *Effect of dual consolidated loss.* For any taxable year in which a dual resident corporation has a dual consolidated loss to which paragraph (a) of this section applies, the following rules shall apply.

(i) If the dual resident corporation is a member of an affiliated group filing a consolidated return, then such affiliated group shall compute its taxable income without regard to the items of income, loss, or deduction of the dual resident corporation for the taxable year. The amount of taxable loss of the dual resident corporation for the taxable year shall be the amount of dual consolidated loss determined under paragraph (f)(1)(i) of this section. Such loss may be carried over or back for use in other taxable years as a net operating loss deduction by the dual resident corporation to the extent permitted under section 172. However, such loss shall be treated as a loss incurred by the dual resident corporation in a separate return limitation year, and, including in the case of a dual resident corporation that is a common parent, shall be subject to all of the limitations of §§ 1.1502–21A(c)(2) or 1.1502–21T(c) (as appropriate) (relating to limitations on net operating loss carryovers and carrybacks from separate return limitation years).

(ii) If the dual resident corporation is a separate unit of a domestic corporation, then such domestic corporation and the affiliated group with which it may file a consolidated return shall compute taxable income for the taxable year without regard to the items of income, loss, or deductions of the dual resident corporation for the current year. Further, the loss of the dual resident corporation (the separate unit of the domestic corporation) shall be treated as a loss incurred by a separate corporation and its use shall be subject to all of the limitations of §§ 1.1502–21A(c)(2) or 1.1502–21T(c) (as appropriate) (relating to limitations on net operating loss carryovers and carrybacks from separate return limitation years), as if such dual resident corporation were filing a consolidated return with the domestic corporation or with the affiliated group with which the domestic corporation files a consolidated return.

(3) *Basis adjustments for dual consolidated losses.* When a dual resident corporation is a member of an affiliated group filing a consolidated return, each member owning stock in the dual resident corporation shall adjust the basis of the stock in the manner described in subparagraphs (i) and (ii) of this paragraph (f)(3).

(i) *Positive adjustment.* Adjustments shall be made in accordance with the principles of § 1.1502–32(b)(1), except that there shall be no positive adjustment under § 1.1502–32(b)(1)(ii) for any amount of the dual consolidated loss which is not absorbed. There shall be no positive adjustment for any amount included in income upon the use of a dual consolidated loss in a foreign country under § 1.1503–2T(c)(3).

(ii) *Negative adjustments.* Adjustments shall be made in accordance with the principles of § 1.1502–32(b)(2), except that there shall be no negative adjustments under § 1.1502–32(b)(2)(ii) for the amount of the dual consolidated loss.

(4) *Examples.* The following examples illustrate this paragraph (f).

Example (1). (i) P, S1, S2, and T are domestic corporations. P owns all of the stock of S1 and S2. S2 owns all of the stock of T. T is a dual resident corporation. None of the exceptions described in paragraph (c) apply with respect to T. P, S1, S2, and T have filed and continue to file a consolidated federal income tax return. X, Y, and Bank are corporations which are not members of the affiliated group of which P is the common parent.

(ii) At the beginning of 1989, P had a basis in S2 of $1000. S2 had a basis in T of $500.

(iii) In 1989, T had an interest expense of $100 on a loan from Bank. T sold a noncapital item *u* in which it had a basis of $10 to S1 for $50. T sold noncapital item *v* in which it had a basis of $200 to S1 for $100. The sale of *u* and *v* are deferred intercompany transactions described in § 1.1502–13(a)(2). S1 had separate taxable income calculated in accordance with § 1.1502–12 of $200. In addition, S1 sold item *w* in which it had a basis of $50 to T for $100. The sale of item *w* is a deferred intercompany transaction described in §1.1502–13(a)(2). P and S2 had no items of income, loss, or deduction for 1989.

(iv) For purposes of determining whether T has a dual consolidated loss in 1989 and the amount of such dual consolidated loss, T's taxable income (loss) is calculated under paragraph (f)(1) as follows:

($100)	interest expense to Bank
($100)	sale of item *v* to S1
$40	sale of item *u* to S1
($160)	

T therefore has a dual consolidated loss of $160 for 1989.

(v) Because T has a dual consolidated loss for the year, the consolidated taxable income of the P affiliated group is calculated without regard to the items of income, loss, or deduction of T. However, T is still a member of the P affiliated group. Therefore, the consolidated taxable income of the P group is $200 (attributable solely to the income of S1). The $50 gain recognized by S1 upon the sale of item *w* to T is deferred pursuant to §1.1502–13(c)(1).

(vi) S2 may not make the positive adjustment provided for in §1.1502–32(b)(1)(ii) to its basis in T for the dual consolidated loss incurred by T. However, S2 must make the negative adjustment provided for in §1.1502–32(b)(2)(i) for the amount of its allocable part of the deficit in earnings and profits of T for the taxable year. Thus, as provided in §1.1502–32(e)(1), S2 shall make a net negative adjustment to its basis in T of $160 and S2's basis in T is now $340. As provided in §1.1502–33(b)(4)(ii)(a), S2's earnings and profits for 1989 must reflect S2's decrease in its basis in T stock for the taxable year. Since S2 has no other earnings and profits for the taxable year, S2 has a deficit in earnings and profits of $160 for the taxable year. As provided in §1.1502–32(b)(2)(i), P must make a negative adjustment for the amount of its allocable part of the deficit in earnings and profits of S2 for the taxable year. Thus, P must make a net negative adjustment to its basis in S2 of $160 and P's basis in S2 is now $840.

Example (2). (i) The facts are the same as in *Example (1),* except that in 1990, S1 sold items *u* and *v* to X for no gain or loss. T incurred an interest expense of $100 on a loan from Bank. T also sold item *q* in which it had a basis of $50 to S1 for $100. T also sold item *r* in which it had a basis of $100 to Y for $300. P and S2 had no items of income, loss, or deduction for 1990.

(ii) For purposes of determining whether T has a dual consolidated loss in 1990 and the amount of such dual consolidated loss, T's taxable income (loss) is:

($100)	interest expense to Bank
$50	sale of item *q* to S1
$200	sale of item *r* to Y
$150	

T therefore has no dual consolidated loss for 1990.

(iii) Since T does not have a dual consolidated loss for the taxable year, the group's consolidated taxable income is calculated in accordance with the general rule of §1.1502–11 and not in accordance with the rule of §1.1503–2T(f)(2). T has separate taxable income calculated in accordance with §1.1502–12 of $100. On the disposition of items *u* and *v* outside the P affiliated group, no gain or loss is restored to income to T in accordance with §1.1502–13(f)(1)(i) because the gain or loss on these items was not deferred, pursuant to §1.1503–2T(f)(3). The $50 gain on the sale of item *q* from T to S1 is an intercompany transaction on which the gain or loss recognized is deferred pursuant to §1.1502–13(c)(1). The consolidated taxable income of the P affiliated group computed without regard to the consolidated net operating loss deduction is $100.

(iv) As provided by §1.1502–21A(c)(2) of the regulations, the amount of the dual consolidated loss arising in 1989 which may be absorbed by the P affiliated group in 1990 is $100; that is, the consolidated taxable income computed without regard to the consolidated net operating loss deduction minus such consolidated taxable income recomputed by excluding the items of income and deduction of T. Section 1.1502–21A(c) allows $100 of the dual consolidated loss to be included in the consolidated net operating loss deduction for 1990. The consolidated taxable income of the P group for 1990 is $0.

(v) S2 must make the positive adjustment provided for in §1.1502–32(b)(1)(i) to its basis in T for the amount of its allocable part of the undistributed earnings and profits of T for the taxable year. S2 can not make the negative adjustment provided for in §1.1502–32(b)(2)(ii) for the dual consolidated loss of T incurred in 1989 and absorbed in 1990. Thus, as provided in §1.1502–32(e)(2), S2 shall make a net positive adjustment to its basis in T of $100 and S2's basis in T is now $440. As provided in §1.1502–33(b)(4)(ii)(a), S2's earnings and profits for 1989 must reflect S2's increase in its basis in T stock for the taxable year. Since S2 has no other earnings and profits for the taxable year, S2 has earnings and profits of $100 for the taxable year. As provided in §1.1502–32(b)(1)(i), P must make a positive adjustment for the amount of its allocable part of the undistributed earnings and profits of S2 for the taxable year. Thus, P must make a net positive adjustment to its basis in S2 of $100 and P's basis in S2 is now $940.

[T.D. 8261, 54 FR 37317, Sept. 8, 1989. Redesignated by T.D. 8434, 57 FR 41093, Sept. 9, 1992, as amended by T.D. 8677, 61 FR 33325, June 27, 1996]

RELATED RULES

§ 1.1551–1 Disallowance of surtax exemption and accumulated earnings credit.

(a) *In general.* If:

(1) Any corporation transfers, on or after January 1, 1951, and before June 13, 1963, all or part of its property (other than money) to a transferee corporation,

(2) Any corporation transfers, directly or indirectly, after June 12, 1963, all or part of its property (other than money) to a transferee corporation, or

(3) Five or fewer individuals are in control of a corporation and one or more of them transfer, directly or indirectly, after June 12, 1963, property (other than money) to a transferee corporation, and the transferee was created for the purpose of acquiring such property or was not actively engaged in business at the time of such acquisition, and if after such transfer the transferor or transferors are in control of the transferee during any part of the taxable year of the transferee, then for such taxable year of the transferee the Secretary or his delegate may disallow the surtax exemption defined in section 11(d) or the accumulated earnings credit of $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975) provided in paragraph (2) or (3) of section 535(c), unless the transferee establishes by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of the transfer.

(b) *Purpose of section 1551.* The purpose of section 1551 is to prevent avoidance or evasion of the surtax imposed by section 11(c) or of the accumulated earnings tax imposed by section 531. It is not intended, however, that section 1551 be interpreted as delimiting or abrogating any principle of law established by judicial decision, or any existing provisions of the Code, such as sections 269 and 482, which have the effect of preventing the avoidance or evasion of income taxes. Such principles of law and such provisions of the Code, including section 1551, are not mutually exclusive, and in appropriate cases they may operate together or they may operate separately.

(c) *Application of section 269(b) to cases covered by section 1551.* The provisions of section 269(b) and the authority of the district director thereunder, to the extent not inconsistent with the provisions of section 1551, are applicable to cases covered by section 1551. Pursuant to the authority provided in section 269(b) the district director may allow to the transferee any part of a surtax exemption or accumulated earnings credit for a taxable year for which such exemption or credit would otherwise be disallowed under section 1551(a); or he may apportion such exemption or credit among the corporations involved. For example, corporation A transfers on January 1, 1955, all of its property to corporations B and C in exchange for all of the stock of such corporations. Immediately thereafter, corporation A is dissolved and its stockholders become the sole stockholders of corporations B and C. Assuming that corporations B and C are unable to establish by the clear preponderance of the evidence that the securing of the surtax exemption defined in section 11(d) or the accumulated earnings credit provided in section 535, or both, was not a major purpose of the transfer, the district director is authorized under sections 1551(c) and 269(b) to allow one such exemption and credit and to apportion such exemption and credit between corporations B and C.

(d) *Actively engaged in business.* For purposes of this section, a corporation maintaining an office for the purpose of preserving its corporate existence is not considered to be ‘‘actively engaged in business’’ even though such corporation may be deemed to be ‘‘doing business’’ for other purposes. Similarly, for purposes of this section, a corporation engaged in winding up its affairs, prior to an acquisition to which section 1551 is applicable, is not considered to be ‘‘actively engaged in business.’’

(e) *Meaning and application of the term ‘‘control’’*—(1) *In general.* For purposes of this section, the term ‘‘control’’ means:

(i) With respect to a transferee corporation described in paragraph (a) (1) or (2) of this section, the ownership by the transferor corporation, its shareholders, or both, of stock possessing either *(a)* at least 80 percent of the total combined voting power of all classes of stock entitled to vote, or *(b)* at least 80 percent of the total value of shares of all classes of stock.

(ii) With respect to each corporation described in paragraph (a)(3) of this section, the ownership by five or fewer individuals of stock possessing *(a)* at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and *(b)* more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such individual only to the extent such stock ownership is identical with respect to each such corporation.

(2) *Special rules.* In determining for purposes of this section whether stock possessing at least 80 percent (or more than 50 percent in the case of subparagraph (1)(ii)*(b)* of this paragraph) of the total combined voting power of all classes of stock entitled to vote is owned, all classes of such stock shall be considered together; it is not necessary that at least 80 percent (or more than 50 percent) of each class of voting stock be owned. Likewise, in determining for purposes of this section whether stock possessing at least 80 percent (or more than 50 percent) of the total value of shares of all classes of stock is owned, all classes of stock of the corporation shall be considered together; it is not necessary that at least 80 percent (or more than 50 percent) of the value of shares of each class be owned. The fair market value of a share shall be considered as the value to be used for purposes of this computation. With respect to transfers described in paragraph (a) (2) or (3) of this section, the ownership of stock shall be determined in accordance with the provisions of section 1563(e) and the regulations thereunder. With respect to transfers described in paragraph (a)(1) of this section, the ownership of stock shall be determined in accordance with the provisions of section 544 and the regulations thereunder, except that constructive ownership under section 544(a)(2) shall be determined only with respect to the individual's spouse and minor children. In determining control, no stock shall be excluded because such stock was acquired before January 1, 1951 (the effective date of section 1551(a)(1)), or June 13, 1963 (the effective date of section 1551(a) (2) and (3)).

(3) *Example.* This paragraph may be illustrated by the following example:

Example. On January 1, 1964, individual A, who owns 50 percent of the voting stock of corporation X, and individual B, who owns 30 percent of such voting stock, transfer property (other than money) to corporation Y (newly created for the purpose of acquiring such property) in exchange for all of Y's voting stock. After the transfer, A and B own the voting stock of corporations X and Y in the following proportions:

Individual	Corp. X	Corp. Y	Identical ownership
A	50	30	30
B	30	50	30
Total	80	80	60

The transfer of property by A and B to corporation Y is a transfer described in paragraph (a)(3) of this section since (i) A and B own at least 80 percent of the voting stock of corporations X and Y, and (ii) taking into account each such individual's stock ownership only to the extent such ownership is identical with respect to each such corporation, A and B own more than 50 percent of the voting stock of corporations X and Y.

(f) *Taxable year of allowance or disallowance*—(1) *In general.* The district director's authority with respect to cases covered by section 1551 is not limited to the taxable year of the transferee corporation in which the transfer of property occurs. Such authority extends to the taxable year in which the transfer occurs or any subsequent taxable year of the transferee corporation if, during any part of such year, the transferor or transferors are in control of the transferee.

(2) *Examples.* This paragraph may be illustrated by the following examples:

Example (1). On January 1, 1955, corporation D transfers property (other than money) to corporation E, a corporation not actively engaged in business at the time of the acquisition of such property, in exchange for 60 percent of the voting stock of E. During a later taxable year of E, corporation D acquires an additional 20 percent of such voting stock. As a result of such additional acquisition, D owns 80 percent of the voting stock of E. Accordingly, section 1551(a)(1) is applicable for the taxable year in which the later acquisition of stock occurred and for each taxable year thereafter in which the requisite control continues.

Example (2). On June 20, 1963, individual A, who owns all of the stock of corporation X, transfers property (other than money) to corporation Y, a corporation not actively engaged in business at the time of the acquision of such property, in exchange for 60 percent of the voting stock of Y. During a later taxable year of Y, A acquires an additional 20 percent of such voting stock. After such acquisition A owns at least 80 percent of the voting stock of corporations X and Y. Accordingly, section 1551(a)(3) is applicable for the taxable year in which the later acquisition of stock occurred and for each taxable year thereafter in which the requisite control continues.

Example (3). Individuals A and B each owns 50 percent of the stock of corporation X. On January 15, 1964, A transfers property (other than money) to corporation Y (newly created by A for the purpose of acquiring such property) in exchange for all the stock of Y. In a subsequent taxable year of Y, individual B buys 50 percent of the stock which A owns in Y (or he transfers money to Y in exchange for its stock, as a result of which he owns 50 percent of Y's stock). Immediately thereafter the stock ownership of A and B in corporation Y is identical to their stock ownership in corporation X. Accordingly, section 1551(a)(3) is applicable for the taxable year in which B acquires stock in corporation Y (see paragraph (g)(3) of this section) and for each taxable year thereafter in which the requisite control continues. Moreover, if B's acquisition of stock in Y is pursuant to a preexisting agreement with A, A's transfer to Y and B's acquisition of Y's stock are considered a single transaction and section 1551(a)(3) also would be applicable for the taxable year in which A's transfer to Y took place and for each taxable year thereafter in which the requisite control continues.

(g) *Nature of transfer*—(1) *Corporate transfers before June 13, 1963.* A transfer made before June 13, 1963, by any corporation of all or part of its assets, whether or not such transfer qualifies as a reorganization under section 368, is within the scope of section 1551(a)(1), except that section 1551(a)(1) does not apply to a transfer of money only. For example, the transfer of cash for the purpose of expanding the business of the transferor corporation through the formation of a new corporation is not a transfer within the scope of section 1551(a)(1), irrespective of whether the new corporation uses the cash to purchase from the transferor corporation stock in trade or similar property.

(2) *Corporate transfers after June 12, 1963.* A direct or indirect transfer made after June 12, 1963, by any corporation of all or part of its assets to a transferee corporation, whether or not such transfer qualifies as a reorganization under section 368, is within the scope of section 1551(a)(2) except that section 1551(a)(2) does not apply to a transfer of money only. For example, if a transferor corporation transfers property to its shareholders or to a subsidiary, the transfer of that property by the shareholders or the subsidiary to a transferee corporation as part of the same transaction is a transfer of property by the transferor corporation to which section 1551(a)(2) applies. A transfer of property pursuant to a purchase by a transferee corporation from a transferor corporation controlling the transferee is within the scope of section 1551(a)(2), whether or not the purchase follows a transfer of cash from the controlling corporation.

(3) *Other transfers after June 12, 1963.* A direct or indirect transfer made after June 12, 1963, by five or fewer individuals to a transferee corporation, whether or not such transfer qualifies under one or more other provisions of the Code (for example, section 351), is within the scope of section 1551(a)(3) except that section 1551(a)(3) does not apply to a transfer of money only. Thus, if one of five or fewer individuals who are in control of a corporation transfers property (other than money) to a controlled transferee corporation, the transfer is within the scope of section 1551(a)(3) notwithstanding that the other individuals transfer nothing or transfer only money.

(4) *Examples.* This paragraph may be illustrated by the following examples:

Example (1). Individuals A and B each owns 50 percent of the voting stock of corporation X. On January 15, 1964, A and B each acquires property (other than money) from X and, as part of the same transaction, each transfers such property to his wholly owned corporation (newly created for the purpose of acquiring such property). A and B retain substantial continuing interests in corporation X. The transfers to the two newly created corporations are within the scope of section 1551(a)(2).

Example (2). Corporation W organizes corporation X, a wholly owned subsidiary, for the purpose of acquiring the properties of corporation Y. Pursuant to a reorganization qualifying under section 368(a)(1)(C), substantially all of the properties of corporation Y are transferred on June 15, 1963, to corporation X solely in exchange for voting stock of corporation W. There is a transfer of property from W to X within the meaning of section 1551(a)(2).

Example (3). Individuals A and B, each owning 50 percent of the voting stock of corporation X, organize corporation Y to which each transfers money only in exchange for 50 percent of the stock of Y. Subsequently, Y uses such money to acquire other property from A and B after June 12, 1963. Such acquisition is within the scope of section 1551(a)(3).

Example (4). Individual A owns 55 percent of the stock of corporation X. Another 25 percent of corporation X's stock is owned in the aggregate by individuals B, C, D, and E. On June 15, 1963, individual A transfers property to corporation Y (newly created for the purpose of acquiring such property) in exchange for 60 percent of the stock of Y, and B, C, and D acquire all of the remaining stock of Y. The transfer is within the scope of section 1551(a)(3).

(h) *Purpose of transfer.* In determining, for purposes of this section, whether the securing of the surtax exemption or accumulated earnings credit constituted ''a major purpose'' of the transfer, all circumstances relevant to the transfer shall be considered. ''A major purpose'' will not be inferred from the mere purchase of inventory by a subsidiary from a centralized warehouse maintained by its parent corporation or by another subsidiary of the parent corporation. For disallowance of the surtax exemption and accumulated earnings credit under section 1551, it is not necessary that the obtaining of either such credit or exemption, or both, have been the sole or principal purpose of the transfer of the property. It is sufficient if it appears, in the light of all the facts and circumstances, that the obtaining of such exemption or credit, or both, was one of the major considerations that prompted the transfer. Thus, the securing of the surtax exemption or the accumulated earnings credit may constitute ''a major purpose'' of the transfer, notwithstanding that such transfer was effected for a valid business purpose and qualified as a reorganization within the meaning of section 368. The taxpayer's burden of establishing by the clear preponderance of the evidence that the securing of either such exemption or credit or both was not ''a major purpose'' of the transfer may be met, for example, by showing that the obtaining of such exemption, or credit, or both, was not a major factor in relationship to the other consideration or considerations which prompted the transfer.

[T.D. 6911, 32 FR 3214, Feb. 24, 1967, as amended by T.D. 7376, 40 FR 42745, Sept. 16, 1975]

§1.1552–1 Earnings and profits.

(a) *General rule.* For the purpose of determining the earnings and profits of each member of an affiliated group which is required to be included in a consolidated return for such group filed for a taxable year beginning after December 31, 1953, and ending after August 16, 1954, the tax liability of the group shall be allocated among the members of the group in accordance with one of the following methods, pursuant to an election under paragraph (c) of this section:

(1)(i) The tax liability of the group shall be apportioned among the members of the group in accordance with the ratio which that portion of the consolidated taxable income attributable to each member of the group having taxable income bears to the consolidated taxable income.

(ii) For consolidated return years beginning after December 31, 1965, a member's portion of the tax liability of the group under the method of allocation provided by subdivision (i) of this subparagraph is an amount equal to the tax liability of the group multiplied by a fraction, the numerator of which is the taxable income of such member, and the denominator of which is the sum of the taxable incomes of all the members. For purposes of this subdivision the taxable income of a member shall be the separate taxable income determined under §1.1502–12, adjusted for the following items taken into account in the computation of consolidated taxable income:

(a) The portion of the consolidated net operating loss deduction, the consolidated charitable contributions deduction, the consolidated dividends received deduction, the consolidated section 247 deduction, the consolidated section 582(c) net loss, and the consolidated section 922 deduction, attributable to such member;

(b) Such member's capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (determined without regard to any net capital loss carryover attributable to such member);

(c) Such member's net capital loss and section 1231 net loss, reduced by the portion of the consolidated net capital loss attributable to such member; and

(d) The portion of any consolidated net capital loss carryover attributable to such member which is absorbed in the taxable year.

If the computation of the taxable income of a member under this subdivision results in an excess of deductions over gross income, then for purposes of this subdivision such member's taxable income shall be zero.

(2)(i) The tax liability of the group shall be allocated to the several members of the group on the basis of the percentage of the total tax which the tax of such member if computed on a separate return would bear to the total amount of the taxes for all members of the group so computed.

(ii) For consolidated return years beginning after December 31, 1965, a member's portion of the tax liability of the group under the method of allocation provided by subdivision (i) of this subparagraph is an amount equal to the tax liability of the group multiplied by a fraction, the numerator of which is the separate return tax liability of such member, and the denominator of which is the sum of the separate return tax liabilities of all the members. For purposes of this subdivision the separate return tax liability of a member is its tax liability computed as if it has filed a separate return for the year except that:

(a) Gains and losses on intercompany transactions shall be taken into account as provided in § 1.1502–13 as if a consolidated return had been filed for the year;

(b) Gains and losses relating to inventory adjustments shall be taken into account as provided in § 1.1502–18 as if a consolidated return had been filed for the year;

(c) Transactions with respect to stock, bonds, or other obligations of members shall be reflected as provided in § 1.1502–13 (f) and (g) as if a consolidated return had been filed for the year;

(d) Excess losses shall be included in income as provided in § 1.1502–19 as if a consolidated return had been filed for the year;

(e) In the computation of the deduction under section 167, property shall not lose its character as new property as a result of a transfer from one member to another member during the year;

(f) A dividend distributed by one member to another member during the year shall not be taken into account in computing the deductions under section 243(a)(1), 244(a), 245, or 247 (relating to deductions with respect to dividends received and dividends paid);

(g) Basis shall be determined under §§ 1.1502–31 and 1.1502–32, and earnings and profits shall be determined under § 1.1502–33, as if a consolidated return had been filed for the year;

(h) Subparagraph (2) of § 1.1502–3(f) shall apply as if a consolidated return had been filed for the year; and

(i) For purposes of Subtitle A of the Code, the surtax exemption of the member shall be an amount equal to $25,000 ($50,000 in the case of a taxable year ending in 1975), divided by the number of members (or such portion of $25,000 or $50,000 which is apportioned to the member pursuant to a schedule attached to the consolidated return for the taxable year). (However, if for the taxable year some or all of the members are component members of a controlled group of corporations (within the meaning of section 1563) and if there are other such component members which do not join in filing the consolidated return for such year, the amount to be divided among the members filing the consolidated return shall be (in lieu of $25,000 or $50,000) the sum of the amounts apportioned to the

component members which join in filing the consolidated return (as determined for taxable years beginning after December 31, 1974 under §1.1561–2(a)(2) or §1.1561–3, whichever is applicable, and for taxable years beginning before January 1, 1975, under §1.561–2A(a)(2) or §1.1561–3A whichever is applicable).)

If the computation of the separate return tax liability of a member under this subdivision does not result in a positive tax liability, then for purposes of this subdivision such member's separate return tax liability shall be zero.

(3)(i) The tax liability of the group (excluding the tax increases arising from the consolidation) shall be allocated on the basis of the contribution of each member of the group to the consolidated taxable income of the group. Any tax increases arising from the consolidation shall be distributed to the several members in direct proportion to the reduction in tax liability resulting to such members from the filing of the consolidated return as measured by the difference between their tax liabilities determined on a separate return basis and their tax liabilities (determined without regard to the 2-percent increase provided by section 1503(a) and paragraph (a) of §1.1502–30A (as contained in the 26 CFR edition revised as of April 1, 1996) for taxable years beginning before January 1, 1964) based on their contributions to the consolidated taxable income.

(ii) For consolidated return years beginning after December 31, 1965, a member's portion of the tax liability of the group under the method of allocation provided by subdivision (i) of this subparagraph shall be determined by:

(a) Allocating the tax liability of the group in accordance with subparagraph (1)(ii) of this paragraph, but

(b) The amount of tax liability allocated to any member shall not exceed the separate return tax liability of such member, determined in accordance with subparagraph (2)(ii) of this paragraph, and

(c) The sum of the amounts which would be allocated to the members but for *(b)* of this subdivision (ii) shall be apportioned among the other members in direct proportion to, but limited to, the reduction in tax liability resulting to such other members. Such reduction for any member shall be the excess, if any, of *(1)* its separate this paragraph.

(4) The tax liability of the group shall be allocated in accordance with any other method selected by the group with the approval of the Commissioner. No method of allocation may be approved under this subparagraph which may result in the allocation of a positive tax liability for a taxable year, among the members who are allocated a positive tax liability for such year, in a total amount which is more or less than the tax liability of the group for such year. (However, see paragraph (d) of §1.1502–33.)

(b) *Application of rules*—(1) *Tax liability of the group.* For purposes of section 1552 and this section, the tax liability of the group for a taxable year shall consist of the Federal income tax liability of the group for such year determined in accordance with §1.1502–2 or §1.1502–30A (as contained in the 26 CFR edition revised as of April 1, 1996), which-ever is applicable. Thus, in the case of a carryback of a loss or credit to such year, although the earnings and profits of the members of the group may not be adjusted until the subsequent taxable year from which the loss or credit was carried back, the effect of the carryback, for purposes of this section, shall be determined by allocating the amount of the adjustment as a part of the tax liability of the group for the taxable year to which the loss or credit is carried. For example, if a consolidated net operating loss is carried back from 1969 to 1967, the allocation of the tax liability of the group for 1967 shall be recomputed in accordance with the method of allocation used for 1967, and the changes resulting from such recomputation shall, for accrual method taxpayers, be reflected in the earnings and profits of the appropriate members in 1969.

(2) *Effect of allocation.* The amount of tax liability allocated to a corporation as its share of the tax liability of the group, pursuant to this section, shall (i) result in a decrease in the earnings and profits of such corporation in such amount, and (ii) be treated as a liability of such corporation for such amount. If the full amount of such liability is not paid by such corporation, pursuant to an agreement among the

members of the group or otherwise, the amount which is not paid will generally be treated as a distribution with respect to stock, a contribution to capital, or a combination thereof, as the case may be.

(c) *Method of election.* (1) The election under paragraph (a) (1), (2), or (3) of this section shall be made not later than the time prescribed by law for filing the first consolidated return of the group for a taxable year beginning after December 31, 1953, and ending after August 16, 1954 (including extensions thereof). If the group elects to allocate its tax liability in accordance with the method prescribed in paragraph (a) (1), (2), or (3) of this section, a statement shall be attached to the return stating which method is elected. Such statement shall be made by the common parent corporation and shall be binding upon all members of the group. In the event that the group desires to allocate its tax liability in accordance with any other method pursuant to paragraph (a)(4) of this section, approval of such method by the Commissioner must be obtained within the time prescribed above. If such approval is not obtained in such time, the group shall allocate in accordance with the method prescribed in paragraph (a)(1) of this section. The request shall state fully the method which the group wishes to apply in apportioning the tax liability. Except as provided in subparagraph (2) of this paragraph, an election once made shall be irrevocable and shall be binding upon the group with respect to the year for which made and for all future years for which a consolidated return is filed or required to be filed unless the Commissioner authorizes a change to another method prior to the time prescribed by law for filing the return for the year in which such change is to be effective.

(2) Each group may make a new election to use any one of the methods prescribed in paragraph (a) (1), (2), or (3) of this section for its first consolidated return year beginning after December 31, 1965, or in conjunction with an election under paragraph (d) of § 1.1502–33, or may request the Commissioner's approval of a method under paragraph (a)(4) of this section for its first consolidated return year beginning after December 31, 1965, irrespective of its previous method of allocation under this section. If such new election is not made in conjunction with an election under paragraph (d) of § 1.1502–33, it shall be effective for the first consolidated return year beginning after December 31, 1965, and all succeeding years. (See § 1.1502–33 for the method of making such new election in conjunction with an election under paragraph (d) of § 1.1502–33.) Any other such new election (or request for the Commissioner's approval of a method under paragraph (a)(4) of this section) shall be made within the time prescribed by law for filing the consolidated return for the first taxable year beginning after December 31, 1965 (including extensions thereof), or within 60 days after July 3, 1968, whichever is later. Such new election shall be made by attaching a statement to the consolidated return for the first taxable year beginning after December 31, 1965, or if such election is made within the time prescribed above but after such return is filed, by filing a statement with the internal revenue officer with whom such return was filed.

(d) *Failure to elect.* If a group fails to make an election in its first consolidated return, or any other election, in accordance with paragraph (c) of this section, the method prescribed under paragraph (a)(1) of this section shall be applicable and shall be binding upon the group in the same manner as if an election had been made to so allocate.

(e) *Definitions.* Except as otherwise provided in this section, the terms used in this section shall have the same meaning as provided in the regulations under section 1502.

(f) *Example.* The provisions of this section may be illustrated by the following example:

Example. Corporation P is the common parent owning all of the stock of corporations S1 and S2, members of an affiliated group. A consolidated return is filed for the taxable year ending December 31, 1966, by P, S1, and S2. For 1966 such corporations had the following taxable incomes or losses computed in accordance with paragraph (a)(1)(ii) of this section:

P	0
S1	$2,000
S2	(1,000)

The group has not made an election under paragraph (c) of this section or paragraph (d) of §1.1502–33. Accordingly, the method of allocation provided by paragraph (a)(1) of this section is in effect for the group. Assuming that the consolidated taxable income is equal to the sum of the members taxable income and losses, or $1,000, the tax liability of the group for the year (assuming a 22-percent rate) is $220, all of which is allocated to S1. S1 accordingly reduces its earnings and profits in the amount of $220, irrespective of who actually pays the tax liability. If S1 pays the $220 tax liability there will be no further effect upon the income, earnings and profits, or the basis of stock of any member. If, however, P pays the $220 tax liability (and such payment is not in fact a loan from P to S1), then P shall be treated as having made a contribution to the capital of S1 in the amount of $220. On the other hand, if S2 pays the $220 tax liability (and such payment is not in fact a loan from S2), then S2 shall be treated as having made a distribution with respect to its stock to P in the amount of $220, and P shall be treated as having made a contribution to the capital of S1 in the amount of $220.

[T.D. 6962, 33 FR 9655, July 3, 1968, as amended by T.D. 7825, 42 FR 64694, Dec. 28, 1977; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 8560, 59 FR 41675, Aug. 15, 1994; T.D. 8597, 60 FR 36680, July 18, 1995; T.D. 8677, 61 FR 33325, June 27, 1996]

CERTAIN CONTROLLED CORPORATIONS

§1.1561–0 Effective date.

(a) *Taxable years beginning after December 31, 1974.* The provisions of §§1.1561–1 through 1.1561–3 apply only to taxable years beginning after December 31, 1974.

(b) *Taxable years beginning before January 1, 1975.* The provisions of §§1.1561–1A through 1.1561–3A apply only to taxable years beginning before January 1, 1975.

[T.D. 7528, 42 FR 64694, Dec. 28, 1977]

§1.1561–1 Limitations on certain multiple tax benefits in the case of certain controlled corporations.

(a) *In general.* Part II (section 1561 and following), subchapter B, chapter 6 of the Code, provides rules relating to certain controlled corporations. In general, section 1561 provides that the component members of a controled group of corporations on a December 31, for their taxable years which include such December 31, shall be limited for purposes of subtitle A to:

(1) One surtax exemption under section 11(d),

(2) One $150,000 amount for purposes of computing the accumlated earnings credit under section 535(c) (2) and (3), and

(3) One $25,000 amount for purposes of computing the limitation on the small business deduction of life insurance companies under sections 804(a)(4) and 809 (d)(10).

For certain definitions (including the definition of a ‘‘controlled group of corporations’’ and a ‘‘component member’’) and special rules for purposes of part II of subchapter B, see section 1563 and the regulations thereunder.

(b) *Tax avoidance.* The provisions of part II, subchapter B, chapter 6 do not delimit or abrogate any principle of law established by judicial decision, or any existing provisions of the code, such as sections 269, 482, and 1551, which have the effect of preventing the avoidance or evasion of income taxes.

(c) *Special rules.* (1) For purposes of sections 1561 and 1563 and the regulations thereunder, the term ‘‘corporation’’ includes an electing small business corporation (as defined in section 1371 (b)). However, for the treatment of an electing small business corporation as an excluded member of a controlled group of corporations, see paragraph (b)(2)(ii) of §1.1563–1.

(2) In the case of corporations electing a 52–53-week taxable year under section 441(f)(1), the provisions of sections 1561 and 1563 and the regulations thereunder shall be applied in accordance with the special rule section 441(f)(2)(A). See paragraph (b)(1) of §1.441–2.

[T.D. 7528, 42 FR 64694, Dec. 28, 1977]

§1.1561–2 Determination of amount of tax benefits.

(a) *Surtax exemption.* (1) If a corporation is a component member of a controlled group of corporations on December 31, the surtax exemption under section 11(d) of such corporation for the taxable year which includes such December 31 shall be an amount equal to:

(i) $50,000 divided by the number of corporations which are component members of such group on such December 31, or

(ii) If an apportionment plan is adopted under § 1.1561–3 which is effective with respect to such taxable year such portion of $50,000 as is apportioned to such member in accordance with such plan.

(2) In the case of a controlled group of corporations which includes component members which join in the filing of a consolidated return and other component members which do not join in the filing of such a return, and where there is no apportionment plan effective under § 1.1561–3 apportioning the $50,000 amount among the component members filing the consolidated return and the other component members of the controlled group, each component member of the controlled group, (including each component member which joins in filing the consolidated return) shall be treated as a separate corporation for purposes of equally apportioning the $50,000 amount under subparagraph (1)(i) of this paragraph. In such case, the surtax exemption of the corporations filing the consolidated return shall be the sum of the amounts apportioned to each component member which joins in filing the consolidated return.

(3) The provisions of section 1561 may reduce the surtax exemption of any corporation which is a component member of a controlled group or corporations and which is subject to the tax imposed by section 11, or by any other provision of subtitle A of the Code if the tax under such other provisions is computed by reference to the amount of the surtax exemption provided by section 11. Such other provisions include, for example, sections 511(a)(1), 594, 802, 831, 852, 857, 882, 1201, and 1378.

(4) This paragraph (a) shall not apply with respect to any component member of a controlled group of corporations on a December 31 if one or more component members of such controlled group has a taxable year including such December 31 which ends after December 31, 1978. Rules pertaining to the apportionment of the surtax exemption with respect to component members of controlled groups of corporations to which this paragraph does not apply are reserved.

(5) The application of this paragraph may be illustrated by the following examples:

Example (1). Corporations W, X, Y, and Z are component members of a controlled group of corporations on December 31, 1975, and each corporation files its income tax return on the basis of a calendar year. For their taxable years ending on December 31, 1975, W and X each incurs a net operating loss; Y has $5,250 of taxable income; and Z has $30,000 of taxable income. If an apportionment plan is not effective for such taxable years, the surtax exemption under section 11(d) of each corporation determined under subparagraph (1)(i) of this paragraph is $12,500 ($50,000÷4). However, the four corporations may avoid a pro rata division of the $50,000 amount by filing an apportionment plan in accordance with the provisions of § 1.1561–3 allocating the $50,000 amount in any manner they deem proper.

Example (2). Corporation A files its income tax return on the basis of a calendar year; corporation B files its income tax return on the basis of a fiscal year ending March 31. On December 31, 1975, A and B are the only component members of a controlled group of corporations. Under subparagraph (1)(i) of this paragraph, the surtax exemption of A for 1975, and the surtax exemption of B for its fiscal year ending March 31, 1976, is $25,000 ($50,000÷2). However, if an apportionment plan is filed in accordance with the provisions of § 1.1561–3, the surtax exemption of each such corporation will be the amount apportioned to the corporation pursuant to the plan.

Example (3). Corporations R, P, and S are component members of a controlled group of corporations on December 31, 1975. P and S file a consolidated return for their fiscal years ending June 30, 1976. R files a separate return for its taxable year ending on December 31, 1975. No apportionment plan is effective with respect to R’s, P’s, and S’s taxable years which include December 31, 1975. Therefore R, P, and S are each apportioned $16,666.67 ($50,000÷3) as their surtax exemption under section 11(d) for their taxable years including such date. The surtax exemption of the affiliated group filing a consolidated return (P and S) for the year ending June 30, 1976, is $33,333.34 (i.e., the sum of the $16,666.67 amounts apportioned to P and S). However, if an apportionment plan is filed in accordance with the provisions of § 1.1561–3, the surtax exemption of the corporations which are members of the affiliated group filing a consolidated return and of each other corporation which is a component member of the controlled group of corporations will be the amount apportioned to such affiliated group and to each such other corporations pursuant to the plan.

(b) *Allocation of amounts of taxable income subject to normal tax.* (1) In the case of a taxable year of a corporation, if:

(i) The amount of normal tax under section 11(b) is equal to the sum of 20 percent of so much of the taxable income as does not exceed $25,000, plus 22 percent of so much of the taxable income as exceeds $25,000 for a taxable year, and

(ii) The amount of surtax exemption of the corporation is less than $50,000 under paragraph (a)(1) (i) or (ii) of this section,

then for purposes of applying section 11(b), the taxable income subject to taxation at the rate of 20 percent shall be (in lieu of the first $25,000 of taxable income) one-half of the amount of the surtax exemption allocated to such corporation under paragraph (a)(1) (i) or (ii) of this section. In addition, the amount of taxable income subject to taxation at the rate of 22 percent shall be (in lieu of the amount of taxable income in excess of $25,000) the taxable income that exceeds one-half of the amount of the surtax exemption allocated to such corporation under paragraph (a)(1) (i) or (ii) of this section for such year. In the case of an affiliated group of corporations filing a consolidated return for a taxable year, the preceding sentence shall be applied by substituting the term ‘‘affiliated group’’ for the term ‘‘corporation’’ each time it appears.

(2) The provisions of this paragraph may be illustrated by the following example:

Example. Corporations P and S are component members of a controlled group of corporations on December 31, 1975, and each corporation files a separate income tax return on the basis of a calendar year. For the taxable year ending on December 31, 1975, P incurs a net operating loss and S has $25,000 of taxable income. If an apportionment plan is not effective for that taxable year, the surtax exemption under section 11(d) of each corporation (determined under paragraph (a)(1)(i) of this section) is $25,000 ($50,000÷2). For purposes of applying section 11(b) to determine S’s liability for tax for 1975, the amount of taxable income subject to taxation at the rate of 20 percent is limited to $12,500 (i.e., one-half of the amount of the surtax exemption allocated to S under paragraph (a)(1)(i) of this section), and the amount of taxable income subject to taxation at the rate of 22 percent is $12,500 (i.e., the amount of taxable income in excess of one-half of the amount of the surtax exemption). If, on the other hand, an apportionment plan is adopted by P and S effective for such taxable years apportioning the entire $50,000 surtax exemption to S, then, for purposes of applying section 11(b) to determine S’s liability for tax for 1975, the amount of taxable income subject to taxation at the rate of 20 percent is $25,000.

(3) If an apportionment plan is adopted under §1.1561–3 for a December 31, and if paragraph (b)(1) of this section applies to any component member whose taxable year includes such December 31, then the plan shall specify:

(i) The amount subject to taxation at the rate of 20 percent, and

(ii) The amount subject to taxation at the rate of 22 percent,

as determined under paragraph (b)(1) of this section for each component member. The information required to be included in a plan by this subparagraph is in addition to the information required under §1.1561–3(a). Where an existing apportionment plan is effective under §1.1561–3(a)(3) for such December 31, the additional information required under this subparagraph may be provided in an amendment of the existing plan as provided in §1.1561–3(c).

(c) *Accumulated earnings credit.* (1) Except as provided in subparagraph (2) of this paragraph, if a corporation is a component member of a controlled group on a December 31, the amount for purposes of computing the accumlated earnings credit under section 535(c) (2) and (3) of such corporation shall be an amount equal to $150,000 divided by the number of corporations which are component members of such group on such December 31. In the case of a controlled group of corporations which includes component members which join in the filing of a consolidated return and other component members which do not join in the filing of such a return, each component member of the controlled group (including each component member which joins in filing the consolidated return) shall be treated as a separate corporation for purposes of equally apportioning the $150,000 amount under this subparagraph. In such case, the amount for purposes of computing the accumulated earnings credit for the component members filing the consolidated return shall be the sum of the amounts apportioned to each component member which joins in filing the consolidated return.

(2) If, with respect to any component member of the controlled group, the amount determined under subparagraph (1) of this paragraph exceeds the sum of (i) such member's accumlated earnings and profits as of the close of the preceding taxable year, plus (ii) such member's earnings and profits for the taxable year which are retained (within the meaning of section 535(c)(1)), then any such excess shall be subtracted from the amount determined under subparagraph (1) of this paragraph with respect to such member and shall be divided equally among those remaining component members of the controlled group that do not have such an excess (until no such excess remains to be divided among those remaining members that have not had such an excess). The excess so divided among such remaining members shall be added to the amount determined under subparagraph (1) with respect to such members. If a controlled group of corporations includes component members which join in the filing of a consolidated return and other component members which do not join in filing such return, the component members filing the consolidated return shall be treated as a single corporation for purposes of this subparagraph.

(3) A controlled group may not adopt an apportionment plan, as provided in § 1.1561–3, with respect to the amounts computed under the provisions of this paragraph.

(4) The provisions of this paragraph may be illustrated by the following example:

Example. A controlled group is composed of four component member corporations, W, X, Y, and Z. Each corporation files a separate income tax return on the basis of a calendar year. The sum of the earnings and profits for the taxable year ending December 31, 1975, which are retained plus the sum of the accumulated earnings and profits (as of the close of the preceding taxable year) is $15,000, $75,000, $37,500, and $300,000 for W, X, Y, and Z, respectively. The amounts determined under this paragraph for W, X, Y, and Z for 1975 are $15,000, $48,750, $37,500, and $48,750, respectively, computed as follows:

	Component members			
	W	X	Y	Z
Earnings and profits	$15,000	$75,000	$37,500	$300,000
Amount computed under subparagraph (1)	37,500	37,500	37,500	37,500
Excess	22,500	0	0	0
Allocation of excess	....	7,500	7,500	7,500
New excess	....	....	7,500	....
Reallocation of new excess	....	3,750	....	3,750
Amount to be used for purposes of section 535(c) (2) and (3)	15,000	48,750	37,500	48,750

(d) *Small business deduction of life insurance companies.* (1) Except as provided in subparagraph (2) of this paragraph, if two or more life insurance companies which are taxable under section 802 are component members of a controlled group of corporations on a December 31, the amount for purposes of computing the limitation on the small business deduction under sections 804(a)(4) and 809(d)(10) of such corporations for their taxable years which include such December 31 shall be an amount equal to $25,000 divided by the number of life insurance companies taxable under section 802 which are component members of such group on such December 31.

(2) If, with respect to any of the component members of the controlled group which are described in subparagraph (1) of this paragraph, the amount determined under such subparagraph exceeds 10 percent of such member's investment yield (as defined in section 304(c)), then any such excess shall be subtracted from the amount determined under subparagraph (1) of this paragraph with respect to such member and shall be divided equally among

those remaining life insurance company members of the controlled group that do not have such an excess (until no such excess remains to be divided among those remaining members that have not had such an excess). The excess so divided among such remaining members shall be added to the amount determined under subparagraph (1) with respect to such members.

(3) A controlled group may not adopt an apportionment plan, as provided in §1.1561–3, with respect to the amounts computed under the provisions of this paragraph.

(e) *Certain short taxable years.* (1) If the return of a corporation is for a short period which does not include a December 31, and such corporation is a component member of a controlled group of corporations with respect to such short period, then for purposes of subtitle A of the Code:

(i) The surtax exemption under section 11(d) of such corporation for such short period shall be an amount equal to $25,000 ($50,000 in the case of a taxable year ending in 1975), divided by the number of corporations which are component members of such controlled group on the last day of such short period;

(ii) The amount to be used in computing the accumulated earnings credit under section 535(c) (2) and (3) of such corporation for such short period shall be an amount equal to $150,000 divided by the number of corporations which are members of such controlled group on the last day of such short period; and

(iii) The amount to be used in computing the limitation on the small business deduction of life insurance companies under sections 804(a)(4) and 809(d)(10) of such corporation for such short period shall not exceed an amount equal to $25,000 divided by the number of life insurance companies taxable under section 802 which are component members of the controlled group on the last day of such short period.

For purposes of the preceding sentence, the term ‘‘short period’’ does not include any period if the income for such period is required to be included in a consolidated return under §1.1502–76. The determination of whether a corporation is a component member of a controlled group of corporations on the last day of a short period is made by applying the definition of ‘‘component member’’ contained in section 1563(b) and §1.1563–1 as if the last day of such short period were a December 31 occurring after December 31, 1974.

(2) The provisions of this paragraph may be illustrated by the following examples:

Example (1). On January 2, 1975, corporation X transfers cash to newly formed corporation Y (which begins business on that date) and receives all of the stock of Y in return. X also owns all of the stock of corporation Z on each day of 1974 and 1975. X uses the calendar year as its taxable year and Z uses a fiscal year ending on March 31. Y adopts a fiscal year ending on June 30 as its annual accounting period, and, therefore, files a return for the short taxable year beginning on January 2, 1975, and ending on June 30, 1975. On June 30, 1975, Y is a component member of a parent-subsidiary controlled group of corporations of which X, Y, and Z are component members. Accordingly, the surtax exemption of Y for the short taxable year ending on June 30, 1975, is $16,666.67 ($50,000÷3). On December 31, 1975, X, Y, and Z are component members of a parent-subsidiary controlled group of corporations. Accordingly, the surtax exemption of each such corporation for its taxable year including December 31, 1975 (i.e., X’s calendar year ending December 31, 1975, Z’s fiscal year ending March 31, 1976, and Y’s fiscal year ending June 30, 1976) is $16,666.67 ($50,000÷3), or, if an apportionment plan is filed under §1.1561–3, the amount apportioned pursuant to such plan.

Example (2). On January 1, 1975, corporation P owns all of the stock of corporations S–1, S–2, and S–3. P, S–1, S–2, and S–3 file separate returns on a calendar year basis. On July 31, 1975, S–1 is liquidated and therefore files a return for the short taxable year beginning on January 1, 1975, and ending on July 31, 1975. On August 31, 1975, S–2 is liquidated and therefore files a return for the short taxable year beginning on January 1, 1975, and ending on August 31, 1975. On July 31, 1975, S–1 is a component member of a parent-subsidiary controlled group of corporations of which P, S–1, S–2, and S–3 are component members. Accordingly, the surtax exemption under section 11(d) of S–1 for the short taxable year ending on July 31, 1975, is $12,500 ($50,000÷4). On August 31, 1975, S–2 is a component member of a parent-subsidiary controlled group of corporations of which P, S–2, and S–3 are component members. Accordingly, the surtax exemption of S–2 for the short taxable year ending on August 31, 1975, is $16,666.67 ($50,000÷3). On December 31, 1975, P and S–3 are component members of a parent-subsidiary controlled group of corporations. Accordingly, the surtax exemption of each such corporation for the calendar year 1975 is $25,000 ($50,000÷2), or, if an apportionment plan is filed under § 1.1561–3, the amount apportioned pursuant to such plan.

[T.D. 7528, 42 FR 64695, Dec. 28, 1977]

§ 1.1561–3 Apportionment of surtax exemption.

(a) *In general.* (1) In the case of corporations which are component members of a controlled group of corporations on a December 31, the single $50,000 surtax exemption under section 11(d) may be apportioned among such members (for the taxable year of each such member which includes such December 31) if all such members consent, in the manner provided in paragraph (b) of this section, to an apportionment plan with respect to such December 31. Such plan shall provide for the apportionment of a fixed dollar amount to one or more of such members, but in no event shall the sum of the amounts so apportioned exceed $50,000. An apportionment plan shall not be considered as adopted with respect to a particular December 31 until each component member which is required to consent to the plan under paragraph (b)(1) of this section filed the original of a statement described in such paragraph (or, the original of a statement incorporating its consent is filed on its behalf). In the case of a return filed before a plan is adopted, the surtax exemption for purposes of such return shall be equally apportioned in accordance with the rules provided in §1.1561–2(a)(1)(i). (If a valid apportionment plan is adopted after the return is filed and within the time prescribed by subparagraph (2) of this paragraph, such return should be amended (or a claim for refund should be made) to reflect the change from equal apportionment.)

(2) A controlled group may adopt an apportionment plan with respect to a particular December 31 only if, at the time such plan is sought to be adopted, there is at least one year remaining in the statutory period (including any extensions thereof) for the assessment of a deficiency against any corporation the tax liability of which would be increased by the adoption of such plan. If there is less than one year remaining with respect to any such corporation, the director of the service center with which such corporation files its income tax return will ordinarily, upon request, enter into an agreement to extend such statutory period for the limited purpose of assessing any deficiency against such corporation attributable to the adoption of such apportionment plan.

(3)(i) The amount apportioned to a component member of a controlled group of corporations in an apportionment plan adopted with respect to a particular December 31 shall constitute such member's surtax exemption for its taxable year including the particular December 31, and for all taxable years of such members including succeeding December 31's, unless the apportionment plan is amended in accordance with paragraph (c) of this section or is terminated under subdivision (ii) of this subparagraph. Thus, the apportionment plan (including any amendments thereof) has a continuing effect and need not be renewed annually.

(ii) If an apportionment plan is adopted with respect to a particular December 31, such plan shall terminate with respect to a succeeding December 31, if:

(*a*) The controlled group ceases to remain in existence during the calendar year ending on such succeeding December 31,

(b) Any corporation which was a component member of such group on the particular December 31 is not a component member of such group on such succeeding December 31, or

(c) Any corporation which was not a component member of such group on the particular December 31 is a component member of such group on such succeeding December 31.

An apportionment plan, once terminated with respect to a December 31, is no longer effective. Accordingly, unless a new apportionment plan is adopted, the surtax exemption of the component members of the controlled group for their taxable years which include such December 31 and all December 31's thereafter will be determined in accordance with the rules provided in paragraph (a)(1)(i) of § 1.1561–2.

(iii) For purposes of subdivision (ii) *(a)—(a)* A parent-subsidiary controlled group of corporations shall be considered as remaining in existence as long as its common parent corporation remains as a common parent.

(b) A brother-sister controlled group of corporations shall be considered as remaining in existence as long as the requirements of paragraph (a)(3)(i) of § 1.1563–1 continue to be satisfied with respect to at least two corporations, taking into account the stock ownership of only those five or fewer persons whose stock ownership was taken into account at the time the apportionment plan adopted by the component members of such group first became effective.

(*c*) A combined group of corporations shall be considered as remaining in existence as long as the brother-sister controlled group of corporations referred to in paragraph (a)(4)(i) of § 1.1563–1 in respect of such combined group remains in existence (within the meaning of (*b*) of this subdivision), and at least one such corporation is a common parent of a parent-subsidiary controlled group of corporations referred to in such paragraph (a)(4)(i).

(*d*) If, by reason of paragraph (a)(5)(i) of § 1.1563–1, two or more insurance companies subject to taxation under section 802 are treated as an insurance group separate from any corporations which are members of a controlled group described in paragraph (a) (2), (3), or (4) of § 1.1563–1, such insurance group shall be considered as remaining in existence as long as the controlled group described in paragraph (a) (2), (3), or (4) of such section, as the case may be, remains in existence (within the meaning of (*a*), (*b*), or (*c*) of this subdivision), and there are at least two insurance companies which satisfy the requirements of paragraph (a)(5)(i) of such section.

(iv) If an apportionment plan is terminated with respect to a particular December 31 by reason of an occurrence described in subdivision (ii) (*b*) or (*c*) of this subparagraph, each corporation which is a component member of the controlled group on such particular December 31 should, on or before the date it files its income tax return for the taxable year which includes such particular December 31, notify the service center with which it files such return of such termination. If an apportionment plan is terminated with respect to a particular December 31 by reason of an occurrence described in subdivision (ii)(*a*) of this subparagraph, each corporation which was a component member of the controlled group on the preceding December 31 should, on or before the date it files its income tax return for the taxable year which includes such particular December 31, notify the service center with which it files such return of such termination.

(b) *Consents to plan.* (1)(i) The consent of a component member (other than a wholly-owned subsidiary) to an apportionment plan with respect to a particular December 31 shall be made by means of a statement, signed by any person who is duly authorized to act on behalf of the consenting member, stating that such member consents to the apportionment plan with respect to such December 31. The statement shall set forth in the name, address, taxpayer account number, and taxable year of the consenting component member, the amount apportioned to such member under the plan, and the service center where the original of the statement is to be filed. The consent of more than one component member may be incorporated in a single statement. The original of a statement of consent shall be filed with the service center with which the component member of the group on such December 31 which has the taxable year ending first on or after such date filed its return for such taxable year. (If two or more component members have the same such taxable year, a statement of consent may be filed with the service center with which the return for any such taxable year is filed.) The original of a statement of consent shall have attached thereto information (referred to in this paragraph as ‘‘group identification’’) setting forth the name, address, taxpayer account number, and taxable year of each component member of the controlled group on such December 31 (including wholly-owned subsidiaries) and the amount apportioned to each such member under the plan. If more than one original statement is filed, a statement may incorporate the group identification by reference to the name, address, taxpayer account number, and taxable year of a component member of the group which has attached such group identification to the original of its statement.

(ii) Each component member of the group on such December 31 (other than wholly-owned subsidiaries) should attach a copy of its consent (or a copy of the statement incorporating its consent) to the income tax return, amended return, or claim for refund filed with its service center for the taxable year including such date. Such copy shall either have attached thereto information on group identification or shall incorporate such information by reference to the name, address, taxpayer account number, and taxable year of a component member of the group which has attached such information to its income tax return, amended return, or claim for refund filed with the same service center for the taxable year including such date.

(2)(i) Each component member of a controlled group which is a wholly-owned subsidiary of such group with respect to a December 31 shall be deemed to consent to an apportionment plan with respect to such December 31, provided each component member of the group which is not a wholly-owned subsidiary consents to the plan. For purposes of this section, a component member of a controlled group shall be considered to be a wholly-owned subsidiary of the group with respect to a December 31 if, on each day preceding such date during its taxable year which includes such date, all of its stock is owned directly by one or more corporations which are component members of the group on such December 31.

(ii) Each wholly-owned subsidiary of a controlled group with respect to a December 31 should attach a statement containing the information which is required to be set forth in a statement of consent to an apportionment plan with respect to such December 31 to the income tax return, amended return, or claim for refund filed with its service center for the taxable year which includes such date. Such statement should either have attached thereto information on group identification or incorporate such information by reference to the name, address, taxpayer account number, and taxable year of a component member of the group which has attached such information to its income tax return, amended return, or claim for refund filed with the same service center for the taxable year including such date.

(c) *Amendment of plan.* An apportionment plan adopted with respect to a December 31 by a controlled group of corporations may be amended with respect to such December 31, or with respect to any succeeding December 31 for which the plan is effective under paragraph (a)(3) of this section. An apportionment plan must be amended with respect to a particular December 31 and the amendments to the plan shall be effective only if adopted in accordance with the rules prescribed in this section for the adoption of an original plan with respect to such December 31.

(d) *Component members filing consolidated returns.* If the component members of a controlled group of corporations on a December 31 include corporations which join in the filing of a consolidated return, the corporations filing the consolidated return shall be treated as a single component member for purposes of this section. Thus, for example, only one consent, executed by the common parent, to an apportionment plan filed pursuant to this section is required on behalf of the component members filing the consolidated return.

[T.D. 7528, 42 FR 64697, Dec. 28, 1977; 43 FR 4603, Feb. 3, 1978]

§ 1.1562–0 Effective date.

The provisions of §§ 1.1562–1 through 1.1562–7 apply only to taxable years beginning before January 1, 1975.

(Secs. 1561(a), (83 Stat. 599; 26 U.S.C. 1561 (a)) and 7805 (68A Stat. 917; 26 U.S.C. 7805, of the Internal Revenue Code))

[T.D. 7528, 42 FR 64702, Dec. 28, 1977]

§ 1.1562–1 Privilege of controlled group to elect multiple surtax exemptions.

(a) *Election*—(1) *In general.* (i) Under section 1562(a)(1) a controlled group of corporations has the privilege of electing to have each of its component members make its returns without regard to section 1561 (relating to single surtax exemption in the case of a controlled group of corporations). The election shall be made with respect to a particular December 31 and shall be valid only if each corporation which is required to consent to the election under the provisions of paragraph (a)(1) of §1.1562–3 gives its consent in the manner and within the time prescribed in such section. An election shall not be considered as made with respect to a particular December 31 until each corporation which is required to consent to the election under paragraph (c)(1) of §1.1562–3 files the original of a statement described in such paragraph (or, the original of a statement incorporating its consent is filed on its behalf). Accordingly, for purposes of returns filed before an election is made, the surtax exemption of component members of a controlled group of corporations shall be determined in accordance with section 1561 and the regulations thereunder. (If a valid election is made after the return is filed and within the time prescribed in §1.1562–3, such return should be amended (or a claim for refund should be made) to reflect the change in the amount of the surtax exemption (and the imposition of the additional tax) resulting from the election.)

(ii) An election once made with respect to a particular December 31 may not thereafter be withdrawn unless such election is terminated with respect to such December 31 in accordance with the provisions of section 1562(c) and §1.1562–2.

(iii) An election under section 1562(a)(1) may be made by a controlled group of corporations with respect to any December 31 (after December 31, 1962), unless:

(a) A component member of such group on such December 31 joins, or is required to join, in the filing of a consolidated return for its taxable year which includes such date, or

(b) Such controlled group is not eligible to make an election with respect to such December 31 by reason of section 1562(d).

See also section 243(b)(3)(A), relating to effect of election of 100-percent dividends received deduction, which may prevent a controlled group from making an election under section 1562(a)(1) with respect to a particular December 31.

(2) *Years for which effective.* (i) A valid election under section 1562(a)(1) by a controlled group of corporations with respect to a particular December 31 is effective with respect to:

(a) The taxable year of each component member of such group on such December 31 which includes such December 31, and

(b) Any succeeding taxable year of any corporation which is a component member of such group (or a successor group) on a succeeding December 31 included within any such succeeding taxable year.

Under section 1562(c) and §1.1562–2, an election under section 1562(a)(1) may be terminated with respect to a December 31 referred to in either (a) or (b) of this subdivision. For years affected by termination, see paragraph (c) of §1.1562–2.

(ii) For the application of an election under section 1562(a)(1) to certain short taxable years not including a December 31, see section 1562(f)(2) and §1.1562–6.

(iii) The provisions of this subparagraph may be illustrated by the following example:

Example. Corporation P is the common parent of a parent-subsidiary controlled group of corporations of which corporations P, S–1, and S–2 are component members on December 31, 1964. On December 31, 1965, the controlled group of corporations consists of the same component members as on December 31, 1964, except that corporation S–3 is also a component member on December 31, 1965. On December 31, 1966, the controlled group of corporations consists of the same component members as on December 31, 1965, except that S–1 is no longer a component member on December 31, 1966. In January 1965, the controlled group makes a valid election under section 1562(a)(1) with respect to December 31, 1964. Under subdivision (i)*(a)* of this subparagraph, the election (unless terminated) is effective with respect to the taxable years of P, S–1, and S–2 which include December 31, 1964. Under subdivision (i)*(b)* of this subparagraph, the election (unless terminated) is also effective with respect to the taxable years of P, S–1, S–2, and S–3 which include December 31, 1965, and with respect to the taxable years of P, S–2, and S–3 which include December 31, 1966.

(b) *Effect of election*—(1) *General.* If an election under section 1562(a)(1) is effective with respect to a taxable year of a corporation, then:

(i) Section 1561 shall not apply to such corporation for such taxable year, but

(ii) The additional tax imposed by section 1562(b) shall apply to such corporation for such taxable year (except as otherwise provided in subparagraph (3) of this paragraph).

(2) *Additional tax.* The additional tax imposed by section 1562(b) is an amount equal to 6 percent of so much of a corporation's taxable income for the taxable year as does not exceed the amount of such corporation's surtax exemption for such taxable year. However, if a corporation computes its tax under section 1201 (relating to alternative tax) and is subject to the additional tax imposed by section 1562(b) for such taxable year, the additional tax applies only to an amount equal to the taxable income reduced by the excess of the net long-term capital gain over the net short-term capital loss for such taxable year (to the extent such amount does not exceed the amount of such corporation's surtax exemption for such taxable year).

(3) *Exceptions.* The additional tax imposed by section 1562(b) shall not apply to a corporation for any taxable year if:

(i) Such corporation is the only component member of a controlled group on the December 31 included within such taxable year which has taxable income for the taxable years including such date, or

(ii) Such corporation's surtax exemption is disallowed for such year under any provision of the Code. For purposes of this subdivision, if the component members of a controlled group of corporations on a December 31 are limited in the aggregate to a single $25,000 surtax exemption for their taxable years which include such date, then the surtax exemption of each such component member shall be considered to be disallowed for such taxable year regardless of how the $25,000 is allocated among such members. For example, if pursuant to the authority provided in section 269(b), the Commissioner allocates a single $25,000 surtax exemption equally between two corporations which are the only component members of an electing controlled group of corporations, the surtax exemption of each such corporation shall be considered to be disallowed.

The application of this subparagraph in respect of a taxable year of a component member of a controlled group of corporations does not constitute the termination of an election made under section 1562(a)(1). Accordingly, such election continues in effect for the subsequent taxable years of such corporation and the other corporations which are component members of the controlled group, unless the election is terminated under section 1562(c).

(4) *Taxable income defined.* For purposes of this paragraph, the term ''taxable income'' means:

(i) In the case of a corporation subject to tax under section 511(a) (relating to tax on unrelated business income of charitable, etc., organizations at corporation rates), its ''unrelated business taxable income'' (as defined in section 512),

(ii) In the case of a life insurance company, its ''life insurance company taxable income'' (as defined in section 802(b)),

(iii) In the case of a regulated investment company, its ''investment company taxable income'' (as defined in section 852(b)(2)),

(iv) In the case of a real estate investment trust, its ''real estate investment trust taxable income'' (as defined in section 857(b)(2)), and

(v) In the case of an electing small business corporation, its ''taxable income'' (as defined in section 1373(d)).

(5) *Tax treated as imposed by section 11, etc.* For purposes of applying other sections of the Code, if for a taxable year a corporation is subject to both the tax imposed by section 11 and to the additional tax imposed by section 1562(b), then the additional tax is treated as if it were imposed by section 11. If a corporation is subject to a tax imposed by any section of chapter 1 of the Code other than section 11 but such tax is computed by reference to section 11, the additional tax is treated for purposes of the Code as imposed by such other section. (For example, the tax imposed by section 831(a) is ''computed

as provided in section 11''; therefore if a corporation is subject to both the tax imposed by section 831(a) and the additional tax imposed by section 1562(b) for any taxable year, the additional tax is treated as imposed by section 831(a) for such taxable year.) Accordingly, the credits against the tax imposed by chapter 1 of the Code allowable, for example, under sections 38 (relating to credit against tax for investment in certain depreciable property) and 33 (relating to credit for taxes of foreign countries and possessions of the United States) may be applied against the additional tax.

(6) *Special rules.* For purposes of sections 244 (relating to dividends received on certain preferred stock), 247 (relating to dividends paid on certain preferred stock of public utilities), 804 (a)(3) (relating to deduction for partially tax-exempt interest in the case of a life insurance company), and 922 (relating to special deduction for Western Hemisphere trade corporations), the normal tax rate referred to in such sections shall be determined without regard to the additional tax imposed by section 1562(b). For example, in the case of a corporation subject to the additional tax imposed by section 1562(b) for its taxable year ending December 31, 1965, the percentage computed under section 244(a)(2)(B) for such taxable year would be 48 percent.

[T.D. 6845, 30 FR 9744, Aug. 5, 1965, as amended by T.D. 6960, 33 FR 9302, June 25, 1968; T.D. 7181, 37 FR 8067, Apr. 25, 1972]

§1.1562–2 Termination of election.

(a) *In general.* An election under section 1562(a)(1) is terminated by any one of the occurrences described in paragraph (b) of this section. For years affected by termination, see paragraph (c) of this section.

(b) *Methods of termination*—(1) *Consent of the members.* An election may be terminated with respect to a particular December 31 by consent of the component members of a controlled group of corporations. A termination by consent shall be made with respect to a particular December 31 and shall be valid only if each corporation which is required to consent to the termination under paragraph (a)(1) of §1.1562–3 gives its consent in the manner and within the time prescribed in such section. A termination by consent shall not be considered as made with respect to a particular December 31 until each corporation which is required to consent to the termination under paragraph (c)(1) of §1.1562–3 files the original of a statement described in such paragraph (or, the original of a statement incorporating its consent is filed on its behalf).

(2) *Refusal by new member to consent.* (i) If on a December 31 a controlled group of corporations which has made an election under section 1562(a)(1) includes a new member which files a statement that it does not consent to the election with respect to such December 31, then such election shall terminate with respect to such date. Such statement shall be signed by any person who is duly authorized to act on behalf of the new member, and shall be attached to the income tax return of such new member for its taxable year which includes such December 31, filed on or before the date prescribed by law (including extensions of time) for the filing of such return. The statement shall set forth the name, address, taxpayer account number, and taxable year of each corporation which was a component member of the controlled group on such December 31. In the event of a termination under this subparagraph, each component member of the controlled group on such December 31 (other than such new member) should, within 30 days after such new member files the statement of refusal to consent, file notification of the termination with the district director with whom it filed (or will file) an income tax return for its taxable year which includes such December 31.

(ii) For purposes of subdivision (i) of this subparagraph, a corporation shall be considered to be a new member of a controlled group of corporations on a December 31 if such corporation:

(a) Is a component member of such group on such December 31, and

(b) Was not a member of such group on the January 1 immediately preceding such December 31.

(3) *Consolidated returns.* (i) If any corporation which is a component member of a controlled group of corporations on a December 31 joins, or is required

to join, in the filing of a consolidated return for its taxable year which includes such date, then an election under section 1562(a)(1) which is effective with respect to preceding taxable years of component members of the group shall terminate with respect to such December 31. In the event of a termination under this subparagraph, each component member of the controlled group on such December 31 which does not join in the filing of a consolidated return for the taxable year which includes such date, should, within 30 days after such consolidated return is filed, file notification of the termination with the district director with whom it filed (or will file) an income tax return for its taxable year which includes such December 31.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. On each day of 1964 and 1965, Brown, an individual, owns all the stock of corporations M and P. Corporation P, in turn, owns all the stock of corporation S. Each corporation files a separate return for its taxable year ending on December 31, 1964. On April 30, 1965, the controlled group of corporations consisting of M, P, and S makes an election under section 1562(a)(1) with respect to December 31, 1964. On March 15, 1966, P and S join in the filing of a consolidated return for their taxable years ending December 31, 1965, and M files a separate return for its taxable year ending on such date. Under this subparagraph, the election by the controlled group with respect to December 31, 1964, is terminated with respect to December 31, 1965. On or before April 14, 1966, M should file notification of the termination with the district director with whom it filed its income tax return for 1965.

(4) *Controlled group no longer in existence.* If a controlled group of corporations is considered as going out of existence with respect to a particular December 31 under paragraph (b) of § 1.1562–5, and if there is no successor group in respect of such controlled group under the rules provided in paragraph (c) of such section, then an election under section 1562(a)(1) with respect to such controlled group shall terminate with respect to such December 31.

(c) *Effect of termination.* A termination under subparagraph (1), (2), (3), or (4) of paragraph (b) of this section is effective with respect to the December 31 referred to in such subparagraph. An election, once terminated, is no longer effective. Thus, a termination is effective with respect to the taxable year of each component member of a controlled group of corporations which includes such December 31 and with respect to all succeeding taxable years of each corporation which is a component member of such group (or a successor group). Moreover, after a termination, the controlled group (and any successor group) may not make a new election except as provided in section 1562(d) and § 1.1562–4.

[T.D. 6845, 30 FR 9745, Aug. 5, 1965]

§ 1.1562–3 Consents to election and termination.

(a) *Consents required*—(1) *General.* An election under paragraph (a)(1) of § 1.1562–1, or a termination by consent under paragraph (b)(1) of § 1.1562–2, may be made by a controlled group of corporations with respect to a particular December 31 only if each corporation, which was a component member of such group (or a successor group) on any December 31 falling within the period beginning on the particular December 31 and ending on the most recently past December 31, consents to the election or termination within the time prescribed in paragraph (b) of this section and in the manner prescribed in paragraph (c) of this section. Such election or termination may be made with respect to a particular December 31 whether or not the electing or terminating group ceases to remain in existence under the principles of paragraph (a) of § 1.1562–5 before such election or termination is made. In the case of an election with respect to December 31, 1963, if each corporation which is required to consent to the election under the rules provided in Treasury Decision 6733, approved May 11, 1964 (29 FR 6320, C.B. 1964–1 (Part 1), 635) gives its consent in the manner provided in such Treasury Decision before December 31, 1964, then a valid election under section 1562(a)(1) shall be considered to have been made with respect to December 31, 1963.

(2) *Examples.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). P Corporation is the common parent of a parent-subsidiary controlled group of which corporations P, S–1, and S–2 are component members on December 31, 1965. On December 31, 1966, the controlled group consists of the same component members as on December 31, 1965, except that S–1 is no longer a component member on December 31, 1966. On December 31, 1967, the controlled group of corporations consists of the same component members as on December 31, 1966, except that corporation S–3 is also a component member on December 31, 1967. In January 1968, the controlled group desires to make an election under section 1562(a)(1) with respect to December 31, 1965. Such election may be made only if P, S–1 (even though S–1 was not a component member of the group on December 31, 1966, or December 31, 1967), S–2, and S–3 (even though S–3 was not a component member of the group on December 31, 1965, or December 31, 1966) consent to the election.

Example (2). Assume the same facts as in example (1) and further assume that in January 1968, the controlled group makes a valid election with respect to December 31, 1965. If, in July 1968, the controlled group desires to terminate the election with respect to December 31, 1966, P, S–2, and S–3 must consent to the termination.

(b) *Time for consents*—(1) *Consents to election.* The consent of each component member of a controlled group of corporations which is required with respect to an election for a particular December 31, shall be made at any time after such December 31 and before the expiration of 3 years after the date on which the income tax return, for the taxable year of the component member of the group on such December 31 which has the taxable year ending first on or after such date, is required to be filed (determined without regard to any extensions of time for the filing of such return). See section 1562(e)(1).

(2) *Consents to termination.* The consent of each component member of a controlled group of corporations which is required with respect to a termination for a particular December 31, shall be made at any time after such December 31 and before the expiration of 3 years after such date. See section 1562(e)(2).

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). The component members of a controlled group of corporations on December 31, 1965, consist of 2 calendar-year corporations, X and Y. The group desires to make an election under section 1562(a)(1) with respect to December 31, 1965. Under subparagraph (1) of this paragraph, the required consents to the election must be made after December 31, 1965, and on or before March 15, 1969. The result is the same whether or not X or Y (or both) ceases to be a component member of the group after December 31, 1965, and whether or not X or Y (or both) is granted an extension of time for the filing of its income tax return for 1965.

Example (2). Assume the same facts as in example (1) except that X files its income tax return on the basis of a fiscal year ending January 31, and Y files its income tax return on the basis of a fiscal year ending on June 30. Under subparagraph (1) of this paragraph, the last day on which the required consents may be made with respect to an election for December 31, 1965, is April 15, 1969.

Example (3). Assume the same facts as in example (1) or (2) except that an election under section 1562(a)(1) is effective for X's and Y's taxable years including December 31, 1965. Assume further that the group desires to terminate the election with respect to December 31, 1965. Under subparagraph (2) of this paragraph, the required consents to the termination must be made after December 31, 1965, and on or before December 31, 1968.

(c) *Manner of consenting*—(1) *General rule.* (i) The consent of a corporation to an election or termination with respect to a particular December 31 (other than a corporation which is a wholly-owned subsidiary in respect of such election or termination) shall be made by means of a statement, signed by any person who is duly authorized to act on behalf of the consenting corporation, stating that such corporation consents to an election or termination (as the case may be) with respect to such December 31. Such statement shall set forth the name, address, and taxpayer account number of the consenting member and the internal revenue district where the original of the statement is to be filed. The consent of more than one component member may be incorporated in a single statement. The original of a statement of consent shall be filed with the district director with whom the component member of the group on the particular December 31 which has the taxable year ending first on or after such date filed its return for such taxable year. (If two or more component members have the same such taxable year, a statement of consent may be filed with the district director with whom the return for any such taxable year is filed.) The original of a statement shall have attached thereto information (referred to in this paragraph as ‘‘group identification’’) setting forth the name, address, taxpayer account number, and taxable year of each component member of the controlled group on such December 31 (including wholly-owned subsidiaries). If the particular December 31 is a December 31 other than the December 31 immediately preceding the date on which such statement is filed then, as part of the ‘‘group identification’’, the original of the statement shall also set forth the information required in the preceding sentence with respect to each other corporation which was a component member of the group (or a successor group) on any December 31 occurring after the particular December 31 on which the consenting corporation was a component member of such group. If more than one original statement is filed, a statement may incorporate the group identification by reference to the name, address, taxpayer account number, and taxable year of a component member of the group which has attached such group identification to the original of its statement.

(ii) Each corporation which was a component member of the electing (or terminating) controlled group (or a successor group) on a December 31 falling within the period beginning on the particular December 31 and ending on the most recently past December 31 (other than a wholly-owned subsidiary in respect of such election or termination) should attach a copy of its consent (or a copy of the statement incorporating its consent) to each income tax return, amended return, or claim for refund filed with its district director for a taxable year which includes any such December 31. Such copy should either have attached thereto information on group identification or incorporate such information by reference to the name, address, taxpayer account number, and taxable year of a component member of the group which has attached such information to its income tax return, amended return, or claim for refund filed with the same district director for a taxable year which includes any such December 31.

(2) *Wholly-owned subsidiaries.* (i) Each corporation which is a wholly-owned subsidiary of a controlled group of corporations in respect of an election or termination with respect to a particular December 31 shall be deemed to consent to such election or termination (as the case may be). For purposes of this section, a corporation shall be considered to be a wholly-owned subsidiary of a controlled group in respect of an election or termination with respect to a particular December 31 if, on each day falling within the period beginning on the first day of such corporation’s taxable year which included such December 31 and ending on the day on which such election or termination is made (or, if such corporation was not in existence on each day of such period, on each day falling within such period during which the corporation was in existence), all the stock of such corporation is owned directly by one or more corporations which are component members of such group (or a successor group) on any December 31 falling within such period.

(ii) Each wholly-owned subsidiary should attach a statement to an income tax return, amended return, or claim for refund filed with its district director for each taxable year which contains a December 31 falling within the period described in the last sentence of subdivision (i) of this subparagraph, stating that an election or termination (as the case may be) is effective for such taxable year and containing the information which would be required to be set forth in a statement of consent to the election or termination filed pursuant to subparagraph (1)(i) of this paragraph. Information on group identification may either be attached to the statement or incorporated by reference to the name, address, taxpayer account number, and taxable year of a component member of the group which has attached such group identification to an income tax return, amended return, or claim for refund filed with the same district director for the taxable year including such date.

(d) *Effect of consent.* Under section 1562(e), any consent to an election under section 1562(a)(1) or a termination under section 1562(c)(1) is deemed to be a consent to the application of section 1562(g)(1) (relating to tolling of statute of limitations on assessment of deficiencies). See §1.1562–7.

[T.D. 6845, 30 FR 9746, Aug. 5, 1965]

§1.1562–4 Election after termination.

(a) *In general.* Under section 1562(d), if a controlled group of corporations has made a valid election under section 1562(a)(1), and such election is terminated by any one of the occurrences described in paragraph (b) of §1.1562–2, then such group (or any controlled group which is a successor to such group within the meaning of paragraph (c) of §1.1562–5) is not eligible to make an election under section 1562(a)(1) with respect to any December 31 before the sixth December 31 after the particular December 31 with respect to which such termination was effective. For the particular December 31 with respect to which a termination is effective, see paragraph (c) of §1.1562–2.

(b) *Example.* The provisions of this section may be illustrated by the following example:

Example. In 1965, a controlled group of corporations makes a valid election under section 1562(a)(1) with respect to December 31, 1964. In 1967, the election is terminated with respect to December 31, 1964, by consent pursuant to paragraph (b)(1) of §1.1562–2. The group (or any successor group) is not eligible to make another election with respect to any December 31 before December 31, 1970 (i.e., the sixth December 31 after December 31, 1964, the particular December 31 with respect to which such termination was effective). If in this example the election had been terminated with respect to December 31, 1965, instead of December 31, 1964, the group (or any successor group) would not be eligible to make another election with respect to any December 31 before December 31, 1971.

[T.D. 6845, 30 FR 9747, Aug. 5, 1965]

§1.1562–5 Continuing and successor controlled groups.

(a) *Controlled group continuing in existence.* For purposes of §§1.1561–3 and 1.1562–1 through 1.1562–4:

(1) *Parent-subsidiary group.* A parent-subsidiary controlled group of corporations shall be considered as remaining in existence as long as (i) such group is not considered, under paragraph (c)(3) of this section, to be a successor controlled group in respect of another controlled group, and (ii) its common parent corporation remains as a common parent and satisfies the requirements of paragraph (a)(2)(i)*(b)* of §1.1563–1 with respect to the ownership of stock of at least one corporation.

(2) *Brother-sister group.* A brother-sister controlled group of corporations shall be considered as remaining in existence as long as the requirements of paragraph (a)(3)(i) of §1.1563–1 continue to be satisfied with respect to at least two corporations, taking into account the stock ownership of only those five or fewer persons whose stock ownership was taken into account with respect to the election under section 1562(a)(1).

(3) *Combined group.* A combined group of corporations shall be considered as remaining in existence as long as (i) the brother-sister controlled group of corporations referred to in paragraph (a)(4)(i) of §1.1563–1 in respect of such combined group remains in existence (within the meaning of subparagraph (2) of this paragraph), and (ii) at least one such corporation is a common parent of a parent-subsidiary controlled group of corporations referred to in such paragraph (a)(4)(i).

(4) *Insurance group.* If, by reason of paragraph (a)(5)(i) of §1.1563–1, two or more insurance companies subject to taxation under section 802 are treated as an insurance group separate from any corporations which are members of a controlled group described in paragraph (a) (2), (3), or (4) of §1.1563–1, such insurance group shall be considered as remaining in existence as long as (i) the controlled group described in paragraph (a) (2), (3), or (4) of such section, as the case may be, remains in existence (within the meaning of subparagraph (1), (2), or (3) of this paragraph), and (ii) there are at least two insurance companies which satisfy the requirements of paragraph (a)(5)(i) of such section.

(b) *Controlled group no longer in existence*—(1) *General.* Except as provided in subparagraph (3) of this paragraph, a controlled group of corporations is considered as going out of existence with respect to a December 31 if such group ceases to remain in existence under the principles of paragraph (a) of this section during the calendar year ending on such date.

(2) *Examples.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples, in which each corporation referred to uses the calendar year as its taxable year:

Example (1). Corporation P was organized on January 1, 1964, and acquired all the stock of corporation S–1 on February 1, 1964, and all the stock of corporation S–2 on March 1, 1965. On April 1, 1965, P sold all its S–1 stock to the public. Beginning on February 1, 1964, P is the common parent corporation of a parent-subsidiary controlled group of corporations. Under paragraph (a)(1) of this section, the controlled group remains in existence throughout the remainder of 1964 and throughout 1965 even though after April 1, 1965, P satisfies the stock ownership requirements of paragraph (a)(2)(i) *(b)* of § 1.1563–1 only with respect to the stock of S–2, a corporation which was not a member of the group at the time the group was formed, and even though S–1 ceased to be a member of the group after the group was formed. Accordingly, if the controlled group makes a valid election under section 1562(a)(1) with respect to December 31, 1964, such election will remain in effect with respect to December 31, 1965, unless terminated under section 1562(c) (1), (2), or (3). Moreover, if such election were made and subsequently terminated with respect to December 31, 1964, the group would not be eligible (by reason of section 1562(d)) to make an election under section 1562(a)(1) with respect to December 31, 1965.

Example (2). Assume the same facts as in example (1) except that corporation S–2 is a franchised corporation as defined in section 1563(f)(4) for its 1965 taxable year. On December 31, 1965, S–2 is treated as an excluded member of the parent-subsidiary controlled group of which P is the common parent. See section 1563(b)(2)(E). Nevertheless, such controlled group is considered as remaining in existence throughout 1965.

Example (3). Assume the same facts as in example (1) except that P sold its S–1 stock on February 28, 1965, instead of April 1, 1965. Under the principles of paragraph (a)(1) of this section, the parent-subsidiary controlled group ceases to remain in existence on February 28, 1965. Accordingly, under subparagraph (1) of this paragraph, such group is considered as going out of existence with respect to December 31, 1965. Thus, if the group makes a valid election under section 1562(a)(1) with respect to December 31, 1964, such election terminates with respect to December 31, 1965. Moreover, the new controlled group of corporations consisting of P and S–2 is not precluded (by reason of section 1562(d)) from making an election under section 1562(a)(1) with respect to December 31, 1965.

Example (4). Smith, an individual, owns 80 percent of the only class of stock of corporations W and X on each day of 1966 and 1967. W, in turn, owns 80 percent of the only class of stock of corporation Y on each day of 1966. On April 15, 1967, X purchases 80 percent of the only class of corporation Z and on April 30, 1967, W sells all its stock in Y. Under paragraph (a)(3) of this section, the combined group remains in existence throughout 1966 and 1967 since (i) the brother-sister controlled group of corporations referred to in paragraph (a)(4)(i) of § 1.1563–1 in respect of such combined group remains in existence, and (ii) at least one corporation is a common parent of a parent-subsidiary controlled group referred to in such paragraph.

Example (5). Assume the same facts as in example (4) except that Y and Z are life insurance companies subject to taxation under section 802 of the Code. Further assume that throughout 1966 and 1967 Y owns all the stock of corporation S, and Z owns all the stock of corporation T. S and T are life insurance companies subject to taxation under section 802. Before April 15, 1967, under paragraph (a)(5)(i) of § 1.1563–1, Y and S are treated as an insurance group of corporations. After April 30, 1967, under paragraph (a)(4) of this section, Z and T are treated as an insurance group which remains in existence throughout 1966 and 1967, since the combined group remains in existence within the meaning of paragraph (a)(3) of this section throughout 1966 and 1967, and there are at all times at least two insurance companies which satisfy the requirements of paragraph (a)(5)(i) of § 1.1563–1. (However, after April 30, 1967, Y and S cease to be members of the combined group and are considered to be a new controlled group of corporations.)

Example (6). Jones, an individual, owns all the stock of corporations M and N on each day of 1966. On February 1, 1967, he gives all the stock of M to his 18-year-old son who continues to hold the M stock throughout the remainder of 1967. Since Jones (or his son) owns, or is considered as owning under paragraph (b)(6)(i) of § 1.1563–3, all the stock of M and N on each day of 1967, under paragraph (a)(2) of this section the brother-sister controlled group consisting of M and N remains in existence throughout 1967.

(3) *Special rule.* If:

(i) Under subparagraph (1) of this paragraph, a controlled group of corporations would (without regard to this subparagraph) be considered as going out of existence with respect to a December 31 because two or more corporations cease to be members of such group during the calendar year ending on such date,

(ii) Under paragraph (c) of this section, there is no successor group in respect of such group, and

(iii) At least two of such corporations are considered to be component members of such group on such December 31 by reason of the additional member rule of paragraph (b)(3) of §1.1563–1,

then such group shall be considered as going out of existence with respect to the December 31 immediately succeeding such December 31. For example, assume that corporations P and S file their returns on the basis of the calendar year. P owns all the stock of S from January 1, 1965, through December 1, 1965. On December 2, 1965, P sells the stock of S to the public. Under subparagraph (1) of this paragraph the controlled group consisting of P and S would (without regard to this subparagraph) be considered as going out of existence with respect to December 31, 1965, because P and S ceased to be members of the group on December 2, 1965. However, since there is no successor group in respect of the controlled group, and P and S are considered to be component members of such group on December 31, 1965, by reason of the additional member rule of paragraph (b)(3) of §1.1563–1, under this subparagraph the group is considered as going out of existence with respect to December 31, 1966, and not December 31, 1965.

(c) *Successor groups*—(1) *Transactions involving a former owner or owners.* If, as a result of the transfer of stock of a corporation or corporations (whether by sale, exchange, distribution, contribution to capital, or otherwise), a controlled group (‘‘old group’’) goes out of existence, and a new controlled group (‘‘new group’’) comes into existence, then the new group shall be considered to be a successor to the old group, provided one of the following applies:

(i) A person or persons who own stock of the new group that meets the more-than-50-percent stock ownership requirement of section 1563(a)(2)(B) owned stock which met such stock ownership requirement with respect to the old group;

(ii) A person or persons who owned more than 50 percent of the fair market value of the stock of the common parent of the old group owns, with respect to the new group, stock that meets the more-than-50-percent stock ownership requirement of section 1563(a)(2)(B); or

(iii) A person or persons who owned stock that met the more-than-50-percent stock ownership requirement of section 1563(a)(2)(B) with respect to the old group owns more than 50 percent of the fair market value of the stock of the common parent of the new group.

For purposes of this paragraph, the term ‘‘owns’’ includes direct ownership and ownership with the application of the rules contained in paragraph (b) of §1.1563–3. For purposes of this subparagraph, if as a result of the transfer of stock, a parent-subsidiary controlled group or a brother-sister controlled group becomes a part of a combined group, then such parent-subsidiary or brother-sister group shall be considered as going out of existence as a result of such transfer. Also for purposes of this subparagraph, if as a result of the transfer of stock, a combined group goes out of existence and a parent-subsidiary or brother-sister group which was part of such combined group remains, then such parent-subsidiary or brother-sister group shall be considered to be a new controlled group which came into existence as a result of such transfer.

(2) *Examples.* The principles of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). On each day of 1971, unrelated individuals Grey, Black, and Green own the following amounts of the only class of outstanding stock of each of corporations R and T: Grey owns 40 percent, Black owns 40 percent, and Green owns 20 percent. On March 1, 1972, Grey sells all his stock in both corporations to unrelated individual Clay. As a result of the transfer, the brother-sister controlled group consisting of R and T goes out of existence. Since Black and Green, who owned stock which met the more-than-50-percent stock ownership requirement of section 1563(a)(2)(B) with respect to the old group, owns stock of the new group (consisting of R and T) that meets the more-than-50-percent stock ownership requirement of section 1563(a)(2)(B), the new group is considered to be the successor to the old group. If Green also sold all his stock in both corporations to unrelated individual Barnes, Black would be the only stockholder of the new group whose stock ownership was taken into account in meeting the more-than-50-percent stock ownership requirement of section 1563(a)(2)(B) with respect to the old group. Since Black would not own stock of the new group that meets the more-than-50-percent stock ownership requirement of section 1563(a)(2)(B), the new group would not be considered a successor to the controlled group which went out of existence.

Example (2). On each day of 1971, all the outstanding stock of corporation P is owned in the following manner: Smith owns 30 percent, Jones owns 30 percent, and White owns 40 percent. P owns all the stock of corporation S_1, S_2, W_1 and W_2. On December 31, 1971, P, S_1, S_2, W_1, and W_2 are component members of the same controlled group. If on March 1, 1972, P distributes all the stock of S_1 and S_2 equally to Smith and Jones and all the stock of W_1 and W_2 to White, the controlled group consisting of P, S_1, S_2, W_1, and W_2 goes out of existence. Since Smith and Jones, who together owned stock which met the more-than-50-percent stock ownership requirement of section 1563 (a)(2)(B) with respect to the old group, now together own stock of the new group (consisting of S_1 and S_2) that meets the more-than-50-percent stock ownership requirement of section 1563(a)(2)(B), such new group is considered the successor to the old group. On the other hand, since White, the sole shareholder of W_1 and W_2, did not own stock which met such stock ownership requirement with respect to the old group, the new group consisting of W_1 and W_2 is not considered a successor of the old group.

(3) *Transactions involving two common parents.* If, as a result of the transfer of stock of a corporation or corporations (whether by sale, exchange, distribution, contribution to capital, or otherwise):

(i) A parent-subsidiary controlled group of corporations goes out of existence because its common parent corporation ceases to be a common parent, and

(ii) The stockholders (immediately before the transfer) of such common parent corporation, as a result of owning stock in such common parent, own (immediately after the transfer) more than 50 percent of the fair market value of the stock of a corporation which is the common parent corporation of a controlled group of corporations immediately after the transfer,

the resulting controlled group shall be considered to be a successor group in respect of the controlled group which went out of existence as a result of the transfer.

(4) *Example.* The provisions of subparagraph (3) of this paragraph may be illustrated by the following example:

Example. Corporation Y, the common parent of a parent-subsidiary controlled group, acquires the assets of corporation X, the common parent of another controlled group, in a statutory merger. The stockholders of X exchange their X stock for 60 percent of the fair market value of all of the outstanding shares of Y. Since, as a result of the exchange, (i) the parent-subsidiary controlled group of which X was the common parent goes out of existence because X ceases to be a common parent, and (ii) the stockholders of X, as a result of owning stock in X, own immediately after the exchange more than 50 percent of the fair market value of the stock of Y (the common parent of a controlled group of corporations immediately after the exchange), the controlled group of which Y is the common parent after the merger is considered to be a successor group in respect of the controlled group of which X was the common parent, and the group of which Y was the common parent before the merger is considered, under paragraph (a)(1) of this section, as no longer in existence. Thus, for example, if before the merger the controlled group of which X was the common parent was not eligible, by reason of the application of section 1562(d), to make an election under section 1562(a)(1) with respect to a December 31 occurring before December 31, 1970, then the successor controlled group would also be ineligible to make an election with respect to a December 31 occurring before December 31, 1970, whether or not the controlled group of which Y was the common parent before the merger had an election in effect pursuant to section 1562(a)(1).

[T.D. 6845, 30 FR 9747, Aug. 5, 1965, as amended by T.D. 7181, 37 FR 8067, Apr. 25, 1972]

§ 1.1562–6 Election for short taxable years.

(a) *Application of election to short taxable years*—(1) *General.* If the return of a corporation is for a short period which does not include a December 31, and if such corporation is a component member of a controlled group of corporations with respect to such short period, then an election under section 1562(a)(1) by such group shall apply with respect to such short period if:

(i) Such election is in effect with respect to both the December 31, immediately preceding such short period (hereinafter in this section referred to as the ‘‘preceding December 31’’) and the December 31 immediately succeeding such short period (hereinafter in this section referred to as the ‘‘succeeding December 31’’), or

(ii) Such election is in effect with respect to either the preceding December 31 or the succeeding December 31, and each corporation which is a component member of such group with respect to a short period falling between such dates consents to the application of such election to such short period. See subparagraph (4) of this paragraph for rules relating to an election with respect to certain short taxable years ending during 1964.

(2) *Component members.* For purposes of this section, the determination of whether a corporation is a component member of a controlled group of corporations with respect to a short period shall be made by applying the definition of component member contained in section 1563(b) and paragraph (b) of §1.1563–1 as if the last day of such short period were a December 31 occurring after December 31, 1963.

(3) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. On December 31, 1964, corporations P, S–1, and S–2 are component members of a parent-subsidiary controlled group of corporations. P, S–1, and S–2 each uses the calendar year as its taxable year. On February 1, 1965, S–1 transfers property to newly formed corporation S–3 (which begins business on that date) and receives all the stock of S–3 in return. S–3 adopts a fiscal year ending on November 30 as its taxable year and, therefore, files a return for the short taxable year beginning on February 1, 1965, and ending on November 30, 1965. On December 5, 1965, S–2 is liquidated, and therefore files a return for the short taxable year beginning on January 1, 1965, and ending on December 5, 1965. S–2 and S–3 are component members of the controlled group of corporations with respect to their short taxable years falling between December 31, 1964, and December 31, 1965, within the meaning of subparagraph (2) of this paragraph. Assume that the controlled group has an election under section 1562(a)(1) in effect with respect to either December 31, 1964, or December 31, 1965, but not both such dates. Under subparagraph (1)(ii) of this paragraph, S–2 and S–3 must both file consents to the application of the section 1562(a)(1) election with respect to their short periods in order for the election to be effective with respect to either such short period.

(4) *Election for certain short taxable years ending during 1964.* If:

(i) A corporation is a component member of a controlled group of corporations with respect to a short taxable year beginning and ending in 1964,

(ii) Each corporation which was a component member of such group on December 31, 1963 (determined without regard to paragraph (b)(2)(iii) of §1.1563–1, relating to the treatment of a corporation which has a taxable year ending on December 31, 1963, as an excluded member of a controlled group on such date) filed its income tax return on the basis of the calendar year ending on such date, and

(iii) Such controlled group of corporations is considered as going out of existence with respect to December 31, 1964, pursuant to paragraph (b)(4) of §1.1562–2,

then, for purposes of paragraph (a)(1)(ii) of this section, an election by such controlled group under section 1562(a)(1) shall be deemed to have been in effect for the preceding December 31. Each corporation which is a component member of such group with respect to a short period falling between such preceding and succeeding December 31’s must, on or before November 3, 1965, consent to the application of such election to its short period falling between such December 31’s.

(b) *Status at time of filing return.* If, on the date a corporation files its income tax return for a short period falling between a preceding and succeeding December 31 (with respect to which period it is a component member of a controlled group of corporations):

(1) *Election not effective.* An election under section 1562(a)(1) is not effective with respect to either such preceding or succeeding December 31, then such member shall determine its surtax exemption for purposes of such return in accordance with section 1561(b).

(2) *Election effective for preceding December 31.* An election under section 1562(a)(1) is effective with respect to such preceding December 31, and if on the date the return is filed the election has not been terminated with respect to such succeeding December 31, then such member may compute its tax for purposes of such return on the assumption that the conditions of paragraph

(a)(1)(i) of this section are satisfied with respect to such short period.

(3) *Election effective for preceding or succeeding December 31.* An election under section 1562(a)(1) is effective with respect to either (but not both) such preceding or succeeding December 31, and the return is filed after such succeeding December 31, then the member's surtax exemption for purposes of such return shall be determined in accordance with section 1561(b) unless:

(i) It attaches to such return its consent to the application of such election to such short period, and

(ii) Each other corporation which is a component member of the group with respect to a short period falling between such December 31's files, within 30 days after such return is filed, a consent to the application of such election to its short period falling between such December 31's.

(c) *Election or termination after returns filed*—(1) *Election.* If, after each component member of a controlled group with respect to a short period falling between a preceding and succeeding December 31 files its return for such short period, the group makes an election under section 1562(a)(1) with respect to such succeeding December 31, then the election shall apply with respect to each such short period only if each such member files, within 30 days after such election is made, a consent to the application of such election to its short period.

(2) *Termination.* If, after each component member of a controlled group with respect to a short period falling between a preceding and succeeding December 31 files its return for such short period, an election under section 1562(a)(1) which is effective with respect to such group with respect to such preceding December 31 is terminated with respect to such succeeding December 31, then such election shall apply with respect to each such short period only if each such member files, within 30 days after the termination occurs, a consent to the application of such election to its short period. For purposes of the preceding sentence, (i) the termination of an election by consent under section 1562(c)(1) shall be considered to occur on the date the termination is made, and (ii) the termination of an election under section 1562(c) (2), (3), or (4) shall be considered to occur on the date the event causing termination occurs (for example, on the date a new member files a refusal to consent, or on the date a consolidated return is filed) unless the election is made after such date, in which case the termination shall be considered to occur on the date the election is made.

(d) *Manner of consenting.* A consent referred to in paragraph (b)(3) or (c) of this section shall be made by means of a statement, signed by any person who is duly authorized to act on behalf of the consenting corporation, stating that such corporation consents to the application of an election under section 1562(a)(1) with respect to its short period. Each such statement shall set forth the name, address, taxpayer account number, and taxable year of (1) each corporation which is a component member of the electing controlled group with respect to a short period falling between the preceding December 31 and the succeeding December 31, and (2) each corporation which is a component member of such group on either the preceding or succeeding December 31. Each consenting corporation shall file such statement with the district director with whom it files (or filed) its income tax return for the short period.

[T.D. 6845, 30 FR 9749, Aug. 5, 1965]

§ 1.1562–7 Extension of statutory periods of limitation.

(a)(1) Under section 1562(g)(1), the statutory period for assessment of any deficiency against a corporation which is a component member of a controlled group of corporations with respect to any taxable year, to the extent such deficiency is attributable to an election under section 1562(a)(1) or a termination by consent under section 1562(c)(1), shall not expire before the expiration of one year after the date such election or termination is made.

(2) Under section 1562(g)(2), the statutory period for allowing or making credit or refund of any overpayment of tax by a corporation which is a component member of a controlled group of

corporations with respect to any taxable year, to the extent such overpayment is attributable to an election under section 1562(a)(1) or a termination by consent under section 1562(c)(1), shall not expire before the expiration of one year after the date such election or termination is made.

(b) For purposes of this section, the deficiency or overpayment in tax attributable to an election under section 1562(a)(1) or a termination by consent under section 1562(c)(1) shall be that amount of the increase or decrease in tax over the amount previously determined (as defined in section 1314(a)) for any taxable year which results from the application or nonapplication of section 1562, as the case may be. In determining the amount of such increase or decrease, due regard shall be given to the effect of any change in the amount of the surtax exemption (or the application or nonapplication of the additional tax under section 1562(b)) on credits allowable for any taxable year. Thus, for example, as a result of such change it may be necessary to recompute the amount of the investment credit allowable under section 38 for a taxable year for which the election or termination is effective and for other taxable years affected, or treated as affected, by an investment credit carryback or carryover (as defined in section 46(b)) determined with reference to the taxable years with respect to which such election or termination is effective.

(c) The provisions of this section shall not be construed to:

(1) Shorten the period within which an assessment of a deficiency may otherwise be made or the credit or refund of an overpayment may otherwise be allowed or made, or

(2) Apply to a deficiency or overpayment for a taxable year if the tax liability for such taxable year has been compromised under section 7122, or is the subject of a closing agreement under section 7121.

[T.D. 6845, 30 FR 9750, Aug. 5, 1965]

§ 1.1563–1 Definition of controlled group of corporations and component members.

(a) *Controlled group of corporations*—(1) *In general.* For purposes of sections 1561 through 1563 and the regulations thereunder, the term ‘‘controlled group of corporations’’ means any group of corporations which is either a ‘‘parent-subsidiary controlled group’’ (as defined in subparagraph (2) of this paragraph), a ‘‘brother-sister controlled group’’ (as defined in subparagraph (3) of this paragraph), a ‘‘combined group’’ (as defined in subparagraph (4) of this paragraph), or an ‘‘insurance group’’ (as defined in subparagraph (5) of this paragraph). For the exclusion of certain stock for purposes of applying the definitions contained in this paragraph, see section 1563(c) and § 1.1563–2.

(2) *Parent-subsidiary controlled group.* (i) The term ‘‘parent-subsidiary controlled group’’ means one or more chains of corporations connected through stock ownership with a common parent corporation if:

(a) Stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned (directly and with the application of paragraph (b)(1) of § 1.1563–3, relating to options) by one or more of the other corporations; and

(b) The common parent corporation owns (directly and with the application of paragraph (b)(1) of § 1.1563–3, relating to options) stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations.

(ii) The definition of a parent-subsidiary controlled group of corporations may be illustrated by the following examples:

Example (1). P Corporation owns stock possessing 80 percent of the total combined voting power of all classes of stock entitled to vote of S Corporation. P is the common parent of a parent-subsidiary controlled group consisting of member corporations P and S.

Example (2). Assume the same facts as in example (1). Assume further that S owns stock possessing 80 percent of the total value of shares of all classes of stock of T Corporation. P is the common parent of a parent-subsidiary controlled group consisting of member corporations P, S, and T. The result would be the same if P, rather than S, owned the T stock.

Example (3). L Corporation owns 80 percent of the only class of stock of M Corporation and M, in turn, owns 40 percent of the only class of stock of O Corporation. L also owns 80 percent of the only class of stock of N Corporation and N, in turn, owns 40 percent of the only class of stock of O. L is the common parent of a parent-subsidiary controlled group consisting of member corporations L, M, N, and O.

Example (4). X Corporation owns 75 percent of the only class of stock of Y and Z Corporations; Y owns all the remaining stock of Z; and Z owns all the remaining stock of Y. Since intercompany stockholdings are excluded (that is, are not treated as outstanding) for purposes of determining whether X owns stock possessing at least 80 percent of the voting power or value of at least one of the other corporations, X is treated as the owner of stock possessing 100 percent of the voting power and value of Y and of Z for purposes of subdivision (i)*(b)* of this subparagraph. Also, stock possessing 100 percent of the voting power and value of Y and Z is owned by the other corporations in the group within the meaning of subdivision (i)*(a)* of this subparagraph. (X and Y together own stock possessing 100 percent of the voting power and value of Z, and X and Z together own stock possessing 100 percent of the voting power and value of Y.) Therefore, X is the common parent of a parent-subsidiary controlled group of corporations consisting of member corporations X, Y, and Z.

(3) *Brother-sister controlled group.* (i) The term ''brother-sister controlled group'' means two or more corporations if the same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of the rules contained in paragraph (b) of § 1.1563–3) stock possessing:

(a) At least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation; and

(b) More than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation. The five or fewer persons whose stock ownership is considered for purposes of the 80 percent requirement must be the same persons whose stock ownership is considered for purposes of the more-than-50 percent requirement.

(ii) The principles of this subparagraph may be illustrated by the following examples:

Example (1). The outstanding stock of corporations P, Q, R, S, and T, which have only one class of stock outstanding is owned by the following unrelated individuals:

CORPORATIONS

Individuals	P	Q	R	S	T	Identical ownership
A	55%	51%	55%	55%	55%	51%.
B	45%	49%	....	....	....	(45% in P & Q).
C	....	....	45%	....	....	
D	....	....	....	45%	....	
E	....	....	....	....	45%	
Total	100%	100%	100%	100%	100%	

Corporations P and Q are members of a brother-sister controlled group of corporations. Although the more-than-50 percent identical ownership requirement is met for all 5 corporations, corporations R, S, and T are not members becasue at least 80 percent of the stock of each of those corporations is not owned by the same 5 or fewer persons whose stock ownership is considered for purposes of the more-than-50 percent identical ownership requirement.

Example (2). The outstanding stock of corporations U and V, which have only one class of stock outstanding, is owned by the following unrelated individuals:

Individuals	Corporations	
	U (percent)	V (percent)
A	12	12
B	12	12
C	12	12
D	12	12
E	13	13
F	13	13
G	13	13
H	13	13
Total	100	100

Any group of five of the shareholders will own more than 50 percent of the stock in each corporation, in identical holdings. However, U and V are not members of brother-sister controlled group because at least 80 percent of the stock of each corporation is not owned by the same five or fewer persons.

Example (3). Corporation X and Y each have two classes of stock outstanding, voting common and non-voting common. (None of this stock is excluded from the definition of stock under section 1563(c).) Unrelated individuals A and B owns the following percentages of the class of stock entitled to vote (voting) and of the total value of shares of all classes of stock (value) in each of corporations X and Y:

Individuals	Corporations	
	X	Y
A	100% voting, 60% value.	75% voting, 60% value.
B	0% voting, 10% value	25% voting, 10% value.

No other shareholder of X owns (or is considered to own) any stock in Y. X and Y are a brother-sister controlled group of corporations. The group meets the more-than-50 percent ownership requirements because A and B own more than 50 percent of the total value of shares of all classes of stock of X and Y in identical holdings. (The group also meets the more-than-50 percent ownership requirement because of A's voting stock ownership.) The group meets the 80 percent requirement because A and B own at least 80 percent of the total combined voting power of all classes of stock entitled to vote.

Example (4). Assume the same facts as in example (3) except that the value of the stock owned by A and B is not more than 50 percent of the total value of shares of all classes of stock of each corporation in identical holdings. X and Y are not a brother-sister controlled group of corporations. The group meets the more-than-50 percent ownership requirement because A owns more than 50 percent of the total combined voting power of the voting stock of each corporation. For purposes of the 80 percent requirement, B's voting stock in Y cannot be combined with A's voting stock in Y since B, who does not own any voting stock in X, is not a person whose ownership is considered for purposes of the more-than-50 percent requirement. Because no other shareholder owns stock in both X and Y, these other shareholders' stock ownership is not counted towards meeting either the more-than-50 percent ownership requirement or the 80-percent ownership requirement.

(iii) Paragraph (a)(3) of this section, as amended, by T.D. 8179 applies to taxable years ending on or after December 31, 1970. See, however, the transitional rule in paragraph (d) of this section.

(4) *Combined group.* (i) The term ''combined group'' means any group of three or more corporations, if:

(a) Each such corporation is a member of either a parent-subsidiary controlled group of corporations or a brother-sister controlled group of corporations, and

(b) At least one of such corporations is the common parent of a parent-subsidiary controlled group and also is a member of a brother-sister controlled group.

(ii) The definition of a combined group of corporations may be illustrated by the following examples:

Example (1). Smith, an individual, owns stock possessing 80 percent of the total combined voting power of all classes of the stock of corporations X and Y. Y, in turn, owns stock possessing 80 percent of the total combined voting power of all classes of the stock of corporation Z. Since:

(a) X, Y, and Z are each members of either a parent-subsidiary or brother-sister controlled group of corporations, and

(b) Y is the common parent of a parent-subsidiary controlled group of corporations consisting of Y and Z, and also is a member of a brother-sister controlled group of corporations consisting of X and Y,

X, Y, and Z are members of the same combined group.

Example (2). Assume the same facts as in example (1), and further assume that corporation X owns 80 percent of the total value of shares of all classes of stock of corporation T, X, Y, Z, and T are members of the same combined group.

(5) *Insurance group.* (i) The term ''insurance group'' means two or more insurance companies subject to taxation under section 802 each of which is a member of a controlled group of corporations described in subparagraph (2), (3), or (4) of this paragraph. Such insurance companies shall be treated as a controlled group of corporations separate from any other corporations which are members of the controlled group described in such subparagraph (2), (3), or (4). For purposes of this section and §1.1562–5, the common parent of the controlled group described in subparagraph (2) of this paragraph shall be referred to as the common parent of the insurance group.

(ii) The definition of an insurance group may be illustrated by the following example:

Example. Corporation P owns all the stock of corporation I which, in turn, owns all the stock of corporation X. P also owns all the stock of corporation Y which, in turn, owns all the stock of corporation J. I and J are life insurance companies subject to taxation under section 802 of the Code. Since I and J are members of a parent-subsidiary controlled group of corporations, such companies are treated as members of an insurance group separate from the parent-subsidiary controlled group consisting of P, X, and Y. For purposes of this section and § 1.1562–5, P is referred to as the common parent of the insurance group even though P is not a member of such group.

(6) *Voting power of stock.* For purposes of § 1.1562–5, this section, and §§ 1.1563–2 and 1.1563–3, in determining whether the stock owned by a person (or persons) possesses a certain percentage of the total combined voting power of all classes of stock entitled to vote of a corporation, consideration will be given to all the facts and circumstances of each case. A share of stock will generally be considered as possessing the voting power accorded to such share by the corporate charter, by-laws, or share certificate. On the other hand, if there is any agreement, whether express or implied, that a shareholder will not vote his stock in a corporation, the formal voting rights possessed by his stock may be disregarded in determining the percentage of the total combined voting power possessed by the stock owned by other shareholders in the corporation, if the result is that the corporation becomes a component member of a controlled group of corporations. Moreover, if a shareholder agrees to vote his stock in a corporation in the manner specified by another shareholder in the corporation, the voting rights possessed by the stock owned by the first shareholder may be considered to be possessed by the stock owned by such other shareholder if the result is that the corporation becomes a component member of a controlled group of corporations.

(b) *Component members*—(1) *In general.* For purposes of sections 1561 through 1563 and the regulations thereunder, a corporation is a component member of a controlled group of corporations on a December 31 (and with respect to the taxable year which includes such December 31) if such corporation:

(i) Is a member of such controlled group on such December 31 and is not treated as an excluded member under subparagraph (2) of this paragraph, or

(ii) Is not a member of such controlled group on such December 31 but is treated as an additional member under subparagraph (3) of this paragraph.

(2) *Excluded members.* (i) A corporation, which is a member of a controlled group of corporations on the December 31 included within its taxable year, but was a member of such group for less than one-half of the number of days in such taxable year which precede such December 31, shall be treated as an excluded member of such group on such December 31.

(ii) A corporation which is a member of a controlled group of corporations on any December 31 shall be treated as an excluded member of such group on such date if, for its taxable year including such date, such corporation is:

(a) Exempt from taxation under section 501(a) (except a corporation which has unrelated business taxable income for such taxable year which is subject to tax under section 511) or 521,

(b) A foreign corporation not subject to taxation under section 882(a) for the taxable year,

(c) An electing small business corporation (as defined in section 1371(b)) not subject to the tax imposed by section 1378,

(d) A franchised corporation (as defined in section 1563(f)(4) and § 1.1563–4), or

(e) An insurance company subject to taxation under section 802 or 821, except that an insurance company taxable under section 802 which (without regard to this subdivision) is a component member of an insurance group described in paragraph (a)(5) of this section shall not be treated as an excluded member of such insurance group.

(iii) A corporation which has a taxable year ending on December 31, 1963, shall be treated as an excluded member of a controlled group on such date.

(3) *Additional members.* A corporation which:

(i) Is not a member of a controlled group of corporations on the December 31 included within its taxable year, and

(ii) Is not described, with respect to such taxable year, in subparagraph (2)(ii) *(a), (b), (c), (d),* or *(e),* or (2)(iii) of this paragraph,

shall be treated as an additional member of such group on such December 31 if it was a member of such group for one-half (or more) of the number of days in such taxable year which precede such December 31.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). Brown, an individual, owns all of the stock of corporations W and X on each day of 1964. W and X each uses the calendar year as its taxable year. On January 1, 1964, Brown also owns all the stock of corporation Y (a fiscal year corporation with a taxable year beginning on July 1, 1964, and ending on June 30, 1965), which stock he sells on October 15, 1964. On December 31, 1964, Brown purchases all the stock of corporation Z (a fiscal year corporation with a taxable year beginning on September 1, 1964, and ending on August 31, 1965). On December 31, 1964, W, X, and Z are members of the same controlled group. However, the component members of the group on such December 31 are W, X, and Y. Under subparagraph (2)(i) of this paragraph, Z is treated as an excluded member of the group on December 31, 1964, since Z was a member of the group for less than one-half of the number of days (29 out of 121 days) during the period beginning on September 1, 1964 (the first day of its taxable year) and ending on December 30, 1964. Under subparagraph (3) of this paragraph, Y is treated as an additional member of the group on December 31, 1964, since Y was a member of the group for at least one-half of the number of days (107 out of 183 days) during the period beginning on July 1, 1964 (the first day of its taxable year) and ending on December 30, 1964.

Example (2). On January 1, 1964, corporation P owns all the stock of corporation S, which in turn owns all the stock of corporation S–1. On November 1, 1964, P purchases all of the stock of corporation X from the public and sells all of the stock of S to the public. Corporation X owns all the stock of corporation Y during 1964. P, S, S–1, X, and Y file their returns on the basis of the calendar year. On December 31, 1964, P, X, and Y are members of a parent-subsidiary controlled group of corporations; also, corporations S and S–1 are members of a different parent-subsidiary controlled group on such date. However, since X and Y have been members of the parent-subsidiary controlled group of which P is the common parent for less than one-half the number of days during the period January 1 through December 30, 1964, they are not component members of such group on such date. On the other hand, X and Y have been members of a parent-subsidiary controlled group of which X is the common parent for at least one-half the number of days during the period January 1 through December 30, 1964, and therefore they are component members of such group on December 31, 1964. Also since S and S–1 were members of the parent-subsidiary controlled group of which P is the common parent for at least one-half the number of days in the taxable years of each such corporation during the period January 1 through December 30, 1964, P, S, and S–1 are component members of such group on December 31, 1964.

Example (3). Throughout 1964, corporation M owns all the stock of corporation F which, in turn, owns all the stock of corporations L–1, L–2, X, and Y. M is a domestic mutual insurance company subject to taxation under section 821, F is a foreign corporation not engaged in trade or business within the United States, L–1 and L–2 are domestic life insurance companies subject to taxation under section 802, and X and Y are domestic corporations subject to tax under section 11 of the Code. Each corporation uses the calendar year as its taxable year. On December 31, 1964, M, F, L-1, L-2, X, and Y are members of a parent-subsidiary controlled group of corporations. However, under subparagraph (2)(ii) of this paragraph, M, F, L–1, and L–2 are treated as excluded members of the group on December 31, 1964. Thus, on December 31, 1964, the component members of the parent-subsidiary controlled group of which M is the common parent include only X and Y. Furthermore, since subparagraph (2)(ii)*(e)* of this paragraph does not result in L–1 and L–2 being treated as excluded members of an insurance group, L–1 and L–2 are component members of an insurance group on December 31, 1964.

(5) *Application of constructive ownership rules.* For purposes of subparagraphs (2)(i) and (3) of this paragraph, it is necessary to determine whether a corporation was a member of a controlled group of corporations for one-half (or more) of the number of days in its taxable year which precede the December 31 falling within such taxable year. Therefore, the constructive ownership rules contained in paragraph (b) of §1.1563–3 (to the extent applicable in making such determination) must be applied on a day-by-day basis. For example, if P Corporation owns all the stock of X Corporation on each day of 1964, and on December 30, 1964, acquires an option to purchase all the stock of Y Corporation (a calendar-year taxpayer which has been in existence on each day of 1964), the application of

paragraph (b)(1) of § 1.1563–3 on a day-by-day basis results in Y being a member of the brother-sister controlled group on only one day of Y's 1964 year which precedes December 31, 1964. Accordingly, since Y is not a member of such group for one-half or more of the number of days in its 1964 year preceding December 31, 1964, Y is treated as an excluded member of such group on December 31, 1964.

(c) *Overlapping groups*—(1) *In general.* If on a December 31 a corporation is a component member of a controlled group of corporations by reason of ownership of stock possessing at least 80 percent of the total value of shares of all classes of stock of the corporation, and if on such December 31 such corporation is also a component member of another controlled group of corporations by reason of ownership of other stock (that is, stock not used to satisfy the at-least-80-percent total value test) possessing at least 80 percent of the total combined voting power of all classes of stock of the corporation entitled to vote, then such corporation shall be treated as a component member only of the controlled group of which it is a component member by reason of the ownership of at least 80 percent of the total value of its shares.

(2) *Brother-sister controlled groups.* (i) If on a December 31, a corporation would, without application of this subparagraph, be a component member of more than one brother-sister controlled group on such date, such corporation shall be treated as a component member of only one such group on such date. Such a corporation may select which group in which it is to be included by filing an election as provided in this subparagraph. The election shall be in the form of a statement designating the group in which the corporation is to be included. The statement shall provide all the information with respect to stock ownership which is reasonably necessary to satisfy the Internal Revenue officer with whom it is filed that the corporation would, but for the election, be a component member of more than one controlled group. Once filed, the election is irrevocable and effective until such time that a change in the stock ownership of the corporation results in termination of membership in the controlled group in which such corporation has been included.

(ii) Except as provided in subdivision (iii) of this subparagraph, the statement shall be signed by a person duly authorized to act on behalf of such corporation and shall be filed on or before the due date (including extension of time) for the filing of the income tax return of such corporation for the taxable year. However, in the case of an election with respect to December 31, 1970, the statement shall be considered as timely filed if filed on or before December 15, 1971. In the event no election is filed in accordance with the provisions of this subdivision, then the district director with audit jurisdiction of such corporation's return for the taxable year which includes such December 31 shall determine the group in which such corporation is to be included, and such determination shall be binding for all subsequent years unless the corporation files a valid election with respect to any such subsequent year.

(iii) If more than one corporation would, without application of this subparagraph, be a component member of more than one controlled group, a single statement shall be signed by persons duly authorized to act on behalf of each such corporation. Such statement shall designate the group in which each corporation is to be included. The statement shall be attached to the income tax return of the corporation that, among those corporations which would (without the application of this subparagraph) belong to more than one group, has the taxable year including such December 31 which ends on the earliest date. However, in the case of an election with respect to December 31, 1970, the statement may be filed by December 15, 1971, with the service center director with whom such corporation's return is filed for the taxable year which includes such December 31. In the event no election is filed in accordance with the provisions of this subdivision, then the district director with audit jurisdiction of such corporation's return for the taxable year that includes such December 31 shall determine the group in which each corporation is to be included, and such determination shall be binding for all subsequent years unless the corporations file a valid election with respect to any such subsequent year.

(iv) The provisions of this subparagraph may be illustrated by the following examples (in which it is assumed that all the individuals are unrelated):

Example (1). On each day of 1970 all the outstanding stock of corporations M, N, and P is held in the following manner:

Individuals	Corporations		
	M	N	P
A	55%	40%	5%
B	40%	20%	40%
C	5%	40%	55%

Since the more-than-50-percent stock ownership requirement of section 1563(a)(2)(B) is met with respect to corporations M and N and with respect to corporations N and P, but not with respect to corporations M, N, and P, corporation N would, without the application of this subparagraph, be a component member on December 31, 1970, of overlapping groups consisting of M and N and of N and P. If N does not file an election in accordance with subdivision (ii) of this subparagraph, the district director with audit jurisdiction of N's return will determine the group in which N is to be included.

Example (2). On each day of 1970, all the outstanding stock of corporations S, T, W, X, and Z is held in the following manner:

Individuals	Corporations				
	S	T	W	X	Z
D	52%	52%	52%	52%	52%
E	40%	2%	2%	2%	2%
F	2%	40%	2%	2%	2%
G	2%	2%	40%	2%	2%
H	2%	2%	2%	40%	2%
I	2%	2%	2%	2%	40%

On December 31, 1970, the more-than-50-percent stock ownership requirement of section 1563(a)(2)(B) may be met with regard to any combination of the corporations but all five corporations cannot be included as component members of a single controlled group because the inclusion of all the corporations in a single group would be dependent upon taking into account the stock ownership of more than five persons. Therefore, if the corporations do not file a statement in accordance with subdivision (iii) of this subparagraph, the district director with audit jurisdiction of the return of the corporation whose taxable year ends on the earliest date will determine the group in which each corporation is to be included. The corporations or the district director, as the case may be, may designate that three corporations be included in one group and two corporations in another, or that any four corporations be included in one group and that the remaining corporation not be included in any group.

(d) *Transitional rules*—(1) *In general.* Treasury decision 8179 amended paragraph (a)(3) of this section to revise the definition of a brother-sister controlled group of corporations. In general, those amendments are effective for taxable years ending on or after December 31, 1970.

(2) *Limited nonretroactivity.* (i) Under the authority of section 7805(b), the Internal Revenue Service will treat an old group as a brother-sister controlled group corporations for purposes of applying sections 401, 404(a), 408(k), 409A, 410, 411, 412, 414, 415, and 4971 of the Code and sections 202, 203, 204, and 302 of the Employment Retirement Income Security Act of 1974 (ERISA) in a plan year or taxable year beginning before March 2, 1988. To the extent necessary to prevent an adverse effect on any old member (or any other corporation), or on any plan or other entity described in such sections (including plans, *etc.*, of corporations not part of such old group), that would result solely from the retroactive effect of the amendment to this section by T.D. 8179. An adverse effect includes the disqualification of a plan or the disallowance of a deduction or credit for a contribution to a plan. The Internal Revenue Service, however, will not treat an old member as a member of an old group to the extent that such treatment will have an adverse effect on that old member.

(ii) Section 7805(b) will not be applied pursuant to paragraph (d)(2)(i) of this section to treat an old member of an old group as a member of a brother-sister controlled group to prevent an adverse effect for a taxable year if, for that taxable year, that old member treats or has treated itself as not being a member of that old group for purposes of section 401, 404(a), 408(k), 409A, 410, 411, 412, 414, 415, and 4971 of the Code and sections 202, 203, 204, and 302 and title IV of ERISA for such taxable year (such as by filing, with respect to such taxable year, a return, amended return, or claim for credit or refund in which the amount of any deduction, credit, limitation, or tax due is determined by treating itself as not being a member of the old group for purposes of those sections). However, the fact that one or more (but not all) of the old members do not qualify for section 7805(b) treatment because of the preceding sentence will not preclude that old member (or members) from being treated as a member of the old group under paragraph (d)(2)(i) of this section in order to prevent the disallowance of a deduction or credit of another old member (or other corporation) or to prevent the disqualification of, or other adverse effect on, another old member's plan (or other entity) described in the sections of the Code and ERISA enumerated in such paragraph.

(3) *Election of general nonretroactivity.* In the case of a taxable year ending on or after December 31, 1970, and before March 2, 1988. An old group will be treated as a brother-sister controlled group of corporations for all purposes of the Code for such taxable year if—

(i) Each old member files a statement consenting to such treatment for such taxable year with the District Director having audit jurisdiction over its return within six months after March 2, 1988, and

(ii) No old member (A) files or has filed, with respect to such taxable year, a return, amended return, or claim for credit or refund in which the amount of any deduction, credit, limitation, or tax due is determined by treating any old member as not a member of the old group or (B) treats the employees of all members of the old group as not being employed by a single employer for purposes of sections 401, 404(a), 408(k), 409A, 410, 411, 412, 414, 415, and 4971 of the Code and sections 202, 203, 204, and 302 of ERISA for such taxable year.

(4) *Definitions.* For purposes of this paragraph (d) of this section—

(i) An ''old group'' is a brother-sister controlled group of corporations, determined by applying paragraph (a)(3) of this section as in effect before the amendments made by Treasury decision 8179, that is not a brother-sister controlled group of corporations, determined by applying paragraph (a)(3) of this section as amended by such Treasury decision, and

(ii) An ''old member'' is any corporation that is a member of an old group.

(5) *Election to choose between membership in more than one controlled group.* If—

(i) An old member has filed an election under paragraph (c)(2) of this section to be treated as a component member of an old group for a December 31 before March 2, 1988, and

(ii) That corporation would (without regard to such paragraph) be a component member of more than one brother-sister controlled group (not including an old group) on the December 31, that corporation may make an election under that paragraph by filing an amended return on or before September 2, 1988. This paragraph (d)(5) does not apply to a corporation that is treated as a member of an old group under paragraph (d)(3) of this section.

(6) *Refunds.* See section 6511(a) for period of limitation on filing claims for credit or refund.

[T.D. 6845, 30 FR 9751, Aug. 5, 1965, as amended by T.D. 6960, 33 FR 9302, June 25, 1968; T.D. 7181, 37 FR 8068, Apr. 25, 1972; T.D. 7293, 38 FR 32803, Nov. 28, 1973; T.D. 8179, 53 FR 6612, Mar. 2, 1988; 53 FR 8302, Mar. 14, 1988]

§ 1.1563–2 Excluded stock.

(a) *Certain stock excluded.* For purposes of sections 1561 through 1563 and the regulations thereunder, the term ''stock'' does not include:

(1) Nonvoting stock which is limited and preferred as to dividends, and

(2) Treasury stock.

(b) *Stock treated as excluded stock*—(1) *Parent-subsidiary controlled group.* If a corporation (hereinafter in this paragraph referred to as ''parent corporation'') owns 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock in another corporation (hereinafter in this paragraph referred to as ''subsidiary corporation''), the provisions of subparagraph (2) of this paragraph shall apply. For purposes of this subparagraph, stock owned by a corporation means stock owned directly plus stock owned with the application of the constructive ownership rules of paragraph (b)

(1) and (4) of § 1.1563–3, relating to options and attribution from corporations. In determining whether the stock owned by a corporation possesses the requisite percentage of the total combined voting power of all classes of stock entitled to vote of another corporation, see paragraph (a)(6) of § 1.1563–1.

(2) *Stock treated as not outstanding.* If the provisions of this subparagraph apply, then for purposes of determining whether the parent corporation or the subsidiary corporation is a member of a parent-subsidiary controlled group of corporations within the meaning of paragraph (a)(2) of § 1.1563–1, the following stock of the subsidiary corporation shall, except as otherwise provided in paragraph (c) of this section, be treated as if it were not outstanding:

(i) *Plan of deferred compensation.* Stock in the subsidiary corporation held by a trust which is part of a plan of deferred compensation for the benefit of the employees of the parent corporation or the subsidiary corporation. The term ‘‘plan of deferred compensation’’ shall have the same meaning such term has in section 406(a)(3) and the regulations thereunder.

(ii) *Principal stockholders and officers.* Stock in the subsidiary corporation owned (directly and with the application of the rules contained in paragraph (b) of § 1.1563–3) by an individual who is a principal stockholder or officer of the parent corporation. A principal stockholder of the parent corporation is an individual who owns (directly and with the application of the rules contained in paragraph (b) of § 1.1563–3) 5 percent or more of the total combined voting power of all classes of stock entitled to vote or 5 percent or more of the total value of shares of all classes of stock of the parent corporation. An officer of the parent corporation includes the president, vice-presidents, general manager, treasurer, secretary, and comptroller of such corporation, and any other person who performs duties corresponding to those normally performed by persons occupying such positions.

(iii) *Employees.* Stock in the subsidiary corporation owned (directly and with the application of the rules contained in paragraph (b) of § 1.1563–3) by an employee of the subsidiary corporation if such stock is subject to conditions which substantially restrict or limit the employee’s right (or if the employee constructively owns such stock, the direct owner’s right) to dispose of such stock and which run in favor of the parent or subsidiary corporation. In general, any condition which extends, directly or indirectly, to the parent corporation or the subsidiary corporation preferential rights with respect to the acquisition of the employee’s (or direct owner’s) stock will be considered to be a condition described in the preceding sentence. It is not necessary, in order for a condition to be considered to be in favor of the parent corporation or the subsidiary corporation, that the parent or subsidiary be extended a discriminatory concession with respect to the price of the stock. For example, a condition whereby the parent corporation is given a right of first refusal with respect to any stock of the subsidiary corporation offered by an employee for sale is a condition which substantially restricts or limits the employee’s right to dispose of such stock and runs in favor of the parent corporation. Moreover, any legally enforceable condition which prohibits the employee from disposing of his stock without the consent of the parent (or a subsidiary of the parent) will be considered to be a substantial limitation running in favor of the parent corporation.

(iv) *Controlled exempt organization.* Stock in the subsidiary corporation owned (directly and with the application of the rules contained in paragraph (b) of § 1.1563–3) by an organization (other than the parent corporation):

(a) To which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies, and

(b) Which is controlled directly or indirectly by the parent corporation or subsidiary corporation, by an individual, estate, or trust that is a principal stockholder of the parent corporation, by an officer of the parent corporation, or by any combination thereof.

The terms ‘‘principal stockholder of the parent corporation’’ and ‘‘officer of the parent corporation'' shall have the same meanings in this subdivision as in subdivision (ii) of this subparagraph. The term ''control'' as used in this subdivision means control in fact and the determination of whether the control requirement of *(b)* of this subdivision is met will depend upon all the facts and circumstances of each case, without regard to whether such control is legally enforceable and irrespective of the method by which such control is exercised or exercisable.

(3) *Brother-sister controlled group.* If five or fewer persons (hereinafter referred to as common owners) who are individuals, estates, or trusts own (directly and with the application of the rules contained in paragraph (b) of § 1.1563–3) stock possessing 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock in a corporation, the provisions of subparagraph (4) of this paragraph shall apply. In determining whether the stock owned by such person or persons possesses the requisite percentage of the total combined voting power of all classes of stock entitled to vote of a corporation, see paragraph (a)(6) of § 1.1563–1.

(4) *Stock treated as not outstanding.* If the provisions of this subparagraph apply, then for purposes of determining whether a corporation is a member of a brother-sister controlled group of corporations within the meaning of paragraph (a)(3) of § 1.1563–1, the following stock of such corporation shall, except as otherwise provided in paragraph (c) of this section, be treated as if it were not outstanding:

(i) *Exempt employees' trust.* Stock in such corporation held by an employees' trust described in section 401(a) which is exempt from tax under section 501(a), if such trust is for the benefit of the employees of such corporation.

(ii) *Employees.* Stock in such corporation owned (directly and with the application of the rules contained in paragraph (b) of § 1.1563–3) by an employee of such corporation if such stock is subject to conditions which run in favor of a common owner of such corporation (or in favor of such corporation) and which substantially restrict or limit the employee's right (or if the employee constructively owns such stock, the record owner's right) to dispose of such stock. The principles of subparagraph (2)(iii) of this paragraph shall apply in determining whether a condition satisfies the requirements of the preceding sentence. Thus, in general, a condition which extends, directly or indirectly, to a common owner or such corporation preferential rights with respect to the acquisition of the employee's (or record owner's) stock will be considered to be a condition which satisfies such requirements. For purposes of this subdivision, if a condition which restricts or limits an employee's right (or record owner's right) to dispose of his stock also applies to the stock in such corporation held by such common owner pursuant to a bona fide reciprocal stock purchase arrangement, such condition shall not be treated as one which restricts or limits the employee's (or record owner's) right to dispose of such stock. An example of a reciprocal stock purchase arrangement is an agreement whereby a common owner and the employee are given a right of first refusal with respect to stock of the employer corporation owned by the other party. If, however, the agreement also provides that the common owner has the right to purchase the stock of the employer corporation owned by the employee in the event that the corporation should discharge the employee for reasonable cause, the purchase arrangement would not be reciprocal within the meaning of this subdivision.

(iii) *Controlled exempt organization.* Stock in such corporation owned (directly and with the application of the rules contained in paragraph (b) of § 1.1563–3) by an organization:

(a) To which section 501(c)(3) (relating to certain educational and charitable organizations which are exempt from tax) applies, and

(b) Which is controlled directly or indirectly by such corporation, by an individual, estate, or trust that is a principal stockholder of such corporation, by an officer of such corporation, or by any combination thereof.

The terms ''principal stockholder'' and ''officer'' shall have the same meanings in this subdivision as in subparagraph

(2)(ii) of this paragraph. The term ‘‘control’’ as used in this subdivision means control in fact and the determination of whether the control requirement of *(b)* of this subdivision is met will depend upon all the facts and circumstances of each case, without regard to whether such control is legally enforceable and irrespective of the method by which such control is exercised or exercisable.

(5) *Other controlled groups.* The provisions of subparagraphs (1), (2), (3), and (4) of this paragraph shall apply in determining whether a corporation is a member of a combined group (within the meaning of paragraph (a)(4) of §1.1563–1) or an insurance group (within the meaning of paragraph (a)(5) of §1.1563–1). For example, under paragraph (a)(4) of §1.1563–1, in order for a corporation to be a member of a combined group such corporation must be a member of a parent-subsidiary group or a brother-sister group. Accordingly, the excluded stock rules provided by this paragraph are applicable in determining whether the corporation is a member of such group.

(6) *Meaning of employee.* For purposes of this section §§1.1563–3 and 1.1563–4, the term ‘‘employee’’ has the same meaning such term is given in section 3306(i) of the Code (relating to definitions for purposes of the Federal Unemployment Tax Act). Accordingly, the term employee as used in such sections includes an officer of a corporation.

(7) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). Corporation P owns 70 of the 100 shares of the only class of stock of corporation S. The remaining shares of S are owned as follows: 4 shares by Jones (the general manager of P), and 26 shares by Smith (who also owns 5 percent of the total combined voting power of the stock of P). P satisfies the 50 percent stock ownership requirement of subparagraph (1) of this paragraph with respect to S. Since Jones is an officer of P and Smith is a principal stockholder of P, under subparagraph (2)(ii) of this paragraph the S stock owned by Jones and Smith is treated as not outstanding for purposes of determining whether P and S are members of a parent-subsidiary controlled group of corporations within the meaning of paragraph (a)(2) of §1.1563–1. Thus, P is considered to own stock possessing 100 percent (70÷70) of the total voting power and value of all the S stock. Accordingly, P and S are members of a parent-subsidiary controlled group of corporations.

Example (2). Assume the same facts as in example (1) and further assume that Jones owns 15 shares of the 100 shares of the only class of stock of corporation S–1, and corporation S owns 75 shares of such stock. P satisfies the 50 percent stock ownership requirement of subparagraph (1) of this paragraph with respect to S–1 since P is considered as owning 52.5 percent (70 percent× 75 percent) of the S–1 stock with the application of paragraph (b)(4) of §1.1563–3. Since Jones is an officer of P, under subparagraph (2)(ii) of this paragraph, the S–1 stock owned by Jones is treated as not outstanding for purposes of determining whether S–1 is a member of the parent-subsidiary controlled group of corporations. Thus, S is considered to own stock possessing 88.2 percent (75÷85) of the voting power and value of the S–1 stock. Accordingly, P, S, and S–1 are members of a parent-subsidiary controlled group of corporations.

Example (3). Corporation X owns 60 percent of the only class of stock of corporation Y. Davis, the president of Y, owns the remaining 40 percent of the stock of Y. Davis has agreed that if he offers his stock in Y for sale he will first offer the stock to X at a price equal to the fair market value of the stock on the first date the stock is offered for sale. Since Davis is an employee of Y within the meaning of section 3306(i) of the Code, and his stock in Y is subject to a condition which substantially restricts or limits his right to dispose of such stock and runs in favor of X, under subparagraph (2)(iii) of this paragraph such stock is treated as if it were not outstanding for purposes of determining whether X and Y are members of a parent-subsidiary controlled group of corporations. Thus, X is considered to own stock possessing 100 percent of the voting power and value of the stock of Y. Accordingly, X and Y are members of a parent-subsidiary controlled group of corporations. The result would be the same if Davis's wife, instead of Davis, owned directly the 40 percent stock interest in Y and such stock was subject to a right of first refusal running in favor of X.

(c) *Exception*—(1) *General.* If stock of a corporation is owned by a person directly or with the application of the rules contained in paragraph (b) of §1.1563–3 and such ownership results in the corporation being a component member of a controlled group of corporations on a December 31, then the stock shall not be treated as excluded stock under the provisions of paragraph (b) of this section if the result of applying such provisions is that such corporation is not a component member of a controlled group of corporations on such December 31.

(2) *Illustration.* The provisions of this paragraph may be illustrated by the following example:

Example. On each day of 1965, corporation P owns directly 50 of the 100 shares of the only class of stock of corporation S. Jones, an officer of P, owns directly 30 shares of S stock and P has an option to acquire such 30 shares from Jones. The remaining shares of S are owned by unrelated persons. If, pursuant to the provisions of paragraph (b)(2)(ii) of this section, the 30 shares of S stock owned directly by Jones is treated as not outstanding, the result is that P would be treated as owning stock possessing only 71 percent (50÷70) of the total voting power and value of S stock, and S would not be a component member of a controlled group of corporations on December 31, 1965. However, since P is considered as owning the 30 shares of S stock with the application of paragraph (b)(1) of this section, and such ownership plus the S stock directly owned by P (50 shares) results in S being a component member of a controlled group of corporations on December 31, 1965, the provisions of this paragraph apply. Therefore, the provisions of paragraph (b)(2)(ii) of this section do not apply with respect to the 30 shares of S stock, and on December 31, 1965, S is a component member of a controlled group of corporations consisting of P and S.

[T.D. 6845, 30 FR 9753, Aug. 5, 1965, as amended by T.D. 7181, 37 FR 8070, Apr. 4, 1972]

§ 1.1563–3 Rules for determining stock ownership.

(a) *In general.* In determining stock ownership for purposes of §§ 1.1562–5, 1.1563–1, 1.1563–2, and this section, the constructive ownership rules of paragraph (b) of this section apply to the extent such rules are referred to in such sections. The application of such rules shall be subject to the operating rules and special rules contained in paragraphs (c) and (d) of this section.

(b) *Constructive ownership*—(1) *Options.* If a person has an option to acquire any outstanding stock of a corporation, such stock shall be considered as owned by such person. For purposes of this subparagraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock. For example, assume Smith owns an option to purchase 100 shares of the outstanding stock of M Corporation. Under this subparagraph, Smith is considered to own such 100 shares. The result would be the same if Smith owned an option to acquire the option (or one of a series of options) to purchase 100 shares of M stock.

(2) *Attribution from partnerships.* (i) Stock owned, directly or indirectly, by or for a partnership shall be considered as owned by any partner having an interest of 5 percent or more in either the capital or profits of the partnership in proportion to his interest in capital or profits, whichever such proportion is the greater.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. Green, Jones, and White, unrelated individuals, are partners in the GJW partnership. The partners' interests in the capital and profits of the partnership are as follows:

Partner	Capital	Profits
	Percent	Percent
Green	36	25
Jones	60	71
White	4	4

The GJW partnership owns the entire outstanding stock (100 shares) of X Corporation. Under this subparagraph, Green is considered to own the X stock owned by the partnership in proportion to his interest in capital (36 percent) or profits (25 percent), whichever such proportion is the greater. Therefore, Green is considered to own 36 shares of the X stock. However, since Jones has a greater interest in the profits of the partnership, he is considered to own the X stock in proportion to his interest in such profits. Therefore, Jones is considered to own 71 shares of the X stock. Since White does not have an interest of 5 percent or more in either the capital or profits of the partnership, he is not considered to own any shares of the X stock.

(3) *Attribution from estates or trusts.* (i) Stock owned, directly or indirectly, by or for an estate or trust shall be considered as owned by any beneficiary who has an actuarial interest of 5 percent or more in such stock, to the extent of such actuarial interest. For purposes of this subparagraph, the actuarial interest of each beneficiary shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary and the maximum use of such stock to satisfy his rights as a beneficiary. A

beneficiary of an estate or trust who cannot under any circumstances receive any interest in stock held by the estate or trust, including the proceeds from the disposition thereof, or the income therefrom, does not have an actuarial interest in such stock. Thus, where stock owned by a decedent's estate has been specifically bequeathed to certain beneficiaries and the remainder of the estate is bequeathed to other beneficiaries, the stock is attributable only to the beneficiaries to whom it is specifically bequeathed. Similarly, a remainderman of a trust who cannot under any circumstances receive any interest in the stock of a corporation which is a part of the corpus of the trust (including any accumulated income therefrom or the proceeds from a disposition thereof) does not have an actuarial interest in such stock. However, an income beneficiary of a trust does have an actuarial interest in stock if he has any right to the income from such stock even though under the terms of the trust instrument such stock can never be distributed to him. The factors and methods prescribed in § 20.2031–7 of this chapter (Estate Tax Regulations) for use in ascertaining the value of an interest in property for estate tax purposes shall be used for purposes of this subdivision in determining a beneficiary's actuarial interest in stock owned directly or indirectly by or for a trust.

(ii) For the purposes of this subparagraph, property of a decedent shall be considered as owned by his estate if such property is subject to administration by the executor or administrator for the purposes of paying claims against the estate and expenses of administration notwithstanding that, under local law, legal title to such property vests in the decedent's heirs, legatees or devisees immediately upon death. With respect to an estate, the term "beneficiary" includes any person entitled to receive property of the decedent pursuant to a will or pursuant to laws of descent and distribution. A person shall no longer be considered a beneficiary of an estate when all the property to which he is entitled has been received by him, when he no longer has a claim against the estate arising out of having been a beneficiary, and when there is only a remote possibility that it will be necessary for the estate to seek the return of property or to seek payment from him by contribution or otherwise to satisfy claims against the estate or expenses of administration. When pursuant to the preceding sentence, a person ceases to be a beneficiary, stock owned by the estate shall not thereafter be considered owned by him.

(iii) Stock owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under Subpart E, Part I, Subchapter J of the Code (relating to grantors and others treated as substantial owners) is considered as owned by such person.

(iv) This subparagraph does not apply to stock owned by any employees' trust described in section 401(a) which is exempt from tax under section 501(a).

(4) *Attribution from corporations.* (i) Stock owned, directly or indirectly, by or for a corporation shall be considered as owned by any person who owns (within the meaning of section 1563(d)) 5 percent or more in value or its stock in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. Brown, an individual, owns 60 shares of the 100 shares of the only class of outstanding stock of corporation P. Smith, an individual, owns 4 shares of the P stock, and corporation X owns 36 shares of the P stock. Corporation P owns, directly and indirectly, 50 shares of the stock of corporation S. Under this subparagraph, Brown is considered to own 30 shares of the S stock ($\frac{60}{100}\times 50$), and X is considered to own 18 shares of the S stock ($\frac{36}{100}\times 50$). Since Smith does not own 5 percent or more in value of the P stock, he is not considered as owning any of the S stock owned by P. If, in this example, Smith's wife had owned directly 1 share of the P stock, Smith (and his wife) would each own 5 shares of the P stock, and therefore Smith (and his wife) would be considered as owning 2.5 shares of the S stock ($\frac{5}{100}\times 50$).

(5) *Spouse.* (i) Except as provided in subdivision (ii) of this subparagraph, an individual shall be considered to

own the stock owned, directly or indirectly, by or for his spouse, other than a spouse who is legally separated from the individual under a decree of divorce, whether interlocutory or final, or a decree of separate maintenance.

(ii) An individual shall not be considered to own stock in a corporation owned, directly or indirectly, by or for his spouse on any day of a taxable year of such corporation, provided that each of the following conditions are satisfied with respect to such taxable year:

(a) Such individual does not, at any time during such taxable year, own directly any stock in such corporation.

(b) Such individual is not a member of the board of directors or an employee of such corporation and does not participate in the management of such corporation at any time during such taxable year.

(c) Not more than 50 percent of such corporation's gross income for such taxable year was derived from royalties, rents, dividends, interest, and annuities.

(d) Such stock in such corporation is not, at any time during such taxable year, subject to conditions which substantially restrict or limit the spouse's right to dispose of such stock and which run in favor of the individual or his children who have not attained the age of 21 years. The principles of paragraph (b)(2)(iii) of § 1.1563–2 shall apply in determining whether a condition is a condition described in the preceding sentence.

(iii) For purposes of subdivision (ii) (*c*) of this subparagraph, the gross income of a corporation for a taxable year shall be determined under section 61 and the regulations thereunder. The terms ''royalties'', ''rents'', ''dividends'', ''interest'', and ''annuities'' shall have the same meanings such terms are given for purposes of section 1244(c). See paragraph (e)(1)(ii), (iii), (iv), (v), and (vi) of § 1.1244(c)–1.

(6) *Children, grandchildren, parents, and grandparents.* (i) An individual shall be considered to own the stock owned, directly or indirectly, by or for his children who have not attained the age of 21 years, and, if the individual has not attained the age of 21 years, the stock owned, directly or indirectly, by or for his parents.

(ii) If an individual owns (directly, and with the application of the rules of this paragraph but without regard to this subdivision) stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock in a corporation, then such individual shall be considered to own the stock in such corporation owned, directly or indirectly, by or for his parents, grandparents, grandchildren, and children who have attained the age of 21 years. In determining whether the stock owned by an individual possesses the requisite percentage of the total combined voting power of all classes of stock entitled to vote of a corporation, see paragraph (a)(6) of § 1.1563–1.

(iii) For purposes of section 1563, and §§ 1.1563–1 through 1.1563–4, a legally adopted child of an individual shall be treated as a child of such individual by blood.

(iv) The provisions of this subparagraph may be illustrated by the following example:

Example (a) Facts. Individual F owns directly 40 shares of the 100 shares of the only class of stock of Z Corporation. His son, M (20 years of age), owns directly 30 shares of such stock, and his son, A (30 years of age), owns directly 20 shares of such stock. The remaining 10 shares of the Z stock are owned by an unrelated person.

(b) F's ownership. Individual F owns 40 shares of the Z stock directly and is considered to own the 30 shares of Z stock owned directly by M. Since, for purposes of the more-than-50-percent stock ownership test contained in subdivision (ii) of this subparagraph, F is treated as owning 70 shares or 70 percent of the total voting power and value of the Z stock, he is also considered as owning the 20 shares owned by his adult son, A. Accordingly, F is considered as owning a total of 90 shares of the Z stock.

(c) M's ownership. Minor son, M, owns 30 shares of the Z stock directly, and is considered to own the 40 shares of Z stock owned directly by his father, F. However, M is not considered to own the 20 shares of Z stock owned directly by his brother, A, and constructively by F, because stock constructively owned by F by reason of family attribution is not considered as owned by him for purposes of making another member of his family the constructive owner of such stock. See paragraph (c)(2) of this section. Accordingly, M owns and is considered as owning a total of 70 shares of the Z stock.

(d) A's ownership. Adult son, A, owns 20 shares of the Z stock directly. Since, for purposes of the more-than-50-percent stock ownership test contained in subdivision (ii) of this subparagraph, A is treated as owning only the Z stock which he owns directly, he does not satisfy the condition precedent for the attribution of Z stock from his father. Accordingly, A is treated as owning only the 20 shares of Z stock which he owns directly.

(c) *Operating rules and special rules*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, stock constructively owned by a person by reason of the application of subparagraph (1), (2), (3), (4), (5), or (6) of paragraph (b) of this section shall, for purposes of applying such subparagraphs, be treated as actually owned by such person.

(2) *Members of family.* Stock constructively owned by an individual by reason of the application of subparagraph (5) or (6) of paragraph (b) of this section shall not be treated as owned by him for purposes of again applying such subparagraphs in order to make another the constructive owner of such stock.

(3) *Precedence of option attribution.* For purposes of this section, if stock may be considered as owned by a person under subparagraph (1) of paragraph (b) of this section (relating to option attribution) and under any other subparagraph of such paragraph, such stock shall be considered as owned by such person under subparagraph (1) of such paragraph.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). A, 30 years of age, has a 90 percent interest in the capital and profits of a partnership. The partnership owns all the outstanding stock of corporation X and X owns 60 shares of the 100 outstanding shares of corporation Y. Under subparagraph (1) of this paragraph, the 60 shares of Y constructively owned by the partnership by reason of subparagraph (4) of paragraph (b) of this section is treated as actually owned by the partnership for purposes of applying subparagraph (2) of paragraph (b) of this section. Therefore, A is considered as owning 54 shares of the Y stock (90 percent of 60 shares).

Example (2). Assume the same facts as in example (1). Assume further that B, who is 20 years of age and the brother of A, directly owns 40 shares of Y stock. Although the stock of Y owned by B is considered as owned by C (the father of A and B) under paragraph (b)(6)(i) of this section, under subparagraph (2) of this paragraph such stock may not be treated as owned by C for purposes of applying paragraph (b)(6)(ii) of this section in order to make A the constructive owner of such stock.

Example (3). Assume the same facts assumed for purposes of example (2), and further assume that C has an option to acquire the 40 shares of Y stock owned by his son, B. The rule contained in subparagraph (2) of this paragraph does not prevent the reattribution of such 40 shares to A because, under subparagraph (3) of this paragraph, C is considered as owning the 40 shares by reason of option attribution and not by reason of family attribution. Therefore, since A satisfies the more-than-50-percent stock ownership test contained in paragraph (b)(6)(ii) of this section with respect to Y, the 40 shares of Y stock constructively owned by C are reattributed to A, and A is considered as owning a total of 94 shares of Y stock.

(d) *Special rule of section 1563 (f)(3)(B)*—(1) *In general.* If the same stock of a corporation is owned (within the meaning of section 1563(d)) by two or more persons, then such stock shall be treated as owned by the person whose ownership of such stock results in the corporation being a component member of a controlled group on a December 31 which has at least one other component member on such date.

(2) *Component member of more than one group.* (i) If, by reason of subparagraph (1) of this paragraph, a corporation would (but for this subparagraph) become a component member of more than one controlled group on a December 31, such corporation shall be treated as a component member of only one such controlled group on such date. The determination as to which group such corporation is treated as a component member of shall be made in accordance with the rules contained in subdivisions (ii), (iii), and (iv) of this subparagraph.

(ii) In any case in which a corporation is a component member of a controlled group of corporations on a December 31 as a result of treating each share of its stock as owned only by the person who owns such share directly, then each such share shall be treated as owned by the person who owns such share directly.

(iii) If the application of subdivision (ii) of this subparagraph does not result in a corporation being treated as a component member of only one controlled group on a December 31, then the stock of such corporation described in subparagraph (1) of this paragraph shall be treated as owned by the one person described in such subparagraph who owns, directly and with the application of the rules contained in paragraph (b) (1), (2), (3), and (4) of this section, the stock possessing the greatest percentage of the total value of shares of all classes of stock of the corporation.

(iv) If the application of subdivision (ii) or (iii) of this subparagraph does not result in a corporation being treated as a component member of only one controlled group of corporations on a December 31, then the determination of that group of which such corporation is to be treated as a component member shall be made by the district director with audit jurisdiction of such corporation's return for the taxable year that includes such December 31 unless such corporation files an election as provided in this subdivision. The election shall be in the form of a statement, signed by a person authorized to act on behalf of such corporation, designating the group in which the corporation has elected to be included. The statement shall provide all the information with respect to stock ownership which is reasonably necessary to satisfy the district director that the corporation would, but for the election, be a component member of more than one controlled group. The statement shall be filed on or before the due date (including extensions of time) for the filing of the income tax return of such corporation for the taxable year. However, in the case of an election with respect to December 31, 1970, the statement shall be considered as timely filed if filed on or before December 15, 1971. Once filed, the election is irrevocable and effective until subdivision (ii) or (iii) of this subparagraph applies or until there is a substantial change in the stock ownership of such corporation.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples, in which each corporation referred to uses the calendar year as its taxable year and the stated facts are assumed to exist on each day of 1970 (unless otherwise provided in the example):

Example (1). Jones owns all the stock of corporation X and has an option to purchase from Smith all the outstanding stock of corporation Y. Smith owns all the outstanding stock of corporation Z. Since the Y stock is considered as owned by two or more persons, under subparagraph (2)(ii) of this paragraph the Y stock is treated as owned only by Smith since he has direct ownership of such stock. Therefore, on December 31, 1970, Y and Z are component members of the same brother-sister controlled group. If, however, Smith had owned his stock in corporation Z for less than one-half of the number of days of Z's 1970 taxable year, then under subparagraph (1) of this paragraph the Y stock would be treated as owned only by Jones since his ownership results in Y being a component member of a controlled group on December 31, 1970.

Example (2). Individual H owns directly all the outstanding stock of corporation M. W (the wife of H) owns directly all the outstanding stock of corporation N. Neither spouse is considered as owning the stock directly owned by the other because each of the conditions prescribed in paragraph (b) (5)(ii) of this section is satisfied with respect to each corporation's 1970 taxable year. H owns directly 60 percent of the only class of stock of corporation P and W owns the remaining 40 percent of the P stock. Under subparagraph (2)(iii) of this paragraph, the stock of P is treated as owned only by H since H owns (directly and with the application of the rules contained in paragraph (b) (1), (2), (3), and (4) of this section) the stock possessing the greatest percentage of the total value of shares of all classes of stock of P. Accordingly, on December 31, 1970, P is treated as a component member of a brother-sister group consisting of M and P.

Example (3). Unrelated individuals A and B each own 49 percent of all the outstanding stock of corporation R, which in turn owns 70 percent of the only class of outstanding stock of corporation S. The remaining 30 percent of the stock of corporation S is owned by unrelated individual C. C also owns the remaining 2 percent of the stock of corporation R. Under the attribution rule of paragraph (b)(4) of this section A and B are each considered to own 34.3 percent of the stock of corporation S. Accordingly, since five or fewer persons own at least 80 percent of the stock of corporations R and S and also own more than 50 percent identically (A's and B's identical ownership each is 34.3 percent, C's identical ownership is 2 percent), on December 31, 1970, corporations R and S are treated as component members of the same brother-sister controlled group.

[T.D. 6845, 30 FR 9755, Aug. 5, 1965, as amended by T.D. 7181, 37 FR 8070, Apr. 25, 1972; T.D. 7779, 46 FR 29474, June 2, 1981; T.D. 8179, 53 FR 6613, Mar. 2, 1988]

§1.1563–4 Franchised corporations.

(a) *In general.* For purposes of paragraph (b)(2)(ii)*(d)* of §1.1563–1, a member of a controlled group of corporations shall be considered to be a franchised corporation for a taxable year if each of the following conditions is satisfied for one-half (or more) of the number of days preceding the December 31 included within such taxable year (or, if such taxable year does not include a December 31, for one-half or more of the number of days in such taxable year preceding the last day of such year):

(1) Such member is franchised to sell the products of another member, or the common owner, of such controlled group.

(2) More than 50 percent (determined on the basis of cost) of all the goods held by such member primarily for sale to its customers are acquired from members or the common owner of the controlled group, or both.

(3) The stock of such member is to be sold to an employee (or employees) of such member pursuant to a bona fide plan designed to eliminate the stock ownership of the parent corporation (as defined in paragraph (b)(1) of §1.1563–2) or of the common owner (as defined in paragraph (b)(3) of §1.1563–2) in such member.

(4) Such employee owns (or such employees in the aggregate own) directly more than 20 percent of the total value of shares of all classes of stock of such member. For purposes of this subparagraph, the determination of whether an employee (or employees) owns the requisite percentage of the total value of the stock of the member shall be made without regard to paragraph (b) of §1.1563–2, relating to certain stock treated as excluded stock. Furthermore, if the corporation has more than one class of stock outstanding, the relative voting rights as between each such class of stock shall be disregarded in making such determination.

(b) *Plan for elimination of stock ownership.* (1) A plan referred to in paragraph (a)(3) of this section must:

(i) Provide a reasonable selling price for the stock of the member, and

(ii) Require that a portion of the employee's compensation or dividends, or both, from such member be applied to the purchase of such stock (or to the purchase of notes, bonds, debentures, or similar evidences of indebtedness of such member held by the parent corporation or the common owner).

It is not necessary, in order to satisfy the requirements of subdivision (ii) of this subparagraph, that the plan require that a percentage of every dollar of the compensation and dividends be applied to the purchase of the stock (or the indebtedness). The requirements of such subdivision are satisfied if an otherwise qualified plan provides that under certain specified conditions (such as a requirement that the member earn a specified profit) no portion of the compensation and/or dividends need be applied to the purchase of the stock (or indebtedness), provided such conditions are reasonable.

(2) A plan for the elimination of the stock ownership of the parent corporation or of the common owner will satisfy the requirements of paragraph (a)(3) of this section and subparagraph (1) of this paragraph even though it does not require that the stock of the member be sold to an employee (or employees) if it provides for the redemption of the stock of the member held by the parent or common owner and under the plan the amount of such stock to be redeemed during any period is calculated by reference to the profits of such member during such period.

[T.D. 6845, 30 FR 9757, Aug. 5, 1965]

§1.1564–1 Limitations on additional benefits for members of controlled groups.

(a) *In general.* Section 1564(a)(1) provides that, with respect to any December 31 after 1969 and before 1975, only one component member of a controlled group of corporations (as defined in section 1563(a)) shall be allowed the full amount of:

(1) The $25,000 surtax exemption under section 1562 (relating to election of multiple surtax exemptions),

(2) The $100,000 amount under section 535(c) (2) and (3) (relating to the accumulated earnings credit), and

(3) The $25,000 limitation on the small business deduction of life insurance companies under sections 804(a)(4) and 809(d)(10).

The amounts otherwise allowed to the other component members of such controlled group for their taxable years which include such December 31 shall be reduced to the amounts set forth in the following schedule:

Taxable years including—	Surtax exemption	Amount under sec. 535(c) (2) and (3)	Small business deduction limitation
Dec. 31, 1970	$20,833	$83,333	$20,833
Dec. 31, 1971	16,667	66,667	16,667
Dec. 31, 1972	12,500	50,000	12,500
Dec. 31, 1973	8,333	33,333	8,333
Dec. 31, 1974	4,167	16,667	4,167

(b) *Election.* (1) Section 1564(a)(2) provides that, with respect to any December 31 after 1969 and before 1975, the component members of a controlled group of corporations shall elect which component member or members of such group shall be allowed for their taxable years which includes such December 31 the full amounts described in paragraph (a) (1), (2), and (3) of this section. In making such election, the members may allocate such full amounts among themselves in any manner they choose. For example, the group may select one of its members to receive the full amount of the $25,000 surtax exemption under section 1562 and another of its members to receive the full $100,000 amount under section 535(c)(2), or it may select one of its members to claim both, such full amounts.

(2) The election shall be made with respect to a particular December 31 and shall be valid only if each corporation which is a component member of the controlled group on such December 31 gives its consent. The consents shall be made by means of a statement, signed by persons duly authorized to act on behalf of each of the component members (other than wholly owned subsidiaries), stating which member has been selected to receive the amount which is not reduced under paragraph (a) of this section. The member so selected shall attach the statement to its income tax return for the taxable year including such December 31. The statement shall set forth the name, address, employer identification number, and taxable years of each of the other component members (including wholly owned subsidiaries) of the controlled group. Such other members shall attach a copy of the statement to their income tax returns for their taxable years including such December 31. An election plan adopted by a controlled group with respect to a particular December 31 shall be valid only for the taxable year of each member of the group which includes such December 31.

(3) Each component member of a controlled group which is a wholly owned subsidiary of such group with respect to a December 31 shall be deemed to consent to an election with respect to such December 31, provided each component member of the group which is not a wholly owned subsidiary consents to the election plan. A component member of a controlled group shall be considered to be a wholly owned subsidiary of the group with respect to a December 31 if, on each day preceding such date during its taxable year which includes such date, all of its stock is owned directly by one or more corporations which are component members of the group on such December 31.

[T.D. 7181, 37 FR 8071, Apr. 25, 1972]

Procedure and Administration

INFORMATION AND RETURNS

RETURNS AND RECORDS

SOURCE: Sections 1.6001–1 to 1.6091–4 contained in T.D. 6500, 25 FR 12108, Nov. 26, 1960, unless otherwise noted.

RECORDS, STATEMENTS, AND SPECIAL RETURNS

§ 1.6001–1 Records.

(a) *In general.* Except as provided in paragraph (b) of this section, any person subject to tax under subtitle A of the Code (including a qualified State individual income tax which is treated pursuant to section 6361(a) as if it were imposed by chapter 1 of subtitle A), or any person required to file a return of information with respect to income, shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.

(b) *Farmers and wage-earners.* Individuals deriving gross income from the business of farming, and individuals whose gross income includes salaries, wages, or similar compensation for personal services rendered, are required with respect to such income to keep such records as will enable the district director to determine the correct amount of income subject to the tax. It is not necessary, however, that with respect to such income individuals keep the books of account or records required by paragraph (a) of this section. For rules with respect to the records to be kept in substantiation of traveling and other business expenses of employees, see §1.162–17.

(c) *Exempt organizations.* In addition to such permanent books and records as are required by paragraph (a) of this section with respect to the tax imposed by section 511 on unrelated business income of certain exempt organizations, every organization exempt from tax under section 501(a) shall keep such permanent books of account or records, including inventories, as are sufficient to show specifically the items of gross income, receipts and disbursements. Such organizations shall also keep such books and records as are required to substantiate the information required by section 6033. See section 6033 and §§1.6033–1 through 1.6033–3.

(d) *Notice by district director requiring returns statements, or the keeping of records.* The district director may require any person, by notice served upon him, to make such returns, render such statements, or keep such specific records as will enable the district director to determine whether or not such person is liable for tax under subtitle A of the Code, including qualified State individual income taxes, which are treated pursuant to section 6361(a) as if they were imposed by chapter 1 of subtitle A.

(e) *Retention of records.* The books or records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 7122, 36 FR 11025, June 8, 1971; T.D. 7577, 43 FR 59357, Dec. 20, 1978; T.D. 8308, 55 FR 35593, Aug. 31, 1990]

§1.6001–2 Returns.

For rules relating to returns required to be made by every individual, estate, or trust which is liable for one or more qualified State individual income taxes, as defined in section 6362, for a taxable year, see paragraph (b) of §301.6361–1 of this chapter (Regulations on procedure and Administration).

[T.D. 7577, 43 FR 59357, Dec. 20, 1978]

TAX RETURNS OR STATEMENTS

§1.6011–1 General requirement of return, statement, or list.

(a) *General rule.* Every person subject to any tax, or required to collect any tax, under Subtitle A of the Code, shall make such returns or statements as are required by the regulations in this chapter. The return or statement shall include therein the information required by the applicable regulations or forms.

(b) *Use of prescribed forms.* Copies of the prescribed return forms will so far as possible be furnished taxpayers by district directors. A taxpayer will not be excused from making a return, however, by the fact that no return form has been furnished to him. Taxpayers not supplied with the proper forms should make application therefor to the district director in ample time to have their returns prepared, verified, and filed on or before the due date with the internal revenue office where such returns are required to be filed. Each taxpayer should carefully prepare his return and set forth fully and clearly the information required to be included therein. Returns which have not been so prepared will not be accepted as meeting the requirements of the Code. In the absence of a prescribed form, a statement made by a taxpayer disclosing his gross income and the deductions therefrom may be accepted as a tentative return, and, if filed within the prescribed time, the statement so made will relieve the taxpayer from liability for the addition to tax imposed for the delinquent filing of the return, provided that without unnecessary delay such a tentative return is supplemented by a return made on the proper form.

(c) *Tax withheld on nonresident aliens and foreign corporations.* For requirements respecting the return of the tax required to be withheld under chapter 3 of the Code on nonresident aliens and foreign corporations and tax-free covenant bonds, see § 1.1461–2.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6922, 32 FR 8713, June 17, 1967]

§ 1.6011–2 Returns, etc., of DISC's and former DISC's.

(a) *Records and information.* Every DISC and former DISC (as defined in section 992(a)) must comply with section 6001 and the regulations thereunder, relating to required records, statements, and special returns. Thus, for example, a DISC is required to maintain the books of account or records described in § 1.6001–1(a). In addition, every DISC must furnish to each of its shareholders on or before the last day of the second month following the close of the taxable year of the DISC a copy of Schedule K (Form 1120–DISC) disclosing the amounts of actual distributions and deemed distributions from the DISC to such shareholder for the taxable year of the DISC. In the case of a deficiency distribution to meet qualification requirements, see § 1.992–3(a)(4) for requirements that distribution be designated in the form of a communication sent to a shareholder and service center at the time of distribution.

(b) *Returns*—(1) *Requirement of return.* Every DISC (as defined in section 992(a)(1)) shall make a return of income. A former DISC (as defined in section 992(a)(3)) shall also make a return of income in addition to any other return required. The return required of a DISC or former DISC under this section shall be made on Form 1120–DISC. The provisions of § 1.6011–1 shall apply with respect to a DISC and former DISC. A former DISC should indicate clearly on Form 1120–DISC that it is making a return of income as a former DISC (for example, by labeling at the top of the Form 1120–DISC ''Former DISC''). In the case of a former DISC, those items on the form which pertain to the computation of taxable income shall not be completed, but Schedules J, K, L, and M must be completed. Except as otherwise specifically provided in the Code or regulations, the return of a DISC or former DISC is considered to be an income tax return.

(2) *Existence of DISC.* A corporation which is a DISC and which is in existence during any portion of a taxable year is required to make a return for that fractional part of its taxable year during which it was in existence.

[T.D. 7533, 43 FR 6603, Feb. 15, 1978]

§ 1.6011–3 Requirement of statement from payees of certain gambling winnings.

(a) *General rule.* Except as provided in paragraph (c) of this section, any person receiving a payment with respect to a wager in a sweepstakes, wagering pool, lottery, or other wagering transaction (including a parimutuel pool with respect to horse races, dog races, or jai alai) shall make a statement to the payer of such winnings upon the payer's demand. Such statements shall accompany the payer's return made with respect to the payment as required pursuant to section 3402(q) or 6041, as the case may be.

(b) *Contents of statement.* The statement referred to in paragraph (a) shall contain information (in addition to that required under section 6041(c)) as to the amount, if any, of winnings from identical wagers to which the recipient is entitled. If any person other than the recipient is entitled to all or a portion of the payment, the statement shall also include information as to the amount, if any, of winnings from identical wagers to which each such person is entitled. The statement shall be provided on Form W–2G or, if persons other than the recipient are entitled to all or a portion of such payment, on Form 5754.

(c) *Exception.* The requirement of paragraph (a) of this section does not apply with respect to any payment of winnings—

(1) From a slot machine play, or a bingo or keno game,

(2) Which is subject to withholding under section 3402(q) without regard to the existence of winnings from identical wagers, or

(3) For which no return of information under section 6041 is required of the payer.

(d) *Meaning of terms,* For purposes of this section, the terms ''sweepstakes'', ''wagering pool'', ''lottery'', ''other wagering transaction'' and ''identical wagers'' shall have the same meanings as ascribed to them under §31.3402(q)–1.

[T.D. 7919, 48 FR 46297, Oct. 12, 1983]

§1.6012–1 Individuals required to make returns of income.

(a) *Individual citizen or resident*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, an income tax return must be filed by every individual for each taxable year beginning before January 1, 1973, during which he receives $600 or more of gross income, and for each taxable year beginning after December 31, 1972, during which he receives $750 or more of gross income, if such individual is:

(i) A citizen of the United States, whether residing at home or abroad,

(ii) A resident of the United States even though not a citizen thereof, or

(iii) An alien bona fide resident of Puerto Rico during the entire taxable year.

(2) *Special rules.* (i) For taxable years beginning before January 1, 1970, an individual who is described in subparagraph (1) of this paragraph and who has attained the age of 65 before the close of his taxable year must file an income tax return only if he receives $1,200 or more of gross income during his taxable year.

(ii) For taxable years beginning after December 31, 1969, and before January 1, 1973, an individual described in subparagraph (1) of this paragraph (other than an individual referred to in section 142(b)):

(a) Who is not married (as determined by applying section 143(a) and the regulations thereunder) must file an income tax return only if he receives $1,700 or more of gross income during his taxable year, except that if such an individual has attained the age of 65 before the close of his taxable year an income tax return must be filed by such individual only if he receives $2,300 or more of gross income during his taxable year.

(b) Who is entitled to make a joint return under section 6013 and the regulations thereunder must file an income tax return only if his gross income received during his taxable year, when combined with the gross income of his spouse received during his taxable year, is $2,300 or more. However, if such individual or his spouse has attained the age of 65 before the close of the taxable year an income tax return must be filed by such individual only if their combined gross income is $2,900 or more. If both the individual and his spouse have attained the age of 65 before the close of the taxable year such return must be filed only if their combined gross income is $3,500 or more. However, this subdivision (ii)*(b)* shall not apply if the individual and his spouse did not have the same household as their home at the close of their taxable year, if such spouse files a separate return for a taxable year which includes any part of such individual's taxable year, or if any other taxpayer is entitled to an exemption for such individual or his spouse under section 151(e) for such other taxpayer's taxable year beginning in the calendar year in which such individual's taxable year begins. For example, a married student more than half of whose support is furnished by his father must file an income tax return if he receives $600 or more of gross income during his taxable year.

(iii) For taxable years beginning after December 31, 1972, an individual described in subparagraph (1) of this paragraph (other than an individual referred to in section 142(b)):

(a) Who is not married (as determined by applying section 143(a) and the regulations thereunder) must file an income tax return only if he receives $1,750 or more of gross income during his taxable year, except that if such an individual has attained the age of 65 before the close of his taxable year an income tax return must be filed by such individual only if he receives $2,500 or more of gross income during his taxable year.

(b) Who is entitled to make a joint return under section 6013 and the regulations thereunder must file an income tax return only if his gross income received during his taxable year, when combined with the gross income of his spouse received during his taxable year, is $2,500 or more. However, if such individual or his spouse has attained the age of 65 before the close of the taxable year an income tax return must be filed by such individual only if their combined gross income is $3,250 or more. If both the individual and his spouse attain the age of 65 before the close of the taxable year such return must be filed only if their combined gross income is $4,000 or more. However, this subdivision (iii)*(b)* shall not apply if the individual and his spouse did not have the same household as their home at the close of their taxable year, if such spouse files a separate return for a taxable year which includes any part of such individual's taxable year, or if any other taxpayer is entitled to an exemption for the taxpayer or his spouse under section 151(e) for such other taxpayer's taxable year beginning in the calendar year in which such individual's taxable year begins. For example, a married student more than half of whose support is furnished by his father must file an income tax return if he receives $750 or more of gross income during the taxable year.

(iv) For purposes of section 6012(a)(1)(A)(ii) and subdivisions (ii)*(b)* and (iii)*(b)* of this subparagraph, an individual and his spouse are considered to have the same household as their home at the close of a taxable year if the same household constituted the principal place of abode of both the individual and his spouse at the close of such taxable year (or on the date of death, if the individual or his spouse died within the taxable year). The individual and his spouse will be considered to have the same household as their home at the close of the taxable year notwithstanding a temporary absence from the household due to special circumstances, as, for example, in the case of a nonpermanent failure on the part of the individual and his spouse to have a common abode by reason of illness, education, business, vacation, or military service. For example, A, a calendar-year individual under 65 years of age, is married to B, also under 65 years of age, and is a member of the Armed Forces of the United States. During 1970 A is transferred to an overseas base. A and B give up their home, which they had jointly occupied until that time; B moves to the home of her parents for the duration of A's absence. They fully intend to set up a new joint household upon A's return. Neither A nor B must file a return for 1970 if their combined gross income for the year is less than $2,300 and if no other taxpayer is entitled to a dependency exemption for A or B under section 151(e).

(v) In the case of a short taxable year referred to in section 443(a)(1), an individual described in subparagraph (1) of this paragraph shall file an income tax return if his gross income received during such short taxable year equals or exceeds his own personal exemption allowed by section 151(b) (prorated as provided in section 443(c)) and, when applicable, his additional exemption for age 65 or more allowed by section 151(c)(1) (prorated as provided in section 443(c)).

(vi) For rules relating to returns required to be made by every individual who is liable for one or more qualified State individual income taxes, as defined in section 6362, for a taxable year, see paragraph (b) of § 301.6361–1 of this chapter (Regulations on Procedure and Administration).

(vii) For taxable years beginning after December 31, 1978, an individual who receives payments during the calendar year in which the taxable year begins under section 3507 (relating to advance payment of earned income credit) must file an income tax return.

(3) *Earned income from without the United States and gain from sale of residence.* For the purpose of determining whether an income tax return must be filed for any taxable year beginning after December 31, 1957, gross income shall be computed without regard to the exclusion provided for in section 911 (relating to earned income from sources without the United States). For the purpose of determining whether an income tax return must be filed for any taxable year ending after December 31, 1963, gross income shall be

computed without regard to the exclusion provided for in section 121 (relating to sale of residence by individual who has attained age 65). In the case of an individual claiming an exclusion under section 121, he shall attach Form 2119 to the return required under this paragraph and in the case of an individual claiming an exclusion under section 911, he shall attach Form 2555 to the return required under this paragraph.

(4) *Return of income of minor.* A minor is subject to the same requirements and elections for making returns of income as are other individuals. Thus, for example, for a taxable year beginning after December 31, 1972, a return must be made by or for a minor who has an aggregate of $1,750 of gross income from funds held in trust for him and from his personal services, regardless of the amount of his taxable income. The return of a minor must be made by the minor himself or must be made for him by his guardian or other person charged with the care of the minor's person or property. See paragraph (b)(3) of §1.6012–3. See §1.73–1 for inclusion in the minor's gross income of amounts received for his personal services. For the amount of tax which is considered to have been properly assessed against the parent, if not paid by the child, see section 6201(c) and paragraph (c) of §301.6201–1 of this chapter (Regulations on Procedure and Administration).

(5) *Returns made by agents.* The return of income may be made by an agent if, by reason of disease or injury, the person liable for the making of the return is unable to make it. The return may also be made by an agent if the taxpayer is unable to make the return by reason of continuous absence from the United States (including Puerto Rico as if a part of the United States) for a period of at least 60 days prior to the date prescribed by law for making the return. In addition, a return may be made by an agent if the taxpayer requests permission, in writing, of the district director for the internal revenue district in which is located the legal residence or principal place of business of the person liable for the making of the return, and such district director determines that good cause exists for permitting the return to be so made. However, assistance in the preparation of the return may be rendered under any circumstances. Whenever a return is made by an agent it must be accompanied by a power of attorney (or copy thereof) authorizing him to represent his principal in making, executing, or filing the return. A form 2848, when properly completed, is sufficient. In addition, where one spouse is physically unable by reason of disease or injury to sign a joint return, the other spouse may, with the oral consent of the one who is incapacitated, sign the incapacitated spouse's name in the proper place on the return followed by the words ''By __________________ Husband (or Wife),'' and by the signature of the signing spouse in his own right, provided that a dated statement signed by the spouse who is signing the return is attached to and made a part of the return stating:

(i) The name of the return being filed,

(ii) The taxable year,

(iii) The reason for the inability of the spouse who is incapacitated to sign the return, and

(iv) That the spouse who is incapacitated consented to the signing of the return.

The taxpayer and his agent, if any, are responsible for the return as made and incur liability for the penalties provided for erroneous, false, or fraudulent returns.

(6) *Form of return.* Form 1040 is prescribed for general use in making the return required under this paragraph. Form 1040A is an optional short form which, in accordance with paragraph (a)(7) of this section, may be used by certain taxpayers. A taxpayer otherwise entitled to use Form 1040A as his return for any taxable year may not make his return on such form if he elects not to take the standard deduction provided in section 141, and in such case he must make his return on Form 1040. For taxable years beginning before January 1, 1970, a taxpayer entitled under section 6014 and §1.6014–1 to elect not to show his tax on his return must, if he desires to exercise such election, make his return on Form 1040A. Form 1040W is an optional short

form which, in accordance with paragraph (a)(8) of this section, may be used only with respect to taxable years beginning after December 31, 1958, and ending before December 31, 1961.

(7)(i) *Use of Form 1040A.* Form 1040A may be filed only by those individuals entitled to use such form as provided by and in accordance with the instructions for such form.

(ii) *Computation and payment of tax.* Unless a taxpayer is entitled to elect under section 6014 and § 1.6014–1 not to show the tax on Form 1040A and does so elect, he shall compute and show on his return on Form 1040A the amount of the tax imposed by subtitle A of the Code and shall, without notice and demand therefor, pay any unpaid balance of such tax not later than the date fixed for filing the return.

(iii) *Change of election to use Form 1040A.* A taxpayer who has elected to make his return on Form 1040A may change such election. Such change of election shall be within the time and subject to the conditions prescribed in section 144(b) and § 1.144–2 relating to change of election to take, or not to take the standard deduction.

(8) *Use of Form 1040W for certain taxable years*—(i) *In general.* An individual may use Form 1040W as his return for any taxable year beginning after December 31, 1958, and ending before December 31, 1961, in which the gross income of the individual, regardless of the amount thereof:

(a) Consists entirely of remuneration for personal services performed as an employee (whether or not such remuneration constitutes wages as defined in section 3401(a)), dividends, or interest, and

(b) Does not include more than $200 from dividends and interest.

For purposes of determining whether gross income from dividends and interest exceeds $200, dividends from domestic corporations are taken into account to the extent that they are includible in gross income. For purposes of this subparagraph, any reference to Form 1040 in §§ 1.4–2, 1.142–1, and 1.144–1 and this section shall also be deemed a reference to Form 1040W.

(ii) *Change of election to use Form 1040W.* A taxpayer who has elected to make his return on Form 1040W may change such election. Such change of election shall be within the time and subject to the conditions prescribed in section 144(b) and § 1.144–2, relating to change of election to take, or not to take, the standard deduction.

(iii) *Joint return of husband and wife on Form 1040W.* A husband and wife, eligible under section 6013 and the regulations thereunder to file a joint return for the taxable year, may, subject to the provisions of this subparagraph, make a joint return on Form 1040W for any taxable year beginning after December 31, 1958, and ending before December 31, 1961, in which the aggregate gross income of the spouses (regardless of amount) consists entirely of remuneration for personal services performed as an employee (whether or not such remuneration constitutes wages as defined in section 3401(a)), dividends, or interest, and does not include more than $200 from dividends and interest. For purposes of determining whether gross income from sources to which the $200 limitation applies exceeds such amount in cases where both spouses receive dividends from domestic corporations, the amount of such dividends received by each spouse is taken into account to the extent that such dividends are includible in gross income. See section 116 and §§ 1.116–1 and 1.116–2. If a joint return is made by husband and wife on Form 1040W, the liability for the tax shall be joint and several.

(9) *Items of tax preference.* For a taxable year ending after December 31, 1969, an individual shall attach Form 4625 to the return required by this paragraph if during the year the individual:

(i) Has items of tax preference (described in section 57) in excess of its minimum tax exemption (determined under § 1.58–1) or

(ii) Uses a net operating loss carryover from a prior taxable year in which it deferred minimum tax under section 56(b).

(b) *Return of nonresident alien individual*—(1) *Requirement of return*—(i) *In general.* Except as otherwise provided in subparagraph (2) of this paragraph, every nonresident alien individual (other than one treated as a resident under section 6013 (g) or (h)) who is engaged in trade or business in the

United States at any time during the taxable year or who has income which is subject to taxation under subtitle A of the Code shall make a return on Form 1040NR. For this purpose it is immaterial that the gross income for the taxable year is less than the minimum amount specified in section 6012(a) for making a return. Thus, a nonresident alien individual who is engaged in a trade or business in the United States at any time during the taxable year is required to file a return on Form 1040 NR even though *(a)* he has no income which is effectively connected with the conduct of a trade or business in the United States, *(b)* he has no income from sources within the United States, or *(c)* his income is exempt from income tax by reason of an income tax convention or any section of the Code. However, if the nonresident alien individual has no gross income for the taxable year, he is not required to complete the return schedules but must attach a statement to the return indicating the nature of any exclusions claimed and the amount of such exclusions to the extent such amounts are readily determinable.

(ii) *Treaty income.* If the gross income of a nonresident alien individual includes treaty income, as defined in paragraph (b)(1) of §1.871–12, a statement shall be attached to the return on Form 1040NR showing with respect to that income:

(a) The amounts of tax withheld,

(b) The names and post office addresses of withholding agents, and

(c) Such other information as may be required by the return form, or by the instructions issued with respect to the form, to show the taxpayer's entitlement to the reduced rate of tax under the tax convention.

(2) *Exceptions*—(i) *Return not required when tax is fully paid at source.* A nonresident alien individual (other than one treated as a resident under section 6013 (g) or (h)) who at no time during the taxable year is engaged in a trade or business in the United States is not required to make a return for the taxable year if his tax liability for the taxable year is fully satisfied by the withholding of tax at source under chapter 3 of the Code. This subdivision does not apply to a nonresident alien individual who has income for the taxable year which is treated under section 871 (c) or (d) and §1.871–9 (relating to students or trainees) or §1.871–10 (relating to real property income) as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, or to a nonresident alien individual making a claim under §301.6402–3 of this chapter (Procedure and Administration Regulations) for the refund of an overpayment of tax for the taxable year. In addition, this subdivision does not apply to a nonresident alien individual who has income for the taxable year that is treated under section 871(b)(1) as effectively connected with the conduct of a trade or business within the United States by reason of the operation of section 897. For purposes of this subdivision, some of the items of income from sources within the United States upon which the tax liability will not have been fully satisfied by the withholding of tax at source under chapter 3 of the Code are:

(a) Interest upon so-called tax-free covenant bonds upon which, in accordance with section 1451 and §1.1451–1, a tax of only 2 percent is required to be withheld at the source,

(b) In the case of bonds or other evidences of indebtedness issued after September 28, 1965, amounts described in section 871(a)(1)(C),

(c) Capital gains described in section 871(a)(2) and paragraph (d) of §1.871– 7, and

(d) Accrued interest received in connection with the sale of bonds between interest dates, which, in accordance with paragraph (h) of §1.1441–4, is not subject to withholding of tax at the source.

(ii) *Return of individual for taxable year of change of U.S. citizenship or residence. (a)* If an alien individual becomes a citizen or resident of the United States during the taxable year and is a citizen or resident of the United States on the last day of such year, he must make a return on Form 1040 for the taxable year. However, a separate schedule is required to be attached to this return to show the income tax computation for the part of the taxable year during which the alien was neither a citizen nor resident of the United States, unless an election under section 6013 (g) or (h) is in effect for the alien. A Form 1040NR, clearly marked ''Statement'' across the top, may be used as such a separate schedule.

(b) If an individual abandons his U.S. citizenship or residence during the taxable year and is not a citizen or resident of the United States on the last day of such year, he must make a return on Form 1040NR for the taxable year, even if an election under section 6013(g) was in effect for the taxable year preceding the year of abandonment. However, a separate schedule is required to be attached to this return to show the income tax computation for the part of the taxable year during which the individual was a citizen or resident of the United States. A Form 1040, clearly marked ''Statement'' across the top, may be used as such a separate schedule.

(c) A return is required under this subdivision (ii) only if the individual is otherwise required to make a return for the taxable year.

(iii) *Beneficiaries of estates or trusts.* A nonresident alien individual who is a beneficiary of an estate or trust which is engaged in trade or business in the United States is not required to make a return for the taxable year merely because he is deemed to be engaged in trade or business within the United States under section 875(2). However, such nonresident alien beneficiary will be required to make a return if he otherwise satisfies the conditions of subparagraph (1)(i) of this paragraph for making a return.

(iv) *Certain alien residents of Puerto Rico.* This paragraph does not apply to a nonresident alien individual who is a bona fide resident of Puerto Rico during the taxable year. See section 876 and paragraph (a)(1)(iii) of this section.

(3) *Representative or agent for nonresident alien individual*—(i) *Cases where power of attorney is not required.* The responsible representative or agent within the United States of a nonresident alien individual shall make on behalf of his nonresident alien principal a return of, and shall pay the tax on, all income coming within his control as representative or agent which is subject to the income tax under subtitle A of the Code. The agency appointment will determine how completely the agent is substituted for the principal for tax purposes. Any person who collects interest or dividends on deposited securities of a nonresident alien individual, executes ownership certificates in connection therewith, or sells such securities under special instructions shall not be deemed merely by reason of such acts to be the responsible representative or agent of the nonresident alien individual. If the responsible representative or agent does not have a specific power of attorney from the nonresident alien individual to file a return in his behalf, the return shall be accompanied by a statement to the effect that the representative or agent does not possess specific power of attorney to file a return for such individual but that the return is being filed in accordance with the provisions of this subdivision.

(ii) *Cases where power of attorney is required.* Whenever a return of income of a nonresident alien individual is made by an agent acting under a duly authorized power of attorney for that purpose, the return shall be accompanied by the power of attorney in proper form, or a copy thereof, specifically authorizing him to represent his principal in making, executing, and filing the income tax return. Form 2848 may be used for this purpose. The agent, as well as the taxpayer, may incur liability for the penalties provided for erroneous, false, or fraudulent returns. For the requirements regarding signing of returns, see §1.6061–1. The rules of paragraph (e) of §601.504 of this chapter (Statement of Procedural Rules) shall apply under this subparagraph in determining whether a copy of a power of attorney must be certified.

(iii) *Limitation.* A return of income shall be required under this subparagraph only if the nonresident alien individual is otherwise required to make a return in accordance with this paragraph.

(4) *Disallowance of deductions and credits.* For provisions disallowing deductions and credits when a return of income has not been filed by or on behalf of a nonresident alien individual,

see section 874(a) and the regulations thereunder.

(5) *Effective date.* This paragraph shall apply for taxable years beginning after December 31, 1966, except that it shall not be applied to require (i) the filing of a return for any taxable year ending before January 1, 1974, which, pursuant to instructions applicable to the return, is not required to be filed or (ii) the amendment of a return for such a taxable year which, pursuant to such instructions, is required to be filed. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.6012–1(b) (Revised as of January 1, 1967).

(c) *Cross reference.* For returns by fiduciaries for individuals, estates, and trusts, see §1.6012–3.

(Sec. 1445 (98 Stat. 655; 26 U.S.C. 1445), sec. 6012 (68A Stat. 732; 26 U.S.C. 6012), and 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 6500, 25 FR 12108, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.6012–1, see the List of CFR Sections Affected in the Finding Aids section of this volume.

§1.6012–2 Corporations required to make returns of income.

(a) *In general*—(1) *Requirement of return.* Except as provided in paragraphs (e) and (g)(1) of this section with respect to charitable and other organizations having unrelated business income and to certain foreign corporations, respectively, every corporation, as defined in section 7701(a)(3), subject to taxation under subtitle A of the Code shall make a return of income regardless of whether it has taxable income or regardless of the amount of its gross income.

(2) *Existence of corporation.* A corporation in existence during any portion of a taxable year is required to make a return. If a corporation was not in existence throughout an annual accounting period (either calendar year or fiscal year), the corporation is required to make a return for that fractional part of a year during which it was in existence. A corporation is not in existence after it ceases business and dissolves, retaining no assets, whether or not under State law it may thereafter be treated as continuing as a corporation for certain limited purposes connected with winding up its affairs, such as for the purpose of suing and being sued. If the corporation has valuable claims for which it will bring suit during this period, it has retained assets and therefore continues in existence. A corporation does not go out of existence if it is turned over to receivers or trustees who continue to operate it. If a corporation has received a charter but has never perfected its organization and has transacted no business and has no income from any source, it may upon presentation of the facts to the district director be relieved from the necessity of making a return. In the absence of a proper showing of such facts to the district director, a corporation will be required to make a return.

(3) *Form of return.* The return required of a corporation under this section shall be made on Form 1120 unless the corporation is a type for which a special form is prescribed. The special forms of returns and schedules required of particular types of corporations are set forth in paragraphs (b) to (g), inclusive, of this section.

(b) *Personal holding companies.* A personal holding company, as defined in section 542, including a foreign corporation within the definition of such section, shall attach Schedule PH, Computation of U.S. Personal Holding Company Tax, to the return required by paragraph (a) or (g), as the case may be, of this section.

(c) *Insurance companies*—(1) *Life insurance companies.* A life insurance company subject to tax under section 802 or 811 shall make a return on Form 1120L. There shall be filed with the return (i) a copy of the annual statement, the form of which has been approved by the National Association of Insurance Commissioners, which is filed by the company for the year covered by such return with the insurance departments of States, Territories, and the District of Columbia, and which shows the reserves used by the company in computing the taxable income reported on its return, and (ii) copies of Schedule A (real estate) and Schedule D (bonds and stocks) of such annual statement.

(2) *Mutual insurance companies.* A mutual insurance company (other than a

life or marine insurance company and other than a fire insurance company subject to the tax imposed by section 831) or an interinsurer or reciprocal underwriter subject to tax under section 821 shall make a return on Form 1120M. See paragraph (a)(3) of § 1.821–1. There shall be filed with the return (i) a copy of the annual statement, the form of which has been approved by the National Association of Insurance Commissioners, which is filed by the company for the year covered by such return with the insurance departments of States, Territories, and the District of Columbia, and (ii) copies of Schedule A (real estate) and Schedule D (bonds and stocks) of such annual statement.

(3) *Other insurance companies.* Every insurance company (other than a life or mutual insurance company), every mutual marine insurance company, and every mutual fire insurance company, subject to tax under section 831, and every mutual savings bank conducting a life insurance business and subject to tax under section 594, shall make a return on Form 1120. See paragraph (c) of § 1.831–1. There shall be filed with the return a copy of the annual statement, the form of which has been approved by the National Association of Insurance Commissioners, which contains the underwriting and investment exhibit for the year covered by such return.

(4) *Foreign insurance companies.* The provisions of subparagraphs (1), (2), and (3) of this paragraph concerning the returns and statements of insurance companies subject to tax under section 802 or 811, section 821, and section 831, respectively, are applicable to foreign insurance companies subject to tax under such sections, except that the copy of the annual statement, the form of which has been approved by the National Association of Insurance Commissioners, required to be submitted with the return shall, in the case of a foreign insurance company, be a copy of the statement relating to the United States business of such company.

(d) *Affiliated groups.* For the forms to be used by affiliated corporations filing a consolidated return, see § 1.1502–75.

(e) *Charitable and other organizations with unrelated business income.* Every organization described in section 511(a)(2) which is subject to the tax imposed by section 511(a)(1) on its unrelated business taxable income shall make a return on Form 990–T for each taxable year if it has gross income, included in computing unrelated business taxable income for such taxable year, of $1,000 or more. The filing of a return of unrelated business income does not relieve the organization of the duty of filing other required returns.

(f) *Farmers' cooperatives.* Farmers' cooperative organizations described in section 521 are required to make a return of income whether or not such organizations are subject to the taxes imposed by sections 11 and 1201 as prescribed in section 522 or 1381. The return shall be made on Form 990–C.

(g) *Returns by foreign corporations.* (1) *Requirement of return*—(i) *In general.* Except as otherwise provided in subparagraph (2) of this paragraph, every foreign corporation which is engaged in trade or business in the United States at any time during the taxable year or which has income which is subject to taxation under subtitle A of the Code (relating to income taxes) shall make a return on Form 1120–F. Thus, for example, a foreign corporation which is engaged in trade or business in the United States at any time during the taxable year is required to file a return on Form 1120–F even though *(a)* it has no income which is effectively connected with the conduct of a trade or business in the United States, *(b)* it has no income from sources within the United States, or *(c)* its income is exempt from income tax by reason of an income tax convention or any section of the Code. However, if the foreign corporation has no gross income for the taxable year, it is not required to complete the return schedules but must attach a statement to the return indicating the nature of any exclusions claimed and the amount of such exclusions to the extent such amounts are readily determinable.

(ii) *Treaty income.* If the gross income of a foreign corporation includes treaty income, as defined in paragraph (b)(1) of § 1.871–12, a statement shall be attached to the return on Form 1120–F showing with respect to that income:

(a) The amounts of tax withheld,

(b) The names and post office addresses of withholding agents, and

(c) Such other information as may be required by the return form or by the instructions issued with respect to the form, to show the taxpayer's entitlement to the reduced rate of tax under the tax convention.

(iii) *Balance sheet and reconciliation of income.* At the election of the taxpayer, the balance sheets and reconciliation of income, as shown on Form 1120–F, may be limited to:

(a) The assets of the corporation located in the United States and to its other assets used in the trade or business conducted in the United States, and

(b) Its income effectively connected with the conduct of a trade or business in the United States and its other income from sources within the United States.

(2) *Exceptions*—(i) *Return not required when tax is fully paid at source—(a) In general.* A foreign corporation which at no time during the taxable year is engaged in a trade or business in the United States is not required to make a return for the taxable year if its tax liability for the taxable year is fully satisfied by the withholding of tax at source under chapter 3 of the Code. For purposes of this subdivision, some of the items of income from sources within the United States upon which the tax liability will not have been fully satisfied by the withholding of tax at source under chapter 3 of the Code are:

(1) Interest upon so-called tax-free covenant bonds upon which, in accordance with section 1451 and §1.1451–1, a tax of only 2 percent is required to be withheld at source,

(2) In the case of bonds or other evidence of indebtedness issued after September 25, 1965, amounts described in section 881(a)(3),

(3) Accrued interest received in connection with the sale of bonds between interest dates, which, in accordance with paragraph (h) of §1.1441–4, is not subject to withholding of tax at source.

(b) Corporations not included. This subdivision (i) shall not apply:

(1) To a foreign corporation which has income for the taxable year which is treated under section 882(d) or (e) and §1.882–2 as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation,

(2) To a foreign corporation making a claim under §301.6402–3 of this chapter (Procedure and Administration Regulations) for the refund of an overpayment of tax for the taxable year, or

(3) To a foreign corporation described in paragraph (c)(2)(i) of §1.532–1 whose accumulated taxable income for the taxable year is determined under paragraph (b)(2) of §1.535–1.

(ii) *Beneficiaries of estates or trusts.* A foreign corporation which is a beneficiary of an estate or trust which is engaged in trade or business in the United States is not required to make a return for the taxable year merely because it is deemed to be engaged in trade or business within the United States under section 875(2). However, such foreign corporation will be required to make a return if it otherwise satisfies the conditions of subparagraph (1)(i) of this paragraph for making a return.

(iii) *Special returns and schedules.* The provisions of paragraphs (b) through (f) of this section shall apply to a foreign corporation except that a foreign corporation which is an insurance company to which paragraph (c)(3) of this section applies shall make a return on Form 1120–F and not on Form 1120. If a foreign corporation which is an insurance company to which paragraph (c) (1) or (2) of this section applies has income for the taxable year from sources within the United States which is not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, the corporation shall attach to its return on Form 1120L or 1120M, as the case may be, a separate schedule showing the nature and amount of the items of such income, the rate of tax applicable thereto, and the amount of tax withheld therefrom under chapter 3 of the Code.

(3) *Representative or agent for foreign corporation*—(i) *Cases where power of attorney is not required.* The responsible representative or agent within the United States of a foreign corporation shall make on behalf of his principal a return of, and shall pay the tax on, all

income coming within his control as representative or agent which is subject to the income tax under subtitle A of the Code. The agency appointment will determine how completely the agent is substituted for the principal for tax purposes. Any person who collects interest or dividends on deposited securities of a foreign corporation, executes ownership certificates in connection therewith, or sells such securities under special instructions shall not be deemed merely by reason of such acts to be the responsible representative or agent of the foreign corporation. If the responsible representative or agent does not have a specific power of attorney from the foreign corporation to file a return in its behalf, the return shall be accompanied by a statement to the effect that the representative or agent does not possess specific power of attorney to file a return for such corporation but that the return is being filed in accordance with the provisions of this subdivision.

(ii) *Cases where power of attorney is required.* Whenever a return of income of a foreign corporation is made by an agent acting under a duly authorized power of attorney for that purpose, the return shall be accompanied by the power of attorney in proper form, or a copy thereof specifically authorizing him to represent his principal in making, executing, and filing the income tax return. Form 2848 may be used for this purpose. The agent, as well as the taxpayer, may incur liability for the penalties provided for erroneous, false, or fraudulent returns. For the requirements regarding signing of returns, see § 1.6062–1. The rules of paragraph (e) of § 601.504 of this chapter (Statement of Procedural Rules) shall apply under this subparagraph in determining whether a copy of a power of attorney must be certified.

(iii) *Limitation.* A return of income shall be required under this subparagraph only if the foreign corporation is otherwise required to make a return in accordance with this paragraph.

(4) *Disallowance of deductions and credits.* For provisions disallowing deductions and credits when a return of income has not been filed by or on behalf of a foreign corporation, see section 882(c)(2) and the regulations thereunder, and paragraph (b) (2) and (3) of § 1.535–1.

(5) *Effective date.* This paragraph shall apply for taxable years beginning after December 31, 1966, except that it shall not be applied to require (i) the filing of a return for any taxable year ending before January 1, 1974, which, pursuant to instructions applicable to the return, is not required to be filed or (ii) the amendment of a return for such a taxable year which, pursuant to such instructions, is required to be filed. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.6012–2(g) (Revised as of January 1, 1967).

(h) *Electing small business corporations.* An electing small business corporation, whether or not subject to the tax imposed by section 1378, shall make a return on Form 1120–S. See also section 6037 and the regulations thereunder.

(i) *Items of tax preference*—(1) *In general.* Every corporation required to make a return under this section, and having items of tax preference (described in section 57 and the regulation thereunder) in an amount specified by Form 4626, shall file such form as part of its return.

(2) *Organizations with unrelated business income and foreign corporations.* Regardless of the provisions of paragraphs (e) and (g) of this section, any organization described in either such paragraph having items of tax preference (described in section 57 and the regulations thereunder) in any amount entering into the computation or unrelated business income is required to make a return on form 990–T or form 120F, respectively, and to attach the required form as part of such return.

(j) *Other provisions.* For returns by fiduciaries for corporations, see § 1.6012–3. For information returns by corporations regarding payments of dividends, see §§ 1.6042–1 to 1.6042–3, inclusive; regarding corporate dissolutions or liquidations, see § 1.6043–1; regarding distributions in liquidation, see § 1.6043–2; regarding payments of patronage dividends, see §§ 1.6044–1 to 1.6044–4, inclusive; and regarding certain payments of interest, see §§ 1.6049–1 and 1.6049–2. For information returns of officers, directors, and shareholders of foreign personal holding companies, as defined in section 552, see §§1.6035–1 and 1.6035–2. For returns as to formation or reorganization of foreign corporations, see §§1.6046–1 to 1.6046–3, inclusive.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.6012–2, see the List of CFR Sections Affecting in the Finding Aids section of this volume.

§1.6012–3 Returns by fiduciaries.

(a) *For estates and trusts*—(1) *In general.* Every fiduciary, or at least one of joint fiduciaries, must make a return of income on form 1041 (or by use of a composite return pursuant to §1.6012–5) and attach the required form if the estate or trust has items of tax preference (as defined in section 57 and the regulations thereunder) in any amount:

(i) For each estate for which he acts if the gross income of such estate for the taxable year is $600 or more;

(ii) For each trust for which he acts, except a trust exempt under section 501(a), if such trust has for the taxable year any taxable income, or has for the taxable year gross income of $600 or more regardless of the amount of taxable income; and

(iii) For each estate and each trust for which he acts, except a trust exempt under section 501(a), regardless of the amount of income for the taxable year, if any beneficiary of such estate or trust is a nonresident alien.

(2) *Wills and trust instruments.* At the request of the Internal Revenue Service, a copy of the will or trust instrument (including any amendments), accompanied by a written declaration of the fiduciary under the penalties of perjury that it is a true and complete copy, shall be filed together with a statement by the fiduciary indicating the provisions of the will or trust instrument (including any amendments) which, in the fiduciary's opinion, determine the extent to which the income of the estate or trust is taxable to the estate or trust, the beneficiaries, or the grantor, respectively.

(3) *Domiciliary and ancillary representatives.* In the case of an estate required to file a return under subparagraph (1) of this paragraph, having both domiciliary and ancillary representatives, the domiciliary and ancillary representatives must each file a return on Form 1041. The domiciliary representative is required to include in the return rendered by him as such domiciliary representative the entire income of the estate. The return of the ancillary representative shall be filed with the district director for his internal revenue district and shall show the name and address of the domiciliary representative, the amount of gross income received by the ancillary representative, and the deductions to be claimed against such income, including any amount of income properly paid or credited by the ancillary representative to any legatee, heir, or other beneficiary. If the ancillary representative for the estate of a nonresident alien is a citizen or resident of the United States, and the domiciliary representative is a nonresident alien, such ancillary representative is required to render the return otherwise required of the domiciliary representative.

(4) *Two or more trusts.* A trustee of two or more trusts must make a separate return for each trust, even though such trusts were created by the same grantor for the same beneficiary or beneficiaries.

(5) *Trusts with unrelated business income.* Every fiduciary for a trust described in section 511(b)(2) which is subject to the tax imposed on its unrelated business taxable income by section 511(b)(1) shall make a return on Form 990–T for each taxable year if the trust has gross income, included in computing unrelated business taxable income for such taxable year, of $1,000 or more. The filing of a return of unrelated business income does not relieve the fiduciary of such trust from the duty of filing other required returns.

(6) *Charitable remainder trusts.* Every fiduciary for a charitable remainder annuity trust (as defined in §1.664–2) or a charitable remainder unitrust (as defined in §1.664–3) shall make a return on Form 1041–B for each taxable year of the trust even though it is nonexempt because it has unrelated business taxable income. The return on Form 1041–B shall be made in accordance with the instructions for the form and shall be filed with the designated Internal Revenue office on or before the 15th day of the fourth month following the close of the taxable year of the trust. A copy of

the instrument governing the trust, accompanied by a written declaration of the fiduciary under the penalties of perjury that it is a true and complete copy, shall be attached to the return for the first taxable year of the trust.

(7) *Certain trusts described in section 4947(a)(1).* For taxable years beginning after December 31, 1980, in the case of a trust described in section 4947(a)(1) which has no taxable income for a taxable year, the filing requirements of section 6012 and this section shall be satisfied by the filing, pursuant to § 53.6011–1 of this chapter (Foundation Excise Tax Regulations) and § 1.6033–2(a), by the fiduciary of such trust of—

(i) Form 990–PF if such trust is treated as a private foundation, or

(ii) Form 990 if such trust is not treated as a private foundation.

When the provisions of this paragraph (a)(7) are met, the fiduciary shall not be required to file Form 1041.

(8) *Estate and trusts liable for qualified tax.* In the case of an estate or trust which is liable for one or more qualified State individual income taxes, as defined in section 6362, for a taxable year, see paragraph (b) of § 301.6361–1 of this chapter (Regulations on Procedure and Administration) for rules relating to returns required to be made.

(9) *A trust any portion of which is treated as owned by the grantor or another person pursuant to sections 671 through 678.* In the case of a trust any portion of which is treated as owned by the grantor or another person under the provisions of subpart E (section 671 and following) part I, subchapter J, chapter 1 of the Internal Revenue Code see § 1.671–4.

(b) *For other persons*—(1) *Decedents.* The executor or administrator of the estate of a decedent, or other person charged with the property of a decedent, shall make the return of income required in respect of such decedent. For the decedent's taxable year which ends with the date of his death, the return shall cover the period during which he was alive. For the filing of returns of income for citizens and alien residents of the United States, and alien residents of Puerto Rico, see paragraph (a) of § 1.6012–1. For the filing of a joint return after death of spouse, see paragraph (d) of § 1.6013–1.

(2) *Nonresident alien individuals*—(i) *In general.* A resident or domestic fiduciary or other person charged with the care of the person or property of a nonresident alien individual shall make a return for that individual and pay the tax unless:

(a) The nonresident alien individual makes a return of, and pays the tax on, his income for the taxable year,

(b) A responsible representative or agent in the United States of the nonresident alien individual makes a return of, and pays the tax on, the income of such alien individual for the taxable year, or

(c) The nonresident alien individual has appointed a person in the United States to act as his agent for the purpose of making a return of income and, if such fiduciary is required to file a Form 1041 for an estate or trust of which such alien individual is a beneficiary, such fiduciary attaches a copy of the agency appointment to his return on Form 1041.

(ii) *Income to be returned.* A return of income shall be required under this subparagraph only if the nonresident alien individual is otherwise required to make a return in accordance with paragraph (b) of § 1.6012–1. The provisions of that paragraph shall apply in determining the form of return to be used and the income to be returned.

(iii) *Disallowance of deductions and credits.* For provisions disallowing deductions and credits when a return of income has not been filed by or on behalf of a nonresident alien individual, see section 874 and the regulations thereunder.

(iv) *Alien resident of Puerto Rico.* This subparagraph shall not apply to the return of a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year. See § 1.876–1.

(v) *Cross reference.* For requirements of withholding tax at source on nonresident alien individuals and of returns with respect to such withheld taxes, see §§ 1.1441–1 to 1.1465–1, inclusive.

(3) *Persons under a disability.* A fiduciary acting as the guardian of a minor, or as the guardian or committee of an insane person, must make the return of income required in respect of

such person unless, in the case of a minor, the minor himself makes the return or causes it to be made.

(4) *Corporations.* A receiver, trustee in dissolution, trustee in bankruptcy, or assignee, who, by order of a court of competent jurisdiction, by operation of law or otherwise, has possession of or holds title to all or substantially all the property or business of a corporation, shall make the return of income for such corporation in the same manner and form as corporations are required to make such returns. Such return shall be filed whether or not the receiver, trustee, or assignee is operating the property or business of the corporation. A receiver in charge of only a small part of the property of a corporation, such as a receiver in mortgage foreclosure proceedings involving merely a small portion of its property, need not make the return of income. See also §1.6041–1, relating to returns regarding information at source; §§1.6042–1 to 1.6042–3, inclusive, relating to returns regarding payments of dividends; §§1.6044–1 to 1.6044–4, inclusive, relating to returns regarding payments of patronage dividends; and §§1.6049–1 and 1.6049–2, relating to returns regarding certain payments of interest.

(5) *Individuals in receivership.* A receiver who stands in the place of an individual must make the return of income required in respect of such individual. A receiver of only part of the property of an individual need not file a return, and the individual must make his own return.

(c) *Joint fiduciaries.* In the case of joint fiduciaries, a return is required to be made by only one of such fiduciaries. A return made by one of joint fiduciaries shall contain a statement that the fiduciary has sufficient knowledge of the affairs of the person for whom the return is made to enable him to make the return, and that the return is, to the best of his knowledge and belief, true and correct.

(d) *Other provisions.* For the definition of the term ‘‘fiduciary’’, see section 7701(a)(6) and the regulations thereunder. For information returns required to be made by fiduciaries under section 6041, see §1.6041–1. As to further duties and liabilities of fiduciaries, see section 6903 and §301.6903–1 of this chapter (Regulations on Procedure and Administration).

[T.D. 6500, 25 FR 12108, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.6012–3, see the List of CFR Sections Affecting in the Finding Aids section of this volume.

§1.6012–4 Miscellaneous returns.

For returns by regulated investment companies of tax on undistributed capital gain designated for special treatment under section 852(b)(3)(D), see §1.852–9. For returns with respect to tax withheld on nonresident aliens and foreign corporations and on tax-free covenant bonds, see §§1.1461–1 to 1.1465–1, inclusive. For returns of tax on transfers to avoid income tax, see §1.1494–1. For the requirement of an annual report by persons completing a Government contract, see 26 CFR (1939) 17.16 (Treasury Decision 4906, approved June 23, 1939), and 26 CFR (1939) 16.15 (Treasury Decision 4909, approved June 28, 1939) , as made applicable to section 1471 of the 1954 Code by Treasury Decision 6091, approved August 16, 1954 (19 FR 5167, C.B. 1954–2, 47). See also §1.1471–1.

[T.D. 7332, 39 FR 44231, Dec. 23, 1974]

EDITORIAL NOTE: For the convenience of the user §§16.15 and 17.16 of 26 CFR (1939) are set forth below:

§16.15 *Annual reports for income taxable years*—(a) *General requirements.* Every contracting party completing a contract or subcontract within the contracting party’s income-taxable year ending after April 3, 1939 shall file with the district director of internal revenue for the internal revenue district in which the contracting party’s Federal income tax returns are required to be filed an annual report on the prescribed form of the profit and excess profit on all contracts and subcontracts coming within the scope of the act and the regulations in this part and completed within the particular income-taxable year. There shall be included as a part of such a report a statement, preferably in columnar form, showing separately for each such contract or subcontract completed by the contracting party within the income-taxable year the total contract price, the cost of performing the contract or subcontract and the resulting profit or loss on each contract or subcontract together with a summary statement showing in detail the computation of the net profit or net loss upon all contracts and subcontracts completed within the income-taxable year and the amount of the excess profit, if any, for the income-taxable year covered by the report. A copy of the report made to the Secretary of the Army (see § 16.14) with respect to each contract or subcontract covered in the annual report, shall be filed as a part of such annual report. In case the income-taxable year of the contracting party is a period of less than twelve months (see § 16.1), the report required by this section shall be made for such period and not for a full year.

(b) *Time for filing annual reports.* Annual reports of contracts and subcontracts coming within the scope of the act and the regulations in this part completed by a contracting party within an income-taxable year must be filed on or before the 15th day of the ninth month following the close of the contracting party's income-taxable year. It is important that the contracting party render on or before the due date an annual report as nearly complete and final as it is possible for the contracting party to prepare. An extension of time granted the contracting party for filing its Federal income tax return does not serve to extend the time for filing the annual report required by this section. Authority consistent with authorizations for granting extensions of time for filing Federal income tax returns is hereby delegated to the various collectors of internal revenue for granting extensions of time for filing the reports required by this section. Application for extensions of time for filing such reports should be addressed to the district director of internal revenue for the district in which the contracting party files its Federal income tax returns and must contain a full recital of the causes for the delay.

§ 17.16 *Annual reports for income-taxable years*—(a) *General requirements.* Every contracting party completing a contract or subcontract within the contracting party's income-taxable year ending after April 3, 1939 shall file, with the district director of internal revenue for the internal revenue district in which the contracting party's Federal income tax return is required to be filed, annual reports on the prescribed forms of the profit and excess profit on all contracts and subcontracts coming within the scope of the act. If any contracts or subcontracts so completed by the contracting party were entered into for the construction or manufacture of any complete naval vessel or any portion thereof, the profit and excess profit on all such contracts and subcontracts completed within the income-taxable year ending after April 3, 1939 shall be computed in accordance with the provisions of § 17.6. If any contracts or subcontracts so completed by the contracting party were entered into for the construction or manufacture of any complete naval aircraft or any portion thereof, the profit and excess profit on all such contracts and subcontracts completed within the income-taxable year ending after April 3, 1939 shall be computed in accordance with the provisions of § 17.7. There shall be included as a part of the annual report a statement, preferably in columnar form, showing separately for each contract or subcontract completed by the contracting party within the income-taxable year and covered by the report, the total contract price, the cost of performing the contract or subcontract and resulting profit or loss on each contract or subcontract together with a summary statement showing in detail the computation of the net profit or net loss upon each group of contracts and subcontracts covered by the report and the amount of the excess profit, if any, with respect to each group of contracts and subcontracts covered by the report. A copy of the report made to the Secretary of the Navy (see § 17.15) with respect to each contract or subcontract covered in the annual report, shall be filed as a part of such annual report. In case the income-taxable year of the contracting party is a period of less than twelve months (see § 17.1), the reports required by this section shall be made for such period and not for a full year.

(b) *Time for filing annual reports.* Annual reports of contracts and subcontracts completed by a contracting party within an income-taxable year ending after April 3, 1939 shall be filed on or before the 15th day of the ninth month following the close of the contracting party's income-taxable year. It is important that the contracting party render on or before the due date annual reports as nearly complete and final as it is possible for the contracting party to prepare. An extension of time granted the contracting party for filing its Federal income tax return does not serve to extend the time for filing the annual reports required by this section. Authority consistent with authorizations for granting extensions of time for filing Federal income tax returns is hereby delegated to the various district directors of internal revenue for granting extensions of time for filing the reports required by this section. Application for extension of time for filing such reports should be addressed to the district director of internal revenue for the district in which the contracting party files its Federal income tax returns and must contain a full recital of the causes for the delay.

§ 1.6012–5 Composite return in lieu of specified form.

The Commissioner may authorize the use, at the option of a person required to make a return, of a composite return in lieu of any form specified in this part for use by such a person, subject to such conditions, limitations, and special rules governing the preparation, execution, filing, and correction thereof as the Commissioner may deem appropriate. Such composite return shall consist of a form prescribed by the Commissioner and an attachment or attachments of magnetic tape or other approved media. Notwithstanding any provisions in this part to the contrary, a single form and attachment may comprise the returns of more than one such person. To the extent that the use of a composite return has been authorized by the Commissioner, references in this part to a specific form for use by such a person shall be deemed to refer also to a composite return under this section.

[T.D. 7200, 37 FR 16544, Aug. 16, 1972]

§1.6012–6 Returns by political organizations.

(a) *Requirement of return*—(1) *In general.* For taxable years beginning after December 31, 1974, every political organization described in section 527(e)(1), and every fund described in section 527(f)(3) or section 527(g), and every organization described in section 501(c) and exempt from taxation under section 501(a) shall make a return of income within the time provided in section 6072(b), if a tax is imposed on such an organization or fund by section 527(b).

(2) *Taxable years beginning after December 31, 1971, and before January 1, 1975.* For taxable years beginning after December 31, 1971, and before January 1, 1975, any political organization which would be described in section 527(e)(1) if such section applied to such years shall not be required to make a return if such organization would not be required to make a return under paragraph (a)(1) of this section.

(b) *Form of return.* The return required by an organization or fund upon which a tax is imposed by section 527(b) shall be made on Form 1120–POL.

[T.D. 7516, 42 FR 57312, Nov. 2, 1977; 43 FR 2721, Jan. 19, 1978]

§1.6012–7T Telephone return filing using voice signature (temporary).

(a) *In general.* For all purposes of the Internal Revenue Code, a return completed by an eligible taxpayer under the TeleFile Voice Signature test in accordance with the instructions provided over the telephone is an individual Federal income tax return filed at the time the TeleFile system interactive voice computer states to the taxpayer that the filing is completed. For provisions relating to the signing and verification of the TeleFile Voice Signature test returns made under this section, see §§1.6061–2T and 1.6065–2T, respectively.

(b) *Manner of filing return by telephone.* An eligible taxpayer who chooses to participate in the TeleFile Voice Signature test must dial the telephone number provided by the Internal Revenue Service from a touch-tone telephone. When an eligible taxpayer dials this telephone number, the TeleFile system interactive voice computer will give the taxpayer filing instructions. The taxpayer must provide all the information and a voice signature at the time and in the manner required by those instructions.

(c) *Eligible taxpayer defined.* An eligible taxpayer is a single individual who lives in the Cincinnati District Office geographic area, who is eligible to file Form 1040EZ, Income Tax Return for Single and Joint Filers With No Dependents, and whose current name and address appear on the mailing label attached to the taxpayer's tax package for the calendar year for which the Form 1040EZ is to be filed.

(d) *Address to which refunds are sent.* If a taxpayer who files a TeleFile Voice Signature test return is entitled to a refund, the taxpayer's refund will be sent to the address on the mailing label attached to the taxpayer's tax package.

(e) *Effective dates.* (1) This section is effective for—

(i) 1992 calendar year returns filed by eligible taxpayers in the TeleFile Voice Signature test after January 13, 1993, and before April 16, 1993; and

(ii) 1993 calendar year returns filed by eligible taxpayers in the TeleFile Voice Signature test after January 12, 1994, and before April 16, 1994.

(2) No returns can be filed under the TeleFile Voice Signature tests between April 16, 1993, and January 12, 1994, or after April 15, 1994.

[T.D. 8510, 58 FR 68296, Dec. 27, 1993]

§ 1.6013–1 Joint returns.

(a) *In general.* (1) A husband and wife may elect to make a joint return under section 6013(a) even though one of the spouses has no gross income or deductions. For rules for determining whether individuals occupy the status of husband and wife for purposes of filing a joint return, see paragraph (a) of § 1.6013–4. For any taxable year with respect to which a joint return has been filed, separate returns shall not be made by the spouses after the time for filing the return of either has expired. See, however, paragraph (d)(5) of this section for the right of an executor to file a late separate return for a deceased spouse and thereby disaffirm a timely joint return made by the surviving spouse.

(2) A joint return of a husband and wife (if not made by an agent of one or both spouses) shall be signed by both spouses. The provisions of paragraph (a)(5) of § 1.6012–1, relating to returns made by agents, shall apply where one spouse signs a return as agent for the other, or where a third party signs a return as agent for one or both spouses.

(b) *Nonresident alien.* A joint return shall not be made if either the husband or wife at any time during the taxable year is a nonresident alien, unless an election is in effect for the taxable year under section 6013 (g) or (h) and the regulations thereunder.

(c) *Different taxable years.* Except as otherwise provided in this section, a husband and wife shall not file a joint return if they have different taxable years.

(d) *Joint return after death.* (1) Section 6013(a)(2) provides that a joint return may be made for the survivor and the deceased spouse or for both deceased spouses if the taxable years of such spouses begin on the same day and end on different days only because of the death of either or both. Thus, if a husband and wife make this return on a calendar year basis, and the wife dies on August 1, 1956, a joint return may be made with respect to the calendar year 1956 of the husband and the taxable year of the wife beginning on January 1, 1956, and ending with her death on August 1, 1956. Similarly, if husband and wife both make their returns on the basis of a fiscal year beginning on July 1 and the wife dies on October 1, 1956, a joint return may be made with respect to the fiscal year of the husband beginning on July 1, 1956, and ending on June 30, 1957, and with respect to the taxable year of the wife beginning on July 1, 1956, and ending with her death on October 1, 1956.

(2) The provision allowing a joint return to be made for the taxable year in which the death of either or both spouses occurs is subject to two limitations. The first limitation is that if the surviving spouse remarries before the close of his taxable year, he shall not make a joint return with the first spouse who died during the taxable year. In such a case, however, the surviving spouse may make a joint return with his new spouse provided the other requirements with respect to the filing of a joint return are met. The second limitation is that the surviving spouse shall not make a joint return with the deceased spouse if the taxable year of either spouse is a fractional part of a year under section 443(a)(1) resulting from a change of accounting period. For example, if a husband and wife make their returns on the calendar year basis and the wife dies on March 1, 1956, and thereafter the husband receives permission to change his annual accounting period to a fiscal year beginning July 1, 1956, no joint return shall be made for the short taxable year ending June 30, 1956. Similarly, if a husband and wife who make their returns on a calendar year basis receive permission to change to a fiscal year beginning July 1, 1956, and the wife dies on June 1, 1956, no joint return shall be made for the short taxable year ending June 30, 1956.

(3) Section 6013(a)(3) provides for the method of making a joint return in the case of the death of one spouse or both spouses. The general rule is that, in the case of the death of one spouse, or of both spouses, the joint return with respect to the decedent may be made only by his executor or administrator, as defined in paragraph (c) of § 1.6013–4. An exception is made to this general rule whereby, in the case of the death of one spouse, the joint return may be made by the surviving spouse with respect to both him and the decedent if all the following conditions exist:

(i) No return has been made by the decedent for the taxable year in respect of which the joint return is made;

(ii) No executor or administrator has been appointed at or before the time of making such joint return; and

(iii) No executor or administrator is appointed before the last day prescribed by law for filing the return of the surviving spouse.

These conditions are to be applied with respect to the return for each of the taxable years of the decedent for which a joint return may be made if more than one such taxable year is involved. Thus, in the case of husband and wife on the calendar year basis, if the wife dies in February 1957, a joint return for the husband and wife for 1956 may be made if the conditions set forth in this subparagraph are satisfied with respect to such return. A joint return also may be made by the survivor for both himself and the deceased spouse for the calendar year 1957 if it is separately determined that the conditions set forth in this subparagraph are satisfied with respect to the return for such year. If, however, the deceased spouse should, prior to her death, make a return for 1956, the surviving spouse may not thereafter make a joint return for himself and the deceased spouse for 1956.

(4) If an executor or administrator is appointed at or before the time of making the joint return or before the last day prescribed by law for filing the return of the surviving spouse, the surviving spouse cannot make a joint return for himself and the deceased spouse whether or not a separate return for the deceased spouse is made by such executor or administrator. In such a case, any return made solely by the surviving spouse shall be treated as his separate return. The joint return, if one is to be made, must be made by both the surviving spouse and the executor or administrator. In determining whether an executor or administrator is appointed before the last day prescribed by law for filing the return of the surviving spouse, an extension of time for making the return is included.

(5) If the surviving spouse makes the joint return provided for in subparagraph (3) of this paragraph and thereafter an executor or administrator of the decedent is appointed, the executor or administrator may disaffirm such joint return. This disaffirmance, in order to be effective, must be made within one year after the last day prescribed by law for filing the return of the surviving spouse (including any extension of time for filing such return) and must be made in the form of a separate return for the taxable year of the decedent with respect to which the joint return was made. In the event of such proper disaffirmance the return made by the survivor shall constitute his separate return, that is, the joint return made by him shall be treated as his return and the tax thereon shall be computed by excluding all items properly includible in the return of the deceased spouse. The separate return made by the executor or administrator shall constitute the return of the deceased spouse for the taxable year.

(6) The time allowed the executor or administrator to disaffirm the joint return by the making of a separate return does not establish a new due date for the return of the deceased spouse. Accordingly, the provisions of sections 6651 and 6601, relating to delinquent returns and delinquency in payment of tax, are applicable to such return made by the executor in disaffirmance of the joint return.

(e) *Return of surviving spouse treated as joint return.* For provisions relating to the treatment of the return of a surviving spouse as a joint return for each of the next two taxable years following the year of the death of the spouse, see section 2 and §1.2–2.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 7274, 38 FR 11345, May 7, 1973; T.D. 7670, 45 FR 6929, Jan. 31, 1980]

§1.6013–2 Joint return after filing separate return.

(a) *In general.* (1) Where an individual has filed a separate return for a taxable year for which a joint return could have been made by him and his spouse under section 6013(a), and the time prescribed by law for filing the return for such taxable year has expired, such individual and his spouse may, under conditions hereinafter set forth, make a joint return for such taxable year. The joint return filed pursuant to section 6013(b) shall constitute the return of the husband and wife for such year, and all payments, credits, refunds, or other repayments, made or allowed with respect to the separate return of either spouse are to be taken into account in determining the extent to which the tax based on the joint return has been paid.

(2) If a joint return is made under section 6013(b), any election, other than the election to file a separate return, made by either spouse in his separate return for the taxable year with respect to the treatment of any income, deduction, or credit of such spouse shall not be changed in the making of the joint return where such election would have been irrevocable if the joint return had not been made. Thus, if one spouse has made an irrevocable election to adopt and use the last-in, first-out inventory method under section 472, this election may not be changed upon making the joint return under section 6013(b).

(3) A joint return made under section 6013(b) after the death of either spouse shall, with respect to the decedent, be made only by his executor or administrator. Thus, where no executor or administrator has been appointed, a joint return cannot be made under section 6013(b).

(4) A nonresidential alien treated as a resident under section 6013 (g) or (h) for any taxable year ending on or after December 31, 1975, and the alien's U.S. citizen or resident spouse may file a joint return for that taxable year, even though one or both of the spouses have previously filed separate returns for that taxable year. In this case, the rule in paragraph (a)(3) of this section does not apply.

(b) *Limitations with respect to making of election.* A joint return shall not be made under section 6013(b)(1) with respect to a taxable year:

(1) Beginning on or before July 30, 1996, unless there is paid in full at or before the time of the filing of the joint return the amount shown as tax upon such joint return; or

(2) After the expiration of three years from the last day prescribed by law for filing the return for such taxable year determined without regard to any extension of time granted to either spouse; or

(3) After there has been mailed to either spouse, with respect to such taxable year, a notice of deficiency under section 6212, if the spouse, as to such notice, files a petition with the Tax Court of the United States within the time prescribed in section 6213; or

(4) After either spouse has commenced a suit in any court for the recovery of any part of the tax for such taxable year; or

(5) After either spouse has entered into a closing agreement under section 7121 with respect to such taxable year, or after any civil or criminal case arising against either spouse with respect to such taxable year has been compromised under section 7122.

(c) *When return deemed filed; assessment and collection; credit or refund.* (1) For the purpose of section 6501, relating to the period of limitations upon assessment and collection, and section 6651, relating to delinquent returns, a joint return made under section 6013(b) shall be deemed to have been filed, giving due regard to any extension of time granted to either spouse, on the following date:

(i) Where both spouses filed separate returns, prior to making the joint return under section 6013(b), on the date the last separate return of either spouse was filed for the taxable year, but not earlier than the last date prescribed by law for the filing of the return of either spouse;

(ii) Where only one spouse was required and did file a return prior to the making of the joint return under section 6013(b), on the date of the filing of the separate return, but not earlier than the last day prescribed by law for the filing of such return; or

(iii) Where both spouses were required to file a return, but only one spouse did so file, on the date of the filing of the joint return under section 6013(b).

(2) For the purpose of section 6511, relating to refunds and credits, a joint return made under section 6013(b) shall be deemed to have been filed on the last date prescribed by law for filing the return for such taxable year, determined without regard to any extension of time granted to either spouse for filing the return or paying the tax.

(d) *Additional time for assessment.* In the case of a joint return made under section 6013(b), the period of limitations provided in sections 6501 and 6502 shall not be less than one year after the date of the actual filing of such joint return. The expiration of the one year is to be determined without regard to the rules provided in paragraph (c)(1) of this section, relating to the application of sections 6501 and 6651 with respect to a joint return made under section 6013(b).

(e) *Additions to the tax and penalties.* (1) Where the amount shown as the tax by the husband and wife on a joint return made under section 6013(b) exceeds the aggregate of the amounts shown as tax on the separate return of each spouse, and such excess is attributable to negligence, intentional disregard of rules and regulations, or fraud at the time of the making of such separate return, there shall be assessed, collected, and paid in the same manner as if it were a deficiency an additional amount as provided by the following:

(i) If any part of such excess is attributable to negligence, or intentional disregard of rules and regulations, at the time of the making of such separate return, but without any intent to defraud, this additional amount shall be 5 percent of the total amount of the excess.

(ii) If any part of such excess is attributable to fraud with intent to evade tax at the time of the making of such separate return, this additional amount shall be 50 percent of the total amount of the excess. The latter addition is in lieu of the 50 percent addition to the tax provided in section 6653(b).

(2) For purposes of section 7206 (1) and (2) and section 7207 (relating to criminal penalties in the case of fraudulent returns), the term ‘‘return’’ includes a separate return filed by a spouse with respect to a taxable year for which a joint return is made under section 6013(b) after the filing of a separate return.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 7670, 45 FR 6929, Jan. 31, 1980; T.D. 8725, 62 FR 39117, July 22, 1997]

§1.6013–3 Treatment of joint return after death of either spouse.

For purposes of section 21 (relating to change in rates during a taxable year), section 443 (relating to returns for a period of less than 12 months), and section 7851(a)(1)(A) (relating to the applicability of certain provisions of the Internal Revenue Code of 1954 and the Internal Revenue Code of 1939), where the husband and wife have different taxable years because of death of either spouse, the joint return shall be treated as if the taxable years of both ended on the date of the closing of the surviving spouse’s taxable year. Thus, in cases where the Internal Revenue Code of 1939 otherwise would apply to the taxable year of the decedent spouse and the Internal Revenue Code of 1954 would apply to the taxable year of the surviving spouse, this provision makes the Internal Revenue Code of 1954 applicable to the taxable years of both spouses if a joint return is filed.

§1.6013–4 Applicable rules.

(a) *Status as husband and wife.* For the purpose of filing a joint return under section 6013, the status as husband and wife of two individuals having taxable years beginning on the same day shall be determined:

(1) If the taxable year of each individual is the same, as of the close of such year; and

(2) If the close of the taxable year is different by reason of the death of one spouse, as of the time of such death.

An individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married. However, the mere fact that spouses have not lived together during the course of the taxable year shall not prohibit them from making a joint return. A husband and wife who are separated under an interlocutory decree of divorce retain the relationship of husband and wife until the decree becomes final. The fact that the taxpayer and his spouse are divorced or legally separated at any time after the close of the taxable year shall not deprive them of their right to file a joint return for such taxable year under section 6013.

(b) *Computation of income, deductions, and tax.* If a joint return is made, the gross income and adjusted gross income of husband and wife on the joint return are computed in an aggregate amount and the deductions allowed and the taxable income are likewise computed on an aggregate basis. Deductions limited to a percentage of the adjusted gross income, such as the deduction for charitable, etc., contributions and gifts, under section 170, will be allowed with reference to such aggregate adjusted gross income. A similar rule is applied in the case of the limitation of section 1211(b) on the allowance of losses resulting from the sale or exchange of capital assets (see § 1.1211–1). Although there are two taxpayers on a joint return, there is only one taxable income. The tax on the joint return shall be computed on the aggregate income and the liability with respect to the tax shall be joint and several. For computation of tax in the case of a joint return, see § 1.2–1. For tax in the case of a joint return of husband and wife electing to pay the optional tax under section 3, see § 1.3–1. For the election not to show on a joint return the amount of tax due in connection therewith, see paragraph (c) of § 1.6014–1 and paragraph (d) of § 1.6014–2. For separate computations of the self-employment tax of each spouse on a joint return, see paragraph (b) of § 1.6017–1.

(c) *Definition of executor or administrator.* For purposes of section 6013 the term ‘‘executor or administrator’’ means the person who is actually appointed to such office and not a person who is merely in charge of the property of the decedent.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 7102, 36 FR 5497, Mar. 24, 1971]

§ 1.6013–5 Spouse relieved of liability in certain cases.

(a) *In general.* A person shall be relieved from liability for any tax, penalties, additions to tax, interest, or other amounts, to the extent that such liability is attributable to an omission from gross income in a taxable year, and:

(1) He filed a joint return with a spouse in such taxable year,

(2) An amount of income which exceeds 25 percent of the amount of gross income which is stated in the return (as determined in a manner provided by section 6501(e)(1)(A) of the Code) and which is attributable to such person’s spouse was omitted from the return, and should have been, under chapter 1 of the Code, included in the return,

(3) He establishes that he did not know of, and had no reason to know of such omission, and

(4) It is inequitable to hold the taxpayer liable for the deficiency in tax for such taxable year attributable to such omission.

(b) *Inequitable defined.* Whether it is inequitable to hold a person liable for the deficiency in tax, within the meaning of paragraph (a)(4) of this section, is to be determined on the basis of all the facts and circumstances. In making such a determination a factor to be considered is whether the person seeking relief significantly benefited, directly or indirectly, from the items omitted from gross income. However, normal support is not a significant ‘‘benefit’’ for purposes of this determination. Evidence of direct or indirect benefit may consist of transfers of property, including transfers which may be received several years after the year in which the omitted item of income should have been included in gross income. Thus, for example, if a person seeking relief receives from his spouse an inheritance of property or life insurance proceeds which are traceable to items omitted from gross income by his spouse, that person will be considered to have benefited from those items. Other factors which may also be taken into account, if the situation warrants, include the fact that the person seeking relief has been deserted by his spouse or the fact that he has been divorced or separated from such spouse.

(c) *Community property laws.* The determination of the spouse to whom items of gross income (other than gross income from property) are attributable shall be made without regard to any applicable community property laws.

(d) *Omission of income.* Section 6013(e) of the Code shall apply only to income which is properly includible as gross income under chapter 1 of the Code, which was, in fact, omitted from a joint return. Section 6013(e) shall not apply to a tax deficiency resulting from erroneous or fraudulent deductions, claims, or other evasions or avoidances of tax.

(e) *Scope of section.* This section does not apply to any taxable year for which a claim for credit or refund is barred by operation of any law or rule of law.

[T.D. 7320, 39 FR 28279, Aug. 6, 1974]

§1.6013–6 Election to treat nonresident alien individual as resident of the United States.

(a) *Election for special treatment*—(1) *In general.* Two individuals who are husband and wife at the close of a taxable year ending on or after December 31, 1975, may make an election under this section for that taxable year if, at the close of that year, one spouse is a citizen or resident of the United States and the other spouse is a nonresident alien. The effect of the election is that each spouse is treated as a resident of the United States for purposes of chapters 1, 5, and 24 and sections 6012, 6013, 6072, and 6091 of the Code for the entire taxable year. An election made under this section is in effect for the taxable year for which made and for all subsequent years of the husband and wife, except:

(i) Any taxable year for which the election is suspended, as described in paragraph (a)(3) of this section, and

(ii) Any taxable year for which the election is terminated in accordance with paragraph (b) of this section and all subsequent taxable years.

A husband and wife may not make an election if an election previously made under this section by either spouse has been terminated under paragraph (b) of this section.

(2) *Particular rules.* (i) As used in paragraph (a)(3) of this section, the term ''U.S. spouse'' means any married individual who is a citizen or resident of the United States at any time during a taxable year.

(ii) An individual's residence is determined by application of the principles of §§301.7701(b)–1 through 301.7701(b)–9 of this chapter relating to what constitutes residence in the United States by an alien individual.

(iii) Whether two individuals are married at the close of a taxable year is determined by application of the rules in §1.6013–4(a).

(iv) The provisions of section 879 and the regulations thereunder shall not apply for any taxable year for which an election under this section is in effect.

(v) An individual who makes an election under this section may not, for United States income tax purposes, claim under any United States income tax treaty not to be a U.S. resident. The relationship of U.S. income tax treaties and the election under this section is illustrated by the following example.

Example. H, a U.S. citizen, is married to W, a nonresident alien of the United States and a domiciliary of country X. H and W maintain their only permanent home in country X. W receives both U.S. source and country X source interest during the taxable year. The interest is not effectively connected with a permanent establishment or a fixed base in any country. H and W make the section 6013 (g) election. Under article ii (1) of the United States—country X Income Tax Convention interest derived and beneficially owned by a resident of one contracting state is exempt from tax in the other contracting state. Article 4 (1) of the treaty provides that an individual is a resident of a contracting state if subject to tax in that country by reason of the individual's domicile, residence, or citizenship. Under article 4 (1) of the treaty, W is a resident of country X by virtue of her domocile in country X and also of the United States by virtue of the section 6013 (g) election. Article 4 (2) of the treaty provides that if an individual is a resident of both the United States and country X by reason of article 4 (1), the individual shall be deemed to be a resident of the contracting state in which he or she has a permanent home available. Because W's sole permanent home is in country X, under article 4 (2) of the treaty W is treated as a resident of country X for purposes of the treaty. Because W has elected under section 6013(g) to be treated as a U.S. resident (and thus to be taxed on worldwide income), W may not, for U.S. income tax purposes, claim under the treaty not to be a U.S. resident. W, therefore, is subject to U.S. income tax on the interest. For purposes of country X income tax, W is considered a resident of country X under the treaty.

(3) *Suspension of election.* (i) An election made under this section is suspended and is not in effect for a taxable year subsequent to the first taxable year for which made if neither spouse is a U.S. spouse during that subsequent

taxable year. Thus, for example, the election is in suspense if both spouses are nonresident aliens for the entire taxable year.

(ii) If either spouse dies during any taxable year for which the election under this section is in effect, other than the first taxable year for which the election is to be in effect, the taxable year shall include, solely for purposes of this paragraph (a)(3), only those days during the taxable year on which both spouses are alive. Thus, for example, if the U.S. spouse dies during the taxable year, the election is not suspended for that year even if the surviving nonresident alien spouse never acquires U.S. citizenship or residency. Similarly, if the nonresident alien spouse dies during the taxable year, the election is not suspended for that year even if the surviving U.S. spouse subsequently abandons U.S. citizenship or residency. However, if neither spouse was a U.S. spouse at any time during the period of the taxable year when both spouses were alive, the election is suspended for that year even if the surviving spouse subsequently acquires U.S. citizenship or residency.

For the effect of the death of either spouse on the status of the election in subsequent taxable years, see paragraph (b)(2) of this section.

(4) *Time and manner of making an election.* (i) A husband and wife shall make the election under this section by attaching a statement to a joint return for the first taxable year for which the election is to be in effect. The election must be made before the expiration of the period prescribed by section 6511(a) (or section 6511(c) if the period is extended by agreement) for making a claim for credit or refund. If either or both spouses die after the close of the taxable year but before the joint return is filed, the election may be made by the executor, administrator, or other person charged with the property of the deceased spouse. If the election is made with a joint amended return, the amended return should be made on Form 1040 or 1040A, the word ‘‘Amended’’ should be written clearly on the front of the return, and an amended return also must be filed for each subsequent taxable year as to which a return previously has been filed by either spouse.

(ii) The statement must contain a declaration that the election is being made and that the requirements of paragraph (a)(1) of this section are met for the taxable year. The statement must also contain the name, address, and taxpayer identifying number of each spouse. If the election is being made on behalf of a deceased spouse, the statement must contain the name and address of the executor, administrator, or other person making the election on behalf of the decreased spouse. The statement must be signed by both persons making the election.

(b) *Termination of election*—(1) *Revocation.* (i) An election under this section shall terminate if either spouse revokes the election. An election that is revoked terminates as of the first taxable year for which the last day prescribed by section 6072(a) and 6081(a) for filing the return of tax has not yet occurred.

(ii) Revocation of the election is made by filing a statement of revocation in the following manner. If the spouse revoking the election is required to file a return under section 6012, the statement is filed by attaching it to the return for the first taxable year to which the revocation applies. If the spouse revoking the election is not required to file a return under section 6012, but files a claim for refund under section 6511, the statement is filed by attaching it to the claim for refund. If the spouse revoking the election is not required to file a return and does not file a claim for refund, the statement is filed by submitting it to the service center director with whom was filed the most recent joint return of the spouses. The revocation may, if the revoking spouse dies after the close of the first taxable year to which the revocation applies but before the return, claim for refund, or statement of revocation is filed, be made by the executor, administrator or other person charged with the property of the deceased spouse.

(iii) A revocation of the election is effective as of a particular taxable year if it is filed on or before the last day prescribed by section 6072(a) and 6081(a) for filing the return of tax for that taxable year. However, the revocation is not final until that last day.

(iv) The statement of revocation must contain a declaration that the election under this section is being revoked. The statement must also contain the name, address, and taxpayer identifying number of each spouse. If the revocation is being made on behalf of a deceased spouse, the statement must contain the name and address of the executor, administrator, or other person revoking the election on behalf of the deceased spouse. The statement must also include a list of the States, foreign countries, and possessions of the United States which have community property laws and in which:

(A) Each spouse is domiciled, or

(B) real property is located from which either of the spouses receives income.

The statement must be signed by the person revoking the election.

(2) *Death.* An election under this section shall terminate if either spouse dies. An election that terminates on account of death terminates as of the first taxable year of the surviving spouse following the taxable year in which the death occurred. However, if the surviving spouse is a citizen or resident of the United States who is entitled to the benefits of section 2, the election terminates as of the first taxable year following the last taxable year for which the surviving spouse is entitled to the benefits of section 2. If both spouses die within the same taxable year, the election terminates as of the first day after the close of the taxable year in which the deaths occurred.

(3) *Legal separation.* An election under this section terminates if the spouses legally separate under a degree of divorce or of separate maintenance. An election that terminates on account of legal separation terminates as of the close of the taxable year preceding the taxable year in which the separation occurs. The rules in §1.6013–4(a) are relevant in determining whether two spouses are legally separated.

(4) *Inadequate records.* An election under this section may be terminated by the Commissioner if it is determined that either spouse has failed to keep adequate records. An election that is terminated on account of inadequate records terminates as of the close of the taxable year preceding the taxable year for which the Commissioner determines that the election should be terminated. Adequate records are the books, records, and other information resonably necessary to ascertain the amount of liability for taxes under chapters 1, 5, and 24 of the code of either spouse for the taxable year. Adequate records also includes the granting of access to the books and records.

(c) *Illustrations.* The application of this section is illustrated by the following examples. In each case the individual's taxable year is the calendar year and the spouses are not legally separated.

Example (1). W, a U.S. citizen for the entire taxable year 1979, is married to H, a nonresident alien individual. W and H may make the section 6013(g) election for 1979 by filing the statement of election with a joint return. If W and H make the election, income from sources within and without the United States received by W and H in 1979 and subsequent years must be included in gross income for each taxable year unless the election later is terminated or suspended. While W and H must file a joint return for 1979, joint or separate returns may be filed for subsequent years.

Example (2). H and W are husband and wife and are both nonresident alien individuals. In June 1980 H becomes a U.S. resident and remains a resident for the balance of the year. H and W may make the section 6013(g) election for 1980. If H and W make the election, income from sources within and without the United States received by H and W for the entire taxable year 1980 and subsequent years must be included in gross income for each taxable year, unless the election later is terminated or suspended.

Example (3) . W, a U.S. resident on December 31, 1981, is married to H, a nonresident alien. W and H make the section 6013(g) election and file joint returns for 1981 and succeeding years. On January 10, 1987, W becomes a nonresident alien. H has remained a nonresident alien. W and H may file a joint return or separate returns for 1987. As neither W or H is a U.S. resident at any time during 1988, their election is suspended for 1988. If W and H have U.S. source or foreign source income effectively connected with the conduct of a U.S. trade or business in 1988, they must file separate returns as nonresident aliens. W becomes a U.S. resident again on January 5, 1990. Their election no longer is in suspense. Income from sources within and without the United States received by W or H in the years their election is not suspended must be included in gross income for each taxable year.

Example (4). H, a U.S. citizen for the entire taxable year 1979, is married to W, who is not a U.S. citizen. While W believes that she is a U.S. resident, H and W make the section 6013(g) election for 1979 to cover the possibility that later it would be determined that she is a nonresident alien during 1979. The election for 1979 will not be considered evidence that W was a nonresident alien in prior years. Income from sources within and without the United States received by H amd W in 1979 and subsequent years must be included in gross income for each taxable year, unless the election later is terminated or suspended.

[T.D. 7670, 45 FR 6929, Jan. 31, 1980, as amended by T.D. 7842, 47 FR 49842, Nov. 3, 1982; T.D. 8411, 57 FR 15241, Apr. 27, 1992]

§ 1.6013–7 Joint return for year in which nonresident alien becomes resident of the United States.

(a) *Election for special treatment*—(1) *In general.* Two individuals who are husband and wife at the close of a taxable year ending on or after December 31, 1975, may make an election under this section for that taxable year if one spouse is a citizen or resident of the United States on the last day of that taxable year and the other spouse is a nonresident alien at the beginning of that taxable year and a citizen or resident of the United States at the close of that taxable year. Two married individuals who are nonresident aliens at the beginning of a taxable year and who are U.S. citizens or residents on the last day of that taxable year qualify for the election. The effect of the election is that each spouse is treated as a resident of the United States for purposes of chapters 1, 5, and 24 and sections 6012, 6013, 6072, and 6091 of the code for all of that taxable year. A husband and wife may not make an election if an election has previously been made under this section by either spouse.

(2) *Particular rules.* The rules in subdivisions (ii) through (v) of § 1.6013–6(a)(2) are applicable to this section.

(3) *Time and manner of making an election.* A husband and wife shall make the election under this section in accordance with the rules in § 1.6013–6(a)(4).

(b) *Section 6013(g) election in effect.* If an election under section 6013(g) is in effect for a year subsequent to the first taxable year for which made and during that subsequent year the husband and wife meet the requirements of section 6013(h) and paragraph (a)(1) of this section, then the election under section 6013(g) shall apply to that subsequent taxable year. A separate election under section 6013(h) is not required for that subsequent taxable year.

[T.D. 7670, 45 FR 6931, Jan. 31, 1980]

§ 1.6014–1 Tax not computed by taxpayer for taxable years beginning before January 1, 1970.

(a) *In general.* If an individual is entitled under paragraph (a)(7) of § 1.6012–1 to use as his return Form 1040A, he may elect not to show thereon the amount of the tax due in connection with such return if his gross income is less than $5,000.

(b) *Computation and payment of tax.* A taxpayer who, in accordance with paragraph (a) of this section, elects not to show the tax on Form 1040A is not required to pay the unpaid balance of such tax at the time he files the return. In such case, the tax will be computed for the taxpayer by the Internal Revenue Service, and a notice will be mailed to the taxpayer stating the amount of tax due. Where it is determined that a refund of tax is due, the Internal Revenue Service will send such refund to the taxpayer. See paragraph (c) of § 301.6402–3 of this chapter (Regulations on Procedure and Administration).

(c) *Joint return.* (1) A husband and wife who, pursuant to paragraph (a)(7) of § 1.6012–1, file a joint return on Form 1040A may elect not to show the tax on such return if their aggregate gross income for the taxable year is less than $5,000.

(2) The tax computed for the taxpayer who files Form 1040A and elects not to show thereon the tax due shall be the lesser of the following amounts:

(i) A tax computed as though the return on Form 1040A constituted the separate returns of the spouses, or

(ii) A tax computed as though the return on Form 1040A constituted a joint return.

(d) *Married individuals filing separate returns.* In the case of a married individual who files a separate return and who elects under this section not to show his tax on Form 1040A his tax shall be computed with reference to the 10-percent standard deduction rather than the minimum standard deduction.

(e) This section shall apply to taxable years beginning before January 1, 1970.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6581, 26 FR 11678, Dec. 6, 1961; T.D. 6792, 30 FR 531, Jan. 15, 1965; T.D. 7102, 36 FR 5497, Mar. 24, 1971]

§1.6014–2 Tax not computed by taxpayer for taxable years beginning after December 31, 1969.

(a) *In general.* An individual subject to the tax imposed by section 1 of the Code may, in accordance with the instructions applicable to the income tax return to be filed, elect, for any taxable year beginning after December 31, 1969, not to show on his income tax return for such year the amount of tax due in connection with such return.

(b) *Restriction on making an election.* The election pursuant to this section shall not be made by an individual who does not file his return (or amended return) making such election on or before the date prescribed in section 6072(a) for the filing of the original return (determined without regard to any extension of time).

(c) *Effects of election.* (1) A taxpayer who, in accordance with the provisions of this section, elects not to show the tax on his income tax return is not required to pay the unpaid balance of such tax at the time he files the return. In such case, the tax will be computed for the taxpayer by the Internal Revenue Service, and a notice will be mailed to the taxpayer stating the amount of tax due. Where it is determined that a refund of tax is due, the Internal Revenue Service will send such refund to the taxpayer. See paragraph (c) of §301.6402–3 of this chapter (Regulations on Procedure and Administration). The computation of tax by the Internal Revenue Service shall be treated for purposes of this chapter as if made by the taxpayer, and such computation or the issuance of a notice or refund pursuant thereto shall not relieve the taxpayer of liability for any deficiency (although the deficiency is based upon an amount of tax different from that computed for the taxpayer by the Internal Revenue Service) or affect the rights of the Internal Revenue Service with respect to any subsequent audit or other review of the taxpayer's return.

(2) Where the election provided for in this section is made by a taxpayer who takes the standard deduction and who has adjusted gross income of less than $10,000, such election constitutes an election to pay the tax imposed by section 3.

(3) A taxpayer who makes an election under section 6014 shall not be precluded from claiming:

(i) Status as a head of household or a surviving spouse;

(ii) The credit under section 31 (relating to tax withheld on wages);

(iii) The credit under section 37 (relating to retirement income);

(iv) The credit under section 38 (relating to investment in certain depreciable property);

(v) The credit under section 39 (relating to certain uses of gasoline and lubricating oil);

(vi) The credit under section 41 (relating to contributions to candidates for public office);

(vii) The credit under section 42 (relating to personal exemptions);

(viii) The credit under section 43 (relating to earned income);

(ix) The credit under section 44 (relating to purchase of new principal residence); or

(x) The credit under section 45 (relating to overpayments of tax).

(d) *Joint returns.* (1) A husband and wife who file a joint return may elect not to show the tax on such return in accordance with the rules prescribed in paragraphs (a) and (b) of this section.

(2) The tax computed for a husband and wife who elect pursuant to this section not to show their tax on their joint income tax return shall be the lesser of the following amounts:

(i) A tax computed as though the return of income constituted a joint return, or

(ii) If sufficient information is provided for the taxable income of each spouse to be determined, a tax computed as though the return of income constituted the separate returns of the spouses.

(e) *Married individuals filing separate returns.* This section shall apply to married individuals filing separate returns unless otherwise provided in the instructions accompanying a return. The instructions may require the taxpayer to attach to his return a statement to the effect that his tax and the tax of his spouse were determined in accordance with the rules of sections 141(d) and 142(a).

(f) *Revocation of election.* An election pursuant to this section may be revoked on an amended return (whether such return is filed before or after the date prescribed in section 6072(a) for filing the original return).

[T.D. 7102, 36 FR 5497, Mar. 24, 1971, as amended by T.D. 7298, 38 FR 35234, Dec. 26, 1973; T.D. 7391, 40 FR 55856, Dec. 2, 1975]

§ 1.6015(a)–1 Declaration of estimated income tax by individuals.

(a) *Requirement*—(1) *Taxable years beginning after December 31, 1971.* With respect to taxable years beginning after December 31, 1971, a declaration of estimated income tax by an individual is not required if the estimated tax (as defined in section 6015(c)) can reasonably be expected to be less than $100. In all other cases a declaration of estimated income tax shall be made by every individual if the following conditions are met and if such individual is not a nonresident alien individual who is excepted under section 6015(i) and § 1.6015(i)–1 from the requirements of making a declaration:

(i) The gross income for the taxable year can reasonably be expected to exceed:

(a) $20,000, in the case of:

(1) A single individual including a head of a household (as defined in section 2(b)) or a surviving spouse (as defined in section 2(a)); or

(2) A married individual entitled under section 6015(b) to file a joint declaration with his spouse, if his spouse has not received wages (as defined in section 3401(a)) for the taxable year; or

(b) $10,000, in the case of a married individual entitled under section 6015(b) to file a joint declaration with his spouse, if both he and his spouse have received wages (as defined in section 3401(a)) for the taxable year; or

(c) $5,000, in the case of a married individual not entitled under section 6015(b) to file a joint declaration with his spouse; or

(ii) The gross income can reasonably be expected to include more than $500 from sources other than wages (as defined in section 3401(a)).

(2) *Taxable years beginning after December 31, 1966, and before January 1, 1972.* With respect to taxable years beginning after December 31, 1966, and before January 1, 1972, a declaration of estimated income tax by an individual is not required if the estimated tax (as defined in section 6015(c)) can reasonably be expected to be less than $40. In all other cases a declaration of estimated income tax shall be made by every individual if the following conditions are met and if such individual is not a nonresident alien individual who is excepted under section 6015(i) and § 1.6015(i)–1 from the requirement of making a declaration:

(i) The gross income for the taxable year can reasonably be expected to exceed:

(a) $5,000, in the case of:

(1) A single individual other than a head of a household (as defined in section 1(b)(2) for taxable years ending before January 1, 1971, or as defined in section 2(b) of the Code as amended by the Tax Reform Act of 1969 for taxable years beginning after December 31, 1970) or a surviving spouse (as defined in section 2(b) for taxable years ending before January 1, 1971, or as defined in section 2(a) of the Code as amended by the Tax Reform Act of 1969 for taxable years beginning after December 31, 1970);

(2) A married individual not entitled under section 6015(b) to file a joint declaration with his spouse; or

(3) A married individual entitled under section 6015(b) to file a joint declaration with his spouse, but only if the aggregate gross income of such individual and his spouse for the taxable year can reasonably be expected to exceed $10,000; or

(b) $10,000, in the case of:

(1) A head of household (as defined in section 1(b)(2) for taxable years ending before January 1, 1971, or as defined in

section 2(b) of the Code as amended by the Tax Reform Act of 1969 for taxable years beginning after December 31, 1970); or

(2) A surviving spouse (as defined in section 2(b) for taxable years ending before January 1, 1971, or as defined in section 2(a) of the Code as amended by the Tax Reform Act of 1969 for taxable years beginning after December 31, 1970); or

(ii) The gross income can reasonably be expected to include more than $200 from sources other than wages (as defined in section 3401(a)).

(3) *Taxable years beginning before January 1, 1967.* With respect to taxable years beginning before January 1, 1967, and after December 31, 1960, a declaration of estimated income tax by an individual is not required if the estimated tax (as defined in section 6015(c)) can reasonably be expected to be less than $40. In all other cases a declaration shall be made by every citizen of the United States, whether residing at home or abroad, every individual residing in the United States though not a citizen thereof, every nonresident alien who is a resident of Canada, Mexico, or Puerto Rico and who has wages subject to withholding at the source under section 3402, and every nonresident alien who has been, or expects to be, a resident of Puerto Rico during the entire taxable year, if:

(i) The gross income for the taxable year can reasonably be expected to exceed:

(a) $5,000, in the case of:

(1) A single individual other than a head of a household (as defined in section 1(b)(2)); or

(2) A married individual not entitled under section 6015(b) to file a joint declaration with his spouse; or

(3) A married individual entitled under section 6015(b) to file a joint declaration with his spouse, but only if the aggregate gross income of such individual and his spouse for the taxable year can reasonably be expected to exceed $10,000; or

(b) $10,000, in the case of:

(1) A head of a household (as defined in section 1(b)(2)); or

(2) A surviving spouse (as defined in section 2(b)); or

(ii) The gross income can reasonably be expected to include more than $200 from sources other than wages (as defined in section 3401(a)).

(b) *Income of child.* In estimating his gross income for the taxable year a parent should not take into account the income of his minor child. Such income is not includible in the gross income of the parent. See section 73 and §1.73–1.

(c) *Exemption of spouse.* For the purpose of determining whether a declaration of estimated tax is required under the provisions of paragraph (a)(3) of this section, a married person filing a separate declaration may not take into account the exemption of his spouse, if his spouse has, or is reasonably expected to have, gross income, or is reasonably expected to be the dependent of another taxpayer for the taxable year.

(d) *Nonresident alien individuals.* For the rules exempting certain nonresident alien individuals from the requirement of making a declaration of estimated income tax, see §1.6015(i)–1.

(e) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). H maintains as his home a household which is the principal place of abode of himself and his two dependent children. H's wife died in 1970 and he has not remarried. H and his wife filed a joint return for 1970. H's salary from January 1, to June 30, 1972, is at the annual rate of $18,000. However, effective July 1, 1972, his annual salary is increased to $24,000, and under the facts then existing it is reasonable to assume that his salary for the remaining portion of 1972 will remain unchanged and that his total salary for the year will, therefore, be $21,000. Since H is a surviving spouse (as defined in section 2(a)) and his gross income can reasonably be expected to exceed $20,000, he is required to file a declaration of estimated tax for 1972. Since it was not reasonable to assume that H's gross income for 1972 would exceed $20,000 until July 1972 (after June 1 and before September 2), H is not required to file a declaration until September 15, 1972. However, if H's estimated tax (as defined in section 6015(c)) can reasonably be expected to be less than $100, he is not required to file a declaration of estimated tax. See section 6073 and §§1.6073–1 to 1.6073–4, inclusive, for rules as to when a declaration must be filed.

Example (2). H, a taxpayer making his return on the calendar year basis, has an annual salary of $12,000 in 1972. W, H's wife, received wages (as defined in section 3401(a)) in December 1972. W did not receive wages prior to December. Assuming that H and W are entitled to file a joint declaration of estimated tax under section 6015(b), H would not be required to file a declaration for 1972 until January 15, 1973, since prior to December 1972 W had not received wages. Since W received wages after September 1, 1972, H must file a declaration on or before January 15, 1973, because, under the rule contained in paragraph (a)(1)(i)*(b)* of this section, H's gross income could reasonably be expected to exceed $10,000 for 1972. However, no declaration would be required if H's estimated tax (as defined in section 6015(c)) could reasonably be expected to be less than $100. No declaration is required prior to January 15, 1973, because, under the rule contained in paragraph (a)(1)(i)*(a)*(2) of this section, H's gross income for 1972 could not reasonably be expected to exceed $20,000.

Example (3). P is a taxpayer making his return on the calendar year basis. P is engaged in the practice of his profession on his own account and has gross income of $2,000 from such profession for the 2 months of January and February 1972. He reasonably expects that his gross income from his profession will continue to average $1,000 each month throughout the year and that he will have no income from any other source during 1972. Since P has gross income which does not constitute wages subject to withholding, he is required to file a declaration of estimated tax for that year since he has income of more than $500 from sources other than wages, unless he reasonably expects his estimated tax to be less than $100.

Example (4). S, a married taxpayer, has been regularly employed for many years. As of January 1, 1972, his weekly wages are $305. For many years, S has also owned stock in a corporation which has regularly paid him annual dividends ranging from $575 to $600. Because his gross income can reasonably be expected to include more than $500 from sources other than wages, S is required to make a declaration of estimated tax for 1972, unless he reasonably expects his estimated tax to be less than $100.

(f) *Declarations made by agents.* The declaration of income may be made by an agent if, by reason of disease or injury, the person liable for the making of the declaration is unable to make it. The declaration may also be made by an agent if the taxpayer is unable to make the declaration by reason of continuous absence from the United States (including Puerto Rico as if a part of the United States) for a period of at least 60 days prior to the date prescribed by law for making the declaration. In addition, a declaration may be made by an agent if the taxpayer requests permission, in writing, of the district director for the internal revenue district in which is located the legal residence or principal place of business of the person liable for the making of the declaration, and such district director determines that good cause exists for permitting the declaration to be so made. However, assistance in the preparation of the declaration may be rendered under any circumstances. Whenever a declaration is made by an agent it must be accompanied by a power of attorney (or copy thereof) authorizing him to represent his principal in making, executing, or filing the declaration. A form 2848, when properly completed, is sufficient. In addition, where one spouse is physically unable by reason of disease or injury to sign a joint declaration, the other spouse may, with the oral consent of the one who is incapacitated, sign the incapacitated spouse's name in the proper place in the declaration followed by the words ''By ___________, Husband (or Wife)'', and by the signature of the signing spouse in his own right, provided that a dated statement signed by the spouse who is signing the declaration is attached to and made a part of the declaration stating:

(1) The name of the declaration being filed,

(2) The taxable year,

(3) The reason for the inability of the spouse who is incapacitated to sign the declaration, and

(4) That the spouse who is incapacitated consented to the signing of the declaration.

The taxpayer and his agent, if any, are responsible for the declaration as made and incur liability for the penalties provided for erroneous, false, or fraudulent declarations.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6817, 30 FR 4537, Apr. 8, 1965; T.D. 7117, 36 FR 9422, May 25, 1971; T.D. 7274, 38 FR 11345, May 7, 1973; T.D. 7282, 38 FR 19027, July 17, 1973; T.D. 7332, 39 FR 44232, Dec. 23, 1974]

§1.6015(b)–1 Joint declaration by husband and wife.

(a) *In general.* A husband and wife may make a joint declaration of estimated tax even though they are not living together. However, a joint declaration may not be made if they are separated under a decree of divorce or of separate maintenance. A joint declaration may not be made if the taxpayer's spouse is a nonresident alien (including a nonresident alien who is a bona fide resident of Puerto Rico during the entire taxable year) or if his spouse has a different taxable year. If the gross income of each spouse meets the requirements of section 6015(a), either a joint declaration must be made or a separate declaration must be made by each. If a joint declaration is made, the amount estimated as the income tax imposed by chapter 1 (other than by section 56) must be computed on the aggregate estimated taxable income of the spouses (see section 6013(d)(3) and §1.2–1), while (for taxable years beginning after December 31, 1966) the amount estimated as the self-employment tax imposed by chapter 2 must be computed on the separate estimated self-employment income of each spouse. See sections 1401 and 1402 and §1.6017–1(b)(1). The liability with respect to the estimated tax, in the case of a joint declaration, shall be joint and several.

(b) *Application to separate returns.* The fact that a joint declaration of estimated tax is made by them will not preclude a husband and his wife from filing separate returns. In case a joint declaration is made but a joint return is not made for the same taxable year, the payments made on account of the estimated tax for such year may be treated as payments on account of the tax liability of either the husband or wife for the taxable year or may be divided between them in such manner as they may agree. In the event the husband and wife fail to agree to a division, such payments shall be allocated between them in accordance with the following rule. The portion of such payments to be allocated to a spouse shall be that portion of the aggregate of all such payments as the amount of tax imposed by chapter 1 (other than by section 56) shown on the separate return of the taxpayer (plus, for taxable years beginning after December 31, 1966, the amount of tax imposed by chapter 2 shown on the return of the taxpayer) bears to the sum of the taxes imposed by chapter 1 (other than by section 56) shown on the separate returns of the taxpayer and his spouse (plus, for taxable years beginning after December 31, 1966, the sum of the taxes imposed by chapter 2 shown on the returns of the taxpayer and his spouse). For example, assume that for calendar yedar 1972 H and his Spouse W make a joint declaration of estimated tax and, pursuant thereto, pay a total of $19,500 of estimated tax. H and W subsequenty file separate returns for 1972 showing tax imposed by chapter 1 (other than by section 56) in the amount of $11,500 and $8,000, respectively. In addition, H's return shows a tax imposed by chapter 2 in the amount of $500. H and W fail to agree to a division of the estimated tax paid. The amount of the aggregate estimated tax payments allocated to H is computed as follows:

(1) Amount of tax, imposed by chapter 1 (other than by section 56) shown on H's return	$11,500
(2) Plus: Amount of tax imposed by chapter 2 shown on H's return	500
(3) Total taxes imposed by chapter 1 (other than by section 56) and by chapter 2 shown on H's return	12,000
(4) Amount of tax imposed by chapter 1 (other than by section 56) shown on W's return	$8,000
(5) Total taxes imposed by chapter 1 (other than by section 56) and by chapter 2 shown on both H's and W's returns	20,000
(6) Proportion of such taxes shown on H's return to total amount of such taxes shown on both H's and W's returns ($12,000÷20,000)	60%
(7) Amount of estimated tax payments allocated to H (60% of $10,500)	$11,700

Accordingly, H's return would show remaining tax liability in the amount of $300 ($12,000 taxes shown less $11,700 estimated tax allocated).

(c) *Death of spouse.* (1) A joint declaration may not be made after the death of either the husband or wife. However, if it is reasonable for a surviving spouse to assume that there will be filed a joint return for himself and the deceased spouse for his taxable year and the last taxable year of the deceased spouse he may, in making a separate declaration for his taxable year which includes the period comprising such last taxable year of his spouse, estimate the amount of the tax imposed by chapter 1 (other than by section 56) on his and his spouse's taxable income on an aggregate basis and compute his estimated tax with respect to such chapter 1 tax in the same manner as though a joint declaration had been filed.

(2) If a joint declaration is made by husband and wife and thereafter one spouse dies, no further payments of estimated tax on account of such joint declaration are required from the estate of the decedent. The surviving spouse, however, shall be liable for the payment of any subsequent installments of the joint estimated tax unless an amended declaration setting forth the separate estimated tax for the taxable year is made by such spouse. Such separate estimated tax shall be paid at the times and in the amounts determined under the rules prescribed in section 6153. For the purpose of (i) the making of such amended declaration by the surviving spouse, and (ii) the allocation of payments made pursuant to a joint declaration between the surviving spouse and the legal representative of the decedent in the event a joint return is not filed, the payments made pursuant to the joint declaration may be divided between the decedent and the surviving spouse in such proportion as the surviving spouse and the legal representative of the decedent may agree. In the event the surviving spouse and the legal representative of the decedent fail to agree to a division, such payments shall be allocated in accordance with the following rule. The portion of such payments to be allocated to the surviving spouse shall be that portion of the aggregate amount of such payments as the amount of tax imposed by chapter 1 (other than by section 56) shown on the separate return of the surviving spouse (plus, for taxable years beginning after December 31, 1966, the amount of tax imposed by chapter 2 shown on the return of the surviving spouse) bears to the sum imposed by chapter 1 (other than by section 56) shown on the separate returns of the surviving spouse and of the decedent (plus, for taxable years beginning after December 31, 1966, the sum of the taxes imposed by chapter 2 shown on the returns of the surviving spouse and of the decedent); and the balance of such payments shall be allocated to the decedent. This rule may be illustrated by analogizing the surviving spouse described in this rule to H in the example contained in paragraph (b) of this section and the decedent in this rule to W in that example.

(d) *Signing of declaration.* A joint declaration of a husband and wife (if not made by an agent of one or both spouses) shall be signed by both spouses. The provisions of paragraph (f) of § 1.6015(a)–1, relating to returns made by agents, shall apply where one spouse signs a declaration as agent for the other, or where a third party signs a declaration as agent for one or both spouses.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T. D. 7274, 38 FR 11345, May 7, 1973; T.D. 7427, 41 FR 34027, Aug. 12, 1976]

§ 1.6015(c)–1 Definition of estimated tax.

(a) *In general.* In the case of an individual, the term ''estimated tax'' means:

(1) The amount which the individual estimates as the amount of the income tax imposed by chapter 1 (other than the tax imposed by section 56 or for taxable years ending before September 30, 1968, the tax surcharge imposed by section 51) for the taxable year (and including the amount which he estimates as the amount of any qualified State individual income taxes which are treated pursuant to section 6361(a) as if they were imposed by chapter 1 for the taxable year), plus

(2) For taxable years beginning after December 31, 1966, the amount which the individual estimates as the amount of the self-employment tax imposed by chapter 2 for the taxable year, minus

(3) The amount which the individual estimates as the sum of any credits against tax provided by part IV of subchapter A of chapter 1. These credits are those provided by section 31 (relating to tax withheld on wages), section 32 (relating to tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds), section 33 (relating to foreign taxes), section 34 (relating to the credit for dividends received on or before December 31, 1964), section 35 (relating to

partially tax-exempt interest), section 37 (relating to the elderly), section 38 (relating to the investment credit), section 39 (relating to certain uses of gasoline, special fuels, and lubricating oil), section 40 (relating to expenses of work incentive programs), section 41 (relating to contributions to candidates), section 42 (relating to general tax credit), section 43 (relating to earned income), section 44 (relating to purchase of new principal residence), section 44A (relating to expenses for household and dependent care services necessary for gainful employment), section 44B (relating to credit for employment of certain new employees), and section 45 (relating to overpayments of tax), minus,

(4) In the case of an individual who is subject to one or more qualified State individual income taxes, the amount which he estimates as the sum of the credits allowed against such taxes pursuant to section 6362(b)(2) (B) or (C) or section 6362(c)(4) and paragraph (c) of §301.6362–4 of this chapter (Regulations on Procedure and Administration) (relating to the credit for income taxes of other States or political subdivisions thereof) and paragraph (c)(2) of §301.6361–1 (relating to the credit for tax withheld from wages on account of qualified State individual income taxes), and minus

(5) For taxable years ending after February 29, 1980, the amount which the individual estimates will be the amount of such individual's overpayment of windfall profit tax imposed by section 4986 of the Code for the taxable year. For this purpose, the amount of such overpayment is the amount by which such individual's aggregate windfall profit tax liability for the taxable year as a producer of crude oil is reasonably expected to be exceeded by withholding of windfall profit tax for the taxable year.

(b) *Example.* A, a self-employed individual not subject to any qualified State individual income tax, estimates that his liabilities for income tax and self-employment tax for 1973 will be $1,600 and $400, respectively. A is required to declare and pay an estimated tax of $2,000 for that year.

(Secs. 6015, 6154, 6654, 6655, and 7805, Internal Revenue Code of 1954 (96 Stat. 2395 and 2396, 68A Stat. 917; 26 U.S.C. 6015, 6154, 6654, 6655, and 7805))

[T.D. 7577, 43 FR 59358, Dec. 20, 1978, as amended by T.D. 8016, 50 FR 11854, Mar. 26, 1985]

§1.6015(d)–1 Contents of declaration of estimated tax.

(a) *In general.* (1) The declaration of estimated tax by an individual shall be made on Form 1040–ES. For the purpose of making the declaration, the amount of gross income which the taxpayer can reasonably be expected to receive or accrue, depending upon the method of accounting upon which taxable income is computed, and the amount of the estimated allowable deductions and credits to be taken into account in computing the amount of estimated tax shall be determined upon the basis of the facts and circumstances existing as at the time prescribed for the filing of the declaration as well as those reasonably to be anticipated for the taxable year. If, therefore, the taxpayer is employed at the date prescribed for filing his declaration at a given wage or salary, it should, in the absence of circumstances indicating the contrary, be presumed by him for the purpose of the declaration that such employment will continue to the end of the taxable year at the wage or salary received by him as of such date. In the case of income other than wages and salary the regularity in the payment of income, such as dividends, interest, rents, royalties, and income arising from estates and trusts is a factor to be taken into consideration. Thus, if the taxpayer owns shares of stock in a corporation and dividends have been paid regularly for several years upon such stock, the taxpayer in the preparation of his declaration should, in the absence of information indicating a change in the dividend policy, include the prospective dividends from the corporation for the taxable year as well as those actually received in such year prior to the filing of the declaration. In the case of a taxpayer engaged in business on his own account, there shall be made an estimate of gross income and deductions and credits in the light of the best available information affecting the trade, business, or profession.

(2) In the case of any individual who can, at the time of the preparation of his declaration, reasonably anticipate that his gross income will be of such amount and character as to enable him to elect upon his return for such year to compute the tax under section 3 (relating to optional tax), in lieu of the tax imposed by section 1, the declaration of estimated tax may be made upon the basis set forth in section 3 and § 1.3–1. The filing of a declaration computed upon the basis of section 3 shall not constitute the making of an election under section 4 (relating to rules for optional tax) nor will it permit the filing of a return on the basis of the optional tax under section 3 unless the taxpayer otherwise comes within the provisions of sections 3 and 4. For the purpose of computing the tax liability in the case of married persons, if the taxable income of one spouse is determined without regard to the standard deduction, the standard deduction is not allowed to either. (See, however, paragraph (c) of § 1.142–1 for exceptions where spouses are legally separated under a decree of divorce or separate maintenance.) Hence, where separate declarations are filed, one spouse should not use section 3 in computing the estimated tax unless the other spouse also uses section 3 or employs the standard deduction in computing the estimated tax.

(b) *Computation of estimated tax.* In computing the estimated tax the taxpayer should take into account the following:

(1) The amount estimated as the income tax imposed by chapter 1 (other than by section 56) for the taxable year after the application of any allowable amounts estimated as the credit for foreign taxes, the dividends received credit (for dividends received on or before December 31, 1964), the credit for partially tax-exempt interest, the retirement income credit, the investment credit, the credit for expenses of work incentive programs, the credit for contributions to candidates, the credit for overpayments of tax, but without regard to the credit under section 31 for tax withheld on wages or to the credit under section 39 for certain uses of gasoline, special fuels, and lubricating oils;

(2) For taxable years beginning after December 31, 1966 (and, if the taxpayer so desires, for an earlier taxable year), the amount estimated as the tax on self-employment income imposed by chapter 2;

(3) The amounts estimated by the taxpayer as the credits under section 31 for tax withheld on wages and under section 39 for certain uses of gasoline, special fuels, and lubricating oils;

(4) For taxable years ending after February 29, 1980, the amount which the taxpayer estimates will be the amount of such taxpayer's overpayment of windfall profit tax imposed by section 4986 of the Code for the taxable year. For this purpose, the amount of such overpayment is the amount by which such individual's aggregate windfall profit tax liability for the taxable year as a producer of crude oil is reasonably expected to be exceeded by withholding of windfall profit tax for the taxable year.

(5) The excess, if any, of the sum of the amounts shown under subparagraphs (b) (1) and (2) of this paragraph over the sum of the amounts shown under subparagraphs (b)(3) and (4) of this paragraph shall be the estimated tax for the taxable year.

(c) *Use of prescribed form.* Copies of Form 1040–ES will so far as possible be furnished taxpayers by district directors. A taxpayer will not be excused from making a declaration, however, by the fact that no form has been furnished to him. Taxpayers not supplied with the proper form should make application therefor to the district director in ample time to have their declarations prepared, verified, and filed with the district director on or before the date prescribed for filing the declaration. If the prescribed form is not available, a statement disclosing the amount estimated as the tax, the estimated credits, and the estimated tax after deducting such credits should be filed as a tentative declaration within the prescribed time, accompanied by the payment of the required installment. Such tentative declaration should be supplemented, without unnecessary delay, by a declaration made on the proper form.

(Secs. 6015, 6154, 6654, 6655, and 7805, Internal Revenue Code of 1954 (96 Stat. 2395 and 2396, 68A Stat. 917; 26 U.S.C. 6015, 6154, 6654, 6655, and 7805))

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 7427, 41 FR 34028, Aug. 12, 1976; T.D. 8016, 50 FR 11854, Mar. 26, 1985]

§1.6015(e)–1 Amendment of declaration.

In the making of a declaration of estimated tax, the taxpayer is required to take into account the then existing facts and circumstances as well as those reasonably to be anticipated relating to prospective gross income, allowable deductions, and estimated credits for the taxable year. Amended or revised declarations may be made in any case in which the taxpayer estimates that his gross income, deductions, or credits will differ from the gross income, deductions, or credits reflected in the previous declaration. An amended declaration may also be made based upon a change in the number of exemptions to which the taxpayer may be entitled for the then current taxable year. However, only one amended declaration may be filed during any interval between installment dates. See paragraph (d) of §1.6073–1. An amended declaration may be filed jointly by husband and wife even though separate declarations have previously been filed. An amended declaration may be made on either Form 1040–ES (marked ‘‘Amended’’). See, however, paragraph (c) of §1.6015(d)–1 for procedure to be followed if the prescribed form is not available.

[T.D. 7427, 41 FR 34028, Aug. 12, 1976]

§1.6015(f)–1 Return as declaration or amendment.

(a) *Time for filing return.* (1)(i) If a taxpayer pays in full the amount computed on the return as payable, and

(a) If a taxpayer (other than a taxpayer referred to in *(b)* of this subdivision):

(1) On the calendar year basis, files his return on or before January 31 of the succeeding calendar year, or

(2) On a fiscal year basis, files his return on or before the last day of the first month immediately succeeding the close of such fiscal year, or

(b) If an individual referred to in section 6073(b), relating to income from farming, or, with respect to taxable years beginning after December 31, 1962, from fishing:

(1) On the calendar year basis, for taxable years beginning before January 1, 1969, files his return on or before February 15, or

(2) On a fiscal year basis, for taxable years beginning before January 1, 1969, files his return on or before the 15th day of the second month after the close of his fiscal year, or

(3) On the calendar year basis, for taxable years beginning after December 31, 1968, files his return on or before March 1, or

(4) On a fiscal year basis, for taxable years beginning after December 31, 1968, files his return on or before the first day of the third month after the close of his fiscal year, then:

(ii)*(a)* If the declaration is not required to be filed during the taxable year, but is required to be filed on or before January 15 of the succeeding year (or the date corresponding thereto in the case of a fiscal year), such return shall be considered as such declaration; or

(b) If a declaration was filed during the taxable year, such return shall be considered as the amendment of the declaration permitted by section 6015(e) to be filed on or before January 15 of the succeeding year (or the date corresponding thereto in the case of a fiscal year).

Hence, for example, an individual taxpayer on the calendar year basis who, subsequent to September 1, 1963, first meets the requirements of section 6015(a) which necessitate the filing of a declaration for 1963, may satisfy the requirements as to the filing of such declaration by filing his return for 1963 on or before January 31, 1964 (February 15, 1964, in the case of a farmer or fisherman), and paying in full at the time of such filing the tax shown thereon to be payable. Likewise, if a taxpayer files on or before September 15, 1963, a timely declaration for such year and subsequent thereto and on or before January 31, 1964, files his return for 1963, and pays at the time of such filing the tax shown by the return to be payable, such return shall be treated as an amended declaration timely filed.

(2) For the purpose of section 6015(f) a taxpayer may file his return on or before the last day of the first month following the close of the taxable year even though he has not been furnished Form W–2 by his employer. In such case the taxpayer shall compute, as accurately as possible, his wages for such year and the tax withheld for which he is entitled to a credit, reporting such wages and tax on his return, together with all other pertinent information necessary to the determination of his tax liability for such year.

(b) *Effect on addition to the tax.* Compliance with the provisions of section 6015(f) will enable a taxpayer to avoid the addition to the tax imposed by section 6654 with respect to an underpayment of the installment not required to be paid until January 15 of the succeeding calendar year (or the corresponding date in the case of a fiscal year). With respect to an underpayment of any earlier installment, compliance with section 6015(f) will not relieve the taxpayer from the addition to the tax imposed by section 6654. However, the period of the underpayment under section 6654(c), with respect to any earlier installment, will terminate on January 15 of the succeeding calendar year (or the corresponding date in the case of a fiscal year). For example, a taxpayer discovers on January 14, 1956, that he has underpaid his estimated tax for the calendar year 1955. He may, in lieu of filing an amended declaration on January 15, 1956, and paying the balance of the estimated tax determined thereon, file his final return on January 31, 1956, and pay in full the amount computed thereon as payable. By so doing, he will avoid the addition to the tax with respect to the underpayment of the installment required to be paid by January 15, 1956. The periods of underpayment, under section 6654(c), as to the installments required to be paid on April 15, 1955, June 15, 1955, and September 15, 1955, also terminate on January 15, 1956.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 7028, 35 FR 3806, Feb. 27, 1970; 35 FR 4293, Mar. 10, 1970]

§ 1.6015(g)–1 Short taxable years of individuals.

(a) *Requirement of declaration.* No declaration may be made for a period of more than 12 months. For purposes of this section a taxable year of 52 or 53 weeks, in the case of a taxpayer who computes his taxable income in accordance with the election permitted by section 441(f) shall be deemed a period of 12 months. For special rules affecting the time for filing declarations and paying estimated tax by such a taxpayer, see paragraph (b) of § 1.441–2. A separate declaration for a fractional part of a year is required where, for example, there is a change, with the approval of the Commissioner, in the basis of computing taxable income from one taxable year to another taxable year. The periods to be covered by such separate declarations in the several cases are those set forth in section 443. No declaration is required if the short taxable year is:

(1) A period of less than four months.

(2) A period of at least four months but less than six months and the requirements of section 6015(a) are first met after the 1st day of the fourth month.

(3) A period of at least six months but less than nine months and the requirements of section 6015(a) are first met after the 1st day of the sixth month, or

(4) A period of nine months or more and the requirements of section 6015(a) are first met after the 1st day of the ninth month.

In the case of a decedent, no declaration need be filed subsequent to the date of death. As to the requirement for an amended declaration if death of one spouse occurs after filing a joint declaration, see paragraph (c) of § 1.6015(b)–1.

(b) *Income and income tax placed on annual basis.* For the purpose of determining whether the anticipated income and tax for a short taxable year resulting from a change of annual accounting period, necessitates the filing of a declaration, income and income tax imposed by chapter 1 (other than by section 56) shall be placed on an annual basis in the manner prescribed in section 443(b)(1). Thus, for example, an unmarried taxpayer who changes from a fiscal year basis to a calendar year basis beginning January 1, 1973, will have a short taxable year beginning July 1, 1972, and ending December 31, 1972. If his anticipated gross income for such short taxable year consists solely of wages (as defined in section 3401(a)) in the amount of $11,000, his total gross income and his gross income from such wages for the purpose of determining whether a declaration is required is $22,000, the amount obtained by placing anticipated income of $11,000 upon an annual basis. Since the taxpayer's anticipated gross income from wages when placed upon an annual basis is in excess of $20,000, he is required to file a declaration of estimated tax for the short taxable year unless the estimated tax can reasonably be expected to be less than $100. However, for taxable years beginning after December 31, 1966, the amount which the individual estimates as the amount of self-employment tax imposed by chapter 2 shall be computed on the actual self-employment income for the short period.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 7427, 41 FR 34028, Aug. 12, 1976]

§1.6015(h)–1 Estates and trusts.

An estate or trust, though generally taxed as an individual, is not required to file a declaration.

§1.6015(i)–1 Nonresident alien individuals.

(a) *Exception from requirement of making a declaration.* No declaration of estimated income tax is required to be made under section 6015(a) and §1.6015(a)–1 by a nonresident alien individual unless:

(1) Such individual has wages, as defined in section 3401(a), and the regulations thereunder, upon which tax is required to be withheld under section 3402,

(2) Such individual has income (other than compensation for personal services upon which tax is required to be withheld at source under section 1441) which is effectively connected for the taxable year with the conduct of a trade or business in the United States by such individual, or

(3) Such individual has been, or expects to be, a resident of Puerto Rico during the entire taxable year.

(b) *Rules applicable to nonresident alien individuals required to make a declaration*—(1) *Tests to be applied.* A nonresident alien individual who is not excepted by paragraph (a) of this section from the requirement of making a declaration of income tax is required to file a declaration if his gross income meets the requirements of section 6015(a) and §1.6015(a)–1. In making the determination under section 6015(a)(1) as to whether the amount of the gross income of a nonresident alien individual is such as to require making a declaration of estimated income tax, only the tests relating to a single individual (other than a head of household) or to a married individual not entitled to file a joint declaration with his spouse shall apply, since a nonresident alien individual may not make a joint declaration by reason of section 6015(b) and is not a head of household. Only in a rare case would a nonresident alien individual be a surviving spouse.

(2) *Determination of gross income.* To determine the gross income of a nonresident alien individual who is not, or does not expect to be, a resident of Puerto Rico during the entire taxable year, see section 872 and §§1.872–1 and 1.872–2. To determine the gross income of a nonresident alien individual who is, or expects to be, a resident of Puerto Rico during the entire taxable year, see section 876 and §1.876–1. For purposes of applying paragraph (a)(2) of this section, income which is effectively connected for the taxable year with the conduct of a trade or business in the United States includes all income which is treated under section 871 (c) or (d) and §1.871–9 (relating to students and trainees) or §1.871–10 (relating to real property income) as income which is effectively connected for such year with the conduct of a trade or business in the United States.

(c) *Effective date.* This section shall apply for taxable years beginning after

December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.6015(a)–1(d) (Rev. as of Jan. 1, 1971).

[T.D. 7332, 39 FR 44232, Dec. 23, 1974]

§ 1.6015(j)–1 Applicability.

Section 6015 is applicable only with respect to taxable years beginning after December 31, 1954. Sections 58, 59, and 60 of the Internal Revenue Code of 1939 and the regulations thereunder, shall continue in force with respect to taxable years beginning before January 1, 1955.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960. Redesignated by T.D. 7332, 39 FR 44232, Dec. 23, 1974]

§ 1.6016–1 Declarations of estimated income tax by corporations.

(a) *Requirement.* For taxable years ending on or after December 31, 1955, a declaration of estimated tax shall be made by every corporation (including unincorporated business enterprises electing to be taxed as domestic corporations under section 1361), which is subject to taxation under section 11 or 1201(a), or subchapter L, chapter 1 of the Code (relating to insurance companies), if its income tax under such sections or such subchapter L for the taxable year can reasonably be expected to exceed the sum of $100,000 plus the amount of any estimated credits allowable under section 32 (relating to tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds), section 33 (relating to taxes of foreign countries and possessions of the United States), and section 38 (relating to investment in certain depreciable property).

(b) *Definition of estimated tax.* The term ‘‘estimated tax’’, in the case of a corporation, means the excess of the amount which such corporation estimates as its income tax liability for the taxable year under section 11 or 1201(a), or subchapter L, chapter 1 of the Code, over the sum of $100,000 and any estimated credits under sections 32, 33, and 38. However, for the rule with respect to the limitation upon the $100,000 exemption for members of certain electing affiliated groups, see section 243(b)(3)(C)(v) and the regulations thereunder.

(c) *Examples.* The application of this section may be illustrated by the following examples:

Example (1). M, a corporation subject to tax under section 11, reasonably anticipates that it will have taxable income of $224,000 for the calendar year 1964. The normal tax and surtax result in an expected liability of $105,000. M determines that it will not have any allowable credits under sections 32, 33, and 38 for 1964. Since M’s expected tax ($105,000) exceeds the exemption ($100,000), a declaration of estimated tax is required to be filed, reporting an estimated tax of $5,000 ($105,000 − $100,000) for the calendar year 1964.

Example (2). Under the facts stated in example (1), except that M estimates it will have an allowable foreign tax credit under section 33 in the amount of $4,000 and an allowable investment credit under section 38 in the amount of $3,000, no declaration is required, since M’s expected tax ($105,000) does not exceed the $100,000 plus the allowable credits totaling $7,000.

[T.D. 6768, 29 FR 14921, Nov. 4, 1964]

§ 1.6016–2 Contents of declaration of estimated tax.

(a) *In general.* The declaration of estimated tax by a corporation shall be made on Form 1120–ES. For the purpose of making the declaration, the estimated tax should be based upon the amount of gross income which the taxpayer can reasonably be expected to receive or accrue as the case may be, depending upon the method of accounting upon the basis of which the taxable income is computed, and the amount of the estimated allowable deductions and credits to be taken into account. Such amounts of gross income, deductions, and credits should be determined upon the basis of facts and circumstances existing as at the time prescribed for the filing of the declaration as well as those reasonably to be anticipated for the taxable year.

(b) *Use of prescribed form.* Copies of Form 1120–ES will so far as possible be furnished taxpayers by district directors. A taxpayer will not be excused from making a declaration, however, by the fact that no form has been furnished. Taxpayers not supplied with the proper form should make application therefor to the district director in ample time to have their declarations prepared, verified, and filed with the district director on or before the date prescribed for filing the declaration. If the prescribed form is not available a statement disclosing the estimated income tax after the exemption and the credits, if any, should be filed as a tentative declaration within the prescribed time, accompanied by the payment of the required installment. Such tentative declaration should be supplemented, without unnecessary delay, by a declaration made on the proper form.

§1.6016–3 Amendment of declaration.

In the making of a declaration of estimated tax the corporation is required to take into account the then existing facts and circumstances as well as those reasonably to be anticipated relating to prospective gross income, allowable deductions, and estimated credits for the taxable year. Amended or revised declarations may be made in any case in which the corporation estimates that its gross income, deductions, or credits will materially change the estimated tax reported in the previous declaration. However, for the rule with respect to the number of amended declarations which may be filed for taxable years beginning after December 31, 1963, see paragraph (d)(2) of §1.6074–1. Such amended declaration may be made on either Form 1120–ES (marked ''Amended'') or on the reverse side of the installment notice furnished the corporation by the district director. See, however, paragraph (b) of §1.6016–2 for procedure to be followed if the prescribed form is not available.

[T.D. 6768, 29 FR 14922, Nov. 4, 1964]

§1.6016–4 Short taxable year.

(a) *Requirement of declaration.* No declaration may be made for a period of more than 12 months. For purposes of this section a taxable year of 52 or 53 weeks, in the case of a corporation which computes its taxable income in accordance with the election permitted by section 441(f), shall be deemed a period of 12 months. For special rules affecting the time for filing declarations and paying estimated tax by such corporation, see paragraph (b) of §1.441–2. A separate declaration is required where a corporation is required to submit an income tax return for a period of less than 12 months, but only if such short period ends on or after December 31, 1955. However, no declaration is required if the short taxable year:

(1) Begins on or before December 31, 1963, and is:

(i) A period of less than 9 months, or

(ii) A period of 9 or more months but less than 12 months and the requirements of section 6016(a) are not met before the 1st day of the last month in the short taxable year, or

(2) Begins after December 31, 1963, and is:

(i) A period of less than 4 months, or

(ii) A period of 4 or more months but less than 12 months and the requirements of section 6016(a) are not met before the 1st day of the last month in the short taxable year.

(b) *Income placed on an annual basis.* In cases where the short taxable year results from a change of annual accounting period, for the purpose of determining whether the anticipated income for a short taxable year will result in an estimated tax liability requiring the filing of a declaration, such income shall be placed on an annual basis in the manner prescribed in section 443(b)(1). If a tax computed on such annualized income exceeds the sum of $100,000 and any credits under part IV, of subchapter A, chapter 1 of the Code, the estimated tax shall be the same part of the excess so computed as the number of months in the short period is of 12 months. Thus, for example, a corporation which changes from a calendar year basis to a fiscal year basis beginning October 1, 1956, will have a short taxable year beginning January 1, 1956, and ending September 30, 1956. If on or before August 31, 1956, the taxpayer anticipates that it will have income of $264,000 for the 9-month taxable year the estimated tax is computed as follows:

(1) Anticipated taxable income for 9 months	$264,000
(2) Annualized income ($264,000×12÷9)	352,000
(3) Tax liability on item (2)	177,540
(4) Item (3) reduced by $100,000 (there are no credits under part IV, subchapter A, chapter 1 of the Code)	77,540
(5) Estimated tax for 9-month period ($77,540×9÷12)	58,155

Since the tax liability on the annualized income is in excess of $100,000, a declaration is required to be filed, reporting an estimated tax of $58,155 for the 9-month taxable period. This paragraph has no application where the short taxable year does not result from a change in the taxpayer's annual accounting period.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6768, 29 FR 14922, Nov. 4, 1964]

§ 1.6017–1 Self-employment tax returns.

(a) *In general.* (1) Every individual, other than a nonresident alien, having net earnings from self-employment, as defined in section 1402, of $400 or more for the taxable year shall make a return of such earnings. For purposes of this section, an individual who is a resident of the Virgin Islands, Puerto Rico, or (for any taxable year beginning after 1960) Guam or American Samoa is not to be considered a nonresident alien individual. See paragraph (d) of § 1.1402(b)–1. A return is required under this section if an individual has self-employment income, as defined in section 1402(b), even though he may not be required to make a return under section 6012 for purposes of the tax imposed by section 1 or 3. Provisions applicable to returns under section 6012(a) shall be applicable to returns under this section.

(2) Except as otherwise provided in this subparagraph, the return required by this section shall be made on Form 1040. The form to be used by residents of the Virgin Islands, Guam, or American Samoa is From 1040SS. In the case of a resident of Puerto Rico who is not required to make a return of income under section 6012(a), the form to be used is Form 1040SS, except that Form 1040PR shall be used if it is furnished by the Internal Revenue Service to such resident for use in lieu of Form 1040SS.

(b) *Joint returns.* (1) In the case of a husband and wife filing a joint return under section 6013, the tax on self-employment income is computed on the separate self-employment income of each spouse, and not on the aggregate of the two amounts. The requirement of section 6013(d)(3) that in the case of a joint return the tax is computed on the aggregate income of the spouses is not applicable with respect to the tax on self-employment income. Where the husband and wife each has net earnings from self-employment of $400 or more, it will be necessary for each to complete separate schedules of the computation of self-employment tax with respect to the net earnings of each spouse, despite the fact that a joint return is filed. If the net earnings from self-employment of either the husband or the wife are less than $400, such net earnings are not subject to the tax on self-employment income, even though they must be shown on the joint return for purposes of the tax imposed by section 1 or 3.

(2) Except as otherwise expressly provided, section 6013 is applicable to the return of the tax on self-employment income; therefore, the liability with respect to such tax in the case of a joint return is joint and several.

(c) *Social security account numbers.* (1) Every individual making a return of net earnings from self-employment for any period commencing before January 1, 1962, is required to show thereon his social security account number, or, if he has no such account number, to make application therefor on Form SS–5 before filing such return. However, the failure to apply for or receive a social security account number will not excuse the individual from the requirement that he file such return on or before the due date thereof. Form SS–5 may be obtained from any district office of the Social Security Administration or from any district director. The application shall be filed with a district office of the Social Security Administration or, in the case of an individual not in the United States, with the district office of the Social Security Administration at Baltimore, Md. An individual who has previously secured a social security account number as an employee shall use that account number on his return of net earnings from self-employment.

(2) For provisions applicable to the securing of identifying numbers and the reporting thereof on returns and schedules for periods commencing after December 31, 1961, see § 1.6109–1.

(d) *Declaration of estimated tax with respect to taxable years beginning after December 31, 1966.* For taxable years beginning after December 31, 1966, section 6015 provides that the term ''estimated tax'' includes the amount which an individual estimates as the amount of self-employment tax imposed by chapter 2 for the taxable year. Thus, individuals upon whom self-employment tax is imposed by section 1401 must make a declaration of estimated tax if they meet the requirements of section 6015(a); except as otherwise provided under section 6015(i).

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6691, 28 FR 12816, Dec. 3, 1963; T.D. 7427, 41 FR 34028, Aug. 12, 1976]

INFORMATION RETURNS

§1.6031–1 Return of partnership income.

(a) *In general*—(1) *General rule.* Except as provided in paragraphs (b) and (d) of this section with respect to certain organizations excluded from the application of subchapter K, chapter 1 of the Code, and certain partnerships having no U.S. business, an unincorporated organization defined as a partnership in section 761(a), through or by means of which any business, financial operation, or venture is carried on, shall make a return for each taxable year on form 1065. For purposes of filing a partnership return, an unincorporated organization will not be considered, within the meaning of section 761(a), to carry on a business, financial operation, or venture as a partnership before the first taxable year in which such organization receives income or incurs any expenditures treated as deductions for Federal income tax purposes. Such return shall state specifically the items of partnership gross income and the deductions allowable by subtitle A of the Code and shall include the names and addresses of all the partners and the amount of the distributive shares of income, gains, loss, deduction, or credit (including any items which enter into the determination of the tax imposed by section 56) allocated to each partner. Such return shall be made for the taxable year of the partnership, irrespective of the taxable years of the partners. For taxable years of a partnership and of a partner, see section 706 and §1.706–1. For signing of a partnership return, see §1.6063–1.

(2) *Special rule.* Except in the case of an unincorporated organization deemed to be excluded from the application of subchapter K in the manner described in paragraph (b)(2)(ii) of §1.761–2 for the first year of its existence, an unincorporated organization described in paragraph (a) of §1.761–2 shall file a partnership return for the first taxable year in which the participants by a formal agreement undertake to engage in joint operations, or in the absence of a formal agreement for the first taxable year in which the participants with respect to the joint use of property jointly have income, or make or incur any expenditures treated as deductions for Federal income tax purposes. Additionally, if an organization described in paragraph (a) of §1.761–2 does not elect under section 761 and the regulations thereunder to be excluded from the application of subchapter K or chapter I of the Code, it is required to file a return for each taxable year subsequent to its first taxable year in accordance with the requirements of this section until an election is made in accordance with paragraph (b)(2)(i) of §1.761–2. Where no annual accounting period has been adopted by an organization described in paragraph (a) of §1.761–2, its taxable year shall be the calendar year in accordance with section 441(g). For special rules in the case of an organization making the election for exclusion under section 761, see paragraphs (b)(2)(i) and (c) of §1.761–2 and paragraph (b) of this section.

(b) *Unincorporated organizations excluded from the application of Subchapter K*—(1) *Wholly excluded.* (i) Any unincorporated organization with respect to which under section 761(a) an election to be excluded from all the provisions of subchapter K of chapter 1 of the Code has been made in the manner described in paragraph (b)(2)(i) of §1.761–2 shall file Form 1065 for the first year with respect to which such an election has been made and such return shall, in lieu of the information therein required, contain or be accompanied by the information required by such paragraph.

(ii) Except as otherwise provided in subdivision (i) of this subparagraph, an unincorporated organization which is wholly excluded from the application of subchapter K need not file a partnership return.

(2) *Partially excluded.* Any unincorporated organization excluded from the

application of part of subchapter K of chapter 1 of the Code shall file a return on Form 1065 containing such information as the Commissioner may require. See section 761 and paragraph (c) of § 1.761–2.

(c) *Partnerships having business or source of income within the United States.* Every partnership engaged in trade or business, or having income from sources, within the United States shall file a partnership return in accordance with this section, whether or not its principal place of business is outside of the United States, and whether or not all its members are nonresident aliens.

(d) *Partnerships having no United States business*—(1) *No return required from partnership.* A partnership carrying on no business in the United States and deriving no income from sources within the United States need not file a partnership return.

(2) *Returns of information with respect to partnership required of citizen or resident partners.* Where a U.S. citizen or resident is a partner in a partnership described in subparagraph (1) of this paragraph which is not required to file a partnership return, the district director or director of the service center may require such person to render such statements or provide such information as is necessary to show whether or not such person is liable for tax on income derived from such partnership. In addition, if an election in accordance with the provisions of section 703 (relating to elections affecting the computation of taxable income derived from a partnership) or section 761 (relating to the election to be excluded from the application of all or part of subchapter K, chapter 1 of the Code) is to be made by or for the partnership, a return on Form 1065 shall be filed for such partnership. See section 6063 and § 1.6063–1, relating to the authority of a partner to sign a partnership return. The filing of one such return for a taxable year of the partnership by a citizen or resident partner shall constitute a filing for the partnership of such partnership return.

(e) *Place and time for filing returns*—(1) *Place for filing*—(i) *Returns filed with district director or Director of International Operations.* The returns of partnerships doing business, or having income from sources, within the United States shall be filed with the district director for the internal revenue district in which the partnership has its principal office or principal place of business within the United States. If a partnership has no office, place of business, or agency within the United States, the return shall be filed with the Director of International Operations, Internal Revenue Service, Washington, DC 20225. A partnership return filed under the authority of paragraph (d)(2) of this section shall be filed with the internal revenue officer with whom the citizen or resident partner files his separate income tax return.

(ii) *Returns filed with service centers.* Notwithstanding subdivision (i) of this subparagraph, unless a return is filed by hand carrying, whenever instructions applicable to partnership returns provide that the return be filed with a service center, the return must be so filed in accordance with the instructions. Returns which are filed by hand carrying shall be filed with the district director (or with any person assigned the administrative supervision of an area, zone or local office constituting a permanent post of duty within the internal revenue district of such director) in accordance with paragraph (e)(1)(i) of this section).

(2) *Time for filing.* The return of a partnership shall be filed on or before the fifteenth day of the fourth month following the close of the taxable year of the partnership, except that the return of a partnership consisting entirely of nonresident aliens shall be filed on or before the fifteenth day of the sixth month following the close of the taxable year of the partnership.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 7012, 34 FR 7690, May 15, 1969; T.D. 7280, 37 FR 20688, Oct. 3, 1972; T.D. 7495, 42 FR 33726, July 1, 1977; T.D. 7564, 43 FR 40497, Sept. 12, 1978]

§ 1.6031(b)–1T Statements to partners (temporary).

(a) *Statement required to be furnished to partners*—(1) *In general.* Except as provided in this paragraph (a)(1) and paragraph (a)(2)(ii) of this section, any partnership required under section 6031(a) and the regulations thereunder to file a partnership return for a taxable year shall furnish to every person who was a partner (within the meaning of section 7701(a)(2)) at any time during the taxable year a written statement containing the information described in paragraph (a)(3) of this section. This section shall not apply to a real estate mortgage investment conduit (REMIC) treated as a partnership under subtitle F of the Code by reason of section 860F(e). For the reporting requirements applicable to REMICs see §1.6031(b)–2T.

(2) *Special rules applicable to partnership interests held by nominees*—(i) *Statements furnished to nominees.* For any partnership taxable year beginning after October 22, 1986, a partnership shall provide a person that holds (directly or indirectly) an interest in such partnership as a nominee on behalf of another person at any time during such year with a statement under paragraph (a)(1) of this section with respect to such interest if—

(A) Such nominee has not furnished the statement required under §1.6031(c)–1T(a)(1)(i) to the partnership with respect to such other person;

(B) Such nominee either holds legal title to such partnership interest in its own name or is identified in a statement provided to the partnership pursuant to §1.6031(c)–1T(a)(1)(i) by another nominee as the person on whose behalf such other nominee holds such interest; and

(C) Such nominee is not a person described in §1.6031(c)–1T(a)(2) (relating to the special rule for clearing agencies).

In such case, the partnership shall assume, for purposes of this section, that the nominee is the beneficial owner of the partnership interest.

(ii) *Statements not required to be furnished to partners holding partnership interests through nominees.* A partnership shall not be required to furnish a statement under paragraph (a)(1) of this section to a partner with respect to any portion of such partner's interest in the partnership that is owned through a nominee if—

(A) Such nominee has not furnished (or is not required to furnish under §1.6031(c)–1T(a)(2)), a statement to the partnership under §1.6031(c)–1T(a)(1)(i) with respect to such partner; and

(B) Such partner has not furnished (or is not required to furnish) a statement to the partnership under §1.6031(c)–1T(a)(3), with respect to such interest in the partnership.

(3) *Contents of statement.* The statement required under paragraph (a)(1) of this section shall include the following information:

(i) The partner's distributive share of partnership income, gain, loss, deduction, or credit required to be shown on the partnership return (or, for taxable years beginning before January 1, 1987, the partner's distributive share of partnership income, gain, loss, deduction, or credit shown on the partnership return); and

(ii) To the extent provided by form or the accompanying instructions, any additional information that may be required to apply particular provisions of subtitle A of the Code to the partner with respect to items related to the partnership.

(b) *Time for furnishing statement.* The statement required to be furnished by the partnership under paragraph (a)(1) of this section shall be furnished on or before the day on which the partnership return for that taxable year is required to be filed (determined with regard to extensions). For partnership returns the due date for which (determined without regard to extensions) is before January 1, 1987, the statement required to be furnished by the partnership under paragraph (a)(1) of this section shall be furnished on or before the day on which the partnership return is filed.

(c) *Statement may be provided to agent.* If a partner designates another person, such as an attorney or an investment advisor, as the partner's (or nominee's) agent in dealing with the partnership, the partnership may provide the statement required under paragraph (a)(1) of this section with respect to such partner to such other person instead of the partner.

(d) *Penalties.* For penalties for failure to comply with the requirements of section 6031(b) and paragraph (a) of this section, see section 6722(a).

(e) *Effective date.* Except as otherwise provided in this section, the provisions of this section apply to partnership taxable years beginning after September 3, 1982.

[T.D. 8225, 53 FR 34490, Sept. 7, 1988]

§ 1.6031(b)–2T REMIC reporting requirements (temporary). [Reserved]

§ 1.6031(c)–1T Nominee reporting of partnership information (temporary).

(a) *Statements required to be furnished to partnership*—(1) *Statement from nominee*—(i) *In general.* Except as otherwise provided in this section, any person who holds, directly or indirectly, an interest in a partnership (required under section 6031(a) and the regulations thereunder to file a partnership return for a taxable year) as a nominee on behalf of another person at any time during the partnership taxable year shall furnish to the partnership a written statement (or statements) for that taxable year with respect to such other person containing the information described in paragraph(a)(1)(ii) of this section.

(ii) *Contents of statement.* The statement required under paragraph (a)(1)(i) of this section shall, except as otherwise provided in paragraph (a)(4) of this section, include the following information:

(A) The name, address, and taxpayer identification number of the nominee;

(B) The name, address, and taxpayer identification number of such other person;

(C) Whether such other person is—

(*1*) A person that is not a United States person;

(*2*) A foreign government, an international organization, or any wholly-owned agency or instrumentality of either of the foregoing; or

(*3*) A tax-exempt entity (within the meaning of section 168(h)(2));

(D) A description of any interest in the partnership held by the nominee on behalf of such other person at the beginning of the partnership taxable year;

(E) A description of any interest in the partnership that the nominee acquires (within the meaning of paragraph (g)(1) of this section) on behalf of such other person during the partnership taxable year, the method of acquisition (e.g., purchase, exchange, acquisition at death, gift, or commencement of nominee relationship) and acquisition cost (within the meaning of paragraph (g)(2) of this section) of such interest, and the date of the acquisition of such interest; and

(F) A description of any interest in the partnership that the nominee transfers (within the meaning of paragraph (g)(5) of this section) on behalf of such other person during the partnership taxable year, the net proceeds from the transfer (within the meaning of paragraph (g)(6) of this section) of such interest, and the date of the transfer of such interest.

A description of a partnership interest must include sufficient detail to enable the partnership to furnish to such other person the statement required under § 1.6031(b)–1T (a).

(2) *Special rule for clearing agencies.* A clearing agency registered pursuant to the provisions of section 17A of the Securities Exchange Act of 1934 (or its nominee) that holds an interest in a partnership as a nominee on behalf of another person shall not be required to furnish any statement described in paragraph (a)(1)(i) of this section with respect to such interest.

(3) *Special rule for brokers and financial institutions*—(i) *Additional statement required.* Any broker (within the meaning of paragraph (g)(3) of this section) or financial institution (within the meaning of paragraph (g)(4) of this section) that holds an interest in a partnership indirectly through a nominee described in paragraph (a)(2) of this section at any time during a partnership taxable year shall furnish (in addition to any statement (or statements) required under paragraph (a)(1)(i) of this section) to the partnership a written statement (or statements) containing the information described in paragraph (a)(3)(ii) of this section with respect to any interest in such partnership that it holds (directly or indirectly) for its own account at any time during such partnership taxable year.

(ii) *Contents of statement.* The statement required under paragraph (a)(3)(i) of this section shall, except as otherwise provided in paragraph (a)(4) of this section, include the following information:

(A) The name, address, and taxpayer identification number of the broker or financial institution;

(B) Whether such broker of financial institution is a person that is not a United States person;

(C) A description of any interest in the partnership held by the broker or financial institution for its own account at the beginning of the partnership taxable year;

(D) A description of any interest in the partnership that the broker or financial institution acquires for its own account during the partnership taxable year, the method of acquisition and acquisition cost of such interest, and the date of the acquisition of such interest; and

(E) A description of any interest in the partnership that the broker or financial institution transfers for its own account during the partnership taxable year, the net proceeds from the transfer of such interest, and the date of the transfer of such interest.

A description of a partnership interest held by a broker or financial institution for its own account must include sufficient detail to enable the partnership to furnish to the broker or financial institution the statement required under §1.6031(b)–1T (a).

(4) *Exception*—(i) *In general.* Except as otherwise provided in this paragraph (a)(4), any statement required under paragraph (a) (1)(i) or (3)(i) of this section for a taxable year is not required to include—

(A) That part of the information described in paragraph (a) (1)(ii)(E) and (3)(ii)(D) of this section regarding the method of acquisition and acquisition cost; or

(B) That part of the information described in paragraph (a)(1)(ii)(F) and (3)(ii)(E) of this section regarding the net proceeds from the transfer;

to the extent that, prior to the beginning of the partnership taxable year, the partnership has provided the nominee with a written statement that the nominee need not provide such information to the partnership, and the partnership has not modified or revoked such statement. For purposes of the preceding sentence, the modification or revocation of a statement furnished to a nominee is effective for a partnership taxable year if and only if the partnership notifies the nominee of such modification or revocation by a written statement more than 60 days before the beginning of the partnership taxable year. The nominee shall retain a copy of any statement that is furnished to it by the partnership under this paragraph (a)(4) in the nominee's records so long as the contents thereof may become material in the administration of any internal revenue law.

(ii) *Effect of election under section 754.* Paragraph (a)(4)(i)(A) of this section shall not apply to a partnership taxable year if—

(A) The partnership has an election in effect under section 754 (relating to optional adjustment to basis of partnership property) for such taxable year; and

(B) The nominee knows or has reason to know of such election more than 60 days before the beginning of such taxable year.

(5) *Examples.* The following examples illustrate the application of this paragraph (a):

Example (1). B, a broker, holds 50 units of interest in Partnership P, a calendar year partnership, in street name for customer A, the beneficial owner. B holds the units on behalf of A at all times during 1989. B must furnish a statement to P for calendar year 1989 under paragraph (a)(1)(i) of this section that includes the information required under paragraph (a)(1)(ii) (A) through (D) of this section. The description of the partnership interest held by B on A's behalf on January 1, 1989, must identify the number of units of P held by B on A's behalf at that time (50), and the class of the partnership interest (including the Committee on Uniform Security Identification Procedures (CUSIP) number of the partnership interest, if known).

Example (2). The facts are the same as in example (1), except that pursuant to A's instructions, B sells 25 of A's units of interest in P on August 1, 1989, receiving net proceeds from the transfer of $500. In addition to the information described in example (1), the statement that B must furnish to P must include the class of the partnership interest transferred (including the CUSIP number of the partnerhsip interest, if known), the number of units transferred (25), the net proceeds from the transfer ($500), and the date of the transfer (August 1, 1989.)

Example (3). The facts are the same as in example (1), except that A is not the beneficial owner, but rather holds the units as a nominee on behalf of C, the beneficial owner, at all times during 1989. In addition to the statement that B must furnish to P (as described in Example (1) of this paragraph (a)(5)), A must furnish a statement to P for calendar year 1989 under paragraph (a)(1)(i) of this section that includes the information required under paragraph (a)(1)(ii) (A) through (D) of this section. If both A and B provide P with the statement required under paragraph (a)(1)(i) of this section, P must provide C with the statement required under § 1.6031(b)–1T (a)(1).

(b) *Time for furnishing statements.* A nominee may furnish to the partnership any statement required under paragraph (a) of this section annually, quarterly, monthly, or on any other basis, provided that all statements required to be furnished under paragraph (a) of this section for a partnership taxable year shall be furnished on or before the last day of the first month following the close of such partnership taxable year.

(c) *Use of magnetic media.* A nominee required to furnish a written statement under paragraph (a) of this section, may, in lieu of furnishing such written statement, furnish the required information on magnetic tape or by other media if the partnership and the nominee so agree.

(d) *Use of single document.* Any person who holds interests in a partnership as a nominee on behalf of more than one other person during the partnership taxable year, may, in lieu of furnishing to the partnership a separate statement for each such other person, furnish to the partnership a single document which includes, for each such other person, the information described in paragraph (a)(1)(ii) of this section. To the extent that a single document is used, references in this section to the statement required under paragraph (a)(1)(i) of this section shall be deemed to refer also to the information included in a single document under this paragraph (d).

(e) *Retention of information.* The nominee shall retain a copy of any statement that is furnished to the partnership under this section in the nominee's records so long as the contents thereof may become material in the administration of any internal revenue law.

(f) *Use of agent.* If a partnership has designated another person, such as a clearing organization, as the partnership's agent for purposes of receiving the statements required under paragraph (a) of this section, such statements may be furnished to that other person instead of the partnership. If a nominee has designated another person as its agent for purposes of furnishing to the partnership (or its agent) the statements required under paragraph (a) of this section, that other person may furnish such statements to the partnership (or its agent) on behalf of the nominee.

(g) *Meaning of terms.* For purposes of this section, the following terms have the meanings set forth below:

(1) The term *acquires* means—

(i) A purchase or other acquisition of a partnership interest; or

(ii) The commencement of a nominee relationship, including the substitution of one nominee for another.

(2) The term *acquisition cost* means the sum of any money paid and the fair market value of any property (other than money) transferred to acquire a partnership interest increased by any expenses paid or incurred with respect to the acquisition (such as broker's fees or commissions).

(3) The term *broker* shall have the meaning set forth in paragraph (a)(1) of § 1.6045ca–1.

(4) The term *financial institution* means a financial institution such as a bank, mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, industrial loan association or bank or other similar organization.

(5) The term *transfer* means—

(i) A sale, exchange, or other disposition of a partnership interest; or

(ii) The termination of a nominee relationship, including the substitution of one nominee for another.

(6) The term *net proceeds from the transfer* means the sum of any money and the fair market value of any property (other than money) received in connection with a transfer of a partnership interest reduced by any expenses paid or incurred with respect to the transfer (such as broker's fees or commissions).

(7) The term *person* includes the United States, a State, the District of

Columbia, a foreign government, a political subdivision of a State or foreign government, or an international organization.

(h) *Statement required by nominees that do not comply with §1.6031(c)–1T (a)*—(1) *In general.* Any person that—

(i) Holds an interest in a partnership as a nominee (other than a nominee described in paragraph (a)(3) of this section) on behalf of another person at any time during the partnership taxable year;

(ii) Does not furnish to such partnership the statement required under paragraph (a)(1)(i) of this section for such other person with respect to such interest in the partnership; and

(iii) Receives from such partnership the statement described in paragraph (a)(1) of §1.6031(b)–1T with respect to such interest in the partnership;

shall furnish to such other person a written statement containing the information described in paragraph (h)(2) of this section with respect to such interest in the partnership.

(2) *Contents of statement.* The statement required under paragraph (h)(1) of this section shall contain the following information:

(i) The distributive share of partnership income, gain, loss, deduction or credit required to be shown on the partnership return that is allocable to such interest in the partnership; and

(ii) Any additional information that may be required to apply particular provisions of subtitle A of the Code to the beneficial owner of such interest in the partnership in connection with items related to the partnership.

(3) *Time for furnishing statements.* A nominee shall furnish the statement required under paragraph (h)(1) of this section within 30 days after receiving the statement described in paragraph (a) of §1.6031(b)–1T.

(i) *REMICs.* This section shall not apply with respect to any interest in a real estate mortgage investment conduit (REMIC) treated as a partnership under subtitle F of the Code by reason of section 860F(e). For the nominee reporting requirements with respect to REMICs see §1.6031(c)–2T.

(j) *Penalties.* [Reserved]

(k) *Effective date*—(1) *In general.* Except as otherwise provided in paragraph (k)(2) of this section, the provisions of this section shall apply to partnership taxable years beginning after October 22, 1986.

(2) *Transitional rule for taxable years beginning before January 1, 1989.* For partnership taxable years beginning before January 1, 1989, —

(i) Any statement that a nominee is required to furnish to a partnership under paragraph (a)(1) of this section shall not be required to include the following information:

(A) The information described in paragraph (a)(1)(ii)(C) of this section;

(B) That part of the information described in paragraph (a)(1)(ii)(E) of this section regarding the method of acquisition and acquisition cost of a partnership interest; or

(C) That part of the information described in paragraph (a)(1)(ii)(F) of this section regarding the net proceeds from the transfer of a partnership interest.

(ii) A broker or financial institution shall not be required to furnish the additional statement described in paragraph (a)(3)(i) of this section.

[T.D. 8225, 53 FR 34491, Sept. 7, 1988]

§1.6031(c)–2T Nominee reporting of REMIC information (temporary). [Reserved]

§1.6032–1 Returns of banks with respect to common trust funds.

Every bank (as defined in section 581) maintaining a common trust fund shall make a return of income of the common trust fund, regardless of the amount of its taxable income. Member banks of an affiliated group that serve as co-trustees with respect to a common trust fund must act jointly in making a return for the fund. If a bank maintains more than one common trust fund, a separate return shall be made for each. No particular fund is prescribed for making the return under this section, but form 1065 may be used if it is designated by the bank as the return of a common trust fund. The return shall be made for the taxable year of the common trust fund and shall be filed on or before the 15th day of the fourth month following the close of such taxable year with the district director for the district in which the income tax return of the bank is filed. Such return shall state specifically with respect to the fund the items of gross income and the deductions allowed by subtitle A of the Code, shall include each participant's name and address, the participant's proportionate share of taxable income or net loss (exclusive of gains and losses from sales or exchanges of capital assets), the participant's proportionate share of gains and losses from sales or exchanges of capital assets, and the participant's share of items which enter into the determination of the tax imposed by section 56. See § 1.584–2 and § 1.58–5. If the common trust fund is maintained by two or more banks that are members of the same affiliated group, the return must also identify the member bank in the group that has contributed each participant's property or money to the fund. A copy of the plan of the common trust fund must be filed with the return. If, however, a copy of such plan has once been filed with a return, it need not again be filed if the return contains a statement showing when and where it was filed. If the plan is amended in any way after such copy has been filed, a copy of the amendment must be filed with the return for the taxable year in which the amendment was made. For the signing of a return of a bank with respect to common trust funds, see § 1.6062–1, relating to the manner prescribed for the signing of a return of a corporation.

[T.D. 7564, 43 FR 40497, Sept. 12, 1978, as amended by T.D. 7935, 49 FR 1695, Jan. 13, 1984]

§ 1.6033–1 Returns by exempt organizations; taxable years beginning before January 1, 1970.

(a) *In general.* (1) Except as provided in section 6033(a) and paragraph (g) of this section, every organization exempt from taxation under section 501(a) shall file an annual return of information specifically stating its items of gross income, receipts and disbursements, and such other information as may be prescribed in the instructions issued with respect to the return. Such information return shall be filed annually regardless of the amount or source of the income or receipts of the organization. Except as provided in paragraph (d) of this section, such return shall be filed annually regardless of whether such organization is chartered by, or affiliated or associated with, any central, parent, or other organization.

(2)(i) Except as otherwise provided in this subparagraph, every organization exempt from taxation under section 501 (a), and required to file a return under section 6033 and this section, other than an organization described in section 401 (a), 501(c) (3), or 501(d), shall file its annual return on Form 990. However, such an exempt organization, instead of filing Form 990, may file its annual return on Form 990 (SF), a short form, if its gross receipts for the taxable year do not exceed $10,000 and its total assets on the last day of its taxable year do not exceed $10,000.

(ii) For purposes of this subparagraph and subparagraph (4) of this paragraph, ''gross receipts'' means the gross amount received by the organization during its annual accounting period from all sources without reduction for any costs or expenses including, for example, cost of goods or assets sold, cost of operations, or expenses of earning, raising, or collecting such amounts. Thus, ''gross receipts'' includes, but is not limited to, *(a)* the gross amount received as contributions, gifts, grants, and similar amounts without reduction for the expenses of raising and collecting such amounts, *(b)* the gross amount received as dues or assessments from members or affiliated organizations without reduction for expenses attributable to the receipt of such amounts, *(c)* gross sales or receipts from business activities (including business activities unrelated to the purpose for which the organization received an exemption, the net income or loss from which may be required to be reported on Form 990–T), *(d)* the gross amount received from the sale of assets without reduction for cost or other basis and expenses of sale, and *(e)* the gross amount received as investment income such as interest, dividends, rents, and royalties.

(3) Every employees' trust described in section 401 (a) which is exempt from taxation under section 501 (a) shall file an annual return on Form 990–P. The

return shall include the information required by paragraph (b)(5) (ii) of § 1.401–1. In addition, the trust must file the information required to be filed by the employer pursuant to the provisions of § 1.404(a)–2, unless the employer has notified the trustee in writing that he has or will timely file such information. If the trustee has received such notification from the employer, then such notification, or a copy thereof, shall be retained by the trust as a part of its records.

(4) Except as otherwise provided in this subparagraph, every organization described in section 501(c) (3), which is required to file a return under section 6033 and this section, shall file its annual return on Form 990–A. However, such an exempt organization, instead of filing Form 990–A, may file its annual return on Form 990–A (SF), a short form, if its gross receipts for the taxable year do not exceed $10,000 and its total assets on the last day of its taxable year do not exceed $10,000. For purposes of this subparagraph, ‘‘gross receipts’’ shall be defined in the manner prescribed in subparagraph (2) (ii) of this paragraph. The forms prescribed by this subparagraph shall be as follows:

(i) Form 990–A shall consist of parts I and II. Part I shall contain, in addition to information required in part II, such information as may be prescribed in the return and instructions which is required to be furnished by section 6033(a) or which is necessary to show whether or not such organization is exempt from tax under section 501(a). Part II, which shall be open to public inspection pursuant to section 6104 and other applicable sections and the regulations thereunder, shall contain principally the information required by section 6033(b) and the regulations thereunder. The information contained in part II, to be furnished by the organization in duplicate in the manner prescribed by the instructions issued with respect to the return, is as follows:

(a) Its gross income for the year. For this purpose, gross income includes tax-exempt income, but does not include contributions, gifts, grants, and similar amounts received. Whether or not an item constitutes a contribution, gift, grant, or similar amount, depends upon all the surrounding facts and circumstances.

(b) Its expenses attributable to such income and incurred within the year.

(c) Its disbursements out of income (including prior years’ accumulations) made within the year for the purposes for which it is exempt. Information shall be included as to the class of activity with a separate total for each activity as well as the name, address, and amount received by each individual or organization receiving cash, other property, or services within the taxable year. If the donee is related by blood, marriage, adoption, or employment (including children of employees) to any person or corporation having an interest in the exempt organization, such as a creator, donor, director, trustee, or officer, the relationship of the donee shall be stated. Activities shall be classified according to purpose in greater detail than merely charitable, educational, religious, or scientific. For example, payments for nursing service, for laboratory construction, for fellowships, or for assistance to indigent families shall be so identified. Where the fair market value of the property at the time of disbursement is used as the measure of the disbursement, the book value of such property (and a statement of how book value was determined) shall also be furnished, and any difference between the fair market value at the time of disbursement and the book value should be reflected in the books of account. The expenses allocable to making the disbursements shall be set forth in such detail as is prescribed by the form or instructions.

(d) Its accumulation of income within the year. The amount of such accumulation is obtained by subtracting from the amount in *(a)* of this subdivision the sum of the amounts determined in *(b)* and *(c)* of this subdivision and the expenses allocable to carrying out the purposes for which it is exempt.

(e) Its aggregate accumulation of income at the beginning and end of the year. The aggregate accumulation of income shall be divided between that which is attributable to the gain or

loss on the sale of assets (excluding inventory items) and that which is attributable to all other income. For this purpose expenses and disbursements shall be allocated on the basis of accounting records, the governing instrument, or applicable local law.

(f) Its disbursements out of principal in the current and prior years for the purposes for which it is exempt. In addition, the same type of information shall be required with respect to disbursements out of principal made in the current year as is prescribed by *(c)* of this subdivision with respect to disbursements out of income.

(g) A balance sheet showing its assets, liabilities, and net worth as of the beginning and end of such year. Detailed information on the assets, liabilities, and net worth shall be furnished on the schedule provided for this purpose on the Form 990–A. Such schedule shall be supplemented by attachments where appropriate.

(h) The total of the contributions and gifts received by it during the year. A statement shall be included showing the gross amount of contributions and gifts collected by the organization, the expenses incurred by the organization in collecting such amount, and the net proceeds.

(i) In addition to the information required in *(a)* through *(h)* of this subdivision, the organization shall furnish such specific information and answer such specific questions as are required by the form or instructions.

(ii) Form 990–A (SF) is a short form consisting of a single part which contains such information as may be prescribed in the return and instructions which is required to be furnished by section 6033(a) or which is necessary to show whether or not such organization is exempt from tax under section 501(a). In addition, Form 990–A (SF) shall contain the information required by section 6033(b) which must be furnished in the manner prescribed in the instructions issued with respect to the return. Form 990–A (SF) shall be open to public inspection pursuant to section 6104 and other applicable sections and the regulations thereunder.

(5)(i) Every religious or apostolic association or corporation described in section 501 (d) which is exempt from taxation under section 501(a) shall file a return on Form 1065 for each taxable year, stating specifically the items of gross income and deductions, and its taxable income. There shall be attached to the return as a part thereof a statement showing the name and address of each member of the association or corporation and the amount of his distributive share of the taxable income of the association or corporation for such year.

(ii) If the taxable year of any member is different from the taxable year of the association or corporation, the distributive share of the taxable income of the association or corporation to be included in the gross income of the member for his taxable year shall be based upon the taxable income of the association or corporation for its taxable year ending with or within the taxable year of the member.

(b) *Accounting period for filing return.* A return on Form 990, 990–A, 990 (SF), 990–A (SF), or 990–P shall be on the basis of the established annual accounting period of the organization. If the organization has no such established accounting period, such return shall be on the basis of the calendar year.

(c) *Returns when exempt status not established.* An information return on Form 990, 990–A, 990 (SF), or 990–A (SF) is not required to be filed by an organization claiming an exempt status under section 501(a) prior to the establishment by the organization of such exempt status under section 501 and § 1.501(a)–1. If the date for filing an income tax return and paying the tax occurs before the tax-exempt status of the organization has been established, the organization is required to file the income tax return and pay the tax. However, see sections 6081 and 6161 and the regulations thereunder for extensions of time for filing the return and paying the tax. Upon establishment of its exempt status, the organization may file a claim for a refund of income taxes paid for the period for which its exempt status is established.

(d) *Group returns.* (1) A central, parent, or like organization (referred to in this paragraph as ‘‘central organization’’), exempt under section 501(a) and described in section 501(c), although required to file a separate annual return for itself under section 6033 and paragraph (a) of this section, may file annually, in addition to such separate annual return, a group return on Form 990 or 990–A, 990 (SF), or 990–A (SF), as may be appropriate. Form 990 (SF) or 990–A (SF) may be used where each local organization qualifies under paragraph (a) of this section. Such group return may be filed for two or more of the local organizations, chapters, or the like (referred to in this paragraph as ''local organizations'') which are (i) affiliated with such central organization at the close of its annual accounting period, (ii) subject to the general supervision or control of the central organization, and (iii) exempt from taxation under the same paragraph of section 501(c) of the Code, although the local organizations are not necessarily exempt under the paragraph under which the central organization is exempt.

(2)(i) The filing of the group return shall be in lieu of the filing of a separate return by each of the local organizations included in the group return. The group return shall include only those local organizations which in writing have authorized the central organization to include them in the group return, and which have made and filed, with the central organization, their statements, specifically stating their items of gross income, receipts, and disbursements, and such other information relating to them as is required to be stated in the group return. Such an authorization by a local organization shall be made annually, under the penalties of perjury, and shall be signed by a duly authorized officer of the local organization in his official capacity and shall contain the following statement, or a statement of like import: ''I hereby declare under the penalties of perjury that this authorization (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is true, correct and complete and made in good faith for the taxable year stated.'' Such authorizations and statements shall be permanently retained by the central organization.

(ii) There shall be attached to the group return and made a part thereof a schedule showing the name and address of each of the local organizations and the total number thereof included in such return, and a schedule showing the name and address of each of the local organizations and the total number thereof not included in the group return.

(3) The group return shall be on the basis of the established annual accounting period of the central organization. Where such central organization has no established annual accounting period, such return shall be on the basis of the calendar year. The same income, receipts, and disbursements of a local organization shall not be included in more than one group return.

(4) The group return shall be filed in accordance with these regulations and the instructions issued with respect to Form 990, 990–A, 990 (SF), or 990–A (SF), whichever is appropriate, and shall be considered the return of each local organization included therein. The tax-exempt status of a local organization must be established under a group exemption letter issued to the central organization before a group return including the local organization will be considered as the return of the local organization. See §1.501(a)–1 for requirements for establishing a tax-exempt status.

(e) *Time and place for filing.* The annual return of information on Form 990, 990–A, 990 (SF), 990–A (SF), or 990–P shall be filed on or before the 15th day of the fifth calendar month following the close of the period for which the return is required to be filed. The annual return on Form 1065 required to be filed by a religious or apostolic association or corporation shall be filed on or before the 15th day of the fourth month following the close of the taxable year for which the return is required to be filed. Each such return shall be filed in accordance with the instructions applicable thereto.

(f) *Penalties.* For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203, 7206, and 7207.

(g) *Organizations not required to file annual returns.* (1) (i) Annual returns on

Form 990–A or Form 990–A (SF) are not required to be filed by an organization described in section 501 (c) (3) which has established its right to exemption from taxation under section 501 (a) and which is:

(a) Organized and operated exclusively for religious purposes;

(b) Operated, supervised, or controlled by or in connection with an organization which is organized and operated exclusively for religious purposes;

(c) An educational organization which normally maintains a regular faculty and curriculum and normally has a regularly organized body of pupils or students in attendance at the place where its educational activities are regularly carried on; or

(d) A charitable organization, or an organization for the prevention of cruelty to children or animals, which is supported, in whole or in part, by funds contributed by the United States or any State or political subdivision thereof, or which is primarily supported by contributions of the general public.

(ii) An educational organization which normally maintains and has a regular faculty, curriculum, and student body and meets the conditions of subdivision (i)*(c)* of this subparagraph, which relieves it from the requirement of filing annual returns, shall not be considered as having thereafter failed to continue meeting such conditions if it is temporarily compelled to curtail or discontinue its normal and regular activities during the existence of abnormal circumstances and conditions.

(iii) An organization organized and operated exclusively for charitable purposes or for the prevention of cruelty to children or animals is ‘‘primarily supported by contributions of the general public’’ for any accounting period if more than 50 percent of its income and receipts for such period is actually derived from voluntary contributions and gifts made by the general public, as distinguished from a few contributors or donors or from related or associated persons. For purposes of this subdivision, the words ‘‘related or associated persons’’ refer to persons of a particular group who are connected with or are interested in the activities of the organization, such as founders, incorporators, shareholders, members, fiduciaries, officers, employees, or the like, or who are connected with such persons by family or business relationships. An organization claiming an exception from the filing of an information return under this subdivision must maintain adequate records in order to substantiate such claim. Furthermore, if it is doubtful to an organization that it falls within this exception for filing annual information returns, it must file the return on Form 990–A or Form 990–A (SF).

(2) The annual return on Form 990 or Form 990 (SF) need not be filed by:

(i) A fraternal beneficiary society, order, or association, described in section 501(c)(8), or

(ii) An organization described in section 501(c)(1) if it is a corporation wholly owned by the United States or any agency or instrumentality thereof, or is a wholly owned subsidiary of such a corporation,

which has established its exemption from tax under section 501(a).

(3) The provisions of section 6033(a) relieving certain specified types of organizations exempt from tax under section 501(a) from filing annual returns do not abridge or impair in any way the powers and authority of district directors or directors of service centers provided for in other provisions of the Code and in the regulations thereunder to require the filing of such returns by such organizations. See section 6001 and § 1.6001–1.

(h) *Records, statements, and other returns of tax-exempt organizations.* (1) An organization which has established its right to exemption from tax under section 501(a) and has also established that it is not required to file annually the return of information on Form 990, 990–A, 990 (SF), or 990–A (SF) shall immediately notify in writing the district director for the internal revenue district in which its principal office is located of any changes in its character, operations, or purpose for which it was originally created.

(2) Every organization which has established its right to exemption from tax, whether or not it is required to file an annual return of information, shall submit such additional information as

may be required by the district director for the purpose of enabling him to inquire further into its exempt status and to administer the provisions of subchapter F (section 501 and following), chapter 1 of the Code, and of section 6033. See section 6001 and §1.6001–1 with respect to the authority of the district director or directors of service centers to require such additional information and with respect to the permanent books of account or records to be kept by such organizations.

(3) An organization which has established its right to exemption from tax under section 501(a), including an organization which is relieved under section 6033 and this section from filing annual returns of information, is not, however, relieved from the duty of filing other returns of information. See, for example, sections 6041 and 6051 and the regulations thereunder.

(i) *Unrelated business tax returns.* In addition to the foregoing requirements of this section, certain organizations otherwise exempt from tax under section 501(a) and described in section 501(c) (2), (3), (5), (6), or (17) or section 401(a) which are subject to tax on unrelated business taxable income are also required to file returns on Form 990–T. See paragraph (e) of §1.6012–2 and paragraph (a)(5) of §1.6012–3 for requirements with respect to such returns.

(j) *Effective date.* The provisions of this section shall apply with respect to returns filed for taxable years beginning before January 1, 1970.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6722, 29 FR 5075, Apr. 14, 1964; T.D. 6972, 33 FR 12907, Sept. 12, 1968; T.D. 6980, 33 FR 16446, Nov. 9, 1968; T.D. 7122, 36 FR 11026, June 8, 1971]

§1.6033–2 Returns by exempt organizations (taxable years beginning after December 31, 1969) and returns by certain nonexempt organizations (taxable years beginning after December 31, 1980).

(a) *In general.* (1) Except as provided in section 6033(a)(2) and paragraph (g) of this section, every organization exempt from taxation under section 501(a) shall file an annual information return specifically setting forth its items of gross income, gross receipts and disbursements, and such other information as may be prescribed in the instructions issued with respect to the return. Except as provided in paragraph (d) of this section, such return shall be filed annually regardless of whether such organization is chartered by, or affiliated or associated with, any central, parent, or other organization.

(2)(i) Except as otherwise provided in this paragraph and paragraph (g) of this section, every organization exempt from taxation under section 501(a), and required to file a return under section 6033 and this section (including, for taxable years ending before December 31, 1972, private foundations, as defined in section 509(a)), other than an organization described in section 401(a) or 501(d), shall file its annual return on Form 990. For taxable years ending on or after December 31, 1972, every private foundation shall file Form 990–PF as its annual information return. For taxable years beginning after December 31, 1977, every section 501(c)(21) black lung trust shall file an annual information return on Form 990–BL or any other form prescribed by the Internal Revenue Service for that purpose.

(ii) The information generally required to be furnished by an organization exempt under section 501(a) is:

(a) Its gross income for the year. For this purpose, gross income includes tax-exempt income, but does not include contributions, gifts, grants, and similar amounts received. Whether an item constitutes a contribution, gift, grant, or similar amount depends upon all the surrounding facts and circumstances. The computation of gross income shall be made by subtracting the cost of goods sold from all receipts other than gross contributions, gifts, grants, and similar amounts received and nonincludible dues and assessments from members and affiliates.

(b) To the extent not included in gross income, its dues and assessments from members and affiliates for the year.

(c) Its expenses incurred within the year attributable to gross income.

(d) Its disbursements (including prior years' accumulations) made within the year for the purposes for which it is exempt.

(e) A balance sheet showing its assets, liabilities, and net worth as of the

beginning and end of such year. Detailed information relating to the assets, liabilities, and net worth shall be furnished on the schedule provided for this purpose on the return required by this section. Such schedule shall be supplemented by attachments where appropriate.

(f) The total of the contributions, gifts, grants and similar amounts received by it during the taxable year, and the names and addresses of all persons who contributed, bequeathed, or devised $5,000 or more (in money or other property) during the taxable year. In the case of a private foundation (as defined in section 509(a)), the names and addresses of all persons who became substantial contributors (as defined in section 507(d)(2)) during the taxable year shall be furnished. In addition, for its first taxable year beginning after December 31, 1969, each private foundation shall furnish the names and addresses of all persons who became substantial contributors before such taxable year. For special rules with respect to contributors and donors, see subdivision (iii) of this subparagraph.

(g) The names and addresses of all officers, directors, or trustees (or any person having responsibilities or powers similar to those of officers, directors, or trustees) of the organization, and, in the case of a private foundation, all persons who are foundation managers, within the meaning of section 4946(b)(1). Organizations described in section 501(c)(3) must also attach a schedule showing the names and addresses of the five employees (if any) who received the greatest amount of annual compensation in excess of $30,000; the total number of other employees who received annual compensation in excess of $30,000; the names and addresses of the five independent contractors (if any) who performed personal services of a professional nature for the organization (such as attorneys, accountants, and doctors, whether such services are performed by such persons in their individual capacity or as employees of a professional service corporation) and who received the greatest amount of compensation in excess of $30,000 from the organization for the year for the performance of such services; and the total number of other such independent contractors who received in excess of $30,000 for the year for the performance of such services.

(h) A schedule showing the compensation and other payments made during the organization's annual accounting period (or during the calendar year ending within such period) which are includible in the gross income of each individual whose name is required to be listed in *(g)* of this subdivision.

(i) For any taxable year ending on or after December 31, 1971, such information as is required by Forms 4848 and 4849 and, only with respect to any such taxable year ending before December 31, 1972, such information as is required by Form 2950. Such forms are required by this section to be filed by an organization exempt from tax under section 501(a) which is an employer who maintains a funded pension or annuity plan for its employees. See paragraph (g) of this section for exceptions from filing. Form 4849 need not be filed by the organization if the fiduciary for the plan has given written notification to the organization that such form will be filed as an attachment to Form 990–P filed by the fiduciary. Form 4848 (and Form 4849 if required to be filed by the organization) shall be filed as a separate return on or before the due date for Form 990. For rules relating to the extension of time for filing, see section 6081 and the regulations thereunder and the instructions for Form 4848. A central organization which files Form 990 as a group return under paragraph (d) of this section may also file Form 4848 as a group return. The rules provided by paragraph (d) of this section with respect to a group return filed on Form 990 shall apply to a group return filed on Form 4848. Unless otherwise expressly provided therein, an authorization to include a local organization in a group for purposes of filing Form 990 as a group return shall be treated as an authorization to include such local organization in a group for purposes of filing Form 4848 as a group return. A group return on Form 4848 shall be filed in accordance with this section and the instructions to Form 4848 and shall be considered the return of each local organization included therein. In addition to the information required to

be furnished by Forms 4848 and 4849, the district director may require any further information that he considers necessary to determine qualification of the plan under section 401 or the taxability under section 403(b) of a beneficiary under an annuity purchased by a section 501(c)(3) organization.

(*j*) In the case of a private foundation liable for tax imposed under chapter 42, such information as is required by Form 4720.

(*k*) Its lobbying expenditures, grass roots expenditures, exempt purpose expenditures, lobbying nontaxable amount, and grass roots nontaxable amount for the taxable year and for prior taxable years that are base years (within the meaning of § 1.501(h)–3(c)(7)), if the organization has an election under section 501(h) in effect for the taxable year. An organization that is a member of an affiliated group of organizations (as defined in § 56.4911–7(e)) but that is not a member of a limited affiliated group (as defined in § 56.4911–10(b)) shall report this information based on the expenditures of all members of the group during the taxable year of the group that ends with or within the member's taxable year and for prior taxable years of the group that are base years (within the meaning of § 56.4911–9(b)). For additional information required to be furnished by members of an affiliated group of organizations, and by controlling members in a limited affiliated group, see §§ 56.4911–9(d) and 56.4911–10(f)(1), respectively.

(iii) *Special rules.* In providing the names and addresses of contributors and donors under subdivision (ii)*(f)* of this subparagraph:

(a) An organization described in section 501(c)(3) which meets the 33⅓ percent-of-support test of the regulations under section 170(b)(1)(A)(vi) (without regard to whether such organization otherwise qualifies as an organization described in section 170(b)(1)(A)) is required to provide the name and address of a person who contributed, bequeathed, or devised $5,000 or more during the year only if his amount is in excess of 2 percent of the total contributions, bequests and devises received by the organization during the year.

(b) An organization other than a private foundation is required to report only the names and addresses of contributors of whom it has actual knowledge. For instance, an organization need not require an employer who withholds contributions from the compensation of employees and pays over to the organization periodically the total amounts withheld, to specify the amounts paid over with respect to a particular employee. In such case, unless the organization has actual knowledge that a particular employee gave more than $5,000 (and in excess of 2 percent if *(a)* of this subdivision is applicable), the organization need report only the name and address of the employer, and the total amount paid over by him.

(c) Separate and independent gifts made by one person in a particular year need be aggregated to determine if his contributions and bequests exceed $5,000 (and in excess of 2 percent if *(a)* of this subdivision is applicable), only if such gifts are of $1,000 or more.

(d)(1) Organizations described in section 501(c) (8) or (10) (and, for taxable years beginning after December 31, 1970, organizations described in section 501(c)(7)) that receive contributions or bequests to be used exclusively for purposes described in section 170(c)(4), 2055(a)(3), or 2522(a)(3), must attach a schedule with respect to all gifts which aggregate more than $1,000 from any one person showing the name of the donor, the amount of the contribution or bequest, the specific purpose for which such amount was received, and the specific use to which such amount was put. In the case of an amount set aside for such purposes, the organization shall indicate the manner in which such amount is held (for instance, whether such amount is commingled with amounts held for other purposes). If the contribution or bequest was transferred to another organization, the schedule must include the name of the transferee organization, a description of the nature of such organization, and a description of the relationship between the transferee and transferor organizations.

(2) For taxable years beginning after December 31, 1970, such organizations must also attach a statement showing

the total dollar amount of contributions and bequests received for such purposes which are $1,000 or less.

(iv) *Listing of States.* A private foundation is required to attach to its return required by this section a list of all States:

(a) To which the organization reports in any fashion concerning its organization, assets, or activities, or

(b) With which the organization has registered (or which it has otherwise notified in any manner) that it intends to be, or is, a charitable organization or a holder of property devoted to a charitable purpose.

(3)(i) For taxable years beginning after December 31, 1969, and ending before December 31, 1971, every employee's trust described in section 401(a) which is exempt from taxation under section 501(a) shall file an annual return on Form 990–P. The return shall include the information required by paragraph (b)(5)(ii) of § 1.401–1. For such years, in addition, the trust must file the information required to be filed by the employer pursuant to the provisions of § 1.404(a)–2, unless the employer has notified the trustee in writing that he has filed or will timely file such information. If the trustee has received such notification from the employer, then such notification, or a copy thereof, shall be retained by the trust as a part of its records.

(ii) For taxable years ending on or after December 31, 1971, and before December 31, 1975, every employee's trust described in section 401(a) which is exempt from taxation under section 501(a) shall file an annual return on Form 990–P. The trust shall furnish such information as is required by such form and the instructions issued with respect thereto.

(4) For taxable years beginning after December 31, 1980, trusts described in section 4947(a)(1) and nonexempt private foundations shall comply with the requirements of section 6033 and this section in the same manner as organizations described in section 501(c)(3) which are exempt from tax under section 501(a). This section shall be applied for taxable years beginning after December 31, 1980 as if trusts described in section 4947(a)(1) and nonexempt private foundations were described in section 501(c)(3). Therefore, for purposes of this section, all references to exempt organizations shall include section 4947(a)(1) trusts and nonexempt private foundations and all references to private foundations shall include section 4947(a)(1) trusts that would be private foundations if they were described in section 501(c)(3) and all nonexempt private foundations. Similarly, for purposes of paragraph (a)(2)(ii)(d), the purposes for which a section 4947(a)(1) trust or a nonexempt private foundation is organized shall be treated as the purposes for which it is exempt. For purposes of this section, the term ''nonexempt private foundation'' means a taxable organization (other than a section 4947(a)(1) trust) that is a private foundation. See section 509(b) and § 1.509(b)–1. See also section 642(c)(6) and § 1.642(c)–4.

(b) *Accounting period for filing return.* A return required by this section shall be on the basis of the established annual accounting period of the organization. If the organization has no such established accounting period, such return shall be on the basis of the calendar year.

(c) *Returns when exempt status not established.* An organization claiming an exempt status under section 501(a) prior to the establishment of such exempt status under section 501 and § 1.501(a)–1, shall file a return required by this section in accordance with the instructions applicable thereto. In such case the organization must indicate on such return that it is being filed in the belief that the organization is exempt under section 501(a), but that the Internal Revenue Service has not yet recognized such exemption.

(d) *Group returns.* (1) A central, parent, or like organization (referred to in this paragraph as ''central organization''), exempt under section 501(a) and described in section 501(c) (other than a private foundation), although required to file a separate annual return for itself under section 6033 and paragraph (a) of this section, may file annually, in addition to such separate annual return, a group return on Form 990. Such group return may be filed for two or more of the local organizations, chapters, or the like (referred to in this paragraph as ''local organizations'') which are (i) affiliated with such central organization at the close of its annual accounting period, (ii) subject to the general supervision or control of the central organization, and (iii) exempt from taxation under the same paragraph of section 501(c) of the Code, although the local organizations are not necessarily exempt under the paragraph under which the central organization is exempt. Such group return may not be filed for a local organization which is a private foundation.

(2)(i) The filing of the group return shall be in lieu of the filing of a separate return by each of the local organizations included in the group return. The group return shall include only those local organizations which in writing have authorized the central organization to include them in the group return, and which have made and filed, with the central organization, their statements, specifically stating their items of gross income, receipts, and disbursements, and such other information relating to them as is required to be stated in the group return. Such an authorization and statement by a local organization shall be made under the penalties of perjury, shall be signed by a duly authorized officer of the local organization in his official capacity, and shall contain the following statement, or a statement of like import: ‘‘I hereby declare under the penalties of perjury that this authorization (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is true, correct and complete and made in good faith.’’ Such authorization and statement with respect to a local organization shall be retained by the central organization until the expiration of 6 years after the last taxable year for which a group return filed by such central organization includes such local organization.

(ii) There shall be attached to the group return and made a part thereof a schedule showing the name, address, and employer identification number of each of the local organizations and the total number thereof included in such return, and a schedule showing the name, address, and employer identification number of each of the local organizations and the total number thereof not included in the group return.

(3) The group return shall be on the basis of the established annual accounting period of the central organization. Where such central organization has no established annual accounting period, such return shall be on the basis of the calendar year. The same income, receipts, and disbursements of a local organization shall not be included in more than one group return.

(4) The group return shall be filed in accordance with these regulations and the instructions issued with respect to Form 990, and shall be considered the return of each local organization included therein. The tax exempt status of a local organization must be established under a group exemption letter issued to the central organization before a group return including the local organization will be considered as the return of the local organization. See § 1.501(a)–1 for requirements for establishing a tax-exempt status.

(5) In providing the information required by paragraph (a)(2)(ii) *(f), (g),* and *(h)* of this section, such information may be provided:

(i) With respect to the central or parent organization on its Form 990, and with respect to the local organizations on separate schedules attached to the group return for the year, or

(ii) On a consolidated basis for all the local organizations and the central or parent organization on the group return.

Such information need be provided only with respect to those local organizations which are not excepted from filing under the provisions of paragraph (g) of this section. A central or parent organization shall indicate whether it has provided such information in the manner described in subdivision (i) or in subdivision (ii) of this subparagraph, and may not change the manner in which it provides such information without the consent of the Commissioner.

(e) *Time and place for filing.* The annual return required by this section shall be filed on or before the 15th day of the fifth calendar month following the close of the period for which the return is required to be filed. The annual return on Form 1065 required to be filed by a religious or apostolic association or corporation shall be filed on or before the 15th day of the fourth month following the close of the taxable year for which the return is required to be filed. Each such return shall be filed in accordance with the instructions applicable thereto.

(f) *Penalties and additions to tax.* For penalties and additions to tax for failure to file a return and filing a false or fraudulent return, see sections 6652, 7203, 7206, and 7207.

(g) *Organizations not required to file annual returns.* (1) Annual returns required by this section are not required to be filed by an organization exempt from taxation under section 501(a) which is:

(i) A church, an interchurch organization of local units of a church, a convention or association of churches, or an integrated auxiliary of a church (as defined in paragraph (h) of this section);

(ii) An exclusively religious activity of any religious order;

(iii) An organization (other than a private foundation) the gross receipts of which in each taxable year are normally not more than $5,000 (as described in subparagraph (3) of this paragraph);

(iv) A mission society sponsored by or affiliated with one or more churches or church denominations, more than one-half of the activities of which society are conducted in, or directed at persons in foreign countries;

(v) A State institution, the income of which is excluded from gross income under section 115(a);

(vi) An organization described in section 501(c)(1); or

(vii) An educational organization (below college level) that is described in section 170(b)(1)(A)(ii), that has a program of a general academic nature, and that is affiliated (within the meaning of paragraph (h)(2) of this section) with a church or operated by a religious order.

(2) The provisions of section 6033(a) relieving certain specified types of organizations exempt from taxation under section 501(a) from filing annual returns do not abridge or impair in any way the powers and authority of district directors or directors of service centers provided for in other provisions of the Code and in regulations thereunder to require the filing of returns or notices by such organizations. See section 6001 and § 1.6001–1.

(3) For purposes of subparagraph (1)(iii) of this paragraph, the gross receipts (as defined in subparagraph (4) of this paragraph) of an organization are normally not more than $5,000 if:

(i) In the case of an organization which has been in existence for 1 year or less, the organization has received, or donors have pledged to give, gross receipts of $7,500 or less during the first taxable year of the organization,

(ii) In the case of an organization which has been in existence for more than one but less than 3 years, the average of the gross receipts received by the organization in its first 2 taxable years is $6,000 or less, and

(iii) In the case of an organization which has been in existence for 3 years or more, the average of the gross receipts received by the organization in the immediately preceding 3 taxable years, including the year for which the return would be required to be filed, is $5,000 or less.

(4) For purposes of this paragraph and paragraph (a)(2) of this section, ‘‘gross receipts’’ means the gross amount received by the organization during its annual accounting period from all sources without reduction for any costs or expenses including, for example, cost of goods or assets sold, cost of operations, or expenses of earning, raising, or collecting such amounts. Thus ‘‘gross receipts’’ includes, but is not limited to (i) the gross amount received as contributions, gifts, grants, and similar amounts without reduction for the expenses of raising and collecting such amounts, (ii) the gross amount received as dues or assessments from members or affiliated organizations without reduction for expenses attributable to the receipt of such amounts, (iii) gross sales or receipts from business activities (including business activities unrelated to the purpose for which the organization qualifies for exemption, the net income or loss from which may be required to be reported on Form 990–T), (iv) the gross amount received from the sale of

assets without reduction for cost or other basis and expenses of sale, and (v) the gross amount received as investment income, such as interest, dividends, rents, and royalties.

(5) [Reserved]

(6) The Commissioner may relieve any organization or class of organizations from filing, in whole or in part, the annual return required by this section where he determines that such returns are not necessary for the efficient administration of the internal revenue laws.

(h) *Integrated auxiliary*—(1) *In general.* For purposes of this title, the *term integrated auxiliary of a church* means an organization that is—

(i) Described both in sections 501(c)(3) and 509(a) (1), (2), or (3);

(ii) Affiliated with a church or a convention or association of churches; and

(iii) Internally supported.

(2) *Affiliation.* An organization is affiliated with a church or a convention or association of churches, for purposes of paragraph (h)(1)(ii) of this section, if—

(i) The organization is covered by a group exemption letter issued under applicable administrative procedures, (such as Rev. Proc. 80–27 (1980–1 C.B. 677); See §601.601(a)(2)(ii)(*b*)), to a church or a convention or association of churches;

(ii) The organization is operated, supervised, or controlled by or in connection with (as defined in §1.509(a)–4) a church or a convention or association of churches; or

(iii) Relevant facts and circumstances show that it is so affiliated.

(3) *Facts and circumstances.* For purposes of paragraph (h)(2)(iii) of this section, relevant facts and circumstances that indicate an organization is affiliated with a church or a convention or association of churches include the following factors. However, the absence of one or more of the following factors does not necessarily preclude classification of an organization as being affiliated with a church or a convention or association of churches—

(i) The organization's enabling instrument (corporate charter, trust instrument, articles of association, constitution or similar document) or bylaws affirm that the organization shares common religious doctrines, principles, disciplines, or practices with a church or a convention or association of churches;

(ii) A church or a convention or association of churches has the authority to appoint or remove, or to control the appointment or removal of, at least one of the organization's officers or directors;

(iii) The corporate name of the organization indicates an institutional relationship with a church or a convention or association of churches;

(iv) The organization reports at least annually on its financial and general operations to a church or a convention or association of churches;

(v) An institutional relationship between the organization and a church or a convention or association of churches is affirmed by the church, or convention or association of churches, or a designee thereof; and

(vi) In the event of dissolution, the organization's assets are required to be distributed to a church or a convention or association of churches, or to an affiliate thereof within the meaning of this paragraph (h).

(4) *Internal support.* An organization is internally supported, for purposes of paragraph (h)(1)(iii) of this section, unless it both—

(i) Offers admissions, goods, services or facilities for sale, other than on an incidental basis, to the general public (except goods, services, or facilities sold at a nominal charge or for an insubstantial portion of the cost); and

(ii) Normally receives more than 50 percent of its support from a combination of governmental sources, public solicitation of contributions, and receipts from the sale of admissions, goods, performance of services, or furnishing of facilities in activities that are not unrelated trades or businesses.

(5) *Special rule.* Men's and women's organizations, seminaries, mission societies, and youth groups that satisfy paragraphs (h)(1) (i) and (ii) of this section are integrated auxiliaries of a church regardless of whether such an organization meets the internal support requirement under paragraph (h)(1)(iii) of this section.

(6) *Effective date.* This paragraph (h) applies for returns filed for taxable years beginning after December 31, 1969. For returns filed for taxable years beginning after December 31, 1969 but beginning before December 20, 1995, the definition for the term *integrated auxiliary of a church* set forth in § 1.6033–2(g)(5) (as contained in the 26 CFR edition revised as of April 1, 1995) may be used as an alternative definition to such term set forth in this paragraph (h).

(7) *Examples of internal support.* The internal support test of this paragraph (h) is illustrated by the following examples, in each of which it is assumed that the organization's provision of goods and services does not constitute an unrelated trade or business:

Example 1. Organization A is described in sections 501(c)(3) and 509(a)(2) and is affiliated (within the meaning of this paragraph (h)) with a church. Organization A publishes a weekly newspaper as its only activity. On an incidental basis, some copies of Organization A's publication are sold to nonmembers of the church with which it is affiliated. Organization A advertises for subscriptions at places of worship of the church. Organization A is internally supported, regardless of its sources of financial support, because it does not offer admissions, goods, services, or facilities for sale, other than on an incidental basis, to the general public. Organization A is an integrated auxiliary.

Example 2. Organization B is a retirement home described in sections 501(c)(3) and 509(a)(2). Organization B is affiliated (within the meaning of this paragraph (h)) with a church. Admission to Organization B is open to all members of the community for a fee. Organization B advertises in publications of general distribution appealing to the elderly and maintains its name on non-denominational listings of available retirement homes. Therefore, Organization B offers its services for sale to the general public on more than an incidental basis. Organization B receives a cash contribution of $50,000 annually from the church. Fees received by Organization B from its residents total $100,000 annually. Organization B does not receive any government support or contributions from the general public. Total support is $150,000 ($100,000 + $50,000), and $100,000 of that total is from receipts from the performance of services (66⅔% of total support). Therefore, Organization B receives more than 50 percent of its support from receipts from the performance of services. Organization B is not internally supported and is not an integrated auxiliary.

Example 3. Organization C is a hospital that is described in sections 501(c)(3) and 509(a)(1). Organization C is affiliated (within the meaning of this paragraph (h)) with a church. Organization C is open to all persons in need of hospital care in the community, although most of Organization C's patients are members of the same denomination as the church with which Organization C is affiliated. Organization C maintains its name on hospital listings used by the general public, and participating doctors are allowed to admit all patients. Therefore, Organization C offers its services for sale to the general public on more than an incidental basis. Organization C annually receives $250,000 in support from the church, $1,000,000 in payments from patients and third party payors (including Medicare, Medicaid and other insurers) for patient care, $100,000 in contributions from the public, $100,000 in grants from the federal government (other than Medicare and Medicaid payments) and $50,000 in investment income. Total support is $1,500,000 ($250,000 + $1,000,000 + $100,000 + $100,000 + $50,000), and $1,200,000 ($1,000,000 + $100,000 + $100,000) of that total is support from receipts from the performance of services, government sources, and public contributions (80% of total support). Therefore, Organization C receives more than 50 percent of its support from receipts from the performance of services, government sources, and public contributions. Organization C is not internally supported and is not an integrated auxiliary.

(i) *Records, statements, and other returns of tax-exempt organizations.* (1) An organization which is exempt from taxation under section 501(a) and is not required to file annually an information return required by this section shall immediately notify in writing the district director for the internal revenue district in which its principal office is located of any changes in its character, operations, or purpose for which it was originally created.

(2) Every organization which is exempt from tax, whether or not it is required to file an annual information return, shall submit such additional information as may be required by the Internal Revenue Service for the purpose of inquiring into its exempt status and administering the provisions of subchapter F (section 501 and following), chapter 1 of subtitle A of the Code, section 6033, and chapter 42 of subtitle D of the Code. See section 6001 and § 1.6001–1 with respect to the authority of the district directors or directors of service centers to require such additional information and with

respect to the books of account or records to be kept by such organizations.

(3) An organization which has established its exemption from taxation under section 501(a), including an organization which is relieved under section 6033 and this section from filing annual returns of information, is not relieved of the duty of filing other returns of information. See, for example, sections 6041, 6043, 6051, 6057, and 6058 and the regulations thereunder.

(j) *Unrelated business tax returns.* In addition to the foregoing requirements of this section, certain organizations otherwise exempt from tax under section 501(a) which are subject to tax on unrelated business taxable income are also required to file returns on Form 990–T. See paragraph (e) of § 1.6012–2 and paragraph (a)(5) of § 1.6012–3 for requirements with respect to such returns.

(k) *Effective date.* The provisions of this section shall apply with respect to returns filed for taxable years beginning after December 31, 1969.

[T.D. 7122, 36 FR 11026, June 8, 1971; 36 FR 11730, June 18, 1971]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.6033–2, see the List of Sections Affected in the Finding Aids section of this volume.

§ 1.6033–3 Additional provisions relating to private foundations.

(a) *In general.* The foundation managers (as defined in section 4946(b)) of every organization (including a trust described in section 4947(a)(1)) which is (or is treated as) a private foundation (as defined in section 509) the assets of which are at least $5,000 at any time during a taxable year shall include the following information on its annual return in addition to that information required under § 1.6033–2(a):

(1) An itemized statement of its securities and all other assets at the close of the year, showing both book and market value,

(2) An itemized list of all grants and contributions made or approved for future payment during the year, showing the amount of each such grant or contribution, the name and address of the recipient (other than a recipient who is not a disqualified person and who receives, from the foundation, grants to indigent or needy persons that, in the aggregate, do not exceed $1,000 during the year), any relationship between any individual recipient and the foundation's managers or substantial contributors, and a concise statement of the purpose of each such grant or contribution,

(3) The address of the principal office of the foundation and (if different) of the place where its books and records are maintained,

(4) The names and addresses of its foundation managers (within the meaning of section 4946(b)), that are substantial contributors (within the meaning of section 507(d)(2)) or that own 10 percent or more of the stock of any corporation of which the foundation owns 10 percent or more of the stock, or corresponding interests in partnerships or other entities, in which the foundation has a 10 percent or greater interest.

For purposes of subparagraph (2) of this paragraph, the business address of an individual grant recipient or foundation manager may be used by the foundation in its annual return in lieu of the home address of such recipient or manager, and the term ''relationship'' shall include, but is not limited to, any case in which an individual recipient of a grant or contribution by a private foundation is (i) a member of the family (as defined in section 4946(d)) of a substantial contributor or foundation manager of such foundation, (ii) a partner of such substantial contributor or foundation manager, or (iii) an employee of such substantial contributor or foundation manager or of an organization which is effectively controlled (within the meaning of section 4946(a)(1)(H)(i) and the regulations thereunder), directly or indirectly, by one or more such substantial contributors or foundation managers.

(b) *Notice to public of availability of annual return.* A copy of the notice required by section 6104(d) (relating to public inspection of private foundations' annual returns), and proof of publication thereof, shall be filed with the annual return required by § 1.6033–2(a). A copy of such notice as published, and a statement signed by a foundation manager stating that such notice was published, setting forth the date of publication and the publication in which it appeared, shall be sufficient proof of publication for purposes of this paragraph.

(c) *Special rules*—(1) *Furnishing of copies to State officers.* The foundation managers of a private foundation shall furnish a copy of the annual return required by section 6033 and § 1.6033–2 to the Attorney General of:

(i) Each State which the foundation is required to list on its return pursuant to § 1.6033–2(a)(2)(iv),

(ii) The State in which is located the principal office of the foundation, and

(iii) The State in which the foundation was incorporated or created.

The annual return shall be sent to each Attorney General described in paragraphs (c)(1) (i), (ii), or (iii) of this section at the same time as it is sent to the Internal Revenue Service. Upon request the foundation managers shall also furnish a copy of the annual return to the Attorney General or other appropriate State officer (within the meaning of section 6104 (c)(2)) of any State. The foundation managers shall attach to each copy of the annual return sent to State officers under this subparagraph a copy of the Form 4720, if any, filed by the foundation for the year.

(2) *Cross-reference.* For additional rules with respect to private foundations' returns and the public inspection of such returns, see section 6104(d) and the regulations thereunder.

(d) *Special rules for certain foreign organizations.* The provisions of paragraphs (b) and (c) of this section shall not apply with respect to an organization described in section 4948(b). The foundation managers of such organizations are not required to publish notice of availability of the annual return for inspection, to make the annual return available at the principal office of the foundation for public inspection under section 6104(d), or to send copies of the annual return to State officers.

(e) *Effective date.* The provisions of this section shall apply with respect to returns filed for taxable years beginning after December 31, 1980.

[T.D. 8026, 50 FR 20756, May 20, 1985]

§ 1.6034–1 Information returns required of trusts described in section 4947(a)(2) or claiming charitable or other deductions under section 642(c).

(a) *In general.* Every trust (other than a trust described in paragraph (b) of this section) claiming a charitable or other deduction under section 642(c) for the taxable year shall file, with respect to such taxable year, a return of information on form 1041–A. In addition, for taxable years beginning after December 31, 1969, every trust (other than a trust described in paragraph (b) of this section) described in section 4947 (a) (2) (including trusts described in section 664) shall file such return for each taxable year, unless all transfers in trust occurred before May 27, 1969. The return shall set forth the name and address of the trust and the following information concerning the trust in such detail as is prescribed by the form or in the instructions issued with respect to such form:

(1) The amount of the charitable or other deduction taken under section 642(c) for the taxable year (and, for taxable years beginning prior to January 1, 1970, showing separately for each class of activity for which disbursements were made (or amounts were permanently set aside) the amounts which, during such year, were paid out (or which were permanently set aside) for charitable or other purposes under section 642(c));

(2) The amount paid out during the taxable year which represents amounts permanently set aside in prior years for which charitable or other deductions have been taken under section 642(c), and separately listing for each class of activity, for which disbursements were made, the total amount paid out;

(3) The amount for which charitable or other deductions have been taken in prior years under section 642(c) and which had not been paid out at the beginning of the taxable year;

(4)(i) The amount paid out of principal in the taxable year for charitable, etc., purposes, and separately listing for each such class of activity, for which disbursements were made, the total amount paid out;

(ii) The total amount paid out of principal in prior years for charitable, etc., purposes;

(5) The gross income of the trust for the taxable year and the expenses attributable thereto, in sufficient detail to show the different categories of income and of expense; and

(6) A balance sheet showing the assets, liabilities, and net worth of the trust as of the beginning of the taxable year.

(b) *Exceptions*—(1) *In general.* A trust is not required to file a Form 1041–A for any taxable year with respect to which the trustee is required by the terms of the governing instrument and applicable local law to distribute currently all of the income of the trust. For this purpose, the income of the trust shall be determined in accordance with section 643(b) and §§1.643(b)–1 and 1.643(b)–2.

(2) *Trusts described in section 4947(a)(1).* For taxable years beginning after December 31, 1980, a trust described in section 4947(a)(1) is not required to file a Form 1041–A.

(c) *Time and place for filing return.* The return on form 1041–A shall be filed on or before the 15th day of the 4th month following the close of the taxable year of the trust, with the internal revenue officer designated by the instructions applicable to such form. For extensions of time for filing returns under this section, see §1.6081–1.

(d) *Other provisions.* For publicity of information on Form 1041–A, see section 6104 and the regulations thereunder in part 301 of this chapter. For provisions relating to penalties for failure to file a return required by this section, see section 6652(d). For the criminal penalties for a willful failure to file a return and filing a false or fraudulent return, see sections 7203, 7206, and 7207.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 7563, 43 FR 40221, Sept. 11, 1978; T.D. 8026, 50 FR 20757, May 20, 1985]

§1.6035–1 Returns of U.S. officers, directors and 10-percent shareholders of foreign personal holding companies for taxable years beginning after September 3, 1982.

(a) *Requirement of returns*—(1) *In general.* For taxable years of a foreign personal holding company beginning after September 3, 1982, each United States citizen or resident who is an officer, director, or 10-percent shareholder of the foreign personal holding company (as defined in section 552) shall file with his income tax return, on or before the date that return is due, Form 5471 and the applicable schedules to be completed in accordance with the instructions setting forth corporate, shareholder, and income information for the foreign personal holding company's annual accounting period that ends with or within the officer's, director's, or shareholder's taxable year. In the case of a foreign personal holding company which is a specified foreign corporation (as defined in section 898), the taxable year of such corporation shall be treated as its annual accounting period.

(2) *General corporate information.* The general foreign personal holding company information required by this section with respect to each taxable year is as follows:

(i) The name and address and employer identification number (if any) of the corporation;

(ii) The kind of business in which the corporation is engaged;

(iii) The date of its incorporation;

(iv) The country under the laws of which the corporation is incorporated;

(v) A description of each class of stock issued and outstanding by the corporation for the beginning and end of the annual accounting period;

(vi) The number of shares and par value of common stock of the corporation issued and outstanding as of the beginning and end of the taxable year;

(vii) The number of shares and par value of preferred stock of the corporation issued and outstanding as of the beginning and end of the taxable year, the rate of dividend on such stock and whether such dividend is cumulative or noncumulative; and

(viii) Any other information required by the appropriate form and its instructions.

For purposes of this paragraph, the term ''share'' includes any security convertible into a share in the corporation and any option granted by the corporation with respect to any share in the corporation.

(3) *Shareholder information.* The shareholder information required by this section is as follows:

(i) The name, address and taxpayer identification number (if any) of each person, whether foreign or U.S., who was a shareholder during the taxable year and the class and number of shares held by each, together with an explanation of any changes in stock holdings during the taxable year,

(ii) The name and address of each holder during the taxable year of securities convertible into stock of the corporation and the class, number, and face value of the securities held by each, together with and explanation of any changes in the holdings of such securities during the taxable year,

(iii) The name and address of each holder during the taxable year of any option granted by the corporation with respect to any share in the corporation, and a full description of the options held by each, together with an explanation of any changes in the holdings of such options during the taxable year, and

(iv) Any other information required by the appropriate form and its instructions.

(4) *Income information.* The income information required by this section is the gross income, deductions and credits, taxable income, foreign personal holding company income, and undistributed foreign personal holding company income for the taxable year and other information required by the appropriate form and its instructions.

(b) *Persons required to file return*—(1) *In general.* The determination of whether a United States citizen or resident is person who is an officer, director, or 10-percent shareholder required to file a return with respect to any foreign corporation is made as of the date that Form 5471 is required to be filed. If there is no such person required to file on that date (because, for example, the corporation has been dissolved), then filing is required of the persons who were officers, directors or 10-percent shareholders on the last day of the most recent taxable year of the corporation for which there was such a person who was a United States citizen or resident.

(2) *10-percent shareholder.* (i) The term ‘‘10-percent shareholder’’ means any individual who owns directly or indirectly (within the meaning of section 544) 10 percent or more in value of the outstanding stock of a foreign corporation.

(ii) An individual who does not own 10 percent or more in value of the outstanding stock directly but is required to file solely by attribution of another United States person’s stock ownership is excused from filing if the direct owner that is an individual furnishes all the information required.

(3) *Two or more persons required to submit the same information.* If two or more persons are required to furnish the information for the same foreign personal holding company for the same period, one person may make one return on Form 5471. The single Form 5471 may be filed with the income tax return of any one of the persons and shall disclose the name, address, and identifying number of each other person or persons on whose behalf the return is filed. Each person on whose behalf the return is filed remains liable for any penalties imposed under sections 6679, 7203, 7206, and 7207.

(4) *Statement required.* Any United States citizen or resident required to furnish information under this section with his return who does not do so by reason of the provisions of subparagraph (2)(ii) or (3) of this paragraph shall file a statement with his income tax return indicating that such requirement has been or will be satisfied and identifying the return with which the information was or will be filed and the place of filing.

(c) *Separate returns for each corporation.* If a person is required to file returns under section 6035 and this section with respect to more than one foreign personal holding company, separate returns must be filed with respect to each company.

(d) *Corrective filing.* If an information return with respect to a taxable year of a foreign personal holding company beginning after September 3, 1982, is filed before [date which is 30 days after the date of publication of a Treasury decision in the FEDERAL REGISTER] and that return does not contain all of the information required by this section, then the filer of the return shall file an amended information return containing all of such information within 90 days after June 4, 1985.

(e) *Penalties*—(1) *Criminal penalties.* For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203, 7206, and 7207.

(2) *Civil penalties.* For civil penalties for failure to file a proper foreign personal holding company information return, see section 6679 and the regulations thereunder.

[T.D. 8028, 50 FR 23408, June 4, 1985; 50 FR 26359, June 26, 1985, as amended by T.D. 8573, 59 FR 64301, Dec. 14, 1994]

§1.6035–2 Returns of U.S. officers and directors of foreign personal holding companies for taxable years beginning before September 4, 1982.

For rules relating to information returns required to be filed by officers and directors of foreign personal holding companies for taxable years beginning before September 4, 1982, see section 6035(a) (as in effect before the enactment of the Tax Equity and Fiscal Responsibility Act of 1982) and 26 CFR 1.6035–1 (Revised as of April 1, 1981).

[T.D. 8028, 50 FR 23409, June 4, 1985]

§1.6035–3 Returns of 50-percent U.S. shareholders of foreign personal holding companies for taxable years beginning before September 4, 1982.

For rules relating to information returns required to be filed by shareholders of foreign personal holding companies for taxable years beginning before September 4, 1982, see section 6035(b) (as in effect before the enactment of the Tax Equity and Fiscal Responsibility Act of 1982) and 26 CFR 1.6035–2 (Revised as of April 1, 1961).

[T.D. 8028, 50 FR 23409, June 4, 1985]

§1.6036–1 Notice of qualification as executor or receiver.

For provisions relating to the notice required of fiduciaries, see the regulations under section 6036 contained in part 301 of this chapter (Regulations on Procedure and Administration).

§1.6037–1 Return of electing small business corporation.

(a) *In general.* Every small business corporation (as defined in section 1371(a)) which has made an election under section 1372(a) not to be subject to the tax imposed by chapter 1 of the Code shall file, with respect to each taxable year for which the election is in effect, a return of income on Form 1120–S. The return shall set forth the items of gross income and the deductions allowable in computing taxable income as required by the return form or in the instructions issued with respect thereto and shall be signed in accordance with section 6062 by the person authorized to sign a return. The return shall also set forth the following information concerning the electing small business corporation:

(1) The names and addresses of all persons owning stock in the corporation at any time during the taxable year;

(2) The number of shares of stock owned by each shareholder at all times during the taxable year;

(3) The amount of money and other property distributed by the corporation during the taxable year to each shareholder;

(4) The date of each distribution of money and other property; and

(5) Such other information as is required by the form or by the instructions issued with respect to such form.

(b) *Time and place for filing return.* The return shall be filed on or before the 15th day of the third month following the close of the taxable year with the internal revenue officer designated in the instructions applicable to Form 1120–S. (See section 6072.)

(c) *Other provisions.* The return on Form 1120–S will be treated as a return filed by the corporation under section 6012, relating to persons required to make returns of income, for purposes of the provisions of chapter 66 of the Code, relating to limitations. Thus, for example, the period of limitation on assessment and collection of any corporate tax found to be due upon a subsequent determination that the corporation was not entitled to the benefits of subchapter S, chapter 1 of the Code, will run from the date of filing the return under section 6037, or from the date prescribed for filing such return, whichever is the later.

(d) *Penalties.* For criminal penalties for failure to file a return, supply information, or pay tax, and for filing a false or fraudulent return, statement, or other document, see sections 7203, 7206, and 7207.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 7012, 34 FR 7690, May 15, 1969]

§ 1.6038–1 Information returns required of domestic corporations with respect to annual accounting periods of certain foreign corporations beginning before January 1, 1963.

(a) *Requirement of return.* For taxable years beginning after December 31, 1960, every domestic corporation shall make a separate annual information return on Form 2952, in duplicate, with respect to each foreign corporation which it controls, as defined in paragraph (b) of this section, and with respect to each foreign subsidiary, as defined in paragraph (c) of this section, for each annual accounting period (described in paragraph (d) of this section) of each such controlled foreign corporation or foreign subsidiary beginning after December 31, 1960, and before January 1, 1963. Such information shall not be required to be furnished, however, with respect to a corporation defined in section 1504(d) of the Code which makes a consolidated return for the taxable year. For annual accounting periods beginning after December 31, 1962, see § 1.6038–2.

(b) *Control.* A domestic corporation shall be deemed to be in control of a foreign corporation if at any time during its taxable year it owns more than 50 percent of the voting stock of such foreign corporation.

(c) *Foreign subsidiary.* A foreign corporation more than 50 percent of the voting stock of which is owned by a controlled foreign corporation at any time during the annual accounting period of such controlled foreign corporation shall be considered a foreign subsidiary.

(d) *Period covered by return*—(1) *Controlled foreign corporation.* The information with respect to a controlled foreign corporation shall be furnished for its annual accounting period ending with or within the domestic corporation's taxable year.

(2) *Foreign subsidiary.* The information with respect to a foreign subsidiary shall be furnished for such subsidiary's annual accounting period ending with or within the controlled foreign corporation's annual accounting period.

(3) *Annual accounting period defined.* For purposes of this section, the annual accounting period of a controlled foreign corporation or of a foreign subsidiary is the annual period on the basis of which the controlled foreign corporation or foreign subsidiary regularly computes its income in keeping its books. The term ''annual accounting period'' may refer to a period of less than 1 year, where for example the foreign income, war profits, and excess profits taxes are determined on the basis of an accounting period of less than 1 year as described in section 902(c)(2).

(e) *Contents of return.* The return on Form 2952 shall contain the following information with respect to each controlled corporation and each foreign subsidiary:

(1) The name and address of the corporation;

(2) The principal place of business of the corporation;

(3) The date of incorporation and the country under whose laws incorporated;

(4) The nature of the corporation's business;

(5) As regards the outstanding stock of the corporation:

(i) A description of each class of the corporation's stock, and

(ii) The number of shares of each class outstanding at the beginning and the end of the annual accounting period;

(6) A list showing the name and address of, and the number of shares of each class of the corporation's stock held by, each citizen or resident of the United States, and each domestic corporation, who is a shareholder of record owning at any time during the annual accounting period 5 percent or more in value of any class of the corporation's outstanding stock;

(7) The amount of the corporation's gross receipts, net profits before taxes and provision for foreign income taxes, for the annual accounting period, as reflected on the financial statements required under paragraph (f) of this section to be filed with the return; and

(8) A summary showing the total amount of each of the following types of transactions of the corporation, which took place during the annual accounting period, with the domestic corporation or any shareholder of the domestic corporation owning at the time of the transaction 10 percent or more of the value of any class of stock outstanding of the domestic corporation:

(i) Sales and purchases of stock in trade;

(ii) Purchases of property of a character which is subject to the allowance for depreciation;

(iii) Compensation paid and compensation received for the rendition of technical, managerial, engineering, construction, scientific, or like services;

(iv) Commissions paid and commissions received;

(v) Rents and royalties paid and rents and royalties received;

(vi) Amounts loaned and amounts borrowed (other than open accounts which arise and are collected in the ordinary course of business);

(vii) Dividends paid and dividends received;

(viii) Interest paid and interest received; and

(ix) Premiums received for insurance or reinsurance.

If the domestic corporation is a bank, as defined in section 581, or is controlled within the meaning of section 368(c) by a bank, the term ‘‘transactions'' shall not, as to a corporation with respect to which a return is filed, include banking transactions entered into on behalf of customers; in any event, however, deposits in accounts between a controlled foreign corporation or a foreign subsidiary and the domestic corporation or a 10-percent shareholder described in this subparagraph and withdrawals from such accounts shall be summarized by reporting end-of-month balances.

(f) *Financial statements.* The following information with respect to each controlled foreign corporation and each foreign subsidiary shall be attached to and filed as part of the return required by this section:

(1) A statement of the corporation's profit and loss for the annual accounting period;

(2) A balance sheet as of the end of the annual accounting period of the corporation showing:

(i) The corporation's assets,

(ii) The corporation's liabilities, and

(iii) The corporation's net worth; and

(3) An analysis of changes in the corporation's surplus accounts during the annual accounting period including both opening and closing balances.

The statements listed in subparagraphs (1), (2), and (3) of this paragraph shall be prepared in conformity with generally accepted accounting principles, and in such form and detail as is customary for the corporation's accounting records.

(g) *Method of reporting.* All amounts furnished under paragraphs (e) and (f) of this section shall be expressed in United States currency with a statement of the exchange rates used.

(h) *Time and place for filing return.* Returns on Form 2952 required under paragraph (a) of this section shall be filed with the domestic corporation's income tax return on or before the fifteenth day of the third month following the close of such corporation's taxable year.

(i) *Extensions of time for filing.* District directors are authorized to grant reasonable extensions of time for filing returns on Form 2952 in accordance with the applicable provisions of §1.6081–1. An application by a domestic corporation for an extension of time for filing a return of income shall also be considered as an application for an extension of time for filing returns on Form 2952.

(j) *Failure to furnish information*—(1) *Effect on foreign tax credit.* (i) Failure by a domestic corporation to furnish, in accordance with the provisions of this section, any return or any information in any return, required to be filed for a taxable year under authority of section 6038 on or before the date prescribed in paragraph (h) of this section (determined with regard to any extension of time for such filing) shall affect the application of section 902 as provided in subparagraph (2) of this paragraph. Such failure shall affect the application of section 902 to such domestic corporation or to any person who acquires from any person any portion (but only to the extent of such portion) of the interest of such domestic corporation in any controlled foreign corporation or foreign subsidiary.

(ii) Where the domestic corporation, having filed the return required by this section except for an omission of, or error with respect to, some of the information referred to in paragraphs (e) and (f) of this section, establishes to the satisfaction of the Commissioner that such omission or error was inadvertent or for reasonable cause and that such domestic corporation has substantially complied with this section, such omission or error shall not constitute a failure under this section.

(2) *Reduction of foreign taxes.* In the application of section 902 to the domestic corporation or person referred to in subparagraph (1)(i) of this paragraph for any taxable year, the amount of taxes paid or deemed paid by each controlled foreign corporation and each foreign subsidiary for the accounting period or periods for which the domestic corporation was required for the taxable year of the failure to furnish information under this section shall be reduced by 10 percent. The 10 percent reduction is not limited to the taxes paid or deemed paid by the controlled foreign corporation or foreign subsidiary with respect to which there is a failure to file information but shall apply to the taxes paid or deemed paid by all controlled foreign corporations and foreign subsidiaries.

(3) *Reduction for continued failure.* (i) If the failure, referred to in subparagraph (1)(i) of this paragraph, continues for 90 days or more after date of written notice by the district director to the domestic corporation, then the amount of the reduction referred to in subparagraph (2) of this paragraph shall be 10 percent plus an additional 5 percent for each 3-month period, or fraction thereof, during which such failure continues after the expiration of such 90-day period.

(ii) Taxes paid by a foreign subsidiary when once reduced for a failure shall not be reduced again for the same failure in their status as taxes deemed paid by a controlled foreign corporation. Where a failure continues, each additional periodic 5 percent reduction, referred to in subdivision (i) of this subparagraph, shall be considered as part of the one reduction.

(4) *Reasonable cause.* (i) For purposes of subsection (b) of section 6038 and this section the time prescribed for furnishing information under this paragraph, and the beginning of the 90-day period after notice by the district director, shall be treated as being not earlier than the last day on which (as shown to the satisfaction of the district director) reasonable cause existed for failure to furnish such information.

(ii) A domestic corporation, which wishes to avoid a reduction in foreign tax credit as provided in subparagraphs (2) and (3) of this paragraph for failure to furnish information in accordance with this section, must make an affirmative showing of all facts alleged as a reasonable cause for such failure in the form of a written statement containing a declaration that it is made under the penalties of perjury.

(5) *Penalties.* The information required by section 6038 of the Code must be furnished even though there are no foreign taxes which would be reduced under the provisions of subparagraph (2) of this paragraph. For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203, 7206, and 7207 of the Code.

[T.D. 6506, 25 FR 12241, Nov. 30, 1960, as amended by T.D. 6621, 27 FR 11878, Dec. 1, 1962]

§ 1.6038–2 Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations beginning after December 31, 1962.

(a) *Requirement of return.* Every U.S. person shall make a separate annual information return with respect to each annual accounting period (described in paragraph (e) of this section) beginning after December 31, 1962, of each foreign corporation which that person controls (as defined in paragraph (b) of this section) for an uninterrupted period of 30 days or more during such annual accounting period. Such information shall not be required to be furnished, however, with respect to a corporation defined in section 1504(d) of the Code which makes a consolidated return for the taxable year. The return shall be made, with respect to annual accounting periods ending with or within the United States person's taxable year, on—

(1) Form 2952 if such taxable year ends before December 31, 1982,

(2) Form 5471 if such taxable year ends on or after December 31, 1983, or

(3) Either Form 5471 or Form 2952 if such taxable year ends on or after December 31, 1982 and before December 31, 1963.

(b) *Control.* A person shall be deemed to be in control of a foreign corporation if at any time during that person's taxable year it owns stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or more than 50 percent of the total value of shares of all classes of stock of the foreign corporation. A person in control of a corporation which, in turn, owns more than 50 percent of the combined voting power, or of the value, of all classes of stock of another corporation is also treated as being in control of such other corporation. The provisions of this paragraph may be illustrated by the following example:

Example. Corporation A owns 51 percent of the voting stock in Corporation B. Corporation B owns 51 percent of the voting stock in Corporation C. Corporation C in turn owns 51 percent of the voting stock in Corporation D. Corporation D is controlled by Corporation A.

(c) *Attribution rules.* For the purpose of determining control of domestic or foreign corporations the constructive ownership rules of section 318(a) shall apply except that:

(1) Stock owned by or for a partner or a beneficiary of an estate or trust shall not be considered owned by the partnership, estate, or trust when the effect is to consider a United States person as owning stock owned by a person who is not a United States person;

(2) A corporation will not be considered as owning stock owned by or for a 50 percent or more shareholder when the effect is to consider a United States person as owning stock owned by a person who is not a United States person; and

(3) If 10 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, section 318(a)(2)(C) shall apply.

The constructive ownership rules of section 318(a) apply only for purposes of determining control as defined in paragraph (b) of this section.

(d) *U.S. person.* For purposes of section 6038 and this section, the term ''United States person'' has the meaning assigned to it by section 7701(a)(30) of the Code, except that—

(1) With respect to a corporation organized under the laws of the Commonwealth of Puerto Rico, such term does not include an individual who is a bona fide resident of Puerto Rico, if a dividened received by such individual during the taxable year from such corporation would be excluded from gross income under section 933(1),

(2) With respect to a corporation organized under the laws of the Virgin Islands, such term does not include an individual who is a bona fide resident of the Virgin Islands and whose income tax obligation under Subtitle A (relating to income taxes) of the Code for the taxable year is satisfied pursuant to section 28(a) of the Revised Organic Act of the Virgin Islands, approved July 22, 1954 (48 U.S.C. 1642), by paying tax on income derived from all sources both within and outside the Virgin Islands into the treasury of the Virgin Islands,

(3) With respect to a corporation organized under the laws of Guam or the Northern Mariana Islands, such term does not include an individual who is a bona fide resident of Guam or the Northern Mariana Islands, respectively, and who is relieved of liability for income tax to the United States under section 935(c)(3) of the Code or section 601 of the Covenant to Establish a Commonwealth of the Northern Mariana Islands in Political Union with the United States of America (Pub. L. 94–241), respectively, for such

individual's taxable year referred to in paragraph (e) of this section, and

(4) With respect to a corporation organized under the laws of any possession of the United States (other than Guam, the Northern Mariana Islands, Puerto Rico, or the Virgin Islands), such term does not include an individual who is a bona fide resident of such possession for the entire taxable year and whose income derived from sources within any possession of the United States is not, by reason of section 931(a), includible in gross income under subtitle A (relating to income taxes) of the Code for the taxable year.

(5) For taxable years ending after December 31, 1987, with respect to a corporation organized under the laws of American Samoa, the term does not include an individual who is a bona fide resident of American Samoa, provided—

(i) 80 percent or more of the gross income of the corporation for the 3-year period ending at the close of the taxable year (or for such part of such period as such corporation or any predecessor has been in existence) was derived from sources within American Samoa or was effectively connected with the conduct of a trade or business in American Samoa; and

(ii) 50 percent or more of the gross income of such corporation for such period (or part) was derived from the conduct of an active trade or business within American Samoa.

An individual for whom an election under section 6013 (g) or (h) is in effect shall, subject to the exceptions contained in this paragraph (d), be considered a United States person for purposes of section 6038 and this section.

(e) *Period covered by return.* The information required under paragraphs (f) and (g) of this section with respect to a foreign corporation shall be furnished for the annual accounting period of the foreign corporation ending with or within the United States person's taxable year. For purposes of this section, the annual accounting period of a foreign corporation is the annual period on the basis of which that corporation regularly computes its income in keeping its books. In the case of a specified foreign corporation (as defined in section 898), the taxable year of such corporation shall be treated as its annual accounting period. The term *annual accounting period* may refer to a period of less than one year, where, for example, the foreign income, war profits, and excess profits taxes are determined on the basis of an accounting period of less than one year as described in section 902(c)(5). If more than one annual accounting period ends with or within the United States person's taxable year, separate annual information returns shall be submitted for each annual accounting period.

(f) *Contents of return.* The return on Form 2952 or Form 5471 shall contain so much of the following information, and in such form or manner, as the form shall prescribe with respect to each foreign corporation:

(1) The name, address, and employer identification number, if any, of the corporation;

(2) The principal place of business of the corporation;

(3) The date of incorporation and the country under whose laws incorporated;

(4) The name and address of the foreign corporation's statutory or resident agent in the country of incorporation;

(5) The name, address, and identifying number of any branch office or agent of the foreign corporation located in the United States;

(6) The name and address of the person (or persons) having custody of the books of account and records of the foreign corporation, and the location of such books and records if different from such address;

(7) The nature of the corporation's business and the principal places where conducted;

(8) As regards the outstanding stock of the corporation—

(i) A description of each class of the corporation's stock, and

(ii) The number of shares of each class outstanding at the beginning and end of the annual accounting period;

(9) A list showing the name, address, and identifying number of, and the number of shares of each class of the corporation's stock held by, each United States person who is a shareholder owning at any time during the annual accounting period 5 percent or

more in value of any class of the corporation's outstanding stock;

(10) For the annual accounting period, the amount of the corporation's:

(i) Current earnings and profits;

(ii) Foreign income, war profits, and excess profits taxes paid or accrued;

(iii) Distributions out of current earnings and profits for the period;

(iv) Distributions other than those described in paragraph (f)(10)(iii) of this section and the source thereof; and

(v) For Forms 5471 filed for taxable years ending after December 15, 1990, such earnings and profits information as the form shall prescribe, including post-1986 undistributed earnings described in section 902(c)(1), pre-1987 amounts, total earnings and profits, and previously taxed earnings and profits described in section 959(c); and

(11) A summary showing the total amount of each of the following types of transactions of the corporation, which took place during the annual accounting period, with the person required to file this return, any other corporation controlled by that person, or any United States person owning at the time of the transaction 10 percent or more in value of any class of stock outstanding of the foreign corporation, or of any corporation controlling that foreign corporation:

(i) Sales and purchases of stock in trade;

(ii) Purchases of tangible property other than stock in trade;

(iii) Sales and purchases of patents, inventions, models, or designs (whether or not patented), copyrights, trademarks, secret formulas or processes, or any other similar property rights;

(iv) Compensation paid and compensation received for the rendition of technical, managerial, engineering, construction, scientific, or like services;

(v) Commission paid and commissions received;

(vi) Rents and royalties paid and rents and royalties received;

(vii) Amount loaned and amounts borrowed (except open accounts resulting from sales and purchases reported under other items listed in this paragraph (f)(11) that arise and are collected in full in the ordinary course of business);

(viii) Dividends paid and dividends received;

(ix) Interest paid and interest received; and

(x) Premiums received for insurance or reinsurance.

For purposes of this paragraph (f)(11), if the United States person is a bank, as defined in section 581, or is controlled within the meaning of section 368(c) by a bank, the term ''transactions'' shall not, as to a corporation with respect to which a return is filed, include banking transactions entered into on behalf of customers; in any event, however, deposits in accounts between a foreign corporation, controlled (within the meaning of paragraph (b) of this section) by a United States person, and a person described in this paragraph (f)(11) and withdrawals from such accounts shall be summarized by reporting end-of-month balances.

(g) *Financial statements.* The following information with respect to the foreign corporation shall be attached to and filed as part of the return required by this section. Forms 5471 filed after September 30, 1991, shall contain this information in such form or manner as the form shall prescribe with respect to each foreign corporation:

(1) A statement of the corporation's profit and loss for the annual accounting period;

(2) A balance sheet as of the end of the annual accounting period of the corporation showing—

(i) The corporation's asset;

(ii) The corporation's liabilities; and

(iii) The corporation's net worth; and

(3) An analysis of changes in the corporation's surplus accounts during the annual accounting period including both opening and closing balances.

The information listed in this paragraph (g) shall be prepared in conformity with generally accepted accounting principles, and in such detail as is customary for the corporation's accounting records.

(h) *Method of reporting.* Except as provided in this paragraph (h), all amounts furnished under paragraphs (f) and (g) of this section shall be expressed in United States dollars with a statement of the exchange rates used. The following rules shall apply for taxable years ending after December 31, 1994, with respect to returns filed after December 31, 1995. All amounts furnished under paragraph (g) of this section shall be expressed in United States dollars computed and translated in conformity with United States generally accepted accounting principles. Amounts furnished under paragraph (g)(1) of this section shall also be furnished in the foreign corporation's functional currency as required on the form. Earnings and profits amounts furnished under paragraphs (f)(10) (i), (iii), (iv), and (v) of this section shall be expressed in the foreign corporation's functional currency except to the extent the form requires specific items to be translated into United States dollars. Tax amounts furnished under paragraph (f)(10)(ii) of this section shall be furnished in the foreign currency in which the taxes are payable and in United States dollars translated in accordance with section 986(a). All amounts furnished under paragraph (f)(11) of this section shall be expressed in U.S. dollars translated from functional currency at the weighted average exchange rate for the year as defined in § 1.989(b)–1. The foreign corporation's functional currency is determined under section 985. All statements submitted on or with the return required under this section shall be rendered in the English language.

(i) *Time and place for filing return.* Returns on Form 2952 or Form 5471 required under paragraph (a) of this section shall be filed with the United States person's income tax return on or before the date required by law for the filing of that person's income tax return. District directors and directors of service centers are authorized to grant reasonable extensions of time for filing returns on Form 2952 or Form 5471 in accordance with the applicable provisions of § 1.6081–1 of this chapter. An application for an extension of time for filing a return of income shall also be considered as an application for an extension of time for filing returns on Form 2952 or Form 5471.

(j) *Two or more persons required to submit the same information*—(1) *Return jointly made.* If two or more persons are required to furnish information with respect to the same foreign corporation for the same period, such persons may, in lieu of making separate returns, jointly make one return. Such joint return shall be filed with the income tax return of any one of the persons making such joint return.

(2) *Persons excepted from furnishing information*—(i) *Conditions.* Any person required to furnish information under this section with respect to a foreign corporation need not furnish that information provided all of the following conditions are met:

(A) Such person does not directly own an interest in the foreign corporation;

(B) Such person is required to furnish the information solely by reason of attribution of stock ownership from a United States person under paragraph (c) of this section; and

(C) The person from whom the stock ownership is attributed furnishes all of the information required under this section of the person to whom the stock ownership is attributed.

(ii) If an individual who is a United States person required to furnish information with respect to a foreign corporation under section 6038 is entitled under a treaty to be treated as a nonresident of the United States, and if the individual claims this treaty benefit, and if there are no other United States persons that are required to furnish information under section 6038 with respect to the foreign corporation, then the individual may satisfy the requirements of paragraphs (f)(10), (f)(11), (g), and (h) of this section by filing the audited foreign financial statements of the foreign corporation with the individual's return required under section 6038.

(iii) *Illustrations.* The rule of this paragraph (j)(2) is illustrated by the following examples:

Example (1). A, a U.S. person owns 100 percent of the stock of M, a domestic corporation. A also owns 100 percent of the stock of N, a foreign corporation organized under the laws of foreign country Y. A, in filing the information return required by this section with respect to N Corporation, in fact furnishes all of the information required of M Corporation with respect to N Corporation. M Corporation need not file the information.

Example (2). X, a domestic corporation owns 100 percent of the stock of Y, a domestic corporation, Y Corporation owns 100 percent of the stock of Z, a foreign corporation.

X Corporation is not excused by this paragraph (j)(2) from filing information with respect to Z Corporation because X Corporation is deemed to control Z Corporation under the provisions of paragraph (b) of this section without recourse to the attribution rules in paragraph (c) of this section.

(3) *Statement required.* Any United States person required to furnish information under this section with his return who does not do so by reason of the provisions of paragraph (j)(1) or (2) of this section shall file a statement with his income tax return indicating that such liability has been (or, in the case of a joint return made under paragraph (j)(1) of this section, will be) satisfied and identifying the return with which the information was or will be filed and the place of filing.

(k) *Failure to furnish information*—(1) *Dollar amount penalty*—(i) *In general.* If any person required to file Form 2952 or Form 5471 under section 6038 and this section fails to furnish any information described in paragraphs (f) and (g) of this section within the time prescribed by paragraph (i) of this section, such person shall pay a penalty of $1,000 for each annual accounting period of each foreign corporation with respect to which such failure occurs.

(ii) *Increase in penalty for continued failure after notification.* If a failure described in paragraph (k)(1)(i) of this section continues for more than 90 days after the date on which the district director mails notice of such failure to the person required to file Form 2952 or Form 5471, such person shall pay a penalty of $1,000, in addition to the penalty imposed by section 6038(b)(1) and paragraph (k)(1)(i) of this section, for each 30-day period (or fraction thereof) during which such failure continues after such 90-day period has expired. The additional penalty imposed by section 6038(b)(2) and this paragraph (k)(1)(ii) shall be limited to a maximum of $24,000 for each failure.

(iii) *Effective date.* The penalty imposed by section 6038(b) and this paragraph (k)(1) shall apply with respect to information for annual accounting periods ending after September 3, 1982.

(2) *Penalty of reducing foreign tax credit*—(i) *Effect on foreign tax credit.* Failure of a United States person to furnish, in accordance with the provisions of this section, any return or any information in any return, required to be filed for a taxable year under authority of section 6038 on or before the date prescribed in paragraph (i) of this section may affect the application of section 901 as provided in paragraph (k)(2)(ii) of this section and may affect the application of sections 902 and 960 as provided in paragraph (k)(2)(iii) of this section. Such failure may affect the application of sections 902 and 960 to any such United States person which is a corporation or to any person who acquires from any other person any portion (but only to the extent of such portion) of the interest of such other person in any such foreign corporation.

(ii) *Application of section 901.* In the application of section 901 to a United States person referred to in paragraph (k)(2)(i) of this section, the amount of taxes paid or deemed paid by such person for any taxable year, with or within which the annual accounting peroid of a foreign corporation for which such person failed to furnish information required under this section ended, may be reduced by 10 percent. However, no tax reduced under paragraph (k)(2)(iii) of this section or deemed paid under section 904(c) shall be reduced under the provisions of this paragraph (k)(2)(ii).

(iii) *Application of sections 902 and 960.* In the application of sections 902 and 960 to a United States person referred to in paragraph (k)(2)(i) of this section for any taxable year, the amount of taxes paid or deemed paid by each foreign corporation for the accounting period or periods for which such person was required for the taxable year of the failure to furnish information under this section may be reduced by 10 percent. The 10-percent reduction is not limited to the taxes paid or deemed paid by the foreign corporation with respect to which there is a failure to file information but may apply to the taxes paid or deemed paid by all foreign corporations controlled by that person. In applying subsections (a) and (b) of section 902, and in applying subsection (a) of section 960, the reduction provided by this paragraph (k)(2) shall not apply for purposes of determining the amount of accumulated profits in excess of income, war profits, and excess profits taxes.

(iv) *Reduction for continued failure after notice.* (A) If the failure referred to in paragraph (k)(2)(i) of this section continues for more than 90 days after the date on which the district director mails notice of such failure to such United States person, then the amount of the reduction referred to in paragraphs (k)(2) (ii) and (iii) of this section may be 10 percent plus an additional 5 percent for each 3-month period, or fraction thereof, during which such failure continues after the expiration of such 90-day period.

(B) No taxes shall be reduced under this paragraph (k)(2) more than once for the same failure. Taxes paid by a foreign corporation when once reduced for a failure shall not be reduced again for the same failure in their status as taxes deemed paid by a corporate shareholder. Where a failure continues, each additional periodic 5-percent reduction, referred to in paragraph (k)(2)(iv)(A) of this section, shall be considered as part of the one reduction.

(v) *Limitation on reduction of foreign tax credit.* The amount of the reduction under this paragraph (k)(2) for each failure to furnish information with respect to a foreign corporation as required under this section shall not exceed the greater of:

(A) $10,000, or

(B) The income of the foreign corporation for its annual accounting period with respect to which the failure occurs. For purposes of this section if a person is required to furnish information with respect to more than one foreign corporation, controlled (within the meaning of paragraph (b) of this section) by that person, each failure to submit information for each such corporation constitutes a separate failure.

(vi) *Offset for dollar amount penalty imposed.* The total amount of the reduction or reductions which, but for this paragraph (k)(2)(vi), may be made under this paragraph (k)(2) with respect to any separate failure, shall not exceed the maximum amount of such reductions which may be imposed, reduced (but not below zero) by the amount of the dollar amount penalty imposed by paragraph (k)(1) of this section with respect to such separate failure.

(3) *Reasonable cause.* (i) For purposes of section 6038 (b) and (c) and this section, the time prescribed for furnishing information under paragraph (i) of this section, and the beginning of the 90-day period after mailing of notice by the district director under paragraphs (k)(1)(ii) and (2)(iv)(A) of this section, shall be treated as being not earlier than the last day on which reasonable cause existed for failure to furnish the information.

(ii) To show that reasonable cause existed for failure to furnish information as required by section 6038 and this section, the person required to report such information must make an affirmative showing of all facts alleged as reasonable cause for such failure in a written statement containing a declaration that it is made under the penalties of prejury. The statement must be filed with the district director for the district or the director of the service center where the return is required to be filed. The district director or the director of the service center shall determine whether the failure to furnish information was due to reasonable cause, and if so, the period of time for which such reasonable cause existed. In the case of a return that has been filed as required by this section except for an omission of, or error with respect to, some of the information required, if the person who filed the return establishes to the satisfaction of the district director or the director of the service center that the person has substantially complied with this section, then the omission or error shall not constitute a failure under this section.

(4) *Other penalties.* The information required by section 6038 and this section must be furnished even though there are no foreign taxes which would be reduced under the provisions of this section, and even though the information required may not affect the amount of any tax due under the Internal Revenue Code. For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203, 7206, and 7207 of the Code.

(5) *Illustrations.* The provisions of this paragraph may be illustrated by the following examples.

Example (1). M, a domestic corporation owns 100 percent of the stock of N, a foreign corporation. Both M and N use the calendar year as a taxable year and annual accounting period, and all of the following events occur in or with respect to the 1980 taxable year. The dividend from N is the only dividend from a foreign corporation received by M during the taxable year, and the foreign taxes listed are the only foreign taxes paid or deemed paid by M and N for the taxable year. On March 15, 1981, M filed its income tax return and paid its income tax, but M did not file Form 2952 with respect to N's 1980 annual accounting period. On June 1, 1961, the district director mailed notice to M of M's failure to file Form 2952 with respect to N. On November 30, 1981, M filed a complete Form 2952 with respect to N's 1980 annual accounting period.

(a) Gains, profits, and income of N	$100,000
(b) Foreign tax paid by N with respect to such gains, profits, and income	40,000
(c) Reduction of foreign tax paid by N (for purposes of M's section 902 deemed paid credit) resulting from M's failure to file information with respect to N as required under section 6038(a) and this section: failure to file within the time prescribed in paragraph (i) of this section, 10-percent reduction; continued failure for one additional 3-month period after 90-day period after notice mailed, 5-percent reduction; total reduction, 15 percent ($40,000 times 15 percent)	6,000
(d) Foreign tax paid by N after section 6038(c)(1)(B) reduction	34,000
(e) Dividend paid by N to M	45,000
(f) Accumulated profits of N as defined in section 902(c)(1) (determined without regard to the section 6038(c)(1)(B) reduction)	100,000
(g) Accumulated profits of N as described in section 902(a) (determined without regard to the section 6038(c)(1)(B) reduction)	60,000
(h) For purposes of the section 902 credit, M is deemed to have paid the same proportion of foreign taxes paid (reduced as provided under section 6038(c)) with respect to the accumulated profits described in section 902(a) (determined without regard to the reduction provided under section 6038(c)) as the amount of the dividend (determined without regard to section 78) bears to such amount of accumulated profits	25,500

(45,000÷60,000)×34,000=25,500 ....

M must include $25,500 in gross income as a dividend under the provisions of section 78 of the Code. This example illustrates that the reductions in foreign taxes paid by the foreign corporation provided under section 8038(c) are taken into account in determining the amount included in gross income of the domestic corporation under section 78 of the Code as foreign taxes deemed paid, but such reductions are not taken into account in computing accumulated profits for purposes of determining the portion of foreign taxes deemed paid with respect to a particular dividend. The dollar amount penalty imposed by section 8038 (b) and paragraph (k)(1) of this section does not apply with respect to information for annual accounting periods ending before September 4, 1982, and therefore does not apply to M with respect to M's failure to file Form 2952 in this example.

Example (2). The facts are the same as in example (1) except that all of the events occur in or with respect to the 1982 taxable year. On March 15, 1983. M filed its income tax return and paid its income tax, but M did not file Form 2952 or Form 5471 with respect to N's 1982 annual accounting period. On June 1, 1983, the district director mailed notice to M of M's failure to file Form 2952 or Form 5471 with respect to N. On November 30, 1983, M filed a complete Form 5471 with respect to N's 1982 annual accounting period. Under paragraph (k)(1)(i) of this section, M is subject to a penalty of $1,000. Under paragraph (k)(1)(ii) of this section, that penalty is increased by $4,000 because the failure continued for 92 days (three full 30-day periods and a fraction of a fourth 30-day period) after the end of the 90-day period following mailing of the notice by the district director, bringing M's dollar amount penalty under paragraph (k)(1) of this section to $5,000. For purpose of determining the foreign tax credit available to M, there may be imposed a reduction of foreign tax paid by N of $6,000, which would be the total of reductions under paragraph (k)(2) of this section with respect to M's failure to file under section 6038 for N's 1982 annual accounting period, before application of paragraph (k)(2)(vi) of this section. Under said paragraph (k)(2)(vi), the amount of the foreign tax reduction imposed is reduced by the amount of the dollar amount penalty, leaving a foreign tax reduction penalty of $1,000 which may be imposed in addition to the $5,000 dollar amount penalty. If imposed, the $1,000 tax reduction would then be applied in the calculation of taxes deemed paid by M under section 902 as in example (1), items (c), (d), and (h).

[T.D. 8040, 50 FR 30163, July 24, 1985, as amended by T.D. 8573, 59 FR 64302, Dec. 14, 1994; T.D. 8733, 62 FR 53385, Oct. 14, 1997]

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(2) Aggregate value of gross payments made or received.
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(k) Consolidated return groups.
(1) Required information.
(2) Maintenance of records and authorization of agent.
(3) Monetary penalties.
(l) District Director.
(m) Examples.
(n) Effective dates.
(1) Section 1.6038A–1.
(2) Section 1.6038A–2.
(3) Section 1.6038A–3.
(4) Section 1.6038A–4.
(5) Section 1.6038A–5.
(6) Section 1.6038A–6.
(7) Section 1.6038A–7.

§ 1.6038A–2 Requirement of return

(a) Form 5472 required.
(1) In general.
(2) Reportable transaction.
(b) Contents of return.
(1) Reporting corporation.
(2) Related party.
(3) Foreign related party transactions for which only monetary consideration is paid or received by the reporting corporation.
(4) Foreign related party transactions involving nonmonetary consideration or less than full consideration.
(5) Additional information.
(6) Reasonable estimate.
(i) Estimate within 25 percent of actual amount.
(ii) Other estimates.
(7) Small amounts.
(8) Accrued payments and receipts.
(c) Method of reporting.
(d) Time and place for filing returns.
(e) Untimely filed return.
(f) Exceptions.
(1) No reportable transactions.
(2) Transactions solely with a domestic reporting corporation.
(3) Transactions with a corporation subject to reporting under section 6038.
(4) Transactions with a foreign sales corporation.
(g) Filing Form 5472 when transactions with related parties engaged in by a partnership are attributed to a reporting corporation.
(h) Effective dates for certain reporting corporations.

§ 1.6038A–3 Record maintenance

(a) General maintenance requirements.
(1) Section 6001 and section 6038A.
(2) Safe harbor.
(3) Examples.
(b) Other maintenance requirements.
(1) Indirectly related records.
(2) Foreign related party or third-party maintenance.
(3) Translation of records.
(4) Exception for foreign governments.
(c) Specific records to be maintained for safe harbor.
(1) In general.
(2) Descriptions of categories of documents to be maintained.
(i) Original entry books and transaction records.
(ii) Profit and loss statements.
(iii) Pricing documents.
(iv) Foreign country and third party filings.
(v) Ownership and capital structure records.
(vi) Records of loans, services, and other non-sales transactions.
(3) Material profit and loss statements.
(4) Existing records test.
(5) Significant industry segment test.
(i) In general.
(ii) Form of the statements.
(iii) Special rule for component sales.
(iv) Level of specificity required.
(v) Examples.
(6) High profit test.
(i) In general.
(ii) Return on assets test.
(iii) Additional rules.
(7) Definitions.
(i) U.S.-connected products or services.
(ii) Industry segment.

(iii) Gross revenue of an industry segment.
(iv) Identifiable assets of an industry segment.
(v) Operating profit of an industry segment.
(vi) Product.
(vii) Related products or services.
(viii) Model.
(ix) Product line.
(8) Example.
(i) Facts.
(ii) Existing records test.
(iii) Signficant industry segments.
(iv) High profit test.
(v) Material profit and loss statements.
(d) Liability for certain partnership record maintenance.
(e) Agreements with the District Director or the Assistant Commissioner (International).
(1) In general.
(2) Content of agreement.
(i) In general.
(ii) Significant industry segment test.
(iii) Example.
(3) Circumstances of agreement.
(4) Agreement as part of APA process.
(f) U.S. maintenance.
(1) General rule.
(2) Non-U.S. maintenance requirements.
(3) Prior taxable years.
(4) Scheduled production for high volume or other reasons.
(5) Required U.S. maintenance.
(g) Period of retention.
(h) Application of record maintenance rules to banks and other financial institutions. [Reserved]
(i) Effective dates.

§1.6038A–4 Monetary penalty

(a) Imposition of monetary penalty.
(1) In general.
(2) Liability for certain partnership transactions.
(3) Calculation of monetary penalty.
(b) Reasonable cause.
(1) In general.
(2) Affirmative showing required.
(i) In general.
(ii) Small corporations.
(iii) Facts and circumstances taken into account.
(c) Failure to maintain records or to cause another to maintain records.
(d) Increase in penalty where failure continues after notification.
(1) In general.
(2) Additional penalty for another failure.
(3) Cessation of accrual.
(4) Continued failures.
(e) Other penalties.
(f) Examples.
Example (1)—Failure to file Form 5472.
Example (2)—Failure to maintain records.
(g) Effective dates.

§1.6038A–5 Authorization of agent

(a) Failure to authorize.
(b) Authorization by related party.
(1) In general.
(2) Authorization for prior years.
(c) Foreign affiliated groups.
(1) In general.
(2) Application of noncompliance penalty adjustment.
(d) Legal effect of authorization of agent.
(1) Agent for purposes of commencing judicial proceedings.
(2) Foreign related party found where reporting corporation found.
(e) Successors in interest.
(f) Deemed compliance.
(1) In general.
(2) Reason to know.
(3) Effect of deemed compliance.
(g) Effective dates.

§1.6038A–6 Failure to furnish information

(a) In general.
(b) Coordination with treaties.
(c) Enforcement proceeding not required.
(d) *De minimis* failure.
(e) Suspension of statute of limitations.
(f) Effective dates.

§1.6038A–7 Noncompliance

(a) In general.
(b) Determination of the amount.
(c) Separate application.
(d) Effective dates.

[T.D. 8353, 56 FR 28060, June 19, 1991]

§1.6038A–1 General requirements and definitions.

(a) *Purpose and scope.* This section and §§1.6038A–2 through 1.6038A–7 provide rules for certain foreign-owned U.S. corporations and foreign corporations engaged in trade or business within the United States (reporting corporations) relating to information that must be furnished, records that must be maintained, and the authorization of the reporting corporation to act as agent for related foreign persons for purposes of sections 7602, 7603, and 7604 that must be executed. Section 6038A(a) and this section require that a reporting corporation furnish certain information annually and maintain certain records relating to transactions between the reporting corporation and certain related parties. This section also provides definitions of terms used in section 6038A. Section 1.6038A–2 provides guidance concerning the information to be submitted and the filing of the required return. Section 1.6038A–3 provides guidance concerning the maintenance of records. Section 1.6038A–4 provides guidance concerning the application of the monetary penalty for the failure either to furnish information or to maintain records. Section 1.6038A–5 provides guidance concerning the authorization of an agent for purposes of sections 7602, 7603, and 7604. Section 1.6038A–6 provides guidance concerning the failure to furnish information requested by a summons. Finally, § 1.6038A–7 provides guidance concerning the application of the noncompliance penalty for failure by the related party to authorize an agent or by the reporting corporation to substantially comply with a summons.

(b) *In general.* A reporting corporation must furnish the information described in § 1.6038A–2 by filing an annual information return (Form 5472 or any successor), and must maintain records as described in § 1.6038A–3.

(c) *Reporting corporation*—(1) *In general.* For purposes of section 6038A, a reporting corporation is either a domestic corporation that is 25-percent foreign-owned as defined in paragraph (c)(2) of this section, or a foreign corporation that is 25-percent foreign-owned and engaged in trade or business within the United States. After November 4, 1990, a foreign corporation engaged in a trade or business within the United States at any time during a taxable year is a reporting corporation. See section 6038C.

(2) *25-percent foreign-owned.* A corporation is 25-percent foreign-owned if it has at least one direct or indirect 25-percent foreign shareholder at any time during the taxable year.

(3) *25-percent foreign shareholder*—(i) *In general.* A foreign person is a 25-percent foreign shareholder of a corporation if the person owns at least 25 percent of—

(A) The total voting power of all classes of stock of the corporation entitled to vote, or

(B) The total value of all classes of stock of the corporation.

(ii) *Total voting power and value.* In determining whether one foreign person owns 25 percent of the total voting power of all classes of stock of a corporation entitled to vote or 25 percent of the total value of all classes of stock of a corporation, consideration will be given to all the facts and circumstances of each case, under principles similar to § 1.957–1(b)(2) (consideration of arrangements to shift formal voting power away from a foreign person).

(iii) *Direct 25-percent foreiqn shareholder.* A foreign person is a direct 25-percent foreign shareholder if it owns directly at least 25 percent of the stock of the reporting corporation, either by vote or by value.

(iv) *Indirect 25-percent foreign shareholder.* A foreign person is an indirect 25-percent foreign shareholder if it owns indirectly (or under the attribution rules of section 318 is considered to own indirectly) at least 25 percent of the stock of the reporting corporation, either by vote or by value.

(4) *Application to prior open years.* For taxable years beginning before July 11, 1989, the definition of a reporting corporation under this paragraph applies in determining whether a foreign-owned corporation is a reporting corporation. An examination may be reopened if the statute of limitations period for that taxable year has not expired. A taxable year may not be reopened under section 6038A for examination purposes if the taxable year is open under section 6511 only for purposes of the carryback of net operating losses or net capital losses.

(5) *Exceptions*—(i) *Treaty country residents having no permanent establishment.* A foreign corporation that has no permanent establishment in the United States under an applicable income tax convention is not a reporting corporation for purposes of section 6038A and this section. Accordingly, such a foreign corporation is not subject to §§ 1.6038A–2, 1.6038A–3, and 1.6038A–5. It must timely and fully provide the required notice to the Commissioner under section 6114. See section 6114 and the regulations thereunder for the notice that such a corporation must file and the applicable penalties for failure to file such notice.

(ii) *Qualified exempt shipping income.* A foreign corporation whose gross income is exempt from U.S. taxation under section 883 is not a reporting corporation provided that it timely and fully complies with the reporting requirements required to claim such exemption. In the event that such a corporation does not timely and fully comply with the reporting requirements under sections 887 and 883, it will be a reporting corporation subject to section 6038A, including the application of the monetary penalty for failure to file required information.

(iii) *Status as foreign related party.* Nothing in this paragraph affects the determination of whether a person is a foreign related party as defined in paragraph (g) of this section.

(d) *Related party.* The term ''related party'' means—

(1) Any direct or indirect 25-percent foreign shareholder of the reporting corporation,

(2) Any person who is related within the meaning of sections 267(b) or 707(b)(1) to the reporting corporation or to a 25-percent foreign shareholder of the reporting corporation, or

(3) Any other person who is related to the reporting corporation within the meaning of section 482 and the regulations thereunder. However, the term ''related party'' does not include any corporation filing a consolidated federal income tax return with the reporting corporation.

(e) *Attribution rules*—(1) *Attribution under section 318.* For purposes of determining whether a corporation is 25-percent foreign-owned and whether a person is a related party under section 6038A, the constructive ownership rules of section 318 shall apply, and the attribution rules of section 267(c) also shall apply to the extent they attribute ownership to persons to whom section 318 does not attribute ownership. However, ''10 percent'' shall be substituted for ''50 percent'' in section 318(a)(2)(C), and section 318(a)(3) (A), (B), and (C) shall not be applied so as to consider a U.S. person as owning stock that is owned by a person who is not a U.S. person. Additionally, section 318(a)(3)(C) and §1.318–1(b) shall not be applied so as to consider a U.S. corporation as being a reporting corporation if, but for the application of such sections, the U.S. corporation would not be 25-percent foreign owned.

(2) *Attribution of transactions with related parties engaged in by a partnership.* The transactions in which a domestic or foreign partnership engages shall be attributed to any reporting corporation whose interest in the capital or profits of the partnership, either directly or indirectly, combined with the interests of all related parties of the reporting corporation partner, equals 25 percent or more of the total partnership interests. Attribution of such transactions shall be made only to the extent of the partnership interest held by that reporting corporation partner. See sections 875 and 702(a) and the regulations thereunder. (Attribution shall not be made however, of transactions directly between the partnership and a reporting corporation.) Accordingly, a reporting corporation partner that is deemed to engage in transactions with related parties under this rule is subject to the information reporting requirements of §1.6038A–2, to the record maintenance requirements of §1.6038A–3, to the monetary penalty under §1.6038A–4, to the requirement of authorization of agent under §1.6038A–5, to the rules of §1.6038A–6 relating to the requirement to produce records, and to the noncompliance penalty adjustment under §1.6038A–7.

(f) *Foreign person.* For purposes of section 6038A, a foreign person is—

(1) Any individual who is not a citizen or resident of the United States, but not including any individual for whom an election under section 6013 (g) or (h) (relating to an election to file a joint return) is in effect;

(2) Any individual who is a citizen of any possession of the United States and who is not otherwise a citizen or resident of the United States;

(3) Any partnership, association, company, or corporation that is not created or organized in the United States or under the law of the United States or any State thereof;

(4) Any foreign trust or foreign estate, as defined in section 7701(a)(31); or

(5) Any foreign government (or agency or instrumentality thereof). To the extent that a foreign government is engaged in the conduct of commercial activity as defined under section 892 and the regulations thereunder, it will be treated as a foreign person under section 6038A and this section only for purposes of the information reporting

requirements of § 1.6038A–2. A foreign government will not be treated as a foreign related party for purposes of §§ 1.6038A–3 and 1.6038A–5.

For purposes of section 6038A, a possession of the United States shall be considered to be a foreign country.

(g) *Foreign related party.* A foreign related party is a foreign person as defined under paragraph (f) of this section that is also a related party as defined under paragraph (d) of this section.

(h) *Small corporation exception.* A reporting corporation that has less than $10,000,000 in U.S. gross receipts for a taxable year is not subject to §§ 1.6038A–3 and 1.6038A–5 for that taxable year. Such a corporation, however, remains subject to the information reporting requirements of § 1.6038A–2 and the general record maintenance requirements of section 6001. For purposes of this paragraph, U.S. gross receipts includes all amounts received or accrued to the extent that such amounts are taken into account for the determination and computation of the gross income of the corporation. For purposes of this test, the U.S. gross receipts of all related reporting corporations shall be aggregated.

(i) *Safe harbor for reporting corporations with related party transactions of de minimis value*—(1) *In general.* A reporting corporation is not subject to §§ 1.6038A–3 and 1.6038A–5 for any taxable year in which the aggregate value of all gross payments it makes to and receives from foreign related parties with respect to related party transactions (including monetary consideration, nonmonetary consideration, and the value of transactions involving less than full consideration), is not more than $5,000,000 and is less than 10 percent of its U.S. gross income. Such a corporation, however, remains subject to the information reporting requirements of § 1.6038A–2 and the general record maintenance requirements of section 6001. For purposes of this paragraph, U.S. gross income means the gross income reportable by the reporting corporation (or the aggregate gross income reportable by all related reporting corporations) for U.S. income tax purposes. Gross payments made to or received from foreign related parties cannot be netted; rather, the gross payments made to and received from foreign related parties are to be aggregated. Thus, for example, if a reporting corporation receives $4,700,000 of gross payments from a related party and makes $500,000 of gross payments to the same related party, it has aggregate gross payments of $5,200,000, and, therefore, does not qualify for the safe harbor under this paragraph.

(2) *Aggregate value of gross payments made or received.* The aggregate value of gross payments made to (or received from) a foreign related party with respect to foreign related party transactions is determined by totaling the dollar amounts of foreign related party transactions as described in § 1.6038A–2(b) (3) and (4) on all Forms 5472 filed by the reporting corporation or related reporting corporations.

(j) *Related reporting corporations.* A reporting corporation is related to another reporting corporation if it is related to that other reporting corporation under the principles described in paragraphs (d) and (e) of this section.

(k) *Consolidated return groups*—(1) *Required information.* If a reporting corporation is a member of an affiliated group for which a U.S. consolidated income tax return is filed, the return requirement of § 1.6038A–2 may be satisfied by filing a consolidated Form 5472. The common parent, as identified on Form 851, must attach a schedule to the consolidated Form 5472 stating which members of the U.S. affiliated group are reporting corporations under section 6038A, and which of those are joining in the consolidated Form 5472. The schedule must provide the name, address, and taxpayer identification number of each member whose transactions are included on the consolidated Form 5472. A member is not required to join in filing a consolidated Form 5472 merely because other members of the group choose to file one or more Forms 5472 on a consolidated basis.

(2) *Maintenance of records and authorization of agent.* Either the common parent or the principal operating company of an affiliated group filing a consolidated income tax return may be authorized under § 1.6038A–5 to act as the

agent for foreign related persons engaged in transactions with members of the group solely for purposes of section 7602, 7603, and 7604 under section 6038A(e)(1) and § 1.6038A–5. Each member of the group, however, must maintain the records required under section 6038A (a) and § 1.6038A–3 relating to its related party transactions.

(3) *Monetary penalties.* The common parent (or principal operating company) and all reporting corporations that join in the filing of a consolidated Form 5472 are liable jointly and severally for penalties for failure to file Form 5472 and for failure to mantain records under section 6038A(d) and § 1.6038A–4(e). See § 1.1502–77(a) regarding the scope of agency of the common parent corporation.

(l) *District Director.* For purposes of the regulations under section 6038A, the term ''District Director'' means any District Director, or the Assistant Commissioner (International) when performing duties similar to those of a District Director with respect to any person over which the Assistant Commissioner (International) has appropriate jurisdiction.

(m) *Examples.* The following examples illustrate the rules of this section.

Example 1. P, a U.S. partnership that is engaged in a U.S. trade or business, is 75 percent owned by FC1, a foreign corporation that, in turn, is wholly owned by another foreign corporation, FC2. The remaining 25 percent of P is owned by Corp, a domestic corporation, that is wholly owned by FC3. P engages in transactions solely with FC2 and FC3. These transactions are attributed to FC1 and Corp. Under section 875, FC1 is considered as being engaged in a U.S. trade or business. For purposes of section 6038A and this section, FC1 and Corp are reporting corporations and must report their pro rata shares of the value of the transactions with FC2 and FC3. Thus, Corp must report 25 percent of P's transactions with FC3 and FC1 must report 75 percent of P's transactions with FC2.

Example 2. FC2 and FC3 are both foreign corporations that are wholly owned by FC1, also a foreign corporation. FC2 engages in a trade or business in the United States through a branch. The branch engages in related party transactions with FC1. FC2 is a reporting corporation. FC3 is a foreign related party. FC1 is a direct 25-percent foreign shareholder of both FC2 and FC3. Neither FC1 nor FC3 is a reporting corporation.

Example 3. FC1 owns 25 percent of total voting power in each of FC2 and FC3. FC2 and FC3 each own 20 percent of the total voting power of Corp, a domestic corporation. The remaining stock of Corp is owned by an unrelated domestic corporation. Neither FC2 nor FC3 is engaged in a U.S. trade or business. Under section 318(a)(2)(C) and paragraph (e) of this section, FC1 constructively owns its proportionate share of the stock of Corp owned directly by FC2 and FC3. Thus, FCl is treated as constructively owning five percent of Corp through each of FC2 and FC3 or a total of 10 percent of the Corp stock. Consequently, Corp is not a reporting corporation because no 25 percent shareholder exists.

Example 4. FP owns 100 percent of FCl which, in turn, owns 100 percent of FC2. FC2 owns 100 percent of FC3 which owns 100 percent of RC. FP, FC1, and FC2 are indirect 25-percent foreign shareholders of RC, and FC3 is a direct 25-percent foreign shareholder.

Example 5. FP owns 100 percent of USS, a U.S. corporation, and 25 percent of FS, a foreign corporation. The remaining 75 percent of FS is publicly owned by numerous small shareholders. Sales transactions occur between USS and FS. Applying the rules of this section, USS is a reporting corporation. It is determined that USS and FS are each controlled by FP under section 482 and the regulations thereunder. Therefore, FS is related to USS within the meaning of section 482 and is a related party to USS. Accordingly, the sales transactions between USS and FS are subject to section 6038A.

Example 6. The facts are the same as in *Example 5,* except that the remaining 75 percent of FS is owned by one shareholder that is unrelated to the FP group and it is determined that FS is not controlled by FP for purposes of section 482. Under these facts, FS is not a related party of either FP or USS. Accordingly, section 6038A does not apply to the sales transactions between FS and USS.

Example 7. P, a U.S. multinational, is a holding company that wholly owns X, a U.S. operating company, which in turn wholly owns FS, a controlled foreign corporation. Applying the rule of section 318(a)(3)(C), FS is deemed to own the stock of X that is actually held by P. However, under the rules of paragraph (e) of this section, X will not be a reporting corporation by reason of section 318.

(n) *Effective dates*—(1) *Section 1.6038A–1.* Paragraphs (c) (relating to the definition of a reporting corporation), (d) (relating to the definition of a related party), (e)(1) (relating to the application of section 318), and (f) (relating to the definition of a foreign person) of this section are effective for taxable Years beginning after July 10, 1989. The remaining paragraphs of this section are effective December 10, 1990, without regard to when the taxable year began.

(2) *Section 1.6038A–2.* Section 1.6038A–2 (relating to the requirement to file Form 5472) is generally effective for taxable years beginning after July 10, 1989. However, § 1.6038A–2 as it applies to reporting corporations whose sole trade or business in the United States is a banking, financing, or similar business as defined in § 1.864–4(c)(5)(i) is effective for taxable years beginning after December 10, 1990.

(3) *Section 1.6038A–3.* Section 1.6038A–3 (relating to the record maintenance requirement) is generally effective December 10, 1990. However, records described in § 1.6038A–3 in existence on or after March 20, 1990, must be maintained, without regard to when the taxable year to which the records relate began.

(4) *Section 1.6038A–4.* Section 1.6038A–4 (relating to the monetary penalty) is generally effective for taxable years beginning after July 10, 1989, for the failure to file Form 5472. For the failure to maintain records or the failure to produce documents under § 1.6038A–4(f)(2), the section is effective December 10, 1990, without regard to when the taxable year to which the records relate began.

(5) *Section 1.6038A–5.* Section 1.6038A–5 (relating to the authorization of agent requirement) is effective December 10, 1990, without regard to when the taxable year to which the records relate began.

(6) *Section 1.6038A–6.* Section 1.6038A–6 (relating to the failure to furnish information under a summons) is effective November 6, 1990, without regard to when the taxable year to which the summons relates began.

(7) *Section 1.6038A–7.* Section 1.6038A–7 (relating to the noncompliance penalty adjustment) is effective December 10, 1990, without regard to when the taxable year began.

[T.D. 8353, 56 FR 28061, June 19, 1991; T.D. 8353, 56 FR 41792, Aug. 23, 1991]

§ 1.6038A–2 Requirement of return.

(a) *Form 5472 required*—(1) *In general.* Each reporting corporation as defined in § 1.6038A–1(c) (or members of an affiliated group filing together as described in § 1.6038A–1(k)) shall make a separate annual information return on Form 5472 with respect to each related party as defined in § 1.6038A–1(d) with which the reporting corporation (or any group member joining in a consolidated Form 5472) has had any reportable transaction during the taxable year. The information required by section 6038A and this section must be furnished even though it may not affect the amount of any tax due under the Code.

(2) *Reportable transaction.* A reportable transaction is any transaction of the types listed in paragraphs (b) (3) and (4) of this section. However, if neither party to the transaction is a United States person as defined in section 7701(a)(30) and the transaction—

(i) Will not generate in any taxable year gross income from sources within the United States or income effectively connected, or treated as effectively connected, with the conduct of a trade or business within the United States, and

(ii) Will not generate in any taxable year any expense, loss, or other deduction that is allocable or apportionable to such income, the transaction is not a reportable transaction.

(b) *Contents of return*—(1) *Reporting corporation.* Form 5472 must provide the following information in the manner the form prescribes with respect to each reporting corporation:

(i) Its name, address (including mailing code), and U.S. taxpayer identification number; each country in which the reporting corporation files an income tax return as a resident under the tax laws of that country; its country or countries of organization, and incorporation; its total assets for U.S. reporting corporation; the places where it conducts its business; and its principal business activity.

(ii) The name, address, and U.S. taxpayer identification number, if applicable, of all its direct and indirect 25-percent foreign shareholders (for an indirect 25-percent foreign shareholder, explain the attribution of ownership); each country in which each 25-percent foreign shareholder files an income tax return as a resident under the tax laws of that country; the places where each 25-percent shareholder conducts its business; and the country or countries of organization, citizenship, and incorporation of each 25-percent foreign shareholder.

(iii) The number of Forms 5472 filed for the taxable year and the aggregate value in U.S. dollars of gross payments as defined in §1.6038A–1(h)(2) made with respect to all foreign related party transactions reported on all Forms 5472.

(2) *Related party.* The reporting corporation must provide information on Form 5472, set forth in the manner the form prescribes, about each related party, whether foreign or domestic, with which the reporting corporation had a transaction of the types described in paragraphs (b) (3) and (4) of this section during its taxable year, including the following information:

(i) The name, U.S. taxpayer identification number, if applicable, and address of the related party.

(ii) The nature of the reated party's business and the principal place or places where it conducts its business.

(iii) Each country in which the related party files an income tax return as a resident under the tax laws of that country.

(iv) The relationship of the reporting corporation to the related party.

(3) *Foreign related party transactions for which only monetary consideration is paid or received by the reporting corporation.* If the related party is a foreign person, the reporting corporation must set forth on Form 5472 the dollar amounts of all reportable transactions for which monetary consideration (including U.S. and foreign currency) was the sole consideration paid or received during the taxable year of the reporting corporation. The total amount of such transactions, as well as the separate amounts for each type of transaction described below, must be reported on Form 5472, in the manner the form prescribes. Where actual amounts are not determinable, a reasonable estimate (as described in paragraph (b)(6) of this section) is permitted. The types of transactions described in this paragraph are:

(i) Sales and purchases of stock in trade (inventory);

(ii) Sales and purchases of tangible property other than stock in trade;

(iii) Rents and royalties paid and received (other than amounts reported under paragraph (b)(3)(iv) of this section);

(iv) Sales, purchases, and amounts paid and received as consideration for the use of all intangible property, including (but not limited to) copyrights, designs, formulas, inventions, models, patents, processes, trademarks, and other similar intangible property rights;

(v) Consideration paid and received for technical, managerial, engineering, construction, scientific, or other services;

(vi) Commissions paid and received;

(vii) Amounts loaned and borrowed (except open accounts resulting from sales and purchases reported under other items listed in this paragraph (b)(3) that arise and are collected in full in the ordinary course of business);

(viii) Interest paid and received;

(ix) Premiums paid and received for insurance and reinsurance; and

(x) Other amounts paid or received not specifically identified in this paragraph (b)(3) to the extent that such amounts are taken into account for the determination and computation of the taxable income of the reporting corporation.

Amounts required to be reported under paragraph (b)(3)(vii) of this section shall be reported as monthly averages or outstanding balances at the beginning and end of the taxable year, as the form shall prescribe.

(4) *Foreign related party transactions involving nonmonetary consideration or less than full consideration.* If the related party is a foreign person, the reporting corporation must provide on Form 5472 a description of any reportable transaction, or group of reportable transactions, listed in paragraph (b)(3) of this section, for which any part of the consideration paid or received was not monetary consideration, or for which less than full consideration was paid or received. A description required under paragraph (b)(4) of this section shall include sufficient information from which to determine the nature and approximate monetary value of the transaction or group of transactions, and shall include:

(i) A description of all property (including monetary consideration), rights, or obligations transferred from the reporting corporation to the foreign related party and from the foreign related party to the reporting corporation;

(ii) A description of all services performed by the reporting corporation for the foreign related party and by the foreign related party for the reporting corporation; and

(iii) A reasonable estimate of the fair market value of all properties and services exchanged, if possible, or some other reasonable indicator of value.

If, for any transaction, the entire consideration received includes both tangible and intangible property and the consideration paid is solely monetary consideration, the transaction should be reported under paragraph (b)(3) of this section if the intangible property was related and incidental to the transfer of the tangible property (for example, a right to warranty services.)

(5) *Additional information.* In addition to the information required under paragraphs (b) (3) and (4) of this section, a reporting corporation must provide on Form 5472, in the manner the form prescribes, the following information:

(i) If the reporting corporation imports goods from a foreign related party, whether the costs taken into account in computing the basis or inventory cost of such goods are greater than the costs taken into account in computing the valuation of the goods for customs purposes, adjusted pursuant to section 1059A and the regulations thereunder, and if so, the reasons for the difference.

(ii) If the costs taken into account in computing the basis or inventory cost of such goods are greater than the costs taken into account in computing the valuation of the goods for customs purposes, whether the documents supporting the reporting corporation's treatment of the items set forth in paragraph (b)(5)(i) of this section are in existence and available in the United States at the time Form 5472 is filed.

(6) *Reasonable estimate*—(i) *Estimate within 25 percent of actual amount.* Any amount reported under this section is considered to be a reasonable estimate if it is at least 75 percent and not more than 125 percent of the actual amount.

(ii) *Other estimates.* If any amount reported under this paragraph (b) of this section fails to meet the reasonable estimate test of paragraph (b)(6)(i) of this section, the reporting corporation nevertheless may show that such amount is a reasonable estimate by making an affirmative showing of relevant facts and circumstances in a written statement containing a declaration that it is made under the penalties of perjury. The District Director shall determine whether the amount reported was a reasonable estimate.

(7) *Small amounts.* If any actual amount required under this section does not exceed $50,000, the amount may be reported as ''$50,000 or less.''

(8) *Accrued payments and receipts.* For purposes of this section, in the case of an accrual basis taxpayer, the terms ''paid'' and ''received'' shall include accrued payments and receipts, respectively.

(c) *Method of reporting.* All statements required on or with the Form 5472 under this section and § 1.6038A–5 shall be in the English language. All amounts required to be reported under paragraph (b) of this section shall be expressed in United States currency, with a statement of the exchange rates used.

(d) *Time and place for filing returns.* A Form 5472 required under this section shall be filed with the reporting corporation's income tax return for the taxable year by the due date (including extensions) of that return. A duplicate Form 5472 (including any attachments and schedules) shall be filed at the same time with the Internal Revenue Service Center, Philadelphia, PA 19255.

(e) *Untimely filed return.* If the reporting corporation's income tax return is untimely filed, Form 5472 (with a duplicate to Philadelphia) nonetheless shall be timely filed at the service center where the return is due. When the income tax return is ultimately filed, a copy of Form 5472 must be attached.

(f) *Exceptions*—(1) *No reportable transactions.* A reporting corporation is not required to file Form 5472 if it has no transactions of the types listed in paragraphs (b) (3) and (4) of this section during the taxable year with any related party.

(2) *Transactions solely with a domestic reporting corporation.* If all of a foreign reporting corporation's reportable transactions are with one or more related domestic reporting corporations that are not members of the same affiliated group, the foreign reporting corporation shall furnish on Form 5472 only the information required under paragraphs (b) (1) and (2) of this section, if the domestic reporting corporations provide the information required under paragraphs (b) (3) through (5) of this section. Such a foreign reporting corporation nonetheless is subject to the record maintenance requirements of §1.6038A–3 and the requirements of §§1.6038A–5 and 1.6038A–6. The name, address, and taxpayer identification number of each domestic reporting corporation that provided such information must be indicated on Form 5472 in the space provided for the information under paragraphs (b) (1) and (2) of this section.

(3) *Transactions with a corporation subject to reporting under section 6038.* A reporting corporation is not required to make a return of information on Form 5472 with respect to a related foreign corporation for a taxable year for which a U.S. person that controls the foreign related corporation makes a return of information on Form 5471 that is required under section 6038 and this section, if that return contains information required under §1.6038–2(f)(11) with respect to the reportable transactions between the reporting corporation and the related corporation for that taxable year. Such a reporting corporation also is not subject to §§1.6038A–3 and 1.6038A–5. It remains subject to the general record maintenance requirements of section 6001.

(4) *Transactions with a foreign sales corporation.* A reporting corporation is not required to make a return of information on Form 5472 with respect to a related corporation that qualifies as a foreign sales corporation for a taxable year for which the foreign sales corporation files Form 1120–FSC.

(g) *Filing Form 5472 when transactions with related parties engaged in by a partnership are attributed to a reporting corporation.* If transactions engaged in by a partnership are attributed under §1.6038A–1(e)(2) to a reporting corporation, the reporting corporation need report on Form 5472 only the percentage of the value of the transaction or transactions equal to the percentage of its partnership interest. Thus, for example, if a partnership buys $1000 of widgets from the foreign parent of a reporting corporation whose partnership interest in the partnership equals 50 percent of the partnership interests (and the remaining 50 percent is held by unrelated parties), the reporting corporation must report $500 of purchases from a foreign related party on Form 5472.

(h) *Effective dates for certain reporting corporations.* For effective dates for this section, see §1.6038A–1(n).

[T.D. 8353, 56 FR 28063, June 19, 1991]

§1.6038A–3 Record maintenance.

(a) *General maintenance requirements*—(1) Section 6001 and section 6038A. A reporting corporation must keep the permanent books of account or records as required by section 6001 that are sufficient to establish the correctness of the federal income tax return of the corporation, including information, documents, or records (''records'') to the extent they may be relevant to determine the correct U.S. tax treatment of transactions with related parties. Under section 6001, the District Director may require any person to make such returns, render such statements, or keep such specific records as will enable the District Director to determine whether or not that person is liable for any of the taxes to which the regulations under part I have application. See section 6001 and the regulations thereunder. Such records must be permanent, accurate, and complete, and must clearly establish income, deductions, and credits. Additionally, in appropriate cases, such records include sufficient relevant cost data from which a profit and loss statement may be prepared for products or services transferred between a reporting corporation and its foreign related parties. This requirement includes records of the reporting corporation itself, as well as to records of any foreign related party that may be relevant to determine the correct U.S. tax treatment of transactions between the reporting corporation and foreign related parties. The relevance of such records with respect to related party transactions shall be determined upon the basis of all the facts and circumstances. Section 6038A and this section provide detailed guidance regarding the required maintenance of records with respect to such transactions and specify penalties for noncompliance. Banks and other financial institutions shall follow the specific record maintenance rules described in paragraph (h) of this section.

(2) *Safe harbor.* A safe harbor for record maintenance is provided under paragraph (c) of this section, which sets forth detailed guidance concerning the types of records to be maintained with respect to related party transactions. The safe harbor consists of an all-inclusive list of record types that could be relevant to different taxpayers under a variety of facts and circumstances. It does not constitute a checklist of records that every reporting corporation must maintain or that generally should be requested by the Service. A specific reporting corporation is required to maintain, and the Service will request, only those records enumerated in the safe harbor (including material profit and loss statements) that may be relevant to its business or industry and to the correct U.S. tax treatment of its transactions with its foreign related parties. Accordingly, not every item listed in the safe harbor must be maintained by every reporting corporation. A corporation that maintains or causes another person to maintain the records listed in paragraph (c)(2) of this section that may be relevant to its foreign related party transactions and to its business or industry will be deemed to have met the record maintenance requirements of section 6038A.

(3) *Examples.* The following examples illustrate the rules of this paragraph.

Example 1. RC, a U.S. reporting corporation, is owned by two shareholders, F and P. F is a foreign corporation that owns 30 percent of the stock of RC. P is a domestic corporation that owns the remaining 70 percent. RC purchases tangible property from F; however, the only potential audit issue with respect to these transactions is their treatment under section 482. It is determined that F does not in fact control RC and the two corporations do not constitute a group of ‘‘controlled taxpayers’’ for purposes of section 482 and the regulations thereunder. There are no other reportable transactions between RC and F. Under § 1.6038A–1(g), F is a foreign related party with respect to RC. Accordingly, RC is required to report its purchases of property from F under the reporting requirements of § 1.6038A–2. Nevertheless, because section 482 is not applicable to the transactions between RC and F, the records created by F with respect to its sales to RC are not relevant for purposes of determining the correct tax treatment of these transactions. RC is required to maintain its own records of these transactions under the requirements of section 6001, but the transactions are not subject to the record maintenance requirements of this section. If, however, on audit it is determined that F does control RC, all records relevant to determining the arm’s length consideration for the tangible property under section 482 will be subject to these requirements.

Example 2. FP, a foreign person, owns 30 percent of the stock of RC, a reporting corporation. The remaining 70 percent of RC stock is held by persons that are not 25-percent foreign shareholders. It is determined that FP is related to RC within the meaning of section 482 and the regulations thereunder. The only transactions between FP and RC are FP’s capital contributions, dividends paid from RC to FP, and loans from FP to RC. Under section 6001, RC is required to maintain all documentation necessary to establish the U.S. tax treatment of the capital contributions, dividends, and loans. RC is not required to maintain records in other categories listed in paragraph (c)(3) of this section because they are not relevant to the transactions between FP and RC. Records of FP not related to these transactions are not subject to the record maintenance requirements under section 6038A(a) and this section.

Example 3. G, a foreign multinational group, creates Sub, a wholly-owned U.S. subsidiary, in order to purchase tangible property from unrelated parties in the United States and resell such property to G. The property purchased by Sub is either used in G’s business or resold to other unrelated parties by G. Sub’s sole function is to act as a buyer for G and these purchases are the only transactions that G has with any U.S. affiliates. Under all the facts and circumstances of this case, it is determined that an analysis of the group’s worldwide profit attributable to the property it purchases from Sub is not relevant for purposes of determining the tax treatment of the sales from Sub to G. Therefore, the records with respect to the profitability of G are not subject to the record maintenance requirements of this section.

However, all records related to the appropriate method under section 482 for determining an arm's-length consideration for the property sold by Sub to G are subject to the record maintenance requirements of this section.

Example 4. S, a U.S. reporting corporation, is the purchasing agent for its multinational parent group. It arranges for the purchase and export of miscellaneous tangible property to X, Y, and Z, each of which is a foreign related party. The miscellaneous tangible property is purchased from unrelated third parties for resale to X, Y, and Z. These resales of miscellaneous tangible property constitute the sole transactions between S and X, Y, and Z. The purchasing agent activity of S is not an integral part of the business activity of S or of any beneficiary of the purchasing agent services provided by S as defined in §1.482–2(b)(7). Under §1.482–2(b)(7), the arm's-length charge is deemed to be equal to the costs or deductions incurred with respect to the provision of the purchasing agent services. S is required to maintain records to permit verification upon audit of such costs or deductions. The records of X, Y, and Z are not relevant to the costs or deductions incurred by S with respect to its purchasing agent activities. Therefore, under section 6038A and this section, only the records maintained by S that permit verification of the costs and deductions of the purchasing agent services are relevant. Accordingly, solely with respect to these transactions, records of X, Y, and Z need not be maintained under section 6038A or this section. If, however, upon audit, it is determined that S is not merely engaging in services not integral to its business as defined in §1.482–2(b)(7), the record maintenance requirements under section 6038A(a) and this section will be applicable to the records of S, X, Y and Z to the extent that such records are relevant for determining the correct tax treatment of transactions engaged in by X, Y, or Z with S. If S has other transactions with X, S must maintain or cause to be maintained records that may be relevant with respect to those transactions.

(b) *Other maintenance requirements*—(1) *Indirectly related records.* This section applies to records that are directly or indirectly related to transactions between the reporting corporation and any foreign related parties. An example of records that are indirectly related to such transactions is records possessed by a foreign subsidiary of a foreign related party that document the raw material or component costs of a product that is manufactured or assembled by the subsdiary and sold as a finished product by the foreign related party to the reporting corporation.

(2) *Foreign related party or third-party maintenance.* If records that are required to be maintained under this section are in the control of a foreign related party, the records may be obtained or compiled (if not already in the possession of the foreign related party or already compiled) under the direction of the reporting corporation and then maintained by the reporting corporation, the foreign related party, or a third party. Thus, for example, a foreign related party may either itself maintain such records outside the United States or permit a third party to maintain such records outside the United States, provided that the conditions described in paragraph (f) of this section are met. Upon a request for such records by the Service, a foreign related party or third party may make arrangements with the District Director to furnish the records directly, rather than through the reporting corporation.

(3) *Translation of records.* When records are provided to the Service under a request for production, any portion of such records must be translated into the English language within 30 days of a request for translation of that portion by the District Director. To the extent that any requested documents are identical to documents that have already been translated, an explanation of how such documents are identical instead may be provided. An extension of this time period may be requested under paragraph (f)(4) of this section. Appropriate extensions will be liberally granted for translation requests where circumstances warrant. If a good faith effort is made to translate accurately the requested documents within the specified time period, the reporting corporation will not be subject to the penalties in §§1.6038A–4 and 1.6038A–7.

(4) *Exception for foreign governments.* A foreign government is not subject to the obligation to maintain records under this section.

(5) *Records relating to conduit financing arrangements.* See §1.881–4 relating to conduit financing arrangements.

(c) *Specific records to be maintained for safe harbor*—(1) *In general.* A reporting corporation that maintains or causes another person to maintain the records specified in this paragraph (c) that are relevant to its business or industry and to the correct U.S. tax treatment of its transactions with its foreign related parties will deemed to have met the record maintenance requirements of this section. This paragraph provides general descriptions of the categories of records to be maintained; the particular title or label applied by a reporting corporation or related party does not control. Functional equivalents of the specified documents are acceptable. Record maintenance in accordance with this safe harbor, however, requires only the maintenance of types of documents described in paragraph (c)(2) of this section that are directly or indirectly related to transactions between the reporting corporation and any foreign related party. Additionally, to the extent the reporting corporation establishes that records in a particular category are not applicable to the industry or business of the reporting corporation and any foreign related party, maintenance of such records is not required under this paragraph. Record maintenance in accordance with this paragraph (c) generally does not require the original creation of records that are ordinarily not created by the reporting corporation or its related parties. (If, however, a document that is actually created is described in this paragraph (c), it is to be maintained even if the document is not of the type ordinarily created by the reporting corporation or its related parties.) There are two exceptions to the rule. First, basic accounting records that are sufficient to document the U.S. tax effects of transactions between related parties must be created and retained, if they do not otherwise exist. Second, records sufficient to produce material profit and loss statements as described in paragraphs (c)(2)(ii) and (3) of this section that are relevant for determining the U.S. tax treatment of transactions between the reporting corporation and foreign related parties must be created if such records are not ordinarily maintained. All internal records storage and retrieval systems used for each taxable year must be retained.

(2) *Descriptions of categories of documents to be maintained.* The following records must be maintained in order to satisfy this paragraph (c) to the extent they may be relevant to determine the correct U.S. tax treatment of transactions between the reporting corporation and any foreign related party.

(i) *Original entry books and transaction records.* This category includes books and records of original entry or their functional equivalents, however designated or labelled, that are relevant to transactions between any foreign related party and the reporting corporation. Examples include, but are not limited to, general ledgers, sales journals, purchase order books, cash receipts books, cash disbursement books, canceled checks and bank statements, workpapers, sales contracts, and purchase invoices. Descriptive material to explicate entries in the foregoing types of records, such as a chart of accounts or an accounting policy manual, is included in this category.

(ii) *Profit and loss statements.* This category includes records from which the reporting corporation can compile and supply, within a reasonable time, material profit and loss statements of the reporting corporation and all related parties as defined in § 1.6038A–1(d) (the ‘‘related party group’’) that reflect profit or loss of the related party group attributable to U.S.-connected products or services as defined in paragraph (c)(7)(i) of this section. The determination of whether a profit and loss statement is material is made under the rules provided in paragraph (c)(3) of this section. The material profit and loss statements described in this paragraph (c)(2)(ii) must reflect the consolidated revenue and expenses of all members of the related party group. Thus, records in this category include the documentation of the cost of raw materials used by a related party to manufacture finished goods that are then sold by another related party to the reporting corporation. The records should be kept under U.S. generally accepted accounting principles if they are ordinarily maintained in such manner; if not, an explanation of the material differences between the accounting principles used and U.S. generally accepted accounting principles must be made available. The statements need not reflect tracing of the actual costs borne by the group with respect to its U.S.-connected products or services; rather, any reasonable method may be used to allocate the group's worldwide costs to the revenues generated by the sales of those products or services. An explanation of the methods used to allocate specific items to a particular profit and loss statement must be made available. The explanation of material differences between accounting principles and the explanation of allocation methods must be sufficient to permit a comparison of the profitability of the group to that of the reporting corporation attributable to the provision of U.S.-connected products or services.

(iii) *Pricing documents.* This category includes all documents relevant to establishing the appropriate price or rate for transactions between the reporting corporation and any foreign related party. Examples include, but are not limited to, documents related to transactions involving the same or similar products or services entered into by the reporting corporation or a foreign related party with related and unrelated parties; shipping and export documents; commission agreements; documents relating to production or assembly facilities; third-party and intercompany purchase invoices; manuals, specifications, and similar documents relating to or describing the performance of functions conducted at particular locations; intercompany correspondence discussing any instructions or assistance relating to such transactions provided to the reporting corporations by the related foreign person (or vice versa); intercompany and intracompany correspondence concerning the price or the negotiation of the price used in such transactions; documents related to the value and ownership of intangibles used or developed by the reporting corporation or the foreign related party; documents related to cost of goods sold and other expenses; and documents related to direct and indirect selling, and general and administrative expenses (for example, relating to advertising, sales promotions, or warranties).

(iv) *Foreign country and third party filings.* This category includes financial and other documents relevant to transactions between a reporting corporation and any foreign related party filed with or prepared for any foreign government entity, any independent commission, or any financial institution.

(v) *Ownership and capital structure records.* This category includes records or charts showing the relationship between the reporting corporation and the foreign related party; the location, ownership, and status (for example, joint venture, partnership, branch, or division) of all entities and offices directly or indirectly involved in the transactions between the reporting corporation and any foreign related party; a worldwide organization chart; records showing the management structure of all foreign affiliates; and loan documents, agreements, and other documents relating to any transfer of the stock of the reporting corporation that results in the change of the status of a foreign person as a foreign related party.

(vi) *Records of loans, services, and other non-sales transactions.* This category includes relevant documents relating to loans (including all deposits by one foreign related party or reporting corporation with an unrelated party and a subsequent loan by that unrelated party to a foreign related party or reporting corporation that is in substance a direct loan between a reporting corporation and a foreign related party); guarantees of a foreign related party of debts of the reporting corporation, and vice versa; hedging arrangements or other risk shifting or currency risk shifting arrangements involving the reporting corporation and any foreign related party; security agreements between the reporting corporation and any foreign related party; research and development expense allocations between any foreign related party and the reporting corporation; service transactions between any foreign related party and the reporting corporation, including, for example, a description of the allocation of charges for management services, time or travel records, or allocation studies; import and export transactions between a reporting corporation and any foreign related party; the registration of patents and copyrights with respect to transactions between the reporting corporation and any foreign related party: and documents regarding lawsuits in foreign countries that relate to such transactions between a reporting corporation and any foreign related party (for example, product liability suits for U.S. products).

(vii) *Records relating to conduit financing arrangements.* See § 1.881–4 relating to conduit financing arrangements.

(3) *Material profit and loss statements.* For purposes of paragraph (c)(2)(ii) of this section, the determination of whether a profit and loss statement is material will be made according to the following rules. An agreement between the reporting corporation and the District Director as described in paragraph (e) of this section may identify material profit and loss statements of the related party group and describe the items to be included in any profit and loss statements for which records are to be maintained to satisfy the requirements of paragraph (c)(2)(ii) of this section. In the absence of such an agreement, a profit and loss statement will be material if it meets any of the following tests: the existing records test described in paragraph (c)(4) of this section, the significant industry segment test described in paragraph (c)(5) of this section, or the high profit test described in paragraph (c)(6) of this section.

(4) *Existing records test.* A profit and loss statement is material under the existing records test described in this paragraph (c)(4) if any member of the related party group creates or compiles such statement in the course of its business operations and the statement reflects the profit or loss of the related party group attributable to the provision of U.S.-connected products or services (regardless of whether the profit and loss attributable to U.S.-connected products or services is shown separately or included within the calculation of aggregate figures on the statement). For example, a profit and loss statement is described in this paragraph if it was produced for internal accounting or management purposes, or for disclosure to shareholders, financial institutions, government agencies, or any other persons. Such existing statements and the records from which they were complied (to the extent such records relate to profit and loss attributable to U.S.-connected products or services) are subject to the record maintenance requirements described in paragraph (c)(2)(ii) of this section.

(5) *Significant industry segment test*—(i) *In general.* A profit and loss statement is material under the significant industry segment test described in this paragraph (c)(5) if—

(A) The statement reflects the profit or loss of the related party group attributable to the group's provision of U.S.-connected products or services within a single industry segment (as defined in paragraph (c)(7)(ii) of this section);

(B) The worldwide gross revenue attributable to such industry segment is 10 percent or more of the worldwide gross revenue attributable to the group's combined industry segments; and

(C) The amount of gross revenue earned by the group from the provision of U.S.-connected products or services within such industry segment is $25 million or more in the taxable year.

(ii) *Form of the statements.* Profit and loss statements compiled for the group's provision of U.S.-connected products or services in each significant industry segment must reflect revenues and expenses attributable to the operations in such segment by all members of the related party group. Statements may show each related party's revenues and expenses separately, or may be prepared in a consolidated format. Any reasonable method may be used to allocate the group's worldwide costs within the industry segment to the U.S.-connected products or services within that segment. An explanation of the methods used to prepare consolidated statements and to allocate specific items to a particular profit and loss statement must be made available, and the records from which the consolidations and allocations were prepared must be maintained.

(iii) *Special rule for component sales.* Where the U.S.-connected products or services consist of components that are incorporated into other products or services before sale to customers, the portion of the total gross revenue derived from sales of the finished products or services attributable to the components may be determined on the basis of relative costs of production. Thus, where relevant for determining whether the $25 million threshold in paragraph (c)(5)(i)(C) of this section has been met, the amount of gross revenue derived by the related party group from the provision of the finished products or services may be reduced by multiplying it by a fraction, the numerator of which is the costs of production of the related party group attributable to the component products or services that constitute U.S.-connected products or services and the denominator of which is the costs of production of the related party group attributable to the finished products in which such components are incorporated.

(iv) *Level of specificity required.* In applying the significant industry segment test of this paragraph (c)(5), groups of related products and services must be chosen to provide a reasonable level of specificity that results in the greatest number of separate significant industry segments in comparison to other possible classifications. This determination must be made on the basis of the particular facts presented by the operations of the related party group. The following rules, however, provide general guidelines for making such classifications. First, the related party group's operations that involve the provision of U.S.-connected products should be grouped into product lines. The rules of this paragraph (c)(5) should then be applied to determine if any such product line would, standing alone, constitute a significant industry segment when compared to the related party group's operations as a whole. Any significant industry segments determined at the level of product lines should be further segregated, and tested for significant industry segments, at the level of separate products. Finally, any significant industry segments determined at the level of separate products should be segregated, and tested for significant industry segments, at the level of separate models. Similar principles should be applied in classifying and testing types of services. A profit and loss statement reflecting the related party group's provision of any product or service (or group of products or services as classified under these rules) that constitutes a significant industry segment will be considered material for purposes of this paragraph (c)(5). For definitions of the terms "product", "related products or services", "model", and "product line", see paragraph (c)(7) of this section.

(v) *Examples.* The rules for determining reasonable levels of specificity for significant industry segments may be illustrated by the following examples.

Example 1. A related party group is engaged in the manufacture and worldwide sales of automobiles and aftermarket parts. The group's operations within the categories of "automobiles" and "aftermarket parts". are each sufficient to constitute significant industry segments for the group under the rules of this paragraph (c)(5). No narrower classification of aftermarket parts results in any significant industry segments. Automobiles produced by the group are generally classified for marketing purposes by trade names; aggregating groups of automobiles by these trade names results in three significant industry segments, those for trade names A, B, and C. Finally, two car models sold under the trade name A ("A1" and "A2") and one car model sold under the trade name B ("B3"), produce sufficient revenue to constitute significant industry segments. Such classifications into trade names and car models are generally used in the related party group's industry; moreover, different types of classifications would produce fewer significant industry segments. Accordingly, a reasonable level of specificity for this related party group's industry segments would be eight categories of products consisting of "automobiles", "aftermarket parts", "A", "B", "C", "A1", "A2", and "B3".

Example 2. A related party group is engaged in manufacturing electronic goods that are distributed at retail in the United States by the reporting corporation. The group sells three types of products in the United States: televisions, radios, and video cassette recorders (VCRs). Each of these three broad product areas constitutes a significant industry segment for the group as a whole. VCRs can be further segregated by price into high-end and low-end models, and the provision of each constitutes a significant industry segment for the group. Revenues from only one VCR model, model number VCRX–10, are sufficiently large to make the provision of that model a significant industry segment. With respect to televisions, the group normally accounts for these products by size. Using this classification, portable televisions, medium-sized televisions, and consoles each constitute significant industry segments. Narrower classifications by television model numbers result in no additional significant industry segments. Finally, a single radio product line, those sold under the trade name R, produces sufficient revenue to constitute a significant industry segment, but no other radio models or product groups are large enough to constitute a significant industry segment. In each case, these classifications conform to normal business practices in the industry and result in the greatest possible number of significant industry segments for this related party group. Accordingly, a reasonable level of specificity for this related party group's industry segments would include the ten categories consisting of ''VCRs'', ''high-end VCRs'', ''low-end VCRs'', ''model number VCRX–10'', ''televisions'', ''portable televisions'', ''medium-sized televisions'', ''console televisions'', ''radios'', and ''radio trade name R''.

(6) *High profit test*—(i) *In general.* A profit and loss statement is material under the high profit test described in this paragraph (c)(6) if—

(A) The statement reflects the profit or loss of the related party group attributable to the group's provision of U.S.-connected products or services within a single industry segment (as defined in paragraph (c)(7)(ii) of this section);

(B) The amount of gross revenue earned by the group from the provision of U.S.-connected products or services within such industry segment is $100 million or more in the taxable year; and

(C) The return on assets test described in paragraph (c)(6)(ii) of this section is satisfied with respect to the products and services attributable to such segment.

Accordingly, a significant industry segment (as determined under paragraph (c)(5) of this section) must be divided into any narrower industry segments that meet the high profit test of this paragraph (c)(6), even if such narrower segments would not, standing alone, meet the significant industry segment test of paragraph (c)(5) of this section.

(ii) *Return on assets test.* An industry segment meets the return on assets test if the rate of return on assets earned by the related party group on its worldwide operations within this industry segment exceeds 15 percent, and is at least 200 percent of the return on assets earned by the group in all industry segments combined. For purposes of this paragraph, the rate of return on assets earned by an industry segment is determined by dividing that segment's operating profit (as defined in paragraph (c)(7)(v) of this section) by its identifiable assets (as defined in paragraph (c)(7)(iv) of this section).

(iii) *Additional rules.* The rules in paragraphs (c)(5)(ii) through (iv) of this section describing the application of the significant industry segment test shall apply in a similar manner for purposes of the high profit test.

(7) *Definitions.* The following definitions apply for purposes of paragraphs (c)(2)(ii), (c)(5), and (c)(6) of this section.

(i) *U.S.-connected products or services.* The term *U.S.-connected products or services* means products or services that are imported to or exported from the United States by transfers between the reporting corporation and any of its foreign related parties.

(ii) *Industry segment.* An industry segment is a segment of the related party group's combined operations that is engaged in providing a product or service or a group of related products or services (as defined in paragraph (c)(7)(vii) of this section) primarily to customers that are not members of the related party group.

(iii) *Gross revenue of an industry segment.* Gross revenue of an industry segment includes receipts (prior to reduction for cost of goods sold) both from sales to customers outside of the related party group and from sales or transfers to other industry segments within the related party group (but does not include sales or transfers between members of the related party group within the same industry segment). Interest from sources outside the related party group and interest earned on trade receivables between industry segments is included in gross revenue if the asset on which the interest is earned is included among the industry segment's identifiable assets, but interest earned on advances or loans to other industry segments is not included.

(iv) *Identifiable assets of an industry segment.* The identifiable assets of an industry segment are those tangible and intangible assets of the related party group that are used by the industry segment, including assets that are used exclusively by that industry segment and an allocated portion of assets used jointly by two or more industry segments. The value of an identifiable asset may be determined using any reasonable method (such as book value or fair market value) applied consistently. Any allocation of assets among industry segments must be made on a reasonable basis, and a description of such basis must be provided. Assets of an industry segment that transfers products or services to another industry segment shall not be allocated to the receiving segment. Assets that represent part of the related party group's investment in an industry segment, such as goodwill, shall be included in the industry segment's identifiable assets. Assets maintained for general corporate purposes (that is, those not used in the operations of any industry segment) shall not be allocated to industry segments.

(v) *Operating profit of an industry segment.* The operating profit of an industry segment is its gross revenue (as defined in paragraph (c)(7)(iii) of this section) minus all operating expenses. None of the following shall be added or deducted in computing the operating profit of an industry segment: revenue earned at the corporate level and not derived from the operations of any industry segment; general corporate expenses; interest expense; domestic and foreign income taxes; and other extraordinary items not reflecting the ongoing business operations of the industry segment.

(vi) *Product.* The term *product* means an item of property (or combination of component parts) that is the result of a production process, is primarily sold to unrelated parties (or incorporated by the related party group into other products sold to unrelated parties), and performs a specific function.

(vii) *Related products or services.* The term *related products or services* means groupings of products and types of services that reflect reasonable accounting, marketing, or other business practices within the industries in which the related party group operates.

(viii) *Model.* The term *model* means a classification of products that incorporate particular components, options, styles, and any other unique features resulting in product differentiation. Examples of models are electronic products that are sold or accounted for under a single model number and automobiles sold under a single model name.

(ix) *Product line.* The term *product line* means a group of products that are aggregated into a single classification for accounting, marketing, or other business purposes. Examples of product lines are groups of products that perform similar functions; products that are marketed under the same trade names, brand names, or trademarks; and products that are related economically (that is, having similar rates of profitability, similar degrees of risk, and similar opportunities for growth).

(8) *Example.* The application of the rules for determining material profit and loss statements under paragraphs (c)(4) through (7) of this section is illustrated by the following example.

Example. (i) *Facts.* A multinational enterprise manufactures 50 different agricultural and chemical products that are sold through Subl, its wholly owned U.S. subsidiary, and other subsidiaries located in foreign countries. The parent company of the enterprise, P, is a foreign corporation. The corporations participating in the enterprise form a related party group, and Subl is a reporting corporation for purposes of section 6038A. Under the facts and circumstances of this case, an analysis of the group's worldwide profit attributable to its products sold in the U.S. is relevant for determining an arm's length consideration under section 482 for the transfers of goods between Subl and its foreign affiliates.

(ii) *Existing records test.* For management purposes, the group prepares profit and loss statements that are segmented by sales in different geographic markets. One of these statements shows the combined worldwide profitability of the group. Another statement shows the profitability of the group attributable to its North American sales. Both of these profit and loss statements reflect aggregate figures that include sales to unrelated parties of products that have been transferred from P and other group members to Subl (that is, the group's ‘‘U.S.-connected products''). The two statements meet the existing records test described in paragraph (c)(4) of this section.

(iii) *Significant industry segments.* The group's worldwide gross revenue in all industry segments is $2 billion. An analysis of the group's 50 products demonstrates that they are reasonably grouped into eight industry segments (each of which earns roughly $250 million in worldwide gross revenue). Segments 1 through 6 relate to agricultural products and Segments 7 and 8 relate to other chemical products. More specific categories would result in groupings that generate less than 10 percent of the group's worldwide gross revenue (that is, less than $200 million each); these narrower categories would thus fail the gross revenue percentage test of paragraph (c)(5)(i)(B) of this section. The gross revenue in each of the eight segments from the sale to unrelated parties of U.S.-connected products is as follows: $180 million for Segment 1; $30 million for Segment 2; and less than $25 million for each of Segments 3 through 8. Under the $25 million threshold test of paragraph (c)(5)(i)(C) of this section, the group's significant industry segments are thus limited to Segments 1 and 2. In addition, the combined operations of the group related to agricultural products (encompassing Segments 1 through 6 on an aggregated basis), constitute a single significant industry segment.

(iv) *High profit test.* One highly profitable product line within Segment 1, HPPL, accounts for $120 million gross revenue from Sub1's domestic sales of U.S.-connected products (and thus exceeds the $100 million gross revenue threshold in paragraph (c)(6)(i)(B) of this section). The return on the identifiable assets attributable to the HPPL product line is 85 percent, which is more than 15 percent and more than twice the return on assets earned by the group from its worldwide operations in its combined industry segments. The group's industry segment for HPPL thus meets the high profit test described in paragraph (c)(6) of this section.

(v) *Material Profit and Loss Statements.* The group's material profit and loss statements consist of statements for combined worldwide sales and North American sales (under the existing records test); Segment 1, Segment 2, and aggregated Segments 1–6 (under the significant industry segment test); and HPPL (under the high profit test). Under paragraph (c) of this section, Subl is required to retain the combined worldwide sales and North American sales profit and loss statements and to maintain sufficient records so that it can compile and supply upon request statements of the group's profitability from sales of its U.S.-connected products within Segment l, Segment 2, aggregated Segments 1–6, and HPPL. These records need not be in the possession of Subl and may be kept under the control of and produced by P or any third party. The statements for Segment l, Segment 2, aggregated Segments 1–6, and HPPL do not require tracing of actual costs to the U.S.-connected products; rather, these statements may be prepared by using any reasonable method to allocate a portion of the industry segment's overall operating costs to the sales of U.S.-connected products within that segment.

(d) *Liability for certain partnership record maintenance.* A reporting corporation to which transactions engaged in by a partnership are attributed under § 1.6038A–1 (e)(2) is subject to the record maintenance requirements of this section to the extent of the transactions so attributed.

(e) *Agreements with the District Director*—(1) *In general.* The District Director who has audit jurisdiction over the reporting corporation may negotiate and enter into an agreement with a reporting corporation that establishes the records the reporting corporation must maintain or cause another to maintain, how the records must be maintained, the period of retention for the records, and by whom the records must be maintained in order to satisfy the reporting corporation's obligations under this section.

(2) *Content of agreement*—(i) *In general.* The agreement may include provisions relating to the authorization of agent requirement, the record maintenance requirement, and the production and translation time periods that vary the rules contained in these regulations under section 6038A. The District Director will generally require a reporting corporation to maintain only those records specified under the safe harbor provisions of paragraph (c) of this section that permit an adequate audit of the income tax return of the reporting corporation and to provide such authorizations of agent that permit adequate access to such records. In most instances, required record maintenance for a particular reporting corporation under a negotiated agreement will be less than the broad range of records described under the safe harbor provisions. Additionally, a provision specifying the effective date and the expiration date of the agreement that may vary the effective date of the regulations may be included.

(ii) *Significant industry segment test.* A District Director may determine which industry segment profit and loss statements are material for purposes of requiring the maintenance of records (under either paragraph (a)(1) of this section or the safe harbor described in paragraph (a)(2) of this section). The industry segments that the District Director determines are material need not be the industry segments that meet the significant industry segment test under paragraph (c)(5) of this section or the high profit test under paragraph (c)(6) of this section. For this purpose, a reporting corporation will be required to maintain only those records from which profit and loss statements for the related party group may be constructed with respect to industry segments identified by the District Director. To the extent that existing profit and loss statements are similar in scope and level of detail to statements for industry segments that would otherwise be described under the tests of paragraphs (c)(5) and (6) of this section, the District Director shall accept the existing statements instead of the statements that would otherwise be required under paragraphs (c)(5) and (6) of this section.

(iii) *Example.* The following example illustrates the rules of paragraph (e)(2)(ii) of this section.

Example. The District Director determines that RC, a reporting corporation that is a manufacturer of related chemical products, has two industry segments, Segment 1 and Segment 2. While both industry segments meet the significant industry segment test of paragraph (c)(5) of this section, Segment 1 has a relatively low volume of sales to foreign related parties. Additionally, Segment 1 consists of products that produce only a small profit margin because the product is generic and other companies also sell the product. The District Director enters into an agreement with RC that requires only records from which a profit and loss statement for the related party group can be constructed for Segment 2. Therefore, RC is not required to maintain records for Segment 1 from which a profit and loss statement for the related party group can be constructed. The other record maintenance requirements under this section apply, however.

(3) *Circumstances of agreement.* The District Director generally will enter into an agreement under this paragraph (e) upon request by the reporting corporation when the District Director believes that the District has or can obtain sufficient knowledge of the business or industry of the reporting corporation to limit the record maintenance requirement to particular documents.

(4) *Agreement as part of APA process.* An agreement with a reporting corporation under this paragraph (e) may be entered into as a part of the Advance Pricing Agreement (APA) process at any time during the APA process, insofar as the agreement relates to the subject matter of the APA.

(f) *U.S. maintenance*—(1) *General rule.* Records that must be maintained under this section must be maintained within the United States, unless the conditions described in paragraph (f)(2) of this section are met.

(2) *Non-U.S. maintenance requirements.* A reporting corporation may maintain outside the United States records not ordinarily maintained in the United States but required to be maintained in the United States under this section. However, the reporting corporation must either:

(i) Deliver to the Service the original documents (or duplicates) requested within 60 days of the request by the Service for such records and provide translations of such documents within 30 days of a request for translations of specific documents; or

(ii) Move the original documents (or duplicates) requested to the United States within 60 days of the request of the Service for such records; provide the Service with an index to the requested records, the name and address of a custodian located within the United States having control over the records, and the address where the records are located within 60 days of the Service's request for the records; and continue to maintain the records within the United States throughout the period of retention described in paragraph (g) of this section. For summons procedures with respect to records that have been moved to the United States, see sections 6038A(e), 7602, 7603, and 7604.

With respect to any material profit and loss statements required to be created (either under paragraph (c) of this section or under an agreement with the District Director), unless otherwise specified, ''120 days'' shall be substituted for ''60 days'' in this paragraph (f)(2), and labels and text with respect to such statements must be in the English language.

(3) *Prior taxable years.* The non-U.S. maintenance requirements described in paragraph (f)(2) of this section apply to records located outside the United States that were in existence on or after March 20, 1990, without regard to the taxable year to which such records relate.

(4) *Scheduled production for high volume or other reasons.* Upon a written request, for good cause shown, the District Director may grant an extension of the time for the production or translation of the requested documents. Such requests should be made within 30 days of the request for records by the Service. If an extension is needed because of the volume of records requested or the amount of translation requested, the District Director may allow production or translation to be scheduled over a period of time so that not all records need be produced or translated at the same time.

(5) *Required U.S. maintenance.* The District Director (with the concurrence of the Assistant Commissioner (International)), may require, for cause, the maintenance within the United States of any records specified in paragraph (f)(1) of this section. Such a requirement will be imposed only if there exists a clear pattern of failure to maintain or timely produce the required records. The assessment of a monetary penalty under section 6038A(d) and § 1.6038A–4 for failure to maintain records is not necessarily sufficient to require the maintenance of records within the United States.

(g) *Period of retention.* Records required to be maintained by section 6038A(a) and this section shall be kept as long as they may be relevant or material to determining the correct tax treatment of any transaction between the reporting corporation and a related party, but in no case less than the applicable statute of limitations on assessment and collection with respect to the taxable year in which the transaction or item to which the records relate affects the U.S. tax liability of the reporting corporation. *See* section 6001 and the regulations thereunder.

(h) *Application of record maintenance rules to banks and other financial institutions.* [Reserved].

(i) *Effective dates.* For effective dates for this section, see § 1.6038A–1(n).

[T.D. 8353, 56 FR 28065, June 19, 1991; T.D. 8353, 56 FR 41792, Aug. 23, 1991, as amended by T.D. 8611, 60 FR 41015, Aug. 11, 1995]

§ 1.6038A–4 Monetary penalty.

(a) *Imposition of monetary penalty*—(1) *In general.* If a reporting corporation fails to furnish the information described in § 1.6038A–2 within the time and manner prescribed in § 1.6038A–2 (d) and (e), fails to maintain or cause another to maintain records as required by § 1.6038A–3, or (in the case of records maintained outside the United States) fails to meet the non-U.S. record maintenance requirements within the applicable time prescribed in § 1.6038A–3(f), a penalty of $10,000 shall be assessed for each taxable year with respect to which such failure occurs. Such a penalty may be imposed by the District Director or the Director of the Internal Revenue Service Center where the Form 5472 is filed. The filing of a substantially incomplete Form 5472 constitutes a failure to file Form 5472. Where, however, the information described in § 1.6038A–2 (b)(3) through (5) is not required to be reported, a Form 5472 filed without such information is not a substantially incomplete Form 5472.

(2) *Liability for certain partnership transactions.* A reporting corporation to which transactions engaged in by a partnership are attributed under § 1.6038A–1(e)(2) is subject to the rules of this section to the extent failures occur with respect to the partnership transactions so attributed.

(3) *Calculation of monetary penalty.* If a reporting corporation fails to maintain records as required by § 1.6038A–3 of transactions with multiple related parties, the monetary penalty may be assessed for each failure to maintain records with respect to each related party. The monetary penalty, however, shall be imposed on a reporting corporation only once for a taxable year with respect to each related party for a

failure to furnish the information required on Form 5472, for a failure to maintain or cause another to maintain records, or for a failure to comply with the non-U.S. maintenance requirements described in §1.6038A–3(f). An additional penalty for another failure may be imposed, however, under the rules of paragraph (d)(2) of this section. Thus, unless such failures continue after notification as described in paragraph (d) of this section, the maximum penalty under this paragraph with respect to each related party for all such failures in a taxable year is $10,000. The members of a group of corporations filing a consolidated return are jointly and severally liable for any monetary penalty that may be imposed under this section.

(b) *Reasonable cause*—(1) *In general.* Certain failures may be excused for reasonable cause, including not timely filing Form 5472, not maintaining or causing another to maintain records as required by §1.6038A–3, and not complying with the non-U.S. maintenance requirements described in §1.6038A–3(f). If an affirmative showing is made that the taxpayer acted in good faith and there is reasonable cause for a failure that results in the assessment of the monetary penalty, the period during which reasonable cause exists shall be treated as beginning on the day reasonable cause is established and ending not earlier than the last day on which reasonable cause existed for any such failure. Additionally, the beginning of the 90-day period after mailing of a notice by the District Director or the Director of an Internal Revenue Service Center of a failure described in paragraph (d) of this section shall be treated as not earlier than the last day on which reasonable cause existed.

(2) *Affirmative showing required*—(i) *In general.* To show that reasonable cause exists for purposes of paragraph (b)(1) of this section, the reporting corporation must make an affirmative showing of all the facts alleged as reasonable cause for the failure in a written statement containing a declaration that it is made under penalties of perjury. The statement must be filed with the District Director (in the case of failure to maintain or furnish requested information permitted to be maintained outside the United States within the time required under §1.6038A–3(f) or a failure to file Form 5472) or the Director of the Internal Revenue Service Center where the Form 5472 is required to be filed (in the case of failure to file Form 5472). The District Director or the Director of the Internal Revenue Service Center where the Form 5472 is required to be filed, as appropriate, shall determine whether the failure was due to reasonable cause, and if so, the period of time for which reasonable cause existed. If a return has been filed as required by §1.6038A–2 or records have been maintained as required by §1.6038A–3, except for an omission of, or error with respect to, some of the information required or a record to be maintained, the omission or error shall not constitute a failure for purposes of section 6038A(d) if the reporting corporation that filed the return establishes to the satisfaction of the District Director or the Director of the Internal Revenue Service Center that it has substantially complied with the filing of Form 5472 or the requirement to maintain records.

(ii) *Small corporations.* The District Director shall apply the reasonable cause exception liberally in the case of a small corporation that had no knowledge of the requirements imposed by section 6038A; has limited presence in and contact with the United States; and promptly and fully complies with all requests by the District Director to file Form 5472, and to furnish books, records, or other materials relevant to the reportable transaction. A small corporation is a corporation whose gross receipts for a taxable year are $20,000,000 or less.

(iii) *Facts and circumstances taken into account.* The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the experience and knowledge of the taxpayer. Isolated computational or transcriptional errors generally are not inconsistent with reasonable cause and good faith. Reliance upon an information return or on the advice of a professional (such as an attorney or accountant) does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, the reliance was reasonable. A taxpayer, for example, may have reasonable cause for not filing a Form 5472 or for not maintaining records under section 6038A if the taxpayer has a reasonable belief that it is not owned by a 25-percent foreign shareholder. A reasonable belief means that the taxpayer does not know or has no reason to know that it is owned by a 25-percent foreign shareholder. For example, a reporting corporation would not know or have reason to know that it is owned by a 25-percent foreign shareholder if its belief that it is not so owned is consistent with other information reported or otherwise furnished to or known by the reporting corporation. A taxpayer may have reasonable cause for not treating a foreign corporation as a related party for purposes of section 6038A where the foreign corporation is a related party solely by reason of § 1.6038A–1(d)(3) (under the principles of section 482), and the taxpayer had a reasonable belief that its relationship with the foreign corporation did not meet the standards for related parties under section 482.

(c) *Failure to maintain records or to cause another to maintain records.* A failure to maintain records or to cause another to maintain records is determined by the District Director upon the basis of the reporting corporation's overall compliance (including compliance with the non-U.S. maintenance requirements under § 1.6038A–3(f)(2)) with the record maintenance requirements. It is not an item-by-item determination. Thus, for example, a failure to maintain a single or small number of items may not constitute a failure for purposes of section 6038A(d), unless the item or items are essential to the correct determination of transactions between the reporting corporation and any foreign related parties. The District Director shall notify the reporting corporation in writing of any determination that it has failed to comply with the record maintenance requirement.

(d) *Increase in penalty where failure continues after notification*—(1) *In general.* If any failure described in this section continues for more than 90 days after the day on which the District Director or the Director of the Internal Revenue Service Center where the Form 5472 is required to be filed mails notice of the failure to the reporting corporation, the reporting corporation shall pay a penalty (in addition to the penalty described in paragraph (a) of this section) of $10,000 with respect to each related party for which a failure occurs for each 30-day period during which the failure continues after the expiration of the 90-day period. Any uncompleted fraction of a 30-day period shall count as a 30-day period for purposes of this paragraph (d).

(2) *Additional penalty for another failure.* An additional penalty for a taxable year may be imposed, however, if at a time subsequent to the time of the imposition of the monetary penalty described in paragraph (a) of this section, a second failure is determined and the second failure continues after notification under paragraph (d)(1) of this section. Thus, if a taxpayer fails to file Form 5472 and is assessed a monetary penalty and later, upon audit, is determined to have failed to maintain records, an additional penalty for the failure to maintain records may be assessed under the rules of this paragraph if the failure to maintain records continues after notification under this paragraph.

(3) *Cessation of accrual.* The monetary penalty will cease to accrue if the reporting corporation either files Form 5472 (in the case of a failure to file Form 5472), furnishes information to substantially complete Form 5472, or demonstrates compliance with respect to the maintenance of records (in the case of a failure to maintain records) for the taxable year in which the examination occurs and subsequent years to the satisfaction of the District Director. The monetary penalty also will

cease to accrue if requested information, documents, or records, kept outside the United States under the requirements of §1.6038A–3(f) and not produced within the time specified are produced or moved to the United States under the rules of paragraph (f)(2)(ii) of this section.

(4) *Continued failures.* If a failure under this section relating to a taxable year beginning before July 11, 1989 occurs, and if the failure continues following 90 days after the notice of failure under this paragraph is sent, the amount of the additional penalty to be assessed under this paragraph is $10,000 for each 30-day period beginning after November 5, 1990, during which the failure continues. There is no limitation on the amount of the monetary penalty that may be assessed after November 5, 1990.

(e) *Other penalties.* For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203 and 7206 of the Code. For the penalty relating to an underpayment of tax, see section 6662.

(f) *Examples.* The following examples illustrate the rules of this section.

Example 1 Failure to file Form 5472. Corp X, a U.S. reporting corporation, engages in related party transactions with FC. Corp X does not timely file a Form 5472 or maintain records relating to the transactions with FC for Year 1 or subsequent years. The Service Center with which Corp X files its income tax return imposes a $10,000 penalty for each of Years 1, 2, and 3 under section 6038A (d) and this section for failure to provide information as required on Form 5472 and mails a notice of failure to provide inrormation. Corp X does not file Form 5472. Ninety days following the mailing of the notice of failure to Corp X an additional penaly of $10,000 is imposed. On the 135th day following the mailing of the notice of failure, Corp X files Form 5472 for Years 1, 2, and 3. The total penalty owed by Corp X for Year 1 is $30,000. ($10,000 for not timely filing Form 5472, $10,000 for the first 30-day period following the expiration of the 90-day period, and $10,000 for the fraction of the second 30-day period). The penalty for Years 2 and 3 for the failure to file Form 5472 is also $30,000 for each year, calculated in the same manner as for Year 1. The total penalty for failure to file Form 5472 for Years 1, 2, and 3 is $90,000.

Example 2 Failure to maintain records. Assume the same facts as in *Example 1.* In Year 5, Corp X is audited for Years 1 through 3. Corp X has not been maintaining records relating to the transactions with FC. The District Director issues a notice of failure to maintain records. Corp X has already been subject to the monetary penalty of $10,000 for each of Years 1, 2, and 3 for failure to file Form 5472 and, therefore, a monetary penalty under paragraph (a) of this section for failure to maintain records is not assessed. However, an additional penalty is assessed after the 90th day following the mailing of the notice of failure to maintain records. Corp X develops a record maintenance system as required by section 6038A and §1.6038A–3. On the 180th day following the mailing of the notice of failure to maintain records, Corp X demonstrates to the satisfaction of the District Director that the newly developed record maintenance system will comply with the requirements of §1.6038A–3 and the increase in the monetary penalty after notification ceases to accrue. The additional penalty for failure to maintain records is $30,000. An additional penalty of $30,000 per year is assessed for each of years 2 and 3 for the failure to maintain records for a total of $90,000.

(g) *Effective dates.* For effective dates for this section, see §1.6038A–1(n).

[T.D. 8353, 56 FR 28072, June 19, 1991]

§1.6038A–5 Authorization of agent.

(a) *Failure to authorize.* The rules of §1.6038A–7 shall apply to any transaction between a foreign related party and a reporting corporation (including any transaction engaged in by a partnership that is attributed to the reporting corporation under §1.6038A–1(e)(2)), unless the foreign related party authorizes (in the manner described in paragraph (b) of this section) the reporting corporation to act as its limited agent solely for purposes of sections 7602, 7603, and 7604 with respect to any request by the Service to examine records or produce testimony that may be relevant to the tax treatment of such a transaction or with respect to any summons by the Service for such records or testimony. The fact that a reporting corporation is authorized to act as an agent for a foreign related party is to be disregarded for purposes of determining whether the foreign related party either has a trade or business in the United States for purposes of the Code or a permanent establishment or fixed base in the United States for purposes of an income tax treaty.

(b) *Authorization by related party*—(1) *In general.* Upon request by the Service, a foreign related party shall authorize as its agent (solely for purposes of sections 7602, 7603, and 7604) the reporting corporation with which it engages in transactions. The authorization must be signed by the foreign related party or an officer of the foreign related party possessing the authority to authorize an agent for purposes of Rule 4 of the Federal Rules of Civil Procedure. The reporting corporation will accept this appointment by providing a statement to that effect, signed by an officer of the reporting corporation possessing the authority to accept such an appointment. The agency shall be effective at all times. For taxable years beginning after July 10, 1989, the authorization and acceptance must be provided to the Service within 30 days of a request by the Service to the reporting corporation for such an authorization. The authorization must contain a heading and statement as set forth below. A foreign government is not subject to the authorization of agent requirement.

AUTHORIZATION OF AGENT

"[Name of foreign related party] hereby expressly authorizes [name of reporting corporation] to act as its agent solely for purposes of sections 7602, 7603, and 7604 of the Internal Revenue Code with respect to any request to examine records or produce testimony that may be relevant to the U.S. income tax treatment of any transaction between [name of the above-named foreign related party] and [name of reporting corporation] or with respect to any summons for such records or testimony.

____

Signature of or for [name of foreign related party]

____

(Title)

____

(Date)

(If signed by a corporate officer, partner, or fiduciary on behalf of a foreign related party: I certify that I have the authority to execute this authorization of agent to act on behalf of [name of foreign related party]).

____

Type or print your name below if signing for a foreign related party that is not an individual.

____

[Name of reporting corporation] accepts this appointment to act as agent for [name of foreign related party] for the above purpose.

____

Signature for (Name of Reporting Corporation]

____

(Title)

____

(Date)

I certify that I have the authority to accept this appointment to act as agent on behalf of (name of foreign related party] and agree to accept service of process for the above purposes.

Type or print your name below.

____

(2) *Authorization for prior years.* A foreign related party shall authorize a reporting corporation to act as its agent with respect to taxable years for which a Form 5472 is required to be filed prior to the date on which the final regulations under section 6038A are published by providing the above executed authorization of agent within 30 days of a request by the Service for such an authorization.

(c) *Foreign affiliated groups*—(1) *In general.* A foreign corporation that has effective legal authority to make the authorization of agent under paragraph (b) of this section on behalf of any group of foreign related parties may execute such an authorization for any members of the group. A single authorization may be made on a consolidated basis. In such a case, the common parent must attach a schedule to the authorization of agent stating which members of the group would otherwise be required to separately authorize the reporting corporation as agent. The schedule must provide the name, address, relationship to the reporting corporation, and U.S. taxpayer identification number, if applicable, of each member.

(2) *Application of noncompliance penalty adjustment.* In circumstances where a consolidated authorization of agent has been executed, if the agency authorization for any member of the group is not legally effective for purposes of sections 7602, 7603, and 7604, the noncompliance penalty adjustment under section 6038A(e) and §1.6038A–7 shall apply.

(d) *Legal effect of authorization of agent.* The legal consequences of a foreign related party authorizing a reporting corporation to act as its agent for purposes of sections 7602, 7603, and 7604 of the Code are as follows.

(1) *Agent for purposes of commencing judicial proceedings.* A reporting corporation that is authorized by a foreign related party to act as its agent for purposes of sections 7602, 7603, and 7604 (including service of process) is also the agent of the foreign related party for purposes of—

(i) The filing of a petition to quash under section 6038A(e)(4)(A) or a petition to review an Internal Revenue Service determination of noncompliance under section 6038A(e)(4)(B), and

(ii) The commencement of a judicial proceeding to enforce a summons under section 7604, whether commenced in conjunction with a petition to quash under section 6038A(e)(4)(A) or commenced as a separate proceeding in the federal district court for the district in which the person to whom the summons is issued resides or is found.

(2) *Foreign related party found where reporting corporation found.* For any purposes relating to sections 7602, 7603, or 7604 (including service of process), a foreign related party that authorizes a reporting corporation to act on its behalf under section 6038A(e)(1) and this section may be found anywhere where the reporting corporation has residence or is found.

(e) *Successors in interest.* A successor in interest to a related party must execute the authorization of agent as described in paragraph (b) of this section.

(f) *Deemed compliance*—(1) *In general.* In exceptional circumstances, the District Director may treat a reporting corporation as authorized to act as agent for a related party for purposes of sections 7602, 7603, and 7604 in the absence of an actual agency appointment by the foreign related party, in circumstances where the actual absence of an appointment is reasonable. Factors to be considered include—

(i) If neither the reporting corporation nor the other party to the transaction knew or had reason to know that the two parties were related at the time of the transaction, and

(ii) The extent to which the taxpayer establishes to the satisfaction of the District Director that all transactions between the reporting corporation and the related party were on arm’s length terms and did not involve the participation of any known related party.

(2) *Reason to know.* Whether the reporting corporation or other party had reason to know that the two parties were related at the time of the transaction will be determined by all the facts and circumstances.

(3) *Effect of deemed compliance.* If a reporting corporation is deemed under this paragraph (f) to have been authorized to act as an agent for a foreign related party for purposes of sections 7602, 7603, and 7604, such deemed compliance is applicable only for that particular transaction and other reportable transactions entered into prior to the time when the reporting corporation knew or had reason to know that the related party, in fact, was related. The noncompliance rule of §1.6038A–7 shall apply to any transaction subsequent to that time with the same related party, unless the related party actually authorizes the reporting corporation to act as its agent under paragraph (a) of this section. In addition, the record maintenance requirements of §1.6038A–3 will apply to all subsequent transactions and, with respect to prior transactions, will apply to relevant records in existence at the time the relationship was discovered.

(g) *Effective dates.* For effective dates for this section, see §1.6038A–1(n).

[T.D. 8353, 56 FR 28073, June 19, 1991; T.D. 8353, 56 FR 41792, Aug. 23, 1991]

§1.6038A–6 Failure to furnish information.

(a) *In general.* The rules of §1.6038A–7 may be applied with respect to a transaction between a foreign related party and the reporting corporation (including any transaction engaged in by a partnership that is attributed to the reporting corporation under § 1.6038A–1(e)(2)) if a summons is issued to the reporting corporation to produce any records or testimony, either directly or as agent for such related party, to determine the correct treatment under title 1 of the Code of such a transaction between the reporting corporation and the related party; and if—

(1)(i) The summons is not quashed in a proceeding, if any, begun under section 6038A(e)(4) and is not determined to be invalid in a proceeding, if any, begun under section 7604 to enforce such summons; and

(ii) The reporting corporation does not substantially and timely comply with the summons, and the District Director has sent by certified or registered mail a notice under section 6038A(e)(2)(C) to the reporting corporation that it has not so complied; or

(2) The reporting corporation fails to maintain or to cause another to maintain records as required by §1.6038A–3, and by reason of that failure, the summons is quashed in a proceeding under section 6038A(e)(4) or in a proceeding begun under section 7604 to enforce the summons, or the reporting corporation is not able to provide the records requested in the summons.

(b) *Coordination with treaties.* Where records of a related party are obtainable on a timely and efficient basis under information exchange procedures provided under a tax treaty or tax information exchange agreement (TIEA), the Service generally will make use of such procedures before issuing a summons. The absence or pendency of a treaty or TIEA request may not be asserted as grounds for refusing to comply with a summons or as a defense against the assertion of the noncompliance penalty adjustment under §1.6038A–7. For purposes of this paragraph, information is available on a timely and efficient basis if it can be obtained within 180 days of the request.

(c) *Enforcement proceeding not required.* The District Director is not required to begin an enforcement proceeding to enforce the summons in order to apply the rules of §1.6038A–7.

(d) *De minimis failure.* Where a reporting corporation's failure to comply with the requirement to furnish information under this section is *de minimis,* the District Director, in the exercise of discretion, may choose not to apply the noncompliance penalty. Thus, for example, in cases where a particular document or group of documents is not furnished upon request or summons, the District Director (in the District Director's sole discretion), may choose not to apply the noncompliance penalty if the District Director deems the document or documents not to have significant or sufficient value in the determination of the correctness of the tax treatment of the related party transaction.

(e) *Suspension of statute of limitations.* If the reporting corporation brings an action under section 6038A(e)(4)(A) (proceeding to quash) or (e)(4)(B) (review of secretarial determination of noncompliance), the running of any period of limitation under section 6501 (relating to assessment and collection of tax) or under section 6531 (relating to criminal prosecutions) for the taxable year or years to which the summons that is the subject of such proceeding relates shall be suspended for the period during which such proceeding, and appeals therein, are pending. In no event shall any such period expire before the 90th day after the day on which there is a final determination in such proceeding.

(f) *Effective dates.* For effective dates for this section, see §1.6038A–1(n).

[T.D. 8353, 56 FR 28075, June 19, 1991]

§1.6038A–7 Noncompliance.

(a) *In general.* In the case of any failure described in §1.6038A–5 or §1.6038A–6, the rules of this §1.6038A–7 apply to the reporting corporation. In such a case—

(1) The amount of the deduction allowed under subtitle A for any amount paid or incurred by the reporting corporation to the related party in connection with such transaction, and

(2) The cost to the reporting corporation of any property acquired in such transaction from the related party or transferred by such corporation in such transaction to the related party, may be determined by the District Director.

(b) *Determination of the amount.* The amount of the deduction or the cost to the reporting corporation shall be the amount determined by the District Director (in the District Director's sole discretion) from the District Director's own knowledge or from such information as the District Director may choose to obtain through testimony or otherwise. The District Director shall consider any information or materials that have been submitted by the reporting corporation or a foreign related party. The District Director, however, may disregard any information, documents, or records submitted by the reporting corporation or the related party if (in the District Director's sole discretion) the District Director deems that they are insufficiently probative of the relevant facts.

(c) *Separate application.* If the noncompliance penalty of this section applies with respect to transactions with a related party of the reporting corporation, it will not be applied with respect to any other related parties of the reporting corporation solely upon the basis of that failure. Thus, for example, if a reporting corporation engages in transactions with related party A and related party B, and the reporting corporation does not respond to a summons for records related to the transactions between the reporting corporation and related party A, the noncompliance penalty imposed as a result of such failure will not apply to the transactions between the reporting corporation and related party B. If a separate summons is issued for records relating to the transactions between the reporting corporation and related party B and the reporting corporation does not produce such records, the noncompliance penalty may be applied to those transactions.

(d) *Effective dates.* For effective dates for this section, see §1.6038A–1(n).

[T.D. 8353, 56 FR 28075, June 19, 1991]

§1.6038B–1 Reporting of certain transactions to foreign corporations..

(a) *Purpose and scope.* This section sets forth information reporting requirements under section 6038B concerning certain transfers of property to foreign corporations. Paragraph (b) of this section provides general rules explaining when and how to carry out the reporting required under section 6038B with respect to the transfers to foreign corporations. Paragraph (c) of this section and §1.6038B–1T(d) specify the information that is required to be reported with respect to certain transfers of property that are described in section 6038B(a)(1)(A) and 367(d), respectively. Section 1.6038B–1T(e) specifies the limited reporting that is required with respect to transfers of property described in section 367(e)(1). Paragraph (f) of this section sets forth the consequences of a failure to comply with the requirements of section 6038B and this section. For effective dates, see paragraph (g) of this section. For rules regarding transfers to foreign partnerships, see section 6038B(a)(1)(B) and any regulations thereunder.

(b) *Time and manner of reporting*—(1) *In general*—(i) *Reporting procedure.* Except for stock or securities qualifying under the special reporting rule of paragraph (b)(2) of this section, any U.S. person that makes a transfer described in section 6038B(a)(1)(A), 367(d) or (e)(1), is required to report pursuant to section 6038B and the rules of this section and must attach the required information to Form 926, ‘‘Return by Transferor of Property to a Foreign Corporation.’’ For special rules regarding cash transfers made in tax years beginning after February 5, 1999, see paragraphs (b)(3) and (g) of this section. For purposes of determining a U.S. transferor that is subject to section 6038B, the rules of §1.367(a)–1T(c) and §1.367(a)–3(d) shall apply with respect to a transfer described in section 367(a), and the rules of §1.367(a)–1T(c) shall apply with respect to a transfer described in section 367(d). Notwithstanding any statement to the contrary on Form 926, the form and attachments must be attached to, and filed by the due date (including extensions) of, the transferor’s income tax return for the taxable year that includes the date of the transfer (as defined in §1.6038B–1T(b)(4)). Any attachment to Form 926 required under the rules of this section is filed subject to the transferor’s declaration under penalties of perjury on Form 926 that the information submitted is true, correct, and complete to the best of the transferor’s knowledge and belief.

(ii) *Reporting by corporate transferor.* If the transferor is a corporation, Form 926 must be signed by an authorized officer of the corporation. If, however, the transferor is a member of an affiliated group under section 1504(a)(1) that files a consolidated Federal income tax return, but the transferor is not the common parent corporation, an authorized officer of the common parent corporation must sign Form 926.

(iii) *Transfers of jointly-owned property.* If two or more persons transfer jointly-owned property to a foreign corporation in a transfer with respect to which a notice is required under this section, then each person must report with respect to the particular interest transferred, specifying the nature and extent of the interest. However, a husband and wife who jointly file a single Federal income tax return may file a single Form 926 with their tax return.

(2) *Exceptions and special rules for transfers of stock or securities under section 367(a)*—(i) *Transfers on or after July 20, 1998.* A U.S. person that transfers stock or securities on or after July 20, 1998 in a transaction described in section 6038B(a)(1)(A) will be considered to have satisfied the reporting requirement under section 6038B and paragraph (b)(1) of this section if either—

(A) The U.S. transferor owned less than 5 percent of both the total voting power and the total value of the transferee foreign corporation immediately after the transfer (taking into account the attribution rules of section 318 as modified by section 958(b)), and either:

(*1*) The U.S. transferor qualified for nonrecognition treatment with respect to the transfer (i.e., the transfer was not taxable under §§ 1.367(a)–3(b) or (c)); or

(*2*) The U.S. transferor is a tax-exempt entity and the income was not unrelated business income; or

(*3*) The transfer was taxable to the U.S. transferor under § 1.367(a)–3(c), and such person properly reported the income from the transfer on its timely-filed (including extensions) Federal income tax return for the taxable year that includes the date of the transfer; or

(B) The U.S. transferor owned 5 percent or more of the total voting power or the total value of the transferee foreign corporation immediately after the transfer (taking into account the attribution rules of section 318 as modified by section 958(b)) and either:

(*1*) The transferor (or one or more successors) properly entered into a gain recognition agreement under § 1.367(a)–8; or

(*2*) The transferor is a tax-exempt entity and the income was not unrelated business income; or

(*3*) The transferor properly reported the income from the transfer on its timely-filed (including extensions) Federal income tax return for the taxable year that includes the date of the transfer.

(ii) *Transfers before July 20, 1998.* With respect to transfers occurring after December 16, 1987, and prior to July 20, 1998, a U.S. transferor that transferred U.S. or foreign stock or securities in a transfer described in section 367(a) is not subject to section 6038B if such person is described in paragraph (b)(2)(i)(A) of this section.

(3) *Special rule for transfers of cash.* A U.S. person that transfers cash to a foreign corporation in a transfer described in section 6038B(a)(1)(A) must report the transfer if—

(i) Immediately after the transfer such person holds directly, indirectly, or by attribution (determined under the rules of section 318(a), as modified by section 6038(e)(2)) at least 10 percent of the total voting power or the total value of the foreign corporation; or

(ii) The amount of cash transferred by such person or any related person (determined under section 267(b)(1) through (3) and (10) through (12)) to such foreign corporation during the 12-month period ending on the date of the transfer exceeds $100,000.

(4) [Reserved]. For further guidance, see § 1.6038B–1T(b)(4).

(c) *Information required with respect to transfers described in section 6038B(a)(1)(A).* A United States person that transfers property to a foreign corporation in an exchange described in section 6038B(a)(1)(A) (including cash transferred in taxable years beginning after February 5, 1999, and other unappreciated property) must provide the following information, in paragraphs labeled to correspond with the number or letter set forth in this paragraph (c) and § 1.6038B–1T(c)(1) through (5). If a particular item is not applicable to the subject transfer, the taxpayer must list its heading and state that it is not applicable. For special rules applicable to transfers of stock or securities, see paragraph (b)(2)(ii) of this section.

(1) through (5) [Reserved]. For further guidance, see § 1.6038B–1T(c)(1) through (5).

(6) *Application of section 367(a)(5).* If the asset is transferred in an exchange described in section 361(a) or (b), a statement that the conditions set forth in the second sentence of section 367(a)(5) and any regulations under

that section have been satisfied, and an explanation of any basis or other adjustments made pursuant to section 367(a)(5) and any regulations thereunder.

(d) and (e) [Reserved]. For further guidance, see §1.6038B–1T(d) and (e).

(f) *Failure to comply with reporting requirements*—(1) *Consequences of failure.* If a U.S. person is required to file a notice (or otherwise comply) under paragraph (b) of this section and fails to comply with the applicable requirements of section 6038B and this section, then with respect to the particular property as to which there was a failure to comply—

(i) That property shall not be considered to have been transferred for use in the active conduct of a trade or business outside of the United States for purposes of section 367(a) and the regulations thereunder;

(ii) The U.S. person shall pay a penalty under section 6038B(b)(1) equal to 10 percent of the fair market value of the transferred property at the time of the exchange, but in no event shall the penalty exceed $100,000 unless the failure with respect to such exchange was due to intentional disregard (described under paragraph (g)(4) of this section); and

(iii) The period of limitations on assessment of tax upon the transfer of that property does not expire before the date which is 3 years after the date on which the Secretary is furnished the information required to be reported under this section. See section 6501(c)(8) and any regulations thereunder.

(2) *Failure to comply.* A failure to comply with the requirements of section 6038B is—

(i) The failure to report at the proper time and in the proper manner any material information required to be reported under the rules of this section; or

(ii) The provision of false or inaccurate information in purported compliance with the requirements of this section. Thus, a transferor that timely files Form 926 with the attachments required under the rules of this section shall, nevertheless, have failed to comply if, for example, the transferor reports therein that property will be used in the active conduct of a trade or business outside of the United States, but in fact the property continues to be used in a trade or business within the United States.

(3) *Reasonable cause exception.* The provisions of paragraph (f)(1) of this section shall not apply if the transferor shows that a failure to comply was due to reasonable cause and not willful neglect. The transferor may do so by providing a written statement to the district director having jurisdiction of the taxpayer's return for the year of the transfer, setting forth the reasons for the failure to comply. Whether a failure to comply was due to reasonable cause

shall be determined by the district director under all the facts and circumstances.

(4) *Definition of intentional disregard.* If the transferor fails to qualify for the exception under paragraph (f)(3) of this section and if the taxpayer knew of the rule or regulation that was disregarded, the failure will be considered an intentional disregard of section 6038B, and the monetary penalty under paragraph (f)(1)(ii) of this section will not be limited to $100,000. See §1.6662–3(b)(2).

(g) *Effective dates.* This section applies to transfers occurring on or after July 20, 1998, except that transfers of cash made in taxable years beginning on or before February 5, 1999 are not required to be reported under section 6038B. See §1.6038B–1T for transfers occurring prior to July 20, 1998.

[T.D. 8770, 63 FR 33568, June 19, 1998, as amended by T.D. 8817, 64 FR 5715, Feb. 5, 1999; 64 FR 15686, 15687, Apr. 1, 1999]

§1.6038B–1T Reporting of certain transactions (temporary).

(a) through (b)(2) [Reserved]. For further guidance, see §1.6038B–1(a) through (b)(2).

(b)(3) [Reserved].

(4) *Date of transfer*—(i) *In general.* For purposes of this section, the date of a transfer described in section 367 is the first date on which title to, possession of, or rights to the use of stock, securities, or other property passes pursuant to the plan for purposes of subtitle A of the Internal Revenue Code. A transfer will not be considered to begin with a

decision of a board of directors or similar action unless the transaction otherwise takes effect for purposes of subtitle A of the Internal Revenue Code on that date.

(ii) *Termination of section 1504(d) election.* A transfer deemed to occur as a result of the termination of an election under section 1504(d) will be considered to occur on the date the contiguous country corporation first fails to continue to qualify for the election under section 1504(d). The rule of this paragraph (b)(3)(ii) is illustrated by the following example.

Example. Domestic corporation W previously made a valid election under section 1504(d) to have its Mexican subsidiary S treated as a domestic corporation. On August 1, 1986, W disposes of its right, title, and interest in 10 percent of the stock of S by selling such stock to an unrelated United States person who is not a director of S. S first fails to continue to qualify for the election under section 1504(d) on August 1, 1986, since on such date it ceases to be directly or indirectly wholly owned or controlled by W. The constructive transfer of assets from ''domestic'' corporation S to Mexican corporation S is considered to occur on that date.

(iii) *Change in classification.* A transfer deemed to occur as a result of a change in classification of an entity caused by a change in the governing documents, articles, or agreements of the entity (as described in § 1.367(a)–1T(c)(6)) will be considered to occur on the date that such changes take effect for purposes of subtitle A of the Internal Revenue Code.

(iv) *U.S. resident under section 6013 (g) or (h).* A transfer made by an alien individual who is considered to be a U.S. resident by reason of a timely election under section 6013 (g) or (h) will be considered to occur, for purposes of this section (but not for purposes of section 367), on the later of—

(A) The date on which the election under section 6013 (g) or (h) is made; or

(B) The date on which the transfer would otherwise be considered to occur under the rules of this paragraph (b)(3).

The rule of this paragraph (b)(3)(iv) is illustrated by the following example.

Example. D is a nonresident alien individual who is married to a United States citizen. On March 1, 1986, D transfers property to a foreign corporation in an exchange described in section 351. On April 15, 1987, D and the spouse timely file with their tax return for the taxable year ended December 31, 1986, an election under section 6013(g) for D to be treated as a United States resident. The election is effective on January 1, 1986. For purposes of section 6038 B, the transfer described in section 367(a) made by D in connection with the section 351 exchange is considered to occur on April 15, 1987, the date on which the timely election was made under section 6013(g).

(c) Introductory text [Reserved]. For further guidance, see § 1.6038B–1(c).

(1) *Transferor.* Provide the name, U.S. taxpayer identification number, and address of the U.S. person making the transfer.

(2) *Transfer.* Provide the following information concerning the transfer:

(i) Name, U.S. taxpayer identification number (if any), address, and country of incorporation of transferee foreign corporation;

(ii) A general description of the transfer, and any wider transaction of which it forms a part, including a chronology of the transfers involved and an identification of the other parties to the transaction to the extent known.

(3) *Consideration received.* Provide a description of the consideration received by the U.S. person making the transfer, including its estimated fair market value and, in the case of stock or securities, the class or type, amount, and characteristics of the interest received.

(4) *Property transferred.* Provide a description of the property transferred. The description must be divided into the following categories, and must include the estimated fair market value and adjusted basis of the property, as well as any additional information specified below.

(i) *Active business property.* Describe any transferred property (other than stock or securities) to be used in the active conduct of a trade or business outisde of the United States. Provide here a general description of the business conducted (or to be conducted) by the transferee, including the location of the business, the number of its employees, the nature of the business, and copies of the most recently prepared balance sheet and profit and loss statement. Property listed within this category may be identified by general type. For example, upon the transfer of the assets of a manufacturing operation, a reasonable description of the property to be used in the business might include the categories of office equipment and supplies, computers and related equipment, motor vehicles, and several major categories of manufacturing equipment. However, any property that is includible both in this subdivision (i) and in subdivision (iii) of this paragraph (c)(4) (property subject to depreciation recapture under §1.367(a)–4T (b)) must be identified in the manner required in subdivision (iii). If property is considered to be transferred for use in the active conduct of a trade or business under a special rule in §1.367(a)–4T, specify the applicable rule and provide information supporting the application of the rule. If property is subject to section 367(a)(1) regardless of its use in a trade or business under the rules of §1.367(a)–4T or §1.367(a)–5T, list the property only in response to subdivision (vii) of this paragraph (c)(4).

(ii) *Stock or securities.* Describe any transferred stock or securities, including the class or type, amount, and characteristics of the transferred stock or securities, as well as the name, address, place of incorporation, and general description of the corporation issuing the stock. In addition, provide the following information if applicable:

(A) *Active trade or business stock.* If the stock or securities are considered to be transferred for use in the active conduct of a trade or business outside of the United States under the rules of §1.367(a)–3T(d)(2), provide information supporting the application of the rule.

(B) *Application of special rules.* If any provision of §1.367(a)–3T applies to except the transfer of stock or securities from the rule of section 367(a)(1), provide information supporting the claimed application of such provision (including information supporting the nonapplicability of either anti-abuse rule under §1.367(a)–3T(h)). If the transferor is entering into an agreement to recognize gain upon a later disposition of the transferred stock by the transferee foreign corporation under §1.367(a)–3T(g), attach the agreement and waiver as required by the rules of that paragraph.

(iii) *Depreciated property.* Describe any property that is subject to depreciation recapture under the rules of §1.367(a)–4T(b). Property within this category must be separately identified to the same extent as was required for purposes of the previously claimed depreciation deduction. Specify with respect to each such asset the relevant recapture provision, the number of months in which such property was in use within the United States, the total number of months the property was in use, the fair market value of the property, a schedule of the depreciation deduction taken with respect to the property, and a calculation of the amount of depreciation required to be recaptured.

(iv) *Property to be leased.* Describe any property to be leased to other persons by the transferee foreign corporation (unless such property is considered to be transferred for use in the active conduct of a trade or business and was thus listed under subdivision (i) of this paragraph (c)(4)). If the rules of §1.367(a)–4T(c)(2) apply to except the transfer from the rule of section 367(a)(1), provide information supporting the claimed application of such provision.

(v) *Property to be sold.* Describe any transferred property that is to be sold or otherwise disposed of by the transferee foreign corporation, as described in §1.367(a)–4T(d).

(vi) *Transfers to FSCs.* Describe any property that is subject to the special rule of §1.367(a)–4T(g) for transfers to FSCs. Provide information supporting the claimed application of that rule.

(vii) *Tainted property.* Describe any property that is subject to §1.367(a)–5T (concerning property that is subject to the rule of section 367(a)(1) regardless of whether it is transferred for use in the active conduct of a trade or business outside of the United States). Such description must be divided into the relevant categories, as follows:

(A) *Inventory, etc.* Property described in §1.367(a)–5T(b);

(B) *Installment obligations, etc.* Property described in §1.367(a)–5T(c);

(C) *Foreign currency, etc.* Property described in §1.367(a)–5T(d);

(D) *Intangible property.* Property described in §1.367(a)–5T(e); and

(E) *Leased property.* Property described in § 1.367(a)–4T(f).

If any exception provided in § 1.367(a)–5T applies to the transferred property (making section 367(a)(1) not applicable to the transfer), provide information supporting the claimed application of such exception.

(viii) *Foreign loss branch.* Provide the information specified in paragraph (c)(5) of this section.

(ix) *Other intangibles.* Describe an intangible property sold or licensed by the transferor to the transferee foreign corporation, and set forth the general terms of each sale or license.

(5) *Transfer of foreign branch with previously deducted losses.* If the property transferred is property of a foreign branch with previously deducted losses subject to the rules of § 1.367(a)–6T, provide the following information:

(i) *Branch operation.* Describe the foreign branch the property of which is transferred, in accordance with the definition of § 1.367(a)–6T(g).

(ii) *Branch property.* Describe the property of the foreign branch, including its adjusted basis and fair market value. For this purpose property must be identified with reasonable particularity, but may be identified by category rather than listing every asset separately. Substantially similar property may be listed together for this purpose, and property of minor value may be grouped into functional categories. For example, a reasonable description of the property of a business office might include the following categories: Word processing or data processing equipment, other office equipment and furniture, and office supplies.

(iii) *Previously deducted losses.* Set forth a detailed calculation of the sum of the losses incurred by the foreign branch before the transfer, and a detailed calculation of any reduction of such losses, in accordance with § 1.367(a)–6T (d) and (e).

(iv) *Character of gain.* Set forth a statement of the character of the gain required to be recognized, in accordance with § 1.367(a)–6T(c)(1).

(6) [Reserved]. For further guidance, see § 1.6038B–1(c)(6).

(d) *Transfers subject to section 367(d)*—(1) *Initial transfer.* A U.S. person that transfers inntangible property to a foreign corporation in an exchange described in section 351 or 361 must provide the following information in paragraphs labelled to correspond with the number or letter set forth below. If a particular item is not applicable to the subject transfer, list its heading and state that it is not applicable. The information required by subdivisions (i) through (iii) need only be provided if such information was not otherwise provided under paragraph (c) of this section. (Note that the U.S. transferor may subsequently be required to file another return under paragraph (d)(2) of this section.)

(i) *Transferor.* Provide the name, U.S. taxpayer identification number, and address of the U.S. person making the transfer.

(ii) *Transfer.* Provide information concerning the transfer, including:

(A) Name, U.S. taxpayer identification number (if any), address, and country of incorporation of the transferee foreign corporation; (B) A general description of the transfer, and any wider transaction of which it forms a part, including a chronology of the transfers involved and an identification of the other parties to the transaction to the extent known.

(iii) *Consideration received.* Provide a description of the consideration received by the U.S. person making the transfer, including its estimated fair market value and, in the case of stock or securities, the class or type, amount, and characteristics of the interest received.

(iv) *Intangible property transferred.* Provide a description of the intangible property transferred, including its adjusted basis. Generally, each intangible asset must be separately identified. Operating intangibles and foreign goodwill or going concern value, as defined in § 1.367(a)–1T(d)(5) (ii) and (iii), should be so identified and classified.

(v) *Annual payment.* Provide and explain the calculation of the annual deemed payment for the use of the intangible property required to be recognized by the transferor under the rules of section 367(d).

(vi) *Election to treat as sale.* List any intangible with respect to which an election is being made under § 1.367(d)–1T(g)(2) to treat the transfer as a sale.

Include the fair market value of the intangible on the date of the transfer and a calculation of the gain required to be recognized in the year of the transfer by reason of the election.

(vii) *Coordination with loss rules.* List any intangible property subject to section 367(d) the transfer of which also gives rise to the recognition of gain under section 904(f)(3) or §1.367(a)–6T. Provide a calculation of the gain required to be recognized with respect to such property, in accordance with the provisions of §1.367(d)–1T(g)(4).

(viii) *Other intangibles.* Describe any intangible property sold or licensed by the transferor to the transferee foreign corporation, and set forth the general terms of each sale or license.

(2) *Subsequent transfers.* If a U.S. person transfers intangible property to a foreign corporation in an exchange described in section 351 or 361, and at any time thereafter (within the useful life of the intangible property) either that U.S. person disposes of the stock of the transferee foreign corporation or the transferee foreign corporation disposes of the transferred intangible, then the U.S. person must provide the following information in paragraphs labelled to correspond with the number or letter set forth below. The information required by subdivisions (i) and (ii) need only be provided if such information was not otherwise provided in the same return, pursuant to paragraph (c) or (d)(1) of this section. For purposes of determining the date on which a return under this subparagraph (2) is required to be filed, the date of transfer is the date of the subsequent transfer of stock or intangible property.

(i) *Transferor.* Provide the name, U.S. taxpayer identification number, and address of the U.S. person making the transfer.

(ii) *Initial transfer.* Provide the following information concerning the initial transfer:

(A) The date of the transfer;

(B) The name, U.S. taxpayer identification number (if any), address, and country of incorporation of the transferee foreign corporation; and

(C) A general description of the transfer and any wider transaction of which it formed a part.

(iii) *Subsequent transfer.* Provide the following information concerning the subsequent transfer:

(A) A general description of the subsequent transfer and any wider transaction of which it forms a part;

(B) A calculation of any gain required to be recognized by the U.S. person under the rules of §1.367(d)–1T (d) through (f); and

(C) The name, address, and identifying number of each person that under the rules of §1.367(d)–1T (e) or (f) will be considered to receive contingent annual payments for the use of the intangible property.

(e) *Transfers subject to section 367(e).* (1) *In general.* If a domestic corporation (distributing corporation) makes a distribution described in section 367(e)(1), the distributing corporation must comply with the reporting requirements under this paragraph (e)(1). Form 926 and other requirements described in this section need not be met by the distributing corporation in the case of a distribution described in section 367(e)(1).

(2) *Reporting requirements if transaction is taxable under section 367(e)(1).* If the distribution is taxable to the distributing corporation under section 367(e)(1) and the regulations thereunder, the distributing corporation must attach to its Federal income tax return for the taxable year that includes the date of the transfer a statement titled ‘‘Section 367(e)(1) Reporting—Compliance With Section 6038B’’, signed under penalties of perjury by an officer of the corporation, disclosing the following information:

(i) A description of the transaction in which the U.S. distributing corporation distributed stock or securities of a controlled corporation (whether domestic or foreign) to one or more foreign distributees.

(ii) The basis and fair market value of the stock and securities that were distributed by the distributing corporation in the transaction.

(3) *Reporting requirements if transaction qualifies for an exception to section 367(e)(1).* If the distributing corporation qualifies for an exception under §1.367(e)–1T(c)(1), the requirements of section 6038B are satisfied if the distributing corporation complies with

the reporting requirements contained in § 1.367(e)–1T(c)(1)(ii). If the distributing corporation qualifies for an exception under § 1.367(e)–1T(c)(2), the requirements of section 6038B are satisfied if the distributing corporation complies with the reporting requirements contained in § 1.367(e)–1T(c)(2)(iii). If the distributing corporation qualifies for an exception under § 1.367(e)–1T(c)(3), the requirements of section 6038B are satisfied if the distributing corporation complies with the reporting requirements contained in § 1.367(e)–1T(c)(3).

(f) [Reserved]. For further guidance, see § 1.6038B–1(f).

(g) *Effective date.* This section applies to transfers occurring after December 31, 1984, except paragraph (e)(1) applies to transfers occurring on or after September 13, 1996. See § 1.6038B–1T(a) through (b)(2), (c) introductory text, and (f) (26 CFR part 1, revised April 1, 1998) for transfers occurring prior to July 20, 1998. See § 1.6038B–1 for transfers occurring on or after July 20, 1998.

[T.D. 8087, 51 FR 17957, May 16, 1986, as amended by T.D. 8682, 61 FR 42177, Aug. 14, 1996; T.D. 8770, 63 FR 33570, June 19, 1998]

§ 1.6038B–2 Reporting of certain transfers to foreign partnerships.

(a) *Reporting requirements*—(1) *Requirement to report transfers.* A United States person that transfers property to a foreign partnership in a contribution described in section 721 (including section 721(b)) must report that transfer on Form 8865 ''Information Return of U.S. Persons With Respect to Certain Foreign Partnerships'' pursuant to section 6038B and the rules of this section, if—

(i) Immediately after the transfer, the United States person owns, directly, indirectly, or by attribution, at least a 10-percent interest in the partnership, as defined in section 6038(e)(3)(C) and the regulations thereunder; or

(ii) The value of the property transferred, when added to the value of any other property transferred in a section 721 contribution by such person (or any related person) to such partnership during the 12-month period ending on the date of the transfer, exceeds $100,000.

(2) *Indirect transfer through a domestic partnership*—For purposes of this section, if a domestic partnership transfers property to a foreign partnership in a section 721 transaction, the domestic partnership's partners shall be considered to have transferred a proportionate share of the property to the foreign partnership. However, if the domestic partnership properly reports all of the information required under this section with respect to the contribution, no partner of the transferor partnership, whether direct or indirect (through tiers of partnerships), is also required to report under this section. For illustrations of this rule, see *Examples 4* and *5* of paragraph (a)(7) of this section.

(3) *Indirect transfer through a foreign partnership.* [Reserved]

(4) *Requirement to report dispositions*—(i) *In general.* If a United States person was required to report a transfer to a foreign partnership of appreciated property under paragraph (a)(1) or (2) of this section, and the foreign partnership disposes of the property while such United States person remains a direct or indirect partner, that United States person must report the disposition by filing Form 8865. The form must be attached to, and filed by the due date (including extensions) of, the United States person's income tax return for the year in which the disposition occurred.

(ii) *Disposition of contributed property in nonrecognition transaction.* If a foreign partnership disposes of contributed appreciated property in a nonrecognition transaction and substituted basis property is received in exchange, and the substituted basis property has built-in gain under § 1.704-3(a)(8), the original transferor is not required to report the disposition. However, the transferor must report the disposition of the substituted basis property in the same manner as provided for the contributed property.

(5) *Time for filing Form 8865*—(i) *General rule.* The Form 8865 on which a transfer is reported must be attached to the transferor's timely filed (including extensions) income tax return (including a partnership return of income) for the tax year that includes the date of the transfer.

(ii) *Time for filing when transferor also required to report information about the partnership under section 6038.* If the United States person required to file under this section is also required to file a Form 8865 under section 6038 for the period in which the transfer occurs, then the United States person must report under this section on the Form 8865 for the foreign partnership's annual accounting period in which the transfer occurred (not its own taxable year) and file with its income tax return for that year as provided in Section 6038 and the regulations thereunder.

(6) *Returns to be made*—(i) *Separate returns for each partnership.* If a United States person transfers property reportable under this section to more than one foreign partnership in a taxable year, the United States person must submit a separate Form 8865 for each partnership.

(ii) *Duplicate form to be filed.* If required by the instructions accompanying Form 8865, a duplicate Form 8865 (including attachments and schedules) must also be filed by the due date for submitting the original Form 8865 under paragraph (a)(5)(i) or (ii) of this section, as applicable.

(7) *Examples.* The application of this paragraph (a) may be illustrated by the following examples:

Example 1. On November 1, 2001, *US,* a United States person that uses the calendar year as its taxable year, contributes $200,000 to *FP,* a foreign partnership, in a transaction subject to section 721. After the contribution, *US* owns a 5% interest in *FP*. *US* must report the contribution by filing Form 8865 for its taxable year ending December 31, 2001. On March 1, 2002, *US* makes a $40,000 section 721 contribution to *FP*, after which *US* owns a 6% interest in *FP*. *US* must report the $40,000 contribution by filing Form 8865 for its taxable year ending December 31, 2002, because the contribution, when added to the value of the other property contributed by *US* to *FP* during the 12-month period ending on the date of the transfer, exceeds $100,000.

Example 2. F, a nonresident alien, is the brother of *US*, a United States person. *F* owns a 15% interest in *FP*, a foreign partnership. *US* contributes $99,000 to *FP*, in exchange for a 1-percent partnership interest. Under sections 6038(e)(3)(C) and 267(c)(2), *US* is considered to own at least a 10-percent interest in *FP* and, therefore, *US* must report the $99,000 contribution under this section.

Example 3. US, a United States person, owns 40 percent of *FC,* a foreign corporation. *FC* owns a 20-percent interest in *FP*, a foreign partnership. Under section 267(c)(1), *US* is considered to own 8 percent of *FP* due to its ownership of *FC. US* contributes $50,000 to *FP* in exchange for a 5-percent partnership interest. Immediately after the contribution, *US* is considered to own at least a 10-percent interest in *FP* and, therefore, must report the $50,000 contribution under this section.

Example 4. US, a United States person, owns a 60-percent interest in *USP*, a domestic partnership. On March 1, 2001, *USP* contributes $200,000 to *FP*, a foreign partnership, in exchange for a 5-percent partnership interest. Under paragraph (a)(2) of this section, *US* is considered as having contributed $120,000 to *FP* ($200,000 × 60%). However, under paragraph (a)(2), if *USP* properly reports the contribution to *FP, US* is not required to report its $120,000 contribution. If *US* directly contributes $5,000 to *FP* on June 10, 2001, *US* must report the $5,000 contribution because *US* is considered to have contributed more than $100,000 to *FP* in the 12-month period ending on the date of the $5,000 contribution.

Example 5. US, a United States person, owns an 80-percent interest in *USP*, a domestic partnership. *USP* owns an 80-percent interest in *USP1,* a domestic partnership. On March 1, 2001, *USP1* contributes $200,000 to *FP*, a foreign partnership, in exchange for a 3-percent partnership interest. Under paragraph (a)(2) of this section, *USP* is considered to have contributed $160,000 ($200,000 × 80%) to *FP*. *US* is considered to have contributed $128,000 to *FP* ($200,000 × 80% × 80%). However, if *USP1* reports the transfer of the $200,000 to *FP*, neither *US* nor *USP* are required to report under this section the amounts they are considered to have contributed. Additionally, regardless of whether *USP1* reports the $200,000 contribution, if *USP* reports the $160,000 contribution it is considered to have made, *US* does not have to report under this section the $128,000 contribution *US* is considered to have made.

(b) *Transfers by trusts relating to state and local government employee retirement plans.* Trusts relating to state and local government employee retirement plans are not required to report transfers under this section, unless otherwise specified in the instructions to Form 8865.

(c) *Information required with respect to transfers of property.* With respect to transfers required to be reported under paragraph (a)(1) or (2) of this section, the return must contain information in such form or manner as Form 8865 (and its accompanying instructions) prescribes with respect to reportable events, including—

(1) The name, address, and U.S. taxpayer identification number of the United States person making the transfer;

(2) The name, U.S. taxpayer identification number (if any), and address of the transferee foreign partnership, and the type of entity and country under whose laws the partnership was created or organized;

(3) A general description of the transfer, and of any wider transaction of which it forms a part, including the date of transfer;

(4) The names and addresses of the other partners in the foreign partnership, unless the transfer is solely of cash and the transferor holds less than a 10-percent interest in the transferee foreign partnership immediately after the transfer;

(5) A description of the partnership interest received by the United States person, including a change in partnership interest;

(6) A separate description of each item of contributed property that is appreciated property subject to the allocation rules of section 704(c)(except to the extent that the property is permitted to be aggregated in making allocations under section 704(c)), or is intangible property, including its estimated fair market value and adjusted basis.

(7) A description of other contributed property, not specified in paragraph (c)(6) of this section, aggregated by the following categories (with, in each case, a brief description of the property)—

(i) Stock in trade of the transferor (inventory);

(ii) Tangible property (other than stock in trade) used in a trade or business of the transferor;

(iii) Cash;

(iv) Stock, notes receivable and payable, and other securities; and

(v) Other property.

(d) *Information required with respect to dispositions of property.* In respect of dispositions required to be reported under paragraph (a)(4) of this section, the return must contain information in such form or manner as Form 8865 (and its accompanying instructions) prescribes with respect to reportable events, including—

(1) The date and manner of disposition;

(2) The gain and depreciation recapture amounts, if any, realized by the partnership; and

(3) Any such amounts allocated to the United States person.

(e) *Method of reporting.* Except as otherwise provided on Form 8865, or the accompanying instructions, all amounts reported as required under this section must be expressed in United States currency, with a statement of the exchange rates used. All statements required on or with Form 8865 pursuant to this section must be in the English language.

(f) *Reporting under this section not required of partnerships excluded from the application of subchapter K*—(1) *Election to be wholly excluded.* The reporting requirements of this section will not apply to any United States person in respect of an eligible partnership as described in § 1.761–2(a), if such partnership has validly elected to be excluded from all of the provisions of subchapter K of chapter 1 of the Internal Revenue Code in the manner specified in § 1.761–2(b)(2)(i).

(2) *Deemed excluded.* The reporting requirements of this section will not apply to any United States person in respect of an eligible partnership as described in § 1.761–2(a), if such partnership is validly deemed to have elected to be excluded from all of the provisions of subchapter K of chapter 1 of the Internal Revenue Code in accordance with the provisions of § 1.761–2(b)(2)(ii).

(g) *Deemed contributions.* Deemed contributions resulting from IRS-initiated section 482 adjustments are not required to be reported under section 6038B. However, taxpayers must report deemed contributions resulting from taxpayer-initiated adjustments. Such information will be furnished timely if filed by the due date, including extensions, for filing the taxpayer's income tax return for the year in which the adjustment is made.

(h) *Failure to comply with reporting requirements*—(1) *Consequences of failure.* If a United States person is required to file a return under paragraph (a) of this section and fails to comply with the reporting requirements of section 6038B and this section, then such person is subject to the following penalties:

(i) The United States person is subject to a penalty equal to 10 percent of the fair market value of the property at the time of the contribution. Such penalty with respect to a particular transfer is limited to $100,000, unless the failure to comply with respect to such transfer was due to intentional disregard.

(ii) The United States person must recognize gain (reduced by the amount of any gain recognized, with respect to that property, by the transferor after the transfer) as if the contributed property had been sold for fair market value at the time of the contribution. Adjustments to the basis of the partnership's assets and any relevant partner's interest as a result of gain being recognized under this provision will be made as though the gain was recognized in the year in which the failure to report was finally determined.

(2) *Failure to comply.* A failure to comply with the requirements of section 6038B includes—

(i) The failure to report at the proper time and in the proper manner any information required to be reported under the rules of this section; and

(ii) The provision of false or inaccurate information in purported compliance with the requirements of this section.

(3) *Reasonable cause exception.* Under section 6038B(c)(2) and this section, the provisions of paragraph (h)(1) of this section will not apply if the transferor shows that a failure to comply was due to reasonable cause and not willful neglect. The transferor may attempt to do so by providing a written statement to the district director having jurisdiction of the taxpayer's return for the year of the transfer, setting forth the reasons for the failure to comply. Whether a failure to comply was due to reasonable cause will be determined by the district director under all the facts and circumstances.

(4) *Statute of limitations.* For exceptions to the limitations on assessment in the event of a failure to provide information under section 6038B, see section 6501(c)(8).

(i) *Definitions*—(1) *Appreciated property.* Appreciated property is property that has a fair market value in excess of basis.

(2) *Domestic partnership.* A domestic partnership is a partnership described in section 7701(a)(4).

(3) *Foreign partnership.* A foreign partnership is a partnership described in section 7701(a)(5).

(4) *Related person.* Persons are related persons if they bear a relationship described in section 267(b)(1) through (3) or (10) through (12), after application of section 267(c) (except for (c)(3)), or in section 707(b)(1)(B).

(5) *Substituted basis property.* Substituted basis property is property described in section 7701(a)(42).

(6) *Taxpayer-initiated adjustment.* A taxpayer-initiated adjustment is a section 482 adjustment that is made by the taxpayer pursuant to §1.482–1(a)(3).

(7) *United States person.* A United States person is a person described in section 7701(a)(30).

(j) *Effective dates*—(1) *In general.* This section applies to transfers made on or after January 1, 1998. However, for a transfer made on or after January 1, 1998, but before January 1, 1999, the filing requirements of this section may be satisfied by—

(i) Filing a Form 8865 with the taxpayer's income tax return (including a partnership return of income) for the first taxable year beginning on or after January 1, 1999; or

(ii) Filing a Form 926 (modified to reflect that the transferee is a partnership, not a corporation) with the taxpayer's income tax return (including a partnership return of income) for the taxable year in which the transfer occurred.

(2) *Transfers made between August 5, 1997 and January 1, 1998.* A United States person that made a transfer of property between August 5, 1997, and January 1, 1998, that is required to be reported under section 6038B may satisfy its reporting requirement by reporting in accordance with the provisions of this section or in accordance with the provisions of Notice 98–17

(1998–11 IRB 6)(see § 601.601(d)(2) of this chapter).

[T.D. 8817, 64 FR 5715, Feb. 5, 1999; 64 FR 15687, Apr. 1, 1999]

§ 1.6039–1 Information returns required of corporations with respect to certain stock option transactions occurring on or after January 1, 1964.

(a) *Requirement of return under section 6039(a)(1).* Every corporation which transfers stock to any person pursuant to such person's exercise on or after January 1, 1964, of a qualified stock option described in section 422(b), or a restricted stock option described in section 424(b), shall make, for each calendar year in which such a transfer occurs, an information return on Form 3921 with respect to each transfer made during such year. The return shall include the following information:

(1) The name, address and employer identification number of the corporation transferring the stock;

(2) The name, address, and identifying number of the person to whom the share or shares of stock were transferred;

(3) The name and address of the corporation the stock of which is the subject of the option (if other than the corporation transferring the stock);

(4) The date the option was granted;

(5) The date the shares were transferred to the person exercising the option;

(6) The fair market value of the stock at the time the option was exercised;

(7) The number of shares of stock transferred pursuant to the option;

(8) The type of option under which the transferred shares were acquired; and

(9) Such other information as may be required by the return or by the instructions issued with respect thereto.

(b) *Requirement of return under section 6039(a)(2).* (1) Every corporation which records, or has by its agent recorded, a transfer of the title to stock acquired by the transferor pursuant to his exercise on or after January 1, 1964, of:

(i) An option granted under an employee stock purchase plan which meets the requirements of section 423(b), and with respect to which the special rule of section 423(c) applied, or

(ii) A restricted stock option which meets the requirements of section 424(b), and with respect to which the special rule of section 424(c)(1) applies, shall make, for each calendar year in which such a recorded transfer of title to such stock occurs, an information return on Form 3922 with respect to each transfer containing the information required by subparagraph (2) of this paragraph.

(2) The return required by subparagraph (1) of this paragraph shall contain the following information:

(i) The name and address of the corporation whose stock is being transferred;

(ii) The name, address, and identifying number of the transferor;

(iii) The date such stock was transferred to the transferor;

(iv) The number of shares to which title is being transferred; and

(v) The type of option under which the transferred shares were acquired.

(3) If the return required by this paragraph is made by the authorized ‘‘transfer agent’’ of the corporation, it shall be deemed to have been made by the corporation. The term ‘‘transfer agent’’, as used in this paragraph, means any designee authorized to keep the stock ownership records of a corporation and to record a transfer of title of the stock of such corporation on behalf of such corporation.

(4) Where a corporation is required by this paragraph to make an information return for the calendar year, such return will only have to supply information relating to the first recorded transfer of title to the share or shares of stock. Thus, for example, if the owner has record title to a share or shares of stock transferred to a recognized broker or financial institution and the stock is subsequently sold by such broker or institution (on behalf of the owner) the corporation is only required to report information relating to the transfer of record title to the broker or financial institution. Similarly, a return is required when a share of stock is transferred by the optionee to himself and another person (or persons) as joint tenants, tenants by the entireties or tenants in common. However, when stock is originally issued to the optionee and another person (or

persons) as joint tenants, or as tenants by the entirety, and a stock certificate was not previously actually issued to the optionee as a sole owner, the return required by this paragraph shall be made (at such time and in such manner as is provided by this section with respect to a transfer by the optionee) in respect of the first transfer of the title to such stock by the optionee.

(5) Every corporation which transfers any share of stock pursuant to the exercise of an option described in this paragraph shall identify such stock in a manner sufficient to enable the accurate reporting of the transfer of record title to such shares. Such identification may be accomplished by assigning to the certificates of stock issued pursuant to the exercise of such options a special serial number, or color.

(c) *Time, place, and manner of filing.* (1) The returns on Forms 3921 and 3922 required by section 6039(a) (1) and (2) and paragraphs (a) and (b) of this section shall be filed as attachments to a summary report on Form 4067 which must be signed by the person required to file the returns or its duly authorized agent. With respect to returns on Form 3921, the summary report on Form 4067 shall indicate the number of returns filed, the number of shares transferred pursuant to exercise of options, the dates on which the options exercised were offered or granted, the fair market value of shares subject to option on such dates, the method by which such value was determined, the type of options under which the transferred shares were acquired, and such other information as may be required by the form or by the instructions issued with respect thereto. With respect to returns on Form 3922, the summary report on Form 4067 shall indicate the number of returns filed, the number of shares transferred, the type of options under which the transferred shares were acquired and such other information as may be required by the form or by the instructions issued with respect thereto. The summary report on Form 4067 and the attached returns on Forms 3921 and 3922 required for any calendar year shall be filed on or before February 28 of the following year with any of the Internal Revenue Service Centers.

(2) If a return is made by the authorized ‘‘transfer agent’’ of the corporation, as described in paragraph (b)(3) of this section, it shall be filed with the district director for the district where the income tax return of the principal corporation is filed after the close of the calendar year for which the return is required, but on or before February 28th of the following calendar year.

(3) For provisions relating to the extension of time for filing the returns required by this section, see §1.6081–1.

(4) For provisions relating to the time for performance of an act when the last day prescribed for performance falls on Saturday, Sunday, or a legal holiday, see §301.7503–1 of this chapter (Regulations on Procedure and Administration).

(d) *Stock to which this section applies.* The rules of this section shall apply to any full share of stock acquired pursuant to the exercise of any qualified or restricted stock option, or any option granted under an employee stock purchase plan, irrespective of whether the transfer of stock pursuant to such excercise qualified for the special tax treatment of section 421 and the regulations thereunder. In addition, the rules of paragraph (b) of this section shall apply to any full shares of stock received in respect of stock which was originally acquired pursuant to the exercise of an option described in the preceding sentence. See section 425(b). For definitions of the terms ‘‘exercise’’ and ‘‘transfer’’ see paragraphs (f) and (g) of §1.421–7. A return is required under paragraph (b) of this section irrespective of whether the transfer of the title constitutes a disposition of such stock as defined by section 425(c).

[T.D. 6887, 31 FR 8813, June 24, 1966]

§1.6039–2 Statements to persons with respect to whom information is furnished.

(a) *Requirement and form of statement.* Every corporation required to make a return on Form 3921 or 3922 under section 6039(a) and §1.6039–1 shall furnish to each person whose identifying number is (or should be) shown on such return a written statement containing the information required to be shown on such return. This requirement may be met by furnishing a copy of the appropriate return to such person. A statement shall be considered to be furnished to a person within the meaning of this section if it is mailed to such person at his last known address.

(b) *Time for furnishing statements*—(1) *In general.* Each statement required by this section to be furnished to any person for a calendar year shall be furnished to such person on or before January 31, of the year following the year for which the statement is required.

(2) *Extension of time.* For good cause shown upon written application of the corporation required to furnish statements under this section, the district director may grant an extension of time not exceeding 30 days in which to furnish such statements. The application shall be addressed to the district director with whom the income tax returns of the applicant-corporation are filed and shall contain a full recital of the reasons for requesting the extension to aid the district director in determining the period of the extension, if any, which will be granted. Such a request in the form of a letter to the district director signed by the applicant (or its agent) will suffice as an application. The application shall be filed on or before the date prescribed in subparagraph (1) of this paragraph for furnishing the statements required by this section.

(3) *Last day for furnishing statement.* For provisions relating to the time for performance of an act when the last day prescribed for performance falls on Saturday, Sunday, or a legal holiday, see § 301.7503–1 of this chapter (Regulations on Procedure and Administration).

(c) *Penalty.* For provisions relating to the penalty provided for failure to furnish a statement under this section, see § 301.6678–1 of this chapter (Regulations on Procedure and Administration).

[T.D. 6887, 31 FR 8814, June 24, 1966]

§ 1.6041–1 Return of information as to payments of $600 or more.

(a) *General rule.* (1) *Information returns required*—(i) *Payments required to be reported.* Except as otherwise provided in §§ 1.6041–3 and 1.6041–4, every person engaged in a trade or business shall make an information return for each calendar year with respect to payments it makes during the calendar year in the course of its trade or business to another person of fixed or determinable income described in paragraph (a)(1)(i) (A) or (B) of this section. For purposes of the regulations under this section, the person described in this paragraph (a)(1)(i) is a payor.

(A) Salaries, wages, commissions, fees, and other forms of compensation for services rendered aggregating $600 or more.

(B) Interest (including original issue discount), rents, royalties, annuities, pensions, and other gains, profits, and income aggregating $600 or more.

(ii) *Information returns required under other provisions of the Internal Revenue Code.* The payments described in paragraphs (a)(1)(i) (A) and (B) of this section shall not include any payments of amounts with respect to which an information return is required by, or may be required under authority of, section 6042(a) (relating to dividends), section 6043(a)(2) (relating to distributions in liquidation), section 6044(a) (relating to patronage dividends), section 6045 (relating to brokers' transactions with customers), sections 6049(a) (1) and (2) (relating to interest), section 6050N(a) (relating to royalties), or section 6050P (a) or (b) (relating to cancellation of indebtedness). In addition, the payments described in paragraphs (a)(1)(i) (A) and (B) of this section shall not include amounts excepted from the definition of dividends under section 6042(b)(2) and § 1.6042–3(b)(1), amounts described in section 6044(b), amounts excepted from reporting under § 1.6045–1(g), amounts excepted from the definition of interest under section 6049(b)(2) (C) or (D), § 1.6049–4(c), or 1.6049–5(b)(6) through (15). Notwithstanding the preceding sentence, interest with respect to a notional principal contract excluded from the definition of interest under § 1.6049–5(b)(15) is reportable under this section. The term *interest* as used in this paragraph (a)(1)(ii) otherwise includes all interest, other than interest coming within the definition of interest provided in § 1.6049–5(a). For example, a closely held corporation borrows money from one of its officers on a promissory note not in registered form bearing annual stated interest of $300. The corporation also pays royalties to the officer amounting to $400 a year. An information return is required under this paragraph (a)(1) to report the payments to the officer because the interest does not come within the definition of interest in §1.6049–5(a) and the aggregate of interest and royalties exceeds $600.

(2) *Prescribed form.* The return required by subparagraph (1) of this paragraph shall be made on Forms 1096 and 1099 except that (i) the return with respect to distributions to beneficiaries of a trust or of an estate shall be made on Form 1041, and (ii) the return with respect to certain payments of compensation to an employee by his employer shall be made on Forms W–3 and W–2 under the provisions of §1.6041–2 (relating to return of information as to payments to employees). Where Form 1099 is required to be filed under this section, a separate Form 1099 shall be furnished for each person to whom payments described in subdivision (i), (ii), or (iii) of subparagraph (1) of this paragraph are made. For time and place for filing Forms 1096 and 1099, see §1.6041–6. For the requirement to submit the information required by Form 1099 on magnetic media for payments after December 31, 1983, see section 6011(e) and §301.6011–2 of this chapter (Procedure and Administration Regulations).

(b) *Persons engaged in trade or business*—(1) *In general.* The term ''all persons engaged in a trade or business'', as used in section 6041(a), includes not only those so engaged for gain or profit, but also organizations the activities of which are not for the purpose of gain or profit. Thus, the term includes the organizations referred to in section 401(a), 501(c), 501(d) and 521 and in paragraph (g) of this section. On the other hand, section 6041(a) applies only to payments in the course of trade or business; hence it does not apply to an amount paid by the proprietor of a business to a physician for medical services rendered by the physician to the proprietor's child.

(2) *Special rule for REMICs.* For purposes of chapter 1 subtitle F, chapter 61A, part IIIB, the terms ''all persons engaged in a trade or business'' and ''any service-recipient engaged in a trade or business'' includes a real estate mortgage investment conduit or REMIC (as defined in section 860D).

(c) *Fixed or determinable income.* Income is fixed when it is to be paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The income need not be paid annually or at regular intervals. The fact that the payments may be increased or decreased in accordance with the happening of an event does not for purposes of this section make the payments any the less determinable. A salesman working by the month for a commission on sales which is paid or credited monthly receives determinable income.

(d) *Payments specifically included*—(1) *In general.* Amounts paid in respect of life insurance, endowment, or annuity contracts are required to be reported in returns of information under this section—

(i) Unless the payment is made in respect of a life insurance or endowment contract by reason of the death of the insured and is not required to be reported by paragraph (b) of §1.6041–2,

(ii) Unless the payment is made by reason of the surrender prior to maturity or lapse of a policy, other than a policy which was purchased *(a)* by a trust described in section 401(a) which is exempt from tax under section 501(a), *(b)* as part of a plan described in section 403(a), or *(c)* by an employer described in section 403(b) (1) (A),

(iii) Unless the payment is interest as defined in §1.6049–2 and is made after December 31, 1962,

(iv) Unless the payment is a payment with respect to which a return is required by §1.6047–1, relating to employee retirement plans covering owner-employees,

(v) Unless the payment is payment with respect to which a return is required by §1.6052–1, relating to payment of wages in the form of group-term life insurance.

(2) *Professional fees.* Fees for professional services paid to attorneys, physicians, and members of other professions are required to be reported in returns of information if paid by persons engaged in a trade or business and paid in the course of such trade or business.

(3) *Prizes and awards.* Amounts paid as prizes and awards that are required to be included in gross income under section 74 and § 1.74–1 when paid in the course of a trade or business are required to be reported in returns of information under this section.

(4) *Disability payments.* Amounts paid as disability payments under section 105(d) are required to be reported in returns of information under this section.

(5) *Notional principal contracts.* Amounts paid after December 31, 1999, with respect to notional principal contracts referred to in §§ 1.863–7 or 1.988–2(e) to persons who are not described in § 1.6049–4(c)(1)(ii) are required to be reported in returns of information under this section. However, a payment made outside the United States (as defined in § 1.6049–5(e)) by a non-U.S. payor or a non-U.S. middleman, or by a U.S. payor or U.S. middleman that is not a U.S. person (such as a controlled foreign corporation defined in section 957(a) or certain foreign corporations or foreign partnerships engaged in a U.S. trade or business) or is a foreign branch of a U.S. bank is not reportable under this section if, in the case of a person that is a U.S. payor, a U.S. middleman, or a foreign branch of a U.S. institution, the payor has no actual knowledge that the payee is a U.S. person. The amount required to be reported under this paragraph (d)(5) is limited to the net income from the notional principal contract as described in § 1.446–3(d). A non-periodic payment is reportable for the year in which an actual payment is made. Any amount of interest determined under the provisions of § 1.446–3(g)(4) (dealing with interest in the case of a significant non-periodic payment) is reportable under this paragraph (d)(5) and not under section 6049 (see § 1.6049–5(b)(15)). See § 1.6041–4(a)(4) for reporting exceptions regarding payments to foreign persons. See, however, § 1.1461–1(c)(1) for reporting amounts described under this paragraph (d)(5) that are paid to foreign persons. The provisions of § 1.6049–5(d) shall apply for determining whether a payment with respect to a notional principal contract is made to a foreign person. See § 1.6049–4(a) for a definition of payor. For purposes of this paragraph (d)(5), a payor includes a middleman defined in § 1.6049–4(f)(4). See § 1.6049–5(c)(5) for a definition of a U.S. payor, a U.S. middleman, a non-U.S. payor, and a non-U.S. middleman.

(e) *Payment made in medium other than cash.* If any payment required to be reported on Form 1099 is made in property other than money, the fair market value of the property at the time of payment is the amount to be included on such form.

(f) *When payment deemed made.* For purposes of a return of information, an amount is deemed to have been paid when it is credited or set apart to a person without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and is made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition.

(g) *Payments made by the United States or a State.* Information returns on:

(1) Forms 1096 and 1099 and

(2) Forms W–3 and W–2 (when made under the provisions of § 1.6041–2)

of payments made by the United States or a State, or political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing, shall be made by the officer or employee of the United States, or of such State, or political subdivision, or of the District of Columbia, or of such agency or instrumentality, as the case may be, having control of such payments or by the officer or employee appropriately designated to make such returns.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6628, 27 FR 12794, Dec. 28, 1962, T.D. 6888, 31 FR 9205, July 6, 1966; T.D. 7284, 38 FR 20827, Aug. 3, 1973; T.D. 7580, 43 FR 60159, Dec. 26, 1978; T.D. 7888, 48 FR 17587, Apr. 25, 1983; T.D. 8458, 57 FR 61313, Dec. 24, 1992; T.D. 8734, 62 FR 53471, Oct. 14, 1997; T.D. 8804, 64 FR 11378, Mar. 9, 1999]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53471, Oct. 14, 1997, § 1.6041–1 was amended by revising paragraphs (a)(1), (d)(1) introductory text, and (d)(3); by adding a sentence at the end of paragraph (a)(2); by adding a heading for paragraphs (d)(2) and (d)(4); and by adding paragraph (d)(5), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.6041–1 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.6041–1 Return of information as to payments of $600 or more.

(a) * * * (1) Except as provided in §1.6041–3, every person engaged in a trade or business shall make an information return for each calendar year with respect to payments made by him during the calendar year in the course of his trade or business to another person of fixed or determinable:

(i) Salaries, wages, commissions, fees, and other forms of compensation for services rendered aggregating $600 or more;

(ii) Interest, rents, royalties, annuities, pensions, and other gains, profits, and income aggregating $600 or more; or

(iii) Foreign items, as defined in §1.6041–4, aggregating $600 or more.

The payments described in subdivisions (i), (ii), and (iii) of this subparagraph shall not include any payments with respect to which a statement is required by, or may be required under authority of, section 6042(a) (relating to dividends), section 6043(a)(2) (relating to distributions in liquidation) section 6044(a) (relating to patronage dividends), section 6045 (relating to brokers' transactions with customers), or section 6049(a) (1) and (2) (relating to interest). Thus, the term ''interest'', as used in subdivision (ii) of this subparagraph, includes all interest other than that coming within the definition of interest provided in §1.6049–2. For example, a closely held corporation borrows money from one of its officers on a promissory note not in registered form the yearly interest on which is $300. It also pays royalties to such officer amounting to $400 a year. An information return is required under subdivision (ii) of this subparagraph with respect to the payments to such officer since the interest does not come within the definition of interest provided in §1.6049–2 and the aggregate of the interest and royalty payments is in excess of $600.

* * * * *

(d) * * * (1) Sums paid in respect of life insurance, endowment, or annuity contracts are required to be reported in returns of information under this section: * * *

(2) * * *

(3) Amounts paid as prizes and awards which are required to be included in gross income under section 74 and §1.74–1 when paid in the course of a trade or business shall be reported in returns of information.

* * * * *

§1.6041–2 Return of information as to payments to employees.

(a)(1) *In general.* Wages, as defined in section 3401, paid to an employee are required to be reported on Form W–2. See section 6011 and the Employment Tax Regulations thereunder. All other payments of compensation, including the cash value of payments made in any medium other than cash, to an employee by his employer in the course of the trade or business of the employer must also be reported on Form W–2 if the total of such payments and the amount of the employee's wages (as defined in section 3401), if any, required to be reported on Form W–2 aggregates $600 or more in a calendar year. A separate Form W–2 shall be furnished for each employee for whom a return must be made. At the election of the employer, components of amounts required to be reported on Form W–2 pursuant to the provisions of this subparagraph may be reported on more than one Form W–2.

(2) *Transmittal form.* The transmittal form for a return on Form W–2 made pursuant to the provisions of subparagraph (1) of this paragraph shall be Form W–3. In a case where an employer must file a Form W–3 under this paragraph and also under §31.6011(a)–4 or §31.6011(a)–5 of this chapter (Employment Tax Regulations), the Form W–3 filed under such §31.6011(a)–4 or §31.6011(a)–5 shall also be used as the transmittal form for a return on Form W–2 made pursuant to the provisions of this paragraph.

(3) *Time for filing*—(i) *General rule.* In a case where an employer must file Forms W–3 and W–2 under this paragraph and also under §31.6011(a)–4 or §31.6011(a)–5 of this chapter (Employment Tax Regulations), the time for filing such forms under this paragraph shall be the same as the time (including extensions thereof) for filing such forms under §31.6011(a)–4 or §31.6011(a)–5.

(ii) *Exception.* In a case where an employer is not required to file Forms W–3 and W–2 under §31.6011(a)–4 or

§ 31.6011(a)–5 of this chapter (Employment Tax Regulations), returns on Forms W–3 and W–2 required under this paragraph for any calendar year shall be filed on or before February 28 of the following year.

(iii) *Cross reference.* For extensions of time for filing returns, see section 6081 and the regulations thereunder.

(4) *Place for filing.* The returns on Forms W–3 and W–2 required under this paragraph shall be filed pursuant to the rules contained in § 31.6091–1 of this chapter (Employment Tax Regulations), relating to the place for filing certain returns.

(b) *Distributions under employees' trust or plan.* (1) Amounts which are:

(i) Distributed or made available to a beneficiary, and to which section 402 (relating to employees' trusts) or section 403 (relating to employee annuity plans) applies, or

(ii) Described in section 72(m)(3)(B), shall be reported on Forms 1096 and 1099 to the extent such amounts are includible in the gross income of such beneficiary if the amounts so includible aggregate $600 or more in any calendar year. In addition, every trust described in section 501(c)(17) which makes one or more payments (including separation and sick and accident benefits) totaling $600 or more in 1 year to an individual must file an annual information return on Form 1096, accompanied by a statement on Form 1099, for each such individual. Payments made by an employer or a person other than the trustee of the trust should not be considered in determining whether the $600 minimum has been paid by the trustee. The provisions of this subparagraph shall not be applicable to payments of supplemental unemployment compensation benefits made after December 31, 1970, which are treated as if they were wages for purposes of section 3401(a). Such amounts are required to be reported on Forms W–3 and W–2. See paragraph (b)(14) of § 31.3401(a)–1 of this chapter (Employment Tax Regulations).

(2) Any amount with respect to which a statement is required by § 1.6047–1, relating to employee retirement plans covering owner-employees, shall not be included in amounts required to be reported under section 6041.

(c) *Payments to foreign persons.* See § 1.6041–4 for reporting exemptions regarding payments to foreign persons. See § 1.6049–5(d) for determining whether a payment is made to a foreign person.

[T.D. 7284, 38 FR 20827, Aug. 3, 1973, as amended by T.D. 7580, 43 FR 60159, Dec. 26, 1978; T.D. 8734, 62 FR 53472, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53472, Oct. 14, 1997, in § 1.6041–2, paragraph (c) was revised, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.6041–2 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.6041–2 Return of information as to payments to employees.

* * * * *

(c) *Special rule for calendar years before 1972.* For calendar years before 1972, the provisions of this section will be deemed to have been complied with if the returns for such years were filed in accordance with the provisions of this section in effect prior to [insert date on which final regulations under this section are published in the FEDERAL REGISTER] or with the instructions applicable to the appropriate forms.

§ 1.6041–3 Payments for which no return of information is required under section 6041.

Returns of information are not required under section 6041 and §§ 1.6041–1 and 1.6041–2 for payments described in paragraphs (a) through (q) of this section. See § 1.6041–4 for reporting exemptions regarding payments to foreign persons.

(a) Payments of income required to be reported on Forms 1120–S, 941, W–2, and W–3 (however, see § 1.6041–2(a) with respect to Forms W–2 and W–3).

(b) Payments by a broker to his customer (but for reporting requirements as to certain of such payments, see sections 6042, 6045, and 6049 and the regulations thereunder in this part).

(c) Payments of bills for merchandise, telegrams, telephone, freight, storage, and similar charges.

(d) Payments of rent made to real estate agents (but the agent is subject to the requirements of paragraph (a)(1)(ii) and (2)(ii) of § 1.6041–1).

(e) Payments representing earned income for services rendered without the United States made to a citizen of the

United States, if it is reasonable to believe that such amounts will be excluded from gross income under the provisions of section 911 and the regulations thereunder.

(f) Compensation and profits paid or distributed by a partnership to the individual partners (but for reporting requirements, see §1.6031–1).

(g) Payments of commissions to general agents by fire insurance companies or other companies insuring property, except when specifically directed by the Commissioner to be filed.

(h)(1) *In general.* Payments made under reimbursement or other expense allowance arrangements that meet the requirements of section 62(c) of the Code and §1.62–2, that do not exceed the amount of the expenses substantiated (i.e., amounts which are treated as paid under an accountable plan), and that are received by an employee on or after January 1, 1989, with respect to expenses paid or incurred on or after January 1, 1989.

(2) *Transition rule.* Payments made under reimbursement or other expense allowance arrangements that are received by an employee on or after January 1, 1989, but prior to July 1, 1990, to the extent that the employee is required to account (within the meaning of the term ''account'' as set forth in §1.162–17(b)(4) or 1.274–5T(f)(4), whichever is applicable) and does so account to the payor for such expenses, provided the payor has made a reasonable, good faith effort to comply with the requirements of section 62(c). In general, compliance with the provisions of this section, as in effect for payments made under reimbursement or other expense allowance arrangements that were received by an employee before January 1, 1989, with respect to expenses paid or incurred before January 1, 1989, will constitute such reasonable good faith compliance. In no event, however, will reasonable good faith compliance exist if a payor fails to report payments made under an arrangement (other than a per diem or mileage allowance type arrangement) under which an employee is not required to substantiate expenses paid or incurred or is not required to return amounts in excess of the substantiated expenses.

(i) Payments of interest on obligations of the United States, or a State, Territory, or political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing (but for requirements for reporting certain such payments by the United States or any agency or instrumentality thereof, see §§1.1461–1 to 1.1461–3, inclusive).

(j) Payments of interest on corporate bonds (but for reporting requirements as to payments on certain corporate bonds, see §1.6049–5.

(k) Amounts paid as an allowance or reimbursement for traveling or other bona fide ordinary and necessary expenses, including an allowance for meals and lodging or a per diem allowance in lieu of subsistence, to persons in the service of an international organization (without regard to whether there is a requirement to account for such amounts) if-

(1) The organization is designated as an international organization by the President of the United States in Executive Orders issued pursuant to 22 U.S.C. 288, and

(2) The organization has immunity with respect to the invoilability of its archives pursuant to an international agreement having full force and effect in the United States.

(l) A payment to an informer as an award, fee, or reward for information relating to criminal activity, but only if such payment is made by the United States, a State, Territory, or political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing, or, with respect to payments made after December 31, 1987, by an organization that is described in section 501(c)(3) and that makes such payments in furtherance of a charitable purpose to lessen the burdens of government within the meaning of §1.501(c)(3)–1(d)(2).

(m) On and after September 9, 1968, payments by a person carrying on the banking business of interest on a deposit evidenced by a negotiable time certificate of deposit (but for reporting requirements as to payments made after December 31, 1962, of interest on certain deposits, see sec. 6049 and the regulations thereunder in this part).

(n) Payments made to principals by persons carrying on the banking business, and by persons which are mutual savings banks, cooperative banks, building and loan associations, homestead associations, credit unions, or similar organizations chartered and supervised by Federal or State law, of funds collected when acting in the capacity of collection agents. This exception does not apply to collection of items on a regular and continuing basis under a so-called escrow, trust, custody, or investment advisory agreement. However, returns of information are not required unless payment is of the type with respect to which such returns would otherwise be required under section 6041 if the payer were engaged in a trade or business; nor are returns of information required on payments pursuant to a trust with respect to which Form 1041 is required to be filed by the trustee. The exception from reporting set forth in this paragraph shall apply until such time as the Commissioner determines that it is feasible for such persons to report the payments, and this paragraph is amended accordingly to require such reporting.

(o) Payments to individuals as scholarships or fellowship grants within the meaning of section 117(b)(1), whether or not ‘‘qualified scholarships’’ as described in section 117(b). This exception does not apply to any amount of a scholarship or fellowship grant that represents payment for services within the meaning of section 117(c). Instead, these amounts are required to be reported as wages on Form W–2. See § 1.1461–1(c) for applicable reporting requirements for amounts paid to foreign persons.

(p) Per diem of certain alien trainees described under section 1441(c)(6).

(q) Payments made to the following persons:

(1) A corporation described in § 1.6049–4(c)(1)(ii)(A), except a corporation engaged in providing medical and health care services or engaged in the billing and collecting of payments in respect to the providing of medical and health care services. However, no reporting is required where payment is made to a hospital or extended care facility described in section 501(c)(3) which is exempt from taxation under section 501(a) or to a hospital or extended care facility owned and operated by the United States, a State, the District of Columbia, a possession of the United States, or a political subdivision, agency or instrumentality of any of the foregoing. For reporting requirements as to payments by cooperatives, and to certain other payments, see sections 6042, 6044, and 6049 and the regulations thereunder in this part.

(2) An organization exempt from taxation under section 501(a), as described in § 1.6049–4(c)(1)(ii)(B)(*1*), or an individual retirement plan, as described in § 1.6049–4(c)(1)(ii)(C).

(3) The United States, as described in § 1.6049–4(c)(1)(ii)(D).

(4) A State, the District of Columbia, a possession of the United States, or any political subdivision of any of the foregoing, as described in § 1.6049–4(c)(1)(ii)(E).

(5) A foreign government or political subdivision of a foreign government, as described in § 1.6049–4(c)(1)(ii)(F).

(6) An international organization, as described in § 1.6049–4(c)(1)(ii)(G).

(7) A foreign central bank of issue, as described in § 1.6049–4(c)(1)(ii)(H) and the Bank for International Settlements.

(8) Any wholly owned agency or instrumentality of any person described in paragraph (q) (2), (3), (4), (5), (6), or (7) of this section.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.6041–3, see the List of Sections Affected in the Finding Aids section of this volume.

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53472, Oct. 14, 1997, § 1.6041–3 was amended by revising the introductory text of the section, and paragraphs (a) and (b); by removing the semicolon at the end of paragraphs (d) through (f) and (h) through (j) and adding a period in its place, and by removing the language ‘‘; and’’ at the end of paragraph (o) and inserting a period in its place; by removing paragraphs (c) and (l); by redesignating paragraphs (d), (e), (f), (g), (h), (i), (j), (k), (m), (n), (o), and (p) as paragraphs (c), (d), (e), (f), (g), (h), (i), (j), (k), (l), (m), and (n), respectively; by revising newly designated paragraphs (f) and (j); and by adding paragraphs (o) through (q), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.6041–3 was delayed until Jan. 1,

2000. For the convenience of the user, the superseded text is set forth as follows:

§1.6041–3 Payments for which no return of information is required under section 6041.

Returns of information are not required under section 6041 and §§1.6041–1 and 1.6041–2 with respect to payments of the following character:

(a) Payments of income required to be reported on Forms 1042, 1042S, 1000, 1001 (including all special variations thereof), 1120–S, 941, W–3, and W–2 (however, see §1.6041–2 with respect to Forms W–3 and W–2);

(b) Payments by a broker to his customer (but for reporting requirements as to certain of such payments made after December 31, 1962, see sections 6042 and 6049 and the regulations thereunder in this part);

(c) Payments to a corporation, except payments made after December 31, 1970, to a corporation engaged in providing medical and health care services or engaged in the billing and collecting of payments in respect to the providing of medical and health care services, other than payments to:

(1) A hospital or extended care facility described in section 501(c)(3) which is exempt from taxation under section 501(a), or

(2) A hospital or extended care facility owned and operated by the United States, a State, the District of Columbia, a possession of the United States, or a political subdivision, agency or instrumentality of any of the foregoing.

For reporting requirements as to payments by cooperatives, and to certain other payments, see sections 6042, 6044, and 6049 and the regulations thereunder in this part;

* * * * *

(g) Salaries and profits paid or distributed by a partnershipto the individual partners;

* * * * *

(k) Payments of interest on corporate bonds (but for reporting requirements as to payments made after December 31, 1962, of interest on certain corporate bonds, see §1.6049–3, inclusive; and as to payments of interest on bonds, mortgages, deeds or trusts, or other similar obligations issued before January 31, 1934, and containing a taxfree covenant, see §§1.1461–1 to 1.1461–3, inclusive);

(l) Payments made to employees for services performed in Puerto Rico;

* * * * *

§1.6041–4 Foreign-related items and other exceptions.

(a) *Exempted foreign-related items*—(1) Returns of information are not required for payments that a payor can, prior to payment, associate with documentation upon which it may rely to treat as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii) or as made to a foreign payee in accordance with §1.6049–5(d)(1) or presumed to be made to a foreign payee under §1.6049–5(d)(2), (3), (4), or (5). However, such payments may be reportable under §1.1461–1(b) and (c). For purposes of this paragraph (a)(1), the provisions in §1.6049–5(c) (regarding rules applicable to documentation of foreign status and definition of U.S. payor and non-U.S. payor) shall apply. See §1.1441–1(b)(3)(iii)(B) and (C) for special payee rules regarding scholarships, grants, pensions, annuities, etc. The provisions of §1.1441–1 shall apply by substituting the term *payor* for the term *withholding agent* and without regard to the fact that the provisions apply only to amounts subject to withholding under chapter 3 of the Internal Revenue Code and the regulations under that chapter.

(2) Returns of information are not required for payments of amounts from sources outside the United States (determined under the provisions of part I, subchapter N, chapter 1 of the Internal Revenue Code and the regulations under those provisions) made by a non-U.S. payor or non-U.S. middleman outside the United States. For a definition of non-U.S. payor and non-U.S. middleman, see §1.6049–5(c)(5). For circumstances in which a payment is considered to be made outside the United States, see §1.6049–5(e).

(3) Returns of information are not required for amounts paid by a foreign intermediary described in §1.1441–1(e)(3)(i) that it has received in its capacity as an intermediary and that are associated with a valid withholding certificate described in §1.1441–1(e)(3)(ii) or (iii) and payments made by a U.S. branch of a foreign bank or of a foreign insurance company described in §1.1441–1(b)(2)(iv) that are associated with a valid withholding certificate described in §1.1441–1(e)(3)(v), which certificate the intermediary or branch has

furnished to the payor or middleman from whom it has received the payment, unless, and to the extent, the intermediary or branch knows that the payments are required to be reported under § 1.6041–1 and were not so reported.

(4) Returns of information are not required for amounts paid with respect to notional principal contracts referred to in § 1.863–7 or 1.988–2(e) which the payor may treat as effectively connected income of a foreign payee under the provisions of § 1.1441–4(a)(3) or if the payee provides a representation in a master agreement that governs the transactions in notional principal contracts between the parties (for example, an International Swap and Derivatives Association (ISDA) Agreement, including the Schedule thereto) or in the confirmation on the particular notional principal contract transaction that the counterparty is a foreign person. See, however, § 1.1461–1(c)(2)(i) for applicable reporting requirements.

(5) Returns of information are not required for the period that the amounts paid represent assets blocked as described in § 1.1441–2(e)(3). The exemption in this paragraph (a)(5) shall terminate when payment is deemed to occur in accordance with the provisions of § 1.1441–2(e)(3).

(b) *Joint owners.* Amounts paid to joint owners for which a certificate or documentation is required as a condition for being exempt from reporting under paragraph (a) of this section are presumed made to U.S. payees who are not exempt recipients if, prior to payment, the payor or middleman cannot reliably associate the payment either with a Form W–9 furnished by one of the joint owners in the manner required in §§ 31.3406(d)–1 through 31.3406(d)–5 of this chapter, or with documentation described in paragraph (a)(1) of this section furnished by each joint owner upon which the payor or middleman can rely to treat each joint owner as a foreign payee or foreign beneficial owner.

(c) *Conversion into United States dollars of amounts paid in foreign currency.* For rules concerning foreign currency conversion, see § 1.6049–4(d)(3)(i).

(d) *Effective date.* The provisions of this section apply to payments made after December 31, 1999.

[T.D. 8734, 62 FR 53473, Oct. 14, 1997, as amended by T.D. 8804, 63 FR 72188, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53473, Oct. 14, 1997, § 1.6041–4 was revised, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.6041–4 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.6041–4 Returns of information as to foreign items.

(a) *In general.* If the amount of foreign items, as defined in paragraph (b) of this section, paid in any calendar year to a citizen or resident of the United States (individual or fiduciary), or a partnership any member of which is a citizen or resident of the United States, is $600 or more, an information return on Form 1099 setting forth the amount of such items is required to be filed by any person who accepts the item for collection as a matter of business or for profit, such as a bank. As used in this section, the term ‘‘collection’’ includes (1) payment of the foreign item in cash; (2) the crediting of the account of the person presenting the foreign item; (3) the tentative crediting of the account of the person presenting the foreign item until the amount of the foreign item is received by the bank or collecting agent from abroad; and (4) the receipt of foreign items for the purpose of transmitting them abroad for deposits.

(b) *Foreign items defined.* The term ‘‘foreign items’’, as used in this section, means any item of interest upon the bonds of a foreign country or of a nonresident foreign corporation not having a fiscal or paying agent in the United States (including Puerto Rico as if a part of the United States), or any item of dividends upon the stock of such corporation.

(c) *License to collect foreign items.* A bank or agent collecting foreign items is required to obtain a license pursuant to the provisions of section 7001 and the regulations thereunder in part 301 of this chapter (Regulations on Procedure and Administration).

§ 1.6041–5 Information as to actual owner.

When a person receiving a payment described in section 6041 is not the actual owner of the income received, the name and address of the actual owner shall be furnished upon demand of the person paying the income, and in default of compliance with such demand the payee becomes liable for the penalties provided. See section 7203.

§1.6041–6 Returns made on Forms 1096 and 1099 under section 6041; contents and time and place for filing.

Returns made under section 6041 on Forms 1096 and 1099 for any calendar year shall be filed on or before February 28 of the following year with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for such forms. The name and address of the person making the payment and the name and address of the recipient of the payment shall be stated on Form 1099. If the present address of the recipient is not available, the last known post office address must be given. See section 6109 and the regulations thereunder for rules requiring the inclusion of identifying numbers in Form 1099.

[T.D. 7284, 38 FR 20828, Aug. 3, 1973]

§1.6041–7 Magnetic media requirement.

(a) *General.* For rules relating to permission to submit the information required by Form 1099 or W–2 on magnetic tape or other media, see §1.9101–1. See also paragraph (b)(2) of §31.6011(a)–7 of this chapter (Employment Tax Regulations) for additional rules relating to Form W–2. High-volume filers of information returns must file their returns on magnetic media. See section 6011(e) and §301.6011–2 of this chapter (Procedure and Administration Regulations) for the requirements for filing on magnetic media.

(b) *Returns on magnetic tape by departments of health care carriers.* (1) For calendar years beginning on or after January 1, 1971, a health care carrier, or an agent thereof, making payment of fees or other compensation to providers of medical and health care services, may make a separate return on magnetic tape for each separate department within a specific line of such carrier's business, so long as all of such returns taken together contain all of the information required by section 6041 with respect to each provider of medical and health care services to whom such health care carrier makes payments aggregating $600 or more during the calendar year. Examples of separate departments within a specific line of such carrier's business (such as health and accident insurance) include, but are not limited to, separate departments to process claims of individual and group policyholders; and separate departments established along geographic lines.

(2) For purposes of this paragraph, the term ‘‘health care carrier’’ means any person making health care payments: (i) In exchange for the payment of a premium, (ii) in accordance with an employee benefit program, or (iii) in connection with a government-sponsored health care program.

[T.D. 7106, 36 FR 6422, Apr. 3, 1971, as amended by T.D. 8734, 62 FR 53473, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53473, Oct. 14, 1997, §1.6041–7 was amended by revising the section heading and adding a sentence to the end of paragraph (a), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.6041–7 was delayed until Jan. 1, 2000.

§1.6041–8 Cross-reference to penalties.

For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6041(a) or (b), see §301.6721–1 of this chapter (Procedure and Administration Regulations). For provisions relating to the penalty provided for failure to furnish timely a correct payee statement required under section 6041(d), see §301.6722–1 of this chapter. See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

[T.D. 8734, 62 FR 53474, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53474, Oct. 14, 1997, §1.6041–8 was added, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.6041–8 was delayed until Jan. 1, 2000.

§1.6041A–1 Returns regarding payments of remuneration for services and certain direct sales.

(a) through (c) [Reserved]

(d) *Exceptions to return requirement.* [Reserved]

(1) and (2) [Reserved]

(3) *Foreign transactions*—(i) *In general.* No return shall be required under section 6041A with respect to payments described in this paragraph (d)(3).

(A) Returns of information are not required for payments that a payor can, prior to payment, associate with documentation upon which it may rely to treat as made to a foreign beneficial owner in accordance with § 1.1441–1(e)(1)(ii) or as made to a foreign payee in accordance with § 1.6049–5(d)(1) or presumed to be made to a foreign payee under § 1.6049–5(d)(2), (3), (4), or (5). However, such payments may be reportable under § 1.1461–1(b) and (c). For purposes of this paragraph (d)(3)(i)(A), the provisions in § 1.6049–5(c) (regarding rules applicable to documentation of foreign status and definition of U.S. payor and non-U.S. payor) shall apply. The provisions of § 1.1441–1 shall apply by substituting the term *payor* for the term *withholding agent.*

(B) Returns of information are not required for payments of remuneration for services and certain direct sales from sources outside the United States (determined under the provisions of part I, subchapter N, chapter 1 of the Internal Revenue Code and the regulations under those provisions) if payments are made outside the United States by a non-U.S. payor or non-U.S. middleman. For a definition of non-U.S. payor or non-U.S. middleman, see § 1.6049–5(c)(5). For circumstances in which a payment is considered to be made outside the United States, see § 1.6049–5(e).

(ii) *Payor.* The term *payor* has the same meaning as described in § 1.6049–4(a)(2).

(iii) *Joint owners.* Amounts paid to joint owners for which a certificate or documentation is required as a condition for being exempt from reporting under paragraph (d)(3)(i) of this section are presumed made to U.S. payees who are not exempt recipients if, prior to payment, the payor or middleman cannot reliably associate the payment either with a Form W–9 furnished by one of the joint owners in the manner required in §§ 31.3406(d)–1 through 31.3406(d)–5 of this chapter, or with documentation described in paragraph (d)(3)(i)(A) of this section furnished by each joint owner upon which it can rely to treat each joint owner as a foreign payee or foreign beneficial owner.

(iv) *Conversion into United States dollars of amounts paid in foreign currency.* For rules concerning foreign currency conversion, see § 1.6049–4(d)(3)(i).

(v) *Effective date.* The provisions of this paragraph (d)(3) apply to payments made after December 31, 1999.

(e) [Reserved]

(f) *Statements to be furnished to persons with respect to whom information is required to be furnished*—(1) [Reserved]

(2) *Time for furnishing statement.* [Reserved]

(3) *Contents of statement.* [Reserved]

(g) [Reserved]

(h) *Cross-reference to penalties.* For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6041A(a) or (b), see § 301.6721–1 of this chapter (Procedure and Administration Regulations). For provisions relating to the penalty provided for failure to furnish timely a correct payee statement required under section 6041A(e), see § 301.6722–1 of this chapter. See § 301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

[T.D. 8734, 62 FR 53474, Oct. 14, 1997, as amended by T.D. 8804, 63 FR 72188, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53474, Oct. 14, 1997, § 1.6041A–1 was added, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.6041A–1 was delayed until Jan. 1, 2000.

§ 1.6042–1 Return of information as to dividends paid in calendar years before 1963.

(a) *Requirement of return*—(1) *In general.* Except as provided in subparagraphs (2) and (3) of this paragraph, every domestic corporation, or foreign corporation engaged in business within the United States or having an office or place of business or a fiscal or paying agent in the United States, making payments during any calendar year before 1963 of $10 or more of dividends and distributions (other than distributions in liquidation) to any shareholder who is an individual (citizen or resident of the United States), a resident fiduciary, or a resident partnership any member of which is a citizen or resident shall file for the calendar year a return setting forth the amount of such payments for such calendar year. A separate return on Form 1099, showing the name and address of the payer and the shareholder, and the amount paid, shall be prepared with respect to each shareholder. These returns shall be accompanied by transmittal Form 1096.

(2) *Federal land bank associations and certain other corporations.* A corporation described in section 501(c) (12), (15), or (16), or section 521(b)(1), or a Federal land bank association or a production credit association, making a payment of a dividend, or a distribution, to any shareholder in any calendar year before 1963 shall file an information return with respect to such payments when they total $100 or more during the calendar year.

(3) *Savings and loan associations, etc.* A savings and loan association, a cooperative bank, a homestead association, a credit union, or a building and loan association is required to file an information return with respect to distributions made to a shareholder during any calendar year before 1963 only if the amount thereof paid to the shareholder during the calendar year, or such amount when aggregated with other payments made to the shareholder during such year of interest, rents, royalties, annuities, pensions, and other gains, profits, and income, as described in paragraph (a)(2)(ii) of § 1.6041–1, totals $600 or more. For this purpose, the term ‘‘distributions to a shareholder’’ includes periodical distributions of earnings on running installment shares of stock paid or credited by a building and loan association to its holders of that class of stock, and the sum received upon withdrawal from a building and loan association in excess of the amounts paid in on account of membership fees and stock subscriptions, consisting of accumulated profits.

(b) *Nontaxable or partly nontaxable distributions.* In the case of a distribution which is made from a depletion or depreciation reserve, or which for any other reason is deemed by the corporation to be nontaxable or partly nontaxable to its shareholders, the corporation shall fill in the information on both sides of Form 1096.

(c) *Information as to actual owner*—(1) *In general.* When the person receiving a payment with respect to which an information return is required under authority of the Code is not the actual owner of the income received, the name and address of the actual owner or payee shall be furnished upon demand of the person paying the income, and in default of a compliance with such demand the payee becomes liable for the penalties provided. See section 7203. Dividends on stock are prima facie the income of the record owner of the stock. If a record owner of stock who is not the actual owner thereof receives dividends on such stock in any calendar year before 1963, he shall file a Form 1087 disclosing the name and address of the actual owner or payee, the name of the issuing corporation, the number of shares of such stock, and the amount of dividends received with respect to such stock during the calendar year. (For the reporting by a nominee of dividends received by him on behalf of another person in any calendar year after 1962, see § 1.6042–2.) Unless such a disclosure is made the record owner will be held liable for any tax based upon such dividends. A separate Form 1087 shall be filed by the record owner for each of the stockholdings of each actual owner for whom he acts as nominee. However, where the record owner is a banking institution, trust company, or brokerage firm, it may, provided it maintains such records as will permit a prompt substantiation of each payment of dividends made to the actual owner, file one Form 1087 for each actual owner for whom it acts as nominee and report thereon the total amount of the dividends paid to such actual owner (without itemization as to the issuing company, class of stock, etc.).

(2) *Exceptions.* The filing of Form 1087 is not required if:

(i) The record owner is required to file a fiduciary return on Form 1041, or a withholding return on Form 1042, disclosing the name and address of the actual owner or payee;

(ii) The actual owner or payee is a nonresident alien individual, foreign partnership, or foreign corporation and the tax has been withheld at the source before receipt of the dividends by the record owner;

(iii) The record owner is a banking institution, a trust company, or a brokerage firm which prepares the individual income tax return of the actual owner, provided the verification on the return with respect to the preparation thereof is executed by such record owner;

(iv) The record owner is a nominee of a banking institution or trust company exercising trust powers, and such banking institution or trust company is required to file a fiduciary return on Form 1041 which reflects the name and address of the actual owner or payee;

(v) The actual owner is an organization exempt from taxation under section 501(a) and is exempt from the requirement of filing a return under section 6033 and paragraph (g) of § 1.6033–1; or

(vi) The record owner is a banking institution or trust company exercising trust powers, or a nominee thereof, and the actual owner is an organization exempt from taxation under section 501(a) for which such banking institution or trust company files an annual return.

See § 1.1441–1, relating to withholding of tax on nonresident alien individuals, and § 1.1442–1, relating to withholding of tax on nonresident foreign corporations.

(d) *Time and place for filing.* Returns made under this section on Forms 1096 and 1099 and Form 1087 for any calendar year shall be filed on or before February 28 of the following year with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for such forms.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6628, 27 FR 12795, Dec. 28, 1962]

§ 1.6042–2 Returns of information as to dividends paid.

(a) *Requirement of reporting*—(1) *In general.* An information return on Form 1099 shall be made under section 6042(a) by—

(i) Every person who makes a payment of dividends (as defined in § 1.6042–3) to any other person during a calendar year. The information return shall show the aggregate amount of the dividends, the name, address, and taxpayer identifying number of the person to whom paid, the amount of tax deducted and withheld under section 3406 from the dividends, if any, and such other information as required by the forms. An information return is generally not required if the amount of dividends paid to the other person during the calendar year aggregates less than $10 or if the payment is made to a person who is an exempt recipient described in § 1.6049–4(c)(1)(ii) unless the payor backup withholds under section 3406 on such payment (because, for example, the payee has failed to furnish a Form W–9 on request), in which case the payor must make a return under this section, unless the payor refunds the amount withheld pursuant to § 31.6413(a)–3 of this chapter.

(ii) Every person, except to the extent that he acts as a nominee described in paragraph (a)(1)(iii) of this section, who receives payments of dividends as a nominee on behalf of another person shall make a return of information under this section for the calendar year of the payment . The information return shall show the aggregate amount of the dividends, the name, address, and taxpayer identification number of the person on whose behalf the dividends are received, the amount of tax deducted and withheld under section 3406 from the dividends, if any, and such other information as required by the forms. An information return is generally not required if the amount of the dividends received on behalf of the other person during the calendar year aggregates less than $10. However, a return of information is not required under this section if—

(A) The record owner is, pursuant to section 6012(a) (3) or (4) and § 1.6012–3, required to file a fiduciary return on Form 1041 that is filed for the estate or trust disclosing the name, address, and identifying number of both the record owner and actual owner and furnishes Form K–1 to each actual owner containing the information required to be shown on the form, including amounts withheld under section 3406;

(B) The record owner is a nominee of a banking institution or trust company exercising trust powers, and such banking institution or trust company is, pursuant to section 6012(a) (3) or (4) and § 1.6012–3, required to file a fiduciary return on Form 1041 that is filed for the estate or trust disclosing the name, address, and identifying number of both the record owner and the actual owner and furnishes Form K–1 to each actual owner containing the information required to be shown on the form, including amounts withheld under section 3406; or

(C) The record owner is a banking institution or trust company exercising trust powers, or a nominee thereof, and the actual owner is an organization exempt from taxation under section 501(a) for which such banking institution or trust company files an annual return but only if the name, address, and identifying number of the record owner are included on or with the annual return filed for the tax exempt organization).

(iii) Every person who is a nominee acting as a custodian of a unit investment trust described in section 851(f)(1) and paragraph (d) of §1.851–7 who, during a calendar year after 1968, receives payments of dividends in such capacity, shall make an information return on Forms 1096 and 1099, for such calendar year showing the information required by such forms and instructions thereto and the name, address, and identifying number of the nominee identified as such. This subdivision shall not apply if the regulated investment company agrees with the nominee to satisfy the requirements of section 6042 and the regulations thereunder with respect to each holder of an interest in the unit investment trust whose shares are being held by the nominee as custodian and within the time limit for furnishing statements prescribed by §1.6042–4, files with the Internal Revenue Service office where such company's return is to be filed for the taxable year, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this subdivision shall be deemed met if the regulated investment company transmits a copy of such statement to the nominee within such period; provided, however, if the regulated investment company fails or is unable to satisfy the requirements of section 6042 with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 45 days following the close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this subdivision within 30 days of such notice.

(2) *Definitions.* The term ''person'' when used in this section does not include the United States, a State, the District of Columbia, a foreign government, a political subdivision of a State or of a foreign government, or an international organization. Therefore, dividends paid by or to one of these entities need not be reported. For purposes of this section, a person who receives a dividend shall be considered to have received it as a nominee if he is not the actual owner of such dividend and if he was required under §1.6109–1 to furnish his identifying number to the payer of the dividend (or would have been so required if the total of such dividends for the year had been $10 or more), and such number was (or would have been) required to be included on an information return filed by the payer with respect to the dividend. However, a person shall not be considered to be a nominee as to any portion of a dividend which is actually owned by another person whose name is also shown on the information return filed by the payer or nominee with respect to such dividend. Thus, in the case of stock jointly owned by a husband and wife, the husband will not be considered as receiving any portion of a dividend on that stock as a nominee for his wife if his wife's name is included on the information return filed by the payer with respect to the dividend.

(3) *Determination of person to whom a dividend is paid or for whom it is received.* For purposes of applying the provisions of this section, the person whose identifying number is required to be included by the payer of a dividend on an information return with respect to such dividend shall be considered the person to whom the dividend is paid. In the case of a dividend received by a nominee on behalf of another person, the person whose identifying number is required to be included on an information return made by the nominee with

respect to such dividend shall be considered the person on whose behalf such dividend is received by the nominee. Thus, in the case of a dividend made payable to a person other than the record owner of the stock with respect to which the dividend is paid, the record owner of the stock shall be considered the person to whom the dividend is paid for purposes of applying the reporting requirements in this section, since his identifying number is required to be included on the information return filed under this section by the payer of the dividend. Similarly, if a stockbroker receives a dividend on stock held in street name for the joint account of a husband and wife, the dividend is considered as received on behalf of the husband since his identifying number should be shown on the information return filed by the nominee under this section. Thus, if the wife has a separate account with the same stockbroker, any dividends received by the stockbroker for her separate account should not be aggregated with the dividends received for the joint account for purposes of information reporting. For regulations relating to the use of identifying numbers, see § 1.6109–1.

(4) *Inclusion of other payments.* The Form 1099 filed by any person with respect to payments of dividends to another person during a calendar year may, at the election of the maker, include other payments made by him to such other person during such year which are required to be reported on Form 1099. Similarly, the Form 1099 filed by a nominee with respect to payments of dividends received by him on behalf of any other person during a calendar year may include payments of interest received by him on behalf of such person during such year which are required to be reported on Form 1099.

(b) *When payment deemed made.* For purposes of a return of information, an amount is deemed to have been paid when it is credited or set apart to a person without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and is made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition.

(c) *Time and place for filing.* The returns required under this section for any calendar year shall be filed after September 30 of such year, but not before the payer's final payment for the year, and on or before February 28 of the following year with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for Form 1096. For extensions of time for filing returns under this section, see § 1.6081–1.

(d) *Cross-reference to penalty.* For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6042(a), see § 301.6721–1 of this chapter (Procedure and Administration Regulations). See § 301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(e) *Magnetic media requirement.* For rules relating to permission to submit the information required by Form 1087 or 1099 on magnetic tape or other media, see § 1.9101–1. For the requirement to submit the information required by Form 1099 on magnetic media for payments after December 31, 1983, see section 6011(e) and § 301.6011–2 of this chapter (Procedure and Administration Regulations).

[T.D. 6628, 27 FR 12796, Dec. 29, 1962, as amended by T.D. 6677, 28 FR 10147, Sept. 17, 1963; T.D. 6879, 31 FR 3493, Mar. 8, 1966; T.D. 6883, 31 FR 6589, May 3, 1966; T.D. 7000, 34 FR 996, Jan. 23, 1969; T.D. 7187, 37 FR 13258, July 6, 1972; T.D. 8734, 62 FR 53474, Oct. 14, 1997; T.D. 8804, 64 FR 11378, Mar. 9, 1999]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53474, Oct. 14, 1997, § 1.6042–2 was amended by revising the section heading, adding introductory text to paragraph (a)(1), and revising paragraphs (a)(1) (i) and (ii); by removing the language ''1099M'' in the first sentence of paragraph (a)(1)(iii), and inserting ''1099A'' in its place; by removing the language ''1087'' in the second sentence and inserting ''1099'' in its place, and by removing the last sentence of paragraph (a)(4); by revising paragraph (d); and by revising the heading of paragraph (e) and adding a sentence to the end of paragraph (e), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.6042–2 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.6042–2 Returns of information as to dividends paid in calendar years after 1962.

(a) *Requirement of reporting*—(1) *In general.* (i) Every person who makes payments of dividends (as defined in §1.6042–3) aggregating $10 or more to any other person during a calendar year after 1962 shall make an information return on Forms 1096 and 1099 for such calendar year showing the aggregate amount of such payments, the name and address of the person to whom paid, the total of such payments for all persons, and such other information as is required by the forms. In the case of dividends paid during the calendar year 1963 or 1964, the requirement of this subdivision for the filing of Form 1099 will be met if a person making payments of dividends to another person on two or more classes of stock files a separate Form 1099 with respect to each such class of stock on which $10 or more of dividends are paid to such other person during the calendar year. Thus, if during 1963 a corporation pays to a person dividends totaling $15 on its common stock and $20 on its preferred stock, it may file separate Forms 1099 with respect to the payments of $15 and $20. If the dividends on the preferred stock totaled $5 instead of $20, no return would be required with respect to the $5. In addition, in the case of dividends paid during calendar years beginning with 1965 and continuing until such time as the Commissioner determines that it is feasible to aggregate payments on two or more separate stock ownership accounts and this subdivision is amended accordingly to provide for reporting on an aggregate basis, the requirement of this subdivision for the filing of Form 1099 will be met if a person making payments of dividends to another person on two or more such separate stock ownership accounts (regardless of whether the payments are made on only one class of stock) files a separate Form 1099 with respect to each such stock ownership account on which $10 or more of dividends are paid to such other person during the calendar year.

(ii) Every person, except to the extent that he acts as a nominee described in subdivision (iii) of this subparagraph, who during a calendar year after 1962 receives payments of dividends as a nominee on behalf of another person aggregating $10 or more shall make an information return on Forms 1096 and 1087 for such calendar year showing the aggregate amount of such dividends, the name and address of the person on whose behalf received, the total of such dividends received on behalf of all persons, and such other information as is required by the forms. Notwithstanding the preceding sentence, the filing of Form 1087 is not required if:

(a) The record owner is required to file a fiduciary return on Form 1041 disclosing the name, address, and identifying number of the actual owner;

(b) The record owner is a nominee of a banking institution or trust company exercising trust powers, and such banking institution or trust company is required to file a fiduciary return on Form 1041 disclosing the name, address, and identifying number of the actual owner; or

(c) The record owner is a banking institution or trust company exercising trust powers, or a nominee thereof, and the actual owner is an organization exempt from taxation under section 501(a) for which such banking institution or trust company files an annual return;

but only if the name, address, and identifying number of the record owner are included on or with the Form 1041 fiduciary return filed for the estate or trust or the annual return filed for the tax exempt organization.

(2) * * *

(3) * * *

(4) * * * In addition, any person required to report payments on both Forms 1087 and 1099 for any calendar year may use one Form 1096 to summarize and transmit such forms.

*   *   *   *   *

(d) *Penalty.* For penalty for failure to file the statements required by this section, see §301.6652–1 of this chapter (Regulations on Procedure and Administration).

(e) *Permission to submit information required by Form 1087 or 1099 on magnetic tape.* * * *

§1.6042–3 Dividends subject to reporting.

(a) *In general.* Except as provided in paragraph (b) of this section, the term *dividend* for purposes of this section and §§1.6042–2 and 1.6042–4 means the amounts described in the following paragraphs (a) (1) through (3) of this section—

(1) Any distribution made by a corporation to its shareholders which is a dividend as defined in section 316; and

(2) Any payment made by a stockbroker to any person as a substitute for a dividend. Such a payment includes any payment made in lieu of a dividend to a person whose stock has been borrowed. See §1.6045–2(h) for coordination of the reporting requirements under sections 6042 and 6045(d) with respect to such payments; and

(3) A distribution from a regulated investment company (irrespective of the fact that any part of the distribution may not represent ordinary income (i.e., may, for example, represent

a capital gain dividend as defined in section 852(b)(3)(C)).

(b) *Exceptions*—(1) *In general.* For purposes of §§ 1.6042–2 and 1.6042–4, the amounts described in paragraphs (b)(1)(i) through (vii) of this section are not dividends.

(i) Amounts paid by an insurance company to a policyholder, other than a dividend upon its capital stock.

(ii) Payments (however denominated) by a mutual savings bank, savings and loan association, or similar organization, in respect of deposits, investment certificates, or withdrawable or repurchasable shares. See, however, section 6049 and the regulations under that section for provisions requiring reporting of these payments.

(iii) Distributions or payments that a payor can, prior to payment, reliably associate with documentation upon which it may rely to treat as made to a foreign beneficial owner in accordance with § 1.1441–1(e)(1)(ii) or as made to a foreign payee in accordance with § 1.6049–5(d)(1) or presumed to be made to a foreign payee under § 1.6049–5(d) (2), (3), (4), or (5). However, such payments may be reportable under § 1.1461–1(b) and (c). For purposes of this paragraph (b)(1)(iii), the provisions in § 1.6049–5(c) (regarding rules applicable to documentation of foreign status and definition of U.S. payor and non-U.S. payor) shall apply. The provisions of § 1.1441–1 shall apply by substituting the term *payor* for the term *withholding agent* and without regard to the fact that the provisions apply only to amounts subject to withholding under chapter 3 of the Internal Revenue Code (Code).

(iv) Distributions or payments from sources outside the United States (as determined under the provisions of part I, subchapter N, chapter 1 of the Code and the regulations under those provisions) paid outside the United States by a non-U.S. payor or a non-U.S. middleman. For a definition of non-U.S. payor and non-U.S. middleman, see § 1.6049–5(c)(5). For circumstances in which a payment is considered to be made outside the United States, see § 1.6049–5(e).

(v) Distributions or payments for the period that the amounts represent assets blocked as described in § 1.1441–2(e)(3). The exemption in this paragraph (b)(1)(v) shall terminate when payment is deemed to occur in accordance with the rules of § 1.1441–2(e)(3).

(vi) Payments made by a foreign intermediary described in § 1.1441–1(e)(3)(i) that it has received in its capacity as an intermediary and that are associated with a valid withholding certificate described in § 1.1441–1(e)(3) (ii) or (iii) and payments made by a U.S. branch of a foreign bank or of a foreign insurance company described in § 1.1441–1(b)(2)(iv) that are associated with a valid withholding certificate described in § 1.1441–1(e)(3)(v), which certificate the intermediary or branch has furnished to the payor or middleman from whom it has received the payment, unless, and to the extent, the intermediary or branch knows that the payments are required to be reported under § 1.6042–2 and were not so reported.

(vii) With respect to amounts paid or credited after December 31, 1982, any amount paid or credited to any person described in § 1.6049–4(c)(1)(ii), unless a tax is withheld under section 3406 and is not refunded by the payor in accordance with § 31.6413(a)–3 of this chapter (Employment Tax Regulations).

(2) *Payor.* The term *payor* has the same meaning as described in § 1.6049–4(a)(2).

(3) *Joint owners.* Amounts paid to joint owners for which a certificate or documentation is required as a condition for being exempt from reporting under this paragraph (b) are presumed made to U.S. payees who are not exempt recipients if, prior to payment, the payor or middleman cannot reliably associate the payment either with a Form W–9 furnished by one of the joint owners in the manner required in §§ 31.3406(d)–1 through 31.3406(d)–5 of this chapter, or with documentation described in paragraph (b)(1)(iii) of this section furnished by each joint owner upon which it can rely to treat each joint owner as a foreign payee or foreign beneficial owner. For purposes of applying this paragraph (b)(3), the grace period described in § 1.6049–5(d)(2)(ii) shall apply only if each payee qualifies for such grace period.

(4) *Conversion into United States dollars of amounts paid in foreign currency.*

For rules concerning foreign currency conversion, see §1.6049–4(d)(3)(i).

(5) *Effective date*—(i) *General rule.* The provisions of this paragraph (b) apply to payments made after December 31, 1999.

(ii) *Transition rules.* The validity of a withholding certificate (namely, Form W–8 or other form upon which the payor is permitted to rely to hold the payee as a foreign person) that was valid on January 1, 1998, under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) and expired, or will expire, at any time during 1998, is extended until December 31, 1998. The validity of a withholding certificate that is valid on or after January 1, 1999, remains valid until its validity expires under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) or, if earlier, until December 31, 2000. The rule in this paragraph (b)(5)(ii), however, does not apply to extend the validity period of a withholding certificate that expires solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the first three sentences of this paragraph (b)(5)(ii), a payor may choose not to take advantage of the transition rule in this paragraph (b)(5)(ii) with respect to one or more withholding certificates valid under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) and, therefore, to require withholding certificates conforming to the requirements described in this section (new withholding certificates). For purposes of this section, a new withholding certificate is deemed to satisfy the documentation requirement under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998). Further, a new withholding certificate remains valid for the period specified in §1.1441–1(e)(4)(ii), regardless of when the certificate is obtained.

(c) *Special rule.* If a person makes a payment which may be a dividend, or if a nominee receives a payment which may be a dividend, but such person or nominee is unable to determine the portion of the payment which is a dividend (as defined in paragraphs (a) and (b) of this section) at the time he files his return under §1.6042–2, he shall, for purposes of such section, treat the entire amount of such payment as a dividend.

[T.D. 6628, 27 FR 12797, Dec. 28, 1962, as amended by T.D. 6908, 31 FR 16774, Dec. 31, 1966; T.D. 7987, 49 FR 42719, Oct. 24, 1984; T.D. 8029, 50 FR 23680, June 5, 1985; T.D. 8734, 62 FR 53475, Oct. 14, 1997; T.D. 8804, 63 FR 72186, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53475, Oct. 14, 1997, §1.6042–3 was amended by revising paragraphs (a) introductory text, (a)(2), and (b); by removing the concluding text immediately following paragraph (a)(2); by adding paragraph (a)(3); and by removing the authority citation at the end of the section, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.6042–3 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.6042–3 Dividends subject to reporting.

(a) *In general.* Except as provided by paragraph (b) of this section, the term ''dividend'' for purposes of this section and §§1.6042–2 and 1.6042–4 means:

(1) * * *

(2) Any payment made by a stockbroker to any person as a substitute for a dividend (as so defined). See §1.6045–2T(h) for coordination of the reporting requirements under sections 6042 and 6045(d) with respect to payments in lieu of dividends.

A ''dividend'' paid by an insurance company to a policy holder, other than a dividend upon its capital stock, is not a dividend for purposes of this section. Similarly, payments (however denominated) by a mutual savings bank, savings and loan association, or similar organization, in respect of deposits, investment certificates, or withdrawable or repurchasable shares are not dividends for purposes of this section (but, for provisions requiring reporting of such payments, see §§1.6049–1 to 1.6049–3, inclusive). The payments by a stockbroker which are defined as dividends in subparagraph (2) of this paragraph include any payment made in lieu of a dividend to a person whose stock has been borrowed in connection with a short sale or other similar transaction. See §1.6045–2(h) for coordination of the reporting requirements under sections 6042 and 6045(d) with respect to payments in lieu of dividends.

(b) *Exceptions.* The term ''dividend'' does not include:

(1) Any distribution or payment by a foreign corporation if it is not engaged in business within the United States and does not have an office or place of business or a fiscal or paying agent in the United States,

(2) Any distribution or payment which is subject to withholding under section 1441 or 1442 (relating to withholding of tax on nonresident aliens and foreign corporations, respectively) by the person making the distribution or payment, or which would be so subject to withholding but for the provisions of a treaty, or for the fact that it is attributable to income from sources outside the United States, or for the fact that withholding is not required by reason of paragraph (a) or (f) of § 1.1441–4,

(3) In the case of a nominee, any distribution or payment which he receives and with respect to which he is required to withhold under section 1441 or 1442, or would be so required to withhold but for the provisions of a treaty, or for the fact that the distribution or payment is attributable to income from sources outside the United States, or for the fact that withholding is not required by reason of paragraph (a) or (f) of § 1.1441–4, or

(4) Any amount which is treated under section 1373 (relating to undistributed taxable income of electing small business corporations) as an amount distributed as a dividend.

* * * * *

(Secs. 6045 and 7805 of the Internal Revenue Code of 1954 (98 Stat. 699, 26 U.S.C. 6045, 68A Stat. 917, 26 U.S.C. 7805)

§ 1.6042–4 Statements to recipients of dividend payments.

(a) *Requirement.* A person required to make an information return under section 6042(a)(1) and § 1.6042–2 must furnish a statement to each recipient whose identifying number is required to be shown on the related information return for dividend payments.

(b) *Form of the statement.* The statement required by paragraph (a) of this section must be either the official Form 1099 prescribed by the Internal Revenue Service for the respective calendar year or an acceptable substitute statement that contains provisions that are substantially similar to those of the official Form 1099 for the respective calendar year. For further guidance on how to prepare an acceptable substitute statement, see Rev. Proc. 95–30 (1995–27 I.R.B. 9) (or its successor), republished as ‘‘Rules and Specifications for Private Printing of Substitute Forms 1096, 1098, 1099 Series, 5498, and W–2G.’’ See § 601.601(d)(2) of this chapter.

(c) *Aggregation of payments.* A payor may aggregate on one Form 1099 all payments made to a recipient with respect to each separate account during a calendar year.

(d) *Manner of providing statements to recipients*—(1) *In general.* The Form 1099, or acceptable substitute statement, must be provided to the recipient either in person or by first-class mail to the recipient's last known address in a statement mailing.

(2) *Statement mailing requirement.* The mailing required under section 6042(c) of a Form 1099 to a payee-recipient must qualify as a statement mailing. A statement mailing must contain the required Form 1099 or acceptable substitute statement (written statement) and must comply with enclosure and envelope restrictions.

(i) *Enclosure restrictions.* To qualify as a statement mailing, the mailing cannot contain any enclosures except those listed in this paragraph (d)(2)(i). Moreover, no promotional or advertising material is permitted in the mailing of the written statement. Even a *de minimis* amount of promotional or advertising material violates the statement mailing requirement. However, a logo on the envelope containing the written statement and on nontax enclosures described in paragraph (d)(2)(i) (A) through (D) of this section does not violate the written statement requirement. The written statement required under section 6042(c) and paragraph (a) of this section may be perforated to a check or to a statement of the recipient-payee's specific account with the payor described in paragraph (d)(2)(i) (A) or (C) of this section. The enclosure to which the written statement is perforated must contain, in a bold and conspicuous type, the legend: ‘‘Important Tax Return Document Attached.’’ The enclosures permitted in a mailing are limited to—

(A) A check with respect to the account reported on the written statement;

(B) A letter explaining why a check with respect to such account is not enclosed with the written statement (for example, because a dividend has not been declared payable);

(C) A statement of the taxpayer-recipient's specific account with the payor if payments on such account are reflected on the written statement;

(D) A letter limited to an explanation of the tax consequences of the information set forth on the enclosed written statement;

(E) Payee statements related to other Forms 1099, Form 1098, and Form 5498 (or the account balance on a Form 5498), Forms W–2 and W–2G; and

(F) Any document concerning the solicitation of the Form W–9, as described in §31.3406(h)–3(a) of this chapter, or of the Form W–8 as described in §1.1441–1(e)(1).

(ii) *Envelope and delivery restrictions*—(A) *Envelope restrictions.* The outside of the envelope in which the written statement is mailed and each nontax enclosure enclosed in the envelope must contain, in a bold and conspicuous type, the legend: ‘‘Important Tax Return Document Enclosed.’’ For purposes of this paragraph (d)(2)(ii), a nontax enclosure is any item listed in paragraphs (d)(2)(i)(A) through (C) of this section. However, a payor is not required to include the legend on the outside of an envelope containing only the enclosures in paragraph (d)(2)(i)(D) through (F) of this section.

(B) *Delivery restrictions.* The requirement to provide the written statement in person or by first-class mail may be satisfied by sending the written statement and any enclosures described in paragraph (d)(2)(i) of this section by intra-office mail, provided that intra-office mail is used by the payor in sending account activity, balance information, and other correspondence to the payee. If a payor does not personally deliver the written statement (i.e., the Form 1099 or its acceptable substitute) to the recipient or mail it to the recipient in a statement mailing as described in this paragraph (d), the payor is considered to have failed to mail the statement required under section 6042(c) and will be subject to the penalty under section 6722.

(e) *Time for furnishing statements*—(1) *In general.* Each statement required by section 6042(c) and this section to be furnished to any person for a calendar year must be furnished to such person after November 30 of the year and on or before January 31 (February 10 in the case of a nominee filing under §1.6042–2(a)(1)(iii)) of the following year, but no statement may be furnished before the final dividend for the calendar year has been paid. However, the statement may be furnished at any time after April 30 if it is furnished with the final dividend for the calendar year.

(2) *Extensions of time.* For good cause upon written application of the person required to furnish statements under this section, the Director, Martinsburg Computing Center, may grant an extension of time not exceeding 30 days in which to furnish such statements. The application must be addressed to the Director, Martinsburg Computing Center, and must contain a full recital of the reasons for requesting the extension to aid the Director in determining the period of the extension, if any, that will be granted. Such a request in the form of a letter to the Director, Martinsburg Computing Center, signed by the applicant will suffice as an application. The application must be filed on or before the date prescribed in paragraph (e)(1) of this section.

(3) *Last day for furnishing statement.* For provisions relating to the time for performance of an act when the last day prescribed for performance falls on Saturday, Sunday, or a legal holiday, see section 7503 and §301.7503–1 of this chapter (Regulations on Procedure and Administration).

(f) *Cross-reference to penalty.* For provisions relating to the penalty provided for failure to furnish timely a correct payee statement required under section 6042(c), see §301.6722–1 of this chapter (Procedure and Administration Regulations). See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(g) *Effective date.* This section is effective for payee statements due after December 31, 1995, without regard to extensions. For the substantially similar statement mailing requirements that apply with respect to forms required to be filed after October 22, 1986, and before January 1, 1996, see Rev. Proc. 84–70 (1984–2 C.B. 716) (or successor revenue procedures). See §601.601(d)(2) of this chapter.

[T.D. 8637, 60 FR 66110, Dec. 21, 1995, as amended by T.D. 8734, 62 FR 53476, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53476, Oct. 14, 1997, § 1.6042–4 was amended by revising paragraphs (d)(2)(i)(F) and (f), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.6042–4 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.6042–4 Statements to recipients of dividend payments.

* * * * *

(d) * * *

(2) * * *

(i) * * *

(F) Any document concerning the solicitation of the Form W–9 or Form W–8.

* * * * *

(f) *Penalty.* For provisions relating to the penalty for the failure to furnish a statement under this section, see section 6722.

* * * * *

§ 1.6043–1 Return regarding corporate dissolution or liquidation.

(a) *Requirement of returns.* Within 30 days after the adoption of any resolution or plan for or in respect of the dissolution of a corporation or the liquidation of the whole or any part of its capital stock, the corporation shall file a return on Form 966, containing the information required by paragraph (b) of this section and by such form. Such return shall be filed with the district director for the district in which the income tax return of the corporation is filed. Further, if after the filing of a Form 966 there is an amendment of or supplement to the resolution or plan, an additional Form 966, based on the resolution or plan as amended or supplemented, must be filed within 30 days after the adoption of such amendment or supplement. A return must be filed under section 6043 and this section in respect of a liquidation whether or not any part of the gain or loss to the shareholders upon the liquidation is recognized under the provisions of section 1002.

(b) *Contents of return*—(1) *In general.* There shall be attached to and made a part of the return required by section 6043 and paragraph (a) of this section a certified copy of the resolution or plan, together with any amendments thereof or supplements thereto, and such return shall in addition contain the following information:

(i) The name and address of the corporation;

(ii) The place and date of incorporation;

(iii) The date of the adoption of the resolution or plan and the dates of any amendments thereof or supplements thereto; and

(iv) The internal revenue district in which the last income tax return of the corporation was filed and the taxable year covered thereby.

(2) *Returns in respect of amendments or supplements.* If a return has been filed pursuant to section 6043 and this section, any additional return made necessary by an amendment of or a supplement to the resolution or plan will be deemed sufficient if it gives the date the prior return was filed and contains a duly certified copy of the amendment or supplement and all other information required by this section and by Form 966 which was not given in the prior return.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6949, 33 FR 5531, Apr. 9, 1968; T.D. 7926, 48 FR 55847, Dec. 16, 1983]

§ 1.6043–2 Return of information respecting distributions in liquidation.

(a) Unless the distribution is one in respect of which information is required to be filed pursuant to paragraph (b) of § 1.332–6, paragraph (a) of § 1.368–3, or § 1.1081–11, every corporation making any distribution of $600 or more during a calendar year to any shareholder in liquidation of the whole or any part of its capital stock shall file a return of information on Forms 1096 and 1099, giving all the information required by such forms and by the regulations in this part. A separate Form 1099 must be prepared for each shareholder to whom such distribution was made, showing the name and address of such shareholder, the number and class of shares owned by him in liquidation of which such distribution was made, and the total amount distributed to him on each class of stock. If the amount distributed to such shareholder on any class of stock consisted in whole or in part of property other than money, the return on such form shall in addition show the amount of money distributed, if any, and shall list separately each class of property other than money distributed, giving a description of the property in each such class and a statement of its fair market value at the time of the distribution. Such forms, accompanied by transmittal Form 1096 showing the number of Forms 1099 filed therewith, shall be filed on or before February 28 of the year following the calendar year in which such distribution was made with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for such forms.

(b) If the distribution is in complete liquidation of a domestic corporation pursuant to a plan of liquidation in accordance with which all the capital stock of the corporation is cancelled or redeemed, and the transfer of all property under the liquidation occurs within some one calendar month pursuant to section 333, and any shareholder claims the benefit of such section, the return on Form 1096 shall show:

(1) The amount of earnings and profits of the corporation accumulated after February 28, 1913, determined as of the close of such calendar month, without diminution by reason of distributions made during such calendar month, but including in such computation all items of income and expense accrued up to the date on which the transfer of all the property under the liquidation is completed;

(2) The ratable share of such earnings and profits of each share of stock canceled or redeemed in the liquidation;

(3) The date and circumstances of the acquisition by the corporation of any or securities distributed to shareholders in the liquidation;

(4) If the liquidation is pursuant to section 333(g), a schedule showing the amount of earnings and profits to which the corporation has succeeded after December 31, 1963, pursuant to any corporate reorganization or pursuant to a liquidation to which section 332 applies, except earnings and profits which on December 31, 1963, constituted earnings and profits of a corporation referred to in section 333(g)(3), and except earnings and profits which were earned after such date by a corporation referred to in section 333(g)(3); and

(5) If the liquidation occurs after December 31, 1966, and is pursuant to section 333(g)(2), the amount of earnings and profits of the corporation accumulated after February 28, 1913, and before January 1, 1967, and the ratable share of such earnings and profits of each share of stock canceled or redeemed in the liquidation.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6949, 33 FR 5531, Apr. 9, 1968; T.D. 8734, 62 FR 53476, Oct. 14, 1997; T.D. 8804, 63 FR 72188, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53476, Oct. 14, 1997, in §1.6043–2, paragraph (a) was amended by removing ‘‘1099L’’ and inserting ‘‘966’’, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.6043–2 was delayed until Jan. 1, 2000.

§1.6043–3 Return regarding liquidation, dissolution, termination, or substantial contraction of organizations exempt from taxation under section 501(a).

(a) *In general*—(1) *Requirement to provide information*. Except as provided in paragraph (b) of this section, for taxable years beginning after December 31, 1969, every organization which for any of its last 5 taxable years preceding any liquidation, dissolution, termination, or substantial contraction of the organization was exempt from taxation under section 501(a) shall provide the information will respect to such liquidation, dissolution, termination, or substantial contraction required by the instructions accompanying the organization’s annual return of information. The information required by this section shall be provided with, and at the time prescribed for filing, the organization’s annual return of information for the period during which any liquidation, dissolution (or the adopting of a resolution or plan for the dissolution or liquidation in whole or part), termination or substantial contraction occurred with respect to the organization. An organization which is no longer exempt from taxation under section 501(a) shall use the annual return of information it would have been required to file when the organization was exempt.

(2) *Transitional rule.* In the case of an annual return of information of an organization which was filed before September 11, 1978, if the organization had failed to provide the information with such return in accordance with paragraph (a)(1) of this section, the organization may comply with this section by providing the information with the organization's first annual return of information filed after such date.

(b) *Exceptions.* The following organizations are not required to provide the information under paragraph (a) of this section:

(1) Churches, their integrated auxiliaries, or conventions or associations of churches;

(2) Any organization which is not a private foundation (as defined in section 509(a)) and the gross receipts of which in each taxable year are normally not more than $5,000;

(3) Any organization which has terminated its private foundation status under section 507(b)(1)(B) with respect to a liquidation, dissolution, termination, or substantial contraction which is in connection with the termination under section 507(b)(1)(B);

(4) Any organization described in section 401(a) if the employer who established such organization files a return which provides the information under paragraph (a) of this section;

(5) Any organization described in section 501(c)(1) and any corporation described in section 501(c)(2) which holds title to property for such 501(c)(1) organizations;

(6) Any organization described in section 501(c)(14)(A) subject to a group exemption letter issued to a state regulatory body; and

(7) Any subordinate unit of a central organization (other than a private foundation) which established its exempt status under the group ruling procedure of regulations § 601.201 (n)(7), if the central or parent organization files an annual information return for the group in accordance with§ 1.6033–2(d); and

(8) Any organization no longer exempt from taxation under section 501(a) and which during the period of its exemption under such section was neither described in section 501(c)(3) nor a corporation described in section 501(c)(2) which held title to property for an organization described in section 501(c)(3).

The Commissioner may relieve any organization or class or organizations from filing the return required by section 6043(b) of this section, where it is determined that such information is not necessary for the efficient administration of the internal revenue laws.

(c) *Penalties.* For provisions relating to the penalty provided for failure to furnish any information required by this section, see section 6652(d) and the regulations thereunder.

(d) *Definitions.* (1)(i) The term ''substantial contraction'', as used in this section, shall include any partial liquidation or any other significant disposition of assets, other than transfers for full and adequate consideration or distributions out of current income. For purposes of this subparagraph, the term ''significant disposition of assets'' shall not include any disposition for a taxable year where the aggregate of—

(A) The dispositions for the taxable year and

(B) Where any disposition for the taxable year is part of a series of related dispositions made during such prior taxable years, the total of the related dispositions made during prior taxable years, is less than 25 percent of the fair market value of the net assets of the organization at the beginning of the taxable year (in the case of (A) of this subdivision) or at the beginning of the first taxable year in which any of the series of related dispositions was made (in the case of (B) of this subdivision). A ''significant disposition of assets'' may result from the transfer of assets to a single organization or to several organizations, and it may occur in a single taxable year (as in (A) of this subdivision) or over the course of two or more taxable years (as in (B) of this subdivision). The determination whether a significant disposition has occurred through a series of related dispositions (within the meaning of (B) of this subdivision) will be determined from all the facts and circumstances of the particular case. Ordinarily, a distribution described in section 170(b)(1)(D)(ii) shall not be taken into account as a significant disposition of assets within the meaning of this subparagraph.

(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). M, an organization described is section 501(c)(4), is on the calendar year basis. It has net assets worth $100,000 as of January 1, 1971. In 1971, in addition to distributions out of current income, M transfers $10,000 to N, $10,000 to O, and $10,000 to P. Such dispositions to N, O, and P are not distributions described in section 170(b)(1)(E)(ii). N, O, and P are all organizations described in section 501(c)(4). Under subdivision (i)(*a*) of this subparagraph, M has made a significant disposition of its assets in 1971 since M has disposed of more than 25 percent of its net assets (with respect to the fair market value of such assets as of January 1, 1971). Thus. M is subject to the provisions of section 6043(b) and this section for the year 1971.

Example (2). U, a tax-exempt private foundation on the calendar year basis, has net assets worth $100,000 as of January 1, 1971. As part of a series of related dispositions in 1971 and 1972. U transfers in 1971, in addition to distributions out of current income, $10,000 to private foundation X and $10,000 to private foundation Y, and in 1972, in addition to distributions out of current income, U transfers $10,000 to private foundation Z. Such dispositions to X, Y, and Z are not distributions described in section 170(b)(1)(E)(ii). Under subdivision (i) of this subparagraph, U is treated as having made a series of related dispositions in 1971 and 1972. The aggregate of the 1972 disposition (under subdivision (i)(*a*)of this subparagraph) and the series of related dispositions (under subdivision (i)(*b*) of this subparagraph) is $30,000, which is more than 25 percent of the fair market value of U's net assets as of the beginning of 1971 ($100,000), the first year in which any such disposition was made. Thus, U has made a significant disposition of its assets and is subject to the provisions of section 6043(b) and this section for the year 1972.

Example (3). Assume in Example (1) that in 1973 M makes a $5,000 disposition related to the 1971 disposition. Under subdivision (i)(B) of this subparagraph M is treated as having made a series of related dispositions in 1971 and 1973. The aggregate of the 1971 disposition under subdivision (i)(A) of this subparagraph and the 1973 related disposition under subdivision (i)(B) of this subparagraph is $35,000, which is more than 25 percent of the fair market value of M's net assets as of the beginning of 1971, the first year in which any disposition was made. Thus M has made a significant disposition of its assets and is subject to the provisions of section 6043(b) and this section for the year 1973.

(2) For the definition of the term ''normally'' as used in paragraph (b)(2) of this section, see §1.6033–2(g)(3).

(3) For examples of the term ''integrated auxiliaries'' as used in paragraph (b)(1) of this section, see §1.6033–2(g)(1)(i)(*a*).

[T.D. 7563, 43 FR 40221, Sept. 11, 1978]

§1.6044–1 Returns of information as to patronage dividends with respect to patronage occurring in taxable years beginning before 1963.

(a) *Requirement*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, any corporation allocating to any patron in respect of patronage occurring in any taxable year of the corporation beginning before January 1, 1963, amounts aggregating $100 or more during a calendar year as patronage dividends, rebates, or refunds (whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, letters of advice, or in some other manner that discloses to each patron the amount of such dividend, rebate, or refund) shall for each such calendar year file a return of information with respect to such allocation on Forms 1096 and 1099. A separate Form 1099 shall be prepared for each patron showing the name and address of the patron to whom such allocation is made, and the amount of the allocation. The allocation shall be reported for the calendar year during which the allocation is made, regardless of whether the allocation is deemed for the purpose of section 522 to be made at the close of a preceding taxable year of the corporation.

(2) *Exception.* A return is not required under this section in the case of any corporation (including any cooperative or nonprofit corporation engaged in rural electrification) described in section 501(c) (12) or (15) which is exempt from tax under section 501(a), or in the case of any corporation subject to a tax imposed by subchapter L, chapter 1, of the Code.

(b) *Time and place for filing.* Returns made under this section on Forms 1096 and 1099 for any calendar year shall be filed on or before February 28 of the following year with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for such forms.

(c) *Definitions.* The terms ''cooperative association'', ''patron'', ''patronage dividends, rebates, and refunds'', and ''allocation'' are defined, for the purpose of this section, in paragraph (b) of § 1.522–1.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6628, 27 FR 12798, Dec. 28, 1962]

§ 1.6044–2 Returns of information as to payments of patronage dividends.

(a) *Requirement of reporting*—(1) *In general.* Except as provided in § 1.6044–4, every organization described in paragraph (b) of this section which makes payments with respect to patronage occurring on or after the first day of the first taxable year of the organization beginning after December 31, 1962, of amounts described in § 1.6044–3 aggregating $10 or more to any person during any calendar year shall make an information return on Forms 1096 and 1099 for the calendar year showing the aggregate amount of such payments, the name and address of the person to whom paid, the total of such payments for all persons, and such other information as is required by the forms. The organization is required to make an information return regardless of the amount of the payment if the tax imposed by section 3406 is required to be withheld. Thus, in the case of any amount subject to backup withholding under section 3406 and not refunded by the payor before the due date of the information return in accordance with the regulations under section 3406, an information return shall be made even if the payment is not generally reportable because it is made to an exempt recipient described in § 1.6049–4(c)(1)(ii) or the amount paid during the calendar year to the recipient aggregates less than $10.

(2) *Definitions.* The term ''person'' when used in this section does not include the United States, a State, the District of Columbia, a foreign government, a political subdivision of a State or of a foreign government, or an international organization. Therefore, payment of amounts described in § 1.6044–3 to one of these entities need not be reported.

(3) *Determination of person to whom a patronage dividend is paid.* For purposes of applying the provisions of this section, the person whose identifying number is required to be included by the cooperative on an information return with respect to a patronage dividend shall be considered the person to whom such dividend is paid. For regulations relating to the use of identifying numbers, see § 1.6109–1.

(4) *Inclusion of other payments.* The Form 1099 filed by an organization with respect to payments of patronage dividends made to any person during a calendar year may, at the election of the organization, include other payments made by it to such person during such year which are required to be reported on Form 1099.

(b) *Organizations subject to reporting requirement.* The organizations subject to the reporting requirements of paragraph (a) of this section are:

(1) Any organization exempt from tax under section 521 (relating to exemption of farmers' cooperatives from tax), and

(2) Any corporation operating on a cooperative basis other than an organization:

(i) Which is exempt from tax under chapter 1 (other than section 521), or

(ii) Which is subject to the provisions of part II of subchapter H of chapter 1 (relating to mutual savings banks, etc.), or subchapter L of chapter 1 (relating to insurance companies), or

(iii) Which is engaged in furnishing electric energy, or providing telephone service, to persons in rural areas.

(c) *When payment deemed made.* For purposes of this section, money or other property (except written notices of allocation) is deemed to have been paid when it is credited or set apart to a person without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and is made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition. A written notice of allocation is considered to have been paid when it is issued by the organization to the distributee. Similarly, a qualified check (as defined in section 1388(d)(4)) is considered to have been paid when it is issued to the distributee.

(d) *Time and place for filing.* The return required under this section on Forms 1096 and 1099 for any calendar year shall be filed after September 30 of such year, but not before the payer's final payment for the year, and on or before February 28 of the following year, with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for such forms. For extensions of time for filing returns under this section, see §1.6081–1.

(e) *Cross-reference to penalty.* For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6044(a), see §301.6721–1 of this chapter (Procedure and Administration Regulations). See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(f) *Magnetic media requirement.* For the requirement to submit the information required by Form 1099 on magnetic media for payments after December 31, 1983, see section 6011(e) and §301.6011–2 of this chapter (Procedure and Administration Regulations). For rules relating to permission to submit the information required by Form 1099 on magnetic tape or other media, see §1.9101–1.

[T.D. 6628, 27 FR 12798, Dec. 28, 1962, as amended by T.D. 6677, 28 FR 10147, Sept. 17, 1963; T.D. 6879, 31 FR 3493, Mar. 8, 1966; T.D. 6883, 31 FR 6589, May 3, 1966; T.D. 8734, 62 FR 53476, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53476, Oct. 14, 1997, §1.6044–2 was amended by revising the section heading; by adding two sentences at the end of paragraph (a)(1); by revising paragraph (e); and by revising the heading and adding a sentence at the beginning of paragraph (f), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.6044–2 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.6044–2 Returns of information as to payments of patronage dividends with respect to patronage occurring in taxable years beginning after 1962.

* * * * *

(e) *Penalty.* For penalty for failure to file the statements required by this section, see §301.6652–1 of this chapter (Regulations on Procedure and Administration).

(f) *Permission to submit information required by Form 1099 on magnetic tape.* * * *

§1.6044–3 Amounts subject to reporting.

(a) *In general.* Except as provided in paragraph (c) of this section, the amounts subject to reporting under §1.6044–2 are:

(1) Payments by all organizations subject to such reporting requirements of:

(i) Patronage dividends (as defined in section 1388(a)) paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except nonqualified written notices of allocation as defined in section 1388(d)); and

(ii) Amounts described in section 1382(b)(2) (relating to redemption of nonqualified written notices of allocation previously paid as patronage dividends) paid in money or property (except written notices of allocation); and

(2) Payments by farmers' cooperatives exempt from tax under section 521 of:

(i) Amounts described in section 1382(c)(2)(A) (relating to distributions with respect to earnings derived from sources other than patronage) paid in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation); and

(ii) Amounts described in section 1382(c)(2)(B) (relating to redemption of nonqualified written notices of allocation previously paid as distributions with respect to earnings derived from sources other than patronage) paid in money or other property (except written notices of allocation).

(b) *Special rules.* (1) If an organization makes a distribution consisting in whole or in part of a written notice of allocation and a qualified check and, at the time it files its return under §1.6044–2, is unable to determine whether such written notice of allocation and such check constitute nonqualified written notices of allocation, such organization shall for purposes of such return treat such written notice of allocation as a qualified written notice of allocation and such qualified check as a payment in money.

(2) An amount described in paragraph (a) of this section is subject to reporting even though the organization paying such amount is allowed no deduction for it because it was not paid within the time prescribed in section 1382. Thus, a patronage dividend of $25 paid by a marketing cooperative must be reported even though it is paid after the end of the payment period (see section 1382(d)) for the organization's taxable year in which the patronage occurred.

(c) *Exceptions.* An amount described in paragraph (a) of this section does not include—

(1) Any amount described in § 1.6042–3(b); or

(2) With respect to amounts paid or credited after December 31, 1982, any amount paid or credited to any person described in § 1.6049–4(c)(1)(ii).

(d) *Determination of amount paid.* For purposes of § 1.6044–2 and this section, in determining the amount of any payment subject to reporting under paragraph (a) of this section:

(1) Property (other than a qualified written notice of allocation) shall be taken into account at its fair market value, and

(2) A qualified written notice of allocation shall be taken into account at its stated dollar amount.

[T.D. 6628, 27 FR 12798, Dec. 28, 1962, as amended by T.D. 8734, 62 FR 53476, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53476, Oct. 14, 1997, § 1.6044–3 was amended by revising paragraph (c), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.6044–3 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.6044–3 Amounts subject to reporting.

* * * * *

(c) *Exceptions.* Reporting under § 1.6044–2 of payments of amounts described in paragraph (a) of this section is not required:

(1) If such payments are made by a foreign corporation which is not engaged in business within the United States and does not have an office or place of business or a fiscal or paying agent in the United States, or

(2) If such payments are subject to withholding under section 1441 or 1442 (relating to withholding of tax on nonresident aliens and foreign corporations, respectively) by the person making the distribution or payment, or would be so subject to withholding but for the provisions of a treaty, or for the fact that it is attributable to income from sources outside the United States.

* * * * *

§ 1.6044–4 Exemption for certain consumer cooperatives.

(a) *In general*—(1) *Determination of exemption.* Exemption from the reporting requirements of § 1.6044–2 shall, upon application therefor, be granted by the district director to any cooperative which he determines is primarily engaged in selling at retail goods or services of a type which is generally for personal, living, or family use. A cooperative is not exempt from the reporting requirements merely because it is an organization of a type to which section 6044(c) and this section relate. In order for the exemption from reporting to apply, it is necessary that the cooperative file an application in accordance with this section and obtain a determination of exemption.

(2) *Basis for exemption.* For a cooperative to qualify for the exemption from reporting provided by section 6044(c) and this section 85 percent of its gross receipts for the preceding taxable year, or 85 percent of its aggregate gross receipts for the preceding three taxable years, must have been derived from the sale at retail of goods or services of a type which is generally for personal, living, or family use. In determining whether an item is of a type that is generally for personal, living, or family use, an item which may be purchased either for such use or for business use and which when acquired for business purposes is generally purchased at wholesale will, when sold by a cooperative at retail, be treated as goods or services of a type generally for personal, living, or family use.

(3) *Period of exemption.* A determination of exemption from reporting shall apply beginning with the payments made during the calendar year in which the determination is made and shall automatically cease to be effective beginning with payments made after the close of the first taxable year of the cooperative in which less than 70 percent of its gross receipts is derived

from the sale at retail of goods or services of a type which is generally for personal, living, or family use.

(b) *Application for exemption.* Application for exemption from the reporting requirements of section 6044 shall be made on Form 3491, and shall be filed with the district director for the internal revenue district in which the cooperative has its principal place of business.

[T.D. 6628, 27 FR 12799, Dec. 28, 1962]

§1.6044–5 Statements to recipients of patronage dividends.

(a) *Requirement.* A person required to make an information return under section 6044(a)(1) and §1.6044–2 must furnish a statement to each recipient whose identifying number is required to be shown on the related information return for patronage dividends paid.

(b) *Form, manner, and time for providing statements to recipients.* The statement required by paragraph (a) of this section must be either the official Form 1099 prescribed by the Internal Revenue Service for the respective calendar year or an acceptable substitute statement. The rules under §1.6042–4 (relating to statements with respect to dividends) apply comparably in determining the form of an acceptable substitute statement permitted by this section. Those rules also apply for purposes of determining the manner of and time for providing the Form 1099 or its acceptable substitute to a recipient under this section. However, each Form 1099 or acceptable substitute statement required by this section must be furnished on or before January 31 of the following year, but no statement may be furnished before the final payment has been made for the calendar year.

(c) *Cross-reference to penalty.* For provisions relating to the penalty provided for failure to furnish timely a correct payee statement required under section 6044(e), see §301.6722–1 of this chapter (Procedure and Administration Regulations). See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(d) *Effective date.* This section is effective for payee statements due after December 31, 1995, without regard to extensions. For the substantially similar statement mailing requirements that apply with respect to forms required to be filed after October 22, 1986, and before January 1, 1996, see Rev. Proc. 84–70 (1984–2 C.B. 716) (or successor revenue procedures). See §601.601(d)(2) of this chapter.

[T.D. 8637, 60 FR 66111, Dec. 21, 1995, as amended by T.D. 8734, 62 FR 53476, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53476, Oct. 14, 1997, §1.6044–5 was amended by revising paragraph (c), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.6044–5 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.6044–5 Statements to recipients of patronage dividends.

* * * * *

(c) *Penalty.* For provisions relating to the penalty for the failure to furnish a statement under this section, see section 6722.

* * * * *

§1.6045–1 Returns of information of brokers and barter exchanges.

(a) *Definitions.* The following definitions apply for purposes of this section, §1.6045–2, and §5f.6045–1 of this chapter:

(1) The term *broker* means any person (other than a person who is required to report a transaction under section 6043), U.S. or foreign, that, in the ordinary course of a trade or business during the calendar year, stands ready to effect sales to be made by others. A broker includes an obligor that regularly issues and retires its own debt obligations or a corporation that regularly redeems its own stock. However, with respect to a sale (including a redemption or retirement) effected at an office outside the United States, a broker includes only a person described as a U.S. payor or U.S. middleman in §1.6049–5(c)(5). In addition, a broker does not include an international organization described in §1.6049–4(c)(1)(ii)(G) that redeems or retires an obligation of which it is the issuer.

(2) The term *customer* means, with respect to a sale effected by a broker, the person (other than such broker) that makes the sale, if the broker acts as:

(i) An agent for such person in the sale;

(ii) A principal in the sale; or

(iii) The participant in the sale responsible for paying to such person or crediting to such person's account the gross proceeds on the sale.

(3) The term *security* means:

(i) A share of stock in a corporation (foreign or domestic);

(ii) An interest in a trust;

(iii) An interest in a partnership;

(iv) A debt obligation;

(v) An interest in or right to purchase any of the foregoing in connection with the issuance thereof from the issuer or an agent of the issuer or from an underwriter that purchases any of the foregoing from the issuer, or

(vi) An interest in a security described in paragraph (a)(3) (i) or (iv) (but not including options or executory contracts that require delivery of such type of security).

(4) The term *barter exchange* means any person with members or clients that contract either with each other or with such person to trade or barter property or services either directly or through such person. The term does not include arrangements that provide solely for the informal exchange of similar services on a noncommercial basis.

(5) The term *commodity* means:

(i) Any type of personal property or an interest therein (other than securities as defined in paragraph (a)(3)) the trading of regulated futures contracts in which has been approved by the Commodity Futures Trading Commission;

(ii) Lead, palm oil, rapeseed, tea, tin, or an interest in any of the foregoing; or

(iii) Any other personal property or an interest therein that is of a type the Secretary determines is to be treated as a ''commodity'' under this section, from and after the date specified in a notice of such determination published in the FEDERAL REGISTER.

(6) The term *regulated futures contract* means a regulated futures contract within the meaning of section 1256(b).

(7) The term *forward contract* means:

(i) An executory contract that requires delivery of a commodity in exchange for cash and which contract is not a regulated futures contract; or

(ii) An executory contract that requires delivery of personal property or an interest therein in exchange for cash, or a cash settlement contract, if such executory contract or cash settlement contract is of a type the Secretary determines is to be treated as a ''forward contract'' under this section, from and after the date specified in a notice of such determination published in the FEDERAL REGISTER.

(8) The term *closing transaction* means any termination of an obligation under a forward contract or a regulated futures contract.

(9) The term *sale* means any disposition of securities, commodities, regulated futures contracts, or forward contracts for cash, and includes redemptions of stock, retirements of indebtedness, and enterings into short sales. In the case of a regulated futures contract or a forward contract, the term ''sale'' means any closing transaction. When a closing transaction in a regulated futures contract involves making or taking delivery, the profit or loss on the contract is a sale, and, if delivery is made, such delivery is a separate sale. When a closing transaction in a forward contract involves making or taking delivery, the delivery is a sale without separation of the profit or loss on the contract from the profit or loss on the delivery, except that taking delivery for United States dollars is not a sale. The term ''sale'' does not include grants or purchases of options, exercises of call options, or enterings into contracts that require delivery of personal property or an interest therein.

(10) The term *effect* means, with respect to a sale, to act as:

(i) An agent for a party in the sale wherein the nature of the agency is such that the agent ordinarily would know the gross proceeds from the sale; or

(ii) A principal in such sale.

Acting as an agent or principal with respect to grants or purchases of options, exercises of call options, or enterings into contracts that require delivery of personal property or an interest therein is not of itself effecting a sale. A broker that has on its books a forward contract under which delivery is made effects such delivery.

(11) The term *foreign currency* means currency of a foreign country.

(12) The term *cash* means United States dollars or any convertible foreign currency.

(13) The term *person* includes any governmental unit and any agency or instrumentality thereof.

(b) *Examples.* The following examples illustrate the definitions in paragraph (a):

Example 1. The following persons generally are brokers within the meaning of paragraph (a)(1):

(i) A mutual fund, an underwriter of the mutual fund, or an agent for the mutual fund, any of which stands ready to redeem or repurchase shares in such mutual fund.

(ii) A professional custodian (such as a bank) that regularly arranges sales for custodial accounts pursuant to instructions from the owner of the property.

(iii) A depositary trust or other person who regularly acts as an escrow agent in corporate acquisitions, if the nature of the activities of the agent is such that the agent ordinarily would know the gross proceeds from sales.

(iv) A stock transfer agent for a corporation, which agent records transfers of stock in such corporation, if the nature of the activities of the agent is such that the agent ordinarily would know the gross proceeds from sales.

(v) A dividend reinvestment agent for a corporation that stands ready to purchase or redeem shares.

Example 2. The following persons are not brokers within the meaning of paragraph (1)(a) in the absence of additional facts that indicate the person is a broker:

(i) A stock transfer agent for a corporation, which agent daily records transfers of stock in such corporation, if the nature of the activities of the agent is such that the agent ordinarily would not know the gross proceeds from sales.

(ii) A person (such as a stock exchange) that merely provides facilities in which others effect sales.

(iii) An escrow agent or nominee if such agency is not in the ordinary course of a trade or business.

(iv) An escrow agent, otherwise a broker, which agent effects no sales other than such transactions as are incidental to the purpose of the escrow (such as sales to collect on collateral).

(v) A floor broker on a commodities exchange, which broker maintains no records with respect to the terms of sales.

(vi) A corporation that issues and retires long-term debt on an irregular basis.

(vii) A clearing organization.

Example 3. A, B, and C belong to a carpool in which they commute to and from work. Every third day, each member of the carpool provides transportation for the other two members. Because the carpool arrangement provides solely for the informal exchange of similar services on a noncommercial basis, the carpool is not a barter exchange within the meaning of paragraph (a)(4).

Example 4. X is an organization whose members include retail merchants, wholesale merchants, and persons in the trade or business of performing services. X's members exchange property and services among themselves using credits on the books of X as a medium of exchange. Each exchange through X is reflected on the books of X by crediting the account of the member providing property or services and debiting the account of the member receiving such property or services. X also provides information to its members concerning property and services available for exchange through X. X charges its members a commission on each transaction in which credits on its books are used as a medium of exchange. X is a barter exchange within the meaning of paragraph (a)(4) of this section.

Example 5. A warehouse receipt is an interest in personal property for purposes of paragraph (a). Consequently, a warehouse receipt for a quantity of lead is a commodity under paragraph (a)(5)(ii). Similarly an executory contract that requires delivery of a warehouse receipt for a quantity of lead is a forward contract under paragraph (a)(7)(ii).

Example 6. The only customers of a depository trust acting as an escrow agent in corporate acquisitions which trust is a broker, are shareholders to whom the trust makes payments or shareholders for whom the trust is acting as an agent.

Example 7. The only customers of a stock transfer agent, which agent is a broker are shareholders to whom the agent makes payments or shareholders for whom the agent is acting as an agent,

Example 8. D, an individual not otherwise exempt from reporting, is the holder of an obligation issued by P, a corporation. R, a broker, acting as an agent for P, retires such obligation held by D. Such obligor payments from R represent obligor payments by P. (See paragraph (c)(3)(v)). D, the person to whom the gross proceeds are paid or credited by R, is the customer of R.

(c) *Reporting by brokers*—(1) *Requirement of reporting.* Any broker shall, except as otherwise provided, report in the manner prescribed in this section.

(2) *Sales required to be reported.* Except as provided in paragraphs (c)(3), (c)(5), (g), and (p)(1), a broker shall make a return of information with respect to

each sale by a customer of the broker effected by the broker in the ordinary course of a trade or business in which the broker stands ready to effect sales to be made by others.

(3) *Exceptions*—(i) *In general.* Except as provided in paragraph (c)(3)(ii) of this section, the exceptions set forth in paragraph (c)(3) of § 5f.6045–1 of this chapter apply to sales effected on or after May 29, 1984. For an exception for certain sales of agricultural commodities and certificates issued by the Commodity Credit Corporation after January 1, 1993, see paragraph (c)(7) of this section. With respect to sales effected before May 29, 1984, the exceptions provided in § 1.6045–1(c)(3) (as contained in the CFR edition revised as of April 1, 1984) apply.

(ii) *Excepted sales.* No return of information is required with respect to a sale effected by a broker for a customer if the sale is an excepted sale. For this purpose, a sale is an excepted sale if it is so designated by the Internal Revenue Service in a revenue ruling or revenue procedure published in the Internal Revenue Bulletin. (See § 601.601(d)(2)(ii)(*b*) of this chapter).

(4) *Examples.* The examples set forth in paragraph (c)(4) of § 5f.6045–1 illustrate the application of the exceptions to sales effected on or after May 29, 1984. With respect to sales effected before May 29, 1984, the examples provided in 26 CFR 1.6045–1(c)(4) (revised as of April 1, 1983) illustrate the application of the exceptions.

(5) *Form of reporting for regulated futures contracts*—(i) *In general.* A broker effecting closing transactions in regulated futures contracts shall report information with respect to regulated futures contracts solely in the manner prescribed in this paragraph (c)(5). In the case of a sale that involves making delivery pursuant to a regulated futures contract, only the profit or loss on the contract is reported as a transaction with respect to regulated futures contracts under this paragraph (c)(5); such sales are, however, subject to reporting under paragraph (d)(2). The information required under this paragraph (c)(5) must be reported on a calendar year basis, unless the broker is advised in writing by an account's owner that the owner's taxable year is other than a calendar year and the broker elects to report with respect to regulated futures contracts in such account on the basis of the owner's taxable year. The following information must be reported as required by Form 1099 with respect to regulated futures contracts held in a customer's account:

(A) The name, address, and taxpayer identification number of the customer.

(B) The net realized profit or loss from all regulated futures contracts closed during the calendar year.

(C) The net unrealized profit or loss in all open regulated futures contracts at the end of the preceding calendar year.

(D) The net unrealized profit or loss in all open regulated futures contracts at the end of the calendar year.

(E) The aggregate profit or loss from regulated futures contracts ((*b*)+(*d*)−(*c*)).

(F) Any other information required by Form 1099. See 17 CFR 1.33. For this purpose, the end of a year is the close of business of the last business day of such year. In reporting under this paragraph (c)(5), the broker shall make such adjustments for commissions that have actually been paid and for option premiums as are consistent with the books of the broker. No additional returns of information with respect to regulated futures contracts so reported are required.

(ii) *Determination of profit or loss from foreign currency contracts.* A broker effecting a closing transaction in foreign currency contracts (as defined in section 1256(g)) shall report information with respect to such contracts in the manner prescribed in paragraph (c)(5)(i) of this section. If a foreign currency contract is closed by making or taking delivery, the net realized profit or loss for purposes of paragraph (c)(5)(i)(B) of this section is determined by comparing the contract price to the spot price for the contract currency at the time and place specified in the contract. If a foreign currency contract is closed by entry into an offsetting contract, the net realized profit or loss for purposes of paragraph (c)(5)(i)(B) of this section is determined by comparing the contract price to the price of the offsetting contract. The net unrealized profit or loss in a foreign currency contract for purposes of paragraphs (c)(5)(i) (C) and (D) of this section is determined by comparing the contract price to the broker's price for similar contracts at the close of business of the relevant year.

(iii) *Examples.* The following examples illustrate the application of the rules in this paragraph (c)(5):

Example 1. On October 30, 1984, A, an individual who is a calendar year taxpayer not otherwise exempt from reporting, buys one March 1985 put on Treasury Bond futures (i.e. A purchases an option to enter into a short regulated futures contract of $100,000 face value U.S. Treasury bonds). A pays $500 for the option. On December 19, 1984, A, through B, exercises the option and enters into the futures contract. On February 15, 1985, A, through B, enters into a closing transaction with respect to the futures contract. These are A's only transactions in the account. Since B's books list A's regulated futures contract on December 31, 1984, B must report for A, for 1984, the unrealized profit or loss in the contract as of December 31, 1984. For 1985, B will report the same amount for A as the unrealized profit or loss at the beginning of 1985. The return of information for 1985 will also include the gain or loss from the contract in the net realized profit or loss from all regulated futures contracts sales during 1985.

Example 2. The facts are the same as in Example (1) except that A does not enter into the closing transaction, but instead, on March 20, 1985, B informs A that A will make delivery under the contract. On March 22, 1985, A does so; consequently, A becomes entitled to the gross proceeds. B enters the closing transaction on its books on March 20, 1985. In addition to the returns of information required by paragraph (c)(5), as described in Example (1), B must report the March 22, 1985 delivery as a separate transaction. B may use as the sale date for the delivery either March 20, 1985, the date the transaction is entered on the books of B, or March 22, 1985, the date A becomes entitled to the gross proceeds. B may not deduct the $500 premium from the gross proceeds with respect to the March 22, 1985 delivery.

Example 3. The facts are the same as in Example (2) except that A buys a call on Treasury bond futures and takes delivery. B will supply the returns of information required by paragraph (c)(5), as described in Example (1). B is not required to make a return of information with respect to A's taking delivery.

Example 4. C, an individual who is a calendar year taxpayer not otherwise exempt from reporting, has an account with D, a broker. C trades both regulated futures contracts and forward contracts through C's account with D. D must report C's regulated futures contracts on an annual basis as required by paragraph (c)(5). With respect to C's forward contracts, D may elect to use the calendar month, quarter, or year as D's reporting period as provided in paragraph (c)(6).

(6) *Reporting periods and filing groups*—(i) *Reporting period*—(A) *In general.* A broker may elect to use the calendar month, quarter, or year as the broker's reporting period. A broker may separately elect a reporting period for each filing group.

(B) *Election.* For each calendar year, a broker shall elect a reporting period by filing Forms 1096 and 1099 in the manner elected. A different reporting period may be subsequently elected by filing in the manner subsequently elected, provided no duplication of reported transactions results.

(ii) *Filing group*—(A) *In general.* A broker may elect to group customers or customer accounts by office, branch, department or other method of operational classification and separately file Forms 1096 and 1099 for each filing group.

(B) *Election.* For each calendar year, a broker shall elect filing groups by filing Forms 1096 and 1099 in the manner elected. Different filing groups may be subsequently elected by filing in the manner subsequently elected, provided no duplication of reported transactions results.

(iii) *Example.* The following example illustrates the rules of this paragraph (c)(6):

Example. The A department of C, a broker, files a separate report for each month of 1984, whereas the B department of C files one report for all of 1984. C makes no other reports or returns of information under section 6045 for 1984. C had thereby elected two filing groups for 1984, the A department and the B department. The A department has the calendar month as its 1984 reporting period, whereas the B department has the calendar year as its 1984 reporting period. The same result would occur if A and B were offices or branches of C.

(7) *Exception for certain sales of agricultural commodities and commodity certificates*—(i) *Agricultural commodities.* No return of information is required under section 6045 for a spot or forward sale

of an agricultural commodity. This paragraph (c)(7)(i) does not except from reporting sales of agricultural commodities pursuant to regulated futures contracts, sales of derivative interests in agricultural commodities, or sales described in paragraph (c)(7)(iii) of this section.

(ii) *Commodity Credit Corporation certificates.* Except as otherwise provided in a revenue ruling or revenue procedure, no return of information is required under section 6045 with respect to a sale of a commodity certificate issued by the Commodity Credit Corporation under 7 CFR 1470.4 (1990).

(iii) *Sales involving designated warehouses.* Paragraph (c)(7)(i) of this section does not apply to any sale involving a warehouse receipt for an agricultural commodity issued by a designated warehouse for an agricultural commodity of the type for which the warehouse is a designated warehouse.

(iv) *Definitions.* For purposes of this paragraph (c)(7):

(A) *Agricultural commodity.* An ‘‘agricultural commodity’’ includes, but is not limited to, a commodity within the meaning of paragraph (a)(5) of this section that is a grain, feed, livestock, meat, oil seed, timber, or fiber.

(B) *Spot sale.* A spot sale is a sale that results in the substantially contemporaneous delivery of a commodity.

(C) *Forward sale.* A forward sale is a sale pursuant to a forward contract within the meaning of paragraph (a)(7) of this section.

(D) *Designated warehouse.* A designated warehouse is a warehouse, depository, or other similar entity, designated by a commodity exchange under 7 CFR 1.43 (1992), in which or out of which a particular type of agricultural commodity is deliverable in satisfaction of a regulated futures contract.

(v) *Effective dates.* Paragraph (c)(7) of this section applies to sales effected on or after January 1, 1993. For sales effected before January 1, 1993, the following transactions are excepted from the information reporting requirements of section 6045:

(A) Spot or forward sales of agricultural products or commodities (but not sales of interests in agricultural products or commodities, such as sales of regulated futures contracts or forward contracts), effected by any person regardless of whether that person takes title to the agricultural products or commodities; and

(B) Sales of negotiable commodity certificates issued by the Commodity Credit Corporation.

(d) *Information required*—(1) *In general.* A broker that is required to make a return of information under paragraph (c) during a reporting period shall report on a separate Form 1096 for each filing group, showing such information as may be required by Form 1096, in the form, manner, and number of copies required by Form 1096.

(2) *Transactional reporting.* As to each sale with respect to which a broker is required to make a return of information under this section, the broker, except as provided in paragraphs (c)(5) and (p)(1), shall show on Form 1099 the name, address, and taxpayer identification number of the customer, the property sold, Committee on Uniform Security Identification Procedures (CUSIP) number of the security sold (if known), the gross proceeds, sale date, and such other information as may be required by Form 1099, in the form, manner, and number of copies required by Form 1099.

(3) *Bond sales between interest payment dates.* As to each sale of a debt obligation prior to maturity with respect to which a broker is required to make a return of information under this section, a broker shall show separately on Form 1099 the amount of accrued and unpaid interest as of the sale date that must be reported by the customer as interest income under §1.61–7(d) (but not the amount of any original issue or market discount). Such interest information shall be shown in the manner and at the time required by Form 1099 and section 6049.

(4) *Sale date.* With respect to sales of property that are reportable under this section, a broker must report a sale as occurring on the date the sale is entered on the books of the broker.

(5) *Gross proceeds.* The gross proceeds on a sale are the total amount paid to the customer or credited to the customer's account as a result of such sale reduced by the amount of any interest

reported under paragraph (d)(3) and increased by any amount not so paid or credited by reason of repayment of margin loans. In the case of a closing transaction which results in a loss, gross proceeds are the amount debited from the customer's account. The broker may, but is not required to, take commissions and option premiums into account in determining gross proceeds, provided the treatment chosen is consistent with the books of the broker.

(6) *Conversion into United States dollars of proceeds paid in foreign currency*—(i) *Conversion rules.* When a payment is made in a foreign currency, the U.S. dollar amount shall be determined by converting such foreign currency into U.S. dollars on the date of payment at the spot rate (as defined in §1.988–1(d)(1)) or pursuant to a reasonable spot rate convention. For example, a withholding agent may use a month-end spot rate or a monthly average spot rate. A spot rate convention must be used consistently with respect to all non-dollar amounts withheld and from year to year. Such convention cannot be changed without the consent of the Commissioner or his or her delegate.

(ii) *Effect of identification under §1.988–5(a), (b), or (c) where the taxpayer effects a sale and a hedge through the same broker*—(A) *In general.* In lieu of the amount reportable under paragraph (d)(6)(i) of this section, the amount subject to reporting shall be the integrated amount computed under §1.988–5(a), (b) or (c) if—

(*1*) A taxpayer effects through a broker a sale or exchange of nonfunctional currency (as defined in §1.988–1(c)) and hedges all or a part of such sale as provided in §1.988–5(a), (b) or (c) with the same broker; and

(*2*) The taxpayer complies with the requirements of §1.988–5(a), (b) or (c) and so notifies the broker prior to the end of the calendar year in which the sale occurs.

(B) *Effective date.* The provisions of this paragraph (d)(6)(ii) apply to transactions entered into after December 31, 1999.

(e) *Reporting of barter exchanges*—(1) *Requirement of reporting.* A barter exchange shall, except as otherwise provided, report in the manner prescribed in this section.

(2) *Exchanges required to be reported*—(i) *In general.* Except as provided in paragraphs (e)(2)(ii), (g), and (p)(2), a barter exchange shall make a return of information with respect to exchanges of personal property or services through the barter exchange during the calendar year among its members or clients or between such persons and the barter exchange. For this purpose, property or services are exchanged through a barter exchange if payment for property or services is made by means of a credit on the books of the barter exchange or scrip issued by the barter exchange or if the barter exchange arranges a direct exchange of property or services among its members or clients or exchanges property or services with a member or client.

(ii) *Exemption.* A barter exchange through which there are fewer than 100 exchanges during the calendar year is not required to report for, or make a return of information with respect to exchanges during, such calendar year. The Commissioner may require multiple barter exchanges to be combined for purposes of the proceeding sentence upon a determination that a material purpose for the formation or continuation of one or more of the barter exchanges to be combined was to receive one or more exemptions pursuant to this subparagraph.

(f) *Information required*—(1) *In general.* A person that is a barter exchange during a calendar year shall report on Form 1096 showing the information required thereon for such year.

(2) *Transactional reporting*—(i) *In general.* As to each exchange with respect to which a barter exchange is required to make a return of information under this section, the barter exchange, except as provided in paragraph (p)(2), shall show on Form 1099 the name, address, and taxpayer identification number of each member or client providing property or services in the exchange, the property or services provided, the amount received by the member or client for such property or services, the date on which the exchange occurred, and such other information as may be required by Form 1099, in the form,

manner, and number of copies required by Form 1099.

(ii) *Exception for corporate member or client.* As to each corporate member or client providing property or services in an exchange for which a return of information is required under this section, the barter exchange may report the name, address, and taxpayer identification number of the corporate member or client, the aggregate amount received by the corporate member or client during the reporting period for property or services provided by such corporate member or client in exchange for which a return of information is required, and such other information as may be required by Form 1099, in the form, manner, and number of copies required by Form 1099.

(iii) *Definition.* For purposes of paragraph (f)(2)(ii) of this section, the term ''corporate member or client'' means a member or client of a barter exchange which is a corporation as defined in section 7701(a)(3) (including an insurance company). The term corporation includes a pool, syndicate, partnership, or unincorporated association composed exclusively of corporations. A barter exchange may treat a member or client as a corporation (and therefore as a corporate member or client) if such member or client provides an exemption certificate as described in §31.3406(h)–3(a) of this chapter or provided that—

(A) The name of the member or client contains the term ''insurance company,'' ''indemnity company,'' ''reinsurance company,'' or ''assurance company'';

(B) The name of the member or client contains one of the following unambiguous expressions of corporate status: Incorporated, Inc., Corporation, Corp., or P.C., but not Company or Co.; or

(C) The member or client is known to the barter exchange to be a corporation through a corporate resolution or similar document on file with the barter exchange clearly indicating corporate status.

(3) *Exchange date.* For purposes of this section an exchange is considered to occur with respect to a member or client of a barter exchange on the date cash, property, a credit, or scrip is actually or constructively received by the member or client as a result of the exchange. (See §1.451–2 for rules pertaining to constructive receipt.)

(4) *Amount received.* The amount received by a member or client in an exchange includes cash received, the fair market value of any property or services received, and the fair market value of any credits to the account of the member or client on the books of the barter exchange or scrip issued to the member or client by the barter exchange, but does not include any amount received by the member or client in a subsequent exchange of credits or scrip. For purposes of this section, the fair market value of a credit or scrip is the value assigned to such credit or scrip by the issuing barter exchange for the purpose of exchanges unless the Commissioner requires the use of a different value that the Commissioner determines more accurately reflects fair market value.

(5) *Meaning of terms.* For purposes of this paragraph (f)—(i) A credit is an amount on the books of the barter exchange that is transferable from one member or client of the barter exchange to another such member or client, or to the barter exchange in payment for property or services;

(ii) Scrip is a token issued by the barter exchange that is transferable from one member or client, of the barter exchange to another such member or client, or to the barter exchange, in payment for property or services; and

(iii) Property does not include a credit or scrip.

(6) *Reporting period.* A barter exchange shall use the calendar year as the reporting period.

(g) *Exempt foreign persons*—(1) *Brokers.* No return of information is required to be made by a broker with respect to a customer who is considered to be an exempt foreign person under this paragraph (g)(1). A broker may treat a customer as an exempt foreign person under the circumstances described in paragraphs (g)(1)(i) through (iii) of this section.

(i) With respect to a sale effected at an office of a broker either inside or outside the United States, the broker may treat the customer as an exempt foreign person if the broker can, prior to the payment, associate the payment with documentation upon which it can rely in order to treat the customer as a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii), or as made to a foreign payee in accordance with §1.6049–5(d)(1) or presumed to be made to a foreign payee under §1.6049–5(d) (2), (3), (4), or (5). For purposes of this paragraph (g)(1)(i), the provisions in §1.6049–5(c) (regarding rules applicable to documentation of foreign status and definition of U.S. payor, U.S. middleman, non-U.S. payor, and non-U.S. middleman) shall apply. The provisions of §1.1441–1 shall apply by substituting the terms *broker* and *customer* for the terms *withholding agent* and *payee* and without regard for the fact that the provisions apply to amounts subject to withholding under chapter 3 of the Internal Revenue Code (Code). The provisions of §1.6049–5(d) shall apply by substituting the terms *broker* and *customer* for the terms *payor* and *payee.* For purposes of this paragraph (g)(1)(i), the broker may rely on a beneficial owner withholding certificate described in §1.1441–1(e)(2)(i) only to the extent that the certificate includes a certification that the beneficial owner has not been and, at the time the certificate is furnished, reasonably expects not to be present in the United States for a period aggregating 183 days or more during each calendar year to which the certificate pertains.

(ii) With respect to a redemption or retirement of stock or an obligation (the interest or original issue discount on, which is described in §1.6049–5(b) (6), (7), (10), or (11) or the dividends on, which are described in §1.6042–3(b)(1)(iv)) that is effected at an office of a broker outside the United States by the issuer (or its paying or transfer agent), the broker may treat the customer as an exempt foreign person if the broker is not also acting in its capacity as a custodian, nominee, or other agent of the payee.

(iii) With respect to a sale effected by a broker at an office of the broker either inside or outside the United States, the broker may treat the customer as an exempt foreign person for the period that those proceeds are assets blocked, as described in §1.1441–2(e)(3). For purposes of this paragraph (g)(1)(iii) and section 3406, a sale is deemed to occur in accordance with paragraph (d)(4) of this section. The exemption in this paragraph (g)(1)(iii) shall terminate when payment of the proceeds is deemed to occur in accordance with the provisions of §1.1441–2(e)(3).

(2) *Barter exchange.* No return of information is required by a barter exchange with respect to a client or a member that the barter exchange may treat as a foreign person pursuant to the procedures described in paragraph (g)(1) of this section.

(3) *Applicable rules*—(i) *Joint owners.* Amounts paid to joint owners for which a certificate or documentation is required as a condition for being exempt from reporting under paragraph (g) (1)(i) or (2) of this section are presumed made to U.S. payees who are not exempt recipients if, prior to payment, the broker or barter exchange cannot reliably associate the payment either with a Form W–9 furnished by one of the joint owners in the manner required in §§31.3406(d)–1 through 31.3406(d)–5 of this chapter, or with documentation described in paragraph (g)(1)(i) of this section furnished by each joint owner upon which it can rely to treat each joint owner as a foreign payee or foreign beneficial owner. For purposes of applying this paragraph (g)(3)(i), the grace period described in §1.6049–5(d)(2)(ii) shall apply only if each payee qualifies for such grace period.

(ii) *Special rules for determining who the customer is.* For purposes of this paragraph (g), the determination of who the customer is shall be made on the basis of the provisions in §1.6049–5(d) by substituting in that section the terms *payor* and *payee* with the terms *broker* and *customer.*

(iii) *Place of effecting sale*—(A) *Sale outside the United States.* For purposes of this paragraph (g), a sale is considered to be effected by a broker at an office outside the United States if, in accordance with instructions directly transmitted to such office from outside the United States by the broker's customer, the office completes the acts necessary to effect the sale outside the United States. The acts necessary to effect the sale may be considered to have been completed outside the

United States without regard to whether—

(*1*) Pursuant to instructions from an office of the broker outside the United States, an office of the same broker within the United States undertakes one or more steps of the sale in the United States; or

(*2*) The gross proceeds of the sale are paid by a draft drawn on a United States bank account or by a wire or other electronic transfer from a United States account.

(B) *Sale inside the United States.* For purposes of this paragraph (g), a sale that is considered to be effected by a broker at an office outside the United States under paragraph (g)(3)(iii)(A) of this section shall nevertheless be considered to be effected by a broker at an office inside the United States if either—

(*1*) The customer has opened an account with a United States office of that broker;

(*2*) The customer has transmitted instructions concerning this and other sales to the foreign office of the broker from within the United States by mail, telephone, electronic transmission or otherwise (unless the transmissions from the United States have taken place in isolated and infrequent circumstances);

(*3*) The gross proceeds of the sale are paid to the customer by a transfer of funds into an account (other than an international account as defined in § 1.6049–5(e)(4)) maintained by the customer in the United States or mailed to the customer at an address in the United States;

(*4*) The confirmation of the sale is mailed to a customer at an address in the United States; or

(*5*) An office of the same broker within the United States negotiates the sale with the customer or receives instructions with respect to the sale from the customer.

(iv) *Special rules where the customer is a foreign intermediary or certain U.S. branches.* A foreign intermediary, as defined in § 1.1441–1(e)(3)(i), is an exempt foreign person, except when the broker has actual knowledge or reason to know (within the meaning of § 1.6049–5(c)(3)) that the person for whom the intermediary acts is a U.S. person. For an example of this exception, see § 1.6049–5(d)(3)(iv) *Example* 6. In addition, if a foreign intermediary (acting as an intermediary) or a U.S. branch receives a payment from a payor or middleman, which payment the payor or middleman can associate with a valid withholding certificate described in § 1.1441–1(e)(3) (ii), (iii), or (v), or in § 1.1441–5(c)(3)(iii) furnished by such intermediary or U.S. branch, then the intermediary or U.S. branch is not required to report such payment when it, in turn, pays the amount to the person whose name is on the certificate furnished by the intermediary or U.S. branch to the payor or middleman, unless, and to the extent, the intermediary or U.S. branch knows that the payment is required to be reported under this section and was not so reported. For purposes of the preceding sentence, a foreign intermediary is one that is described in § 1.1441–1(e)(3)(i) and a U.S. branch is one that is described in § 1.1441–1(b)(2)(iv).

(4) *Examples.* The application of the provisions of this paragraph (g) may be illustrated by the following examples:

Example 1. FC is a foreign corporation that is not a U.S. payor or U.S. middleman described in § 1.6049–5(c)(5) that regularly issues and retires its own debt obligations. A is an individual whose residence address is inside the United States, who holds a bond issued by FC that is in registered form (within the meaning of section 163(f) and the regulations under that section). The bond is retired by FP, a foreign corporation that is a broker within the meaning of paragraph (a)(1) of this section and the designated paying agent of FC. FP mails the proceeds to A at A's U.S. address. The sale would be considered to be effected at an office outside the United States under paragraph (g)(3)(iii)(A) of this section except that the proceeds of the sale are mailed to a U.S. address. For that reason, the sale is considered to be effected at an office of the broker inside the United States under paragraph (g)(3)(iii)(B) of this section. Therefore, FC is a broker under paragraph (a)(1) of this section with respect to this transaction because, although it is not a U.S. payor or U.S. middleman, as described in § 1.6049–5(c)(5), it is deemed to effect the sale in the United States. FP is a broker for the same reasons. However, under the multiple broker exception under § 5f.6045–1(c)(3)(ii) of this chapter, FP, rather than FC, is required to report the payment because FP is responsible for paying the holder the proceeds from the retired obligations. Under paragraph (g)(1)(i) of this section, FP may not treat A as an exempt foreign person and must make an information return under section 6045 with respect to the retirement of the FC bond, unless FP obtains the certificate or documentation described in paragraph (g)(1)(i) of this section.

Example 2. The facts are the same as in *Example 1* except that FP mails the proceeds to A at an address outside the United States. Under paragraph (g)(3)(iii)(A) of this section, the sale is considered to be effected at an office of the broker outside the United States. Therefore, under paragraph (a)(1) of this section, neither FC nor FP is a broker with respect to the retirement of the FC bond. Accordingly, neither is required to make an information return under section 6045.

Example 3. The facts are the same as in *Example 2* except that FP is also the agent of A. The result is the same as in *Example 2.* Neither FP nor FC are brokers under paragraph (a)(1) of this section with respect to the sale since the sale is effected outside the United States and neither of them are U.S. payors (within the meaning of §1.6049–5(c)(5)).

Example 4. The facts are the same as in *Example 1* except that the registered bond held by A was issued by DC, a domestic corporation that regularly issues and retires its own debt obligations. Also, FP mails the proceeds to A at an address outside the United States. Interest on the bond is not described in paragraph (g)(1)(ii) of this section. The sale is considered to be effected at an office outside the United States under paragraph (g)(3)(iii)(A) of this section. DC is a broker under paragraph (a)(1)(i)(B) of this section. DC is not required to report the payment under the multiple broker exception under §5f.6045–1(c)(3)(ii) of this chapter. FP is not required to make an information return under section 6045 because FP is not a U.S. payor described in §1.6049–5(c)(5) and the sale is effected outside the United States. Accordingly, FP is not a broker under paragraph (a)(1) of this section.

Example 5. The facts are the same as in *Example 4* except that FP is also the agent of A. DC is a broker under paragraph (a)(1) of this section. DC is not required to report under the multiple broker exception under §5f.6045–1(c)(3)(ii) of this chapter. FP is not required to make an information return under section 6045 because FP is not a U.S. payor described in §1.6049–5(c)(5) and the sale is effected outside the United States and therefore FP is not a broker under paragraph (a)(1) of this section.

Example 6. The facts are the same as in *Example 4* except that the bond is retired by DP, a broker within the meaning of paragraph (a)(1) of this section and the designated paying agent of DC. DP is a U.S. payor under §1.6049–5(c)(5). DC is not required to report under the multiple broker exception under §5f.6045–1(c)(3)(ii) of this chapter. DP is required to make an information return under section 6045 because it is the person responsible for paying the proceeds from the retired obligations unless DP obtains the certificate or documentary evidence described in paragraph (g)(1)(i) of this section.

Example 7. Customer A owns U.S. corporate bonds issued in registered form after July 18, 1984 and carrying a stated rate of interest. The bonds are held through an account with foreign bank, X, and are held in street name. X is a wholly-owned subsidiary of a U.S. company and is not a qualified intermediary within the meaning of §1.1441–1(e)(5)(ii). X has no documentation regarding A. A instructs X to sell the bonds. In order to effect the sale, X acts through its agent in the United States, Y. Y sells the bonds and remits the sales proceeds to X. X credits A's account in the foreign country. X does not provide documentation to Y.

(i) *Y's obligations to withhold and report.* Y is not required to report the sales proceeds under the multiple broker exception under §5f.6045–1(c)(3)(ii), because X is the person responsible for paying the proceeds from the sale to A. However, the portion of the payment that represents interest accrued on the obligation since the last payment date and that is received as part of the total sales proceeds from the transaction is reportable under §1.1461–1 (b) and (c)(2)(i)(E), as an amount paid to a foreign person that is subject to withholding under chapter 3 of the Code within the meaning of §1.1441–2(a) (even though no withholding is required under chapter 3 of the Code based on §1.1441–3(b)(2)(i), unless §1.1441–3(b)(2)(ii) applies). The multiple broker exception under the regulations under section 6045 does not affect a withholding agent's obligation to report an amount otherwise required to be reported under §1.1461–1 (b) and (c). Under §1.1461–1(c)(3), Y must file Form 1042–S in the name of X who, under §1.1441–1(b)(3)(v)(A), is presumed to be acting for its own account because Y cannot associate the payment of interest with a valid intermediary Form W–8 described in §1.1441–1(e)(3) (ii) or (iii) from X.

(ii) *X's obligations to withhold and report.* X may also have reporting and withholding obligations when it credits A's account with the sales proceeds. Although the sale is considered to be effected at an office outside the United States under paragraph (g)(3)(iii)(A) of this section, X is a broker with respect to the sale because, as a wholly-owned subsidiary of a U.S. company, it meets the definition of a broker under paragraph (a)(1) of this section. Under the presumptions described in §1.6049–5(d)(2), X, as a U.S. payor, must presume that, with respect to the sales proceeds, A is a U.S. person who is not an exempt recipient. Therefore, the payment of sales proceeds to A by X is reportable on a

Form 1099 under paragraph (c)(2) of this section. X has no obligation to backup withhold on the payment, based on the exemption under § 31.3406(g)–1(e), unless X has actual knowledge that A is a U.S. person who is not an exempt recipient. X is also a withholding agent with respect to the portion of the sales proceeds that represents accrued interest on the bonds. Based on the presumptions under §§ 1.6049–5(d)(2) and 1.1441–1(b)(3)(iii)(D), X must presume that A is a foreign person with respect to the interest portion of the payment, because the interest amount is an amount subject to withholding, within the meaning of § 1.1441–2(a) (even though a withholding agent is not required to withhold on such amounts). Thus, X is required to file a Form 1042 and 1042–S with respect to the interest portion of the payment. Y's filing of a Form 1042–S with respect to that portion of the payment to X does not meet the conditions for the multiple withholding agent exception under § 1.1461–1(c)(4)(i) because Y did not report the payment to X as a payment to an intermediary.

(5) *Effective date*—(i) *General rule.* The provisions of this paragraph (g) apply to payments made after December 31, 1999.

(ii) *Transition rules.* The validity of a withholding certificate (namely, Form W–8 or other form upon which the payor is permitted to rely to hold the payee as a foreign person) that was valid on January 1, 1998, under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) and expired, or will expire, at any time during 1998, is extended until December 31, 1998. The validity of a withholding certificate that is valid on or after January 1, 1999, remains valid until its validity expires under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) or, if earlier, until December 31, 2000. The rule in this paragraph (g)(5)(ii), however, does not apply to extend the validity period of a form that expires in 1998 solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the first three sentences of this paragraph (g)(5)(ii), a payor may choose not to take advantage of the transition rule in this paragraph (g)(5)(ii) with respect to one or more withholding certificates valid under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) and, therefore, to require withholding certificates conforming to the requirements described in this section (new withholding certificates). For purposes of this section, a new withholding certificate is deemed to satisfy the documentation requirement under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998). Further, a new withholding certificate remains valid for the period specified in § 1.1441–1(e)(4)(ii), regardless of when the certificate is obtained.

(h) *Identity of customer*—(1) *In general.* For purposes of this section, a broker or barter exchange shall treat the person who appears on the books and records of the broker or barter exchange with respect to property or services as the principals with respect thereto.

(2) *Examples.* The following examples illustrate the rule of this paragraph (h):

Example 1. The records of A, a broker, show an account in the name of ''B''. B is a nominee for C. All reporting with respect to such account shall treat B as the customer.

Example 2. J, an individual, places an order with H, a broker, to sell J's stock that is held by P, a broker/dealer, in an account for J with P designated as nominee for J, and to credit the gross proceeds from the sale to J's account with P. The account is in the name of P, so that H's customer is P.

(i) [Reserved]

(j) *Time and place for filing; cross-reference to penalty.* Forms 1096 and 1099 required under this section shall be filed after the last calendar day of the reporting period elected by the broker or barter exchange and on or before the end of the second calendar month following the close of the calendar year of such reporting period with the appropriate Internal Revenue Service Center, the address of which is listed in the instructions for Form 1096. See paragraph (l) of this section for the requirement to file certain returns on magnetic media. For provisions relating to the penalty provided for the failure to file timely a correct information return under section 6045(a), see § 301.6721–1 of this chapter. See § 301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(k) *Requirement and time for furnishing statement; cross-reference to penalty*—(1) *General requirements.* A broker or barter exchange making a return of information under this section with respect to a transaction shall furnish to the person whose identifying number is (or is required to be) shown on such return a written statement showing the information required by paragraph (c)(5), (d), (f), or (p) of this section and containing a legend stating that such information is being reported to the Internal Revenue Service. If the return of information is not made on magnetic media, this requirement may be satisfied by furnishing to such person a copy of all Forms 1099 with respect to such person filed with the Internal Revenue Service Center. A statement shall be considered to be furnished to a person to whom a statement is required to be made under this paragraph (k) if it is mailed to such person at the last address of such person known to the broker or barter exchange.

(2) *Time for furnishing statements.* A broker or barter exchange may furnish the statements required by this paragraph (k) yearly, quarterly, monthly, or on any other basis, without regard to the reporting period elected by the broker or barter exchange, provided that all statements required to be furnished under this paragraph (k) for a calendar year shall be furnished on or before January 31 of the following calendar year.

(3) *Cross-reference to penalty.* For provisions for failure to furnish timely a correct payee statement, see §301.6724–1 of this chapter (Procedure and Administration Regulations). See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(l) *Use of magnetic media.* For information returns filed after December 31, 1996, see §301.6011–2 of this chapter for rules relating to filing information returns on magnetic media and for rules relating to waivers granted for undue hardship. A broker or barter exchange that fails to file a Form 1099 on magnetic media, when required, may be subject to a penalty under section 6721 for each such failure. See paragraph (j) of this section.

(m) *Reporting on options transactions.* [Reserved]

(n) *Reporting on bond discounts.* [Reserved]

(o) *Additional reporting by stock transfer agents.* [Reserved]

(p) *Transitional rules*—(1) *Information required from brokers.* In the case of reporting periods ending before January 1, 1984, a broker may show the information required by this paragraph (p)(1) on Form 1099 in lieu of the information required under paragraph (d)(2). As to each customer account for which a return of information is required under this section with respect to sales, the broker must report the name, address, and taxpayer identification number of the customer, the aggregate gross proceeds of all sales of the account during the reporting period for which a return of information is required under this section, and such other information as may be required by Form 1099, in the form, manner, and number of copies required by Form 1099.

(2) *Information required from barter exchanges.* In the case of reporting periods ending before January 1, 1984, a barter exchange may show the information required by this paragraph (p)(2) on Form 1099 in lieu of the information required under paragraph (f)(2). As to each member or client providing property or services in an exchange for which a return of information is required under this section, the barter exchange must report the name, address, and taxpayer identification number of the member or client, the aggregate amount received by the member or client during the reporting period for property or services provided by such member or client in exchanges for which a return of information is required, and such other information as may be required by Form 1099, in the form, manner, and number of copies required by Form 1099.

(q) *Effective date.* This section applies to calendar year 1983 and all succeeding calendar years, and, as to 1983, only to transactions occurring on or after July 1, 1983. With regard to paragraph (l) of this section, see section 6011(e) of the Internal Revenue Code for information returns required to be filed after December 31, 1989, and before January 1, 1997; and see paragraph (l) of this section for information returns required to be filed after December 31, 1996.

[T.D. 7873, 48 FR 10304, Mar. 11, 1983, as amended by T.D. 7932, 48 FR 57485, Dec. 30, 1983; 49 FR 2469, Jan. 20, 1984; T.D. 7960, 49 FR 22283, May 29, 1984; T.D. 8445, 57 FR 53032, Nov. 6, 1992; T.D. 8452, 57 FR 58984, Dec. 14, 1992; T.D. 8683, 61 FR 53060, Oct. 10, 1996; T.D. 8734, 62 FR 53476, Oct. 14, 1997; T.D. 8445, 63 FR 12410, Mar. 13, 1998; T.D. 8770, 63 FR 35519, June 30, 1998; T.D. 8804, 63 FR 72186, 72188, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53476, Oct. 14, § 1.6045–1 was amended by revising the heading of paragraph (a), paragraph (a) introductory text, paragraphs (a)(1), (d)(4), (d)(6), (f)(2)(iii) last sentence of introductory text, (g), (j), (k), and (l); by removing paragraph (a)(12) and redesignating paragraph (a)(13) as paragraph (a)(12); by adding new paragraph (a)(13); by redesignating paragraph (b) *Example (1)* through *Example (8)* as *Example 1* through *Example 8*, respectively, by removing newly designated *Example* 1(ii), and by redesignating *Example 1*(iii) through (vi) as *Example 1*(ii) through (v), respectively; by redesignating paragraphs (c)(5)(i)(*a*) through (c)(5)(i)(*f*) as paragraphs (c)(5)(i)(A) through (c)(5)(i)(F), respectively; by redesignating paragraph (c)(5)(ii) and *Example (1)* through *Example (4)* as paragraph (c)(5)(iii) and *Example 1* through *Example 4*, respectively; by adding new paragraph (c)(5)(ii); by redesignating paragraphs (c)(6)(i)(*a*) and (c)(6)(i)(*b*) as paragraphs (c)(6)(i)(A) and (c)(6)(i)(B), respectively; by redesignating paragraphs (c)(6)(ii)(*a*) and (c)(6)(ii)(*b*) as paragraphs (c)(6)(ii)(A) and (c)(6)(ii)(B), respectively; by redesignating paragraph (h)(2), *Example (1)* and *Example (2)* as paragraph (h)(2), *Example 1* and *Example 2*, respectively; and by removing the authority citation at the end of the section, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.6045–1 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.6045–1 Returns of information of brokers and barter exchanges.

(a) *Meaning of terms.* The following definitions apply for purposes of this section:

(1) The term *broker* means a person that, in the ordinary course of a trade or business during the calendar year, stands ready to effect sales to be made by others.

* * * * *

(12) The term *convertible foreign currency* means a foreign currency that is either:

(i) Readily convertible into United States dollars; or

(ii) Of a type the Secretary determines is to be treated as a ‘‘convertible foreign currency,’’ from and after the date specified in a notice of such determination published in the FEDERAL REGISTER.

* * * * *

(b) * * *

Example 1 * * * (i) * * *

(ii) An obligor that regularly issues and retires its own notes.

* * * * *

(d) * * *

(4) *Sale date*—(i) *In general.* Except as otherwise provided in this paragraph (d) (4), a broker may report a sale as occurring on the date the sale is entered on the books of the broker of the date the customer becomes entitled to the gross proceeds thereof. The method of reporting the date the sale occurs shall be consistently applied by the broker as to all reports with respect to a filing group during a calendar year.

(ii) *Exception.* For purposes of this section, a broker shall report a short sale as occurring on the date the short sale is entered on the books of the broker.

(iii) *Example.* The following example illustrates the application of the rules in this paragraph (d)(4):

Example. C, an individual not otherwise exempt from reporting, through J, a broker, enters into a short sale with respect to 100 shares of the stock of corporation B for $50 per share on July 12, 1985. J is required to report the sale as occurring on July 12, 1985 with gross proceeds of $5,000 dollars.

(5) * * *

(6) *Conversion of proceeds paid in foreign currency*—(i) *Convertible currency.* In the event the proceeds of a sale are paid in convertible foreign currency, the amount subject to reporting under this section shall be computed by converting such foreign currency into United States dollars at the exchange rate determined in the following manner. The broker may choose, with respect to a filing group, to use either the exchange rate on the date the sale occurs or the exchange rate at the close of business on the last business day of the reporting period in which the sale occurs. In either case, the broker may use as such exchange rate the rate at which the broker was able to purchase the foreign currency at the relevant time or, if there is no such rate, the exchange rate quote for such foreign currency at such time in any generally recognized financial publication, provided the broker consistently uses the same publication.

(ii) *Nonconvertible currency.* [Reserved]

* * * * *

(f) * * *

(2) * * *

(iii) * * * A barter exchange may treat a member or client as a corporation (and therefore as a corporate member or client) if such member or client provides an exemption certificate as described in A–29 of §35a.9999–1 of the Temporary Employment Tax Regulations or provided that—

* * * * *

(g) *Exempt foreign persons*—(1) *In general.* No return of information is required with respect to the participation in any transaction during a calendar year of a person who furnishes during such calendar year (or who has furnished during any of the two preceding calendar years) to the broker or barter exchange (irrespective of whether the branch of the broker or barter exchange is within or without the United States) a statement, signed under penalty of perjury, that such person is an exempt foreign person, unless an employee or other agent of the broker or barter exchange who is responsible for receiving or reviewing such statement has actual knowledge that such statement is incorrect. However, the broker or barter exchange may, at its option, require the statement to be provided with respect to each separate transaction. The broker or barter exchange shall retain such statement for at least four years following the end of the last calendar year for which a return of information is not required by reason of such statement. See §1.6001–1 (relating to records in general) for the requirements relating to the retention of statements provided under this paragraph (g). If, after providing such statement, the person ceases to be an exempt foreign person, such person shall so notify the broker or barter exchange in writing within 30 days of this change in status. For purposes of this paragraph (g), an exempt foreign person is a person who, during a calendar year in which such person participates in transactions with respect to which a return of information would otherwise be required under this section:

(i) Is neither a citizen of the United States, a resident of the United States, nor a person treated as a resident of the United States by reason of an election under section 6013 (g) or (h);

(ii) Is not subject to the provisions of section 877;

(iii) In the case of an individual, has not been, and at the time the statement is furnished reasonably expects not to be, present in the United States for a period aggregating 183 or more days (or is a beneficiary of a tax treaty to which the United States is a party and pursuant to which gains from such person's transactions are exempt from Federal income taxation); and

(iv) At the time the statement is furnished, is not, or reasonably expects not to be, engaged in a trade or business in the United States during such year (or is a beneficiary of a tax treaty to which the United States is a party and pursuant to which gains from such person's transactions are exempt from Federal income taxation).

(2) *Example.* The following example illustrates the application of the exception to the reporting requirements for exempt foreign persons:

Example. In March 1983, F, an individual, opens an account with G, a foreign branch of a brokerage firm incorporated in the United States. G requires new customers to complete a form signed under penalty of perjury that includes 4 questions corresponding to the 4 criteria for an exempt foreign person listed in paragraph (g)(1)(i) through (iv). F's responses to the 4 questions indicate that the 4 criteria are satisfied, and the sole employee of G responsible for receiving and reviewing such statement has no actual knowledge to the contrary. G does not require F to provide a statement that F is an exempt foreign person for each separate transaction it effects on F's behalf and does not require F to provide such a statement on a periodic basis. During 1984, 1985 and 1986, F does not furnish to G a statement that F is an exempt foreign person. If G is not notified by F that F has ceased to be an exempt foreign person, G is not required to make a return of information with respect to sales effected for F during 1983, 1984 and 1985. However, if no other exception applies, G is required to make a return of information with respect to sales effected for F during 1986.The same result would occur if G were a United States branch of either a United States or a foreign brokerage firm.

* * * * *

(j) *Time and place for filing.* Forms 1096 and 1099 required under this section shall be filed after the last calendar day of the reporting period elected by the broker or barter exchange and on or before the end of the second calendar month following the close of the calendar year of such reporting period with the appropriate Internal Revenue Service Center, the address of which is listed in the instructions for Form 1096.

(k) *Requirement and time for furnishing statement*—(1) *Requirement for furnishing statements.* A broker or barter exchange making a return of information under this section with respect to a transaction shall furnish to the person whose identifying number is (or is required to be) shown on such return a written statement showing the information required by paragraph (c)(5), (d), (f), or (p) of this section and containing a legend stating that such information is being reported to the Internal Revenue Service if the return of information is not made on magnetic media, this requirement may be satisfied by furnishing to such person a copy of all Forms 1099 with respect to such person filed with the Internal Revenue Service Center. A statement shall be considered to be furnished to a person to whom a statement is required to be made under this paragraph (k) if it is mailed to such person at the last address of such person known to the broker or barter exchange.

(2) *Time for furnishing statements.* A broker or barter exchange may furnish the statements required by this paragraph (k) yearly, quarterly, monthly or on any other basis, without regard to the reporting period elected by the broker or barter exchange, provided that all statements required to be furnished under this paragraph (k) for a calendar year shall be furnished on or before January 31 of the following calendar year.

(l) *Use of magnetic media*—(1) *In general.* Except as otherwise provided by paragraphs (l) (2) and (3), a broker or a barter exchange required to file returns of information under this section, shall, in lieu of filing Form 1099 for such year, file such returns of information on magnetic media authorized by the Commissioner and shall follow the appropriate revenue procedures for such magnetic media filing in lieu of following Form 1099 instructions.

(2) *Exception for undue hardship.* (i) The Commissioner may authorize a broker or barter exchange to file returns of information on Form 1099 instead of on magnetic media if undue hardship is shown on an application filed with the appropriate Internal Revenue Service Center.

(ii) In the case of a person who is a broker or barter exchange on July 1, 1983, an application to file returns of information on Form 1099 must be filed on or before September 15, 1983. In the case of a person who becomes a broker or barter exchange after July 1, 1983, such application must be filed by the end of the second month following the month in which such person becomes a broker or barter exchange.

(3) *Transitional rule.* A broker or barter exchange may submit returns of information on Form 1099 for reporting periods that:

(i) End before January 1, 1984; or

(ii) Begin before 30 days after the date on which a timely filed request to file returns of information on Form 1099 is denied.

* * * * *

(Secs. 6011(e), 6045 and 7805 of the Internal Revenue Code of 1954, (96 Stat. 610, 68A Stat. 747, 917; 26 U.S.C. 6011(e), 6045, 7805); secs. 3451(b), 3452 (b), (c), (d), and (f), 3453 (b), (c), and (e), 3454 (a) and (b), 3455(b), 3456 (b) and (d), and of the Internal Revenue Code of 1954 (96 Stat. 576, 26 U.S.C. 3451(b); 96 Stat. 577, 578, and 579, 26 U.S.C. 3452 (b), (c), (d), and (f); 96 Stat. 580, 26 U.S.C. 3453 (b), (c), and (e); 96 Stat. 580 and 582, 26 U.S.C. 3454 (a) and (b); 96 Stat. 584, 26 U.S.C. 3455(b); 96 Stat. 585, 26 U.S.C. 3456 (b) and (d); 68A Stat. 775, 26 U.S.C 6302 and in section 308 of the Tax Equity and Fiscal Responsibility Act of 1982 (96 Stat. 591); (secs. 6045 and 7805 of the Internal Revenue Code of 1954 (96 Stat. 600, 68A Stat. 917; 26 U.S.C. 6045, 7805))

§ 1.6045–1T Returns of information of brokers and barter exchanges (temporary).

(a)–(k) [Reserved]

For further guidance, see § 1.6045–1 (a) through (k).

(l) *Use of magnetic media.* For information returns filed after December 31, 1996, see § 301.6011–2T of this chapter for rules relating to filing information returns on magnetic media and for rules relating to waivers granted for undue hardship. For information returns filed prior to January 1, 1997, see § 1.6045–1(l)

[T.D. 8683, 61 FR 53060, Oct. 10, 1996]

§ 1.6045–2 Furnishing statement required with respect to certain substitute payments.

(a) *Requirement of furnishing statements*—(1) *In general.* Any broker (as defined in paragraph (a)(4)(ii) of this section) that transfers securities (as defined in § 1.6045–1(a)(3)) of a customer (as defined in paragraph (a)(4)(iii) of this section) for use in a short sale and receives on behalf of the customer a substitute payment (as defined in paragraph (a)(4)(i)) shall, except as otherwise provided, furnish a statement to the customer identifying such payment as being a substitute payment.

(2) *Special rule for transfers for broker's own use.* Any broker that borrows securities of a customer for use in a short sale entered into for the broker's own account shall be deemed to have transferred the stock to itself and received on behalf of the customer any substitute payment made with respect to the transferred securities, and shall be required to furnish a statement with respect to such payments in accordance with paragraph (a)(1) of this section.

(3) *Special rule for furnishing statements to individual customers with respect to payments in lieu of dividends*—(i) *In*

general. Except as otherwise provided, a broker that receives a substitute payment in lieu of a dividend on behalf of a customer who is an individual (''individual customer'') need not furnish a statement to the customer.

(ii) *Exception for certain dividends.* Any broker that receives on behalf of an individual customer a substitute payment in lieu of—

(A) An exempt-interest dividend (as defined in paragraph (a)(4)(vii) of this section);

(B) A capital gain dividend (as defined in paragraph (a)(4)(vi) of this section);

(C) A distribution treated as a return of capital under section 301(c)(2) or (c)(3); or

(D) An FTC dividend (as defined in paragraph (a)(4)(viii) of this section) shall furnish a statement to the individual customer identifying the payment as being a substitute payment as prescribed by this section, provided that the broker has reason to know not later than the record date of the dividend payment that the payment is a substitute payment in lieu of an exempt-interest dividend, a capital gain dividend, a distribution treated as a return of capital, or an FTC dividend.

(4) *Meaning of terms.* The following definitions apply for purposes of this section.

(i) The term *substitute payment* means a payment in lieu of—

(A) Tax-exempt interest, to the extent that interest has accrued on the obligation for the period during which the short sale is open;

(B) A dividend, the ex-dividend date for which occurs during the period after the transfer of stock for use in a short sale, and prior to the closing of the short sale; or

(C) Any other item specified in a rule-related notice published in the FEDERAL REGISTER (provided that such items shall be subject to the rules of this section only subsequent to the time of such publication).

For purposes of this section original issue discount accruing on an obligation (the interest upon which is exempt from tax under section 103) for the period during which the short sale is open shall be deemed a payment in lieu of tax-exempt interest.

(ii) The term *broker* means both a person described in § 1.6045–1(a)(1) and a person that, in the ordinary course of a trade or business during the calendar year, loans securities owned by others.

(iii) The term *customer* means, with respect to a transfer of securities for use in a short sale, the person that is the record owner of the securities so transferred.

(iv) The term *dividend* means a dividend (as defined in section 316) or a distribution that is treated as a return of capital under section 301(c)(2) or (c)(3).

(v) The term *tax-exempt interest* means interest to which the exception in section 6049 (b)(2)(B) applies.

(vi) The term *capital gain dividend* means a capital gain dividend as defined in section 852(b)(3)(C) or section 857(b)(3)(C).

(vii) The term *exempt-interest dividend* means an exempt-interest dividend as defined in section 852(b)(5)(A).

(viii) The term *FTC dividend* means a dividend with respect to which the recipient is entitled to claim a foreign tax credit under section 901 (but not by virtue of taxes deemed paid under section 902 or 960).

(5) *Examples.* The following examples illustrate the definition of a substitute payment in lieu of tax-exempt interest found in paragraph (a)(4)(i)(A) of this section.

Example (1). On September 1, 1984, L, a broker, borrows 200 State Q Bonds (the interest upon which is exempt from tax under section 103) held in street name for customer R and transfers the bonds to W for use in a short sale. The bonds each have a face value of $100 and bear 12% stated annual interest paid semiannually on January 1 and July 1 of each year. The bonds were not issued with original issue discount. On November 1, 1984, W closes the short sale and returns State Q Bonds to L. On January 1, 1985, L receives a $1200 interest payment (6%×$100×200 bonds =$1200) from State Q with respect to R's bonds. Four hundred dollars (2 months the bonds were on loan/6 months in the interest period =⅓×$1200=$400) of the interest payment represents accrued interest on the obligations for the period during which the short sale was open and is a substitute payment in lieu of tax-exempt interest within the meaning of paragraph (a)(4)(i)(A) of this section. L must furnish a statement under paragraph (a) of this section to R for calendar year 1985 with respect to the $400 substitute payment.

Example (2). Assume the same facts as in Example (1), except that W closes the short sale on February 1, 1985. On January 1, 1985, L receives a $1200 payment from W with respect to R's bonds. Eight hundred dollars (4 months the bonds were on loan prior to January 1, 1985/6 months in the interest period =⅔×$1200=$800) of the payment represents accrued interest on the obligation for the period during which the short sale was open and is a substitute payment in lieu of tax-exempt interest. On July 1, 1985, L receives a $1200 payment from State Q. Two hundred dollars (1 month the bonds were on loan after December 31, 1984/6 months in the interest period =⅙×$1200=$200) of the payment represents accrued interest on the obligation for the period during which the short sale was open and is a substitute payment in lieu of the tax-exempt interest. Because both payments are received by L in 1985, L must furnish a statement under paragraph (a) of this section to R for that year with respect to both payments.

(b) *Exceptions*—(1) *Minimal payments.* No statement is required to be furnished under section 6045(d) or this section to any customer if the aggregate amount of the substitute payments received by a broker on behalf of the customer during a calendar year for which a statement must be furnished is less than $10.

(2) *Exempt recipients*—(i) *In general.* A statement shall not be required to be furnished with respect to substitute payments made to a broker on behalf of—

(A) An organization exempt from taxation under section 501(a);

(B) An individual retirement plan;

(C) The United States, a possession of the United States, or an instrumentality or a political subdivision or a wholly-owned agency of the foregoing;

(D) A State, the District of Columbia, or a political subdivision or a wholly-owned agency or instrumentality of either of the foregoing;

(E) A foreign government or a political subdivision thereof;

(F) An international organization; or

(G) A foreign central bank of issue, as defined in § 1.6049–4(c)(1)(ii)(H), or the Bank for International Settlements.

(ii) *Determination of whether a person is described in paragraph (b)(2)(i) of this section.* The determination of whether a person is described in paragraph (b)(2)(i) of this section shall be made in the manner provided in § 5f.6045–1(c)(3)(i)(B) of the Temporary Income Tax Regulations under the Tax Equity and Fiscal Responsibility Act of 1982.

(3) *Exempt foreign persons.* A statement shall not be required to be furnished with respect to substitute payments made to a broker on behalf of a person that is an exempt foreign person as described in § 1.6045–1(g)

(c) *Form of statement.* A broker shall furnish the statement required by paragraph (a) of this section on Form 1099. The statement must show the aggregate dollar amount of all substitute payments received by the broker on behalf of a customer (for which the broker is required to furnish a statement) during a calendar year, and such other information as may be required by Form 1099. A statement shall be considered to be furnished to a customer if it is mailed to the customer at the last address of the customer known to the broker.

(d) *Time for furnishing statements.* A broker must furnish the statements required by paragraph (a) of this section for each calendar year. Such statements shall be furnished after April 30th of such calendar year but in no case before the final substitute payment for the calendar year is made, and on or before January 31 of the following calendar year.

(e) *When substitute payment deemed received.* A Broker is deemed to have received a substitute payment on behalf of a customer when the amount is paid or deemed paid to the broker (or as it accrues in the case of original issue discount deemed a payment in lieu of tax-exempt interest).

(f) *Identification of customer and recordkeeping with respect to substitute payments*—(1) *Payments in lieu of tax-exempt interest and exempt-interest dividends.* A broker that receives substitute payments in lieu of tax-exempt interest, exempt-interest dividends, or other items (to the extent specified in a rule-related notice published pursuant to paragraph (a)(4)(i)(C) of this section) on behalf of a customer and is required to furnish a statement under paragraph (a) of this section must determine the identity of the customer whose security was transferred and on whose behalf the broker received such substitute payments by specific identification of the record owner of the security so transferred. A broker must keep adequate records of the determination so made.

(2) *Payments in lieu of dividends other than exempt-interest dividends*—(i) *Requirements and methods.* A broker that receives substitute payments in lieu of dividends, other than exempt-interest dividends, on behalf of a customer and is required to furnish a statement under paragraph (a) of this section must make a determination of the identity of the customer whose stock was transferred and on whose behalf such broker receives substitute payments. Such determination must be made as of the record date with respect to the dividend distribution, and must be made in a consistent manner by the broker in accordance with any of the following methods:

(A) Specific identification of the record owner of the transferred stock;

(B) The method of allocation and selection specified in paragraph (f)(2)(ii) of this section; or

(C) Any other method, with the prior approval of the Commissioner.

A broker must keep adequate records of the determination so made.

(ii) *Method of allocation and selection*—(A) *Allocation to borrowed shares and individual and nonindividual pools.* With respect to each substitute payment in lieu of a dividend received by a broker, the broker must allocate the transferred shares (*i.e.*, the shares giving rise to the substitute payment) among all shares of stock of the same class and issue as the transferred shares which were (*1*) borrowed by the broker, and (*2*) which the broker holds (or has transferred in a transaction described in paragraph (a)(1) of this section) and is authorized by its customers to transfer (including shares of stock of the same class and issue held for the broker's own account) (''loanable shares''). The broker may first allocate the transferred shares to any borrowed shares. Then to the extent that the number of transferred shares exceeds the number of borrowed shares (or if the broker does not allocate to the borrowed shares first), the broker must allocate the transferred shares between two pools, one consisting of the loanable shares of all individual customers (the ''individual pool'') and the other consisting of the loanable shares of all nonindividual customers (the ''nonindividual pool''). The transferred shares must be allocated to the individual pool in the same proportion that the number of loanable shares held by individual customers bears to the total number of loanable shares available to the broker. Similarly, the transferred shares must be allocated to the nonindividual pool in the same proportion that the number of loanable shares held by nonindividual customers bears to the total number of loanable shares available to the broker.

(B) *Selection of deemed transferred shares within the nonindividual pool.* The broker must select which shares within the nonindividual pool are deemed transferred for use in a short sale (the ''deemed transferred shares''). Selection of deemed transferred shares may be made either by purely random lottery or on a first-in-first-out (''FIFO'') basis.

(C) *Selection of deemed transferred shares within the individual pool.* The broker must select which shares within the individual pool are deemed transferred shares (in the manner described in the preceding paragraph) only with respect to substitute payments as to which a statement is required to be furnished under paragraph (a)(2)(ii) of this section.

(3) *Examples.* The following examples illustrate the identification of customer rules of paragraph (f)(2):

Example (1). A, a broker, holds X corporation common stock (of which there is only a single class) in street name for five customers: C, a corporation; D, a partnership; E, a corporation; F, an individual; and G, a corporation. C owns 100 shares of X stock, D owns 50 shares of X stock, E owns 100 shares of X stock, F owns 50 shares of X stock, and G owns 100 shares of X stock. A is authorized to loan all of the X stock of C, D, E, and F. G, however, has not authorized A to loan its X stocks. A does not hold any X stock in its trading account nor has A borrowed any X stock from another broker. A transfers 150 shares of X stock to H for use in a short sale on July 1, 1985. A dividend of $2 per share is declared with respect to X stock on August 1, 1985, payable to the owners of record as of August 15, 1985 (the ''record'' date). A receives $2 per transferred share as a payment in lieu of a dividend with respect to X stock or a total of $300 on September 15, 1985. H closes the short sale and returns X stock to A on January 2, 1986. A's records specifically identify the owner of each loanable share of stock held in street name. From A's records it is determined that the shares transferred to H consisted of 100 shares owned by C, 25 shares owned by D, and 25 shares owned by F. The substitute payment in lieu of dividends with respect to X stock is therefore attributed to C, D and F based on the actual number of their shares that were transferred to H. Accordingly, C receives $200 (100 shares × $2 per share), and D and F each receive $50 (25 shares each × $2 per share). A must furnish statements identifying the payments as being in lieu of dividends to both C and D, unless they are exempt recipients as defined in paragraph (b)(2) of this section or exempt foreign persons as defined in paragraph (b)(3) of this section. Assuming that A had no reason to know on the record date of the payment that the dividend paid by X is of a type described in paragraphs (a)(3)(ii)(A) through (D) of this section, A need not furnish F with a statement under section 6045(d) because F is an individual. (However, A may be required to furnish F with a statement in accordance with section 6042 and the regulations thereunder. See paragraph (h) of this section.) By recording the ownership of each share transferred to H, A has complied with the identification requirement of paragraph (f)(2) of this section.

Example (2). Assume the same facts as in example (1), except that A's records do not specifically identify the record owner of each share of stock. Rather, all shares of X stock held in street name are pooled together. When A receives the $2 per share payment in lieu of a dividend, A determines the identity of the customers to which the payment relates by the method of allocation and selection prescribed in paragraph (f)(2)(ii) of this section. First, the transferred shares are allocated proportionately between the individual pool and the nonindividual pool. One-sixth of the transferred shares or 25 shares are allocated to the individual pool (50 loanable shares owned by individuals/300 total loanable shares-⅙; ⅙×150 transferred shares=25 shares). Assuming A has no reason to know by the record date of the payment that the payment is in lieu of a dividend of a type described in paragraphs (a)(3)(ii)(A) through (D) of this section, no selection of deemed transferred shares within the individual customer pool is required. (However, A may be required to furnish F with a statement under section 6042 and the regulations thereunder. See paragraph (h) of this section.) Five-sixths of the transferred shares or 125 shares are allocated to the nonindividual pool (250 loanable shares owned by nonindividuals/300 total loanable shares=⅚; ⅚×150 transferred shares=125 shares). A must select which 125 shares within the nonindividual pool are deemed to have been transferred. Using a purely random lottery, A selects 100 shares identified as being owned by C, and 25 shares identified as being owned by D. Accordingly, A is deemed to have transferred 100 shares and 25 shares owned by C and D respectively, and received substitute payments in lieu of dividends of $200 (100 shares × $2 per share) and $50 (25 shares × $2 per share) on behalf of C and D respectively. A must furnish statements to both C and D identifying such payments as being in lieu of dividends unless they are exempt recipients as defined in paragraph (b) (2) of this section or exempt foreign persons as defined in paragraph (b) (3) of this section. A has complied with the identification requirement of paragraph (f)(2) of this section.

(g) *Reporting by brokers*—(1) *Requirement of reporting.* Any broker required to furnish a statement under paragraph (a) of this section shall report on Form 1096 showing such information as may be required by Form 1096, in the form, manner, and number of copies required by Form 1096. With respect to each customer for which a broker is required to furnish a statement, the broker shall make a return of information on Form 1099, in the form, manner and number of copies required by Form 1099.

(2) *Use of magnetic media.* For information returns filed after December 31, 1996, see § 301.6011–2 of this chapter for rules relating to filing information returns on magnetic media and for rules relating to waivers granted for undue hardship. A broker or barter exchange that fails to file a Form 1099 on magnetic media, when required, may be subject to a penalty under section 6721 for each such failure. See paragraph (g)(4) of this section.

(3) *Time and place of filing.* The returns required under this paragraph (g) for any calendar year shall be filed after September 30 of such year, but not before the final substitute payment for the year is received by the broker, and on or before February 28 of the following year with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for Form 1096.

(4) *Cross-reference to penalties.* For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6045(d) and § 1.6045–2(g)(1), including a failure to file on magnetic media, see § 301.6721–1 of this chapter. For provisions relating to the penalty provided for failure to furnish timely a correct

payee statement required under section 6045(d) and §1.6045–2(a), see §301.6722–1 of this chapter. See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(h) *Coordination with section 6042.* In cases in which reporting is required by both sections 6042 and 6045(d) with respect to the same substitute payment in lieu of a dividend, the provisions of section 6045(d) control, and no report or statement under section 6042 need be made. If reporting is not required under section 6045(d) with respect to a substitute payment in lieu of a dividend, a report under section 6042 must be made if required in accordance with the rules of section 6042 and the regulations thereunder. Thus, if a broker receives a substitute payment in lieu of a dividend on behalf of an individual customer and the broker does not have reason to know by the record date of the payment that the payment is in lieu of a dividend of a type described in paragraphs (a)(3)(ii)(A) through (D) of this section, the broker must report with respect to the substitute payment if required in accordance with section 6042 and the regulations thereunder.

(i) *Effective date.* These regulations apply to substitute payments received by a broker after December 31, 1984. With regard to paragraph (g)(2) of this section, see section 6011(e) of the Internal Revenue Code for information returns required to be filed after December 31, 1989, and before January 1, 1997; and see paragraph (g)(2) of this section for information returns required to be filed after December 31, 1996.

[T.D. 8029, 50 FR 23677, June 5, 1985, as amended by T.D. 8683, 61 FR 53060, Oct. 10, 1996; T.D. 8734, 62 FR 53480, Oct. 14, 1997; T.D. 8770, 63 FR 35519, June 30, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53480, Oct. 14, 1997, §1.6045–2 was amended by removing the period at the end of paragraphs (b)(2)(i)(A), (b)(2)(i)(B), (b)(2)(i)(C), and (b)(2)(i)(D) and adding semicolons in each place; by removing the language ‘‘, or’’ in paragraph (b)(2)(i)(E) and adding a semicolon in its place; by removing the period at the end of paragraph (b)(2)(i)(F) and adding ‘‘, or’’ in its place; by adding paragraph (b)(2)(i)(G); by revising paragraph (g)(2); and by adding paragraph (g)(4), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.6045–2 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

1.6045–2 Furnishing statement required with respect to certain substitute payments.

*   *   *   *   *

(g) * * *

(2) *Use of magnetic media.* Brokers not receiving an undue hardship exception under paragraph (l)(2) of §1.6045–1 shall file the returns required by this paragraph on magnetic media in accordance with paragraph (l)(1) of §1.6045–1.

*   *   *   *   *

1.6045–2T Furnishing statement required with respect to certain substitute payments (temporary).

(a)–(g)(1) [Reserved]

For further guidance, see §1.6045–2 (a) through (g)(1).

(g)(2) *Use of magnetic media.* For information returns filed after December 31, 1996, see §301.6011–2T of this chapter for rules relating to filing information returns on magnetic media and for rules relating to waivers granted for undue hardship. For information returns filed prior to January 1, 1997, see §1.6045–2(g)(2).

[T.D. 8683, 62 FR 53060, Oct. 10, 1996]

§1.6045–4 Information reporting on real estate transactions with dates of closing on or after January 1, 1991.

(a) *Requirement of reporting.* Except as otherwise provided in paragraphs (c) and (d) of this section, a real estate reporting person (‘‘reporting person’’) must make an information return with respect to a real estate transaction and, under paragraph (m) of this section, must furnish a statement to the transferor. A reporting person may also report with respect to transactions otherwise excepted in paragraphs (c) and (d) of this section. However, if the reporting person so elects, the return must be filed and the statement furnished in accordance with the provisions of this section. For the definition of a real estate transaction for purposes of these reporting requirements, see paragraph (b) of this section. For rules for determining the reporting person with respect to a real estate transaction, see paragraph (e) of this section.

(b) *Definition of real estate transaction*—(1) *In general.* A transaction is a ''real estate transaction'' under this section if the transaction consists in whole or in part of the sale or exchange of ''reportable real estate'' (as defined in paragraph (b)(2) of this section) for money, indebtedness, property other than money, or services. The term ''sale or exchange'' shall include any transaction properly treated as a sale or exchange for Federal income tax purposes, whether or not the transaction is currently taxable. Thus, for example, a sale or exchange of a principal residence is a real estate transaction under this section even though the transferor is entitled to defer recognition under section 1034 (relating to rollover of gain on sale of principal residence), or the transferor is entitled to the special one-time exclusion of gain from the sale of a principal residence provided by section 121 to certain persons who have attained age 55.

(2) *Definition of reportable real estate.* Except as otherwise provided in paragraph (c)(2) of this section, the term ''reportable real estate'' means any present or future ownership interest in—

(i) Land (whether improved or unimproved), including air space;

(ii) Any inherently permanent structure, including any residential, commercial or industrial building;

(iii) Any condominium unit, including appurtenant fixtures and common elements (including land); or

(iv) Any stock in a cooperative housing corporation (as defined in section 216).

For purposes of this section, the term ''ownership interest'' includes fee simple interests, life estates, reversions, remainders, and perpetual easements. In addition, the term ''ownership interest'' includes any previously created rights to possession or use for all or a portion of any particular year (*i.e.*, a leasehold, easement, or ''timeshare''), with a remaining term of at least 30 years, including any period for which such rights may be renewed at the option of the holder of the rights, as determined on the date of closing (as defined in paragraph (h)(2)(ii) of this section). Thus, for example, a pre-existing leasehold on a building with an original term of 99 years is an ownership interest in real estate for purposes of this section if it has a remaining term of 35 years as of the date of closing, but not if it has a remaining term of only 10 years as of the date of closing. However, the term ''ownership interest'' does not include an option to acquire otherwise reportable real estate.

(c) *Exception for certain exempt transactions*—(1) *Certain transfers.* No return of information is required with respect to—

(i) A transaction that is not a sale or exchange (such as a gift (including a transaction treated as a gift under section 1041) or bequest, or a financing or refinancing that is not related to the acquisition of reportable real estate), even if the transaction involves reportable real estate, as defined in paragraph (b)(2) of this section;

(ii) A transfer in full or partial satisfaction of any indebtedness secured by the property so transferred including a foreclosure, a transfer in lieu of foreclosure or an abandonment; or

(iii) A transaction (a ''de minimis transfer'') in which it can be determined with certainty that the total consideration (in money, services and property), received or to be received in connection with the transaction is less than $600 in value (determined without regard to any allocation of gross proceeds among multiple transferors under paragraph (i)(5) of this section) as of the date of the closing (as defined in paragraph (h)(2)(ii) of this section), even if the transaction involves reportable real estate. Thus, for example, if a contract for sale of reportable real estate recites total consideration of ''$1.00 plus other valuable consideration,'' the transfer is not a de minimis transfer unless the reporting person can determine that the ''other valuable consideration'' received or to be received is less than $599 in value as measured on the date of closing.

(2) *Certain property.* Notwithstanding the provisions of paragraph (b)(2) of this section, no return of information

is required with respect to a sale or exchange of an interest in any of the following property—provided the sale or exchange of such property is not related to the sale or exchange of reportable real estate—

(i) An interest in surface or subsurface natural resources (*i.e.*, timber, water, ores and other natural deposits) or crops, whether or not such natural resources or crops are severed from the land;

(ii) A burial plot or vault; or

(iii) A manufactured structure used as a dwelling that is manufactured and assembled at a location different from that where it is used, but only if such structure is not affixed, at the date of closing (as defined in paragraph (h)(2)(ii) of this section), to a foundation. Thus, a transfer of an unaffixed mobile home that is unrelated to the sale or exchange of reportable real estate is excepted from the reporting requirements of this section.

(d) *Exception for certain exempt transferors*—(1) *General rule.* No return of information is required with respect to a transferor that is a corporation under section 7701(a)(3) or section 7704(a) or is considered under paragraph (d)(2) of this section to be—

(i) A corporation;

(ii) A governmental unit; or

(iii) An exempt volume transferor.

In the case of a real estate transaction with respect to which there is one or more exempt transferor(s) and one or more non-exempt transferor(s), the reporting person is required to report with respect to any non-exempt transferor. The special rule for allocation of gross proceeds, as provided in paragraph (i)(5) of this section, applies to such a transaction.

(2) *Treatment as exempt transferor.* Absent actual knowledge to the contrary, a reporting person may treat a transferor as—

(i) A corporation if—

(A) The name of the transferor contains an unambiguous expression of corporate status, such as Incorporated, Inc., Corporation, Corp., or P.C. (but not Company or Co.);

(B) The name of the transferor contains the term ‘‘insurance company,’’ ‘‘reinsurance company,’’ or ‘‘assurance company’’; or

(C) The transfer or loan documents clearly indicate the corporate status of the transferor;

(ii) A governmental unit if the transferor is—

(A) The United States or a state, the District of Columbia, a possession of the United States, a political subdivision of any of the foregoing, or any wholly owned agency or instrumentality of any one or more of the foregoing; or

(B) A foreign government, a political subdivision thereof, an international organization, as defined in section 7701(a)(18), or any wholly-owned agency or instrumentality of the foregoing; or

(iii) An exempt volume transferor if, and only if, the reporting person receives a certification of exempt status under paragraph (d)(3) of this section.

(3) *Certification of exempt status*—(i) *In general.* A certification of exempt status must contain—

(A) The name, address, and taxpayer identification number of the transferor (the address must be that of the permanent residence (in the case of an individual), that of the principal office (in the case of a corporation or partnership), or that of the permanent residence or principal office of any fiduciary (in the case of a trust or estate));

(B) Sufficient information to identify any otherwise reportable real estate not reported by virtue of the exempt status of the transferor; and

(C) A declaration that the transferor has sold or exchanged during either of the prior two calendar years, or previously sold or exchanged during the current calendar year, or, as of the date of closing (as defined in paragraph (h)(2)(ii) of this section), reasonably expects to sell or exchange during the current calendar year at least 25 separate items of reportable real estate (as defined in paragraph (b)(2) of this section) to at least 25 separate transferees, and that each such item, at the date of closing of the sale of such item was or will be held primarily for sale or resale to customers in the ordinary course of a trade or business. For example, the declaration may be worded as follows:

[Insert name of transferor]

[check one or more]:

(1) ____ has sold or exchanged during either of the prior two calendar years,

(2) ____ previously sold or exchanged during the current calendar year,

(3) ____ on the date of closing expects to sell or exchange during the current calendar year,

at least 25 separate items of reportable real estate to at least 25 separate transferees and each such item, at the date of closing of such item was or will be held primarily for sale or resale to customers in the ordinary course of a trade or business.

(ii) *Additional requirements.* A certification of exempt status must be—

(A) Signed under penalties of perjury by the transferor or any person who is authorized to sign a declaration under penalties of perjury in behalf of the transferor as described in section 6061 and the regulations thereunder;

(B) Received by the reporting person no later than the time of closing; and

(C) Retained by the reporting person for four years following the close of the calendar year in which the date of closing (as determined under paragraph (h)(2)(ii) of this section) occurs.

(iii) *Reporting person may accept or disregard certification.* A reporting person may solicit or merely accept a certification of exempt status. Moreover, notwithstanding a transferor's furnishing of such certification, a reporting person may disregard the certification and, instead, report with respect to the transaction. See paragraph (a) of this section for the requirement that such elective reporting must be in compliance with the provisions of this section.

(e) *Person required to report*—(1) *In general.* Although there may be other persons involved in a real estate transaction, only the reporting person is required to report with respect to any real estate transaction. Except as provided in a designation agreement under paragraph (e)(5) of this section, the reporting person with respect to a real estate transaction is—

(i) The person responsible for closing the transaction, as defined in paragraph (e)(3) of this section; or

(ii) If there is no person responsible for closing the transaction, the person determined to be the reporting person under paragraph (e)(4) of this section.

A person may be the reporting person with respect to a transaction whether or not such person performs or is licensed to perform real estate brokerage services for a commission or fee.

(2) *Employees, agents, and partners.* For purposes of this paragraph (e), if an employee, agent, or partner (other than an employee, agent, or partner of the transferor or the transferee) acting within the scope of such person's employment, agency, or partnership participates in a real estate transaction—

(i) Such participation shall be attributed to such person's employer, principal, or partnership; and

(ii) Only the employer, principal, or partnership (and not such person) may be the reporting person with respect to such transaction as a result of such participation.

However, the participation of a person described in paragraph (e)(3)(i) of this section (*i.e.*, a person listed on the Uniform Settlement Statement as the settlement agent) acting as an agent of another is not attributed to the principal.

(3) *Person responsible for closing the transaction*—(i) *Uniform Settlement Statement used.* If a Uniform Settlement Statement prescribed under the Real Estate Settlement Procedures Act of 1974 (RESPA), 12 U.S.C. 2601 *et seq.* (a ''Uniform Settlement Statement''), is used with respect to the real estate transaction and a person is listed as settlement agent on the statement, such person is the person responsible for closing the transaction. For purposes of this section, a Uniform Settlement Statement shall include any amendments or variations thereto, or substitutions therefore that may hereafter be prescribed under RESPA, provided that any such amended, varied, or substituted form requires disclosure of the parties to the transaction, the application of the proceeds of the transaction, and the identity of the settlement agent or other person responsible for preparing the form.

(ii) *Other closing statement used.* If a Uniform Settlement Statement is not used, or if a Uniform Settlement Statement is used, but no person is listed as settlement agent, the person responsible for closing the transaction is the person who prepares a closing statement presented to the transferor and transferee at, or in connection with, the closing of the real estate transaction. For purposes of this section, a closing statement is any closing statement, settlement statement (including a Uniform Settlement Statement), or other written document that identifies the transferor and transferee, reasonably identifies the transferred real estate, and describes the manner in which the proceeds payable to the transferor are to be (or were) disbursed at, or in connection with, the closing.

(iii) *No closing statement used or multiple closing statements used.* If no closing statement is used or multiple closing statements are used, the person responsible for closing the transaction is the first-listed of the persons that participate in the transaction as—

(A) The attorney for the transferee who is present at the occasion of the delivery of either the transferee's note or a significant portion of the cash proceeds to the transferor, or who prepares or reviews the preparation of the document(s) transferring legal or equitable ownership of the real estate;

(B) The attorney for the transferor who is present at the occasion of the delivery of either the transferee's note or a significant portion of the cash proceeds to the transferor, or who prepares or reviews the preparation of the document(s) transferring legal or equitable ownership of the real estate; or

(C) The disbursing title or escrow company that is most significant in terms of gross proceeds disbursed.

If more than one attorney would be the person responsible for closing the transaction under the preceding sentence, the person among such attorneys who is considered responsible for closing the transaction under this paragraph (e)(3)(iii) is the person whose involvement in the transaction is most significant.

(4) *Determination of the real estate reporting person in the absence of a person responsible for closing the transaction.* If no person is responsible for closing the transaction (within the meaning of paragraph (e)(3) of this section), the reporting person with respect to the real estate transaction is the person first-listed below of the persons that participate in the transaction as—

(i) The mortgage lender (as defined in paragraph (e)(6)(i) of this section);

(ii) The transferor's broker (as defined in paragraph (e)(6)(ii) of this section);

(iii) The transferee's broker (as defined in paragraph (e)(6)(iii) of this section); or

(iv) The transferee (as defined in paragraph (e)(6)(iv) of this section).

(5) *Designation agreement*—(i) *In general.* If a written designation agreement executed at or prior to the time of closing designates one of the persons described in paragraph (e)(5)(ii) of this section as the reporting person with respect to the transaction and the designated person is a party to the agreement, the designated person is the reporting person with respect to the transaction. It is not necessary that all parties to the transaction (or that more than one party) be parties to the agreement.

(ii) *Persons eligible.* A person may be designated as the reporting person under this paragraph (e)(5) only if the person is—

(A) The person responsible for closing the transaction (as defined in paragraph (e)(3) of this section);

(B) A person described in paragraph (e)(3)(iii) (A), (B) or (C) of this section (whether or not such person is responsible for closing the transaction); or

(C) The mortgage lender (as defined in paragraph (e)(6)(i) of this section).

(iii) *Form of designation agreement.* A designation agreement may be in any form that is consistent with the requirements of this paragraph (e)(5), and may be included on a closing statement with respect to the transaction. The designation agreement must, however, include the name and address of the transferor and transferee and the address and any additional information necessary to identify the real estate transferred. The agreement must identify, by name and address, the person designated as the reporting person with respect to the transaction, and all other parties (if any) to the agreement. All parties to the agreement must date and sign the agreement and must retain the agreement for four years following the close of the calendar year in which the date of closing (as determined under paragraph (h)(2)(ii) of this section) occurs. Upon request by the

Internal Revenue Service, or any person involved in the transaction who did not participate in the designation agreement, the agreement must be made available for inspection.

(6) *Meaning of terms*—(i) *Mortgage lender.* For purposes of this paragraph (e), the term ''mortgage lender'' means the person who lends new funds in connection with the transaction, but only if the repayment of such funds is secured in whole or in part by the real estate transferred. If new funds are advanced by more than one person, the mortgage lender is the person who advances the largest amount of new funds. If two or more persons advance equal amounts of new funds and no other person advances a greater amount of new funds, the mortgage lender among the persons advancing such equal amounts is the person with the security interest that is most senior in terms of priority. For purposes of this paragraph (e)(6)(i), any amounts advanced by the transferor are not treated as new funds.

(ii) *Transferor's broker.* For purposes of this paragraph (e), the term ''transferor's broker'' means only the broker that contracts with the transferor and is compensated in connection with the transaction.

(iii) *Transferee's broker.* For purposes of this paragraph (e), the term ''transferee's broker'' means only the broker that participates to a significant extent in the preparation of the transferee's offer to acquire the real estate or that presents such offer to the transferor. If more than one person is so described, the transferee's broker is the person whose participation in the preparation of the transferee's offer to acquire the real estate is most significant or, in the event there is no such person, the person whose participation in the presentation of the offer is most significant.

(iv) *Transferee.* For purposes of this paragraph (e), the term ''transferee'' means the person who acquires the greatest interest in the real estate. If there is no such person, the transferee is the person listed first on the document(s) transferring legal or equitable ownership of the real estate.

(f) *Multiple transferors*—(1) *General rule.* In the case of multiple transferors, each of which transfers an interest in the same reportable real estate, the reporting person shall make a separate information return with respect to each transferor. Paragraph (i)(5) of this section provides rules for the determination of gross proceeds to be reported in the case of multiple transferors.

(2) *Rules for spouses.* Transferors who are husband and wife at the time of closing and hold the reportable real estate as tenants in common, joint tenants, tenants by the entirety, or community property are treated as a single transferor for purposes of paragraphs (f)(1), (h)(1)(i), (i)(5) and (l)(1)(i) of this section, unless the reporting person receives, at or prior to the time of closing, an uncontested allocation of gross proceeds between them. In the case of a husband and wife treated as a single transferor, the reporting person may treat either as the transferor for purposes of paragraphs (h)(1)(i) and (l)(1) of this section, relating to reporting and soliciting taxpayer identification numbers.

(g) *Prescribed form.* Except as otherwise provided in paragraph (k) of this section, the information return required by paragraph (a) of this section shall be made on Form 1099.

(h) *Information required*—(1) *In general.* The following information must be set forth on the Form 1099 required by this section:

(i) The name, address, and taxpayer identification number (TIN) of the transferor (see also paragraph (f)(2) of this section);

(ii) A general description of the real estate transferred (in accordance with paragraph (h)(2)(i) of this section);

(iii) The date of closing (as defined in paragraph (h)(2)(ii) of this section);

(iv) To the extent required by the Form 1099 and its instructions, the entire gross proceeds with respect to the transaction (as determined under the rules of paragraph (i) of this section), and, in the case of multiple transferors, the gross proceeds allocated to the transferor (as determined under paragraph (i)(5) of this section);

(v) To the extent required by the Form 1099 and its instructions, an indication that the transferor—

(A) Received (or will, or may, receive) property (other than cash and consideration treated as cash in computing gross proceeds) or services as part of the consideration for the transaction,

(B) May receive property (other than cash) or services in satisfaction of an obligation having a stated principal amount, or

(C) May receive, in connection with a contingent payment transaction, an amount of gross proceeds that cannot be determined with certainty using the method described in paragraph (i)(3)(iii) of this section and is therefore not included in gross proceeds under paragraphs (i)(3)(i) and (i)(3)(iii) of this section;

(vi) The real estate reporting person's name, address, and TIN;

(vii) [Reserved]; and

(viii) Any other information required by the Form 1099 or its instructions.

(2) *Meaning of terms*—(i) *General description of the real estate transferred.* A general description of the real estate transferred includes the complete address of the property. If the address would not sufficiently identify the property, a general description of the real estate also includes a legal description (*e.g.*, section, lot, and block) of the property.

(ii) *Date of closing.* In the case of a real estate transaction with respect to which a Uniform Settlement Statement is used, the date of closing shall be the date (if any) properly described as the ‘‘Settlement Date’’ on such statement. In all other cases, the date of closing shall be the earlier of the date on which title is transferred or the date on which the economic burdens and benefits of ownership of the real estate shift from the transferor to the transferee.

(i) *Gross proceeds*—(1) *In general.* Except as otherwise provided in this paragraph (i), the term ‘‘gross proceeds’’ means the total cash received or to be received by or on behalf of the transferor in connection with the real estate transaction. For purposes of this paragraph (i), the following amounts are treated as cash received or to be received by or on behalf of the transferor in connection with the real estate transaction:

(i) The stated principal amount of any obligation to pay cash to or for the benefit of the transferor in the future (including any obligation having a stated principal amount that may be satisfied by the delivery of property (other than cash) or services);

(ii) The amount of any liability of the transferor assumed by the transferee as part of the consideration for the transfer or of any liability to which the real estate acquired is subject (whether or not the transferor is personally liable for the debt); and

(iii) In the case of a contingent payment transaction, as defined in paragraph (i)(3)(ii) of this section, the maximum determinable proceeds, as defined in paragraph (i)(3)(iii) of this section.

Gross proceeds does not include the value of any property (other than cash and consideration treated as cash) or services received by, or on behalf of, the transferor in connection with the real estate transaction. See paragraph (h)(1)(v) of this section for the information that must be included on the Form 1099 required by this section in cases in which the transferor receives (or will, or may, receive) property (other than cash and consideration treated as cash) or services as part of the consideration for the transfer.

(2) *Treatment of sales commissions and similar expenses.* In computing gross proceeds, the total cash received or to be received by or on behalf of the transferor shall not be reduced by expenses borne by the transferor (such as sales commissions, expenses of advertising the real estate, expenses of preparing the deed, and the cost of legal services in connection with the transfer).

(3) *Special rules for contingent payments*—(i) *In general.* If a real estate transaction is a contingent payment transaction, gross proceeds consist of the maximum determinable proceeds, if any.

(ii) *Contingent payment transaction.* For purposes of this section, the term ‘‘contingent payment transaction’’ means a real estate transaction with respect to which the receipt, by or on behalf of the transferor, of cash or consideration treated as cash under paragraph (i)(1)(i) of this section is subject to a contingency.

(iii) *Maximum determinable proceeds.* For purposes of this section, the term ''maximum determinable proceeds'' means the gross proceeds determined by assuming that all of the contingencies contemplated by the documents available at closing are met or otherwise resolved in a manner that will maximize the gross proceeds. If the maximum amount of gross proceeds cannot be determined with certainty using this method, the maximum determinable proceeds are the greatest amount that can be determined with certainty using this method. See paragraph (h)(1)(v)(C) of this section for the information that must be included on the Form 1099 required by this section in cases in which the maximum amount of gross proceeds cannot, by using the method described in this paragraph (i)(3)(iii), be determined with certainty.

(4) *Uniform Settlement Statement used.* If a Uniform Settlement Statement is used with respect to a real estate transaction involving a transfer of reportable real estate solely for cash and consideration treated as cash in computing gross proceeds, the gross proceeds generally will be the same amount as the contract sales price properly shown on that statement.

(5) *Special rules for multiple transferors*—(i) *General rules.* In the case of multiple transferors (within the meaning of paragraph (f) of this section) each of which transfers an interest in the same reportable real estate, the reporting person must request the transferors to provide an allocation of the gross proceeds among the transferors. The request must be made at or before the time of closing. Neither the request nor the response is required to be in writing. The reporting person must make a reasonable effort to contact all transferors of whom the reporting person has actual knowledge. The reporting person may, however, rely on the unchallenged response of any transferor and need not make additional efforts to contact other transferors after at least one complete allocation (whether or not contained in a single response) is received. Except as otherwise provided in this paragraph (i)(5), the reporting person shall report the gross proceeds in accordance with any allocation received at or before the time of closing. The reporting person may (but is not required to) report the gross proceeds in accordance with any allocation received after the time of closing and before the date (determined without regard to extensions) the Forms 1099 are required to be filed. The reporting person may not report the gross proceeds in accordance with any allocation received on or after the date (determined without regard to extensions) the Forms 1099 are required to be filed. If no gross proceeds are allocated to a transferor because no allocation or an incomplete allocation is received by the reporting person, the reporting person shall report the entire unallocated gross proceeds (if any) on the return of information made with respect to such transferor. If the reporting person receives conflicting allocations from the transferors, the reporting person shall report the entire gross proceeds on each return of information made with respect to the transaction.

(ii) *Rules for spouses.* The reporting person need not request an allocation of gross proceeds if the only transferors are husband and wife at the time of closing. If there are other transferors, the reporting person need only make a reasonable effort to contact either the husband or wife in connection with the request for an allocation. See paragraph (f)(2) of this section for rules that treat a husband and wife as multiple transferors if an uncontested allocation of gross proceeds is received by the reporting person at or prior to the time of closing.

(6) *Multiple asset transactions.* In the case of a real estate transaction reportable under this section that involves the transfer of reportable real estate and other assets, the amount attributable to both the real estate and other assets is treated as the gross proceeds with respect to that real estate transaction. No allocation of gross proceeds is made among the assets.

(j) *Time and place for filing.* A reporting person shall file the information returns required by this section with respect to a real estate transaction after December 31 of the calendar year that includes the date of closing (as determined under paragraph (h)(2)(ii) of this section) and on or before February 28 of the following calendar year. The returns shall be filed with the appropriate Internal Revenue Service Center at the address listed in the Instructions to Form 1099.

(k) *Use of magnetic media and substitute forms*—(1) *Magnetic media*—(i) *General rule.* A reporting person that is required to make a return of information under this section shall, except as otherwise provided in paragraph (k)(1) (ii) or (iii) of this section, submit the information required by this section on magnetic media (within the meaning of 26 CFR 301.6011–2). Returns on magnetic media shall be made in accordance with 26 CFR 301.6011–2) and applicable revenue procedures.

(ii) *Exception for low-volume filers.* For rules allowing a reporting person to make the information returns required by this section on the prescribed paper Form 1099 if the reporting person is required by this section to file fewer than 250 returns during the calendar year, see section 6011(e) and guidance issued by the Internal Revenue Service thereunder.

(iii) *Undue hardship.* The Commissioner may authorize a reporting person to file information returns on the prescribed paper Form 1099 instead of on magnetic media if undue hardship is shown either on Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media, or on a written statement requesting a waiver for undue hardship filed with the Martinsburg Computing Center, Martinsburg, West Virginia in accordance with applicable revenue procedures.

(2) *Substitute forms.* A reporting person that is described in paragraph (k)(1)(ii) of this section or that receives permission to file returns on the prescribed paper Form 1099 under paragraph (k)(1)(iii) of this section may prepare and use a form that contains provisions identical with those of Form 1099 if the reporting person complies with all applicable revenue procedures relating to substitute Form 1099, including any requirement relating to the use of machine-readable paper forms.

(l) *Requesting taxpayer identification numbers (TINS)*—(1) *Solicitation*—(i) *General requirements.* A reporting person who is required to make an information return with respect to a real estate transaction under this section must solicit a TIN from the transferor at or before the time of closing. The solicitation may be made in person or in a mailing that includes other items. Any person whose TIN is solicited under this paragraph (l) must furnish such TIN to the reporting person and certify that the TIN is correct. See paragraph (f)(2) of this section for rules that treat a husband and wife as a single transferor (and provide for the TIN solicitation of either) in the absence of an allocation of gross proceeds under paragraph (i)(5) of this section.

(ii) *Content of solicitation.* The solicitation shall be made by providing to the person from whom the TIN is solicited a written statement that the person is required by law to furnish a correct TIN to the reporting person, and that the person may be subject to civil or criminal penalties for failing to furnish a correct TIN. For example, the solicitation may be worded as follows:

> You are required by law to provide [insert name of reporting person] with your correct taxpayer identification number. If you do not provide [insert name of reporting person] with your correct taxpayer identification number, you may be subject to civil or criminal penalties imposed by law.

The solicitation shall contain space for the name, address, and TIN of the person from whom the TIN is solicited and for the person to certify under penalties of perjury that the TIN furnished is that person's correct TIN. The wording of the certification must be substantially similar to the following: ‘‘Under penalties of perjury, I certify that the number shown on this statement is my correct taxpayer identification number.’’ The requirements of this paragraph (l)(1)(ii) may be met by providing to the transferor a copy of Form W–9. In the case of a real estate transaction for which a Uniform Settlement Statement is used, the requirements of this paragraph (l)(1)(ii) may be met by providing to the transferor a copy of such statement that is modified to conform to the requirements of this paragraph (l)(1)(ii).

(iii) *Retention requirement.* The solicitation shall be retained by the reporting person for four years following the close of the calendar year that includes the date of closing (as determined under paragraph (h)(2)(ii) of this section). Such solicitation must be made available for inspection upon request by the Internal Revenue Service.

(2) *No TIN provided.* A reporting person that does not receive the transferor's TIN will not be subject to any penalty cross-referenced in paragraph (n) of this section by reason of failure to report such TIN if the reporting person has complied with the requirements of paragraph (l)(1) of this section in good faith (determined with proper regard for a course of conduct and the overall results achieved for the year).

(m) *Furnishing statements to transferors*—(1) *Requirement of furnishing statements.* A reporting person who is required to make a return of information under paragraph (a) of this section shall furnish to the transferor whose TIN is required to be shown on the return a written statement of the information required to be shown on such return. The written statement must bear either the legend shown on the recipient copy of Form 1099 or the following:

> This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines that it has not been reported.

This requirement may be satisfied by furnishing to the transferor a copy of a completed Form 1099 (or substitute Form 1099 that complies with current revenue procedures). In the case of a real estate transaction for which a Uniform Settlement Statement is used, this requirement also may be satisfied by furnishing to the transferor a copy of a completed statement that is modified to comply with the requirements of this paragraph (m), and by designating on the Uniform Settlement Statement the items of information (such as gross proceeds or allocated gross proceeds) required to be set forth on the Form 1099. For purposes of this paragraph (m), a statement shall be considered furnished to a transferor if it is given to the transferor in person, either at the closing or thereafter, or is mailed to the transferor at the transferor's last known address.

(2) *Time for furnishing statement.* The statement required under this paragraph (m) shall be furnished to the transferor on or after the date of closing and before February 1 of the following calendar year.

(n) *Cross-reference to penalties.* See the following sections regarding penalties for failure to comply with the requirements of section 6045(e) and this section:

(1) Section 6721 for failure to file a correct information return;

(2) Section 6722 for failure to furnish a correct statement to the transferor;

(3) Section 6723 for failure to comply with other information reporting requirements (including the requirement to furnish a TIN);

(4) Section 6724 for definitions and rules relating to waiver and payment; and

(5) Section 7203 for willful failure to supply information (including a taxpayer identification number).

(o) *No separate charge.* A reporting person may not separately charge any person involved in a real estate transaction for complying with any requirements of this section.

(p) *Backup withholding requirements.* [Reserved.]

(q) *Federally-subsidized indebtedness.* [Reserved].

(r) *Examples.* The following examples illustrate the application of this section:

Example 1 Sale or exchange. (i) On June 1, 1991, A, an individual, buys a house from B, an individual, for $200,000. The entire $200,000 is financed by B under an ‘‘installment land contract,’’ whereby A takes possession and assumes all significant economic benefits and burdens of ownership of the house, and B retains legal title to the property until A fully performs under the contract. On June 1, 1994, A refinances his purchase of the house with Z, a financial institution. The balance owed to B is repaid and B relinquishes title to the house. A retains possession and the benefits and burdens of ownership of the house.

(ii) For federal income tax purposes, the transaction occurring on June 1, 1991 is considered a sale of the house by B, notwithstanding his retention of legal title to the property. B's sale is subject to information reporting under this section. However, the transaction occurring on June 1, 1994 is not a sale or exchange for federal income tax purposes, and notwithstanding the change in legal title upon the deeding over of the property, that transaction is not subject to information reporting under this section.

Example 2 Sale or exchange. On August 10, 1991, C, an individual, accepts an offer from Y, a corporation that acts on behalf of T (C's employer) to facilitate moves of T's transferred employees from one part of the country to another. Under the offer, C transfers his residence to Y for $250,000 by executing a deed to the property in blank and giving Y a power of attorney to dispose of the residence. C also immediately vacates the residence, whereupon Y begins paying all costs associated with the residence and is entitled to all income from the residence, including sales proceeds. On October 1, 1991, Y sells the residence to D and inserts C's name in the deed previously executed by C. Thus, neither Y nor T ever become record owners of the residence. C's transfer of the residence to Y on August 10, 1991 is a sale of reportable real estate and is subject to information reporting under this section; however, the sale on October 1, 1991 is not required to be reported because Y (the transferor in that sale) is a corporation. See paragraph (d) of this section.

Example 3 Definition of ownership interest. E, an individual, owns a perpetual timeshare interest in a residential unit of real property at an oceanfront resort. For consideration, on November 15, 1991, E sells her rights in the property for the period January 1, 1992 through December 31, 1992 to F. The transfer of E's property interest is not the transfer of an ownership interest, as defined in paragraph (b)(2) of this section and therefore is not reportable real estate under paragraph (b)(2) of this section. Accordingly, the transfer is not a real estate transaction under section (b)(1) of this section, and no return of information is required with respect to E's property transfer.

Example 4 Gross proceeds (exchange). (i) G, an individual, agrees to transfer Blackacre, which has a fair market value of $100,000, plus $10,000 cash to H, an individual, in exchange for Whiteacre, which as a fair market value of $120,000 and is encumbered by a $10,000 liability (which is assumed by G). No other liabilities are involved in the transaction. P is the reporting person with respect to both sides of the transaction.

(ii) With respect to the transfer of Blackacre by G to H, P must report gross proceeds of $–0– (even though the exchange agreement may recite total exchange value of $120,000). See paragraph (i)(1) of this section. In addition, (to the extent required by the Form 1099 and its instructions) P must indicate that G will receive property as part of the consideration for the transaction. See paragraph (h)(v)(A) of this section.

(iii) With respect to the transfer of Whiteacre by H to G, P must report gross proceeds of $20,000 (the amount received by H consisting of cash ($10,000) and consideration treated as cash ($10,000) under paragraph (i) of this section). No other amount is reported under paragraph (i)(1) of this section even though the exchange agreement may recite total exchange value of $120,000. In addition, (to the extent required by the Form 1099 and its instructions) P must indicate that H will receive property as part of the consideration for the transaction. See paragraph (h)(v)(A) of this section.

Example 5 Gross proceeds (deferred exchange). [Reserved]

Example 6 Gross proceeds (contingencies). K, an individual, sells an unencumbered apartment building to L for $500,000, payable at closing, plus an amount equal to 2% of gross rents from the apartment building for each of the next 5 years, the contingent payments to be made annually with adequate stated interest. The agreement provides that the maximum amount K may receive (including the downpayment but excluding the interest) is $600,000. Under paragraph (i)(3)(ii) of this section the real estate transaction is a ''contingent payment transaction.'' Under paragraph (i)(3)(iii) of this section, the maximum amount of gross proceeds determined by assuming all contingencies are satisfied is $600,000. Thus, $600,000 is the ''maximum determinable proceeds'' and is the amount reported.

Example 7 Gross proceeds (contingencies). The facts are the same as in example (6), except that the agreement does not provide for adequate stated interest. The result is the same as in example (6).

Example 8 Gross proceeds (contingencies). The facts are same as in example (6), except that no maximum amount is stated in the agreement (or any other document available at closing). Under paragraph (i)(3)(iii) of this section, assuming all contingencies are satisfied, the maximum amount of gross proceeds cannot be determined with certainty. The greatest amount that can be determined with certainty at the time of the closing, assuming all contingencies are satisfied, is $500,000, the cash downpayment. Therefore, $500,000 is the ''maximum determinable proceeds'' under paragraph (i)(3)(iii) of this section and is the amount reported. In addition, (to the extent required by the Form 1099 and its instructions) the reporting person must indicate that the gross proceeds cannot be determined with certainty. See paragraph (h)(1)(iv)(C) of this section.

Example 9 Gross proceeds (contingencies). The facts are the same as in example (8), except that the agreement provides that the minimum amount K will receive (including the downpayment) is $570,000. Thus, under paragraph (i)(3)(iii) of this section, assuming all contingencies are satisfied, the maximum amount of gross proceeds cannot be determined with certainty. The greatest amount that can be determined with certainty at the time of the closing, assuming all contingencies are satisfied, is $570,000, the minimum amount stated in the agreement. Therefore, $570,000 is the ''maximum determinable proceeds'' under paragraph (i)(3)(iii) of this section and is the amount reported. In addition, (to the extent required by the Form 1099 and its instructions) the reporting person must indicate that the gross proceeds cannot be determined with certainty. See paragraph (h)(1)(iv)(C) of this section.

(s) *Effective date.* This section is effective for real estate transactions with dates of closing (as determined under paragraph (h)(2)(ii) of this section) that occur on or after January 1, 1991.

[T.D. 8323, 55 FR 51284, Dec. 13, 1990; 56 FR 559, Jan. 7, 1991; 56 FR 3419, Jan. 30, 1991]

§ 1.6046–1 Returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock, on or after January 1, 1963.

(a) *Officers or directors*—(1) *When liability arises on January 1, 1963.* Each U.S. citizen or resident who is on January 1, 1963, an officer or director of a foreign corporation shall make a return on Form 959 showing the name, address, and identifying number of each U.S. person who, on January 1, 1963, owns 5 percent or more in value of the outstanding stock of such foreign corporation.

(2) *When liability arises after January 1, 1963*—(i) *Requirement of return.* Each U.S. citizen or resident who is at any time after January 1, 1963, an officer or director of a foreign corporation shall make a return on Form 959 setting forth the information described in subdivision (ii) of this subparagraph with respect to each U.S. person who, during the time such citizen or resident is such an officer or director:

(a) Acquires (whether in one or more transactions) outstanding stock of such corporation which has, or which when added to any such stock then owned by him (excluding any stock owned by him on January 1, 1963, if on that date he owned 5 percent or more in value of such stock) has, a value equal to 5 percent or more in value of the outstanding stock of such foreign corporation, or

(b) Acquires (whether in one or more transactions) an additional 5 percent or more in value of the outstanding stock of such foreign corporation.

(ii) *Information required to be shown on return.* The return required under subdivision (i) of this subparagraph shall contain the following information:

(a) Name, address, and identifying number of each shareholder with respect to whom the return is filed;

(b) A statement showing that the shareholder is either described in subdivision (i)*(a)* or (i)*(b)* of this subparagraph; and

(c) The date on which the shareholder became a person described in subdivision (i)*(a)* or (i)*(b)* of this subparagraph.

(3) *Application of rules.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). A, a United States citizen, is, on January 1, 1963, a director of M, a foreign corporation. X, on January 1, 1963, is a United States person owning 5 percent in value of the outstanding stock of M Corporation. A must file a return under the provisions of subparagraph (1) of this paragraph.

Example (2). The facts are the same as in Example (1) except that X owns only 2 percent in value of the outstanding stock of M Corporation on January 1, 1963. On July 1, 1963, X acquires 2 percent in value of the outstanding stock of M Corporation and on September 1, 1963, he acquires an additional 2 percent in value of such stock. The July 1, 1963, transaction does not give rise to liability to file a return; however, A must file a return as a result of the September 1, 1963, transaction because X's holdings now exceed 5 percent.

Example (3). The facts are the same as in Example (2) and, on September 15, 1963, X acquires an additional 4 percent in value of the outstanding stock of M Corporation (X's total holdings are now 10 percent). On November 1, 1963, X acquires an additional 2 percent in value of the outstanding stock of M Corporation. The September 15, 1963, transaction does not give rise to liability to file a return since X has not acquired 5 percent in value of the outstanding stock of M Corporation since A last became liable to file a return. However, A must file a return as a result of the November 1, 1963, transaction because X has not acquired an additional 5 percent in value of the outstanding stock of M Corporation.

Example (4). The facts are the same as in examples (2) and (3) and, in addition, B, a United States citizen, becomes an officer of M Corporation on October 1, 1963. B is not required to file a return either as a result of the facts set forth in Example (2) or as a result of the September 15, 1963, transaction described in Example (3). However, B is required to file a return as a result of the November 1, 1963, transaction described in Example (3) because X has acquired an additional 5 percent in value of the outstanding stock of M Corporation while B is an officer or director.

(b) *Returns required of U.S. persons when liability to file arises on January 1, 1963.* Each U.S. person who, on January 1, 1963, owns 5 percent or more in value of the outstanding stock of a foreign corporation, shall make a return on Form 959 with respect to such foreign corporation setting forth the following information:

(1) The name, address, and identifying number of the shareholder (or shareholders) filing the return, and the internal revenue district in which such shareholder filed his most recent United States income tax return;

(2) The name, business address, and employer identification number, if any, of the foreign corporation, the name of the country under the laws of which it is incorporated, and the name of the country in which is located its principal place of business;

(3) The date of organization and, if any, of each reorganization of the foreign corporation if such reorganization occurred on or after January 1, 1960, while the shareholder owned 5 percent or more in value of the outstanding stock of such corporation;

(4) The name and address of the foreign corporation's statutory or resident agent in the country of incorporation;

(5) The name, address, and identifying number of any branch office or agent of the foreign corporation located in the United States;

(6) If the foreign corporation has filed a United States income tax return, or participated in the filing of a consolidated return, for any of its last three calendar or fiscal years immediately preceding January 1, 1963, state each year for which a return was filed (including, in the case of a consolidated return, the name of the corporation filing such return), the type of form used, the internal revenue office to which it was sent, and the amount of tax, if any, paid;

(7) The name and address of the person (or persons) having custody of the books of account and records of the foreign corporation, and the location of such books and records if different from such address;

(8) The names, addresses, and identifying numbers of all United States persons who are principal officers (for example, president, vice president, secretary, treasurer, and comptroller) or members of the board of directors of the foreign corporation as of January 1, 1963;

(9) A complete description of the principal business activities in which the foreign corporation is actually engaged and, if the foreign corporation is a member of a group constituting a chain of ownership with respect to each unit of which the shareholder owns 5 percent or more in value of the outstanding stock, a chart showing the foreign corporation's position in the chain of ownership and the percentages of ownership;

(10) The following information prepared in accordance with generally accepted accounting principles and in such detail as is customary for the corporation's accounting records:

(i) The corporation's profit and loss statement for the most recent complete annual accounting period; and

(ii) The corporation's balance sheet as of the end of the most recent complete annual accounting period;

(11) A statement showing as of January 1, 1963, the amount and type of any indebtedness of the foreign corporation:

(i) To any United States person owning 5 percent or more in value of its stock, or

(ii) To any other foreign corporation owning 5 percent or more in value of the outstanding stock of the foreign corporation with respect to which the return is filed provided that the shareholder filing the return owns 5 percent or more in value of the outstanding stock of such other foreign corporation,

together with the name, address, and identifying number, if any, of each such shareholder or entity;

(12) A statement, as of January 1, 1963, showing the name, address, and

identifying number, if any, of each person who is, on January 1, 1963, a subscriber to the stock of the foreign corporation, and the number of shares subscribed to by each;

(13) A statement showing the number of shares of each class of stock of the foreign corporation owned by each shareholder filing the return and:

(i) If such stock was acquired after December 31, 1953, the dates of acquisition, the amounts paid or value given therefor, the method of acquisition, i.e., by original issue, purchase on open market, direct purchase, gift, inheritance, etc., and from whom acquired; or

(ii) If such stock was acquired before Janaury 1, 1954, a statement that such stock was acquired before such date, and the value at which such stock is carried on the books of such shareholder;

(14) A statement showing as of January 1, 1963, the name, address, and identifying number of each United States person who owns 5 percent or more in value of the outstanding stock of the foreign corporation, the classes of stock held, the number of shares of each class held, including the name, address, and identifying number, if any, of each actual owner if such person is different from the shareholder of record and a statement of the nature and amount of the interests of each such actual owner; and

(15) The total number of shares of each class of outstanding stock of the foreign corporation (or other data indicating the shareholder's percentage of ownership).

(c) *Returns required of U.S. persons when liability to file arises after January 1, 1963*—(1) *U.S. persons required to file.* A return on Form 959, containing the information required by subparagraph (3) of this paragraph, shall be made by each U.S. person when at any time after January 1, 1963:

(i) Such person acquires (whether in one or more transactions) outstanding stock of such foreign corporation which has, or which when added to any such stock then owned by him (excluding any stock owned by him on January 1, 1963, if on that date he owned 5 percent or more in value of such stock) has, a value equal to 5 percent or more in value of the outstanding stock of such foreign corporation, or

(ii) Such person, having already acquired the interest referred to in paragraph (b) of this section or in subdivision (i) of this subparagraph—

(a) Acquires (whether in one or more transactions) an additional 5 percent or more in value of the outstanding stock of such foreign corporation,

(b) Owns 5 percent or more in value of the outstanding stock of such foreign corporation when such foreign corporation is reorganized (as defined in paragraph (f)), or

(c) Disposes of sufficient stock in such foreign corporation to reduce his interest to less than 5 percent in value of the outstanding stock of such foreign corporation.

The provisions of this subparagraph may be illustrated by the following examples:

Example (1). On January 15, 1963, A, a United States person, acquires 5 percent in value of the outstanding stock of M, a foreign corporation. A must file a return under the provisions of this subparagraph.

Example (2). On January 1, 1963, B, a United States person, owns 2 percent in value of the outstanding stock of M, a foreign corporation. B is not required to file a return under the provisions of this section because he does not own 5 percent or more in value of the outstanding stock of M Corporation. On February 1, 1963, B acquires an additional 3 percent in value of the outstanding stock of M Corporation. B must file a return under the provisions of this subparagraph.

Example (3). On January 1, 1963, C, a United States person, owns 6 percent in value of the outstanding stock of M, a foreign corporation. C must file a return under the provisions of paragraph (b) of this section. On February 1, 1963, C acquires an additional 2 percent in value of the outstanding stock of M Corporation in a transaction not involving a reorganization. C is not required to file a return under the provisions of this subparagraph.

Example (4). The facts are the same as in Example (3) except that, in addition, on April 1, 1963, C acquires 2 percent in value of the outstanding stock of M Corporation in a transaction not involving a reorganization. (C's total holdings are now 10 percent.) C is not required to file a return under the provisions of this subparagraph because he has not acquired 5 percent or more in value of the outstanding stock of M Corporation since he last became liable to file a return. On May 1, 1963, C acquires 1 percent in value of the outstanding stock of M Corporation. C must file a return under the provisions of this subparagraph.

Example (5). On June 1, 1963, D, a United States person, owns 12 percent in value of the outstanding stock of M, a foreign corporation. Also, on June 1, 1963, M Corporation is reorganized and, as a result of such reorganization, D owns only 6 percent of the outstanding stock of such foreign corporation. D must file a return under the provisions of this subparagraph.

Example (6). The facts are the same as in Example (5) except that, in addition, on November 1, 1970, D donates 2 percent of the outstanding stock of M Corporation to a charity. Since D has disposed of sufficient stock to reduce his interest in M Corporation to less than 5 percent in value of the outstanding stock of such corporation, D must file a return under the provisions of this subparagraph.

(2) *Shareholders who become U.S. persons.* A return on Form 959, containing the information required by subparagraph (3) of this paragraph, shall be made by each person who at any time after Janaury 1, 1963, becomes a U.S. person while owning 5 percent or more in value of the outstanding stock of such foreign corporation.

(3) *Information required to be shown on return*—(i) *In general.* The return on Form 959, required to be filed by persons described in subparagraph (1) or (2) of this paragraph, shall set forth the same information as is required by the provisions of paragraph (b) of this section except that where such provisions require information with respect to January 1, 1963, such information shall be furnished with respect to the date on which liability arises to file the return required under this paragraph.

(ii) *Additional information.* In addition to the information required under subdivision (i) of this subparagraph, the following information shall also be furnished in the return required under this paragraph:

(a) The date on or after January 1, 1963, if any, on which such shareholder (or shareholders) last filed a return under this section with respect to the corporation;

(b) If a return is filed by reason of becoming a United States person, the date the shareholder became a United States person;

(c) If a return is filed by reason of the disposition of stock, the date and method of such disposition and the person to whom such disposition was made; and

(d) If a return is filed by reason of the organization or reorganization of the foreign corporation on or after January 1, 1963, the following information with respect to such organization or reorganization:

(1) A statement showing a detailed list of the classes and kinds of assets transferred to the foreign corporation including a description of the assets (such as a list of patents, copyrights, stock, securities, etc.), the fair market value of each asset transferred (and, if such asset is transferred by a United States person, its adjusted basis), the date of transfer, the name, address, and identifying number, if any, of the owner immediately prior to the transfer, and the consideration paid by the foreign corporation for such transfer;

(2) A statement showing the assets transferred and the notes or securities issued by the foreign corporation, the name, address, and identifying number, if any, of each person to whom such transfer or issue was made, and the consideration paid to the foreign corporation for such transfer or issue; and

(3) An analysis of the changes in the corporation's surplus accounts occurring on or after January 1, 1963.

(iii) *Exclusion of information previously furnished.* In any case where any identical item of information required to be filed under this paragraph by a shareholder with respect to a foreign corporation has previously been furnished by such shareholder in any return made in accordance with the provisions of this section, such shareholder may satisfy the requirements of this paragraph by filing Form 959, identifying such item of information, the date furnished, and stating that it is unchanged.

(d) *Associations, etc.* Returns are required to be filed in accordance with the provisions of this section with respect to any foreign association, foreign joint-stock company, or foreign insurance company, etc., which would be considered to be a corporation under §301.7701–2 of this chapter (Regulations on Procedure and Administration). Persons who would qualify by the nature of their functions and ownership in such associations, etc., as officers, directors, or shareholders thereof will be treated as such for purposes of this section without regard to their designations under local law.

(e) *Special provisions*—(1) *Return jointly made.* Any two or more persons required under paragraph (a) of this section to make a return with respect to one or more shareholders of the same corporation, or under paragraph (b) or (c) of this section to make a return with respect to the same corporation, may in lieu of making several returns, jointly make one return.

(2) *Separate return for each corporation.* When returns are required with respect to more than one foreign corporation, a separate return must be made for each corporation.

(3) *Use of power of attorney by officers or directors*—(i) *In general.* Any two or more persons required under paragraph (a) of this section to make a return with respect to one or more shareholders of the same corporation may, by means of one or more duly executed powers of attorney, constitute one of their number as attorney in fact for the purpose of making such returns or for the purpose of making a joint return under subparagraph (1) of this paragraph.

(ii) *Nature of power of attorney.* The power of attorney referred to in subdivision (i) of this subparagraph shall be limited to the making of returns required under paragraph (a) of this section and shall be limited to a single calendar year with respect to which such returns are required.

(iii) *Manner of execution of power of attorney.* The use of technical language in the preparation of the power of attorney referred to in subdivision (i) of this subparagraph is not necessary. Such power of attorney shall be signed by the individual United States citizen or resident required to file a return or returns under paragraph (a) of this section. Such power of attorney must be acknowledged before a notary public or, in lieu thereof, witnessed by two disinterested persons. The notarial seal must be affixed unless such seal is not required under the laws of the state or country wherein such power of attorney is executed.

(iv) *Manner of execution of return under authority of power of attorney.* A return made under authority of one or more powers of attorney referred to in subdivision (i) of this subparagraph shall be signed by the attorney in fact for each principal for which such attorney in fact is acting. A copy of such one or more powers of attorney shall be kept at a convenient and safe location accessible to internal revenue officers, and shall at all times be available for inspection by such officers.

(v) *Effect on penalties.* The fact that a return is made under authority of a power of attorney referred to in subdivision (i) of this subparagraph shall not affect the principal's liability for penalties provided for failure to file a return required under paragraph (a) of this section or for filing a false or fraudulent return.

(4) *Persons excepted from filing returns*—(i) *Return required of officer or director under paragraph (a)(1).* Notwithstanding paragraph (a)(1) of this section, any U.S. citizen or resident required to make a return under such paragraph with respect to shareholders of a foreign corporation, need not make such return if, on January 1, 1963, three or fewer U.S. persons own 95 percent or more in value of the outstanding stock of such foreign corporation and file a return or returns with respect to such corporation under paragraph (b) of this section.

(ii) *Return required of officer or director under paragraph (a)(2).* Notwithstanding paragraph (a)(2) of this section, any U.S. citizen or resident required to make a return under such paragraph with respect to a person acquiring stock of a foreign corporation in an acquisition described in subdivision (i)*(a)* or *(b)* of such paragraph need not make such return, if:

(a) As a result of such acquisition of stock of such foreign corporation, a U.S. person files a return as a shareholder under paragraph (c) (1) of this section, and

(b) Immediately after such acquisition of stock, three or fewer U.S. persons own 95 percent or more in value of the outstanding stock of such foreign corporation.

(iii) *Return required by reason of attribution rules.* Notwithstanding paragraph (b) or (c) of this section, any person required to make a return under such paragraph with respect to a foreign corporation need not make such return, if:

(a) Such person does not directly own an interest in the foreign corporation,

(b) Such person is required to furnish the information solely by reason of attribution of stock ownership from a U.S. person under paragraph (i) of this section, and

(c) The person from whom the stock ownership is attributed furnishes all of the information required under paragraph (b) or (c) of this section of the person to whom such stock ownership is attributed.

(iv) *Return required of officer or director with respect to person described in subdivision (iii).* Notwithstanding paragraph (a) of this section, any U.S citizen or resident required to make a return under such paragraph with respect to a person exempted under subdivision (iii) of this subparagraph from making a return need not make a return with respect to such person.

(5) *Persons excepted from furnishing items of information.* Any person required to furnish any item of information under paragraph (b) or (c) of this section with respect to a foreign corporation, may, if such item of information is furnished by another person having an equal or greater stock interest (measured in terms of value of such stock) in such foreign corporation, satisfy such requirement by filing a statement with his return on Form 959 indicating that such liability has been satisfied and identifying the return in which such item of information was included.

(f) *Meaning of terms.* For purposes of this section:

(1) *Acquisition.* Stock in a foreign corporation shall be considered acquired when a person has an unqualified right to receive such stock even though such stock is not actually issued. For example, when under the law of a foreign country, all the necessary steps for incorporation are completed but stock in the corporation will not be issued within 30 days, every United States citizen or resident who is an officer or a director of such corporation, provided a United States person has an interest of 5 percent or more in such corporation, and every such United States person shall, within 90 days of the date of incorporation, file the returns required under section 6046 and this section. In the case of a reorganization, new stock may be acquired, depending on the type of reorganization, whether or not any stock certificates are surrendered or exchanged or the designation of such stock is altered.

(2) *Reorganization.* With respect to a foreign corporation, the term ''reorganization'' shall mean not only a transaction described in section 368(a)(1) and the regulations thereunder but also any other transaction or series of transactions which has the same effect.

(3) *U.S. person.* For purposes of section 6046 and this section the term ''United States person'' has the meaning assigned to it by section 7701(a)(30) of the Code, except that:

(i) With respect to a corporation organized under the laws of the Commonwealth of Puerto Rico, such term does not include an individual who is a bona fide resident of Puerto Rico, if a dividend received by such individual during the taxable year from such corporation would, for purposes of section 933(1), be treated as income derived from sources within Puerto Rico,

(ii) With respect to a corporation organized under the laws of the Virgin Islands, such term does not include an individual who is a bona fide resident of the Virgin Islands and whose income tax obligation under subtitle A (relating to income taxes) of the Code for the taxable year is satisfied pursuant to section 28(a) of the Revised Organic Act of the Virgin Islands, approved July 22, 1954 (48 U.S.C. 1642), by paying tax on income derived from all sources both within and outside the Virgin Islands into the treasury of the Virgin Islands, and

(iii) With respect to a corporation organized under the laws of any possession of the United States (other than Puerto Rico or the Virgin Islands), such term does not include an individual who is a bona fide resident of such possession and whose income derived from sources within any possession of the United States is not, by reason of section 931(a), includible in gross income under subtitle A (relating to income taxes) of the Code for the taxable year.

The provisions of paragraph (b), (c), or (d), respectively, of § 1.957–4 shall apply for purposes of determining whether an individual is excepted under subdivision (i), (ii), or (iii), respectively, of this subparagraph from being a U.S. person with respect to a corporation described in such subdivision.

(4) *Applicable Form 959.* The Form 959 which shall be used for purposes of this section is Form 959 (Revised January 1963) or such subsequent revision of such form as may be in use at the time the liability to file a return on Form 959 arises.

(5) *Accounting period and taxable year.* In the case of a specified foreign corporation (as defined in section 898), the taxable year of such corporation shall be treated as its annual accounting period.

(g) *Method of reporting.* All amounts furnished in returns prescribed under this section shall be expressed in United States currency with a statement of the exchange rates used. All statements required to be submitted on or with returns under this section shall be rendered in the English language. For taxable years ending after December 31, 1994, with respect to returns filed after December 31, 1995, all amounts furnished under paragraph (c) of this section shall be expressed in United States dollars computed and translated in conformity with United States generally accepted accounting principles. Amounts furnished under paragraph (c)(3)(i) of this section shall also be furnished in the foreign corporation's functional currency as required on the form. Information described in paragraphs (b)(10) and (c)(3) of this section shall be submitted in such form or manner as the form shall prescribe. If an individual who is a United States person required to make a return with respect to a foreign corporation under section 6046 is entitled under a treaty to be treated as a nonresident of the United States, and if the individual claims this treaty benefit, and if there are no other United States persons that are required to furnish information under section 6046 with respect to the foreign corporation, then the individual may satisfy the requirements of paragraphs (b)(10), (11) and (12), (c)(3)(ii)(*d*), and (g) of this section by filing the audited foreign financial statements of the foreign corporation with the individual's return required under section 6046.

(h) *Actual ownership of stock.* If any shareholder, referred to in this section, is not the actual owner of the stock of the foreign corporation, the information required under this section shall be furnished in the name of and by such actual owner. For example, in the case of stock held by a nominee, the information required under this section shall be furnished by the actual owner of such stock.

(i) *Constructive ownership of stock*—(1) *In general.* Stock owned directly or indirectly by or for a foreign corporation or a foreign partnership shall be considered as being owned proportionately by its shareholders or partners. Thus, any United States person who is a member of a nonresident foreign partnership which becomes a shareholder in a foreign corporation shall be considered to be a shareholder in such foreign corporation to the extent of his proportionate share in such partnership.

(2) *Members of family.* An individual shall be considered as owning the stock owned directly or indirectly by or for his brothers and sisters (whether by the whole or half blood), his spouse, his ancestors, and his lineal descendants. However, when stock is treated as owned by an individual under the rule provided in this subparagraph, it shall not be treated as owned by him for the purpose of again applying such rule in order to make another the constructive owner of such stock. The provisions of this subparagraph may be illustrated by the following example:

Example. H, W, and HF are United States citizens. W, wife of H, owns 20 percent of the value of the outstanding stock of X, a foreign corporation. X Corporation owns 90 percent of the value of the outstanding stock of Y Corporation, a foreign corporation. Y Corporation becomes the owner of 50 percent of the value of the outstanding stock of each of two newly organized foreign corporations, M and N. In applying the ''members of family'' rule, H is considered to own 20 percent of the value of the outstanding stock of X Corporation, and 18 percent of the value of the outstanding stock of Y Corporation, and 9 percent of M Corporation and N Corporation. However, HF, the father of H, is not considered to own stock of X, Y, M, or N since his son, H, is not treated as the owner of such stock for purposes of again applying the ''members of family'' rule.

(j) *Time and place for filing return*—(1) *Time for filing.* Any return required by section 6046 and this section shall be filed on or before the 90th day after the date on which a United States citizen, resident, or person becomes liable to file such return under any provision of section 6046(a) and of paragraph (a), (b), or (c) of this section. With respect to returns filed after September 3, 1982, such return shall be filed on or before such later date (if any) as may be authorized by the return form. The Director of the Internal Revenue Service Center where the return is required to be filed is authorized to grant reasonable extensions of time for filing returns under section 6046 and this section in accordance with the applicable provisions of section 6081(a) and §1.6081–1.

(2) *Place for filing.* Returns required by section 6046 and this section shall be filed with the Internal Revenue Service Center designated in the instructions of the applicable form.

(k) *Penalties.* (1) For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203, 7206, and 7207.

(2) For civil penalty for failure to file return, or failure to show information required on a return, under this section, see section 6679.

(Approved by the Office of Management and Budget under control number 1545-0794)

[T.D. 6623, 27 FR 11882, Dec. 1, 1962, as amended by T.D. 6997, 34 FR 932, Jan. 22, 1969; T.D. 7322, 39 FR 30932, Aug. 27, 1974; T.D. 7925, 48 FR 55454, Dec. 13, 1983; T.D. 8573, 59 FR 64302, Dec. 14, 1994; T.D. 8733, 62 FR 53385, Oct. 14, 1997]

§1.6046–2 Returns as to foreign corporations which are created or organized, or reorganized, on or after September 15, 1960, and before January 1, 1963.

(a) *Requirement of returns.* In the case of any foreign corporation which is created or organized, or reorganized, on or after September 15, 1960, and before January 1, 1963:

(1) Each United States citizen or resident who was an officer or director of such corporation at any time within 60 days after such creation or organization, or reorganization, and

(2) Each United States shareholder of such corporation by or for whom, at any time within 60 days after such creation or organization, or reorganization, 5 percent or more in value of such corporation's then outstanding stock was owned directly or indirectly (including, in the case of an individual stock owned by members of his family),

shall file a return on Form 959 (Rev. Oct. 1960), United States Information Return With Respect to the Creation or Organization, or Reorganization, of a Foreign Corporation.

(b) *Information required to be shown on return.* The return required by section 6046, prior to its amendment by section 20(b) of the Revenue Act of 1962, and this section shall set forth the following information:

(1) The name and address of the person (or persons) filing the return, and an indication that he is a United States shareholder, officer, or director;

(2) The name and business address of the foreign corporation;

(3) The name of the country under the laws of which the foreign corporation was created or organized, or reorganized;

(4) The name and address of the foreign corporation's statutory or resident agent in the country of incorporation;

(5) The date of the foreign corporation's creation or organization, or reorganization;

(6) A statement of the manner in which the creation or organization, or reorganization, of the foreign corporation was effected;

(7) A complete statement of the reasons for, and the purposes sought to be accomplished by, the creation or organization, or reorganization, of the foreign corporation;

(8) A statement showing the classes and kinds of assets transferred to the foreign corporation in connection with its creation or organization, or reorganization, including a list completely describing each asset or group of assets, its value, date of transfer, and the name and address of person (or persons) owning such asset or group immediately prior to the transfer;

(9) A statement showing the assets transferred and the securities issued by the foreign corporation in its creation or organization or reorganization, as well as the name and address of each person to whom such a transfer or issuance was made;

(10) A statement specifying the amount and type of any indebtedness due from the foreign corporation to each of its shareholders and the name of each such shareholder;

(11) The names and addresses of the shareholders of the foreign corporation at the time of its creation or organization or reorganization, and the classes of stock and number of shares held by each;

(12) The names and addresses of subscribers to the stock of the foreign corporation, and the number of shares subscribed to by each; and

(13) The name and address of the person (or persons) having custody of the books of account and records of the foreign corporation, and the location of such books and records if different from such address.

(c) *Time and place for filing return.* The return required by section 6046, prior to its amendment by section 20(b) of the Revenue Act of 1962, and this section shall be filed with the Internal Revenue Service Center designated in the instructions of the applicable form. Such return shall be filed on or before the 90th day after the date such foreign corporation is created or organized, or reorganized.

[T.D. 6623, 27 FR 11882, Dec. 1, 1962, as amended by T.D. 7322, 39 FR 30932, Aug. 27, 1974]

§ 1.6046–3 Returns as to formation or reorganization of foreign corporations prior to September 15, 1960.

(a) *Requirement of returns.* Every attorney, accountant, fiduciary, bank, trust company, financial institution, or other person, who, on or before September 14, 1960, aids, assists, counsels, or advises in, or with respect to, the formation, organization, or reorganization of any foreign corporation shall file an information return on Form 959 (as in use prior to the October 1960 revision). The return must be filed in every such case regardless of:

(1) The nature of the counsel or advice given, whether for or against the formation, organization, or reorganization of the foreign corporation, or the nature of the aid or assistance rendered, and

(2) The action taken upon the advice or counsel, that is, whether the foreign corporation is actually formed, organized or reorganized.

(b) *Special provisions*—(1) *Employers.* In the case of aid, assistance, counsel, or advice in, or with respect to, the formation, organization, or reorganization of a foreign corporation given by a person in whole or in part through the medium of employees (including, in the case of a corporation, the officers thereof), the return made by the employer must set forth in detail the information required by this section including that which, as an incident to such employment, is within the possession or knowledge or under the control of such employees.

(2) *Employees.* The obligation of an employee (including, in the case of a corporation, the officers thereof) to file a return with respect to any aid, assistance, counsel, or advice in or with respect to the formation, organization, or reorganization of a foreign corporation, given as an incident to his employment, will be satisfied if a return as prescribed by this section is duly filed by the employer. Clerks, stenographers, and other employees rendering aid or assistance solely of a clerical or mechanical character in or with respect to the formation, organization, or reorganization of a foreign corporation are not required to file returns by reason of such services.

(3) *Partners.* In the case of aid, assistance, counsel, or advice in, or with respect to, the formation, organization, or reorganization of a foreign corporation given by one or more members of a partnership in the course of its business, the obligation of each such individual member to file a return will be satisfied if a return as prescribed by this section is duly filed by the partnership executed by all the members of the firm who gave any such aid, assistance, counsel, or advice. If, however, the partnership has been dissolved at the time the return is due, individual returns must be filed by each member of the former partnership who gave any such aid, assistance, counsel, or advice.

(4) *Return jointly made.* If two or more persons aid, assist, counsel, or advise in, or with respect to, the formation, organization, or reorganization of a particular foreign corporation, any two or more of such persons may, in lieu of filing several returns, jointly execute and file one return.

(5) *Separate return for each corporation.* If a person aids, assists, counsels, or advises in, or with respect to, the formation, organization, or reorganization of more than one foreign corporation, a separate return must be filed with respect to each foreign corporation.

(c) *Information required to be shown on return.* The return required by section 6046, prior to its amendment by section 7(a) of the Act of September 14, 1960, and this section shall set forth the following information to the extent the information is within the possession or knowledge, or under the control, of the person filing the return:

(1) The name and address of the person (or persons) to whom, and the person (or persons) for whom, or on whose behalf, the aid, assistance, counsel, or advice was given;

(2) The name and address of the foreign corporation and the country under the laws of which it was formed, organized, or reorganized;

(3) The month and year when the foreign corporation was formed, organized, or reorganized;

(4) A statement of the manner in which the formation, organization, or reorganization of the foreign corporation was effected;

(5) A complete statement of the reasons for, and the purposes sought to be accomplished by, the formation, organization, or reorganization of the foreign corporation;

(6) A statement showing the classes and kinds of assets transferred to the foreign corporation in connection with its formation, organization, or reorganization, including a detailed list of any stock or securities included in such assets, and a statement showing the names and addresses of the persons who were the owners of such assets immediately prior to the transfer;

(7) The names and addresses of the shareholders of the foreign corporation at the time of the completion of its formation, organization, or reorganization, showing the classes of stock and number of shares held by each and, in the case of Forms 959 filed after December 31, 1958, the names and addresses of the subscribers to the stock of the foreign corporation and the number of shares subscribed to by each;

(8) The name and address of the person (or persons) having custody of the books of account and records of the foreign corporation; and

(9) Such other information as is required by the return form.

(d) *Privileged communications.* An attorney-at-law is not required to file a return with respect to any advice given or information obtained through the relationship of attorney and client.

(e) *Time and place for filing return*—(1) *Time for filing.* Returns required by section 6046, prior to its amendment by section 7(a) of the Act of September 14, 1960, and this section shall be filed within 30 days after the first performance of any of the functions referred to in paragraph (a) of this section. If in a particular case, the aid, assistance, counsel, or advice given by any person extends over a period of more than one day, such person, to avoid multiple filing of returns, shall file a return within 30 days after either of the following events:

(i) The formation, organization, or reorganization of the foreign corporation, or

(ii) The termination of his aid, assistance, counsel, or advice in, or with respect to, the formation, organization, or reorganization of the foreign corporation.

(2) *Place for filing.* Returns required by section 6046 of the Internal Revenue Code of 1954 and this section shall be filed with the Internal Revenue Service Center designated in the instructions of the applicable form.

(f) *Penalties.* For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203, 7206, and 7207.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6623, 27 FR 11882, Dec. 1, 1962; T.D. 7322, 39 FR 30932, Aug. 27, 1974]

§ 1.6047–1 Information to be furnished with regard to employee retirement plan covering an owner-employee.

(a) *Trustees and insurance companies*—(1) *Requirement of return.* (i) Every trustee of a trust described in section 401(a) and exempt from tax under section 501(a) which makes payments of amounts described in subparagraph (2) of this paragraph aggregating $10 or more during any calendar year to an individual (or his beneficiary) who was covered, within the meaning of paragraph (a)(2) of § 1.401–10, as an owner-employee under the plan of which such trust is a part shall make a return on Forms 1096 and 1099 for such year showing the name and address of the person to whom paid, the aggregate amount of such payments, specifically identified as an amount to which this paragraph applies, and such other information as is required by the forms. A separate Form 1099 shall be filed with respect to each payee. The term ''owner-employee'' means an owner-employee as defined in section 401(c)(3) and paragraph (d) of § 1.401–10. Any custodial account which satisfies the requirements of section 401(f) shall be treated as a qualified trust and the custodian of such a custodial account must comply with the requirements of this section as if he were the trustee.

(ii) Every issuer of a contract which is treated as an annuity contract under sections 401 through 404 purchased by a trust described in section 401(a) and exempt from tax under section 501(a) or under a plan described in section 403(a) which makes payments of amounts described in subparagraph (2) of this paragraph aggregating $10 or more during any calendar year to an individual (or his beneficiary) who was covered, within the meaning of paragraph (a)(2) of § 1.401–10, as an owner-employee under the plan of which such trust is a part or under which such contract was purchased shall make a return on Forms 1096 and 1099 for such year showing the name and address of the person to whom paid, the aggregate amount of such payments, specifically identified as an amount to which this paragraph applies, and such other information as is required by the form. A separate Form 1099 shall be filed with respect to each payee.

(2) *Amounts subject to this section.* The amounts subject to reporting under subparagraph (1) of this paragraph include all amounts distributed or made available to which section 402(a) (relating to employees' trusts) or section 403(a) (relating to employee annuity plans) applies, whether or not such amounts are includible in gross income and whether or not attributable to contributions made while the individual to whom they relate was an owner-employee. However, amounts subject to reporting do not include any amounts distributed or made available by the trustee of any trust or the issuer of any contract under any plan with respect to which he has not received the notification provided in either subparagraph (3) of this paragraph or paragraph (b) of this section. Amounts distributed or made available under the plan include, for example, amounts received by the individual as loans on contracts purchased under the plan, and payments made to the individual by reason of the surrender of contracts purchased under the plan, whether or not prior to their maturity.

(3) *Notification by trustee.* The trustee of any trust described in section 401(a) and exempt from tax under section 501(a) who receives notification from any owner-employee that contributions have been made to the trust on behalf of that owner-employee as an owner-employee shall notify in writing the issuer of any contract which is treated as an annuity contract under sections 401 through 404 purchased by the trust for the benefit of that owner-employee that such contributions have been made to such trust. Such notification shall be delivered to such issuer at the time such contract is purchased or within 90 days after the notification required by paragraph (b) of this section is received by the trustee, whichever is later. Only one such notification must be made with respect to any contract.

(4) *Record keeping.* Any trustee, insurance company, or other person, which is referred to in subparagraph (1) of this paragraph and which is notified under section 6047(b) that contributions to the trust or under the plan have been made on behalf of an owner-employee shall maintain a record of such notification until all funds of the

trust or under the plan on behalf of the owner-employee have been distributed.

(5) *Inclusion of other payments.* The Form 1099 filed under this section by any person with respect to payments to another person during a calendar year may, at the election of the maker, include other payments made by him to such other person during such year which are required to be reported on Form 1099.

(6) *Time and place for filing.* The return required under this section for any calendar year shall be filed after the close of that year and on or before February 28 of the following year with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for Form 1096. For extensions of time for filing returns under this section, see §1.6081–1.

(b) *Notification by owner-employee.* Any owner-employee on behalf of whom contributions are made to a trust described in section 401(a) and exempt under section 501(a) or under a plan described in section 403(a) shall notify in writing:

(1) The trustee of such a trust, or

(2) The issuer of any contract which is treated as an annuity contract under sections 401 through 404 under such plan,

that such contributions have been made to such trust or plan. Such notification shall be delivered to such trustee or such issuer during the first calendar year in which such contributions are made or on or before February 28 of the year following such year. Only one such notification must be made with respect to any contract or any trust.

(c) *Penalties.* For civil penalty for failure to file a return required by this section, and for criminal penalty for furnishing fraudulent information under this section, see §§301.6652–3 and 301.7207–1 respectively.

(d) *Permission to submit information required by Form 1099 on magnetic tape.* For rules relating to permission to submit the information required by Form 1099 on magnetic tape or other media, see §1.9101–1.

[T.D. 6677, 28 FR 10147, Sept. 17, 1963, as amended by T.D. 6883, 31 FR 6589, May 3, 1966; T.D. 7551, 43 FR 29292, July 7, 1978]

§1.6049–1 Returns of information as to interest paid in calendar years before 1983 and original issue discount includible in gross income for calendar years before 1983.

(a) *Requirement of reporting*—(1) *In general.* (i) Every person who makes payments of interest (as defined in §1.6049–2) aggregating $10 or more to any other person during a calendar year before 1983 shall make an information return on Forms 1096 and 1099 for such calendar year showing the aggregate amount of such payments, the name and address of the person to whom paid, the total of such payments for all persons, and such other information as is required by the forms.In the case of interest paid during calendar years beginning with 1963 and continuing until such time as the Commissioner determines that it is feasible to aggregate payments on two or more accounts, insurance contracts, or investment certificates and this subdivision is amended accordingly to provide for reporting on an aggregate basis, the requirement of this subdivision for the filing of Form 1099 will be met if a person making payments of interest to another person on two or more such accounts, insurance contracts, or investment certificates, files a separate Form 1099 with respect to each such account, contract, or certificate on which $10 or more of interest is paid to such other person during the calendar year. In the case of evidences of indebtedness described in section 6049(b)(1)(A), separate Forms 1099 may be filed as provided in the preceding sentence with respect to holdings in different issues. Thus, if a bank pays to a person interest totaling $15 on one account and $20 on a second account, it may file separate Forms 1099 with respect to the payments of $15 and $20. If the interest on the second account totaled $5 instead of $20, no return would be required with respect to the $5.

(ii)*(a)* Every person which is a corporation that has outstanding any bond, debenture, note, or certificate or other evidence of indebtedness (referred to in this section and §1.6049–2 as an obligation) in ‘‘registered form’’ (as defined in paragraph (d) of §1.6049–2) issued after May 27, 1969 (other than an obligation issued by a corporation pursuant to a written commitment which was binding on May 27, 1969, and at all times thereafter) and on or before December 31, 1982, as to which there is during any calendar year before 1983 an amount of original issue discount (as defined in § 1.6049–2) aggregating $10 or more includible as interest in the gross income for such calendar year of any holder (determined, if semiannual record date reporting is being used under *(b)(1)* of this subdivision, by treating each holder as holding the obligation on every day it was outstanding during the calendar year), shall make an information return on Forms 1096 and 1099–OID for such calendar year showing the following:

(1) The name and address of each record holder for whom such aggregate amount of original issue discount is $10 or more and, for calendar years subsequent to 1972, the account, serial, or other identifying number of each obligation for which a return is being made.

(2) The aggregate amount of original issue discount includible by each such holder for the period during the calendar year for which the return is made (or, if the aggregation rules of *(b)(2)* of this subdivision are being used, that he held the obligations). If however, the semiannual record date reporting rules are being used under *(b)(1)* of this subdivision, such aggregate amount shall be determined by treating each such record date holder as if he held each such obligation on every day it was outstanding during the calendar year. For purposes of this section, an obligation shall be considered to be outstanding from the date of original issue (as defined in paragraph (b)(3) of § 1.1232–3). In the case of a time deposit open account arrangement to which paragraph (e)(5) of § 1.1232–3A applies, for example, the amount to be shown under this subdivision *(2)* on the Forms 1096 and 1099–OID is the sum (computed under such paragraph (e)(5)) of the amounts separately computed for each deposit made pursuant to the arrangement.

(3) The issue price of the obligation (as defined in paragraph (b)(2) of § 1.1232–3).

(4) The stated redemption price of the obligation at maturity (as defined in paragraph (b)(1)(iii) of § 1.1232–3).

(5) The ratable monthly portion of original issue discount with respect to the obligation as defined in section 1232(a)(3)(A) (determined without regard to a reduction for a purchase allowance or whether the holder purchased at a premium).

(6) The name and address of the person filing the form.

(7) Such other information as is required by the form. And,

(8) The sum, for all such holders of the aggregate amounts of such original issue discount includible for such calendar year for each such holder.

(b) With respect to any obligation (other than an obligation to which paragraph (e) or (f) of § 1.1232–3A applies (relating respectively to deposits in banks and similar financial institutions and to face-amount certificates)), the issuing corporation (or an agent acting on its behalf):

(1) Shall be permitted (until this subdivision *(1)* is amended) to prepare a Form 1099–OID only for each person who is a holder of record of the obligation on the semiannual record date (if any) used by the corporation (or agent) for the payment of stated interest or, if there is no such date, the semiannual record dates shall be considered to be June 30, and December 31.

(2) Shall be permitted to aggregate all original issue discount with respect to 2 or more obligations of the same issue for which the amounts specified in *(a)(2)*, *(a)(3)*, *(a)(4)*, and *(a)(5)* of this subdivision are proportional and, therefore, may file one Form 1099–OID for all such obligations being aggregated, except that for calendar year 1971 this aggregation rule shall apply only where such specified amounts are identical. For an illustration of proportional aggregation, see example (4) in *(d)* of this subdivision.

(c) In any case in which any one holder of a particular obligation for the calendar year held such obligation on more than one record date, only one Form 1099–OID shall be filed for that year with respect to that holder and that obligation. This provision applies

only in the case in which any corporation prepares Forms 1099–OID in accordance with the record date reporting rule of *(b)(1)* of this subdivision.

(d) The requirements of *(a)(3), (a)(4),* and *(a)(5)* of this subdivision shall not apply to a time deposit open account arrangement to which paragraph (e)(5) of § 1.1232–3A applies, or to a face-amount certificate to which paragraph (f) of § 1.1232–3A applies.

(e) The provisions of this subdivision (ii) may be illustrated by the following examples:

Example (1). On January 1, 1971, a corporation issued a 10-year bond in registered form which pays stated interest to the holder of record on June 30 and December 31. The bond has an issue price (as defined in paragraph (b)(2) of § 1.1232–3) of $7,600, a stated redemption price (as defined in paragraph (b)(1) of § 1.1232–3) at maturity of $10,000, and a ratable monthly portion of original issue discount (as defined in section 1232(a)(3)(A)) of $20. The corporation's books indicate that A was the holder of record on June 30, 1971, and B was the holder on December 31, 1971. Under *(b)(1)* of this subdivision, the corporation is permitted to file separate Forms 1099–OID for both A and B showing, on each form, all items required by *(a)* of this subdivision, including the total original issue discount of $240 for the entire calendar year (which includes original issue discount for all holders), the issue price of $7,600, the stated redemption price at maturity of $10,000, and the ratable monthly portion of original issue discount of $20.

Example (2). Assume the facts stated in Example (1), except that A is recorded on the books of the corporation as holding the bond on June 30 and December 31, 1971. The corporation shall complete and file only one Form 1099–OID for A.

Example (3). Assume the facts stated in Example (1), except that the books of the corporation show that A held 2 of the bonds at all times in 1971. The amounts of the items listed in *(a)*(2), *(a)*(3), *(a)*(4), and *(a)*(5) of this subdivision are identical for the 2 bonds. Under *(b)*(2) of this subdivision, the corporation is permitted to treat the 2 bonds as one for purposes of completing and filing a Form 1099–OID for 1971 and aggregate the amounts being reported.

Example (4). On January 1, 1972, a corporation issued to C 3 bonds in registered form of the same issue with stated redemption prices of $1,000, $5,000, and $10,000. The aggregate amounts of original issue discount for each year, the issue prices, the stated redemption prices, and the monthly portions of original issue discount are the same for each $1,000 of stated redemption price. Thus, all relevant amounts for any one bond are proportional to such amounts for any other bond. Therefore, so long as C holds the bonds the corporation shall be permitted to aggregate on one Form 1099–OID all original issue discount with respect to such obligations in accordance with *(b)(2)* of this subdivision.

Example (5). On June 1, 1971, a corporation issues a 10-year bond to D, for which the ratable monthly portion of original issue discount is $10. For 1971, the corporation uses the record date reporting system permitted by *(b)(1)* of this subdivision. The corporation's books show that E held the bond on June 30, 1971, and that F held the bond on December 31, 1971, the dates on which the corporation pays stated interest on the bond. The corporation shall file a Form 1099–OID for both E and F showing on each form the aggregate amount of original issue discount includible for 1971 or $70 since E and F are each treated as if each held the bond every day it was outstanding and it was outstanding 7 months in 1971. As to D, the corporation is not required to file a Form 1099–OID since D did not hold the bond on either of the 2 record dates.

(iii) Every person who during a calendar year before 1983 receives payments of interest as a nominee on behalf of another person aggregating $10 or more shall make an information return on Forms 1096 and 1087 for such calendar year showing the aggregate amount of such interest, the name and address of the person on whose behalf received, the total of such interest received on behalf of all persons, and such other information as is required by the forms.

(iv) Except with respect to an obligation to which paragraph (e) or (f) of § 1.1232–3A applies (relating respectively to deposits in banks and similar financial institutions and to face-amount certificates), every person who is a nominee on behalf of the actual owner of an obligation as to which there is original issue discount aggregating $10 or more includible in the gross income of such owner during a calendar year before 1983, regardless of whether he receives a Form 1099–OID with respect to such discount, shall make an information return on Forms 1096 and 1087–OID for such calendar year showing in the manner prescribed on such forms the same information for the actual owner as is required or permitted in subdivision (ii) of this subparagraph for the record holder.

(v) Notwithstanding the provisions of subdivisions (iii) and (iv) of this subparagraph, the filing of Form 1087 or Form 1087–OID is not required if:

(a) The record owner is required to file a fiduciary return on Form 1041 disclosing the name, address, and identifying number of the actual owner;

(b) The record owner is a nominee of a banking institution or trust company exercising trust powers, and such banking institution or trust company is required to file a fiduciary return on Form 1041 disclosing the name, address, and identifying number of the actual owner; or

(c) The record owner is a banking institution or trust company exercising trust powers, or a nominee thereof, and the actual owner is an organization exempt from taxation under section 501(a) for which such banking institution or trust company files an annual return,

but only if the name, address, and identifying number of the record owner are included on or with the Form 1041 fiduciary return filed for the estate or trust or the annual return filed for the tax exempt organization.

(vi) Every person carrying on the banking business who makes payments of interest to another person (whether or not aggregating $10 or more) during a calendar year with respect to a certificate of deposit issued in bearer form (other than such a certificate issued in an amount of $100,000 or more) shall make an information return on Forms 1096 and 1099–BCD for such calendar year. The preceding sentence applies whether such payments are made during the term of the certificate or at its redemption. The information return required by this subdivision for the calendar year shall show the following:

(*a*) The name, address, and taxpayer identification number of the person to whom the interest is paid;

(*b*) The aggregate amount of interest paid to such person during the calendar year with respect to the certificate of deposit;

(*c*) The name, address, and taxpayer identification number of the person to whom the certificate was originally issued;

(*d*) The portion of the interest with respect to the certificate reported under (*b*) that is attibutable to the current calendar year; and

(*e*) Such other information as is required by the form.

The application of this subdivision (vi) may be illustrated by the following examples:

Example (1). On June 1, 1978, X Bank issues a $1,000 bearer certificate of deposit to A. The certificate of deposit is not redeemable until May 31, 1979, and no interest is to be paid on the instrument until its redemption. On September 1, 1978. A transfers the bearer certificate to B and on May 31, 1979, B presents the certificate to X for payment and receives the $1,000 principal amount plus all the accrued interest. Under paragraph (a)(1)(vi) of this section, X is not required to make an information return for 1978 with respect to the bearer certificate of deposit because no interest is actually paid to a holder of the certificate during 1978. X is required to file an information return for 1979 with respect to the certificate, identifying B as the payee of the entire amount of the interest and A as the original purchaser of the certificate. (For rules relating to statements to be made to recipients of interest payments, see § 1.6049–3.)

Example (2). On July 1, 1978, Y Bank issues a $5,000 bearer certificate of deposit to C. The certificate of deposit is not redeemable until June 30, 1981, and no interest is to be paid on the instrument until its redemption. C holds the certificate for the entire term and on June 30, 1981, presents it to Y for payment and receives the $5,000 principal amount plus the accrued interest. Under paragraph (a)(1)(vi) of this section, Y is not required to file an information return for calendar years 1978, 1979, or 1980 with respect to this bearer certificate of deposit because no interest is acutally paid to C during those calendar years. Y is required to file an information return for 1981 with respect to the certificate identifying C as the payee of the entire amount of the interest and as the original purchaser. (Although Y is not required to file an information return for interest paid on the certificate until its redemption in 1981, C must report as income on his tax returns for 1978, 1979, 1980, and 1981 the ratable portion of such interest includible in income under section 1232.)

(2) *Definitions.* (i) The term ''person'' when used in this section does not include the United States, a State, the District of Columbia, a foreign government, a political subdivision of a State or of a foreign government, or an international organization. Therefore, interest paid by or to one of these entities

need not be reported. Similarly, original issue discount in respect of an obligation issued by or to one of these entities need not be reported.

(ii) For purposes of this section, a person who receives interest shall be considered to have received it as a nominee if he is not the actual owner of such interest and if he was required under §1.6109–1 to furnish his identifying number to the payer of the interest (or would have been so required if the total of such interest for the year had been $10 or more), and such number was (or would have been) required to be included on an information return filed by the payer with respect to the interest. However, a person shall not be considered to be a nominee as to any portion of an interest payment which is actually owned by another person whose name is also shown on the information return filed by the payer or nominee with respect to such interest payment. Thus, in the case of a savings account jointly owned by a husband and wife, the husband will not be considered as receiving any portion of the interest on that account as a nominee for his wife if his wife's name is included on the information return filed by the payer with respect to the interest.

(iii) For purposes of this section, in the case of a person who receives a Form 1099–OID, the determination of who is considered a nominee shall be made in a manner consistent with the principles of subdivision (ii) of this subparagraph.

(iv) For purposes of this section and §1.6049–3, the term ''Form 1099–OID'' means the appropriate Form 1099 for original issue discount prescribed for the calendar year.

(3) *Determination of person to whom interest is paid or for whom it is received.* For purposes of applying the provisions of this section, the person whose identifying number is required to be included by the payer of interest on an information return with respect to such interest shall be considered the person to whom the interest is paid. In the case of interest received by a nominee on behalf of another person, the person whose identifying number is required to be included on an information return made by the nominee with respect to such interest shall be considered the person on whose behalf such interest is received by the nominee. Thus, in the case of interest made payable to a person other than the record owner of the obligation with respect to which the interest is paid, the record owner of the obligation shall be considered the person to whom the interest is paid for purposes of applying the reporting requirements of this section, since his identifying number is required to be included on the information return filed under such section by the payer of the interest. Similarly, if a stockbroker receives interest on a bond held in street name for the joint account of a husband and wife, the interest is considered as received on behalf of the husband since his identifying number should be shown on the information return filed by the nominee under this section. Thus, if the wife has a separate account with the same stockbroker, any interest received by the stockbroker for her separate account should not be aggregated with the interest received for the joint account for purposes of information reporting. For regulations relating to the use of identifying numbers, see §1.6109–1.

(4) *Determination of person by whom original issue discount is includible or for whom a Form 1099–OID showing original issue discount is received.* For purposes of applying the provisions of this section, the determination of the person by whom original issue discount is includible or for whom a Form 1099–OID is received shall be made in a manner consistent with the principles of subparagraph (3) of this paragraph.

(5) *Inclusion of other payments.* The Form 1099 filed by any person with respect to payments of interest to another person during a calendar year prior to 1972 may, at the election of the maker, include payments other than interest made by him to such other person during such year which are required to be reported on Form 1099. Similarly, the Form 1087 filed by a nominee with respect to payments of interest received by him on behalf of any other person during a calendar year prior to 1972 may include payments of dividends received by him on behalf of such person during such year

which are required to be reported on Form 1087. However, except as provided in subparagraph (1)(ii) *(b)* of this paragraph, a separate Form 1087–OID or 1099–OID shall be filed for each obligation in respect of which original issue discount is required to be reported for any calendar year before 1983. In addition, any person required to report payments on both Forms 1087, 1087–OID, 1099, and 1099–OID, for any calendar year may use one Form 1096 to summarize and transmit such forms.

(b) *When payment deemed made.* For purposes of section 6049, interest is deemed to have been paid when it is credited or set apart to a person without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and is made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition.

(c) *Time and place for filing*—(1) *Payment of interest.* The returns required under this section for any calendar year for the payment of interest shall be filed after September 30 of such year, but not before the payer's final payment for the year, and on or before February 28 of the following year with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for Form 1096. For extensions of time for filing returns under this section, see § 1.6081–1.

(2) *Original issue discount.* (i) The returns required under this section for any calendar year for original issue discount shall be filed after December 31 of such year and on or before February 28 of the following year with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for Form 1096. For extensions of time for filing returns under this section, see § 1.6081–1.

(ii) The time for filing returns for the calendar year 1971 required under this section for original issue discount in respect of obligations to which paragraph (e) of § 1.1232–3A applies (relating to deposits in banks and other similar financial institutions) is extended to April 15, 1972.

(d) *Penalty.* For penalty for failure to file the statements required by this section, see § 301.6652–1 of this chapter (Regulations on Procedure and Administration).

(e) *Permission to submit information required by Form 1087 or 1099 on magnetic tape.* For rules relating to permission to submit the information required by Form 1087 or 1099 on magnetic tape or other media, see § 1.9101–1.

(Secs. 6049 (a), (b), and (d) and 7805 of the Internal Revenue Code of 1954 (96 Stat. 592, 594; 26 U.S.C. 6049 (a), (b), and (d); 68A Stat. 917, 26 U.S.C. 7805), and in sec. 309 of the Tax Equity and Fiscal Responsibility Act of 1982 (96 Stat. 591)

[T.D. 6628, 27 FR 12800, Dec. 28, 1962, as amended by T.D. 6879, 31 FR 3494, Mar. 8, 1966; T.D. 6883, 31 FR 6589, May 8, 1966; T.D. 7000, 34 FR 996, Jan. 23, 1969, T.D. 7154, 36 FR 25009, Dec. 28, 1971; 37 FR 527, Jan. 13, 1972; T.D. 7311, 39 FR 11881, Apr. 1, 1974; T.D. 7584, 44 FR 1103, Jan. 4, 1979; T.D. 7881, 48 FR 12968, Mar. 28, 1983]

§ 1.6049–2 Interest and original issue discount subject to reporting in calendar years before 1983.

(a) *Interest in general.* Except as provided in paragraph (b) of this section, the term ''interest'' when used in this section and §§ 1.6049–1 and 1.6049–3 means:

(1) Interest on evidences of indebtedness issued by a corporation in ''registered form'' (as defined in paragraph (d) of this section). The phrase ''evidences of indebtedness'' includes bond, debentures, notes, certificates and other similar instruments regardless of how denominated.

(2) Interest on deposits (except deposits evidenced by negotiable time certificates of deposit issued in an amount of $100,000 or more) paid (or credited) by persons carrying on the banking business. In the case of a certificate of deposit issued in bearer form, the term ''interest'', as used in the preceding sentence and in paragraph (a)(1)(vi) of § 1.6049–1, has the same meaning as in §1.61–7 (regardless of whether taxable to the payee in the year the information return is made).

(3) Amounts, whether or not designated as interest, paid (or credited) by mutual savings banks, savings and loan associations, building and loan associations, cooperative banks, homestead associations, credit unions, or

similar organizations in respect of deposits, face amount certificates, investment certificates, or withdrawable or repurchasable shares. Thus, even though amounts paid or credited by such organizations with respect to deposits are designated as ''dividends'', such amounts are included in the definition of interest for purposes of section 6049.

(4) Interest on amounts held by insurance companies under agreements to pay interest thereon. This includes interest paid by insurance companies with respect to policy ''dividend'' accumulations (see sections 61 and 451 and the regulations thereunder for rules as to when such interest is considered paid), and interest paid with respect to the proceeds of insurance policies left with the insurer. The so-called ''interest element'' in the case of annuity or installment payments under life insurance or endowment contracts does not constitute interest for purposes of this section.

(5) Interest on deposits with stockbrokers, bondbrokers, and other persons engaged in the business of dealing in securities.

(b) *Exceptions.* The term ''interest'' when used in section 6049 does not include:

(1) Interest on obligations described in section 103(a) (1) or (3), relating to certain governmental obligations.

(2) Any payment by:

(i) A foreign corporation,

(ii) A nonresident alien individual, or

(iii) A partnership composed in whole or in part of nonresident aliens,

if such corporation, individual, or partnership is not engaged in trade or business within the United States and does not have an office or place of business or a fiscal or paying agent in the United States.

(3) Any interest which is subject to withholding under section 1441 or 1442 (relating to withholding of tax on nonresident aliens and foreign corporations, respectively) by the person making the payment, or which would be so subject to withholding but for the provisions of a treaty, or for the fact that under section 861(a)(1) it is not from sources within the United States, or for the fact that withholding is not required by reason of paragraph (a) or (f) of §1.1441–4.

(4) In the case of a nominee, any interest which he receives and with respect to which he is required to withhold under section 1441 or 1442, or would be so required to withhold but for the provisions of a treaty, or for the fact that under section 861(a)(1) it is not from sources within the United States, or for the fact that withholding is not required by reason of paragraph (a) or (f) of §1.1441–4.

(5) Any amount on which the person making the payment is required to deduct and withhold a tax under section 1451 (relating to tax-free covenant bonds), or would be so required but for section 1451(d) (relating to benefit of personal exemptions).

(6) Any amount which is subject to reporting as original issue discount.

(c) *Original issue discount*—(1) *In general.* The term ''original issue discount'' when used in this section and §§1.6049–1 and 1.6049–3 means original issue discount subject to the ratable inclusion rules of paragraph (a) of §1.1232–3A, determined without regard to any reduction by reason of a purchase allowance under paragraph (a)(2)(ii) of §1.1232–3A or a purchase at a premium as defined in paragraph (d)(2) of §1.1232–3.

(2) *Coordination with interest reporting.* In the case of an obligation issued after May 27, 1969 (other than an obligation issued pursuant to a written commitment which was binding on May 27, 1969, and at all times thereafter) and on or before December 31, 1982, original issue discount which is not subject to the reporting requirements of paragrah (a)(1)(ii) of §1.6049–1 is interest within the meaning of pargraph (a) of this section. Original issue discount which is subject to the reporting requirements of paragraph (a)(1)(ii) of §1.6049–1 is not interest within the meaning of paragraph (a) of this section.

(3) *Exceptions.* Reporting of original issue discount is not required in respect of an obligation which paragraph (b)(2) of this section except from interest reporting.

(d) *Definition of ''in registered form.''* For purposes of §1.6049–1 and this section, an evidence of indebtedness is in registered form if it is registered as to both principal and interest (or, for purposes of reporting with respect to original issue discount, if it is registered as to principal) and if its transfer must be effected by the surrender of the old instrument and either the reissuance by the corporation of the old instrument to the new holder or the issuance by the corporation of a new instrument to the new holder.

(Secs. 6049 (a), (b), and (d) and 7805 of the Internal Revenue Code of 1954 (96 Stat. 592, 594; 26 U.S.C. 6049 (a), (b), and (d); 68A Stat. 917, 26 U.S.C. 7805), and in sec. 309 of the Tax Equity and Fiscal Responsibility Act of 1982 (96 Stat. 591)

[T.D. 6628, 27 FR 12801, Dec. 28, 1962, as amended by T.D. 6908, 31 FR 16774, Dec. 31, 1966; T.D. 6966, 33 FR 11262, Aug. 8, 1968; T.D. 7154, 36 FR 25011, Dec. 28, 1971; T.D. 7584, 44 FR 1104, Jan. 4, 1979; T.D. 7881, 48 FR 12968, Mar. 28, 1983]

§ 1.6049–3 Statements to recipients of interest payments and holders of obligations to which there is attributed original issue discount in calendar years before 1983.

(a) *Requirement.* Every person filing (1) a Form 1099 or 1087 under section 6049(a)(1) and § 1.6049–1 with respect to payments of interest or (2) a Form 1099–OID or 1087–-OID with respect to original issue discount includible in gross income, shall furnish to the person whose identifying number is (or should be) shown on the form a written statement showing the information required by paragraph (b) of this section. With respect to interest, no statement is required to be furnished under section 6049(c) and this section to any person if the aggregate of the payments to (or received on behalf of) such person shown on the form would be less than $10. With respect to original issue discount, no statement is required to be furnished under section 6049(c) and this section to any person if the aggregate amount of original issue discount on the statement to such person with respect to the obligation would be less than $10. References in this section to Form 1099 shall be construed to include Form 1099–BCD, except that in applying paragraph (b)(2) of this section no information relating to the person to whom the certificate of deposit was originally issued shall be disclosed to another person to whom the payment of interest is made.

(b) *Form of statement*—(1) *In general.* The written statement required to be furnished to a person under paragraph (a) of this section shall show:

(i) With respect to payments of interest (as defined in § 1.6049–2) aggregating $10 or more to any person during a calendar year before 1983:

(a) The aggregate amount of payments shown on the Form 1099 or 1087 as having been made to (or received on behalf of) such person and a legend stating that such amount is being reported to the Internal Revenue Service, and

(b) The name and address of the person filing the form, and

(ii) With respect to original issue discount (as defined in § 1.6049–2) which would aggregate $10 or more on the statement to the holder during a calendar year after 1970 and prior to calendar year 1983:

(a) The aggregate amount or original issue discount includible by (or on behalf of) such person with respect to the obligation, as shown on Form 1099–OID or Form 1087–OID for such calendar year (determined by applying the rules of paragraph (a)(1)(ii) of § 1.6049–1 for purposes of completing either form),

(b) All other items shown on such Form 1099–OID or Form 1087–OID for such calendar year (so determined), and

(c) A legend stating that such amount and such items are being reported to the Internal Revenue Service.

(2) *Special rule.* The requirements of this section for the furnishing of a statement to any person, including the legend requirement of this paragraph, may be met by the furnishing to such person of a copy of the Form 1099, 1099–OID, 1087, or 1087–OID filed pursuant to § 1.6049–1, or a reasonable facsimile thereof, in respect of such person. However, in the case of Form 1087–OID or 1099–OID, a copy of the instructions must also be sent to such person. A statement shall be considered to be furnished to a person within the meaning of this section if it is mailed to such person at his last known address.

(c) *Time for furnishing statements*—(1) *In general*—(i) *Payment of interest.* Each statement required by this section to be furnished to any person for a calendar year for the payment of interest shall be furnished to such person after November 30 of the year and on or before January 31 of the following year, but no statement may be furnished before the final interest payment for the calendar year has been paid. However, the statement may be furnished at any time after April 30 if it is furnished with the final interest payment for the calendar year.

(ii) *Original issue discount. (a)* Except as otherwise provided in this subdivision (ii), each statement required by this section to be furnished to any person for a calendar year for original issue discount shall be furnished to such person after December 31 of the year and on or before January 31 of the following year.

(b) The time for furnishing each statement required by this section to be furnished to any person for the calendar year 1971 for original issue discount in respect of obligations to which paragraph (e) of §1.1232–3A applies (relating to deposits in banks and other similar financial institutions) is extended to March 15, 1972.

(c) The time for furnishing each statement required by this section to be furnished by a nominee to any person for the calendar year 1971 for original issue discount is extended to February 28, 1972.

(2) *Extensions of time.* For good cause shown upon written application of the person required to furnish statements under this section, the district director may grant an extension of time not exceeding 30 days in which to furnish such statements. The application shall be addressed to the district director with whom the income tax returns of the applicant are filed and shall contain a full recital of the reasons for requesting the extension to aid the district director in determining the period of the extension, if any, which will be granted. Such a request in the form of a letter to the district director signed by the applicant will suffice as an application. The application shall be filed on or before the date prescribed in subparagraph (1) of this paragraph for furnishing the statements required by this section.

(3) *Last day for furnishing statement.* For provisions relating to the time for performance of an act when the last day prescribed for performance falls on Saturday, Sunday, or a legal holiday, see §301.7503–1 of this chapter (Regulations on Procedure and Administration).

(d) *Penalty.* For provisions relating to the penalty provided for failure to furnish a statement under this section see §301.6678–1 of this chapter (Regulations on Procedure and Administration).

(Secs. 6049 (a), (b), and (d) and 7805 of the Internal Revenue Code of 1954 (96 Stat. 592, 594; 26 U.S.C. 6049 (a), (b), and (d); 68A Stat. 917, 26 U.S.C. 7805), and in sec. 309 of the Tax Equity and Fiscal Responsibility Act of 1982 (96 Stat. 591)

[T.D. 6628, 27 FR 12801, Dec. 28, 1962, as amended by T.D. 7154, 36 FR 25011, Dec. 28, 1971; 37 FR 527, Jan. 13, 1972; T.D. 7584, 44 FR 1104, Jan. 4, 1979; T.D. 7624, 44 FR 31012, May 30, 1979; T.D. 7881, 48 FR 12968, Mar. 28, 1983]

§1.6049–4 Return of information as to interest paid and original issue discount includible in gross income after December 31, 1982.

(a) *Requirement of reporting*—(1) *In general.* Except as provided in paragraph (c) of this section, an information return shall be made by a payor, as defined in paragraph (a)(2) of this section, of amounts of interest and original issue discount paid after December 31, 1982. Such return shall contain the information described in paragraph (b) of this section.

(2) *Payor.* A payor is a person described in paragraph (a)(2) (i) or (ii) of this section.

(i) Every person who makes a payment of the type and of the amount subject to reporting under this section (or under an applicable section under this chapter) to any other person during a calendar year; however, persons not treated as payors for purposes of §31.3406(a)–2 of this chapter shall not be treated as payors for purposes of this paragraph (a)(2).

(ii) Every person who collects on behalf of another person payments of the type and of the amount subject to reporting under this section (or under an applicable section under this chapter), including middlemen treated as payors under §31.3406(a)–2 of this chapter, or who otherwise acts as a middleman (as defined in paragraph (f)(4) of this section) with respect to such payment.

(b) *Information to be reported*—(1) *Interest payments.* Except as provided in paragraphs (b) (3) and (5) of this section, in the case of interest other than original issue discount treated as interest under § 1.6049–5(f), an information return on Form 1099 shall be made for the calendar year showing the aggregate amount of the payments, the name, address, and taxpayer identification number of the person to whom paid, the amount of tax deducted and withheld under section 3406 from the payments, if any, and such other information as required by the forms. An information return is generally not required if the amount of interest paid to a person aggregates less than $10 or if the payment is made to a person who is an exempt recipient described in paragraph (c)(1)(ii) of this section, unless the payor backup withholds under section 3406 on such payment (because, for example, the payee (i.e., exempt recipient) has failed to furnish a Form W–9 on request), in which case the payor must make a return under this section, unless the payor refunds the amount withheld pursuant to § 31.6413(a)–3 of this chapter (Employment Tax Regulations). For reporting interest paid to a Canadian nonresident alien individual, see § 1.6049–8.

(2) *Original issue discount.* Except as provided in paragraph (b)(3) and (b)(5) of this section, in the case of original issue discount, an information return on Forms 1096 and 1099 shall be made for each calendar year of any holder of an obligation as to which there is original issue discount includible in gross income aggregating $10 or more. For calendar years before 1992, semiannual record date reporting under § 1.6049–1(a)(1)(ii)(*b*)(*1*) may be used, and if it is used, the original issue discount includible in gross income is determined by treating each holder as holding the obligation on every day it was outstanding during the calendar year. An information return shall be made, however, in any case in which an amount of tax is required to be deducted and withheld under section 3406. In such case, the amount required to be reported is the amount subject to withholding even if the amount of original issue discount includible in gross income is less than $10. With respect to an obligation described in § 1.1232–3A (e) or (f) (relating respectively to deposits in banks and similar financial institutions and to face-amount certificates), § 1.6049–1(a)(1)(ii)(*d*) and the last sentence of § 1.6049–1(a)(1)(ii)(*a*)(*2*) shall apply. The information return shall show:

(i) The name, address, and taxpayer identification number of each record holder for whom an amount of original issue discount is includible in gross income;

(ii) The account, serial, or other identifying number of each obligation with respect to which a return is being made;

(iii) The aggregate amount of original issue discount includible in the gross income of each holder for the period during the calendar year for which the return is made (or, if the aggregation rules of § 1.6049–1(a)(1)(ii)(*b*)(*2*) are being used, the aggregate amount or original issue discount for the period such holder held the obligations). For calendar years before 1992, semiannual record date reporting under § 1.6049–1(a)(1)(ii)(*b*)(*1*) may be used, and if it is used, the original issue discount includible in gross income is determined by treating each holder as holding the obligation on every day it was outstanding during the calendar year. For purposes of this section, an obligation shall be considered to be outstanding from the date of original issue (as defined in § 1.1232–3(b)(3));

(iv) The amount of tax withheld under section 3406, if any;

(v) The name and address of the person filing the return: and

(vi) Such other information as is required by the forms.

Section 1.6049–1(a)(1)(ii)(*b*)(*2*) and, for calendar years before 1992, § 1.6049–1(a)(1)(ii) (*b*)(*1*), and (*c*), apply for purposes of this paragraph.

(3) *Returns made by middleman*—(i) *In general.* Except as provided in paragraph (b)(5) of this section, every person acting as a middleman (as defined in paragraph (f)(4) of this section) shall make an information return for the calendar year. In the case of interest payments (other than original issue

discount and other than interest described in §1.6049–8), the information return shall be made on Form 1099 and shall show the aggregate amount of the interest, the name, address, and taxpayer identification number of the person on whose behalf received, the amount of tax withheld under section 3406, if any, and such other information as required by the forms. In the case of original issue discount, the information return shall show the information required to be shown for the person on whose behalf received, as described in paragraph (b)(2) of this section. See §1.6049–5(f) to determine whether a middleman is required to make an information return with respect to original issue discount. A middleman shall make an information return regardless of whether the middleman receives a Form 1099. A middleman shall not be required to make an information return if the payment of interest aggregates less than $10 or if the payment is made to an exempt recipient described in paragraph (c)(1)(ii) of this section, unless the payor backup withholds under section 3406 on such payment (because, for example, the payee has failed to furnish a Form W–9 on request), in which case the payor must make a return under this section, unless the payor refunds the amount withheld pursuant to §31.6413(a)–3 of this chapter (Employment Tax Regulations).

(ii) *Forwarding of interest coupons and original issue discount obligations.* In the case of a middleman who, from within the United States, forwards an interest coupon or discount obligation on behalf of a payee for presentation, collection or payment outside the United States, the middleman shall make an information return on Form 1099 for the calendar year showing, in the case of an interest coupon, the information required under paragraph (b)(3)(i) of this section and, in the case of a discount obligation, information required under paragraph (b)(2) of this section. For purposes of this paragraph (b)(3)(ii), a middleman is considered to forward an interest coupon or discount obligation on behalf of a payee for presentation, collection or payment outside the United States if the middleman forwards the coupon or obligations outside the United States on or after the date when the payee is entitled to be paid or at an earlier date that is within 90 days of such date or if the middleman has actual knowledge that the coupon or obligation is being forwarded outside the United States for presentation, collection, or payment outside the United States. However, the transfer, although subject to information reporting under this section, is not subject to backup withholding under section 3406.

(iii) *Example.* The following example illustrates the provisions of paragraph (b)(3)(ii) of this section:

Example. Individual F, who is entitled to payment on an interest coupon, instructs an office of Bank M in the United States to forward the coupon to Bank N for collection by Bank N outside the United States. Bank M in the United States forwards the interest coupon to Bank N outside the United States. Bank M is required to make an information return for the calendar year under paragraph (b)(3)(ii) of this section showing the aggregate amount of the interest coupon forwarded, the name, address of the permanent residence, and the taxpayer identification number, if any, of Individual F and such other information as the form requires.

(4) *Returns made with respect to payments on certificates of deposit issued in bearer form.* Except as provided in paragraph (b)(5) of this section, every person carrying on the banking business who makes payments of interest to another person (whether or not aggregating $10 or more) during a calendar year with respect to a certificate of deposit issued in bearer form shall make an information return on Forms 1096 and 1099. The information return shall show the information required in §1.6049–1(a)(1)(vi) (*a*) through (*e*) inclusive and a statement as to the amount of tax withheld under section 3406, if any.

(5) *Interest payments to Canadian nonresident alien individuals*—(i) *General rule.* In the case of interest paid to a Canadian nonresident alien individual (as described in §1.6049–8(a)), the payor or middleman shall make an information return on Form 1042–S for the calendar year in which the interest is paid. The payor or middleman shall prepare and transmit Form 1042–S at the time and in the manner prescribed by section 1461 and the regulations

under that section and by the form and its accompanying instructions. See § 1.6049–6(e)(4) for furnishing a copy of the Form 1042–S to the payee. To determine whether an information return is required for original issue discount, see §§ 1.6049–5(f) and 1.6049–8(a).

(ii) *Effective date.* Paragraph (b)(5)(i) of this section shall be effective for payments made after December 31, 1996 with respect to a Form W–8 (Certificate of Foreign Status) furnished to the payor or middleman after that date.

(c) *Information returns not required*—(1) *Payment to exempt recipient*—(i) *In general.* No information return is required with respect to any payment made to an exempt recipient described in paragraph (c)(1)(ii) of this section, except to the extent otherwise provided in § 1.6049–5(d)(3) (ii) and (iii). However, if the payor backup withholds under section 3406 on such payment (because, for example, the payee has failed to furnish a Form W–9 on request), then the payor is required to make a return under this section, unless the payor refunds the amount withheld in accordance with § 31.6413(a)–3 of this chapter (Employment Tax Regulations).

(ii) *Exempt recipient defined.* The term *exempt recipient* means any person described in paragraphs (c)(1)(ii) (A) through (Q) of this section. An exempt recipient is generally exempt from information reporting without filing a certificate claiming exempt status unless the provisions of this paragraph (c)(1)(ii) require a payee to file a certificate. A payor may in any case require a payee not otherwise required to file a certificate under this paragraph (c)(1)(ii) to file a certificate in order to qualify as an exempt recipient. See § 31.3406(h)–3 (a)(1)(iii) and (c)(2) of this chapter for the certificate that a payee must provide when a payor requires it in order to treat the payee as an exempt recipient under this paragraph (c)(1)(ii). A payor may treat a payee as an exempt recipient based upon a properly completed form as described in § 31.3406(h)–3(e)(2) of this chapter, its actual knowledge that the payee is a person described in this paragraph (c)(1)(ii), or the indicators described in this paragraph (c)(1)(ii).

(A) *Corporation.* A corporation, as defined in section 7701(a)(3), whether domestic or foreign, is an exempt recipient. In addition, for purposes of this paragraph (c)(1), the term *corporation* includes a partnership all of whose members are corporations described in this paragraph (c)(1), but only if the partnership files with the payor a certificate stating that each member of the partnership meets the requirements of paragraph (c)(1)(ii)(A) (*1*) through (*4*) of this section. Absent actual knowledge otherwise, a payor may treat a payee as a corporation (and, therefore, as an exempt recipient) if one of the requirements of paragraph (c)(1)(ii)(A) (*1*), (*2*), (*3*), or (*4*), of this section are met before a payment is made.

(*1*) The name of the payee contains an unambiguous expression of corporate status that is Incorporated, Inc., Corporation, Corp., P.C., (but not Company or Co.) or contains the term *insurance company, indemnity company, reinsurance company,* or *assurance company*, or its name indicates that it is an entity listed as a per se corporation under § 301.7701–2(b)(8)(i) of this chapter.

(*2*) The payor has on file a corporate resolution or similar document clearly indicating corporate status. For this purpose, a similar document includes a copy of Form 8832, filed by the entity to elect classification as an association under § 301.7701–3(b) of this chapter.

(*3*) The payor receives a Form W–9 which includes an EIN and a statement from the payee that it is a domestic corporation.

(*4*) The payor receives a withholding certificate described in § 1.1441–1(e)(2)(i), that includes a certification that the person whose name is on the certificate is a foreign corporation.

(B) *Tax exempt organization*—(*1*) *In general.* Any organization that is exempt from taxation under section 501(a) is an exempt recipient. A custodial account under section 403(b)(7) shall be considered an exempt recipient under this paragraph. A payor may treat an organization as an exempt recipient under this paragraph (c)(1)(ii)(B) without requiring a certificate if the organization's name is listed in the compilation by the Commissioner of organizations for which a deduction for charitable contributions is allowed, if the name of the organization contains an unambiguous indication that it is a tax-exempt organization, or if the organization is known to the payor to be a tax-exempt organization.

(*2*) *Examples.* The application of the provisions of this paragraph (c)(1)(ii)(B) may be illustrated by the following examples:

Example 1. The following persons maintain accounts at M Bank: N College, O University, and P Church. M may treat N, O, and P as exempt recipients even though such persons have not filed an exemption certificate with M because the names of the organizations contain an unambiguous indication that they are tax exempt organizations.

Example 2. Q is listed in the current edition of Internal Revenue Service Publication 78 as an organization for which deductions are permitted for charitable contributions under section 170(c). Such listing has not been revoked by an announcement published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter). A payor may treat Q as an exempt recipient even though Q has not filed an exemption certificate with the payor.

Example 3. Employer R maintains a section 403(b)(7) custodial account with Regulated Investment Company S on behalf of R's employees. S may treat the account as an exempt recipient even though R or its employees have not filed an exemption certificate with S.

(C) *Individual retirement plan.* An individual retirement plan as defined in section 7701(a)(37) is an exempt recipient. A payor may treat any such plan of which it is the trustee or custodian as an exempt recipient under this paragraph (c)(1) without requiring a certificate.

(D) *United States.* The United States Government and any wholly-owned agency or instrumentality thereof are exempt recipients. A payor may treat a person as an exempt recipient under this paragraph (c)(1) without requiring a certificate if the name of such person reasonably indicates it is described in this paragraph (c)(1).

(E) *State.* A State, the District of Columbia, a possession of the United States, a political subdivision of any of the foregoing, wholly-owned agency or instrumentality of any one or more of the foregoing, and a pool or partnership composed exclusively of any of the foregoing are exempt recipients. A payor may treat a person as an exempt recipient under this paragraph (c)(1) without requiring a certificate if the name of such person reasonably indicates it is described in this paragraph (c)(1) or if such person is known generally in the community to be a State, the District of Columbia, a possession of the United States or a political subdivision or a wholly-owned agency or instrumentality of any one or more of the foregoing (for example, an account held in the name of ''Town of S'' or ''County of T'' may be treated as held by an exempt recipient under this paragraph (c)(1)(ii)(E)).

(F) *Foreign government.* A foreign government, a political subdivision of a foreign government, and any wholly-owned agency or instrumentality of either of the foregoing are exempt recipients. A payor may treat a foreign government or a political subdivision thereof as an exempt recipient under this paragraph (c)(1) without requiring a certificate provided that its name reasonably indicates that it is a foreign government or provided that it is known to the payor to be a foreign government or a political subdivision thereof (for example, an account held in the name of the ''Government of V'' may be treated as held by a foreign government).

(G) *International organization.* An international organization and any wholly-owned agency or instrumentality thereof are exempt recipients. The term *international organization* shall have the meaning ascribed to it in section 7701(a)(18). A payor may treat a payee as an international organization without requiring a certificate if the payee is designated as an international organization by executive order (pursuant to 22 U.S.C. 288 through 288(f)).

(H) *Foreign central bank of issue.* A foreign central bank of issue is an exempt recipient. A foreign central bank of issue is a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency. See §1.895–1(b)(1). A payor may treat a person as a foreign central bank of issue (and, therefore, as an exempt recipient) without requiring a certificate provided that such person is known generally in the financial community as a foreign central bank of issue or if its name reasonably indicates that it is a foreign central bank of issue.

(I) *Securities or commodities dealer.* A dealer in securities, commodities, or notional principal contracts, that is registered as such under the laws of the United States or a State or under the laws of a foreign country is an exempt recipient. A payor may treat a dealer as an exempt recipient under this paragraph (c)(1) without requiring a certificate if the person is known generally in the investment community to be a dealer meeting the requirements set forth in this paragraph (c)(1) (for example, a registered broker-dealer or a person listed as a member firm in the most recent publication of members of the National Association of Securities Dealers, Inc.).

(J) *Real estate investment trust.* A real estate investment trust, as defined in section 856 and § 1.856–1, is an exempt recipient. A payor may treat a person as a real estate investment trust (and, therefore, as an exempt recipient) without requiring a certificate if the person is known generally in the investment community as a real estate investment trust.

(K) *Entity registered under the Investment Company Act of 1940.* An entity registered at all times during the taxable year under the Investment Company Act of 1940, as amended (15 U.S.C. 80a–1), (or during such portion of the taxable year that it is in existence), is an exempt recipient. An entity that is created during the taxable year will be treated as meeting the registration requirement of the preceding sentence provided that such entity is so registered at all times during the taxable year for which such entity is in existence. A payor may treat such an entity as an exempt recipient under this paragraph (c)(1) without requiring a certificate if the entity is known generally in the investment community to meet the requirements of the preceding sentence.

(L) *Common trust fund.* A common trust fund, as defined in section 584(a), is an exempt recipient. A payor may treat the fund as an exempt recipient without requiring a certificate provided that its name reasonably indicates that it is a common trust fund or provided that it is known to the payor to be a common trust fund.

(M) *Financial institution.* A financial institution such as a bank, mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, industrial loan association or bank, or other similar organization, whether organized in the United States or under the laws of a foreign country is an exempt recipient. A financial institution also includes a clearing organization defined in § 1.163–5(c)(2)(i)(D)(*8*) and the Bank for International Settlements. A payor may treat any person described in the preceding sentence as an exempt recipient without requiring a certificate if the person's name (including a foreign name, such as ''Banco'' or ''Banque'') reasonably indicates the payee is a financial institution described in the preceding sentence. In the case of a foreign person, a payor may also treat a person on such list as the Internal Revenue Service may publish or approve (such as in the Thomson Bank Directory or a list approved by the Federal Reserve Board).

(N) *Trust.* A trust which is exempt from tax under section 664(c) (i.e., a charitable remainder annuity trust or a charitable remainder unitrust) or is described in section 4947(a)(1) (relating to certain charitable trusts) is an exempt recipient. A payor which is a trustee of the trust may treat the trust as an exempt recipient without requiring a certificate.

(O) *Nominees or custodians.* A nominee or custodian.

(P) *Brokers.* A broker as defined in section 6045(c) and § 1.6045–1(a)(1).

(Q) *Swap dealers.* A dealer in notional principal contracts as defined in § 1.446–3(c)(4)(iii).

(iii) *Exempt recipient no longer exempt.* Any person who ceases to be an exempt recipient shall, no later than 10 days after such cessation, notify the payor in writing when it ceases to be an exempt recipient unless it reasonably appears that the person formerly qualifying as an exempt recipient will not thereafter receive a reportable payment from the payor. If a payor treats a person as an exempt recipient by requiring the exempt recipient to file a certificate claiming exempt status, that person shall revoke the certificate as provided in the preceding sentence. If the exempt recipient terminates its relationship with the payor prior to the time that the notice of change in status is otherwise required, the exempt recipient is not required to notify the payor. If, however, the person who formerly qualified as an exempt recipient later reinstates the relationship with the payor, the person must, prior to receiving a reportable payment from such relationship, notify the payor that it no longer qualifies as an exempt recipient in case the payor relies upon the previous treatment.

(2) *Payments by certain middlemen.* An information return shall not be required if:

(i) The record owner is required to file a fiduciary return on Form 1041 disclosing the name, address, and taxpayer identification number of the actual owner, and furnishes Form K–1 to each actual owner containing the information required to be shown on the form, including amounts withheld under section 3406;

(ii) The record owner is a nominee of a banking institution or trust company exercising trust powers, and such banking institution or trust company is required to file a fiduciary return on Form 1041 disclosing the name, address, and identifying number of the actual owner, and furnishes Form K–1 to each actual owner containing the information required to be shown on the form, including amounts withheld under section 3406;

(iii) The record owner is a banking institution or trust company exercising trust powers, or a nominee thereof, and the actual owner is an organization exempt from taxation under section 501(a) for which such banking institution or trust company files an annual return, but only if the name, address, and taxpayer identification number of the record owner is included on or with the Form 1041 fiduciary return filed for the estate or trust or the annual return filed for the tax exempt organization.

(d) *Special rules*—(1) *Aggregation of payments.* For purposes of paragraph (b) of this section, until such time as the Commissioner determines that it is feasible to require aggregation of payments on two or more accounts, insurance contracts, or investment certificates, and, until this section is amended accordingly to provide for reporting on an aggregate basis, the requirement for filing Form 1099 under this section will be met if a person making payments of interest subject to reporting files a separate Form 1099 with respect to each account, insurance contract, or investment certificate. In the case of obligations described in section 6049(b)(1)(A), separate Forms 1099 may be filed as provided in the preceding sentence with respect to holdings in different issues.

(2) *Treatment of original issue discount.* The amount of original issue discount subject to reporting under section 6049 shall be the amount of original issue discount includible in the gross income of any holder that is treated as paid under §1.6049–5(f).

(3) *Conversion into United States dollars of amounts paid in foreign currency*—(i) *Conversion rules.* When a payment is made in foreign currency, the U.S. dollar amount of the payment shall be determined by converting such foreign currency into U.S. dollars on the date of payment at the spot rate (as defined in §1.988–1(d)(1)) or pursuant to a reasonable spot rate convention. For example, a withholding agent may use a month-end spot rate or a monthly average spot rate. A spot rate convention must be used consistently with respect to all non-dollar amounts withheld and from year to year. Such convention cannot be changed without the consent of the Commissioner or the Commissioner's delegate.

(ii) *Special rule for §1.988–5(a) transactions where the payor on both components of a qualified hedging transaction is the same person*—(A) *In general.* Interest or original issue discount on a qualified debt instrument that is part of a qualified hedging transaction under §1.988–5(a) shall be computed for section 6049 reporting purposes under the rules described in §1.988–5(a)(9)(ii) if—

(*1*) The payor on the qualified debt instrument and the counterparty to the §1.988–5(a) hedge are the same person; and

(*2*) The payee complies with the requirements of §1.988–5(a) and so notifies its payor prior to the date required for filing Form 1099 as required by this section.

(B) *Effective date.* The provisions of this paragraph (d)(3)(ii) apply to transactions entered into after December 31, 1999.

(4) *Determination of person to whom interest or original issue discount is paid or for whom it is received.* Section 1.6049–1(a)(3) and (4) shall apply with respect to payments of interest and original issue discount after December 31, 1982.

(5) *Payments by governmental units.* In the case of payments made by any governmental unit or any agency or instrumentality thereof, the officer or employee having control of the payment of interest or original issue discount (or the person appropriately designated for purposes of this section) shall make the returns and statements required under section 6049.

(6) *When payment deemed made*—(i) *In general.* Except as provided in paragraph (d)(6)(ii) of this section, for purposes of section 6049, interest is deemed to have been paid when it is credited or set apart to a person without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and is made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition.

(ii) *Instruments paid on presentment or demand.* In the case of a payment made on an obligation described in paragraph (e)(2) of this section (relating to transactional reporting), interest is deemed to have been paid at the time the obligation is presented for payment. For example, interest represented by a coupon detached from a bond is considered paid for purposes of section 6049 when the coupon is presented for payment.

(7) *Magnetic media requirement.* For rules relating to permission to submit the information required by Form 1099 on magnetic tape or other media, see §1.9101–1. For the requirement to submit the information required by Form 1099 on magnetic media for payments after December 31, 1983, see section 6011(e) and §301.6011–2 of this chapter (Regulations on Procedure and Administration).

(8) *Obligations that are not exempt from taxation.* When an issuer of an obligation that is not exempt from taxation receives an envelope or ‘‘shell’’, signed by the payee, stating that interest on the obligation is exempt from taxation under section 103(a) (as described in §1.6049–5(b)(2), the issuer shall make an information return under section 6049. The information return shall show the name, address, and taxpayer identification number of the person who signed the statement claiming that interest on the obligation is exempt from taxation, the amount of interest paid, and such other information as is required by the form. An information return is required regardless of the amount of interest. The issuer shall also furnish a written statement to such person showing the information required by §1.6049–6(b).

(9) *Savings bonds*—(i) *In general.* A person who makes payment on a United States savings bond when the bond is presented for payment shall report the difference between the amount to be paid and the amount paid for the bond. The amount subject to reporting shall not be reduced to take into account:

(A) Amounts previously included in the income of a holder as a result of an election under section 454 to include annually the increase in the redemption price of the bond; or

(B) Amounts accrued prior to transfer of the bond where the bond has been reissued in the name of the person presenting the bond for payment.

With respect to a savings bond that is reissued in another person’s name, the amount subject to reporting when the bond is reissued is the amount of interest that has accrued. With respect to a savings bond that is exchanged in a tax-deferred transaction (as described in section 1037), the amount subject to reporting is the amount of cash paid to the holder at the time of the transaction.

(ii) *Examples.* The application of the provisions of paragraph (d)(9)(i) of this section may be illustrated by the following examples:

Example (1). On June 10, 1943, A purchases a $50 Series E savings bond. The amount paid for the savings bond is $37.50. A elects under section 454 to include the increase in the redemption price of the bond annually in income. A presents the bond to Bank M to be cashed on July 1, 1983. The amount to be paid on the bond on that date is $204.96. Bank M is required to make an information return under section 6049 showing that it paid $167.46 (the difference between $204.96 and $37.50) of interest, without regard to A's election to include annually the increase in the redemption price of the bond.

Example (2). On December 1, 1970, B purchases a $500 Series E savings bond. The amount paid for the bond is $375. On August 1, 1984, the bond is reissued by the Bureau of Public Debt by deleting B's name and inserting the name of B's child. At the time of reissue, the redemption value of the bond is $1,015.80. The accrued interest is $640.80 (the difference between $1,015.80 and $375). The reissue is a taxable transaction, and B must include in income the accrued interest at the time of reissue. The Bureau of Public Debt is required to make an information return under section 6049 showing that it paid $640.80 of interest to B.

Example (3). Assume the same facts as in example (2) except that B exchanges the bond for a Series HH savings bond in the amount of $1,000 issued in B's name. The exchange is tax-deferred under section 1037. The Bureau of Public Debt stamps a legend on the bond stating that interest of $625 has been deferred. The amount of $15.80 is paid to B. The Bureau of the Public Debt must make an informatiion return showing that it paid $15.80 of interest to B.

Example (4). Assume the same facts as in example (3) except that the exchange is not a tax-deferred exchange. The Bureau of the Public Debt must make an information return showing that it paid $640.80 of interest to B.

(e) *Transactional reporting*—(1) *In general.* An information return required to be made under paragraph (b) of this section may be made on a transaction-by-transaction basis, rather than on an annual aggregation basis, if payment described in paragraph (e)(2) of this section is made by a person described in paragraph (e)(3) of this section.

(2) *Payments subject to transactional reporting.* An information return may be made on a transactional basis if payment is made on:

(i) A United States savings bond,

(ii) An interest coupon (but see §1.6049–5(b) which provides that no information return is required to be made with respect to an interest coupon that is exempt from taxation),

(iii) A discount obligation having a maturity at issue of 1 year or less, including commercial paper and short-term government obligations defined in section 1232(a)(3), and

(iv) Any obligation similar to those described in subdivisions (i) through (iii).

The information return with respect to payments on the types of obligations described in this paragraph shall be made on Form 1099–INT. A payor may include all interest paid in one transaction on one information return, irrespective of whether obligations of different issuers are paid as part of the transaction.

(3) *Persons subject to transactional reporting.* A person may make a return on a transactional basis if the person is:

(i) A middleman (as defined in paragraph (f)(4) of this section) who is required to make an information return under paragraph (b)(3) of this section with respect to any payment described in paragraph (e)(2) of this section, or

(ii) A Federal agency making payments on a United States savings bond.

(4) *Transaction defined.* For purposes of this paragraph (e), a transaction means a payment at one time on one or more obligations. For example, if an individual who is exempt from withholding under section 3406 presents at one time five Series EE bonds on each of which $3 of interest has accrued, $15 of interest will be paid as part of the transaction. Accordingly, an information return is required under §1.6049–4 (a)(2)(iii) because the interest paid in the transaction exceeds $10. If only three of the savings bonds were presented, however, no return would be required even if the remaining two bonds were redeemed the following day. See paragraph (a)(2)(i) of this section for the requirement that an information return be made if any amount of tax is withheld under section 3406.

(5) *Information required.* The information return for any transaction under paragraph (e) of this section shall show the following:

(i) The name, address, and taxpayer identification number of the person to whom the interest is paid;

(ii) The name and address of the person filing the form;

(iii) The amount of interest paid;

(iv) The amount of tax withheld under section 3406, if any; and

(v) Such other information as is required by the form.

(f) *Definitions.* For purposes of section 6049, this section, and §§ 1.6049–5 and 1.6049–6:

(1) *Person.* The term *person* includes any governmental unit, international organization, and any agency or instrumentality thereof. Therefore, interest paid by one of these entities must be reported unless one of the exceptions under section 6049 applies.

(2) *Natural person.* The term *natural person* means any individual, but shall not include a partnership (whether of not composed entirely of individuals), a trust, or an estate.

(3) *Obligation.* The term *obligation* includes bonds, debentures, notes, certificates, and other evidences of indebtedness regardless of how denominated.

(4) *Middleman*—(i) *In general.* The term *middleman* means any person. including a financial institution as described in paragraph (c)(1)(ii)(M) of this section, a broker as defined in section 6045(c), or a nominee, who makes payment of interest for, or collects interest on behalf of, another person, or otherwise acts in a capacity as intermediary between a payor and a payee. For example, a person (other than an issuer of an obligation) who makes payment on an interest coupon of the obligation to another person is a middleman, irrespective of whether such person purchases the coupon for his own account, accepts the coupon as agent for the payee, or otherwise deals with the coupon. The term ''middleman'' also includes a trustee, including a corporate trustee of a trust where the trust is the payee. See § 1.6049–4(c)(2) providing that the trustee does not have to make an information return on Form 1099 to a beneficiary if the trustee is required to file Form 1041 and furnishes Form K–1 to the beneficiary showing the information required to be shown on the form, including amounts withheld under section 3406. A person shall be considered to be a middleman as to any portion of an interest payment made to such person which portion is actually owned by another person, whether or not the other person's name is also shown on the information return filed with respect to such interest payment, except that a husband or wife will not be considered as acting in the capacity of a middleman with respect to his or her spouse. A person who, from within the United States, forwards an interest coupon or discount obligation on behalf of a payee for presentation, collection or payment outside the United States is also a middleman for purposes of this section (but the transfer, although subject to information reporting under this section, does not make the payment subject to backup withholding under section 3406).

(ii) *Example.* The application of the provisions of paragraph (f)(4) of this section may be illustrated by the following example:

Example. In January, 1984, Broker B purchases on behalf of its customer, Individual A, and obligation issued by partnership RR in a public offering on that date. Broker B holds the obligation for A throughout 1984. Broker B is required to make an information return showing the amount of original issue discount treated as paid to A under § 1.6049–5(f).

(g) *Time and place for filling a return for the payment of interest*—(1) *Annual return.* Except as provided in paragraph (g)(2) of this section, the returns required under this section for any calendar year for the payment of interest shall be filed after September 30 of such year, but not before the payor's final payment to the payee for the year, and on or before February 28 of the following year. Such returns shall be filed with the appropriate Internal Revenue Service Center, the address of which is listed in the instructions for Form 1096. For extensions of time for filing returns under this section, see § 1.6081–1.

(2) *Transactional return.* In the case of a return under paragraph (e) of this section, relating to returns on a transactional basis, such return shall be filed at any time but in no event later than February 28 of the year following the calendar year in which the interest was paid. The return shall be filed with

the appropriate Internal Revenue Service Center, the address of which is listed in the instructions for Form 1096. For extensions of time for filing returns under this section, see §1.6081–1.

(3) *Cross-reference to penalty.* For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6049(a) and §1.6049–4(a)(1), see §301.6721–1 of this chapter (Procedure and Administration Regulations). See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

[T.D. 7881, 48 FR 12968, Mar. 28, 1983, as amended by T.D. 8366, 56 FR 49518, Sept. 30, 1991; T.D. 8664, 61 FR 17573, Apr. 22, 1996; T.D. 8734, 62 FR 53480, Oct. 14, 1997; T.D. 8804, 63 FR 72188, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 52480, Oct. 14, 1997, §1.6049–4 was amended by removing the reference ‘‘section 3451’’ and adding ‘‘section 3406’’ each place it appears in the following locations: In the third sentence of paragraph (b)(2) introductory text, in paragraph (b)(2)(iv), in the last sentence of paragraph (b)(4), in paragraph (c)(2)(i), in the concluding text of paragraph (c)(2)(ii), in the second and last sentences of paragraph (e)(4), in paragraph (e)(5)(iv), and in the fourth sentence of paragraph (f)(4)(i); by revising paragraphs (a), (b)(1), (b)(3), (c)(1), and (d)(3); by removing the reference ‘‘§1.6049–5(c)’’ in paragraphs (b)(5)(i) last sentence, and (d)(2) and adding ‘‘§1.6049–5(f)’’ in its place; by revising the heading for paragraph (d)(7) and adding a sentence to the end of the paragraph; by removing the reference ‘‘§1.6049–5(b)(1)(ii)’’ in the first sentence of paragraph (d)(8) and adding ‘‘1.6049–5(b)(2)’’ in its place; by removing the reference ‘‘paragraph (d)(10)(i)’’ in paragraph (d)(9)(ii) introductory text, and adding ‘‘paragraph (d)(9)(i)’’ in its place; by removing the reference ‘‘paragraph (c)(1)(K)’’ in the first sentence of paragraph (f)(4)(i) and adding ‘‘paragraph (c)(1)(ii)(M)’’ in its place; by revising the last two sentences of paragraph (f)(4)(i); by revising the last sentence of the *Example* in paragraph (f)(4)(ii); and by adding paragraph (g)(3), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.6049–4 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.6049–4 Return of information as to interest paid and original issue discount includible in gross income after December 31, 1982.

(a) *Requirement of reporting*—(1) *In general.* Except as provided in paragraph (c) of this section, an information return shall be made by the persons described in paragraph (a)(2) of this section with respect to any payment of interest (as defined in §1.6049–5) after December 31, 1982. Such return shall contain the information required in paragraph (b) of this section.

(2) *Persons required to make reports.* The persons required to make an information return under section 6049(a) and this section are:

(i) Every person who is required to deduct and withhold the tax imposed by section 3451;

(ii) Every person who makes a payment of interest aggregating $10 or more to any other person during a calendar year; and

(iii) Every person who collects (or otherwise acts as a middleman (as defined in paragraph (f)(4) of this section) with respect to) payments of interest on behalf of another person aggregating $10 or more during a calendar year.

(b) *Information to be reported*—(1) *Interest payments.* Except as provided in paragraph (b)(3) and (b)(5) of this section, in the case of a payment of interest other than original issue discount treated as interest under §1.6049–5(c), an information return on Forms 1096 and 1099 shall be made for the calendar year showing the aggregate amount of the payments, the name, address, and taxpayer identification number of the person to whom paid, the amount of tax deducted and withheld under section 3451 from the payments, and such other information as is required by the forms. An information return is required if the aggregate amount of interest is $10 or more unless the tax imposed by section 3451 is required to be withheld. In such event, the amount required to be shown is the amount subject to withholding even if such amount is less than $10.

(2) * * *

(3) *Returns made by the middleman.* Except as provided in paragraph (b)(5) of this section, every person acting as a middleman (as defined in paragraph (f)(4) of this section) shall make an information return on Form 1096 and 1099 for teh calendar year. In the case of interest payments (other than original issue discount), the return shall show the aggregate amount of such interest, the name, address, and taxpayer identification number of the person on whose behalf received, the amount of tax withheld under section 3451, if any, and such other information as is required by the forms, In the case of original issue discount, the return shall show the information required to be shown for the actual owner, as described in paragraph (b)(2) of this section. A middleman shall make an information return regardless of whether the middleman receives a Form 1099. A middleman shall not be required to make an information return if the payments of interest aggregate less than $10 unless such amount is subject to withoolding under

sction 3451. If an amount of tax is required to be deducted and withheld under section 3451, a return shall be made irrespective of the amount of the payment and irrespective of whether the payment is made to an exempt recipient described in paragraph (c)(1)(ii) of this section.

* * * * *

(c) *Information returns not required*—(1) *Payment to exempt recipient.* (i) In the case of a payment to a person described in paragraph (c)(1)(ii) of this section, no return shall be required to be made unless such payment is made by a person required to make a return by paragraph (a)(2)(i) of this section (relating to persons required to withhold tax). Thus, a person who withholds tax under section 3451 is required to make an information return regardless of whether the payee is an exempt recipient described in paragraph (c)(1)(ii) of this section.

(ii) An information return shall not be required with respect to payments made to:

(A) A corporation as defined in section 7701(a)(3), whether domestic or foreign,

(B) An organization exempt from taxation under section 501(a) or an individual retirement plan,

(C) The United States or a State, the District of Columbia, a possession of the United States, or a political subdivision or a wholly-owned agency or instrumentality of any one or more of the foregoing,

(D) A foreign government, a political subdivision thereof, or an international organization,

(E) A foreign central bank of issue (as defined in § 1.895–1(b)(i) to be a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency),

(F) A dealer in securities or commodities required to register as such under the laws of the United States or a State,

(G) A real estate investment trust (as defined in section 856),

(H) An entity registered at all times during the taxable year under the Investment Company Act of 1940,

(I) A common trust fund (as defined in section 584(a)),

(J) A nominee or custodian,

(K) A financial institution such as a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, industrial loan association or bank, or other similar organization,

(L) A broker as defined in section 6045(c), or

(M) Any trust which:

(*1*) Is exempt from tax under section 664(c) (*i.e.*, a charitable remainder annuity trust or a charitable remainder unitrust), or

(*2*) Is described in section 4947(a)(1) (relating to a certain charitable trust).

A payor who may treat any person as an exempt recipient for withholding purposes as described in § 31.3452(c)–1 (b) through (p) without requiring such person to file an exemption certificate may treat the persons listed in this subdivision (ii)(A) through (M) as an exempt recipient for information reporting purposes. A payor shall make an information return with respect to an individual who files an exemption certificate to be exempt from withholding under section 3451. The individual is not exempt for reporting purposes. A payor shall make an information return with respect to a trust which is an exempt individual under section 3452(b)(4) and § 31.3452(b)–1(d). See § 1.6049–4(c)(2) providing that the trust satisfies the reporting requirements under section 6049 if the trust files a Form 1041 and furnishes a beneficiary a Form K–1 containing the information required to be shown on the form, including amounts withheld under section 3451.

(iii) The application of this paragraph (c) may be illustrated by the following examples:

Example (1). In 1980, Corporation Y issued 10-year debentures with 9 percent interest coupons payable semiannually on June 30 and December 31. Individual F, who is exempt from withholding under section 3451, presents a coupon for payment at Bank M on the interest payment date. Bank M transmits the coupon to Bank N, which in turn presents the coupon to Corporation Y for payment. Bank M is required to make an information return with respect to the payment to individual F under § 1.6049–4(a)(2)(iii). Bank N is not required to make an information return with respect to the payment to Bank M, and Corporation Y is not required to make an information return with respect to the payment to Bank N because Banks M and N are exempt recipients described in § 1.6049–4(c)(1)(ii)(K).

Example (2). Broker E acquires a bond issued in 1980 by the United States Treasury through the Bureau of Public Debt. Broker E sells interests in the bond to the public after December 31, 1982. A purchaser may acquire an interest in any interest payment falling due under the bond or an interest in the principal of the bond. The bond is held by Custodian H for the benefit of the persons acquiring these interests. Custodian H files an exemption certificate claiming exemption from withholding under § 31.3452(c)–1(n). On receipt of interest and principal payments under the bond, Custodian H transfers the amount received to the person whose ownership interest corresponds to the component giving rise to the payment. Under section 1232B, each bond component is treated as a bond issued with original issue discount equal to the excess of the stated redemption price at maturity over the purchase price of the bond component. Accordingly, H is required to make an information return setting forth the information required in § 1.6049–4(b)(2) with respect to each holder of an interest in the bond. The Bureau of Public Debt is not required to make an information return since it made payment to Custodian H who is an exempt recipient described in § 1.6049–4(c)(1)(ii)(J).

Example (3). On January 1, 1984, the United States Treasury through the Bureau of Public Debt issues $1 million of obligations with a maturity of 1 year or less. The obligations are represented by entries on records maintained through Federal Reserve banks and branches for the account of member banks of the Federal Reserve system. Bank O, which is a member bank of the Federal Reserve system, tenders an offer for $100,000 of the obligations. The Federal Reserve opens an account for Bank O showing that it owns $100,000 of the obligations. When Bank O sells any of these obligations to an investor, it maintains a book entry account showing such investor's ownership. Upon maturity, the United States Treasury credits the amount due the Federal Reserve bank holding an interest in the obligation. The Federal Reserve bank in turn credits the account of Bank O, which then credits the accounts of the persons owning the obligations. Bank O must make the information return required under section 6049 and this section with respect to the payments made by it to persons not described in § 1.6049–4(c)(1). Thus, if, at maturity of the obligation, Bank O held an obligation on its books for D, an individual, Bank O is required to make an information return with respect to the payment made to individual D. Neither the Bureau of Public Debt nor the Federal Reserve bank is required to make an information return since such payments were made to persons described in § 1.6049–4(c)(1)(ii).

Example (4). Assume the same facts as example (3) except a brokerage house buys the $100,000 of obligations through the Federal Reserve bank. The Federal Reserve maintains a book entry account showing that a member bank holds $100,000 of obligations for a brokerage house. The brokerage house sells these obligations to its customers. The brokerage house holds $50,000 of the obligations for a pension trust, $30,000 of the obligations for Corporation Z, and $10,000 of the obligations each for Individuals I and J. The brokerage house is required to make an information return with respect to the payments of interest at maturity on the obligations it holds for its customers who are not described in § 1.6049–4(c)(1). Thus, the brokerage house is required to make an information return with respect to the payments made to Individuals I and J. No information return is required with respect to the payments made to the pension trust or Corporation Z because such persons are exempt recipients described in § 1.6049–4(c)(1)(ii). The Bureau of Public Debt and the Federal Reserve bank are not required to make an information return because they made payment to a person described in § 1.6049–4(c)(1)(ii).

* * * * *

(d) * * *

(3) *Conversion of amounts paid in foreign currency into United States dollars*—(i) *Convertible foreign currency.* In the event that an amount of interest or an amount of original issue discount on an obligation with a maturity at issue of not more than 1 year is paid or credited in convertible foreign currency, the amount shall be converted into United States dollars, and the amount subject to reporting under section 6049 shall be computed on such United States dollar amount, on the date of the payment or crediting. For this purpose, the term ''convertible foreign currency'' means currency of a foreign country that either is readily convertible into United States dollars or is of a type the Secretary determines is to be treated as a convertible foreign currency from the date specified in a notice of such determination published in the FEDERAL REGISTER.

(ii) *Nonconvertible foreign currency.* [Reserved]

(iii) *Original issue discount on foreign currency obligations with a maturity at issue of more than 1 year.* [Reserved]

* * * * *

(7) *Permission to submit information required by Form 1099 on magnetic take.* * * *

* * * * *

(f) * * *

(4) * * * (i) * * * A person shall not be considered to be a middleman as to any portion of an interest payment which is actually owned by another person whose name is also shown on the information return filed with respect to such interest payment. Thus, in the case of a savings account jointly owned by a husband and wife, the husband will not be considered as acting in the capacity of a middleman with respect to his wife if his wife's name is included on the information return filed by the payor with respect to the interest.

(ii) * * **Example.* * * * Broker B is required to make an information return showing the amount of original issue treated as paid to A during 1984 under § 1.6049–5(c).

* * * * *

§ 1.6049–5 Interest and original issue discount subject to reporting after December 31, 1982.

(a) *Interest subject to reporting requirement.* For purposes of §§ 1.6049–4, 1.6049–6 and this section, except as provided in paragraph (b) of this section, the term ‘‘interest’’ means:

(1) Interest on an obligation:

(i) In registered form (as defined in § 5f.103–1(c)), or

(ii) Of a type offered to the public. Principles consistent with § 5f.163–1 shall be applied to determine whether an obligation is of a type offered to the public.

(2) Interest on deposits with persons carrying on the banking business. Such term shall include deposits evidenced by time certificates of deposit issued in any amount whether negotiable or nonnegotiable. The term ‘‘interest’’ includes payments to a mortgage escrow account and amounts paid with respect to repurchase agreements and banker’s acceptances. Property which the payee receives from the payor as interest (or in lieu of a cash payment of interest) shall be interest for purposes of section 6049. The amount subject to reporting is the fair market value of such property.

(3) Amounts, whether or not designated as interest, paid or credited by mutual savings banks, savings and loan associations, building and loan associations, cooperative banks, homestead associations, credit unions, industrial loan associations or banks, or similar organizations, in respect of deposits, face amount certificates, investment certificates, or withdrawable or repurchasable shares. Thus, even though amounts paid or credited by such organizations with respect to deposits are designated as ‘‘dividends’’, such amounts are included in the definition of interest for purposes of section 6049. The term ‘‘interest’’ includes payments to a mortgage escrow account and amounts paid with respect to repurchase agreements. Property which the payee receives from the payor as interest (or in lieu of a cash payment of interest) is ‘‘interest’’ for purposes of section 6049. The fair market value of such property is the amount subject ot reporting.

(4) Interest on amounts held by insurance companies under an agreement to pay interest thereon. Any increment in value of ‘‘advance premiums’’, ‘‘prepaid premiums’’, or ‘‘premium deposit funds’’ which is applied to the payment of premiums due on insurance policies, or made available for withdrawal by the policyholder, shall be considered interest subject to reporting. Interest that an insurance company pays pursuant to an agreement with the policyholder to a beneficiary because he payment due has been delayed is interest subject to reporting. Interest subject to reporting also includes interest paid by insurance companies with respect to policy ‘‘dividend’’ accumulations (see sections 61 and 451 and the regulations thereunder for rules as to when such interest is considered paid), and interest paid with respect to the proceeds of insurance policies left with the insurer. The so-called ‘‘interest element’’ in the case of annuity or installment payments under life insurance or endowment contracts does not constitute interest for purposes of section 6049.

(5) Interest on deposits with brokers as defined in section 6045(c) and the regulations thereunder. Any payment made in lieu of interest to a person whose obligation has been borrowed in connection with a short sale or other similar transaction is subject to reporting under section 6049. See § 1.6045–2T for reporting requirements with respect to payments in lieu of tax-exempt interest. See § 1.6045–2 for reporting requirements with respect to payments in lieu of tax-exempt interest.

(6) Interest paid on amounts held by investment companies as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. section 80 a-3) and on amounts invested in other pooled funds or trusts. For purposes of section 6049, interest paid on amounts invested in pooled funds or trusts, such as mortgage pass-through certificates or mortgage participation certificates, shall be considered to be the interest paid as stated on the certificate, and shall not be the interest on any notes or obligations underlying such certificates. See § 1.6049–4(c)(2) providing that in the case of interest paid on amounts invested in such pooled funds or trusts, the reporting requirements of section

6049 shall be considered satisfied if the issuer files Form 1041 as the fiduciary of a grantor trust and furnishes Form K–1 to each beneficiary, containing the information required by the form, including amounts withheld under section 3406.

(b) *Interest excluded from reporting requirement.* The term *interest* or *original issue discount* (OID) does not include—

(1) Interest on any obligation issued by a natural person as defined in § 1.6049–4(f)(2), irrespective of whether such interest is collected on behalf of the holder of the obligation by a middleman.

(2) Interest on any obligation if such interest is exempt from taxation under section 103(a), relating to certain governmental obligations, or interest which is exempt from taxation under any other provision of law without regard to the identity of the holder. The holder of a tax exempt obligation that is not in registered form must provide written certification to the payor (other than the issuer of the obligation) that the obligation is exempt from taxation.A statement that interest coupons are tax exempt on the envelope or shell commonly used by financial institutions to process such coupons, signed by the payee, will be sufficient for this purpose if the envelope is properly completed (i.e., shows the name, address, and taxpayer identification number of the payee). A payor may rely on such written certification in treating such interest as tax exempt for purposes of section 6049. See § 1.6049–4(d)(8) with respect to the requirement that the issuer of a taxable obligation shall make an information return if such issuer receives an envelope which improperly claims that the interest coupons contained therein are tax exempt.

(3) Interest on amounts held in escrow to guarantee performance on a contract or to provide security. However, interest on amounts held in escrow with a person described in paragraph (a)(2) or (3) of this section is interest subject to reporting under section 6049.

(4) Interest that a governmental unit pays with respect to tax refunds.

(5) Interest on deposits for security, such as deposits posted with a public utility company. However, interest on deposits posted for security with a person described in paragraph (a)(2) or (3) of this section is interest subject to reporting under section 6049.

(6) Amounts from sources outside the United States (determined under the provisions of part I, subchapter N, chapter 1 of the Internal Revenue Code (Code) and the regulations under those provisions) paid outside the United States by a non-U.S. payor or a non-U.S. middleman (as defined in paragraph (c)(5) of this section). See paragraph (e) of this section for circumstances in which a payment is considered to be made outside the United States.

(7) Portfolio interest, as defined in § 1.871–14(b)(1), paid with respect to obligations in bearer form described in section 871(h)(2)(A) or 881(c)(2)(A) or with respect to a foreign-targeted registered obligation described in § 1.871–14(e)(2) for which the documentation requirements described in § 1.871–14(e)(3) and (4) have been satisfied (other than by a U.S. middleman (as defined in paragraph (c)(5) of this section) that, as a custodian or nominee of the payee, collects the amount for, or on behalf of, the payee, regardless of whether the middleman is also acting as agent of the payor).

(8) Portfolio interest described in § 1.871–14(c)(1)(ii), paid with respect to obligations in registered form described in section 871(h)(2)(B) or 881(c)(2)(B) that is not described in paragraph (b)(7) of this section.

(9) Any amount paid by an international organization described in § 1.6049–4(c)(1)(ii)(G) (or its paying, transfer, or other agent that is not also a payee's agent) with respect to an obligation of which the international organization is the issuer.

(10)(i) Amounts paid outside the United States (other than by a U.S. middleman (as defined in paragraph (c)(5) of this section) that, as a custodian or nominee or other agent of the payee, collects the amount for, or on behalf of, the payee, regardless of whether the middleman is also acting as agent of the payor) with respect to an obligation that: Has a face amount or principal amount of not less than $500,000 (as determined based on the spot rate on the date of issuance if in foreign currency); has a maturity (at issue) of 183 days or less; satisfies the requirements of sections 163(f)(2)(B)(i) and (ii)(I) and the regulations thereunder (as if the obligation would otherwise be a registration-required obligation within the meaning of section 163(f)(2)(A)) (however, an original issue discount obligation with a maturity of 183 days or less from the date of issuance is not required to satisfy the certification requirement of § 1.163–5(c)(2)(i)(D)(*3*)) and is issued in accordance with the procedures of § 1.163–5(c)(2)(i)(D); and has on its face the following statement (or a similar statement having the same effect):

By accepting this obligation, the holder represents and warrants that it is not a United States person (other than an exempt recipient described in section 6049(b)(4) of the Internal Revenue Code and regulations thereunder) and that it is not acting for or on behalf of a United States person (other than an exempt recipient described in section 6049(b)(4) of the Internal Revenue Code and the regulations thereunder).

(ii) If the obligation is in registered form, it must be registered in the name of an exempt recipient described in § 1.6049–4(c)(1)(ii). For purposes of this paragraph (b)(10), a middleman may treat an obligation as described in section 163(f)(2)(B)(i) and (ii)(I) and the regulations under that section if the obligation, or coupons detached therefrom, whichever is presented for payment, contains the statement described in this paragraph (b)(10).

(11) Amounts paid with respect to an account or deposit with a U.S. or foreign branch of a domestic or foreign corporation or partnership that is paid with respect to an obligation described in either paragraph (b)(11)(i) or (ii) of this section, if the branch is engaged in the commercial banking business; and the interest or OID is paid outside the United States (other than by a U.S. middleman (as defined in paragraph (c)(5) of this section) that acts as a custodian, nominee, or other agent of the payee, and collects the amount for, or on behalf of, the payee, regardless of whether the middleman is also acting as agent of the payor).

(i) An obligation is described in this paragraph (b)(11)(i) if it is not in registered form (within the meaning of section 163(f) and the regulations under that section), is described in section 163(f)(2)(B) and issued in accordance with the procedures of § 1.163–5(c)(2)(i)(C) or (D), and, in the case of a U.S. branch, is part of a larger single public offering of securities. For purposes of this paragraph (b)(11)(i), a middleman may treat an obligation as described in section 163(f)(2)(B) if the obligation, and any detachable coupons, contains the statement described in section 163(f)(2)(B)(ii)(II) and the regulations under that section.

(ii)(A) An obligation is described in this paragraph (b)(11)(ii) if it produces income described in section 871(i)(2)(A); has a face amount or principal amount of not less than $500,000 (as determined based on the spot rate on the date of issuance if in foreign currency); satisfies the requirements of sections 163(f)(2)(B)(i) and (ii)(I) and the regulations thereunder (as if the obligation would otherwise be a registration-required obligation within the meaning of section 163(f)(2)(A)) and is issued in accordance with the procedures of § 1.163–5(c)(2)(i) (C) or (D) (however, an original issue discount obligation with a maturity of 183 days or less from the date of issuance is not required to satisfy the certification requirement of § 1.163–5(c)(2)(i)(D)(3)). For purposes of this paragraph (b)(11)(ii), a middleman may treat an obligation as described in sections 163(f)(2)(b) (i) and (ii) and the regulations under that section if the obligation, or any detachable coupon, contains the statement described in paragraph (b)(11)(ii)(b) of this section.

(B) The obligation must have on its face, and on any detachable coupons, the following statement (or a similar statement having the same effect):

By accepting this obligation, the holder represents and warrants that it is not a United States person (other than an exempt recipient described in section 6049(b)(4) and regulations under that section) and that it is not acting for or on behalf of a United States person (other than an exempt recipient described in section 6049(b)(4) and the regulations under that section).

(C) If the obligation is in registered form, it must be registered in the name of an exempt recipient described in § 1.6049–4(c)(1)(ii).

(12) Payments that a payor can, prior to payment, reliably associate with documentation upon which it may rely to treat the payment as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii) or as made to a foreign payee in accordance with paragraph (d)(1) of this section or presumed to be made to a foreign payee under paragraph (d) (2), (3), (4), or (5) of this section. However, such payments may be reportable under §1.1461–1 (b) and (c). The provisions of §1.1441–1 shall apply by substituting the term *payor* for the term *withholding agent* and without regard to the fact that the provisions apply only to amounts subject to withholding under chapter 3 of the Code. In the event of a conflict between the provisions of §1.1441–1 and paragraph (d) of this section in determining the foreign status of the payee, the provisions of §1.1441–1 shall govern for payments of amounts subject to withholding under chapter 3 of the Code and the provisions of paragraph (d) of this section shall govern in other cases. This paragraph (b)(12) does not apply to interest paid to a Canadian nonresident alien individual as provided in §1.6049–8.

(13) Amounts for the period that the debt obligation with respect to which the interest arises represents an asset blocked as described in §1.1441–2(e)(3). Payment of such amounts, including interest that is past due and OID on obligations that mature on or before the date that the assets are no longer blocked, is deemed to occur in accordance with the rules of §1.1441–2(e)(3).

(14) Payments made by a foreign intermediary described in §1.1441–1(e)(3)(i) that it has received in its capacity as an intermediary and that are associated with a valid withholding certificate described in §1.1441–1(e)(3) (ii) or (iii) and payments made by a U.S. branch of a foreign bank or of a foreign insurance company described in §1.1441–1(b)(2)(iv) that are associated with a valid withholding certificate described in §1.1441–1(e)(3)(v), which certificate the intermediary or branch has furnished to the payor or middleman from whom it has received the payment, unless, and to the extent, the intermediary or branch knows that the payments are required to be reported under §1.6049–4 and were not so reported.

(15) Amounts of interest as determined under the provisions of §1.446–3(g)(4) (dealing with interest in the case of a significant non-periodic payment with respect to a notional principal contract). Such amounts are governed by the provisions of section 6041. See §1.6041–1(d)(5).

(c) *Applicable rules*—(1) *Documentary evidence for offshore accounts.* A payor may rely on documentary evidence described in this paragraph (c)(1) instead of a beneficial owner withholding certificate described in §1.1441–1(e)(2)(i) in the case of a payment made outside the United States to an offshore account or, in the case of broker proceeds described in §1.6045–1(c)(2), in the case of a sale effected outside the United States (as defined in §1.6045–1(g)(3)(iii)(A)). For purposes of this paragraph (c)(1), an offshore account means an account maintained at an office or branch of a U.S. or foreign bank or other financial institution at any location outside the United States (i.e., other than in any of the fifty States or the District of Columbia) and outside of U.S. possessions. Thus, for example, an account maintained in a foreign country at a branch of a U.S. bank or of a foreign subsidiary of a U.S. bank is an offshore account.For the definition of a payment made outside the United States, see paragraph (e) of this section. A payor may rely on documentary evidence if the payor has established procedures to obtain, review, and maintain documentary evidence sufficient to establish the identity of the payee and the status of that person as a foreign person (including, but not limited to, documentary evidence described in §1.1441–6(c) (3) or (4)); and the payor obtains, reviews, and maintains such documentary evidence in accordance with those procedures. A payor maintains the documents reviewed by retaining the original, certified copy, or a photocopy (or microfiche or similar means of record retention) of the documents reviewed and noting in its records the date on which and by whom the document was received and reviewed. Documentary evidence furnished for the payment of an amount subject to withholding under chapter 3 of the Code must contain all of the information that is necessary to complete a Form 1042–S for that payment.

(2) *Other applicable rules.* The provisions of §1.1441–1(e)(4)(i) through (ix) (regarding who may sign a certificate, validity period of certificates, retention of certificates, etc.) shall apply (by substituting the term *payor* for the term *withholding agent* and disregarding the fact that the provisions under §1.1441–1(e)(4) only apply to amounts subject to withholding under chapter 3 of the Code) to withholding certificates and documentary evidence furnished for purposes of this section. See §1.1441–1(b)(2)(vii) for provisions dealing reliable association of a payment with documentation.

(3) *Standards of knowledge.* A payor may not rely on a withholding certificate or documentary evidence described in paragraph (c)(1) or (4) of this section if it has actual knowledge or reason to know that any information or certification stated in the certificate or documentary evidence is unreliable. A payor has reason to know that information or certifications are unreliable only if the payor would have reason to know under the provisions of §1.1441–7(b)(2)(ii) and (3) that the information and certifications provided on the certificate or in the documentary evidence are unreliable or, in the case of a Form W–9 (or an acceptable substitute), it cannot reasonably rely on the documentation as set forth in §31.3406(h)–3(e) of this chapter (see the information and certification described in §31.3406(h)–3(e)(2)(i) through (iv) of this chapter that are required in order for a payor reasonably to rely on a Form W–9). The provisions of §1.1441–7(b)(2)(ii) and (3) shall apply for purposes of this paragraph (c)(3) irrespective of the type of income to which §1.1441–7(b)(2)(ii) is otherwise limited. The exemptions from reporting described in paragraphs (b)(10) and (11) of this section shall not apply if the payor has actual knowledge that the payee is a U.S. person who is not an exempt recipient.

(4) *Special documentation rules for certain payments.* This paragraph (c)(4) modifies the provisions of this paragraph (c) for payments to offshore accounts maintained at a bank or other financial institution of amounts that are not subject to withholding under chapter 3 of the Code, other than amounts described in (d)(3)(iii) of this section (dealing with U.S. short-term OID and U.S. bank deposit interest). Amounts are not subject to withholding under chapter 3 of the Code if they are not included in the definition of amounts subject to withholding under §1.1441–2(a) (e.g., deposit interest with foreign branches of U.S. banks, foreign source income, or broker proceeds).

(i) *Alternative documentary evidence.* In the case of payments to which this paragraph (c)(4) applies, the bank or other financial institution may, instead of a beneficial owner withholding certificate described in §1.1441–1(e)(2)(i) or documentary evidence described in paragraph (c)(1) of this section, rely on a customer's declaration of foreign status made on an account opening form that contains the statement described in this paragraph (c)(4)(i) (or such substitute statement as the Internal Revenue Service may prescribe) if the mailing and permanent residence address of the customer is in the country in which the branch or office is located and, under the local laws, regulations, or practices applicable to the type of account or transaction described in this paragraph (c)(4), it is not customary to obtain documentary evidence described in paragraph (c)(1) of this section or, it is customary to obtain such documentary evidence, but it is not customary to request that it be renewed periodically. Reliance on the documentary evidence described in this paragraph (c)(4)(i) is permitted only if there are no indications that the person opening the account is a U.S. person (e.g., permanent residence address is in a foreign country, the person does not have a mailing address in the United States, the person is not employed by a U.S.-based multinational organization).If reliance is not permitted because there are indications of U.S. status (e.g., the person's permanent residence address is in the United States, the person changes his mailing address to the United States, the person is employed by a U.S.-based multinational organization) then the payor must obtain either documentary evidence described in paragraph (c)(1) of this section or a Form W–8 described in §1.1441–1(e)(2)(i) in order to treat the customer as a foreign payee. The form or documentary evidence must be renewed every three years in accordance with the renewal procedures set forth in §1.1441–1(e)(4)(ii)(A) for as long as indicia of U.S. status continue to be present. The statement referred to in this paragraph (c)(4)(i) must appear near the signature line and must read as follows:

> By opening this account and signing below, the account owner represents and warrants that he/she/it is not a U.S. person for purposes of U.S. federal income tax and that he/she/it is not acting for or on behalf of a U.S. person. A false statement or misrepresentation of tax status by a U.S. person could lead to penalties under U.S. law. If your tax status changes and you become a U.S. citizen or a resident, you must notify us within 30 days.

(ii) *Continuous validity of declaration of foreign status subject to due diligence by financial institution.* A declaration of foreign status described in paragraph (c)(4)(i) of this section does not expire if the financial institution complies with the mailing requirement described in paragraph (c)(4)(iii) of this section, unless the bank or other financial institution becomes aware of circumstances indicating that the customer may be a U.S. person (including indications described in §1.1441–7(b)(2)(ii), dealing with due diligence standards applicable to financial institutions). If circumstances indicate that the customer may be a U.S. person, then the financial institution may rely on the foreign status of the customer only if it obtains documentary evidence from the customer that is described in paragraph (c)(1) of this section or a beneficial withholding certificate described in §1.1441–1(e)(2)(i). Such documentary evidence or certificate does not expire after the three-year validity period otherwise prescribed for such documentation but must be renewed each time new circumstances occur indicating that the customer may be a U.S. person.

(iii) *Negative confirmation of change of status.* In order for a declaration of foreign status to remain valid, the financial institution must include the following statement on a year-end statement mailed to the customer:

> You have declared to us that you are not a U.S. person and, unless you notify us to the contrary, we will continue to rely on that declaration to treat the account as owned by a non-U.S. person. You have an obligation to notify us if your status changes and you become a U.S. citizen or a U.S. resident. A U.S. person who fails to report earnings on the account could be subject to penalties under U.S. law.

(iv) *Special rule when non-renewable documentary evidence is customary.* If it is customary in the country in which the branch or office is located to obtain documentary evidence described in paragraph (c)(1) of this section, but it is not customary for such documentary evidence to be renewed, then a payor must request such documentary evidence in lieu of the statement described in paragraph (c)(4)(i) of this section. All other requirements described in paragraphs (c)(4)(ii) and (c)(4)(iii) of this section shall apply.

(v) *Exception for existing accounts.* The rules of paragraphs (c)(4)(i) and (iv) of this section shall apply only to accounts opened on or after January 1, 2000.

(5) *U.S. payor, U.S. middleman, non-U.S. payor, and non-U.S. middleman.* The terms *payor* and *middleman* have the meanings ascribed to them under §1.6049–4(a). A *non-U.S. payor* or *non-U.S. middleman* means a payor or middleman other than a U.S. payor or U.S. middleman. The term *U.S. payor* or *U.S. middleman* means—

(i) A person described in section 7701(a)(30) (including a foreign branch or office of such person);

(ii) The government of the United States or the government of any State or political subdivision thereof (or any agency or instrumentality of any of the foregoing);

(iii) A controlled foreign corporation within the meaning of section 957(a);

(iv) A foreign partnership, if at any time during its tax year, one or more of its partners are U.S. persons (as defined in §1.1441–1(c)(2)) who, in the aggregate hold more than 50 percent of the income or capital interest in the partnership or if, at any time during its tax year, it is engaged in the conduct of a trade or business in the United States;

(v) A foreign person 50 percent or more of the gross income of which, from all sources for the three-year period ending with the close of its taxable year preceding the collection or payment (or such part of such period as the person has been in existence), was effectively connected with the conduct of trade or business within the United States; or

(vi) A U.S. branch of a foreign bank or a foreign insurance company described in § 1.1441–1(b)(2)(iv).

(6) *Examples.* The following examples illustrate the provisions of paragraphs (b) and (c) of this section:

Example 1. FC is a foreign corporation that is not engaged in a trade or business in the United States during the current calendar year. D, an individual who is a resident and citizen of the United States, holds a registered obligation issued by FC in a public offering. Interest is paid on the obligation within the United States by DC, a U.S. corporation that is the designated paying agent of FC. D does not have an account with DC. Although interest paid on the obligation issued by FC is foreign source, the interest paid by DC to D is considered to be interest for purposes of information reporting under section 6049 because it is paid in the United States.

Example 2. The facts are the same as in *Example 1* except that D is a nonresident alien individual who has furnished DC with a Form W–8 in accordance with the provisions of § 1.1441–1(e)(1)(ii). By reason of paragraph (b)(12) of this section, the payment of interest by DC to D is not considered to be a payment of interest for purposes of information reporting under section 6049. Therefore, DC is not required to make an information return under section 6049.

Example 3. The facts are the same as in *Example 2* except that D has not furnished a Form W–8 and DC pays interest on the obligation at its branch outside the United States. The payment of interest by DC to D is not considered to be a payment of interest for purposes of information reporting under section 6049 because DC, although a U.S. person is not a middleman or a payor within the meaning of § 1.6049–4(a) and (f)(4). Thus, the amount is described in paragraph (b)(6) of this section. Therefore, DC is not required to make an information return under section 6049.

Example 4. The facts are the same as in *Example 3* except that the obligation of FC is held in a custodial account for D by FB, a foreign branch of a U.S. financial institution. By reason of paragraph (c)(5) of this section, FB is considered to be a U.S. middleman. Therefore, FB is required to make an information return unless FB may treat D as a beneficial owner that is a foreign person in accordance with the provisions of § 1.1441–1(e)(1)(ii).

Example 5. The facts are the same as in *Example 4* except that the FC obligation is held for D by NC, in a custodial account at NC's foreign branch. NC is a foreign corporation that is a non-U.S. middleman described in paragraph (c)(5) of this section. Under paragraph (b)(6) of this section, the payment by NC to D is not considered to be a payment of interest for purposes of section 6049. Therefore, NC is not required to make an information return under section 6049 with respect to the payment.

(d) *Determination of status as U.S. or foreign payee and applicable presumptions in the absence of documentation*—(1) *Identifying the payee.* The provisions of § 1.1441–1(b)(2) shall apply (by substituting the term *payor* for the term *withholding agent*) to identify the payee for purposes of this section (and other sections of regulations under this chapter to which this paragraph (d)(1) applies), except to the extent provided in this paragraph (d)(1) in the case of payments of amounts that are not subject to withholding under chapter 3 of the Code. Amounts are not subject to withholding under chapter 3 of the Code if they are not included in the definition of amounts subject to withholding under § 1.1441–2(a) (e.g., deposit interest with foreign branches of U.S. banks, foreign source income, or broker proceeds). The exceptions to the application of § 1.1441–1(b)(2) to amounts that are not subject to withholding under chapter 3 of the Code are as follows:

(i) The provisions of § 1.1441–1(b)(2)(ii), dealing with payments to a U.S. agent of a foreign person, shall not apply. Thus, a payment to a U.S. agent of a foreign person is treated as a payment to a U.S. payee.

(ii) Payments to U.S. branches of certain banks or insurance companies described in § 1.1441–1(b)(2)(iv) shall be treated as payments to a foreign payee, irrespective of the fact that the U.S. branch may have arranged with the payor to be treated as a U.S. person for payments of amounts subject to withholding and irrespective of the fact that the branch is treated as a U.S.

payor for purposes of paragraph (c)(5) of this section.

(2) *Presumptions of U.S. or foreign status in the absence of documentation*—(i) *In general.* For purposes of this section (and other sections of regulations under this chapter to which this paragraph (d)(2) applies), the provisions of §1.1441–1(b)(3)(i), (ii), (iii), (vii), (viii), and (ix) shall apply (by substituting the term *payor* for the term *withholding agent*) to determine the status of a payee as a U.S. or a foreign person and its relevant characteristics (e.g., as an owner or intermediary, or as an individual, corporation, or flow-through entity), irrespective of whether the payments are subject to withholding under chapter 3 of the Code. In addition, the rules of §1.1441–1(b)(2)(vii) shall apply for purposes of determining when a payment can reliably be associated with documentation, by substituting the term *payor* for the term *withholding agent.* For this purpose, the documentary evidence described in paragraph (c)(4) of this section can be treated as documentation with which a payment can be associated.

(ii) *Grace period in the case of indicia of a foreign payee.* When the conditions of this paragraph (d)(2)(ii) are satisfied, the 30-day grace period provisions under section 3406(e) shall not apply and the provisions of this paragraph (d)(2)(ii) shall apply instead. A payor that, at any time during the grace period described in this paragraph (d)(2)(ii), credits an account with amounts reportable under section 6042, 6045, or 6049 with respect to actively traded securities, or under section 6050N in the case of royalties from a unit investment trust that are (or were upon issuance) publicly offered and are registered with the Securities and Exchange Commission under the Securities Act of 1933 (15 U.S.C. 77a) may, instead of treating the account as owned by a U.S. person and applying backup withholding under section 3406, choose, in its discretion, to treat the account as owned by a foreign person if, at the beginning of the grace period, the address that the payor has in its records for the account holder is in a foreign country, the payor has been furnished the information contained in a withholding certificate described in §1.1441–1(e)(2)(i) or (3)(i) (by way of a facsimile copy of the certificate or other non-qualified electronic transmission of the information required to be stated on the certificate), or the payor holds a withholding certificate that is no longer reliable. In the case of a newly opened account, the grace period begins on the date that the payor first credits the account. In the case of an existing account for which the payor holds a Form W–8 or documentary evidence of foreign status, the grace period begins on the date that the payor first credits the account after the existing documentation held with regard to the account can no longer be relied upon (other than because the validity period described in §1.1441–1(e)(4)(ii)(A) has expired). A new account shall be treated as an existing account if the account holder already holds an account at the branch location at which the new account is opened. It shall also be treated as an existing account if an account is held at another branch location if the institution maintains a coordinated account information system described in §1.1441–1(e)(4)(ix).The grace period terminates on the earlier of the close of the 90th day from the date on which the grace period begins, the date that the documentation is provided, or the last day of the calendar year in which the grace period begins. The grace period also terminates when the remaining balance in the account (due to withdrawals or otherwise) is equal to or less than 31 percent of the total amounts credited since the beginning of the grace period that would be subject to backup withholding if the provisions of this paragraph (d)(2)(ii) did not apply. At the end of the grace period, the payor shall treat the amounts credited to the account during the grace period as paid to a U.S. or foreign payee depending upon whether documentation has been furnished and the nature of any such documentation furnished upon which the payor may rely to treat the account as owned by a U.S. or foreign payee. If the documentation has not been received on or before the date of expiration of the grace period, the payor may also apply the presumptions described in this paragraph (d) to amounts credited to the account after the date on which the grace period expires (until such time as the payor can reliably associate the documentation with amounts credited). See § 31.6413(a)–3(a)(1)(iv) of this chapter for treating backup withheld amounts under section 3406 as erroneously withheld when the documentation establishing foreign status is furnished prior to the end of the calendar year in which backup withholding occurs. If the provisions of this paragraph (d)(2)(ii) apply, the provisions of § 31.3406(d)–3 of this chapter shall not apply. For purposes of this paragraph (d)(2)(ii), an account holder's reinvestment of gross proceeds of a sale into other instruments constitutes a withdrawal and a non-qualified electronic transmission of information on a withholding certificate is a transmission that is not in accordance with the provisions of § 1.1441–1(e)(4)(iv). See § 1.1092(d)–1 for a definition of the term *actively traded* for purposes of this paragraph (d)(2)(ii).

(iii) *Joint owners.* Amounts paid to accounts held jointly for which a certificate or documentation is required as a condition for being exempt from reporting under paragraph (b) of this section are presumed made to U.S. payees who are not exempt recipients if, prior to payment, the payor cannot reliably associate the payment either with a Form W–9 furnished by one of the joint owners in the manner required in §§ 31.3406(d)–1 through 31.3406(d)-5 of this chapter, or with documentation described in paragraph (b)(12) of this section furnished by each joint owner upon which it can rely to treat each joint owner as a foreign payee or foreign beneficial owner. For purposes of applying this paragraph (d)(2)(iii), the grace period described in paragraph (d)(2)(ii) of this section shall apply only if each payee qualifies for such grace period.

(3) *Payments to foreign intermediaries*—(i) *Payments of amounts subject to withholding under chapter 3 of the Internal Revenue Code.* In the case of payments of amounts that are subject to withholding under chapter 3 of the Code, the provisions of § 1.1441–1(b) (2)(v) and (3)(v) shall apply (by substituting the term *payor* for the term *withholding agent*) to identify the payee and determine the applicable presumptions for purposes of this section (and other sections of regulations under this chapter to which this paragraph (d)(3) applies).

(ii) *Payments of amounts not subject to withholding under chapter 3 of the Internal Revenue Code.* Amounts that are not subject to withholding under chapter 3 of the Code that the payor may treat as paid to a foreign intermediary in accordance with § 1.1441–1(b)(3)(v)(A) shall be treated as made to an exempt recipient described in § 1.6049–4(c)(1)(ii) (M), (O), (P), or (Q) except to the extent that the payor has actual knowledge that any person for whom the intermediary is collecting the payment is a U.S. person who is not an exempt recipient. In the case of such actual knowledge, the payor shall treat the payment that it knows is allocable to such U.S. person as a payment to a U.S. payee who is not an exempt recipient. If the payor does not have sufficient reliable information regarding the portion of the payment to the foreign intermediary that is allocable to such presumed U.S. payee, then the payor shall treat the maximum portion of the payment that could be allocable to such presumed U.S. payee as so allocable.

(iii) *Special rule for payments of certain short-term original issue discount and bank deposit interest*—(A) *General rule.* A payment of U.S. source original issue discount on an obligation with a maturity from the date of issue of 183 days or less (short-term OID) described in sections 871(g)(1)(B) or 881(a)(3) or of U.S. source interest (including original issue discount) on deposits with banks and other financial institutions described in sections 871(i)(2)(A) or 881(d) that the payor may treat as paid to a foreign intermediary in accordance with the provisions of § 1.1441–1(b)(3)(v)(A) shall be treated as paid to an exempt recipient only to the extent that the payor can treat the payment as made to a foreign person that is a beneficial owner in accordance with the provisions of § 1.1441–1(e)(1)(ii), or can treat as a payment to a U.S. beneficial owner in accordance with the provisions of § 1.1441–1(d)(4) (except to the extent that the payment is associated with a Form W–9 described in § 1.1441–1(d)(2) relating to a U.S. payee who is not an exempt recipient), or can rely on the payee's claim that the payee assumes withholding responsibility in accordance with §1.1441–1(e)(5)(iv).

(B) *Payee has not furnished reliable documentation.* If the payment is made to a person described in §1.6049–4(c)(1)(ii) that the payor may treat as an exempt recipient without requiring documentation and the payor may not treat the payee as a foreign intermediary in accordance with the provisions of §1.1441–1(b)(3)(v)(A), then the payee shall be treated as an exempt recipient only if the payor can treat the person as a U.S. person, or if the person has furnished a certificate as a U.S. branch described in §1.1441–1(b)(2)(iv), or the person has furnished a certificate such that the payor can treat the payment as a payment made to a foreign person that is a beneficial owner, or if the payor can treat the person as a foreign person that has furnished an indication to the payor that such person is receiving the payment for its own account. A payor must treat the payee as a foreign person for purposes of this paragraph (d)(3)(iii) if the payor has actual knowledge of the person's employer identification number and that number begins with the two digits ''98,'' if the payor's communications with the person are mailed to an address in a foreign country, or if the payment is made outside the United States (as defined in paragraph (e) of this section).The payor may treat as a U.S. person any person not described in the preceding sentence for purposes of this paragraph (d)(3)(iii). If the payee is treated as a foreign person under this paragraph (d)(3)(iii)(B), it must be treated as not acting for its own account unless it furnishes an indication of beneficial ownership in any manner that the payor and the person may choose, provided the indication is documented in the payor's records. The indication is not required to be under penalties of perjury. The provisions of this paragraph (d)(3)(iii) shall not apply to deposits with banks and other financial institutions that remain on deposit for a period of two weeks or less, to amounts of original issue discount arising from a sale and repurchase transaction that is completed within a period of two weeks or less, or to amounts described in paragraphs (b)(7), (10) and (11) of this section (relating to certain obligations issued in bearer form).

(iv) *Examples.* The rules of this paragraph (d)(3) are illustrated by the following example:

Example 1. A payor, X, makes a payment to Y of U.S. source interest on debt obligations issued prior to July 18, 1984. Therefore, the interest does not qualify as portfolio interest under sections 871(h) or 881(d). Y is a nonqualified foreign intermediary that has furnished to X a valid intermediary withholding certificate described in §1.1441–1(e)(3)(iii) to which it has attached a valid Form W–9 for A, and two valid beneficial owner Forms W–8, one for B and one for C. Y's withholding certificate does not contain reliable information regarding B and C's share of the payment. B's withholding certificate (attached to Y's withholding certificate) indicates that B is a foreign pension fund, exempt from U.S. tax under the U.S. income tax treaty with Country T. C's withholding certificate (attached to Y's withholding certificate) indicates that C is a foreign corporation not entitled to a reduced rate of withholding. Under paragraph (b)(12) of this section, X may rely on the withholding certificates to determine the status of A, B, and C for purposes of deciding whether the amounts paid are interest within the meaning of this section. However, because X cannot reliably determine how much of the payment is allocable to B and C, it must presume under paragraph (d)(3)(i) of this section and §1.1441–1(b)(3)(v)(C) that 80 percent of the payment (i.e., all of the payment less A's share) is allocable to C because the rate of withholding applicable to the payment to C is the highest of the withholding rates applicable to B and C. Thus, based on such presumption, X may treat C as a foreign payee under paragraph (b)(12) of this section and, therefore, may treat the payment as not being interest reportable under §1.6049–4(a).

Example 2. The facts are the same as in *Example 1*, except that X can reliably determine C's allocable share, but cannot reliably determine A's and B's share. No withholding is required under chapter 3 of the Code or under section 3406 on the payment to A or B since A is a U.S. person who has furnished a valid Form W–9 and B is an exempt recipient (as defined in §1.6049–4(c)(1)(ii)(B)) and a foreign tax-exempt organization exempt from chapter 3 withholding (see §1.1441–9). However, X estimates that A, as a U.S. person, is subject to a higher U.S. tax liability with respect to the payment than B is, since B is a foreign tax-exempt organization. Therefore, X must presume under paragraph (d)(3)(i) of this section and §1.1441–1(b)(3)(v)(C) that 70 percent of the payment (i.e., all of the payment less C's share) is allocable to A. Consequently, X must report all of the payment on the Form 1099 filed for A under § 1.6049–4(a).

Example 3. A payor, X, makes a payment of foreign source interest to Y, a non-qualified foreign intermediary that has furnished an intermediary withholding certificate described in § 1.1441–1(e)(3)(iii) to which it has attached a withholding certificate described in § 1.1441–1(e)(3)(iii) for Z, that is also a non-qualified foreign intermediary. Beneficial owner certificates are attached to Z's certificate. Under paragraph (d)(1) of this section, X must rely on the provisions of § 1.1441–1(b)(2)(v) to treat the payment as made to the persons whose withholding certificates are attached to Z's certificate to the extent both Y and Z have reliably certified in accordance with § 1.1441–1(e)(3)(iii)(D) that the certificates that each of them has attached to their respective intermediary withholding certificate represent all of the persons to whom the intermediary withholding certificate relates. X must rely on the provisions of § 1.1441–1(b)(2)(v) even though the payment is not an amount subject to withholding under chapter 3 of the Code.

Example 4. A payor, X, makes a payment to Y of foreign source interest and U.S. source dividends. Y has furnished to X a qualified intermediary withholding certificate described in § 1.1441–1(e)(3)(ii) for itself. Y indicates that 10 percent of each type of payments is allocable to the category described in § 1.1441–1(e)(5)(v)(B)(*3*), relating to assets owned by persons for whom the qualified intermediary does not hold the documentation. X has no actual knowledge that the persons owning the assets are U.S. persons. With respect to the payment of foreign source interest (an amount that is not subject to withholding under chapter 3 of the Code), X must, under paragraph (d)(3)(ii) of this section, treat the payment as made to a foreign payee. Such treatment is effective for purposes of paragraph (b)(12) of this section, meaning that the 10-percent amount is not treated as interest for purposes of reporting under § 1.6049–4(a). With respect to the amount of U.S. source dividends, X must, under paragraph (d)(3)(i) of this section, treat the payment as made to a foreign payee (based upon paragraph (d)(3)(i)'s cross-reference to § 1.1441–1(b)(3)(v)(B)). Such treatment is effective for purposes of § 1.6042–3(b)(1)(iii), meaning that the 10-percent amount is not treated as a dividend for purposes of reporting under § 1.6042–2(a).

Example 5. A payor, X, makes a payment of foreign source interest to Y, a non-qualified foreign intermediary that has furnished an intermediary withholding certificate described in § 1.1441–1(e)(3)(iii) to which it has attached beneficial owner Forms W–8. In its withholding certificate, Y represents to X that 30 percent of the payment is allocable to a U.S. person who has not furnished a Form W–9 and whom Y cannot treat as an exempt recipient. Under paragraph (d)(3)(ii) of this section, X must treat 70 percent of the payment as made to a foreign payee. X, however, may not rely on the rule of paragraph (d)(3)(ii) of this section to treat the remainder of the payment as made to a foreign payee because X has actual knowledge that the remainder of the payment is allocable to a U.S. person. Under paragraph (d)(3)(ii) of this section, X must treat 30 percent of the payment as made to a U.S. payee who is not an exempt recipient.

Example 6. A payor, X, holds a valid withholding certificate from Y, a qualified intermediary, with which it reliably associates payments made to A, a U.S. individual who maintains an account relationship with Y and who has furnished a valid Form W–9 to Y. Y has furnished A's Form W–9 to X who has set up a separate account for those assets held in Y's name, and which Y has indicated are allocable to A. The assets consist of 10,000 shares of stock of domestic corporation T, publicly traded on a U.S. stock exchange. When dividends are paid on the T stock held in the Y/A account, X credits the dividend amounts to the account and reports the dividend amounts credited to that account on a Form 1099–DIV under section 6042, treating A as the payee in accordance with paragraph (d)(1) of this section (cross-referencing § 1.1441–1(b)(2)(v)). When A later instructs Y to sell the shares, X effects the sale and credits the Y/A account with the gross proceeds from the sale of 10,000 shares of the T stock. Under § 1.6045–1(c)(2) and paragraph (d)(3)(ii) of this section, X must report the gross proceeds credited to the Y/A account on a Form 1099–-B made in the name of A since it has actual knowledge that the gross proceeds are paid to a U.S. person who is not an exempt recipient. See section 1.6045–1(g)(3)(iv).

Example 7. A payor, X, holds a valid withholding certificate from Y, a non-qualified intermediary, and can reliably associate a payment of U.S. short-term OID and proceeds from the sale of shares with the certificate. Y has not attached any certificates or documentary evidence to its certificate and informs X that the payment is allocable to persons for whom it holds no documentation. Under paragraph (d)(3)(iii) of this section, X must, for purposes of this section and section 3406, treat the payment of short-term OID as made to a U.S. payee who is not an exempt recipient. However, under paragraph (d)(3)(ii) of this section, the payment of gross proceeds from the sale of shares is treated as made to a foreign payee. X must rely on this treatment for purposes of determining its reporting obligations under section 6045 and the regulations under that section (see

§1.6045–1(g)(1)(i)) and, consequently, its withholding obligations under section 3406 and the regulations under that section.

(4) *Determination of partnership and partners status in the absence of documentation*—(i) *Payments of amounts subject to withholding under chapter 3 of the Internal Revenue Code.* In the case of payments of amounts that are subject to withholding under chapter 3 of the Code, the provisions of §§1.1441–1(b)(3)(ii) and 1.1441–5(c)(1), and (d) shall apply (by substituting the term *payor* for the term *withholding agent*) to determine the status of the payee as a partnership, as a domestic or foreign partnership, and the status of its partners for purposes of this section (and other sections of regulations under this chapter to which this paragraph (d)(4) applies).

(ii) *Payments of amounts not subject to withholding under chapter 3 of the Internal Revenue Code.* In the case of amounts that are not subject to withholding under chapter 3 of the Code, the provisions of §§1.1441–1(b)(3)(ii) and 1.1441–5(c)(1), and (d) shall also apply (by substituting the term *payor* for the term *withholding agent*), subject to the following exceptions—

(A) If, in the absence of documentation, the payor treats the payee as a partnership in accordance with the presumptions set forth in §1.1441–1(b)(3)(ii), the presumptions of §1.1441–5(d)(2) shall not apply to treat the partnership as a foreign partnership; instead, the person treated as a partnership shall be presumed to be a domestic partnership; and

(B) In the case of payments described in §1.1441–5(d)(3)(i) (dealing with lacking or unreliable documentation regarding the status of partners) or in §1.1441–5(d)(3)(iii), dealing with lacking or unreliable information regarding the number of partners represented by the withholding certificate), the partners are presumed to be U.S. payees who are not exempt recipients and not foreign payees.

(5) *Presumptions for payments to or by foreign trusts or estates.* [Reserved]

(e) *Determination of whether amounts are considered paid outside the United States*—(1) *In general.* For purposes of section 6049 and this section, an amount is considered to be paid by a payor or middleman outside the United States if the payor or middleman completes the acts necessary to effect payment outside the United States. See paragraphs (e)(2), (3), and (4) of this section for further clarification of where amounts are considered paid. A payment shall not be considered to be made within the United States for purposes of section 6049 merely by reason of the fact that it is made on a draft drawn on a United States bank account or by a wire or other electronic transfer from a United States account. However, without regard to the location of the account from which the amount is drawn, an amount that is described in paragraph (e)(1) (i) or (ii) of this section and paid by transfer to an account maintained by the payee in the United States or by mail to a United States address is not considered to be paid outside the United States.

(i) An amount is described in this paragraph (e)(1)(i) if it is paid by an issuer or the paying agent of the issuer and the obligation is either—

(A) Issued by a U.S. payor, as defined in paragraph (c)(5) of this section;

(B) Registered under the Securities Act of 1933 (15 U.S.C. 77a); or

(C) Listed on an exchange that is registered as a national securities exchange in the United States or included in an interdealer quotation system in the United States.

(ii) An amount is described in this paragraph (e)(1)(ii) if it is paid by a U.S. middleman (as defined in paragraph (c)(5) of this section) that, as a custodian, nominee, or other agent of a payee, collects the amount for or on behalf of the payee.

(2) *Amounts paid with respect to deposits or accounts with banks and other financial institutions.* Notwithstanding paragraph (e)(1) of this section, an amount paid by a bank or other financial institution with respect to a deposit or with respect to an account with the institution is considered paid at the branch or office at which the amount is credited unless the amount is collected by the financial institution as the agent of the payee. However, an amount will not be considered to be paid at the branch or office where the amount is considered to be credited unless the branch or office is a permanent

place of business that is regularly maintained, occupied, and used to carry on a banking or similar financial business; the business is conducted by at least one employee of the branch or office who is regularly in attendance at such place of business during normal business hours; and the branch or office receives deposits and engages in one or more of the other activities described in § 1.864–4(c)(5)(i). In addition, an amount paid by a bank or other financial institution with respect to a deposit or an account with the institution is not considered paid at a branch or office outside the United States if the customer has transmitted instructions to an agent, branch, or office of the institution from inside the United States by mail, telephone, electronic transmission, or otherwise concerning the deposit or account (unless the transmission from the United States has taken place in isolated and infrequent circumstances).

(3) *Coupon bonds and discount obligations in bearer form.* Notwithstanding paragraph (e)(1) of this section, an amount paid with respect to a bond with coupons attached (including a certificate of deposit with detachable interest coupons) or a discount obligation that is not in registered form (within the meaning of section 163(f) and the regulations thereunder) is considered to be paid where the coupon or the discount obligation is presented to the payor or its paying agent for payment. However, without regard to where the coupon or discount obligation is presented for payment, an amount paid with respect to either a bond with coupons attached or a discount obligation by transfer to an account maintained by the payee in the United States or by mail to the United States is considered paid in the United States if the payment is described in paragraphs (e)(3) (i) and (ii) of this section.

(i) The amount is paid by an issuer or the paying agent of the issuer and the obligation is either—

(A) Issued by a U.S. payor, as defined in paragraph (c)(5) of this section;

(B) Registered under the Securities Act of 1933 (15 U.S.C. 77a); or

(C) Listed on an exchange that is registered as a national securities exchange in the United States or included in a interdealer quotation system in the United States.

(ii) The amount is paid by a U.S. middleman (as defined in paragraph (c)(5) of this section) that, as a custodian, nominee, or other agent of payee, collects the amount for or on behalf of the payee.

(4) *Foreign-targeted registered obligations.* Notwithstanding paragraph (e)(1) of this section, where the payor is the issuer or the issuer's agent, an amount is considered paid outside the United States with respect to a foreign-targeted registered obligation, as described in § 1.871–14(e)(2), if either the amount is paid by transfer to an account maintained by the registered owner outside the United States, or by mail to an address of the registered owner outside the United States, or by credit to an international account. For purposes of this paragraph (e)(4), the term *international account* means the book-entry account of a financial institution (within the meaning of section 871(h)(4)(B)) or of an international financial organization with the Federal Reserve Bank of New York for which the Federal Reserve Bank of New York maintains records that specifically identify an international financial organization or a financial institution (within the meaning of section 871(h)(4)(B)) as either a non-United States person or a foreign branch of a United States person as registered owner. An international financial organization is a central bank or monetary authority of a foreign government or a public international organization of which the United States is a member to the extent that such central bank, authority, or organization holds obligations solely for its own account and is exempt from tax under section 892 or 895.

(5) *Examples.* The application of the provisions of this paragraph (e) are illustrated by the following examples:

Example 1. FC is a foreign corporation that is not a U.S. payor or U.S. middleman, as defined in paragraph (c)(5) of this section. A holds FC coupon bonds that are not in registered form under section 163(f) and the regulations thereunder, that were issued by FC in a public offering outside the United States, that are not registered under the Securities Act of 1933 (15 U.S.C. 77a), and that are neither listed on an exchange that is registered as a national securities exchange in the United States nor included in an interdealer quotation system. DC, a U.S. corporation that is engaged in a commercial banking business, is the designated fiscal agent for FC. FB, a foreign branch of DC, is the designated paying agent with respect to the bonds issued by FC. A does not have an account with FB. A presents a coupon from a FC bond for payment to FB at its office outside the United States. FB pays A with a check drawn against a bank account maintained in the United States. For purposes of section 6049, the place of payment of interest on the FC bond by FB to A is considered to be outside the United States under paragraph (e)(3) of this section.

Example 2. The facts are the same as in *Example 1* except that A presents the coupon to FB at its office outside the United States with instructions to transfer funds in payment to a bank account maintained by A in the United States. FB transfers the funds in accordance with A's instructions. Even though the amount is credited to an account in the United States, the place of payment of interest on the FC bonds is considered to be outside the United States under paragraph (e)(3) of this section because the coupon is presented for payment outside the United States; because FC is a foreign person that is not a U.S. payor or U.S. middleman, as defined in paragraph (d)(1) of this section; because FB is not acting as A's agent; and because the obligation is not registered under the Securities Act of 1933 (15 U.S.C. 77a), listed on a securities exchange that is registered as a national securities exchange in the United States, or included in an interdealer quotation system.

Example 3. FC is a foreign corporation that is not a U.S. payor or U.S. middleman, as defined in paragraph (d)(1) of this section. B, a United States citizen, holds a bond issued by FC in registered form under section 163(f) and the regulations thereunder and registered under the Securities Act of 1933 (15 U.S.C. 77a). The bond is not a foreign-targeted registered obligation as defined in §1.871–14(e)(2). DB, a United States branch of a foreign corporation engaged in the commercial banking business, is the registrar of the bonds issued by FC. DB supplies FC with a list of the holders of the FC bonds. Interest on the FC bonds is paid to B and other bondholders by checks prepared by FC at its principal office outside the United States, and B's check is mailed from there to his designated address in the United States. The bond is described in paragraph (e)(1)(i)(B) of this section. The place of payment to B by FC of the interest on the FC bonds is considered to be inside the United States under paragraph (e)(1) of this section.

Example 4. The facts are the same as in Example 3 except that the checks are prepared and mailed in the United States by DC, a U.S. corporation engaged in the commercial banking business that is the designated paying agent with respect to the bonds issued by FC, and B's check is mailed to his designated address outside the United States. For purposes of section 6049, the place of payment by DC of the interest on the FC bonds is considered to be within the United States under paragraph (e)(1) of this section.

Example 5. Individual C deposits funds in an account with FB, a foreign country X branch of DB, a U.S. corporation engaged in the commercial banking business. FB maintains an office and employees in foreign country X, accepts deposits, and conducts one or more of the other activities listed in §1.864–4(c)(5)(i). The terms of C's deposit provide that it will be payable in six months with accrued interest. On the day that the interest is credited to C's account with FB, C telephones DB from inside the United States and asks DB to direct FB to transfer the funds in his account with FB to an account C maintains in the United States with DB. Transmissions from the United States concerning this account have taken place in isolated and infrequent circumstances. Under paragraph (e)(2) of this section, FB is considered to have paid the interest on C's deposit outside the United States.

Example 6. The facts are the same as in *Example 5* except that C has placed his deposit with FB for an indefinite period of time. Interest will be credited to C's account daily. C has instructed FB to wire the interest at 90-day intervals to C's account with DB within the United States. FB is considered to have paid the interest credited to A's account within the United States under paragraph (e)(2) of this section because the regular crediting of the account disqualifies the transmission from being isolated or infrequent.

Example 7. DC, a U.S. corporation engaged in the commercial banking business, maintains FB, a branch in foreign country X. FB has an office and employees in foreign country X, accepts deposits, and engages in one or more of the other activities listed in §1.864–4(c)(5)(i). D, a United States citizen, purchases a certificate of deposit issued in 1980 by FB. The certificate of deposit has a maturity of 20 years and has detachable interest coupons payable at six-month intervals. D presents some of the coupons at the U.S. office of DC and receives payment in cash. Because the coupon is presented to DC for payment within the United States, DC is considered to have made the payment within the United States under paragraph (e)(3) of this section.

Example 8. FB is recognized by both foreign country X and by the Federal Reserve Bank as a foreign country X branch of DC, a U.S. corporation engaged in the commercial banking business. A local foreign country X bank serves as FB's resident agent in Country X. FB maintains no physical office or employees in foreign country X. All the records, accounts, and transactions of FB are handled at the United States office of DC. E deposits funds in an amount maintained with FB. Interest earned on the deposit is periodically credited to E's account with FB by employees of DC. For purposes of section 6049, the place of payment of the interest on E's deposit with FB is considered to be within the United States by reason of paragraphs (e)(1) and (2) of this section.

Example 9. DC is a U.S. corporation. A holds bonds that were issued by DC in registered form under section 163(f) and the regulations thereunder and that are foreign-targeted registered obligations as defined in § 1.871–14(e)(2). DB, a commercial banking business, is the registrar of bonds issued by DC. Interest on the DC bonds is paid to A and other bondholders by check prepared by DB at its principal office inside the United States and mailed from there to A's address outside the United States. The check is drawn on a United States account maintained by DC with DB within the United States. The place of payment to A by DB of the interest on the DC bonds is considered to be outside the United States under paragraph (e)(4) of this section.

(f) *Original issue discount treated as payment of interest.* In determining whether an obligation is one which was issued at a discount and the amount of discount which is includible in income of the holder, a payor (other than the issuer of the obligation) may rely on the Internal Revenue Service's publication of publicly traded original issue discount obligations. In the case of an obligation as to which there is during any calendar year an amount of original issue discount includible in the gross income of any holder (as determined under sections 1232 and 1232A and the regulations thereunder), the issuer of the obligation or a middleman (as defined in § 1.6049–4(f)(4)) shall be treated as having paid to such holder during such calendar year an amount of interest equal to the amount of original issue discount so includible without regard to any reduction by reason of a purchase allowance under sections 1232(a)(2)(C)(ii), 1232A (a)(6) or (b)(4) or a purchase at a premium under 1232A(c)(4)(A) or paragraph (d)(2) of § 1.1232–3. Thus, the determination of the amount of original issue discount includible in the gross income of any holder with respect to any obligation shall be determined as if any holder of the obligation were the original holder. In the case of (1) an obligation to which section 1232A does not apply (for example, a short-term government obligation as defined in section 1232(a)(3)) and (2) an obligation issued on or before December 31, 1982, in bearer form, the amount of original issue discount includible in gross income shall be treated as if paid in the calendar year in which the date of maturity occurs or in which the date of redemption occurs if redemption occurs before maturity.The amount subject to reporting on an obligation issued in bearer form with a maturity at the date of issue of more than 1 year (a long term obligation) is the amount of original issue discount includible in the gross income of the holder during the calendar year of maturity or redemption if redemption occurs before maturity. The amount of original issue discount subject to reporting on a long term obligation shall not be reduced to reflect any purchase allowance. Discount on short term government obligations as defined in section 1232(a)(3), such as Treasury bills, and discount on other obligations with a maturity at the date of issue of not more than 1 year (a short term obligation), including commercial paper, when paid at maturity or redemption if redemption occurs before maturity, shall constitute a payment of interest for purposes of section 6049. In general, the amount subject to reporting on short term obligations is the difference between the stated redemption price at maturity and the original issue price. The procedure set forth in section 3455(b)(2)(B) and § 31.3455(b)–1(b)(3) for establishing the price at which a holder purchased an obligation subsequent to the date of original issue shall apply for purposes of section 6049. Original issue discount on an obligation (including an obligation with a maturity of not more than 6 months from the date of original issue) held by a nonresident alien individual or foreign corporation is interest described in paragraph (b)(1)(vi) (A) or (B) of this section and, therefore is not interest subject to reporting under section 6049 unless it is described in § 1.6049–8(a) (relating to bank deposit interest paid to a Canadian nonresident alien individual).

(g) *Effective date*—(1) *General rule.* The provisions of paragraphs (b)(6) through (15), (c), (d), and (e) of this section apply to payments made after December 31, 1999.

(2) *Transition rules.* The validity of a withholding certificate (namely, Form W–8 or other form upon which the payor is permitted to rely to hold the payee as a foreign person) that was valid on January 1, 1998, under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) and expired, or will expire, at any time during 1998, is extended until December 31, 1998. The validity of a withholding certificate that is valid on or after January 1, 1999, remains valid until its validity expires under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) or, if earlier, until December 31, 2000. The rule in this paragraph (g)(2), however, does not apply to extend the validity period of a withholding certificate that expires solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the first three sentences of this paragraph (g)(2), a payor may choose not to take advantage of the transition rule in this paragraph (g)(2) with respect to one or more withholding certificates valid under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998) and, therefore, may require withholding certificates conforming to the requirements described in this section (new withholding certificates). For purposes of this section, a new withholding certificate is deemed to satisfy the documentation requirement under the regulations in effect prior to January 1, 2000 (see 26 CFR parts 1 and 35a, revised April 1, 1998). Further, a new withholding certificate remains valid for the period specified in §1.1441–1(e)(4)(ii), regardless of when the certificate is obtained.

[T.D. 7881, 48 FR 12972, Mar. 28, 1983, as amended by T.D. 7987, 49 FR 42719, Oct. 24, 1984; T.D. 8029, 50 FR 23680, June 5, 1985; T.D. 8664, 61 FR 17573, Apr. 22, 1996; T.D. 8734, 62 FR 53483, Oct. 14, 1997; T.D. 8804, 63 FR 72186, 72188, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53483, Oct. 14, 1997, §1.6049–5 was amended by removing the reference ‘‘section 3451’’ in paragraph (a)(6) and adding ‘‘section 3406’’ in its place; by removing the last sentence of paragraph (a)(6); by revising paragraph (b); by redesignating paragraph (c) as paragraph (f); and by adding new paragraphs (c), (d), (e) and (g), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.6049–5 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.6049–5 Interest and original issue discount subject to reporting after December 31, 1982.

(a) * * *

(6) * * * See §31.3454(a)–1(a)(7) for the provisions relating to withholding.

(b) *Interest excluded from reporting requirement*—(1) *In general.* Subject to the provisions of §1.6049–8, the term *interest* does not include:

(i) Interest on any obligation issued by a natural person as defined in §1.6049–4(f)(2) irrespective of whether such interest is collected on behalf of the holder of the obligation by a middleman.

(ii) Interest on any obligation if such interest is exempt from taxation under section 103(a), relating to certain governmental obligations, or interest which is exempt from taxation under any other provision of law without regard to the identity of the holder. The holder of a tax exempt obligation must provide written certification to the payor (other than the issuer of the obligation) that the obligation is exempt from taxation. A statement that interest coupons are tax exempt on the envelope or ‘‘shell’’ commonly used by financial institutions to process such coupons, signed by the payee, will be sufficient for this purpose if the envelope is properly completed (*i.e.,* shows the name, address, and taxpayer identification number of the payee). A payor may rely on such written certification in treating such interest as tax exempt for purposes of section 6049. See §1.6049–4(d)(8) with respect to the requirement that the issuer of a taxable obligation shall make an information return if such issuer receives an envelope which improperly claims that the interest coupons contained therein are tax exempt.

(iii) Interest on amounts held in escrow to guarantee performance on a contract or to provide security. However, interest on amounts held in escrow with a person described in paragraph (a) (2) or (3) of this section is interest subject to reporting under section 6049.

(iv) Interest that a governmental unit pays with respect to tax refunds.

(v) Interest on deposits posted for security, such as deposits posted with a public utility company. However, interest on deposits posted for security with a person described in paragraph (a) (2) or (3) of this section is interest subject to reporting under section 6049.

(vi) Any amount paid to:

(A) Any nonresident alien or foreign corporation, if the amount paid is subject to withholding of tax under subchapter A of chapter 3 of the Code by the person paying such amount, or

(B) Any nonresident alien or foreign corporation, if the amount paid would be subject to withholding of tax under subchapter A of chapter 3 of the Code by the person paying such amount but for the fact that:

(*1*) Under section 862(a)(1) such amount is considered to be from sources outside the United States,

(*2*) The amount is exempted from withholding of tax by reason of the provisions of a tax treaty,

(*3*) The amount of tax is exempt from withholding of tax under section 1441(a) or 1442(a) by reason of the application of section 1441(c) and paragraph (a) or (f) of §1.1441–4, or

(*4*) The amount is original issue discount (within the meaning of section 1232 (b)(1)),

(vii) Any amount paid with respect to an obligation of, or a deposit with, an issuer or other obligor which is:

(A) A foreign government or international organization or any agency or instrumentality thereof,

(B) A foreign central bank of issue,

(C) A foreign corporation not engaged in trade or business in the United States within the calendar year of the payment,

(D) A foreign corporation, the interest payments of which would be exempt from withholding under subchapter A of chapter 3 of the Code if such an amount were paid to a person who is not a United States person, or

(E) A partnership which is not engaged in a trade or business in the United States within the calendar year of the payment and which is composed in whole of nonresident alien individuals or persons described in paragraphs (b)(1)(vii) (A) through (C) of this section.

(viii) Any amount on which the person making the payment is required to deduct and withhold a tax under section 1451 (relating to tax-free convenant bonds), or would be so required but for section 1451(d) (relating to benefit of personal exemptions).

(ix) Any amount not otherwise described in paragraph (b)(1) of this section which is paid outside the United States and which is income from sources outside the United States within the meaning of section 862(a)(1).

(2) *Amount paid to persons who are not United States persons.* (i) A payor may treat an amount as an amount described in paragraph (b)(1)(vi)(A) of this section if such payor in fact withholds tax on such amount under subchapter A of chapter 3 of the Code in accordance with the provisions of chapter 3.

(ii) Unless it has actual knowledge that the payee of an amount is a United States person, a payor may treat such amount as an amount described in paragraph (b)(1)(vi)(B)(*2*) of this section if with respect to such amount the payor is provided by the payee with a Form 1001 in accordance with §1.1441–6 (b) or (c), or with a certificate or corresponding letter in accordance with §1.1441–6(c)(3).

(iii) Unless it has actual knowledge that the payee of an amount is a United States person, a payor may treat such amount as an amount described in paragraph (b)(1)(vi)(B)(*3*) of this section if with respect to such amount it has received a Form 4224 from the payee in accordance with §1.1441–4(a) or has on file with respect to such amount a notice described in §1.1441–4(f)(2)(ii).

(iv) Unless it has actual knowledge that the payee of an amount is a United States person, a payor may treat such amount as an amount described in paragraphs (b)(1)(vi)(B) (*1*) or (*4*) of this section if it receives a statement, signed by the payee under penalties of perjury, certifying that the payee is not a United States person, or, in the case that the payee is an indivudual, that he is neither a citizen nor a resident of the United States. In addition to such certification, the statement shall contain the name of the payee, the address of the payee, and the taxpayer identification number (if any) of the payee. The address provided for an individual shall be that of his permanent residence; the address provided for a partnership or corporation shall be the address of its principal office; and the address provided for a trust or an estate shall be the address of the permanent residence or principal office of any fiduciary of the trust or estate. The statement may be made, at the option of the payor, on a Form W–8 or on a form prepared by the payor which is substantially similar to Form W–8. Blank copies of Form W–8 will be supplied to payors upon request to the district director. The statement must be received by the payor in the calendar year in which the payment is made or collected or in either of the preceding 2 calendar years. The payor, however, may require the statement from the payee each time it makes a payment to, or collects an amount on behalf of, the payee. The payor shall retain the statement for at least 4 years following the end of the last calendar year during which the amount to which the statement relates, is paid or collected. If the person providing the statement becomes a United States citizen or resident during the period to which the statement relates such person shall notify the payor in writing within 30 days of such change in status. In the case of a trust or an estate, the statement shall be provided by a fiduciary, as defined in section 7701(a)(6), on behalf of the trust or estate; and in the case of a partnership, the statement shall be provided by any general partner on behalf of the partnership. The payor need not receive the statement described in this paragraph (b)(2)(iv) with respect to an amount paid to a payee during a calendar year if, with respect to any other payment to such payee in that year, the payor has withheld tax under subchapter A of chapter 3 of the Code in accordance with the provisions of chapter 3 or if, with respect to any amount that is or may be paid to the payee during that year, the payor has received the documentation described in paragraph (b)(2) (ii) or (iii) of this section in accordance with the provisions of §1.1441–4 or §1.1441–6.

(3) *Amounts paid by certain foreign obligors and amounts from sources outside the United States.* (i) The provisions of this paragraph (b)(3)(i) apply with respect to determinations made by paying agents and middlemen as to whether an amount is paid with respect to an obligation or deposit of an entity described in paragraph (b)(1)(vii) of this section and as to whether an amount is income from sources outside the United States for purposes of paragraph (b)(1)(ix) of this section. Absent actual knowledge to the contrary, a paying agent or middleman may treat an entity as a foreign government, an international organization, or a foreign central bank of issue if the paying agent or middleman could treat such entity as an exempt recipient without requiring an exemption certificate as provided in §31.3452(c)–1 (g), (h), or (i). Absent actual knowledge to the contrary, a middleman generally may treat a corporation as a foreign corporation if its name reasonably so indicates and may treat such corporation as a corporation either which is not engaged in trade or business within the United States or the interest payments of which would be exempt from withholding under subchapter A of chapter 3 of the Code if such payments were made to a person who is not a United States person. However, a paying agent of, or a middleman having a contractual relationship with, the foreign corporation with respect to the payment or collection of an amount must receive a statement, signed under penalties of perjury, from the secretary or other authorized representative of the foreign corporation either that the corporation is not, or does not expect during the calendar year of payment to be, engaged in trade or business in the United States or that the interest paid by the foreign corporation would be exempt from withholding under subchapter A of chapter 3 of the Code if such interest were paid to a person who is not a United States person. Absent actual knowledge to the contrary, a middleman generally may treat a domestic corporation as as corporation the interest payments of which would not be subject to withholding under subchapter A of chapter 3 of the Code if such payments were made to a person who is not a United States person if an annual report, offering circular, or other standard source of financial information published by the corporation reasonably so indicates. However, a paying agent of, or middleman having a contractual relationship with, a domestic corporation with respect to the payment or collection of an amount may, absent actual knowledge to the contrary, treat a domestic corporation as such a corporation only if the secretary or other authorized representative of the corporation provides the paying agent or middleman with a statement, signed under penalties of perjury, that interest paid by such corporation would not be subject to withholding under subchapter A of chapter 3 of the Code if such interest were paid to a person who is not a United States person. A paying agent or middleman may, absent actual knowledge to the contrary, treat a partnership as a partnership which is not engaged in trade or business in the United States during the calendar year of payment and which is composed in whole of nonresident alien individuals or persons described in paragraph (b)(1)(vii) (A), (B), or (C) of this section if it receives a statement, signed under penalties of perjury, from any general partner of the partnership that the partnership is not, and is not expected during the calendar year of the payment to be, engaged in trade or business in the United States and that all of its partners are, and are expected during the calendar year of payment to be, nonresident alien individuals or persons described in paragraph (b)(1)(vii) (A), (B), or (C) of this section. A statement received by a paying agent or middleman in accordance with the provisions of this paragraph (b)(3) must be provided to such paying agent or middleman in the calendar year in which a payment is made or collected or in either of the 2 preceding calendar years. The paying agent or middleman may, however, require such a statement from the corporation or partnership each time it makes a payment for the corporation or partnership. The paying agent or middleman shall retain the statement for at least 4 years following the end of the last calendar year during which an amount to which the statement relates is paid or collected. If after providing such statement the status of the corporation or partnership changes from that reflected in the statement, the corporation or partnership shall notify the paying agent or middleman within 30 days of such change in status.

(ii) Notwithstanding the provisions of paragraph (b)(1)(vii) of this section, amounts described in such paragraph are considered to be interest for purposes of this section when paid within the United States to a United States person. In such case, the person required to report under section 6049 is the payor which makes the payment within the United States. For purposes of this paragraph, the term ''United States person'' is defined in section 7701(a)(30).

(iii) Paragraph (b)(3)(ii) of this section shall not apply with respect to an international organization (as described in paragraph (b)(1)(vii)(A) of this section) which is paying interest within the United States if the international organization is an organization of which the United States is a member and which enjoys immunity with respect to the inviolability of its archives pursuant to an international agreement having full force and effect in the United States.

(iv) For purposes of paragraph (b)(3)(ii) of this section, a payor may, unless it has actual knowledge to the contrary, treat a person to whom it makes a payment within the United States as a person who is not a United States person if, during the calendar year of payment, it withholds tax on any amount paid to such person under subchapter A of chapter 3 of the Code in accordance with the provisions of chapter 3 or, if, with respect to any amount which is or may be paid to such person during that calendar year, it has received documentation described in paragraph (b)(2) (ii), (iii), or (iv) of this section in accordance with the provisions of such paragraphs and of § 1.1441–4 or § 1.1441–6.

(4) *Examples.* The application of paragraph (b) of this section may be illustrated by the following examples:

Example (1). Corporation X is a foreign corporation which is not engaged in trade or business in the United States during the calendar year. A, a United States citizen, holds bonds of Corporation X that were issued in a public offering. A collects the interest on such bonds by presenting the coupons to M, a paying agent of Corporation X whose office is in the United States. Amounts paid with respect to obligations of Corporation X are generally not considered to be interest for purposes of section 6049 since Corporation X is an entity described in paragraph (b)(1)(vii)(C) of this section. However, because M makes a payment of such amounts within the United States to a United States person, the payment by M is considered to be a payment of interest for purposes of section 6049, and M is required to report under section 6049.

Example (2). The facts are the same as in example (1) except that A presents his coupons directly to Corporation X at its office in the United States. In accordance with paragraph (b)(3)(ii) of this section, the payment by Corporation X with respect to the coupons is considered to be a payment of interest for purposes of section 6049, and Corporation X is required to report.

Example (3). The facts are the same as in example (1) except that A is a nonresident alien individual. A provides M with the statement described in paragraph (b)(2)(iv) of this section, which certifies that A is not a United States citizen or resident. Unless M has actual knowledge that the statement provided by A is false, M may rely on such statement and is not required to report under section 6049.

Example (4). The facts are the same as in example (1) except that Corporation X is engaged in trade or business in the United States and 50 percent or more of its gross income for the preceding 3-year period described in section 861(a)(1)(C) has been income which is effectively connected to its United States trade or business. Corporation X is not a beneficiary of an income tax treaty to which the United States is a party. A presents its coupons for payment directly to Corporation X at its office outside the United States. The amount paid by Corporation X is not excluded from the definition of interest for purposes of section 6049 under either paragraph (b)(1)(vii) (C) or (D) of this section since Corporation X is engaged in trade or business in the United States and since all or a portion of the interest paid by it would be subject to withholding under Subchapter A of Chapter 3 of the Code if such interest were paid to a person who is not a United States person. Therefore, Corporation X is required to report the amount paid to A under section 6049.

Example (5). The facts are the same as in example (4) except that Corporation X is a resident of a country which has an income tax treaty with the United States that precludes the United States from imposing tax on interest paid by residents of that country to persons who are not United States persons. Under paragraph (b)(1)(vii)(D) of this section, the amount paid by Corporation X on its bonds is not considered to be interest for purposes of section 6049 since, by reason of the application of a treaty, interest paid by Corporation X would be exempt from withholding under Subchapter A of Chapter 3 of the Code if such interest were paid to a person other than a United States person. Corporation X is not required to report on the amounts paid to A under section 6049.

Example (6). The facts are the same as in example (5) except that A presents its coupons from the Corporation X bonds for payment to N, a paying agent of Corporation X in the United States. The payment by N to A is considered to be a payment of interest under paragraph (b)(3)(ii) of this section, and N is required to report the payment to A under section 6049.

Example (7). Corporation Y is a domestic corporation, all of the gross income of which for the 3-year period described in section 861 (a)(1)(B) has been from sources outside the United States. B, a United States citizen, holds bonds issued by Corporation Y in a public offering. B presents the coupons from such bonds for payment to Corporation Y at an office maintained by Corporation Y outside the United States. Under paragraph (b)(1)(ix) of this section, the amounts paid by Corporation Y are not considered to be interest for purposes of section 6049 since such amounts are considered to be from sources outside the United States under sections 861(a)(1)(B) and 862(a)(1) and are paid outside the United States. Corporation Y is not required under section 6049 to report its payment to B.

Example (8). D has a deposit in an account maintained with a foreign branch of R, a domestic corporation which carries on a commercial banking business. R makes payment of amounts with respect to such deposit outside the United States. Such amounts are considered to be income from sources outside the United States under sections 861(a)(1)(F)(i) and 862(a)(1) and, in accordance with paragraph (b)(1)(ix) of this section, are not considered to be interest for purposes of section 6049. Therefore, R is not required to report under section 6049 regardless of whether D is or is not a United States person.

Example (9). The facts are the same as in example (8) except that D's deposit is in a Puerto Rican branch of a United States bank. The amounts paid with respect to such deposit are income from sources outside the United States within the meaning of sections 861(a)(1)(F)(i) and 862(a)(1). In accordance with the provisions of paragraph (b)(1)(ix) of this section, such amounts are not considered to be interest for purposes of section 6049, and R is not required by section 6049 to report the amounts paid to D regardless of whether D is or is not a United States person.

Example (10). E, a nonresident alien individual, maintains an account in the United States with Corporation S, a domestic corporation which carries on a commerical banking business. S receives the statement described in paragraph (b)(2)(iv) of this section from E with respect to the amount paid on the deposit in E's account with S. The amount paid by S to E with respect E's deposit is considered to be from sources outside the United States under sections 861(a)(1)(A) and 862(a)(1) and is not subject to withholding under Subchapter A of Chapter 3 of the Code. In accordance with provisions of paragraph (b)(1)(vi)(B)(1) of this section, such amount is not considered to be interest for purposes of section 6049. Thus, S is not required to report.

Example (11). U is a domestic corporation which is engaged in a commerical banking business in the United States and outside the United States through a foreign branch. F, an alien individual resident of the United States, holds a non-deposit obligation of U which is a part of a public debt issuance. F makes a demand for payment of the interest due on such obligation at the foreign branch of U. The amount paid by U is considered to be income from sources within the United States under section 861(a)(1) and is considered to be interest under section 6049. U, therefore, is required to report the payment to F under section 6049.

Example (12). The facts are the same as in example (11) except that the obligation held by F was issued by W, a wholly-owned foreign subsidiary of U. W is not engaged in trade or business in the United States during the calendar year. F makes a demand for payment at the office of W outside the United States. Under paragraph (b)(1)(vii)(C) of this section, the amounts paid by W to F are not considered to be interest for purposes of section 6049. Therefore, W is not required under section 6049 to report the payment to F, regardless of whether F is or is not a United States person.

Example (13). Q, a domestic corporation, acts within the United States as custodian for G with respect to obligations of Z that are owned by G. G is a nonresident alien individual who is a resident of a country with which the United States has an income tax treaty. Z is a foreign corporation the interest payments of which would not be subject to withholding under Subchapter A of Chapter 3 of the Code if such payments were made to a person who is not a United States person. During the preceding calendar year, Q received a Form 1001 from G in accordance with the provisions of §1.1441–6(c) with respect to interest paid on other corporate obligations held by Q on G's behalf. During the present calendar year Q collects amounts paid on the Z obligations on behalf of G. G does not give Q the statement described in paragraphs (b)(2)(iv) and (b)(3)(iv) of this section with respect to such amounts. However, as the Form 1001 submitted by G in the preceding calendar year is effective during the present calendar year with respect to certain amounts that are or may be paid to G, Q is not required to report on the amounts collected on G's behalf with respect to the Z obligations.

§1.6049–5T Reporting by brokers of interest and original issue discount on and after January 1, 1986 (temporary).

For purposes of §1.6049–5 (c), relating to original issue discount treated as interest subject to reporting, on and after January 1, 1986, a payor who is a broker or middleman holding as a nominee—

(a) A bank certificate of deposit (without regard to whether the broker or middleman sold the certificate of deposit to the owner), or

(b) Any other original issue discount debt instrument that is specified by the Commissioner,

must determine whether that obligation is one that was issued at a discount and the amount of discount that is includible in the income of the owner. However, before January 1, 1987, reporting is required only with respect to certificates of deposit (or any such other obligations) held by a broker or middleman as a nominee on or after June 1, 1986, that were sold by the broker or middleman (whether for the broker's account or as an agent of the issuer) to the owner. The preceding two sentences do not apply to certificates of deposit (or any such other obligations) held on or after January 1, 1986, but disposed of before June 1, 1986; reporting requirements with respect to such certificates of deposit (or any other such obligations) shall be determined under the provisions of § 1.6049–5 (c) as in effect immediately prior to publication of this § 1.6049–5T.

[T.D. 8109, 51 FR 45106, Dec. 17, 1986]

§ 1.6049–6 Statements to recipients of interest payments and holders of obligations for attributed original issue discount.

(a) *Requirement of furnishing statement to recipient.* Every person filing a Form 1099 under section 6049(a) and § 1.6049–4(e) shall furnish to the person whose identifying number is required to be shown on the form a written statement showing the information required by paragraph (b) of this section. With respect to interest other than interest reported on a transactional basis under § 1.6049–4(e), no statement is required to be furnished under section 6049(c) and this section if the aggregate of the payments for the calendar year is less than $10, unless such payment is subject to the tax imposed under section 3406. In the case of any payment that is subject to withholding under section 3406, a statement shall be furnished irrespective of the amount of the payment. With respect to payments which are reported on a transactional basis, no statement is required to be furnished under section 6049(c) and this section to a person if the payment of interest to (or received on behalf of) such person for the transaction is less than $10 unless the payment is subject to withholding under section 3406. Again, in the case of any payment that is subject to withholding under section 3406, a statement shall be furnished irrespective of the amount of the payment.

(b) *Form of statement.* The written statement required to be furnished to a person under paragraph (a) of this section shall show the following information:

(1) With respect to payments of interest (other than original issue discount) to any person during a calendar year, the statement shall show:

(i) The aggregate amount of payments shown on Form 1099 as having been made to (or received on behalf of) such person;

(ii) The amount of tax withheld under section 3406, if any;

(iii) The name and address of the person filing the form; and

(iv) A legend stating that such amount is being reported to the Internal Revenue Service.

(2) With respect to original issue discount includible in the gross income of a holder of an obligation during a calendar year, the statement shall show:

(i) The aggregate amount of original issue discount includible in the gross income by (or on behalf of) such person for the calendar year with respect to the obligation (determined by applying the rules of paragraph (b)(2) of § 1.6049–4);

(ii) The amount of tax withheld under section 3406, if any;

(iii) The account, serial, or other identifying number of each obligation with respect to which a return is being made;

(iv) All other items shown on Form 1099 for such calendar year; and

(v) A legend stating that such amount and such items are being reported to the Internal Revenue Service.

(c) *Time for furnishing statements.* Each statement required by this section to be furnished to any person for a calendar year with respect to a payment of interest (other than interest where a middleman or a Federal agency makes a return on a transactional basis (as described in paragraph (e) of § 1.6049–4)) shall be furnished to such person after April 30 of the year of payment and on or before January 31 of the following year, but no statement may be furnished before the final interest payment for the calendar year. If a middleman or a Federal agency makes a return on a transactional basis, the statement shall be furnished at, or any time subsequent to, the time of payment, but in no event later than January 31 of the year following the calendar year of payment.

(d) *Special rule.* The requirements of this section for the furnishing of a statement to any person, including the legend requirement of paragraph (b)(1)(iv) and (2)(v) of this section, may be met by the furnishing to such person a copy of the Form 1099 filed pursuant to §1.6049–4, or an acceptable substitute, in respect of such person. However, in the case of Form 1099 with respect to original issue discount on obligations subject to section 1232A, a copy of the instructions must also be sent to such person. A statement shall be considered to be furnished to a person within the meaning of this section if it is mailed to such person at his last known address.

(e) *Statements to recipients*—(1) *Requirement.* A person required to make an information return under section 6049(a) and §1.6049–4 must furnish a statement to each recipient whose identifying number is required to be shown on the related information return for interest or original issue discount paid or accrued.

(2) *Form, manner, and time for providing statements to recipients.* The statement required by paragraph (e)(1) of this section must be either the official Form 1099 prescribed by the Internal Revenue Service for the respective calendar year or an acceptable substitute statement. The rules under §1.6042–4 (relating to statements with respect to dividends) apply comparably in determining the form of an acceptable substitute statement permitted by this paragraph (e). Those rules also apply for purposes of determining the manner of and time for providing the Form 1099 or its acceptable substitute to a recipient under paragraph (e)(1) of this section. However, with respect to original issue discount, the Form 1099 or acceptable substitute statement required by paragraph (e)(1) of this section must show the aggregate amount of original issue discount includible in the gross income by the recipient for the calendar year with respect to the obligation (determined by applying the rules of §1.6049–4(b)(2)), and the amount, serial number, or other identifying number of each obligation with respect to which a return is being made. With respect to interest or original issue discount, the Form 1099 or acceptable substitute statement required by paragraph (e)(1) of this section must be furnished to the recipient on or before January 31 of the year following the calendar year for which the return under section 6049(a)(1) was required to be made.

(3) *Cross-reference to penalty.* For provisions relating to the penalty provided for failure to furnish timely a correct payee statement required under section 6049(c) and §1.6049–6(a), see §301.6722–1 of this chapter (Procedure and Administration Regulations). See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(4) *Special rule for amounts described in §1.6049–8(a) paid after December 31, 1996.* In the case of amounts described in §1.6049–8(a) (relating to payments of interest to Canadian nonresident alien individuals) paid after December 31, 1996, any person who makes a Form 1042–S under section 6049(a) and §1.6049–4(b)(5) shall furnish a statement to the recipient. The statement shall include a copy of the Form 1042–S required to be prepared pursuant to §1.6049–4(b)(5) and a statement to the effect that the information on the form is being furnished to the United States Internal Revenue Service and may be furnished to Canada.

(5) *Effective date.* This paragraph (e) is effective for payee statements due after December 31, 1995, without regard to extensions. For the substantially similar statement mailing requirements that apply with respect to forms required to be filed after October 22, 1986, and before January 1, 1996, see Rev. Proc. 84–70 (1984–2 C.B. 716) (or

successor revenue procedures). See § 601.601(d)(2) of this chapter.

[T.D. 7881, 48 FR 12976, Mar. 28, 1983, as amended by T.D. 8637, 60 FR 66111, Dec. 21, 1995; 61 FR 11307, Mar. 20, 1996; T.D. 8664, 61 FR 17574, Apr. 22, 1996; T.D. 8664, 61 FR 40993, Aug. 7, 1996; T.D. 8734, 62 FR 53491, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53491, Oct. 14, 1997, in § 1.6049–6 paragraph (d) was amended by removing the language ‘‘a reasonable facsimile thereof’’ and inserting ‘‘an acceptable substitute’’ in its place; and by revising paragraph (e)(3), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.6049–6 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.6049–6 Statements to recipients of interest payments and holders of obligations for attributed original issue discount.

* * * * *

(e) * * *

(3) *Penalty.* For provisions relating to the penalty for the failure to furnish a statement under this section, see section 6722.

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§ 1.6049–7 Returns of information with respect to REMIC regular interests and collateralized debt obligations.

(a) *Definition of interest*—(1) *In general.* For purposes of section 6049(a), for taxable years beginning after December 31, 1986, the term *interest* includes:

(i) Interest actually paid with respect to a collateralized debt obligation (as defined in paragraph (d)(2) of this section),

(ii) Interest accrued with respect to a REMIC regular interest (as defined in section 860G(a)(1)), or

(iii) Original issue discount accrued with respect to a REMIC regular interest or a collateralized debt obligation.

(2) *Interest deemed paid.* For purposes of this section and in determining who must make an information return under section 6049(a), interest as defined in paragraphs (a)(1) (ii) and (iii) of this section is deemed paid when includible in gross income under section 860B (b) or section 1272.

(b) *Information required to be reported to the Internal Revenue Service*—(1) *Requirement of filing Form 8811 by REMICs and other issuers*—(i) *In general.* Except in the case of a REMIC all of whose regular interests are owned by one other REMIC, every REMIC and every issuer of a collateralized debt obligation (as defined in paragraph (d)(2) of this section) must make an information return on Form 8811, Information Return for Real Estate Mortgage Investment Conduits (REMICs) and Issuers of Collateralized Debt Obligations. Form 8811 must be filed in the time and manner prescribed in paragraph (b)(1)(iii) of this section. The submission of Form 8811 to the Internal Revenue Service does not satisfy the election requirement specified in § 1.860D-1T(d) and does not require election of REMIC status.

(ii) *Information required to be reported.* The following information must be reported to the Internal Revenue Service on Form 8811—

(A) The name, address, and employer identification number of the REMIC or the issuer of a collateralized debt obligation (as defined in paragraph (d)(2) of this section);

(B) The name, title, and either the address or the address and telephone number of the official or representative of the REMIC or the issuer of a collateralized debt obligation who will provide to any person specified in paragraph (e)(4) of this section the interest and original issue discount information specified in paragraph (e)(2) of this section;

(C) The startup day (as defined in section 860G(a)(9)) of the REMIC or the issue date (as defined in section 1275(a)(2)) of the collateralized debt obligation;

(D) The Committee on Uniform Security Identification Procedure (CUSIP) number, aocount number, serial number, or other identifying number or information, of each class of REMIC regular interest or collateralized debt obligation;

(E) The name, title, address, and telephone number of the official or representative of the REMIC or the issuer of a collateralized debt obligation whom the Internal Revenue Service may contact, and

(F) Any other information required by Form 8811.

(iii) *Time and manner of filing of information return*—

(A) *Manner of filing.* Form 8811 must be filed with the Internal Revenue Service at the address specified on the form. The information specified in paragraph (b(1)(ii) of this section must be provided on Form 8811 regardless of whether other information returns are filed by use of electronic media.

(B) *Time for filing.* Form 8811 must be filed by each REMIC or issuer of a collateralized debt obligation on or before the later of July 31, 1989, or the 30th day after—

(*1*) the startup day (as defined in section 860G(a)(9)) in the case of a REMIC, or

(*2*) the issue date (as defined in section 1275(a)(2)) in the case of a collateralized debt obligation.

Further, each REMIC or issuer of a collateralized debt obligation must file a new Form 8811 on or before the 30th day after any change in the information previously provided on Form 8811.

(2) *Requirement of reporting by REMICs, issuers, and nominees*—(i) *In general.* Every person described in paragraph (b)(2)(ii) of this section who pays to another person $10 or more of interest (as defined in paragraph (a) of this section) during any calendar year must file an information return on Form 1099, unless the interest is paid to a person specified in paragraph (c) of this section.

(ii) *Person required to make reports.* The persons required to make an information return under section 6049(a) and this section are—

(A) REMICs or issuers of collateralized debt obligations (as defined in paragraph (d)(2) of this section), and

(B) Any broker who holds as a nominee or middleman who holds as a nominee any REMIC regular interest or any collateralized debt obligation.

(iii) *Information to be reported*—(A) *REMIC regular interests and collateralized debt obligations not issued with original issue discount.* An information return on Form 1099 must be made for each holder of a REMIC regular interest or collateralized debt obligation not issued with original issue discount, but only if the holder has been paid interest (as defined in paragraph (a) of this section) of $10 or more for the calendar year. The information return must show—

(*1*) The name, address, and taxpayer identification number of the record holder,

(*2*) The CUSIP number, account number, serial number, or other identifying number or information, of each REMIC regular interest or collateralized debt obligation, with respect to which a return is being made,

(*3*) The aggregate amount of interest paid or deemed paid to the record holder for the period during the calendar year for which the return is made,

(*4*) The name, address, and taxpayer identification number of the person required to file this return, and

(*5*) Any other information required by the form.

(B) *REMIC regular interests and collateralized debt obligations issued with original issue discount.* An information return on Form 1099 must be made for each holder of a REMIC regular interest or a collateralized debt obligation issued with original issue discount, but only if the holder has been paid interest (as defined in paragraph (a) of this section) of $10 or more for the calendar year. The information return must show—

(*1*) The name, address, and taxpayer identification number of the record holder,

(*2*) The CUSIP number, account number, serial number, or other identifying number or information, of each REMIC regular interest or collateralized debt obligation, with respect to which a return is being made,

(*3*) The aggregate amount of original issue discount deemed paid to the record holder for the period during the calendar year for which the return is made,

(*4*) The aggregate amount of interest, other than original issue discount, paid or deemed paid to the record holder for the period during the calendar year for which the return is made,

(*5*) The name, address, and taxpayer identification number of the person required to file this return, and

(*6*) Any other information required by the form.

(C) *Cross-reference.* See §1.67–3T(f)(3)(ii) for additional information required to be included on an information return on Form 1099 with respect to certain holders of regular interests in REMICs described in § 1.67–3T(a)(2)(ii).

(iv) *Time and place for filing a return with respect to amounts includible as interest.* The returns required under paragraph (b)(2) of this section for any calendar year must be filed after September 30 of that year, but not before the payor's final payment to the payee for the year, and on or before February 28 of the following year. These returns must be filed with the appropriate Internal Revenue Service Center, the address of which is listed in the instructions for Form 1099. For extensions of time for filing returns under this section, see § 1.6081–1. For magnetic media filing requirements, see § 301.6011–2 of this chapter.

(c) *Information returns not required.* An information return is not required under section 6049(a) and this section with respect to payments of interest on a REMIC regular interest or collateralized debt obligation, if the holder of the REMIC regular interest or the collateralized debt obligation is—

(1) An organization exempt from taxation under section 501(a) or an individual retirement plan;

(2) The United States or a State, the District of Columbia, a possession of the United States, or a political subdivision or a wholly-owned agency or instrumentality of any one or more of the foregoing;

(3) A foreign government, a political subdivision thereof, or an international organization;

(4) A foreign central bank of issue (as defined in § 1.895–1(b)(1)) or the Bank for International Settlements;

(5) A trust described in section 4947(a)(1) (relating to certain charitable trusts);

(6) For calendar quarters and calendar years after 1988, a broker (as defined in section 6045(c) and § 1.6045–1(a)(1));

(7) For calendar quarters and calendar years after 1988, a person who holds the REMIC regular interest or collateralized debt obligation as a middleman (as defined in § 1.6049–4(f)(4));

(8) For calendar quarters and calendar years after 1988, a corporation (as defined in section 7701(a)(3)), whether domestic or foreign;

(9) For calendar quarters and calendar years after 1988, a dealer in securities or commodities required to register as such under the laws of the United States or a State;

(10) For calendar quarters and calendar years after 1988, a real estate investment trust (as defined in section 856);

(11) For calendar quarters and calendar years after 1988, an entity registered at all times during the taxable year under the Investment Company Act of 1940;

(12) For calendar quarters and calendar years after 1988, a common trust fund (as defined in section 584 (a));

(13) For calendar quarters and calendar years after 1988, a financial institution such as a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, industrial loan association or bank, or other similar organization;

(14) For calendar quarters and calendar years after 1988, any trust which is exempt from tax under section 664(c) (*i.e.*, a charitable remainder annuity trust or a charitable remainder unitrust); and

(15) For calendar quarters and calendar years after 1988, a REMIC.

(d) *Special provisions and definitions*—(1) *Incorporation of referenced rules.* The special rules of § 1.6049–4(d) are incorporated in this section, as applicable, except that § 1.6049–4(d)(2) does not apply to any REMIC regular interest or any other debt instrument to which section 1272(a)(6) applies. Further, § 1.6049–5(c) does not apply to any REMIC regular interest or any other debt instrument to which section 1272(a)(6) applies.

(2) *Collateralized debt obligation.* For purposes of this section, the term ‘‘collateralized debt obligation’’ means any debt instrument (except a tax-exempt obligation) described in section 1272(a)(6)(C)(ii) that is issued after December 31, 1986.

(e) *Requirement of furnishing information to certain nominees, corporations,* *and other specified persons*—(1) *In general.* For calendar quarters and calendar years after 1988, each REMIC or issuer of a collateralized debt obligation (as defined in paragraph (d)(2) of this section) must provide the information specified in paragraph (e)(2) of this section in the time and manner prescribed in paragraph (e)(3) of this section to any persons specified in paragraph (e)(4) of this section who request the information.

(2) *Information required to be reported.* For each class of REMIC regular interest or collateralized debt obligation and for each calendar quarter specified by the person requesting the information, the REMIC or issuer of a collateralized debt obligation must provide the following information—

(i) The name, address and Employer Identification Number of the REMIC or issuer of a collateralized debt obligation;

(ii) The CUSIP number, account number, serial number, or other identifying number or information, of each specified class of REMIC regular interest or collateralized debt obligation and, for calendar quarters and calendar years after 1991, whether the information being reported is with respect to a REMIC regular interest or a collateralized debt obligation;

(iii) Interest paid on a collateralized debt obligation in the specified class for each calendar quarter, and the aggregate amount for the calendar year if the request is made for the last quarter of the calendar year;

(iv) Interest accrued on a REMIC regular interest in the specified class for each accrual period any day of which is in the specified calendar quarter, and the aggregate amount for the calendar year if the request is made for the last quarter of the calendar year;

(v) Original issue discount accrued on a collateralized debt obligation or REMIC regular interest in the specified class for each accrual period any day of which is in that calendar quarter, and the aggregate amount for the calendar year if the request is made for the last quarter of the calendar year;

(vi) The daily portion of original issue discount per $1,000 of original principal amount (or for calendar quarters prior to 1992, per other specified unit) as determined under section 1272(a)(6) and the regulations thereunder for each accrual period any day of which is in the specified calendar quarter;

(vii) The length of the accrual period;

(viii) The adjusted issue price (as defined in section 1275(a)(4)(B)(ii)) of the REMIC regular interest or the collateralized debt obligation at the beginning of each accrual period any day of which is in the specified calendar quarter;

(ix) The information required by paragraph (f)(3) of this section;

(x) Information required to compute the accrual of market discount including, for calendar years after 1989, the information required by paragraphs (f)(2)(i)(G) or (f)(2)(ii)(K) of this section; and

(xi) For calendar quarters and calendar years after 1991, if the REMIC is a single class REMIC (as described in §1.67–3T (a)(2)(ii)(B)), the information described in §1.67–3T (f)(1) and (f)(3)(ii) (A) and (B).

(3) *Time and manner for providing information*—(i) *Manner of providing information.* The information specified in paragraph (e)(2) of this section may be provided as follows—

(A) By telephone;

(B) By written statement sent by first class mail to the address provided by the requesting party;

(C) By causing it to be printed in a publication generally read by and available to persons specified in paragraph (e)(4) and by notifying the requesting persons in writing or by telephone of the publication in which it will appear, the date of its appearance, and, if possible, the page upon which it appears; or

(D) By any other method agreed to by the parties. If the information is published, then the publication should also specify the date and, if possible, the page on which corrections, if any, will be printed.

(ii) *Time for furnishing the information.* Each REMIC or issuer of a collateralized debt obligation must furnish the information specified in paragraph (e)(2) of this section on or before the later of—

(A) The 30th day after the close of the calendar quarter for which the information was requested, or

(B) The day that is two weeks after the receipt of the request.

(4) *Persons entitled to request information.* The following persons may request the information specified in paragraph (e)(2) of this section with respect to a specified class of REMIC regular interests or collateralized debt obligations from a REMIC or issuer of a collateralized debt obligation in the manner prescribed in paragraph (e)(5) of this section—

(i) Any broker who holds on its own behalf or as a nominee any REMIC regular interest or collateralized debt obligation in the specified class,

(ii) Any middleman who is required to make an information return under section 6049 (a) and paragraph (b)(2) of this section and who holds as a nominee any REMIC regular interest or collateralized debt obligation in the specified class,

(iii) Any corporation or non-calendar year taxpayer who holds a REMIC regular interest or collateralized debt obligation in the specified class directly, rather than through a nominee,

(iv) Any other person specified in paragraphs (c)(9) through (15) of this section who holds a REMIC regular interest or collateralized debt obligation in the specified class directly, rather than through a nominee, or

(v) A representative or agent for a person specified in paragraphs (e)(4)(i), (ii), (iii) or (iv) of this section.

(5) *Manner of requesting information from the REMIC.* A requesting person specified in paragraph (e)(4) of this section should obtain Internal Revenue Service Publication 938, Real Estate Mortgage Investment Conduit (REMIC) and Collateralized Debt Obligation Reporting Information (or other guidance published by the Internal Revenue Service). This publication contains a directory of REMICs and issuers of collateralized debt obligations. The requesting person can locate the REMIC or issuer from whom information is needed and request the information from the official or representative of the REMIC or issuer in the manner specified in the publication. The publication will specify either an address or an address and telephone number. If the publication provides only an address, the request must be made in writing and mailed to the specified address. Further, the request must specify the calendar quarters (*e.g.*, all calendar quarters in 1989) and the classes of REMIC regular interests or collateralized debt obligations for which information is needed.

(f) *Requirement of furnishing statement to recipient*—(1) *In general.* Every person filing a Form 1099 under section 6049 (a) and this section must furnish to the holder (the person whose identifying number is required to be shown on the form) a written statement showing the information required by paragraph (f)(2) of this section. The written statement provided by a REMIC must also contain the information specified in paragraph (f)(3) of this section.

(2) *Form of statement*—(i) *REMIC regular interests and collateralized debt obligations not issued with original issue discount.* For a REMIC regular interest or collateralized debt obligation issued without original issue discount, the written statement must specify for the calendar year the following information—

(A) The aggregate amount shown on Form 1099 to be included in income by that person for the calendar year;

(B) The name, address, and taxpayer identification number of the person required to furnish this statement;

(C) The name, address, and taxpayer identification number of the person who must include the amount of interest in gross income;

(D) A legend, including a statement that the amount is being reported to the Internal Revenue Service, that conforms to the legend on Form 1099, Copy B, For Recipient;

(E) The CUSIP number, account number, serial number, or other identifying number or information, of each REMIC regular interest or collateralized debt obligation, with respect to which a return is being made;

(F) All other items shown on Form 1099 for the calendar year; and

(G) Information necessary to compute accrual of market discount. For calendar years after 1989, this requirement is satisfied by furnishing to the holder for each accrual period during the year a fraction computed in the manner described in either paragraph (f)(2)(i)(G)(*1*) or (f)(2)(i)(G)(*2*) of this section. For calendar years after December 31, 1991, the REMIC or the issuer of the collateralized debt obligation must be consistent in the method used to compute this fraction.

(*1*) The numerator of the fraction equals the interest, other than original issue discount, allocable to the accrual period. The denominator of the fraction equals the interest, other than original issue discount, allocable to the accrual period plus the remaining interest, other than original issue discount, as of the end of that accrual period. The interest allocable to each accrual period and the remaining interest are calculated by taking into account events which have occurred before the close of the accrual period and the prepayment assumption, if any, determined as of the startup day (as defined in section 860G(a)(9)) of the REMIC or the issue date (as defined in section 1275(a)(2)) of the collateralized debt obligaiton that would be made in computing original issue discount if the debt instrument had been issued with original issue discount.

(*2*) If the REMIC regular interest or the collateralized debt obligation has de minimis original issue discount (as defined in section 1273(a)(3) and any regulations thereunder), then, at the option of the REMIC or the issuer of the collateralized debt obligation, the fraction may be computed in the manner specified in paragraph (f)(2)(ii)(K) of this section taking into account the de minimis original issue discount.

(ii) *REMIC regular interests and collateralized debt obligations issued with original issue discount.* For a REMIC regular interest or collateralized debt obligation issued with original issue discount, the written statement must specify for the calendar year the following information—

(A) The aggregate amount of original issue discount includible in the gross income of the holder for the calendar year with respect to the REMIC regular interest or the collateralized debt obligation;

(B) The aggregate amount of interest, other than original issue discount, includible in the gross income of the holder for the calendar year with respect to the REMIC regular interest or the collateralized debt obligation;

(C) The name, address, and taxpayer identification number of the person required to file this form;

(D) The name, address, and taxpayer identification number of the person who must include the amount of interest specified in paragraphs (f)(2)(ii) (A) and (B) of this section in gross income;

(E) For calendar years after 1987, the daily portion of original issue discount per $1,000 of original principal amount (or for calendar years prior to 1992, per other specified unit) as determined under section 1272(a)(6) and the regulations thereunder for each accrual period any day of which is in that calendar year;

(F) For calendar years after 1987, the length of the accrual period;

(G) All other items shown on Form 1099 for the calendar year;

(H) A legend, including a statement that the information required under paragraphs (f)(2)(ii) (A), (B), (C), (D) and (G) of this section is being reported to the Internal Revenue Service, that conforms to the legend on Form 1099, Copy B, For Recipient;

(I) For calendar years after 1987, the adjusted issue price (as defined in section 1275(a)(4)(B)(ii)) of the REMIC regular interest or the collateralized debt obligation at the beginning of each accrual period with respect to which interest income is required to be reported on Form 1099 for the calendar year;

(J) The CUSIP number, account number, serial number, or other identifying number or information, of each class of REMIC regular interest or collateralized debt obligation, with respect to which a return is being made; and

(K) Information necessary to compute accrual of market discount. For calendar years after 1989, this information includes:

(*1*) For each accrual period in the calendar year, a fraction, the numerator of which equals the original issue discount allocable to that accrual period, and the denominator of which equals the original issue discount allocable to that accrual period plus the remaining original issue discount as of the end of that accrual period, and

(*2*) [Reserved]

The original issue discount allocable to each accrual period and the remaining original issue discount are calculated by taking into account events which have occurred before the close of the accrual period and the prepayment assumption determined as of the startup day (as defined in section 860G (a)(9)) of the REMIC or the issue date (as defined in section 1275 (a)(2)) of the collateralized debt obligation.

(3) *Information with respect to REMIC assets*—(i) *95 percent asset test.* For calendar years after 1988, the written statement provided by a REMIC must also contain the following information for each calendar quarter—

(A) The percentage of REMIC assets that are qualifying real property loans under section 593,

(B) The percentage of REMIC assets that are assets described in section 7701 (a)(19), and

(C) The percentage of REMIC assets that are real estate assets defined in section 856 (c)(6)(B), computed by reference to the average adjusted basis (as defined in section 1011) of the REMIC assets during the calendar quarter (as described in § 1.860F–4 (e)(1)(iii)). If for any calendar quarter the percentage of REMIC assets represented by a category is at least 95 percent, then the statement need only specify that the percentage for that category, for that calendar quarter, was at least 95 percent.

(ii) *Additional information required if the 95 percent test not met.* If, for any calendar quarter after 1988, less than 95 percent of the assets of the REMIC are real estate assets defined in section 856 (c)(6)(B), then, for that calendar quarter, the REMIC's written statement must also provide to any real estate investment trust (REIT) that holds a regular interest the following information—

(A) The percentage of REMIC assets described in section 856 (c)(5)(A), computed by reference to the average adjusted basis of the REMIC assets during the calendar quarter (as described in § 1.860F–4 (e)(1)(iii)),

(B) The percentage of REMIC gross income (other than gross income from prohibited transactions defined in section 860F (a)(2)) described in section 856 (c)(3)(A) through (E), computed as of the close of the calendar quarter, and

(C) The percentage of REMIC gross income (other than gross income from prohibited transactions defined in section 860F (a)(2)) described in section 856 (c)(3)(F), computed as of the close of the calendar quarter. For purposes of this paragraph (f)(3)(ii)(C), the term ‘‘foreclosure property’’ contained in section 856 (c)(3)(F) shall have the meaning specified in section 860G (a)(8).

In determining whether a REIT satisfies the limitations of section 856 (c)(2), all REMIC gross income is deemed to be derived from a source specified in section 856 (c)(2).

(iii) *Calendar years 1988 and 1989.* For calendar years 1988 and 1989, the percentage of assets required in paragraphs (f)(3)(i) and (ii) of this section may be computed by reference to the average fair market value of the assets of the REMIC during the calendar quarter (as described in § 1.860F–4 (e)(1)(iii)), instead of by reference to the average adjusted basis of the assets of the REMIC during the calendar quarter.

(4) *Cross-reference.* See § 1.67–3T (f)(2)(ii) for additional information that may be separately stated on the statement required by this paragraph (f) with respect to certain holders of regular interests in REMICs described in § 1.67–3T (a)(2)(ii).

(5) *Time for furnishing statements*—(i) *For calendar quarters and calendar years after 1988.* For calendar quarters and calendar years after 1988, each statement required under this paragraph (f) to be furnished to any person for a calendar year with respect to amounts includible as interest must be furnished to that person after April 30 of that year and on or before March 15 of the following year, but not before the final interest payment (if any) for the calendar year.

(ii) *For calendar quarters and calendar years prior to 1989*—(A) *In general.* For calendar quarters and calendar years prior to 1989, each statement required under this paragraph (f) to be furnished to any person for a calendar year with respect to amounts includible as interest must be furnished to that person after April 30 of that year and on or before January 31 of the following year, but not before the final interest payment (if any) for the calendar year.

(B) *Nominee reporting.* For calendar quarters and calendar years prior to 1989, each statement required under this paragraph (f) to be furnished by a nominee must be furnished to the actual owner of a REMIC regular interest or a collateralized debt obligation to which section 1272 (a)(6) applies on or before the later of—

(*1*) The 30th day after the nominee receives such information, or

(*2*) January 31 of the year following the calendar year to which the statement relates.

(6) *Special rules*—(i) *Copy of Form 1099 permissible.* The requirements of this paragraph (f) for the furnishing of a statement to any person, including the legend requirement of paragraphs (f)(2)(i)(D) and (f)(2)(ii)(H) of this section, may be met by furnishing to that person—

(A) A copy of the Form 1099 filed pursuant to paragraph (b)(2) of this section in respect of that person, plus a separate statement (mailed with the Form 1099) that contains the information described in paragraphs (f)(2)(i)(E) and (G), (f)(2)(ii)(E), (F), (I), and (K), (f)(3), and (f)(4) of this section, if applicable, or

(B) A substitute form that contains all the information required under this paragraph (f) and that complies with any current revenue procedure concerning the reproduction of paper substitutes of Forms 1099 and the furnishing of substitute statements to forms recipients. The inclusion on the substitute form of the information specified in this paragraph (f) that is not required by the official Forms 1099 will not cause the substitute form to fail to meet any requirements that limit the information that may be provided with a substitute form.

(ii) *Statement furnished by mail.* A statement mailed to the last known address of any person shall be considered to be furnished to that person within the meaning of this section.

(7) *Requirement that nominees furnish information to corporations and certain other specified persons*—(i) *In general.* For calendar quarters and calendar years after 1988, every broker or middleman must provide in writing or by telephone the information specified in paragraph (e)(2) of this section to—

(A) A corporation,

(B) A non-calendar year taxpayer, or

(C) Any other person specified in paragraphs (c)(9) through (15) of this section

who requests the information and for whom the broker or middleman holds as a nominee a REMIC regular interest or a collateralized debt obligation. A corporation, non-calendar year taxpayer, or any other person specified in paragraphs (c)(9) through (15) of this section may request the information in writing or by telephone for any REMIC regular interest or collateralized debt obligation for calendar quarters any day of which the person held the interest or obligation.

(ii) *Time for furnishing information.* The statement required in paragraph (f)(7)(i) of this section must be furnished on or before the later of—

(A) The 45th day after receipt of the request,

(B) The 45th day after the close of the calendar quarter for which the information was requested, or

(C) If the request is made for the last calendar quarter in a year, March 15 of the year following the calendar quarter for which the information was requested.

(g) *Information required to be set forth on face of debt instrument*—(1) *In general.* In the case of any REMIC regular interest or collateralized debt obligation that is issued after April 8, 1988, and that has original issue discount, the issuer must set forth on the face of the REMlC regular interest or collateralized debt obligation—

(i) The amount of the original issue discount,

(ii) The issue date,

(iii) The rate at which interest is payable (if any) as of the issue date,

(iv) The Yield to maturity, including a statement as to the assumption made under section 1272 (a)(6)(B)(iii),

(v) The method used to determine yield where there is a short accrual period, and

(vi) The amount of the original issue discount allowable to the short accrual period based on the prepayment assumption determined on the startup day (as defined in section 860G (a)(9)) or the issue date (as defined in section 1275 (a)(2)).

In cases where it is not possible to set forth the information required by this paragraph (g) on the face of the REMIC regular interest or collateralized debt obligation by the issue date, the issuer must deliver to the holder a sticker containing this information within 10 days after the issue date. For rules relating to the penalty imposed for failure to show the information required by this paragraph (g) on the regular interest or collateralized debt obligation, see section 6706 (a) and the regulations thereunder.

(2) *Issuer.* For purposes of this paragraph (g), the term ''issuer'' includes not only domestic issuers but also any foreign issuer who is otherwise subject to United States income tax law, unless the issue is neither listed on an established securities market (as defined in § 1.453–3 (d)(4)) in the United States nor offered for sale or resale in the United States in connection with its original issuance.

[T.D. 8366, 56 FR 49518, Sept. 30, 1991; T.D. 8366, 57 FR 5054, Feb. 12, 1992, as amended by T.D. 8431, 57 FR 40322, Sept. 3, 1992; 57 FR 46243, Oct. 7, 1992; T.D. 8734, 62 FR 53491, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53491, Oct. 14, 1997, § 1.6049–7 was amended by revising paragraph (c)(4), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.6049–7 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.6049–7 Returns of information with respect to REMIC regular interests and collateralized debt obligations.

* * * * *

(c) * * *

(4) A foreign central bank of issue (as defined in § 1.895–1(b)(1) to be a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency);

* * * * *

§ 1.6049–7T Market discount fraction reported with other financial information with respect to REMICs and collateralized debt obligations (temporary).

For purposes of § 1.6049–7(f)(2)(i)(G)(*1*) relating to the market discount fraction to be reported with other financial information with respect to REMICs and other collateralized debt obligations, if the REMIC regular interest or the collateralized debt obligation has de minimis original issue discount (as defined in section 1273(a)(3) and any regulations thereunder), then, at the option of the REMIC or the issuer of the collateralized debt obligation, a fraction computed in the manner specified in paragraph (f)(2)(ii)(K) of this section taking into account the de minimis original issue discount may be reported instead of the fraction specified in § 1.6049–7(f)(2)(i)(G)(*1*)(*i*). The REMIC or the issuer of the collateralized debt obligation, however, must be consistent in the method used to compute this fraction.

[T.D. 8366, 56 FR 49518, Sept. 30, 1991]

§ 1.6049–8 Interest and original issue discount paid to residents of Canada.

(a) *Interest subject to reporting requirement.* For purposes of §§ 1.6049–4, 1.6049–6 and this section and except as provided in paragraph (b) of this section, the term *interest* means interest paid to a Canadian nonresident alien individual after December 31, 1996, where the interest is described in section 871(i)(2)(A) with respect to a deposit maintained at an office within the United States. For purposes of the regulations under section 6049, a Canadian nonresident alien individual is an individual who resides in Canada and is not a United States citizen. The payor or middleman may rely upon the permanent residence address (as defined in section 1441 and the regulations under that section) as stated on the Form W–8 (described in section 6049 and the regulations under that section) in order to determine whether the payment is made to a Canadian nonresident alien individual. The payor or middleman may rely upon the permanent residence address (as defined in § 1.1441–1(e)(2)(ii)) as stated on the Form W–8 described in

§1.1441–1(e)(2)(i) in order to determine whether the payment is made to a Canadian nonresident alien individual. If the permanent residence address stated on the certificate is in Canada, or if the payor has actual knowledge of the individual's residence address in Canada, the payor must presume that the individual resides in Canada. Amounts described in this paragraph (a) are not subject to backup withholding under section 3406. See §31.3406(g)-1(d) of this chapter.

(b) *Interest excluded from reporting requirement.* The term *interest* does not include an amount that is paid by the issuer or its agent outside the United States with respect to an obligation that is described in paragraph (b) (1) or (2) of this section.

(1)(i) The obligation is not in registered form (within the meaning of section 163(f) and the regulations thereunder); is part of a larger single public offering of securities; and is described in section 163(f)(2)(B).

(ii) Unless it has actual knowledge to the contrary, a middleman may treat an obligation as if it is described in section 163(f)(2)(B) if the obligation or coupon therefrom, whichever is presented for payment, contains the statement described in section 163(f)(2)(B)(ii)(II) and the regulations thereunder.

(2)(i) The obligation has a face or principal amount of not less than $500,000, and satisfies the requirements described in paragraphs (b)(2)(i) (A), (B), and (C) of this section.

(A) The obligation satisfies the requirements of sections 163(f)(2)(B) (i) and (ii)(I) and the regulations thereunder (as if it were a registration-required obligation within the meaning of section 163(f)(2)(A)) and is issued in accordance with the procedures of §1.163–5(c)(2)(i)(D)).

(B) If the obligation is in registered form, it is registered in the name of an exempt recipient described in §1.6049–4(c)(1)(ii).

(C) The obligation has on its face and on any detachable coupons the following statement (or a similar statement having the same effect): ''By accepting this obligation or coupon, the holder represents and warrants that it is not a United States person (other than an exempt recipient described in the regulations under section 6049(b)(4) of the Internal Revenue Code and the regulations thereunder) and that it is not acting for or on behalf of a United States person (other than an exempt recipient described in the regulations under section 6049(b)(4) of the Internal Revenue Code and the regulations thereunder).''

(ii) Unless the middleman has actual knowledge to the contrary, it may treat an obligation as satisfying the requirements of sections 163(f)(2)(B) (i) and (ii)(I) and the regulations thereunder if the obligation or a coupon therefrom, whichever is presented for payment, contains the statement in paragraph (b)(2)(i)(C) of this section.

[T.D. 8664, 61 FR 17574, Apr. 22, 1996, as amended by T.D. 8734, 62 FR 53491, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53491, Oct. 14, 1997, in §1.6049–8, paragraph (a) was amended by removing the last two sentences and inserting four new sentences in their place, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.6049–8 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.6049–8 Interest and original issue discount paid to residents of Canada.

(a) * * * Amounts described in this paragraph (a) are not subject to backup withholding under section 3406. See §31.3406(g)–1(d) of this chapter.

* * * * *

§1.6050A–1 Reporting requirements of certain fishing boat operators.

(a) *Requirement of reporting.* The operator of a boat on which one or more individuals during a calendar year performed services described in §31.3121(b)(20)–1(a) shall make an information return on Form 1099–MISC for that calendar year. The return shall include the following information:

(1) The name and taxpayer identification number of each individual performing the services;

(2) The percentage of each individual's share of the catch of fish or other forms of aquatic life (hereinafter ''fish'');

(3) The percentage of the operator's share of the catch of fish;

(4) If the individual receives all or part of his share of the catch in kind, the type and weight of the share and, if it can be ascertained, the fair market value of his share;

(5) If the individual receives a share of the proceeds of the catch, the dollar amount received; and

(6) Any other information that is required by the form.

For purposes of this section, the term, ''boat operator'' means an employer (as defined in § 31.3121(d)–2) of an employee whose services are excepted from employment by section 3121(b)(20) and § 31.3121(b)(20)–1. The boat operator may make separate returns on Form 1099–MISC for each crew member for each voyage, or he may aggregate the information required by this paragraph for an individual for all or any part of a return period in which the type of catch (if required) and the percentage due the crew member remain the same.

(b) *Time and place for filing.* Returns required to be made under this section on Form 1099–MISC shall be filed with the Internal Revenue Service Center, designated in the instructions for Form 1099–MISC, on or before February 28 of the year follolwing the year in which the relevant services were performed.

(c) *Requirement of and time for furnishing statement*—(1) *requirement of furnishing statement.* Every person filing a Form 1099–MISC under this section shall furnish to the individual whose identifying number is (or should be) shown on the form a written statement showing the information required by paragraph (a) of this section. The requirement of the preceding sentence may be met by furnishing to the individual copy B of Form 1099–MISC or a reasonable facsimile of Form 1099–MISC that was filed pursuant to this section.

(2) *Time for furnishing statement.* Each statement required by this paragraph to be furnished to any individual for a calendar year shall be furnished on or before January 31 of the year following the calendar year for which the return was made.

(d) *Cross-reference to penalties.* For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6050A(a) and § 1.6050A–1(a), see § 301.6721–1 of this chapter (Procedure and Administration Regulations). For provisions relating to the penalty provided for failure to furnish timely a correct payee statement required under section 6050A(b) and § 1.6050A–1(c), see § 301.6722–1 of this chapter. See § 301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

[T.D. 7716, 45 FR 57123, Aug. 27, 1980, as amended by T.D. 8734, 62 FR 53492, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53492, Oct. 14, 1997, in § 1.6050A–1 pargraphs (a) introductory text, (a) concluding text, (b), and (c)(1) were amended by removing the language ''Form 1099F'' and inserting ''Form 1099–MISC'' and by adding paragraph (d), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.6050A–1 was delayed until Jan. 1, 2000.

§ 1.6050B–1 Information returns by person making unemployment compensation payments.

For taxable years beginning after December 31, 1978, every person who makes payments of unemployment compensation (as defined in section 85 (c)) aggregating $10 or more to any individual during any calendar year shall file a Form 1099UC in accordance with the instructions to such form.

[T.D. 7705, 45 FR 46070, July 9, 1980]

§ 1.6050D–1 Information returns relating to energy grants and financing.

(a) *Requirement of reporting.* Every person who administers a Federal, State, or local program a principal purpose of which is to provide subsidized energy financing (as defined in section 23(c)(10)(C) and the regulations thereunder) or grants for projects designed to conserve or produce energy shall make an information return for each calendar year beginning after December 31, 1983. However, the preceding sentence shall not apply if none of the financing and grants provided under such program during the calendar year relate either to expenditures described in section 23(c)(1) or (2), relating to the residential energy credit, made by a taxpayer before January 1, 1986, with respect to a dwelling unit or to section 38 property (as defined in section 48 and the regulations thereunder). That return shall be made on Form 6497 or, in the case of taxable gants, on Form 1099-G. (The latter form is prescribed pursuant to section 6041 as well as section 6050D.) The return shall include the following information:

(1) The name, address, and taxpayer identification number of each taxpayer receiving financing or a grant made under such program during the calendar year with respect to either section 38 property or in the case of financing or a grant for energy conservation expenditures or renewable energy source expenditures made by the taxpayer before January 1, 1986, a dwelling unit that is located in the United States;

(2) The aggregate amount of financing and grants received by the taxpayer under the program during the calendar year,

(3) In the case of returns for financing or nontaxable grants, the name of the program under which the financing or grants are made; and

(4) Any other information that is required by the form.

For purposes of this section, the term ''person'' means the officer or employee having control of the program, or the person appropriately designated for purposes of section 6050D and this section.

(b) *Time and place for filing.* Returns required to be made under this section shall be filed with the Internal Revenue Service Center designated in the instructions for Form 6497 or 1099-G by the last day of the first February following the calendar year for which the return (reporting payments made during such calendar year) is required.

(Secs. 6050D and 7805, Internal Revenue Code of 1954 (94 Stat. 259, 26 U.S.C. 6050D; 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 8018, 50 FR 12532, Mar. 29, 1985, as amended by T.D. 8146, 52 FR 26673, July 16, 1987]

§1.6050E–1 Reporting of State and local income tax refunds.

(a) *Applicability.* Section 6050E and this section apply to any refund officer who, with respect to an individual, makes payments of refunds of State or local income taxes or allows credits or offsets with respect to such taxes aggregating $10 or more for such individual in any calendar year.

(b) *Definitions.* For purposes of this section.—

(1) The term *refund officer* means the officer or employee of a State or local taxing jurisdiction having control of payments of refunds or the allowance of credits or offsets, or the person approporiately designated for purposes of this section.

(2) The term *State* shall include the District of Columbia but shall not include the Commonwealth of Puerto Rico or any possession of the United States.

(3) The term *individual* shall not include an estate or trust.

(4) The term *credit or offset* means an overpayment of tax which, in lieu of being refunded to the taxpayer, is:

(i) Applied against an existing liability of the taxpayer,

(ii) Available for application against a future liability of the taxpayer, or

(iii) Otherwise used or available for use for the taxpayer's benefit.

(c) *Requirement of reporting.* Every refund officer described in paragraph (a) of this section shall make an information return in accordance with this section for each calendar year. An information return must be made even if the refund officer is not required to furnish a statement to the applicable taxpayer under paragraph (k)(2) of this section.

(d) *Prescribed Form.* Except as otherwise provided in paragraph (i) of this section, the information return required by paragraph (c) of this section shall be made on Forms 1096 and 1099.

(e) *Refunds involving different taxable years.* In the case of refunds paid or credits or offsets allowed during a calendar year with respect to two or more taxable years of an individual, a separate Form 1099 shall be filed with respect to each taxable year of the individual. Thus, if during calendar year 1983 a refund officer pays to an individual a refund of $15 with respect to that individual's taxable year ending in 1982 and $20 with respect to that individual's taxable year ending in 1981, a separate Form 1099 shall be filed for each of the two payments. If, instead, the refund with respect to the individual's taxable year ending in 1982 were $5 instead of $15, no return would be required for the payment of $5.

(f) *Information required.* The information required to be reported on Forms 1096 and 1099 includes the aggregate amount of refunds, credits, and offsets made or allowed during the calendar year with respect to the taxable year of the individual covered by the return; the name, address and taxpayer identification number of the individual with respect to whom such payment, credit, or offset was made or allowed; the taxable year covered by the return; and such other information as may be required by the forms. In addition, the nature of the tax is required to be indicated on the Form 1099 in any case where the refund, credit or offset is made or allowed with respect to a payment attributable to an income tax that applies exclusively to income from a trade or business and is not a tax of general application.

(g) *When credit or offset deemed allowed.* For purposes of a return of information under this section, a credit or offset is deemed to be allowed when the liability to pay or credit such amount is admitted by the State or local taxing jurisdiction. Thus, if an amount with respect to a taxpayer's 1982 taxable year is credited in 1983 to reduce the liability of the taxpayer to make estimated tax payments in 1983, it is reportable as a credit allowed in 1983. It is not reportable in the taxable year that gives rise to the refund, credit or offset.

(h) *Time and place for filing.* The returns required under this section for any calendar year shall be filed after September 30 of that calendar year, but not before the refund officer's final payment (or allowance of credit or offset) for the year, and on or before February 28 of the following year. Returns shall be filed with the appropriate Internal Revenue Service Center, the addresses of which are listed in the instructions for Forms 1099. For extensions of time for filing returns under this section, see § 1.6081–1.

(i) *Use of magnetic media and substitute forms*—(1) *Magnetic media.* A refund officer may be required to file the Forms 1099 required by this section on magnetic media or machine-readable paper forms. See section 6011(e) and applicable regulations and revenue procedures thereunder. If a refund officer is not required to file the Forms 1099 required by this section on magnetic media, the refund officer may request permission under applicable regulations and revenue procedures to submit the information required by this section on magnetic media.

(2) *Substitute forms.* A refund officer may prepare and use a form which contains provisions identical with those of Form 1096 if the refund officer complies with all revenue procedures relating to substitute Form 1096 in effect at that time. In addition, if a refund officer is not required to file the Forms 1099 required by this section on magnetic media or machine-readable paper forms, the refund officer may prepare and use a form which contains provisions identical with those of Form 1099 if the refund officer complies with all revenue procedures relating to substitute Form 1099 in effect at that time.

(j) *Voluntary information exchange agreements.* The requirements of reporting information to the Internal Revenue Service under this section may be satisfied for any calendar year by submission of the information required under paragraph (f) of this section in accordance with the terms of a voluntary information exchange agreement between the State and the United States in effect during such year.

(k) *Requirement of furnishing statements to recipients*—(1) *In general.* Except as provided in paragraph (k)(2) of this section, every refund officer required to make a return of information under this section shall furnish to the individual whose identifying number is required to be shown on the return a written statement showing the aggregate amount shown on the information return of refunds, credits and offsets made or allowed to such individual with respect to each taxable year of the individual, the name of the State or local taxing jurisdiction paying such refund or allowing such credits or offsets, the taxable year giving rise to the refund, credit or offset and a legend stating that such amount is being reported to the Internal Revenue Service.

The requirement of this paragraph may be met by furnishing to the individual a copy of the Form 1099 filed with respect to that individual provided that the form bears a legend stating that such amount is being reported to the Internal Revenue Service. For purposes of this paragraph, a statement shall be considered to be furnished to an individual if it is mailed to the individual at the individual's last known address.

(2) *Exception for nonitemizers.* A refund officer need not furnish a statement to an individual under paragraph (k)(1) of this section if the refund officer verifies that the individual did not claim itemized deductions for Federal income tax purposes for the taxable year giving rise to the refund, credit, or offset. This exception shall not apply, however, if the refund, credit, or offset is made or allowed with respect to a payment attributable to an income tax that applies exclusively to income from a trade or business and is not a tax of general application. For purposes of this paragraph (k)(2), verification shall be made solely from—

(i) The State or local income tax return, or

(ii) Information obtained through a voluntary information exchange agreement with the United States for the applicable taxable year.

(3) *Verification from the State or local income tax return.* A refund officer shall verify from the State or local income tax return that an individual did not claim itemized deductions for Federal income tax purposes for the applicable taxable year only if—

(i)(A) An individual who itemized deductions for Federal income tax purposes either must attach a copy of Schedule A of the individual's Federal income tax return to the State or local income tax return or must transcribe information from Schedule A of the individual's Federal income tax return on the State or local income tax return;

(B) The information contained on or transcribed from the Schedule A is required for the purpose of computing liability for the State or local income tax; and

(C) The omission of a copy of the Schedule A, or of the information required to be transcribed from the Schedule A, is consistent with the taxpayer's computation of tax on the State or local income tax return; or

(ii) Individuals are required to transcribe information from their Federal income tax return (other than from Schedule A) on the State or local income tax return for the purpose of computing liability for the State or local income tax and the information can be used to determine conclusively whether the taxpayer itemized deductions for Federal income tax purposes.

(4) *Example.* The provisions of paragraph (k)(3)(ii) of this section may be illustrated by the following example:

Example. State X asks for transcription of the following information on its 1983 income tax return from the taxpayer's 1983 Federal income tax return: Adjusted gross income; taxable income; and number of exemptions claimed. The amount of adjusted gross income and the number of exemptions claimed on the Federal income tax return are taken into account in computing the liability for income tax under the laws of State X. The amount of taxable income transcribed from the Federal return, however, does not enter into the computation of liability for income tax under the laws of State X. Thus, this amount may not be taken into account by the refund officer of State X for purposes of verifying whether a taxpayer itemized deductions for Federal income tax purposes. Since the refund officer of State X will not be able to determine conclusively from the amount of adjusted gross income and the number of exemptions transcribed from the Federal return whether a taxpayer itemized deductions for Federal income tax purposes, the transcribed information does not meet the requirements of paragraph (k)(3)(ii) of this section.

(l) *Time for furnishing statements*—(1) *General rule.* The statement required under paragraph (k) of this section shall be furnished after December 31 of the year in which the refund is paid or credit or offset is allowed, and on or before January 31 of the following year.

(2) *Extensions of time.* For good cause shown upon written application of the refund officer, the service center director may grant an extension of time not exceeding 30 days in which to furnish statements under this paragraph. The application shall be addressed to the Service Center with which the Forms 1099 required under this section are required to be filed and shall contain a

concise statement of the reasons for requesting the extension to aid the service center director in determining the period of the extension, if any, which will be granted. The application shall state at the top of the first page that it is made under this section and shall be signed by the refund officer. In general, the application shall be filed after September 30 of the year in which the refund is paid or credit or offset is allowed, and before January 15 of the following year.

(m) *Effective date.* This section applies to payments of refunds and credits and offsets allowed after December 31, 1982.

[T.D. 8052, 50 FR 37349, Sept. 13, 1985]

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(ii) Failure to furnish TIN.

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[T.D. 8571, 59 FR 63250, Dec. 8, 1994]

§1.6050H–1 Information reporting of mortgage interest received in a trade or business from an individual.

(a) *Information reporting requirement*—(1) *Overview.* The information reporting requirements of section 6050H, this section, and §1.6050H–2 apply to an interest recipient who receives at least $600 of interest on a qualified mortgage for a calendar year or who makes a reimbursement of interest described in §1.6050H–2(a)(2)(iv). Paragraph (b) of this section defines qualified mortgage. Paragraph (c) of this section defines interest recipient. Paragraph (d) of this section contains additional rules relating to the reporting requirement for foreign persons, cooperative housing corporations, and nonresident alien individuals. Paragraph (e) of this section contains rules for determining the amount of interest received on a mortgage for a calendar year. Paragraph (f) of this section provides rules for determining when prepaid interest in the form of points is taken into account as interest for purposes of section 6050H, this section, and §1.6050H–2.

(2) *Reporting requirement.* Except as otherwise provided in this section and §1.6050H–2, an interest recipient that either receives at least $600 of interest on a qualified mortgage for a calendar year or makes reimbursements of interest described in §1.6050H–2(a)(2)(iv) must, with respect to that interest—

(i) File an information return with the Internal Revenue Service; and

(ii) Furnish a statement to the payor of record on the mortgage.

(3) *Optional reporting.* An interest recipient may, but is not required to, report its receipt of less than $600 of interest on a qualified mortgage for a calendar year. Similarly, an interest recipient also may report reimbursements of interest on a qualified mortgage even if the reimbursements are not required to be reported by §1.6050H–2(a)(2)(iv). An interest recipient that chooses, but is not required, to file a return as provided in this section and §1.6050H–2(a) or to furnish a statement as provided in this section and §1.6050H–2(b) is subject to the requirements of this section and §1.6050H–2.

(b) *Qualified mortgage*—(1) *In general.* A mortgage is a qualified mortgage if the payor of record on the mortgage is an individual, including an individual acting in a capacity as a sole proprietor of a business. A mortgage is not a qualified mortgage if the payor of record on the mortgage is not an individual (such as a trust, estate, partnership, association, company, or corporation), even though an individual is a co-borrower on the mortgage and all the trustees, beneficiaries, partners, members, or shareholders of the payor of record are individuals.

(2) *Mortgage*—(i) *In general.* Except as otherwise provided in paragraphs (b)(2)(ii) and (b)(2)(iii) of this section, an obligation is a mortgage if real property (regardless of where located) secures all or part of the obligation. An interest recipient must determine whether real property secures an obligation at the time the obligation is created or, if security is added or removed at a later time, at that later time. Real property includes a manufactured home as defined in section 25(e)(10). An obligation includes a line of credit or a credit card obligation. For purposes of this section and §1.6050H–2, a borrower incurs a line of credit or credit card obligation when the borrower first has the right to borrow against the line of credit or credit card, whether the borrower actually borrows an amount at that time. An obligation will not fail to be treated as a mortgage solely because, under an applicable State or local homestead law or other debtor protection law in effect on August 16, 1986, the security

interest is ineffective or the enforceability of the security interest is restricted.

(ii) *Transitional rule for certain obligations existing on December 31, 1984*—(A) *In general.* An obligation that existed on December 31, 1984, is not a mortgage if, at the time the payor of record incurred the obligation, the interest recipient reasonably classified the obligation as other than a mortgage, real property loan, real estate loan, or other similar type of obligation. A reasonable classification of an obligation must be consistent with industry practices and determined according to the purpose of the obligation, the property securing the obligation, and any other reasonable factor. For purposes of this paragraph (b)(2)(ii)(A), an obligation was not reasonably classified as other than a mortgage, real property loan, real estate loan, or other similar type of obligation if, at the time the payor of record incurred the obligation, more than one-half of the obligations in the particular class in which the obligation was classified were secured primarily by real property.

(B) *Examples.* The following examples illustrate the rules of paragraph (b)(2)(ii)(A) of this section:

Example (1). B offers an unsecured line of credit and a line of credit secured by real property. B separately markets the two credit lines, and they are governed by different terms and conditions. For accounting purposes, B classifies the two types of loans as a single class. For purposes of paragraph (b)(2)(ii)(A) of this section, the two types of loans are different classes of obligations.

Example (2). B operates a program to make loans to small businesses. Depending on the amount of the loan and the credit history of the borrower, B may or may not require security for the loan. If B requires security, it may consist of real or personal property. For accounting purposes, B classifies all of the loans within this program as a single class. For purposes of paragraph (b)(2)(ii)(A) of this section, all of the loans within this program may be classified as belonging to a single class.

(iii) *Transitional rule for certain obligations existing on December 31, 1987.* An obligation that was incurred after December 31, 1984, and that existed on December 31, 1987, is not a mortgage if the obligation is not primarily secured by real property.

(3) *Payor of record.* A payor of record on a mortgage is the person carried on the books and records of the interest recipient as the principal borrower on the mortgage. If the books and records of the interest recipient do not indicate which borrower is the principal borrower, the interest recipient must designate a borrower as the principal borrower.

(4) *Lender of record.* The lender of record is the person who, at the time the loan is made, is named as the lender on the loan documents and whose right to receive payment from the payor of record is secured by the payor of record's principal residence. An intention by the lender of record to sell or otherwise transfer the loan to a third party subsequent to the close of the transaction will not affect the determination of who is the lender of record.

(c) *Interest recipient*—(1) *Trade or business requirement.* Except as provided in paragraph (c)(4) of this section, an interest recipient is a person that is engaged in a trade or business (whether or not the trade or business of lending money) and that, in the course of the trade or business, either receives interest on a mortgage or makes a reimbursement of interest on a qualified mortgage described in §1.6050H–2(a)(3). For purposes of this paragraph (c)(1), if a person holds a mortgage which was originated or acquired in the course of a trade or business, the interest on the mortgage is considered to be received in the course of that trade or business. For example, if real estate developer A lends money to individual B to enable B to purchase a house in a subdivision owned and developed by A, and B gives a mortgage to A for the loan, A is an interest recipient for interest received on the mortgage. Alternatively, if C, a person engaged in the trade or business of being a physician, lends money to individual D to enable D to purchase C's home, and D gives a mortgage to C for the loan, C is not an interest recipient for interest received on the mortgage, because C will not receive the interest in the course of the trade or business of being a physician.

(2) *Interest received or collected on behalf of another person*—(i) *General rule.*

Except as otherwise provided in paragraph (c)(2)(ii) or (3) of this section, a person that, in the course of its trade or business, receives or collects interest on a mortgage on behalf of another person (e.g., the lender of record) is the interest recipient (the initial recipient) for the mortgage. In this case, the reporting requirement of paragraph (a) of this section does not apply to the transfer of interest from the initial recipient to the person for which the initial recipient receives or collects the interest. For example, if financial institution A collects interest on behalf of financial institution B, A is the initial recipient for the mortgage and is subject to the reporting requirements of section 6050H, and B is not required to report the interest received on the mortgage from A.

(ii) *Exception*—(A) *Scope of exception.* Paragraph (c)(2)(i) of this section does not apply for any period for which—

(*1*) An initial recipient does not possess the information needed to comply with the reporting requirement of paragraph (a) of this section; and

(*2*) The person for which the interest is received or collected would receive the interest in the course of its trade or business if the interest were paid directly to that person. For purposes of this paragraph (c)(2)(ii)(A)(*2*), if interest is received or collected on behalf of a person other than an individual, that person is presumed to receive interest in a trade or business.

(B) *Application of exception.* If the exception provided by this paragraph (c)(2)(ii) applies, the person for which the interest is received or collected is the interest recipient with respect to interest received or collected on the mortgage during the period described in this paragraph (c)(2)(ii).

(3) *Interest received in the form of points.* For purposes of this section and §1.6050H–2, in the case of prepaid interest received in the form of points (as defined in paragraph (f) of this section):

(i) *In general.* Except as provided in paragraph (c)(3)(ii) of this section, only the lender of record or a qualified person (as defined in §1.6050H–2(d)(2)) is treated as receiving the points. The lender of record or qualified person is treated as receiving all points paid directly by the payor of record in connection with the purchase of the principal residence.

(ii) *If designation agreement is in effect.* If a designation agreement is executed pursuant to §1.6050H–2(d) with respect to points, only the designated party under the agreement is treated as receiving points with respect to any mortgage to which the agreement applies. The designated party is treated as receiving all points with respect to any mortgage to which the agreement applies.

(4) *Governmental unit.* A governmental unit or an agency or instrumentality of a governmental unit that receives interest on a mortgage is an interest recipient without regard to the requirement of paragraph (c)(1) of this section that the interest be received in the course of a trade or business. A governmental unit or an agency or instrumentality of a governmental unit that is an interest recipient must designate an officer or employee to satisfy the reporting requirements of paragraph (a) of this section.

(5) *Examples.* The following examples illustrate the rules of paragraph (c) of this section:

Example (1). Financial institution F collects mortgage interest on behalf of financial institution G and deposits the amount collected into G's account held with F. F possesses the information needed to comply with the reporting requirement of paragraph (a) of this section. F is the interest recipient for the mortgage. G is not required to report.

Example (2). The facts are the same as in example (1), except that F does not possess the information needed to comply with the reporting requirement. G, the person for which F collects the interest, is the interest recipient for the mortgage. F is not required to report.

Example (3). S, an individual, sells real property to another individual, P, and takes back a mortgage from P to finance the sale. S does not receive the interest in the course of a trade or business. B, a bank, collects P's payments of principal and interest on behalf of S and deposits that amount into an account held at the bank in S's name. B does not possess the information needed to comply with the reporting requirement of paragraph (a) of this section. B is the interest recipient for P's mortgage without regard to paragraph (c)(2)(ii) of this section, because S would not receive the interest in the course of a trade or business. S is not required to report.

Example (4). X collects mortgage interest on behalf of Y, who would receive the interest in the course of a trade or business. X possesses the information needed to comply with the reporting requirement of paragraph (a) of this section. On July 1, 1988, Z assumes X's interest collection responsibilities. Z does not possess the information needed to comply with the reporting requirement of paragraph (a) of this section. X is the interest recipient for interest received from January 1, 1988, through June 30, 1988. Because Z does not possess the requisite information and Y would receive the interest in the course of a trade or business, Y is the interest recipient for interest received from July 1, 1988, through December 31, 1988.

Example (5). On December 1, Borrower obtains from Lender funds with which to purchase an existing structure to be used as Borrower's principal residence. In connection with the mortgage, Lender charges Borrower $300 as points. Borrower pays this amount to Lender at closing using unborrowed funds. In addition, Lender receives from Borrower with respect to the mortgage $300 as interest (as determined under paragraph (e) of this section) other than points. Because Lender has received at least $600 in interest, including points, with respect to Borrower's mortgage during the calendar year, Lender must report the payments in accordance with paragraph (a) of this section and § 1.6050H–2. Under those sections, Lender must separately state on the information return and the statement to Borrower the $300 received as interest (other than points) and the $300 received as points.

(d) *Additional rules*—(1) *Reporting by foreign person.* An interest recipient that is not a United States person (as defined in section 7701(a)(30)) must report interest received on a qualified mortgage only if it receives the interest—

(i) At a location in the United States, or

(ii) At a location outside the United States if the interest recipient is—

(A) A controlled foreign corporation (within the meaning of section 957(a)), or

(B) A person, 50 percent or more of the gross income of which, from all sources for the three-year period ending with the close of the taxable year preceding the receipt of interest (or for such part of the period as the person was in existence), was effectively connected with the conduct of a trade or business within the United States.

(2) *Reporting with respect to nonresident alien individual*—(i) *In general.* The reporting requirement of paragraph (a) of this section does not apply if—

(A) The payor of record is a nonresident alien individual, and

(B) Real property located in the United States does not secure the mortgage.

(ii) *Nonresident alien individual status.* For purposes of paragraph (d)(2)(i)(A) of this section, an interest recipient must apply the following documentary evidence rules to determine whether a payor of record is a nonresident alien individual:

(A) If interest is paid outside the United States, the interest recipient must satisfy the documentary evidence standard provided in § 1.6049–5(c) with respect to the payor of record; and

(B) If interest is paid within the United States, the interest recipient must secure from the payor of record a Form W–8 or a substantially similar statement signed by the payor under penalty of perjury as described in § 1.1441–1(e)(1).

For purposes of this paragraph (d)(2)(ii), the place of payment is the place where the payor of record completes the acts necessary to effect payment. An amount paid by transfer to an account maintained by an interest recipient in the United States or by mail to a United States address is considered to be paid within the United States.

(3) *Reporting by cooperative housing corporations.* For purposes of this section and § 1.6050H–2, an amount received by a cooperative housing corporation from an individual tenant-stockholder that represents the tenant-stockholder's proportionate share of interest described in section 216(a)(2) is interest received on a qualified mortgage in the course of the cooperative housing corporation's trade or business. A cooperative housing corporation is an interest recipient with respect to each tenant-stockholder's proportionate share of interest and must report $600 or more of interest received from an individual tenant-stockholder. The terms ''cooperative housing corporation,'' ''tenant-stockholder,'' and ''tenant-stockholder's proportionate share'' are defined in section 216 and the regulations thereunder.

(e) *Amount of interest received on mortgage for calendar year*—(1) *In general.* For purposes of this section and §1.6050H–2, interest includes mortgage prepayment penalties and late charges other than late charges for a specific mortgage service. Interest also includes prepaid interest in the form of points (as defined in paragraph (f) of this section). Whether an interest recipient receives $600 or more of interest on a mortgage for a calendar year is determined on a mortgage-by-mortgage basis. An interest recipient need not aggregate interest received on all of the mortgages of a payor of record held by the interest recipient to determine whether the $600 threshold is met. Therefore, an interest recipient need not report interest of less than $600 received on a mortgage, even though it receives a total of $600 or more of interest on all of the mortgages of the payor of record for a calendar year.

(2) *Calendar year*—(i) *In general.* Except as otherwise provided in paragraph (e)(2)(ii) or (iii) of this section, the calendar year for which interest is received is the later of the calendar year in which the interest is received or the calendar year in which the interest properly accrues.

(ii) *De minimis rule.* An interest recipient may treat interest received during the current calendar year which properly accrues by January 15 of the subsequent calendar year as interest received for the current calendar year. For example, if an interest recipient receives a monthly interest payment on December 31, 1988, which includes interest accruing for the period December 5, 1988, to January 5, 1989, the interest recipient may treat the entire interest payment as received for 1988. If a portion of an interest payment received in a current calendar year accrues after January 15 of the subsequent calendar year, an interest recipient must report as interest received for the current calendar year only the portion that properly accrues by the end of the current calendar year. For example, if an interest recipient receives a monthly payment that includes interest accruing for the period December 20, 1988, through January 20, 1989, the interest recipient may not report as interest received for 1988 any interest accruing after December 31, 1988. The interest recipient must report the interest accruing after December 31, 1988, as received for calendar year 1989.

(iii) *Applicability to points.* Paragraphs (e)(2)(i) and (ii) of this section do not apply to prepaid interest in the form of points (as defined in paragraph (f) of this section). Points (as defined in paragraph (f) of this section) must be reported in the calendar year in which they are received.

(3) *Certain interest not received on mortgage*—(i) *Interest received from seller on payor of record's mortgage.* Interest received from a seller or a person related to a seller within the meaning of section 267(b) or section 707(b)(1) on a payor of record's mortgage is not interest received on a mortgage. For example, interest is not received on a mortgage if a real estate developer deposits an amount in escrow with an interest recipient and advises it to draw on the account to pay interest on a payor of record's mortgage (e.g., a buy-down mortgage). Similarly, interest is not received on a mortgage if an interest recipient receives a lump sum from a real estatge developer for interest on a payor of record's mortgage.

(ii) *Interest received from governmental unit.* Interest received from a governmental unit or an agency or instrumentality of a governmental unit is not interest received on a mortgage. For example, interest is not received on a mortgage if received as a housing assistance payment from the Department of Housing and Urban Development on a mortgage insured under section 235 of the National Housing Act (12 U.S.C. 1701–1715z (1982 & Supp. 1983)). Except as otherwise provided in paragraph (e) (1) and (2) of this section, interest received on a mortgage is only the excess of interest received on the mortgage over interest received from a governmental unit or an agency or instrumentality of a governmental unit.

(4) *Interest calculated under Rule of 78s method of accounting.* An interest recipient permitted by Revenue Procedure 83–40, 1983–1, C.B. 774 (or other revenue procedure) to use the Rule of 78s method of accounting to calculate interest earned on a transaction may report as interest received on a mortgage interest earned on the transaction as

calculated under the Rule of 78s method of accounting only if the interest recipient satisfies the notice requirement of § 1.6050H–2(c).

(f) *Points treated as interest*—(1) *General rule.* Subject to the limitations of paragraph (f)(2) of this section, an amount is deemed to be points paid in respect of indebtedness incurred in connection with the purchase of the payor of record's principal residence (points) for purposes of this section and § 1.6050H–2 to the extent that the amount—

(i) Is clearly designated on the Uniform Settlement Statement prescribed under the Real Estate Settlement Procedures Act of 1974, 12 U.S.C. 2601 et seq., (e.g., the Form HUD–1) as points incurred in connection with the indebtedness, for example *as loan origination fees* (including amounts so designated on Veterans Affairs (VA) and Federal Housing Administration (FHA) loans), *loan discount, discount points,* or *points*;

(ii) Is computed as a percentage of the stated principal amount of the indebtedness incurred by the payor of record;

(iii) Conforms to an established practice of charging points in the area in which the loan is issued and does not exceed the amount generally charged in the area;

(iv) Is paid in connection with the acquisition by the payor of record of a residence that is the principal residence of the payor of record and that secures the loan. For this purpose, the lender of record may rely on a signed written statement of the payor of record that states whether the proceeds of the loan are for the purchase of the mortgagor's principal residence; and

(v) Is paid directly by the payor of record.

(2) *Limitations.* An amount is not points for purposes of this section to the extent that the amount is—

(i) Paid in connection with indebtedness incurred for the improvement of a principal residence;

(ii) Paid in connection with indebtedness incurred to purchase or improve a residence that is not the payor of record's principal residence, such as a second home, vacation property, investment property, or trade or business property;

(iii) Paid in connection with a home equity loan or a line of credit, even though the loan is secured by the payor of record's principal residence;

(iv) Paid in connection with a refinancing loan (except as provided by paragraph (f)(4) of this section), including a loan incurred to refinance indebtedness owed by the borrower under the terms of a land contract, a contract for deed, or similar forms of seller financing;

(v) Paid in lieu of amounts that ordinarily are stated separately on the Form HUD–1, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes; or

(vi) Paid in connection with the acquisition of a principal residence, to the extent that the amount is allocable to indebtedness in excess of the aggregate amount that may be treated as acquisition indebtedness under section 163(h)(3)(B)(ii).

(3) *Special rule*—(i) *Amounts paid directly by payor of record.* For purposes of this section, an amount is considered *paid directly* by the payor of record if it is—

(A) Provided by the payor of record from funds that have not been borrowed from the lender of record for this purpose as part of the overall transaction. The amount provided may include amounts designated as down payments, escrow deposits, earnest money applied at the closing, and other funds actually paid over by the payor of record at or before the time of closing; or

(B) Paid as points (within the meaning of this paragraph (f)) on behalf of the payor of record by the seller. For this purpose, an amount paid as points to an interest recipient by the seller on behalf of the payor of record is treated as paid to the payor of record and then paid directly by the payor of record to the interest recipient.

(ii) *Examples.* The provisions of this paragraph (f) are illustrated by the following examples:

Example 1. Financed payment of points. Buyer purchases a principal residence for $100,000. There is a total of $7,000 in closing costs (exclusive of down payment) charged in connection with the sale. Of this amount,

$3,000 is charged as points (within the meaning of paragraph (f) of this section). At closing, Buyer makes a down payment of $20,000 and provides unborrowed funds in the amount of $4,000 for the payment of various closing costs other than points. Buyer finances payment of the points by increasing the principal amount of the loan by $3,000. Seller makes no payments on Buyer's behalf. Because Buyer has provided at closing funds that have not been borrowed from the lender of record for this purpose in an amount at least equal to the amount charged as points in the transaction, the lender of record (or a qualified person) must report $3,000 as points in accordance with this section and §1.6050H–2.

Example 2. Seller-paid points. Buyer purchases a principal residence for $100,000. There is a total of $7,000 in closing costs (exclusive of down payment) charged in connection with the sale. Of this amount, $3,000 is charged as points (within the meaning of this paragraph (f)). Seller agrees to pay all closing costs on behalf of Buyer, including the amount charged as points. Accordingly, the amount paid by Seller as points is treated as paid directly by Buyer, and the lender of record (or a qualified person) must report the $3,000 as points in accordance with this section and §1.6050H–2.

(4) *Construction loans*—(i) *In general.* An amount paid in connection with indebtedness incurred to construct a residence, or to refinance indebtedness incurred to construct a residence, is deemed to be points for purposes of this section to the extent the amount—

(A) Is clearly designated on the loan documents as points incurred in connection with the indebtedness, for example, as *loan origination fees, loan discount, discount points,* or *points;*

(B) Is computed as a percentage of the stated principal amount of the indebtedness incurred by the payor of record;

(C) Conforms to an established practice of charging points in the area in which the loan is issued and does not exceed the amount generally charged in the area;

(D) Is paid in connection with indebtedness incurred by the payor of record to construct (or to refinance construction of) a residence that is to be used, when completed, as the principal residence of the payor of record;

(E) Is paid directly by the payor of record; and

(F) Is not allocable to indebtedness in excess of the aggregate amount that may be treated as acquisition indebtedness under section 163(h)(3)(B)(ii).

(ii) *Limitation on refinancing of construction loans.* Amounts paid in connection with refinancing indebtedness incurred to construct a residence are not treated as points to the extent they are allocable to indebtedness that exceeds the indebtedness incurred to construct the residence.

(5) *Amounts paid to mortgage brokers.* Amounts received directly or indirectly by a mortgage broker are treated as points under this paragraph (f) to the same extent the amounts would be so treated if they were paid to and retained by the lender of record, and must be reported by the lender of record in accordance with this section and §1.6050H–2.

(6) *Effect on deduction of points.* This section and §1.6050H–2 address only the information reporting requirements of section 6050H and do not affect a payor of record's deduction for any amount in accordance with applicable provisions of the Internal Revenue Code.

(g) *Effective date*—(1) *In general.* Except as provided in paragraph (g)(2) of this section, this section is effective for mortgage interest received after December 31, 1987. Section 1.6050H–1T contains rules for reporting mortgage interest received after December 31, 1984, and before January 1, 1988.

(2) *Points.* The reporting requirements of this section do not apply to prepaid interest received in the form of points before January 1, 1995. In addition, the inclusion of points in the determination of interest under paragraph (e)(1) of this section applies only to transactions occurring after December 31, 1994.

[T.D. 8191, 53 FR 12002, Apr. 12, 1988, as amended by T.D. 8571, 59 FR 63251, Dec. 8, 1994; T.D. 8734, 62 FR 53492, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53492, Oct. 14, 1997, §1.6050H–1 was amended in paragraph (d)(2)(ii)(A) by removing the language "§35a.9999–4T, Q/A–5(iii)" and inserting "§1.6049–5(c) in its place; and in paragraph (d)(2)(ii)(B) by removing the language "§1.6049–5(b)(2)(ii)(B)" and inserting "§1.1441–1(e)(1) in its place, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.6050H–1 was delayed until Jan. 1, 2000.

§ 1.6050H–1T Information reporting of mortgage interest received in a trade or business from individuals after 1985 and before 1988 (temporary).

The following questions and answers relate to the requirement of reporting mortgage interest under section 6050H of the Internal Revenue Code of 1954, as added by section 145 of the Tax Reform Act of 1984 (Pub. L. 98–369, 98 Stat. 685):

REQUIREMENT OF REPORTING

In general

Q–1: What does section 6050H provide with respect to the reporting of mortgage interest?

A–1: In general, section 6050H provides that an information return must be made by any person who is engaged in a trade or business and who, in the course of such trade or business, receives from any individual $600 or more of interest on any mortgage in a calender year. For purposes of this section—

(a) Any person who is engaged in a trade or business and who, in the course of such trade or business, receives interest on any mortgage is referred to as an ''interest recipient''; and

(b) Any individual who pays interest on any mortgage is referred to as a ''payor''.

Interest Subject To Reporting

Q–2: Does the reporting requirement apply to all interest received by an interest recipient?

A–2: No. The reporting requirement applies only to interest received from a payor on a mortgage (as defined in A–4 and A–5 of this section). The reporting requirement does not apply to interest received from a trust, estate, partnership, association, company, or corporation.

Q–3: Does the reporting requirement apply to any amount of mortgage interest received from a payor?

A–3: No. The reporting requirement applies only if $600 or more of interest is received from a payor on any mortgage in a calendar year. The $600 threshold is determined on an obligation by obligation basis. Therefore, if the interest received from a payor on an obligation is less than $600, reporting with respect to that interest is not required even if the total interest received from the payor on all obligations held by the interest recipient exceeds $600 in a calendar year.

Q–4: What is a mortgage, for purposes of this section and section 6050H, with respect to obligations in existence on December 31, 1984?

A–4: An obligation in existence on December 31, 1984, that is secured primarily by real property (regardless of whether the property is located inside or outside the United States) is a mortgage unless, at the time the obligation was incurred, the interest recipient reasonably classified such obligation as other than a mortgage, real property loan, real estate loan, or other similar type of obligation. (See A–12 of this section for rules relating to interest received by foreign persons.) For example, if an obligation incurred in 1980 was secured primarily by real property, but the interest recipient reasonably classified the obligation as a commercial loan because the proceeds were used to finance the payor's trade or business, the obligation is not considered a mortgage for purposes of this section and section 6050H. If, however, a majority of the obligations in a particular class are primarily secured by real property, it is not reasonable to classify such obligations as other than mortgages, real property loans, real estate loans, or other similar types of obligations; such obligations are, therefore, mortgages for purposes of section 6050H and this section. For purposes of this definition, real property includes stock in a cooperative housing corporation. A mortgage does not include a credit card obligation that is secured primarily by real property or a line of credit that is secured primarily by real property.

Q–5: What is a mortgage, for purposes of this section and section 6050H, with respect to obligations incurred after December 31, 1984?

A–5: With respect to obligations incurred after December 31, 1984, a mortgage is any obligation that is secured primarily by real property, regardless of whether the property is located inside or outside the United States. (See A–12 of this section for rules relating to interest received by foreign persons.) For purposes of this definition, real property includes stock in a cooperative housing corporation. A mortgage does not include a credit card obligation that is secured primarily by real property or a line of credit that is secured primarily by real property. The determination of whether a particular obligation is a mortgage shall be made without regard to the interest recipient's classification of that obligation. For example, if an obligation is secured primarily by real property, but the interest recipient classifies the obligation as a commercial loan because the proceeds are to be used to finance the payor's trade or business, the obligation is nevertheless a mortgage for purposes of this section and section 6050H.

Q–6: If the amount of interest received on a mortgage in a calendar year is less than the amount of interest due on the mortgage, what amount of interest must be reported under this section?

A–6: The amount of interest received must be reported. For example, assume that $800 of interest is payable in a calendar year but only $600 of interest is received in the calendar year. The amount of interest received ($600) must be reported under this section. Similarly, assume that an interest recipient accrues $900 of interest on a mortgage in a calendar year but only $800 of interest is payable and is received in the calendar year (resulting in a $100 increase in the unpaid balance of the loan). The amount of interest received ($800) must be reported under this section.

Q–7: If a payor remits 13 payments of interest on any mortgage in a calendar year, but the interest recipient receives only 12 payments in the calendar year, what amount should the interest recipient report?

A–7: The interest recipient should report the interest actually received in the calendar year. For example, if a payor mails the 13th payment on December 31 or a calendar year, and the interest recipient does not receive it until the following calendar year, the interest recipient should report only the 12 payments received in the calendar year.

Trade or Business Requirement

Q–8: Must an interest recipient be engaged in the trade or business of lending money to be subject to the reporting requirement of this section?

A–8: No. An interest recipient (other than a governmental unit, or any agency or instrumentality thereof) is subject to this reporting requirement if the interest recipient is engaged in any trade or business and, in the course of such trade or business, receives from an individual $600 or more of interest on any mortgage in a calendar year. For example, if A, a real estate developer, provides financing to B, an individual, to enable B to purchase a house in a subdivision owner and developed by A, and that house is the primary security for the financing, A is subject to this reporting requirement. Alternatively, if C, a physician, who is not engaged in any other trade or business, lends money to D to enable D to purchase C's home, C is not subject to the reporting requirement of this section because C will not receive the interest in the course of his sole trade or business of being a physician.

Q–9: How does the trade or business requirement apply to a governmental unit?

A–9: A governmental unit (or any agency or instrumentality thereof) which receives from a payor $600 or more of interest on any mortgage in a calendar year is subject to the reporting requirement without regard to the requirement that the money be received in the course of a trade or business. A governmental unit (or any agency or instrumentality thereof) that is subject to the reporting requirement must designate an officer or employee to make the return. The designated officer or employee must make the return in the form and manner prescribed by this section.

Treatment of Cooperative Housing Corporations

Q–10: How does this reporting requirement apply in the case of cooperative housing corporation?

A–10: For purposes of section 6050H and this section, a cooperative housing corporation (as defined in section 216) is treated as a person who is engaged in a trade or business and who, in the course of such trade or business, receives interest from its tenant-stockholders on a mortgage. Therefore, a cooperative housing corporation is required to report under section 6050H and this section.

Interest Received on Behalf of Another

Q–11: If, in the course of a trade or business, a person receives (collects) interest on behalf of another, who is required to report?

A–11: The person first receiving (collecting) the interest is required to report. For example, a servicing bank that receives $600 or more of mortgage interest in a calendar year from a payor on behalf of a lender is required to report the interest received under this section. No reporting is required under this section upon the transfer of the interest from the servicing bank to the lender for whom the interest was received.

Interest Received by Foreign Persons

Q–12: Must an interest recipient that is a foreign person report under section 6050H and this section?

A–12: An interest recipient that is a foreign person must report with respect to mortgage interest that is received at a location within the United States. In the case of interest received at locations outside the United States, an interest recipient that is a foreign person must report—

(a) If the foreign person is a controlled foreign corporation within the meaning of section 957(a); or

(b) If the foreign person is a corporation any interest received from which would be considered to be from sources within the United States under section 861(a)(1)(C) (without regard to whether the interest is paid or credited by a domestic branch of a foreign corporation engaged in the commercial banking business).

Multiple Borrowers

Q–13: When there is more than one borrower on a mortgage, must the interest recipient report with respect to each borrower?

A–13: No. The interest recipient must report only with respect to the payor of record (as defined in A–14 of this section) on the mortgage. The amount of interest subject to reporting is the full amount received by the interest recipient with respect to the mortgage during the calendar year.

Q–14: Who is a payor of record?

A–14: For purposes of this section, the payor of record is the individual carried on the books and records of the interest recipient as the principal borrower or the individual designated by the interest recipient as the payor of record.

Interest Paid by Third Parties

Q–15: If an interest recipient receives interest on a mortgage from a person other than the borrower, must the interest recipient report this amount as received from the borrower?

A–15: In general, yes. Except as otherwise provided in this A–15 and A–15a of this section, an interest recipient must report all amounts received on a borrower's mortgage as received from the borrower under section 6050H and this section. For example, assume that N is the borrower on a mortgage and that interest is received on the mortgage from N's mother. The interest that is received from N's mother on N's mortgage is reportable under section 6050H and this section as received from N. However, interest that is paid by a seller on a purchaser's mortgage shall not be reported under section 6050H and this section as received from the purchaser. For example, if a real estate developer deposits an amount in escrow with the interest recipient and advises the interest recipient to draw on the account to pay interest on a purchaser's mortgage, this interest is not reportable under section 6050H and this section. Similarly, if a real estate developer pays a lump sum to the interest recipient for interest on a purchaser's mortgage, this interest is not reportable under section 6050H and this section. In addition, amounts received by the interest recipient as housing assistance payments from the Department of Housing and Urban Development (''HUD'') on a borrower's mortgage that is insured under section 235 of the National Housing Act (12 U.S.C. 1701–1715z (1982 and Supp. 1983)) shall not be reported as interest received from the borrower. In such a case, therefore, only the amount of interest received on the mortgage that exceeds the amount of housing assistance payments received from HUD shall be reported.

Q–15a: If an interest recipient receives, with respect to a borrower's mortgage, an amount from a governmental unit, or any agency or instrumentality thereof (other than an amount received from HUD as described in A–15 of this section), should the interest recipient report the amount as received from the borrower?

A–15a: If the interest is received after December 31, 1986, it must be reported in the same manner as interest on mortgages with respect to which housing assistance payments are received from HUD, as described in A–15 of this section. If the interest is received before January 1, 1987, it may, but need not, be reported.

FORM AND MANNER OF RETURN

Form of Return

Q–16: What form must be used to make a return required by section 6050H and this section?

A–16: An interest recipient must make the return on Form 1098 (with Form 1096 as the transmittal form). The interest recipient may, however, prepare and use a form that contains provisions substantially similar to those of Forms 1096 and 1098 if that person complies with any revenue procedures relating to substitute Forms 1096 and 1098 in effect at that time. A separate return must be made for each mortgage with respect to which $600 or more of interest is received for a calendar year.

Information Included on Return

Q–17: What information must an interest recipient include on Form 1098?

A–17: An interest recipient must include the following information on the Form 1098:

(a) The name, address, and TIN (as defined in section 7701(a)) of the payor or payor of record;

(b) The name and address of the interest recipient;

(c) The amount of interest (not including points and other prepaid interest) received on the mortgage in the calendar year; and

(d) Any other information as may be required by Form 1098 or its instructions.

Time for Filing

Q–18: When must an interest recipient file the return or returns required by section 6050H and this section?

A–18: An interest recipient must file the return or returns on or before February 28 of the year following the calendar year in which the mortgage interest is received.

Place for Filing

Q–19: Where must the return or returns required under section 6050H and this section be filed?

A–19: The return or returns must be filed with the same Internal Revenue Service Center where other returns of the interest recipient are filed.

Use of Magnetic Media

Q–20: What rules apply with respect to the use of magnetic media?

A–20: Any return required under section 6050H and this section must be filed on magnetic media to the extent required by section 6011(e) and the regulations thereunder. Any person not required by section 6011(e) to file returns on magnetic media may request permission to do so. See § 1.9101 for rules relating to permission to submit information on magnetic tape or other media. If a person required to file returns on magnetic media fails to do so, the penalty under section 6652 (failure to file an information return) applies.

REQUIREMENT OF FURNISHING STATEMENTS TO PAYORS

In General

Q–21: What statements are required to be furnished to payors under section 6050H and this section?

A–21: Any interest recipient required to make an information return under section 6050H must also furnish a statement to the payor or, if applicable, payor of record (see A–13 and A–14 of this section). For the date when the statement must be furnished, see A–26 of this section.

Q–22: Is the statement considered to be furnished to the payor or payor of record if it is mailed to him at his last known address?

A–22: Yes.

Q–23: If an interest recipient furnishes a statement required under a Federal mortgage program will the requirements of A–21 of this section be met?

A–23: Yes, if the statement furnished contains all the information required under A–24 of this section and is furnished to the payors or payors of record by the date required under A–26 of this section.

Information Included on Statement

Q–24: What information must be included on the statement required to be furnished to payors or payors of record under section 6050H and this section?

A–24: The statement must include the following information:

(a) The information required under A–17 of this section;

(b) A legend stating that the information is being reported to the Internal Revenue Service; and

(c) A legend stating that the amount reported on the statement is deductible by the payor for Federal income tax purposes only to the extent the payor actually paid the amount and was not reimbursed by another person.

Copy of Form 1098 to Payors

Q–25: Can an interest recipient meet the requirement to furnish a statement to a payor or payor of record by furnishing a copy of the Form 1098 filed with respect to that payor or payor of record?

A–25: Yes. The requirement of furnishing a statement may be met by furnishing to the payor or payor of record a copy of the Form 1098 containing the same information filed with the Service with respect to such payor, or a form that contains provisions substantially similar to those of Form 1098, provided that the form bears the legends described in A–24 of this section.

Time for Furnishing Statement

Q–26: When is a statement required to be furnished by an interest recipient to the payor or payor of record?

A–26: A statement is required to be furnished by the interest recipient to the payor or payor of record on or before January 31 of the year following the calendar year in which the mortgage interest is received.

PENALTIES

In General

Q–27: Are there any penalties for failing to comply with the requirements of section 6050H and this section?

A–27: Yes. The penalty for failing to make an information return with respect to a payor or payor of record is provided in section 6652. The penalty for failing to furnish a statement to a payor or payor of record is provided in section 6678.

Q–28: Are there any penalties for failing to furnish a TIN upon request?

A–28: Yes. Any payor or payor of record is subject to a $50 penalty by the Internal Revenue Service if such payor fails to furnish his TIN upon the request of an interest recipient. For rules relating to the requesting of TINs by interest recipients, see A–30 and A–31 of this section.

Q–29: Is an interest recipient subject to any penalties for failing to furnish the TIN of a payor or payor of record?

A–29: Yes. In general, the penalties provided under section 6676 will be assessed against interest recipients who fail to furnish to the Internal Revenue Service the TIN of a payor or payor of record. With respect to mortgages in existence on December 31, 1984, however, the interest recipient will not be subject to the section 6676 penalties if the interest recipient followed the rules of A–30 and A–31 of this section for requesting TINs and properly processed the responses.

Requesting TINS

Q–30: What rules apply with respect to the requesting of TINs by interest recipients?

A–30: With respect to obligations incurred after December 31, 1984, the interest recipient must take all reasonable steps to obtain the TIN of the payor or payor of record at the time the obligation is incurred. With respect to any mortgage for which the interest recipient does not have the TIN of the payor or payor of record in its accounting system, the interest recipient must request, at least once a year, the TIN of such payor.

The request for a TIN need not be in a separate mailing. The request may be included, for example, in the interest recipient's regular mailings of payment coupon booklets or annual statements. However, if the interest recipient makes no other mailings to the payor or payor of record during 1985 (or during the year in which the obligation is incurred for obligations incurred after 1985), then the interest recipient must request the TIN in a separate mailing.

Q–31: What form must the interest recipient use to request the TIN of a payor or a payor of record?

A–31: No particular form must be used to request the TIN. However, the request must be made on a separate piece of paper and the request must clearly notify the payor that the Internal Revenue Service requires the payor to furnish his TIN in order to verify any deduction for mortgage interest. The interest recipient must also notify such payor that he is subject to a $50 penalty, imposed by the Internal Revenue Service, if he fails to furnish his TIN.

Effective Date

Q–32: When is this section effective?

A–32: This section generally is effective for mortgage interest received after December 31, 1984, and before January 1, 1988. However, Q/A–15a of this section is effective for mortgage interest received after December 31, 1986, and before January 1, 1988.

(26 U.S.C. 6050H)

[T.D. 8047, 50 FR 33530, Aug. 20, 1985, as amended by T.D. 8191, 53 FR 12002, Apr. 12, 1988]

§ 1.6050H–2 Time, form, and manner of reporting interest received on qualified mortgage.

(a) *Requirement to file return*—(1) *Form of return.* An interest recipient must file a return required by § 1.6050H–1(a) on Form 1098 (with Form 1096 as the transmittal form). An interest recipient may use forms containing provisions substantially similar to those in Forms 1098 and 1096 if it complies with applicable revenue procedures relating to substitute Forms 1098 and 1096. An interest recipient must file a separate return for each qualified mortgage for which it receives $600 or more of interest for a calendar year.

(2) *Information included on return.* An interest recipient must include on Form 1098:

(i) The name, address, and taxpayer identification number (TIN) (as defined in section 7701(a)(41)) of the payor of record;

(ii) The name, address, and TIN of the interest recipient;

(iii) The amount of interest (other than points) required to be reported with respect to the qualified mortgage for the calendar year;

(iv) With respect to reimbursements of interest on a qualified mortgage (as discussed in paragraph (a)(3) of this section) made to the payor of record in the calendar year—

(A) Reimbursements aggregating $600 or more; and

(B) Reimbursements aggregating less than $600, but only if $600 or more of interest on the qualified mortgage is received in the calendar year from the payor of record;

(v) The amount of points paid directly by the payor of record (within the meaning of § 1.6050H–1(f)(3)) required to be reported with respect to the qualified mortgage for the calendar year; and

(vi) Any other information required by Form 1098 or its instructions.

Section 1.6050H–1(e) contains rules to determine the amount of interest received on a mortgage for a calendar year.

(3) *Reimbursements of interest on a qualified mortgage.* For purposes of paragraph (a)(2)(iv) of this section, a reimbursement of interest on a qualified mortgage is a reimbursement of an amount received in a prior year that was required to be reported for that prior year under paragraph (a)(2)(iii) of this section by any interest recipient. Only the interest recipient that makes the reimbursement is required to report the reimbursement under this section. Form 1098 and the statement furnished to the payor of record under paragraph (b) of this section must not include any amount that constitutes interest on the reimbursement paid to the payor of record. Rules relating to the requirement to report interest on a reimbursement are, in the case of a person carrying on the banking business (or a middleman, as defined in § 1.6049–4(f)(4), of a person carrying on the banking business), provided in section 6049 and the regulations thereunder, and, for other persons, provided in section 6041 and the regulations thereunder. Reimbursements of interest on a qualified mortgage (as described in this section) made in 1993 and subsequent calendar years must be reported on Form 1098 and statements

furnished to payors of record. Reimbursements made prior to 1993 are not required to be reported.

(4) *Time and place for filing return.* An interest recipient must file a return required by paragraph (a) of this section on or before February 28 of the year following the calendar year for which it receives the mortgage interest. If no interest is required to be reported for the calendar year, but a reimbursement of interest on a qualified mortgage is required to be reported for the calendar year, then a return required by paragraph (a) of this section must be filed on or before February 28 of the year following the calendar year in which the reimbursement was made. An interest recipient must file the return required by paragraph (a) of this section with the IRS office designated in the instructions for Form 1098.

(5) *Use of magnetic media.* An interest recipient must file the return required by paragraph (a) of this section on magnetic media only if required by section 6011(e) and the regulations thereunder. An interest recipient not required by section 6011(e) to file returns on magnetic media may request permission to do so. Section 301.6011–2 contains rules relating to the use of magnetic media. A failure to file on magnetic media when required constitutes a failure to file an information return under section 6721.

(b) *Requirement to furnish statement*—(1) *In general.* An interest recipient that must file a return under paragraph (a) of this section must furnish a statement to the payor of record.

(2) *Information included on statement.* An interest recipient must include on the statement that it must furnish to a payor of record:

(i) The information required under paragraph (a)(2) of this section;

(ii) A legend that—

(A) Identifies the statement as important tax information that is being furnished to the IRS; and

(B) Notifies the payor of record that if the payor of record is required to file a return, a negligence penalty or other sanction may be imposed on the payor of record if the IRS determines that an underpayment of tax results because the payor of record overstated a deduction for this mortgage interest (if any) or understated income from this mortgage interest reimbursement (if any) on the payor of record's return;

(iii) A legend stating that the payor of record may be unable to deduct the full amount of mortgage interest reported on the statement; that limitations based on the cost and value of the property securing the mortgage may apply; and that the payor of record may only deduct mortgage interest to the extent it was incurred, actually paid by the payor of record, and not reimbursed by another person; and

(iv) With respect to any information required to be reported under paragraph (a)(2)(iv) of this section, an instruction providing that the amount of the reimbursement is not to be deducted and that the amount must be included in the gross income of the payor of record if the reimbursed interest was deducted by the payor of record in a prior year so as to reduce income tax.

(3) *Statement furnished pursuant to Federal mortgage program.* An interest recipient that furnishes a statement to a payor of record under a Federal mortgage program will satisfy the requirement of paragraph (b)(1) of this section if the statement contains all the information and legends required by paragraph (b)(2) of this section and is furnished by the time and at the place required by paragraph (b)(6) of this section.

(4) *Copy of Form 1098 to payor of record.* An interest recipient will satisfy the requirement of paragraph (b)(1) of this section by furnishing to a payor of record a copy of Form 1098 (or a substitute statement that complies with applicable revenue procedures) containing all the information filed with the Internal Revenue Service and all the legends required by paragraph (b)(2) of this section by the time and at the place required by paragraph (b)(6) of this section.

(5) *Furnishing statement with other information reports.* An interest recipient may transmit the statement required by paragraph (b)(1) of this section to the payor of record with other information, including other information returns, as permitted by applicable revenue procedures.

(6) *Time and place for furnishing statement.* An interest recipient must furnish a statement required by paragraph (b)(1) of this section to a payor of record on or before January 31 of the year following the calendar year for which it receives the mortgage interest. If no mortgage interest is required to be reported for the calendar year, but a reimbursement of interest on a qualified mortgage is required to be reported for the calendar year, then the statement required by paragraph (b)(1) of this section must be furnished on or before January 31 of the year following the calendar year in which the reimbursement was made. The interest recipient will be considered to have furnished the statement to the payor of record if it mails the statement to the payor of record's last known address.

(c) *Notice requirement for use of Rule of 78s method of accounting*—(1) *In general.* An interest recipient seeking to report interest received on a mortgage under the Rule of 78s method of accounting as permitted under § 1.6050H–1(e)(4) must notify the payor of record that the Rule of 78s method of accounting was used to calculate interest received on the mortgage and that the payor of record may not deduct as interest the amount calculated under the Rule of 78s method of accounting unless the payor of record properly uses that method to determine interest deductions. The notice must state that the payor of record may use the Rule of 78s method of accounting to determine interest paid for Federal income tax purposes only for a self-amortizing consumer loan requiring level payments at regular intervals (at least annually) over no longer than a five-year period, with no balloon payment at the end of the loan term, and only when the loan agreement provides for use of the Rule of 78s method of accounting to determine interest earned. See Rev. Proc. 83–40, 1983–1 C.B. 774; Rev. Rul. 83–84, 1983–1 C.B. 97.

(2) *Time and manner.* An interest recipient must provide notice required by paragraph (c)(1) of this section to a payor of record on or with the statement required by paragraph (b) of this section. An interest recipient may provide notice on a separate paper or on the statement required by paragraph (b) of this section.

(d) *Reporting under designation agreement*—(1) *In general.* An interest recipient that receives or collects interest (including points) on a mortgage may designate a qualified person to satisfy the reporting requirements of paragraphs (a), (b), and (c) of this section. If a designated qualified person reports as permitted under this paragraph (d), it will satisfy the requirement of paragraph (a)(2)(ii) of this section by including on Form 1098 (and Form 1096) the name, address, and TIN of the designated qualified person.

(2) *Qualified person.* A qualified person is either—

(i) A trade or business with respect to which the interest recipient is under common control within the meaning of § 1.414(c)–2; or

(ii) A person who is named as the designee by the lender of record or by a qualified person (under paragraph (d)(2) of this section) in a designation agreement entered into in accordance with paragraph (d)(3) of this section, and who either was involved in the original loan transaction or is a subsequent purchaser of the loan.

(3) *Designation agreement.* An interest recipient that designates a qualified person to satisfy the reporting requirements described in paragraphs (a), (b), and (c) of this section must make that designation in a written designation agreement. The designation agreement must identify the mortgage(s) and calendar years for which the designated qualified person must report, and must be signed by both the designator and designee. A designee may report an amount as having been paid directly by the payor of record (for purposes of paragraph (a)(2)(v) of this section) only if the designation agreement contains the designator's representation that it did not lend such amount to the payor of record as part of the overall transaction. The designator must retain a copy of the designation agreement for four years following the close of the calendar year in which the loan is made. The designation agreement need not be filed with the Internal Revenue Service.

(4) *Penalties.* A designated qualified person is subject to any applicable penalties provided in part II of subchapter B of chapter 68 of the Internal Revenue Code as if it were an interest recipient. A designator is relieved from liability for applicable penalties by designating a qualified person under the provisions of paragraph (d)(3) of this section. Paragraph (e) of this section describes applicable penalties.

(e) *Penalty provisions*—(1) *Returns and statements the due date for which (determined without regard for extensions) is after December 31, 1987, and before December 31, 1989.* For purposes of this paragraph (e)(1) only, all references to sections of the Internal Revenue Code refer to sections of the Internal Revenue Code of 1986, as amended on or before December 31, 1987.

(i) *Failure to file return or to furnish statement.* The section 6721 penalty applies to an interest recipient that fails to file a return required by paragraph (a) of this section with respect to a payor of record. The section 6722 penalty applies to an interest recipient that fails to furnish a statement required by paragraph (b) of this section to a payor of record.

(ii) *Failure to furnish TIN.* The section 6676 penalty may apply to an interest recipient that fails to furnish the TIN of a payor of record on a return required by paragraph (a) of this section. The section 6676 penalty may apply to an interest recipient that fails to request and to obtain the TIN of a payor of record under paragraph (f) of this section.

(iii) *Failure to include correct information.* The section 6723 penalty may apply to an interest recipient that fails to include correct information on a return required by paragraph (a) of this section or on a statement required by paragraph (b) of this section to be furnished to a payor of record.

(2) *Returns and statements the due date for which (determined without regard for extensions) is after December 31, 1989*—(i) *Failure to file return or to furnish statement.* The section 6721 penalty applies to an interest recipient that fails to file a return required by paragraph (a) of this section with respect to a payor of record. The section 6722 penalty applies to an interest recipient that fails to furnish a statement required by paragraph (b) of this section to a payor of record.

(ii) *Failure to furnish TIN.* The section 6721 penalty may apply to an interest recipient that fails to furnish the TIN of a payor of record on a return required by paragraph (a) of this section. The section 6721 penalty may apply to an interest recipient that fails to request and to obtain the TIN of a payor of record under paragraph (f) of this section.

(iii) *Failure to include correct information.* The section 6721 penalty may apply to an interest recipient that fails to include correct information on a return required by paragraph (a) of this section. The section 6722 penalty may apply to an interest recipient that fails to include correct information on a statement required by paragraph (b) of this section to be furnished to a payor record.

(f) *Requirement to request and to obtain TIN*—(1) *In general.* For obligations incurred after December 31, 1987, an interest recipient must make all reasonable efforts to obtain the TIN of a payor of record when the payor of record incurs the obligation. For example, an interest recipient may require a borrower to furnish a TIN during the mortgage approval or application process. If an interest recipient does not maintain the TIN of a payor of record on a mortgage, whenever incurred, it must request the TIN at least annually and must process responses properly and promptly.

(2) *Manner of requesting TIN.* An interest recipient need not separately mail a request for a TIN. An interest recipient may include a request in its regular mailing of payment coupon booklets or annual statements. If an interest recipient makes no mailing to a payor of record during the year in which the payor of record incurs the obligation, it must request the TIN in a separate mailing. No particular form is required to request a TIN. Nevertheless, an interest recipient must make the request on a separate paper and must clearly notify a payor of record that the Internal Revenue Service requires the payor of record to furnish a TIN in order to verify any mortgage interest deduction. An interest recipient

must notify a payor of record that failure to furnish a TIN subjects the payor of record to a $50 penalty imposed by the Internal Revenue Service. A request for a TIN made on Form W–9 satisfies the requirement of this paragraph (f)(2).

(g) *Effective date*—(1) *In general.* Except as provided in paragraph (g)(2) of this section, this section is effective for mortgage interest received after December 31, 1987. Section 1.6050H–1T contains rules for reporting mortgage interest received after December 31, 1984, and before January 1, 1988.

(2) *Points.* The reporting requirement of this section does not apply to prepaid interest in the form of points received before January 1, 1995.

[T.D. 8191, 53 FR 12005, Apr. 12, 1988, as amended by T.D. 8507, 58 FR 68753, Dec. 29, 1993; T.D. 8571, 59 FR 63253, Dec. 8, 1994]

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[T.D. 8652, 61 FR 7, Jan. 2, 1996]

§ 1.6050I–1 Returns relating to cash in excess of $10,000 received in a trade or business.

(a) *Reporting requirement*—(1) *In general.* Any person (as defined in section 7701(a)(1)) who, in the course of a trade or business in which such person is engaged, receives cash in excess of $10,000 in 1 transaction (or 2 or more related transactions) shall, except as otherwise provided, make a return of information with respect to the receipt of cash.

(2) *Cash received for the account of another.* Cash in excess of $10,000 received by a person for the account of another must be reported under this section. Thus, for example, a person who collects delinquent accounts receivable for an automobile dealer must report with respect to the receipt of cash in excess of $10,000 from the collection of a particular account even though the proceeds of the collection are credited to the account of the automobile dealer (*i.e.*, where the rights to the proceeds from the account are retained by the automobile dealer and the collection is made on a fee-for-service basis).

(3) *Cash received by agents*—(i) *General rule.* Except as provided in paragraph (a)(3)(ii) of this section, a person who in the course of a trade or business acts as an agent (or in some other similar capacity) and receives cash in excess of $10,000 from a principal, must report the receipt of cash under this section.

(ii) *Exception.* An agent who receives cash from a principal and uses all of the cash within 15 days in a cash transaction (the ''second cash transaction'') which is reportable under section 6050I or 5312 of title 31 of the United States Code and the regulations thereunder (31 CFR Part 103), and who discloses the name, address, and taxpayer identification number of the principal to the recipient in the second cash transaction need not report the initial receipt of cash under this section. An agent will be deemed to have met the disclosure requirements of this paragraph (a)(3)(ii) if the agent discloses only the name of the principal and the agent knows that the recipient has the principal's address and taxpayer identification number.

(iii) *Example.* The following example illustrates the application of the rules in paragraphs (a)(3) (i) and (ii) of this section:

Example. B, the principal, gives D, an attorney, $75,000 in cash to purchase real property on behalf of B. Within 15 days D purchases real property for cash from E, a real estate developer, and discloses to E, B's name, address, and taxpayer identification number. Because the transaction qualifies for the exception provided in paragraph (a)(3)(ii) of this section, D need not report with respect to the initial receipt of cash under this section. The exception does not apply, however, if D pays E by means other than cash, or effects the purchase more than 15 days following receipt of the cash from B, or fails to disclose B's name, address, and taxpayer identification number (assuming D does not know that E already has B's address and taxpayer identification number), or purchases the property from a person whose sale of the property is not in the course of that person's trade or business. In any such case, D is required to report the receipt of cash from B under this section.

(b) *Multiple payments.* The receipt of multiple cash deposits or cash installment payments (or other similar payments or prepayments) on or after January 1, 1990, relating to a single transaction (or two or more related transactions), is reported as set forth in paragraphs (b)(1) through (b)(3) of this section.

(1) *Initial payment in excess of $10,000.* If the initial payment exceeds $10,000, the recipient must report the initial payment within 15 days of its receipt.

(2) *Initial payment of $10,000 or less.* If the initial payment does not exceed $10,000, the recipient must aggregate the initial payment and subsequent payments made within one year of the initial payment until the aggregate amount exceeds $10,000, and report with respect to the aggregate amount within 15 days after receiving the payment that causes the aggregate amount to exceed $10,000.

(3) *Subsequent payments.* In addition to any other required report, a report must be made each time that previously unreportable payments made within a 12-month period with respect to a single transaction (or two or more related transactions), individually or in the aggregate, exceed $10,000. The report must be made within 15 days after receiving the payment in excess of $10,000 or the payment that causes the aggregate amount received in the 12-month period to exceed $10,000. (If more than one report would otherwise be required for multiple cash payments within a 15-day period that relate to a single transaction (or two or more related transactions), the recipient may make a single combined report with respect to the payments. The combined report must be made no later than the

date by which the first of the separate reports would otherwise be required to be made.) A report with respect to payments of $10,000 or less that are reportable under this paragraph (b)(3) and are received after December 31, 1989, but before July 10, 1990, is due July 24, 1990.

(4) *Example.* The following example illustrates the application of the rules in paragraphs (b)(1) through (b)(3) of this section:

Example. On January 10, 1991, M receives an initial cash payment of $11,000 with respect to a transaction. M receives subsequent cash payments with respect to the same transaction of $4,000 on February 15, 1991, $6,000 on March 20, 1991, and $12,000 on May 15, 1991. M must make a report with respect to the payment received on January 10, 1991, by January 25, 1991. M must also make a report with respect to the payments totalling $22,000 received from February 15, 1991, through May 15, 1991. This report must be made by May 30, 1991, that is, within 15 days of the date that the subsequent payments, all of which were received within a 12-month period, exceeded $10,000.

(c) *Meaning of terms.* The following definitions apply for purposes of this section—

(1) *Cash*—(i) *Amounts received prior to February 3, 1992.* For amounts received prior to February 3, 1992, the term *cash* means the coin and currency of the United States or of any other country, which circulate in and are customarily used and accepted as money in the country in which issued.

(ii) *Amounts received on or after February 3, 1992.* For amounts received on or after February 3, 1992, the term *cash* means—

(A) The coin and currency of the United States or of any other country, which circulate in and are customarily used and accepted as money in the country in which issued; and

(B) A cashier's check (by whatever name called, including ''treasurer's check'' and ''bank check''), bank draft, traveler's check, or money order having a face amount of not more than $10,000—

(*1*) Received in a designated reporting transaction as defined in paragraph (c)(1)(iii) of this section (except as provided in paragraphs (c)(1)(iv), (v), and (vi) of this section), or

(*2*) Received in any transaction in which the recipient knows that such instrument is being used in an attempt to avoid the reporting of the transaction under section 6050I and this section.

(iii) *Designated reporting transaction.* A designated reporting transaction is a retail sale (or the receipt of funds by a broker or other intermediary in connection with a retail sale) of—

(A) A consumer durable,

(B) A collectible, or

(C) A travel or entertainment activity.

(iv) *Exception for certain loans.* A cashier's check, bank draft, traveler's check, or money order received in a designated reporting transaction is not treated as cash pursuant to paragraph (c)(l)(ii)(B)(*1*) of this section if the instrument constitutes the proceeds of a loan from a bank (as that term is defined in 31 CFR part 103). The recipient may rely on a copy of the loan document, a written statement from the bank, or similar documentation (such as a written lien instruction from the issuer of the instrument) to substantiate that the instrument constitutes loan proceeds.

(v) *Exception for certain installment sales.* A cashier's check, bank draft, traveler's check, or money order received in a designated reporting transaction is not treated as cash pursuant to paragraph (c)(1)(ii)(B)(*1*) of this section if the instrument is received in payment on a promissory note or an installment sales contract (including a lease that is considered to be a sale for Federal income tax purposes). However, the preceding sentence applies only if—

(A) Promissory notes or installment sales contracts with the same or substantially similar terms are used in the ordinary course of the recipient's trade or business in connection with sales to ultimate consumers; and

(B) The total amount of payments with respect to the sale that are received on or before the 60th day after the date of the sale does not exceed 50 percent of the purchase price of the sale.

(vi) *Exception for certain down payment plans.* A cashier's check, bank draft, traveler's check, or money order received in a designated reporting transaction is not treated as cash pursuant to paragraph (c)(1)(ii)(B)(*1*) of this section is the instrument is received pursuant to a payment plan requiring one or more down payments and the payment of the balance of the purchase price by a date no later than the date of the sale (in the case of an item of travel or entertainment, a date no later than the earliest date that any item of travel or entertainment pertaining to the same trip or event is furnished). However, the preceding sentence applies only if—

(A) The recipient uses payment plans with the same or substantially similar terms in the ordinary course of its trade or business in connection with sales to ultimate consumers; and

(B) The instrument is received more than 60 days prior to the date of the sale (in the case of an item of travel or entertainment, the date on which the final payment is due).

(vii) *Examples.* The following examples illustrate the definition of ''cash'' set forth in paragraphs (c)(l)(ii) through (vi) of this section.

Example 1. D, an individual, purchases gold coins from M, a coin dealer, for $13,200. D tenders to M in payment United States currency in the amount of $6,200 and a cashier's check in the face amount of $7,000 which D had purchased. Because the sale is a designated reporting transaction, the cashier's check is treated as cash for purposes of section 6050I and this section. Therefore, because M has received more than $10,000 in cash with respect to the transaction, M must make the report required by section 6050I and this section.

Example 2. E, an individual, purchases an automobile from Q, an automobile dealer, for $11,500. E tenders to Q in payment United States currency in the amount of $2,000 and a cashier's check payable to E and Q in the amount of $9,500. The cashier's check constitutes the proceeds of a loan from the bank issuing the check. The origin of the proceeds is evident from provisions inserted by the bank on the check that instruct the dealer to cause a lien to be placed on the vehicle as security for the loan. The sale of the automobile is a designated reporting transaction. However, under paragraph (c)(1)(iv) of this section, because E has furnished Q documentary information establishing that the cashier's check constitutes the proceeds of a loan from the bank issuing the check, the cashier's check is not treated as cash pursuant to paragraph (c)(1)(ii)(B)(*1*) of this section.

Example 3. F, an individual, purchases an item of jewelry from S, a retail jeweler, for $12,000. F gives S traveler's checks totalling $2,400 and pays the balance with a personal check payable to S in the amount of $9,600. Because the sale is a designated reporting transaction, the traveler's checks are treated as cash for purposes of section 6050I and this section. However, because the personal check is not treated as cash for purposes of section 6050I and this section, S has not received more than $10,000 in cash in the transaction and no report is required to be filed under section 6050I and this section.

Example 4. G, an individual, purchases a boat from T, a boat dealer, for $16,500. G pays T with a cashier's check payable to T in the amount of $16,500. The cashier's check is not treated as cash because the face amount of the check is more than $10,000. Thus, no report is required to be made by T under section 6050I and this section.

Example 5. H, an individual, arranges with W, a travel agent, for the chartering of a passenger aircraft to transport a group of individuals to a sports event in another city. H also arranges with W for hotel accommodations for the group and for admission tickets to the sports event. In payment, H tenders to W money orders which H had previously purchased. The total amount of the money orders, none of which individually exceeds $10,000 in face amount, exceeds $10,000. Because the transaction is a designated reporting transaction, the money orders are treated as cash for purposes of section 6050I and this section. Therefore, because W has received more than $10,000 in cash with respect to the transaction, W must make the report required by section 6050I and this section.

(2) *Consumer durable.* The term *consumer durable* means an item of tangible personal property of a type that is suitable under ordinary usage for personal consumption or use, that can reasonably be expected to be useful for at least 1 year under ordinary usage, and that has a sales price of more than $10,000. Thus, for example, a $20,000 automobile is a consumer durable (whether or not it is sold for business use), but a $20,000 dump truck or a $20,000 factory machine is not.

(3) *Collectible.* The term *collectible* means an item described in paragraphs (A) through (D) of section 408(m)(2) (determined without regard to section 408(m)(3)).

(4) *Travel or entertainment activity.* The term *travel or entertainment activity* means an item of travel or entertainment (within the meaning of §1.274–2(b)(1)) pertaining to a single trip or event where the aggregate sales price

of the item and all other items pertaining to the same trip or event that are sold in the same transaction (or related transactions) exceeds $10,000.

(5) *Retail sale.* The term *retail sale* means any sale (whether for resale or for any other purpose) made in the course of a trade or business if that trade or business principally consists of making sales to ultimate consumers.

(6) *Trade or business.* The term *trade or business* has the same meaning as under section 162 of the Internal Revenue Code of 1954.

(7) *Transaction*—(i) The term *transaction* means the underlying event precipitating the payer's transfer of cash to the recipient. Transactions include (but are not limited to) a sale of goods or services; a sale of real property; a sale of intangible property; a rental of real or personal property; an exchange of cash for other cash; the establishment or maintenance of or contribution to a custodial, trust, or escrow arrangement; a payment of a preexisting debt; a conversion of cash to a negotiable instrument; a reimbursement for expenses paid; or the making or repayment of a loan. A transaction may not be divided into multiple transactions in order to avoid reporting under this section.

(ii) The term *related transactions* means any transaction conducted between a payer (or its agent) and a recipient of cash in a 24-hour period. Additionally, transactions conducted between a payer (or its agent) and a cash recipient during a period of more than 24 hours are related if the recipient knows or has reason to know that each transaction is one of a series of connected transactions.

(iii) The following examples illustrate the definition of paragraphs (c)(7) (i) and (ii).

Example (1). A person has a tacit agreement with a gold dealer to purchase $36,000 in gold bullion. The $36,000 purchase represents a single transaction under paragraph (c)(7)(i) of this section and the reporting requirements of this section cannot be avoided by recasting the single sales transaction into 4 separate $9,000 sales transactions.

Example (2). An attorney agrees to represent a client in a criminal case with the attorney's fee to be determined on an hourly basis. In the first month in which the attorney represents the client, the bill for the attorney's services comes to $8,000 which the client pays in cash. In the second month in which the attorney represents the client, the bill for the attorney's services comes to $4,000, which the client again pays in cash. The aggregate amount of cash paid ($12,000) relates to a single transaction as defined in paragraph (c)(7)(i) of this section, the sale of legal services relating to the criminal case, and the receipt of cash must be reported under this section.

Example (3). A person intends to contribute a total of $45,000 to a trust fund, and the trustee of the fund knows or has reason to know of that intention. The $45,000 contribution is a single transaction under paragraph (c)(7)(i) of this section and the reporting requirement of this section cannot be avoided by the grantor's making five separate $9,000 cash contributions to a single fund or by making five $9,000 cash contributions to five separate funds administered by a common trustee.

Example (4). K, an individual, attends a one day auction and purchases for cash two items, at a cost of $9,240 and $1,732.50 respectively (tax and buyer's premium included). Because the transactions are related transactions as defined in paragraph (c)(7)(ii) of this section, the auction house is required to report the aggregate amount of cash received from the related sales ($10,972.50), even though the auction house accounts separately on its books for each item sold and presents the purchaser with separate bills for each item purchased.

Example (5). F, a coin dealer, sells for cash $9,000 worth of gold coins to an individual on three successive days. Under paragraph (c)(7)(ii) of this section the three $9,000 transactions are related transactions aggregating $27,000 if F knows, or has reason to know, that each transaction is one of a series of connected transactions.

(8) *Recipient.* (i) The term *recipient* means the person receiving the cash. Except as provided in paragraph (c)(8)(ii) of this section, each store, division, branch, department, headquarters, or office (''branch'') (regardless of physical location) comprising a portion of a person's trade or business shall for purposes of this section be deemed a separate recipient.

(ii) A branch that receives cash payments will not be deemed a separate recipient if the branch (or a central unit linking such branch with other branches) would in the ordinary course of business have reason to know the identity of payers making cash payments to other branches of such person.

(iii) *Examples.* The following examples illustrate the application of the rules in paragraphs (c)(8)(i) and (ii) of this section:

Example (1). N, an individual, purchases regulated futures contracts at a cost of $7,500 and $5,000, respectively, through two different branches of Commodities Broker X on the same day. N pays for each purchase with cash. Each branch of Commodities Broker X transmits the sales information regarding each of N's purchases to a central unit of Commodities Broker X (which settles the transactions against N's account). Under paragraph (c)(8)(ii) of this section the separate branches of Commodities Broker X are not deemed to be separate recipients; therefore. Commodities Broker X must report with respect to the two related regulated futures contracts sales in accordance with this section.

Example (2). P, a corporation, owns and operates a racetrack. P's racetrack contains 100 betting windows at which pari-mutuel wagers may be made. R, an individual, places cash wagers of $3,000 each at five separate betting windows. Assuming that in the ordinary course of business each betting window (or a central unit linking windows) does not have reason to know the identity of persons making wagers at other betting windows, each betting window would be deemed to be a separate cash recipient under paragraph (c)(8)(i) of this section. As no individual recipient received cash in excess of $10,000, no report need be made by P under this section.

(d) *Exceptions to the reporting requirements of section 6050I*—(1) *Receipt of cash by certain financial institutions.* A financial institution as defined in subparagraphs (A), (B), (C), (D), (E), (F), (G), (J), (K), (R), and (S) of section 5312 (a)(2) of Title 31, United States Code is not required to report the receipt of cash exceeding $10,000 under section 6050I.

(2) *Receipt of cash by certain casinos having gross annual gaming revenue in excess of $1,000,000*—(i) *In general.* If a casino receives cash in excess of $10,000 and is required to report the receipt of such cash directly to the Treasury Department under 31 CFR 103.22(a)(2) and 103.25 and is subject to the recordkeeping requirements of 31 CFR 103.36, then the casino is not required to make a return with respect to the receipt of such cash under section 6050I and these regulations.

(ii) *Casinos exempt under 31 CFR 103.45(c).* Under the authority of section 6050I(c)(1)(A), the Secretary may exempt from the reporting requirements of section 6050I casinos with gross annual gaming revenue in excess of $1,000,000 that are exempt under 31 CFR 103.45(c) from reporting certain cash transactions to the Treasury Department under 31 CFR 103.22(a)(2) and 103.25. The determination whether a casino which is granted an exemption under 31 CFR 103.45(c) will be required to report under section 6050I will be made on a case by case basis, concurrently with the granting of such an exemption.

(iii) *Reporting of cash received in a nongaming business.* Nongaming businesses (such as shops, restaurants, entertainment, and hotels) at casino hotels and resorts are separate trades or businesses in which the receipt of cash in excess of $10,000 is reportable under section 6050I and these regulations. Thus, a casino exempt under paragraph (d)(2) (i) or (ii) of this section must report with respect to cash in excess of $10,000 received in its nongaming businesses.

(iv) *Example.* The following example illustrates the application of the rules in paragraphs (d)(2) (i) and (iii) of this section:

Example. A and B are casinos having gross annual gaming revenue in excess of $1,000,000. C is a casino with gross annual gaming revenue of less than $1,000,000. Casino A receives $15,000 in cash from a customer with respect to a gaming transaction which the casino reports to the Treasury Department under 31 CFR 103.22(a)(2) and 103.25. Casino B receives $15,000 in cash from a customer in payment for accommodations provided to that customer at Casino B's hotel. Casino C receives $15,000 in cash from a customer with respect to a gaming transaction. Casino A is not required to report the transaction under section 6050I or these regulations because the exception for certain casinos provided in paragraph (d)(2)(i) (''the casino exception'') applies. Casino B is required to report under section 6050I and these regulations because the casino exception does not apply to the receipt of cash from a nongaming activity. Casino C is required to report under section 6050I and these regulations because the casino exception does not apply to casinos having gross annual gaming revenue of $1,000,000 or less which do not have to report to the Treasury Department under 31 CFR 103.22(a)(2) and 103.25.

(3) *Receipt of cash not in the course of the recipient's trade or business.* The receipt of cash in excess of $10,000 by a person other than in the course of the person's trade or business is not reportable under section 6050I. Thus, for example, F, an individual in the trade or business of selling real estate, sells a motorboat for $12,000, the purchase price of which is paid in cash. F did not use the motorboat in any trade or business in which F was engaged. F is not required to report under section 6050I or these regulations because the exception provided in this paragraph (d)(3) applies.

(4) *Receipt is made with respect to a foreign cash transaction*—(i) *In general.* Generally, there is no requirement to report with respect to a cash transaction if the entire transaction occurs outside the United States (the fifty states and the District of Columbia). An entire transaction consists of both the transaction as defined in paragraph (c)(7)(i) of this section and the receipt of cash by the recipient. If, however, any part of an entire transaction occurs in the Commonwealth of Puerto Rico or a possession or territory of the United States and the recipient of cash in that transaction is subject to the general jurisdiction of the Internal Revenue Service under title 26 of the United States Code, the recipient is required to report the transaction under this section.

(ii) *Example.* The following example illustrates the application of the rules in paragraph (d)(4)(i) of this section:

Example. W, an individual engaged in the trade or business of selling aircraft, reaches an agreement to sell an airplane to a U.S. citizen living in Mexico. The agreement, no portion of which is formulated in the United States, calls for a purchase price of $125,000 and requires delivery of and payment for the airplane to be made in Mexico. Upon delivery of the airplane in Mexico, W receives $125,000 in cash. W is not required to report under section 6050I or these regulations because the exception provided in paragraph (d)(4)(i) of this section (''foreign transaction exception'') applies. If, however, any part of the agreement to sell had been formulated in the United States, the foreign transaction exception would not apply and W would be required to report the receipt of cash under section 6050I and these regulations.

(e) *Time, manner, and form of reporting*—(1) *Time of reporting.* The reports required by this section must be filed with the Internal Revenue Service by the 15th day after the date the cash is received. However, in the case of multiple payments relating to a single transaction (or two or more related transactions), see paragraph (b) of this section.

(2) *Form of reporting.* A report required by paragraph (a) of this section must be made on Form 8300. A return of information made in compliance with this paragraph must contain the name, address, and taxpayer identification number of the person from whom the cash was received; the name, address, and taxpayer identification number of the person on whose behalf the transaction was conducted (if the recipient knows or has reason to know that the person from whom the cash was received conducted the transaction as an agent for another person); the amount of cash received; the date and nature of the transaction; and any other information required by Form 8300. Form 8300 can be obtained from any Internal Revenue Service Forms Distribution Center.

(3) *Manner of reporting*—(i) *Where to file.* A person making a return of information under this section must file Form 8300 by mailing it to the address shown in the instructions to the form.

(ii) *Verification.* A person making a return of information under this section must verify the identity of the person from whom the reportable cash is received. Verification of the identity of a person who purports to be an alien must be made by examination of such person's passport, alien identification card, or other official document evidencing nationality or residence. Verification of the identity of any other person may be made by examination of a document normally acceptable as a means of identification when cashing or accepting checks (for example, a driver's license or a credit card). In addition, a return will be considered incomplete if the person required to make a return knows (or has reason to know) that an agent is conducting the transaction for a principal, and the return does not identify both the principal and the agent.

(iii) *Retention of returns.* A person required to make an information return under this section must keep a copy of each return filed for five years from the date of filing.

(f) *Requirement of furnishing statements*—(1) *In general.* Any person required to make an information return under this section must furnish a single, annual, written statement to each person whose name is set forth in a return (''identified person'') filed with the Internal Revenue Service.

(2) *Form of statement.* The statement required by the preceding paragraph need not follow any particular format, but it must contain the following information:

(i) The name and address of the person making the return;

(ii) The aggregate amount of reportable cash received by the person who made the information return required by this section during the calendar year in all cash transactions relating to the identified person; and

(iii) A legend stating that the information contained in the statement is being reported to the Internal Revenue Service.

(3) *When statement is to be furnished.* Statements required under this paragraph (f) must be furnished to an identified person on or before January 31 of the year following the calendar year in which the cash is received. A statement shall be considered to be furnished to an identified person if it is mailed to the identified person at the identified person's last known address.

(g) *Cross-reference to penalty provisions*—(1) *Failure to file correct information return.* See section 6721 for civil penalties relating to the failure to file a correct return under section 6050I(a) and paragraph (a) of this section.

(2) *Failure to furnish correct statement.* See section 6722 for civil penalties relating to the failure to furnish a correct statement to identified persons under section 6050I(e) and paragraph (f) of this section.

(3) *Criminal penalties.* Any person who willfully fails to make a return or makes a false return under section 6050I and this section may be subject to criminal prosecution.

[T.D. 8098, 51 FR 31611, Sept. 4, 1986; 51 FR 33033, Sept. 18, 1986, as amended by T.D. 8373, 56 FR 57976, 57977, Nov. 15, 1991; 58 FR 16496, Mar. 29, 1993; T.D. 8479, 58 FR 33764, June 21, 1993]

§1.6050I–2 Returns relating to cash in excess of $10,000 received as bail by court clerks.

(a) *Reporting requirement.* Any clerk of a Federal or State court who receives more than $10,000 in cash as bail for any individual charged with a specified criminal offense must make a return of information with respect to that cash receipt. For purposes of this section, a clerk is the clerk's office or the office, department, division, branch, or unit of the court that is authorized to receive bail. If someone other than a clerk receives bail on behalf of a clerk, the clerk is treated as receiving the bail for purposes of this paragraph (a).

(b) *Meaning of terms.* The following definitions apply for purposes of this section—

Cash means—

(1) The coin and currency of the United States, or of any other country, that circulate in and are customarily used and accepted as money in the country in which issued; and

(2) A cashier's check (by whatever name called, including treasurer's check and bank check), bank draft, traveler's check, or money order having a face amount of not more than $10,000.

Specified criminal offense means—

(1) A Federal criminal offense involving a controlled substance (as defined in section 802 of title 21 of the United States Code), provided the offense is described in Part D of Subchapter I or Subchapter II of title 21 of the United States Code;

(2) Racketeering (as defined in section 1951, 1952, or 1955 of title 18 of the United States Code);

(3) Money laundering (as defined in section 1956 or 1957 of title 18 of the United States Code); and

(4) Any State criminal offense substantially similar to an offense described in this paragraph (b).

(c) *Time, form, and manner of reporting*—(1) *Time of reporting*—(i) *In general.* The information return required by this section must be filed with the Internal Revenue Service by the 15th day after the date the cash bail is received.

(ii) *Multiple payments.* If multiple payments are made to satisfy bail reportable under this section and the initial payment does not exceed $10,000, the initial payment and subsequent payments must be aggregated and the information return required by this section must be filed with the Internal Revenue Service by the 15th day after receipt of the payment that causes the aggregate amount to exceed $10,000. However, if payments are made to satisfy separate bail requirements, no aggregation is required. Thus, if in Month 1 a clerk receives $6,000 in bail for an individual charged with a specified criminal offense and later, in Month 2, receives $7,000 in bail for that same individual charged with another specified criminal offense, no aggregation is required.

(2) *Form of reporting.* The return of information required by paragraph (a) of this section must be made on Form 8300 and must contain the following information—

(i) The name, address, and taxpayer identification number (TIN) of the individual charged with the specified criminal offense;

(ii) The name, address, and TIN of each person posting the bail (payor of bail), other than a person posting bail who is licensed as a bail bondsman in the jurisdiction in which the bail is received;

(iii) The amount of cash received;

(iv) The date the cash was received; and

(v) Any other information required by Form 8300 or its instructions.

(3) *Manner of reporting*—(i) *Where to file.* Returns required by this section must be filed with the Internal Revenue Service office designated in the instructions for Form 8300. A copy of the information return required to be filed under this section must be retained for five years from the date of filing.

(ii) *Verification of identity.* A clerk required to make an information return under this section must, in accordance with § 1.6050I–1(e)(3)(ii), verify the identity of each payor of bail listed in the return.

(d) *Requirement to furnish statements*—(1) *Information to Federal prosecutors*—(i) *In general.* A clerk required to make an information return under this section must furnish a written statement to the United States Attorney for the jurisdiction in which the individual charged with the specified crime resides and the United States Attorney for the jurisdiction in which the specified criminal offense occurred (applicable United States Attorney(s)). The written statement must be filed with the applicable United States Attorney(s) by the 15th day after the date the cash bail is received.

(ii) *Form of statement.* The written statement must include the information required by paragraph (c)(2) of this section. The requirement of this paragraph (d)(1)(ii) will be satisfied if the clerk provides to the applicable United States Attorney(s) a copy of the Form 8300 that is filed with the Internal Revenue Service pursuant to this section.

(2) *Information to payors of bail*—(i) *In general.* A clerk required to make an information return under this section must furnish a written statement to each payor of bail whose name is set forth in a return required by this section. A statement required under this paragraph (d)(2) must be furnished to a payor of bail on or before January 31 of the year following the calendar year in which the cash is received. A statement will be considered furnished to a payor of bail if it is mailed to the payor's last known address.

(ii) *Form of statement.* The statement required by this paragraph (d)(2) need not follow any particular format, but must contain the following information—

(A) The name and address of the clerk's office making the return;

(B) The aggregate amount of reportable cash received during the calendar year by the clerk who made the information return required by this section in all cash transactions relating to the payor of bail; and

(C) A legend stating that the information contained in the statement has been reported to the Internal Revenue

Service and the applicable United States Attorney(s).

(iii) *Aggregate amount.* The requirement of furnishing the aggregate amount in paragraph (d)(2)(ii)(B) of this section will be satisfied if the clerk provides to the payor of bail either a single written statement listing the aggregate amount, or a copy of each Form 8300 relating to that payor of bail.

(e) *Cross-reference to penalty provisions.* See sections 6721 through 6724 for penalties relating to the failure to comply with the provisions of this section.

(f) *Effective date.* This section applies to cash received by court clerks on or after February 13, 1995.

[T.D. 8652, 61 FR 7, Jan. 2, 1996]

§1.6050J–1T Questions and answers concerning information returns relating to foreclosures and abandonments of security (temporary).

The following questions and answers relate to the requirement of reporting foreclosures and abandonments of security under section 6050J of the Internal Revenue Code Act of 1954, as added by section 148 of the Tax Reform Act of 1984 (98 Stat. 687).

REQUIREMENT OF REPORTING

In General

Q–1: What does section 6050J provide with respect to the reporting of acquisitions and abandonments of property that secures indebtedness?

A–1: Section 6050J provides that an information return must be made by any person who, in connection with a trade or business conducted by the person (except as provided in A–13), lends money and, in full or partial satisfaction of the debt, acquires an interest in any property that is security for the debt, or has reason to know that the property has been abandoned. For purposes of these questions and answers, a person who lends money in connection with a trade or business is referred to as a ‘‘lender’’.

Trade or Business Requirement

Q–2: Must a person be in the trade or business of lending money in order to be subject to the reporting requirement of this section?

A–2: No. A person does not have to be in the trade or business of lending money to be subject to this reporting requirement. Thus, if L sells automobiles and lends money to B to enable B to purchase an automobile from L for use in B’s trade or business, and that automobile is security for the loan, L would be subject to this reporting requirement. Similarly, if P promotes interests in an oil well, and lends money to I to enable I to invest in the oil well which is security for the loan, P would be subject to this reporting requirement.

Q–3: How does the reporting requirement apply in the case of pools, fixed investment trusts, or other similar arrangements through which undivided beneficial interests or participations in indebtedness are offered?

A–3: In these cases, the owners of the undivided beneficial interests or participations are not subject to this reporting requirement. Instead, the trustee, record owner, or person acting in a similar capacity is treated as the lender for purposes of this reporting requirement and is the party required to report. For purposes of both section 6050J and the applicable penalty provisions, only one return and one statement must be filed with respect to each loan or other evidence of indebtedness. For situations when more than one return or statement must be filed, see A–29, A–31, and A–41. The trustee, record owner, or person acting in a similar capacity, rather than the owners of beneficial interests or participations, is subject to the applicable penalty provisions (see A–43).

Q–4: How does the reporting requirement apply in the case of corporate, tax-exempt, or other bond issues?

A–4: In these cases, the owners or holders of a bond issue are not required to report. Instead, the trustee or person acting in a similar capacity is treated as the lender for purposes of this reporting requirement and is the party required to report. For purposes of both section 6050J and the applicable penalty provisions, only one return and one statement must be filed with respect to a bond issue. For situations when more than one return or statement must be filed, see A–29, A–31, and A–41. The trustee or person acting in a similar capacity, rather than the owners or holders of a bond issue, is subject to the applicable penalty provisions (see A–43).

Property Subject to Reporting

Q–5: Does the reporting requirement apply to all types of property securing indebtedness?

A–5: No. The reporting requirement does not apply to any loan made to an individual and secured by an interest in tangible personal property which is neither held for investment nor used in a trade or business. For rules governing when the reporting requirment applies to tangible personal property of a type ordinarily used for personal purposes, see A–8.

Q–6: Does the reporting requirement apply when property securing indebtedness is held both for personal use and for use in a trade or business?

A–6: Yes. The reporting requirement applies when property securing indebtedness is held both for personal use and for use in a trade or business. Similarly, the reporting requirement applies when the borrower holds such property both for personal use and for investment purposes.

Q–7: Does the reporting requirement apply to indebtedness secured by a personal residence?

A–7: Yes. A lender is subject to the reporting requirement if the property that is security for the loan is real property, including a personal residence, whether or not held for investment or used in a trade or business.

Q–8: In the case of a loan made to an individual and secured by personal property of a type that is ordinarily used for personal purposes, how does a lender know whether such property is used in a trade or business or held for investment purposes?

A–8: In the case of a loan made to an individual and secured by personal property of a type that is ordinarily used for personal purposes, such as an automobile, computer, or boat, the lender is subject to the reporting requirement if the lender knows that the property will be used in a trade or business or held for investment purposes. For this purpose, a lender knows information if the information is included on the books and records of the lender or its agents pertaining to the loan, or is known by the lender or agent's officers, partners, principals or employees, but only if such information was acquired in the course of their ordinary business activities on behalf of the lender. For example, if a borrower indicates on the loan agreement or disclosure statement that the borrower intends to use the property securing the loan in the borrower's trade or business, the lender is subject to this reporting requirement. Similarly, if the borrower notifies the lender that the borrower intends to convert the property from personal use to use in a trade or business, the lender is subject to the reporting requirement.

Q–9: If a lender maintains a system under which the lender classifies loans according to the use of property that secures the loan (such as use in a trade or business or personal use), may the lender rely on this system in determining whether the reporting requirement applies?

A–9: Yes. A lender may rely on the classification system to determine whether the reporting requirement applies, provided that the classification system is designed and reasonably maintained to ensure accuracy in identifying the use of property.

Acquisition of an Interest

Q–10: For purposes of the reporting requirement, when is a lender treated as acquiring an interest in property that is security for indebtedness?

A–10: In general, an interest in property is acquired on the earlier of the date title is transferred to the lender or the date possession and the burdens and benefits of ownership are transferred to the lender. If State or other applicable law provides for an objection period within which the borrower and other appropriate parties may object to the lender's proposal toretain the property in satisfaction of the indebtedness, a lender is treated as acquiring an interest in the property on the date this objection period expires. If the lender purchases the property at a sale held to satisfy the indebtedness, such as at a foreclosure or execution sale, the lender is treated as acquiring an interest in the property on the later of the date of the sale or the date the borrower's right of redemption, if any, expires. See 4A–15 for rules governing reporting when a party other than the lender acquires property securing indebtedness at a foreclosure, execution or similar sale.

Q–11: If a lender takes possession of property that is security for a loan for a limited purpose, such as completing construction on or improvement to the property, is the lender treated as having acquired an interest in the property at that point?

A–11: No. The lender in these circumstances is not treated as acquiring an interest in the property. However, the lender must report if he later acquires an interest in the property in full or partial satisfaction of the indebtedness (see A–10 or A–15).

Indirect Acquisition

Q–12: If a lender acquires an interest in a partnership, trust, or other entity in full or partial satisfaction of a loan that is secured by the assets or property owned by the partnership, trust, or other entity, is the lender treated as acquiring an interest in the property securing the loan?

A–12: Yes. A lender in this case acquires an interest in the underlying assets or property and the reporting requirements of this section apply to the acquisition of that interest in a partnership, trust, or other entity.

Treatment of Governmental Units

Q–13: How does the reporting requirement apply to a governmental unit?

A–13: A governmental unit (or any agency or instrumentality thereof) which lends money secured by property is subject to the reporting requirement without regard to the requirement that the money be lent in connection with a trade or business. A governmental unit (or any agency or instrumentality thereof) subject to the reporting requirement must designate an officer or employee to make the return. The officer or employee appropriately designated must make the return in the form and manner prescribed by this section.

Notification of Sale Under Section 7425(b)

Q–14: Does a return filed as required under this section constitute a notification of sale under section 7425(b)?

A–14: No. A return filed under this section is not considered a notification of sale under section 7425(b).

Sale to Third Party

Q–15: If a party other than the lender purchases property securing a loan at a foreclosure, execution, or similar sale, must the lender report under this section?

A–15: Yes. The lender must report if a party other than the lender purchases property securing the lender's loan at a foreclosure, execution, or similar sale. If the proceeds of that sale are applied to satisfy all or any portion of the lender's loan, the lender must treat the property as having been abandoned. The lender will be treated as having reason to know that the property has been abandoned as of the date of the sale (see A–19). If no proceeds of such a sale are made available to satisfy any portion of the lender's loan but the lender's security interest foreclosed upon is terminated, reduced, or otherwise impaired by reason of the sale, the lender will be treated as having reason to know that the property has been abandoned as of the date of the sale (see A–19).

Treatment of Foreign Borrowers

Q–16: How does the reporting requirement apply in the case of foreign borrowers where the property securing the loan is located outside the United States?

A–16: No reporting is required where both of the following requirements are met: (a) The property securing the loan is located outside the United States, and (b) at any time before the lender is required to report, the borrower furnishes the lender with a statement, signed upon penalty of perjury, that he is an exempt foreign person (unless an employee or other agent of the lender who is responsible for receiving or reviewing these statements has actual knowledge that the statement is incorrect). For purposes of this section, the borrower is an exempt foreign person if he:

(1) Is not a citizen of the United States, a resident of the United States, a person treated as a resident of the United States by reason of an election under section 6013 (g) or (h) or a United States corporation or other United States entity;

(2) Is not subject to the provisions of section 877; and

(3) At the time the statement is furnished, is not, or reasonably expects not to be, engaged in a trade or business in the United States during the current year in connection with the loan or property securing the loan.

If, after providing the statement, the borrower ceases to be an exempt foreign person, he must so notify the lender in writing within 30 days of this change in status. If the lender is so notified, this exemption from the reporting requirement no longer applies.

Abandonments

Q–17: For purposes of this reporting requirement, when has an abandonment occurred?

A–17: An abandonment has occurred when the objective facts and circumstances indicate that the borrower intended to and has permanently discarded the property from use.

Q–18: Does the fact that a lender knows or has reason to know of an abandonment of property securing a loan mean that the borrower is entitled to an abandonment loss?

A–18: No. The definition of an abandonment of property securing a loan in A–17 applies only for purposes of this reporting requirement and is not intended to apply for other purposes, such as determining whether a borrower would be entitled to an abandonment loss.

Q–19: Under what circumstances will a lender be considered to have reason to know that property which is security for a loan has been abandoned?

A–19: Whether a lender has reason to know that property which is security for a loan has been abandoned is to be determined with reference to all the facts and circumstances concerning the status of the property. When the lender in the ordinary course of business becomes aware or should become aware of circumstances indicating that the property has been abandoned, the lender will be deemed to know all the information that would have been discovered through a reasonable inquiry. For example, if a borrower has failed (without adequate explanation) to make payments on the loan for a substantial period, the lender must make a reasonable inquiry to determine whether there has been an abandonment. If a reasonable inquiry would reveal objective facts and circumstances indicating that the borrower intended to and has permanently discarded the property from use, then the lender has reason to know that the property has been abandoned. If a lender knows or has reason to know that the property has been abandoned and reasonably expects to commence foreclosure, execution sale, or similar proceedings, see A–20.

Q–20: If a lender has reason to know that property that is security for a loan has been abandoned and reasonably expects to commence within three months foreclosure, execution sale, or similar proceedings, is reporting of the abandonment required?

A–20: In these circumstances, the lender need not report as of the date he knows or has reason to know that the property has been abandoned. Instead, the lender must report as of the date he acquires an interest in the property or a third party purchases the property at a foreclosure, execution or similar sale (see A–10 and A–15). In any other case, the lender must report as of the date the lender knows or has reason to know that the property has been abandoned (see A–18).

Q–21: If a lender has reason to know that property that is security for a loan has been abandoned and reasonably expects to commence within three months foreclosure, execution sale or similar proceedings but in fact does not commence such proceedings within the three month period, must the lender report?

A–21: Yes. In these circumstances, the lender's obligation to report the abandonment arises at the close of the three month period. For example, if on December 31, 1985, a lender first has reason to know that property securing his loan has been abandoned and reasonably expects to commence foreclosure proceedings within three months, the lender is not required to report as of December 31, 1985 (see A–20). However, if the lender does not in fact commence foreclosure proceedings by March 31, 1986, the lender's obligation to report arises on this date. The lender must provide information on the abandonment under A–27 as of the date the lender first had reason to know of the abandonment (December 31, 1985). The lender must file the return required under this section with the Internal Revenue Service on or before February 28, 1987, and furnish a statement to the borrower on or before January 31, 1987 (see A–33 and A–40).

Subsequent Holder of a Loan

Q–22: To whom does the reporting requirement apply when a person lends money secured by property and subsequently transfers his interest in the indebtedness to another person?

A–22: The subsequent holder of a loan is treated as the lender for purposes of this reporting requirement and is the party required to report with respect to events occurring after the date he acquires the loan. This rule applies to all subsequent holders of a secured loan, including governmental units or any agencies or instrumentalities thereof. For example, if the Federal National Mortgage Association purchases real property loans from a lender, it would be subject to the reporting requirement.

Multiple Lenders

Q–23: If more than one person lends money secured by the same property, and one lender forecloses upon or otherwise acquires an interest in the property, must the other lenders report under this section?

A–23: Yes. In these circumstances, other lenders must report if they know or have reason to know that the property securing their loans is foreclosed upon or otherwise acquired by another lender and the sale or other acquisition terminates, reduces, or otherwise impairs their security interests in the property (see A–15). For example, if there is a first and second mortgage on a building, and the second mortgagee knows or has reason to know that the first mortgagee has foreclosed upon the building, the second mortgagee is subject to the reporting requirement even if no part of the indebtedness owed to him is satisfied by the proceeds of the foreclosure sale. For a description of the reporting requirement applicable to the first mortgagee, see A–10 and A–15.

Q–24: If more than one person lends money secured by property, and one lender knows or has reason to know that the property has been abandoned, must each lender report under this section?

A–24: No. Each lender is required to report only when he knows or has reason to know that property has been abandoned (see A–19).

FORM AND MANNER OF RETURN

Form of Return

Q–25: What form shall be used to make a return required by section 6050J?

A–25: Except as provided in A–35, the return must be made on Forms 1096 and 1099. The person required to make the return, however, may prepare and use a form which contains provisions substantially similar with those of Forms 1096 and 1099 if the person complies with any revenue procedures relating to substitute Forms 1096 and 1099 in effect at that time.

Information Included on Return

Q–26: What information must be included on a return required by reason of an acquisition of an interest in property that is security for a loan?

A–26: The following information must be included on the return:

(a) The name and address of the borrower with respect to the secured indebtedness;

(b) The borrower's TIN, as defined in Section 7701(a);

(c) A general description of the property in which an interest is acquired;

(d) Whether the borrower is personally liable for repayment of the indebtedness;

(e) The date on which the person acquired an interest in the property (see A–10 or A–15);

(f) The amount of the indebtedness outstanding at the time the interest in property is acquired;

(g) If the borrower is personally liable for repayment of the indebtedness, the fair market value of the property at the time the interest is acquired;

(h) The amount of the indebtedness satisfied by the acquisition; and

(i) Any other information as may be required by Forms 1096 and 1099.

Q–27: What information must be included on a return required because a person knows or has reason to know that property which is security for a loan has been abandoned?

A–27: The following information must be included on the return:

(a) The information required in A–26 (a), (b), and (d);

(b) A general description of the property abandoned;

(c) The date on which the person first knows or has reason to know that the property has been abandoned;

(d) The amount of the indebtedness outstanding as of the date on which the person first knows or has reason to know that the property has been abandoned;

(e) If the borrower is personally liable for repayment of the indebtedness, the fair market value of the property at the time of abandonment; and

(f) Any other information as may be required by Forms 1096 and 1099.

Partnership Borrower

Q–28: If a borrower is a partnership, must the TIN of each partner be reported?

A–28: No. If a borrower is a partnership, only the TIN of the partnership must be reported.

Multiple Borrowers

Q–29: If there is more than one borrower on a single secured loan, must a person required to report under this section make a return with respect to each borrower on the loan?

A–29: Yes. Generally, a separate return must be made with respect to each borrower on a secured loan. However, only one report is required if the lender knows that the borrowers hold property as tenants by the entirety or that the property is held as community property.

General Description of Property

Q–30: What type of information constitutes a general description of the property?

A–30: A general description of the property consists of information that sufficiently identifies the property. In the case of real property, a general description consists of the property's address unless this information is not available or would not sufficiently identify the property, in which case a legal description (*i.e.*, section, lot, block) must be provided instead. A general description of personal property consists of the type, make and model (where applicable) of the property. For example, an automobile would be described as ''Car—1983 Pontiac Firebird.'' However, in the case of a single loan secured by more than one piece of personal property, a general description consists of the type or category of the pieces acquired or abandoned. For example, if the security for a single loan is six desks and seven typewriters, a general description of the property would be ''Office Equipment.''

Multiple Acquisitions and Abandonments

Q–31: Must each acquisition and abandonment that occurs in a taxable year be reported on a separate return?

A–31: Generally, each acquisition and abandonment required to be reported by a person for a taxable year must be reported on a separate return. However, in the case of a single loan secured by more than one piece of property, separate returns will not be required when a person acquires an interest in, or knows or has reason to know of the abandonment of, more than one piece of property that is security for the single loan in a taxable year. Instead, the person shall make one return for all of the acquisitions and one return for all of the abandonments of property that are security for the loan for a taxable year.

Fair Market Value

Q–32: In the case of a foreclosure, execution, or similar sale, what is the fair market value of the property for purposes of the reporting requirement?

A–32: In general, in the absence of clear and convincing evidence to the contrary, the proceeds of the foreclosure, execution, or similar sale will be considered the fair market value of the property for purposes of this reporting requirement.

Time for Filing

Q–33: When must a person file the return or returns required by section 6050J with the Internal Revenue Service?

A–33: The return or returns must be filed on or before February 28th of the year following the calendar year in which the acquisition of an interest in the property occurs or in which the lender knows or has reason to know of the abandonment of the property.

Place for Filing

Q–34: Where must the return or returns be filed?

A–34: The return or returns must be filed with the appropriate Internal Revenue Service Center, the addresses of which are listed in the instructions for the Form 1099 series.

Use of Magnetic Media

Q–35: What rules apply with respect to the use of magnetic media?

A–35: Any return required under section 6050J must be filed on magnetic media to the extent required by section 6011(e). Any person not required by section 6011(e) to file returns under section 6050J on magnetic media may request permission to do so. See §1.9101 for rules relating to permission to submit information on magnetic tape or other media.

If a person required to file returns on magnetic media fails to do so, the penalty under section 6652 (failure to file an information return) applies.

REQUIREMENT OF FURNISHING STATEMENTS TO BORROWERS

In General

Q–36: What statements must be furnished to borrowers?

A–36: Any person required to make an information return under section 6050J must furnish a statement to each borrower whose name is required to be set forth in a return filed with the Internal Revenue Service. For the date when the statement must be furnished, see A–40.

Q–37: Is the statement considered to be furnished to the borrower if it is mailed to the borrower at the borrower's last known address?

A–37: Yes.

Information Included on Statement

Q–38: What information must be included on the statement?

A–38: The statement must include the following information:

(a) Except in the case where the return is made on behalf of a governmental unit (or any agency or instrumentality thereof), the name and address of the person required to make the information return;

(b) In the case where the return is made on behalf of a governmental unit or any agency or instrumentality thereof, the name and address of such unit, agency or instrumentality;

(c) The information required under A–26 or A–27, whichever is applicable; and

(d) A legend stating that the information is being reported to the Internal Revenue Service.

Copy of Form 1099 to Borrowers

Q–39: May the requirement of furnishing a statement be met by furnishing a copy of the Form 1099 filed with respect to that borrower?

A–39: Yes. The requirement of furnishing a statement may be met by furnishing to the borrower a copy of the Form 1099 containing the same information filed with the Service with respect to that borrower, or a reasonable facsimile thereof, provided that the form or the reasonable facsimile bears a legend stating that the information is being reported to the Internal Revenue Service.

Time of Furnishing Statement

Q–40: When is a statement required to be furnished to the borrower?

A–40: A statement is required to be furnished to the borrower on or before January 31 of the year following the calendar year in which the acquisition or abandonment of property occurs.

Multiple Borrowers

Q–41: If a person required to report under this section must make an information return with respect to more than one borrower on a single loan, of an interest in the property occurs or in which the lender knows or has reason to know of the abandonment of the property.

A–41: Yes. A separate statement must be furnished to each borrower with respect to which a separate return is required under section 6050J.

Extensions of Time

Q–42: Are there any circumstances under which an extension of time may be granted with respect to the requirement of furnishing statements to borrowers?

A–42: Yes. Upon written application of the person required to report, the service center director may, for good cause shown, grant that person an additional period (not to exceed 30 days) in which to furnish statements under section 6050J with respect to any calendar year. The application for an extension must be addressed to the director of the service center with which the returns must be filed. The application must contain a concise statement of the reasons for requesting the extension in order to aid the service center director in determining the period of extension, if any, to be granted. The application must state at the top of the first page that it is made under section 1.6050J–1T and must be signed by the person required to report under section 6050J. In general, the application should be filed not earlier than September 30 of the year in which the acquisition of an interest in the property occurs or in which the lender knows or has reason to know of the abandonment of the property, and not later than January 15 of the following year.

PENALTIES

Q–43: Are there penalties for failing to comply with the requirements of section 6050J and the regulations thereunder?

A–43: Yes. The penalty for failing to make any information return with respect to any borrower under section 6050J is provided in section 6652. The penalty for failing to furnish a statement to any borrower is provided in section 6678.

EFFECTIVE DATE

Q–44: When is section 6050J effective?

A–44: Section 6050J is effective for acquisitions and abandonments of property after December 31, 1984.

(Approved by the Office of Management and Budget under control number 1545–0877)

(Secs. 6050J and 7805 of the Internal Revenue Code of 1954 (98 Stat. 687, 68A Stat. 917, 26 U.S.C. 6050J, 7805 respectively)

[T.D. 7971, 49 FR 34460, Aug. 31, 1984]

§1.6050K–1 Returns relating to sales or exchanges of certain partnership interests.

(a) *Partnership return required*—(1) *In general.* Except as otherwise provided in this paragraph (a), a partnership shall make a separate return on Form 8308 with respect to each section 751(a) exchange (as defined in paragraph (a)(4)(i) of this section) of an interest in such partnership which occurs after December 31, 1984. A partnership that is in doubt as to whether partnership property constitutes section 751 property to any extent or as to whether a transfer of a partnership interest constitutes a section 751(a) exchange may file Form 8308 in order to avoid the risk of incurring a penalty under section 6721. The penalty under section 6721 will generally apply, however, to partnerships that do not file Form 8308 where in fact a section 751(a) exchange occurred, except as provided in paragraphs (a)(2) and (e) of this section.

(2) *Return required under section 6045.* No return shall be required under section 6050K(a) and paragraph (a)(1) of this section with respect to the sale or exchange of a partnership interest if a return is required to be filed under section 6045 with respect to such sale or exchange.

(3) *Single or composite documents.* The Commissioner may authorize the use, at the option of the partnership, of a single document which includes all of the partnership's returns for a calendar year in the case of partnerships required under paragraph (a)(1) of this section to make 25 or more returns on Form 8308 for any calendar year. In addition, the Commissioner may authorize the use for this purpose, also at the option of such a partnership, of a composite document. These authorizations shall be subject to such conditions, limitations, and special rules governing the preparation, execution, filing, and correction thereof as the Commissioner may deem appropriate. Such composite document shall consist of a form prescribed by the Commissioner and an attachment or attachments of magnetic tape or other approved media. To the extent that the use of a single or composite document has been authorized by the Commissioner, references in this section to Form 8303 shall be deemed to refer also to returns included in a single or composite document under this paragraph (a)(3). Any single or composite document so authorized shall include the information required to be provided on Form 8308 under paragraph (b) of this section with respect to each section 751(a) exchange.

(4) *Definitions.* For purposes of section 6050K of the Code and this section—

(i) *Section 751(a) exchange.* The term *section 751(a) exchange* means any sale or exchange of a partnership interest (or portion thereof) in which any portion of any money or other property received by a transferor partner in exchange for all or a part of his or her interest in the partnership is attributable to section 751 property. The term does not include a distribution which is treated as a sale or exchange between the distributee and the partnership under section 751(b) of the Code.

(ii) *Section 751 property.* The term *section 751 property* means unrealized receivables, as defined in section 751(c) of the Code, and inventory items which have appreciated substantially in value (“substantially appreciated inventory items”), as defined in section 751(d) of the Code.

(iii) *Transferor and transferee.* The term *transferor* means the beneficial owner of a partnership interest immediately before the transfer of that interest. The term “transferee” means the beneficial owner of a partnership interest immediately after the transfer of that interest. However, if a partnership does not know the identity of the beneficial owner of an interest in the partnership, the record holder of such interest shall be treated as the transferor or transferee (as the case may be) for purposes of paragraphs (b) and (c) of this section.

(b) *Contents of return.* The return on Form 8308 shall include the following information:

(1) The names, addresses, and taxpayer identification numbers of the

transferee and transferor in the exchange and of the partnership filing the return;

(2) The date of the exchange; and

(3) Such other information as may be required by Form 8308 or its instructions.

(c) *Statement to be furnished to transferor and transferee.* Every partnership required to file a return under paragraph (a) of this section must furnish to each person whose name is required to be set forth in such return a written statement on or before January 31 of the calendar year following the calendar year in which the section 751 (a) exchange occurred to which the return under paragraph (a) relates (or, if later, 30 days after the partnership is notified of the exchange as defined in paragraph (e) of this section). The partnership shall use a copy of the completed Form 8308 as a statement unless the Form 8308 contains information with respect to more than one section 751 (a) exchange (see paragraph (a) (3) of this section). If the partnership does not use a copy of Form 8308 as a statement, the statement shall include the information required to be shown on Form 8308 with respect to the section 751 (a) exchange to which the person to whom the statement is furnished is a party. In addition, it shall state that—

(1) The information shown on the statement has been supplied to the Internal Revenue Service,

(2) A transferor of a partnership interest in a sale or exchange described in section 751 (a) of the Internal Revenue Code is required to treat a portion of any gain or loss resulting from the sale or exchange as ordinary income or loss, and

(3) The transferor in a section 751 (a) sale or exchange is required under paragraph (a) (3) of § 1.751–1 to attach a statement relating to the sale or exchange to his or her income tax return for the taxable year in which the sale or exchange occurred.

(d) *Requirement that transferor notify partnership*—(1) *In general.* The transferor of any partnership interest in a section 751 (a) exchange shall notify the partnership of such exchange in writing within 30 days of the exchange (or, if earlier, January 15 of the calendar year following the calendar year in which the exchange occurred). The written notification from the transferor shall include the following information:

(i) The names and addresses of the transferor and transferee in the section 751 (a) exchange;

(ii) The taxpayer identification numbers of the transferor and, if known, of the transferee; and

(iii) The date of the exchange.

Any transferor who notified a partnership under section 6050K (c) (1) prior to January 22, 1986 by a notification that does not meet the requirements of this paragraph (d) shall furnish such partnership with the written notification described in this paragraph (d) on or before February 21, 1986.

(2) *Return required under section 6045.* No transferor shall be required to notify a partnership of the sale or exchange of a partnership interest under section 6050K (c) (1) or paragraph (d) (1) of this section if a return is required to be filed under section 6045 with respect to such sale or exchange.

(e) *Partnership not required to make a return or furnish statements under this section until it has notice of the exchange.* A partnership shall not be required to make a return or furnish statements under section 6050K and this section with respect to any section 751 (a) exchange until it has been notified of the exchange. For purposes of section 6050K (c) (2) and this section, a partnership is notified of a section 751 (a) exchange when either:

(1) The partnership receives the written notification from the transferor required under paragraph (d) of this section; or

(2) The partnership has knowledge that there has been a transfer of a partnership interest or any portion thereof, and, at the time of the transfer, the partnership had any section 751 property. However, no return or statements are required under section 6050K if the transfer was not a section 751 (a) exchange (*e.g.*, a transfer which in its entirety constitutes a gift for federal income tax purposes). For purposes of this paragraph (e) (2), the partnership may rely on a written statement from the transferor that the transfer was not a section 751 (a) exchange in the absence of knowledge to the contrary.

For rules applicable where the partnership is in doubt as to whether partnership property constitutes section 751 property to any extent or as to whether a transfer of a partnership interest constitutes a section 751 (a) exchange, see paragraph (a) (1) of this section.

(f) *Partnership return is to be attached to Form 1065*—(1) *In general.* Any partnership return on Form 8308 required under this section shall be filed as an attachment to the partnership's Form 1065 for its taxable year in which the calendar year in which the section 751 (a) exchange occurred ends and shall be filed at the time (determined with regard to any extension of time for filing) and place prescribed for filing of the partnership's Form 1065 for that taxable year (see paragraph (e) of §1.6031–1 for the time and place for filing Form 1065).

(2) *Notification after Form 1065 is filed.* If a partnership is notified of an exchange (as defined in paragraph (e) of this section) after the partnership has filed Form 1065 for the taxable year with respect to which the exchange should have been reported, Form 8308 shall be filed with the service center or other Internal Revenue office with which the partnership's Form 1065 was filed, on or before the thirtieth day after the partnership is notified of the exchange.

(g) *Penalties.* For penalties for failure of:

(1) Transferors to furnish the notification required by paragraph (d) of this section see section 6722 (b);

(2) Partnerships to furnish any statement required under paragraph (c) of this section see section 6722 (a); and

(3) Partnerships to file the return on Form 8308 as required by paragraph (a) of this section see section 6721.

[T.D. 8119, 52 FR 41, Jan. 2, 1987]

§1.6050L–1 Information return by donees relating to certain dispositions of donated property.

(a) *Information returns*—(1) *Disposition of charitable deduction property.* If a donee of any charitable deduction property (as defined in paragraph (e) of this section), sells, exchanges, consumes, or otherwise disposes of (with or without consideration) such property (or any portion thereof) within 2 years after the date of the donor's contribution of such property, the donee shall make an information return on the form prescribed by the Internal Revenue Service. For special rules with respect to successor donees, see paragraph (c) of this section.

(2) *Disposition of items appraised for $500 or less*—(i) *In general.* Paragraph (a)(1) of this section shall not apply with respect to an item of charitable deduction property disposed of by sale if the appraisal summary (as defined in §1.170A–13(c)(4)) signed by the donee with respect to the item contains, at the time of the donee's signature, a statement signed by the donor that the appraised value of the item does not exceed $500. In the case of an appraisal summary that describes more than one item, this exception shall apply only with respect to an item clearly identified as having an appraised value of $500 or less. For purposes of this paragraph (a)(2)(i), items that form a set (such as, for example, a collection of books written by the same author, components of a stereo system, or a group of place settings of a pattern of silverware) are considered one item. In addition, all nonpublicly traded stock is considered one item as are all nonpublicly traded securities other than nonpublicly traded stock.

(ii) *Transitional rule.* Paragraph (a)(2)(i) of this section is satisfied with respect to an appraisal summary submitted to the donee on or before January 31, 1986, if such donee obtained the required statement from the donor on or before March 31, 1986, on either an amended appraisal summary or an attachment to the original appraisal summary.

(3) *Consumption for distribution of exempt purpose.* Paragraph (a)(1) of this section shall not apply with respect to an item of charitable deduction property consumed or distributed by a donee without consideration if the consumption or distribution is in furtherance of a purpose or function constituting a basis for such donee's exemption under section 501 of the Code. For example, no reporting is required with respect to medical supplies consumed or distributed by a tax-exempt relief organization in aiding disaster victims.

(b) *Information required to be provided on return.* The information return required by paragraph (a)(1) of this section shall include the following:

(1) The name, address, and employer identification number of the donee making the information return;

(2) A description of the property (or portion disposed of) in sufficient detail to identify the charitable deduction property received by such donee;

(3) The name and taxpayer identification number of the donor (social security number if the donor is an individual or employer identification number if the donor is a corporation or partnership);

(4) The date of the contribution to such donee;

(5) Any amount received by such donee with respect to the disposition;

(6) The date of the disposition by such donee; and

(7) Such other information as may be specified by the form or its instructions.

(c) *Successor donees*—(1) *In general.* Section 6050L and this section shall apply to successor donees that receive charitable deduction property (as defined in paragraph (e) of this section) that was transferred by the original donee after July 5, 1988, (whether the successor donee received the property from the original donee or another successor donee). For definitions of the terms ''donor,'' ''donee,'' ''original donee,'' and ''successor donee,'' see § 1.170A–13(c)(7)(iv)–(vii).

(2) *Information required to be provided on return.* With respect to charitable deduction property that is transferred to one or more successor donees to which this section applies, the information return required by paragraph (a)(1) of this section shall include, in addition to the information described in paragraph (b) of this section, the following:

(i) The name, address, and employer identification number of the immediately succeeding successor donee (if any) and the immediately preceding successor donee (if any);

(ii) The name, address, and employer identification number of the original donee if different from the information required by paragraph (b)(1) of this section;

(iii) The date of contribution to the original donee; and

(iv) Such other information as may be specified by the form or its instructions.

(3) *Information to be provided to transferor.* Every successor donee to which this section applies that receives any charitable deduction property within the 2-year period described in paragraph (a)(1) of this section shall provide its name, address, and employer identification number to that preceding donee on or before the 15th day after the later of—

(i) The date of transfer to such successor donee, or

(ii) The date such successor donee receives a copy of the appraisal summary from the preceding donee.

(4) *Donees that transfer property to successor donees.* In addition to complying with the requirements of paragraph (a)(1) of this section, every donee that transfers any charitable deduction property to a successor donee to which this section applies within the 2-year period described in paragraph (a)(1) of this section—

(i) Shall provide its name, address, and employer identification number and a copy of the appraisal summary (as described in § 1.170A–13(c)(4)) relating to the transferred property to the successor donee on or before the 15th day after the latest of—

(A) The date of such transfer, or

(B) The date the original donee signs the appraisal summary, or

(C) In a case in which the transferring donee is a successor donee, the date such donee receives a copy of the appraisal summary from such donee's transferor, and

(ii) Shall provide a copy of its information return required by paragraph (a)(1) this section to the successor donee on or before the 15th day after the transferring donee files the information return pursuant to paragraph (e)(2) of this section.

(5) *Donee.* In the case of charitable deduction property that is transferred to a successor donee to which this section applies, the term *donee* as used in paragraph (a)(2) and (e) of this section means only the original donee.

(d) *Special rules*—(1) *Statement to be furnished to donors.* Every donee making a return under section 6050L and this section with respect to the disposition of charitable deduction property shall furnish a copy of the return to the donor of the property.

(2) *Retention of appraisal summary.* Every donee shall retain the appraisal summary described in §1.170A–13(c)(4) in the donee's records for so long as it may be relevant in the administration of any internal revenue law.

(e) *Charitable deduction property.* For purposes of this section, the term *charitable deduction property* means any property (other than money and publicly traded securities to which §1.170A–13(c)(7)(xi)(B) does not apply) contributed after December 31, 1984, with respect to which the donee signs (or is presented with for signature in cases described in §1.170A–13(c)(4)(iv)(C)(*2*)) an appraisal summary (as required by §1.170A–13(c)(4)(i)(B)). For purposes of this section, if such donee signs (or is presented with for signature in cases described in §1.170A–13(c)(4)(iv)(C)(*2*)) the appraisal summary after the date of contribution of the property, the property is deemed to be charitable deduction property from the date of contribution.

(f) *Place and time for filing information returns*—(1) *Place for filing.* The donee information return required by section 6050L and this section shall be filed with the Internal Revenue Service center listed on the return form or its instructions.

(2) *Time for filing*—(i) *In general.* Except as provided in paragraph (f)(2)(ii) of this section, the donee information return shall be filed on or before the 125th day after a donee sells, exchanges, consumes or otherwise disposes of the charitable deduction property. A donee information return filed pursuant to this paragraph (f)(2)(i) does not have to include the information required by paragraphs (b) (3), (4), (5), or (6), or (c)(2)(i)–(iii) of this section if such information is not available to the donee by the due date of the return.

(ii) *Exception.* Notwithstanding paragraph (f)(2)(i) of this section, in the case of a donee who, on the date of receipt of the transferred property, had no reason to believe that the substantiation requirements of §1.170A–13(c) apply with respect to the property, the donee information return is not required to be filed until the 60th day after the later of May 5, 1988, or the date on which such donee has reason to believe that the substantiation requirements of §1.170A–13(c) apply with respect to the property. A donee information return filed pursuant to this paragraph (f)(2)(ii) does not have to include the information required by paragraph (b) (3), (4), (5), or (6), or (c)(2)(i)–(iii) of this section if such information is not available to the donee by the due date of the return.

(g) *Penalties.* For penalties for failure to compy with the requirements of this section, see sections 6676, 6721, and 6723.

[T.D. 8199, 53 FR 16085, May 5, 1988; T.D. 8199, 53 FR 18372, May 23, 1988]

§1.6050M–1 Information returns relating to persons receiving contracts from certain Federal executive agencies.

(a) *General rule.* Except as otherwise provided in paragraph (c) of this section, the head of every Federal executive agency or his or her delegate shall make an information return to the Internal Revenue Service reporting the following information with respect to each contract entered into by that Federal executive agency—

(1) Name and address of the contractor;

(2) Contractor's TIN and, if the contractor is a member of an affiliated group of corporations that files its Federal income tax returns on a consolidated basis, the name and TIN of the common parent of the affiliated group;

(3) The date of the contract action;

(4) The expected date of completion of the contract as determined under any reasonable method, such as the expected contract delivery date under the contract schedule;

(5) The total amount obligated under the contract action; and

(6) Any other information required by Forms 8596 and 8596A and their instructions, or by any other administrative guidance issued by the Internal Revenue Service (such as a revenue procedure).

See paragraph (e) of this section relating to the manner in which to report increases in amounts obligated under existing contracts. See paragraph (d)(5) of this section for special rules for agencies that submit contract information to the Federal Procurement Data Center. For provisions concerning the requesting and furnishing of identifying numbers, see section 6109 and the regulations thereunder.

(b) *Definitions*. The following definitions apply for purposes of this section—

(1) *Federal executive agency*. The term ''Federal executive agency'' means—

(i) Any executive agency (as defined in 5 U.S.C. 105) other than the General Accounting Office;

(ii) Any military department (as defined in 5 U.S.C. 102); and

(iii) The United States Postal Service and the Postal Rate Commission.

(2) *Contract*—(i) *General rule*. The term ''contract'' means an obligation of a Federal executive agency to make payment of money (or other property) to a person in return for the sale of property, the rendering of services, or other consideration. The term ''contract'' includes, for example, such an obligation arising from a written agreement executed by the agency and the contractor, an award or notice of award, a job order or task letter issued under a basic ordering agreement, a letter contract, an order that becomes effective only upon written acceptance or performance, or an action described in paragraph (e) of this section.

(ii) *Exceptions*. For purposes of this section, the term ''contract'' does not include—

(A) A license granted by a Federal executive agency;

(B) An obligation of a contractor (other than a Federal executive agency) to a subcontractor;

(C) A debt instrument of the United States Government or a Federal agency, such as a Treasury note, Treasury bond, Treasury bill, savings bond, or similar instrument; or

(D) An obligation of a Federal executive agency to lend money, lease property to a lessee, or sell property.

(iii) *Special rule for certain contracts of the Small Business Administration*. Any subcontract entered into by the Small Business Administration (SBA) under a prime contract between the SBA and a procuring Federal executive agency pursuant to section 8(a) of the Small Business Act (15 U.S.C. 637(a)) shall not be treated as a contract of the SBA but shall be treated as a contract of the procuring agency for purposes of this section.

(iv) *Certain schedule contracts*. For purposes of this section, any of the following contracts entered into on behalf of one or more Federal executive agencies is not a ''contract'' to be reported by the General Services Administration or the Department of Veteran's Affairs at the time of execution:

(A) A Federal Supply Schedule Contract entered into by the General Services Administration,

(B) An Automated Data Processing Schedule Contract entered into by the General Services Administration, or

(C) A schedule contract entered into by the Department of Veteran's Affairs.

Instead, an order placed by a Federal executive agency, including the General Services Administration or the Department of Veteran's Affairs, under such a schedule contract is a ''contract'' for purposes of this section.

(v) *Blanket purchase agreements*. For purposes of this section, the term *contract* does not include a blanket purchase agreement between one or more Federal executive agencies and one or more contractors. Instead, an order placed by a Federal executive agency under the terms of a blanket purchase agreement is a ''contract'' for purposes of this section.

(vi) *Contracts entered into using nonappropriated funds*. [Reserved]

(3) *Contractor*. The term *contractor* means any person who enters into a contract with a Federal executive agency.

(4) *Person and TIN*. The terms *person* and *TIN* are defined in sections 7701(a)(1) and (41), respectively.

(c) *Exceptions to information reporting requirement*—(1) *General exceptions*. The following do not need to be reported pursuant to this section:

(i) Any contract or contract action for which the amount obligated is $25,000 or less;

(ii) Any contract with a contractor who, in making the agreement, is acting in his or her capacity as an employee of a Federal executive agency (*e.g.*, any contract of employment under which the employee is paid wages subject to the withholding provisions contained in chapter 24 of subtitle C);

(iii) Any contract between a Federal executive agency and another Federal governmental unit (or any agency or instrumentality thereof);

(iv) Any contract with a foreign government (or any agency or instrumentality thereof);

(v) Any contract with a state or local governmental unit (or any agency or instrumentality thereof);

(vi) Any contract with a person who is not required to have a TIN (see, for example, §301.6109–1(g));

(vii) Any contract the terms of which provide that all amounts payable under the contract by any Federal executive agency will be paid on or before the 120th day following the date of the contract action, and for which it is reasonable to except that all amounts will be so paid.

(viii) Any contract under which all money (or other property) that will be received by the contractor after the 120th day after the date of the contract action will come from persons other than a Federal executive agency or an agent of such an agency (*e.g.*, a contract under which the contractor will collect amounts owed to a Federal executive agency by the agency's debtor and will remit to the agency the money collected less an amount that serves as the contractor's consideration under the contract).

(ix) Any contract for which the Commissioner determines that the information described in paragraph (a) of this section will not facilitate the collection of Federal tax liabilities because of the manner, method, or timing of payment by the agency under that contract.

(2) *Special rule for certain classified or confidential contracts.* Contracts described in section 6050M(e)(3), relating to certain classified or confidential contracts, are to be reported only in accordance with section 6050M(e)(2).

(d) *Filing requirements*—(1) *Frequency and time for filing.* The information returns required by this section with respect to contracts of a Federal executive agency entered into on or after January 1, 1989, must be filed on a quarterly basis for the calendar quarters ending on the last day of March, June, September, and December. Except as provided in paragraph (d)(5) of this section, the returns for contracts entered into during a calendar quarter must be filed on or before the last day of the month following that quarter. Notwithstanding the preceding sentence, returns filed before May 7, 1990, will be considered timely filed.

(2) *Form of reporting*—(i) *General rule concerning magnetic media.* The information returns required by this section with respect to contracts of a Federal executive agency for each calendar quarter shall be made in one submission (or in multiple submissions if permitted by paragraph (d)(4) of this section). Except as provided in paragraph (d)(2)(ii) of this section, the required returns shall be made on magnetic media (within the meaning of §301.6011–2(a)(1)) in accordance with any applicable revenue procedure or other guidance promulgated by the Internal Revenue Service for the filing of such returns under section 6050M.

(ii) *Magnetic media exception for low-volume filers.* Any Federal executive agency that on any October 1 has a reasonable expectation of entering into, during the one year period beginning on that date, fewer than 250 contracts that are subject to the reporting requirements under this section may make the information returns required by this section for each quarter of that one year period on the prescribed paper Form 8596 in accordance with the instructions accompanying such form.

(3) *Place of filing*—(i) *Returns on magnetic media.* Information returns made under this section on magnetic media shall be filed with the Internal Revenue Service at the Martinsburg Computing Center, Martinsburg, West Virginia 25401–1359, in accordance with any applicable revenue procedure or other guidance promulgated by the Internal Revenue Service relating to the filing of returns under section 6050M.

(ii) *Form 8596.* Information returns made on Form 8596 shall be filed with the Ifternal Revenue Service at the location specified in the instructions for that form.

(4) *Special rule concerning multiple returns.* To the extent permitted in any revenue procedure or other guidance relating to the filing of information returns under this section, a Federal executive agency which files information returns under this section on magnetic media may make more than one magnetic media submission for any quarter, if each submission for that quarter contains all of the information required by paragraph (a) of this section with respect to contracts entered into by one or more departments, branches, bureaus, agencies, or other readily identifiable operating functions (such as a geographic region) of the Federal executive agency.

(5) *Special rules for agencies reporting to the Federal Procurement Data Center*—(i) *Election to have the Director of the Federal Procurement Data Center make returns on behalf of agency.* If, in complying with the requirements of the Federal Procurement Data System (FPDS) (as established under the authority of the Office of Federal Procurement Policy Act, as amended, 41 U.S.C. 401 *et seq.*), a Federal executive agency is required to submit to the Federal Procurement Data Center (FPDC) all the information with respect to one or more contracts required to be reported by paragraph (a) of this section, that Federal executive agency may, in lieu of making returns directly to the Internal Revenue Service with respect to those contracts, elect to have the Director of the FPDC (or his or her delegate) make the required returns with respect to all of those contracts on its behalf. In order to make this election for such contracts entered into during a calendar quarter, the head of a Federal executive agency (or his or her delegate) shall attach to its submission to the FPDC for that quarter a signed statement to the effect that:

(A) The Director of the FPDC (or his or her delegate) is authorized, in accordance with an election made under 26 CFR 1.6050M–1(d)(5) to make, on the agency's behalf, the required returns for such contracts for that quarter, and

(B) Under the penalties of perjury, such official has examined the information to be submitted by the agency to the FPDC for making those returns and certifies that information to be, to the best of such official's knowledge and belief, a compilation of agency records maintained in the normal course of business for the purpose of providing the information necessary for making true, correct, and complete returns as required by section 6050M.

If the election is made, the Director of the FPDC (or his or her delegate) shall, on the electing agency's behalf, make the returns required by paragraph (a) of this section with respect to the contracts to which the election applies.

(ii) *Time, manner, and place of filing.* The Director of the FPDC (or his or her delegate) must—

(A) Make the required returns for a quarter on or before the earlier of;

(*1*) 45 days following the date that the contract information is required to be submitted to the FPDC, or

(*2*) 90 days following the end of the calendar quarter for which the election is made, except that, if that calendar quarter ends September 30, 105 days following the end of that quarter, and

(B) Comply with paragraph (d)(2)(i) and (3)(i) of this section, relating to form and place of filing.

Notwithstanding the preceding sentence, returns made before May 7, 1990, will be considered timely filed.

(iii) *Contracts reported directly to the Internal Revenue Service.* Even if the election is made, all information with respect to any particular contract required to be reported under paragraph (a) of this section must be reported directly to the Internal Revenue Service by the electing agency if the FPDS does not require that information to be submitted to the FPDC. An electing agency shall not, however, make direct returns to the Internal Revenue Service of contract information that is subject to the election.

(6) *Certification of return*—(i) *Returns made directly with the Internal Revenue Service.* Each return made under this section by a Federal executive agency directly with the Internal Revenue Service on magnetic media or on

Forms 8596 and 8596–A shall be signed by the head of the Federal executive agency (or his or her delegate) under the penalties of perjury, certifying that such official has examined the return, that it is prepared pursuant to the requirements of section 6050M and that, to the best of such official's knowledge and belief, it is compiled from agency records maintained in the normal course of business for the purpose of making a true, correct, and complete return as required by section 6050M.

(ii) *Returns made by Director of FPDC on agency's behalf.* Each return made under this section by the Director of the FPDC on behalf of a Federal executive agency shall be signed by the Director of the FPDC (or his or her delegate) under the penalties of perjury, certifying that such official has examined the return, that it is prepared pursuant to the requirements of section 6050M and that, to the best of such official's knowledge and belief, it is compiled from information submitted by the Federal executive agency to the FPDC pursuant to §1.6050M–1(d)(5)(i) for the purpose of making a true, correct, and complete return as required by section 6050M.

(e) *Special rules relating to increases in amount obligated.* If, through the exercise of an option contained in a basic or initial contract or under any other rule of contract law, express or implied, the amount of money or other property obligated under the contract is increased by more than $25,000 in one contract action, then that action shall be treated as the entering into of a new contract with respect to which the information required by paragraph (a) of this section is to be reported to the Internal Revenue Service for the calendar quarter in which the increase occurs.

(f) *Effective date*—(1) *Contracts required to be reported.* Except as otherwise provided in this paragraph (f), this section applies to each Federal executive agency with respect to its contracts entered into on or after January 1, 1989 (including any increase in amount obligated on or after January 1, 1989, that is treated as a new contract under paragraph (e) of this section).

(2) *Contracts not required to be reported.* A Federal executive agency is not required to report—

(i) Any basic or initial contract entered into before January 1, 1989,

(ii) Any increase contract action occurring before January 1, 1989, that is treated as a new contract under paragraph (e) of this section, or

(iii) Any increase contract action that is treated as a new contract under paragraph (e) of this section if the basic or initial contract to which that contract action relates was entered into before January 1, 1989, and—

(A) The increase occurs before April 1, 1990, or

(B) The amount of the increase does not exceed $50,000.

(3) *Illustration*—(i) If Federal executive agency enters into an initial contract on December 1, 1988, and the amount of money obligated under the contract is increased by $55,000 on April 15, 1990, then (A) there is no reporting requirement with respect to the contract when entered into on December 1, 1988, and (B) the April 15, 1990, increase, which is treated as a new contract under paragraph (e) of this section, is subject to the reporting requirements of this section because it is considered to be a new contract entered into on April 15, 1990.

(ii) If the $55,000 increase had occurred before April 1, 1990, there would have been no reporting requirement with respect to that increase.

[T.D. 8275, 54 FR 50369, Dec. 6, 1989; 55 FR 13522, Apr. 11, 1990]

§1.6050N–1 Statements to recipients of royalties paid after December 31, 1986.

(a) *Requirement.* A person required to make an information return under section 6050N(a) must furnish a statement to each recipient whose name is required to be shown on the related information return for royalties paid.

(b) *Form, manner, and time for providing statements to recipients.* The statement required by paragraph (a) of this section must be either the official Form 1099 prescribed by the Internal Revenue Service for the respective calendar year or an acceptable substitute statement. The rules under §1.6042–4 (relating to statements with respect to dividends) apply comparably in determining the form of the acceptable substitute statement permitted by this section. Those rules also apply for purposes of determining the manner of and time for providing the Form 1099 or its acceptable substitute statement to a recipient under this section.

(c) *Exempted foreign-related items*—(1) *In general.* No return shall be required under paragraph (a) of this section for payments of the items described in paragraphs (c)(1)(i) through (iv) of this section.

(i) Returns of information are not required for payments of royalties that a payor can, prior to payment, associate with documentation upon which it may rely to treat as made to a foreign beneficial owner in accordance with § 1.1441–1(e)(1)(ii) or as made to a foreign payee in accordance with § 1.6049–5(d)(1) or presumed to be made to a foreign payee under § 1.6049-5(d)(2), (3), (4), or (5). However, such payments may be reportable under § 1.1461–1(b) and (c).

For purposes of this paragraph (c)(1)(i), the provisions in § 1.6049–5(c) (regarding rules applicable to documentation of foreign status and definition of U.S. payor and non-U.S. payor) shall apply. See § 1.1441–1(b)(3)(iii)(B) and (C) for special payee rules regarding scholarships, grants, pensions, annuities, etc. The provisions of § 1.1441–1 shall apply by substituting the term *payor* for the term *withholding agent* and without regard to the fact that the provisions apply only to amounts subject to withholding under chapter 3 of the Internal Revenue Code.

(ii) Returns of information are not required for payments of royalties from sources outside the United States (determined under Part I of subchapter N and the regulations under these provisions) made outside the United States by a non-U.S. payor or non-U.S. middleman. For a definition of non-U.S. payor or non-U.S. middleman, see § 1.6049–5(c)(5). For circumstances in which a payment is considered to be made outside the United States, see § 1.6049–5(e).

(iii) Returns of information are not required for payments made by a foreign intermediary described in § 1.1441–1(e)(3)(i) that it has received in its capacity as an intermediary and that are associated with a valid withholding certificate described in § 1.1441–1(e)(3)(ii) or (iii) and payments made by a U.S. branch of a foreign bank or of a foreign insurance company described in § 1.1441–1(b)(2)(iv) that are associated with a valid withholding certificate described in § 1.1441–1(e)(3)(v), which certificate the intermediary or branch has furnished to the payor or middleman from whom it has received the payment, unless, and to the extent, the intermediary or branch knows that the payments are required to be reported and were not so reported.

(2) *Definitions*—(i) *Payor.* For purposes of this section, the term *payor* shall have the meaning ascribed to it under § 1.6049–4(a).

(ii) *Joint owners.* Amounts paid to joint owners for which a certificate or documentation is required as a condition for being exempt from reporting under this paragraph (c) of this section are presumed made to U.S. payees who are not exempt recipients if, prior to payment, the payor cannot reliably associate the payment either with a Form W–9 furnished by one of the joint owners in the manner required in §§ 31.3406(d)-1 through 31.3406(d)-5 of this chapter, or with documentation described in paragraph (c)(1)(i) of this section furnished by each joint owner upon which it can rely to treat each joint owner as a foreign payee or foreign beneficial owner. For purposes of applying this paragraph (c)(2)(ii), the grace period described in § 1.6049–5(d)(2)(ii) shall apply only if each payee qualifies for such grace period.

(d) *Cross-reference to penalties.* For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6050N(a), see § 301.6721–1 of this chapter (Procedure and Administration Regulations). For provisions relating to the penalty provided for failure to furnish timely a correct payee statement required under section 6050N(b) and § 1.6050N–1(a), see § 301.6722–1 of this chapter. See § 301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(e) *Effective date*—This section, except paragraph (c), applies to payee statements due after December 31, 1995, without regard to extensions. For further guidance regarding the substantially similar statement mailing requirements that apply with respect to forms required to be filed after October 22, 1986, and before January 1, 1996 (see Rev. Proc. 84–70 (1984–2 C.B. 716) and §601.601(d)(2) of this chapter). The provisions of paragraph (c) of this section apply to payments made after December 31, 1999.

[T.D. 8637, 60 FR 66111, Dec. 21, 1995, as amended by T.D. 8734, 62 FR 53492, Oct. 14, 1997; T.D. 8804, 63 FR 72188, Dec. 31, 1998]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53492, Oct. 14, 1997, §1.6050N–1 was amended by revising the section heading and paragraphs (c) and (d); and adding paragraph (e), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of §1.6050N–1 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§1.6050N–1 Statements to recipients of royalties.

* * * * *

(c) *Penalty.* For provisions relating to the penalty for failure to furnish a statement under this section, see section 6722.

(d) *Effective date.* This section is effective for payee statements due after December 31, 1995, without regard to extensions. For the substantially similar statement mailing requirements that apply with respect to forms required to be filed after October 22, 1986, and before January 1, 1996, see Rev. Proc. 84–70 (1984–2 C.B. 716) (or successor revenue procedures). See §601.601(d)(2) of this chapter.

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[T.D. 8654, 61 FR 268, Jan. 4, 1996]

§1.6050P–1 Information reporting for discharges of indebtedness by certain financial entities.

(a) *Reporting requirement*—(1) *In general.* Except as provided in paragraph (d) of this section, any applicable financial entity (as defined in section 6050P(c)(1)) that discharges an indebtedness of any person (within the meaning of section 7701(a)(1)) of at least $600 during a calendar year must file an information return on Form 1099–C with the Internal Revenue Service. Solely for purposes of the reporting requirements of section 6050P and this section, a discharge of indebtedness is deemed to have occurred, except as provided in paragraph (b)(3) of this section, if and only if there has occurred an identifiable event described in paragraph (b)(2) of this section, whether or not an actual discharge of indebtedness has occurred on or before the date on which the identifiable event has occurred. The return must include the following information—

(i) The name, address, and taxpayer identification number (TIN), as defined in section 7701(a)(41), of each person for which there was an identifiable event during the calendar year;

(ii) The date on which the identifiable event occurred, as described in paragraph (b) of this section;

(iii) The amount of indebtedness discharged, as described in paragraph (c) of this section;

(iv) An indication whether the identifiable event was a discharge of indebtedness in a bankruptcy, if known; and

(v) Any other information required by Form 1099–C or its instructions, or current revenue procedures.

(2) *No aggregation.* For purposes of reporting under this section, multiple discharges of indebtedness of less than $600 are not required to be aggregated unless such separate discharges are pursuant to a plan to evade the reporting requirements of this section.

(3) *Amounts not includible in income.* Except as otherwise provided in this section, discharged indebtedness must be reported regardless of whether the debtor is subject to tax on the discharged debt under sections 61 and 108 or otherwise by applicable law.

(4) *Time and place for reporting*—(i) *In general.* Except as provided in paragraph (a)(4)(ii) of this section, returns required by this section must be filed with the Internal Revenue Service office designated in the instructions for Form 1099–C on or before February 28 of the year following the calendar year in which the identifiable event occurs.

(ii) *Indebtedness discharged in bankruptcy.* Indebtedness discharged in bankruptcy that is required to be reported under this section must be reported for the later of the calendar year in which the amount of discharged indebtedness first becomes ascertainable, or the calendar year in which the identifiable event occurs.

(b) *Date of discharge*—(1) *In general.* Solely for purposes of this section, except as provided in paragraph (b)(3) of this section, indebtedness is discharged on the date of the occurrence of an identifiable event specified in paragraph (b)(2) of this section.

(2) *Identifiable events*—(i) *In general.* An identifiable event is—

(A) A discharge of indebtedness under title 11 of the United States Code (bankruptcy);

(B) A cancellation or extinguishment of an indebtedness that renders a debt unenforceable in a receivership, foreclosure, or similar proceeding in a federal or State court, as described in section 368(a)(3)(A)(ii) (other than a discharge described in paragraph (b)(2)(i)(A) of this section);

(C) A cancellation or extinguishment of an indebtedness upon the expiration of the statute of limitations for collection of an indebtedness, subject to the limitations described in paragraph (b)(2)(ii) of this section, or upon the expiration of a statutory period for filing a claim or commencing a deficiency judgment proceeding;

(D) A cancellation or extinguishment of an indebtedness pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor's right to pursue collection of the indebtedness;

(E) A cancellation or extinguishment of an indebtedness that renders a debt unenforceable pursuant to a probate or similar proceeding;

(F) A discharge of indebtedness pursuant to an agreement between an applicable financial entity and a debtor to discharge indebtedness at less than full consideration;

(G) A discharge of indebtedness pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge debt; or

(H) The expiration of the non-payment testing period, as described in paragraph (b)(2)(iv) of this section.

(ii) *Statute of limitations.* In the case of an expiration of the statute of limitations for collection of an indebtedness, an identifiable event occurs under paragraph (b)(2)(i)(C) of this section only if, and at such time as, a debtor's affirmative statute of limitations defense is upheld in a final judgment or decision of a judicial proceeding, and the period for appealing the judgment or decision has expired.

(iii) *Decision to discontinue collection activity; creditor's defined policy.* For purposes of the identifiable event described in paragraph (b)(2)(i)(G) of this section, a creditor's defined policy includes both a written policy of the creditor and the creditor's established business practice. Thus, for example, a creditor's established practice to discontinue collection activity and abandon debts upon expiration of a particular non-payment period is considered a defined policy for purposes of paragraph (b)(2)(i)(G) of this section.

(iv) *Expiration of non-payment testing period.* There is a rebuttable presumption that an identifiable event under paragraph (b)(2)(i)(H) of this section has occurred during a calendar year if a creditor has not received a payment on an indebtedness at any time during a testing period (as defined in this paragraph (b)(2)(iv)) ending at the close of the year. The testing period is a 36-month period increased by the number of calendar months during all or part of which the creditor was precluded from engaging in collection activity by a stay in bankruptcy or similar bar under state or local law. The presumption that an identifiable event has occurred may be rebutted by the creditor if the creditor (or a third-party collection agency on behalf of the creditor) has engaged in significant, bona fide collection activity at any time during the 12-month period ending at the close of the calendar year, or if facts and circumstances existing as of January 31 of the calendar year following expiration of the 36-month period indicate that the indebtedness has not been discharged. For purposes of this paragraph (b)(2)(iv)—

(A) Significant, bona fide collection activity does not include merely nominal or ministerial collection action, such as an automated mailing;

(B) Facts and circumstances indicating that an indebtedness has not been discharged include the existence of a lien relating to the indebtedness against the debtor (to the extent of the value of the security), or the sale or packaging for sale of the indebtedness by the creditor; and

(C) In no event will an identifiable event described in paragraph (b)(2)(i)(H) of this section occur prior to December 31, 1997.

(3) *Permitted reporting.* If a discharge of indebtedness occurs before the date on which an identifiable event occurs, the discharge may, at the creditor's discretion, be reported under this section.

(c) *Indebtedness.* For purposes of this section, indebtedness means any amount owed to an applicable financial entity, including stated principal, fees, stated interest, penalties, administrative costs and fines. The amount of indebtedness discharged may represent all, or only a part, of the total amount owed to the applicable financial entity.

(d) *Exceptions from reporting requirement*—(1) *Certain bankruptcy discharges*—(i) *In general.* Reporting is required under this section in the case of a discharge of indebtedness in bankruptcy only if the creditor knows from information included in the reporting entity's books and records pertaining to the indebtedness that the debt was incurred for business or investment purposes as defined in paragraph (d)(1)(ii) of this section.

(ii) *Business or investment debt.* Indebtedness is considered incurred for business purposes if it is incurred in connection with the conduct of any trade or business other than the trade or business of performing services as an employee. Indebtedness is considered incurred for investment purposes if it is incurred to purchase property held for investment, as defined in section 163(d)(5).

(2) *Interest.* The discharge of an amount of indebtedness that is interest is not required to be reported under this section.

(3) *Non-principal amounts in lending transactions.* In the case of a lending transaction, the discharge of an amount other than stated principal is not required to be reported under this

section. For this purpose, a lending transaction is any transaction in which a lender loans money to, or makes advances on behalf of, a borrower (including revolving credits and lines of credit).

(4) *Indebtedness of foreign debtors held by foreign branches of U.S. financial institutions*—(i) *Reporting requirements.* [Reserved]

(ii) *Definition.* An indebtedness held by a foreign branch of a U.S. financial institution is described in this paragraph (d)(4) only if—

(A) The financial institution is engaged through a branch or office in the active conduct of a banking or similar business outside the United States;

(B) The branch or office is a permanent place of business that is regularly maintained, occupied, and used to carry on a banking or similar financial business;

(C) The business is conducted by at least one employee of the branch or office who is regularly in attendance at such place of business during normal working hours;

(D) The indebtedness is extended outside of the United States by the branch or office in connection with that trade or business; and

(E) The financial institution does not know or have reason to know that the debtor is a United States person.

(5) *Acquisition of indebtedness by related party.* No reporting is required under this section in the case of a deemed discharge of indebtedness under section 108(e)(4) (relating to the acquisition of an indebtedness by a person related to the debtor), unless the disposition of the indebtedness by the creditor was made with a view to avoiding the reporting requirements of this section.

(6) *Releases.* The release of a co-obligor is not required to be reported under this section if the remaining debtors remain liable for the full amount of any unpaid indebtedness.

(7) *Guarantors and sureties.* Solely for purposes of the reporting requirements of this section, a guarantor is not a debtor. Thus, in the case of guaranteed indebtedness, reporting under this section is not required with respect to a guarantor, whether or not there has been a default and demand for payment made upon the guarantor.

(e) *Additional rules*—(1) *Multiple debtors*—(i) *In general.* In the case of indebtedness of $10,000 or more incurred on or after January 1, 1995, that involves more than one debtor, a reporting entity is subject to the requirements of paragraph (a) of this section for each debtor discharged from such indebtedness. In the case of indebtedness incurred prior to January 1, 1995, and indebtedness of less than $10,000 incurred on or after January 1, 1995, involving multiple debtors, reporting under this section is required only with respect to the primary (or first-named) debtor. Additionally, only one return of information is required under this section if the reporting entity knows, or has reason to know, that co-obligors were husband and wife living at the same address when an indebtedness was incurred, and does not know or have reason to know that such circumstances have changed at the date of a discharge of the indebtedness. This paragraph (e)(1) applies to discharges of indebtedness after December 31, 1994.

(ii) *Amount to be reported.* In the case of multiple debtors jointly and severally liable on an indebtedness, the amount of discharged indebtedness required to be reported under this section with respect to each debtor is the total amount of indebtedness discharged. For this purpose, multiple debtors are presumed to be jointly and severally liable on an indebtedness in the absence of clear and convincing evidence to the contrary.

(2) *Multiple creditors*—(i) *In general.* Except as otherwise provided in this paragraph (e)(2), if indebtedness is owned (or treated as owned for federal income tax purposes) by more than one creditor, each creditor that is an applicable financial entity must comply with the reporting requirements of this section with respect to any discharge of indebtedness of $600 or more allocable to such creditor. A creditor will be considered to have complied with the requirements of this section if a lead bank, fund administrator, or other designee of the creditor complies on its behalf in any reasonable manner, such as by filing a single return reporting the aggregate amount of indebtedness

discharged, or by filing a return with respect to the portion of the discharged indebtedness allocable to the creditor. For purposes of this paragraph (e)(2)(i), any reasonable method may be used to determine the portion of discharged indebtedness allocable to each creditor.

(ii) *Partnerships.* For purposes of paragraph (e)(2)(i) of this section, indebtedness owned by a partnership is treated as owned by the partners.

(iii) *Pass-through securitized indebtedness arrangement*—(A) *Reporting requirements.* [Reserved]

(B) *Definition.* For purposes of this paragraph (e)(2)(iii), a pass-through securitized indebtedness arrangement is any arrangement whereby one or more debt obligations are pooled and held for twenty or more persons whose interests in the debt obligations are undivided co-ownership interests that are freely transferrable. Co-ownership interests that are actively traded personal property (as defined in §1.1092(d)–1) are presumed to be freely transferrable and held by twenty or more persons.

(iv) *REMICs.* [Reserved]

(3) *Coordination with reporting under section 6050J.* If, in the same calendar year, a discharge of indebtedness reportable under section 6050P occurs in connection with a transaction also reportable under section 6050J (relating to foreclosures and abandonments of secured property), an applicable financial entity need not file both a Form 1099–A and a Form 1099–C with respect to the same debtor. The filing requirements of section 6050J will be satisfied with respect to a borrower if, in lieu of filing Form 1099–A, a Form 1099–C is filed in accordance with the instructions for the filing of that form. This paragraph (e)(3) applies to discharges of indebtedness after December 31, 1994.

(4) *Direct or indirect subsidiary.* For purposes of section 6050P(c)(1)(C), the term direct or indirect subsidiary means a corporation in a chain of corporations beginning with an entity described in section 6050P(c)(1)(A), if at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of all classes of stock, of such corporation is directly owned by the entity described in section 6050P(c)(1)(A), or by one or more other corporations in the chain.

(5) *Use of magnetic media.* Any return required under this section must be filed on magnetic media to the extent required by section 6011(e) and the regulations thereunder. A failure to file on magnetic media when required constitutes a failure to file an information return under section 6721. Any person not required by section 6011(e) to file returns on magnetic media may request permission to do so under applicable regulations and revenue procedures.

(6) *TIN solicitation requirement*—(i) *In general.* For purposes of reporting under this section, a reasonable effort must be made to obtain the correct name/taxpayer identification number (TIN) combination of a person whose indebtedness is discharged. A TIN obtained at the time an indebtedness is incurred satisfies the requirement of this section, unless the entity required to file knows that such TIN is incorrect. If the TIN is not obtained prior to the occurrence of an identifiable event, it must be requested of the debtor for purposes of satisfying the requirement of this paragraph (e)(6).

(ii) *Manner of soliciting TIN.* Solicitations made in the manner described in §301.6724–1(e)(1)(i) and (2) of this chapter will be deemed to have satisfied the reasonable effort requirement set forth in paragraph (e)(6)(i) of this section. A TIN solicitation made after the occurrence of an identifiable event must clearly notify the debtor that the Internal Revenue Service requires the debtor to furnish its TIN, and that failure to furnish such TIN may subject the debtor to a $50 penalty imposed by the Internal Revenue Service. A TIN provided under this section is not required to be certified under penalties of perjury.

(7) *Recordkeeping requirements.* Any applicable financial entity required to file a return with the Internal Revenue Service under this section must also retain a copy of the return, or have the ability to reconstruct the data required to be included on the return under paragraph (a)(1) of this section, for at least four years from the date such return is required to be filed under paragraph (a)(4) of this section.

(8) *No multiple reporting.* If discharged indebtedness is reported under this section, no further reporting under this section is required for the amount so reported, notwithstanding that a subsequent identifiable event occurs with respect to the same amount. Further, no additional reporting or Form 1099–C correction is required if a creditor receives a payment of all or a portion of a discharged indebtedness reported under this section for a prior calendar year.

(f) *Requirement to furnish statement*—(1) *In general.* Any applicable financial entity required to file a return under this section must furnish to each person whose name is shown on such return a written statement that includes the following information—

(i) The information required by paragraph (a)(1) of this section;

(ii) The name, address, and TIN of the applicable financial entity required to file a return under paragraph (a) of this section;

(iii) A legend identifying the statement as important tax information that is being furnished to the Internal Revenue Service; and

(iv) Any other information required by Form 1099–C or its instructions, or current revenue procedures.

(2) *Furnishing copy of Form 1099–C.* The requirement to provide a statement to the debtor will be satisfied if the applicable financial entity furnishes copy B of the Form 1099–C or a substitute statement that complies with the requirements of the current revenue procedure for substitute Forms 1099.

(3) *Time and place for furnishing statement.* The statement required by this paragraph (f) must be furnished to the debtor on or before January 31 of the year following the calendar year in which the identifiable event occurs. The statement will be considered furnished to the debtor if it is mailed to the debtor's last known address.

(g) *Penalties.* For penalties for failure to comply with the requirements of this section, see sections 6721 through 6724.

(h) *Effective dates*—(1) *In general.* The rules in this section apply to discharges of indebtedness after December 21, 1996, except paragraphs (e)(1) and (e)(3) of this section, which apply to discharges of indebtedness after December 31, 1994.

(2) *Earlier application.* Notwithstanding the provisions of paragraph (h)(1) of this section, an applicable financial entity may, at its discretion, apply any of the provisions of this section to any discharge of indebtedness occurring on or after January 1, 1996, and before December 22, 1996.

[T.D. 8654, 61 FR 268, Jan. 4, 1996]

§ 1.6052–1 Information returns regarding payment of wages in the form of group-term life insurance.

(a) *Requirement of reporting*—(1) *In general.* Every employer, who during any calendar year provides any one of his employees remuneration for services in the form of group-term life insurance on the life of such employee any part of the cost of which is to be included in such employee's gross income as provided in section 79(a), shall make a separate return on Form W–2 with respect to each such employee for such year which includes the following information:

(i) Name, address, and identifying number of the employer;

(ii) Name, address, and social security number of the employee; and

(iii) Total amount includible in the employee's gross income by reason of the provisions of section 79(a), computed as if each employee reported his income on the basis of a calendar year (determined as if the employer making such return is the only employer paying the employee remuneration in the form of group-term life insurance on his life which is includible in his gross income under section 79(a)).

Returns on Form W–2 required to be filed pursuant to the provisions of this section shall be transmitted by Form W–3. In a case where, with respect to the same employee, an employer must make a return on Form W–2 under this section and also under § 31.6011(a)–4 or § 31.6011(a)–5 of this chapter (Employment Tax Regulations), or under § 1.6041–2 (relating to return of information as to payments to employees), such employer may make such returns on the same Form W–2 or on separate Forms W–2. In a case where an employer must file a Form W–3 under this section and also under §31.6011(a)–4 or §31.6011(a)–5 of this chapter (Employment Tax Regulations), the Form W–3 filed under such §31.6011(a)–4 or §31.6011(a)–5 shall also be used as the transmittal form for a return on Form W–2 made pursuant to the provisions of this section.

(2) *Definitions.* Terms used in subparagraph (a)(1) of this section and in section 79 and the regulations thereunder have the meaning ascribed to them in section 79 and the regulations thereunder.

(b) *Time and place for filing*—(1) *Time for filing*—(i) *General rule.* In a case where an employer must file Forms W–3 and W–2 under this section and also under §31.6011(a)–4 or §31.6011(a)–5 of this chapter (Employment Tax Regulations), the time for filing such forms under this section shall be the same as the time (including extensions thereof) for filing such forms under §31.6011(a)–4 or §31.6011(a)–5.

(ii) *Exception.* In a case where an employer is not required to file Forms W–3 and W–2 under §31.6011(a)–4 or §31.6011(a)–5 of this chapter (Employment Tax Regulations), returns on Forms W–3 and W–2 required under paragraph (a) of this section for any calendar year shall be filed on or before February 28 of the following year.

(iii) *Cross reference.* For extensions of time for filing returns, see section 6081 and the regulations thereunder.

(2) *Place for filing.* The returns on Forms W–3 and W–2 required under paragraph (a) of this section shall be filed pursuant to the rules contained in §31.6091–1 of this chapter (Employment Tax Regulations), relating to the place for filing certain returns.

(c) *Special rule for calendar years before 1972.* For calendar years before 1972, the provisions of this section will be deemed to have been complied with if the returns for such years were filed in accordance with the provisions of this section in effect prior to August 3, 1973, or with the instructions applicable to the appropriate forms.

(d) *Last day for filing return.* For provisions relating to the time for performance of an act when the last day prescribed for performance falls on Saturday, Sunday, or a legal holiday, see §301.7503–1 of this chapter (Regulations on Procedure and Administration).

(e) *Penalty.* For provisions relating to the penalty provided for failure to file the information returns required by this section, see section 6652 and the regulations thereunder.

[T.D. 6888, 31 FR 9205, July 6, 1966, as amended by T.D. 7284, 38 FR 20828, Aug. 3, 1973; T.D. 7580, 43 FR 60160, Dec. 26, 1978; T.D. 7623, 44 FR 28800, May 17, 1979]

§1.6052–2 Statements to be furnished employees with respect to wages paid in the form of group-term life insurance.

(a) *Requirement.* Every employer filing a return under section 6052(a) and §1.6052–1 with respect to group-term life insurance on the life of an employee shall furnish to the employee whose name is set forth in such return a written statement showing the information required by paragraph (b) of this section.

(b) *Form of statement.* The written statement required to be furnished to an employee under paragraph (a) of this section shall show:

(1) The total amount includible in the employee's gross income by reason of the provisions of section 79(a), but determined as if the employer furnishing such statement is the only employer paying the employee remuneration in the form of group-term life insurance on his life which is includible in his gross income under section 79(a).

(2) The name, address, and identifying number of the employer filing the statement.

The requirement of this section for the furnishing of a statement to an employee may be satisfied by the furnishing to such employee of a copy of the return filed pursuant to §1.6052–1 in respect of such employee. A statement shall be considered to be furnished to a person within the meaning of this section if it is mailed to such person at his last known address.

(c) *Time for furnishing statements*—(1) *In general.* Each statement required by this section to be furnished to any employee for a calendar year shall be furnished to such person after the close of that year and on or before January 31 of the following year.

(2) *Extensions of time.* For good cause shown upon written application of the employer required to furnish statements under this section, the district director may grant an extension of time not exceeding 30 days in which to furnish such statements. The application shall be addressed to the district director with whom the income tax returns of the applicant are filed and shall contain a full recital of the reasons for requesting the extension to aid the district director in determining the period of the extension, if any, which will be granted. Such a request in the form of a letter to the district director signed by the applicant will suffice as an application. The application shall be filed on or before the date prescribed in subparagraph (1) of this paragraph for furnishing the statements required by this section.

(3) *Last day for furnishing statement.* For provisions relating to the time for performance of an act when the last day prescribed for performance falls on Saturday, Sunday, or a legal holiday, see § 301.7503–1 of this chapter (Regulations on Procedure and Administration).

(d) *Special rule where Form W–2 is used.* The provisions of this paragraph shall apply notwithstanding anything to the contrary in paragraph (b) or (c) of this section. The requirement of this section for the furnishing of a statement to an employee may be satisfied by furnishing to such employee the employee's copy of Form W–2 filed pursuant to § 1.6052–1 in respect of such employee. In a case where the statement furnished by an employer to an employee for purposes of complying with this section is the employee's copy of a Form W–2, then the rules in § 31.6051–1 of this chapter (Employment Tax Regulations) shall apply with respect to the means and time (including extensions thereof) for furnishing such statements to the employee and making corrections on such form.

(e) *Definitions.* Terms used in this section and in section 79 and the regulations thereunder have the meaning ascribed to them in section 79 and the regulations thereunder.

(f) *Penalty.* For provisions relating to the penalty provided for failure to furnish a statement under this section, see section 6678 and the regulations thereunder.

(g) *Special rule for calendar years before 1972.* For calendar years before 1972, the provisions of this section will be deemed to have been complied with if the statements for such years were furnished in accordance with the provisions of this section in effect prior to August 3, 1973, or with the instructions applicable to the appropriate forms.

[T.D. 6888, 31 FR 9205, July 6, 1966, as amended by T.D. 7284, 38 FR 20828, Aug. 3, 1973; T.D. 7580, 43 FR 60160, Dec. 26, 1978; T.D. 7623, 44 FR 28800, May 17, 1979]

§ 1.6060–1 Reporting requirements for income tax return preparers.

(a) *In general.* (1) Each person who employs (or engages) one or more income tax return preparers to prepare any return of tax under subtitle A of the Internal Revenue Code of 1954 or claim for refund of tax under subtitle A of the Internal Revenue Code of 1954, other than for the person, at any time during a return period shall satisfy the requirements of section 6060 of the Code by:

(i) Retaining a record of the name, taxpayer identification number, and principal place of work during the return period of each income tax return preparer employed (or engaged) by the person at any time during that period; and

(ii) Making that record available for inspection upon request by the district director.

The record described in this paragraph (a) must be retained and kept available for inspection for the 3-year period following the close of the return period to which that record relates.

(2) The person may chose any form of documentation to be used under this section as a record of the preparers employed (or engaged) during a return period. However, the record must disclose on its face which individuals were employed (or engaged) as income tax return preparers during that period.

(3) For the definition of the term ''income tax return preparer'' (or ''preparer''), see section 7701(a)(36) and § 301.7701–15. For the definition of the term ''return period'', see paragraph (b) of this section.

(4)(i) For purposes of this section, any individual who, in acting as an income tax return preparer, is not employed by another income tax return preparer shall be treated as his (or her) own employer. Thus, a sole proprietor shall retain and make available a record with respect to himself (or herself) as provided in this section.

(ii) A partnership shall, for purposes of this section, be treated as the employer of the partners of the partnership and shall retain and make available a record with respect to the partners and others employed (or engaged) by the partnership as provided in this section.

(b) *Return period defined.* For purposes of this section, the term *return period* means the 12-month period beginning on July 1 of each year.

(c) *Penalty.* For the civil penalty for failure to retain and make available a record of the preparers employed (or engaged) during a return period as required under this section, or for failure to include an item in the record required to be retained and made available under this section, see §1.6695–1(e).

[T.D. 7640, 44 FR 49451, Aug. 23, 1979]

SIGNING AND VERIFYING OF RETURNS AND OTHER DOCUMENTS

§1.6061–1 Signing of returns and other documents by individuals.

(a) *Requirement.* Each individual (including a fiduciary) shall sign the income tax return required to be made by him, except that the return may be signed for the taxpayer by an agent who is duly authorized in accordance with paragraph (a)(5) or (b) of §1.6012–1 to make such return. Other returns, statements, or documents required under the provisions of subtitle A or F of the Code or of the regulations thereunder to be made by any person with respect to any tax imposed by subtitle A of the Code shall be signed in accordance with any regulations contained in this chapter, or any instructions, issued with respect to such returns, statements, or other documents.

(b) *Cross references.* For provisions relating to the signing of returns, statements, or other documents required to be made by corporations and partnerships with respect to any tax imposed by subtitle A of the Code, see §§1.6062–1 and 1.6063–1, respectively. For provisions relating to the making of returns by agents, see paragraphs (a)(5) and (b) of §1.6012–1; and to the making of returns for minors and persons under a disability, see paragraph (a)(4) of §1.6012–1 and paragraph (b) of §1.6012–3.

[T.D. 7332, 39 FR 44232, Dec. 23, 1974]

§1.6061–2T Signing of returns by voice signature (temporary).

(a) *In general.* An eligible taxpayer who makes an income tax return under §1.6012–7T in the TeleFile Voice Signature test is treated, for all purposes of the Internal Revenue Code, as having signed that return by providing the voice signature at the time and in the manner required by the instructions that are provided over the telephone by the TeleFile system interactive voice computer. For provisions relating to the verification of the TeleFile returns made under §1.6012–7T, see §1.6065–2T.

(b) *Effective dates.* This section is effective for—

(1) 1992 calendar year returns filed by eligible taxpayers in the TeleFile Voice Signature test after January 13, 1993, and before April 16, 1993; and

(2) 1993 calendar year returns filed by eligible taxpayers in the TeleFile Voice Signature test after January 12, 1994, and before April 16, 1994.

[T.D. 8510, 58 FR 68296, Dec. 27, 1993]

§1.6062–1 Signing of returns, statements, and other documents made by corporations.

(a) *Returns*—(1) *In general.* Returns required to be made by corporations under the provisions of subtitle A or F of the Code, or the regulations thereunder, with respect to any tax imposed by subtitle A of the Code, shall be signed for the corporation by the president, vice-president, treasurer, assistant treasurer, chief accounting officer, or any other officer duly authorized to sign such returns. It is not necessary that the corporate seal be affixed to the return. Spaces provided on return forms for affixing the corporate seal are for the convenience of corporations required by charter, or by law of the jurisdiction in which they are incorporated, to affix their corporate seals in the execution of instruments.

(2) *By fiduciaries.* A return with respect to income required to be made for a corporation by a fiduciary, pursuant to the provisions of section 6012(b)(3), shall be signed by such fiduciary. See paragraph (b)(4) of § 1.6012–3.

(3) *By agents.* A return with respect to income required to be made by an agent for a foreign corporation shall be signed by such agent. See paragraph (g) of § 1.6012–2.

(b) *Statements and other documents.* Statements and other documents required to be made by or for corporations under the provisions of subtitle A or F of the Code, or the regulations thereunder, with respect to any tax imposed by subtitle A, shall be signed in accordance with the regulations contained in this chapter, or the forms and instructions, issued with respect to such statements or other documents.

(c) *Evidence of authority to sign.* An individual's signature on a return, statement, or other document made by or for a corporation shall be prima facie evidence that such individual is authorized to sign such return, statement, or other document.

(d) *Related provisions.* For the rules realating to the verification of returns, see § 1.6065–1.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 7293, 38 FR 32804, Nov. 28, 1973]

§ 1.6063–1 Signing of returns, statements, and other documents made by partnerships.

(a) *In general.* Returns, statements, and other documents required to be made by partnerships under the provisions of subtitle A or F of the Code, or the regulations thereunder, with respect to any tax imposed by subtitle A of the Code shall be signed by any one of the partners. However, with respect to the signing of powers of attorney, see paragraph (a)(2) of § 601.504 of this chapter (Statement of Procedural Rules).

(b) *Evidence of authority to sign.* A partner's signature on a return, statement, or other document made by or for a partnership of which he is a member shall be prima facie evidence that such partner is authorized to sign such return, statement, or other document.

§ 1.6065–1 Verification of returns.

(a) *Persons signing returns.* If a return, declaration, statement, or other document made under the provisions of subtitle A or F of the Code, or the regulation thereunder, with respect to any tax imposed by subtitle A of the Code is required by the regulations contained in this chapter, or the form and instructions, issued with respect to such return, declaration, statement, or other document, to contain or be verified by a written declaration that it is made under the penalties of perjury, such return, declaration, statement, or other document shall be so verified by the person signing it.

(b) *Persons preparing returns*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, if a return, declaration, statement, or other document is prepared for a taxpayer by another person for compensation or as an incident to the performance of other services for which such person receives compensation, and the return, declaration, statement, or other document requires that it shall contain or be verified by a written declaration that it is prepared under the penalties of perjury, the preparer must so verify the return, declaration, statement, or other document. A person who renders mere mechanical assistance in the preparation of a return, declaration, statement, or other document as, for example, a stenographer or typist, is not considered as preparing the return, declaration, statement, or other document.

(2) *Exception.* The verification required by subparagraph (1) of this paragraph is not required on returns, declarations, statements, or other documents which are prepared:

(i) For an employee either by his employer or by an employee designated for such purpose by the employer, or

(ii) For an employer as a usual incident of the employment of one regularly or continuously employed by such employer.

§1.6065–2T Verification of returns by voice signature (temporary).

(a) *In general.* An eligible taxpayer who makes an income tax return under §1.6012–7T in the TeleFile Voice signature test, by providing the voice signature at the time and in the manner required by the instructions that are provided over the telephone by the TeleFile system interactive voice computer, is treated for all purposes of the Internal Revenue Code as having affirmed that the return is made under penalties of perjury and as having verified the return.

(b) *Effective dates.* This section is effective for—

(1) 1992 calendar year returns filed by eligible taxpayers in the TeleFile Voice Signature test after January 13, 1993, and before April 16, 1993; and

(2) 1993 calendar year returns filed by eligible taxpayers in the TeleFile Voice Signature test after January 12, 1994, and before April 16, 1994.

[T.D. 8510, 58 FR 68297, Dec. 27, 1993]

TIME FOR FILING RETURNS AND OTHER DOCUMENTS

§1.6071–1 Time for filing returns and other documents.

(a) *In general.* Whenever a return, statement, or other document is required to be made under the provisions of subtitle A or F of the Code, or the regulations thereunder, with respect to any tax imposed by subtitle A of the Code, and the time for filing such return, statement, or other document is not provided for by the Code, it shall be filed at the time prescribed by the regulations contained in this chapter with respect to such return, statement, or other document.

(b) *Return for a short period.* In the case of a return with respect to tax under subtitle A of the Code for a short period (as defined in section 443), the district director or director of the Internal Revenue Service Center may, upon a showing by the taxpayer of unusual circumstances, prescribe a time for filing the return for such period later than the time when such return would otherwise be due. However, the district director or director of the Internal Revenue Service Center may not extend the time when the return for a DISC (as defined in section 992(a)(1)) must be filed, as specified in section 6072(b).

(c) *Time for filing certain information returns.* (1) For provisions relating to the time for filing returns of partnership income, see paragraph (e)(2) of §1.6031–1.

(2) For provisions relating to the time for filing information returns by banks with respect to common trust funds, see §1.6032–1.

(3) For provisions relating to the time for filing information returns by certain organizations exempt from taxation under section 501(a), see paragraph (e) of §1.6033–1.

(4) For provisions relating to the time for filing returns by trusts claiming charitable deductions under section 642(c), see paragraph (c) of §1.6034–1.

(5) For provisions relating to the time for filing information returns by officers, directors, and shareholders of foreign personal holding companies, see §§1.6035–1 and 1.6035–2.

(6) For provisions relating to the time for filing information returns with respect to certain stock option transactions, see paragraph (c) of §1.6039–1.

(7) For provisions relating to the time for filing information returns by persons making certain payments, see §1.6041–2(a)(3) and §1.6041–6.

(8) For provisions relating to the time for filing information returns regarding payments of dividends, see §1.6042–2(c).

(9) For provisions relating to the time for filing information returns by corporations with respect to contemplated dissolution or liquidations, see paragraph (a) of §1.6043–1.

(10) For provisions relating to the time for filing information returns by corporations with respect to distributions in liquidation, see paragraph (a) of §1.6043–2.

(11) For provisions relating to the time for filing information returns with respect to payments of patronage dividends, see §1.6044–2(d).

(12) For provisions relating to the time for filing information returns with respect to formation or reorganization of foreign corporations, see §1.6046–1.

(13) For provisions relating to the time for filing information returns regarding certain payments of interest, see § 1.6049–4(g).

(14) For provisions relating to the time for filing information returns with respect to payment of wages in the form of group-term life insurance, see paragraph (b) of § 1.6052–1.

(15) For provisions relating to the time for filing the annual information return on Form 1042–S of the tax withheld under chapter 3 of the Code (relating to withholding of tax nonresident aliens and foreign corporations and tax-free covenant bonds), see § 1.1461–1(c).

(16) For provisions relating to the time for filing the annual information return on Form 1042S of the tax withheld under chapter 3 of the Code (relating to withholding of tax on nonresident aliens and foreign corporations and tax-free covenant bonds), see paragraph (c) of § 1.1461–2.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6887, 31 FR 8814, June 24, 1966; T.D. 6908, 31 FR 16775, Dec. 31, 1966; T.D. 7284, 38 FR 20829, Aug. 3, 1973; T.D. 7533, 43 FR 6604, Feb. 15, 1978; T.D. 8734, 62 FR 53492, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53492, Oct. 14, 1997, § 1.6071–1 was amended by revising paragraphs (c)(7), (8), (11), (13), and (15), effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.6071–1 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.6071–1 Time for filing returns and other documents.

* * * * *

(c) * * *

(7) For provisions relating to the time for filing information returns by persons making certain payments, see paragraph (a)(4) of § 1.6041–2 and § 1.6041–6.

(8) For provisions relating to the time for filing information returns regarding payments of dividends, see paragraph (d) of § 1.6042–1, and paragraph (c) of § 1.6042–2 (relating to returns for calendar years after 1962).

* * * * *

(11) For provisions relating to the time for filing information returns with respect to payments of patronage dividends, see paragraph (b) of § 1.6044–1, and paragraph (d) of § 1.6044–2 (relating to returns for calendar years after 1962).

* * * * *

(13) For provisions relating to the time for filing information returns regarding certain payments of interest, see paragraph (c) of § 1.6049–1.

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(15) For provisions relating to the time for filing ownership certificates with respect to interest payments on certain bonds, mortgages, deeds of trust, and other similar obligations, see § 1.1461–1.

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§ 1.6072–1 Time for filing returns of individuals, estates, and trusts.

(a) *In general.* Except as provided in paragraphs (b) and (c) of this section, returns of income required under sections 6012, 6013, 6014, and 6017 of individuals, estates, domestic trusts, and foreign trusts having an office or place of business in the United States (including unrelated business tax returns of such trusts referred to in section 511(b)(2)) shall be filed on or before the fifteenth day of the fourth month following the close of the taxable year.

(b) *Decedents.* In the case of a final return of a decedent for a fractional part of a year, the due date of such return shall be the fifteenth day of the fourth month following the close of the 12-month period which began with the first day of such fractional part of the year.

(c) *Nonresident alien individuals and foreign trusts.* The income tax return of a nonresident alien individual (other than one treated as a resident under section 6013 (g) or (h)) and of a foreign trust which does not have an office or place of business in the United States (including unrelated business tax returns of such trusts referred to in section 511(b)(2)0 shall be filed on or before the fifteenth day of the sixth month following the close of the taxable year. However, a nonresident alien individual who for the taxable year has wages subject to withholding under chapter 24 of the Code shall file his income tax return on or before the fifteenth day of the fourth month following the close of the taxable year.

(d) *Last day for filing return.* For provisions relating to the time for filing a return where the last day for filing falls on Saturday, Sunday, or a legal holiday, see section 7503 and §301.7503–1 of this chapter (Regulations on Procedure and Administration).

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 7426, 41 FR 33263, Aug. 9, 1976; T.D. 7670, 45 FR 6931, Jan. 31, 1980]

§1.6072–2 Time for filing returns of corporations.

(a) *Domestic and certain foreign corporations.* The income tax return required under section 6012 of a domestic corporation or of a foreign corporation having an office or place of business in the United States shall be filed on or before the fifteenth day of the third month following the close of the taxable year.

(b) *Foreign corporations not having an office or place of business in the United States.* The income tax return of a foreign corporation which does not have an office or place of business in the United States shall be filed on or before the fifteenth day of the sixth month following the close of the taxable year.

(c) *Exempt organizations.* For taxable years beginning after November 10, 1978, the income tax return required under section 6012 and §1.6012–2(e) of an organization exempt from taxation under section 501(a) (other than an employee's trust under section 401(a)) shall be filed on or before the fifteenth day of the fifth month following the close of the organization's taxable year.

(d) *Cooperative organizations.* The income tax return of the following cooperative organizations shall be filed on or before the fifteenth day of the ninth month following the close of the taxable year:

(1) A farmers', fruit growers', or like association, organized and operated in compliance with the requirements of section 521 and §1.521–1; and

(2) For a taxable year beginning after December 31, 1962, a corporation described in section 1381(a)(2), which is under a valid enforceable written obligation to pay patronage dividends (as defined in section 1388(a) and paragraph (a) of §1.1388–1) in an amount equal to at least 50 percent of its net earnings from business done with or for its patrons, or which paid patronage dividends in such an amount out of the net earnings from business done with or for patrons during the most recent taxable year for which it had such net earnings. Net earnings for this purpose shall not be reduced by any taxes imposed by Subtitle A of the Code and shall not be reduced by dividends paid on capital stock or other proprietary interest.

(e) *DISC's and former DISC's.* The return required under section 6011(c)(2) of a corporation which is a DISC (as defined in section 992(a) shall be filed on or before the 15th day of the 9th month following the close of the taxable year. For the rule that a DISC may not have an extension of time in which to file such return, see §§1.6071–1(b), 1.6081–1(a), and 1.6081–3(e). The return required under §1.6011–2(b)(1) by a former DISC shall be filed at the time it is required to file its income tax return.

(f) *Cross references.* For provisions relating to the time for filing a return where the last day for filing falls on Saturday, Sunday, or a legal holiday, see section 7503 and §301.7503–1 of this chapter (Regulations on Procedure and Administration). For provisions relating to the fixing of a later time for filing in the case of a return for a short period, see paragraph (b) of §1.6071–1. For provisions relating to time for filing consolidated returns and separate returns for short periods not included in consolidated returns, see §§1.1502–75 and 1.1502–76.

[T.D. 6500, 25 FR 12133, Nov. 26, 1960, as amended by T.D. 6643, 28 FR 3163, Apr. 2, 1963; T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7533, 43 FR 6604, Feb. 15, 1978; T.D. 7896, 48 FR 23818, May 27, 1983]

§1.6072–3 Income tax due dates postponed in case of China Trade Act corporations.

(a) With respect to a taxable year beginning after December 31, 1948, and ending before October 1, 1956, the income tax return of any corporation organized under the China Trade Act of 1922 (15 U.S.C. ch. 4), as amended, shall not become due until December 31, 1956, provided that during any such taxable year conditions in China have been generally so unsettled as to militate against the normal commercial operations and corporate activities of such corporation. However, the postponement of the due date shall not apply to an income tax return for any such taxable year if:

(1) The books of account and business records are available so as to permit the filing of a proper return, and the corporation has otherwise been in a position to carry on its commercial operations and corporate activities and to make a proper distribution of its earnings or profits, if any, so as to permit the certification required by section 941(b); or

(2) All the commercial operations and corporate activities of such corporation have been carried on in Hong Kong, Macao, or Taiwan (Formosa).

(b) Notwithstanding the provisions of paragraph (a) (1) or (2) of this section, the postponed due date referred to in this section will apply if a corporation satisfies the Commissioner that special circumstances exist, related to the unsettled conditions in China, which warrant such postponement.

(c) The postponed due date provided for in this section is expressly subject to the power of the Commissioner to extend, as in other cases, the time for filing the income tax return. See section 6081 and the regulations thereunder.

§1.6072–4 Time for filing other returns of income.

(a) *Reports for recovery of excessive profits on Government contracts.* For the time for filing annual reports by persons completing Government contracts, see 26 CFR (1939) 17.16 (Treasury Decision 4906, approved June 23, 1939), and 26 CFR (1939) 16.15 (Treasury Decision 4909, approved June 28, 1939), as made applicable to section 1471 of the Internal Revenue Code of 1954 by Treasury Decision 6091, approved August 16, 1954 (19 FR 5167, C.B. 1954–2, 47).

(b) *Returns of tax on transfers to avoid income tax.* For the time for filing returns of tax under Chapter 5 of the Code, see §1.1494–1.

[T.D. 6908, 31 FR 16775, Dec. 31, 1966]

§1.6073–1 Time and place for filing declarations of estimated income tax by individuals.

(a) *Individuals other than farmers or fishermen.* Declarations of estimated tax for the calendar year shall be made on or before April 15th of such calendar year by every individual whose anticipated income for the year meets the requirements of section 6015(a). If, however, the requirements necessitating the filing of the declaration are first met, in the case of an individual on the calendar year basis, after April 1st, but before June 2d of the calendar year, the declaration must be filed on or before June 15th; if such requirements are first met after June 1st and before September 2d, the declaration must be filed on or before September 15th; and if such requirements are first met after September 1st, the declaration must be filed on or before January 15th of the succeeding calendar year. In the case of an individual on the fiscal year basis, see §1.6073–2. A special rule applies to nonresident aliens who do not have wages subject to withholding under Chapter 24 of the code and are not treated as residents under section 6013 (g) or (h) of the code. For taxable years beginning after December 31, 1976, these aliens are not required to file a declaration of estimated tax before June 15th.

(b) *Farmers or fishermen*—(1) *In general.* In the case of an individual on a calendar year basis:

(i) If at least two-thirds of the individual's total estimated gross income from all sources for the calendar year is from farming or fishing (including oyster farming), or

(ii) If at least two-thirds of the individual's total gross income from all sources shown on the return for the preceding taxable year was from farming or fishing (including oyster farming) (with respect to declarations of estimated tax for taxable years beginning after November 10, 1978),

He may file a declaration of estimated tax on or before the 15th day of January of the succeeeding calendar year in lieu of the time prescribed in paragraph (a) of this section. For the filing of a return in lieu of a declaration, see paragraph (a) of §1.6015–1.

(2) *Farmers.* The estimated gross income from farming is the estimated income resulting from oyster farming, the cultivation of the soil, the raising or harvesting of any agricultural or horticultural commodities, and the raising of livestock, bees, or poultry. In other words, the requisite gross income must be derived from the operations of a stock, dairy, poultry, fruit, or truck farm, or plantation, ranch, nursery, range, orchard, or oyster bed. If an individual receives for the use of his land income in the form of a share of the crops produced thereon such income is from farming. As to determination of income of farmers, see sections 61 and 162 and the regulations thereunder.

(3) *Fishermen.* The estimated gross income from fishing is the estimated income resulting from the catching, taking, harvesting, cultivating or farming of any kind of fish, shellfish (for example, clams and mussels), crustacea (for example, lobsters, crabs, and shrimps), sponges, seaweeds, or other aquatic forms of animal and vegetable life. The estimated gross income from fishing includes the income expected to be received by an officer or member of the crew of a vessel while the vessel is engaged in any such activity, whether or not the officer or member of the crew is himself so engaged, and, in the case of an individual who is engaged in any such activity in the employ of any person, the income expected to be received by such individual from such employment. In addition, income expected to be received for services performed as an ordinary incident to any such activity is estimated gross income from fishing. Similarly, for example, the estimated gross income from fishing includes income expected to be received from the shore services of an officer or member of the crew of a vessel engaged in any such activity, if such services are an ordinary incident to any such activity. Services performed as an ordinary incident to such activities include, for example, services performed in such cleaning, icing, and packing of fish as are necessary for the immediate preservation of the catch.

(c) *Nonresident aliens.* Notwithstanding the provisions of paragraph (a) of this section, for taxable years beginning after December 31, 1976, in the case of a nonresident alien described in section 6072(c) (relating to returns of nonresident aliens whose wages are not subject to withholding) whose estimated gross income for the calendar year meets the requirements of section 6015(a), a declaration of estimated tax for the calendar year need not be made before June 15th of such calendar year.

(d) *Place for filing declaration.* Except as provided in paragraph (b) of §301.6091–1 (relating to hand-carried documents), the declaration of estimated tax shall be filed at the place prescribed by the instructions applicable to such declaration. For example, if the instructions applicable to a declaration provide that the declaration of a taxpayer located in North Carolina be filed with the Director, Internal Revenue Service Center, Chamblee, Ga., such declaration shall be filed with the service center.

(e) *Amendment of declaration.* An amended declaration of estimated tax may be filed during any interval between installment dates prescribed for the taxable year. However, no amended declaration may be filed until after the installment date on or before which the original declaration was filed and only one amended declaration may be filed during each interval between installment dates. Except as provided in paragraph (b) of §301.6091–1 (relating to hand-carried documents), an amended declaration shall be filed with the internal revenue officer with whom the original declaration was filed.

[T.D. 6678, 28 FR 10516, Oct. 1, 1963, as amended by T.D. 6950, 33 FR 5355, Apr. 4, 1968; T.D. 7670, 45 FR 6931, Jan. 31, 1980; T.D. 7719, 45 FR 60902, Sept. 15, 1980]

§1.6073–2 Fiscal years.

(a) *Individuals other than farmers or fishermen.* In the case of an individual on the fiscal year basis, the declaration must be filed on or before the 15th day of the 4th month of the taxable year. If, however, the requirements of section 6015(a) are first met after the 1st day of the 4th month and before the 2d day of the 6th month, the declaration must be filed on or before the 15th day of the 6th month of the taxable year. If such requirements are first met after the 1st day of the 6th month, and before the 2d day of the 9th month, the declaration must be filed on or before the 15th day of the 9th month of the taxable year. If such requirements are first met after the 1st day of the 9th month, the declaration must be filed on or before the 15th day of the 1st month of the succeeding fiscal year. Thus, if an individual taxpayer has a fiscal year ending on June 30, 1956, his declaration must be filed on or before October 15, 1955, if the requirements of section 6015(a) are met on or before October 1, 1955. If, however, such requirements are not met until after October 1, 1955, and before December 2, 1955, the declaration need not be filed until December 15, 1955.

(b) *Farmers or fishermen.* In the case of an individual on a fiscal year basis:

(1) If at least two-thirds of the individual's total estimated gross income from all sources for the fiscal year is from farming or fishing (including oyster farming), or

(2) If at least two-thirds of the individual's total gross income from all sources shown on the return for the preceding taxable year was from farming or fishing (including oyster farming) (with respect to declarations of estimated tax for taxable years beginning after November 10, 1978),

he may file a declaration on or before the 15th day of the month immediately following the close of his taxable year, in lieu of the time prescribed in paragraph (a) of this section.

(c) *Nonresident aliens.* Notwithstanding the provisions of paragraph (a) of this section, in the case of a nonresident alien described in section 6072(c) (relating to returns of nonresident aliens whose wages are not subject to withholding) whose anticipated income for the fiscal year meets the requirements of section 6015(a), § 1.6015(a)–1, and § 1.6015(i)–1, the declaration of estimated tax for the fiscal year need not be filed before the 15th day of the 6th month of such fiscal year.

[T.D. 6678, 28 FR 10516, Oct. 1, 1963, as amended by T.D. 7719, 45 FR 60903, Sept. 15, 1980]

§ 1.6073–3 Short taxable years.

(a) *Individuals other than farmers or fishermen.* In the case of short taxable years the declaration shall be filed on or before the 15th day of the 4th month of such taxable year if the requirements of section 6015(a) are met on or before the 1st day of the 4th month of such year. If such requirements are first met after the 1st day of the 4th month but before the 2d day of the 6th month, the declaration must be filed on or before the 15th day of the 6th month. If such requirements are first met after the 1st day of the 6th month but before the 2d day of the 9th month, the declaration must be filed on or before the 15th day of the 9th month. If, however, the period for which the declaration is filed is one of 4 months, or one of 6 months and the requirements of section 6015(a) are not met until after the 1st day of the 4th month, or one of 9 months and such requirements are not met until after the 1st day of the 6th month, the declaration may be filed on or before the 15th day of the succeeding taxable year.

(b) *Farmers or fishermen.* In the case of an individual:

(1) Whose current taxable year is a short taxable year and whose estimated gross income from farming or fishing (including oyster farming) is at least two-thirds of his total estimated gross income from all sources for such current taxable year, or

(2) Whose taxable year preceding the current taxable year was a short taxable year and whose gross income from farming or fishing (including oyster farming) was at least two-thirds of the total gross income from all sources shown on the return for such preceding short taxable year (with respect to declarations of estimated tax for taxable years beginning after November 10, 1978),

he may file a declaration of estimated tax on or before the 15th day of the month immediately following the close of the current taxable year, in lieu of the time prescribed in paragraph (a) of this section.

(c) *Nonresident aliens.* Notwithstanding the provisions of paragraph (a) of this section, in the case of a short taxable year, a nonresident alien described in section 6072(c) (relating to returns of nonresident aliens whose wages are not subject to withholding) whose anticipated income for the short taxable year meets the requirements of section 6015(a). Sections 1.6015(a)–1, 1.6015(g)–1, and 1.6015(i)–1 on or before the 1st day of the 6th month following the beginning of such year need not file a declaration of estimated tax before the 15th day of the 6th month following the beginning of such year.

[T.D. 6678, 28 FR 10516, Oct. 1, 1963, as amended by T.D. 7719, 45 FR 60903, Sept. 15, 1980]

§1.6073–4 Extension of time for filing declarations by individuals.

(a) *In general.* District directors and directors of service centers are authorized to grant a reasonable extension of time for filing a declaration or an amended declaration. Except as provided in paragraph (b) of §301.6091–1 (relating to hand-carried documents), an application for an extension of time for filing such a declaration shall be addressed to the internal revenue officer with whom the taxpayer is required to file his declaration, and must contain a full recital of the causes for the delay. Except in the case of taxpayers who are abroad, no extension for filing declarations may be granted for more than 6 months.

(b) *Citizens outside of the United States.* In the case of a United States citizen outside the United States and Puerto Rico on the 15th day of the 4th month of his taxable year, an extension of time for filing his declaration of estimated tax otherwise due on or before the 15th day of the 4th month of the taxable year is granted to and including the 15th day of the 6th month of the taxable year. For purposes of applying this paragraph to taxable years beginning prior to January 1, 1964, Alaska shall be considered outside the United States.

(c) *Residents outside the United States.* In the case of a U.S. resident living or traveling outside the United States and Puerto Rico on the 15th day of the 4th month of a taxable year beginning after December 31, 1978, an extension of time for filing the declaration of estimated tax otherwise due on or before the 15th day of the 4th month of the taxable year is granted to and including the 15th day of the 6th month of the taxable year.

(d) *Addition to tax applicable.* An extension of time for filing the declaration of estimated tax automatically extends the time for paying the estimated tax (without interest) for the same period. However, such extension does not relieve the taxpayer from the addition to the tax imposed by section 6654, and the period of the underpayment will be determined under section 6654(c) without regard to such extension.

[T.D. 6500, 25 FR 12008, Nov. 26, 1960, as amended by T.D. 6638, 28 FR 1765, Feb. 26, 1963; T.D. 6950, 33 FR 5355, Apr. 4, 1968; T.D. 7736, 45 FR 76143, Nov. 18, 1980]

§1.6074–1 Time and place for filing declarations of estimated income tax by corporations.

(a) *Taxable years beginning on or before December 31, 1963.* For taxable years ending on or after December 31, 1955, and beginning on or before December 31, 1963, declarations of estimated tax for the taxable year shall be filed on or before the 15th day of the 9th month of such year by every corporation whose then anticipated income tax liability under section 11 or 1201(a), or subchapter L, chapter 1 of the Code, for the year meets the requirements of section 6016(a). If, however, the requirements necessitating the filing of a declaration are first met after the last day of the 8th month and before the first day of the 12th month of the taxable year the declaration shall be filed on or before the 15th day of the 12th month of the taxable year. If, however, the requirements of section 6016(a) are not met before the first day of the 12th month of the taxable year, no declaration need be filed for such year.

(b) *Taxable years beginning after December 31, 1963.* A declaration of estimated tax for a taxable year beginning after December 31, 1963, required of a corporation by section 6016 shall be filed as follows:

If the requirements of section 6016 are first met—	The declaration shall be filed on or before—
before the 1st day of the 4th month of the taxable year.	the 15th day of the 4th month of the taxable year
after the last day of the 3d month and before the 1st day of the 6th month of the taxable year.	the 15th day of the 67th month of the taxable year
after the last day of the 5th month and before the 1st day of the 9th month of the taxable year.	the 15th day of the 9th month of the taxable year
after the last day of the 8th month and before the 1st day of the 12th month of the taxable year.	the 15th day of the 12th month of the taxable year

(c) *Place for filing declaration.* Except as provided in paragraph (b) of §301.6091–1 (relating to hand-carried documents), the declaration of estimated tax shall be filed at the place prescribed by the instructions applicable to such declaration. For example, if the instructions applicable to a declaration provide that the declaration of a corporation located in North Carolina be filed with the Director, Internal Revenue Service Center, Chamblee, Ga., such declaration shall be filed with the service center.

(d) *Amendment of declaration*—(1) *Taxable years beginning on or before December 31, 1963.* A declaration of estimated tax for a taxable year beginning on or before December 31, 1963, which is filed by a corporation prior to the 15th day of the 12th month of the taxable year may be amended in the manner prescribed in §1.6016–3, at any time on or before such 15th day. An amended declaration shall be filed with the internal revenue officer with whom the original declaration was filed.

(2) *Taxable years beginning after December 31, 1963.* In any case where a declaration of estimated tax for a taxable year beginning after December 31, 1963, has been filed, an amended declaration of estimated tax may be filed during any interval between installment dates prescribed for the taxable year. However, no amended declaration may be filed until after the installment date on or before which the original declaration was filed and only one amended declaration may be filed during each interval between installment dates. See §1.6016–3 for the manner of making an amended declaration. Except as provided in paragraph (b) of §301.6091–1 (relating to hand-carried documents), an amended declaration shall be filed with the internal revenue officer with whom the original declaration was filed.

[T.D. 6768, 29 FR 14922, Nov. 4, 1964, as amended by T.D. 6950, 33 FR 5355, Apr. 4, 1968]

§1.6074–2 Time for filing declarations by corporations in case of a short taxable year.

(a) *Taxable years beginning on or before December 31, 1963*—(1) *In general.* In the case of a short taxable year of 9 months or more beginning on or before December 31, 1963, where the requirements of section 6016(a) are met before the 1st day of the 9th month of the short taxable year, the declaration shall be filed on or before the 15th day of the 9th month of such short year. In the case of a short taxable year of more than 9 months, where the requirements of section 6016(a) are first met after the last day of the 8th month, but before the 1st day of the last month of the short taxable year, the declaration shall be filed on or before the 15th day of the last month of such short year. See §1.6016–4, relating to the requirement of a declaration in the case of a short taxable year, and paragraph (a) of §1.6154–2, relating to the time for payment of the estimated tax in case of a short taxable year.

(2) *Example.* The application of the provisions of this paragraph may be illustrated by the following example:

Example. A corporation which changes from a calendar year basis to a fiscal year basis beginning November 1, 1960, will have a short taxable year beginning January 1, 1960, and ending October 31, 1960. If the requirements of section 6016(a) are met before September 1, 1960 (the 1st day of the 9th month), the corporation is required to file its declaration on or before September 15, 1960 (the 15th day of the 9th month). However, if the requirements of section 6016(a) are first met after August 31, 1960 (the last day of the 8th month), but before October 1, 1960 (the 1st day of the last month of the short year), the corporation is required to file its declaration on or before October 15, 1960 (the 15th day of the last month of the short year).

(b) *Taxable years beginning after December 31, 1963*—(1) *In general.* In the case of a short taxable year of 4 or more months which begins after December 31, 1963, the declaration shall be filed on or before the applicable date specified in paragraph (b) of §1.6074–1, except that in the case of a short taxable year ending after November 30, 1964, the declaration shall be filed on or before the 15th day of the last month of the short taxable year if the requirements of section 6016(a) are first met before the first day of such last month and the date specified in such paragraph (b) as applicable is not within the short taxable year. See §1.6016–4, relating to the requirement of a declaration in the case of a short taxable year, and paragraph (b) of §1.6154–2, relating to the time for payment of the estimated tax in case of a short taxable year.

(2) *Examples.* The application of the provisions of this paragraph may be illustrated by the following examples:

Example (1). A corporation filing on a calendar year basis which changes to a fiscal year beginning September 1, 1965, will have a short taxable year beginning January 1, 1965, and ending August 31, 1965. If the requirements of section 6016(a) are met before April 1, 1965 (the 1st day of the 4th month), the declaration of estimated tax must be filed on or before April 15, 1965 (the 15th day of the 4th month).

Example (2). If, in the first example, the corporation first meets the requirements of section 6016(a) during July 1965, then the requirements of section 6016(a) were met before the first day of the last month of the short taxable year, and a declaration of estimated tax is required to be filed on or before August 15, 1965, for the short taxable year. However, if the corporation does not meet the requirements of section 6016(a) until August 1, 1965, then the requirements of section 6016(a) were not met before the first day of the last month of the short taxable year, and no declaration of estimated tax is required to be filed for the short taxable year.

(c) *Amendment of declaration*—(1) *Taxable years beginning on or before December 31, 1963.* Where a declaration of estimated tax for a short taxable year of more than 9 months beginning on or before December 31, 1963, is filed before the 15th day of the last month of the short taxable year, an amended declaration may be filed any time on or before such 15th day.

(2) *Taxable years beginning after December 31, 1963.* Where a declaration of estimated tax for a short taxable year beginning after December 31, 1963, has been filed, an amended declaration may be filed during any interval between installment dates. However, no amended declaration for a short taxable year may be filed until after the installment date on or before which the original declaration was filed and only one amended declaration may be filed during each interval between installment dates. For purposes of this subparagraph the term ‘‘installment date’’ includes the 15th day of the last month of a short taxable year if such 15th day does not fall on a prescribed installment date.

[T.D. 6768, 29 FR 14923, Nov. 4, 1964]

§1.6074–3 Extension of time for filing declarations by corporations.

(a) *In general.* District directors and directors of service centers are authorized to grant a reasonable extension of time for filing a declaration or an amended declaration. Except as provided in paragraph (b) of §301.6091–1 (relating to hand-carried documents), an application by a corporation for an extension of time for filing such a declaration shall be addressed to the internal revenue officer with whom the corporation is required to file its declaration and must contain a full recital of the causes for the delay.

(b) *Addition to tax applicable.* An extension of time granted to a corporation for filing a declaration of estimated tax automatically extends the time for paying the estimated tax (without interest) for the same period. However, such extension does not relieve the corporation from the addition to the tax imposed by section 6655, and the period of the underpayment will be determined under section 6655(c) without regard to such extension.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6950, 33 FR 5355, Apr. 4, 1968]

EXTENSION OF TIME FOR FILING RETURNS

§1.6081–1 Extension of time for filing returns.

(a) *In general.* District directors and directors of service centers are authorized to grant a reasonable extension of time for filing any return, declaration, statement, or other document which relates to any tax imposed by subtitle A of the code and which is required under the provisions of subtitle A or F of the code or the regulations thereunder. However, other than in the case of taxpayers who are abroad, such extensions of time shall not be granted for more than 6 months, and an extension of time for the filing of a return of a DISC (as defined in section 992(a)), as specified in section 6072(b), shall not be granted. Except in the case of an extension of time pursuant to §1.6081–2, an extension of time for filing an income-tax return shall not operate to extend the time for the payment of the tax or any installment thereof unless specified to the contrary in the extension.

In the case of an extension of time pursuant to § 1.6081–2, an extension of time for filing an income-tax return shall operate to extend the time for the payment of the tax or any installment thereof unless specified to the contrary in the extension. For rules relating to extension of time for paying tax, see § 1.6161–1.

(b) *Application for extension of time*—(1) *In general.* A taxpayer desiring an extension of the time for filing a return, statement, or other document shall submit an application therefor on or before the due date of such return, statement, or other document. Except as provided in subparagraph (3) of this paragraph and, except as provided in paragraph (b) of § 301.6091–1 (relating to hand-carried documents), such application shall be made to the internal revenue officer with whom such return, statement, or other document is required to be filed. Such application shall be in writing, properly signed by the taxpayer or his duly authorized agent, and shall clearly set forth (i) the particular tax return, information return, statement, or other document, including the taxable year or period thereof, with respect to which the extension of the time for filing is desired, and (ii) a full recital of the reasons for requesting the extension to aid such internal revenue officer in determining the period of extension, if any, which will be granted. In the case of a cemetery perpetual care fund trust, a distributee cemetery's failure to make timely expenditures of distributions which prevents accurate determination of the allowable deduction under section 642(i) will be considered reasonable grounds for a 6-month extension of time for filing the trust's return. See § 1.642(i)–1(c)(2).

(2) *Additional information in the case of Form 1040.* In addition to the information required under subparagraph (1) of this paragraph, the application of a taxpayer desiring an extension of the time for filing an individual income tax return on Form 1040 for any taxable year beginning after December 31, 1958, shall also set forth (i) whether an income tax return has been filed on or before its due date for each of the three taxable years immediately preceding the taxable year of such return, and if not, the reason for each failure, and (ii) whether the taxpayer was required to file a declaration of estimated tax for the taxable year of such return, and if so, whether each required estimated tax payment was made on or before its due date. For purposes of this subparagraph a return is considered as filed on or before its due date if it is filed on or before the applicable date provided in section 6072 or on or before the last day of the period covered by an extension of time granted pursuant to the provisions of section 6081, and each required payment of estimated tax is considered as paid on or before its due date if it is paid on or before the applicable date provided in section 6153 on or before the last day of the period covered by an extension of time granted pursuant to the provisions of section 6161.

(3) *Information returns filed with Service Center.* An application for an extension of the time for filing any information return required to be filed with an Internal Revenue Service Center shall state the location of the Service Center with which such return will be filed. Except as provided in paragraph (b) of § 301.6091–1 (relating to hand-carried documents), such application shall be made to the internal revenue officer with whom the applicant is required to file an income tax return or with whom the applicant would be required to file an income tax return if such a return were required of him.

(4) *Taxpayer unable to sign.* In any case in which a taxpayer is unable, by reason of illness, absence, or other good cause, to sign a request for an extension, any person standing in close personal or business relationship to the taxpayer may sign the request on his behalf, and shall be considered as a duly authorized agent for this purpose, provided the request sets forth the reasons for a signature other than the taxpayer's and the relationship existing between the taxpayer and the signer.

(5) *Form of application.* The application for an extension of the time for filing a return, statement, or other document may be made in the form of a letter. However, in the case of an individual income tax return on Form 1040, the application for an extension of the

time for filing may be made either on Form 2688 or in the form of a letter.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6581, 26 FR 11678, Dec. 6, 1961; T.D. 6950, 33 FR 5355, Apr. 4, 1968; T.D. 7260, 38 FR 4258, Feb. 12, 1973; T.D. 7533, 43 FR 6604, Feb. 15, 1978; T.D. 7651, 44 FR 61597, Oct. 26, 1979; T.D. 8241, 54 FR 7762, Feb. 23, 1989]

§1.6081–1T Extension of time to file return in case of taxpayers with mixed straddles (temporary).

The due date for the income tax return of trusts, estates, partnerships, and individual taxpayers filing their return for calendar year 1984 or for a fiscal year ending before February 1, 1985, shall be October 15, 1985, if—

(a) The taxpayer obtained an extension of time to file the return pursuant to §1.6081–1 or §1.6081–4, and the due date for the return (taking the extension into account) falls after August 7, 1985 and before October 16, 1985;

(b) The taxpayer did not file the return prior to August 8, 1985; and

(c) The taxpayer held one or more mixed straddles (within the meaning of section 1092(b)(2)) at any time after December 31, 1983, and before August 8, 1985.

[T.D. 8058, 50 FR 42014, Oct. 17, 1985]

§1.6081–2 Automatic extension of time to file partnership return of income.

(a) *In general.* A partnership required to file a return of income on Form 1065, U.S. Partnership Return of Income, for any taxable year will be allowed an automatic 3-month extension of time to file the return after the date prescribed for filing the return if an application under this section is filed in accordance with paragraph (b) of this section. In the case of a partnership described in §1.6081–5(a)(1), the automatic extension allowed under this section runs concurrently with an extension of time to file granted pursuant to §1.6081–5(a).

(b) *Requirements.* In order to satisfy this paragraph (b), an application for an automatic extension under this section must be—

(1) Submitted on Form 8736, Application for Automatic Extension of Time To File U.S. Return for a Partnership, REMIC or for Certain Trusts, or in any other manner as may be prescribed by the Commissioner;

(2) Filed on or before the later of—

(i) The date prescribed for filing the partnership return (without regard to any extensions of the time for filing such return); or

(ii) The expiration of any extension of time to file granted such partnership pursuant to §1.6081–5(a); and

(3) Filed with the Internal Revenue Service office designated in the application's instructions.

(c) *Payment of section 7519 amount.* An automatic extension of time for filing a partnership return under this section does not extend the time for payment of any amount due under section 7519, relating to required payments for entities electing not to have a required taxable year.

(d) *Section 444 election.* An automatic extension of time for filing a partnership return will run concurrently with any extension of time for filing a return allowed because of section 444, relating to the election of a taxable year other than a required taxable year.

(e) *Effect of extension on partner.* An automatic extension of time for filing a partnership return under this section does not operate to extend the time for filing a partner's income tax return or the time for the payment of any tax due on the partner's income tax return.

(f) *Termination of automatic extension.* The district director, including the Assistant Commissioner (International), or the director of a service center may terminate at any time an automatic extension by mailing to the partnership a notice of termination. The notice must be mailed at least 10 days prior to the termination date designated in such notice. The notice of termination must be mailed to the address shown on Form 8736 or to the partnerships's last known address.

(g) *Penalties.* See section 6698 for failure to file a partnership return.

(h) *Coordination with §1.6081–1.* Except in undue hardship cases, no extension of time for filing a partnership return of income will be granted under §1.6081–1 until an automatic extension has been allowed pursuant to the provisions of this section.

(i) *Effective date.* This section is effective for applications for an automatic extension of time to file a partnership return of income filed on or after December 31, 1996.

[T.D. 8703, 61 FR 69029, Dec. 31, 1996]

§ 1.6081–3 Automatic extension of time for filing corporation income tax returns.

(a) *In general.* A corporation shall be allowed an automatic extension of time to the fifteenth day of the sixth month (third month in the case of taxable years ending before December 31, 1982) following the month in which falls the date prescribed for the filing of its income tax return provided the following requirements are met:

(1) An application must be signed by a person authorized by the corporation to request such extension. Such person must be a person authorized under section 6062 to execute the return of the corporation; a person currently enrolled to practice before the Treasury Department; or after November 7, 1965, either an attorney who is a member in good standing of the bar of the highest court of a State, possession, territory, commonwealth, or the District of Columbia, or a certified public accountant duly qualified to practice in a State, possession, territory, commonwealth, or the District of Columbia.

(2) The application must be filed on or before the date prescribed for the filing of the return of the corporation with the internal revenue officer with whom the corporation is required to file its income tax return.

(3) The corporation shall make a remittance, on or before the date prescribed for payment, of the amount of the properly estimated unpaid tax liability. For taxable years beginning before 1983, the corporation shall make a remittance of an estimated amount of tax which shall not be less than would be required as the first installment under section 6152(a)(1) should the corporation elect to pay the tax in installments.

Upon the timely filing of Form 7004, properly prepared, the 6-month (3-month in the case of taxable years ending before December 31, 1982) extension shall be considered as allowed. For taxable years beginning before 1983, if the taxpayer elects to pay in installments the tax shown on Form 7004, the installment privilege provided in section 6152(a)(1) is limited to the amount shown on the form.

(b) *Consolidated returns.* An application for an automatic extension of time for filing a consolidated return shall be made by a person authorized by the parent corporation to request such extension. Such person must be a person authorized under section 6062 to execute the return of the parent corporation; a person currently enrolled to practice before the Treasury Department; or after November 7, 1965, either an attorney who is a member in good standing of the bar of the highest court of a State, possession, territory, commonwealth, or the District of Columbia, or a certified public accountant duly qualified to practice in a State, possession, territory, commonwealth, or the District of Columbia. There shall be attached to such application a statement listing the name and address of each member of the affiliated group for which such consolidated return will be made. For taxable years beginning after December 31, 1970, the application shall be filed with the internal revenue officer with which the parent corporation will file its income tax return. Upon the timely filing of Form 7004 with the internal revenue officer with which such corporation files its return, the 6-month (3-month in the case of taxable years ending before December 31, 1982) extension shall be considered as granted to the affiliated group for the filing of its consolidated return or for the filing of each member's separate return.

(c) *Special rule for the extension of time for the payment of tax.* Notwithstanding the application of § 1.6081–1(a), any automatic extension of time for filing a corporation income tax return granted under paragraph (a) or (b) of this section shall not operate to extend the time for payment of any tax due on such return.

(d) *Termination of automatic extension.* The district director, including the Director of International Operations, or the director of a service center may, in his discretion, terminate at any time an automatic extension by mailing to the corporation (parent corporation in the case of an affiliated group), or the person who requested such extension for the corporation, a notice of termination. The notice shall be mailed at least 10 days prior to the termination date designated in such notice. The notice of termination shall be sufficient for all purposes when mailed to the corporation at its address shown on Form 7004 or to the person who requested such extension for the corporation at his last known address or last known place of business, even if such corporation has terminated its existence, or such person is deceased or is under a legal disability.

(e) Paragraphs (a) through (d) of this section shall not apply to returns filed by a DISC pursuant to section 6011(c)(2).

[T.D. 7567, 43 FR 45582, Oct. 3, 1978, as amended by T.D. 7885, 48 FR 16484, Apr. 18, 1983]

§1.6081–4 Automatic extension of time for filing individual income tax returns.

(a) *In general*—(1) *Period of extension*. An individual who is required to file an individual income tax return will be allowed an automatic 4-month extension of time to file the return after the date prescribed for filing the return provided the requirements contained in paragraphs (a)(2), (3), and (4) of this section are met. In the case of an individual described in §1.6081–5(a)(5) or (6), the automatic 4-month extension will run concurrently with the extension of time to file granted pursuant to §1.6081–5.

(2) *Manner for submitting an application*. An application must be submitted—

(i) On Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return; or

(ii) In any other manner as may be prescribed by the Commissioner.

(3) *Time and place for filing application*. Except in the case of an individual described in §1.6081–5(a)(5) or (6), the application must be filed on or before the date prescribed for filing the individual income tax return. In the case of an individual described in §1.6081–5(a)(5) or (6), the application must be filed on or before the expiration of the extension of time to file granted pursuant to §1.6081–5. The application must be filed with the Internal Revenue Service office designated in the application's instructions.

(4) *Proper estimate of tax*. An application for extension must show the full amount properly estimated as tax for the taxable year.

(5) *Coordination with §1.6081–1*. Except in undue hardship cases, no extension of time for filing an individual income tax return will be granted under §1.6081–1 until an automatic extension has been allowed pursuant to the provisions of this paragraph (a).

(b) *Special rule for the extension of time for the payment of tax*. Notwithstanding the application of §1.6081–1(a), any automatic extension of time for filing an individual income tax return granted under paragraph (a) of this section shall not operate to extend the time for payment of any tax due on such return.

(c) *Termination of automatic extension*. The district director, including the Assistant Commissioner (International), or the director of a service center may terminate at any time an automatic extension by mailing to the taxpayer a notice of termination. The notice must be mailed at least 10 days prior to the termination date designated in such notice. The notice of termination must be mailed to the taxpayer at the address shown on Form 4868 or to the taxpayer's last known address.

(d) *Penalties*. See section 6651 for failure to file an individual income tax return or failure to pay the amount shown as tax on the return. In particular, see §301.6651–1(c)(3) of this chapter (relating to a presumption of reasonable cause in certain circumstances involving an automatic extension of time for filing an individual income tax return).

(e) *Effective date*. This section is effective for applications for an automatic extension of time to file an individual income tax return filed on or after December 31, 1996.

[T.D. 7567, 43 FR 45583, Oct. 3, 1978, as amended by T.D. 7885, 48 FR 16484, Apr. 18, 1983; T.D. 8651, 61 FR 261, Jan. 4, 1996; T.D. 8703, 61 FR 69030, Dec. 31, 1996]

§1.6081–5 Extensions of time in the case of certain partnerships, corporations and U.S. citizens and residents.

(a) The rules in paragraphs (a) through (e) of this section apply to returns of income due after April 15, 1988. An extension of time for filing returns of income and for paying any tax shown on the return is hereby granted to and including the fifteenth day of the sixth month following the close of the taxable year in the case of:

(1) Partnerships which are required under §1.6031–1(e)(2) to file returns on the fifteenth day of the fourth month following the close of the taxable year of the partnership, and which keep their records and books of account outside the United States and Puerto Rico;

(2) Domestic corporations which transact their business and keep their records and books of account outside the United States and Puerto Rico;

(3) Foreign corporations which maintain an office or place of business within the United States;

(4) Domestic corporations whose principal income is from sources within the possessions of the United States;

(5) United States citizens or residents whose tax homes and abodes, in a real and substantial sense, are outside the United States and Puerto Rico; and

(6) United States citizens and residents in military or naval service on duty, including non-permanent or short term duty, outside the United States and Puerto Rico.

(b) In order to qualify for the extension under this section, a statement must be attached to the return showing that the person for whom the return is made is a person described in paragraph (a) of this section.

(c) For purposes of paragraph (a)(5) of this section, whether a person is a United States resident will be determined in accordance with section 7701(b) of the Code. The term ‘‘tax home,’’ as used in paragraph (a)(5), will have the same meaning which it has for purposes of section 162(a)(2) (relating to travel expenses away from home). If a person does not have a regular or principal place of business, that person’s tax home will be considered to be his regular place of abode in a real and substantial sense.

(d) In order to qualify for the extension under paragraph (a)(6), the assigned tour of duty outside the United States and Puerto Rico must be for a period that includes the entire due date of the return.

(e) A person otherwise qualifying for the extension under paragraph (a)(5) or paragraph (a)(6) shall not be disqualified because he is physically present in the United States or Puerto Rico at any time, including the due date of the return.

(f) With respect to income tax returns due on April 15, 1988, an extension of time for filing a return of income and for paying any tax shown on that return is hereby granted to and including the fifteenth day of the sixth month following the close of the taxable year in the case of citizens or residents of the United States who are traveling outside the United States and Puerto Rico. A taxpayer will be considered to be traveling outside the United States and Puerto Rico only if the period of travel outside the United States and Puerto Rico is a period of at least fourteen days continuous travel that includes all of April 15, 1988. For returns due after April 15, 1988, no extension will be granted to taxpayers traveling outside the United States and Puerto Rico.

[T.D. 8312, 55 FR 37227, Sept. 10, 1990; 55 FR 41310, Oct. 10, 1990]

§1.6081–6 Automatic extension of time to file trust income tax return.

(a) *In general.* A trust required to file an income tax return on Form 1041, U.S. Income Tax Return for Estates and Trusts, for any taxable year will be allowed an automatic 3-month extension of time to file the return after the date prescribed for filing the return if an application under this section is filed in accordance with paragraph (b) of this section.

(b) *Requirements.* To satisfy this paragraph (b), an application for an automatic extension under this section must—

(1) Be submitted on Form 8736, Application for Automatic Extension of Time To File U.S. Return for a Partnership, REMIC or for Certain Trusts,

or in any other manner as may be prescribed by the Commissioner;

(2) Be filed on or before the date prescribed for filing the trust income tax return with the Internal Revenue Service office designated in the application's instructions; and

(3) Show the full amount properly estimated as tax for the trust for the taxable year.

(c) *Effect of extension on beneficiary.* An automatic extension of time to file a trust income tax return under this section will not operate to extend the time for filing the income tax return of a beneficiary of the trust or the time for the payment of any tax due on the beneficiary's income tax return.

(d) *Termination of automatic extension.* The district director, including the Assistant Commissioner (International), or the director of a service center may terminate at any time an automatic extension by mailing to the trust a notice of termination. The notice must be mailed at least 10 days prior to the termination date designated in such notice. The notice of termination must be mailed to the address shown on Form 8736 or to the trust's last known address.

(e) *Penalties.* See section 6651 for failure to file a trust income tax return or failure to pay the amount shown as tax on the return.

(f) *Coordination with §1.6081–1.* Except in undue hardship cases, no extension of time for filing a trust income tax return will be granted under §1.6081–1 until an automatic extension has been allowed pursuant to the provisions of this section.

(g) *Effective date.* This section is effective for applications for an automatic extension of time to file a trust income tax return filed on or after December 31, 1996.

[T.D. 8703, 61 FR 69030, Dec. 31, 1996]

§1.6081–7 Automatic extension of time to file Real Estate Mortgage Investment Conduit (REMIC) income tax return.

(a) *In general.* A Real Estate Mortgage Investment Conduit (REMIC) required to file an income tax return on Form 1066, U.S. Real Estate Mortgage Investment Conduit Income Tax Return, for any taxable year will be allowed an automatic 3-month extension of time to file the return after the date prescribed for filing the return if an application under this section is filed in accordance with paragraph (b) of this section.

(b) *Requirements.* To satisfy this paragraph (b), an application for an automatic extension under this section must—

(1) Be submitted on Form 8736, Application for Automatic Extension of Time To File U.S. Return for a Partnership, REMIC or for Certain Trusts, or in any other manner as may be prescribed by the Commissioner;

(2) Be filed on or before the date prescribed for filing the REMIC income tax return with the Internal Revenue Service office designated in the application's instructions; and

(3) Show the full amount properly estimated as tax for the REMIC for the taxable year.

(c) *Effect of extension on residual or regular interest holders.* An automatic extension of time to file a REMIC income tax return under this section will not operate to extend the time for filing the income tax return of a residual or regular interest holder of the REMIC or the time for the payment of any tax due on the residual or regular interest holder's income tax return.

(d) *Termination of automatic extension.* The district director, including the Assistant Commissioner (International), or the director of a service center may terminate at any time an automatic extension by mailing to the REMIC a notice of termination. The notice must be mailed at least 10 days prior to the termination date designated in such notice. The notice of termination must be mailed to the address shown on Form 8736 or to the REMIC's last known address.

(e) *Penalties.* See sections 6698 and 6651 for failure to file a REMIC income tax return or failure to pay the amount shown as tax on the return.

(f) *Coordination with §1.6081–1.* Except in undue hardship cases, no extension of time for filing a REMIC income tax return will be granted under §1.6081–1 until an automatic extension has been allowed pursuant to the provisions of this section.

(g) *Effective date.* This section is effective for applications for an automatic extension of time to file a REMIC income tax return filed on or after December 31, 1996.

[T.D. 8703, 61 FR 69030, Dec. 31, 1996]

PLACE FOR FILING RETURNS OR OTHER DOCUMENTS

§ 1.6091–1 Place for filing returns or other documents.

(a) *In general.* Except as provided in § 1.6091–4, whenever a return, statement, or other document is required to be made under the provisions of subtitle A or F of the Code, or the regulations thereunder, with respect to any tax imposed by subtitle A of the Code, and the place for filing such return, statement, or other document is not provided for by the Code, it shall be filed at the place prescribed by the regulations contained in this chapter.

(b) *Place for filing certain information returns.* (1) For the place for filing returns of parnership income, see paragraph (e)(1) of § 1.6031–1.

(2) For the place for filing information returns by banks with respect to common trust funds, see § 1.6032–1.

(3) For the place for filing information returns by certain organizations exempt from taxation under section 501(a), see paragraph (e) of § 1.6033–1.

(4) For the place for filing information returns by trusts claiming charitable deductions under section 642(c), see paragraph (c) of § 1.6034–1.

(5) For the place for filing information returns by officers, directors, and shareholders of foreign personal holding companies, see paragraph (d) of § 1.6035–1 and paragraph (d) of § 1.6035–2.

(6) For the place for filing information returns relating to certain stock option transactions, see paragraph (c) of § 1.6039–1.

(7) For the place for filing returns of information reporting certain payments, see paragraph (a)(5) of § 1.6041–2 and § 1.6041–6.

(8) For the place for filing returns of information regarding payments of dividends, see paragraph (d) of § 1.6042–1 and paragraph (c) of § 1.6042–2 (relating to returns for calendar years after 1962).

(9) For the place for filing information returns by corporations relating to contemplated dissolution or liquidation, see paragraph (a) of § 1.6043–1.

(10) For the place for filing information returns by corporations relating to distributions in liquidation, see paragraph (a) of § 1.6043–2.

(11) For the place for filing returns of information regarding payments of patronage dividends, see paragraph (b) of § 1.6044–1, and paragraph (d) of § 1.6044–2 (relating to returns for calendar years after 1962).

(12) For the place for filing information returns relating to formation or reorganization of foreign corporations, see paragraph (e) of § 1.6046–1.

(13) For the place for filing information returns regarding certain payments of interest, see paragraph (c) of § 1.6049–1.

(14) For the place for filing information returns with respect to payment of wages in the form of group-term life insurance, see paragraph (b) of § 1.6052–1.

(15) For the place for filing information returns on Forms 1042–S with respect to certain amounts paid to foreign persons, see instructions to the form.

(16) For the place for filing information returns on Form 5074 with respect to the allocation of individual income tax to Guam, see paragraph (b)(3) of § 1.935–1 and paragraph (d) of § 301.7654–1 of this chapter (Regulations on Procedure and Administration).

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6887, 31 FR 8814, June 24, 1966; T.D. 6922, 32 FR 8713, June 17, 1967; T.D. 7284, 38 FR 20829, Aug. 3, 1973; T.D. 7385, 40 FR 50264, Oct. 29, 1975; T.D. 8734, 62 FR 53493, Oct. 14, 1997]

EFFECTIVE DATE NOTE: By T.D. 8734, 62 FR 53493, Oct. 14, 1997, in § 1.6091–1, paragraph (b)(15) was revised, effective Jan. 1, 1999. By T.D. 8804, 63 FR 72183, Dec. 31, 1998, the effectiveness of § 1.6091–1 was delayed until Jan. 1, 2000. For the convenience of the user, the superseded text is set forth as follows:

§ 1.6091–1 Place for filing returns or other documents.

* * * * *

(b) * * *

(15) For the place for filing information returns on Form 1042S with respect to certain

amounts paid to nonresident alien individuals, foreign partnerships, or foreign corporations, see paragraph (c) of §1.1461–2.

* * * * *

§1.6091–2 Place for filing income tax returns.

Except as provided in §1.6091–3 (relating to income tax returns required to be filed with the Director of International Operations) and §1.6091–4 (relating to exceptional cases):

(a) *Individuals, estates, and trusts.* (1) Except as provided in paragraph (c) of this section, income tax returns of individuals, estates, and trusts shall be filed with the district director for the internal revenue district in which is located the legal residence or principal place of business of the person required to make the return, or, if such person has no legal residence or principal place of business in any internal revenue district, with the District Director at Baltimore, Md. 21202.

(2) An individual employed on a salary or commission basis who is not also engaged in conducting a commercial or professional enterprise for profit on his own account does not have a ‘‘principal place of business’’ within the meaning of this section.

(b) *Corporations.* Except as provided in paragraph (c) of this section, income tax returns of corporations shall be filed with the district director for the internal revenue district in which is located the principal place of business or principal office or agency of the corporation.

(c) *Returns filed with service centers.* Notwithstanding paragraphs (a) and (b) of this section, whenever instructions applicable to income tax returns provide that the returns be filed with a service center, the returns must be so filed in accordance with the instructions.

(d) *Hand-carried returns.* Notwithstanding paragraphs (1) and (2) of section 6091(b) and paragraph (c) of this section:

(1) *Persons other than corporations.* Returns of persons other than corporations which are filed by hand carrying shall be filed with the district director (or with any person assigned the adminstrative supervision of an area, zone or local office constituting a permanent post of duty within the internal revenue district of such director) as provided in paragraph (a) of this section.

(2) *Corporations.* Returns of corporations which are filed by hand carrying shall be filed with the district director (or with any person assigned the administrative supervision of an area, zone or local office constituting a permanent post of duty within the internal revenue district of such director) as provided in paragraph (b) of this section.

See §301.6091–1 of this chapter (Regulations on Procedure and Administration) for provisions relating to the definition of hand carried.

(e) *Amended returns.* In the case of amended returns filed after April 14, 1968, except as provided in paragraph (d) of this section:

(1) *Persons other than corporations.* Amended returns of persons other than corporations shall be filed with the service center serving the internal revenue district referred to in paragraph (a) of this section.

(2) *Corporations.* Amended returns of corporations shall be filed with the service center serving the internal revenue district referred to in paragraph (b) of this section.

(f) *Returns of persons subject to a termination assessment.* Notwithstanding paragraph (c) of this section:

(1) *Persons other than corporations.* Returns of persons other than corporations with respect to whom an assessment was made under section 6851(a) with respect to the taxable year shall be filed with the district director as provided in paragraph (a) of this section.

(2) *Corporations.* Returns of corporations with respect to whom an assessment was made under section 6851(a) with respect to the taxable year shall be filed with the district director as provided in paragraph (b) of this section.

(g) *Returns of persons subject to a termination assessment.* Notwithstanding paragraph (c) of this section, income tax returns of persons with respect to whom an income tax assessment was made under section 6852(a) with respect to the taxable year must be filed with the district director as provided in paragraphs (a) and (b) of this section.

[T.D. 6950, 33 FR 5356, Apr. 4, 1968, as amended by T.D. 7012, 34 FR 7690, May 15, 1969; T.D. 7495, 42 FR 33726, July 1, 1977; T.D. 7575, 43 FR 58816, Dec. 18, 1978; T.D. 8628, 60 FR 62210, Dec. 5, 1995]

§1.6091–3 Income tax returns required to be filed with Director of International Operations.

The following income tax returns shall be filed with the Director of International Operations, Internal Revenue Service, Washington, DC 20225, or the district director, or the director of the service center, depending on the appropriate officer designated on the return form or in the instructions issued with respect to such form:

(a) Income tax returns on which all, or a portion, of the tax is to be paid in foreign currency. See §§301.6316–1 to 301.6316–6 inclusive, and §§301.6316–8 and 301.6316–9 of this chapter (Regulations on Procedure and Administration).

(b) Income tax returns on an individual citizen of the United States whose principal place of abode for the period with respect to which the return is filed is outside the United States. A taxpayer's principal place of abode will be considered to be outside the United States if his legal residence is outside the United States or if his return bears a foreign address.

(c) Income tax returns of an individual citizen of a possession of the United States (whether or not a citizen of the United States) who has no legal residence or principal place of business in any internal revenue district in the United States.

(d) Except in the case of any departing alien return under section 6851 and §1.6851–2, the income tax return of any nonresident alien (other than one treated as a resident under section 6013 (g) or (h)).

(e) The income tax return of an estate or trust the fiduciary of which is outside the United States and has no legal residence or principal place of business in any internal revenue district in the United States.

(f) Income tax returns of foreign corporations.

(g) The return by a withholding agent of the income tax required to be withheld at source under chapter 3 of the Code on nonresident aliens and foreign corporations and tax-free covenant bonds, as provided in §1.1461–2.

(h) Income tax returns of persons who claim the benefits of section 911 (relating to earned income from sources without the United States).

(i) Income tax returns of corporations which claim the benefits of section 922 (relating to special deduction for Western Hemisphere trade corporations) except in the case of consolidated returns filed pursuant to the regulations under section 1502.

(j) Income tax returns of persons who claim the benefits of section 931 (relating to income from sources within possessions of the United States).

(k) Income tax returns of persons who claim the benefits of section 933 (relating to income from sources within Puerto Rico).

(l) Income tax returns of corporations which claim the benefits of section 941 (relating to the special deduction for China Trade Act corporations).

[T.D. 6950, 33 FR 5357, Apr. 4, 1968, as amended by T.D. 7012, 34 FR 7690, May 15, 1969; T.D. 7670, 45 FR 6931, Jan. 31, 1980]

§1.6091–4 Exceptional cases.

(a) *Permission to file in district other than required district.* (1) The Commissioner may permit the filing of any income tax return required to be made under the provisions of subtitle A or F of the Code, or the regulations in this part, in any internal revenue district, notwithstanding the provisions of paragraphs (1) and (2) of section 6091(b) and §§1.6091–1 to 1.6091–3, inclusive.

(2) In cases where the Commissioner authorizes (for all purposes except venue) a director of an internal revenue service center to receive returns, such returns pursuant to instructions issued with respect thereto, may be sent directly to the director and are thereby filed with him for all purposes except as a factor in determining venue. However, after initial processing all such returns shall be forwarded by the director of a service center to the office with which such returns are, without regard to this subparagraph, required to be filed. For the sole purpose of determining venue,

such returns are filed only with such office.

(3) Notwithstanding the provisions of other sections of this chapter or any rule issued under this chapter:

(i) In cases where, in accordance with subparagraph (2) of this paragraph, a return is filed with the director of a service center, the authority of the district director with whom such return would, without regard to such subparagraph, be required to be filed shall remain the same as if the return had been so filed;

(ii) Unless a return or other document is a proper attachment to, or is, a return which the director of a service center is expressly authorized to receive, such return or other document shall be filed as if all returns sent directly to the service centers, in accordance with subparagraph (2) of this paragraph, were filed in the office where such returns are, without regard to such subparagraph, required to be filed; and

(iii) Unless the performance of an act is directly related to the sending of a return directly to the director of a service center, such act shall be performed as if all returns sent directly to the service centers, in accordance with subparagraph (2) of this paragraph, were filed in the office where such returns are, without regard to such subparagraph, required to be filed.

(4) The application of subparagraphs (2) and (3) of this paragraph may be illustrated by the following examples:

Example (1). The Commissioner has authorized the Director, Internal Revenue Service Center, Chamblee, Georgia (for all purposes except venue), to receive Forms 1040 and 1040A. A, a resident of Greensboro, North Carolina, is required to file his Form 1040 for the calendar year 1964 with the District Director, Greensboro, North Carolina. In addition, A is required to file his declaration of estimated tax, Form 1040ES, for the calendar year 1965, which under paragraph (c) of §1.6073–1 must be filed with the district director for the district in which A expects to file his income tax return. Under subparagraph (2) of this paragraph A may send his Form 1040 to either the director of the service center or to his district director. However, since his Form 1040ES is not a proper attachment to his income tax return, he shall send his Form 1040ES to his district director (with whom he is, without regard to subparagraph (2) of this paragraph, required to file his income tax return).

Example (2). Assume the same facts as in Example (1), and in addition, that A is required to attach copies of his Forms W–2 to his income tax return, Form 1040. Therefore, A must attach copies of his Forms W–2 to his Form 1040 and send both to either his district director or the director of the service center.

Example (3). Assume the facts in Example (1) and in addition, that A sends his Form 1040 to the director of the service center. Assume further that A is entitled to file a claim under section 6421 for refund of certain taxes paid for gasoline used for certain nonhighway uses. Under paragraph (c) of §48.6421(c)–1 of this chapter the claim on Form 843 shall be filed with the district director with whom the claimant filed his latest income tax return. Since Form 843 is not a proper attachment to A's Form 1040, the claim shall be sent to A's district director since his is the office with which A would, without regard to subparagraph (2) of this paragraph, be required to file his Form 1040.

Example (4). Taxpayer B sends his Form 1040 to the director of a service center. B wishes to apply for an extension of the period of replacement for involuntarily converted property pursuant to section 1033 of the Code. Under paragraph (c)(3) of §1.1033(a)-2 of this chapter such application is to be made to the district director for the internal revenue district in which the income tax return is filed for the first taxable year during which any of the gain from the involuntary conversion is realized. Pursuant to subparagraph (3) of this paragraph, B shall apply to the district director for the internal revenue district in which such income tax return is, without regard to subparagraph (2) of this paragraph, required to be filed. Such district director is authorized to grant or withhold such extension of the period of replacement.

Example (5). Taxpayer C sends his return directly to the director of a service center. C wishes to receive certain information concerning the value of a reversionary interest with respect to his charitable contribution under section 170 of the Code. Under paragraph (d)(2) of §1.170–2 of this Chapter, C may upon request, obtain the information from the district director with whom he files his income tax return. Under subparagraph (3) of this paragraph, C shall request such information from the district director with whom he would, without regard to subparagraph (2) of this paragraph, be required to file his return.

(b) *Returns of officers and employees of the Internal Revenue Service.* The Commissioner may require any officer or employee of the Internal Revenue Service to file his income tax return in any district selected by the Commissioner.

(c) *Residents of Guam.* Income tax returns of an individual citizen of the United States who is a resident of Guam shall be filed with Guam, as provided in paragraph (b)(1) of § 1.935–1.

[T.D. 6500, 25 FR 12108, Nov. 26, 1960, as amended by T.D. 6793, 30 FR 704, Jan. 22, 1965; T.D. 7385, 40 FR 50264, Oct. 29, 1975]

MISCELLANEOUS PROVISIONS

§ 1.6102–1 Computations on returns or other documents.

For provisions with respect to the rounding off to whole-dollar amounts of money items on returns and accompanying schedules, see § 301.6102–1 of this chapter (Regulations on Procedure and Administration).

[T.D. 6500, 25 FR 12137, Nov. 26, 1960]

§ 1.6107–1 Income tax return preparer must furnish copy of return to taxpayer and must retain a copy or record.

(a) *Furnishing copy to taxpayer.* The person who is an income tax return preparer of any return of tax under subtitle A of the Internal Revenue Code of 1954 or claim for refund of tax under subtitle A of the Internal Revenue Code of 1954 shall furnish a completed copy of the original return or claim for refund to the taxpayer (or nontaxable entity) not later than the time the original return or claim for refund is presented for the signature of the taxpayer (or nontaxable entity). The preparer may, if it wishes request a receipt or other evidence from the taxpayer (or nontaxable entity) sufficient to show satisfaction of the requirement of this paragraph (a).

(b) *Copy or record to be retained.* The person who is an income tax return preparer of any return or claim for refund shall:

(1)(i) Retain a completed copy of the return or claim for refund; or

(ii) Retain a record, by list, card file, or otherwise of the name, taxpayer identification number, and taxable year of the taxpayer (or nontaxable entity) for whom the return or claim for refund was prepared and the type of return of claim for refund prepared;

(2) Retain a record, by retention of a copy of the return or claim for refund, maintenance of a list or card file, or otherwise, for each return or claim for refund presented to the taxpayer (or nontaxable entity) of the name of the individual preparer required to sign the return or claim for refund pursuant to § 1.6695–1(b); and

(3) Make the copy or record of returns and claims for refund and record of the individuals required to sign available for inspection upon request by the district director.

The material described in this paragraph (b) shall be retained and kept available for inspection for the 3–year period following the close of the return period during which the return or claim for refund was presented for signature to the taxpayer (or nontaxable entity). However, in the case of a return which becomes due (with extensions, if any) during a return period following the return period during which the return was presented for signature, the material shall be retained and kept available for inspection or the 3–year period following the close of the later return period in which the return became due. For the definition of ''return period'' see section 6060(c). If the person subject to the record retention requirement of this paragraph (b) is a corporation or a partnership which is dissolved before completion of the 3-year period, then all persons who under state law are responsible for the winding up of the affairs of the corporation or partnership shall be subject, on behalf of the corporation or partnership, to these record retention requirements until completion of the 3-year period. If state law does not specify any person or persons as responsible for winding up, then, collectively, the directors or general partners shall be subject, on behalf of the corporation or partnership, to the record retention requirements of this paragraph (b). For purposes of the penalty imposed by section 6695(d), such designated persons shall be deemed to be the income tax return preparer and will be jointly and severally liable for each failure.

(c) *Preparer.* For the definition of ''income tax return preparer'', see section 7701(a)(36) and § 3071.7701–15. For purposes of applying this section, in the case of:

(1) An employment arrangement between two or more income tax return

preparers, the person who employs (or engages) one or more other preparers to prepare for compensation any return or claim for refund other than for the person shall be considered to be the sole income tax return preparer; and

(2) A partnership arrangement for the preparation of returns and claims for refund, the partnership shall be considered to be the sole income tax return preparer.

(d) *Penalties.* (1) For the civil penalty for failure to furnish a copy of the return or claim for refund to the taxpayers (or nontaxable entity) as required under paragraphs (a) and (c) of this section, see section 6695(a) and §1.6695–(a).

(2) For the civil penalty for failure to retain a copy of the return or claim for refund, or to retain a record as required under paragraphs (b) and (c) of this section, see section 6695(d) and §1.6695–1(d).

(Sec. 6060(b), Internal Revenue Code of 1954 (90 Stat. 1691, (26 U.S.C. 6060(b))); sec. 7805, Internal Revenue Code of 1954 (68A Stat. 917, (26 U.S.C. 7805))

[T.D. 7519, 42 FR 59967, Nov. 23, 1977, as amended by T.D. 7640, 44 FR 49452, Aug. 23, 1979; T.D. 7948, 49 FR 8601, Mar. 8, 1984]

§1.6109–1 Identifying numbers.

(a) *Information to be furnished after April 15, 1974.* For provisions concerning the requesting and furnishing of identifying numbers with respect to returns, statements, and other documents which must be filed after April 15, 1974, see §301.6109–1 of this chapter (Regulations on Procedure and Administration).

(b) *Information to be furnished before April 15, 1974.* For provisions concerning the requesting and furnishing of identifying numbers with respect to returns, statements, and other documents which must be filed before April 16, 1974, see 26 CFR §1.6109–1 (revised as of April 1, 1973).

[T.D. 7306, 39 FR 9946, Mar. 15, 1974; 39 FR 11080, Mar. 25, 1974]

§1.6109–2 Furnishing identifying number of income tax return preparer.

(a) *Furnishing identifying number.* Each return of tax under subtitle A of the Internal Revenue Code of 1954 or claim for refund of tax under subtitle A of the Internal Revenue Code of 1954 prepared by one or more income tax return preparers shall bear the identifying number of the preparer required by §1.6695–1(b) to sign the return or claim for refund. In addition, it there is a partnership or employment arrangement between two or more preparers, the identifying number of the partnership or the person who employs (or engages) one or more other persons to prepare for compensation the return or claim for refund shall also appear on the return or claim for refund. If the preparer is:

(1) An individual (not described in subparagraph (2) of this paragraph (a) who is a citizen or resident of the United States such preparer's social security account number shall be affixed; and

(2) A person (whether an individual, corporation, or partnership) who employs (or engages) one or more persons to prepare the return or claim for refund (other than for the person), or who is not a citizen or resident of the United States and also is not employed or engaged by another preparer, such preparer's employer identification number shall be affixed.

For the definition of the term ''income tax return preparer'' (or ''preparer'') see section 7701(a)(36) and §301.7701–15.

(b) *Furnishing address.* (1) Each return or claim for refund which is prepared by one or more income tax return preparers shall bear the street address, city, State, and postal ZIP code of that preparer's place of business where the preparation of the return or claim for refund was completed. However, if this place of business is not maintained on a year-round basis, the return or claim for refund shall bear the street address, city, State, and postal ZIP code of such preparer's principal office or business location which is maintained on a yearround basis, or it none, that preparer's residence.

(2) For purposes of satisfying the requirement of the first sentence of paragraph (b)(1) of this section, and income tax return preparer, may, on returns and claims for refund, disclose only the postal ZIP code of the described place of business as a satisfactory address, but only if the preparer first by written

notice advises each affected Internal Revenue Service Center that he intends to follow this practice.

(c) *Penalty.* For the civil penalty for failure to furnish an identifying number as required under paragraph (a) of this section, see section 6695(c) and § 1.6695–1(c).

[T.D. 7519, 42 FR 59967, Nov. 23, 1977]

§ 1.6115–1 Disclosure requirements for quid pro quo contributions.

(a) *Good faith estimate defined*—(1) *In general.* A good faith estimate of the value of goods or services provided by an organization described in section 170(c) in consideration for a taxpayer's payment to that organization is an estimate of the fair market value, within the meaning of § 1.170A–1(c)(2), of the goods or services. The organization may use any reasonable methodology in making a good faith estimate, provided it applies the methodology in good faith. If the organization fails to apply the methodology in good faith, the organization will be treated as not having met the requirements of section 6115. See section 6714 for the penalties that apply for failure to meet the requirements of section 6115.

(2) *Good faith estimate for goods or services that are not commercially available.* A good faith estimate of the value of goods or services that are not generally available in a commercial transaction may be determined by reference to the fair market value of similar or comparable goods or services. Goods or services may be similar or comparable even though they do not have the unique qualities of the goods or services that are being valued.

(3) *Examples.* The following examples illustrate the rules of this paragraph (a).

Example 1. Facility not available on a commercial basis. Museum *M,* an organization described in section 170(c), is located in Community *N.* In return for a payment of $50,000 or more, *M* allows a donor to hold a private event in a room located in *M.* Private events other than those held by such donors are not permitted to be held in *M.* In Community *N,* there are four hotels, *O, P, Q,* and *R,* that have ballrooms with the same capacity as the room in *M.* Of these hotels, only *O* and *P* have ballrooms that offer amenities and atmosphere that are similar to the amenities and atmosphere of the room in *M* (although *O* and *P* lack the unique collection of art that is displayed in the room in *M*). Because the capacity, amenities, and atmosphere of ballrooms in *O* and *P* are comparable to the capacity, amenities, and atmosphere of the room in *M,* a good faith estimate of the benefits received from *M* may be determined by reference to the cost of renting either the ballroom in *O* or the ballroom in *P.* The cost of renting the ballroom in *O* is $2500 and, therefore, a good faith estimate of the fair market value of the right to host a private event in the room at *M* is $2500. In this example, the ballrooms in *O* and *P* are considered similar and comparable facilities to the room in *M* for valuation purposes, notwithstanding the fact that the room in *M* displays a unique collection of art.

Example 2. Services available on a commercial basis. Charity *S* is an organization described in section 170(c). *S* offers to provide a one-hour tennis lesson with Tennis Professional *T* in return for the first payment of $500 or more that it receives. *T* provides one-hour tennis lessons on a commercial basis for $100. Taxpayer pays $500 to *S* and in return receives the tennis lesson with *T.* A good faith estimate of the fair market value of the lesson provided in exchange for Taxpayer's payment is $100.

Example 3. Celebrity presence. Charity *U* is an organization described in section 170(c). In return for the first payment of $1000 or more that it receives, *U* will provide a dinner for two followed by an evening tour of Museum *V* conducted by Artist *W,* whose most recent works are on display at *V. W* does not provide tours of *V* on a commercial basis. Typically, tours of *V* are free to the public. Taxpayer pays $1000 to *U* and in return receives a dinner valued at $100 and an evening tour of *V* conducted by *W.* Because tours of *V* are typically free to the public, a good faith estimate of the value of the evening tour conducted by *W* is $0. In this example, the fact that Taxpayer's tour of *V* is conducted by *W* rather than *V*'s regular tour guides does not render the tours dissimilar or incomparable for valuation purposes.

(b) *Certain goods or services disregarded.* For purposes of section 6115, an organization described in section 170(c) may disregard goods or services described in § 1.170A–13(f)(8)(i).

(c) *Value of the right to purchase tickets to college or university athletic events.* For purposes of section 6115, the right to purchase tickets for seating at an athletic event in exchange for a payment described in section 170(l) is treated as having a value equal to twenty percent of such payment.

(d) *Goods or services provided to employees or partners of donors*—(1) *Certain* *goods or services disregarded.* For purposes of section 6115, goods or services provided by an organization described in section 170(c) to employees of a donor or to partners of a partnership that is a donor in return for a payment to the donee organization may be disregarded to the extent that the goods or services provided to each employee or partner are the same as those described in §1.170A–13(f)(8)(i).

(2) *Description permitted in lieu of good faith estimate for other goods or services.* The written disclosure statement required by section 6115 may include a description of goods or services, in lieu of a good faith estimate of their value, if the donor is—

(i) An employer and, in return for the donor's quid pro quo contribution, an organization described in section 170(c) provides the donor's employees with goods or services other than those described in paragraph (d)(1) of this section; or

(ii) A partnership and, in return for its quid pro quo contribution, the organization provides partners in the partnership with goods or services other than those described in paragraph (d)(1) of this section.

(e) *Effective date.* This section applies to contributions made on or after December 16, 1996. However, taxpayers may rely on the rules of this section for contributions made on or after January 1, 1994.

[T.D. 8690, 61 FR 65954, Dec. 16, 1996]

TIME AND PLACE FOR PAYING TAX

PLACE AND DUE DATE FOR PAYMENT OF TAX

§1.6151–1 Time and place for paying tax shown on returns.

(a) *In general.* Except as provided in section 6152 and paragraph (b) of this section, the tax shown on any income tax return shall, without assessment or notice and demand, be paid to the internal revenue officer with whom the return is filed at the time fixed for filing the return (determined without regard to any extension of time for filing the return). For provisions relating to the time for filing income tax returns, see section 6072 and §§1.6072–1 to 1.6072–4, inclusive. For provisions relating to the place for filing income tax returns, see section 6091 and §§1.6091–1 to 1.6091–4, inclusive.

(b)(1) *Returns on which tax is not shown.* If a taxpayer files a return and in accordance with section 6014 and the regulations thereunder, elects not to show the tax on the return, the amount of tax determined to be due shall be paid within 30 days after the date of mailing to the taxpayer a notice stating the amount payable and making demand upon the taxpayer therefor. However, if the notice is mailed to the taxpayer more than 30 days before the due date of the return, payment of the tax shall not be required prior to such due date.

(2) *Where tax is shown on the return.* In any case in which a taxpayer files a return on Form 1040A pursuant to paragraph (a)(7) of §1.6012–1 and shows the amount of tax on the return, the unpaid balance of the tax shall, without assessment or notice and demand, be paid not later than the date fixed for filing the return.

(c) *Date fixed for payment of tax.* In any case in which a tax imposed by subtitle A of the Code is required to be paid on or before a certain date, or within a certain period, any reference in subtitle A or F of the Code to the date fixed for payment of such tax shall be deemed a reference to the last day fixed for such payment (determined without regard to any extension of time for paying the tax).

(d) *Use of Government depositaries.* (1) For provisions relating to the use of Federal Reserve banks or authorized financial institutions in depositing income and estimated income taxes of certain corporations, see §1.6302–1.

(2) For provisions relating to the use of such financial institutions for the deposit of taxes required to be withheld under chapter 3 of the Code on nonresident aliens and foreign corporations and tax-free covenant bonds, see §1.6302–2.

(Approved by the Office of Management and Budget under control number 1545–0257)

[T.D. 6500, 25 FR 12137, Nov. 26, 1960, as amended by T.D. 6922, 32 FR 8713, June 17, 1967; T.D. 6950, 33 FR 5357, Apr. 4, 1968; T.D. 7102, 36 FR 5498, Mar. 24, 1971; T.D. 7953, 49 FR 19644, May 9, 1984]

§ 1.6152–1 Installment payments.

(a) *Privilege of corporation to elect to make installment payments*—(1) *Amount to be paid.* In the case of any taxable year ending on or after December 31, 1954, a corporation subject to the taxes imposed by chapter 1 of the Code may elect, as provided in subparagraph (2) of this paragraph, to pay the unpaid amount of such tax for the taxable year in two equal installments instead of making a single payment. If such an election is made, the installments shall be paid as follows:

(i) Fifty percent on or before the date prescribed for the payment of the tax as a single payment, and

(ii) The remaining 50 percent on or before three months after the date prescribed for the payment of the first installment.

For provisions relating to installment payments of estimated income tax by corporations, see section 6154 and §§ 1.6154–1 to 1.6154–3, inclusive.

(2) *Method of election.* A corporation shall be considered to have made an election to pay its tax in installments if:

(i) It files its income tax return on or before the date prescribed therefor (determined without regard to any extension of time) and pays 50 percent of the unpaid amount of the tax at such time, or

(ii) It files an application on Form 7004 for an automatic extension of time to file its income tax return, as provided in § 1.6081–3, and pays 50 percent of the unpaid amount of the tax at such time. Except as provided in paragraph (c) of this section, the installment privilege is limited to the unpaid amount of tax as shown on the income tax return filed in accordance with the provisions of subdivision (i) of this subparagraph, or as shown on the Form 7004 filed in accordance with the provisions of this subdivision.

(3) *Use of Government depositaries.* For provisions relating to the use of Federal Reserve banks and authorized financial institutions in depositing the taxes see § 1.6302–1.

(b) *Privilege of estates of decedents to make installment payments.* With respect to the income tax imposed by chapter 1 of the Code upon estates of decedents, the fiduciary may elect to pay the tax in four equal installments instead of in a single payment. If the election is made, the tax shall be paid as follows:

(1) Twenty-five percent on or before the date prescribed for the payment of the tax as a single payment,

(2) Twenty-five percent on or before three months after the date prescribed for payment of the first installment,

(3) Twenty-five percent on or before six months after the date prescribed for payment of the first installment, and

(4) Twenty-five percent on or before nine months after the date prescribed for payment of the first installment.

(c) *Proration of deficiency to installments.* If an election has been made to pay the tax imposed by chapter 1 of the Code in installments, and a deficiency has been assessed, the deficiency shall be prorated equally to all the installments, whether paid or unpaid. Except as provided in section 6861, relating to jeopardy assessment, the part of the deficiency so prorated to any installment which is not yet due shall be collected at the same time as and as part of such installment. The part of the deficiency so prorated to any installment the date for payment of which has arrived shall be paid upon notice and demand from the district director.

(d) *Acceleration of payment.* If a taxpayer elects under the provisions of this section to pay the tax in installments, any installment may be paid prior to the date prescribed for its payment. If an installment is not paid in full on or before the date fixed for its payment the whole amount of the unpaid tax shall be paid upon notice and demand from the district director.

(Approved by the Office of Management and Budget under control number 1545–0257)

[T.D. 6500, 25 FR 12138, Nov. 26, 1960, as amended by T.D. 6914, 32 FR 3819, Mar. 8, 1967; T.D. 7953, 49 FR 19644, May 9, 1984]

§ 1.6153–1 Payment of estimated tax by individuals.

(a) *In general.* (1) The time for payment of the estimated tax by individuals for calendar years shall be as follows:

Date of filing declaration	Dates of payment of estimated tax
(i) On or before April 15	In 4 equal installments—one at time of filing declaration, one on or before June 15, one on or before September 15, and one on or before January 15 of the succeeding taxable year
(ii) After April 15 and before June 16 if not required to be filed on or before April 15.	In 3 equal installments—one at time of filing declaration, one on or before September 15, and one on or before January 15 of the succeeding taxable year
(iii) After June 15 and before September 16 if not required to be filed on or before June 15.	In 2 equal installments—one at time of filing declaration, and the other on or before January 15 of the succeeding taxable year
(iv) After September 15 if not required to be filed on or before September 15.	In full at time of filing declaration

(2) If, for example, due to the nature and amount of his gross income for 1955, the taxpayer is not required to file his declaration as of April 15, but is required to file the declaration on or before June 15, 1955, the case comes within the scope of subparagraph (1)(ii) of this paragraph and the estimated tax is payable in 3 equal installments, the 1st on the date of filing, the 2d on or before September 15, 1955, and the 3d installment on or before January 15, 1956.

(3) If a declaration is filed after the time prescribed in section 6073(a) (including any extension of time granted for filing the declaration), there shall be paid at such time all installments of the estimated tax which would have been payable on or before such date of filing if the declaration had been timely filed in accordance with the provisions of section 6073(a). The remaining installments shall be paid at the times and in the amounts in which they would have been payable if the declaration had been timely filed. Thus, for example, B, a single man who makes his return on the calendar year basis, was employed from the beginning of 1955 and for several years prior thereto at an annual salary of $6,000, thus meeting the requirements of section 6015(a). B filed his declaration for 1955 on September 16, 1955. In such case, B should have filed a declaration on or before April 15, 1955, and at the time of filing his declaration he was delinquent in the payment of three installments of his estimated tax for the taxable year 1955. Hence, upon his filing the declaration on September 16, 1955, three-fourths of the estimated tax shown thereon must be paid.

(4) In the case of a decedent, payments of estimated tax are not required subsequent to the date of death. See, however, paragraph (c) of §1.6015(b)–1, relating to the making of an amended declaration by a surviving spouse if a joint declaration was made before the death of the decedent.

(5) The payment of any installment of the estimated tax shall be considered payment on account of the tax for such taxable year. Hence, upon the return for such taxable year, the aggregate amount of the payments of estimated tax should be entered as payments to be applied against the tax shown on such return.

(b) *Farmers or fishermen.* Special provisions are made with respect to the filing of the declaration and the payment of the tax by an individual whose estimated gross income from farming or, with respect to taxable years beginning after December 31, 1962, from fishing is at least two-thirds of his total gross income from all sources for the taxable year. As to what constitutes income from farming or fishing within the meaning of this paragraph, see paragraph (b) of §1.6073–1. The declaration of such an individual may be filed on or before January 15 of the succeeding taxable year in lieu of the time prescribed for individuals generally. Where such an individual makes a declaration of estimated tax after September 15 of the taxable year, the estimated tax shall be paid in full at the time of the filing of the declaration.

(c) *Amendment of declaration.* If any amendment of a declaration is filed, the remaining installments, if any, shall be ratably increased or decreased, as the case may be, to reflect the increase or decrease in the estimated tax by reason of the amendment. If any amendment is made after September 15 of the taxable year, any increase in the estimated tax by reason thereof shall be paid at the time of making the amendment.

(d) *Installments paid in advance.* At the election of the taxpayer any installment of the estimated tax may be paid prior to the date prescribed for its payment.

[T.D. 6500, 25 FR 12139, Nov. 26, 1960, as amended by T.D. 6678, 28 FR 10517, Oct. 1, 1963]

§ 1.6153–2 Fiscal years.

In the case of an individual on the fiscal year basis, the dates prescribed for payment of the estimated tax shall be the 15th day of the 4th month, the 15th day of the 6th month, and the 15th day of the 9th month of the taxable year and the 15th day of the 1st month of the succeeding taxable year. For example, if an individual having a fiscal year ending on June 30, 1956, first meets the requirements of section 6015(a) on January 15, 1956, and the declaration is filed on or before March 15, 1956, the estimated tax shall be paid in 2 equal installments, one at the time of filing of such declaration and the other on or before July 15, 1956.

[T.D. 6500, 25 FR 12139, Nov. 26, 1960]

§ 1.6153–3 Short taxable years.

In the case of a short taxable year of an individual for which a declaration is required to be filed the estimated tax shall be paid in equal installments, one at the time of filing the declaration, one on the 15th day of the 6th month of the taxable year and another on the 15th day of the 9th month of such year unless the short taxable year closed during or prior to such 6th or 9th month, and one on the 15th day of the 1st month of the succeeding taxable year. For example, if the short taxable year is the period of 10 months from January 1, 1955, to October 31, 1955, and the declaration is required to be filed on or before April 15, 1955, the estimated tax is payable in 4 equal installments, one on the date of filing the declaration, and one each on June 15, September 15, and November 15, 1955. If in such case the declaration is required to be filed after April 15 but on or before June 15, the tax will be payable in 3 equal installments, one on the date of filing the declaration, and one each on September 15, and November 15, 1955. The provisions of paragraph (a)(3) of § 1.6153–1, relating to payment of estimated tax in any case in which the declaration is filed after the time prescribed in section 6073 and §§ 1.6073–1 to 1.6073–4, inclusive, are equally applicable to the payment of the estimated tax for short taxable years.

[T.D. 6500, 25 FR 12139, Nov. 26, 1960]

§ 1.6153–4 Extension of time for paying the estimated tax.

An extension of time granted an individual under section 6081 for filing the declaration of estimated tax automatically extends the time for paying the estimated tax (without interest) for the same period. See § 1.6073–4 for rules relating to extensions of time for filing declarations of estimated tax by individuals. Except as provided in paragraph (b) of § 301.6091–1 (relating to hand-carried documents), an application for an extension of time for paying a particular installment of the estimated tax shall be addressed to the internal revenue officer with whom the taxpayer files his declaration. Each application must contain a full recital of the causes for the delay. Such extension may be for a reasonable period not to exceed 6 months from the date fixed for payment thereof except in the case of a taxpayer who is abroad. Such extension does not relieve the taxpayer from the addition to the tax imposed by section 6654, and the period of the underpayment will be determined under section 6654(c) without regard to such extension.

[T.D. 6950, 33 FR 5357, Apr. 4, 1968]

§ 1.6154–1 Payment of estimated tax by corporations.

(a) *Taxable years beginning on or before December 31, 1963*—(1) *Amount required to be paid.* Every corporation required to file a declaration of estimated tax for a taxable year beginning on or before December 31, 1963, shall pay the following percentage of its estimated tax:

If the taxable year ends—	The amount required to be paid is the following percentage of the estimated tax
On or after Dec. 31, 1955, and before Dec. 31, 1956 ..	10

If the taxable year ends—	The amount required to be paid is the following percentage of the estimated tax
On or after Dec. 31, 1956, and before Dec. 31, 1957 ..	20
On or after Dec. 31, 1957, and before Dec. 31, 1958 ..	30
On or after Dec. 31, 1958, and before Dec. 31, 1959 ..	40
On or after Dec. 31, 1959	50

(2) *Time for payment.* (i) In the case of a corporation on the calendar year basis which files its declaration on or before September 15 of the taxable year, the percentage of the estimated tax required to be paid is payable in two equal installments, one at the time of filing the declaration, and the other on or before December 15 of the taxable year. If the corporation files its declaration after September 15 of the taxable year, the percentage of the estimated tax required to be paid is payable in full on or before December 15 of the taxable year.

(ii) In the case of a corporation whose taxable year is a fiscal year, the dates prescribed for payment of the estimated tax shall be the 15th day of the 9th month and the 15th day of the 12th month of such taxable year. If the corporation files its declaration after the 15th day of such 9th month, the percentage of the estimated tax required to be paid is payable in full on or before the 15th day of such 12th month.

(3) *Amendment of declaration.* In the case of an amended declaration, filed in accordance with section 6074, the installment payable on the 15th day of the 12th month of the taxable year shall be ratably increased or decreased, as the case may be, to reflect the increase or decrease in the estimated tax by reason of the amended declaration. For example, X, a corporation on the calendar year basis, filed a declaration on September 15, 1955, reporting an estimated tax in the amount of $20,000. The first installment of $1,000 (5 percent of $20,000) accompanied the declaration. However, X filed an amended declaration on December 15, 1955, showing an estimated tax of $30,000. Since X has already paid $1,000, it must make a payment in the amount of $2,000 computed as follows:

Required amount of estimated tax which must be paid for calendar year 1955 (10% of $30,000)	$3,000
Amount paid with original estimate (5% of $20,000)	1,000
Balance to accompany amended declaration	2,000

Had the amended declaration been filed on December 10, 1955, then only the balance of the first installment ($500) otherwise due on September 15 would have been required to be paid with the declaration and the installment required to be paid on or before December 15, 1955, would be $1,500.

(b) *Taxable years beginning after December 31, 1963*—(1) *Amount and time for payment of each installment*—(i) *In general.* Paragraphs (1) through (4) of section 6154(a) contain four tables setting forth the percentages of estimated tax for each taxable year beginning after December 31, 1963, which shall be paid as installments of estimated tax and the date on or before which each such installment shall be paid. The date on or before which the declaration of estimated tax for a taxable year is required, under the provisions of section 6074(a), to be filed determines which of the four installment payment tables shall be used by the corporation for that taxable year. Therefore, if the declaration is required to be filed by the 15th day of the 4th, 6th, 9th, or 12th month, the estimated tax will be required to be paid in four, three, two, or one installment, respectively. However, see subdivision (iii) of this subparagraph for the rules applicable in case of the late filing of a declaration.

(ii) *Examples.* The application of the tables in section 6154(a) may be illustrated by the following examples:

Example (1). X, a corporation reporting on a calendar year basis, is required for the calendar year 1966 to file a declaration of estimated tax on or before the 15th day of the 4th month thereof (April 15, 1966) reporting an estimated tax liability of $250,000. Assuming that the original declaration is filed on or before April 15, 1966, and is not subsequently amended, X is required to pay its estimated tax in four installments. The first and second installments, each in the amount of $22,500 (9 percent of $250,000), are to be paid on or before April 15, 1966, and June 15, 1966, respectively, and the third and fourth installments, each in the amount of $62,500 (25 percent of $250,000), are to be paid on or before September 15, 1966, and December 15, 1966, respectively.

Example (2). Y, a corporation which reports on a calendar year basis, is required for the calendar year 1967 to file a declaration of estimated tax on or before the 15th day of the 6th month thereof (June 15, 1967) reporting an estimated tax liability of $100,000. Assuming that the original declaration is filed on or before June 15, 1967, and is not subsequently amended, Y is required to pay its estimated tax in three installments. The first installment, in the amount of $18,666.67 (18⅔ percent of $100,000), is to be paid on or before June 15, 1967, and the second and third installments, each in the amount of $29,666.67 (29⅔ percent of $100,000), are to be paid on or before September 15, 1967, and December 15, 1967, respectively.

Example (3). Z, a corporation which reports on a fiscal year basis ending with June 30 of each year, is required for the fiscal year ended June 30, 1968, to file a declaration of estimated tax on or before the 15th day of the fourth month thereof (October 15, 1967) reporting an estimated tax liability of $200,000. Assuming that the original declaration is filed on or before October 15, 1967, and is not subsequently amended, Z is required to pay its estimated tax in four installments. The first and second installments, each in the amount of $28,000 (14 percent of $200,000), are to be paid on or before October 15, 1967, and December 15, 1967, respectively, and the third and fourth installments, each in the amount of $50,000 (25 percent of $200,000), are to be paid on or before March 15, 1968, and June 15, 1968, respectively.

(iii) *Late filing of declaration of estimated tax.* If a declaration of estimated tax is filed after the date prescribed by section 6074(a) (determined without regard to any extension of time for filing the declaration under section 6081), the tables set forth in paragraphs (2), (3), and (4) of section 6154(a) do not apply except as provided in this subdivision. In such a case, there shall be paid at the time of the filing of the declaration all installments of the estimated tax which would have been payable under the appropriate table in section 6154(a) on or before such date of filing if the declaration had been timely filed in accordance with the provisions of section 6074(a). The remaining installments shall be paid at the times and in the amounts in which they would have been payable if the declaration had been timely filed. For example, Z, a corporation filing its returns on a calendar year basis, fails to file a declaration of estimated tax on April 15, 1968, even though the requirements for filing a declaration were met before April 1, 1968. However, Z does file its declaration of estimated tax on July 1, 1968, disclosing an estimated tax of $75,000. As the first two installment dates specified in paragraph (1) of section 6154(a) (the 15th days of the 4th and 6th months) have passed, Z is required to pay $28,500 (2 installments, each in the amount of 19 percent of $75,000) when the declaration is filed on July 1, 1968. If there are no subsequent amendments of the declaration for this year, Z will be required to pay installments, each in the amount of $18,750 (25 percent of $75,000), on or before September 15, 1968, and December 15, 1968, respectively.

(2) *Amendment of declaration*—(i) *In general.* If any amendment of a declaration is filed, the amount of each remaining installment (including the installment due on the date of the filing of the amendment where the amendment is filed on an installment date), if any, is the amount which would have been payable as such installment if the new estimate had been the original estimate, adjusted as provided in this subdivision. The adjustment is for the difference between *(a)* the amount of estimated tax required to be paid before the date of the filing of the amendment and *(b)* the amount of estimated tax which would have been required to have been paid before such date if the new estimate had been the original estimate. The difference is divided by the number of remaining installments (including the installment due on the date of the filing of the amendment where the amendment is filed on an installment date), and the resulting amount is added to (if the amended declaration increases the amount of estimated tax) or subtracted from (if the amended declaration decreases the amount of the estimated tax) the amount which would have been payable on each remaining installment date if the new estimate had been the original estimate.

(ii) *Examples.* The application of the provisions of this subparagraph may be illustrated by the following examples:

Example (1). X, a calendar year corporation, determines that its estimated tax liability for the year 1967 is $100,000 and files a declaration of estimated tax by April 15, 1967, with an installment payment of $14,000. On June 15, 1967, the second installment payment of $14,000 is made. On July 1, 1967, X discovers that its 1967 estimated tax may reasonably be expected to be $150,000 and on

September 15, 1967, files an amended declaration in that amount. The amounts to be paid on September 15, 1967, and December 15, 1967, are computed as follows:

Installment payments required to be made under the original declaration before date of filing of amendment (14% of $100,000 is $14,000×2)	$28,000
Installment payments which would have been required to be made before date of filing of amendment if the original declaration were in the amount of the amended declaration (14% of $150,000 is $21,000×2)	42,000
Difference	14,000
Amount of each installment payment due on September 15, 1967, and December 15, 1967, computed as if the original declaration were in the amount of the amended declaration (25% of $150,000)	$37,500
Add: Amount of difference divided by number of remaining installments ($14,000÷2)	7,000
Amount of each remaining installment (September 15, 1967, and December 15, 1967)	44,500

Example (2). Assume the same facts as in example (1), except that instead of filing the amended declaration on September 15, 1967, X files an amended declaration on June 15, 1967, disclosing an estimated tax of $70,000. The installment payments for June 15, 1967, September 15, 1967, and December 15, 1967, are computed as follows:

Installment payment required to be made under the original declaration before the date of filing of amendment (14% of $100,000)	$14,000
Installment payment which would have been required to be made before date of filing of amendment if the original declaration were in the amount of the amended declaration (14% of $70,000)	9,800
Difference	4,200
June 15, 1967, installment computation:	
Installment payment due on June 15, 1967, computed as if the original declaration were in the amount of the amended declaration (14% of $70,000)	9,800
Less: Amount of difference divided by number of remaining installments ($4,200÷3)	1,400
Amount to be paid as an installment on June 15, 1967	8,400
September 15, 1967, and December 15, 1967, installments computation:	
Amount of each installment payment due on September 15, 1967, and December 15, 1967, computed as if the original declaration were in the amount of the amended declaration (25% of $70,000)	17,500
Less: Amount of difference divided by number of remaining installments ($4,200÷3)	1,400
Amount of each remaining installment (September 15, 1967, and December 15, 1967)	16,100

(c) *Installments paid in advance.* A corporation may, at its election, pay any installment of its estimated tax in advance of the due date.

(d) *Considered payment of income tax.* Payments of estimated tax shall be considered payments on account of the income tax liability for the taxable year. Hence the amount of estimated tax paid shall be entered on the income tax return and applied in payment of the tax liability shown thereon.

[T.D. 6768, 29 FR 14924, Nov. 4, 1964]

§ 1.6154–2 Short taxable years.

(a) *Taxable years beginning on or before December 31, 1963*—(1) *In general.* In the case of a corporation filing a declaration for a short taxable year beginning on or before December 31, 1963, the amount of the estimated tax required to be paid shall be paid as follows:

(i) If the short taxable year is a period of more than 9 months and the declaration is required to be filed on or before the 15th day of the 9th month, the amount of the estimated tax required to be paid shall be paid in 2 installments; the 1st on or before the 15th day of the 9th month and the 2d on or before the 15th day of the last month of the short taxable year.

(ii) If the short taxable year is a period of 9 or more months and the declaration is not required to be filed until the 15th day of the last month of the short taxable year, the amount of the estimated tax required to be paid shall be paid in full on or before the 15th day of the last month of the short taxable year.

(2) *Examples.* The application of the provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). If a corporation changes from a calendar year to a fiscal year beginning November 1, 1956, and ending October 31, 1957, a declaration is required on or before September 15, 1956, for the short taxable year January 1, 1956, to October 31, 1956, if such corporation otherwise meets the requirements of section 6016(a) on or before August 31, 1956. In such case the first installment of the estimated tax must be paid with the declaration filed on September 15, 1956. The second installment must be paid on or before October 15, 1956, the 15th day of the last month of the short taxable year.

Example (2). If, in the first example, the corporation did not meet the requirements of section 6016(a) until after August 31, 1956, but before October 1, 1956, the declaration would have been due on October 15, 1956. In such case the amount of the estimated tax required to be paid must be paid in full with the declaration filed on October 15, 1956.

(b) *Taxable years beginning after December 31, 1963*—(1) *In general.* In the case of a short taxable year which begins after December 31, 1963, and in respect of which a declaration of estimated tax is required to be filed (see paragraph (b) of § 1.6074–2), the amount of, and time for payment of, each installment of estimated tax shall be determined by paragraphs (1) to (4), inclusive, of section 6154(a), except that in the case of a short taxable year ending after November 30, 1964, any estimated tax payable in installments which is not paid before the 15th day of the last month of the short taxable year (whether or not the date otherwise specified in section 6154(a) for payment has arrived) shall be paid on such 15th day of the last month of the short taxable year.

(2) *Examples.* The application of the provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). X, a corporation filing on a calendar year basis, changes to a fiscal year beginning September 1, 1965, and ending August 31, 1966, and is required to file a declaration on or before April 15, 1965, for the short taxable year January 1, 1965, to August 31, 1965. X must make two 4 percent installment payments of the estimated tax, the first on or before April 15, 1965, and the second on or before June 15, 1965, and must pay 50 percent (25 percent for the 3d installment plus 25 percent for the 4th installment) of the estimated tax on or before August 15, 1965 (the 15th day of the last month of the short taxable year), as the last installment.

Example (2). If, in the first example, X does not meet the requirements of section 6016(a) until June 15, 1965, the declaration is due on or before August 15, 1965. X is required to pay 58 percent of the estimated tax on or before August 15, 1965 (the 15th day of the last month of the short taxable year).

(3) *Late filing of declaration of estimated tax.* In the case of a declaration of estimated tax for a short taxable year beginning after December 31, 1963, filed after the date prescribed by section 6074(a) (determined without regard to any extension of time for filing the declaration under section 6081), the provisions of paragraph (b)(1)(iii) of § 1.6154–1 shall be applied in determining the amount of and time for payment of each installment. However, in the case of short taxable years beginning after December 31, 1963, and ending after November 30, 1964, where, under the provisions of paragraph (b)(1)(iii) of § 1.6154–1, installments are to be paid after the close of the short taxable year, such installments shall be paid on or before the 15th day of the last month of the short taxable year.

(4) *Amended declarations.* In the case of an amended declaration of estimated tax for a short taxable year beginning after December 31, 1963, filed in accordance with section 6074(b), the provisions of paragraph (b)(2) of § 1.6154–1 shall apply to determine the amount of each remaining installment. However, where, under the provisions of such paragraph (b)(2), installments are to be paid after the close of the short taxable year, such installments shall be paid on or before the 15th day of the last month of the short taxable year.

[T.D. 6768, 29 FR 14925, Nov. 4, 1964]

§ 1.6154–3 Extension of time for paying estimated tax.

An extension of time granted a corporation under section 6081 for filing the declaration of estimated tax automatically extends the time for paying the estimated tax (without interest) for the same period. See § 1.6074–3 for rules relating to extensions of time for filing declarations of estimated tax by corporations. Except as provided in paragraph (b) of § 301.6091–1 (relating to hand-carried documents), an application for an extension of time for paying an installment of the estimated tax shall be addressed to the internal revenue officer with whom the taxpayer files its declaration. Each application must contain a full recital of the causes for the delay. Any such extension will not relieve the taxpayer from the addition to the tax imposed by section 6655, and the period of the underpayment will be determined under section 6655(c) without regard to such extension.

[T.D. 6950, 33 FR 5357, Apr. 4, 1968]

§1.6154–4 Use of Government depositaries.

For provisions relating to the use of Federal Reserve banks and authorized financial institutions in depositing the taxes see §1.6302–1.

(Approved by the Office of Management and Budget under control number 1545–0257)

[T.D. 6914, 32 FR 3819, Mar. 8, 1967, as amended by T.D. 7953, 49 FR 19644, May 9, 1984]

§1.6154–5 Definition of estimated tax.

For taxable years beginning after December 31, 1976, the term *estimated tax* means the excess of—

(a) The amount which the corporation estimates as its income tax liability for the taxable year under section 11 or 1201(a), or subchapter L of chapter 1 of the Code, whichever is applicable, over

(b) The sum of—

(1) Any estimated credits against tax provided by part IV of subchapter A of chapter 1 of the Code, plus

(2) For taxable years ending after February 29, 1980, the amount which the corporation estimates will be the amount of such corporation's overpayment of windfall profit tax imposed by section 4986 of the Code for the taxable year. For this purpose, the amount of such overpayment is the amount by which such corporation's aggregate windfall profit tax liability for the taxable year as a producer of crude oil is reasonably expected to be exceeded by withholding of windfall profit tax for the taxable year.

(Secs. 6015, 6154, 6654, 6655, and 7805, Internal Revenue Code of 1954 (96 Stat. 2395 and 2396, 68A Stat. 917; 26 U.S.C. 6015, 6154, 6654, 6655, and 7805))

[T.D. 8016, 50 FR 11855, Mar. 26, 1985]

EXTENSIONS OF TIME FOR PAYMENT

SOURCE: Sections 1.6161–1 to 1.6165–1 contained in T.D. 6500, 25 FR 12140, Nov. 26, 1960, unless otherwise noted.

§1.6161–1 Extension of time for paying tax or deficiency.

(a) *In general*—(1) *Tax shown or required to be shown on return.* A reasonable extension of the time for payment of the amount of any tax imposed by subtitle A of the Code and shown or required to be shown on any return, or for payment of the amount of any installment of such tax, may be granted by the district directors (including the Director of International Operations) at the request of the taxpayer. The period of such extension shall not be in excess of six months from the date fixed for payment of such tax or installment, except that if the taxpayer is abroad the period of the extension may be in excess of six months.

(2) *Deficiency.* The time for payment of any amount determined as a deficiency in respect of tax imposed by chapter 1 of the Code, or for the payment of any part thereof, may, at the request of the taxpayer, be extended by the internal revenue officer to whom the tax is required to be paid for a period not to exceed 18 months from the date fixed for payment of the deficiency, as shown on the notice and demand, and, in exceptional cases, for a further period not in excess of 12 months. No extension of the time for payment of a deficiency shall be granted if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax.

(b) *Undue hardship required for extension.* An extension of the time for payment shall be granted only upon a satisfactory showing that payment on the due date of the amount with respect to which the extension is desired will result in an undue hardship. The extension will not be granted upon a general statement of hardship. The term ''undue hardship'' means more than an inconvenience to the taxpayer. It must appear that substantial financial loss, for example, loss due to the sale of property at a sacrifice price, will result to the taxpayer for making payment on the due date of the amount with respect to which the extension is desired. If a market exists, the sale of property at the current market price is not ordinarily considered as resulting in an undue hardship.

(c) *Application for extension.* An application for an extension of the time for payment of the tax shown or required to be shown on any return, or for the payment of any installment thereof, or for the payment of any amount determined as a deficiency shall be made on

Form 1127 and shall be accompanied by evidence showing the undue hardship that would result to the taxpayer if the extension were refused. Such application shall also be accompanied by a statement of the assets and liabilities of the taxpayer and an itemized statement showing all receipts and disbursements for each of the 3 months immediately preceding the due date of the amount to which the application relates. The application, with supporting documents, must be filed on or before the date prescribed for payment of the amount with respect to which the extension is desired. If the tax is required to be paid to the Director of International Operations, such application must be filed with him, otherwise, the application must be filed with the applicable district director referred to in paragraph (a) or (b) of § 1.6091–2, regardless of whether the return is to be filed with, or tax is to be paid to, such district director. The application will be examined, and within 30 days, if possible, will be denied, granted, or tentatively granted subject to certain conditions of which the taxpayer will be notified. If an additional extension is desired, the request therefor must be made on or before the expiration of the period for which the prior extension is granted.

(d) *Payment pursuant to extension.* If an extension of time for payment is granted, the amount the time for payment of which is so extended shall be paid on or before the expiration of the period of the extension without the necessity of notice and demand. The granting of an extension of the time for payment of the tax or deficiency does not relieve the taxpayer from liability for the payment of interest thereon during the period of the extension. See section 6601 and § 301.6601–1 of this chapter (Regulations on Procedure and Administration). Further, the granting of an extension of the time for payment of one installment of the tax does not extend the time for payment of subsequent installments.

(e) *Cross reference.* For extensions of time for payment of estimated tax, see §§ 1.6073–4 and 1.6074–3.

[T.D. 6500, 25 FR 12140, Nov. 26, 1960, as amended by T.D. 6950, 33 FR 5357, Apr. 4, 1968; T.D. 7260, 38 FR 4259, Feb. 12, 1973]

§ 1.6162–1 Extension of time for payment of tax on gain attributable to liquidation of personal holding companies.

(a) *In general.* (1) If it is shown to the satisfaction of the district director that undue hardship to the taxpayer will result from the payment of such portion of the amount determined as the tax under chapter 1 of the Code by the taxpayer as is attributable to the short-term or long-term capital gain derived by the taxpayer from the receipt by him of property other than money on a complete liquidation of a corporation to which section 331(a)(1) or 342 applies, the district director may grant an extension of time for the payment of such portion of the tax. For the meaning of the term ''undue hardship'', see paragraph (b) of § 1.6161–1.

(2) The extension of time for payment shall be for a period not in excess of five years. The extension shall only be granted for a taxable year beginning before January 1, 1956, and shall apply only if the corporation, for its taxable year preceding the year in which occurred the complete liquidation (or the first of the series of distributions in complete liquidation), was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company.

(b) *Requirement of bond.* As a condition to the granting of an extension of time for payment, the taxpayer will usually be required by the district director to furnish a bond as provided in section 6165 and the regulations thereunder. For other provisions with respect to bonds, see section 7101 and the regulations in part 301 of this chapter (Regulations on Procedure and Administration).

§ 1.6164–1 Extensions of time for payment of taxes by corporations expecting carrybacks.

(a) *In general.* If a corporation in any taxable year files a statement with respect to an expected net operating loss carryback from such taxable year, such corporation may extend the time for the payment of all or part of any tax imposed by subtitle A of the Code for the taxable year immediately preceding such taxable year to the extent and subject to the limitations provided in section 6164. A corporation may extend the time for payment with respect to only such taxes as meet the following requirements:

(1) The tax must be one imposed by subtitle A of the Code;

(2) The tax must be for the taxable year immediately preceding the taxable year of the expected net operating loss;

(3) The tax must be shown on the return or must be assessed within the taxable year of the expected net operating loss; and

(4) The tax must not have been paid or required to have been paid prior to the filing of the statement.

(b) *Statement for purpose of extending time for payment.* (1) The time for payment of the tax is automatically extended upon the filing of a statement on Form 1138 by the corporation with the district director for the district where the tax is payable. The statement on Form 1138 must be filled out in accordance with the instructions accompanying the form, and all information required by the form and the instructions must be furnished by the taxpayer. The district director, upon request, will furnish a receipt for any statement filed. Such receipt will show the date the statement was filed.

(2) The period of extension is that provided in section 6164(d) and §1.6164–5 unless sooner terminated by action of either the district director or the corporation.

§1.6164–2 Amount of tax the time for payment of which may be extended.

(a) *Total amount to which extension may relate.* The total amount of tax the time for payment of which may be extended under section 6164 may not exceed the amount of the reduction of the taxes previously determined attributable to the expected carryback.

(b) *Amount of tax to which extension may relate.* (1) The taxpayer shall specify on Form 1138 the kind of tax and the amount thereof the time for payment of which is to be extended. The amount of tax to which an extension may relate shall not exceed the amount of such tax shown on the return as filed, increased by any amount assessed as a deficiency (or as interest or addition to the tax) prior to the date of filing the statement and decreased by any amount paid or required to be paid prior to such date. In determining the amount of tax required to be paid prior to the date of filing the statement, only the following amounts shall be taken into consideration:

(i) The amount of the tax shown on the return as filed; and

(ii) Any amount assessed as a deficiency (or as interest or addition to the tax) if the tenth day after notice and demand for its payment occurs prior to the date of the filing of the statement.

(2) Delinquent installments are to be considered amounts required to be paid prior to the date of filing the statement. In the case of any authorized extension of time under sections 6161 and 6162, the amount of tax the time for payment of which is so extended is not to be considered required to be paid prior to the end of such extension. Similarly, any amount assessed as a deficiency (or as interest or addition to the tax) is not to be considered required to be paid prior to the date of the filing of the statement unless the tenth day after notice and demand for its payment falls prior to the date of the filing of the statement.

(3) The taxpayer may choose to extend the time for payment of all of one or more taxes, or it may choose to extend the time for payment of portions of several taxes. The taxes chosen by the taxpayer need not be those taxes which are affected by the carryback.

§1.6164–3 Computation of the amount of reduction of the tax previously determined.

(a) *Tax previously determined.* The taxpayer is to determine the amount of the reduction, attributable to the expected carryback, in the aggregate of the taxes previously determined for taxable years prior to the taxable year of the expected net operating loss. The tax previously determined is to be ascertained in accordance with the method prescribed in section 1314(a). Thus, the tax previously determined will be the tax shown on the return as filed, increased by any amounts assessed (or collected without assessment) as deficiencies prior to the date of the filing of the statement, and decreased by any amounts abated, credited, refunded, or otherwise repaid prior to such date. Any items as to which the Internal Revenue Service and the taxpayer are in disagreement at the time of the filing of the statement shall be taken into account in ascertaining the tax previously determined only if, and to the extent that, they were reported in the return, or were reflected in any amounts assessed (or collected without assessment) as deficiencies, or in any amounts abated, credited, refunded, or otherwise repaid, prior to the date of the filing of the statement. The tax previously determined will reflect the foreign tax credit and the credit for tax withheld at source provided in section 32.

(b) *Reduction attributable to the expected carryback.* The reduction, attributable to the expected carryback or related adjustments, in any tax previously determined is to be ascertained by applying the expected carryback as if it were a determined net operating loss carryback, in accordance with the provisions of section 172 and the regulations thereunder. Items must be taken into account only to the extent that such items were included in the return, or were reflected in amounts assessed (or collected without assessment) as deficiencies, or in amounts abated, credited, refunded, or otherwise repaid, prior to the date of the filing of the statement. Thus, for example, if the taxpayer claims a deduction for depreciation of $10,000 in its return and the Internal Revenue Service asserts that only $4,000 is properly deductible, no change is to be made in the $10,000 depreciation deduction as shown by the taxpayer on his return unless a deficiency has been assessed, or an amount collected without assessment, prior to the date of filing of the statement as a result of a change in the depreciation deduction, or unless such change in the depreciation deduction was reflected in an amount abated, credited, refunded, or otherwise repaid prior to such date.

[T.D. 6500, 25 FR 12140, Nov. 26, 1960, as amended by T.D. 6862, 30 FR 14432, Nov. 18, 1965]

§ 1.6164–4 Payment of remainder of tax where extension relates to only part of the tax.

(a) *Time for payment.* If an extension of time relates to only part of the tax, the time for payment of the remainder of the tax shall be considered to be the dates on which payments would have been required if such remainder had been the tax and the taxpayer had elected to pay the tax in installments as provided in section 6152(a).

(b) *Example.* The provisions of this section may be illustrated by the following example:

Example. Corporation X, which keeps its books and makes its tax returns on the calendar year basis, filed its income tax return for 1956 on March 15, 1957. The corporation showed a tax of $1,000 on its return and paid 50 percent of such tax, or $500 on March 15, 1957. On June 3, 1957, Corporation X, pursuant to the provisions of section 6164, extended the time for payment of $400 of such tax. The remainder of the tax the time for payment of which was not so extended, i.e., $600, is to be considered the tax for purposes of determining when it is to be paid. The remainder is considered to be due on the dates on which payment would have been required if such remainder had been the tax. Since the taxable year ended on December 31, 1956, the tax is payable in two equal installments of $300 each on March 15, 1957, and June 17, 1957. The taxpayer, having paid $500 on March 15, 1957, will have $100 to pay on June 17, 1957.

§ 1.6164–5 Period of extension.

If the time for the payment of any tax has been extended pursuant to section 6164, such extension shall expire:

(a) On the last day of the month in which falls the last date prescribed by law (including any extension of time granted the taxpayer) for the filing of the return for the taxable year of the expected net operating loss; or

(b) If an application for a tentative carryback adjustment provided in section 6411 with respect to such loss is filed before the expiration of the period specified in paragraph (a) of this section, on the date on which notice is mailed by registered mail prior to September 3, 1958, and by either registered or certified mail on and after September 3, 1958, to the taxpayer that such application is allowed or disallowed in whole or in part.

§1.6164–6 Revised statements.

(a) *Requirements and effect.* A corporation may file more than one statement under section 6164 with respect to any one taxable year. Each statement is to be considered a new statement and not an amendment of any prior statement. Each such new statement is to be in lieu of the last statement previously filed with respect to the taxable year. The new statement may extend the time for payment of a greater or lesser amount of tax than was extended under the prior statement or may change the kind of tax the time for payment of which is to be extended. The extension may not relate to any amount of tax which was paid or required to be paid prior to the date of filing the new statement. Any amount of tax the time for payment of which was extended under a prior statement, however, may continue to be extended under the new statement. If the amount the time for payment of which is extended under the new statement is less than the amount so extended under the last statement previously filed, the extension of time shall be terminated on the date the new statement is filed as to the difference between the two amounts. See §1.6164–8 for the dates on which such difference must be paid. If a corporation pays any amount of tax, the time for payment of which was extended, prior to the date the extension would otherwise terminate, the extension with respect to such amount shall be deemed terminated, without regard to whether a new statement is filed, on the date such amount is paid. The corporation shall indicate on each new statement filed that it has already filed one or more prior statements with respect to the taxable year. The corporation shall likewise indicate the date each prior statement was filed and the amount of each tax the time for payment of which was extended under each prior statement.

(b) *Example.* The provisions of this section may be illustrated by the following example:

Example. Corporation Y, which keeps its books and makes its tax returns on the calendar year basis, filed its income tax return for 1956 on March 15, 1957, showing a tax of $100,000. At the same time it filed a statement under section 6164 in which it stated that it expected to have a net operating loss of $75,000 in 1957 and that the reduction in the tax previously determined for 1955 (the second taxable year preceding the year of the expected net operating loss) attributable to the expected net operating loss carryback resulting from such expected loss, would be $39,000. The corporation accordingly extended the time for payment of $39,000 of its income tax for 1956, and paid $30,500 (50 percent of the excess of $100,000 over $39,000) of such tax on March 15, 1957 (see section 6164(c) and §1.6164–4). As a result of its operations during the next several months, the corporation filed a second statement on June 3, 1957, in which it stated that its expected net operating loss for 1957 would amount to $150,000 and that the corresponding reduction in the tax for 1955 would amount to $78,000. Corporation Y under the new statement may extend the time for payment of $30,500, the installment due on June 17, 1957, and the time for payment of the $39,000 extended under the first statement filed on March 15, 1957, may continue to be extended under the second statement. The $30,500 which was paid on March 15, 1957, will not be affected by the second statement filed on June 3, 1957.

§1.6164–7 Termination by district director.

(a) *After an examination of the statement filed by the corporation is made.* The district director is authorized to make such examination of the statements filed as he deems necessary and practicable. If, upon such examination as he may make, the district director believes that, as of the time he makes the examination, all or any part of the statement is in a material respect erroneous or unreasonable, he will terminate the extension as to any part of the amount to which such extension relates which he deems should be terminated.

(b) *Jeopardy.* If the district director believes that the collection of any amount to which an extension under section 6164 relates is in jeopardy, he will immediately terminate the extension. In the case of such a termination, notice and demand shall be made by the district director for payment of such amount, and there may be no further extension of time under section 6164 with respect to such amount.

§1.6164–8 Payments on termination.

(a) *In general.* If an extension of time under section 6164 is terminated with respect to any amount either (1) by the filing of a new statement by the taxpayer under section 6164(e) extending the time for payment of a lesser amount than was extended in a prior statement, or (2) by action of the district director under section 6164(f) after making an examination of the statement filed by the corporation, no further extension of time may be made under section 6164 with respect to such amount. The time for payment of such amount shall be the dates on which payments would have been required if there had been no extension with respect to such amount and the taxpayer had elected under section 6152(a) to pay the tax in installments.

(b) *Example.* The provisions of this section may be illustrated by the following example:

Example. Corporation Z, which keeps its books and makes its tax returns on the calendar year basis, filed its income tax return for 1956 on March 15, 1957, showing a tax of $100,000. At the same time it filed a statement under section 6164 extending the time for payment of the entire $100,000 on the basis of an expected net operating loss carryback from 1957. On April 10, 1957, the corporation filed a new statement indicating that the reduction, attributable to the carryback from 1957, in its income tax for 1956, would only be $80,000, and thus terminated the above extension of $20,000. The time for payment of such $20,000 may not be extended again, and such $20,000 is payable as if it were the tax for 1956 and Corporation Z had elected to pay such tax in installments. That is, $10,000 is payable on March 15, 1957, and $10,000 payable on June 17, 1957. Inasmuch as the March 15 date had already passed when the Corporation Z terminated the extension with respect to the $20,000, $10,000 is payable immediately upon such termination, and the other installment of $10,000 is payable on June 17, 1957. This example would also apply if the extension of time for payment of the $20,000 were terminated instead by the district director on April 10, 1957.

§ 1.6164–9 Cross references.

For provisions with respect to interest due on amounts the payment of which is extended under section 6164, see section 6601 and paragraph (e) of § 301.6601–1 of this chapter (Regulations on Procedure and Administration). For extensions of time under section 6164 in the case of corporations making or required to make consolidated returns, see § 1. 1502–77(a).

[T.D. 6500, 25 FR 12140, Nov. 26, 1960, as amended by T.D. 7244, 37 FR 28897, Dec. 30, 1972]

§ 1.6165–1 Bonds where time to pay the tax or deficiency has been extended.

The district director, including the Director of International Operations, may, as a condition to the granting of an extension of time within which to pay any tax or any deficiency therein, require the taxpayer to furnish a bond in an amount not exceeding double the amount of the tax with respect to which the extension is granted. Such bond shall be furnished in accordance with the provisions contained in section 7101 and the regulations in part 301 of this chapter (Regulations on Procedure and Administration).

COLLECTION

GENERAL PROVISIONS

§ 1.6302–1 Use of Government depositaries in connection with corporation income and estimated income taxes and certain taxes of tax-exempt organizations.

(a) *Requirement.* A corporation (and, for taxable years beginning after December 31, 1986, any organization subject to the tax imposed by section 511, and any private foundation subject to the tax imposed by section 4940) shall deposit with an authorized depositary of Federal taxes all payments of tax imposed by chapter 1 of the Code (or treated as so imposed by section 6154 (h)), including any payments of estimated tax, on or before the date otherwise prescribed for paying such tax. This paragraph does not apply to a foreign corporation or entity which has no office or place of business in the United States.

(b) *Manner of deposit*—(1) *Deposit by Federal tax deposit coupon.* A deposit required to be made by this section shall be made separately from a deposit required by any other section. A corporation may make one, or more than one, remittance of the amount required by this section to be deposited. Each remittance shall be accompanied by a Federal Tax Deposit form which shall be prepared in accordance with the instructions applicable thereto. The remittance, together with the Federal Tax Deposit form, shall be forwarded to a financial institution authorized as a depositary for Federal taxes in accordance with 31 CFR part 214 or, at the election of the corporation, to a Federal Reserve bank. For procedures governing the deposit of Federal taxes at a Federal Reserve bank, see 31 CFR part 214.7. The timeliness of the deposit will be determined by the date stamped on the Federal Tax Deposit form by the Federal Reserve bank or the authorized financial institution or, if section 7502(e) applies, by the date the deposit is treated as received under section 7502(e). Each corporation making deposits under this section shall report on the return, for the period with respect to which such deposits are made, information regarding such deposits according to the instructions that apply to such return. Amounts deposited under this section shall be considered as payment of the tax.

(2) *Deposits by electronic funds transfer.* For the requirement to deposit corporation income and estimated income taxes and certain taxes of tax-exempt organizations by electronic funds transfer, see §31.6302–1(h) of this chapter. A taxpayer not required to deposit by electronic funds transfer pursuant to §31.6302–1(h) of this chapter remains subject to the rules of paragraph (b)(1) of this section.

(c) *Procurement of the prescribed forms.* Copies of the Federal Tax Deposit form will so far as possible be furnished corporations. A corporation will not be excused from making a deposit, however, by the fact that no form has been furnished to it. Corporations not supplied with the proper form should make application therefor to the district director (or director of a service center) in ample time to make the required deposits within the time prescribed. The corporation may secure the form or additional forms by applying therefor and supplying the district director or director of a service center with its name, identification number, address and the taxable year to which the deposits will relate.

(d) *Failure to deposit.* For provisions relating to the penalty for failure to make a deposit within the prescribed time, see the provisions of §301.6656–1 of this chapter (Regulations on Procedure and Administration).

[T.D. 6914, 32 FR 3820, Mar. 8, 1967, as amended by T.D. 6941, 32 FR 18040, Dec. 16, 1967; T.D. 7293, 38 FR 32804, Nov. 28, 1973; T.D. 7953, 49 FR 19644, May 9, 1984; T.D. 8157, 52 FR 33809, Sept. 9, 1987; T.D. 8723, 62 FR 37492, July 14, 1997]

§1.6302–2 Use of Government depositaries for payment of tax withheld on nonresident aliens and foreign corporations.

(a) *Time for making deposits*—(1) *Deposits for 1973 and subsequent years*—(i) *Monthly deposits.* Except as provided in subdivisions (ii) and (iv) of this subparagraph, every withholding agent who, pursuant to chapter 3 of the Code, has accumulated at the close of any calendar month beginning on or after January 1, 1973, an aggregate amount of undeposited taxes of $200 or more shall deposit such aggregate amount with a Federal Reserve bank or authorized financial institution (see paragraph (b)(1)(ii) of this section) within 15 days after the close of such calendar month. However, the preceding sentence shall not apply if the withholding agent has made a deposit of taxes pursuant to subdivision (ii) of this subparagraph with respect to a quarter-monthly period which occurred during such month.

(ii) *Quarter-monthly deposits.* If at the close of any quarter-monthly period within a calendar month beginning on or after January 1, 1973, the aggregate amount of undeposited taxes required to be withheld pursuant to chapter 3 of the Code is $2,000 or more, the withholding agent shall deposit such aggregate amount in a Federal Reserve bank or authorized financial institution within 3 banking days after the close of such quarter-monthly period. For purposes of determining the amount of undeposited taxes at the close of a quarter-monthly period, undeposited taxes withheld with respect to items paid during a prior quarter-monthly period shall not be taken into account if the withholding agent made a deposit with respect to such prior quarter-monthly period. A withholding agent will be considered to have complied with the requirements of this subdivision with respect to the close of a quarter-monthly period if:

(a) His deposit is not less than 90 percent of the aggregate amount of the taxes required to be withheld during the period for which the deposit is made, and

(b) If such quarter-monthly period occurs in a month other than December, he deposits any underpayment with his first deposit which is otherwise required by this subparagraph to be made after the 15th day of the following month. Any underpayment of $200 or more for a quarter-monthly period closing during December must be deposited on or before the following January 31.

For purposes of this subparagraph, the term ''quarter-monthly period'' means the first 7 days of a calendar month, the 8th day through the 15th day of a calendar month, the 16th day through the 22d day of a calendar month, or the portion of a calendar month following the 22d day of such month.

(iii) *Excess deposits.* The excess (if any) of a deposit over the actual taxes for a monthly or quarter-monthly deposit period shall be applied in order of time to each of the withholding agent's succeeding deposits with respect to the same calendar year, until exhausted, to the extent that the amount by which the taxes for a subsequent deposit period exceed the deposit for such subsequent deposit period.

(iv) *Annual deposits.* If at the close of the month of December of each calendar year beginning on or after January 1, 1973, the aggregate amount of undeposited taxes required to be withheld pursuant to chapter 3 of the Code is less than $200, the withholding agent may deposit such aggregate amount in a Federal Reserve bank or authorized financial institution on or before March 15 of the following calendar year. If such aggregate amount is not so deposited, it shall be remitted in accordance with paragraph (a)(2) of § 1.1461–3.

(2) *Cross reference.* For rules relating to the adjustment of deposits, see § 1.1461–4(b) and § 1.6414–1. For rules requiring payment of any undeposited tax, see § 1.1461–3.

(b) *Deposits by Federal tax deposit coupon*—(1) *Remittances.* Each remittance of amounts required to be deposited by paragraph (a) of this section shall be accompanied by a Federal Tax Deposit form which shall be prepared in accordance with the instructions applicable thereto. The remittance, together with the Federal Tax Deposit form, shall be forwarded to a financial institution authorized as a depositary for Federal taxes in accordance with 31 CFR part 214 or, at the election of the withholding agent, to a Federal Reserve bank. For procedures governing the deposit of Federal taxes at a Federal Reserve bank, see 31 CFR 214.7. The timeliness of the deposit will be determined by the date stamped on the Federal Tax Deposit form by the Federal Reserve bank or the authorized financial institution or, if section 7502(e) applies, by the date the deposit is treated as received under section 7502(e). Each withholding agent making deposits under this section shall report on the return, for the period with respect to which such deposits are made, information regarding such deposits according to the instructions that apply to such return.

(2) *Voluntary deposits.* An amount of tax which is not required to be deposited may nevertheless be deposited if the withholding agent so desires.

(3) *Separation of deposits.* A deposit required by paragraph (a) of this section for any period occurring in one calendar year shall be made separately from any deposit for any period occurring in another calendar year. In addition, a deposit required to be made by paragraph (a) of this section shall be made separately from a deposit required by any other section.

(4) *Multiple remittances.* A withholding agent may make one, or more than one, remittance of the amount required to be deposited if each remittance is accompanied by the applicable deposit form.

(5) *Time deemed paid.* In general amounts deposited under this section shall be considered as paid on the last day prescribed for filing the return (Form 1042) in respect of such tax (determined without regard to any extension of time for filing such return), or at the time deposited, whichever is later. For purposes of section 6511 and

the regulations thereunder, relating to period of limitation on credit or refund, if an amount is so deposited prior to April 15th of a calendar year immediately succeeding the calendar year in which occurs the period for which such amount was so deposited, such amount shall be considered as paid on such April 15th.

(6) *Procurement of Federal Tax Deposit form.* Copies of the Federal Tax Deposit form will so far as possible be furnished withholding agents. A withholding agent will not be excused from making a deposit, however, by the fact that no form has been furnished to it. A withholding agent not supplied with the form should make application therefor in ample time to make the required deposits within the time prescribed. The withholding agent may secure the form or additional forms by applying therefor and supplying its name, identification number, address, and the taxable period to which the deposit will relate. Copies of the Federal Tax Deposit form may be secured by application therefor to the district director or director of a service center.

(c) *Deposits by electronic funds transfer.* For the requirement to deposit taxes withheld on nonresident aliens and foreign corporations by electronic funds transfer, see §31.6302–1(h) of this chapter. A taxpayer not required to deposit by electronic funds transfer pursuant to §31.6302–1(h) of this chapter remains subject to the rules of paragraph (b) of this section.

(d) *Penalties for failure to make deposits.* For provisions relating to the penalty for failure to make a deposit within the time prescribed by this section, see §301.6656–1 of this chapter (Procedure and Administration Regulations).

(e) *Saturday, Sunday, or legal holidays.* For provisions relating to the time for performance of acts where the last day falls on Saturday, Sunday, or a legal holiday, see §301.7503–1 of this chapter (Procedure and Administration Regulations).

(f) *Employer identification number.* For the definition of the term ''employer identification number'', see §301.7701–12 of this chapter (Procedure and Administration Regulations). For provisions relating to the penalty for failure to include the employer identification number in a return, statement, or other document, see §301.6676–1 of such chapter.

(g) *Effective date.* Except as otherwise provided, this section shall apply to tax required to be withheld under chapter 3 of the Code after 1966.

[T.D. 6922, 32 FR 8713, June 17, 1967, as amended by T.D. 6941, 32 FR 18040, Dec. 16, 1967; T.D. 7243, 38 FR 22, Jan. 3, 1973; T.D. 7953, 49 FR 19644, May 9, 1984; T.D. 8723, 62 FR 37492, July 14, 1997]

§1.6302–3 Use of Government depositaries in connection with estimated taxes of certain trusts.

(a) *Requirement.* A bank or other financial institution described in paragraph (b) of this section shall deposit in its Treasury Tax & Loan account 0described in 31 CFR 203 or with a Federal Reserve Bank all payments of estimated tax required to be paid on or after September 15, 1988, under section 6654(l) with respect to trusts for which such institution acts as a fiduciary on or before the date otherwise prescribed for paying such tax.

(b) *Banks and financial institutions subject to this requirement.* The requirement of paragraph (a) of this section applies to banks and other financial institutions described in sections 581 and 591 that have been designated as authorized Federal tax depositaries described in section 6302(c) and that act as fiduciaries for at least 200 trusts to which section 6654(l) applies that during the calendar year are required to make installment payments of estimated tax with respect to such trusts. For purposes of this section, a fiduciary is the person responsible for filing the tax returns and paying the taxes with respect to a trust.

(c) *Cross-references.* For further guidance and instructions for certain banks and financial institutions acting as fiduciaries with respect to taxable trusts, see Rev. Proc. 89–49 (1989–2 C.B. 615), (see §601.601(d)(2) of this chapter) or any successor revenue procedure. For the requirement to deposit estimated tax payments of taxable trusts by electronic funds transfer, see §31.6302–1(h) of this chapter.

[T.D. 8192, 53 FR 12008, Apr. 12, 1988; T.D. 8192, 53 FR 13464, Apr. 25, 1988, as amended by T.D. 8723, 62 FR 37492, July 14, 1997]

§ 1.6302–4 Use of financial institutions in connection with individual income taxes.

Voluntary payments by electronic funds transfer. An individual may voluntarily remit by electronic funds transfer all payments of tax imposed by subtitle A of the Code, including any payments of estimated tax. Such payments must be made in accordance with procedures to be prescribed by the Commissioner.

[T.D. 8723, 62 FR 37492, July 14, 1997]

§ 1.6361–1 Collection and administration of qualified State individual income taxes.

Except as otherwise provided in §§ 301.6361–1 to 301.6365–2, inclusive, of this chapter (Regulations on Procedure and Administration), the provisions of this part under subtitle F of the Internal Revenue Code of 1954 relating to the collection and administration of the taxes imposed by chapter 1 of such Code on the incomes of individuals (or relating to civil or criminal sanctions with respect to such collection and administration) shall apply to the collection and administration of qualified State individual income taxes (as defined in section 6362 of such Code and the regulations thereunder) as if such taxes were imposed by chapter 1.

[T.D. 7577, 43 FR 59358, Dec. 20, 1978]

ABATEMENTS, CREDITS, AND REFUNDS

§ 1.6411–1 Tentative carryback adjustments.

(a) *In general.* Any taypayer who has a net operating loss under section 172, a net capital loss under section 1211(a) which is a carryback under section 1212, an unused investment credit under section 46, or an unused work incentive program (WIN) credit under section 50A, may file an application under section 6411 for a tentative carryback adjustment of the taxes for taxable years prior to the taxable year of the net operating or capital loss or the unused credit, whichever is applicable, which are affected by the net operating loss carryback, the capital loss carryback, the unused investment credit carryback, or the unused WIN credit carryback, resulting from such loss or unused credit. The regulations under section 6411 shall apply with respect to investment credit carrybacks for taxable years ending after December 31, 1961, but only with respect to applications for tentative carryback adjustments for investment credit carrybacks filed after November 2, 1966. The regulations under section 6411 shall apply with respect to WIN credit carrybacks for taxable years beginning after December 31, 1971. The right to file an application for a tentative carryback adjustment is not limited to corporations, but is available to any taxpayer otherwise entitled to carryback a loss or unused credit. A corporation may file an application for a tentative carryback adjustment even though it has not extended the time for payment of tax under section 6164. In determining any decrease in tax under §§ 1.6411–1 through 1.6411–4, the decrease in tax is determined net of any increase in the tax imposed by section 56 (relating to the minimum tax for tax preferences).

(b) *Contents of application.* (1) The application for a tentative carryback adjustment shall be filed, in the case of a corporation, on Form 1139, and in the case of taxpayers other than corporations, on Form 1045. The application shall be filled out in accordance with the instructions accompanying the form, and all information required by the form and the instructions must be furnished by the taxpayer.

(2) An application for a tentative carryback adjustment does not constitute a claim for credit or refund. If such application is disallowed by the district director or director of a service center in whole or in part, no suit may be maintained in any court for the recovery of any tax based on such application. The filing of an application for a tentative carryback adjustment will not constitute the filing of a claim for credit or refund within the meaning of section 6511 for purposes of determining whether a claim for credit or refund was filed prior to the expiration of the applicable period of limitation. The taxpayer, however, may file a claim for credit or refund under section 6402 at any time prior to the expiration of the applicable period of limitation, and may maintain a suit based on such

claim if it is disallowed or if the district director or director of a service center does not act on the claim within 6 months from the date it is filed. Such claim may be filed before, simultaneously with, or after the filing of the application for a tentative carryback adjustment. A claim for credit or refund under section 6402 filed after the filing of an application for a tentative carryback adjustment is not to be considered an amendment of such application. Such claim, however, in proper cases may constitute an amendment to a prior claim filed under section 6402.

(c) *Time and place for filing application.* Except as otherwise provided in this paragraph the application for a tentative carryback adjustment shall be filed on or after the date of the filing of the return for the taxable year of the net operating loss, net capital loss, unused investment credit, or unused WIN credit and shall be filed within a period of twelve months from the end of such taxable year. With respect to any portion of an investment credit carryback or a WIN credit carryback from a taxable year attributable to a net operating loss carryback or a capital loss carryback from a subsequent taxable year, the twelve-month period shall be measured from the end of such subsequent taxable year. In the case of an application for a tentative carryback adjustment attributable to the carryback of an unused investment credit, the twelve-month period for filing shall not expire before the close of December 31, 1966. Any application filed prior to the date on which the return for the taxable year of the loss or unused credit is filed shall be considered to have been filed on the date such return is filed. In the case of an application filed before April 15, 1968, the application shall be filed with the internal revenue officer to whom the tax was paid or by whom the assessment was made. Except as provided in paragraph (b) of §301.6091–1 (relating to hand-carried documents), in the case of an application filed after April 14, 1968, if the tax was paid to the Director of International Operations, the application shall be filed with him; otherwise the application shall be filed with the internal revenue office with which the return was filed.

[T.D. 6500, 25 FR 12144, Nov. 26, 1960, as amended by T.D. 6862, 30 FR 14432, Nov. 18, 1965; T.D. 6950, 33 FR 5357, Apr. 4, 1968; T.D. 7301, 39 FR 973, Jan. 4, 1974; T.D. 7564, 43 FR 40498, Sept. 12, 1978; T.D. 8107, 51 FR 43347, Dec. 2, 1986]

§1.6411–2 Computation of tentative carryback adjustment.

(a) *Tax previously determined.* The taxpayer is to determine the amount of decrease, attributable to the carryback, in tax previously determined for each taxable year before the taxable year of the net operating loss, net capital loss, unused investment credit, or unused WIN credit. The tax previously determined is to be ascertained in accordance with the method prescribed in section 1314(a). Thus, the tax previously determined will be the tax shown on the return as filed, increased by any amounts assessed (or collected without assessment) as deficiencies before the date of the filing of the application for a tentative carryback adjustment, and decreased by any amounts abated, credited, refunded, or otherwise repaid prior to such date. Any items as to which the Internal Revenue Service and the taxpayer are in disagreement at the time of the filing of the application shall be taken into account in ascertaining the tax previously determined only if, and to the extent that, they were reported in the return, or were reflected in any amounts assessed (or collected without assessment) as deficiencies, or in any amounts abated, credited, refunded, or otherwise repaid, before the date of filing the application. The tax previously determined, therefore, will reflect the foreign tax credit and the credit for tax withheld at source provided in section 32.

(b) *Decrease attributable to carryback.* The decrease in tax previously determined which is affected by the carryback or any related adjustments, is to be determined, except for such carryback and related adjustments, on the basis of the items which entered into the computation of such tax as previously determined; the tax previously determined being ascertained in the manner described in this section.

In determining any such decrease, items shall be taken into account only to the extent that they were reported in the return, or were reflected in amounts assessed (or collected without assessment) as deficiencies, or in amounts abated, credited, refunded, or otherwise repaid, before the date of filing the application for a tentative carryback adjustment. If the Internal Revenue Service and the taxpayer are in disagreement as to the proper treatment of any item, it shall be assumed for purposes of determining the decrease in the tax previously determined that such item was correctly reported by the taxpayer unless, and to the extent that, the disagreement has resulted in the assessment of a deficiency (or the collection of an amount without an assessment), or the allowing or making of an abatement, credit, refund, or other repayment, before the date of filing the application. Thus, if the taxpayer claimed a deduction on its return of $50,000 for salaries paid its officers but the district director asserts that such deduction should not exceed $20,000, and the Internal Revenue Service and the taxpayer have not agreed on the amount properly deductible before the date the application for a tentative carryback adjustment is filed, $50,000 shall be considered as the amount properly deductible for purposes of determining the decrease in tax previously determined in respect of the application for a tentative carryback adjustment. In determining the decrease in tax previously determined, any items which are affected by the carryback must be adjusted to reflect such carryback. Thus, unless otherwise provided, any deduction limited, for example, by adjusted gross income, such as the deduction for medical, dental, etc., expenses is to be recomputed on the basis of the adjusted gross income as affected by the carryback.

[T.D. 6500, 25 FR 12144, Nov. 26, 1960, as amended by T.D. 7301, 39 FR 973, Jan. 4, 1974]

§ 1.6411–3 Allowance of adjustments.

(a) *Time prescribed.* The district director or director of a service center (either of whom are sometimes hereinafter referred to in this section as internal revenue officer) shall act upon any application for a tentative carryback adjustment filed under section 6411(a) within a period of 90 days from whichever of the following two dates is the later:

(1) The date the application is filed; or

(2) The last day of the month in which falls the last date prescribed by law (including any extension of time granted the taxpayer) for filing the return for the taxable year of the net operating loss, net capital loss, unused investment credit, or unused WIN credit from which the carryback results.

(b) *Examination.* Within the 90-day period described in paragraph (a) of this section, the district director or director of a service center shall make, to the extent he deems practicable in such period, an examination of the application to discover omissions and errors of computation. He shall determine within such period the decrease in tax previously determined, affected by the carryback or any related adjustments, upon the basis of the application and such examination. Such decrease shall be determined in the same manner as that provided in section 1314(a) for the determination by the taxpayer of the decrease in taxes previously determined which must be set forth in the application for a tentative carryback adjustment. Such internal revenue officer, however, may correct any errors of computation or omissions he may discover upon examination of the application. In determining the decrease in tax previously determined which is affected by the carryback or any related adjustment, he accordingly may correct any mathematical error appearing on the application and he may likewise correct any modification required by the law and incorrectly made by the taxpayer in computing the net operating loss, net capital loss, unused investment credit, or unused WIN credit, the resulting carrybacks, or the net operating loss deduction, capital loss deduction, investment credit or WIN credit allowable. If the required modification has not been made by the taxpayer and such internal revenue officer has available the necessary information to make such modification within the 90-day period, he may, in his discretion, make such modification. In determining such decrease, however, such internal revenue officer will not, for example, change the amount claimed on the return as a deduction for depreciation because he believes that the taxpayer has claimed an excessive amount; likewise, he will not include in gross income any amount not so included by the taxpayer, even though such officer believes that such amount is subject to tax and properly should be included in gross income.

(c) *Disallowance in whole or in part.* If the district director or director of a service center finds that an application for a tentative carryback adjustment contains materials omissions or errors of computation, he may disallow such application in whole or in part without further action. If, however, he deems that any error of computation can be corrected by him within the 90-day period, he may do so and allow the application in whole or in part. Such internal revenue officer's determination as to whether he can correct any error of computation within the 90-day period shall be conclusive. Similarly, his action in disallowing, in whole or in part, any application for a tentative carryback adjustment shall be final and may not be challenged in any proceeding. The taxpayer in such case, however, may file a claim for credit or refund under section 6402, and may maintain a suit based on such claim if it is disallowed or if such internal revenue officer does not act upon the claim within 6 months from the date it is filed.

(d) *Application of decrease.* (1) Each decrease determined by the district director or director of a service center in any previously determined tax which is affected by the carryback or any related adjustments shall first be applied against any unpaid amount of the tax with respect to which such decrease was determined. Such unpaid amount of tax may include one or more of the following:

(i) An amount with respect to which the taxpayer is delinquent;

(ii) An amount the time for payment of which has been extended under section 6164 and which is due and payable on or after the date of the allowance of the decrease; and

(iii) An amount (including an amount the time for payment of which has been extended under section 6162, but not including an amount the time for payment of which has been extended under section 6164) which is due and payable on or after the date of the allowance of the decrease.

(2) In case the unpaid amount of tax includes more than one of such amounts, the district director, or director of a service center in his discretion, shall determine against which amount or amounts, and in what proportion, the decrease is to be applied. In general, however, the decrease will be applied against any amounts described in subparagraph (1) (i), (ii), and (iii) of this paragraph in the order named. If there are several amounts of the type described in subparagraph (1)(iii) of this paragraph, any amount of the decrease which is to be applied against such amount will be applied by assuming that the tax previously determined minus the amount of the decrease to be so applied is ''the tax'' and that the taxpayer had elected to pay such tax in installments. The unpaid amount of tax against which a decrease may be applied under subparagraph (1) of this paragraph may not include any amount of tax for any taxable year other than the year of the decrease. After making such application, such internal revenue officer will credit any remainder of the decrease against any unsatisfied amount of any tax for the taxable year immediately preceding the taxable year of the net operating loss, capital loss, unused investment credit, or unused WIN credit, the time for payment of which has been extended under section 6164.

(3) Any remainder of the decrease after such application and credits may, within the 90-day period, in the discretion of the district director or director of a service center, be credited against any tax or installment thereof then due from the taxpayer, and, if not so credited, shall be refunded to the taxpayer within such 90-day period.

[T.D. 6950, 33 FR 5358, Apr. 4, 1968, as amended by T.D. 7301, 39 FR 973, Jan. 4, 1974]

§1.6411–4 Consolidated groups.

For further rules applicable to consolidated groups, see §1.1502–78. For further rules applicable to consolidated groups that include insolvent financial institutions, see § 301.6402–7 of this chapter.

[T.D. 8446, 57 FR 53034, Nov. 6, 1992]

§ 1.6414–1 Credit or refund of tax withheld on nonresident aliens and foreign corporations.

(a) *In general.* Any withholding agent who for the calendar year pays more than the correct amount of:

(1) Tax required to be withheld under chapter 3 of the Code, or

(2) Interest, addition to the tax, additional amount, or penalty with respect to such tax,

may file a claim for credit or refund of the overpayment in the manner and subject to the conditions stated in the Procedure and Administration Regulations (Part 301 of this chapter) under section 6402, or may claim credit for the overpayment as provided in paragraph (b) of this section.

(b) *Claim for credit on Form 1042.* The withholding agent may claim credit of an overpayment described in paragraph (a) of this section for any calendar year by showing the amount of overpayment on the return on Form 1042 for such calendar year, which shall constitute a claim for credit under this paragraph. The claim for credit shall be evidenced by a statement on the return setting forth the amount determined as an overpayment and showing such other information as may be required by the instructions relating to the return. The amount so claimed as a credit may be applied, to the extent it has not been applied under paragraph (b) of § 1.1461–4, by the withholding agent to reduce the amount of a payment or deposit of tax required by § 1.1461–3 or paragraph (a) of § 1.6302–2 for any payment period occurring in the calendar year following the calendar year of overwithholding. The amount so claimed as a credit shall also be entered on the annual return on Form 1042 for the calendar year following the calendar year of overwithholding and shall be applied as a payment on account of the tax shown on such form. If the withholding agent files a claim for credit or refund of the overpayment on Form 843 in accordance with § 301.6402–2 of this chapter (Procedure and Administration Regulations), or a claim for refund of the overpayment on Form 1042 in accordance with § 301.6402–3 of such chapter, he may not claim credit for the overpayment under this paragraph.

(c) *Overpayment of amounts actually withheld.* No credit or refund to the withholding agent shall be allowed for the amount of any overpayment of tax which, after taking into account paragraph (b) of § 1.1464–1, the withholding agent has actually withheld from an item of income under chapter 3 of the Code.

[T.D. 6922, 32 FR 8714, June 17, 1967]

§ 1.6425–1 Adjustment of overpayment of estimated income tax by corporation.

(a) *In general.* Any corporation which has made an overpayment of estimated income tax for a taxable year beginning after December 31, 1967, may file an application for an adjustment of such overpayment. The right to file an application for an adjustment of overpayment of estimated income tax is limited to corporations.

(b) *Contents of application.* (1) The application for an adjustment of overpayment of estimated income tax shall be filed on Form 4466. The application shall be filled out in accordance with the instructions accompanying the form, and all information required by the form and instructions must be furnished by the corporation. The application shall be verified in the manner prescribed by section 6065 as in the case of a return of the corporation.

(2) An application for an adjustment of overpayment of estimated income tax does not constitute a claim for credit or refund. If such application is disallowed by the district director, or director of a service center, in whole or in part, no suit may be maintained in any court for the recovery of any tax based on such application. The filing of an application for an adjustment of overpayment of estimated income tax will not constitute the filing of a claim for credit or refund within the meaning of section 6511 for the purpose of determining whether a claim for refund was filed prior to the expiration of the applicable period of limitation. The corporation, however, may file a claim for credit or refund under section 6402 at any time prior to the expiration of the

applicable period of limitation and may maintain a suit based on such claim if it is disallowed or if the district director, or director of a service center, does not act on the claim within 6 months from the date it is filed. Such claim may be filed before, simultaneously with, or after the filing of the application for the adjustment of overpayment of estimated tax. A claim for credit or refund under section 6402 filed after the filing of an application for an adjustment of overpayment of estimated income tax is not to be considered an amendment of such application. Such claim, however, in proper cases, may constitute an amendment to a prior claim filed under section 6402.

(c) *Time and place for filing application.* (1) The application for an adjustment of overpayment of estimated income tax shall be filed after the last day of the taxable year and on or before the 15th day of the third month thereafter, or before the date on which the corporation first files its income tax return for such taxable year (whether or not it subsequently amends the return), whichever is earlier.

(2) Except as provided in paragraph (b)(2) of §301.6091–1 of this chapter (relating to hand-carried documents), the application on Form 4466 shall be filed with the internal revenue officer designated in instructions applicable to such form.

[T.D. 7059, 35 FR 14546, Sept. 17, 1970]

§1.6425–2 Computation of adjustment of overpayment of estimated tax.

(a) *Income tax liability defined.* For purposes of §§1.6425–1 through 1.6425–3 and 1.6655–5, relating to excessive adjustment, the term ''income tax liability'' means the excess of:

(1) The tax imposed by section 11 or 1201(a), or subchapter L of chapter 1 of the Code, whichever is applicable, over

(2) The credits against tax provided by part IV of subchapter A of chapter 1 of the code.

(b) *Computation of adjustment.* The amount of an adjustment under section 6425 is an amount equal to the excess of the estimated income tax paid by the corporation during the taxable year over the amount which, at the time of filing Form 4466, the corporation estimates as its income tax liability for the taxable year.

[T.D. 7059, 35 FR 14547, Sept. 17, 1970]

§1.6425–3 Allowance of adjustments.

(a) *Limitation.* No application under section 6425 shall be allowed unless the amount of the adjustment is (1) at least 10 percent of the amount which, at the time of filing Form 4466 the corporation estimates as its income tax liability for the taxable year, and (2) at least $500.

(b) *Time prescribed.* The Internal Revenue Service shall act upon an application for an adjustment of overpayment of estimated income tax within a period of 45 days from the date on which such application is filed.

(c) *Examination.* Within the 45-day period described in paragraph (b) of this section, the Internal Revenue Service shall make, to the extent it deems practicable in such period, a limited examination of the application to discover omissions and errors therein. The Service shall calculate the adjustment, which calculation must be set forth in the application for such adjustment, in the manner provided in section 6425(c)(2) for the determination by the corporation of such adjustment. The Service, however, may correct any material error or omission that is discovered upon examination of the application. In determining the adjustment, the Service may correct any mathematical error appearing on the application, and it may likewise make any modification required by the law to correct the corporation's computation of the adjustment. If the required modification has not been made by the corporation and the Service has available the necessary information to make such modification within the 45-day period, it may make such modification. The examination of the application and the allowance of the adjustment shall not prejudice any right of the Service to claim later that the adjustment was improper.

(d) *Disallowance in whole or in part.* If the Internal Revenue Service finds that an application for an adjustment of overpayment of estimated tax contains material omissions or errors, the Service may disallow such application in whole or in part without further action. If, however, the Service deems that any omission or error can be corrected by it within the 45-day period, it may do so and allow the application in whole or in part. In the case of a disallowance or modification, the Service shall notify the corporation of such action. The Service's determination as to whether it can correct any omission or error shall be conclusive. Similarly, its action in disallowing, in whole or in part, any application for an adjustment of overpayment of estimated income tax shall be final and may not be challenged in any proceeding. The corporation in such case, however, may file a claim for credit or refund under section 6402, and may maintain a suit based on such claim if it is disallowed or if the Service does not act upon the claim within 6 months from the date it is filed.

(e) *Application of adjustment.* If the Internal Revenue Service allows the adjustment, it may first credit the amount of the adjustment against any liability in respect of an internal revenue tax on the part of the corporation which is due and payable on the date of the allowance of the adjustment before making payment of the balance to the corporation. In such a case, the Service shall notify the corporation of the credit, and refund the balance of the adjustment.

(f) *Effect of adjustment.* (1) For purposes of all sections of the Code except section 6655, relating to additions to tax for failure to pay estimated income tax, any adjustment under section 6425 is to be treated as a reduction of prior estimated tax payments as of the date the credit is allowed or the refund is paid. For the purpose of section 6655 (a) through (f) credit or refund of an adjustment is to be treated as if not made in determining whether there has been any underpayment of estimated income tax and, if there is an underpayment, the period during which the underpayment existed. However, an excessive adjustment under section 6425 shall be taken into account in applying the addition to tax under section 6655(g).

(2) *Excessive adjustment.* For the effect of an excessive adjustment under section 6425, see § 1.6655–5.

[T.D. 7059, 35 FR 14547, Sept. 17, 1970]

ADDITIONS TO THE TAX, ADDITIONAL AMOUNTS, AND ASSESSABLE PENALTIES

§ 1.6654–1 Addition to the tax in the case of an individual.

(a) *In general.* (1) Section 6654 imposes an addition to the taxes under chapters 1 and 2 of the Code in the case of any underpayment of estimated tax by an individual (with certain exceptions described in section 6654(d)), including any underpayment of estimated qualified State individual income taxes which are treated pursuant to section 6361(a) as if they were imposed by chapter 1. This addition to the tax is in addition to any applicable criminal penalties and is imposed whether or not there was reasonable cause for the underpayment. The amount of the underpayment for any installment date is the excess of:

(i) The following percentages of the tax shown on the return for the taxable year or, if no return was filed, of the tax for such year, divided by the number of installment dates prescribed for such taxable year:

(A) 80 percent in the case of taxable years beginning after December 31, 1966, of individuals not referred to in section 6073(b) (relating to income from farming or fishing);

(B) 70 percent in the case of taxable years beginning before January 1, 1967, of such individuals; and

(C) 66⅔ percent in the case of individuals referred to in section 6073(b); over

(ii) The amount, if any, of the installment paid on or before the last day prescribed for such payment.

(2) The amount of the addition is determinated at the annual rate referred to in the regulations under section 6621 upon the underpayment of any installment of estimated tax for the period from the date such installment is required to be paid until the 15th day of the fourth month following the close of the taxable year, or the date such underpayment is paid, whichever is earlier. For purposes of determining the period of the underpayment (i) the date

prescribed for the payment of any installment of estimated tax shall be determined without regard to any extension of time, and (ii) a payment of estimated tax on any installment date, to the extent that it exceeds the amount of the installment determined under subparagraph (1)(i) of this paragraph for such installment date, shall be considered a payment of any previous underpayment.

(3) In determining the amount of the installment paid on or before the last day prescribed for payment thereof, the estimated tax shall be computed without any reduction for the amount which the taxpayer estimates as his credit under section 31 (relating to tax withheld at source on wages), and the amount of such credit shall be deemed a payment of estimated tax. An equal part of the amount of such credit shall be deemed paid on each installment date (determined under section 6153) for the taxable year unless the taxpayer establishes the dates on which all amounts were actually withheld. In the latter case, all amounts withheld shall be considered as payments of estimated tax on the dates such amounts were actually withheld. Under section 31 the entire amount withheld during a calendar year is allowed as a credit against the tax for the taxable year which begins in such calendar year. However, where more than one taxable year begins in any calendar year no portion of the amount withheld during the calendar year will be treated as a payment of estimated tax for any taxable year other than the last taxable year beginning in such calendar year. The rules prescribed in this subparagraph for determining the time as of which the amount withheld shall be deemed paid are applicable even though such amount was withheld during a taxable year preceding that for which the credit is allowed.

(4) The term *tax* when used in subparagraph (1)(i) of this paragraph shall mean:

(i) The tax imposed by chapter 1 of the Code (other than by section 56 or, for taxable years ending before September 30, 1968, the tax surcharge imposed by section 51), including any qualified State individual income taxes which are treated pursuant to section 6361(a) as if they were imposed by chapter 1, plus—

(ii) For taxable years beginning after December 31, 1966, the tax imposed by chapter 2 of the Code, minus

(iii) All credits allowed by part IV, subchapter A of chapter 1, except the credit provided by section 31, relating to tax withheld at source on wages, minus

(iv) In the case of an individual who is subject to one or more qualified State individual incomes taxes, the sum of the credits allowed against such taxes pursuant to section 6362(b)(2) (B) or (C) or section 6362(c)(4) and paragraph (c) of §301.6362–4 of this chapter (Regulations on Procedure and Administration) (relating to the credit for income taxes of other States or political subdivisions thereof) and paragraph (c)(2) of §301.6361–1 (relating to the credit for tax withheld from wages on account of qualified State individual income taxes), and minus

(v) For taxable years ending after February 29, 1980, the individual's overpayment of windfall profit tax imposed by section 4986 of the Code for the taxable year. For this purpose, the amount of such overpayment is the sum of (A) the amount by which such individual's aggregate windfall profit tax liability for the taxable year as a producer of crude oil is exceeded by withholding of windfall profit tax for the taxable year, and (B) any amount treated under section 6429 or 6430 as an overpayment of windfall profit tax for crude oil removed during the taxable year. The deemed payment date in section 4995(a)(4)(B) for the amount of windfall profit tax withheld with respect to payments for crude oil shall have no effect in the determination of the overpayment of windfall profit tax.

(b) *Statement relating to underpayment.* If there has been an underpayment of estimated tax as of any installment date prescribed for its payment and the taxpayer believes that one or more of the exceptions described in §1.6654–2 precludes the assertion of the addition to the tax under section 6654, he should attach to his income tax return for the taxable year a Form 2210 showing the applicability of any exception upon which he relies.

(c) *Examples.* The method prescribed in paragraph (a) of this section for computing the addition to the tax may be illustrated by the following examples:

Example (1). An individual taxpayer files his return for the calendar year 1972 on April 15, 1973, showing a tax (income and self-employment tax) of $30,000. He had paid a total of $20,000 of estimated tax in four installments of $5,000 on each of the four installment dates prescribed for such year. No other payments were made prior to the date the return was filed. Since the amount of each installment paid by the last date prescribed for payment thereof is less than one-quarter of 80 percent of the tax shown on the return, the addition to the tax is applicable in respect of the underpayment existing as of each installment date and is computed as follows:

(1) Amount of tax shown on return	$30,000
(2) 80 percent of item (1)	24,000
(3) One-fourth of item (2)	6,000
(4) Deduct amount paid on each installment date	5,000
(5) Amount of underpayment for each installment date (item (3) minus item (4))	1,000
(6) Addition to the tax:	
1st installment—period 4–15–72 to 4–15–73	60
2nd installment—period 6–15–72 to 4–15–73	50
3rd installment—period 9–15–72 to 4–15–73	35
4th installment—period 1–15–73 to 4–15–73	15
Total	$160

Example (2). An individual taxpayer files his return for the calendar year 1955 on April 15, 1956, showing a tax of $30,000. The requirements of section 6015(a) were first met after April 1 and before June 2, 1955, and a total of $18,000 of estimated tax was paid in three equal installments of $6,000 on each of the three installment dates prescribed for such year. Since the amount of each installment paid by the last date prescribed for payment thereof is less than one-third of 70 percent of the tax shown on the return, the addition to the tax is existing as of each installment date and is applicable in respect of the underpayment computed as follows:

(1) Amount of tax shown on return	$30,000
(2) 70 percent of item (1)	21,000
(3) One-third of item (2)	7,000
(4) Deduct amount paid on each installment date	6,000
(5) Amount of underpayment for each installment date (item (3) minus item (4))	1,000
(6) Addition to the tax:	
1st installment—period 6–15–55 to 4–15–56	$50
2d installment—period 9–15–55 to 4–15–56	35
3d installment—period 1–15–56 to 4–15–56	15
Total	100

(Secs. 6015, 6154, 6654, 6655, and 7805, Internal Revenue Code of 1954 (96 Stat. 2395 and 2396, 68A Stat. 917; 26 U.S.C. 6015, 6154, 6654, 6655, and 7805))

[T.D. 6500, 25 FR 12146, Nov. 26, 1960, as amended by T.D. 7384, 40 FR 49322, Oct. 22, 1975; T.D. 7427, 41 FR 34029, Aug. 12, 1976; T.D. 7577, 43 FR 59358, Dec. 20, 1978; T.D. 8016, 50 FR 11855, Mar. 26, 1985]

§ 1.6654–2 Exceptions to imposition of the addition to the tax in the case of individuals.

(a) *In general.* The addition to the tax under section 6654 will not be imposed for any underpayment of any installment of estimated tax if, on or before the date prescribed for payment of the installment, the total amount of all payments of estimated tax made equals or exceeds the least of the following amounts:

(1) The amount which would have been required to be paid on or before the date prescribed for payment if the estimated tax were the tax shown on the return for the preceding taxable year, provided that the preceding taxable year was a year of 12 months and a return showing a liability for tax was filed for such year. However, this subparagraph shall not apply with respect to any taxable year which ends on or after September 30, 1968, for which a tax is imposed by section 51 (relating to tax surcharge), in the case of a payment of estimated tax the time prescribed for payment of which is on or after September 15, 1968.

(2) The amount which would have been required to be paid on or before the date prescribed for payment if the estimated tax were an amount equal to a percentage of the tax computed by placing on an annual basis the taxable income for the calendar months in the taxable year ending before the month in which the installment is required to be paid. That percentage is 80 percent in the case of taxable years beginning after December 31, 1966, of individuals not referred to in section 6073(b) (relating to income from farming or fishing), 70 percent in the case of taxable years beginning before January 1, 1967, of

such individuals, and 66⅔ percent in the case of individuals referred to inferred to in section 6073(b). With respect to taxable years beginning after December 31, 1966, the adjusted self-employment income shall be taken into account in determining the amount referred to in this subparagraph if net earnings from self-employment (as defined in section 1402(a)) for the taxable year equal or exceed $400. For purposes of this subparagraph:

(i) Taxable income shall be placed on an annualized basis:

(A) For taxable years beginning after 1976, by:

(*1*) Multiplying by 12 (or the number of months in the taxable year if less than 12) the adjusted gross income and the itemized deductions for the calendar months in the taxable year ending before the month in which the installment is required to be paid,

(*2*) Dividing the resulting amounts by the number of such calendar months,

(*3*) Increasing the amount of the annualized adjusted gross income by the unused zero bracket amount, if any, determined by reference to the annualized itemized deductions, or decreasing the amount of the annualized adjusted gross income by the excess itemized deductions, if any, determined by reference to the annualized itemized deductions (the amount resulting under this step is annualized tax table income), and

(*4*) Deducting from the annualized tax table income the deduction for personal exemptions (such personal exemptions being determined as of the date prescribed for payment of the installment).

If the taxpaper would be eligible to use the tax tables on the basis of annualized tax table income, the amount which would have been required to be paid for purposes of this subparagraph may be determined by applying the tax tables to annualized tax table income. the amount resulting under (3).

(B) For taxable years beginning before 1977, by:

(*1*) Multiplying by 12 (or the number of months in the taxable year if less than 12) the taxable income (computed without the standard deduction and without the deduction for personal exemptions), or the adjusted gross income if the standard deduction is to be used for the calendar months in the taxable year ending before the month in which the installment is required to be paid,

(*2*) Dividing the resulting amount by the number of such calendar months, and

(*3*) Deducting from such amount the standard deduction, if applicable, and the deduction for personal exemptions (such personal exemptions being determined as of the date prescribed for payment of the installment).

(ii) The term ‘‘adjusted self-employment income’’ means:

(A) The net earnings from self-employment (as defined in section 1402(a)) for the calendar months in the taxable year ending before the month in which the installment is required to be paid, computed as if such months constituted the taxable year, but not more than

(B) The excess of:

(1) For taxable years beginning after 1966, $6,600

(2) For taxable years beginning after 1971, $9,000,

(3) For taxable years beginning after 1972, $10,800,

(4) For taxable years beginning after 1973, $13,200, and

(5) For taxable years beginning after 1974, an amount equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) which is effective for the calendar year in which the taxable year begins, over the amount of the wages (within the meaning of section 1402(b)) for such calendar months placed on an annual basis. For this purpose, wages are annualized by multiplying by 12 (or the number of months in the taxable year in the case of a taxable year of less than 12 months) the wages for such calendar months and dividing the resulting amount by the number of such months.

(3) An amount equal to 90 percent of the tax computed, at the rates applicable to the taxable year, on the basis of the actual taxable income for the calendar months in the taxable year ending before the month in which the the installment is required to ber paid, as if such months constituted the entire

taxable year. For taxable years beginning after December 31, 1966, such computation shall include the tax imposed by chapter 2 on the actual self-employment income for such months. For purposes of this subparagraph, the term ''actual self-employment income'' means:

(i) The net earnings from self-employment (as defined in section 1402(a))for such calendar months, computed as if such months constituted the taxable year, but not more than

(ii) The excess of:

(A) For taxable years beginning after 1966, $6,600,

(B) For taxable years beginning after 1971, $9,000,

(C) For taxable years beginning after 1972, $10,800,

(D) For taxable years beginning after 1973, $13,200, and

(E) For taxable years beginning after 1974, an amount equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) which is effective for the calendar year in which the taxable year begins, over the amount of wages (within the meaning of section 1402(b)) for such months.

(4) The amount which would have been required to be paid on or before the date prescribed for payment if the estimated tax were an amount equal to a tax determined on the basis of the tax rates and the taxpayer's status with respect to personal exemptions under section 151 for the taxable year, but otherwise on the basis of the facts shown on the return for the preceding taxable year and the law applicable to such year, in the case of an individual required to file a return for such preceding taxable year.

In the case of a taxpayer whose taxable year consists of 52 or 53 weeks in accordance with section 441(f), the rules prescribed by paragraph (b) of § 1.441–2 shall be applicable in determining, for purposes of subparagraph (1) of this paragraph, whether a taxable year was a year of 12 months and, for purposes of subparagraphs (2) and (3) of this paragraph, the number of calendar months in a taxable year preceding the date prescribed for payment of an installment of estimated tax. For the rules to be applied in determining taxable income for any period described in subparagraphs (2) and (3) of this paragraph in the case of a taxpayer who employs accounting periods *(e.g.*, thirteen 4-week periods or four 13-week periods) none of which terminates with the end of the applicable period described in subparagraph (2) or (3) of this paragraph, see paragraph (a)(5) of § 1.6655–2.

(b) *Meaning of terms.* As used in this section and § 1.6654–3:

(1) The term ''tax'' means:

(i) The tax imposed by chapter 1 of the Code (other than by section 56), including any qualified State individual income taxes which are treated pursuant to section 6361(a) as if they were imposed by chapter 1, plus

(ii) For taxable years beginning after December 31, 1966, the tax imposed by chapter 2 of the Code, minus

(iii) The credits against tax allowed by part iv, subchapter A, chapter 1 of the Code, other than the credit against tax provided by section 31 (relating to tax withheld on wages), and without reduction for any payments of estimated tax, minus

(iv) In the case of an individual who is subject to one or more qualified State individual income taxes, the sum of the credits allowed against such taxes pursuant to section 6262(b)(2) (B) or (C) or section 6262(c)(4) and paragraph (c) of § 301.6362–4 of this chapter (Regulations on Procedure and Administration) (relating to the credit for income taxes of other States or political subdivisions thereof) and paragraph (c)(2) of § 301.6361–1 (relating to the credit for tax withheld from wages on account of qualified State individual income taxes), and minus

(v) For taxable years ending after February 29, 1980, the individual's overpayment of windfall profit tax imposed by section 4986 of the Code for the taxable year. For this purpose, the amount of such overpayment is the sum of (A) the amount by which such individual's aggregate windfall profit tax liability for the taxable year as producer of crude oil is exceeded by withholding of windfall profit tax for the taxable year, and (B) any amount treated under section 6429 or 6430 as an overpayment of windfall profit tax for crude oil removed during the taxable year. The deemed payment date in section 4995(a)(4)(B) for the amount of windfall profit tax withheld with respect to payments for crude oil shall have no effect in the determination of the overpayment of windfall profit tax.

(2) The credits against tax allowed by part IV, subchapter A, chapter 1 of the Code, are:

(i) In the case of the exception described in paragraph (a)(1) of this section, the credits shown on the return for the preceding taxable year,

(ii) In the case of the exceptions described in paragraph (a)(2) and (3) of this section, the credits computed under the law and rates applicable to the current taxable year, and

(iii) In the case of the exception described in paragraph (a)(4) of this section, the credits shown on the return for the preceding taxable year, except that if the amount of any such credit would be affected by any change in rates or status with respect to personal exemptions, the credits shall be determined by reference to the rates and status applicable to the current taxable year.

A change in rate may be either a change in the rate of tax, such as a change in the rate of the tax imposed by section 1 or section 1401, or a change in a percentage affecting the computation of the credit, such as a change in the rate of withholding under chapter 3 of the Code or a change in the percentage of a qualified investment which is specified in section 46 for use in determining the amount of the investment credit allowed by section 38.

(3) The term ''return for the preceding taxable year'' means the income tax return for such year which is required by section 6012(a)(1) and, in the case of taxable years beginning after December 31, 1966, the self-employment tax return for such year which is required by section 607.

(c) *Examples.* The following examples illustrate the application of the exceptions to the imposition of the addition to the tax for an underpayment of estimated tax, in the case of an individual whose taxable year is the calendar year:

Example (1). A, a married man with one child and a dependent parent, files a joint return with his spouse, B, for 1955 on April 15, 1956, showing taxable income of $44,000 and a tax of $16,760. A and B had filed a joint declaration of estimated tax on April 15, 1955, showing an estimated tax of $10,000 which was paid in four equal installments of $2,500 each on April 15, June 15, and September 15, 1955, and January 15, 1956. The balance of $6,760 was paid with the return. A and B have an underpayment of estimated tax of $433 (¼ of 70 percent of $16,760, less $2,500) for each installment date. The 1954 calendar year return of A and B showed a liability of $10,000. Since the total amount of estimated tax paid by each installment date equalled the amount that would have been required to be paid on or before each of such dates if the estimated tax were the tax shown on the return for the preceding year, the exception described in paragraph (a)(1) of this section applies and no addition to the tax will be imposed.

Example (2). Assume the same facts as in example (1), except that the joint return of A and B for 1954 showed taxable income of $32,000 and a tax liability of $10,400. Assume further that only two personal exemptions under section 151 appeared on the 1954 return. The exception described in paragraph (a)(1) of this section would not apply. However, A and B are entitled to four exemptions under section 151 for 1955. Taxable income for 1954 based on four exemptions, but otherwise on the basis of the facts shown on the 1954 return, would be $30,800. The tax on such amount in the case of a joint return would be $9,836. Since the total amount of estimated tax paid by each installment date exceeds the amount which would have been required to be paid on or before each of such dates if the estimated tax were $9,836, the exception described in paragraph (a)(4) of this section applies and no addition to the tax will be imposed.

Example (3). C, who is self-employed (other than as a farmer or fisherman), has annualized taxable income of $6,900 for the period January 1, 1967, through August 31, 1967, the income tax on which is $1,171. For the same period his net earnings from self-employment are $5,000 and his wages are $2,000. The estimated tax payments made by C for 1967 on or before September 15, 1967, total $1,200. For the purposes of the exception described in paragraph (a)(2) of this section, the adjusted self-employment income is $3,600, computed as follows:

(1) Net earnings from self-employment	$5,000
(2) $6,600 minus annualized wages ($6,600 − 3,000 ($2,000×12÷8))	3,600
(3) Lesser of (1) or (2)	3,600

The tax on C's adjusted self-employment income would be $230.40 ($3,600×6.4 percent). Since the total amount of estimated tax paid on or before September 15, 1967, exceeds $1,121.12, that is, 80 percent of $1,401.40 ($1,171+230.40), the exception described in paragraph (a)(2) of this section applies and no addition to tax will be imposed.

Example (4). D, who is self-employed (other than as a farmer or fisherman), has actual taxable income of $3,800 for the period January 1, 1967, through August 31, 1967, the income tax on which is $586. For the same period his net earnings from self-employment are $5,000 and his wages are $2,000. The estimated tax payments made by D for 1967 on or before September 15, 1967, total $840. For the purposes of the exception described in paragraph (a)(3) of this section, the actual self-employment income for this period is $4,600, computed as follows:

(1) Net earnings from self-employment	$5,000
(2) $6,600 minus wages ($6,600−2,000)	4,600
(3) Lesser of (1) or (2)	4,600

The tax on D's actual self-employment income would be $294.40 ($4,600×6.4 percent). Since the total amount of estimated tax paid by September 15, 1967, exceeds $792.36, that is, 90 percent of $880.40 ($586+294.40), the exception described in paragraph (a)(3) of this section applies and no addition to tax will be imposed.

Example (5). E and F, his spouse, filed a joint return for the calendar year 1967, showing a tax liability of $10,000. The liability, attributable primarily to income received during the last quarter of the year, included both income and self-employment tax. Their aggregate payments of estimated tax on or before September 15, 1967, total $1,350, representing three installments of $450 paid on each of the first three installment dates prescribed for the taxable year. Since each installment paid, $450, was less then $2,000 (¼ of 80 percent of $10,000), there was an underpayment on each of the installment dates. Assume that the exceptions described in paragraph (a) (1) and (4) of this section do not apply. Actual taxable income for the three months ending March 31, 1967, was $2,000 and for the five months ending May 31, 1967, was $4,500. Actual self-employment income, for the same periods, was $2,000 and $4,000, respectively. Since the amounts paid by the April 15 and June 15 installment dates, $450 and $900, respectively, exceed $376.20 and $873.90, respectively (90 percent of the income tax on the actual taxable income of $2,000 and $4,500, respectively, determined on the basis of a joint return, and the self-employment tax on the actual self-employment income of $2,000 and $4,000, respectively), the exception described in paragraph (a)(3) of this section applies and no addition to the tax will be imposed for the underpayments on the April 15 and June 15 installment dates. For the eight months ending August 31, 1967, actual taxable income, assuming E and F did not elect to use the standard deduction, was $7,500; net earnings from self-employment were $6,000 and wages were $2,700. Since the total amount paid by the September 15 installment date, $1,350, was less than $1,381.14 (90 percent of the income tax on the actual taxable income of $7,500 determined on the basis of a joint return and the self-employment tax on actual self-employment income of $3,900 ($6,600−2,700)), the exception described in paragraph (a)(3) of this section does not apply to the September 15 installment. Furthermore, the exception described in paragraph (a)(2) of this section does not apply, as illustrated by the following computation:

(1) Income tax:	
Taxable income for the period ending Aug. 31, 1967 (without deduction for personal exemptions) on an annual basis ($8,700×12÷8)	$13,050.00
Deduction for two personal exemptions	1,200.00
	11,850.00
Tax on $11,850 (on the basis of a joint return)	2,227.00
(2) Self-employment tax:	
Net earnings from self-employment	6,000.00
Adjusted self-employment income ($6,600−4,050 annualized wages ($2,700×12÷8))	2,550.00
Tax on adjusted self-employment income ($2,550×6.4 percent)	163.20
(3) Total tax ($2,227.00+163.20)	2,390.20
(4) ¾ of 80 percent of $2,390.20	1,434.12
Amount paid by Sept. 15, 1967	1,350.00

An addition to the tax will thus be imposed for the underpayment of $1,550 ($2,000−450) on the September 15 installment.

Example (6).

Example (6). Assume the same facts as in example (5) and assume further that adjusted gross income for the eight months ending August 31, 1967, was $9,200 and the amount of deductions (other than the deduction for personal exemptions) not allowable in determining adjusted gross income aggregate only $500. If E and F elect, they may use the standard deduction in computing the tax for purposes of the exceptions described in paragraph (a) (2) and (3) of this section. Taxable income for purposes of the exception described in paragraph (a)(3) of this section would be reduced to $7,080 ($9,200 less $1,200 for two personal exemptions and $920 for the standard deduction). The income tax thereon is $1,205.20; income tax and self-employment tax total $454.80 ($1,205.20+249.60 ($3,900×6.4 percent)). Since the amount paid by the September 15 installment date, $1,350, exceeds $1,309.32 (90 percent of $1,454.80), the exception described in paragraph (a)(3) of this section applies. However, the exception described in paragraph (a)(2) of this section does not apply, as illustrated by the following computation:

Adjusted gross income for period ending Aug. 31, 1967	$9,200.00
Adjusted gross income annualized ($9,200×12÷8)	13,800.00
Taxable income annualized ($13,800 minus $1,200 for two personal exemptions and $1,000 for the standard deduction)	11,600.00

Tax on $11,600 (on basis of joint return)	2,172.00
Self-employment tax on adjusted self-employment income ($2,550×6.4 percent)	163.20
Total tax ($2,172.00+163.20	2,335.20
¾ of 80 percent of $2,335.20	1,401.12
Amount paid by Sept. 15, 1967	1,350.00

Example (7). G was a married individual, 73 years of age, who filed a joint return with his wife, H, for the calendar year 1956. H, who was 70 years of age, had no income during the year. G had taxable income in the amount of $7,000 for the eight-month period ending on August 31, 1956, which included $2,000 of dividend income (after excluding $50 under section 116) and $900 of rental income. The $7,000 figure also reflected a deduction of $2,400 for personal exemptions ($600×4), since G and H are both over 65 years of age. The application of the exception described in paragraph (a)(2) of this section to an underpayment of estimated tax on the September 15 installment date may be illustrated by the following computation:

Taxable income for the period ending Aug. 31, 1956 (without deduction for personal exemptions) on an annual basis ($9,400×12÷8)	$14,100.00
Deduction for personal exemptions	2,400.00
Taxable income on an annual basis	11,700.00
Tax (on the basis of a joint return)	2,642.00
Dividends received for 8-month period	2,050.00
Less: Amount excluded from gross income under section 116	50.00
Dividends included in gross income	2,000.00
Dividend income annualized ($2,000×12÷8)	3,000.00
Dividends received credit under section 34 (4 percent of $3,000)	120.00
Tax less dividends received credit	2,522.00
Retirement income (as defined in section 37(c)) includes:	
Dividend income (to extent included in gross income)	2,000.00
Rental income	900.00
Total retirement income	2,900.00
Limit on amount of retirement income under section 37(d)	1,200.00
Retirement income credit under section 37 (20 percent of $1,200)	240.00
Tax less credits under section 34 and section 37	2,282.00
Amount determined under the exception described in paragraph (a)(2) of this section (¾ of 70 percent of $2,282)	1,198.05

Example (8). C, an unmarried individual for whom another taxpayer is entitled to a deduction under section 151(e), has adjusted gross income of $4,000 for the period January 1, 1977, through August 31, 1977. All of C's income is non-exempt interest. For the same period C, who is entitled to one personal exemption, has itemized deductions amounting to $300. C is entitled to no credits other than the general tax credit. C filed a declaration of estimated tax on April 15, 1977, and on or before September 15, 1977, makes estimated tax payments for 1977 which total $460. For purposes of determing whether the exception described in paragraph (a)(2) of this section applies, the following computations are necessary:

Adjusted gross income for the period ending Aug. 31, 1977, on an annual basis ($4,000 × 12÷8)		$6,000.00
Itemized deductions for the period ending Aug. 31, 1977, on an annual basis ($300 × 12÷8)		450.00
Unused zero bracket amount computation required under sec. 63(e)(1)(D):		
Zero bracket amount	$2,200.00	
Annualized itemized deductions	450.00	
Unused zero bracket amount	1,750.00	
Annualized adjusted gross income		6,000.00
Plus: unused zero bracket amount		1,750.00
Annualized tax table income		7,750.00
Tax from tables		757.00
Amount specified in paragraph (a)(2) of this section (¾×80 pct.×$757)		$454.20

The exception described in paragraph (a)(2) applies, and no addition to tax will be imposed.

Example (9). An unmarried taxpayer entitled to one exemption, has adjusted gross income of $16,000 and itemized deductions of $2,000 for the period for the period January 1, 1977, through August 31, 1977. D has no net earnings from self-employment and is entitled to no credits other than the general tax credit. D files a declaration of estimated tax on April 15, 1977, and on or before September 15, 1977, makes estimated tax payments for 1977 which total $3,000. For purposes of determining whether the exception in paragraph (a)(2) of this section applies, the following computations are necessary:

Adjusted gross income for the period ending Aug. 31, 1977, on an annual basis ($16,000 × 12÷8)		$24,000
Itemized deductions for the period ending Aug. 31, 1977, on an annual basis ($2,000 × 12÷8)		3,000
Annualized itemized deductions	$3,000	
Minus zero bracket amount	2,200	
Excess itemized deductions	800	
Annualized adjusted gross income		24,000
Minus excess itemized deductions		800
Annualized tax table income		23,200
Minus: Personal exemption		750
Annualized taxable income		22,450
Tax under sec. 1(c) on annualized taxable income		5,325
Minus: general tax credit		180
Total		5,145
Amount specified in paragraph (a)(2) of this section (¾×80 pct.×$5,145)		3,087

The exception described in paragraph (a)(2) does not apply.

(d) *Determination of taxable income for installment periods*—(1) *In general.* (i) In determining the applicability of the exceptions described in paragraph (a) (2) and (3) of this section, there must be an accurate determination of the amount of income and deductions for the calendar months in the taxable year preceding the installment date as of which the determination is made, that is, for the period terminating with the last day of the third, fifth, or eighth month of the taxable year. For example, a taxpayer distributes year-end bonuses to his employees but does not determine the amount of the bonuses until the last month of the taxable year. He may not deduct any portion of such year-end bonuses in determining his taxable income for any installment period other than the final installment period for the taxable year, since deductions are not allowable until paid or accrued, depending on the taxpayer's method of accounting.

(ii) If a taxpayer on an accrual method of accounting wishes to use either of the exceptions described in paragraphs (a) (2) and (3) of this section, he must establish the amount of income and deductions for each applicable period. If his income is derived from a business in which the production, purchase, or sale of merchandise is an income-producing factor requiring the use of inventories, he will be unable to determine accurately the amount of his taxable income for the applicable period unless he can establish, with reasonable accuracy, his cost of goods sold for the applicable installment period. The cost of goods sold for such period shall be considered, unless a more exact determination is available, as such part of the cost of goods sold during the entire taxable year as the gross receipts from sales for such installment period is of gross receipts from sales for the entire taxable year.

(2) *Members of partnerships.* The provisions of this subparagraph shall apply in determining the applicability of the exceptions described in paragraphs (a) (2) and (3) of this section to an underpayment of estimated tax by a taxpayer who is a member of a partnership.

(i) For purposes of determining taxable income, there shall be taken into account:

(A) The partner's distributive share of partnership items set forth under section 702,

(B) The amount of any guaranteed payments under section 707(c), and

(C) Gains or losses on partnership distributions which are treated as gains or losses on sales of property.

(ii) For purposes of determining net earnings from self-employment (for taxable years beginning after December 31, 1966) there shall be taken into account:

(A) The partner's distributive share of income or loss, described in section 702(a)(9), subject to the special rules set forth in section 1402(a) and §§ 1.1402(a)–1 to 1.1402(a)–16, inclusive, and

(B) The amount of any guaranteed paments under section 707(c), except for payments received from a partnership not engaged in a trade or business within the meaning of section 1402(c) and § 1.1402(c)–1.

In determining a partner's taxable income and, for taxable years beginning after December 31, 1966, net earnings from self-employment, for the months in his taxable year which precede the month in which the installment date falls, the partner shall take into account items set forth in sections 702 and 1402(a) for any partnership taxable year ending with or within his taxable year to the extent that such items are attributable year which precede the month in which the installment date falls. For special rules used in computing a partner's net earnings from self-employment in the case of the termination of his taxable year as a result of death, see section 1402(f) and § 1.1402(f)–1. In addition, a partner shall include in his taxing after December 31, 1966, net earnings from self-employment, for the months in his taxable year which precede the month in which the installment date falls guaranteed payments from the partnership to the extent that such guaranteed payments are includible in his taxable income for such months. See section 706(a), section 707(c), paragraph (c) of § 1.707–1 and section 1402(a).

(iii) The provisions of subdivision (i) (A) and (B) of this subdivision (ii) of this subparagraph may be illustrated by the following examples:

Example (1). A, whose taxable year is the calendar year, is a member of a partnership whose taxable year ends on January 31. A must take into account, in determining his taxable income for the installment due on April 15, 1973, all of his distributive share of partnership items described in section 702 and the amount of any guaranteed payments made to him which were deductible by the partnership in the partnership taxable year beginning on February 1, 1972, and ending on January 31, 1973. A must take into account, in determining his net earnings from self-employment, his distributive share of partnership income or loss described in section 702(a)(9), subject to the special rules set forth in section 1402(a) and §§ 1.1402(a)–1 to 1.1402(a)–16, inclusive.

Example (2). Assume that the taxable year of the partnership of which A, a calendar year taxpayer, is a member ends on June 30. A must take into account in the determination of his taxable income and net earnings from self-employment for the installment due on April 15, 1973, his distributive share of partnership items for the period July 1, 1972, through March 31, 1973; for the installment due on June 15, 1973, he must take into account such amounts for the period July 1, 1972, through May 31, 1973; and for the installment due on September 15, 1973, he must take into account such amounts for the entire partnership taxable year of July 1, 1972, through June 30, 1973 (the date on which the partnership taxable year ends).

(3) *Beneficiaries of estates and trusts.* In determining the applicability of the exceptions described in paragraph (a) (2) and (3) of this section as of any installment date, the beneficiary of an estate or trust must take into account his distributable share of income from the estate or trust for the applicable period (whether or not actually distributed) if the trust or estate is required to distribute income to him currently. If the estate or trust is not required to distribute income currently, only the amounts actually distributed to the beneficiary during such period must be taken into account. If the taxable year of the beneficiary and the taxable year of the estate or trust are different, there shall be taken into account the beneficiary's distributable share of income, or the amount actually distributed to him as the case may be, during the months in the taxable year of the estate or trust ending within the taxable year of the beneficiary which precede the month in which the installment date falls. See subparagraph (2) of this paragraph for examples of a similar rule which is applied when a partner and the partnership of which he is a member have different taxable years.

(e) *Special rule in case of change from joint return or separate return for the preceding taxable year*—(1) *Joint return to separate returns.* In determining the applicability of the exceptions described in paragraph (a) (1) and (4) of this section to an underpayment of estimated tax, a taxpayer filing a separate return who filed a joint return for the preceding taxable year shall be subject to the following rule: The tax:

(i) Shown on the return for the preceding taxable year, or

(ii) Based on the tax rates and personal exemptions for the current taxable year but otherwise determined on the basis of the facts shown on the return for the preceding taxable year, and the law applicable to such year,

shall be that portion of the tax which bears the same ratio to the whole of the tax as the amount of the tax for which the taxpayer would have been liable bears to the sum of the taxes for which the taxpayer and his spouse would have been liable had each spouse filed a separate return for the preceding taxable year. For rules with respect to the allocation of joint payments of estimated tax, see section 6015(b) and § 1.605(b)–1(b).

(2) *Examples.* The rule in paragraph (i) of this paragraph may be illustrated by the following examples:

Example (1). H and W filed a joint return for the calendar year 1955 showing taxable income of $20,000 and a tax of $5,280. Of the $20,000 taxable income, $18,000 was atributable to H, and $2,000 was attributable to W. H and W filed separate returns for 1956. The tax shown on the return for the preceding taxable year, for purposes of determining the applicability of the exception described in paragraph (a)(1) of this section to an underpayment of estimated tax by H for 1956, is determined as follows:

Taxable income of H for 1955	$18,000
Tax on $18,000 (on basis of separate return)	6,200
Taxable income of W for 1955	2,000
Tax on $2,000 (on basis of separate return)	400
Aggregate tax of H and W (on basis of separate returns)	6,600
Portion of 1955 tax shown on joint return attributable to H (6200/6600×5280)	4,960

Example (2). Assume the same facts as in example (1) and that H and W file a joint declaration of estimated tax for 1956 and pay estimated tax in amounts determined on the basis of their eligibility for three rather than two exemptions for 1956. H and W ultimately file separate income tax returns for 1956. Assume further that the exception described in paragraph (a)(1) of this section does not apply. The tax based on the tax rates and personal exemptions for 1956 but otherwise determined on the basis of the facts shown on the return for 1955 and the law applicable to 1955, for purposes of determining the applicability of the exception described in paragraph (a)(4) of this section to an underpayment of estimated tax by H for 1956, is determined as follows:

Taxable income of H and W for 1955 based on additional personal exemption for 1956	$19,400
Tax on 1955 income based on joint return rate for 1956	5,076
Portion of 1955 tax attributable to H (computed as in example (1) but allowing benefit of additional exemption to H)	5900/6300
Portion of tax attributable to H based on tax rates and personal exemptions for 1956 but otherwise on facts on 1955 return ($5900/6300×$5,076)	$4,754

Example (3). Assume that H and W had the same taxable income in 1972 as in 1955, and that they filed a joint return for 1972 and separate returns for 1973. Assume further that H's taxable income for 1972 included net earnings from self-employment in excess of the $9,000 maximum base for the self-employment tax for 1972, and that the joint return filed by H and W for 1972 showed tax under Chapter 1 (other than section 56) and tax under Chapter 2 totaling $5,055. The tax shown on the return for 1972, for purposes of determining the applicability of the exception described in paragraph (a)(1) of this section to an underpayment of estimated tax by H for 1973, is determined as follows:

Taxable income of H for 1972	$18,000
Chapter 1 tax (other than section 56 tax) on $18,000 (on basis of separate return)	5,170
Self-employment income of H for 1972	9,000
Chapter 2 tax on $9,000	$675
Total of such taxes	$5,845
Taxable income of W for 1972	2,000
Chapter 1 tax (other than section 56 tax) on $2,000 (on basis of separate return)	310
Aggregate tax on H and W (on basis of separate returns)	$6,155
Portion of 1972 tax shown on joint return attributable to H (5845/6155×$5,055)	$4,800.40

(3) *Separate return to joint return.* In the case of a taxpayer who files a joint return for the taxable year with respect to which there is an underpayment of estimated tax and who filed a separate return for the preceding taxable year:

(i) The tax shown on the return for the preceding taxable year, for purposes of determining the applicability of the exception described in paragraph (a)(1) of this section, shall be the sum of both the tax shown on the return of the taxpayer and the tax shown on the return of the taxpayer's spouse for such preceding year, and

(ii) The facts shown on both the taxpayer's return and the return of his spouse for the preceding taxable year shall be taken into account for purposes of determining the applicability of the exception described in paragraph (a)(4) of this section.

(4) *Example.* The rules described in subparagraph (3) of this paragraph may be illustrated by the following example:

Example. H and W filed separate income tax returns for the calendar year 1954 showing tax liabilities of $2,640 and $350, respectively. In 1956 they married and participated in the filing of a joint return for that year. In the filing of a joint return for that year. Thus, for the purpose of determining the applicability of the exceptions described in paragraph (a)(1) and (4) of this section to an underpayment of estimated tax for the year 1955, the tax shown on the return for the preceding taxable year is $2,990 ($2,640 plus $350).

(Secs. 6015, 6154, 6654, 6655, and 7805, Internal Revenue Code of 1954 (96 Stat. 2395 and 2396, 68A Stat. 917; 26 U.S.C. 6015, 6154, 6654, 6655, and 7805))

[T.D. 7427, 41 FR 34029, Aug. 12, 1976, as amended by T.D. 7577, 43 FR 59359, Dec. 20, 1978; T.D. 7585, 44 FR 1105, Jan. 4, 1979; T.D. 8016, 50 FR 11855, Mar. 26, 1985; 50 FR 18244, Apr. 30, 1985]

§ 1.6654–3 Short taxable years of individuals.

(a) *In general.* The provisions of section 6654, with certain modifications relating to the application of subsection (d) thereof, which are explained in paragraph (b) of this section, are applicable in the case of a short taxable year for which a declaration is required to be filed. (See § 1.6015(g)–1 for requirement of declaration for short taxable year.)

(b) *Rules as to application of section 6654(d).* (1) In any case in which the taxable year for which an underpayment of estimated tax exists is a short taxable year due to a change in annual accounting periods, in determining the tax:

(i) Shown on the return for the preceding taxable year (for purposes of section 6654(d)(1)), or

(ii) Based on the personal exemptions and rates for the current taxable year but otherwise on the basis of the facts shown on the return for the preceding taxable year, and the law applicable to such year (for purposes of section 6654(d)(4)),

the tax will be reduced by multiplying it by the number of months in the short taxable year and dividing the resulting amount by 12.

(2) If the taxable year for which an underpayment of estimated tax exists is a short taxable year due to a change in annual accounting periods, in annualizing the taxable income for the months in the taxable year preceding an installment date, for purposes of section 6654(d)(1)(C), the personal exemptions allowed as deductions under section 151 shall be reduced to the same extent that they are reduced under section 443(c) in computing the tax for a short taxable year.

(3) If ''the preceding taxable year'' referred to in section 6654(d)(4) was a short taxable year, for purposes of determining the applicability of the exception described in section 6654(d)(4), the tax, computed on the basis in the facts shown on the return for the preceding year, shall be the tax computed on the annual basis in the manner described in section 443(b)(1) (prior to its reduction in the manner described in the last sentence thereof). If the tax rates or the taxpayer's status with respect to personal exemptions for the taxable year with respect to which the underpayment occurs differ from such rates or status applicable to the preceding taxable year, the tax determined in accordance with this subparagraph shall be recomputed to reflect the rates and status applicable to the year with respect to which the underpayment occurs.

[T.D. 6500, 25 FR 12149, Nov. 26, 1960, as amended by T.D. 7427, 41 FR 34033, Aug. 12, 1976]

§ 1.6654–4 Waiver of penalty for underpayment of 1971 estimated tax by an individual.

(a) *In general.* Section 207 of the Revenue Act of 1971 provides that, in the case of individuals, the penalty prescribed by section 6654(a) and § 1.6654–1 for underpayment of estimated tax shall not apply in certain cases to taxable years beginning after December 31, 1970, and ending before January 1, 1972. The penalty shall be waived only if the taxpayer meets one of the gross income requirements contained in paragraph (b) of this section and if the limitation contained in paragraph (c) of this section is not applicable.

(b) *Gross income requirement.* Except as provided in paragraph (c) of this section, the waiver provided in paragraph (a) of this section shall be applicable only:

(1) If the gross income for the taxable year does not exceed $10,000 in the case of:

(i) A single individual who is neither a head of a household (as defined in section 2(b)) nor a surviving spouse (as defined in section 2(a)), or

(ii) A married individual not entitled under section 6013 to file a joint return for the taxable year, or

(2) If the gross income for the taxable year does not exceed $20,000 in the case of:

(i) A head of a household (as defined in section 2(b)) or

(ii) A surviving spouse (as defined in section 2(a)), or

(3) If the aggregate gross income for the taxable year does not exceed $20,000 in the case of a married individual (entitled under section 6013 to file a joint return for the taxable year) and his spouse.

(c) *Limitation.* Notwithstanding any other provision of this section, the waiver provided in paragraph (a) of this section shall not be applicable if, in the taxable year, the taxpayer has income from sources other than wages (as defined in section 3401(a)) in excess of $200 ($400 in the case of a husband and wife entitled to file a joint return for the taxable year under section 6013). Thus, for example, even if the aggregate gross income of a husband and wife (entitled under section 6013 to file a joint return for the taxable year) does not exceed $20,000, the waiver of the penalty for underpayment of estimated tax shall not apply if the husband and wife have, in the aggregate, income from sources other than wages in excess of $400.

[T.D. 7282, 38 FR 19028, July 17, 1973]

§ 1.6654–5 Applicability.

Section 6654 is applicable only with respect to taxable years beginning after December 31, 1954. Section 294(d) of the Internal Revenue Code of 1939 shall continue in force with respect to taxable years beginning before January 1, 1955.

[T.D. 6500, 25 FR 12150, Nov. 26, 1960. Redesignated by T.D. 7282, 38 FR 19028, July 17, 1973]

§ 1.6655–1 Addition to the tax in the case of a corporation.

(a) *In general.* (1) Section 6655 imposes an addition to the tax under chapter 1 of the Code in the case of any underpayment of estimated tax by a corporation (with certain exceptions described in section 6655(d)). This addition to the tax is in addition to any applicable criminal penalties and is imposed whether or not there was reasonable cause for the underpayment. The amount of the underpayment for any installment date is the excess of:

(i) 70 percent of the tax shown on the return for the taxable year or, if no return was filed, 70 percent of the tax for such year, multiplied by the percentage of estimated tax required to be paid on or before the installment date, over

(ii) The amount, if any, of the installment paid on or before the last day prescribed for such payment.

(2) The amount of the addition is determined at the annual rate referred to in the regulations under section 6621 upon the underpayment of any installment of estimated tax for the period from the date such installment is required to be paid until the 15th day of the third month following the close of the taxable year, or the date such underpayment is paid, whichever is earlier. For purposes of determining the period of the underpayment (i) the date prescribed for payment of any installment of estimated tax shall be determined without regard to any extension of time, and (ii) a payment of estimated tax on any installment date, to the extent that it exceeds the amount of the installment determined under subparagraph (1)(i) of this paragraph for such date, shall be considered a payment of the previous underpayment, if any.

(3) The term *tax* as used in subparagraph (1)(i) of this paragraph means the excess of the tax imposed by section 11 or 1201(a), or subchapter L, chapter 1 of the Code, whichever is applicable, over the sum of $100,000 and the credits against tax provided by sections 32, 33, and 38. However, for the rule with respect to the limitation upon the $100,000 exemption for members of certain electing affiliated groups, see section 243(b)(3)(C)(v) and the regulations thereunder.

(4) For special rules relating to the determination of the amount of the underpayment in the case of a corporation whose income is included in a consolidated return, see § 1.1502–5(b).

(b) *Statement relating to underpayment.* If there has been an underpayment of estimated tax as of the installment date prescribed for its payment and the taxpayer believes that one or more of the exceptions described in § 1.6655–2 precludes the assertion of the addition to the tax under section 6655, it should attach to its income tax return for the taxable year a Form 2220 showing the applicability of any exception upon which the taxpayer relies.

(c) *Example.* The method prescribed in paragraph (a) of this section of computing the addition to the tax may be illustrated by the following example:

Example. A corporation using the calendar year basis reported on its declaration for 1955, estimated tax in the amount of $50,000. It made payments of $2,500 each on September 15, 1955, and December 15, 1955. On March 15, 1956, it filed its final income tax return showing a tax liability of $200,000. Since the amount of each of the two installments paid by the last date prescribed for payment thereof was less than 5 percent of 70 percent of the tax shown on the return, the addition to the tax under section 6655(a) is applicable and is computed as follows:

(1) Tax as defined in paragraph (a) of this section ($200,000 – $100,000 (no credits allowable under sections 32 and 33))	$100,000
(2) 70% of item (1)	70,000

(3) Amount of estimated tax required to be paid on each installment date (5% of $70,000)	3,500
(4) Deduct amount paid on each installment date	2,500
(5) Amount of underpayment for each installment date (item (3) minus item (4))	1,000
(6) Addition to the tax:	
First installment—period 9–15–55 to 3–15–56	30
Second installment—period 12–15–55 to 3–15–56	15
Total	45

[T.D. 6500, 25 FR 12150, Nov. 26, 1960, as amended by T.D. 6768, 29 FR 14926, Nov. 4, 1964; T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7384, 40 FR 49322, Oct. 22, 1975]

§1.6655–2 Exceptions to imposition of the addition to the tax in the case of corporations.

(a) *In general.* The addition to the tax under section 6655 will not be imposed for any underpayment of any installment of estimated tax if, on or before the date prescribed for payment of the installment, the total amount of all payments of estimated tax made equals or exceeds the amount which would have been required to be paid on or before such date if the estimated tax were the least of the following amounts:

(1) The tax shown on the return for the preceding taxable year, provided that the preceding taxable year was a year of 12 months and a return showing a liability for tax was filed for such year;

(2) An amount equal to a tax determined on the basis of the tax rates for the taxable year but otherwise on the basis of the facts shown on the return for the preceding taxable year and the law applicable to such year, in the case of a corporation required to file a return for such preceding taxable year; or

(3) An amount equal to 70 percent of the tax determined by placing on an annual basis the taxable income for:

(i) The first 3 months of the taxable year, in the case of the installment required to be paid in the 4th month,

(ii) Either the first 3 months or the first 5 months of the taxable year (whichever results in no addition being imposed), in the case of the installment required to be paid in the 6th month,

(iii) Either the first 6 months or the first 8 months of the taxable year (whichever results in no addition being imposed), in the case of the installment required to be paid in the 9th month, and

(iv) Either the first 9 months or the first 11 months of the taxable year (whichever results in no addition being imposed), in the case of the installment required to be paid in the 12th month.

The taxable income so determined shall be placed on an annual basis by first multiplying it by 12, and then dividing the resulting amount by the number of months in the taxable year for which the taxable income was so determined.

(4) In the case of a taxpayer whose taxable year consists of 52 or 53 weeks in accordance with section 441(f), the rules prescribed by paragraph (b) of §1.441–2 shall be applicable in determining, for purposes of subparagraph (1) of this paragraph, whether a taxable year was a year of 12 months and in determining, for purposes of subparagraph (3) of this paragraph, the commencement of the 3-month period, or the 3- or 5-month period, or the 6- or 8-month period, or the 9- or 11-month period, whichever is applicable. For example, if a taxable year begins on December 26, 1956, taxable income for the first 6 months of such year, for purposes of subparagraph (3) of this paragraph, shall be taxable income for the period beginning on December 26, 1956, and ending on June 30, 1957, since such taxable year is deemed to commence on January 1, 1957, under section 441(f).

(5) If the end of any accounting period employed by the taxpayer (e.g., any of either thirteen 4-week periods or four 13-week periods) does not correspond to the termination date of the applicable 3-month, or 3- or 5-month, or 6- or 8-month, or 9- or 11-month, period, taxable income shall be determined from the beginning of the taxable year to the close of the accounting period ending immediately before the termination date of the applicable 3-month, or 3- or 5- month, or 6- or 8-month, or 9- or 11-month, period and to the close of the accounting period within which such termination date falls. There shall be determined that portion of the

difference between the two amounts of taxable income so determined which bears the same ratio to the total difference between such amounts as the number of days from the close of the first such accounting period to the close of such applicable 3-month, or 3- or 5-month, or 6- or 8-month, or 9- or 11-month, period bears to the total number of days between the termination dates of such two accounting periods. The portion of the difference between such amounts so determined shall then be added to (or subtracted from) taxable income determined to the close of the first such accounting period to determine taxable income for such applicable 3-month, or 3- or 5-month, or 6- or 8-month, or 9- or 11-month, period. For example, a taxpayer whose taxable year consists of 52 or 53 weeks in accordance with section 441(f) has a taxable year beginning on December 26, 1956, and thirteen 4-week accounting periods are employed in determining taxable income. Taxable income from December 26, 1956, to the close of the 4-week accounting period ending on June 11, 1957, is $200,000, and taxable income from December 26, 1956, to the close of the 4-week accounting period ending on July 9, 1957, is $228,000. Taxable income for the 6-month period ending on June 30, 1957, is $219,000 ($200,000+(19×28,000 ÷28)).

(b) *Meaning of terms.* (1) For the purpose of the exceptions described in paragraph (a) of this section, the term *tax* means the excess of the tax imposed by section 11 or 1201(a), or subchapter L, chapter 1 of the Code, whichever is applicable, over the sum of $100,000 plus the credits against tax allowed by sections 32, 33, and 38.

(2) The credits against the tax allowed by sections 32, 33, and 38, are:

(i) In the case of the exception described in paragraph (a)(1) of this section, such credits shown on the return for the preceding taxable year,

(ii) In the case of the exception described in paragraph (a)(2) of this section, such credits shown on the return for the preceding taxable year, except that if the amount of any such credits would be affected by any change in rates, the credits shall be determined by reference to the rates applicable to the current taxable year, and

(iii) In the case of the exception described in paragraph (a)(3) of this section, such credits computed under the law and rates applicable to the current taxable year.

The provisions of subdivision (ii) of this subparagraph may be illustrated by the following example:

Example. Assume that during the taxable year within which the normal tax rate in section 11 changes from 30 percent to 25 percent, Corporation X has an underpayment of estimated tax. One-fourth of the taxable income of Corporation X for the taxable year preceding that in which such underpayment occurs was from sources within foreign country Y. The return of Corporation X for such preceding year shows taxable income of $325,000 and a tax, without regard to any credits, of $163,500. The credit allowed by section 33 on account of taxes paid to foreign country Y may not exceed one-fourth of such amount, or $40,875, under section 904. The tax for the preceding year, computed by using the rates applicable to the year during which the underpayment occurs, would be reduced to $147,250 and the limitation under section 904 on the credit allowed under section 33 for taxes paid to foreign country Y would be reduced to $36,812.50, for purposes of determining the applicability of the exception described in paragraph (a)(2) of this section. Therefore, the exception described in paragraph (a)(2) of this section will be applicable if, on or before the date prescribed for such payment, the total amount paid by Corporation X equals or exceeds the amount which would have been required to be paid by such date if the estimated tax were $10,437.50 ($147,250 less ($100,000÷$36,812.50)).

(3) For the purpose of the exceptions described in paragraphs (a) (1) and (2) of this section, the term ''return for the preceding taxable year'' means the income tax return for such year which is required by section 6012(a)(2).

(c) *Examples.* The application of the exceptions to the imposition of the addition to tax may be illustrated by examples employing the following statement of facts:

STATEMENT OF FACTS

Y, a corporation reporting on a calendar year basis, filed a declaration on April 15, 1965, showing an estimated tax of $47,100 for its taxable year ending December 31, 1965. The first installment of 4 percent of the estimated tax or $1,884 was paid with the filing of the declaration, the second installment in the same amount was paid on June 15, 1965, and the third and fourth installments of $11,775 (25 percent of the estimated tax) each were paid on September 15, 1965, and December 15, 1965, respectively. Y reported a tax liability of $175,900 on its return due March 15, 1966. There was an underpayment in the amount of $241.20 on each of the first and second installment dates and $1,507.50 on each of the third and fourth installments dates determined as follows:

(1) Tax as defined in paragraph (b) of this section ($175,900 − $100,000)	$75,900.00
(2) 70% of item (1)	53,130.00
(3) 4% of item (2)	2,125.20
(4) Deduct amount paid on each of the first and second installment dates	1,884.00
(5) Amount of underpayment at each of the first and second installment dates (item (3) minus item (4))	241.20
(6) 25% of item (2)	13,282.50
(7) Deduct amount paid on each of the last two installment dates	11,775.00
(8) Amount of underpayment at each of the third and fourth installment dates (item (6) minus item (7))	1,507.50

The application of each exception described in paragraph (a) of this section is determined as follows:

(1) Assume Y reported a liability of $158,000 on its return for the taxable year ending December 31, 1964. If the estimated tax were $158,000 reduced by $100,000, or $58,000, the amount which would have been required to be paid on or before each of the first and second installment dates would be 4 percent of $58,000, or $2,320. The amount which would have been required to be paid on or before each of the third and fourth installment dates would be 25 percent of $58,000, or $14,500. Since these amounts exceed the corresponding amounts actually paid on each installment date ($1,884 and $11,775, respectively), the exception described in paragraph (a) (1) of this section does not apply.

(2) As the corporation tax rates under section 11 are different for the taxable years ending December 31, 1964, and December 31, 1965, the amount of tax determined under paragraph (a)(2) of this section and the amounts required to be paid on or before each installment date must be determined. The tax liability determined on the basis of the calendar year 1965 rates but on the basis of the calendar year 1964 return is $151,900 and the estimated tax is $151,900 less $100,000, or $51,900. The amount which would have been required to be paid on or before each of the first and second installment dates would be 4 percent of $51,900, or $2,076, and the amount which would have been required to be paid on or before each of the third and fourth installment dates would be 25 percent of $51,900, or $12,975. Since these amounts exceed the corresponding amounts actually paid on each installment date ($1,884 and $11,775, respectively), the exception described in paragraph (a)(2) of this section does not apply.

(3) Y determined that its taxable income for the first 3, 5, 6, 8, 9, and 11 months was $87,500, $155,000, $185,000, $246,000, $288,000, and $341,000, respectively. The income for each period is annualized as follows:

$87,500×12÷3=$350,000
$155,000×12÷5=$372,000
$185,000×12÷6=$370,000
$246,000×12÷8=$369,000
$288,000×12÷9=$384,000
$341,000×12÷11=$372,000

To determine whether the installment payment made on April 15, 1965, equals or exceeds the amount which would have been required to be paid if the estimated tax were equal to 70 percent of the tax computed on the annualized income for the 3-month period, the following computation is necessary:

	3 months
(1) Annualized income	$350,000
(2) Tax on item (1) reduced by $100,000	61,500
(3) 70 percent of item (2)	43,050
(4) 4 percent of item (3)	1,722

To determine whether the installment payments made on or before June 15, 1965, equal or exceed the amount which would have been required to be paid if the estimated tax were equal to 70 percent of the tax computed on the annualized income for either the 3- or 5-month period, the following computation is necessary:

	3 months	5 months
(1) Annualized income	$350,000.00	$372,000.00
(2) Tax on item (1) reduced by $100,000	61,500.00	72,060.00
(3) 70 percent of item (2)	43,050.00	50,442.00
(4) 8 percent of item (3)	3,444.00	4,035.36

To determine whether the installment payments made on or before September 15, 1965, equal or exceed the amount which would have been required to be paid if the estimated tax were equal to 70 percent of the tax computed on the annualized income for either the 6- or 8-month period, the following computation is necessary:

	6 months	8 months
(1) Annualized income	$370,000.00	$369,000.00
(2) Tax on item (1) reduced by $100,000	71,100.00	70,620.00
(3) 70 percent of item (2)	49,770.00	49,434.00
(4) 33 percent of item (3)	16,424.10	16,313.22

To determine whether the installment payments made on or before December 15, 1965, equal or exceed the amount which would have been required to be paid if the estimated tax were equal to 70 percent of the tax computed on the annualized income for either the 9- or 11-month period, the following computation is necessary:

	9 months	11 months
(1) Annualized income ..	$384,000.00	$372,000.00
(2) Tax on item (1) reduced by $100,000	77,820.00	72,060.00
(3) 70 percent of item (2)	54,474.00	50,442.00
(4) 58 percent of item (3)	31,594.92	29,256.36

The total amounts of all payments of estimated tax actually paid on or before the installment dates of April 15, 1965, June 15, 1965, September 15, 1965, and December 15, 1965, are $1,884, $3,768, $15,543, and $27,318, respectively. Since the total amounts of estimated tax actually paid on the first and second installment dates (April 15, 1965, and June 15, 1965) exceed the amounts required to be paid on such dates if the estimated tax were 70 percent of the tax determined by placing on an annualized basis the taxable income for the first 3 months of the taxable year, the exception described in paragraph (a)(3) of this section applies and no addition to tax will be imposed for the installments paid on April 15, 1965, and June 15, 1965. However, since the total amount of all payments of estimated tax actually paid on or before the third and fourth installment dates (September 15, 1965, and December 15, 1965) does not equal or exceed the applicable alternative amounts, the addition to the tax with respect to the underpayment of the September 15, 1965, and December 15, 1965, installments must be imposed.

(d) *Determination of taxable income for portion of taxable year.* In determining the applicability of the exception described in paragraph (a)(3) of this section, there must be an accurate determination of the amount of income and deductions for the appropriate period, that is, for the first 3, 5, 6, 8, 9, or 11 months of the taxable year. See paragraph (d)(1) of § 1.6654–2 for a description of a similar requirement with respect to individuals.

[T.D. 6500, 25 FR 12151, Nov. 26, 1960, as amended by T.D. 6768, 29 FR 14926, Nov. 4, 1964]

§ 1.6655–2T Safe harbor for certain installments of tax due before July 1, 1987 (temporary).

(a) *Applicability*—(1) *Safe harbor.* The safe harbor provided by paragraph (b) of this section applies only to installment payments of corporate estimated tax required to be made before July 1, 1987, for taxable years beginning in 1987.

(2) *Subsequent payment.* The requirement that a corporation using the safe harbor provided by this section make a timely subsequent installment payment in accordance with paragraph (c) of this section applies with respect to the corporation's first installment payment (''the subsequent installment payment'') of estimated tax required to be made after the last payment computed under the safe harbor rule.

(3) *Section inapplicable to new corporation.* This section shall not apply in the case of any corporation whose first taxable year began after December 31, 1986.

(b) *Safe harbor for use of annualization exception*—(1) *In general.* A corporation computing an installment payment of estimated tax using the annualization exception provided in section 6655(d)(3) will not be subject to an addition to tax under section 6655 with respect to an installment payment of estimated tax that satisfies the requirements of this paragraph (b), except as provided in paragraph (c) of this section. For purposes of this paragraph (b)—

(i) A corporation shall assume that its annualized taxable income for the current year equals or exceeds 120 percent of the taxable income shown on its return for the preceding taxable year, and

(ii) The term ''tax'' as used in section 6655(d)(3) shall be defined by reference to section 6655(f) without regard to section 6655(f)(1) (B) and (C) (that is, without regard to the alternative minimum tax imposed by section 55 or the environmental tax imposed by section 59A).

(2) *Special rules for determining taxable income for preceding year.* For purposes of paragraph (b)(1)(i) of this section, the taxable income shown on the return of the corporation for its preceding taxable year shall be—

(i) Adjusted to eliminate any net operating loss deduction taken into account in that preceding year, and

(ii) Annualized, if that preceding year was of less than 12 months.

(3) *Credits taken into account*—(i) *In general.* In computing the amount of an installment payment under paragraph (b)(1) of this section, the corporation may take into account any credits

against tax that are permitted to be taken into account under section 6655(d)(3) for the current taxable year.

(ii) *Foreign tax credit.* For purposes of paragraph (b)(3)(i) of this section, the amount of foreign tax credit that is permitted to be taken into account for the current taxable year is equal to the foreign tax credit allowed for the preceding taxable year multiplied by the fraction specified in the following sentence. The numerator of the fraction is the highest tax rate applicable for the taxable year under section 11, as adjusted under section 15, and the denominator is 46 percent. This alternative computation of the foreign tax credit is applicable only for purposes of computing a safe harbor installment payment under paragraph (b) of this section and cannot be applied for other estimated tax purposes.

(4) *Net operating loss carryover.* A corporation that has a net operating loss carryover as of the first day of the taxable year for which the estimated tax is being paid may use that carryover to reduce the annualized taxable income referred to in paragraph (b)(1)(i) of this section. For example, if a corporation with a net operating loss carryover of $3,000 had taxable income of $10,000 in 1986, it may use the carryover to reduce its annualized taxable income to $9,000, (($10,000 × 120%) − 3,000).

(c) *Corporation must bring aggregate payments to required level through timely subsequent installment*—(1) *In general.* A corporation using the safe harbor provided by paragraph (b) of this section shall make a timely subsequent installment payment of estimated tax in an amount sufficient to satisfy the requirements of either paragraph (c)(3) or paragraph (c)(4) of this section.

(2) *Applicable percentage.* For purposes of this paragraph (c), the applicable percentage is—

(i) 45 percent (50 percent × 90 percent), if the subsequent installment payment is the second installment payment for the taxable year, or

(ii) 67.5 percent (75 percent × 90 percent), if the subsequent installment payment is the third installment payment for the taxable year.

(3) *Annualization exception.* The subsequent installment payment of a corporation satisfies the requirements of this paragraph (c)(3) if the amount of the payment is sufficient to satisfy the requirements of section 6655(d)(3) with respect to all applicable taxes specified in section 6655(f). Thus, the corporation must determine its annualized taxable income under section 6655(d)(3)(A) (ii) or (iii), whichever is applicable, and compute the resulting tax. The resulting tax shall include the alternative minimum tax under section 55 and the environmental tax under section 59A and may take credits into account to the extent permitted under section 6655(d)(3). The sum of this subsequent installment payment and the earlier installment payment or payments of the corporation must equal or exceed the applicable percentage of the tax so computed. In determining whether the corporation has satisfied the requirements of section 6655(d)(3)(A) (ii) or (iii) with respect to the subsequent installment, the safe harbor provided in paragraph (b)(1) of this section shall not apply.

(4) *Installment payments equal to applicable percentage of tax shown on return.* The subsequent installment payment of a corporation satisfies the requirement of this paragraph (c)(4) if the sum of that payment and the earlier installment payment or payments of the corporation equals or exceeds the applicable percentage of the tax shown on the return of the corporation for the taxable year to which the installment payments relate. The tax shown on the return includes all taxes specified in section 6655(f).

(5) *Consequence of corporation's failure to satisfy requirements for subsequent installment*—(i) *In general.* If a corporation fails to satisfy the requirements set out in this paragraph (c), the corporation shall lose the benefit of the safe harbor provided by paragraph (b)(1) of this section.

(ii) *Limit on penalty.* The aggregate underpayment penalty with respect to any installment payment or payments for which a corporation loses the benefit of the safe harbor under paragraph (c)(5)(i) of this section shall be limited to the ‘‘shortfall penalty amount.’’ The shortfall penalty amount is the penalty that would be imposed under section 6655(a) if there were an underpayment of the subsequent installment payment equal to the excess of—

(A) The amount required to be paid, as determined under this paragraph (c), on or before the due date of the subsequent installment payment, over

(B) The amount actually paid on or before such date with respect to the subsequent installment payment.

For purposes of this determination, the period of the underpayment shall run from the due date of the subsequent installment payment until the earlier of the dates specified in section 6655(c) (1) or (2).

(iii) *Example.* The provisions of this paragraph (c)(5) may be illustrated by the following example:

Example. Corporation M, which uses the calendar year as its taxable year, relies on the safe harbor provided by paragraph (b) of this section for its first two installment payments of estimated tax for 1987. M is required by this paragraph (c) to make a timely subsequent installment payment of $1,000,000 by September 15, 1987, but M's actual installment payment by that date is only $990,000. Because of this shortfall, M loses the benefit of the safe harbor and is subject to underpayment penalties with respect to the first two installments. The aggregate penalties with respect to those two installments, however, cannot exceed the amount of the underpayment penalty to which M would be subject if there were an underpayment of $10,000 with respect to the September 15, 1987, installment payment. Such penalties are independent of any penalty that may apply with respect to M's third installment payment under the normal rules of section 6655.

(d) *Example.* The provisions of this section may be illustrated by the following example:

Example. (i) Corporation X (which is not a life insurance company) uses as its taxable year a fiscal year ending on January 31 and is required to pay an installment of estimated income tax by May 15, 1987, for its taxable year beginning on February 1, 1987. On its return for the taxable year ending January 31, 1987, which was a year of 12 months, X reported taxable income of $10,000,000 ($9,000,000 of which was ordinary income and $1,000,000 of which was net capital gain) and did not claim any net operating loss deduction. As of February 1, 1987, X has no net operating loss carryforwards and no credit carryforwards. X has no credits against tax that are permitted to be taken into account under section 6655(d)(3) for 1987. If X uses the safe harbor provided in paragraph (b)(1) of this section, X must make by May 15, 1987, an installment payment of estimated tax of at least $1,037,836, computed as follows:

(1) Taxable income shown on return for taxable year ending on January 31, 1987	$10,000,000
(2) Annualized taxable income for taxable year ending January 31, 1988, determined pursuant to paragraph (b)(1) of this section (Item (1)x120%)	$12,000,000

(Note: 120%xordinary income of $9,000,000=$10,800,000;
120%xnet capital gain of $1,000,000=$1,200,000)

(3) Tax on annualized taxable income (Item 2) using rates under section 11 and 1201, taking into account section 15, applicable to the taxable year ending January 31, 1988	$4,612,603
(4) Amount described in section 6655(d)(3)(A)(i) (Item (3)x22.5%)	$1,037,836

(ii) To preclude imposition of an addition to tax under section 6655 with respect to its May 15, 1987, installment payment, X must make by July 15, 1987, a second installment payment of estimated tax sufficient to bring its aggregate payments to the minimum level required under paragraph (c) of this section.

(iii) X may satisfy the requirements of paragraph (c)(3) of this section by making a second installment payment sufficient to bring X within the exception provided in section 6655(d)(3). Thus, if X determines under that section that the aggregate of X's installment payments of estimated tax by July 15, 1987, must equal at least $3,000,000, X may obtain the benefit of the safe harbor provided in paragraph (b)(1) of this section with respect to the May 15, 1987, installment payment by making a timely second installment payment of $1,962,164 ($3,000,000—$1,037,836).

(iv) Even if X fails to satisfy the requirements of paragraph (c)(3) of this section, X may obtain the benefit of the safe harbor for the May 15, 1987, installment payment if X's second installment payment, when aggregated with the first payment, equals at least 45 percent of the tax (including the alternative minimum tax under section 55 and the environmental tax under section 59A) shown on X's return for X's taxable year beginning on February 1, 1987. Thus, if the tax shown on that return is $6,000,000, X's second installment payment under paragraph (c)(4) of this section must be at least $1,662,164, computed as follows:

45 percent of $6,000,000	$2,700,000
less first payment	1,037,836

Minimum second installment	$1,662,164

[T.D. 8132, 52 FR 10051, Mar. 30, 1987]

§1.6655–3 Short taxable years in the case of corporations.

(a) *In general.* The provisions of section 6655, with certain modifications relating to the application of subsection (d) thereof, which are explained in paragraph (b) of this section, are applicable in the case of a short taxable year for which a declaration is required to be filed. (See §1.6016–4 for requirement of declaration for short taxable year.)

(b) *Rules as to application of section 6655(d).* In any case in which the taxable year for which an underpayment of estimated tax exists is a short taxable year due to a change in annual accounting periods, in determining the tax:

(1) Shown on the return for the preceding taxable year (for purposes of section 6655(d)(1));

(2) Based on the current year's rates but otherwise on the basis of the facts shown on the return for the preceding taxable year and the law applicable to such year (for purposes of section 6655(d)(2)); or

(3) Computed by placing taxable income for a portion of the current year on an annual basis under section 6655(d)(3);

the tax will be reduced by multiplying it by the number of months in the short taxable year and dividing the resulting amount by 12. The application of the exception provided in section 6655(d)(3) shall be determined as if the estimated tax were 70 percent of the tax so reduced.

(c) *Preceding taxable year a short taxable year.* If ‘‘the preceding taxable year’’ referred to in section 6655(d)(2) was a short taxable year, the tax computed on the basis of the facts shown on the return for such preceding year, for purposes of determining the applicability of the exception described in section 6655(d)(2), shall be the tax computed on the annual basis in the manner described in section 443(b)(1) (prior to its reduction in the manner described in the last sentence thereof). If the tax rates for the taxable year with respect to which the underpayment occurs differ from the rates applicable to the preceding taxable year, the tax determined in accordance with the preceding sentence shall be recomputed using the rates applicable to the year with respect to which the underpayment occurs.

[T.D. 6500, 25 FR 12152, Nov. 26, 1960]

§1.6655–5 Addition to tax on account of excessive adjustment under section 6425.

(a) *In general.* (1) Section 6655(g) imposes an addition to the tax under chapter 1 of the Code in the case of any excessive amount (as defined in subparagraph (3) of this paragraph) of an adjustment under section 6425 which is made before the 15th day of the third month following the close of a taxable year beginning after December 31, 1967. This addition to tax is imposed whether or not there was reasonable cause for an excessive adjustment.

(2) If the amount of an adjustment under section 6425 is excessive, there shall be added to the tax under chapter 1 for the taxable year an amount determined at the annual rate referred to in the regulations under section 6621 upon the excessive amount from the date on which the credit is allowed or the refund paid to the 15th day of the third month following the close of the taxable year. A refund is paid on the date it is allowed under section 6407.

(3) The excessive amount is equal to the lesser of the amount of the adjustment or the amount by which (i) the income tax liability (as defined in section 6425(c) of the Code) for the taxable year, as shown on the return for the taxable year, exceeds (ii) the estimated income tax paid during the taxable year, reduced by the amount of the adjustment.

(4) The computation of the addition to the tax imposed by section 6655 is made independently of, and does not affect the computation of, any addition to the tax which a corporation may otherwise owe for an underpayment of an installment of estimated tax.

(5) The provisions of section 6655 may be illustrated by the following example:

Example. Corporation A, a calendar year taxpayer, had an underpayment as defined in section 6655(b) for its fourth installment of estimated tax which was due on December 15, 1968, in the amount of $10,000. Nevertheless, on January 1, 1969, corporation A filed an application for adjustment of overpayment of estimated income tax for 1968 in the amount of $20,000. On February 15, 1969, the Internal Revenue Service in response to the application, refunded $20,000 to Corporation A. On March 15, 1969, corporation A filed its 1968 tax return and made a payment in settlement of its total tax liability. Under section 6655(a), corporation A is subject to an addition to tax in the amount of $150 ($10,000×6 percent×3⁄12) on account of corporation A's December 15, 1968 underpayment. Under section 6655(g) corporation A is subject to an addition to tax in the amount of $100 ($20,000×6 percent ×1⁄2) on account of corporation A's excessive adjustment under section 6425. In determining the amount of the addition to tax under section 6655(a) for failure to pay estimated income tax, the excessive adjustment under section 6425 is not taken into account.

(6) An adjustment is generally to be treated as a reduction of estimated income tax paid as of the date of the adjustment. However, for purposes of §§ 1.6655–1 through 1.6655–3, the adjustment is to be treated as if not made in determining whether there has been any underpayment of estimated income tax and, if there is an underpayment, the period during which the underpayment existed.

[T.D. 7059, 35 FR 14548, Sept. 17, 1970, as amended by T.D. 7384, 40 FR 49322, Oct. 22, 1975]

§ 1.6655–7 Special rules for estimating the corporate alternative minimum tax book income adjustment under the annualization exception.

(a) *In general.* For purposes of section 6655(e) (relating to the ''annualization exception'') a corporate taxpayer must take into account the tax imposed by section 55 (relating to the alternative minimum tax) and the tax imposed by section 59A (relating to the environmental tax). Thus, a taxpayer using the annualization exception must estimate alternative mimimum taxable income, including the book income adjustment, for the period of the taxable year that is annualized (the ''annualization period'').

(b) *Estimating the book income adjustment.* The book income adjustment for the annualization period is determined in accordance with the rules of § 1.56–1, except as otherwise provided in this section.

(c) *Applicable financial statement for the annualization period*—(1) *In general.* A taxpayer's applicable financial statement for an annualization period is the financial statement of highest priority described in section 56(f)(3)(A) and § 1.56–1(c) that is prepared for such annualization period by the date the installment payment is due. However, if a taxpayer reasonably expects to have a financial statement of higher priority for such period no later than 30 days after the date the installment payment is due, the taxpayer shall make a reasonable estimate of the adjusted net book income that will result from such statement, and such estimate shall be used as the taxpayer's adjusted net book income for that annualization period. If the date that is 30 days after the due date of the installment falls on a Saturday, Sunday or legal holiday, the 30-day period is extended to the immediately following day that is not a Saturday, Sunday or legal holiday. For example, an event arising subsequent to the installment due date that causes the taxpayer's estimate of net book income to be understated will not result in a recomputation of the book income adjustment for the annualization period, if, based on all the facts and circumstances at the time the installment payment was made, it was not reasonably foreseeable that the subsequent event would occur.

(2) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. A is a public corporation that is a calendar year taxpayer. A's first installment payment of estimated tax is due April 15. A uses the annualization exception under section 6655(e) in order to determine whether it is liable for an addition to tax due to an underpayment of estimated tax. In the case of the first installment, the applicable annualization period is the first three months of the taxable year. On April 15, A has an unaudited financial statement for the first three-month period that is used for credit purposes. By May 15, A will file a quarterly report, Form 10-Q, with the Securities and Exchange Commission. Since the financial statement filed with the SEC has higher priority than the unaudited statement and A can reasonably expect to have such statement no later than 30 days after the installment due date, A must make a reasonable estimate of the adjusted net book income that will result from such statement. This estimate shall be used as A's adjusted net book income for the annualization period.

(d) *Earnings and profits*—(1) *In general.* If an applicable financial statement is not available by the date a payment is due for an annualization period or reasonably expected to be available no later than 30 days after the payment is due under the rules of paragraph (c) of this section, current earnings and profits for the applicable annualization period must be used in lieu of net book income. See §1.56–1(b)(5) for rules relating to computing current earnings and profits for purposes of computing the book income adjustment.

(2) *Election to use earnings and profits*—(i) *In general.* A taxpayer may elect to use current earnings and profits for the applicable annualization period if the taxpayer has only a statement for such period that is described in section 56(f)(3)(A)(iv) and §1.56–1(c)(1)(iv) and th taxpayer has elected under the rules of section 56(f)(3)(B)(ii) and §1.56–1(c)(2) to use current earnings and profits to compute the book income adjustment for purposes of filing its annual Federal income tax return. Once the election has been made, current earnings and profits must be used for any annualization period for which the taxpayer has only an applicable financial statement described in section 56(f)(3)(A)(iv) and §1.56–1(c)(1)(iv).

(ii) *Election during 1987 taxable year.* During its taxable year beginning in 1987, a taxpayer may elect to use current earnings and profits for an applicable annualization period even if the taxpayer has not elected to use current earnings and profits for purposes of computing its annual Federal income tax liability under section 56(f)(3)(B)(ii) and §1.56–1(c)(2). In addition, a taxpayer electing in 1987 to use current earnings and profits for purposes of its installment payments of estimated tax is not required to use current earnings and profits to compute the book income adjustment when filing its annual Federal income tax return. However, unless an annual election under section 56(f)(3)(B)(ii) is made when filing the taxpayer's 1987 Federal income tax return, the election to use current earnings and profits for purposes of computing its estimated tax liability in taxable years beginning after 1987 is terminated.

(iii) *Manner of making election.* If a taxpayer elects to use current earnings and profits for the applicable annualization period under the rules of this section, the taxpayer must attach a statement to its Federal income tax return for the taxable year in which the election was made. The statement must include the electing taxpayer's name, address and taxpayer identification number, identify the election and indicate that it was made under the provisions of §1.6655–7, state that the only financial statement of the taxpayer available for the annualization period is described in §1.56–1(c)(1)(iv).

[T.D. 8307, 55 FR 33689, Aug. 17, 1990]

§1.6655(e)–1 Time and manner for making election under the Omnibus Budget Reconciliation Act of 1993.

(a) *Description.* Section 6655(e)(2)(C), as added by section 13225 of the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103–66, 107 Stat. 486), allows a corporate taxpayer to make an annual election to use a different annualization period to determine annualized income for purposes of paying any required installment of estimated income tax for a taxable year beginning after December 31, 1993.

(b) *Time and manner for making the election.* An election under section 6655(e)(2)(C) must be made on or before the date required for the payment of the first required installment for the taxable year. For a calendar or fiscal year corporation, Form 8842, Election to Use Different Annualization Periods for Corporate Estimated Tax, must be filed by the 15th day of the 4th month of the taxable year for which the election is to apply. Form 8842 must be filed with the Internal Revenue Service Center where the corporation files its income tax return.

(c) *Revocability of election.* The election described in this section is irrevocable.

(d) *Effective date.* The rules set forth in this section are effective December 12, 1996.

[T.D. 8688, 61 FR 65322, Dec. 12, 1996]

§ 1.6661–1 Addition to tax in the case of a substantial understatement of tax liability.

(a) *In general.* Section 6661 imposes an addition to tax (penalty) for an understatement of tax liability that constitutes a substantial understatement of income tax. This section prescribes the effective date of the penalty. The manner of computing understatements subject to the penalty is set forth in § 1.6661–2. The definition of ''substantial authority'' is set forth in § 1.6661–3. Rules concerning the adequacy of disclosure are set forth in § 1.6661–4. The treatment of ''tax shelters'' is provided in § 1.6661–5. The circumstances in which the penalty may or will be waived by the Commissioner are set forth in § 1.6661–6.

(b) *Effective date.* The penalty under section 6661 applies to returns the due date (determined without regard to extensions of the time for filing) of which is after December 31, 1982. The penalty does not apply to amended returns, so-called, if the due date for the return to which the amended return relates (determined without regard to extensions) is before January 1, 1983.

[T.D. 8017, 50 FR 12014, Mar. 27, 1985]

§ 1.6661–2 Computation of penalty; meaning of terms.

(a) *Amount of penalty.* If there is a substantial understatement of income tax for a taxable year (as defined in paragraph (b) of this section), section 6661 imposes a penalty equal to 10 percent of the understatement of tax liability.

(b) *Substantial understatement.* The term *substantial understatement* means an understatement (as defined in paragraph (c) of this section) that exceeds the greater of—

(1) 10 percent of the tax required to be shown on the return for the taxable year (as defined in paragraph (d)(4) of this section); or

(2) $5,000 ($10,000 in the case of a corporation other than an S corporation (as defined in section 1361(a)(1)) or a personal holding company (as defined in section 542)).

(c) *Understatement.* The term *understatement* means the excess of—

(1) The amount of tax required to be shown on the return for the taxable year (as defined in paragraph (d)(4) of this section), over

(2) The amount of tax shown on the return for the taxable year (as defined in paragraph (d)(2) of this section), reduced by any rebate (as defined in paragraph (d)(3) of this section).

(d) *Determination of amounts*—(1) *Amount of tax.* For purposes of section 6661, the amount of tax is the amount of tax imposed by Subtitle A of the Code.

(2) *Tax shown on return.* For purposes of section 6661, the amount of tax shown on the return for the taxable year is determined with the adjustments prescribed in this paragraph (d)(2), without regard to the items described in paragraph (d)(5) of this section, without regard to any net operating loss carryback, tax credit carryback, capital loss carryback, or commodity futures loss carryback (''carryback''), and without regard to any amount of additional tax shown on a return (including an amended return, so-called) filed after the taxpayer is first contacted by the Internal Revenue Service concerning the tax liability of the taxpayer for the taxable year. See § 1.6661–6(c) for rules relating to waiver of the penalty if the taxpayer files a ''qualified amended return.'' If no return was filed for the taxable year or if the return (other than a return filed under section 6014) shows no tax due, the amount of tax shown on the return is considered to be zero. The amount of tax shown on the return for the taxable year is determined by computing the tax as if the following items (in addition to the items that were properly reported on the return) had received the proper tax treatment:

(i) Items (other than tax shelter items as defined in § 1.6661–5(c)) for which there is or was substantial authority for the treatment claimed (as provided in § 1.6661–3).

(ii) Items (other than tax shelter items as defined in § 1.6661–5(c)) with respect to which there is adequate disclosure (as provided in § 1.6661–4).

(iii) Tax shelter items (as defined in §1.6661–5(c)) for which there is or was substantial authority for the treatment claimed (as provided in §1.6661–3), and with respect to which the taxpayer reasonably believes that the tax treatment of the item was more likely than not the proper tax treatment (as provided in §1.6661–5(d)).

(iv) Items taken into account in computing the amount of any net operating loss, unused tax credit, or net capital loss for a taxable year the return for which was due (determined without regard to extensions of time for filing) before January 1, 1983 (regardless of whether there is substantial authority or adequate disclosure with respect to such items).

(3) *Rebate.* For purposes of section 6661, the amount of a rebate is the rebate (within the meaning of section 6211(b)(2) and §301.6211–1(f)), determined as if any items to which the rebate is attributable that are described in paragraphs (d)(2) (i) through (iv) of this section (in addition to the items that were properly reported on the return) had received the proper tax treatment.

(4) *Tax required to be shown.* For purposes of section 6661, the amount of tax required to be shown on the return for the taxable year is the amount of tax imposed on the taxpayer for the taxable year determined without regard to items described in paragraph (d)(5) of this section and without regard to any allowable carryback that was not taken into account in computing the amount of a rebate for the taxable year.

(5) *Items disregarded.* The amount of tax shown on the return for the taxable year and the amount of tax required to be shown on the return for the taxable year are both determined without regard to—

(i) The credit under section 31 for tax withheld;

(ii) The credit under section 33 for tax withheld at source on nonresident aliens and foreign corporations;

(iii) Any credit resulting from the collection of amounts assessed under section 6851 as the result of a termination assessment;

(iv) Payments of tax or estimated tax by the taxpayer; and

(v) Any tax that the taxpayer is not required to assess on the return (such as the tax imposed by section 535 on the accumulated taxable income of a corporation).

(6) *Treatment of carryovers*—(i) *In general.* A net operating loss carryover, tax credit carryover, or capital loss carryover shall be treated for purposes of section 6661 as a credit or deduction in the year in which the carryover is taken into account. See paragraph (d)(2)(iv) of this section for rules applicable to carryovers from a taxable year the return for which was due (without regard to extensions of time for filing) before January 1, 1983.

(ii) *Carryovers treated as carrybacks.* For purposes of section 6661, a carryover to a taxable year shall be treated as a carryback rather than a carryover with respect to such year to the extent such carryover exceeds the amount of the carryover determined without taking into account carrybacks from taxable years subsequent to such years.

(e) *Examples.* The following examples illustrate the computation of an understatement:

Example (1). In 1983, An individual calendar year taxpayer, files a return for 1982, which shows taxable income of $18,200 and tax liability of $3,194. Subsequent adjustments on audit for 1982 increase taxable income to $51,500 and tax liability to $17,068. There was substantial authority for an item resulting in an adjustment that increases taxable income by $5,300. The item is not a tax shelter item. In computing the amount of the understatement, the amount of tax shown on A's return is determined as if the item for which there was substantial authority had been given the proper tax treatment. Thus, the amount of tax that is treated as shown on A's return is $4,837 (the tax on $23,500) ($18,200 taxable income actually shown on A's return plus $5,300, the amount of the adjustment for which there was substantial authority). The amount of the understatement is $12,231 ($17,068 (the amount of tax required to be shown) less $4,837 (the amount of tax treated as shown on A's return after adjustment for the item for which there was substantial authority)). Because the understatement exceeds the greater of 10 percent of the tax required to be shown on the return for the year ($1,707 ($17,068×.10)) or $5,000, A has a substantial understatement of income tax for the year. The amount of section 6661 penalty is $1,223.10 (.10×$12,231).

Example (2). Corporation X was formed on January 1, 1982. In 1983, X adopts a calendar taxable year and files a return for 1982 showing a tax liability of $10,000. In 1984, X determines that it has an unused investment tax credit for taxable year 1983 in the amount of $20,000. X files an amended return, so-called, for taxable year 1982 claiming an investment tax credit carryback of $20,000 and receives a rebate of $10,000 (the tax liability shown on X's original return for taxable year 1982). On audit for taxable years 1982 and 1983, adjustments increase tax liability for 1982 to $24,000, and decrease the unused investment tax credit for 1983 to $8,000. There was not substantial authority and X did not make adequate disclosure with respect to the items comprising the 1982 adjustments, but there was substantial authority for $1,000 of the $12,000 investment tax credit disallowed for 1983. The amount of the section 6661 penalty for 1982 is computed as follows:

(i) The amount of tax required to be shown on the return for 1982 is $16,000 (*i.e.*, the tax liability as adjusted on audit ($24,000) reduced by the allowable tax credit carryback taken into account in computing the amount of the rebate ($8,000)).

(ii) The amount of tax shown on the return is $10,000 (*i.e.*, the tax shown on the return without adjustment for carryback of the investment tax credit).

(iii) The amount of the rebate is $9,000 (i.e., the amount of the rebate determined as if the items described in paragraph (d)(2)(i) of this section ($1,000 item for which there was substantial authority) had received the proper tax treatment ($10,000 − $1,000=$9,000)).

(iv) The understatement is $15,000 (*i.e.*, the excess of the tax required to be shown ($16,000) over the tax shown reduced by the rebate ($10,000 − $9,000=$1,000)).

(v) Since the understatement exceeds the greater of 10 percent of the tax required to be shown or $10,000, X has a substantial understatement of income tax for the year. The amount of the section 6661 penalty is $1,500 (.10 x $15,000).

Example (3). Corporation Y was formed on January 1, 1982. In 1983, Y adopts a calendar taxable year and files a return for 1982 showing tax liability of $50,000. Y subsequently determines that it has unused investment tax credits in the amount of $20,000 for taxable year 1983, $20,000 for taxable year 1984, and $37,000 for taxable year 1985. Y files an amended return, so-called, for taxable year 1982 claiming investment tax credit carrybacks of $77,000 and receives a rebate of $50,000 (the tax liability shown on Y's original return for 1982). On audit for taxable years 1982, 1983, 1984, and 1985, the only adjustments decrease the unused investment tax credit for taxable year 1983 to $5,000, and the unused investment tax credit for 1984 to $8,000. There was not substantial authority and X did not make adequate disclosure with respect to the items comprising the 1983 and 1984 adjustments. The amount of the section 6661 penalty for 1982 is computed as follows:

(i) The amount of the tax required to be shown on the return for 1982 is $27,000 (*i.e.*, the original tax liability ($50,000) reduced by the allowable carrybacks taken into account in computing the amount of the rebate ($5,000+$8,000+$10,000=$23,000)).

(ii) The amount of the tax shown on the return is $50,000 (*i.e.*, the tax shown on the return without adjustment for carryback of the investment tax credit).

(iii) The amount of the rebate is $50,000 (*i.e.*, the amount of the rebate determined as if any items described in paragraph (d)(2)(i)–(iv) of this section ($0) had received the proper tax treatment ($50,000 − 0=$50,000)).

(iv) The understatement is $27,000 (*i.e.*, the excess of the tax required to be shown ($27,000) over the tax shown reduced by the rebate ($50,000 − $50,000=0)).

(v) Since the understatement exceeds the greater of 10 percent of the tax required to be shown or $10,000, Y has a substantial understatement of income tax for the year. The amount of the section 6661 penalty is $2,700 (.10 x $27,000).

(f) *Coordination with penalty for valuation overstatments*—(1) *In general.* The amount of the penalty imposed under section 6661 shall be determined without taking into account the portion of the substantial understatement on which the penalty under section 6659 (relating to valuation overstatements) has been imposed. The portion of the understatement on which the penalty under section 6659 has been imposed is taken into account, however, in determining whether there is a substantial understatement of tax. For purposes of section 6661, a penalty under section 6659 is not considered to have been imposed to the extent that the penalty is waived under the authority of section 6659(e). If a penalty is imposed under section 6659, the amount to which the section 6661 penalty applies is the amount by which the understatement exceeds the amount of the underpayment attributable to a valuation overstatement as determined under section 6659.

(2) *Example.* The following example illustrates the coordination of the penalties under sections 6659 and 6661:

Example. In 1983, A, an individual calendar year taxpayer, files a return for 1982 which shows taxable income of $40,000 and tax liability of $11,408. Subsequent adjustments on audit for 1982 increases taxable income to

$70,000 and tax liability to $26,318. The increase in taxable income is attributable to a $20,000 adjustment for a valuation overstatement and a $10,000 adjustment not related to a valuation overstatement. There are no adjustments under paragraph (d)(2) of this section. Since the amount of the understatement, $14,910 ($26,318–$11,408), exceeds the greater of $2,631.80 (10 percent of the tax required to be shown) or $5,000, there is a substantial understatement. Assume that under section 6659 the $20,000 adjustment for the valuation overstatement results in a $10,000 underpayment attributable to a valuation overstatement on which the section 6659 penalty is imposed. The amount of the understatement on which the section 6661 penalty is imposed is $4,910. (The amount by which the $14,910 understatement exceeds the $10,000 underpayment to which the section 6659 penalty applies.) The amount of the section 6661 penalty is $491 ($4,910×.10).

[T.D. 8017, 50 FR 12014, Mar. 27, 1985]

§1.6661–3 Substantial authority.

(a) *General rule*—(1) *Effect of having substantial authority.* If there is or was substantial authority for the tax treatment of an item (other than a tax shelter item as defined in §1.6661–5(c)), the item is treated as if it were shown properly on the return for the taxable year in computing the amount of tax shown on the return. Thus, for purposes of section 6661, the tax attributable to the item is not included in the understatement for the year. (See paragraph (d)(2) of §1.6661–2.)

(2) *Substantial authority standard.* The substantial authority standard is less stringent than a ‘‘more likely than not’’ standard (that is, a greater than 50-percent likelihood of being upheld in litigation), but stricter than a reasonable basis standard (the standard which, in general, will prevent imposition of the penalty under section 6653 (a), relating to negligence or international disregard of rules and regulations). Thus, a position with respect to the tax treatment of an item that is arguable but fairly unlikely to prevail in court would satisfy a reasonable basis standard, but not the substantial authority standard.

(b) *Determination of whether substantial authority is present*—(1) *Evaluation of authorities.* There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary positions. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists and the weight of those authorities is determined in light of the pertinent facts and circumstances in the manner prescribed in paragraph (b)(3) of this section. There may be substantial authority for more than one position with respect to the same item. The taxpayer’s belief that the authorities with respect to the tax treatment of an item constitute substantial authority is not taken into account in determining whether there is substantial authority.

(2) *Types of authority.* In determining whether there is substantial authority (other than in cases described in paragraph (b) (4) (i) of this section), only the following will be considered authority. Applicable provisions of the Internal Revenue Code and other statutory provisions; temporary and final regulations construing such statutes; court cases; administrative pronouncements (including revenue rulings and revenue procedures); tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; and Congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill’s managers. Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by other tax professionals, descriptions of statutes prepared after enactment (such as ‘‘General Explanations’’ prepared by the Staff of the joint Committee on Taxation), general counsel memoranda (other than those published in pre-1955 volumes of the Cumulative Bulletin), actions on decisions, technical memoranda, written determinations (except as provided in paragraph (b)(4)(i) of this section), and proposed regulations are not authority. The authorities underlying such expressions of opinion where applicable to the facts of a particular case, however, may give rise to substantial authority for the tax treatment of an

item. (See § 1.6661–6(b), however, regarding waiver of the penalty when the taxpayer relies on proposed regulations.)

(3) *Nature of analysis.* Except as otherwise provided in this section, the weight of the authorities for the tax treatment of an item is determined by the same analysis that a court would be expected to follow in evaluating the tax treatment of the item. Thus, the weight of authorities depends on their persuasiveness and relevance as well as their source. For example, a case or revenue ruling having some facts in common with the tax treatment at issue would not be considered particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. Similarly, an authority that merely states a conclusion ordinarily would be given less weight than an authority that reaches its conclusion by cogently relating the applicable law to pertinent facts. There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

(4) *Special rules*—(i) *Written determinations.* There is substantial authority for the tax treatment of an item if the treatment is supported by the holding of a ruling or a determination letter (as defined in § 301.6110–2 (d) and (e)) issued to the taxpayer, by the holding of a technical advice memorandum in which the taxpayer is named, or by an affirmative statement in a revenue agent's report with respect to a prior taxable year of the taxpayer (''written determinations''). The preceding sentence shall not apply, however, if there has been a misstatement or omission of a material fact, the facts that subsequently develop are materially different from the facts on which the written determination was based, or authority supporting a contrary position has arisen since the date of the written determination.

(ii) *Taxpayer's jurisdiction.* The applicability of court cases to the taxpayer by reason of the taxpayer's residence in a particular jurisdiction is not taken into account in determining whether there is substantial authority for the tax treatment of an item. Notwithstanding the preceding sentence, however there is substantial authority for the tax treatment of an item if the treatment is supported by controlling precedent of a United States Court of Appeals to which the taxpayer has a right of appeal with respect to the item.

(iii) *When substantial authority determined.* For purposes of section 6661, there is substantial authority for the tax treatment of an item if there is substantial authority at the time the return containing the item is filed or there was substantial authority on the last day of the taxable year to which the return relates.

[T.D. 8017, 50 FR 12016, Mar. 27, 1985]

§ 1.6661–4 Disclosure of certain information.

(a) *In general.* Items (other than tax shelter items as defined in § 1.6661–5(c)) for which there is adequate disclosure are treated as if such items were shown properly on the return for the taxable year in computing the amount of tax shown on the return. Thus, for purposes of section 6661, the tax attributable to such items is not included in the understatement for the year. (See paragraph (d)(2) of § 1.6661–2.) Disclosure is adequate with respect to the tax treatment of an item on a return only if it is made on such return or in a statement attached thereto. Thus, disclosure with respect to a recurring item, such as the basis of recovery property, made on a return or statement attached thereto for one taxable year is not adequate disclosure with respect to the item for any other taxable year. (See paragraph (d) of this section for special rules relating to disclosure with respect to carrybacks and carryovers.)

(b) *Disclosure in attached statement*—(1) *In general.* Disclosure will be adequate with respect to an item (or group of similar items, such as the specific deduction of business bad debts or the deduction of amounts paid or incurred for supplies by a taxpayer engaged in business), if it is made on a properly completed Form 8275 or if it takes the form of a statement attached to the return that includes the following:

(i) A caption identifying the statement as disclosure under section 6661.

(ii) An identification of the item (or group of similar items) with respect to which disclosure is made.

(iii) The amount of the item (or group of similar items).

(iv) The facts affecting the tax treatment of the item (or group of similar items) that reasonably may be expected to apprise the Internal Revenue Service of the nature of the potential controversy concerning the tax treatment of the item (or items).

(2) *Disclosure of legal issue.* In lieu of setting forth the facts affecting the tax treatment of an item (or group of similar items) in accordance with paragraph (b)(1)(iv) of this section, the taxpayer may set forth a concise description of the legal issue presented by such facts.

(3) A concise description of the taxpayer's legal position with respect to the items.

(4) *Requirement of particularity.* Disclosure is not adequate with respect to an item (or group of similar items) if it consists of undifferentiated information that is not arranged in a manner that reasonably may be expected to apprise the Internal Revenue Service of the identity of the item, its amount, and the nature of the potential controversy concerning the item (or items). For example, attachment to the return of an acquisition agreement generally will not constitute adequate disclosure of the issues involved in determining the basis of certain acquired assets.

(c) *Disclosure on return.* The Commissioner may by revenue procedure prescribe the circumstances in which information provided on the return in accordance with the applicable forms and instructions will be adequate disclosure for purposes of section 6661.

(d) *Carryovers and carrybacks.* In the case of a carryover or carryback attributable to the tax treatment of an item on a return to which section 6661 applies (see paragraph (b) of §1.6661–1 and paragraph (d)(2)(iv) of §1.6661–2), disclosure is adequate with respect to the item only if it is made on the return for the taxable year in which the item arises or in a statement attached thereto. In such a case, disclosure with respect to the item is not required on the return for the taxable year in which the carryover or carryback attributable to the item is taken into account.

(e) *Pass-through entities.* In the case of items attributable to a pass-through entity ("pass-through items"), disclosure regarding the tax treatment of such items should be made on the return of the entity or on an attachment thereto. For this purpose, a pass-through entity is a partnership, an S corporation (as defined in section 1361(a)(1)), an estate, a trust, a regulated investment company (as defined in section 851(a)), or a real estate investment trust (as defined in section 856(a)). A taxpayer (partner, shareholder, or beneficiary) also may make adequate disclosure with respect to a pass-through item, however, if the taxpayer files a separate statement in duplicate, one copy attached to and filed with the taxpayer's return and the other copy filed with the Internal Revenue Service Center with which the return of the entity is required to be filed. Each statement filed shall relate to the pass-through items of only one entity and shall include the following:

(1) An identification of the taxpayer and the entity by name, address, and taxpayer identification number.

(2) The taxable year of the entity to which the disclosure relates.

(3) An identification of the items with respect to which the taxpayer has made disclosure under this paragraph.

(4) Such additional information as would be required for adequate disclosure with respect to the items under paragraphs (a), (b), and (d) of this section.

(5) A notation to the effect that the statement is to be associated with the return of the entity.

[T.D. 8017, 50 FR 12017, Mar. 27, 1985]

§1.6661–5 Items relating to tax shelters.

(a) *In general.* (1) Tax shelter items (as defined in paragraph (c) of this section) are treated as if such items were shown properly on the return for the taxable year in computing the amount of tax shown on the return if—

(i) There is or was substantial authority for the tax treatment of the items (as provided in § 1.6661–3); and

(ii) The taxpayer reasonably believes at the time the return is filed that the tax treatment claimed is more likely than not the proper tax treatment of the items (see paragraph (d) of this section).

Thus, for purposes of section 6661, the tax attributable to such items is not included in the understatement for the year. (See paragraph (d)(2) of § 1.6661–2.)

(2) Disclosure (whether or not adequate under § 1.6661–4) with respect to tax shelter items (as defined in paragraph (c) of this section) does not affect the amount of the understatement.

(b) *Tax shelter*—(1) *In general.* For purposes of section 6661, the term ''tax shelter'' means—

(i) A partnership or other entity (such as a corporation or trust),

(ii) An investment plan or arrangement, or

(iii) Any other plan or arrangement, if the principal purpose of the entity, plan, or arrangement, based on objective evidence, is the avoidance or evasion of Federal income tax. The principal purpose of an entity, plan or arrangement is the avoidance or evasion of Federal income tax if that purpose exceeds any other purpose. See § 1.269–3(a). Typical of tax shelters are transactions structured with little or no motive for the realization of economic gain, and transactions that utilize the mismatching of income and deductions, overvalued assets or assets with values subject to substantial uncertainty, nonrecourse financing, financing techniques which do not conform to standard commercial business practices, or the mischaracterization of the substance of the transaction. The existence of economic substance does not of itself establish that a transaction is not a tax shelter if the transaction includes other characteristics that indicate it is a tax shelter.

(2) *Principal purpose.* The principal purpose of an entity, plan or arrangement is not the avoidance or evasion of Federal income tax if the entity, plan or arrangement has as its purpose the claiming of exclusions from income, accelerated deductions or other tax benefits in a manner consistent with the statute and Congressional purpose. For example, an entity, plan or arrangement will not be considered to have as its principal purpose the avoidance or evasion of Federal income tax merely as a result of the following uses of tax benefits provided by the Internal Revenue Code: The claiming of the investment credit under section 38; the purchase or holding of an obligation bearing interest which is excluded from gross income under section 103; entering into a safe-harbor lease transaction under section 168(f)(8); taking an accelerated cost recovery system (ACRS) allowance under section 168; taking the percentage depletion allowance under section 613 or section 613A; deducting intangible drilling and development costs as expenses under section 263(c); establishing a qualified retirement plan under the provisions of sections 401–409A, claiming the possession tax credit under section 936; or claiming tax benefits available by reason of an election under section 992 to be taxed as a domestic international sales corporation (DISC), under section 927(f)(1) to be taxed as a foreign sales corporation (FSC), or under section 1362 to be taxed as an S corporation.

(c) *Tax shelter item.* An item of income, gain, loss, deduction or credit will be considered a ''tax shelter item'' if the item is directly or indirectly attributable to the principal purpose of a tax shelter to avoid or evade Federal income tax. Thus, if a partnership is established for the principal purposes of the avoidance or evasion of Federal income tax by acquiring and overvaluing property for the purpose of claiming the investment credit under section 38, the investment credit with respect to the property would be a tax shelter item. However, a deduction claimed in connection with a separate transaction carried on by the same partnership is not a tax shelter item if the transaction does not constitute a plan or arrangement the principal purpose of which is the avoidance or evasion of tax.

(d) *Reasonable belief.* For purposes of section 6661, a taxpayer will be considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if—

(1) The taxpayer analyzes the pertinent facts and authorities in the manner described in §1.6661–3(b)(3) and, in reliance upon that analysis, reasonably concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld in litigation if the claimed treatment is challenged by the Internal Revenue Service; or

(2) The taxpayer in good faith relies on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in §1.6661–3(b)(3) and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld in litigation if the claimed tax treatment is challenged by the Internal Revenue Service.

(e) *Pass-through entities.* In the case of tax shelter items (as defined in paragraph (e) of this section) attributable to a pass-through entity (as defined in §1.6661–4(e)), the actions described in paragraphs (d) (1) and (2) of this section, if taken by the entity, will be deemed to have been taken by the taxpayer and will be considered in determining whether the taxpayer reasonably believes that the tax treatment of an item is more likely than not the proper tax treatment.

[T.D. 8017, 50 FR 12017, Mar. 27, 1985]

§1.6661–6 Waiver of penalty.

(a) *In general.* The Commissioner may waive all or part of the penalty imposed by section 6661 on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith. The circumstances taken into account in determining whether to waive the penalty are described in paragraph (b) of this section. In addition, paragraph (c) of this section describes circumstances in which the penalty will always be waived.

(b) *Reasonable cause and good faith.* In making a determination regarding waiver of the penalty under section 6661, the most important factor in all cases not described in paragraph (c) of this section will be the extent of the taxpayer's effort to assess the taxpayer's proper tax liability under the law. For example, reliance on a position contained in a proposed regulation would ordinarily constitute reasonable cause and good faith. In addition, circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge, and education of the taxpayer. Moreover, a computational or transcriptional error would, in general, indicate reasonable cause and good faith. Reliance on an information return or on the advice of a professional (such as an appraiser, an attorney, or an accountant) would not necessarily constitute a showing of reasonable cause and good faith. Similarly, reliance on facts that, unknown to the taxpayer, are incorrect would not necessarily constitute a showing of reasonable cause and good faith. Reliance on an information return, professional advice, or other facts, however, would constitute a showing of reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. For example, reliance on erroneous information (such as an error relating to the cost of property, the date property was placed in service, or the amount of opening or closing inventory) inadvertently included in data compiled by the various divisions of a multidivisional corporation or in financial books and records prepared by those divisions would, in general, indicate reasonable cause and good faith, provided the corporation had internal controls and procedures, reasonable under the circumstances, that were designed to identify factual errors. Accordingly, waiver of the section 6661 penalty attributable to an understatement caused by such an error would be appropriate. Similarly, a taxpayer's reliance on erroneous information reported on a Form 1099 would indicate reasonable cause and good faith, and waiver would be appropriate, if the taxpayer did not know or have reason to know that the information was incorrect. Generally, a taxpayer would know or have reason to know that the information on a Form 1099 is incorrect only if such information is inconsistent with other information reported to the taxpayer or is inconsistent with the taxpayer's knowledge concerning the amount and rate of return of the payor's obligation. In the case of an understatement that is related to an item on the return of a pass-through entity (as defined in § 1.6661–4(e)), the good faith or lack of good faith of the entity generally will be imputed to the taxpayer that has the understatement. Any good faith imputed to the taxpayer under the preceding sentence, however, may be refuted by other factors indicating lack of good faith on the part of the taxpayer.

(c) *Automatic waiver; qualified amended returns*—(1) *In general.* If the taxpayer shows an additional amount of tax or makes adequate disclosure with respect to an item in the manner prescribed in § 1.6661–4 on a qualified amended return, the Commissioner will waive any penalty that would not have been imposed if the additional amount of tax had been shown or the adequate disclosure had been made on the return of the taxpayer. Thus, the entire penalty will be waived if there would not have been a substantial understatement (as defined in paragraph (b) of § 1.6661–2) had the taxpayer shown the additional amount of tax or made the adequate disclosure on the taxpayer's original return.

(2) *Qualified amended return.* For purposes of this paragraph, a "qualified amended return" is an amended return, so-called, or a timely request for an administrative adjustment under section 6227, filed after the due date of the return and before the earlier of—

(i) The time the taxpayer is first contacted by the Internal Revenue Service concerning an examination of the return; or

(ii) The time any person described in section 6700(a) (relating to the penalty for promoting abusive tax shelters) is first contacted by the Internal Revenue Service concerning an examination of an activity described in section 6700(a) with respect to which the taxpayer claimed any tax benefit on the return directly or indirectly through the entity, plan, or arrangement described in section 6700(a)(1)(A).

(3) *Pass-through entities.* For purposes of paragraph (c)(1) of this section, no account is taken of an additional amount of tax shown or disclosure made with respect to an item attributable to a pass-through entity (as defined in § 1.6661–4(e)), unless the qualified amended return is filed by the taxpayer before the date such pass-through entity is first contacted by the Internal Revenue Service concerning an examination of the return of which the item is attributable.

(4) *Special rule.* The Commissioner may by revenue procedure prescribe the manner in which this section may apply to particular classes of taxpayers.

[T.D. 8017, 50 FR 12018, Mar. 27, 1985]

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[T.D. 8381, 56 FR 67497, Dec. 31, 1991; T.D. 8381, 57 FR 6165, Feb. 20, 1992, as amended by T.D. 8519, 59 FR 4794, Feb. 2, 1994; T.D. 8533, 59 FR 12548, Mar. 17, 1994; T.D. 8551, 59 FR 35031, July 8, 1994; T.D. 8617, 60 FR 45663, Sept. 1, 1995; T.D. 8656, 61 FR 4879, Feb. 9, 1996; T.D. 8656, 61 FR 14248, Apr. 1, 1996; T.D. 8790, 63 FR 66434, Dec. 2, 1998]

§ 1.6662–1 Overview of the accuracy-related penalty.

Section 6662 imposes an accuracy-related penalty on any portion of an underpayment of tax required to be shown on a return that is attributable to one or more of the following:

(a) Negligence or disregard of rules or regulations;

(b) Any substantial understatement of income tax;

(c) Any substantial valuation misstatement under chapter 1;

(d) Any substantial overstatement of pension liabilities; or

(e) Any substantial estate or gift tax valuation understatement.

Sections 1.6662–1 through 1.6662–5 address only the first three components of the accuracy-related penalty, *i.e.*, the penalties for negligence or disregard of rules or regulations, substantial understatements of income tax, and substantial (or gross) valuation misstatements under chapter 1. The penalties for disregard of rules or regulations and for a substantial understatement of income tax may be avoided by adequately disclosing certain information as provided in § 1.6662–3(c) and §§ 1.6662–4(e) and (f), respectively. The penalties for negligence and for a substantial (or gross) valuation misstatement under chapter 1 may not be avoided by disclosure. No accuracy-related penalty may be imposed on any portion of an underpayment if there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. The reasonable cause and good faith exception to the accuracy-related penalty is set forth in § 1.6664–4.

[T.D. 8381, 56 FR 67498, Dec. 31, 1991, as amended by T.D. 8617, 60 FR 45664, Sept. 1, 1995]

§ 1.6662–2 Accuracy-related penalty.

(a) *In general.* Section 6662(a) imposes an accuracy-related penalty on any portion of an underpayment of tax (as defined in section 6664(a) and § 1.6664–2) required to be shown on a return if such portion is attributable to one or more of the following types of misconduct:

(1) Negligence or disregard of rules or regulations (see § 1.6662–3);

(2) Any substantial understatement of income tax (see § 1.6662–4); or

(3) Any substantial (or gross) valuation misstatement under chapter 1 (''substantial valuation misstatement'' or ''gross valuation misstatement''), provided the applicable dollar limitation set forth in section 6662(e)(2) is satisfied (see § 1.6662–5).

The accuracy-related penalty applies only in cases in which a return of tax is filed, except that the penalty does not apply in the case of a return prepared by the Secretary under the authority of section 6020(b). The accuracy-related penalty under section 6662 and the penalty under section 6651 for failure to timely file a return of tax may both be imposed on the same portion of an underpayment if a return is filed, but is filed late. The fact that a return is filed late, however, is not taken into account in determining whether an accuracy-related penalty should be imposed. No accuracy-related penalty may be imposed on any portion of an underpayment of tax on which the fraud penalty set forth in section 6663 is imposed.

(b) *Amount of penalty*—(1) *In general.* The amount of the accuracy-related penalty is 20 percent of the portion of an underpayment of tax required to be shown on a return that is attributable to any of the types of misconduct listed in paragraphs (a)(1) through (a)(3) of this section, except as provided in paragraph (b)(2) of this section.

(2) *Increase in penalty for gross valuation misstatement.* In the case of a gross valuation misstatement, as defined in section 6662(h)(2) and §1.6662–5(e)(2), the amount of the accuracy-related penalty is 40 percent of the portion of an underpayment of tax required to be shown on a return that is attributable to the gross valuation misstatement, provided the applicable dollar limitation set forth in section 6662(e)(2) is satisfied.

(c) *No stacking of accuracy-related penalty components.* The maximum accuracy-related penalty imposed on a portion of an underpayment may not exceed 20 percent of such portion (40 percent of the portion attributable to a gross valuation misstatement), notwithstanding that such portion is attributable to more than one of the types of misconduct described in paragraph (a) of this section. For example, if a portion of an underpayment of tax required to be shown on a return is attributable both to negligence and a substantial understatement of income tax, the maximum accuracy-related penalty is 20 percent of such portion. Similarly, the maximum accuracy-related penalty imposed on any portion of an underpayment that is attributable both to negligence and a gross valuation misstatement is 40 percent of such portion.

(d) *Effective dates*—(1) *Returns due before January 1, 1994.* Section 1.6662–3(c) and §§1.6662–4 (e) and (f) (relating to methods of making adequate disclosure) (as contained in 26 CFR part 1 revised April 1, 1995) apply to returns the due date of which (determined without regard to extensions of time for filing) is after December 31, 1991, but before January 1, 1994. Except as provided in the preceding sentence and in paragraphs (d)(2), (3), and (4) of this section, §§1.6662–1 through 1.6662–5 apply to returns the due date of which (determined without regard to extensions of time for filing) is after December 31, 1989, but before January 1, 1994. To the extent the provisions of these regulations were not reflected in the statute as amended by the Omnibus Budget Reconciliation Act of 1989 (OBRA 1989), in Notice 90–20, 1990–1 C.B. 328, or in rules and regulations in effect prior to March 4, 1991 (to the extent not inconsistent with the statute as amended by OBRA 1989), these regulations will not be adversely applied to a taxpayer who took a position based upon such prior rules on a return filed before January 1, 1992.

(2) *Returns due after December 31, 1993.* Except as provided in paragraphs (d)(3) and (4) of this section and the last sentence of this paragraph (d)(2), the provisions of §§1.6662–1 through 1.6662–4 and §1.6662–7 (as revised to reflect the changes made to the accuracy-related penalty by the Omnibus Budget Reconciliation Act of 1993) and of §1.6662–5 apply to returns the due date of which (determined without regard to extensions of time for filing) is after December 31, 1993. These changes include raising the disclosure standard for the penalties for disregarding rules or regulations and for a substantial understatement of income tax from not frivolous to reasonable basis, eliminating the disclosure exception for the negligence penalty, and providing guidance on the meaning of reasonable basis. The Omnibus Budget Reconciliation Act of 1993 changes relating to the penalties for negligence or disregard of rules or regulations will not apply to returns (including qualified amended returns) that are filed on or before March 14, 1994, but the provisions of §§1.6662–1 through 1.6662–3 (as contained in 26 CFR part 1 revised April 1, 1995) relating to those penalties will apply to such returns.

(3) *Special rules for tax shelter items.* Sections 1.6662–4(g)(1) and 1.6662–4(g)(4) apply to returns the due date of which (determined without regard to extensions of time for filing) is after September 1, 1995. Except as provided in the last sentence of this paragraph (d)(3), §§ 1.6662–4(g)(1) and 1.6662–4(g)(4) (as contained in 26 CFR part 1 revised April 1, 1995) apply to returns the due date of which (determined without regard to extensions of time for filing) is on or before September 1, 1995 and after December 31, 1989. For transactions occurring after December 8, 1994, §§ 1.6662–4(g)(1) and 1.6662–4(g)(2) (as contained in 26 CFR part 1 revised April 1, 1995) are applied taking into account the changes made to section 6662(d)(2)(C) (relating to the substantial understatement penalty for tax shelter items of corporations) by section 744 of Title VII of the Uruguay Round Agreements Act, Pub. L. 103–465 (108 Stat. 4809).

(4) *Special rules for reasonable basis.* Section 1.6662–3(b)(3) applies to returns filed on or after December 2, 1998.

[T.D. 8381, 56 FR 67498, Dec. 31, 1991, as amended by T.D. 8617, 60 FR 45664, Sept. 1, 1995; T.D. 8790, 63 FR 66434, Dec. 2, 1998]

§ 1.6662–3 Negligence or disregard of rules or regulations.

(a) *In general.* If any portion of an underpayment, as defined in section 6664(a) and § 1.6664–2, of any income tax imposed under subtitle A of the Code that is required to be shown on a return is attributable to negligence or disregard of rules or regulations, there is added to the tax an amount equal to 20 percent of such portion. The penalty for disregarding rules or regulations does not apply, however, if the requirements of § 1.6662–3(c)(1) are satisfied and the position in question is adequately disclosed as provided in § 1.6662–3(c)(2), or to the extent that the reasonable cause and good faith exception to this penalty set forth in § 1.6664–4 applies. In addition, if a position with respect to an item is contrary to a revenue ruling or notice (other than a notice of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin, this penalty does not apply if the position has a realistic possibility of being sustained on its merits. See § 1.6694–2(b) of the preparer penalty regulations for a description of the realistic possibility standard.

(b) *Definitions and rules*—(1) *Negligence.* The term *negligence* includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return. ‘‘Negligence’’ also includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly. A return position that has a reasonable basis as defined in paragraph (b)(3) of this section is not attributable to negligence. Negligence is strongly indicated where—

(i) A taxpayer fails to include on an income tax return an amount of income shown on an information return, as defined in section 6724(d)(1);

(ii) A taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be ‘‘too good to be true’’ under the circumstances;

(iii) A partner fails to comply with the requirements of section 6222, which requires that a partner treat partnership items on its return in a manner that is consistent with the treatment of such items on the partnership return (or notify the Secretary of the inconsistency); or

(iv) A shareholder fails to comply with the requirements of section 6242, which requires that an S corporation shareholder treat subchapter S items on its return in a manner that is consistent with the treatment of such items on the corporation’s return (or notify the Secretary of the inconsistency).

(2) *Disregard of rules or regulations.* The term *disregard* includes any careless, reckless or intentional disregard of rules or regulations. The term ‘‘rules or regulations’’ includes the provisions of the Internal Revenue Code, temporary or final Treasury regulations issued under the Code, and revenue rulings or notices (other than notices of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin. A disregard of rules or regulations is

''careless'' if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to the rule or regulation. A disregard is ''reckless'' if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe. A disregard is ''intentional'' if the taxpayer knows of the rule or regulation that is disregarded. Nevertheless, a taxpayer who takes a position contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits.

(3) *Reasonable basis.* Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in §1.6662–4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in §1.6662–4(d)(2). (See §1.6662–4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.) In addition, the reasonable cause and good faith exception in §1.6664–4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard.

(c) *Exception for adequate disclosure*—(1) *In general.* No penalty under section 6662(b)(1) may be imposed on any portion of an underpayment that is attributable to a position contrary to a rule or regulation if the position is disclosed in accordance with the rules of paragraph (c)(2) of this section and, in case of a position contrary to a regulation, the position represents a good faith challenge to the validity of the regulation. This disclosure exception does not apply, however, in the case of a position that does not have a reasonable basis or where the taxpayer fails to keep adequate books and records or to substantiate items properly.

(2) *Method of disclosure.* Disclosure is adequate for purposes of the penalty for disregarding rules or regulations if made in accordance with the provisions of §§1.6662–4(f)(1), (3), (4), and (5), which permit disclosure on a properly completed and filed Form 8275 or 8275–R, as appropriate. In addition, the statutory or regulatory provision or ruling in question must be adequately identified on the Form 8275 or 8275–R, as appropriate. The provisions of §1.6662–4(f)(2), which permit disclosure in accordance with an annual revenue procedure for purposes of the substantial understatement penalty, do not apply for purposes of this section.

(d) *Special rules in the case of carrybacks and carryovers*—(1) *In general.* The penalty for negligence or disregard of rules or regulations applies to any portion of an underpayment for a year to which a loss, deduction or credit is carried, which portion is attributable to negligence or disregard of rules or regulations in the year in which the carryback or carryover of the loss, deduction or credit arises (the ''loss or credit year'').

(2) *Transition rule for carrybacks to pre-1990 years.* A 20 percent penalty under section 6662(b)(1) is imposed on any portion of an underpayment for a carryback year, the return for which is due (without regard to extensions) before January 1, 1990, if—

(i) That portion is attributable to negligence or disregard of rules or regulations in a loss or credit year; and

(ii) The return for the loss or credit year is due (without regard to extensions) after December 31, 1989.

(3) *Example.* The following example illustrates the provisions of paragraph (d) of this section. This example does not take into account the reasonable cause exception under §1.6664–4.

Example. Corporation M is a C corporation. In 1990, M had a loss of $200,000 before taking into account a deduction of $350,000 that M claimed as an expense in careless disregard of the capitalization requirements of section

263 of the Code. M failed to make adequate disclosure of the item for 1990. M reported a $550,000 loss for 1990 and carried back the loss to 1987 and 1988. M had reported taxable income of $400,000 for 1987 and $200,000 for 1988, before application of the carryback. The carryback eliminated all of M's taxable income for 1987 and $150,000 of taxable income for 1988. After disallowance of the $350,000 expense deduction and allowance of a $35,000 depreciation deduction with respect to the capitalized amount, the correct loss for 1990 was determined to be $235,000. Because there is no underpayment for 1990, the penalty for negligence or disregard of rules or regulations does not apply for 1990. However, as a result of the 1990 adjustments, the loss carried back to 1987 is reduced from $550,000 to $235,000. After application of the $235,000 carryback, M has taxable income of $165,000 for 1987 and $200,000 for 1988. This adjustment results in underpayments for 1987 and 1988 that are attributable to the disregard of rules or regulations on the 1990 return. Therefore, the 20 percent penalty rate applies to the 1987 and 1988 underpayments attributable to the disallowed carryback.

[T.D. 8381, 56 FR 67498, Dec. 31, 1991, as amended by T.D. 8617, 60 FR 45664, Sept. 1, 1995; T.D. 8790, 63 FR 66434, Dec. 2, 1998]

§ 1.6662–4 Substantial understatement of income tax.

(a) *In general.* If any portion of an underpayment, as defined in section 6664(a) and § 1.6664–2, of any income tax imposed under subtitle A of the Code that is required to be shown on a return is attributable to a substantial understatement of such income tax, there is added to the tax an amount equal to 20 percent of such portion. Except in the case of any item attributable to a tax shelter (as defined in paragraph (g)(2) of this section), an understatement is reduced by the portion of the understatement that is attributable to the tax treatment of an item for which there is substantial authority, or with respect to which there is adequate disclosure. General rules for determining the amount of an understatement are set forth in paragraph (b) of this section and more specific rules in the case of carrybacks and carryovers are set forth in paragraph (c) of this section. The rules for determining when substantial authority exists are set forth in § 1.6662–4(d). The rules for determining when there is adequate disclosure are set forth in § 1.6662–4 (e) and (f). This penalty does not apply to the extent that the reasonable cause and good faith exception to this penalty set forth in § 1.6664–4 applies.

(b) *Definitions and computational rules*—(1) *Substantial.* An understatement (as defined in paragraph (b)(2) of this section) is ''substantial'' if it exceeds the greater of—

(i) 10 percent of the tax required to be shown on the return for the taxable year (as defined in paragraph (b)(3) of this section); or

(ii) $5,000 ($10,000 in the case of a corporation other than an S corporation (as defined in section 1361(a)(1)) or a personal holding company (as defined in section 542)).

(2) *Understatement.* Except as provided in paragraph (c)(2) of this section (relating to special rules for carrybacks), the term ''understatement'' means the excess of—

(i) The amount of the tax required to be shown on the return for the taxable year (as defined in paragraph (b)(3) of this section), over

(ii) The amount of the tax imposed which is shown on the return for the taxable year (as defined in paragraph (b)(4) of this section), reduced by any rebate (as defined in paragraph (b)(5) of this section).

The definition of understatement also may be expressed as—

$$\text{Understatement} = X - (Y - Z)$$

where *X* = the amount of the tax required to be shown on the return; *Y* = the amount of the tax imposed which is shown on the return; and *Z* = any rebate.

(3) *Amount of the tax required to be shown on the return.* The ''amount of the tax required to be shown on the return'' for the taxable year has the same meaning as the ''amount of income tax imposed'' as defined in § 1.6664–2(b).

(4) *Amount of the tax imposed which is shown on the return.* The ''amount of the tax imposed which is shown on the return'' for the taxable year has the same meaning as the ''amount shown as the tax by the taxpayer on his return,'' as defined in § 1.6664–2(c), except that—

(i) There is no reduction for the excess of the amount described in § 1.6664–2(c)(1)(i) over the amount described in § 1.6664–2(c)(1)(ii), and

(ii) The tax liability shown by the taxpayer on his return is recomputed as if the following items had been reported properly:

(A) Items (other than tax shelter items as defined in §1.6662–4(g)(3)) for which there is substantial authority for the treatment claimed (as provided in §1.6662–4(d)).

(B) Items (other than tax shelter items as defined in §1.6662–4(g)(3)) with respect to which there is adequate disclosure (as provided in §1.6662–4 (e) and (f)).

(C) Tax shelter items (as defined in §1.6662–4(g)(3)) for which there is substantial authority for the treatment claimed (as provided in §1.6662–4(d)), and with respect to which the taxpayer reasonably believed that the tax treatment of the items was more likely than not the proper tax treatment (as provided in §1.6662–4(g)(4)).

(5) *Rebate.* The term *rebate* has the meaning set forth in §1.6664–2(e), except that—

(i) ‘‘Amounts not so shown previously assessed (or collected without assessment)’’ includes only amounts not so shown previously assessed (or collected without assessment) as a deficiency, and

(ii) The amount of the rebate is determined as if any items to which the rebate is attributable that are described in paragraph (b)(4) of this section had received the proper tax treatment.

(6) *Examples.* The following examples illustrate the provisions of paragraph (b) of this section. These examples do not take into account the reasonable cause exception under §1.6664–4:

Example 1. In 1990, Individual A, a calendar year taxpayer, files a return for 1989, which shows taxable income of $18,200 and tax liability of $2,734. Subsequent adjustments on audit for 1989 increase taxable income to $51,500 and tax liability to $12,339. There was substantial authority for an item resulting in an adjustment that increases taxable income by $5,300. The item is not a tax shelter item. In computing the amount of the understatement, the amount of tax shown on A’s return is determined as if the item for which there was substantial authority had been given the proper tax treatment. Thus, the amount of tax that is treated as shown on A’s return is $4,176, i.e., the tax on $23,500 ($18,200 taxable income actually shown on A’s return plus $5,300, the amount of the adjustment for which there was substantial authority). The amount of the understatement is $8,163, i.e., $12,339 (the amount of tax required to be shown) less $4,176 (the amount of tax treated as shown on A’s return after adjustment for the item for which there was substantial authority). Because the $8,163 understatement exceeds the greater of 10 percent of the tax required to be shown on the return for the year, i.e., $1,234 ($12,339 × .10) or $5,000, A has a substantial understatement of income tax for the year.

Example 2. Individual B, a calendar year taxpayer, files a return for 1990 that fails to include income reported on an information return, Form 1099, that was furnished to B. The Service detects this omission through its document matching program and assesses $3,000 in unreported tax liability. B’s return is later examined and as a result of the examination the Service makes an adjustment to B’s return of $4,000 in additional tax liability. Assuming there was neither substantial authority nor adequate disclosure with respect to the items adjusted, there is an understatement of $7,000 with respect to B’s return. There is also an underpayment of $7,000. (See §1.6664–2.) The amount of the understatement is not reduced by imposition of a negligence penalty on the $3,000 portion of the underpayment that is attributable to the unreported income. However, if the Services does impose the negligence penalty on this $3,000 portion, the Service may only impose the substantial understatement penalty on the remaining $4,000 portion of the underpayment. (See §1.6662–2(c), which prohibits stacking of accuracy-related penalty components.)

(c) *Special rules in the case of carrybacks and carryovers*—(1) *In general.* The penalty for a substantial understatement of income tax applies to any portion of an underpayment for a year to which a loss, deduction or credit is carried that is attributable to a ‘‘tainted item’’ for the year in which the carryback or carryover of the loss, deduction or credit arises (the ‘‘loss or credit year’’). The determination of whether an understatement is substantial for a carryback or carryover year is made with respect to the return of the carryback or carryover year. ‘‘Tainted items’’ are taken into account with items arising in a carryback or carryover year to determine whether the understatement is substantial for that year.

(2) *Understatements for carryback years not reduced by amount of carrybacks.* The amount of an understatement for a

carryback year is not reduced on account of a carryback of a loss, deduction or credit to that year.

(3) *Tainted items defined*—(i) *In general.* Except in the case of a tax shelter item (as defined in paragraph (g)(3) of this section), a ''tainted item'' is any item for which there is neither substantial authority nor adequate disclosure with respect to the loss or credit year.

(ii) *Tax shelter items.* In the case of a tax shelter item (as defined in paragraph (g)(3) of this section), a ''tainted item'' is any item for which there is not, with respect to the loss or credit year, both substantial authority and a reasonable belief that the tax treatment is more likely than not the proper treatment.

(4) *Transition rule for carrybacks to pre-1990 years.* A 20 percent penalty under section 6662(b)(2) is imposed on any portion of an underpayment for a carryback year, the return for which is due (without regard to extensions) before January 1, 1990, if—

(i) That portion is attributable to one or more ''tainted items'' (as defined in paragraph (c)(3) of this section) arising in a loss or credit year; and

(ii) The return for the loss or credit year is due (without regard to extensions) after December 31, 1989.

The preceding sentence applies only if the understatement in the carryback year is substantial. See *Example 2* in paragraph (c)(5) of this section.

(5) *Examples.* The following examples illustrate the rules of paragraph (c) of this section regarding carrybacks and carryovers. These examples do not take into account the reasonable cause exception under § 1.6664–4.

Example 1. (i) Corporation N, a calendar year taxpayer, is a C corporation. N was formed on January 1, 1987, and timely filed the following income tax returns:

[In dollars]

	Tax Year			
	1987	1988	1989	1990 (before NOLCO)
Taxable income	30,000	100,000	(300,000)	50,000
Tax liability	4,575	22,250	....	7,500

(ii) During 1990, N files Form 1139, Corporation Application for Tentative Refund, to carry back the NOL generated in 1989 (NOLCB). N received refunds of $4,575 for 1987 and $22,250 for 1988.

(iii) For tax year 1990, N carries over $50,000 of the 1989 loss to offset $50,000 of income earned in 1990 and reduce taxable income to zero. N would have reported $7,500 of tax liability for 1990 if it were not for use of the net operating loss carryover (NOLCO). N assumes there is a remaining NOLCO of $120,000 to be applied for tax year 1991.

(iv) In June 1991, the Service completes its examination of the 1989 loss year return and makes the following adjustment:

Taxable income per 1989 return	($300,000)
Adjustment: Unreported income	310,000
Corrected taxable income	$10,000
Corrected tax liability	$1,500

(v) There was not substantial authority for N's treatment of the items comprising the 1989 adjustment and N did not make adequate disclosure.

(vi) As a result of the adjustment to the 1989 return, N had an understatement of $4,575 for tax year 1987; an understatement of $22,250 for tax year 1988; an understatement of $1,500 for tax year 1989; and an understatement of $7,500 for tax year 1990. Only the $22,250 understatement for 1988 is a substantial understatement, i.e., it exceeds the greater of (a) $2,225 (10 percent of the tax required to be shown on the return for the taxable year (.10 X $22,250)) or (b) $10,000. The underpayment for 1988 is subject to a penalty rate of 20 percent.

Example 2. The facts are the same as in *Example 1,* except that in addition to examining the 1989 return, the Service also examines the 1987 return and makes an adjustment that results in an understatement. (This adjustment is unrelated to the adjustment on the 1987 return for the disallowance of the NOLCB from 1989.) If the understatement resulting from the adjustment to the 1987 return, when combined with the understatement resulting from the disallowance of the NOLCB from 1989, exceeds the greater of (a) 10 percent of the tax required to be shown on the return for 1987 or (b) $10,000, the underpayment for 1987 will also be subject to a substantial understatement penalty. The portion of the underpayment attributable to the adjustment unrelated to the disallowance of the NOLCB will be subject to a penalty rate of 25 percent under former section 6661. The portion of the underpayment attributable to the disallowance of the NOLCB will be subject to a penalty rate of 20 percent under section 6662.

Example 3. Individual P, a calendar year single taxpayer, files his 1990 return reporting taxable income of $10,000 and a tax liability of $1,504. An examination of the 1990 return results in an adjustment for unreported income of $25,000. There was not substantial authority for P's failure to report the income, and P did not make adequate disclosure with respect to the unreported income. P's correct tax liability for 1990 is determined to be $7,279, resulting in an understatement of $5,775 (the difference between the amount of tax required to be shown on the return ($7,279) and the tax shown on the return ($1,504)). Because the understatement exceeds the greater of (a) $728 (10 percent of the tax required to be shown on the return (.10 × $7,279)) or (b) $5,000, the understatement is substantial. Subsequently, P files his 1993 return showing a net operating loss. The loss is carried back to his 1990 return, reducing his taxable income for 1990 to zero. However, the amount of the understatement for 1990 is not reduced on account of the NOLCB to that year. P is subject to the 20 percent penalty rate under section 6662 on the underpayment attributable to the substantial understatement for 1990, notwithstanding that the tax required to be shown on the return for that year, after application of the NOLCB, is zero.

(d) *Substantial authority*—(1) *Effect of having substantial authority.* If there is substantial authority for the tax treatment of an item, the item is treated as if it were shown properly on the return for the taxable year in computing the amount of the tax shown on the return. Thus, for purposes of section 6662(d), the tax attributable to the item is not included in the understatement for that year. (For special rules relating to tax shelter items see §1.6662–4(g).)

(2) *Substantial authority standard.* The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard as defined in §1.6662–3(b)(3). The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.

(3) *Determination of whether substantial authority is present* —(i) *Evaluation of authorities.* There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatement is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed by paragraph (d)(3)(ii) of this section. There may be substantial authority for more than one position with respect to the same item. Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment.

(ii) *Nature of analysis.* The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted, such as a private letter ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions. The type of document also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue. An older private letter ruling, technical advice memorandum, general counsel memorandum or action on decision generally must be accorded less weight than a more recent one. Any document described in the preceding sentence that is more than 10 years old generally is accorded very little weight. However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document. There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

(iii) *Types of authority.* Except in cases described in paragraph (d)(3)(iv) of this section concerning written determinations, only the following are authority for purposes of determining whether there is substantial authority for the tax treatment of an item: Applicable provisions of the Internal Revenue Code and other statutory provisions; proposed, temporary and final regulations construing such statues; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers; General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book); private letter rulings and technical advice memoranda issued after October 31, 1976; actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin); Internal Revenue Service information or press releases; and notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin. Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority. The authorities underlying such expressions of opinion where applicable to the facts of a particular case, however, may give rise to substantial authority for the tax treatment of an item. Notwithstanding the preceding list of authorities, an authority does not continue to be an authority to the extent it is overruled or modified, implicitly or explicitly, by a body with the power to overrule or modify the earlier authority. In the case of court decisions, for example, a district court opinion on an issue is not an authority if overruled or reversed by the United States Court of Appeals for such district. However, a Tax Court opinion is not considered to be overruled or modified by a court of appeals to which a taxpayer does not have a right of appeal, unless the Tax Court adopts the holding of the court of appeals. Similarly, a private letter ruling is not authority if revoked or if inconsistent with a subsequent proposed regulation, revenue ruling or other administrative pronouncement published in the Internal Revenue Bulletin.

(iv) *Special rules*—(A) *Written determinations.* There is substantial authority for the tax treatment of an item by a taxpayer if the treatment is supported by the conclusion of a ruling or a determination letter (as defined in § 301.6110–2 (d) and (e)) issued to the taxpayer, by the conclusion of a technical advice memorandum in which the taxpayer is named, or by an affirmative statement in a revenue agent's report with respect to a prior taxable year of the taxpayer (''written determinations''). The preceding sentence does not apply, however, if—

(*1*) There was a misstatement or omission of a material fact or the facts that subsequently develop are materially different from the facts on which the written determination was based, or

(*2*) The written determination was modified or revoked after the date of issuance by—

(*i*) A notice to the taxpayer to whom the written determination was issued,

(*ii*) The enactment of legislation or ratification of a tax treaty,

(*iii*) A decision of the United States Supreme Court,

(*iv*) The issuance of temporary or final regulations, or

(*v*) The issuance of a revenue ruling, revenue procedure, or other statement published in the Internal Revenue Bulletin.

Except in the case of a written determination that is modified or revoked on account of §1.6662–4(d)(3)(iv)(A)(*1*), a written determination that is modified or revoked as described in §1.6662–4(d)(3)(iv)(A)(*2*) ceases to be authority on the date, and to the extent, it is so modified or revoked. See section 6404(f) for rules which require the Secretary to abate a penalty that is attributable to erroneous written advice furnished to a taxpayer by an officer or employee of the Internal Revenue Service.

(B) *Taxpayer's jurisdiction.* The applicability of court cases to the taxpayer by reason of the taxpayer's residence in a particular jurisdiction is not taken into account in determining whether there is substantial authority for the tax treatment of an item. Notwithstanding the preceding sentence, there is substantial authority for the tax treatment of an item if the treatment is supported by controlling precedent of a United States Court of Appeals to which the taxpayer has a right of appeal with respect to the item.

(C) *When substantial authority determined.* There is substantial authority for the tax treatment of an item if there is substantial authority at the time the return containing the item is filed or there was substantial authority on the last day of the taxable year to which the return relates.

(v) *Substantial authority for tax returns due before January 1, 1990.* There is substantial authority for the tax treatment of an item on a return that is due (without regard to extensions) after December 31, 1982 and before January 1, 1990, if there is substantial authority for such treatment under either the provisions of paragraph (d)(3)(iii) of this section (which set forth an expanded list of authorities) or of §1.6661–3(b)(2) (which set forth a narrower list of authorities). Under either list of authorities, authorities both for and against the position must be taken into account.

(e) *Disclosure of certain information*—(1) *Effect of adequate disclosure.* Items for which there is adequate disclosure as provided in this paragraph (e) and in paragraph (f) of this section are treated as if such items were shown properly on the return for the taxable year in computing the amount of the tax shown on the return. Thus, for purposes of section 6662(d), the tax attributable to such items is not included in the understatement for that year.

(2) *Circumstances where disclosure will not have an effect.* The rules of paragraph (e)(1) of this section do not apply where the item or position on the return—

(i) Does not have a reasonable basis (as defined in §1.6662–3(b)(3));

(ii) Is attributable to a tax shelter (as defined in section 6662(d)(2)(C)(iii) and paragraph (g)(2) of this section); or

(iii) Is not properly substantiated, or the taxpayer failed to keep adequate books and records with respect to the item or position.

(3) *Restriction for corporations.* For purposes of paragraph (e)(2)(i) of this section, a corporation will not be treated as having a reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction entered into after August 5, 1997, if the treatment does not clearly reflect the income of the corporation.

(f) *Method of making adequate disclosure*—(1) *Disclosure statement.* Disclosure is adequate with respect to an item (or group of similar items, such as amounts paid or incurred for supplies by a taxpayer engaged in business) or a position on a return if the disclosure is made on a properly completed form attached to the return or to a qualified amended return (as defined in §1.6664–2(c)(3)) for the taxable year. In the case of an item or position other than one that is contrary to a regulation, disclosure must be made on Form 8275 (Disclosure Statement); in the case of a position contrary to a regulation, disclosure must be made on Form 8275–R (Regulation Disclosure Statement).

(2) *Disclosure on return.* The Commissioner may by annual revenue procedure (or otherwise) prescribe the circumstances under which disclosure of information on a return (or qualified amended return) in accordance with applicable forms and instructions is adequate. If the revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275–R, as appropriate, attached to the return for the year or to a qualified amended return.

(3) *Recurring item.* Disclosure with respect to a recurring item, such as the

basis of recovery property, must be made for each taxable year in which the item is taken into account.

(4) *Carrybacks and carryovers.* Disclosure is adequate with respect to an item which is included in any loss, deduction or credit that is carried to another year only if made in connection with the return (or qualified amended return) for the taxable year in which the carryback or carryover arises (the ''loss or credit year''). Disclosure is not also required in connection with the return for the taxable year in which the carryback or carryover is taken into account.

(5) *Pass-through entities.* Disclosure in the case of items attributable to a pass-through entity (pass-through items) is made with respect to the return of the entity, except as provided in this paragraph (f)(5). Thus, disclosure in the case of pass-through items must be made on a Form 8275 or 8275–R, as appropriate, attached to the return (or qualified amended return) of the entity, or on the entity's return in accordance with the revenue procedure described in paragraph (f)(2) of this section, if applicable. A taxpayer (i.e., partner, shareholder, beneficiary, or holder of a residual interest in a REMIC) also may make adequate disclosure with respect to a pass-through item, however, if the taxpayer files a properly completed Form 8275 or 8275–R, as appropriate, in duplicate, one copy attached to the taxpayer's return (or qualified amended return) and the other copy filed with the Internal Revenue Service Center with which the return of the entity is required to be filed. Each Form 8275 or 8275–R, as appropriate, filed by the taxpayer should relate to the pass-through items of only one entity. For purposes of this paragraph (f)(5), a pass-through entity is a partnership, S corporation (as defined in section 1361(a)(1)), estate, trust, regulated investment company (as defined in section 851(a)), real estate investment trust (as defined in section 856(a)), or real estate mortgage investment conduit (''REMIC'') (as defined in section 860D(a)).

(g) *Items relating to tax shelters*—(1) *In general*—(i) *Noncorporate taxpayers.* Tax shelter items (as defined in paragraph (g)(3) of this section) of a taxpayer other than a corporation are treated for purposes of this section as if such items were shown properly on the return for a taxable year in computing the amount of tax shown on the return, and thus the tax attributable to such items is not included in the understatement for the year, if—

(A) There is substantial authority (as provided in paragraph (d) of this section) for the tax treatment of that item; and

(B) The taxpayer reasonably believed at the time the return was filed that the tax treatment of that item was more likely than not the proper treatment.

(ii) *Corporate taxpayers*—(A) *In general.* Except as provided in paragraph (g)(1)(ii)(B) of this section, all tax shelter items (as defined in paragraph (g)(3) of this section) of a corporation are taken into account in computing the amount of any understatement.

(B) *Special rule for transactions occurring prior to December 9, 1994.* The tax shelter items of a corporation arising in connection with transactions occurring prior to December 9, 1994 are treated for purposes of this section as if such items were shown properly on the return if the requirements of paragraph (g)(1)(i) are satisfied with respect to such items.

(iii) *Disclosure irrelevant.* Disclosure made with respect to a tax shelter item of either a corporate or noncorporate taxpayer does not affect the amount of an understatement.

(iv) *Cross-reference.* See § 1.6664–4(e) for certain rules regarding the availability of the reasonable cause and good faith exception to the substantial understatement penalty with respect to tax shelter items of corporations.

(2) *Tax shelter*—(i) *In general.* For purposes of section 6662(d), the term ''tax shelter'' means—

(A) A partnership or other entity (such as a corporation or trust),

(B) An investment plan or arrangement, or

(C) Any other plan or arrangement,

if the principal purpose of the entity, plan or arrangement, based on objective evidence, is to avoid or evade Federal income tax. The principal purpose of an entity, plan or arrangement is to avoid or evade Federal income tax if that purpose exceeds any other purpose. Typical of tax shelters are transactions structured with little or no motive for the realization of economic gain, and transactions that utilize the mismatching of income and deductions, overvalued assets or assets with values subject to substantial uncertainty, certain nonrecourse financing, financing techniques that do not conform to standard commercial business practices, or the mischaracterization of the substance of the transaction. The existence of economic substance does not of itself establish that a transaction is not a tax shelter if the transaction includes other characteristics that indicate it is a tax shelter.

(ii) *Principal purpose.* The principal purpose of an entity, plan or arrangement is not to avoid or evade Federal income tax if the entity, plan or arrangement has as its purpose the claiming of exclusions from income, accelerated deductions or other tax benefits in a manner consistent with the statute and Congressional purpose. For example, an entity, plan or arrangement does not have as its principal purpose the avoidance or evasion of Federal income tax solely as a result of the following uses of tax benefits provided by the Internal Revenue Code: the purchasing or holding of an obligation bearing interest that is excluded from gross income under section 103; taking an accelerated depreciation allowance under section 168; taking the percentage depletion allowance under section 613 or section 613A; deducting intangible drilling and development costs as expenses under section 263(c); establishing a qualified retirement plan under sections 401–409; claiming the possession tax credit under section 936; or claiming tax benefits available by reason of an election under 992 to be taxed as a domestic international sales corporation (''DISC''), under section 927(f)(1) to be taxed as a foreign sales corporation (''FSC''), or under section 1362 to be taxed as an S corporation.

(3) *Tax shelter item.* An item of income, gain, loss, deduction or credit is a ''tax shelter item'' if the item is directly or indirectly attributable to the principal purpose of a tax shelter to avoid or evade Federal income tax. Thus, if a partnership is established for the principal purpose of avoiding or evading Federal income tax by acquiring and overstating the basis of property for purposes of claiming accelerated depreciation, the depreciation with respect to the property is a tax shelter item. However, a deduction claimed in connection with a separate transaction carried on by the same partnership is not a tax shelter item if the transaction does not constitute a plan or arrangement the principal purpose of which is to avoid or evade tax.

(4) *Reasonable belief*—(i) *In general.* For purposes of section 6662(d) and paragraph (g)(1)(i)(B) of this section (pertaining to tax shelter items of noncorporate taxpayers), a taxpayer is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled)—

(A) The taxpayer analyzes the pertinent facts and authorities in the manner described in paragraph (d)(3)(ii) of this section, and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service; or

(B) The taxpayer reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in paragraph (d)(3)(ii) of this section and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service.

(ii) *Facts and circumstances; reliance on professional tax advisor.* All facts and circumstances must be taken into account in determining whether a taxpayer satisfies the requirements of paragraph (g)(4)(i) of this section. However, in no event will a taxpayer be considered to have reasonably relied in good faith on the opinion of a professional tax advisor for purposes of paragraph (g)(4)(i)(B) of this section unless the requirements of § 1.6664–4(c)(1) are met. The fact that the requirements of § 1.6664–4(c)(1) are satisfied will not necessarily establish that the taxpayer reasonably relied on the opinion in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

(5) *Pass-through entities.* In the case of tax shelter items attributable to a pass-through entity, the actions described in paragraphs (g)(4)(i)(A) and (B) of this section, if taken by the entity, are deemed to have been taken by the taxpayer and are considered in determining whether the taxpayer reasonably believed that the tax treatment of an item was more likely than not the proper tax treatment.

[T.D. 8381, 56 FR 67499, Dec. 31, 1991; T.D. 8381, 57 FR 6165, Feb. 20, 1992, as amended by T.D. 8617, 60 FR 45665, Sept. 1, 1995; T.D. 8790, 63 FR 66435, Dec. 2, 1998]

§ 1.6662–5 Substantial and gross valuation misstatements under chapter 1.

(a) *In general.* If any portion of an underpayment, as defined in section 6664(a) and § 1.6664–2, of any income tax imposed under chapter 1 of subtitle A of the Code that is required to be shown on a return is attributable to a substantial valuation misstatement under chapter 1 (‘‘substantial valuation misstatement’’), there is added to the tax an amount equal to 20 percent of such portion. Section 6662(h) increases the penalty to 40 percent in the case of a gross valuation misstatement under chapter 1 (‘‘gross valuation misstatement’’). No penalty under section 6662(b)(3) is imposed, however, on a portion of an underpayment that is attributable to a substantial or gross valuation misstatement unless the aggregate of all portions of the underpayment attributable to substantial or gross valuation misstatements exceeds the applicable dollar limitation ($5,000 or $10,000), as provided in section 6662(e)(2) and paragraphs (b) and (f)(2) of this section. This penalty also does not apply to the extent that the reasonable cause and good faith exception to this penalty set forth in § 1.6664–4 applies. There is no disclosure exception to this penalty.

(b) *Dollar limitation.* No penalty may be imposed under section 6662(b)(3) for a taxable year unless the portion of the underpayment for that year that is attributable to substantial or gross valuation misstatements exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation (as defined in section 1361(a)(1)) or a personal holding company (as defined in section 542)). This limitation is applied separately to each taxable year for which there is a substantial or gross valuation misstatement.

(c) *Special rules in the case of carrybacks and carryovers*—(1) *In general.* The penalty for a substantial or gross valuation misstatement applies to any portion of an underpayment for a year to which a loss, deduction or credit is carried that is attributable to a substantial or gross valuation misstatement for the year in which the carryback or carryover of the loss, deduction or credit arises (the ‘‘loss or credit year’’), provided that the applicable dollar limitation set forth in section 6662(e)(2) is satisfied in the carryback or carryover year.

(2) *Transition rule for carrybacks to pre-1990 years.* The penalty under section 6662(b)(3) is imposed on any portion of an underpayment for a carryback year, the return for which is due (without regard to extensions) before January 1, 1990, if—

(i) That portion is attributable to a substantial or gross valuation misstatement for a loss or credit year; and

(ii) The return for the loss or credit year is due (without regard to extensions) after December 31, 1989.

The preceding sentence applies only if the underpayment for the carryback year exceeds the applicable dollar limitation ($5,000, or $10,000 for most corporations). See *Example 3* in paragraph (d) of this section.

(d) *Examples.* The following examples illustrate the provisions of paragraphs (b) and (c) of this section. These examples do not take into account the reasonable cause exception under § 1.6664–4.

Example 1. Corporation Q is a C corporation. In 1990, the first year of its existence, Q had taxable income of $200,000 without considering depreciation of a particular asset. On its calendar year 1990 return, Q overstated its basis in this asset by an amount that caused a substantial valuation misstatement. The overstated basis resulted in depreciation claimed of $350,000, which was $250,000 more than the $100,000 allowable. Thus, on its 1990 return, Q showed a loss of $150,000. In 1991, Q had taxable income of $450,000 before application of the loss carryover, and Q claimed a carryover loss deduction under section 172 of $150,000, resulting in taxable income of $300,000 for 1991. Upon audit of the 1990 return, the basis of the asset was corrected, resulting in an adjustment of $250,000. For 1990, the underpayment resulting from the $100,000 taxable income (−$150,000+$250,000) is attributable to the valuation misstatement. Assuming the underpayment resulting from the $100,000 taxable income exceeds the $10,000 limitation, the penalty will be imposed in 1990. For 1991, the elimination of the loss carryover results in additional taxable income of $150,000. The underpayment for 1991 resulting from that adjustment is also attributable to the substantial valuation misstatement on the 1990 return. Assuming the underpayment resulting from the $150,000 additional taxable income for 1991 exceeds the $10,000 limitation, the substantial valuation misstatement penalty also will be imposed for that year.

Example 2. (i) Corporation T is a C corporation. In 1990, the first year of its existence, T had a loss of $3,000,000 without considering depreciation of its major asset. On its calendar year 1990 return, T overstated its basis in this asset in an amount that caused a substantial valuation misstatement. This overstatement resulted in depreciation claimed of $3,500,000, which was $2,500,000 more than the $1,000,000 allowable. Thus, on its 1990 return, T showed a loss of $6,500,000. In 1991, T had taxable income of $4,500,000 before application of the carryover loss, but claimed a carryover loss deduction under section 172 in the amount of $4,500,000, resulting in taxable income of zero for that year and leaving a $2,000,000 carryover available. Upon audit of the 1990 return, the basis of the asset was corrected, resulting in an adjustment of $2,500,000.

(ii) For 1990, the underpayment is still zero (−$6,500,000+$2,500,000=−$4,000,000). Thus, the penalty does not apply in 1990. The loss for 1990 is reduced to $4,000,000.

(iii) For 1991, there is additional taxable income of $500,000 as a result of the reduction of the carryover loss ($4,500,000 reported income before carryover loss minus corrected carryover loss of $4,000,000=$500,000). The underpayment for 1991 resulting from reduction of the carryover loss is attributable to the valuation misstatement on the 1990 return. Assuming the underpayment resulting from the $500,000 additional taxable income exceeds the $10,000 limitation, the substantial valuation misstatement penalty will be imposed in 1991.

Example 3. Corporation V is a C corporation. In 1990, V had a loss of $100,000 without considering depreciation of a particular asset which it had fully depreciated in earlier years. V had a depreciable basis in the asset of zero, but on its 1990 calendar year return erroneously claimed a basis in the asset of $1,250,000 and depreciation of $250,000. V reported a $350,000 loss for the year 1990, and carried back the loss to the 1987 and 1988 tax years. V had reported taxable income of $300,000 in 1987 and $200,000 in 1988, before application of the carryback. The $350,000 carryback eliminated all taxable income for 1987, and $50,000 of the taxable income for 1988. After disallowance of the $250,000 depreciation deduction for 1990, V still had a loss of $100,000. Because there is no underpayment for 1990, no valuation misstatement penalty is imposed for 1990. However, as a result of the 1990 depreciation adjustment, the carryback to 1987 is reduced from $350,000 to $100,000. After absorption of the $100,000 carryback, V has taxable income of $200,000 for 1987. This adjustment results in an underpayment for 1987 that is attributable to the valuation misstatement on the 1990 return. The valuation misstatement for 1990 is a gross valuation misstatement because the correct adjusted basis of the depreciated asset was zero. (See paragraph (e)(2) of this section.) Therefore, the 40 percent penalty rate applies to the 1987 underpayment attributable to the 1990 misstatement, provided that this underpayment exceeds $10,000. The adjustment also results in the elimination of any loss carryback to 1988 resulting in an increase in taxable income for 1988 of $50,000. Assuming the underpayment resulting from this additional $50,000 of income exceeds $10,000, the gross valuation misstatement penalty is imposed on the underpayment for 1988.

(e) *Definitions*—(1) *Substantial valuation misstatement.* There is a substantial valuation misstatement if the value or adjusted basis of any property claimed on a return of tax imposed under chapter 1 is 200 percent or more of the correct amount.

(2) *Gross valuation misstatement.* There is a gross valuation misstatement if the value or adjusted basis of any property claimed on a return of tax imposed under chapter 1 is 400 percent or more of the correct amount.

(3) *Property.* For purposes of this section, the term ‘‘property’’ refers to both tangible and intangible property.

Tangible property includes property such as land, buildings, fixtures and inventory. Intangible property includes property such as goodwill, covenants not to compete, leaseholds, patents, contract rights, debts and choses in action.

(f) *Multiple valuation misstatements on a return*—(1) *Determination of whether valuation misstatements are substantial or gross.* The determination of whether there is a substantial or gross valuation misstatement on a return is made on a property-by-property basis. Assume, for example, that property A has a value of 60 but a taxpayer claims a value of 110, and that property B has a value of 40 but the taxpayer claims a value of 100. Because the claimed and correct values are compared on a property-by-property basis, there is a substantial valuation misstatement with respect to property B, but not with respect to property A, even though the claimed values (210) are 200 percent or more of the correct values (100) when compared on an aggregate basis.

(2) *Application of dollar limitation.* For purposes of applying the dollar limitation set forth in section 6662(e)(2), the determination of the portion of an underpayment that is attributable to a substantial or gross valuation misstatement is made by aggregating all portions of the underpayment attributable to substantial or gross valuation misstatements. Assume, for example, that the value claimed for property C on a return is 250 percent of the correct value, and that the value claimed for property D on the return is 400 percent of the correct value. Because the portions of an underpayment that are attributable to a substantial or gross valuation misstatement on a return are aggregated in applying the dollar limitation, the dollar limitation is satisfied if the portion of the underpayment that is attributable to the misstatement of the value of property C, when aggregated with the portion of the underpayment that is attributable to the misstatement of the value of property D, exceeds $5,000 ($10,000 in the case of most corporations).

(g) *Property with a value or adjusted basis of zero.* The value or adjusted basis claimed on a return of any property with a correct value or adjusted basis of zero is considered to be 400 percent or more of the correct amount. There is a gross valuation misstatement with respect to such property, therefore, and the applicable penalty rate is 40 percent.

(h) *Pass-through entities*—(1) *In general.* The determination of whether there is a substantial or gross valuation misstatement in the case of a return of a pass-through entity (as defined in § 1.6662–4(f)(5)) is made at the entity level. However, the dollar limitation ($5,000 or $10,000, as the case may be) is applied at the taxpayer level (*i.e.*, with respect to the return of the shareholder, partner, beneficiary, or holder of a residual interest in a REMIC).

(2) *Example.* The rules of paragraph (h)(1) of this section may be illustrated by the following example.

Example. Partnership P has two partners, individuals A and B. P claims a $40,000 basis in a depreciable asset which, in fact, has a basis of $15,000. The determination that there is a substantial valuation misstatement is made solely with reference to P by comparing the $40,000 basis claimed by P with P's correct basis of $15,000. However, the determination of whether the $5,000 threshold for application of the penalty has been reached is made separately for each partner. With respect to partner A, the penalty will apply if the portion of A's underpayment attributable to the passthrough of the depreciation deduction, when aggregated with any other portions of A's underpayment also attributable to substantial or gross valuation misstatements, exceeds $5,000 (assuming there is not reasonable cause for the misstatements (*see* § 1.6664–4(c)).

(i) [Reserved]

(j) *Transactions between persons described in section 482 and net section 482 transfer price adjustments.* [Reserved]

(k) *Returns affected.* Except in the case of rules relating to transactions between persons described in section 482 and net sections 482 transfer price adjustments, the provisions of section 6662(b)(3) apply to returns due (without regard to extensions of time to file) after December 31, 1989, notwithstanding that the original substantial or gross valuation misstatement occurred on a return that was due (without regard to extensions) before January 1, 1990. Assume, for example, that a calendar year corporation claimed a deduction on its 1990 return for depreciation of an asset with a basis of X. Also assume that it had reported the same basis for computing depreciation on its returns for the preceding 5 years and that the basis shown on the return each year was 200 percent or more of the correct basis. The corporation may be subject to a penalty for substantial valuation misstatements on its 1989 and 1990 returns, even though the original misstatement occurred prior to the effective date of sections 6662(b)(3) and (e).

[T.D. 8381, 56 FR 67504, Dec. 31, 1991; T.D. 8381, 57 FR 6165, Feb. 20, 1992]

§1.6662–5T Substantial and gross valuation misstatements under chapter 1 (temporary).

(a)–(e)(3) [Reserved]. For further information, see §1.6662–5(a) through (e)(3).

(e)(4) *Tests related to section 482*—(i) *Substantial valuation misstatement.* There is a substantial valuation misstatement if there is a misstatement described in §1.6662–6 (b)(1) or (c)(1) (concerning substantial valuation misstatements pertaining to transactions between related persons).

(ii) *Gross valuation misstatement.* There is a gross valuation misstatement if there is a misstatement described in §1.6662–6 (b)(2) or (c)(2) (concerning gross valuation misstatements pertaining to transactions between related persons).

(iii) *Property.* For purposes of this section, the term *property* refers to both tangible and intangible property. Tangible property includes property such as money, land, buildings, fixtures and inventory. Intangible property includes property such as goodwill, covenants not to compete, leaseholds, patents, contract rights, debts, choses in action, and any other item of intangible property described in §1.482–4(b).

(f)–(h) [Reserved] For further information, see §1.6662–5 (f) through (h).

(i) [Reserved]

(j) *Transactions between persons described in section 482 and net section 482 transfer price adjustments.* For rules relating to the penalty imposed with respect to a substantial or gross valuation misstatement arising from a section 482 allocation, see §1.6662–6.

[T.D. 8656, 61 FR 4879, Feb. 9, 1996; T.D. 8656, 61 FR 14248, Apr. 1, 1996]

§1.6662–6 Transactions between persons described in section 482 and net section 482 transfer price adjustments.

(a) *In general*—(1) *Purpose and scope.* Pursuant to section 6662(e) a penalty is imposed on any underpayment attributable to a substantial valuation misstatement pertaining to either a transaction between persons described in section 482 (the transactional penalty) or a net section 482 transfer price adjustment (the net adjustment penalty). The penalty is equal to 20 percent of the underpayment of tax attributable to that substantial valuation misstatement. Pursuant to section 6662(h) the penalty is increased to 40 percent of the underpayment in the case of a gross valuation misstatement with respect to either penalty. Paragraph (b) of this section provides specific rules related to the transactional penalty. Paragraph (c) of this section provides specific rules related to the net adjustment penalty, and paragraph (d) of this section describes amounts that will be excluded for purposes of calculating the net adjustment penalty. Paragraph (e) of this section sets forth special rules in the case of carrybacks and carryovers. Paragraph (f) of this section provides coordination rules between penalties. Paragraph (g) of this section provides the effective date of this section.

(2) *Reported results.* Whether an underpayment is attributable to a substantial or gross valuation misstatement must be determined from the results of controlled transactions that are reported on an income tax return, regardless of whether the amount reported differs from the transaction price initially reflected in the taxpayer's books and records. The results of controlled transactions that are reported on an amended return will be used only if the amended return is filed before the Internal Revenue Service has contacted the taxpayer regarding the corresponding original return. A written statement furnished by a taxpayer subject to the Coordinated

Examination Program or a written statement furnished by the taxpayer when electing Accelerated Issue Resolution or similar procedures will be considered an amended return for purposes of this section if it satisfies either the requirements of a qualified amended return for purposes of § 1.6664–2(c)(3) or such requirements as the Commissioner may prescribe by revenue procedure. In the case of a taxpayer that is a member of a consolidated group, the rules of this paragraph (a)(2) apply to the consolidated income tax return of the group.

(3) *Identical terms used in the section 482 regulations.* For purposes of this section, the terms used in this section shall have the same meaning as identical terms used in regulations under section 482.

(b) *The transactional penalty*—(1) *Substantial valuation misstatement.* In the case of any transaction between related persons, there is a substantial valuation misstatement if the price for any property or services (or for the use of property) claimed on any return is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct price.

(2) *Gross valuation misstatement.* In the case of any transaction between related persons, there is a gross valuation misstatement if the price for any property or services (or for the use of property) claimed on any return is 400 percent or more (or 25 percent or less) of the amount determined under section 482 to be the correct price.

(3) *Reasonable cause and good faith.* Pursuant to section 6664(c), the transactional penalty will not be imposed on any portion of an underpayment with respect to which the requirements of § 1.6664–4 are met. In applying the provisions of § 1.6664–4 in a case in which the taxpayer has relied on professional analysis in determining its transfer pricing, whether the professional is an employee of, or related to, the taxpayer is not determinative in evaluating whether the taxpayer reasonably relied in good faith on advice. A taxpayer that meets the requirements of paragraph (d) of this section with respect to an allocation under section 482 will be treated as having established that there was reasonable cause and good faith with respect to that item for purposes of § 1.6664–4. If a substantial or gross valuation misstatement under the transactional penalty also constitutes (or is part of) a substantial or gross valuation misstatement under the net adjustment penalty, then the rules of paragraph (d) of this section (and not the rules of § 1.6664–4) will be applied to determine whether the adjustment is excluded from calculation of the net section 482 adjustment.

(c) *Net adjustment penalty*—(1) *Net section 482 adjustment.* For purposes of this section, the term *net section 482 adjustment* means the sum of all increases in the taxable income of a taxpayer for a taxable year resulting from allocations under section 482 (determined without regard to any amount carried to such taxable year from another taxable year) less any decreases in taxable income attributable to collateral adjustments as described in § 1.482–1(g). For purposes of this section, amounts that meet the requirements of paragraph (d) of this section will be excluded from the calculation of the net section 482 adjustment. Substantial and gross valuation misstatements that are subject to the transactional penalty under paragraph (b) (1) or (2) of this section are included in determining the amount of the net section 482 adjustment. See paragraph (f) of this section for coordination rules between penalties.

(2) *Substantial valuation misstatement.* There is a substantial valuation misstatement if a net section 482 adjustment is greater than the lesser of 5 million dollars or ten percent of gross receipts.

(3) *Gross valuation misstatement.* There is a gross valuation misstatement if a net section 482 adjustment is greater than the lesser of 20 million dollars or twenty percent of gross receipts.

(4) *Setoff allocation rule.* If a taxpayer meets the requirements of paragraph (d) of this section with respect to some, but not all of the allocations made under section 482, then for purposes of determining the net section 482 adjustment, setoffs, as taken into account under § 1.482–1(g)(4), must be applied ratably against all such allocations. The following example illustrates the principle of this paragraph (c)(4):

Example. (i) The Internal Revenue Service makes the following section 482 adjustments for the taxable year:

(1) Attributable to an increase in gross income because of an increase in royalty payments	$9,000,000
(2) Attributable to an increase in sales proceeds due to a decrease in the profit margin of a related buyer	6,000,000
(3) Because of a setoff under §1.482–1(g)(4)	(5,000,000)
Total section 482 adjustments	10,000,000

(ii) The taxpayer meets the requirements of paragraph (d) with respect to adjustment number one, but not with respect to adjustment number two. The five million dollar setoff will be allocated ratably against the nine million dollar adjustment ($9,000,000/$15,000,000×$5,000,000=$3,000,000) and the six million dollar adjustment ($6,000,000/$15,000,000×$5,000,000=$2,000,000). Accordingly, in determining the net section 482 adjustment, the nine million dollar adjustment is reduced to six million dollars ($9,000,000–$3,000,000) and the six million dollar adjustment is reduced to four million dollars ($6,000,000–$2,000,000). Therefore, the net section 482 adjustment equals four million dollars.

(5) *Gross receipts.* For purposes of this section, gross receipts must be computed pursuant to the rules contained in §1.448–1T(f)(2)(iv), as adjusted to reflect allocations under section 482.

(6) *Coordination with reasonable cause exception under section 6664(c).* Pursuant to section 6662(e)(3)(D), a taxpayer will be treated as having reasonable cause under section 6664(c) for any portion of an underpayment attributable to a net section 482 adjustment only if the taxpayer meets the requirements of paragraph (d) of this section with respect to that portion.

(7) *Examples.* The principles of this paragraph (c) are illustrated by the following examples:

Example 1. (i) The Internal Revenue Service makes the following section 482 adjustments for the taxable year:

(1) Attributable to an increase in gross income because of an increase in royalty payments	$2,000,000
(2) Attributable to an increase in sales proceeds due to a decrease in the profit margin of a related buyer	2,500,000
(3) Attributable to a decrease in the cost of goods sold because of a decrease in the cost plus mark-up of a related seller	2,000,000
Total section 482 adjustments	6,500,000

(ii) None of the adjustments are excluded under paragraph (d) of this section. The net section 482 adjustment ($6.5 million) is greater than five million dollars. Therefore, there is a substantial valuation misstatement.

Example 2. (i) The Internal Revenue Service makes the following section 482 adjustments for the taxable year:

(1) Attributable to an increase in gross income because of an increase in royalty payments	$11,000,000
(2) Attributable to an increase in sales proceeds due to a decrease in the profit margin of a related buyer	2,000,000
(3) Because of a setoff under §1.482–1(g)(4)	(9,000,000)
Total section 482 adjustments	4,000,000

(ii) The taxpayer has gross receipts of sixty million dollars after taking into account all section 482 adjustments. None of the adjustments are excluded under paragraph (d) of this section. The net section 482 adjustment ($4 million) is less than the lesser of five million dollars or ten percent of gross receipts ($60 million×10%=$6 million). Therefore, there is no substantial valuation misstatement.

Example 3. (i) The Internal Revenue Service makes the following section 482 adjustments to the income of an affiliated group that files a consolidated return for the taxable year:

(1) Attributable to Member A	$1,500,000
(2) Attributable to Member B	1,000,000
(3) Attributable to Member C	2,000,000
Total section 482 adjustments	4,500,000

(ii) Members A, B, and C have gross receipts of 20 million dollars, 12 million dollars, and 11 million dollars, respectively. Thus, the total gross receipts are 43 million dollars. None of the adjustments are excluded under paragraph (d) of this section. The net section 482 adjustment ($4.5 million) is greater than the lesser of five million dollars or ten percent of gross receipts ($43 million × 10% = $4.3 million). Therefore, there is a substantial valuation misstatement.

Example 4. (i) The Internal Revenue Service makes the following section 482 adjustments to the income of an affiliated group that files a consolidated return for the taxable year:

(1) Attributable to Member A	$1,500,000

(2) Attributable to Member B	3,000,000
(3) Attributable to Member C	2,500,000
Total section 482 adjustments	7,000,000

(ii) Members A, B, and C have gross receipts of 20 million dollars, 35 million dollars, and 40 million dollars, respectively. Thus, the total gross receipts are 95 million dollars. None of the adjustments are excluded under paragraph (d) of this section. The net section 482 adjustment (7 million dollars) is greater than the lesser of five million dollars or ten percent of gross receipts ($95 million × 10% = $9.5 million). Therefore, there is a substantial valuation misstatement.

Example 5. (i) The Internal Revenue Service makes the following section 482 adjustments to the income of an affiliated group that files a consolidated return for the taxable year:

(1) Attributable to Member A	$2,000,000
(2) Attributable to Member B	1,000,000
(3) Attributable to Member C	1,500,000
Total section 482 adjustments	4,500,000

(ii) Members A, B, and C have gross receipts of 10 million dollars, 35 million dollars, and 40 million dollars, respectively. Thus, the total gross receipts are 85 million dollars. None of the adjustments are excluded under paragraph (d) of this section. The net section 482 adjustment ($4.5 million) is less than the lesser of five million dollars or ten percent of gross receipts ($85 million × 10%=$8.5 million). Therefore, there is no substantial valuation misstatement even though individual member A's adjustment ($2 million) is greater than ten percent of its individual gross receipts ($10 million × 10%=$1 million).

(d) *Amounts excluded from net section 482 adjustments*—(1) *In general.* An amount is excluded from the calculation of a net section 482 adjustment if the requirements of paragraph (d) (2), (3), or (4) of this section are met with respect to that amount.

(2) *Application of a specified section 482 method*—(i) *In general.* An amount is excluded from the calculation of a net section 482 adjustment if the taxpayer establishes that both the specified method and documentation requirements of this paragraph (d)(2) are met with respect to that amount. For purposes of this paragraph (d), a method will be considered a specified method if it is described in the regulations under section 482 and the method applies to transactions of the type under review. A qualified cost sharing arrangement is considered a specified method. See § 1.482–7. An unspecified method is not considered a specified method. See §§ 1.482–3(e) and 1.482–4(d).

(ii) *Specified method requirement.* The specified method requirement is met if the taxpayer selects and applies a specified method in a reasonable manner. The taxpayer's selection and application of a specified method is reasonable only if, given the available data and the applicable pricing methods, the taxpayer reasonably concluded that the method (and its application of that method) provided the most reliable measure of an arm's length result under the principles of the best method rule of § 1.482–1(c). A taxpayer can reasonably conclude that a specified method provided the most reliable measure of an arm's length result only if it has made a reasonable effort to evaluate the potential applicability of the other specified methods in a manner consistent with the principles of the best method rule. The extent of this evaluation generally will depend on the nature of the available data, and it may vary from case to case and from method to method. This evaluation may not entail an exhaustive analysis or detailed application of each method. Rather, after a reasonably thorough search for relevant data, the taxpayer should consider which method would provide the most reliable measure of an arm's length result given that data. The nature of the available data may enable the taxpayer to conclude reasonably that a particular specified method provides a more reliable measure of an arm's length result than one or more of the other specified methods, and accordingly no further consideration of such other specified methods is needed. Further, it is not necessary for a taxpayer to conclude that the selected specified method provides a more reliable measure of an arm's length result than any unspecified method. For examples illustrating the selection of a specified method consistent with this paragraph (d)(2)(ii), see § 1.482–8. Whether the taxpayer's conclusion was reasonable must be determined from all the facts and circumstances. The factors relevant to this determination include the following:

(A) The experience and knowledge of the taxpayer, including all members of the taxpayer's controlled group.

(B) The extent to which reliable data was available and the data was analyzed in a reasonable manner. A taxpayer must engage in a reasonably thorough search for the data necessary to determine which method should be selected and how it should be applied. In determining the scope of a reasonably thorough search for data, the expense of additional efforts to locate new data may be weighed against the likelihood of finding additional data that would improve the reliability of the results and the amount by which any new data would change the taxpayer's taxable income. Furthermore, a taxpayer must use the most current reliable data that is available before the end of the taxable year in question. Although the taxpayer is not required to search for relevant data after the end of the taxable year, the taxpayer must maintain as a principal document described in paragraph (d)(2)(iii)(B)(*9*) of this section any relevant data it obtains after the end of the taxable year but before the return is filed, if that data would help determine whether the taxpayer has reported its true taxable income.

(C) The extent to which the taxpayer followed the relevant requirements set forth in regulations under section 482 with respect to the application of the method.

(D) The extent to which the taxpayer reasonably relied on a study or other analysis performed by a professional qualified to conduct such a study or analysis, including an attorney, accountant, or economist. Whether the professional is an employee of, or related to, the taxpayer is not determinative in evaluating the reliability of that study or analysis, as long as the study or analysis is objective, thorough, and well reasoned. Such reliance is reasonable only if the taxpayer disclosed to the professional all relevant information regarding the controlled transactions at issue. A study or analysis that was reasonably relied upon in a prior year may reasonably be relied upon in the current year if the relevant facts and circumstances have not changed or if the study or analysis has been appropriately modified to reflect any change in facts and circumstances.

(E) If the taxpayer attempted to determine an arm's length result by using more than one uncontrolled comparable, whether the taxpayer arbitrarily selected a result that corresponds to an extreme point in the range of results derived from the uncontrolled comparables. Such a result generally would not likely be closest to an arm's length result. If the uncontrolled comparables that the taxpayer uses to determine an arm's length result are described in §1.482–1(e)(2)(iii)(B), one reasonable method of selecting a point in the range would be that provided in §1.482–1(e)(3).

(F) The extent to which the taxpayer relied on a transfer pricing methodology developed and applied pursuant to an Advance Pricing Agreement for a prior taxable year, or specifically approved by the Internal Revenue Service pursuant to a transfer pricing audit of the transactions at issue for a prior taxable year, provided that the taxpayer applied the approved method reasonably and consistently with its prior application, and the facts and circumstances surrounding the use of the method have not materially changed since the time of the IRS's action, or if the facts and circumstances have changed in a way that materially affects the reliability of the results, the taxpayer makes appropriate adjustments to reflect such changes.

(G) The size of a net transfer pricing adjustment in relation to the size of the controlled transaction out of which the adjustment arose.

(iii) *Documentation requirement*—(A) *In general.* The documentation requirement of this paragraph (d)(2)(iii) is met if the taxpayer maintains sufficient documentation to establish that the taxpayer reasonably concluded that, given the available data and the applicable pricing methods, the method (and its application of that method) provided the most reliable measure of an arm's length result under the principles of the best method rule in §1.482–1(c), and provides that documentation to the Internal Revenue Service within 30 days of a request for it in connection with an examination of the taxable year to which the documentation relates. With the exception of the documentation described in paragraphs (d)(2)(iii)(B) (*9*) and (*10*) of this section, that documentation must be in existence when the return is filed. The district director may, in his discretion, excuse a minor or inadvertent failure to provide required documents, but only if the taxpayer has made a good faith effort to comply, and the taxpayer promptly remedies the failure when it becomes known. The required documentation is divided into two categories, principal documents and background documents as described in paragraphs (d)(2)(iii) (B) and (C) of this section.

(B) *Principal documents.* The principal documents should accurately and completely describe the basic transfer pricing analysis conducted by the taxpayer. The documentation must include the following—

(*1*) An overview of the taxpayer's business, including an analysis of the economic and legal factors that affect the pricing of its property or services;

(*2*) A description of the taxpayer's organizational structure (including an organization chart) covering all related parties engaged in transactions potentially relevant under section 482, including foreign affiliates whose transactions directly or indirectly affect the pricing of property or services in the United States;

(*3*) Any documentation explicitly required by the regulations under section 482;

(*4*) A description of the method selected and an explanation of why that method was selected;

(*5*) A description of the alternative methods that were considered and an explanation of why they were not selected;

(*6*) A description of the controlled transactions (including the terms of sale) and any internal data used to analyze those transactions. For example, if a profit split method is applied, the documentation must include a schedule providing the total income, costs, and assets (with adjustments for different accounting practices and currencies) for each controlled taxpayer participating in the relevant business activity and detailing the allocations of such items to that activity;

(*7*) A description of the comparables that were used, how comparability was evaluated, and what (if any) adjustments were made;

(*8*) An explanation of the economic analysis and projections relied upon in developing the method. For example, if a profit split method is applied, the taxpayer must provide an explanation of the analysis undertaken to determine how the profits would be split;

(*9*) A description or summary of any relevant data that the taxpayer obtains after the end of the tax year and before filing a tax return, which would help determine if a taxpayer selected and applied a specified method in a reasonable manner; and

(*10*) A general index of the principal and background documents and a description of the recordkeeping system used for cataloging and accessing those documents.

(C) *Background documents.* The assumptions, conclusions, and positions contained in principal documents ordinarily will be based on, and supported by, additional background documents. Documents that support the principal documentation may include the documents listed in § 1.6038A–3(c) that are not otherwise described in paragraph (d)(2)(iii)(B) of this section. Every document listed in those regulations may not be relevant to pricing determinations under the taxpayer's specific facts and circumstances and, therefore, each of those documents need not be maintained in all circumstances. Moreover, other documents not listed in those regulations may be necessary to establish that the taxpayer's method was selected and applied in the way that provided the most reliable measure of an arm's length result under the principles of the best method rule in § 1.482–1(c). Background documents need not be provided to the Internal Revenue Service in response to a request for principal documents. If the Internal Revenue Service subsequently requests background documents, a taxpayer must provide that documentation to the Internal Revenue Service within 30 days of the request. However, the district director may, in his discretion, extend the period for producing the background documentation.

(3) *Application of an unspecified method*—(i) *In general.* An adjustment is excluded from the calculation of a net section 482 adjustment if the taxpayer establishes that both the unspecified method and documentation requirements of this paragraph (d)(3) are met with respect to that amount.

(ii) *Unspecified method requirement*—(A) *In general.* If a method other than a specified method was applied, the unspecified method requirement is met if the requirements of paragraph (d)(3)(ii) (B) or (C) of this section, as appropriate, are met.

(B) *Specified method potentially applicable.* If the transaction is of a type for which methods are specified in the regulations under section 482, then a taxpayer will be considered to have met the unspecified method requirement if the taxpayer reasonably concludes, given the available data, that none of the specified methods was likely to provide a reliable measure of an arm's length result, and that it selected and applied an unspecified method in a way that would likely provide a reliable measure of an arm's length result. A taxpayer can reasonably conclude that no specified method was likely to provide a reliable measure of an arm's length result only if it has made a reasonable effort to evaluate the potential applicability of the specified methods in a manner consistent with the principles of the best method rule. However, it is not necessary for a taxpayer to conclude that the selected method provides a more reliable measure of an arm's length result than any other unspecified method. Whether the taxpayer's conclusion was reasonable must be determined from all the facts and circumstances. The factors relevant to this conclusion include those set forth in paragraph (d)(2)(ii) of this section.

(C) *No specified method applicable.* If the transaction is of a type for which no methods are specified in the regulations under section 482, then a taxpayer will be considered to have met the unspecified method requirement if it selected and applied an unspecified method in a reasonable manner. For purposes of this paragraph (d)(3)(ii)(C), a taxpayer's selection and application is reasonable if the taxpayer reasonably concludes that the method (and its application of that method) provided the most reliable measure of an arm's length result under the principles of the best method rule in §1.482–1(c). However, it is not necessary for a taxpayer to conclude that the selected method provides a more reliable measure of an arm's length result than any other unspecified method. Whether the taxpayer's conclusion was reasonable must be determined from all the facts and circumstances. The factors relevant to this conclusion include those set forth in paragraph (d)(2)(ii) of this section.

(iii) *Documentation requirement*—(A) *In general.* The documentation requirement of this paragraph (d)(3) is met if the taxpayer maintains sufficient documentation to establish that the unspecified method requirement of paragraph (d)(3)(ii) of this section is met and provides that documentation to the Internal Revenue Service within 30 days of a request for it. That documentation must be in existence when the return is filed. The district director may, in his discretion, excuse a minor or inadvertent failure to provide required documents, but only if the taxpayer has made a good faith effort to comply, and the taxpayer promptly remedies the failure when it becomes known.

(B) *Principal and background documents.* See paragraphs (d)(2)(iii) (B) and (C) of this section for rules regarding these two categories of required documentation.

(4) *Certain foreign to foreign transactions.* For purposes of calculating a net section 482 adjustment, any increase in taxable income resulting from an allocation under section 482 that is attributable to any controlled transaction solely between foreign corporations will be excluded unless the treatment of that transaction affects the determination of either corporation's income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States.

(5) *Special rule.* If the regular tax (as defined in section 55(c)) imposed on the taxpayer is determined by reference to an amount other than taxable income, that amount shall be treated as the taxable income of the taxpayer for purposes of section 6662(e)(3). Accordingly, for taxpayers whose regular tax is determined by reference to an amount other than taxable income, the increase in that amount resulting from section 482 allocations is the taxpayer's net section 482 adjustment.

(6) *Examples.* The principles of this paragraph (d) are illustrated by the following examples:

Example 1. (i) The Internal Revenue Service makes the following section 482 adjustments for the taxable year:

(1) Attributable to an increase in gross income because of an increase in royalty payments	$9,000,000
(2) Not a 200 percent or 400 percent adjustment	2,000,000
(3) Attributable to a decrease in the cost of goods sold because of a decrease in the cost plus mark-up of a related seller	9,000,000
Total section 482 adjustments	20,000,000

(ii) The taxpayer has gross receipts of 75 million dollars after all section 482 adjustments. The taxpayer establishes that for adjustments number one and three, it applied a transfer pricing method specified in section 482, the selection and application of the method was reasonable, it documented the pricing analysis, and turned that documentation over to the IRS within 30 days of a request. Accordingly, eighteen million dollars is excluded from the calculation of the net section 482 adjustment. Because the net section 482 adjustment is two million dollars, there is no substantial valuation misstatement.

Example 2. (i) The Internal Revenue Service makes the following section 482 adjustments for the taxable year:

(1) Attributable to an increase in gross income because of an increase in royalty payments	$9,000,000
(2) Attributable to an adjustment that is 200 percent or more of the correct section 482 price	2,000,000
(3) Attributable to a decrease in the cost of goods sold because of a decrease in the cost plus mark-up of a related seller	9,000,000
Total section 482 adjustments	20,000,000

(ii) The taxpayer has gross receipts of 75 million dollars after all section 482 adjustments. The taxpayer establishes that for adjustments number one and three, it applied a transfer pricing method specified in section 482, the selection and application of the method was reasonable, it documented that analysis, and turned the documentation over to the IRS within 30 days. Accordingly, eighteen million dollars is excluded from the calculation of the section 482 transfer pricing adjustments for purposes of applying the five million dollar or 10% of gross receipts test. Because the net section 482 adjustment is only two million dollars, the taxpayer is not subject to the net adjustment penalty. However, the taxpayer may be subject to the transactional penalty on the underpayment of tax attributable to the two million dollar adjustment.

Example 3. CFC1 and CFC2 are controlled foreign corporations within the meaning of section 957. Applying section 482, the IRS disallows a deduction for 25 million dollars of the interest that CFC1 paid to CFC2, which results in CFC1's U.S. shareholder having a subpart F inclusion in excess of five million dollars. No other adjustments under section 482 are made with respect to the controlled taxpayers. However, the increase has no effect upon the determination of CFC1's or CFC2's income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States. Accordingly, there is no substantial valuation misstatement.

(e) *Special rules in the case of carrybacks and carryovers.* If there is a substantial or gross valuation misstatement for a taxable year that gives rise to a loss, deduction or credit that is carried to another taxable year, the transactional penalty and the net adjustment penalty will be imposed on any resulting underpayment of tax in that other taxable year. In determining whether there is a substantial or gross valuation misstatement for a taxable year, no amount carried from another taxable year shall be included. The following example illustrates the principle of this paragraph (e):

Example. The Internal Revenue Service makes a section 482 adjustment of six million dollars in taxable year 1, no portion of which is excluded under paragraph (d) of this section. The taxpayer's income tax return for year 1 reported a loss of three million dollars, which was carried to taxpayer's year 2 income tax return and used to reduce income taxes otherwise due with respect to year 2. A determination is made that the six million dollar allocation constitutes a substantial valuation misstatement, and a penalty is imposed on the underpayment of tax in year 1 attributable to the substantial valuation misstatement and on the underpayment of tax in year 2 attributable to the disallowance of the net operating loss in year 2. For purposes of determining whether there is a substantial or gross valuation misstatement for year 2, the three million dollar reduction of the net operating loss will not be added to any section 482 adjustments made with respect to year 2.

(f) *Rules for coordinating between the transactional penalty and the net adjustment penalty*—(1) *Coordination of a net section 482 adjustment subject to the net adjustment penalty and a gross valuation misstatement subject to the transactional penalty*. In determining whether a net section 482 adjustment exceeds five million dollars or 10 percent of gross receipts, an adjustment attributable to a substantial or gross valuation misstatement that is subject to the transactional penalty will be taken into account. If the net section 482 adjustment exceeds five million dollars or ten percent of gross receipts, any portion of such amount that is attributable to a gross valuation misstatement will be subject to the transactional penalty at the forty percent rate, but will not also be subject to net adjustment penalty at a twenty percent rate. The remaining amount is subject to the net adjustment penalty at the twenty percent rate, even if such amount is less than the lesser of five million dollars or ten percent of gross receipts.

(2) *Coordination of net section 482 adjustment subject to the net adjustment penalty and substantial valuation misstatements subject to the transactional penalty*. If the net section 482 adjustment exceeds twenty million dollars or 20 percent of gross receipts, the entire amount of the adjustment is subject to the net adjustment penalty at a forty percent rate. No portion of the adjustment is subject to the transactional penalty at a twenty percent rate.

(3) *Examples*. The following examples illustrate the principles of this paragraph (f):

Example 1. (i) Applying section 482, the Internal Revenue Service makes the following adjustments for the taxable year:

(1) Attributable to an adjustment that is 400 percent or more of the correct section 482 arm's length result	$2,000,000
(2) Not a 200 or 400 percent adjustment	2,500,000
Total	4,500,000

(ii) The taxpayer has gross receipts of 75 million dollars after all section 482 adjustments. None of the adjustments is excluded under paragraph (d) (Amounts excluded from net section 482 adjustments) of this section, in determining the five million dollar or 10% of gross receipts test under section 6662(e)(1)(B)(ii). The net section 482 adjustment (4.5 million dollars) is less than the lesser of five million dollars or ten percent of gross receipts ($75 million × 10% = $7.5 million). Thus, there is no substantial valuation misstatement. However, the two million dollar adjustment is attributable to a gross valuation misstatement. Accordingly, the taxpayer may be subject to a penalty, under section 6662(h), equal to 40 percent of the underpayment of tax attributable to the gross valuation misstatement of two million dollars. The 2.5 million dollar adjustment is not subject to a penalty under section 6662(b)(3).

Example 2. The facts are the same as in *Example 1,* except the taxpayer has gross receipts of 40 million dollars. The net section 482 adjustment ($4.5 million) is greater than the lesser of five million dollars or ten percent of gross receipts ($40 million × 10% = $4 million). Thus, the five million dollar or 10% of gross receipts test has been met. The two million dollar adjustment is attributable to a gross valuation misstatement. Accordingly, the taxpayer is subject to a penalty, under section 6662(h), equal to 40 percent of the underpayment of tax attributable to the gross valuation misstatement of two million dollars. The 2.5 million dollar adjustment is subject to a penalty under sections 6662(a) and 6662(b)(3), equal to 20 percent of the underpayment of tax attributable to the substantial valuation misstatement.

Example 3. (i) Applying section 482, the Internal Revenue Service makes the following transfer pricing adjustments for the taxable year:

(1) Attributable to an adjustment that is 400 percent or more of the correct section 482 arm's length result	$6,000,000
(2) Not a 200 or 400 percent adjustment	15,000,000
Total	21,000,000

(ii) None of the adjustments are excluded under paragraph (d) (Amounts excluded from net section 482 adjustments) in determining the twenty million dollar or 20% of gross receipts test under section 6662(h). The net section 482 adjustment (21 million dollars) is greater than twenty million dollars and thus constitutes a gross valuation misstatement. Accordingly, the total adjustment is subject to the net adjustment penalty equal to 40 percent of the underpayment of tax attributable to the 21 million dollar gross valuation misstatement. The six million dollar adjustment will not be separately included for purposes of any additional penalty under section 6662.

(g) *Effective date.* This section is effective February 9, 1996. However, taxpayers may elect to apply this section to all open taxable years beginning after December 31, 1993.

[T.D. 8656, 61 FR 4880, Feb. 9, 1996; T.D. 8656, 61 FR 14248, Apr. 1, 1996; 62 FR 46877, Sept. 5, 1997]

§ 1.6662–7 Omnibus Budget Reconciliation Act of 1993 changes to the accuracy-related penalty.

(a) *Scope.* The Omnibus Budget Reconciliation Act of 1993 made certain changes to the accuracy-related penalty in section 6662. This section provides rules reflecting those changes.

(b) *No disclosure exception for negligence penalty.* The penalty for negligence in section 6662(b)(1) may not be avoided by disclosure of a return position.

(c) *Disclosure standard for other penalties is reasonable basis.* The penalties for disregarding rules or regulations in section 6662(b)(1) and for a substantial understatement of income tax in section 6662(b)(2) may be avoided by adequate disclosure of a return position only if the position has at least a reasonable basis. See § 1.6662–3(c) and §§ 1.6662–4(e) and (f) for other applicable disclosure rules.

(d) *Reasonable basis.* For purposes of §§ 1.6662–3(c) and 1.6662–4(e) and (f) (relating to methods of making adequate disclosure), the provisions of § 1.6662–3(b)(3) apply in determining whether a return position has a reasonable basis.

[T.D. 8617, 60 FR 45665, Sept. 1, 1995, as amended by T.D. 8790, 63 FR 66435, Dec. 2, 1998]

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§ 1.6664–4T Reasonable cause and good faith exception to section 6662 penalties

(a)—(c) [Reserved]
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[T.D. 8381, 56 FR 67505, Dec. 31, 1991, as amended by T.D. 8519, 59 FR 4799, Feb. 2, 1994; T.D. 8617, 60 FR 45666, Sept. 1, 1995; T.D. 8656, 61 FR 4885, Feb. 9, 1996; T.D. 8790, 63 FR 66435, Dec. 2, 1998]

§ 1.6664–1 Accuracy-related and fraud penalties; definitions and special rules.

(a) *In general.* Section 6664(a) defines the term ''underpayment'' for purposes of the accuracy-related penalty under section 6662 and the fraud penalty under section 6663. The definition of ''underpayment'' of income taxes imposed under subtitle A is set forth in § 1.6664–2. Ordering rules for computing the total amount of accuracy-related and fraud penalties imposed with respect to a return are set forth in § 1.6664–3. Section 6664(c) provides a reasonable cause and good faith exception to the accuracy-related penalty. Rules relating to the reasonable cause and good faith exception are set forth in § 1.6664–4.

(b) *Effective date*—(1) *In general.* Sections 1.6664–1 through 1.6664–3 apply to returns the due date of which (determined without regard to extensions of time for filing) is after December 31, 1989.

(2) *Reasonable cause and good faith exception to section 6662 penalties.* Section 1.6664–4 applies to returns the due date of which (determined without regard to extensions of time for filing) is after September 1, 1995. Except as provided in the last sentence of this paragraph (b)(2), § 1.6664–4 (as contained in 26 CFR part 1 revised April 1, 1995) applies to returns the due date of which (determined without regard to extensions of time for filing) is on or before September 1, 1995 and after December 31, 1989. For transactions occurring after December 8, 1994, § 1.6664–4 (as contained in 26 CFR part 1 revised April 1, 1995) is applied taking into account the changes made to section 6662(d)(2)(C) (relating to the substantial understatement penalty for tax shelter items of corporations) by section 744 of Title VII of the Uruguay Round Agreements Act, Pub. L. 103–465 (108 Stat. 4809).

[T.D. 8381, 56 FR 67506, Dec. 31, 1991, as amended by T.D. 8617, 60 FR 45666, Sept. 1, 1995]

§ 1.6664–2 Underpayment.

(a) *Underpayment defined.* In the case of income taxes imposed under subtitle A, an underpayment for purposes of section 6662, relating to the accuracy-related penalty, and section 6663, relating to the fraud penalty, means the amount by which any income tax imposed under this subtitle (as defined in paragraph (b) of the section) exceeds the excess of—

(1) The sum of—

(i) The amount shown as the tax by the taxpayer on his return (as defined in paragraph (c) of this section), plus

(ii) Amounts not so shown previously assessed (or collected without assessment) (as defined in paragraph (d) of this section), over

(2) The amount of rebates made (as defined in paragraph (e) of this section).

The definition of underpayment also may be expressed as—

$$Underpayment=W-(X+Y-Z),$$

where *W*=the amount of income tax imposed; *X*=the amount shown as the tax by the taxpayer on his return; *Y*=amounts not so shown previously assessed (or collected without assessment); and *Z*=the amount of rebates made.

(b) *Amount of income tax imposed.* For purposes of paragraph (a) of this section, the ''amount of income tax imposed'' is the amount of tax imposed on the taxpayer under subtitle A for the taxable year, determined without regard to—

(1) The credits for tax withheld under sections 31 (relating to tax withheld on wages) and 33 (relating to tax withheld at source on nonresident aliens and foreign corporations);

(2) Payments of tax or estimated tax by the taxpayer;

(3) Any credit resulting from the collection of amounts assessed under section 6851 as the result of a termination assessment, or section 6861 as the result of a jeopardy assessment; and

(4) Any tax that the taxpayer is not required to assess on the return (such as the tax imposed by section 531 on the accumulated taxable income of a corporation).

(c) *Amount shown as the tax by the taxpayer on his return*—(1) *Defined.* For purposes of paragraph (a) of this section, the ''amount shown as the tax by the taxpayer on his return'' is the tax liability shown by the taxpayer on his return, determined without regard to the items listed in § 1.6664–2(b) (1), (2), and (3), except that it is reduced by the excess of—

(i) The amounts shown by the taxpayer on his return as credits for tax withheld under section 31 (relating to tax withheld on wages) and section 33 (relating to tax withheld at source on nonresident aliens and foreign corporations), as payments of estimated tax, or as any other payments made by the taxpayer with respect to a taxable year before filing the return for such taxable year, over

(ii) The amounts actually withheld, actually paid as estimated tax, or actually paid with respect to a taxable year before the return is filed for such taxable year.

(2) *Effect of qualified amended return.* The ''amount shown as the tax by the taxpayer on his return'' includes an amount shown as additional tax on a qualified amended return (as defined in paragraph (c)(3) of this section), except that such amount is not included if it relates to a fraudulent position on the original return.

(3) *Qualified amended return defined.* A qualified amended return is an amended return, or a timely request for an administrative adjustment under section 6227, filed after the due date of the return for the taxable year (determined with regard to extensions of time to file) and before the earliest of—

(i) The time the taxpayer is first contacted by the Internal Revenue Service concerning an examination of the return;

(ii) The time any person described in section 6700(a) (relating to the penalty for promoting abusive tax shelters) is first contacted by the Internal Revenue Service concerning an examination of an activity described in section 6700(a) with respect to which the taxpayer claimed any tax benefit on the return directly or indirectly through the entity, plan or arrangement described in section 6700(a)(1)(A); or

(iii) In the case of a pass-through item (as defined in § 1.6662–4(f)(5)), the time the pass-through entity (as defined in § 1.6662–4(f)(5)) is first contacted by the Internal Revenue Service in connection with an examination of the return to which the pass-through item relates.

A qualified amended return includes an amended return that is filed solely to disclose information pursuant to § 1.6662–3(c) or § 1.6662–4 (e) and (f) and that does not report any additional tax liability.

(4) *Special rule for qualified amended returns.* The Commissioner may by revenue procedure prescribe the manner in which the rules of paragraph (c) of this section regarding qualified amended returns apply to particular classes of taxpayers.

(d) *Amounts not so shown previously assessed (or collected without assessment).* For purposes of paragraph (a) of this section, ''amounts not so shown previously assessed'' means only amounts assessed before the return is filed that were not shown on the return, such as termination assessments under section 6851 and jeopardy assessments under section 6861 made prior to the filing of the return for the taxable year. For purposes of paragraph (a) of this section, the amount ''collected without assessment'' is the amount by which the total of the credits allowable under section 31 (relating to tax withheld on wages) and section 33 (relating to tax withheld at source on nonresident aliens and foreign corporations), estimated tax payments, and other payments in satisfaction of tax liability made before the return is filed, exceed the tax shown on the return (provided such excess has not been refunded or allowed as a credit to the taxpayer).

(e) *Rebates.* The term ''rebate'' means so much of an abatement credit, refund or other repayment, as was made on the ground that the tax imposed was less than the excess of—

(1) The sum of—

(i) The amount shown as the tax by the taxpayer on his return, plus

(ii) Amounts not so shown previously assessed (or collected without assessment), over

(2) Rebates previously made.

(f) *Underpayments for certain carryback years not reduced by amount of carrybacks.* The amount of an underpayment for a taxable year that is attributable to conduct proscribed by sections 6662 or 6663 is not reduced on account of a carryback of a loss, deduction or credit to that year. Such conduct includes negligence or disregard of rules or regulations; a substantial understatement of income tax; and a substantial (or gross) valuation misstatement under chapter 1, provided that the applicable dollar limitation is satisfied for the carryback year.

(g) *Examples.* The following examples illustrate this section:

Example 1. Taxpayer's 1990 return showed a tax liability of $18,000. Taxpayer had no amounts previously assessed (or collected without assessment) and received no rebates of tax. Taxpayer claimed a credit in the amount of $23,000 for income tax withheld under section 3402, which resulted in a refund received of $5,000. It is later determined that the taxpayer should have reported additional income and that the correct tax for the taxable year is $25,500. There is an underpayment of $7,500, determined as follows:

Tax imposed under subtitle A	....	$25,500
Tax shown on return	$18,000	....
Tax previously assessed (or collected without assessment)	None	....
Amount of rebates made	None	....
Balance	....	$18,000
Underpayment	....	$7,500

Example 2. The facts are the same as in *Example 1* except that the taxpayer failed to claim on the return a credit of $1,500 for income tax withheld. This $1,500 constitutes an amount collected without assessment as defined in paragraph (d) of this section. The underpayment is $6,000, determined as follows:

Tax imposed under subtitle A	....	$25,500
Tax shown on return	$18,000	....
Tax previously assessed (or collected without assessment)	1,500	....
Amount of rebates made	None	....
Balance	....	$19,500
Underpayment	....	$6,000

Example 3. On Form 1040 filed for tax year 1990, taxpayer reported a tax liability of $10,000, estimated tax payments of $15,000, and received a refund of $5,000. Estimated tax payments actually made with respect to tax year 1990 were only $7,000. For purposes of determining the amount of underpayment subject to a penalty under section 6662 or section 6663, the tax shown on the return is $2,000 (reported tax liability of $10,000 reduced by the overstated estimated tax of $8,000 ($15,000–$7,000)). The underpayment is $8,000, determined as follows:

Tax imposed under subtitle A	....	$10,000
Tax shown on return	$2,000	....
Tax previously assessed (or collected without assessment)	None	....
Amount of rebates made	None	....
Balance	....	$2,000
Underpayment	....	$8,000

[T.D. 8381, 56 FR 67506, Dec. 31, 1991; T.D. 8381, 57 FR 6165, Feb. 20, 1992]

§1.6664–3 Ordering rules for determining the total amount of penalties imposed.

(a) *In general.* This section provides rules for determining the order in which adjustments to a return are taken into account for the purpose of computing the total amount of penalties imposed under sections 6662 and 6663, where—

(1) There is at least one adjustment with respect to which no penalty has been imposed and at least one with respect to which a penalty has been imposed, or

(2) There are at least two adjustments with respect to which penalties have been imposed and they have been imposed at different rates.

This section also provides rules for allocating unclaimed prepayment credits to adjustments to a return.

(b) *Order in which adjustments are taken into account.* In computing the portions of an underpayment subject to penalties imposed under sections 6662 and 6663, adjustments to a return are considered made in the following order:

(1) Those with respect to which no penalties have been imposed.

(2) Those with respect to which a penalty has been imposed at a 20 percent rate (*i.e.*, a penalty for negligence or disregard of rules or regulations, substantial understatement of income tax, or substantial valuation misstatement, under sections 6662(b)(1) through 6662(b)(3), respectively).

(3) Those with respect to which a penalty has been imposed at a 40 percent rate (*i.e.*, a penalty for a gross valuation misstatement under sections 6662 (b)(3) and (h)).

(4) Those with respect to which a penalty has been imposed at a 75 percent rate (*i.e.*, a penalty for fraud under section 6663).

(c) *Manner in which unclaimed prepayment credits are allocated.* Any income tax withholding or other payment made before a return was filed, that was neither claimed on the return nor previously allowed as a credit against the tax liability for the taxable year (an ''unclaimed prepayment credit''), is allocated as follows—

(1) If an unclaimed prepayment credit is allocable to a particular adjustment, such credit is applied in full in determining the amount of the underpayment resulting from such adjustment.

(2) If an unclaimed prepayment credit is not allocable to a particular adjustment, such credit is applied in accordance with the ordering rules set forth in paragraph (b) of this section.

(d) *Examples.* The following examples illustrate the rules of this § 1.6664–3. These examples do not take into account the reasonable cause exception to the accuracy-related penalty under § 1.6664–4.

Example 1. A and B, husband and wife, filed a joint federal income tax return for calendar year 1989, reporting taxable income of $15,800 and a tax liability of $2,374. A and B had no amounts previously assessed (or collected without assessment) and no rebates had been made. Subsequently, the return was examined and the following adjustments and penalties were agreed to:

Adjustment #1 (No penalty imposed)		$1,000
Adjustment #2 (Substantial understatement penalty imposed)		40,000
Adjustment #3 (Civil fraud penalty imposed)		45,000
Total adjustments		$86,000
Taxable income shown on return		15,800
Taxable income as corrected		$101,800
Computation of underpayment:		
Tax imposed by subtitle A		$25,828
Tax shown on return	$2,374	
Previous assessments	None	
Rebates	None	
Balance		$2,374
Underpayment		$23,454

Computation of the portions of the underpayment on which penalties under section 6662(b)(2) and section 6663 are imposed:

Step 1 Determine the portion, if any, of the underpayment on which no accuracy-related or fraud penalty is imposed:

Taxable income shown on return	$15,800
Adjustment #1	1,000
''Adjusted'' taxable income	$16,800
Tax on ''adjusted'' taxable income	$2,524
Tax shown on return	2,374
Portion of underpayment on which no penalty is imposed	$150

Step 2 Determine the portion, if any, of the underpayment on which a penalty of 20 percent is imposed:

''Adjusted'' taxable income from step 1	$16,800
Adjustment #2	40,000
''Adjusted'' taxable income	56,800
Tax on ''adjusted'' taxable income	$11,880
Tax on ''adjusted'' taxable income from step 1	$2,524
Portion of underpayment on which 20 percent penalty is imposed	$9,356

Step 3 Determine the portion, if any, of the underpayment on which a penalty of 75 percent is imposed:

Total underpayment		$23,454

Less the sum of the portions of such underpayment determined in:		
Step 1	$150	
Step 2	9,356	
Total	....	$9,506
Portion of underpayment on which 75 percent penalty is imposed	....	$13,948

Example 2. The facts are the same as in *Example 1* except that the taxpayers failed to claim on their return a credit of $1,500 for income tax withheld on unreported additional income that resulted in Adjustment #2. Because the unclaimed prepayment credit is allocable to Adjustment #2, the portion of the underpayment attributable to that adjustment is $7,856 ($9,356—$1,500). The portions of the underpayment attributable to Adjustments #1 and #3 remain the same.

Example 3. The facts are the same as in *Example 1* except that the taxpayers made a timely estimated tax payment of $1,500 for 1989 which they failed to claim (and which the Service had not previously allowed). This unclaimed prepayment credit is not allocable to any particular adjustment. Therefore, the credit is allocated first to the portion of the underpayment on which no penalty is imposed ($150). The remaining amount ($1,350) is allocated next to the 20 percent penalty portion of the underpayment ($9,356). Thus, the portion of the underpayment that is not penalized is zero ($150—$150), the portion subject to a 20 percent penalty is $8,006 ($9,356—$1,350) and the portion subject to a 75 percent penalty is unchanged at $13,948.

[T.D. 8381, 56 FR 67507, Dec. 31, 1991; T.D. 8381, 57 FR 6165, Feb. 20, 1992]

§ 1.6664–4 Reasonable cause and good faith exception to section 6662 penalties.

(a) *In general.* No penalty may be imposed under section 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. Rules for determining whether the reasonable cause and good faith exception applies are set forth in paragraphs (b) through (g) of this section.

(b) *Facts and circumstances taken into account*—(1) *In general.* The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. (See paragraph (e) of this section for certain rules relating to a substantial understatement penalty attributable to tax shelter items of corporations.) Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice, or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. (See paragraph (c) of this section for certain rules relating to reliance on the advice of others.) For example, reliance on erroneous information (such as an error relating to the cost or adjusted basis of property, the date property was placed in service, or the amount of opening or closing inventory) inadvertently included in data compiled by the various divisions of a multidivisional corporation or in financial books and records prepared by those divisions generally indicates reasonable cause and good faith, provided the corporation employed internal controls and procedures, reasonable under the circumstances, that were designed to identify such factual errors. Reasonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of property. Other factors to consider include the methodology and assumptions underlying the appraisal, the appraised value, the relationship between appraised value and purchase price, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer or to the activity in which the property is used. (See paragraph (g) of this section for certain rules relating to appraisals for charitable deduction property.) A taxpayer's reliance on erroneous information reported on a Form W–2, Form 1099, or other information return indicates reasonable cause and good faith, provided the taxpayer did not know or have reason to know that the information was incorrect. Generally, a taxpayer knows, or has reason to know, that the information on an information return is incorrect if such information is inconsistent with other information reported or otherwise furnished to the taxpayer, or with the taxpayer's knowledge of the transaction. This knowledge includes, for example, the taxpayer's knowledge of the terms of his employment relationship or of the rate of return on a payor's obligation.

(2) *Examples.* The following examples illustrate this paragraph (b). They do not involve tax shelter items. (See paragraph (e) of this section for certain rules relating to the substantial understatement penalty attributable to the tax shelter items of corporations.)

Example 1. A, an individual calendar year taxpayer, engages B, a professional tax advisor, to give A advice concerning the deductibility of certain state and local taxes. A provides B with full details concerning the taxes at issue. B advises A that the taxes are fully deductible. A, in preparing his own tax return, claims a deduction for the taxes. Absent other facts, and assuming the facts and circumstances surrounding B's advice and A's reliance on such advice satisfy the requirements of paragraph (c) of this section, A is considered to have demonstrated good faith by seeking the advice of a professional tax advisor, and to have shown reasonable cause for any underpayment attributable to the deduction claimed for the taxes. However, if A had sought advice from someone that A knew, or should have known, lacked knowledge in the relevant aspects of Federal tax law, or if other facts demonstrate that A failed to act reasonably or in good faith, A would not be considered to have shown reasonable cause or to have acted in good faith.

Example 2. C, an individual, sought advice from D, a friend who was not a tax professional, as to how C might reduce his Federal tax obligations. D advised C that, for a nominal investment in Corporation X, D had received certain tax benefits which virtually eliminated D's Federal tax liability. D also named other investors who had received similar benefits. Without further inquiry, C invested in X and claimed the benefits that he had been assured by D were due him. In this case, C did not make any good faith attempt to ascertain the correctness of what D had advised him concerning his tax matters, and is not considered to have reasonable cause for the underpayment attributable to the benefits claimed.

Example 3. E, an individual, worked for Company X doing odd jobs and filling in for other employees when necessary. E worked irregular hours and was paid by the hour. The amount of E's pay check differed from week to week. The Form W–2 furnished to E reflected wages for 1990 in the amount of $29,729. It did not, however, include compensation of $1,467 paid for some hours E worked. Relying on the Form W–2, E filed a return reporting wages of $29,729. E had no reason to know that the amount reported on the Form W–2 was incorrect. Under the circumstances, E is considered to have acted in good faith in relying on the Form W–2 and to have reasonable cause for the underpayment attributable to the unreported wages.

Example 4. H, an individual, did not enjoy preparing his tax returns and procrastinated in doing so until April 15th. On April 15th, H hurriedly gathered together his tax records and materials, prepared a return, and mailed it before midnight. The return contained numerous errors, some of which were in H's favor and some of which were not. The net result of all the adjustments, however, was an underpayment of tax by H. Under these circumstances, H is not considered to have reasonable cause for the underpayment or to have acted in good faith in attempting to file an accurate return.

(c) *Reliance on opinion or advice*—(1) *Facts and circumstances; minimum requirements.* All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. However, in no event will a taxpayer be considered to have reasonably relied in good faith on advice unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a professional tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

(i) *All facts and circumstances considered.* The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or should know, to be relevant to the proper tax treatment of an item.

(ii) *No unreasonable assumptions.* The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.

(2) *Advice defined.* Advice is any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty. Advice does not have to be in any particular form.

(3) *Cross-reference.* For rules applicable to advisors, see e.g., §§1.6694–1 through 1.6694–3 (regarding preparer penalties), 31 CFR 10.22 (regarding diligence as to accuracy), 31 CFR 10.33 (regarding tax shelter opinions), and 31 CFR 10.34 (regarding standards for advising with respect to tax return positions and for preparing or signing returns).

(d) *Pass-through items.* The determination of whether a taxpayer acted with reasonable cause and in good faith with respect to an underpayment that is related to an item reflected on the return of a pass-through entity is made on the basis of all pertinent facts and circumstances, including the taxpayer's own actions, as well as the actions of the pass-through entity.

(e) *Special rules for substantial understatement penalty attributable to tax shelter items of corporations*—(1) *In general; facts and circumstances.* The determination of whether a corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item (as defined in §1.6662–4(g)(3)) is based on all pertinent facts and circumstances. Paragraphs (e)(2), (3), and (4) of this section set forth rules that apply, in the case of a penalty attributable to a substantial understatement of income tax (within the meaning of section 6662(d)), in determining whether a corporation acted with reasonable cause and in good faith with respect to a tax shelter item.

(2) *Reasonable cause based on legal justification*—(i) *Minimum requirements.* A corporation's legal justification (as defined in paragraph (e)(2)(ii) of this section) may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item only if the authority requirement of paragraph (e)(2)(i)(A) of this section and the belief requirement of paragraph (e)(2)(i)(B) of this section are satisfied (the minimum requirements). Thus, a failure to satisfy the minimum requirements will preclude a finding of reasonable cause and good faith based (in whole or in part) on the corporation's legal justification.

(A) *Authority requirement.* The authority requirement is satisfied only if there is substantial authority (within the meaning of §1.6662–4(d)) for the tax treatment of the item.

(B) *Belief requirement.* The belief requirement is satisfied only if, based on all facts and circumstances, the corporation reasonably believed, at the time the return was filed, that the tax treatment of the item was more likely than not the proper treatment. For purposes of the preceding sentence, a corporation is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled)—

(*1*) The corporation analyzes the pertinent facts and authorities in the manner described in § 1.6662–4(d)(3)(ii), and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service; or

(*2*) The corporation reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in § 1.6662–4(d)(3)(ii) and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service. (For this purpose, the requirements of paragraph (c) of this section must be met with respect to the opinion of a professional tax advisor.)

(ii) *Legal justification defined.* For purposes of this paragraph (e), *legal justification* includes any justification relating to the treatment or characterization under the Federal tax law of the tax shelter item or of the entity, plan, or arrangement that gave rise to the item. Thus, a taxpayer's belief (whether independently formed or based on the advice of others) as to the merits of the taxpayer's underlying position is a legal justification.

(3) *Minimum requirements not dispositive.* Satisfaction of the minimum requirements of paragraph (e)(2) of this section is an important factor to be considered in determining whether a corporate taxpayer acted with reasonable cause and in good faith, but is not necessarily dispositive. For example, depending on the circumstances, satisfaction of the minimum requirements may not be dispositive if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed tax benefits that are unreasonable in comparison to the taxpayer's investment in the tax shelter, or if the taxpayer agreed with the organizer or promoter of the tax shelter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter.

(4) *Other factors.* Facts and circumstances other than a corporation's legal justification may be taken into account, as appropriate, in determining whether the corporation acted with reasonable cause and in good faith with respect to a tax shelter item regardless of whether the minimum requirements of paragraph (e)(2) of this section are satisfied.

(f) *Tranactions between persons described in section 482 and net section 482 transfer price adjustments.* [Reserved]

(g) *Valuation misstatements of charitable deduction property*—(1) *In general.* There may be reasonable cause and good faith with respect to a portion of an underpayment that is attributable to a substantial (or gross) valuation misstatement of charitable deduction property (as defined in paragraph (g)(2) of this section) only if—

(i) The claimed value of the property was based on a qualified appraisal (as defined in paragraph (g)(2) of this section) by a qualified appraiser (as defined in paragraph (g)(2) of this section); and

(ii) In addition to obtaining a qualified appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

(2) *Definitions.* For purposes of this paragraph (g):

Charitable deduction property means any property (other than money or publicly traded securities, as defined in § 1.170A–13(c)(7)(xi)) contributed by the taxpayer in a contribution for which a deduction was claimed under section 170.

Qualified appraisal means a qualified appraisal as defined in § 1.170A–13(c)(3).

Qualified appraiser means a qualified appraiser as defined in § 1.170A–13(c)(5).

(3) *Special rules.* The rules of this paragraph (g) apply regardless of whether § 1.170A–13 permits a taxpayer to claim a charitable contribution deduction for the property without obtaining a qualified appraisal. The rules of this paragraph (g) apply in addition

to the generally applicable rules concerning reasonable cause and good faith.

[T.D. 8381, 56 FR 67508, Dec. 31, 1991; T.D. 8381, 57 FR 6166, Feb. 20, 1992, as amended by T.D. 8617, 60 FR 45666, Sept. 1, 1995; T.D. 8790, 63 FR 66435, Dec. 2, 1998]

§1.6664–4T Reasonable cause and good faith exception to section 6662 penalties.

(a)–(e) [Reserved]

(f) *Transactions between persons described in section 482 and net section 482 transfer price adjustments.* For purposes of applying the reasonable cause and good faith exception of section 6664(c) to net section 482 adjustments, the rules of §1.6662–6(d) apply. A taxpayer that does not satisfy the rules of §1.6662–6(d) for a net section 482 adjustment cannot satisfy the reasonable cause and good faith exception under section 6664(c). The rules of this section apply to underpayments subject to the transactional penalty in §1.6662–6(b). If the standards of the net section 482 penalty exclusion provisions under §1.6662–6(d) are met with respect to such underpayments, then the taxpayer will be considered to have acted with reasonable cause and good faith for purposes of this section.

[T.D. 8656, 61 FR 4885, Feb. 9, 1996]

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(d) Effective date.

[T.D. 8382, 56 FR 67514, Dec. 31, 1991]

§1.6694–1 Section 6694 penalties applicable to income tax return preparer.

(a) *Overview.* Section 6694(a) and section 6694(b) impose penalties on income tax return preparers for certain understatements of liability on a return or claim for refund. The section 6694(a) penalty is imposed for an understatement of liability with respect to tax imposed by subtitle A of the Internal Revenue Code that is due to a position for which there was not a realistic possibility of being sustained on its merits. The section 6694(b) penalty is imposed for an understatement of liability with respect to tax imposed by subtitle A of the Internal Revenue Code that is due to a willful attempt to understate tax liability or that is due to reckless or intentional disregard of rules or regulations. See § 1.6694–2 for rules relating to the penalty under section 6694(a). See § 1.6694–3 for rules relating to the penalty under section 6694(b).

(b) *Income tax return preparer*—(1) *In general.* Solely for purposes of the regulations under section 6694, the term ''income tax return preparer'' (''preparer'') means any person who is an income tax return preparer within the meaning of section 7701(a)(36) and § 301.7701–15 of this chapter, except that no more than one individual associated with a firm (for example, as a partner or employee) is treated as a preparer with respect to the same return or claim for refund. If a signing preparer is associated with a firm, that individual, and no other individual associated with the firm, is a preparer with respect to the return or claim for purposes of section 6694. If two or more individuals associated with a firm are income tax return preparers with respect to a return or claim for refund, within the meaning of section 7701(a)(36) and § 301.7701–15 of this chapter, and none of them is the signing preparer, only one of the individuals is a preparer (i.e., nonsigning preparer) with respect to that return or claim for purposes of section 6694. In such a case, ordinarily, the individual who is a preparer for purposes of section 6694 is the individual with overall supervisory responsibility for the advice given by the firm with respect to the return or claim. To the extent provided in § 1.6694–2(a)(2) and § 1.6694–3(a)(2), an individual and the firm with which the individual is associated may both be subject to penalty under section 6694 with respect to the same return or claim for refund. If an individual (other than the sole proprietor) who is associated with a sole proprietorship is subject to penalty under section 6694, the sole proprietorship is considered a ''firm'' for purposes of this paragraph.

(2) *Signing and nonsigning preparers.* A ''signing preparer'' is any preparer who signs a return of tax or claim for refund as a preparer. A ''nonsigning preparer'' is any preparer who is not a signing preparer. Examples of nonsigning preparers are preparers who provide advice (written or oral) to a taxpayer or to a preparer who is not associated with the same firm as the preparer who provides the advice.

(3) *Example.* The provisions of paragraph (b) of this section are illustrated by the following example:

Example. Attorney A provides advice to Client C concerning the proper treatment of a significant item on C's income tax return. The advice constitutes preparation of a substantial portion of the return. In preparation for providing that advice, A discusses the matter with Attorney B, who is associated with the same firm as A, but A is the attorney with overall supervisory responsibility for the advice. Neither Attorney A nor any other attorney associated with A's firm signs C's return as a preparer. For purposes of the regulations under section 6694, A is a preparer with respect to C's return and is subject to penalty under section 6694 with respect to C's return. B is not a preparer with respect to C's return and, therefore, is not subject to penalty under section 6694 with respect to a position taken on C's return. This would be true even if B recommends that A advise C to take an undisclosed position that did not satisfy the realistic possibility standard. In addition, since B is not a preparer for purposes of the regulations under section 6694, A may not avoid a penalty under section 6694 with respect to C's return by claiming he relied on the advice of B. See § 1.6694–2(d)(5).

(c) *Understatement of liability.* For purposes of the regulations under section 6694, an ''understatement of liability'' exists if, viewing the return or claim for refund as a whole, there is an understatement of the net amount payable with respect to any tax imposed by subtitle A of the Internal Revenue Code, or an overstatement of the net amount creditable or refundable with respect to any tax imposed by subtitle A of the Internal Revenue Code. The net amount payable in a taxable year with respect to the return for which the preparer engaged in conduct proscribed by section 6694 is not reduced by any carryback. Tax imposed by subtitle A of the Internal Revenue Code does not include additions to the tax provided by section 6654 and section 6655 (relating to underpayments of estimated tax). Except as provided in paragraph (d) of this section, the determination of whether an understatement of liability exists may be made in a proceeding involving the preparer apart from any proceeding involving the taxpayer.

(d) *Abatement of penalty where taxpayer's liability not understated.* If a penalty under section 6694(a) or section 6694(b) concerning a return or claim for refund has been assessed against one or more preparers, and if it is established at any time in a final administrative determination or a final judicial decision that there was no understatement of liability relating to the return or claim for refund, then—

(1) The assessment must be abated; and

(2) If any amount of the penalty was paid, that amount must be refunded to the person or persons who so paid, as if the payment were an overpayment of tax, without consideration of any period of limitations.

(e) *Verification of information furnished by taxpayer*—(1) *In general.* For purposes of section 6694(a) and section 6694(b), the preparer generally may rely in good faith without verification upon information furnished by the taxpayer. Thus, the preparer is not required to audit, examine or review books and records, business operations, or documents or other evidence in order to verify independently the taxpayer's information. However, the preparer may not ignore the implications of information furnished to the preparer or actually known by the preparer. The preparer must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete. Additionally, some provisions of the Code or regulations require that specific facts and circumstances exist— for example, that the taxpayer maintain specific documents, before a deduction may be claimed. The preparer must make appropriate inquiries to determine the existence of facts and circumstances required by a Code section or regulation as a condition to the claiming of a deduction.

(2) *Example.* The provisions of paragraph (e) of this section are illustrated by the following example:

Example. A taxpayer, during an interview conducted by the preparer, stated that he had paid $6,500 in doctor bills and $5,000 in deductible travel and entertainment expenses during the tax year, when in fact he had paid smaller amounts. On the basis of this information, the preparer properly calculated deductions for medical expenses and for travel and entertainment expenses which resulted in an understatement of liability for tax. The preparer had no reason to believe that the medical expense and travel and entertainment expense information presented was incorrect or incomplete. The preparer did not ask for underlying documentation of the medical expenses but inquired about the existence of travel and entertainment expense records. The preparer was reasonably satisfied by the taxpayer's representations that the taxpayer had adequate records (or other sufficient corroborative evidence) for the deduction of $5,000 for travel and entertainment expenses. The preparer is not subject to a penalty under section 6694.

(f) *Effective date.* Sections 1.6694–1 through 1.6694–3 are generally effective for documents prepared and advice given after December 31, 1991. However, §1.6694–3(c)(3) (which provides that a preparer is not considered to have recklessly or intentionally disregarded a revenue ruling or notice if the position contrary to the ruling or notice has a realistic possibility of being sustained on its merits) is effective for documents prepared and advice given after December 31, 1989. Except as provided in the preceding sentence, section 6694 and the existing rules and regulations thereunder (to the extent not inconsistent with the statute as amended by the Omnibus Budget Reconciliation Act of 1989), and Notice 90–20, 1990–1 C.B. 328, apply to documents prepared and advice given on or before December 31, 1991. For the effective date of §1.6694–4, see §1.6694–4(d).

[T.D. 8382, 56 FR 67514, Dec. 31, 1991; T.D. 8382, 57 FR 6061, Feb. 19, 1992]

§ 1.6694–2 Penalty for understatement due to an unrealistic position.

(a) *In general*—(1) *Proscribed conduct.* Except as otherwise provided in this section, if any part of an understatement of liability relating to a return of tax under subtitle A of the Internal Revenue Code or claim for refund of tax under subtitle A of the Internal Revenue Code is due to a position for which there was not a realistic possibility of being sustained on its merits, any person who is a preparer with respect to such return or claim for refund who knew or reasonably should have known of such position is subject to a penalty of $250 with respect to such return or claim for refund.

(2) *Special rule for employers and partnerships.* An employer or partnership of a preparer subject to penalty under section 6694(a) is also subject to penalty only if—

(i) One or more members of the principal management (or principal officers) of the firm or a branch office participated in or knew of the conduct proscribed by section 6694(a);

(ii) The employer or partnership failed to provide reasonable and appropriate procedures for review of the position for which the penalty is imposed; or

(iii) Such review procedures were disregarded in the formulation of the advice, or the preparation of the return or claim for refund, that included the position for which the penalty is imposed.

(b) *Realistic possibility of being sustained on its merits*—(1) *In general.* A position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits (realistic possibility standard). In making this determination, the possibility that the position will not be challenged by the Internal Revenue Service (e.g., because the taxpayer's return may not be audited or because the issue may not be raised on audit) is not to be taken into account. The analysis prescribed by § 1.6662–4(d)(3)(ii) for purposes of determining whether substantial authority is present applies for purposes of determining whether the realistic possibility standard is satisfied.

(2) *Authorities.* The authorities considered in determining whether a position satisfies the realistic possibility standard are those authorities provided in § 1.6662–4(d)(3)(iii).

(3) *Examples.* The provisions of paragraphs (b)(1) and (b)(2) of this section are illustrated by the following examples:

Example 1. A new statute is unclear as to whether a certain transaction that a taxpayer has engaged in will result in favorable tax treatment. Prior law, however, supported the taxpayer's position. There are no regulations under the new statute and no authority other than the statutory language and committee reports. The committee reports state that the intent was not to adversely affect transactions similar to the taxpayer's transaction. The taxpayer's position satisfies the realistic possibility standard.

Example 2. A taxpayer has engaged in a transaction that is adversely affected by a new statutory provision. Prior law supported a position favorable to the taxpayer. The preparer believes that the new statute is inequitable as applied to the taxpayer's situation. The statutory language is unambiguous as it applies to the transaction (e.g., it applies to all manufacturers and the taxpayer is a manufacturer of widgets). The committee reports do not specifically address the taxpayer's situation. A position contrary to the statute does not satisfy the realistic possibility standard.

Example 3. The facts are the same as in *Example 2,* except the committee reports indicate that Congress did not intend to apply the new statutory provision to the taxpayer's transaction (e.g., to a manufacturer of widgets). Thus, there is a conflict between the general language of the statute, which adversely affects the taxpayer's transaction, and a specific statement in the committee reports that transactions such as the taxpayer's are not adversely affected. A position consistent with either the statute or the committee reports satisfies the realistic possibility standard. However, a position consistent with the committee reports constitutes a disregard of a rule or regulation and, therefore, must be adequately disclosed in order to avoid the section 6694(b) penalty.

Example 4. The instructions to an item on a tax form published by the Internal Revenue Service are incorrect and are clearly contrary to the regulations. Before the return is prepared, the Internal Revenue Service publishes an announcement acknowledging the error and providing the correct instruction. Under these facts, a position taken on a return which is consistent with the regulations satisfies the realistic possibility standard. On the other hand, a position taken on a return which is consistent with the incorrect instructions does not satisfy the realistic possibility standard. However, if the preparer relied on the incorrect instructions and was not aware of the announcement or the regulations, the reasonable cause and good faith exception may apply depending on all facts and circumstances. See § 1.6694–2(d).

Example 5. A statute is silent as to whether a taxpayer may take a certain position on the taxpayer's 1991 Federal income tax return. Three private letter rulings issued to other taxpayers in 1987 and 1988 support the taxpayer's position. However, proposed regulations issued in 1990 are clearly contrary to the taxpayer's position. After the issuance of the proposed regulations, the earlier private letter rulings cease to be authorities and are not taken into account in determining whether the taxpayer's position satisfies the realistic possibility standard. See § 1.6694–2(b)(2) and § 1.6662–4(d)(3)(iii). The taxpayer's position may or may not satisfy the realistic possibility standard, depending on an analysis of all the relevant authorities.

Example 6. In the course of researching whether a particular position has a realistic possibility of being sustained on its merits, a preparer discovers that a taxpayer took the same position on a return several years ago and that the return was audited by the Service. The taxpayer tells the preparer that the revenue agent who conducted the audit was aware of the position and decided that the treatment on the return was correct. The revenue agent's report, however, made no mention of the position. The determination by the revenue agent is not authority for purposes of the realistic possibility standard. However, the preparer's reliance on the revenue agent's determination in the audit may qualify for the reasonable cause and good faith exception depending on all facts and circumstances. See § 1.6694–2(d). Also see § 1.6694–2(b)(4) and § 1.6662–4(d)(3)(iv)(A) regarding affirmative statements in a revenue agent's report.

Example 7. In the course of researching whether an interpretation of a phrase incorporated in the Internal Revenue Code has a realistic possibility of being sustained on its merits, a preparer discovers that identical language in the taxing statute of another jurisdiction (e.g., a state or foreign country) has been authoritatively construed by a court of that jurisdiction in a manner which would be favorable to the taxpayer, if the same interpretation were applied to the phrase applicable to the taxpayer's situation. The construction of the statute of the other jurisdiction is not authority for purposes of determining whether the position satisfies the realistic possibility standard. See § 1.6694–2(b)(2) and § 1.6662–4(d)(3)(iii). However, as in the case of conclusions reached in treatises and legal periodicals, the authorities underlying the court's opinion, if relevant to the taxpayer's situation, may give a position favorable to the taxpayer a realistic possibility of being sustained on its merits. See § 1.6694–2(b)(2) and § 1.6662–4(d)(3)(iii).

Example 8. In the course of researching whether an interpretation of a statutory phrase has a realistic possibility of being sustained on its merits, a preparer discovers that identical language appearing in another place in the Internal Revenue Code has consistently been interpreted by the courts and by the Service in a manner which would be favorable to the taxpayer, if the same interpretation were applied to the phrase applicable to the taxpayer's situation. No authority has interpreted the phrase applicable to the taxpayer's situation. The interpretations of the identical language are relevant in arriving at a well reasoned construction of the language at issue, but the context in which the language arises also must be taken into account in determining whether the realistic possibility standard is satisfied.

Example 9. A new statutory provision is silent on the tax treatment of an item under the provision. However, the committee reports explaining the provision direct the Treasury to issue regulations interpreting the provision in a specified way. No regulations have been issued at the time the preparer must recommend a position on the tax treatment of the item, and no other authorities exist. The position supported by the committee reports satisfies the realistic possibility standard.

(4) *Written determinations.* To the extent a position has substantial authority with respect to the taxpayer by virtue of a ''written determination'' as provided in § 1.6662–4(d)(3)(iv)(A), such position will be considered to satisfy the realistic possibility standard with respect to the taxpayer's preparer for purposes of section 6694(a).

(5) *When ''realistic possibility'' determined.* For purposes of this section, the requirement that a position satisfy the realistic possibility standard must be satisfied on the date prescribed by paragraph (b)(5)(i) or (b)(5)(ii) of this section, whichever is applicable.

(i) *Signing preparers*—(A) In the case of a signing preparer, the relevant date is the date the preparer signs and dates the return or claim for refund.

(B) If the preparer did not date the return or claim for refund, the relevant date is the date the taxpayer signed and dated the return or claim for refund. If the taxpayer also did not date the return or claim for refund, the relevant date is the date the return or claim for refund was filed.

(ii) *Nonsigning preparers.* In the case of a nonsigning preparer, the relevant date is the date the preparer provides the advice. That date will be determined based on all the facts and circumstances.

(c) *Exception for adequate disclosure of nonfrivolous positions*—(1) *In general.* The section 6694(a) penalty will not be imposed on a preparer if the position taken is not frivolous and is adequately disclosed. For an exception to the section 6694(a) penalty for reasonable cause and good faith, see paragraph (d) of this section.

(2) *Frivolous.* For purposes of this section, a ‘‘frivolous’’ position with respect to an item is one that is patently improper.

(3) *Adequate disclosure*—(i) *Signing preparers.* In the case of a signing preparer, disclosure of a position that does not satisfy the realistic possibility standard is adequate only if the disclosure is made in accordance with § 1.6662–4(f) (which permits disclosure on a properly completed and filed Form 8275 or 8275–R, as appropriate, or on the return in accordance with an annual revenue procedure).

(ii) *Nonsigning preparers.* In the case of a nonsigning preparer, disclosure of a position that does not satisfy the realistic possibility standard is adequate if the position is disclosed in accordance with § 1.6662–4(f) (which permits disclosure on a properly completed and filed Form 8275 or 8275–R, as appropriate, or on the return in accordance with an annual revenue procedure). In addition, disclosure of a position is adequate in the case of a nonsigning preparer if, with respect to that position, the preparer complies with the provisions of paragraph (c)(3)(ii)(A) or (B) of this section, whichever is applicable.

(A) *Advice to taxpayers.* If a nonsigning preparer provides advice to the taxpayer with respect to a position that does not satisfy the realistic possibility standard, disclosure of that position is adequate if the advice includes a statement that the position lacks substantial authority and, therefore, may be subject to penalty under section 6662(d) unless adequately disclosed in the manner provided in § 1.6662–4(f) (or in the case of a tax shelter item, that the position lacks substantial authority and, therefore, may be subject to penalty under section 6662(d) regardless of disclosure). If the advice with respect to the position is in writing, the statement concerning disclosure (or the statement regarding possible penalty under section 6662(d)) also must be in writing. If the advice with respect to the position is oral, advice to the taxpayer concerning the need to disclose (or the advice regarding possible penalty under section 6662(d)) also may be oral. The determination as to whether oral advice as to disclosure (or the oral advice regarding possible penalty under section 6662(d)) was in fact given is based on all facts and circumstances. Contemporaneously prepared documentation of the oral advice regarding disclosure (or the oral advice regarding possible penalty under section 6662(d)) generally is sufficient to establish that the advice was given to the taxpayer.

(B) *Advice to another preparer.* If a nonsigning preparer provides advice to another preparer with respect to a position that does not satisfy the realistic possibility standard, disclosure of that position is adequate if the advice includes a statement that disclosure under section 6694(a) is required. If the advice with respect to the position is in writing, the statement concerning disclosure also must be in writing. If the advice with respect to the position is oral, advice to the preparer concerning the need to disclose also may be oral. The determination as to whether oral advice as to disclosure was in fact given is based on all facts and circumstances. Contemporaneously prepared documentation of the oral advice regarding disclosure generally is sufficient to establish that the advice regarding disclosure was given to the other preparer.

(d) *Exception for reasonable cause and good faith.* The penalty under section 6694(a) will not be imposed if considering all the facts and circumstances, it is determined that the understatement was due to reasonable cause and that the preparer acted in good faith. Factors to consider include:

(1) *Nature of the error causing the understatement.* Whether the error resulted from a provision that was so complex, uncommon, or highly technical that a competent preparer of returns or claims of the type at issue reasonably could have made the error. The reasonable cause and good faith exception does not apply to an error that would have been apparent from a general review of the return or claim for refund by the preparer.

(2) *Frequency of errors.* Whether the understatement was the result of an isolated error (such as an inadvertent mathematical or clerical error) rather than a number of errors. Although the reasonable cause and good faith exception generally applies to an isolated error, it does not apply if the isolated error is so obvious, flagrant or material that it should have been discovered during a review of the return or claim. Furthermore, the reasonable cause and good faith exception does not apply if there is a pattern of errors on a return or claim for refund even though any one error, in isolation, would have qualified for the reasonable cause and good faith exception.

(3) *Materiality of errors.* Whether the understatement was material in relation to the correct tax liability. The reasonable cause and good faith exception generally applies if the understatement is of a relatively immaterial amount. Nevertheless, even an immaterial understatement may not qualify for the reasonable cause and good faith exception if the error or errors creating the understatement are sufficiently obvious or numerous.

(4) *Preparer's normal office practice.* Whether the preparer's normal office practice, when considered together with other facts and circumstances such as the knowledge of the preparer, indicates that the error in question would rarely occur and the normal office practice was followed in preparing the return or claim in question. Such a normal office practice must be a system for promoting accuracy and consistency in the preparation of returns or claims and generally would include, in the case of a signing preparer, checklists, methods for obtaining necessary information from the taxpayer, a review of the prior year's return, and review procedures. Notwithstanding the above, the reasonable cause and good faith exception does not apply if there is a flagrant error on a return or claim for refund, a pattern of errors on a return or claim for refund, or a repetition of the same or similar errors on numerous returns or claims.

(5) *Reliance on advice of another preparer.* Whether the preparer relied on the advice of or schedules prepared by (‘‘advice’’) another preparer as defined in §1.6694–1(b). The reasonable cause and good faith exception applies if the preparer relied in good faith on the advice of another preparer (or a person who would be considered a preparer under §1.6694–1(b) had the advice constituted preparation of a substantial portion of the return or claim for refund) who the preparer had reason to believe was competent to render such advice. A preparer is not considered to have relied in good faith if—

(i) The advice is unreasonable on its face;

(ii) The preparer knew or should have known that the other preparer was not aware of all relevant facts; or

(iii) The preparer knew or should have known (given the nature of the preparer's practice), at the time the return or claim for refund was prepared, that the advice was no longer reliable due to developments in the law since the time the advice was given.

The advice may be written or oral, but in either case the burden of establishing that the advice was received is on the preparer.

(e) *Burden of proof.* In any proceeding with respect to the penalty imposed by section 6694(a), the issues on which the preparer bears the burden of proof include whether—

(1) The preparer knew or reasonably should have known that the questioned position was taken on the return;

(2) There is reasonable cause and good faith with respect to such position; and

(3) The position was disclosed adequately in accordance with paragraph (c) of this section.

[T.D. 8382, 56 FR 67516, Dec. 31, 1991; T.D. 8382, 57 FR 6061, Feb. 19, 1992]

§ 1.6694–3 Penalty for understatement due to willful, reckless, or intentional conduct.

(a) *In general*—(1) *Proscribed conduct.* If any part of an understatement of liability relating to a return of tax under subtitle A of the Internal Revenue Code or claim for refund of tax under subtitle A of the Internal Revenue Code is due to—

(i) A willful attempt in any manner to understate the liability for tax by a preparer of the return or claim for refund; or

(ii) Any reckless or intentional disregard of rules or regulations by any such person,

such preparer is subject to a penalty of $1,000 with respect to such return or claim for refund.

(2) *Special rule for employers and partnerships.* An employer or partnership of a preparer subject to penalty under section 6694(b) is also subject to penalty only if—

(i) One or more members of the principal management (or principal officers) of the firm or a branch office participated in or knew of the conduct proscribed by section 6694(b);

(ii) The employer or partnership failed to provide reasonable and appropriate procedures for review of the position for which the penalty is imposed; or

(iii) Such review procedures were disregarded in the formulation of the advice, or the preparation of the return or claim for refund, that included the position for which the penalty is imposed.

(b) *Willful attempt to understate liability.* A preparer is considered to have willfully attempted to understate liability if the preparer disregards, in an attempt wrongfully to reduce the tax liability of the taxpayer, information furnished by the taxpayer or other persons. For example, if a preparer disregards information concerning certain items of taxable income furnished by the taxpayer or other persons, the preparer is subject to the penalty. Similarly, if a taxpayer states to a preparer that the taxpayer has only two dependents, and the preparer reports six dependents on the return, the preparer is subject to the penalty.

(c) *Reckless or intentional disregard.* (1) Except as provided in paragraphs (c)(2) and (c)(3) of this section, a preparer is considered to have recklessly or intentionally disregarded a rule or regulation if the preparer takes a position on the return or claim for refund that is contrary to a rule or regulation (as defined in paragraph (f) of this section) and the preparer knows of, or is reckless in not knowing of, the rule or regulation in question. A preparer is reckless in not knowing of a rule or regulation if the preparer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable preparer would observe in the situation.

(2) A preparer is not considered to have recklessly or intentionally disregarded a rule or regulation if the position contrary to the rule or regulation is not frivolous as defined in § 1.6694–2(c)(2), is adequately disclosed in accordance with paragraph (e) of this section and, in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of the regulation.

(3) In the case of a position contrary to a revenue ruling or notice (other than a notice of proposed rulemaking) published by the Service in the Internal Revenue Bulletin, a preparer also is not considered to have recklessly or intentionally disregarded the ruling or notice if the position has a realistic possibility of being sustained on its merits.

(d) *Examples.* The provisions of paragraphs (b) and (c) of this section are illustrated by the following examples:

Example 1. A taxpayer provided a preparer with detailed check registers reflecting personal and business expenses. One of the expenses was for domestic help, and this expense was identified as personal on the check register. The preparer knowingly deducted the expenses of the taxpayer's domestic help as wages paid in the taxpayer's business. The preparer is subject to the penalty under section 6694(b).

Example 2. A taxpayer provided a preparer with detailed check registers to compute the taxpayer's expenses. However, the preparer knowingly overstated the expenses on the return. After adjustments by the examiner, the tax liability increased significantly. Because the preparer disregarded information provided in the check registers, the preparer is subject to the penalty under section 6694(b).

Example 3. A revenue ruling holds that certain expenses incurred in the purchase of a business must be capitalized. The Code is silent as to whether these expenses must be capitalized or may be deducted currently, but several cases from different courts hold that these particular expenses may be deducted currently. There is no other authority. Under these facts, a position taken contrary to the revenue ruling on a return or claim for refund is not a reckless or intentional disregard of a rule, since the position contrary to the revenue ruling has a realistic possibility of being sustained on its merits. Therefore, the preparer will not be subject to a penalty under section 6694(b) even though the position is not adequately disclosed.

Example 4. Final regulations provide that certain expenses incurred in the purchase of a business must be capitalized. One Tax Court case has expressly invalidated that portion of the regulations. Under these facts, a position contrary to the regulation will subject the preparer to the section 6694(b) penalty even though the position may have a realistic possibility of being sustained on its merits. However, because the contrary position on these facts represents a good faith challenge to the validity of the regulations, the preparer will not be subject to the section 6694(b) penalty if the position is adequately disclosed in the manner provided in paragraph (e) of this section.

(e) *Adequate disclosure*—(1) *Signing preparers.* In the case of a signing preparer, disclosure of a position that is contrary to a rule or regulation is adequate only if the disclosure is made in accordance with §1.6662–4(f) (1), (3), (4) and (5) (which permit disclosure on a properly completed and filed Form 8275 or 8275–R, as appropriate). In addition, the disclosure of a position that is contrary to a rule or regulation must adequately identify the rule or regulation being challenged. The provisions of §1.6662–4(f)(2) (which permit disclosure on the return in accordance with an annual revenue procedure) do not apply for purposes of this section.

(2) *Nonsigning preparers.* In the case of a nonsigning preparer, disclosure of a position that is contrary to a rule or regulation is adequate if the position is disclosed in the manner provided in paragraph (e)(1) of this section. In addition, disclosure of a position is adequate in the case of a nonsigning preparer if, with respect to that position, the preparer complies with the provisions of paragraph (e)(2) (i) or (ii) of this section, whichever is applicable.

(i) *Advice to taxpayers.* In the case of a nonsigning preparer who provides advice to the taxpayer with respect to a position that is contrary to a rule or regulation, disclosure of that position is adequate if the advice includes a statement that—

(A) The position is contrary to a specified rule or regulation and, therefore, is subject to a penalty described in section 6662(c) unless adequately disclosed in the manner provided in §1.6662–3(c)(2) (which permits disclosure on a properly completed and filed Form 8275 or 8275–R, as appropriate, and which requires adequate identification of any rule or regulation being challenged); and

(B) In the case of a position contrary to a regulation, the position must represent a good faith challenge to the validity of the regulation.

If the advice with respect to the position is in writing, the statement concerning disclosure also must be in writing. If the advice with respect to the position is oral, advice to the taxpayer concerning the need to disclose also may be oral. The determination as to whether oral advice as to disclosure was in fact given is based on all facts and circumstances. Contemporaneously prepared documentation of the oral advice regarding disclosure generally is sufficient to establish that the advice was given to the taxpayer.

(ii) *Advice to another preparer.* If a nonsigning preparer provides advice to another preparer with respect to a position that is contrary to a rule or regulation, disclosure of that position is considered adequate if the advice includes a statement that disclosure under section 6694(b) is required. If the advice with respect to the position is in writing, the statement concerning disclosure also must be in writing. If the advice with respect to the position is oral, advice to the preparer concerning the need to disclose also may be oral. The determination as to whether oral advice as to disclosure was in fact given is based on all facts and circumstances. Contemporaneously prepared documentation of the oral advice regarding disclosure generally is sufficient to establish that the advice was given to the other preparer.

(f) *Rules or regulations.* The term ''rules or regulations'' includes the provisions of the Internal Revenue Code, temporary or final Treasury regulations issued under the Code, and revenue rulings or notices (other than notices of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin.

(g) *Section 6694(b) penalty reduced by section 6694(a) penalty.* The amount of any penalty to which a preparer may be subject under section 6694(b) for a return or claim for refund is $1,000 reduced by any amount assessed and collected against the preparer under section 6694(a) for the same return or claim.

(h) *Burden of proof.* In any proceeding with respect to the penalty imposed by section 6694(b), the Government bears the burden of proof on the issue of whether the preparer willfully attempted to understate the liability for tax. See section 7427. The preparer bears the burden of proof on such other issues as whether—

(1) The preparer recklessly or intentionally disregarded a rule or regulation;

(2) A position contrary to a regulation represents a good faith challenge to the validity of the regulation; and

(3) Disclosure was adequately made in accordance with paragraph (e) of this section.

[T.D. 8382, 56 FR 67518, Dec. 31, 1991]

§ 1.6694–4 Extension of period of collection where preparer pays 15 percent of a penalty for understatement of taxpayer's liability and certain other procedural matters.

(a) *In general.* (1) The Internal Revenue Service will investigate the preparation by a preparer of a return of tax under subtitle A of the Internal Revenue Code or claim for refund of tax under subtitle A of the Internal Revenue Code and will send a report of the examination to the preparer before the assessment of either—

(i) A penalty for understating tax liability due to a position for which there was not a realistic possibility of being sustained on its merits under section 6694(a); or

(ii) A penalty for willful understatement of liability or reckless or intentional disregard of rules or regulations under section 6694(b).

Unless the period of limitations (if any) under section 6696(d) may expire without adequate opportunity for assessment, the Internal Revenue Service will also send, before assessment of either penalty, a 30-day letter to the preparer notifying him of the proposed penalty or penalties and offering an opportunity to the preparer to request further administrative consideration and a final administrative determination by the Internal Revenue Service concerning the assessment. If the preparer then makes a timely request, assessment may not be made until the Internal Revenue Service makes a final administrative determination adverse to the preparer.

(2) If the Internal Revenue Service assesses either of the two penalties described in section 6694(a) and section 6694(b), it will send to the preparer a statement of notice and demand, separate from any notice of a tax deficiency, for payment of the amount assessed.

(3) Within 30 days ofter the day on which notice and demand of either of the two penalties described in section 6694(a) and section 6694(b) is made against the preparer, the preparer must either—

(i) Pay the entire amount assessed (and may file a claim for refund of the amount paid at any time not later than 3 years after the date of payment); or

(ii) Pay an amount which is not less than 15 percent of the entire amount assessed with respect to each return or claim for refund and file a claim for refund of the amount paid.

(4) If the preparer pays an amount and files a claim for refund under paragraph (a)(3)(ii) of this section, the Internal Revenue Service may not make, begin, or prosecute a levy or proceeding in court for collection of the unpaid remainder of the amount assessed until the later of—

(i) A date which is more than 30 days after the earlier of—

(A) The day on which the preparer's claim for refund is denied; or

(B) The expiration of 6 months after the day on which the preparer filed the claim for refund; and

(ii) Final resolution of any proceeding begun as provided in paragraph (b) of this section.

However, the Internal Revenue Service may counterclaim in any proceeding begun as provided in paragraph (b) of this section for the unpaid remainder of the amount asssessed. Final resolution of a proceeding includes any settlement between the Internal Revenue Service and the preparer, any final determination by a court (for which the period for appeal, if any, has expired) and, generally, the types of determinations provided under section 1313(a) (relating to taxpayer deficiencies). Notwithstanding section 7421(a) (relating to suits to restrain asssessment or collection), the beginning of a levy or proceeding in court by the Internal Revenue Service in contravention of this paragraph (a)(4) may be enjoined by a proceeding in the proper court.

(b) *Preparer must bring suit in district court to determine liability for penalty.* If, within 30 days after the earlier of—

(1) The day on which the preparer's claim for refund filed under paragraph (a)(3)(ii) of this section is denied; or

(2) The expiration of 6 months after the day on which the preparer filed the claim for refund.

The preparer fails to begin a proceeding for refund in the appropriate United States district court, the Internal Revenue Service may proceed with collection of the amount of the penalty not paid under paragraph (a)(3)(ii) of this section.

(c) *Suspension of running of period of limitations on collection.* The running of the period of limitations provided in section 6502 on the collection by levy or by a proceeding in court of the unpaid amount of a penalty or penalties described in section 6694(a) or section 6694(b) is suspended for the period during which the Internal Revenue Service, under paragraph (a)(4) of this section, may not collect the unpaid amount of the penalty or penalties by levy or a proceeding in court.

(d) *Effective date.* The provisions of this section are effective as of December 19, 1989.

[T.D. 8382, 56 FR 67519, Dec. 31, 1991, T.D. 8382, 57 FR 6061, Feb. 19, 1992]

§1.6695–1 Other assessable penalties with respect to the preparation of income tax returns for other persons.

(a) *Failure to furnish copy to taxpayer.* (1) A person who is an income tax return preparer of any return of tax under subtitle A of the Internal Revenue Code or claim for refund of tax under subtitle A of the Internal Revenue Code and who fails to satisfy the requirements imposed by section 6107(a) and §1.6107–1 (a) and (c) to furnish a copy of the return or claim for refund to the taxpayer (or nontaxable entity), shall be subject to a penalty of $50 for such failure, with a maximum penalty of $25,000 per person imposed with respect to each calendar year, unless it is shown that the failure is due to reasonable cause and not due to willful neglect. Thus, no penalty may be imposed under section 6695(a) and this paragraph (a)(1) upon a person who is an income tax return preparer solely by reason of—

(i) Section 301.7701–15 (a)(2) and (b) on account of having given advice on specific issues of law; or

(ii) Section 301.7701–15(b)(3) on account of having prepared the return solely because of having prepared another return which affects amounts reported on the return.

(2) No penalty may be imposed under section 6695(a) and paragraph (a)(1) of this section upon an income tax return preparer who furnishes a copy of the return or claim for refund to a taxpayer:

(i) Who holds an elected or politically appointed position with the government of the United States or a State or political subdivision thereof; and

(ii) Who, in order faithfully to carry out his official duties, has so arranged his affairs that he has less than full knowledge of the property which he holds or of the debts for which he is responsible, if information is deleted from the copy in order to preserve or maintain this arrangement.

(b) *Failure to sign return.* (1) Unless the Secretary has prescribed another method of signing pursuant to § 301.6061–1(b) of this chapter on or after July 21, 1995, an individual who is an income tax return preparer with respect to a return of tax under subtitle A of the Internal Revenue Code (Code) or claim for refund of tax under subtitle A of the Code shall manually sign the return or claim for refund (which may be a photocopy) in the appropriate space provided on the return or claim for refund after it is completed and before it is presented to the taxpayer (or nontaxable entity) for signature. Except as provided in paragraphs (b)(4)(iii) and (iv) of this section, an individual preparer may not satisfy this requirement by use of a facsimile signature stamp or signed gummed label. If the preparer is unavailable for signature, another preparer shall review the entire preparation of the return or claim for refund, and then shall manually sign the return or claim for refund.

(2) If more than one income tax return preparer is involved in the preparation of the return or claim for refund, the individual preparer who has the primary responsibility as between or among the preparers for the overall substantive accuracy of the preparation of such return or claim for refund shall be considered to be the income tax return preparer for purposes of this paragraph.

(3) The application of paragraphs (b)(1) and (2) of this section is illustrated by the following examples:

Example (1). X law firm employs Y, a lawyer, to prepare for compensation returns and claims for refund of taxes. X is employed by T, a taxpayer, to prepare his 1977 Federal tax return. X assigns Y to prepare T's return. Y obtains the information necessary for completing the return from T and makes determinations with respect to the proper application of the tax laws to such information in order to determine T's tax liability. Y then forwards such information to C, a computer tax service which performs the mathematical computations and prints the return form by means of computers. C then sends the completed return to Y who reviews the accuracy of the return. Y is the individual preparer who is primarily responsible for the overall accuracy of T's return. Y must sign the return as preparer.

Example (2). X partnership is a national accounting firm which prepares for compensation returns and claims for refund of taxes. A and B, employees of X, are involved in preparing the 1977 tax return of T Corporation. After they complete the return, including the gathering of the necessary information, the proper application of the tax laws to such information, and the performance of the necessary mathematical computations, C, a supervisory employee of X, reviews the return. As part of this review, C reviews the information provided and the application of the tax laws to this information. The mathematical computations and carried-forward amounts are proved by D, an employee of X's comparing and proving department. The policies and practices of X require that P, a partner, finally review the return. The scope of P's review includes reviewing the information provided by applying to this information his knowledge of T's affairs, observing that X's policies and practices have been followed, and making the final determination with respect to the proper application of the tax laws to determine T's tax liability. P may or may not exercise these responsibilities, or may exercise them to a greater or lesser extent, depending on the degree of complexity of the return, his confidence in C (or A and B), and other factors. P is the individual preparer who is primarily responsible for the overall accuracy of T's return. P must sign the return as preparer.

Example (3). C corporation maintains an office in Seattle, Washington, for the purpose of preparing for compensation returns and claims for refund of taxes. C makes compensatory arrangements with individuals (but provides no working facilities) in several States to collect information from taxpayers and to make determinations with respect to the proper application of the tax laws to the information in order to determine the tax liabilities of such taxpayers. E, an individual, who has such an arrangement in Los Angeles with C, collects information from T, a taxpayer, and completes a worksheet kit supplied by C which is stamped with E's name and an identification number assigned to E by C. In this process, E classifies this information in appropriate income and deduction categories for the tax determination. The completed worksheet kit signed by E, is then mailed to C. D, an employee in C's office, reviews the worksheet kit to make sure it was properly completed. D does not review the information obtained from T for its validity or accuracy. D may, but did not, make the final determination with respect to the proper application of tax laws to the information. The data from the worksheet is entered into a computer and the return form is completed. The return is prepared for submission to T with filing instructions. E is the individual preparer primarily responsible for the overall accuracy of T's return. E must sign the return as preparer.

Example (4). X employs A, B, and C to prepare income tax returns for taxpayers. After A and B have collected the information from the taxpayer and applied the tax laws to the information, the return form is completed by computer service. On the day the returns prepared by A and B are ready for their signatures, A is away from the city for 1 week on another assignment and B is on detail to another office for the day. C may sign the returns prepared by A, provided that (i) C reviews the information obtained by A relative to the taxpayer, and (ii) C reviews the preparation of each return prepared by A. C may not sign the returns prepared by B because B is available.

(4)(i) [Reserved]. For further guidance on acceptable methods of meeting the manual signature requirement of paragraphs (b)(1) and (2) of this section, see §1.6695–1T(b)(4)(i).

(ii) If mechanical preparation of the return or claim for refund is accomplished by computer not under the control of the individual preparer, then the manual signature requirement of paragraphs (b) (1) and (2) of this section may be satisfied by a manually signed attestation by the individual preparer attached to the return or claim for refund that all the information contained in the return or claim for refund was obtained from the taxpayer and is true and correct to the best of his knowledge, but only if that information (including any supplemental written information provided and signed by the preparer) is not altered on the return or claim for refund by another person. For purposes of the preceding sentence, the correction of arithmetical or clerical errors, discernible from the information submitted by the preparer does not constitute an alteration. The information submitted by the preparer shall be retained by the employer of the preparer or by the partnership in which the preparer is a partner, or by the preparer (if not employed or engaged by a preparer and not a partner in a partnership which is a preparer). A record of any arithmetical or clerical errors corrected shall be retained by the person required to retain the information submitted by the preparer and made available upon request.

(iii) A preparer of a return or claim for refund for a nonresident alien individual taxpayer who is authorized to sign the return or claim for refund for the taxpayer may satisfy the manual signature requirement of paragraphs (b) (1) and (2) of this section by a facsimile signature if the preparer is permitted to use a facsimile signature in signing the return or claim for refund for the taxpayer. This subdivision (iii) shall apply only if the preparer submits to the Internal Revenue Service with the returns or claims for refund bearing the preparer's facsimile signature a letter, manually signed by the preparer, indentifying by taxpayer name and identification number each return or claim for refund bearing the facsimile signature and declaring that the facsimile signature appearing on these returns or claims for refund is the signature used by the preparer to sign these documents. After the facsimile signature is affixed, no person other than the preparer may alter any entries on the return or claim for refund other than to correct arithmetical errors discernible on the return or claim for refund. The employer of the preparer or the partnership in which the preparer is a partner, or the preparer (if not employed or engaged by a preparer and not a partner in a partnership which is a preparer) shall retain a manually signed copy of the letter submitted to the Internal Revenue Service with the returns or claims for refund. A record of any arithmetical errors corrected shall be retained by the person required to retain the manually signed letter and made available upon request.

(iv) A preparer of a fiduciary return may satisfy the manual signature requirement of paragraphs (b) (1) and (2) of this section by a facsimile signature only if the preparer submits to the Internal Revenue Service with the returns bearing the preparer's facsimile signature a letter, manually signed by the preparer, identifying by taxpayer name and identification number each return bearing the facsimile signature and declaring under penalties of perjury that the facsimile signature appearing on these returns is the signature used by the preparer to sign these documents. After the facsimile signature is affixed, no person other than the preparer may alter any entries on the return other than to correct arithmetical errors discernable on the return. The employer of the preparer or the partnership in which the preparer is a partner, or the preparer (if not employed or engaged by a preparer and not a partner in a partnership which is a preparer), shall retain a manually signed copy of the letter submitted to the Internal Revenue Service with the returns. A record of any arithmetical errors corrected shall be retained by the person required to keep the manually signed letter and that person shall make the record available to the Internal Revenue Service upon request. The preparer of a fiduciary claim for refund may not satisfy the manual signature requirement of paragraphs (b) (1) and (2) of this section by a facsimile signature.

(v) Any items required to be retained and kept available for inspection under paragraph (b)(4) (i), (ii), (iii), or (iv) of this section shall be retained and kept available for inspection for the same period that the material described in § 1.6107–1(b) must be retained and kept available for inspection.

(vi) If the district director, service center director, or compliance center director (director) determines that a preparer or preparers have abused the permissive signature rules of this paragraph (b)(4), such as by altering the return or claim for refund after signature (in contravention of paragraph (b)(4)(i) of this section), by altering information on the return or claim for refund after attestation (in contravention of paragraph (b)(4)(ii) of this section), or by failing to comply with the provisions of paragraph (b)(4) (iii) or (iv) of this section, then the director may, by written notice, prospectively deny to the preparer or preparers the right to use the permissive signature rules of this paragraph (b)(4).

(5) An individual required by this paragraph (b) to sign a return or claim for refund shall be subject to a penalty of $50 for each failure to sign, with a maximum of $25,000 per person imposed with respect to each calendar year, unless it is shown that the failure is due to reasonable cause and not due to willful neglect. For purposes of this paragraph (b), reasonable cause is a cause which arises despite ordinary care and prudence exercised by the individual preparer. Thus, no penalty may be imposed under section 6695(b) and this paragraph (b) upon a person who is an income tax return preparer solely by reason of—

(i) Section 301.7701–15(a)(2) and (b) on account of having given advice on specific issues of law; or

(ii) Section 301.7701–15(b)(3) on account of having prepared the return solely because of having prepared another return which affects amounts reported on the return.

If the preparer asserts reasonable cause for failure to sign, the Service shall require a written statement in substantiation of the preparer's claim of reasonable cause.

(c) *Failure to furnish identifying number.* (1) A person who is an income tax return preparer of any return of tax under subtitle A of the Internal Revenue Code or claim for refund of tax under subtitle A of the Internal Revenue Code and who fails to satisfy the requirement of section 6109(a)(4) and § 1.6109–2(a) to furnish one or more identifying numbers of preparers on a return or claim for refund shall be subject to a penalty of $50 for each failure, with a maximum of $25,000 per person imposed with respect to each calendar year, unless it is shown that the failure is due to reasonable cause and not due to willful neglect. Thus, no penalty may be imposed under section 6695(c) and this paragraph (c)(1) upon a person who is an income tax return preparer solely by reason of—

(i) Section 301.7701–15 (a)(2) and (b) on account of having given advice on specific issues of law; or

(ii) Section 301.7701–15(b)(3) on account of having prepared the return solely because of having prepared another return which affects amounts reported on the return.

(2) No penalty may be imposed under section 6695(c) and paragraph (c)(1) of this section upon:

(i) A preparer who is employed (or engaged) by a person who is also a preparer of the return or claim for refund, or

(ii) A preparer who is a partner in a partnership which is also a preparer of the return or claim for refund.

(3) No more than one penalty of $50 may be imposed under section 6695(c) and paragraph (c)(1) of this section with respect to a single return or claim for refund.

(d) *Failure to retain copy or record.* (1) A person who is an income tax return preparer of any return of tax under subtitle A of the Internal Revenue Code of 1954 or claim for refund of tax under subtitle A of the Internal Revenue Code of 1954 and who fails to satisfy the reruirements imposed upon him by section 6107(b) and §1.6107–1 (b) and (c) (other than the record requirement described in both §1.6107–1(b) (2) and (3)) to retain and make available a copy of the return or claim for refund, or to include the return or claim for refund in a record of returns and claims for refund and make the record available for inspection, shall be subject to a penalty of $50 for the failure, unless it is shown that the failure is due to reasonable cause and not due to willful neglect. Thus, no penalty may be imposed under section 6695(d) and this paragraph (d)(1) upon a person who is an income tax return preparer solely by reason of:

(i) Section 301.7701–15 (a)(2) and (b) on account of having given advice on specific issues of law; or

(ii) Section 301.7701–15(b)(3) on account of having prepared the return solely because of having prepared another return which affects amounts reported on the return.

(2) A person may not, for returns or claims for refund presented to the taxpayers (or nontaxable entities) during any single return period, be subject to more than $25,000 in penalties under section 6695(d) and paragraph (d)(1) of this section.

(e) *Failure to file correct information returns.* A person who is subject to the reporting requirements of section 6060 and §1.6060–1 and who fails to satisfy these requirements shall pay a penalty of $50 for each such failure, with a maximum of $25,000 per person imposed for each calendar year, unless such failure was due to reasonable cause and not due to willful neglect.

(f) *Negotiation of check.* (1) No person who is an income tax return preparer may endorse or otherwise negotiate, directly or through an agent, a check for the refund of tax under subtitle A of the Internal Revenue Code of 1954 which is issued to a taxpayer other than the preparer if the person was a preparer of the return or claim for refund which gave rise to the refund check.

(2) Section 6695(f) and paragraph (f)(1) and (3) of this section do not apply to a preparer-bank which—

(i) Cashes a refund check and remits all of the cash to the taxpayer or accepts a refund check for deposit in full to a taxpayer's account, so long as the bank does not initially endorse or negotiate the check (unless the bank has made a loan to the taxpayer on the basis of the anticipated refund); or

(ii) Endorses a refund check for deposit in full to a taxpayer's account pursuant to a written authorization of the taxpayer (unless the bank has made a loan to the taxpayer on the basis of the anticipated refund).

A preparer-bank may also subsequently endorse or negotiate a refund check as a part of the check-clearing process through the financial system after initial endorsement or negotiation.

(3) The preparer shall be subject to a penalty of $500 for each endorsement or negotiation of a check prohibited under section 6695(f) and paragraph (f)(1) of this section.

(Sec. 6060(b), Internal Revenue Code of 1954 (90 Stat. 1691, (26 U.S.C. 6060(b))); sec. 7805, Internal Revenue Code of 1954 (68A Stat. 917, (26 U.S.C. 7805))

[T.D. 7519, 42 FR 59969, Nov. 23, 1977, as amended by T.D. 7640, 44 FR 49452, Aug. 23, 1979; T.D. 8549, 59 FR 33432, June 29, 1994; T.D. 8689, 61 FR 65320, Dec. 12, 1996; T.D. 8803, 63 FR 72182, Dec. 31, 1998]

§1.6695–1T Other assessable penalties with respect to the preparation of income tax returns for other persons (temporary).

(a) through (b)(3) [Reserved]. For further guidance, see §1.6695–1(a) through (b)(3).

(b)(4)(i) The manual signature requirement of §1.6695–1(b)(1) and (2) may be satisfied by a photocopy of a copy of the return or claim for refund which copy is manually signed by the preparer after completion of its preparation. After a copy of the return or claim for refund is signed by the preparer and before it is photocopied, no person other than the preparer may alter any entries on the copy other than to correct arithmetical errors discernible on the return or claim for refund. The employer of the preparer or the partnership in which the preparer is a partner, or the preparer (if not employed or engaged by a preparer and not a partner of a partnership which is a preparer), must retain the manually signed copy of the return or claim for refund. In the alternative, for a return or claim for refund presented to a taxpayer for signature after December 31, 1998 and for returns or claims for refund retained on or before that date, the person required to retain the manually signed copy of the return or claim for refund may choose to retain a photocopy of the manually signed copy of the return or claim for refund, or use an electronic storage system to store and produce a copy of the manually signed return or claim for refund. For purposes of this paragraph (b)(4)(i), an electronic storage system must meet the electronic storage system requirements prescribed in section 4 of Rev. Proc. 97–22 (1997–1 C.B. 652)(see § 601.601(d)(2) of this chapter) or procedures subsequently prescribed by the Commissioner. A record of any arithmetical errors corrected must be retained and made available upon request by the person required to retain the manually signed copy of the return or claim for refund.

(b)(4)(ii) through (f) [Reserved]. For further guidance, see § 1.6695–1(b)(4)(ii) through (f).

(g) *Effective date.* This section applies to income tax returns and claims for refund presented to a taxpayer for signature after December 31, 1998 and for returns or claims for refund retained on or before December 31, 1998. This section expires on December 31, 2001.

[T.D. 8803, 63 FR 72182, Dec. 31, 1998]

§ 1.6695–2T Preparer due diligence requirements for determining earned income credit eligibility (temporary).

(a) *Penalty for failure to meet due diligence requirements.* A person who is an income tax return preparer (preparer) of an income tax return or claim for refund under subtitle A of the Internal Revenue Code (Code) with respect to determining the eligibility for, or the amount of, the earned income credit (EIC) under section 32 and who fails to satisfy the due diligence requirements of paragraph (b) of this section will be subject to a penalty of $100 for each such failure. However, no penalty will be imposed under section 6695(g) on a person who is an income tax return preparer solely by reason of—

(1) Section 301.7701–15(a)(2) and (b) of this chapter, on account of having given advice on specific issues of law; or

(2) Section 301.7701–15(b)(3) of this chapter, on account of having prepared the return solely because of having prepared another return that affects amounts reported on the return.

(b) *Due diligence requirements.* A preparer must satisfy the following due diligence requirements:

(1) *Completion of eligibility checklist.* (i) The preparer must either—

(A) Complete Form 8867, *Paid Preparer's Earned Income Credit Checklist,* or such other form as may be prescribed by the IRS (Eligibility Checklist); or

(B) Otherwise record in the preparer's paper or electronic files the information necessary to complete the Eligibility Checklist (Alternative Eligibility Record). The Alternative Eligibility Record may consist of one or more documents containing the required information.

(ii) The preparer's completion of the Eligibility Checklist or Alternative Eligibility Record must be based on information provided by the taxpayer to the preparer or otherwise reasonably obtained by the preparer.

(2) *Computation of credit.* (i) The preparer must either—

(A) Complete the *Earned Income Credit Worksheet* in the Form 1040 instructions or such other form as may be prescribed by the IRS (Computation Worksheet); or

(B) Otherwise record in the preparer's paper or electronic files the preparer's EIC computation, including the method and information used to make the computation (Alternative Computation Record). The Alternative Computation

Record may consist of one or more documents containing the required information.

(ii) The preparer's completion of the Computation Worksheet or Alternative Computation Record must be based on information provided by the taxpayer to the preparer or otherwise reasonably obtained by the preparer.

(3) *Knowledge.* The preparer must not know, or have reason to know, that any information used by the preparer in determining the taxpayer's eligibility for, or the amount of, the EIC is incorrect. The preparer may not ignore the implications of information furnished to, or known by, the preparer, and must make reasonable inquiries if the information furnished to, or known by, the preparer appears to be incorrect, inconsistent, or incomplete.

(4) *Retention of records.* (i) The preparer must retain—

(A) A copy of the completed Eligibility Checklist or Alternative Eligibility Record;

(B) A copy of the Computation Worksheet or Alternative Computation Record; and

(C) A record of how and when the information used to complete the Eligibility Checklist or Alternative Eligibility Record and the Computation Worksheet or Alternative Computation Record was obtained by the preparer, including the identity of any person furnishing the information.

(ii) These items must be retained for three years after the June 30th following the date the return or claim for refund was presented to the taxpayer for signature, and may be retained on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance.

(c) *Exception to penalty.* The section 6695(g) penalty will not be applied with respect to a particular income tax return or claim for refund if the preparer can demonstrate to the satisfaction of the IRS that, considering all the facts and circumstances, the preparer's normal office procedures are reasonably designed and routinely followed to ensure compliance with the due diligence requirements of paragraph (b) of this section, and the failure to meet the due diligence requirements of paragraph (b) of this section with respect to the particular return or claim for refund was isolated and inadvertent.

(d) *Effective date*—(1) *In general.* This section applies to income tax returns and claims for refund for taxable years beginning after December 31, 1996. This section expires on December 21, 2001. For the applicable Eligibility Checklist see paragraph (d)(2) of this section.

(2) *Eligibility Checklist*—(i) *For the 1997 taxable year.* For taxable year 1997, the applicable Eligibility Checklist is the Eligibility Checklist published in Notice 97–65 (1997–51 I.R.B. 14) December 22, 1997. (See §601.601(d)(2)(ii)(*b*) of this chapter.)

(ii) *For the 1998 taxable year.* For taxable year 1998 the applicable Checklist is either—

(A) The Checklist published in Notice 97–65 (1997–51 I.R.B. 14) December 22, 1997, modified however, by applying the figures $10,030, $26,473, $30,095, and $2,300 in place of $9,770, $25,760, $29,290, and $2,250, respectively, each time these figures appear on the 1997 Checklist; or

(B) Form 8867, *Paid Preparer's Earned Income Credit Checklist.*

(iii) *For taxable years after 1998.* For taxable years beginning after December 31, 1998, the applicable Eligibility Checklist is the Eligibility Checklist contained in Form 8867, *Paid Preparer's Earned Income Credit Checklist,* or such other form as may be prescribed by the IRS.

[T.D. 8798, 63 FR 70340, Dec. 21, 1998]

§1.6696–1 Claims for credit or refund by income tax return preparers.

(a) *Notice and demand.* (1) The Internal Revenue Service shall issue to each income tax return preparer one or more statements of notice and demand for payment for all penalties assessed against the preparer under section 6694 and §1.6694–1, or under section 6695 and §1.6695–1.

(2) For the definition of the term ''income tax return preparer'' (or ''preparer''), see section 7701(a)(36) and §301.7701–15. However, a person who prepares a claim for credit or refund under this section for another person is not, with respect to that preparation,

an income tax return preparer as defined in section 7701(a)(36) and § 301.7701–15.

(b) *Claim filed by preparer.* A claim for credit or refund of a penalty (or penalties) assessed against a preparer under section 6694 and § 1.6694–1, or under section 6695 and § 1.6695–1, may be filed under this section only by the preparer (or the preparer's estate) against whom the penalty (or penalties) is assessed and not by for example, the preparer's employer. This paragraph is not intended, however, to impose any restrictions on the preparation of this claim for credit or refund. rified by a written declaration by the preparer that the information is provided under penalty of perjury.

(c) *Separation and consolidation of claims.* (1) Unless paragraph (c)(2) of this section applies, a preparer shall file a separate claim for each penalty asserted in each statement of notice and demand issued to the preparer.

(2) A preparer may file one or more consolidated claims for any or all penalties imposed on the preparer by a single Internal Revenue Service Center (or district director) under section 6695(a) and § 1.6695–1(a) (relating to failure to furnish copy of return to taxpayer), section 6695(b) and § 1.6695–1(b) (relating to failure to sign), section 6695(c) and § 1.6695–1(c) (relating to failure to furnish identifying number), or under section 6695(d) and § 1.6695(d) (relating to failure to retain copy of return or record), whether the penalties are asserted on a single or on separate statements of notice and demand. In addition, a preparer may file one consolidated claim for any or all penalties imposed on the preparer by a single Internal Revenue Service Center (or district director) under section 6695(e) and § 1.6695–1(e) (relating to failure to file correct information return), which are asserted on a single statement of notice and demand.

(d) *Content of claim.* Each claim for credit or refund or any penalty (or penalities) paid by a preparer under section 6694 and § 1.6694–1, or under section 6695 and § 1.6695–1, shall include the following information, verified by a written declaration by the preparer that the information is provided under penalty of perjury;

(1) The preparers's name.

(2) The preparer's identification number. If the preparer is:

(i) An individual (not described in subdivision (iii) of this paragraph (d)(2)) who is a citizen or resident of the United States, the preparer's social security account number shall be provided;

(ii) An individual who is not a citizen or resident of the United States and also was not employed (or engaged) by another preparer to prepare the document (or documents) with respect to which the penalty (or penalties) was assessed, the preparer's employer identification shall be provided; or

(iii) A person (whether an individual, corporation, or partnership) who employed (or engaged) one or more persons to prepare the document (or documents) with respect to which the penalty (or penalties) was assessed, the preparer's employer identification number shall be provided.

(3) The preparer's address where the Internal Revenue Service mailed the statement (or statements) of notice and demand and, if different, the preparer's address shown on the document (or documents) with respect to which the penalty (or penalities) was assessed.

(4)(i) The address of the Internal Revenue Service Center (or district director) which issued to the preparer the statement (or statements) of noticve and demand for payment of the penalty (or penalties) included in the claim; and

(ii) The date (or dates) and identifying number (or numbers) of the statement (or statements) of notice and demand.

(5)(i) The identification, by amount, type, and document of which related, of each penalty included in the claim. Each document referred to in the preceding sentence shall be identified by the form title or number, by the taxpayer's (or nontaxable entity's) name and identification number, and by the taxable year to which the document relates;

(ii) The date (or dates) of payment of the amount (or amounts) of the penalty (or penalties) included in the claim; and

(iii) The total amount claimed.

(6) A statement setting forth in detail:

(i) Each ground upon which each penalty overpayment claim is based; and

(ii) Facts sufficient to apprise the Internal Revenue Servicve of the exact basis of each such claim.

(e) *Form for filing claim.* Notwithstanding §301.640–2(c), Form 6118 is the form prescribed for making a claim as provided in this section.

(f) *Place for filing claim.* A claim filed under this section shall be filed with the Internal Revenue Service Center (or district director) which issued to the preparer the statement (or statements) of notice and demand for payment of the penalty (or penalities) included in the claim.

(g) *Time for filing claim.* (1) Except as provided in section 6694(c)(1) and §1.6694–2, (a)(3)(ii) and (4), and in section 6694(d) and §1.6694–1(c):

(i) A claim for a penalty paid by a preparer under section 6694 and §1.6694–1, or under section 6695 and §1.6695–1, shall be filed within 3 years from the date the payment was make; and

(ii) A consolidated claim, permitted under paragraph (c)(2) of this section, shall be filed within 3 years from the first date of payment of any penalty included in the claim.

For purposes of this paragraph (g)(1), payment is considered made on the date payment is received by the Internal Revenue Service or, where applicable, on the date an amount is credited in satisfaction of the penalty.

(2) The rules under sections 7502 and 7503 and the regulations thereunder apply to the timely filing of a claim as provided in this section.

(h) *Application of refund to outstanding liability of income tax return preparer.* The Internal Revenue Service may, within the applicable period of limitation, credit any amount of an overpayment by a preparer of a penalty (or penalities) paid under section 6694 and §1.6694–1, or under section 6695 and §1.6695–1, against any outstanding liability for any tax (or for any interest, additional amount, addition to the tax, or assessable penalty) owed by the preparer making the overpayment. If a portion of an overpayment is so credited, only the balance will be refunded to the preparer.

(i) *Interest.* (1) Section 6611 and the regulations thereunder apply to the payment by the Internal Revenue Service of interest on an overpayment by a preparer of a penalty (or penalties) paid under section 6694 and §1.6694–1, or under section 6695 and §1.6695–1.

(2) Section 6601 and the regulations thereunder apply to the payment of interest by a preparer to the Internal Revenue Service on any penalty (or penalties) assessed against the preparer under section 6694 and §1.6694–1 or under section 6695 and §1.6695–1.

(j) *Suits for refund of preparer penalty.* (1) A preparer may not maintain a civil action for the recovery of any penalty paid under section 6694 and §1.6694–1 or under section 6695 and §1.6695–1, unless the preparer has previously filed a claim for credit or refund of the penalty as provided in this section (and the court has jurisdiction of the proceeding). See sections 6694(c) and 7422.

(2)(i) Except as provided in section 6694(c)(2) and §1.6694–2(b), the periods of limitation contained in section 6532 and the regulations thereunder apply to a preparer's suit for the recovery of any penalty paid under section 6694 and §1.6694–1, or under section 6695 and §1.6695–1.

(ii) The rules under section 7503 and the regulations thereunder apply to the timely commencement by a preparer of a suit for the recovery of any penalty paid under section 6694 and §1.6694–1, or under section 6695 and §1.6695–1.

[T.D. 7621, 44 FR 27985, May 14, 1979]

§1.6709–1T Penalties with respect to mortgage credit certificates (temporary).

(a) *Material misstatement*—(1) *Negligence.* If any person makes a material misstatement in any affidavit or other statement under a penalty of perjury made with respect to the issuance of a mortgage credit certificate and such misstatement is due to the negligence of that person, that person shall pay a penalty of $1,000 for each mortgage credti certificate with respect to which that misstatement was made.

(2) *Fraud.* If a misstatement described in subparagraph (1) is due to fraud on the part of the person making the misstatement, that person shall

pay a penalty of $10,000 for each mortgage credit certificate with respect to which the fraudulent misstatement was made. The penalty imposed by this paragraph (a)(2) is in addition to any criminal penalty.

(b) *Reports.* (1) Any person required by § 1.25–8T to file a report with respect to any mortgage credit certificate who fails to file the report at the time and in the manner required by § 1.25–8T shall pay a penalty of $200 for each mortgage credit certificate with respect to which that failure occurred. The preceding sentence shall not apply if it is shown that such failure is due to reasonable cause and not to willful neglect.

(2) In the case of any report required under § 1.25–8T(b), the aggregate amount of the penalty imposed by this paragraph shall not exceed $2,000.

[T.D. 8023, 50 FR 19355, May 8, 1985]

JEOPARDY, BANKRUPTCY, AND RECEIVERSHIPS

§ 1.6851–1 Termination assessments of income tax.

(a) *Authority for making*—(1) *In general.* This section applies to assessments authorized by a district director under section 6851(a) (hereinafter referred to as termination assessments). The district director shall immediately authorize a termination assessment of the income tax for the current or preceding taxable year if the district director finds that a taxpayer designs to do an act which would tend to prejudice proceedings to collect the income tax for such year or years unless such proceedings are brought without delay. In addition, the district director shall immediately authorize such a termination assessment if the district director determines that the taxpayer designs to do any act which would tend to render such proceedings wholly or patially ineffective unless brought without delay. A termination assessment will be made if collection is determined to be in jeopardy because at least one of the following conditions exists.

(i) The taxpayer is or appears to be designing quickly to depart from the United States or to conceal himself or herself.

(ii) The taxpayer is or appears to be designing quickly to place his, her, or its property beyond the reach of the Government either by removing it from the United States, by concealing it, by dissipating it, or by transferring it to other persons.

(iii) The taxpayer's financial solvency is or appears to be imperiled.

Paragraph (a)(1)(iii) of this section does not include cases where the taxpayer becomes insolvent by virtue of the accrual of the proposed assessment of tax, and penalty, if any. A tax assessed under this section shall become immediately due and payable and the district director shall serve upon such taxpayer notice and demand for immediate payment of such tax.

(2) *Computation of tax.* If a termination assessment of the income tax for the current year is made, the income tax for such year shall be computed for the period beginning on the first day of such year and ending on the day of the assessment. A credit shall be allowed for any tax for the taxable year previously assessed under section 6851. The taxpayer is entitled to a deduction for the personal exemptions (as limited in the case of certain non-resident aliens) without any proration for or because of the short taxable period.

(3) *Taxable year not affected by termination.* Notwithstanding any termination assessment a taxpayer shall file a return in accordance with section 6012 and the regulations thereunder for the taxpayer's full taxable year. The term ''full taxable year'' means the taxpayer's usual annual accounting period determined without regard to any action under section 6851 and this section. The return shall show all items of gross income, deductions, and credits for such taxable year. Any tax collected as a result of a termination assessment will be applied against the tax due for the taxpayer's full taxable year. Except as provided in § 1.6851–2 (relating to departing aliens), no return is required to be filed for a terminated period other than a full taxable year.

(4) *Evidence of compliance with income tax obligations.* Citizens of the United States or of possessions of the United States departing from the United

States or its possessions will not be required to procure certificates of compliance or to present any other evidence of compliance with income tax obligations. However, for the rules relating to the furnishing of evidence of compliance with the income tax obligations by certain departing aliens, see §1.6851–2.

(5) *Section 6851 inapplicable where section 6861 applies.* No termination assessment for the preceding taxable year shall be made after the due date of the taxpayer's return for such year (determined with regard to extensions of time to file such return).

(b) *Notice of deficiency.* Where notice and demand for payment (following a termination assessment) takes place after February 28, 1977, the district director shall, within 60 days after the later of:

(1) The date the taxpayer files a return for the full taxable year; or

(2) The due date of such return (determined with regard to extensions); send the taxpayer a notice of deficiency under section 6212(a). The amount of the deficiency shall be computed in accordance with section 6211 and the regulations thereunder. In applying section 6211, the tax imposed and the amount shown upon the return shall be determined on the basis of the taxpayer's full taxable year. Thus, for example assume that on November 1, 1979, a termination assessment against A, a calendar year taxpayer, is made in the amount of $18,000. The termination assessment is for the period from January 1, 1979 through November 1, 1979. Further assume that on or before April 15, 1980, A files a form 1040 showing an income tax liability for the full year 1979 of $10,000. If the district director determines A's liability for tax for 1979 is $16,000, a notice of deficiency for $6,000 shall be sent to A on or before June 14, 1980. Assuming that the district director had collected the $18,000 assessed, $2,000 shall be refunded.

(c) *Immediate payment.* The district director shall make demand for immediate payment of the amount of the termination assessment, and the taxpayer shall immediately pay such amount or shall immediately file the bond provided in section 6863.

(d) *Abatement.* The provisions of §§301.6861–1(e) and 301.6861–1(f) relating to the abatement of jeopardy assessments, shall apply to assessments made under section 6851.

[T.D. 7575, 43 FR 58816, Dec. 18, 1978]

§1.6851–2 Certificates of compliance with income tax laws by departing aliens.

(a) *In general*—(1) *Requirement.* The rules of this section are applicable, except as otherwise expressly provided, to any alien who departs from the United States or any of its possessions after January 20, 1961. Except as provided in subparagraph (2) of this paragraph, no such alien, whether resident or nonresident, may depart from the United States unless he first procures a certificate that he has complied with all of the obligations imposed upon him by the income tax laws. In order to procure such a certificate, an alien who intends to depart from the United States (i) must file with the district director for the internal revenue district in which he is located the statements or returns required by paragraph (b) of this section to be filed before obtaining such certificate, (ii) must appear before such district director if the district director deems it necessary, and (iii) must pay any taxes required under paragraph (b) of this section to be paid before obtaining the certificate. Either such certificate of compliance, properly executed, or evidence that the alien is excepted under subparagraph (2) of this paragraph from obtaining the certificate must be presented at the point of departure. An alien who presents himself at the point of departure without a certificate of compliance, or evidence establishing that such a certificate is not required, will be subject at such departure point to examination by an internal revenue officer or employee and to the completion of returns and statements and payment of taxes as required by paragraph (b) of this section.

(2) *Exceptions*—(i) *Employees of foreign governments or international organizations—(a) Diplomatic representatives, their families and servants.* (1) Representatives of foreign governments bearing diplomatic passports, whether accredited to the United States or

other countries, and members of their households shall not, upon departure from the United States or any of its possessions, be examined as to their liability for United States income tax or be required to obtain a certificate of compliance. If a foreign government does not issue diplomatic passports but merely indicates on passports issued to members of its diplomatic service the status of the bearer as a member of such service, such passports are considered as diplomatic passports for income tax purposes.

(2) Likewise, the servant of a diplomatic representative who accompanies any individual bearing a diplomatic passport upon departure from the United States or any of its possessions shall not be required, upon such departure, to obtain a certificate of compliance or to submit to examination as to his liability for United States income tax. If the departure of such a servant from the United States or any of its possessions is not made in the company of an individual bearing a diplomatic passport, the servant is required to obtain a certificate of compliance. However, such certificate will be issued to him on Form 2063 without examination as to his income tax liability upon presentation to the district director for the internal revenue district in which the servant is located of a letter from the chief of the diplomatic mission to which the servant is attached certifying *(i)* that the name of the servant appears on the ''White List'', a list of employees of diplomatic missions, and *(ii)* that the servant is not obligated to the United States for any income tax, and will not be so obligated up to and including the intended date of departure.

(b) Other employees. Any employee of an international organization or of a foreign government (other than a diplomatic representative to whom *(a)* of this subdivision applies) whose compensation for official services rendered to such organization or government is excluded from gross income under section 893 and who has received no gross income from sources within the United States, and any member of his household who has received no gross income from sources within the United States, shall not, upon departure from the United States or any of its possessions after November 30, 1962, be examined as to his liability for United States income tax or be required to obtain a certificate of compliance.

(c) Effect of waiver. An alien who has filed with the Attorney General the waiver provided for under section 247(b) of the Immigration and Nationality Act (8 U.S.C. 1257(b)) is not entitled to the exception provided by this subdivision.

(ii) *Alien students, industrial trainees, and exchange visitors.* A certificate of compliance shall not be required, and examination as to United States income tax liability shall not be made, upon the departure from the United States or any of its possessions of—

(A) An alien student, industrial trainee, or exchange visitor, and any spouse and children of that alien, admitted solely on an F–1, F–2, H–3, H–4, J–1 or J–2 visa, who has received no gross income from sources inside the United States other than—

(*1*) Allowances to cover expenses incident to study or training in the United States (including expenses for travel, maintenance, and tuition);

(*2*) The value of any services or accommodations furnished incident to such study or training;

(*3*) Income derived in accordance with the employment authorizations in 8 CFR 274a.12(b) and (c) that apply to the alien's visa; or

(*4*) Interest on deposits described in section 871(i)(2)(A); or

(B) An alien student, and any spouse or children of that alien admitted solely on an M–1 or M–2 visa, who has received no gross income from sources inside the United States other than income derived in accordance with the employment authorization in 8 CFR 274a.12(c)(6) or interest on deposits described in section 871(i)(2)(A).

(iii) *Other aliens temporarily in the United States.* A certificate of compliance shall not be required, and examination as to United States income tax liability shall not be made, upon the departure from the United States or any of its possessions of an alien hereinafter described in this subdivision, unless the district director has reason to believe that such alien has received taxable income during the taxable year up to and including the date of departure or during the preceding taxable year and that collection of income tax from such alien will be jeopardized by his departure from the United States:

(a) An alien visitor for pleasure admitted solely on a B–2 visa;

(b) An alien visitor for business admitted on a B–1 visa, or on both a B–1 visa and a B–2 visa, who does not remain in the United States or a possession thereof for a period or periods exceeding a total of 90 days during the taxable year;

(c) An alien in transit through the United States or any of its possessions on a C–1 visa or under a contract, including a bond agreement, between a transportation line and the Attorney General pursuant to section 238(d) of the Immigration and Nationality Act (8 U.S.C. 1228(d));

(d) An alien who is admitted to the United States on a border-crossing identification card or with respect to whom passports, visas, and border-crossing identification cards are not required, if such alien is a visitor for pleasure, or if such alien is a visitor for business who does not remain in the United States or a possession thereof for a period or periods exceeding a total of 90 days during the taxable year, or if such alien is in transit through the United States or any of its possessions;

(e) An alien military trainee admitted to the United States to pursue a course of instruction under the auspices of the Department of Defense who departs from the United States on official military travel orders; or

(f) An alien resident of Canada or Mexico who commutes between such country and the United States at frequent intervals for the purpose of employment and whose wages are subject to the withholding of tax.

(b) *Issuance of certificate of compliance*—(1) *In general.* (i) Upon the departure of an alien required to secure a certificate of compliance under paragraph (a) of this section, the district director shall determine whether the departure of such alien jeopardizes the collection of any income tax for the current or the preceding taxable year, but the district director may determine that jeopardy does not exist in some cases. If the district director finds that the departure of such an alien results in jeopardy, the taxable period of the alien will be terminated, and the alien will be required to file returns and make payment of tax in accordance with subparagraph (3)(iii) of this paragraph. On the other hand, if the district director finds that the departure of the alien does not result in jeopardy, the alien will be required to file the statement or returns required by subparagraph (2) or (3)(ii) of this paragraph, but will not be required to pay income tax before the usual time for payment.

(ii) The departure of an alien who is a resident of the United States or a possession thereof (or treated as a resident under section 6013 (g) or (h)) and who intends to continue such residence (or treatment as a resident) shall be treated as not resulting in jeopardy, and thus not requiring termination of his taxable period, except when the district director has information indicating that the alien intends by such departure to avoid the payment of his income tax. In the case of a nonresident alien (including a resident alien discontinuing residence), the fact that the alien intends to depart from the United States will justify termination of his taxable period unless the alien establishes to the satisfaction of the district director that he intends to return to the United States and that his departure will not jeopardize collection of the tax. The determination of whether the departure of the alien results in jeopardy will be made on examination of all the facts in the case. Evidence tending to establish that jeopardy does not result from the departure of the alien may be provided, for example, by information showing that the alien is engaged in trade or business in the United States or that he leaves sufficient property in the United States to secure payment of his income tax for the taxable year and of any income tax for the preceding year which remains unpaid.

(2) *Alien having no taxable income and resident alien whose taxable period is not terminated.* A statement on Form 2063 shall be filed with the district director by every alien required to obtain a certificate of compliance:

(i) Who is a resident of the United States and whose taxable period is not terminated either because he has had no taxable income for the taxable year up to and including the date of his departure (and for the preceding taxable year where the period for making the income tax return for such year has not expired) or because, although he has had taxable income for such period or periods, the district director has not found that this departure jeopardizes collection of the tax on such income; or

(ii) Who is not a resident of the United States and who has had no taxable income for the taxable year up to and including the date of his departure (and for the preceding taxable year where the period for making the income tax return for such year has not expired).

Any alien described in subdivision (i) or (ii) of this subparagraph who is in default in making return of, or paying, income tax for any taxable year shall, in addition, file with the district director any returns which have not been made as required and pay to the district director the amount of any tax for which he is in default. Upon compliance by an alien with the foregoing requirements of this subparagraph, the district director shall execute and issue to the alien the certificate of compliance attached to Form 2063. The certificate of compliance so issued shall be effective for all departures of the alien during his current taxable year, subject to revocation upon any subsequent departure should the district director have reason to believe that such subsequent departure would result in jeopardy. The statement required of a resident alien under this subparagraph, if made before January 21, 1961, with respect to a departure after January 20, 1961, may be made on a Form 1040C in lieu of a Form 2063.

(3) *Nonresident alien having taxable income and resident alien whose taxable period is terminated*—(i) *Nonresident alien having taxable income.* Every nonresident alien required to obtain a certificate of compliance (but not described in subparagraph (2) of this paragraph) who wishes to establish that his departure does not result in jeopardy shall furnish to the district director such information as may be required for the purpose of determining whether the departure of the alien jeopardizes collection of the income tax and thus requires termination of his taxable period.

(ii) *Nonresident alien whose taxable period is not terminated.* Every nonresident alien described in subdivision (i) of this subparagraph whose taxable period is not terminated upon departure shall file with the district director:

(a) A return in duplicate on Form 1040C for the taxable year of his intended departure, showing income received, and reasonably expected to be received, during the entire taxable year within which the departure occurs; and

(b) Any income tax returns which have not been filed as required.

Upon compliance by the alien with the foregoing requirements of this subdivision, and the payment of any income tax for which he is in default, the district director shall execute and issue to the alien the certificate of compliance on the duplicate copy of Form 1040C. The certificate of compliance so issued shall be effective for all departures of the alien during his current taxable year, subject to revocation by the district director upon any subsequent departure if the taxable period of the alien is terminated on such subsequent departure.

(iii) *Alien (whether resident or nonresident) whose taxable period is terminated.* Every alien required to obtain a certificate of compliance, whether resident or nonresident, whose taxable period is terminated upon departure shall file with the district director:

(a) A return in duplicate on Form 1040C for the short taxable period resulting from such termination, showing income received, and reasonably expected to be received, during the taxable year up to and including the date of departure;

(b) Where the period for filing has not expired, the return required under section 6012 and § 1.6012–1 for the preceding taxable year; and

(c) Any other income tax returns which have not been filed as required.

Upon compliance with the foregoing requirements of this subdivision, and payment of the income tax required to be shown on the returns filed pursuant to *(a)* and *(b)* of this subdivision and of any income tax due and owing for prior years, the departing alien will be issued the certificate of compliance on the duplicate copy of Form 1040C. The certificate of compliance so issued shall be effective only for the specific departure with respect to which it is issued. A departing alien may postpone payment of the tax required to be shown on the returns filed in accordance with *(a)* and *(b)* of this subdivision until the usual time of payment by furnishing a bond as provided in §301.6863–1.

(4) *Joint return on Form 1040C.* A departing alien may not file a joint return on Form 1040C unless:

(i) Such alien and his spouse may reasonably be expected to be eligible to file a joint return at the normal close of their taxable periods for which the return is made; and

(ii) If the taxable period of such alien is terminated, the taxable periods of both spouses are so terminated as to end at the same time.

(5) *Annual return.* Notwithstanding that Form 1040C has been filed for either the entire taxable year of departure or for a terminated period, the return required under section 6012 and §1.6012–1 for such taxable year shall be filed. Any income tax paid on income shown on the return on Form 1040C shall be applied against the tax determined to be due on the income required to be shown on the subsequent return under section 6012 and §1.6012–1.

[T.D. 6537, 26 FR 547, Jan. 20, 1961, as amended by T.D. 6620, 27 FR 11803, Nov. 30, 1962; T.D. 7575, 43 FR 58817, Dec. 18, 1978; T.D. 7670, 45 FR 6931, Jan. 31, 1980; T.D. 8332, 56 FR 3034, Jan. 28, 1991; T.D. 8526, 59 FR 10067, Mar. 3, 1994]

§1.6851–3 Furnishing of bond to insure payment; cross reference.

See section 6863 and §301.6863–1 of this chapter (regulations on procedure and administration) for rules relating to the furnishing of bond to stay collection.

[T.D. 7575, 43 FR 58817, Dec. 18, 1978]

THE TAX COURT

DECLARATORY JUDGMENTS RELATING TO QUALIFICATION OF CERTAIN RETIREMENT PLANS

§1.7476–1 Interested parties.

(a) *In general*—(1) *Notice requirement.* Before the Internal Revenue Service can issue an advance determination as to the qualified status of certain retirement plans, the applicant must provide the Internal Revenue Service with satisfactory evidence that such applicant has notified the persons who qualify as interested parties, under regulations prescribed under section 7476(b)(1) of the Code, of the application for such determination. See section 3001(a) of the Employee Retirement Income Security Act of 1974 (88 Stat. 995). For the rules for giving notice to interested parties, see §1.7476–2 and paragraph (o) of §601.201 of this chapter (Statement of Procedural Rules).

(2) *Declaratory judgments.* Section 7476 provides a procedure for obtaining a declaratory judgment by the Tax Court with respect to the initial or continuing qualification under subchapter D of chapter 1 of the Code of a retirement plan defined in section 7476(d), in the case of an actual controversy involving:

(i) A determination by the Internal Revenue Service with respect to the initial qualification or continuing qualification under such subchapter of such a plan, or

(ii) A failure by the Internal Revenue Service to make a determination with respect to:

(A) Such initial qualification of such a plan, or

(B) Such continuing qualification of such a plan, if the controversy arises from a plan amendment or plan termination.

Under section 7476(d) the term ‘‘retirement plan’’ means a pension profitsharing, or stock bonus plan described in section 401(a), or a trust which is part of such a plan, an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a). This procedure is available only to the employer, the plan administrator as defined in section 414(g), an employee who qualifies as an interested party as defined in this section, or the Pension Benefit Guaranty Corporation, where such person has an actual controversy involving a determination described in paragraph (a)(2)(ii) of this section. In the case of an application for such a determination, this procedure is available only if such determination or failure to make such determination is with respect to an application described in paragraph (b)(7) of this section. In addition, in the case of such an application, if a petitioner was the applicant for the determination, the Tax Court may hold, under section 7476(b)(2), the filing of a pleading for a declaratory judgment to be premature unless the petitioner establishes to the satisfaction of the Tax Court that such petitioner has caused the interested parties to be notified in accordance with this section and § 1.7476.2

(b) *Interested parties*—(1) *In general.* If paragraphs (b) (2), (3), (4), and (5) of this section do not apply, then, except as otherwise provided in paragraphs (b)(6) (i), (ii), and (iii) of this section, the following persons shall be interested parties with respect to an application for an advance determination as to the qualified status of a retirement plan:

(i) All present employees of the employer who are eligible to participate in the plan (as defined in paragraph (d)(2) of this section), and

(ii) All other present employees of the employer whose principal place of employment (as defined in paragraph (d)(3) of this section) is the same as the principal place of employment of any employee described in paragraph (b)(1)(i) of this section.

(2) *Certain plans covering a principal owner.* Notwithstanding paragraph (b)(1) of this section, where:

(i) A principal owner (within the meaning of paragraph (d)(2) of § 1.414(c)–3) of the employer or of a common parent of the employer (where the employer is a member of a parent-subsidiary group of trades or businesses under common control under section 414 (b) or (c)) is eligible to participate in the plan, and

(ii) The number of employees employed by such employer (including all employees who by reason of section 414 (b) or (c) are treated as employees of such employer) is 100 or less then except as otherwise provided in paragraphs (b)(6) (i), (ii), and (iv) of this section, all present employees of the employer shall be interested parties with respect to an application for an advance determinations as to the qualified status of the retirement plan.

(3) *Certain plan amendments.* In the case of an application for an advance determination as to whether a plan amendment affects the continuing qualification of a plan, if:

(i) There is outstanding a favorable determination letter for a plan year to which section 410 applies, and

(ii) The amendment does not alter the participation provisions of the plan, then paragraphs (b) (1) and (2) of this section shall not apply, and all present employees of the employer who are eligible to participate in the plan (as defined in paragraph (d)(2) of this section), shall be interested parties. For the purpose of this paragraph (b)(3), if qualification of the plan is dependent upon benefits under the plan integrating with those benefits provided under the Social Security Act or a similar program, and if such integration results in excluding any employee or could possibly result in any participant's benefit being reduced to zero and the amendment alters contributions to or the amount of benefits payable under the plan, then the amendment shall be considered to alter the participation provisions of the plan.

(4) *Collectively bargained plans.* In the case of an application with respect to a plan described in section 413(a) (relating to collectively bargained plans), paragraphs (b) (1), (2) and (3) of this section shall not apply and all present employees covered by a collective-bargaining agreement pursuant to which the plan is maintained shall be interested parties.

(5) *Plan terminations.* In the case of an application for an advance determination with respect to whether a plan termination affects the continuing qualification of a retirement plan, paragraphs (b) (1), (2), (3) and (4) of this section shall not apply, and all present

employees with accrued benefits under the plan, all former employees with vested benefits under the plan, and all beneficiaries of decreased former employees currently receiving benefits under the plan, shall be interested parties.

(6) *Exceptions.* (i) In the case of an application to which paragraph (b) (1) or (2) of this section applies, an employee who is not eligible to participate in the plan shall not be an interested party if such employee is excluded from consideration for purposes of section 410(b)(1) by reason of section 410(b)(2) (B) or (C).

(ii) In the case of an application to which paragraph (b) (1) or (2) of this section applies, an application to which paragraph (b) (1) or (2) of this section applies, an employee who is not eligible to participate in the plan shall not be an interested party if such plan meets the eligibility standards of section 410(b)(1)(A).

(iii) In the case of an application to which paragraph (b)(1) of this section applies, an employee who is not eligible to participate in the plan shall not be an interested party with respect to such plan if such employee is eligible to participate in any other plan of the employer with respect to which a favorable determination letter is outstanding (whether or not issued pursuant to an application to which this section applies), or in such a plan of another employer whose employees, by reason of section 414 (b) or (c), are treated as employees of the employer making the application.

(iv) In the case of an application to which paragraph (b)(2) of this section applies, an employee who is not eligible to participate in the plan shall not be an interested party with respect to such plan if such employee is eligible to participate in a plan described in section 413(a) (relating to collectively bargained plans) maintained by the employer with respect to which a favorable determination letter is outstanding (whether or not issued purusant to an application to which this section applies), or in such a plan of another employer whose employees by reason of section 414 (b) or (c), are treated as employees of the employer making the application.

(7) *Applicability.* Paragraph (b) of this section shall only apply in the case of an application made to the internal Revenue Service requesting an advance determination that a retirement plan as defined in section 7476(d) and paragraph (a) of this section meets the requirements for qualification for a plan year or years to which section 410 applies to such plan. See paragraphs (c) (4) and (5) of this section for special rules in respect of years to which section 410 applies.

(c) *Special rules.* For purposes of paragraph (b) of this section and §1.7476–2:

(1) *Time of determination.* The status of an individual as an interested party and as a present employee or former employee shall be determined as of a date determined by the applicant, which date shall not be earlier than five business days before the first date on which the notice of the application is given to interested parties pursuant to §1.7476–2 nor later than the date on which such notice is given.

(2) *Controlled groups, etc.* An individual shall be considered to be an employee of an employer if such employee is treated as that employer's employee under section 414 (b) or (c).

(3) *Self-employed individuals.* A self-employed individual shall be considered an employee.

(4) *Years to which section 410 relates.* For purposes of paragraph (b)(7) of this section, section 410 shall be considered to apply to a plan year if an election has been made under section 1017(d) of the Employee Retirement Income Security Act of 1974 to have section 410 apply to such plan year, whether or not the election is conditioned upon the issuance by the Commissioner of a favorable determination letter.

(5) *Government, church plans, etc.* In the case of an organization described in section 410(c)(1), section 410 will be considered to apply to a plan year of such organization for any plan year to which section 410(c)(2) applies to such plan.

(d) *Definitions.* For the purposes of paragraph (b) of this section and §1.7476–2:

(1) *Employer.* The term ''employer'' includes all employers who maintain the plan with respect to which an advance determination applies. A sole

proprietor shall be considered such person's own employer and a partnership is considered to be the employer of each of the partners.

(2) *Eligible to participate.* For purposes of this section, an employee is eligible to participate in a plan if such employee:

(i) Is a participant in the plan,

(ii) Would be a participant in the plan if such employee met the minimum age and service requirements of the plan or

(iii) Would be a participant in the plan upon making mandatory employee contributions.

In applying this paragraph (d)(2), plan provisions (with respect to which the determination regarding qualification is to be based) not in effect on the first date on which notice is given to interested parties shall be treated as though they were in effect on such date.

(3) *Place of employment.* A place of employment includes all worksites within a plant, installation, store, office, or similar facility. Any employee who has no principal place of employment shall be treated as though such employee's principal place of employment is that place to which such employee regularly reports to the employer.

[T.D. 7421, 41 FR 20876, May 21, 1976; 41 FR 22561, June 4, 1976, as amended by T.D. 8179, 53 FR 6613, Mar. 2, 1988]

§ 1.7476–2 Notice to interested parties.

(a) *In general.* Any person applying to a district director for a determination described in paragraph (b)(7) of § 1.7476–1 shall cause notice of the application to be given to persons who qualify as interested parties under § 1.7476–1 with respect to the application, whether or not such application is received by the Internal Revenue Service before the date on which section 410 applies to the plan.

(b) *Nature of notice.* The notice required by this section shall be given in writing, shall contain the information and be given within the time prescribed in paragraph (o)(3) of § 601.201 of this chapter (Statement of Procedural Rules), and shall be given in the manner prescribed in paragraph (c) of this section.

(c) *Method of giving notice*—(1) *Present employee.* In the case of a present employee who is an interested party, notice shall be given in person, by mailing, by posting, or by printing it in a publication of the employer or an employee organization which is distributed in such a manner so as to be reasonably available to such employee. Notice given by posting shall be made by posting such notice (i) at those locations within the principal places of employment of the interested parties which are customarily used for employer notices to employees with regard to labor-management relations matters, or (ii) if the plan is maintained pursuant to one or more collective-bargaining agreements, at those locations described in (i) or at those locations customarily used by the employee representatives for posting notices with regard to labor-management relations maters (such as local union meeting places) in the geographical area or areas within which the interested parties are employed. Regardless of which method is used to notify an employee, if an interested party who is a present employee is in a unit of employees covered by a collective-bargaining agreement between employee representatives and one or more employers, notice shall also be given in person or by mail to the collective-bargaining representative of such interested party.

(2) *Former employee or beneficiary.* (i) Except as otherwise provided in paragraph (c)(2)(ii) of this section, in the case of a former employee or beneficiary who is an interested party, notice shall be given in person or by mail to the last known address of such former employee or beneficiary.

(ii) In cases in which compliance with the methods for notication prescribed in paragraph (c)(2)(i) of this section will present unusual financial or administrative burdens or, by reason of the peculiar circumstances of the case, cannot reasonably be expected to result in adequate and timely notice, applicants for advance determination letters may cause notice to be given to former employees or beneficiaries by methods other than those described in such paragraph (c)(2)(i) provided such methods are reasonably calculated to provide timely notice to such employees or beneficiaries who are interested parties, or to established representatives of such interested parties who may be reasonably expected to act in their interest and on their behalf. In such a case, the application for determination shall be accompanied by a full description of the method of notification used, as well as the particular financial or administrative burdens that would have occurred if notice had been given pursuant to the methods prescribed in paragraph (c)(2)(i) of this section, or the reasons why such prescribed methods would not have resulted in adequate or timely notice.

(d) *Effective date.* (1) The provisions of §1.7476–1 and this section shall apply to applications referred to in paragraph (b) of §1.7476–1 made on or after June 21, 1976. Sections 11.7476–1, and 11.7476–2 of this chapter (Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974) as promulgated by Treasury Decision 7358 (May 30, 1975) shall apply to applications made before such date. However, an applicant may elect to have the provisions of §1.7476–1 and this section apply with respect to an application made after May 20, 1976 and before June 21, 1976. Such election may be made by attaching to the application as originally submitted, a statement that the applicant has elected to have the provisions of §1.7476–1 and this section apply.

(2) Notwithstanding paragraph (d)(1) of this section, if:

(i) The plan or plan amendment which is the subject of an application for advance determination, is adopted on or before May 30, 1976, and,

(ii) Such application for advance determination is made before September 2, 1976, the applicant may elect to have the provisions of §§11.7476–1 and 11.7476–2 of this chapter (Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974) apply with respect to such application made on or after June 21, 1976 and before September 2, 1976. Such an election may be made by attaching to the application as originally submitted, a statement that the applicant has elected to have the provisions of §§11.7476–1 and 11.7476–2 of this chapter (Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974) apply.

[T.D. 7421, 41 FR 20876, May 21, 1976]

§1.7476–3 Notice of determination.

(a) *In general.* Under section 7476(b)(5) if a district director sends to the employer, the plan administrator, an interested party with respect to the plan, or the Pension Benefit Guaranty Corporation (or in the case of certain individuals who qualify as interested parties under paragraph (b) of §1.7476–1, to the person described under paragraph (c) of this section as the representative of such individuals) by certified or registered mail a notice of determination with respect to the qualification of a retirement plan described in section 7476(d), no proceeding for a declaratory judgment by the United States Tax Court with respect to the qualification of such plan may be initiated by such person unless the pleading initiating such proceeding is filed by such person with such Court before the ninety-first day after the day after such notice is mailed.

(b) *Address for notice of determination*—(1) *Applicant.* In the case of the applicant for a determination, a notice of determination referred to in section 7476(b)(5) shall be sufficient if mailed to such person at the address set forth on the application for the determination.

(2) *Interested party.* In the case of an interested party or parties who, pursuant to section 3001(b) of the Employee Retirement Income Security Act of 1974 (88 Stat. 995), submitted a comment to a district director with respect to the qualification of the plan, a notice of determination referred to in section 7476(b)(5) shall be sufficient if mailed to the address designated in the comment as the address to which correspondence should be sent.

(c) *Representative of interested parties.* (1) In the case of an interested party who, in accordance with section 3001(b) of the Employee Retirement Income Security Act of 1974 (88 Stat. 995), requests the Secretary of Labor to submit a comment to a district director on matters respecting the qualification of the plan, where pursuant to such request such Secretary does in fact submit such a comment, the Administrator of Pension and Welfare Benefit

Programs, Department of Labor, shall be the representative of such interested party for purposes of receiving the notice referred to in section 7476(b)(5) with respect to those matters on which the Secretary of Labor commented.

(2) In the event a single comment with respect to the qualification of the plan is submitted to a district director by two or more interested parties, the representative designated in the comment for receipt of correspondence shall be the representative of all the interested parties submitting the comment for purposes of receiving the notice referred to in section 7476(b)(5) on behalf of all of them. Such designated representative must be either one of the interested parties who submitted the comment or a person described in paragraph (e)(6) (i), (ii) or (iii) of § 601.201 of this chapter (Statement of Procedural Rules). If one person is not designated in the comment as the representative for receipt of correspondence, a notice of determination mailed to any interested party who submitted the comment shall be notice to all the interested parties who submitted the comment for purposes of section 7476(b)(5).

[T.D. 7421, 41 FR 20877, May 21, 1976]

§ 1.7519–0T Table of contents (temporary).

This section lists the captions that appear in the temporary regulations under section 7519.

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§1.7519–1T Required payments for entities electing not to have required year (temporary).

(a) *In general*—(1) *Applicability.* This section applies to any taxable year that a partnership or S corporation has an election under section 444 in effect (an ''applicable election year'').

(2) *Returns and required payments.* For each applicable election year, a partnership or S corporation must—

(i) File a return as provided in §1.7519—2T (a)(2), and

(ii) Make a required payment (as defined in paragraph (a)(3) of this section) as provided in §1.7519–2T.

However, if the required payment for an applicable election year is not more than $500 and the partnership or S corporation has not been required to make a required payment for a prior year, the partnership or S corporation should not make a required payment for such applicable election year.

(3) *Required payment.* The term ''required payment'' means, with respect to any applicable election year, an amount equal to the excess of—

(i) The product of the applicable percentage of the adjusted highest section 1 rate, multiplied by the net base year income (as defined in paragraph (b) (5) of this section) of the entity over

(ii) The cumulative amount of required payments actually made for all preceding applicable election years (reduced by the cumulative amount of such payments refundable under section 7519(c) for all such preceding years).

Furthermore, the amount of the required payment is determined without regard to the required payment of any other partnership or S corporation. See example (3) in paragraph (d) of this section.

(4) *Examples.* The provisions of paragraph (a) of this section may be illustrated by the following examples.

Example (1). A, a partnership, makes a section 444 election to retain its taxable year ending September 30. For A's first applicable election year, A's required payment, as defined in paragraph (a) (3) of this section, is $400. Thus, A does not have to make a required payment for that year. However, A is required to file the return prescribed by §1.7519–2T(a)(2).

Example (2). The facts are the same as in example (1), and, in addition to those facts, for A's second applicable election year, the amount determined under paragraph (a)(3)(i) of this section is $800. Because A did not actually make a required payment for A's first applicable election year, A's required payment is $800 for its second applicable election year. Since the required payment is greater than $500, A must make a required payment for its second applicable election year. Furthermore, A must file the return prescribed by §1.7519–2T(a)(2).

Example (3). The facts are the same as in example (2), and, in addition to those facts, for A's third applicable election year, the amount determined under paragraph (a)(3)(i) of this section is $1,200. Thus, A's required payment is $400 ($1,200 determined under paragraph (a)(3)(i) of this section less $800 determined under paragraph (a)(3)(ii) of this section). Although A's required payment for its third applicable election year is not more than $500, A must make its required payment for such year because the required payment for a preceding applicable election year exceeded $500. A must also file the return prescribed by §1.7519–2T(a)(2) for its third applicable election year.

(b) *Definitions and special rules*—(1) *Applicable percentage*—(i) *In general.* Except as provided in paragraph (b)(1)(ii) of this section, the term ''applicable percentage'' means the percentage determined in accordance with the following table:

If the applicable election year of the partnership or S corporation begins during—	The applicable percentage is—
1987	.25
1988	.50
1989	.75
1990 or thereafter	100

(ii) *Exception for certain applicable election years beginning after 1987.* [Reserved]

(iii) *Example.* The provisions of paragraph (b)(1) of this section may be illustrated by the following example.

Example. B is a corporation that has historically used a June 30 taxable year. For its taxable year beginning July 1, 1987, B elects to be an S corporation and elects under

§ 1.444–1T(b)(3) to retain its June 30 taxable year. Had B changed to a calendar year, its required year under section 1378, B's shareholders would not have been entitled to the 4-year spread under section 806(e)(2)(C) of the Tax Reform Act of 1986 because B was not an S corporation for its taxable year beginning in 1986. Nevertheless, for purposes of determining the required payment for B's applicable election year beginning July 1, 1987, the applicable percentage is 25 percent.

(2) *Adjusted highest section 1 rate*—(i) *General rule.* For any applicable election year, the term ''adjusted highest section 1 rate'' means the highest rate of tax under section 1 applicable to the period defined in paragraph (b)(2)(ii) of this section, plus 1 percentage point. Notwithstanding the preceding sentence, the adjusted highest section 1 rate is 36 percent for applicable election years beginning in 1987. For purposes of this section, the highest rate of tax is determined without regard to the effect of section 1(g), relating to the phaseout of the 15-percent rate and personal exemptions.

(ii) *Period for determining highest section 1 rate.* For purposes of paragraph (b)(2)(i) of this section, the period for determining the highest rate of tax under section 1 is the 12 month period that—

(A) Ends with the required taxable year for the applicable election year, and

(B) Includes the end of the base year.

For example, assume that a partnership's applicable election year begins on October 1, 1988 and that the required taxable year for such applicable election year is December 31. Based upon these facts, the period for determining the highest section 1 rate is the 12-month period ending December 31, 1988.

(3) *Base year.* The term ''base year'' means, with respect to any applicable election year, the taxable year of the partnership or S corporation preceding such applicable election year.

(4) *Special rules for certain applicable election years*—(i) *First applicable election year of new entities.* If an applicable election year is a partnership's or S corporation's first year in existence (*i.e.,* the partnership or S corporation is newly formed and therefore does not have a base year), the required payment for such applicable election year is zero.

(ii) *Applicable election years ending prior to the required taxable year.* If a partnership or S corporation makes a section 444 election and the resulting applicable election year (the ''first applicable election year'') of the partnership or S corporation ends prior to the last day of the required year, the required payment for the first applicable election year is zero. See example (5) in paragraph (b)(5)(vi) of this section.

(5) *Net base year income*—(i) *In general.* Except as provided in paragraph (b)(5)(v) of this section (relating to short base years), the net base year income of a partnership or S corporation is the sum of—

(A) The deferral ratio multiplied by the partnership's or S corporation's net income for the base year, plus

(B) The excess (if any) of—

(*1*) The deferral ratio multiplied by the aggregate amount of applicable payments made by the partnership or S corporation during the base year, over

(*2*) The aggregate amount of such applicable payments made during the deferral period of the base year.

The term ''deferral ratio'' means the ratio which the number of months in the deferral period (as defined in § 1.444–1T (b)(4)) of the applicable election year bears to 12 months.

(ii) *Partnership net income.* For purposes of paragraph (b)(5)(i) of this section—

(A) *In general.* The net income of the partnership is the amount (not below zero) determined by taking into account the aggregate amount of the partnership's items described in section 702(a), except for—

(*1*) Credits,

(*2*) Tax-exempt income, and

(*3*) Guaranteed payments under section 707(c).

(B) *Treatment of deductions and losses.* For purposes of determining the aggregate amount of partnership items, deductions and losses are treated as negative income. Thus, for example, if under section 702(a) a partnership has $1,000 of ordinary taxable income, $500 of specially allocated deductions, and $300 of capital loss, the net income of the partnership is $200 ($1,000–$500–$300).

(C) *Partner limitations disregarded.* Any limitation on the amount of a partnership item described in section 702(a) which may be taken into account for purposes of computing the taxable income of a partner shall be disregarded in computing the net income of the partnership.

(iii) *S corporation net income.* For purposes of paragraph (b)(5)(i) of this section—

(A) *In general.* The net income of an S corporation is the amount (not below zero) determined by taking into account the aggregate amount of the S corporation's items described in section 1366(a) (other than credits and tax-exempt income). If the S corporation was a C corporation for the base year, the taxable income of the C corporation shall be treated as the net income of the S corporation for such year.

(B) *Treatment of deductions and losses.* For purposes of determining the aggregate amount of S corporation items, deductions and losses are treated as negative income. Thus, for example, if under section 1366(a) an S corporation has $2,000 of ordinary taxable income, $1,000 of deductions described in section 1366(a)(1)(A) of the Code, and $500 of capital loss, the net income of the S corporation is $500 ($2,000–$1,000–$500).

(C) *Shareholder limitations disregarded.* Any limitation on any amount described in section 1366(a) which may be taken into account for purposes of computing the taxable income of a shareholder shall be disregarded in computing the net income of the S corporation.

(iv) *Applicable payments*—(A) *In general.* The term *applicable payment* means any amount deductible in the base year that is includable at any time, directly or indirectly, in the gross income of a taxpayer that during the base year is a partner or shareholder.

(B) *Exceptions.* The term *applicable payment* does not include any guaranteed payments under section 707(c).

(C) *Special rule for corporation electing S status.* If an S corporation was a C corporation for the base year, the corporation shall be treated as if it were an S corporation for the base year for purposes of determining the amount of applicable payments under this section. Thus, amounts deductible by the C corporation in the base year that are includable at any time in the gross income of a taxpayer that is a shareholder during the base year are treated as if from an S corporation, and therefore within the meaning of the term ''applicable payments.''

(D) *Special rules for certain payments*—(*1*) *Certain indirect payments.* For purposes of paragraph (b)(5)(iv)(A) of this section, an amount is indirectly includable in the gross income of a partner or shareholder of a partnership or S corporation that has a section 444 election in effect (an electing partnership or S corporation) if the amount is includable in the gross income of—

(*i*) The spouse (other than a spouse who is legally separated from the partner or shareholder under a decree of divorce or separate maintenance) or child (under age 14) of such partner or shareholder, or

(*ii*) A corporation more than 50 percent (measured by fair market value) of which is owned in the aggregate by partners or shareholders (and individuals related under paragraph (b)(5)(iv)(D)(*1*)(*i*) of this section to any such partners or shareholders), of the electing partnership or S corporation, or

(*iii*) A partnership more than 50 percent of the profits and capital of which is owned in the aggregate by partners or shareholders (and individuals related under paragraph (b)(5)(iv)(D)(*1*)(*i*) of this section to any such partners or shareholders) of the electing partnership or S corporation, or

(*iv*) A trust more than 50 percent of the beneficial ownership of which is owned in the aggregate by partners or shareholders (and individuals related under paragraph (b)(5)(iv)(D)(*1*)(*i*) of this section to any such partners or shareholders), of the electing partnership or S corporation.

For purposes of this paragraph (b)(5)(iv)(D)(*1*), ownership by any person described in this paragraph (b)(5)(iv)(D)(*1*) shall be treated as ownership by the partners or shareholders of the electing partnership or S corporation. This paragraph (b)(5)(iv)(D)(*1*) does not apply to amounts deductible by a partnership or S corporation that has made a section 444 election (the ''deducting partnership'') and included in the gross income of a partnership or

S corporation defined in paragraphs (b)(5)(iv)(D)(*1*) (*ii*) or (*iii*) of this section (the ''including partnership''), if the including partnership has the same taxable year as the deducting partnership and the including partnership has a section 444 election in effect. Furthermore, notwithstanding the general effective date provided in § 1.7519–3T, this paragraph (b)(5)(iv)(D)(*1*) is effective for amounts deductible on or after June 1, 1988.

(*2*) *Payments by a downstream controlled partnership*—(*i*) *In general.* If a partnership or S corporation has made a section 444 election, any amounts deducted by a downstream controlled partnership will be considered deducted by the partnership or S corporation that has made the section 444 election for purposes of determining the applicable payments of the partnership or S corporation that has made the section 444 election.

(*ii*) *Definition of a downstream controlled partnership.* If a partnership or S corporation that has made a section 444 election owns more than 50 percent of a partnership's profits and capital, such owned partnership is considered a downstream controlled partnership for purposes of paragraph (b)(5)(iv)(D)(*2*)(*i*) of this section. Furthermore, if more than 50 percent of a partnership's profits and capital are owned by a downstream controlled partnership, such owned partnership is considered a downstream controlled partnership for purposes of paragraph (b)(5)(iv)(D)(*2*)(*i*) of this section.

(*3*) *Examples.* The provisions of this paragraph (b)(5)(iv)(D) may be illustrated by the following examples.

Example (1). I1 and I2, calendar year individuals, own 100 percent of the profits and capital of C1, a partnership. In addition to owning C1, I1 and I2 also own 100 percent of the profits and capital of C2, a calendar year partnership. For its taxable years beginning February 1, 1987, 1988, and 1989, C1 has a section 444 election in effect to use a January 31 taxable year. During its base years beginning February 1, 1986, 1987, and 1988, C1 deducted $10,000, $11,000, and $12,000, respectively that was included in C2's gross income. Furthermore, of the $12,000 deducted by C1 for its taxable year beginning February 1, 1988, $7,000 was deducted during the period June 1, 1988 to January 31, 1989. Pursuant to paragraph (b)(5)(iv)(D)(*1*) of this section, the $7,000 deducted by C1 on or after June 1, 1988, and included in C2's gross income is considered an applicable payment for C1's base year beginning February 1, 1988. Amounts deducted by C1 prior to June 1, 1988, are not subject to paragraph (b)(5)(iv)(D)(*1*) of this section.

Example (2). The facts are the same as in example (1), except that I1 and I2 own only 51 percent of C2's profits and capital. Since the two partners in C1 (*i.e.*, I1 and I2) own more than 50 percent of C2's profits and capital, C2 is considered controlled by the partners of C1 pursuant to paragraph (b)(5)(iv)(D)(*1*)(*iii*) of this section. Thus, the conclusions in example (1) are unchanged. Furthermore, if the $7,000 deducted by C1 was included in the income of a partnership more than 50 percent of the profits and capital of which is owned by C2, such $7,000 would be considered an applicable payment for its base year beginning February 1, 1988.

Example (3). The facts are the same as in example (1), except that for its taxable years beginning February 1, 1987, 1988, and 1989, C2 has a section 444 election in effect to use a January 31 taxable year. Since both C1 and C2 have the same taxable year and both have section 444 elections in effect, paragraph (b)(5)(iv)(D)(*1*) of this section does not apply to the $7,000 deducted by C1 for its base year beginning February 1, 1988.

Example (4). I3 and I4, calendar year individuals, own 100 percent of the profits and capital of C3, a partnership. C3 has made a section 444 election to retain a year ending June 30 for its taxable year beginning July 1, 1987. Furthermore, C3 owns more than 50 percent of the profits and capital of C4, a partnership that historically used a June 30 taxable year. Pursuant to § 1.706–3T(b), C4 retains its year ending June 30 for its taxable year beginning July 1, 1987. For its taxable year beginning July 1, 1986, C4 deducted $20,000 that was included in I3's gross income. Pursuant to paragraph (b)(5)(iv)(D)(*2*) of this section, the $20,000 deducted by C4 is considered an applicable payment by C3 for its base year beginning July 1, 1986.

Example (5). The facts are the same as in example (4), except that the $20,000 deducted by C4 is included in the gross income of a calendar year partnership 100 percent owned by I3 and I4. Pursuant to paragraphs (b)(5)(v)(D) (*1*) and (*2*) of this section, the $20,000 deducted by C4 is considered an applicable payment by C3 for its base year beginning July 1, 1986.

Example (6). The facts are the same as in example (4), except that instead of directly owning a portion of C4, C3 owns more than 50 percent of the profits and capital of C5. Furthermore, C5 owns more than 50 percent of the profits and capital of C4. Pursuant to paragraph (b)(5)(iv)(D)(*2*)(*ii*) of this section, both C5 and C4 are considered downstream controlled partnerships of C3. Thus, pursuant to paragraph (b)(5)(iv)(D)(*2*)(*i*) of this section, the $20,000 deducted by C4 is considered an applicable payment by C3 for its base year beginning July 1, 1986.

(v) *Special rule for base year of less than twelve months*—(A) *In general.* If a base year is a taxable year of less than twelve months (a ‘‘short base year’’), net base year income for such year is an amount equal to the excess, if any, of—

(*1*) The deferral ratio multiplied by the annualized short base year income, over

(*2*) Applicable payments made during the deferral period of the applicable election year following the base year.

(B) *Annualized short base year income.* The annualized short base year income is determined by—

(*1*) Increasing the net income for the short base year by applicable payments deductible in the short base year, and

(*2*) Multiplying the short base year income as increased in paragraph (b)(5)(v)(B)(*1*) of this section by twelve, and dividing the result by the number of months in the short base year.

(vi) *Examples.* The provisions of paragraph (b)(5) of this section may be illustrated by the following examples.

Example (1). D, a partnership, is owned 10 percent by a C corporation with a September 30 taxable year and 90 percent by calendar year individuals. D has historically used a September 30 taxable year. For its taxable year beginning October 1, 1987, D makes a section 444 election to retain its September 30 taxable year. For the base year from October 1, 1986 to September 30, 1987, D has net income of $200,000 and no applicable payments. D’s deferral ratio is 3/12 (the ratio of the number of months in the deferral period to 12 months). Based upon these facts, D has net base year income of $50,000 ($200,000 × 3/12).

Example (2). The facts are the same as in example (1) except that D’s net income for the base year is $140,000, after applicable payments of $60,000. Of the applicable payments $15,000 were deductible during the deferral period of the base year. Based upon these facts, D has net base year income of $35,000, determined as follows:

Net income multiplied by deferral ratio	$140,000 × 3/12		$35,000
Plus the excess, if any, of applicable payments multiplied by deferral ratio	$60,000 × 3/12	$15,000	
Over aggregate amount of applicable payments deductible during deferral period of base year		$15,000	0
Net base year income			$35,000

Example (3). The facts are the same as in example (2) except that of the $60,000 applicable payments only $10,000 are deductible during the deferral period of the base year. Based on these facts, D has net base year income of $40,000, determined as follows:

Net income multiplied by deferral ratio	$140,000 x 3/12		$35,000
Plus the excess, if any, of applicable payments multiplied by deferral ratio	$60,000 x 3/12	$15,000	....
Over aggregate amount of applicable payments deductible during deferral period of base year		$10,000	$5,000
Net base year income			$40,000

Example (4). E is a C corporation that has historically used a January 31 taxable year. For its taxable year beginning February 1, 1987, E makes an election to be an S corporation and also makes a section 444 election to retain its January 31 taxable year. E’s taxable income for the taxable year beginning

February 1, 1986 to January 31, 1987 is $120,000. Pursuant to paragraph (b)(5)(iii)(A) of this section, the base year for X's first applicable election year is the taxable year beginning February 1, 1986 and ending January 31, 1987. Thus, E's net income for the base year is $120,000. During the base year, E pays its sole shareholder, A, a salary of $5,000 a month plus a $30,000 bonus on January 15, 1987. Thus, under paragraph (b)(5)(iv)(C) of this section, E's applicable payments for the base year are $90,000, of which $55,000 are applicable payments deductible during the deferral period of the base year (February 1 to December 31, 1986). Based upon these facts, E's net base year income is $137,500, determined as follows:

Net income multiplied by deferral ratio	$120,000 x 11/12		$110,000
Plus the excess, if any, of applicable payments multiplied by the deferral ratio	$90,000 x11/12	$82,500	
Over aggregate amount of applicable payments deductible during deferral period of base year		$55,000	$27,500
Net base year income			$137,500

Example (5). E, a corporation that has historically used a taxable year ending July 31, makes an election to be an S corporation for its taxable year beginning August 1, 1987. For that year, E also makes a section 444 election to use a taxable year ending September 30. Thus, E has two applicable election years beginning in 1987, the first beginning August 1, 1987 and ending September 30, 1987, and the second beginning October 1, 1987 and ending September 30, 1988. E's required year under section 1378 is the calendar year. Because E's first applicable election year ends prior to the last day of E's required year (*i.e.,* December 31, 1987), the required payment for E's first applicable election year is zero. However, E is required to file a return for such year as provided in § 1.7519–2T.

Example (6). The facts are the same as in example (5). E's second applicable election year is the year from October 1, 1987 to September 30, 1988, and the base year for the second applicable election year is a period of less than 12 months (i.e., August 1, 1987 to September 30, 1987). Thus, E must compute its net base year income using the special rule for short base years provided in paragraph (b)(5)(v) of this section. Assume E's net income for the short base year is $50,000, and E's applicable payments for the short base year are $15,000. Pursuant to paragraph (b)(5)(v)(B) of this section, E's annualized short base year net income is $390,000 ($65,000 x 12/2). Furthermore, assume E's applicable payments for the deferral period of its second applicable election year are $20,000. Based on these facts, the net base year income for the applicable election year beginning October 1, 1987 is $77,500, computed as follows:

Annualized short base year income multiplied by deferral ratio	$390,000 x 3/12	$97,500
Less: Applicable payments for deferral period		$20,000
Net base year income		$77,500

(c) *Refunds of required payments.* A partnership of S corporation is entitled to make a claim for refund, in accordance with the procedures provided in § 1.7519–2T(a)(6), if—

(1) The amount specified in paragraph (a)(3)(i) of this section is less than the amount specified in paragraph (a)(3)(ii) of this section; or

(2) The partnership or S corporation terminates its section 444 election, within the meaning of § 1.444–1T(a)(5).

(d) *Example.* The provisions of this section may be illustrated by the following examples.

Example (1). G, a partnership, is owned 10 percent by a C corporation with a June 30 taxable year, and 90 percent by calendar year individuals. G has historically used a June 30 taxable year. For its taxable year beginning July 1, 1987, G makes a section 444 election to retain its June 30 taxable year. For the base year from July 1, 1986 to June 30, 1987, G has net income of $300,000 and no applicable payments. G's deferral ratio is 6/12 (the ratio of the number of months in the deferral period to 12 months). Based on these facts, G's net base year income is $150,000 ($300,000 x 6/12). Thus, G's required payment for its first applicable election year is $13,500 ($150,000 of net base year income multiplied by 9 percent (the product of the applicable percentage for 1987, 25 percent, and the highest section 1 rate for 1987, 36 percent)).

Example (2). The facts are the same as in example (1). In addition, G continues its section 444 election for the taxable year beginning July 1, 1988, and G's net base year income for the year beginning July 1, 1987 is $150,000. The required payment for G's second applicable election year is $8,250 ($150,000 of net base year income multiplied by 14.5 percent (the product of the applicable percentage for 1988 applicable election years, 50 percent, and the adjusted highest section 1 rate for 1988, 29 percent) less G's $13,500 required payment for the first applicable election year).

Example (3). H, a partnership with a taxable year ending September 30, desires to make a section 444 election for its taxable year beginning October 1, 1987. H is 15 percent owned by I, a partnership with a taxable year ending September 30, and 85 percent owned by calendar year individuals. Assume H and I are qualified to make section 444 elections as a result of the ''same taxable year exception'' provided in §1.444–2T(e). If H and I make section 444 elections, they must each make a required payment (assuming the amount computed under paragraph (a)(3) of this section is greater than $500). Pursuant to paragraph (a)(3) of this section, the required payments of H and I are calculated independent of each other. Thus, in determining the amount of its required payment, I may not exclude its income attributable to H, even though H must also make a required payment on the same income.

Example (4). The facts are the same as in example (1) except that H is 90 percent owned by I and 10 percent owned by calendar year individuals. Pursuant to §1.706–3T, if I makes a section 444 election to retain its taxable year ending September 30, H's required year will be September 30, because H's majority interest partner will have a September 30 taxable year. Thus, H is not required to make a section 444 election and a required payment in order to use a September 30 taxable year. I, however, must make a required payment.

[T.D. 8205, 53 FR 19706, May 27, 1988]

§1.7519–2T Required payments—procedures and administration (temporary).

(a) *Payment and return required*—(1) *In general.* With respect to any taxable year for which a partnership or S corporation has a section 444 election in effect (an ''applicable election year''), the partnership or S corporation shall file a return as provided in paragraphs (a) (2) and (3) of this section and make a payment, if required, as provided in paragraph (a)(4) of this section.

(2) *Return required*—(i) *In general.* A return showing the required payment shall be made, even if the required payment for the applicable election year is zero. For an applicable election year beginning in 1987, the return shall be made on Form 720, ''Quarterly Federal Excise Tax Return.'' For an applicable election year beginning after 1987, the return shall also be made on Form 720 unless another form is prescribed by the Commissioner.

(ii) *Procedure if amount for applicable election year (and all proceeding years) is not greater than $500.* If a partnership or S corporation is not required to make a payment under section 7519 for an applicable election year, the partnership or S corporation should type or legibly print ''zero'' on the appropriate line of the prescribed form.

(3) *Time and place for filing return*—(i) *Applicable election years beginning in 1987.* For an applicable election year beginning in 1987, the Form 720 must be filed with the Service Center indicated by the instructions for the Form 720. The date for filing such form is as follows—

(A) *Taxpayers that would otherwise file Form 720 for the second quarter of 1988.* Taxpayers that are required, without regard to this section, to file Form 720 for the second quarter of 1988 (*e.g.*, taxpayers reporting liability for manufacturers excise tax) must file Form 720 by the normal due date of such form for the second quarter of 1988. Thus, such taxpayers must generally file Form 720 on or before July 31, 1988. However, if such taxpayers must also report tax imposed by section 4251 (relating to communications services tax), sections 4261 and 4271 (relating to air transportation tax), or section 4986 (relating to windfall profits tax) for the second quarter of 1988, they must file Form 720 on or before August 31, 1988.

(B) *Other taxpayers.* Taxpayers that are not described in paragraph (a)(3)(i)(A) of this section (*i.e.,* taxpayers that but for this section would not be required to file Form 720 for the second quarter of 1988) must file Form 720 on or before July 31, 1988.

(ii) *Applicable election years beginning after 1987*—(A) *Return made on Form 720.* [Reserved].

(B) *Return made on form other than Form 720.* For an applicable election year beginning after 1987, the return showing the required payment is to be filed with the Service Center indicated by the instructions for the form prescribed for payment. The return must be filed on or before the date prescribed by the instructions to the form.

(iii) *Special rule for back-up section 444 election.* See § 1.444–3T(b)(4)(iii) for a special rule that may extend the due date for filing a return required by paragraph (a)(2) of this section.

(4) *Time and place for making required payment*—(i) *Applicable election years beginning in 1987.* For an applicable election year beginning in 1987, the required payment is due and payable without assessment and notice on or before the date the taxpayer's Form 720 for the second quarter is due (as specified in paragraph (a)(3) of this section). The required payment must be paid by check or money order, and such check or money order must indicate the partnership's or S corporation's taxpayer identification number and must include the statement: ''IRS NO. 11 PAYMENT.'' The check or money order must be sent, together with Form 720, to the Service Center indicated by the instructions for the Form 720.

(ii) *Applicable election years beginning after 1987.* For an applicable election year beginning after 1987, the required payment is due and payable without assessment or notice, on or before May 15 of the calendar year following the calendar year in which the applicable election year begins.

(iii) *Special rule for back-up section 444 election.* See § 1.444–3T(b)(4)(iii) for a special rule that may extend the due date for making a required payment.

(5) *Penalties for failure to pay.* In the case of any failure by a partnership or S corporation to pay the required payment on or before the date prescribed in paragraph (a)(4) of this section, there shall be assessed on such partnership or S corporation a penalty of 10 percent of the underpayment. For purposes of this section, the term ''underpayment'' means the excess of the amount of the payment required under this section over the amount (if any) of such payment paid on or before the date prescribed in paragraph (a)(4) of this section.

(6) *Refund of required payment*—(i) *In general.* If a partnership or S corporation is entitled to make a claim for refund pursuant to § 1.7519–1T(c), such partnership or S corporation should file a claim for refund, as provided in paragraph (a)(6)(ii) of this section. However, in no event shall a refund be made prior to April 15 of the second calendar year that follows the calendar year in which an applicable election year begins. For example, assume a partnership made a section 444 election to retain its taxable year for its taxable year beginning October 1, 1987, and as a result made a required payment for such year. Further assume that the partnership terminates its election for its taxable year beginning October 1, 1988. Based on these facts, the partnership will be entitled to a refund, but no earlier than April 15, 1989.

(ii) *Procedures for claiming refund.* [Reserved].

(iii) *Interest on refund.* No interest shall be allowed with respect to any refund of a required payment under § 1.7519–1T(C).

(b) *Assessment and collection of payment.* A required payment shall be assessed and collected in the same manner as if it were a tax imposed by subtitle C. Furthermore, no deduction shall be allowable to a partnership or S corporation (or their owners) with respect to the required payment.

(c) *Termination due to willful failure.* See § 1.444–1T(a)(5)(i)(C), which provides that willful failure to comply with the requirements of this section will result in the termination of the section 444 election.

(d) *Negligence and fraud penalties made applicable.* For purposes of section 6653, relating to additions to tax for negligence and fraud, any payment required by this section shall be treated as a tax.

[T.D. 8205, 53 FR 19709, May 27, 1988]

§1.7519–3T Effective date (temporary).

The provisions of §§1.7519–1T through §1.7519–3T are effective for taxable years beginning after December 31, 1986.

[T.D. 8205, 53 FR 19710, May 27, 1988]

GENERAL ACTUARIAL VALUATIONS

§1.7520–1 Valuation of annuities, unitrust interests, interests for life or terms of years, and remainder or reversionary interests.

(a) *General actuarial valuations.* (1) Except as otherwise provided in this section and in §1.7520–3 (relating to exceptions to the use of prescribed tables under certain circumstances), in the case of certain transactions after April 30, 1989, subject to income tax, the fair market value of annuities, interests for life or for a term of years (including unitrust interests), remainders, and reversions is their present value determined under this section. See §20.2031–7(d) (and, for certain prior periods, §20.2031–7A) of this chapter, Estate Tax Regulations, for the computation of the value of annuities, unitrust interests, life estates, terms for years, remainders, and reversions, other than interests described in paragraphs (a)(2) and (a)(3) of this section.

(2) For a transfer to a pooled income fund after April 30, 1989, see §1.642(c)–6(e) (or, for certain prior periods, §1.642(c)–6A) with respect to the valuation of the remainder interest.

(3) For a transfer to a charitable remainder annuity trust after April 30, 1989, see §1.664–2 with respect to the valuation of the remainder interest. See §1.664–4 (or, for certain prior periods, §1.664–4A) with respect to the valuation of the remainder interest in property transferred to a charitable remainder unitrust.

(b) *Components of valuation*—(1) *Interest rate component*—(i) *Section 7520 Interest rate.* The section 7520 interest rate is the rate of return, rounded to the nearest two-tenths of one percent, that is equal to 120 percent of the applicable Federal mid-term rate, compounded annually, for purposes of section 1274(d)(1), for the month in which the valuation date falls. In rounding the rate to the nearest two-tenths of a percent, any rate that is midway between one two-tenths of a percent and another is rounded up to the higher of those two rates. For example, if 120 percent of the applicable Federal mid-term rate is 10.30, the section 7520 interest rate component is 10.4. The section 7520 interest rate is published monthly by the Internal Revenue Service in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter).

(ii) *Valuation date.* Except as provided in §1.7520–2, the valuation date is the date on which the transaction takes place.

(2) *Mortality component.* The mortality component reflects the mortality data most recently available from the United States census. As new mortality data becomes available after each decennial census, the mortality component described in this section will be revised periodically and the revised mortality component tables will be published in the regulations at that time. For transactions with valuation dates after April 30, 1989, the mortality component table (Table 80CNSMT) is contained in §20.2031–7(d) of this chapter (Estate Tax Regulations). See §20.2031–7A for mortality component tables applicable to transactions for which the valuation date falls before May 1, 1989.

(c) *Tables.* The present value on the valuation date of an annuity, life estate, term of years, remainder, or reversion is computed by using the section 7520 interest rate component that is described in paragraph (b)(1) of this section and the mortality component that is described in paragraph (b)(2) of this section. Actuarial factors for determining these present values are included in tables in these regulations and in publications by the Internal Revenue Service. If a special factor is required in order to value an interest, the Internal Revenue Service will furnish the factor upon a request for a ruling. The request for a ruling must be accompanied by a recitation of the facts, including the date of birth for each measuring life and copies of relevant instruments. A request for a ruling must comply with the instructions for requesting a ruling published periodically in the Internal Revenue Bulletin (see Rev. Proc. 94–1, 1994–1 I.R.B. 10, and subsequent updates, and

§§601.201 and 601.601(d)(2)(ii)(*b*) of this chapter) and include payment of the required user fee.

(1) *Regulation sections containing tables with interest rates between 4.2 and 14 percent.* Section 1.642(c)–6(e)(4) contains Table S used for determining the present value of a single life remainder interest in a pooled income fund as defined in §1.642(c)–5. Section 1.664–4(e)(6) contains Table D (actuarial factors used in determining the present value of a remainder interest postponed for a term of years), Table U(1) (actuarial factors for one life), and Table F (payout factors) used in determining the present value of a remainder interest in a charitable remainder unitrust as defined in §1.664–3. Section 20.2031–7(d)(6) of this chapter (Estate Tax Regulations) contains Table S (actuarial factors for one life), Table B (actuarial factors used in determining the present value of an interest for a term of years), Table K (annuity end-of-interval adjustment factors), Table J (term certain annuity beginning-of-interval adjustment factors), and Table 80CNSMT (mortality components) used in determining the present value of annuities, life estates, remainders, and reversions. The regulations will be revised periodically to include new mortality component tables and new tables of factors.

(2) *Internal Revenue Service publications containing tables with interest rates between 2.2 and 26 percent.* The following documents (with the exception of Publication 1459) have been published for sale by the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402:

(i) Internal Revenue Service Publication 1457, ''Actuarial Values, Alpha Volume,'' (8/89). This publication includes tables of valuation factors, as well as examples that show how to compute other valuation factors, for determining the present value of annuities, life estates, terms of years, remainders, and reversions, measured by one or two lives. These factors may also be used in the valuation of interests in a charitable remainder annuity trust as defined in §1.664–2 of this chapter and a pooled income fund as defined in §1.642(c)–5 of this chapter.

(ii) Internal Revenue Service Publication 1458, ''Actuarial Values, Beta Volume,'' (8/89). This publication includes term certain tables and tables of one and two life valuation factors for determining the present value of remainder interests in a charitable remainder unitrust as defined in §1.664–3 of this chapter.

(iii) Internal Revenue Service Publication 1459, ''Actuarial Values, Gamma Volume,'' (8–89) is no longer available for purchase from the Superintendent of Documents. However, it may be obtained by requesting a copy from: CC:DOM:CORP:T:R (IRS Publication 1459), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. This publication includes tables for computing depreciation adjustment factors. See §1.170A–12 of this chapter.

(d) *Effective date.* This section is effective as of May 1, 1989.

[T.D. 8540, 59 FR 30149, June 10, 1994]

§1.7520–2 Valuation of charitable interests.

(a) *In general*—(1) *Valuation.* Except as otherwise provided in this section and in §1.7520–3 (relating to exceptions to the use of prescribed tables under certain circumstances), the fair market value of annuities, interests for life or for a term of years, remainders, and reversions for which an income tax charitable deduction is allowable is the present value of such interests determined under §1.7520–1.

(2) *Prior-month election rule.* If any part of the property interest transferred qualifies for an income tax charitable deduction under section 170(c), the taxpayer may elect (under paragraph (b) of this section) to compute the present value of the interest transferred by use of the section 7520 interest rate for the month during which the interest is transferred or the section 7520 interest rate component for either of the 2 months preceding the month during which the interest is transferred. Paragraph (b) of this section explains how a prior-month election is made. The interest rate for the month so elected is the applicable section 7520 interest rate. If the actuarial factor for either or both of the 2 months preceding the month during

which the interest is transferred is based on a mortality experience that is different from the mortality experience at the date of the transfer and if the taxpayer elects to use the section 7520 rate for a prior month with the different mortality experience, the taxpayer must use the actuarial factor derived from the mortality experience in effect during the month of the section 7520 rate elected. All actuarial computations relating to the transfer must be made by applying the interest rate component and the mortality component of the month elected by the taxpayer.

(3) *Transfers of more than one interest in the same property.* If a taxpayer transfers more than one interest in the same property at the same time, for purposes of valuing the transferred interests, the taxpayer must use the same interest rate and mortality component for each interest in the property transferred. If more than one interest in the same property is transferred in two or more separate transfers at different times, the value of each interest is determined by the use of the interest rate component and mortality component in effect during the month of the transfer of that interest or, if applicable under paragraph (a)(2) of this section, either of the two months preceding the month of the transfer.

(4) *Information required with tax return.* The following information must be attached to the income tax return (or to the amended return) if the taxpayer claims a charitable deduction for the present value of a temporary or remainder interest in property—

(i) A complete description of the interest that is transferred, including a copy of the instrument of transfer;

(ii) The valuation date of the transfer;

(iii) The names and identification numbers of the beneficiaries of the transferred interest;

(iv) The names and birthdates of any measuring lives, a description of any relevant terminal illness condition of any measuring life, and (if applicable) an explanation of how any terminal illness condition was taken into account in valuing the interest; and

(v) A computation of the deduction showing the applicable section 7520 interest rate that is used to value the transferred interest.

(5) *Place for filing returns.* See section 6091 of the Internal Revenue Code and the regulations thereunder for the place for filing the return or other document required by this section.

(b) *Election of interest rate component*—(1) *Time for making election.* A taxpayer makes a prior-month election under paragraph (a)(2) of this section by attaching the information described in paragraph (b)(2) of this section to the taxpayer's income tax return or to an amended return for that year that is filed within 24 months after the later of the date the original return for the year was filed or the due date for filing the return.

(2) *Manner of making election.* A statement that the prior-month election under section 7520(a) of the Internal Revenue Code is being made and that identifies the elected month must be attached to the income tax return (or to the amended return).

(3) *Revocability.* The prior-month election may be revoked by filing an amended return within 24 months after the later of the date the original return of tax for the year was filed or the due date for filing the return. The revocation must be filed in the place referred to in paragraph (a)(5) of this section.

(c) *Effective dates.* Paragraph (a) of this section is effective as of May 1, 1989. Paragraph (b) of this section is effective for elections made after June 10, 1994.

[T.D. 8540, 59 FR 30149, June 10, 1994]

§1.7520–3 Limitation on the application of section 7520.

(a) *Internal Revenue Code sections to which section 7520 does not apply.* Section 7520 of the Internal Revenue Code does not apply for purposes of—

(1) Part I, subchapter D of subtitle A (section 401 et. seq.), relating to the income tax treatment of certain qualified plans. (However, section 7520 does apply to the estate and gift tax treatment of certain qualified plans and for purposes of determining excess accumulations under section 4980A);

(2) Sections 72 and 101(b), relating to the income taxation of life insurance,

endowment, and annuity contracts, unless otherwise provided for in the regulations under sections 72, 101, and 1011 (see, particularly, §§ 1.101–2(e)(1)(iii)(*b*)(*2*), and 1.1011–2(c), *Example 8*);

(3) Sections 83 and 451, unless otherwise provided for in the regulations under those sections;

(4) Section 457, relating to the valuation of deferred compensation, unless otherwise provided for in the regulations under section 457;

(5) Sections 3121(v) and 3306(r), relating to the valuation of deferred amounts, unless otherwise provided for in the regulations under those sections;

(6) Section 6058, relating to valuation statements evidencing compliance with qualified plan requirements, unless otherwise provided for in the regulations under section 6058;

(7) Section 7872, relating to income and gift taxation of interest-free loans and loans with below-market interest rates, unless otherwise provided for in the regulations under section 7872; or

(8) Section 2702(a)(2)(A), relating to the value of a nonqualified retained interest upon a transfer of an interest in trust to or for the benefit of a member of the transferor's family; and

(9) Any other sections of the Internal Revenue Code to the extent provided by the Internal Revenue Service in revenue rulings or revenue procedures. (See §§ 601.201 and 601.601 of this chapter).

(b) *Other limitations on the application of section 7520*—(1) *In general*—(i) *Ordinary beneficial interests.* For purposes of this section:

(A) An *ordinary annuity interest* is the right to receive a fixed dollar amount at the end of each year during one or more measuring lives or for some other defined period. A standard section 7520 annuity factor for an ordinary annuity interest represents the present worth of the right to receive $1.00 per year for a defined period, using the interest rate prescribed under section 7520 for the appropriate month. If an annuity interest is payable more often than annually or is payable at the beginning of each period, a special adjustment must be made in any computation with a standard section 7520 annuity factor.

(B) An *ordinary income interest* is the right to receive the income from, or the use of, property during one or more measuring lives or for some other defined period. A standard section 7520 income factor for an ordinary income interest represents the present worth of the right to receive the use of $1.00 for a defined period, using the interest rate prescribed under section 7520 for the appropriate month.

(C) An *ordinary remainder or reversionary interest* is the right to receive an interest in property at the end of one or more measuring lives or some other defined period. A standard section 7520 remainder factor for an ordinary remainder or reversionary interest represents the present worth of the right to receive $1.00 at the end of a defined period, using the interest rate prescribed under section 7520 for the appropriate month.

(ii) *Certain restricted beneficial interests.* A *restricted beneficial interest* is an annuity, income, remainder, or reversionary interest that is subject to a contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances. In general, a standard section 7520 annuity, income, or remainder factor may not be used to value a restricted beneficial interest. However, a special section 7520 annuity, income, or remainder factor may be used to value a restricted beneficial interest under some circumstances. See paragraph (b)(4) *Example 2* of this section, which illustrates a situation where a special section 7520 actuarial factor is needed to take into account the shorter life expectancy of the terminally ill measuring life. See § 1.7520–1(c) for requesting a special factor from the Internal Revenue Service.

(iii) *Other beneficial interests.* If, under the provisions of this paragraph (b), the interest rate and mortality components prescribed under section 7520 are not applicable in determining the value of any annuity, income, remainder, or reversionary interest, the actual fair market value of the interest (determined without regard to section 7520) is based on all of the facts and circumstances if and to the extent permitted by the Internal Revenue Code provision applicable to the property interest.

(2) *Provisions of governing instrument and other limitations on source of payment*—(i) *Annuities.* A standard section 7520 annuity factor may not be used to determine the present value of an annuity for a specified term of years or the life of one or more individuals unless the effect of the trust, will, or other governing instrument is to ensure that the annuity will be paid for the entire defined period. In the case of an annuity payable from a trust or other limited fund, the annuity is not considered payable for the entire defined period if, considering the applicable section 7520 interest rate at the valuation date of the transfer, the annuity is expected to exhaust the fund before the last possible annuity payment is made in full. For this purpose, it must be assumed that it is possible for each measuring life to survive until age 110. For example, for a fixed annuity payable annually at the end of each year, if the amount of the annuity payment (expressed as a percentage of the initial corpus) is less than or equal to the applicable section 7520 interest rate at the date of the transfer, the corpus is assumed to be sufficient to make all payments. If the percentage exceeds the applicable section 7520 interest rate and the annuity is for a definite term of years, multiply the annual annuity amount by the Table B term certain annuity factor, as described in §1.7520–1(c)(1), for the number of years of the defined period. If the percentage exceeds the applicable section 7520 interest rate and the annuity is payable for the life of one or more individuals, multiply the annual annuity amount by the Table B annuity factor for 110 years minus the age of the youngest individual. If the result exceeds the limited fund, the annuity may exhaust the fund, and it will be necessary to calculate a special section 7520 annuity factor that takes into account the exhaustion of the trust or fund. This computation would be modified, if appropriate, to take into account annuities with different payment terms. See §25.7520–3(b)(2)(v) *Example 5* of this chapter, which provides an illustration involving an annuity trust that is subject to exhaustion.

(ii) *Income and similar interests*—(A) *Beneficial enjoyment.* A standard section 7520 income factor for an ordinary income interest may not be used to determine the present value of an income or similar interest in trust for a term of years or for the life of one or more individuals unless the effect of the trust, will, or other governing instrument is to provide the income beneficiary with that degree of beneficial enjoyment of the property during the term of the income interest that the principles of the law of trusts accord to a person who is unqualifiedly designated as the income beneficiary of a trust for a similar period of time. This degree of beneficial enjoyment is provided only if it was the transferor's intent, as manifested by the provisions of the governing instrument and the surrounding circumstances, that the trust provide an income interest for the income beneficiary during the specified period of time that is consistent with the value of the trust corpus and with its preservation. In determining whether a trust arrangement evidences that intention, the treatment required or permitted with respect to individual items must be considered in relation to the entire system provided for in the administration of the subject trust. Similarly, in determining the present value of the right to use tangible property (whether or not in trust) for one or more measuring lives or for some other specified period of time, the interest rate component prescribed under section 7520 and §1.7520–1 may not be used unless, during the specified period, the effect of the trust, will or other governing instrument is to provide the beneficiary with that degree of use, possession, and enjoyment of the property during the term of interest that applicable state law accords to a person who is unqualifiedly designated as a life tenant or term holder for a similar period of time.

(B) *Diversions of income and corpus.* A standard section 7520 income factor for an ordinary income interest may not be used to value an income interest or similar interest in property for a term of years or for one or more measuring lives if—

(*1*) The trust, will, or other governing instrument requires or permits the beneficiary's income or other enjoyment to be withheld, diverted, or accumulated for another person's benefit without the consent of the income beneficiary; or

(*2*) The governing instrument requires or permits trust corpus to be withdrawn from the trust for another person's benefit during the income beneficiary's term of enjoyment without the consent of and accountability to the income beneficiary for such diversion.

(iii) *Remainder and reversionary interests.* A standard section 7520 remainder interest factor for an ordinary remainder or reversionary interest may not be used to determine the present value of a remainder or reversionary interest (whether in trust or otherwise) unless, consistent with the preservation and protection that the law of trusts would provide for a person who is unqualifiedly designated as the remainder beneficiary of a trust for a similar duration, the effect of the administrative and dispositive provisions for the interest or interests that precede the remainder or reversionary interest is to assure that the property will be adequately preserved and protected (e.g., from erosion, invasion, depletion, or damage) until the remainder or reversionary interest takes effect in possession and enjoyment. This degree of preservation and protection is provided only if it was the transferor's intent, as manifested by the provisions of the arrangement and the surrounding circumstances, that the entire disposition provide the remainder or reversionary beneficiary with an undiminished interest in the property transferred at the time of the termination of the prior interest.

(iv) *Pooled income fund interests.* In general, pooled income funds are created and administered to achieve a special rate of return. A beneficial interest in a pooled income fund is not ordinarily valued using a standard section 7520 income or remainder interest factor. The present value of a beneficial interest in a pooled income fund is determined according to rules and special remainder factors prescribed in § 1.642(c)–6 and, when applicable, the rules set forth in paragraph (b)(3) of this section, if the individual who is the measuring life is terminally ill at the time of the transfer.

(3) *Mortality component.* The mortality component prescribed under section 7520 may not be used to determine the present value of an annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life is terminally ill at the time of the transaction. For purposes of this paragraph (b)(3), an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within 1 year. However, if the individual survives for eighteen months or longer after the date of the transaction, that individual shall be presumed to have not been terminally ill at the time of the transaction unless the contrary is established by clear and convincing evidence.

(4) *Examples.* The provisions of this paragraph (b) are illustrated by the following examples:

Example 1. Annuity funded with unproductive property. The taxpayer transfers corporation stock worth $1,000,000 to a trust. The trust provides for a 6 percent ($60,000 per year) annuity in cash or other property to be paid to a charitable organization for 25 years and for the remainder to be distributed to the donor's child. The trust specifically authorizes, but does not require, the trustee to retain the shares of stock. The section 7520 interest rate for the month of the transfer is 8.2 percent. The corporation has paid no dividends on this stock during the past 5 years, and there is no indication that this policy will change in the near future. Under applicable state law, the corporation is considered to be a sound investment that satisfies fiduciary standards. Therefore, the trust's sole investment in this corporation is not expected to adversely affect the interest of either the annuitant or the remainder beneficiary. Considering the 6 percent annuity payout rate and the 8.2 percent section 7520 interest rate, the trust corpus is considered sufficient to pay this annuity for the entire 25-year term of the trust, or even indefinitely. Although it appears that neither beneficiary would be able to compel the trustee to make the trust corpus produce investment income, the annuity interest in this case is considered to be an ordinary annuity interest, and the standard section 7520 annuity factor may be used to determine the present value of the annuity. In this case, the section 7520 annuity factor would represent the right to receive $1.00 per year for a term of 25 years.

Example 2. Terminal illness. The taxpayer transfers property worth $1,000,000 to a charitable remainder unitrust described in section 664(d)(2) and §1.664–3. The trust provides for a fixed-percentage 7 percent unitrust benefit (each annual payment is equal to 7 percent of the trust assets as valued at the beginning of each year) to be paid quarterly to an individual beneficiary for life and for the remainder to be distributed to a charitable organization. At the time the trust is created, the individual beneficiary is age 60 and has been diagnosed with an incurable illness and there is at least a 50 percent probability of the individual dying within 1 year. Assuming the presumption in paragraph (b)(3) of this section does not apply, because there is at least a 50 percent probability that this beneficiary will die within 1 year, the standard section 7520 unitrust remainder factor for a person age 60 from the valuation tables may not be used to determine the present value of the charitable remainder interest. Instead, a special unitrust remainder factor must be computed that is based on the section 7520 interest rate and that takes into account the projection of the individual beneficiary's actual life expectancy.

(5) *Additional limitations.* Section 7520 does not apply to the extent as may otherwise be provided by the Commissioner.

(c) *Effective date.* Section 1.7520–3(a) is effective as of May 1, 1989. The provisions of paragraph (b) of this section are effective with respect to transactions after December 13, 1995.

[T.D. 8540, 59 FR 30150, June 10, 1994, as amended by T.D. 8630, 60 FR 63915, Dec. 13, 1995]

§1.7520–4 Transitional rules.

(a) *Reliance.* If the valuation date is after April 30, 1989, and before June 10, 1994, a taxpayer can rely on Notice 89–24, 1989–1 C.B. 660, or Notice 89–60, 1989–1 C.B. 700 (See §601.601(d)(2)(ii)(*b*) of this chapter), in valuing the transferred interest.

(b) *Effective date.* This section is effective as of May 1, 1989.

[T.D. 8540, 59 FR 30150, June 10, 1994]

§1.7701(l)–1 Conduit financing arrangements.

Section 7701(l) authorizes the issuance of regulations that recharacterize any multiple-party financing transaction as a transaction directly among any two or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by title 26 of the United States Code.

[T.D. 8611, 60 FR 41015, Aug. 11, 1995, as amended by T.D. 8735, 62 FR 53502, Oct. 14, 1997]

§1.7702B–1 Consumer protection provisions.

(a) *In general.* Under sections 7702B(b)(1)(F), 7702B(g), and 4980C, qualified long-term care insurance contracts and issuers of those contracts are required to satisfy certain provisions of the Long-Term Care Insurance Model Act (Model Act) and Long-Term Care Insurance Model Regulation (Model Regulation) promulgated by the National Association of Insurance Commissioners (NAIC), as adopted as of January 1993. The requirements for qualified long-term care insurance contracts under section 7702B(b)(1)(F) and (g) relate to guaranteed renewal or noncancellability, prohibitions on limitations and exclusions, extension of benefits, continuation or conversion of coverage, discontinuance and replacement of policies, unintentional lapse, disclosure, prohibitions against post-claims underwriting, minimum standards, inflation protection, prohibitions against pre-existing conditions exclusions and probationary periods, and prior hospitalization. The requirements for qualified long-term care insurance contracts under section 4980C relate to application forms and replacement coverage, reporting requirements, filing requirements for marketing, standards for marketing, appropriateness of recommended purchase, standard format outline of coverage, delivery of a shopper's guide, right to return, outline of coverage, certificates under group plans, policy summary, monthly reports on accelerated death benefits, and incontestability period.

(b) *Coordination with State requirements*—(1) *Contracts issued in a State that imposes more stringent requirements.* If a State imposes a requirement that is more stringent than the analogous requirement imposed by section

7702B(g) or 4980C, then, under section 4980C(f), compliance with the more stringent requirement of State law is considered compliance with the parallel requirement of section 7702B(g) or 4980C. The principles of paragraph (b)(3) of this section apply to any case in which a State imposes a requirement that is more stringent than the analogous requirement imposed by section 7702B(g) or 4980C (as described in this paragraph (b)(1)), but in which there has been a failure to comply with that State requirement.

(2) *Contracts issued in a State that has adopted the model provisions.* If a State imposes a requirement that is the same as the parallel requirement imposed by section 7702B(g) or 4980C, compliance with that requirement of State law is considered compliance with the parallel requirement of section 7702B(g) or 4980C, and failure to comply with that requirement of State law is considered failure to comply with the parallel requirement of section 7702B(g) or 4980C.

(3) *Contracts issued in a State that has not adopted the model provisions or more stringent requirements.* If a State has not adopted the Model Act, the Model Regulation, or a requirement that is the same as or more stringent than the analogous requirement imposed by section 7702B(g) or 4980C, then the language, caption, format, and content requirements imposed by sections 7702B(g) and 4980C with respect to contracts, applications, outlines of coverage, policy summaries, and notices will be considered satisfied for a contract subject to the law of that State if the language, caption, format, and content are substantially similar to those required under the parallel provision of the Model Act or Model Regulation. Only nonsubstantive deviations are permitted in order for language, caption, format, and content to be considered substantially similar to the requirements of the Model Act or Model Regulation.

(c) *Effective date.* This section applies with respect to contracts issued after December 10, 1999.

[T.D. 8792, 63 FR 68186, Dec. 10, 1998]

§ 1.7702B–2 Special rules for pre-1997 long-term care insurance contracts.

(a) *Scope.* The definitions and special provisions of this section apply solely for purposes of determining whether an insurance contract (other than a qualified long-term care insurance contract described in section 7702B(b) and any regulations issued thereunder) is treated as a qualified long-term care insurance contract for purposes of the Internal Revenue Code under section 321(f)(2) of the Health Insurance Portability and Accountability Act of 1996 (Public Law 104–191).

(b) *Pre-1997 long-term care insurance contracts*—(1) *In general.* A pre-1997 long-term care insurance contract is treated as a qualified long-term care insurance contract, regardless of whether the contract satisfies section 7702B(b) and any regulations issued thereunder.

(2) *Pre-1997 long-term care insurance contract defined.* A pre-1997 long-term care insurance contract is any insurance contract with an issue date before January 1, 1997, that met the long-term care insurance requirements of the State in which the contract was sitused on the issue date. For this purpose, the long-term care insurance requirements of the State are the State laws (including statutory and administrative law) that are intended to regulate insurance coverage that constitutes ‘‘long-term care insurance’’ (as defined in section 4 of the National Association of Insurance Commissioners (NAIC) Long-Term Care Insurance Model Act, as in effect on August 21, 1996), regardless of the terminology used by the State in describing the insurance coverage.

(3) *Issue date of a contract*—(i) *In general.* Except as otherwise provided in this paragraph (b)(3), the issue date of a contract is the issue date assigned to the contract by the insurance company. In no event is the issue date earlier than the date the policyholder submitted a signed application for coverage to the insurance company. If the period between the date the signed application is submitted to the insurance company and the date coverage under which the contract actually becomes effective is substantially longer than under the insurance company's usual

business practice, then the issue date is the later of the date coverage under which the contract becomes effective or the issue date assigned to the contract by the insurance company. A policyholder's right to return a contract within a free-look period following delivery for a full refund of any premiums paid is not taken into account in determining the contract's issue date.

(ii) *Special rule for group contracts.* The issue date of a group contract (including any certificate issued thereunder) is the date on which coverage under the group contract becomes effective.

(iii) *Exchange of contract or certain changes in a contract treated as a new issuance.* For purposes of this paragraph (b)(3)—

(A) A contract issued in exchange for an existing contract after December 31, 1996, is considered a contract issued after that date;

(B) Any change described in paragraph (b)(4) of this section is treated as the issuance of a new contract with an issue date no earlier than the date the change goes into effect; and

(C) If a change described in paragraph (b)(4) of this section occurs with regard to one or more, but fewer than all, of the certificates evidencing coverage under a group contract, then the insurance coverage under the changed certificates is treated as coverage under a newly issued group contract (and the insurance coverage provided by any unchanged certificate continues to be treated as coverage under the original group contract).

(4) *Changes treated as the issuance of a new contract*—(i) *In general.* For purposes of paragraph (b)(3) of this section, except as provided in paragraph (b)(4)(ii) of this section, the following changes are treated as the issuance of a new contract—

(A) A change in the terms of a contract that alters the amount or timing of an item payable by either the policyholder (or certificate holder), the insured, or the insurance company;

(B) A substitution of the insured under an individual contract; or

(C) A change (other than an immaterial change) in the contractual terms, or in the plan under which the contract was issued, relating to eligibility for membership in the group covered under a group contract.

(ii) *Exceptions.* For purposes of this paragraph (b)(4), the following changes are not treated as the issuance of a new contract—

(A) A policyholder's exercise of any right provided under the terms of the contract as in effect on December 31, 1996, or a right required by applicable State law to be provided to the policyholder;

(B) A change in the mode of premium payment (for example, a change from monthly to quarterly premiums);

(C) In the case of a policy that is guaranteed renewable or noncancellable, a classwide increase or decrease in premiums;

(D) A reduction in premiums due to the purchase of a long-term care insurance contract by a family member of the policyholder;

(E) A reduction in coverage (with a corresponding reduction in premiums) made at the request of a policyholder;

(F) A reduction in premiums as a result of extending to an individual policyholder a discount applicable to similar categories of individuals pursuant to a premium rate structure that was in effect on December 31, 1996, for the issuer's pre-1997 long-term care insurance contracts of the same type;

(G) The addition, without an increase in premiums, of alternative forms of benefits that may be selected by the policyholder;

(H) The addition of a rider (including any similarly identifiable amendment) to a pre-1997 long-term care insurance contract in any case in which the rider, if issued as a separate contract of insurance, would itself be a qualified long-term care insurance contract under section 7702B and any regulations issued thereunder (including the consumer protection provisions in section 7702B(g) to the extent applicable to the addition of a rider);

(I) The deletion of a rider or provision of a contract that prohibited coordination of benefits with Medicare (often referred to as an HHS (Health and Human Services) rider);

(J) The effectuation of a continuation or conversion of coverage right that is provided under a pre-1997 group contract and that, in accordance with the terms of the contract as in effect on December 31, 1996, provides for coverage under an individual contract following an individual's ineligibility for continued coverage under the group contract; and

(K) The substitution of one insurer for another insurer in an assumption reinsurance transaction.

(5) *Examples.* The following examples illustrate the principles of this paragraph (b):

Example 1. (i) On December 3, 1996, A, an individual, submits a signed application to an insurance company to purchase a nursing home contract that meets the long-term care insurance requirements of the State in which the contract is sitused. The insurance company decides on December 20, 1996, that it will issue the contract, and assigns December 20, 1996, as the issue date for the contract. Under the terms of the contract, A's insurance coverage becomes effective on January 1, 1997. The company delivers the contract to A on January 3, 1997. A has the right to return the contract within 15 days following delivery for a refund of all premiums paid.

(ii) Under paragraph (b)(3)(i) of this section, the issue date of the contract is December 20, 1996. Thus, the contract is a pre-1997 long-term care insurance contract that is treated as a qualified long-term care insurance contract.

Example 2. (i) The facts are the same as in *Example 1,* except that the insurance coverage under the contract does not become effective until March 1, 1997. Under the insurance company's usual business practice, the period between the date of the application and the date the contract becomes effective is 30 days or less.

(ii) Under paragraph (b)(3)(i) of this section, the issue date of the contract is March 1, 1997. Thus, the contract is not a pre-1997 long-term care insurance contract, and, accordingly, the contract must meet the requirements of section 7702B(b) and any regulations issued thereunder to be a qualified long-term care insurance contract.

Example 3. (i) B, an individual, is the policyholder under a long-term care insurance contract purchased in 1995. On June 15, 2000, the insurance coverage and premiums under the contract are increased by agreement between B and the insurance company.

(ii) Under paragraph (b)(4)(i)(A) of this section, a change in the terms of a contract that alters the amount or timing of an item payable by the policyholder or the insurance company is treated as the issuance of a new contract. Thus, B's coverage is treated as coverage under a contract issued on June 15, 2000, and, accordingly, the contract must meet the requirements of section 7702B(b) and any regulations issued thereunder in order to be a qualified long-term care insurance contract.

Example 4. (i) C, an individual, is the policyholder under a long-term care insurance contract purchased in 1994. At that time and through December 31, 1996, the contract met the long-term care insurance requirements of the State in which the contract was sitused. In 1996, the policy was amended to add a provision requiring the policyholder to be offered the right to increase dollar limits for inflation every three years (without the policyholder being required to pass a physical or satisfy any other underwriting requirements). During 2002, C elects to increase the amount of insurance coverage (with a resulting premium increase) pursuant to the inflation provision.

(ii) Under paragraph (b)(4)(ii)(A) of this section, an increase in the amount of insurance coverage at the election of the policyholder (without the insurance company's consent and without underwriting or other limitations on the policyholder's rights) pursuant to a pre-1997 inflation provision is not treated as the issuance of a new contract. Thus, C's contract continues to be a pre-1997 long-term care insurance contract that is treated as a qualified long-term care insurance contract.

(c) *Effective date.* This section is applicable January 1, 1999.

[T.D. 8792, 63 FR 68187, Dec. 10, 1998]

§ 1.7703–1 Determination of marital status.

(a) *General rule.* The determination of whether an individual is married shall be made as of the close of his taxable year unless his spouse dies during his taxable year, in which case such determination shall be made as of the time of such death; and, except as provided in paragraph (b) of this section, an individual shall be considered as married even though living apart from his spouse unless legally separated under a decree of divorce or separate maintenance. The provisions of this paragraph may be illustrated by the following examples:

Example (1). Taxpayer A and his wife B both make their returns on a calendar year basis. In July 1954, they enter into a separation agreement and thereafter live apart, but no decree of divorce or separate maintenance is issued until March 1955. If A itemizes and claims his actual deductions on his return for the calendar year 1954, B may not elect the standard deduction on her return since B is considered as married to A (although permanently separated by agreement) on the last day of 1954.

Example (2). Taxpayer A makes his returns on the basis of a fiscal year ending June 30. His wife B makes her returns on the calendar year basis. A died in October 1954. In such case, since A and B were married as of the date of death, B may not elect the standard deduction for the calendar year 1954 if the income of A for the short taxable year ending with the date of his death is determined without regard to the standard deduction.

(b) *Certain married individuals living apart.* (1) For purposes of Part IV of Subchapter B of Chapter 1 of the Code, an individual is not considered as married for taxable years beginning after December 31, 1969, if (i) such individual is married (within the meaning of paragraph (a) of this section) but files a separate return; (ii) such individual maintains as his home a household which constitutes for more than one-half of the taxable year the principal place of abode of a dependent *(a)* who (within the meaning of section 152 and the regulations thereunder) is a son, stepson, daughter, or stepdaughter of the individual, and *(b)* with respect to whom such individual is entitled to a deduction for the taxable year under section 151; (iii) such individual furnishes over half of the cost of maintaining such household during the taxable year; and (iv) during the entire taxable year such individual's spouse is not a member of such household.

(2) For purposes of subparagraph (1)(ii)*(a)* of this paragraph, a legally adopted son or daughter of an individual, a child (described in paragraph (c)(2) of §1.152–2) who is a member of an individual's household if placed with such individual by an authorized placement agency (as defined in paragraph (c)(2) of §1.152–2) for legal adoption by such individual, or a foster child (described in paragraph (c)(4) of §1.152–2) of an individual if such child satisfies the requirements of section 152(a)(9) of the Code and paragraph (b) of §1.152–1 with respect to such individual, shall be treated as a son or daughter of such individual by blood.

(3) For purposes of subparagraph (1)(ii) of this paragraph, the household must actually constitute the home of the individual for his taxable year. However, a physical change in the location of such home will not prevent an individual from qualifying for the treatment provided in subparagraph (1) of this paragraph. It is not sufficient that the individual maintain the household without being its occupant. The individual and the dependent described in subparagraph (1)(ii)*(a)* of this paragraph must occupy the household for more than one-half of the taxable year of the individual. However, the fact that such dependent is born or dies within the taxable year will not prevent an individual from qualifying for such treatment if the household constitutes the principal place of abode of such dependent for the remaining or preceding part of such taxable year. The individual and such dependent will be considered as occupying the household during temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which a child or stepchild is absent for less than 6 months in the taxable year of the taxpayer, shall be considered a temporary absence due to special circumstances. Such absence will not prevent an individual from qualifying for the treatment provided in subparagraph (1) of this paragraph if (i) it is reasonable to assume that such individual or the dependent will return to the household and (ii) such individual continues to maintain such household or a substantially equivalent household in anticipation of such return.

(4) An individual shall be considered as maintaining a household only if he pays more than one-half of the cost thereof for his taxable year. The cost of maintaining a household shall be the expenses incurred for the mutual benefit of the occupants thereof by reason of its operation as the principal place of abode of such occupants for such taxable year. The cost of maintaining a household shall not include expenses otherwise incurred. The expenses of maintaining a household include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises. Such expenses do not include the cost of clothing, education,

medical treatment, vacations, life insurance, and transportation. In addition, the cost of maintaining a household shall not include any amount which represents the value of services rendered in the household by the taxpayer or by a dependent described in subparagraph (1)(ii)*(a)* of this paragraph.

(5) For purposes of subparagraph (1)(iv) of this paragraph, an individual's spouse is not a member of the household during a taxable year if such household does not constitute such spouse's place of abode at any time during such year. An individual's spouse will be considered to be a member of the household during temporary absences from the household due to special circumstances. A nonpermanent failure to occupy such household as his abode by reason of illness, education, business, vacation, or military service shall be considered a mere temporary absence due to special circumstances.

(6) The provisions of this paragraph may be illustrated by the following example:

Example. Taxpayer A, married to B at the close of the calendar year 1971, his taxable year, is living apart from B, but A is not legally separated from B under a decree of divorce or separate maintenance. A maintains a household as his home which is for 7 months of 1971 the principal place of abode of C, his son, with respect to whom A is entitled to a deduction under section 151. A pays for more than one-half the cost of maintaining that household. At no time during 1971 was B a member of the household occupied by A and C. A files a separate return for 1971. Under these circumstances, A is considered as not married under section 143(b) for purposes of the standard deduction. Even though A is married and files a separate return A may claim for 1971 as his standard deduction the larger of the low income allowance up to a maximum of $1,050 consisting of both the basic allowance and additional allowance (rather than the basic allowance only subject to the $500 limitation applicable to a separate return of a married individual) or the percentage standard deduction subject to the $1,500 limitation (rather than the $750 limitation applicable to a separate return of a married individual). See § 1.141–1. For purposes of the provisions of part IV of subchapter B of chapter 1 of the Code and the regulations thereunder, A is treated as unmarried.

[T.D. 7123, 36 FR 11086, June 9, 1971. Redesignated by T.D. 8712, 62 FR 2283, Jan. 16, 1997]

§ 1.7704–1 Publicly traded partnerships.

(a) *In general*—(1) *Publicly traded partnership.* A domestic or foreign partnership is a publicly traded partnership for purposes of section 7704(b) and this section if—

(i) Interests in the partnership are traded on an established securities market; or

(ii) Interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof.

(2) *Partnership interest*—(i) *In general.* For purposes of section 7704(b) and this section, an interest in a partnership includes—

(A) Any interest in the capital or profits of the partnership (including the right to partnership distributions); and

(B) Any financial instrument or contract the value of which is determined in whole or in part by reference to the partnership (including the amount of partnership distributions, the value of partnership assets, or the results of partnership operations).

(ii) *Exception for non-convertible debt.* For purposes of section 7704(b) and this section, an interest in a partnership does not include any financial instrument or contract that—

(A) Is treated as debt for federal tax purposes; and

(B) Is not convertible into or exchangeable for an interest in the capital or profits of the partnership and does not provide for a payment of equivalent value.

(iii) *Exception for tiered entities.* For purposes of section 7704(b) and this section, an interest in a partnership or a corporation (including a regulated investment company as defined in section 851 or a real estate investment trust as defined in section 856) that holds an interest in a partnership (lower-tier partnership) is not considered an interest in the lower-tier partnership.

(3) *Definition of transfer.* For purposes of section 7704(b) and this section, a transfer of an interest in a partnership

means a transfer in any form, including a redemption by the partnership or the entering into of a financial instrument or contract described in paragraph (a)(2)(i)(B) of this section.

(b) *Established securities market.* For purposes of section 7704(b) and this section, an established securities market includes—

(1) A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);

(2) A national securities exchange exempt from registration under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f) because of the limited volume of transactions;

(3) A foreign securities exchange that, under the law of the jurisdiction where it is organized, satisfies regulatory requirements that are analogous to the regulatory requirements under the Securities Exchange Act of 1934 described in paragraph (b) (1) or (2) of this section (such as the London International Financial Futures Exchange; the Marche a Terme International de France; the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited; the Frankfurt Stock Exchange; and the Tokyo Stock Exchange);

(4) A regional or local exchange; and

(5) An interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise.

(c) *Readily tradable on a secondary market or the substantial equivalent thereof*—(1) *In general.* For purposes of section 7704(b) and this section, interests in a partnership that are not traded on an established securities market (within the meaning of section 7704(b) and paragraph (b) of this section) are readily tradable on a secondary market or the substantial equivalent thereof if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market.

(2) *Secondary market or the substantial equivalent thereof.* For purposes of paragraph (c)(1) of this section, interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof if—

(i) Interests in the partnership are regularly quoted by any person, such as a broker or dealer, making a market in the interests;

(ii) Any person regularly makes available to the public (including customers or subscribers) bid or offer quotes with respect to interests in the partnership and stands ready to effect buy or sell transactions at the quoted prices for itself or on behalf of others;

(iii) The holder of an interest in the partnership has a readily available, regular, and ongoing opportunity to sell or exchange the interest through a public means of obtaining or providing information of offers to buy, sell, or exchange interests in the partnership; or

(iv) Prospective buyers and sellers otherwise have the opportunity to buy, sell, or exchange interests in the partnership in a time frame and with the regularity and continuity that is comparable to that described in the other provisions of this paragraph (c)(2).

(3) *Secondary market safe harbors.* The fact that a transfer of a partnership interest is not within one or more of the safe harbors described in paragraph (e), (f), (g), (h), or (j) of this section is disregarded in determining whether interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof.

(d) *Involvement of the partnership required.* For purposes of section 7704(b) and this section, interests in a partnership are not traded on an established securities market within the meaning of paragraph (b)(5) of this section and are not readily tradable on a secondary market or the substantial equivalent thereof within the meaning of paragraph (c) of this section (even if interests in the partnership are traded or readily tradable in a manner described in paragraph (b)(5) or (c) of this section) unless—

(1) The partnership participates in the establishment of the market or the inclusion of its interests thereon; or

(2) The partnership recognizes any transfers made on the market by—

(i) Redeeming the transferor partner (in the case of a redemption or repurchase by the partnership); or

(ii) Admitting the transferee as a partner or otherwise recognizing any rights of the transferee, such as a right of the transferee to receive partnership distributions (directly or indirectly) or to acquire an interest in the capital or profits of the partnership.

(e) *Transfers not involving trading*—(1) *In general.* For purposes of section 7704(b) and this section, the following transfers (private transfers) are disregarded in determining whether interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof—

(i) Transfers in which the basis of the partnership interest in the hands of the transferee is determined, in whole or in part, by reference to its basis in the hands of the transferor or is determined under section 732;

(ii) Transfers at death, including transfers from an estate or testamentary trust;

(iii) Transfers between members of a family (as defined in section 267(c)(4));

(iv) Transfers involving the issuance of interests by (or on behalf of) the partnership in exchange for cash, property, or services;

(v) Transfers involving distributions from a retirement plan qualified under section 401(a) or an individual retirement account;

(vi) Block transfers (as defined in paragraph (e)(2) of this section);

(vii) Transfers pursuant to a right under a redemption or repurchase agreement (as defined in paragraph (e)(3) of this section) that is exercisable only—

(A) Upon the death, disability, or mental incompetence of the partner; or

(B) Upon the retirement or termination of the performance of services of an individual who actively participated in the management of, or performed services on a full-time basis for, the partnership;

(viii) Transfers pursuant to a closed end redemption plan (as defined in paragraph (e)(4) of this section);

(ix) Transfers by one or more partners of interests representing in the aggregate 50 percent or more of the total interests in partnership capital and profits in one transaction or a series of related transactions; and

(x) Transfers not recognized by the partnership (within the meaning of paragraph (d)(2) of this section).

(2) *Block transfers.* For purposes of paragraph (e)(1)(vi) of this section, a block transfer means the transfer by a partner and any related persons (within the meaning of section 267(b) or 707(b)(1)) in one or more transactions during any 30 calendar day period of partnership interests representing in the aggregate more than 2 percent of the total interests in partnership capital or profits.

(3) *Redemption or repurchase agreement.* For purposes of section 7704(b) and this section, a redemption or repurchase agreement means a plan of redemption or repurchase maintained by a partnership whereby the partners may tender their partnership interests for purchase by the partnership, another partner, or a person related to another partner (within the meaning of section 267(b) or 707(b)(1)).

(4) *Closed end redemption plan.* For purposes of paragraph (e)(1)(viii) of this section, a redemption or repurchase agreement (as defined in paragraph (e)(3) of this section) is a closed end redemption plan only if—

(i) The partnership does not issue any interest after the initial offering (other than the issuance of additional interests prior to August 5, 1988); and

(ii) No partner or person related to any partner (within the meaning of section 267(b) or 707(b)(1)) provides contemporaneous opportunities to acquire interests in similar or related partnerships which represent substantially identical investments.

(f) *Redemption and repurchase agreements.* For purposes of section 7704(b) and this section, the transfer of an interest in a partnership pursuant to a redemption or repurchase agreement (as defined in paragraph (e)(3) of this section) that is not described in paragraph (e)(1) (vii) or (viii) of this section is disregarded in determining whether interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof only if—

(1) The redemption or repurchase agreement provides that the redemption or repurchase cannot occur until at least 60 calendar days after the partner notifies the partnership in writing

of the partner's intention to exercise the redemption or repurchase right;

(2) Either—

(i) The redemption or repurchase agreement requires that the redemption or repurchase price not be established until at least 60 calendar days after receipt of such notification by the partnership or the partner; or

(ii) The redemption or repurchase price is established not more than four times during the partnership's taxable year; and

(3) The sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership (other than in private transfers described in paragraph (e) of this section) does not exceed 10 percent of the total interests in partnership capital or profits.

(g) *Qualified matching services*—(1) *In general.* For purposes of section 7704(b) and this section, the transfer of an interest in a partnership through a qualified matching service is disregarded in determining whether interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof.

(2) *Requirements.* A matching service is a qualified matching service only if—

(i) The matching service consists of a computerized or printed listing system that lists customers' bid and/or ask quotes in order to match partners who want to sell their interests in a partnership (the selling partner) with persons who want to buy those interests;

(ii) Matching occurs either by matching the list of interested buyers with the list of interested sellers or through a bid and ask process that allows interested buyers to bid on the listed interest;

(iii) The selling partner cannot enter into a binding agreement to sell the interest until the 15th calendar day after the date information regarding the offering of the interest for sale is made available to potential buyers and such time period is evidenced by contemporaneous records ordinarily maintained by the operator at a central location;

(iv) The closing of the sale effected by virtue of the matching service does not occur prior to the 45th calendar day after the date information regarding the offering of the interest for sale is made available to potential buyers and such time period is evidenced by contemporaneous records ordinarily maintained by the operator at a central location;

(v) The matching service displays only quotes that do not commit any person to buy or sell a partnership interest at the quoted price (nonfirm price quotes) or quotes that express interest in a partnership interest without an accompanying price (nonbinding indications of interest) and does not display quotes at which any person is committed to buy or sell a partnership interest at the quoted price (firm quotes);

(vi) The selling partner's information is removed from the matching service within 120 calendar days after the date information regarding the offering of the interest for sale is made available to potential buyers and, following any removal (other than removal by reason of a sale of any part of such interest) of the selling partner's information from the matching service, no offer to sell an interest in the partnership is entered into the matching service by the selling partner for at least 60 calendar days; and

(vii) The sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership (other than in private transfers described in paragraph (e) of this section) does not exceed 10 percent of the total interests in partnership capital or profits.

(3) *Closing.* For purposes of paragraph (g)(2)(iv) of this section, the closing of a sale occurs no later than the earlier of—

(i) The passage of title to the partnership interest;

(ii) The payment of the purchase price (which does not include the delivery of funds to the operator of the matching service or other closing agent to hold on behalf of the seller pending closing); or

(iii) The date, if any, that the operator of the matching service (or any person related to the operator within the meaning of section 267(b) or 707(b)(1)) loans, advances, or otherwise arranges for funds to be available to the seller in anticipation of the payment of the purchase price.

(4) *Optional features.* A qualified matching service may be sponsored or operated by a partner of the partnership (either formally or informally), the underwriter that handled the issuance of the partnership interests, or an unrelated third party. In addition, a qualified matching service may offer the following features—

(i) The matching service may provide prior pricing information, including information regarding resales of interests and actual prices paid for interests; a description of the business of the partnership; financial and reporting information from the partnership's financial statements and reports; and information regarding material events involving the partnership, including special distributions, capital distributions, and refinancings or sales of significant portions of partnership assets;

(ii) The operator may assist with the transfer documentation necessary to transfer the partnership interest;

(iii) The operator may receive and deliver funds for completed transactions; and

(iv) The operator's fee may consist of a flat fee for use of the service, a fee or commission based on completed transactions, or any combination thereof.

(h) *Private placements*—(1) *In general.* For purposes of section 7704(b) and this section, except as otherwise provided in paragraph (h)(2) of this section, interests in a partnership are not readily tradable on a secondary market or the substantial equivalent thereof if—

(i) All interests in the partnership were issued in a transaction (or transactions) that was not required to be registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.); and

(ii) The partnership does not have more than 100 partners at any time during the taxable year of the partnership.

(2) *Exception for certain offerings outside of the United States.* Paragraph (h)(1) of this section does not apply to the offering and sale of interests in a partnership that was not required to be registered under the Securities Act of 1933 by reason of Regulation S (17 CFR 230.901 through 230.904) unless the offering and sale of the interests would not have been required to be registered under the Securities Act of 1933 if the interests had been offered and sold within the United States.

(3) *Anti-avoidance rule.* For purposes of determining the number of partners in the partnership under paragraph (h)(1)(ii) of this section, a person (beneficial owner) owning an interest in a partnership, grantor trust, or S corporation (flow-through entity), that owns, directly or through other flow-through entities, an interest in the partnership, is treated as a partner in the partnership only if—

(i) Substantially all of the value of the beneficial owner's interest in the flow-through entity is attributable to the flow-through entity's interest (direct or indirect) in the partnership; and

(ii) A principal purpose of the use of the tiered arrangement is to permit the partnership to satisfy the 100-partner limitation in paragraph (h)(1)(ii) of this section.

(i) [Reserved]

(j) *Lack of actual trading*—(1) *General rule.* For purposes of section 7704(b) and this section, interests in a partnership are not readily tradable on a secondary market or the substantial equivalent thereof if the sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership (other than in transfers described in paragraph (e), (f), or (g) of this section) does not exceed 2 percent of the total interests in partnership capital or profits.

(2) *Examples.* The following examples illustrate the rules of this paragraph (j):

Example 1. Calculation of percentage interest transferred. (i) ABC, a calendar year limited partnership formed in 1996, has 9,000 units of limited partnership interests outstanding at all times during 1997, representing in the aggregate 95 percent of the total interests in capital and profits of ABC. The remaining 5 percent is held by the general partner.

(ii) During 1997, the following transactions occur with respect to the units of ABC's limited partnership interests—

(A) 800 units are sold through the use of a qualified matching service that meets the requirements of paragraph (g) of this section;

(B) 50 units are sold through the use of a matching service that does not meet the requirements of paragraph (g) of this section; and

(C) 500 units are transferred as a result of private transfers described in paragraph (e) of this section.

(iii) The private transfers of 500 units and the sale of 800 units through a qualified matching service are disregarded under paragraph (j)(1) of this section for purposes of applying the 2 percent rule. As a result, the total percentage interests in partnership capital and profits transferred for purposes of the 2 percent rule is .528 percent, determined by—

(A) Dividing the number of units sold through a matching service that did not meet the requirements of paragraph (g) of this section (50) by the total number of outstanding limited partnership units (9,000); and

(B) Multiplying the result by the percentage of total interests represented by limited partnership units (95 percent)

([50/9,000]×.95=.528 percent).

Example 2. Application of the 2 percent rule. (i) ABC operates a service consisting of computerized video display screens on which subscribers view and publish nonfirm price quotes that do not commit any person to buy or sell a partnership interest and unpriced indications of interest in a partnership interest without an accompanying price. The ABC service does not provide firm quotes at which any person (including the operator of the service) is committed to buy or sell a partnership interest. The service may provide prior pricing information, including information regarding resales of interests and actual prices paid for interests; transactional volume information; and information on special or capital distributions by a partnership. The operator's fee may consist of a flat fee for use of the service; a fee based on completed transactions, including, for example, the number of nonfirm quotes or unpriced indications of interest entered by users of the service; or any combination thereof.

(ii) The ABC service is not an established securities market for purposes of section 7704(b) and this section. The service is not an interdealer quotation system as defined in paragraph (b)(5) of this section because it does not disseminate firm buy or sell quotations. Therefore, partnerships whose interests are listed and transferred on the ABC service are not publicly traded for purposes of section 7704(b) and this section as a result of such listing or transfers if the sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership (other than in transfers described in paragraph (e), (f), or (g) of this section) does not exceed 2 percent of the total interests in partnership capital or profits. In addition, assuming the ABC service complies with the necessary requirements, the service may qualify as a matching service described in paragraph (g) of this section.

(k) *Percentage interests in partnership capital or profits*—(1) *Interests considered*—(i) *General rule.* Except as otherwise provided in this paragraph (k), for purposes of this section, the total interests in partnership capital or profits are determined by reference to all outstanding interests in the partnership.

(ii) *Exceptions*—(A) *General partner with greater than 10 percent interest.* If the general partners and any person related to the general partners (within the meaning of section 267(b) or 707(b)(1)) own, in the aggregate, more than 10 percent of the outstanding interests in partnership capital or profits at any one time during the taxable year of the partnership, the total interests in partnership capital or profits are determined without reference to the interests owned by such persons.

(B) *Derivative interests.* Any partnership interests described in paragraph (a)(2)(i)(B) of this section are taken into account for purposes of determining the total interests in partnership capital or profits only if and to the extent that the partnership satisfies paragraph (d) (1) or (2) of this section.

(2) *Monthly determination.* For purposes of this section, except in the case of block transfers (as defined in paragraph (e)(2) of this section), the percentage interests in partnership capital or profits represented by partnership interests that are transferred during a taxable year of the partnership is equal to the sum of the percentage interests transferred for each calendar month during the taxable year of the partnership in which a transfer of a partnership interest occurs (other than a private transfer as described in paragraph (e) of this section). The percentage interests in capital or profits of interests transferred during a calendar month is determined by reference to the partnership interests outstanding during that month.

(3) *Monthly conventions.* For purposes of paragraph (k)(2) of this section, a partnership may use any reasonable convention in determining the interests outstanding for a month, provided the convention is consistently used by the partnership from month to month during a taxable year and from year to year. Reasonable conventions include,

but are not limited to, a determination by reference to the interests outstanding at the beginning of the month, on the 15th day of the month, or at the end of the month.

(4) *Block transfers.* For purposes of paragraph (e)(2) of this section (defining block transfers), the partnership must determine the percentage interests in capital or profits for each transfer of an interest during the 30 calendar day period by reference to the partnership interests outstanding immediately prior to such transfer.

(5) *Example.* The following example illustrates the rules of this paragraph (k):

Example. Conventions. (i) ABC limited partnership, a calendar year partnership formed in 1996, has 1,000 units of limited partnership interests outstanding on January 1, 1997, representing in the aggregate 95 percent of the total interests in capital and profits of ABC. The remaining 5 percent is held by the general partner.

(ii) The following transfers take place during 1997—

(A) On January 15, 10 units of limited partnership interests are sold in a transaction that is not a private transfer;

(B) On July 10, 1,000 additional units of limited partnership interests are issued by the partnership (the general partner's percentage interest is unchanged); and

(C) On July 20, 15 units of limited partnership interests are sold in a transaction that is not a private transfer.

(iii) For purposes of determining the sum of the percentage interests in partnership capital or profits transferred, ABC chooses to use the end of the month convention. The percentage interests in partnership capital and profits transferred during January is .95 percent, determined by dividing the number of transferred units (10) by the total number of limited partnership units (1,000) and multiplying the result by the percentage of total interests represented by limited partnership units ([10/1,000]×.95). The percentage interests in partnership capital and profits transferred during July is .7125 percent ([15/2,000]×.95). ABC is not required to make determinations for the other months during the year because no transfers of partnership interests occurred during such months. ABC may qualify for the 2 percent rule for its 1997 taxable year because less than 2 percent (.95 percent+.7125 percent=1.6625 percent) of its total interests in partnership capital and profits was transferred during that year.

(iv) If ABC had chosen to use the beginning of the month convention, the interests in capital or profits sold during July would have been 1.425 percent ([15/1,000]×.95) and ABC would not have satisfied the 2 percent rule for its 1997 taxable year because 2.375 percent (.95 + 1.425) of ABC's interests in partnership capital and profits was transferred during that year.

(l) *Effective date*—(1) *In general.* Except as provided in paragraph (l)(2) of this section, this section applies to taxable years of a partnership beginning after December 31, 1995.

(2) *Transition period.* For partnerships that were actively engaged in an activity before December 4, 1995, this section applies to taxable years beginning after December 31, 2005, unless the partnership adds a substantial new line of business after December 4, 1995, in which case this section applies to taxable years beginning on or after the addition of the new line of business. Partnerships that qualify for this transition period may continue to rely on the provisions of Notice 88–75 (1988–2 C.B. 386) (see §601.601(d)(2) of this chapter) for guidance regarding the definition of readily tradable on a secondary market or the substantial equivalent thereof for purposes of section 7704(b).

(3) *Substantial new line of business.* For purposes of paragraph (l)(2) of this section—

(i) Substantial is defined in §1.7704–2(c); and

(ii) A new line of business is defined in §1.7704–2(d), except that the applicable date is ''December 4, 1995'' instead of ''December 17, 1987''.

(4) *Termination under section 708(b)(1)(B).* The termination of a partnership under section 708(b)(1)(B) due to the sale or exchange of 50 percent or more of the total interests in partnership capital and profits is disregarded in determining whether a partnership qualifies for the transition period provided in paragraph (l)(2) of this section.

[T.D. 8629, 60 FR 62029, Dec. 4, 1995]

§1.7704–2 Transition provisions.

(a) *Transition rule*—(1) *Statutory dates.* Section 7704 generally applies to taxable years beginning after December 31, 1987. In the case of an existing partnership, however, section 7704 and the regulations thereunder apply to taxable years beginning after December 31, 1997.

(2) *Effective date of regulations.* These regulations are effective for taxable

years beginning after December 31, 1991.

(b) *Existing partnership*—(1) *In general.* For purposes of §1.7704–2, the term ‘‘existing partnership’’ means any partnership if—

(i) The partnership was a publicly traded partnership (within the meaning of section 7704(b)) on December 17, 1987;

(ii) A registration statement indicating that the partnership was to be a publicly traded partnership was filed with the Securities and Exchange Commission (SEC) with respect to the partnership on or before December 17, 1987; or

(iii) With respect to the partnership, an application was filed with a state regulatory commission on or before December 17, 1987, seeking permission to restructure a portion of a corporation as a publicly traded partnership.

(2) *Changed status of an existing partnership.* A partnership will not qualify as an existing partnership after a new line of business is substantial.

(c) *Substantial*—(1) *In general.* A new line of business is substantial as of the earlier of—

(i) The taxable year in which the partnership derives more than 15 percent of its gross income from that line of business; or

(ii) The taxable year in which the partnership directly uses in that line of business more than 15 percent (by value) of its total assets.

(2) *Timing rule.* If a substantial new line of business is added during the taxable year (*e.g.*, by acquisition), the line of business is treated as substantial as of the date it is added; otherwise a substantial new line of business is treated as substantial as of the first day of the taxable year in which it becomes substantial.

(d) *New line of business*—(1) *In general.* A new line of business is any business activity of the partnership not closely related to a pre-existing business of the partnership to the extent that the activity generates income other than ‘‘qualifying income’’ within the meaning of section 7704 and the regulations thereunder.

(2) *Pre-existing business.* A business activity is a pre-existing business of the partnership if—

(i) The partnership was actively engaged in the activity on or before December 17, 1987; or

(ii) The partnership is actively engaged in the business activity that was specifically described as a proposed business activity of the partnership in a registration statement or amendment thereto filed on behalf of the partnership with the SEC on or before December 17, 1987. For this purpose, a specific description does not include a general grant of authority to conduct any business.

(3) *Closely related.* All of the facts and circumstances will determine whether a new business activity is closely related to a pre-existing business of the partnership. The following factors, among others, will help to establish that a new business activity is closely related to a pre-existing business of the partnership and therefore is not a new line of business:

(i) The activity provides products or services very similar to the products or services provided by the pre-existing business.

(ii) The activity markets products and services to the same class of customers as that of the pre-existing business.

(iii) The activity is of a type that is normally conducted in the same business location as the pre-existing business.

(iv) The activity requires the use of similar operating assets as those used in the pre-existing business.

(v) The activity’s economic success depends on the success of the pre-existing business.

(vi) The activity is of a type that would normally be treated as a unit with the pre-existing business in the business’ accounting records.

(vii) If the activity and the pre-existing business are regulated or licensed, they are regulated or licensed by the same or similar governmental authority.

(viii) The United States Bureau of the Census assigns the activity the same four-digit Industry Number Standard Identification Code (Industry SIC Code) as the pre-existing business. Such codes are set forth in the Executive Office of the President, Office of

Management and Budget, Standard Industrial Classification Manual, prepared, and from time to time revised, by the Statistical Policy Division of the United States Office of Management and Budget. For example, if a partnership's pre-existing business is manufacturing steam turbines and then the partnership begins an activity manufacturing hydraulic turbines, both activities would be assigned the same Industry SIC Code, 3511—Steam, Gas, and Hydraulic Turbines, and Turbine Generator Set Units. In the case of a pre-existing business or activity that is listed under the Industry SIC Code, 9999—Nonclassifiable Establishments—or under a miscellaneous category (e.g., most Industry SIC Codes ending in a ''9'' are miscellaneous categories), the similarity of the SIC Codes is ignored as a factor in determining whether the activity is closely related to the pre-existing business. The dissimilarity of the SIC Codes is considered in determining whether the business activity is closely related to the pre-existing line of business.

(e) *Activities conducted through controlled corporations*—(1) *In general.* An activity conducted by a corporation controlled by an existing partnership may be treated as an activity of the existing partnership if the effect of the arrangement is to permit the partnership to engage in an activity the income from which is not subject to a corporate-level tax and which would be a new line of business if conducted directly by the partnership. This determination is based upon all facts and circumstances.

(2) *Safe harbor*—(i) *In general.* This paragraph (e)(2) provides a safe harbor for activities of a corporation controlled by an existing partnership. An activity conducted by a corporation controlled by an existing partnership is not deemed to be an activity of the partnership for purposes of determining whether an existing partnership has added a new line of business if no more than 10% of the gross income that the partnership derives from the corporation during the taxable year is section 7704(d) qualifying income that is recharacterized as nonqualifying income under paragraphs (e)(2) (ii) and (iii) of this section. The Internal Revenue Service will not presume that an activity conducted through a corporation controlled by an existing partnership is an activity of the partnership solely because the partnership fails to satisfy the requirements of this paragraph (e)(2)(i).

(ii) *Recharacterization of qualifying income.* Gross income received by a partnership from a controlled corporation that would be qualifying income under section 7704(d) is subject to recharacterization as nonqualifying income if the amount is deductible in computing the income of the controlled corporation.

(iii) *Extent of recharacterization.* The amount of income described in paragraph (e)(2)(ii) of this section that is recharacterized as nonqualifying income is—

(A) The amount described in paragraph (e)(2)(ii) of this section; multiplied by

(B) The controlled corporation's taxable income (determined without regard to deductions for amounts paid to the partnership) that would not be qualifying income within the meaning of section 7704(d) if earned directly by the partnership; divided by

(C) The controlled corporation's taxable income (determined without regard to deductions for amounts paid to the partnership).

(3) *Control.* For purposes of paragraphs (e) (1) and (2) of this section, control of a corporation is determined generally under the rules of section 304(c). However, the application of section 304(c) is modified to apply only to partners who own five percent or more by value (directly or indirectly) of the existing partnership unless a principal purpose of the arrangement is to avoid tax at the corporate level.

(4) *Example.* The following example illustrates the application of the this paragraph (e):

Example. (i) PTP, an existing partnership, acquired all the stock of X corporation on January 1, 1993. During PTP's 1993 taxable year it received $185,000 of dividends and $15,000 of interest from X. Determined without regard to interest paid to PTP, X's taxable income during that period was $500,000 none of which was ''qualifying income'' within the meaning of section 7704 and the regulations thereunder. In computing the income of X, the $15,000 of interest paid to PTP is deductible.

(ii) Under paragraph (e)(2)(ii) of section, all $15,000 of PTP's interest income was nonqualifying income ($15,000 x 500,000/500,000). Under paragraph (e)(2) of this section, however, the activities of X will not be considered to be activities of PTP for the 1993 taxable year because no more than 10 percent of the gross income that PTP derived from X would be treated as other than qualifying income (15,000/200,000=7.5%).

(f) *Activities conducted through tiered partnerships.* An activity conducted by a partnership in which an existing partnership holds an interest (directly or through another partnership) will be considered an activity of the existing partnership.

(g) *Exceptions*—(1) *Coordination with gross income requirements of section 7704(c)(2).* A partnership that is either an existing partnership as of December 31, 1997, or an existing partnership that ceases to qualify as an existing partnership is subject to section 7704 and the regulations thereunder. Section 7704(a) does not apply to these partnerships, however, if these partnerships meet the gross income requirements of paragraphs (c) (1) and (2) of section 7704. For purposes of applying section 7704(c) (1) and (2) to these partnerships, the only taxable years that must be tested are those beginning on and after the earlier of—

(i) January 1, 1998; or

(ii) The day on which the partnership ceases to qualify as an existing partnership because of the addition of a new line of business; or

(iii) The first day of the first taxable year in which a new line of business becomes substantial (if the new line of business becomes substantial after the year in which it is added).

(2) *Specific exceptions.* In determining whether a partnership is an existing partnership for purposes of section 7704, the following events do not in themselves terminate the status of existing partnerships—

(i) Termination of the partnership under section 708(b)(1)(B) due to the sale or exchange of 50 percent or more of the total interests in partnership capital and profits;

(ii) Issuance of additional partnership units; and

(iii) Dropping a line of business. This event, however, could affect an existing partnership's status indirectly. For example, dropping one line of business could change the composition of the partnership's gross income. The change in composition could make a new line of business ''substantial,'' under paragraph (c) of this section, and terminate the partnership's status. See paragraph (b)(2) of this section.

(h) *Examples.* The following examples illustrate the application of this section:

Example 1. (i) On December 17, 1987, PTP, a calendar-year publicly traded partnership, owned and operated citrus groves. On March 1, 1993, PTP purchased a processing business involving frozen citrus products. In the partnership's 1993 taxable year, the partnership directly used in the processing business more than 15 percent (by value) of its total assets.

(ii) The citrus grove activities provide different products from the processing activities, are marketed to customers different from the customers of the processing activities, require different types of operating assets, are not commonly conducted at the same location, are not commonly treated as a unit in accounting records, do not depend upon one another for economic success, and do not have the same Industry SIC Code. Under the facts and circumstances, the processing business is not closely related to the citrus grove operation and is a new line of business under paragraph (d)(1) of this section.

(iii) The assets of the partnership used in the new line of business are substantial under paragraph (c)(2) of this section. Because PTP added a substantial new line of business after December 17, 1987, paragraph (b)(2) of this section terminates PTP's status as an existing partnership on March 1, 1993.

Example 2. (i) On December 17, 1987, PTP, a calendar-year publicly traded partnership, owned and operated retirement centers that serve the elderly. Each center contains three sections—

(A) A residential section, which includes suites of rooms, dining facilities, lounges, and gamerooms;

(B) An assisted-living section, which provides laundry and housekeeping services, health monitoring, and emergency care; and

(C) A nursing section, which provides private and semiprivate rooms, dining facilities, examination and treatment rooms, drugs, medical equipment, and physical, speech, and occupational therapy.

(ii) The business activities of each section constitute pre-existing businesses of PTP under paragraph (d)(2) of this section, because PTP was actively engaged in the activities on or before December 17, 1987.

(iii) The nursing sections primarily furnish health care. They employ nurses and therapists, are subject to federal, state, and local licensing requirements, and may change certain costs to government programs like Medicare and Medicaid.

(iv) In 1993, PTP acquired new nursing homes that treat inpatient adults of all ages. The nursing homes provide private and semi-private rooms, dining facilities, examination and treatment rooms, drugs, medical equipment, and physical, speech, and occupational therapy. The nursing homes primarily furnish health care. They employ nurses and therapists, are subject to federal, state, and local licensing requirements, and may charge certain costs to government programs like Medicare and Medicaid.

(v) PTP's new nursing homes and old nursing sections provide very similar services, market to very similar customers, use similar types of property and personnel, and are licensed by the same regulatory agencies. The nursing homes and old nursing sections have the same Industry SIC Code. Under these facts and circumstances, the new nursing homes are closely related to a pre-existing business of the partnership. Accordingly, under paragraph (d)(1) of this section, the acquisition of the new nursing homes is not the addition of a new line of business.

(vi) PTP was a publicly traded partnership on December 17, 1987, and was an existing partnership under paragraph (b)(1)(i) of this section. Because PTP has added no substantial new line of business after December 17, 1987, paragraph (b)(2) of this section does not terminate PTP's status as an existing partnership.

Example 3. (i) On December 17, 1987, PTP, a calendar-year publicly traded partnership, owned and operated cable television systems in the northeastern United States. PTP's registration statement described as its proposed business activities the ownership and operation of cable television systems, any ancillary operations, and any business permitted by the laws of the state in which PTP was formed.

(ii) PTP's cable systems include cables strung along telephone lines, converter boxes in subscribers' homes, other types of cable equipment, satellite dishes that receive programs broadcast by various television networks, and channels that carry public service announcements of local interest. Subscribers pay the systems a fee for the right to receive both the local announcements and the network signals relayed through the cables. Those fees constitute PTP's primary revenue. The systems operate under franchise agreements negotiated with each municipality in which they do business.

(iii) On September 1, 1993, PTP purchased a television station in the northwestern United States. The station owns broadcasting facilities, satellite dishes that receive programs broadcast by the station's network, and a studio that produces programs of interest to the area that receives the station's broadcasts. Fees from advertisers constitute the station's primary revenue. The station operates under a license from the Federal Communications Commission.

(iv) In the partnership's 1993 taxable year, the station generated less than 15 percent of PTP's gross income and constituted less than 15 percent of its total assets (by value). In PTP's 1994 taxable year, the station generated more than 15 percent of PTP's gross income.

(v) The cable systems relay signals through cables to subscribers and earn revenue from subscriber fees; the station broadcasts signals to the general public and earns revenue by selling air time for commercials. Despite certain similarities, the two types of activities generally require different operating assets and earn income from different sources. They are regulated by different agencies. They are not commonly conducted at the same location and do not generally depend upon one another for their economic success. They have different Industry SIC Codes. Under the facts and circumstances, the television station activities are not closely related to PTP's pre-existing business, the cable system activities.

(vi) As of December 17, 1987, PTP did not own and operate any television station. PTP's registration statement specifically described as its proposed business activities only the ownership and operation of cable television systems and any ancillary operations. For purposes of paragraph (d)(2) of this section, a specific description does not include PTP's general authority to carry on any business permitted by the state of its formation. Therefore, the television station line of business was not specifically described as a proposed business activity of PTP in its registration statement. PTP's acquisition of the television station business activity constitutes a new line of business under paragraph (d)(1) of this section.

(vii) PTP was a publicly traded partnership on December 17, 1987, and was an existing partnership under paragraph (b)(1)(i) of this section. PTP added a new line of business in 1993, but that line of business was not substantial under paragraph (c) of this section, and thus PTP remained an existing partnership for its 1993 taxable year. In 1994, the new line of business became substantial because it generated more than 15 percent of PTP's gross income. Paragraph (b)(2) of this section therefore terminates PTP's existing partnership status as of January 1, 1994, the first day of the first taxable year beginning after

December 31, 1987, in which PTP's new line of business became substantial.

[T.D. 8450, 57 FR 58708, Dec. 11, 1992]

§1.7704–3 Qualifying income.

(a) *Certain investment income*—(1) *In general.* For purposes of section 7704(d)(1), qualifying income includes capital gain from the sale of stock, income from holding annuities, income from notional principal contracts (as defined in §1.446–3), and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner. Income from a notional principal contract is included in qualifying income only if the property, income, or cash flow that measures the amounts to which the partnership is entitled under the contract would give rise to qualifying income if held or received directly by the partnership.

(2) *Limitations.* Qualifying income described in paragraph (a)(1) of this section does not include income derived in the ordinary course of a trade or business. For purposes of the preceding sentence, income derived from an asset with respect to which the partnership is a broker, market maker, or dealer is income derived in the ordinary course of a trade or business; income derived from an asset with respect to which the taxpayer is a trader or investor is not income derived in the ordinary course of a trade or business.

(b) *Calculation of gross income and qualifying income*—(1) *Treatment of losses.* Except as otherwise provided in this section, in computing the gross income and qualifying income of a partnership for purposes of section 7704(c)(2) and this section, losses do not enter into the computation.

(2) *Certain positions that are marked to market.* Gain recognized with respect to a position that is marked to market (for example, under section 475(f), 1256, 1259, or 1296) shall not fail to be qualifying income solely because there is no sale or disposition of the position.

(3) *Certain items of ordinary income.* Gain recognized with respect to a capital asset shall not fail to be qualifying income solely because it is characterized as ordinary income under section 475(f), 988, 1258, or 1296.

(4) *Straddles.* In computing the gross income and qualifying income of a partnership for purposes of section 7704(c)(2) and this section, a straddle (as defined in section 1092(c)) shall be treated as set forth in this paragraph (b)(4). For purposes of the preceding sentence, two or more straddles that are part of a larger straddle shall be treated as a single straddle. The amount of the gain from any straddle to be taken into account shall be computed as follows:

(i) *Straddles other than mixed straddle accounts.* With respect to each straddle (whether or not a straddle during the taxable year) other than a mixed straddle account, the amount of gain taken into account shall be the excess, if any, of gain recognized during the taxable year with respect to property that was at any time a position in that straddle over any loss recognized during the taxable year with respect to property that was at any time a position in that straddle (including loss realized in an earlier taxable year).

(ii) *Mixed straddle accounts.* With respect to each mixed straddle account (as defined in §1.1092(b)–4T(b)), the amount of gain taken into account shall be the annual account gain for that mixed straddle account, computed pursuant to §1.1092(b)–4T(c)(2).

(5) *Certain transactions similar to straddles.* In computing the gross income and qualifying income of a partnership for purposes of section 7704(c)(2) and this section, related interests in property (whether or not personal property as defined in section 1092(d)(1)) that produce a substantial diminution of the partnership's risk of loss similar to that of a straddle (as defined in section 1092(c)) shall be combined so that the amount of gain taken into account by the partnership in computing its gross income shall be the excess, if any, of gain recognized during the taxable year with respect to such interests over any loss recognized during the taxable year with respect to such interests.

(6) *Wash sale rule*—(i) *Gain not taken into account.* Solely for purposes of section 7704(c)(2) and this section, if a partnership recognizes gain in a section 7704 wash sale transaction with respect to one or more positions in either a straddle (as defined in section 1092(c))

or an arrangement described in paragraph (b)(5) of this section, then the gain shall not be taken into account to the extent of the amount of unrecognized loss (as of the close of the taxable year) in one or more offsetting positions of the straddle or arrangement described in paragraph (b)(5) of this section.

(ii) *Section 7704 wash sale transaction.* For purposes of this paragraph (b)(6), a section 7704 wash sale transaction is a transaction in which—

(A) A partnership disposes of one or more positions of a straddle (as defined in section 1092(c)) or one or more related positions described in paragraph (b)(5) of this section; and

(B) The partnership acquires a substantially similar position or positions within a period beginning 30 days before the date of the disposition and ending 30 days after such date.

(c) *Effective date.* This section applies to taxable years of a partnership beginning on or after December 17, 1998. However, a partnership may apply this section in its entirety for all of the partnership's open taxable years beginning after any earlier date selected by the partnership.

[T.D. 8799, 63 FR 69553, Dec. 17, 1998]

§§ 1.7872–1—1.7872–4 [Reserved]

§ 1.7872–5T Exempted loans (temporary).

(a) *In general*—(1) *General rule.* Except as provided in paragraph (a)(2) of this section, notwithstanding any other provision of section 7872 and the regulations thereunder, section 7872 does not apply to the loans listed in paragraph (b) of this section because the interest arrangements do not have a significant effect on the Federal tax liability of the borrower or the lender.

(2) *No exemption for tax avoidance loans.* If a taxpayer structures a transaction to be a loan described in paragraph (b) of this section and one of the principal purposes of so structuring the transaction is the avoidance of Federal tax, then the transaction will be recharacterized as a tax avoidance loan as defined in section 7872 (c)(1)(D).

(b) *List of exemptions.* Except as provided in paragraph (a) of this section, the following transactions are exempt from section 7872:

(1) Loans which are made available by the lender to the general public on the same terms and conditions and which are consistent with the lender's customary business practice;

(2) Accounts or withdrawable shares with a bank (as defined in section 581), or an institution to which section 591 applies, or a credit union, made in the ordinary course of its business;

(3) Acquisitions of publicly traded debt obligations for an amount equal to the public trading price at the time of acquisition;

(4) Loans made by a life insurance company (as defined in section 816 (a)), in the ordinary course of its business, to an insured, under a loan right contained in a life insurance policy and in which the cash surrender values are used as collateral for the loans;

(5) Loans subsidized by the Federal, State (including the District of Columbia), or Municipal government (or any agency or instrumentality thereof), and which are made available under a program of general application to the public;

(6) Employee-relocation loans that meet the requirements of paragraph (c)(1) of this section;

(7) Obligations the interest on which is excluded from gross income under section 103;

(8) Obligations of the United States government;

(9) Gift loans to a charitable organization (described in section 170(c)), but only if at no time during the taxable year will the aggregate outstanding amount of gift loans by the lender to that organization exceed $250,000. Charitable organizations which are effectively controlled, within the meaning of § 1.482–1(a)(1), by the same person or persons shall be considered one charitable organization for purposes of this limitation.

(10) Loans made to or from a foreign person that meet the requirements of paragraph (c)(2) of this section;

(11) Loans made by a private foundation or other organization described in section 170(c), the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B);

(12) Indebtedness subject to section 482, but such indebtedness is exempt from the application of section 7872 only during the interest-free period, if any, determined under §1.482–2(a)(1)(iii) with respect to intercompany trade receivables described in §1.482–2(a)(1)(ii)(A)(*ii*). See also §1.482–2(a)(3);

(13) All money, securities, and property—

(i) Received by a futures commission merchant or registered broker/dealer or by a clearing organization (A) to margin, guarantee or secure contracts for future delivery on or subject to the rules of a qualified board or exchange (as defined in section 1256(g)(7)), or (B) to purchase, margin, guarantee or secure options contracts traded on or subject to the rules of a qualified board or exchange, so long as the amounts so received to purchase, margin, guarantee or secure such contracts for future delivery or such options contracts are reasonably necessary for such purposes and so long as any commissions received by the futures commission merchant, registered broker-dealer, or clearing organization are not reduced for those making deposits of money, and all money accruing to account holders as the result of such futures and options contacts or

(ii) Received by a clearing organization from a member thereof as a required deposit to a clearing fund, guaranty fund, or similar fund maintained by the clearing organization to protect it against defaults by members.

(14) Loans the interest arrangements of which the taxpayer is able to show have no significant effect on any Federal tax liability of the lender or the borrower, as described in paragraph (c)(3) of this section; and

(15) Loans, described in revenue rulings or revenue procedures issued under section 7872(g)(1)(C), if the Commissioner finds that the factors justifying an exemption for such loans are sufficiently similar to the factors justifying the exemptions contained in this section.

(c) *Special rules*—(1) *Employee-relocation loans*—(i) *Mortgage loans.* In the case of a compensation-related loan to an employee, where such loan is secured by a mortgage on the new principal residence (within the meaning of section 217 and the regulations thereunder) of the employee, acquired in connection with the transfer of that employee to a new principal place of work (which meets the requirements in section 217(c) and the regulations thereunder), the loan will be exempt from section 7872 if the following conditions are satisfied:

(A) The loan is a demand loan or is a term loan the benefits of the interest arrangements of which are not transferable by the employee and are conditioned on the future performance of substantial services by the employee;

(B) The employee certifies to the employer that the employee reasonably expects to be entitled to and will itemize deductions for each year the loan is outstanding; and

(C) The loan agreement requires that the loan proceeds be used only to purchase the new principal residence of the employee.

(ii) *Bridge loans.* In the case of a compensation-related loan to an employee which is not described in paragraph (c)(1)(i) of this section, and which is used to purchase a new principal residence (within the meaning of section 217 and the regulations thereunder) of the employee acquired in connection with the transfer of that employee to a new principal place of work (which meets the requirements in section 217(c) and the regulations thereunder), the loan will be exempt from section 7872 if the following conditions are satisfied:

(A) The conditions contained in paragraphs (c)(1)(i) (A), (B), and (C) of this section;

(B) The loan agreement provides that the loan is payable in full within 15 days after the date of the sale of the employee's immediately former principal residence;

(C) The aggregate principal amount of all outstanding loans described in this paragraph (c)(1)(ii) to an employee is no greater than the employer's reasonable estimate of the amount of the equity of the employee and the employee's spouse in the employee's immediately former principal residence, and

(D) The employee's immediately former principal residence is not converted to business or investment use.

(2) *Below-market loans involving foreign persons.* (i) Section 7872 shall not apply to a below-market loan (other than a compensation-related loan or a corporation-shareholder loan where the borrower is a shareholder that is not a C corporation as defined in section 1361(a)(2)) if the lender is a foreign person and the borrower is a U.S. person unless the interest income imputed to the foreign lender (without regard to this paragraph) would be effectively connected with the conduct of a U.S. trade or business within the meaning of section 864(c) and the regulations thereunder and not exempt from U.S. income taxation under an applicable income tax treaty.

(ii) Section 7872 shall not apply to a below-market loan where both the lender and the borrower are foreign persons unless the interest income imputed to the lender (without regard to this paragraph) would be effectively connected with the conduct of a U.S. trade or business within the meaning of section 864(c) and the regulations thereunder and not exempt from U.S. income taxation under an applicable income tax treaty.

(iii) For purposes of this section, the term ‘‘foreign person’’ means any person that is not a U.S. person.

(3) *Loans without significant tax effect.* Whether a loan will be considered to be a loan the interest arrangements of which have a significant effect on any Federal tax liability of the lender or the borrower will be determined according to all of the facts and circumstances. Among the factors to be considered are—

(i) Whether items of income and deduction generated by the loan offset each other;

(ii) The amount of such items;

(iii) The cost to the taxpayer of complying with the provisions of section 7872 if such section were applied; and

(iv) Any non-tax reasons for deciding to structure the transaction as a below-market loan rather than a loan with interest at a rate equal to or greater than the applicable Federal rate and a payment by the lender to the borrower.

(26 U.S.C. 7872)

[T.D. 8045, 50 FR 33520, Aug. 20, 1985, as amended by T.D. 8093, 51 FR 25033, July 10, 1986; 51 FR 28553, Aug. 8, 1986; T.D. 8204, 53 FR 18282, May 23, 1988]

PUBLIC LAW 74, 84TH CONGRESS

SOURCE: Sections 1.9000–1 to 1.9000–8 contained in T.D. 6500, 25 FR 12155, Nov. 26, 1960, unless otherwise noted.

§ 1.9000–1 Statutory provisions.

The Act of June 15, 1955 (Pub. L. 74, 84th Cong., 69 Stat. 134), provides as follows:

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. *Repeal of sections 452 and 462*—(a) *Prepaid income.* Section 452 of the Internal Revenue Code of 1954 is hereby repealed.

(b) Reserves for estimated expenses, etc. Section 462 of the Internal Revenue Code of 1954 is hereby repealed.

SEC. 2. *Technical amendments.* The following provisions of the Internal Revenue Code of 1954 are hereby amended as follows:

(1) Subsection (c) of section 381 is amended by striking out paragraph (7) (relating to carryover of prepaid income in certain corporate acquisitions).

(2) The table of sections for subpart B of part II of subchapter E of chapter 1 (relating to taxable year for which items of gross income included) is amended by striking out

‘‘Sec. 452. Prepaid income.’’

(3) The table of sections for subpart C of such part II (relating to taxable year for which deductions are taken) is amended by striking out:

‘‘Sec. 462. Reserves for estimated expenses, etc.’’

SEC. 3. *Effective date.* The amendments made by this act shall apply with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

SEC. 4. *Saving provisions*—(a) *Filing of statement.* If:

(1) the amount of any tax required to be paid for any taxable year ending on or before the date of the enactment of this act is increased by reason of the enactment of this act, and

(2) the last date prescribed for payment of such tax (or any installment thereof) is before December 15, 1955,

then the taxpayer shall, on or before December 15, 1955, file a statement which shows the increase in the amount of such tax required to be paid by reason of the enactment of this act.

(b) *Form and effect of statement*—(1) *Form of statement, etc.* The statement required by subsection (a) shall be filed at the place fixed for filing the return. Such statement shall be in such form, and shall include such information necessary or appropriate to show the increase in the amount of the tax required to be paid for the taxable year by reason of the enactment of this act, as the Secretary of the Treasury or his delegate shall by regulations prescribe.

(2) *Treatment as amount shown on return.* The amount shown on a statement filed under subsection (a) as the increase in the amount of the tax required to be paid for the taxable year by reason of the enactment of this act shall, for all purposes of the internal revenue laws, be treated as tax shown on the return. Notwithstanding the preceding sentence, that portion of the amount of increase in tax for any taxable year which is attributable to a decrease (by reason of the enactment of this act) in the net operating loss for a succeeding taxable year shall not be treated as tax shown on the return.

(3) *Waiver of interest in case of payment on or before December 15, 1955.* If the taxpayer, on or before December 15, 1955, files the statement referred to in subsection (a) and pays in full that portion of the amount shown thereon for which the last date prescribed for payment is before December 15, 1955, then for purposes of computing interest (other than interest on overpayments) such portion shall be treated as having been paid on the last date prescribed for payment. This paragraph shall not apply if the amount shown on the statement as the increase in the amount of the tax required to be paid for the taxable year by reason of the enactment of this act is greater than the actual increase unless the taxpayer establishes, to the satisfaction of the Secretary of the Treasury or his delegate, that his computation of the greater amount was based upon a reasonable interpretation and application of sections 452 and 462 of the Internal Revenue Code of 1954, as those sections existed before the enactment of this act.

(c) *Special rules*—(1) *Interest for period before enactment.* Interest shall not be imposed on the amount of any increase in tax resulting from the enactment of this act for any period before the day after the date of the enactment of this act.

(2) *Estimated tax.* Any addition to the tax under section 294(d) of the Internal Revenue Code of 1939 shall be computed as if this act had not been enacted. In the case of any installment for which the last date prescribed for payment is before December 15, 1955, any addition to the tax under section 6654 of the Internal Revenue Code of 1954 shall be computed as if this act had not been enacted.

(3) *Treatment of certain payments which taxpayer is required to make.* If:

(A) The taxpayer is required to make a payment (or an additional payment) to another person by reason of the enactment of this act, and

(B) The Internal Revenue Code of 1954 prescribes a period, which expires after the close of the taxable year, within which the taxpayer must make such payment (or additional payment) if the amount thereof is to be taken into account (as a deduction or otherwise) in computing taxable income for such taxable year,

then, subject to such regulations as the Secretary of the Treasury or his delegate may prescribe, if such payment (or additional payment) is made on or before December 15, 1955, it shall be treated as having been made within the period prescribed by such Code.

(4) *Treatment of certain dividends.* Subject to such regulations as the Secretary of the Treasury or his delegate may prescribe, for purposes of section 561(a)(1) of the Internal Revenue Code of 1954, dividends paid after the 15th day of the third month following the close of the taxable year and on or before December 15, 1955, may be treated as having been paid on the last day of the taxable year, but only to the extent (A) that such dividends are attributable to an increase in taxable income for the taxable year resulting from the enactment of this act, and (B) elected by the taxpayer.

(5) *Determination of date prescribed.* For purposes of this section, the determination of the last date prescribed for payment or for filing a return shall be made without regard to any extension of time therefor and without regard to any provision of this section.

(6) *Regulations.* For requirement that the Secretary of the Treasury or his delegate shall prescribe all rules and regulations as may be necessary by reason of the enactment of this act, see section 7805(a) of the Internal Revenue Code of 1954.

§1.9000–2 Effect of repeal in general.

(a) Section 452 (relating to prepaid income) and section 462 (relating to reserves for estimated expenses) of the Internal Revenue Code of 1954 were repealed by the Act of June 15, 1955 (Pub. L. 74, 84th Cong., 69 Stat. 134), with respect to all years subject to such Code. The effect of the repeal will generally be to increase the tax liability of taxpayers who elected to adopt the methods of accounting provided by sections 452 and 462. References to sections of law in §§1.9000–2 to 1.9000–8, inclusive, are references to the Internal Revenue Code of 1954 unless otherwise specified.

(b) The Act of June 15, 1955, provides that if the amount of any tax is increased by the repeal of sections 452 and 462 and if the last date prescribed for the payment of such tax (or any installment thereof) is before December 15, 1955, then the taxpayer shall on or before such date file a statement as prescribed in § 1.9000–3. The last date prescribed for payment for this purpose shall be determined without regard to any extensions of time and without regard to the provisions of the Act of June 15, 1955.

§ 1.9000–3 Requirement of statement showing increase in tax liability.

(a) *Returns filed before June 15, 1955.* Where a return reflecting an election under section 452 or 462 was filed before June 15, 1955, the taxpayer must file on or before December 15, 1955, a statement on Form 2175 showing the increase in tax liability resulting from the repeal of sections 452 and 462. The provisions of this paragraph may be illustrated by the following example:

Example. Corporation X filed its income tax return for the calendar year 1954 on March 15, 1955, and elected under section 6152 to pay the unpaid amount of the tax shown thereon in two equal installments. Such installment payments are due on March 15, 1955, and June 15, 1955, respectively. The corporation elected to compute its tax for such taxable year under the methods of accounting provided by sections 452 and 462. Corporation X's tax liability is increased by reason of the enactment of Public Law 74, and since the last date prescribed for paying its tax expires before December 15, 1955, it is required to submit the prescribed statement on or before December 15, 1955, showing its increase in tax liability.

(b) *Returns filed on or after June 15, 1955.* A taxpayer filing a return on or after June 15, 1955, for a taxable year ending on or before such date, may elect to apply the accounting methods provided in sections 452 and 462. The election may be exercised by either of the following methods:

(1) By computing the tax liability shown on such return as though the provisions of sections 452 and 462 had not been repealed. In such a case, the taxpayer must file on or before December 15, 1955, a statement on Form 2175 showing the increase in tax liability resulting from the repeal of sections 452 and 462.

(2) By computing his tax liability without regard to sections 452 and 462. In this case, Form 2175 must be filed with the return. However, taxable income and the tax liability computed with the application of sections 452 and 462 shall be shown on lines 8 and 14, respectively, of the form in lieu of the amounts otherwise called for on those lines.

If a taxpayer does not make an election to have the provisions of sections 452 and 462 apply, the savings provisions of section 4 of the Act of June 15, 1955, are not applicable.

(c) *Taxable years ending after June 15, 1955.* A taxpayer having a taxable year ending after June 15, 1955, may not elect to apply the methods of accounting prescribed in sections 452 and 462 in computing taxable income for such taxable year. Such a taxpayer must file his return and pay the tax as if such sections had not been enacted.

(d) *Other situations requiring statements.* (1) A person who made an election under section 452 or 462 but whose tax liability was not increased by reason of the enactment of the Act of June 15, 1955, is nevertheless required to file a statement on Form 2175 if his gross income is increased or his deductions are decreased as the result of the repeal of sections 452 and 462. A partnership which makes an election under such sections must file such a statement. In addition, a partner, stockholder, distributee, etc. (whether or not such person made an election under section 452 or 462), shall file a statement showing any increase in his tax liability resulting from the effects of the repeal on the gross income or deductions of any person mentioned in the previous sentences of this subparagraph.

(2) A statement shall also be filed for a taxable year, other than a year to which an election under section 452 or 462 is applicable, if the repeal of such sections increases the tax liability of such year. Thus, a statement must be filed for any taxable year to which a net operating loss is carried from a year to which an election under section 452 or 462 is applicable, provided that

the repeal of such sections affects the amount of the tax liability for the year to which such loss is carried. A separate statement must also be filed for a year in which there is a net operating loss which is changed by reason of the repeal of sections 452 and 462. Where there is a short taxable year involved, a taxpayer may have two taxable years to which elections under sections 452 and 462 are applicable and, in such a case, a statement, on Form 2175, must be filed for each such year.

§1.9000–4 Form and content of statement.

(a) *Information to be shown.* The statement shall be filed on Form 2175 which may be obtained from district directors. It shall be filed with the district director for the internal revenue district in which the return was filed. The statement shall be prepared in accordance with the instructions contained thereon and shall show the following information:

(1) The name and address of the taxpayer,

(2) The amounts of each type of income deferred under section 452,

(3) The amount of the addition to each reserve deducted under section 462,

(4) The taxable income and the tax liability of the taxpayer computed with the application of sections 452 and 462,

(5) The taxable income and the tax liability of the taxpayer computed without the application of sections 452 and 462,

(6) The details of the recomputation of taxable income and tax liability, including any changes in other items of income, deductions, and credits resulting from the repeal of sections 452 and 462, and

(7) If self-employment tax is increased, the computations and information required on page 3 of Schedule C, Form 1040.

(b) *Procedure for recomputing tax liability.* In determining the taxable income and the tax liability computed without the application of sections 452 and 462, such items as vacation pay and prepaid subscription income shall be reported under the law and regulations applicable to the taxable year as if such sections had not been enacted. The tax liability for the year shall be recomputed by restoring to taxable income the amount of income deferred under section 452 and the amount of the deduction taken under section 462. Other deductions or credits affected by such changes in taxable income shall be adjusted. For example, if the deduction for contributions allowed for the taxable year was limited under section 170(b), the amount of such deduction shall be recomputed, giving effect to the increase in adjusted gross income or taxable income, as the case may be, by reason of the adjustments required by the repeal of sections 452 and 462.

§1.9000–5 Effect of filing statement.

(a) *Years other than years affected by a net operating loss carryback.* If the taxpayer files a timely statement in accordance with the provisions of §1.9000–3, the amount of the increase in tax shown on such statement for a taxable year shall, except as provided in paragraph (b) of this section, be considered for all purposes of the Code, as tax shown on the return for such year. In general, such increase shall be assessed and collected in the same manner as if it had been tax shown on the return as originally filed. The provisions of this paragraph may be illustrated by the following example:

Example. A taxpayer filed his return showing a tax liability computed under the methods of accounting provided by sections 452 and 462 as $1,000 and filed the statement in accordance with §1.9000–3 showing an increase in tax liability of $200. The tax computed as though sections 452 and 462 had not been enacted is $1,200, and the difference of $200 is the increase in the tax attributable to the repeal of sections 452 and 462. This increase is considered to be tax shown on the return for such taxable year. Additions to the tax for fraud or negligence under section 6653 will be determined by reference to $1,200 (that is, $1,000 plus $200) as the tax shown on the return.

(b) *Years affected by a net operating loss carryback.* In the case of a year which is affected by a net operating loss carryback from a year to which an election under section 452 or 462 applies, that portion of the amount of increase in tax shown on the statement for the year to which the loss is carried back which is attributable to a decrease in such net operating loss shall not be treated as tax shown on the return.

§ 1.9000–6 Provisions for the waiver of interest.

(a) *In general.* If the statement is filed in accordance with § 1.9000–3 and if that portion of the increase in tax which is due before December 15, 1955 (without regard to any extension of time for payment and without regard to the provisions of §§ 1.9000–2 to 1.9000–8, inclusive), is paid in full on or before such date, then no interest shall be due with respect to that amount. The provisions of this paragraph may be illustrated by the following example:

Example. Corporation M's return for the calendar year 1954 was filed on March 15, 1955, and the tax liability shown thereon was paid in equal installments on March 15, 1955, and June 15, 1955. M filed a statement on December 15, 1955, showing the increase in its tax liability resulting from the repeal of sections 452 and 462 and paid at that time the increase in tax shown thereon. No interest will be imposed with respect to the amount of such payment.

Interest shall be computed under the applicable provisions of the internal revenue laws on any portion of the increase in tax shown on the statement which is due after December 15, 1955, and which is not paid when due.

(b) *Limitation on application of waiver.* The provisions of paragraph (a) of this section shall not apply to any portion of the increase in tax shown on the statement if such increase reflects an amount in excess of that attributable solely to the repeal of sections 452 and 462, i. e., is attributable in whole or in part to excessive or unwarranted deferrals or accruals under section 452 or 462, as the case may be, in computing the tax liability with the application of such sections. Notwithstanding the preceding sentence, paragraph (a) of this section shall be applicable if the taxpayer can show that the tax liability as computed with the application of sections 452 and 462 is based upon a reasonable interpretation and application of such sections as they existed prior to repeal. If the taxpayer complied with the provisions of the regulations under sections 452 and 462 in computing the tax liability with the application of such sections, he will be regarded as having reasonably interpreted and applied sections 452 and 462. In this regard, it is not essential that the taxpayer submit with his return the detailed information required by such regulations in support of the deduction claimed under section 462, but such information shall be supplied at the request of the Commissioner.

(c) *Interest for periods prior to June 16, 1955.* No interest shall be imposed with respect to any increase in tax resulting solely from the repeal of sections 452 and 462 for any period prior to June 16, 1955 (the day after the date of the enactment of the Act of June 15, 1955). The preceding sentence does not apply to that part of any increase in tax which is due to the improper application of sections 452 and 462. The provisions of this paragraph shall not apply to interest imposed under section 3779 of the Internal Revenue Code of 1939. (See paragraph (d) of this section.)

(d) *Amounts deferred by corporations expecting carrybacks.* Interest shall be imposed at the rate of 6 percent on so much of the amount of tax deferred under section 3779 of the Internal Revenue Code of 1939 as is not satisfied within the meaning of section 3779(i)(1), notwithstanding the fact that a greater amount would have been satisfied, had sections 452 and 462 not been repealed. Interest will be imposed at such rate until the amount not so satisfied is paid.

§ 1.9000–7 Provisions for estimated tax.

(a) *Additions to tax under section 294(d) of the Internal Revenue Code of 1939.* Any addition to the tax under section 294(d) (relating to estimated tax) of the Internal Revenue Code of 1939 shall be computed as if the tax for the year for which the estimate was made were computed with sections 452 and 462 still applicable to such taxable year. For the purpose of the preceding sentence, it is not necessary for the taxpayer actually to have made an election under section 452 or 462; it is only necessary for the taxpayer to have taken such sections into account in estimating its tax liability for the year. Thus, if in determining the amount of estimated tax, the taxpayer computed his estimated tax liability by applying those sections, that portion of any additions to tax under section 294(d) resulting from the repeal of sections 452 and 462 shall be disregarded.

(b) *Additions to tax under section 6654.* In the case of an underpayment of estimated tax, any additions to the tax under section 6654, with respect to installments due before December 15, 1955, shall be computed without regard to any increase in tax resulting from the repeal of sections 452 and 462. Any additions to the tax with respect to installments due on or after December 15, 1955, shall be imposed in accordance with the applicable provisions of the Code, and as though sections 452 and 462 had not been enacted. Thus, a taxpayer whose declaration of estimated tax was based upon an estimate of his taxable income for the year of the estimate which was determined by taking sections 452 and 462 into account, must file an amended declaration on or before the due date of the next installment of estimated tax due on or after December 15, 1955. Such amended declaration shall reflect an estimate of the tax without the application of such sections. If the taxpayer bases his estimate on the tax for the preceding taxable year under section 6654(d)(1)(A), an amended declaration must be filed on or before the due date of the next installment due on or after December 15, 1955, if the tax for the preceding taxable year is increased as the result of the repeal of sections 452 and 462. Similarly, if the taxpayer bases his estimate on the tax computed under section 6654(d)(1)(B), he must file an amended declaration on or before the due date of the next installment due on or after December 15, 1955, taking into account the repeal of sections 452 and 462 with respect to the preceding taxable year. Any increase in estimated tax shown on an amended declaration filed in accordance with this paragraph must be paid in accordance with section 6153(c).

(c) *Estimated tax of corporations.* Corporations required to file a declaration of estimated tax under section 6016 for taxable years ending on and after December 31, 1955, shall estimate their tax liability for such year as if sections 452 and 462 had not been enacted. Thus, if the corporation bases its estimated tax liability under section 6655(d) (1) or (2) on its operations for the preceding taxable year, the effect of the repeal of sections 452 and 462 with respect to such year must be taken into account.

§1.9000–8 Extension of time for making certain payments.

(a) *Time for payment specified in Code.* (1) If the treatment of any payment (including its allowance as a deduction or otherwise) is dependent upon the making of a payment within a period of time specified in the Code the period within which the payment is to be made is extended where the amount to be paid is increased by reason of the repeal of sections 452 and 462: *Provided,* That:

(i) The taxpayer, because of a pre-existing obligation, is required to make a payment or an additional payment to another person by reason of such repeal;

(ii) The deductibility of the payment or additional payment is contingent upon its being made within a period prescribed by the Code, which period expires after the close of the taxable year; and

(iii) The payment or additional payment is made on or before December 15, 1955.

If the foregoing conditions are met, the payment or additional payment will be treated as having been made within the time specified in the Code, and, subject to any other conditions in the Code, it shall be deductible for the year to which it relates. The provision of this paragraph may be illustrated by the following examples:

Example 1. Section 267 (relating to losses, expenses and interest between related taxpayers) applies to amounts accrued by taxpayer A for salary payable to B. For the calendar year 1954, A is obligated to pay B a salary equal to 5 percent of A's taxable income for the taxable year. The amount accrued as salary payable to B for 1954 is $5,000 with the taxable income reflecting the application of section 462. As a result of the repeal of section 462 the salary payable to B for 1954 is increased to $6,000. The additional $1,000 is paid to B on December 15, 1955. In recomputing A's tax liability for 1954 the additional deduction of $1,000 for salary payable to B will be treated as having been made within two and one-half months after the close of the taxable year and will be deductible in that year.

Example 2. On March 1, 1955, Corporation X, a calendar year taxpayer using the accrual method of accounting, makes a payment described in section 404(a)(6) (relating to contributions to an employees' trust) of $10,000 which is accrued for 1954 and is determined on the basis of the amount of taxable income for that year. The taxpayer filed its return on March 15, 1955. By reason of the repeal of section 462, X's taxable income is increased so that it is required to make an additional contribution of $2,000 to the employees' trust. The additional payment is made on December 15, 1955. For purposes of recomputing X's tax liability for 1954, this additional payment is deemed to have been made on the last day of 1954.

(2) The time for inclusion in the taxable income of the payee of any additional payment of the type described in subparagraph (1) of this paragraph, shall be determined without regard to section 4(c)(3) of the Act of June 15, 1955, and §§ 1.9000–2 to 1.9000–8, inclusive.

(b) *Dividends paid under section 561.* under section 4(c)(4) of the Act of June 15, 1955, the period during which distributions may be recognized as dividends paid under section 561 for a taxable year to which section 452 or 462 apply may be extended under the conditions set forth below.

(1) *Accumulated earnings tax or personal holding company tax.* In the case of the accumulated earnings tax or the personal holding company tax, if:

(i) The income of a corporation is increased for a taxable year by reason of the repeal of sections 452 and 462 so that it would become liable for the tax (or an increase in the tax) imposed on accumulated earnings or personal holding companies unless additional dividends are distributed;

(ii) The corporation distributes dividends to its stockholders after the 15th day of the 3d month following the close of its taxable year and on or before December 15, 1955, which dividends are attributable to an increase in its accumulated taxable income or undistributed personal holding company income, as the case may be, resulting from the repeal of sections 452 and 462, and

(iii) The corporation elects in its statement, submitted under § 1.9000–3, to have the provisions of section 4(c)(4) of the Act of June 15, 1955, apply:

Then such dividends shall be treated as having been paid on the last day of the taxable year to which the statement applies.

(2) *Regulated investment companies.* In the case of a regulated investment company taxable under section 852, if:

(i) The taxable income of the regulated investment company is increased by reason of the repeal of sections 452 and 462 (without regard to any deduction for dividends paid as provided for in this subparagraph);

(ii) The company distributes dividends to its stockholders after the 15th day of the 3d month following the close of its taxable year and on or before December 15, 1955, which dividends are attributable to an increase in its investment company income resulting from the repeal of sections 452 and 462; and

(iii) The company elects in its statement, submitted under § 1.9000–3, to have the provisions of section 4(c)(4) of the Act of June 15, 1955, apply:

then such dividends are to be treated as having been paid on the last day of the taxable year to which the statement applies. The dividends paid are to be determined under this subparagraph without regard to the provisions of section 855.

(3) *Related provisions.* An election made under subparagraph (1) or (2) of this paragraph is irrevocable. The time for inclusion in the taxable income of the distributees of any distributions of the type described in subparagraph (1) or (2) of this paragraph shall be determined without regard to section 4(c)(4) of the Act of June 15, 1955, and §§ 1.9000–2 to 1.9000–8, inclusive.

RETIREMENT-STRAIGHT LINE ADJUSTMENT ACT OF 1958

SOURCE: Sections 1.9001 to 1.9001–4 contained in T.D. 6500, 25 FR 12158, Nov. 26, 1960, unless otherwise noted.

§ 1.9001 Statutory provisions; Retirement-Straight Line Adjustment Act of 1958.

Section 94 of the Technical Amendments Act of 1958 (72 Stat. 1669) provides as follows:

SEC. 94. *Change from retirement to straight line method of computing depreciation in certain cases*—(a) *Short title.* This section may be cited as the ''Retirement-Straight Line Adjustment Act of 1958''.

(b) *Making of election.* Any taxpayer who held retirement-straight line property on his 1956 adjustment date may elect to have this section apply. Such an election shall be made at such time and in such manner as the Secretary shall prescribe. Any election under this section shall be irrevocable and shall apply to all retirement-straight line property as hereinafter provided in this section (including such property for periods when held by predecessors of the taxpayer).

(c) *Retirement-straight line property defined.* For purposes of this section, the term ''retirement-straight line property'' means any property of a kind or class with respect to which the taxpayer or a predecessor (under the terms and conditions prescribed for him by the Commissioner) for any taxable year beginning after December 31, 1940, and before January 1, 1956, changed from the retirement to the straight line method of computing the allowance of deductions for depreciation.

(d) *Basis adjustments as of 1956 adjustment date.* If the taxpayer has made an election under this section, then in determining the adjusted basis on his 1956 adjustment date of all retirement-straight line property held by the taxpayer, in lieu of the adjustments for depreciation provided in section 1016(a) (2) and (3) of the Internal Revenue Code of 1954, the following adjustments shall be made (effective as of his 1956 adjustment date) in respect of all periods before the 1956 adjustment date:

(1) *Depreciation sustained before March 1, 1913.* For depreciation sustained before March 1, 1913, on retirement-straight line property held by the taxpayer or a predecessor on such date for which cost was or is claimed as basis and which either:

(A) *Retired before changeover.* Was retired by the taxpayer or a predecessor before the changeover date, but only if (i) a deduction was allowed in computing net income by reason of such retirement, and (ii) such deduction was computed on the basis of cost without adjustment for depreciation sustained before March 1, 1913. In the case of any such property retired during any taxable year beginning after December 31, 1929, the adjustment under this subparagraph shall not exceed that portion of the amount attributable to depreciation sustained before March 1, 1913, which resulted (by reason of the deduction so allowed) in a reduction in taxes under the Internal Revenue Code of 1954 or prior income, war-profits, or excess-profits tax laws.

(B) *Held on changeover date.* Was held by the taxpayer or a predecessor on the changeover date. This subparagraph shall not apply to property to which paragraph (2) applies.

The adjustment determined under this paragraph shall be allocated (in the manner prescribed by the Secretary) among all retirement-straight line property held by the taxpayer on his 1956 adjustment date.

(2) *Property disposed of after changeover and before 1956 adjustment date.* For that portion of the reserve prescribed by the Commissioner in connection with the changeover which was applicable to property:

(A) Sold, or

(B) With respect to which a deduction was allowed for Federal income tax purposes by reason of casualty or ''abnormal'' retirement in the nature of special obsolescence, if such sale occurred in, or such deduction was allowed for, a period on or after the changeover date and before the taxpayer's 1956 adjustment date.

(3) *Depreciation allowable from changeover to 1956 adjustment date.* For depreciation allowable, under the terms and conditions prescribed by the Commissioner in connection with the changeover, for all periods on and after the changeover date and before the taxpayer's 1956 adjustment date.

This subsection shall apply only with respect to taxable years beginning after December 31, 1955.

(e) *Effect on period from changeover to 1956 adjustment date.* If the taxpayer has made an election under this section, then in determining the adjusted basis of any retirement-straight line property as of any time on or after the changeover date and before the taxpayer's 1956 adjustment date, in lieu of the adjustments for depreciation provided in section 1016(a) (2) and (3) of the Internal Revenue Code of 1954 and the corresponding provisions of prior revenue laws, the following adjustments shall be made:

(1) *For prescribed reserve.* For the amount of the reserve prescribed by the Commissioner in connection with the changeover.

(2) *For allowable depreciation.* For the depreciation allowable under the terms and conditions prescribed by the Commissioner in connection with the changeover.

This subsection shall not apply in determining adjusted basis for purposes of section 437(c) of the Internal Revenue Code of 1939. This subsection shall apply only with respect to taxable years beginning on or after the changeover date and before the taxpayer's 1956 adjustment date.

(f) *Equity invested capital, etc.* If an election is made under this section, then (notwithstanding the terms and conditions prescribed by the Commissioner in connection with the changeover):

(1) *Equity invested capital.* In determining equity invested capital under sections 458 and 718 of the Internal Revenue Code of 1939, accumulated earnings and profits as of the changeover date, and as of the beginning of each taxable year thereafter, shall be reduced by the depreciation sustained before March 1, 1913, as computed under subsection (d)(1)(B); and

(2) *Definition of equity capital.* In determining the adjusted basis of assets for the purpose of section 437(c) of the Internal Revenue Code of 1939 (and in addition to any other adjustments required by such Code), the basis shall be reduced by depreciation sustained before March 1, 1913 (as computed under subsection (d)), together with any depreciation allowable under subsection (e)(2) for any period before the year for which the excess profits credit is being computed.

(g) *Definitions.* For purposes of this section:

(1) *Depreciation.* The term ''depreciation'' means exhaustion, wear and tear, and obsolescence.

(2) *Changeover.* The term ''changeover'' means a change from the retirement to the straight line method of computing the allowance of deductions for depreciation.

(3) *Changeover date.* The term ''changeover date'' means the first day of the first taxable year for which the changeover was effective.

(4) *1956 adjustment date.* The term ''1956 adjustment date'' means, in the case of any taxpayer, the first day of his first taxable year beginning after December 31, 1955.

(5) *Predecessor.* The term ''predecessor'' means any person from whom property of a kind or class to which this section refers was acquired, if the basis of such property is determined by reference to its basis in the hands of such person. Where a series of transfers of property has occurred and where in each instance the basis of the property was determined by reference to its basis in the hands of the prior holder, the term includes each such prior holder.

(6) The term ''Secretary'' means the Secretary of the Treasury or his delegate.

(7) The term ''Commissioner'' means the Commissioner of Internal Revenue.

§ 1.9001–1 Change from retirement to straight-line method of computing depreciation.

(a) *In general.* The Retirement-Straight Line Adjustment Act of 1958 (72 Stat. 1669), which is contained in section 94 of the Technical Amendments Act of 1958, approved September 2, 1958, provides various adjustments to be made by certain railroads which changed from the retirement to the straight-line method of computing the allowance of deductions for the depreciation of those roadway assets which are defined in this section as retirement-straight line property. The adjustments are available to all eligible taxpayers who make an irrevocable election to have the provisions of the Retirement-Straight Line Adjustment Act of 1958 apply. This election shall be made at the time and in the manner prescribed by this section. If an election is made in accordance with this section, then the provisions of the Act and of §§ 1.9001 to 1.9001–4, inclusive, shall apply. An election made in accordance with this section shall not be considered a change in accounting method for purposes of section 481 of the Code.

(b) *Making of election.* (1) Subsection (b) of the Act provides that any taxpayer who held retirement-straight line property on its 1956 adjustment date may elect to have the provisions of the Act apply. The election shall be irrevocable and shall apply to all retirement-straight line property, including such property for periods when held by predecessors of the taxpayer.

(2) An election may be made in accordance with the provisions of this section even though the taxpayer has, at the time of election, litigated some or all of the issues covered by the provisions of the Act and has received from the courts a determination which is less favorable to the taxpayer than the treatment provided by the Act. Once an election has been made in accordance with the provisions of this section, the taxpayer may not receive the benefit of more favorable treatment, as a result of litigation, than that provided by the Act on the issues involved.

(3) The election to have the provisions of the Act apply shall be made by filing a statement to that effect, on or before January 11, 1960, with the district director for the internal revenue district in which the taxpayer's income tax return for its first taxable year beginning after December 31, 1955, was filed. A copy of this statement shall be filed with any amended return, or claim for refund, made under the Act.

(c) *Definitions.* For purposes of the Act and §§ 1.9001 to 1.9001–4, inclusive:

(1) *The Act.* The term *the Act* means the Retirement-Straight Line Adjustment Act of 1958, as contained in section 94 of the Technical Amendments Act of 1958 (72 Stat. 1669).

(2) *Commissioner.* The term *Commissioner* means the Commissioner of Internal Revenue.

(3) *Retirement-straight line property.* The term *retirement-straight line property* means any property of a kind or

class with respect to which the taxpayer (or a predecessor of the taxpayer) changed, pursuant to the terms and conditions prescribed for it by the Commissioner, from the retirement to the straight-line method of computing the allowance for any taxable year beginning after December 31, 1940, and before January 1, 1956, of deductions for depreciation. The term does not include any specific property which has always been properly accounted for in accordance with the straight-line method of computing the depreciation allowances or which, under the terms-letter, was permitted or required to be accounted for under the retirement method.

(4) *Depreciation.* The term *depreciation* means exhaustion, wear and tear, and obsolescence.

(5) *Predecessor.* The term *predecessor* means any person from whom property of a kind or class to which the Act refers was acquired, if the basis of such property is determined by reference to its basis in the hands of such person. Where a series of transfers of property has occurred and where in each instance the basis of the property was determined by reference to its basis in the hands of the prior holder, the term includes each such prior holder.

(6) *Changeover.* The term *changeover* means a change from the retirement to the straight-line method of computing the allowance of deductions for depreciation.

(7) *Changeover date.* The term *changeover date* means the first day of the first taxable year for which the changeover was effective.

(8) *1956 adjustment date.* The term *1956 adjustment date* means, in the case of any taxpayer, the first day of its first taxable year beginning after December 31, 1955.

(9) *Terms-letter.* The term *terms-letter* means the terms and conditions prescribed by the Commissioner in connection with the changeover.

(10) *Terms-letter reserve.* The term *terms-letter reserve* means the reserve for depreciation prescribed by the Commissioner in connection with the changeover.

(11) *Depreciation sustained before March 1, 1913.* The term *depreciation sustained before March 1, 1913* may be construed to mean, to the extent that it is impossible to determine the actual amount of such depreciation from the books and records, that amount which is obtained by (i) deducting the ‘‘cost of reproduction new less depreciation’’ from the ‘‘cost of reproduction new’’, as ascertained as of the valuation date by the Interstate Commerce Commission under the provisions of section 19a of part I of the Interstate Commerce Act (49 U.S.C. 19a), and then (ii) making such retroactive adjustments to the remainder as are required, in the opinion of the Commissioner of Internal Revenue, to properly reflect the depreciation sustained before March 1, 1913. For this purpose, any retirement-straight line property held on March 1, 1913, and retired on or before the valuation date shall be taken into account.

§1.9001–2 Basis adjustments for taxable years beginning on or after 1956 adjustment date.

(a) *In general.* Subsection (d) of the Act provides the basis adjustments required to be made by the taxpayer as of the 1956 adjustment date in respect of all periods before that date in order to determine the adjusted basis of all retirement-straight line property held by the taxpayer on that date. This adjusted basis on the 1956 adjustment date shall be used by the taxpayer for all purposes of the Code for any taxable year beginning after December 31, 1955. In order to arrive at the adjusted basis on the 1956 adjustment date, the taxpayer shall start with the unadjusted basis of all retirement-straight line property held on the changeover date by the taxpayer or a predecessor and shall, with respect to both the asset and reserve accounts, (1) make the adjustments prescribed by this section and subsection (d) of the Act and (2) also make those adjustments required, in accordance with the method of accounting regularly used, for those additions, retirements, and other dispositions of property which occurred on or after the changeover date and before the taxpayer’s 1956 adjustment date. For an illustration of adjustments required in accordance with the method of accounting regularly used, see paragraph (e)(3) of this section. The adjustments required by subsection (d) of the

Act shall be made in lieu of the adjustments for depreciation otherwise required by section 1016(a) (2) and (3) of the Code. The adjustments required by subsection (d) of the Act are set forth in paragraphs (b), (c), and (d) of this section.

(b) *Adjustment for depreciation sustained before March 1, 1913*—(1) *In general.* Subsection (d)(1) of the Act requires an adjustment to be made as of the 1956 adjustment date for depreciation sustained before March 1, 1913, on all retirement-straight line property held on March 1, 1913, by the taxpayer or a predecessor for which cost was or is claimed as basis and which was either (i) retired before the changeover date by the taxpayer or a predecessor or (ii) held on the changeover date by the taxpayer or a predecessor. This adjustment for depreciation sustained before March 1, 1913, shall be made in accordance with the conditions and limitations described in subparagraphs (2) and (3) of this paragraph and shall be allocated, in the manner prescribed in subparagraph (4) of this paragraph, among all retirement-straight line property held by the taxpayer on its 1956 adjustment date. The term ‘‘cost’’, when used in this paragraph with reference to the basis of property, shall be construed to mean the amount paid for the property or, if that amount could not be determined, then such other amount as was accepted by the Commissioner as ‘‘cost’’ for basis purposes.

(2) *Depreciation sustained on property retired before the changeover date.* Pursuant to subsection (d)(1)(A) of the Act, an adjustment to the basis of retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be made as of that date for depreciation sustained before March 1, 1913, on all retirement-straight line property held on March 1, 1913, by the taxpayer or a predecessor for which cost was claimed as the basis and which was retired before the changeover date by the taxpayer or a predecessor, except that:

(i) The adjustment shall be made only if a deduction was allowed in computing net income by reason of the retirement and the deduction so allowed was computed on the basis of the cost of the property unadjusted for depreciation sustained before March 1, 1913, and

(ii) In the case of any such property retired during any taxable year beginning after December 31, 1929, the adjustment shall not exceed that portion of the amount attributable to depreciation sustained before March 1, 1913, which resulted, by reason of the deduction so allowed, in a reduction of taxes under the Code or under prior income, war-profits or excess-profits tax laws.

(3) *Depreciation sustained on property held on the changeover date.* Pursuant to subsection (d)(1)(B) of the Act, an adjustment to the basis of retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be made as of that date for depreciation sustained before March 1, 1913, on all retirement-straight line property held on March 1, 1913, by the taxpayer or a predecessor for which cost was or is claimed as basis and which was held on the changeover date by the taxpayer or a predecessor. This subparagraph shall not apply, however, to any such property which (i) was disposed of on or after the changeover date by reason of sale, casualty, or abnormal retirement in the nature of special obsolescence, and (ii) is property to which paragraph (c) of this section and subsection (d)(2) of the Act apply.

(4) *Manner of allocating adjustment.* Pursuant to subsection (d)(1) of the Act, the amount of the adjustment required under this paragraph for depreciation sustained before March 1, 1913, which is attributable to a particular kind or class of retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be made with respect to that kind or class of such property. If the adjustment required under this paragraph for depreciation sustained before March 1, 1913, is attributable to retirement-straight property of a particular kind or class no longer held by the taxpayer on its 1956 adjustment date, then the part of the adjustment to be allocated to any retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be that amount which bears the same ratio to the adjustment as the unadjusted basis of the property so held bears to the entire unadjusted basis of all retirement-straight line

property held by the taxpayer on its 1956 adjustment date.

(c) *Adjustment for part of terms-letter reserve applicable to property disposed of on or after changeover date and before 1956 adjustment date.* Pursuant to subsection (d)(2) of the Act, an adjustment to the basis of retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be made as of that date for that part of the terms-letter reserve which was applicable to any retirement-straight line property disposed of by sale, casualty, or abnormal retirement in the nature of special obsolescence, but only if the sale occurred in, or a deduction by reason of such casualty or abnormal retirement was allowed for Federal income-tax purposes for a period on or after the changeover date and before the taxpayer's 1956 adjustment date. This paragraph shall apply even though, in computing the adjusted basis of the property for purposes of determining gain or loss on the sale, casualty, or abnormal retirement, the basis of the retirement-straight line property was not reduced by the part of the terms-letter reserve applicable to the property. If necessary, the adjustment required by this paragraph shall be allocated, in the manner prescribed in paragraph (b)(4) of this section, among all retirement-straight line property held by the taxpayer on its 1956 adjustment date.

(d) *Adjustment for depreciation allowable under the terms-letter for periods on and after the changeover date and before the 1956 adjustment date.* Pursuant to subsection (d)(3) of the Act, an adjustment to the basis of retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be made as of that date for the entire amount of depreciation allowable under the terms-letter for all periods on and after the changeover date and before the taxpayer's 1956 adjustment date. This adjustment shall include all such depreciation allowable with respect to any retirement-straight line property which was disposed of on or after the changeover date and before the 1956 adjustment date.

(e) *Illustration of basis adjustments required for taxable years beginning on or after the 1956 adjustment date.* The application of this section may be illustrated by the following example, which is based upon the assumption that multiple asset accounts are used:

Example. (1) Assume that on its changeover date, January 1, 1943, the taxpayer or its predecessor held retirement-straight line property with an unadjusted cost basis of $10,000. The terms-letter reserve established as of January 1, 1943, with respect to such property was $3,000. Depreciation sustained before March 1, 1913, on retirement-straight line property held on that date by the taxpayer or its predecessor, for which cost was or is claimed as basis, amounts to $800. Of this total depreciation sustained before March 1, 1913, $200 is attributable to retirement-straight line property retired before January 1, 1943, under circumstances requiring the adjustment under paragraph (b)(2) of this section, and $600 is attributable to retirement-straight line property held on January 1, 1943, by the taxpayer or its predecessor. On December 31, 1954, retirement-straight line property costing $1,500 was permanently retired under circumstances giving rise to an abnormal retirement in the nature of special obsolescence. The terms-letter reserve applicable to this retired property was $450, of which $120 represents depreciation sustained before March 1, 1913. On December 31, 1954, retirement-straight line property costing $1,000 was also permanently retired under circumstances giving rise to a normal retirement. None of the property retired on December 31, 1954, had any market or salvage value on that date. Depreciation allowable under the terms-letter on retirement-straight line property for all periods on and after January 1, 1943, and before January 1, 1956 (the taxpayer's 1956 adjustment date), amounts to $2,155, of which $345 is applicable to the property retired as an abnormal retirement.

(2) The reserve for depreciation as of January 1, 1956, contains a credit balance of $3,360, determined as follows but without regard to the Act:

(i) Credits to reserve:		
Terms-letter reserve as of January 1, 1943		$3,000
Depreciation allowable under terms-letter from January 1, 1943, to December 31, 1955		2,155
Balance		5,155
(ii) Charges to reserve:		
Part of terms-letter reserve applicable to property abnormally retired	$450	
Depreciation applicable to property abnormally retired and allowable from January 1, 1943, to December 31, 1954	345	
Adjustment for normal retirement	1,000	

	$1,795
(iii) Balance as of January 1, 1956	3,360

(3) The adjusted basis on January 1, 1956, of the retirement-straight line property held by the taxpayer on that date is $6,010, determined as follows and in accordance with this section:

(i) Asset account:		
Unadjusted cost on January 1, 1943		$10,000
Less:		
Adjustment for abnormal retirement	$1,500	
Adjustment for normal retirement	1,000	
		2,500
Balance as of January 1, 1956		7,500
(ii) Credits to reserve for depreciation:		
Depreciation sustained before March 1, 1913, on—		
Property retired before January 1, 1943		200
Property held on January 1, 1943	$600	
Less part of such depreciation sustained on property abnormally retired on December 31, 1954	120	
		480
Part of terms-letter reserve applicable to property abnormally retired on December 31, 1954 (including $120 depreciation sustained before March 1, 1913)		450
Depreciation allowable under terms-letter from January 1, 1943, to December 31, 1955		2,155
Total Credits		3,285
(iii) Charges to reserve for depreciation:		
Part of terms-letter reserve applicable to property abnormally retired		450
Depreciation applicable to property abnormally retired and allowable from January 1, 1943, to December 31, 1954		345
Adjustment for normal retirement		1,000
Total charges		1,795
(iv) Balance in reserve for depreciation:		
Total credits		3,285
Total charges		1,795
Balance as of January 1, 1956		1,490
(v) Adjusted basis of property:		
Balance in asset account		7,500
Balance in reserve for depreciation		1,490
Adjusted basis as of January 1, 1956		6,010

(4) The following adjustments to the reserve determined under subparagraph (2) of this paragraph may be made in order to arrive at the reserve determined under subparagraph (3)(iv) of this paragraph:

(i) Credit balance in reserve, as determined under subparagraph (2) of this paragraph		$3,360
(ii) Credit adjustments:		
Depreciation sustained before March 1, 1913, on—		
Property retired before January 1, 1943	$200	
Property held on January 1, 1943	480	
Part of terms-letter reserve applicable to property abnormally retired on December 31, 1954	450	
		1,130
Balance		4,490
(iii) Debit adjustment:		
Terms-letter reserve as of January 1, 1943		3,000
(iv) Credit Balance in reserve, as determined under subparagraph (3)(iv) of this paragraph		1,490

(5) The $6,010 adjusted basis as of January 1, 1956, of the retirement-straight line property held by the taxpayer on that date is to be recovered over the estimated remaining useful life of that property. The remaining useful life of the property will be reviewed regularly, and appropriate adjustments in the rates will be made as necessary in order to spread the remaining cost less estimated salvage over the estimated remaining useful life of the property. See § 1.167(a)–1.

§ 1.9001–3 Basis adjustments for taxable years between changeover date and 1956 adjustment date.

(a) *In general.* (1) Subsection (e) of the Act provides the adjustments required to be made in determining the adjusted basis of any retirement-straight line property as of any time on or after the changeover date and before the taxpayer's 1956 adjustment date. This adjusted basis shall be used for all purposes of the Internal Revenue Code of 1939 and the Internal Revenue Code of 1954 for taxable years beginning on or after the changeover date and before the taxpayer's 1956 adjustment date, except as provided in subparagraph (4) of this paragraph. The adjustments so required, which are set forth in paragraphs (b) and (c) of this section, shall not be used in determining the adjusted basis of property for taxable years beginning before the changeover date or on or after the taxpayer's 1956 adjustment date.

(2) In order to arrive at the adjusted basis as of any specific date occurring on or after the changeover date and before the 1956 adjustment date, the taxpayer shall start with the unadjusted

basis of all retirement-straight line property held on the changeover date by the taxpayer or its predecessor and shall, as of that specific date and with respect to both the asset and reserve accounts, (i) make the adjustments prescribed by this section and subsection (e) of the Act and (ii) also make those adjustments required, in accordance with the method of accounting regularly used, for additions, retirements, and other dispositions of property. For an illustration of adjustments required in accordance with the method of accounting regularly used, see the example in paragraph (d) of this section.

(3) The adjustments required by subsection (e) of the Act shall be made in lieu of the adjustments for depreciation otherwise required by section 1016(a) (2) and (3) of the Code and by the corresponding provisions of prior revenue laws.

(4) Although this section, and subsection (e) of the Act, shall apply in determining the excess-profits tax, they shall not apply in determining adjusted basis for the purpose of computing equity capital for any day under section 437(c) (relating to the Excess Profits Tax Act of 1950) (64 Stat. 1137) of the Internal Revenue Code of 1939. For the adjustments to be made in computing equity capital under such section, see paragraph (c) of §1.9001–4.

(b) *Adjustment for terms-letter reserve.* Pursuant to subsection (e)(1) of the Act, the basis of any retirement-straight line property shall be adjusted, as of any specific applicable date occurring on or after the changeover date and before the 1956 adjustment date, for the amount of the terms-letter reserve applicable to such property.

(c) *Adjustment for depreciation allowable under the terms-letter.* Pursuant to subsection (e)(2) of the Act, the basis of any retirement-straight line property shall be adjusted, as of any specific applicable date occurring on or after the changeover date and before the 1956 adjustment date, for depreciation applicable to such property and allowable under the terms-letter.

(d) *Illustration of basis adjustments required for taxable years beginning on or after the changeover date and before the 1956 adjustment date.* The application of this section may be illustrated by the following example, which is based upon the assumption that multiple asset accounts are used:

Example. (1) The facts are assumed to be the same as those in the example under paragraph (e) of §1.9001–2, except that the adjusted basis of retirement-straight line property is determined as of January 1, 1955, and the depreciation allowable under the terms-letter from the changeover date to December 31, 1954, is $2,100.

(2) The adjusted basis on January 1, 1955, of the retirement-straight line property held by the taxpayer on that date is $4,195, determined as follows and in accordance with this section:

(i) Asset account:		
Unadjusted cost on January 1, 1943		$10,000
Less:		
Adjustment for abnormal retirement	$1,500	
Adjustment for normal retirement	1,000	
		2,500
Balance as of January 1, 1955		7,500
(ii) Credits to reserve for depreciation:		
Entire terms-letter reserve as of January 1, 1943		3,000
Depreciation allowable under terms-letter from January 1, 1943, to December 31, 1954		2,100
Total credits		5,100
(iii) Charges to reserve for depreciation:		
Part of terms-letter reserve applicable to property abnormally retired on December 31, 1954		450
Depreciation applicable to property abnormally retired and allowable from January 1, 1943, to December 31, 1954		345
Adjustment for normal retirement		1,000
Total charges		1,795
(iv) Balance in reserve for depreciation:		
Total credits		5,100
Total charges		1,795
Balance as of January 1, 1955		3,305
(v) Adjusted basis of property:		
Balance in asset account		7,500
Balance in reserve for depreciation		3,305
Adjusted basis as of January 1, 1955		4,195

§1.9001–4 Adjustments required in computing excess-profits credit.

(a) *In general.* Subsection (f) of the Act provides adjustments required to be made in computing the excess-profits credit for any taxable year under the Excess Profits Tax Act of 1940 (54

Stat. 975) or under the Excess Profits Tax Act of 1950 (64 Stat. 1137). These adjustments are set forth in paragraphs (b) and (c) of this section, and they shall apply notwithstanding the terms-letter.

(b) *Equity invested capital.* (1) Pursuant to subsection (f)(1) of the Act, in determining equity invested capital for any day of any taxable year under section 458 (relating to the Excess Profits Tax Act of 1950) or section 718 (relating to the Excess Profits Tax Act of 1940) of the Internal Revenue Code of 1939, the accumulated earnings and profits as of the changeover date, and as of the beginning of each taxable year thereafter, shall be reduced by the depreciation sustained before March 1, 1913, on all retirement-straight line property held on March 1, 1913, by the taxpayer or a predecessor for which cost was or is claimed as basis and which was held on the changeover date by the taxpayer or a predecessor.

(2) For the computation of accumulated earnings and profits in determining equity invested capital, see 26 CFR (1941 Supp.) 30.718–2, as amended by Treasury Decision 5299, approved October 1, 1943, 8 FR 13451, C.B. 1943, 747 (Regulations 109); 26 CFR (1943 Cum. Supp.) 35.718–2 (Regulations 112); and 26 CFR (1939) 41.458–4 (Regulations 130).

(c) *Equity capital.* (1) Pursuant to subsection (f)(2) of the Act, in determining the adjusted basis of assets for the purpose of computing equity capital for any day under section 437(c) (relating to the Excess Profits Tax Act of 1950) of the Internal Revenue Code of 1939, the basis of the assets which enter into the computation shall also be reduced by:

(i) Depreciation sustained before March 1, 1913, on all retirement-straight line property held on March 1, 1913, by the taxpayer or a predecessor for which cost was or is claimed as basis and which was:

(a) Retired before the changeover date by the taxpayer or a predecessor, or

(b) Held on the changeover date by the taxpayer or a predecessor and also held as of the beginning of the day for which the equity capital is being determined; and

(ii) All depreciation applicable to the assets which enter into the computation and allowable under the terms-letter for all periods on and after the changeover date and before the taxable year for which the excess-profits credit is being computed.

(2) The adjustment required to be made by subparagraph (1)(i)*(a)* of this paragraph as of the beginning of the day for which the equity capital is being determined shall be made in accordance with the conditions and limitation described in paragraph (b)(2) of § 1.9001–2.

(3) For the determination of equity capital under section 437(c) of the Internal Revenue Code of 1939, see 26 CFR (1939) 40.437–5 (Regulations 130).

DEALER RESERVE INCOME ADJUSTMENT ACT OF 1960

§ 1.9002 Statutory provisions; Dealer Reserve Income Adjustment Act of 1960 (74 Stat. 124).

SECTION 1. *Short title.* This Act may be cited as the ‘‘Dealer Reserve Income Adjustment Act of 1960’’.

SEC. 2. *Persons to whom this Act applies.* This Act shall apply to any person who, for his most recent taxable year ending on or before June 22, 1959:

(1) Computed, or was required to compute, taxable income under an accrual method of accounting.

(2) Treated any dealer reserve income, which should have been taken into account (under the accrual method of accounting) for such taxable year, as accruable for a subsequent taxable year, and

(3) Before September 1, 1960, makes an election under section 3(a) or 4(a) of this Act.

SEC. 3. *Election to have section 481 apply—(a) General rule.* If:

(1) For the year of the change (determined under subsection (b)), the treatment of dealer reserve income by any person to whom this Act applies is changed to a method proper under the accrual method of accounting (whether or not such person initiated the change),

(2) Such person makes an election under this subsection, and

(3) Such person does not make the election provided by section 4(a),

then, for purposes of section 481 of the Internal Revenue Code of 1954, the change described in paragraph (1) shall be treated as a change in method of accounting not initiated by the taxpayer.

(b) *Year of change, etc.* In applying section 481 of the Internal Revenue Code of 1954 for purposes of this section, the ''year of the change'' in the case of any person is:

(1) Except as provided in paragraph (2), the first taxable year ending after June 22, 1959, or

(2) The earliest taxable year (whether the Internal Revenue Code of 1954 or the Internal Revenue Code of 1939 applies to such year) for which:

(A) On or before June 22, 1959:

(i) The Secretary of the Treasury or his delegate issued a notice of deficiency, or a written notice of a proposed deficiency, with respect to dealer reserve income, or

(ii) Such person filed with the Secretary or his delegate a claim for refund or credit with respect to dealer reserve income, and

(B) The assessment of any deficiency, or the refund or credit of any overpayment, whichever is applicable, was not, on June 21, 1959, prevented by the operation of any law or rule of law.

For purposes of this section, section 481 of such Code shall be treated as applying to any year of the change to which the Internal Revenue Code of 1939 applies.

SEC. 4. *Election to have section 481 not apply; payment in installments*—(a) *General rule.* If a person to whom this Act applies makes an election under this subsection, then for purposes of Chapter 1 of the Internal Revenue Code of 1954 (and the corresponding provisions of prior law) a change in the treatment of dealer reserve income to a method proper under the accrual method of accounting shall be treated as not a change in method of accounting in respect of which section 481 of the Internal Revenue Code of 1954 applies. Any election under this subsection shall apply to all taxable years ending on or before June 22, 1959 (whether the provisions of the Internal Revenue Code of 1954 or the corresponding provisions of prior law apply), for which the assessment of any deficiency, or for which refund or credit of any overpayment, whichever is applicable, was not, on June 21, 1959, prevented by the operation of any law or rule of law.

(b) *Election to pay tax in installments*—(1) *Eligibility.* If the net increase in tax (as defined in paragraph (2)) which results solely from the effect of the election provided by subsection (a) exceeds $2,500, then the taxpayer may elect (at the time the election is made under subsection (a)) to pay in two or more (but not to exceed 10) equal annual installments any portion of such net increase which (on the date of such election) is unpaid.

(2) *Net increase in tax defined.* For purposes of this section, the term ''net increase in tax'' means the amount (if any) by which:

(A) The sum of the increases in tax (including interest) for all taxable years to which the election applies and which is attributable to the election, exceeds

(B) The sum of the decreases in tax (including interest) for all taxable years to which the election applies and which is attributable to the election.

For purposes of this paragraph, interest for the period before the date of the election shall be computed as provided in Chapter 67 of the Internal Revenue Code of 1954 (or the corresponding provisions of prior revenue laws).

(c) *Due date for installments.* If an election is made under subsection (b), the first installment shall be paid on or before the date prescribed by section 6151(a) of the Internal Revenue Code of 1954 for payment of the tax for the taxable year in which the election was made, and each succeeding installment shall be paid on or before the date which is one year after the date prescribed by this subsection for payment of the preceding installment.

(d) *Effect of subsequent redetermination of tax*—(1) *Redetermination.* If:

(A) The taxpayer makes an election under subsection (b), and

(B) There is a redetermination of the taxpayer's tax for any taxable year to which the election provided by subsection (a) applies,

then the net increase in tax (as defined in subsection (b)(2) shall be redetermined.

(2) *Effect of increase.* If the redetermination described in paragraph (1)(B) results in an increase in the net increase in tax (as defined in subsection (b)(2)), the resulting increase shall be prorated to ull the installments. The part of such resulting increase so prorated to any installment the date for payment of which has not arrived shall be collected at the same time as, and as a part of, such installment. The part of such resulting increase so prorated to any installment the date for payment of which has arrived shall be paid upon notice and demand from the Secretary of the Treasury or his delegate.

(3) *Effect of decrease.* For treatment of a decrease in the net increase in tax as the result of a redetermination described in paragraph (1)(B), see section 6403 of the Internal Revenue Code of 1954 (relating to overpayment of installment).

(e) *Suspension of interest*—(1) *In general.* If an election under subsection (a) applies and there is a net increase in tax (as defined in subsection (b)(2)), no interest shall be imposed on any underpayment (and no interest shall be paid on any overpayment) attributable to such election for the period beginning on the date of such election and ending on the date prescribed by section 6151(a) of the Internal Revenue Code of 1954 for payment of the tax for the taxable year in which the election was made.

(2) *No interest during installment period.* If an election under subsection (b) applies, no interest shall be imposed for the period on or after the date fixed for payment of the first

installment unless payment of unpaid installments is accelerated under subsection (f) or (g).

(3) *Interest where payment is accelerated.* If payment is accelerated under subsection (f) or (g), interest determined in accordance with the provisions of section 6601 of the Internal Revenue Code of 1954 on the entire unpaid tax shall be payable:

(A) If payment is accelerated under subsection (f), from the date of notice and demand provided by such subsection to the date such tax is paid, or

(B) If payment is accelerated under subsection (g), from the date fixed for paying the unpaid installment to the date such tax is paid.

(f) *Termination of installment payment privilege.* The extension of time provided by this section for payment of tax shall cease to apply, and any unpaid installments shall be paid upon notice and demand from the Secretary of the Treasury or his delegate, if:

(1) In the case of a taxpayer who is an individual, he dies or ceases to engage in a trade or business,

(2) In the case of a taxpayer who is a partner, the entire interest of such partner is transferred or liquidated or the partnership terminates, or

(3) In the case of a taxpayer which is a corporation, the taxpayer ceases to engage in a trade or business, unless the unpaid portion of the tax payable in installments is required to be taken into account by the acquiring corporation under section 5(d).

(g) *Failure to pay installment.* If any installment under this section is not paid on or before the date fixed for its payment by this section (including any extension of time for payment of such installment), the unpaid installments shall be paid upon notice and demand from the Secretary of the Treasury or his delegate.

(h) *Suspension of running of periods of limitation.* The running of the periods of limitation provided by section 6502 of the Internal Revenue Code of 1954 (or corresponding provision of prior law) for the collection of any amount of tax payable in installments under this section shall be suspended for the period of any extension of time for payment granted under this section.

SEC. 5. *Definitions; special rules*—(a) *Dealer reserve income.* For purposes of this Act, the term ''dealer reserve income'' means:

(1) That part of the consideration derived by any person from the sale or other disposition of customers' sales contracts, notes, and other evidences of indebtedness (or derived from customers' finance charges connected with such sales or other dispositions) which is:

(A) Attributable to the sale by such person to such customers, in the ordinary course of his trade or business, of real property or tangible personal property, and

(B) Held in a reserve account, by the financial institution to which such person disposed of such evidences of indebtedness, for the purpose of securing obligations of such person or of such customers, or both; and

(2) That part of the consideration:

(A) Derived by any person from a sale described in paragraph (1)(A) in respect of which part or all of the purchase price of the property sold is provided by a financial institution to or for the customer to whom such property is sold, or

(B) Derived by such person from finance charges connected with the financing of such sale,

which is held in a reserve account by such financial institution for the purpose of securing obligations of such person or of such customer, or both.

(b) *Financial institution.* For purposes of this Act, the term ''financial institution'' means any person regularly engaged in the business of acquiring evidences of indebtedness of the kind described in subsection (a)(1), or of financing sales of the kind described in subsection (a)(2), or both.

(c) *Other terms; application of other laws.* Except where otherwise distinctly expressed or manifestly intended, terms used in this Act shall have the same meaning as when used in the Internal Revenue Code of 1954 and all provisions of law shall apply with respect to this Act as if this Act were a part of such Code.

(d) *Acquiring corporation.* In the case of the acquisition of assets of a corporation by another corporation in a distribution or transfer described in section 381(a) of the Internal Revenue Code of 1954, the acquiring corporation shall, for purposes of this Act, be treated as if it were the distributor or transferor corporation.

(e) *Statutes of limitations*—(1) *Extension of period for assessment and refund or credit.* For purposes of applying sections 3 and 4 of this Act, if the assessment of any deficiency, or the refund or credit of any overpayment, for any taxable year was not prevented on June 21, 1959, by the operation of any law or rule of law, but would be so prevented prior to September 1, 1961, the period within which such assessment, or such refund or credit, may be made shall not expire prior to September 1, 1961. An election by a taxpayer under section 3 or 4 of this Act shall be considered as a consent to the application of the provisions of this subsection.

(2) *Years closed by closing agreement or compromise.* For purposes of this Act, if the assessment of any deficiency, or the refund or credit of any overpayment, for any taxable year is prevented on the date of an election under section 3 or 4 of this Act by the operation of the provisions of Chapter 74 of the Internal Revenue Code of 1954 (relating to closing agreements and compromises) or by the corresponding provisions of the Internal

Revenue Code of 1939, such assessment, or such refund or credit, shall be considered as having been prevented on June 21, 1959.

(f) *Regulations.* The Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this Act, including regulations relating to:

(1) The application of the provisions of this Act in the case of partnerships, and

(2) The manner in which the elections provided by this Act are to be made.

[T.D. 6490, 25 FR 8369, Sept. 1, 1960]

§1.9002–1 Purpose, applicability, and definitions.

(a) *In general.* The Dealer Reserve Income Adjustment Act of 1960 (74 Stat. 124) contains transitional provisions relating to adjustments to income resulting from a change in the income tax treatment of dealer reserve income. The purpose of the Act is to provide eligible taxpayers who elect to have its provisions apply with two alternatives for accounting for the adjustments to income resulting from a change to a proper method of reporting dealer reserve income. The Act also provides certain taxpayers with an election to pay in installments any net increase in tax. Eligible taxpayers must make any election under the provisions of the Act prior to September 1, 1960. If any election is made, then the applicable provisions of the Act and §§1.9002–1 to 1.9002–8, inclusive, shall apply.

(b) *Eligibility to elect.* In order to be eligible to make any of the elections provided by the Act, a taxpayer must have, for his most recent taxable year ending on or before June 22, 1959, (1) computed, or been required to compute, taxable income under an accrual method of accounting, and (2) treated dealer reserve income (or portions thereof) which should have been taken into account (under the accrual method of accounting) for such most recent taxable year as accruable for a subsequent taxable year. Thus, the elections provided by the Act are not available to a person who, for his most recent taxable year ending on or before June 22, 1959, reported dealer reserve income under a method proper under the accrual method of accounting or who was not required to compute taxable income under the accrual method of accounting. An election may be made even though the taxpayer is litigating his liability for income tax based upon his treatment of dealer reserve income, whether in The Tax Court of the United States or any other court, and an election filed by a taxpayer who is litigating his liability for income tax based upon his treatment of dealer reserve income does not constitute a waiver of his right to continue pending litigation until final judicial determination. He must, however, comply with the provisions of the Act and the regulations thereunder.

(c) *Definitions.* For purposes of the Act and §§1.9002–1 to 1.9002–8, inclusive:

(1) *The Act.* The term *the Act* means the Dealer Reserve Income Adjustment Act of 1960 (74 Stat. 124).

(2) *Dealer reserve income.* The term *dealer reserve income* means:

(i) That part of the consideration derived by any person from the sale or other disposition of customers' sales contracts, notes, and other evidences of indebtedness (or derived from customers' finance charges connected with such sales or other dispositions) which is:

(a) Attributable to the sale by such person to such customers, in the ordinary course of his trade or business, of real property or tangible personal property, and

(b) Held in a reserve account, by the financial institution to which such person disposed of such evidences of indebtedness, for the purpose of securing obligations of such person or of such customers, or both; and

(ii) That part of the consideration:

(a) Derived by any person from a sale described in subdivision (i)*(a)* of this subparagraph in respect of which part or all of the purchase price of the property sold is provided by a financial institution to or for the customer to whom such property is sold, or

(b) Derived by such person from finance charges connected with the financing of such sale, which is held in a reserve account by such financial institution for the purpose of securing obligations of such person or of such customer, or both. Thus, the term includes amounts held in a reserve account by a financial institution in transactions in which the customer becomes obligated to the institution as well as such

amounts so held by a financial institution in transactions in which the taxpayer is the obligee on the contract, note, or other evidence of indebtedness. For purposes of the definition of the term ''dealer reserve income'' it is immaterial whether or not the taxpayer guarantees the customer's obligation in excess of the reserve retained by the financial institution. The term does not include the consideration derived from transactions relating to the sale of intangible property such as stocks, bonds, copyrights, patents, etc. Further, the term does not include consideration derived by the taxpayer from transactions relating to the sale of property by a person not the taxpayer or to casual sales of property not in the ordinary course of the taxpayer's trade or business.

(3) *Financial institution.* The term *financial institution* means any person regularly engaged in the business of acquiring evidences of indebtedness of the kind described in section 5(a)(1) of the Act, or of financing sales of the kind described in section 5(a)(2) of the Act, or both. It thus includes banking institutions, finance companies, building and loan associations, and other similar type organizations, as well as an individual or partnership regularly engaged in the described business.

(4) *Taxpayer.* The term *taxpayer* means any person to whom the Act applies.

(5) *Other terms.* All other terms which are not specifically defined shall have the same meaning as when used in the Code except where otherwise distinctly expressed or manifestly intended.

[T.D. 6490, 25 FR 8371, Sept. 1, 1960]

§ 1.9002–2 Election to have the provisions of section 481 of the Internal Revenue Code of 1954 apply.

(a) *In general.* Section 3(a) of the Act provides that if the income tax treatment of dealer reserve income by the taxpayer is changed (whether or not such change is initiated by the taxpayer) to a proper method under the accrual method of accounting, then the taxpayer may elect to have such change treated as a change in method of accounting not initiated by the taxpayer to which the provisions of section 481 of the Code apply. This election may be made only when the alternative election under section 4(a) of the Act has not been exercised.

(b) *Year of change.* Where an election has been made under section 3(a) of the Act to have section 481 of the Code apply, then for purposes of applying section 481 of the Code the year of change shall be determined in accordance with the provisions of section 3(b) of the Act. Section 3(b) provides that the year of change is the earlier of (1) the first taxable year ending after June 22, 1959, or (2) the earliest taxable year for which, on or before June 22, 1959,

(i) There was issued a notice of deficiency or written notice of a proposed deficiency attributable to the erroneous treatment of dealer reserve income, or

(ii) The taxpayer filed a claim for refund or credit with respect to the treatment of such income,

and in respect of which the assessment of any deficiency, or the refund or credit of any overpayment, was not prevented on June 21, 1959, by the operation of any law or rule of law. The written notice of proposed deficiency includes a 15- or 30-day letter issued under established procedure or other similar written notification.

(c) *Application to pre-1954 Code years.* If the earliest year described in paragraph (b) of this section is a year subject to the Internal Revenue Code of 1939 in respect of which assessment of any deficiency or refund or credit of any overpayment was not prevented on June 21, 1959, by the operation of any law or rule of law, section 481 of the Internal Revenue Code of 1954 shall be treated as applying in the same manner it would have applied had it been enacted as part of the Internal Revenue Code of 1939.

(d) *Examples.* The operation of this section in determining the year of change may be illustrated by the following examples:

Example (1). D, a taxpayer on the calendar year basis who employs the accrual method of accounting, voluntarily changed to the proper method of accounting for dealer reserve income for the taxable year 1959. A statutory notice of deficiency, however, was issued prior to June 23, 1959, relating to the erroneous treatment of such income for the taxable year 1956, which was the earliest taxable year in respect of which assessment of a deficiency or credit or refund of an overpayment was not prevented on June 21, 1959. Prior to September 1, 1960, D properly exercises his election under section 3 of the Act to have the change in the treatment of dealer reserve income treated as a change in method of accounting not initiated by the taxpayer to which section 481 of the Code applies. Under these facts, 1956 is the year of the change for purposes of applying section 481. Accordingly, the net amount of any adjustment found necessary as a result of the change in the treatment of dealer reserve income which is attributable to taxable years subject to the 1954 Code shall be taken into account for the year of change in accordance with section 481. The net amount of the adjustments attributable to pre-1954 Code years is to be disregarded. The income of each taxable year succeeding the year of change in respect of which the assessment of any deficiency or refund or credit of any overpayment is not prevented will be recomputed under the proper method of accounting initiated by the change.

Example (2). Assume the same facts as set forth in example (1), except that no notice of a proposed deficiency of any type has been issued, and assume further that no claim for refund has been filed. Since there was no earlier year open on June 21, 1959, for which the taxpayer either was notified of a proposed deficiency attributable to the erroneous treatment of dealer reserve income or for which he had filed a claim for refund or credit with respect to the treatment of such income, the year of change is 1959, the first taxable year ending after June 22, 1959. Accordingly, the net amount of any adjustment found necessary as a result of the change in the treatment of dealer reserve income which is attributable to taxable years subject to the 1954 Code shall be taken into account for the year of the change in accordance with section 481. The net amount of the adjustments attributable to pre-1954 Code years is to be disregarded.

Example (3). Assume the same facts as set forth in example (1), except that a refund claim specifying adjustments relative to dealer reserve income was timely filed for the taxable year 1951, which was the earliest taxable year for which a refund or credit of an overpayment or assessment of a deficiency was not prevented on June 21, 1959. Under this factual situation, the year of change for purposes of applying section 481 would be 1951. Section 481 would be applied to 1951 and be given effect for that year in the same manner as it would have applied had it been enacted as a part of the 1939 Code and as if the change to the proper method of accounting had not been initiated by the taxpayer. Any adjustment with regard to dealer reserve income attributable to pre-1951 years is disregarded. The income of each taxable year succeeding the year of change in respect of which the assessment of any deficiency or refund or credit of any overpayment is not prevented will be recomputed under the proper method of accounting initiated by the change.

[T.D. 6490, 25 FR 8371, Sept. 1, 1960]

§1.9002–3 Election to have the provisions of section 481 of the Internal Revenue Code of 1954 not apply.

Section 4(a) of the Act provides that in the treatment of dealer reserve income by the taxpayer is changed to a method proper under the accrual method of accounting, then the taxpayer may elect to have such change treated as not a change in method of accounting to which the provisions of section 481 of the Internal Revenue Code of 1954 apply. This election shall apply to all taxable years ending on or before June 22, 1959, for which the assessment of any deficiency, or for which refund or credit of any overpayment, was not prevented on June 21, 1959, by the operation of any law or rule of law. This election may be made only if the alternative election under section 3(a) of the Act has not been exercised. If an election is made under section 4(a) of the Act, taxable income (or net income in the case of a taxable year to which the Internal Revenue Code of 1939 applies) shall be recomputed under a proper method of accounting for dealer reserve income for each taxable year to which the election applies, without regard to section 481.

[T.D. 6490, 25 FR 8372, Sept. 1, 1960]

§1.9002–4 Election to pay net increase in tax in installments.

(a) *Election.* If an election is made under section 4(a) of the Act and if the net increase in tax determined in accordance with paragraph (b) of this section exceeds $2,500, the taxpayer may also make an election under section 4(b) of the Act prior to September 1, 1960, to pay any portion of such net increase in tax, unpaid on the date of the election, in 2 or more, but not to exceed 10, equal annual installments. If the taxpayer making the election under section 4(a) of the Act is a partnership or a small business corporation electing under Subchapter S, Chapter 1 of the Code, the determination as to whether the net increase in tax exceeds

$2,500 shall be made separately as to each partner or shareholder, respectively, with regard to his individual liability. Thus, if a partnership makes an election under section 4(a) of the Act, and partners A and B had a net increase in tax of $3,000 and $2,000, respectively, as a result of dealer reserve income adjustments to partnership income, partner A may elect under section 4(b) of the Act to pay the net increase in 2 or more, but not exceeding 10, equal annual installments to the extent that such tax was unpaid on the date of the election. Partner B may not make the election since his net increase in tax does not exceed $2,500.

(b) *Net increase in tax.* (1) The term ‘‘net increase in tax’’ means the amount by which the sum of the increases in tax (including interest) for all taxable years to which the election under section 4(a) of the Act applies and which is attributable to the election exceeds the sum of the decreases in tax (including interest) for all taxable years to which the election under such section applies and which is attributable to the election.

(2) In determining the net increase in tax, the tax and interest for each taxable year to which the election applies is computed by taking into account all adjustments necessary to reflect the change to the proper treatment of dealer reserve income. If the computation results in additional tax for a taxable year, then interest is computed under section 6601 of the Code (or corresponding provisions of prior law) on such additional tax for the taxable year involved from the last date prescribed for payment of the tax for such taxable year to the date the election is made. The interest so computed is then added to the additional tax determined for such taxable year. The sum of these two items (tax plus interest) represents the increase in tax for such taxable year. If the computation of the tax after taking into account the appropriate dealer reserve income adjustments results in a reduction in tax for any taxable year to which the election applies, interest under section 6611 of the Code (or corresponding provisions of prior law) is computed from the date of the overpayment of the tax for such year to the date of the election. The amount of the interest so computed is then added to the reduction in tax to determine the total decrease in tax for such year. The net increase in tax is then determined by adding together the total increases in tax for each year to which the election applies and from the resulting total subtracting the sum of the total decreases in tax for each year. If the total increases in tax for all such years do not exceed the total decreases in tax, there is no net increase in tax for purposes of section 4(b) of the Act. For purposes of determining the net increase in tax, net operating losses affecting the computation of tax for any prior taxable year not otherwise affected shall be taken into account.

(c) *Time for paying installments.* If the election under this section is made to pay the unpaid portion of the net increase in tax in installments, the first installment shall be paid on or before the date prescribed by section 6151(a) of the Code for payment of the tax for the taxable year in which such election is made. Each succeeding installment shall be paid on or before the date which is one year after the date prescribed for the payment of the preceding installment.

(d) *Termination of installment privilege*—(1) *For nonpayment of installment.* The extension of time provided by section 4(b) of the Act for payment of the net increase in tax in installments shall terminate, and any unpaid installments shall be paid upon notice and demand from the district director if any installment under such section is not paid by the taxpayer on or before the date fixed for its payment, including any extension of time for payment of any such installment.

(2) *For other reasons.* The extension of time provided by section 4(b) of the Act for payment of the net increase in tax in installments shall terminate, and any unpaid installments shall be paid upon notice and demand from the district director if:

(i) In the case of an individual, he dies or ceases to engage in any trade or business,

(ii) In the case of a partner, his entire interest in the partnership is transferred or liquidated or the partnership terminates, or

(iii) In the case of a corporation, it ceases to engage in a trade or business, unless the unpaid portion of the tax payable in installments is required to be taken into account by an acquiring corporation under section 5(d) of the Act.

The installment privilege is not terminated under this subparagraph even though the taxpayer terminates the trade or business in respect of which the dealer reserve income is attributable provided the taxpayer continues in a trade or business. Further, the privilege is not terminated by a transfer of a part of a partnership interest so long as the partner retains any interest in the partnership. Also, the privilege is not terminated by a transaction falling within the provisions of section 381(a) of the Code if, under section 5(d) of the Act, the acquiring corporation is required to take into account the unpaid portion of the net increase in tax. In such a case the privilege may be continued by the acquiring corporation in the same manner and under the same conditions as though it were the distributor or transferor corporation.

(e) *Redetermination of tax subsequent to exercise of installment election.* Section 4(d) of the Act provides that where a taxpayer has elected to pay the net increase in tax in installments and thereafter it becomes necessary to redetermine the taxpayer's tax for any taxable year to which the election provided by section 4(a) of the Act applies, then the net increase in tax shall be redetermined. Where the redetermination does not involve adjustments affecting the treatment of dealer reserve income, then the net increase in tax previously computed will not be disturbed. The net increase in tax is limited to the amount of tax computed under section 4(b)(2) of the Act as a result of the change in treatment accorded dealer reserve income. If the redetermination of tax for any taxable year to which the election applies results in an addition to the net increase in tax previously computed, then such addition shall be prorated to all of the installments whether paid or unpaid. The part of the addition, prorated to installments which are not yet due, shall be collected at the same time as, and as a part of, such installments. The part of the addition prorated to installments, the time for payment of which has arrived, shall be paid upon notice and demand from the district director. Under section 4(g) of the Act, failure to make such payment within 10 days after issuance of notice and demand will terminate the installment privilege. The imposition of interest on the addition to the net increase in tax as a result of the redetermination will be determined in the same manner as interest on the previously computed net increase in tax. Thus, no interest will be imposed on the amount of the addition to the net increase in tax prorated to installments not yet due unless the installment privilege is terminated under subsection (f) or (g) of section 4 of the Act. If a reduction in the net increase in tax results from a redetermination of tax for any taxable year to which the election applies, the entire amount of such reduction shall, in accordance with the provisions of section 6403 of the Code (relating to overpayment of installments), be prorated to the installments which are not yet due, resulting in a pro rata reduction in each of such installments. Where the redetermination does not involve adjustments pertaining to dealer reserve income, then any resulting deficiency pertaining to the year to which the election applies will be assessed and collected, in accordance with the applicable provisions of the Code (or corresponding provisions of prior law) without regard to any election made under the Act.

(f) *Periods of limitation.* Section 4(h) of the Act provides that where there is an extension of time for payment of tax under the provisions of section 4(b) of the Act, the running of the periods of limitation provided by section 6502 of the Code (or corresponding provisions of prior law) for collection of such tax is suspended for the period of time for which the extension is granted.

[T.D. 6490, 25 FR 8372, Sept. 1, 1960]

§1.9002–5 Special rules relating to interest.

(a) *In general.* Where an election is made under section 4(a) of the Act interest is computed under section 6601 of the Code (or corresponding provisions of prior law) on any increase in tax attributable to such election for each taxable year involved for the period from the last date prescribed for payment of the tax for such year (determined without regard to any extensions of time for filing the return) through the date preceding the date on which the election is made. Where the election under section 4(a) of the Act results in a decrease in tax for any year to which the election applies, interest is computed in accordance with section 6611 of the Code (or corresponding provisions of prior law) from the date of overpayment through the date preceding the date on which the election is made. Where there is a net increase in tax as a result of the election under section 4(a) of the Act, no interest shall be imposed on any underpayment (and no interest shall be paid on any overpayment) attributable to the dealer reserve income adjustment for any year to which the election applies for the period commencing with the date such election is made and ending on the date prescribed for filing the return (determined without regard to extensions of time) for the taxable year in which the election is made. This rule applies regardless of whether the election under section 4(b) of the Act is made. If there is no net increase in tax, interest on any underpayment or overpayment attributable to the dealer reserve income adjustment for any taxable year to which the election applies for the period commencing with the date of the election shall be determined in accordance with §§ 301.6601–1 and 301.6611–1 of this chapter (Regulations on Procedure and Administration).

(b) *Installment period*—(1) *Where payment is not accelerated.* If the election under section 4(b) of the Act is made to pay the net increase in tax in installments, no interest will be imposed on such net increase in tax for the period beginning with the due date fixed under section 4(c) of the Act for the first installment payment and ending with the date fixed under such section for the last installment payment unless payment of the unpaid installments is accelerated under other provisions of the Act. See subsections (f) and (g) of section 4 of the Act.

(2) *Where payment is accelerated.* Where payment of the unpaid installments is accelerated because of the termination of the installment privilege, interest will be computed under section 6601 of the Code on the entire unpaid net increase in tax for the applicable period set forth below:

(i) In the case of acceleration under section 4(f) of the Act for reasons other than nonpayment of an installment, from the date of the notice and demand for payment of the unpaid tax to the date of payment; or

(ii) In the case of acceleration under section 4(g) of the Act for nonpayment of an installment, from the date fixed for payment of the installment to the date of payment.

When payment is accelerated under section 4(f) of the Act, however, no interest will be charged where payment of the unpaid installments is made within 10 days of issuance of the notice and demand for such payment.

[T.D. 6490, 25 FR 8373, Sept. 1, 1960]

§ 1.9002–6 Acquiring corporation.

Section 5(d) of the Act provides that for purposes of such Act in the case of the acquisition of the assets of a corporation by another corporation in a distribution or transfer described in section 381(a) of the Code the acquiring corporation shall be treated as if it were the distributor or transferor corporation.

[T.D. 6490, 25 FR 8373, Sept. 1, 1960]

§ 1.9002–7 Statute of limitations.

(a) *Extension of period for assessment and refund or credit.* Under section 5(e) of the Act, if an election is made to have the Act apply, and if the assessment of any deficiency, or the refund or credit of any overpayment attributable to the election, for any taxable year to which the Act applies was not prevented on June 21, 1959, by the operation of any law or rule of law (except as provided in paragraph (b) of this section, relating to closing agreements and compromises), but would be so prevented prior to September 1, 1961, the period within which such assessment, or such refund or credit, may be made with respect to such taxable year shall not expire prior to September 1, 1961.

An election under either section 3 or 4 of the Act will be considered to be a consent to the extension of the period of limitation for purposes of assessment for any year to which the Act applies. Thus, for example, if, as the result of an election under section 4(a) of the Act, assessment of a deficiency for the taxable year 1955 was not prevented by the statute of limitations, a judicial decision that had become final, or otherwise, on June 21, 1959, but would (except for section 5(e) of the Act) be prevented on a later date, as for instance September 1, 1959, then for purposes of applying section 4 of the Act, assessment may be made at any time prior to September 1, 1961, with respect to such year if the taxpayer made an election under the Act prior to September 1, 1960. Section 5(e) of the Act will, in no event, operate to shorten the period of limitation otherwise applicable with respect to any taxable year.

(b) *Years closed by closing agreement or compromise.* For purposes of the Act, if the assessment of any deficiency or a refund or credit of any overpayment for any taxable year was not prevented on June 21, 1959, but is prevented on the date of an election under section 3 or 4 of the Act by the operation of the provisions of chapter 74 of the Code (relating to closing agreements and compromises), assessment, refund, or credit will, nevertheless, be considered as being prevented on June 21, 1959.

[T.D. 6490, 25 FR 8373, Sept. 1, 1960]

§1.9002–8 Manner of exercising elections.

(a) *By whom election is to be made*—(1) *In general.* Generally, the taxpayer to whom the Act applies will exercise the elections provided therein. In the case of a partnership or a corporation electing under the provisions of subchapter S, chapter 1 of the Code, the election shall be exercised by the persons specified in subparagraphs (2) and (3) of this paragraph, respectively.

(2) *Partnerships.* In the case of a partnership, the election under section 3 or 4(a) of the Act shall be exercised by the partnership. If an election is made by the partnership under section 4(a) of the Act, any election under section 4(b) of the Act to pay the net increase in tax in installments shall be made by each partner separately. The determination as to whether the net increase in tax resulting from the election under section 4(a) of the Act exceeds $2,500 shall be made with reference to the increase or decrease in the tax of each partner attributable to the adjustment to his distributive share of the partnership income resulting from the election.

(3) *Subchapter S corporations.* In the case of an electing small business corporation under subchapter S, chapter 1 of the Code, the election under section 3 or 4(a) of the Act shall be made by such corporation. An election under section 4(b) of the Act to pay the net increase in tax in installments shall, to the extent the net increase in tax resulting from the election is attributable to adjustments to income for taxable years for which the corporation was not an electing small business corporation, be made by the corporation. The determination as to whether the net increase in tax for such taxable years exceeds $2,500 shall be made with reference to the increase or decrease in tax of the corporation. Any election under section 4(b) of the Act to pay the net increase in tax in installments shall, to the extent the increase in tax is attributable to years for which the corporation was an electing small business corporation, be made by the shareholders separately. The determination in such a case as to whether the net increase in tax for such taxable years exceeds $2,500 shall be made with reference to the increases or decreases in the tax of each shareholder attributable to the adjustments to taxable income of the electing small business corporation resulting from the election.

(b) *Time and manner of making elections*—(1) *In general.* Any election made under the Act shall be made by the taxpayers described in paragraph (a) of this section before September 1, 1960, by filing a statement with the district director with whom such taxpayer's income tax return for the taxable year in which the election is made is required to be filed. A copy of the statement of election shall be attached to and filed with such taxpayer's income tax return for such taxable year.

(2) *Election to have section 481 apply.* An election under section 3 of the Act shall be made in the form of a statement which shall include the following:

(i) A clear indication that an election is being made under section 3 of the Act;

(ii) Information sufficient to establish eligibility to make the election; and

(iii) The year of change as defined in section 3(b) of the Act.

An amended income tax return reflecting the increase or decrease in tax attributable to the election shall be filed for the year of change together with schedules showing how the tax was recomputed under section 481 of the Code. If income tax returns have been filed for any taxable years subsequent to the year of change, amended returns reflecting the proper treatment of dealer reserve income for such years shall also be filed. In the case of partnerships and electing small business corporations under subchapter S, chapter 1 of the Code, amended returns shall be filed by the partnership or electing small business corporation, as well as by the partners or shareholders, as the case may be. Any amended return shall be filed with the office of the district director with whom the taxpayer files his income tax return for the taxable year in which the election is made and, if practicable, on the same date the statement of election is filed, but amended returns shall be filed in no event later than November 30, 1960, unless an extension of time is granted under section 6081 of the Code. Whenever the amended returns do not accompany the statement of election, a copy of the statement shall be submitted with the amended returns.

(3) *Election not to have section 481 apply.* An election under section 4(a) of the Act shall be made in the form of a statement which shall include the following:

(i) A clear indication that an election is being made under section 4(a) of the Act;

(ii) Information sufficient to establish eligibility to make the election; and

(iii) The taxable years to which the election applies.

Amended income tax returns reflecting the increase or decrease in tax attributable to the election shall be filed for the taxable years to which the election applies. If income tax returns have been filed for any subsequent taxable years, amended returns reflecting the proper treatment of dealer reserve income for such years shall also be filed. In the case of partnerships and electing small business corporations under subchapter S, chapter 1 of the Code, amended returns shall be filed by the partnership or electing small business corporation, as well as by the partners or shareholders, as the case may be. Any amended return shall be filed with the office of the district director with whom the taxpayer files his income tax return for the taxable year in which the election is made and, if practicable, on the same date the statement of election is filed, but amended returns shall be filed in no event later than November 30, 1960, unless an extension of time is granted under section 6081 of the Code. Whenever the amended returns do not accompany the statement of election, a copy of the statement shall be submitted with the amended return.

(4) *Election to pay tax in installments.* (i) Except as otherwise provided in subdivision (ii) of this subparagraph, if the taxpayer making the election under section 4(a) of the Act also desires to make the election under section 4(b) of the Act to pay the increase in tax in installments, then the statement of election shall include the following additional information:

(a) A clear indication that an election is also being made under section 4(b) of the Act;

(b) A summary of the total increases and decreases in tax, together with interest thereon, in sufficient detail to establish eligibility to make the election; and

(c) The number of annual installments in which the taxpayer elects to pay the net increase in tax.

(ii) Where a partnership or electing small business corporation under subchapter S, chapter 1 of the Code, has made an election under section 4(a) of the Act, and any partner or shareholder, as the case may be, desires to make an election under section 4(b) of the Act, a statement of election shall be filed by such partner or shareholder containing the following information:

(a) A clear indication that an election is being made under section 4(b) of the Act;

(b) A summary of the total increases and decreases in tax, together with interest thereon, of such partner or shareholder in sufficient detail to establish eligibility to make the election;

(c) The number of annual installments in which the partner or shareholder elects to pay the net increase in tax; and

(d) The office of the district director and the date on which the election under section 4(a) of the Act was filed by such partnership or corporation.

The statement of election under section 4(b) of the Act shall be accompanied by a copy of the statement of election under section 4(a) of the Act made by the partnership or electing small business corporation under subchapter S, chapter 1 of the Code, as the case may be.

(c) *Effect of election.* An election made under section 3 or 4 of the Act shall become irrevocable on September 1, 1960, and shall be binding on the taxpayer for all taxable years to which it applies.

[T.D. 6490, 25 FR 8373, Sept. 1, 1960]

PUBLIC DEBT AND TAX RATE EXTENSION ACT OF 1960

AUTHORITY: Sections 1.9003 to 1.9003–5 issued under sec. 302(c), 74 Stat. 292, as amended; 26 U.S.C. 613 note.

§1.9003 Statutory provisions; section 4 of the Act of September 14, 1960 (Pub. L. 86–781, 74 Stat. 1017).

SEC. 4. Subsection (c) of section 302 of the Public Debt and Tax Rate Extension Act of 1960 (Pub. L. 86–564; 74 Stat. 293) is amended to read as follows:

(c) *Effective date*—(1) *In general.* Except as provided in paragraph (2), the amendments made by subsections (a) and (b) shall be applicable only with respect to taxable years beginning after December 31, 1960.

(2) *Calcium carbonates, etc.*—(A) *Election for past years.* In the case of calcium carbonates or other minerals when used in making cement, if an election is made by the taxpayer under subparagraph (C):

(i) The amendments made by subsection (b) shall apply to taxable years with respect to which such election is effective, and

(ii) Provisions having the same effect as the amendments made by subsection (b) shall be deemed to be included in the Internal Revenue Code of 1939 and shall apply to taxable years with respect to which such election is effective in lieu of the corresponding provisions of such Code.

(B) *Years to which applicable.* An election made under subparagraph (C) to have the provisions of this paragraph apply shall be effective for all taxable years beginning before January 1, 1961, in respect of which:

(i) The assessment of a deficiency,

(ii) The refund or credit of an overpayment, or

(iii) The commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954,

is not prevented on the date of the enactment of this paragraph by the operation of any law or rule of law. Such election shall also be effective for any taxable year beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before the date of the enactment of this paragraph.

(C) *Time and manner of election.* An election to have the provisions of this paragraph apply shall be made by the taxpayer on or before the 60th day after the date of publication in the FEDERAL REGISTER of final regulations issued under authority of subparagraph (F), and shall be made in such form and manner as the Secretary of the Treasury or his delegate shall prescribe by regulations. Such election, if made, may not be revoked.

(D) *Statutes of limitation.* Notwithstanding any other law, the period within which an assessment of a deficiency attributable to the application of the amendments made by subsection (b) may be made with respect to any taxable year to which such amendments apply under an election made under subparagraph (C), and the period within which a claim for refund or credit of an overpayment attributable to the application of such amendments may be made with respect to any such taxable year, shall not expire prior to one year after the last day for making an election under subparagraph (C). An election by a taxpayer under subparagraph (C) shall be considered as a consent to the application of the provisions of this subparagraph.

(E) *Terms; applicability of other laws.* Except where otherwise distinctly expressed or manifestly intended, terms used in this paragraph shall have the same meaning as when used in the Internal Revenue Code of 1954 (or corresponding provisions of the Internal Revenue Code of 1939) and all provisions of law shall apply with respect to this paragraph as if this paragraph were a part of such Code (or corresponding provisions of the Internal Revenue Code of 1939).

(F) *Regulations.* The Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of this paragraph.

[T.D. 6492, 25 FR 8904, Sept. 16, 1960]

§ 1.9003–1 Election to have the provisions of section 613(c) (2) and (4) of the 1954 Code, as amended, apply for past years.

(a) *In general.* Section 4 of the Act of September 14, 1960 (Pub. L. 86–781, 74 Stat. 1017), amended section 302(c) of the Public Debt and Tax Rate Extension Act of 1960 to permit certain taxpayers for taxable years beginning before January 1, 1961, to apply the provisions of section 302(b) of that Act. Section 302(b) of the Act amended section 613(c) (2) and (4) of the Internal Revenue Code of 1954 to read in part as follows:

SEC. 613. *Percentage Depletion.* * * *

(c) *Definition of gross income from property.* For purposes of this section:

* * * * *

(2) *Mining.* The term ''mining'' includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

* * * * *

(4) *Treatment processes considered as mining.* The following treatment processes where applied by the mine owner or operator shall be considered as mining to the extent they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under section 611:

* * * * *

(F) In the case of calcium carbonates and other minerals when used in making cement—all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;

(b) *Election.* Under section 302(c)(2) of the Act, the taxpayer, in the case of calcium carbonates or other minerals when used by him in making cement, may elect to apply the provisions of section 613(c) (2) and (4) of the 1954 Code as amended in lieu of the corresponding provisions of prior law. The taxpayer must make the election in accordance with § 1.9003–4 on or before November 15, 1960, and the election shall become irrevocable on November 15, 1960.

(c) *Years to which the election is applicable.* If the election described in paragraph (b) of this section is made by the taxpayer, the provisions of section 613(c) (2) and (4) as amended by section 302(b) of the Act apply to all taxable years beginning before January 1, 1961, in respect of which:

(1) The assessment of any deficiency,

(2) Refund or credit of any overpayment,

(3) Commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954,

is not prevented on September 14, 1960, by the operation of any law or rule of law. The election also applies to taxable years beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before September 14, 1960.

[T.D. 6492, 25 FR 8905, Sept. 16, 1960]

§ 1.9003–2 Effect of election.

(a) *In general.* If a taxpayer makes the election described in paragraph (b) of § 1.9003–1, he shall be deemed to have consented to the application of section 302(b) of the Act with respect to all taxable years to which the election applies. Thus, subparagraph (F) of section 613(c)(4) of the Internal Revenue Code of 1954 as amended must be applied in determining gross income from mining for the taxable years to which the election applies (including years subject to the Internal Revenue Code of 1939) whether or not the taxpayer is litigating the issue. Further, the election shall apply to all calcium carbonates or other minerals mined and used by the taxpayer in making cement.

(b) *Effect on gross income from mining.* The election is only determinative of what constitutes ''mining'' for purposes of computing percentage depletion and has no effect on the method employed in determining the amount of gross income from mining. In applying the election to the years affected there shall be taken into account the effect that any adjustments resulting from the election shall have on other items affected thereby, such as charitable contributions, foreign tax credit, net operating loss, and the effect that adjustments to any such items shall have on other taxable years. The provisions of section 302(b) of the Act are applicable with respect to taxable years subject to the Internal Revenue Code of 1939 for purposes of applying sections 450 and 453 of that Code.

[T.D. 6492, 25 FR 8905, Sept. 16, 1960]

§1.9003–3 Statutes of limitation.

Under section 302(c)(2) of the Act, the period within which the assessment of any deficiency or the credit or refund of any overpayment attributable to the election may be made shall not expire sooner than 1 year after November 15, 1960. Thus, if assessment of a deficiency or credit or refund of an overpayment, whichever is applicable, is not prevented on September 14, 1960, the time for making assessment or credit or refund shall not expire for at least 1 year after November 15, 1960, notwithstanding any other provision of law to the contrary. Even though assessment of a deficiency is prevented on September 14, 1960, if commencement of a suit for recovery of a refund under section 7405 of the Code may be made on such date, then any deficiency resulting from the election may be assessed at any time within 1 year after November 15, 1960. If the taxpayer makes the election he shall be deemed to have consented to the application of the provisions of section 302(c)(2) of the Act extending the time for assessing a deficiency attributable to the election. Section 302(c)(2) of the Act does not shorten the period of limitations otherwise applicable. An agreement may be entered into under section 6501(c)(4) of the Code and corresponding provisions of prior law to extend the period for assessment.

[T.D. 6492, 25 FR 8905, Sept. 16, 1960]

§1.9003–4 Manner of exercising election.

(a) *By whom election is to be made.* Generally, the taxpayer whose tax liability is affected by the election shall make the election. In the case of a partnership, or a corporation electing under the provisions of subchapter S, chapter 1 of the Code, the election shall be exercised by the partnership or such corporation, as the case may be.

(b) *Time and manner of making election.* The election shall be made on or before November 15, 1960, by filing a statement with the district director with whom the taxpayer's income tax return for the taxable year in which the election is made is required to be filed. The statement shall include the following:

(1) A clear indication that an election is being made under section 302(c)(2) of the Act, and

(2) The taxable years to which the election applies.

Amended income tax returns reflecting any increase or decrease in tax attributable to the election shall be filed for the taxable years to which the election applies. In the case of partnerships and electing small business corporations under subchapter S, chapter 1 of the Code, amended returns shall be filed by the partnership or electing small business corporations, as well as by the partners or shareholders, as the case may be. Any amended return shall be filed with the office of the district director with whom the taxpayer files his income tax return for the taxable year in which the election is made and, if practicable, on the same date the statement of election is filed, but amended returns shall be filed in no event later than February 28, 1961, unless an extension of time is granted under section 6081 of the Code. Whenever the amended returns do not accompany the statement of election, a copy of the statement shall be submitted with the amended returns. The amended returns shall be accompanied by payment of the additional tax (together with interest thereon) resulting from the election.

[T.D. 6492, 25 FR 8905, Sept. 16, 1960]

§1.9003–5 Terms; applicability of other laws.

All other terms which are not otherwise specifically defined shall have the same meaning as when used in the Code (or the corresponding provisions of prior law) except where otherwise distinctly expressed or manifestly intended to the contrary. Further, all provisions of law contained in the Code (or the corresponding provisions of prior law) shall apply to the extent that they can apply. Thus, all of the provisions of subtitle F of the Code and the corresponding provisions of prior law shall apply to the extent they can apply, including the provisions of law relating to assessment, collection, credit or refund, and limitations. For purposes of this section and §§ 1.9003–1 to 1.9003–4, inclusive, the term ''Act'' means the Public Debt and Tax Rate Extension Act of 1960 as amended (74 Stat. 293, 1018).

[T.D. 6492, 25 FR 8905, Sept. 16, 1960]

CERTAIN BRICK AND TILE CLAY, FIRE CLAY, AND SHALE; REGULATIONS UNDER THE ACT OF SEPTEMBER 26, 1961

§ 1.9004 Statutory provisions; the Act of September 26, 1961 (Pub. L. 87–312, 75 Stat. 674).

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) *Election for past years.* In the case of brick and tile clay, fire clay, or shale used by the mineowner or operator in the manufacture of building or paving brick, drainage and roofing tile, sewer pipe, flower pots, and kindred products (without regard to the applicable rate of percentage depletion), if an election is made under subsection (c), for the purpose of applying section 613(c) of the Internal Revenue Code of 1954 (and corresponding provision of the Internal Revenue Code of 1939) for each of the taxable years with respect to which the election is effective:

(1) Gross income from the property shall be 50 per centum of the amount for which the manufactured products are sold during the taxable year except that with respect to such manufactured products, gross income from the property shall not exceed an amount equal to $12.50 multiplied by the number of short tons used in the manufactured products sold during the taxable year, and

(2) For purposes of computing the 50 per centum limitation under section 613(a) of the Internal Revenue Code of 1954 (or the corresponding provision of the Internal Revenue Code of 1939), the taxable income from the property (computed without allowance for depletion) shall be 50 per centum of the taxable income from the manufactured products sold during the taxable year (computed without allowance for depletion).

(b) *Years to which applicable.* An election made under subsection (c) to have the provisions of this section apply shall be effective for all taxable years beginning before January 1, 1961, in respect of which:

(1) The assessment of a deficiency,

(2) The refund or credit of an overpayment, or

(3) The commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954, is not prevented on the date of the enactment of this Act by the operation of any law or rule of law. Such election shall also be effective for any taxable year beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before the date of the enactment of this Act.

(c) *Time and manner of election.* An election to have the provisions of this section apply shall be made by the taxpayer on or before the sixtieth day after the date of publication in the FEDERAL REGISTER of final regulations issued under authority of subsection (f), and shall be made in such form and manner as the Secretary of the Treasury or his delegate shall prescribe by regulations. Such election, if made, may not be revoked.

(d) *Statutes of limitation.* Notwithstanding any other law, the period within which an assessment of a deficiency attributable to the election under subsection (c) may be made with respect to any taxable year for which such election is effective, and the period within which a claim for refund or credit of an overpayment attributable to the election under such subsection may be made with respect to any such taxable year, shall not expire prior to one year after the last day for making an election under subsection (c). An election by a taxpayer under subsection (c) shall be considered as a consent to the application of the provisions of this subsection.

(e) *Terms; applicability of other laws.* Except where otherwise distinctly expressed or manifestly intended, terms used in this section shall have the same meaning as when used in the Internal Revenue Code of 1954 (or corresponding provisions of the Internal Revenue Code of 1939) and all provisions of law shall apply with respect to this section as if this section were a part of such Code (or corresponding provisions of the Internal Revenue Code of 1939).

(f) *Regulations.* The Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of this section.

(75 Stat. 674; 26 U.S.C. 613 note)

[T.D. 6575, 26 FR 9632, Oct. 12, 1961]

§1.9004–1 Election relating to the determination of gross income from the property for taxable years beginning prior to 1961 in the case of certain clays and shale.

(a) *In general.* The Act of September 26, 1961 (Pub. L. 87–312, 75 Stat. 674), provides that certain taxpayers may elect to apply the provisions thereof to all taxable years beginning before January 1, 1961, with respect to which the election is effective. The Act prescribes special rules for the application of section 613 (a) and (c) of the Internal Revenue Code of 1954 (and corresponding provisions of the Internal Revenue Code of 1939) in the case of shale and certain clays used by the mine owner or operator in the manufacture of certain clay and shale products.

(b) *Election.* The election to apply the provisions of the Act may be made only by a mine owner or operator with respect to brick and tile clay, fire clay, or shale which he mined and used in the manufacture of building or paving brick, drainage and roofing tile, sewer pipe, flower pots, and kindred products. The election must be made in accordance with §1.9004–4 on or before December 11, 1961, and the election shall become irrevocable on December 11, 1961.

(c) *Years to which the election is applicable.* If the election described in paragraph (b) of this section is made by the taxpayer, the provisions of the Act shall be effective for all taxable years beginning before January 1, 1961, in respect of which the:

(1) Assessment of a deficiency,

(2) Refund or credit of an overpayment, or

(3) Commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954,

is not prevented on September 26, 1961, by the operation of any law or rule of law. The election is also effective for any taxable year beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before September 26, 1961.

(75 Stat. 674; 26 U.S.C. 613 note)

[T.D. 6575, 26 FR 9632, Oct. 12, 1961]

§1.9004–2 Effect of election.

(a) *In general.* If a taxpayer makes the election described in paragraph (b) of §1.9004–1, he shall be deemed to have consented to the application of the Act with respect to all the clay and shale described in that paragraph for all taxable years for which the election is effective whether or not the taxpayer is litigating the issue for any of such years. Thus, in applying section 613 of the Internal Revenue Code of 1954 (and corresponding provisions of the Internal Revenue Code of 1939) to those years:

(1) The ‘‘gross income from the property’’ for purposes of section 613(c) of the Internal Revenue Code of 1954 (and corresponding provisions of the Internal Revenue Code of 1939) shall be 50 percent of the amount for which the mineowner or operator sold, during the taxable year, the building or paving brick, drainage and roofing tile, sewer pipe, flower pots, and kindred products manufactured from the clay and shale described in paragraph (b) of §1.9004–1, but shall not exceed an amount equal to $12.50 multiplied by the number of short tons of all such clay or shale mined and used by the mineowner or operator in the manufacture of the products sold during the taxable year; and

(2) The ‘‘taxable income from the property’’ (computed without allowance for depletion) for purposes of section 613(a) of the Internal Revenue Code of 1954 (and corresponding provisions of the Internal Revenue Code of 1939) shall be 50 percent of the taxable income from the manufactured products sold during the taxable year (computed without allowance for depletion).

(b) *Effect on depletion rates and other items.* The election shall have no effect on the applicable rate of percentage depletion for the taxable years to which the election is effective. In applying the election to the years affected there shall be taken into account the effect that any adjustments resulting from the election shall have on other items affected thereby, such as charitable contributions, foreign tax credit, net operating loss, and the effect that adjustments to any such items shall have on other taxable years. The provisions of the Act are applicable with respect to taxable years subject to the Internal Revenue Code of 1939 for purposes of applying sections 450 and 453 of that Code.

(75 Stat. 674; 26 U.S.C. 613 note)

[T.D. 6575, 26 FR 9632, Oct. 12, 1961]

§ 1.9004–3 Statutes of limitation.

The period within which the assessment of any deficiency or the credit or refund of any overpayment attributable to the election may be made shall not expire sooner than one year after December 11, 1961. Thus, if assessment of a deficiency or credit or refund of an overpayment, whichever is applicable, is not prevented on September 26, 1961, the time for making assessment or credit or refund shall not expire for at least one year after December 11, 1961, notwithstanding any other provision of law to the contrary. Even though assessment of a deficiency is prevented on September 26, 1961, if commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954 may be made on such date, then any deficiency resulting from the election may be assessed at any time within 1 year after December 11, 1961. If a taxpayer makes the election, he shall be deemed to have consented to the application of the provisions of the Act extending the time for assessing a deficiency attributable to the election. The Act does not shorten the periods of limitation otherwise applicable. An agreement may be entered into under section 6501(c)(4) of the Internal Revenue Code of 1954 and corresponding provisions of prior law to extend the period for assessment.

(75 Stat. 674; 26 U.S.C. 613 note)

[T.D. 6575, 26 FR 9632, Oct. 12, 1961]

§ 1.9004–4 Manner of exercising election.

(a) *By whom election is to be made.* Generally, the taxpayer whose tax liability is affected by the election shall make the election. In the case of a partnership, or a corporation electing under the provisions of subchapter S, chapter 1 of the Internal Revenue Code of 1954, the election shall be exercised by the partnership or such corporation, as the case may be.

(b) *Time and manner of making election.* The election shall be made on or before December 11, 1961, by filing a statement with the district director with whom the taxpayer's income tax return for the taxable year in which the election is made is required to be filed. The statement shall include the following:

(1) A clear indication that an election is being made under the Act, and

(2) The taxable years to which the election applies.

Amended income tax returns reflecting any increase or decrease in tax attributable to the election shall be filed for the taxable years to which the election applies. In the case of partnerships and electing small business corporations under subchapter S, chapter 1 of the Internal Revenue Code of 1954, amended returns shall be filed by the partnership or electing small business corporation, as well as by the partners or shareholders, as the case may be. Any amended return shall be filed with the office of the district director with whom the taxpayer files his income tax return for the taxable year in which the election is made and, if practicable, on the same date the statement of election is filed, but amended returns shall be filed in no event later than March 31, 1962, unless an extension of time is granted under section 6081 of the Internal Revenue Code of 1954. Whenever the amended returns do not accompany the statement of election, a copy of the statement shall be submitted with the amended returns. The amended returns shall be accompanied by payment of the additional tax (together with interest thereon) resulting from the election.

(75 Stat. 674, 26 U.S.C. 613 note)

[T.D. 6575, 26 FR 9633, Oct. 12, 1961]

§ 1.9004–5 Terms; applicability of other laws.

All other terms which are not otherwise specifically defined shall have the same meaning as when used in the Internal Revenue Code of 1954 (or the corresponding provisions of prior law) except where otherwise distinctly expressed or manifestly intended to the contrary. Further, all provisions of law contained in the Code (or the corresponding provisions of prior law) shall apply to the extent that they can apply. Thus, all the provisions of subtitle F of the Code (and the corresponding provisions of prior law) shall apply to the extent they can apply, including the provisions of law relating to assessment, collection, credit or refund, and limitations. For purposes of this section and §§1.9004–1 to 1.9004–4, inclusive, the term ''Act'' means the Act of September 26, 1961 (Pub. L. 87–312, 75 Stat. 674).

(75 Stat. 674, 26 U.S.C. 613 note)

[T.D. 6575, 26 FR 9633, Oct. 12, 1961]

QUARTZITE AND CLAY USED IN PRODUCTION OF REFRACTORY PRODUCTS; ELECTION FOR PRIOR TAXABLE YEARS

§1.9005 Statutory provisions; section 2 of the Act of September 26, 1961 (Pub. L. 87–321, 75 Stat. 683).

SEC. 2. *Election for quartzite and clay used in the production of refractory products*—(a) *Election for past years.* If an election is made under subsection (c), in the case of quartzite and clay used by the mine owner or operator in the production of refractory products, for the purpose of applying section 613(c) of the Internal Revenue Code of 1954 (and corresponding provisions of the Internal Revenue Code of 1939) for each of the taxable years with respect to which the election is effective:

(1) The term ''ordinary treatment processes'' shall include crushing, grinding, and separating the mineral from waste, but shall not include any subsequent process; and

(2) The gross income from mining for each short ton of such quartzite or clay used in the production of all refractory products sold during the taxable year shall be equal to 87½ percent of the lesser of:

(A) The average lowest published or advertised price, or

(B) The average lowest actual selling price, at which, during the taxable year, the mine owner or operator offered to sell, or sold, such quartzite or clay (in the form and condition of such products after the application of only the processes described in paragraph (1) and before transportation from the plant in which such processes were applied). For purposes of this paragraph, exceptional, unusual, or nominal sales or selling prices shall be disregraded. If the mine owner or operator makes no sales of, or makes only exceptional, unusual, or nominal sales of, such quartzite or clay after application of only the processes described in paragraph (1), then in lieu of the price provided for in subparagraph (A) or (B) there shall be used the average lowest recognized selling price for the taxable year for such quartzite or clay in the marketing area of the mine owner or operator published in a trade journal or other industry publication.

(b) *Years to which applicable.* An election made under subsection (c) to have the provisions of this section apply shall be effective on and after January 1, 1951, for all taxable years beginning before January 1, 1961, in respect of which:

(1) The assessment of a deficiency,

(2) The refund or credit of an overpayment, or

(3) The commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954,

is not prevented on the date of the enactment of this Act by the operation of any law or rule of law. Such election shall also be effective on and after January 1, 1951, for any taxable year beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before the date of the enactment of this Act.

(c) *Time and manner of election.* An election to have the provisions of this section apply shall be made by the taxpayer on or before the 60th day after the date of publication in the Federal Register of final regulations issued under authority of subsection (f), and shall be made in such form and manner as the Secretary of the Treasury or his delegate shall prescribe by regulations. Such election, if made, may not be revoked.

(d) *Statutes of limitations.* Notwithstanding any other law, the period within which an assessment of a deficiency attributable to the election under subsection (c) may be made with respect to any taxable year for which such election is effective, and the period within which a claim for refund or credit of an overpayment attributable to the election under such subsection may be made with respect to any such taxable year, shall not expire prior to one year after the last day for making an election under subsection (c). An election by a taxpayer under subsection (c) shall be considered as a consent to the application of the provisions of this subsection.

(e) *Terms; applicability of other laws.* Except where otherwise distinctly expressed or manifestly intended, terms used in this section shall have the same meaning as when used in the Internal Revenue Code of 1954 (or corresponding provisions of the Internal Revenue Code of 1939) and all provisions of law shall apply with respect to this section as if this section were a part of such Code (or corresponding provisions of the Internal Revenue Code of 1939).

(f) *Regulations.* The Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of this section.

(Sec. 2(f), 75 Stat. 683; 26 U.S.C. 613 note)

[T.D. 6583, 26 FR 12077, Dec. 16, 1961]

§ 1.9005–1 Election relating to the determination of gross income from the property for taxable years beginning prior to 1961 in the case of clay and quartzite used in making refractory products.

(a) *In general.* Section 2 of the Act of September 26, 1961 (Pub. L. 87–321, 75 Stat. 683), provides that certain taxpayers may elect to apply the provisions of such section to all taxable years beginning before January 1, 1961, with respect to which the election is effective. Section 2 of the Act prescribes special rules for the application of section 613(c) of the Internal Revenue Code of 1954 (and corresponding provisions of the Internal Revenue Code of 1939) in the case of quartzite and clay used by the mine owner or operator in the production of refractory products.

(b) *Election.* The election to apply the provisions of section 2 of the Act may be made only in the case of quartzite and clay used in the production of products generally recognized as refractory products by the refractories industry. Examples of such products are clay firebrick, silica brick, and refractory bonding mortars. The election may be made only by a taxpayer who both mined the clay or quartzite and used it in the production of refractory products. The election must be made in accordance with § 1.9005–4 on or before February 14, 1962, and the election shall become irrevocable on that date.

(c) *Years to which the election is applicable.* If the election described in paragraph (b) of this section is made by the taxpayer, the provisions of section 2 of the Act shall be effective on and after January 1, 1951, for all taxable years beginning before January 1, 1961, in respect of which the:

(1) Assessment of a deficiency,

(2) Refund or credit of an overpayment, or

(3) Commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954, was not prevented on September 26, 1961, by the operation of any law or rule of law. The election is also effective on and after January 1, 1951, for any taxable year beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before September 26, 1961.

(Sec. 2(f), 76 Stat. 683, 26 U.S.C. 613 note)

[T.D. 6583, 26 FR 12078, Dec. 16, 1961]

§ 1.9005–2 Effect of election.

(a) *In general.* If a taxpayer makes the election described in paragraph (b) of § 1.9005–1, he shall be deemed to have consented to the application of section 2 of the Act with respect to all the clay and quartzite described in that paragraph for all taxable years for which the election is effective whether or not the taxpayer is litigating the issue for any of such years. Thus, in applying section 613(c) of the Internal Revenue Code of 1954 (and corresponding provisions of the Internal Revenue Code of 1939) to those years:

(1) The term ‘‘ordinary treatment processes’’ shall include crushing, grinding, and separating the mineral from waste, but shall not include any subsequent process; and

(2) The gross income from mining for each short ton of quartzite or clay mined by the taxpayer and used by him in the production of all refractory products sold during the taxable year shall be equal to 87½ percent of the lesser of:

(i) The average lowest published or advertised price, or

(ii) The average lowest actual selling price at which the mine owner or operator offered to sell or sold any such quartzite or clay during the taxable year.

(b) *Rules for applying paragraph (a) of this section.* (1) The price described in paragraph (a)(2) of this section and any price described in this paragraph shall be determined with reference to quartzite or clay in the form and condition of such products after the application of only the processes described in paragraph (a)(1) of this section and before transportation from the plant in which such processes were applied.

(2) If quartzite and clay were mined and used by the taxpayer in the production of refractory products, a separate price shall be used with respect to each mineral.

(3) There shall be used for each mineral the lowest price at which it was sold or offered for sale by the taxpayer during the taxable year. Thus, only one price shall be used with respect to each mineral regardless of variations in type or grade.

(4) For purposes of this paragraph, exceptional, unusual, or nominal sales of quartzite or clay shall be disregarded. Thus, for example, if the taxpayer made an accommodation sale during the taxable year at other than the regular price, such sale is to be disregarded.

(5) If the taxpayer made no sales during the taxable year of quartzite or clay in the form and condition described in subparagraph (1) of this paragraph, or if his sales were exceptional, unusual, or nominal, there shall be used the lowest recognized selling price for the taxpayer's marketing area for quartzite or clay (of the same grade and type as that used by him) which was published for the taxable year in a trade journal or other industry publication.

(6) If subparagraph (5) of this paragraph does not apply for the reason that there is no recognized selling price published in a trade journal or other industry publication for the taxpayer's marketing area, there shall be used the lowest price at which quartzite or clay comparable to that used by the taxpayer was sold or offered for sale during the taxable year in that area by other producers similarly circumstanced as the taxpayer or, if appropriate, the lowest price paid by the taxpayer for purchased quartzite or clay.

(7) If the lowest selling price otherwise applicable under the preceding provisions of this paragraph fluctuated during the taxable year, the two or more lowest selling prices shall be averaged according to the number of days during the taxable year that each such price was in effect.

(c) The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1) —(i) *Facts.* Taxpayer A, a calendar year taxpayer, mined quartzite and clay and used them in the production of recognized refractory products. During the taxable year, the lowest price for which A sold clay after the application of crushing and grinding was $13.75 per short ton. He also sold some ground clay of a different type at $20.00 per short ton. A sold quartzite after the application of crushing and grinding for various prices, depending upon type, ranging from $14.00 per short ton to $20.00 per short ton. During the taxable year, the prices for the various types of ground clay and quartzite did not change. None of the sales by A of ground clay or quartzite were exceptional, unusual, or nominal.

(ii) *Determination of gross income from mining.* If A makes the election described in paragraph (b) of § 1.9005–1, the gross income from mining per short ton of clay mined by A and used in the production of refractory products sold during the taxable year is $12.03 (87½ percent of $13.75), and the gross income from mining per short ton of quartzite mined by A and used in the production of refractory products sold during the taxable year is $12.25 (87½ percent of $14.00). To determine his gross income from mining, A must compute the sum of:

(a) $12.03 multiplied by the number of short tons of clay which were mined by A (whether or not during the taxable year) and which were used by A in the production of refractory products (refractory bonding mortar, fire brick, etc.) sold during the taxable year; plus

(b) $12.25 multiplied by the number of short tons of quartzite which were mined by A (whether or not during the taxable year) and which were used by A in the production of refractory products sold during the taxable year.

Example (2). Assume the same facts as in example (1) except that on October 1 of the taxable year A's lowest price for clay after the application of crushing and grinding increased to $14.40 per short ton. In this case, the average lowest price for which A sold ground clay during the taxable year must be determined by taking into account the price adjustment of October 1. Under these circumstances, the average lowest price for the ground clay would be $13.91, that is $13.75×273/365 plus $14.40×92/365.

(d) *Effect on depletion rates and other items.* The election shall have no effect on the applicable rate of percentage depletion for the taxable years for which the election is effective. In applying the election to the years affected there shall be taken into account the effect that any adjustments resulting from the election shall have on other items affected thereby, such as charitable contributions, foreign tax credit, net operating loss, and the effect that adjustments to any such items shall have on other taxable years. The provisions of section 2 of the Act are applicable with respect to taxable years subject to the Internal Revenue Code of 1939 for purposes of applying sections 450 and 453 of that Code. The election shall have no effect on the determination of the treatment processes which are to be considered as mining or on the determination of gross income from mining for any taxable year beginning after December 31, 1960.

(Sec. 2(f), 75 Stat. 683; 26 U.S.C. 613 note)

[T.D. 6583, 26 FR 12078, Dec. 16, 1961]

§ 1.9005–3 Statutes of limitation.

Notwithstanding any provision of law to the contrary, the period within which the assessment of any deficiency attributable to the election may be made, or within which the credit or refund of any overpayment attributable to the election may be made, shall not expire sooner than one year after the last day for making the election. Thus, if assessment of a deficiency or credit or refund of an overpayment, whichever is applicable, was not prevented on September 26, 1961, the time for making assessment or credit or refund shall not expire for at least one year after the last day for making the election. Even though assessment of a deficiency was prevented on September 26, 1961, if commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954 may have been made on such date, then any deficiency resulting from the election may be assessed at any time within one year after the last day for making the election. If a taxpayer makes the election, he shall be deemed to have consented to the application of the provisions of section 2 of the Act extending the time for assessing a deficiency attributable to the election. Section 2 of the Act does not shorten the period of limitations otherwise applicable. An agreement may be entered into under section 6501(c)(4) of the Internal Revenue Code of 1954 and corresponding provisions of prior law to extend the period for assessment.

(Sec. 2(f), 75 Stat. 683; 26 U.S.C. 613 note)

[T.D. 6583, 26 FR 12079, Dec. 16, 1961]

§ 1.9005–4 Manner of exercising election.

(a) *By whom election is to be made.* Generally, the taxpayer whose tax liability is affected by the election shall make the election. In the case of a partnership, or a corporation electing under the provisions of subchapter S, chapter 1 of the Internal Revenue Code of 1954, the election shall be exercised by the partnership or such corporation, as the case may be.

(b) *Time and manner of making election.* The election shall be made on or before February 14, 1962, by filing a statement with the district director with whom the taxpayer's income tax return for the taxable year in which the election is made is required to be filed. The statement shall include the following:

(1) A clear indication that an election is being made under section 2 of the Act, and

(2) The taxable years to which the election applies.

Amended income tax returns reflecting any increase or decrease in tax attributable to the election shall be filed for the taxable years to which the election applies. In the case of partnerships and electing small business corporations under subchapter S, chapter 1 of the Internal Revenue Code of 1954, amended returns shall be filed by the partnership or electing small business corporation, as well as by the partners or shareholders, as the case may be. Any amended return shall be filed with the office of the district director with whom the taxpayer files his income tax return for the taxable year in which the election is made, and, if practicable, on the same date the statement of election is filed, but amended returns shall be filed in no event later than May 31, 1962, unless an extension of time is granted under section 6081 of the Internal Revenue Code of 1954. Whenever the amended returns do not accompany the statement of election, a copy of the statement shall be submitted with the amended returns. The amended returns shall be accompanied by payment of the additional tax (together with interest thereon) resulting from the election.

(Sec. 2(f), 75 Stat. 683; 26 U.S.C. 613 note)

[T.D. 6583, 26 FR 12079, Dec. 16, 1961]

§1.9005–5 Terms; applicability of other laws.

All other terms which are not otherwise specifically defined shall have the same meaning as when used in the Internal Revenue Code of 1954 (or the corresponding provisions of prior law) except where otherwise distinctly expressed or manifestly intended to the contrary. Further, all provisions of law contained in the Code (or the corresponding provisions of prior law) shall apply to the extent that they can apply. Thus, all the provisions of subtitle F of the Code (and the corresponding provisions of prior law) shall apply to the extent they can apply, including the provisions of law relating to assessment, collection, credit or refund, and limitations. For purposes of this section and §§1.9005–1 to 1.9005–4, inclusive, the term ''Act'' means the Act of September 26, 1961 (Pub. L. 87–321, 75 Stat. 683).

(Sec. 2(f), 75 Stat. 683; 26 U.S.C. 613 note)

[T.D. 6583, 26 FR 12079, Dec. 16, 1961

TAX REFORM ACT OF 1969

§1.9006 Statutory provisions; Tax Reform Act of 1969.

Section 946 of the Tax Reform Act of 1969 (83 Stat. 729) provides as follows:

SEC. 946. *Interest and penalties in case of certain taxable years*—(a) *Interest on underpayment.* Notwithstanding section 6601 of the Internal Revenue Code of 1954, in the case of any taxable year ending before the date of the enactment of this Act, no interest on any underpayment of tax, to the extent such underpayment is attributable to the amendments made by this Act, shall be assessed or collected for any period before the 90th day after such date.

(b) *Declarations of estimated tax.* In the case of a taxable year beginning before the date of the enactment of this Act, if any taxpayer is required to make a declaration or amended declaration of estimated tax, or to pay any amount or additional amount of estimated tax, by reason of the amendments made by this Act, such amount or additional amount shall be paid ratably on or before each of the remaining installment dates for the taxable year beginning with the first installment date on or after the 30th day after such date of enactment. With respect to any declaration or payment of estimated tax before such first installment date, sections 6015, 6154, 6654, and 6655 of the Internal Revenue Code of 1954 shall be applied without regard to the amendments made by this Act. For purposes of this subsection, the term ''installment date'' means any date on which, under section 6153 or 6154 of such Code (whichever is applicable), an installment payment of estimated tax is required to be made by the taxpayer.

[T.D. 7088, 36 FR 3052, Feb. 17, 1971]

§1.9006–1 Interest and penalties in case of certain taxable years.

(a) *Interest on underpayment.* The Internal Revenue Code of 1954 was amended in many important respects by the Tax Reform Act of 1969. Certain of these amendments affect taxable years ending prior to December 30, 1969 (the date of enactment of the Act) and thereby may cause underpayments of tax by a number of taxpayers for those years. Under section 6601(a) of the Code, interest at the rate of 6 percent per annum is imposed upon the amount of any such underpayment. The effect of section 946(a) of the Act is to prevent the assessment or collection of interest on an underpayment of tax for any taxable year ending before December 30, 1969, if such underpayment is attributable to any amendment made by such Act, for the period from the due date for payment until March 30, 1970. Thus, the taxpayer is afforded an interest-free period of 90 days from the date of enactment of such Act within which to account for the changes in the law affecting him and to remit the amount of such underpayment. If, on or after March 30, 1970, the amount of any underpayment (or portion thereof) attributable to an amendment made by the Act remains unpaid, then, as of such date, such underpayment (or portion thereof) shall be subject to interest as provided by section 6601 of the Code, to be computed from such date. However, if a corporation or farmers' cooperative elects to pay its final tax in two installments under section 6152 of the Code and if the second installment is due after March 30, 1970, then, in order to escape the imposition of interest under section 6601, such corporation or cooperative need pay only one-half of the additional tax arising from an amendment made by the Act before March 30, 1970, with the remaining one-half payable as part of the second installment on the regular due date for that installment. In the case of an underpayment of tax which is only partly attributable to an amendment made by the Act, section 946(a) of such Act shall apply only to the extent that such underpayment is so attributable.

(b) *Declarations and payments of estimated tax.* (1) In the case of a taxable year beginning before December 30, 1969, section 946(b) of the Tax Reform Act of 1969 provides transitional rules with respect to the payment of estimated tax and, in the case of an individual, the filing of a declaration of estimated tax. Under such section 946(b) in the case of such a year, if any taxpayer is required to make a declaration or amended declaration of estimated tax, or to pay any amount or additional amount of estimated tax, by reason of the amendments made by the Act, such amount or additional amount shall be paid ratably on or before each of the remaining installment dates for the taxable year beginning with the first installment date on or after February 15, 1970. For purposes of section 946(b) of such Act and this section, the term ‘‘installment date’’ means any date on which, under section 6153 or 6154 of the Code (whichever is applicable), an installment payment of estimated tax is required to be made by the taxpayer.

(2) With respect to any declaration or payment of estimated tax before February 15, 1970, sections 6015, 6153, 6154, 6654, and 6655 of the Code shall be applied without regard to the amendments made by such Act. Therefore, any underpayment which occurs solely by reason of the amendments made by such Act shall not be treated as an underpayment in the case of installment dates before February 15, 1970. Similarly, in the case of a taxpayer all of whose installment dates occur prior to February 15, 1970, no payment of estimated tax need be made to reflect the amendments made by such Act.

(3) The following example illustrates the application of the provisions of subparagraphs (1) and (2) of this paragraph:

Example. A, a fiscal year taxpayer with a taxable year from July 1, 1969, through June 30, 1970, had, without regard to the enactment of the Tax Reform Act of 1969, a total tax liability, which would have been shown on his return, of $500. A is not a farmer or fisherman described in section 6037(b). A’s tax liability is increased by $20 to $520, attributable to an amendment made by such Act. A makes an installment payment of estimated tax of $90 on each of the following four installment dates: October 15, 1969; December 15, 1969; March 15, 1970; and July 15, 1970. Assume that A is unaffected by the exceptions provided in section 6654(d). Therefore, A is underpaid by $10 on both October 15 and December 15, and by $18 on both March 15 and July 15. Such underpayments are computed as follows:

(a) October 15 and December 15 installment dates:	
(1) Tax without regard to Tax Reform Act of 1969	$500
(2) 80% of item (1)	400
(3) Minimum payment to avoid underpayment, determined without regard to Act:	
October 15, 1969 (25% of item (2))	100
December 15, 1969 (25% of item (2))	100
(4) Actual payment:	
October 15, 1969	90
December 15, 1969	90
(5) Amount of underpayment:	
October 15, 1969 ($100 − $90)	10
December 15, 1969 ($100 − $90)	10
(b) March 15 and July 15 installment dates:	
(1) Tax with regard to Act	520
(2) 80% of item (1)	416
(3) Less total of minimum payments to avoid underpayment, determined without regard to Act for October 15, 1969 and December 15, 1969 ($100+$100)	200
(4) Difference of items (2) and (3)	216
(5) Minimum payment to avoid underpayment, determined with regard to Act:	
March 15 (50% of $216)	108
July 15 (50% of $216)	108
(6) Actual payment:	
March 15	90
July 15	90
(7) Amount of underpayment:	
March 15 ($108 − $90)	18
July 15 ($108 − $90)	18

(c) *Cross references.* (1) Taxpayers affected by the following sections, among others, of the Tax Reform Act of 1969 may be subject to the provisions of section 946 (a) or (b) (whichever is applicable) of such Act:

(i) Act section 201(a), which adds section 170(f)(2) to the Code and which applies to gifts made after July 31, 1969.

(ii) Act section 201(c), which repeals section 673(b) of the Code and which applies to transfers in trust made after April 22, 1969.

(iii) Act section 212(c), which amends section 1031 of the Code and which applies to taxable years to which the 1954 Code applies.

(iv) Act section 332, which amends section 677 of the Code and which applies to property transferred in trust after October 9, 1969.

(v) Act section 411(a), which adds section 279 to the Code and which applies to interest paid or incurred on an indebtedness incurred after October 9, 1969.

(vi) Act sections 412 (a) and (b), which adds section 453(b)(3) to the Code and which apply to sales or other dispositions occurring after May 27, 1969, which are not made pursuant to a contract entered into on or before that date.

(vii) Act section 413, which amends sections 1232(a), 1232(b)(2), and 6049 of the Code and which applies to bonds and other evidences of indebtedness issued after May 27, 1969.

(viii) Act section 414, which adds section 249 to the Code and which applies to convertible bonds or other convertible evidences of indebtedness repurchased after April 22, 1969.

(ix) Act section 421(a), which amends section 305 of the Code and which applies to distributions made after January 10, 1969.

(x) Act sections 516 (a) and (d), which add section 1001(e) to the Code and which apply to sales of life estates made after October 9, 1969.

(xi) Act section 601, which amends section 103 of the Code and which applies to obligations issued after October 9, 1969.

(xii) Act section 703 which amends sections 46(b) and 47(a) of the Code and which applies to section 38 property built or acquired after April 18, 1969.

(xiii) Act section 905, which adds section 311(d) to the Code and which applies to distributions made after November 30, 1969.

(2) In addition to the references in subparagraph (1) of this paragraph, section 946(b) of the Tax Reform Act of 1969 may apply to taxpayers affected by the following sections, among others, of such Act:

(i) Act section 201(a), which adds section 170(e) to the Code and which applies to contributions paid after December 31, 1969.

(ii) Act sections 501 (a) and (b), which amend section 613 of the Code and which apply to taxable years beginning after October 9, 1969.

(iii) Act sections 516 (c) and (d) which add section 1253 to the Code and which apply to transfers after December 31, 1969.

(iv) Act section 701(a), which amends section 51 of the Code and which applies to taxable years ending after December 31, 1969, and beginning before July 1, 1970.

[T.D. 7088, 36 FR 3053, Feb. 17, 1971]

MISCELLANEOUS PROVISIONS

§1.9101–1 Permission to submit information required by certain returns and statements on magnetic tape.

In any case where the use of a Form 1087 or 1099 is required by the regulations under this part for the purpose of making a return or reporting information, such requirement may be satisfied by submitting the information required by such form on magnetic tape or by other media, provided that the prior consent of the Commissioner or other authorized officer or employee of the Internal Revenue Service has been obtained. Applications for such consent must be filed in accordance with procedures established by the Internal Revenue Service. In any case where the use of Form W–2 is required for the purpose of making a return or reporting information, such requirement may be satisfied by submitting the information required by such form on magnetic tape or other approved media, provided that the prior consent of the Commissioner of Social Security (or other authorized officer or employee thereof) has been obtained.

[T.D. 6883, 31 FR 6589, May 3, 1966, as amended by T.D. 7580, 43 FR 60159, Dec. 26, 1978]

§1.9200–1 Deduction for motor carrier operating authority.

(a) *In general.* Section 266 of the Economic Recovery Tax Act of 1981 (Pub. L. 97–34, 95 Stat. 265) provides that, for purposes of chapter 1 of the Internal Revenue Code of 1954, an ordinary deduction shall be allowed in computing the taxable income of all taxpayers who either held one or more motor carrier operating authorities on July 1, 1980, or later acquired a motor carrier operating authority pursuant to a binding contract in effect on July 1, 1980. The deduction for each motor carrier operating authority is to be allowed ratably over a 60-month period and is equal to the adjusted basis of the motor carrier operating authority on July 1, 1980. Except as provided in this section, no deduction is allowable for any diminution in value of any motor carrier operating authority caused by administrative or legislative actions to decrease restrictions on entry into the interstate motor carrier business.

(b) *Person entitled to claim deduction.* In general, the deduction provided by this section for a particular motor carrier operating authority may be claimed only by the taxpayer which held the authority on July 1, 1980. However, if another person acquired the motor carrier operating authority after July 1, 1980, pursuant to a binding contract in effect on that date, the deduction for such authority may be claimed only by the acquirer and may not be claimed by the taxpayer which held the authority on July 1, 1980. A taxpayer, otherwise entitled to claim a deduction under this section, who sells a motor carrier operating authority after July 1, 1980 may not claim an amortization deduction for such authority for any month which begins after the date of such sale. In addition, acquisition of a motor carrier operating authority after July 1, 1980, if not pursuant to a binding contract in effect on July 1, 1980, will not entitle the acquirer to a deduction under this section, unless the operating authority is acquired pursuant to a transaction to which section 381 applies.

(c) *Allowance of deduction*—(1) *Determination of period for deduction.*—(i) *General rule.* Except as provided in paragraph (c)(1)(ii) of this section, the 60-month period for taking the deduction provided by this section for a particular motor carrier operating authority begins with the month of July 1980, or, if later, the month in which the motor carrier operating authority was acquired pursuant to a binding contract in effect on July 1, 1980.

(ii) *Election.* In lieu of beginning the 60-month period as provided in paragraph (c)(1)(i) of this section, the taxpayer may elect to begin the 60-month period with the first month of the taxpayer's first taxable year beginning after July 1, 1980. This election, if made, shall apply to the deduction for all motor carrier operating authorities either held by the taxpayer on July 1, 1980, or later acquired by the taxpayer by the end of the first month of the first taxable year beginning after July 1, 1980, pursuant to a binding contract in effect on July 1, 1980. Any such election will not apply to the determination of the period for amortizing the bases of authorities acquired by the taxpayer after the end of the first month of the first taxable year beginning after July 1, 1980.

(2) *Amount of monthly deduction.* In the case of each motor carrier operating authority for which the taxpayer is entitled (under paragraph (b) of this section) to claim a deduction, the deduction for each month during the 60-month period relating to the motor carrier operating authority is equal to the adjusted basis (determined under paragraph (e) of this section) of the motor carrier operating authority divided by 60.

(d) *Definition of motor carrier-operating authority.* For purposes of § 1.9200–2 and this section, the term ''motor carrier operating authority'' means a certificate or permit held by a motor common carrier or motor contract carrier of property and issued pursuant to the Revised Interstate Commerce Act, 49 U.S.C. 10921–10933 (Supp. III 1979). The terms ''motor common carrier'' and ''motor contract carrier'' shall be defined as in 49 U.S.C. 10102 (Supp. III 1979) and do not include persons meeting the definition of freight forwarder contained in 49 U.S.C. 10102 (Supp. III 1979).

(e) *Adjusted basis of motor carrier operating authority*—(1) *In general.* Except as provided in paragraph (e)(2) of this section, the adjusted basis of a motor carrier operating authority for which a deduction is allowed under this section is the adjusted basis of the motor carrier operating authority as determined under sections 1012 and 1016 in the hands of the taxpayer who is entitled to claim the deduction under paragraph (b) of this section.

(2) *Special rule in case of certain stock acquisitions*—(i) *Election by holder*. A corporation entitled to claim a deduction under paragraph (b) of this section for a motor carrier operating authority may elect to allocate a portion of the cost basis of a qualified acquiring party in the stock of an acquired corporation, to the basis of the authority. A qualified acquiring party is a corporation (or a noncorporate person or group of noncorporate persons described in paragraph (e)(2)(ii) of this section) that after June 21, 1952, and on or before July 1, 1980 (or after July 1, 1980 under a binding contract in effect on such date) acquired by purchase, within the meaning of section 334(b)(3) and during a period of not more than 12 months, 80 percent or more of the stock (as described in section 334(b)(2)(B)) of a corporation (the acquired corporation) which held the authority directly or indirectly on the date which is the end of the period of 12 months or less within which such 80 percent of the acquired corporation's stock was purchased. The election to allocate basis in an acquired corporation's stock to the basis in an authority may be made only if 80 percent of all classes of the acquired corporation's stock (other than nonvoting stock which is limited and preferred as to dividends) was acquired by purchase (within the meaning of section 334(b)(3)) during a period of not more than 12 months, as described in section 334(b)(2)(B). If the qualified acquiring party is a corporation, the taxpayer holding the authority on July 1, 1980, may elect the basis allocation of this paragraph only if it is a member of the affiliated group (as defined in section 1504(a)) of which the qualified acquiring party is a member. If there is more than one acquisition of stock that might permit an election to allocate basis under this paragraph (e)(2)(i), the taxpayer may elect to allocate to the authority only the basis in the acquired corporation's stock held by the qualified acquiring party which became a qualified acquiring party as a result of the last of such acquisitions.

(ii) *Certain noncorporate persons treated as qualified parties*. For purposes of paragraphs (e)(2) (i) through (vi) of this section, the term ‘‘qualified acquiring party’’ shall include a noncorporate person or group of noncorporate persons which, after June 21, 1952 and on or before July 1, 1980, acquired in one purchase, stock in a corporation (the acquired corporation) which at the time of acquisition held, directly or indirectly, a motor carrier operating authority. In order to be treated as a qualified acquiring party under this paragraph, a noncorporate person or group of noncorporate persons must have held stock constituting control (within the meaning of section 368(c)) of the acquired corporation on July 1, 1980. A group of noncorporate persons consists of two or more noncorporate persons who, acting together on the same date, made the required purchase of stock in the acquired corporation.

(iii) *Portion of stock basis allocable to basis of authority when stock of direct holder of authority is acquired*. If the qualified acquiring party acquired the stock of a corporation directly holding the authority, the portion of the stock basis allocable to the basis of the authority is the amount that would have been properly allocable under section 334(b)(2) if the qualified acquiring party were a corporation that had received the authority in a distribution of all the acquired corporation's assets in a complete liquidation of the acquired corporation immediately after the acquisition of the acquired corporation's stock. If the acquired corporation's stock was acquired on more than one date, the date on which the liquidation is deemed to have occurred shall be the date which is the date of the last acquisition by purchase of stock of the acquired corporation within the 12-month period described in section 334(b)(2)(B).

(iv) *Portion of stock basis allocable to basis of authority when stock of indirect holder of authority is acquired*. If the qualified acquiring party acquired the stock of a corporation indirectly holding the authority (such as by owning all of the stock of a subsidiary that directly holds the authority), a portion of the qualified acquiring party's cost basis in the stock of the acquired corporation may be allocated to the basis in the operating authority. The portion allocable is the amount that would have been properly allocable under section 334(b)(2) if, immediately before the liquidation of the acquired corporation on the date of the last acquisition by purchase of stock of the acquired corporation within the 12-month period described in section 334(b)(2)(B), the authority had been transferred in such a way (such as by liquidating the subsidiary that directly holds the authority) that the qualified acquiring party would have received direct ownership of the authority upon the liquidation of the acquired corporation immediately after the acquisition.

(v) *Other assets to be accounted for.* For purposes of paragraphs (e)(2) (iii) or (iv) of this section, in determining the portion of stock basis properly allocable to the operating authority under section 334(b)(2), the portion of the qualified acquiring party's basis in the acquired corporation's stock that would have been allocable following the liquidation to other assets of the acquired corporation, including intangible assets such as goodwill and going concern value, must be taken into account.

(vi) *Adjustments to basis in acquired corporation's stock and other assets.* If a taxpayer makes the election provided by paragraph (e)(2)(i) of this section, the qualified acquiring party's basis in the stock of the acquired corporation shall be decreased, effective as of July 1, 1980, by the amount determined by the following formula:

$$\frac{\text{Basis in acquired corporation's stock}}{\text{Basis in acquired corporation's stock plus unsecured liabilities of acquired corporation}} \times \text{Amount allocated to basis in authority under section 334(b)(2) minus acquired corporation's basis in authority.}$$

In addition, if the aggregate basis of the assets of the acquired corporation other than the authority as of July 1, 1980 (reduced by the liabilities secured by such assets) exceeds the qualified acquiring party's basis in the stock of the acquired corporation remaining after application of the preceding sentence, then the bases of such assets shall be reduced proportionately so that their aggregate basis as of such date (minus secured liabilities) is equal to such remaining stock basis. If the acquired corporation held the authority indirectly, appropriate basis reductions shall be made to reflect the transfers deemed to have occurred under paragraph (e)(iv) of this section.

(vii) *Pre-TEFRA law applies.* References made in this section to section 334 of the Code relate to such section as it existed before amendment by the Tax Equity and Fiscal Responsibility Act of 1982.

(f) *Adjustment to basis of motor carrier operating authority.* A taxpayer's basis in a motor carrier operating authority must be reduced by the amount of any amortization deductions allowable to the taxpayer under this section.

(g) *Examples.* The principles of this section may be illustrated by the following examples:

Example (1). (i) Corporation X acquired all the stock of corporation Y for $130,000 in 1970. Y's assets at the time of acquisition consisted of a motor carrier operating authority valued at $180,000 in which it has a basis of $60,000, trucks with a fair market value of $70,000 and an aggregate basis of $30,000, and goodwill valued at $30,000. Y has $50,000 of liabilities secured by the trucks and $100,000 of unsecured liabilities. Both X and Y use a June 30 fiscal year for tax purposes.

(ii) Y is the only taxpayer eligible to claim a deduction under § 1.9200–1(b). If X sold its Y stock to Z in October 1980 (other than pursuant to a binding contract in effect on July 1, 1980), Y would continue to be the only taxpayer eligible to claim the deduction. However, if Y sold the operating authority to W in February 1981, neither Y nor W would be eligible to claim the monthly deduction for the remainder of the 60-month period. Also, Y would realize gain or loss on the sale after reducing its basis in the authority by any amortization claimed for the period prior to the sale.

(iii) Y must begin the 60-month period in July 1980 unless it elects under paragraph (c)(1)(ii) of this section to begin the 60-month period with the first month of the first taxable year beginning after July 1, 1980, which in Y's case would be July 1981.

(iv) Y's allowable monthly deduction is equal to its adjusted basis in the operating authority of $60,000, divided by 60, or $1,000. However, Y may elect under § 1.9200–1(e)(2) to allocate to its basis in the authority a portion of X's basis in Y stock, since X is a qualified acquiring party under paragraph (e)(2)(i) of this section and Y is a member of an affiliated group of which X is a member.

Assuming Y makes the election, Y may allocate to the basis of the authority the amount of X's basis in Y stock that would have been allocable under section 334(b)(2) if X had received the authority in a distribution of all of Y's assets in a complete liquidation of Y immediately after X acquired Y's stock.

Therefore, for purposes of the allocation, X's $130,000 cost basis in Y stock is deemed to be increased by Y's $100,000 of unsecured liabilities to $230,000. Of the $230,000 deemed basis, $180,000 is allocated to the authority, $30,000 to goodwill, and $20,000 to the trucks. Y's allowable monthly amortization deduction would be $180,000 divided by 60, or $3,000. X's $130,000 cost basis in its Y stock must be decreased to $62,174 as provided in paragraph (e)(2)(vi) of this section. Y's $30,000 aggregate basis in its trucks remains unchanged.

Example (2). Assume the same facts as in Example (1), except that Y's aggregate basis in the trucks is $120,000. If Y makes the election under §1.9200–1(e)(2), the same allocation as in Example (1) would occur. However, in addition to the decrease in X's basis in its Y stock to $62,174, the $120,000 aggregate basis in the trucks must be reduced to $112,174 (so that the $112,174 basis minus secured liabilities of $50,000 is equal to X's $62,174 remaining stock basis).

Example (3). Assume the same facts as in Example (1), excet that X pays a negotiated purchase price of $120,000 for the Y stock, in order to take into account an anticipated tax liability of $10,000, relating to potential section 1245 recapture. If Y makes the election under §1.9200–1(e)(2), then for purposes of allocating X's basis in Y stock, X's cost basis is deemed to be increased by Y's $100,000 of unsecured liabilities as well as the $10,000 of potential tax liability resulting from section 1245 recapture, to $230,000. The $10,000 of potential recapture tax is treated as a general liability and the deemed basis is allocated among Y's assets as in Example (1). In order to take into account the potential recapture tax liability, such amount must be based on the same fair market values that are used to determine the amount of the stock basis allocable to the operating authority.

(Sec. 266, Economic Recovery Tax Act of 1981 (Pub. L. 97–34; 95 Stat. 265); sec. 517, Highway Revenue Act of 1982 (Pub. L. 97–424; 96 Stat. 2097); and sec. 7805, Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805)

[T.D. 7947, 49 FR 8247, Mar. 6, 1984; 49 FR 12244, Mar. 29, 1984]

§1.9200–2 Manner of taking deduction.

(a) *In general.* The deduction provided by §1.9200–1 shall be taken by multiplying the amount of the monthly deduction determined under §1.9200–1(c)(2) for each motor carrier operating authority by the number of months in the taxable year for which the deduction is allowable, and entering the resulting amount at the appropriate place on the taxpayer's return for each year in which the deduction is properly claimed. Additionally, any taxpayer who has claimed the deduction provided by §1.9200–1 must (unless it has already filed a statement containing the required information) attach a statement to the next income tax return of the taxpayer which has a filing due date on or after June 4, 1984. The statement shall provide, in addition to the taxpayer's name, address, and taxpayer identification number, the following information for each motor carrier operating authority for which a deduction was claimed:

(1) The taxable year of the taxpayer for which the deduction was first claimed;

(2) Whether the taxpayer's deduction was determined using the adjusted basis of the authority under section 1012 or an allocated stock basis under §1.9200–1 (e) (2); and

(3) If an allocation of stock basis has been made under §1.9200–1(e)(2), the calculations made in determining the amount of basis to be allocated to the authority.

(b) *Filing and amendment of returns.* A taxpayer who has filed its return for the taxable year that includes July 1, 1980, claiming the deduction allowed under §1.9200–1, may amend its return for such year in order to elect under §1.9200–1(c)(1)(ii) to begin the 60-month period in the subsequent taxable year. A taxpayer eligible to take the deduction under §1.9200–1 who has filed its returns for both the taxable year that includes July 1, 1980, and the following taxable year without claiming the deduction, may claim the deduction by filing amended returns or claims for refund for the taxable year in which the taxpayer elects to begin the 60-month period, and for subsequent taxable years. If a taxpayer first claims the deduction on an amended return under the preceding sentence, the statement required by paragraph (a) of this section must be attached to such amended return.

(c) *Deduction taken for operating authority other than under § 1.9200–1.* If a deduction other than the deduction allowed under § 1.9200–1 was taken in any taxable year for the reduction in value of a motor carrier operating authority caused by administrative or legislative actions to decrease restrictions on entry into the interstate motor carrier business, the taxpayer should file an amended return for such taxable year which computes taxable income without regard to such deduction.

(Approved by the Office of Management and Budget under control number 1545–0767)

(Sec. 266, Economic Recovery Tax Act of 1981 (Pub. L. 97–34; 95 Stat. 265); sec. 517, Highway Revenue Act of 1982 (Pub. L. 97–424; 96 Stat. 2097); and sec. 7805, Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805)

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